Lender Finance

How Does the Capital Stack?

EQUIPMENT LEASING & FINANCE
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The Foundation is the only research organization dedicated solely to the equipment finance industry.

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

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

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

Table of Contents

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The Equipment Leasing and Finance Foundation commissioned The Alta Group to analyze how Independents are raising capital in the post-Financial Recession environment and whether banks are lending to equipment lessors across the industry.

To effectuate this study, Alta reviewed events leading up to and immediately after the Financial Recession, how banks responded to lending to the industry and how the current environment attracted new sources of capital. Integral to our analysis was an extensive examination of Lender Finance, the primary capital source for Independents historically.

For purposes of this study, Lender Finance:

- Is defined as "lending to non-depository financial institutions secured by a portfolio of financial instruments that were originated by third parties"
- Includes different types of lenders or participants such as traditional banks to newer entrants such as FinTech Venture Capital, Private Equity and, to a lesser extent, Insurance firms
- Serves non-depository financial institutions or asset classes including commercial equipment leasing, asset-based lending, timeshare lending, transportation leasing, healthcare lending among others

The aftermath of the financial crisis generally dampened the lending appetite of traditional commercial banks. Yet, the emergence of a new breed of lenders, such as marketplace lenders, tempted the banks to finance them attracted, in part, by wide lending margins. Speculation that this spelled the end of banks supporting equipment lessors is nothing short of inaccurate. While "alternative lenders" are the favored child in today's market, it is the equipment leasing industry that will emerge as the winner over time.

We encourage the reader to benefit from both the lessons revealed in this study as well as the forward opportunities presented for Independents seeking capital raising alternatives.

John C. Deane
Chief Executive Officer

The Alta Group℠

Purpose of the Study

The purpose of this study is to dimension the dynamics of the Lender Finance marketplace post-Financial Crisis. This Lender Finance study will determine whether bank appetite to be both a lender and participant in the leasing business has changed since the crisis. It will also review the implications for Equipment Leasing and Finance Association's member base – will more or less funding be available to Independents, in what form and to whom? Readers, whether suppliers or users of Lender Finance will benefit from this study.

What is Lender Finance?

For purposes of this paper, Lender Finance is defined as specialized lending to non-depository financial institutions secured by a portfolio of financial instruments executed by third party obligors. There are different types of lenders from traditional banks to newer entrants such as FinTech Venture Capital, Private Equity and, to a lesser extent, Insurance firms. Alternative Lenders make up the qualifying borrower base including equipment leasing companies, asset-based lenders, middle market loan companies, timeshare companies, transportation lessors, healthcare lenders and tax lien aggregators.

Figure 1: Representative Companies in the Asset Classes Targeted by Lender Finance Participants

Type	*Description*	*Representative Participants*		
Equipment Lessors	Providing both lending and leasing options for a variety of commercial equipment from small businesses to large, global corporations.	• Ascentium Capital • LEAF Financial • Cisco Capital	• Xerox Financial Services • Hitachi Capital America • De Lage Landen Financial	• Deutsche Leasing • Element Financial
Transportation Lessors	Specializing in leasing commercial transportation equipment.	• Chicago Freight • Ryder • TAL International • American Railcar Leasing	• Penske Truck Leasing • Idealease • GATX • Trinity Leasing	• Air Lease Corp • Banks and equipment lessors
Asset-Based Lenders	Lending to businesses secured against inventory, accounts receivable and equipment.	• Abacus Finance • Gerber Capital • New Star Business Credit • NXT Capital	• Oxford Finance • Prestige Capital • Saas Capital • Sierra Lending	• Major banks and equipment lessors
Middle Market Loan Companies	Providing a range of financings to businesses with revenues between $50 million and $1 billion.	• CBAC • Cerebus Business Finance • Culver Capital	• Fifth Street Asset Mgmt. • MidCap Financial	• Banks, insurance companies and equipment lessors
Timeshare Lenders	Financing fractional ownership in properties such as campgrounds, and recreational vehicles.	• Capital Direct (Canada) • CapitalSource • LightSteam (SunTrust div)	• Prosper (P2P) • Timeshare Lending,net	
Healthcare Lenders	Offering terms financing and revolving lines of credit for healthcare service providers.	• AccessOne • Healthcare Finance • Gemino Healthcare • Lending Club	• Triumph Healthcare	• Captives of healthcare OEMs, major banks, equipment lessors
Tax Lien Aggregators	Managing tax assets such as tax liens, structured settlements and REO assets for investors, municipalities, and institutions.	• Tax Ease • Terra Echelon LLC • MTAG Services	• Alterna • Law Firms	
Business Development Companies	Offering publicly traded closed-end funds that invest in private and public companies.	• Ares Capital • Harvest Capital • Golub Capital • Medallion Financial	• Monroe Capital • Prospect Capital • Rand Capital • Solar Senior Capital	• TICC Capital

Executive Summary

The Financial Crisis of 2008 was tantamount to a financial earthquake altering the financial services landscape forever. Among its immediate casualties were venerable financial institutions such as Bear Stearns, Lehman Brothers, AIG, Fannie Mae and Freddie Mac. In the ensuing aftershocks, new regulations such as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank") and The Third Basel Accord ("Basel III") targeted the banking industry as the primary culprit of the crisis and sought to reign in their predatory lending practices and shaky capital structures. These regulations created new fault lines as banks' lending practices shifted towards "safer" asset classes. As a result, new, non-bank lenders entered the consumer and business markets to fill the void the banks left behind. Does this portend a seismic shift in how the banks will participate in the equipment leasing industry? Are banks withdrawing from their long-standing role as funding sources for leasing companies? How are the capital raising activities of Independent lessors responding to this potential change?

While both new and pending regulations continue to cast uncertainty on the overall banking industry, the Lender Finance market is thriving as is the banks' appetite to lend to the equipment leasing industry. While it is difficult to estimate its overall size, the Lender Finance market tends to be quite elastic reflecting economic conditions as well as new, financeable asset classes. To that end, the emergence of Alternative Lenders, including Business Development Companies ("BDCs") and Payday Lenders, offer strong growth opportunities coupled with very attractive lending margins. These lenders see more modest growth in equipment leasing although they do recognize that the industry, as a whole, performed well during the Great Recession, a significant strength compared to these newer asset classes.

The number of Lender Finance participants is greater today than at the turn of the Century given the strong growth rates and attractive margins in a variety of asset classes from the well-established leasing industry to financeable new and emerging asset classes. The complexion of these new lenders is an interesting mix of traditional banks, FinTech Venture Capital, Private Equity and to a lesser extent, Insurance firms. Banks are attracted to the Lender Finance market because it allows them to participate in certain assets classes that are difficult, for either regulatory, structural, geographic reasons. Lender Finance enables them to develop significant scale in origination, asset and obligor management.

So what does a thriving Lender Finance market with new types of lenders imply for Independent lessors?

Although there are more lenders with an appetite for lease assets in the space, they are discerning and methodical in selecting on which horse to place their capital. Simply put, with performance come options for funding. Strong Independent lessors demonstrated their ability to weather a financial crisis and emerge with performing portfolios and stronger balance sheets. Those in this category boast more than $25 million in equity value and post annual volumes levels north of $250 million. Some Independents, in the midst of the crisis, were committed to preserving the balance sheet through both additional amounts and sources of equity.

Lender Finance *How Does the Capital Stack?*

Paramount to a Lender Finance provider's view of an attractive client is how well the management team has set a course for growth and followed through on delivering excellent overall portfolio performance. Bank lenders first and foremost want a management team that has honed a successful business strategy and adhered to it while managing the associated lease underwriting with focus and discipline.

Large Independents are experiencing more flexibility in bank line structure amid pricing that improved and has now stabilized post crisis. Lender Finance providers are more likely to offer flexibility in structuring advance rates than pricing. Most lessors have multiple bank lines with costs associated in the 100-200 basis point ranges over 30 day London Interbank Offered Rates ("LIBOR").

Securitization is the perfect funding pairing to bank lines for Independents strong enough to access the asset-backed market. Annual or semi-annual securitization issuance freeing up bank lines for future volume is the most common funding framework. Pricing for securitization is typically 35-50 basis points better than bank lines.

Only the largest Independents can satisfy the arduous, costly legal and reporting requirements to issue and service securitization. For those with the resource and size sufficient to have re-entered the securitization market post crisis, it is once again a powerful tool to ensure ability to grow and optimize overall blended cost of funds.

Capital continues to flow into the equipment leasing market based on the strength of the assets yet the new regulatory environment for U.S. and European Bank lenders has had a mirroring effect on Independents. They feel the effects of changing capital requirements compliance with a heightened regulatory environment in the U.S. and Europe through tightened covenants and strict requirements.

Optimizing funding strategy in the midst of the new regulatory reality for lenders has created a new challenge in the effort to maintain a consistent capital funnel. Moreover, the strategy must enable the business strategy by providing funding for the right new business volume, mix of credits, transaction sizes and types. In this post-Crisis environment, the optimal approach to accomplish this is to maintain diversity both in number, type and geographic origin of lending institutions. Larger Independents have multiple banks lines and have shown a preference for a mix of U.S. and European based lenders.

The strong performance of equipment leasing portfolios and the relatively higher yields they offer are beginning to garner the attention of non-traditional lenders to the space. This dynamic on top of regulatory constraints faced by bank lenders and increasing desire for funding of nonstandard contracts as well as continued technology innovation has created the perfect environment for new entrants. Insurance companies and hedge funds are among the strong new entrants. Although structure and cost may be higher than traditional bank lines for vehicles offered through these new entrants, the trade-off may well be worth it for Independents looking for breadth and flexibility within their stable of funding sources.

Although banks have had to make adjustments to their terms and structure in funding lines offered to Independent Lessors, lending into the space remains very attractive to banks as does participation in the direct origination of leasing assets. This study found no evidence to suggest banks are pulling back on Lender Finance or their desire to grow their direct leasing businesses.

Recent M&A activity provides evidence that banks intend to grow their leasing businesses through acquisition. Beyond the immediate asset growth acquisitions offer, the cost of funds advantage banks have over Independent lessors adds an instant bump to margins over and above the already superior yield these assets offer to traditional bank loan products. Significant examples post crisis of banks acquiring leasing companies include; City National's purchase of First American, Wells Fargo's 2016 acquisition of GE Capital's equipment finance business, CIT buying Direct Capital in 2014 and Umpqua Bank's 2013 purchase of Financial Pacific.

Lender Finance will continue to be a stable source of capital for the Independent lessors that meet the lending standards. Should there be a credit event with Alternative Lenders, Independent lessors will likely benefit from a flight to quality.

How Did We Get Here?

U.S. commercial banks have a longstanding role in the equipment leasing industry, first as primary providers of capital and then as direct participants. For the last fifty years, the banking industry continued its historical role as the primary funding source for scores of Independent and Captive lessors. Through their "Lender Finance" divisions, the larger money center and regional banks offered a variety of products from credit facilities to term loans to access to the Capital Markets through Medium Term Note and Securitization programs. At the same time, they became direct competitors offering a robust set of leasing products aimed at U.S. businesses across a variety of industries. Given their size and cost of funds advantage, bank-owed lessors tended to compete for the more complex, mid-to-large-ticket credits whereas most of the Independents they financed focused on the smaller-ticket transactions. Indeed, bank growth in revenues, assets and profitability benefited from its dual role – funding source and participant - in the equipment leasing industry for over half a century.

However, that harmonious strategy changed with the arrival of the Financial Crisis which cast a level of chaos on the financial markets not witnessed since the Great Depression some 80 years earlier. The implosion of the mortgage industry and the tandem rapid reversal of U.S. housing prices in 2008 triggered a chain reaction tantamount to a financial earthquake; massive losses for U.S. banks, numerous bank failures and ultimately, the global economy plunged into a disastrous tailspin. Without access to capital, banks were forced to tighten their lending standards which precipitated stock markets to crash around the world. Trillions of dollars of market capitalization for the banking sector evaporated in a few short weeks.

For some, the hubris of the banking system and its outlandish risk-taking and overly inflated paychecks prompted the financial meltdown. For others, there were a host of significant or egregious contributory factors such as regulatory failures, inflated credit ratings and abusive behavior by the investment banks.

Regardless of the root cause, the financial services landscape was altered forever. In the immediate aftermath, the government effectively imposed ownership on hundreds of banks, it implemented new, aggressive regulations to ensure greater transparency and curb abusive lending practices, and it created a new breed of regulators to enforce them. Meanwhile, banks responded to the collapse of the financial markets by tightening credit and refocused on repairing their balance sheets, preserving their deposit base and restoring profitability. When businesses across the U.S., concerned about their own liquidity, drew down on their credit lines, it effectively caused a run on the banks thus freezing all lending activities overnight.

Impact on the U.S. Equipment Leasing Industry

The impact on the U.S. equipment leasing industry was swift: an upheaval of capital availability on which so many lessors depended for survival. Traditional sources of capital for Independent and Captive equipment lessors were no longer available as bank lending into the equipment leasing industry screeched to a grinding halt. Credit lines, term loans and warehouse facilities – all the lifeblood for many Independent lessors – were either pulled on technicalities or became too expensive. Lack of investor confidence shut down medium-term note programs and the equipment lease-backed securitization market collapsed shortly after the implosion of the mortgage-backed securities market. The dearth of liquidity sent Independent lessors scrambling to preserve whatever funding sources they had and to fund their best clients. Over the next 2 years, many Independents simply vanished from the industry – either through liquidation or sales to stronger industry players.

For those Independents who survived, their access to capital was further complicated by a slew of new regulatory oversight stemming from the Crisis. First came the Basel Committee on Banking Supervision's comprehensive set of reforms, known as Basel III, mandating stronger capital and liquidity requirements for global banking system. Within the U.S., Congress passed the Dodd-Frank Act in 2010 which required bank holding companies with more than $50 billion in assets to adhere to rigorous capital and liquidity standards as well as restrictions around incentive compensation. Dodd-Frank also created the Financial Stability Oversight Council which combined the efforts of various regulatory agencies for larger, systemically important banks – most with equipment leasing operations. At the same time, individual regulatory authorities increased their own scrutiny of the banking system. All toted up, the costs related to these Financial Recession-induced requirements had banks increasing their spreads over the Federal Funds rate by about 1-percentage point.[1] Furthermore, a growing hysteria about the increased level of banking regulation and potential legal changes, either from new legislation or judicial decisions, effectively choked off the equipment leasing industry in terms of credit appetite.

In addition to raising the cost of borrowing, these new regulatory requirements yielded both significant and subtle changes in bank lending practices which created new challenges for Independent lessors. According to the new regulations, loans to cash-flow based companies like BDC was classified as "leveraged," therefore needing additional support. There was, and still is, some concern among bankers that lending to the equipment leasing industry ultimately will be deemed "leveraged" in the eyes of the federal banking regulators. This concern tempered interest by banks to lend to Independents. In turn, that meant that the banks tightened their Risk Acceptance Criteria ("RACs" are criteria which detail acceptable transaction structures, credit profiles and required risk-adjusted returns), essentially making it harder for Independents to qualify for new financings. At the same time, liquidity concerns plagued both the banks and Independents. The combination of these factors directly threatened Independents' ability not only to fund themselves but also to survive the crisis.

Meanwhile, for banks that were both lenders to and participants in the equipment leasing arena, there was growing concern that required capital levels, risk quality, losses on loans and leases and diversification meant banks would have to choose one path over the other. There is ample evidence to suggest that bank-owned lessors will continue both as direct participants and as lenders to the equipment leasing industry. Bank-owned lessors emerged from the Financial Crisis in a very strong position. With the exception of a few asset classes like corporate aircraft, equipment leasing portfolios performed markedly better than most other bank lending portfolios. As a recent Equipment Leasing and Finance Foundation study pointed out, equipment lease and loan securitizations performed better than virtually all other asset-backed securitizations during the financial crisis.

Given that performance, there's a major push from banks for more growth in these assets, be it origination platforms or portfolios. Indeed, banks have emerged as successful bidders on acquisition opportunities that have arisen – in part given their obvious advantage over Independents e.g., a lower cost of funds and higher leverage thresholds. Examples include City National's purchase of First American, Wells Fargo's pending acquisition of GE Capital's equipment finance business, and CIT buying Direct Capital. Traditionally, banks targeted mid-to-large ticket lessors so that they could directly originate leases with the lessors. However, these same banks are now expanding into small-ticket leasing as evidenced by Umpqua Bank's purchase of Financial Pacific in 2013.

Over the last five years, banks and other providers of debt capital have entered into the Lender Finance arena not only to lend into the equipment leasing market but also into new asset classes as well. Anecdotally, there is little concern among industry lenders that the regulators will classify these activities as 'Leveraged Lending." The fact pattern implies that bank-owned lessors will continue in its dual role as major equipment leasing industry participants as well as a funding source to the industry. Independents that emerged from the crisis with strong portfolios have benefitted both from a larger number of suppliers of capital, but also from revived securitization and medium term note markets.

Lender Finance Market Dynamics: Market Size, Participants and Products

Market Size

The Lender Finance market is composed of several asset classes or end-user customers. These include: ELFA leasing companies, asset-based lenders, middle market loan companies such as Merchant Cash Advance and BDCs, timeshare companies, transportation lessors (fleet, rail, containers, commercial aircraft and commercial aircraft engines), healthcare lenders, tax lien aggregators, Commercial Real Estate and to a lesser extent, venture debt.

Sizing the Lender Finance market is difficult as no market share statistics are recorded, nor is there a related industry trade association. Overall market size tends to be quite elastic reflecting economic conditions as well as new, financeable asset classes. To that end, the emergence of Alternative Lenders added a new growth engine to the overall Lender Finance market. Other asset classes, such as BDCs and Payday Lenders, are exhibiting stronger growth rates, outpacing the equipment leasing which is a mature asset class with modest growth opportunities and narrower margins. Some industry participants see consistent long-term demand from equipment leasing while others are focusing on the faster growing, higher margin asset classes.

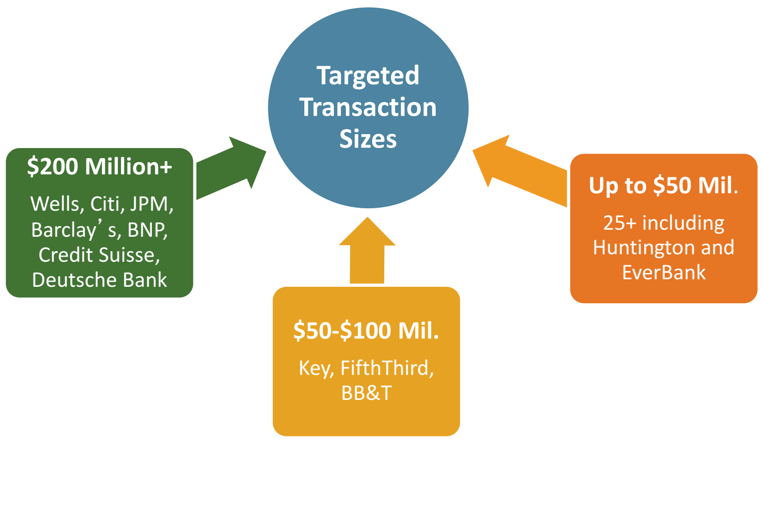
Looking at equipment leasing's share of the Lender Finance market, industry participants determine the market size by measuring the total balance sheet assets of Independent lessors overlaid with an assumption for opportunities for certain Captive organizations. Anecdotal evidence suggests that the ELFA membership accounts for anywhere between 20-25% of the Lender Finance market. Equipment leasing's share of the overall Lender Finance market has remained fairly stable since 2009 for two reasons: one, the number of eligible Independents and Captives are small; and two, the ELFA Members who are attractive borrowers are very well financed.

The Lenders

The number of Lender Finance participants has significantly expanded over the last 15 years. Whereas there used to about 10 significant participants, today there are more than 50 attracted to the strong growth rates and attractive margins in the financeable new and emerging asset classes. While many of the new entrants are traditional banks, what's notable is that non-traditional lenders such as FinTech Venture Capital, Private Equity and, to a lesser extent, Insurance firms, are actively entering the Lender Finance space. FinTech Venture Capital and Private Equity firms, which are more risk tolerant than traditional bank lenders, are specifically targeting the Alternative Lenders. In fact, they already have deployed significant amounts of capital into that space. Insurance companies are more focused on established markets and strong credits, a perspective well-suited for Independent equipment lessors.

Lender Finance participants generally fall into three categories which is a function of their hold position.

Figure 2: Competition in the Lender Finance Space



At the top are investment banks and large money center banks that provide credit lines in excess of $150 million-200 million. These bank lenders also provide securitization and investment banking services as a matter of course. Among this group of bank lenders is Wells Fargo which is widely considered the market leader. Other top bank lenders are Bank of America, JP Morgan Chase, Barclays, BNP, Credit Suisse and Deutsche Bank. The next tier is large regional banks with significant footprints in the U.S. such as KeyBank, Fifth Third and BB&T. Their lending sweet spot is in the $50-100 million range. The final tier is made up of a group of about 25 lenders: regional banks, Independent equipment lessors and select Captives. Names like Huntington National Bank and Everbank Commercial offer credit lines up to $50 million. A few Lender Finance providers, such as Webster Bank, exited the marketplace when they stopped being competitive.

Banks are attracted to the Lender Finance market because it allows them to participate in certain assets classes that are out of bounds either for regulatory, structural or geographic reasons e.g., the operating lease container business. It is worth pointing out that entering the Lender Finance market is not an easy task. While the market is growing, it is still a relatively small market which means it can only support a small number of lenders profitably. In addition, it requires a very specialized skill set, not one that is easily transferable from a general lending platform. To be successful, a Lender Finance provider must have the underlying expertise and backroom skills.

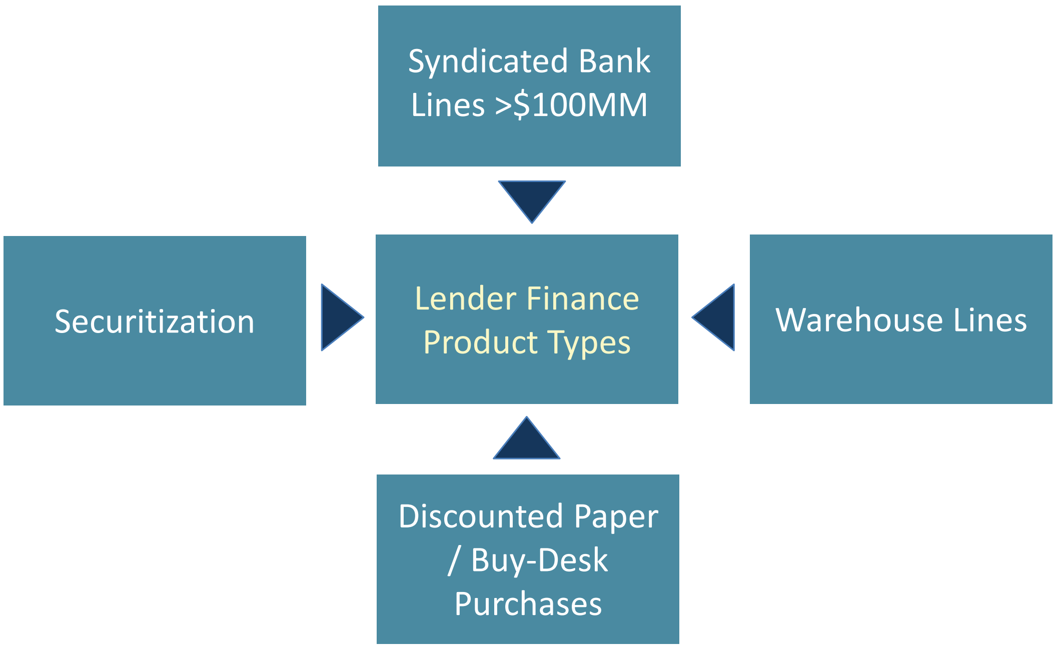
The structures of the Lender Finance units varies from organization to organization. Generally, there are three organization designs. The most common structure has Lender Finance as a unit of the Corporate Bank but reporting in to the Equipment Leasing division. This approach dates back decades when the lending was predominately about the cash flow and resale value of the underlying equipment. However, if equipment leasing is not a competency of the bank, then Lender Finance reports to the Corporate Bank.

Other organizations split Lender Finance between commercial lending, capital markets and investment banking.

Lender Finance Product Spectrum

Products offered by lenders to Independent lessors fall into four broad categories; bank lines or syndicated bank lines, warehouse lines, asset based securitization facilities and discounted paper or buy/sell desk types of programs. Independent lessors use products in most if not all of these categories to fund their business. The spectrum of products offered is dynamic, changing as the Independent lessor grows. Smaller Independents fund volume largely through discounted paper programs and small warehouse lines. Larger lessors utilize large bank lines coupled with securitization facilities. The largest most well established leasing companies with a demonstrated track record for portfolio performance have access to the broadest spectrum of Lender Finance products.

Figure 3: Lender Finance Product Spectrum



Bank Lines / Syndicated Bank Facilities

Bank lines are essentially lines of credit secured by an underlying portfolio of lease contracts. It is, in fact, a traditional revolving credit line in that it includes loan covenants (or promises) tied to financial reporting, indebtedness and legal structure among other things but also includes very specific requirements related to the lease assets which are described in a following section. These lines are short to medium term, typically renewable every one to three years at the lenders discretion. The larger the bank line the more likely it is that the underwriting bank will syndicate or participate portions of the line to other banks in order to manage concentration risk. Typical size bank lines in the survey group are between $125 million-$150 million. This type of bank line is generally available only to the medium to large Independents.

From the Independent lessor perspective, the full cost of these bank lines blended with equity comprises its cost of funds. For those lessors that also utilize a securitization facility, the cost of the facility is blended with the cost of the bank lines and equity to determine a true, all in cost of funds. Bank lines have a certain advance rate such that, for each lease or loan funded via the facility, some percentage less than 100% is funded with the remainder funded with the lessor's equity. (Cash flow analysis for advance rate includes residual values so the advance rate is against the full funded amount including equity and any residual position; in other words, the full booked asset value or equipment cost.) Advance rates in the 90-94% range are most common.

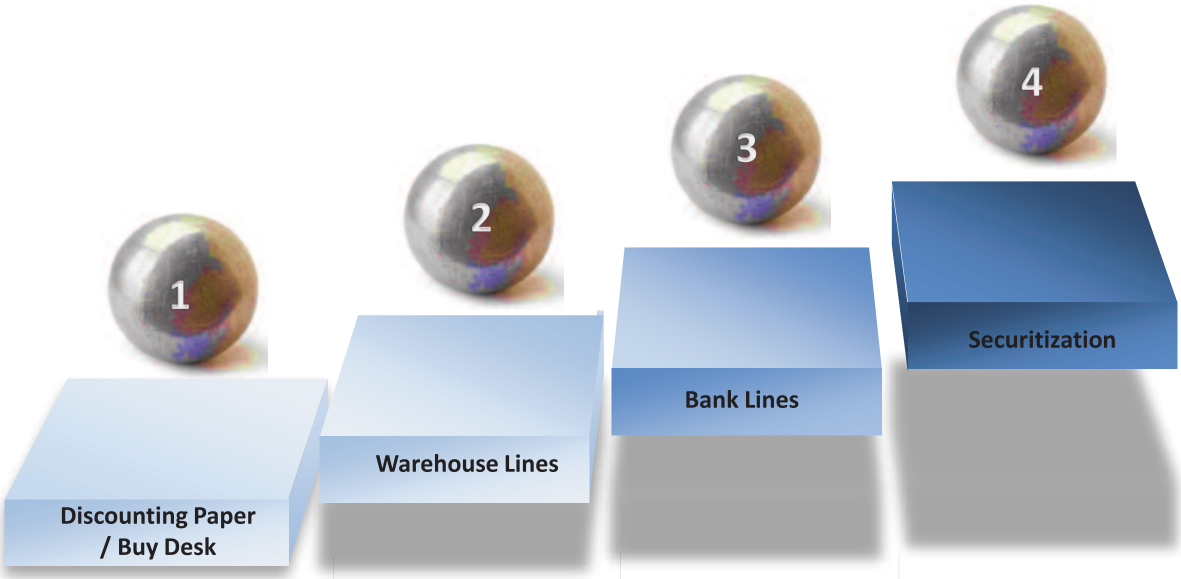
Securitization

Securitization is the bundling of equipment lease and loan contracts into a rated debt security. The 2015 Equipment Leasing and Finance Foundation paper: *Securitization: A Renaissance for Equipment Finance*? summarized the definition of securitization in the following way:

> "Securitization is the process whereby a large number of financial contracts, receivables or, in some instances, long-lived operating assets (constituting a representative sample of the originator's, seller's or lessor's entire portfolio, i.e., no adverse selection of assets for the ABS deal) are transferred by the originator, seller or lessor to a bankruptcy-remote entity which (directly or indirectly) issues a new financial instrument either collateralized by, or representing an ownership interest in, the financial contracts and the receivables. Investors and rating agencies examine the historical loss, delinquency and performance statistics for the sponsor's owned and managed portfolio, and compare it to the level of credit enhancement provided in the transaction structure to cover a multiple of historical losses and fully repay the debt."

Securitization remains a key, historically well performing funding source for large, Independent lessors. It does, however, come with significant cost in time and resources, in order to provide the necessary data and reporting to substantiate the performance of the securitized assets, as well as to document the underwriting criteria and demonstrate adequate servicing capability. The requirements to support a securitization vehicle significantly exceed those for a bank facility. Nevertheless, bank lines and securitization together are the powerful capital sources deployed to fund growth in large Independents.

Figure 4: Lender Finance Product Highlights



- Used by all leasing companies - banks, captives and Independents
- Deals sold for credit exposure, income enhancement and income
- Primary funding mechanism for small independents / brokers

- Stepping stone for growing Independents
- Offered by banks and larger independent finance companies
- $10 million - $50 million common size
- Holding point for transaction prior to sale

- For large Independents
- Strong portfolio performance critical
- Primary cost of funds driver
- Sized to fund 12 - 18 months of volume

- Efficient funding vehicle 35-50 basis points lower than bank lines
- Costly resource intensive process
- Requires origination scale – ABS securities typically greater than $100 million

Warehouse Lines

Warehouse lines, as the name suggests, are facilities used to fund and hold lease or loan transactions that are ultimately placed elsewhere within in a 3-12 month time frame. Similar to bank lines, warehouse lines are secured by a portfolio of lease or loan contracts yet these lines are typically much smaller and more expensive than bank lines. The typical warehouse line is sized between $10 million -$100 million. In the spectrum of Lender Finance tools, Independents that utilize warehouse lines have graduated from small lessor or broker status and these lines provide the lifeblood to fuel their growth. They have established a history of generating consistent volume and performing assets while building equity.

Regional banks are key providers of warehouse lines. Other providers include larger Independent lessors who wish to warehouse transactions sometimes with a contractual right of “first offer” for final placement of the transactions.

Discount Paper / Buy / Sell Desk

Discounting paper involves the selling of lease or loan paper by selling a stream of payments, discounted at a rate lower than the rate in the transaction. It is common practice across the leasing industry. It is, in fact, a tool utilized by brokers, Independents, banks and Captives alike. It can involve the sale of a single transaction or the sale of a portfolio of transactions. It may involve some level of support from the seller or be done on a non-recourse basis.

Large Independent lessors and banks have buy / sell desks and are utilized to syndicate deals in order to manage credit exposure to specific customers, manage portfolio exposure to specific vendors or collateral types, enhance overall portfolio spreads or provide income enhancement. These desks are sophisticated resources honed to buy and sell assets to balance portfolio risks.

The 2015 SEFA data, (Survey of Equipment Finance Activity) reports a total of $12.2 billion of lease transactions were sold by survey respondent in 2014. The reasons for sale specified are 61.5% for exposure/credit management or asset concentration purposes, 2.6% for yield enhancement, 11.9% for finance fee income and 20.2% utilize it as a funding source.

For smaller Independents, having established relationships with buy desks at larger institutions whether banks or Independents is a critical funding tool. Post-recession buyers, especially banks, have become much more rigid in the scope of deals they will purchase. Developing fewer but more strategic buy / sell relationships that are a good fit with transaction size, type, and credit is a critical success factor.[2]

In order to accomplish these goals Independent equipment lessors utilize multiple Lender Finance products. The spectrum of Lender Finance products is a fluid suite of tools through which new volume is funded. For the typical larger Independent lessor the bank line is the core day -to- day workhorse used to fund volume. Once the bucket is full, securitization provides the mechanism through which assets are emptied from the bank line and packaged for securitization freeing up the bank lines for new volume.

Traditional bank Lender Finance participants offer all of these products in some form yet distinguish the mix of products offered to the lessor based on financial strength, size and past portfolio performance history. A Lender Finance provider's goal is to maximize the products offered and income earned. Independent lessors focus on maximizing funding capacity and minimizing cost of funds.

Typical Finance Structures Used By Lender Finance Providers

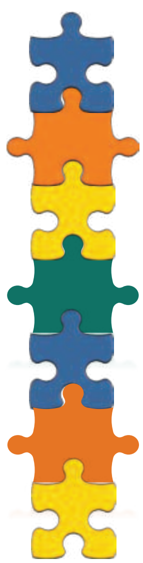
The importance of total portfolio performance simply cannot be overstated in the world of Lender Finance. It is the single overriding factor that lenders or investors consider whether it is a securitization, bank line, warehouse line or sale of a single lease.

Lender Finance providers lend where they have comfort that they have true visibility into the risk reward and are getting paid accordingly.

The starting point for underwriting a bank line is to assess performance of the management team and the portfolio. This is essential regardless of whether or not the line is to be participated among a bank syndicate. Lenders want the management team to clearly articulate its value proposition and market focus. Once the business strategy is understood, the provider will drill down to see if there's evidence of the management team sticking to its knitting. Have they had a steadfast, consistent approach in their origination strategy? Have they stuck to the industries, collaterals and credit mix they claim is their core business strategy? What is their pricing strategy and have they been disciplined in the ultimate pricing of transactions? Do they have a demonstrated successful collections process? Do they follow a generally accepted approach to delinquent transaction work-out and write off? Understanding and testing the answers to these key questions is essential for the lender's diligence efforts.

The bar is set intentionally high for the underwriting and issuance of securitization vehicle. The documentation and reporting necessary is focused on portfolio performance and the legal structure of the security. Extensive documentation, reporting and legal opinions are required in order to create the ABS security. These arduous and time consuming requirements are designed to give the potential investor full transparency into and assurance about the past performance of the assets, the competence of the management team, confirmation of documented and functioning policies, procedures and reporting, as well as protection of the assets in the case of an adverse change in the financial sponsor's (Independent leasing company) financial condition.

Figure 5: Typical Lender Finance Structures



True Sale / SPV and warehouse line structures rely on performance of portfolio securing facility

Segregate cash

Eligibility requirements

Borrowing bases

True Sale Opinions

Servicer needs to be a liquid, quality organization

Spreads are a little higher than a typical securitization and risk tolerance a little lower

The Structure of Lender Finance varies widely based on the size and type of product. Bank lines are most often structured as a revolving asset based facility. The borrower grants a security interest in its lease or loan documents to the lender. When assets are repaid or sold, the line is paid down opening up room for additional volume.

In an ABS securitization, the assets must be transferred to a bankruptcy-remote, special purpose entity (SPE). The originator must provide a true sale opinion, as to itself and the SPE. Securitizations also include credit enhancements in the form of excess cash flow and equipment residual values where applicable.[3]

Segregation of Cash

A key element of any securitization structure is the segregation of the cash associated with all assets pledged to the ABS vehicle as well as any excess cash included for credit enhancement. A separated lock box and cash application process or waterfall applies to all cash received by the SPE.

Borrowing Bases and Negotiated Advance Rates

Bank lines and securitization use advance rates to protect the lender or investors from credit losses. The borrowing base is the total amount of assets volume projected for a bank line or total assets pledged to the securitization vehicle. Based on past loss history of the borrower's portfolio and the credit mix of the end user borrowers the bank will settle on an advance rate for each line. For example, if the advance rate is 92% the line will fund 92% of each transaction with the remainder funded with the lessor's equity. Since the line is secured by the entire portfolio, the bank is protected on losses up to 8% suffered in the secured portfolio.

The advance rate is used to protect investors from losses and to enhance the credit rating of the security in ABS securitization transactions. The advance rate enhances the credit rating of the securitization vehicle by providing a cushion for losses. ABS facilities with predominantly BBB to BBB- rated paper, can, through the use of advance rates, achieve an A rating.

Various Eligibility Requirements

Whether a bank line or a securitization the pricing associated with the facility is based on assumptions about the mix of the assets and projected assets. These assumptions include stability of the credit mix in the portfolio based on obligor credit ratings, collateral types, duration of the transaction, size of transactions and residual value risks, if any. If the portfolio exceeds limits in any of these specified areas, additional assets with those attributes will be ineligible.

True Sale Opinion

ABS securitization transaction investors require that a reputable outside counsel deliver a "true sale" opinion stating that in the event of the bankruptcy of the seller (the lessor or other sponsor), assets will not constitute "property of the estate" of the seller under the Bankruptcy Code.[4]

Rigorous Reporting Requirements

Rigorous reporting allows banks or investors to understand the ongoing performance of the portfolio. Bank lines have reporting requirements around financial covenants such as cash flow and equity level as well as detailed requirements for reporting on new volume originations and portfolio performance with particular focus in key areas such as pricing spreads and credit losses. The ability to produce vintage static pool analysis reports is a critical reporting requirement for securitizations. The detail of portfolio reporting has increased post crisis with little difference in rigor required for lending banks and ABS securitizations.

Servicing

ABS securitization facilities require that the issuer pay the sponsor originating organization an arm's length fee for servicing the portfolio. Servicing includes billing, collecting, cash application customer service, asset management and reporting. In order to qualify to act as a servicer for a securitization, an organization must be a highly liquid organization with an excellent track record for service and integrity. A back up or standby servicer must be retained in the event that the primary servicer must be replaced due to non-performance or adverse financial change.

Market Observations

The two principal products of Lender Finance, bank lines and securitization, are available solely to the largest Independents. Many banks have a minimum threshold of at least $25 million for bank lines. In fact, many of the large money center banks concentrate their lending in the space to those with $50 million or greater in equity. During and immediately post crisis, some Independents restructured taking on additional investors to build equity and strengthen their balance sheet.

Typical line sizes are $125 million-$150 million with most having lines with at minimum two different bank lenders. The largest Independents have seen pricing increase post crisis but have not experienced any decrease in bank appetite to lend. At the time of this report, pricing on larger lines was about 25-75 basis points over 30-day LIBOR, with unused fees at 25-30 basis points. Since the LIBOR index is a floating rate index, most lessors hedge, to varying degrees, through the use of swaps.

Generally, bank lines tend to be a bit less risk tolerant more in the 'A' area than the 'BBB' or 'BBB- area and priced, on average, 35-50 basis points higher than in securitizations. The most common advance rates range within 90-94%.

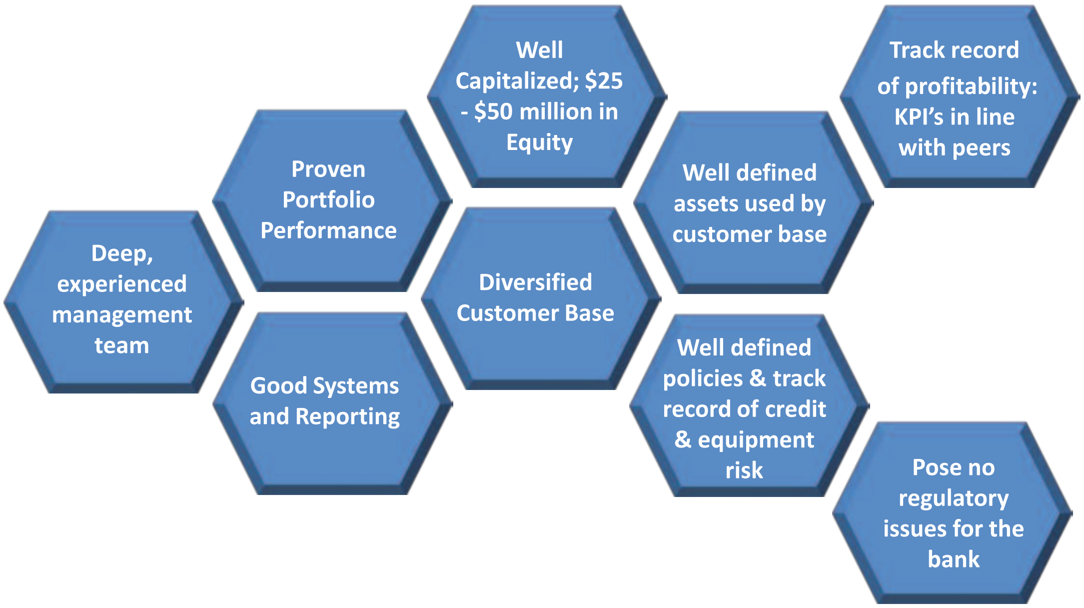
For Independent lessors with equity of less than $25 million, bank lines provide the largest funding source. These are offered largely through regional and local bank relationships and are coupled with non-recourse deal or portfolio sales to trusted investors in order to round out the funding strategy.

All in cost of funds for the largest Independents is in the 200 to 300 basis point range with 6:1 the most common leverage (see Equity Capital below for further explanation). Smaller Independents cost of funds is much higher at 300–600 basis points.

Lender Finance Underwriting Criteria – The Requirements

The underwriting standards employed in Lender Finance are similar to those all equipment lessors use in their financing activities.

Figure 6: Lender Finance – Underwriting Criteria



Equity Capital

The single-most important determinant is the level of capitalization. Generally, the minimum amount of equity capital acceptable to most of these lenders is in the $25-50 million range. Equity capital includes subordinated debt, mezzanine debt and equity. Some smaller Lender Finance providers will accept equity capital as low as $15 million. Firms with less than $10 million in equity capital tend to have local bank relationships and sell transactions on a non-recourse basis to a group of trusted third parties.

Quality of Management

Broad and deep management teams provide a window on how an institution is run. Strong management teams have a well-defined strategy and related value proposition as well as a good track record of performance and credibility with their various stakeholders. These are all excellent indicators of a management team's decision-making and operating expertise. Another quality factor is the firm's cultural identity; a strong culture typically is supported by strong business practices and a commensurate risk appetite for the firm's business strategy and stated goals.

Well Defined Policies and Track Record Around Equipment and Credit Risk

Lender Finance providers examine whether risk controls balance a firm's stated growth targets and financial goals. High risk appetites to achieve lofty growth targets are acceptable as long as strong risk controls in place to mitigate the higher collateral and credit risk thresholds. To assess the sophistication of a risk management environment, these lenders are looking for well-documented risk policies that address credit, market and operational risk. Hallmarks of a strong risk framework include clearly defined credit authorities, limits around credit concentrations, geography and market risks as well as the use of established credit tools such as a risk ratings system, customized scorecards and third-party credit databases. For equipment lessors, it is critical to have policies and procedures around residual value setting, operating lease depreciation methodology, and asset disposal.

Proven Portfolio Performance

Portfolios that have weathered various economic cycles or market shocks are the best indicators of strong underwriting criteria and portfolio management practices. New and fast growing portfolios can mask the true quality of the portfolio since it hasn't had sufficient time to mature. This may well be the case with respect to the Alternative Lenders that have recently entered the lending space. However, it is worth noting that many of the Alternative Lenders' borrowers have solid credit fundamentals. In fact, one Alternative Lender, Kabbage, Inc, reports that about two-thirds of its portfolio meet classic bank lending criteria.[5] Nonetheless, Lender Finance participants desire portfolios where there is an optimal spread of risk among the customer base, geographies and internally assessed risk ratings.

Other Key Underwriting Criteria

Lender Finance providers look at a number of other underwriting characteristics as well:

- Good systems and reporting capabilities that provide intelligence on portfolio and operating performance, especially around early-warning indicators.
- Well defined assets that are considered "essential use" or important to the client's business.
- Key performance indicators ("KPI") in-line with the peer group, with special attention to a demonstrated track record of profitability.
- Customer poses no regulator issues for the Lender Finance provider.

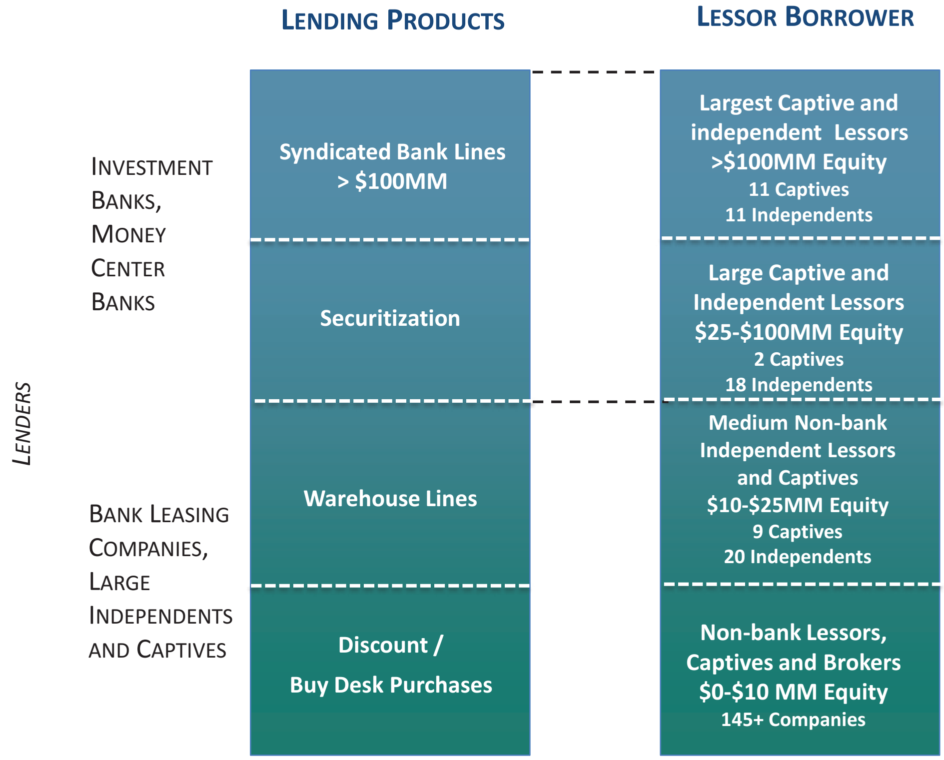
The Independent Lessor "Borrower"

The overall size of the equipment leasing market is $270 billion in annual originations in 2015, according to estimates by The Alta Group. Of that total, 21% or $46 billion was financed through non-bank owned, non-Captive Independents.

Segmentation of Independent Lessor Market

Independent lessors fall broadly into four categories, the largest Captives and Independents, medium to large size Independents, small to medium emerging or specialized lessors and small Independent or brokers. Figure 7 below depicts the number of lessors in each category and maps the most common type of Lender Finance products used for funding. The top three categories combined have 49 companies or 24% of the total number of Independent leasing companies where the smallest category includes more than 145 lessors/ brokers. It is important to note that these categories are fluid and the numbers provided reflect 2014 data. M&A activity, both acquisition and divestures, as well as improved growth rates in capital spending provide for an environment with significant movement within the categories.

Figure 7: Lender Finance Products and Lessor End User



Largest Captive and Independents

- Ten companies - separated from the next largest category by a significant margin in all measurements
- Included in this category are the largest Captive finance companies such as CAT, IBM Global Finance and GE Capital
- Post divesture, GE Capital's new down-sized Captive will continue to have a portfolio north of $100B and continue to fit squarely in this largest Independent/ Captive group
- Average annual originations are $8.5 billion
- Total portfolio size is greater than $20 billion
- Equity levels are well north of $100 million, with most greater than $1 billion

Medium to Large Size Independents

- Eighteen companies
- Includes companies such as GreatAmerica Financial Services, Marlin Leasing, Hitachi Capital, Ascentium Capital and LEAF Commercial Capital
- Average originations in this category topped $300 million
- Average portfolios > than $600 million
- Range of equity is between $25 million-$100 million, most have equity >$100MM. *Small to Medium Emerging / Specialized Independent Lessors*

Medium to Small Independents

- Fourteen Companies
- Examples of Independent in this group include Pacific Rim Capital and Creekridge Financial; emerging alternate lessors such as IMCA Capital
- Average annual originations range between $50 million-$200 million
- Most common equity range is between $10 million-$25 million

Small Independents / Brokers

- Small Independents and broker comprises this, the largest and most fluid category: more than 145 lessors / brokers
- Examples include GSG Financial and North Mill Equipment Financial
- Equity levels in this category are less than $10 million with most having under $5 million in equity
- Originations are under $100 million with average originations of $50 million although most are originating $20 million or less

Representative Funding Strategies

All Independent finance companies aspire to the most efficient, cost effective funding strategy that allows for sufficient growth and flexibility in managing their portfolio. The larger the company the more alternatives are available for funding. Clear thresholds are in place for the biggest tools in the funding toolbox - bank lines and ABS securitization. Nevertheless, in the post crisis environment there is a supply of capital in search of strong, stable assets. The current economy provides no shortage of investment opportunities for banks and other investors, providing varied funding options for the small broker to the largest Independent. Figure 8 highlights key elements of the funding strategy by lessor size.

Figure 8: Key Funding Strategy Elements By Lessor Size

Small to Medium Emerging/ Specialized Independents	Small to Medium Lessors / Brokers	Medium to Large Independents	Largest Captives and Independents
• Single bank or institutional funding line $40-$100 million • Periodic portfolio sales $5-$15 million 4 to 8 times per year	• Relationships with multiple investors for sale of one off non-recourse transactions • Can be on lessor paper or through sale and assignment on investor paper	• Multiple bank lines $100-$150 million each • ABS Securitization 1-2 per year to release • 6 or more syndication partners for credit exposure	• Parent Senior Debt • Bonds • ABS Securitization conduit – large multi-year conduit facilities • Syndication for credit exposure

Largest Captives and Independents

The largest Captives and Independents have the full breadth of capital markets tools at their disposal. Large Captives most often have a treasury group consolidated with the parent company treasury or with direct reporting. The largest pool of funding for these companies comes from senior debt. For most Captives it is the senior debt of the parent company and bonds issued by the parent company.

In a recent example of large Independent funding strategies, Element Financial made the following announcement on December 17, 2015 with regard to funding strategy and capacity for their Fleet management business post acquisition of fleet businesses from PHH and GE Capital.

> *"Element Financial closed Chesapeake Funding II, the new $4.8 billion rated asset backed security funding conduit that Element has established as the permanent funding platform for its U.S. fleet management business.*
>
> *In conjunction with the establishment of the new ABS conduit, Element issued $1.5 billion in variable funding notes and is expected to close an additional $1.8 billion in term notes on December 31, 2015. Subsequent to these issuances, Element will have un-drawn commitments of $1.5 billion from Chesapeake Funding II to fund future growth in fleet assets. Interest rate spreads for these notes were in line with previously funded fleet ABS transactions. Proceeds from the notes will be used to repay a portion of Element's three-year term senior secured credit facility."*

Lessors in this largest category utilize the syndication or buy/ sell desk market to selectively manage credit exposure. The most common leverage level in this group is 7:1.

Medium Size Independents

Medium size Independents comprised the largest percentage of our interview group. By and large, the three tools used by this group for funding beyond their own equity is bank lines, securitization and syndication partners. The most common leverage in this group is 8:1. The breadth of funding options is primarily dictated by demonstrated portfolio performance. Liquidity is much easier to come by with good results. Banks scrutinize past performance much more than they focus on profitability.

Bank lines are the first critical element of the funding strategy for these lessors. Flexibility and diversity are paramount in crafting an effective funding strategy. A minimum of two banks is common in this group with some maintaining four to six lines. Lines are sized to $100 million-$150 million each with advance rates in the 91-94% spectrum. Across the board medium size lessors have seen bank line pricing increase post crisis. One CFO noted, "Given regulatory constraints banks are offering flexibility on structure rather than price. Where immediately post crisis banks were looking for AAA and low advance rates now they are moving to AA or even A to provide flexibility. " In the current regulatory environment, once a line is in place, there is no flexibility about compliance with the covenants. Banks who may have been able to give good lessor borrowers a little wiggle room no longer have the flexibility to do so.

Tenors on the bank lines are commonly 1-3 years with staggered maturities. Pricing is in the 100-275 basis point range over 30-day LIBOR for used lines and 25-35 basis points for the unused portions. Many lessors use hedging as a tool to mitigate risk in the volatility of the underlying rate basis such as 30-day LIBOR. Eligible asset guidelines and associated covenants have become stricter. Very specific parameters are in place regarding credit, company size and type and eligible assets and transaction sizes.

There is a clear awareness among this group that in the current regulatory environment bank lenders want to deepen relationships with existing customers. It is common to have one of the larger bank lenders offer a 1-2 year line with the associated investment bank underwriting the ABS securitization. In order to free up the bank lines for future funding, securitizations are issued once or twice a year. Pricing on the securitizations is improving post crisis and is generally 35-50 basis lower than the bank lines.

A lesson that hit home to lessors in this grouping is the need to diversify their lending sources. Regulations and capital requirements hit U.S. and European banks differently. Medium size lessors have become aware of the value of geographic diversity in bank lenders. A mix of U.S., European and Canadian banks provide the most cushion from the impact of regulatory pressure from the lending banks. Given medium size lessors' dependence on bank lending, they become a mirror of capital and other regulatory pressures for the lending banks.

Pressures felt by the lending banks have motivated some medium size lessors to investigate other institutional sources of funds. The pricing may be slightly more expensive than banks and these institutions may wish to hold assets with the lessor maintaining servicing. Cultivating additional funding options such as these help medium size lessors maintain flexibility and growth capacity.

Medium size lessors round out their funding strategy through syndication. They have cultivated relationships with banks and other syndication partners for over exposure credits or those that do not fit the parameters of the bank lines. Most have a stable group of 3-12 significant relationships.

Small to Medium Emerging / Specialized or Alternative Lessors

Lessors in this group have emerged from the small or broker category, have begun to build equity and their balance sheet and are in a critical growth period. There is a broad mix in this group from $10 million-$25 million in equity value. The most common leverage is 7:1 and originations can fall anywhere from $50 million-$200 million. Clearly, those at the top of this range are beginning to push the envelope towards access to larger, less expensive bank lines. Beyond portfolio performance a volume threshold is the key to entering the realm of funding possibilities that include large bank lines and securitization.

The core funding strategy in this group is a bank line. A majority of Lender Finance providers in this space are regional banks though it is a target for some institutional and hedge funds. Pricing for these lines is set at a spread over LIBOR and varies significantly to 4%–10% and may be tied to reaching certain covenants. These lines are secured by the lease contracts and credit enhancement is sometimes achieved through the pledging of unfunded residual values.

Funding capacity is released through the sale of assets using non-recourse discounting programs. Rather than selling on one off basis deals are bundled into $5 million-$15 million portfolios and sold to investors.

In some cases, partner relationships are in place where transactions are directly funded by partners. This is more prevalent in alternative lender business models. "Owning" the customer relationship is key for small lessors and, as such, they will tend to want to retain servicing of assets within the sold portfolios.

Small Lessors / Brokers

The key for small lessors and brokers is establishing relationships with funding sources who have an appetite for the type of asset originated and can consistently execute on funding transactions. Building this stable of investors, just as in the larger lessor categories, is heavily dependent on performance. Investors will want to continue to work with an originator which has established a history of originating quality, well documented transactions. This track record will also, along with market conditions, dictate the discount rate at which the deals are sold and ultimately the spread the lessor is able to retain.

Some on the larger side of this category may have very small warehouse lines with institutions or regional or local banks potentially in the $1 million-$10 million warehouse line range but most do not. Since most lessors in this space have little to no equity they can fund very few, if any, transactions on their own balance sheet. Transactions may be documented on lease paper under the investor's name within a sale and assignment arrangement or be documented under the lessor or broker name and then transferred.

Regulatory Impacts and Considerations

The current regulatory climate reflects a plethora of new regulations on all financial services organizations in an effort to avoid the financial practices that led to the Financial Crisis. The two most significant regulations are:

• The Third Basel Accord ("Basel III") which introduced a new, stronger capital ratio requirement as well as greater liquidity provisions.

• The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")
Implements a multitude of regulatory oversight changes. Among those impacting the Lender Finance arena: the imposition of stricter capital requirements, the "Volcker rule" restricting banks from making certain types of speculative investments, a slew of more rigorous requirements for the securitization market, new regulations affecting credit rating agencies, more exacting requirements for corporate governance and executive compensation and the creation of the Consumer Financial Protection Bureau ("CFPB") to enforce compliance with consumer finance regulations.

Based on interviews with current Lender Finance providers, neither Basel III nor Dodd-Frank are creating any significant stresses on the business at the moment. The two biggest reasons are that many of the rules around Dodd-Frank have yet to be written and not all banks must be Basel III compliant. Regulators largely have left it to the discretion of the banks to self-report compliance with the new regulations already in place. Certainly that could change in the future as some of the Dodd-Frank provisions are finalized. Yet the largest concern from these lenders, all lenders not just Lender Finance providers, is the possible role of the CFPB in regulating credit granting organizations. For now, it appears that the industry is bracing itself before the storm of rules yet to be promulgated under Dodd-Frank.

However, it is the current set of regulators from the Office of Comptroller of the Currency (OCC) to the Federal Deposit Insurance Corporation (FDIC) to the Federal Reserve that is causing the most pain among bank lenders and by extension, Lender Finance providers. The regulatory compliance burden continues to get heavier as more and more regulatory requirements are unveiled every year. That's driven up the cost of compliance in all banking organizations due to the required staffing and resource needs to fulfill deadlines and regulatory requests. These higher regulatory compliance costs, in turn, have driven up the overall cost of these transactions.

Some Lender Finance providers, but not all, are concerned about whether the OCC, FDIC and the Federal Reserve will lump lending to Alternative Lenders and BDCs in with Highly Leveraged Transactions ("HLT"). Apparently regulators, in a few cases, are now looking at these pools on the assumption that they are really HLTs which, of course, are restricted for banks. It is up to the banks themselves to explain to the regulators the fundamental and structural differences between HLTs and lending to Alternative Lenders, namely that the financings are typically on a portfolio basis and well-structured with eligibility requirements for investments. At least one Lender Finance provider indicated that there's a regulatory push back to classify BDC loans as "indirect" HLTs.

Outlook for The Lenders

Challenges

Increased regulatory requirements remain a top concern for all lenders across the financial services landscape. Banks are finding it difficult to stay ahead of the regulatory curve given continued uncertainty around potential new areas of regulatory focus and even stricter capital requirements. The challenge is continuing to meet the heightened levels of regulatory scrutiny and additional compliance requirements while combating chronic regulatory-fatigue. Aggravating matters is the cost of compliance per Section 1071 of Dodd Frank, which not only raises the cost of borrowing, but also places a drag on overall bank profitability.

Another related regulatory challenge is whether regulators will impose the definition of HLT lending on Lender Finance. As discussed in the Regulatory Impacts and Consideration section above, the banks themselves are left to educate the regulators on the differences in HLT lending (which dates back to the 1980s during the HLT lending crisis) and lending to BDCs and Alternative Lenders. Regulators are somewhat confused in that lending to both this type of financial lender does not meet the leveraged lending hurdles. Recently, regulators decided that lending to BDCs will be classified as "indirect leveraged lending" which should be combined with direct leveraged lending under the terms of the HLT definition. It is not known what the impact will be on overall bank HLT limits. There's one other area where some bankers think the regulators might apply the HLT definition – lending to leasing companies. While not formally articulated by any regulator at the moment, bankers need to teach two other lessons: one, while the business model employs leverage, leasing that leasing is not "leveraged lending" per se, because the lessor actually retains ownership of the asset and two, more than two-thirds of the industry's originations qualify as traditional financing structures, and not true leases.

The final major challenge is recovering from the adverse or unseen consequences of tightening of risk acceptance criteria during the Financial Crisis. Forced to clean up their balance sheets and facing a lack of liquidity, banks raised their lending standards and only funded pristine credits and important customers. One casualty of that pullback in credit availability was the small and medium size businesses. As a recovery ensued, a new breed of competitors emerged – the Alternative Lenders – and filled that void. Today, this new entrant is one of the fastest growing competitors, taking away historic bank customers. Another pressure comes from FinTech VCs that are using new technologies to reach these customers and therefore are disrupting the traditional go-to-market practices.

Opportunities

Lender Finance is an area of growth for lenders. The market is growing quickly with the emergence of several new asset classes such as Alternative Lenders, Payday Lenders and the like. Margins on lending facilities to this new breed of lenders are quite high, thus offering substantial profit opportunities. As that sector grows, it may also grow up in its need for financing products from plain vanilla credit lines to even more lucrative products.

While the Lender Finance market offers significant growth potential for the banks, there is strong evidence that the banks remain committed to participating in the direct leasing market. For the majority of banks, their equipment leasing businesses came out of the Financial Crisis as one of their best performing businesses. Even today, five years post-Crisis, spreads in the leasing portfolio are wider and improving compared to the traditional core banking business. Wider margins and strong portfolio performance over the cycle are two reasons why banks are eager to add leasing assets. From an M&A perspective, banks are active buyers of leasing companies and portfolios as they have excess capital to deploy in the current market. Banks likely will be more successful buyers of these assets as opposed to the Independents given the banks' natural funding advantage. Of note is the increasing number of small and mid-sized banks that are buying leasing businesses.[6]

Outlook for Independent Lessors

Challenges

Availability of funding for growth is a significant and ongoing challenge for Independent lessors. Only the largest Independents – roughly 20% of the Equipment Leasing and Finance Association's membership – qualify for the underwriting criteria required by the banks. There are however 108 independent lessors ELFA members representing 51% of total membership a statistic that clearly highlights the need for funding beyond the target market for large lender finance providers.

Compared to bank lessors, the all in cost of funds is 100-200 basis points higher, even for Independents that can access bank lines and the securitization market. That cost of funds spread gap is much wider for medium to small lessors. Medium to large size Independent lessors, which compete directly with banks for transactions, must continually enhance their value proposition focusing on flexibility of offering and service excellence, coupled with expertise in select equipment types, industry specialization and focused client relationship management in order to bridge the pricing gap.

The uncertainty caused by regulatory pressure and fluctuating capital requirements by the governing authorities across the globe has encouraged Independents to more widely diversify their funding sources. These regulatory pressures on lenders, coupled with growing customer requirements for higher levels of service and software deals, and other non-standard types of contracts are creating concern about the potential for significant portions of their volume to become ineligible for funding because of existing financial covenants around eligible assets.

Alternative lenders are beginning to nip at the heels of traditional Independent lessors. A tremendous amount of capital is chasing FinTech alternative lenders, most of whom are offering working capital and loan type products. There is a clear concern that the amount of capital in the space outweighs the depth of credit and underwriting expertise positioning these lenders for potentially large losses in the next economic downturn. The popularity of such lenders is attracting scrutiny from regulators. If lenders in this space begin to suffer losses, it may exacerbate regulator concern creating a spillover effect to not only alternative lessors but potentially small ticket lessors adding cost and complexity that may render some business models unsustainable.

Across the Independent space, there is growing concern that the CFPB will begin to write specific requirements associated with rule mandating non-discrimination on credit decisions. Independents worry that the CFPB will begin to require them to gather and report on data related to credit application that they do not collect today precisely because they do not want to have any demographic information that would allow such discrimination to occur.

Opportunities

Independent leasing companies have been able to grow and thrive in no small part because of their nimble, yet disciplined, approach to origination and portfolio management. The strong performance of equipment lease assets during and post crisis has landed them among the most highly sought after asset classes. The assets are relatively low risk and offer higher margins than many bank loan products. This strong combination will keep liquidity flowing into the market.

The strength of the asset class will keep banks interested in Lender Finance and growing existing relationships. The securitization market has strengthened post crisis and continues to provide a consistent tool for medium to large Independents to fund their growth. The strong performance of the leasing asset class has not gone unnoticed by non-bank lenders and investors. Institutional players such as the insurance industry, hedge funds, venture capital and BDCs have all made forays into investing in the industry on both the debt and equity side. These non-traditional lenders in the space may have arrived just in time to help create funding structures for deals with higher service and software content and non-standard contracts - a chasm the banks are unlikely to cross.

Regulatory pressure has meant that some banks have narrowed the focus of their own direct leasing companies reducing the competition in the lower credit and smaller ticket credit sphere. This gap is creating an opportunity for alternative lenders as well as a chance to maintain or improve pricing margins for smaller to medium-sized Independent lessors active in this product space.

The drive for asset growth among banks and the relative margin attractiveness of leasing assets have made Independent lessors increasingly attractive M&A targets. Several regional banks have acquired small to medium leasing companies, buoying perceived value of leasing companies and their ability to attract funding.

Methodology

The methodology employed by The Alta Group reflects a three-pronged approach.

One: Quantitative. Alta used a number of resources to dimension both the Lender Finance marketplace and the current state of Independent lessors including the extensive database of the ELFA, several studies commissioned by the ELFF as well as academic research studies.

Two: Qualitative. The Alta Group conducted interviews with senior executives from leading Independent lessors, bank-owned lessors and several Lender Finance providers. Interviews were based on a set of common questions developed by Alta, customized for both Independent lessors and Lender Finance Providers. Alta supplemented these formal interviews with informal testing of results with Chief Executive Officers of select bank-owned leasing companies.

Three: Qualitative / Quantitative Synthesis: The Alta Group analyzed the data sources and interview learnings, overlaid with its own knowledge of equipment leasing and Lender Finance, to reach the study's findings and conclusions.

Primary and Secondary Information Sources

Information sources for this study comes from a variety of valuable sources, both qualitative and quantitative. Descriptions and practices are placed in the context of accepted business academic theory and best practices where possible. These sources include:

- Formal interviews with industry leaders. Principals of The Alta Group interviewed 10 experienced and respected executives from either Independent lessor or top Lender Finance operations in the U.S. These interviews averaged 45 minutes in length and were performed on a common set of questions, tailored to each of the three perspectives. The interviews were done conducted independently by telephone.
- Informal interviews were also done with four senior executives of bank-owned leasing companies, one Lender Finance marketing officer and one M&A specialist for a U.S. investment bank.

- The extensive database of the ELFA, especially "Survey of Equipment Finance Activity" (survey years 2007 – 2015) to size growth patterns and capital structures of Independent, Captive and Bank-owned lessors
- Various studies from the ELFF including:
  - *The Place of the Independent* (2011)
  - *Securitization: A Renaissance for Equipment Finance?* (2015)
  - *The Indirect Equipment Finance and Leasing Markets: Relationships Between Larger Intermediaries and Their Purchasing Partners* (2013)
- Academic research on U.S. commercial bank lending practices during the financial recession:
  - Federal Reserve Bank of San Francisco, *Financial Crisis and Bank Lending* (Simon H. Kwan, May 2010)
  - Journal of Financial Economics, *Bank Lending During the Financial Crisis* (Victoria Ivashina and David Scharfstein, 2010)

The Interviews

The Alta Group interviewed the following individuals for this study:
- Lender Finance Executives: Dennis Conway, Huntington National Bank, Dave D'Antonio, Everbank Commercial Finance; Rian Emmett, Key Equipment Finance; and Andrea Petro, Wells Fargo Capital Finance.
- Independent Leasing Executives: Charles Anderson, IMCA Capital; Tony Golobic, GreatAmerica Financial Services; Miles Herman, LEAF Financial; Luke Lukens, Sasser Family Holdings; Joe Terfler, GreatAmerica Financial Services and Evan Wilkoff, Ascentium Capital.
- Informal interviews: Rich Doherty, PNC Equipment Finance; Jeff Elliott, Huntington Equipment Finance; Richard D. Gumbrecht, Everbank Commercial Finance; Stewart Hayes, Wells Fargo Capital Finance; Arjay Jensen, Guggenheim Securities; and Adam Warner, Key Equipment Finance.

Interview Questionnaire for the Lender Finance providers:
- How long have you provided funding to the industry?
- In what segments do you participate?
- What type of facilities (LOC, Secured, unsecured)?
- How large do you estimate the market to be?
- What would you estimate to be your market share?
- Does your organization have an Equipment Finance and Leasing unit?
- If yes, how do you interact?
- Over the past 5 years how would describe your business arrow up, arrow down, arrow sideways?
- Any significant changes after the recession in terms of client selection or internal/external oversight?
- With respect to Dodd-Frank and Basel III, how have these rules directly affected your business?
- How do your KPI's stack up against other units in the bank?
- Have there been any discussions, general or otherwise, concerning capital allocation in a constrained business environment?
- If yes, in what quartile do you think you would fall?
- With respect to competition, a) any new entrants, b) any established organizations exit?
- How would you say the market has changed in the last 5 years? (pricing, T&C's, additional client requirements)

- How do you see the market changing over the next 5 years?
- What exogenous events do you see that would have a detrimental effect on the industry?

Interview Questionnaire for Independent Lessors:

General Company background information

- How long have you been in the industry?
- In what segments do you participate and what products do you offer?

Market and Competitive Dynamics

- How large is the market? What do you estimate to be your market share?
- Do you compete with any banks that are also lenders to the equipment leasing industry?
- Are new online origination sources affecting your strategy - go to market or funding?
- With respect to competition, have you seen any new entrant or exits by any established organizations?

Funding Strategy

- What is you funding mix – % by instrument: commercial paper, medium term notes, senior debt, securitization, private placements, bank lines, preferred stock, common equity, non-recourse discounting, (under sale and assignment agreement), other?
- Discuss changes in terms and conditions of these structural mechanisms
  - Advance rates
  - Covenants
- Do you have any leverage thresholds?
- How is your primary funding structured; buying deals under a sale and assignment agreement? Providing a funding line secured by a portfolio?
- What is the pricing associated with each funding source?
- How do you think your COF compares to competitors, both banks and other independents?
- How do you compete against those whose COF is lower than yours?
- Do you anticipate any changes in the short or medium term to your funding strategy?

Market Environment

- Over the past 5 years how would describe your business arrow up, arrow down, arrow sideways? How would you say the market has changed in the last 5 years? (pricing, T&C's, additional client requirements)
- How do you see the market changing over the next 5 years?
- What exogenous events do you see that would have a detrimental or positive effect on the industry?

Regulatory Environment

- Any significant changes after the recession in terms of client selection or internal/external oversight?
- With respect to Dodd-Frank and Basel III, how have these rules directly affected your business?
- Who is your primary regulator(s)?
- Has the regulatory environment facing bank participants in your market segments been an advantage or disadvantage for you? How?

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About the Researchers

Valerie L. Gerard
Managing Director, The Alta Group
vgerard@thealtagroup.com

Valerie L. Gerard has more than 30 years of experience in business strategy, capital markets/funding, corporate reputation and valuation, investor relations and rating agency relations. As Leader of Alta's management consulting practice, she advises clients on strategic initiatives, market and competitive analysis, capital markets access, corporate and structured credit ratings and investment community messaging. She is a former chair of Investor Relations Advisory Task Force for the Equipment Leasing and Finance Association and played an instrumental role on the committee that launched the ELFA's first Investors' Conference.

George L. Lehnertz
Director, The Alta Group
glehnertz@thealtagroup.com

George L. Lehnertz has extensive executive experience with vendor and captive finance services, domestic and international financial institutions, and industry mergers and acquisitions. He has helped develop, build and manage profitable business operations; purchase, sell, and integrate companies; and create successful business teams.

Patricia M. Voorhees
Director, The Alta Group
pvoorhees@thealtagroup.com

Patricia M. Voorhees has over 25 years of experience spanning business development and commercial finance with a particular focus in establishing vendor finance programs and facilitating mergers and acquisitions within the commercial finance industry. She served as General Manager of GE Capital's small ticket Office Imaging Group and served as Strategic Pricing Leader forming a team that played a pivotal role in portfolio optimization during the Financial Crisis. Other areas of expertise include business ethics and mindfulness and leadership. Patricia serves as a Director for Fordham University's Consortium for Trustworthy Organizations.

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Endnotes

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