



The Alta GroupSM

2021

Insights for Equipment Finance

Introduction

What a difference a year can make.

Covid-19's toll on humanity has been staggering and its impact on the economy and our industry profound. A year ago, few could foresee how the virus would become a lingering pandemic, changing business risks and opportunities while inspiring the rise of the virtual workforce.

There have been many "aha" moments for equipment finance because of Covid-19 but one of the most significant is around the adoption of Industry 4.0 technologies. These technologies weren't just temporary measures to allow equipment finance firms to respond to the pandemic but are here to stay, having demonstrated the potential for digitally enabled productivity gains. The pandemic is also advancing industry trends that have been gaining momentum for some time, including the adoption of new business models and corporate sustainability initiatives. Other trends like work-from-home will shape equipment finance this year as well, regardless of the fate of Covid-19.

The Virtual Workforce Stays

Shifting Workers Permanently

Before the pandemic, the concept of work-from-home was not widely accepted by businesses. Virtually overnight, and out of necessity, Covid-19 changed business attitudes about the viability and effectiveness of a remote workforce. While vaccines and improved treatments should encourage more companies to return workers to their offices sometime in 2021, work-from-home arrangements will become increasingly common in a variety of industries, including equipment finance. There is significant evidence that most businesses plan to move at least part of their on-site workforce to permanent remote positions after the pandemic. More hybrid arrangements are expected to allow employees to split their work hours between home and office.



Rethinking Office Space

With more employees working remotely, many equipment finance companies will reexamine their need for current office space. Some will contemplate shrinking their physical footprints or reconfiguring existing space to allow more square footage per employee for social distancing. Some will consider moving from higher-priced downtown locations to lower-rent options, which could also shorten employee commutes. These efforts to reduce physical space will lower rental and mortgage expenses over time, thus enhancing overall efficiency and profitability metrics.

Changing HR Strategies

The rise of the virtual workforce adds another new requirement for companies: putting policies and procedures in place that protect the technology security and confidentiality of workers operating in home office environments.

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Workforce recruiting, retention and development will also shift to reflect the new realities. Remote work expands the talent pool to hire the best and brightest no matter where they are located, but it also creates challenges. Some companies will have difficulty hiring professionals for office-based positions when fewer want to return to an office environment, while some businesses working remotely may be challenged by retaining employees who prefer office work. We also anticipate the growth of “traveling” workers, such as customer service personnel, who work for multiple employers.

Human resources (HR) strategies in equipment finance businesses must adapt to these changes by incorporating policies and practices that promote the efficiency of distributed teams and a strong corporate culture.

Leveraging Technology – Not Travel

Zoom and similar platforms will remain important channels for sales calls and meetings, and the use of other technologies (outlined in the section below) will climb as a result of the virtual workplace.

Business travel will be limited until Covid-19 cases drop significantly and possibly will remain low for several years as companies reexamine whether travel is really necessary when virtual conferencing has proven so effective. Traditional travel and entertainment budgets will likely shrink, which will have a beneficial impact on expense ratios.

These are encouraging trends but equipment finance companies also run the risk of over-automation, particularly in their business development efforts. There is no substitute for in-person meetings when it comes to forging strong relationships with potential new customers and business partners.

Advanced Technology Investments Climb

Accelerating New Technology Adoption

The equipment finance industry traditionally has been slow to embrace new technologies, with many companies content to cobble together incremental fixes. That all changed when equipment finance firms adopted Industry 4.0 technologies in their pandemic response. The net effect is that the industry will now see the productivity gains promised by the Fourth Industrial Revolution much sooner than expected in the pre-Covid mindset.

Mainstreaming E-Signatures

Electronic signatures (e-signatures) are the digital world’s version of handwritten signatures – a way to confirm legal consent on a document. They have been a trending topic in equipment finance for years but were mostly confined to vendor finance and small-ticket transactions before the pandemic hit. Covid-19 changed that by limiting in-person meetings and shifting more work online, via home offices. The adoption of e-signatures for middle-market and large-ticket transactions has exploded out of necessity and will become standard practice in 2021.



Digitizing the Day-to-Day

The pandemic has fast-forwarded another trending development in equipment finance: automation. Companies that once handled mundane, repetitive processes such as know your customer (KYC) compliance manually will increasingly automate these tasks — benefitting companies but not all their workers. Automation boosts business efficiency but also enables companies to trim the workforce.

On the other hand, collaborative software and other digital communications solutions for the virtual workplace should be welcomed by most employees. These solutions will remain in great demand and continue to evolve to meet the needs of equipment finance.

Mitigating Increased Risks

If the pandemic has taught us anything it is to be prepared for contingencies. Expect equipment finance companies to prioritize Industry 4.0 technologies that will enable them to weather the next storm.

Organizations will also focus on cybersecurity. The risk of hacking vulnerabilities rises as technologies supporting the virtual workforce are deployed, and there is greater potential for fraud as criminals are using increasingly sophisticated tactics to pose as customers and business partners. One of the latest incidents illustrating what's at stake: the SolarWinds software hack, reportedly at the hands of Russian operatives, that exposed U.S. federal agencies, technology giants and other businesses.

Vigilance pays. Cybersecurity solutions and experts such as certified fraud examiners (CFEs) should be in growing demand in our industry.

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Corporate Sustainability Gains Traction

Meeting New Requirements

Corporate sustainability has become a business imperative. More regulators, rating agencies, investors and customers are requiring companies to demonstrate they are making a positive impact on society by committing to environmental, social and governance (ESG) objectives. The investment community has long been committed to the concepts of ESG but now feels more empowered to demand quantifiable metrics showing progress. One example of this is NASDAQ's proposed ESG disclosure requirement, designed to provide greater transparency for stakeholders by ensuring companies have at least two diverse board members. There is also momentum for the United Nations' Sustainable Development Goals, which some governments and companies will incorporate into their strategic plans.



Driving this trend are younger generations that prioritize ESG goals in their purchasing decisions, and increasing evidence showing it's good for the balance sheet, too. But Covid-19 also has played a role by exposing social and economic disparities.

Addressing Climate Change

We believe 2021 may be the year that economic and political forces converge to address climate change in a meaningful way. Leading countries are setting carbon neutral targets and in Canada, for example, economic recovery plans are being tied to climate goals. The U.S., which is by some accounts the world's second largest emitter of greenhouse gases (behind China), will transition to a new presidential administration that plans to invest more than \$2 trillion in clean energy infrastructure projects and rejoin the Paris Climate Agreement. Developments like this should further drive sustainability initiatives in the equipment finance industry.

Business models promoting the circular economy will flourish, including managed services featuring pay-per-use, as-a-service product offerings, as will programs for environmentally friendly "green" industries.

Rather than detract from climate concerns, Covid-19 has highlighted the potential risks of failing to act decisively on global threats. And the rise of the virtual workforce, inspired by the pandemic, has had positive environmental impacts by reducing pollution and traffic in some areas.

Retooling Equipment Finance

What does this mean for equipment finance, an industry already focused on asset efficiency and reuse? Business models promoting the circular economy will flourish, including managed services featuring pay-per-use, as-a-service product offerings, as will programs for environmentally friendly "green" industries. As a result, the asset management function will become more strategic in practice, supporting circular economy business models.

Environmental pushback will also create opportunities for equipment finance. As banks and public companies retreat from "dirty" industries, independents could step into the breach to increase equipment financing for coal, oil/gas, tobacco, and other sectors.

Growth Hinges on Pandemic

Seizing Timely Opportunities

Covid-19 will continue to be a dominant force determining growth opportunities for equipment finance until infection rates drop significantly, the timing of which likely depends on when a majority of the population achieves immunity. The effectiveness and pace of vaccine rollouts will be extremely important in this regard. There will also be lasting impacts from the pandemic that influence growth.

Technology equipment has been a clear winner in terms of equipment in demand, especially solutions supporting remote work, automation, and virtual classrooms. The proliferation of online shopping and home delivery has increased opportunities for financing forklifts and other materials handling equipment needed by warehouses, trucking, and logistics services. Clean technology and infrastructure for "green" transportation will continue to gain ground, undaunted by Covid-19, and spending on these initiatives should increase significantly in the U.S. if the incoming Biden administration is successful in promoting clean infrastructure projects. These are just a few of the sectors that are thriving in the midst of the pandemic. Looking ahead, expect a greater focus on domestic supply chains and preventing their disruption, which bodes well for over-the-road (OTR) transportation, logistics, possibly long-term models for food services, manufacturing robotics and delivery drones.



There will also be opportunities for larger independents to expand market share with below-investment-grade obligors at attractive spreads. This will come as bank-owned finance companies maintain tighter credit standards and institute pricing floors in an effort to increase margins.

Reducing Over-Exposure

Some vertical industries are struggling more than others thanks to the crushing blow the pandemic laid on the hospitality industry. Airlines continue to face on-going pressures to fly planes at reduced capacity, absorb higher cleaning costs and waive cancellation fees to lower the risks of Covid-19 transmission. Rail has been similarly hard-hit.

Restaurants and many smaller brick-and-mortar retailers are hurting despite their efforts to promote outdoor dining, contactless pickup, and home deliveries. Other sectors to watch include traditional office furniture and commercial real estate as companies rethink their office needs given the rise in work-from-home arrangements. More companies may also decide to move offices away from costly downtown hubs, which will put additional pressure on nearby restaurants, shops, Uber, Lyft and taxi services that depend on their business.

Risk Considerations Mount

Awaiting Government Stimulus

There are a lot of “what ifs” regarding the timing and effectiveness of stimulus money that governments will award businesses and individuals in 2021 to help offset the continuing impacts of the pandemic.

With or without stimulus funding, some businesses will default in 2021 as a result of Covid-19. But a reduction or elimination of government stimulus packages could plunge even more companies in default in the industries that are hardest hit, including restaurants, fitness centers, leisure and hospitality, spas and salons, and movie theaters. This would create an oversupply of certain types of used equipment in the market and further depress values and end-of-lease estimates, resulting in residual value impairments.

Managing Equipment Values

Cautions aside, Alta predicts most equipment values will begin to recover in 2021. Desirable asset types include ISO shipping containers (which were hot globally in 2020, both new and used, and are expected to remain so this year), and semiconductor tools, computers, agriculture equipment, trucks/trailers, and construction machinery. Also predicted to do well, in the middle of the pack, are chemical processing, medical, telecom, and machine tools.

Some equipment like passenger aircraft, marine, plastics, rail, and steel will experience more protracted recoveries, with a smaller rebound in values. And then there are equipment types that will continue to suffer until we return to normal, such as restaurant equipment, motor coaches, printing and equipment for the live event industry.



Preparing for Losses

Certainly, the past year has been extremely challenging from a credit perspective after a decade of economic expansion. On the positive side, there is currently less concern about banks weathering a pandemic-induced recession than there was during the Great Recession over a decade ago.

Provisions for losses are stronger due to Current Expected Credit Loss (CECL) implementation by the big banks, which requires booking reserves on all loans upfront, and because most smaller banks that have not yet adopted the CECL standard have been conservative with reserves.

M&A Activity Rebounds

Resuming Bank Mergers

Mergers and acquisitions involving national and regional banks should pick up again in 2021, driven by the need for banks to invest in and maintain expensive technology platforms, reduce costs, and access additional deposits. The equipment finance divisions of some acquired banks may find themselves displaced, resulting in lift-out team opportunities and portfolio sales.

Acquiring Small Independents

Still reeling from the impact of the pandemic, many small independent finance companies will find it difficult to compete with their larger rivals in 2021. Some smaller independents will seek acquisitions by rivals to gain access to their superior technology platforms, lower cost of funds, and lower operating costs through scale and efficiency – all of which help offset the costs of regulatory compliance.

Partnering with Fintechs

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Expect more partnerships between bank/independent/captive finance companies and fintechs in 2021. Most will be strategic like the American Express acquisition of Kabbage, which expanded Amex's payment and working capital solutions for small businesses but excluded Kabbage's existing portfolio; and Enova's purchase of OnDeck, which diversified products but more importantly resulted in economies of scale, with an estimated \$50 million in annual cost synergies and \$15 million in run-rate net revenue synergies, both of which should be fully phased in by the end of 2022.

The biggest trend driving these partnerships is embedded finance, also known as point-of-sale (POS) finance, which has been hastened by the dramatic rise in e-commerce sales. Many traditional banks, fincos and original equipment manufacturers (OEMs) don't have the necessary technological capabilities for this, so strategic partnerships with fintechs have become increasingly attractive.

Geopolitical Pressures Affect Competitiveness

Monitoring China's Expansion

China's growing role in the global economy will increase competitive pressures this year for equipment companies and equipment finance businesses in the United States, Europe, and Asia Pacific markets, including Japan. The most tangible example of this expansion is China's Belt and Road Initiative, which has hit road bumps due to the pandemic and political backlash in some countries but is nonetheless ambitious, aiming to connect more than 70 countries across Asia, Europe and Africa by way of a "New Silk Road" of railways, highways and ports.

Spotting Risks and Opportunities

Other risks affecting global business are troubling, but harder to quantify. New geopolitical alignments may drive certain trends in the future of equipment financing demand.

Gaps between the developed world and emerging markets in terms of interest rates and fiscal stability are also concerning but may offer high-yield business opportunities for equipment finance. Therefore, equipment leasing in emerging markets may become a very attractive opportunity because sound credit and asset management would protect the relatively high yields that can be obtained in emerging markets in this new normal. Gaps between the developed world and emerging markets in terms of interest rates and fiscal stability are also concerning but may offer high-yield business opportunities for equipment finance. Therefore, equipment leasing in emerging markets may become a very attractive opportunity because sound credit and asset management would protect the relatively high yields that can be obtained in emerging markets in this new normal.



Interestingly, the energy self-sufficiency of the United States will continue encouraging major bank lessors to avoid international expansion, which will open more doors to European, Japanese and Chinese lessors in the global leasing industry. United States captives in construction, equipment and technology will need to reinforce their international strategies so they keep their

competitiveness, if they don't want to follow the path of U.S. auto manufacturers' captives that lost their global leadership by the beginning of this 21st Century.

To defeat digital divide, inequality, and low internet access, large investments in both developed and emerging markets will be required. Herein lies a great growth opportunity for the leasing industry.

There is also a unique opportunity for North American and European equipment finance firms to provide a counterweight to Chinese investment in the Asia Pacific region. We are seeing pent up demand for non-China investment and a potential race to avoid over liquidity and the consequences it will have on pricing.

Accounting Standards Support Managed Services

Sustainability and Covid-19 are not the only forces fueling interest in managed services-type structures in equipment finance. The impact of new accounting standards – both ASC 842 in the U.S. and IFRS 16 internationally and GASB 87 for government entities – on policies and processes for incorporating equipment into business and government operations is increasing demand for these “asset-as-a-service” and “pay-per-use” transactions.



Accounting is only one of the motivating factors for managed services arrangements, but it is an important one for lessors to understand this year and moving forward. ASC 842 established a system for putting leases on a lessee's balance sheet, and the “on/off” switch for the balance sheet shifted to the question of “what is a lease?” If an arrangement is a service rather than a lease, it is not subject to lease accounting and there is no liability or asset recognized. That leads to more interest in managed services arrangements.

As with many things, however, the question of what is a lease or what is a service is not a simple either/or. There are a range of possible outcomes, and it helps to think of them in terms of risk transfers and asset control transfers. There are straight leases, leases bundled with services, and pure service arrangements. The accounting will always separate a lease from a service if the lessee controls the asset used to provide the service. Even if an arrangement contains a lease, the amount a lessee recognizes on the balance sheet depends on the pricing mechanism and amounts. And that depends on how much of the pricing is fixed versus how much is variable. These are some of the questions equipment finance companies will be tackling this year when considering expanding into managed services.

Looking for more insights?

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