

# Survival of the Fittest

## *Upheaval in the European Leasing Landscape*



With a projected negative market growth of approximately minus ten per cent in 2009, Arthur D. Little estimates that the number of leasing providers in Europe will decrease by up to 30 per cent in the next five years. Slowing investment, reduced liquidity, cost of funds issues and a turbulent market environment create the background against which only the best companies will prosper. Which players will survive and what business model do they need to adopt to succeed?

In recent years, the degree to which leasing providers have penetrated the European market has risen steadily. By 2007, leasing represented over 20% of European asset investment. Leasing finance for equipment, in particular, is now an important source of funding throughout Europe, accounting for approximately 29% of all equipment investment in Europe during 2007.

However, due to the impact of the credit crunch on the leasing industry while most European markets enjoyed annual average growth rates of over ten per cent in the first two quarters of 2008, these rates declined to values of between minus ten and plus six by the year end. After years of relatively easy growth, 2009 represents a challenging period for the asset finance industry. Across Europe, decreasing demand for investment goods as well as the suffering automotive industry have brought the commercialization of residual values to slumber. Along with this, restricted refinancing possibilities have made leasing more expensive. Average refinancing margins are now 200 to 300 basis points for preferred customers and more than 500 for those with higher risk. Many banks are backing out of the market and offering refinancing only to their own leasing subsidiaries.

Despite these challenges, overall leasing nonetheless remains an attractive way of financing, as scarce credit drives customers to asset-backed financing. Robust commercial decisions, best practice operations and market-beating distribution strategies are key for leasing companies who want to capture these customers and remain successful.

### **Consolidation and acquisition**

Consolidation of the market is being driven by increasing short-term pressure created by the financial liquidity crisis and deteriorating residual values. However, there are three major drivers that will continue fuelling deal activities: geographic expansion into central and eastern European growth markets, consolidation in mature markets and restructuring of business models and the value chain. The scarcity of risk capital required to decrease leverage on the balance sheet, combine with a shortage of liquidity and funding from weaker parent banks, will force providers to asset stripping, selling of portfolios, leasing subsidiaries and/or leasing companies providing excellent opportunities for strategic investors.

Most large leasing providers and banks are now consolidating their activities, with some planning an extension of business through, for instance, acquisitions. Examples of this type of activity include: the international bundling of UniCredit's leasing business; the formation of a leasing holding entity by Landesbank Baden-Württemberg (LBBW); the consolidation of Commerzbank Group's asset-backed-finance activities; and the acquisition of Athlon Car Holding by De Lage Landen. HBOS and Lloyds TSB plan to merge, as did Alliance & Leicester and Santander. The mergers of their respective leasing businesses will emerge some real heavy weights. For example, HBOS/Lloyds Leasing entity will have in its automotive business unit a portfolio of around 400,000 vehicles in its home market in the UK, thus realizing economies of scale and significantly improving their position among the top European players (see figure 1).

Figure 1. Top 15 European leasing companies 2007

Name	Bil. € <sup>1</sup>	Market share <sup>2</sup>	Growth 2007	Rank 2006
1 UniCredit Group	14,9	4,7%	35,4%	2
2 BNP Paribas Lease Group	12,6	3,9%	51,8%	5
3 SG Equipment Finance	10,1	3,2%	13,4%	4
4 Fortis Lease Group	9,0	2,8%	30,4%	7
5 ING Lease Holding	8,9	2,8%	30,8%	8
6 Lombard	8,6	2,7%	-28,9%	1
7 Deutsche Leasing	7,8	2,4%	23,8%	9
8 Leasint SpA	6,8	2,1%	4,6%	8
9 De Lage Landen	6,5	2,0%	25%	12
10 Volkswagen Leasing GmbH	6,4	2,0%	12,2%	11
11 Gruppo bancario Banca Italease	5,9	1,8%	-36,5%	3
12 Crédit Agricole Leasing	5,0	1,5%	32,9%	16
13 Raiffeisen-Leasing GmbH	4,9	1,5%	42,8%	19
14 CommerzReal AG	4,8	1,5%	37,1%	17
15 Lloyds TSB Asset Finance	4,7	1,4%	-4%	13

Source: Annual reports, Bundesverband Deutscher Leasing-Unternehmen, Leaseurope Ranking 2006 und 2007; <sup>1</sup> Volume of new business  
<sup>2</sup> calculation based on the investigated companies and total volume of European market (Leaseurope: 315,5 Bil. Euro)

Simultaneously, a number of providers are now considering exiting their respective markets as they can no longer generate profitable growth. Hence, acquisition activities in the European leasing market are high. The sale of the ASL and Disko Leasing to GE Capital and now Dresdner Bank/KGaL to Commerzbank by Allianz; the sale of Banque Artesia, the Commercial Finance business of Belgian-French financial services group Dexia, to GE Capital; and the sale of LHS to BMW Financial Services all set new benchmarks in terms of transaction value.

Small and medium sized independent leasing companies are often stuck in the middle, with limited capital, and are partially facing management problems in terms of getting adequate successors for the retired owner. Hence, there are sellers in the market. And, whilst the market is currently somewhat dry, there are also buyers. These include strategic investors from the international banking and financial services industries, who consider leasing as part of their core business.

In addition, financial investors are discovering the advantages of the leasing business: Cerberus, for example, moved to acquire GMAC and Chrysler Finance, Lonestar acquired IKB Leasing within the IKB bail-out. These investors act as additional consolidators in the marketplace, and their impact on the market mirrors that of the natural consolidation taking place in the banking markets and the respective merger activity among its leasing businesses.

As a result, Arthur D. Little expects the number of significant players in the European leasing industry to decrease by up to 30 per cent in the next five years.

### Options for international growth

Those companies committed to developing or expanding their leasing business show three main approaches to creating a business in foreign countries:

#### Leveraging on banking group's M&A strategy

The first approach is leveraging the bank parents M&A strategy by buying a number of indigenous banks and merging the leasing operations of the parent and the purchased banks. This seems to be RBS's strategy in the United States. Its asset-finance business is operated through Citizens, which has three leasing brands: RBS Asset Finance, Citizens Asset Finance and Charter One Asset Finance. Citizens claims that this combined business is the eighth largest bank-affiliated leasing company in the US, with a portfolio of \$6bn (2007). HBOS has built up its leasing business in North America in a similar way.

#### Multiple acquisition

The second approach involves a "multiple acquisition strategy". This approach has been applied by GE Commercial Finance, in particular, in its equipment financing business. Over the years, GE has acquired 20 companies throughout Europe to create a leasing business with net earning assets of over \$10bn (2007). Another example is CIT, which is pursuing a similar approach.

#### Organic growth

The third strategy is to set up a leasing business in the target country and grow organically by applying a global vendor partnership strategy ("Follow your customer"). This is the approach adopted by the Dutch banking group, Rabobank with respect to its leasing subsidiary, De Lage Landen (DLL). DLL pursues a strict global vendor financing partnership approach and has acquired and developed a number of well-known brands, including Komatsu, Hyundai, Panasonic, Sony, John Deere, AGCO, SchmitzCargo Bull, to name a few.

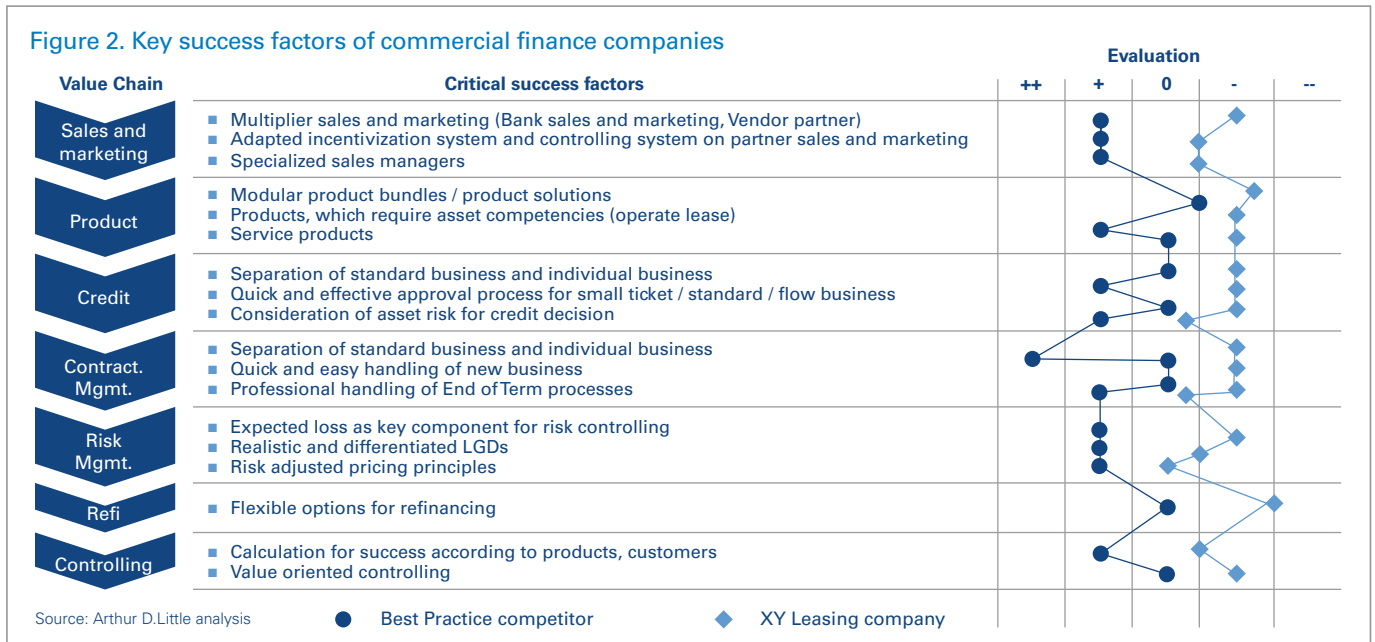
Whichever of the three approaches an organization chooses, one thing is clear, to succeed in creating a business in another country, there needs to be a financially strong parent in the background with a well-established reputation in its country of origin.

#### Lean leasing for profitable growth

There are several factors that determine whether a leasing company is able to achieve sustainable growth (see figure 2).

Cost-effectiveness is a number one priority. Among the top players, the cost/income ratio lies far below 50 per cent – and is constantly decreasing.

Figure 2. Key success factors of commercial finance companies



To achieve a similar cost/income ratio, leasing companies need to practice 'lean leasing' and, in particular, to address the following areas:

- Distribution network:** Companies who want to be ranked among the most profitable should align their distribution network with their distribution partners. An efficiently operated network can realize a reduction in average distribution costs of up to 45 per cent. At the same time new acquisition by a member of the sales team can be increased by up to 80% by leveraging the sales representatives of the vendor partner.
- Product portfolio:** A balanced product portfolio and a focused knowledge of assets and re-marketing channels play an important role. Due to the increasing importance of operate leases, excellent asset management to calculate the future fair values for potential remarketing is a key factor in managing residual value risks and achieving adequate post-contractual profits at the end of the transaction.
- IT systems:** Lean processes must be supported by appropriate IT: web-based proposal-management systems and automated credit scoring can reduce average transaction costs by up to 40 percent.
- Risk and performance management:** In order to maintain flexibility and growth, leasing companies must adopt a holistic view of risk and performance management. Smart companies, for example, are adopting performance-management solutions to break down information silos.

These new systems are designed to fit all requirements and incorporate consolidation tools as well as enterprise portals and dashboards to provide management and employees with timely information on performance and compliance.

### Three models for leasing companies

A recent study by Arthur D. Little identifies three categories of leasing providers currently dominating the market. However, each of the categories has differing prospects of success:

#### Niche providers

Niche providers most likely to succeed are those that maintain a strong position in a specialty niche market, have valuable vendor or lessee relationships, realize high residual values by being an equipment specialist, and/or provide value-added services to their customers.

A "leasing factory," providing small-ticket financing and using web-based front-end tools, fully automated credit scoring and electronic contract administration to achieve cost-efficiency gains of up to 40% compared with traditional providers, is a good example of this type of niche provider. In addition, providers specializing in certain asset classes (e.g. IT, games, entertainment, health and fitness), customer groups (e.g. commercial customers, small enterprises) or single distribution approaches (e.g. on-line distribution) are well placed to succeed. Captives and medium-sized providers also fall into the category of niche providers, although in the long term, they have only limited growth opportunities.

Niche players need to adopt a strategy that combines cost-leadership with service excellence. They should focus on specific assets, streamline their operations and improve profitability by offering customized product and service bundles.

### Disciplined, diversified providers

Disciplined, diversified providers – or “multi-liners” – command a manageable number of distribution channels and distribute products and services in a standardized manner through them. Thanks to long-standing customer relationships, multi-liners have an excellent knowledge of the leased assets and have established international portfolios that meet critical size. Many bank-owned leasing institutions as well as the leasing companies of large industrial business groups with a significant proportion of third-party business are multi-liners. Some have excellent growth opportunities, but given the complexity of their international operations they need tight management. For multi-liners to succeed, managers must manage sales channels rigorously, standardize the product portfolio, lay out a clear IT roadmap and manage the credit portfolio professionally.

### Disorganized opportunists

Disorganized opportunists have no clearly defined business model and use a range of distribution approaches as the opportunity arises. This provider type is very frequent and includes all sizes of leasing companies, both independent and bank-owned. Because the opportunists compete across a broad range of asset categories, and are caught up in the finance-margin loop, they often fail to achieve critical portfolio sizes.

### Future winners

Liquidity and financing means are currently in short supply. Despite optimism on new business volumes and a bullish outlook regarding the potential for acquisition, a storm is now hitting the industry. Worries over bad debt and restricted availability of capital are resulting in tougher underwriting criteria, reduced service levels and pressure to reduce costs. While many lessors see opportunities in the current fallout, our market observations raise questions on whether all these ambitions can be realized.

Only a few providers will be able to keep pace with the changing trends. Many current market players lack the capital required for acquisitions or to invest in their own business model and corporate infrastructure. This is particular true for small and medium-sized leasing companies. Losers will be those players that are unable to access liquidity and do not rapidly adjust pricing to reflect the scarcity value of capital, market risk and customer risk. The winners will be large and/or specialized, well-financed companies with a clear strategy, who are focused on a return on capital aligned with a growth strategy, especially those in markets where competitors are contracting or exiting and contract margins remain strong due to a lack of market maturity for certain leasing services. A robust business model based on our lean leasing approach will weather the storm (market cycles) and work in both good and bad times.

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