

Financial Institutions Consulting

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**Review of the 2001 State of the Industry Report  
Leasing & Finance:  
Continued Growth, But Tougher Times**

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Equipment Leasing Association  
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# Summary

- Industry growth slowed in 2000 and has contracted in 2001
- Large ticket continues to outperform other segments. As independents disappear, banks drive new business volume and continue to generate the highest ROE
- Pricing pressure eased in 2000 and continues to do so in 2001, but the slow economy requires a focus on internal efficiencies
- Funding continues to be a priority for the industry
- Ongoing success demands that management access competitive funding, tighten operation efficiency, and execute on a defensible value added strategy

# Today's discussion

- Short-Term Economic Outlook
- Industry Performance
- Results by Ticket Segment
- Results by Lessor Type
- Cross-Sectional Results
- Challenges and Recommendations

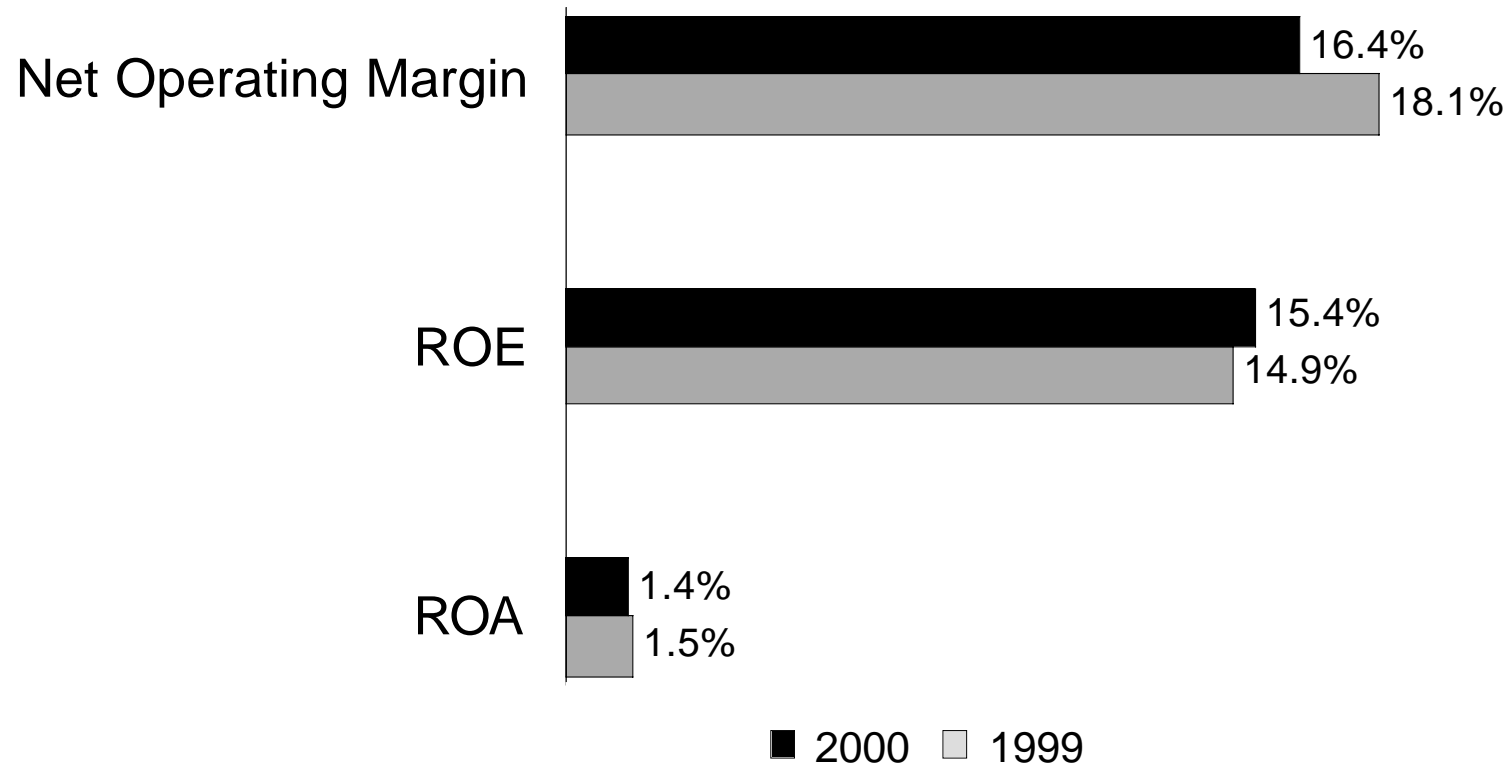
# ***SHORT-TERM ECONOMIC OUTLOOK***

## **The short-term outlook for the leasing industry is anything but rosy**

- Since December 2000, manufacturing output has declined over 5%
- Growth in business equipment investment projected to decline 14 to 18 percent by the end of 2001
- In the wake of the September 11 attacks, airlines have laid off over 100,000 people; Continental Airlines delayed \$70 million lease payment

# ***INDUSTRY PERFORMANCE***

## **Leasing remains a profitable industry**



Source: 2001 ELA Survey of Industry Activity Report

# Pricing pressures eased in 2000 even as cost of funds increased

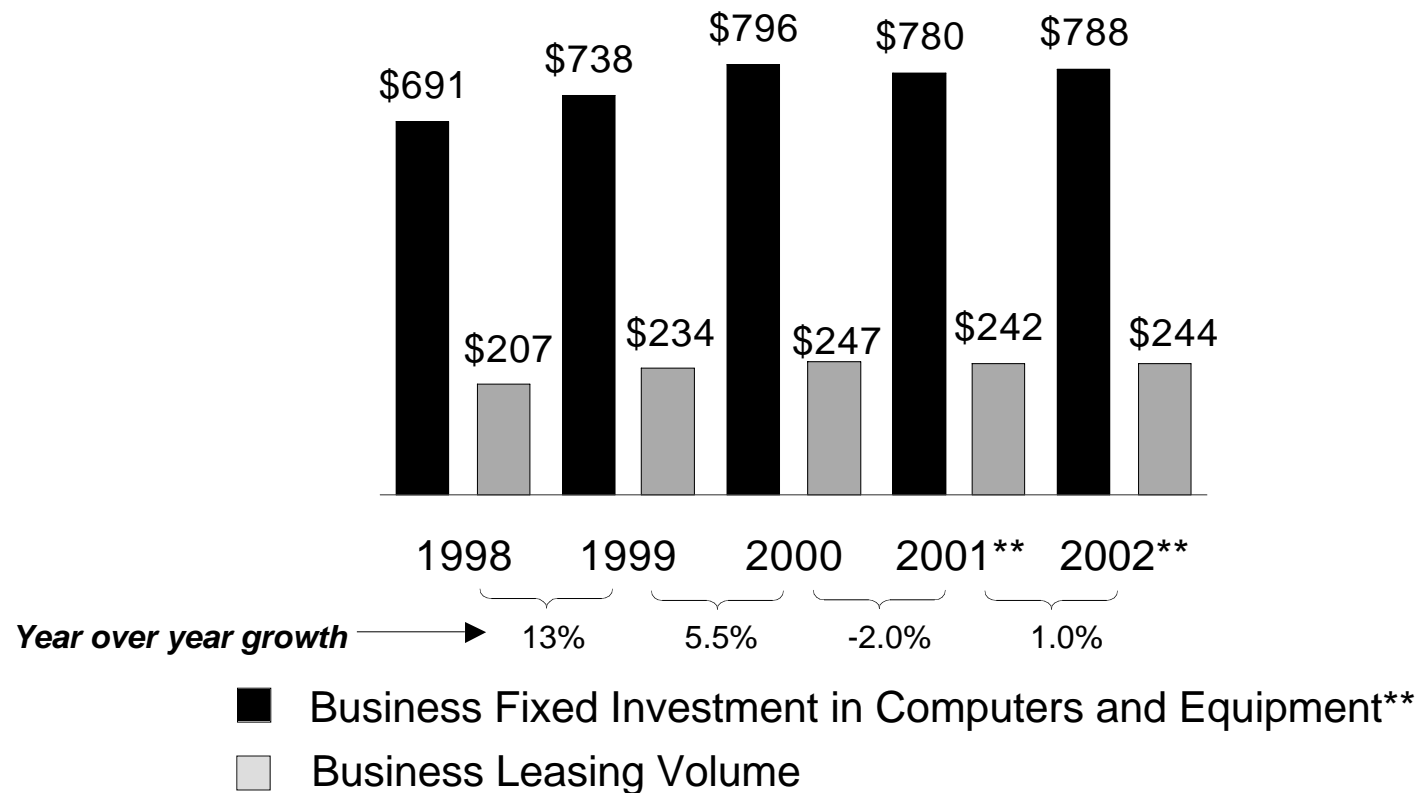
Overall pre-tax spread

|                                  | <b>Pre-tax yield</b> | <b>- Cost of funds</b> | <b>= Pre-tax spread</b> |
|----------------------------------|----------------------|------------------------|-------------------------|
| <b>1999<br/>(overall)</b>        | 9.6%                 | 6.2%                   | 3.4%                    |
| <b>2000<br/>(overall)</b>        | 10.2%                | 6.6%                   | 3.6%                    |
| <b>Sept 2001<br/>(estimates)</b> | 10.4%                | 6.0%                   | 4.4%                    |

Source: 2001 ELA Survey of Industry Activity Report, FIC Analysis

# Growth in business fixed investments has slowed considerably

Total Domestic Business Fixed Investment and Lease Financing Volume\*  
(\$'s in billions)



Source: ELA, FIC Analysis, National Association of Business Economists

\* Does not include software \*\* Estimates

# To get beyond the numbers, FIC interviewed a cross-section of lessors and service providers

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# Interviews focused on critical industry topics

- What is the effect of the economic downturn?
- What effect is the funding squeeze having on various lessor types?
- How is consolidation affecting the industry?
- How has e-commerce changed industry dynamics?
- How will independents survive?

# Survey data shows strong 2000 performance, but interviews indicate a tough row to hoe in 2001

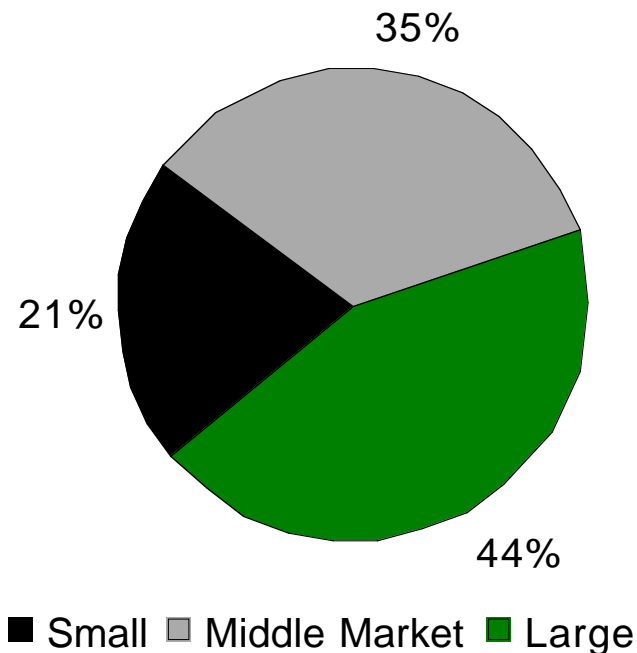
- In 2000, leasing volume growth slowed; leasing volume contraction predicted for 2001
- Margin pressures are easing for efficient players, but continue to impact those with operational and funding issues
- Consolidation continues and many view acquisitions as a means for growth
- Profitability and challenges vary by ticket size and lessor type

# TICKET SEGMENT

## Large Ticket

### Large ticket segment still drives volume

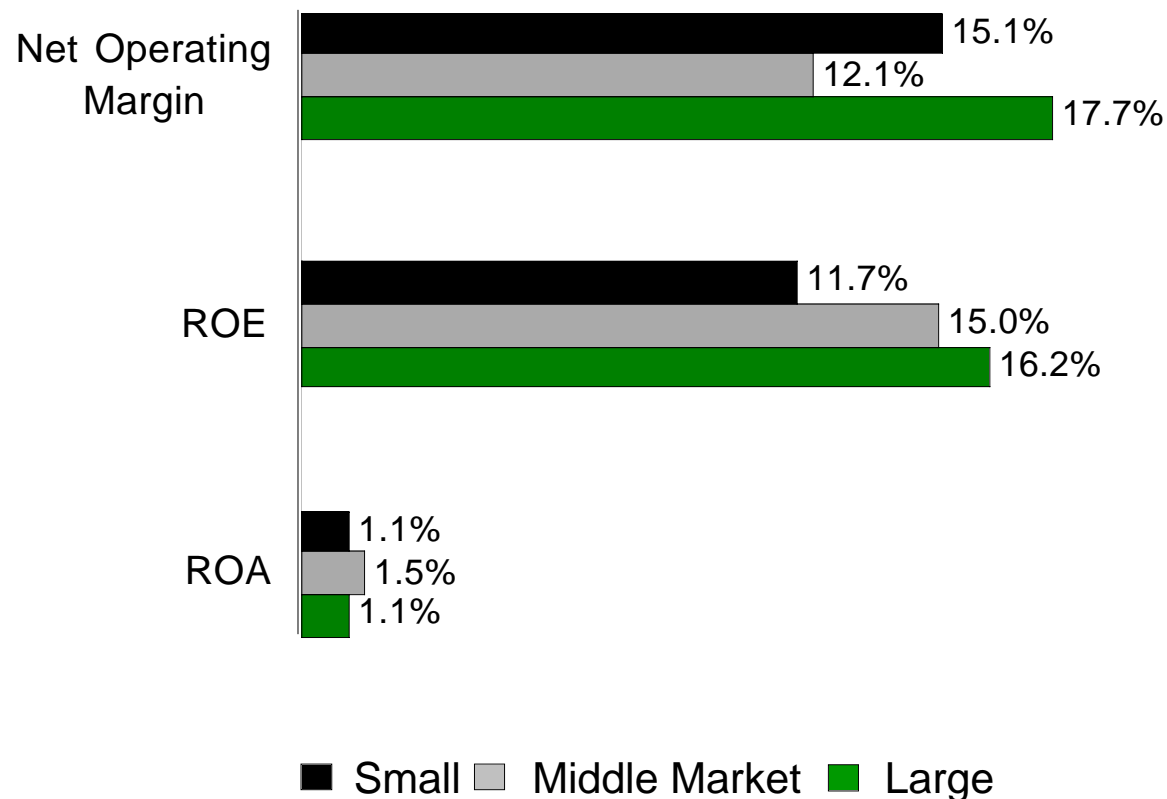
2000 Total New Business Volume Allocation  
by Ticket Segment



Source: 2001 ELA Survey of Industry Activity Report

# Performance varies significantly between market segments

## 2000 Profitability Ratios by Ticket Segment



Source: 2001 ELA Survey of Industry Activity Report

# Large ticket transactions remain profitable

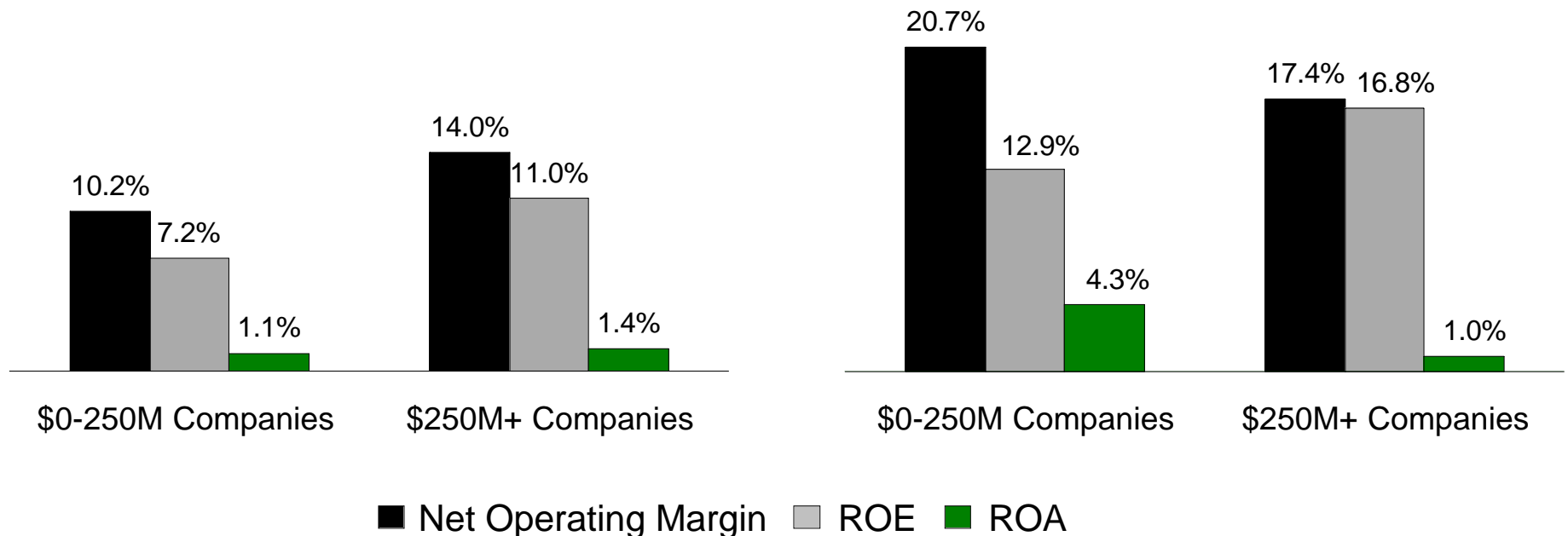
- “Large ticket transactions are highly customized. We may spend a great deal of time putting a deal together, but we get paid well for it”
- “It costs relatively little to originate a large ticket deal, you don’t need legions of sales people to get the job done”
- “The two biggest advantage in large ticket is the ability to premium price and the low origination and maintenance costs”

# Profit disparity widens further by lessor size

## 2000 Profitability Ratios by Lessor Volume\*

### Small Ticket Transactions

### Large Ticket Transactions



\*Sufficient data was not available to include Middle Market Transactions  
 Source: 2001 ELA Survey of Industry Activity Report

# Smaller firms compete well in the large ticket arena

- High pre-tax income suggest tighter cost control and lower overhead
- Higher ROE is indicative of larger firms ability to leverage
- High ROA for smaller firms indicate better pricing and fewer non-earning assets

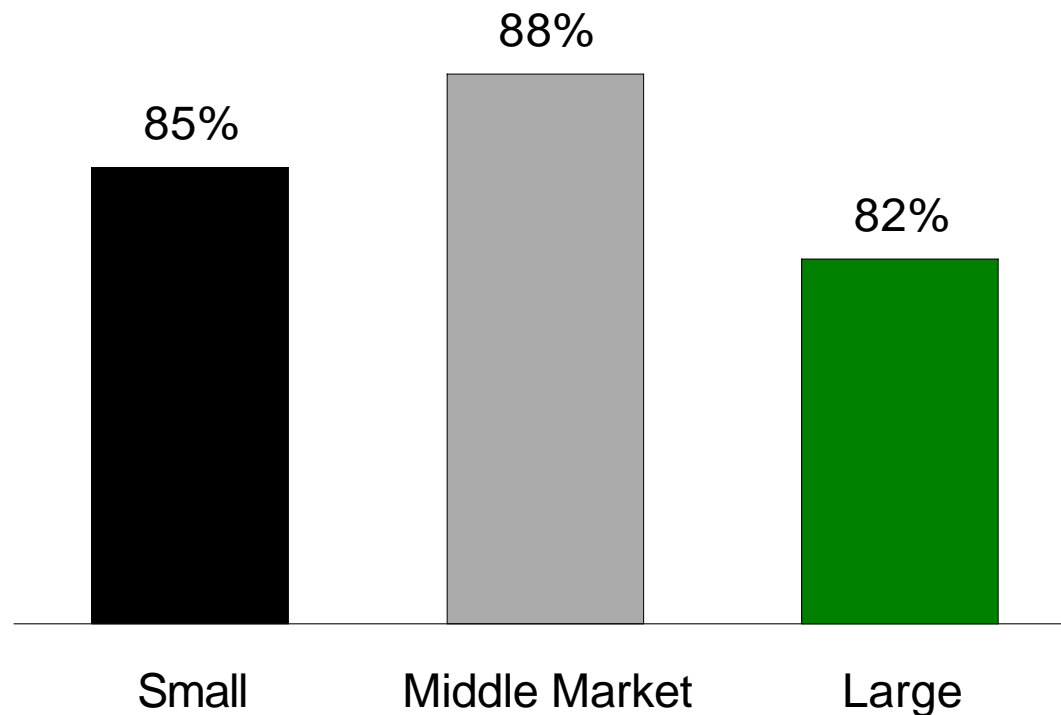
## *Middle Ticket*

# **The middle market remains a tough business**

- “Small ticket players are biting off the lower end of middle market, and large ticket players are taking the top end. They both have competitive advantages, reducing the size of the middle market arena”
- “The middle market is a hard place to play in. You have all the worst aspects of both large and small ticket transactions – customized deals and commodity pricing”
- “It’s tough. Most of us have not been very successful at driving cost out of these deals, particularly on the sales side”

# Controlling costs is the biggest middle market challenge

2000 Total Expenses Relative to Total Revenue  
by Ticket Segment



Source: 2001 ELA Survey of Industry Activity Report

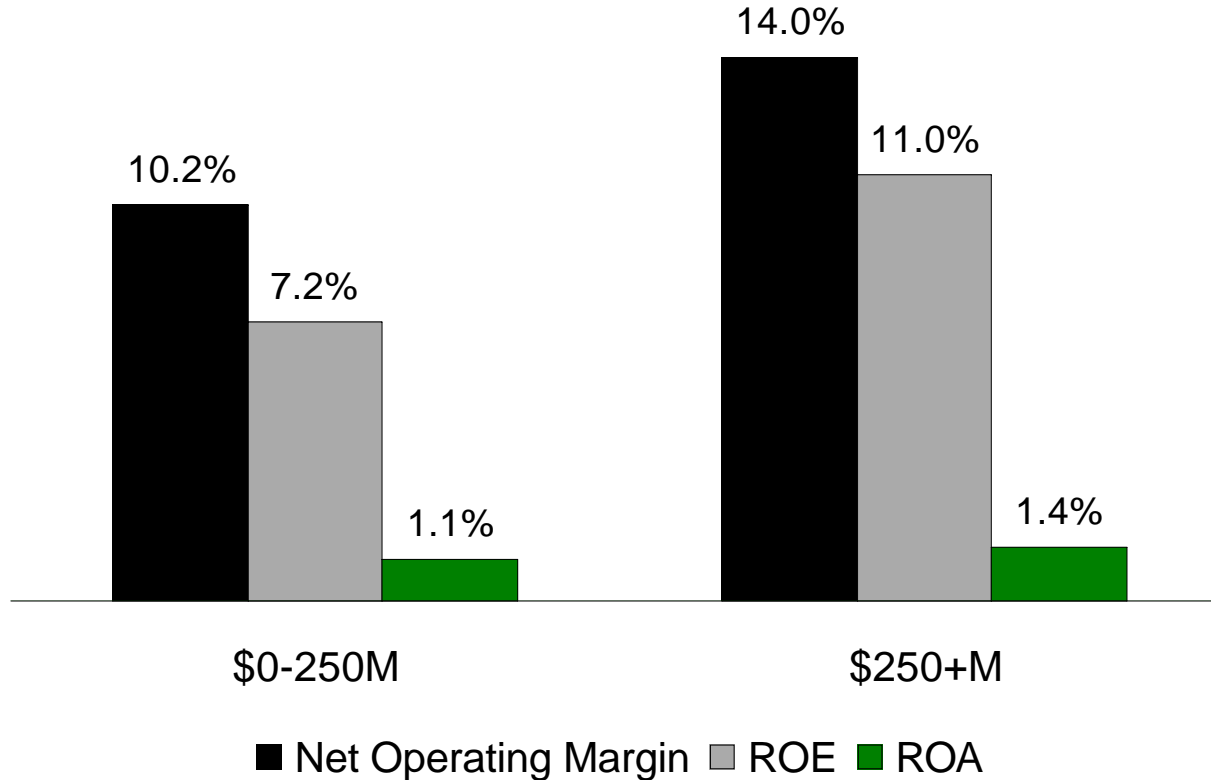
## *Small Ticket*

### **High-tech/low touch is mandatory to succeed in small ticket**

- “You have to run an extremely tight ship from an efficiency and technology standpoint”
- “Small ticket is an entirely different world. You have to deliver high volume at a low cost. Automation and technology is the only way to do it”
- “Pricing is really cut-throat in small ticket. Customers want low prices and a lot of service. But when push comes to shove, they care most about price”

# Economies of scale allow larger firms to compete most effectively in this market

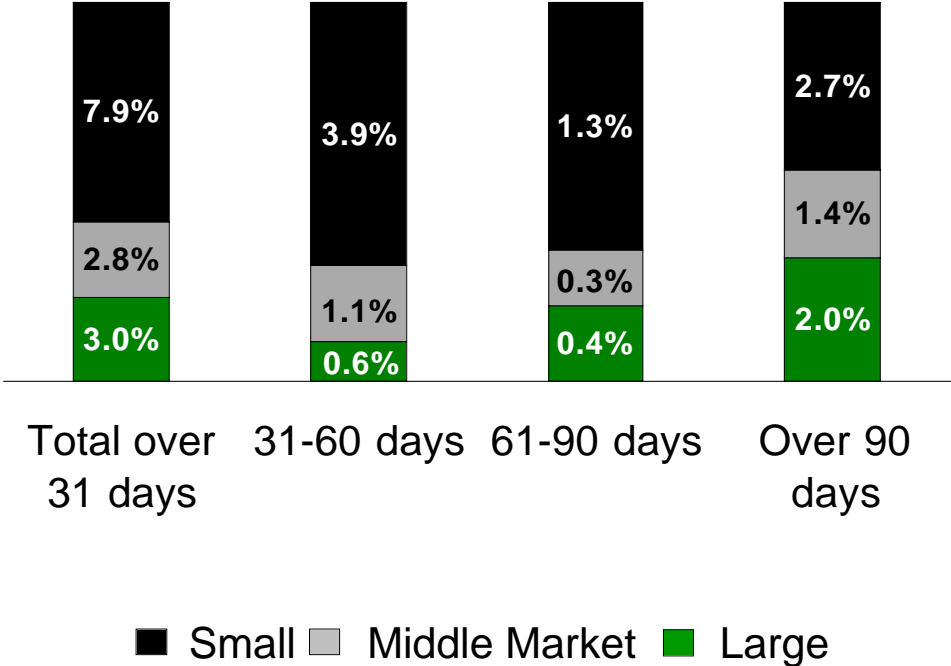
2000 Profitability Ratios by Lessor Volume



Source: 2001 ELA Survey of Industry Activity Report

# High small ticket delinquencies require high-tech servicing and collection procedures

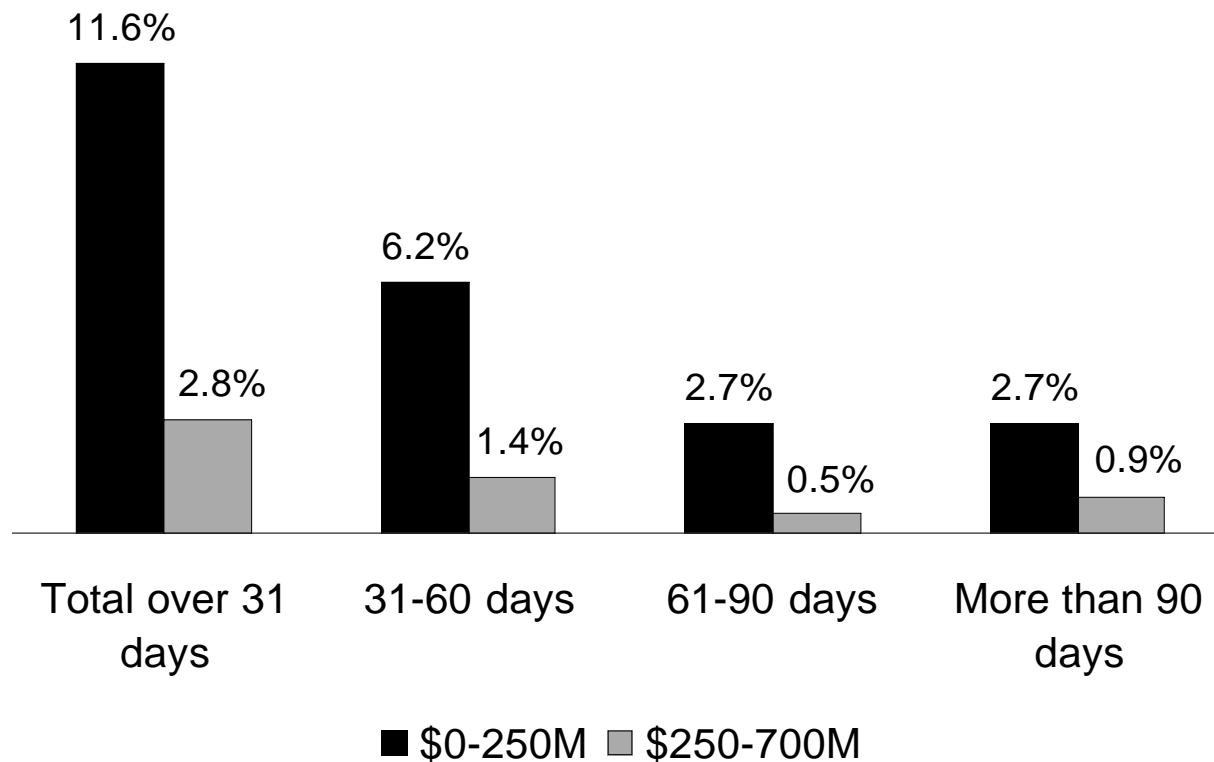
2000 Delinquency of Receivables by Ticket Segment



Source: 2001 ELA Survey of Industry Activity Report, FIC Analysis

# Larger firms are generating much lower delinquencies than smaller firms

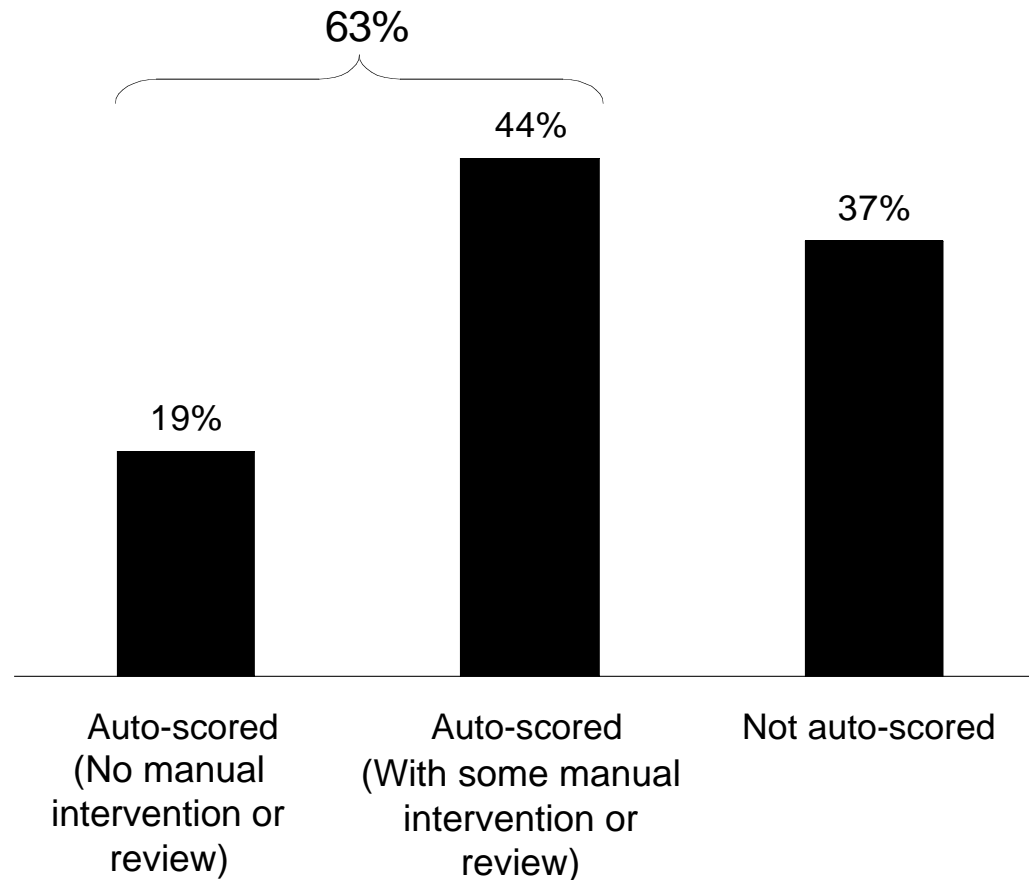
2000 Delinquency of Receivables  
by Lessor Volume



Source: 2001 ELA Survey of Industry Activity Report, FIC Analysis

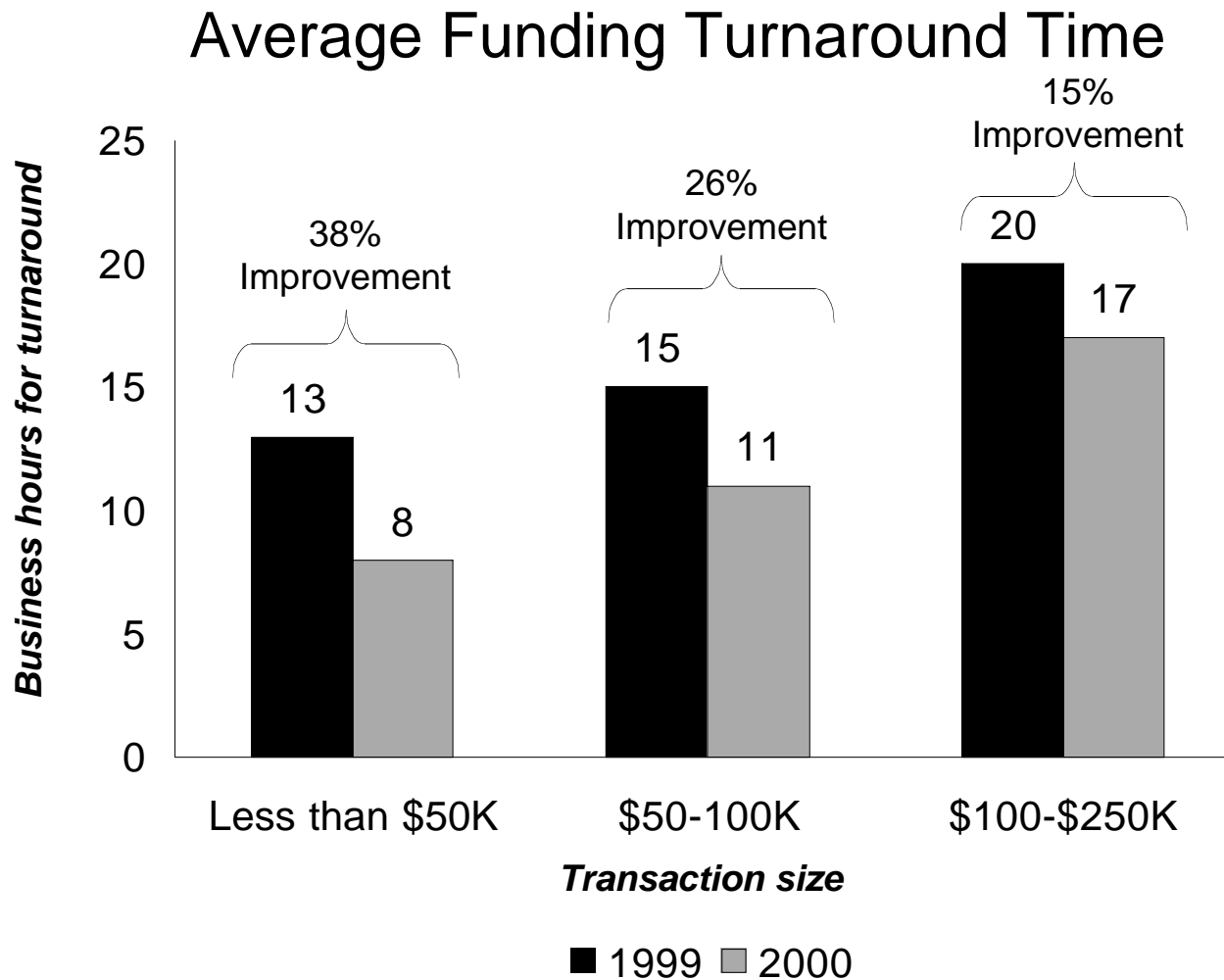
# Most small ticket deals are automatically credit scored

Credit Decision Method Used



Source: 2001 ELA Survey of Industry Activity Report, FIC Analysis

# Small ticket lessors are extending the use of automation to include larger transactions

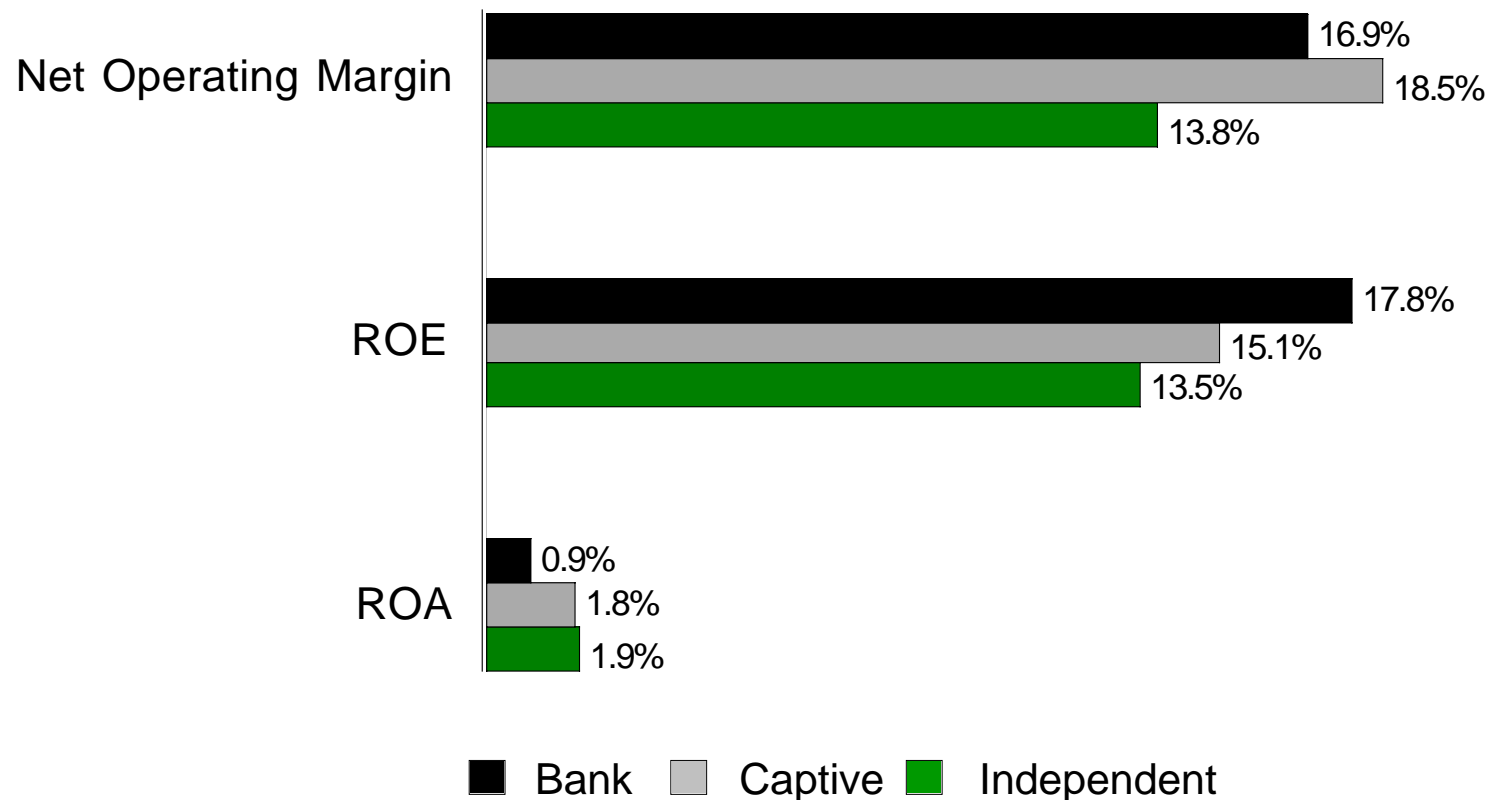


Source: 2001 ELA Survey of Industry Activity Report, FIC Analysis

# LESSOR TYPE

## Banks and captives exceed independents in profitability

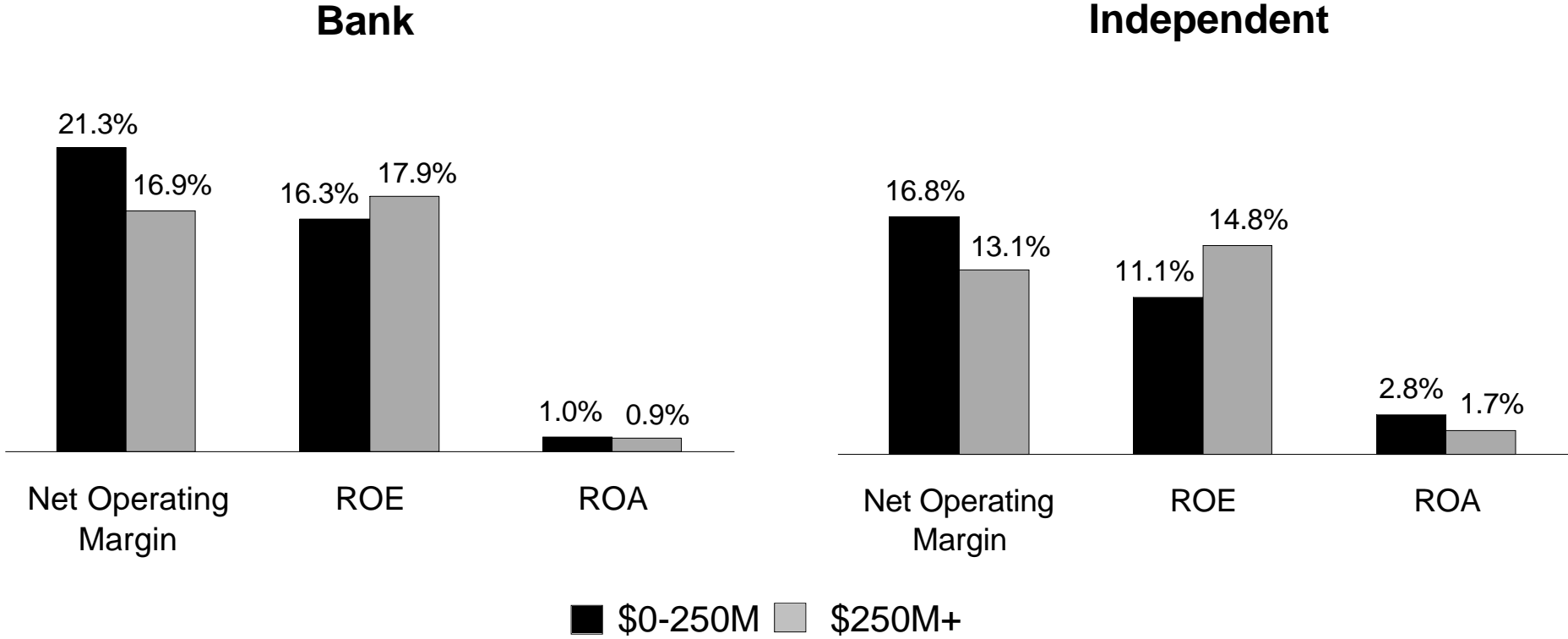
2000 Profitability Ratios by Lessor Type



Source: 2001 ELA Survey of Industry Activity Report

# While smaller lessors enjoy higher pre-tax earnings they are less leveraged than larger institutions

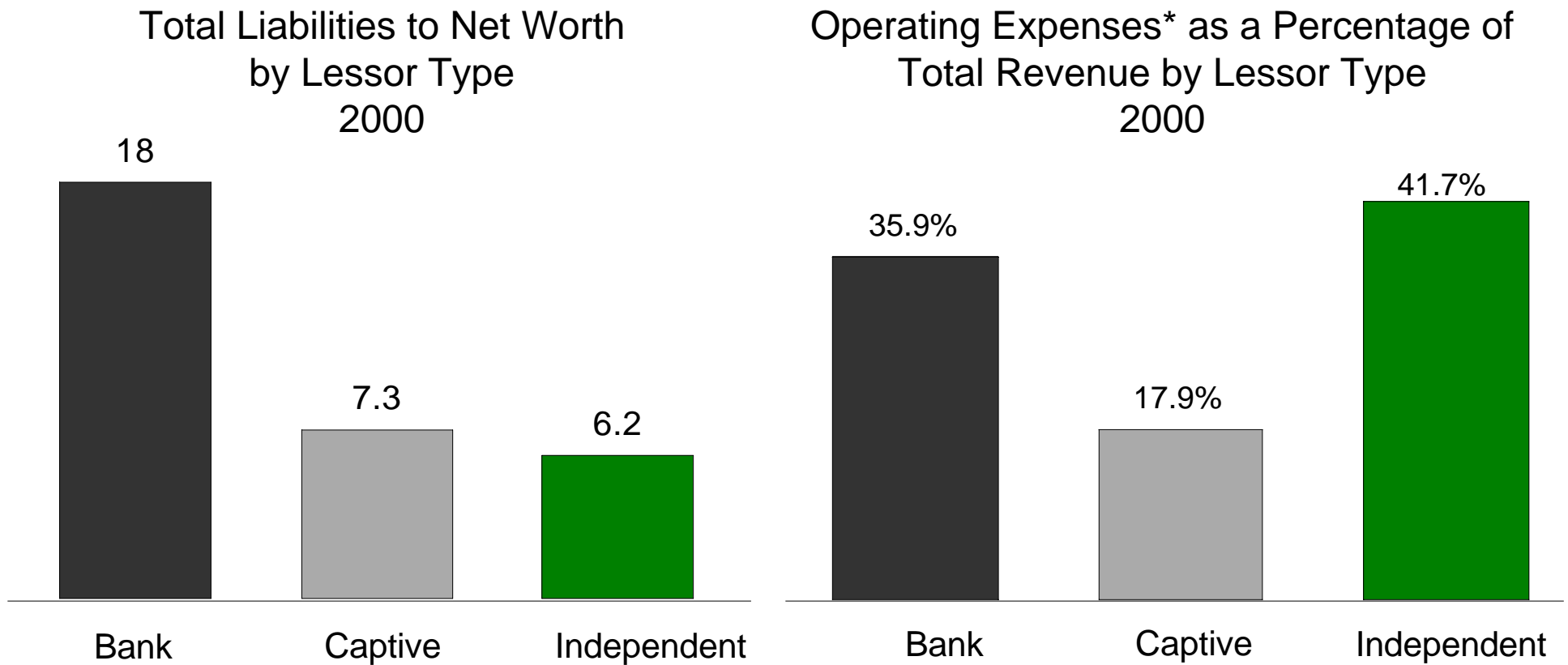
2000 Profitability Ratios  
by Lessor Volume\*



Source: 2001 ELA Survey of Industry Activity Report

# Banks

## Higher leverage and cost efficiencies benefit the banks



*\*Operating expenses include 2000 SIA income statement categories: Sales and Marketing, Operating, and Other*

*Source: 2001 ELA Survey of Industry Activity Report*

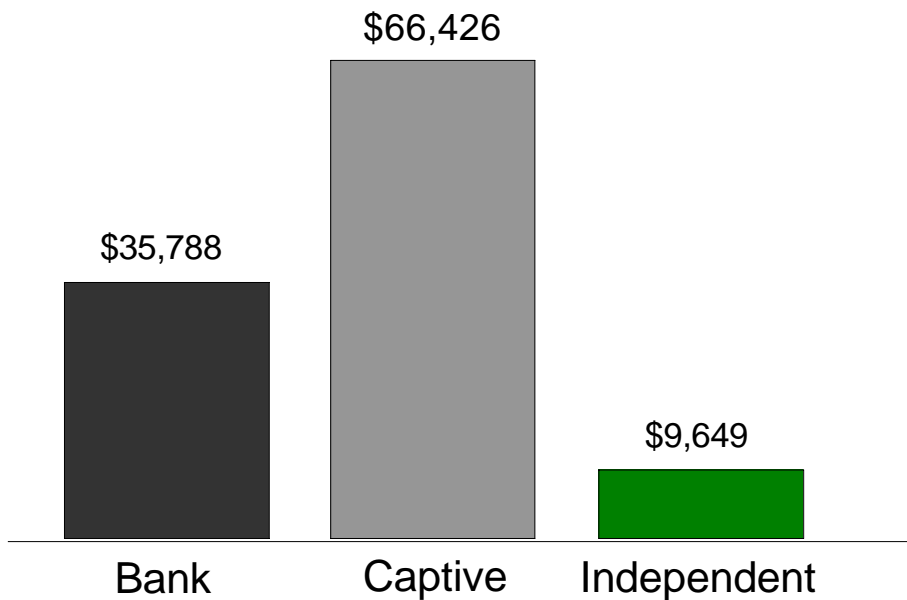
# Banks are extremely competitive

- “Once the current market situation turns, banks will come back and be more aggressive, even though there will be fewer of them. They will be more focused on where they want to be playing”
- “Banks don’t have to spend a lot of time looking for funding – as it is already there, and it is very competitively priced. They can divert the time others use for funding to growing the business”
- “Banks have an advantage in that they can leverage their existing customers. They really get first shot and pick off the best customers”

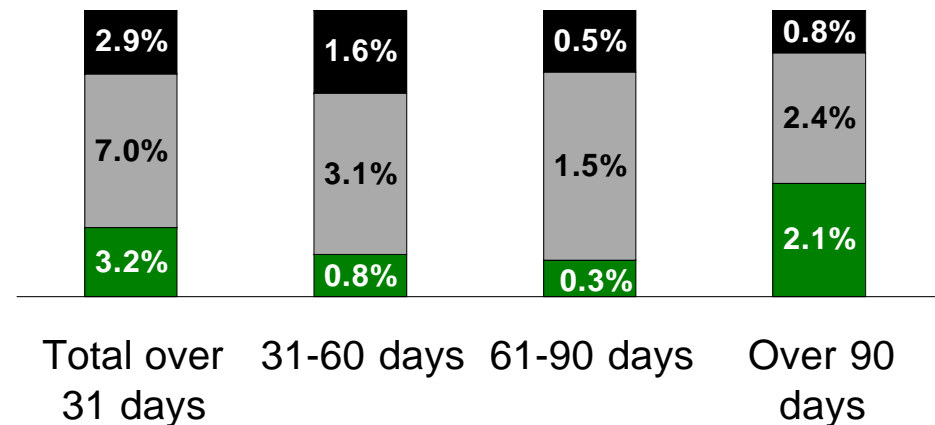
# Captives

## Captives lead the industry in both productivity and delinquency rates

New Business Volume per Sales Employee\* (000's) by Lessor Type 2000



Delinquency of Receivables by Lessor Type 2000



■ Bank ■ Captive ■ Independent/Financial Advisors

\*Sales employees include mean inside and outside sales  
 Source: 2001 ELA Survey of Industry Activity Report, FIC Analysis

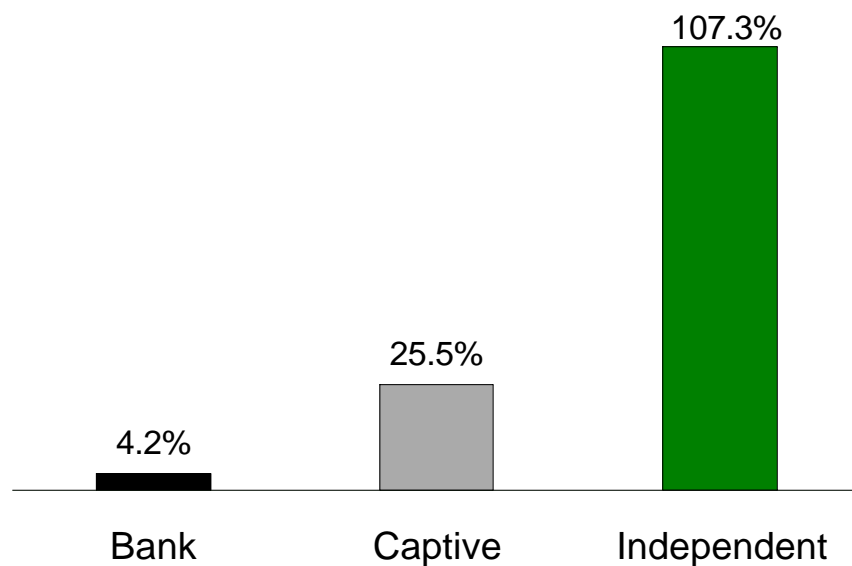
# Typically, captives operate with a favored position vis-a-vis customers

- “As a captive lessor, we are with the customer at point-of-sale. That is a tremendous advantage”
- “We have several advantages: we are there at point-of-sale, we know the asset being financed, and we can subsidize the finance cost with the profit on sale”
- “Captive leasing is often a means to close the sale. We can negotiate price and payout using intimate knowledge of the equipment. It is a great place to be”

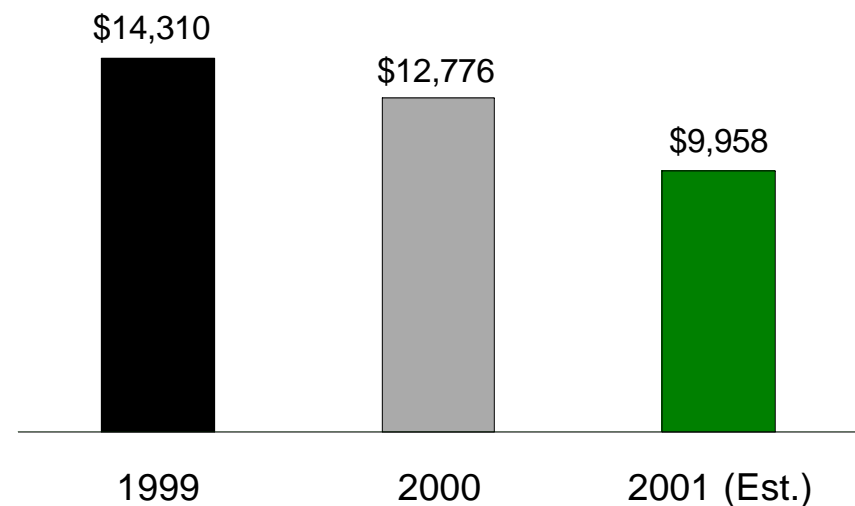
# *Independents*

## **Independent lessors have relied heavily on securitization, a highly volatile funding source**

Securitized Managed Assets As Percentage of Total Assets\*



Lease Securitization Volume (\$M)



\* Total balance sheet assets

Source: 2001 ELA Survey of Industry Activity Report, Asset-Backed Alert

# “Is there a future for the independent lessor?”

- “In the short term, it is going to be extremely difficult to survive based on access to capital. Independents must compete on a service and deal structure level”
- “I think the independents will do fine in small ticket. Banks often outsource their smaller deals, and this would be the marketplace for the independent”
- “This industry would not be where it is if it were not for independents, because banks were originally uninterested or too slow at leasing. As soon as some of the challenges facing them softens, the independents will be right at the forefront”
- “Independents can succeed with knowledge based specific niche. To find an expertise intensive business, you have to adapt and identify where you want to play in the field”

# ***CROSS-SECTIONAL RESULTS***

**Five key metrics define cross-sectional performance**

**ROE**

**ROA**

**Net Operating Margin**

**Pre-tax Yield**

**Receivables aged  
>30 days**

# And the winner is...

## *Market Segment*

## *Lessor Key Metric Ranking*

Small Ticket



- 1. Captive**
2. Independent

Middle Market



- 1. Independent**
2. Bank
3. Captive

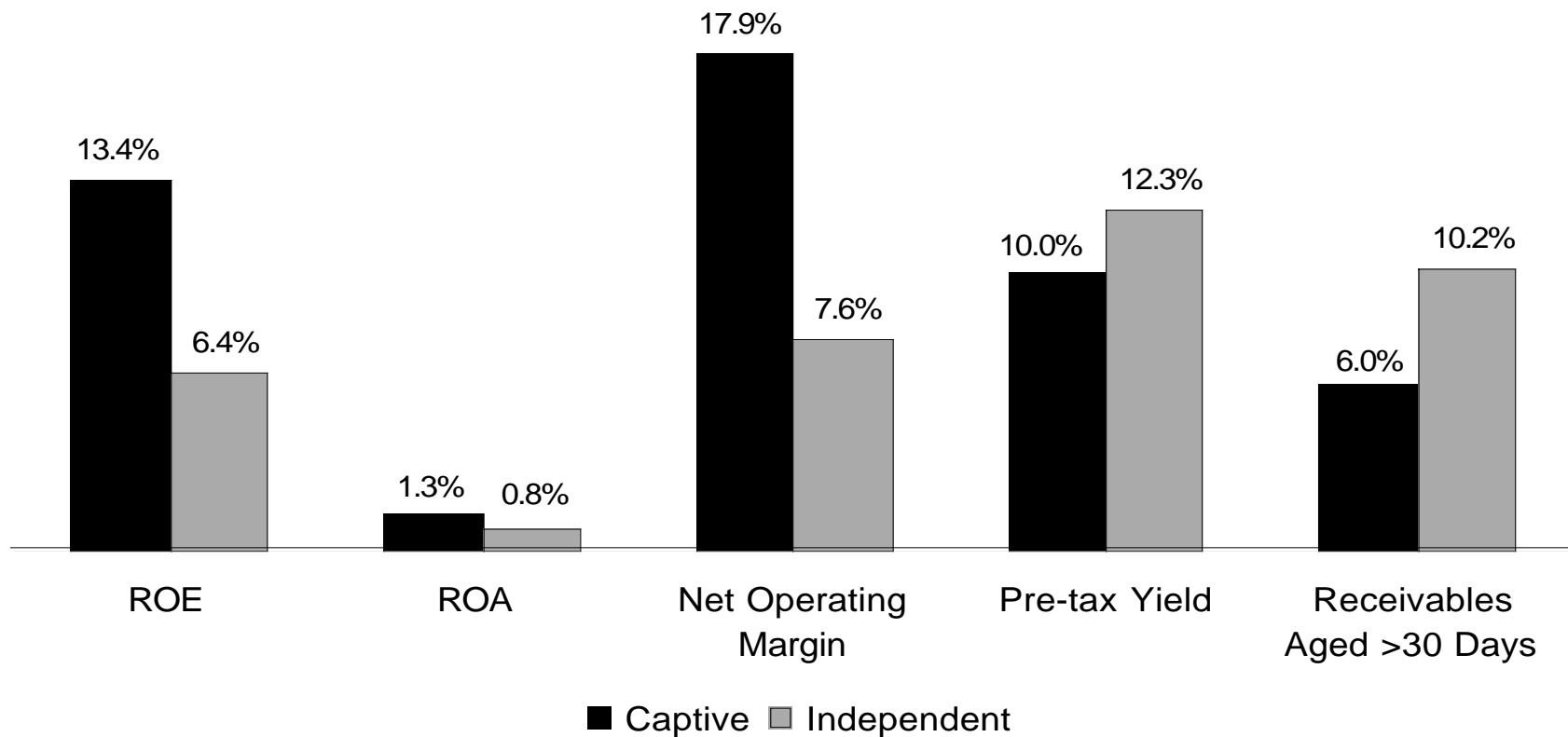
Large Ticket



- 1. Bank (Tied)**
- 1. Independent (Tied)**

# Captives generate the highest profits in the small ticket segment

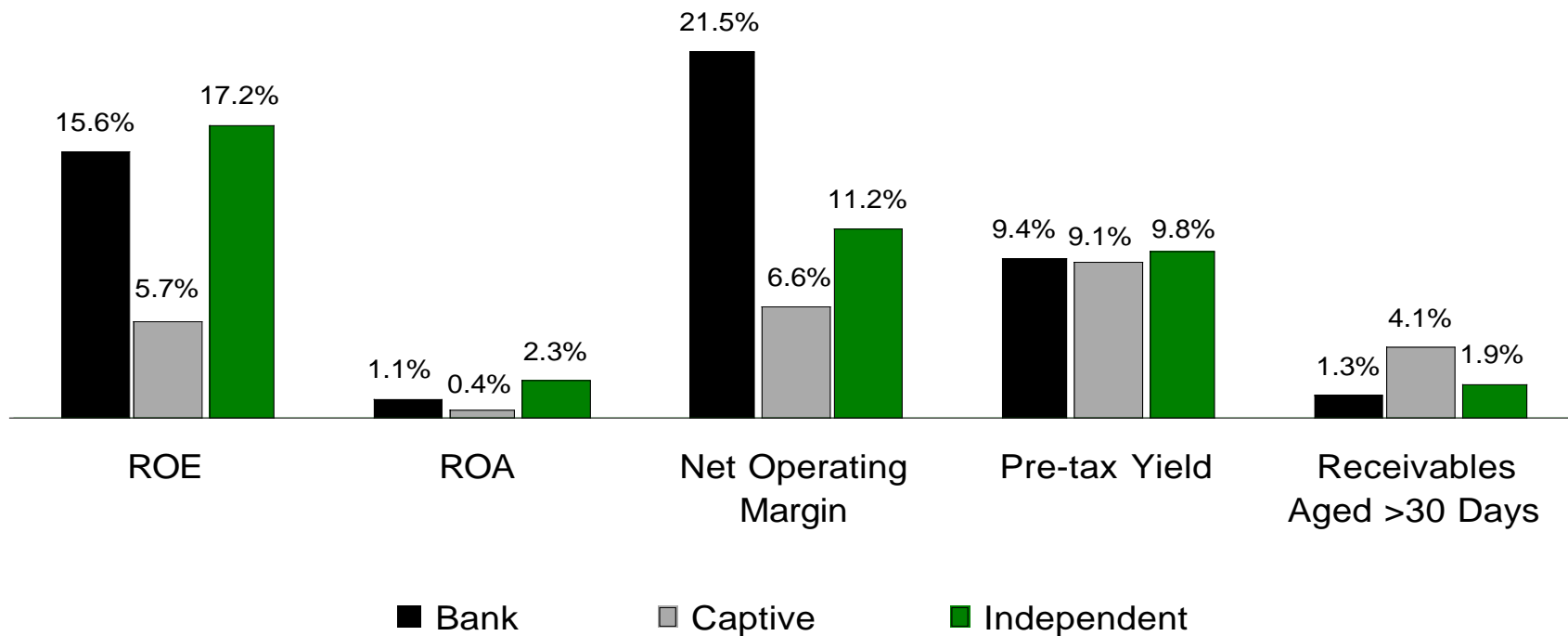
2000 Small Ticket Segment Key Ratios  
by Lessor Type\*



\* Sufficient data was not available to include Banks  
Source: 2001 ELA Survey of Industry Activity Report

# In the middle market, independents command a higher price while banks maintain lower costs

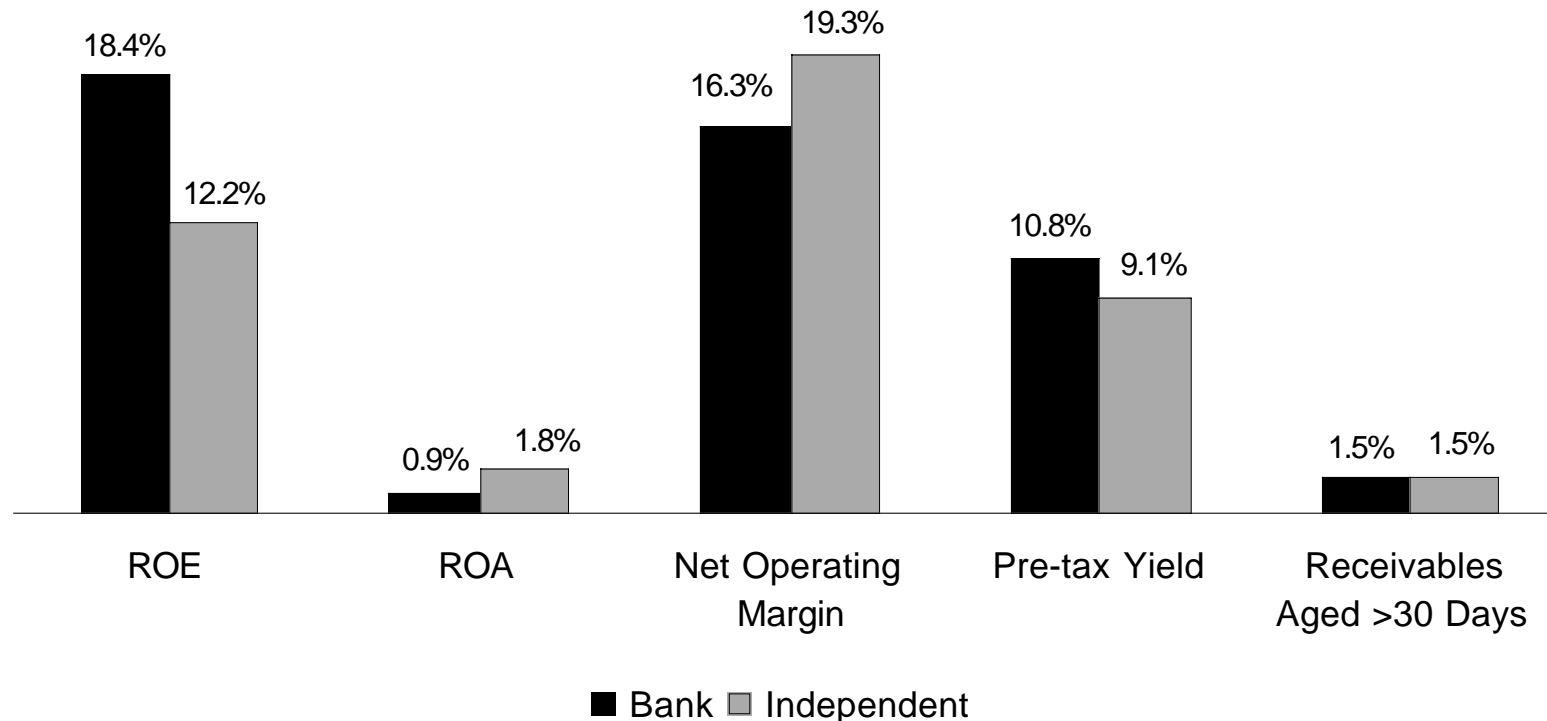
## 2000 Key Middle Market Segment Ratios by Lessor Type



Source: 2001 ELA Survey of Industry Activity Report

# With large ticket deals, banks generate better pricing, but independents optimize costs

## 2000 Key Large Segment Ratios by Lessor Type\*






\* Sufficient data was available to include Captives

Source: 2001 ELA Survey of Industry Activity Report

# ***CHALLENGES***

## **Several challenges confront the equipment leasing industry**

-  Economic pressures force a focus on operational efficiencies
-  Funding challenges put small and independent players at a disadvantage. Therefore, consolidation activity continues
-  Changing business models create the need to rethink Internet and e-commerce strategies

## *Challenge 1*

# **Economic pressures force a focus on operational efficiencies**

- Process reengineering is necessary for survival in today's economic downturn
- The leasing industry lacks benchmarks to set process performance standards
- Technology is both critically important and expensive; cost control and customer service strategies must be considered as alternatives to revenue generation
- So far, lessors have not significantly reduced personnel as a result of technology, rather, people have been reallocated to higher value tasks

# Operational excellence rules

- “We spend a great deal of time and energy looking for ways to cut costs”
- “With our Internet based customer service, we were able to move service representatives off the phones and get them selling”
- “We are always looking for cost efficiencies. Unfortunately, to really get big savings you have to spend money up front, and we just can’t do that now”

## *Challenge 2*

# **Funding challenges put small and independent players at a disadvantage. Consolidation activity continues**

- Lessors see strong correlation between debt ratings and access to funding; companies with unhealthy balance sheets are excluded from capital markets
- Certain industry sectors have a funding advantage over others; some equipment types are poison to funders
- Securitization is no longer an option for those lessors that most need it
- High profile failures have tainted the industry in the eyes of the investment community
- Lessors with funding issues will seek acquisition or disappear

# The investment community has become much more discriminating

- “A big challenge for the industry is to make sure some of these smaller and mid-size companies get continued access to bank funding”
- “Rating agencies have become a lot more diligent than they once were. Buyers are more discriminating as well”
- “The leasing industry is still a viable market. However, because there are fewer issuers and less paper out there, some investors feel not much opportunities exists to make revenue off these purchases”
- “It is not all doom and gloom in the securitization market, but there is more worry about overall liquidity and access to funding for the leasing industry”

# Consolidation continues at a rapid pace

- Funding crunch forces some lessors to seek acquisition by funding partner
- Strong companies go bargain hunting to build, or grow, their leasing business
- Economic issues force “growth by acquisition”

**“In general, consolidation is the biggest thing to happen in the industry in a long time. It seems like it is going to continue for some time”**

## *Challenge 3*

# **Changing business models create the need to rethink an Internet and e-commerce strategy for multiple delivery channels**

- E-commerce generated new business volume is nominal at best
- Many lessors are seeing the value of the Internet as a service, not sales, channel
- But, internal “e-business” systems can generate cost efficiencies and boost service quality

# Industry leaders see a new use for online

- “Although everyone wants Internet access, the actual usage and the actual transaction volume remains low”
- “The Internet is not viewed as a sales channel, but as a very important business tool. It is used to improve service to clients in terms of communicating with the back office, accessing data, and facilitating payment processes”
- “The Internet will happen. But, whether its impact will occur two years from now or five years from now, no one knows”

# Other challenges confront the industry

- **Continued shortage of talented labor even in a slower economy**
  - “It takes a different kind of person, or a different degree of expertise, to really be proficient in the leasing industry”
  - “If you look at college curriculums right now, you see lease topics addressed in more detail – it is slowly being viewed as a viable option, but has not developed into a major interest yet”
  - “Where is the next generation of leadership?”

➤ **Proposed FASB 13 changes still threatens off-balance treatment of assets:**

- “It’s not going to be the end of the business, but it will force you to adapt a different set of rules”
- “When these rules take effect, we will lose a major benefit of leasing”

➤ **Government regulation**

- “Consumer lending laws may migrate over to the commercial lending side. That would have a huge impact on the industry”
- “Leasing is very entrepreneurial, kind of like the wild west. If we are not careful, we will become regulated, like banking – not from the federal level but from the state level. We have to keep a close eye on state legislatures”

# No single solution exists on the path to continued success

- *Renewed emphasis on risk/return pricing.* Price every deal to make money
- *Determine your technology approach.* Small ticket lessors must continue to automate to drive down costs. For others, the focus is on improving service and adding value
- *Back to basics: set strategy and specific tactics.* Lessors must “pick their spots”, offering selected products to selected segments. As lease financing becomes increasingly commoditized, lessors must provide value added knowledge and services to provide differentiation



## EQUIPMENT LEASING AND FINANCE FOUNDATION

Founded in 1989 by the Equipment Leasing Association of America, The Equipment Leasing and Finance Foundation is a 501(c)3 non-profit organization dedicated to enhancing recognition and understanding of equipment lease financing.

### **Strategic Objectives**

- ❖ Maximize the role that equipment leasing plays in the world economy
- ❖ Develop and disseminate knowledge of the leasing industry

### **The Mission**

- ❖ Identify, study, and report on critical issues affecting equipment leasing and finance
- ❖ Develop knowledge of equipment leasing and finance for use by the equipment leasing and finance business, academic, and public policy communities

# Financial Institutions Consulting, Inc.

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Founded in 1995, Financial Institutions Consulting (FIC) focuses on issues of productivity and growth for financial services clients.

We emphasize practical, bottom-line results based on quantitative and qualitative research and an in-depth understanding of industry dynamics.

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## Area Expertise

Commercial Finance/Leasing  
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Recent commercial finance client work includes:

- ELFF State of the Industry Report
- Process streamlining for equipment lessor credit origination and servicing
- Growth opportunity analysis for middle market equipment leasing business
- Profitability analysis and segmentation strategy for vendor lessor
- New business development evaluation for lessor

## Matthew L. Harvey

Matthew Harvey, Engagement Manager, joined FIC in July 2000. Previously he worked in small business consulting and accounting in Boston. As a small business consultant, he worked directly with small business owners in all aspects of small business management including financial, marketing, and information systems. His experience includes financial planning and strategy, operations evaluation, and IT needs assessment.

While at FIC, Mr. Harvey was responsible for research and publication of the *2001 Small Business State of the Market Report*. He also co-authors articles for FIC's monthly newsletter to the leasing industry and has spoken at the Equipment Leasing Association's Captive Lessor Conference. Consulting work at FIC has focused on market entry strategies and product development.

Mr. Harvey holds a B.S.B.A. in Finance and International Economics from Boston University and an M.B.A. in Information Systems and International Business from Fordham University.

The Equipment Leasing and Finance Foundation  
wishes to express appreciation to

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