

U.S. Equipment Finance Market Study

2012-2013





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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We extend our gratitude to the volunteer Steering Committee who guided this research project and provided critical feedback throughout the drafting process.

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Preface

Purpose of this study

In 2007, The Equipment Leasing & Finance Foundation (The Foundation) commissioned Global Insight (IHS) to conduct comprehensive research on the size and expected growth of the U.S. equipment finance market. In 2012, The Foundation commissioned IHS to conduct a new study, analyze changes, and forecast future growth. By cross-referencing various public and proprietary databases, the new study provides an in-depth review and analysis of equipment financing volume at the national and state level.

While this study utilizes data from a number of sources, a key input came from a custom survey of businesses that purchased equipment in 2011. The Foundation borrower survey was conducted in August/September of 2012 by IHS on behalf of The Foundation. In the course of the survey, respondents were asked to convey key current and historic data concerning their firm's industry classification, revenue, size, value of equipment purchases, and financing tendencies by equipment type. The respondents also shared their opinions on the key drivers of the equipment investment and made forward-looking statements regarding their intent to increase investment. Because much of the data provided by survey participants contained sensitive company-specific information, the results have been aggregated in this report to ensure confidentiality.



This report offers an independent assessment of the equipment financing market. Although The Foundation served as a resource and reviewer of findings, IHS is exclusively responsible for this report and all of the analysis and content contained

herein. The analysis and metrics developed during the course of this research represent the independent views of IHS and are intended to provide a comprehensive look at the current state of the equipment finance market and how the environment may change in the future. Because it is impossible to address all interpretations of these outcomes, IHS encourages the reader to form their own assessment of the report conclusions as they pertain to their particular business activity.

Additional information on this survey can be found in the Appendix.

Primary & Secondary Data Sources

The following data sources were referenced during the course of the study:

Federal Reserve Senior Loan Officer Opinion Survey on Bank Lending Practices

Federal Reserve Flow of Funds

2012 Monitor 100

The Equipment Leasing and Finance Association (ELFA) *2012 Survey of Equipment Finance Activity*

Foundation surveys

IHS Equipment Market Monitor

Market Segmentation

For the purposes of this study, equipment financing refers to retail or end-user financing of equipment and software. The financing market estimates reflect lending to businesses and government agencies. This allows for a clearer comparison to the Department of Commerce statistics on U.S. equipment investment.

Equipment finance volume estimates in this study are primarily derived from a survey of businesses that acquired equipment in 2011. IHS also incorporated lender-based surveys by the Federal Reserve and others to capture industry trends. The propensity to finance is determined by tracking equipment purchases that firms self-report as being financed by leases (operating, capital, and other), secured loans, lines of credit, cash or credit card (paid in full each month), and other.



Executive Summary

The equipment finance market has emerged from the Great Recession with renewed vitality. Finance volumes are at all-time highs, the return on assets is at a five-year high, and the charge-off rate is at a five-year low. Banks have taken a more prominent role in the market, but there are still many viable market segments where captives and independents have excelled. During the climb back to previous peak finance volumes, the equipment finance industry has reaped the benefit of double-digit growth in equipment investment and a favorable interest rate environment. The weight of evidence from this study suggests that the equipment finance industry will find the next 12 to 18 months to be more challenging overall. Businesses faced with rising uncertainty over the economy and regulatory policies will be more cautious about spending on equipment and software, as well as taking on more credit. The silver lining to this cloud is that technological innovation and equipment replacement needs should spur rapid growth in volume in late 2014 and beyond. A summary of the key study findings follows.

- In 2012, equipment finance volume has returned to pre-recession levels and the 2012 estimate for the equipment finance market is \$725 billion. The current IHS macroeconomic outlook and the 2012 Foundation borrower survey suggest the equipment finance market will expand over the next two years; however, the growth rate will slow.
- The equipment finance sector is a significant contributor to capital formation in the U.S. economy. Of the projected \$1.3 trillion to be invested in plant, equipment, and software in 2013, 55% (\$742 billion) of that investment is expected to be financed through loans, leases, and lines of credit. In 2014, the market size is projected to grow by \$36 billion to \$778 billion.
- According to the 2012 survey, 72% of firms used at least one form of financing (excluding credit card use). Companies with less than \$1 million in revenues used financing in only 49% of their equipment acquisitions, while companies with revenues between \$25 million and \$100 million used financing in 86% of their acquisitions.
- Bank financing dominated the market, according to the 2012 Foundation borrower survey, and increased its share of the market relative to the 2007 borrower survey. This increase in share reflects banks' low cost of funds, which provides organic growth, as well as the challenges many

independent finance companies faced during the downturn. Banks were the primary lenders across all equipment types in 2011, with the smallest penetration in trucks and trailers. Medical equipment financing shows a significant shift from manufacturers to banks from 2006 to 2011.

- Between 2006 and 2011, banks actively moved their new financing volume to companies with lower risk profiles. The share of bank financing of highly profitable companies rose from 26% to 47% between 2006 and 2011, while the share of bank lending to unprofitable companies declined from 65% to 53%.
- The share of cash payments declined for large companies from 2007 to 2012, according to Foundation surveys, as larger companies have enjoyed greater access to credit markets. In the current low interest rate environment, financing equipment acquisitions is especially attractive.
- According to the Foundation survey, companies with sales between \$25 million and \$100 million doubled their share of leasing volume from 2006 to 2011. Companies with less than 51 employees also doubled their share of equipment acquisition via leasing in this time period. This may be in part a reflection of the difficulty in obtaining other forms of credit for these segments of the market.
- Both the 2012 and 2007 Foundation surveys confirm that larger ticket purchases are financed to a greater degree than smaller ticket purchases.
- Even though the overall share of computer hardware financing has declined, the Foundation survey analysis reveals an increase in the share of leasing of computer hardware acquisitions between 2007 and 2012. The share of leasing of software acquisitions has also increased as captives have rolled out more financing programs and independents are increasingly attracted to this asset class.
- As revealed in the Foundation survey, the share of financing in furniture and fixtures acquisitions has risen dramatically from 40% in 2006 to 83% in 2011. The increase is likely due to a greater propensity to bundle furniture and fixtures purchases as well as additional “soft costs” such as delivery, warranty, etc., with other financed assets.
- According to the 2012 Foundation survey, larger companies are more concerned with the pending elimination of off-balance sheet financing. This may be due to large companies having a greater propensity to make large-ticket acquisitions that are often financed through off-balance sheet structures.
- Corporate perceptions of the economic outlook are the primary driver behind business investment decisions. Small companies have the greatest degree of concern about general economic conditions, according to the 2012 Foundation survey.
- In the 12 months following the Foundation survey, 30% of companies anticipate increasing their equipment investment, according to the 2012 Foundation survey. This group of companies is disproportionately represented by large companies.
- Business investment spending for equipment and software is expected to slow over the 2013 and 2014 period. Although there will be pockets of strength, overall finance volume is not expected to keep pace with total investment during this period. Small businesses, which represent more than half of the volume of equipment finance, are expected to curtail spending. According to the IHS macroeconomic outlook, sometime during 2014 as business uncertainties begin to wane and the prospect of higher interest rates looms, larger firms may be inclined to draw on their cash reserves to acquire equipment. This adjustment would contribute to finance volume growth trailing the overall growth in equipment investment.

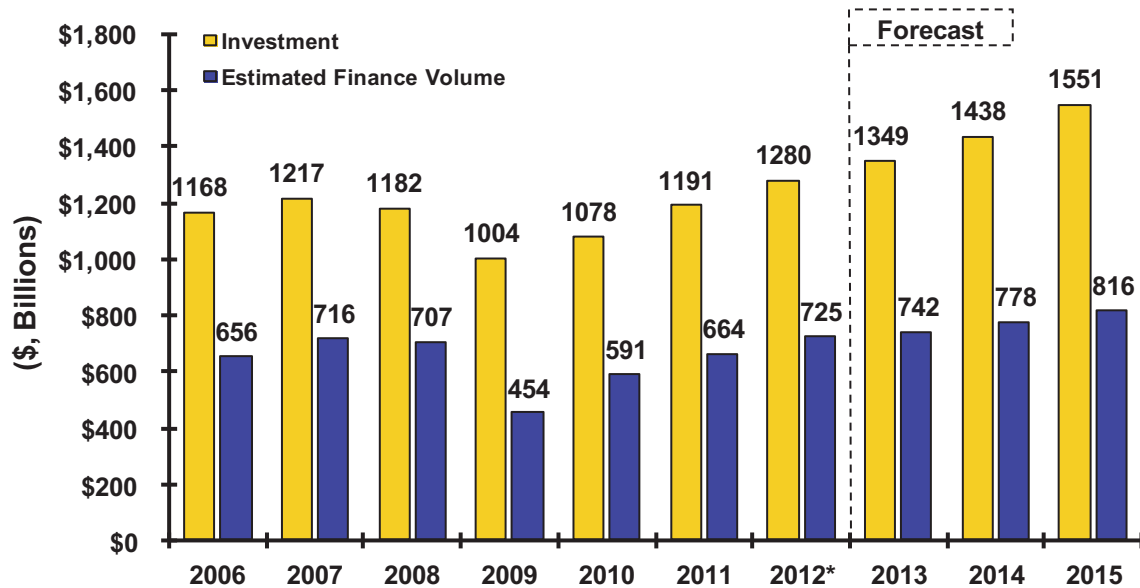
Gauging the Current Market for Equipment Finance

The equipment finance industry is a vital driver of the U.S. economy, which underpins equipment investment and enables more than half of all equipment acquisitions. An estimate based on data from IHS and the U.S. Department of Commerce suggests the total size of private and public investment in equipment and software totaled \$1.19 trillion in 2011 and will reach \$1.28 trillion in 2012. The 2012 Foundation survey shows that nearly 56% of that volume was financed. By the end of 2012, IHS expects total equipment finance volume to exceed its 2007 pre-recessionary peak reaching \$725 billion.

When measured from the perspective of businesses acquiring equipment, the volume of equipment financed appears significantly larger than estimates based upon creditor surveys. Surveys of equipment leasing and finance companies provide valuable information on the performance of the industry, but they can only provide a partial picture of the size of the industry. This is due in part to the fact that borrowing for equipment acquisitions is also often classified under more generic forms of credit such as a commercial and industrial loan or line of credit. These financial assets, however, also cover business borrowing for many other purposes, making it difficult to isolate equipment financing. The Foundation survey addresses this short-coming by focusing on businesses that acquired equipment and asking survey respondents to share their method of financing for their acquisitions in 2011. This data is then extrapolated to yield the total value of equipment financed.

Investment in equipment suffered a strong blow during the recession, declining over 17% from a peak of \$1.22 trillion in 2007 to a trough of \$1.00 trillion in 2009 (Figure 1). With credit markets contracting even more rapidly and the asset-backed security market nearly disappearing, the share of investment in equipment that was financed also plummeted, from 59% in 2007 to only 45% in 2009. As the economy began to slowly turn around in 2010, the investment in equipment started

Figure 1: Public and Private Investment in Equipment and Software



* Estimated on partial-year data

Source: US Department of Commerce Bureau of Economic Analysis and IHS Global Insight

to grow again. While lenders maintained tight control over credit and total lending volumes remained far below the pre-recessionary levels, businesses with access to credit began to increase the financed share of their equipment investment. Picking up from a very low base, equipment financing volume grew more than 30% in 2010 and over 12% in 2011. In 2012, the equipment financing market is expected to grow 9% reaching \$725 billion.

In order to gauge the size of the market from the creditor's perspective, the Federal Reserve's Flow of Funds database, which contains asset and liability data from a stratified random sample of finance and mortgage companies, was examined. Similar to the findings published in The Foundation's *U.S. Equipment Finance Market Study 2007-2008*, IHS found that although the overall equipment financing market looks smaller from the creditor's perspective, it follows the same overall trends. The owned and managed receivables data for non-depository institutions (a proxy for independent finance companies and captives) collected through the Federal Reserve represented \$96 billion in new loans and leases in 2011. This estimate is based on an analysis of the flow and level data with an assumption that 25% of the previously outstanding debt is amortized each year. The estimate also excludes wholesale loans (and includes securitized assets). To approximate the overall market for this type of lending, finance company loan volume is divided by its share of the market as revealed by the Foundation survey. As a result, the total estimated finance volume from the lenders represented in Flow of Funds and the survey equates to \$246 billion in 2011, roughly on par with the values generated in the 2007 study.

"...the equipment financing market is expected to grow 9% reaching \$725 billion."

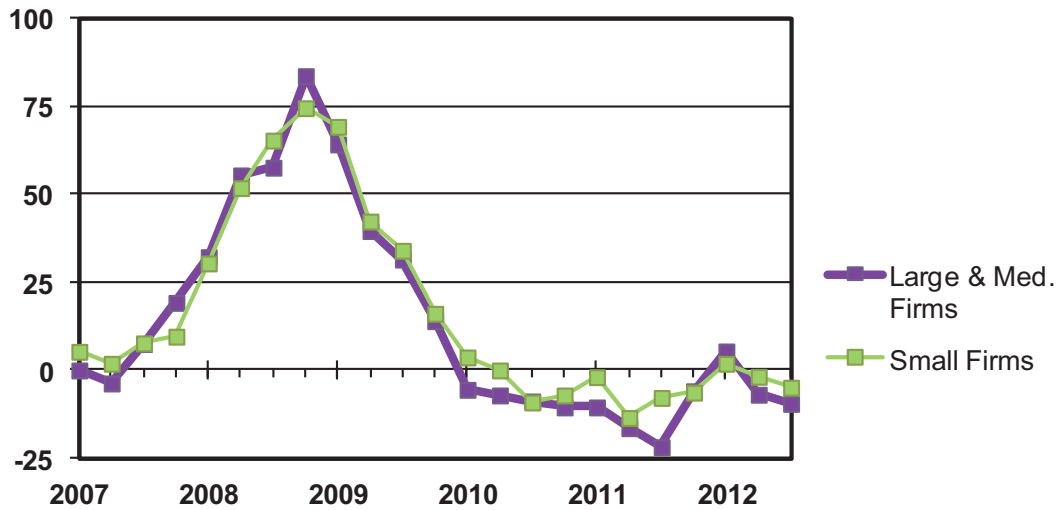
The *2012 Monitor 100 Report* published by the Xander Media Group provides similar insight. The *Monitor 100* report tracks equipment-related loans and leases for the 100 largest equipment finance and leasing companies in the U.S. who volunteer to report their data. In the 2012 Monitor 100 Report, the total size of all new originations for 2011 was estimated at \$200 billion.

The Prospects for Equipment Finance Growth Improve, but Challenges Remain

The estimates of the equipment finance volume in 2012 reflect a gradual improvement in the equipment finance market, with financing volumes returning to pre-recessionary levels. There are three main factors driving the improvements in the equipment financing industry: modest easing of lending standards paired with historically low interest rates; pent-up need to replace aging equipment; and, a gradual improvement in companies' end market demand, which supports a moderate increase in expansionary equipment investment. More recently, the strong revival in the equipment investment market appears to be held back by uncertainty over the political paralysis in the United States and Europe. Weakening export demand is also discouraging expansionary investment in export-oriented industries.

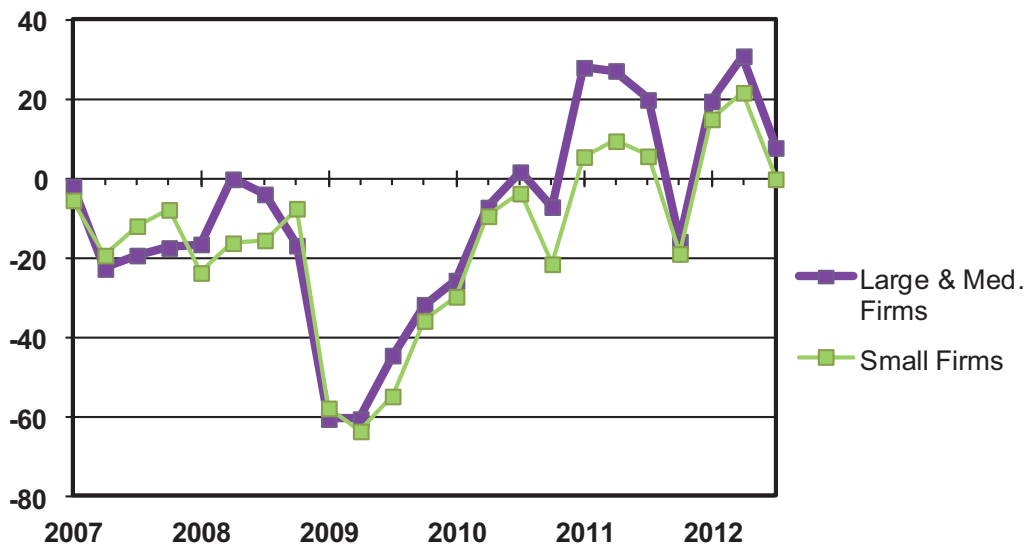
According to the July 2012 *Senior Loan Officer Opinion Survey on Bank Lending Practices*, published by the Federal Reserve, banks eased their lending standards over much of the last two and one-half years, and the demand for many types of loans strengthened (Figures 2 & 3). Over the past three months, large- and medium-size firms saw a greater degree of lending standards easing, while standards on loans to small firms have not changed much. At the same time, loan demand from large and middle-market firms strengthened somewhat, and loan demand from small firms was unchanged. The Federal Reserve continues to ease monetary policy with an open-ended bond-buying program (QE3) and a promise to keep interest rates low through 2014. Banks' prime rate

Figure 2: Percent of Banks Reporting Tightening Credit Conditions, C&I Credit



Source: Federal Reserve Senior Loan Officer Opinion Survey Bank Lending Practices

Figure 3: Percent of Banks Reporting Stronger Loan Demand, C&I Credit



Source: Federal Reserve Senior Loan Officer Opinion Survey Bank Lending Practices

has come down to 3.25% from the pre-recessionary peak of 8.25%. Low interest rates and the easing of lending standards support growth in the equipment finance market.

With short-term supply conditions relatively favorable for borrowers, future market expansion hinges on credit demand growth. Pent-up demand for equipment replacement is another driver of equipment investment. With the recession bankrupting many companies with weak balance sheets, those who remained in the market cut back dramatically on their expenses and investments during

the recession. As a result, equipment that would have been replaced or updated remains in companies' use. As demonstrated in Table 1, the average age of equipment and software increased for most equipment types between 2008 and 2011. While pent-up demand for replacement equipment is already pushing forward investment in the construction, agriculture, and transportation categories, other equipment types have not yet entered the replacement cycle. According to a senior banking executive, the aircraft industry's equipment replacement cycle is notably lagging behind other industries. Since aircraft are large-ticket items, aircraft acquisition is often accomplished through sophisticated finance structures. Yet, over the past decade, many of the previously used financing methods, such as leveraged leases, have largely disappeared from the market due to regulatory tightening. The limited number of options available to creditors to structure attractive deals with borrowers is hindering the growth of aircraft sales. As pent-up demand for aircraft replacement continues to accumulate, the finance industry will likely develop new structures to accommodate the demand. The timing of this innovation, however, remains uncertain.

Table 1: Current Cost Average Age at Year-end of Private Fixed Assets, Equipment and Software, and Structures by Type

	2004	2005	2006	2007	2008	2009	2010	2011
Computers and peripheral equipment	1.9	1.9	1.6	1.4	1.2	2	2.1	2.1
Medical equipment and instruments	4.2	4.2	4.2	4.2	4.2	4.3	4.4	4.5
Communication equipment	5.3	5.5	5.5	5.5	5.6	5.8	5.9	6.1
Office and accounting equipment	2.2	2.2	2.2	2.7	2.9	3.2	3.6	3.8
Transportation equipment	7	7	7	7	7.4	7.9	8.2	8
Aircraft	8.9	9.1	9.5	9.6	9.6	10	10.3	10.5
Agricultural machinery	7.4	7.1	7	7	6.8	6.8	6.7	6.6
Construction machinery	5.3	5.1	4.8	4.7	4.8	5.1	5.2	5.1
Furniture and fixtures	6.1	6.2	6.2	6.3	6.5	6.8	7.2	7.4

Source: Bureau of Economic Analysis

Modest improvements in demand in some markets also support the increase in equipment investment. The beginning revival of the housing market is likely to contribute to an increase in construction equipment investment. Unconventional energy production is also beginning to attract large capital investments. According to a study published by IHS, unconventional gas and oil production has already driven \$87 billion in capital investment in 2012 alone. Annual investment will almost double to \$173 billion in 2020 and a total of 3 million jobs will be created by 2020. The expansion in the energy sector will reinvigorate equipment investment in construction, transportation, computer and other related equipment categories.

While the future holds promise for stronger growth, present day equipment investment growth remains constrained by uncertainties at home and abroad. Companies are flush with cash, yet they defer making large-scale expansionary investment until important tax and regulatory decisions have been made. With sluggish economic growth and a mismatch between perceived risk and market return, the banking sector remains reluctant to significantly ease lending standards further despite unprecedentedly high excess reserves.

Finance Market Evolves in the Wake of the Recession of 2008-09

In order to understand the shifts in borrowing patterns, IHS conducted an end-user survey across a broad range of companies and compared the results with those from its survey conducted in 2007. This deeper look into the end-user perspective reveals that the way companies finance equipment acquisitions overall has changed little over the past five years; however, the shifts are more pronounced within the sub-levels of company sizes and equipment types.

The overall propensity to finance has not changed significantly between 2006 and 2011. According to the 2012 Foundation survey, 72% of respondents declared that they used at least one form of financing when acquiring equipment in 2011. This share is slightly above the 70% observed in the 2007 survey for 2006 activity.

A deeper look into the survey results reveals that the share of companies using any amount of credit in their equipment acquisitions differs by the level of revenue. As demonstrated in Table 2 below, only 45% of small companies with annual revenues of less than \$1 million reported using any form of credit in 2006. By contrast, 76% of large companies with revenues between \$25 and \$100 million used credit in the same year. With borrowing costs declining between 2006 and 2011, more companies sought credit for their equipment acquisitions in 2011. This trend is evident in the 2012 Foundation survey with more companies of all revenue levels reporting using credit in their equipment acquisitions in 2011. However, similar to the results obtained in 2007, small companies did not use credit markets as much as large companies did, and only 49% of small companies reported using credit in 2011. Companies with revenues between \$25 and \$100 million remained at the top with 86% of companies reporting using credit to acquire equipment.

Table 2: Financing by Company Size*

	2012 Survey	2007 Survey
	% Share of Companies that Used Financing	
Less than \$1 mil	49%	45%
\$1 mil - \$5 mil	81%	75%
\$5 mil - \$25 mil	75%	66%
\$25 mil - \$100 mil	86%	76%
Over \$100 mil	82%	73%
TOTAL	72%	70%

Source: Foundation surveys

*Total survey respondents, unweighted

From the end user's perspective, the equipment finance market is delineated by secured loans, leases (operating, capital, and other), and lines of credit. In the 2012 Foundation survey, IHS introduced credit card (paid in full each month) as a separate category. As revealed by the 2012 Foundation survey, sometimes businesses finance their equipment purchases via credit cards in order to maintain a paper trail or to facilitate transactions. The credit cards would be paid in full within 30 days and, therefore, are closely related to cash. The credit card category added additional detail by capturing all transactions that should be regarded as cash equivalents, rather than as lines of credit transactions. Figures 4A and 4B provide the breakdown of the total investment volume by method of financing in 2011 and 2006, respectively.

Figure 4A: Equipment Investment by Method of Finance, 2012 Survey

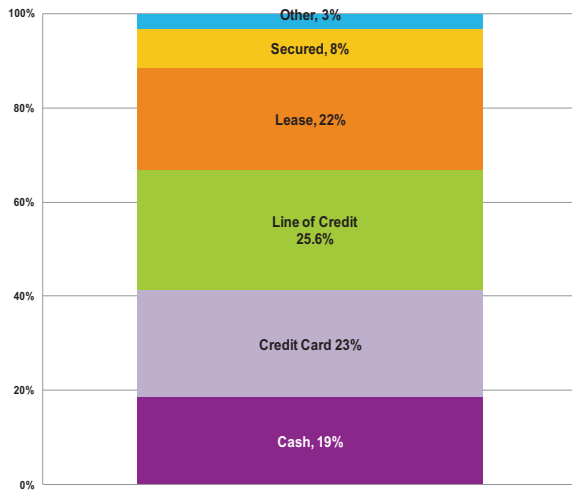
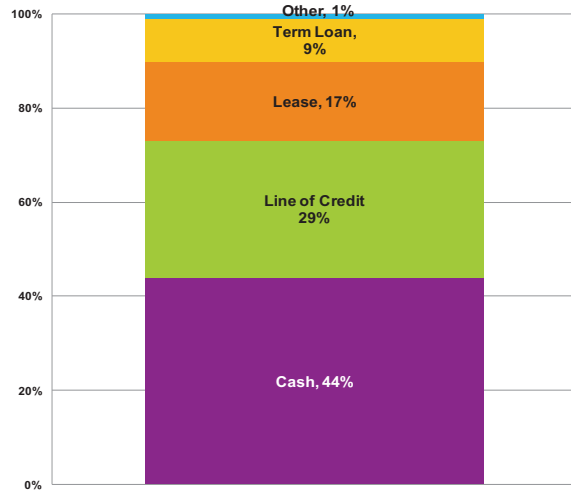


Figure 4B: Equipment Investment by Method of Finance, 2007 Survey



Source: Foundation surveys

With the credit card category representing an extension of cash financing, the distribution of total equipment investment by method of finance in 2011 is very similar to the distribution in 2006.

Leasing volume as a share of total investment has revealed the largest shift, increasing from 17% in 2006 to 21% in 2011. This increase in leasing activity is particularly dramatic for very small companies, those with 50 or fewer employees (Figures 5A and 5B). The companies in that category saw their leasing proportion double between 2006 and 2011, from 6% to 13%.

Figure 5A: Equipment Investment by Company Size and Method of Finance, 2012 Survey

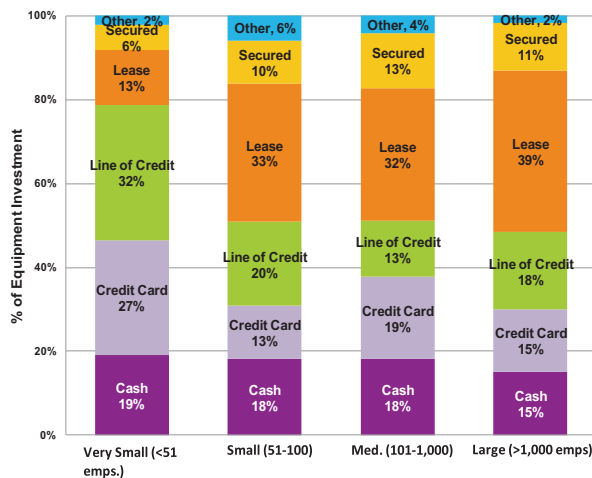
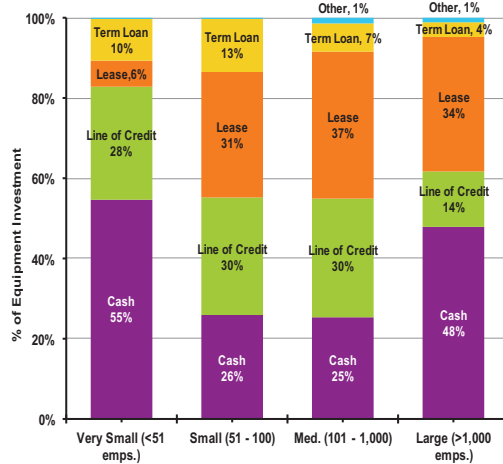


Figure 5B: Equipment Investment by Company Size and Method of Finance, 2007 Survey

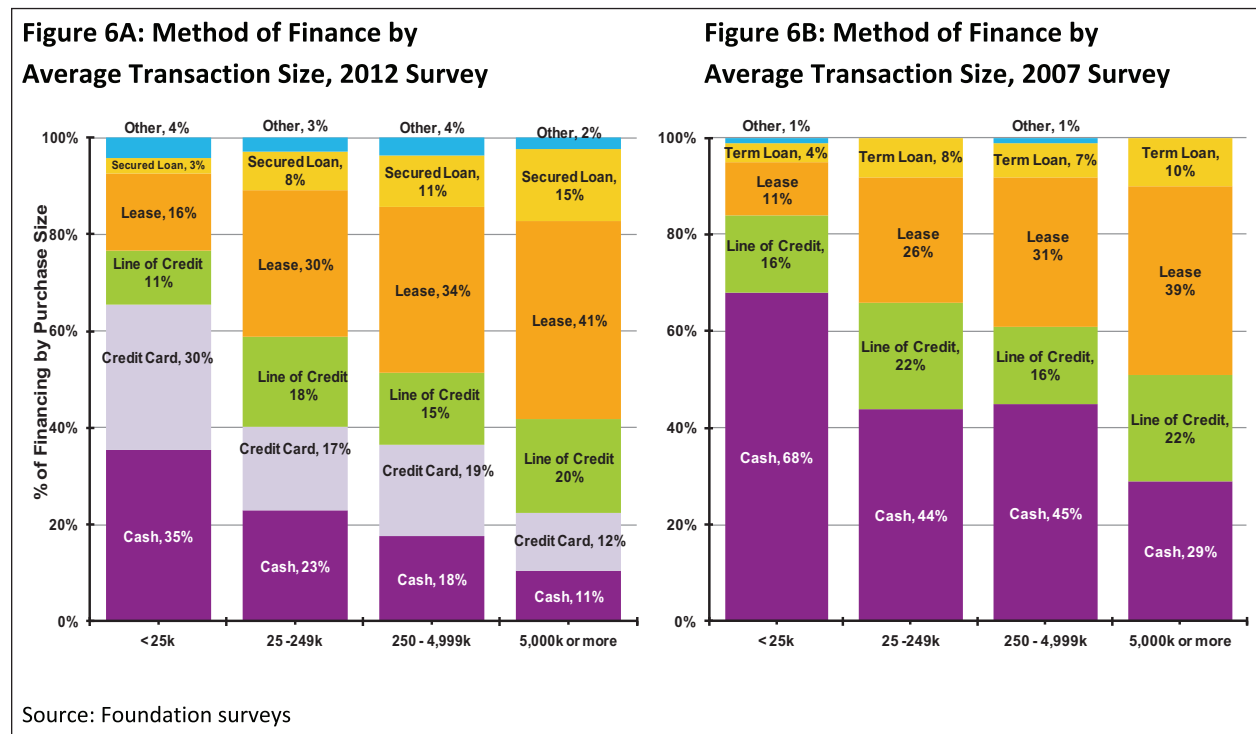


Source: Foundation surveys

This outcome is not particularly surprising. Leasing equipment usually does not require an initial outlay of capital, which allows companies to optimize their cash flows. These benefits of leasing may be particularly important to smaller companies that are more dependent on maintaining the strongest possible financial position especially during a time of uncertainty and relatively tight credit. Smaller companies who had difficulty securing traditional bank loans through the credit crunch may also have turned to leasing as an alternative.

Another major finding from the 2012 Foundation borrower survey is that companies with 1,000 employees or more have increased their share of financing equipment acquisition from 52% in 2006 to 70% in 2011. Possible explanations for this shift are that large companies have better access to credit and are capitalizing on the current low interest rate environment. However, this shift may prove to be only a temporary response to the low interest rate environment. It may also be the case that larger companies are maintaining higher cash balances to protect themselves against a sudden turn in economic conditions. One result of large companies' move to preserve cash and pursue more financing is that the use of leasing increased from 34% in 2006 to 39% in 2011. The three biggest equipment categories that large companies finance are communication equipment, computer equipment, and software, which together accounted for nearly 65% of the large companies' total financing volume in 2011.

Also, both the 2012 and 2007 Foundation surveys confirm that companies with larger average transaction sizes for equipment acquisitions tend to use more financing (Figures 6A and 6B) than those with smaller average transaction sizes. On the other hand, the share of financing has increased for all companies despite their average transaction size. Please note that the shares of indicated methods of financing do not suggest that the financing for an *individual* transaction was split between those methods. The charts below suggest that companies with the specified average transaction size across all their transactions utilize multiple credit sources.



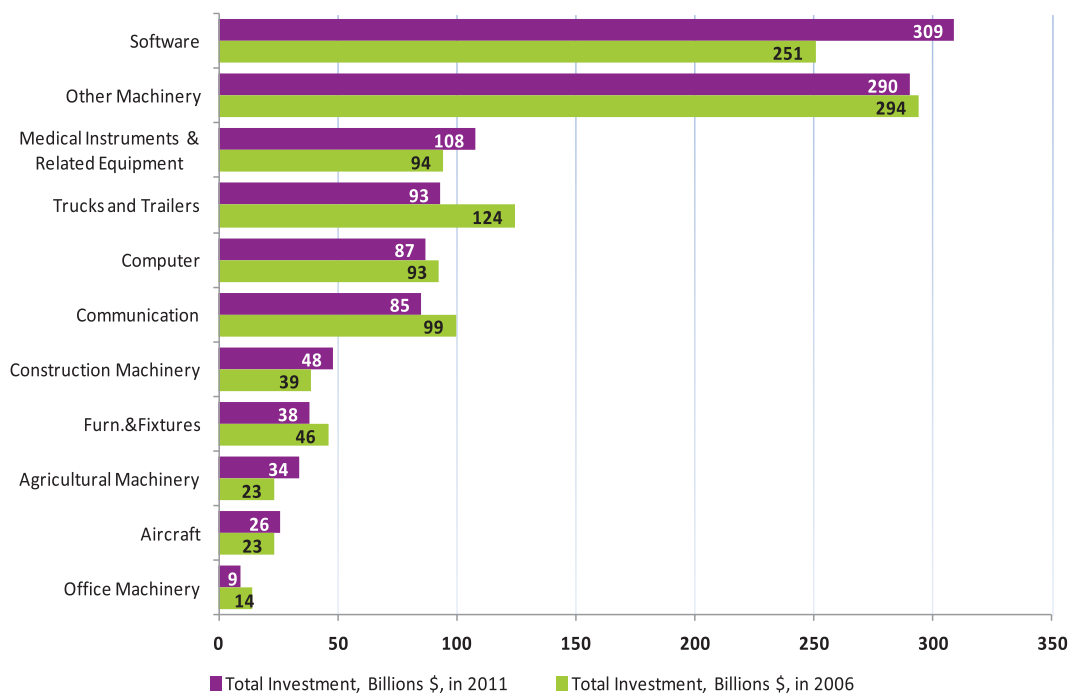
Shifts in Software and Hardware Financing

As demonstrated in Figures 8A and 8B, financing methods vary significantly by equipment type; however, some equipment categories revealed significant shifts in financing methods. The 2007 Foundation survey found that nearly 64% of software acquisition expenditures were paid in cash in 2006. The results of the 2012 borrower survey reveal that the share of cash in software payments dropped to 45% in 2011. Software is the largest equipment investment category, with total annual investment volume of \$309 billion in 2011 (Figure 7).

The shift in software financing is particularly important, and is indicative of the changes taking place in the financing industry. Software acquisition and upgrades have become integral to successful business operations over the past two decades. With that, the need for a greater variety in financing methods has also grown. Historically, banks have been less inclined to finance intangible assets such as software. However, as the size of the software investment grew, banks have increased their share of financing from 34% in 2006 to 38% in 2011.

Leasing of software increased significantly from 19% of total financing volume in 2006 to 33% in 2011. In order to respond to the growing demand for financing, many software vendors and independents have expanded their financing programs offering a broader range of services. Many vendors and independents finance the soft costs of software acquisitions, such as implementation, service, and maintenance. Businesses, in turn, are increasingly finding software leasing an effective way to keep their costs low while benefiting from the most up to date automation tools. In the world of ever more rapid technological advancement, new software depreciates quickly, forcing businesses to upgrade or fall behind. Software leasing provides an opportunity to minimize initial capital outlays and significantly reduce the risk of owning obsolete technology.

Figure 7: Total Investment in 2011 and 2006 by Equipment Type (\$ billions)



Source: HIS

Cloud computing is becoming a new way to deliver the benefits of modern technology to the end user. Software as a service (SaaS) model offers many benefits of a standardized product, such as lower monthly payments, access to software updates, ease of implementation and use. Infrastructure as a service (IaaS) model provides companies with an opportunity to shift their hardware spending towards off-premise server providers and save costs. While critics remain concerned that the cloud wouldn't provide adequate security for potentially massive loads of data, the emergence of the cloud is already transforming the way companies consume software and hardware. As a result, the way companies pay for software and hardware is also likely to change as cloud computing continues to gain prominence. With the "pay-as-you-go" model, cloud computing will allow companies to substitute fixed capital expenditures for information technology (IT) with a variable payment structure. This will impact the type of financial products companies will seek. Some captives and independents are already offering cloud financing options; however, cloud adoption and financing are only beginning to gain momentum.

Figure 8A: Method of Finance by Equipment Type, 2012 Survey

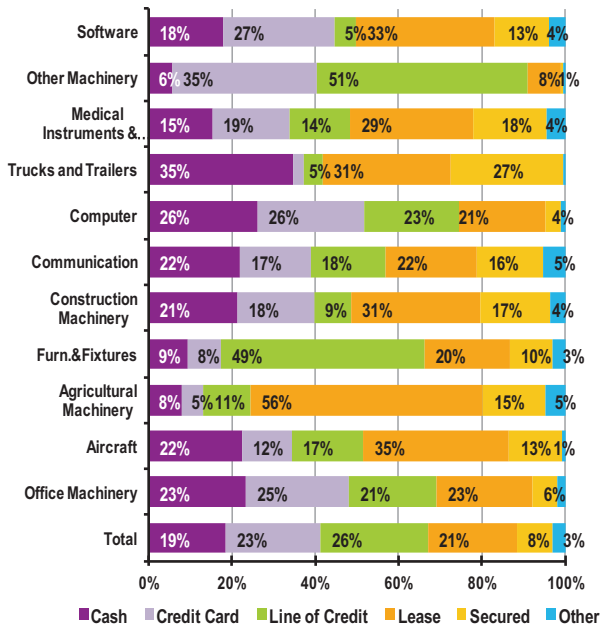
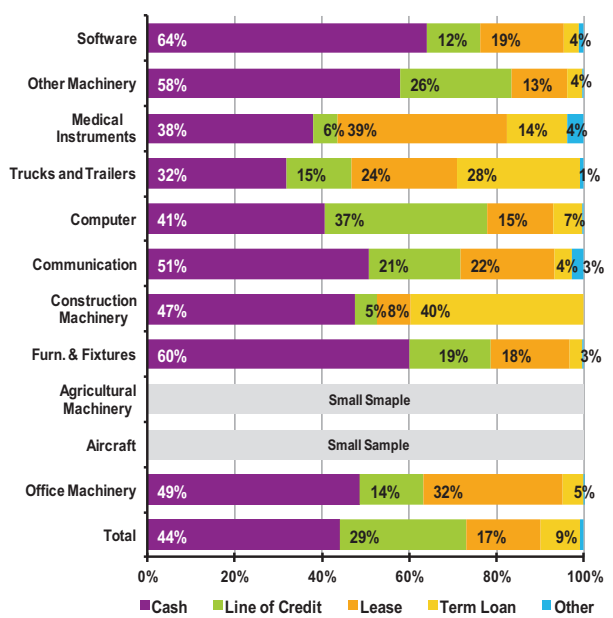


Figure 8B: Method of Finance by Equipment Type, 2007 Survey



Source: Foundation surveys

The Foundation surveys reveal a shift taking place in computer financing towards cash and credit card purchases. In 2011, nearly 52% of all computer acquisition transactions were paid in cash or with credit cards. This proportion is materially larger than the 41% share observed in 2006. The shift likely reflects the tight lending standards and the declining costs of hardware. While large-ticket items require a greater share of financing despite how difficult it may be to obtain a loan, small-ticket items may be easier paid with cash, especially when financing is not readily available. With the cost of hardware declining, smaller companies with less access to capital markets are becoming more likely to pay for their computers in cash. As a side note, when companies access credit markets to finance computer acquisitions, an increasing share is turning to leasing. The incentives for leasing computers are not much different from those for leasing software. Smaller

initial outlays of capital and low risk of owning obsolete technology make hardware leasing an attractive option. Also, attractive financing programs offered by IT captives help accelerate this shift.

The Foundation surveys reveal that the share of financing in furniture and fixtures purchases has risen dramatically from 40% in 2006 to 83% in 2011. The shift in furniture and fixtures financing is likely due to the increasing propensity to bundle those purchases as well as additional “soft costs” such as delivery, warranty etc. with other financed assets. This trend of bundling has become more prevalent over the past five years.

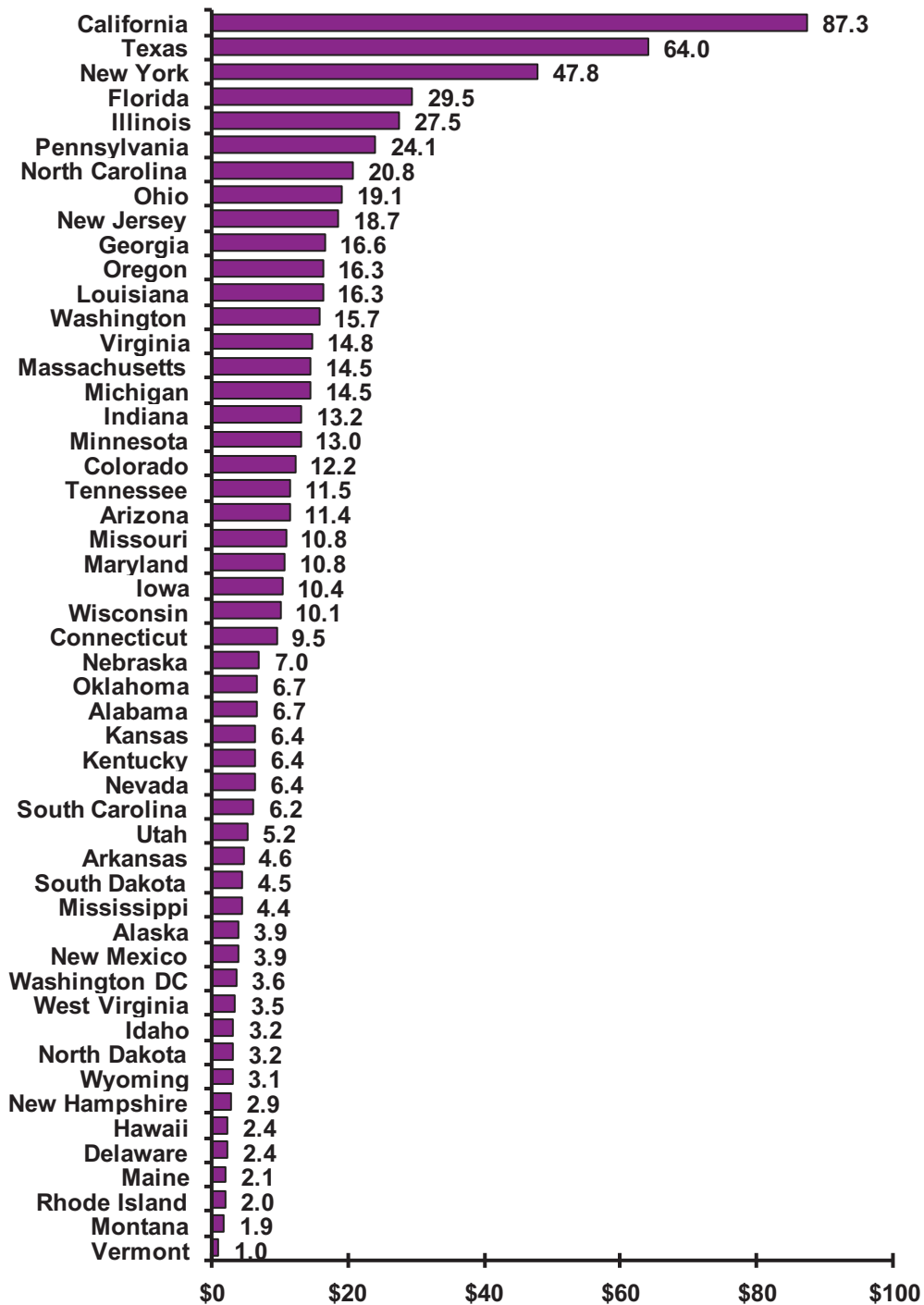
The analysis shows a noticeable shift in construction machinery acquisitions from term loans to leasing between 2006 and 2011. This shift is likely reflective of the elevated risk level associated with construction equipment financing. During the recession, the construction industry suffered tremendous losses. With bank lending shifting towards safer asset classes and more profitable companies, the supply of term loan financing for construction equipment likely decreased, opening the door for more leasing. As revealed by the survey, construction equipment leasing increased from 8% to 31% between 2006 and 2011 while term loan financing shrank to 17% from 40% observed previously.



In order to estimate the geographic distribution of financing, IHS utilized its equipment demand database to estimate investment by state and equipment types. The share of financing volume for each equipment type from the Foundation’s borrower survey was then applied to the equipment investment estimates by type and industry end-users in each state. State and industry totals were then generated by aggregating the financing volumes in each state.

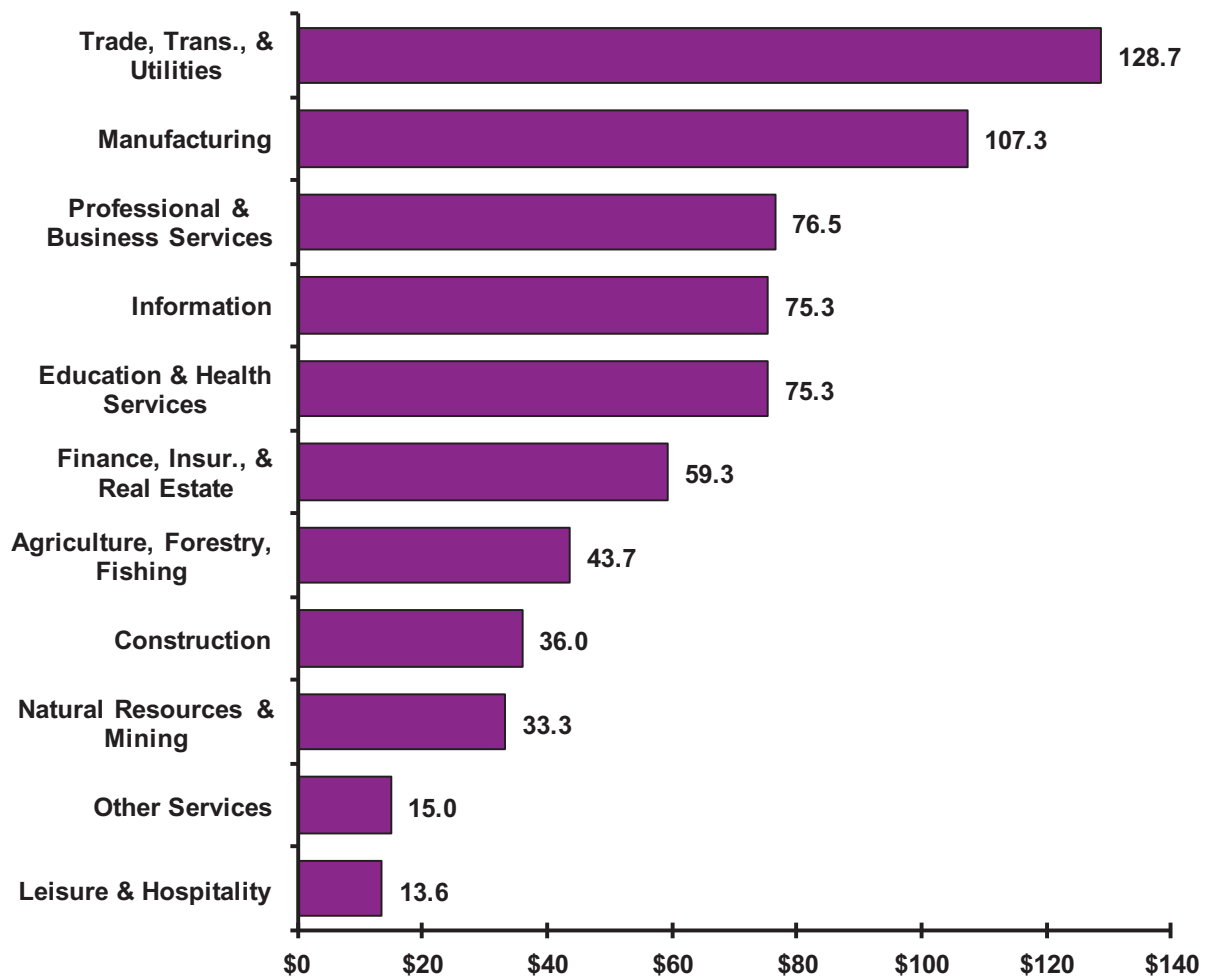
As Figure 9 shows, California had the largest volume of equipment financed, at \$87.3 billion, representing 13% of the U.S. market. The top-five states accounted for 39% of the equipment finance market in 2011, illustrating the geographically concentrated nature of the national market. Figure 10 illustrates that trade, transportation, and utilities had the highest level of equipment finance volume in 2011 among end-user industries, with \$128.7 billion financed. Manufacturing followed closely behind with \$107.3 billion in equipment finance volume. The top-two industries made up 36% of equipment financing volume in 2011.

Figure 9: US Equipment Finance by State in 2011, \$Billions



Source: IHS

Figure 10: US Equipment Finance by End-User Industry in 2011, \$Billions



Source: IHS

Banks Capitalize on Market Conditions

Between 2006 and 2011, banks' share of equipment financing had risen from 47% of total equipment finance volume to 57% (Figures 11A and 11B). During the recession, banks gained share as many smaller institutions were unable to withstand the crisis or were severely constrained due to unavailability of funding. With the Federal Reserve's efforts to spur domestic demand through quantitative easing programs, banks have also grown organically. Nevertheless, uncertainties surrounding the economy, weaknesses in the mortgage market, and continuing consumer deleveraging leave fewer opportunities for banks to lend their excess reserves. With more than \$1.4 trillion in excess reserves and balance sheets that are largely free of toxic assets, banks are uniquely positioned to provide financing, and they are placing greater emphasis on their C&I portfolio where loan demand is on the rise. Therefore, it is not surprising that, despite maintaining stiff lending standards, banks were the primary lenders across all equipment types in 2011.

Among the various equipment market segments, the smallest penetration of bank financing was present in trucks and trailers. Medical equipment showed a significant shift from manufacturer to bank financing between 2006 and 2011. Banks perceive medical equipment loans and leases as relatively safe assets. The increased penetration of bank financing in medical equipment versus trucks and trailers, where residuals can be tricky and borrowers tend to be riskier, reflects banks' generally higher appetite for safe assets and stronger credit.

Figure 11A: Lender by Equipment Type, 2012 Survey

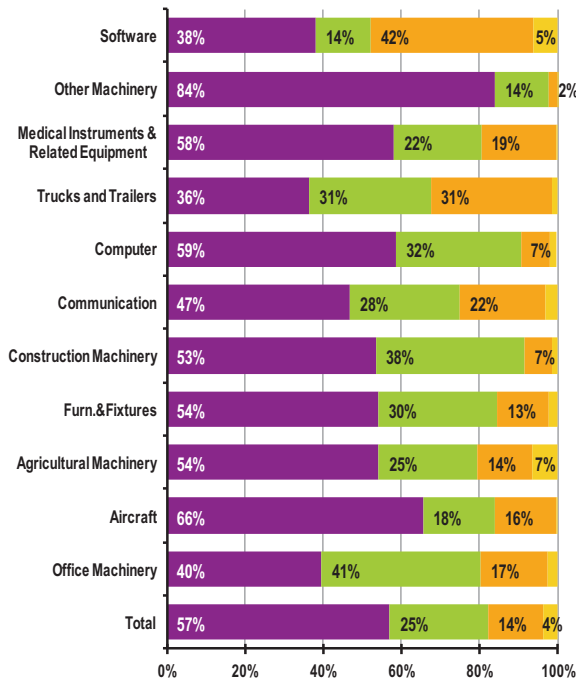
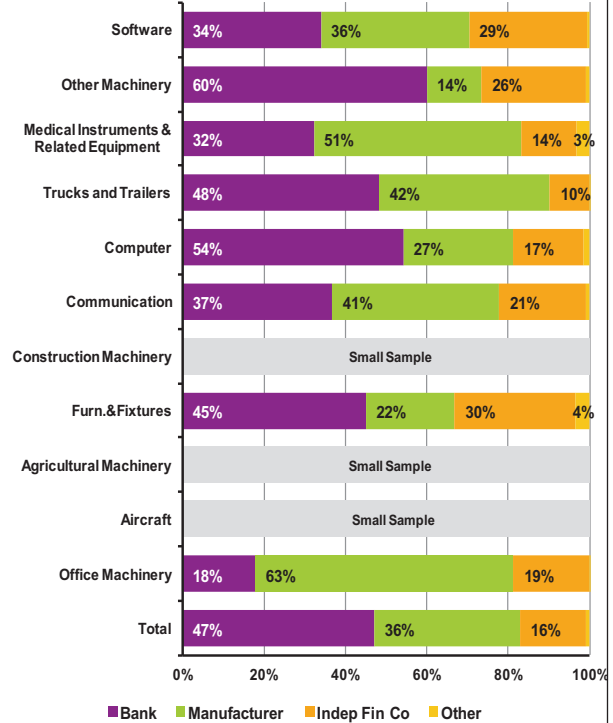


Figure 11B: Lender by Equipment Type, 2007 Survey



Source: Foundation surveys

Another way to assess the appetite for risk and the market niches of lenders is to examine financing for companies across various levels of profitability. For example, between 2006 and 2011, banks actively moved their new financing volume to a lower risk profile. Companies that lost money in 2011 declared that nearly 53% of their borrowing came from banks, a material drop from the 65% share observed in the 2007 Foundation survey. On the flip side, companies with profits representing 20% or more of their sales declared that their share of bank borrowing was 47%, a sharp increase over the 26% share observed in the 2007 Foundation survey (Figures 12A and 12B). A comparison of the two surveys also helps to illustrate the extent to which independent financing companies have successfully moved in to fill the void, increasing their penetration to borrowers with weaker earnings.

Figure 12A: Lender by Company Profitability, 2012 Survey

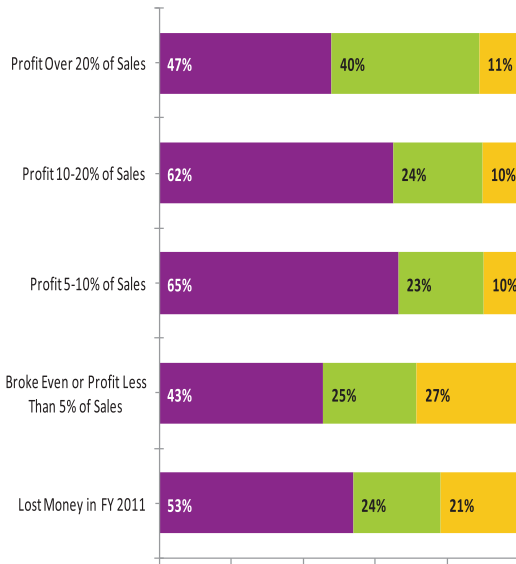
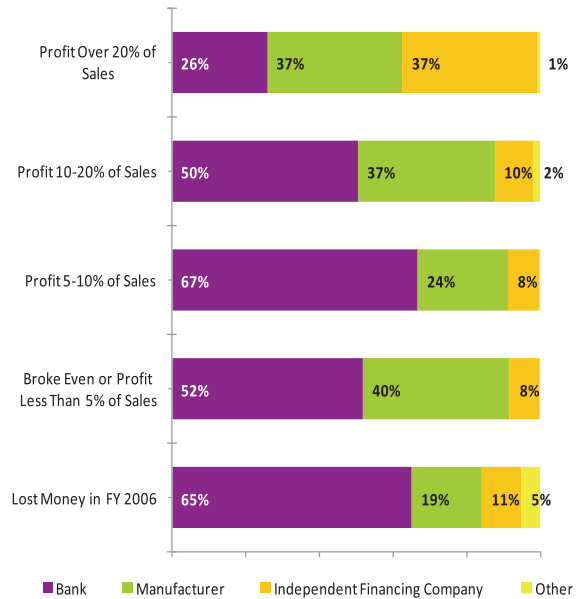


Figure 12B: Lender by Company Profitability, 2007 Survey



Source: Foundation surveys

Creditor’s Perspective

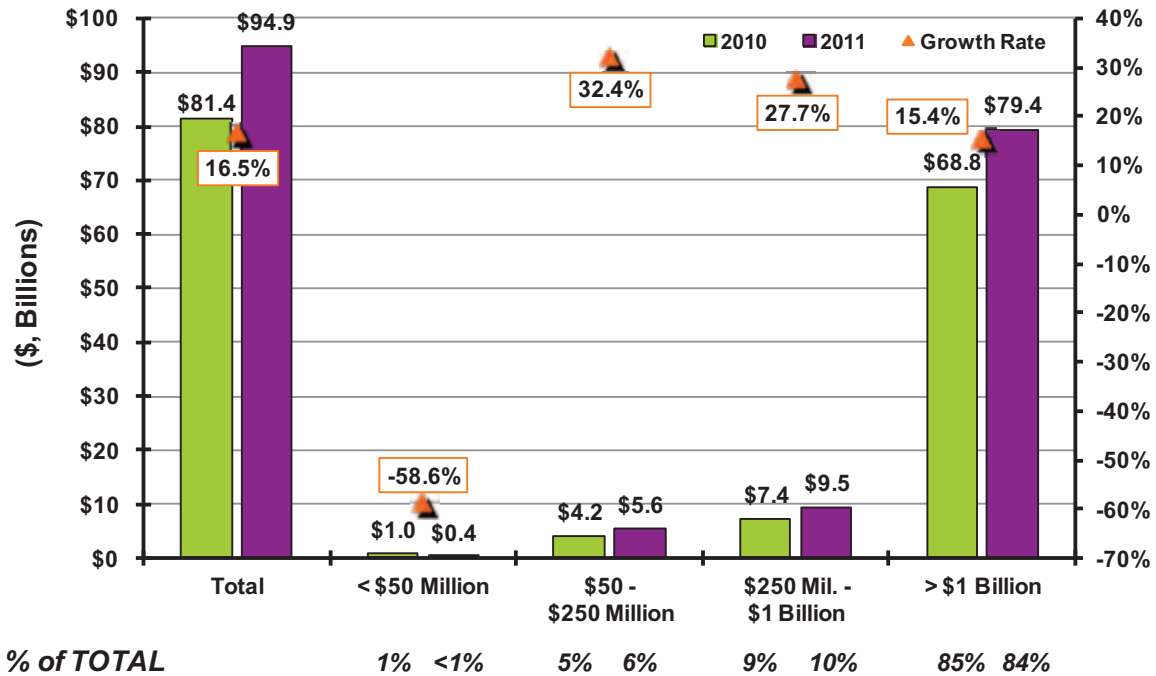
The U.S. leasing and equipment finance sector is experiencing renewed growth after a difficult run of years during the 2008-2009 recession. According to the annual ELFA Survey of Equipment Finance Activity (SEFA), new business volume from lenders that responded rose 16.5% to \$94.9 billion in 2011. The ELFA Monthly Leasing and Finance Index (MLFI-25), which measures economic activity for the equipment finance sector, also showed a similar increase in 2011, as cumulative new business volume rose 25% from 2010 to 2011.

Despite the recent gains, pockets of the industry are lagging behind. For example, small lenders are trailing larger competitors, and actually suffered decreased new business volume in 2011. A major conclusion of the 2012 Foundation survey was the increased role of banks as lenders. Although the 2012 ELFA SEFA shows a similar trend, it is not quite as pronounced from the lender perspective as it is from the borrower’s side. Banks continue to dominate the marketplace, driving independent financial services organizations to considerably lower new business volume than in 2006. The contraction in new business volume has been driven by increased competition from banks, as well as increased funding challenges. Growth in new business volume for small independents picked up significantly in 2011, but remains well below pre-recession levels of business volume.

Analysis of the 2012 Survey of Equipment Finance Activity

The ELFA’s 2012 SEFA is a helpful tool to help gauge the current state of the industry. The following summary of the survey illustrates the comeback of the equipment leasing and finance sector from very low levels. It is important to note that the 2012 SEFA is a survey of creditors and provides a different perspective than the Foundation borrower survey. Although the surveys are similar, they have differing methodologies and the findings may vary somewhat.

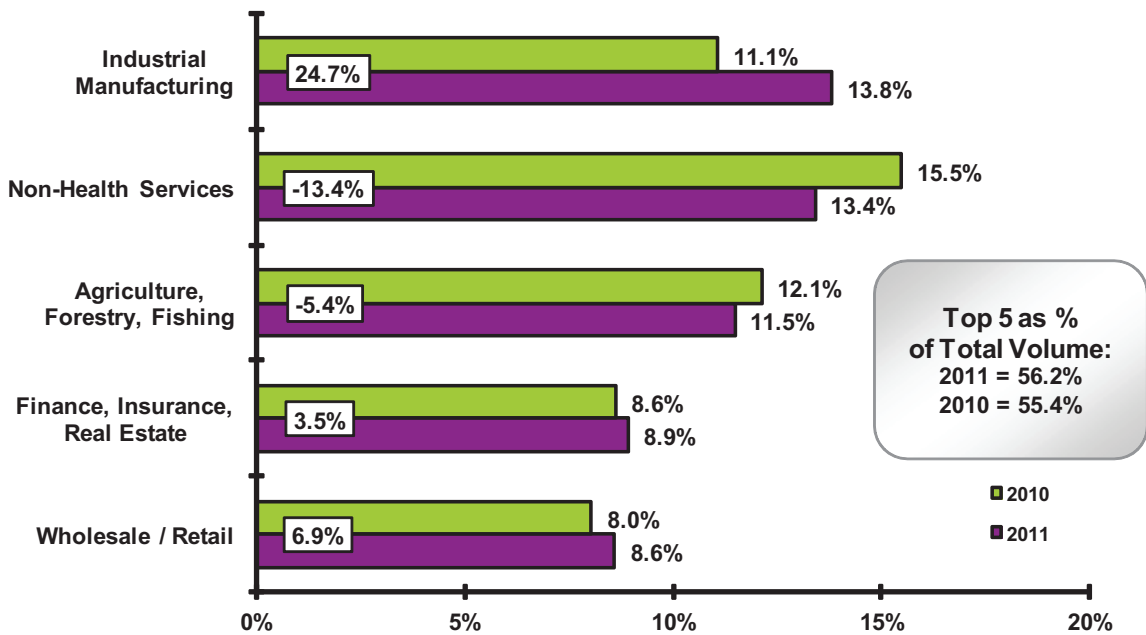
Figure 13: New Business Volume by Lessor Size (by Annual Volume)



Source: 2012 ELFA Survey of Equipment Finance Activity

New business volume, a measure of growth, showed an overall increase of 16.5% in 2011 compared to 2010 (Figure 13). The total volume remains below the level reported in the 2007 survey, but survey participants differ from year to year, making comparisons over five years difficult to interpret. Respondents to the 2012 survey reported strong growth in new business volume, particularly among lenders with over \$1 billion in annual volume. This segment of the market captured nearly 80% of the \$13.5-billion volume growth between 2010 and 2011. New business volume grew in 2011 for each of the lender size segments, except for companies with less than \$50 million in annual volume. The declining share for small companies is consistent with the findings of the Foundation’s borrower survey, although the severity of the loss may be exaggerated due to the constraints of the sample size.

Figure 14: New Business Volume by End-User Industry (% Distribution over 2 Years)

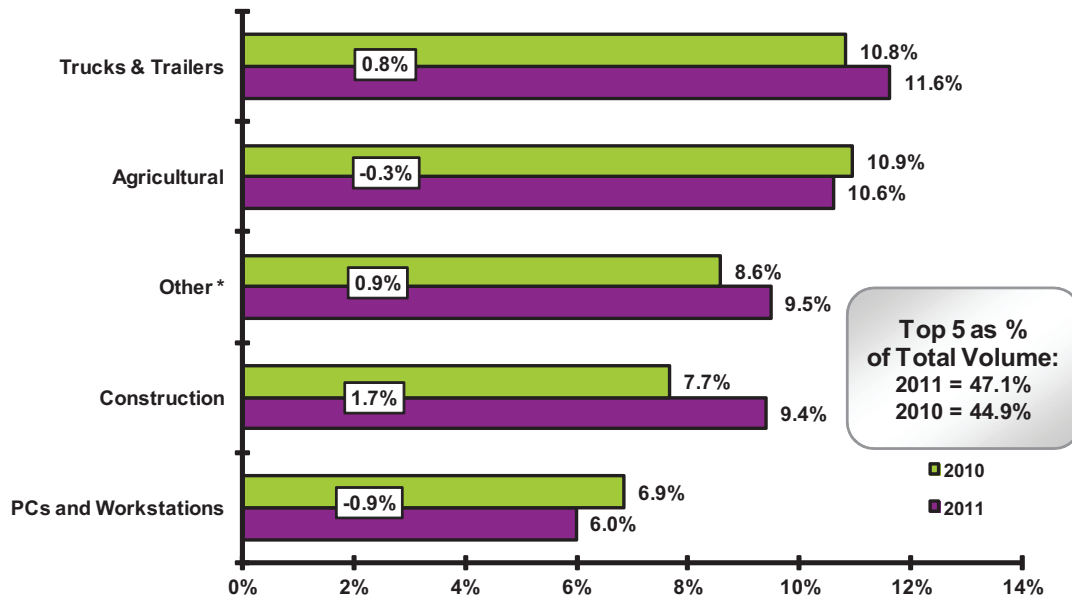


Note: Trend data is provided only for respondents who reported both years of data
 Source: 2012 ELFA Survey of Equipment Finance Activity

From an end-user perspective, the top-five end-user industries generated 56% of new business volume in 2011, a very slight increase from 2010 (Figure 14). Even among the largest end-markets, growth was uneven. Industrial manufacturing experienced a strong increase in market share in 2011, increasing to 13.8% of total new business volume, and overtaking non-health services as the top end-user industry. Industrial manufacturing was one of the strong points of the U.S. economy in 2011, as the U.S. industrial production index expanded by 4.1% and export growth increased by 6.7%. Non-health services and agriculture, forestry, and fishing each experienced declining market share in 2011. Severe drought conditions in the Midwest United States during the summer of 2011 may have contributed to the declining market share for agriculture, forestry, and fishing.

As a percentage of total new business volume, construction equipment experienced the largest gain in market share among the top-five equipment categories in 2011, increasing to 9.4% (Figure 15). Construction investment was partially driven by renewed growth in the multi-family housing segment. Multi-family housing starts were particularly strong in 2011, expanding 55.8% over 2010. Trucks and trailers equipment, the largest equipment category, expanded its market share to 11.6%. Much of the gain for trucks and trailers equipment may be attributed to the replacement cycle, as the transportation equipment class had an average age of 8.2 years in 2010 (Table 1). PCs and workstations had the largest decline in market share among the top five, declining from 6.9% in 2010 to 6.0% in 2011. This is unsurprising as many borrowers choose to pay for PCs and workstations with cash, rather than financing. This was reflected in the Foundation borrower survey, which reported 59% of computer purchases were made with cash or credit card in 2011 (Figure 11A). The top-five equipment categories as a percent of total new business volume increased significantly between 2010 and 2011, expanding from 44.9% to 47.1%.

Figure 15: New Business Volume by Equipment Type (% Distribution over 2 Years)

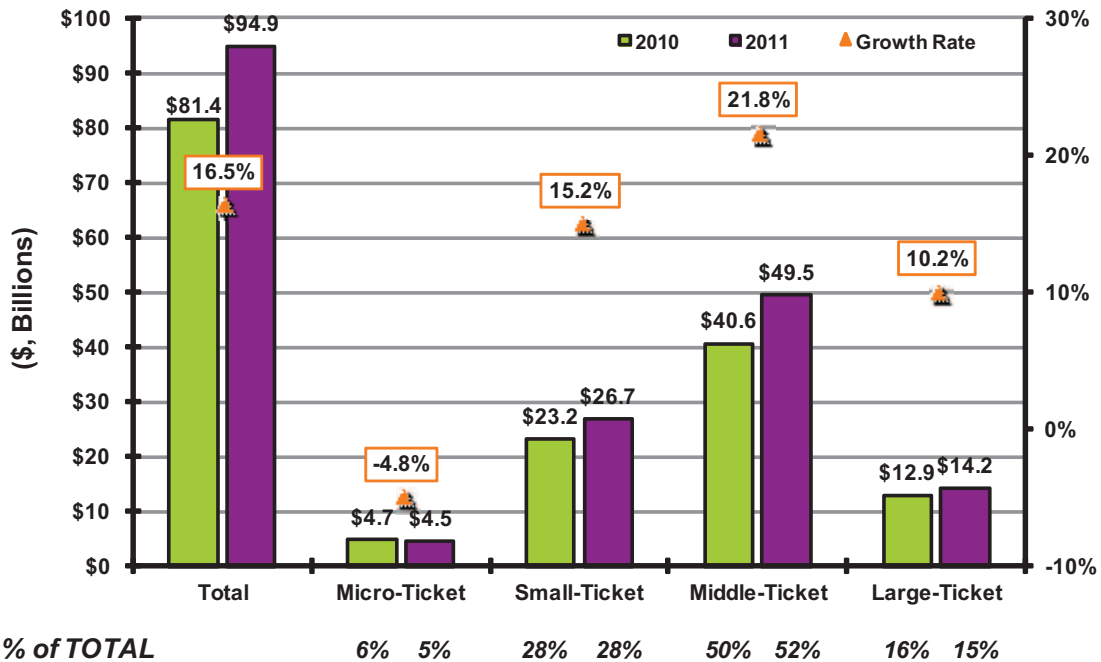


Note: Trend data is provided only for respondents who reported both years of data

Source: 2012 ELFA Survey of Equipment Finance Activity

*Other includes uncategorized or miscellaneous such as consumer goods and food processing industry.

Figure 16: Total New Business Volume by Market Segment

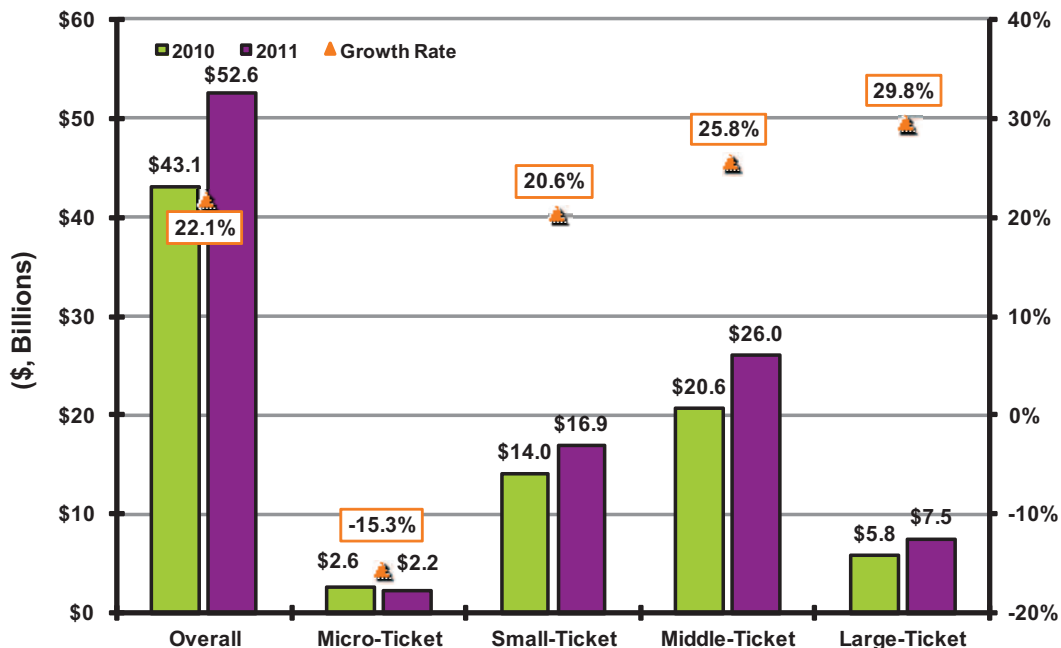


Source: 2012 ELFA Survey of Equipment Finance Activity

Figure 16 categorizes survey respondents into market segments based on the average transaction size of the majority of their new business volume. The respondent may be active in many market segments, but can only be categorized in a single-market segment for purposes of the survey. The micro-ticket segment contains respondents whose new business volume had an average transaction size under \$25,000. The other segments were categorized as small-ticket, between \$25,000 and \$250,000; middle-ticket, between \$250,000 and \$5,000,000; and large-ticket, over \$5,000,000.

As Figure 16 shows, middle-ticket financing experienced the largest gain in new business volume in 2011 with an increase of 21.8%. Along with the increased volume of middle-ticket financing, small-ticket and large-ticket financing expanded by 15.2% and 10.2%, respectively, in 2011. Micro-ticket financing, which made up 5% of total new business volume, suffered a 4.8% loss in new business volume in 2011 compared with the prior year. This is indicative of the difficulty small companies have had during the recovery.

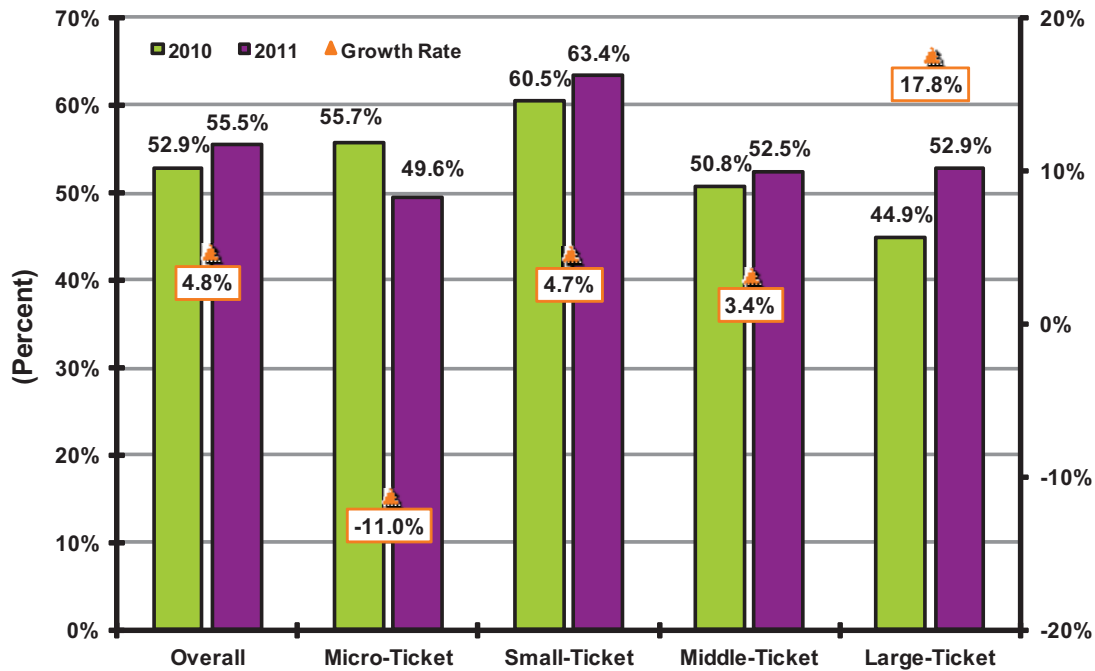
Figure 17: New Business Volume Booked through Loan Financing



Source: 2012 ELFA Survey of Equipment Finance Activity

Loan financing includes conditional sales agreements as well as traditional loans. In 2010, survey respondents reported booking \$43.1 billion in new business volume through conditional sales agreements and traditional loans (Figure 17). In 2011, new business volume booked through these same products increased 22.1% to \$52.6 billion. The increased volume of “non-leasing” products in 2011 was spread across three of the four transaction sizes, while micro-ticket transactions booked through loan financing fell to \$2.2 billion, from \$2.6 billion in 2010 (a 15.3% decrease). Tougher credit requirements, along with weak economic conditions may have contributed to the decline in the micro-ticket market which largely caters to small businesses.

Figure 18: Loan Financing as a Share of Total New Business Volume



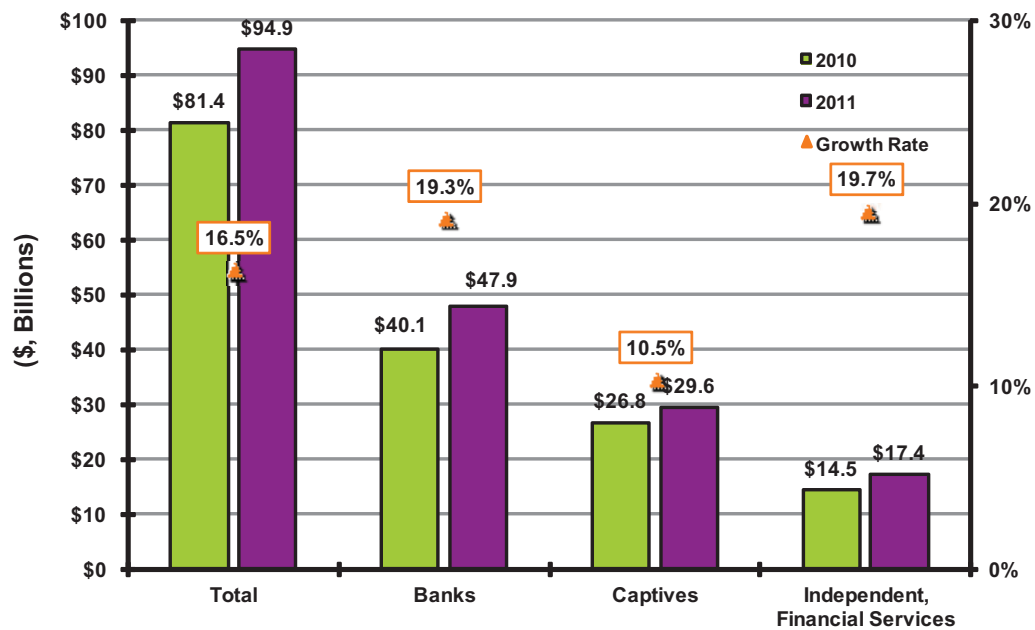
Source: 2012 ELFA Survey of Equipment Finance Activity

New business volume booked through loan financing as a share of total financing grew from 52.9% in 2010 to 55.5% in 2011, an increase of 4.8% (Figure 18). The share of loan financing for the micro-ticket market fell from 55.7% in 2010 to 49.6% in 2011. The micro-ticket market had the smallest share of loan financing as a percentage of total new business volume in 2011. Loan financing for the small-ticket market has the largest share of total new business volume at 63.4%. The large-ticket market saw the largest increase in loan financing share, growing 17.8% from 44.9% in 2010 to 52.9% in 2011.

The survey results indicate increased opportunities in 2011 versus 2010.

In summary, new business volumes have increased for both lease and loan products, as well as for several segments of the equipment finance market. The market continues to be dominated by large companies. The middle-ticket market is the largest market by volume for lease and loan products, while the micro-ticket market is small and, while still growing, represents a smaller percent of overall financing activity.

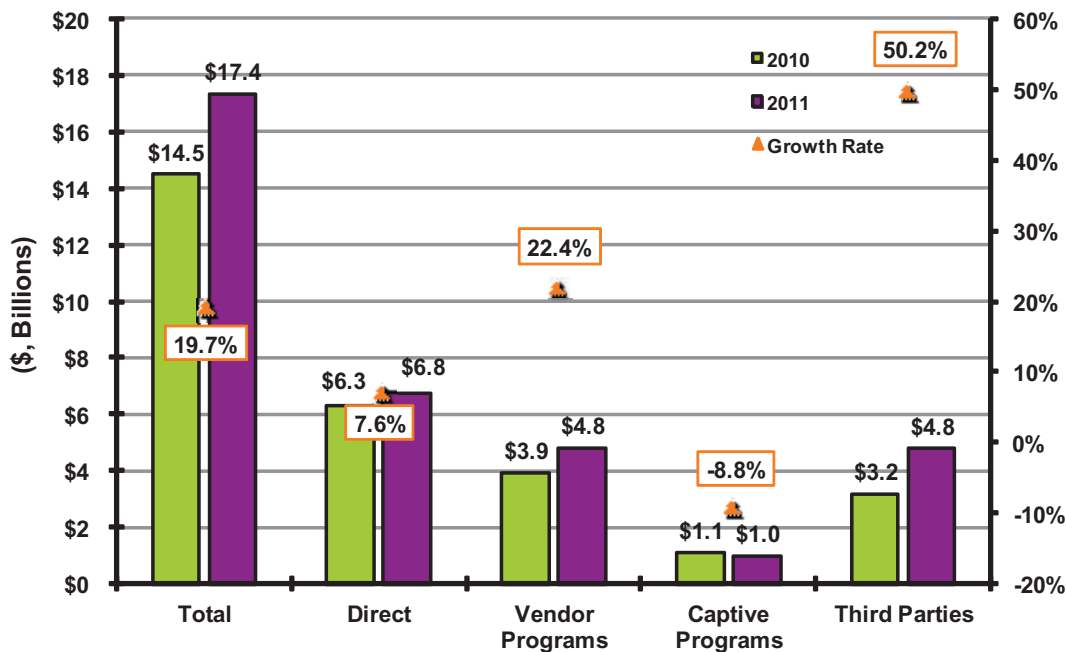
Figure 19: New Business Volume by Lender Type



Source: 2012 ELFA Survey of Equipment Finance Activity

The equipment finance industry is bouncing back after a difficult string of years. For those lenders reporting to the SEFA survey, total new business volume expanded 16.5% in 2011 to \$94.9 billion (Figure 19). New business volume increased in 2011 in all three organization types. Banks continue to be the largest lender by volume and experienced a 19.3% increase in 2011. The high level of bank volume coincides with the results of the 2012 Foundation survey, although not to the same degree. The variation between the surveys could potentially be due to a self-reporting bias, as borrowers may have misclassified their loans. While the borrower survey reported 57% of lending was conducted by banks, respondents to the Survey of Equipment Finance Activity reported that banks contributed 51% of lending volume in 2011. Captives did not fare as well as other organization types. In 2011, new business volume for captives expanded to \$29.6 billion. Captives may have benefited from strong growth in software and a rebound in construction equipment growth. Independent/financial services organizations had the strongest year-over-year growth in 2011, increasing 19.7%; nonetheless, new business volume remains well below the pre-recession level. Independents have gained market share from banks in niche segments, trucks and trailers, and higher-credit-risk segments, such as retail. The advantage of Independents in the trucks and trailers segment is of particular note, as many banks choose not to participate in this market.

Figure 20: Independent/Financial Services New Business Volume

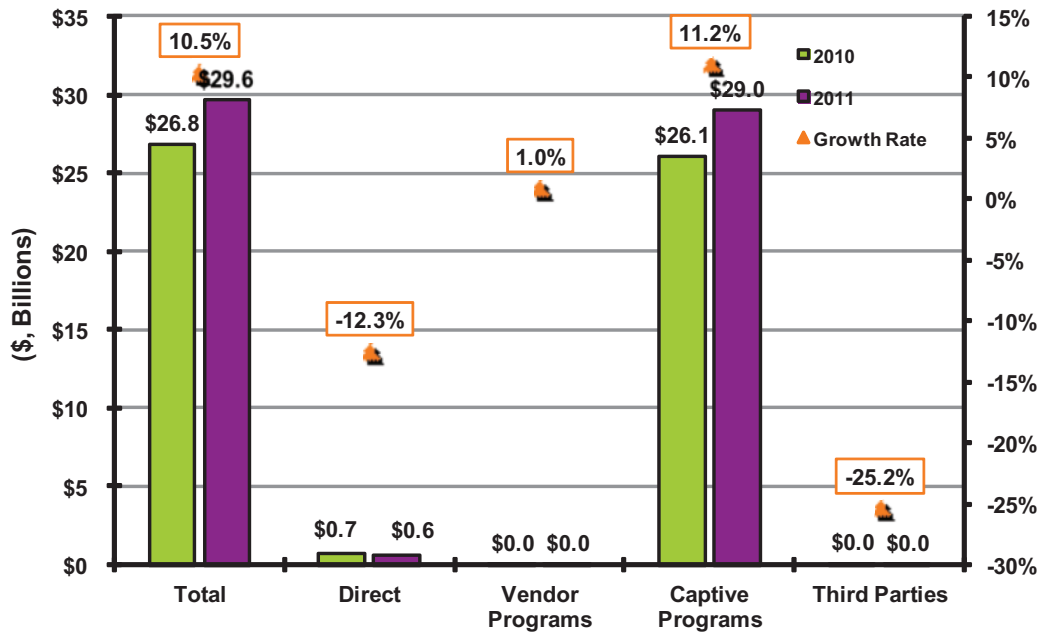


Source: 2012 ELFA Survey of Equipment Finance Activity

The competitive landscape for independents has changed significantly since the pre-recession years. The flexibility and service provided by independent finance companies were frequently noted as significant competitive advantages. In addition, their structuring capabilities provided an advantage over captives, and their asset-management skills were an advantage over banks. Independents did much of their business with smaller, somewhat riskier businesses, which may have made them more vulnerable to the economic downturn and related funding challenges than banks, which had the benefit of more diverse revenue streams and a steady flow of funding.

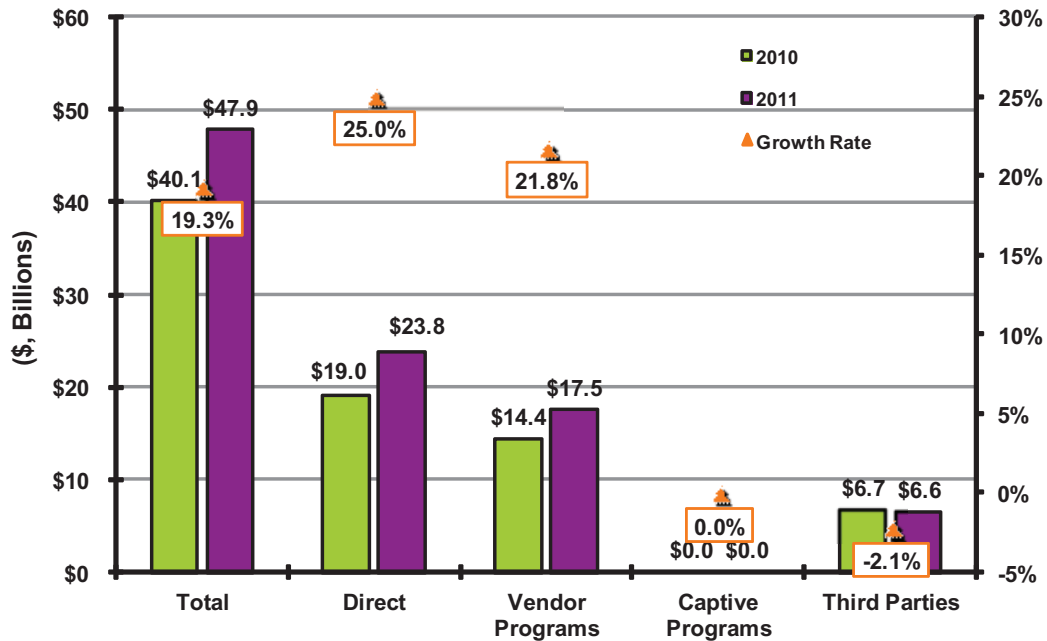
Captive and vendor programs have long been considered an area of opportunity for independents. Small independents targeted small manufacturers that lacked the scale and capabilities to create their own captive finance units, and were less attractive to larger independents because of their low volume. In recent years the financing of captive programs by independent/financial services organizations has fallen considerably – offset by a significant increase in non-captive vendor programs. In 2011, new business volume for captive programs declined 8.8% to a mere \$1.0 billion (Figure 20). Vendor programs picked up in 2011, increasing by 22.4%, but volume of \$4.8 billion remains well below pre-recession levels. Direct originations by independents have had the biggest drop since the recession. New business volume originated directly from end users stood at just \$6.8 billion in 2011, compared to \$22.1 billion in 2006. While the decline in volume may be exaggerated by changes in the sample between the surveys, the size of the shift is particularly notable. Although still at a relatively low level, direct originations saw a 7.6% year-over-year increase in 2011, indicating some recovery for independents in this channel. Likewise, a significant lift in indirect originations may signal a revival of broker originated business.

Figure 21: Captives New Business Volume



Source: 2012 ELFA Survey of Equipment Finance Activity

Figure 22: Banks New Business Volume

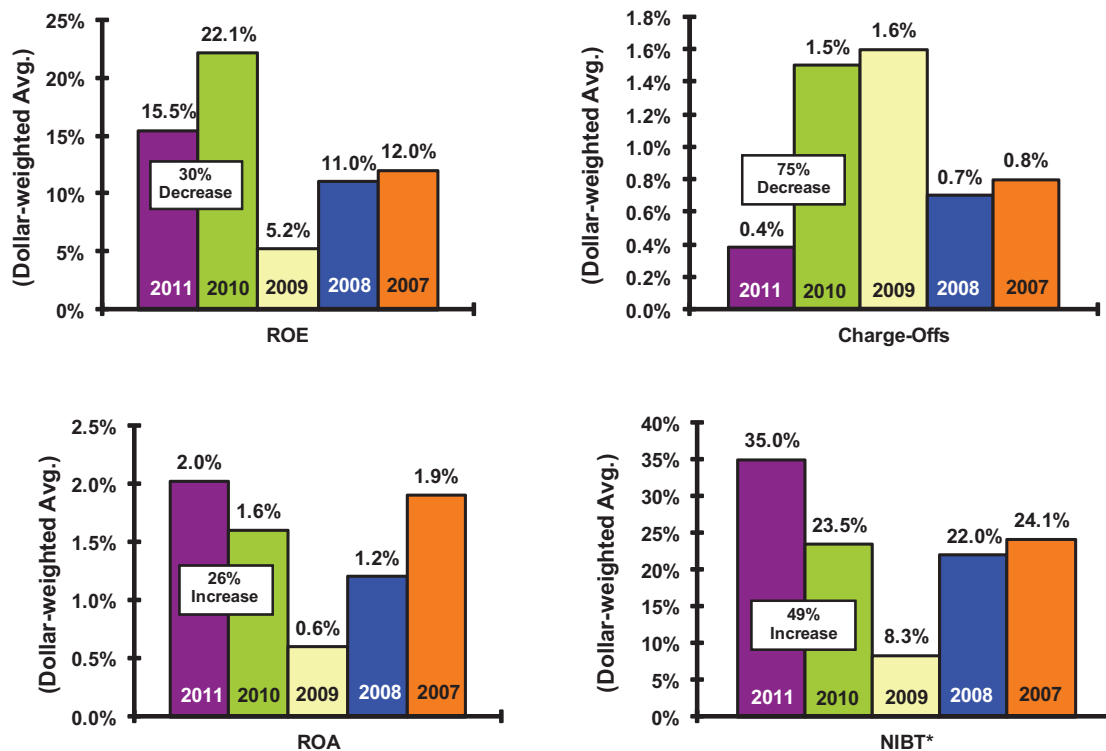


Source: 2012 ELFA Survey of Equipment Finance Activity

While Independents remain well below pre-recession levels for new business volume, captives (Figure 21) and banks (Figure 22) have held up relatively well. New business volume for captives expanded by 10.5% in 2011, reaching \$29.6 billion for the year. Meanwhile, banks experienced a 19.3% increase in new business volume in 2011, with the strongest growth coming from direct programs. Banks saw a 2.1% decline in programs originated through third parties, which was a particularly strong growth area for independents in 2011 (Figure 20). New business volume for captives is primarily conducted through captive programs and they have very little involvement in other programs.

Industry Financials

Figure 23: Five-Year Historic Financial Indicators

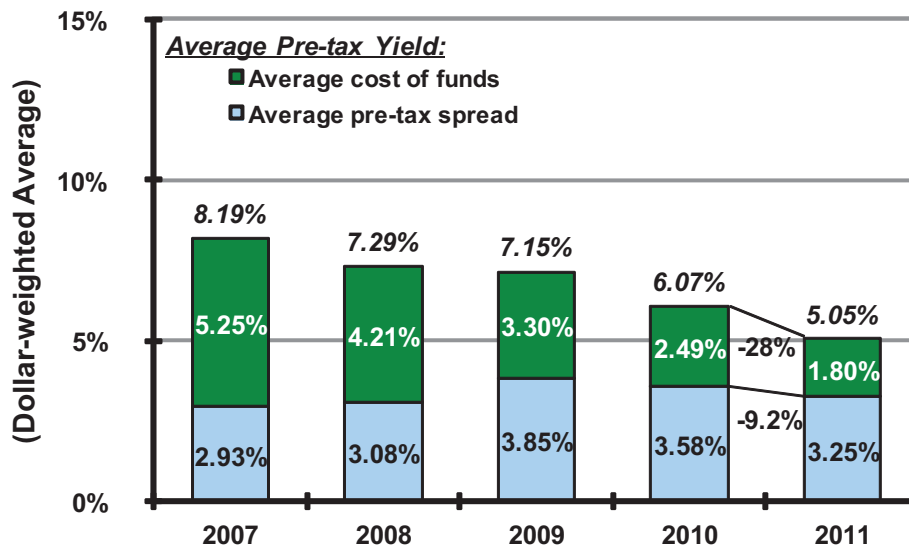


* As a percentage of total revenue
 Source: 2012 ELFA Survey of Equipment Finance Activity

Following the collapse of asset values in the financial market crisis of 2008, loan default rates in the equipment finance industry peaked at 1.6% in 2009. With profits falling quicker than the value of the assets, the return on assets earned by the industry lenders fell to 0.6% in the same year. Rapidly deteriorating balance sheet asset values have triggered the deleveraging wave that swept through the system eroding equity and driving many financial institutions into the red. By 2010, the financial system began to see some balance sheet improvements. With the help of the government’s T.A.R.P. program, the financial sector has written off most of the non-performing debt. The profits made on the good assets and divided by a smaller asset base have yielded strong improvements in the asset returns. Lower equity prices and higher profits, in turn, led to a sharp improvement in the equity return ratios. While financial sector’s profits continued to improve in 2011, the

value of the equity recovered relatively quicker. With less leverage and more equity on the balance sheets, average returns on equity showed a decline. Yet, as lending standards remained tight, the increase in profits was not accompanied by a significant increase in assets. As a result, the returns on assets have continued to grow into 2011. Net income before taxes (NIBT) as a percentage of revenues increased to 35.0% in 2011, based on an average of all respondents' pre-tax income weighted by their total dollar new business volume—this is well above percentages seen over the past five years. With the cost base at such low levels, recent volume increases have had a beneficial impact on profits. As volume growth slows, the impact of prospectively thinning spreads has the potential to take a toll on profits. Furthermore, with charge-offs at historic lows, provisions will increase at some point instead of being released. As a result, the equipment finance industry will be looking for new ways to continue to cut costs and add value to optimize returns.

Figure 24: Pre-Tax Yield, Cost of Funds, and Pre-Tax Spread



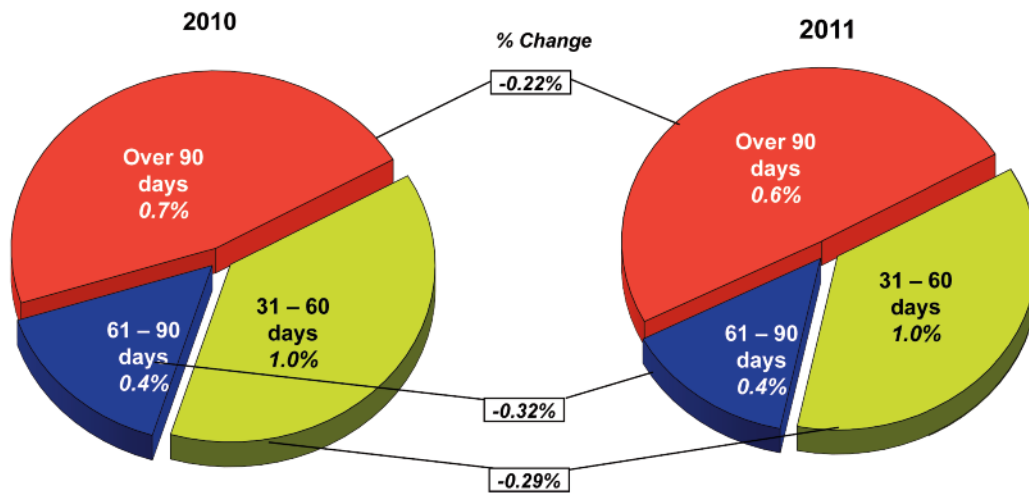
Source: 2012 ELFA Survey of Equipment Finance Activity

The average pre-tax yield has declined steadily since 2007 and stood at 5.1% in 2011 (Figure 24). The average pre-tax spread spiked in 2009, likely due to a lack of liquidity. The pre-tax spread has fallen since 2009, while the average cost of funds dropped significantly from 5.3% in 2007 to only 1.8% in 2011.

Credit Quality

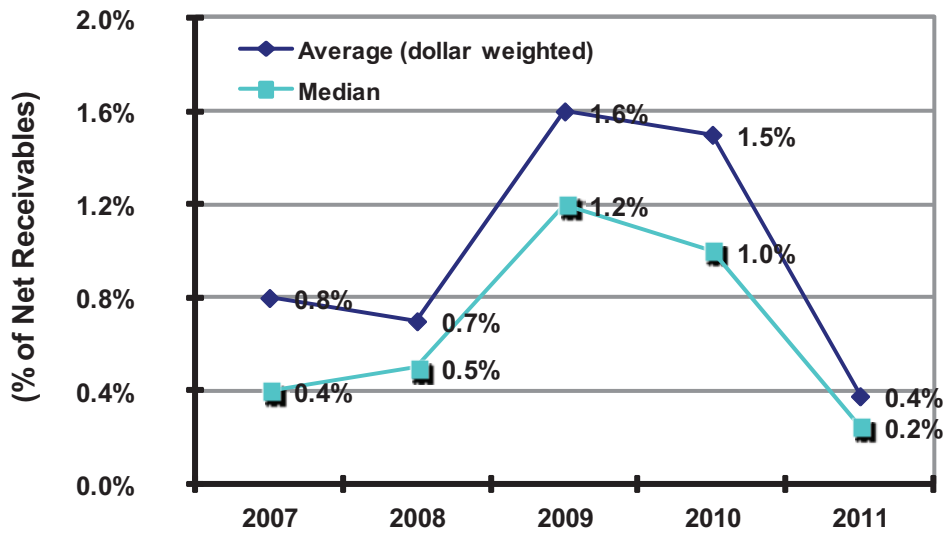
In 2011, 98.6% of average net investments were current (less than 30 days past due). Overall, credit quality has improved slightly since 2010. Delinquencies, measured as receivables over 31 days, declined 0.3% in 2011 (Figure 25). Receivables over 90 days declined 0.2%, while delinquencies of 61 to 90 days and 31 to 60 days each declined 0.3%. The lower rate of delinquencies suggests there is still some longevity left to charge-offs levels which are already at a five-year low (Figure 26).

Figure 25: Accounts Receivable Aging (Over 31 Days)



Source: 2012 ELFA Survey of Equipment Finance Activity

Figure 26: Full-Year Loss (Charge-Offs), Five-Year History



Source: 2012 ELFA Survey of Equipment Finance Activity

Average charge-offs declined to only 0.4% of net receivables, compared to 1.6% and 1.5% in 2009 and 2010, respectively (Figure 26). Median charge-offs fell to a mere 0.2% in 2011. This suggests that lenders may be poised to ease credit standards once economic conditions strengthen.

Accounting and Regulatory Issues

Over the past several years, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been working to develop a new regulatory model that would transform lease accounting rules. Under the rules proposed as of the date of this study, operating leases, which are currently treated as rental expense in the income statement, would be capitalized (as both a liability and an asset) and added to the lessee's balance sheet. IHS recently conducted a study on the economic impact of the proposed changes to lease accounting standards. The study found that operating lease capitalization may increase the cost of leasing and result in a permanent reduction in equity for U.S. companies; however, based on the feedback received by FASB/IASB, many companies view the proposed regulatory changes positively. The main concerns center on the specifics of the new accounting methods, the cost of reprogramming information technology (IT) systems, and the impacts on the existing debt covenants. One of the main controversies is the proposal for accelerated method of lease accounting that will likely be applicable to most long-term equipment leases. This method will result in the front loading of lease expenses, which will increase liabilities relative to assets in the earlier years of financing. Companies that are most affected by the change will likely attempt to pass the increased costs of lease financing onto their customers or to structure their leases in ways that will minimize the impact of the new rules.

While balance sheet dynamics will change permanently with more assets, more debt, and less equity reported, the new accounting method is unlikely to seriously affect the size of the underlying equipment investment market. For most companies, the decision to acquire equipment ultimately depends on the demand for their products. As long as demand continues to grow, companies will make the necessary investments to ensure they produce enough to meet their market's needs. Based on the weighted responses from the 2012 Foundation survey, only 6% of companies think the elimination of off-balance sheet financing will have an impact on their decision to lease additional equipment in the next 12 months. The other 94% are more concerned with general economic conditions, credit market accessibility, taxes, technological advancements, and other issues.



While the proposed accounting rules will change how leases are recorded on corporate balance sheets, they will not affect the definition of leasing. Equipment leasing will continue to provide companies with many of the same benefits as in the past, such as no initial capital outlay, soft costs financing, easier upgrades, etc. On the other hand, if the perceived costs of longer-term leasing begin to seem higher, companies may try to switch to the shorter-term lease agreements or opt out of leasing in favor of purchasing. This means the proposed accounting rule changes may alter the way lessors and lessees interact and the type of financing companies prefer, but not the amount they choose to invest.

Short-Term Outlook for Equipment Finance

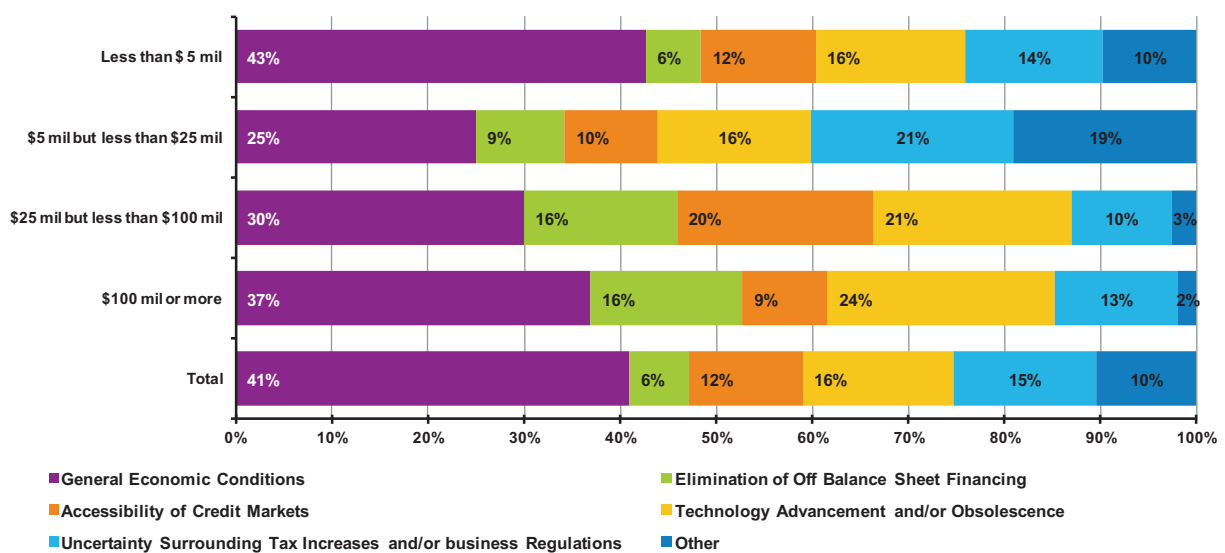
Multiple Factors Drive Investment Trends over the Next 12 Months

In order to obtain a deeper understanding of the equipment investment market and to identify what drives the investment decisions of companies, IHS surveyed companies on their opinions about the future. Businesses were asked to provide their opinion on the most important factors affecting their equipment investment decisions and to indicate whether or not they are planning to increase equipment investment in the upcoming year.

When presented with a list of potential factors that will drive future investment decisions, the overwhelming response was “general economic conditions”. Other factors that consistently influence future equipment spending are technological advancement and/or obsolescence, uncertainty surrounding tax increases and/or business regulations, and accessibility of credit (Figure 27).

The size of the business respondents also played an interesting role in shaping perceptions for future spending. “General economic conditions” were the number one driver for all company size

Figure 27: Which of the Following External Factors Will Have the Greatest Influence of Your Company’s Decision to Lease or Finance Additional Equipment in the Next 12 Months?



Source: Foundation surveys

classes, but it is particularly important to small companies that have less than \$5 million in sales. Another notable finding from this question was that for companies with sales of \$25 million or more, the second-most-important factor was keeping up with general technological advancements or obsolescence. In other words, larger companies appear to be most concerned about the possibility of losing productivity due to reliance on aging or obsolescent equipment.

As far as future equipment investment goes, the elimination of off-balance sheet financing is generally further down the list of influencers. This may be attributable to the fact that the off-balance sheet financing issue has been well vetted by the industry at this point. The companies that demonstrated the most sensitivity to the pending accounting changes were those with sales greater than \$25 million. Off-balance sheet financing allows companies to finance equipment without bearing the cost of increased corporate leverage. Large companies that tend to be relatively more dependent on the capital markets may see the cost of their debt increase once off-balance sheet financing is eliminated. Therefore, it is not surprising that larger companies are more concerned with the elimination of off-balance sheet financing.

Economic Outlook

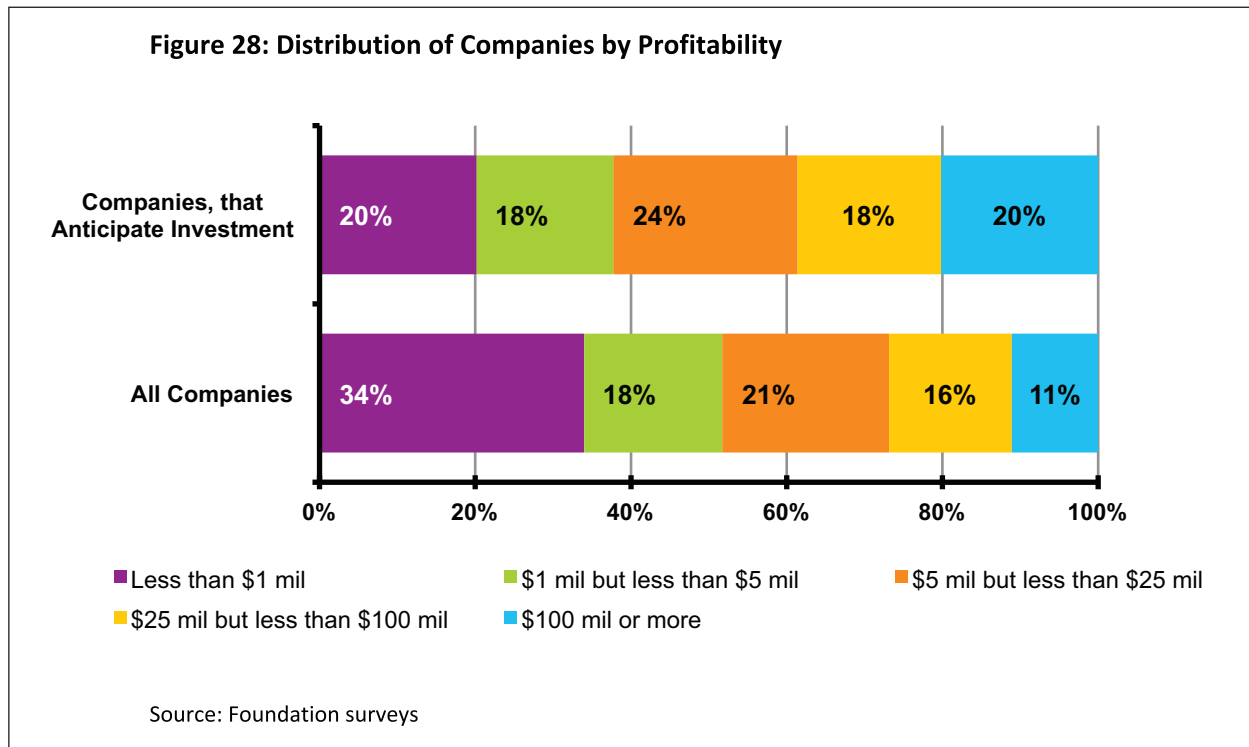
The economic recovery can be best characterized as possessing weak momentum that has not ground to a halt. Exports and business fixed investment—two key drivers of the recovery thus far—have run out of steam in the face of global economic headwinds and domestic policy uncertainty. A combination of slower growth around the world and a stronger U.S. dollar is dampening U.S. export growth. Business fixed investment, the second key driver of the U.S. recovery, is also weakening. IHS expects business fixed investment will have dropped in the third quarter of 2012, the first decline since the recovery began.

“...uncertainty over fiscal policy is likely to remain a fact of life—and a deterrent to risk taking.”

A deeper Eurozone crisis and a harder landing in China remain the principal global risks. The primary domestic risk is a policy mistake that fails to recognize the vulnerability of the U.S. economy. Budgetary wrangling that produces sharp cuts to domestic and military spending or steep tax hikes without a phased approach has the potential to push the economy into a recession.

Both fiscal and monetary policy will play a significant role in future path of the economy. IHS assumes the a policy mistake will be avoided and that the new congress and President Obama will eventually produce a compromise involving spending cuts and tax increases—phased in over many years—to replace what would be a catastrophic fiscal tightening. In addition, IHS expects that in the continued effort to stimulate the economy, the Federal Reserve will expand its QE3 program of asset purchases in 2013, and that it will keep the federal funds rate near zero until mid-2015, in line with its latest guidance. Even though IHS believes that the worst case scenario will be avoided, the extreme uncertainty over fiscal policy is likely to remain a fact of life—and a deterrent to risk taking—well into 2013. Real GDP is expected to grow only about 1.5% in the second half of 2012, and the IHS projection for 2013 is 1.8%.

Despite the sluggish near-term outlook, there are many reasons to be confident that growth will rebound at the tail end of 2013 or during 2014 once there is more clarity on the future course of macro and micro policies. There is growing evidence that households are primed to replace aging cars and to take the risk of buying a house. In addition, both the U.S. household and financial sectors have aggressively reduced their debt levels over the last four years. As this deleveraging process eases, consumers will funnel funds into spending, and banks will do more lending. Finally, the burgeoning energy boom in the United States will create thousands of new jobs in exploration and petrochemicals industries for some time to come.

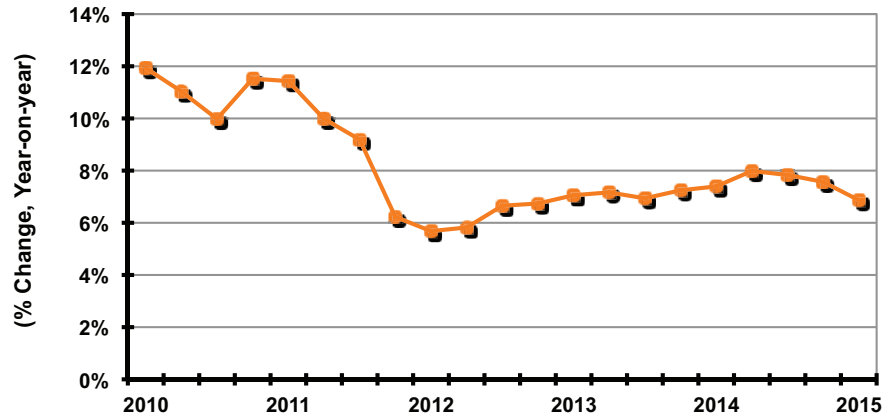


Opportunities and Risks

The 2012 Foundation survey asked respondents to indicate if they are planning to increase their equipment investment in the next 12 months. It is encouraging to note that even with the relatively high degree of uncertainty over the economy and regulations/fiscal policy, nearly 30% of the survey respondents indicated they anticipate an increase in equipment investment at their firm.

Who are these 30% that remain optimistic about future equipment spending? One thing we know from the survey is that this positive view was not shared uniformly across companies. When comparing the responses of those increasing investment to the overall distribution of companies participating in the survey, it is clear that large companies make up a disproportionately high share of this pool and that smaller companies are underrepresented (Figure 28).

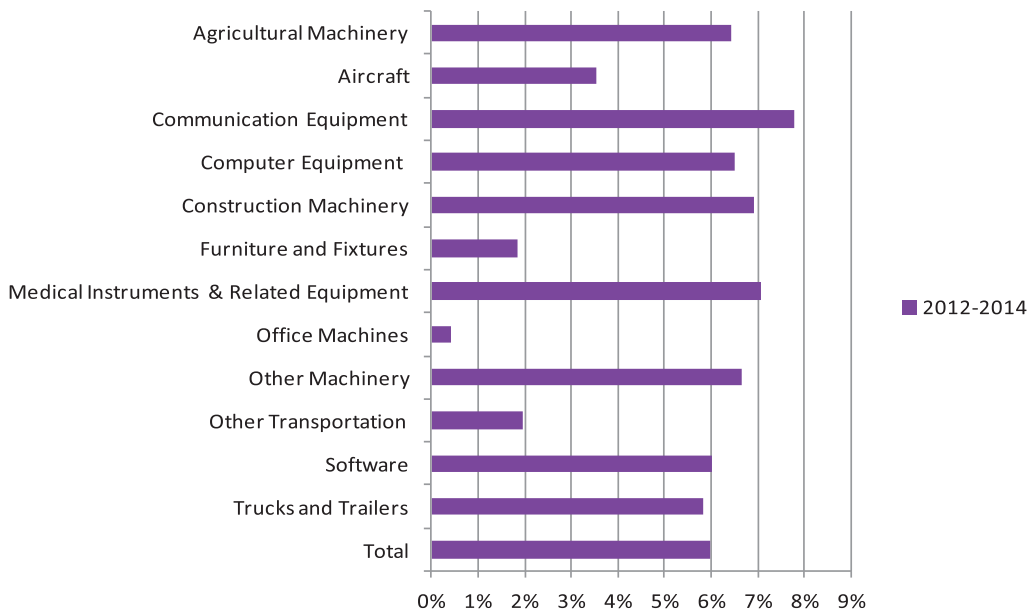
Figure 29: Total Real Investment for Equipment & Software



Source: IHS

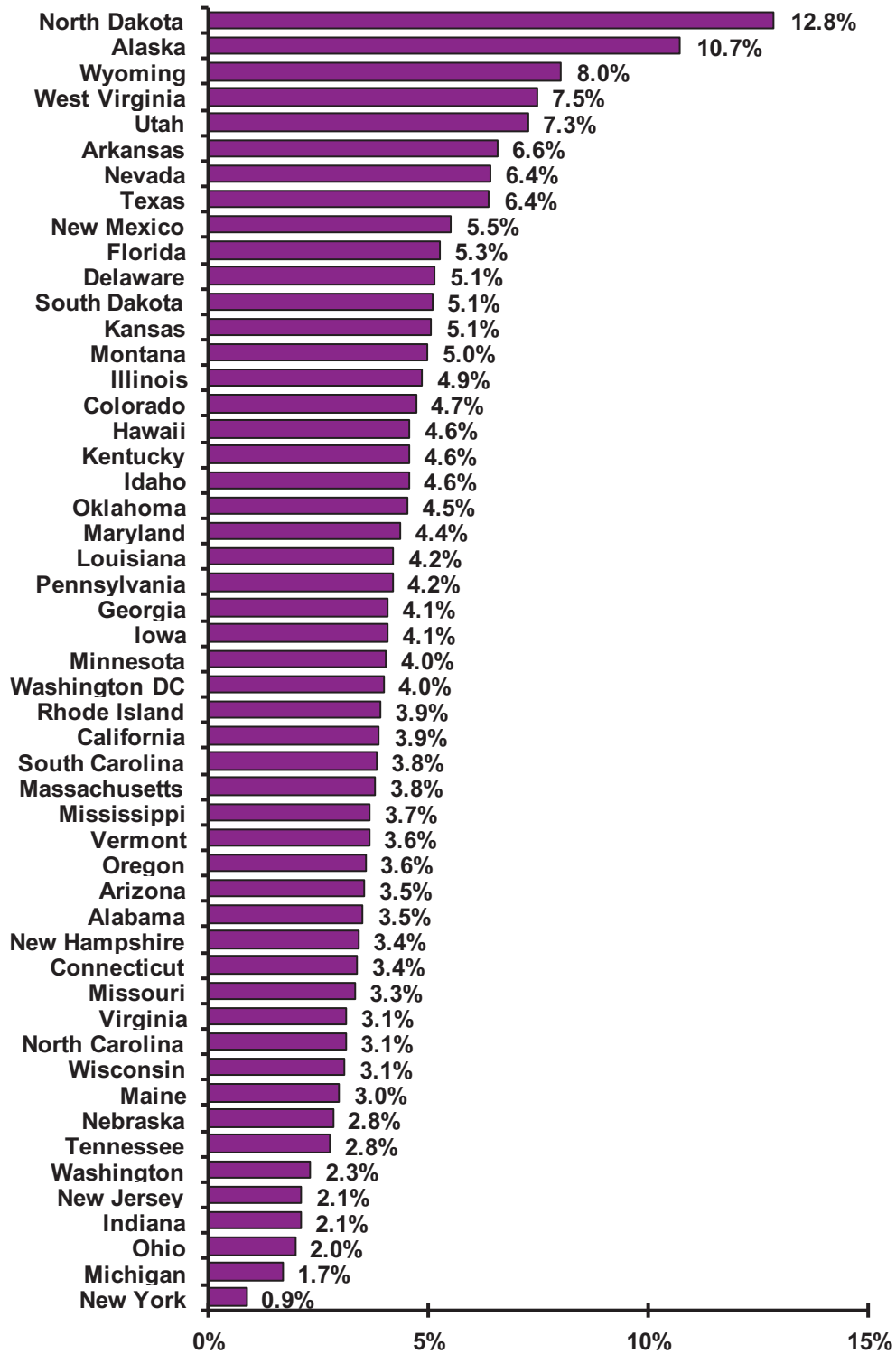
While past financing choices are not necessarily indicative of the future, a look into last year’s financing methods used by the companies that intend to increase financing next year may help to develop a better profile of “tomorrow’s investor.” A deeper look into this pool of anticipated investors reveals that nearly 29% of the last year’s transaction volume was financed through leases. Cash and credit financing represented 27% and 16%, respectively.

Figure 30: Equipment Spending Outlook by Equipment Type, Compound Annual Growth Rate (CAGR)



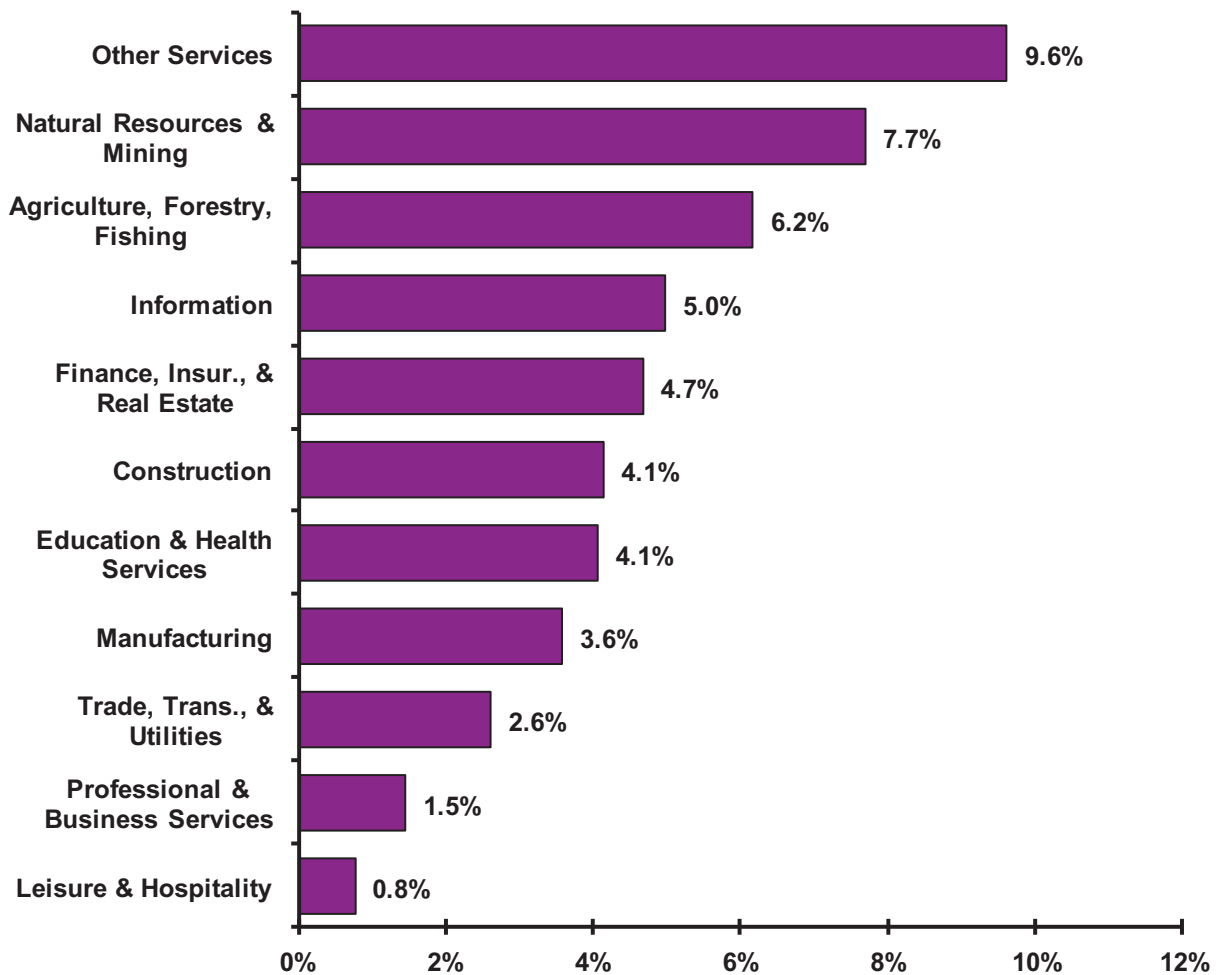
Source: IHS

Figure 31 : US Equipment Finance Outlook by State, 2012-15 CAGR



Source: IHS

Figure 32: U.S. Equipment Finance Outlook by End-User Industry, Projected 2012-15 CAGR



Source: IHS

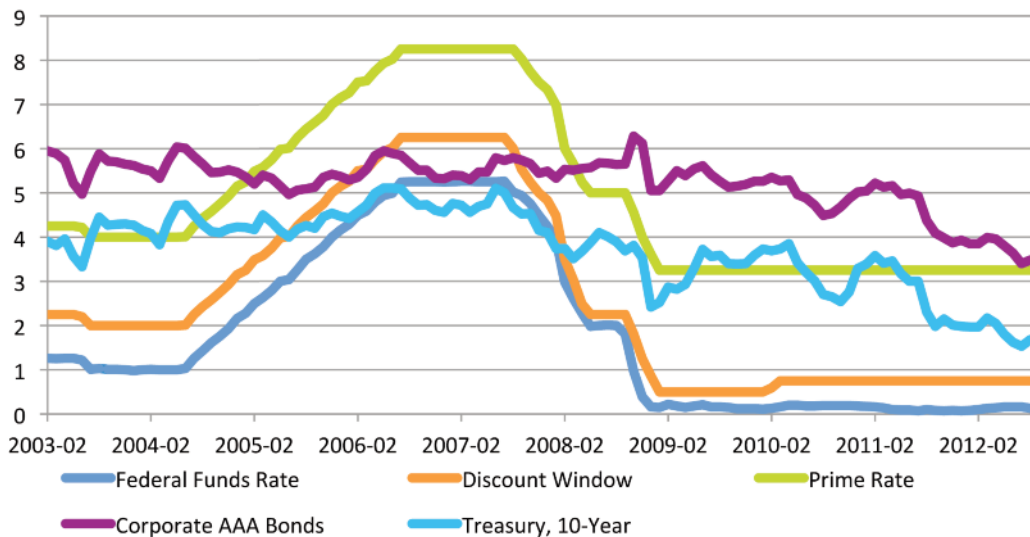
Recent economic trends also suggest that certain assets or equipment types are poised for higher growth. For example, the housing market is beginning to show real signs of improvement. Household formation is reviving despite sluggish employment growth, and the recovery in demand is spreading from rental units to the owner-occupied sector. IHS expects a 23% increase in housing starts in 2012, albeit from a low base, concentrated in the multi-family segment, where pent-up demand is helping the rental market. With housing prices going up and housing starts rising, the construction equipment market is likely to experience a boost in demand, especially in 2014 as the economic recovery gathers momentum.

While there is an overall moderation in equipment spending expected during the next two years (Figure 29), there are several asset types positioned for above-average growth (Figure 30). Most of this growth is apparent in equipment types experiencing rapid innovation, which stimulates replacement demand. IHS anticipates strong gains in electro-medical measuring and control instrumentation. Communications (wireless and broadband equipment), computer and software equipment will also be strong contributors to equipment spending.

Figure 31 captures equipment finance outlook on a state level. North Dakota is projected to have the strongest growth in equipment finance volume from 2012 to 2015, expanding at a 12.8% compound annual growth rate (CAGR). Growth in North Dakota will be driven by booming activity in the natural resources and mining sector. The Bakken shale formation in the northwest portion of the state has been the focus of a drilling bonanza, and oil production in the region has nearly quadrupled since 2005. Although equipment financing stood at a relatively low level in 2011 (Figure 9), it is an area of great opportunity.

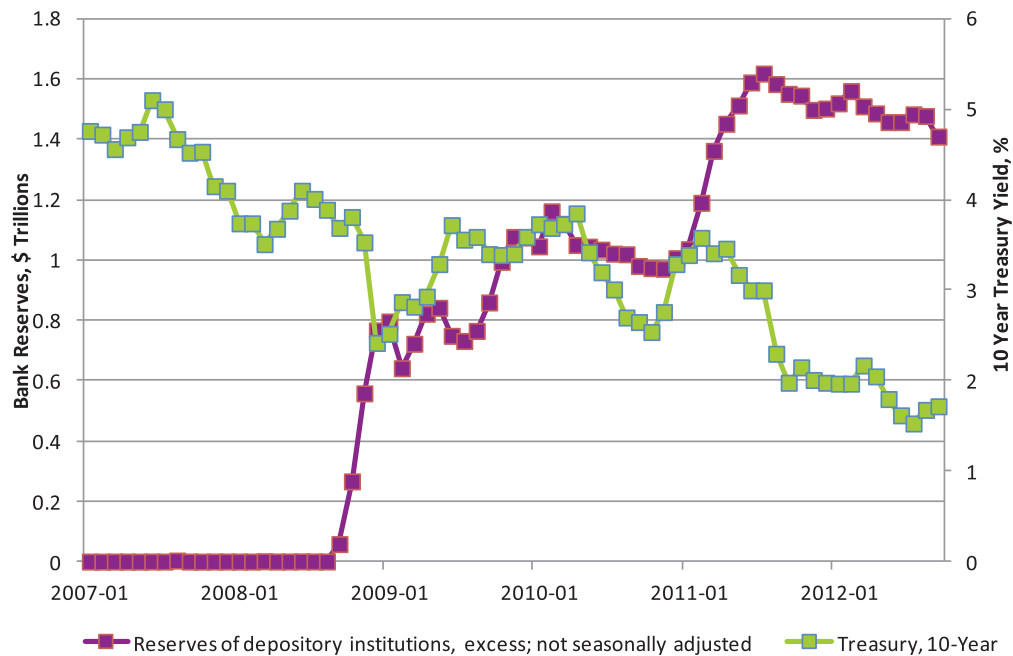
Meanwhile, California, which is the largest state by equipment finance volume, is forecast to expand by a CAGR of 3.9% from 2012 to 2015. Similar insights can be obtained by comparing the expected growth in finance volume by state in Figure 31 with the 2011 state finance volumes in Figure 9. From an end-user industry perspective (Figure 32), other services and the natural resources and mining sectors are projected to expand 9.6% and 7.7%, respectively, from 2012 to 2015. The largest end-user industry by volume, trade, transportation, and utilities, is expected to have a CAGR of 2.6% from 2012 to 2015. To get some perspective on the size of the other end-user industries, please refer to Figure 10.

Figure 33: Key Interest Rates (%)



Source: Federal Reserve

Figure 34: 10-Year Treasury Rate and Bank Excess Reserves



Source: Federal Reserve

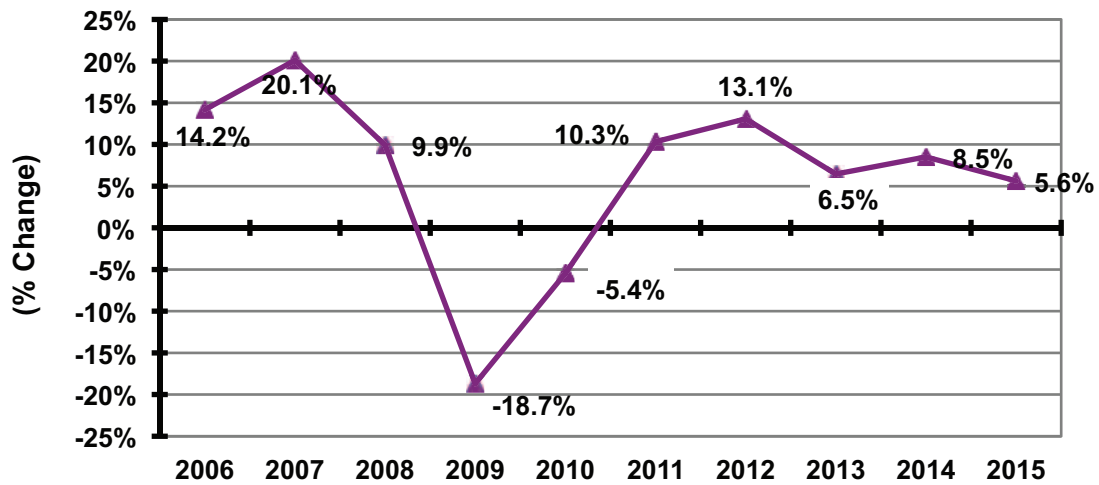
Capital Markets

Debt

The combination of slower global growth and a deepening Eurozone crisis has sent 10-year Treasury bond yields down, at times driving them below 1.5%. With the prime rate set at 3.25% and corporate AAA rated bond spread less than 180 basis points over 10-year Treasury, high-quality corporate debt is unprecedentedly cheap (Figure 33). The low interest rate environment not only reflects banks' low cost of debt and high excess reserves, but also points to a weak demand for credit from businesses, as well as relatively restrictive lending standards. The latter two factors, in turn, underline broader economic weakness.

The Federal Reserve is determined to continue supplying liquidity into the financial system. Thus far, however, large capital injections into the banking system and the low interest rate environment have only provided limited stimulus to the economy. Banks accumulated unprecedentedly high excess reserves (Figure 34), yet only a modest share of that capital flows to businesses and consumers in the form of credit. Regulatory uncertainties may also be a contributing factor to the moderate expansion of business credit. Business demand for capital remains constrained, as the fears of deflation, as well as political and economic uncertainties, deter large capital investment. According to the IHS Global Insight forecast, business credit growth is expected to slow to 6.5% in 2013, from 13.1% year-on-year growth in 2012 (Figure 35). The business credit measure includes more than just equipment finance and is a good proxy for broader capital market conditions.

Figure 35: Business Credit



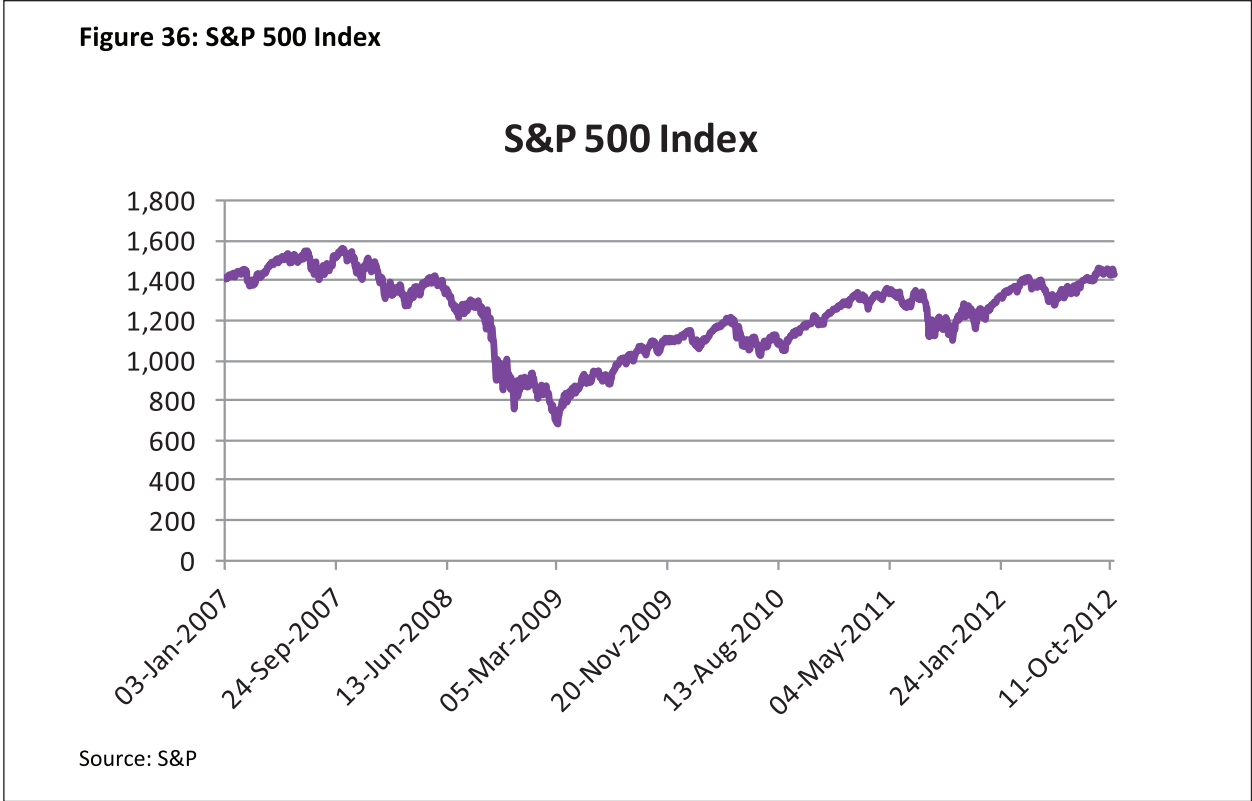
Source: IHS

Equity

On September 14, 2012, the day after the Federal Reserve announced the open-ended bond-buying program, the S&P 500 Index reached 1,465.77. This level was the highest since the beginning of 2008 and was 117% above the lowest point of 676.53 that the index hit on March 9, 2009 (Figure 36). With treasury yields near historic lows and more easing under way, it is not surprising that investors seek higher returns from equity markets. Foreign investors also perceive the U.S. stock market as a safe haven, which attracts foreign capital and increases the value of the U.S. dollar. Higher equity prices, in turn, improve corporate balance sheets, which attract more investment, helping companies open up avenues for additional equity and debt financing.

Despite stock market gains, investor confidence remains fragile. State Street Corporation publishes a monthly Investor Confidence Index that assesses investors' appetite for risk by analyzing the buying and selling patterns of institutional investors. In September 2012, the Investor Confidence Index plunged to 81.1, which is only slightly above the year's low of 80.8. The uncertainty and the underlying economic weaknesses at home and abroad deter further flow of funds into the equity markets. In this type of environment, companies are more hesitant to take on additional debt. As a result, larger companies may be more inclined to draw down some of their cash reserves to finance necessary equipment purchases.

Figure 36: S&P 500 Index



CONCLUSIONS

The equipment finance market has emerged from the great recession with renewed vitality. Finance volumes are at all-time highs, the return on assets is at a five-year high, and the charge-off rate is at a five-year low. Banks have taken a more prominent role in the market, but there are still many viable market segments where captives and independents have excelled.

While the future is very promising for the industry, the study suggests that finance volumes will expand at a more moderate pace for the next 12–18 months. IHS expects the growth in public and private investment in equipment and software to slow from 10% in 2011 to 7% in 2012. Uncertainties around the economy and future business conditions will hamper spending in the first half of 2013. As a result, overall growth for the year will slow to 5% and then accelerate to 7% in 2014. Companies will remain cautious about taking on the risks associated with large capital investments until after the important decisions impacting short and long term fiscal stability have been made.

In addition to investment spending growth slowing down, select segments of the market are expected to adjust their financing behavior. Based upon the findings of the 2012 Foundation survey, the financing decisions of smaller companies are especially sensitive to general economic conditions. Even though this segment relies heavily on cash to finance their equipment purchases, it represents a significant share of the overall market. A contraction in this segment of the market will pull down overall market volumes.

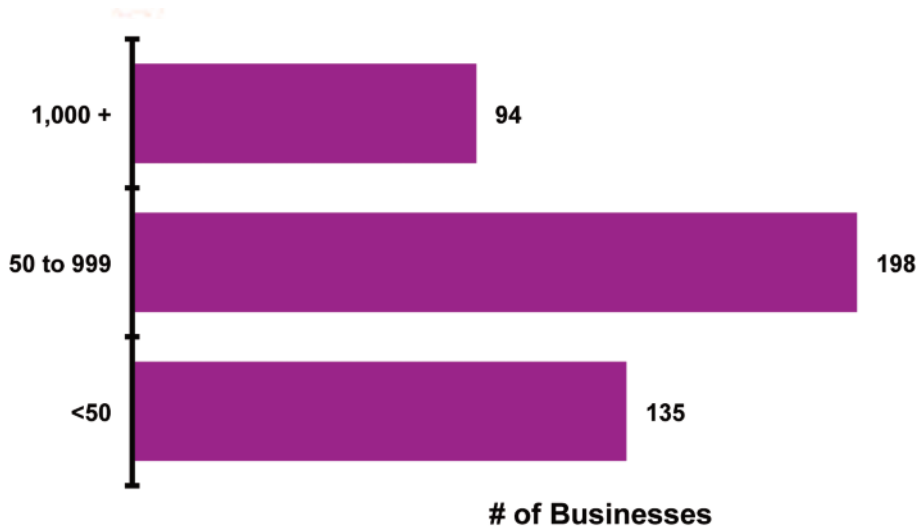
In addition, the survey findings suggest that it is primarily larger businesses who anticipate increasing their equipment spending over the next 12 months. With slowing earnings growth, this segment of the market may have a greater incentive to utilize cash reserves to help finance their equipment purchases. As a result, overall finance volume growth is expected to trail equipment investment growth with gains of 2% and 5% in 2013 and 2014, respectively.

As the economy gathers momentum and the path to fiscal stability becomes clearer, there will be a gradual easing of lending standards for large and medium enterprises, as well as an improvement in business credit demand. The equipment financing industry will remain an important source of funding for business expansion and equipment upgrades.

APPENDIX

Responses were collected from 427 businesses, of which 372 acquired business equipment in 2011.

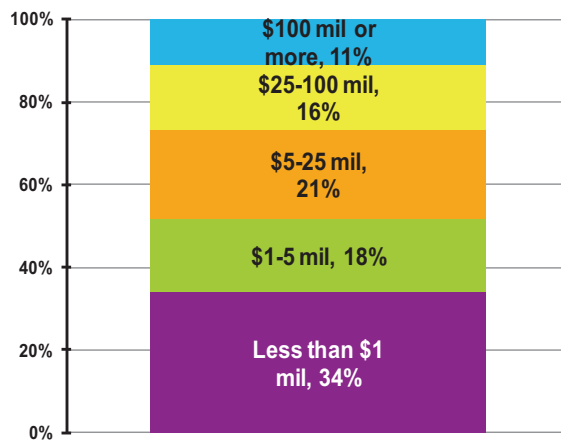
Figure A: Number of Companies in the Sample by the Number of Employees



Source: Foundation surveys

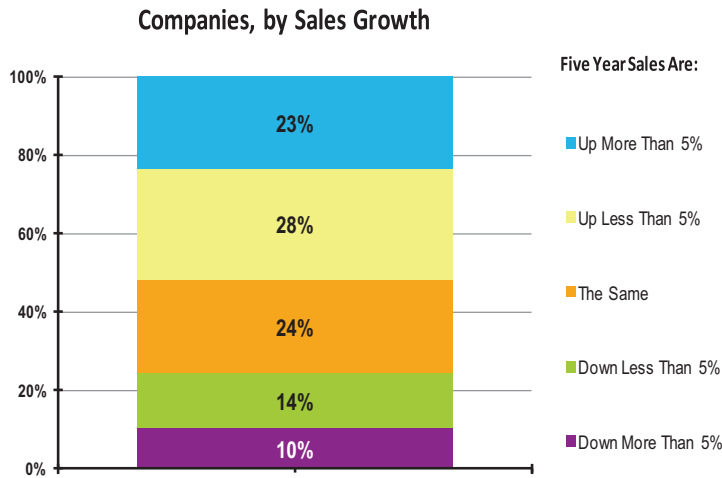
Figure B: Sample Companies by Sales Volume

Companies, by Sales Volume



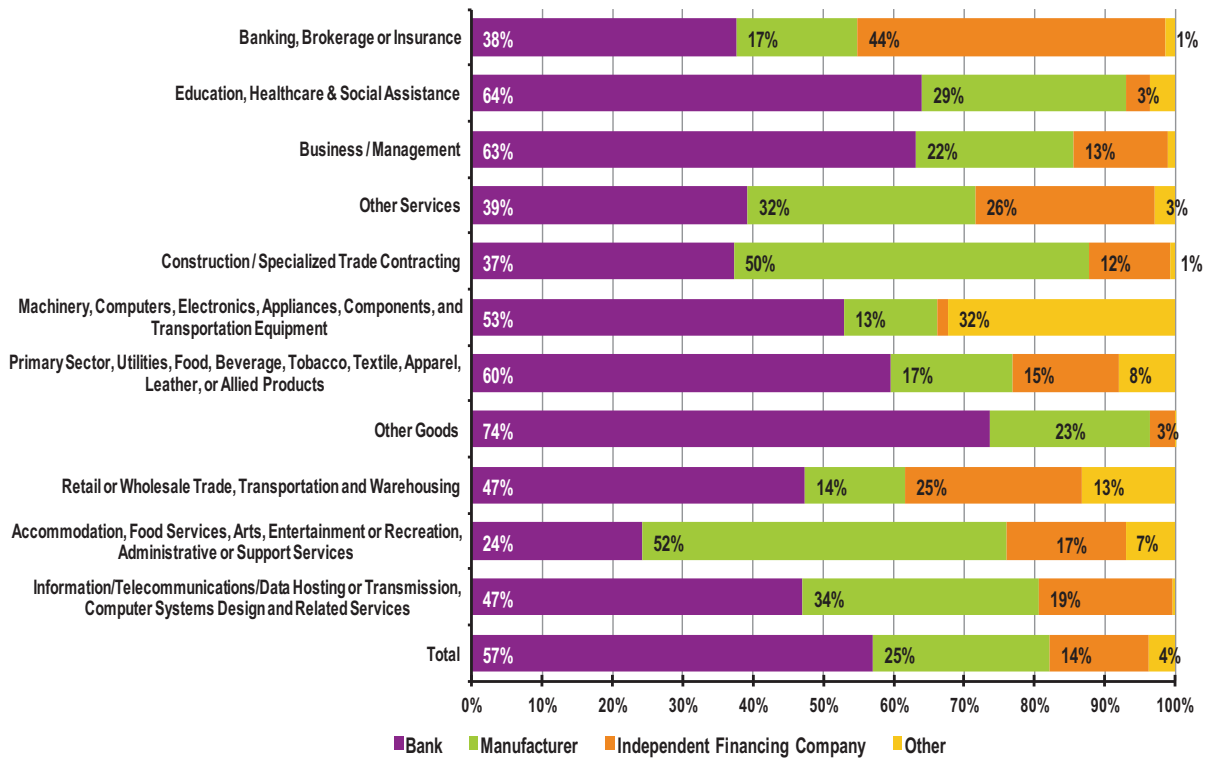
Source: Foundation surveys

Figure C: Companies by Sales Growth



Source: Foundation surveys

Figure D: Lenders by Industry



Source: Foundation surveys

Equipment Investment Categories Tracked by the Foundation Survey

(responses included relevant bundled soft costs)

1. Communication equipment
2. Computer equipment
3. Agricultural machinery
4. Construction machinery
5. Other machinery (machine tools, material handling, mining, printing, etc.)
6. Furniture and fixtures
7. Medical instruments and related equipment
8. Office machines (office and accounting equipment, duplicating and related equipment)
9. Software
10. Trucks and trailers
11. Aircraft
12. Other transportation
13. Other

Comparison of Equipment Finance Industry Benchmarks

Alternative estimated for the volume of equipment financing in 2011:

- U.S. Equipment Finance Market Study by Equipment Leasing & Finance Foundation
 - o Lease volume: \$256 billion
 - o Lease + secured loan: \$357 billion
- Monitor 100 by Xander Group
 - o Equipment finance: \$200 billion
- 2012 Foundation survey:
 - o Estimated Total Finance Volume: \$664 billion
- Federal Reserve Flow of Funds:
 - o Estimated Total Finance Volume: \$246 billion



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Presented by the Source for Independent, Unbiased and Reliable Study

The Equipment Leasing & Finance Foundation

The Equipment Leasing & Finance Foundation, established in 1989 by the Equipment Leasing Association, is dedicated to providing future-oriented, in-depth, independent research about and for the equipment finance industry. Information involving the markets, the future of the industry and the methods of successful organizations are researched to provide studies that include invaluable information for developing strategic direction within your organization.

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- Industry future council workbooks
- Reports on entering international markets
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