


Ears to the Ground, Eyes on the Horizon

Lessors are guarding their portfolios against future harm.

By Susan L. Hodges

Peg Maloney might not think of herself as a surveillance specialist, but these days, she spends a lot of time watching. It's not that she waits for an enemy to blink or a chick to hatch from its shell; Maloney is senior vice president of credit at Key Equipment Finance (KEF), and her charge is the company's small-ticket portfolio. "We're in the mode of evaluating exactly what's going on," says Maloney, who is also chair of ELFA's Credit and Collections Committee. "We haven't tightened our credit yet [at KEF]," she explains; "we're just watching it closely. And we're probably more focused on it than we were even six months ago."



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Welcome to Credit 2007, where risk managers across the industry poise over their portfolios and credit managers hover over their credit models in painstaking efforts to balance caution and underwriting discipline with opportunities for solid new business. “Everyone is just very cautious,” says Maloney, speaking of the industry as a whole, “and evaluating whether there’s a deterioration in the quality of applicants or in their performance.” At this point, she adds, KEF is not leaving any deals on the table, nor has it noticed any specific trends in delinquencies or charge-offs. KEF tracks the amount and quality of business its vendors bring in monthly, and so far, Maloney says there is not enough [downward] trend information available to change the strategic credit policy.

But information provider PayNet has some facts on this emerging trend. In the small and middle markets, data from PayNet shows risk is up from one year ago by 50 basis points on average in terms of defaults for 30-day delinquencies. This is a 10 to 20 percent increase over delinquencies a year ago.

Bill Phelan, president of PayNet, also observes a shift starting to occur in the market between the riskiest lenders and those that are more conservative. Higher-risk lenders

are experiencing even bigger spikes, he says, while lower-risk lenders are seeing only a small up-tick. “This is a phenomenon we saw during the last downturn in 2001,” says Phelan. “The delinquency performance difference between the highest risk lenders and the lowest risk lenders widened dramatically.” He also notes that credits in higher-risk segments like transportation are showing a bit more deterioration than those in more stable markets.

No wonder established lessors and financiers seem excessively careful now. As recently as 2000-2001, many companies entered markets they knew little about and wrote deals at prices and terms that would be unthinkable today—just so they could place business on the books during a recessed economy.

No one wants to make the same mistake again, and executives at the firms interviewed for this article say that so far, they haven’t. Delinquency rates are creeping up in transportation, for example, but lessors say portfolios are still robust and that they’re determined to keep them that way. “This is not a time when we’ll look back and call our underwriters a bunch of cowboys,” said a lessor at the recent Industry Future Council conference. “I think we’re at one of our strongest times as an industry.”

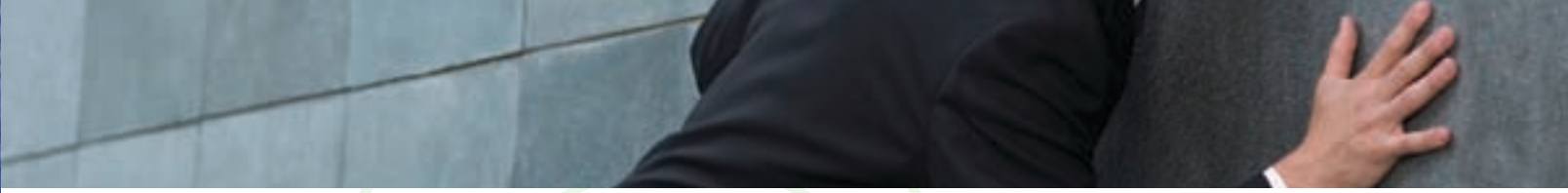
Intensity in Small Ticket

He might be right. The strategies of Mary Wynn, assistant vice president of collections at Hitachi Capital America Corp., Norwalk, Connecticut, exemplify the wisdom being applied in some areas of the market. Wynn isn’t seeing defaults, but she is seeing an increase in requests for restructuring, especially in construction. “We tell our customers to call us if they’re having a problem, because then we can work them,” Wynn says. And calling they are, saying business has slowed and they’re unable to make their payments. “But before we’ll restructure, we have to bring them current,” says Wynn. Once this is done, the contract can be redrawn so that for several months, the client is allowed to pay interest only.

At the same time some distressed clients are looking for more lenient terms, Wynn says others are seeking more credit. “I have credit analysts come to me daily about clients [who are behind on payments, but] asking for another deal,” she says. “We have to say we’re sorry, but until we collect our money [on the first deal], we won’t be doing another one.”

Formerly focused on large ticket, Hitachi Capital America Corp. transitioned into the small ticket market two years ago. Wynn says business has since “exploded.” But she also says the company is taking the long view on every opportunity presented: “We’re not interested in mortgaging our future trying to chase a quick dollar.”

This kind of restraint is reflected in ELFA’s Monthly Leasing and Finance Index (MLFI-25) for this past November: at that time, credit-approval ratios stood at 78 percent of all deals submitted. That number was the lowest reported for 2006, indicating that



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enough good-quality deals were still available to prevent any measurable tightening of credit.

But how long this abundance will last is anyone's guess. ELFA Chair Valerie Jester, president of Brandywine Capital Associates, Inc., an independent small-ticket company in West Chester, Pennsylvania, already sees a few chinks in the fortress of due diligence. "The market is so over-

capitalized that the drive to fill the demand for business on the funding side is creating some sloppiness," she says. Deals in small-ticket are so plentiful that players "have little reason to be creative, because they can move on to the next transaction, and the next one after that." As a result, some funders' demand for volume is beginning to overshadow due diligence.

Jester says most of these deals

involve the purchase of paper on a third-party basis and are based purely on rate. Customers are bringing this business to whomever has the least stringent requirements—and many times, the takers are new entrants to the industry.

"True, established players in marketplace are not the problem," says Jester. What she sees is quasi-educated community banks and others that are being brought into the marketplace by those who originate for them. And these originators, she says, do whatever works best in the field.

Currently, the impact on established small-ticket leasing and finance firms is a loss of some business. But since certain funders work with both new and established lessors, Jester worries that down the road these sources of capital "may start getting a



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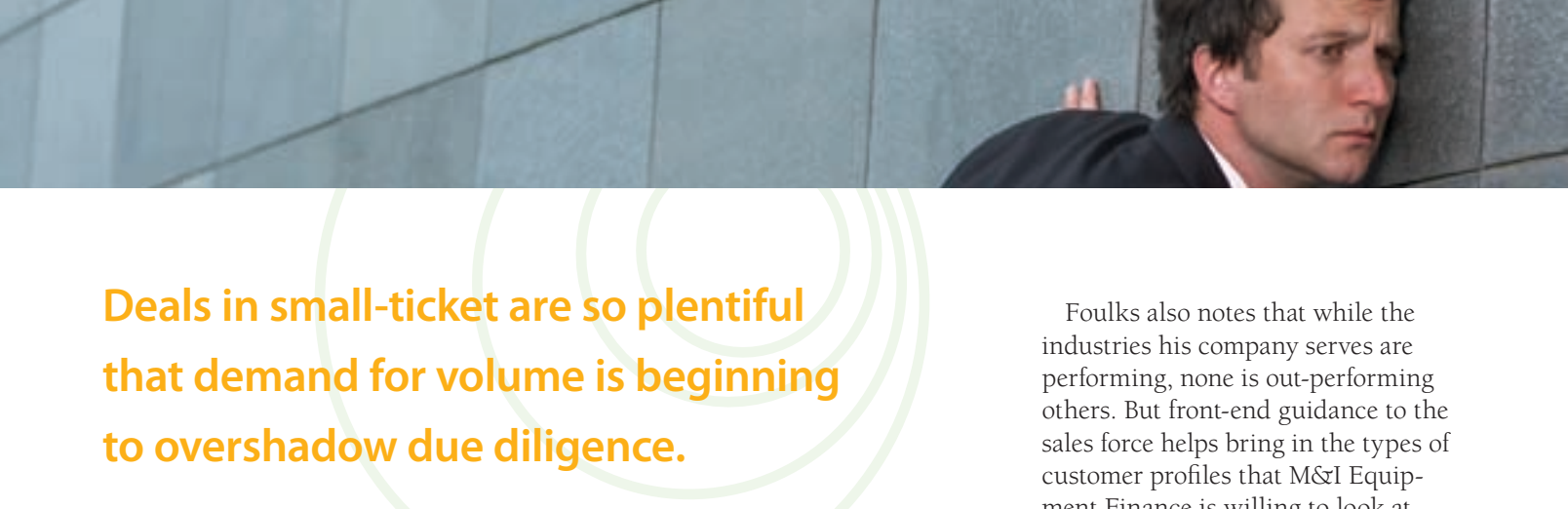
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Deals in small-ticket are so plentiful that demand for volume is beginning to overshadow due diligence.

bad taste in their mouth,” and if they do, she suspects they won’t differentiate between newer and veteran participants, and will withdraw from the market altogether. Says Jester, “We need to be constantly aware that the big supply of money could dry up tomorrow. And then what will we do?”

Moderation in the Middle-Market

The same concerns exist in the middle market, but seem a bit less pronounced. Jeff Foulks, vice presi-

dent at M&I Equipment Finance, a bank-owned middle-market firm in Milwaukee, says his company’s existing portfolio is healthy. “We are currently enjoying a very solid and stable credit environment,” he says.

That’s not to say the company’s credit analysts aren’t working hard. Foulks says that in transportation particularly, based on equipment values and residuals, they’re monitoring their portfolio closely for incremental business with transport companies. “We don’t want to get too concentrated in one market,” he says.

Foulks also notes that while the industries his company serves are performing, none is out-performing others. But front-end guidance to the sales force helps bring in the types of customer profiles that M&I Equipment Finance is willing to look at.

M&I isn’t the only middle-market company maintaining a balanced approach. Mark Lempko, general manager for the U.S. Operations of Alter Moneta, in Buffalo, says his credit department has been applying a consistent philosophy that has resulted in the need to say no whenever necessary. “We see the current U.S. credit environment as unbalanced. Due to the intense competition, price is not commensurate with risk,” says Lempko. “If a request doesn’t fit our risk-based pricing model, we say no.”

Alter Moneta has used the same



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model for eight years and doesn't plan to throw it out now. It withstood the tests of 2000-2001, when the company experienced a slight increase in delinquencies and loan loss, but Lempko says these were not significant. "Our model is battle-tested," he says. "We haven't been doing the deals that

Another Choice for Small Ticket Delinquencies

How does your firm handle delinquencies? Whether you use an internal collections department, an outside collection agency or a law firm, Bob Boehm wants you to know there's another way.

Boehm's company is TBF Financial, LLC, and it specializes in buying delinquent small-ticket accounts. "What we bring to the equation is certainty," says Boehm, TBF Financial's president. "Lessors who use us know that when 1- to 2 percent of their leases become uncollectible, they can get X percent out of those leases, depending on when they sell them."

In other words, TBF will buy your non-pays either before you send them to a collection agency or after an agency has tried to collect and failed. But the time value of money dictates that you'll receive a higher price for these accounts if they're still "fresh." Either way, lessors "know they can get a good price from us," says Boehm, "and this is found money that goes right to their bottom lines."

Boehm says his business is growing; that certain of the largest companies in the industry now sell their delinquencies to TBF. And why not? There seem to be several advantages to doing so. Not only are firms paid a percentage for accounts that would otherwise be charged off as zero; internal collections professionals are also freed up to spend more time working accounts that are 30 to 89 days old, thereby potentially reducing the number of delinquencies that occur. Companies may even be able to redeploy their collections professionals or reduce head count. What's more, all the processes associated with trying to collect after 90 days are eliminated, freeing up resources ranging from paper and postage to telephone lines.

Boehm emphasizes that TBF Financial works only with accounts under \$100,000. But he offers a suggestion for lessors with delinquencies of any size: that they work to elicit a payment guarantee, especially from new customers, before approving transactions. "I've told this to lessors and sometimes they reply that their competitors aren't doing this," says Boehm, "but I know of companies that will only do deals if they get a guarantee." The upshot: If you ask for a guarantee, you may get one—and create another tool to reduce your risk.



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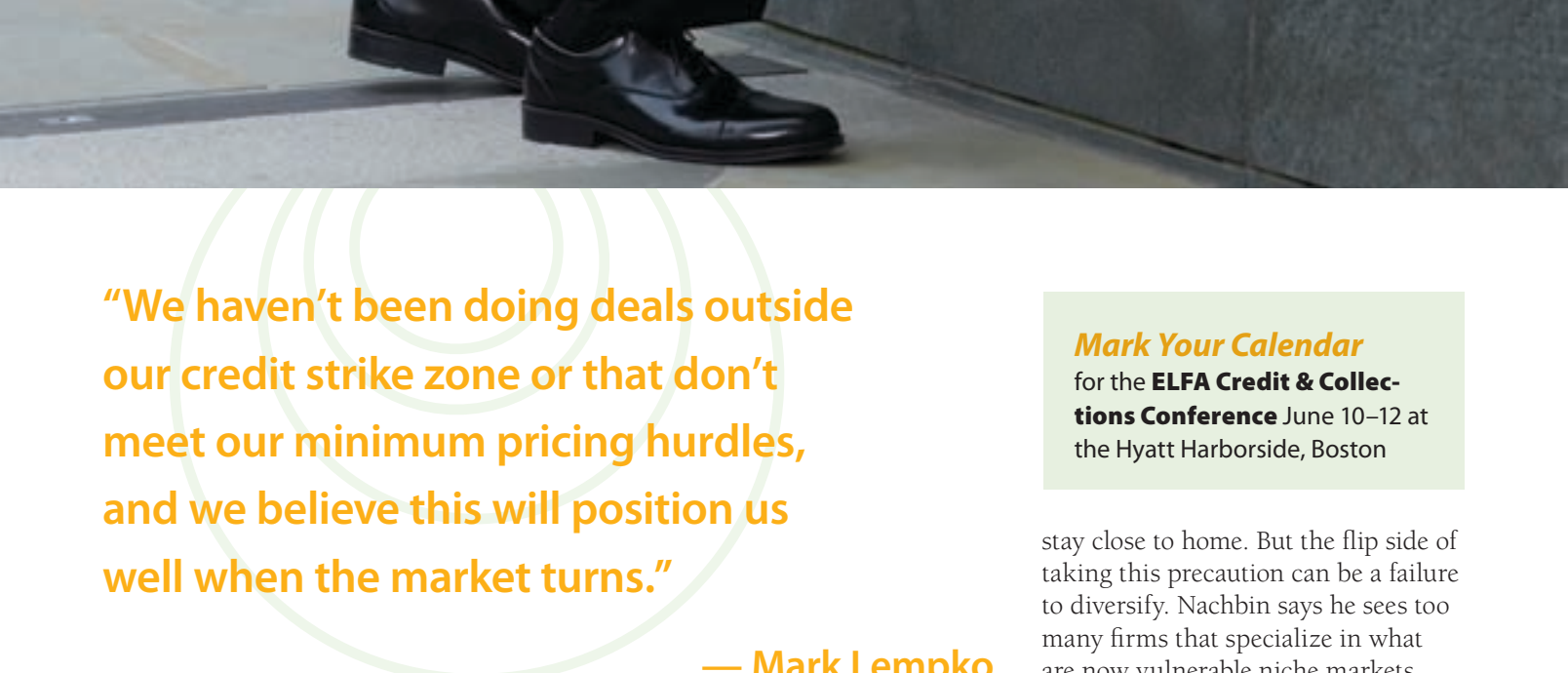
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“We haven’t been doing deals outside our credit strike zone or that don’t meet our minimum pricing hurdles, and we believe this will position us well when the market turns.”

— Mark Lempko

are outside of our credit strike zone or don’t meet our minimum pricing hurdles, and we believe this will position us well when the market turns.”

Status Quo in Large Ticket

In contrast to smaller borrowers, larger businesses typically don’t show credit deterioration early, and this is the case now. Orix Financial Services, Inc. in Kennesaw, Georgia, no longer originates, so Senior Vice President David West cannot comment on credit conditions of deals currently available. “But I can tell you generally that for our large-ticket exposures, we’re not experiencing anything of a significant deterioration,” he says.

The longer delinquencies continue to inch up, though, the greater the chance big-ticket companies will feel the pinch. “If this problem sticks around for a year or so,” says Bill Phelan, “large companies will probably begin to show deterioration in their performance and ability to meet their obligations.”

Whether your firm is feeling comfy or concerned about its current credit situation, Cherry Hill, New Jersey-based Joe Nachbin, a principal at corporate consulting and advisory services firm The Alta Group, suggests several steps you can take to protect your portfolio even further.

“You need to look at the key things that drive your business (credit approvals, charge-offs and other profit factors) and keep focusing on them,” he says. Managers in each function area should be given performance metrics, and employees informed about their responsibilities to help meet those numbers. “Then you need to create a compensation system that rewards [achievement of] the metrics you want,” says Nachbin, adding, “Sometimes we see companies that are still using old metrics to reward business goals they no longer have.”

Nachbin says the need for suitable metrics is being made still stronger by private-equity investors who are demanding key performance data. “These investors are used to being able to judge how a company is doing,” he says. And when they don’t see numbers on book-to-look, book-to-approval rates and sources of delinquencies, they ask for them. “Equity investors want you to be able to slice and dice your information in many ways,” adds Nachbin, “and we’re seeing a lot of clients who don’t know what factors they should be measuring to come up with these numbers.”

Conversely, however, The Alta Group is seeing more leasing and finance companies that “know what they don’t know.” Rather than enter markets in which they have no expertise, more companies are choosing to

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stay close to home. But the flip side of taking this precaution can be a failure to diversify. Nachbin says he sees too many firms that specialize in what are now vulnerable niche markets, like auto leasing. “If you’re not going to diversify, you’d better know your residual values, how to obtain them, and how to measure them,” he warns. Leasing firms in the auto industry, at least, can no longer afford to compete with manufacturer programs by taking aggressive residual values.

Nachbin also has a tip for collections managers: don’t reward your people for making a certain number of calls per day; reward them instead for results. “You can make hundreds of calls a day, but if you don’t get any promises to pay, it doesn’t matter,” he says. By the same token, you can elicit promises from a dozen customers a day, but if those promises aren’t kept, your delinquency rates won’t show improvement.

Another consideration: if you’re spending most of your time calling those who are just 30 or 60 days behind, you may be keeping delinquencies from increasing, but you’re not doing enough to resolve the ones you already have.

By fortifying themselves in the current credit environment, then, lessors and financiers can do much to guard against slings and arrows that might be launched in the near future. After all, it was Cervantes who said, “To be prepared is half the victory.” ■

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