Executive Summary

As detailed in this Report, the state of the equipment finance industry in 2007 was generally good. Results showed slight volume growth while providing mixed indications for future industry performance. For example, Return on Equity (ROE) and portfolio quality declined while Return on Assets (ROA) and operational efficiency increased.

However, since year end, the market disruptions indicated in 2007 have become much more pointed and suggest a difficult and highly unpredictable operating environment for 2008 and beyond. Industry analysts, interviewees, and FIC's clients agree that a confluence of macroeconomic issues, including the subprime mortgage meltdown, the collapse of the credit and default swap markets, the continuing decline in real estate values, and the volatility of energy and commodity prices, among other concerns, have significantly changed the game for the equipment finance industry.

The key themes that emerged from the interviews and analysis include:

• *Continued market disruption and declining confidence.* Most executives and analysts expect current market instability to continue for a significant period of time, up to another four-six quarters, as customer performance slides and lenders and the markets are forced to work through mounting losses in various areas. Nearly everyone interviewed expects "another shoe to drop," although the expected problem areas vary.

• *Funding as the critical area of focus.* As a result of losses in mortgage-related investments and the failure of key areas of the credit markets, liquidity for providers of equipment finance, including some units owned by banks, has significantly declined. As one executive stated, "Two years ago we were awash in liquidity. Today, it is a desert."

Those players with continuing access to reasonably priced funding have a distinct advantage and possess a clear opportunity to grow high quality market share. Those without must either curtail activities or find non-traditional sources of funding, including, for a few, Private Equity investments. One indication of the industry's funding focus: several bank-owned equipment lenders are beginning to leverage new technology, specifically Remote Deposit Capture, to gather deposits from customers outside their retail bank's footprint. Some larger independents, understanding the value of a deposit franchise, have either purchased or started banks.

Independent players lacking the track record and portfolio quality to obtain traditional bank credit may be forced to further deleverage their balance sheets, reducing their ability to drive either volume or returns. Unless funding opportunities improve, their long-term survival has to be in question.

• *Seismic change in the competitive environment.* In past economic downturns, smaller Independents suffered as bank credit became more expensive and terms and covenants more onerous; the smallest and weakest sometimes failed or were acquired. Big banks, with access to low-cost deposits as a funding source, increased market share.

In this cycle, the largest financial institutions, collectively having lost hundreds of billions of dollars, have experienced major funding challenges themselves; both large bank and non bank players have pulled back or dropped out of segments of the equipment finance market. Large Independents, once with access to the Commercial Paper and debt markets for relatively inexpensive capital, are now experiencing a significant increase in their cost of funds linked to a lack of market liquidity.

As a result, the overall competitive picture has changed significantly: previously aggressive players have become more selective; some large players have exited the industry; new types of competitors, particularly those backed by Private Equity, are beginning to enter and at the early stage of becoming a force within the market. At the end of this cycle, there will likely be fewer players with smaller players being most adversely affected.

• *A "return to sanity."* Virtually all interviewee stated that they are seeing a swift return to pricing and structuring sanity in the market. Over the first half of 2008, pricing and spreads have increased and deal structures have tightened. Executives note that, for the first time in years, the risk/return relationship is where it should be. An additional positive factor is that many end customers appear more interested in working with a reliable financing source rather than issuing price-oriented RFPs. They want deals that preserve cash and are willing to accept higher margins to do so.

• *Increased regulation will likely have a significant impact.* Most insiders agree that, as a result of the current financial crisis, increased regulatory oversight is inevitable. While few expressed significant concerns related to the implementation of Basel II or the shift to international accounting standards, most believe that regulators will expand their authority to include all types of lenders, including those

currently subject to little if any scrutiny. Executives express concern that requirements for increased provisions, lower leverage, and consumer-like protection for all borrowers may result in reduced profitability and less competition.

• *2008 will show strong performance … for some.* Based on both anecdotal evidence and statistics compiled by the ELFA and PayNet[1], new business volume has increased over 2007, spreads have improved, and losses, while ticking up, are well below 2003 levels, the last significant problem year.

Industry analysts attribute the apparent increase in volume to two factors: first, an increased demand for equipment financing as companies work to preserve cash and, second, fewer players in the market. Virtually every executive interviewed expects delinquencies and losses to increase beyond current levels. However, in order to minimize potential losses, most indicate that they have tightened their collection efforts in addition to evaluating risk management practices and increasing credit requirements for new deals.

• *Scale over smarts?* In previous Reports, FIC has often featured case studies of niche players that have managed to succeed because of their ability to segment and differentiate themselves versus larger players. While “smarts” will remain important, given funding and capital requirements, going forward it may no longer be sufficient for success. “Brawn”, discussed in the next section, will also be increasingly important going forward.

The state of the industry in 2008 appears to be more volatile and complex than in many years. The handful of very strong players will exploit their funding depth and competitive gaps to grow. Many others, hamstrung by capital and funding issues, will narrow their level and scope of activity. Some, unable to find sufficient amounts of either, may discontinue operations or shrink to a point of insignificance.

Analysts agree that the industry will experience continued volatility and uncertainty over the next 12-18 months and that, ultimately, it will look very different than it does today, both with fewer total players and, in all likelihood, fewer small players. In our view, the 1950 Betty Davis movie *All About Eve* concisely captures our likely near-term operating environment: “Fasten your seat belts, it’s going to be a bumpy night!”

[1]PayNet provides predictive credit and risk management tools to improve the process of originating loans to small businesses. *www.paynetonline.com*