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White Clarke Group Canada Asset and Auto Finance Country Survey

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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:

http://www.whiteclarkegroup.com/downloads/view/global_leasing_report_2012

Acknowledgements

Brendan Gleeson, global sales and marketing director, White Clarke Group; Robin Somerville, director, the Centre for Spatial Economics; David Powell, Canadian Finance & Leasing Association; Nicholas Logan, president of National Leasing Group (Canada Western Bank); Peter Horan, president and CEO of De Lage Landen Financial Services Canada; Moe Danis, vice president of Lease Finance at Pacific & Western Bank of Canada; Jeff Hartley, president of Foss National Leasing (FNL); Jim Case, CEO of Richie Bros. Financial Services; Doug McKenzie, managing director, BAL Global Finance Canada Corporation; Jonathan Dodds, CEO- Americas of White Clarke Group; Loraine D. McIntosh- partner at Deloitte; John J. Tobin tax partner with Torys LLP of Toronto.

http://www.whiteclarkegroup.com/
http://www.assetfinanceinternational.com

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Introduction

This Asset Finance International Country Survey provides a balanced view of the asset finance and leasing market in Canada. It covers the background economic conditions and the specific characteristics of the Canadian leasing industry; the challenges and opportunities; provincial differences; and reviews of accounting practice and tax issues; with comment on the market and its outlook from key industry figures.

Canada has long played a central role on the world economic stage, being one of the founder members of the G7 group of nations. It is the world's second largest country by area and the largest country having a single border with another country. That country is of course the US, and the two are necessarily closely linked, not least economically.

Although Canada could no more avoid the financial crisis of 2008-09 than it could sever links with the US financial markets, Canada's banks emerged from that period relatively strongly, owing to the banking sector's tradition of conservative lending practices and strong capitalization. This was aided by the fact that, prior to the crisis, Canada had already put into place various fiscal austerity measures, the adoption of inflation targets, separation of investment banking from traditional banking activities and the development of a strong regulatory system.

According to Minister of Finance Jim Flaherty: "Canada's economic performance over the recession and recovery has been solid relative to our peer countries. This reflects Canada's sound economic, fiscal and financial sector fundamentals, along with the significant and timely support provided under Canada's Economic Action Plan. As a result, Canada has posted the strongest growth in employment in the G7 during the recovery."

"Looking forward, the International Monetary Fund (IMF) predicts that Canada will be among the fastest growing advanced industrialized economies both this year and next." (Statement Prepared for the IMF International Monetary and Financial Committee – Washington, DC, April 21, 2012.)

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Since that announcement the markets have experienced further turbulence, but recently the Bank of Canada stated that, although the risk of further deterioration in global financial conditions remains, "Canada's financial system continues to be robust despite the challenging global environment. In contrast to the volatility in European credit markets, markets in Canada have been relatively stable, and Canadian banks continue to have good access to wholesale funding markets." (Bank of Canada, Financial System Review – June 2012.)

Business climate

Notwithstanding the continuing fluctuations in the global markets, forecasts place Canada ahead of most established economies. Oil and other natural resources are a major economic driver – Alberta's oil sands mean Canada now has the world's third largest proven oil reserves.

The IMF's most recent outlook stated: "In Canada, the determinants of growth are both external and internal – externally, world commodity prices and demand from the US will influence growth; internally, the planned fiscal tightening and high household debt are constraints. Growth is forecast to moderate from 2.5% in 2011 to 2% in 2012, reflecting retreating commodity prices, ongoing fiscal withdrawal, and slow recovery in the US. As a result, inflation is projected to fall to the midpoint of the target band by 2013." (IMF, World Economic Outlook, April 2012.)

The Organization for Economic Co-operation and Development (OECD) was slightly more optimistic in its recent forecast: "The outlook has been gradually improving, despite the persistent European debt crisis and consequent economic uncertainties. Against this backdrop, the main drivers of growth will continue to be private consumption and investment. External demand is also expected to be increasingly supportive. By contrast, fiscal consolidation will work in the opposite direction. In all, growth is projected to be around 2.25% in 2012 and 2.5% in 2013." (OECD, Canada – Economic forecast summary, May 2012.)

The most recent Grant Thornton International Business Report shows that, in Q1 2012, optimism for the outlook of Canada's economy over the next 12 months stood at 51%, up from 46% in the previous quarter. These figures compare with an average confidence level among G7 countries of 16% for Q1 2012 (Grant Thornton International Business Report 2012).

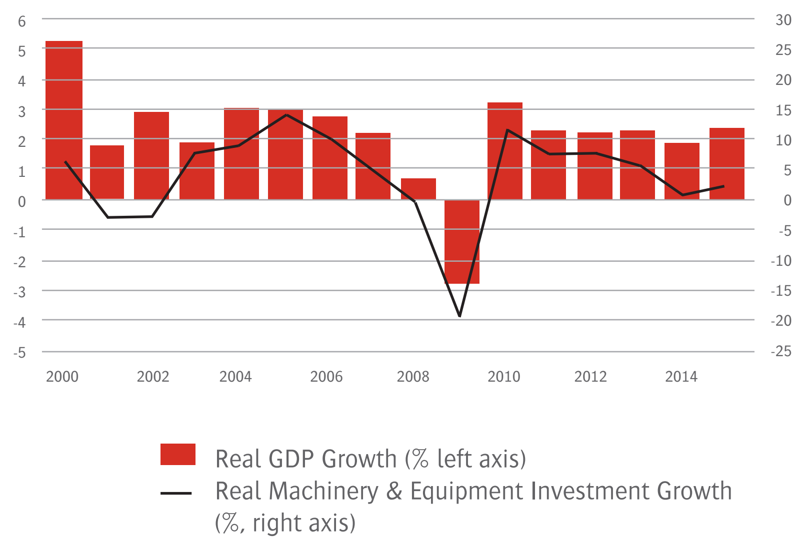
Economic overview

When looking at the Canadian economy, key variables to focus on when discussing prospects for the leasing industry are:

- real gross domestic product (GDP) growth;
- machinery and equipment (M&E) investment (real and nominal);
- interest rates (3-month Treasury Bill and Government of Canada 10-year Bond); and
- exchange rate.

The first chart in this section, as supplied by The Centre for Spatial Economics (C4SE), plots real GDP and M&E investment growth. M&E investment is far more volatile than GDP. GDP growth is expected to be solid, if unspectacular, over the next few years but investment spending is expected to slow by the middle of the decade.

Activity in Canada



Source: C4SE (www.c4se.com)

The second chart (overleaf) plots nominal investment spending growth (excluding government sector) – a primary determinant of leasing sector activity – and the long-term government bond yield. Interest rates will rise again, but it's anyone's guess as to when. Investment spending is expected to be reasonable, at least for 2012 and 2013.

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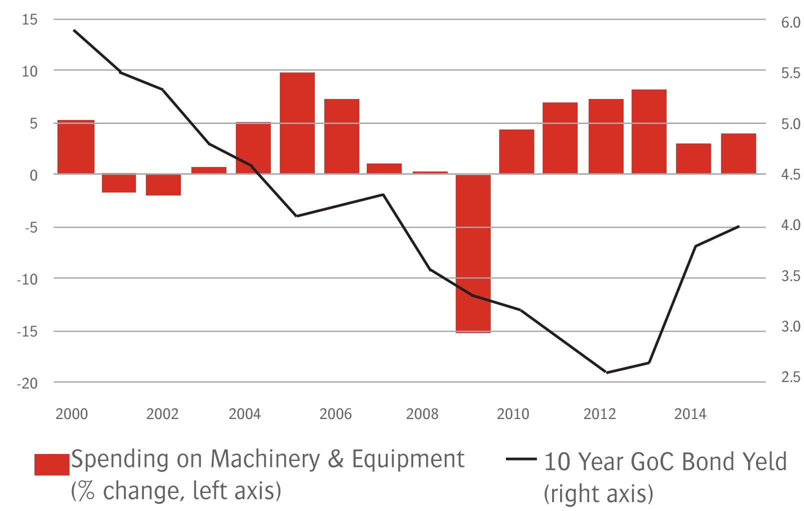
Investment spending and interest rates

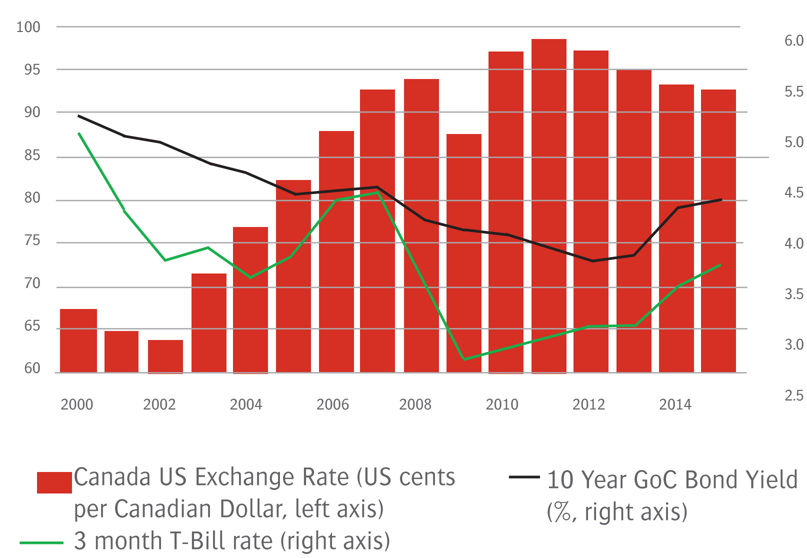


Source: C4SE (www.c4se.com)

The third chart plots the Canada-US exchange rate and interest rates. The exchange rate is expected to remain above purchasing power parity (PPP) levels but trade between US$0.90 and $1.00 over the next few years with, perhaps, brief periods above parity depending on commodity prices. (PPP is a notional measure of the 'fair' value of the currency which is currently estimated to be about US$0.80.)

The yield curve (the difference between the 10-year bond yield and the T-Bill rate) has narrowed, but is a long way from signalling trouble and is expected to stay at this level for the next few years.

Financial markets



Source: C4SE (www.c4se.com)

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The Statistics Canada survey of investment intentions for 2012 indicates that public and private spending on M&E is expected to rise by 2.1% to C$112.4bn. However, the stated intentions of the organizations involved are no more accurate than other forecasts – for 2011 the expected rise was 2.4%, but the actual figure came in at 6.8%.

The main upswing, as shown in the table, is anticipated to come from the mining and oil and gas extraction sector. The mining and oil and gas sector's M&E spending is expected to rebound by 15.5% this year, with utilities up 9.4% and transportation and warehousing (which includes pipelines) up 9.8%. On the weak side is finance and insurance (-13.1%). As can be seen in the table giving investment intentions by Province, the Provinces with oil and natural gas will do well this year: Atlantic Canada, Manitoba/Saskatchewan and Alberta.

Canada: Machinery & Equipment Expenditures by Sector

	Millions of C$		**% Growth**	
	2012F	**2011**	**2012F**	**2011**
Agriculture, forestry, fishing and hunting	3,455	3,471	-0.5%	-7.3%
Mining and oil and gas extraction	10,560	9,146	15.5%	-14.9%
Utilities	7,035	6,429	9.4%	37.1%
Construction	5,288	5,054	4.6%	-2.8%
Manufacturing	15,616	14,755	5.8%	19.0%
Wholesale trade	5,046	4,975	1.4%	22.5%
Retail trade	5,006	4,984	0.4%	5.7%
Transportation and warehousing	10,847	9,879	9.8%	21.4%
Information and cultural industries	6,837	6,759	1.2%	8.5%
Finance and insurance	9,382	10,794	-13.1%	-3.2%
Real estate and rental and leasing	8,932	9,203	-3.0%	-8.0%
Professional, scientific and technical services	3,902	3,899	0.1%	29.1%
Management of companies and enterprises	124	152	-18.5%	20.7%
Administrative and support	2,173	2,349	-7.5%	71.3%
Educational services	2,711	2,672	1.4%	3.5%
Health care and social assistance	3,189	3,387	-5.8%	0.7%
Arts, entertainment and recreation	1,379	1,273	8.3%	48.4%
Accommodation and food services	1,148	1,399	-17.9%	27.1%
Other services (except public administration)	1,531	1,591	-3.8%	6.8%
Public administration	8,261	7,893	4.7%	-1.7%
Total expenditures	**112,418**	**110,063**	**2.1%**	**6.8%**

Source: Statistics Canada - 61-205-X (2012), C4SE

Machinery & Equipment Expenditures by Province

	Millions of C$	**% Growth**		
	2012F	**2011**	**2012F**	**2011**
Canada	112,418	110,063	2.1%	6.8%
Atlantic	6,594	6,267	5.2%	6.7%
Quebec	20,949	20,077	4.3%	6.3%
Ontario	42,503	43,104	-1.4%	12.3%
Manitoba/Saskatchewan	9,569	8,932	7.1%	15.0%
Alberta	19,720	18,930	4.2%	-6.8%
British Columbia	12,444	12,230	1.8%	8.3%

Source: Statistics Canada - 61-205-X (2012), C4SE

Doing business

Canada is one of the better countries in which to conduct business. The World Bank ranked Canada 13th out of 183 countries for overall 'ease of doing business' in its 'Doing Business 2012' survey, a drop of one place from the previous year. In terms of 'ease of getting credit' Canada was ranked 24th, down three places from 2011.

In 'The Global Competitiveness Report 2011-2012' produced by the World Economic Forum (WEF), Canada was ranked 12th – down from 10th the previous year, but with a slight improvement overall in score. As can be seen from the chart, the country benefits from highly efficient markets, with its goods, labour and financial markets ranked 12th, 5th and 13th, respectively.

The WEF singled out a particular area for comment: "Improving the sophistication and innovative potential of the private sector, with greater research and development (R&D) spending and producing goods and services higher on the value chain, would enhance Canada's competitiveness and productive potential going into the future."

As for perceived problems for doing business, the factors most frequently cited in the Global Competitiveness Report are similar to those in most of the mature economies, such as inefficiencies in government bureaucracy, tax rates and tax regulations. At the other end of the scale, it is encouraging to note the lack of concern regarding corruption and crime.

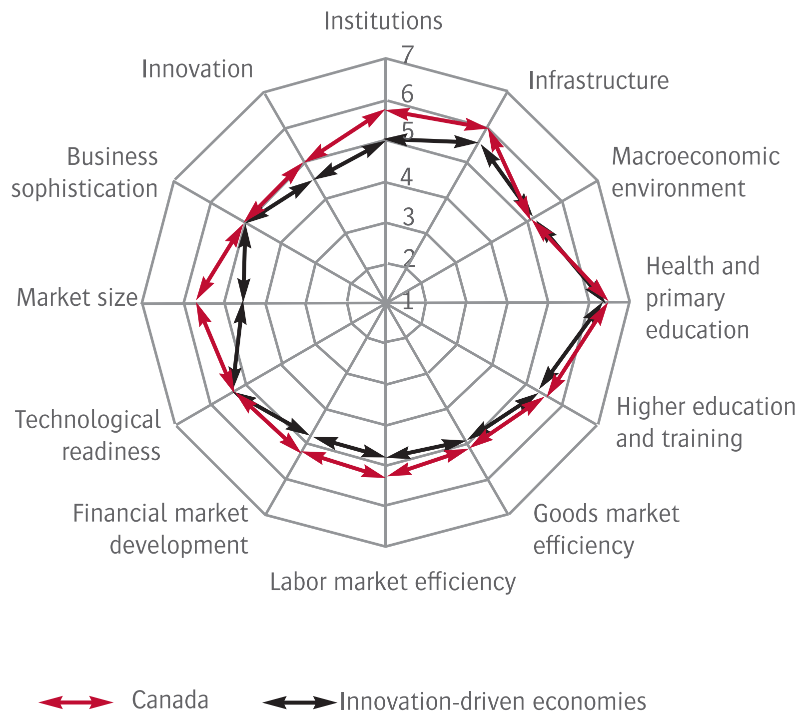
Access to financing is another common complaint and is a key reason for the continued strength of leasing. This runs contra to the view of the robust state of the financial system from the Bank of Canada, which states in its June Financial System Review that "lending conditions for businesses remain favorables. The Bank of Canada's Senior Loan Officer Survey for the first quarter of 2012 showed an easing in both price and non-price lending conditions for all classes of borrowers. Larger firms in Canada also continue to enjoy good market access to credit as corporate bond yields have remained near historic lows."

Global Competitiveness Index

	Rank out of 142	Score (1-7)
GCI 2011-2012	**12**	**5.3**
GCI 2010-2011 (out of 139)	10	5.3
GCI 2009-2010 (out of 133)	9	5.3
Basic requirements (20%)	**13**	**5.8**
Institutions	11	5.6
Infrastructure	11	5.9
Macroeconomic environment	49	5.1
Health and primary education	6	6.6
Efficiency enhancers (50.0%)	**6**	**5.8**
Higher education and training	12	5.6
Goods market efficiency	12	5.1
Labor market efficiency	5	5.4
Financial market development	13	5.2
Technological readiness	16	5.4
Market size	14	5.4
Innovation and sophistication factors (30.0%)	**15**	**5.0**
Business sophistication	24	4.9
Innovation	11	5.1

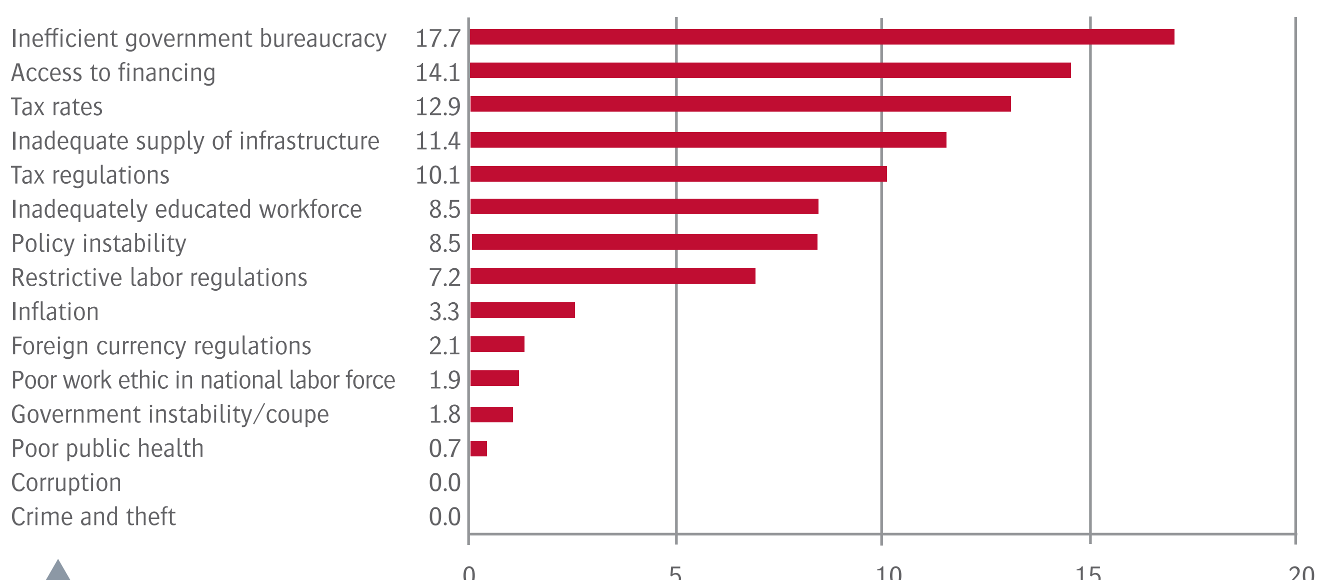
Source: Global Competitiveness Report 2011 - 2012, World Economic Forum, Switzerland

Stage of development



Source: Global Competitiveness Report 2011-2012, World Economic Forum, Switzerland

Most problematic factors for doing business



Source: Global Competitiveness Report 2011-2012, World Economic Forum, Switzerland

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The leasing market in Canada

The asset-based financing and leasing industry is the largest provider of debt financing to business customers and consumers in Canada after the traditional lenders (banks and credit unions).

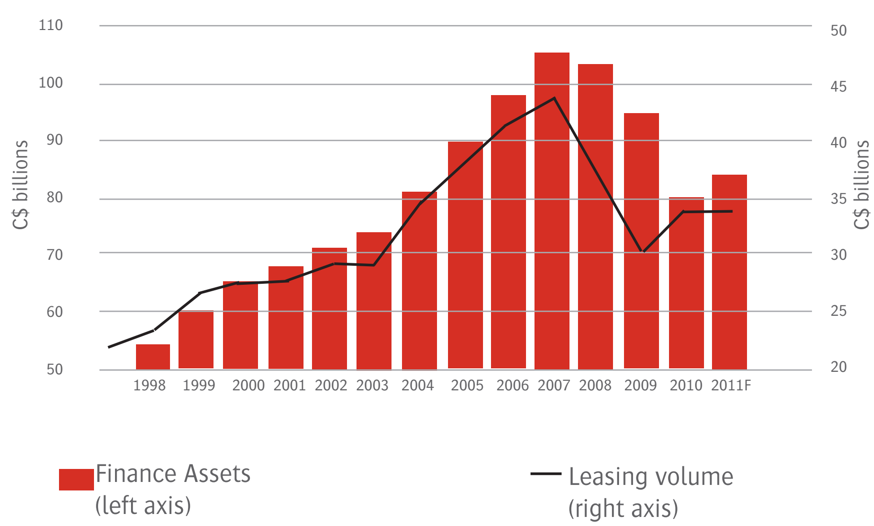
The industry is represented by the Canadian Finance & Leasing Association (CFLA), which is the only organization advocating the interests of the asset-based financing, vehicle and equipment leasing industry in Canada. As at June 30, 2011, CFLA had 198 members.

CFLA publishes an annual survey of the asset-based financing, equipment and vehicle leasing business activity carried on by reporting members. The latest survey, 'Leasing Market 2011', produced by the Centre for Spatial Economics, is the basis for the data in this section.

The leasing market includes machinery and equipment, commercial vehicles and retail (consumer/personal) vehicles. In 2011 the market was estimated to have finance assets (owned and managed) of C$84bn, of which C$39bn comprised equipment and commercial vehicles and C$45bn was made up by retail vehicles. This total shows a 5% increase over the previous year, following consecutive falls since 2007.

Leasing volume (new business) in 2011 was estimated to total C$34bn, split evenly between equipment and commercial vehicles (C$17bn) and retail vehicles (C$17bn), although the former segment figure represents a 5% year-on-year rise, while the latter is a 5% decrease.

Leasing market in Canada



Source: CFLA, C4SE

In the equipment plus commercial vehicle leasing segment, new business volume for 2011 was C$17bn, a year-on-year increase of 5% and continuing an upward trend from the low point of 2009. The leasing market penetration rate was 15%, based on the equipment and commercial vehicle leasing market as a share of public and private spending on machinery and equipment (C$109bn in 2011).

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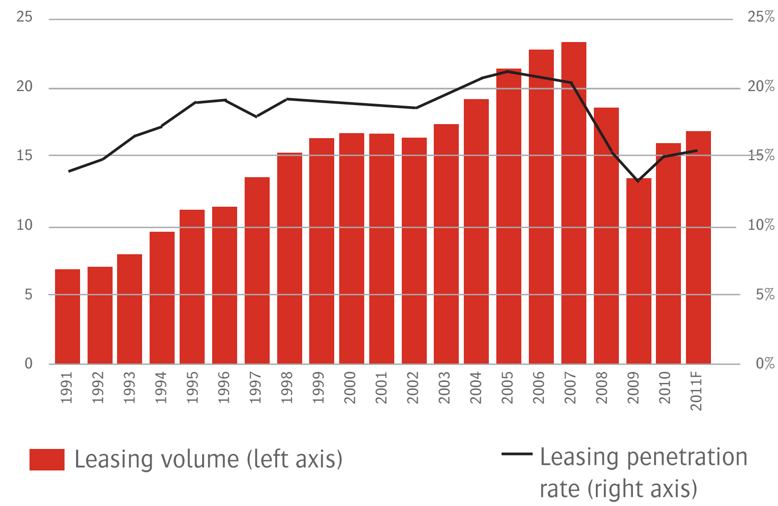
Equipment & Commercial Vehicle Leasing in Canada

Source: CFLA, C4SE



The tables below show new business share by origin and channel for equipment lessors and vehicle lessors. The vehicle lessor data refers to the sum of commercial (fleet) and retail (consumer) vehicle activity.

New business by direct dealing remains pre-eminent for equipment lessors. The Vehicles segment has seen a gradual move away from vendor programmes to captive programmes, although vendor programmes are still dominant.

It should be noted that the asset-based financing industry in Canada includes companies that offer customers loan as well as lease products. The market size figures, therefore, include the value of loans made by these companies. 'Capital leases' is analogous to 'hire purchase' in the UK.

According to Canadian Automotive Fleet magazine's 2012 Fact Book there were 104,316 fleet car registrations and 179,921 fleet light truck registrations in 2011, representing approximately 15% and 19% of new car and truck vehicle sales in Canada, respectively.

Equipment Lessors – New Business

	2011 (F)	2010	2009
New Business by Origination (shares):			
Direct	64%	64%	63%
Vendor Programmes	19%	20%	18%
Captive Programmes	15%	14%	16%
Third Parties	2%	3%	3%
New Business by Channel (shares):			
Total Leasing	39%	37%	43%
Operating Leases	3%	7%	9%
Capital Leases	36%	26%	29%
Loans	61%	63%	57%

Vehicle Lessors – New Business

	2011 (F)	2010	2009
New Business by Origination (shares):			
Direct	14%	13%	13%
Vendor Programmes	42%	45%	48%
Captive Programmes	25%	23%	21%
Third Parties	19%	19%	18%

Source: CFLA, C4SE

The effect of the economic situation on asset finance and leasing

The Canadian economy so far in 2012 has been in a state of slow-to-moderate growth, although the general consensus in the asset finance industry is one of caution. The strong Canadian dollar and low interest rates have provided some stimulus to equipment purchase, but pricing is very competitive, with more dollars chasing fewer deals. Employment rates are improving slightly, and companies are planning to hire.

The economy in Canada has been relatively stable compared to the rest of the world; however, there is concern about the direction it could take, depending on what happens in the eurozone, the US and China in particular.

Asset Finance International spoke to a number of senior executives at the sharp end of the industry, and on this subject the experts were positive. From the banking perspective, Nicholas Logan, president of National Leasing Group (part of the Canadian Western Bank) said simply: "We are having record months and that will continue in Canada."

In the opinion of Peter Horan, president and CEO of De Lage Landen Financial Services Canada: "The Canadian domestic market for equipment financing is prospering in spite of troubled times in other parts of the globe. Many regions in Canada are stable, while certain pockets are experiencing very positive growth. The demand for capital assets is still strong and leasing industry consolidation in recent years has provided opportunity for increased market share for participants who are willing to invest."

Asset finance is of vital importance to the small and medium-sized enterprise (SME) sector, but Canadian SMEs have a traditionally cautious approach to funding. Moe Danis, vice president, Lease Finance, at Pacific & Western Bank of Canada, a financial institution that specializes in SME finance, explained that "the sector translates much of this into a 'wait and see' approach towards decisions involving capital outlay for new equipment. Wait to see if the economy is truly in recovery or still very fragile and subject to the happenings in the US, Europe and Asia. There have been many 'ifs' to consider for the cautious."

"Having said that, we still see 2012 as a growth year. There is considerable pent-up demand after three soft years and with a strong loony [Canadian dollar] and very low interest rates, the table is set for a pick-up in equipment sales. This is positive for leasing companies in general."

In the fleet vehicle market, Jeff Hartley, president, Foss National Leasing (FNL), agreed: "The current economic situation for businesses in Canada causes them to be cautious with their capital spending," but added that "one market that remains positive is the oil patch, particularly businesses that are related to the [Alberta] Tar Sands."

However, Hartley continued: "As I mentioned, the oil industry is the main engine of growth in Canada. The result being that Western Canada is where most of the economic growth is coming from. The increase in demand for oil has caused the Canadian dollar to increase in value, causing the manufacturing sector in Eastern Canada to be hurt as the dollar limits exports."

Another area of interest to the industry concerns asset disposal, including end-of-lease assets, which in turn provides finance for capital expenditure. Ritchie Bros. is the world's largest auctioneer of heavy equipment and trucks, and Jim Case, CEO, Ritchie Bros. Financial Services, stressed the industry's positive outlook: "Capital expenditures effectively drive our market and as the need for capital expenditures increases or decreases so does the need to finance equipment. The recession had a detrimental effect on the equipment industry and therefore was also detrimental for equipment finance businesses. As the economy rebounded after the recession we saw growth in investment in equipment – as the equipment market grows, so do we."

And Brendan Gleeson, global sales and marketing director of software solutions and consulting services provider White Clarke Group, told Asset Finance International: "I see a lot of positive trends at present. The replacement of equipment in North America is proceeding well, although there is still much inventory that needs absorbing into the economy."

"But greater liquidity is apparent, pricing has gone down and leverage reduced. In short, many companies are making more money."

Market challenges

Unsurprisingly, the main challenges in the near and medium term are centered on macroeconomic events and the ongoing global uncertainty. Events in Europe and the continuing lack of resolution to the debt crisis there, falling oil prices coupled with overall reductions in demand for commodities, and concerns about the sustainability of the US recovery and the forthcoming US presidential election are adding to the 'wait and see' attitude for potential asset acquirers and lessees.

Nicholas Logan points out that: "Banks are under pressure to tighten mortgage lending, consumer lending and credit cards. With new capital requirements, fewer banks will focus on commercial lending so costs will go up."

Doug McKenzie, managing director, BAL Global Finance Canada Corporation (a subsidiary of Bank of America), told Asset Finance International: "Funding was an issue from late 2007 to 2009, when securitization conduits dried up. It's better today but still a challenge for the small independents. They will go through an aggregator and then part of a securitization." McKenzie also picked out local Canadian government spending cutbacks as a problem area.

Access to financing is another cause for concern, as emphasized by Jeff Hartley: "The instability in the markets also causes some leasing companies to still have some difficulty sourcing the funding that they need. Others can source the funding but the risk spreads remain quite high."

And there can be a knock-on effect. Peter Horan made the point that there is a booming agricultural market; however, it is suffering from equipment shortages.

Jim Case maintains that low interest rates and reduced demand are the main challenges: "Low interest rates are always challenging. Competing with low bank rates makes it more difficult for equipment leasing and financing businesses to maintain margins – they have to manage a slightly higher risk profile in order to achieve better margins. Currently, with rates at historical lows it is more difficult for us to price that margin into our offerings." He adds that "any lower demand for Canadian resources on a macro level trickles down over a period of time, which results in Canadian businesses not investing in as much new and/or replacement equipment."

However, Case sees the upside: "Some of these challenges are offset by the value of the Canadian dollar against other currencies. In some cases, equipment imported from countries with currencies at par or lower is making investment in more productive plant and equipment more attractive to Canadian buyers."

Moe Danis feels that too much emphasis is placed on the macroeconomic factors, and suggests: "If companies could focus on their immediate surroundings and assess the prospects, the market would likely be far more robust."

Areas for growth

The general consensus is that the equipment leasing and financing market in Canada will grow faster than GDP, which would indicate short-term moderate growth at best as overall growth targets have been reduced. However, as Doug McKenzie of BAL points out, this means “the Canadian economy is still fairly resilient, with regional pockets doing well”, or, as Nicholas Logan of National Leasing puts it: “Canadian business is sound.”

If informed opinion has growth at around 2%, FNL’s Jeff Hartley looks to better things: “I expect the commercial vehicle market to be somewhat stronger than this as there is some pent-up demand in the system.”

Other segments highlighted for above-average performance include agriculture, as mentioned earlier, technology (including financing for cloud computing), construction equipment and most definitely resources, where the strong oil industry means growth for oil and gas servicing companies and miners.

Peter Horan of De Lage Landen sums up: “Traditional segments such as construction, technology, industrial, agriculture and manufacturing are doing well, with particular emphasis on energy. Clean technology and healthcare represent the brightest prospects for the future.”

As previously mentioned, the SME segment has tended towards a cautious approach, meaning that the larger businesses are better positioned for recovery as they have the resources to make the necessary capital investments. Jeff Hartley makes the point that “the medium size companies in Canada have taken the biggest hit as the number of these companies is actually shrinking as they are consumed by the large public companies. The spin-off from this is that there are many small companies trying to start up as people are being displaced from the medium-size firms.”

Pacific & Western’s Moe Danis adds: “Large business appears to be stronger, and positioned for recovery. Balance sheets are, in general, quite strong, with manageable debt levels, and resources are available to take advantage of the low rates and strong Canadian dollar. SMEs just do not have the wherewithal to withstand a misstep.”

Finally, regarding the large business and SME segments, Jim Case of Ritchie Bros. explains: “There are areas within each of those segments that are doing very well, and those that aren’t. Generally, businesses that thrive provide good value and service the needs of their customers – we see these companies often financing equipment for new projects. Businesses that have not adapted to the changing market and did not strengthen over this last downturn are not doing as well – and are not investing.”

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The Canadian difference - comparison with the US

Canada and the US have an interesting relationship with each other – often referred to as “elephant and mouse”. There is probably a lot more in common between the US and Canada than there are differences. Areas of commonality include cultural, social and economic ties that affect every aspect of daily life on both sides of the border.

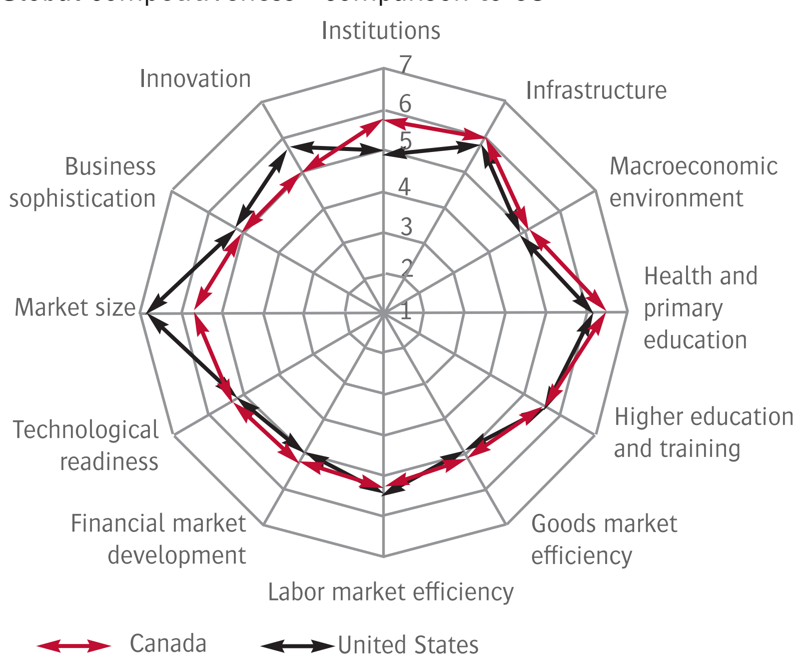
Overlaying the Global Competitive Index (GCI) data for both countries from the WEF Global Competitiveness Report illustrates some of the more important and interesting differences between the two countries. Both countries are among the most developed in the world and have similar GCI scores (5.43 US, 5.33 Canada).

The chart shows that Canada outscores the US in eight of the 12 categories and is tied in one other. In particular, Canada is considered to have stronger institutions, a better macroeconomic environment, better health and primary education, better higher education and training, better financial market development, better infrastructure and better technological readiness. Canada was an early adopter of debit card technology and – although a laggard by European standards – has adopted chip & pin credit/debit card technology which is yet to be seen anywhere in the US.

Canada’s strengths are, however, in the low-weighted ‘Basic Requirements’ category. Canada’s principal weakness, relative to the US, is the size of its market. The sheer size of the US economy confers a huge advantage to US businesses. Business sophistication and innovation are also hallmarks of the US economy, while labour market practices in the US typically make it far easier to hire and fire people than in any other developed economy.

These indices are relevant to the leasing industry: size of market, the macroeconomic environment, financial market development, business sophistication and innovation (and perhaps also technological readiness) are all factors that play a role in the success of the leasing industry. The strength of both countries in these areas goes a long way towards explaining the success of leasing in both economies.

Global competitiveness - comparison to US



Source: Global Competitiveness Report 2011-2012, World Economic Forum, Switzerland

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Market size

The inevitable ties between the Canadian and US markets were commented on by industry experts, but, importantly, most were keen to point to what differentiates the Canadian leasing market from its close neighbor.

The difference in market size was certainly highlighted. Jonathan Dodds, CEO – Americas of White Clarke Group, told Asset Finance International: "The main difference between the Canadian and the US leasing industry has to do with scale. The US market is 10 times the size of Canada's and as a result the US leasing companies tend to be larger and more highly capitalized, giving them access to funding markets and rates that the smaller Canadian leasing companies do not have access to."

Doug McKenzie of BAL points out the demographic difference: "Smaller scale – the Canadian population is 33 million, the US is 330 million."

But McKenzie adds: "Canada puts a great focus on the cost of the financing. In the US they have more of a risk/reward culture and tend more to focus on what incremental money can be made (or saved) if they acquire new equipment."

The size advantage enjoyed by US lessors and the subsequent greater access to financial markets is picked up by Jeff Hartley of FNL, who says: "In particular, access to the commercial paper and securitization markets are somewhat limited to the Canadian companies as they are not large enough to participate in them. The scale also has a role to play in the operations departments. The larger scale in the US enables them to be more productive with their back-shop operations."

Dodds, however sees more similarities than differences: "With regards to Canada and the US, there is not a tremendous amount of difference between the two markets. We are both predominately a capital lease or loan-type environment for the majority of the capital equipment that is purchased. We have similar laws and our business behaviors are similar – I don't see a great deal of cultural difference between the two countries overall."

And looking further afield, Dodds adds: "In terms of comparing us to other areas around the world, there are definitely some differences. For example, Canada is less dependent on an operating lease structure for the growth in our industry compared to many overseas markets."

Provincial issues

One aspect of Canadian business which requires mention is the dual language situation in Quebec. However, the main issue, if any, is as likely to be appreciation and knowledge of the civil law as of the language.

From Nicholas Logan's point of view this is not an issue at all at National Leasing, and for Jeff Hartley at Foss, "This is basically a non-issue. Some companies work on a regional basis but it is not because of language."

BAL's Doug McKenzie says: "Most leasecos will talk about the basic language barrier, although it's not a huge issue." However, McKenzie states that the civil code law can be a constraint: "The Quebec legal system is fairly slow, i.e. collection and payment default disputes take much longer to settle." He also makes the separate point that "there is more government subsidy for Quebec-based companies."

For Pacific & Western, Moe Danis says: "We believe that to succeed in Quebec, one must have a presence at the 'street level', be fully fluent in French and have an appreciation and familiarity with the nuances of Quebec civil law."

A similar view is provided by Jim Case: "I suppose to an outsider it may be seen to be more difficult than it actually is. There are slightly different laws in the province of Quebec than the rest of Canada and you have to ensure you have the policies and procedures as well as the systems and processes in place to support those differences. And of course, you must deliver your goods and services to your French-speaking customers in the language in which they feel comfortable and confident."

De Lage Landen's Peter Horan sums up: "For those that want to provide full national coverage in Canada, a strong understanding of language, law, culture and geographic population distribution are critical to success."

Perhaps the final word on what makes Canada different as a whole should also come from Horan: "Canadians may not be bombastic in their approach to life but they are solid individuals with strong core values who value relationships and are loyal friends."

Industry consolidation

There has been a fair amount of merger and acquisition (M&A) activity in the equipment finance and leasing segment since the financial crisis broke, details of which are given in the table.

It is noticeable from the table that an aggregator in the equipment finance field has been Element Financial Corp (Element). In a report on the company, Cormark Securities Inc. wrote: "A key aspect of what makes the equipment leasing segment attractive is the fact that it is one that the Canadian banks do not currently dominate. This has left the sector as one of the more fragmented sub-sectors of the financial services industry, providing room for a new entrant such as Element to successfully pursue an aggressive growth strategy that is focused on both organic growth and acquisitions." (Cormark Securities Inc., 'Element Financial Corp. – The Elements of Success', June 2012, author Jeff Fenwick.)

Reported M&A transactions - equipment finance and leasing

Date	Target	Vendor	Acquirer	Loan Assets. (C$m)	Acq Price (C$m)
Canadian Equipment Finance M&A					
May-12	TLS Fleet Management	Scotiabank	Element Financial	430	147
Mar-12	Lease Plus Financial	Lease Plus Services	Lease Link Canada	n/a	n/a
Aug-11	Alter Moneta	Caisse de Depot, National Bank	Element Financial	156	161
May-11	Capital Underwriters	Capital Underwriters	TD Bank	n/a	n/a
Apr-11	50% of Dell Fin Sv. Canada	CIT Group Inc.	Dell Inc	324	n/a
Nov-10	MCAP Commercial LP, Leasing	MCAP	Royal Bank	n/a	n/a
Aug-10	Arctic Cat Floorplan Financing	Textron Financial Canada	TCF Com. Finance Canada	n/a	n/a
Nov-10	National Leasing Group	National Leasing Group	Canadian Western Bank	>650	98
Sep-08	AgriFinancial Canada Corp.	C.A. Bancorp and Sentry Select	Bank West	n/a	20

Source: Cormark Securities Inc., Monitor Daily, S&P Capital IQ

Industry opinion on further consolidation in the market is varied. Nicholas Logan takes a negative outlook, stating: "No, there are only one or two for sale", while Peter Horan says he would be surprised, as "there is nothing left of any substance to acquire. Canadian bank leasing companies have started to acquire brokers, which means they are purchasing goodwill only and no assets. That is about as low as you can go."

Jim Case tends to agree, saying: "There has been quite a bit of consolidation in the Canadian and US marketplace over the last five years. There is probably room for a little bit more, but I believe the bulk of it has already taken place."

Others, however, are more open to M&A activity continuing. Jeff Hartley sees further consolidation as a possibility: "Larger companies are continually looking for growth in a market that is relatively flat. The only way they can grow is to gain more market share and consolidation is a quick way to achieve this. In addition, the smaller companies have less access to competitive funding so the prospect of merging with a larger entity can be attractive. Also the increased scale can result in cost efficiencies."

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Doug McKenzie is quite positive: "Definitely. Lots of activity in the independent leaseco/broker space. Two of the big five banks in Canada have recently acquired small independent leasecos/brokers."

The point of view from the SME perspective is provided by Moe Danis: "We have and continue to experience a wave of consolidation in the small and medium-sized lessors. Some of the consolidation is due to economic conditions, (lessors buying lessors), some strategic (banks buying lessors) and some demographic, driven by boomers looking to retire – this latter reason being somewhat unique."

Prospects for the industry

The asset finance and leasing industry is seen to be performing well under difficult economic pressures. However, the economics in Canada are sound at the Federal level. Deficit is coming down and the government knows that the country must sell resources to maintain revenue.

The markets are being sustained by a number of factors, including pent-up demand from delayed purchases of equipment during the downturn, proven productivity gains from new product innovation, diversification of trading partners outside of US for Canadian manufacturers, and Asian demand for commodities resulting in capital equipment purchases for Canadian suppliers.

De Lage Landen's Peter Horan told Asset Finance International: "There is liquidity in the market for SMEs and large businesses have benefited from debt reduction, improved operating costs and stability in the Canadian financial community."

Jim Case of Ritchie Bros. Financial Services makes the point that "companies focusing on value-added products within the supply chain and which deal with Canada's raw materials are doing very well currently and I see that continuing – these are always great prospects for the equipment financing industry."

However, given the size of the market, it may be that the most profitable route for expansion will be into different markets and asset types, such as the financing of service contracts.

With the Canadian dollar remaining strong and with continuing low interest rates, there is the potential for realignment in the lessor community, according to Moe Danis of Western & Pacific, who explains: "In Canada, a number of large US players have pulled out, choosing to take care of business at home. This gives rise to Canadian lessors large and small to step in and fill the void. For the victors, 2012 will definitely be a growth year."

International expansion

From a banking point of view, as stated by Doug McKenzie of BAL Global Finance Canada, there is future growth potential for "big leasecos going global, particularly for a vendor model shop."

For companies that already have a global reach, there is still great opportunity. Peter Horan says: "DLL believes that partnership with vendors will take it to the evolving pockets of growth which currently are in emerging markets like China, India and other emerging economies. However, there is still room for solid growth in places such as Canada, the US and Europe for financiers who demonstrate innovation and creativity resulting in enhanced value for customers."

And for auctioneers Ritchie Bros, Jim Case says: "We see growth opportunity within North America and abroad. We are always trying to grow our business by becoming more educated as to our customers' needs; understanding the equipment, its intended use and its resale value helps us help our customers with better financial solutions."

A final point on the current and future state of the industry was provided by Moe Danis of Western & Pacific, who stressed that the Canadian Federal government recently acknowledged the importance of the lease industry during the downturn by specifically providing a support programme when needed, which helped to stabilize the market until traditional funders returned.

Danis concluded: "The leasing industry has always had to deal with change. Whether it is changes brought on by the economic conditions, changes due to accounting, or tax treatment, or the generational passing of the torch, we believe the industry will not only survive, but will thrive. Unchanged is the fact that lessors provide industry and commerce important access to productivity-enhancing equipment, an alternative source of capital to traditional bank lending and which adds value through greater leverage due to reliance and better knowledge of the underlying assets. By using the capital available through leasing, companies maintain those liquidity lines provided by their banks. The two sources of capital are very complementary."

Accounting for leases in Canada: The rules of the game are changing

Loraine D. McIntosh is a partner at Deloitte

Until recently, the accounting for leases in Canada was pretty straightforward (relatively speaking); a single leasing model applied by both lessees and lessors that classified a lease as either an operating lease or a financing lease based on a series of long-standing and well-understood criteria. That is not to say, however, that all were happy with the results that this accounting model produced.

In 2011 we saw the emergence of two groups of lessees and lessors: those required to (or that chose to) follow International Financial Reporting Standards (IFRS) and those that follow Accounting Standards for Private Enterprises (ASPE). The IFRS framework for lease accounting is set out in IAS17 while the ASPE framework (effectively a carryover of the old Canadian model) is set out in ASPE 3065.

On the surface, these two frameworks are not that different. Both require that leases that transfer "substantially all of the risks and rewards" associated with ownership of the underlying leased asset be treated as a financing lease (e.g. equivalent to a financed purchase), with all other leases treated as operating leases (e.g. equivalent to rental contracts).

IAS 17 requirements

So what is different? IAS 17 introduces a few additional criteria to the classification model intended to ensure that the 'substance' of a leasing arrangement is more explicitly considered in the classification process. This would mean no more 'bright line' tests – that is, applying explicit percentage thresholds when assessing the criteria (i.e. '75% test' and '90% test').

In addition to describing the four main criteria (i.e. transfer of title, bargain purchase, economic life test, and fair value test) in less explicit terms thereby requiring more judgment in application, IAS 17 requires consideration of:

- whether or not the leased asset is specialized in nature;
- the existence of bargain renewal options;
- who is exposed to residual value gains and losses; and
- who bears losses associated with early termination.

The result: for companies following IFRS, expect to see a few more leases reflected as financing leases; particularly those that were explicitly 'structured' to achieve off-balance sheet operating lease treatment for the lessee. Examples include automotive fleet leases, large-ticket 'ABC' leases and certain technology leases. (An ABC lease is a lease that provides a series of end-of-term options – e.g. lease renewal, purchase option, return of equipment – that is specifically constructed to enable operating lease treatment, although in many cases it is very likely that the lessee will exercise the option that either extends the term or results in asset ownership.)

IASB / FASB proposals

Bigger changes, however, are coming with the joint IASB / FASB project to overhaul lease accounting. Under the new model, it is expected that lessees following IFRS will be required to show the impact of virtually all leases (including property leases) on-balance sheet. Although not yet final, the proposed income statement treatment is likely to be even more challenging.

At the most recent Board meeting in June a tentative decision was reached that would result in an accelerated or "front end loaded" expense recognition pattern for virtually all equipment and finance leases. It is clear that this will have a significant impact on key performance metrics and ratios. At the time of writing, the final requirements and expected timing of implementation are as yet unknown. A re-exposure draft is expected sometime in autumn 2012.

The process does, however, raise a number of considerations for lessees, lessors and users of their financial statements. With the current and expanding divergence in requirements between the IFRS and ASPE frameworks for leasing, it will be increasingly important to understand which model applies when reviewing financial performance.

More important for lessors, however, will be an understanding of their target market. To the extent that their lessees follow ASPE it is business as usual. To the extent that some or all follow IFRS, the question is whether or not the combination of balance sheet and income statement treatment proposed in the new framework will impact the demand for leasing product and/or the way in which it is priced, structured and marketed going forward.

Industry perspective on the proposed changes to lease accounting

There is still a good deal of uncertainty and confusion in the asset finance and leasing industry regarding IFRS, summed up by Peter Horan of De Lage Landen: "Our intelligence tells us that the consequences are not yet front of mind. We are educating our vendor partners as the situation evolves and searching for opportunities that may result from the changes. There is still a great deal of confusion for those in the know and inaction by those that don't."

Doug McKenzie of BAL suggests three areas of change: "First, some credit people will argue a reduction in financial reporting clarity due to the more notes-based presentation. Second, the technology captives will put even more focus on total asset management through the life-cycle as opposed to the tax or off-balance sheet treatment for operating leases. Third, we will start to see 'fleet conversion' deals where large companies are selling their equipment to a third party and renting it back."

Pacific & Western's Moe Danis explains that, although the new regime will not apply to the majority of SMEs as it is optional, "the IFRS impending changes to lease accounting really are an enigma. The stated purpose was to be greater clarity and transparency. In my personal opinion, the proposed changes fail to accomplish those goals. It will, however, be a home-run for fee generation for the accounting industry. At this point it appears the changes will have less impact on equipment lessors than on real estate, but given the extended timelines for implementation, I do not believe it is impacting current decisions."

Recent Canadian tax developments for the finance and leasing industry

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Over the last few years, tax managers in the Canadian finance and leasing industry have been focused on the impact of the credit crisis, changes to commodity taxes and their enforcement, changes to the Federal taxation rules on leasing to tax-exempt entities, and changes affecting Canada's thin capitalization rules.

Impact of the credit crisis

The credit crisis severely impacted access to funding for Canadian finance and leasing participants. The Federal government's commitment to a C$12bn Canadian secured credit facility to assist asset-backed securities made temporary credit available to participants reliant on securitization and assisted in establishing credit spreads in a weak market.

But credit remained tight. Several large participants migrated to bank status either in Canada or abroad in an effort to access consumer deposit funding. This subjected those institutions to being regulated in Canada as banks, which had the further effect in Canada of excluding them from the domestic auto leasing sector. For example, a number of automobile finance companies thus became subject to the Bank Act (Canada) (the 'Bank Act'). Under the Bank Act, Canadian banks cannot lease consumer automobiles or engage in any asset-based leasing, unless, in the latter case, the lease comes within the definition of a 'financing lease' in the Bank Act.

Consequently, several of these companies had to cease their leasing activities, resulting in the rolling off of their deferred tax liability and the recognition through recaptured depreciation of taxes which had been deferred. Other participants have been required to dispose of their fleet leasing businesses to ensure that they remain compliant with the Bank Act. This prohibition on consumer automobile leasing by banks has also led to the development of direct consumer loans that mimic lease economics, but are structured as conditional sales contracts with put options.

Changes to commodity taxes

In 2010, Ontario harmonized its retail sales tax with the Federal goods and service tax (GST), creating a single harmonized sales tax (HST) for the province. While the effective tax rate remained at 13%, firms faced costs to adapt their systems to comply with the HST. British Columbia also implemented a harmonized sales tax in 2010. However, in a referendum held in August 2011, voters chose to abolish it. Consequently, British Columbia will re-implement the previous provincial sales tax (PST) regime on April 1, 2013. The province will introduce an online system that allows firms to track their PST information and remit payments; however, firms still have to bear the costs of undoing changes made in anticipation of the HST and complying with transitional rules.

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The finance and leasing industry has been under increasing scrutiny in the form of government audits of commodity taxes. GST and HST are value-added taxes, and so, in general, businesses that acquire goods or services for use in their commercial activities can fully recover taxes paid as input tax credits. However, most financial products (such as equipment loans and conditional sales contracts) are exempt from GST so that lenders cannot recover input tax credits on their own input costs. Recent audit activity has focused on securitization structures and on the allocation of input tax credits within firms between recoverable and non-recoverable activities.

Conversely, lessors are able to recover GST and HST. Recent audit activity has focused on such taxes on deferred rents and on the manner in which end-of-term excess kilometer charges and damage payments are reported for tax purposes.

Changes to Federal taxation rules

The 2010 Federal budget announced the extension of the specified leasing property rules in the Income Tax Act (Canada) to what was previously exempt property if it is leased to non-taxable entities, including governments and non-resident entities. The specified leasing property rules are intended to restrict lessors of certain property from claiming capital cost allowance (CCA) (i.e. tax depreciation) so that the CCA deductible is essentially limited to the 'principal' portion of rent.

Certain property, including general purpose office equipment and computers, motor vehicles, trucks, tractors and trailers designed for hauling freight or railway cars, is exempt. For such exempt property, CCA rates often exceed taxable income producing a net present value benefit to a lessor from leasing. However, under the new rules, property with a value of over C$1m that is leased to a non-taxable entity will now be restricted. As a result of this change, lessors can no longer obtain a net present value benefit from leasing to a tax-exempt entity.

Changes affecting thin capitalization rules

Finally, the 2012 Federal budget proposed to change Canada's thin capitalization rule from the existing 2:1 ratio to a 1.5:1 ratio. Existing thin capitalization rules are designed to limit the deduction of interest by Canadian companies where the debt-to-equity ratio of a foreign related party debt exceeds the above ratio. These changes will increase costs for financial institutions that obtain significant amounts of financing from related non-residents or that use significant internal leverage in their financing models.