White Clarke Group

White Clarke Group is the market leader in software solutions and business consultancy to the automotive and asset finance sector for retail, fleet and wholesale. WCG solutions enable end-to-end credit processing and administration to streamline business practice, cut operational cost and deliver outstanding customer service. WCG has a twenty year track record of leadership and innovation in finance technology, consultancy and new market entry. Clients value WCG industry knowledge, market intelligence and innovation. The company employs some 500 finance and technology professionals, with offices in the UK, USA, Canada, Australia, Austria and Germany.

White Clarke Group publish the Global Leasing Report, which is part of The World Leasing Yearbook. To download a copy please go to:


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Introduction
The United States is the single largest economy in the world and, although
events elsewhere such as developments in the Eurozone and growth in China
will have global repercussions, in terms of influence the US remains firmly at
the forefront. It is more susceptible these days to global forces, such as the
sovereign debt problems in the Eurozone, but it continues to set the marker
for the wellbeing of the global economy.

The US is also the benchmark for asset finance, with by far the largest
equipment finance and leasing industry. In fact, leasing was first developed in
the US in the 1950s and has since been successfully exported to developed
economies and increasingly to emerging markets around the globe. The
equipment leasing industry has grown to become a major force in the US
economy, with an estimated value of $628bn in 2011.

After four years of global recession, the good news is that the US economy is
seen to be gradually recovering. However, the effects of the financial crisis are
still being felt.

In his Jackson Hole speech on August 31, 2012, Federal Reserve (Fed)
chairman Ben Bernanke said that "stresses in credit and financial markets
continue to restrain the economy. Earlier in the recovery, limited credit
availability was an important factor holding back growth, and tight borrowing
conditions for ... small businesses remain a problem today."

Access to financing is a problem that continues to face many medium-sized
businesses, as well as small ones. A solution to the problem is increasingly
being sought through leasing.

This Country Survey aims to provide a balanced view of the equipment finance
and leasing market in the US. Although the economic background is
universally well documented, some brief indicators are provided regarding the
conditions for business.

The survey will then provide a summary of US leasing activity; provide
comment from key industry figures on the market, its outlook and the
challenges and opportunities that face it; and review the latest developments
in the floorplan market, accounting practice and taxation.
Economic overview

The short-term global outlook continues to be one of uncertainty. Although the MSCI World Index stood at almost the same level on October 1, 2012 as it was six months earlier at the beginning of April, that period conceals another trough in share prices in the developed world.

However, conditions in global financial markets have eased significantly since June, aided by central bank interventions, particularly the Fed’s proposed new quantitative easing program (QE3).

The latest World Bank Global Economic Monitor update stated: “Though activity is likely to pick up by the fourth quarter, the recent slowdown implies global GDP growth in 2012 will be weaker than earlier projected. Looking forward, the easing of conditions in financial markets, cuts to interest rates and/or fiscal stimulus in some large developing countries bodes well for a pick-up in economic activity.” (Developing Trends: September 2012, Development Economics Prospects Group.)

A recent setback is that the US economy slowed in Q2 2012, but the upside is that the longer-term prospects remain positive, with forecasts for continuing growth of a steady if unspectacular nature. Real GDP is expected to grow, and inflation should drop with the assistance of the Fed’s monetary policy, which is committed to keeping the policy rate low until at least 2014.

However, there are serious fiscal constraints scheduled for the start of 2013 – the so-called ‘fiscal cliff’ – due to the simultaneous expiration of various temporary measures, including tax cuts originally set up under the George W. Bush administration, and automatic spending cuts under the 2011 Budget, which could act as a major brake on any economic recovery. This is exacerbated by the November elections, with little prospect of action on fiscal policy in the immediate months.

In spite of this uncertainty, the forecasting bodies are generally agreed in their projections. The Organization for Economic Co-operation and Development (OECD) stated: “The economic recovery has gained momentum since the first half of last year, with moderate employment gains and a pick-up in the pace of consumer spending.

Nevertheless, real GDP growth is projected to increase only gradually this year and next, as the economy is still overcoming important hurdles.” (OECD, United States – Economic Outlook, June 2012.)

At the International Monetary Fund (IMF), the head of the US team, Gian Maria Milesi-Ferretti, stressed: “We expect the US economy to recover at a tepid pace in 2012 and 2013,” adding: “But the outlook remains difficult.” (Interview with ‘IMF Survey Online’, August 2, 2012.)
The Economist Intelligence Unit (EIU) continues this line, agreeing that the US economy is continuing to grow but foreseeing little sign of a pick-up in the near term, despite QE3: “We are not, for now, raising next year’s forecast because of the new QE programme; if we do, any increase is likely to be modest. For next year, we expect a weaker lead-in from 2012 and negative sentiment associated with fiscal tightening to weigh on confidence and spending.” (EIU, September 19, 2012)

Positive signs

The employment gains mentioned above are one sign of an improving economy, with the unemployment rate falling for three consecutive months to September. The drop in September came as a surprise to many pundits, and the new jobless rate of 7.8% announced by the Labor Department is the lowest since January 2009.

Further indications of growth can be found in the latest figures from the Institute for Supply Management, which shows a return to expansion in the manufacturing sector after three months of contraction. The purchasing managers’ index (PMI) rose by 1.9% to 51.5% (September 2012 Manufacturing ISM ‘Report on Business’).

The latest monthly data from the National Federation of Independent Business (NFIB) showed a rise in confidence among small businesses in August, the first increase in four months. The NFIB Small Business Optimism Index gained 1.7 points to 92.9, with indicators showing improving sentiment regarding prospects for employment, capital outlays and business conditions. However, political uncertainty remains a major constraint for small businesses.

Finally, regarding the equipment finance market, the most recent data released by the Equipment Leasing & Finance Foundation (ELFF) has revealed that, in September 2012, overall confidence in the equipment finance market stood at 53.0, an increase from the August index of 50.2. “reflecting increased optimism despite concerns over companies’ willingness to expand their businesses in the face of economic and political uncertainty.” (ELFF Monthly Confidence Index (MCI-EFI), September 2012)
Business climate

Size isn’t everything, and being the biggest economy does not always equate to being best in all spheres; however, on the whole, the US is a good place for business.

In its ‘Doing Business 2012’ report, the World Bank ranks the US fourth out of 183 countries for overall ‘ease of doing business’, the same position as in 2011. Other rankings are given in the table below, where it can be seen that the US is particularly good for the ease of getting credit and investor protection, whereas it is placed considerably lower when it comes to ease of paying taxes.

Ease of doing business in the US

<table>
<thead>
<tr>
<th>Topic</th>
<th>DB 2012 Rank</th>
<th>DB 2011 Rank</th>
<th>Change in Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Starting a business</td>
<td>13</td>
<td>11</td>
<td>-2</td>
</tr>
<tr>
<td>Dealing with a construction permit</td>
<td>17</td>
<td>17</td>
<td>No change</td>
</tr>
<tr>
<td>Getting electricity</td>
<td>17</td>
<td>16</td>
<td>-1</td>
</tr>
<tr>
<td>Registering property</td>
<td>16</td>
<td>11</td>
<td>-5</td>
</tr>
<tr>
<td>Getting credit</td>
<td>4</td>
<td>4</td>
<td>No change</td>
</tr>
<tr>
<td>Protecting investors</td>
<td>5</td>
<td>5</td>
<td>No change</td>
</tr>
<tr>
<td>Paying taxes</td>
<td>72</td>
<td>70</td>
<td>-2</td>
</tr>
<tr>
<td>Trading across borders</td>
<td>20</td>
<td>20</td>
<td>No change</td>
</tr>
<tr>
<td>Enforcing contracts</td>
<td>7</td>
<td>7</td>
<td>No change</td>
</tr>
<tr>
<td>Resolving insolvency</td>
<td>15</td>
<td>14</td>
<td>-1</td>
</tr>
</tbody>
</table>


As can be seen in the first of the two charts that follow, the US economy stands very favorably on the ease of doing business compared with other economies and compared with the regional average.

How US and comparator economies rank on ease of doing business

United States  4
Canada  13
Germany  19
Regional average (OECD high income)  29
Mexico  53
China  91
Russian Federation  120
India  132

Ease of doing business
Regarding ease of getting credit, the rankings for comparator economies and the regional average ranking shown in the second chart show how well regulations and institutions in US support lending and borrowing.

How the US and comparator economies rank on the ease of getting credit

![Ranking chart]

### Competitiveness

In ‘The Global Competitiveness Report 2012-2013’ produced by the World Economic Forum (WEF), the US is ranked in seventh position, down two places from the previous year and marking a continuing slide.

The report states: “Although many structural features continue to make its economy extremely productive, a number of escalating and unaddressed weaknesses have lowered the US ranking in recent years.”

As can be seen in the charts below, US firms rank highly for innovation and sophistication, and for flexibility in the labor market, with higher education and training systems that dovetail successfully with business. These factors help to make the US one of the most competitive global economies.

There are weaknesses, most notably apparent in the lack of macroeconomic stability (in 111th place, down even further from 90th last year).

However, the report observes: “On a more positive note, measures of financial market development continue to indicate a recovery, improving from 31st two years ago to 16th this year in that pillar, thanks to the rapid intervention that forced the deleveraging of the banking system from its toxic assets following the financial crisis.”

When it came to the most problematic factors for doing business, as perceived by the Global Competitiveness Report respondents, the main factors selected are common to the majority of mature economies, such as inefficient government bureaucracy, and issues relating to tax rates and regulations. However, also relatively high on the list is access to financing, a problem that is increasingly addressed through leasing.
Global Competitiveness Index

<table>
<thead>
<tr>
<th>Factor</th>
<th>Rank out of 144</th>
<th>Score (1-7)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GCI 2012-2013</td>
<td>7</td>
<td>5.5</td>
</tr>
<tr>
<td>GCI 2011-2012 (out of 142)</td>
<td>5</td>
<td>5.4</td>
</tr>
<tr>
<td>GCI 2010-2011 (out of 139)</td>
<td>4</td>
<td>5.4</td>
</tr>
</tbody>
</table>

**Basic requirements (20%)**
- Institutions: 41 (4.6)
- Infrastructure: 14 (5.8)
- Macroeconomic environment: 111 (4.0)
- Health and primary education: 34 (6.1)

**Efficiency enhancers (50.0%)**
- Higher education and training: 8 (5.7)
- Goods market efficiency: 23 (4.9)
- Labor market efficiency: 6 (5.4)
- Financial market development: 16 (5.1)
- Technological readiness: 11 (5.8)
- Market size: 1 (6.9)

**Innovation and sophistication factors (30.0%)**
- Business sophistication: 10 (5.3)
- Innovation: 6 (5.5)

Source: Global Competitiveness Report 2012-2013, World Economic Forum, Switzerland
Most problematic factors for doing business

Source: Global Competitiveness Report 2012-2013, World Economic Forum, Switzerland

- Inefficient government bureaucracy: 15.0
- Tax rates: 14.1
- Tax regulations: 10.8
- Access to financing: 9.5
- Restrictive labor regulations: 7.1
- Inflation: 7.1
- Inadequately educated workforce: 6.8
- Policy instability: 6.5
- Poor work ethic in national labor force: 4.3
- Inadequate supply of infrastructure: 3.1
- Foreign currency regulations: 2.7
- Government instability/coups: 2.5
- Corruption: 2.2
- Crime and theft: 1.1
- Poor public health: 1.0

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The leasing industry in the US

The equipment finance and leasing industry in the US is represented by the Equipment Leasing and Finance Association (ELFA), which was founded as the Association of Equipment Lessors in 1961. Currently, ELFA represents around 580 company members, including affiliates, and membership continues to grow.

Annual investment in capital goods and software (excluding real estate, which is not covered in this survey) by American businesses and government agencies totals more than $1.2 trillion. Of this, more than half, or an estimated $628bn in 2011, is financed through loans, leases and other financial instruments, which equates to around 4% of US GDP, according to IMF estimates.

ELFA publishes an annual Survey of Equipment Finance Activity (SEFA) based on submissions by reporting members. The 2012 SEFA Report on business volumes in 2011 is the basis for the data in the next section. More details of the report are at http://www.elfaonline.org/SEFA

Annual new business

The survey shows that in 2011 new business volume (NBV) grew by 16.5%, to $94.9bn.

Of this, banks took just over half ($47.9bn), captive companies took 31% ($29.6bn), and independent lessors took 18% ($17.4bn). The greatest rate of increase was for independents (+19.7%), closely followed by banks (+19.3%) and with captives some way behind (+10.5%).

This was the second consecutive annual rise in NBV, showing a welcome acceleration over the increase of 3.9% in 2010, which had followed a severe decline of over 30% in 2009.
In terms of growth by size of organization, there was growth in all market segments during 2011, except for the smallest. Organizations with over $1bn in NBV grew by 15.4%, taking $79.4bn of the total; those with NBV of $250m to $1bn rose 27.7% to $9.5bn; those with NBV of $50-250m rose 32.4% to $5.6bn; but the smallest segment (less than $50m NBV) fell 58.6% to $0.4bn.

Similarly, looking at growth by market segment, all segments showed growth in NBV apart from the smallest. NBV grew 10.2% to $14.2bn in the large ticket segment; 21.8% to $49.5bn in the middle ticket segment; 15.2% to $26.7bn in the small ticket segment; but fell 4.8% to $4.5bn in the micro segment.
In all, 75.7% of respondents to the survey saw NBV increase in 2011, compared to 28.3% in 2010.

New business volume by origination channel ($ bn)

In terms of asset type, the equipment types with the greatest growth in NBV were: construction; trucks & trailers; and computer equipment. End-user industries with the greatest growth in NBV were: industrial & manufacturing (metal & machine); wholesale/retail; and finance, insurance and real estate.

Looking at volumes by origination channel, the direct channel was the largest originator of NBV in 2011, rising 19.8% to $31.2bn and overtaking captive programs, which rose by only 10.4% to $30.0bn. The other channels also showed higher rates of growth than captives, with vendor programs rising 21.9% to $22.3bn, and third parties rising 16.8% to $11.4bn.
For the industry as a whole, assets under management remained at a similar level to the previous year, increasing by just 0.6% to $233.2bn.

Although the return on average equity fell in 2011 compared to 2010, it remained at a healthy 15.5%.
Recent new business

ELFA’s Monthly Leasing and Finance Index (MLFI-25) shows that new business volume in 2012 has fluctuated, although, as can be seen in the chart below, the trend is an upward one. A year-on-year comparison shows NBV for the first eight months of 2012 up by 15.5% on the same period in 2011.

MLFI-25 new business volume (year-on-year comparison)

However, the Equipment Leasing & Finance Foundation’s latest Q4 Outlook, released in October 2012, forecast growth in equipment and software investment for 2012 at a rate of 6.7%, down from the 2011 growth rate of 11.0%.

Its revised projection for investment in 2013 is for growth of 4.5%, down from the original forecast of 8%. On a slightly more optimistic note, the report stated: “Although growth in equipment and software investment slowed to an annualized rate of 4.8% in the second quarter from 5.4% in Q1, it continues to be a driver of growth in an otherwise subdued economy.”
Insiders’ views of the industry

Asset Financial International spoke to a number of senior executives in the equipment finance and leasing industry in the US to get their opinions on the current state of the market, and the opportunities and challenges they see it facing in the coming months.

The effect of the current economic situation on the market

The most immediate concerns expressed across the board were that the economy was in danger of slowing further due to continuing fluctuations globally, in particular in the Eurozone, coupled with political and legislative uncertainty - all of which would have an inevitable effect on the leasing industry.

David Merrill, president of Fifth Third Equipment Finance Company, began by stressing the economic uncertainty: “I see continued hesitation in making commitments to purchase equipment until there is clarity in the economic picture both here and abroad. The market would like to see definitive movement from policy makers on what they will do to fix the ailing economy. I predict a slowdown in activity for 2013.

“Having said that, there is still a moderate amount of activity in the marketplace. The competition is fierce, which will lead to margin compression and weaker structures. Portfolio quality will remain strong unless we see further deterioration in the economy.”

This point was also made by Adam Warner, president of Key Equipment Finance: “From a liquidity perspective, US asset finance companies are in very good shape. The challenge many lenders face today is a lack of demand due to the economic uncertainty.

“In general, businesses felt more optimistic about growth a year ago than they do today. This has already started to result in lower confidence of purchasing managers, who will ultimately begin delaying equipment purchases without stronger signs from the global economy.”

Small business sector

The point of view of small and medium-sized enterprises (SMEs) was made by Chris Enbom, CEO of Allegiant Partners: “Our customers are primarily small companies in the US, and with them demand for commercial equipment seems to rise and fall based on the Wall Street Journal headlines. I think these companies are waiting for a clear indication that there will be growth in the US economy over the next few years, and then they will start expanding again.

“This being said, many small companies have actually paid down considerable amounts of debt and have survived the recession in pretty good shape. When a real rebound occurs, I think it will be pretty dramatic. Once the US Presidential election is done and the US budget is figured out we will also see an uptick, assuming the rest of the world continues to hold together.”
Ron Arrington, president of CIT Global Vendor Finance, continued this theme: “One of the challenges in the marketplace is that small and medium-sized businesses in the US continue to be cautious and reluctant to invest capital because of the continued uncertainties around healthcare, taxes and the general economic environment, particularly in this election year.

“That said, CIT recently conducted a study in the US that showed four out of five companies have made at least one capital goods acquisition of significant value in the past year with nearly the same number planning to in the next six to 18 months. As companies have kept equipment longer, the need for maintenance will compel businesses to upgrade their equipment at some point. As confidence increases, releasing pent-up demand for new equipment, companies can benefit from leasing.”

“Interesting dynamics”

Bill Stephenson, chairman of De Lage Landen Vendor Finance division, sees conflicting forces: “The market is exhibiting some really interesting dynamics. On one hand you have the pace of recovery in the US, which until recently was moving in the right direction, albeit at a painfully slow pace. Even the Federal Reserve was motivated enough to announce a third round of quantitative easing in mid-September, and not wait until after the US Presidential elections or early 2013. Their action was truly telling.

He added: “At the end of the day, these actions are meant to apply further pressure on long-term interest rates and push more capital into the market. So on the supply side of our market, I do not believe liquidity will be a limiting factor in the near to medium term.

“On the other hand you have uncertainty, which is becoming more pervasive on all fronts, whether economic, regulatory or political. This uncertainty, and the resultant drop in confidence it drives with US businesses, is starting to rein in the activity levels our industry experienced earlier this year. After enjoying double-digit growth in the first half of 2012, most of the major indices within the US leasing industry started cooling down in July and August. Activity levels are still above what we experienced in the same period last year, but they are slowing and appear positioned to continue slowing in the second half of 2012.”

A final view, emphasizing that gradual improvement can be detected, came from Crit DeMent, chairman and CEO, LEAF Commercial Capital, who sees a situation “filled with opportunities”.

“The key,” he explained, “is in knowing how to find them, and then taking advantage of them. My sense is that many people in our industry — and in many other industries as well — are still somewhat paralyzed by uncertainty. They look at Dodd-Frank, the FASB changes to lease accounting, the economy, the election — the list goes on — and wonder what’s going to happen.

“My feeling is that you need to move beyond that. The economy seems to be inching along, at a slow but steady pace. And regardless of the uncertainty that exists, businesses are still buying equipment. Equipment finance companies need to make sure that we are ready, willing and able to fund those purchases.”
Challenges faced by the market

It is hardly surprising that the interviewees saw the primary constraint as the sustainability of economic recovery and what that entails in terms of liquidity and its effect on demand. The immediate Presidential election and surrounding uncertainty regarding fiscal policy was another front-runner. Chris Enbom put it succinctly: “I think demand for equipment is the primary challenge, and this is dependent on political and economic clarity.”

This point was expanded on by others. Ron Arrington said: “The continued uncertainties and pending policy changes and how they might affect the decisions of small and medium-sized business to make capital purchases are the main challenges. Companies are optimistic and want to grow their businesses and as the economic and political landscape becomes more certain you will see them invest.”

The theme was taken up by Kurt Ruhlin, COO Americas of software solutions and consulting services provider White Clarke Group, who said: “Small and medium-size businesses are trying to adopt strategies to enable them to become more competitive by reducing costs and increasing productivity. They see this can be achieved by acquiring new equipment and restructuring and rationalizing processes, but unlike the large corporations, they need the means to finance this and to have confidence in the markets.”

Stimulating growth

Demand was also picked out by Adam Warner, along with how to stimulate growth: “The two biggest challenges I see are: 1) demand; and 2) interest rates. In regards to demand, equipment loan growth has been significantly outpacing the US GDP growth rate for quite some time. This has been primarily due to pent-up equipment demand during the recession. Without stronger economic indicators, loan and lease growth will start to wane and, at some point, come more in line with real economic growth.

“As for interest rates, the US Federal Reserve has committed to keep interest rates low through 2015. While this could be helpful to stimulate more borrowing, it is difficult for lenders to bake in the premiums needed for more robust returns.”

The need to provide access to the available liquidity and encouraging the market to make use of it is a near-term challenge in Crit DeMent’s eyes: “In the near term, I think that it’s shaking off the veil of uncertainty and moving off the bubble. We need to get our capital in play and finance equipment purchases. I think a lot of businesses in many different industries are still standing on the sideline waiting to see what happens. That could be a long wait. So our short-term challenge is to carry a message to the equipment-buying marketplace that the time to acquire new equipment is right now.”

For the medium term, DeMent singles out the need for firms to keep a competitive edge: “In the medium term, I think that each finance and leasing company needs to focus on remaining competitive. We are no longer a commodity industry. The only way we can remain competitive is to offer value-added services bundled with our basic financing transactions. This can be accomplished by leveraging enabling technologies to achieve a strategic advantage and competitive edge.”
Competition is also viewed as a prime challenge by Bill Stephenson: “Over the near term, increasing liquidity in a slowing market is really going to drive competition for market share. I think we are seeing that already in the US market. In most equipment sectors in which De Lage Landen operates, there has been a downward push on pricing (spreads). At the same time, we are also seeing expansion of credit bandwidth (acceptance rates) with many of our competitors.”

Stephenson sees external economic problems as potentially significant: “Over the medium term, the largest threat to our industry is another significant global or pan-regional financial crisis. Whether the Eurozone, or the slowing of activity levels in China and India, how it will happen is less important than how our industry will deal with it. I take comfort in the fact that experience breeds wisdom.

“At De Lage Landen, after successfully navigating through recent years and emerging even stronger, we are better positioned and prepared to deal with a repeat occurrence of such conditions.”

In addition to the threats of economic and political uncertainty, David Merrill points to changes in accounting practice as posing a challenge: “In the near term, the sluggish economy and uncertainty on how the problem will be solved will remain the largest challenges for the industry. With the upcoming election, business owners are growing increasingly concerned about the impact of changes to our current tax policy and fear that we could enter into another recession in the US. The upcoming changes in lease accounting are a longer-term issue for the industry and could present significant headwinds as the implementation date draws nearer.”

*An update on the lease accounting issue is provided in a later section of this survey.*
Growth prospects

Asked by Asset Finance International whether they see the leasing market growing over the coming 12 months, the industry experts were positive, but hardly bullish, with the same constraints being cited.

In Chris Enbom’s opinion: “I think a lot depends on the US political situation and the world economy, but my prediction is that Europe will not completely melt down but muddle through austerity, and the US will come to a logical budget/tax outcome, and US growth will be better than expected next year.”

Bill Stephenson viewed it thus: “I believe you will see that the demand cycle for capital equipment will closely parallel the economic circumstances. In other words, generally slowing in the second half of 2012 and continuing into 2013.”

He added: “Of course, that trend will vary between equipment markets. Some of the more resilient sectors will experience muted growth levels, while other sectors may see material drops in order activity and sales revenues. With regard to the vendor finance space, this slowing in business investment will inevitably impact activity levels for many US asset finance and leasing companies.”

He continued: “In the equipment sectors where we continue to see growth, a big part of it has been driven by pent-up demand. During the last economic downturn, many customers elected to defer new equipment acquisitions and held onto existing assets far longer than what was customary. At some point, these assets have to be retired and replaced, regardless of external factors, such as the dour economic conditions.”

Heading in the right direction

Ron Arrington looked at the situation from the point of view of the SME: “The US economy is growing, and we expect it to continue to grow, albeit at a modest pace. We expect the small and medium-sized business segment to begin reinvesting in their businesses once they gain confidence that the economy is heading in the right direction and there is less uncertainty in the market.”

Crit DeMent again emphasized the view that the financial institutions can help provide momentum. On overall market growth, his view was: “Yes, certainly growing. As I said, right now it’s a somewhat slow and tedious process, but things are improving. I also think it’s the role of the equipment financing and leasing industry to help move it along any way that we can.”

DeMent continued, stressing that growth needs supply and demand to sustain it: “There is plenty of capital out there. Large corporations trimmed fat, streamlined operations, made money and stockpiled it, but equipment wears out and must be replaced. Also from a demand standpoint, businesses have streamlined, using and leveraging technology to reduce head count and improve efficiencies. They need to acquire equipment to make that happen. And that’s where we come in. We match the available capital to our customers’ needs. But before we can do that, we must also show our customers what to do and how to do it. That’s where the valued-added piece is the critical missing link.”

The general view of caution was summed up by Adam Warner: “At this point, I believe the US markets will grow over the next year but not at the pace we need for a full recovery.”
Market segment performance

Large businesses will be expected to perform better during difficult times, whereas SMEs, the traditional backbone of the economy, find access to funding that much more of a problem, as witnessed during the current financial crisis.

In the view of De Lage Landen’s Bill Stephenson: “Typically, the larger regional, multi-national and global players have the ability to take a longer-term view on the market, and therefore are more willing to make certain investments today. I would argue some of these firms are even opportunistic, realizing that depressed activity levels have made for a more competitive environment.”

“The truly savvy players,” he added, “are seizing the opportunity to acquire equipment at deeper price discounts and lower borrowing costs.”

“In the small to medium-size business space, many of these firms simply do not have an income statement or balance sheet that allows them to take a longer-term view on the market. These companies are forced to scale back expansion plans and defer most investments, whether in new hires or new equipment. Until we can get some of the uncertainty out of the market, I think it will be difficult to motivate these customers.”

Prepared to invest

Fifth Third’s David Merrill stated: “We operate primarily in the mid-cap to large-cap marketplace where companies are well capitalized and have significant levels of cash on the balance sheet. They are prepared to invest in equipment purchases but are hesitant because of the sluggish economy and fears that the demand will decline.

“Demand in the small to medium-size business appears to be soft and will not pick up until key indicators like employment and housing show sustained improvement.”

However, Crit DeMent at LEAF sees a wider demand for funding: “I believe that there is demand in both segments. You just need to be able to find it and capitalize on it. In the larger companies, CFOs seem to think that capital will be tight for the next several years. So for any finance company with money to lend, that’s a misconception that needs to be addressed. The medium and smaller-sized segment knows that costs must be contained and that processes must be streamlined. The segment is a little less clear on how to do this. I think that by offering this segment integrated financing for bundled solutions, we can help them get over this hurdle.”

CIT’s Ron Arrington continued the point he made earlier that there was demand from the SME segment, as his own company research had found: “In our survey many middle market executives indicated they are in the market for business equipment. And while some companies are waiting on the sidelines, many are already making such acquisitions. More than a third of those surveyed reported that the business need was simply too strong to delay equipment purchases.

“Others said customer demand made such investments mandatory, or pointed to emerging opportunities that required new equipment. And while many companies remain focused on cutting costs, some are getting leaner by buying new capital assets that deliver efficiency gains, which goes a long way to explaining why almost half of new equipment purchased in the last year was IT infrastructure.”
Sector prospects

Not all of the interviewees expressed opinions on segment performance, seeing sectors as more important, particularly considering their own company’s specialist areas. This angle was taken by Chris Enbom of Allegiant: “I think it really depends on the niche of the company. For example, we finance trucking companies that service people who order goods online, and that market is growing, while the overnight express letter market is shrinking due both to the economy and technological change. Each individual niche has its own dynamics, and some are based on the economy but much is based on the technological revolution we are experiencing.”

Key’s Adam Warner concurred: “I think market performance is varied more by industry type than business size. The technology sector continues to report healthy numbers as companies invest for future efficiency. I believe residential construction, real estate and other corollary industries will continue to have an uphill climb due to the abundance of available housing.”

Technology is a sector that is attracting much attention. Following on from his previous comment, Ron Arrington noted: “All sectors have their challenges and opportunities. That said, we are seeing more activity in the IT, office equipment and telecommunications markets, i.e. essential-use equipment for businesses that helps increase productivity, which businesses are looking to optimize.”

White Clarke Group’s Kurt Ruhlin added: “Advances in software mean that technology is a sector that will continue to expand and require investment. Companies across all sectors need to keep up with developments in technology as this will help them capitalize on market opportunities to add value to existing relationships and create new partnerships.”

Renewable energy

One sector that often produces an ambivalent reaction is renewable energy, but for Bill Stephenson cleantech is a growth sector: “There are still opportunities for growth. For example, a few years ago, De Lage Landen started a group dedicated to the clean technology market, which specialized in financing renewable energy solutions, such as solar or wind, and energy-efficient technology, such as LED lighting.

“In a few short years,” he explained, “we have financed more than 250 solar projects in the US market alone. This is real win-win stuff. Net new business for our company also supplements our efforts to create a more sustainable environment for future generations.”
Crit DeMent sees changes to the sectors themselves, often brought about by new technology: “Service sectors are strong but are undergoing a transformation in how they acquire products and services; they don’t care about the equipment, they care about what it does. As different technologies converge, a whole new business model is emerging. Managed services combine traditional document processing and management with communications, data storage and even building security to create a whole new area of opportunity. The ability to fund this kind of multi-faceted, multi-vendor solution is critical.

“In terms of future prospects, we’re looking closely at healthcare. In my opinion, the uncertainty in healthcare related to PPACA [The Patient Protection and Affordable Care Act, popularly known as Obamacare] translates to outstanding opportunity. Whether PPACA remains in effect or gets repealed doesn’t matter. The fact remains that there is tremendous pressure – in both the government and society – to offer more comprehensive healthcare services to more people for less money.

“The only way to do that,” he stressed, “will be to rely heavily on new technologies and related equipment. Someone will need to finance the healthcare industry as it reconfigures itself.”

There is still, of course, strength in more traditional sectors, and prospects in rail and transportation were pointed out by David Merrill: “We see continued strength in certain markets like rail and trucking. The demand in these markets is likely to remain steady, but I do not predict robust growth. Other markets like healthcare and construction have been good but seem to be slowing somewhat now. In the current market, you need to survey the landscape and determine your portfolio strategy from there. For example, the coal industry is extremely soft while natural gas is strong. If you are a rail car lessor, you should adjust your strategy and asset valuations accordingly.”
Lease accounting: “Don’t hold your breath”

The current situation regarding the ongoing deliberations as to implementing changes to lease accounting is covered in the later section of this survey, but there was certainly plenty of comment on the subject from the interviewees. Most of the opinions were that it’s been going on for long enough and it’s time something decisive was done. The question was, whether the protracted process was causing uncertainty?

For Bill Stephenson, the answer was: “Absolutely, but at the same time I would caution you not to hold your breath waiting for resolution! There has been an extensive amount of time, energy and talk invested into what these changes will mean to our industry as a whole, and yet there is still little clarity on what will be delivered.

“My understanding is a new exposure draft may not be put on the table until 2013 and, assuming you can get alignment between the IASB and FASB, the effective date for these changes would not be until 2017 or 2018. That is a lifetime in our business, literally. In most of the markets we operate, the average term of an equipment lease is 48 to 60 months.”

David Merrill saw no real cause for concern: “The pending accounting changes have been on the horizon for years now. They have not had a material impact on the industry but may begin to cause concern when the regulations become final and CFOs can assess the impact on their businesses. The regulations will not become effective until 2016 or 2017, so our industry will have plenty of time to react and create solutions for our clients. The leases will end up on the balance sheet and that may change the structure that a client selects, but it will not eliminate the need for financing of capital goods.”

Ron Arrington was also inclined to take a longer view: “Since the impending changes are still to be defined, and it’s been a lengthy process with questions still outstanding and comment period occurring, I think most companies are taking a ‘wait and see’ attitude. Many companies are following the developments, but are not yet making changes. I don’t think on its own it’s causing undue uncertainty, but it is consistently mentioned as contributing to the overall uncertainty in the markets. I expect there will continue to be dialogue, but believe the content of that dialogue will be more defined once we see the proposal.”

The off balance sheet aspect of the proposal was pointed to by Chris Enbom as a reason for it being less of an issue for smaller companies “which use leasing as a way to improve cash flow as opposed to an off balance sheet accounting tool.”
A negative impact

Adam Warner, however, saw some problem areas: “Lease accounting changes will clearly have a negative impact on the US leasing market as some of the financial incentives to lease have been removed. The ELFA has done extensive work on this subject and I would refer [your readers] to their recent study on the impact of the accounting changes.”

For Crit DeMent, where there is challenge there is opportunity: “Of course there is uncertainty, but that also means there is opportunity. As the FASB and IASB deliberate on the proposed changes, everyone is wondering not only about the final outcome, but when it will become effective. Clearly, some of the changes that have been discussed will have a direct impact on how leases affect the balance sheet and tax return.

“So the first opportunity I see here is in helping customers to understand these changes and to provide assistance in planning accordingly. You can’t predict the future, so the only option is to continue doing business as usual, and when the rules change, adapt to them. Since leasing and finance companies already have internal resources that are following these developments — or should have, anyway — transferring this knowledge to customers should be fairly easy. The value, of course, is in building and strengthening the customer relationship.”

He added: “But you also have to acknowledge that there are more benefits to leasing equipment — especially if it’s a lease for a bundled, multi-faceted solution — that extend beyond tax and balance sheet issues. Technology refresh, cost per unit billing, and master lease programs are all significant benefits of leasing that will continue regardless of what the FASB does.”
Developing the industry

There were varied opinions on the way the industry is moving, where it is evolving and innovating, and where it should be looking to develop.

As Crit DeMent perceptively commented: “Leasing and finance is no longer a commodity. It used to simply be a matter of providing the lowest rate and the quickest turnaround. But that’s no longer the case. Customers demand impeccable service and value-added offerings to keep them in the fold. Today, it’s clearly a matter of building long-term, lasting relationships instead of simply closing a transaction.”

He continued: “Many of us in this industry have been around since the early days of leasing. We’ve seen how external forces change our industry internally. The truth is that we’ve been successfully innovating for decades, and must continue to do so. Today I think the focus needs to be on relationship building, and in leveraging technology to create end-to-end, lifecycle products, instead of trying to offer the least expensive lease transaction available.”

Cloud computing

Bill Stephenson stated the position from De Lage Landen’s point of view: “In many markets, we continue to see an emerging trend toward usage of an asset over outright ownership. This trend will absolutely drive innovation and influence some of the financial instruments and products that De Lage Landen will bring (or has already brought) to the market - whether the focus is on cloud computing and the need for software as a service (SaaS) or managed services financing in the IT market, utility-based ‘cost per print...test...hour’ products in the office equipment, healthcare and construction industries respectively, or innovative mobility solutions for the automotive leasing sector.”

The evolution of cloud computing was also referred to by Ron Arrington: “The structure of leases will become more complex as managed services structures, the cloud and variable billing continue to evolve. CIT has experience in these areas and we will continue to expand these offerings to meet the needs of our customers.”

Likely industry consolidation

In the aftermath of the Great Recession, there has already been consolidation in the banking market. This has naturally had an effect on bank subsidiaries, but a decline in numbers often means companies with stronger fundamentals.

With the gradual economic recovery underway, Asset Finance International asked whether consolidation could go further among financial institutions.
Both Adam Warner and Chris Enbom see further consolidation in the banking sector. For Warner, “some of this will be driven by smaller and mid-size banks grappling with the cost and resources needed to manage regulatory compliance. Much of the consolidation will happen outside of the major money-center banks that are of significant size and scale already.”

Enbom sees much the same: “There are very few independent finance companies in the US, so most of the consolidation would come with banks consolidating. I think we will see smaller/medium-sized banks consolidate, but not large banks which are already bumping up against deposit limits.”

David Merrill was not of the opinion that much would happen in the near future: “In the past few months, we have seen the first few acquisitions to happen after an extended period of inactivity. This could be the beginning of a new trend, but I doubt we will see much activity until we have demonstrable growth in GDP. Businesses tend to downsize and cut costs during slow economic cycles. A large number of companies have the capital to make a purchase, but I do not think we will see them make deals until the traditional returns come back into the M&A market.”

A period of stability

Bill Stephenson foresees a period of stability, at least for financial institutions: “I don’t think we are going to see much more consolidation within the US asset finance and leasing industry. The top-tier players will continue focus on organic growth and increasing market share. From time to time, we will see the introduction and emergence of a boutique firm, possibly bringing certain expertise or innovation to a specific equipment market, but generally I think the US market is fairly settled.”

He continued: “Now, on the equipment side, that is another story. In some equipment markets, I think we have only scratched the surface on consolidation, as certain manufacturers will seek increased efficiencies and market-share via mergers and acquisitions. Of course, if you are a major player in vendor finance, this certainly could have repercussions to your business model. We will continue to monitor these trends closely.”

There is always an opportunity, as far as Crit DeMent is concerned: “Yes, consolidation is a way of life in just about any industry. That’s the way the world works. But one thing that many people – both inside and outside the leasing and finance industry – do not realize is that there is plenty of room for entrepreneurs in this business.

“No, not everyone can start a leasing and finance company,” he stressed. “However, with industry experience, the right contacts and a solid track record of success, you can gain access to capital. With an entrepreneurial spirit of innovation and continuous improvement, the right person can start a new leasing company and build it up. So despite consolidation, there will always be smaller, more agile and very flexible companies to fill in the gaps.”
Expansion – internal or cross-border

The final question for the industry experts to consider was whether future growth for asset finance providers and lessors was likely to be within the US or internationally. The general view was that, if the firm is international, or part of an international group, then growth will tend to be in that direction.

There were, however, caveats. Adam Warner believes: “most US lessors will look for the most growth domestically. This is driven by many banks adopting a relationship-based strategy where they can bring more bank products and services to their clients. That can be a challenge for many US banks that do not offer those products internationally. I believe that is also why we have seen fewer European banks investing in US equipment leasing. As they recapitalize, they are looking for more strategic relationship-based capital deployment.”

Ron Arrington’s view is that “there is opportunity in all the geographies in which we do business, some driven by economic growth, others by the evolving equipment leasing markets. The benefits of equipment lending and leasing transcend borders and are a key focus for international manufacturers. As a global player, CIT stands to benefit from both.”

For Crit DeMent, the answer to internal or cross-border expansion is: “Both. We now live and work in a global community with a closely integrated economy. So yes, there is significant growth potential overseas. But I also think that there is plenty of opportunity in the US and probably right in your back yard. Ultimately, I feel strongly that opportunity exists wherever you seek it. The determining factor is how a particular lease and finance company is set up, and whether the internal technology infrastructure facilitates the administration of international transactions.”

And equally, for Bill Stephenson: “To be honest, the answer is both. De Lage Landen recently announced H1 2012 results, which were quite positive. We saw strong growth in portfolio, new business volumes and net income. At the time, our CEO commented that the growth of the global portfolio was primarily due to the performance of our vendor finance business and further, it was diversified across our entire global footprint, with virtually half of our business activity conducted in the Americas and Asia and the other half within Europe (including Central/Eastern Europe and Russia).”

However, with all the market uncertainty, perhaps Chris Enbom wasn’t being totally light-hearted in his response to where the market might expand: “I am trying to figure that out myself!”
Floorplan financing once again on the move

Ken Adams examines a crucial source of funding

The recent recession saw a sustained period of uncertainty and the decline in the availability of funds for the US floorplan industry.

Today, capital is again flowing and the industry is growing. Floorplan, or wholesale, lending is a form of inventory financing in which each loan advance is made against a specific piece of collateral in a retail dealer’s inventory. As each piece of collateral is sold by the dealer, the loan advance against that piece of collateral is repaid.

Items commonly subject to floorplan debt are automobiles, large home appliances, furniture, television and stereo equipment, boats, recreational vehicles, power sports, manufactured housing, and other types of merchandise usually sold under a sales finance contract. Floorplan lending is a key component in the supply chain for goods as without it, dealers typically cannot afford to purchase inventory.

There are three sources available for floorplan loans – manufacturers’ finance companies, referred to as ‘captives’ (e.g. Ford Credit), banks and independent finance companies. The chart provides an overview of the automotive floorplan market and the dominant providers.

Floorplan Market Outstandings

Source: 2010 JDPower Dealer Satisfaction Survey
During the financial crisis, several captives, banks and independent finance organizations cut back, sold or closed, leading to a liquidity crisis for the affected dealers. The US Small Business Administration (SBA) stepped in to offer loan guaranties with a new pilot program that has been recently extended to Sept 30, 2013. Due to the complexities of the program, the take-up rate has been lower than expected, but still has had a positive impact for participating lenders and dealers.

So far this year, several important new entrants to the floorplan loan market have emerged. In February, Volvo Cars announced the establishment of Volvo Car Financial Services which will offer a co-branded floorplan program with Bank of America. General Motors (GM) created GM Financial after purchasing sub-prime lender AmeriCredit Corp. in 2010 and began offering floorplan loans in April. This was in addition to its new deal in March with Wells Fargo to offer floorplan (and retail) loans to its dealers in the western states.

In part due to the new SBA guaranty, banks, too, are once again eager to offer floorplan loans. In addition to the large national banks, local and regional banks are now offering competitive new programs designed to attract dealers from a variety of industries. Also, credit unions are increasingly becoming a source for dealers for some floorplan lines.

On the independent front, Manheim Financial Services completed the acquisition of Dealer Services Corporation in March reinforcing its commitment to provide inventory financing to independent auto dealers.

On the non-auto side, the market leader is GE Capital which lends approximately $33bn annually in 17 industries. New to this market as of this spring is Northpoint Commercial Finance. This organization brings together experienced floorplan professionals with financial backing from Perella Weinberg Partners’ Asset Based Value strategy and Goldman Sachs Bank USA to provide much needed inventory finance lending for manufacturers, distributors and dealers.

According to a recent article in Reuters, the structured-finance market has enjoyed significant growth in the US, which is providing the necessary capital for lenders through the securitization of assets. Securitization analysts say there is a chance the US asset-based securities (ABS) issuance may surpass $200bn this year – the highest volume since the onset of the financial crisis. Year-to-date volume stands at more than $137bn. Total 2011 ABS volume was about $128bn, versus $135bn in 2010.

This presages growth for the floorplan industry and the potential for future new entrants as growing liquidity will provide the necessary capital for lenders to once again finance inventory for dealers across the US.

Ken Adams is vice president, Business Development – Americas, of the White Clarke Group.
The US view of the Lease Accounting Standards Project

*Bill Bosco outlines the ELFA’s position*

The Equipment Leasing and Finance Association (ELFA) has supported the primary objective of the IASB/FASB Leases Project – capitalizing operating lease obligations.

One of the reasons for this support is the position taken by the Securities and Exchange Commission (SEC) in its 2005 report on off-balance sheet arrangements, citing operating leases as a major off-balance sheet transaction that analysts routinely capitalize to adjust their financial measures and ratios.

We also realize that, in a going concern, the ‘hell-or-high water’ provision in lease contracts indicates a firm obligation on the part of the lessee.

On the other hand, we also know that the US tax and legal systems recognize leases as either financings or executory contracts; therefore, the tax and bankruptcy laws do not treat leases as assets and obligations (debt).

Current US GAAP (generally accepted accounting principles) for leases (classified as either a financing or a lease based on risks and rewards criteria and straight line P&L cost for operating leases) is in line with US tax and legal regimes. As such, tax deductions generally match accounting expense requiring no deferred tax accounting, the balance sheet does not reflect an asset for personal property tax or income tax compliance purposes, and the balance sheet does not reflect an asset or a liability (debt) for bankruptcy analysis.

Combining the SEC’s and analysts’ desire to put leases on balance sheet and the practical economic, tax and legal aspects of doing so, the ELFA’s position has always been to support the capitalization of operating leases as separately reported and clearly labelled assets and liabilities (not debt), while maintaining other aspects of current GAAP that are ingrained in the tax, legal and business systems in the US. This is what analysts and lessees need to manage compliance with tax laws and provide users of financial statements with useful information.

**Changing the classification tests**

Instead, the IASB and FASB have decided to change the lease classification tests for equipment leases to an approach in which the lessee’s P&L would receive straight-line treatment only in cases in which the lease term and present value of rents are insignificant compared to the useful life and fair value of the leased equipment, respectively.

Virtually all equipment leases will have front-ended costs for lessees and receivables and residuals with finance income for lessors. Virtually all leases will be accounted for under a method contrary to the current legal and tax view of the contract. Lessees no will longer report capital lease assets and liabilities separately from capitalized operating lease assets and liabilities.

Lessee accounting will be unduly complex, especially when considering the huge volume of small ticket leases that are transacted and the fact that the major users of equipment leases are small and medium sized companies with limited IT and relatively unsophisticated accounting staff.

Lessor accounting will also ignore tax benefits, eliminate leveraged lease accounting and limit up-front gross profit recognition even where residuals are fully guaranteed – all permitted today under current GAAP.

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Shortcomings in the proposals

The ELFA’s view is that the proposed new rules, which, in all likelihood, will be included in the new exposure draft expected to be issued in the first quarter of 2013, are not an improvement over current GAAP.

Users, in particular credit analysts and potential lenders, will not have to, or be able to, develop critical information that is currently available for lessee financial statements. Lessee preparers will still have to maintain records under current GAAP for tax compliance and to give potential lenders information as to which assets will survive and which liabilities will be considered debt in a bankruptcy.

Lessee preparers will have to make deferred tax adjustments as reported costs exceed tax deductions throughout the life of the lease. This creates a permanent deferred tax asset and permanent ‘paper’ loss of equity for any user that continues to lease new assets. For growing companies, the front-ended lease cost pattern creates a drag on financial results. Lease contracts will appear to be ‘under water’ as the lease asset amortizes more quickly than the liability, despite the Boards’ stated objective of accounting for the lease contract as a unit and the Boards’ overall financial reporting objective of getting the values ‘right’ for all assets and liabilities.

Under the proposed new rules, any lease that terminates early will result in a gain, which is a sure indicator that the balance sheet values are incorrect. Lessees will have to perform complex calculations to record and adjust individual leases if assumptions change.

Lessor accounting would also take a step backwards in sophistication. The lessor revenue recognition in a lease will eliminate the recognition of tax credits as a constant yield revenue item; instead, tax credits will be reported as a reduction of tax expense, either up front or straight lined.

Distorted revenue pattern

As a result, leases will have a distorted revenue pattern that does not reflect the economics of the transaction. Leveraged lease accounting, which many observers think most closely reflects the economics of a tax lease, would be eliminated under the proposed new rules. Profit recognition in sales-type leases would be deferred despite the presence of a residual guarantee or insurance.

These proposed changes in lessor accounting will result in higher lease rates charged to lessees to compensate for the irrational impact to reported lessor earnings. Lessors who are in the full-service, medium-term, operating lease business will have to report finance earnings rather than rent income, which will obscure financial results for users of their financials.

The ELFA cannot support these decisions, which only serve to obscure the true economic effects for lessees and lessors. We think a cost-benefit analysis of the proposed new rules will show inordinately high costs for lessee preparers and no benefits for lessees and lessors; in fact, there will be less transparency compared to current GAAP.

Throughout the project, now in its sixth year, the association has provided the Boards with constructive feedback and reasonable alternatives to some of the decisions they have made on both lessee and lessor accounting. And we continue to do so. The Boards should provide users with an accurate capitalized value of lessee operating lease obligations, be it on balance sheet or in financial statement disclosures, while keeping the rest of current GAAP intact.
US tax and regulatory environment for leasing
Melanie Gnazzo provides an update on the current situation

Tax overview

The equipment leasing industry in the US benefits from various tax incentives designed to spur investment in new equipment, some of which were enhanced as part of the overall economic stimulus programs adopted at the Federal level in response to the financial crises.

Certain of the enhanced tax incentives are set to expire at the end of 2012 and the legislative agenda for 2013 is expected to focus on deficit reduction funded in part with tax reforms. The tax benefits currently available for equipment lessors doing business in the US include the following:

- equipment lessors are generally entitled to deduct the cost of their investment in leased equipment during the first few years after the equipment is placed in service using a modified accelerated cost recovery system (MACRS). Under MACRS, the depreciation deduction for tax is typically computed using a 200% declining balance method and a recovery period of 3, 5 or 7 years, depending on the type of equipment.

However, for equipment leased to governmental or other tax-exempt user, accelerated depreciation is generally not available and tax depreciation is instead computed on a straight line basis over the expected useful life of the equipment;

- in recent years, equipment lessors have also had the option to claim bonus depreciation in the first year that new equipment is placed in service in an amount equal to either 100% of equipment cost (in 2011) or 50% of equipment cost (in 2012). Any bonus depreciation claimed reduces the cost basis in the equipment that is then eligible for depreciation. Bonus depreciation expires as of December 31, 2012 and is not expected to be renewed;

- equipment lessors may also be eligible to claim tax credits for investing in qualifying types of equipment, such as equipment used to generate energy from renewable sources such as wind, solar, biomass, geothermal and solid waste (but not including more common types of equipment such as office equipment or vehicles). The amount of the credit against US Federal income taxes due is a specified percentage of the cost of the qualified energy equipment that varies from 10-30% based on the type of equipment. (Note: There are detailed rules governing which components of a renewable energy generating system qualify for the investment tax credit but generally speaking the credit applies to new equipment that is necessary to generate energy but not to transmit or distribute energy.)

If an investment tax credit is claimed the cost basis in the energy equipment is reduced by 50% of the amount of the tax credit claimed. As an example, in the case of solar generating equipment, if the original cost of the qualified equipment is $100, the investment tax credit would be $30, the depreciable basis would be reduced by $15, and the remaining $85 of original equipment cost would be depreciated over the applicable cost recovery period;
• the investment tax credit is not available for renewable energy equipment that is leased to governmental or other tax-exempt users. However, the energy generated may be sold to governmental and tax-exempt entities under long-term power purchase agreements so long as such agreements meet specified requirements for classification as a service contract (rather than a disguised lease or loan arrangement).

Such long-term power purchase arrangements are often used as a mechanism to provide owners and lessees of renewable energy equipment with a dedicated source of revenue to support investments in such equipment;

• investment tax credits are subject to recapture if the equipment is disposed of in the first five years after it is placed in service. As a result, most transactions do not permit the lessee or energy off-taker to exercise buyout rights until after the recapture period expires. The investment tax credit for renewable energy equipment is a temporary incentive that is scheduled to expire at various dates between December 31, 2012 and December 31, 2016.

In some instances, the investment tax credit is reduced but not entirely eliminated as of such dates (for example, the ITC for solar reduces from 30% to 10% for equipment placed in service after 12/31/16);

• the American Recovery and Reinvestment Act of 2009 also offered equipment lessors and other owners of renewable energy equipment the option to claim a cash grant in lieu of the investment tax credit so long as construction of the equipment or project commenced before the end of 2011. The grant-in-lieu of investment tax credit incentive is all but expired and is not expected to be renewed in the near future.

A basic requirement of US Federal income tax law is that the lessor of equipment must qualify as the tax owner of the equipment in order to claim the various tax incentives described above.

Use of an agreement entitled ‘Lease’ or ‘Equipment Lease’ is not determinative. Rather, various economic and other factors are analyzed to determine tax ownership based on which party holds the primary economic benefits and burdens associated with the equipment. These factors include the term of the lease relative to the useful life of the equipment, the amount financed under the lease relative to the original equipment cost, the impact of various purchase and renewal options on the ability to realize upside potential and/or minimize downside risk, and similar factors.

Vehicle leases benefit from a statutory exception to these general rules that allows the lessor to qualify as tax owner even if the vehicle lease includes a provision obligating the lessee at the end of the lease term to either purchase the vehicle for a price equal to its expected residual value at lease inception, or reimburse the lessor for shortfalls in disposition proceeds as compared to such expected residual value.

Secured indebtedness

Transactions cast in the form of a lease but for which the lessor is not treated as the tax owner of the equipment are most often re-characterized as secured indebtedness. In the case of equipment leased to governmental and tax-exempt lessees, this alternative debt-for-tax characterization is often preferred, especially if the interest being generated would qualify as tax-exempt interest under US Federal income tax rules.
Regulatory overview

Leases of equipment used for commercial purposes and made to commercial entities are generally subject to limited regulation in the US. Such leases typically contain provisions requiring the lessee to bear all costs associated with repair and maintenance of the equipment, compliance with governmental requirements applicable to the manner or place of use for the equipment, and all excise, sales and property taxes applicable to the equipment.

In addition, the lessee typically bears all risk of loss associated with the equipment pursuant to 'hell or high water' provisions that require the lessee to replace damaged equipment or pay a stipulated loss value if the lease is terminated. Absent fraud, such provisions are typically found to be enforceable once the lessee has received and formally accepted the equipment that is the subject of the lease.

An equipment lessor that is leasing equipment for use in the US is typically treated as doing business in the US for tax and other purposes and may be required to register to do business and/or obtain permits at the applicable state level.

Consumer use

Leases of equipment, including vehicles, intended for personal or consumer use are subject to various forms of Federal and state regulation, often in a manner that is the same or similar to that applicable to loans and other credit products extended to consumers. Consumer credit products have been the subject of various reform initiatives at both the US Federal and state level, many of which are not yet fully implemented and that were undertaken in response to perceived abuses contributing to the recent financial crises. Lessor looking to lease equipment used in the US for personal or consumer purposes will need to stay tuned!

Securitization

Various regulatory reforms have also been proposed in connection with securitization of financial assets, including minimum risk retention for sponsors and enhanced loan and lease level data reporting to investors in securitized pools of financial assets. Such securitization reforms are generally expected to apply to securitizations of equipment and vehicle leases and other equipment finance contracts but most such reform proposals have not yet been finalized or become effective.

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