2009 *State of the* EQUIPMENT FINANCE INDUSTRY

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Preface

Purpose of This Study

In 2009, Equipment Leasing & Finance Foundation (the foundation) commissioned IHS Global Insight to conduct a comprehensive research study on the current industry trends and short-term outlook of the U.S. equipment finance market. By integrating information from various databases with insights from leaders in the equipment financing industry, the study provides an in-depth review and analysis of the industry's current status, trends, and outlook.

While this study utilizes information from a number of sources, a key input came from a series of conversations with equipment finance executives. In the course of the interviews, respondents were asked for their opinions on economic and credit conditions, accounting and regulatory issues, industry trends, and asset management. These discussions provided valuable information on the ways in which currenteconomic conditions and potential changes in regulations are affecting different types of firms as well as the expectations firms have for the future of the U.S. equipment leasing and finance industry.

Primary and Secondary Data Sources

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

- The Equipment Leasing and Finance Association (ELFA) 2009 Survey of Equipment Finance Activity (for fiscal year-end 2008);
- Monitor 100;
- Selected interviews with industry leaders;
- IHS Global Insight Macroeconomic Forecast;
- U.S. Financial Accounting Standards Board (FASB);
- International Accounting Standards Board (IASB);
- ELFA Monthly Leasing and Finance Index (MLFI-25); and
- Equipment Leasing and Finance Foundation Monthly Confidence Index—Equipment Finance Industry (MCI-EFI).

Interviewees

We would like to thank the following industry experts for participating in our interviews. Their input and perspectives have been incorporated into this report.

Kent M. Adams - President; Caterpillar Financial Services Corporation

Kenneth E. Bentsen Jr. - Former President; Equipment Leasing and Finance Association

Edward A. Dahlka, Jr. - President; Assurance Asset Finance

Crit DeMent - Chairman & CEO; LEAF Financial Corporation

Paul W. Frechette - Executive Vice President, Business Development; Tygris Vendor Finance

Tony Golobic - Chairman & CEO; GreatAmerica Leasing Corporation

James P. Grace - Senior Vice President, Equipment Management; Bank of America

Thomas M. Jaschik - President; BB&T Equipment Finance

Joseph C. Lane - Vice Chairman; Sinter Capital

James McGrane - President & CEO; Tygris Vendor Finance

Deborah J. Monosson - President & CEO; Boston Financial & Equity Corporation

Robert C. Neagle - Senior Vice President & General Manager; First Data Global Leasing

Rick Remiker - Senior Vice President, Chief Administrative Officer; RBS Asset Finance, Inc.

Todd W. Skulte - General Manager, Structured Solutions Group; GE Healthcare Financial Services (HFS)

Martin Weissburg - President & CEO; Volvo Financial Services the Americas

Market Definition

For the purposes of this study, equipment financing refers to domestic retail or end-user financing reflecting loans and leasing to businesses and government agencies. Forecasts used in this study were prepared by IHS Global Insight's Macroeconomic Forecasting Group.

Executive Summary

- The financial crisis had a major impact on the equipment finance industry. The U.S. economy experienced the steepest peak-to-trough decline in postwar history. Credit conditions are extremely tight, and business investment growth reached unprecedented lows.
- Access to capital is very limited. The Federal Reserve's Term Asset-Backed Securities Loan Facility (TALF) program is providing some relief, but assistance is limited, as only firms with the highest credit ratings are eligible.
- The equipment finance industry is showing signs of increased consolidation. Tough economic conditions and scarce credit are driving some players out of the industry. Being depository funded, banks are in the strongest position, while independents run the highest risk of being driven out of the industry.
- In 2008, banks gained some market share from the previous year, while independents lost market share. Market share for captives remains almost unchanged.
- Respondents to the 2009 Survey of Industry Activity reported the strongest activity in large-ticket leasing compared to the rest. Large-ticket volume grew a modest 1.9% to $21 billion. Micro-ticket volume experienced the weakest activity in 2008, contracting 19.1% from the previous year.
- Profitability for the leasing industry, as measured by return on assets (ROA) and return on equity (ROE), in 2008, were 1.2% and 11.0%, respectively, showing declines from previous years.
- Credit quality has deteriorated in 2008 and through the first half of 2009. Charge-offs and delinquencies are up significantly from 2007 levels.
- A number of respondents in our telephone interviews emphasize an increasing importance of improving business relationships with core clients. As a result of funding challenges, many equipment finance institutions are focusing more attention on serving core customers during this time.
- The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) will likely revise current accounting rules so that companies must capitalize assets that have traditionally fallen under the "operating lease" category. These changes will potentially transform certain parts of the industry, particularly bigger-ticket lessors, while leaving others relatively untouched.
- The second half of 2009 is showing positive signs of stabilization in the economy and in the equipment finance industry. IHS Global Insight expects slight positive economic growth in the second half of 2009. Business investment for equipment is beginning to stabilize, and respondents to our telephone interviews are optimistic about the industry stabilizing and returning to growth in the first half of 2010.
- Under tough economic conditions in the past, the equipment finance industry has proved to be resilient. Although the industry is undergoing change in this uncertain economic climate, we are confident that the fundamental offering of secured lending and equipment leasing will continue to be key vehicles for businesses to acquire new equipment.

Current State of the Equipment Finance Market

Current "State of the Industry"

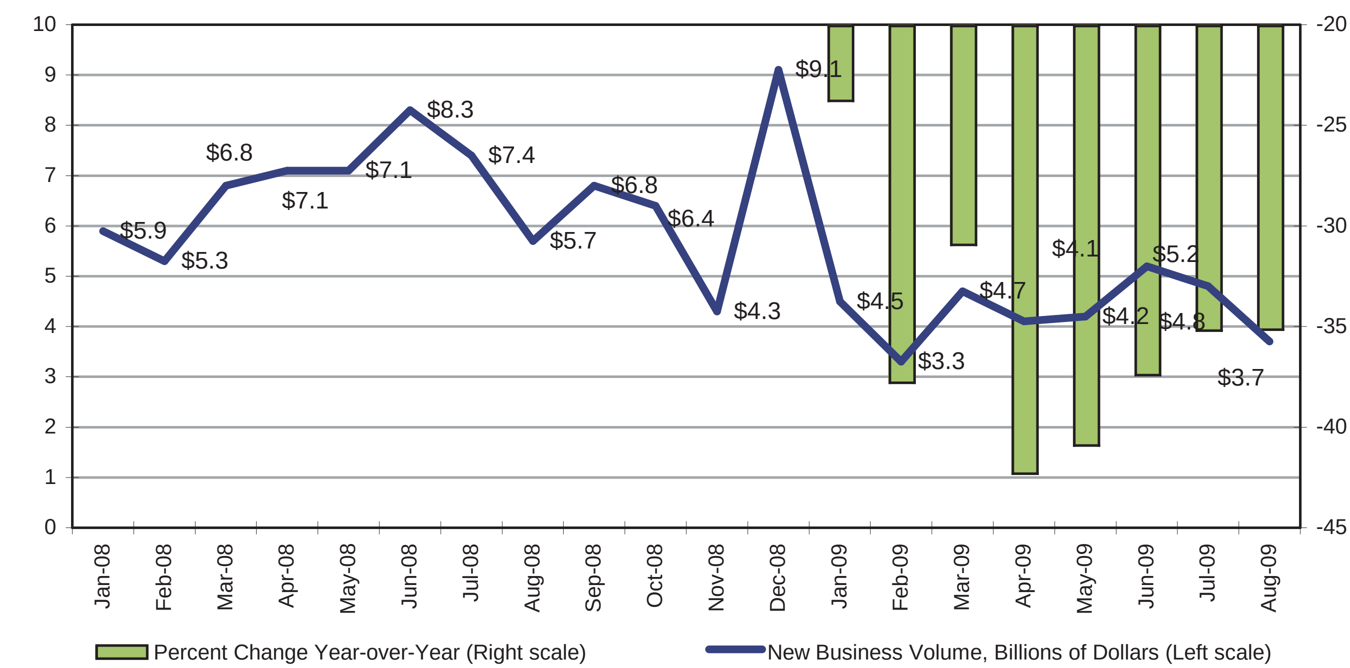
Since last year's report, the equipment finance industry has endured the worst economic and capital market collapse since the Great Depression. A fundamental question facing industry participants is, "Where do we go from here?" A persistent climate of tight credit and tough economic conditions is shifting the equipment finance industry into a smaller market, as larger and more capitalized institutions push institutions facing capital constraints out of the leasing market. This is particularly affecting independent equipment finance companies. The largest challenge facing the industry currently is the scarce availability of capital. A weak economy, characterized by extremely tight credit, has caused business investment in equipment spending to experience steep declines last year and in the first half of 2009. These challenges are clearly evident in indicators such as the Equipment Leasing and Finance Association's Monthly Leasing and Finance Index (MLFI).

Although the industry may still be strained by the liquidity crisis and limited credit availability, there are signs of stabilization in the market. Month-over-month activity in the MLFI-25 New Business Volume Index has increased from its February 2009 low in each subsequent month thereafter. Total business sales are beginning to rebound, and the signals from capital-goods orders suggest that the bottom for equipment demand is behind us. The Equipment Leasing and Finance Foundation's Monthly Confidence Index (MCI) is also showing some improvement: after a slight retreat in July (falling to 49.22 from 51.84 in June), confidence bounced back in August at an index value of 54.94. As the economy begins to show signs of recovery, we expect the equipment leasing and finance industry to follow.

Economic Conditions

During the current recession, the U.S. economy has undergone the steepest peak-to-trough decline in U.S. postwar history. The U.S. economy experienced a 3.9% decline in

Figure 1. MLFI-25 New Business Volume
(Year-over-year comparison)



Source: ELFA Monthly Leasing and Finance Index (MLFI-25) August 2009 real GDP from the second quarter of 2008 to the second quarter of 2009 (see Table 1). The recession had a major impact on equipment finance; as used equipment sits idle, the demand for new equipment plummets. Nevertheless, even though IHS Global Insight still expects the recovery to be slow, recent improvements in home sales, stabilizing home prices, and improving global markets suggest that economic growth in the second half of 2009 will be more rapid than originally anticipated. IHS Global Insight believes the recovery is off to a fast, yet unsustainable start, forecasting the U.S. economy to grow at 3.7% in the third quarter of 2009, with growth easing back to 2.0% by the first quarter of 2010. The main driver of growth in the second half of the year remains the turn in the inventory cycle. Firms will initially cut their inventories less rapidly, and then by the fourth quarter begin to add to them. The success of the "Cash for Clunkers" program is accentuating the cycle in automobile sales, as the surge in demand is depleting supplies of popular vehicles and manufacturers are raising their production plans in response.

Consumer spending remains sluggish as personal incomes have declined amid increasing unemployment, low wage increases or wage cuts, and short working hours, while debt burdens remain high and wealth losses remain heavy despite the recent improvement in the stock market. Much better affordability, and the extra stimulus from the first-time homebuyers' tax credit have led to improvements in single-family home sales, housing starts, and builder confidence. The signals from capital-goods orders suggest that the bottom for equipment demand is behind us, as IHS Global Insight expects business-equipment demand spending to begin its recovery in the third quarter of 2009. Nonresidential construction spending, in contrast to equipment spending, saw an increase in the second quarter, but the gain looks unsustainable as tight credit conditions and investor uncertainty persist.

Business investment is beginning to stabilize—at least for equipment. Second-quarter equipment spending fell 9%, about one-quarter the rate of decline seen in the first quarter. The bellwether demand indicator—nondefense capital-equipment orders, excluding aircraft—is now edging higher. IHS Global Insight expects equipment spending to begin its recovery in the second half of the year on the strength of new orders and increased exports. For 2009 overall, IHS Global Insight foresees a 16.8% drop in equipment spending, followed by a 9.8% increase in 2010.

Credit Conditions

Credit conditions, which have deteriorated considerably during the onset of the financial crisis, still remain tight. Overall credit provided to the private sector of the economy continues to fall rather sharply despite the pump-priming efforts of the Federal Reserve. There are still major problems in getting credit flowing smoothly through the economy—consumer credit continues to see downward pressure and business credit remains weak. These latest developments carry both good news and bad news.

Table 1. Business Equipment Investment

(Billions of U.S. dollars)

Nonresidential Investment	2007Q1	2007Q2	2007Q3	2007Q4	2008Q1	2008Q2	2008Q3	2008Q4	2009Q1	2009Q2
Communications Equipment	96.1	95.8	97.0	100.3	100.1	102.9	102.7	95.1	86.9	90.3
Annualized Percent Change	*42.9%*	*-1.4%*	*5.4%*	*14.0%*	*-0.8%*	*11.7%*	*-0.8%*	*-26.5%*	*-30.0%*	*16.6%*
Computer Equipment	88.8	86.9	88.2	93.1	93.7	92.9	84.3	75.8	71.1	71.8
Annualized Percent Change	*20.2%*	*-8.4%*	*6.0%*	*24.3%*	*2.5%*	*-3.3%*	*-32.1%*	*-34.6%*	*-22.5%*	*3.7%*
Industrial Equipment	182.1	198.8	199.0	192.9	195.3	197.3	194.8	187.9	157.8	151.5
Annualized Percent Change	*-3.5%*	*42.3%*	*0.4%*	*-11.8%*	*5.1%*	*4.1%*	*-4.9%*	*-13.4%*	*-50.2%*	*-15.0%*
Information Processing Equipment	525.1	530.1	538.4	555.8	566.3	576.2	568.8	540.2	508.3	503.7
Annualized Percent Change	*11.0%*	*3.9%*	*6.4%*	*13.6%*	*7.8%*	*7.1%*	*-5.0%*	*-18.7%*	*-21.6%*	*-3.5%*
Other Equipment	185.2	191.6	195.2	198.2	192.7	192.0	201.1	194.7	178.0	162.5
Annualized Percent Change	*-11.6%*	*14.6%*	*7.7%*	*6.3%*	*-10.6%*	*-1.4%*	*20.3%*	*-12.1%*	*-30.1%*	*-30.5%*
Transportation Equipment	192.3	183.0	176.5	175.1	164.3	143.8	125.9	95.3	65.4	70.7
Annualized Percent Change	*-11.4%*	*-17.9%*	*-13.5%*	*-3.2%*	*-22.4%*	*-41.4%*	*-41.2%*	*-67.2%*	*-77.8%*	*36.5%*

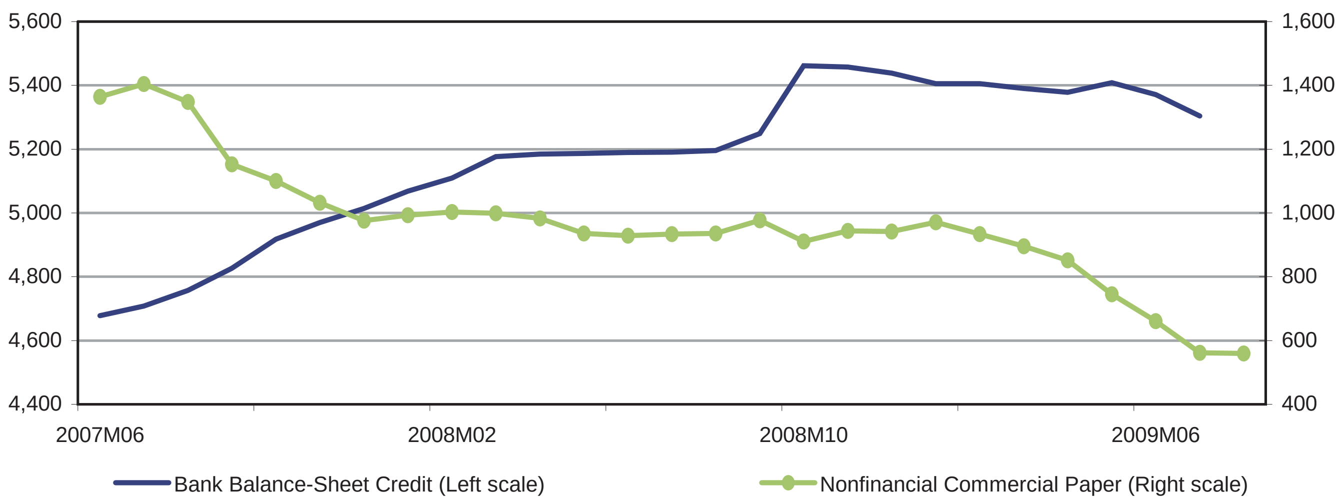
Source: IHS Global Insight Macroeconomic Service

The good news is that consumers are rapidly shedding debt. Total consumer credit fell by $21.6 billion in July of 2009, following a decline of $15.5 billion in June. The steep descent of consumer credit is partially driven by credit card industry's move to raise interest rates and reduce credit lines. Given the threat to their incomes from rising unemployment, consumers are acting in a responsible manner that will eventually lead to an easing of lending standards.

The bad news is that credit extended by finance companies dropped considerably, and securitized lending fell $2.1 billion in July, suggesting that the positive impact of the TALF program has been limited.

Indicators of business credit are still showing broad declines in the amount of outstanding credit. Bank balance-sheet credit and nonfinancial commercial paper, two measures of (bank) business credit, have been declining steadily

Figure 2. Business Credit Still Falling Sharply
(Billions)



Source: IHS Global Insight Macroeconomic Service

Figure 3. Business Credit Is Still Struggling
(Percent change from a year earlier)

Source: IHS Global Insight Macroeconomic Service

(see figures 2 and 3). At an aggregate level, other funding sources—bonds, net equities, and trade credit—are also experiencing a contraction in growth.

Liquidity continues to be squeezed among financial and nonfinancial institutions. Banks, among other institutions, have been greatly affected by the fallout in liquidity. There has been a sharp increase in nonperforming consumer and mortgage loans over the past year. When banks charge off bad debt, it limits their capacity to support lending. Bad debt is deducted from capital reserves, and in order to maintain an acceptable capital ratio, banks must reduce their assets to offset the reduction in equity. As assets are written down, the scarcity of capital greatly reduces the availability of credit in the economy, as well as a source of funds for much of the equipment finance industry.

There is a delicate balance between the speed at which banks choose to write down assets and their ability to rebuild capital. Brian Bethune, Chief Financial Economist at IHS Global Insight, believes that the increased write-offs by banks are being partially offset by higher operating earnings. In response to solvency problems in the financial system, the Federal Reserve lowered interest rates close to zero, which in turn created a large positive yield curve and allowed banks to generate much higher operating earnings through their trading arms. The improvement in operating earnings in the first half of 2009 has allowed banks to report profits despite the rising number of write-offs.

Overall, the credit markets continue to be strained, as liquidity dwindles and credit is scarce. Consumers are reluctant to borrow in view of declining household values and downward pressure on wages and salaries. On the supply side, with future write-offs a continuing threat, underwriting standards in the banking system remain tight and credit is only available to firms with pristine debt ratings. We have yet to see much of a material change in the demand and supply conditions of the credit markets that would support the incipient recovery. Consumers, businesses, and lenders are all working to deleverage their balance sheets. The process will be slow, but as industry players rebuild their capital positions, the foundation of the future health of the equipment finance industry will be secured.

Accounting and Regulatory Issues

The FASB and IASB have concentrated their efforts toward rewriting lease accounting standards for both lessees and lessors since 1996. In July 2008, however, FASB and IASB decided to defer revisions to lessor accounting and focus on lessee accounting amendments. Some interviewed leasing industry executives expressed grave concerns regarding lessor accounting updates in the future as parent companies would be required to disclose leases on their balance sheets, causing major problems with capital requirements and liquidity ratios. Lessor accounting changes are not presently being discussed, though, and we do not see revisions to the current model in the near future.

The revised lessee accounting standards objective is to ensure all assets and liabilities within leasing contracts can be easily identified in companies' statements of financial position.[1] The FASB and IASB published a discussion paper in March 2009 presenting a preliminary view of the new accounting model for lessees. This model defines an asset as the right to use the leased item, and a liability is the obligation to pay rentals. The accounting boards have also tentatively agreed that a lessee's assets and liabilities should be based on the most likely terms using a measurement that includes the probability-weighted estimate of contingent rental payables.[2]

Both accounting boards received comments regarding the preliminary accounting model and will discuss them at their joint September 2009 meeting. An exposure draft of the new lease accounting standards is expected to be released in the second quarter of 2010, with the finalized standards being implemented in the second quarter of 2011. Once comments and industry insight are taken into account, we could see accounting standards implemented that are very different from the March 2009 proposal. Although progress has been very slow, these accounting changes seem inevitable. There is a call for increased transparency, especially after last year's financial crises.

1 International Accounting Standards Board. Snapshot: Leases-Preliminary Views (March 2009).
2 International Accounting Standards Board. Snapshot: Leases-Preliminary Views (March 2009), page 9.

The majority of equipment leasing industry executives we surveyed believe the proposed lessee accounting rules may affect their business to some degree, dependent upon which rules are actually implemented and the company's position in the industry. If new accounting regulations cause a dramatic increase in lessees' paperwork, businesses may use other financing methods. In our interview, a small-ticket equipment leasing industry executive stated, "In small-ticket leasing, the accounting consequences are secondary to why businesses lease equipment. In our segment of small ticket leasing, most of our dealers' customers lease because of speed and convenience, so we don't foresee any significant impact of new accounting regulations." From the other side of the industry, a large-ticket equipment leasing executive stated, "It's going to have a negative impact on the attractiveness of leasing compared to other financing options." Although the final accounting changes have not been confirmed, our research shows that these changes will potentially transform certain parts of the industry, bigger-ticket lessors in particular, while leaving others relatively untouched.

Industry Trends

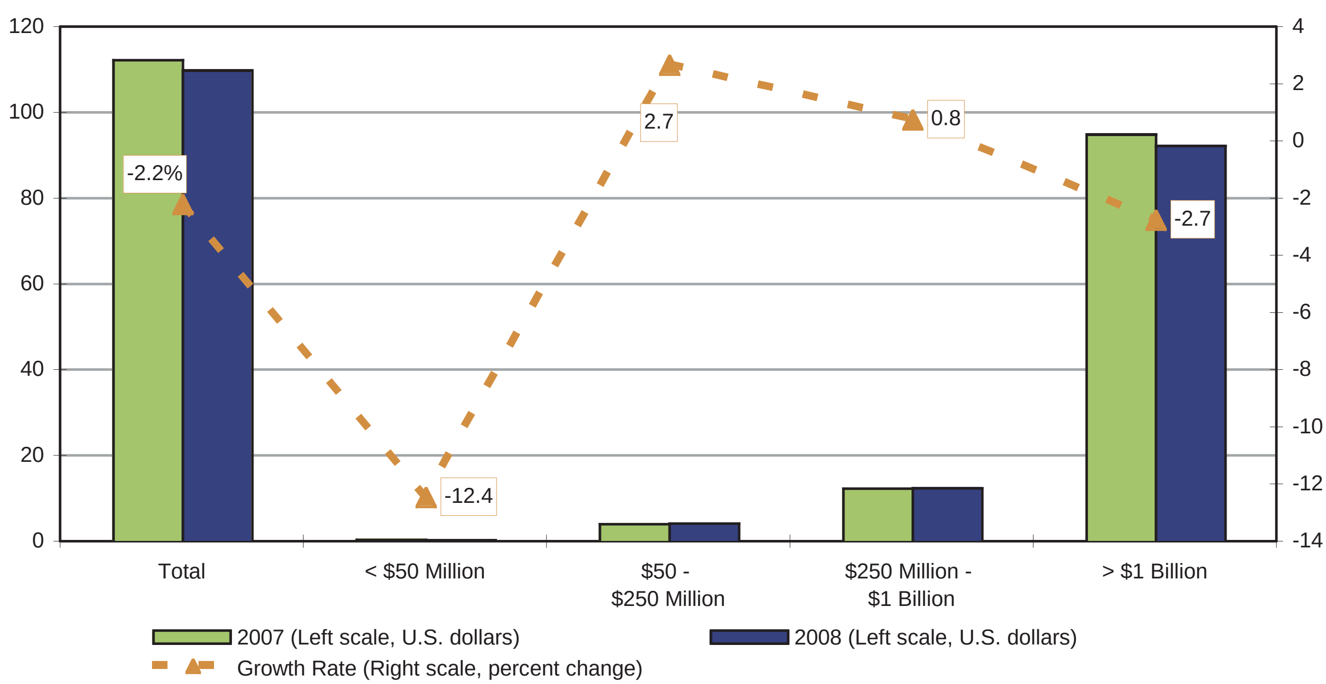
Business Volume Trends

The Equipment Leasing and Finance Association's 2009 Survey of Equipment Finance Activity (SEFA) is an important tool to help gauge the current state of the industry. The following summary of the survey reveals that the equipment leasing and finance sector as a whole has contracted, but the depth and magnitude of the decline varies across industry players. This year's ELFA survey includes 122 survey responses from 114 organizations active in the equipment leasing and finance industry. Four companies provided separate surveys for their various lines of business.

Each year's survey asks respondents for current and prior-year data. Unless otherwise indicated, data charts comparing two years' data include only those respondents providing information for both years. Since the respondent set varies each year, it is not possible to compare absolute numbers between different years' survey reports. However, the Survey Administrator, PricewaterhouseCoopers, analyzed data representing a number of years and determined that the relative data (for example, percentage of new business volume generated by a specific lessor type or percentage of new business originated through a certain channel) is statistically accurate. Therefore, some of the analysis of the survey relies on relative, not absolute, data.

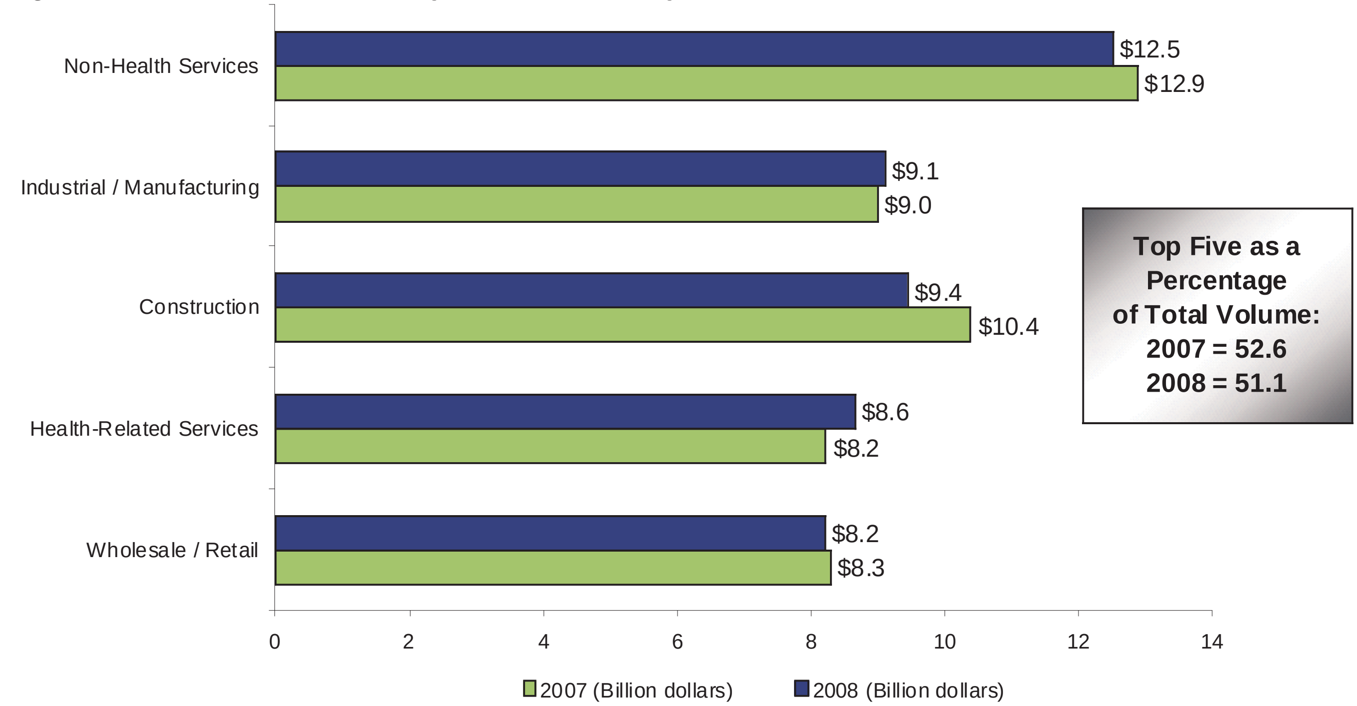
New business volume reported by SEFA respondents shows an overall decline of 2.2% in 2008 (see Figure 4). While we see overall declining growth in total new business volume, the distribution of volume by size of lessor slightly reallocates, weighting from the less-than-$50-million group to the over-$1-billion group. The market is still dominated by large companies with over $1 billion in annual volume. Some weak positive growth was enjoyed by midsize lessors, those with annual volume between $50 million and $1 billion, increasing new business volume by 2.7% for those with annual volume between $50 million and $250 million and 0.8% for those with annual volume between $250 million and $1 billion. Small-sized lessors—those with annual volume less than $50 million—suffered a noted strong contraction in volume of 12.4%.

Figure 4. New Business Volume by Organization Size (by Annual Volume)



Source: ELFA 2009 Survey of Equipment Finance Activity

Figure 5. New Business Volume by End-User Industry, in Billion Dollars



Source: ELFA 2009 Survey of Equipment Finance Activity

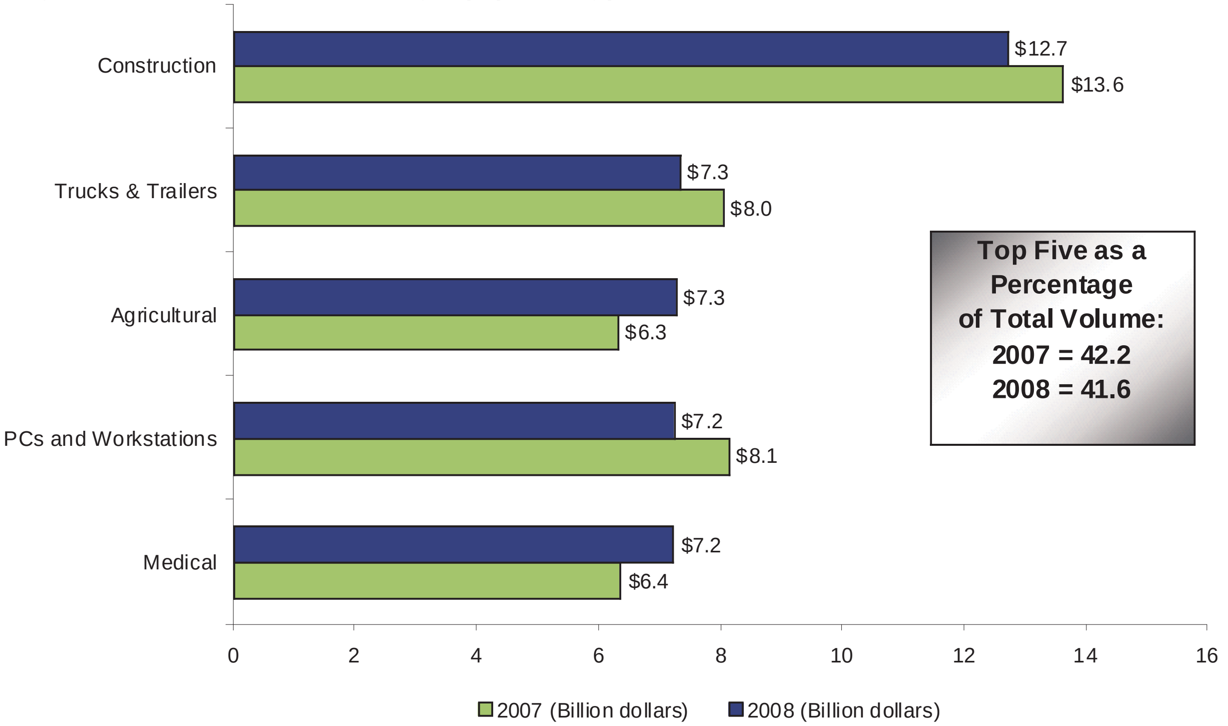
ELFA's Monthly Leasing and Finance Index also reports economic activity for the equipment finance sector. This index includes data that currently extend through August 2009, and exhibit a much steeper contraction in new business volume in the first half of 2009 than the SEFA registers for 2008. The index reveals that overall business volume declined 35.1% in August 2009 from one year earlier.

From an end-user perspective, the top-five end-user industries generated over 50% of new business volume, virtually unchanged from the previous year. Three of the top-five industries experienced a decline in market share over the previous year, with construction equipment contracting the most, losing a 10% share of total volume. Non-health services and wholesale/retail also lost market share, experiencing declines of 3.9% and 2.1%, respectively. The volume of equipment acquired by health-related services experienced an increase of 4.3%, and volume of equipment acquired by industrial/manufacturing grew 0.2%.

As a percentage of total volume, two of the top-five equipment categories grew significantly over 2007 (see Figure 6). The biggest winners from the equipment perspective were agricultural and medical equipment, with market share growth of 15.5% and 14.0%, respectively. PCs and work stations decreased their market share significantly by 10.9%. In addition, both construction and trucks and trailers equipment also decreased their market share from the previous year, with declines of 6.4% and 8.5%, respectively.

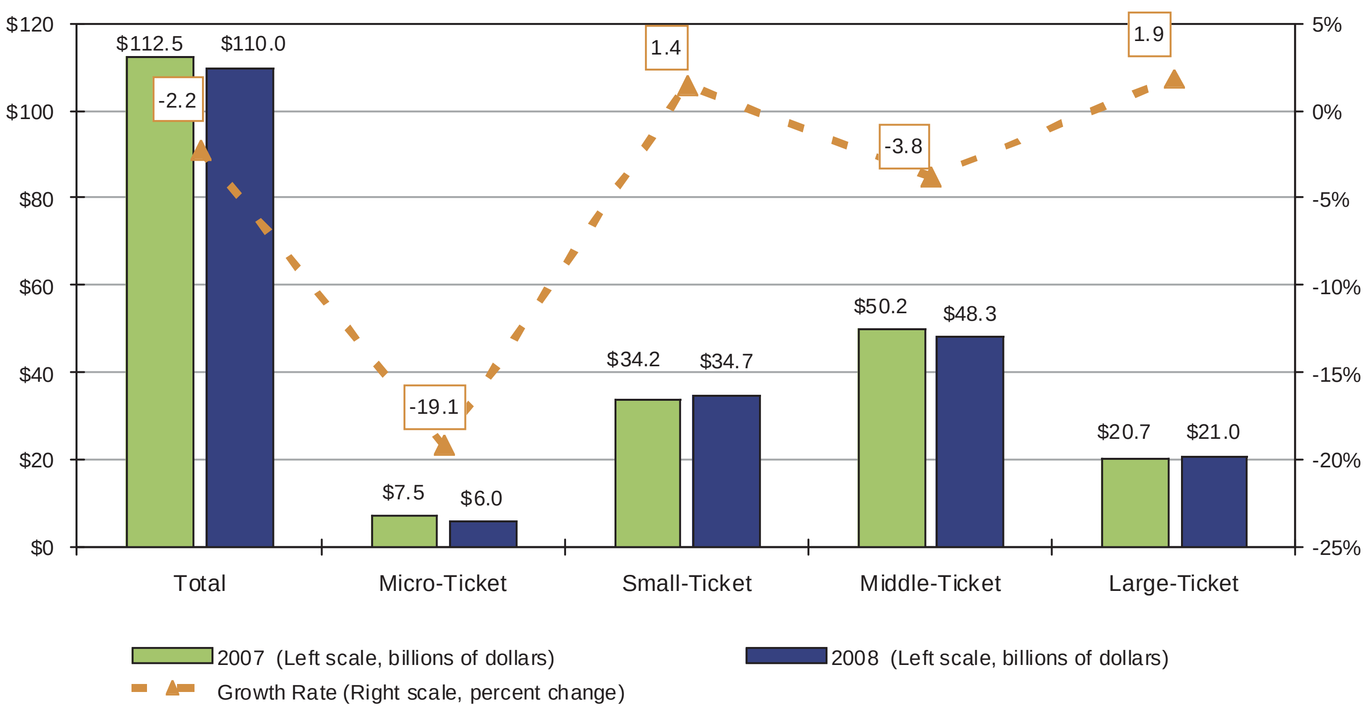
New business volume from micro-ticket (transactions less than $25,000) financing declined by over 19% in 2008, and its market share declined by 2% from the previous year to 5% of total new business volume (see Figure 7). Small-ticket volume grew by a modest 1.4%, while middle-ticket volume declined 3.8%. Middle-market financing represents almost half of the market share at 45%. Respondents to the 2009 survey reported that large-ticket volume grew by a moderate 1.9% to $21 billion, while market share rose slightly from the previous year, increasing from 18% to 19%. The industry as a whole declined 2.2%.

Figure 6. New Business Volume by Equipment Type, in Billion Dollars



Source: ELFA 2009 Survey of Equipment Finance Activity

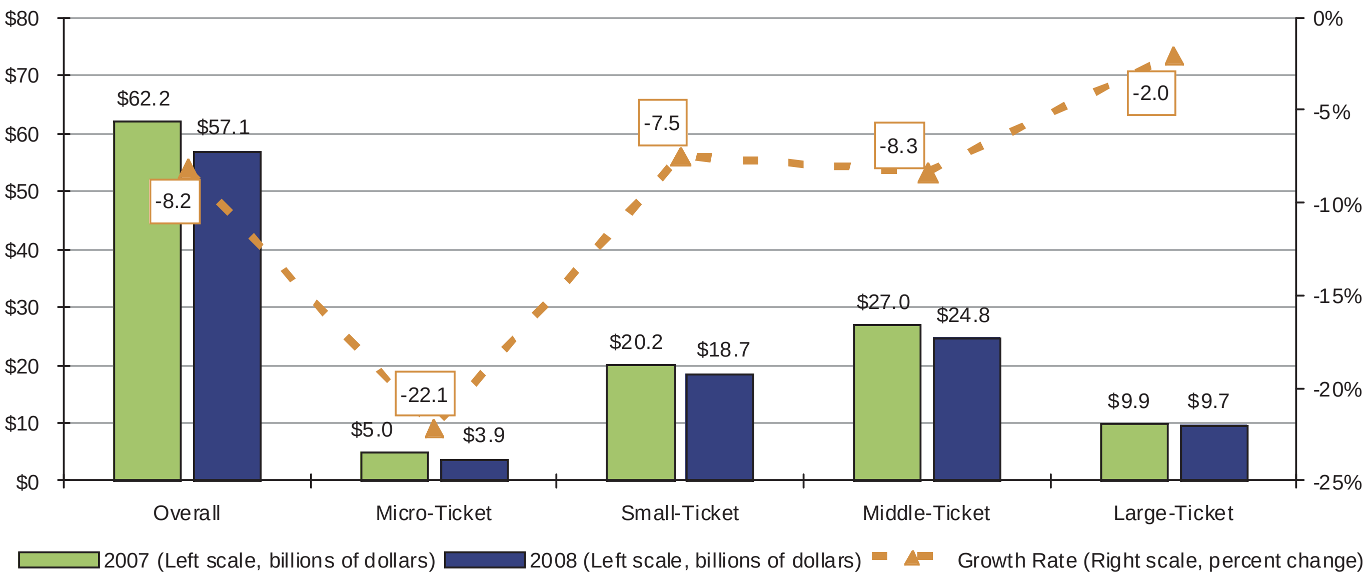
Figure 7. Total New Business Volume by Market Segment



Source: ELFA 2009 Survey of Equipment Finance Activity

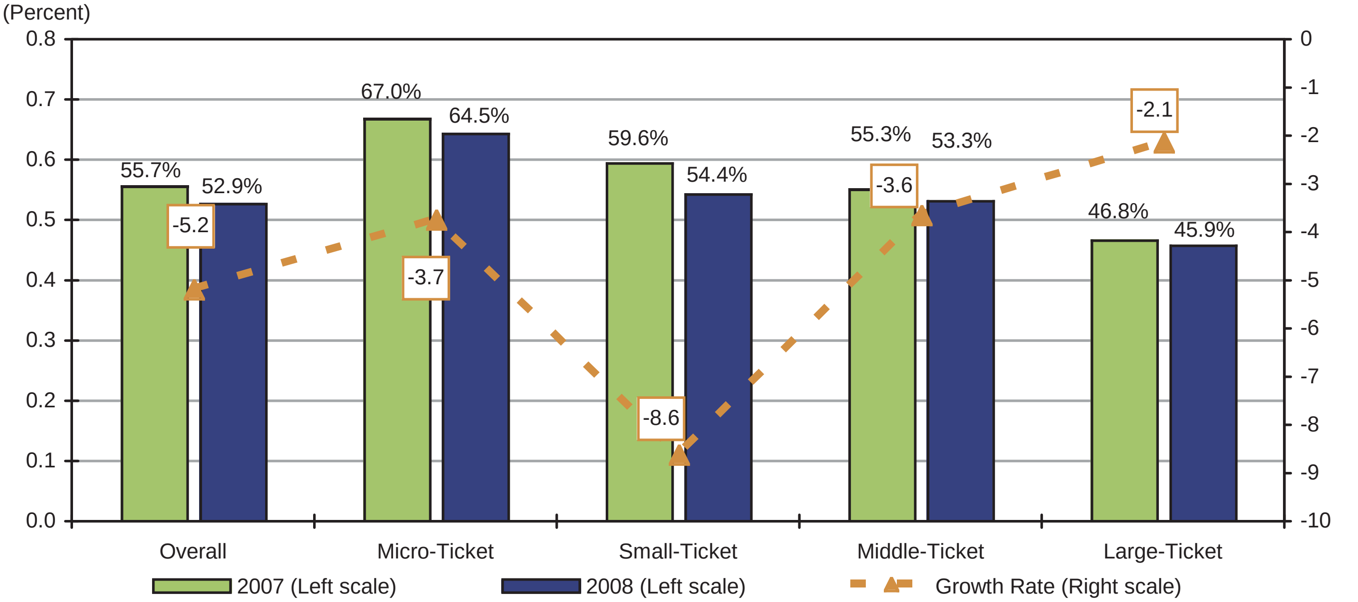
In 2007, survey respondents reported booking $62.2 billion in new business volume through conditional sales agreements and traditional loans. By 2008, new business booked through these products fell to $57.1 billion, a decline of 8.2%. By transaction size, the magnitude of declining volumes of "nonleasing" products varies across segments. The largest decline is in the micro-ticket category, registering a 22.1% decline from 2007 levels. Small- and middle-ticket volume declined by 7.5% and 8.3%, respectively. Although large-ticket volume also experienced a decline through conditional sales agreements and traditional loans, this category registered the smallest decline, at 2%.

Figure 8. New Business Volume Booked Through Loan Financing



Source: ELFA 2009 Survey of Equipment Finance Activity

Figure 9. Loan Financing as a Share of Total New Business Volume [3]



Source: ELFA 2009 Survey of Equipment Finance Activity

3 Data in Figure 9 is not consistent with figures 7 and 8 due to the nature of the survey data.

New business volume booked through loan financing as a share of total financing has decreased from 55.7% in 2007 to 52.9% in 2008, a decline of 5.2%. Loan financing for the small-ticket segment has just over half of the total small-ticket market, a decline of 8.6% compared with last year. Loan financing for the micro-ticket segment has the largest share of its total market at 64.5%, while loan financing for the large-ticket segment has the smallest share of its total market at 45.9%.

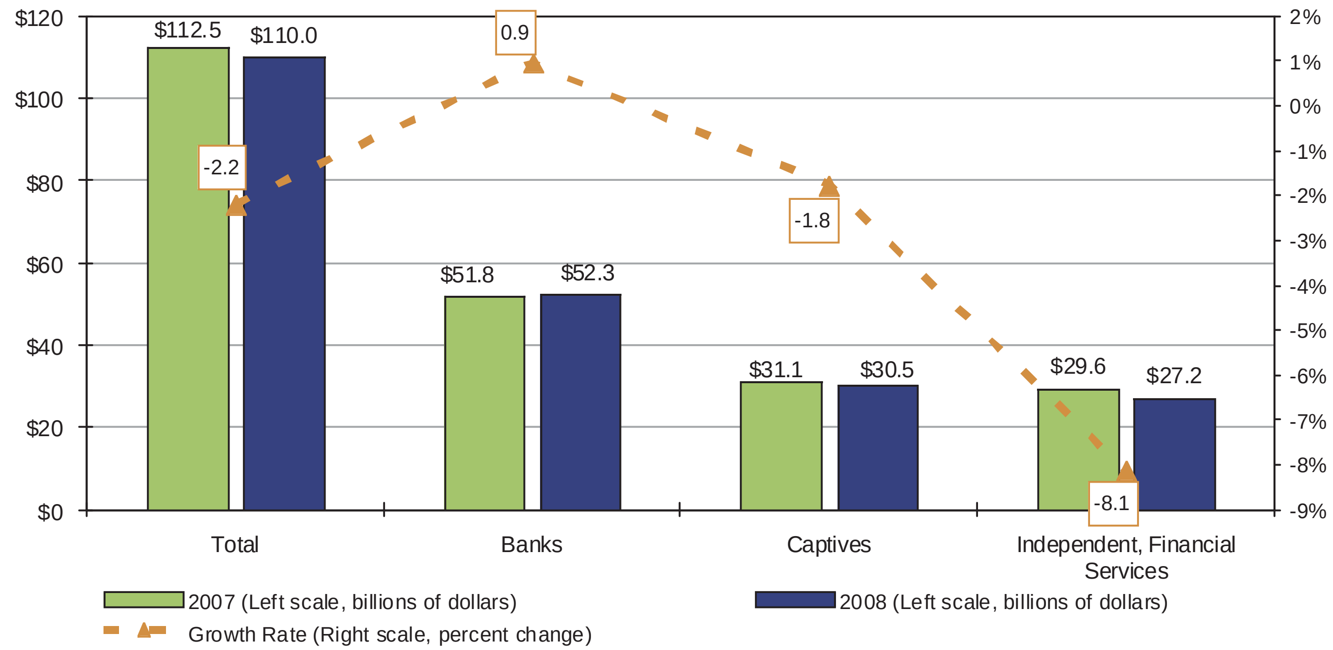
The survey results make it clear that in 2008, there were limited opportunities for both lease and loan products within various segments of the equipment finance market. The general notion that the large-ticket segment favors lease products, while the micro-ticket segment prefers nonlease products did not hold true. Players that understand their customers' needs and that have the flexibility to offer the products that best meet those needs will survive in the industry. Successful equipment finance companies also realize that their value proposition must also be strong enough to compel potential customers to choose their products over internal cash on hand.

Competitive Environment

The competitive environment in the equipment finance industry is showing signs of weakening, as tough economic conditions and scarce credit are driving some players out of the industry. The weakening competitive environment, characterized by a decrease in the number of players in the industry, has affected the various organization types in different magnitudes. Being depository-funded, banks are in the strongest position emerging from the financial crisis. Less-well-capitalized independent financing institutions are the lessors that run the largest risk of falling out of the industry. Unable to obtain adequate funding from traditional sources, some smaller and weaker equipment financing institutions are facing the prospect of exiting the market. These institutions are also less likely to receive federal TALF funds, as only institutions with very high credit ratings qualify. This is a trend that is being seen across the equipment leasing industry. Many industry players are seeing the movement toward consolidation in recent history. An executive of a small-ticket lessor states, "there has been a significant drop in competitive pressures compared to two years ago…there are fewer players; however, the remaining players are stronger." He believes that "in the future, we are going to see fewer but larger competitors in the small ticket market."

The view toward a more consolidated market is consistent among the majority of survey respondents in our telephone interviews. Many respondents expect to see fewer and stronger players in the industry in the future. One executive of a major small-ticket leasing institution states that he sees "a lot of consolidation in the industry as smaller and less well-financed companies are having a very hard time…smaller and less-well-capitalized companies are struggling to stay afloat, and I expect to see fewer smaller finance companies in the future." Captives are also feeling the strain of the financial crisis. One survey respondent states that as an executive in a major captive financing firm, he is witnessing other captive financing firms getting out of the business.

Figure 10. New Business Volume by Organization Size Type



Source: ELFA 2009 Survey of Equipment Finance Activity

This trend toward consolidation in the equipment finance industry is reflected in recent sales data. New business volume showed an overall decline of 2.2%. Bank volume grew by 0.9% and is the only lessor type to experience any positive growth in new business volume. Captives saw a 1.8% decline in new business in 2008. Independents have endured the steepest decline in new business volume, registering an 8.1% drop from 2007 levels.

Table 2. Market Share by Type of Organization

Lessor Type	2007	2008	Change
Banks	46.06%	47.54%	1.48%
Captives	27.64%	27.76%	0.12%
Independent, Financial Services	26.30%	24.71%	-1.60%

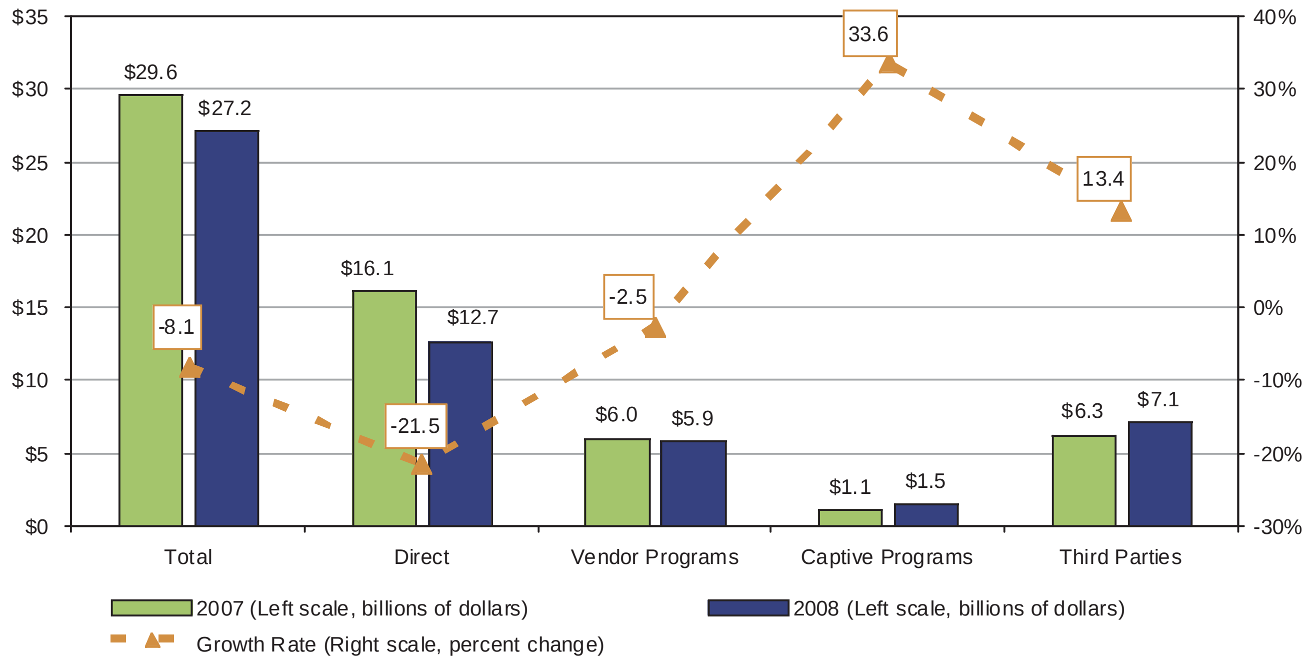
Source: ELFA 2009 Survey of Equipment Finance Activity Rep

The allocation of market share is moving in favor of banks (see Table 2). This suggests that the equipment finance industry is already seeing some deterioration in the competitive environment, as new business for independents and captives is being replaced by banks. Market share for captives remains almost unchanged from 2007; however, it is evident that the market presence of independents is fading while banks gain market share. Banks enjoyed 47.5% of the market in 2008, a 1.5% increase from their 2007 market-share estimate.

Independents are also struggling in the point-of-sale channel, providing vendor and captive programs. Total new business volume generated by independents has declined by 8.1% (see Figure 11). The majority of this decline comes from a 24% decline in volume from direct and vendor percent over the previous year. The survival of smaller independents depends on their ability to identify and exploit market niches quickly, reduce origination costs, preserve credit quality, and retain access to funding.

When this study went to print in September 2009, CIT Group, a large Independent financing firm, is one such independent that is seeking to avoid bankruptcy. The potential loss of this major industry player would have a sizable impact on the makeup of the equipment finance industry. When asked about their view of the recent events involving the CIT Group, most industry executives agree that they would be disheartened to see CIT Group leave the industry. An industry executive of a middle-ticket leasing firm laments, "CIT is huge and I don't know who would be able

Figure 11. Independent, Financial Services New Business Volume



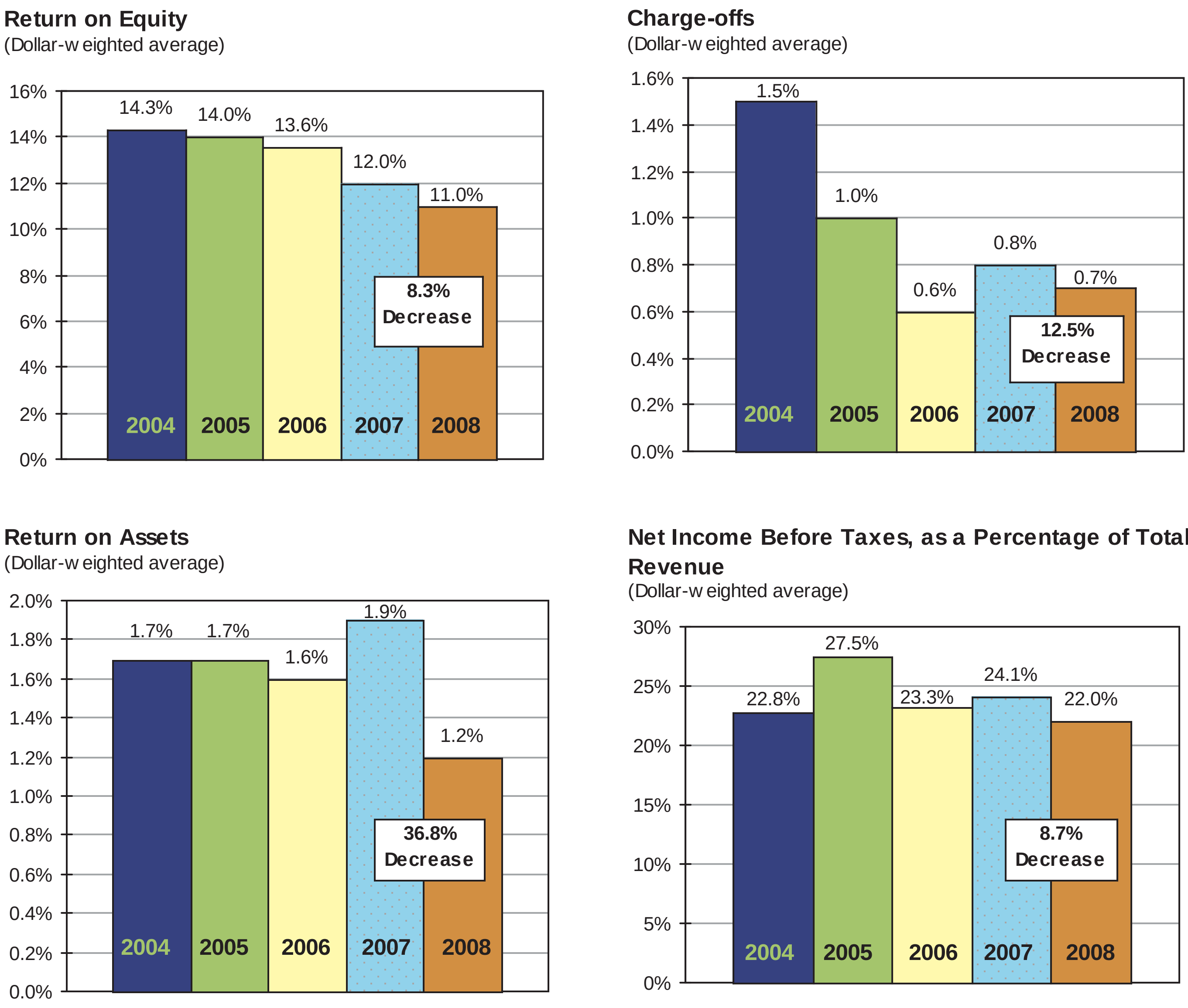
Source: ELFA 2009 Survey of Equipment Finance Activity

to pick up that void… I don't want to see someone like CIT go under. I think it's going to have a large effect on the market and I don't think the banks will be able to fill the void." Other executives believe that CIT Group's financial trouble is not good for any finance company. One small-ticket leasing executive notes, "The current events with CIT Group have the potential to raise concerns about the entire industry. A possible concern may be, if CIT has challenges, others may, too."

The competitive environment in the equipment finance industry is weakening. Limited access to capital and weak economic conditions are driving some players out of the industry, resulting in a more consolidated business environment. Weaker and less-capitalized firms, particularly independents, are affected most, and the structure of the equipment finance industry is moving toward one with fewer, but stronger competitors.

Profitability

Figure 12. Five-Year Historic Financial Indicators

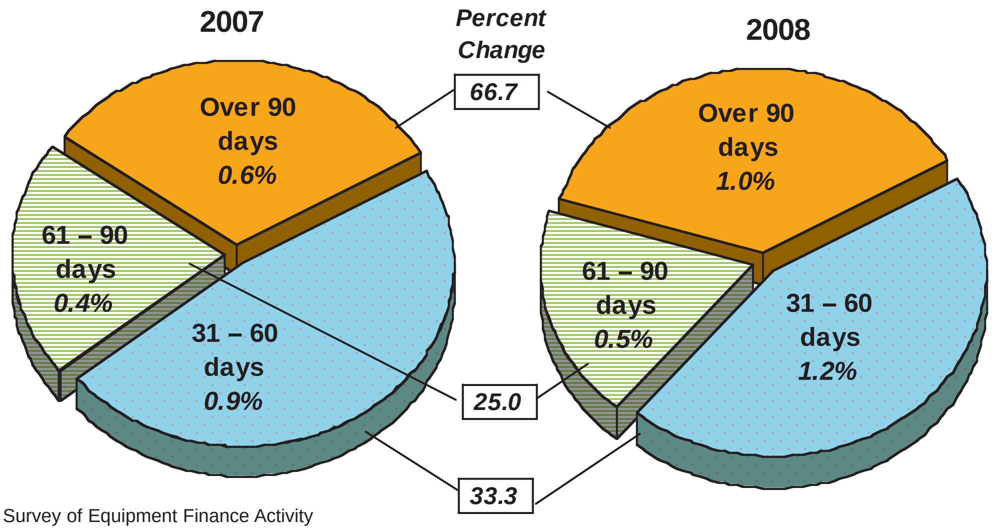


Source: ELFA 2009 Survey of Equipment Finance Activity

Based on the 2009 SEFA results, profitability for the equipment finance industry, as measured by ROA and ROE, has weakened in 2008. In 2008, ROA was at its lowest level for the years examined in the survey and stood at 1.2%. ROE also declined in 2008 and has been continually falling since 2004. The average charge-off is 0.7% of the average net lease receivables balance, a slight decrease compared with last year when charge-offs were 0.8%. Net income before taxes (NIBT) as a percentage of revenues is 22%, based on an average of all respondent's pretax income weighted by their total-dollar new business volume.

Respondents in our telephone interview have mixed responses about profitability. Some executives explain that for equipment financing institutions that do have access to low-cost capital, margins are actually growing. One executive of a major leasing institution suggests that large lessors

Figure 13. Accounts Receivable Aging—Over 31 Days



Source: ELFA 2009 Survey of Equipment Finance Activity

and banks are still getting their funds at a very low cost. He states that "spread margins have increased very significantly; for the lessee/borrower, the cost is much higher than two or three years ago, even for top-quality credit. These companies have been willing to pay more because for them, it is not a question of price—it has become a question of availability." Institutions that are capital-constrained are seeing stronger declines in margins. Other respondents in our telephone interview report falling profits. For some institutions, profitability has suffered because of increased delinquencies and charge-offs, as well as higher costs of funds. Data from recent months (May through July 2009) do point to stabilization in delinquency and charge-off rates, indicating an expected pickup in profitability for the second half of the year (see Figure 16).

Credit Quality

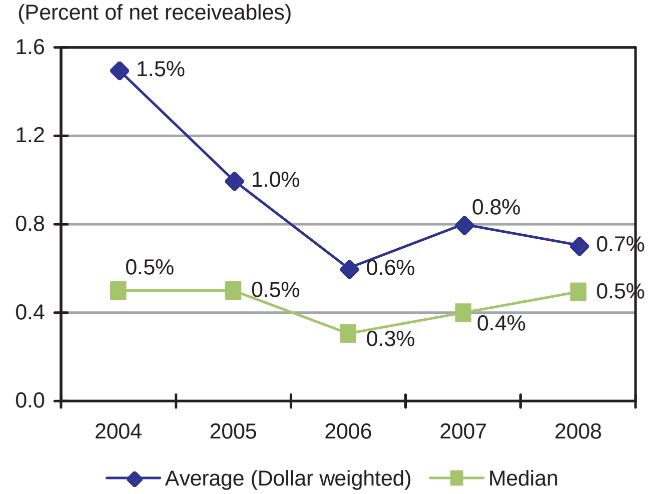
In 2008, 97.4% of average net investments are current (less than 30 days past due).

Of the total net investment, 1% is more than 90 days past due. Overall, credit quality and portfolio performance worsened in 2008. Delinquencies, measured as receivables over 31 days past due, showed a modest increase in 2008, growing by only 33.3% (see Figure 13). Receivables over 90 days past due grew by 66.7%. The receivables data are somewhat encouraging, given the degree to which the economy softened in 2008.

Average charge-offs dipped from 0.8% of net receivables in 2007 to 0.7% in 2008 (see Figure 14). Median charge-offs crept from 0.4% to 0.5% in 2008. This compares favorably to other secured loans reported by commercial banks to the Federal Reserve. For example, the average charge-off rate for commercial real estate loans was 1.2% and the rate reported for residential mortgages was 1.3%.

Figure 14. Full-Year Loss (Charge-Offs) - Five-Year History

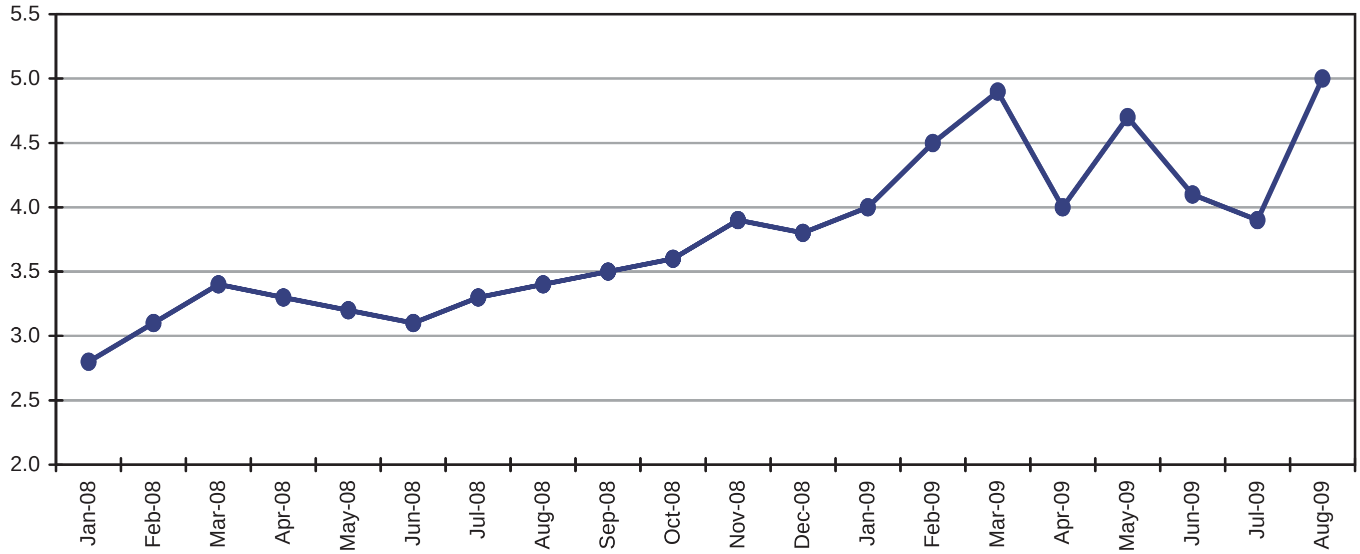
(Percent of net receiveables)



Source: ELFA 2009 Survey of Equipment Finance Activity

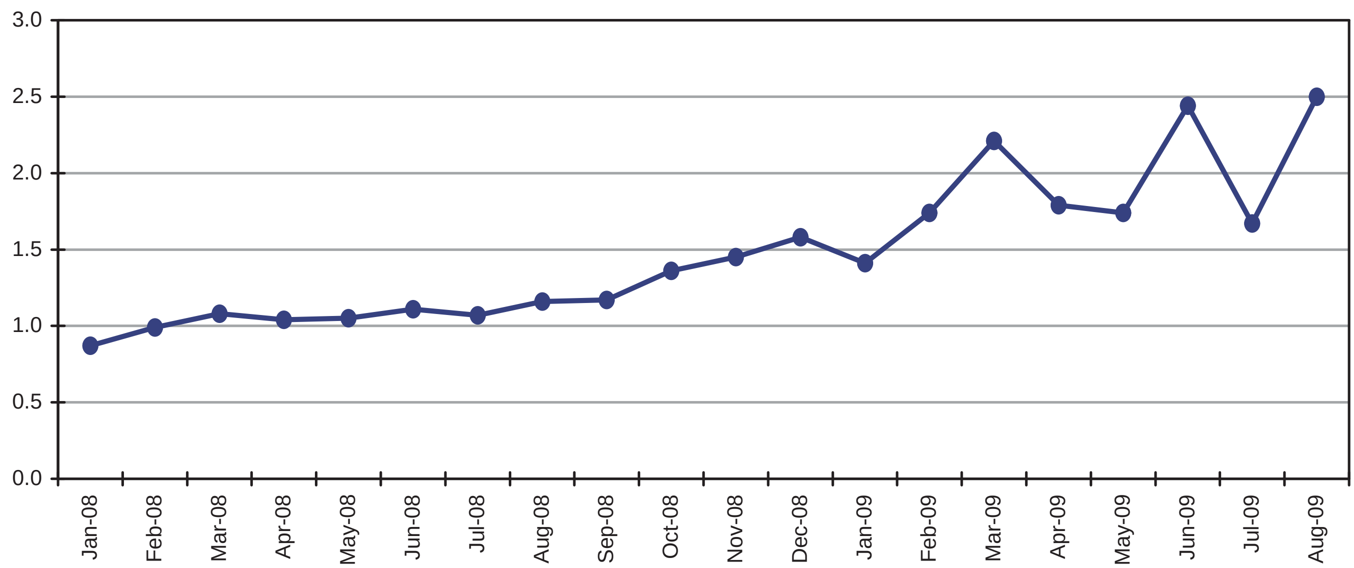
Figure 15. Aging of Receivables

(Percent of receivables over 30 days)



Source: ELFA Monthly Leasing and Finance Index (MLFI-25) July 2009

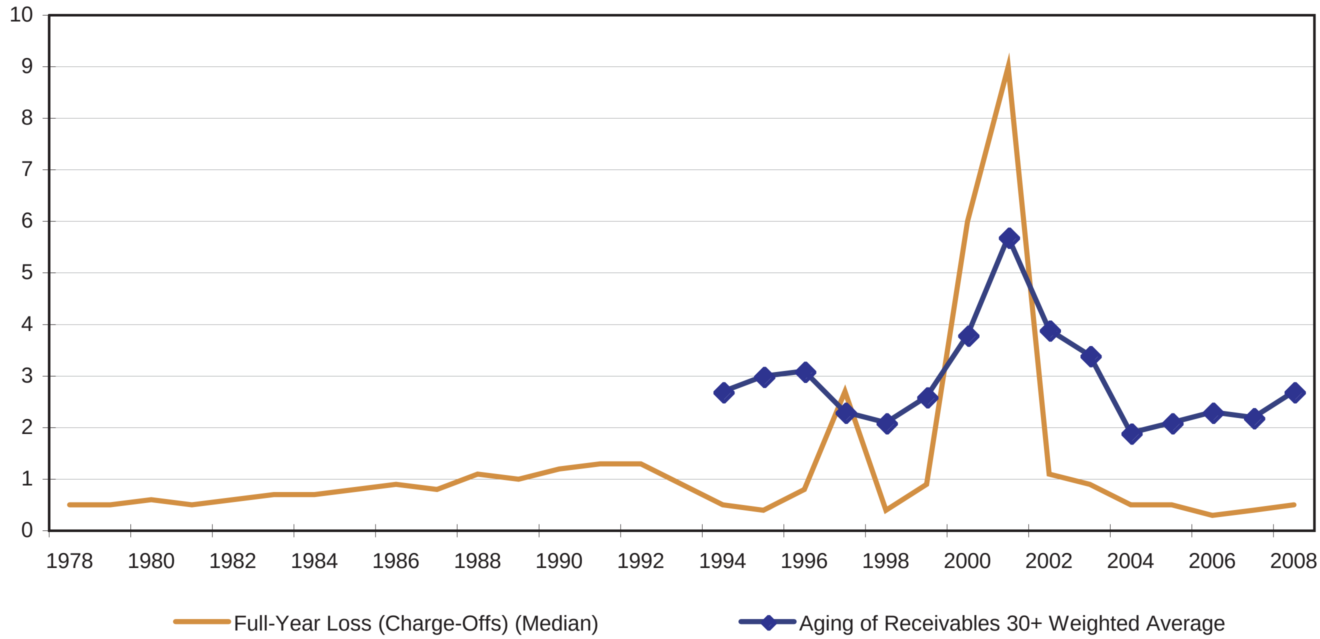
Figure 16. Average Losses (Charge-offs) as a Percentage of Net Receivables



Source: ELFA Monthly Leasing and Finance Index (MLFI-25) July 2009

Not surprisingly, there has been an overall deterioration in credit quality since the onset of the financial crisis. The ELFA Monthly Leasing and Finance Index shows an increase in commercial delinquencies and charge-offs through the first portion of 2009. The good news is that after climbing steadily since 2008, delinquencies and charge-offs are showing signs of stabilization in recent months. Figures 15 and 16 show the slowdown in delinquency and charge-off rates, respectively, in June and July 2009. The majority of respondents in our telephone survey

Figure 17. Average Losses (Charge-offs) and Aged Receivables as a Percentage of Net Receivables



Source: ELFA Survey of Equipment Finance Activity (1978-2009)

agree that after seeing charge-offs and delinquencies rise through the first half of 2009, they are beginning to see improvement in recent months.

If this is indeed the peak in charge-offs and past-due receivables, this is a testament to the equipment finance industry's relatively conservative underwriting practices. The 2009 credit quality statistics from ELFA MLFI-25 are below previous peaks from the ELFA SEFA despite the increase in credit risks associated with worst recession in the post-war era (see Figure 17).

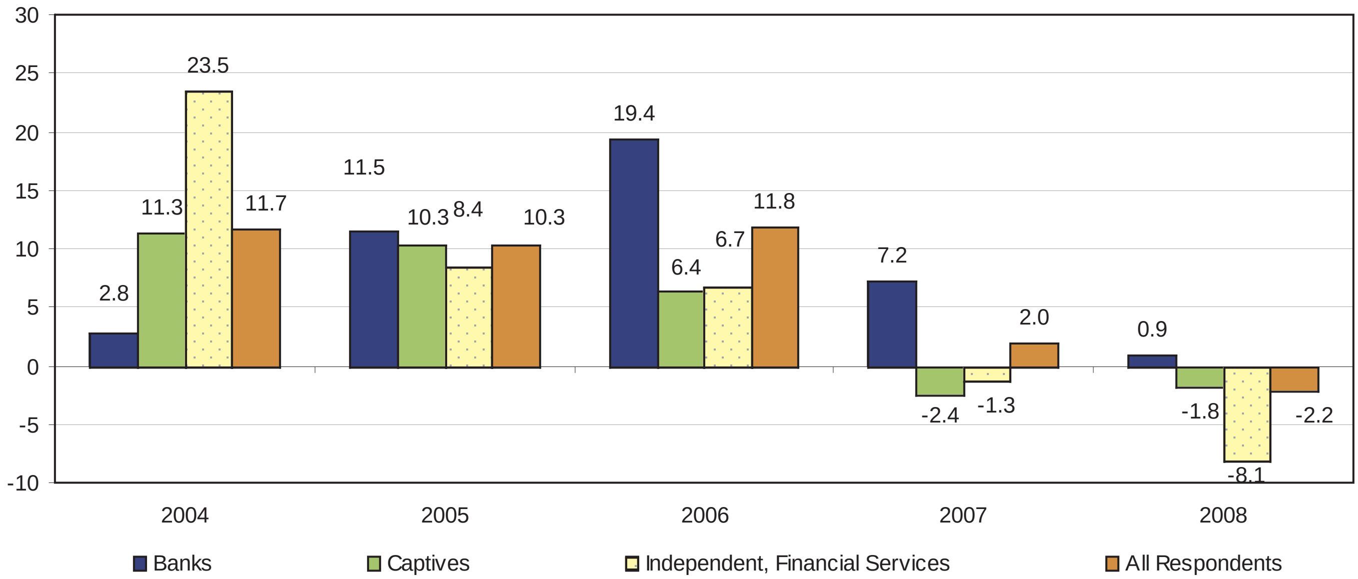
State of Funding Sources

Generally, leasing and financing companies carry on during downtimes as more consumers and businesses are in need of loans or leases. However, the credit crunch dramatically reduced lending. Some financial institutions—already suffering massive capital losses as a result of bad debt stemming from the bursting of the housing bubble and the subsequent rise in credit defaults and delinquencies—have much less available capital to dole out among the growing pool of applicants.

Overall business credit is struggling, but how do current credit conditions compare with the end of 2008? The general feeling among the 15 surveyed executives from a variety of equipment leasing and finance firms is that compared to the end of last year, credit markets are slightly better, but access to capital is still difficult. The Federal Reserve's TALF program was launched in March with the specific purpose of resuscitating the asset-backed securities market by providing non-recourse funding to borrowers with eligible collateral. Although some respondents are seeing some easing in credit markets, partially because of relief from the TALF program, access to credit is still very limited.

The level of accessible capital is varied among players in the industry. Due to their access to depository funding for equipment leasing and finance activities, banks are in a better position than independent financing companies and captives. Some of the surveyed equipment leasing and finance institutions are not feeling the constraint in capital markets. One executive of a large-ticket bank-owned leasing institution states that his leasing institution is not currently capital-constrained. He compares overall credit availability in the last two years to a faucet: "it went from fully open to just a trickle, to back open again." For this institution, however, he

Figure 18. Growth in New Business Volume by Type of Organization
(Percent change from a year earlier)



Source: 2009 Survey of Equipment Finance Activity

states that because his firm is owned by a bank, "access to capital is not a significant issue to us at this point in time."

Some respondents feel that credit markets are still tight, but credit conditions will begin to ease. One executive of a small-ticket leasing institution believes the credit conditions to leasing institutions are currently at the bottom: "I don't see it getting any worse than it is today. The only way to go is up."

Some executives are not as optimistic, though. Independent financing companies are facing the toughest credit conditions. Tight credit markets are hindering the ability of equipment finance and leasing companies to acquire a funding source to generate new business volume. This is especially true for independents. While all types of equipment finance and leasing companies experienced stable volume growth in the years leading up to the financial crisis, new business volume began to decline in 2007 for captives and independents. Given the scarcity of credit, independent financing firms took the hardest hit in 2008; undergoing an 8.1% decline in new business volume from 2007 levels. During the same time, captives experienced a smaller decline and banks saw a modest increase in new business growth.

Recently, the TALF program has been extended through March 2010, which would help inject liquidity into secondary equipment finance markets. Securitized lending credit expanded for the first time in many months, indicating that the TALF program is having some success. While this program is enhancing the availability of credit to the equipment finance industry as a whole, many institutions that lack a top-grade credit rating, primarily independents, are not able to take advantage of this additional extension of credit.

While the scarcity of funding sources certainly hinders business activity in the equipment finance industry, there are some positive consequences of the credit crunch. With funding more difficult to come by, respondents in our telephone survey report a stronger emphasis on credit due diligence in the second half of 2009 compared with the end of 2008. More robust analysis in the distribution and allocation of credit will have a positive impact on the equipment finance industry in the future. A number of respondents in our telephone survey also emphasize an increasing importance of improving business relationships with core clients. Due to funding challenges, many equipment finance institutions are focusing more attention on serving core customers with strong credit histories during this time, rather than providing capital to other industry players.

State of Secondary Markets

The secondary market is used to manage outstanding receivables. By selling asset-backed securities, firms receive new capital for financing efforts. The asset-backed securities market is an important source of capital for equipment leasing and finance companies, and its instability can have a notable impact on the industry. The asset-backed security market virtually froze in the second half of 2008, causing massive credit constraints and dysfunctional financial markets. The asset-backed security market accounts for a large portion of consumer lending, which is extremely important because consumer spending represents almost two-thirds of economic activity. The Federal Reserve used the TALF program to loosen credit markets by backing loans used to purchase new issues of asset-backed securities. The Federal Open Market Committee continues to use aggressive monetary policy as they intend to purchase US$1.25 trillion of mortgage-backed securities by the end of 2009. This aggressive policy stance has proved effective as key mortgage and corporate borrowing spreads have declined, and general trading conditions in equities have improved, but the yield curve has flattened. The slope of the yield curve decreased in July. This is the first month of decrease in the yield curve over the past six months, but it was expected as long-term bond yields declined. Despite these impediments, short-term commercial paper markets have shown signs of improvement and risk spreads on corporate bonds have come down considerably. Lately, investors have been willing to get back into the market as key indicators show a decline in financial market general risk aversion. These recent improvements show signs of stabilization in equity and fixed-income markets.

Some leasing-industry executives we interviewed believe that investment-grade companies could use the secondary market as a funding source; however, cost of funds is extremely high relative to historical standards. It is unlikely that small independents and firms with bad credit history would be able to utilize the secondary markets, as investors and banks are still hesitant when making investments. Even though the secondary market is expensive, it is a viable source of funding for a number of companies. The ability to use the secondary market indicates that credit conditions are easing and the Federal Open Market Committee's aggressive policy seems to be working.

Short-Term Outlook for Equipment Finance

Economic and Capital Market

More recently, the tone of the financial markets has been somewhat positive, yet there is still a long way to go as the recovery is expected to be slow. Incoming evidence of improving home sales, stabilizing home prices and rising capital-goods shipments suggests relatively strong GDP growth in late 2009. This information has allowed IHS Global Insight to increase GDP forecasts as GDP is expected to grow by 3.7% in the third quarter of 2009 and subsequently slow to 2.0% growth in the first quarter of 2010. IHS Global Insight believes GDP growth and current home-buyer tax credits will permit overall residential fixed investment to increase in the third quarter—the first increase since the fourth quarter of 2005. House prices will take longer to stabilize, but are getting close to the bottom. Real GDP is expected to decline by 2.5% in 2009, followed by increases of 2.0% and 2.9% in 2010 and 2011, respectively. Although IHS Global Insight sees a mild recovery in the second half of 2009, many leasing-industry executives have a less-optimistic view of the future. The majority of leasing-industry executives we surveyed believe business conditions will continue to deteriorate, and a two- or three-month trend is not enough information to conclude we have hit the bottom.

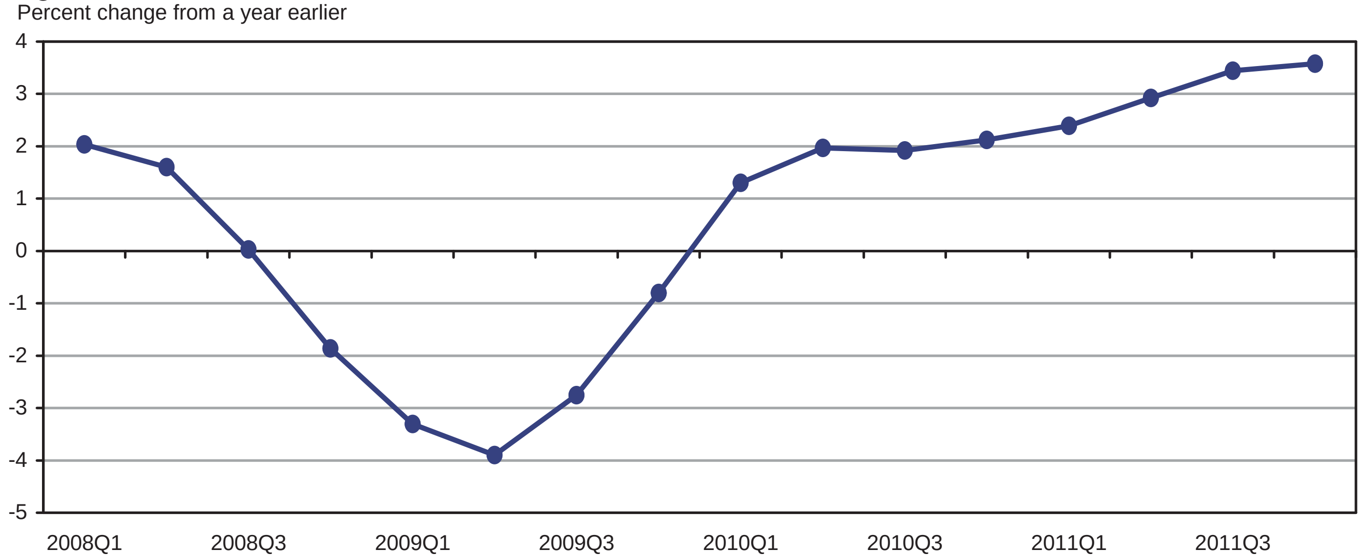
The lack of consumer spending is obstructing economic recovery as people are hesitant to purchase large-ticket items. Tentative spending is driven by the rising unemployment rate, which is expected to peak at 10.0%, and massive declines in wealth caused by fluctuations in financial markets and housing prices. Real total consumption is expected to decrease by 0.8% in 2009, with increases of 1.6% and 2.3% in 2010 and 2011, respectively.

Business investment is beginning to stabilize as second-quarter equipment spending fell 9%, nearly one-quarter the rate of decline experienced in the first quarter. Nondefense capital-equipment orders, excluding aircraft, are beginning to edge higher and the gap between orders and capital-goods shipments has started to close. This indicates the durable-goods market has started the stabilization process, although we are still experiencing declines in defense and aircraft orders.

Orders for nondefense capital goods excluding aircraft are 7.7% above their April trough, a signal that capital-equipment demand in the United States and abroad has turned the corner. IHS Global Insight expects equipment and software spending to begin its recovery in the second half of

Figure 19. Real GDP Growth Rate

Percent change from a year earlier



Source: IHS Global Insight Macroeconomic Service

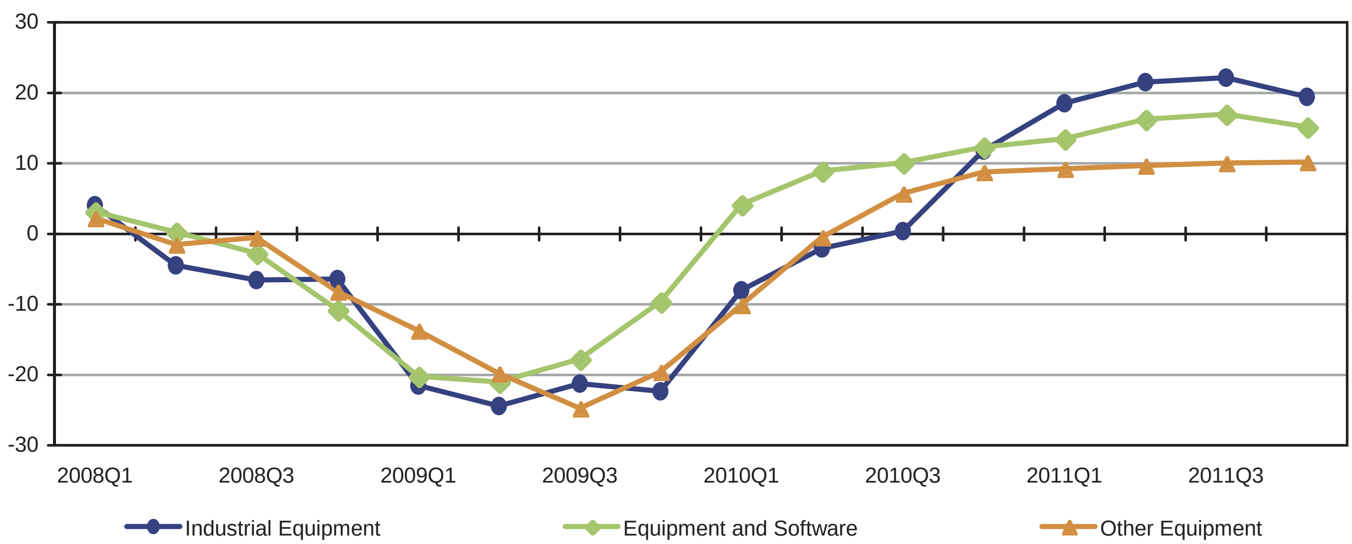
2009, experiencing a projected 17.3% drop and an 8.9% increase in 2009 and 2010, respectively. IHS Global Insight expects transportation equipment and information equipment to experience growth in 2010; however, industrial and "other" equipment will experience very weak growth and lag the overall equipment recovery. An overwhelming majority of interviewed leasing industry executives have seen the demand for leasing and financing decrease in the last three months. Some individuals that have noticed an increase in volume associate it with diminishing competition and recognize that the market is experiencing a decline in equipment sales.

Although credit conditions have been constrained since the second half of 2008, we anticipate they will recover before nonresidential investment does. Credit conditions are expected to ease in the second half of 2009, followed by dramatic improvements in 2010 and 2011. Mortgage credit is expected to begin its recovery in the third quarter of 2009; but business credit will lag slightly, recovering in early 2010. The TALF program, which has been extended until March 31, 2010, aids credit market easing. Nevertheless, the benefits from this program are mostly limited to investment-grade companies. Some leasing industry executives interviewed intend to take advantage of the TALF program, while others express their inability to do so. Expected GDP growth, lagging nonresidential investment, and easing credit conditions suggest a slow recovery will begin sometime in the second half of 2009.

The outlook for credit markets provides some glimmers of hope. IHS Global Insight approximates that credit markets will begin to stabilize in the third and fourth quarters of 2009. Brian Bethune, Chief Financial Economist at IHS Global Insight, believes that the low interest rates set by the Federal Reserve will continue to cushion both the losses endured by banks and the resulting increase in operating earnings, and will create a more stable financial situation. IHS Global Insight expects business investment and credit to pick up in the second half of 2009 as firms will initially cut their inventories less rapidly, and then by the fourth quarter begin to add to them.

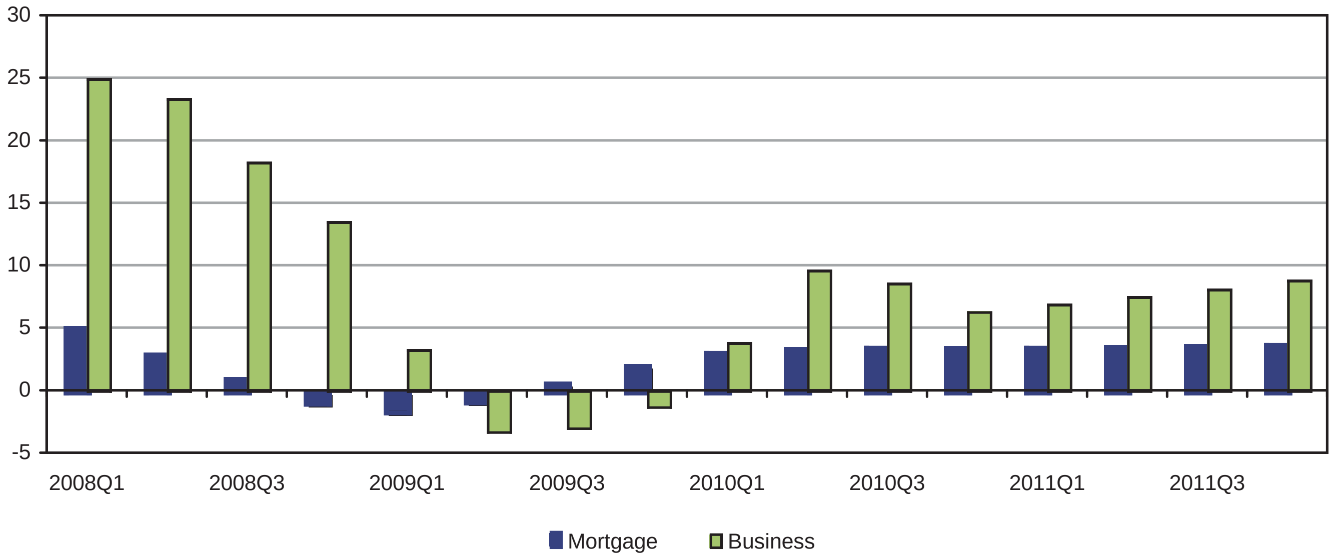
Looking out on a global scale, the European banking climate is similar to that in the United States. Many economists believe that European banks are in a slightly worse position than U.S. banks because they are lagging behind in capital restitution efforts. Credit conditions in Europe are expected to remain tight, and IHS Global Insight believes that a credit recovery in Europe will lag that of the United States.

Figure 20. Real Nonresidential Investment Growth Rates
(Percent change from a year earlier)



Source: IHS Global Insight Macroeconomic Service

Figure 21. Consumer Mortgage and Business Credit
(Percent change from a year earlier)



Source: IHS Global Insight Macroeconomic Service

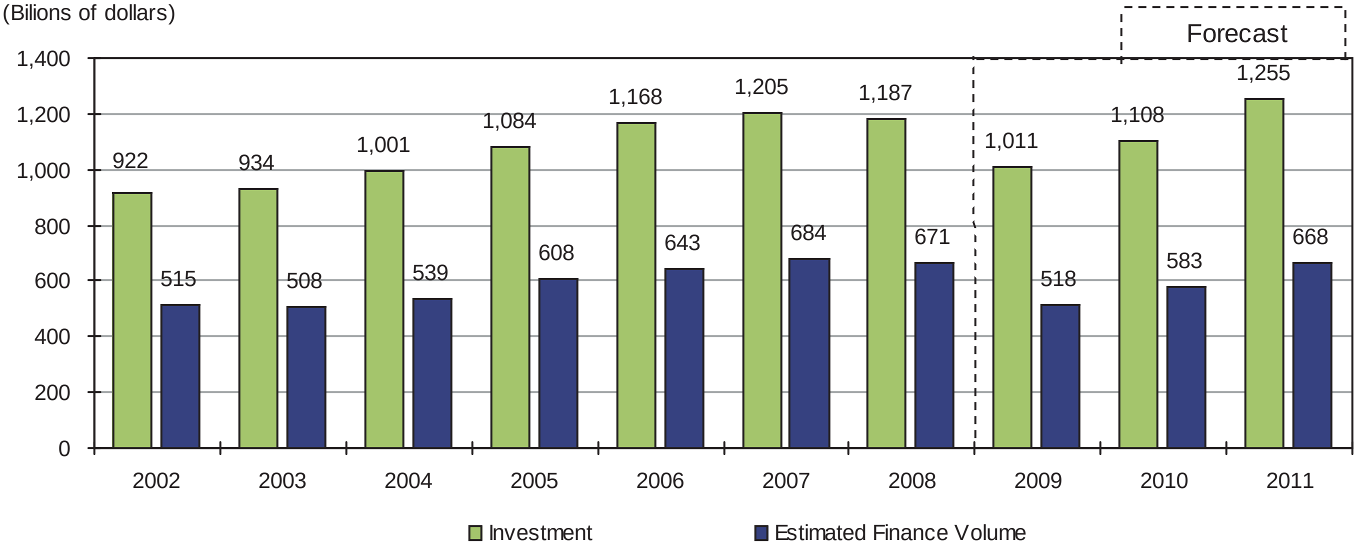
Expected Growth in Equipment Finance (2009 to 2011)

An uptick in equipment is expected in late 2009, but changes in the equipment financing industry over the last 12 months will influence which competitors will benefit from the inevitable increase in demand. The credit crunch has caused major funding issues in the equipment financing industry. Liquidity and secure funding sources are essential, which is why depository institutions in general are much better positioned than independent firms. The majority of leasing industry executives we surveyed believe independent firms are suffering the most because of limited and expensive funding sources. If an independent firm is able to secure funding, their margins are very small, making it extremely difficult to turn a profit. Strong companies with secured funding sources are more likely to thrive in the future, considering the current opportunities to increase market share.

Leasing-industry executives we surveyed see the industry's competitive landscape changing in the future. Funding challenges have modified business plans, as there is an increased focus on core clients and less acquisition activity. A large-ticket equipment-leasing-industry executive stated, "It's all about relationship management." Our survey results confirm that there are numerous acquisition opportunities in the market place because credit-constrained independents are looking for buyers. Nevertheless, these acquisition opportunities are not being executed as larger firms and banks are still hesitant to take on additional risk.

The general consensus among interviewees is that we will see fewer firms in the industry. In the next few years there is an expected rise in consolidation, increasing the size of the average firm and decreasing the number of small independents. This trend in consolidation could negatively affect lessees as large firms are expected to favor well-diversified portfolios, potentially causing lessors to reject financing on grounds of overexposure. Independent firms that remain in the market are likely to be specialized niche players. Specialization and niche industry expertise is likely to be the synergy that keeps independent firms profitable.

Figure 22. Public and Private Investment in Equipment and Software
(Bilions of dollars)



Source: IHS Global Insight

Spotlight on Asset Management

Current State of Asset Values

The credit crunch that started in 2008 led to the development of a saturated secondary market for equipment, causing asset values to plummet. The majority of leasing-industry executives we surveyed are facing an extraordinary decrease in asset and residual values, well below the expected residual values at the time of origination. Diminishing residual asset values are adding to the credit constraints and increasing delinquency problems the leasing industry has been forced to deal with as of late. These depressed asset values are forcing lessors to be very conservative when calculating the expected future value of equipment. We are not going to see conventional asset values until economic conditions ease and inventories start to increase, giving businesses the means and confidence to purchase equipment and make project commitments. One equipment type that has held up better than would be expected in this severe recession is trucks. While values are down, the supply of used trucks in the market would be much higher were it not for the record level of exports to Eastern Europe and Russia in 2007 and 2008.

IHS Global Insight anticipates inventories will decrease in the third quarter of 2009, but increase in the fourth quarter, leading to an increase in demand for business credit. Asset values will not rebound until old equipment depreciates or increasing inventories causes an increase in demand for business credit. IHS Global Insight expects real spending on industrial and other equipment to turn around in early 2010 as businesses start adding to their inventories, thus, increasing the demand for equipment and potentially elevating the asset values for some types of equipment. The uncertainty surrounding asset values is associated with saturated secondary markets.

Asset Resale Trends

Depressed demand, large inventories, and increases in delinquencies and charge-offs, as demonstrated by the ELFA Monthly Leasing and Financing Index, continue to drive asset resale values down. Asset resale values are particularly low in the construction and aerospace sectors, which historically experience large cyclical fluctuations. These low residual values have been an added burden for financing companies. The only equipment markets that have not experienced dramatic decreases in residual values are markets that have historically low resale prices, such as office equipment.

The majority of survey respondents stress the fact that equipment secondary markets continue to be weak and resale prices have not recovered. This trend has contributed to an increase in lease and rental renewals, which have proven to be beneficial for both parties. Our survey results show that lessors are benefiting from extending terms on lease agreements instead of accepting low market residual values. An increasing number of lessees are not in a position to purchase new equipment, making lease and rental renewals a viable short-term solution. Once economic and credit conditions improve, we are likely to see lease and rental renewals revert back to historical levels.

Conclusions

The equipment leasing and finance industry has taken a blow from the economic and credit cycles over the last 18 months. The financial crisis has limited credit availability and stunted business investment growth. Its impact has been felt across the equipment leasing and finance industry—IHS Global Insight estimates that financing volume declined by 23% in 2009. Independents seem to be affected most, as their source of funds has become much more limited. The difficult economic and credit conditions have forced some players out of the industry, moving the business into a more consolidated market.

The picture that emerges presents both challenges and opportunities. Understanding the financing preferences of end-users by business size, industry, and equipment type will help equipment financing companies plan for future growth. A major industry participant is cautious about the near term and states, "the short-term outlook is still day to day. Things appear to be getting better, but we're not back to equal." Regarding the longer term, he is "optimistic about this business. We've had continued disruption in the industry, but this asset class will survive through this because it's still economically rational for businesses to secure financing through a lease or a loan."

As the economy begins its recovery and credit markets stabilize, we expect the equipment finance industry to see improvement and thrive in a new era of more conservative underwriting. The equipment finance industry has proved to be resilient in the past. Although the equipment finance industry is undergoing structural change in this economic cycle, there are reasons to be confident that it will emerge in a strong position to contribute to the expansion of business-equipment investment.

About the Study's Authors

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