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Beyond the Leasing Product...
Is It Best to 'Commodify' or Customize?

Looking to the future, will banks continue to perpetuate the "leasing product" as the first-line point of entry to other cross-selling opportunities? Certainly with the right economies of scale, banks can "commodify" the product profitably. On the other hand, it is important to consider a "leasing plus" paradigm in which independents and captives have the flexibility to support niche opportunities to deliver value added services.

By Thomas Wajnert and Steven Sherman

Since 2003, FairView Advisors has asked *Monitor* readers: How does a leasing organization increase its value and what's ahead for the 2006-2007 "*Monitor* year"? The U.S. capital goods sector for 2006 looks positive thanks to increased equipment demands and a robust economy. The technology, construction, healthcare and office equipment leasing sectors are rebounding. The European economy is booming, Asia more so, and barriers to entry are falling in many emerging markets.

However, this is a turbulent time for the leasing industry. It is a pressurized environment, owing to the current regulatory climate, compliance challenges, globalization, tax law changes and the effects of consolidation. Moreover, each lessor has its own unique challenges in their quest to grab market share from the "competition."

But who is the "competition"?

As captives, independents and banks pursue common customers, offering a mix of different value propositions (brand, transactional expedience, industry focus, speed of execution, convenience), the offerings of indirect competitors may very likely be on the customer's table. From a product perspective, these include alternative lending products and cash; on the organizational side, these include hedge funds, REITs and foreign companies.

According to the ELA's 2006 Industry Future Council Report, "Providers of financing will face competition from multiple directions, and lessees will continue to compare and contrast similar-but-different solutions. Consequently, competitive 'losses' will require careful examination, as the reasons expand beyond price, terms and responsiveness from similarly situated competitors."

Lessors must now place an increased emphasis on differentiating the leasing product from alternative sources. Certainly, general leasing is a mature industry, and with maturity comes "commodification." Innovation has traditionally centered on accounting and tax structures; however, with the current regulatory climate, those opportunities have all but vanished. Service delivery, relationship focus, equipment expertise and other value-addeds are becoming increasingly important. Global transaction capability is another must, in many cases; even smaller leasing companies are facing increased requests for borderless transactions, according to ELA.

Industry-specific value-added services make a powerful argument for leasing and enhance the value of the lessor able to provide them. Consider the IT leasing industry as an example. Through 2009, IDC expects at least one-third of large, multisite, multinational companies to revise and revamp their lease management processes. Within large companies, lease management has historically been administered by departments, divisions or functional business units. Centralizing lease management (through business processes and technology) can create both organizational and IT cost efficiencies; an experienced, niche-focused lessor can provide critical knowledge capital.

As leasing becomes increasingly important to banks, it becomes more difficult for the banks to find attractive growth opportunities. Large acquisition candidates are becoming scarce as there are fewer independents and captives.

In the past, we've identified eight keys to success to increase a leasing company's value. These are:

- Increasing owned asset base
- Boost profits through increased fee income
- Build profitable track record
- Differentiate and innovate
- Create scarcity value; guard brand/reputation
- Credit quality
- Accounting conservatism
- Strategic securitization

In this climate, we propose a ninth: Compete successfully against indirect sources.

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The issue persists: Which organizations — banks, captives or independents — are best positioned to deliver "leasing plus"? Moreover, is "commodification" a negative, and which channel is ideally suited to deliver the leasing "product"?

Whatever the case, we think that organizations that find the right "sweet spot" and do it profitably — by managing costs, exploiting niches and partnerships, and stringently controlling credit — will enhance their worth.

With these issues in mind, we will review the past year's activity, look at international opportunities and, with an eye on 2007, consider the issue of "product" versus "leasing plus."

Where relevant, we include a comparison of this year's and last year's Monitor 100 rankings (2006/2005).

Merger and Acquisition Activity

The composition of this year's Monitor 100 reflects the impact of the "mega bank deals" that transpired in 2004-2005. For the most part, these new bank leasing companies are the byproduct of parent bank mergers, rather than a bank's acquisition of a leasing company. New deals are presently in the works, which should certainly impact the 2007 Monitor 100. Wachovia Leasing (7/8) is expanding west with its planned acquisition of Golden West Financial. Capital One Equipment Finance (89/93) acquired Hibernia and recently announced its intent to purchase New York-based NorthFork Bank. North Fork is the parent of All Points Capital, one of the Monitor 100's fastest movers; it jumped from No. 45 in 2004 to No. 38 on this year's list.

Also, after being barred from acquisition activity in 2005 for regulatory purposes, CitiCapital (8/7) is back on the scene, having recently acquired a portion of GE Commercial Finance's Construction and Industrial Equipment business.

Yet as leasing becomes increasingly important to banks, it becomes more difficult for the banks to find attractive growth opportunities. Large acquisition candidates are becoming scarce as there are fewer independents and captives. At the lower end of the market, however, there has been a good deal of merger and acquisition activity in recent years; it will take a few years for the "trickle-up" effect to occur as these banks increase in size, join the ranks of the Monitor 100 and continue to grow or be acquired. In the past year there has also been an increase in small banks acquiring or partnering with independent lessors, often to serve a particular industry or regional niche.

Several recent deals point to the increased optimism in the healthcare sector. CIT Group (3/2) plans to acquire Healthcare Business Credit, a full service asset-based and cash-flow financing company. Also looking to expand its footprint in medical equipment financing is Siemens Financial Services (28/21), which purchased Broadcastle Plc in a $74 million deal.

LEAF Financial (74/87) is on the rise owing to acquisitions and several high-profile partnerships; last year it acquired Allco Credit and is partnering with Merrill Lynch on a leasing program with Gateway. LEAF recently announced plans to acquire healthcare lessor Unicyn Financial. After this acquisition, LEAF will manage approximately $475 million of finance assets for its own account, institutions and third-party investors. In July, independent lessor IFC Credit (96) acquired business operations of Blue Dot Funding LLC. IFC's goal is to producing $500 million in annual lease originations by 2009.

Among the larger players, the trend toward divesting non-core businesses continues. After seeking a buyer for months, Morgan Stanley announced the sale of its aircraft leasing business to European private equity firm Terra Firma for $2.5 billion in cash. According to the Morgan Stanley CEO John Mack, "It just didn't fit in with our strategy."

In early April, Interpool, Inc. announced that its wholly owned subsidiary, Interpool Containers Limited, sold a substantial majority of its operating lease portfolio of standard dry marine cargo containers to a Swiss investor group. The divestiture was intended to provided an additional source of capital and reduce debt, improve capital structure and reduce the cost of future financings.

One high-profile transaction we reported on last year has been in continuous flux. Pitney Bowes announced in April 2005 that it intended to spin off its Capital Services division as part of a deal with Cerberus Capital Management. In March 2006, the company announced it was assessing a broader range of asset and business disposition options, including a spin-off, a sale of the business, or a piecemeal divestiture of the division's assets. On May 1, the company seemed to be taking a step in the latter direction with the announcement of the sale of its Oce Imagistics lease portfolio for approximately $288 million to De Lage Landen. A few weeks later, Pitney Bowes signed a definitive agreement with a Cerberus affiliate for the sale of its Capital Services external financing business; the company expects to generate $1.16 billion of cash from the sale.

Family conflict can also be a powerful motivator for divestiture. Triton Container International, one of the world's largest lessors of intermodal containers, has retained Goldman Sachs to represent the company in sale negotiations. Sources say could be worth as much as $2.5 billion. According to a story from Reuters, the planned sale is a result of an ongoing dispute among heirs of the Pritzker family estate, the Chicago-based family business that owns Triton.

Buckeye State Battleground?

February 2006 marked the start of a third year of expansion in U.S. machine tool consumption, according to AMT, The Association for Manufacturing Technology, and AMTDA, the American Machine Tool Distributors' Association.

So if Rust Belt investment in manufacturing equipment is on the upswing, it should be interesting to see which lessors are most successful at snaring market share. Keep an eye on the highly competitive Ohio banking industry, especially Key Equipment Finance (10/10), National City Commercial Capital (22/29), Fifth Third Leasing (23/25) and Huntington Bank Equipment Finance (68/66).

International

Europe

The European leasing industry broke several records last year. Leaseurope estimates that new leasing contracts worth just above 270 billion euros ($326.3 billion) were concluded during 2005, making the European leasing market the largest in the world; its 14% growth rate has outperformed the rest of the European economy on average. Among the joint ventures announced last year is Key Equipment Finance's strategic partnership with UBS Leasing. Key will provide products such as project financing, technology refresh and off balance sheet financing.

China

The Chinese leasing market is growing more than 40% a year, according to ELA. At the beginning of 2005, the legal framework regulating foreign leasing companies in China was amended, making it possible for foreign firms to establish a finance leasing company without the necessity of having a Chinese joint-venture partner.

The "first movers" in the Chinese market are beginning to see results, establish a permanent foothold and introduce new financing concepts to this complex marketplace. In 1998 CIT established a joint venture with two Chinese companies; last month CIT acquired

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the remaining 45% ownership stake. CIT has nearly $650 million in total assets in China, and is the largest vendor organization there. Caterpillar Financial (4/5), another pioneer, just introduced its "CAT Rental" rental store concept to customers in China, and 12 CAT Rental stores have opened this year.

"A customer coming into one of these new rental stores will have the full product support they expect from Caterpillar and its independent dealers, including the option to rent, lease or buy new or used equipment and even to obtain financing from Caterpillar China Financial Leasing," said Rod Beeler, Caterpillar vice president for Asia Pacific Marketing. Caterpillar plans to place significant emphasis on leasing and rental education for potential customers; the concept of "non-ownership" is still quite new in China. Other recent developments: Deutsche Leasing opened its China headquarters in March and is planning to invest almost $24 million in the country in 2006. Societe Generale is opening a new subsidiary in Shanghai, which will handle its long-term leasing, car fleet management and equipment financing activities.

Facing the Future: Product vs. "Lease Plus," Banks vs. Independents

With advantages such as plentiful capital, a ready-made customer base and low cost of funds, banks should continue to dominate the leasing industry. Nonetheless, banks must contend with stricter underwriting and pricing resulting in less flexibility, regulatory pressures, compliance costs and expertise needed to fully understand implications of leasing tax laws and regulations.

Moreover, size does not necessarily equal strength, and that is why execution is critical: for wresting market share from other banks, for competing profitably against independents and for optimally positioning the leasing product within the bank's portfolio of solutions. For banks to successfully grow organically, they must tightly integrate their commercial bankers and leasing specialists.

Will banks be the most successful perpetuators of the "leasing product" in the future? If well entrenched in the banking product platform, leasing becomes a first-line point of entry to other cross-sell opportunities. Moreover, with the right economies of scale, banks can "commodify" profitably.

Moving forward, will "leasing plus" be the exclusive domain of the independents and captives? It is certainly possible, as they may have either the flexibility or expertise to support niche opportunities and latitude to deliver customized packages and value-added services. Hewlett-Packard's free data-cleansing program on the hard drives of end-of-lease PCs to help customers enhance their security and meet regulatory compliance is a good example of a "value-add" that taps into their industry expertise and addresses a critical issue.

It's important to recognize that "valuable" companies exist beyond the pale of the Monitor 100. There are many leasing organizations that put value principles to work by focusing on steady and smart growth, controlling risk and knowing their customer and market. Perhaps these "tortoises" will be Monitor 100 companies at some time, perhaps not. More importantly, they may be the standard bearers of innovation in an age of consolidation and commodification. **m**

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