The Alta Group 2024 Insights

Introduction

Equipment finance companies entered 2023 with a mix of confidence and trepidation. Many companies were bullish at the end of 2022, with some reporting record business growth as end-user customers accelerated their equipment purchases before inflation increased the underlying cost of the equipment. But with inflation remaining stubbornly high and predictions of a looming recession coming from almost every direction—with little consensus about its timing or severity—there was an underlying tone of uncertainty.

In February, we began noticing a shift in focus away from pure growth, and toward increasing returns. Then in March, the dramatic failures of Silicon Valley Bank and Signature Bank showed us what a modern-day bank run looks like, as depositors acting on a flow of real-time headlines moved massive amounts of money with just the touch of a screen. The underlying cause of these failures was largely self-inflicted, either due to a concentration in crypto based assets or heavy investment in Treasury Bonds whose values plummeted as the Federal Reserve continued to raise interest rates.

The failures had a chilling effect across much of the U.S. banking industry that would last for the rest of 2023, causing banks to take steps to strictly manage expenses, reduce risk and prioritize deposit retention. With limited liquidity and capital to deploy, many banks shifted their strategies to focus on their core business and depository relationships. Toward the end of 2023, we even saw evidence of banks de-emphasizing their equipment financing divisions, reducing them from a material contributor to a simple product offering, if not exiting this market. Syndication markets either closed altogether or otherwise increased their pricing and credit approval criteria to limit the use of precious capital for non- core purposes. This put a damper on M&A activity, as banks had less capital available for acquisitions and limited appetite for acquiring or expanding an existing equipment-finance platform.

In contrast, the story was not the same for independent and captive equipment finance companies, who have benefitted from the retrenchment of the banks from equipment financing. Indeed, many independents closed out 2023 with record levels of business volume benefitting creditworthy borrowers abandoned by the banks or “Fallen Angels.” As 2024 brings a new set of challenges and opportunities, we expect to continue to see this shift of independents and captives taking on greater volumes of equipment financing business as a result of banks’ ongoing reevaluation of their presence in equipment finance.

Alta predicts we will see more of this fallout in 2024, and the Monitor100 rankings could look quite different next year, with lower overall industry volumes, and banks falling in the rankings while independents and captives rise as they welcome and support those abandoned bank clients. Against this backdrop, we examine the major headwinds and tailwinds that we believe will impact the equipment leasing and finance industry in 2024.

Headwinds

Uncertainty abounds.

An unpredictable economy, combined with a geopolitical climate in which wars on two major fronts are under way simultaneously, has many finance executives feeling far less confident about the scoring models and base assumptions that underlie their business. While a textbook recession didn't hit in 2023, there were many indications toward the end of the year of a potential slowdown. The first quantifiable measure was the Equipment Leasing and Finance Association (ELFA)'s Monthly Leasing and Finance Index (MLFI) which reported a 5% decline in new business volume year-over-year owing to high interest rates and tightening lending standards. In October, MLFI showed an even greater drop in new business volume of nearly 9%. This sentiment also showed up in the Equipment Leasing and Finance Foundation's October 2023 Monthly Confidence Index for the Equipment Finance Industry (MCI-EFI), which dropped to 40.1 from 50.3 in September. The October and November MCI statistics continued to demonstrate concerns around prevailing business conditions and expectations for the near future.

Macroeconomics still signal concern.

While the recession many were predicting at the start of 2023 didn't happen last year, it was certainly a year of economic volatility, with high interest rates, inflation, bank failures and the remnants of pandemic-era supply-chain problems in the first part of the year as major pressure points. The final months of 2023 offered evidence that the economy may have achieved the hoped-for "soft landing." While interest rates remain high, the Federal Reserve has signaled it expects to begin easing rates in 2024. However, industry leaders should note that many macroeconomic indicators still point to the potential for recessionary conditions in 2024. The December Equipment Leasing and Finance Foundation-Keybridge Recession Monitor signaled an imminent recession. Another data point is the fourth quarter AICPA & CIMA Economic Outlook Survey of Finance Executives, which revealed a 5% decline in optimism around the U.S. economy over the next 12 months. Top CFO concerns are inflation, prospects of a recession, softening in hiring and tightening of IT spending —hallmark actions of battening down the hatches in uncertain times.

Other factors weighing on the 2024 economic outlook include:

- Evidence of declining credit quality.
- Slowing global economic growth.
- Inflation that remains high, above Fed targets.
- Rising consumer debt and the restart of student loan payments.
- Energy price volatility.
- Two major wars.
- Supply-chain disruptions due to Red Sea turmoil.

Credit quality is challenged.

As 2023 began, key credit quality metrics such as delinquencies and charge-offs were strong and at historic lows. As the year progressed, we began to hear about pockets of deterioration and pressures on credit quality. Credit pressures on equipment asset classes were the greatest in trucking and transportation, where business fell off from the pandemic-era boom when trucks filled such a critical role in cross-country goods shipment. Manufacturing displayed a general softness, unspecific to any region or equipment types. Somewhat counter-intuitive to us was office equipment, which performed solidly, despite rising office vacancies resulting, in part, from the trend toward remote work. Borrowers in this sector are feeling good about their short-term business prospects.

Capital is harder to access.

The SVB and Signature Bank failures marked a major change of direction in the banking industry, and as 2023 ended, many banks continued to prioritize deposit growth over new business. In addition, many banks pulled back their Lender Finance businesses, creating liquidity issues for some regional banks and independents involved in equipment finance, although the impact was not felt uniformly across the board. This puts renewed emphasis on funding best practices that can increase resilience to economic downturns:

- Diversification of funding sources and mechanisms.
- Staggered long-term facility maturity dates.
- Maintaining a relationship with secondary funding sources.
- Open communication with lenders/investors.
- Real-time portfolio reporting.

Finance models are challenged.

High interest rates, paired with the overall impacts of inflation and wage growth in recent years, pose a challenge to the low-rate-based equipment-finance model that has dominated over much of the past decade. These factors could create an environment conducive to the return of more traditional equipment leasing. In fact, we're seeing many clients re-teaching their sales executives about operating leases— both the advantages in a high-rate environment and how to structure them. This refreshed skillset for today's sales teams is critical, as many of them have not worked in past high-rate environments.

Tailwinds

Inflation is ebbing, but remains significantly above Fed targets.

Economic indicators released in the third quarter of 2023 showed core inflation down significantly year-over-year (3.5% in October '23 versus 5.5% in September '22) and indicated that some durable goods categories were actually experiencing deflation. As core inflation moves closer to the Federal Reserve's target of 2%, the market is gaining confidence that interest rates have peaked—and toward the end of 2023, many started predicting when rates would start to drop. **The 2024 presidential election** introduces an additional political incentive to hold the line on interest rates.

Pricing has become more rational in equipment financing.

Industry, led by banks, is shifting away from intense focus on new business volume growth and year-over-year asset growth, and toward a heightened focus on risk-adjusted returns and overall profitability. With less capital available to lend, firms are not competing as aggressively on the price of financing. This puts less pressure on firms to be constantly cutting their margins. This could mean that while new business volume may be down in 2024, many companies may be more profitable, if we don't see a major deterioration in credit quality. Successful companies will continue to focus on diversifying their funding sources, a major lesson from the banking crisis of spring 2023.

Tighter credit creates an opportunity to reexamine leasing options.

The increased cost of financing means there is now a higher value proposition for true equipment leasing, for those who can successfully communicate that the risk is manageable. Companies also have an opportunity to grow revenues by offering new kinds of lease structures, managed services and equipment-as-a-service models. Continued advancements in predictive analytics and artificial intelligence will drive innovation in equipment-financing product offerings in 2024 and beyond.

Modest growth continues in many sectors, while new markets pose an opportunity for expansion.

We see growth coming from several different new and existing market segments in 2024, including:

- **Climate-focused equipment.** This emerging category is predicted to explode in coming years, with capital investment of the equipment estimated to be in the trillions in the U.S. alone. This presents vast opportunity for equipment leasing professionals to position themselves as the domain experts in equipment management from both an economic and sustainability perspective. Embracing this new domain requires commitment to a strategy to manage associated risks, ranging from technology performance to longer tenors to regulatory constraints. Companies may need to augment their capabilities in risk assessment and legal resources to understand national and local rules governing subsidies and tax credits.
- **Life sciences.** While the category of life sciences covers a broad spectrum of equipment, laboratory diagnostic equipment has been of particular interest to equipment finance companies. Several factors are driving this interest. Awareness of the importance of diagnostic laboratory testing has increased dramatically in a post-Covid world. In addition to initial high-dollar transaction values, some diagnostic equipment also retains substantial residual value. Strong secondary markets for this equipment have emerged with the advent of cannabis testing requirements in states that have legalized cannabis usage. In addition, over-penetration in other equipment markets has required equipment finance firms to seek expansion into new communities that include scientific and academic institutions. There

is also an advantage to equipment that lends itself to the creation of usage models for shared-use laboratories, hospitals, clinics, etc.

- **Pharmaceutical equipment.** As the U.S. attempts to boost domestic production of drugs and drug ingredients, this could also be a growth area in 2024.
- **Nearshoring**. This trend of moving supply chains closer to North American markets is also driving significant opportunities for equipment leasing firms to work with companies that make everything from automobiles to toys to electronics and semiconductors, as they pour hundreds of millions of dollars into new and expanded plants in Latin America.

Growth will also come from shifts within the industry. Independents and some banks will expand their existing vendor finance positions, taking advantage of those super-regional and regional banks shrinking their EF footprint.

AREAS TO WATCH

The march of regulations in our industry continues apace.

The promulgating of long-awaited regulations under Dodd-Frank Section 1071 continues to keep leasing companies on edge, but the good news going into 2024 is that thanks to the persistent efforts of the ELFA and other interested parties, an injunction has been imposed on any new 1071 regulations, at least for now. Lessors and lenders will not yet be required to gather and report to the U.S. Treasury Department extensive demographic details on their borrowers. It remains to be seen how long this relief will last, but it will give companies some time to get all the new financial disclosure rules under their belts before having to comply with another demanding and intrusive national regulatory requirement.

Speaking of which, the California financial disclosure requirements (perhaps the most detailed in the country) have now been in effect for a year, and New York has already passed that milestone. These being the largest markets in the country means that many companies, no matter where they are actually located, have found it necessary to comply with those rules, and many have already (at least partially) automated their compliance processes in this regard. Calculating and disclosing APR on every deal has been a challenge, as many factors unique to leasing must be taken into account; but as with regulatory compliance in general, practitioners are becoming more familiar with the disclosure requirements, and they are able to integrate the formalities into their sales and booking processes.

Perhaps the most difficult issue in pre-acceptance financial disclosures is turning out to be the plethora of new laws coming into effect in different jurisdictions (with different requirements) throughout the country. At least seven states have now enacted new financial disclosure laws, and at least seven more are considering proposals for such laws. There are some major and many minor differences from one state to another, ranging from exemptions and deal size all the way down to what size font must be used in disclosures; but although there has been discussion of a federal commercial financial disclosure law, it is likely that companies will continue to struggle with finding common factors across the states they serve so as to allow for efficient (and compliant) rendering of these statements.

Continued advancement of technology

In 2024, we will continue to see technology play a major role in transforming our industry. The increasing digitization of back-office functions will drive continued improvements in efficiency. In addition, the use of artificial intelligence in equipment finance—while still in its infancy—is showing early promise and has the potential to alter the way business is originated, underwritten and managed.

Digitization

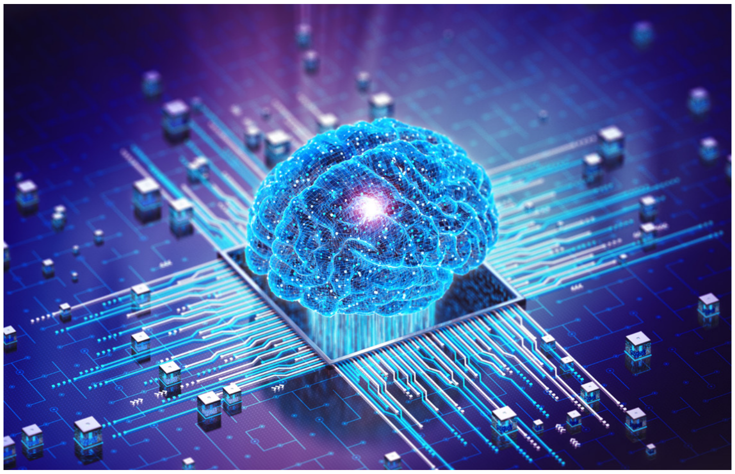
Industry participants are starting to look at their digital ecosystems to identify the best ways to digitize their operations. Critical elements include having Digital Asset Certainty that the digital loan contract is tamper-proof, auditable and has all the legal protections of a paper contract. In an effort to put on new business more efficiently, many Equipment Finance companies are looking into e-Contracting, which digitizes the origination process all the way to funding those new transactions. Greater digitization within the back-office includes modernizing process workflows, thus creating greater operational efficiencies. We believe that digitization will ultimately improve the industry's access to capital, owing to greater transparency of information on a secured, immutable platform.

With this will come a need for more powerful fraud prevention tools, and this is one way we see blockchain technology playing a greater role in our industry. Once the hot tech topic until the crypto crash slowed its momentum, blockchain is coming back. Its ability to promote security, transparency and traceability around financial transactions makes it an important piece of the overall digitization of equipment finance functions. Immediate use cases include enhancing Know Your Customer and Anti-Money Laundering compliance practices. In addition, we predict a demand-pull effect regarding the industry's adoption of blockchain technology from exogenous sources such as the Capital Markets which is embracing blockchain, especially in the securitization marketplace.

Artificial Intelligence

Some task-based AI has been in use for some time, particularly within managed services. The real power of this capability is in generative AI applications, which are still developing, but we see a number of potential use cases across the leasing cycle. Smart companies will start thinking about how AI could enhance their effectiveness in the put-on, put-through and takeoff processes, and may want to appoint a task force, or specific individuals to take ownership of when and how implementation should happen. Here are just a few of the areas where we see potential for AI to drive enhancements:

- Credit scoring and risk assessment.
- Matching lenders with businesses seeking equipment financing based on specific criteria.
- Review of contracts, with AI highlighting where human intervention is needed.
- Sales support around customer behavior, such as predicting when an end user might need to renew a lease or upgrade equipment.



- Asset management, predicting residual values and end-of-lease behavior.
- Fraud detection.
- Regulatory compliance.
- Finance where AI modules automate tasks such as creating reports.

Implementing AI in the equipment finance industry requires careful consideration of data privacy, security, and ethical implications. Moreover, collaboration with industry experts and compliance with relevant regulations are crucial for the successful integration of AI technologies in financial services.

M&A Outlook

Economic factors including inflation and high interest rates continue to dampen the level of M&A activity in the industry. But this situation will be temporary. As long as banks maintain their current focus on their core customers given current capital restraint, they will not be doing a lot of acquisitions; however, that will change as conditions ease.

Many of the regional banks still need to merge in order to gain economies of scale to cover the increased costs of regulatory compliance, invest in digital platforms, and expand their deposit base. This may lead to displacement of bank-owned finance companies, in turn creating new startups and opportunities for seasoned lift-out teams.

Those independent finance companies with available capital that are able to take advantage of the banking industry pullback stand to benefit from this situation. But the opportunity will be temporary. We predict that at some point in 2024, the banking tide will change, and the need to grow assets and portfolio will resume, creating a more robust M&A environment.

Conclusion

While 2024 will be a year of slower growth, there remains vast opportunity for increased profitability and business expansion in equipment leasing and finance this year. Independents and captives will pick up the slack from the retrenchment of super-regional banks in equipment finance activity. Whether this will be a permanent structural outcome remains to be seen. Success this year will require the ability to be nimble, to act fast and adjust to changing circumstances. This is an environment that will reward business strategies rooted in patience and the long-term perspective.

2024 will be a challenging year for the equipment finance industry. While some of the economic pressures of 2023 have abated to a degree, the operating environment remains challenging, as both inflation and interest rates have stopped their climb at historically high rates. The situation is somewhat reminiscent of the early 1990s, a decade that began with recessionary fears, but gave way to significant business growth due in part to advancements in technology. Could we be at the start of a similar growth cycle? In the year ahead, the continued advancement of digitization and artificial intelligence will give us a better sense of how technology will drive growth in our industry into the future.

Looking for more on this?

Contact
Valerie L. Gerard
vgerard@thealtagroup.com
+1 917-664-4192 (mobile)

The Alta Group[SM]

Powerful Insights » Proven Results
Global advisors in equipment finance

Published by The Alta Group, a global advisory firm dedicated exclusively to equipment finance since 1992. Alta's interdisciplinary team of advisors approaches every client engagement with the future in focus, best practices in mind and a deep understanding of various sectors and market trends. Alta's team harnesses decades of C-suite equipment finance experience to provide real-world strategies for banks, independents, captives and OEMs, fintechs, service providers and other commercial finance enterprises in asset finance.

For information on the group's services in the United States and Canada, Latin America, Europe, the Middle East and Africa, China and Asia-Pacific, visit thealtagroup.com.