Debunking the Myths Of Equipment Finance

WHITE PAPER

OCTOBER 2013

There's an old adage that if you repeat something enough times it's probably true. Unfortunately, the myths surrounding equipment finance have been perpetuated for so long within the banking industry that they are taken as fact. Yet, as we examine the most common myths of equipment finance, we realize that they are nothing more than red herrings designed to mask the real reasons behind not offering leasing.

Equipment finance is not the first product solution to be dismissed by the banking industry. Take Internet banking. Ten years ago you'd be hard pressed to find a community bank extolling the virtues of online banking. Leaving the new-fangled technology to bigger banks, most banks had sound reasons why they didn't offer it:

- *It's not secure.*
- *We don't have the internal resources.*
- *Our customers don't want it.*
- *None of my competitors are offering it – why should I?*

Deciding to leave it to the big banks, smaller banks ignored the trend and relied on their traditional delivery systems to service their customers. Unfortunately that trend wasn't a passing fad and Internet banking soon became a way of life. According to the latest data from Pew Research Center, more than 60% of U.S. Internet users bank online[1]. That's 120 million Americans. And 32% of adults transact bank business on their mobile phones. As smartphones and other handheld devices take over our world, that number will rise.

Thanks to competitive pressures, most banks found a way to overcome these obstacles to deliver what their customers wanted. Today, banks now consider it mandatory to have sophisticated, well-functioning technologies like online and mobile banking to support their customer base.

Ignoring Another Trend?

Like Internet banking, most banks generally have left equipment finance to the larger banks and independent finance companies. And, as before, they have reasons why they don't offer it to their customers:

- *It's too risky.*
- *Our pipeline is full.*
- *Our customers don't lease equipment.*
- *My competitors don't offer it – why should I?*

Sound familiar? The similarities are striking. Let's review them one at a time.

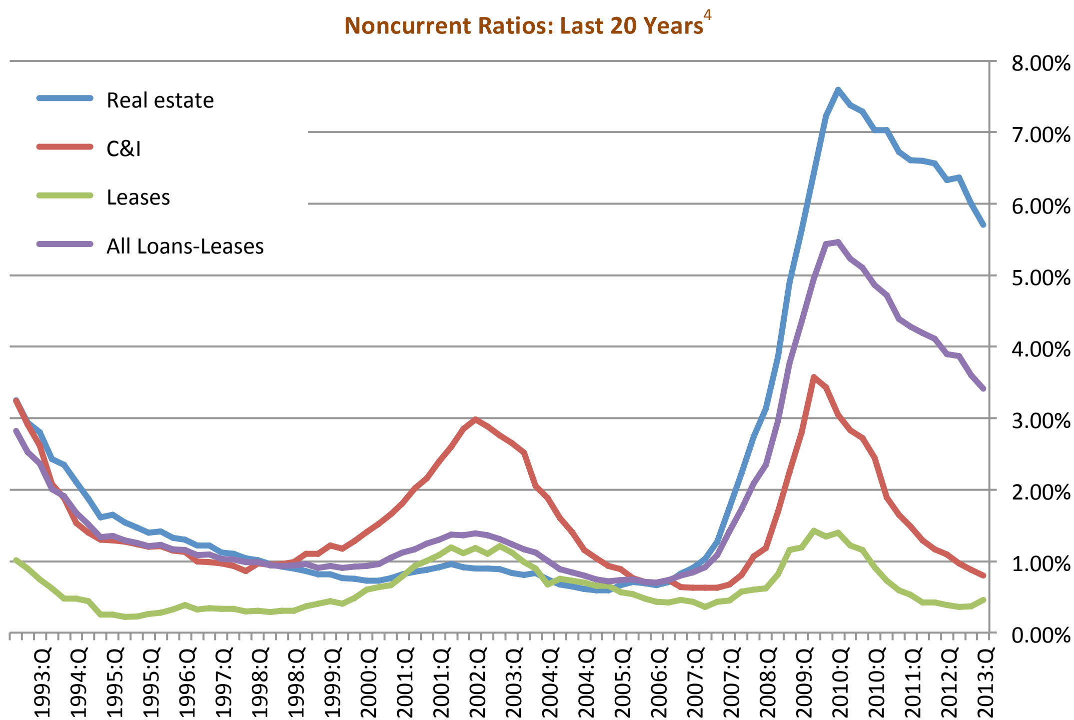
1. Leasing Is Too Risky.

Not really, at least according to the latest data from the Federal Deposit Insurance Corp (FDIC). In fact, no single asset class has outperformed leasing in the last 20 years.

That bears repeating: In the last 80 quarters, leasing is the safest asset class in a bank portfolio. Leasing beats residential mortgage, multifamily, commercial real estate, consumer lending and even C&I lending.

Nonetheless, banks remain addicted to real estate. For the last 25 years, the number of banks with a specialty in commercial real estate lending has increased from 2% in 1984 to 24% in 2011.[2] During the same period, banks with CRE or mortgages as their main specialty were the worst performers by pre-tax return on assets. And four out of 10 (40%) community banks that increased their CRE loans to greater than 30% of total assets during that time failed.[3]

How many times have you heard, "Well, at least I got the dirt." As we saw in 2008, if you were heavily invested in real estate, that's about all you had. How'd that work out?



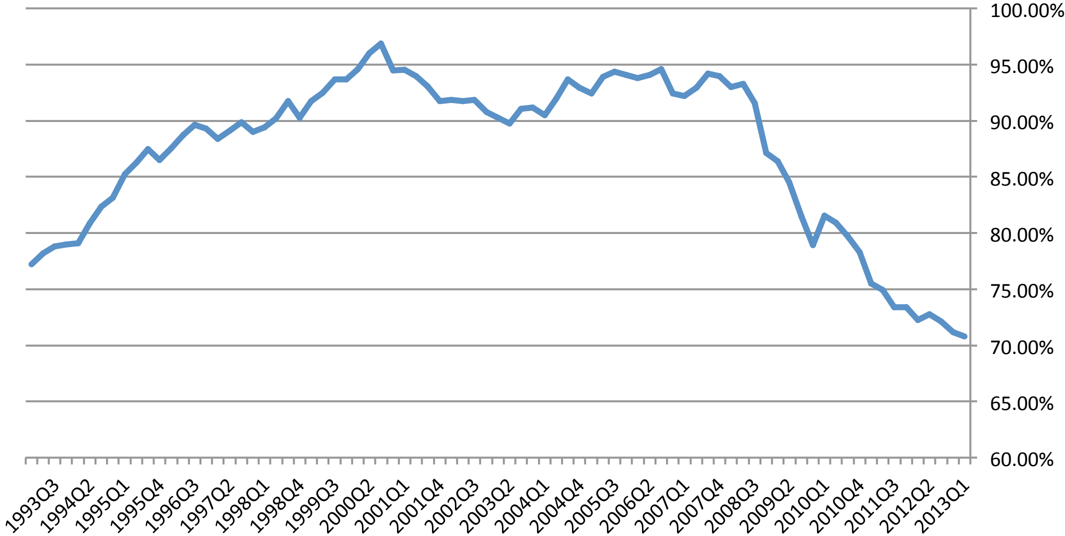
2. Our Pipeline is Full.

As banks mend their beleaguered loan portfolios, they face a new issue: meager loan demand. Since the FDIC first started reporting consolidated loan-to-deposit (LTD) ratios in 1984, the banking industry has never seen LTDs this low – that's 29 years (116 quarters).

Yet, you wouldn't know it from talking to lenders. Pipelines are full and robust, they report. But the numbers don't lie. No one is borrowing, especially small businesses. So where's the disconnect? Lending officers might think they are on to some hot prospects but in the end those pipelines could be overstated. We've all been there. Sometimes borrowing decisions are delayed for legitimate reasons: new management changes priorities, client needs change or the client simply can't make a decision. The fact is that the longer a lending opportunity languishes in a pipeline the more likely it is to die.

Now consider the equipment finance industry. Annually more than $700 billion a year in fixed capital and equipment is financed via operating or capital leases. That business is left largely to money-center banks and independent finance companies. Most regional and community banks, in need of earning assets, do not offer the solution to their business customers. Apparently they have too much going on (although the graph below suggests otherwise).

Loan-to-Deposit Ratio: Last 20 Years[5]



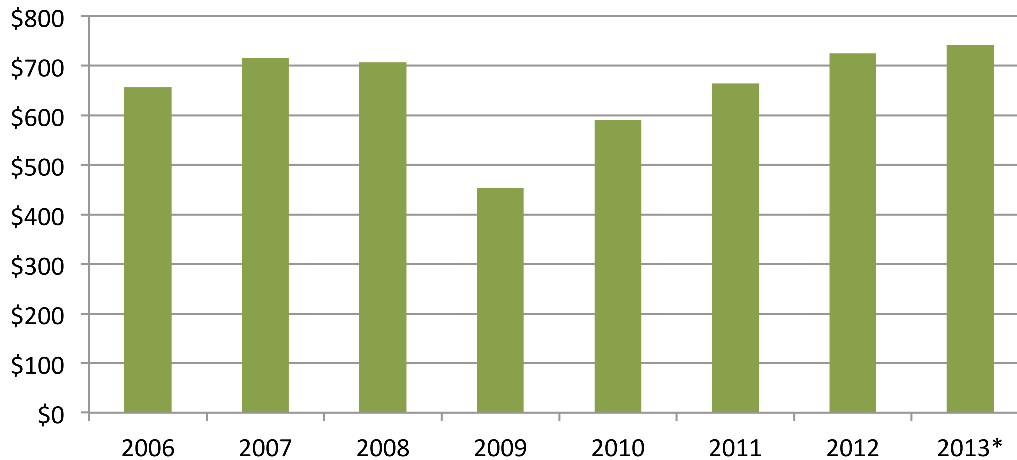
3. Our Customers Don't Lease Equipment.

In many cases, lenders assume that their commercial customers don't need leasing because they never ask for it. Or, they think that an equipment loan is identical to a lease. In both cases, the lenders would be wrong.

The Small Business Administration estimates that more than 80% of all U.S. businesses lease some equipment. The leasing industry is enormous. Every major segment of the U.S. economy utilizes leasing in some form – from agriculture, aircraft and construction to manufacturing, IT, healthcare, medical, energy, railroad and trucking.

Still, because they already provide financing for a warehouse or an office building, bankers think they have all of their customer's business when, in actuality, they do not. Don't believe it? See for yourself with this easy, three-step process.

First, identify your top five C&I customers. Next, order a standard UCC search from the Secretary of State. Finally, count the number of finance providers on each report that aren't you. Just because you're not providing a leasing solution doesn't mean your customers don't need one. Chances are they are soliciting term sheets from a variety of financing alternatives, including manufacturers (John Deere Financial, GE Capital, etc.), local leasing companies and (worst of all) your direct competitors.



Source: Equipment Leasing & Finance Association (ELFA)
* ELFA estimate

Lenders often mistakenly equate leasing to lending. "Why would my customers lease when we can do a loan for them?" is a common question. Though similar, loan and lease structures can be quite different. In fact, the differences are too great to list here. Safe to say, however, that for certain assets like IT the flexibility of lease structures, especially operating leases, often fits the needs of businesses better than a traditional bank loan.

4. My Competitors Don't Offer It – Why Should I?

True, most banks have been late to the leasing party—but the attendee list is growing. According to the *2010 Survey of Equipment Finance Activity*, banks generate 49% of all equipment financing and leasing activity in the U.S. Yet, most of that activity is from money-center banks. Banks with less than $1 billion in assets make up a very small portion of that total number.

Nonetheless, as researcher Scott Wheeler discovered in a study for his 2011 white paper *Community Banks and Equipment Finance – What It Takes to Be a Success*, that while many community banks were not presently in the equipment finance space, he found a large majority of banking executives were open to exploring the potential of equipment financing and leasing assets. Wheeler, a respected bank consultant, explains that "the strongest and most forward-thinking community banks will embrace the opportunity to enter into or expand their current participation in the commercial equipment finance and leasing industry."[6]

Certainly, barriers exist to enter the equipment finance industry. Moreover, some community banks might never have the resources, energy or necessary buy-in from internal constituents to execute an effective leasing strategy. However, community banks have a variety of inexpensive ways to enter the space without hiring an entire leasing team. From sending existing customers to outside leasing partners for a referral fee, to lease discounting and private-label leasing solutions, community banks have ample opportunities to deliver value to their customers via commercial equipment financing.

Conclusion

Certain myths and misconceptions regarding equipment finance exist within the banking industry. Yet, as we have seen from the data, the underlying issues are not that leasing is unsafe or unwanted. On the contrary, leasing is a safe and robust asset class and the industry is only getting bigger. Unfortunately, most banks simply are not properly equipped to offer and administer the solution to their customers – just like they weren't properly outfitted to provide Internet banking a decade ago.

With Internet banking, banks did not suddenly become IT experts to develop a solution in-house. Instead, most partnered with outside providers that helped develop solutions that worked for them. Similarly, the solution to equipment finance often requires banks to look to outside resources and third-party experts to help them develop a safe, effective offering to deliver to their customers.

Of course, the hope is that banks of all sizes come to the realization that equipment finance is nothing more than another C&I product offering for their customers. Like Internet banking, equipment finance is not a passing fad but an effective finance alternative for commercial customers for years to come.

About the Author

Tom Grady serves as Vice President, Capital Markets for K2 Capital Group where he is responsible for developing and managing partnerships with banking institutions across the country. Prior to his current role, he has worked with companies in a variety of industries, primarily in banking, finance and asset management. He holds a bachelor's degree in English from Saint Louis University and a master's of business administration degree from the Freeman School of Business at Tulane University. He can be reached at (952) 224-2479 or tgrady@k2capitalgroup.com.

References

[1] Fox, S., Pew Research Center, August 7, 2013,

[2] 2012 FDIC Community Banking Study

[3] 2012 FDIC Community Banking Study

[4] Federal Deposit Insurance Corp. Q1 2013

[5] Federal Deposit Insurance Corp. Q1 2013

[6] Wheeler, S., *Community Banks and Equipment Finance – What It Takes to Be a Success; 2011.*