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UBI SUNT SMALL TICKET LEASING¹

By Barry S. Marks²

The current economic environment has put pressure on all aspects of finance including the small ticket transaction. While some companies are clearly thriving in the tight credit environment, others have closed their doors and exited the market entirely or gone on hold for the next several months while things sort out. This article will discuss the possible impact of the current economic crisis on small ticket leasing.

First we need to consider exactly what we mean by "small ticket" leasing. While there is plenty of room for debate as to whether the term should apply to transactions of less than \$250,000, \$100,00 or some other line of demarcation, certain facts about small ticket leasing are common, if not universal.

Accent on credit, not collateral. In today's legal environment, it is uneconomic to attempt to repossess, repair, market and sell items of collateral having low value. While this can certainly be done on a mass basis (see below), the focus in most small ticket transactions is on the credit of the lessee, rather than the value of the collateral. Small computers, kitchen equipment and even individual manufacturing items or vehicles are often not worth the cost by the time the lessor is able to recover them, particularly if the lessee is not cooperative. For this reason, personal guaranties are the rule rather than the exception.

Importance of Volume. While investors may find it worthwhile to dip their toe in the pool with a few participations in larger transactions or portfolios of small transactions, operating a small ticket leasing company requires volume. The analysis is not unlike that used by insurance companies and other risk managers: there are going to be a higher volume of defaults and the occasional bad deal that must be offset by better deals; the cost of managing the portfolio may be higher than that of a few larger transaction and it makes sense to spread the cost over a larger volume of deals.

¹ For those who slept through their freshman English survey course, *ubi sunt* means, loosely "where is gone". Just think "Ubi Sunt, Joe DiMaggio".

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Simple deal structures and documents. There is not enough money involved in a single transaction to negotiate documents on a line-by-line basis or devise complicated structures and collateral arrangements. Small ticket transactions are form-driven and the *K.I.S.S.* principle rules.

High Yield, High Risk. Perhaps most important for the analysis is the fact that small ticket leases often involve higher risk and therefore command higher implicit rates and yield. For this reason, many larger banks are unable to participate in small ticket programs while community banks have found that purchasing portfolios of small ticket transactions from reputable originators is a good source of loan diversification and yield. As to the risk of the transactions, unlike larger transactions, small ticket transactions include a wide variety of credits and, as noted often weak collateral. Large ticket transactions rarely include start-ups or thinly-capitalized entities (they simply cannot get financing) while many small ticket deals find homes on the basis of the high yield.

Market Stratification. Perhaps because of the varying credit and collateral qualities, the small ticket market is exemplified by distinct strata of lenders: A lenders (including banks lending to their existing customers), B lenders, C-D lenders and very high risk/yield lenders divide up the market and some transactions move from one level to another as an originator seeks a home. Each type of lender/funder matches a preferred rate to the acceptable credit profile.

Where the Market is Going. These are not the only observations possible about the small ticket market and the writer does not mean to suggest that they are universally true. Nevertheless, armed with them it may be possible to make a few observations about the short-term future of the small ticket market.

First, as the remarkably loose money lending environment of the past decade becomes a more distant memory and credit tightens, it can be anticipated that many of the transactions will drop one or two tiers through the lender/funder markets. What this means is that a credit that was formerly a weak *õAõ* or *õBõ* may find itself dropping down in the C-D profile and require a higher rate to have any hope of being funded.

This situation may be exacerbated by a flood in the market of certain types of collateral as weaker credits fail and repossessions become more common. Borrowers, particularly those with floating rate loans, will experience a double whammy of higher rates and tighter money in 2009. Declining real estate values and interest in expanding mortgage portfolios will dry up anticipated sources of revenue even if the markets for goods remain strong. All this will lead to defaults, repossessions and sales of equipment collateral.

All is not, however, doom-and-gloom. At the present time many banks have tightened their lending or sent out word that they are on the sidelines for the next several months. If we fast forward to the end of the first quarter of 2009, it is entirely possible that these banks will find themselves enjoying much higher-rate lending at a time when the stock market has settled if not begun its inevitable, if slow climb.

Higher potential yields will become increasingly attractive, particularly for financial institutions whose real estate portfolios remain depressed even if improved.

While the writer's crystal ball is at the cleaners and it is anyone's guess what ultimately happens, it is not unreasonable to expect that more banks, particularly community banks who have maintained good levels of capital and available cash but are looking to diversify and improve yields (attracting stockholders who have left the large investments behind) are likely to be attracted to portfolios of good quality, high yield, non-real estate investments: small ticket leases.

Another observation that may be safer is that we will see some players exit the market permanently. In the free money environment, the application-only transaction has resulted in a lot of sloppiness. Lessors who have put too much reliance on high volume and not enough on individual transactions, either with respect to credit or documentation will experience heavy losses. Some big players are already experiencing serious difficulties and more will follow. Recent years saw a narrowing of margins in credit extensions to better credits and increased competition. It seems likely that this trend will continue in the very short term, and then be replaced with better results as rates are allowed to rise.

At the same time, a change in lending/funding criteria is likely. While the app-only transaction may not go the way of the buffalo it is submitted that less of this loose money will be available in the years to come, the speed with which these transactions are turned may slow and the level of app-only lending is likely to drop. Whether or not it is fair, many institutions will blame the app-only program for losses and be unable to explain it to their directors and shareholders.

As those who buy or lend against leases cut back on staff to reduce overhead, they will be forced to cut off unproductive originators and those whose transactions require time and attention. This, together with reduced appetite for application-only transactions will require originators to learn or re-learn financial analysis and award the hardest-working, most sophisticated originators while penalizing those whose sales talent was not matched with back-office skills and knowledge.

In the short-run, it is likely that small ticket leasing, like all leasing and other finance activity, will suffer while the current financial crisis works itself out. The Equipment Leasing and Finance Association recently reported that leasing volume across the board has declined in October and is flat for 2008. Experience has shown that leasing activity reacts negatively to sudden changes in the financial or legal environment, and then recovers whatever the change. It is likely that many lenders and lessors will wait on the sidelines while interest rates recover and the financial health of the nature improves.

In the longer run, the small ticket leasing market will be healthy and probably improve over current levels simply because, at least at present, the appetite for borrowing remains strong. The best guess at this end, however, is that there will be less players, higher rates,

a return to the full credit package including financial statements as the norm and a general retreat to the market conditions we knew several years ago, before money got loose and many of us got a bit too brave. Small ticket leasing will be harder to do, but possibly even more rewarding for the best originators, lenders and lessors. As with pilots, there will be old small ticket lessors and bold small ticket lessors but no old, bold small ticket lessors in the years to come.

Barry Marks and Kenneth P. Weinberg are founding partners of Marks & Weinberg, PC. They have significant experience in dealing with virtually every type of equipment and facility lease financing, have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. If you would like more cases or articles on leasing, or have any questions or comments about this Article or other leasing issues, please visit www.lease lawyer.com or contact Barry at 205-251-8303 or Ken at 205-251-8307.

