

2013

# Industry Future Council

**Near-Term Uncertainty, Long-Term Prosperity**





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.

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## About the Industry Future Council Report

Each year, the Equipment Leasing & Finance Foundation brings together a group of industry executives to form the Industry Future Council. The IFC is tasked with exploring trends, challenges and opportunities and then evaluating how these issues may impact the equipment leasing and finance business in the next three to five years.

The annual IFC Report summarizes these discussions and attempts to bring into focus what equipment leasing and finance companies may want to consider as they plan for future growth. It is the hope of the Foundation that readers will benefit from the insights of the IFC and use this report as a resource planning tool.



The 2013 Industry Council Future Council (IFC) decided to set the stage for its look forward by first looking back – what did the IFC say five years ago when it issued the 2008 Industry Future Council Report? Almost five years since the financial crisis of 2008, there is a sense that the U.S. economy remains in a holding pattern, unable to grow with any vitality, but mercifully free of any traumatic shocks to the system in the years since.

The U.S. equipment finance industry weathered 2008 and the recession it brought, and came through healthy thanks to sound portfolios, credit discipline and limited exposure in affected markets. But, judging from the 2013 IFC meeting, convened at the end of January, the equipment finance business is itself in something of a holding pattern.

The Equipment Leasing & Finance Foundation sponsors the IFC each year to take the industry's temperature and discuss the near- to mid-term trends that will impact it and the opportunities that will present themselves.

Leasing and finance companies are strong, coming off reasonably good years. The 2012 IFC stated that one of the indicators of returning prosperity would be the health of machine tool orders. As it turns out, machine tool orders totaled \$499.43 million in 2012 – their best year since 1996.

Yet few IFC members were bullish on the short term. Political and fiscal uncertainty hangs over the economy, unemployment hovers around eight percent as reported and up to 15 percent by earlier measurements.

Equipment finance companies are in much better shape than a few years ago. Portfolio quality is sound and credit standards are high. But the IFC was hard-pressed to identify specific growth opportunities over the near term. Specialization and niches will be important, companies that can extend their range of offerings to include funding services will be on the leading edge, and those that can leverage a geographically-dispersed, technologically connected workforce may have an important differentiating advantage. But the kind of opportunities – whether in markets or products – that get people buzzing just don't seem to be close at hand.

The 2013 IFC discussed myriad factors internal and external – from politics to funding opportunities to market structure to human resources – to attain a sense of what the near- to mid-term holds for the equipment finance industry. This report is an attempt to encapsulate the Council's deliberations.

## External Conditions

According to most members of the 2013 IFC, 2012 was a good year – in total. Business in the first two quarters was brisk enough to make up for a flat second half of the year. The consensus was that the

### Going Green?

When handed lemons, equipment lessors are a lemonade-making bunch. They'll find opportunities in any situation. So it speaks volumes about the "green" economy that got so much attention from the IFC of four years ago that the 2013 IFC wasn't as enthusiastic about the renewable energy market.

"Alternative energy is less and less important as an end-user industry," said one member.

"You'd have to be careful to get into alternative energy with comprehensive tax reform on the horizon," said a bank lessor.

But the problem with that segment is more fundamental. While members noted that some alternative energy technologies have begun to "work," they're still a long way from the scale needed to make them attractive to investment, so they still rely on subsidies.

One IFC member put it succinctly: "It's hard to underwrite a business model that involves this level of government subsidies."

On the flip side, environmental regulations increase the cost of doing business for many finance companies, and potential exposure to environmental litigation means companies must be very cautious about financing in some industries.

An IFC member who's company funds equipment in enhanced energy recovery (hydraulic fracturing – method of extracting natural gas that's been much maligned by environmentalists) said, "You've really got to know what you're doing. Fracking's been banned in some places, and in others it's a boom or bust situation. You have to know what your equipment is doing, what your trucks are hauling, what's going into your rail cars, etc."

Another member said that goes for just about every industry these days. "You always have to be conscious of environmental impact and factor it in when you're looking at new markets."

As for regulations, an IFC member speculated that as states become desperate for revenue, they may "go the California route" of charging environmental disposal fees on a variety of equipment types. The Council noted that to date, these charges remain entirely disconnected from actual disposal, and are simply another tax on doing business.

"In fact it's getting so you can't throw anything away anymore. There's got to be money to be made in financing disposal equipment."

Lemonade, anyone?

sense of “uncertainty” grew as the year progressed, slowing activity in all sectors. That trend had some IFC members pessimistic about the short-to-medium term.

As one member put it, “A lot of the tail winds we’ve had are abating. The growth we’ve seen over the last couple of years is going to be tougher to get.”

Several IFC members said that economic uncertainty and an onerous regulatory environment are causing customers to pull back from already modest equipment acquisition budgets.

A captive lessor said, “We finance equipment and people have no reason to acquire it right now. The CFOs of major companies are saying, ‘I’m putting this project on hold, and that project on hold.’ He thought predictions for even flat growth in 2013 were overly optimistic. Another agreed, saying “there’s no leading indicator out there right now that gives anybody any comfort or confidence.”

“Small business owners are worried about the requirements and costs of ObamaCare,” said another. “They’re not hiring, they’re not signing up for more debt.” As a result, some IFC members observed that their conversion rates on new business had fallen sharply.

Others, though, were more optimistic. One small ticket lessor said he saw a business model “very similar to that of ’06 –’07. The challenge will be in managing the spread side of the equation.”

Another pointed out that the industry is back to ’07 levels of origination and portfolio performance, and delinquencies and defaults are at record lows. Furthermore, nearly every company represented at the IFC is actively hiring people.

Still, there was a general unease reflected in the IFC’s deliberations.

If equipment financiers expected the resolution of the 2012 election to quash the economic, tax and regulatory uncertainty of the last few years, they’ve been disappointed. “We had the election followed by the fiscal cliff panic followed by the ‘triple trough’ [recession] panic – and things are still unsettled,” said a bank lessor. “Delaying the inevitable doesn’t resolve uncertainty, and decisions continue to be pushed further down the calendar.”

The outcome of the election suggests that regulatory activity “will only increase over the next four years,” said a member. “Small businesses will be squeezed.”

So while the election’s inherent uncertainty was cited by last year’s IFC, as it played out, the election, itself, did not provide resolution – the outcome prolongs the IFC’s expectation of uncertainty.

The 2013 IFC didn’t expect to see major shifts in the external factors that impact the equipment finance business over the next couple of years. Regulation will continue to be a factor on small business activity and the sluggish economy doesn’t show signs of picking up any time soon.

## MarketScape

### *Banking on the Business*

Over the years, a common refrain when talking about economic cycles and their impact on the equipment leasing and finance market was, “will the banks stay in?” In the wake of the 2008 financial crisis, the answer is a resounding yes. “No reputable banks got out,” one IFC member said.

Why? “This time, they had a lot more skin in the game,” said one bank lessor. “They couldn’t easily get out.”

“Banks were flush with deposits,” when the downturn came, according to another IFC member. “They had to put their money somewhere and they saw that leases weren’t tanking.”

Bank-owned finance companies make up a large and thriving segment of the market in 2013, and aren’t going away anytime soon.

Partly, that’s because of Fed policy on interest rates. As one IFC member put it, “Banks today are in-

### **What’s a Bank?**

It’s clear that banks are more involved than ever in the equipment finance segment. But ... what is a bank? Specifically, what determines whether an equipment finance company belongs in the bank-owned or affiliated category? Does parentage determine “what is a bank”, or do lineage and business practice differentiate “independents” from “banks?”

The IFC discovered an interesting difference of view, as some members declared that bank-owned finance companies that were originally independent and continue to operate autonomously are not really considered “banks.” Meanwhile, some independents, who rely on bank funding with regulatory oversight and compliance, find themselves operating effectively like banks. Thus, definition by ownership – the traditional identifier for the industry – came under fire as a definition that needs re-thinking.

What did the 2013 IFC say about what makes a bank lessor? Opinion was split between funds and regulation. “Where do you get your funding from?” said one member. “If it’s from the bank, you’re a bank.” But is it a matter of how much of a company’s funding comes from the bank? Does it have to be 100 percent to represent affiliation?

Another participant said what matters is “who you’re regulated by and what regulations apply.” If a bank-affiliated equipment finance entity is regulated with the bank and subject to the same strictures, it should be categorized as a bank.

So why does it matter? With so many equipment finance companies being bank-owned, does the industry risk being viewed categorically as “banks” by legislators and regulators? As one bank lessor said, “Regulatory scrutiny on banks is intense, and that’s creeping into commercial finance.”

creasing their market share” in the equipment finance sector, “because they know what their cost of funds is going to be for the next few years.”

But more than that, banks have come to understand and view equipment finance as an important part of their business. The Council pointed out that equipment leases fared better during the downturn than nearly any other asset class.

Equipment leases provide a reliable revenue stream and, as one IFC member said, “Banks are on a treadmill to keep assets on the books. They understand that a lease is pretty sticky, and has a longer tenor than most other bank products.”

Having an equipment finance entity in-house has other benefits. “The equipment finance company brings the bank a better understanding of the end-user space, and access to that space,” said a Council member. “More often than not, the bank gets a customer” for its other products when the finance company originates new leasing business.

Conversely, the absence of those characteristics is why banks haven’t moved aggressively into the vendor finance space. One bank lessor explained, “We can take a much more aggressive position on direct business because we know the end-user well. In vendor finance, we’re less willing to take risk.”

Risk, and how much of it traditionally conservative banks are willing to take, has been a constant struggle between bank parents and their equipment finance entities. IFC members suggested that banks have become far more comfortable with leasing risk, and consequently more aggressive in the sector. “Banks now understand the risk profile [of equipment finance] in a way they didn’t five years ago,” a bank lessor explained. “When they understand, they give you the resources to grow.”

Of course, with their cost of funds, banks don’t necessarily have to take as much risk as others. “Banks don’t have to take as high a residual position,” said a captive lessor. “Their position could be one-third of what a captive has to take” to offset the cost-of-funds advantage.

Looking forward, the IFC expected banks looking to expand beyond real estate and commercial loans would continue to enter the equipment finance marketplace. Eventually, some consolidation will follow. “Cutting costs and increasing efficiency is crucial for banks moving forward,” said a bank lessor. “Mergers may look really attractive.”

### *Independents Fill the Gaps*

Although the 2012 IFC anticipated expanding opportunities for independents, the truth is that there just aren’t that many of them left in the equipment finance space. And, according to one bank lessor, banks today look more and more like independents used to.

“Now, bank-owned lessors are run by leasing people, and act more entrepreneurially,” he said. “They’re fast like independents, use simple documents, specialize the way independents do. There’s just not as much difference between bank-owned entities and independents as there was 10 years ago.”

An independent lessor said that companies like his do have a harder time these days. Their cost of funds means they can't often compete with aggressive bank financiers. Once upon a time, they could offset the cost of funds differential by leveraging their equipment knowledge to take more aggressive residual positions. But, as stated above, bank leasing companies are increasingly run by "leasing people" or, at least, have been in the segment long enough that they have acquired more equipment knowledge in house.

But many banks still are cautious about which industries they serve. That leaves niches for nimble independents. "It's a very fragmented business, and if you do it well, you can anchor a segment," a small ticket player observed.

But for independents to exist, they must be able to access funding. According to the IFC, there's some good news on that front. One bank lessor said that there's a robust lender finance market that provides a lot of money to the equipment finance industry for on-balance sheet business.

"Startup leasing companies are getting lender financing from banks within 18 months of their start-up. You need good management, controls and a track record. But nobody's lost money in lender finance – it came through the cycle unscathed."

Securitization is back as a means of raising capital. "Everything is on-balance sheet, so it's more accepted," according to a councilmember. "I'm kind of bullish about securitization."

But, according to another, "rating agencies are a sticking point. Too many people lost too much money on securitization, so they're very cautious. A solid track record is a necessary credential, and first-time issuers will have a tough time. You can be a new issuer, but you have to be really solid."

### *Captivating Services*

Banks' cost of funds may give them a decisive advantage in some ways, and independents may still be the most agile players in town, but there's one way in which captive finance companies have an edge over either banks or independents. Customer demand for bundling – including services and even consumables in the lease or finance package – continues to grow.

Independents are most challenged to offer bundled products with soft costs, partly because of underwriting challenges, but also because of difficulty obtaining funding for bundled transactions. "Funding sources understand the risk/reward of financing equipment, and trying to sell them on financing a service contract or consumables will be tough," said an IFC member.

Manufacturing captives are obviously the best positioned to provide bundled solutions. A bank lessor said bundling still presents "formidable barriers to entry. You have to make big infrastructure investments." Not even captives will provide all the services customers want – "It's extremely complicated," said one.

Still, "Customers in our industry are moving in the direction of wanting services, and the company

that sees it as an opportunity can have a huge impact,” according to a captive. “It’s going to take thinking differently – perhaps building consortiums” to fill customer demands.

Going forward, there may not even be a lease involved in the transaction. “It could be a rental, or a lease without contract terms, a challenge to the hell-or-high water concept,” mused an IFC member. Accounting rules may add momentum to service contracts or pay-for-use alternatives to the traditional lease product.

Such developments would surely have a broader impact for the business. It was suggested that the industry is at “an inflection point,” where new finance products are needed to unlock “enhanced returns, extensions and residuals.”

It appears that the topography of the equipment finance industry won’t undergo dramatic changes in the next few years. With interest rates unlikely to increase any time soon, banks will continue to leverage their cost of funds advantage and play an increasingly big role in the marketplace. Captives should benefit from their natural ability to meet growing customer preference for bundled solutions and services. Independents will have opportunities to establish themselves in niches where banks don’t or won’t play – potentially a more limited arena than in the past because of banks’ growing knowledge and confidence in equipment financing.

## **These Kids Today**

A recurring question for a “graying” industry over the last several years is “How do we attract smart, motivated young people to the business?”

The 2013 IFC, like others before it, began by discussing what about the contemporary industry might appeal to the next generation’s “best and brightest.” One lessor suggested that being able to say your business is growing and you have a loyal customer base is appealing to young professionals. Another suggested saying to them, “You’ll never see as many transactions of various kinds as you will in this industry. Equipment finance is a great experience for anyone with a future in financial services.”

An IFC member from a large bank observed that the young people he’s interviewed and hired “spend a lot of time talking about things like community and green initiatives. They believe it and like it.” Also, young workers “don’t want to be pigeonholed.”

They also, according to an IFC member, “don’t want to move.” That is, they prefer to remain where they are comfortable and work remotely. Technology – together with their comfort and familiarity with it – makes it possible. And many IFC members found it desirable.

“We don’t even want our people under the same roof anymore,” said one. “Everything moves electronically.” Another, a bank lessor, said none of the people he manages “even live in the same city as I do. Hotels are my offices much of the time; video conferencing and online meetings have gotten amazingly good.”

But managing people remotely is difficult, and aspects of the culture, such as creativity and loyalty, may be impacted. “You need to be a better manager,” said a participant. “I’m concerned about the younger generation’s self-discipline. When hiring, you have to be very selective, and you have to consider the

## BYOD?

“Online-bid models have been tried and failed in our business,” an IFC member said. “This is a people industry. Good people with good systems” couldn’t make an online quote and origination concept work for equipment finance. “This stuff’s not vanilla.”

Yes, most equipment finance is anything but vanilla, so it poses unique challenges when trying to apply new technologies to the business. How, for example, do leasing companies make the most of social media?

One IFC member said that these days, “In some cases your first contact with the customer is on Twitter.”

Another was more doubtful. “On the workflow side of things, technology changes are very useful – apps for keeping up with accounts, etc. But new business from social media? I don’t see it.” On the other hand, companies ignore these technologies at their peril. Indeed, about half the IFC members said their companies monitor social media for “defense” – customer complaints are more and more frequently being “published, and quick response can be crucial to maintaining your brand’s integrity.”

“We have a team that monitors social media,” said a member from a large bank lessor. “If they see negative tweets or posts about us from a customer, we go right to the client to get it resolved. You have to deal with disgruntled customers very quickly” when they can make their unhappiness known on the Internet.

One place where technology is proving a boon for equipment finance companies is in sales. Sales people carry iPads or other tablet computers loaded with everything they need to conduct business with a prospective customer. Companies no longer have to print sales collateral; specialized apps and slide shows are ready to go. Online applications, approvals, documentation, and even signatures are becoming more prevalent. “The pace of play increases,” said a lessor, “and it will keep increasing.”

And many companies no longer supply technology devices to their salesforce – or other employees. “Bring Your Own Devices” (a new twist on “BYO”) is a growing trend in business. In a world where just about everyone has smart phones and constant Internet access, it’s not unreasonable to expect employees to come ready to link in. “We don’t provide anything,” said a bank lessor.

This, however, adds new dimensions for integrating software, and certainly for IT security. The Council was nearly unanimous in its expectation that the days of “standard-issue hardware and software” were quickly moving to the rear-view mirror. Concurrently, customers expect to interact with their finance providers in open, transparent, and non-proprietary language online.

positions you're hiring for. I wouldn't want credit people working remote, but tax people certainly could."

One participant suggested that there are situations where economies of scale make having all or most of your people under one roof desirable. Another said that in small ticket, which is "basically an assembly line, we believe there's value having our people in one location. In the vendor business, we've found we get higher ratings from our vendor partners when we're under one roof."

But there are other considerations: "There's no more 9-5," a councilmember observed. "If you're remote and working from home, you can't turn it off. You'd better be available."

One captive, whose finance company is "almost exclusively remote," says they believe "you get too much group-think in a campus environment. We want ideas from our different regions."

"Companies are learning to generate ideas through technology," a bank lessor added. "Recent graduates have a different skill set. They'll throw a problem out electronically to the work force and say 'what do you think?'"

But isn't equipment finance the ultimate relationship business? Some participants worry that remote arrangements make it impossible to build relationships and can even erode the social skills so valued in equipment finance.

"We believe in relationships," one councilmember stated. "You can't build them when you can't see your people." The answer, according to another, is to find ways to include far flung employees in the business's culture, to create "points of contact."

Equipment finance, the "people business," will continue to move toward increasing technology-driven internal interaction. What impact that has on the industry remains to be seen, but how customers perceive and respond to it will determine its ultimate adoption. Clearly, a competitive advantage lies in understanding and using the strengths of a young workforce at home with wireless technology and social media.

## **Moving Forward**

The equipment finance industry is healthy by any measure, and getting healthier. Last year, ELFA gained almost 80 new members. Some robust M&A activity is occurring. Portfolios are relatively clean, credit is good and still improving, and companies are hiring.

Players across the segment are hungry for growth. But continuing uncertainty obscures the horizon as industry leaders attempt to navigate into the future.

What is clear is that customer expectations continue to evolve toward more comprehensive solutions. In some segments, customers want pay-per-use, pay-per-seat, service contracts, consumables – a range of options and services unthinkable to the equipment finance industry a couple of decades ago. There will always be a place for the equipment lease – the simple, 100 percent financed product that offers

the customer the benefits of use without the cost and risk of ownership. But these days, leasing is one product among many, subject to impending tax and accounting changes that could impact its attractiveness.

It's also becoming apparent that for independents and more nimble bank-owned companies, the ability to spot and establish themselves in niches will be an invaluable asset in the medium-term.

Fortunately, creativity and the ability to adapt are hallmarks of the equipment finance industry. Smart, well-capitalized firms that understand and manage their risk will do what they've always done: thrive.

The 2013 IFC sensed that the industry is impatiently waiting for the rest of the world to right itself. It has the people, systems and business models in place. It can specialize and improvise, and it will be around for a long time. It's the waiting that's the hardest part.

## 2013 Industry Future Council Roster

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