2007 Industry Future Council Report

Equipment Leasing & Finance Foundation
Your Eye On The Future

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About The Equipment Leasing and Finance Foundation

The Equipment Leasing and Finance Foundation is the only not for profit organization dedicated to providing future-focused, in-depth independent research about the equipment financing industry. The Foundation accomplishes its mission through development of studies and reports identifying critical issues impacting the industry. All products developed by the Foundation are donor supported and donors receive products free of charge. Non donors may purchase these studies.

The Foundation works with various groups to further the industry's body of knowledge including enjoying fruitful relationships with universities and academics nationwide.

To access the Foundation's comprehensive industry information,
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"My impression is that leasing has moved further out on the risk curve."

— an IFC member

Foreword:

The Industry Future Council (IFC) meeting, is an annual event, now in its 26th year, hosted by the Equipment Leasing & Finance Foundation. The IFC is comprised of 20-25 leading executives from equipment finance companies, industry analysts, rating agencies and service providers. During one and one half days of deliberation, the IFC addresses issues impacting the equipment finance industry, and their potential impact on the future of the industry.

The mission of the Equipment Leasing & Finance Foundation – to be *your eye on the future*, is exemplified through the IFC meeting and report.

Last year, the Industry Future Council changed its strategy for focusing on the future of the equipment leasing and finance industry. Rather than analyzing the information brought by members and distilling it into a report, the IFC used the information to create a set of important questions that industry participants could address within their own companies to help them prepare for the next one to three years.

So well received was the *2006 IFC Report* that Council members repeated the strategy in 2007, identifying trends, issues and potential economic indicators, and then extrapolating questions for use by readers. Excerpts from *The Wall Street Journal*, identifying trends and making projections about the future of the economy were used as stimulus. By referencing the IFC report from 2002, the IFC members asked "what did we believe then, what actually happened over the last five years, what were the key factors that either confirmed or altered the course we expected to see, and what might be the corresponding factors over the next five years?"

IFC members were also asked to prepare for the meeting by conferring with their constituencies (if they represent an Equipment Leasing and Finance Association Business Council) or to consider from their company's perspective the issues contained in the excerpts. The goal: to foster debate and dialogue representing multiple perspectives from around the industry.

Thus was identified the first major challenge – defining the "industry". The unofficial theme for the IFC became *"…and Finance"* reflecting the apparent, continuing trend away from traditional leasing, and toward a broader focus on financing in the product lines and portfolios of the industry constituents. The theme also seemed timely, given the recent re-naming of the industry association to the Equipment Leasing and Finance Association (ELFA).

Defining Today's Leasing and Finance Industry

Because of the changing mix between leases and loan-like financings being offered by lessors in the market, the IFC focused on the associated evolution of the traditional "drivers" of the lease product: transfer of tax benefits, off-balance-sheet accounting, residual risk management, and access to alternate funding sources. The effects of tax and accounting regulation, and the continuing migration toward lease structures that are more finance-like, have made the differentiation of leases from loans less distinct. Additionally, the increasing demand by customers to include greater percentages of soft-costs and services as part of a bundled or comprehensive financial offering has affected the balance between the traditional equipment lease and hybrid products – in some cases, threatening the clarity of rights and responsibilities of the parties in the transaction. The IFC discussed the direction and momentum of these trends to anticipate their impact on the products, the markets, and the participants in the business of the future.

One attendee observed that the financial services industry as a whole is experiencing "a merging of capital and commerce" as customers look to sellers to provide ongoing services. "Customers want to be able to select from a menu, and players are having to react," said another IFC member, adding, "Deals are going to those who can provide these menus, and sometimes, doing so can move [these players] away from the products they would typically prefer to sell." Consequently, to serve and retain their customers, members of the equipment leasing and finance industry engage in a range of transactions today, not all of which can be classified as equipment leases or loans, but which still seem to have equipment and assets as their common basis.

Are there common characteristics among the financial products being offered in the leasing and finance industry today? The IFC identified several:

• A stream of payments

Whether software, services or equipment, the item being financed creates a stream of payments.

• The production of revenue

The assets financed are typically deployed in the production of revenue by the user.

• Enablement of the customer to acquire and use assets

Leasing and financing continue to be at the core of capital formation, enabling users more convenient or more efficient access to the assets they need to grow, become more efficient, or expand to new markets.

• A commercial focus

While consumers also rent, lease and finance equipment, the industry focuses on the commercial markets. There remain strong feelings among some of the players that they expressly do NOT want to approach or cross the line between commercial and consumer finance, emphasizing the different standards of regulatory involvement, restrictions, and disclosures.

• A customer focus

Because customers have choices, and because of the diversity of primary focus among the various sources of capital in the market, customers have a stronger position in determining the shape of the financial products they find attractive. The industry continues to innovate, but much of the innovation is reactive to customer demands. Plentiful capital adds weight to the customer side of the equation.

• An asset basis

Whether the item(s) sought by the customer are hard or soft assets, the lease or financing generally supports the acquisition of assets.

• An entrepreneurial approach

The industry continues to develop more efficient means of interacting with customers, providing value-adding services, and creating transparency.

- ➢ Do we know what our customers need?
- ➢ Do we know what others are offering our customers?
- ➢ Can we bundle and unbundled costs/services as requested by our customers?
- ➢ Are our company's processes set up to allow us to quickly reengineer based on customer demands?
- ➢ Do we know the "true" cost of our product offerings?
- ➢ Are we being adequately compensated for the risks inherent in our products?
- ➢ How can we be proactive in anticipating our customer's needs before they become demands?
- ➢ How often do we touch base with our customers to ensure we know their needs?
- ➢ Can we identify the primary reasons why our customers lease?
- ➢ Do we know what alternatives our customers have for their financing?

Today's Industry Participants

The Evolution of Traditional Players

The recent addition to the industry association's name of the phrase, "and Finance" carries several implications. The name change reflects member companies' evolution from "leasing" to a more inclusive range of financing products. Meanwhile, IFC members noted that banks and large, well-funded independents are generating a greater percentage of total income from non-spread sources, such as fees.

While the IFC members generally agreed that the industry players can still be identified as either "Bank", "Captive" or "Independent", they also agreed that the category known as Independents can be further divided into two sub-categories:

- large, diversified, well-funded financial services companies that generally originate, buy and hold portfolio
- privately-held, smaller companies that typically focus on origination

Although mid-size independents still exist, they are few in number. Observed one IFC member, "We have more independents today than we did five years ago, but most are very large or very small." The IFC reiterated its earlier observation that smaller independents either remain small and focused, or become attractive as acquisition targets when they reach a certain critical mass.

Captives, meanwhile, continue their primary mission as facilitators of acquiring branded products, most of which are manufactured by their parent companies. But increasing pressure by parents for in-house finance companies to produce returns appropriate to the capital allocation they receive from enterprise is creating broader interest in "outsourcing" to private-label or vendor program providers. While there are examples of new captives being formed, the stock-price-multiples typically associated with financial companies remain lower than the corresponding multiples for many of the parent companies' other businesses. This dynamic tension promises to create continuing evolution in this market segment.

Banks continue to emphasize "share of wallet" and the number of different financial products deployed with each customer. Product design emphasizes (logically) banks' strength (credit underwriting, lower cost of funds), and de-emphasize competitors' relative strengths (residual remarketing, aggressive structuring, bundling of services and maintenance). Consequently, the impact on the traditional lease product offered by banks has been a migration toward a more loan-like financing, creating less differentiation. Customer strength in demanding product design (as described above), has therefore encouraged the non-bank providers to migrate the structure of their offerings along a similar, less-differentiated path.

Each of the three "player-types" then approaches a leasing or financing opportunity from its own, relative position of strength or motivation. None of the strengths is unique to any of the types, but are relatively ranked..:

- Independents emphasize their customer intimacy and responsiveness, and an ability to maximize the variables within any given transaction
- Banks emphasize comprehensive customer relationships, and multiple financial products
- Captives emphasize asset knowledge and ability to provide integrated offerings

➢ Is size an advantage for us?
➢ Do we understand the relative strength of our position in the market?
➢ What is our strategy to compete against well funded large lessors?
➢ What is our strategy to compete with the smaller, more nimble players?
➢ Do we understand our growth plan and where it takes us in the market?
➢ Are we thinking constantly about alliances, merger or acquisition opportunities and other ways to compete?

New Entrants

Hedge funds and private equity entry into the market is affecting traditional leasing and finance companies in several ways:

- In the small- and micro-ticket market, new sources of capital are acquiring traditional funding sources;
- In middle-ticket market, new sources have been less visible to date, but one IFC member noted that some hedge funds are loaning mid-tier companies millions of dollars.
- At the large-ticket level, new sources of capital have made significant asset-buys.

Respecting the savvy and creative talent usually associated with private equity and hedge funds, one IFC member noted, "They tend to be opportunistic buyers whose take-out will not be the same as a strategic player's." The fact that these new entrants are buying in at this time, seems to suggest further upside in valuations. Observed one Council member, "Perhaps what these investors see is an opportunity to build around or to aggregate things that in total may be worth more than their individual parts."

- ➢ Are we familiar with new players and their product offerings?
- ➢ Do we understand the motivations and objectives of new players in our market?
- ➢ Are we reviewing our value creation model?
- ➢ Will we recognize the signals that direction or momentum of the market is changing?

Economic Trends

Indicators of a Possible Correction

In a market characterized by plentiful capital, spread compression has affected overall profitability. Past cycles would indicate that the natural response of players in the industry will be to pursue volume growth, perhaps venturing further along the risk curve to find it. Consensus of the IFC was that this is happening today, and will likely continue into the future.

However, as in previous cycles, underlying factors can signal – then create – a correction that will usually "over-correct" before arriving at a new balance. Following the tragedy of September 11, 2001, the market for commercial aircraft demonstrated that there can be conditions during which there is effectively NO market for certain equipment types (not often incorporated into original transaction approval processes). Now, as total aircraft sales are increasing again, the portfolios of previous aircraft lessors have in some cases been sold, some with aircraft in their portfolios have discontinued new financing of that asset category, and new entrants will be affecting the current market with terms and conditions and pricing that will not necessarily be reflective of previous markets.

The IFC focused on signals or indicators that might foretell a coming correction, including:

- inflation
- rising oil prices
- rising default rates in consumer credit (mortgages, credit cards)
- reduction in capital expenditure levels
- slowdown in transportation volumes (trucking, rail, container)

The prior correction, in 2002 was impacted by overcapacity in transportation. At and telecommunications markets. The pace of acquisition of new technology had slowed, and the ability to earn an appropriate, risk-adjusted return was problematic. Equipment lessors and financiers in these segments were questioning whether they were being adequately compensated for their assumed risk, but remained under pressure to grow revenues.

Today, leasing and finance companies should identify their sources of profit, and to grow in those areas. If a company has built the infrastructure to support "an originations machine", it becomes difficult to reduce or disassemble that infrastructure. Established firms will find themselves under pressure to accept the prevailing market pricing, or to create a capital markets capability to sell off originated product. As emphasis is placed on originating product-for-sale, the logical extension may be to make that product more fungible, more generic, and more homogenous. Traditional lease products relied on uniqueness and differentiated terms or conditions which may be lost in the future. Market forces, including industry consolidation, bank lessors expansion, increased professional (vs. entrepreneurial) managment of leasing and finance companies, and general maturing of the industry may all serve to will further encourage a migration away from uniqueness and toward conformity. Because of a variety of current factors, such as potential changes in lease accounting rules, the Council believes that the distinction between lease-like and loan-like financings will further diminish in the coming years.

Do these trends, if they come to pass, mean that equipment lessors and financiers have less capability to specialize or differentiate themselves? Perhaps the opposite. With market forces pushing toward uniformity, there may be more opportunity to succeed through differentiation in the future. Perhaps the entrepreneurial thinking that has distinguished the industry in the past should be focused more strategically to evaluate the new, more standardized industry landscape.

- ➢ Are we watching economic and market conditions, and assessing our portfolio mix?
- ➢ Are we prepared to exit markets as appropriate?
- ➢ Is our risk tolerance in line with our growth objectives?
- ➢ If our product offerings are commoditized, what is our value proposition?
- ➢ Is our product offering attractive to funding sources?
- ➢ Do we have information sources to help us predict market moves?

- ➢ Is our product line differentiated? What makes it different?
- ➢ What are the scenarios that could change conditions in the marketplace?
- ➢ Is our portfolio diversified? Could we withstand a material loss in any segment (geographic, industry, equipment type, etc.)
- ➢ Are we prepared to address each scenario?

The Effects of Liquidity

In 2002, capital was scarce, but available to well-run companies. None of the IFC members felt that capital is scarce – or even tight – today. Some visible trends:

- Fixed-income hedge funds, using borrowed money to finance bank-loan and junk-bond purchases at higher rates
- Private-equity funds, which have fueled the supply of high-yield bonds
- Soaring real estate prices have encouraged consumers to refinance and extract cash equity
- Tax cuts created a stimulus in recent years
- New regulations require increased transparency
- Strong international markets are still driving money into the U.S. market

In 2006, companies issued $624 billion of speculative grade bonds and loans, up from $389 billion in 2005. At the same time, the appetite for higher yield appears to have distorted the perception of risk, as issuers of junk bonds continue to find appetite for "covenant-lite" terms. With corporate defaults at record lows (less than 1%), the market's expectations for risk-adjusted returns has compressed spreads traditionally associated with higher risk. So saturated is the system with cash that riskier assets, such as emerging-market debt instruments, are priced only slightly above US Treasuries Notes of comparable term. The same is true for junk-rated corporate debt. With so much money chasing investments, rates have compressed. This has increased the difficulty with which leasing and finance industry players have been able to earn appropriate risk-adjusted investment returns. This difficulty may tempt leasing and finance companies to lower their lending standards. IFC members pondered if in 2012, the industry would look back on 2007 and observe that leasing and finance companies underwrote excessive companies had taken on uncompensated risk in pursuit of volume growth.

The consensus was that underwriting standards are still strong and the equipment leasing and finance industry of 2007 is robust. As well, risk is now diffused and risk management systems are more sophisticated than in the past. These fundamental changes suggest a possible change in the typical cycle of cash availability.

How lessors and financiers view current conditions will likely influence their future behavior. Those who believe today's environment is part of a boom-and-bust business cycle may wait to to put their money to work (anticipating that we are in an environment of exceptionally competitive pricing pressures and on the brink of higher loan losses). Those who see these risks may adapt by altering their product mix and their methods of doing business.

- ➢ Do we constantly review our underwriting standards?
- ➢ Do we stay abreast of changing conditions in the market? How do we respond?
- ➢ Do we use up-to-date risk management tools?
- ➢ Do we understand where risk is "housed" on our transactions?
- ➢ How will the risk bearers react if there is a market correction? How will those reactions influence us?
- ➢ If liquidity tightens, are we prepared with alternative funding sources?

Industry Trends

The Diffusion of Risk

Increasing use of derivatives, particularly in the credit-default swap market, along with syndication, has changed the fundamentals of managing risk. Growing two-fold every year since 2001, the growth in the credit default swap (CDS) market continues to surprise industry analysts. The CDS market has grown so rapidly that regulators have had difficulty developing a system to track deals. Although the exact size of the market is unknown, it is estimated at between $28 trillion and $30 trillion globally, with 40% in the US, 40% in Europe and 20% in Asia. Now that hedge funds, asset pools and high-net-worth individual investors have become more prominent as holders of debt, banks have become a smaller overall factor in determining the shape of the market; their role in the market place as setters of lending standards has diminished. As observed in *The Wall Street Journal*, banks are consequently "less likely to contribute to choking off the credit that drives economic growth." Risk is being sliced and diced, and distributed more broadly into the market through sophisticated, financially-engineered derivatives and other products. As transactional risk is diffused more broadly, we may see a continuing separation of the ultimate risk-bearer from the original transaction from which it arises. The IFC speculated that it may even be difficult to identify where the ultimate risk resides when a classic "work-out" is required with the customer.

A related concern is that there are now other players involved in housing risk. With risk trading more freely those that hold it at any given time may have a very different cost basis in that risk – particularly verse the traditional buy and hold players. This may lead to confusion and conflict as various players attempt to recover various returns in a workout.

In the words of one IFC member, "Leasing may exist today as an off-ramp to keep our industry from being pulled into the major throughway that is finance." With fewer terms and conditions, the lease product has softened, actually moving it away from the "safer" end of the risk-adjusted return curve; this represents a significant market shift, as most lessors have traditionally believed that the provisions of a lease, including ownership of the asset, requirement to reaffirm or reject a lease in timely fashion upon bankruptcy of a lessee, and the "hell-or-high-water" nature of rental payment obligations, made the lease product fundamentally "safer" than either unsecured or secured lending.

The situation is compounded by structuring and commoditization of risk. The ability to securitize components of risk within leases or pools of leases creates a new stage on which multiple players may find themselves interacting – especially if workout or recovery becomes necessary. "You may know who has the risk today, but not tomorrow," summarized a conference attendee. And as the risk moves, the selling price becomes a new basis for the subsequent investor. Anticipating a new and complex set of processes in the event of a downturn, lessors and lenders are "standing by" with assembled teams of workout specialists. "There are whole teams of workout people waiting for this to happen," said one IFC member. "Everyone is hedging themselves with workout professionals who'll be ready if the market goes down."

- As risk is diffused, do we know who will be the players if a "work out" is required?
- Do we know everyone who holds some of the risk in each deal?
- Are we satisfied with the risk-adjusted returns available in the market? How are we reacting?
- Are we aware of the various tools and devises for mitigating risk?
- Do we rely on selling down risk? If that market tightens up, will we have alternatives?
- Have we diversified our risk by term? Equipment type? Industry?
- How are our competitors measuring and managing risk?

The EBO Effect

Because underwriting standards are still strong and much of the emphasis is on products, IFC members discussed whether most industry players still focus on residual values, a traditional differentiator of the lease product and leasing marketplace. The IFC discussed even the troublesome terminology commonly used in the market (e.g. "the non-lease lease", "synthetic lease", etc.) that signals compromise or mitigation of differentiating standards. Consequently, a true lease, that achieves bona fide off-balance sheet treatment for the lessee, retains tax ownership for the lessor, and does not convey risk or reward of asset ownership to the lessee will, in the future, likely reflect a return to stricter standards, and will likely be for a term reflecting less of the anticipated useful life of the assets. "You'd better become good at asset management," said one conference attendee, "because the residual lease is where the game is."

But that may be more easily said than done. The proliferation of Early Buy Out (EBO) options, caps and collars on purchase options, Fixed Price Purchase Options (FPPO's), etc. have established market expectations about treatment of residual risk and reward. "I believe the ability to get fair value in some markets no longer exists," said one Council member, "because customers have the option to optimize their residual options based on prevailing market terms."

Adding to the residual realization challenge is the growing trend toward inclusion of soft costs, bundled services, maintenance, and other non-residual-oriented components within financings. This trend toward inclusiveness, IFC members agreed, adds to transaction risk. "The ability to make money on good deals is disappearing," one attendee summarized. "There are some products out there that appear to take residual risk where there is not likely any residual value."

- What is our company's asset management philosophy?
- Do we have resources to assess, manage, and optimize asset values?

- ➢ Are we being adequately compensated for residual risk?
- ➢ Where is our company looking for new markets?
- ➢ Are there new markets our company can enter in which our customers are already doing business?
- ➢ With whom are we speaking, and what are we reading to learn about trends and conditions outside our industry?
- ➢ Do we frequently consider new approaches that broaden our product offerings?
- ➢ Do we distinguish our leasing products from our loans? Should we?

Growing Dependence on Fees

The Industry Future Council of 2002 predicted that sources of revenue would expand to include soft costs such as services. But few realized then that the industry would move into different products through its financing of software and services. Today's IFC Council believes the trend to add services will continue as spread income derived from leasing and lending continues to be "squeezed" by the abundance of capital seeking deployment in the market.

As evidence, IFC members noted that the non-financial revenue component at many financial institutions is growing as a percentage of all revenue. At least one major bank now derives more than 50 percent of its revenue from non-interest income – a significant shift in mix from historical norms.

With infrastructures in place to originate transactions, more and more funding sources are looking at syndication as a means of mitigating risk, while also generating fee income. The "originate-to-sell" model encourages the development of financial products that have the broadest possible appeal in the financial markets, which further suggests a trend toward less-differentiated, more generic products with the broadest market appeal. This has added additional momentum to the migration of the lease product toward a loan-like product, as existing origination machines continue to pursue increasing volume, not constrained by their own portfolio capacity, but relying on the originate-to-sell model.

A company with a strong origination platform should be able to generate a continuous flow of deals that qualify for securitization. Without continuing spread income, or expectation of residual upside, many of these originators are also emphasizing fee generation. "I'm seeing small-ticket firms build six or seven different fees into their lease forms," said one IFC member. In addition to fees for documentation and insurance, at least one firm had begun to charge an equipment return fee. The consequence: further scrutiny by regulatory and business practice overseers, on guard against the non-transparent elements of financial products.

The IFC also discussed the difference between annuity-like portfolio earning streams, versus the non-repeating nature of one-time fees and charges, and a growing emphasis "originate to sell" model. The fact that one-time revenue items must be re-generated and expanded from a "zero base" each year to demonstrate growth, changes another element of the traditional lease portfolio stream of continuing revenue, enhanced by residual realization.

- ➢ How often do we review our product offerings and add new products?
- ➢ Do we operate on an "originate-to-sell" model? Are we prepared for a more "lumpy" income or growth pattern?
- ➢ Are we disciplined to alter our model when a market correction occurs?
- ➢ Will we see the warning signs of the impending correction and be prepared to act quickly?
- ➢ What is our mix of spread and fee income? Is this the appropriate mix? What is the trend line?

Product Influences

Customer Demands

As customers become ever more sophisticated in their knowledge of leasing, it seems reasonable that they desire a better understanding of component pricing. At a firm represented by one IFC member, the trend among customers two years ago was to ask that equipment, warranties and software be bundled into a single product. But upon receiving the bundled price, customers would then "peel the onion" in an attempt to break out each price and negotiate it separately.

In addition to seeking the "best of both worlds" (the benefits of bundling with the scrutiny of line-item pricing), customers want a single point of contact at the leasing or finance company for all aspects of a transaction. Said a conference attendee, "They want one throat to choke – and one set of terms and conditions that apply around the world." IFC members shared multiple anecdotes about customers requesting the same terms and conditions, including residual valuations, for assets deployed around the globe, even though the markets for used equipment may differ enormously, regulations may require different structures, and often the customers want only the "local" entity to be financially responsible for compliance locally, despite the expectation that pricing would reflect the parent company's strength. These challenges are common in the market, and the trend appears to continue in this direction.

- ➢ How can we meet our customer's demands while remaining profitable?
- ➢ Are we serving our customers in all the markets where they would like to work with us?
- ➢ What checks and balances do we use to ensure we are complying with current governing law?

Regulation

The IFC sees no end to the continuing effort by regulatory bodies – both tax and accounting – to tighten the standards around which leases can be structured. Additionally, the members saw an increasing influence of non-US entities (IASB, and Basel II for example) on their US counterparts, suggesting the possibility that continuing changes may be affected by, or determined by, the "global market". Industry players who do not conduct active business outside the United States may find themselves having to learn and comply with new standards driven from outside their traditional markets, increasing the need to stay informed and aware of such regulatory trends. As one conference attendee explained, "We can't focus on the future until we understand the platform we're standing on." [**Note:** Readers can find a detailed discussion of how outside trends can affect our industry, and where to look for these trends, on pages 1 through 3 of the 2006 IFC Report, download at www.leasefoundation.org/index.cfm]

- ➢ How will global expansion affect the way we do business in the U.S. Market?
- ➢ What expertise do we need to help us navigate the regulatory landscape?
- ➢ How do we provide creative solutions to address customer demands without compromising our standards?
- ➢ What can we do now to position our products and processes for anticipated new regulations?

Personnel Trends

As recently as a decade ago, new talent was drawn to the leasing industry for its entrepreneurial character, the intersection of financial with hard-asset knowledge and skills, the relatively unregulated market environment, and its differentiation from more traditional investment banking or commercial banking.. Today, mergers and acquisitions, as well as the tendency of banks and captives to rotate employees through leasing as part of a career in general finance, have populated the industry with as many resources who are "passing through" as those who are on a singular career path in leasing. As leasing becomes more of a "product" than an "identity", the competition for talent will continue to focus on the differences – what, exactly, makes this industry attractive to new talent?

The leasing industry used to embrace a kind of "alignment of interests" through compensation plans that rewarded transaction originators for actual performance of their transactions (residual upside playing a role in total compensation, and credit losses creating negative sales compensation). As more emphasis is placed on separation of duties, and accountability of disciplines (as is common among larger institutions), transaction originators find less direct impact on their personal compensation for generating the more difficult (albeit more profitable) true lease than a more generic, loan-like product. Consequently, the separation of duties has, in an odd way, created a separation of motivation that is reflecting itself in the types of transactions originated. "Selling" a customer a more differentiated product in the face of competition that is responding to the "buyers market" through concessions on rate and terms becomes a simple cost/benefit analysis at the sales level. Without differentiated reward, it becomes difficult to justify the time, effort, and risk of pushing a more complicated or more differentiated product. Additionally, the high level of merger and acquisition activity has fostered a shorter "view" of the future for many individuals in the industry. "It's somewhat like major-league sports," commented one IFC member; "No one ends up with the same team they started on."

- ➢ Where are we going to find new talent?
- ➢ Are we actively involving our new talent in all aspects of our business/industry?
- ➢ Are we creatively identifying the mix of skills necessary to grow our business?
- ➢ How can we promote the benefits of employment within our industry?
- ➢ What is our industry? How big is it? Why would someone want to be employed within this industry?
- ➢ How does employment in the equipment finance industry differ from employment elsewhere in the financial markets? The pros and cons?

- ➢ Are our employees compensated for creativity? Are incentives aligned with long-term company interests?
- ➢ Does our current compensation model work within the "new" framework of this industry? How can we be more creative in compensating employees?
- ➢ How do we identify and groom our future leaders? Do we have a succession plan?
- ➢ How do we justify to our stakeholders the time/cost it takes to develop future leaders?
- ➢ Do we "know" what it takes to be successful in this industry?
- ➢ How do we evaluate outsourcing and off-shoring of jobs?
- ➢ Are we operating at peak efficiency?

Recruiting Effectively

A trend among new entrants to the industry is to lure experienced but lower-level employees from competitors by paying them significantly more than they made previously. By avoiding the "training" aspect of resource development, these companies can justify higher incremental pay for trained/somewhat experienced personnel. This cycle forces established companies to recruit continually to fill these spaces. But IFC members foresee a greater problem: fallout from a market that is over-saturated with players. "Yield and volume pressure are forcing small banks and other financial services companies to add more arrows to their quivers," said a conference attendee. "The impact of these companies entering our market, and providing apparently "larger" opportunities for our human resources, will continue to put pressure on us to provide career advancement opportunities in an industry that is otherwise undergoing organizational flattening, as we eliminate layers of management to achieve efficiency."

More established players recruit recent college graduates, professionals from other firms inside and outside leasing, and people employed in vendor services. Hiring from vendor sales can be especially successful, one member reported, because the transition to lease sales is a logical progression. Vendor sales teaches pricing, valuing and documentation. It also requires interaction with customers on a daily basis. "What [those in vendor sales] don't know about presentation and marketing skills is not a major obstacle," this member stressed, "because they know leasing, and that earns customers' trust." Oddly, of the firms that have new employee recruitment and training programs today, many are independents and other smaller companies.

Another IFC member suggested that companies broaden the field of back-office candidates by recruiting in different pools of resources – including the non-college-graduate pools. These hires would not be expected to advance into senior management unless they later obtained more education, but provide cost-effective service that is more easily balanced with their expectations for work-life balance.

Yet another source of potential industry resources: work-from-home professionals. Companies that limit their hires to those able or willing to commute to an outside office fail to consider an entire population of workers who've either made enough money to improve their quality of work life, or wish to work from home for other reasons. Implementing flex time and work-at-home privileges could greatly increase the pool of employee candidates.

No matter where new employees are recruited, though, IFC members agreed that opportunities arising from the graying of the industry should be emphasized. Many companies are growing rapidly and expect to make further acquisitions, which in turn will require more finance professionals. College graduates who join the industry will learn to sell, structure and negotiate. And by working for growing companies, they'll have opportunities to relocate as their firms expand. In the words of one IFC member, "These chairs need to be filled, and they're not low-paying positions. But we need to find the time and resources to develop people once they join our industry."

The "Cool" Factor

The IFC included representation from the Future Leasing Leaders group, and a broad range of individuals at the early stage of their career in our industry provided input for the Council's consideration. New business-school graduates are drawn to fields like investment banking because of the prestige associated with that "industry". But few students graduating today are even familiar with equipment leasing, and this absence of knowledge impedes recruitment. While not a new phenomenon, such low levels of visibility and awareness seldom exist in a "mature industry", as the IFC was inclined to call the leasing and finance industry. "If I'm 21 years old and I say I'm in investment banking, my friends are impressed," said one attendee. "If I say I'm in leasing, they won't know what I'm talking about."

The social status of investment banking may be cyclical, as the Council analyzed the tendency of Wall Street to overpopulate when times are good, and to contract ruthlessly when volumes and targets are not made. News of enormous bonuses and high visibility adds to the appeal, and the expansion of opportunities with hedge funds and private equity firms presents yet another alternative to the leasing and finance industry.

An important feature that this industry can provide, however, is continuing education and credentialing. For example, the Chartered Financial Analyst (CFA) designation requires either a bachelor's degree or four years of comparable experience, along with commitment to a code of professional conduct. To pass each of three course levels, students devote at least 250 hours to study. Earning the designation engenders pride among young professionals and fosters their commitment to the profession. Were the equipment leasing and finance industry to develop and promote such a designation program, upcoming business graduates, as well as mid-level managers in outside industries, could be attracted in greater numbers. The Council recognized the existence of certain certificated programs sponsored within the industry, but the relative appeal or recognition remains low compared with those in other industries.

Outsourcing and Off-shoring

IFC members concurred that outsourcing and off-shoring are valuable business tools and trends of which industry participants should be aware. Examples of traditional outsourcing include the use of a collection agency, an accounting firm or a legal firm. Taken to its desired result, outsourcing puts in the hands of specialists those tasks that they can do better than lessors and financiers.

Some companies move large portions of their back offices to locations at which pay rates are low and/or unemployment is high. These companies may move their back offices periodically as new locations with greater attractiveness emerge. One IFC attendee noted that a former employer moved back-office services first to Asia, then to Mexico, then to the Maritimes in Canada, and more recently to Eastern Michigan as the economic situations in each of these regions changed. The question arose as to whether the cost of chasing inexpensive labor negates its benefits, but several IFC members whose companies have engaged in off-shoring indicated their experience shows that the savings are typically large enough to accommodate these costs, but normally not as large as the basic wage-rate differential would suggest.

- Are our employees compensated for creativity?
- Does our current compensation model work within the "new" framework of this industry?
- How can we be more creative in compensating employees?
- How do we identify and groom our future leaders? Do we have a succession plan?
- Do we "know" what it takes to be successful in this industry?
- Are we prepared for the void created from generational retiring?
- How do we evaluate off shore employment? Is it really financially affective?

Technology Trends

While increasing efficiency and convenience, the use of technology aids the industry's growth and attractiveness to new resources. As few as five years ago, many industry participants believed that face-to-face interaction with clients was crucial to doing business and creating customer intimacy. Today, however, many clients no longer expect or wish to spend face time with their lessors and lenders. Their preferred method of contact is either the Internet or the telephone. The Council noted a continuing trend toward paperless transactions (see Foundation study slated for release later this year), from origination to billing to asset management to automatic account debiting and email communication.

"People want technology with highly efficient, front-end origination in the office, but which can be disconnected to do business on a hand-held device and later brought back to the office, whether it's a billion-dollar deal or small-ticket," said one IFC member. Having this ability could facilitate doing business abroad without establishing a foreign office. This is particularly important for industry players being challenged to become an international company. A solution could involve U.S.-based technology and best practices, and a "presence" in foreign economies.

Past as Prologue

One of the Wall Street Journal articles used in preparation for the IFC speculated that fundamental changes had occurred in the world's financial markets, the result of which would be a "compression" of the peaks and valleys of previous cycles. While instinct led most members to view such analysis with skepticism, the Council did note that some of its own conclusions derived during the meeting might actually support such a theory. For example, the packaging and distribution of risk, allowing holders of portfolio to manage and sell (or syndicate) risk that previously remained attached at the asset level, might actually alter the way portfolios are dealt with in an economic downturn. While the "benefits" of securitizing risk may be offset by the uncertainty of how various parties may react, the Council generally agreed that response and reaction between lessors and troubled lessees may be different in the future than in the past.

Regulatory constraint and market pressures on spreads may have resulted in a movement of lease product further along the risk curve compared with other financial products.

The diluted differentiation of the lease product, and the demand-driven expectations of lessees have driven the mix of "true leases" and "loan-like leases" in portfolios toward a greater percentage of "financings" and a lower percentage of "leases".

A less-differentiated leasing industry presents an increasing challenge for attracting and retaining new talent. Expectations of new resources regarding non-financial compensation (image, clarity of career path, training, credentialing) may not be in line with what the industry has to offer.

As in past cycles, the return available from today's competitive pricing may not be full compensation on a risk-adjusted return scale. Volume and profitability growth objectives have placed greater emphasis on the non-spread components of returns (fees, and other incremental-but-non-recurring items).

New entrants to the industry bring a different set of motivations and expectations, presenting a challenge for traditional players to understand their motivations for value creation or enhancement.

The potential impact of globally-aligned regulatory guidelines will likely increase in the US market.

Influences on tomorrow's industry, the group identified certain areas of consensus, around which every industry participant should be planning for the future:

- "Leasing" and "Financing" have become less differentiated, as indicated by the broader umbrella defining "the industry"
- Contemporary "lease" structures may present a more challenging risk-adjusted return profile than in the past
- The market is being defined by customer-driven product design and terms
- The mix of equipment, soft costs and services in "solution-type" financing continues to evolve
- Plentiful capital, and recent loss experience have compressed margins overall and narrowed credit spreads
- Risk is being diffused, packaged, and dispersed through capital markets
- The distribution of risk may present different challenges for workout and recovery processes
- If historical cycles are predictors of the future, current conditions suggest a "correction" ahead
- The timing and intensity of a correction remains uncertain; predictive indicators may come from other industries
- Previous cycles may not be accurate predictors of the "peaks and valleys" of future cycles
- New entrants suggest a continuing, robust industry, but new forms of value creation may be motivating their interest
- The US domestic marketplace is increasingly affected by international standards and influences
- The ability to attract, motivate and retain new talent will depend on psychic, as well as financial rewards

Despite, or perhaps motivated by, ever-changing tax, accounting, and financial variables, the "Equipment Leasing and Finance" industry continues to evolve, to grow, to adapt. Looking "back" from 2012, the 2007 Leasing and Finance industry will have been a step on a path, leading in directions no one can today predict. Those making the observations in 2012 will be those who were best informed, most adaptive, and cleverly responsive "back" in 2007.

Meeting Mechanics

The 24 members of the Equipment Leasing & Finance Foundation's 2007 Industry Future Council met for two days on January 23-24 in Tampa, Florida.

The conference opened with brief introductions from all Council members, noting the industry and outside experience of each. Facilitator Joseph C. Lane then led attendees through a thorough discussion of the industry's position – and composition – in 2007.

On day two, Council members examined the causes of multiple influences on the industry, from deteriorating risk-reward ratios to the diminishing numbers of young professionals now making equipment leasing and finance their career.

Members also perused current economic conditions for signs of a pending market correction. Throughout the conference, members shared their experiences and observations and then posed questions that report readers can ask of themselves and their companies in an effort to prepare for the future.

Equipment Leasing & Finance Foundation
Your Eye On The Future

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