The uncertain recovery in the North American equipment finance industry

By Crit DeMent, LEAF Commercial Capital, Inc.

June 2011 marked the two-year anniversary of the end of the US Great Recession and in many ways Americans are more wary of the economy now than they were in 2009. While large corporate profits have soared during this recovery period, many small businesses are still in the same place they were two years ago. With housing prices continuing to decline and unemployment at a record high, consumer confidence is at an all-time low and consumers are just not spending; and justifiably so. In Q2 consumer spending was up a meagre 0.1% so many Americans are still reluctant to spend any of their rebuilt savings for fear of losing it all again. Since consumer purchases makes up 70% of the US economy, the current low spending levels have the recovery moving slower than initially expected. In the first half of 2011 GDP growth has been the slowest since the recovery began, with 0.4% growth in Q1 and 1.3% growth in Q2. As long as consumers hold back on spending, corporations hold back on hiring new workers and retooling their businesses, and the vicious cycle continues.

Further adding to the struggling American economic recovery are high energy and food prices and concerns about European debt, each of which have contributed to further constricting consumer spending and especially the continued weak housing market. The stubbornly high unemployment rate coupled with reluctant consumers is keeping a lid on the growth of the housing market and the housing market will not begin to rebound without buyers. While mortgage applications are at an all-time high, the volume is mostly to refinance existing mortgages, taking advantage of the low interest rates, not the purchase of new homes.

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Economic uncertainty is a major obstacle to steady economic growth and job creation. Each week there are more conflicting reports that have Americans shaking their heads at the lack of clarity on the current state of the economy. Every piece of good news seems to be masked by an equally negative report. In an unprecedented move, Standard & Poor's downgraded the US credit rating from a pristine AAA rating to AA+. This coupled with continued weak numbers have pushed markets over the edge and have created fear that we are headed for a double-dip recession. Greatly fuelling the uncertainty is the perception that the US Government does not have a clear path for the future. With political polarisation growing and with an upcoming 2012 election, Washington does not appear to have actionable steps for real growth and job creation.

Corporations are as nervous about the US economy as consumers. Although they are bringing in healthy profits, constant mixed messages about the health of the economy are creating a chaotic business environment and it is no wonder they are reluctant to spend their cash, estimated to be over US$1 trillion. The majority of these corporate profits are primarily coming from cost control efforts and overseas expansion. During the recession, most companies looked at their internal processes and budgets and performed major revisions in order to keep costs down. Many of the cost control steps included improved technology platforms that resulted in staff reductions. These cost control measures have continued into the recovery and as sales started to climb again so did corporate profits without adding any significant headcount. Companies have simply learned how to do more with less.

This economic uncertainty is one of the most significant reasons why companies are not spending their cash reserves. Historically, if a business needed operating cash, it could get it in the form of a bank line of credit. However, in today's current environment businesses are fearful to rely on the availability of credit, so they are keeping staggering sums of cash on hand. All that unused cash does not sit well with investors and company stakeholders. Economists state that the best way to lower the unemployment rate is for companies to spend their cash on expansion and subsequently on new hires, but most prefer to spend it other ways. Corporate America is focused on taking advantage of historically low interest rates and benefiting from attractive tax breaks for adding new equipment, which results in corporate spending, but not hiring. Workers are getting more expensive due to higher healthcare costs and benefits, while equipment has gotten cheaper. To some companies it makes better sense to expand their business by upgrading their equipment now to stay ahead of the competition. With bonus depreciation not set to be reduced until 2012 this trend in buying equipment versus hiring could continue through the end of the year. A key beneficiary of this type of capital investment will be the lease and financing industry.

Unlike large corporations, American small businesses have not fared as well in the recovery. They were hit hardest during the recession and it has been a slower recovery overall for small businesses, plagued with limited access to credit, uneven sales demand, and reduced workforces. Small businesses have always been the backbone of the US economy and have traditionally led the US out of economic recessions, but that has not been the case this time. Many small businesses are overwhelmed by fear of the unknown and are nervous to make any major changes that would help move the economy forward – such as new hires and expansion. Since the small business sector has been significantly underperforming during this recovery there is currently legislation pending to provide the small business sector with additional tax incentives and increased access to capital. These initiatives may act as a catalyst to rebuild their confidence in the economy resulting in hiring new employees and increasing capital expenditures.

So how do all of these economic recovery factors impact the performance of the equipment leasing and finance industry? A key industry indicator is the Monthly Leasing and Finance Index (MLFI-25), which is comprised of a cross-section of 25 typical financial services organisations, and is produced by the Equipment Leasing and Finance Association, the trade association representing financial services companies and manufacturers in the US$521bn US equipment finance sector. According to the latest index, the overall new business volume for June 2011 was US$7.3bn, up 33% from volume of US$5.5bn in the same period in June 2010. In 2010 many of the transactions funded were for replacement equipment not expansion equipment. The pent-up demand that businesses had was to replace or patch up the assets that they currently have. Now companies are just starting to move away from survival mode and are looking to acquire the equipment they need for growth as demonstrated in the June new business volume numbers. From the start of the recovery to the present, credit and portfolio quality have also dramatically improved. Growth is slow, but as these survey results demonstrate, the equipment leasing and finance industry is growing.

According to the latest MLFI-25, the overall new business volume in the US equipment finance sector for June 2011 was US$7.3bn, up 33% from US$5.5bn in the same period in June 2010.

This lack of consistent growth and mixed market messages has resulted in a very uncertain and fragile recovery causing businesses to be wary of investing in the future. The American economy has been through downturns before and has always weathered the storm and eventually rebounded even stronger. Although it seems that the recovery has been two steps forward and one step back, the recovery will pick up steam and the equipment finance industry needs to be ready when it does, in order to take advantage of the economic revitalisation. The resurgence of the securitisation marketplace along with unprecedented levels of bank liquidity has enabled equipment finance companies to return to a more diversified funding strategy, allowing them to begin to rebuild their asset base. With new entrants into the market, credit quality improving, and more money than deals; competition is fierce and will continue to be well into the future. In order to survive and flourish in today's market, a company needs to be willing to take a long hard look at its business model and start to apply real change to areas that could be improved. It is not just about doing the deal any longer. Today's business wants to know what more they are going to get than just a monthly payment. The equipment finance industry needs to be prepared to take advantage of this unique growth opportunity where businesses are beginning to delve back into making expansion equipment purchases. With interest rates at record low levels, companies cannot compete on price alone. Now is the time to reevaluate and take a deeper look at messaging, strategy, and processes to ensure that they are keeping pace with today's marketplace. In order to survive, companies are going to have to be innovative, creative, smart, and have a great marketing plan in place. It is going to take more than just having the capital available to win customers in a re-energised economy.

This is a challenging but exciting time for the US equipment leasing and finance industry. As the country moves through this recovery process, those companies that are adaptive, forward thinking, and open to change will not only survive, but they will thrive. The equipment finance industry is one that is strong, stable, and will continue to be around supporting the equipment needs of its customers for a long time to come. Despite uncertainty and mixed economic reports, the equipment finance industry is slowly gaining stability again.

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