

THE NEW NORMAL...

Making the Best of Difficult Market Conditions

BY BRUCE KROPSCHOT

The year 2009 has certainly been challenging for our industry, with new business volume decreasing significantly, high delinquency levels and charge-offs, plus many traditional funding sources evaporating. However, the seasoned industry veterans at The Alta Group recognize the economic recession has impacted various segments of the market differently. Bruce Kropschot explains the impacts as well as the emergence of the “new normal.”

As 2009 winds down, this year will undoubtedly finish as one of the worst ever for the North American equipment leasing and financing industry. We all know the economic recession that has gripped much of the world has greatly reduced business commitments for new equipment. But to what extent? Unfortunately, a recent Equipment Leasing and Finance Association (ELFA) MLFI-25 survey of member companies indicated new business volume declined by 40% in the second quarter of 2009 versus the same period last year. This follows year-to-year declines of 31% in the first quarter of 2009 and 17% in the fourth quarter of 2008.

While the decline in business volume is attributable primarily to a lack of demand, tightened credit standards certainly have had an impact on organizations still trying to acquire equipment. MLFI-25 survey participants reported credit approvals have decreased to 65% of submissions this year as compared to 74% a year earlier. The soft economy also has resulted in equipment leasing and financing companies experiencing much higher delinquencies and charge-offs. In fact, participants in the MLFI-25 survey reported June 2009 charge-offs as a percent of net receivables more than doubled compared to those of June 2008. Furthermore, the funding constraints experienced by many equipment leasing companies have made it necessary for them to limit the amount of new business they accept.

Most portfolio purchases in the current market have involved distressed assets and/or distressed sellers, and the selling prices are reflecting significant discounts. Many of the buyers are not leasing companies, but instead are businesses that specialize in distressed situations.



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Although there were earlier signs of danger, the crisis in the U.S. financial markets became front-page news in September 2008. Within a 24-hour period, Lehman Brothers filed for bankruptcy and Merrill Lynch agreed to be acquired by Bank of America to stave off a financial disaster. As those of us in the equipment leasing and financing business know, the financial markets have been in a turmoil ever since.

The securitization market has been virtually non-existent for equipment leasing and financing transactions for the past year, depriving some companies of a main funding source. Unfortunately, equipment leasing and financing businesses also have been mostly unsuccessful in accessing the public and private debt and equity markets during this period. Many banks also have experienced financial problems in the past year, resulting in greater regulatory scrutiny and a reduced interest in making commercial loans

to leasing companies.

Impact on the Various Types of Market Participants

The year 2009 has certainly been challenging for our industry, with new business volume decreasing significantly, high delinquency levels and charge-offs, plus many traditional funding sources evaporating. However, The Alta Group recognizes the economic recession has impacted various segments of the market differently. The greatest adverse impact has been on smaller independent leasing companies and lease brokers. Many of these organizations concentrate on small-ticket leases with typically weaker credits. In this sector, the demand for new leasing usually declines precipitously in a severe economic downturn such as we are experiencing now.

Smaller independent lessors that relied on the securitization market for funding have found this market closed. Major banks that are still in the market of lending

to leasing companies have become much stingier with credit approvals and advance rates. Many small- to mid-sized banks throughout the United States that typically have been good funding sources for small independent leasing companies, either through lines of credit or the purchase of transactions on a non-recourse or limited-recourse basis, also have stopped providing lease funding. Some of these banks experienced excessive credit losses in their leasing activities, but others discontinued their leasing business despite excellent results.

In some cases, this was due to a need to reduce lending and increase liquidity in response to problem loans in other areas of the bank. Or bank management decided leasing was not a strategic business. Lease brokers have been hit especially hard by the reduced funding availability. According to one industry publication, more than 50 leasing companies and banks that actively pursued the purchase of leases from brokers have stopped accepting broker business in the past year.

With few attractive companies for sale and seemingly fewer buyers in the market, neither party has a clear advantage in the price negotiations unless the seller is facing significant funding constraints.

Major independent leasing companies and captive finance organizations generally have diversified their funding sources. Those heavily dependent on securitizations, in particular, have had to look elsewhere for funding. Most of the stronger major independents and captives have been able to find alternative sources through banks and the debt markets. Several of the larger independents that specialize in small-ticket leasing, however, have experienced critical funding constraints, forcing them to significantly reduce new originations.

The problems of CIT Group have been well publicized, with many of them related to activities outside of equipment leasing and financing. However, the company's inability to access the capital markets is causing a serious disruption in its equipment leasing and financing businesses. CIT originated nearly \$13 billion of such business in 2008, according to the most recent *Monitor 100* report, which ranked the company #5 in volume. Not surprising, its funding constraints are impacting the markets it serves. GE Capital, ranked #1 in the *Monitor 100*, originated more than \$37 billion of new business in 2008. After initial concerns about the financial risks inherent in the business, GE Capital has continued to access the capital markets in these uncertain times. Captive finance companies Deere, Caterpillar and IBM, ranked #2 and #4, respectively, in the *Monitor 100*, have benefited in the capital markets by the strength of their parent companies.

Bank leasing companies also have been impacted by challenges faced by their parents, often negatively. Many have been forced to adopt more restrictive credit parameters in their origination of new equipment leases and loans. Some of the large bank leasing companies, such as Wells Fargo Equipment Finance (#7 in the *Monitor 100*), have seen the reduced liquidity and higher cost of funds experienced by competitors as an opportunity to increase market share. With their cost of funds near historic lows, bank leasing companies currently enjoy a significant competitive advantage in comparison to the funding costs of independent and captive equipment finance businesses. However, many smaller banks have determined that equipment leasing is not a high priority, and they have reduced or eliminated direct originations and purchases of leases from other leasing companies.

Capitalizing on Opportunities

Every major economic disruption creates opportunities for companies with the staying power and management talent needed to take advantage of changing market conditions. Based on discussions with Alta clients, the following summarizes what some progressive equipment leasing and financing companies are pursuing:

- Developing relationships with equipment vendors whose current leasing partners do not have adequate financial resources to service the needs of the vendors' customers
- Entering leasing markets that have become less competitive due to the exit of one or more major participants
- Being creative in developing new leasing products that will give them an advantage in competing for customers (vendors, end-users or lease brokers)
- Stepping up commitments to provide excellent service to customers, with no hesitation in telling them a credit decision is "no"
- Increasing spreads; with capital scarce, price accordingly
- Being aggressive in pricing renewals of leases with fair market value purchase options; many lessees are not in a position to secure new replacement equipment
- Considering the acquisition of complementary businesses and/or the development of strategic relationships

Opportunities for Acquisitions & Strategic Relationships

Merger and acquisition activity in the United States declined over the past two years, with the first half of 2009 showing a decline of 49.2% in the value of announced deals as compared to the first half of 2008, according to Thomson Reuters. The fact is there have been very few acquisitions of equipment leasing and financing companies this year. This is not surprising, given the challenging environment in which equipment leasing companies are operating. Owners are often reluctant to sell when their businesses decline in profitability. An independent leasing company in danger of losing valuable vendor or lessee relationships due to funding constraints, however, may lose considerably more value if it is not acquired by a party with greater access to capital.

Some potential buyers are reluctant to make acquisitions until conditions improve in the current financial market. Who can blame them? Other buyers are exclusively looking for bargains where the owners are desperate to sell and have few alternatives. Often such troubled companies are worth more dead than alive, and end up being liquidated through a portfolio sale. Nevertheless, there are buyers willing to pay a reasonable price for an ongoing business that helps them fulfill their strategic objectives.

With few attractive companies for sale and seemingly fewer buyers in the market, neither party has a clear advantage in the price negotiations unless the seller is facing significant funding constraints. Often the only way the buyer can meet the seller's price expectations is through an "earn-out" arrangement, wherein part of the purchase price is contingent upon future results. Such earn-outs work best when key management members have an equity stake in the business, and thus have substantial upside potential if they achieve performance targets after the acquisition.

From our perspective, to be an attractive acquisition candidate a company must have a good business strategy and attractive growth prospects with a good return on investment. In addition, its management team should have demonstrated favorable results in the past, either with the company or a previous employer. Companies that specialize and have a strong position in niche markets are generally of greater interest to acquirers.

Companies that provide value-added services to vendors or end-users also are more attractive than those in a commodity-type business.

Buyers prefer companies that have strong relationships with their vendors and/or lessees because of the greater predictability of future business, and buyers often pay a premium for specialized expertise. The trend in the industry has been away from leases with fair market value purchase options. The relatively few companies that have demonstrated expertise in achieving substantial profits from equipment residual values on fair market value leases may be attractive to companies with no specialized equipment expertise.

Some equipment leasing and financing companies have grown in the past through portfolio purchases. However, given the current limitations on capital availability, there are very few buyers that want to put assets on their balance sheet without also obtaining an ongoing business. Most portfolio purchases in the current market have involved distressed assets and/or distressed sellers, and the selling prices are reflecting significant discounts. Many of the buyers are not leasing companies, but instead are businesses that specialize in distressed situations.

While some leasing companies are reluctant to buy or sell at this time, development of strategic relationships may be to their benefit. A bank leasing company whose customers want fair market value leases on computers, for example, might engage in a relationship with a computer leasing company. The debt funding for the lease is provided by the bank and most of the residual risk and reward go to the computer leasing company.

For a captive leasing company that has funding constraints, a strategic relationship with a strong vendor leasing or bank leasing company may make sense. A small independent leasing company or lease brokerage firm whose funding sources have dried up may be interested in a relationship to provide first right of refusal to a local bank — enabling the company to stay in business. Also, with many leasing companies not having a current appetite to retain the good business they are able to originate, it becomes more important for such companies to develop syndication capabilities through strategic partners.

What types of companies are likely to be acquirers of equipment leasing and financing entities in the current market? Alta believes well-capitalized banks that have not taken, or have repaid, government TARP funds are in the best position to make acquisitions. The large banks already have leasing businesses, so the most likely acquisitions for them would be of companies that have expertise in a market that the bank leasing company does not. Banks have the advantage of a lower cost of funds and higher leverage ratios than other potential leasing company acquirers. They could be a good match, in particular, for an independent leasing company that has funding limitations. In addition, banks are also the most likely buyers of non-troubled portfolios. Mid-sized banks have not generally been strong in equipment leasing, but Alta believes equipment leasing represents a good diversification opportunity for banks seeking to reduce their exposure to real estate and construction lending. The key is to educate those banks on the benefits they could derive from acquiring an equipment leasing business.

In past years, GE Capital and CIT have been aggressive acquirers of other equipment leasing companies. That is not likely to be the case again anytime soon because of the intent of General Electric to reduce the size of GE Capital and CIT's continuing financial problems. However, the few small independent leasing companies that are well capitalized, and have a funding capability could be logical acquirers of smaller independent companies that are facing severe funding constraints.

In addition, a number of private equity groups are interested in the equipment leasing industry. They have invested in established companies

and supported management teams in forming several new leasing companies in recent years. Hedge funds have shown interest in investing in lease portfolios and leasing companies, as well. They have been good partners in helping some leasing companies purchase portfolios. Several hedge funds concentrate on the purchase of distressed assets, including lease and loan portfolios. However, their need for substantial volumes of high-yielding assets limits the types of leasing investment opportunities they pursue.

Challenges of the 'New Normal'

In past recessions, most leasing companies operated under the premise that when the economy recovered business would return to normal. However, Alta thinks the disruptions in the financial markets over the past year make it likely that leasing companies will have to adapt to a "new normal." Just as the wave of bank consolidations is not over, we expect there will continue to be a growing concentration of equipment leasing activity in a few major players. In fact, bank consolidation and the growing concentration of leasing business in the largest banks caused the *Monitor* to change its *Monitor Bank 50* rankings to the *Monitor Bank 25* in 2009. The publication estimated that the top 25 bank leasing companies represented 95% of the assets of the top 50 banks.

Smaller independent leasing companies are the most vulnerable to being squeezed out of the market because of inadequate and/or too expensive funding. Some of these companies will undoubtedly be sold or liquidated. A few independent leasing companies have formed banks, and CIT even changed its status to a bank holding company. It is likely that more independent leasing companies and diversified financial service businesses will take advantage of the funding benefits that having a bank, or being part of one, can provide. Of course, bank status brings a heavily regulated environment. Unless the securitization market makes a significant comeback or new institutional funders enter the market, independent and captive leasing companies will continue to be at a considerable disadvantage in accessing competitive lease funding.

Funding is not the only issue of concern for equipment leasing and financing companies. It is evident the credit criteria used by many leasing companies was flawed to a certain extent in this recession. This is especially true in the small-ticket, application-only market where credit scoring parameters proved to be woefully inadequate at some companies. These companies hopefully have learned their lessons and will not return to doing "business as normal."

The equipment leasing and financing industry has benefitted from many very talented executives who have led their leasing companies through tough times in the past. We have no doubt the industry will survive this period of turmoil, albeit with fewer ongoing participants. The industry's leaders, however, must understand the market realities that will be impacting the leasing industry going forward and develop strategies that will ensure that their organizations are among the survivors. It certainly is not too soon to begin preparing for the "new normal." **m**

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