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A Look at the Industry:
Opportunities to Achieve Growth, Cultivate Worth in 2004

Positive economic trends — combined with the aging of current plants and equipment — are spurring investment in capital expenditures and, in turn, lease volume. In an effort to build value, lessors should revisit past "perfect storms." In other words, they should benefit from history, rather than perpetuate it.

By Thomas Wajnert and Steven Sherman

When our article "Mergers And Acquisitions: Believe It Or Not, Opportunities Still Exist" appeared in the June 2003 issue of the Monitor, the leasing industry's mindset was one of cautious conservatism. Capital investment was sluggish, and accordingly, lease volume followed suit.

It's different today, and although it would be exciting to report that the "industry did something different" and fascinating to dissect the reasons why, that's just not the case. As the economy goes, so goes the leasing industry, and a rising tide lifts all ships. In leasing, we finance a portion of investment in plants and equipment. For example, of the $668 billion spent by U.S. businesses on productive assets in 2003, $208 billion, or 31 percent, was acquired through leasing. This third-of-the-pie share hasn't changed much over the years.

The economy's foundations have been fortified over the past three years. Strengthening factors include low interest rates, serious cost cutting, and a surge in worker productivity driving improved profit margins. Cash on hand has risen to record levels as a percent of all corporate assets, debt-to-equity ratios have returned to pre-boom levels, and free cash flow is headed toward a new record. Data published in the May 2004 Thomson Financial Quarterly CAPEX Report revealed the first uptick in capital expenditure growth (0.4%) among U.S. companies since Q4 2001. These positive economic trends — combined with the aging of current plants and equipment — are spurring investment in capital expenditures and, in turn, lease volume.

Last year, we reviewed the various opportunities and hazards involved in merging two organizations in a sluggish economy. This year, we'll focus on achieving growth aided by public or private investment. Finally, we'll discuss how companies can increase their value — something no leasing company can afford to ignore, even if raising capital or a sale is not on the intermediate horizon.

Macro Trends & the Leasing Industry

U.S. manufacturers began rebounding in late 2003 and show signs of moving higher in 2004. According to the ELA's 2004 Industry Futures Council Report, 2004 looks encouraging in the small- to mid-ticket segment. Conversely, large-ticket lessors remain under pressure and face uncertainty, especially regarding regulatory and tax policy. Yet, lessors believe that competitive pressures will lead to further consolidation, presaging continuing competition within a smaller crowd. Pressure on returns could potentially limit the total availability of capacity due to credit concentration issues. Finally, innovations continue, but they appear to be focused on organizational and transactional efficiencies rather than creative structures.

The Return of the IPO & Other Big Deals

Last year we said, "It's a good time to be a buyer, if you can find a motivated seller." The pendulum is now shifting, albeit slowly, toward the seller. Valuations are beginning to rise. This trend is largely driven by increased valuation of public companies since there have not been many recent comparable M&A transactions.

One of last year's big influences on leasing valuations did not originate from within the leasing industry. In August, CapitalSource (CSE), a senior and mezzanine commercial finance lender, went public. CSE was priced at the high end of its expected range ($14.50 per share) and traded up 26% the first day. The company ignited a veritable firestorm of interest in the market, and its success had the industry and outside investors abuzz. Next, Marlin Business Services Corp. (MRLN) followed with its IPO a few months later and traded up 15% its first day. These two IPOs captured the focus of Wall Street and the private equity communities, stimulated demand (CapitalSource), and confirmed that these valuations were sustainable (Marlin). Coincidental with raising values, private equity interest in the leasing sector was stimulated, IPOs became a real liquidity event alternative, and selling a leasing company became an attractive option.

Major M&A deals during 2003 and the first half 2004 reflected the efforts of companies seeking to divest themselves of non-core-competency or underperforming divisions. We believe that this makes a lot of sense. Given the relative scarcity of capital, many companies find it hard to rationalize investing in their leasing business when their core business requires more capital to maintain its competitive footing. Rating agencies are scrutinizing parents of captive leasing companies, creating pres-

ATTRACTING PRIVATE EQUITY INVESTMENT

Attracting private equity investment is a much more viable option for a leasing company today than it was just a few years ago. Nevertheless, keep the following realities in mind:

- We've discussed some of the general attributes private equity firms seek in a potential funding recipient, but no two firms are exactly alike in their approach. It is important for the leasing company to match its characteristics to the private equity firm's investment criteria and style. Is this an early stage investment? Later stage? What is the company's access to debt funding? Securitizations? How will growth be achieved? What is the exit plan?
- Private equity firms have a high return requirement. Typically, the private equity investor is looking for a return in excess of 20%, and the leasing company is producing a 13% to 20% return on equity. This difference needs to be made up some way, possibly in the form of a liquidity event.
- Private equity firms must provide liquidity to their investors by either selling or going public with their investments in a three- to ten-year time horizon.
- Any investment made by a private equity firm is only one of several being made in other portfolio companies. While the private equity firm will want (and often require) involvement in many of your company's major decisions with potential impact on their investment, they will often be rationing their time among many other investments. This potential lack of availability may be frustrating at best and at worst may lead to a lack of market responsiveness of the firm.

sure for the companies to reevaluate the value of owning a leasing company versus selling the leasing company and entering into a vendor program. In April, GATX (whose portfolio is 80% transportation based) announced its plans to shed its technology leasing division. IKON Office Solutions sold its U.S. leasing portfolio to GE Capital Corporation, and is in talks to sell its Canadian portfolio to GE as well. IKON stated that the sale was intended to improve IKON's financial and organizational flexibility, operating performance, and balance sheet. In late May, GE Commercial Finance agreed to purchase approximately $2 billion in assets from Boeing Capital Corporation. With leasing valuations going up, it was hard for these companies not to consider selling their financial assets.

While M&A activity has increased somewhat, there are still few transactions being completed. Buyers remain very selective despite pressure to increase volumes of leasing companies, and they're carefully considering both acquisition price and the strategic fit before proposing a deal.

Nevertheless, acquisition presents an attractive asset growth option. Many potential acquirers wait for the "right portfolio" of assets to come their way — but it's often a long wait. Buyers who can creatively make an acquisition work for the seller may find themselves at an advantage in this marketplace, where sellers are willing to close deals for the right price and the right circumstances. Keep in mind that there are very few independent leasing companies represented in the Monitor 100; acquisition opportunities exist for those firms outside of the "100" and for creative transactions with the larger firms.

Raising Capital

Going Public

This spring, the Dow once again hit 10,000. Is it a good time for privately held lessors to think about an equity offering? Today, the main advantage of going public is that it is a viable option, investment bankers and investors seem eager to support new offerings, and the offering can be reasonably priced — not the case just a few years ago.

The public market may represent a continuing source of equity to finance leasing company growth. First, the company needs to be confident that it has achieved enough critical mass to attract institutional funding and research coverage necessary to support its long-term value. Many public companies with market capitalizations under $300 million languish because of lack of equity research coverage and the resultant institutional investors. It's worth remembering that an IPO does not necessarily mean instant liquidity for the primary shareholders of the formerly private company (their shares convert to public shares). Finally, the company must be prepared for public scrutiny and the pressure to produce quarterly growth and earnings with limited flexibility over reporting and accounting practices.

Considerable initial and ongoing opportunity costs (and responsibility) are associated with going public. First, there are the legal fees and other costs associated not only with the IPO but with ongoing filings and highly specific oversight. Investor relations expertise must be retained or cultivated from within. New mandates concerning financial disclosure and corporate governance now require specialized, professional expertise to ensure compliance.

Private Equity Investments

An alternative to raising money on the Street is to seek private equity or venture funding. Just as in 2003, the PE players sought out leasing companies to balance the riskier healthcare and technology deals in their portfolios.

Private equity firms demand sustainable success and scalability. A myriad of financial and operational factors need to mesh seamlessly to deliver optimal returns. Private equity firms will look to see whether the funding recipient's business model fits their risk profile and other investment criteria. From human to IT resources, the prospective funding recipient should demonstrate that its infrastructure is robust enough to support the entire leasing lifecycle in its current and future business model.

Perhaps the biggest questions posed by PE firms are, how seasoned is the company's leadership, and have they successfully returned a profit to their investors before? In assessing the management team, private investors will judge whether collective abilities are in sync and achievements are replicable. Long-term viability (and thus, investor gain) extends past impressive originations; it's all about the ability of a management team to develop and successfully run a leasing organization.

With these last attributes in mind, it will be interesting to watch the performance of a new small-ticket company entering the arena backed by substantial private funds. U.S. Express Leasing (U.S.XL) is led by a team of industry veterans: CEO Jim McGrane is the former president of Heller Global Vendor Finance and a 25-year industry veteran with experience at AT&T Capital and U.S. Leasing; other management team members previously held senior-level positions at GE, CIT, Heller, DLL, AT&T Capital, and The Alta Group. U.S.XL will originate through the dealer channel and provide vendor financing directly for select manufacturers; market segments served include healthcare, IT/telecom, furniture, and office equipment. U.S.XL is a portfolio company of DLJ Merchant Banking Partners III, L.P., the flagship private equity fund within CSFB Private Equity, the global private equity arm of Credit Suisse First Boston. It's likely that CSFB's decision to take a major stake in U.S.XL was driven by a

combination of favorable market conditions and confidence in management's ability to execute based on its past track record.

Making It Work

The best way to foster a positive relationship with a private equity firm is to ensure that the business plan is clear, that the management team and the private equity firm's interests are aligned, and that the management team delivers (or over-delivers) on the business plan commitments. Private equity firms generally do not want to operate a business — that's management's job — but they will review the business on a constant basis from the board level and through the monthly or quarterly results.

Private equity firms are committed to return a relatively high level (20% to 35% or more) of return to their investors. If an investment is not on track to generate expected returns, they step up involvement — perhaps through their board positions, exercising features of their investment instruments, or, potentially, by bringing in new management.

Value Creation in Today's Environment

Think forward to the day when it will be your opportunity to cash out of your investment. No matter what your strategy (ready to sell the company, seek additional funding, or benefit from a buoyant equity market), your rewards stand to be much greater if you have created value through sound management, financial stewardship, and repeatable successes. Strategies worth considering include:

- Begin by increasing your owned asset base. Expand current accounts, attract new vendors (once gained, maintain strong relationships), and mine your lessee base for new products and services. This is also a great time to grow by acquisition and portfolio purchases.
- Boost profits by increasing your residual and fee income and lowering your cost of funds.
- Build a track record of consistently strong profits.
- Differentiate your business. Pick up or strengthen a niche market, add international servicing capabilities, improve your service quality — there are many such opportunities for innovation. This differentiation also helps your vendors add value to their offerings; success engenders loyalty.
- Create "scarcity value" by becoming the strongest lessor in your chosen niche.
- Maintain credit quality.
- Use conservative accounting practices and limit gain on sale accounting.
- Remember the power of brand and the importance of reputation.
- Securitize strategically. Remember that over half the target companies in the ELA's landmark "Perfect Storm" study relied almost exclusively on securitization as a funding method. Note that you won't see them on this year's Monitor 100 because they're no longer around.

Perhaps that's a fitting close. Market and industry optimism can be contagious, yet it can also foster a collective amnesia. Even with metrics pointing to "repeatable success," no one can accurately predict the future. In your efforts to build value, revisit the lessons of past "perfect storms". Benefit from history; don't perpetuate it. *m*

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