State of the Equipment Finance Industry 2014

Managing through the investment cycle

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye on the Future
Celebrating 25 Years

EQUIPMENT LEASING & FINANCE

FOUNDATION

Your Eye on the Future

The Foundation is the only research organization dedicated solely to the equipment finance industry.

The Foundation accomplishes its mission through development of future-focused studies and reports identifying critical issues that could impact the industry.

The Foundation research is independent, predictive and peer-reviewed by industry experts. The Foundation is funded solely through contributions. Contributions to the Foundation are tax deductible.

Equipment Leasing & Finance Foundation
1825 K Street • Suite 900
Washington, DC 20006
www.leasefoundation.org
202-238-3429
Kelli Jones Nienaber, Executive Director

Message from the Chairman

As we celebrate the 25th year of the Equipment Leasing & Finance Foundation, we are pleased to present the 2014 State of the Equipment Finance Industry ("SEFI"). This year's report highlights key trends in our industry, including growth, portfolio performance, financial performance, and business operations. By and large, the 2014 SEFI shows a continuation of many trends from the prior year. Namely, there is heightened competition in our industry as a result of unprecedented levels of liquidity chasing low risk and high yields relative to other financial sectors. Our sector continues to outpace overall economic growth, but we are experiencing a slowdown as the post-recession replacement cycle comes to a close. Against this backdrop, equipment finance companies of all shapes and sizes continue to find ways to improve business processes, enhance the customer experience, and provide much needed capital to the U.S. economy.

This year's SEFI also takes a long-term view of industry growth drivers and potential risks. Macroeconomic data indicate that our industry may be at or near a peak in the cycle, suggesting that growth may be slower than normal unless the overall economy is able to accelerate. Additionally, external risks have largely shifted from domestic policy uncertainty to a full slate of geopolitical conflicts that could lead to slower global and U.S. economic growth. In the face of these obstacles, our industry continues to thrive and provide much needed capital for American businesses to grow and create jobs. In fact, the Foundation's latest market projections show that the industry is approaching $1 trillion in size.

The Foundation's researcher, Keybridge LLC, developed several new analytical tools for examining trends in the equipment finance industry both in the U.S and abroad. The first new addition is a quarterly index that gauges the U.S. private sector's "propensity to finance" equipment purchases in real-time. The second addition to the SEFI is a set of Equipment and Software Investment Momentum Monitors for Europe, China, and Canada. Those of you who are familiar with the Foundation's U.S. Economic Outlook and Equipment & Software Investment Momentum Monitors will recognize these indices as leading indicators of investment activity in their respective markets. More detailed information on these new analytical tools can be found in the report.

On behalf of the Board of Trustees, I hope you enjoy this year's SEFI and the Foundation's many other research publications. We would like to thank the contributors to this report, including the executives who participated in interviews and the companies and individuals who provided data for ELFA's Survey of Equipment Finance Activity.

Rich Gumbrecht
Chairman, Equipment Leasing & Finance Foundation

A Year in Review

The equipment finance industry experienced intense competition in 2013 due to a combination of slower growth and unprecedented levels of liquidity. Although profitability declined slightly from 2012, the industry's overall performance was strong. Industry growth measured by new business volume slowed from 16.4% in 2012 to 9.3% in 2013, and the median return on assets declined slightly in 2013. On the positive side, charge-offs fell to a new all-time low. Key findings from the 2014 State of the Equipment Finance Industry report include:

New business volume growth slowed from 2012 to 2013. Similar to 2012, industry-specific dynamics (e.g., maturity of the equipment replacement cycle, policy uncertainty, and macroeconomic forces) drove equipment demand.

- Data suggest that the propensity to finance increased in 2013 due to continued low interest rates.
- Banks' growth decelerated from 22.2% in 2012 to 6.2% in 2013, and they appeared to have lost market share. Captives saw slightly faster overall growth at 11.3% in 2013 compared to 10.8% in 2012. Stronger performance was driven largely by an improving construction machinery market. Independents saw a sharp acceleration in growth, as new business volume increased 17.7% in 2013 versus just 7.4% in 2012. Independents benefitted from exposure to the transportation and construction markets as well as small-ticket deals.

The industry is flush with liquidity. The cost of funds is at an all-time low and spreads remain tight.

- An enormous amount of liquidity has fostered an intensely competitive market. As a result, spreads are thin and some in the industry worry about the re-emergence of overly aggressive deal structures.
- The 2014 data is likely to show even further spread compression and narrower net margins. Looking ahead to 2015, we expect the Federal Reserve to begin raising short-term interest rates. The speed and trajectory of the rate hikes will be a factor in whether or not lenders can pass on higher cost of funds and have additional room for margin expansion.

2013 portfolio performance surpassed its previous all-time best in 2012.

- Although credit standards are generally loosening across the U.S. economy, the equipment finance market experienced record-setting portfolio performance in 2013. A slow but steadily improving economy, solid corporate profits, and a focus on credit quality led to the lowest delinquencies and charge-offs on record.

In light of intense competition and declining profitability, the industry placed an emphasis on improved productivity.

- Return on Equity, Return on Assets, and Earnings Before Taxes all dipped from 2012 to 2013.
- New Business Volume per Sales Employee increased nearly 10% from $20,389 in 2012 to $22,385 in 2013. Sales, General & Administrative Expense per FTE (Full-Time Equivalent employee) declined 8% in 2013.

Growth in 2014 has been steady but below its historical average, and margins are reportedly tighter than 2013. Our forecasts for 2015 suggest that growth will stabilize and profitability could rebound.

Thus far in 2014, new business volume is up almost 6% year-to-date according to the monthly MLFI-25 survey. This is compared to average annual growth rates of about 8% since 2005. Additionally, many SEFI interviewees reported that they have seen limited growth across most asset types and end-user industries. With the exception of several equipment verticals, companies that are experiencing robust growth largely attribute their success to capturing market share rather than an expanding market.

Portfolio performance hit a new all-time best after a record-setting performance in 2012. Business loan credit standards have loosened slightly, but have not yet resulted in higher delinquencies. Some in the equipment finance industry are concerned that competition has led to increasingly risky deals, but this is countered by recent portfolio performance and the notion that corporate borrowers generally have strong balance sheets and profitability to support their capital investments and manageable debt burdens.

Expectations are mixed for 2015, but marginally stronger economic growth could spur a commensurate acceleration in demand for equipment. Also, with interest rates likely to rise, the propensity to finance should increase as businesses may look to lock in lower rates.

Regulatory uncertainty is less of a concern this year, but has been replaced with geopolitical tensions.

There is a strong inverse relationship between policy uncertainty and equipment finance sector confidence. Since the government shutdown in 2013, policy uncertainty has been on a steady decline, and equipment finance sector confidence has risen concurrently. While this trend has been a positive for the overall economy in the short-term, persistent gridlock in Washington has precluded the resolution of a number of important policy and regulatory issues. It is highly unlikely that major issues such as comprehensive tax reform can be addressed during the remainder of the current administration; and it remains to be seen whether the next administration will be able to build consensus on partisan issues. In the meantime, two less-politically linked uncertainties remain with monetary policy and potential commercial market regulation by the Consumer Finance Protection Bureau ("CFPB").

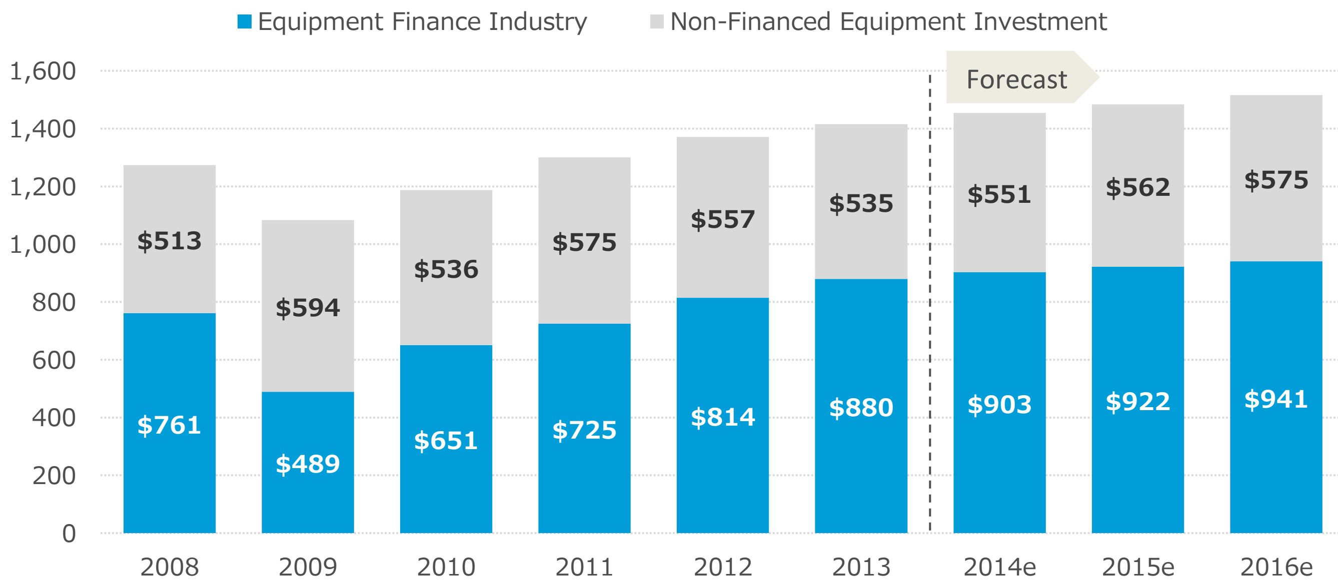
The heightened domestic uncertainty of 2012-2013 has largely been replaced by a significant degree of geopolitical tension in 2014. In particular, the primary issues are the Russia-Ukraine conflict and America's recent intervention against terrorist groups in Iraq and Syria. Although these conflicts have remained contained for the time being, they have raised concerns over the stability of the European economy and the potential for a global oil price shock. Additionally, the current environment raises the risk of additional geopolitical "flare ups" – for example, open conflict between China and Japan. Geopolitical risks are discussed in greater detail in the Scenarios section of this report.

A Rising Propensity to Finance in 2013

The calendar year 2013 saw a continuation of many trends from 2012. Relatively slow economic growth, a sense of fragility in the economic recovery, and heightened policy uncertainty surrounding the government shutdown and potential regulatory changes. The result was slower equipment investment growth and a continued focus on portfolio quality and business productivity. With low interest rates and strong corporate profitability, data suggest that businesses' propensity to finance equipment purchases increased in 2013 and halfway into 2014. Therefore, despite a slowdown in businesses' capital spending, the equipment finance industry continued to grow, albeit at the slowest rate in 3 years.

Equipment Finance Industry Size

(in billions of dollars)

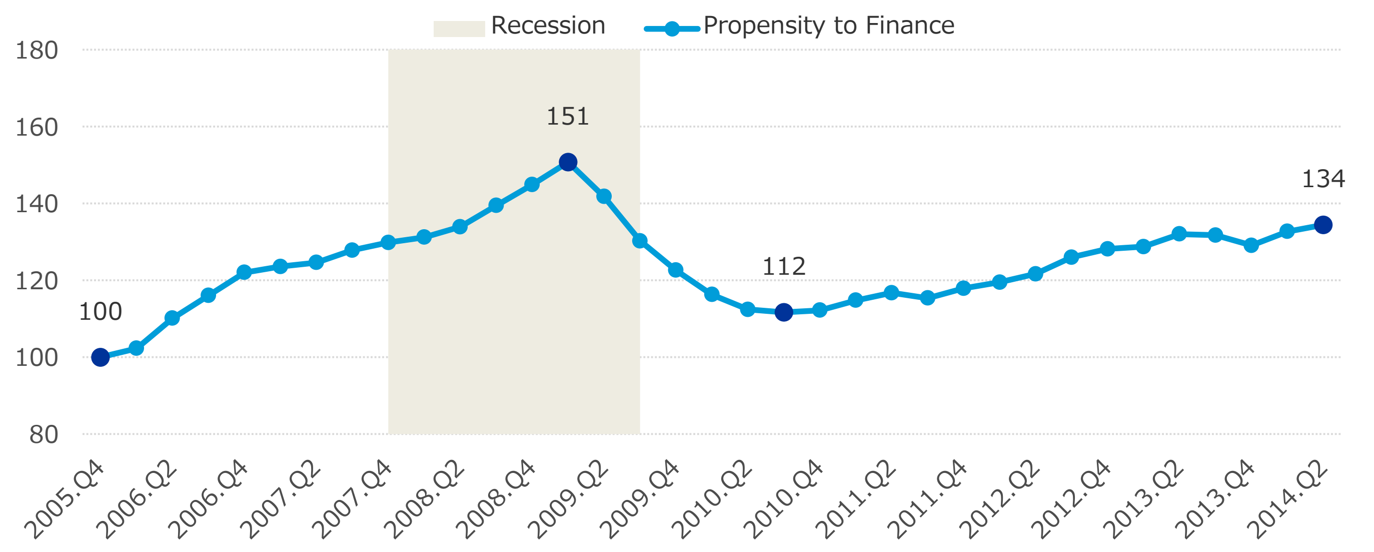


Sources: 2012-2013 ELFA U.S. Equipment Finance Market Study, Macrobond Financial, Keybridge LLC

Why have the industry size figures changed since the 2013 SEFI? The size of the equipment finance industry is estimated based on two main components – total public and private sector equipment and software investment, and the propensity to finance those equipment investments. Investment figures are estimated by the Bureau of Economic Analysis, and are subject to revisions on a regular basis. Every 5 years the propensity to finance has been measured through a Foundation-sponsored survey – the last survey being conducted in 2012 on 2011 investment and financing activity. Historically, the SEFI's industry size estimates were based almost entirely on these survey results and on certain assumptions made about the propensity to finance in interim years. This year, Keybridge has incorporated a new measure of the propensity to finance – the Propensity to Finance Equipment Index, for the current calendar year. The index and its methodology are explained below.

The Propensity to Finance Equipment Index ("PFEI") is a composite of two separate measures. The first measure estimates the share of C&I loans that go towards equipment purchases and compares that to total equipment and software investment. The second measure compares trends in the ELFA MLFI-25 New Business Volume to trends in total equipment and software investment. Both measures are converted to an index and then averaged to result in the final propensity to finance index.

Propensity to Finance Equipment Index



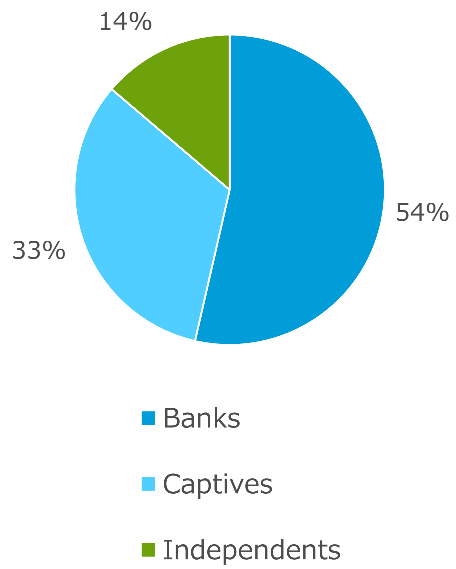
Sources: ELFA, Macrobond Financial, Keybridge LLC

Interpreting the PFEI. Leading up to and partially through the Great Recession of 2008-09, private companies took on increasingly more debt to finance their capital expenditures. The PFEI clearly shows this trend, as the index increased 51% from Q4 2005 to Q1 2009. As the financial crisis reached its peak, businesses began to deleverage their balance sheets – not only by paying down or writing off debt, but also by financing a smaller portion of their capital spending. As a result, the propensity to finance hit a low point in the 3rd quarter of 2010 as the economy struggled to gain a solid footing and there was a high degree of policy, regulatory, and economic uncertainty.

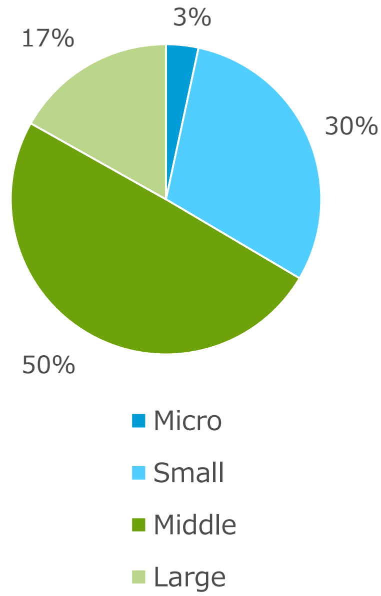
Around the time the second round of quantitative easing began in November 2010, deleveraging in the nonfinancial corporate sector ended and reversed course. The trend in the PFEI over the past several years suggests that the propensity to finance has increased steadily since hitting a post-recession low point in late 2010. A combination of low interest rates and rising corporate profits has enabled private companies to take on marginally more debt. These trends are also echoed in other macroeconomic data. For example, nonfinancial corporate sector liabilities as a share of nominal GDP peaked at 91% in Q4 2008, bottomed-out at 87% in Q4 2010, and have subsequently rebounded to 93% as of Q1 2014. Although the PFEI is not forward looking, it does provide a guidepost for the conditions in which the propensity to finance would rise or fall. For example, in an environment of steady growth and rising interest rates, the propensity to finance is likely to increase as businesses want to lock in lower rates. Indeed, we believe this could be one of the major themes for 2015.

New Business Volume (percent of total)

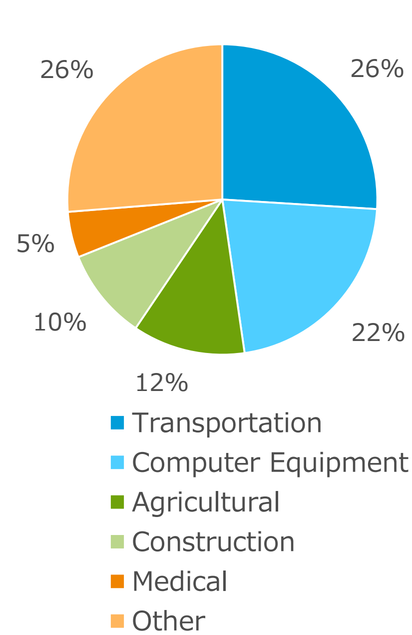
By business model



By ticket size



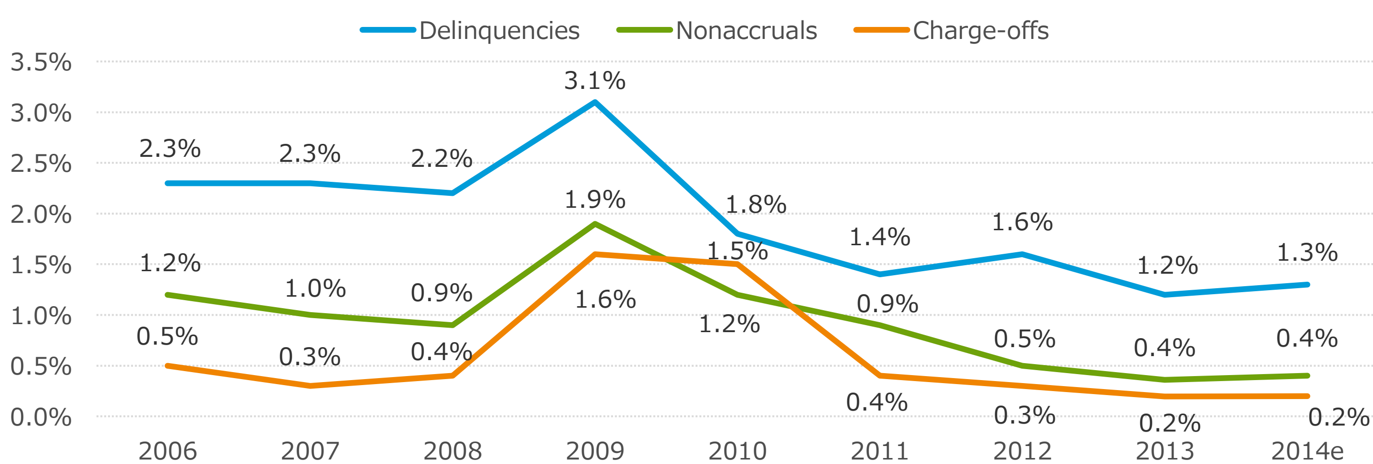
By equipment vertical



Sources: 2014 ELFA Survey of Equipment Finance Activity

Portfolio Performance (percent of assets; weighted-average)

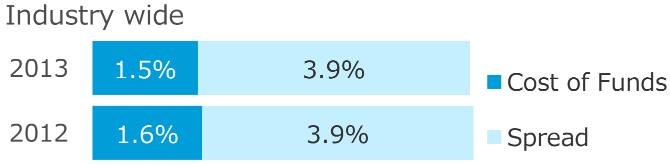
Industry wide



Source: 2008 & 2014 ELFA Surveys of Equipment Finance Activity

Yield & Funding (percent; median)

Industry wide



Source: 2014 ELFA Survey of Equipment Finance Activity

Operating Profit (percent of revenue; weighted-average)

Industry wide

A Buyer's Market

Although the equipment finance industry remains in a strong position, 2013 was marked by below-average growth, lower yields, tighter spreads, and intense competition for deals. Growth continued in 2013, as the industry outpaced the overall economy, yet several factors held back growth. First, replacement demand, which drove the tremendous growth seen in recent years, appears to be waning. Secondly, as a mature industry, equipment finance is marked by intense competition in pricing, causing companies to focus either on lowering their prices or on providing added-value to customers. Moreover, the current low interest rate environment has flooded the equipment finance industry with capital – a trend that is generally positive for buyers yet has further crowded an already-competitive industry. Ultimately, this combination of factors – low yields, tight spreads, and hyper-competition – has transformed the equipment finance industry into "a buyer's market" in which customers get more for their money and financers struggle to grow their profits. Despite facing these challenges, among others, the equipment industry has shown its ability to adapt and continue to find new sources of growth.

Slow macroeconomic growth and a waning replacement cycle led to below average growth for equipment, machinery, and software in 2013. Real GDP grew 2.2% in 2013, evidence of the continued, yet sluggish economic recovery. Total public and private sector equipment and software investment grew by only 3.2% in 2013, but the equipment finance industry increased more than 8% due to rising propensity to finance. Most investment activity was the result of an ongoing replacement cycle across many sectors.

A solidifying economic recovery points to faster equipment and software investment growth in 2014. A stronger-than-expected rebound in the second quarter followed a disappointing start to the year, as real GDP and equipment and software investment grew 4.6% and 9.6%, respectively. Furthermore, continued expansion in the manufacturing sector and recent boosts in durable goods orders suggest that strong equipment investment growth will continue through the year. While still below-average, 2014 growth in equipment investment is likely to exceed 2013 levels.

2014 is shaping up to be a good year for portfolio performance, but equipment finance growth is still slowing. Recent MLFI-25 data points to continued strong portfolio performance for the equipment finance industry, as charge-offs have stayed low since the beginning of the year. Through August, new business volume is up nearly 6% from 2013, yet growth for all of 2014 is likely to be slightly below the 9.3% growth seen in 2013.

Notwithstanding a broader economic expansion, equipment investment and financing activity may struggle to grow over a 2 to 3 year period. Equipment and software investment is at an all-time high percentage of GDP and capacity utilization has been stuck below 80%, suggesting there is little room for expansion of the U.S. industrial base, which is a leading indicator of equipment demand. Additionally, with interest rates likely to increase in 2015, the propensity to finance may decline marginally relatively to recent highs. Taken with the price competition already facing equipment finance, these factors indicate slowing industry growth in coming years.

Pockets of growth can be found in certain industries. Printing, Construction, and Agriculture equipment led equipment finance growth in 2013, while other equipment types – notably Office Machines – contracted. Additionally, Materials Handling, Industrial, and Mining & Oilfield equipment investment have seen fast growth in recent months, in part due to the domestic energy boom and a rebounding industrial sector. Looking forward to the rest of 2014, strong growth is likely to come from several equipment types, including Construction, Materials Handling, Railroad, and Trucks.

Multiple sources of uncertainty continue to weigh on the economy and equipment finance sector. Regulatory concerns are prevalent within the equipment finance industry, particularly in regards to Dodd-Frank and potential new regulations from the CFPB. In 2014, however, uncertainty has grown more internationally-focused, reflecting conflicts in Ukraine, the Middle East, and the South China Sea. As opposed to the policy uncertainty fueled by partisan fighting, geopolitical risks are now the biggest potential disrupters to business confidence and investment.

The industry is finally seeing light at the end of the tunnel for lease accounting rules. After several years of uncertainty, the proposed rules for lease accounting have taken a decidedly positive turn. Instead of creating a harmonized standard, the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") are nearly certain to issue two separate standards, resulting in lease accounting rules that are much friendlier to the equipment finance industry. A final decision will come later this month, after which the equipment finance industry should have plenty of time to alter and implement new lease accounting systems. In fact, the new rules are unlikely to take effect before 2018, providing the industry with a substantial preparation period.

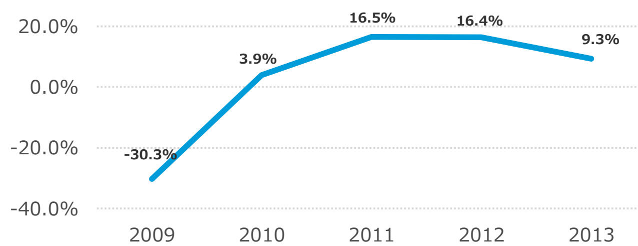
Key Performance Indicators

All data sourced from the 2009-2014 ELFA Surveys of Equipment Finance Activity

New Business Volume Performance Indicators

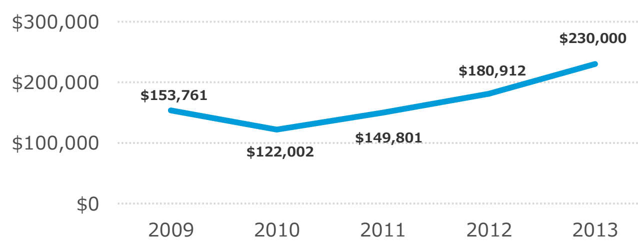
Growth in New Business Volume

Growth declined following two years of strong gains yet remains well-above levels seen during the recession.



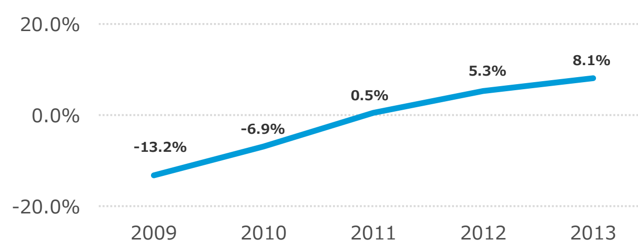
Median New Business Volume Per Lessor ($000s)

Median new business volume reached its highest level in over ten years.



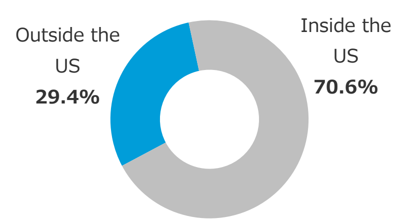
Growth in Assets under Management

Assets under management saw accelerated positive growth for the third consecutive year.



New Business Volume Originated by Region

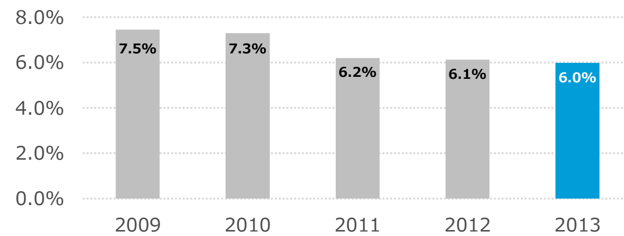
Nearly one third of Survey of Equipment Finance Activity ("SEFA")[i] respondents sourced new business outside of the United States, a slightly smaller share than seen in 2012.



Yield and Funding Performance Indicators

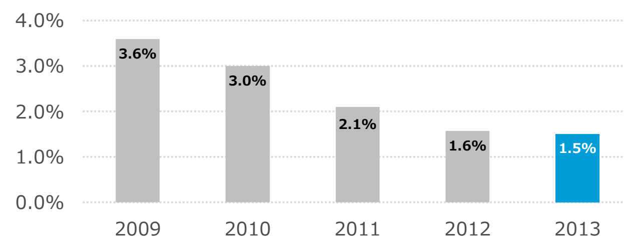
Pre-Tax Yield (median)

Yields continued to steadily decline, marking the fifth straight decrease.



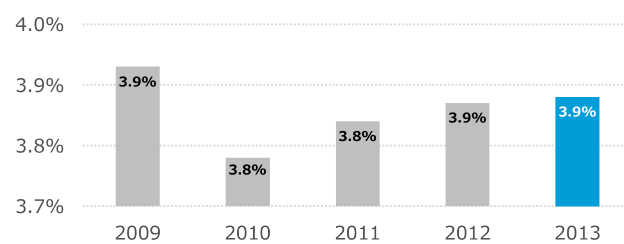
Cost of Funds (median)

In an ongoing low interest rate environment, cost of funds has decreased since 2008.



Pre-Tax Spread (median)

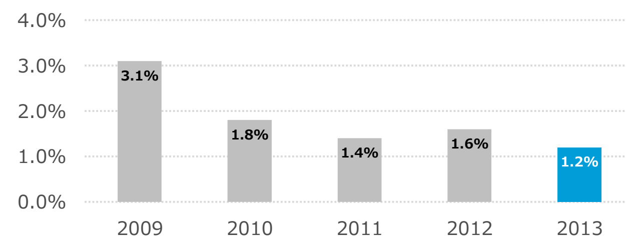
Spreads were virtually unchanged in 2013, as both yields and cost of funds continued to decline.



Portfolio Performance Indicators

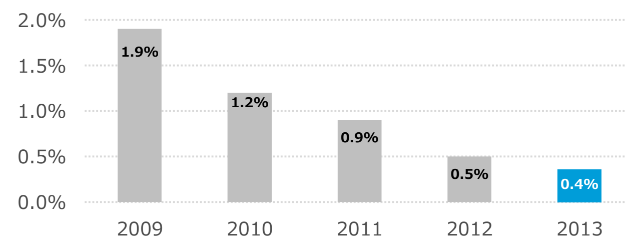
Delinquent Portfolio Over 30 Days (weighted-average)

After ticking up in 2012, delinquencies fell to a six-year low.



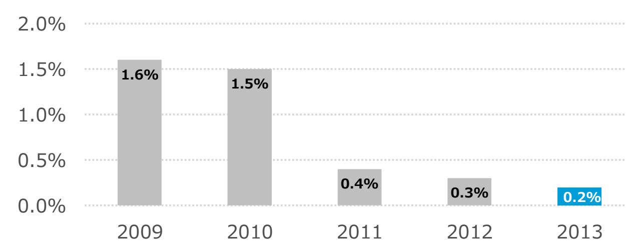
Non-Accrual Assets as a Percent of Receivables and Non-Accrual Assets (weighted-average)

Nonaccruals continued to decline, reaching a six-year low.



Net Full-Year Loss (Charge-Off) as a Percent of Full-Year Average Receivables (weighted-average)

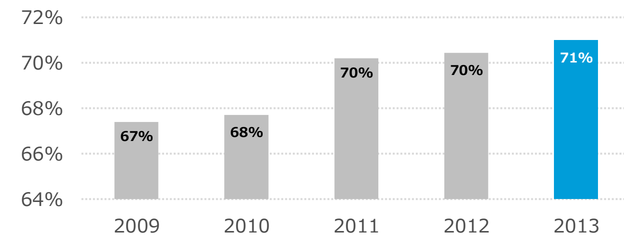
Charge-offs fell for the fourth consecutive year following a spike in 2009.



Business Processes Performance Indicators

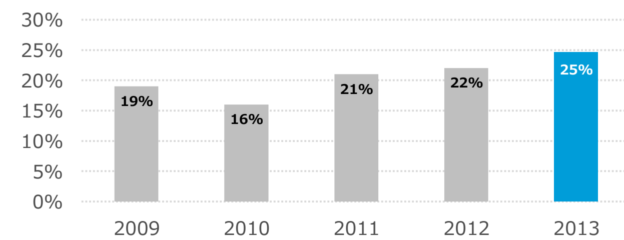
Applications Booked & Funded/Sold as a Percent of Approved (based on $ amount)

In terms of booking contracts, business efficiency continued to improve.



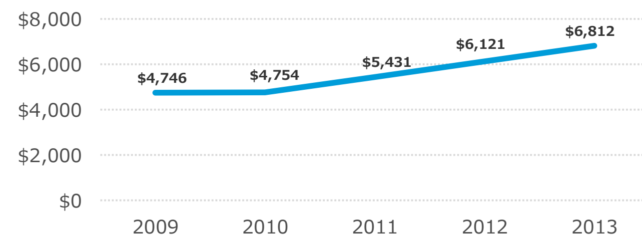
Residual or Salvage Position as a Percent of Original Equipment Cost

Residual values continued to increase, reaching a six-year high.



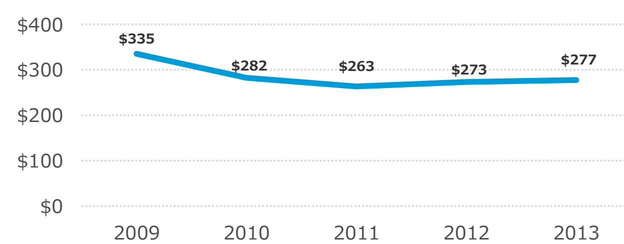
New Business Volume per Full-Time Equivalent (FTE)

Increasing since 2009, New Business Volume per FTE has now surpassed pre-crisis levels.



Sales, General & Administrative Expense per Full-Time Equivalent (FTE)

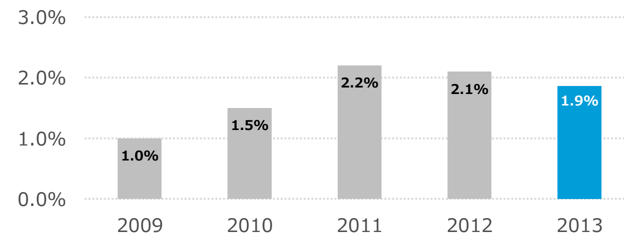
Expenses per FTE ticked up following a five-year low in 2012.



Financial Performance Indicators

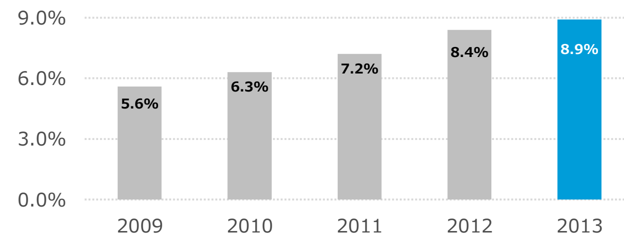
Return on Average Assets (median)

Return on assets declined for the second year yet remains at a healthy level.



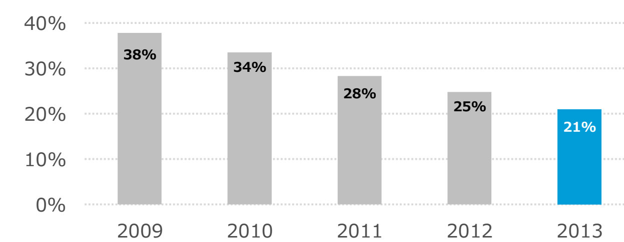
Sales & Marketing Expense as a Percent of Total Revenue (median)

Sales and marketing expenses continued to increase as a percentage of total revenue.



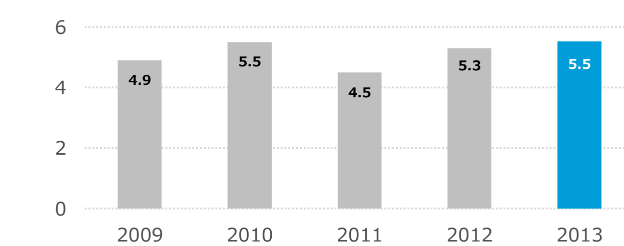
Interest Expense as a Percent of Adjusted Revenue (median)

Reflecting decreasing cost of funds, interest expenses continued to decline as a percentage of adjusted revenue.



Debt to Equity (median)

Increasing debt to equity indicates that companies are taking on more debt following the deleveraging of the past few years.



New Business Volume

The equipment leasing and finance industry exhibited solid growth in 2013, although at a slower pace than seen in the two previous years. Total new business volume grew 9.3%, down from 16.4% in 2012 yet still a major improvement from the contractions and slow growth immediately following the recession of 2008-2009. Nominal equipment and software investment increased 4.7% in 2013, outpacing nominal GDP, which expanded 3.7%. Due to their larger shares of small-ticket transactions and other fast-growing market segments, Captives and Independents grew faster than Banks, a reversal of trends in 2012. Factors which benefitted Banks the previous year – including a low share of small-ticket transactions and a high share of large-ticket transactions – ultimately curtailed their new business volume growth in 2013. On the end-user level, the Printing & Publishing, Telecommunications, and Transportations industries led growth in 2013, while the Printing, Construction, and Agriculture equipment types were among the fastest-growing. Lastly, growth in international new business volume turned negative after a strong 2012, pulled down by contracting new business volume in emerging economies. Looking ahead, recent new business volume data points to modest growth through 2014.

Thousands of Dollars or Percent	Industry	Banks	Captives	Independents
2013 Median New Business Volume	$230,000	$357,408	$232,634	$96,397
Growth in Total New Business Volume, 2012-2013	9.3%	6.2%	11.3%	17.7%
Growth in Assets Under Management, 2012-2013	8.1%	10.1%	9.3%	-0.1%
Five Year Growth in Median NBV	12.5%	-15.0%	-17.1%	-6.2%

Source: 2014 ELFA Survey of Equipment Finance Activity

Total equipment and software investment continues to outpace overall growth. Real equipment and software investment (adjusted for inflation) grew 4.2% in 2013, compared to 2.2% for the overall economy. As the economy contracted 2.1% in the first quarter of 2014, equipment and software investment slipped only 0.4%. In 2014 Q2 total real equipment and software investment increased at a 9.6% annualized rate, while the economy expanded 4.6%. Although equipment and software investment likely cannot sustain significantly faster growth than the overall economy over the long term, recent data suggests that it will outpace GDP for the rest of 2014.

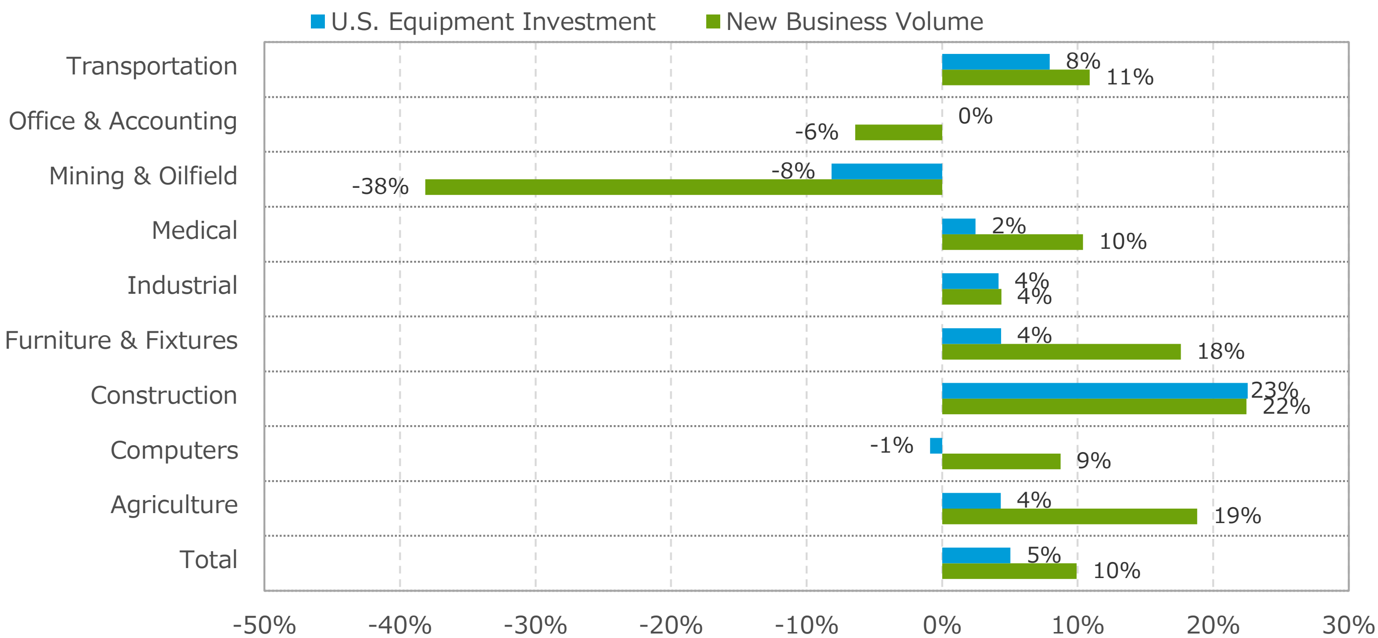
Equipment and software investment growth further decelerated in 2013. Following growth of 11.9% in 2011 and 6.5% in 2012, real equipment and software investment expanded 4.2% in 2013, suggesting an ebbing of the replacement demand which pushed up growth following the recession. A similar slowdown in growth was also seen in several equipment verticals, including Software, Trucks, Aircraft, and Materials Handling. Recent data has been positive; equipment investment rebounded a solid 9.6% in Q2 2014, and the latest MLFI-25 shows that year-to-date new business volume is up nearly 6% from last year. Combined with this summers' strong durable goods data, the Q2 rebound suggests that 2014 equipment and software investment growth will exceed 2013 growth.

Most asset types saw positive growth in 2013. Out of the twelve major equipment verticals, Construction and Ships & Boats saw the fastest growth rates in 2013, at 20.4% and 16.1%, respectively. Expanding 11.4%, investment in Trucks also saw strong growth in 2013. On the other side of the spectrum, Railroad Equipment investment plunged nearly 30% following two years of solid expansion, and Mining & Oilfield investment fell 8.7%.

The propensity to finance increased for many asset classes in 2013. End-users are more likely financing equipment types in which new business volume outpaces equipment investment, as shown by data provided by the SEFA and Bureau of Economic Analysis. The chart below suggests that propensity to finance increased for several end-user industries, particularly Furniture & Fixtures, Computers, and Agriculture. While end-users in the Mining & Oilfield industry seemed particularly likely to finance equipment in 2012, the sharp contraction in 2013 new business volume suggests stalled propensity to finance for that industry.

Equipment Finance Penetration

(2013 annual growth rate)



Source: 2014 ELFA Survey of Equipment Finance Activity, Bureau of Economic Analysis

In a reversal of last year's trends, Independents led Banks and Captives in new business volume growth. After increasing only 7.4% in 2012, Independents saw new business volume growth of over 17% in 2013. Captives also experienced stronger new business volume growth than Banks, increasing by roughly 11% for the fourth consecutive year. On the other hand, Banks' new business volume decelerated in 2013 after two years of rapid growth.

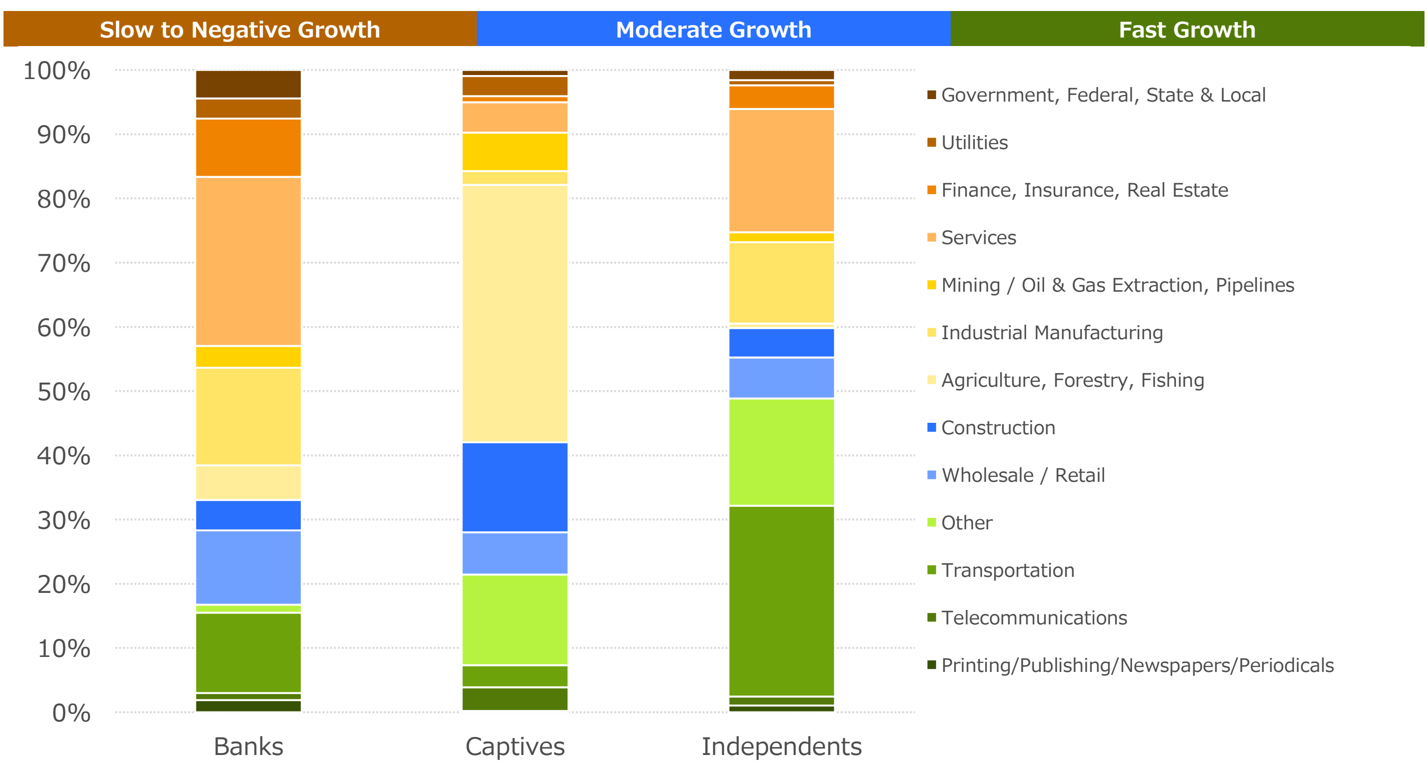
Several factors which boosted Banks' growth in 2012 held them back in 2013. In particular, Banks continued to have the largest market shares of medium-ticket and large-ticket transactions compared to Captives and Independents. While the large-ticket market segment grew faster than the others in 2012, its new business volume growth slowed substantially in 2013 – benefiting Banks in 2012 but hurting them in 2013. Additionally, growth slowed for several industries, including Transportation and Industrial Manufacturing, which Banks weighted heavily.

New business volume growth was strongest for the Printing/Publishing, Telecommunications, and Transportation industries. By end-user industry, new business volume increased the most for the Printing/Publishing/Newspapers/Periodicals (57%), Telecommunications (39%), and Transportation industries (35%). Fast growth in the Transportation industry helped Independents, which received nearly 30% of their new business volume from Transportation. New business volume decreased the most for the Government (-23%), Utilities (-5%), and Finance, Insurance, & Real Estate industries (-2%). The decline in Finance, Insurance, & Real Estate new business volume hurt Banks given the large share of their portfolio (9.1%) devoted to the industry in 2013. Interestingly, several industries shifted between the fastest-growing and slowest-growing categories, notably Utilities and Transportation.

End-Purchaser Growth Attribution

(percent of new business volume)

Note: Each column represents the composition of new business volume by end-purchaser. The color-coding refers to the pace of growth for each end-purchaser. For example, Independents had a relatively large share of new business volume from the Transportation industry compared with Captives, which grew significantly faster than new business volume from the Utilities industry.



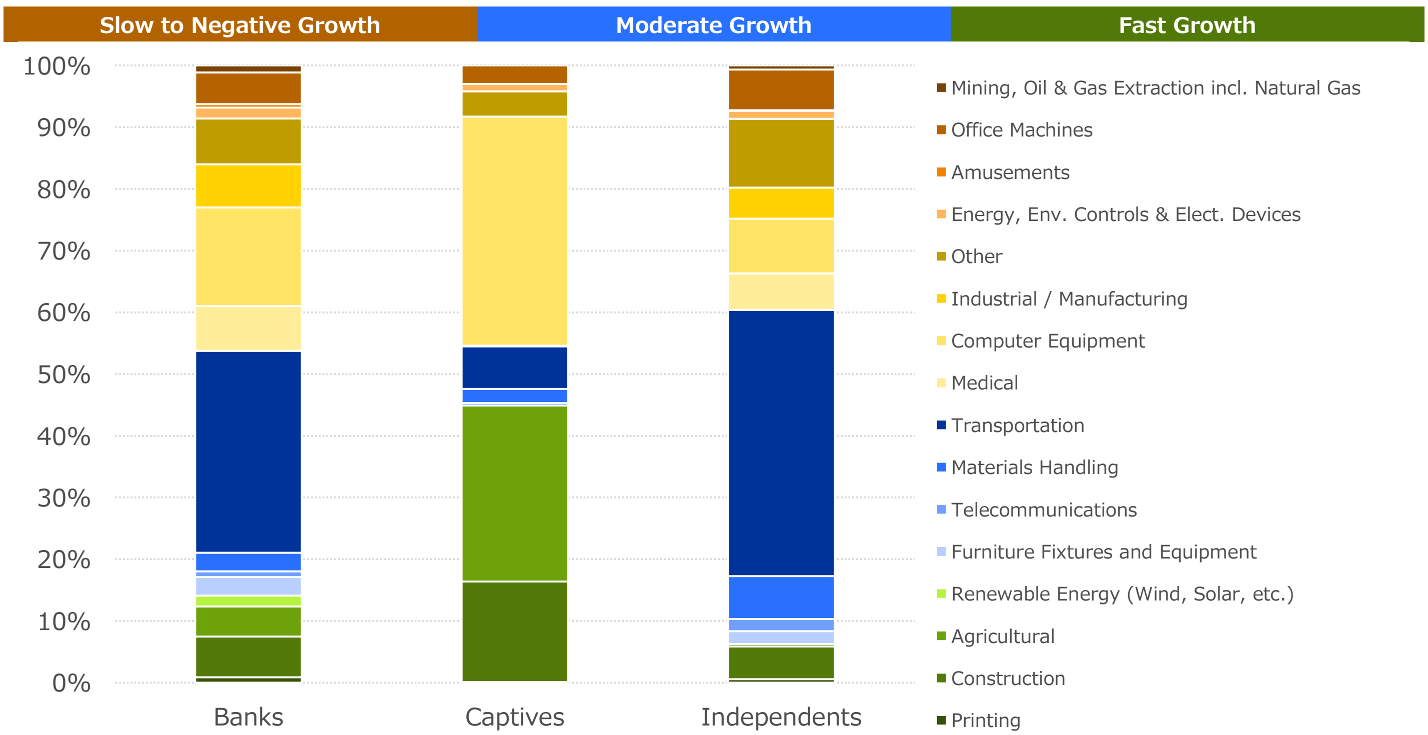
Source: 2014 ELFA Survey of Equipment Finance Activity, Keybridge LLC

Among asset types, new business volume was strongest for Printing, Construction, and Agricultural equipment. By equipment vertical, Printing (55%), Construction (22%), and Agricultural equipment (19%) were top performers, experiencing the fastest growth rates in new business volume. While Captives were unable to capitalize on fast-growing industries in 2012, they were situated in stronger markets in 2013, with 16% and 29% of their new business volume coming from Construction and Agriculture, respectively. Banks and Independents, however, hurt themselves by placing weight in Office Machines, one of the slowest-growing equipment types in 2013.

Equipment Vertical Growth Attribution

(percent of new business volume)

Note: Each column represents the composition of new business volume by equipment type. The color-coding refers to the pace of growth for each equipment type. For example, Captives had a relatively large share of new business volume in the form of Agriculture equipment compared with Independents, which grew significantly faster than new business volume in the form of Office Machine equipment.



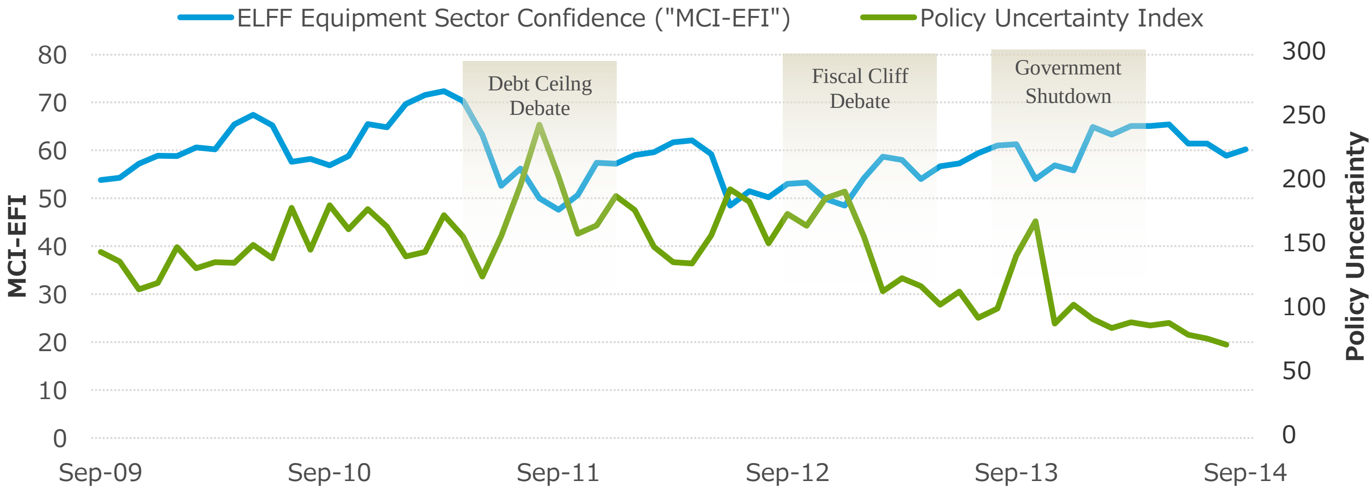
Source: 2014 ELFA Survey of Equipment Finance Activity, Keybridge LLC

Despite some concerns, policy uncertainty is falling – a boost for industry confidence. As business confidence is generally inversely related to policy uncertainty, lower policy uncertainty is keeping equipment finance industry confidence at a relatively elevated level. The chart on the following page shows that the Equipment Leasing & Finance Foundation's Monthly Confidence Index of the Equipment Finance Industry ("MCI-EFI") and the Economic Policy Uncertainty Index. While uncertainty spiked during the government shutdown and debt ceiling debate of fall 2013, uncertainty has since fallen to post-recession lows.

However, a variety of regulatory and policy concerns continue to weigh on industry confidence. Multiple respondents highlighted financial market regulations among their top concerns for the equipment finance industry. A few individuals from the industry also noted pessimism over the potential for tax reform and concerns over continued partisanship in Washington, yet these worries seemed to have lessened somewhat from recent years.

Policy Uncertainty and Industry Confidence

(index values)

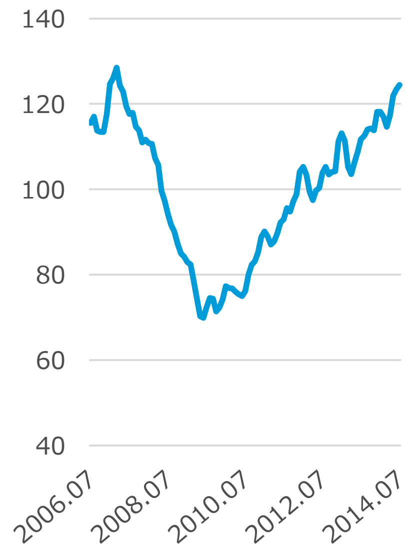


Source: ELFA, Macrobond Financial

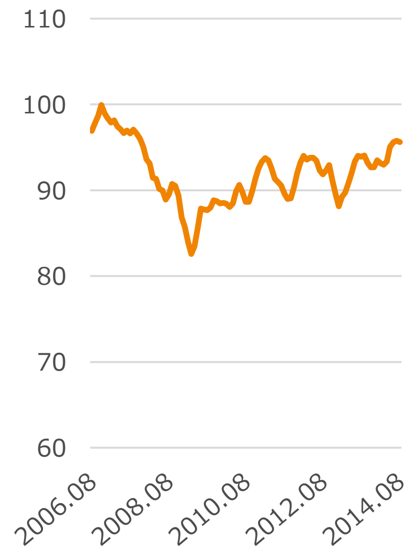
Small-ticket transactions led growth, suggesting recovery for small businesses. The micro-ticket market segment (transaction size less than $25,000) contracted again in 2013, while the middle-ticket segment (transaction size between $25,000 and $5 million) grew 8.5% and the large-ticket (transaction size above $5 million) segment expanded 6.8%. With new business volume growth of 14.3%, the small-ticket market segment (transaction size between $25,000 and $250,000) saw the fastest growth, potentially signaling a turning point in small business confidence. In fact, this turnaround in small-ticket transaction growth mirrors gains seen in a variety of small business indicators, including the PayNet Small Business Lending Index (SBLI), the NFIB Small Business Optimism Index, the Intuit Small Business Revenue Index, and the Wells Fargo/Gallup Small Business Index. For example, the NFIB Small Business Optimism Index increased consistently through 2013 and reached post-recession highs earlier this summer. Additionally, at the industry level, the Intuit Small Business Revenue Indices highlight that construction, professional, scientific, & technical services, and retail trade are rebounding rapidly for small businesses.

Small Business Dashboard

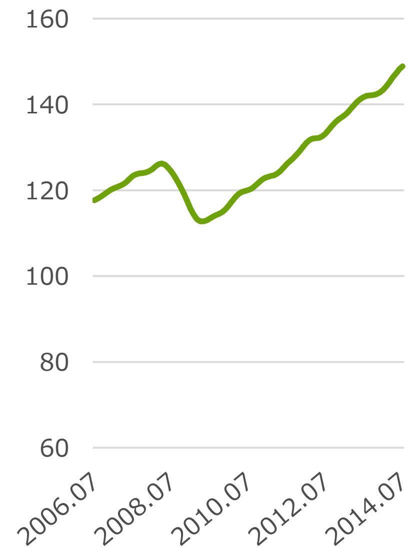
PayNet Small Business Lending Index (3-Month Moving Avg.)



NFIB Small Business Optimism Index (3-Month Moving Avg.)



Intuit Small Business Revenue Index

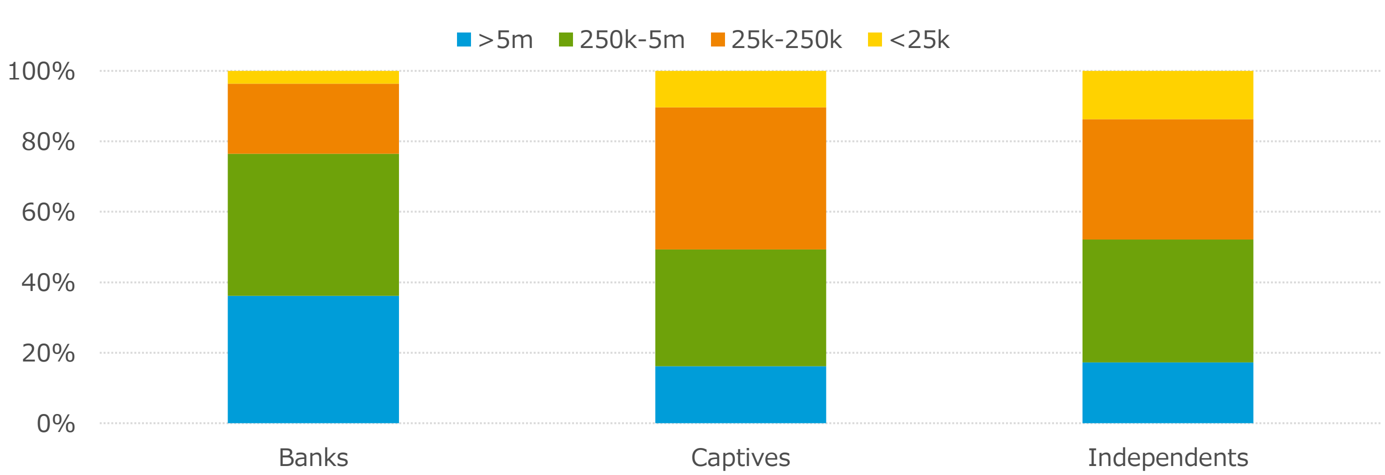


Sources: Macrobond Financial, PayNet

A lower weight on small-ticket transactions hurt Banks in 2013. Compared to 2012, when a relatively low weight on small-ticket transactions and a relatively high weight on large-ticket transactions propelled Banks to faster growth, the opposite occurred in 2013. Only 19.9% of Banks' new business volume came from small-ticket transactions ($25,000 to $250,000), compared to 40.4% of Captives' and 34.1% of Independents' new business volume.

Share of Portfolio by Transaction Size

(percent of total portfolio)

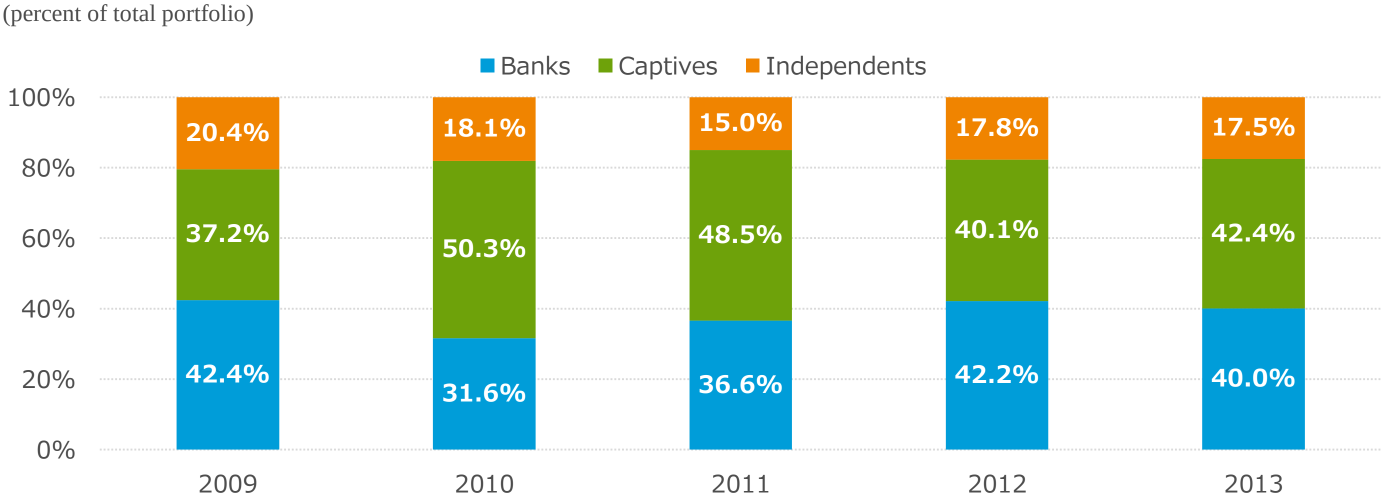


Source: 2014 ELFA Survey of Equipment Finance Activity

Banks lost small-ticket market share, while Captives expanded. All three organization types saw small-ticket new business volume growth in 2013, yet only Captives captured small-ticket market share. Banks' small-ticket market share fell from 42.2% in 2012 to 40.0% in 2013. Conversely, Captives' gained market share in 2013, while Independents' small-ticket market share was virtually unchanged. This is likely a function of growth in particular equipment verticals – namely, construction and agriculture machinery – where captives have a large presence, rather than a shift in small businesses' purchasing habits.

Share of Small-Ticket New Business Volume by Organization Type

(percent of total portfolio)



Source: 2009-2014 ELFA Survey of Equipment Finance Activity

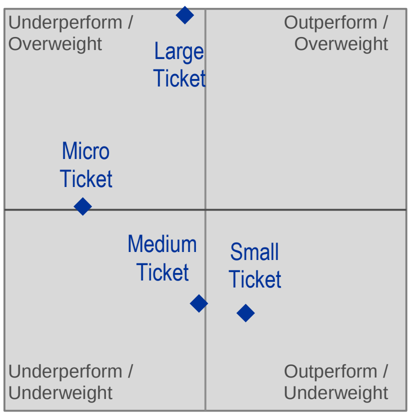
An organization's position in the market greatly influences growth. The charts on page 24 attribute the relative growth rates of Banks, Captives, and Independents across three factors – ticket size, equipment type, and end-user industry. The charts display each organization type's relative weighting in various sectors and each sector's new business volume growth relative to the industry average (9.3%). For each organization type, all four ticket size categories (micro, small, medium, and large) were included, along with the two end-user industries and equipment types with the smallest weights of new business volume and the two end-user industries and equipment types with the largest weights. For example, small-ticket transactions made up 34.1% of Independents' new business volume in 2013, higher than the industry average of 30.1%. Small-ticket new business volume grew 14.3% in 2013, above the total-industry growth rate of 9.3%. Therefore, by over-weighting an over-performing market segment (small-ticket), Independents benefitted from faster growth. Similarly, Independents under-weighted the State & Local Government end-user industry (0.2% of Independents' new business volume versus 2.6% for the industry overall), which contracted 30% in 2013. Thus, by largely avoiding the State & Local Government industry, Independents prevented it from pulling down their overall new business volume growth. On the other hand, by placing too-little weight on fast-growing sectors and too much weight on slow-growing ones, other organizations hurt their growth rates.

A look at specific end-user industries and equipment types also offers a better understanding of 2013 growth. Generally, all three organization types (Banks, Captives, and Independents) selected fast-growing industries to overweight and avoided some of the industries which contracted the most. However, both Banks and Independents over-weighted Truck & Trailer Transportation, which grew by only 1.5% in 2013 – much lower than the industry-wide rate of 9.3%.

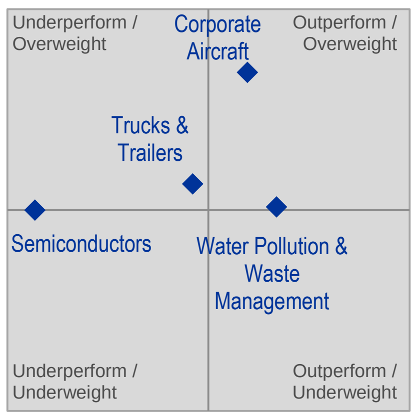
Equipment Finance Industry Performance Attribution Analysis

Banks

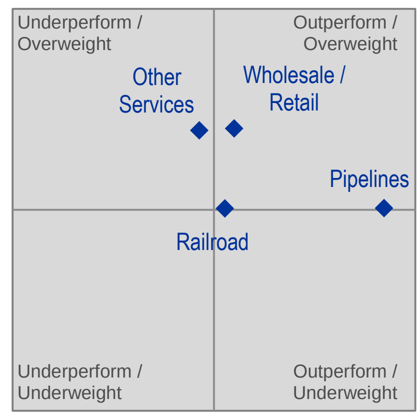
by ticket size



by equipment type

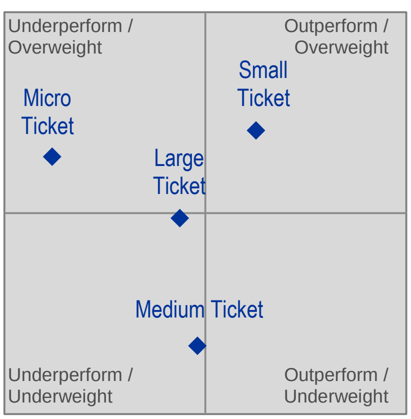


by end-user industry

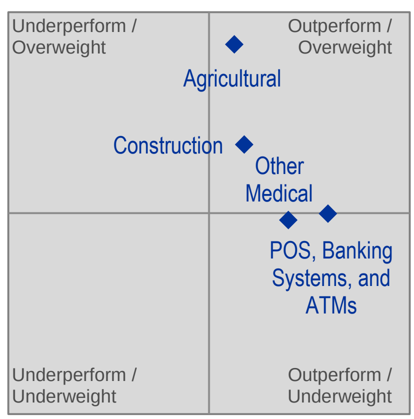


Captives

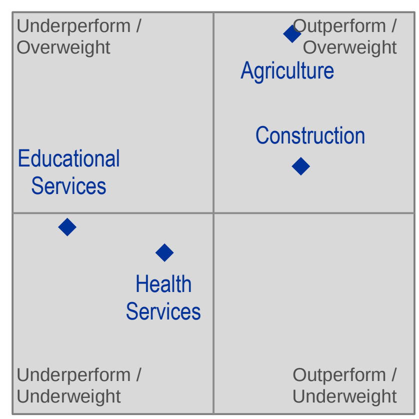
by ticket size



by equipment type

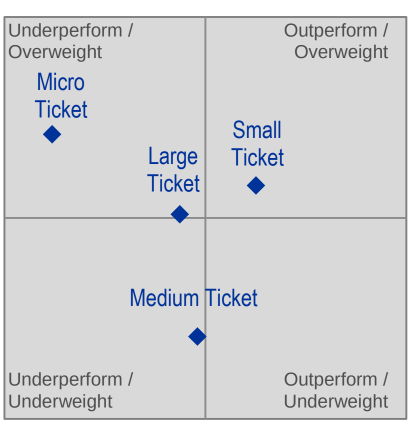


by end-user industry

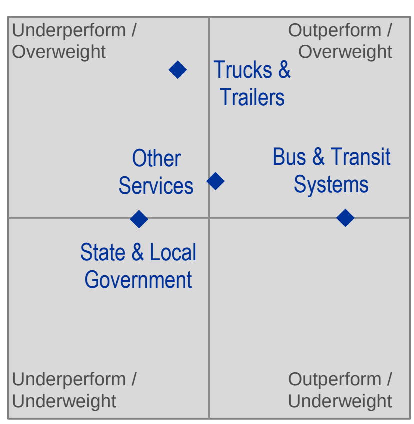


Independents

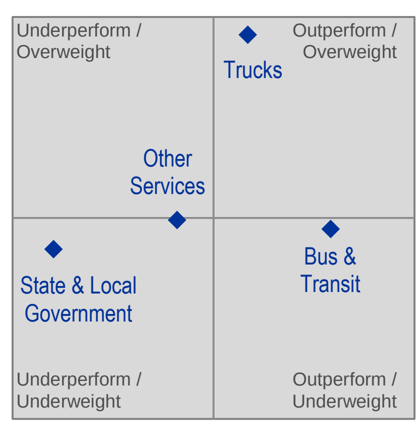
by ticket size



by equipment type



by end-user industry



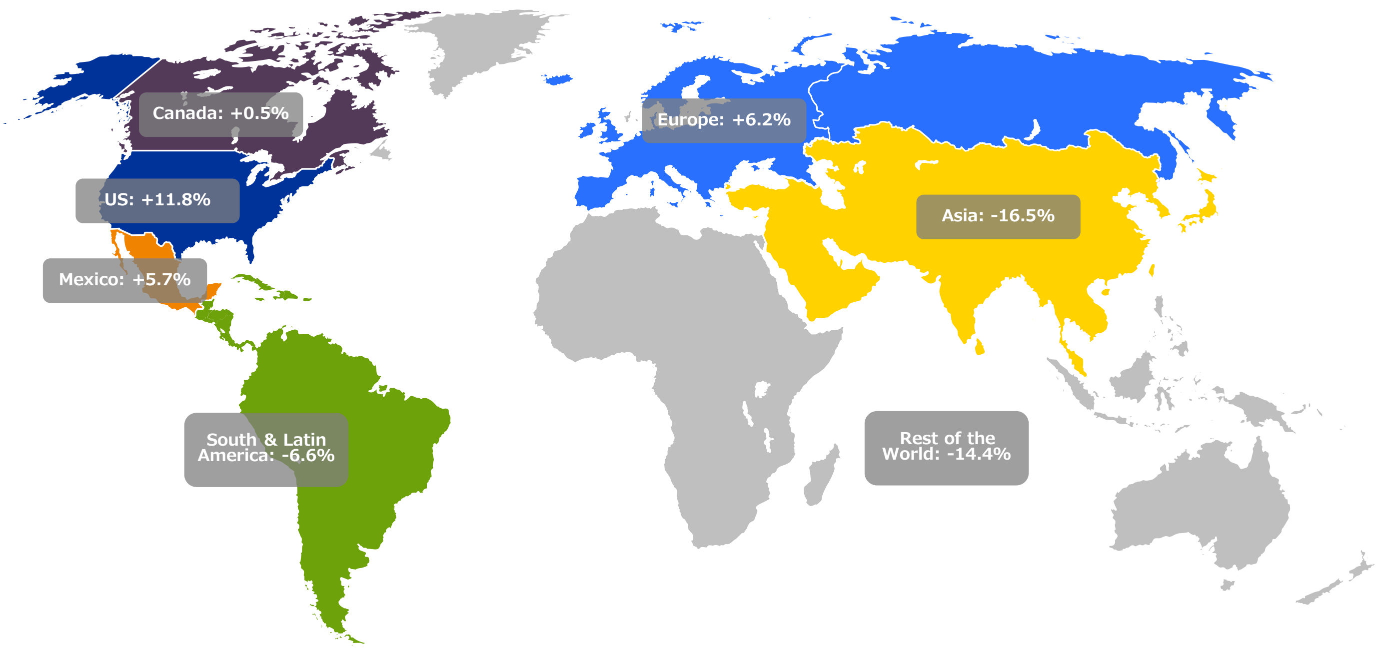
Source: 2014 ELFA Survey of Equipment Finance Activity, Keybridge LLC

International business volume slipped in 2013 following strong gains in 2012. In a reversal of last year's trends, international new business volume decreased 3.7% and made up a smaller share of total new business volume. Also in contrast to 2012, new business volume from emerging economies in Asia and South & Latin America declined. On the other hand, new business volume in Europe and North America continued to grow in 2013, but at much slower rates than the year before.

Reflecting close ties to their parent companies, a greater share of Captives were involved in international equipment finance business than Banks or Independents, and large organizations (with total origination above $1 billion) were more likely to be involved in international business than smaller organizations – continuing trends seen in 2012. Furthermore, a slightly greater share of Captives were involved in international business volume in 2013 than in 2012, while the percent of large organizations involved in international new business was unchanged in 2013.

International New Business Volume

(2012-2013 percent change)



Source: 2014 ELFA Survey of Equipment Finance Activity

The world economy slowed in 2013, and the recovery remained feeble for many countries. Global growth slowed in 2013, slipping to 3.2% from 3.5% in 2012. Moreover, world trade growth ticked down from 2.3% in 2012 to 2.2% in 2013. Canada's economy expanded 2.0% in 2013, driven by consumer spending and residential construction. Both the International Monetary Fund (IMF) and the latest Economist poll of forecasters predict Canadian growth of 2.3% in 2014. China's economy grew 7.7% in 2013, unchanged from 2012 but down from 9.3% in 2011. Growth is expected to slow slightly to 7.5% in 2014, as China struggles with a real estate slowdown, high debt levels, and structural reforms aimed at reorienting the economy towards consumption. The Euro Area economy, marked by persistently high unemployment, weak productivity growth, and low inflation, contracted 0.4% in 2013, yet is expected to rebound slightly in 2014; the latest Economist poll of forecasters puts 2014 growth at 0.9%. Overall, the Eurozone is not expected to significantly contribute to global growth in 2014.

Additionally, growth weakened for many emerging economies in 2013 – offering some explanation for the drop in African and Latin & South American new business volume. According to the IMF, total growth for “emerging market and developing economies” equaled 4.7% in 2013, down from 5.1% in 2012. In particular, growth for the ASEAN-5 countries (Indonesia, Malaysia, Philippines, Thailand, and Vietnam) slowed from 6.2% to 5.2% in 2013.

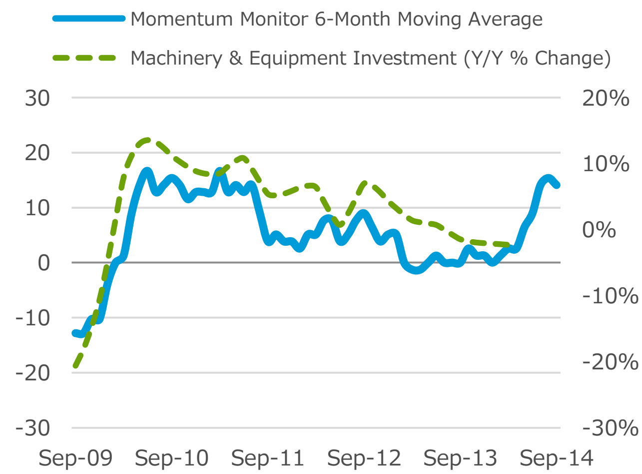
Global growth concerns are dominant in 2014. While domestic issues were largely the source of uncertainty in recent years, geopolitical risks and a faltering global recovery are now key sources of concern. The IMF expects sluggish 2014 growth from the Eurozone (1.1%), Japan (1.6%), and Brazil (1.3%), while the Ukraine conflict and Western sanctions have Russia teetering towards recession (0.2%). Similarly, geopolitical risks and the European economy topped concerns from the latest survey of Wall Street Journal economists. Despite these concerns, the IMF expects overall global growth to tick up to 3.4% in 2014 from 3.2% in 2013, suggesting that international new business volume may stabilize or slightly increase this year.

Because the faltering global recovery and geopolitical tensions have emerged as major concerns in 2014, this year’s SEFI includes international equipment investment momentum monitors for three major economies: Canada, Europe, and China. The charts on the following page show how equipment investment has fared in these three economies following the global recession of 2008-2009 and offer an equipment investment outlook for the next three to six months.

International Equipment Investment Momentum Monitors

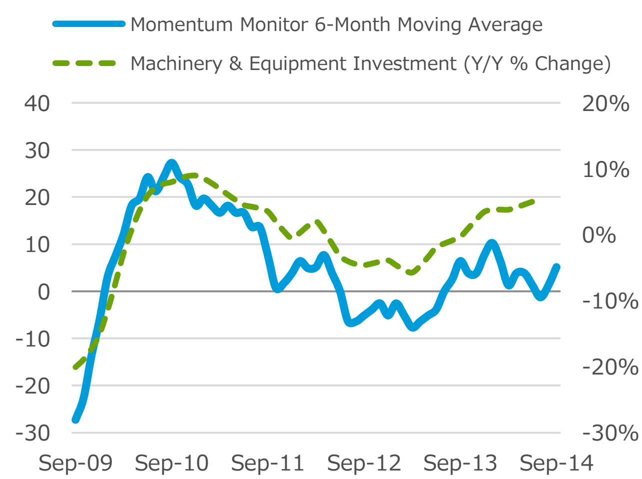
Canada

Marked by slow-to-negative growth in recent years, Canadian machinery and equipment investment appears poised for a turnaround over the next three to six months. Equipment investment was down 2.3% year-over-year in March, a four-year low, yet growth may finally be bottoming out. The momentum monitor's six-month moving average increased for five consecutive months before slipping in September. Overall, its elevated level indicates a strong pick-up in equipment investment in the near term.



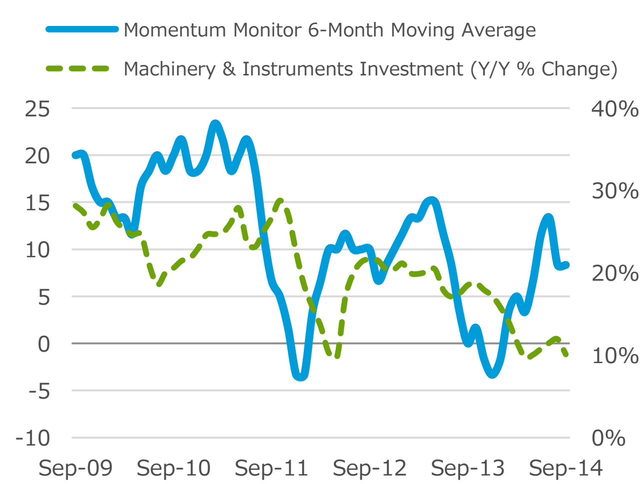
Europe

While the 28-member European Union has seen some rebound in machinery and equipment investment, growth remains subdued. Up 5.0% from a year ago, equipment investment growth hit a three-year high in September, yet growth was stuck in negative territory for much of 2012 and 2013. Similarly, the momentum monitor's six-month moving average has yet to recover, instead hovering around zero growth. The index's recent upward momentum suggests an uptick in equipment investment, but not breakout growth.



China

China has seen solid, yet slowing, growth in machinery and instruments investment over the past several years, as the economy fared the global recession much better than many advanced economies. Declining equipment investment growth likely reflects both the country's efforts to rebalance its economy away from investment and the broader slowdown in growth seen more recently. However, the momentum monitor's six-month moving average is at an elevated level and points to moderate growth over the next three to six months.

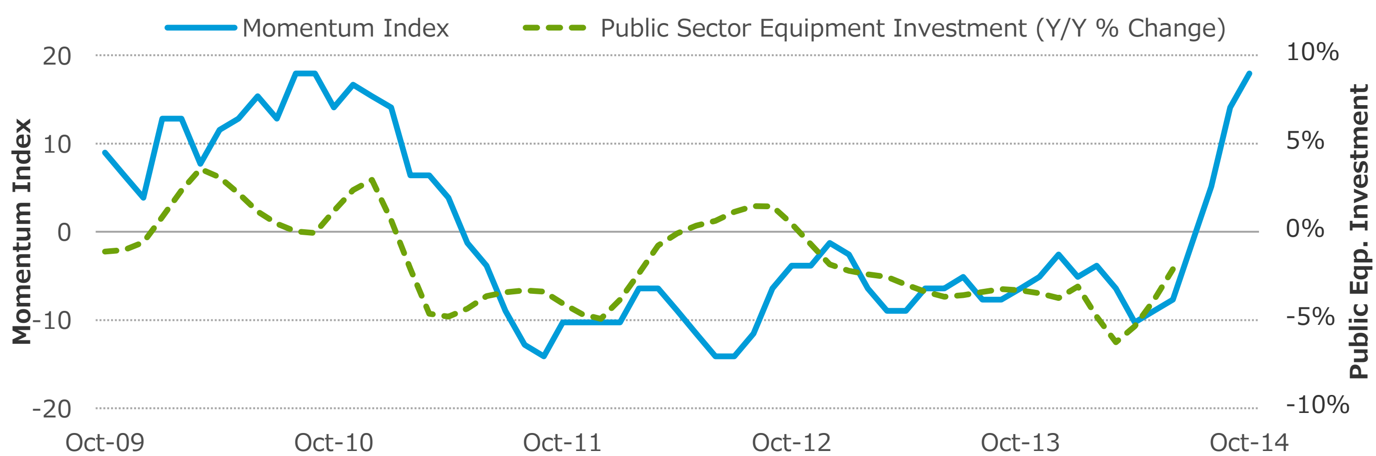


Public sector new business volume decreased in 2013 but looks to gain momentum through 2014. New business volume for the public sector contracted 23.1% in 2013, as a decline in State & Local Government new business volume more than offset a sharp increase in Federal Government new business volume. Weak new business volume for the public sector was reflective of fiscal consolidation and budget constraints holding back government spending in recent years. However, the downward trend in government spending appears to be reversing. In the second quarter of 2014 government spending added 0.31 percentage points to GDP after subtracting from economic growth in both Q4 2013 and Q1 2014. The positive contribution in Q2 was solely from state and local governments, as federal government spending contracted for the 7th consecutive quarter.

The U.S. Public Sector Equipment Investment Momentum Monitor has accurately predicted trends in public sector equipment investment with a 3 to 6 month lead time. For example, the Momentum Index remained in negative territory for much of 2012 and 2013 – indicating contraction in government capital spending. More recently, however, the momentum monitor has accelerated sharply, suggesting that the recent turnaround in public sector equipment investment will continue through the end of 2014 and into early 2015.

U.S. Public Sector Equipment Investment Momentum Monitor

(index values or percent)



Source: Macrobond Financial, Keybridge LLC

Yield & Funding

As seen in 2012, the Federal Reserve's accommodative monetary policy has kept interest rates at historical lows, creating a "search for yield" struggle for investors. In this low interest rate environment, a steady decline in cost of funds has been matched by falling yields. As a result, the equipment finance industry has faced continued spread compression, cutting into profitability. In essence, the industry is currently a "buyer's market" characterized by high levels of competition and declining yields and spreads. However, the Fed has been scaling down its bond-purchasing program ("QE3") since January 2014 and is set to end these purchases in October. Additionally, the debate over the Fed's first interest rate increase is now in full-force; the market consensus puts the first rate hike at mid-2015, but improving economic conditions could spur the Fed into action sooner. Similarly, the gradual economic recovery will also bring higher interest rates. With increased competition within the equipment finance industry weighing on profits, rising interest rates are likely to be a welcome trend for the industry.

Percent	Industry	Banks	Captives	Independents
Weighted-Average Pre-Tax Yield	4.35%	4.05%	4.30%	7.74%
Weighted-Average Pre-Tax Spread	3.00%	2.87%	2.85%	5.22%
Weighted-Average Cost of Funds	1.35%	1.18%	1.46%	2.52%
Median Pre-Tax Yield	6.10%	4.20%	6.60%	9.35%
Median Pre-Tax Spread	3.89%	3.12%	4.50%	4.91%
Median Cost of Funds	1.54%	1.16%	2.00%	3.52%

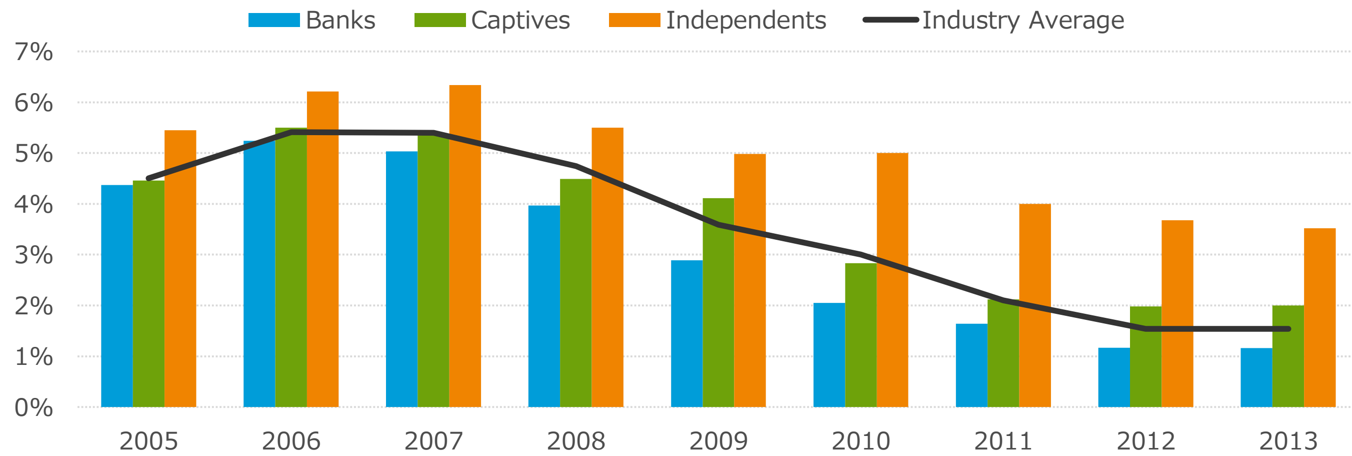
Source: 2014 ELFA Survey of Equipment Finance Activity

The cost of funds continued to decline in 2013, hitting new lows. Fueled by low inflation and accommodative Federal Reserve policy, cost of funds (weighted-average) fell for all three organization types in 2013, reducing the cost of capital. Long-term rates have stayed relatively low, and the Fed discount rate has remained 0.75% through September 2014.

In 2013, Banks maintained their competitive advantage on cost of funds. Banks once again had the lowest cost of funds, followed by Captives and Independents. Banks' competitive advantage largely reflects their direct access to the Fed discount window. However, the cost of funds gap between Banks and Independents narrowed from 2.5% in 2012 to 2.4% in 2013, suggesting a partial erosion of Banks' competitive advantage.

Median Cost of Funds

(percent)



Source: 2014 ELFA Survey of Equipment Finance Activity

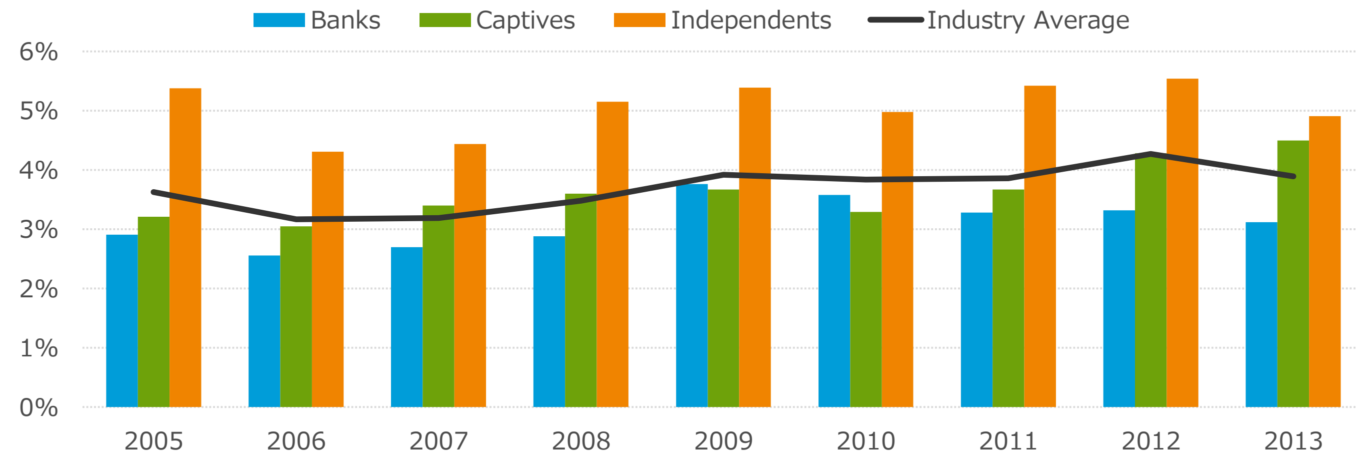
Spreads continued to compress, reflecting intense competition within the equipment finance industry. Between 2009 and 2013, weighted-average pre-tax spreads compressed from 3.85% to 3.00%. Median spreads were largely unchanged in 2013 yet declined slightly for Independents. As seen in recent years, the low interest rate environment and increased number of industry players has fueled greater competition, tightening spreads for all three organization types. Multiple industry experts noted rising competition as a top pressure on pricing and spreads.

The large-ticket market segment continues to have the lowest cost of funds and spreads. Small-ticket spreads dropped 33 basis points, followed by a 12 basis-point drop for middle-ticket spreads. Large-ticket spreads actually increased from 2012 to 2013; however, at 2.51% (weighted-average), they remain the lowest of the market segments. Additionally, the large-ticket market segment benefitted from lower cost of funds than the small- or middle-ticket segments.

Banks, Captives, and Independents all saw spread compression in 2013. Spreads for Independents declined the most out of any organization type, falling 54 basis points to 5.22% (weighted-average). Additionally, while Banks had the lowest spreads in 2012, Captives' spreads (weighted-average) were slightly lower than Banks' in 2013. Looking at median spreads, however, Banks continued to have lower spreads than Captives or Independents. As noted last year, an organization type's business model helps explain trends in spreads. For instance, Independents had a large share of small-ticket transactions in 2013 which also experienced the greatest spread compression.

Median Pre-Tax Spread

(percent)



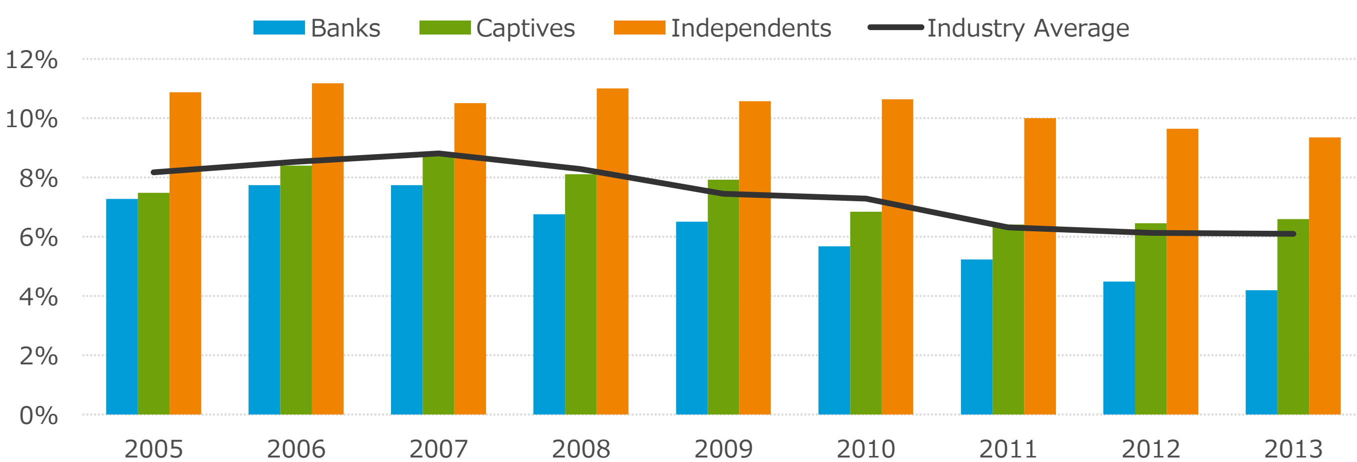
Source: 2014 ELFA Survey of Equipment Finance Activity

Yields fell further in 2013. Since 2006, the industry-wide pre-tax yield (weighted-average) has declined from 8.30% to just 4.43% in 2013. Yields continue to be lower for Banks (4.05%) than for Captives (4.30%) or for Independents (7.74%). Independents' yields decreased 69 basis points, potentially pointing to increased competition in the small-ticket market segment – which Independents weighted heavily in 2013.

Banks' lower yields reflect their greater share of large-ticket transactions. As already noted, the large-ticket market segment has much lower yields relative to the small- or middle-ticket segments: 3.72% (weighted-average) compared to 4.33% for middle-ticket transactions and 4.59% for small-ticket transactions. As Banks maintained a large share of large-ticket transactions in 2013, their yields remained lower than those of Captives of Independents.

Median Pre-Tax Yield

(percent)

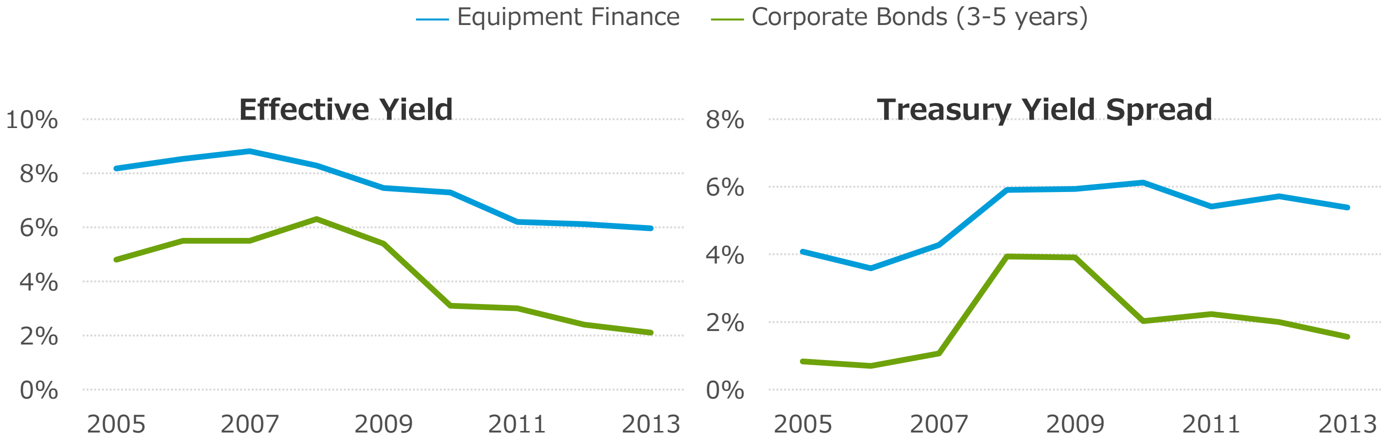


Source: 2014 ELFA Survey of Equipment Finance Activity

Despite declines, the equipment industry's yields and spreads are still high relative to corporate debt. Equipment yields have generally followed the path of financial markets, decreasing since 2007. However, equipment finance yields remain higher than those on corporate debt, making equipment finance relatively attractive to investors. Additionally, since 2006, the spread on equipment finance compared to 3-year U.S. Treasuries has risen slightly, while the spread on corporate bonds is now largely unchanged from its 2006 level.

Yield & Spread Comparison

(percent)

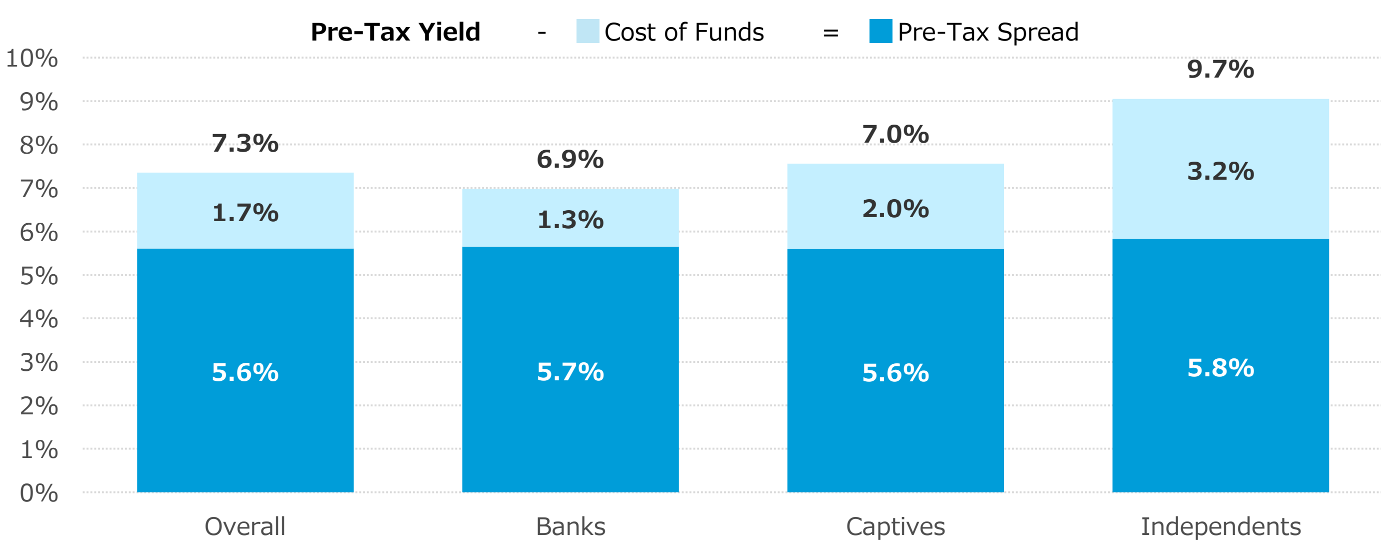


Source: 2014 ELFA Survey of Equipment Finance Activity, St. Louis Federal Reserve, Macrobond Financial, Keybridge LLC

The cost of funds, yield, and spread all declined for the small-ticket market segment in 2013. The median small-ticket pre-tax spread slipped from 5.66% in 2012 to 5.61% in 2013, as yields in the small-ticket market segment fell faster than cost of funds. Within the small-ticket market segment, Banks continue to have the lowest cost of funds yet have slightly higher spreads than Captives. Captives' cost of funds is on par with overall trends in the small-ticket market segment, despite their pre-tax yield being slightly lower. Additionally, Independents' pre-tax spread grew more in-line with the overall small-ticket segment in 2013.

Small-Ticket Equipment Finance Yield & Funding

(median; based on dollar amount)



Source: 2014 ELFA Survey of Equipment Finance Activity

Portfolio Performance

For the equipment finance industry, portfolio performance further strengthened in 2013. Key metrics – including delinquencies, nonaccruals, and charge-offs – continued to decline, reaching multi-year lows. Banks once again led Captives and Independents in portfolio performance, reflecting Banks' greater focus on high quality of credit. Both Captives and the small-ticket market segment saw significant improvement in their portfolio performance in 2013, while several industries – including Air Transportation, Water Transportation, and Bus & Transit Systems – stood out as being both fast-growth and low-risk. Thus far in 2014, portfolio performance looks strong, as charge-offs are hovering near historical lows; however, aging of receivables over 30 days spiked to 1.3% in August – the highest level in over a year. As the economic recovery further boosts industry confidence, lending standards are likely to loosen and therefore increase delinquency and charge-off rates. The fact that delinquency and charge-off rates have not yet increased suggests that the equipment finance industry has not forgotten the lessons of the financial crisis. Still, these metrics are likely to tick up, bringing an end to the record portfolio performances of 2012 and 2013.

Percent	Industry	Banks	Captives	Independents
Delinquent Portfolio Over 30 Days (weighted-average)	1.2%	0.7%	2.6%	1.2%
Non-accrual Assets as a Percentage of Receivables and Non-accrual Assets (weighted-average)	0.3%	0.2%	0.5%	0.7%
Net Full-Year Loss (Charge-off) as a Percentage of Full-Year Average Receivables (weighted-average)	0.20%	0.02%	0.53%	0.43%

Source: 2014 ELFA Survey of Equipment Finance Activity

Stronger portfolio performance comes with continued economic recovery. In the wake of the 2008-2009 financial crisis, portfolio performance improved in many sectors as lending standards tightened and the economy recovered from deep recession. Delinquency rates on consumer loans, business loans, and agricultural loans have continued to decline and now stand at – or even below – pre-recession levels. Both commercial and residential real estate loan delinquencies remain above pre-recession levels but have fallen significantly from their peaks; as of Q2 2014, commercial real estate loan delinquencies were 1.9%, down from 8.8% in Q2 2010, while residential real estate loan delinquencies were 7.4%, down from 11.3% in Q1 2010.

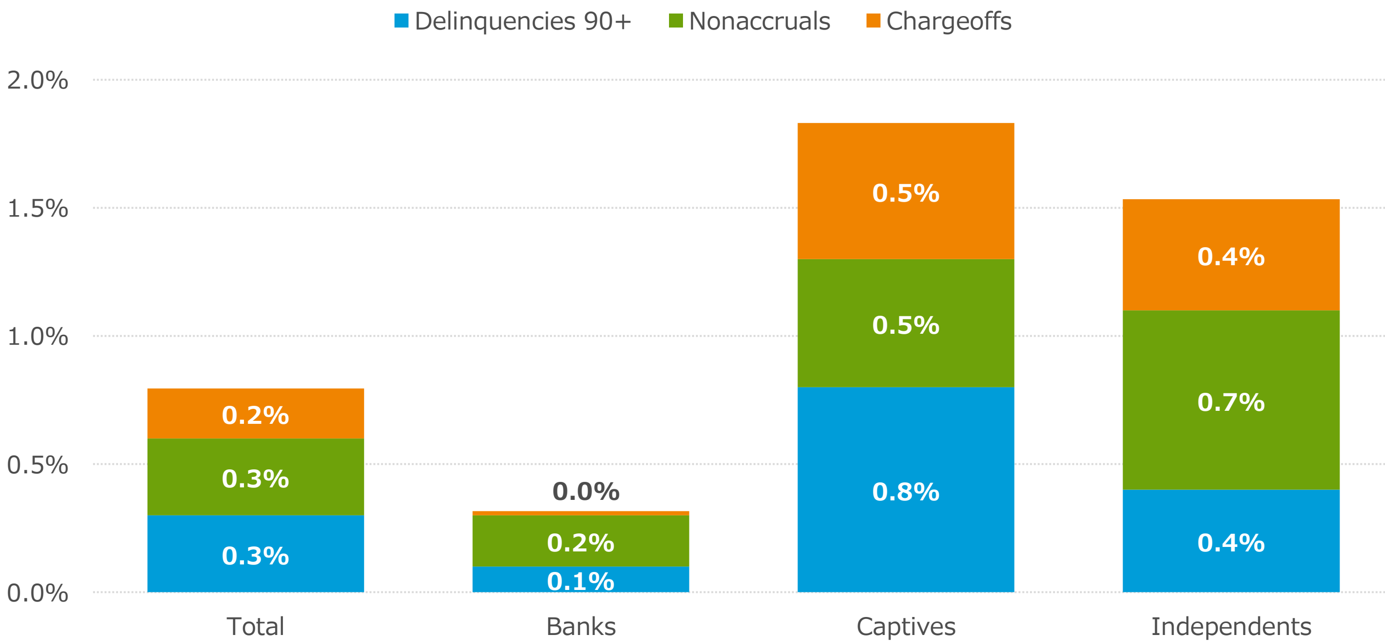
Overall, the equipment finance industry shows strong portfolio performance. The latest MLFI-25 data from ELFA showed that average losses (charge-offs) as a percentage of net receivables have remained at low levels (0.2%

year-over year) since March. Furthermore, the aging of receivables over 30 days stayed relatively low for most of the year; however, it jumped from 1.0% in July to 1.3% in August. Two ongoing trends – limited risk-taking by lessors and a solidifying economic recovery – continue to improve portfolio performance.

Once again, Banks led Captives and Independents in portfolio performance. Compared to Captives and Independents, Banks had the lowest levels for all three performance metrics: delinquencies over 30 days, accrual rates, and charge-offs. In particular, Banks' charge-offs, at only 0.02%, were substantially lower than those of both Captives (0.53%) and Independents (0.43%). Banks' strong portfolio performance relative to Captives and Independents reflects greater risk aversion from Banks; Captives may take on more risk to serve their parent companies, while Independents generally operate in riskier market segments to balance out their cost of funds disadvantage.

Portfolio Quality by Type of Organization

(weighted-average percent)



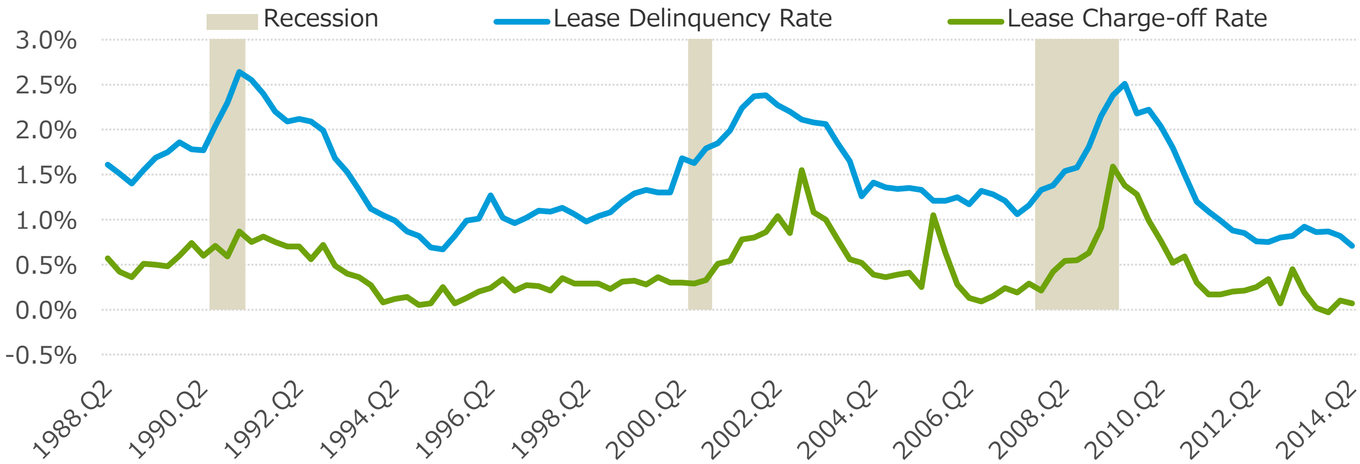
Source: 2014 ELFA Survey of Equipment Finance Activity

Delinquencies dropped sharply for Captives, while staying steady for Banks and Independents. Previously plagued by stubbornly-high delinquency rates, Captives saw their delinquencies decrease from 4.0% in 2012 to 2.6% in 2013. Both Banks and Independents had lower delinquency rates than Captives, which were unchanged from 2012 levels at 0.7% and 1.2%, respectively.

Loosening credit markets have yet to pull up delinquencies and charge-offs. Portfolio performance often matches the economic cycle, yet delinquencies and charge-offs have continued decline despite continued economic recovery and loosening credit standards. Over the past 30 years, lease delinquencies and charge-offs peaked during or shortly after a recession – from peak to trough, the "performance cycle" has averaged about 9 years. Both lease delinquencies and charge-offs peaked in 2009, immediately after the recession officially ended, and have declined over the last five years. After several years of consistently falling, delinquencies and charge-offs look to be bottoming out. Coupled with the strengthening economic recovery, the current stage in the performance cycle suggests that delinquencies and charge-offs are likely to slowly rise in the near term. Some industry experts worry that this is the "next shoe to drop" – a downturn in the economy could pull the cover off of several years of loosened credit standards, and portfolio performance could worsen significantly.

Lease Delinquencies and Charge-offs for all U.S. Commercial Banks

(annualized percent rate)



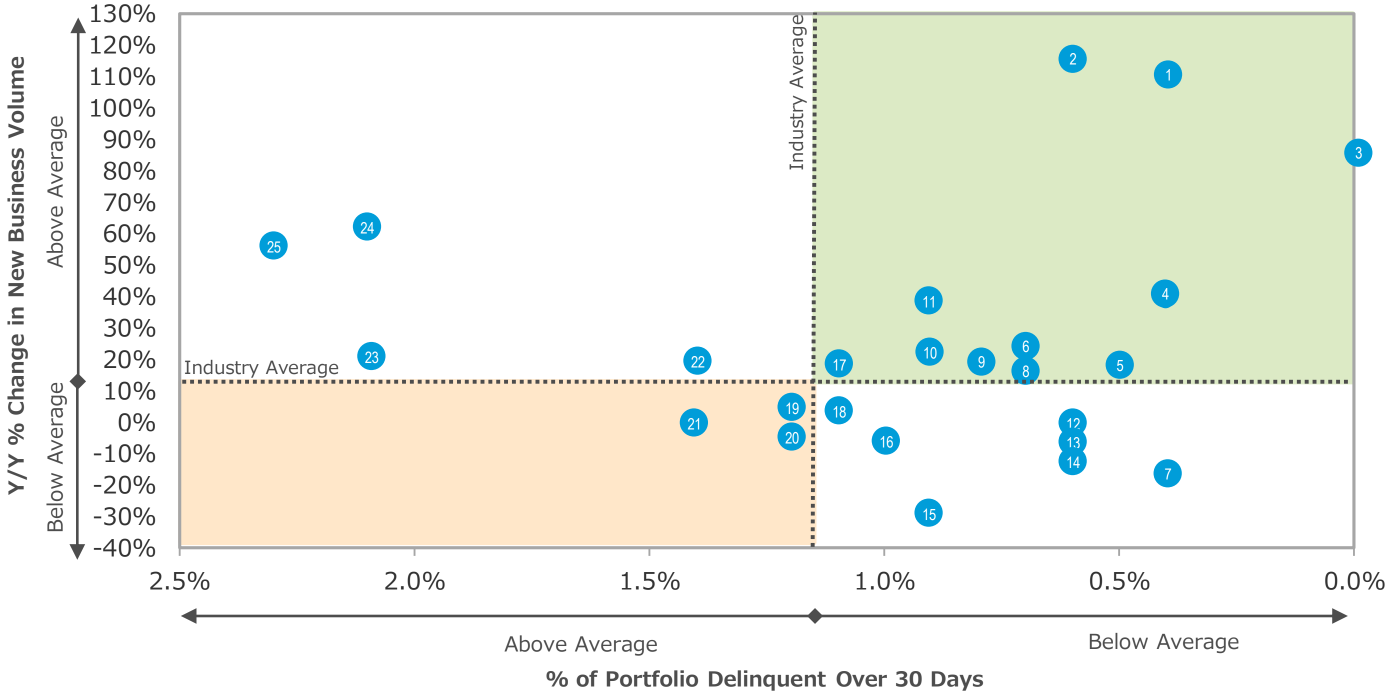
Source: Macrobond Financial, Federal Reserve

Mirroring 2012, the Printing and Publishing industry had the highest delinquency rate in 2013, while Water Transportation had the lowest. The Printing and Publishing industry had the worst delinquency and non-accrual rates out of the 25 end-user industries, with 2.3% of receivables delinquent by over 30 days and 1.3% classified as non-accrual assets. Printing and Publishing has been struggling for years due to the emergence of electronic-reading technologies and also had the worst portfolio performance out of the end-user industries in 2012. With 2.1% of receivables delinquent over 30 days, the Federal Government and Wood, Paper, & Other Manufacturing had the second-worst delinquency rates. Lastly, Construction continued to have weak portfolio performance in 2013, marked by high delinquency and non-accrual rates.

Overall, end-user industry analysis points to mixed, yet strong overall portfolio performance. Out of 25 end-user industries, 17 experienced higher delinquency rates in 2013; however, several industries, including Construction, Agriculture, and Truck Transportation, saw improvements in their delinquencies. Additionally, all 25 end-user industries had lower accrual rates in 2013 than in 2012, indicating that portfolio performance generally strengthened in 2013.

Pairing delinquency rates and growth in new business volumes reveals attractive industries that equipment lessors and financers can target. Differentiation among industries is a crucial focal point for businesses that seek to either increase their business volume in existing markets or to penetrate new markets. In terms of equipmentintensive industries, some continue to grow, while others continue to lag – which has a salient effect on their ability to remain current on loans and leases. The figure below plots the year-over-year change in new business volume and delinquency rates by end-user industry, offering a summary of each end-user industry's risk level and growth rate. The matrix offers insight into the movement of industries over the past year and can be instructive for equipment asset allocation and business expansion efforts.

Risk-Growth Analysis by End-User Industry



1. Transportation – Air
2. Pipelines
3. Transportation – Water
4. Transportation – Bus, Transit
5. Services – Accommodation/Food
6. Industrial – Other
7. Services – Transportation
8. Transportation – Railroad
9. Transportation – Truck
10. Wholesale / Retail
11. Telecommunications
12. Finance, Insurance, Real Estate
13. Utilities
14. Services – Educational
15. Government – State & Local
16. Industrial – Metal & Machinery
17. Agriculture, Forestry, Fishing
18. Mining / Oil & Gas Extraction
19. Services – Health
20. Services – Arts, Entertainment & Rec.
21. Services – Other
22. Construction
23. Industrial – Wood, Paper, Chem. & Plastic
24. Government – Federal
25. Printing, Publishing

Source: 2014 ELFA Survey of Equipment Finance Activity

Several transportation sectors – including Air Transportation, Pipelines, Water Transportation, and Bus & Transit Systems – were in the fast-growth / low-risk category. In the chart above, the industries within the top right quadrant of the matrix – including Air Transportation, Pipelines, Water Transportation, and Bus & Transit Systems – were among the fastest-growing and best-performing industries in 2013. However, industries in the bottom left quadrant, such as Printing & Publishing, experienced both higher-than-average delinquencies and slow-to-negative growth.

Non-accruals and charge-offs declined for the small-ticket market segment in 2013. For small-ticket transactions, net full-year losses (charge-offs) as a percentage of full-year average receivables dropped from 0.4% in

2012 to 0.2% in 2013, and non-accrual assets ticked down from 0.5% to 0.4%. Although delinquencies increased slightly from 1.4% to 1.5%, the data paint a picture of improving portfolio performance for small businesses. Taken with the small-ticket market segment's strong new business volume growth in 2013, decreasing non-accruals and charge-offs point to an economic turnaround for small businesses.

Delinquencies and charge-offs are likely to tick up as the economy continues to recover. Delinquencies have remained at historically low levels for most of 2012 and 2013. Due to the economic downturn, some lower-quality borrowers — in particular, many small businesses — were likely extended less credit, which may have resulted in selection bias in the performance benchmarks. As equipment lessors and financers look for more business opportunities and broaden their lending base, it is possible that delinquencies could rise marginally as the composition of the lending base changes. This will be a trend to watch and a potential concern if risk is not appropriately priced. Lowering credit standards is one way for businesses to grow, particularly in an environment where companies fight for market share; however, this may adversely affect the industry's risk/return profile. As mentioned previously, the ongoing economic recovery is likely to bring up delinquencies and charge-offs, which have stayed historically low. Greater confidence in the economy, receding scars of the financial crisis, and increased competition within the equipment finance industry could work to lower credit standards, which industry experts generally do not see as a major risk.

Many industry experts predict portfolio performance to slightly weaken. Both the strengthening economy and the equipment finance industry's record portfolio performance are likely to boost confidence and cause businesses to loosen their lending standards. In interviews, several industry participants noted a gradual shift towards less-stringent standards and more aggressive deal structures compared to those of the past two years. As a result, delinquencies and charge-offs are expected to increase from their current lows. However, few industry experts conveyed alarm over the pace of credit-loosening or the structuring of deals, particularly in comparison to trends seen prior to the financial crisis of 2008-2009.

Business Operations

Trends in business operations in 2013 reflect the equipment finance industry's ongoing efforts to increase productivity and efficiency – largely a reaction to increased competition. Looking at the industry average, two key metrics for productivity and efficiency improved in 2013: new business volume per sales full-time equivalent (FTE) and applications booked & funded/sold as a percent of applications approved. Within the industry, however, a clear divergence has emerged between Captives and Banks & Independents. Namely, Captives achieved productivity and efficiency gains in 2013, pulling them further ahead of Banks and Independents. Additionally, residual values of equipment increased in 2013, suggesting that equipment lessors are accepting more risk in exchange for potential profits from longer equipment life-cycles. Again, Captives led this trend, while Banks' and Independents' residual positions were little changed. Finally, industry employment grew in 2013 after slipping in 2012.

Thousands of Dollars or Percent	Industry	Banks	Captives	Independents
Booked & Funded/Sold as a Percent of Approved (based on $ amount)	71.0%	67.7%	78.8%	64.6%
Residual or Salvage Position as a Percent of Original Equipment Cost	25.4%	23.0%	37.5%	19.3%
Percentage of Full-Time Equivalents (FTE) in Sales/Origination	23.5%	25.7%	16.1%	30.8%
New Business Volume per Sales Full-Time Equivalent	$22,385	$23,521	$34,539	$7,130
Sales, Gen & Admin Expense per FTE	$267	$185	$233	$584

Source: 2014 ELFA Survey of Equipment Finance Activity

An emphasis on efficiency. In a hyper-competitive environment, the equipment finance industry has placed greater emphasis on efficiency and on providing "value-added" to customers. As evidenced in the 2014 SEFA data and in interviews with industry professionals, improved efficiency and productivity reflect an effort to reduce costs in the face of compressed margins. Many industry participants also noted a gradual shift towards greater specialization as a way for businesses to distinguish themselves from competitors. Independents have generally made progress by altering their business models, while Banks are farther behind on this trend and are more likely to specialize in a new market segments through acquisitions. Overall, as increased competition and low rates have largely benefitted customers, some equipment lessors are finding new ways of attracting new business.

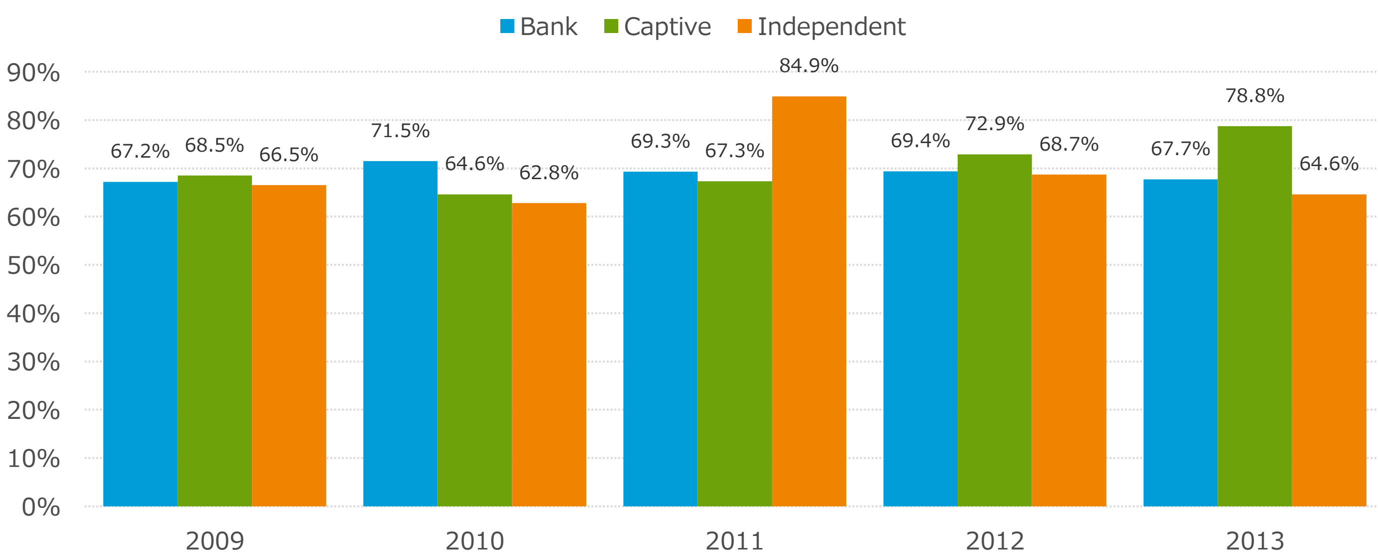
Data from the SEFA cover a wide range of business operations data, from all stages of the new business that equipment lessors and financers execute. This report discusses the most important metrics within the context of broader trends in business operations.

Approval rates increased in 2013, and Captives continued to approve the largest share of applications submitted. The industry-wide approval rate increased from 68.9% to 70.7% in 2013, driven by higher approval rates from Banks and Independents. Despite declining in 2013, Captives' approval rate – at 82.9% - remained much higher than those of Banks or Independents. Once again, this trend reflects Captives' focus on facilitating the sale of their parent manufacturers' products, which causes them to often be more flexible on credit quality. Banks, on the other hand, place more emphasis on high credit quality; their approval rate (based on dollar amount) was 66.8% compared to Captives' 82.9%.

Applications booked & funded/sold as a percent of applications approved increased for Captives, yet decreased for Banks and Independents. Applications booked and funded/sold as a percent of applications approved (dollar amount) ticked up from 70.4% to 71.0%, likely reflecting industry-wide efforts to increase efficiency in the face of heightened competition. While both Banks' and Independents' "booked/funded/sold-to-approved" ratios decreased slightly in 2013, Captives' ratio jumped nearly six percentage points to 78.8%.

Applications Booked & Funded/Sold as a Percent of Approved

(based on dollar amount)



Source: 2009 through 2014 ELFA Surveys of Equipment Finance Activity

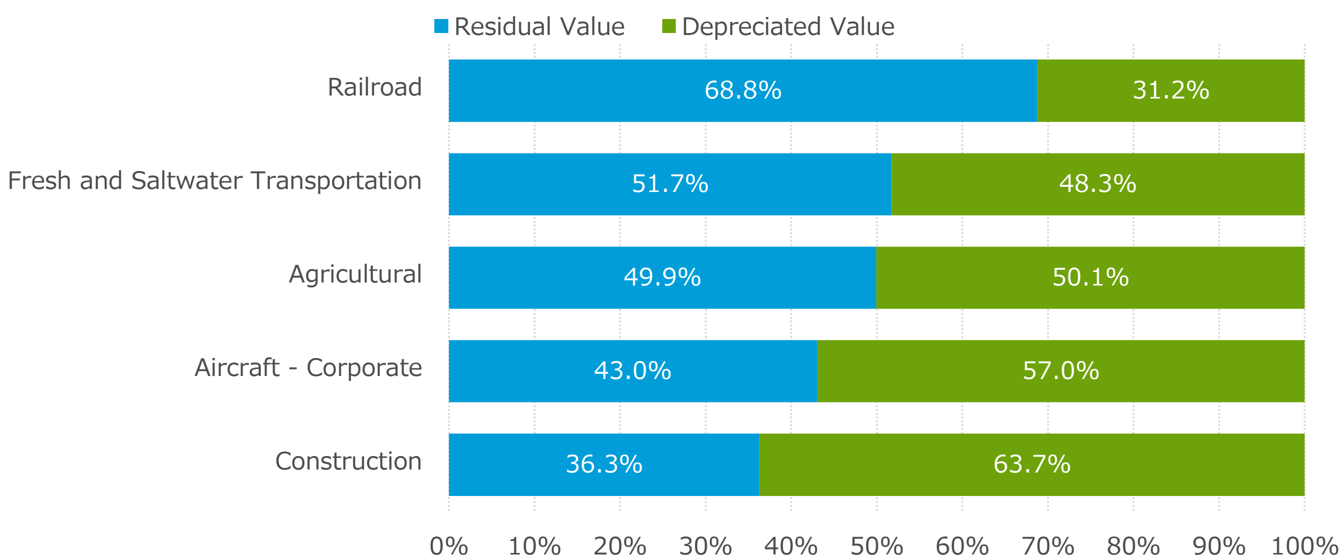
Captives continued to lead Banks and Independents in operational efficiency. Captives' "booked/funded/sold-to-approved" ratio remained higher than Banks' and Independents' ratios in 2013, at 78.8% versus 67.7% and 64.6%. Furthermore, as efficiency increased for Captives in 2013 but fell for Banks and Independents, the efficiency "gap" separating Captives from Banks and Independents expanded. Key to understanding this difference is Captives' business model, which focuses on bringing in business for their parent companies. As such, Captives not only lead in applications booked and funded/sold as percent of approved but also in other efficiency metrics, including applications approved as a percent of those submitted.

The average residual position as a percentage of original equipment cost (OEC) increased to 25.4% in 2013, driven by Captives' high residual positions. The average residual position as a percent of OEC slipped for Banks and Independents, while Captives' average residual position increased sharply from 29.8% to 37.5%. Once again, Captives had the highest residual position out of the three organization types: 37.5% compared to Banks' 23.0% and Independents' 19.3%. Moreover, while Captives' residual position led the industry average by roughly six percentage points in 2012, Captives' residual position was twelve percentage points above the industry average in 2013 – a twofold increase.

Below are the five equipment types with the highest residual value as a percentage of the original equipment cost – Railroad, Fresh and Saltwater Transportation, Agriculture, Corporate Aircraft, and Construction. The top five industries in 2013 are nearly identical to those in 2012, with the exception of Corporate Aircraft replacing Commercial Aircraft. Conversely, among those equipment types with the lowest residual value as a percentage of original equipment cost are three Computer sub-industries: Software (0.3%), POS, Banking Systems, & ATMs (1.0%), and Storage (2.1%).

Top Five Equipment Types with Highest Residual Value

(based on dollar amount)

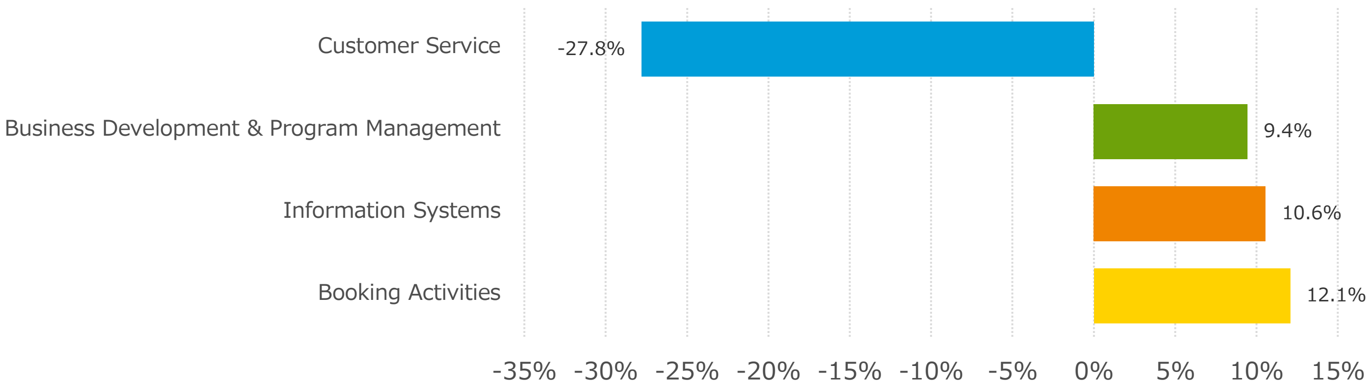


Source: 2014 ELFA Survey of Equipment Finance Activity

After declining 0.3% in 2012, employment among SEFA respondents increased 2.0% in 2013. Job creation was not evenly dispersed among employment sub-categories; eleven experienced growth, while nine contracted. The chart below shows the four employment sub-categories with the largest shifts in 2013. Booking Activities, Information Systems, and Business & Program Management all saw strong growth, yet Customer Service employment fell sharply. The areas of growth, which also include Credit Approval Activities, suggest a renewed focus on efficiency and productivity. Conversely, decreased employment within Servicing Activities (which includes Customer Service) indicates that the equipment finance industry may be placing less focus on customer relations.

Changes in Employment: Select Sub-Categories

(year-over-year percent change)



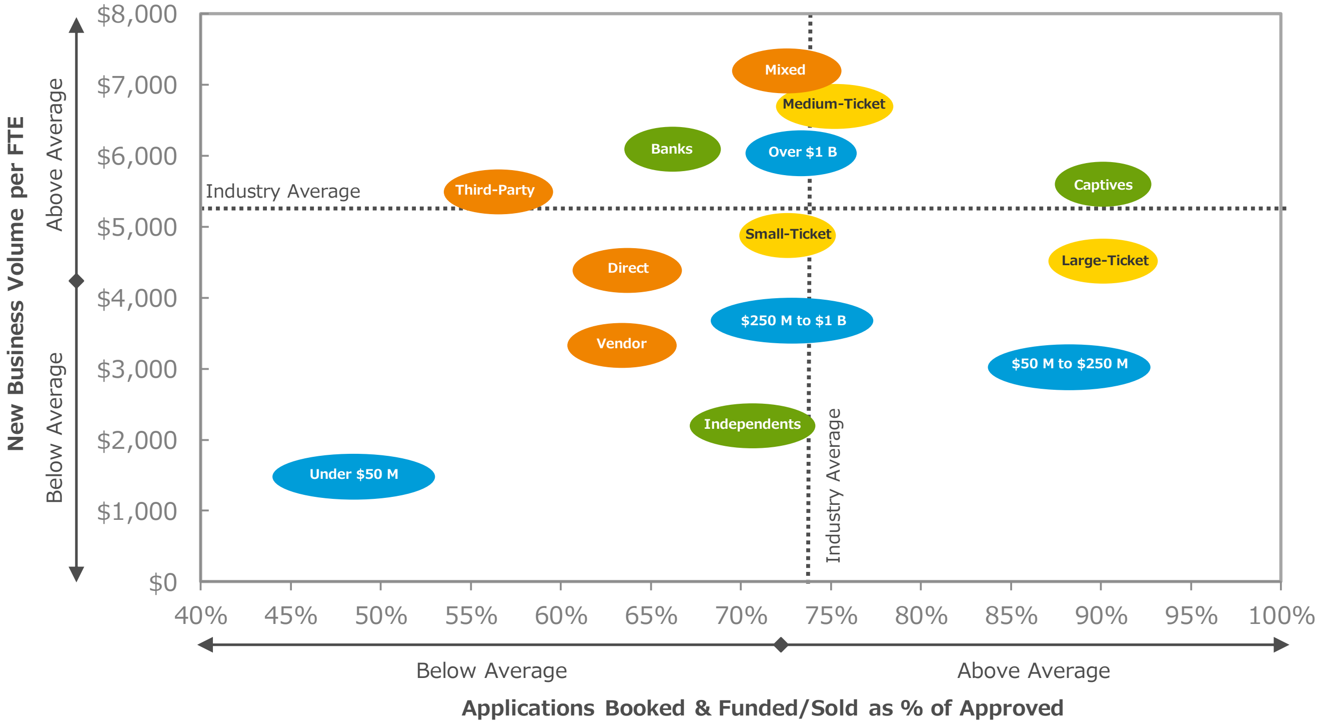
Source: 2014 ELFA Survey of Equipment Finance Activity

After solid growth in 2013, employment in the equipment finance industry looks to be leveling off in 2014. The latest ELFA MLFI-25 data showed slowing employment growth in recent months after peaking at 4.5% year-over-year in March 2014. In fact, year-over-year employment growth was just 0.5% in July – the lowest rate in over a year – before ticking up to 1.0% in August. Despite slowing in August, economy-wide job growth was strong for much of the spring and summer, and these gains suggest that the equipment finance industry will see positive employment growth through 2014.

As the competition increases within the industry, productivity has steadily improved. New business volume per sales full-time equivalent ("FTE") reached a five-year high in 2013, with gains seen across all three organization types. However, as noted last year, we may be seeing a divergence in productivity trends between Banks and Captives; Captives' new business volume per sales FTE was much higher and fast-growing compared to Banks. Additionally, Independents' productivity trend looks to be finally rebounding after several years of weak or negative growth. However, at $7,130 compared to Banks' $23,521 and Captives' $34,539, Independents' new business volume per sales FTE is by far the lowest among organization types. In part, this difference reflects Independents' greater weight on sales employment; over 30% of employment among Independent SEFA respondents was in Sales/Origin, compared to 26% for Banks and 16% for Captives.

The efficiency-productivity matrix offers a breakdown of which organizations have the best and worst business operations. On the following page is a two-by-two matrix that plots productivity and efficiency by organization type in green (Banks, Captives, and Independents), ticket size in yellow (small, medium, and large), origination channels in orange (direct, vendor, third-party, and mixed), and lessor size in blue (under $50 million in new originations, $50 million to $250 million, $250 million to $1 billion, and over $1 billion).

Efficiency & Productivity Matrix



Source: 2014 ELFA Survey of Equipment Finance Activity

Only Captives and the Medium-Ticket market segment had efficiency and productivity levels that were both above the industry average in 2013. As already noted, Captives led Banks and Independents in both efficiency (applications booked and funded/sold as a percent of approved) and productivity (new business volume per FTE) in 2013. The medium-ticket market segment also showed strong efficiency and productivity, while organizations with over $1 billion in origination had above-average productivity and about-average efficiency. Conversely, small organizations – those with total originations under $50 million – exhibited weak efficiency and productivity. Clearly, productivity increases with organization size, as larger organization benefit from economies of scale.

A recent increase in mergers and acquisitions (M&A) activity may be driving efficiency and productivity gains. Multiple individuals in the equipment finance industry noted that mergers and acquisitions were picking up as the industry matured and consolidated. However, one industry expert stated that M&A activity is currently largely confined to smaller-scale acquisitions by Banks looking to expand into new market segments and that larger mergers between Banks are not expected in the near future.

Looking ahead, technology is likely to shape the equipment finance industry, as both a potential disruptor and benefit. When asked about longer-term trends shaping the industry, several individuals named technology as a key shift over the next ten years. Industry participants saw various ways for technology to shape their business, from increasing efficiency to improving data management and creating new ways to access potential customers. While some noted technology as a potential disruptor, hurting some businesses within the equipment finance industry, many viewed technology more as an enabler of future innovation and growth within the industry.

Credit decision turnaround time increases with transaction size. Calculated several ways using different timing methodologies, credit decision turnaround time (weighted-average) was consistently the shortest for transactions under $250,000 and the longest for transactions over $5 million. For example, measuring turnaround time from the initial customer contact to the initial credit decision, transactions less than $250,000, between $250,000 and $5 million, and over $5 million had credit decision turnaround times of 3.4 hours, 2.2 days, and 3.3 days, respectively.

Financial Performance

As predicted last year, financial performance in the equipment finance industry remained strong in 2013, yet spread compression and increased competition caused profitability to dip. Key profitability ratios, including return on assets, return on equity, and income to revenue, declined in 2013 following record-setting 2012 levels. On the other hand, coverage ratios continued to fall in 2013, reflecting low interest rates, yet this trend is likely to reverse as interest rates rise. Looking ahead, solid new business volume growth and productivity gains will help the industry's performance in 2014 and 2015. Conversely, rising interest expenses and steep competition may weigh on financial performance in the near future.

Percent (Median)	Industry	Banks	Captives	Independents
Return on Total Average Assets (ROA)	1.9%	1.5%	3.0%	2.3%
Return on Average Equity (ROE)	14.7%	17.4%	13.5%	11.2%
Sales & Marketing Expense as Percent of Total Revenue	8.9%	8.4%	6.5%	10.8%
Debt as Percent of Total Assets	79.1%	83.5%	66.3%	73.9%
Debt to Equity	5.5	8.6	2.8	3.8
Liabilities to Equity	6.2	10.7	4.2	3.9

Source: 2014 ELFA Survey of Equipment Finance Activity

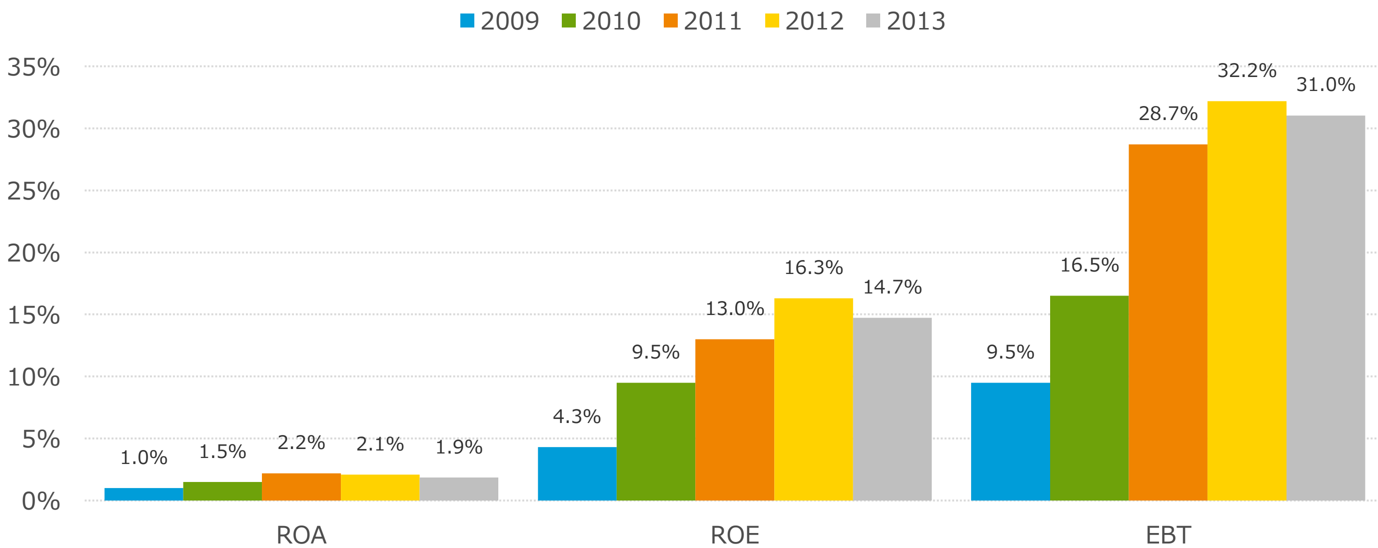
While profitability declined for the equipment finance industry, corporate profits are at record highs. An indication of strong economic fundamentals, corporate profits have risen to a record-high of $1.8 trillion in Q2 2014, well above the pre-recession high of $1.4 trillion in Q3 2006. However, there is some concern that companies are not reinvesting these record profits but are instead engaging in stock buy-backs and hoarding cash, particularly when faced with uncertainty over corporate tax policy. This continued business uncertainty and steep industry competition are both weighing on equipment finance profitability.

Lower profitability mirrors performance trends seen in traditional financial activities. Both Return on Average Assets (ROA) and Return on Average Equity (ROE) for all U.S. banks remain below their pre-recession peaks and have actually dipped from 2013 levels. In Q1 2014, ROA was 1.03%, compared to 1.12% in Q1 2013; similarly, ROE was 9.13%, down from 9.91% a year earlier. Overall, moderate bottom-line performance for traditional financial activities helps explain investors' continued search for yield.

Despite slipping in 2013, profitability ratios remained at healthy levels. Return on average assets, return on average equity, and pre-tax income as a percent of total revenue all ticked down in 2013. However, all three profitability metrics remained elevated compared to previous years; both return on assets and return on equity were above their 2011 levels. Considering that the equipment finance industry experienced record-setting profitability in 2012, the declines seen in 2013 point to the industry moving back to long-term averages. Below is the five year historical trend for these three indicators:

Profitability Ratios, Five-Year History

(median)



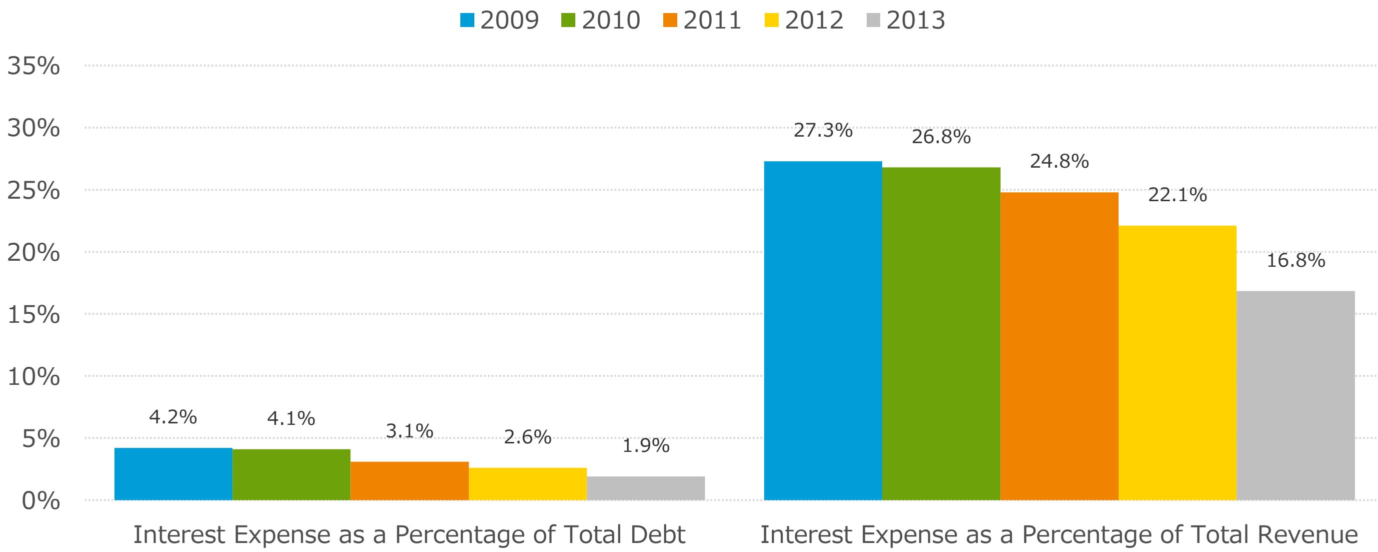
Source: 2014 ELFA Survey of Equipment Finance Activity

Banks continue to outperform Captives and Independents in terms of return on average equity. Mirroring 2012 trends, Banks had the highest return on average equity (median), at 17.4%, followed by Captives (13.5%) and Independents (11.2%). However, at 3.0%, Captives saw the highest return on average assets (median) in 2013, followed by Independents (2.3%) and Banks (1.5%).

Further declines in coverage ratios point to the equipment finance industry's strong financial performance. Interest expense as a percent of both total debt and total revenue fell for the sixth consecutive year in 2013. In fact, as shown in the chart on the next page, the rate of decrease picked up for both coverage ratios; interest expense as a percent of total debt fell from 2.6% to 1.9%, and interest expense as a percent of total revenue fell from 22.1% to 16.8%. On the following page is the five year historical trend for these two indicators:

Coverage Ratios, Five-Year History

(median)



Source: 2014 ELFA Survey of Equipment Finance Activity

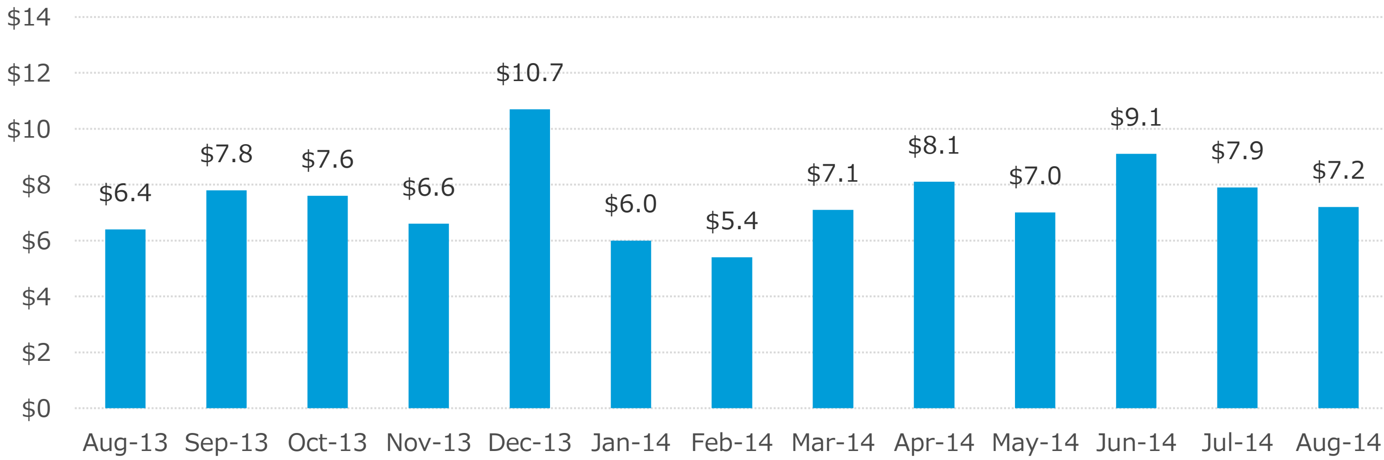
Low interest rates continue to bring down coverage ratios, but shifting Fed policy is set to reverse this trend. As the Federal Reserve plans to end its bond-purchasing program (QE3) in October, interest rates will drift up, while an improving economy should also continue to pull up interest rates. Furthermore, the Fed is now debating the timeline for its first interest rate hike, which the market puts at mid-2015. These combined factors will change the interest-rate environment in coming years and will likely lead equipment lessors to increase their rates and could pull forward investment.

Overall, industry experts welcome higher interest rates. Multiple interviewees expressed a readiness for the Federal Reserve to raise interest rates. While a few noted that a too-fast transition could further compress spreads, many predicted the Federal Reserve to gradually raise interest rates, posing little risk to the equipment finance industry. Several industry participants also predicted that rising interest rates will ease some of the hyper competition currently facing the industry and thus improve profitability.

So far in 2014, new business volume is down slightly from levels seen in the second half of 2013. The last six months of 2013 saw average new business volume growth (year-over-year) of $7.7 billion, while the first eight months of 2014 averaged $7.2 in monthly new business volume growth. However, when compared to the same time period from last year (January through August), new business volume is nearly 6% higher in 2014, pointing to moderate industry growth this year.

MLFI-25 New Business Volume

(billions of dollars)



Source: ELFA

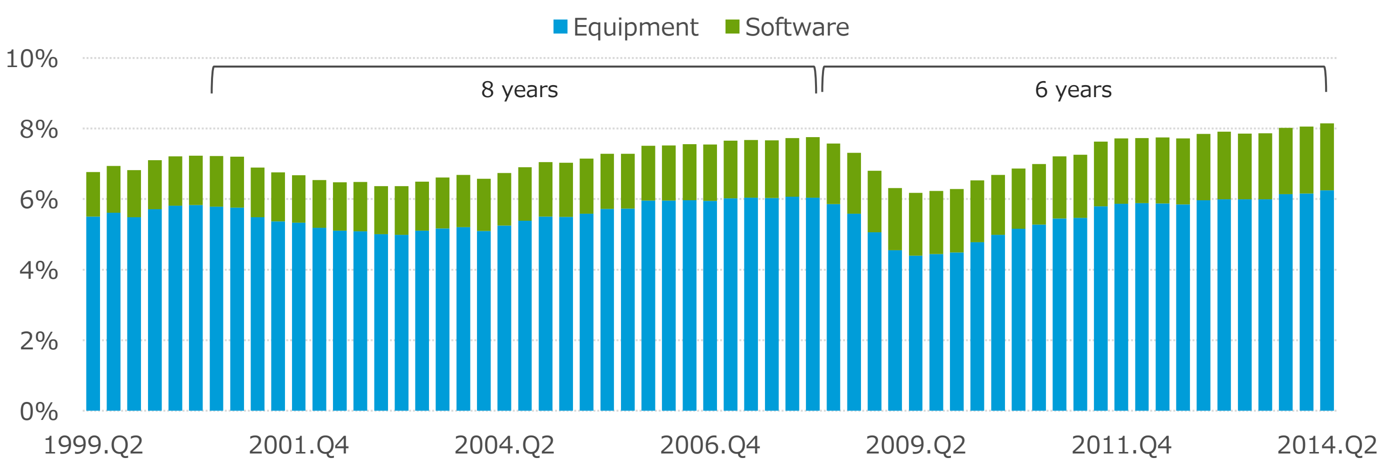
Growing competition, rising interest rates, and business confidence are among factors shaping the industry's financial performance. Looking ahead, these factors may weigh on the financial performance of the equipment finance industry. As a mature industry, equipment finance is likely to experience continued competition. However, improving business confidence and rising interest rates are both factors set to benefit the industry's financial performance by providing room for margin expansion. An acceleration in the economy recovery or, conversely, an escalation of global conflicts are events likely to impact business confidence. Otherwise, a steady economic recovery should slowly improve confidence and put moderate upward pressure on interest rates.

Long-term Equipment Investment Trends

The equipment investment cycle is driven by both macroeconomic forces and industry-level trends. In 2013 and 2014, one of the most dominant forces has been the equipment investment cycle. Measured by equipment and software investment as a share of GDP, the U.S. is 6 years into the current cycle and has already exceeded the prior peak in Q1 2008. Over the past 30 years, the equipment cycle has averaged 8 years, suggesting the current cycle has several years remaining. However, as the cycle has neared a peak in 2013-2014, there has been a convergence of growth in equipment and software investment and the overall economy. With capacity utilization below expansionary levels, and the post-recessionary replacement cycle slowing down, it is unlikely that capital spending will reach significantly faster growth than U.S. GDP over the course of the next 1 to 2 years. In this context, this section highlights the key long-term trends affecting the equipment finance sector as a whole, as well as particular verticals.

Equipment Investment Cycle

(percent of real gdp)



Source: Macrobond Financial, Keybridge LLC

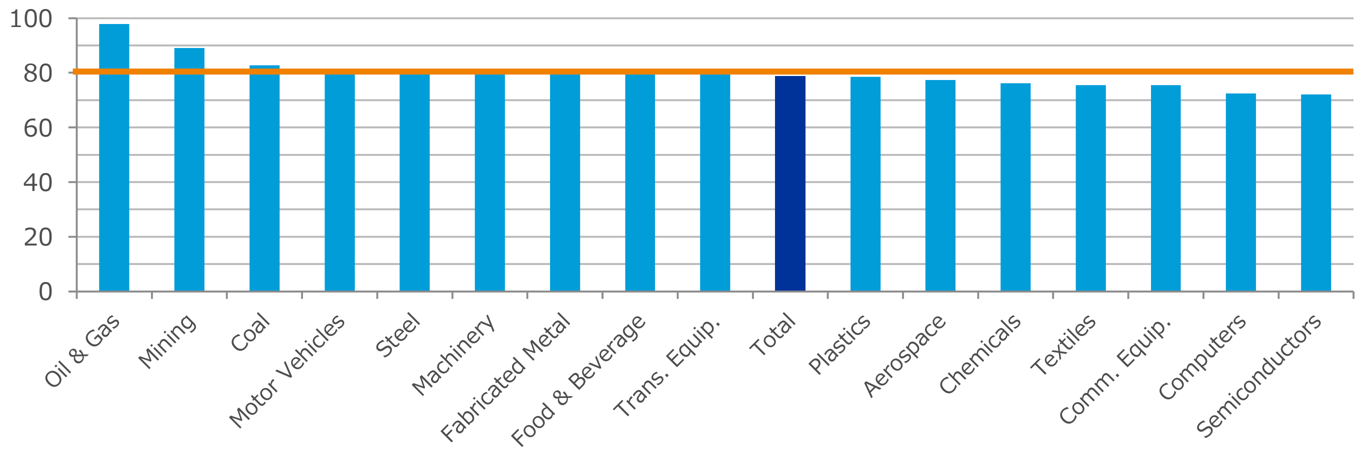
Equipment investment continues to increase yet may be nearing a peak. Equipment and software investment as a share of GDP is now 8.1%, an all-time high. Since 1999, software investment has consistently increased as a share of GDP, reflecting businesses' increased usage of software over time, while equipment investment as a share of GDP has fluctuated. In the past year, however, equipment investment has been the main driver of growth; software investment has hovered around 1.9% of GDP since Q2 2013, yet equipment investment has increased from 6.0% to nearly 6.3% of GDP. Additionally, at $1.00 trillion and $300 billion, respectively, in Q2 2014, both equipment and software investment are at record-highs in terms of dollar value.

Historical data shows that the equipment investment cycle lasts an average of 8 years, yet equipment and software investment's recent record highs suggest that the current cycle may have already reached a peak. If, in fact, equipment investment is nearing a peak, growth in the equipment finance industry may slow in the near term. This outlook is consistent with the modest growth expected by some industry experts in 2014.

Slack capacity is holding back capital spending. In addition to the equipment cycle appearing to be near a peak, another factor holding back more robust growth in capital spending is slack capacity. The private sector typically begins to add new production capacity when utilization rates hit 80% or higher. Economy-wide capacity utilization has been stuck at 79%, and only a handful of manufacturing sectors have crossed the threshold – these include the energy sector and heavy manufacturing industries.

Capacity Utilization

(percent)

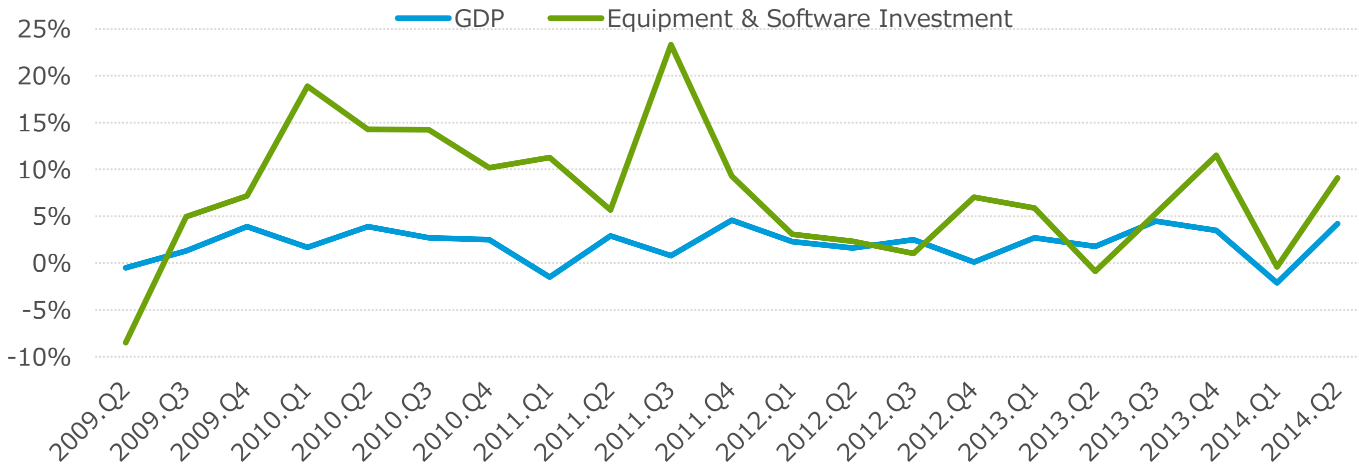


Source: Macrobond Financial, Keybridge LLC

Growth in capital spending and the overall economy are converging. Beginning in Q3 2009, growth in real equipment and software investment has exceeded real GDP growth for all but two quarters of the economic recovery. Between Q1 1999 and Q2 2009, equipment and software investment expanded at a faster rate than GDP roughly half the time, compared to 90% of the quarters since the recovery began. This divergence highlights equipment and software investment as a consistent source of strength for the U.S. economy following the recession. However, as the equipment cycle has matured, sector and economy-wide growth rates have converged. Going forward it is unlikely that equipment and software investment can continue to consistently outpace overall growth.

Real GDP and Equipment & Software Investment Growth

(percent change q/q, saar)

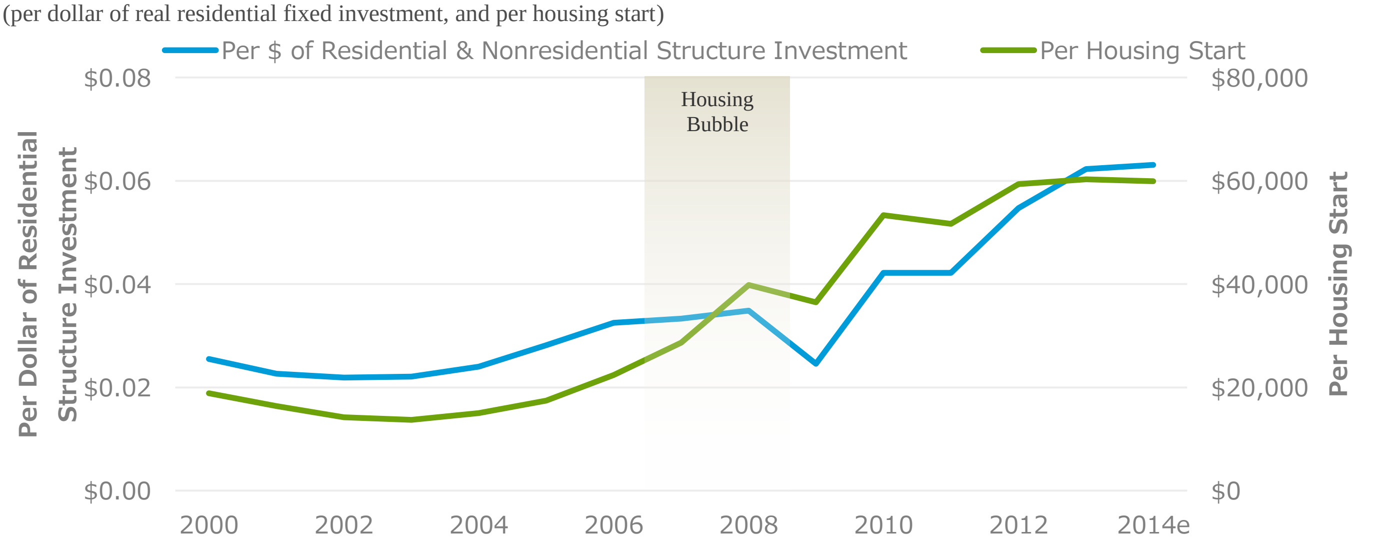


Source: Macrobond Financial

Is construction equipment investment at its peak? Starting in 2008, there was a build-up in construction machinery, and the latest data suggest that the sector may be reaching a peak. Construction equipment investment per housing start and per dollar invested in residential & nonresidential structures increased during the housing bubble before dipping in 2009. Interestingly, construction equipment investment did not return to pre-housing bubble levels during the economic recovery but instead resumed its upward trend (see chart below). Based on data from the first half of 2014, however, construction equipment investment appears to be leveling off and – as seen in construction equipment investment per housing start – even decreasing slightly.

Real Construction Equipment Investment

(per dollar of real residential fixed investment, and per housing start)



Source: Bureau of Economic Analysis, U.S. Census Bureau, Keybridge LLC

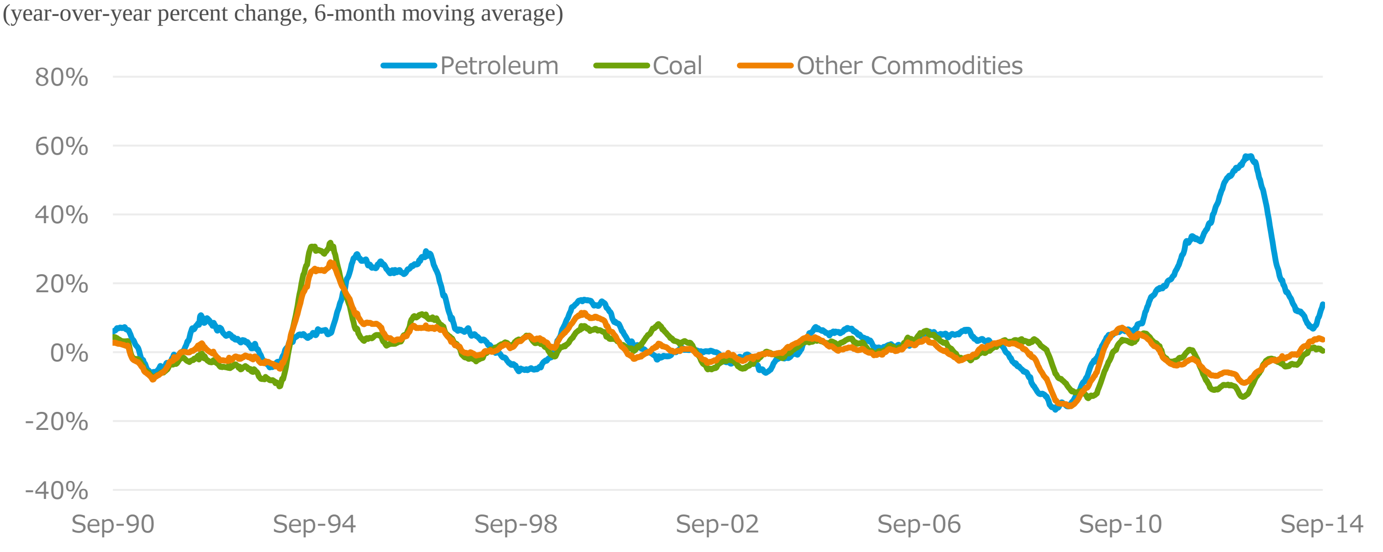
In part, this slowdown in construction equipment growth reflects a housing recovery which has repeatedly failed to gain momentum. The housing recovery remains "herky-jerky," characterized by a largely-recovered multi-family market and a disappointing single-family market in which many households are still hesitant to purchase a home. Mixed data point to a sector struggling to accelerate; for example, housing starts surged 22% in July before falling 14.4% in August. Similarly, existing home sales increased in July yet slipped 1.8% in August. Other recent data has been solidly positive. The Housing Market Index, an indicator of builders' confidence, increased to 59 in August, its highest level since November 2005, and new home sales surged 18% in August, the biggest monthly increase since 1992. Given these factors, growth in construction equipment investment should continue to moderate as the level of equipment normalizes compared to the level of construction activity.

Update on the U.S. manufacturing renaissance: Is it for real? Amidst debate over the legitimacy of a U.S. manufacturing rebound, the last few months have seen an ongoing solidification of the industrial sector, which is shaping up to be a major bright spot in 2014. Key indicators of manufacturing experienced strong increases through most of the summer; industrial production rose for six consecutive months through July, auto sales surged to a nine-year high in August, and the ISM Manufacturing Index – a leading indicator of industrial expansion and confidence – hit a three-year high in August. While both industrial production and manufacturing output slipped in August, they were still up 4.1% and 3.6%, respectively, year-on-year. In addition to increased output, the U.S. manufacturing sector is also gaining competitiveness vis-à-vis other countries, in large part due to low energy costs. Analyzing multiple manufacturing cost categories, an April Boston Consulting Group report listed the U.S. as a "rising star" of manufacturing competitiveness.[ii] Out of the top 25 exporting countries, the report found that the U.S. is now the second most competitive, behind China. Moreover, the manufacturing cost gap between the U.S. and China is narrowing; compared to China, U.S. manufacturing costs were 14% higher in 2004 but are only 5% higher today. Recent data and research suggest that the U.S. manufacturing renaissance is, in fact, real and point to prolonged benefits to the U.S. economy. As manufacturers expand their operations and "reshore" facilities back to the U.S., industrial equipment investment is likely to increase, particularly for durable goods manufacturing. Furthermore, future expansions in the U.S. manufacturing sector are likely to be capital-intensive, requiring equipment investment more than additional labor.

How does a shifting domestic energy picture affect railroad equipment investment? While much has been said about the U.S. energy boom's impact on the industrial sector, surging domestic oil production also presents new opportunities for the railroad industry. As high capital expenses, limited flexibility, and longer construction time are obstacles to constructing new pipelines for transporting crude oil, the rail industry has become a lasting alternative. Today, 1.6 million barrels per day, or about 20% of the oil produced in the U.S., is transported by rail. Similarly, in Canada, the amount of crude oil shipped by rail has quadrupled since 2012. Rail companies have already invested in new facilities and equipment to load, transport, and unload crude oil, with more projects in the planning stages. However, key uncertainties come from (1) competition with pipelines and (2) increased regulations spurred by safety concerns. The Department of Transportation recently proposed new measures requiring companies to test crude oil before transporting it by rail, among other requirements. Overall, shipment of crude oil is among the fastest-growing segments of rail transportation – seen in the surge in carloads of petroleum since 2010. Additionally, the rail industry stands to benefit from transporting both supplies needed for oil and gas production, such as sand, and petrochemicals, production of which has been boosted by lower energy costs.

Rail Traffic - Carloads Originated

(year-over-year percent change, 6-month moving average)



Source: Macrobond Financial

Another aspect of the changing domestic energy picture is also affecting the rail industry. While crude by rail has increased, rail shipments of coal have declined over the past several years, reflecting lower coal exports, price competition with natural gas, and the implementation of new EPA regulations. The combination of abundant natural gas resources and new environmental regulations has made the operation of coal plants costlier. Thus, since 2007, coal's annual share of domestic net electricity generation has declined from 50% to 39%, and it is expected to decrease through 2040.[iii] Coal's declining competitiveness is impacting the rail industry – coal carloads fell to 5.8 million in 2013, the lowest level since 1994. Furthermore, new EPA regulations on new and existing coal-fired power plants, which aim to lower carbon dioxide emissions, may further reduce coal's cost advantage. While the outlook for coal carries significant uncertainty, it is unlikely that coal transportation will boost railroad equipment investment in coming years. Ultimately, it seems that the U.S. energy boom is having a mixed effect on demand for railroad equipment, with multiple factors – from natural gas prices to new regulations – determining how the next few years will play out.

Smooth Sailing or a Perfect Storm?

Although U.S. economic growth remains uneven, and sub-par on average, most economists agree that the economy is on relatively firm ground. Notwithstanding structural concerns about income inequality, long-term unemployment, and political gridlock, there are multiple reasons to feel cautiously optimistic about U.S. growth going forward. Namely, the housing sector recovery continues to move forward, an abundance of cheap domestic energy is literally and figuratively fueling job growth and a rebound in U.S. manufacturing, the auto sector is strong, corporate profits are high, and U.S. consumers are feeling more confident. Indeed, worldwide, many of the economic concerns of the past five years have largely faded. They have been replaced, however, by a growing concern over geopolitical tensions. The conflict between Ukraine and Russia, the resurgence of terrorist groups in Iraq and Syria, continued turmoil in Libya, and China's economic maturation comprise most of the major threats to global economic growth. The scenarios discussed below are aimed at providing alternative views of how these events could play out.

Since the beginning of the 2008-09 recession and financial crisis, economic risk has been at the forefront of executives' minds. Will the U.S. have a double-dip recession? Will the EU implode? Will China have a hard landing? These were all real risks to the equipment finance industry's growth, portfolio performance, and profitability. Five years after the end of the Great Recession, the dust has mostly settled. Although the U.S. and global economies are not experiencing rapid growth, the tail risks of a significant economic shock appear to be greatly diminished. Additionally, the fog of U.S. domestic policy uncertainty that weighed so heavily on confidence has also dissipated.

In the meantime, however, geopolitical risks have clearly risen. The conflict between Russia and Ukraine, the Syrian civil war, the return of insurgents in northern Iraq, continued turmoil in Libya, negotiations over Iran's nuclear program, China's economic transition and tumultuous relationship with Japan, and a variety of other events raise the risk of slower world trade, oil price shocks, and a drop in consumer and business confidence. If just some of these conflicts turn for the worse, the negative fallout would almost certainly slow global economic growth, push fragile economies into recession, and potentially exacerbate financial imbalances underlying several major economies including the U.S. and China. The discussion below offers two alternative views of the world over the next 5 years. The two scenarios described below, *Smooth Sailing* and *A Perfect Storm*, portray a steady versus volatile geopolitical landscape and how they would translate into economic growth and equipment finance industry performance.

Smooth Sailing

This scenario creates an environment of a stable, but not necessarily risk-free, geopolitics. Even in calm seas, storms may lurk on the horizon – this is inevitable on a dynamic global geopolitical stage. However, under this scenario, political leaders are more heavily influenced by their economic interests, and as cooler heads prevail uncertainty wanes, resulting in a boost of confidence and moderately accelerated economic activity.

In an era of somewhat diminished U.S. influence abroad – due to a combination of conscious decisions to disengage in certain areas of the world and the emergence of new regional leaders – this scenario would likely require western industrialized nations to maintain the economic, political, and military clout needed to manage a relatively calm world order. A more stable and predictable geopolitical environment allows leaders and policymakers to focus on domestic issues and the structural reforms that both developed and emerging economies need to enhance both short- and long-term productivity and more balanced economic growth. The private sector would have a clearer picture of the future landscape and, on the margins, would be more likely to invest in growth-oriented projects.

This scenario is characterized by effectiveness on the part of global leaders to navigate through regional and global conflicts. In particular:

- The U.S. is able to build international coalitions to exert political, economic, and limited military pressure in a timely fashion. The current conflict in Syria and Iraq serve as a blueprint of the U.S. demonstrating the patience and diplomacy to create influential partnerships. In addition to turning the tide on insurgents in northern Iraq, America leverages relationships with regional allies to move forward negotiations with Iran regarding its nuclear program, and also work towards a more lasting stability in Northern Africa.
- U.S. and European leaders are able to use a combination of sanctions and soft power to ease tensions between Russia and Ukraine. Cooler heads prevail at least to the extent that Russia's oil and gas exports are not disrupted and the threat of a larger military conflict is all but eliminated.
- China stabilizes its real estate and banking sectors and is able to put the economy on a smooth transition towards economic liberalization. This new growth path is more sustainable over the long-term and provides a more balanced allocation of income across capital and labor, which eases social tensions.
- Japan is able to implement the third pillar of "Abenomics" – structural reforms to boost competitiveness which spurs exports and growth.

A Moderate Positive Impact on Economic Growth. This scenario is less about generating positive economic jolts and more about reducing the "tail risks" of geopolitical events, thereby boosting confidence as uncertainty subsides. More predictable and diminished exogenous risks opens a path for more straightforward monetary and fiscal policies as well as business planning, capital investments, and innovation. The result would likely be marginally stronger global economic growth and improvements in the labor force. However, this could lead to significantly stronger long-term growth in equipment demand. With the U.S. economy running at approximately 79 percent capacity utilization, there is not enough pressure to drive companies to expand their operations. Accelerating growth – even if relatively modest – would boost utilization rates above the critical tipping point of 80 percent and induce businesses to plan for expansion. Over a 3 to 5 year period, expansions in manufacturing capacity are key drivers of the demand for equipment – approximately 90 cents out of every dollar of capital spending goes towards equipment. Moreover, stronger domestic manufacturing and exports drive demand throughout the supply chain – particularly intermodal equipment – rail and trucks – would benefit from rising exports of American-made capital goods.

The benefits to other equipment verticals would largely be second- and third-order effects from a generally more positive economic environment. In addition, the equipment finance industry would benefit from a rising interest rate environment due to stronger economic growth, monetary policy, and a reversal of the “flight to safety” capital flows into U.S. Treasuries. Rising rates would likely lead to 3 main effects: (1) businesses would pull the trigger on planned capital investments, (2) they would likely finance a greater portion of those investments in order lock-in lower interest rates, and (3) equipment finance companies could price in larger spreads and improve their net interest margins. Therefore, even though the overall economic growth might not be significantly boosted by this scenario, the equipment finance industry could see a strong boost in growth and profitability.

A Perfect Storm

The downside risks from geopolitical events have clearly increased in 2014. While most of the current conflicts are regional in nature, they are weighing on confidence and are a global concern. A recent McKinsey survey revealed that private sector executives believe that geopolitical instability is the top risk to global growth.[iv] As a result, executives are far less optimistic about the global economy – 39 percent expect global economic conditions to improve in the next six months, compared with 59 percent in June.

This scenario is the result of a confluence of geopolitical conflicts and policy missteps that would negatively affect global growth through the direct impact of slower world trade and higher oil prices, and the indirect effect of heightened uncertainty and diminished consumer and producer confidence. To worsen matters, the aforementioned geopolitical events could turn sour in an environment of Federal Reserve tightening, a European recession, rising risk premiums in peripheral Europe and emerging markets, and weak domestic structural reforms in China and Japan, and a combination of political gridlock and tapped out public finances in many industrialized nations limiting the scope policy solutions. All of these events occurring at once is a highly unlikely scenario, but also not necessary for global growth to be noticeably affected.

If some or all of the current geopolitical hotspots – Ukraine, the Middle East, North Africa, and East Asia – take a turn for the worse, there could be a material impact on world trade, oil prices, confidence, and overall growth. The Perfect Storm would be marked by some, but not necessarily all, of these types of events:

- The decline in U.S. foreign policy continues to leave a power vacuum in key regions. Europe remains distracted by its economic and structural problems. China and Russia are emboldened to challenge the West's influence abroad.
- Insurgents in Syria and northern Iraq strike back with intense brutality against unarmed civilians, and they strike key infrastructure assets that curtail oil production and exports.
- Armed conflict in Libya escalates and the recent gains in oil production are reversed sending a shock to global oil prices.
- Russia escalates military action against Ukraine and threatens to cut off Europe from its gas exports. The threat alone drives energy prices higher and pushes the fragile European economy into recession.
- China's real estate bubble bursts, causing a "hard-landing" recession, which then ripples through China's major trade partners including Australia, Brazil, and most of Southeast Asia. The slowdown distracts Chinese leaders from prudent economic policy as they attempt to bolster growth with wasteful capital projects.
- Japan is unable to improve competitiveness, and the massive aging of its population is too much to overcome as the economy goes into a long-term economic decline.

A Spike in Oil Prices and Lack of Confidence. A sustained shock to world trade and oil prices would result in a significant slowdown in world GDP. Higher oil prices alone would have a material impact on growth – for every sustained $10 increase in oil prices, U.S. GDP growth decreases by about 0.2 to 0.3 percentage points. With the price of Brent crude oil around $94, a loss of Libyan or Iraqi production could easily push prices up $10 to $20. Additionally, heightened geopolitical tensions, economic shocks in China, and a European recession would slow world trade and dent consumer and business confidence; potentially shaving several more tenths of a percent off of U.S. and world growth. In an already fragile economic environment, this would all but ensure that the U.S. economy would remain stuck in a prolonged period of sub-par growth and weak job creation.

With the U.S. equipment investment cycle likely near its peak, slower economic growth would almost certainly dampen capital spending. An economic slowdown would widen the slack in production capacity, which would lessen the need for investments in new facilities and equipment. Businesses would continue to focus on productivity by maintaining lean workforces and investing carefully in efficiency-enhancing assets. As a result, equipment investment would remain in an extended and decelerating replacement cycle.

Major industrialized nations have limited potential to implement further budgetary and monetary accommodations to combat major economic shocks. Indeed, a geopolitical event could cause a "flight to safety" flow of capital into U.S. markets, pushing down U.S. Treasury yields and expanding risk spreads on European and emerging market bonds. An unclear monetary policy environment would likely result in low rates, ample liquidity, and a continued search for yield. Equipment finance yields and spreads would remain compressed as an intense industry competition is prolonged.

The industry's portfolio performance could also be affected in particular ways. In addition to a softer macroeconomic environment that could put upward pressure on delinquencies and charge-offs, a spike in oil prices and a slowdown in world trade would negatively impact energy- and export-intensive industries. In particular, the transportation and durable goods manufacturing sectors could see weaker cash flows. Equipment finance portfolios over-exposed to these end-users could see outsized losses vis-à-vis the overall industry.

Economic Forecasts

Scenario (percent annual growth)	**2014**	**2015**	**2016**	**2017**	**2018**
Baseline					
GDP	2.2%	3.4%	3.0%	2.8%	2.5%
Equipment & Software Investment	5.5%	4.0%	3.5%	3.2%	3.0%
Smooth Sailing					
GDP	2.1%	3.6%	3.2%	3.0%	2.8%
Equipment & Software Investment	3.5%	6.5%	5.0%	4.3%	3.6%
A Perfect Storm					
GDP	1.8%	2.0%	2.2%	2.4%	2.5%
Equipment & Software Investment	2.5%	1.5%	2.0%	2.6%	2.8%

Source: Keybridge LLC

Acknowledgements

This research was guided by a steering committee of dedicated industry volunteers who gave their time and expertise by providing comments and suggestions throughout the development of the report. Their participation is appreciated greatly. They are: Rich Gumbrecht, Jeff Elliott, Scott Thacker, Ralph Petta, Bill Choi, Amy Vogt, and Kelli Nienaber. We also extend special recognition to those individuals who donated their time to be interviewed for the 2014 SEFI. Their expertise and insights provided valuable information concerning the critical issues facing the equipment finance industry.

Steve Byrnes - Principal, Capgemini Financial Services USA Inc.
Anthony Cracchiolo – President and CEO, U.S. Bank Equipment Finance
Mike DiCecco - President, Huntington Equipment Finance
Dan Dyer - Co-Founder & CEO, Marlin Leasing Corp
Rich Gumbrecht - Chief Growth Officer, Everbank Commercial Finance
Ed Hetherington - President, Doosan Infracore Financial Solutions
Brian Holland - Senior Vice President & Chief Financial Officer, Fleet Advantage
Valerie Jester - President, Brandywine Capital Associates, Inc.
Dave Mirsky - CEO, Pacific Rim Capital
Ralph Petta - Chief Operating Officer, Equipment Leasing and Finance Association
Bob Rinaldi - CEO, Commercial Industrial Finance, LLC
Jud Snyder - President, BMO Harris Equipment Finance Company
Bill Verhelle - CEO, First American Equipment Finance, a City National Bank company
Adam Warner - President, Key Equipment Finance

About Keybridge

Keybridge is a boutique economic and public policy consulting firm. Founded in 2001, Keybridge's mission is to be the most trusted source of analysis and advice to business leaders and policymakers on matters at the forefront of public policy economics. We are economists, policy experts and strategic advisers, working at the intersection of economics and public policy. We provide technical analysis and strategic advice to our clients, who include financial institutions, Fortune 500 companies, trade associations, nonprofits and government agencies. Our services range from rigorous and objective quantitative analysis to business strategy, investment and public policy advice. We specialize in developing long-term partnerships with our clients. This enables us to operate as a trusted natural extension of their organization, providing unbiased advice and looking after their strategic interests.

Keybridge Research LLC
3050 K Street NW, Suite 220
Washington, DC 20007
www.keybridgedc.com
202.965.9486
Robert F. Wescott, President

Endnotes

[i] The Equipment Leasing and Finance Association conducts an annual Survey of Equipment Finance Activity that directly measures industry benchmarks for growth, funding, portfolio performance, financial performance, and business operations.

[ii] The Boston Consulting Group, "Study Reveals Striking Shifts in Global Manufacturing Costs over the Past Decade." April 2014.

[iii] Energy Information Administration, "What Is the Role of Coal in the United States?" June 2014.

[iv] McKinsey&Company, "McKinsey Global Survey Results: Economic Conditions Snapshot." September 2014.

EQUIPMENT LEASING & FINANCE
FOUNDATION
Celebrating 25 Years
Your Eye on the Future
www.leasefoundation.org

Independent, Future-Focused Industry Research

The Equipment Leasing & Finance Foundation
Established in 1989, the Equipment Leasing & Finance Foundation is a 501c3 non-profit organization dedicated to providing future-oriented, in-depth, independent research for and about the $827 billion equipment finance industry.

Future-Focused Research
The Foundation provides comprehensive, forward-looking research for business leaders, analysts and others interested in the industry. Resources include the State of the Equipment Finance Industry report, Industry Future Council report and strategic market studies available at no cost to donors in the Foundation's online library. **www.store.leasefoundation.org**

Equipment Leasing & Finance U.S. Economic Outlook
This comprehensive report analyzes global and domestic trends impacting capital spending and economic growth in the coming year. It identifies key signposts specific to the equipment finance industry and features Momentum Monitors that identify turning points for 12 verticals in their respective investment cycles. The outlooks are updated quarterly.
www.leasefoundation.org/IndRsrcs/EO

Monthly Confidence Index
Through a monthly survey of the industry's executive leadership, we've established a confidence index related to the equipment finance sector and the U.S. economy. The results provide greater understanding of prevailing business conditions and expectations for the future.
www.leasefoundation.org/IndRsrcs/MCI

Journal of Equipment Lease Financing
The only scholarly periodical dedicated to equipment leasing, the Journal spotlights industry research, case studies and trends. . Published three times a year, the *Journal* reaches thousands of professionals, academics, libraries and government and financial institutions. Article contributions are welcome.
www.leasefoundation.org/Periodicals/Journal

University and Academic Relations
The Foundation is committed to working closely with academics to further the industry's body of knowledge. Academics may apply for research grants, write for the Journal and access the entire Foundation library and statistical databases for approved research projects.

Your Support is Vital to the Industry's Future
The Foundation is funded entirely through corporate and individual donations. Investing in the industry through a contribution is one of the best decisions you can make – and it's tax-deductible. We value our donors and recognize contributors in print, online and at a distinguished awards presentation. More information on contributing and the current list of donors is available at
www.leasefoundation.org/Giving

Stay Connected
Subscribe to the Foundation Forecast –
www.leasefoundation.org/Periodicals/Forecast

LinkedIn – **www.linkedin.com/groups?gid=89692**
twitter – **www.twitter.com/LeaseFoundation**
facebook – **www.facebook.com/LeaseFoundation**
YouTube – **www.youtube.com/ELFAChannel**

1825 K Street NW • Suite 900 • Washington, DC 20006 • Phone: 202-238-3400 • Fax: 202-238-3401 • www.leasefoundation.org

EQUIPMENT LEASING & FINANCE
FOUNDATION
Your Eye on the Future

1825 K Street • Suite 900
Washington, DC 20006
www.leasefoundation.org
202-238-3429
Kelli Jones Nienaber, Executive Director