Analysis

EXPERT Q&A

Europe's asset finance market is large and has historically exhibited attractive risk-return characteristics, so why have the banks been retrenching in some areas? Paul Burdell of LCM Partners reflects on how the industry is evolving and what opportunities are available to alternative asset managers

European asset finance: What's not to like?

Q What is the size of the European asset finance market?

The European asset finance market is in good health. Levels of activity have rebounded strongly since the global financial crisis and figures from the 2019 World Leasing Yearbook show that annual leasing volumes are now at all-time highs and well in excess of $400 billion.

Within Europe, activity is dominated by the UK, Germany, France and Italy, with the UK ($92bn of annual volumes) and Germany ($78bn of annual volumes) being the third and fourth largest markets globally after the US and China.

Q How has the asset class performed historically?

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Given the in-built security of a lessor retaining ownership of the underlying asset while it is out on lease, it's unsurprising that performance of the asset class as a whole has been strong. This is particularly evident when analysing SME default and loss rates from

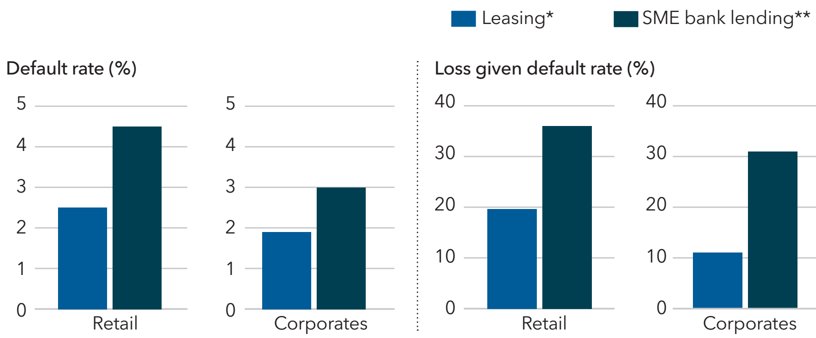
$428bn

Annual leasing volumes in Europe's asset finance market

the financial crisis. In 2013, Leaseurope commissioned Deloitte to write a point of view paper, *The Risk Profile of Leasing in Europe*, which covers this topic in detail. As part of the report, Deloitte reviewed information on 3.3 million asset finance and lease contracts in 15 European markets, covering almost 200,000 defaults between 2007 and 2011. The chart opposite shows the report's findings for average one year default rates and average one year loss given default rates on those defaults over a five year period. The findings equate to average annual net loss rates of 0.2% and 0.5% for corporate and retail leasing respectively over a period of heightened macroeconomic stress.

To put these findings in the context of the broader market, the chart compares these leasing default and loss rates against traditional bank SME lending by using the European Banking Authority (EBA) 2010 loss and default rate data from its 2011 EU-Wide Stress Test Aggregate Report as the comparable; although those SME bank loans still displayed robust performance it is clear that defaults were higher and recoveries lower when considered beside leases.

Leasing and traditional bank SME lending default and loss rates during the financial crisis



* average one-year leasing default and loss rates, 2007-11
** 2010 data

Source: Deloitte; EBA; based on Basel II asset class classifications

Q What are the current market dynamics?

Given the growth in European asset finance, and the historical performance of the asset class, one might expect the industry to be an area of focus for the banks. Certain parts of the market are undoubtedly highly competitive but it's also the case that SMEs remain underfunded overall and we've seen banks deciding to exit some product segments of the asset finance market or even whole geographies over the past five years.

Through the LCM Credit Opportunities strategy, we acquire performing, rescheduled and non-performing loans. In recent years we have acquired two significant leasing portfolios in the UK where the vendors have decided to exit the business line. Not only have the transactions performed well, these purchases have helped us to improve our understanding of the asset class in a number of ways. First, the portfolios have been serviced by LCM's servicing affiliate, Link Financial, which has developed its own proprietary system with the ability to manage the full complexity of leases as a product. Second, we have multi-year loan level performance data on the borrowers from these pools. Third, following demand from the underlying customers for the provision of additional financing, we launched our direct lending strategy LCM Strategic Origination & Lending Opportunities (SOLO) in 2018, which has leasing as one of its core points of focus.

Q What's driving some banks to exit asset finance?

Ultimately, it's about capital efficiency. The banks are increasingly capital constrained under regulatory legislation such as Basel III and are focused on deploying capital in core business areas that generate the highest returns on equity. Some banks have failed to gain sufficient scale in asset finance and, as a result, the business has been deemed non-core.

Similarly, the decision on how best to deploy capital is also being affected by new accounting standards, such as IFRS 9. This introduces an expected loss – instead of an incurred loss – provisioning methodology and obliges banks to take larger and earlier provisions across their loan books. The issue for lenders in relation to asset finance is that leases are longer term, typically 48 to 60 months, meaning a proportionately higher risk weight is applied compared with shorter dated loans and that capital is then tied up for the term of the lease. Even for banks with well-established asset finance businesses, there are now question marks as to whether the industry will offer attractive risk-weighted returns over the long term on both an absolute and a relative basis.

Q What are the opportunities for alternative asset managers?

The obvious starting point would be the largest markets in Europe, namely the UK, Germany, France and Italy. This is particularly true for us, given that we have a local presence in each of these countries through our pan-European servicing operations. However, the reality is the opportunities are far more nuanced.

Italy is a country where we don't expect to be active, given that the advantages of being an asset manager backed by third-party capital are limited as all leasing operations are required to hold regulatory capital.

Conversely, the regulatory regime in Spain, another country where we have a local servicing operation, has made it an attractive place for us to transact. Lease revenue streams are treated as "royalty" payments and are taxed for non-resident lessors, so an ability to transact locally is advantageous. This has put off some foreign market participants and reduced competition, particularly in the smaller-ticket transactions that are of less interest to the Spanish banks.

In terms of the types of opportunities, it's about focusing on those clients that the banks are not able to service and differentiating one's offering from other market participants.

We've had a number of conversations with businesses looking for a pan-European financing solution that have found dealing with banks across jurisdictions to be cumbersome. The added advantage for us is we're able to offer a pan-European servicing capability alongside any financing arrangement.

Moreover, it's important to be flexible. Clients are becoming increasingly innovative, and although banks often struggle to accommodate non-standard demands such as 'pay as you go' or 'pay per use' products, asset managers can be more creative with their solutions and quicker to market.

Asset finance is a popular product among SMEs with leasing penetration rates as high as 30% in some cases, such as those involved in UK equipment leasing. For those that are able to gain traction in areas where the banks are less active, we think the investment opportunities are compelling.

Asset finance is an important constituent of our SOLO strategy and, given LCM's experience and pan-European footprint, we believe we are well positioned to take advantage of the opportunity presented by more traditional funding sources shifting their focus from the market. ▯