

Asset-based financing and leasing: Canadian market overview

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(prepared for the Canadian Finance and Leasing Association)

INTRODUCTION

The Canadian economy slipped into recession in 2008, growing by just 0.4%, a rate significantly slower than the 2.5% rate in the previous year. The economy in 2008 was affected by slumping exports and both residential and non-residential construction. Government spending and personal consumption spending remained strong while business investment in machinery and equipment posted a gain of 0.5%.

The credit crisis and ensuing global recession have ushered in an era of significant contraction for the asset-based financing industry. In 2008, equipment lessors and commercial vehicles new business fell 5%¹.

The outlook for 2009 remains bleak but a modest recovery is still anticipated in 2010. The recession in the U.S. and Canada's other trading partners is leading to a substantial decline in both the demand and the price paid for our exports. Most lessors are not optimistic about activity in 2009 as public and private spending on machinery and equipment is expected to shrink 6.7%².

This article provides a review of recent trends, the outlook for and highlights of major trends in the leasing sector, and ends with a summary of the key issues facing the asset-based financing and leasing industry in Canada.

ECONOMIC AND CAPITAL INVESTMENT OUTLOOK 2009

Looking forward, the Canadian economy is expected to shrink by 2.1% in 2009 and then to grow 1.6% in 2010. Exports, business investment and household spending are all expected to contract in 2009. Stimulus spending by governments is the only positive for the economy.

Business investment in Canada is expected to fall 7% in 2009 but this pales in comparison to the 21% drop expected in the U.S. Inevitable delays in getting spending for "shovel ready" projects approved means that the bulk of government stimulus spending will occur in 2010 rather than 2009. Lower commodity prices and weak foreign demand have also led to the delay or cancellation of a number of natural resource-based projects across the country.

No province is expected to experience positive growth in 2009. New Brunswick and Nova Scotia are expected to fare the best at zero growth. Newfoundland and Labrador is expected to experience the largest decline followed by Ontario, Alberta and British Columbia. All the provinces are expected to experience positive growth in 2010 with Newfoundland and Labrador leading the country.

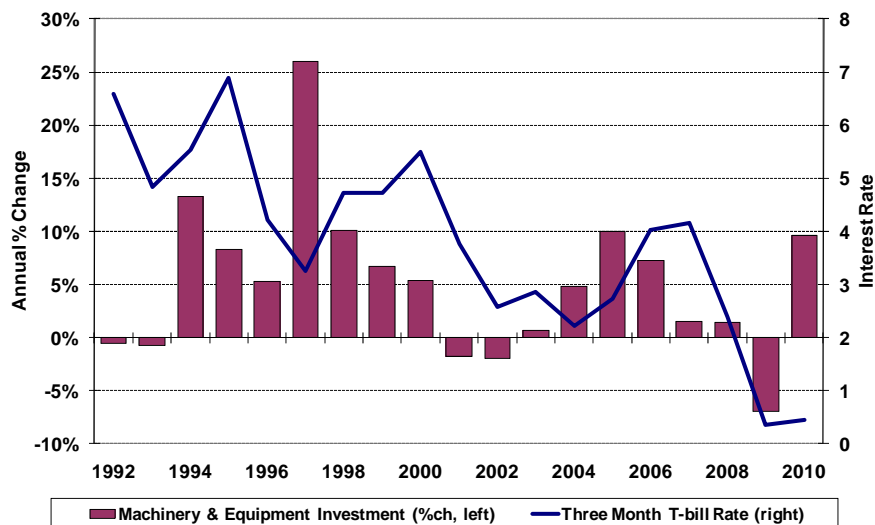
Large reductions in natural resources investment and exports are responsible for the economic declines in Newfoundland and Labrador, British Columbia, Alberta and Saskatchewan. Saskatchewan also has to contend with the likelihood of a poor harvest. Ontario's economy remains a victim of the decline of its manufacturing sector.

¹ Based on estimates derived from a survey of member companies of the Canadian Finance and Leasing Association.

² 2009 Private and Public Investment in Canada, Intentions, *Catalogue no. 61-205-X*, Statistics Canada, March 2009.

The chart shows the C₄SE's forecast for growth in business spending on new machinery and equipment³ falling 7.0% in 2009 before recovering in 2010. The apparent difficulty in getting infrastructure projects funded by government stimulus spending started contributes to the lack of spending in 2009 and the anticipated surge next year.

Waiting Out The Storm Canadian Leasing Market Determinants



Source: The Centre for Spatial Economics

The Statistics Canada survey of public and private investment intentions for 2009 anticipates a fall in capital spending over 2008. Public and private spending on new machinery and equipment was expected to fall 6.7% or C\$7.7 billion this year following the 0.3% increase in 2008. CFLA survey respondents were, however, significantly less optimistic about new business in 2009, anticipating a decline in new equipment leasing business of 20%.

Statistics Canada's survey reported that significant declines in investment are expected for the mining and oil and gas extraction industry, accommodation and food services, and administration services. Manufacturing sector investment is expected to decline another 8.5% in 2009 with lower capital spending expected in 13 of the 20 industries that make up the sector. The largest declines are expected for wood products, petroleum and coal products, and transportation equipment.

Public sector investment is expected to grow 10.5% in 2009, following a 22.3% increase in 2008. While all levels of government have increased spending, local government spending is responsible for much of the growth. This spending is also responsible for modest growth in the utilities, transit and ground passenger transportation sectors where the public sector is responsible for over two-thirds of investment spending.

The decline in capital spending is expected to be largest in Alberta and British Columbia as a number of projects in the oil and gas extraction industry are postponed or cancelled. Ontario is affected by spending declines in manufacturing, finance and insurance, and administration services but will be partially offset by increases in public sector spending.

FINANCIAL MARKET DEVELOPMENTS

The credit crisis precipitated a global recession. The simultaneous decline of the world's major economies has, in turn, placed further pressure on financial markets. Coordinated government intervention through

³ This data excludes the public sector spending which is included in Statistics Canada's public and private investment intentions data. The C₄SE's projection for 2009 is also based on more recent information than was available to the participants in Statistics Canada's intentions survey.

stimulus spending, injections of capital into financial markets and the bailout of companies considered too big to fail has averted a potential worst-case 1930s style depression scenario.

Credit spreads have narrowed from their peaks at the onset of the crisis but still remain high by historical standards as investors have significantly reduced their tolerance for risk. In an attempt to increase the flow of funds available to finance companies, in its January 2009 budget, the Government of Canada launched the Canadian Secured Credit Facility (CSCF) with an allocation of up to C\$12 billion, to purchase term asset-backed securities (ABS) backed by loans and leases on vehicles and equipment. Critics have argued that the program is too expensive and cumbersome and may not achieve its twin goals of providing finance companies with access to funds and promoting the resumption of a normal market for asset-backed commercial paper. The program has also been criticized for serving only a small number of large companies with smaller leasing companies unable to benefit directly from the program.

Federal officials contend, however, that the CSCF was designed to respond to industry concerns voiced in late 2008 that they could not access capital at any price. Officials maintain that the government only intended the CSCF as a temporary backstop, allowing lessors to confidently originate new transactions knowing that federal financing was available if private sector funding was not.

The government justifies the cost of funds as reflecting the market rate. Officials assert that the \$12-billion on offer was oversubscribed at the rate determined in early spring. While the government could offer financing at a much lower rate given the government's cost of funds and still make a profit, officials were concerned about being trapped in the program over the long-term because private investors would be displaced, abandoning the market for a much longer period of time, uninterested in competing at lower than market rates.

For the government, the CSCF is considered win-win. If lessors take up their allocation of federal funds, the industry will have been helped. If lessors do not take up their allocation, it is because the private sector has resumed funding and the government believes that the CSCF played a role in jumpstarting market interest in the industry.

As for the general cost of funds, the Bank of Canada has reduced rates in line with the U.S. to ease the negative impacts of the credit crisis and to increase economic growth. Short and long-term interest rates have fallen sharply in 2009 as the Bank of Canada has acted to support economic growth by keeping rates near U.S. rates so as to limit an appreciation of the exchange rate. The 3-month Treasury bill rate is expected to remain at about 0.5 percent for the balance of 2009 and 2010 in line with U.S interest rates

The Canada-U.S. exchange rate continues to make headlines as rapidly shifting investor sentiment pushes up or down the US dollar against other currencies. The Canadian dollar is expected to depreciate from \$US 0.96 in 2008 to average \$US 0.88 in 2009. This outlook is consistent with lower commodity prices and weaker economic performance. Significant fluctuations in the value of the dollar, however, remain likely as global investors continue to assess the riskiness of their US dollar assets.

ASSET-BASED FINANCE MARKET IN CANADA

The leasing cycle is typically coincident with the equipment expenditure cycle. As a result, the outlook for leasing this year is poor but activity should resume in 2010 provided there is sufficient access to credit. The Government of Canada's Canadian Secured Credit Facility is designed to provide finance companies with access to funds and promote the resumption of a normal market for asset-backed commercial paper. As discussed above, the program faces significant criticism and it remains to be seen when credit conditions will improve.

The market size estimates generated based on the CFLA's 2009 Survey of Industry Activity indicate that the value of non-consumer finance assets rose 2% to C\$53.8 billion while new business volume fell 5% to C\$22.6 billion in 2008.

The current market estimates indicate that 19.6% of new business equipment purchased in Canada is financed by the industry; down from 20.8% in 2007. This marks the third consecutive year of declines in this proportion.

Survey respondents expect new business to fall 20% in 2009 accompanied by a significant restructuring of the industry as both major and minor players merge or exit the industry.