EQUIPMENT LEASING & FINANCE FOUNDATION

State of the Equipment Finance Industry

Review and Economic Outlook for 2017-18

Prepared for:
Equipment Leasing & Finance Foundation

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Presented:
Orlando
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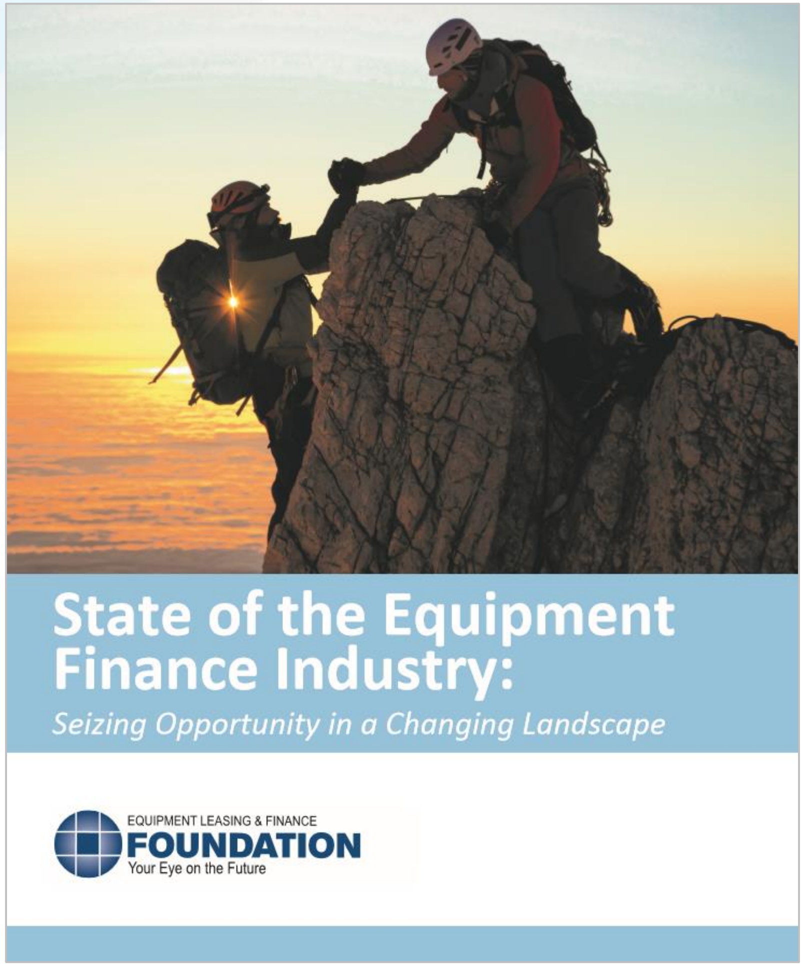
Agenda

1. Snapshot of the 2017 SEFI Report
2. Economic trends to watch in 2018
3. Great tax debate of 2017 (and 2018?)
4. Could inflation become a problem?
5. Other SEFI takeaways
6. Final thoughts

1. Snapshot of the 2017 SEFI Report

The 2017 SEFI report highlights that big, macro changes in the economy affected the leasing industry last year and will continue to in the future.


State of the Equipment Finance Industry:

Seizing Opportunity in a Changing Landscape

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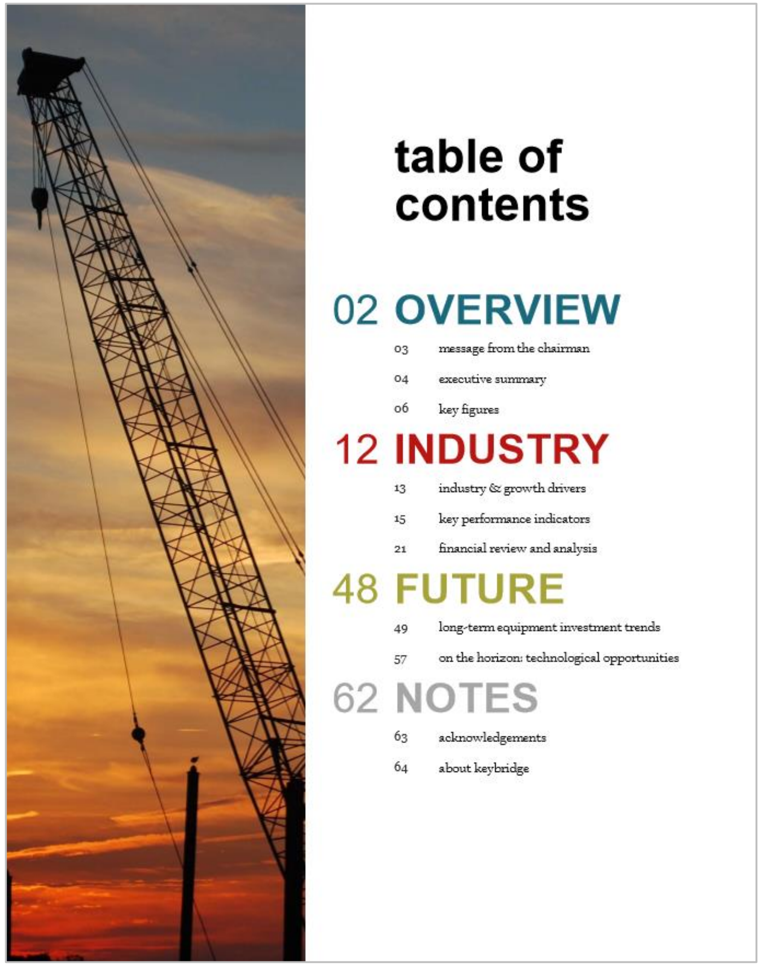
Your Eye on the Future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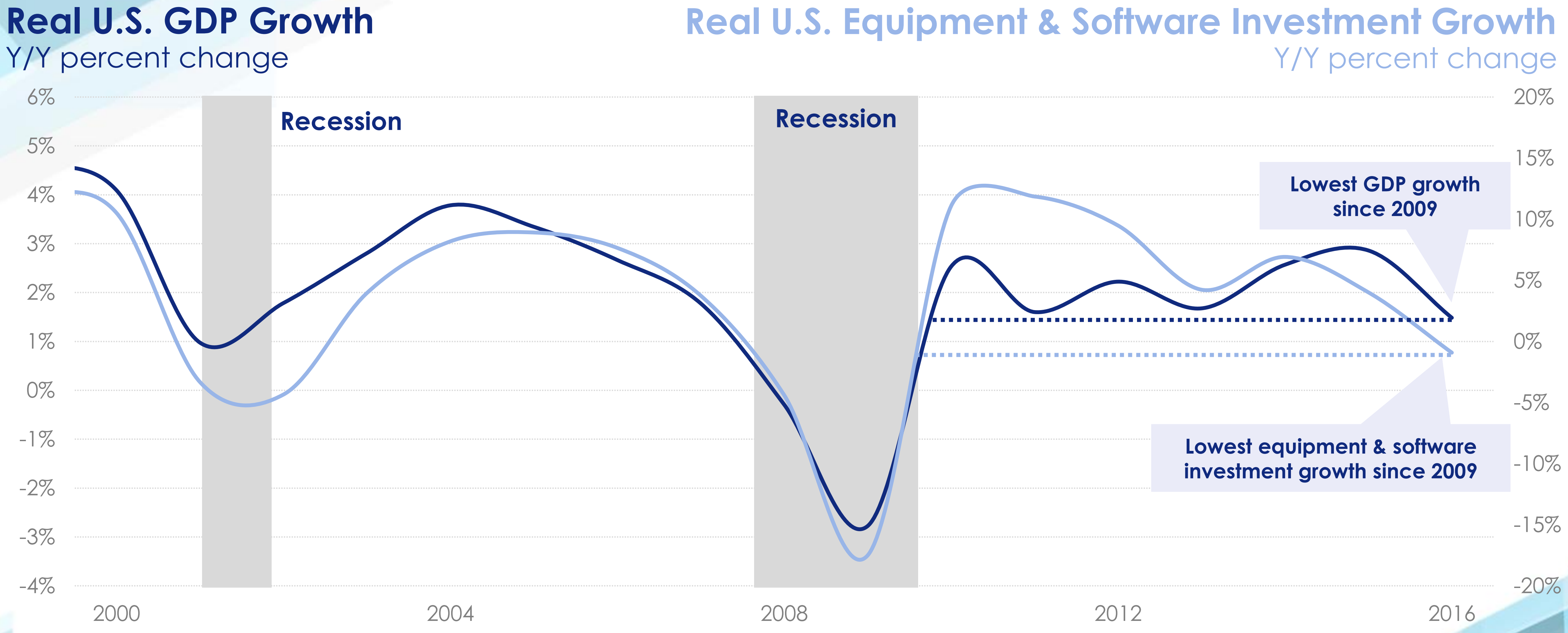
Source: State of the Equipment Finance Industry 2017

2016: a “growth pause” for the U.S. economy due to low oil prices and weak foreign growth. GDP and equipment investment suffered their worst years since 2009.

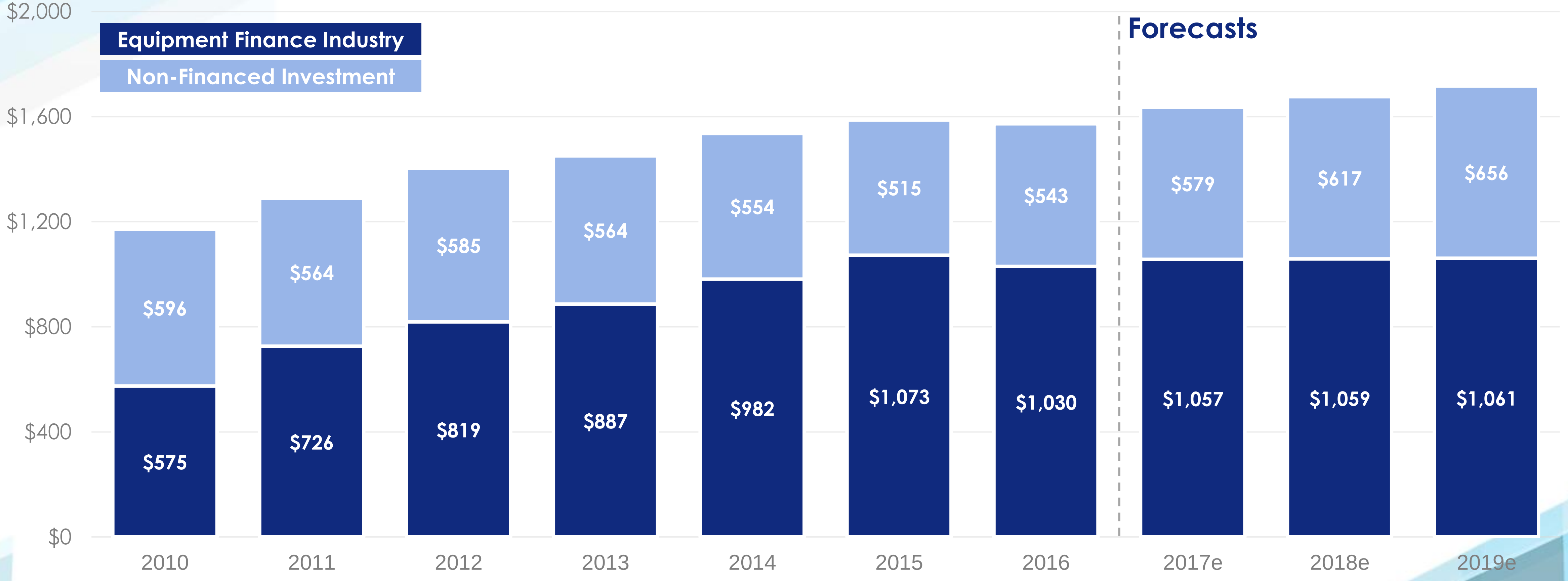


Source: Macrobond Financial

As a result, the equipment finance industry contracted slightly in 2016. However, it remained above the $1 trillion mark.

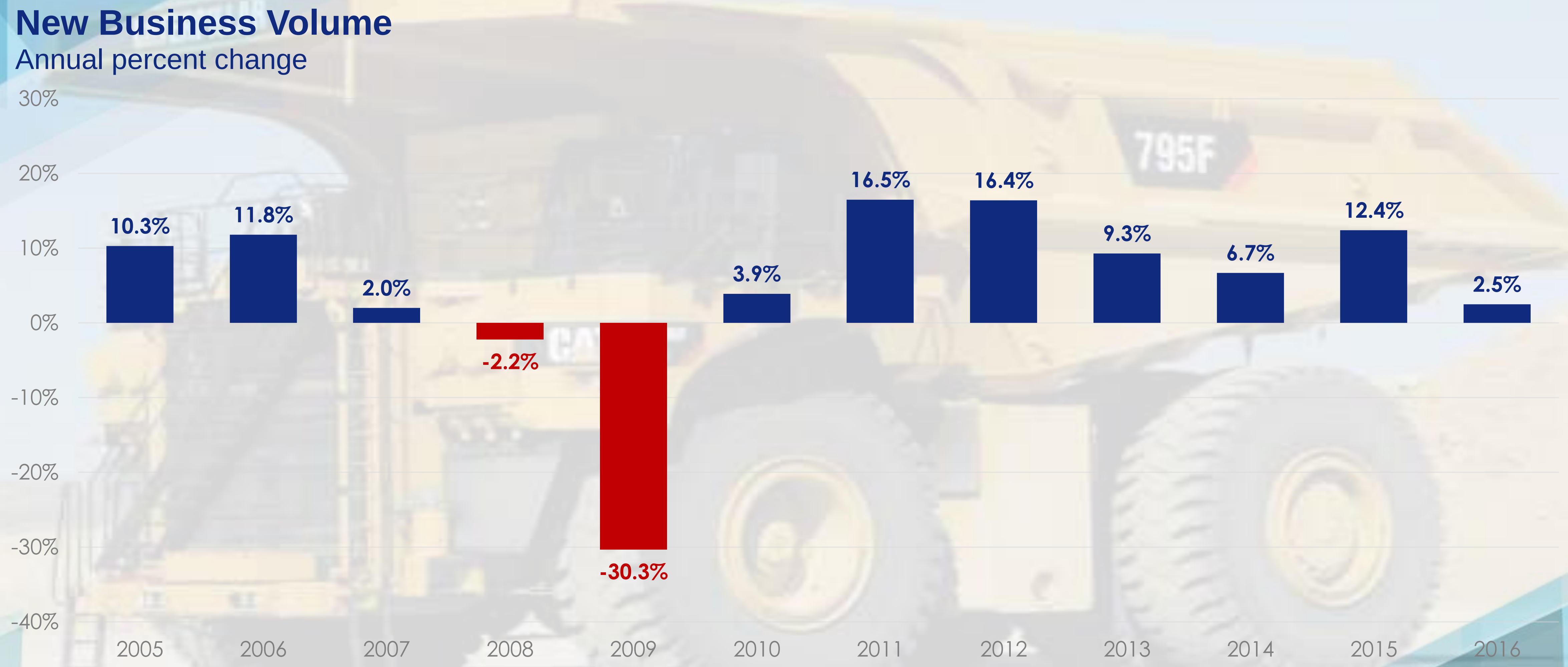
Equipment Finance Industry Size

Billions of dollars



Source: State of the Equipment Finance Industry (SEFI) 2017; Keybridge

New business volume expanded 2.5% in 2016, according to the Survey of Equipment Finance Activity—the slowest pace since 2009.

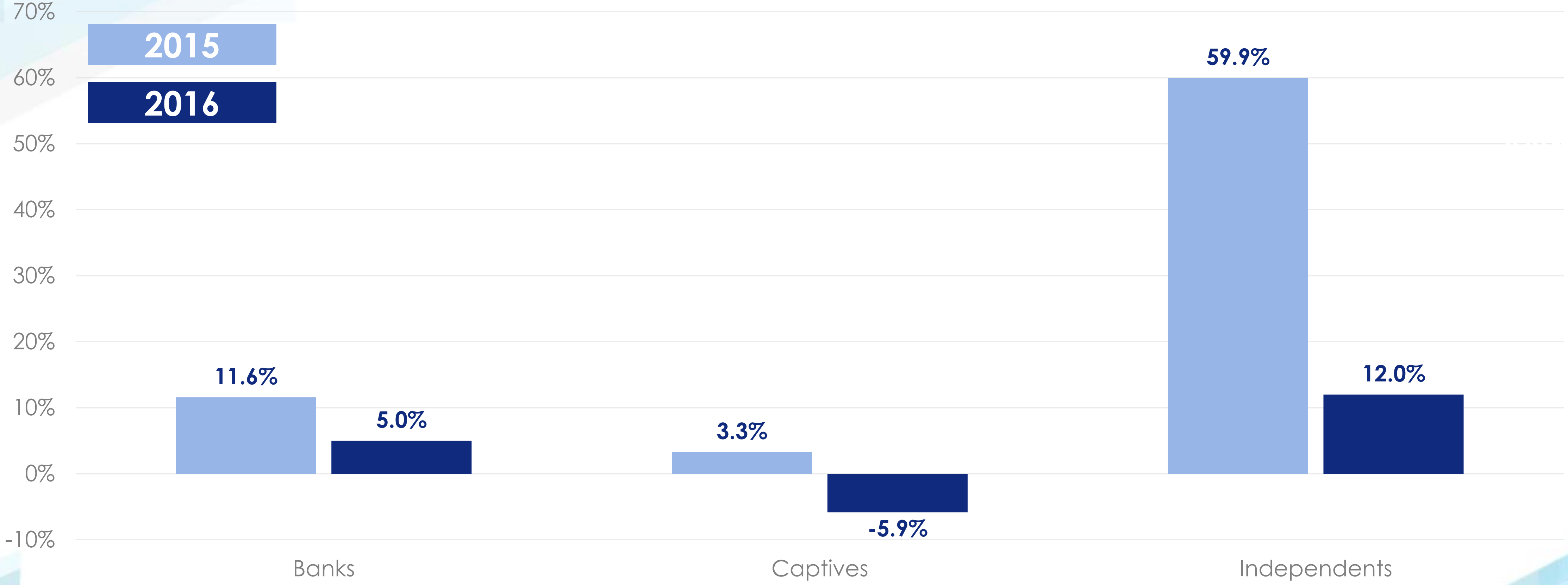


Source: Survey of Equipment Finance Activity (SEFA) 2017; State of the Equipment Finance Industry (SEFI) 2017; Keybridge

All organization types saw slower new business volume growth in 2016. Weak performance in key industries, like agriculture, hurt Captives the most.

New Business Volume Growth, by Organization Type

Annual percent change

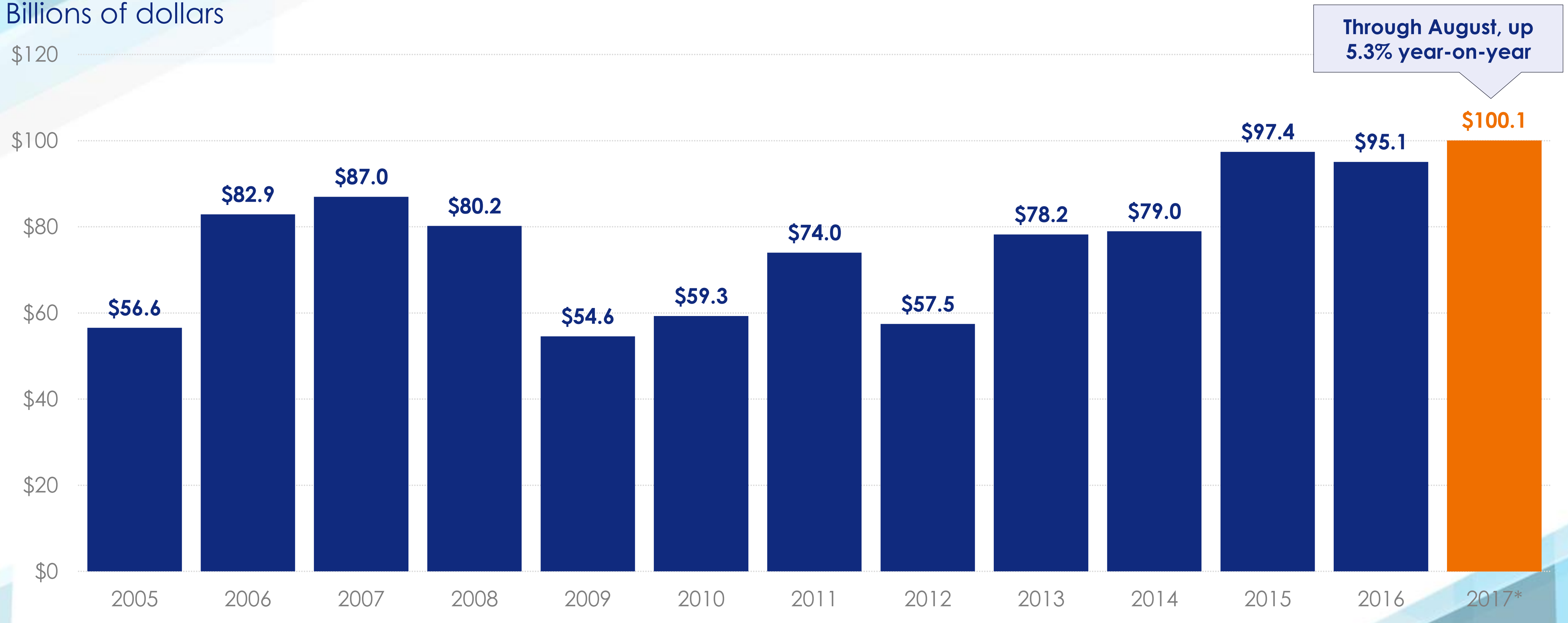


Source: State of the Equipment Finance Industry (SEFI) 2017; ELFA 2017 Survey of Equipment Finance Activity (SEFA) 2017

2017 has brought a decent recovery with moderately strong growth for the industry. Cumulative new business volume now stands 5.3% above its level one year ago.

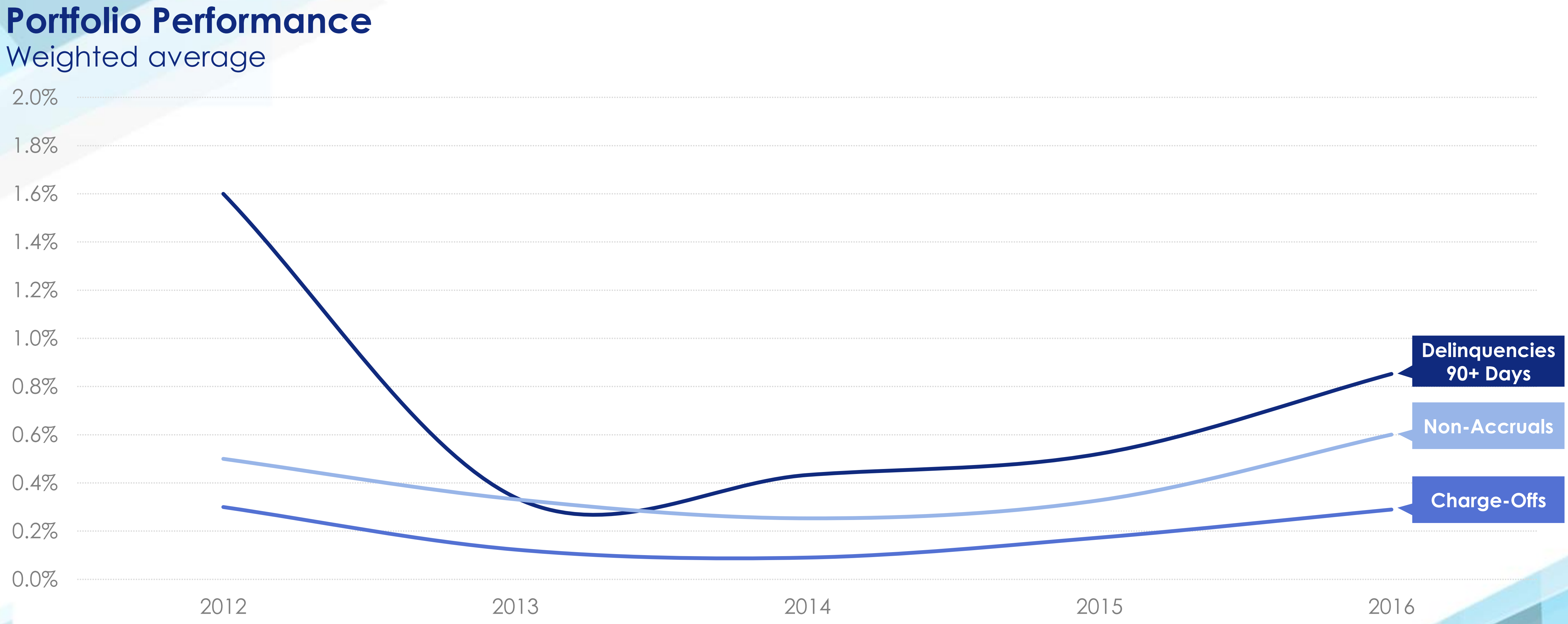
MLFI-25 New Business Volume

Billions of dollars



Source: ELFA

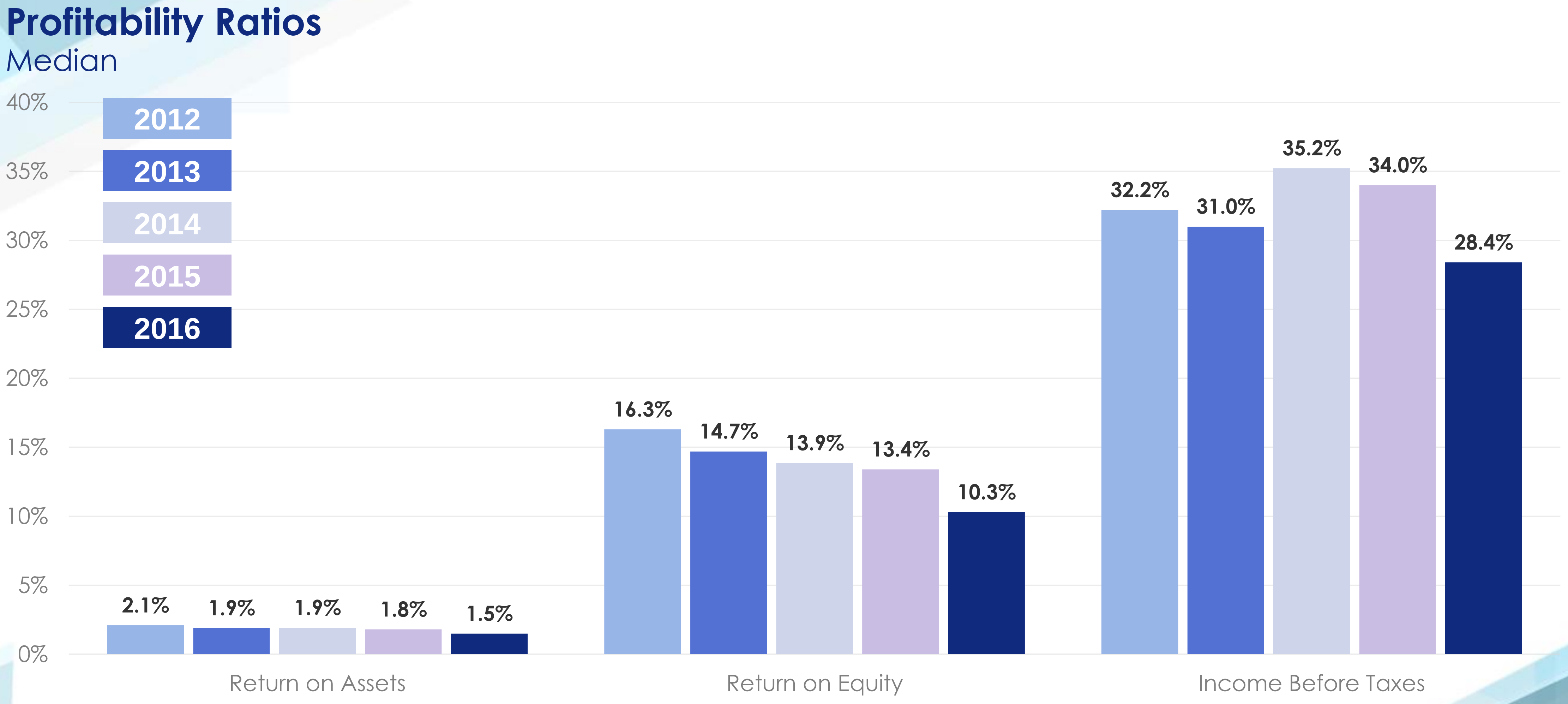
Credit quality? Despite a slight increase in delinquencies and charge-offs, industry portfolio performance remains strong overall.



Source: Survey of Equipment Finance Activity (SEFA) 2017; State of the Equipment Finance Industry (SEFI) 2017; Keybridge

Worth noting: the uptick in delinquencies has been driven primarily by the agriculture, railroad, and oil & gas sectors.

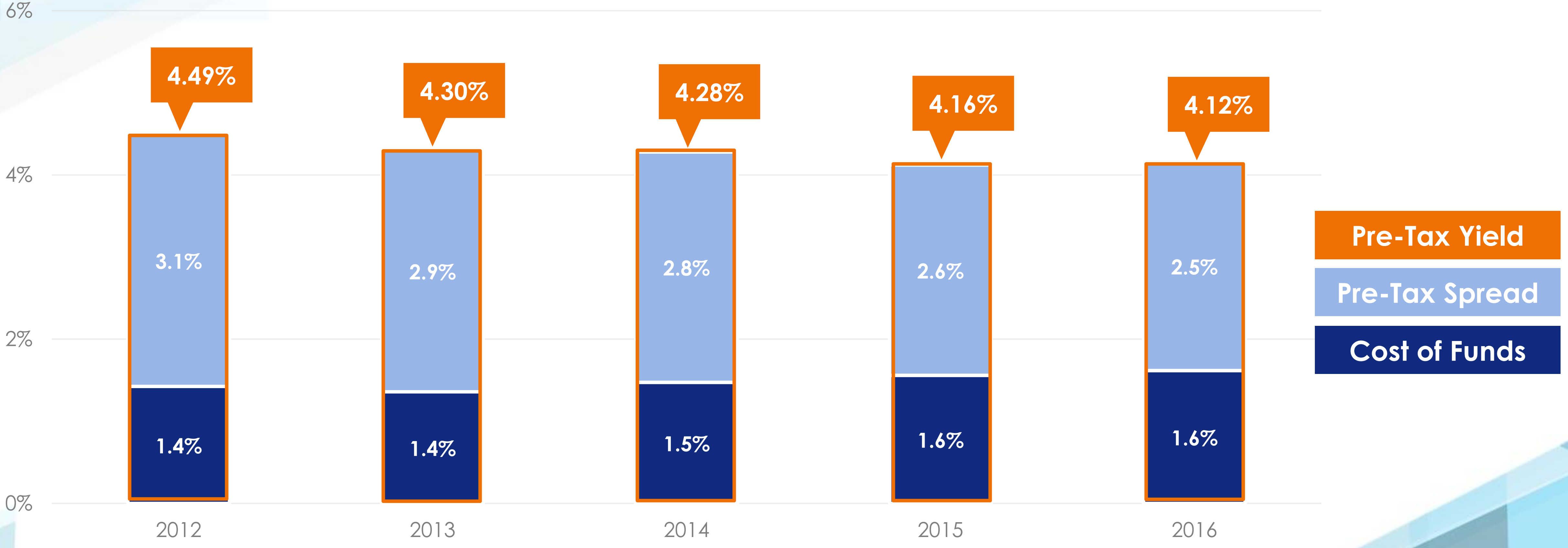
Profitability? In 2016, industry profitability declined by all key measures.



Source: State of the Equipment Finance Industry (SEFI) 2017; Survey of Equipment Finance Activity (SEFA) 2017

And historically low interest rates contributed to further spread compression in 2016. Higher interest rates in 2017 and 2018 may reverse this trend.

Yield Composition
Weighted average



Source: State of the Equipment Finance Industry (SEFI) 2017; Survey of Equipment Finance Activity (SEFA) 2017

Industry employment expanded by a robust 13% in 2016, and continues to grow strongly this year. Many new hires, however, are in compliance areas.

Total Number of Employees

Percent change Y/Y

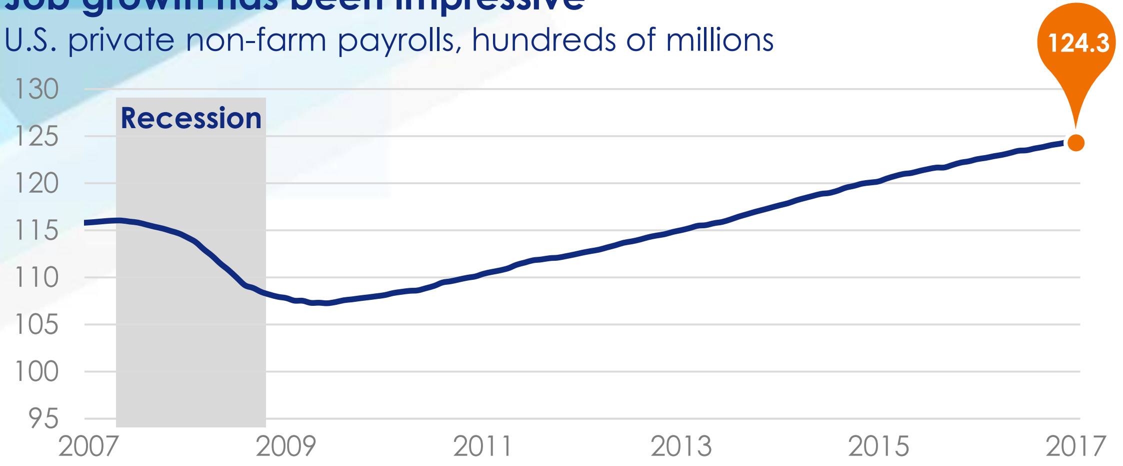
Source: Survey of Equipment Finance Activity (SEFA) 2017; State of the Equipment Finance Industry (SEFI) 2017; ELFA

2. Economic trends to watch in 2018

Consumption and investment account for about 85% of GDP. Consumers continue to get back on their feet and should support steady growth in 2018.

Job growth has been impressive

U.S. private non-farm payrolls, hundreds of millions

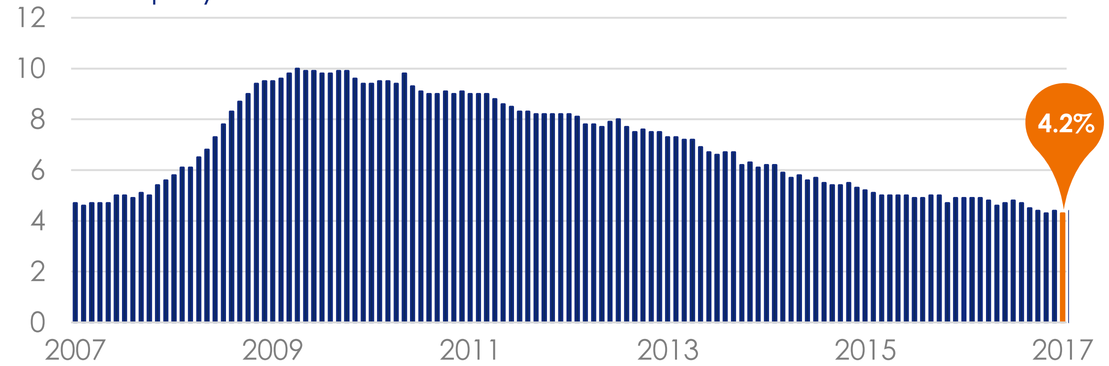


Consumer confidence is at historic highs

Conference Board Consumer Confidence Index

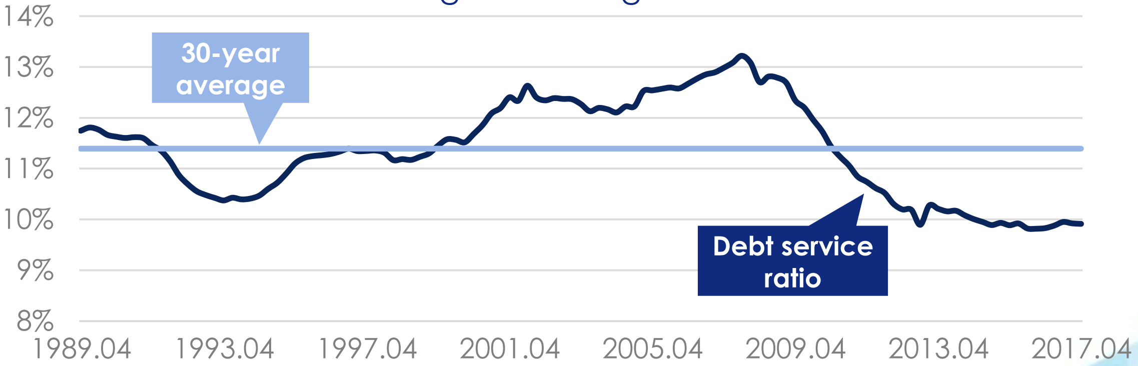
The unemployment rate is at a 17-year low

U.S. unemployment rate



And consumer debt levels are manageable

U.S. debt service ratio & long-run average



Bottom Line: Consumers should help deliver underlying 2.25-2.5% growth in 2018.

Source: Macrobond Financial

The key uncertainty for the economy in 2018 involves capex spending. Here are the main drivers of investment spending.

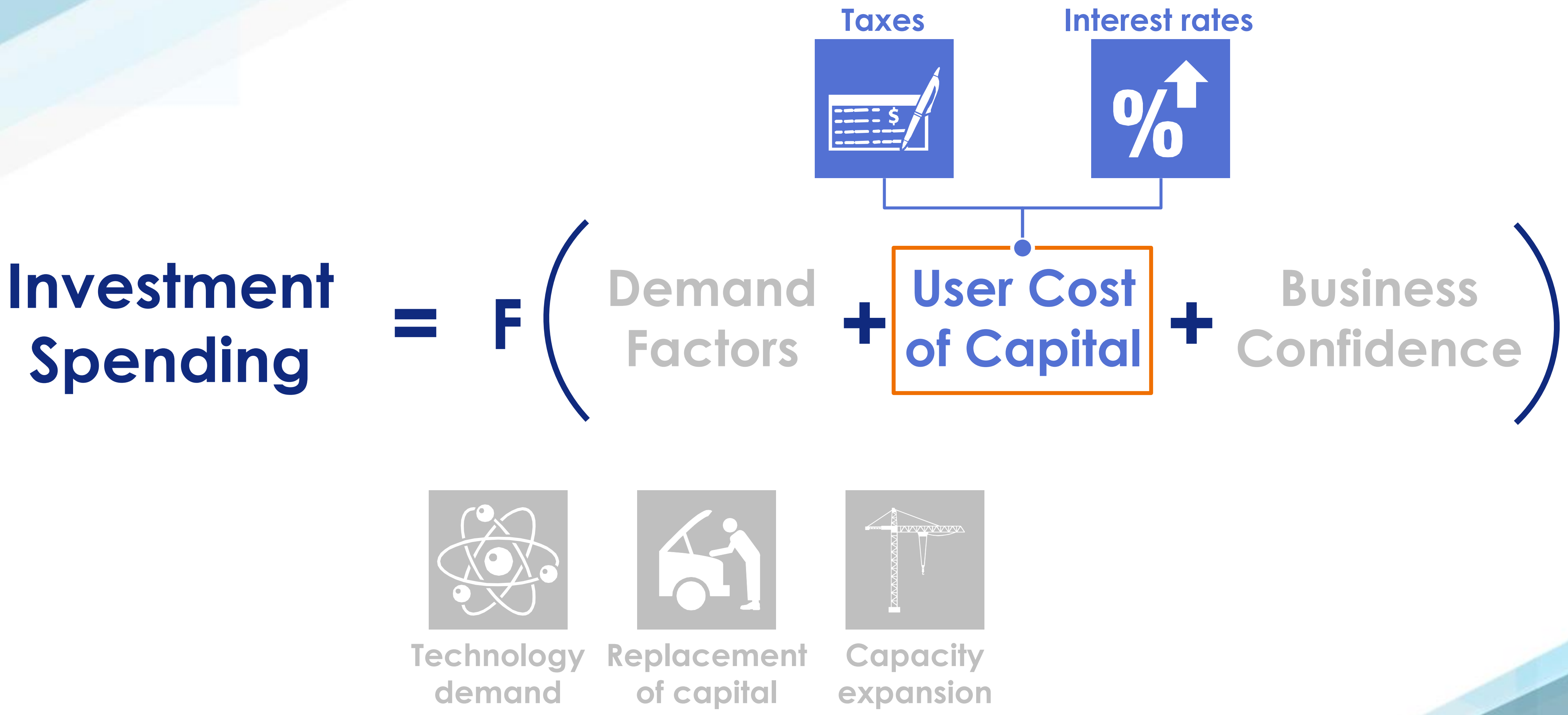
$$\text{Investment Spending} = F\left(\text{Demand Factors} + \text{User Cost of Capital} + \text{Business Confidence}\right)$$

Technology demand and replacement of capital have been the main drivers on the demand side. A tightening labor market should spur technology investment.

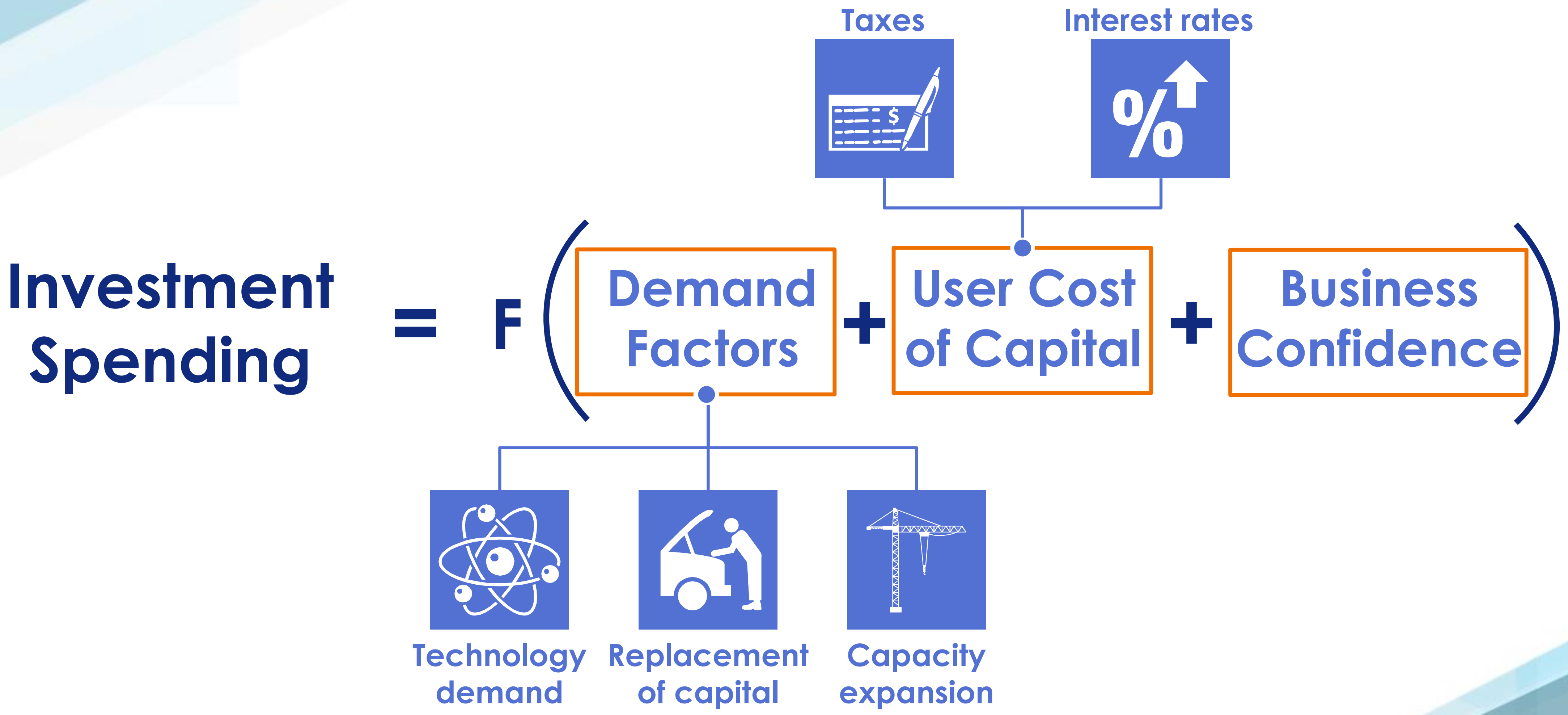
Investment Spending = F (Demand Factors + User Cost of Capital + Business Confidence)

Technology demand | Replacement of capital | Capacity expansion

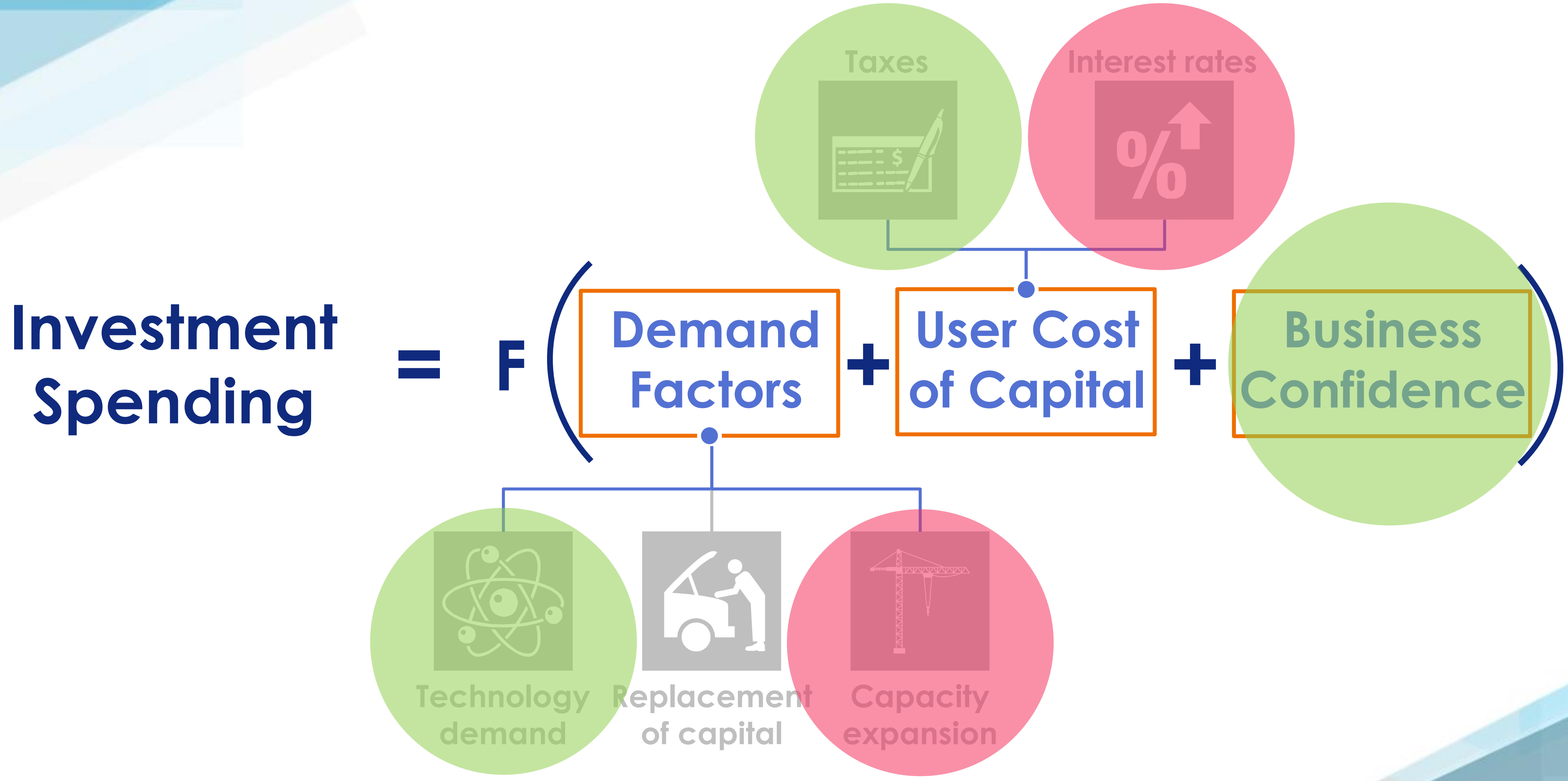
User cost of capital depends on interest rates and taxes (rates, expensing/ depreciation rules, etc.) Lower tax rates will boost corporate cash flow.



Finally, business confidence can be critical. John Maynard Keynes stressed the role of “animal spirits”. Lower taxes and less regulation should help boost confidence.



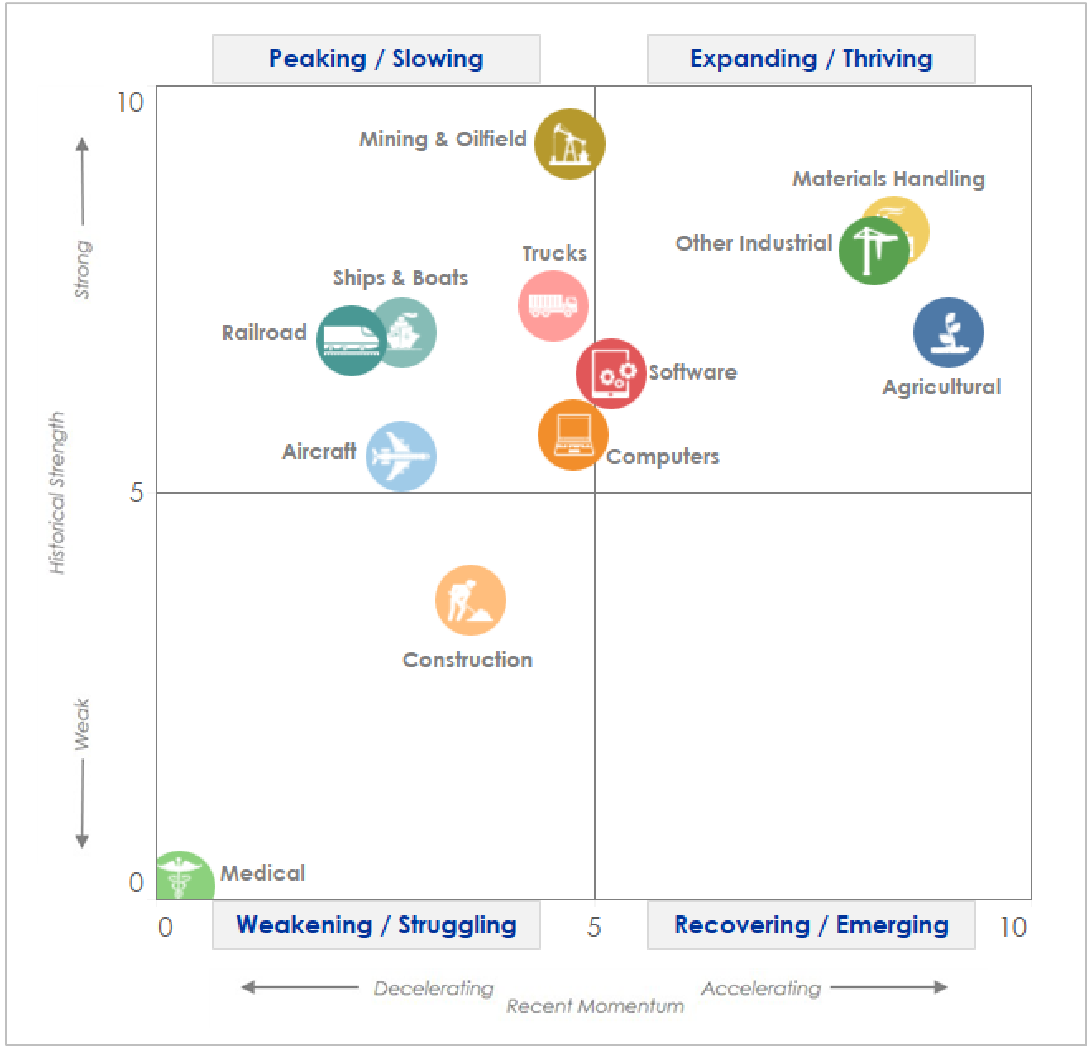
Looking to 2018, tax reform is likely to boost capex spending. But a still-low capacity utilization rate and rising interest rates will provide some moderating forces.



Most equipment verticals are performing well compared to their historical strength, suggesting some gains in replacement demand. But several appear to be peaking.

ELFF Momentum Monitor Sector Matrix

October 2017



Source: ELFF, Keybridge

Macro themes for 2018? On track for solid growth, but with factors to watch closely.

1

Investment — a leading sector

2

Healthy consumer spending will help a firming economy

3

Labor markets continue to tighten

4

Financial markets continue to normalize (more rate hikes)

BUT

Watch for clear policy action…especially on taxes!

3. Great tax debate of 2017 (and 2018?)

One of the most emotional issues for business leaders is taxes. Although many observers strongly believe that tax cuts boost growth, the evidence isn't always clear cut.

President	Year(s)	Following 7 Years Average GDP Growth
Kennedy/Johnson	1964	3.9%
Reagan	1981	3.6%
Clinton (tax hike)	1993	4.0%
Bush	2001-3	1.6%

Source: Macrobond Financial

On paper we have unified Republican government. The reality is that three separate factions have differing policy priorities.

Populists

Deport Illegals

Border Wall

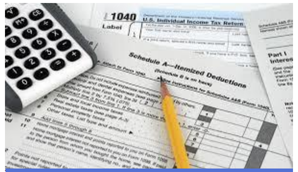
Protectionism

Infrastructure Spending

Traditional pro-business

Regulatory Reform

Free trade

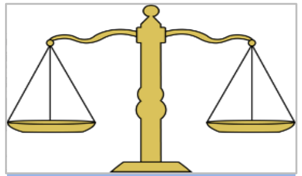


Tax Reform

Entitlement Reform

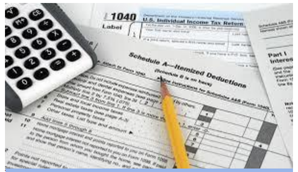
Freedom Caucus

Anti-government spending



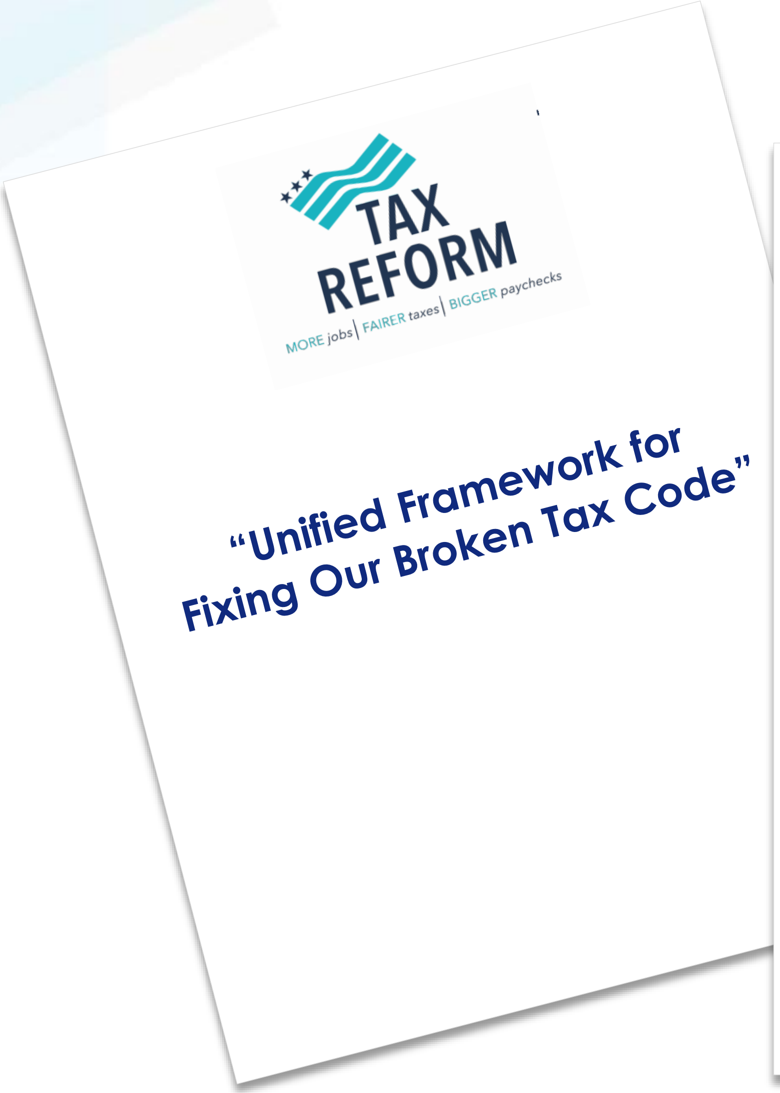
Balanced Budget

Entitlement cuts



Tax Reform

Here are some key components of the “Big Six” tax reform effort:



“Big Six” Tax Reform Plan

- ✓ *Corporate tax rate reduced from 35% to 20%*
- ✓ *Pass-through tax rate reduced to 25%*
- ✓ *Reduced tax for repatriation of overseas holdings*
- ✓ *Top personal income tax rate reduced from 39.6% to 35%*
- ✓ *Elimination of the estate tax*

Current prospects for tax reform?

Political pundits are doubtful of 2017 chances

"My bet is that if any kind of tax bill is passed, either reform or a cut, it will be fairly modest, leaving Republicans with the challenge of having to pass lots of small things."

Banks see a better chance of tax reform in 2018

65%

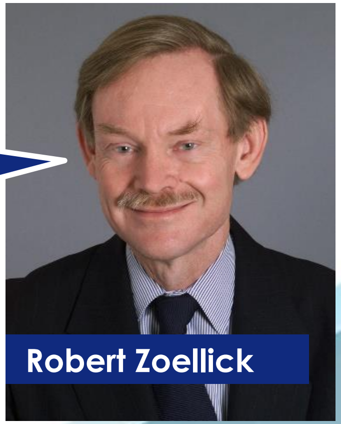
Goldman Sachs sees a 65% chance that tax reform passes in 2018.

Betting markets see a low chance of a tax cut in 2017

Market-implied probability of a corporate tax cut in 2017

Finance officials see even odds of tax reform passing

If Senate Republicans can pass a budget, the chances of tax reform are between 50% and 60%.



Source: Predictit, Goldman Sachs, Cook Political, Marketwatch

Here are some of the key debates about corporate tax cuts.

How much of the tax cut will go to capex?

25-35%

Of additional revenue from tax cuts usually goes to capex

How much will go to middle-class workers?

$4000?

Extra income for the average family?

Will cuts pay for themselves?

25-30%

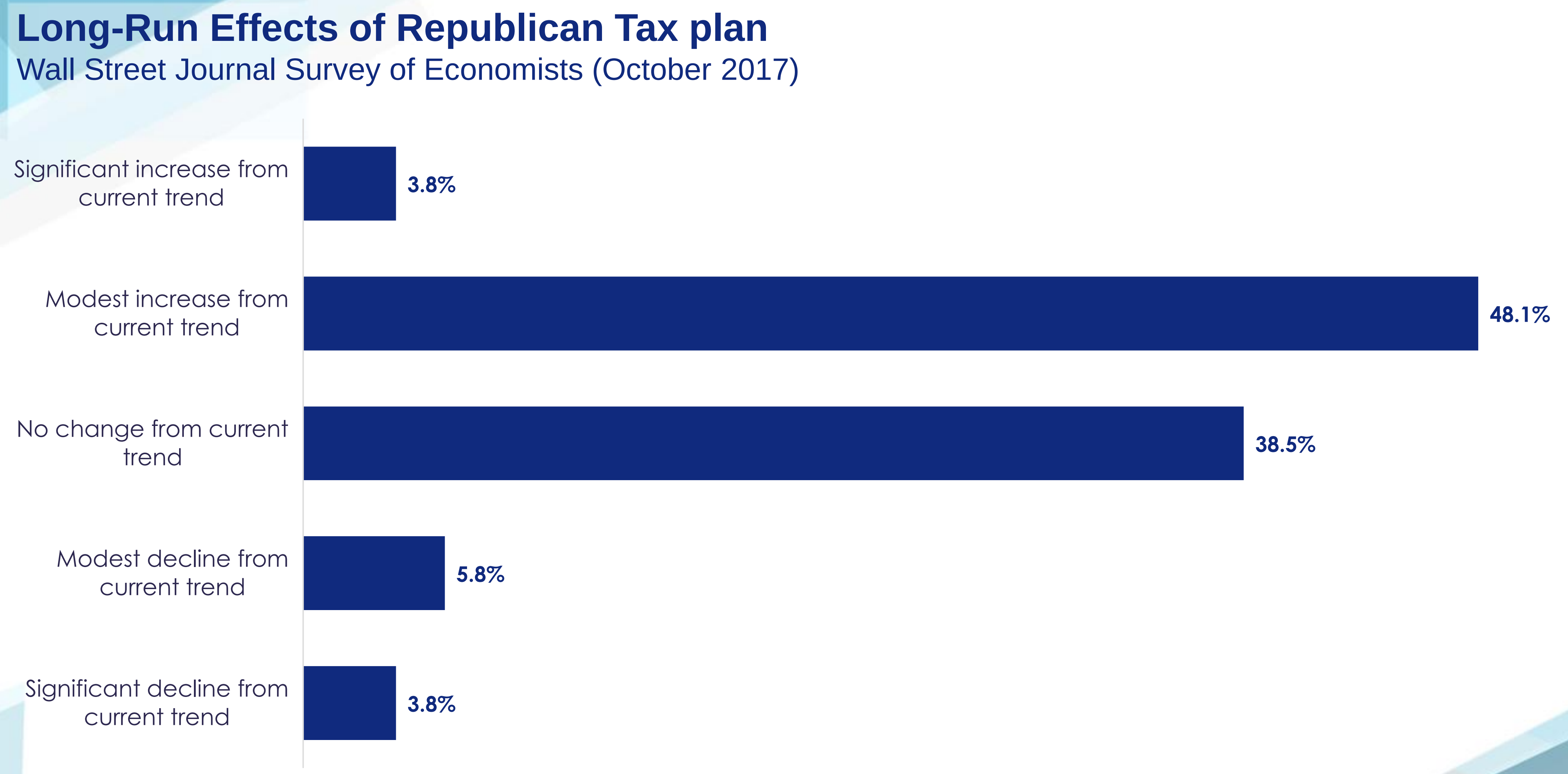
Of lost revenue will be recouped via economic growth

Impact on deficit and interest rates?

$150B

In added annual deficit could lead to 10-20 bp increase

What about long-run effects of tax reform? Most economists see only a modest increase from the current trend of economic growth.



Source: WSJ Survey of Economists

Industry winners and losers? A reduced 20% corporate tax rate should help highly-taxed industries (like services). Lesser-taxed industries should see comparatively less benefit.

Effective Tax Rates for Money-Making Companies, by Industry

Effective Tax Rate

High Tax

Telecom (wireless) *(37.7%)*	Trucking *(37.5%)*	Cable TV *(37.2%)*	Transportation (Railroads) *(35.9%)*	Business & Consumer Svcs. *(35.5%)*
Telecom Services *(34.8%)*	Homebuilding *(34.4%)*	Retail *(34.2%)*	Engineering & Construction *(33.9%)*	Financial Services (Nonbank/ insurance) *(31.8%)*
Office Equipment & Services *(31.3%)*	Brokerage & Investment Banking *(30.6%)*	Bank (money center) *(30.2%)*	Utility (general) *(30.1%)*	Steel *(27.6%)*

Average = 26%

Beverage (Soft) *(23.5%)*	Aerospace/ Defense *(23.2%)*	Real Estate (General/ Diversified) *(22.3%)*	Semiconductors *(18.9%)*	Drugs (Pharmaceutical) *(18.8%)*
Healthcare Products *(16.5%)*	Computer Services *(15.6%)*	Auto & Truck *(12.7%)*	Paper & Forest Products *(12.6%)*	Hotel & Gaming *(12.1%)*
Chemicals (diversified) *(11.6%)*	Oil & Gas (integrated) *(8.0%)*	Oil & Gas (production & exploration) *(7.1%)*	REITs *(2.2%)*	Coal and Related Energy *(0.7%)*

Low Tax

Source: NYU Stern School of Business

Implications? Tax reform will create cross-currents for the equipment leasing industry. The broader U.S. economy will likely enjoy a moderate boost in the near term.

Macroeconomy?

1. +0.1 to +0.25% to short run GDP
2. Boost corporate cash flow

Equipment leasing?

1. More demand for equipment
2. Less tax incentive to lease

Deficit and interest rates?

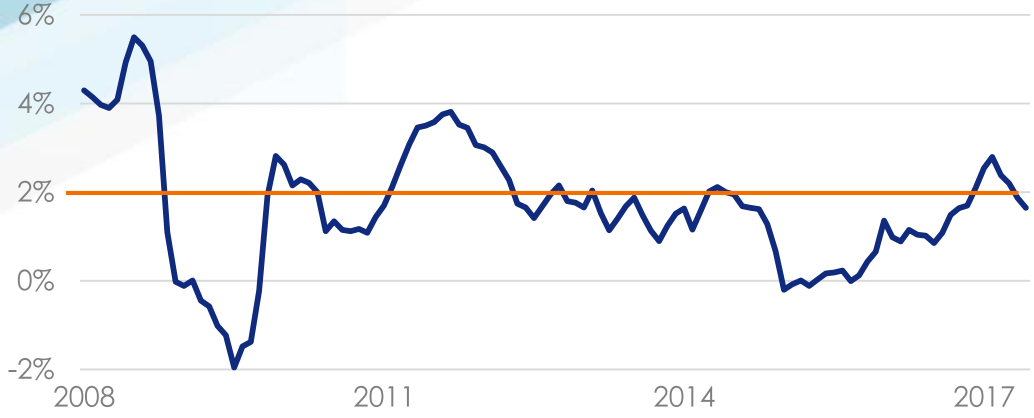
1. Increased federal debt & deficits
2. Interest rates rise

4. Could inflation become a problem?

Conventional wisdom: inflation will remain low for the foreseeable future.

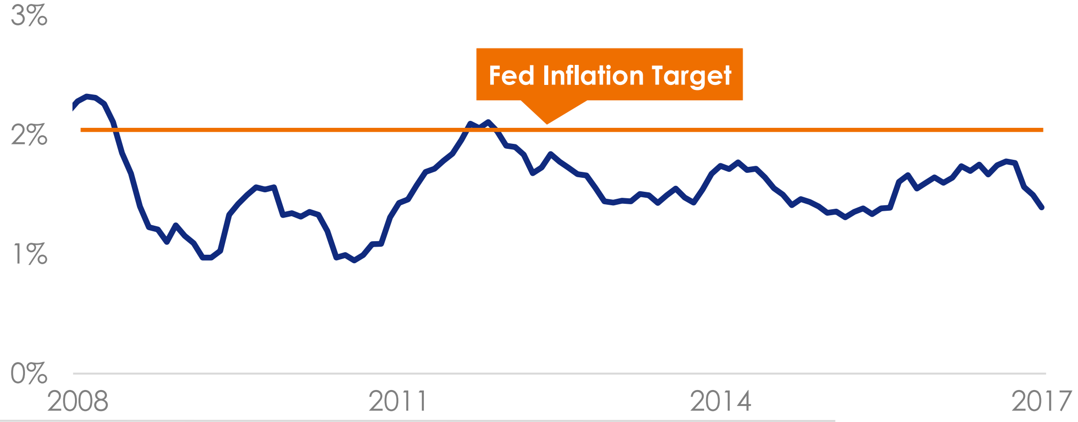
Low inflation has been the norm for nearly a decade

Headline CPI Inflation



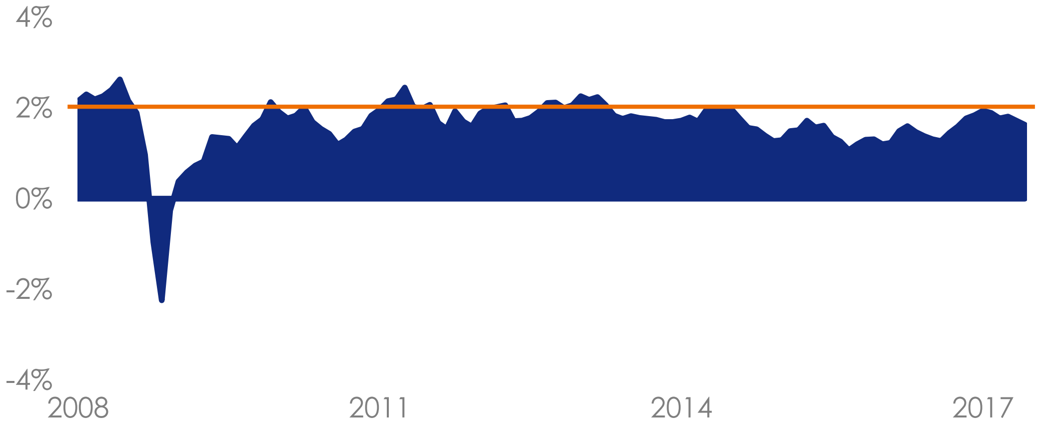
The Fed's favorite measure of inflation is similarly subdued

Core PCE Inflation



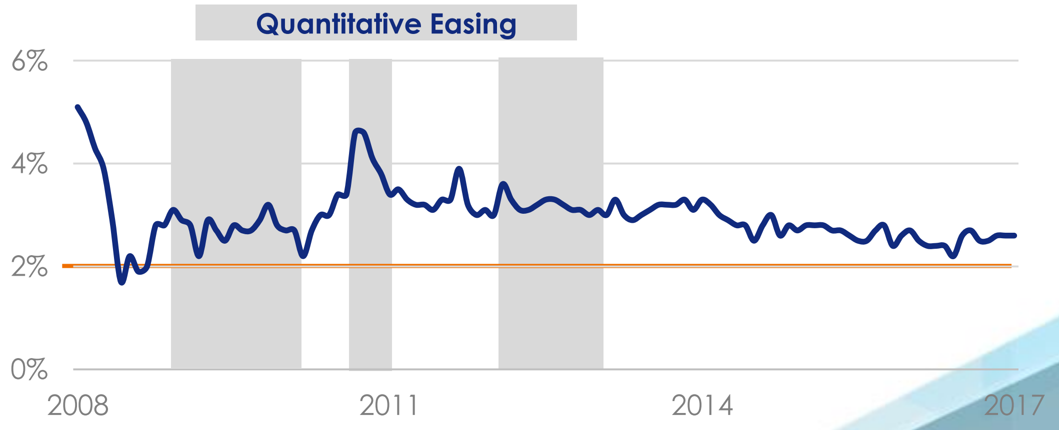
Market-implied inflation expectations remain depressed

5-Year Breakeven Inflation Rate (TIPS Implied)



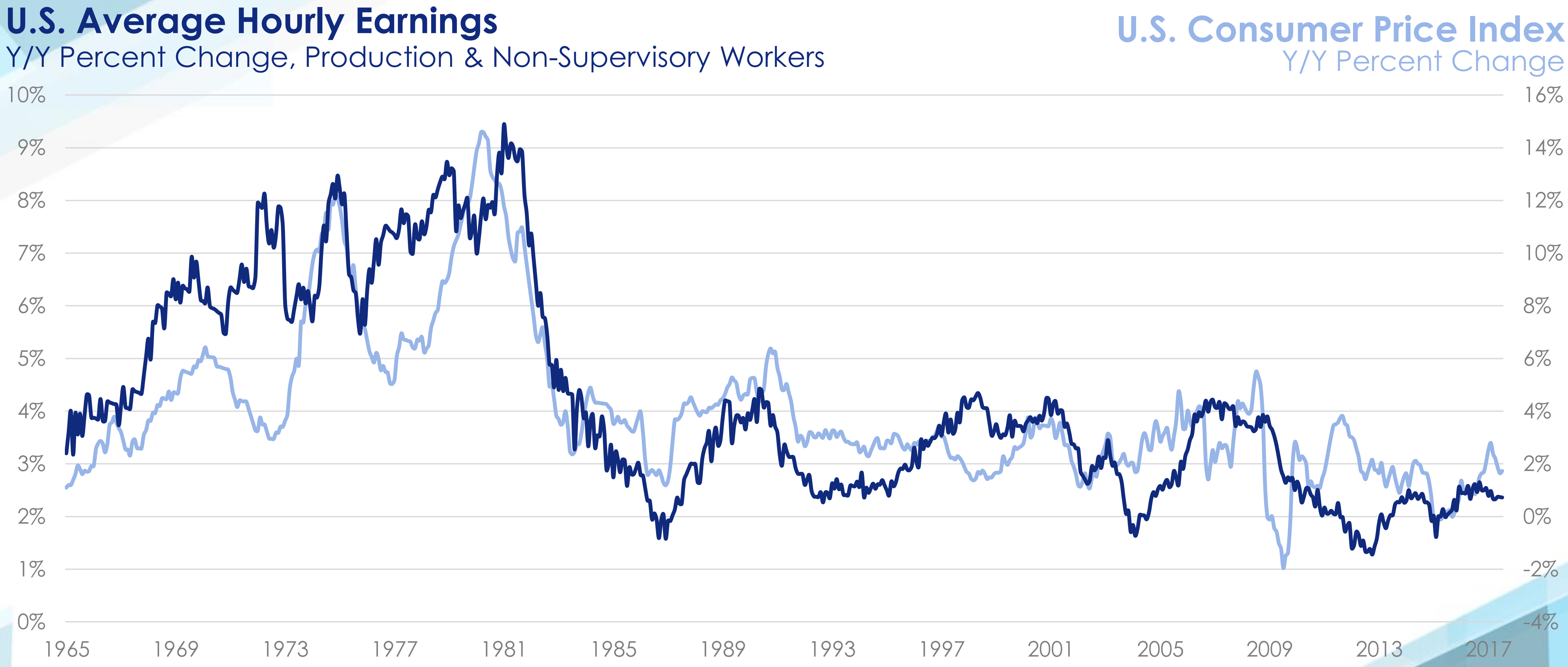
And inflation expectations have become well "anchored"

University of Michigan One-Year Inflation Expectations



Source: Macrobond Financial

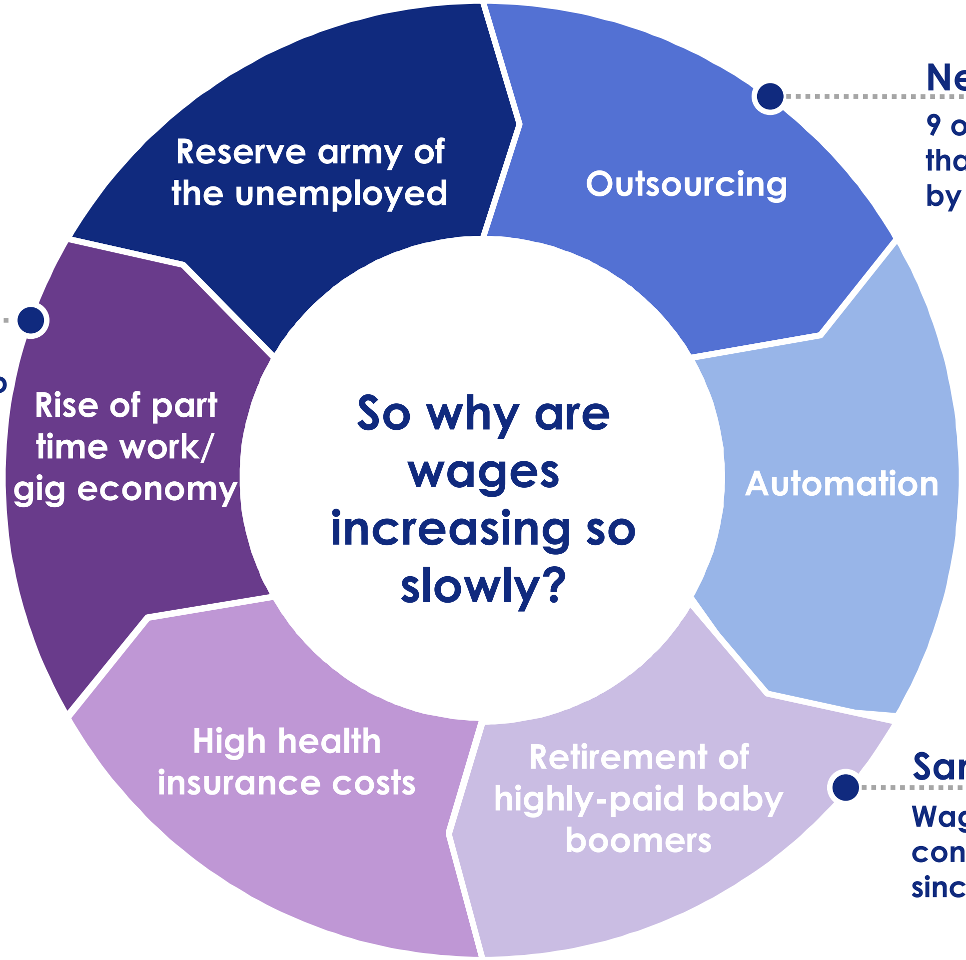
Typically, knowing where wages are going is a good signal for where inflation is going.



Source: Macrobond Financial

Key question for economists today: why is wage growth so tame?

? Current theories for explaining sluggish wage growth:



New Gallup Poll:
9 out of 10 workers report that they are unthreatened by outsourcing

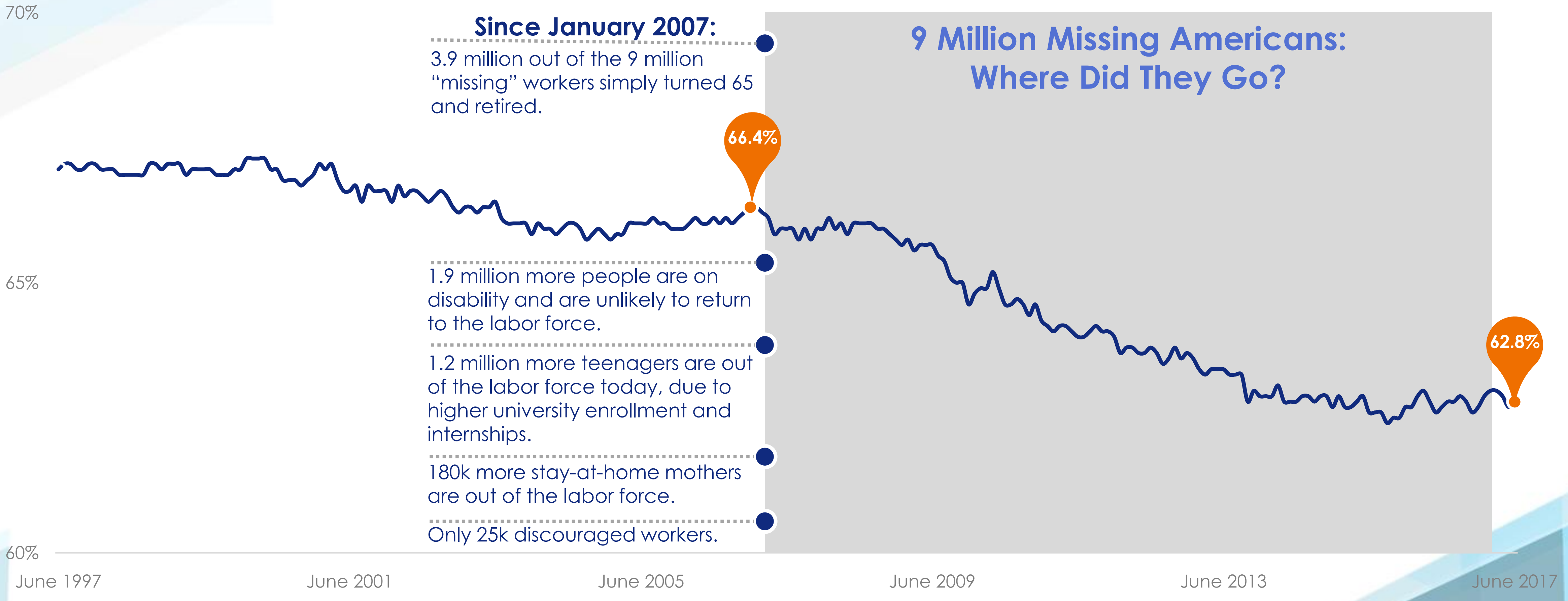
New Gallup Poll:
59% say now is a good time to find a full-time, quality job (up from 10% in 2010)

San Francisco Fed Study:
Wages of workers continuously employed since 2012 up 4% Y/Y

My view: There is no large-scale army of unemployed people. The recent decline in labor force participation is mostly demographic, not cyclical.

U.S. Labor Force Participation Rate

Share of 16-and-over Civilian Non-Institutional Population

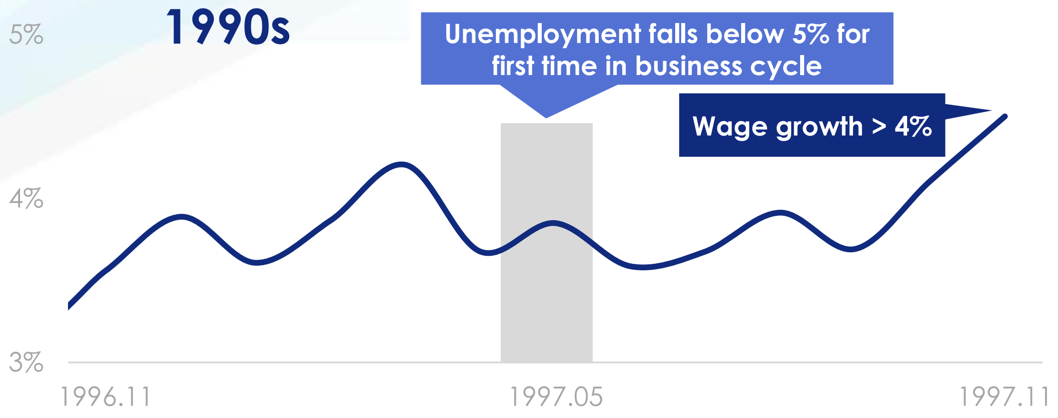


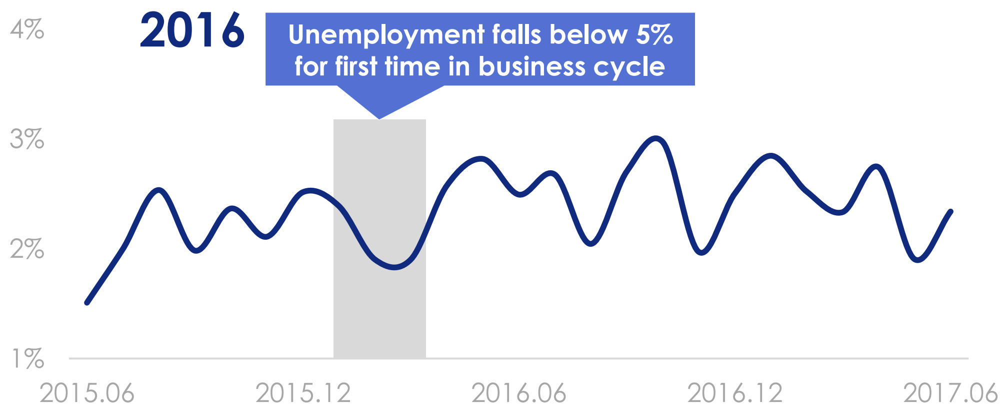
Source: Macrobond Financial, Keybridge LLC

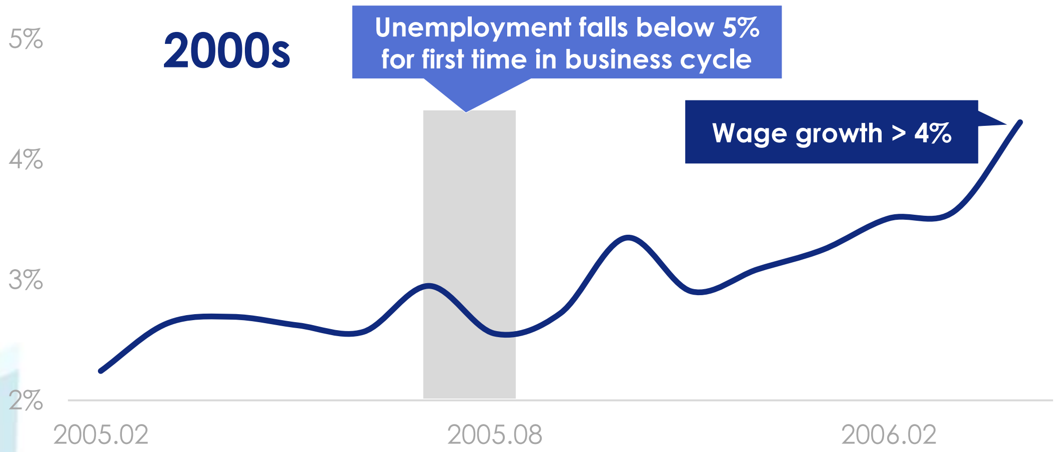
Normally, when the unemployment rate drops below 5%, wage growth accelerates due to labor shortages. Not so this time…at least so far.

Average Hourly Earnings

Production & Nonsupervisory Workers, Y/Y % Change







Debate:

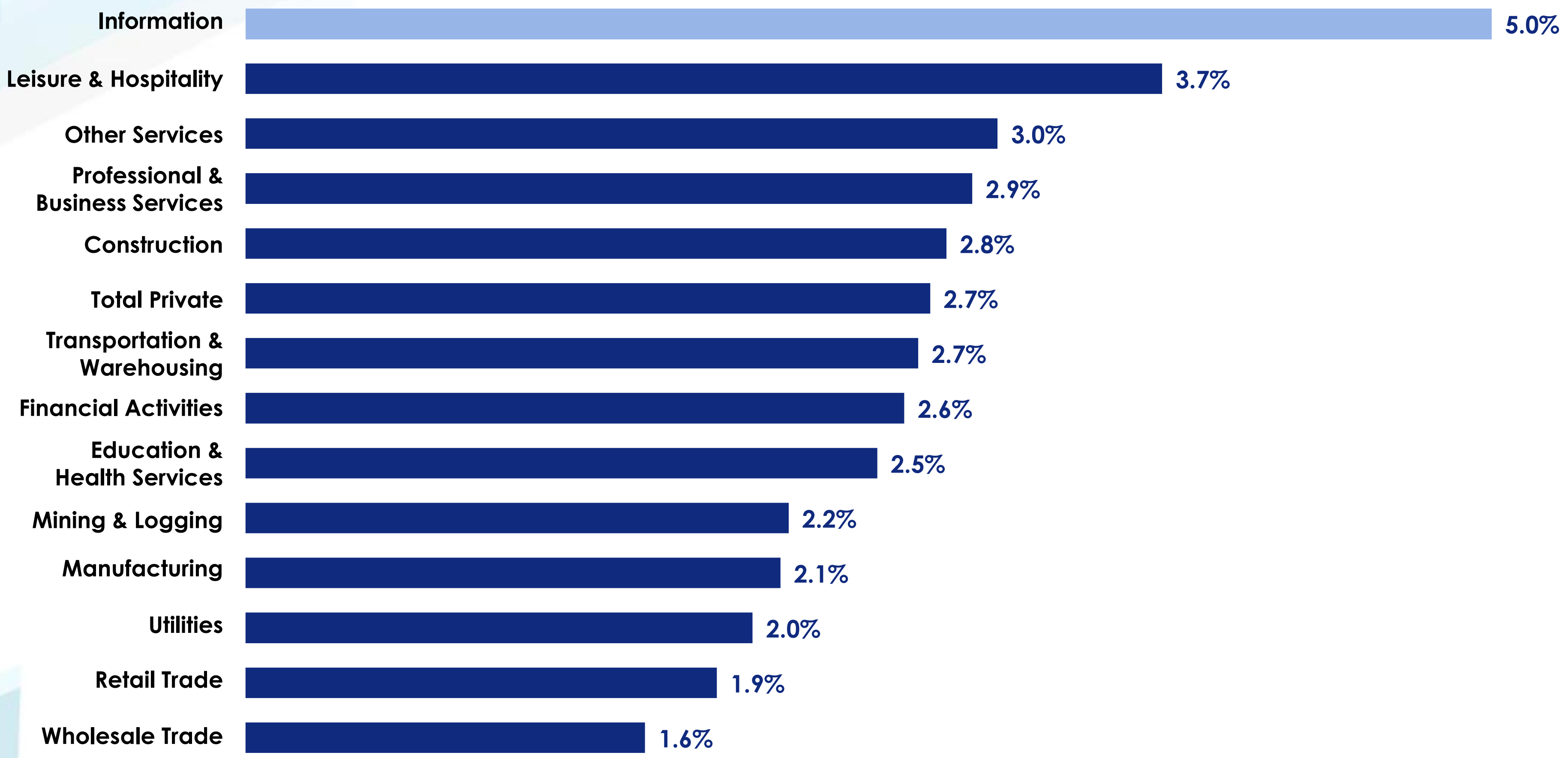
Why haven't we seen faster wage growth yet?

Source: Macrobond Financial

However, we are seeing evidence that wages for high-tech workers are starting to accelerate. Will overall wage growth finally ramp up?

Average Hourly Earnings by Industry

Total Employees, Y/Y Percent Change in 3-Mo. Moving Average, September 2017



Source: Macrobond Financial

Rising inflation? Signposts to watch.

Evidence of rising inflation?

- Wages of tech/information workers rise notably
- Further weakening of the U.S. dollar
- Overall wages accelerate 1% or more in a year

What will it mean?

- Fed: more rapid increases in interest rates
- Lower profit margins and lower equity valuations for firms that cannot raise prices easily
- A ray of good news? Rising wages would boost tax collections and help reduce federal and state budget deficits.

5. Other SEFI takeaways

The 2017 SEFI explores other underlying trends in the U.S. economy that will shape discussions for years to come.

1

We are entering an era of energy abundance

2

U.S. manufacturing capacity will return

3

The U.S. retail sector is undergoing drastic changes

The 2017 SEFI also examines four key technologies that present significant opportunities for the equipment leasing industry.

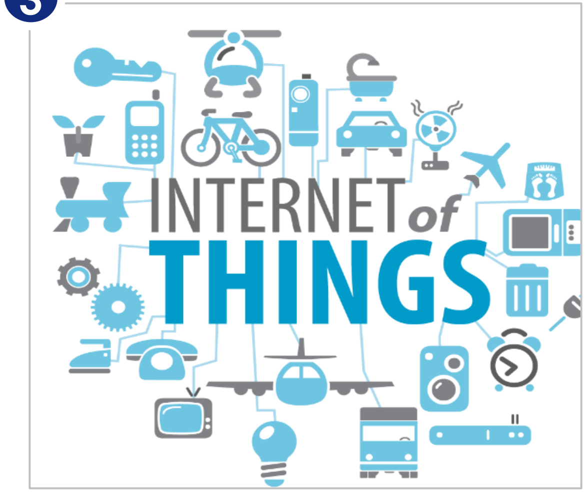
1

Financial technologies

2

Changing nature of ownership

3



The internet of things and artificial intelligence

4

Blockchain

6. Final thoughts

Final thoughts?

2016: a tough year for equipment finance because of the economy's growth pause.

Equipment finance has gotten back on track in 2017.

Corporate tax cut likely by early 2018, but not assured.

Capex will be key to the 2018 economic growth story. 2018 should be a good year if tax reform passes.

Watch for rising inflation risks.