Rental finance basics

As most of the major economies continue to recover, rental companies have seen big changes within their banks and leasing companies. This is particularly the case in the UK and some other European markets, where funders are competing on interest rates and credit criteria in a way not seen since the mid-2000s. But what does this mean for the rental industry, how long will it continue, and how should rental companies react? Finance consultant Jeff Eisenberg takes a closer look.

During the 2008 downturn, much of the banking system effectively stopped working in many countries. Governments injected vast sums of cash and took equity stakes in banks. In the UK for example, two of the largest banks, RBS and Lloyds, had government bail-outs that are still being paid back. Germany and Scandinavia (excluding Denmark) were less affected by this crash than other countries. Their banks were not as aggressive refinancing 'sub-prime' mortgages particularly in the US, partly due to cultural reasons. Sweden had its own banking meltdown in the early 1990s, and indeed their experience in nationalising their banking system in the previous crisis probably helped them avoid the latest meltdown.

Large scale construction requires a healthy banking system to finance building projects, so the equipment rental industry was doubly hit by the banking crisis, due to steep declines in demand from contractors at the same times as finance for rental companies dried up. Many rental companies found they had 2007 debt with 2009 cash flows, resulting in share price collapses and debt restructuring.

UK market - top to bottom

The UK equipment finance market is the largest and most developed in Europe. At the top are large bank-owned finance companies which provide billions for the financing of rental equipment through a variety of financial structures. Some of the funders are owned by UK banks - such as RBS-owned Lombard with more than £7 billion in assets - but prior to 2008 foreign owned institutions such as ING, GE, multiple Irish banks, and others also injected billions into the equipment market.

Rental companies with strong balance sheets can obtain lines of credit from the big leasing companies for margins of 0.75 to three percent over cost of funds. The majority of the largest funders have their own salesforces but some of them have traditionally taken some broker introduced business as well. (This has changed significantly post-recession, but more on that later).

In the middle of the market, dozens of funders compete including bank owned leasing companies, along with companies like JCB Finance, Siemens Financial Services, Hitachi Capital, and Caterpillar Financial services etc… who started out financing parent company manufactured products but are now significant diversified equipment funders. They typically charge a range of margins of say 1.25 to five percent over the cost of funds. In construction equipment, much of the business is done via close relationships between the suppliers of the equipment and the funders.

The UK is unusual in Europe in that it has a thriving 'sub-prime' equipment finance market. Young rental companies, those which have emerged from insolvency and the relatively undercapitalised, can turn to the likes of Close Asset Finance, Five Arrows Leasing Group - formerly most active as State Securities - and a handful of specialist leasing companies that will charge seven to 15 percent plus interest per annum. The best of these companies understand exactly what the values of used and repossessed assets will be, and are real 'asset funders' who depend heavily on the values of the equipment to compensate for somewhat weaker company financials. Their higher margins compensate for higher average default rates and much of their business has been originated via brokers and advisors rather than having a direct salesforce.

This sub-prime equipment finance business is very rare in the rest of Europe. One executive of a leading European leasing company said that in most countries "Either the money is there at attractive rates, or it is not there." In contrast to the UK where newer rental companies start their fleets with expensive money from sub-prime leasing companies, then with each passing year and hopefully strengthening financials, they work their way up the ladder to lower cost providers.

Captives

Most medium to large suppliers of construction equipment have some kind of 'Captive' or in-house financing capability. Rarely does the supplier actually finance the equipment with their own funds. Instead they introduce outside funders, or re-finance the leases behind the scenes. This refinancing may or may not be visible to the

customer. Manufacturers will only use precious capital to support the finance of incremental sales or as a tool to increase or maintain equipment pricing.

The manufacturer will though often provide 'credit enhancement' to the funder, either through introduced funders or refinanced leases. This enhancement may be an agreement to repurchase or remarket the equipment in the event of default, or 'recourse' agreements to share the losses if the recovered equipment does not cover the lease payments outstanding.

Credit enhancement does encourage funders to give larger credit lines, longer terms, residual risk/operating leases, smaller up front deposit requirements, or a lower cost of funds, depending on market demands and how hungry the supplier is for the incremental sales. Some of these 'captives' are well developed finance companies in their own right, even joint ventures with bank-owned leasing companies, while others are merely a division or trading style of the manufacturer who acts as a broker. In some cases, the captive is actually a programme, where the funder dedicates one or more employees to work for the supplier under the supplier's own brand. Therefore, the captive may be able to introduce sub-prime lenders for smaller customers, or organise larger, low cost funding with the high street banks, or anything in the middle. Some former captives such as JCB Finance are now diversified successful finance companies in their own right.

Captives are also uniquely placed to offer part of rental company fleet financed on a low risk basis. This may include operating leases or early return options, which can lower the lease payment or lower the risk of fleet ownership for the rental company, or both. As many rental markets have not seen rental rates or volumes return to pre-crisis levels, this can be a very attractive proposition.

The recovery and interest rates

Most European markets, even Spain (less so Italy and Greece) are feeling the benefits of economic recovery. Credit is becoming more readily available, and interest rate margins are falling. It is worth keeping in mind that the banks own cost of funds have come down drastically since 2008, with the UK dropping from four to five percent to half a percent and the Euro-Zone to a quarter of one percent (see chart). For companies currently investing in equipment or refinancing this represents a huge saving. The biggest surprise in the UK leasing market is just how quickly funder margins have also come down. This is mostly due to extreme rate competition from the High Street banks and leasing companies that have re-entered the market in the past year.

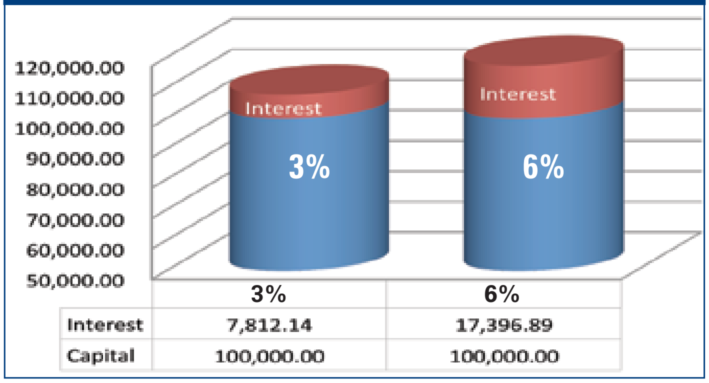
The amount of equipment investment for rental fleets in most countries is moderate, and mostly comprises replacement or refreshment of fleets after a five or more year pause during the downturn. Meanwhile funders with their cost of funds at historical all-time lows are aggressively trying to rebuild leasing volumes faster than the customers are adding to their fleets.

One executive of a mid-priced leasing company in the UK complained: "In the recession we would have got the deal at say nine percent, but now even when there are only two of us submitting prices for a proposed transaction, we are coming in at seven percent, and the high street banks are immediately bidding three percent or less." Another added: "In the UK we see a lot of 'stupid' funding going on in terms of pricing and credit quality."

Of course for the rental companies the question is how do we get some of this 'stupid' pricing?

In the UK, the first step is to contact the cheapest funders - the high street Banks and their leasing affiliates. But contact them directly as some - such as Lombard - are no longer taking broker-introduced business. During the recession, several studies showed a correlation between broker-introduced transactions and higher default rates, plus this appeared to be

Total interest payable 3% vs 6% - *5 year financing on €100,000 value*



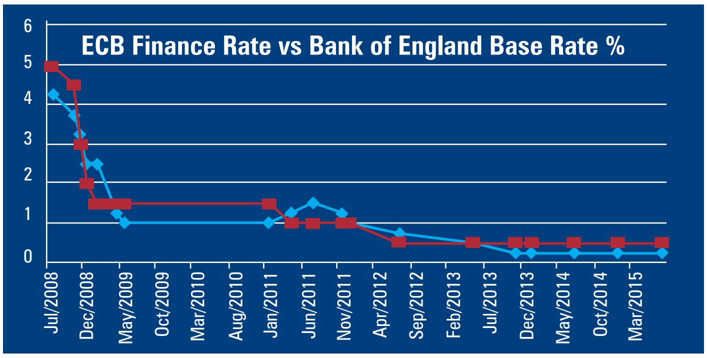
a way for the funder to keep the broker's margin.

ING, one of the largest lessors for construction equipment in the UK, closed its doors for new business in late 2012 with hundreds of millions of broker-introduced business on its books. Its parent bank was eventually bailed out by the Netherlands government.

However, incredibly for the funders - but good news for customers - the high street banks and other lessors that would have paid a brokerage fee of between half and two percent or more, seem to be just passing all the savings on to the customer. The broker of course has an incentive to only introduce funders who will pay a commission, or to favour those paying larger commission.

contact the funder directly. Some funders will hear an alarm bell ringing and refuse a transaction if they see the same customer or transaction via more than one channel.

In conclusion, low interest rates are likely to stay with us for some time. The Euro-Zone and UK recoveries are relatively slow and inflation seems to be a far-off risk, which will keep the bank cost of funds low for some time. Strong competition among equipment funders will also maintain the pressure on them to reduce margins. With rental volumes and rates recovering at a painfully slow rate in many markets, lower finance costs and increased access to credit lines for fleet replacement and growth is very welcome news for rental companies.



Where is a broker useful?

A reputable broker can be extremely useful, particularly for younger companies that are still building their balance sheet. Sourcing enough investment for a sizable rental fleet may require several funders, a mix of sub-prime and mid-market leasing companies, some of which have no sales forces and rely on brokers for all of their lease origination. But a rental company should be careful to work with only ONE broker and agree where they will try to place a transaction via the broker and where the company will

About the author

Jeff Eisenberg has been involved with the equipment rental industry since the mid 1990s, initially helping set up Genie Financial Services. Since 2000 his roles have included rental company director, shareholder, advisor, consultant and even equipment operator. While his career has been controversial at times, he certainly knows his way around a balance sheet and the finance market. In more recent years he founded and runs Claremont Consulting, advising financial institutions, investors and rental companies. He can be contacted on jeff@claremont-consulting.com

Arvid Bergli with his HIAB in Lofoten, Norway

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