Beyond Traditional Paths
A Look at Evolving M&A Strategies in Equipment Leasing

In 2023, various factors influenced M&A activity in the equipment finance industry, including early-year regional bank issues. Despite this, forward-thinking companies are primed for renewed success in this sector's M&A landscape.

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Before we roll into my acquisition activity projections for 2024, we must truly understand the impacts of a tumultuous year on the community banking and equipment finance industries.

2023 Community Bank Recap

Starting at about the end of the first quarter of 2022, the Federal Reserve set in place a rapid succession of 11 rate increases over the following 18 months, a total increase of 500 basis points in the prime rate of interest (or 5.0 percent) from a low of 3.5 percent to its current 8.5 percent as of this writing. The rapid succession of rate increases played havoc in many ways for the community banking industry. Typically, rising interest rates are a good thing for banks. However, the speed of increases seriously impacted bank's investments in their bond portfolios. As rates rise, the price of existing bonds decreases.

Here is an example. If a bank parked its extra cash in, say, 20-year treasuries earning a paltry 2 percent in 2022, and rates on similar new 20-year bonds in the fourth quarter of 2023 were yielding 5.3 percent, well, the value of the existing 2022 bonds took a significant loss (on paper). Providing the bank did not need to sell any of these bonds to raise cash, then no big deal. But if the bank needed to raise cash due to, say, a flight of some of its core deposits, these bonds may have to be sold at a steep realized loss to their original purchase price. Those losses to equity value would have far-reaching impacts on the bank. Indeed, since it hasn't happened in recent memory, the possibility of that happening would be remote. In 2023, that remote possibility did happen. After several high-profile regional bank failures, depositors fled banks for higher yields such as money market accounts and/or to the big money center banks for safety. This, in turn, required banks to shore up their balance sheets and increase their dependence on and the cost of new deposits.

If all the above wasn't bad enough, let's add another looming issue for community banks. Community banks have historically committed a significant portion of their assets to financing commercial real estate. The percentage of these assets being stressed is increasing, and non-insignificantly so. Specifically, this is seen in the average community bank's growth in the percentage of delinquent portfolios, non-performing status and troubled debt restructuring status.

Why does all this matter in regard to M&A in the equipment leasing and finance industry? Here's why. The rising cost of deposits (interest rates high enough to attract depositors) that community banks then lend out (interest rate on loans to new borrowers) is reducing who they can lend to if it is not for commercial real estate. Moreover, banks have to shore up their capital via several means, such as cutting back their lending activity, selling or pledging some of their loan portfolios to raise cash, and of course cutting costs/expenses.

One of the most common solutions was for banks to allocate their capital sparingly. They chose to only lend to their core customers in their core geographical markets that a) generate other types of non-interest loan income for the bank, such as fees of all types, and b) have deposits in their bank. Any other

type of lending gets second-tier status for the time being. Therefore, anything transactional and not considered relationship-based lending was curtailed. National leasing programs were a direct target to cut. Wholesale (capital markets) buy desks were also a direct target.

Not surprisingly, for most of 2023, community banks have hunkered down in the foxhole while assessing where they will be by year-end and their posture going into 2024. There are about 5,000 community banks in the U.S. About one-third are what can be referred to as zombie banks, meaning they cannot find a place to lend that would allow them to generate deposits at such a rate as to make a reasonable profit margin. These banks will be sleepwalking like zombies for the foreseeable future or will have to find another bank to merge with or sell to.

There is another third that, let's say, will use a walker or crutch for the next year or so to see if they can find an avenue to sustainability. That leaves another 1,500 or so big enough (i.e., have the scale) to cover the compliance burdens and retain a value-added franchise in their markets. These banks have an opportunity to enter into the equipment lease and loan industry. The equipment lease and loan industry, especially small- to mid-ticket, has a history of generating above-average returns on assets compared to the general commercial and industrial bank lending model. Moreover, our industry also generally runs at a lower net charge-off ratio. I hope this provides an adequate backdrop for the meat of this article, which is projections for M&A in our industry for 2024.

Equipment Lease and Loan Industry

The rapid interest rate increases impacted parts of our industry, too. Most notable, though, is the over-the-road truck and trailer sector. Concurrent with the rate increases, the Paynet Small Business Default Index jumped almost 60 percent from ~1.75 to ~2.75 at the end of 2023. (See table 1.)

While I do not have the industry sector detail behind the default data, it would be plausible to assume that a significant portion of the default increase is attributable to this transportation sector since it is one of the largest asset category sectors in the equip-

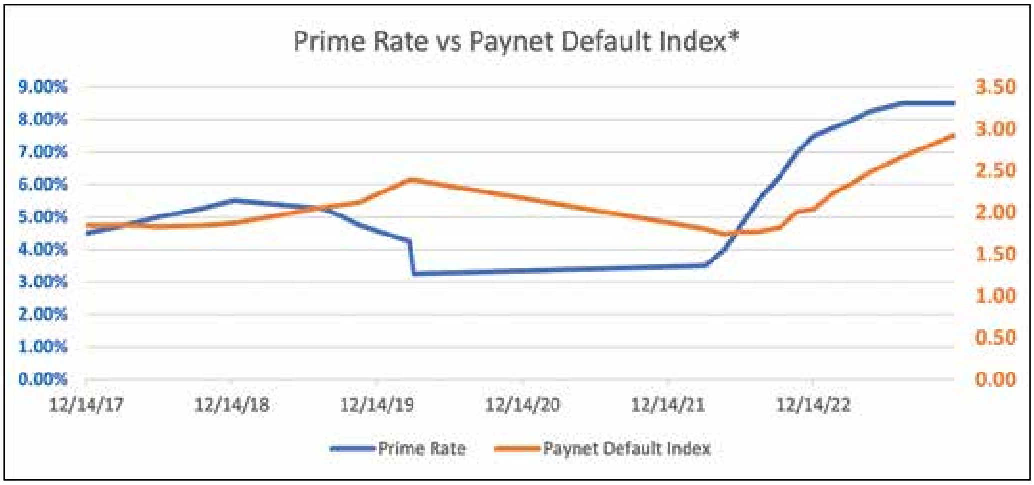
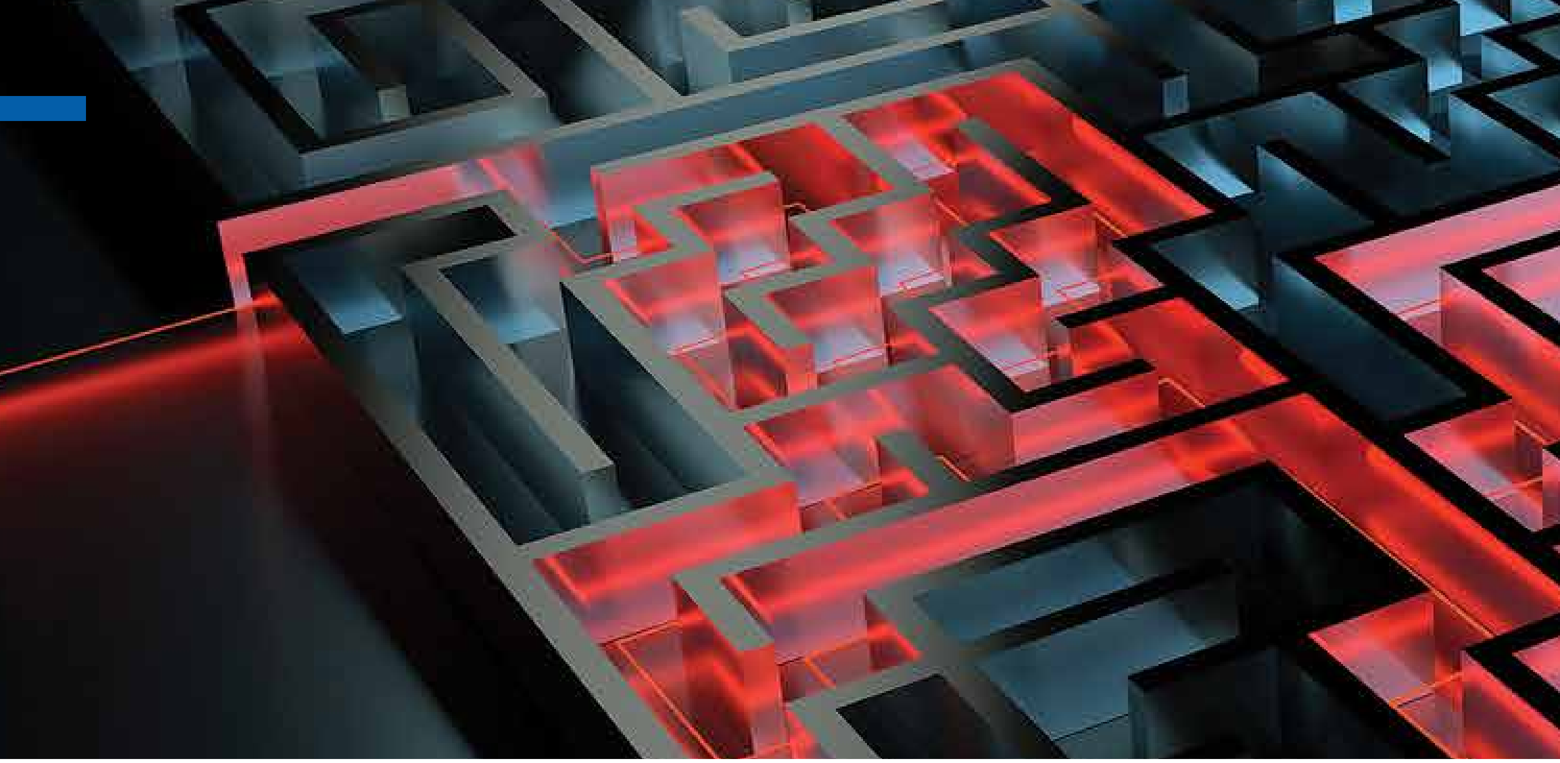


Table 1

**Paynet Default Index ("SPDFI") provided by Paynet, an Equifax company. SPDFI is an economic indicator designed to gauge small business defaults and signal insolvency across multiple sectors of the economy at the national, state and industry levels.*



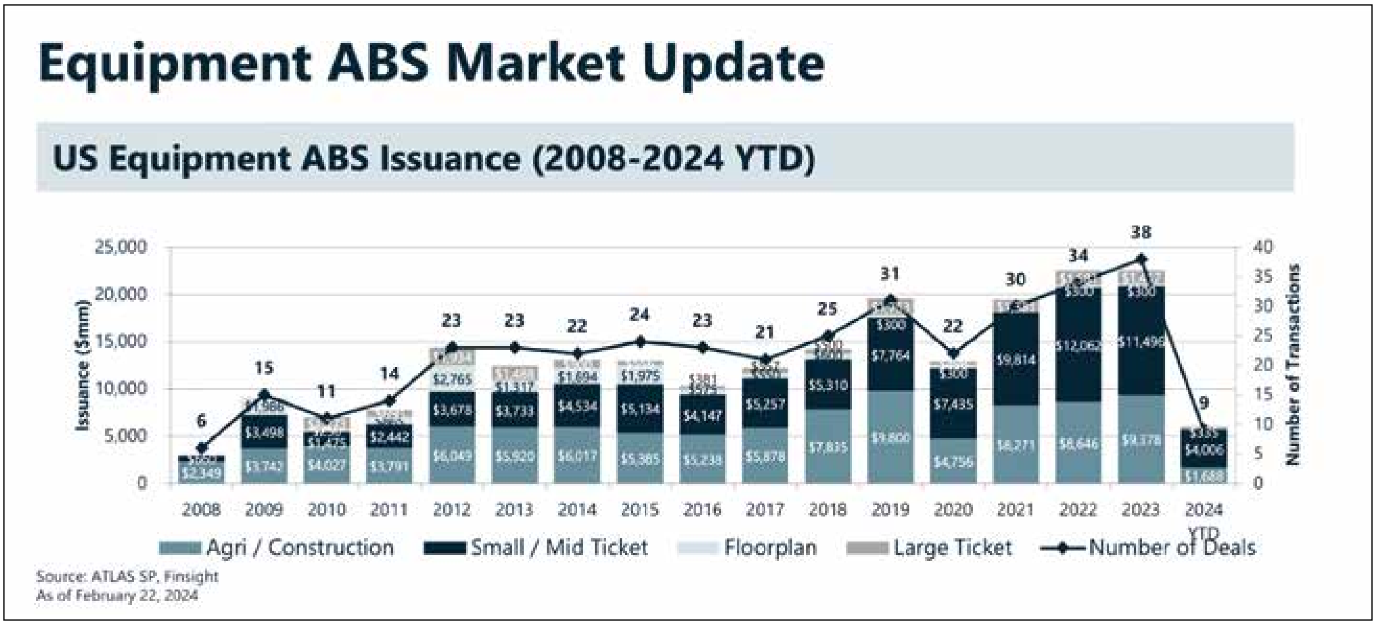


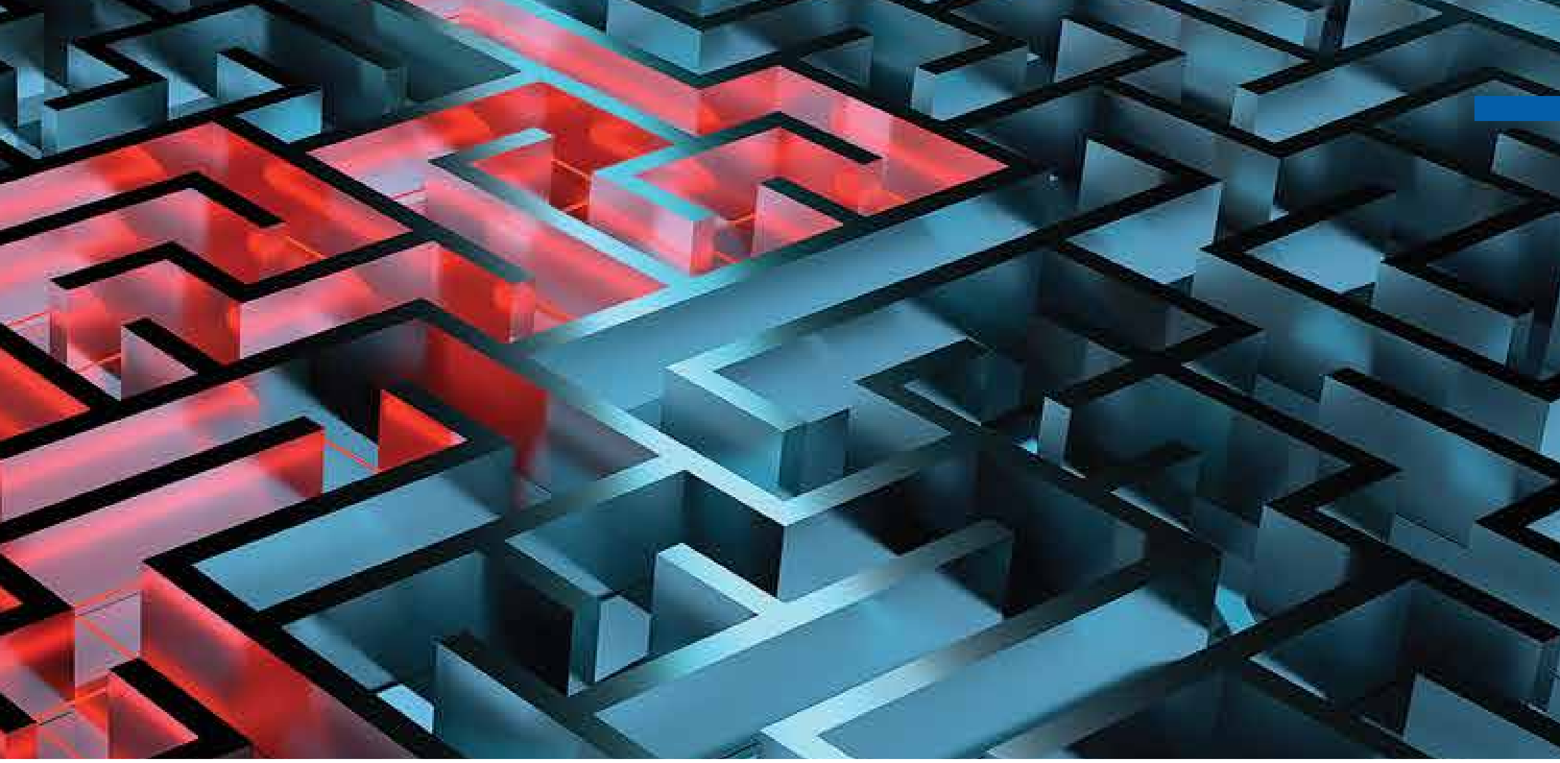
Table 2 *Courtesy of Finsight and Atlas – SP*

ment leasing industry. Let's add to that the fact that asset values (both new and used trucks and trailers) saw price inflation during COVID-19 of 30 to 50 percent, which drove supply such that when demand fell, the freight rates plummeted, taking many small and large freight companies with them. Combine that with the inflated prices our industry paid and financed, and you have a significant flight from the truck and trailer sector. Over time, this too shall pass and fade into memory. Those leasing companies well-capitalized enough to weather this storm will be the long-term winners as their competition will have fled the sector, and customers will not forget.

Most other sectors, while exhibiting an increase in delinquency and charge-offs, as shown in the ELFA MLFI Dec 2023 reading, are not expecting wholesale stress among the other asset classes. But the way I see it, we are just reverting to the mean in terms of delinquency and charge-offs. On the heels of COVID, these same metrics were at near-all-time lows. This is a widespread phenomenon coming out of a recession. So, chart a path between the highs and lows in delinquency and charge-off, and we revert to the mean or average between the two. Keep in mind, nobody feels the average, ever! But we remember the highs and lows only.

M&A Projections

We are at an exciting point in the state of independent leasing companies and, to a lesser extent, bank-owned leasing companies. It used to be that when we talked about M&A in equipment leasing, the discussion was limited to only independent lessors that have started to scale but need more capital to satisfy the demand that their balance sheets could not provide. That has changed. Now, we must consider several different permutations of M&A. To follow are the participants in the market. I will



continue the M&A Projections topic at the end of the article.

Independents with Some Scalability and Bank-ready

These are still few, as always. The majority of the top 50 of the *Monitor 100* ranking are bank-owned or large captives. Many of the remaining independents have found their growth capital in the securitization market as an alternative to traditional permanent bank lines. Table 2 depicts the growth of the securitization marketplace for equipment leasing by ticket size. By far, the most significant volume is coming from small ticket equipment finance. From 2021 through December 2023, over $32 billion of funding capacity for small ticket lessors came from the securitization market as opposed to traditional bank lines. What does that mean and portend? It means that independent lessors were able to grow to larger annual new business volumes without selling themselves to banks. It also means investors such as private equity firms generally backed these high-growth independent leasing companies. Many of them are reaching their investors' time horizon. What happens to them? That is a rhetorical question, by the way. Only significant-sized regional community banks can write checks big enough to purchase them.

The rest of the Independents, generating less than $200 million per year in annual originations will be able to find attractive homes in the smaller regional community banks that have weathered the storm described earlier. Yes, there are enough left that have the means and need the attractive ROA and charge-off metrics found in the equipment leasing and finance industry.

Brokers Can Now Join the Party

Earlier I discussed the rise of the securitization marketplace. So independent leasing companies that need to get to the $200 million per year threshold should be attractive acquirers of brokers whose principals are either aging out or want to fast-track the process of morphing from brokers to lessors that hold some book of assets on their balance sheet. However, these brokers will need to up their games to be attractive tuck-ins to these independents. Upping their game means investing in systems, specifically in data warehouse technology, to mine the data to validate their value proposition. Only a few of these technology companies have emerged as of late and are easy to find as they have been front and center if anyone has paid attention.

Bank-Owned Leasing Companies

Earlier I discussed that there are a number of these entities whose parent banks have found themselves in the position of raising their capital and curtailing their assets in the national equipment leasing and finance markets. RAS is seeing a great deal of angst in these bank-owned leasing groups. What does that mean? They may be drivers of lift-outs to other banks that have come out of the 2023 meat grinder in good shape and are actively looking for an entry into our industry.

M&A Projections (continued)

As we reflect on the intricate dynamics of the equipment leasing and finance landscape, 2024 emerges as a year of profound significance, characterized by a blend of challenges and opportunities. Amidst the aftermath of a turbulent period for community banks and the leasing industry, the stage is set for a transformative shift in the realm of mergers and acquisitions.

What becomes abundantly clear is the evolving nature of traditional norms, with independent lessors, bank-owned leasing entities, and brokers converging with renewed determination. The landscape of M&A in 2024 promises to be far from the "same ole rock 'n' roll" as diverse stakeholders navigate the rest of the year and early next year with strategic foresight and resilience. The opportunity they all see and have in common is adding equipment leasing and finance assets to their balance sheets, where the means are less important than the outcome. In this unfolding narrative, new entrants and investor-led existing entities are preparing to capitalize on opportunities through innovative methods and strategic collaborations. The next 12 to 18 months hold a myriad of possibilities, where adaptability and forward-thinking will serve as the cornerstone of progress and result in the sunny outlook we are projecting using our expanded definition of M&A activity.

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