Small Ticket Equipment Leasing & Finance

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Small Ticket Equipment Leasing and Finance – COVID-19 Update

Since Colonnade last commented on the small ticket equipment leasing and finance industry in September 2018, the sector has been performing well. Volume has grown steadily, capital has been readily available, some new players emerged and there has been significant acquisition activity. The environment abruptly changed in early March 2020 as the scope of the coronavirus crisis emerged and all levels of government began to take necessary, drastic actions to curtail person-to-person transmission of the virus. These actions have pounded the economy, which will seriously impact all financial institutions that fund small to mid-sized businesses. Government efforts to aid the business sector during this unprecedented break in normal commerce should soften the impact of the pandemic. The Coronavirus Aid, Relief and Economic Security Act ("CARES act") will help, and there are likely to be more fiscal programs following this $2 trillion boost to the economy. Aggressive monetary actions by the Federal Reserve will also help. COVID-19 is the most serious mass influenza outbreak since the Spanish Flu of 1918. Without a doubt, however, this disease will be defeated in time, and the world economy will recover.

In this commentary, we will review the state of the small ticket equipment leasing and finance sector before COVID-19, the likely near-term impact on the sector and what might happen in the post-crisis environment. While we cannot predict the specifics of the path through this crisis, we can make some educated conjectures.

The small ticket leasing and finance sector consists of firms that focus on transactions of less than $250,000 (including the "micro-ticket" participants that focus on deals under $25,000). This segment accounts for about a third of the $1 trillion of equipment acquisitions funded by the entire equipment leasing and finance sector. A significant amount of this financing volume is utilized by smaller enterprises – the small ticket leasing and finance sector is a major source of capital for Main Street America's businesses. Small ticket equipment leasing and finance firms also serve large enterprises. The providers and users of this form of financing are quite diverse. Major banks, captive finance arms of manufacturers, independent finance companies and nimble intermediaries are all significant players in the sector; customers that utilize small ticket equipment leasing and finance range from sole proprietorships to major corporations. The dominant go-to-market strategy in this sector is indirect transaction origination via channel partners (equipment OEMs, vendors, dealers, retailers). Successful small ticket equipment leasing and finance firms have built strong mutually-beneficial relationships with their channel partners.

During the financial crisis and recession of 2008 – 2010, the small ticket equipment leasing and finance industry wobbled but did not fall. While delinquencies and write-offs increased, the level of distress in the sector was not fatal. The velocity of the asset class allowed delinquencies and write-offs to be resolved quickly, and equity cushions generally proved adequate to allow industry participants to make it through these difficulties. The liquidity crisis forced some firms to stop funding new transactions. The only significant participant in the small ticket leasing sector to file bankruptcy was CIT Group, but it was not the small ticket equipment finance business that crippled that large firm (and it did emerge from Chapter 11 and is currently alive and well). Recent history provides some comfort regarding the near-term future as we head into a period of economic distress caused by the COVID-19 crisis.

Since our last commentary on the industry, there has been robust M&A transaction activity in small ticket leasing and finance industry. In fact, several new transactions were announced during the first two months of 2020 just before the scope of the pandemic emerged.

The economic disruption caused by the COVID-19 outbreak will weaken the commitment of some multi-line financial institutions to the small ticket equipment leasing and finance sector. This could lead to the spin-off of subsidiaries or portfolios in the wake of the pandemic.

The CARES Act and additional aid will presumably reduce the level of business failures and will help the portfolios of small ticket leasing and finance firms. We remain confident in the long-term viability of the small ticket equipment leasing and finance industry.

Small Ticket Equipment Leasing and Finance Sector – B.C. ("Before Coronavirus")

The small ticket equipment leasing and finance segment had a stellar year in 2019, and the beginning of 2020 was also quite encouraging. The global equipment leasing and finance industry recorded nine consecutive years of growth according to the White Case Global Leasing Report, which was released in early March 2020 – the global industry grew by 131% between 2011 and 2019. The Equipment Leasing and Finance Association Monthly Leasing & Finance Index of 25 major U.S. leasing firms ("MLFI-25") reported that transaction volume for that group increased by 5% in 2019; write-offs stayed relatively flat at around 0.50%. The small ticket equipment leasing and finance sector grew more rapidly than the overall industry in 2019. A group of independent firms reported their results at the beginning of 2020.

Name of Firm	Volume Growth 2019	Comments
Ascentium Capital	22.3%	Large independent firm, owned by Warburg Pincus and recently sold to Regions Bank
Chesswood Group Ltd.	10.5%	Canadian public company, traded on TSE
GreatAmerica Financial Services	8.0%	Large independent firm, privately owned
Marlin Business Services	18.7%	Public company, NASDAQ: MRLN
North Star Leasing	40.0%	Growing firm, owned by Copley Equity Partners

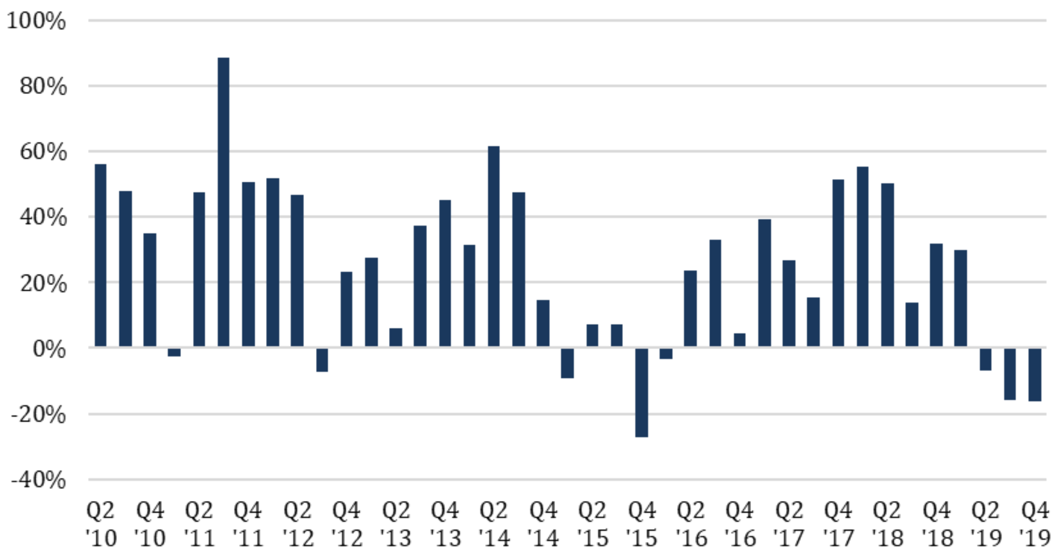
The small ticket leasing and finance segment still accounts for about one third of the $1 trillion equipment finance/leasing market in the United States, according to the Equipment Leasing and Finance Association (ELFA). About 68% of all capital equipment purchases in the United States are financed; the rest are cash purchases. Companies elect to finance/lease equipment for a variety of reasons:

- Preserve capital for other mission-critical purposes
- Match equipment cost with future cash flows
- Maximize the value of tax benefits associated with equipment ownership by leasing assets

Of course, the health of the overall U.S. economy drives the demand for capital equipment. Prior to the coronavirus outbreak, overall business investment in fixed assets (equipment and real estate) was holding up as the economic expansion moved forward. The growth in fixed asset investment cooled somewhat in the second half of 2019, and some segments of the economy were beginning to soften, notably the transportation sector and construction equipment industry. Class 8 heavy duty truck orders dropped to a 10-year low in 2019, and new orders for construction equipment dropped by 7.5%. Small ticket leasing and finance firms that focus on these segments did experience some increased credit quality costs in the second half of 2019.

BUSINESS INVESTMENT

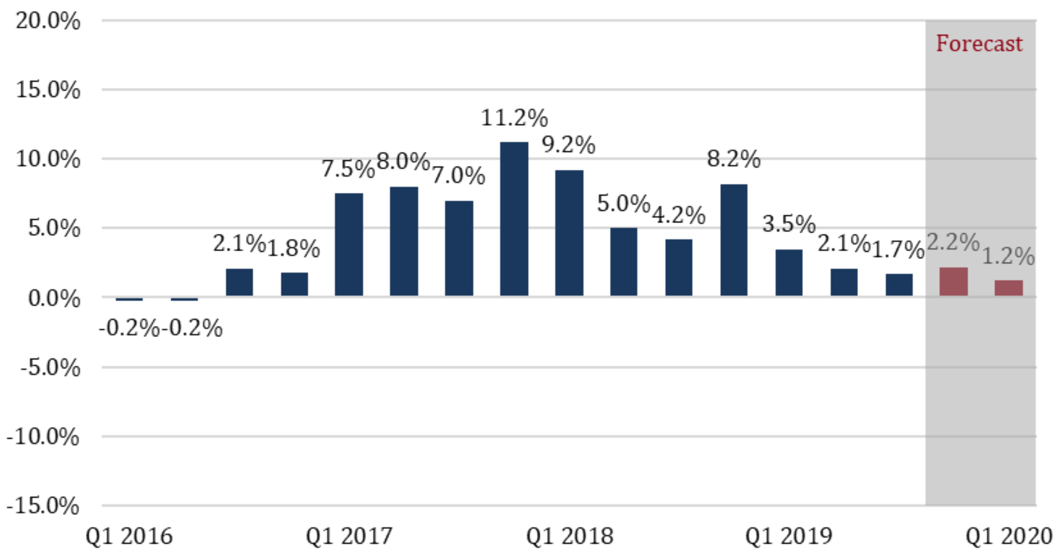
Real Nonresidential Fixed Investment, Percent Change from Previous Quarter (Seasonally adjusted annual rate)



Investment in real equipment and software grew by 3.7% in 2019 (seasonally adjusted annual rate estimate) according to the Equipment Leasing and Finance Foundation's 2020 Outlook. The ELFF expected the annual growth rate to decline to around 1% in 2020; the COVID-19 crisis has muddied the outlook. It is possible that a decline in the wake of the outbreak will be followed by a robust increase in equipment investment later in 2020, but that outcome is uncertain.

REAL EQUIPMENT & SOFTWARE INVESTMENT GROWTH

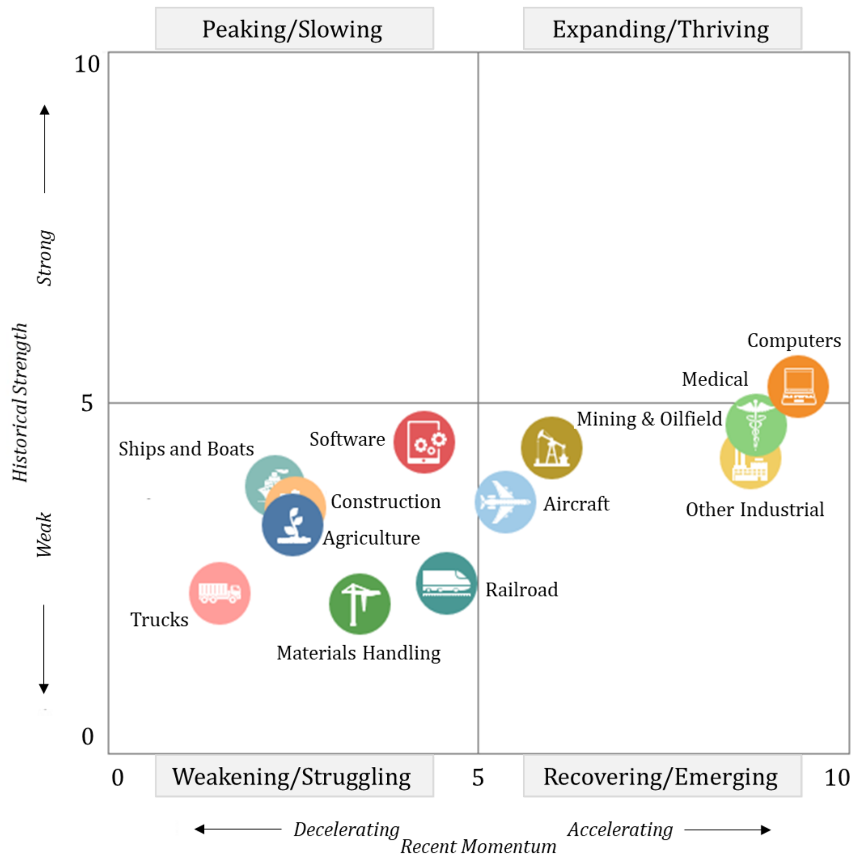
Q/Q Percent Change, SAAR



The overall capital equipment market is comprised of several significant sub-markets. The ELFA compiles a "momentum index" for the major sectors. The momentum index was flashing some warning signals earlier this year – only computer equipment and medical equipment appeared to be strengthening; many sectors were slowing.

EQUIPMENT & SOFTWARE INVESTMENT

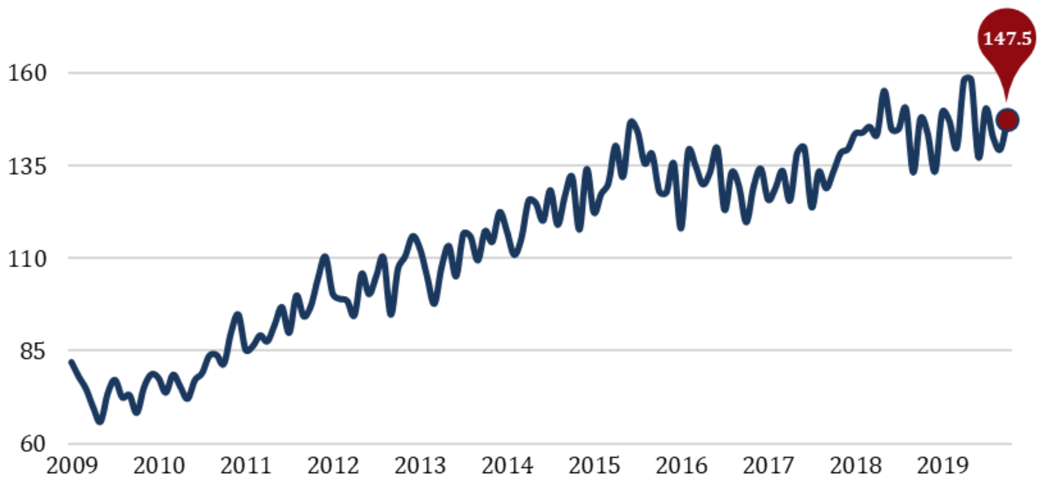
Momentum Monitor (Equipment Vertical Performance Matrix)



Source: https://www.leasefoundation.org/industry-resources/momentum-monitor/

Demand for credit by small businesses held up fairly well in 2019. PayNet's Small Business Lending Index provides a measure of loans and leases issued to small businesses over the past 30 days. The index was mostly flat year-over-year through the third quarter of 2019. Small business lending has declined severely since the pandemic hit – many firms have been forced to close due to "shelter in place" orders. Once again, the CARES Act and other aid packages should accelerate the recovery from this public health crisis.

PAYNET SMALL BUSINESS LENDING INDEX (SBLI)
January 2005 = 100



As we outlined in Colonnade's September 2018 commentary on the industry, the small ticket equipment leasing and finance market has the following primary features:

- Small ticket: $25,000 to $250,000; micro-ticket: under $25,000
- Generally, a flow business; primarily indirect origination via channel partnerships; banks and non-banks participate in this segment
- Credit scoring is often used, although custom underwriting is also common
- Driven by relationships with channel partners (equipment manufacturers, distributors, vendors/retailers and transaction brokers)
- A few firms have a direct origination strategy

Since most small ticket equipment leasing and finance and leasing firms originate via channel partnerships, industry statistics from the vendor equipment finance sector provide a picture of the scale and dynamics of the market. Many of the largest participants in the sector are bank-owned; the top 25 participants in vendor channel equipment finance/leasing include 18 bank-owned firms that generate 90% of the volume of the group. Regions Bank's recent acquisition of Ascentium Capital (#10) solidifies this point.

TOP 25 VENDOR CHANNEL LEASING/FINANCING FIRMS

Rank	Company	2018 Volume ($'s in MM's)	Ownership
1	DLL USA	11,393	Foreign bank
2	Wells Fargo Equipment Finance	9,043	Domestic bank
3	Banc of America Leasing	3,505	Domestic bank
4	U.S. Bank Equipment Finance	2,592	Domestic bank
5	PNC Equipment Finance	2,068	Domestic bank
6	Key Equipment Finance	1,671	Domestic bank
7	Bank of the West	1,454	Domestic bank
8	TIAA Commercial Finance (fka EverBank)	1,002	Domestic bank
9	GreatAmerica Financial Services	992	Privately-owned
10	Ascentium Capital	990	Private equity
11	TCF Capital Solutions	951	Domestic bank
12	People's United Equipment Brands	765	Domestic Bank
13	Sumitomo Mitsui Finance and Leasing Co., Inc.	701	Foreign non-bank
14	Hitachi Capital America	615	Foreign non-bank
15	ENGS Commercial Finance	505	Private equity
16	Marlin Business Services	438	Public
17	Navitas Credit	296	Domestic bank
18	SunTrust Equipment Finance & Leasing	271	Domestic bank
19	Canon Financial Services	271	Foreign non-bank
20	Western Equipment Finance	250	Domestic bank
21	Stearns Bank	196	Domestic bank
22	Eastern Funding	195	Domestic bank
23	FNB Equipment Finance	178	Domestic bank
24	Amur Equipment Finance	153	Private equity
25	VAR Technology Finance	152	Privately-owned

There are dozens of smaller, private firms that operate in the small ticket equipment leasing and finance sector. Some of these companies are owned by private equity firms or family offices; others are still controlled by the founders.

Small ticket equipment leasing and finance and leasing transactions generate solid asset yields with manageable credit quality costs. The quality of these assets has attracted the attention of investors, especially banks. Merger and acquisition activity in the small ticket leasing sector has been robust over the past few years, right up to the beginning of the coronavirus crisis. One of the largest transactions in several years, the acquisition of Ascentium Financial by Regions Bank, closed on April 1, 2020.

A selection of M&A transactions completed over the past 45 months is presented below.

Date	Buyer/Investor	Target
Apr-20	Regions Bank	Ascentium Capital LLC
Mar-20	Alliance Funding	Pinnacle Capital Partners
Nov-19	Tokyo Century	Allegiant Partners Inc.
Sep-19	Kingsbridge Holdings	Technology Finance Corporation
Apr-19	TimePayment	LeaseQ
Jan-19	People's United Bank	VAR Technology Finance
Dec-18	Great Western Leasing	All Points Equipment
Dec-18	Equitable Group	Bennington Financial Equipment Finance
Oct-18	Mitsubishi UFJ	ENGS Commercial Finance
Sep-19	Marlin Business Services	Fleet Financing Resources
Aug-18	Wafra Capital Partners	North Mill Equipment Finance
Jul-18	People's United Bank	Vend Lease Company
Jul-18	Verdant Commercial Capital	Intech Funding Corp.
Apr-18	Sterling National Bank	Advantage Funding (Marubeni)
Jan-18	CWB Financial Group	Canadian Commercial and Vendor Finance assets of ECN Capital Corp
Jan-18	Copley Equity Partners	North Star Leasing
Jan-18	United Community Banks Inc.	Navitas Credit Corp.
Aug-17	Solar Capital	Nations Equipment Finance
Jul-17	People's United Bank N.A.	LEAF Commercial Capital Inc.
Mar-17	Lease Dimensions	Genpact
Feb-17	PNC Financial Services Group	ECN Capital's U.S. Commercial, Vendor Finance Business
Jan-17	Currency Capital, LLC	Lovell Minnick Partners
Jan-17	Marlin Business Services Corp (NASDAQ: MRLN)	Horizon Keystone Financial
Dec-16	Radius Bank	NewStar (NASDAQ: NEWS)
Nov-16	LeaseQ	Noesis
Oct-16	Hanmi Financial Corporation (NASDAQ: HAFC)	Banc of California CSF portfolio
Oct-16	Engs Commercial Finance Co.	Connext Financial, Ltd.
Oct-16	Laurentian Bank of Canada	CIT Canada (NYSE: CIT Group)
Oct-16	Warburg Pincus	Ascentium Capital
Aug-16	Platinum Equity	Electro Rent Corporation
Aug-16	TZP Capital Partners II	Kingsbridge Holdings

Impact of the COVID-19 Pandemic on the Small Ticket Equipment Leasing and Finance Sector

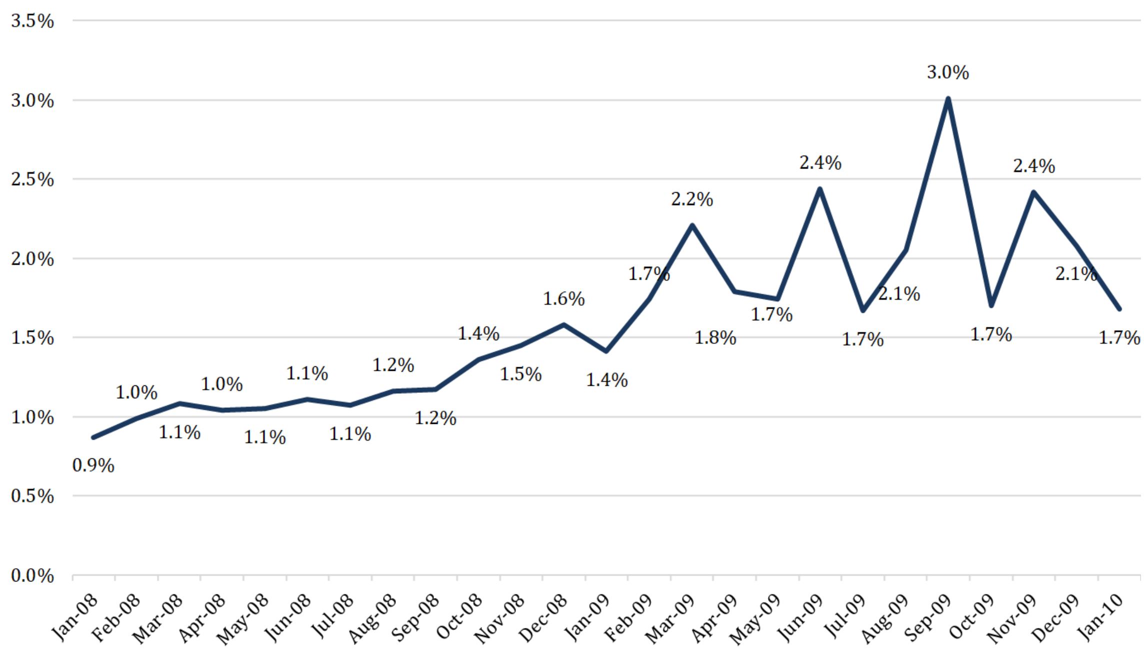
The impact of the coronavirus crisis is looming over the small ticket equipment leasing and finance industry. As of today, more than 16 million Americans filed for unemployment in the last three weeks – if all those people lived in the same state, it would be the 5th most populous state in the country, after New York. The speed and size of this spike in unemployment is unprecedented in living memory.

GreatAmerica Financial Services (one of the largest independent firms in the sector) told Colonnade that March delinquencies held relatively steady. North Star Leasing proactively offered a two-month moratorium on payments to its clients to get ahead of the situation and generate customer goodwill. On April 9, Marlin Business Services (a small ticket equipment finance firm focused on small businesses) announced that 120 employees would be furloughed as of April 13 and that senior management will take salary cuts. This is the first move by a small ticket equipment leasing firm to cut costs in response to the COVID-19 crisis.

The impact of the pandemic will become fully visible in April, which is the first full month of the activity restrictions implemented to slow the spread of the virus. The outlook is cloudy, but we can gain a bit of perspective on the future by looking at the past. Our last major economic disruption was the financial crisis and recession of 2008 – 2010. The Equipment Leasing and Finance Association's monthly leasing and finance index of 25 major leasing firms (MLFI-25) provides a snapshot of the movement of charge-offs during the crisis and recession:

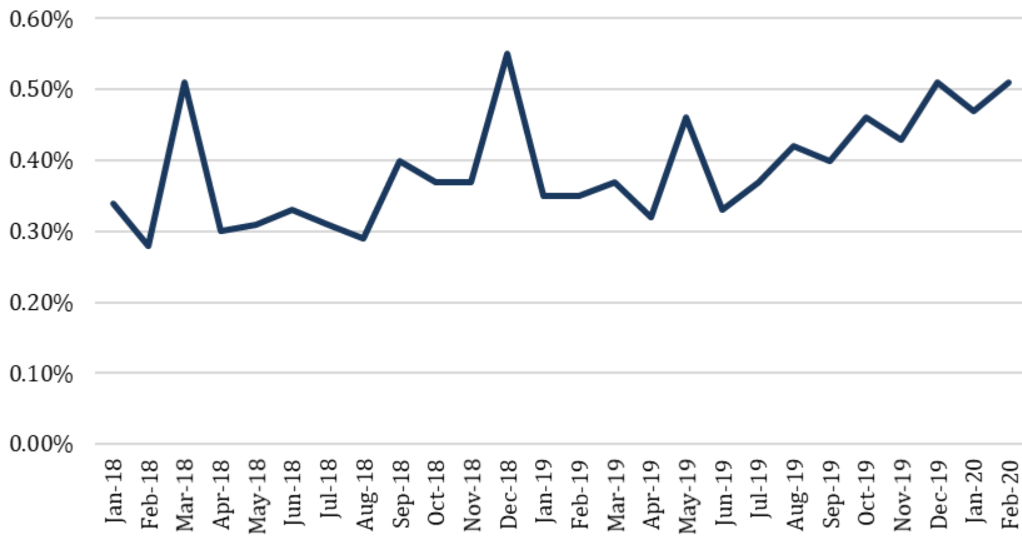
MLFI-25 CHARGE-OFFS – JANUARY 2008 THROUGH JANUARY 2010

Average Losses (Charge-offs) as a % of net receivables



Prior to the financial crisis and recession, charge-offs were about 1% of net receivables; that number tripled over the course of the recession. Over the past two years, charge-offs reported by the companies in the MLFI-25 have remained stable and were about 0.5% of average receivables in February 2020.

MLFI-25 CHARGE-OFFS – JANUARY 2018 THROUGH JANUARY 2020



It is reasonable to assume that the COVID-19 crisis will cause a charge-off spike equal to or greater than that experienced in 2008 – 2009. The spike will happen quickly since the shut-down of major sectors of the economy happened so fast. It is also important to note that the MLFI-25 index includes several industry players that do not participate in the small ticket equipment leasing and finance segment. Small ticket lessors generally have higher yields and higher credit quality costs than firms that focus on larger, more credit-worthy customers. In addition, some small ticket equipment leasing and finance firms have a significant component of small business customers that are in the retail and food service (restaurant) segments. Those small ticket leasing firms will suffer more significant portfolio deterioration than firms that lack that industry concentration.

The other main difference between the 2008-2009 recession and the coronavirus crisis relates to the quick realization of the economic decline caused by the shut-downs – there is already a flood of loan modification requests from borrowers that have not defaulted yet. One small ticket equipment lease/loan portfolio servicing firm told Colonnade that it expects half of all small ticket lessees/borrowers to request modifications to their payment obligations. If the pandemic can be brought under control in the next 60 to 90 days, these loan modifications may never turn into charge-offs.

Our estimate for credit losses in the small ticket equipment leasing and finance sector calls for a rapid increase to 5%-8% of average receivables. This spike will fade rather quickly due to the impact of government assistance and, more importantly, the eventual re-opening of the shuttered portions of the U.S. economy as the pandemic fades away. It is quite possible that pent-up demand for goods and services will cause an unprecedented recovery from this crisis.

Small Ticket Equipment Leasing and Finance Sector – A.C. ("After Coronavirus")

While there will be terrible loss of life and short-term economic pain, the novel coronavirus will be defeated. This type of shock causes "after-shocks" in various industries, and the small ticket equipment leasing and finance sector will be no exception to this rule. The two post-pandemic repercussions could lead to change and opportunity.

1. *Re-pricing Risk of Certain Segments:* Once the credit losses suffered by small ticket equipment finance firms become clear, we expect market participants to re-price risks in certain segments. Non-essential retail businesses, restaurants, hotels and travel-related businesses could carry a risk premium for a few years, and the capital available to these sectors could become less available.
2. *Re-assessment and Retreat by Certain Market Participants:* Several banks entered, re-entered or expanded their participation in the small ticket leasing and finance sector in the 2012 – 2019 period. We expect that the shockwaves of the COVID-19 disaster will weaken their commitment to the sector. We expect some banks to exit the small ticket leasing and finance sector in the 2021 – 2022 timeframe, creating opportunities for non-bank investors – we saw a similar dynamic play out in the wake of the 2008-2009 financial crisis and recession.

Conclusion

After nine years of growth and profitability, the small ticket equipment leasing and finance sector has been rocked by the COVID-19 outbreak. While the future is uncertain, there is reason to believe that this unprecedented economic disruption will fade quickly as the pandemic comes under control. While some blood will be spilled, the long-term health of the sector is not threatened. The shock of the experience may cause some multi-market lenders to exit the small ticket equipment finance segment. This could lead to a rash of transactions that will create a new generation of independent small ticket leasing and finance firms.

Colonnade advised Technology Finance Corporation on its sale to Kingsbridge Holdings

October 2019. Kingsbridge Holdings, a leading independent lessor of information technology, industrial, healthcare, and commercial essential-use equipment based in Lake Forest, Illinois, acquired Technology Finance Corporation (TFC). Kevin Pruett, TFC's CEO and co-founder, will continue to lead the company.

Founded in 2004 and headquartered in Scottsdale, Arizona, TFC provides information technology infrastructure leasing and financing to small- and medium-sized businesses throughout the United States. TFC funds over $125 million annually, sourced through a network of vendor relationships, value-added resellers, software partners, and service providers.

For more information on the small ticket equipment leasing and finance sector, please contact:

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