

Forecasting Quality

An Executive Guide to Company Evaluation





The Equipment Leasing and Finance Foundation is a 501 (c) 3 non-profit organization established by the Equipment Leasing Association of America in 1989.

The Foundation develops and promotes the body of knowledge to enhance recognition and understanding of equipment lease financing. The Foundation's strategic objectives are:

- To maximize the role that equipment leasing plays in the world economy, and;
- To be the prime developer and disseminator of a body of knowledge of the leasing industry.

The Mission

To promote the growth and effectiveness of equipment leasing and finance through programs that:

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

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The Equipment Leasing and Finance
Foundation wishes to express appreciation to
The Alta Group for donating the time and
resources to create this report.



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Introduction

The Equipment Leasing and Finance Foundation, in 2000, commissioned The Alta Group to examine why an unusually large number of companies had exited the industry in a short period of time. The purpose of this study, aptly titled *The Perfect Storms*, was to determine why, although most companies are successful, a few failed in a condensed timeframe.

*The Perfect Storms*¹ study consisted of ten companies (the target companies) that had exited the industry, either voluntarily or involuntarily, during the period 1998-2000. These companies represented a broad cross-section of the equipment leasing industry and were active in several different markets.

Specifically, the Foundation sought to determine if this Perfect Storms was a series of isolated events, or an indication of a failing industry. More importantly, the Foundation wanted to know if there were any signals or indicators of these eventual problems. The conclusion reached in this study was that highly questionable decisions were made that, when combined with external factors, created disastrous results for the companies involved. Furthermore, there were signals and trends presaging these results.

For example, many of the target companies shared causal themes for exiting the equipment lease and finance market, and definite patterns emerged. This commonality clearly points to specific areas of risk and concern for the industry, which is good news from an analytical perspective. And, yes – there were signals and indicators of growing and impending problems that management did not recognize, understand, or address on a timely basis.

Important follow-on questions to this conclusion include “What were these signals?”, “How can they be recognized?” and “How can they be used?” The Foundation has decided to seek out the answers to these questions.

New Foundation Study

Numerous and diverse companies left the industry in the years targeted by the Perfect Storms study, in spite of a peak in economic activity. Since that time, the leasing industry has weathered the effects of a bad economic climate, in addition to the risks and pitfalls that continually face players in a leveraged industry.

¹ Many of the conclusions and recommendations in *Forecasting Quality* are premised upon knowledge of the issues and conclusions in *The Perfect Storms*. It is suggested, therefore, that *The Perfect Storms* be read or reviewed as a means to gain the maximum benefit and understanding from this report. A copy of *The Perfect Storms* can be downloaded from the Foundation’s website at www.LeaseFoundation.org.

Now, however, optimism has returned to the leasing industry, in spite of some uncertainty in the large ticket market. Economic indicators are strong, confidence is increasing, and capital spending is expanding in several sectors of the economy.

While it appears that the economy is becoming stronger, lessors must be mindful that the Perfect Storms occurred in a period of strong economic growth. The equipment leasing industry cannot afford to fall into the trap that George Santayana identified; that is, “Those who do not learn from history are doomed to repeat it.”

With this in mind, the Foundation asked The Alta Group to identify key measures and useful indicators helpful in successfully managing an equipment leasing and finance business. Lessors can use *Forecasting Quality* to evaluate their own financial health, that of possible acquisition targets, and continue to make good business decisions.

Based on an analysis and review of the trends and signals that occurred in the Perfect Storms, this study isolates tools helpful in achieving success and avoiding another cataclysmic event such as *The Perfect Storms*. These tools are separated into two categories. The first category consists of filters that can be used to assess the internal preparedness of the company for dealing with ongoing events. The second category is more specific in nature and relates to industry benchmarking.

Decision Filters

One of managements’ shortcomings in the Perfect Storms was the failure to understand or recognize the signals and indicators of growing and impending problems. Using filters can assist management and others in recognizing those warning signs.

Causal themes were identified for the demise of the target companies in *The Perfect Storms*. The value of understanding these causal themes is that they can be used as the basis for filters through which decisions, strategies, and operational issues can be passed. The following section discusses key decision filters.

Business Model

The finance industry has risks that must be managed within the business model. Leverage, for example, works to the company’s advantage when things go well, but it magnifies and accelerates problems when they do not. To rely on a business model that increases the leverage risk is not a sound strategy; yet, over half the target companies in the Perfect Storms relied almost exclusively on securitization as a funding method.

This percentage can be compared to how the leasing industry uses securitization, i.e., 20% of total funding over the last seven years. Relying on a single source of funding is not a wise choice for a lessor, as it limits liquidity. The same can be said for significant reliance on gain on sale accounting, as is becoming even more evident as the accounting authorities increasingly focus on revenue recognition issues.

Questions that should be directed at the review of a business model include:

1. Is the model sustainable over the long run? This is not the case with securitization or gain on sale accounting. As was discovered in *The Perfect Storms*, using these techniques as the basis for the company's business model created unrealistic demands on volume generation.
2. Does the model expose the company to undue or concentrated risks in any manner? For example, by relying on securitization to such a high degree, the target companies did not maintain adequate liquidity, as they discovered to their dismay during the liquidity crisis of 1998.
3. How much of a shift from our current model does the new model represent?
4. Does the business model align with:
 - a. The industry?
 - b. Our risk parameters?
 - c. Our capabilities?
 - d. Our vision?
5. Do we have the infrastructure to support the business model?
6. How committed are we to the new business model/direction?
7. Are the return expectations for this business model materially higher than industry norms? The gain on sale accounting model, for instance, created returns substantially higher than average industry returns. Management could have questioned why, if the gain on sale model was so effective, the rest of the industry was not embracing it to such a high degree?

Management Issues

Strong, capable, and experienced management is critical to success in the equipment leasing and finance industry. For example, management issues were a factor for 70% of the target companies in the Perfect Storms. The inadequacy of senior management played a significant role in several of the target company failures and management problems were encountered at both the strategic and operational levels.

Questions that should apply to this issue include:

1. Does management have leasing-related experience?
2. What is the length and quality of that experience? A common discussion among leasing executives is that there is not enough management talent in the industry at the mid to lower levels. This point also is relevant to question 6.
3. Are we relying too much on too few executives?
4. Does management have relational, executive business experience?
5. Is top management focusing on the proper things? Alta is increasingly seeing this issue as an area of concern for lessors in its business. Management is paying more attention to controls, strategy, and leadership.
6. Is top management receiving strong managerial support at lower levels?
7. Does management have the skills and leadership ability to contend with the rapid changes of today's business environment?

As the 2001 *Industry Future Council Report* stated:

“To compete effectively, firms will require more focused and consistent leadership....Leasing companies, must, for example, find more managers with longer-term, strategic outlooks – who are more strategic than tactical, more tactical than operational and transactional.”

This observation is unchanging - the need for leadership skills is just as high today as it was in 2000 – perhaps even more so.

Rapid Growth

Seven of the target companies of the Perfect Storms experienced rapid to very rapid growth during the several years preceding their exit from the industry.² This is not to say that growth, or even rapid growth, is bad, in and of itself. It must, however, be carefully monitored and potential trouble spots identified.

As an example, many target companies did not have the infrastructure to perform the basic functions of billing, collection, and end-of-term activities necessary to support their growth. Questions to be asked include:

² Growth, for purposes of this study, means the volume of new business generation. Rapid growth refers to growth in excess of 25% per annum.

1. How is the growth being achieved (organic, acquisition, relaxed standards)? Feedback from investors at the recent ELA Investor Conference, for instance, reflected a preference for organic growth, as it comes without encumbrances such as credit issues, integration problems, personnel, etc.
2. Do we have unusual employee turnover due to operational stress, for example?
3. Are our margins changing?
4. What is happening to our S,G,&A, not only in total, but as a percentage of earning assets?
5. Why are we growing? Is growth:
 - a. A central point in our strategy?
 - b. A byproduct of a move into new markets or industries?
 - c. A management tactic to address declining margins?
6. Are we addressing the entire leasing process, and not just the front-end functions of sales and marketing?
7. Is our asset quality deteriorating?
8. Can management control the growth in terms of managerial ability, operations, and control and governance? There were several target companies in the Perfect Storms that, after going public, grew substantially through acquisition. The companies, however, did not have adequate infrastructure and management ability to control the problems attendant to this growth.
9. Does the company have an adequate infrastructure in place to handle its current levels of business?
10. Does the company have the infrastructure necessary to support its growth?
11. Is the company capable of generating adequate accounting information to allow management to perform its oversight and control function? Alta continues to see ongoing emphasis on MIS systems and other management reporting functionalities.

Controls

In the Perfect Storms, there were weaknesses in oversight and corporate governance, as well as internal control mechanisms such as accounting and risk management policies and procedures. The study identified three constituencies with varying degrees of responsibilities for control. These groups include the Board of Directors, the external auditors, and the lenders.

Questions that should be addressed in this area include:

1. Is the Board of Directors sufficiently independent?
2. Is the Board of Directors well versed in corporate governance?
3. Does the Board of Directors possess sufficient relational experience?

4. Does management understand the role and responsibilities of the outside auditor? Is this specific understanding shared with the outside auditor?
5. Do the lenders truly understand the leasing businesses to which they are lending?
6. Do the lenders appreciate the magnitude of the distinctions between leasing and lending? Lessors can take a proactive role in respect to this question by educating their lenders. An excellent resource for this purpose is *A Guide for Effective Funding and Capital Market Presentations*, available from the ELA³.
7. Is there an alignment of interests between the lender and management?
8. Are the procedures and controls relating to credit risk, nonaccrual, and write-offs being circumvented through the use of “approved management exceptions”? This was a major issue for one of the target companies. Management granted exceptions to the credit policies as a means of achieving growth, a practice that ultimately caught up to the company.
9. Is management paying proper attention to the reserve for doubtful accounts, credit concentrations, and overall credit quality?
10. Is the company generating timely, valid, and adequate accounting information and other management data?

Management can apply decision filters such as these to identify potential problems and issues before they reach critical mass.

Financial Measures

In addition to an important set of decision filters, *The Perfect Storms* also yielded key financial measures that can be used as early signals and indicators. As part of *The Perfect Storms*, financial statement data was gathered for as many of the target companies as possible (mostly public company data). The primary measures considered are shown in Exhibit One.

The baseline for the numerical analysis was the overall industry performance for the five-year study period of 1996 through 2000, based on industry data from the ELA's *Survey of Industry Activity*. Although there was some inconsistency of data between companies, the data comparisons between the target companies and the baseline yielded interesting conclusions. Perhaps not so coincidentally, these conclusions dovetail with the decision filters discussed earlier in this report.

As can be seen in Exhibit Two, there were significant differences in several of the measures between ELA SIA averages⁴ and the target companies. Only those

³ This report is available at

http://www.elaonline.com/ELAstore/index.cfm?fuseaction=view_product&prod_id=91

⁴ ELA measures represent the average for the years 1996-2002.

measures that differ significantly from the ELA SIA averages, however, are addressed in this study.

Exhibit One

Financial Measures

Leverage
Times Interest Earned
ROA
ROE
Asset Growth Rate
Income Growth Rate
Net Margin
Provision for Credit Losses
Charge-offs to Assets
SG&A to Assets
Other Assets to Total Assets
Average Cost of Funds

Exhibit Two

ELA SIA/Target

	ELA	Targets	Difference	Magnitude
Leverage	5.27	5.42	0.15	2.81%
Times Interest Earned	1.58	1.03	(0.54)	(34.55%)
ROE	12.79%	21.68%	8.90%	69.57%
ROA	1.46%	2.82%	1.36%	93.22%
Asset Growth Rate	16.03%	68.62%	52.59%	328.00%
NAT Growth Rate	13.27%	2.70%	(10.57%)	(79.67%)
Net Margin	2.64%	5.89%	3.26%	123.60%
Provision for Losses	1.84%	1.33%	(0.51%)	(27.66%)
Charge-offs: Assets	1.14%	0.05%	(1.09%)	(96.00%)
SG&A: Assets	3.32%	7.99%	4.66%	140.25%
Other Assets: Total Assets	14.85%	2.93%	(11.92%)	(80.24%)
Average Cost of Funds	6.15%	6.59%	0.43%	7.05%

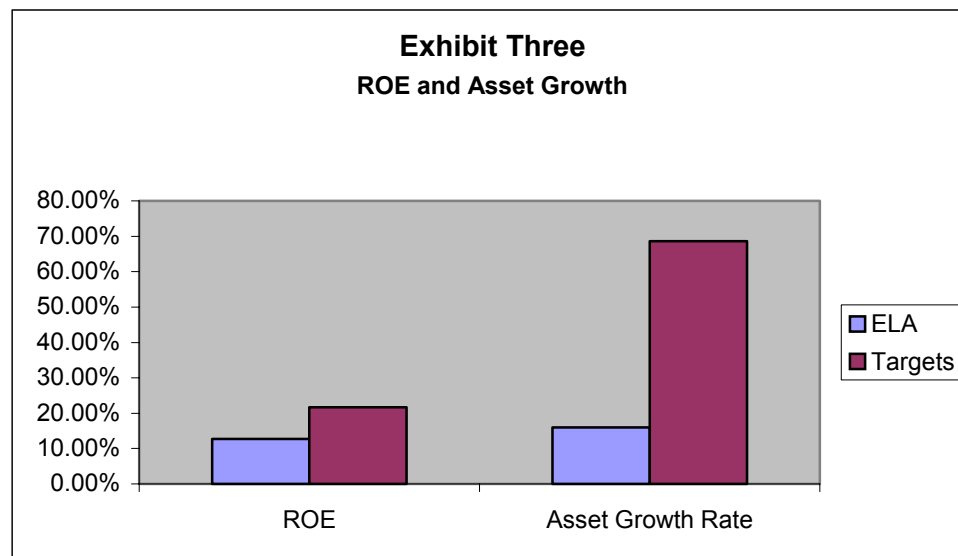
A line-by-line analysis of the measures in Exhibit Two suggests the following conclusions relating to the signals these measures may send.

Times Interest Earned – Lower than the industry average. This number should be higher for the target companies, due to gain on sale accounting. The lower ratio, however, is reflective of the spiraling interest costs they experienced due to the financial/liquidity crises of 1998. **Further analysis would have disclosed the risky strategies of relying on a single source of funding and an unsustainable business model (gain on sale accounting).**

ROA – Higher than the industry average. This number is higher for the target companies, given their reliance on gain on sale accounting. **Further analysis would have disclosed the reliance on an unsustainable business model (gain on sale accounting).**

ROE – Higher than the industry average. This number is higher for the target companies, due to gain on sale accounting. **Further analysis would have disclosed the reliance on an unsustainable business model (gain on sale accounting).**

Asset Growth Rate – Substantially higher than the industry average, as shown in Exhibit Three. **Further analysis would have disclosed the potential risks of rapid growth, and its accompanying control, sustainability, and infrastructure issues.**

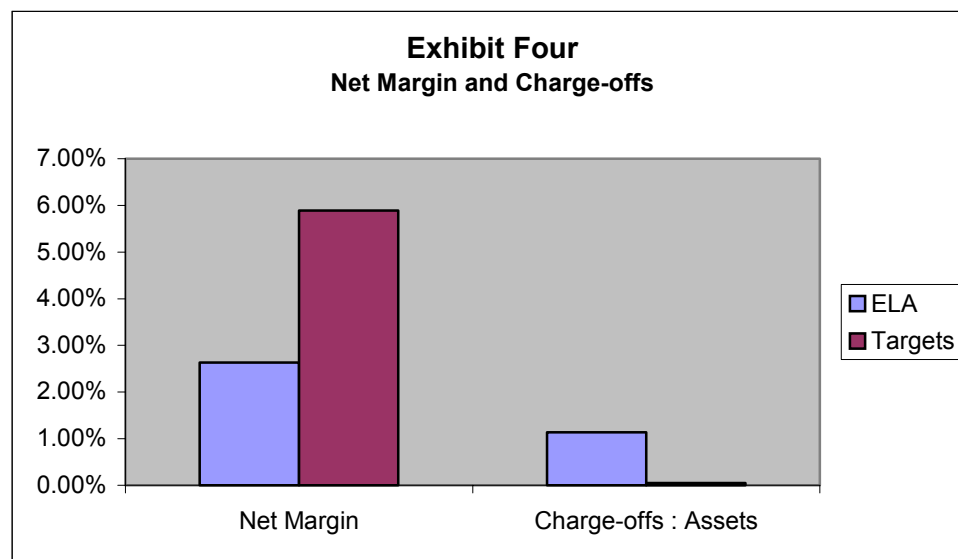


NAT Growth Rate – Lower than the industry average. This number is reflective of the spiraling interest costs due to the financial implosion of 1998. **Further analysis would have disclosed unreasonable growth rates prior to this time of five times the industry average.**

Net Margin – Substantially higher than the industry average, due to the target companies' gain on sale accounting. **Further analysis would have disclosed the reliance on an unsustainable business model (gain on sale accounting).**

Provision for Credit Losses – Lower than the industry average. **Further analysis would have raised questions as to the adequacy of controls, risk management issues, and the disconnect between lower credit losses accompanied by high growth.**

Charge-offs to Assets – Lower than the industry average, as shown in Exhibit Four. **Further analysis would have raised questions as to the adequacy of controls, risk management issues, and the disconnect between lower credit losses accompanied by high growth.**



As is always the case, performance indicators and data should not be looked at in a vacuum. It is important to not only examine company trend lines and percentage changes, but also the absolute variance between the company and industry data. The analysis also presupposes functioning and effective management reporting systems. Even so, there were trends and indications of trouble common to most of the target companies that would have been revealed through these financial measures.

Comparative Analysis

As was mentioned in *The Perfect Storms*, it is easy to look back with hindsight. This fact, however, does not diminish the value of the lessons learned, which are still valid in today's environment. In this respect, the financial measures identified in this report were tested by calculating these measures for two lessors, DVI, Inc.⁵, and Financial Federal Corporation⁶, for the years 1999 through 2003.

The comparison between Financial Federal and the ELA SIA averages is contained in Exhibit Five, while the same comparison for DVI can be seen in Exhibit Six.

Exhibit Five

ELA SIA/Financial Federal Comparative

	ELA	Financial Federal	Difference	Magnitude
Leverage	5.27	4.61	(0.66)	-12.44%
Times Interest Earned	1.58	1.98	0.41	25.72%
ROE	12.79%	14.16%	1.38%	10.79%
ROA	1.46%	2.37%	0.91%	62.57%
Asset Growth Rate	16.03%	11.99%	-4.05%	-25.25%
NAT Growth Rate	13.27%	13.53%	0.26%	1.95%
Net Margin	2.64%	3.73%	1.09%	41.49%
Prov. For Cred Losses	1.84%	0.45%	-1.39%	-75.39%
Charge-offs : Assets	1.14%	0.35%	-0.79%	-69.55%
SG&A : Assets	3.32%	0.49%	-2.83%	-85.27%
Other Assets: Total Assets	14.85%	0.98%	-13.88%	-93.42%
Average Cost of Funds	6.15%	5.23%	-0.93%	-15.08%
Securitization %	18.99%	16.70%	-2.29%	-12.07%

Although an exhaustive study of DVI and Financial Federal was not performed in this study, it is interesting to note the differences in financial measures between the two companies.

⁵ DVI, Inc., a publicly held leasing company, filed for bankruptcy in the second half of 2003.

⁶ Financial Federal Corporation is a publicly held leasing company that is still active in the equipment leasing and finance industry.

The Financial Federal measures track with industry average data fairly closely. In several of the cases in which the data does not track, it does so in Financial Federal's favor (e.g., it is more conservative). This is not to say that the indicators should not be analyzed in more detail. The loss provisions and charge-offs, for example, are significantly below industry average. This could indicate either superior underwriting, or control and nonrecognition issues.

Exhibit Six

ELA SIA/DVI

	ELA	DVI	Difference	Magnitude
Leverage	5.27	4.67	(0.60)	-11.32%
Times Interest Earned	1.58	1.36	(0.22)	-13.90%
ROE	12.79%	6.92%	-5.87%	-45.91%
ROA	1.46%	1.14%	-0.32%	-21.86%
Asset Growth Rate	16.03%	19.48%	3.45%	21.51%
NAT Growth Rate	13.27%	-17.85%	-31.12%	-234.46%
Net Margin	2.64%	0.51%	-2.13%	-80.81%
Provision for Losses	1.84%	1.30%	-0.54%	-29.48%
Charge-offs:Assets	1.14%	0.60%	-0.54%	-47.16%
SG&A:Assets	3.32%	1.28%	-2.04%	-61.48%
Other Assets:Total Assets	14.85%	7.39%	-7.46%	-50.24%
Average Cost of Funds	6.15%	7.95%	1.80%	29.21%
Securitization %	18.99%	95.78%	76.78%	404.31%

DVI⁷, on the other hand, does not track with the ELA data at all. Returns are substantially below average, in spite of the fact that DVI's credit losses are below the industry average. Of particular interest is the 95% reliance on securitization as a funding method. This business model was a major contributor to the demise of many of the target companies in the Perfect Storms.

As a side note, the claimants in pending securities litigation against DVI have alleged that DVI failed to timely write down the value of certain assets which had become impaired; that its accounting and financial reporting policies and procedures for nonrecurring transactions were inadequate; and that DVI lacked adequate internal controls. All of these factors also represent causal themes of the Perfect Storms.

⁷ Only the years 1999-2002 were used for the DVI average statistics, as the data for 2003 is highly distorted.

Conclusion

The analysis in *The Perfect Storms* indicated that the failures of the target companies were a result of avoidable problems, and that, in many cases, the available signals and indicators of impending trouble were not recognized, understood, or addressed by management.

Useful indicators have been identified in *Forecasting Quality* that lessors can use to continue to successfully manage their businesses and, thereby, prevent scenarios similar to the Perfect Storms from occurring in the future. These indicators, such as decision filters and financial measures, give a company, its managers, and investors, tools to identify problems before they balloon out of control.

The tools are there – using them will help lessors gauge their financial health, identify potential problems, manage more successfully, and assist the Foundation in achieving its goal of a strong industry.

Appendix One

2004 Foundation Board of Trustees

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Equipment Leasing and Finance Foundation

The Resources You Need!

The Equipment Leasing and Finance Foundation is a nonprofit organization whose mission is to promote the growth and effectiveness of equipment leasing and finance companies through programs that identify, study and report on critical issues affecting equipment leasing and finance. The Foundation works to develop the body of knowledge of equipment leasing and finance for use by the industry, academic, and policy communities. The Foundation provides the following FREE resources to you:

- **Research Grant Program**

The Foundation awards grants funds to academics to study topics of interest to the equipment leasing and finance industry. Proposals are accepted three times each year. Average grant is \$10,000.

- **Authorship Honorariums**

The *Journal of Equipment Lease Financing*, the official Journal of the Foundation, is published twice annually. Authorship honorariums are available to academics and industry professionals that contribute in-depth articles on topics of interest to those working in and/or researching this industry.

- **Academic Internships**

The Foundation works closely with university students and industry leaders to place students in academic internships within the lease financing industry.

- **Industry Reports and Analysis**

Annually, the Equipment Leasing and Finance Foundation produces numerous reports and research papers on trends, industry analysis, forecasting and the state of the industry. These Research reports and studies are available to you FREE of charge.

- **Website Resources**

The websites of both the Equipment Leasing and Finance Foundation and the Equipment Leasing Association (ELA) contain myriad research, statistical material, and industry related information for your use and exploration. Site addresses: www.leasefoundation.org and www.elaonline.com.

- **Case Studies and Teaching Modules**

The Foundation has worked with industry and academic leaders to develop cutting edge classroom teaching material including real-life case studies and teaching modules available to academics through the Foundation website.

All of this and so much more is available through the Equipment Leasing and Finance Foundation—and its ALL FREE. Why? Because the Foundation’s mission is to enhance the body of knowledge within the equipment lease financing industry. We are happy to provide this information to all academics and professionals interested in the industry.

We would also appreciate receiving your tax-deductible contribution to help support the Foundation ongoing efforts. To make a contribution visit the website www.leasefoundation.org, or call Lisa Levine, Foundation Executive Director at 703-527-8655.