Independents: Niche Focus for Continued Success

By Charles Wendel

Despite multiple challenges, Independents of various types and sizes have continued to thrive and even dominate some sectors. These challenges include cost-of-funds disadvantages, increased focus by some banks on equipment finance, rising IT costs, and the downturn of the early 2000s. Based on a Foundation study, this article highlights the current role of Independents, how they have evolved since 2011, and their potential evolution over the next five years.

Independents remain a strong and critically important segment of the equipment finance and leasing industry. All signs point to their continuing to play a vital role going forward, no matter the business environment. The most successful players will adapt to changing circumstances, finding niche opportunities to meet customer needs while achieving strong returns.

Most Independents will continue to avoid direct competition with Captives and Banks, instead focusing on niches and customer types with which they can demonstrate value. The future is never certain, but Independents have demonstrated their ability to consistently generate strong returns.

FIC Advisors recently completed a report for the Equipment Leasing & Finance Foundation that involved assessing Independents' recent economic performance and interviewing more than 20 industry leaders concerning their day-to-day challenges as well as future expectations. This work enabled us to look at past results and to develop a perspective on why the industry succeeds today and how it has positioned itself for the future.

ECONOMICS: GROWTH, STRONG RETURNS, AND PRICING FOR RISK.

Based on ELFA's Survey of Equipment Finance Activity (SEFA), over the past 20+ years, Independents' share of total new business volume (NBV) has declined from a high of about 70% in the mid-1990s to 4.6% in the most recent year. A second survey, the Foundation's 2018 Equipment Leasing & Finance Industry Horizon Report, based on end-user customer interviews rather than ELFA members, estimates Independents' NBV share at 16%.

An observer might say that any industry seeing share erosion from 70% to 5% is fighting for survival and relevancy. But there are myriad reasons for the share decline, some of which result from the attractiveness of equipment finance overall as well as individual companies.

The reasons for the share decline include:

- Industry consolidation due to Banks acquiring Independents.
- Increased Bank focus on equipment leasing as both a lead and cross-sell offer.
- The inability of weaker or smaller Independents to maintain the required funding sources during the downturn.
- Changes in classification. SEFA respondents classify themselves as Banks, Captives, or Independents. In years past a number of companies, including CIT, DLL, and GE Capital, reclassified themselves from Independents to Banks or Captives, reducing NBV for the Independents' segment. The reclassification in part resulted from CIT becoming a bank to ensure its survival post-Great Recession and in part from the dismantling of GE Capital, with many of its noncaptive businesses sold mostly to banks.

Data from the Horizon report also helped to quantify the

Editor's note: This article is based on a Foundation research report titled Independents: Banking on the Non-Banks, *published in February 2019. It is available at* www.leasefoundation.org.

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market size opportunity for Independents. Based on the key industry verticals that Independents focus on, their financing opportunity is large and in many industries growing, now exceeding $122 billion. (By "vertical," we mean an industry or subindustry focus. For example, it might involve transportation or a niche within the industry in which the Independent can demonstrate its expertise, thereby differentiating itself from competitors.)

In addition, recent growth and performance metrics for Independents show this segment's continued importance and strength:

- NBV growth for Independents has exceeded that of Banks and Captives in each of the last five years, at 10% last year versus 5.3% and 9.9% for Banks and Captives, respectively. Almost 65% of all Independents increased their NBV last year, higher percentages than for competitors.
- While Independents operate with a higher cost of funds, Table 1 shows Independents generate higher yields and returns versus Banks and Captives, in part due to lower compliance costs and capital requirements.

In summary, while share has declined, the market opportunity for Independents remains large. Growth trends are positive. As we will discuss below, higher returns suggest that Independents operate guided by management practices that include a strong pricing discipline and a focus on those customers that are willing to pay higher financing rates either due to their risk profiles, need for structuring flexibility, time requirements, or other factors.

Independents believe they can manage the higher risk they may take on due to their industry knowledge, structuring expertise, and ability to balance risk and reward.

BUILDING AND SUSTAINING INDEPENDENTS' SUCCESS

FIC interviewed a cross section of Independents, both large and small, and startups as well as companies in operation for decades. Three factors play a key role in determining how Independents operate day to day: culture, strong practices in personnel selection and management, and what we term "strategic opportunism."

Culture

Culture often defines how employers interact with employees and how employees interact with each other and with customers. Our Foundation study presents a case example featuring GreatAmerica, a company that its founder created, in part, based on instilling a common culture of openness and respect both internally and toward customers.

Many interviewees at other firms stated that the cultures they were establishing stood in stark contrast to their experience at prior employers. One commented: "I worked for a company that said all the right things, but it was not authentic."

Culture incorporates a number of support elements:

- Accountability and responsibility. Interviewees stressed the importance of personal responsibility and the fact that "There is no place to hide here."
- Constant communication and transparency. One executive said, "If anything, we overcommunicate our vision."
- Employee training and internal "muscle-building." Muscle-building involves moving employees from one unit to another to develop them and provide more career options. One manager mentioned this approach was particularly important to attract and retain millennials.
- Adaptability. Over the decades equipment finance companies have had to respond to multiple disruptive events, including accounting rule changes, funding crunches, greater competition from banks and, more recently, the emergence of nonbank digital lenders such as Paypal, Amazon, American Express, and OnDeck, that are willing to make equipment-related loans, typically for small ticket amounts.

The most successful Independents have managed through these changes and more. They possess the culture, skills, and management strength required to proactively identify macrochanges and redirect their company's efforts as necessary. Independents have been "pivoting" (meaning evaluating the competitive landscape and thoughtfully altering direction as required) before the word was in wide use. The ability to pivot, in addition to a culture of innovation, is in the genes of most Independents.

Table 1. Performance Returns (%)

	Industry	Banks	Captives	Independents
Median pretax yield	5.70	4.52	5.84	8.81
Median pretax spread	3.00	2.50	2.90	4.62
Return on average assets	1.70	1.50	2.40	3.00
Return on average equity	16.70	15.70	20.0	21.20

Source: 2018 ELFA Survey of Equipment Finance Activity, illustrations 10c, 18a, and 18d.

Strong Practices in Personnel Selection and Management

Building a strong culture carries over to personnel choices. Independents focus on finding people with the right fit for their company. For example, a Midwestern company has found that non-Midwesterners usually fail at that firm. In that executive's view, there is a distinctiveness to a Midwestern approach that "outsiders" find a difficult fit.

Hiring philosophies differ widely. Some companies pursue millennials, interns, and nerds, while others want highly experienced employees who can contribute from day one. Compensation for sales staff is another area in which Independents try to distinguish themselves. Several mention that they place no caps on sales compensation, contrary to some Banks and Captives.

Strategic Opportunism

As discussed below, the success of Independents relies on their ability to exploit verticals and niches. Most Independents operate with organizational flexibility, minimal internal bureaucracy, and relatively few steps required to make a decision. They can quickly seize business opportunities that arise.

In one instance, the head of a transportation business learned of a niche player for sale. The niche player represented a new business line: one that would expand capabilities and add an experienced team that would immediately contribute to earnings. The company was able to react to this strategic opportunity and acquire that niche company within a matter of weeks.

HOW INDEPENDENTS DIFFERENTIATE THEMSELVES

Independents operate in a world in which Banks can offer lower rates and Captives have a point-of-sale advantage. For one thing, they must provide benefits to their customers that in most instances also involve higher financing costs. Independents differentiate themselves and provide value based on at least one, but more often a combination, of three elements: their knowledge of verticals and niches, the relationships they develop, and their use of technology.

The Power of Niches and Verticals

Typically, Independents target areas that larger players do not emphasize. Whenever possible, Independents avoid head-to-head competition, selecting subsegments that the biggest competitors may view as too small or too complex.

One company FIC interviewed focuses on the agriculture business, largely dominated by major manufacturers and their Captives. However, this company targets areas that are outside the interest of most Captives: "We focus on used farm equipment that most others avoid. We also have a specialized knowledge of some fairly unusual equipment. Big lenders don't want to bother with this." Other companies mentioned they concentrate on areas in which the potential volumes are limited and where "most banks don't find the area attractive."

Independents also develop areas of vertical industry expertise while being aware of potential concentration risk. They approach managing concentration risk in different ways. One Independent focuses on financing IT, healthcare, and materials handling equipment. Another works with 20 verticals to avoid concentration risk.

The Independents' niche emphasis goes beyond vertical or subsegment focus to include deal structures. Independents often focus on transactions that require complex structures, an area banks may avoid except for a top-tier credit: "We want to do a nonbank friendly asset. We will do nonstandard equipment with little liquidation value and some air ball. A bank won't do that."

One company addresses potential risk issues by using an intense due diligence process to price, underwrite, and monitor credits: "We know the equipment, we structure it with a security deposit, and we have corporate guarantees. We make money because we may ask 20 or more questions than the banker."

Moreover, unlike some larger competitors, most Independents operate with more limited NBV expectations. One executive commented, "We don't need 25% market share," meaning his company can pick relatively small subsegments to focus on and not stretch for deals.

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Independents are continually evaluating their niches, eliminating some while adding others. One interviewee discussed the structured approach his company uses to evaluate new niche opportunities: "We look at a possible new niche at least once a year. … The business and sales leaders evaluate its size and attractiveness, and risk people also have a view. … You should be doing this as a matter of course; it takes five to six years to build a niche."

Another Independent assesses each industry quarterly, with

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more formal annual reviews. Independents exit a business based on rate pressures and credit performance: "In the past few years we pulled out of two or three vertical markets because the underwriting quality was not that great and there was some compression in rates."

Importantly, exiting a niche does not appear to create internal defensiveness. One industry veteran summarized his firm's continual review process: "We have been in 74 verticals since we started. Now, we are in 20 significantly." In short, developing a niche focus requires a dynamic review process.

Relationships Still Matter

Building strong relationships with customers continues to be critically important to Independents' success. But, today the basis of a relationship rests on the differentiating value that an Independent can provide. The specific value on which Independents base their relationships varies: information, integration, speed of decisioning, structuring ability based on industry expertise, and so on.

One interviewee summarized how his firm uses value to build a sustainable relationship: "Value is worth more than a lower price. If I can process a transaction more efficiently, it will save time. That creates value. If I can provide a more integrated offer … that creates value. If I can develop a program to help the customer sell more … that creates value as well. If our billing is clear and error free and if our dispute resolution is fast, that creates value. This approach has allowed us to build long-term relationships with our vendors."

Technology May Separate the Excellent From the Mediocre

To a significant degree, Independents vary in their focus on and their use of technology. Some firms state they are "all in" on technology; others sit on various stages of the digital path. Virtually all are spending more time and dollars on IT. Even those companies that emphasize the power of their relationships also understand the value technology brings, both to increase efficiency and to build client ties.

Increasingly, companies are using technology both to improve efficiencies and to increase the value they provide. Table 2 summarizes some areas in which companies are applying IT solutions.

While most interviewees view leveraging IT as essential, some continue to doubt the need to focus here. Ironically, one Independent that works with end customers on IT-related financing described itself as being "like the shoemaker's children," saying that state-of-the-art IT was not necessary: "We don't need it. What the customer needs is our innovative funding approaches." Other Independents disagree.

A relationship approach backed up by technology is vital. IT can both create a barrier to new competitors and position a firm for the long term by linking it closely with its customers and making them difficult to dislodge. "Some say automation drives customization. For us automation drives differentiation. We offer a convenience-driven solution."

Companies that drag their feet in making IT investments may be at a disadvantage: "We cannot be on the fence related to IT. We give our technology to our clients and are very proactive in providing them with insights."

Table 2. Technology Application — Examples

Marketing	Origination	Underwriting	Risk management	Customer service and differentiation
▪ Digital marketing ▪ Database analysis of leads ▪ All activities entered into CRM	▪ Paperless applications ▪ Faster decisioning	▪ Credit scoring ▪ Pricing models ▪ Risk analysis	▪ Early warning system ▪ Portfolio management	▪ Portal ▪ Cost-management insights

Source: FIC Advisors.

CONTINUED OPPORTUNITY FOR THE BEST INDEPENDENTS, BUT…

Recent performance shows strong returns and low delinquencies and losses. Despite uncertainty, the general outlook for the economy and business fundamentals remains positive.

Cautious Optimism

Experienced Independents know that good times cannot last indefinitely and are preparing for a downturn: "It's a cycle. These are the heydays. We are looking at how to prepare for a downturn. That involves reviewing our portfolio, looking at internal limits, making sure we have an early warning system, and not being afraid to slow down growth, if quality growth is not there."

Just as some players are evaluating their own growth plans, they express skepticism about fast- growing rivals, particularly those that have generated significant volume in recent years.

Several even view a downturn as positive for their companies: "We do better when credit is rapidly expanding or shrinking. We would like a little more turbulence so that the Banks pull back."

Questioning Rapid Growth

Just as some players are evaluating their own growth plans, they express skepticism about fast-growing rivals, particularly those that have generated significant volume in recent years. One company executive commented: "The behavior today seems like the same as before the 2008 downturn. … Some people think there is a 'new normal,' but I don't buy that. Subprime is subprime."

Several interviewees mentioned they have observed competitors that, in their view, were "stretching for growth."

More Acquisitions?

Does the future also involve another round of consolidation of the Independent space as Banks look to acquire more assets? One potential buyer thought there is little of quality to buy right now, given high pricing expectations: "There are slim pickings on the acquisition front. We're not finding a lot of big Independent leasing companies to buy."

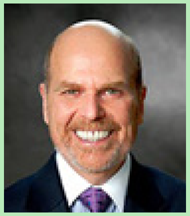
What Could Go Wrong?

Interviewees raised a number of possible problem areas:

- Funding. "Banks could have a bust and reduce funding, but a major fraud is more likely to cause Banks to stop funding Independents."
- Credit quality. "Many companies that have been started up in recent years have been built to sell. Those companies have been focusing on the short term. Some have been growing by giving dollars away. The problems do not show up for several years."
- Business segment risk. "Over the next 10 years, small ticket loans will be commoditized, like the credit card."
- Interest rates. "With rates going up, there is an increasing squeeze on spreads. More risk-taking has been occurring due to the low interest rate spreads. This has pushed risk-taking to new heights. There is so much liquidity that people want to put to work. This will come back to haunt some companies."
- The emergence of Fintechs. Independents are increasingly aware that digitally enabled lenders have the potential to disrupt their segment. For example, recently OnDeck announced its entrance into small ticket leasing. One interviewee mentioned about his firm: "We've been a Fintech for a long time but just didn't call ourselves that." More Independents are also evaluating whether and how to partner with Fintechs.

Management discipline, marketing focus, and a strong and supportive culture typify the most successful Independents. While the next downturn may push out those companies that have compromised credit quality for growth, Independents will continue to adapt to changing circumstances in the future as they have in the past.

Betting against Independents is a mistake.



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