Managed Solutions: Evolutionary or Revolutionary?

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.

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Preface

The concept of the Managed Solutions project arose from the most classic of sources – the widespread interest of the members of the Equipment Leasing & Finance Association. An interest directed to understanding a major, new dynamic in the marketplace driven by the changing needs of our customers.

At the start of this engagement, both the Foundation and Alta saw the effort to develop an understanding of the future size, scope and components of Managed Solutions as potentially very important to our industry. With the research now completed, we can confirm that the future role of Managed Solutions in our industry will be a very big deal indeed. The emergence and growth of Managed Solutions will take their place among the recent accounting changes, federal regulatory requirements and historical tax law changes as major drivers for the growth and composition of our industry.

Managed Solutions, however, are different than these other drivers – this is a very positive emergence that will provide material growth and investment return opportunities for those equipment leasing and financing companies ready to take on the challenges that Managed Solutions present. Our industry has always embraced change and market needs with innovation. This is another opportunity to carry on a more than one-half century performance of leasing equipping America.

An Alta team of seven professionals participated in the research and analysis for this project, each of whom has extensive leasing industry experience at both the strategic and tactical levels including work with clients involving Managed Solutions. More than three dozen industry leaders participated in the project through detailed interviews, sharing their Managed Solutions experience, questions and concerns. Alta also worked closely with the Equipment Leasing & Finance Foundation Steering Committee to frame the project research and results in a way to best understand the significance of Managed Solutions and the practical details that define their development and potential future direction. Alta thanks the interview participants and the Committee for their time and contributions to this Study.

Finally, one of the most significant conclusions driven by this Study is that there is no such thing as "a Managed Solution" – this is not a one-size-fits-all alternative. Whether revolutionary or evolutionary, our future understanding and use of Managed Solutions will be driven by the individual needs of equipment leasing and financing companies and their customers. While much will change over the coming years, it is our intent that this Study will provide the early foundation for that journey.

John C. Deane
Chief Executive Officer

The Alta Group℠

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Purpose of the Study

The Alta Group was commissioned by the Equipment Leasing & Finance Foundation to research, analyze, and report on the impact of a rapidly emerging type of business structure known by many names, but referred to in this Study as a Managed Solutions Transaction, or "MST." In the course of this Study the reader will learn the fundamental differences between MSTs and traditional equipment leases and financings; and critical issues affecting the major equipment leasing core functions and disciplines will be discussed in detail. It is the hope of the Study research team that the reader will learn more about, and become much better acquainted with, the questions of why and how MSTs are very likely to affect virtually every aspect of our industry over the next few years.

Methodology

The principals of The Alta Group designed a three pronged approach to data gathering for this Study:

- **Quantitative**. Alta used a number of resources, including the ELFA SEFA report to dimension the MST activity within the equipment leasing and financing industry.
- **Qualitative**. Alta interviewed an extensive and varied group of industry participants to address the critical aspects of MST. Interviews covered a range of equipment lessors in the information technology, healthcare, document technology, agriculture, energy, material handling, transportation, lift truck and general commercial equipment sectors. Interview participants included captive, independent and bank lessors as well as funders, rating agencies and service providers.
- **Quantitative/Qualitative Synthesis**. Alta analyzed the data sources and interview findings, overlaid with its own knowledge of MSTs, to reach the Study's findings and conclusions.

Primary and Secondary Information Sources

Information sources for this Study come 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. Given the highly sensitive nature of the competitive information discussed in the interviews, Alta agreed not to publish individual survey responses in an effort to preserve interview respondent confidentiality. The information sources include:

- Formal interviews with 16 equipment leasing and finance companies. Alta interviewed industry leading senior executives representing a deliberate mix of industry/equipment specialties including information technology, document technology, healthcare, materials handling, office equipment, lift trucks, agriculture, fleet/trucking and commercial equipment. These interviews, conducted independently by telephone, averaged 90 minutes in length and were performed on a common set of questions. The Interview Questionnaire is at the end of this Study. The interview participants are:

- Bank lessors: De Lage Landen Financial Services, EverBank Commercial Finance, Key Equipment Finance, Societe General Equipment Finance and US Bank Equipment Finance.
- Captive lessors: Cisco Systems Capital Corporation, GE Healthcare Financial Services, John Deere Financial Services, Lenovo Global Financial Services, Microsoft Capital, Toyota Industries Commercial Finance and Xerox Financial Services.
- Independent lessors: Element Financial Corporation - Fleet Management, GreatAmerica Financial Services, Pacific Rim Capital and SparkFund.

- Formal Interviews with 11 other industry participants such as service providers, legal experts, lender finance providers and rating agencies. These interviews averaged 30 minutes in length and were performed using a common set of questions as detailed in the Interview Questionnaire at the end of this Study. The interview participants include:
  - Legal experts: Blank Rome LLP, Cisco Systems Capital Corporation, De Lage Landen Financial Services, GreatAmerica Financial Services and Kutak Rock LLP.
  - Lender finance providers: Macquarie Capital and Wells Fargo Lender Finance.
  - Rating agencies: Fitch Ratings and Kroll Bond Rating Agency.
  - Service Providers: Genpact Limited and International Decision Systems.
- Informal interviews. Alta conducted 8 informal interviews with several lessors and a number of legal, accounting and capital markets participants to gather their perspectives. Several interview participants requested to remain anonymous.
- The extensive database of the ELFA, especially "Survey of Equipment Finance Activity" (2015) and the following Non-Standard Financing presentations from the ELFA 53rd Annual Convention:
  - "Non-Standard Financing (aka "Managed Services," "X as a Service," "Consumption Financing," "Pay as you Go") Agreements: A Primer"
  - "Non-standard Financing Agreements: Anatomy of a Deal"
  - "Navigating The Legal and Accounting Requirements for Non-Standard Financings"
- Various studies from the ELFF including:

  Financing The Cloud: A Market Study (2015).
- MarketsandMarkets.com.
- Technology Business Research Webcast "PC Services Disrupt the Hardware Landscape" (April 28, 2016).

Executive Summary

Managed Solutions Transactions, in a wide variety of forms and structures, are rapidly becoming an important component of many equipment leasing companies' product offerings in today's marketplace. Interestingly, however, these structures are not new to the industry. They actually trace their roots to the 1980s, when Xerox Corporation first offered its customers fixed term financing contracts for the use of photocopiers on a so-called cost-per-copy (CPC) basis. Customers were charged a fixed monthly rent for machines together with a variable charge based upon the number of photocopies actually produced and a fee tied to providing equipment maintenance and consumable supplies for the customer. Following this early example, other industries such as information technology and telecommunications began to offer similar forms of transactions—combining equipment with services into a single "bundle" or, as we would say today, an MST.

Although customers have generally appreciated the convenience of MST structures since those early days, particularly in technology-oriented applications, it is only in recent years that such products have become increasingly attractive to customers across a broad range of markets. End User-driven demand for MSTs and related offerings is being propelled by:

- Rapidly declining costs of hardware and equipment (for equivalent capabilities and capacity), resulting in much higher ratios in cost of services to cost of equipment.
- Increasing customer demand for flexibility in timing, term, and commitment for acquiring services, largely based upon customer experience in their utilization of appliances, wireless devices, transportation services, and other daily exposures to services providers.
- Decreasing customer interest in or demand for long-term ownership of goods or personal property, arising from shifts in broad cultural patterns and societal norms which more and more favor temporary uses, short-term rentals, frequent upgrades and trade-ins, and flexibility in the utilization of hardware and equipment—in short, we live in a "renter society," in which customers prefer to throw something away and replace it rather than keep, maintain, and own it.

By utilizing MSTs instead of entering into fixed-term or fixed obligation financing, customers find they can make more efficient (and more selective) use of third party Service Providers, they can avoid the hazards and obligations of equipment ownership, and they can realize the benefits of aligning their costs more closely with their business demands through more flexible payment, pricing, termination, and re-financing terms.

Of course, for the equipment leasing and financing industry as a whole, providing such flexibility and capability means changing many of the fundamentals upon which the industry has traditionally relied, including customer payments backed up by hell-or-high-water ("HOHW") contractual obligations, free assignability of agreements and payment streams, insulation from risk of nonperformance by third party Service Providers, and underlying ownership of actual repossessable assets. MSTs also mean significant changes in the capital market structures and processes that are most familiar to equipment leasing and finance companies; capitalization of "assets," ratings of portfolios of MST-backed paper (if such portfolios indeed come to pass), and industry- or sector-wide credit analyses will all be directly affected by these new product offerings. Questions regarding how the industry may or should address these and many other concerns are at the heart of the researchers' efforts in this Study and of the Report that follows.

Perhaps the most basic question, as reflected in the title of this Study, is whether the industry changes resulting from the increasing demand of customers for MST-like structures are more evolutionary or more revolutionary in nature. That is, are they likely to be more transformative, providing a reasonable growth path for the industry and for individual companies who are active in this market, or more disruptive, requiring prompt and radical change in how companies do business, change their processes, and respond to extrinsic market factors.

"One of the most significant impacts of MSTs is the 'quantum changes' in equipment churn which requires more rigor around the equipment's mid-term lease experience."

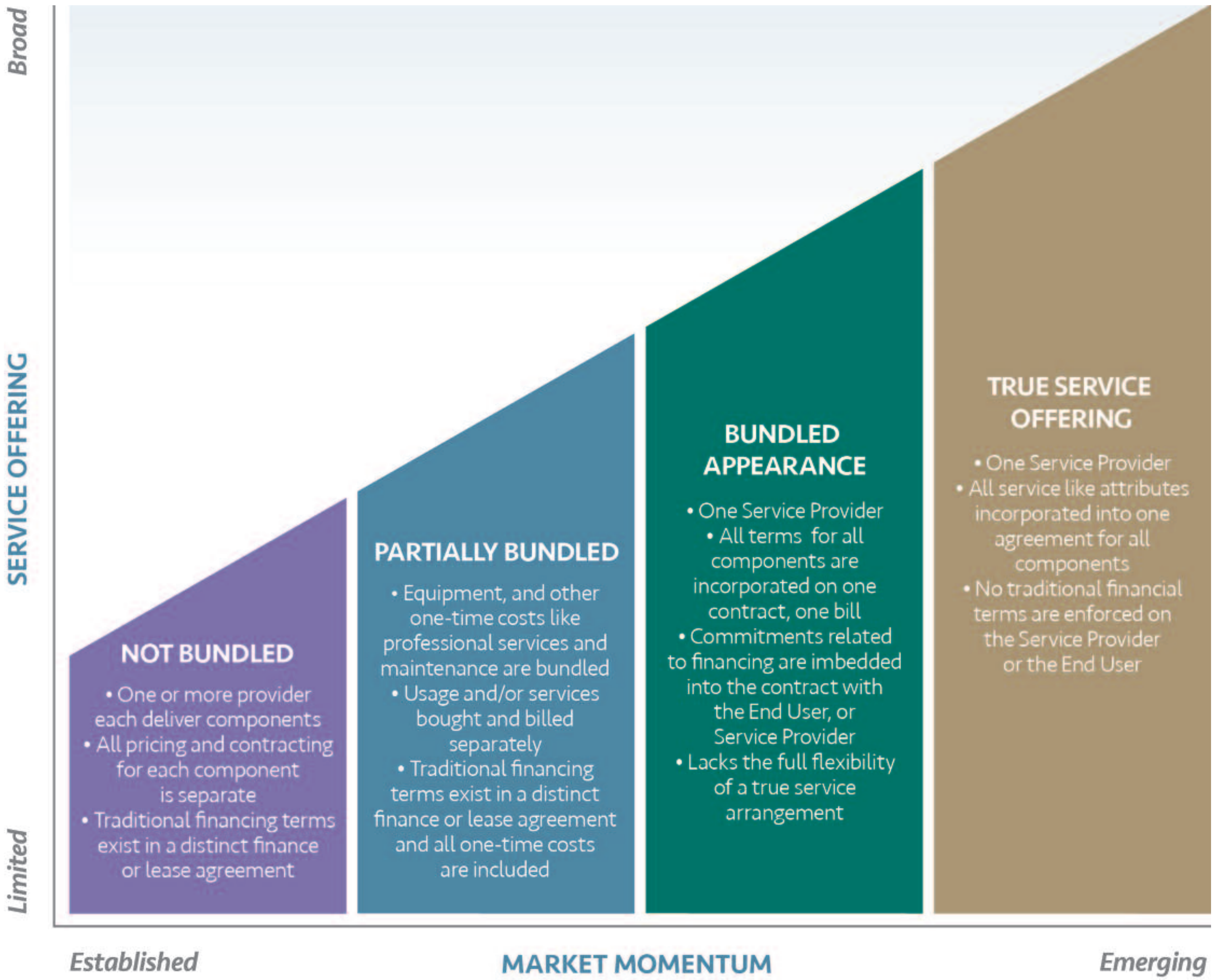
- CEO, captive lessor

There is little doubt that MSTs and similar structures and forms of doing business in the equipment leasing and finance industry are here to stay; demand is too great and customers are too accustomed to the benefits of the inherent flexibility of MSTs for the industry to go back to business as usual. And the resulting changes are likely to affect all major industry verticals and segments by which the industry measures its business activity.

The researchers of this Study, however, find that, for the equipment leasing industry, the changes are most likely to be more evolutionary than revolutionary in nature. That said, for some captives it may feel more revolutionary as their business models shift from sales to services. Companies will continue to approach transactional opportunities using the common business sense that has traditionally guided their decision making; each new MST, no matter how much more complex and unusual it may seem on the surface, will still be assessed from the standpoint of aligning pricing with risk and with long-term growth objectives, much as transactions of all kinds have historically been assessed. Customer demands for new and more flexible transaction structures offering more "use" and less long-term "ownership" of assets will of course be satisfied, but the companies choosing to meet these demands will most likely do so by inching gently into the new world of MSTs, where "finance companies" (as distinct from Service Providers) will no longer have the last word in transaction structuring, pricing, terms, and execution.

Accordingly, the industry-wide development of MSTs is not likely to be disruptive but rather to take place along a transformative continuum of development as more and more companies respond to the increasing customer demand for such changes, as described in the following figure.

Figure 1: MST Continuum



Clearly, today most MST providers fall into the first two categories. However, Alta sees this changing significantly over time as most MST providers will be in the 'bundled appearance' and 'true service offering' categories. Of course, the rate at which equipment leasing and finance companies progress along this continuum will depend upon each company's risk tolerance, its relationships with third party Service Providers whose offerings (and the quality of those offerings) are essential to retaining End User customers and their payment streams, its ability to price and structure transactions in ways that maintain margins while satisfying End User customers' demands, and its focus on providing flexible End User solutions rather than pat one-size-fits-all methods, documents, and products.

Taken all together, the Study researchers find that:

"Think very carefully about what is actually going on with the transaction structure to be sure it makes business sense."

- CEO, independent lessor

- MSTs or MST-like structures are very likely to continue growing as a proportion of all offerings of equipment leasing and finance industry participants.
- They will grow organically along a continuum of increasingly "bundled" equipment, financing, and services.
- They will present growth opportunities for captive, bank and independent lessors across a wide variety of industries.
- They will require a fair amount of rethinking and retooling of many individual industry practices, disciplines, and functions which comprise the overall business of providing equipment leasing and financing services today.

Looking ahead, MSTs will have some profound changes and opportunities for the equipment leasing and finance industry. While it is difficult to accurately predict all such trends, the forward implications include:

- MSTs on track to reach 22% or more of the total equipment leasing and finance industry volumes over the next 3 to 5 years.
- Significant equipment churn, prompted by the End User's desire to upgrade and swap equipment throughout the term of the MST, demands heightened asset management diligence around mid-term solution experience.
- Incremental headcount in all of the disciplines necessary to structure and manage an MST portfolio: credit, asset management, treasury, legal, accounting and systems.
- Lease management system upgrades to handle the complexities posed by MSTs since manual work arounds will be too burdensome, especially as it relates to reporting and compliance challenges.
- Substantial outbound education efforts with regulators, lenders and rating agencies concerning MSTs and attendant risks and rewards.

What Is A Managed Solutions Transaction?

Managed Solutions Transactions may take varying forms and employ varying structures based upon the demands of each industry in which they are employed and even according to the requirements of individual End User customers and Service Providers. They have been referred to as bundled solutions agreements, pay-as-you-go or pay-per-use contracts (or CPC agreements, as noted above), managed equipment and services (MES) transactions, variable use agreements, "everything" as a service (SaaS, IaaS, ACaaS) arrangements, consumption financing contracts, and many other names and descriptions.

For purposes of this Study, the researchers have used the following working definition of MST.

- One or more Service Providers enter into agreements with an End User (Customer) to provide specific services or "solutions" to the End User.
- The End User solution may include access to equipment, software, professional services and/or operational support. The equipment is not necessarily "incidental" to the offering, as it can be a heavy component of the services portion of the overall solution.
- A Service Provider may utilize one or more subcontractors to provide some of the required services, hardware, software or support.
- The End User payment may be structured as a subscription service or it may be based upon usage.
- Although some service agreements may incorporate non-cancellable terms, others may be very fluid or even cancellable at will. The trend is toward "pay-as-you-use," with increasing cancellation flexibility.
- Service level requirements ("SLRs") are incorporated into the managed services or solutions agreement and directly govern the performance obligations of the Service Provider.
- Equipment and/or software is typically owned by a Service Provider or one of its subcontractors.
- The agreement with an End User may or may not be monetized by the Service Provider depending on the risk parameters.

Throughout this Study, the following terms are intended to be used as shown in Chart 1 on the next page.

Chart 1: MST Terminology

TERM USED	DEFINITION
MST	MST Managed Solutions Transaction
END USER	Ultimate user of the equipment/solution, the customer
SERVICE PROVIDER	The entity delivering the solution to the End User, the vendor, the OEM, the subcontractor
FINANCE ENTITY	A member of the Equipment Leasing and Finance industry, lessor, industry participant, funder
EQUIPMENT	Hardware, asset, device or other financeable fixed cost like software or professional services
BUNDLER	The entity providing (and committing to) a defined combination of services, equipment, and/or funding solutions

How Did We Get Here?

Historically, U.S. equipment lease agreements in the form of MSTs were documented essentially as fixed term financing agreements with supplemental features under which additional customer obligations could be added to pay for services, maintenance, supplies, and various consumables related to the purpose of the underlying equipment. As noted above, such agreements originated in the office equipment segment of the industry and typically obligated End Users (lessees) to pay fixed periodic rentals for use of the leased equipment together with additional (usually variable) periodic charges for services and other add-ons. In substance, these agreements were essentially fixed term, fixed obligation lease agreements which included a number of provisions by which they could be capitalized through refinancings, back leveraging, or assignment.

Due to their close functional connection with direct equipment management and services, these early forms of MST were most often offered by industrial or manufacturer captive finance companies. Although independent leasing companies and even bank captives provided funding for many of these transactions, it was manufacturer and industrial captives who were most comfortable offering maintenance and related services directly to their End Users and who found such transactions attractive for their role in End User control and account management. Consequently, this form of equipment financing was concentrated primarily in the vendor and captive segment of the leasing industry for the major portion of its early history; and, because these agreements were at heart very similar to the equipment leases used throughout other industry segments, such early forms of "bundled" agreements were not generally considered to require special attention or focus during the negotiating of terms.

By the turn of the 21st Century, however, End User acceptance had grown rapidly as MSTs became fairly routine among technology companies, including Cisco, HP and IBM. The bundling of fairly low cost, low margin computing and networking hardware with high margin, high value services proved financially attractive for Service Providers and ultimately made acquiring both equipment and services easier for the End User. Similarly, fleet management companies such as PHH Corporation (now part of Element Financial) began offering end-to-end solutions for End Users' fleet transportation requirements, from vehicle acquisition to maintenance to fueling to vehicle disposition.

Today, MSTs extend well beyond these traditional markets to include farming, healthcare, energy and other applications. Even industries with less obvious services components have demonstrated the need for MSTs, including, for example, the water purification sector, in which Service Providers may combine the equipment required for their solutions with various consumables, services, and customer care alternatives. Companies in an expanding array of industries are demanding this kind of bundling of financing and services from their traditional funding sources, thereby allowing them to focus entirely on their own core business needs.

Even industries with less obvious services components have demonstrated the need for MSTs.

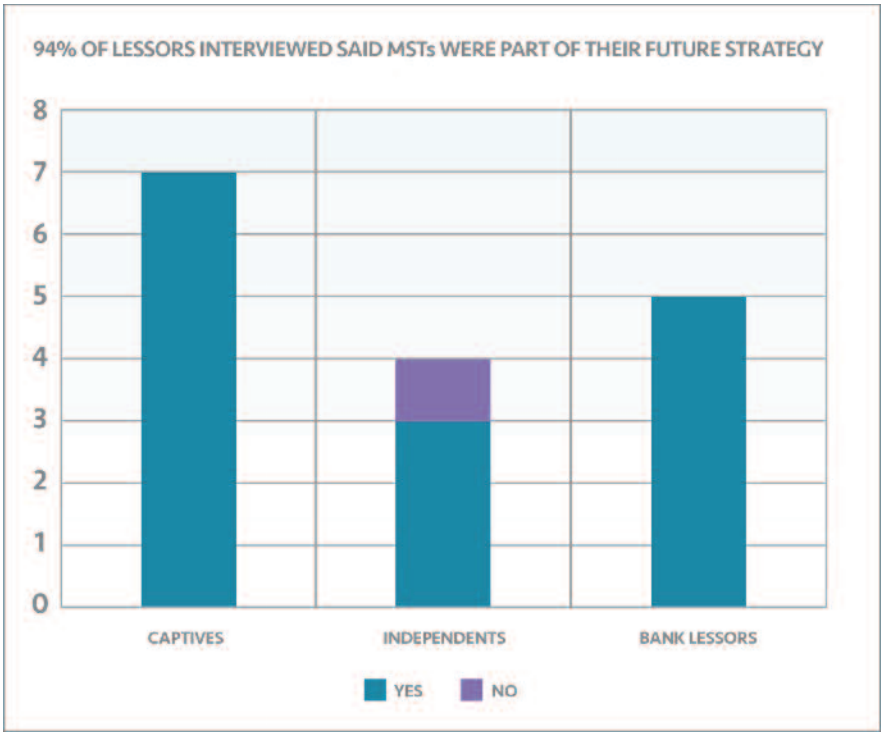
But if the concept of MSTs is not new, why is the application of managed solutions and related structures suddenly growing ever more rapidly and being considered as a possible game changer within the equipment leasing and finance industry? In short, our industry has reached a tipping point where market factors and client demand are pushing this solution to the forefront of industry attention.

Managed Solutions Transactions: Market Size and Dynamics

According to the market research firm MarketsandMarkets, the overall size of the Managed Solutions market in the U.S. is forecast to grow to $193.3 billion by 2019, up from $107.2 billion in 2014—a 12.5% compounded annual growth rate.[1] The banking, financial services and insurance segment of the global economy is expected to become the largest industry segment participating in this marketplace, while North America will continue to be the largest single region due to its singular combination of a large customer pool with a high relative concentration of managed Service Providers.[2] This market estimate is directional in nature, since it does not reflect estimates for some markets such as Trucks/Trailers and Smart Grid/Smart Cities, both of which are also experiencing strong End User demand for MST offerings.[3]

What are the implications for the U.S. equipment leasing and finance industry? The Alta Group estimates that MSTs will reach more than 22% of total US equipment leasing volume over the next 3 to 5 years. This estimate reflects a combination of projected volume growth in equipment classes best suited for a Managed Solutions offering; specific Managed Solutions growth estimates in select asset classes such as Smart Grid/Smart City applications, in which 54% growth is expected through 2019; detailed information provided during Alta's interviews for this Study with senior practitioners throughout the industry; and Alta's own research and intellectual property.[4] Information technology, healthcare, trucking, office technology and construction are expected by the Alta researchers to be the areas of strongest growth as measured by forecast transaction volumes.

Figure 2: Lessors Interviewed on MSTs as Part of Future Strategy



Although, as mentioned above, industrial captive finance companies have generally pioneered the use of MSTs and related structures in the U.S. equipment leasing and finance marketplace, bank leasing companies have reported in interviews with Alta seeing strong growth opportunities across essentially all equipment classes, with information technology and healthcare showing the highest demand. Independents have also indicated increasing interest in transactions of this kind, typically in the traditional areas of technology and IT but also in providing solutions in the transportation and healthcare sectors. And FinTechs also have a role to play in offering MSTs. SparkFund, for example, is a company which focuses on energy efficiency and clean-tech infrastructure financing solutions for energy savings projects. The company has developed a sophisticated software platform to enable what the company calls "Efficiency Technology-as-a-Service," through which SparkFund's Service Providers may sell their energy products, installation and monitoring services to their own customers under a simple "Service Plan" combining the charges for use of equipment and related services into a single all-inclusive monthly payment. The growing demand from End Users for such arrangements is expected to provide growing opportunities for non-captive leasing and finance companies to take a meaningful market share in the Managed Services arena; and many of these lessors may benefit further once captives reach concentration thresholds, which may happen very quickly given the anticipated potential size of the MST market.

It is important to note that markets outside of the U.S. are also witnessing strong growth in MSTs, as End Users are similarly focused on usage and on greater operating flexibility rather than on equipment acquisition and ownership. In Europe, for example, there is particularly strong demand in the healthcare, information technology and construction equipment industry verticals, although a singular challenge in Europe is the ability to offer MSTs to End Users across the region in multiple written and spoken languages In Australia, although volumes are relatively much smaller than in the U.S. or Europe, Alta's research indicates that sustained End User requests are currently being experienced in both information technology and document print services.

"MST is a natural fit or captives and independents but less so for banks with a direct sales model and diverse asset and customer base."

- Head of vendor finance, bank lessor

Technological Advances Drive New End User Requirements

The pace of technological advances is a primary factor in the increased demand for MSTs in the U.S. All industries considering the value of offering their End Users an MST now have the access to the tools to make such an offer a reality, and the growing acceptance of the Cloud in the last decade as a means of accessing a wide and varied range of services is perhaps the key contributor to the MST model and mindset. The very opening statement in the Harvard Business Review's article "Cloud Computing Comes of Age" articulates the Managed Solutions theme:

"For much of its history, cloud computing has been viewed by many businesspeople as a way to gain new capabilities quickly, without having to work with – and get bogged down by – the internal IT department. Figure out what you want to do, find a service provider that can help you do it, grab your credit card, and pay as you go. No arduous development process. No large capital out lays [sic] to be approved. No hardware and software to maintain… 'Renting' versus owning the technology has been a huge boon to business agility."[5]

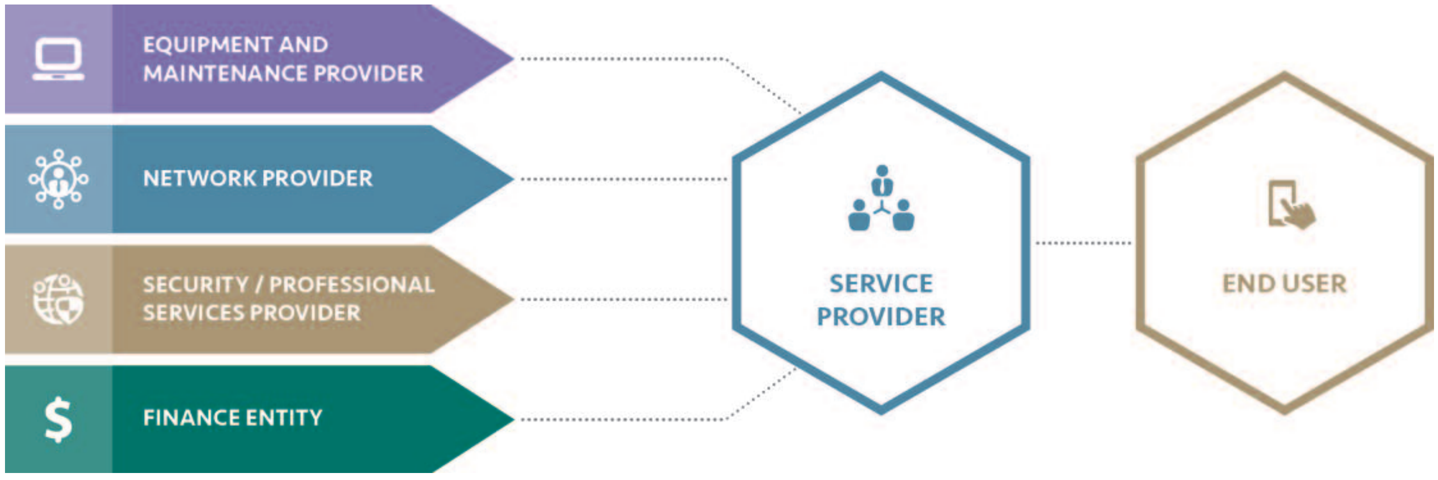
Businesses, capitalizing on the "On-Demand Economy," want the ability to use the Cloud quickly and inexpensively to build out historically expensive IT infrastructure. As consumers become more enamored with on-demand services for rides and food delivered by the likes of Uber and GrubHub, it is only logical that businesses delivering these services will expect, and in fact demand, the same on-demand capability from their Service Providers. Coupled with the need for access to sophisticated infrastructure is the need for access to such services through a high volume of mobile devices which are low cost and virtually disposable. The locality and cost of these access point devices make ownership-like responsibilities and administration undesirable for an End User. These factors tend to drive the delivery of these solutions away from the traditional lease and loan and toward the MST.

The information technology and office automation industries are top of mind when discussing MSTs because, by their very nature, they are obvious users of current technology. However, many industries are leveraging access to technology to design their own versions of MST. As previously stated, consumer on-demand services are introduced regularly to address everyday needs centered on quick, easy and convenient delivery. Similarly, new commercial applications are also being developed. For example, EM3 AgriServices, a Delhi, India-based company, has launched Farming as a Service (FaaS) in order to "enhance the wealth of small and marginal farmers through building an ecosystem and scalable platform."[6] By tapping into multiple industry experts in both the agriculture and technology industry, EM3 is positioned to "...become India's first organized small-hold agricultural services platform at scale and will materially improve farm processes and productivity among small farmers in India."[7]

Financial Impacts Influence Service Provider and End User Behavior

Before the advent of Managed Solutions Transactions, it was necessary for End Users to solicit multiple bids for any large services-driven project, *e.g.*, a comprehensive IT expansion, culminating in multiple negotiations with multiple vendors and Service Providers over multiple contracts and agreements—one for network hardware, one for maintenance on that hardware, one for installation of the network, one for maintenance of the network, one for professional services, one for security, and (eventually) one for the financing for the hardware and other one-time financeable costs. Each bid and each negotiation was handled as a separate procurement activity, requiring multiple bid responses and evaluations and ultimately separate awards.

Figure 3: MST Participants



A single Service Provider may have been able to respond to one or two of the multiple components of such projects, but only with bids that were clearly in the Service Provider's specific area of expertise. To ensure a successful project outcome, the Service Provider had to engage and closely coordinate with other project participants, whether suppliers, subcontractors, or specialists in specific functions and activities, including leasing or finance companies. Under this commonly experienced scenario, no single Service Provider had control over the others, and therefore the End User was required to undertake ultimate management responsibility for the project.

An MST, however, is potentially a very 'sticky' high margin transaction in which the cost of historically low margin equipment, typically commodity assets, is blended with traditionally higher margin value-added services, including maintenance, professional services, and direct customer responses. Under this arrangement, the Service Provider becomes the "general manager" of the project, selecting and taking responsibility for the performance of all of its participants and for the project as a whole. Given this ultimate control and responsibility, not only does the Service Provider have access to more avenues for generating marginal revenue but the Service Provider is also more likely to see an increase in the proportion of successfully executed projects.

However, as attractive as such a structure may sound, there are also some potentially negative financial impacts, as well. From a revenue perspective, the Service Provider may not be able to recognize up front the revenue associated with the sale of customer equipment supporting the project. As a result, the Service Provider may have to take ownership of the equipment at project inception, reflecting the project assets on its balance sheet. In addition, the Service Provider's additional management and administrative responsibilities may result in negative financial impact. For example, as the party responsible for bringing all of the components of the project solution into a single service agreement, both contractually and financially, the Service Provider may be obligated to accept the ongoing billing and account management tasks associated with project oversight. If the solution requires usage-based billing, say in the case of an IT or telecoms installation, the investment in software and infrastructure necessary for the Service Provider to manage the complexity of billings may also be significant.

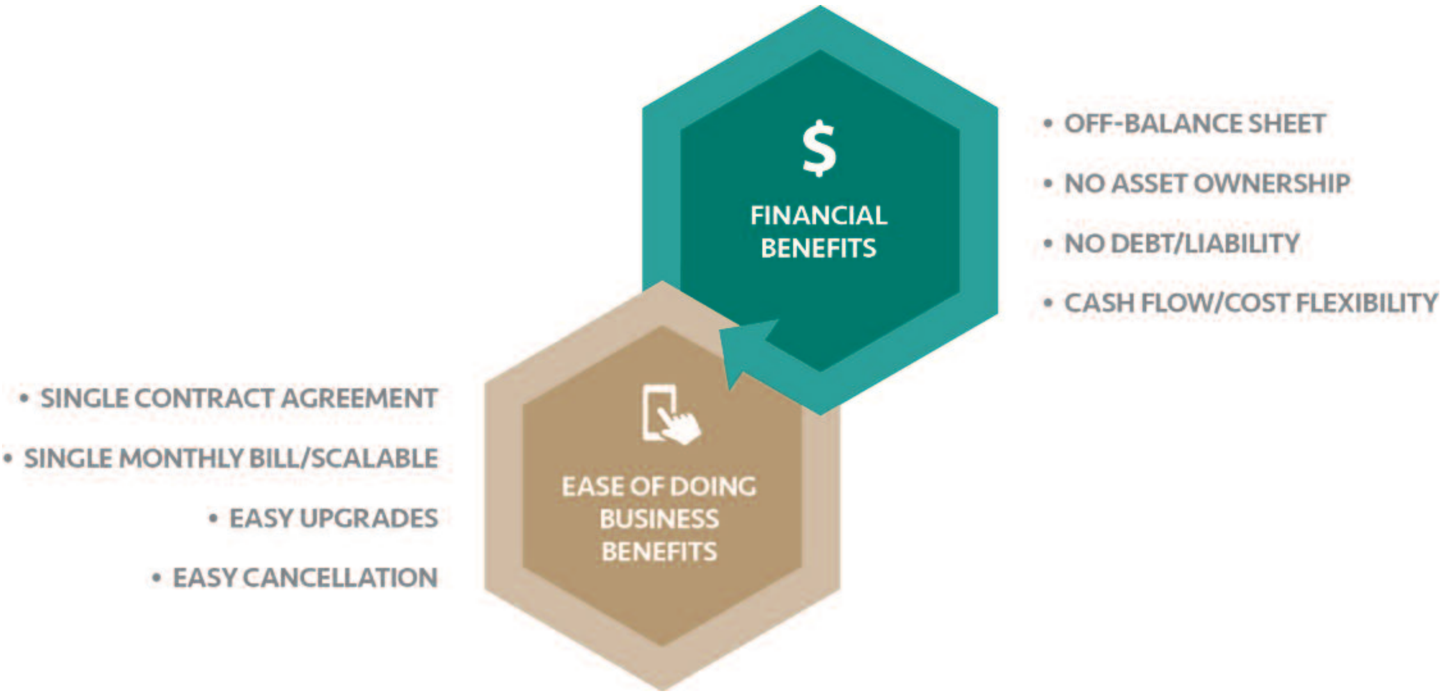
For every challenge which an MST creates for the Service Provider, however, there is an offsetting and compelling benefit for the End User driving the demand for this structure. Although the historical process of negotiating each element of a project with a separate Service Provider may have resulted in better overall pricing for the End User on the total solution, the savings achieved were often eroded by the higher costs of managing the project, administering multiple providers, coordinating and carrying out installations, and routine invoicing and service related issues. For both Service Providers and End Users, the clear benefits of the MST structure are the consolidation and ultimate simplicity (albeit sometimes based upon more complex structuring and details) of the long-term solution and the relief of the End User from the burdens of asset ownership, management, and responsibility.

In particular, MSTs drive efficiencies for End Users because they eliminate the need to manage multiple Service Providers and all of the capital expenses associated with such management. End Users are able to pay as they use equipment and other assets, including software, on a single bill under a single contract with a single point of contact. They incur no long-term or fixed debt obligations and do not own the underlying equipment, relieving them of balance sheet pressure. They enjoy improved cash flow flexibility based upon expected savings and/or increased revenue afforded by the bundled solutions without having to commit to fixed terms of payment or even to fixed payments at all. In short, End Users may substantially reduce their business forecasting risks by paying only for what they actually use and not for functionality and capabilities that may or may not be needed in the near or distant future.

MSTs drive efficiencies for End Users because they eliminate the need to manage multiple Service Providers and all the associated capital expenses.

Of course, the natural next question is "what about the Finance Entity that traditionally would have leased equipment to this Service Provider and/or this End User?" Within the past decade, several case studies have made it clear that the "lease" portions of MSTs have been shown on the balance sheets of the respective lessees, and Finance Entities have since then been searching for ways of structuring solutions to resemble pure service contracts. At the heart of this search is the fact that each of the two primary parties to every MST, the Service Provider(s) and the End User, seeks to enjoy the same financial benefits and the same ease of doing business as the other.

Figure 4: MST Financial Benefits for the Service Providers and End Users



However, because neither of these parties is willing to accept a firm term commitment on the asset portion of the solution, backed up by a traditional HOHW payment obligation, and because neither of them is willing to commit to a fixed periodic payment amount, Finance Entities have struggled with delivering financial solutions that provide the parties with the benefits they seek while still being coupled with acceptable risk profiles and meeting overriding profitability and regulatory requirements. Various structures have been used over the years to achieve these objectives, including tech refresh programs, short term walk away leases or rentals and pass-through billing structures, but few so far have eloquently provided the desired result to all parties involved.

Deviations from Traditional Lease and Loan Transactions

MSTs represent a shift in customer demands and expectations to which lessors must adapt. This section identifies how MSTs differs from traditional equipment finance transactions.

Risk and Asset Management

Introduction

When it comes to risk management, there is no single set of rules that dictate the approach an individual organization must take in deciding how far into the maze of MSTs they want to venture. There are some governors such as the accounting, legal and regulatory considerations as discussed in subsequent sections of this report. However, it is as much the external concerns as it is the underlying risk culture of the organization itself which drive the decision. Each organization, be it a bank-owned, captive or independent lessor, will evaluate the various risks and weigh these against the established risk appetite within the organization. This section focuses on the main risks in an MST - performance, credit, cancellation and asset/residual value risk; each of which is addressed below.

> *"Lessors need to evaluate not only the credit of the End User but also their integrity, based on the MSTs exposure in MSTs and the possibility of feigning performance issues."*
>
> *- Chief credit officer for captive lessor*

Most, if not all, leasing companies interviewed were in substantial agreement on where the issues and risks are in MSTs and to what degree they differ from other leasing transactions currently in the marketplace. That, however, did not necessarily drive them to the same conclusions regarding the role each wanted to play in this new environment which, of course, will be dependent upon how each assesses the risks relative to their respective risk appetites.

Performance Risk

The defining difference between a MST and other transactions from a risk standpoint is the dominant role of performance risk. The vendor and, if a separate entity, the service provider, play key roles and the performance of each is the most significant risk factor in the MST equation, a statement that was echoed by all interview respondents.

Since the vendor or other Service Provider will act as the general contractor in most transactions, some of the non-vendor interview respondents felt that significantly greater due diligence had to be performed on these entities – e.g. past performance, if any, on similar projects as well as references.

Speaking to the degree to which MSTs differ from other leasing transactions in the marketplace, one important measure is the flexibility of terms regarding lease termination afforded to the End Users and whether the transaction is supported by a HOHW clause, as further discussed in the Legal section of this Study. The more flexible the terms and/or the absence of HOHW, the more important it is to be able to rely on the vendor for performance risk. Some of the non-vendor interview respondents, in fact, felt that indemnification would be needed from the vendors as well as the right to replace the Service Provider, if necessary, as measured by service level agreements to be included in the documentation.

Aside from additional protection in the form of indemnities and service agreements, it is important to note that with the increased level of risk focused on the vendor and Service Provider, these MSTs should include only those vendor players and Service Providers that the finance providers are comfortable with. While the vetting of the vendors and Service Providers is commonplace for finance providers with current vendor programs, MSTs elevate vendor risk as it is much more complex and thus requires additional in-depth scrutiny.

Because MSTs potentially involve subcontractors, introducing this additional layer will add to the overall risk. This was echoed by the interviewees, primarily by those in the captive space where the effect would likely be most impactful and they felt that it was absolutely necessary for the subcontractors to be thoroughly vetted before engaging them in the transaction.

Credit Risk

> *"Only the best of our partners will pass our diligence process."*
>
> *- CEO, independent lessor*

While performance risk takes "center stage" in MSTs, credit risk is certainly a key element in these transactions, intertwined with, and in some cases, a component of performance risk. The credit of the End User is obviously an important part of the decision to adjudicate an MST, however the actual weight placed on its importance can be somewhat subjective, depending on the perspective of a particular organization. The response to questioning whether these transactions necessitated added focus on End User credit produced mixed reactions from the interview respondents. Some believed that if the End User were going to default, they were going to default and the credit decision process would be the same as in any other transaction. However, others felt that the proportion of soft costs had an influence – where they were higher and the underlying value less tangible, the credit of the End User was more important and tighter standards needed to be applied to these transactions.

Chart 2: Risk Profile for Finance Entity

TRADITIONAL EQUIPMENT LEASE	MANAGED SOLUTION TRANSACTION
End User credit risk only	Service Provider(s) and End User Credit risk
Limited to no service performance risk	Considerable Performance Risk potentially across multiple Service Providers
Asset is available as collateral and/or ownership	Asset may be owned by Service Provider(s) (or there may be no or limited traditional "asset"); knowledge of services essentiality is a key component
Direct relationship with End User for residual management	Indirect relationship to End User, possibility of no residual management in walk away termination
Direct relationship with End User billing and collection management	Indirect relationship to End User, stronger reliance on Service Provider capabilities
Fully enforceable and assignable (HOHW) payment obligation	Modified or conditional payment obligation

An interesting perspective shared by one respondent offered that the credit **and** integrity of the End User were of great importance. Attendant to the recognition of the heightened risk of vendor performance and the other non-credit risks in MSTs, this respondent felt that the credit strength of the End User was vital and also had to be accompanied by the willingness to "play well with others," to help mitigate the potential for conflicts with the other participants in MSTs.

For the Finance Entity, in addition to assessing performance capabilities, a critical element in the approval process is the vetting of the other parties involved, be it the vendor, Service Provider and/or subcontractor, with respect to their credit strength. In addition, to the extent the vendor is relying on a subcontractor and/or other Service Provider, the interview respondents emphasized that it is critical for the vendor party to make sure that their performance partners have the financial wherewithal, in addition to the technical skillsets, to perform their necessary roles in the process. The heightened risk associated with performance in MSTs, combined with the possibility of a watered-down or absent HOHW clause, could drive the Finance Entity to require its vendor partner to guaranty performance through indemnification. This is outside of its normal business practices, could put additional strain on its financial resources and needs to be considered by the Finance Entity accordingly.

Cancellation Risk

One of the reasons that performance risk plays such a dominant role in an MST is the fluid nature of these transactions and the possibility of cancellation without penalty. Imbedded in the discussion of cancellation is the topic of presence or lack thereof of the HOHW clause. It is obvious that the risk factor is increased in the absence of HOHW and the heightened possibility of the end-user walking away from the transaction. What is not obvious is how a particular Finance Entity will react to the situation. This is one of those circumstances in which the external legal and regulatory issues as well as the underlying risk culture of the organization will influence the decision. It is definitely not "one size fits all." While lessors have, to a great extent, come to rely on the non-cancellable aspects present in most lease contracts, the reaction to moving to a less-insulated environment produced mixed responses from our interviewees and the degree to which each was willing to let go of this protection to allow the end-user more flexibility regarding duration and withdrawal from the contract.

While there were some respondents who felt that, based on advice of legal counsel, the language should remain in the document and allow for negotiation, others felt that they could forego the clause completely, with some outside mitigants – including primarily vendor and/or Service Provider reliance such as indemnification. One respondent felt that while it was highly desirable to have HOHW, the nature of the service contract was executory to begin with and they could live without the clause. The captive companies also spoke to the high profit margins they enjoy and the resulting reduced gap they would have to recover in the event of cancellation.

Asset/Residual Value Risk

The importance placed upon asset and residual value risk is dependent upon, at least two factors; one, the specific underlying assets and their value, as further discussed below and two, the ratio of assets to services and other MST components. In looking at financing a mix that involves a larger percentage of hard assets, greater emphasis is placed on their value and, therefore, there is an increased residual value risk focus. One feature of some MSTs, in addition to possible walkaway, is the ability of the End User to freely change equipment, including upgrading and/or downgrading. With this in mind, some survey respondents spoke of the need to focus on the reality of dealing with a potential increase in the level of equipment returns during the existing contract, as service needs changed or went away. In these situations, these same respondents recognized the importance of assessing the ability of their existing infrastructure (including their existing network of outside services) to take on the added needs of MSTs or what would be the necessary steps needed to upgrade. Some examples of industry segments that would be subject to more frequent upgrades and downgrades, driven by demand and/or equipment needs, include office technology and the copier market in particular; the healthcare industry and its migration to pay-per-use vs. traditional purchase of equipment as well as the rise in integrated radiological floors within hospitals; and the construction rental market that has seen a 75% increase over the past few years.

Chart 3: Asset Ownership for Finance Entity

TRADITIONAL EQUIPMENT LEASE	MANAGED SOLUTION TRANSACTION
Asset owned and depreciated	May be owned by the Service Provider or End User
Residual value is a key component of the structure and economics	Residual value may be maintained by the Service Provider
Asset recovery a requirement at end-of-lease or in event of default	Asset recovery likely not available to the Finance Entity

In those transactions that are more heavily weighted with services and/or equipment with traditionally minimal collateral value, there is less of a focus on the asset values in an MST. However, the nature of the specific underlying assets still play a critical role, with respect to their applicability and essentiality to the operations of the End User, which could impact the cancellation factor. All interviewed lessor respondents felt essentiality was an important consideration, although some did not see it materially different than the traditional structures. The difference in opinion resulted from the specific assets being financed and the degree to which the traditional product, itself, already provided essentiality on its own. For example, certain enterprise software and networking equipment can be critical to the ongoing operation of an enterprise, based on its defined use and would not depend on a particular application or project within the organization. Other examples would include telecommunications infrastructure and energy management systems.

As part of the discussion on asset and residual risk, it is important to recognize that MSTs provide the possibility of the assets actually being owned by the Service Provider as compared to the lessor or lessee in a traditional transaction. Looking back at the previous discussion addressing the need to vet all parties in MSTs, dealing with third-party asset ownership is yet another reason to do so. With this in mind, the interview respondents did not feel that the ownership by the Service Provider added an inordinate amount of risk to the equation and they could deal with it through documentation with the other parties owning the equipment.

Additional Observations

Attendant to the discussion on the various MST-specific risks is the degree of involvement of the parent and/or regulatory entities that oversee the activities of the Finance Entity. Looking first at parent involvement, the information from our respondents indicated that this is a factor of how far down the road the organization has gone with MSTs. In those entities where the MST is more established, there has been ongoing interaction with the parent. Captive respondents looking at the potential impact of the MST offering but have not yet had any significant volume have not yet had substantial dialogue with their parent. Somewhat surprising was the lack of significant discussions between the regulators and our bank lessors given the fact that there are specific limitations that have been placed on leasing by banks, which may have ramification in considering MSTs. This issue is addressed more fully in the "Legal" section of this Report.

One additional question that was posed to all interviewees and not focused on specific risks dealt with whether the MST product is viable for all leasing company types. While there were some inconsistencies, all felt that there was a play for everyone. However, there was also widespread agreement that the structure would be the toughest on the bank lessors, who might or might not enter these transactions directly versus funding another company that might deal directly with the End User. Most felt that the vendor captive was probably best equipped to acclimate to the environment although there were some who also felt that independents might have more flexibility than captives regarding the nature of the product being financed, not being limited by what a parent company might manufacture.

Accounting

The economic concept behind an MST is that the customer pays the provider for a service on an ongoing, periodic basis. In such an arrangement, the End User receives and consumes the benefits of the provider's performance as the provider performs its obligations. These arrangements generally are viewed as executory contracts. From a financial reporting perspective, an executory contract is not recognized in the End User's balance sheet and the cost of the contract is expensed pro rata over time.

Industry leaders believe MSTs are a viable product for all leasing company types.

Not all MSTs will be deemed executory contracts from an accounting perspective, however, as there are some solutions that are deemed to contain a lease. While an MST, to the extent it is a new product for the parties, creates financial reporting issues for the Service Provider and the service recipient, the rules on how to account for these transactions have been in place for many years.

ASC 840, *Leases*, requires that arrangements in which equipment is involved in delivering the service be assessed as to whether the contract contains a lease or not. If an arrangement does contain a lease, the lease must be classified under the capitalization criteria of ASC 840-10-25-1 and recorded separately.

End User

For the End User, this process requires separating the other components of the MST (viewed as executory costs) from the lease component and identifying the cost of each. The lessee is required to make an estimate of that cost based on market data for comparable transactions to the extent the cost of an element is unknown.

Examples of how the End User may assign values to the various cost elements include using relative standalone prices if an observable price for each component exists or employing a residual method when observable standalone prices are available for one or more, but not all, components. The other elements of the arrangement are then accounted for separately from the lease based on the nature of each element.

An arrangement is deemed to contain a lease if all the following conditions are met:

- Specific property, plant, or equipment is identified (either explicitly or implicitly).
- The fulfillment of the arrangement is dependent on the use of the identified property, plant, and equipment.
- The arrangement conveys to the lessee/purchaser the right to use the identified property, plant and equipment.

The arrangement is not a lease if it does not transfer the right to use the asset(s) from one party to another. Furthermore, the asset may not be considered the subject of a lease, even if it is explicitly identified, if fulfillment of the arrangement is not dependent on the use of that specific asset.

Consider, for example, an End User that contracts with a managed solutions provider for data storage through a centralized data center. Although the arrangement speaks to the use of a specified server, the provider has the ability to substitute another server without the End User's consent.

Furthermore, the provider has multiple, identical servers maintained in a central, accessible location and there are no barriers (economic or otherwise) to substituting any of the servers for another. In this case, even though an asset is identified and the End User has the right to use it, the arrangement does not contain a lease, as fulfillment of the provider's obligation is not dependent on the specified property.

Vendors

Vendor lessors face different accounting issues related to service contracts than third-party and independent lessors. For one thing, the service contract in a manufacturing environment typically is based on an enterprise approach to pricing the transaction. This enterprise approach encompasses multiple business units with differing objectives and measurement criteria. The vendor also acts more as a principal (versus an agent) in the delivery of the services in the arrangement.

Just as the End User, the vendor must assess whether the contract contains a lease. This determination is made more critical for the vendor in that the answer will drive revenue recognition. For example, if the arrangement does not contain a lease, there is not a sale of the underlying asset used to perform the services. This lack of a sale has the potential to negatively impact the parent's revenue recognition as it moves into an MST environment.

Revenue recognition also may be negatively affected if the arrangement contains a lease, depending on the nature of the MST. For example, a true subscription-based offering that contains a lease most likely will result in the lease being classified as an operating lease. This operating lease classification means that revenue must be recognized over the term of the arrangement, as opposed to being recognized up front as in a sales-type lease.

Depending on the nature of the MST, revenue recognition may be negatively affected if an MST arrangement contains a lease.

When an arrangement contains a lease and non-lease elements, the lessor must account for the elements separately. The lease is to be accounted for according to the guidelines of ASC 840, whereas the other elements are to be accounted for under the appropriate revenue recognition guidance.[8]

Of course, part of the End User appeal of an MST is a single price that covers multiple services – consequently, there generally is not a breakdown of each element. This issue is exacerbated in a captive environment by the enterprise approach to winning the deal. The rub, therefore, is identifying how much of the overall consideration in the transaction is to be allocated to the various elements, each of which is considered a separate unit of accounting. This process is illustrated later.

Under current guidance, the total arrangement consideration should be allocated to each identified unit of a transaction based on the unit's relative fair value. Under this method, any discount is shared proportionately among each unit of the transaction based on its relative fair value.

This fair value is based on vendor specific objective evidence, which is the price for which a vendor sells the product on a stand-alone basis. Vendor specific objective evidence also may include the price for which other vendors sell a similar product. The SEC has indicated that the range of product fair values in a population of cash transactions should be the same as the range of the same product fair values in a financed transaction.

As part of this process, the lessor must determine whether there is objective and reliable evidence of the fair value of the element(s). For cases in which such evidence is not available for all elements of the transaction, the residual method also can be used.

Under the residual method, when there is reliable and objective evidence for one or more of the other elements, the fair value of those elements for which there is no evidence can be derived by subtracting the aggregate fair value of the other elements from the total arrangement consideration. The difference between the two represents the fair value of the elements for which there is no reliable and objective evidence.

Chart 4: Accounting Treatment for MST Participants

	TRADITIONAL EQUIPMENT LEASE	MANAGED SOLUTION TRANSACTION
END USER	Classifies the lease as either capital or operating and accounts for the transaction accordingly	Determines if the arrangement contains a lease
		Assigns value to each element of the arrangement
		Classifies the lease as either capital or operating, and accounts for the lease accordingly
		Accounts for each of the other elements accordingly
SERVICE PROVIDER	Classifies the lease as either capital or operating and accounts for the transaction accordingly	Determines if the arrangement contains a lease
		Assigns a selling value to each element of the arrangement
		Classifies the lease as either capital or operating
	Recognizes revenue on the transfer of the asset, as appropriate	Recognizes revenue on each element, as appropriate
		Accounts for the lease accordingly
		Accounts for each of the other elements accordingly
FINANCE ENTITY	Classifies the lease as either capital or operating and accounts for the transaction accordingly	Determines if the arrangement contains a lease
		Assigns value to each element of the arrangement
		Classifies the lease as either capital or operating, and accounts for the lease accordingly
		Accounts for each of the other elements accordingly, based on whether the entity is a principal or an agent

When allocating the total consideration among the various elements of the MST, care must be taken to avoid using allocation practices that may inaccurately reflect the revenue recognition. Some of these include:

- Using artificial equipment values to decrease the implicit interest rate, in order to create sales-type leases.
- Using artificial implicit interest rates in order to inflate equipment sale revenues.

- Allocating portions of the service contract stream (e.g., maintenance) to the equipment in order to accelerate up-front revenue recognition.
- Adjusting residual values to manipulate revenue recognition.

The process to allocate total consideration to the various elements can be illustrated through the following example:

- A manufacturer enters into an agreement to provide an MST that encompasses hardware, professional services and maintenance services. The manufacturer's various business units have collaborated on the transaction and have arrived at an overall price for the solution of $500,000. Furthermore, the manufacturer has determined that each of the promised goods or services represents a separate performance obligation.
- Because the manufacturer frequently sells professional services and maintenance on a standalone basis, it uses those transactions to determine standalone selling prices of $62,500 and $37,500, respectively. The manufacturer rarely sells the hardware on a standalone basis, though, so it estimates the standalone selling price of the hardware at $462,500, based on a combination of the cost of the hardware, the manufacturer's targeted margin on that particular model, and the amount of margin the entity believes the market will bear.

Based on the above factors, the overall consideration of $500,000 would be allocated to the performance obligations as follows:

Chart 5: Consideration for Performance Obligations

PERFORMANCE OBLIGATION	ESTIMATED STANDALONE SELLING PRICE	% OF RELATIVE SELLING PRICE	ALLOCATED DISCOUNT	ALLOCATION OF TRANSACTION PRICE
Hardware	$ 462,500	82.2%	$ (51,400)	$ 411,100
Professional Services	62,500	11.1	(6,900)	55,600
Maintenance Services	37,500	6.7	(4,200)	33,300
TOTAL	**$ 562,500**	**100.0%**	**$ (62,500)**	**$ 500,000**

Vendors also will face additional accounting challenges from an operational and balance sheet management perspective. Operationally, many lease management systems (LMS) do not have the functionality required to administer all aspects of MSTs, so manual workarounds are required.

An MST offering also creates balance sheet management challenges, particularly as vendors seek to monetize as many elements of the MST as possible. Although a Finance Entity may be willing to advance cash against elements of the MST, these elements represent unrecognized financial assets on the books of the vendor/Service Provider.

The transfer of finance lease receivables to the Finance Entity from the vendor may qualify for sales treatment, resulting in a gain or loss and derecognition of the associated receivables. The proceeds of a transfer of the unrecognized financial assets associated with an MST to a Finance Entity, however, must be recorded as a borrowing that is amortized over the term of the transferred contract. In essence, the debt remains on the balance sheet of the vendor.

Finance Entities

Whereas, a manufacturer, acting as a principal in the transaction, takes an enterprise approach to pricing the managed solution, a Finance Entity usually does not. Instead, the Finance Entity, such as a bank acting as a vendor partner, primarily plays the role of agent and/or servicer in the delivery of the services in the arrangement.

In this role, the Finance Entity may, among other things, and in various combinations:

- Create a lease and link it to the vendor's service contract with the End User so as to present an MST.
- Monetize one or more aspects of the service contract for the vendor.
- Service the MST, for a fee, on behalf of the vendor.
- Service the service contract, for a fee, on behalf of the vendor.
- Contract for and combine with the lease, various services on a pass-through basis.

The Finance Entity in an MST does not face revenue recognition issues like a vendor does. The accounting for a managed solution in this environment, therefore, does not present any particularly onerous challenges from a financial reporting standpoint as the accounting lines up with the Finance Entity's normal financing activities. An MST does, however, increase the operational complexity of administering the transaction. The Finance Entity must have an LMS that is robust enough to link and process the multiple elements in an MST.

The Finance Entity must have a lease management system that is robust enough to link and process the multiple elements in an MST.

Interviews with lessors indicate that this area is problematic in that vendor partners are still developing their solutions, making it difficult to standardize their requirements. They also indicate that existing LMS' either do not have the functionality, or were not configured to address these needs during installation, particularly subscription-based/variable activity. Consequently, manual workarounds to address the nuances of the MST are not uncommon for finance entities, either.

New Accounting Rules

ASC 842, *Leases*, the new lease accounting standard, effective in 2019, retains many of the same rules as the current standard for recognizing the economic results of an MST. The context in which these rules apply, however, has changed dramatically, along with whether an arrangement contains a lease. This change will put new pressures on providers and End Users to achieve their varied financial reporting goals, particularly for operating leases.

Under the current lease accounting rules, an operating lease embedded in an MST is off balance sheet, as are most of the other elements of the managed solution. Consequently, there is little concern over separately identifying the components of the MST, since, if the components are not broken out, they follow the treatment of the operating lease by remaining off the balance sheet and being expensed over time.

The new requirement to place all leases on the balance sheet, however, will incentivize lessees to break out the separate components of the MST, and possibly, seek out more MSTs in order to minimize the amount of the solution capitalized. By themselves, the non-equipment elements in a managed solution will still remain eligible to be off balance sheet and expensed over time, but only if they are separately identified.

Since any elements not separately identified will be capitalized as part of the lease and put on the balance sheet, concern has been expressed by lessors over having to provide lessees with a breakdown, by element, of the cost of the MST. Lessors interviewed by Alta, however, indicated that their customers were not yet raising this issue.

Tax Concerns

An MST has many of the characteristics of a product construct in the Internal Revenue Code ("IRC") known as a service contract. A service contract from an IRS perspective is an arrangement in which the service provided by one party to another party requires the use of a type of asset, but not a specific asset.

A service contract differs from a true lease in that the service is not based on the use of a specific asset (i.e., the Service Provider has discretion as to which assets it uses to provide the service). A service contract also differs from a conditional sale in that the ownership of the asset necessary to provide the service is retained by the Service Provider, with the only benefit transferred to the service recipient being the provided service.

Concern over characterizing an arrangement as a service contract for Federal income tax purposes generally has less to do with compliance than with establishing the Service Provider as the tax owner of the asset being used to provide the service. As such, meeting the service contract criteria primarily is important only in tax sensitive transactions, particularly those that involve alternative energy tax credits or cash grants. In these situations, it is very important to the Service Provider to be considered the owner of the asset being used to provide the service.

This ownership may be questioned by the IRS when, for instance, assets central to providing the service are, in effect, in the lessee's possession and potential control. This issue is exacerbated since there is not a standalone lease agreement to analyze as to which party bears the risks and rewards of equipment ownership under current tax guidelines. The Service Provider/lessor may lose the tax benefits unless it is able to prove it is bearing the risks and rewards of ownership of the asset.

The most current application of the service contract rules in the equipment leasing and finance industry occurred in the leveraged lease environment when the IRS disallowed the use of the replacement lease structure to maintain the investor's tax benefits. The genesis of the service contract issue, however, lies with Xerox's decades-long practice of providing managed solutions. In this instance, Xerox was able to maintain its access to the investment tax credits of the underlying equipment by successfully arguing that it was the owner of the equipment being used to provide the managed solution to its End Users.

Since that time, the IRS has established the criteria that must be met for an arrangement to be considered a service contract under Section 7701(e) of the IRC (thereby allowing the Service Provider to retain tax ownership). Under these criteria, the Service Provider must control and operate the asset and be responsible for the performance of the asset. Factors indicating a service contract under §7701(e) include:

- Physical possession of the asset by the provider.
- Control of the property by the provider.
- A possessory or economic interest of the provider.
- Risk of nonperformance is borne by the provider.
- Concurrent use of the asset for other service recipients.
- Rental value versus contract fees.

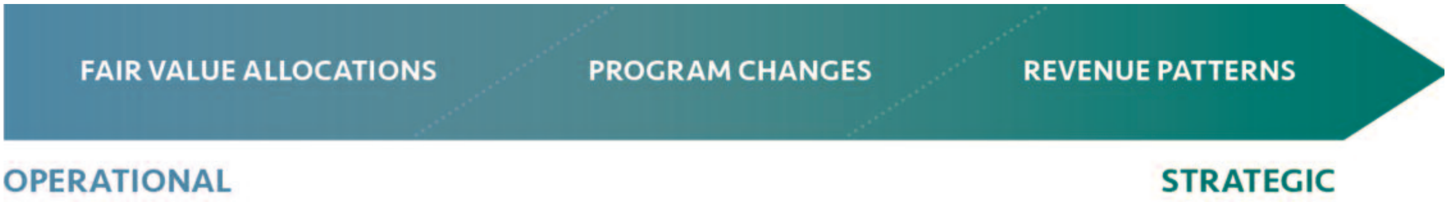
The Service Provider can subcontract operations to a third party (who can be the lessee) and the lessee can guarantee cash flows in the service contract period. There are safe harbors for service contract treatment for qualified solid waste disposal facilities, cogeneration facilities, alternative energy facilities, or water treatment works facilities, assuming that certain requirements are met.

While there are criteria for establishing a service contract for IRS purposes, the concern around meeting them has not yet been raised to the level of the true lease versus sale distinction so familiar to many in the equipment leasing market. It is suggested that interested readers further analyze these rules in the context of their own situation.

Summary

Revenue recognition has been identified as one of the accounting challenges of an MST for vendors. This challenge spans a spectrum of activities ranging from operational to strategic.

Figure 5: Revenue Recognition Spectrum



Perhaps the most important of these is the decision whether to pursue up-front revenue recognition (emphasizing the equipment sale element) or to focus on the overall MST revenue pattern that occurs over time. Although these decisions only affect the timing of when the revenue is recognized, the vendor's decision will have to consider not just the investors' perspective but also the market potential and, hence, total revenue opportunities of the MST.

Another aspect of revenue recognition for vendors relates to the nature of the MST and its impact on the provisions of any vendor or funding program that it may have. Finance Entity feedback, for instance, indicates that the nature of the MST, particularly the lack of a HOHW clause, may require additional vendor support in the form of indemnifications, buy backs, remarketing, etc. This added level of support is likely to have a dilutive effect on the vendor's ability to achieve current revenue recognition.

Revenue recognition is perceived by the lessors contacted by Alta to be more of an issue for the vendor partners than an internal challenge for finance entities. In most MSTs, including transfers of the various receivables, there is no particularly thorny issue involved in accounting and booking the contracts. As one lessor serving its vendor partners put it, "Other than system limitations, it is business as usual from the accounting side."

In most MSTs there is no particularly thorny issue involved in accounting and booking the contracts.

For vendors, revenue recognition and balance sheet management will continue to be important considerations. Both vendors and Finance Entity respondents to the Alta survey, however, mentioned encountering system limitations in administering MSTs. These limitations require manual workarounds, particularly with variable usage agreements. Additional operational complexity is added due to the number of schedules per MST that must be tracked along with assuring proper treatment of ad valorem taxes, particularly outside the US.

Legal

As noted elsewhere in this Report, the Equipment Leasing and Finance industry is experiencing increasing growth in the demand for, and increasing industry-wide acceptance and use of, Managed Solutions Transactions as a form of providing End Users with both the services they require and the equipment related to providing such services. Along with expanding growth in this product area has come an increase in the impact of MSTs in those areas traditionally concerned with related legal and regulatory issues – issues which have typically been at the heart of equipment leasing and financing.

For purposes of discussion, it is useful to organize these areas of focus into several general categories, including transaction structure, transaction documentation and written provisions, issues related to enforcement and collectability, issues related to assignability and assignment of transactions, and issues related to specific provisions of the U.C.C. In addition, MSTs may involve or trigger the applicability and understanding of various federal and state regulations and regulatory regimes which continue to have an increasing impact of their own on the broader commercial leasing and financing industry.

Historical Background

As noted elsewhere in this Report, MST agreements originated in the office equipment segment of the industry and typically obligated End Users (lessees) to pay fixed periodic rentals for use of the leased equipment together with additional (usually variable) periodic charges for services and other add-ons. These initial MSTs usually committed the End Users for a fixed term of months or years, although they often included provisions for the upgrading of equipment to newer or more advanced models (with concomitant adjustments in rent, extensions of term, and other accommodations), and they frequently allowed for trade-ins or swaps in such cases as inducements for End Users to continue leasing equipment. In substance, however, as described above, such agreements were essentially fixed term, fixed obligation lease agreements which included a number of provisions by which they could be capitalized through refinancings, back leveraging, or assignment.

Even as MSTs or their equivalents became more popular and more prevalent from a business standpoint, their underlying documentation continued to be structured essentially in accordance with long standing industry standard forms and practices, including irrevocability and hell-or-high-water provisions, warranty disclaimers, free and full assignability for lessors, strong default and remedy provisions, and, in more recent times, provisions incorporating U.C.C. Article 2A protections and disclaimers. Such provisions have often been included, either directly or in standalone financing agreements, in documenting most bundled transactions or MSTs.

Much more recent changes in the business paradigm, however, together with the continuing encroachment of federal regulation on financing industry practices in general, have prompted a rethinking of the documentation and legal issues supporting MSTs and bundled transactions. Some of these issues are discussed in the following paragraphs. Transaction structuring and documentation must generally be adjusted to support End Users' demands for short-term or "temporary" services; for extreme flexibility in pricing, tenor, termination, and cancellation rights; for End User remedies in the event of defaults or failures in providing services; for availability of services anywhere and at any time; and for focus on the "use" rather than on the "ownership" (whether current or end-of-term) of underlying equipment and tangible assets.

Forms of Documentation

Attorneys who practice in this area have historically been (and to some extent continue to be) divided as to the best overall form of agreement to use for MSTs or any form of bundled transaction. One form that is customarily used is a "master agreement" (sometimes a "subscription agreement") which embodies all of the provisions necessary to accommodate both the providing of services by one or more third party vendors and the statement of rights and obligations which affect the financing of underlying equipment (or even pre-paid services). Sometimes master agreements of this kind are executed by all of the parties involved in the transaction (*i.e.*, the End User, the equipment vendor(s), the Service Provider(s), and the Finance Entity(ies), if any), while sometimes such agreements run only between the End User and the party serving as the bundler or consolidator of services and equipment. In the latter case, additional schedules or ancillary agreements (essentially subcontracts) are typically used to contract for third party services or specific items of equipment or systems.

Alternatively, MSTs are often documented in the form of separate agreements covering the providing of and payment for services, together with related supplies, maintenance, and consumables, and for the providing and financing of equipment or hardware essential to the providing of such services. This structure allows for the statement in the "financing agreement" of most of the more traditional terms and conditions customarily found in equipment lease agreements while establishing separate and independently enforceable rights, responsibilities, and obligations of the parties to the service agreement(s).

As may be expected, practitioners find both pros and cons in each of these structures. The master agreement form of documentation provides for a certain degree of convenience and harmonization of terms and conditions covering both services and financing. It may also be useful in providing the End User with a clear understanding of its obligations in paying for both equipment and services on a single consolidated invoice or in a single periodic payment amount throughout a fixed term transaction. (This model is essentially the form referred to above in describing the earliest forms of bundled transactions.)

Chart 6: Forms of MST Documentation

MASTER LEASE / SUBSCRIPTION AGREEMENT	BIFURCATED OR INDEPENDENT CONTRACTS
All parties subject to one set of terms and conditions	Opportunity for confusion under separate agreements with unrelated parties
Opportunity for disputes in commingling obligation to pay for current services with obligation to pay future stream of rent for tangible assets	Clearer separation of End User payments for on-going services from term obligations to pay for possession and use of equipment
Convenience of including schedules and addenda for specific aspects of the transaction, such as services, financing, and consumables	Certainty of setting forth all necessary terms and conditions for each aspect of the transaction
Opportunity for misunderstanding and dispute regarding allocation of End User obligations in the event of payment default	Specific statement of End User's obligations for services and for financing, even if specific allocation is not disclosed to End User in a single document

However, the convenience and relative simplicity of the master agreement or unitary contract may also be a source of difficulty following an End User payment default or the failure of a services vendor to provide contractually satisfactory services. It is at such times that End User (or vendor) misunderstandings or disputes may arise regarding the proper allocation of payments between services and "lease" payment obligations and the enforceability of the financing portions or services portions of consolidated payments. In addition, such a fully consolidated or integrated contract, together with resulting consolidated periodic payments, may give rise to difficulty in assigning to third party funders only the portions of such payments allocable to equipment financing, resulting in limited ability to back leverage or sell individual contracts or portfolios of such contracts.

On the other hand, utilizing separate or bifurcated agreements for providing services and for providing related financing of equipment may render the whole concept of bundling or managed solutions ineffective, especially in the eyes of an End User whose preference was to avoid a term financing agreement in the first place. Although the services agreement may offer the flexibility that is key to MSTs, the separate financing agreement, particularly if it includes hell-or-high-water or other such firm obligation provisions, may take the entire transaction outside the realm of managed solutions benefits and convenience.

This obstacle has been overcome to some extent through the use of alternative forms of addressing the noncancelability and irrevocability of equipment financing agreements, as discussed in greater detail below. Such a "bifurcated" arrangement may also be constructed in a way that emphasizes the services elements of the transaction while providing only the financing provisions that are essential to enforcing the End User's fixed equipment payment obligations.

Of course, the selection of which form of agreement is best depends upon the underlying assumptions and requirements of the transaction itself.

Of course, the selection of which form of agreement is best depends upon the underlying assumptions and requirements of the transaction itself and the ultimate credit support for the parties' respective obligations. If the total value of the MST involves only a small percentage of equipment cost and a relatively large portion of costs for services, then consolidating the necessary contractual provisions into a single bundled agreement may be preferable as a long-term benefit to the End User, as a form of End User account management and control, and as an acceptable risk or inconvenience regarding the End User's actual equipment payment obligations. If an MST involves a substantial majority of equipment cost and only a nominal portion of cost for related services, then bifurcated (or only loosely connected) agreements setting forth the Service Providers' and End User's obligations separately from the End User's equipment payment obligations may continue to be the most prudent (and enforceable) means of documenting the transaction.

The choice of contractual form also depends ultimately upon the nature of the bundler and its objectives in entering into an MST in the first place. Within the traditional equipment leasing community, vendor or manufacturer captive finance companies may generally be more comfortable with the master agreement, single subscription agreement, or consolidated agreement form.

Although the issue of revenue recognition is something that must be contended with under such an agreement, it is often the case that equipment manufacturer affiliated companies are more accustomed to dealing with equipment details and with services-related matters and are relatively less concerned with documenting transactions in a way that allows them to be readily assigned to or financed by third party funders.

Conversely, companies who participate in MSTs and whose primary business has traditionally been as financiers of transactions from multiple vendors and manufacturers, such as bank captives and independent leasing companies which are not directly related to equipment providers, have typically preferred to use documents which set forth rather more clearly the payment obligations of the End User and which clarify the separation between payment obligations related to "financing" and payments related to services. Accordingly, such documents have often been bifurcated, if not in physical form then in segmentation of specific terms and conditions, so as to allow fixed periodic payment obligations to be independently stated and assigned or refinanced.

In the current marketplace, however, given the growing End User preference for convenience and flexibility and away from fixed term irrevocable payment obligations, the industry trend is toward consolidation of services provisions and "financing" provisions within a single master or consolidated agreement, with individual provisions sorted out and set forth as discussed further below. Although such agreements currently tend to be lengthy, relatively complex, and thoroughly negotiated, and therefore best suited to larger transactions and not to high volume or flow business, this trend is expected to continue along with efforts to craft more streamlined and (following sufficient testing in court) effective terms and conditions to satisfy the needs of End Users, bundlers, and third party funding sources.

Specific Contractual Provisions

Hell-or-High-Water. Considerations of the use and effectiveness of traditional HOHW payment provisions have been dominant in legal circles as MSTs have become more popular and more prevalent in the U.S. equipment leasing and finance industry. Such provisions have traditionally been a mainstay of equipment lease agreements, primarily because they serve to provide firm contractual assurance of End User (lessee) payments both to lessors and to their assignees, as third party funders, and because they provide a tried and tested legal basis for claims and remedies in the event of lessee payment defaults. This has generally held true as a matter both of common law and of relevant statutory protections, particularly including lessors' rights as set forth in U.C.C. Article 2A.

In the structuring and documenting of MSTs, however, there has been notable pushback from End Users to the inclusion of traditional HOHW provisions. This is due to the growing trend of End Users to demand greater flexibility in payment terms, pricing, transaction tenor, and outright cancellation of such contracts. Accordingly, such provisions are either being tempered to include various exceptions and alternatives tailored to the specific

In the structuring and documenting of MSTs there has been notable pushback from End Users to the inclusion of HOHW provisions.

transactions and End Users at hand, or they are (in the case of some bifurcated agreements or separately stated “financing” sections or provisions) being moved into those documents or sections of integrated agreements that deal specifically with financing matters.

One concept that is widely espoused in this respect by many, if not most, bundlers or originating funding sources in structuring and drafting MST agreements is first to satisfy and foster their relationships with equipment vendors or Service Providers and then to address the needs of End Users. That is, in the event of End User payment defaults, MST bundlers and financing companies most often choose, and design their documents, first to establish procedures for working with Service Providers to resolve payment or performance issues (*i.e.*, to determine whether defaults are due to End Users’ withholding payments on the basis of vendors’ failures to provide satisfactory services or are due simply to End User credit issues). If resolution can be reached with the Service Provider or vendor, then accommodations can subsequently be made directly between the vendor and the End User, and the financing portion of the End Users’ payment obligations can be managed accordingly. On the other hand, if a default is determined to be merely a failure, inability, or refusal of the End User to pay, then the HOHW (or equivalent) provisions of the financing sections or agreements may be invoked and appropriate remedial action taken to recover the bundler’s (or funding source’s) losses.

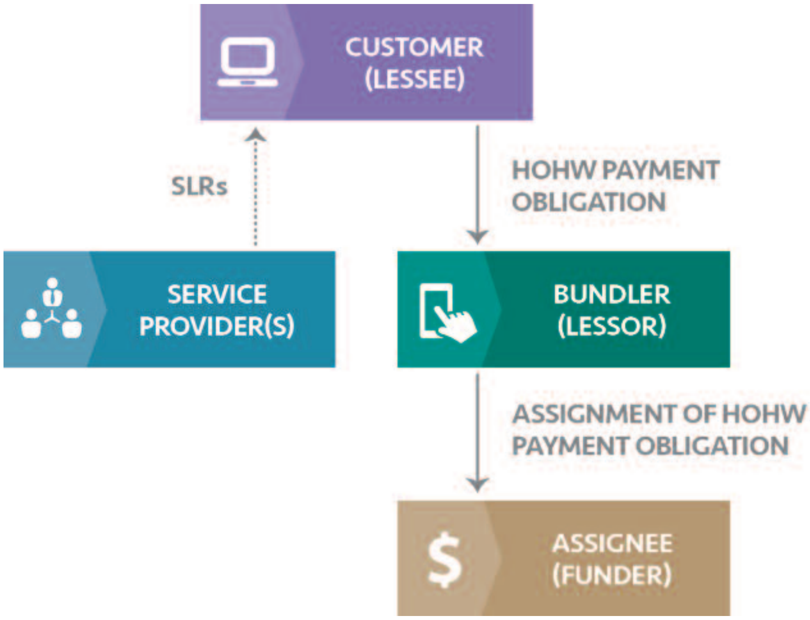
The growing development of MSTs has also fostered new thinking among legal professionals regarding possible alternatives to traditional HOHW provisions. For example, MST documents may now rely more on indemnification obligations running directly from Service Providers or vendors than on customary HOHW obligations of the End User to enforce a funding source’s right to receive payments. Working with Service Providers, whether under a master agreement form or through separate financing and services contracts, a bundler or funding source may choose to look directly to the Service Providers or equipment vendors to indemnify itself against losses resulting from failures (or even colorable claims of failure) by these parties to meet minimum Service Level Requirements ("SLRs") or contractual obligations to the End User, even though such failures may actually arise under the service agreements to which the funding source itself may not be a party.

It is anticipated that as funding sources become more acquainted and comfortable with MSTs and related bundled transactions, such non-traditional approaches to protecting third party funders’ essential rights to be paid will continue to be developed, incorporated into documents, and ultimately tested in the courts to determine their viability and applicability throughout the industry.

<u>Assignments and Assignability</u>. A fundamental construct in equipment leasing and finance has always been the free assignability by lessors and funding sources of lease agreements or of streams of rental payments due under lease agreements. Assignments of transactions allow lease originators and lessors to recapitalize or monetize their investments in transactions and provide an essential source of capital for further investments and funding of leases and loans.

From a credit and enforceability standpoint, one of the most important underpinnings of this construct has traditionally been the HOHW clause, which appears in essentially every traditional U.S. equipment lease agreement. It is this provision upon which third party funders and assignees can rely for assurance that the lessee obligations supporting the payment streams they are buying can be enforced without regard to the specific equipment, operations, or circumstances of any particular transaction. Rather, third party funders can proceed directly against obligors under the terms of the HOHW clause itself.

Figure 6: Traditional Assignment

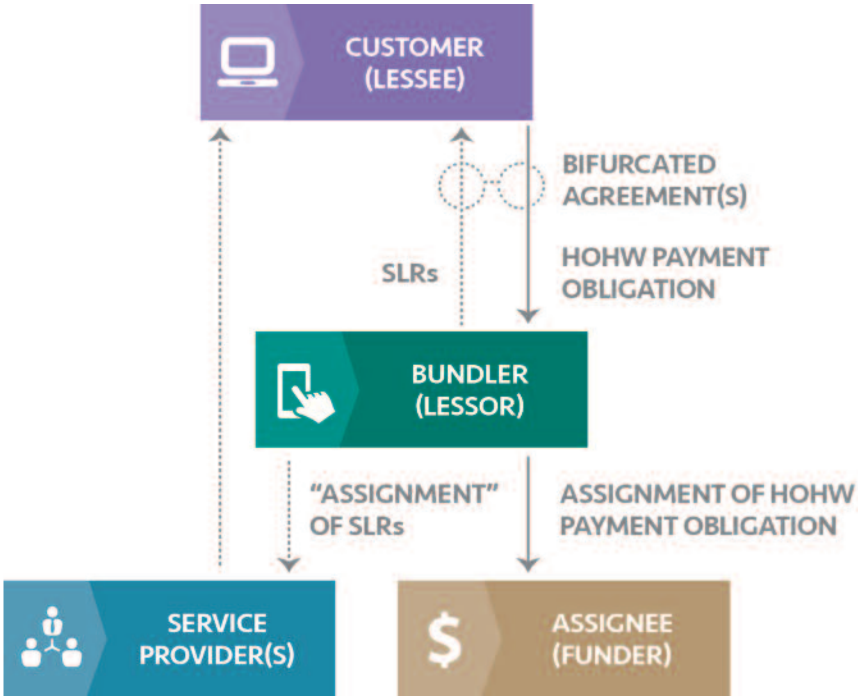


As discussed above, however, the trend in MST structures and documentation is to avoid traditional forms of HOHW provisions and to substitute other methods, both legal and operational, for assuring the enforceability of End Users' obligations to pay periodic rentals or other amounts due for the use of tangible assets and for related services.[9] Given this trend, practitioners have been confronted with the question of how to assure that MSTs remain fully and freely assignable without the traditional coverage of a robust HOHW provision.

The trend in MSTs is to avoid traditional forms of HOHW and to substitute other methods, both legal and operation, for ensuring enforceability.

At the heart of this question is clarifying the nature of the interests and obligations to be assigned to third party funders. In the event of MSTs which are bifurcated, either structurally (using separate agreements for providing services and for financing underlying equipment) or contractually (using a bundled or master agreement but functionally separating the provisions which apply to services from those which apply to financing), it is a relatively straightforward matter to assign to third parties only the periodic payments and accompanying contractual obligations which apply to equipment financing and are supported by an HOHW or related enforceability provision.

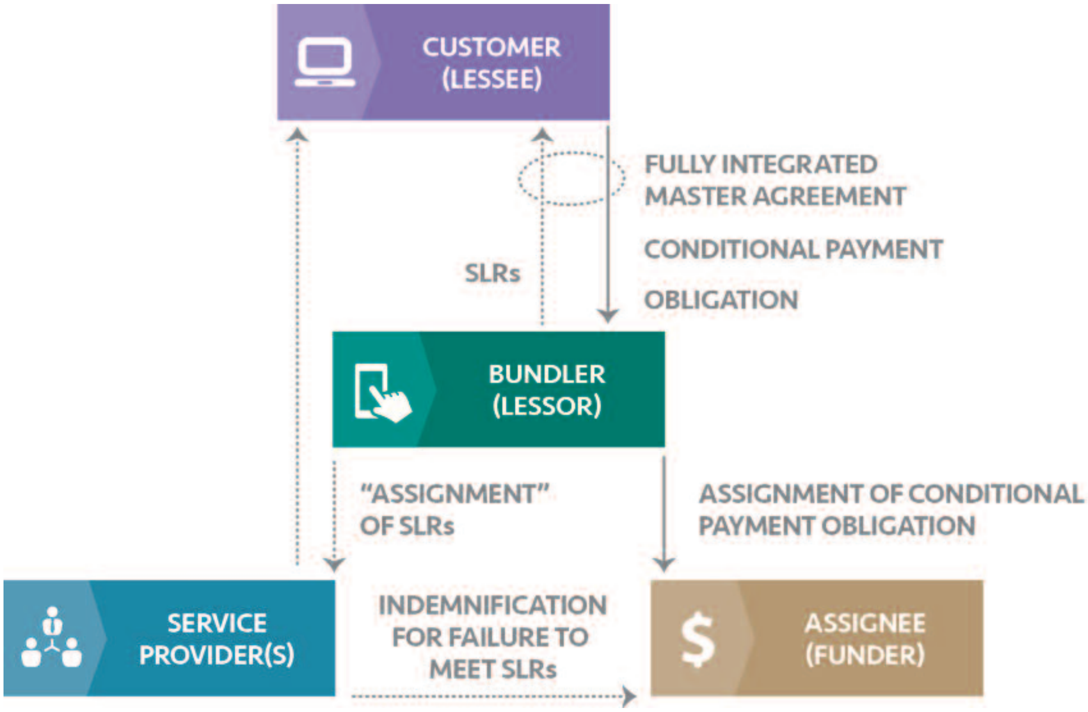
Figure 7: Bifurcated Agreements (Clearly Defined Obligations)



Utilizing truly integrated master agreements, on the other hand, may hinder the ease with which MSTs can be back leveraged or assigned to third party funders. Whether or not this is a material obstacle in any particular transaction, of course, often depends upon how large a portion of the End User's periodic payment obligations is allocated to rent or repayment of costs for tangible assets as opposed to payment for on-going services. In the case of *de minimis* payments for equipment relative to total payments for services, the enforceability of the asset portion of the obligation may not be a significant factor. (Indeed, in such a transaction there may be no practical need to assign the rental or debt repayment portion of the End User's payments in the first place.)

Where a more significant portion of the End User's periodic payments is allocable to equipment, however, consideration must be given to whether and how this portion of the payments can be monetized or assigned to a third party funder along with adequate assurance of the enforceability of the End User's continuing payment obligation. Without a customary HOHW provision (or other contractual assurance of payment such as an independent guaranty which includes similar noncancelability, irrevocability, and no-setoff provisions), third party funders remain somewhat reluctant to purchase streams of payments arising from MST obligations, particularly if the tangible asset portion of payments cannot be readily separated and enforced by other means (*e.g.*, lockbox or escrow arrangements or independent contractual undertakings). In addition, as discussed further below, the matter of the characterization of bundled payments under MSTs for purposes of applying U.C.C. provisions and protections continues to be an important consideration for assignees of such payments.

Figure 8: Integrated Agreement (Payment Obligations Conditioned on Services)



Overall, practitioners continue to seek the best ways to document and enforce third party funders' protections under assignments of true MST master agreements or subscription agreements; and efforts are continuing to develop methods and practices allowing bundlers, lessors, and originators of MSTs to monetize at least the direct funding portions of such transactions while still offering satisfactorily robust enforcement tools to a wider range of third party funding sources.

<u>U.C.C. Issues</u>. An issue closely related to the enforcement of End Users' tangible asset payment obligations under MSTs is the treatment of such obligations under the U.C.C. It is widely understood and agreed that, because it is by definition applicable only to the purchase, sale, financing, and leasing of "goods," the U.C.C. does not apply, at least directly, to payments by End Users for intangible services. Accordingly, if End User payments under an MST are truly bundled, with compensation for services and payments for the acquisition and use of underlying equipment being combined into single periodic amounts, the questions of how and whether to apply the protections available to equipment lessors and secured parties under the U.C.C. must be addressed.

It is generally agreed that where MST payment obligations (or definable portions of obligations) are clearly allocable to the payment of "rent" for the use of tangible assets or to the repayment of debt incurred for the acquisition of tangible assets, then the U.C.C. applies as it would in the case of a true lease or secured loan under traditional forms of documentation. In such transactions, the possession of original transaction documentation as chattel paper, the filing of financing statements (UCC-1s) for the perfection of security interests in the equipment, and the availability of various rights and remedies of the funding source under Article 2A and Article 9, if applicable, may all be treated as they would be under typical equipment leases or loans.

However, if payments for services and equipment under an MST are bundled together, and particularly if payment provisions and grants of security interests under the MST documents themselves do not provide adequate guidance in the matter, then questions may arise regarding the characterization of documents as chattel paper for purposes of protecting certain of the funding source's rights in the transaction and in the equipment; regarding the priority of filings and the perfection of security interests in the underlying equipment (including the availability of purchase money security interests); and regarding the applicability of certain statutory rights and protections of the funding source (or the waiver of certain statutory rights of the End User) under the U.C.C.

It is expected that many variations in documentation will be introduced as volumes grow and End User requirements become more refined.

Accordingly, practitioners typically structure master agreement documentation and take other contractual steps to clarify that the End User's obligations to pay "rent" or make debt service payments for the tangible assets involved in an MST are separate and independently defined for purposes of applicable provisions of the U.C.C. and for the enforcement of creditors' rights generally. The specific means by which these objectives are being documented currently are quite variable; and they are often based upon the particular industry segment involved and the parties' ultimate business objectives in offering MSTs, sometimes even on a transaction by transaction basis. For example, in many office equipment transactions the financing terms (often including HOHW provisions) are integrated directly into the body of a master agreement because the equipment manufacturer, whether as a direct vendor or through a dealer, serves both as the Services Provider and as the Finance Entity; the refinancing or third party assignment of such agreements is typically not a high priority for such a party. An independent originator or bundler, on the other hand, may often seek to refinance or assign its transactions to third party Finance Entities and may therefore utilize bifurcated or legally severable documents so as to provide its third party assignees with "standalone" (or at least clearly defined) financing terms upon which to base the calculation, pricing, and relative enforceability of future periodic payment obligations, making them more readily assignable.

It has been pointed out that the structuring and documentation of MST transactions in the current market includes many elements commonly found in project financings, *i.e.*, the lack of a "balance sheet credit," the reliance upon the continuing performance and uptime of the assets (or services) being financed, the relative discretion of the End User in deciding upon the tenor and terms of the financing, and the reliance of various "independent" third parties (whether Services Providers, energy offtakers, feedstock providers, or others) for the viability of the underlying transaction. Such elements of relative uncertainty may deter traditional leasing and finance companies from becoming early adopters of MSTs and related forms of transaction origination. It is to be expected, however, that over time (and given the fertile imaginations of transaction originators and their attorneys) such concerns will be more fully and satisfactorily addressed; and new forms of transaction documentation will continue to be developed, will be accepted by the various parties involved, will be challenged and tested in court, and ultimately will become the standards for use throughout the industry. It is expected that many different forms and variations in documentation practice in this area will be introduced as the volume of these products grows and as both End User and funder requirements become more refined.

Chart 7: Legal Terms for Finance Entity

TRADITIONAL EQUIPMENT LEASE	MANAGED SOLUTION TRANSACTION
Hell-or-high-water clause	Enhanced indemnification provisions, extending to Service Providers or vendors
Documentation as separate financing agreements and Service Provider contracts	One master agreement with risks and obligations allocated according to each party's role in the transaction
Enforceability against a single obligor	Enforceability against two or more obligors based upon nature of default – financial or failure to render required services
Full and free assignability of right to receive fixed periodic payments, supported by hell-or-high-water rights	Assignability subject to a variety of factors unique to the transaction, including strength of indemnifications and payment obligations

Dispute Resolution. As an alternative to traditional means of enforcing lessors' and funding sources' rights under new forms of MSTs, it may be worthwhile to consider introducing into the equipment leasing and finance industry a concept that has been well developed in other industries characterized by the providing of services together with the acquisition of tangible assets. In particular, in the implementation and management of large real estate construction projects, which entail the providing of material goods along with the services of suppliers and tradespeople to customize and install them, the mechanism of dispute review boards ("DRB"s) has become prevalent. A DRB is a panel of knowledgeable experts or practitioners in the field, often including senior representatives of the various parties to a project (*i.e.*, owner, general contractor, principal subcontractors, suppliers, and sometimes independent experts), which is chartered at project inception to hear and resolve disputes concerning the project, typically those exceeding a certain level of materiality, as they arise in real time during the course of the project. This means of promptly addressing and resolving disputes as and when they occur has provided measurable savings in time, cost, and frustration over the alternative of taking adversary positions on particular issues, potentially initiating legal action, and litigating disputes while project progress stalls and costs mount.

Perhaps in the context of larger MSTs which provide full integration of services with obligations for the acquisition of equipment, when disputes arise over failures to meet minimum service level requirements, failures of Service Providers to perform strictly in accordance with contracts, or disagreements regarding which portions of payments should be allocated to equipment and which to services, there may be a role for something akin to a DRB to be available to resolve such disputes quickly and cooperatively, with the participation of senior representatives of the parties, so that payments may continue without interruption and contracts may be carried out in full without litigation and attendant costs and difficulties.

In coming years, as MSTs are expected to represent a growing proportion of volume, alternatives such as DRB-like dispute resolution must necessarily be developed and accepted.

In coming years, as MSTs are expected to represent a growing proportion of volume in the traditional equipment leasing and finance industry, alternatives such as DRB-like dispute resolution mechanisms or other non-judicial means of enforcing End User obligations without the traditional structure of HOHW language, fixed tenor and fixed payment agreements, and statutory protections afforded only to owners, lessors, and secured lenders of tangible assets, as discussed above in this Report, must necessarily be developed and accepted by originators, bundlers, and third party funding sources of MSTs.

Multiple Party Issues

Under many forms of MST, there are multiple parties involved in delivering services, providing hardware and equipment, and/or providing financing for underlying assets (or in some cases even for pre-paid services). Consequently, the matter of sorting out various rights, obligations, and expectations of the parties is one of the most important, and potentially difficult, considerations in structuring and documenting such transactions. In particular, when the payment obligation of the End User is at least in part contingent upon the satisfactory providing of services by a number of parties, each with different expectations, over some period of time, then the documents themselves must be able to render guidance regarding the defaults, rights, and remedies for all parties under many different circumstances.

One of the thorniest of scenarios in this regard arises when payments for both services and financing of equipment are bundled together into one lump sum which the customer is expected to pay periodically throughout the term of the transaction. First, it is imperative to define in as much detail as practical what the service expectations of the parties are, whether through a standalone services agreement, in a document setting forth specific service level requirements, or in a distinct section of the master agreement devoted to defining in reasonable detail the services which comprise full and satisfactory performance by the vendor or Service Provider (or by each Service Provider, if more than one is involved in the transaction). In the event of a claim by the customer that services are not satisfactory, it becomes especially important for the bundler or funder (or the funder's assignee) to be able to address the Service Provider(s) or vendor(s) with a clear understanding of what is expected under the applicable agreements. If technical failures to provide satisfactory services can be worked out amicably among the various parties, then the customer can be approached with a solution, and protracted withholding of payments or further payment delinquencies can be avoided.

By the same token, even in the event of a credit delinquency or default on the part of the End User it is important that the bundler or funder have a direct relationship with the Service Provider(s) or vendor(s) so that a determination can be made promptly regarding the basis for the End User's failure to pay. If the bundler or funder and the Service Provider(s) establish and maintain a strong working relationship in this regard, particularly if the financial obligations of the End User are set forth in reasonable detail, whether as part of a master agreement or in a separate financing document, then the enforcement of payment default remedies directly against the End User may be undertaken more quickly and efficiently without adversely impacting the Service Providers' operations and receipt of payments for current services.

Licensing and Regulatory Considerations

Given the accelerating pace of both state and federal efforts to regulate the financing industry, and with the continuing blurring of the distinction between commercial and consumer forms of financing for regulatory purposes, it will be necessary for practitioners, bundlers, and funding sources involved in MSTs to continue to monitor and assess the impact of changing regulations affecting equipment leasing, financing, and bundled solutions. For the moment, transactions which exclusively (or nearly exclusively) provide services to End Users and do not involve financing of equipment in the traditional sense are for the most part not affected by state regulations and licensing regimes which are intended to regulate the "financing" industry.

This is generally the case for true leases, as well, as it is for non-MST transactions in which lessors acquire equipment for their own account and lease it to End User lessees, End User lessees pay periodic rent for the exclusive use of lessors' equipment, and lessors and lessees are not "lenders" or "borrowers" for purposes of regulation and licensing. Of course, federally chartered banks, bank leasing companies, and bank captives considering funding MSTs must still take into account existing regulatory limitations and restrictions on personal property leases. This is particularly the case for transactions which may be found to include financing for the eventual acquisition of material underlying hardware or equipment. Whether or not a specific MST constitutes a "lease" under any specific regulatory requirement will depend upon the facts and circumstances of the transaction,[10] and counsel for originators of MSTs in various industries and applications may be expected to provide guidance in particular areas as this form of funding becomes increasingly prevalent.

To the extent that MSTs include the advance of funds by bundlers or Service Providers that must be repaid by End Users over time, even in conjunction with the providing of related services, then they risk falling within the ambit of both state and federal regulations governing loans and lending. Regulatory requirements in this area are for the most part state-specific, although efforts of the Consumer Financial Protection Bureau ("CFPB") under the auspices of the 2010 Dodd-Frank legislation and on-going related rules are increasingly broadening definitions and increasing the scope of federal regulation of both bank and non-bank financing practices, as well.

Under the MST structure generally described in this Report, it is unlikely as of now that MSTs would lead to any greater degree of regulation, or would require any greater requirement for state licensing, than would most typical equipment leasing or lending transactions of the same equipment type and dollar value. However, as bundled and integrated structures become more prevalent, and as more variations are brought to market combining the providing of services with the providing of actual equipment financing, practitioners and participating companies would be well advised continually to monitor developments in both state and regulatory arenas to be certain that what appears to be an unregulated business transaction is not transformed by the stroke of a regulator's pen into a regulated or licensed financing activity.[11] As a rule of thumb, the more a transaction appears to resemble a lease or loan transaction, the more likely it is that it will fall within the scope of some form of regulation.

As a rule, the more a transaction appears to resemble a lease or loan, the more likely it is to fall within the scope of some form of regulation.

Pricing and Structuring

Pricing is an area of increasing tension in the market today between End Users who want to utilize the newest technology tailored to their exact usage need delivered just when they need it, Service Providers' desire to preserve and grow customer relationships and finance companies' stretching to structure transactions that preserve essential elements to mitigate risk. Historically, as was reviewed in the financial impact section, End Users negotiated on a line item, per provider basis. In an MST, the Service Provider is at the epicenter of the tension working with their captive finance arm or a third party finance source to sculpt a holistic solution that makes business sense for all parties.

Captive finance companies, particularly in the technology space, are stretching the boundaries of pricing and structure in response to End User demand and competitive pressures. Technology Service Providers are focused on End User behaviors and trends across industries that are driving the increase in usage based and cloud based solutions. Financing transactions are priced either on a cost per seat or usage based model or a hybrid of both. For some captive finance companies such transaction structures comprise a relatively small but growing percent of transactions yet for others, such as predominantly software solutions, it is all or the majority of transactions. Captives often bundle the pricing such that the customer can evaluate the cost of the overall solution yet less likely to be able to negotiate on a particular line item.

MST transactions are deemed to be riskier by captive and independent finance companies alike and, as such, typically garner higher margins. The increased margin expectation reflects the greater risk a Service Provider bears while at the same time guarding against line item negotiation. Assumptions often are made in the pricing model regarding the level of cancellations or upgrades that will occur during the term which, in turn, increases the pricing of such transactions relative to fixed term contracts. It is common that an MST is priced from the bottom up, the margin assessed to each component and totaled into an overall price. If it is a cost per seat that total price is then divided among the number of seats. If it is a fully or partially usage based MST there is a minimum usage and a true up to actual usage at a rate and timing specified in the contact. Where there is a usage based component a technology solution is deployed to automate the required usage monitoring.

Captives working with their lines of business and often partners providing a part of the MST, will push to have pricing bundled so that End Users see one overall price or price per seat. Where cancellation or upgrade is allowed, it is typically specified in the terms and conditions of the contract with clear limitation on timing and percentage of upgrade allowed. As such, it is included in the original pricing model as discussed earlier and therefore, usually does not come with an incremental cost at the time of upgrade. Asset management capabilities are paramount in the captive's ability to offer upgrade flexibility. They optimize the ability to deploy equipment displaced by upgrades across their End User base thereby mitigating the financial impact of returned equipment. In the case of software based solutions heftier software profit margins provide a cushion to absorb the cost of early upgrades.

Independent and bank owned finance companies are responding to Service Provider demand for MST solutions structuring financing that, by and large, leaves upgrade and performance risk squarely with the Service Provider. These structures begin with an underwriting of the partner whether manufacturer or dealer, who will supply the service and supplies elements. For larger vendor partners these structures are much more likely to include indemnification for the lessor for service related issues, which include specific circumstances under which the Service Provider will buy out a transaction.

"MSTs really reflect a broader shift to access versus ownership. It is akin to the Netflix model; we want to watch content but no-one wants to own a bunch of DVD's."

- CEO, independent lessor

The cost per copy model common in the office imaging space is the most time tested usage based solution. It comprises 30-40% of financing for lessors partnering with copier manufacturers. Models developed for this space often reserve the right of lessors to replace the dealer who is the Service Provider in the instance of service performance issues in order to avoid any service related delinquency or losses. Cost per copy deals today include a HOHW language and specify a usage minimum that guarantees the rental payment is covered. Increasingly lessors in the space provide an automated ability to meter copiers. Payments for service and supplies are done on a pass through basis.

A critical capability consistently leveraged to sculpt and support the offering of MSTs is strong asset management capabilities. Technology providers described as essential the ability to cascade equipment displaced in upgrades or cancelations within or across their customer base. Expertise in the future value of assets is equally critical in both pricing of these transactions up front and preserving anticipated margin throughout the life of the transaction. Even in cases where the lessor is not taking the residual risk in the transaction, such as TRAC leases commonly used in vehicle or fleet transactions, remarketing capability is a key component of the value proposition. Assuring customers and, demonstrating through past performance, an ability to garner top dollar for assets thereby allowing them more flexibility in choosing when to upgrade – a clear value to the lessee.

Across the board, equipment lessors and their partners emphasize the positive customer acquisition and retention outcomes of offering MSTs. Given the often complex and highly integrated nature of

MST all note a much higher retention or "stickiness" levels for customers utilizing these types of solutions. In addition to enhanced retention offering MSTs solutions can lead to much higher conversion rates. An example noted within the energy space involves offering energy efficiency solutions structured such that payments match energy saving rates. The overall solution is offered as a service with an underlying operating lease and service agreement. Customer conversion rates for the service providers in this case during a trial period increased 40%.

Funding

The legal terms outlined in Chart 7 above are of paramount importance in understanding the funding implications of MSTs. A finance company that secures debt in order to fund customer leases and loans will need to collateralize the debt with those same contracts, and in order to so, they must include some level of HOHW payment language and ability to assign a third party.

The importance of effective language in lease or loan contracts is underscored by the manner in which a lender decides the level of bank line to be extended to a lessor and the associated pricing. It begins with an understanding of the full borrowing base which is the asset level expected to be originated and pledged to the facility. From there, through a careful diligence of asset quality and mix as well as organizational performance and rigorous reporting, an advance rate is determined. The difference between the total borrowing base and the advance rate creates the risk cushion for the lender. The potential complication of MSTs derives directly from the predictability and performance of the contracts along with the language in the leases themselves.

Given these clear lending guidelines, an MST provider offering a solution with no minimum payment or language referenced earlier to assure enforceability will struggle to find those assets included among the base on which a lender will advance funding. The office imaging industry does however, provide an example of a level of bundling and usage based product that can still be pledged to and lent against by funders. The manner used to structure such transactions is to require a minimum payment in the lease contract to which HOHW language is applied. Although there may likely be usage levels above the minimum and pass through payments for service and supplies collected on behalf of the providing copier dealers, bank lenders rest their underwriting on the minimum payment. The lessors' track record for servicing such assets and managing service related delinquency will be a key factor in determining the level at which banks will include such assets in the advance rate.

> *"In order for bankers to begin to lend against contracts with upgrade and cancelation provisions, very specific parameters around levels allowed and robust reporting around performance against such parameters will need to be developed."*
>
> *- Senior lending executive to the industry*

Newer models, such as those emerging in the energy industry, are adopting similar methods to the office imaging space. Transactions are structured as a service; they may include an operating lease and a separate services contract. The timing and amounts of the payments are modeled to match the associated energy savings and often include variability or usage based payments. Despite the selling of a service oriented MST, there is a minimum payment required and the documentation has HOHW language imbedded as well as assignability language. It is a workable solution today allowing for emerging structures to mature and yet allowing for funding based on traditional underwriting criteria. Banks providing lender finance are watching these emerging models closely. These lenders will be looking for strict parameters around such flexibility and detailed performance metrics and reporting before they will be willing to include them in the borrowing base. To the extent the level of flexibility affects asset performance it will affect the advance rate and, in turn, has the likelihood to drive up overall cost of funds.

Investment Community

There is an alarming disconnect between the business marketplace's migration toward Managed Solutions and the investment community's awareness of it. Rating agency familiarity with the Managed Solutions trend and its potential impact on Service Provider's revenue recognition, key financial growth metrics, potential equipment ownership, heightened risk profile and capital structure varied between the agencies themselves. Not surprisingly, corporate rating analysts covering information technology firms such as Cisco Systems and Dell were more acquainted with Managed Solutions and the financial impacts. One analyst was not fazed by the revenue recognition issues stating any revenue deferrals would be ameliorated or "equalized" on the cash flow statement. At the other end of the spectrum was an analyst who acknowledged an understanding of "the Managed Solutions concept but not an accounting familiarity with it." Another analyst admitted to being unfamiliar with the Managed Solutions but quickly understood the prospective impact on both the balance sheet and income statement.

Interestingly, the understanding of MSTs even varied within the agencies themselves. As mentioned, one would expect the corporate rating analysts following information technology leaders to be well versed on the topic of MSTs. However, the rating analysts following the captive finance and leasing companies of these same parent organizations had a vague understanding of MSTs, at best. The general consensus was this issue was more appropriate for their corporate rating brethren as MSTs were posited as being insignificant to a finance or leasing company, especially when it came to revenue recognition. They also believed that MSTs would not be an issue for rated independent lessors.

Rating analysts specializing in asset-backed securities, particularly leased-backed transactions, universally did not have MSTs on their radar screen as they are mostly transactionally focused. However, when discussing basic elements of MSTs, they expressed reservations about the ability to securitize due to true sale treatment, the lack of HOHW clauses and assignability.

A possible explanation for the differing levels of rating agency understanding of MSTs is low financial visibility on most Service Providers' financial statements, outside of the information technology sector.[12] As MSTs becomes a prominent product offering in other industries, services will appear as a larger component of the face of the financials thus driving greater awareness and understanding. As

"Lessors are asking how do you transform the market without cannibalizing sales and have the Street understand what you are doing without penalizing you for it?"

- CEO, captive lessor

a result, the rating agencies will become more conversant on the topic.

It is clear that the investment community is lagging behind the MST trend, although through no fault of its own. Once these transactions become more commonplace and have both measureable and material impacts on financial statements, both rating agencies and investors will become increasingly savvy about MSTs and its attendant risks. Rating agencies who put forward ratings guidance on the MST will be filling an expressed investment community need, one that might become urgent in the event of an economic event that may pressure existing MSTs and the Service Providers that carry them on their books. Meanwhile, it is up to the Service Providers themselves to educate the investment community about the deferred revenue and balance sheet impacts of offering MSTs.

Future Industry Implications

As mentioned throughout the Study, the equipment leasing and finance industry now has reached a tipping point where MSTs are becoming a major new offering due to a combination of client demand and market factors. Alta believes MSTs will be an evolutionary change for the industry overall and perhaps more revolutionary for several industry participants.

While it is difficult to accurately predict all such trends, the forward implications for the equipment leasing and finance industry over the next five years include:

- MSTs on track to reach 22% or more of the total equipment leasing and finance industry volumes.
- Information technology, healthcare, trucking, office technology and construction are forecasted to be the areas of strongest growth in terms of originations.
- Significant equipment churn, prompted by the End User's desire to upgrade and swap equipment throughout the term of the MST, demands heightened asset management diligence around mid-term solution experience.
- Incremental headcount in all of the disciplines necessary to structure and manage an MST portfolio: credit, asset management, treasury, legal, accounting and systems.
- Lease management system upgrades to handle the complexities posed by MSTs since manual work arounds will be too burdensome, especially as it relates to reporting and compliance challenges.
- Substantial outbound education efforts with regulators, lenders and rating agencies concerning MSTs and attendant risks and rewards.

Case Study

The following case study dimensions how an MST works, the roles of each party and various structures that can be used by the Service Providers.

THE PROBLEM STATEMENT

A U.S. Clothing Retail Company, headquartered in New York has 130 store locations across 20 different states from coast to coast. The company struggles to manage its inventory efficiently and ensure the right quantity of the various clothing lines are in stock, available on demand, when and where they are needed. The current process used by the company consolidates inventory needs on a weekly basis. Although this process ensures a high level of accuracy, the time between when a need is recognized, an order is fulfilled and arrives at a location can take up to two weeks. The stores complain to the home office that they are losing sales regularly by not having the right inventory in store or not having the ability to guaranty delivery of an item within hours.

In order to ensure the best possible customer experience is aligned with the company's need for operational efficiency, it must find a way to transmit data between the stores, the home office and clothing manufacturers on a real time basis. The data must be transmitted fast and securely. To complicate matters, the company routinely opens, moves and closes store locations. Other attributes of the company include a very limited IT department, strong financials and a limited capital budget.

After discussions with a trusted consultant, the company determines it will make an investment in the technology needed to address the latency issue being experienced with the current systems and process. The key objectives are summarized as follows:

- Real time, fast and secure data transmission.
- Operational efficiency while maintaining effective controls.
- Ease of use (no additional IT resources are available).
- Monthly billings to be paid from the operating expense budget.
- Flexibility to routinely add/subtract/move store locations.

With the objectives clearly identified, the company solicits bids for a Wide Area Network Solution capable of transmitting voice, video and data amongst all its store locations, to the home office and outside clothing vendors. The solution is to be proposed as a turn-key service that will include all equipment, maintenance, network access, network monitoring and security. The requirements outlined for potential respondents to the bid are developed to address the key objectives identified by the company and are identified as market standard. The core bid requirements are:

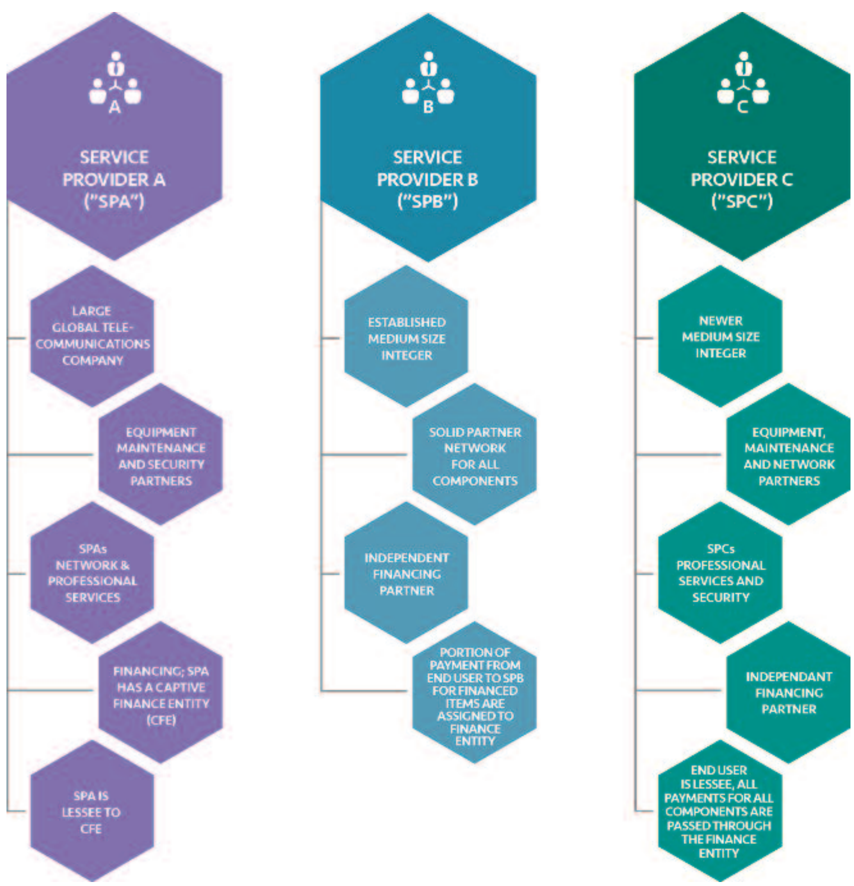
- To address the technology and statistical useful life trends; a contract term of three years where software and equipment upgrades will be included during the term at no charge.

- To address performance, financial and operational predictability;
  - A base line / minimum monthly payment commitment is acceptable, but the company must be able to add and delete access locations for a pre-determined monthly payment adjustment as needed.
  - The contract end-date is fixed, regardless of when any particular device or site is added or deleted. The customer does not expect nor want to have any ownership of assets, nor the right to obtain ownership (no purchase option).
  - At the end of the contract term, the company must have the right to renew the contract for a negotiated term or terminate the contract, in which case all equipment will be returned to the Service Provider.
- To ensure network location flexibility, there will be no cancellation penalties or early termination fees. Cancellation for convenience must be permitted.

THE BID RESPONSE

Three Service Providers responded to the RFP from the End User. The profile of the respondents is in Figure 9 below.

Figure 9: Three Service Provider Responses



Service Provider A ("SPA") is a global telecommunications company with an extensive global network. They have a strong infrastructure, a solid network of strategic partners, vast experience and the financial wherewithal to provide a credible response to this bid. Their impressive capabilities definitely come at a cost.

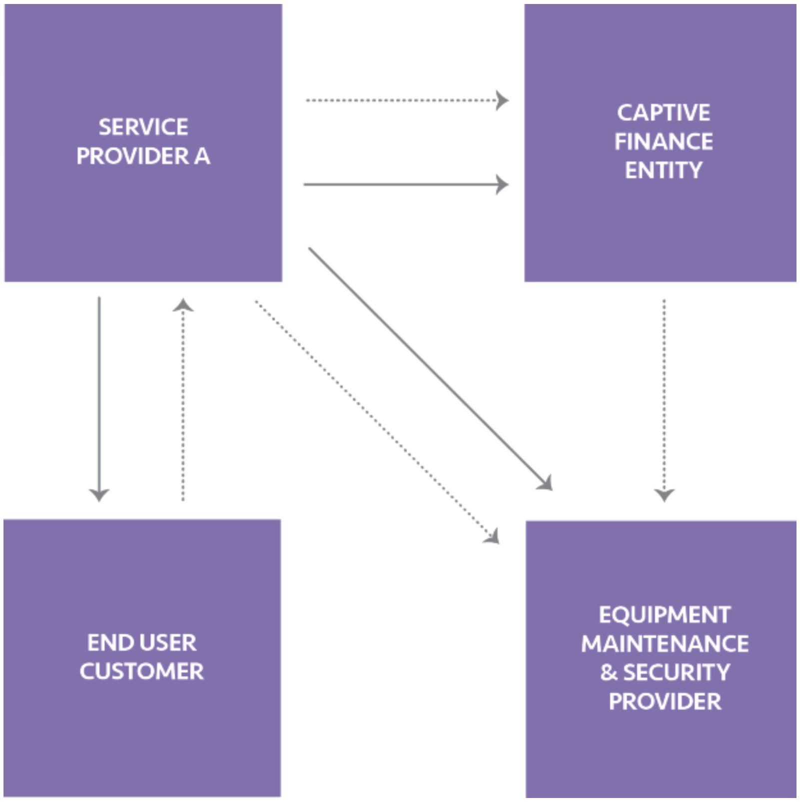
Service Provider B ("SPB") is a well-established technology integrator. Their expertise centers on their ability to pull together the right combination of strategic partners to deliver a comprehensive solution. Their financials are solid, but they are not a particularly large company.

Service Provider C ("SPC") has made an impact in the technology space in a fairly short period of time. They have exceptional ingenuity and accomplish impressive results for their customer's not achievable by their competition. Leveraging their own designs, they partner with various vendors to deliver solutions on a shoe string budget.

Each Service Provider's individual situation will directly dictate how they are able to structure their response.

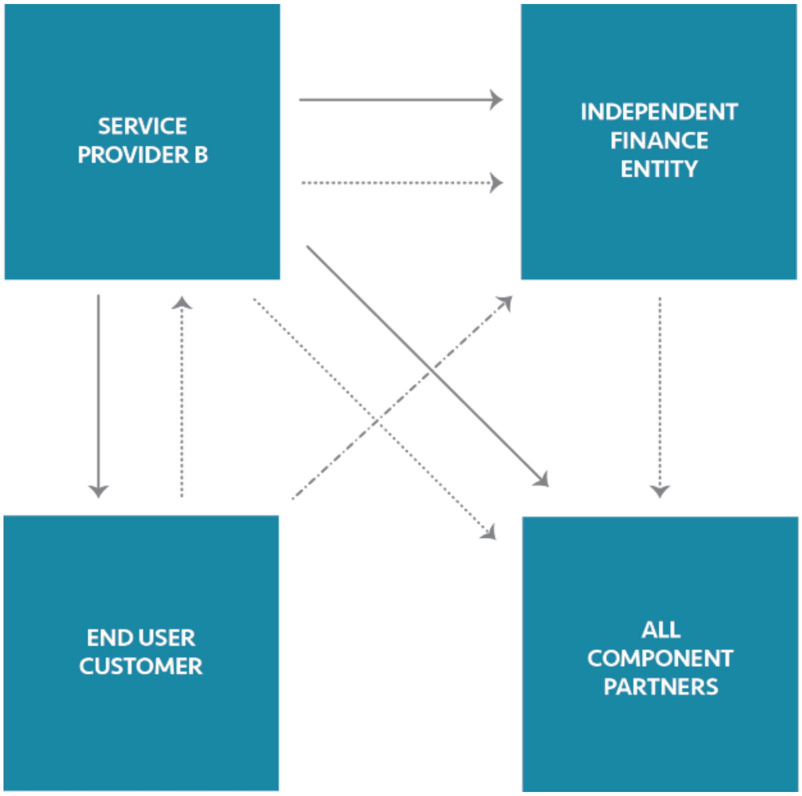
Proposed structure for each respondent

Figure 10: Proposed Structure – Service Provider A



SPA, the global telecommunications provider, is interested in this transaction so that it can retain the End User within its customer footprint. It provides a structure that meets all the End User's objectives by offering a single solution under a service agreement contract. SPA will enter into a financing arrangement as lessee for all up-front, one time charges so it can convert these charges into a monthly payment for End User. SPA will take on this financial obligation without passing on like terms to the End User meaning it will accept the credit and performance risk inherent in the solution. The billing will be consolidated combining the financing payment with the network and security monthly charges. Due to the significant gap between the obligations committed to by SPA, and the obligations being signed up for in the End User contract, the cost of the solution will come at a premium price.

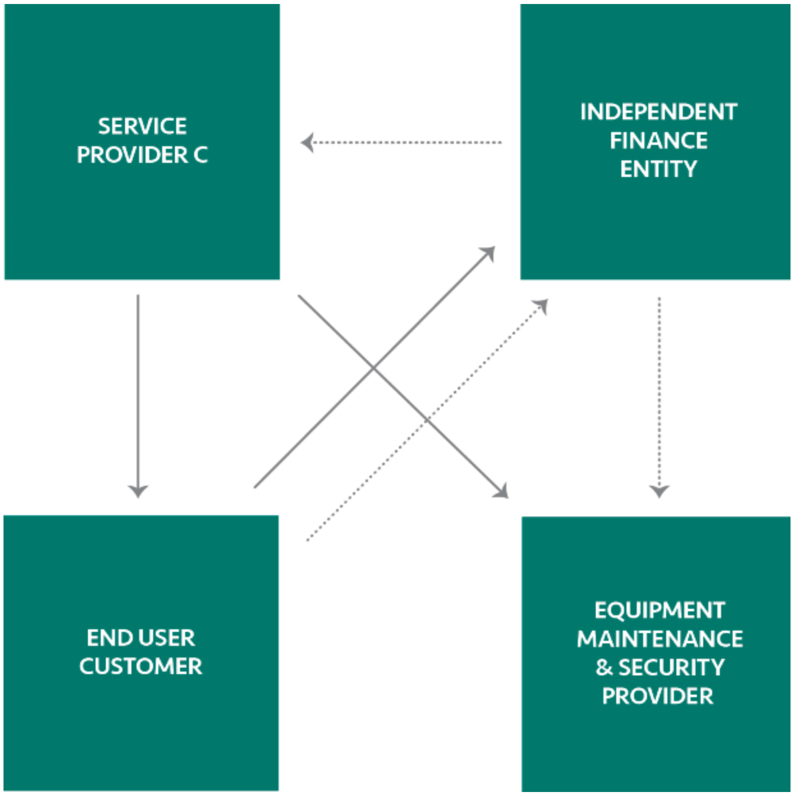
Figure 11: Proposed Structure – Service Provider B



SPB has concluded that its skill set is a perfect match for this opportunity. Although it will be necessary for it to take several exceptions to the End User's requirements SPB still is confident it can put forth a compelling offer at a competitive price. The SPB proposal will offer a single solution under a Service Agreement that will include imbedded financing terms. The structure of this agreement will allow SPB to recover its up-front costs, a critical requirement for a company of its size. It will assign, non-recourse, the portion of the payment stream related to the financeable items to an independent Finance Entity, thereby leaving an acceptable exposure/risk profile (performance only). To minimize the administration impact to the End User, SPB will bill and collect the monthly payments and remit monthly to the Finance Entity.

SPC, as a newer entrant into the Service Provider and integrator space, is excited to showcase its capabilities for this large opportunity. SPC's financial profile is such that it is not able to absorb the responsibilities associated with payments to the strategic partners or to facilitate the combined billing to the End User. The End User will sign two contracts – a Service Agreement with SPC and a financing contract with an independent lessor. All payments from the End User will flow through to the Finance Entity, which will distribute the monthly payments to SPC and the strategic partners, accordingly. SPC will seek a sophisticated Finance Entity

Figure 12: Proposed Structure – Service Provider C



with the administrative capability to manage the cash flow requirements. Although the solution does not offer the customer all the flexibility it had outlined in the bid, the offset is a superior technological solution and a price well below any competition.

Risk Assessment

The Service Provider and the Finance Entity both have to evaluate the risk profile associated with their offers. For the Finance Entity, understanding the role the Service Provider plays will determine how far it will need to dig into the particulars of the transaction. Whether the Service Provider is the lessee or the End User is the Lessee, directly or indirectly, will dictate the evaluation as it relates to credit (Service Provider and End User), essentiality of the solution, equipment to soft cost mix, equipment ownership responsibilities, documentation, pricing and overall structure.

Chart 8: Risk Assessment Responsibilities in the Three Proposed Structures

WHO OWNS RESPONSIBILITY FOR:	SPA	SPB	SPC
End User Credit	Service Provider	Shared (SP and FE)	Finance Entity
Financing Contract	Service Provider	Shared (SP and EU)	End User
Equipment Ownership/Tracking	Service Provider	Shared (SP and EU)	End User
Payment to Partners	Shared (SP and FE)	Shared (SP and FE)	Finance Entity
Administration, Billing/Collecting	Service Provider	Service Provider	Finance Entity

Chart 9: RFP Response Evaluation Form

	SPA		SPB		SPC	
TECHNOLOGICAL ASPECTS	YES	NO	YES	NO	YES	NO
Fast, Secure and Reliable?	X		X		X	
Contract Term of 3 Years?	X		X		X	
Free Equipment & Software Upgrades	X			X		X
FINANCIAL ASPECTS	YES	NO	YES	NO	YES	NO
Baseline Monthly Payment?	X		X		X	
Pre-determine Add/Delete?	X			X		X
Single Service Agreement?	X		X			X
Fixed Contract End Date?	X		X		X	
Renewal Option?	X		X		X	
Return Option?	X		X		X	
Purchase Option?		X	X		X	
Monthly Payment?	X		X		X	
Termination Fees?		X	X		X	

PRICE POINT HIGHEST X MIDDLE X LOWEST X

After consulting with its accountant, the End User acknowledges that SPA's solution will result in operating expense treatment because it is both structured and documented as a true service agreement with no financing terms or HOHW commitments. On the other hand, the financing terms for the SPB and SPC solutions are explicit; SPB's financing terms are imbedded in the service agreement and SPC's financing terms are contained in a separate agreement. Therefore, operating expense treatment for these two solutions will depend on specific terms embedded in the agreement as well as whether the financial arrangement receives operating or capital treatment. Specifics on this evaluation can be found in the Accounting section of this report for the End User and as summarized in Chart 4.

SUMMARY

The chart above helps the End User assess the responses and how they align with its original objectives and requirements. SPA would appear to be the obvious winner – it met all the objectives and this solution clearly represents the highest flexibility and, therefore, the lowest financial risk to the company. The offset of realizing all these criteria is a significant premium in price, so close evaluation of the other two offers is warranted. They each offer a better price point so the End User must decide if the gives are a worthy exchange for the lower price.

The SPB contract reduces flexibility and termination fees could quickly erode the lower price point. In addition, the End User will incur impacts to its financials and administrative duties by having contractual responsibility to the Financing Entity. This final offer clearly puts the most burden on the company. A full assessment of the quantitative impacts of each response will be conducted, but on initial pass SPA appears to be the safest choice.

Interview Questionnaire

GENERAL QUESTIONS

a) Does your organization currently offer managed solutions to its customers?

b) If not, are you considering doing so? Why?

c) If yes, is this a demand-pull from your customers?

d) What is the primary reason for the demand pull?

e) How much of these are you doing (# transactions, $ volume/year, % of total business, etc.)?

f) What market segments are requesting these options?

g) How is your organization preparing for this new product offering?

h) Are you creating cross-disciplinary teams? Who / which key disciplines are leading the team? Who are the team members?

i) What types of returns (ROE) do you think are acceptable for this type of structure?

j) Bank/Independent vendor programs: Who will be the primary interface to the customer?

k) Bank/Independent vendor programs: Will different skill sets be required to address monthly usage discussions?

l) Compensation: How will managed solutions be compensated vs. separate HW or services sales?

m) Are your existing systems adequate to support a Managed Solutions offering? If not, do you intend to invest in new systems capabilities or use a third-party?

CREDIT AND RISK MANAGEMENT

1. Viability of the Managed Solutions Product

a) From a global perspective, do you think the product is viable in your organization as a meaningful alternative method of financing for your customers and their needs? Do you see your organization competing in this marketspace?

b) Whether your organization decides to compete or not, what limits (if any) do you perceive in addressing these types of transactions?

c) Are there particular verticals in your organization where this is a better fit? Are there others where you believe it won't work? Please be specific in listing the verticals and your reasoning.

d) Do you think this product is viable for all leasing company types - i.e. can the bank, captive and independent lessors all compete? Are the risks more challenging for some vs. others?

e) Is this product a part of your business strategy going forward? If yes, how important is it?

2. Risk weighting of the various components involved

a) Do you perceive a shift in the risk weighting of the various participants/components involved? If so:

   i. Is the credit of the end user any more or less important in these situations?

ii. Does the Vendor / OEM role change and, if so, does that increase or decrease the risk, especially performance risk?

iii. If Vendor/OEM risk has increased, how do you mitigate this risk?

iv. If you do not believe the Vendor/OEM risk has increased, especially performance risk, why not?

v. If the vendor is working with subcontractors, in what ways, if any, does that change the risk assessment associated with the vendor - e.g. indemnification, etc.?

vi. Does the reliance placed on the underlying assets change? Is the asset composition any more or less important?

vii. How important is the overall essentiality of the managed solution to the decision process? Please be specific.

3. Unique characteristics of the product structure

a) Based on the unique aspects of the structure – payment flexibility, cancellation opportunities lack of firm term, etc. – do you see a need to consider different/additional risk mitigants for this particular product? Please provide some examples or specifics.

b) There has been some discussion about the fact that the hell-and-high-water clause may not be enforceable in this type of financing. Do you see alternatives/substitutes that could get you comfortable without this clause?

i. No, without the hell-and-high water clause, we cannot get comfortable.

ii. Yes, there are options available that could get us comfortable.

iii. While the hell-and-high water clause is extremely important, we would be willing to explore other options in lieu of.

vi. Some other response?

c) Beyond end-user credit, are you factoring in performance risk related to the OEM or provider of services? If yes, how do you mitigate this risk? If no, why not?

4. Organizational Dynamics

a) Have there been any discussions in your organization, including the parent company if applicable, about this product?

i. No, we have not had any discussions within the organization.

ii. Yes, we have had discussions within the business unit but not beyond that. (If so, please comment regarding the feedback, including issues that have been raised.)

iii. Yes, we have had discussions both within the business unit and the parent level. (If so, please comment regarding the respective feedback, including issues that have been raised.)

b) Has your organization engaged outside resources (consultants, legal, etc.) to help research and better understand Managed solutions? If so, what kind of advisor? Who and how helpful were they?

c) If your organization is in a regulated environment, have you had any discussions with the regulatory bodies to get their "read"?

   i. No, we had not had discussions with the regulators and don't plan to do so.

   ii. Yes, we have had discussions. (If so, please comment regarding the feedback.)

   iii. We have not yet had discussions but plan to do so in the future. (If so, please comment regarding the timing.)

d) Understanding that this type of financing breaks new ground on the risk side, do you plan to provide additional training for your risk personnel to handle the adjudication process?

   i. No, we feel that our risk personnel are adequately trained and can handle the different dynamics of this product

   ii. Yes, we plan to provide additional training for our risk personnel. (If so, please explain.)

e) If your organization is an OEM, do you anticipate specific credit training needs with this product which might entail moving from 30/60/90 day sales terms to 3, 4, 5 year service contract terms with added hardware? Answer YES or NO.

f) If yes, please explain how you plan to provide additional training for various personnel in your organization.

5. Current experience with Managed Solutions Financing

a) If you have had experience with the product, please provide any insights and/or comments that you think might be helpful in better understanding the nuances of this nascent product for the benefit of all ELFA member companies.

PRICING, MARGIN AND USAGE BASED COMPONENTS

1. Components of a Solution

a) What are the typical components of a solution?

   i. What is the breakdown of hardware, software and services, (both one time and ongoing)

   ii. How is each element priced?

   iii. Are all elements provided through your company or with partners?

b) What if any elements are financed? What lease / loan structure and terms are used? Is total margin assessed on the entire transaction as a whole or in component parts?

c) Are there any elements of the solution subject to internal transfer pricing and if so how is that accounted for?

d) How are sales incentive compensation structured for the product and how does it vary from more "standard' transactions?

e) How exactly is the pricing stated to the customer in the proposal or contract? How is it reflected in periodic billing?

f) Who is the primary interface to the customer? Have they received additional training for selling managed solutions?

g) If elements are provide through partners how is the billing and remittance handled?

h) Do you have a capability to manage the residual value? If not, how is that factored into pricing? (For example, without RV capability, idle or returned assets can't mitigate the risk.)

2. Upgrades / Usage based Elements

a) Is there a firm term associated with the customer contract? Is there any ability to upgrade or trade out any elements of the solution within the contracted period? If so are there any upgrade or early termination charges? Is there an ability to roll any required unpaid balances into the upgraded solution?

b) Do you have an asset management function that handles residual value setting and equipment remarketing? How is it anticipated that returns associated with upgrades are or will be handled?

c) Are there any utilization based elements to the solution? How are these priced? Are there minimums / maximums or tiered commitments?

d) How are utilization-based elements monitored – how is it automated and verified?

3. Overall Product Offering

a) In what ways are the current structures limiting ability to offer solutions with the flexibility customers are requesting or new solutions you wish to offer?

b) Describe the "perfect" solution structure.

<u>ACCOUNTING</u>

1. Revenue Recognition

a) What will be the impact of the new revenue recognition standard be on how your company accounts for its Managed Solutions?

b) What is the process for allocating transaction-level discounts across the specific elements of the Managed Solution?

c) What steps has the company taken to address the impact of its funding activities on profit recognition and the balance sheet?

2. Operational

a) In addition to multiple elements in a managed solution, other operational factors include such things as payment variability, pay-for-use, payment waterfalls, and multiparty involvement. What constraints does your LMS place on your ability to properly track and account for the numerous aspects of a managed solution transaction?

b) What constraints does your LMS place on your ability to properly track and account for midterm changes, asset swaps, and/or modifications to a customer's managed solution?

c) Do you maintain an accounting policy to determine when a transaction contains a lease? If so, what are the key elements in making that determination?

d) For captives: Please differentiate between the benefits of using 3rd party funders under sale/leaseback options vs. funding internally. (For example....sale/leaseback could create a lease liability vs. internal funding where it doesn't.)

e) For captives: Are there other benefits/risks of doing either that will drive different behavior vs. relying on a 3rd party program?

3. Customer-Focused

a) How will the lease capitalization requirements under the new lease accounting rules impact the company's go-to-market efforts for Managed Solutions?

b) How do you respond to lessee requests to segregate the cost of each element of the Managed Solution?

c) Do you have a policy as to how the company responds to such cost segregation requests?

4. Tax

a) Are there any unique tax requirements that need to be considered?

<u>LEGAL AND REGULATORY</u>

1. Transaction documentation in general.

a) Will traditional leasing and loan documents, with a few necessary modifications, be adequate for documenting the kind of MST structure described above.

   i. Yes, most of the traditional provisions will still apply and can be adapted to these kinds of transactions.

   ii. No, these transactions are completely different in scope and structure and will require entirely new documentation.

   iii. Some other response?

b) Should a form of "participation agreement" or "master agreement" be used to allocate the obligations and rights of all of the various parties to an MST transaction (i.e., the customer, the funder, the vendor(s), the parent companies, if applicable)?

   i. Yes, because this is the only document to which they are all parties.

   ii. Yes, because it is similar in purpose to an intercreditor agreement, which defines the rights and obligations among potentially "competing" parties.

   iii. No, because that just makes the transaction more complicated.

   iv. No, because the interests of the parties are too divergent from one another.

   v. Some other answer. (Please explain.)

2. Assignments and indemnification issues.

a) Can the customer's obligation to pay for bundled hardware and services be assigned to a third-party funding source?

   i. Yes, the entire payment obligation can be discounted and assigned pretty much as lessors are used to doing now.

   ii. No, the entire bundled payment obligation cannot be assigned under any circumstances.

   iii. The "equipment" part of the payment obligation can be assigned but not the "services" portion.

   iv. Some other answer? Please explain.

b) If the payment obligations of the customer can be assigned, can the assignment be made without recourse to the original funder?

   i. Yes, because the funder can "pass through" the obligation of the vendor(s) to perform in accordance with the services agreement.

   ii. No, because the assignee will expect its assignor (the original funder) to be responsible for at least some of the obligations underlying its purchase of the future payment stream.

   iii. Only in certain circumstances. Please explain.

c) If the customer's payment obligations can be assigned to a funding source, are there waivers of defenses that may be required to make the transaction readily assignable?

   i. Probably so.

   ii. Probably not.

   iii. Maybe. Please explain.

   iv. If the customer's payment obligations can be assigned to a funding source, what indemnifications, guarantees, or undertakings, if any, of the vendor(s) and/or the customer are or should be required in the original documents?

3. Defaults and remedies provisions.

a) Should a managed services agreement between the customer and the funder include provisions defining payment defaults?

   i. Yes, as traditionally used in equipment leases.

   ii. Yes, but they are different from traditional default provisions. (Please explain.)

   iii. No, because there is no defined hell-or-high-water payment obligation.

   vi. Some other response? Please explain.

b) Should a Managed Solutions agreement between the customer and the funder include traditional provisions such as grace periods and late fees?

   i. Yes, because the payments are still fixed obligations of the customer.

ii. Yes, but the provisions must be different in scope and application from rental payments. Please explain.

iii. No, because the services provisions cannot be structured in the same way as lease rental Please elaborate.

c) How should default provisions in a Managed Solutions agreement treat such matters as minimum service levels (on the part of the vendor(s)) and failure of the vendor(s) to perform as required?

d) In a Managed Solutions agreement under which only a small portion of the funder's total advance pays for equipment or hard assets as opposed to services, will traditional remedies (e.g., foreclosure of a lien, acceleration of payments, repossession of equipment) be applicable? If so, how can they be enforced? Must there be additional collateral security for the "services" portion of the advance?

e) In a managed services agreement under which only a small portion of the funder's total advance pays for equipment or hard assets as opposed to services, must there be different types of defaults, cure periods, and remedies for service level defaults or failures to perform services than there are for simple payment defaults by the customer?

i. Yes, because they are different types of defaults under different documents.

ii. No, because the obligation of the customer is a fixed payment for aggregated equipment and services.

iii. Something else. (Please explain.)

4. Security interests / UCC implications.

a) Does the MST structure described above qualify as a sale of goods for purposes of UCC Article 2? Does it qualify as a secured financing under Article 9?

b) Does the UCC apply to such a transaction at all?

c) If the UCC does not apply, is there anything to be gained by recording a financing statement (UCC-1)?

d) Should the documentation of a transaction such as the MST structure described above include a security agreement? If so, how would the security interest being granted by the customer be defined or characterized?

5. Hell-or-high-water provisions.

a) Assuming the MST structure described above, is a traditional hell-or-high-water provision workable for establishing a firm, irrevocable obligation on the part of the obligor to pay a fixed periodic amount over a fixed number of payment periods? If not, why not?

b) Assuming the MST structure described above, hell-or-high-water documentation provisions are:

i. Both workable and appropriate.

ii. Neither workable nor appropriate.

iii. Appropriate but not workable.

iv. Workable but not appropriate.

c) Assuming the MST structure described above, and assuming further that the original funder wishes to assign or back leverage such a transaction, either individually or as part of a larger portfolio of similar transactions, can such an assignment or "third party funding" be achieved without a specific hell-or-high-water provision?

i. No, not under any circumstances because it is not an unconditional promise to pay.

ii. Yes, under any circumstances because it is the same as an unconditional promise to pay.

iii. Possibly, but only under certain circumstances. (Please explain).

d) In the context of a transaction in which a large majority of funding is used to purchase or provide services (as opposed to hardware or equipment), what would a typical lease hell-or-high-water provision really mean (i.e., what obligations would it actually impose upon the customer)?

6. Licensing implications.

a) Are "lender" or "finance company" licenses required for originating or funding the kind of MST structure described above?

i. No, because these are primarily service agreements.

ii. Yes, because they still include the fundamentals of "lending" to the customer.

iii. Depends on the state where the transaction is originated and/or funded.

b) Are specific licenses required for a company to assign or "back leverage" a transaction using the kind of MST structure described above?

i. No, because they are originated by someone else.

ii. No, because they are primarily service agreements.

iii. Yes, because the back leverage is still a "loan" originated by the funder.

iv. Depends on the state where the transaction is originated and/or funded.

v. Some other response. Please explain.

c) If a "lender" license is required, can (or must) the "loan" of funds somehow be separated from the services part of the agreement?

i. Yes, because the loan is still the controlling element of the deal.

ii. No, because the transaction is essentially a services agreement with a small amount of financing attached to it.

iii. Some other response. Please explain.

7. Other regulatory issues.

a) Do managed solutions agreements invoke/implicate other statutory provisions (e.g., FDCPA, Dodd-Frank, ECOA, etc.)?

i. No, because they are commercial transactions.

ii. No, because they are not “loans” but rather essentially services agreements.

iii. Yes, because the customer may still be considered a consumer for regulatory purposes.

iv. Yes, because the services element dictates a higher degree of regulatory scrutiny.

v. Other response. Please explain.

b) Will MST structures of the kind described above have an effect on the already diminishing distinctions between consumer and commercial financing?

i. They will probably slow down the process of blurring the line between consumer and commerci financing because they are clearly commercial transactions.

ii. They will probably speed up the process of blurring the line between consumer and commercial financing because the services element will be construed more as a consumer transaction.

iii. They will probably have no effect one way or the other.

c) Under current regulations, will banks or bank-affiliated leasing companies be eligible to participate in MST structures of the kind described above?

i. Probably so.

ii. Probably not.

iii. It depends. Please explain.

INVESTMENT COMMUNITY

a) What is your level of familiarity with Managed Solutions (aka bundled services)?

b) What is the general awareness of this trend in the debt and equity communities?

c) How do you view the risk associated with Managed Solutions?

d) What are the capital implications of these transactions?

e) How do you think about pricing Managed Solutions? What are your thoughts with respect to return thresholds?

f) Are these transactions financeable?

g) Are these transactions securitizable?

h) Are the current set of rating agency criteria sufficient to address this form of financing? Does this raise any red flags in terms of risk? Quality of earnings?

Acknowledgements

The Alta researchers would like to thank the Equipment Leasing & Finance Foundation Steering Committee members Andrew Blacklock, Diane Croessmann, Timothy Hricko, Brian Madison, Bob Neagle, Kelli Nienaber, Ralph Petta, Kelly Reale and Nick Small and for their guidance and valuable suggestions.

In addition, the researchers are grateful to the following individuals whose keen insights into Managed Solutions elevated the depth of this report: Andrew K. Alper, Jim Ambrose, Deborah Brady, Paul Christensen, Jason Clayton, Diane Croessmann, Linda D'Amico, Katie Emmel, John Falcone, Jeff Goedken, Mark Hamroff, Eric Hanson, Stan Herkelmann, Michael Infante, Gene H. Karger, Kristie Kosobuski, Sanjay Kumar, Pierre LaFarge, Dominic Liberatore, Fran Maier, Julie Martinez, Dave Mirsky, David Peterson, Andrea Petro, Ian Robertson, Martin B. Robins, John Rees, Marjan Riggi, Kristine A. Snow, William Stephenson, Wayne Super, Mike Sweeney, Mike Tobak, Richa Tripathi, Ken Turner, Joel Van Vark, Adam Warner, Kristi Webb, Ken Weinstein, Chris Whalen, Stephen T. Whelan and the handful of individuals who wished to remain anonymous.

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About The Alta Group

The Alta Group is the leader in global consulting and corporate advisory services to the equipment leasing and asset finance industry.

Alta is dedicated exclusively to the business of equipment leasing and asset finance. Since 1992, Alta has represented equipment leasing and finance companies, financial institutions, manufacturers and Service Providers, offering management consulting and expertise in global market entry, vendor and captive finance, professional development, legal services, asset management, mergers and acquisitions, and digital business advisory. Alta has advised over 100 equipment leasing and asset finance firms.

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Alta's equipment finance knowledge is derived from true hands-on experience as market leaders, industry participants, leasing executives and senior managers; and in successful companies and transactions. Alta is distinctively a principals-only consulting practice which means all of its client work is hands-on and conducted exclusively by a team of seasoned senior level equipment finance industry veterans.

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Endnotes

[1]MarketsandMarkets.com "Managed Services Market by Managed Data Center, Managed Network, Managed Information, Managed Mobility, Managed Infrastructure, Managed Communications, Managed Security – Global Forecast to 2019," January 2015.

[2]Ibid.

[3]MarketsandMarkets' Global Forecast is segmented by type of:

- Services: Managed Data Center, Managed Network, Managed Mobility, Managed Infrastructure, Managed Communications, Managed Information, Managed Security and other managed services;
- Business Size: Small Office Home Offices, Small and Medium Businesses and Large Enterprises;
- Industry Vertical: Public Sector and Government, Banking, Financial Services and Insurance (BFSI), Education, Retail, Contact Centers and Service industries, High Tech and Telecommunications, Healthcare and Pharmaceuticals, Travel and Logistics, Manufacturing, Energy and Utilities and others; and,
- Region: North America, Asia-Pacific, Europe, Latin America, Middle East and Africa.

[4]ResearchandMarkets.com "Global Smart Grid Managed Services Market 2015-2019," January 2015.

[5] Harvard Business Review, *Cloud Computing Comes of Age*, 2015.

[6]Agfunder News, *Aspada Invests $3.3M in Indian Farming-as-a-Service (FAAS) Provider EM3 AgriServices*, June 3, 2015.

[7] Ibid.

[8] Application of the revenue recognition standard will determine whether the revenue from each element is to be recognized up front or over the term of the arrangement.

[9] It should be noted, of course, that HOHW provisions apply only to the payment of amounts due either to a lessor for the payment of on-going rent, to a lessor or lender for the repayment of amounts advanced at transaction inception, or to a Service Provider for the payment of services rendered satisfactorily from time to time. They do not apply to a customer's obligation to pay for services to be rendered in the future. That is, they are not applicable or useful in the enforcement, for example, of remedies involving acceleration of future bundled payments which may include a component of compensation for services which have not yet been performed.

[10]Reference is made specifically to national bank statutes codified at 12 U.S.C. 24, federal regulations set forth at 12 CFR §23, and related regulations and O.C.C. guidelines. Restrictions regarding aggregate investment in leases, assumption of residual risk, and structuring of full-payout leases may all potentially apply in the origination or acquisition of MSTs by federally chartered banks.

[11] It is noted that ELFA maintains on its Website a great deal of current information and news regarding regulatory activities and updates, both nationally and state-by-state.

[12] Several information technology firms such as Cisco Systems and HP provide revenue and deferred revenue information from its Services business in its earnings and Securities and Exchange Commission filings. In fact, Cisco discloses that one risk to its gross margin is tied to its XaaS offering while HP reports that its software business is challenged given the shift to SaaS.

Notes

EQUIPMENT LEASING & FINANCE
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