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The Equipment Leasing & Finance Foundation
1825 K Street NW
Suite 900
Washington, DC 20006
202.238.3400
www.leasefoundation.org

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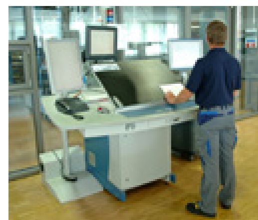
Do Financial Covenants Have a Place in Equipment Finance?
By James M. Johnson, PhD, and Barry S. Marks
Financial covenants are promises by a borrower or lessee to achieve or maintain specific financial targets, often expressed as ratios, such as net worth or total debt levels, or cash flow debt coverage ratios. A survey of banks, independents, and middle-market companies examines whether, in the wake of the Great Recession, financial covenants have become commonplace in equipment finance documentation.

A Cape Town Protocol for Marine Assets: What Can We Agree on Right Now?
By Michael Kim
The Cape Town Convention on International Interests in Mobile Equipment has served financiers of aircraft and their counsels very well. Such is not the case, however, with the ship finance industry. This article examines past attempts to develop a marine protocol, addresses whether cross border maritime issues are too difficult to fix, and proposes steps and guidelines for tailoring a workable protocol. Momentum may build once an initial set of principles is agreed upon.

M&A Has Rapidly Changed the Canadian Commercial Equipment Finance Marketplace
By Hugh Swandel
Since the global crisis of 2008, consolidation and change have redefined the major players in the Canadian leasing industry. As with other types of financial services, the leasing industry was trying to understand a situation few had predicted and none could navigate with certainty. Banks and credit unions have gained market share at the expense of independent and foreign lessors. This article explains how those changes occurred and what they may portend.



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M&A Has Rapidly Changed the Canadian Commercial Equipment Finance Marketplace

By Hugh Swandel

Since the global crisis of 2008, consolidation and change have redefined the major players in the Canadian leasing industry. As with other types of financial services, the leasing industry was trying to understand a situation few had predicted and none could navigate with certainty. Banks and credit unions have gained market share at the expense of independent and foreign lessors. This article explains how those changes occurred and what they may portend.

In recent years, the Canadian commercial equipment finance marketplace has undergone consolidation and changes that have redefined the major players in the industry (Figure 1). The drivers that created all this change include the credit crisis, the aging of independent owners and operators, and the consequences of designating General Electric Capital Corp. Inc. (GE) as too big to fail.

The credit crisis of 2007–2008 appears to have been the catalyst for a constant stream of more than 35 M&A transactions that have realigned market shares held by the various constituents in the industry. As Table 1 indicates, banks and credit unions have gained considerable market share at the expense of independent and foreign lessors in Canada.

AGENTS OF CHANGE

How did these changes happen, and what are the consequences for the future of the Canadian commercial equipment finance industry? Most industry executives would agree that the global collapse of credit markets was an event that few predicted. Fewer still could have understood the consequences of the rapid deterioration of the operating environment for commercial equipment finance companies. Many commercial equipment finance firms had to reevaluate their future in the industry, while others would see the changing environment as an opportunity to gain valuable market share and new product lines.

These were challenging times for finance companies in Canada. Large numbers of lessors relied heavily on the insurance industry, public market securitization, and bank syndicates as sources of funding. Virtually overnight, public market securitization for commercial equipment finance in Canada halted and did not recover for years. Some insurance industry sources, concerned with their own liquidity and sources, increased the cost of capital significantly and with little notice.

Banking community uncertainties about their own liquidity meant that nonbank finance companies found their existing facility sizes reduced and deal terms altered. During this period, shareholders and executives were scrambling for options that would help them survive.

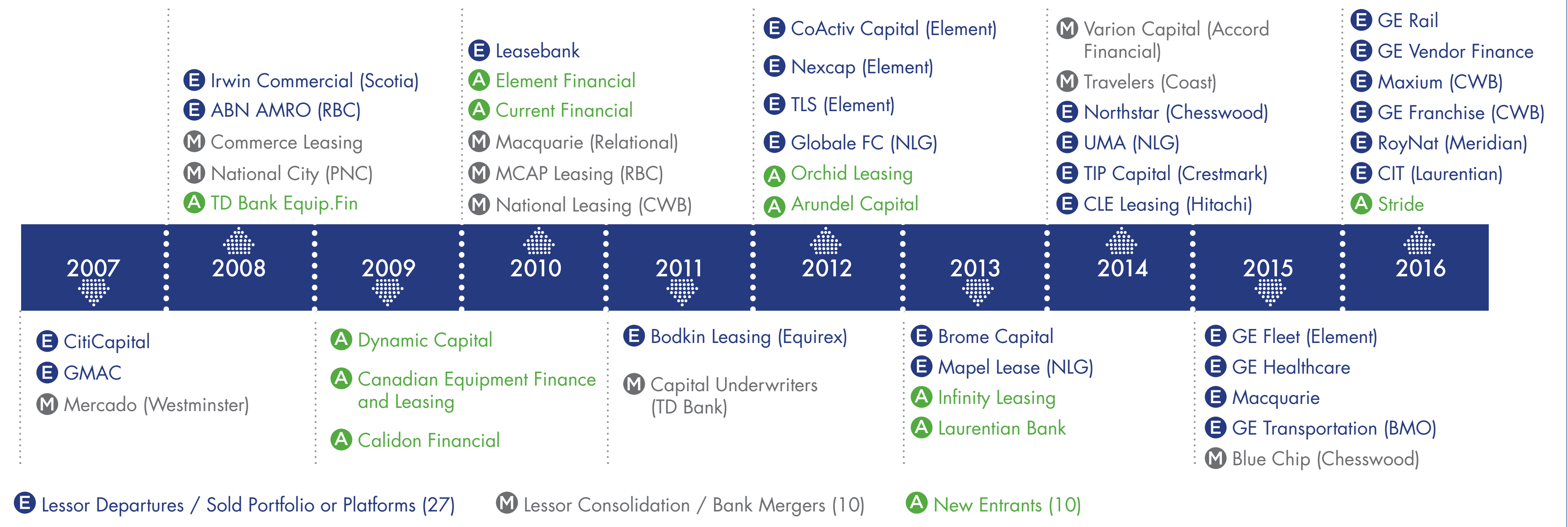
The Canadian Finance & Leasing Association (CFLA), like other financial services associations around the globe, was trying to understand a situation few had predicted and none could navigate with certainty. The CFLA focused on lobbying the federal government to provide solutions to the lack of available capital for nonbank finance companies, includ-

Table 1. Change in Canadian Market Share, 2013–2016

	2016	2013	Change
Captive finance companies	11.7%	12.0%	-2.9%
Banks and credit unions	70.5%	62.0%	13.6%
Government agencies	8.8%	10.0%	-11.6%
Independent and foreign	7.0%	14.0%	-50.3%
Insurance	2.1%	2.1%	0.0%

Sources: Alta Canada proprietary database, CFLA.

Figure 1. Noteworthy Exits, Mergers, and Arrivals



Source: The Alta Group.

Table 2. Some Facts About the Canadian Market

Equipment Finance Market Size Estimates

CDN $ millions	2015	2013	% change
Private sector spending			
New financing	$29,039	$28,498	2%
Spending on M&E	$72,824	$64,845	12%
Finance share	40%	44%	
Public sector spending			
New financing	$5,707	$5,767	-1%
Spending on M&E	$14,313	$13,123	9%
Finance share	40%	44%	
Equipment finance market size			
New financing	$34,747	$34,265	1%
Spending on M&E	$87,137	$77,967	12%
Finance share	40%	44%	

Sources: Statistics Canada, CLFA.

ing captive finance arms of manufacturers and independent finance companies.

Experiencing periods of low liquidity is nothing new for finance companies, but the severity of the events of these years was unprecedented and unanticipated. Although some firms acknowledge that the liquidity crisis directly caused the sale of their companies, other factors were also at work over a number of years.

EMERGENCE OF ELEMENT CAPITAL

Perhaps the best example of change caused by the 2008 financial turmoil and resulting frozen credit markets was the founding of Element Financial by Steve Hudson. While the financial community was struggling with a lack of liquidity and an unclear lending climate, a prescient Hudson saw an opportunity to pursue the acquisition of companies, assets, and talented executives made available by a nervous industry. In a relatively short span of time, Element Financial has created two of the largest finance firms in North America.

The original intent was for Element to be a Canadian equipment finance firm, so the first acquisitions were Canadian independent equipment lessors. It could be said that the efforts of Element to find acquisition targets planted seeds with a number of owners who later did sell, but not to Element.

The company that grew into the Element we know today began in 2010 when a private investor group led by Hudson acquired what was then a very small independent commercial equipment finance company, Element Financial. Element came to the acquisition market when some of the best Canadian companies had already been sold or were in the process of selling. Scotiabank acquired Irwin Financial in 2008, Canadian Western Bank (CWB) acquired National Leasing in 2010, and Royal Bank of Canada (RBC) acquired MCAP Leasing later the same year.

These three companies all had a strong track record and were among the largest independent finance companies in Canada at the time. The banks acquiring these companies offered a viable long-term solution to the sellers' treasury issues, and the deal terms were strong enough to adequately reward selling shareholders.

In the case of Scotiabank, the acquisition of Irwin Canada gave it a vendor-focused sales force with a strong reputation and a management team with a long history of providing results for a variety of shareholders.

After the acquisition in 2008, the Irwin team was rebranded under Scotiabank's subsidiary RoyNat Lease Finance. Over the span of eight years, the portfolio grew from $400 million to $1 billion in assets under management. In 2016, Scotiabank sold RoyNat Lease Finance to Ontario-based Meridian Credit Union, citing a desire to pursue larger ticket transactions.

CWB acquired National Leasing in 2010 at a time when the company had long been the target of acquisition suitors desiring the strength of National's award-winning management team, strong corporate culture, and years of profitable origination growth. When the sale was made public, National stated that it had difficulty managing a complex treasury with a large number of funding partners and this was a contributing reason for selling.

CWB was a strong bank with a good balance sheet but had been criticized by investors and regulators for having high exposure geographically and to certain industries. National Leasing was a perfect solution for these issues as it provided assets across the country along with a sales force that delivered considerable diversity of credit, equipment, and geography.

National was allowed to operate as a subsidiary of the bank with only nominal changes in direction and influence from the new owners. The bank's treasury and balance sheet strength enabled National to consistently hit growth and profit targets.

At the time of the sale of National Leasing Group, there were a number of bidders for National including Royal Bank of Canada. RBC, which had been contracting with National Leasing to service its commercial equipment finance portfolio for a number of years, pursued other acquisitions after losing National to CWB. RBC subsequently acquired MCAP Leasing, and the servicing relationship with National was ended.

ACQUIRED FIRMS GAIN FROM BANK OWNERSHIP

Irwin, National, and MCAP had all competed with each other for years, and as each one sold to a bank with a very low cost of funds, the others had to compete with lower pricing against the strong balance sheets of the banks. The banks making these acquisitions were all subsequently rewarded with strong growth in originations and profits.

Element was seeking acquisitions at the time of the sale of National Leasing and MCAP but either arrived on the scene too late to entice these sellers or was passed over because the multiples paid on these transactions were beyond the scope of a publicly traded company.

Element subsequently began scouring the Canadian market for acquisition targets; when it saw only limited Canadian opportunities the company began to expand its appetite to include U.S. firms and firms engaged in fleet financing. The initial acquisitions by Element included the remaining portfolio of Alter Moneta, which was winding down at the time; NexCap Financial, a niche market equipment lessor; and TLS Financial, a Canadian fleet lessor.

In addition to these completed transactions, Element targeted most of the significant players in Canada and aggressively solicited acquisitions. By now, the Canadian market had witnessed a series of acquisitions by deposit-takers, along with the aggressive acquisitions of Element Financial, and this sparked several of the remaining players to begin considering how and when they would sell their businesses.

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The changes that started with a flurry of acquisitions continued as uncertainty and the altered competitive landscape caused more companies and executives to reconsider their options. Element continued to acquire in Canada but shifted focus to

larger acquisitions in Canada and beyond. Independent Canadian firms that had been pursued unsuccessfully by multiple buyers became intrigued after seeing deal terms that would make sense to their shareholders.

The sheer size of GE Capital cannot be overstated. In 2013, the Monitor list of the top 100 commercial equipment financing companies had GE in the number one position and showed the total assets being managed as more than twice the size of the second largest firm.

Subsequently, Hitachi Capital entered the Canadian market by acquiring Canadian Leasing Enterprises. Chesswood Group acquired Northstar Leasing, Blue Chip Leasing, and Ecohome Financial. Other acquisitions continued with deposit-takers and foreign lessors adding strategic assets.

GE CAPITAL SOLD

As time passed, regulators began to propose new laws and requirements that in theory would prevent a future liquidity crisis. It is debatable whether these measures will truly prevent future market disruptions, but there were clear consequences due to the subsequent regulatory changes. The most significant consequence was the decision by GE to sell all its finance companies.

In July 2013, the U.S.-based Financial Stability and Oversight Council designated four nonbank financial companies as too big to fail, and this list included GE. The impact of this decision on GE was significant and was part of the reason that the company decided to return to its roots via restructuring the company. This decision of GE to sell the largest commercial finance company in the world has resulted in a number of transactions that are reshaping the industry in Canada and around the world.

The sheer size of GE Capital cannot be overstated. In 2013, the Monitor list of the top 100 commercial equipment financing companies had GE in the number one position and showed the total assets being managed as more than twice the size of the second largest firm, Banc of America Leasing. Since making the announcement to sell these businesses, GE has transacted multiple divestitures in Canada including sales to Wells Fargo Canada, Canadian Western Bank, Bank of Montreal, Element Financial, and other Canadian entities.

An additional consequence of the changes at GE Capital was the constant exodus of talented GE executives looking to leverage their years of experience into new opportunities. New firms were started and existing firms were expanded as a result of the GE changes. Laurentian Bank of Canada added a group of former GE executives who made a strong impact on the market. There are numerous other firms that have added GE people in senior management and leadership positions.

The dispersal of GE executives through the sale of business units and departures to new and existing firms will have a lasting and significant change on the industry in Canada and around the world.

As the GE transactions were completed, some additional M&A activity was also occurring with more deals recorded by Canadian deposit-taking institutions. In 2016, CWB announced the acquisition of Maxium Financial, an Ontario-based lessor that pursued larger ticket transactions than National Leasing Group and provided further geographic, industry, and equipment diversity.

Recently, CWB was the winning bidder for the GE Franchise finance assets and team in Canada. The needs of CWB exemplify what has driven many of the acquisitions by deposit-taking institutions in Canada. Deposit-takers buying equipment finance companies generally need to deploy capital rapidly, reduce their dependence on real estate based lending transactions, and generate strong margins.

Additional examples of institutions acquiring commercial finance companies include the Bank of Montreal acquisition of GE Transportation, the sale of RoyNat Leasing to Meridian Credit Union, and the acquisition of CIT Canada by Laurentian Bank of Canada.

WHAT HAPPENS NEXT?

The pace of change in the Canadian commercial equipment finance industry is unprecedented, and the full consequences of the change are yet to be determined. The shift in market share to financial institutions is similar to past trends in the United States. When larger banks had a high level of funds on deposit, they competed to acquire independent commercial equipment finance companies as a way to deploy capital and quickly improve results.

The companies making the acquisitions in Canada are in most cases large with competing institutional agendas. Over time, institutions often narrow their credit and product appetite, and this will be a sign to entrepreneurs to expand or start independent finance firms.

Some of the financial institutions that have made acquisitions appear to be integrating their acquisitions wisely, and these companies should continue to grow. Canadian Western Bank and Laurentian Bank seem well positioned for growth. The recent decision of Scotiabank to

sell RoyNat (formerly Irwin) after eight years of ownership is an example of an institution headed in the opposite direction from the time it made the acquisition.

Scotiabank cited a lack of interest in relatively smaller transactions as a key driver for selling the business. The buyer, Meridian Credit Union, has many small business customers, and the acquisition would appear to be a better strategic fit. Time will tell where recent acquisitions fit with bank acquirers' future plans.

The recent decline in oil, gas, and other commodity prices has put considerable regional strain on bank and credit union portfolios, resulting in amended credit policies. Some see these credit appetite adjustments as an overcorrection. Independent finance firms have succeeded by filling gaps in the lending markets that have been created by changes in traditional lender credit appetites. This could be the opportunity for existing and new independent lessors to gain market share.

The current community of independent companies may be small, but the leadership and talent in these companies are well positioned for expansion. Capital for independent firms is again abundant, and investors recognize there is opportunity in the market and strong management teams worth backing. It is expected that independents will experience strong growth and that the number of firms will increase.

One of the consequences of CFLA lobbying was the creation of a new source of funding for independent firms, which should ensure that a repeat of liquidity problems does not have the same impact on the independent community. The Business Development Bank of Canada (BDC), a bank owned by the federal government, is the provider through an intermediary, TAO Asset Management (TAO). The BDC and TAO are helping incubate new and smaller leasing companies, and as these firms increase in size, market share will once again change. The BDC and TAO are now playing a critical role in the rejuvenation of the independent finance community in Canada.

The most recent indications from Element Financial are that it continues to seek additional acquisitions that may include further activity in Canada. Element has approved the split of the company into a fleet company and a commercial equipment finance entity. Time will also tell how well Element can perform as it digests the numerous acquisitions since 2010.

CONCLUSION

The Canadian leasing industry is considerably different in 2016 from eight years ago, and much of that change was initiated by the unprecedented events starting with the collapse of credit markets in 2007–2008. The resulting climate of uncertainty led to numerous acquisitions by Element Financial, banks, credit unions, and other industry players.

Even without the sale of GE companies, the Canadian commercial equipment financing market has been through a material transformation. The sale of GE Capital companies has further redefined the commercial equipment finance market as well as distributed talented executives throughout the industry.

The pace of these changes has been rapid, and the full impact of the market share shifts is continuing independently and in addition to merger and acquisition activity. Time will tell if the decline of independent finance and foreign leasing company market share is permanent. Perhaps the most interesting part of the story of Canada's changing commercial equipment finance marketplace is how the next chapter will read.

Hugh Swandel

hswandel@thealtagroup.com

Based in Winnipeg, Manitoba, Hugh Swandel is the senior managing director of The Alta Group in Canada. He has assisted many equipment leasing and asset finance firms in market entry, due diligence, funding, and strategic planning. Moreover, he has a strong reputation as an effective negotiator with regard to mergers and acquisitions, business development, market entry, securitization, and other areas of importance to lessors. Prior to founding his consulting firm, Swandel and Associates, in 2001, Mr. Swandel served as president and CEO of Electric Financial Group. During the global credit crisis, he was retained by the Canadian Finance & Leasing Association (CFLA) to provide insight into the effects on independent finance companies. He presented his findings to advisors of the Canadian minister of finance and contributed to policy development discussions with government and industry representatives. In both 2006 and 2010, Mr. Swandel received the Canadian leasing industry's highest honor when he was named CFLA Member of the Year. He serves on the board of CFLA, is past president of the National Equipment Financing Association, and is a member of the Equipment Leasing and Finance Association (ELFA). In recent years, he co-authored a research study for ELFA on the Canadian market. Mr. Swandel received a bachelor of arts degree with honors and distinction from the University of Winnipeg in Manitoba and also holds a bachelor of commerce degree with honors from the University of Manitoba in Winnipeg.