The Rise of Independents, Decline of Captives in LAR
A podcast transcript of Jon Fales' interview with Rafael Castillo-Triana concerning the 2017 LAR 100 Report.

Jonathan Fales: Hi, and welcome to The Alta Group podcast. I am your host, Jon Fales, and today we get a chance to speak with one of the principal authors of the annual LAR 100 Report, Rafael Castillo. Rafael is CEO of Alta's Latin America Region. And today he'll discuss several surprising and interesting trends he observed in Latin America equipment leasing, over the last 12 months. Hi Rafael. How are you?

Rafael Castillo-Triana: Fine, Jon, thank you very much.

(Discussion about past event of Hurricane Irma's potential impact not included in this transcript.)

Jon: Look, the purpose of our podcast today is to talk about the recently released LAR 100. Rafael, a lot of our listeners have probably heard of it, but may not have seen a copy. Some may not have heard anything about it at all. So could you tell everybody what exactly the LAR 100 is and what it contains?

Rafael: Okay, good. The *Alta LAR 100* is actually a ranking of the largest equipment in financing companies in Latin America. The LAR, you know, is an abbreviation for Latin American Region. And we decided around 15 years ago to start gathering data about the main players of the equipment leasing and finance industry in Latin America, and build a rank around that. A ranking.

Based upon what we have been gathering, a lot of interesting information comes out. So what we're covering is, who are the largest players? What is their size? What is their profitability? How fast they grow? What is the behavior of the corresponding countries and what are the drivers for growth or not, in each of the countries? And it becomes a very interesting exercise. After we released the first report, we actually received very good feedback from all the key players in the industry worldwide. This became the only source of information and competitive intelligence for the equipment leasing and financing industry in Latin America.

Jon: I had forgotten, Rafael, that you've been doing it for so many years. I know it had been out there for a good while. You've had a chance to see trends over the years and so forth. What would you say are the key takeaways from this year's report?

Rafael: Well, it's interesting. Back in 2012, we hold an annual conference in Miami, where we gather most of the players of the industry. And we share with them the details and drill down on the conclusions from the report.

In 2012, the main thing was the Mayan Calendar, you know, remember that it was believed that probably the world was going to end in December 2012? And many books and movies were prepared around that. But what that meant in reality is that there would be substantial change in the way life happens.

That reflected into the equipment leasing and financing industry, meaning a major shift in the business model of leasing companies. This is exactly what we have been observing increasingly in the last five years. The industry has achieved a level of maturity where the finance lease product went onto the backburner. And in the front burner we have innovation through operating leases.

Most of the players are moving in that direction, because in operating leases they can really create more value and capture more value that drives their profitability. Also we are anticipating that the next step of the evolution of the operating lease is the servitization of the business. Meaning that now companies are combining services, incorporated in bundling services into the value preposition and that goes beyond financing. So this is what we are currently experiencing. This is the first trend. This trend shows winners and losers. Certainly there is a space on the banks. And the winners are independent companies that are fed by capital.

In the case of Latin America, the capital has three basic sources. Which are family offices, private equity firms and there are some institutional investors like insurance companies that come into the business. But banks are fading away. We don't complain about that, you know, that's a reality. The thing is that the business models of the banks are changing.

Jon: Rafael, let me ask you a question about that. I mean, I think people can understand why the banks are going through that. The regulations and requirements are so intense worldwide. But it's not intuitively obvious why the captives would be pulling back and the independents would grow. I mean, captives typically are the ones that do provide financing in most of the rest of the world. Why are you not seeing that in

Latin America?

Rafael: This is very interesting and I was a little bit amazed when we saw the results. Some explanations for that: One is another amazing finding that we made. Most of the captives operating in Latin America traditionally, were U.S. captives, I mean, the affiliates of U.S. manufacturers, such as Caterpillar Financial, HP Financial Services, IBM Global Financing, and so on and so forth.

Well, later on when we started looking at who are the players that are actually selling equipment into Latin America, we are finding that the main source of equipment in most of the areas is China, not the U.S. That's one of the explanations of this. The second one is something that is more related to the strategy of the parent companies.

Captives have generated issues in terms of revenue recognition. When the captives provided financing, it is very difficult for the parent company to really, you know, isolate the financing and the retention of risk, for the purpose of recognizing revenue. So, we have seen the tendency of many players including, for example, Caterpillar Financial, that have started to outsource their customer financing to third parties. So, what the captives should have done on their own, currently is outsourced to many third-party players. Most of them are independents.

Jon: We also had a note for people that are not familiar with the Chinese leasing market. That China captives do not...there are basically aren't any China captives to speak of, there is a few. But very few of them are doing international leasing. Isn't that your experience?

Rafael: That's exactly right. What we are seeing about the presence of China in Latin America, is just because Chinese banks have acquired some Latin American banks. But out of our list of 100, we have only two banks that are controlled by Chinese companies. And that's an interesting concept, because if you take a look at the Fortune 500 data that was recently released, out of the 500 Fortune companies, 109 are Chinese.

So it's interesting how things are moving. It seems that in the way of the financing, especially in the space of equipment leasing and financing, the Chinese companies are a little bit behind, and then there is, of course, a lot of good examples of what the U.S. market has been showing to them. So probably that's something that in some years from now may change, and we will have more activity from the captive

Chinese companies. But not today.

Jon: Right. Interesting, very interesting. All right. So rise of operating leases is one trend. Rise of the independents and the decline of the captives, at least short-term, was the second. What are some of the takeaways in this year's report?

Rafael: There is an interesting growth of the participation of real-estate leasing among the total investment. This is interesting for many reasons. One of them is most of the countries in Latin America are increasingly urbanizing themselves. I mean, people are moving more and more to the cities. And the cities are generating a lot of demand, in terms of investment and in terms of life quality.

So many players started to venture with the help of...of course of the economic policy. The help of the governments, in the case of Chile, Columbia, Peru, started to move into the space of real estate leasing and that space covers two areas. One is the traditional commercial real estate, you know, offices, buildings, industrial plants, shopping malls, whatever you want.

But on the other hand, there are also households. Households at the beginning were a little bit difficult to get into the scene, because it seems to be more consumption-type financing than investment. But overall and especially with the support of the governments and economic policy in these countries, and I mentioned in especially Chile, Columbia and Peru, you'll find that they had been growing very fast and that is creating an interesting profile. Which, by the way, is very similar to what we see in Europe, when Leaseurope releases their data. They also have a large representation of real estate leases. So this is an area that is growing, it's an area of innovation. It's a little bit tricky from a standpoint of credit risk management. But it's certainly something that we anticipate, that we'll keep growing and it had been growing in the last five years.

Jon: Interesting. I wasn't aware that the amount of real estate leasing in Europe was as big as it is either. But you'd mentioned that before too. Rafael, another area that you'd mentioned was regulations. I mean, that's a big deal, pretty much anywhere in the world. What has the role of regulations been in Latin America?

Rafael: Well, you know, I would say that it's a role of counter-intuitive if you want. I mean, regulations have generated an opposite reaction to what they wanted. You know, the bank regulations are intended to increase financial inclusion, financial penetration. In developing emerging markets, it is a priority that more people should have access to credit.

But with the recent regulations, especially Basel III, what has happened is exactly the opposite. The banks decided to become more risk averse and they started to migrate out of growing in some sophisticated businesses like financing capital goods, which is, by the way, the engine of the economy.

So, the good news about that is that because regulators are not concerned very much about the crazy practices of people who assume a risk or something like that, then that opened the door to the independent companies to come into the scene. But different from the past, independent companies in the past, were companies not subject to any checks and balances. Today they are. They go to the capital markets. They are credit rated by the credit rating agencies. They issue a paper in order to get funding and they are accountable and publish their financial statements. So we can really measure them in terms of their efficiencies, corporate governance and so on.

So, all the effects that are pursued by a regulation are being taken care of by the market itself. So regulation is funny, because regulations are basically focusing on the banking system. And they are basically appreciating the banking system, when other players are coming in. There have been a lot of regulations in Latin America.

Jon: Rafael, a related question. What is the availability of the syndications and securitization market in Latin America, to small and medium-sized independent lessors? Is that a viable way to provide capital into the business?

Rafael: Nowadays, it is. We see, for example, in Mexico, there has been...because the market is very liquid today and, you know, that's the key issue when you go into the capital markets. If there is liquidity, the capital markets are going to be eager to provide, you know, tools for players, even if the originators of the leases are not too big. This is happening today.

A lot of small and medium-sized independent companies are issuing securitizations, that are called in Mexico the Bursas. But we can also see the same feature in Argentina, and in a way, we also see that in Brazil with the so-called debentures.

In Argentina, what they use are trusts, which are basically securitization. The trust issues paper and they place it either through a private placement or through the capital markets. Again, the originators are not necessarily large companies. Could be medium-sized or even small leasing companies and that's a way that, I say, I currently found in the deals.

Jon: That's fascinating. You know, it's interesting with the Chinese beginning to be more pronounced in Latin America. That's one thing. The Chinese lessors could learn from their Latin America counterparts. Syndication, securitization has been ongoing in China for years. But typically only for the bigger players, you know, I spend a fair amount of time over there. The small and medium companies just cannot use that as a tool at all. So it's good that their Latin American counterparts can though.

Rafael: Yeah. But there is a voice of caution with that, Jon. Which is after Ms. Yellen's doing her work to reduce liquidity and the Central Bank of Europe agrees on, you know, terminated the quantitative easement that is happening around the area. Probably liquidity is going to become scarce, and the situation may change.

Jon: Well, that might be the subject of a future podcast then. Those events are pretty fluid right now as we all know. Rafael, one last thing. We talked about this earlier. Another trend that you noted was that investors in the market, the profile of the investors is changing, and that we are seeing fewer U.S.-based investors and a return of the Europeans. What's causing that?

Rafael: That's interesting. You know, we have been from different angles approaching this, you know, the situation in the last five to seven years. We started to observe that the former main players of the leasing industry, U.S. Leasing International, you know, was the most important player who expanded the leasing industry. And has been followed by companies like AT&T Capital, Newcourt CIT.

There is a long list of companies that, you know, went on to become real multinationals. Eventually, these companies decided to come back home, several years ago. It was not with the last administration, making “America Great” is not new. That was a corporate strategy many years ago.

But in the mean time, they opened spaces to some other players that are really in a growing mode. We see, for example, that French banks, Spanish banks like Santander, BBVA. French banks like BNP Paribas and Societe Generale. We are watching also the expansion of the German banks and some U.K. banks. Although they are also in the same backwards mode, because of Brexit.

We see these continental Europe invasions again. We call this, you know, the second phase of the Conquistadors, coming back into Latin America. Taking away the spaces that were left free by the U.S. companies that migrated. And taking advantage of the fact that they have more expertise, know-how in the business and a bunch of global relationships. So in a way, they are eating the lunch that the Americans left. This is exactly what is happening today.

Jon: Eating the American's lunch that they left. That's great. One thing that occurs to me, too, is that culturally, I think the Europeans generally--European banks specifically--probably are a closer cultural fit with many of the Latin America lessors and banks there than the American counterparts. Would you agree with that?

Rafael: Well, it's funny. In principle, the answer is yes. I mean, because you compare the law, the legal systems are very similar. All these countries are managed under civil law systems. But when you start drilling down in the way as business practices behave and the management styles, you find an amazing predominancy of U.S. management style.

A lot of the CEOs and members of the board of directors of leasing companies were relocated, either in Harvard...excuse my pronunciation. Yale. I don't mean prison, I mean, Yale University out of Connecticut. All these Ivy leagues. So they have a management style, which is basically U.S. management style. And that creates when the Europeans come, that creates a cultural clash between the Europeans and the Latins. Yes, you go to the law and, yes, there are a lot of similarities. You go to the language and certainly there are similarities. I mean, French can understand Spanish easier than they can understand English.

But anyway, there are some gaps and they need to get used to these different gaps. Not to mention the gap that exist between the Germans and the Latin Americans. They are two different worlds. But the Germans are fascinated with all these “indiscipline” and lack of order that they find in Latin America.

Jon: Lack of order. Another question. We really haven't covered this yet. Brazil has been going through some big economic challenges. And that's been reflected both in their economy and also in our industry and the reduced volumes there. What's your observation on what's going on in Brazil from an equipment financing standpoint?

Rafael: You know, it's a perfect storm. There are many different winds blowing there. One of them is certainly what has happened with the economy in terms that they reduce the demand for capital goods because of the down-turn in the economy. That happened, that was fueled in a way by the fact that China in the last...prior two years, I would say. Because now they are coming back to the market and that's the reason why Brazil is growing again. But China was a little bit out of buying more commodities that were produced by Brazil. So that led in a way to a reduction in investment. That was one of the main factors. The second factor is the syndrome of the “spoiled brat child,” that I will call. The leasing industry was a “spoiled brat,” always favored since 1973, with tax deduction that was unconditional to all lessees. Whether the lease was a final lease or a final operating lease.

Many other countries changed the rules and they forced their industries to become more innovative, and to invest more in their know-how and to grow and create alternative business models. Brazilians didn’t do that, because it was too easy to get customers. Because of that, you know, talent went away. I mean, if you do the same thing every day and there is no incentive for you for innovation, you walk away and probably you start, you know, a different business. Probably a dot-com, Fintech. Anything else because leasing is not fun. In all the other countries leasing is fun, because you have a lot of challenges.

So that was part of our...we saw a lot of immigration of talent. And because talent immigrated, then the leftovers went to the typical approach to say, "What's the difference between a leasing business and any other bank business?" So the second, a storm that came into Brazil was the new civil code. Well, not as new. It started in 2002. But it brought an alternative, financing a structure which is basically a guarantee trust. Where what can happen is that whoever wants to fund equipment, sells the equipment or transfers the equipment in trust to the creditor. So if the obligor defaults the creditor as trustee, can really dispose and sell the goods in the open market and pay the outstanding obligation.

So that became easier to implement, easier to negotiate and that has started to lead, especially in the banking world, the migration from the equipment leasing portfolio balance to the secured lending balance in the secured lending balance point. So that was the second major factor.

And the third factor is the government intervention. For many years, Brazil structure an economic policy based on financing local manufacturing. That created the measuring facilities in the government-owned bank that is called the BNDS. So, most of the players that finance equipment, they compete with BNDS. And of course their competition from BNDS, which basically found a small lessors, is something that in many cases conflicts with the purposes of, let's say, a U.S. vendor or European vendor, trying to sell their equipment using the equipment financing in the country. So these three areas led to the reduction in Brazil.

Jon: Wow.

Rafael: The compensation on that is that there is an emerging industry of non-regulated operating lessors. We have seen that to the point that currently in the 10 largest companies, we have...no. Sorry. In the 25 largest companies, we have currently three of these which is interesting. So banks are going down. But the independent lessors in Brazil are going up.

Jon: Wow! I see a future podcast here just on Brazil with you. Rafael, closing now. You mentioned that you've got your Latin America leasing conference coming up, and that is shortly after the ELFA Convention. Is it not?

Rafael: Yes, it is. Finally, we have to set the conference between November 8 through November 10. What we do is basically we use three days. The first day is a forum. Originally was designed to be a legal forum. But over the years, the SMBs asked to have something more pragmatic and not only legal. Something that could help them improve their operation.

So we undertake a kind of a workshop approach and there are many important subjects today because we are in the front door of two new accounting standards that are going to be game changers for the industry. And these are IFRS 16, which is the new accounting standard. But as you know, the general one that is parallel to the ASC 2016-02, which is the new accounting standard in the U.S. And we have also

IFRS 9, which is the new accounting standard for account receivables. And of course has to do a lot with the research of the portfolio, which also is a big game changer. So we are undertaking for that purpose of very comprehensive workshop to this, because what can be done and the change that must be done in the day-to-day operations in order to cope with these and the challenges of the market.

And the other two days, which are the ordinary conference. We are going to dedicate that to the evaluation of the profitability. How to generate profits and how the leasing companies in Latin America and compared with the rest of the world are generating profits. So what kind of returns of equity are they delivering? What kind of return on assets? What are the other metrics that they use? What are the tools that they are using in terms of funding, in terms of pricing, in terms of volume origination, and so on and so forth.

Productivity of the workforce. The combination of the use of the machine. You know, basic artificial intelligence and everything else, and how they are really using the systems in order to be more productive. That's part of the whole themes that we are proposing to have in the final two days.

By the way, we have a website, which is www.thealtaconferencias.com. It's a combination of an English...Spanglish if you want. But following that link, everyone can get the information about the events and registration and everything else.

Jon: Yeah. And we'll post that link on the podcast site too, for anybody that would like to access it from there. I've had a chance to go to the conference in past years and it's terrific. As far as I know, the only one of its kind that gets these many people from all over Latin America and from around the world that are focused just on the equipment financing industry. Good use of time. Rafael, any closing thoughts? We've covered a lot of territory here. But any thoughts you'd like to leave with everybody?

Rafael: I think that our main challenge nowadays, and not only in Latin America, but around the rest of the world, is that our business is suffering big transformations. One of the transformation is we must not ignore that this is still a global village. Even if everyone tends to behave in a different way. Even if we have the Brexit or make “America Great” again or whatever. This is still a global village. Whatever we do or cease to do, someone else, as we mentioned, is going to eat our lunch. Unless we really are vigilant and ready to innovate. Many challenges, but many opportunities at the same time. Technology is bringing challenges. But at the same time, it's bringing opportunities.

Capital is flowing, but we need to keep capital happy. And that's the reason why profitability is one of the main issues in the agenda. I think that that's a little bit of the takeaway that we get, as the industry is behaving today. I would say that we have a very bright landscape today and I hope that that should be that way for the future as well.

Jon: Me too and thank you. I really appreciate your time and your thoughts on a very rich and vibrant subject matter, which is equipment financing and Latin America. Rafael, thank you. I really appreciate your time.

Rafael: Thank you, Jon, and thank you everyone.

Jon: You can find links to download a summary of this year's LAR 100 Report and to the conference website, for the 2017 Latin America Leasing Conference. At our website, the thealtagroup.com. Our podcast are available on Apple Podcast, Google Play, Stitcher, TuneIn and from our website.

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