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Legal Guide to Leasing in Russia for Foreign Lessors

By Irma Foley

Favorable changes in Russian leasing law are making leasing more attractive than other financing methods for both Russian lessees and foreign lessors. Increased economic effectiveness, flexibility, and accessibility are some of the positive changes.

The Response to Customer Default: Captive Versus Non-captive Lessors

By Itzhak Ben-David and James S. Schallheim, PhD

Repossession or write-off? The default remedies of captive and non-captive leasing companies can vary significantly. This Foundation-commissioned study explores the behavioral differences between captives and non-captives in instances of default.

Management of a Diverse Workforce: Meanings and Practices

By Jenny Hoobler, PhD, Tim Basadur and Grace Lemmon

What does diversity management mean in a leasing setting? To find out, this study commissioned by the Foundation surveyed human resources managers in leasing companies as well as diverse individuals within those same firms.

The Response to Customer Default: Captive Versus Non-captive Lessors

By Itzhak Ben-David and James S. Schallheim, PhD

A better understanding of how lessors respond to default could help increase efficiency in the leasing market. Market participants would better understand how to react to default themselves by knowing how other institutions behave under similar situations. In addition, knowledge of a leasing company's specialization in core assets and its accompanying default remedies could help other lessors target their market niches.

In further support of this belief, several economic theories have suggested that default response may be an important differentiating factor between captive and non-captive lessors. For these reasons, this study focused on default procedures—specifically, how captive and non-captive lessors differ in their default remedies.

Using the PayNet database, we documented several characteristics of the lease contracts.¹ These include asset type, contract size, and term of the contract as well as default remedies implemented. This research revealed:

- Captive leasing companies (in which at least 50% of the lease portfolio consists of products produced by a parent or affiliates) are significant participants in the leasing marketplace. According to the Equipment Leasing Association's 2005 *Survey of Industry Activity* (SIA), 25% of new-lease volume in 2003 and 2004 was reported by captive lessors.²
- Most captive lessors are subsidiaries of equipment manufacturers that specialize in leasing a range of products that is narrower than the variety leased by non-captive lessors.

Captives seem to have two conflicting motivations when it comes to default response. On the one hand, captives can incur higher indirect

costs than non-captives when repossessing assets in default. For example, captives risk their brand reputation as well as their long-term relationship with a customer when they repossess an asset. Hence, captives may prefer to renegotiate the loan instead of taking the more drastic measure of repossession.

On the other hand, captives have the ability to generate higher values from repossessions than non-captives, because they can resell used equipment at a price based not on a cursory reading of the market but on proprietary information that they or their parent companies have amassed about the asset and its customers.

Recognition of this conflict led to the formation of a simple, testable hypothesis.

Hypothesis: Captive lessors are more likely to repossess equipment as a default remedy than are non-captive lessors.

Support for an alternative hypothesis can be found in arguments concerning a captive's relations with its parent's customers. Wilner (2000) argues that vendors are more inclined to renegotiate bad loans rather than to repossess assets, because they can lose their reputation and destroy current and future relationships. Brennan (1988) reasoned that vendors provide financing to their customers in the first place because it is an effective marketing tool that delivers better value to credit-constrained customers. Hence, vendors may attract customers with low credit that prefer to lease assets from a more lenient captive lessor.

Alternative hypothesis: Captives are less likely to use repossession as a default remedy than are non-captive lessors.

Results from researching the hypothesis and its alternative revealed the following.

Default response may be an important differentiating factor between captive and non-captive lessors. The results of this study support the hypothesis that captives are more likely to repossess in default.

Captives are in the unique position of having access to a known customer database of potential lessees. Captive lessors are also more sales- and customer-driven, whereas non-captives are more credit driven.

- Captives have the ability to remarket equipment after repossession and potentially obtain top dollar. Thus, with lower disposal costs, vendors prefer repossession over litigation or renegotiation, especially if the chances of the customer surviving are low.
- Non-captive leasing companies, including subsidiaries of some of the largest banks, specialize in providing funds and monitoring leases for equipment in a wide range of classes and manufacturers.

Captives are in the unique position of having access to a known customer database of potential lessees (Petersen 1997). Captive lessors are also more sales- and customer-driven, whereas non-captives are more credit driven. And because captives are more willing to repossess equipment in case of default, they place more weight on equipment values than on lessee credit characteristics. Therefore, captives may be willing to take on lessees with lower credit qualifications than would non-captives. These arguments led to a corollary hypothesis.

Corollary: Captive lessors are willing to provide leases to lower credit quality lessees.

DATA SAMPLE

The data sample for this study consisted of over 600,000 individual leases and loans obtained from the PayNet database. These data cover the period from January 2002 to April 2004. Contracts were randomly selected from approximately one-half of the PayNet database. When a lessee was selected, we were careful to include in the sample all contracts with lessors for the sample period.³

Table 1 shows the default frequency for the entire sample. As seen here, the default rate for non-captives is slightly higher, at 4.5%, than for captives, at 4.2%. These numbers do not indicate that captives are providing credit to lower-quality lessees in terms of default, as proposed in the corollary to our hypothesis.

But it is informative to compare this information to that from an alternative data source: the

Table 1

Sample of 608,612 Individual Contracts from the PayNet Database, 2002-2004

Procedure	Captives	Non-Captives
In default procedures	4.2%	4.5%
No default procedure	95.8	95.5
Total	100.0%	100.0%
No. of observations	226,440	382,172

Survey of Industry Activity. The SIA does not report default rates, but does report the aging of receivables. In it, captives have higher receivables in the past-due, 30+ days categories (3.7% in 2003 and 3.1% in 2004) as compared to the non-captives, with past-due, 30+ days receivables (2.9% in 2003 and 1.9% in 2004). The SIA evidence for “late payments” is more consistent with the idea that captives’ customers may reflect higher credit risk, as suggested by the corollary.

TESTING THE HYPOTHESIS

To test the main hypothesis, that captive lessors are more likely to repossess equipment as a default remedy than are non-captive lessors, we examined default remedies by type of lessor. PayNet identifies the following default procedures in its database:

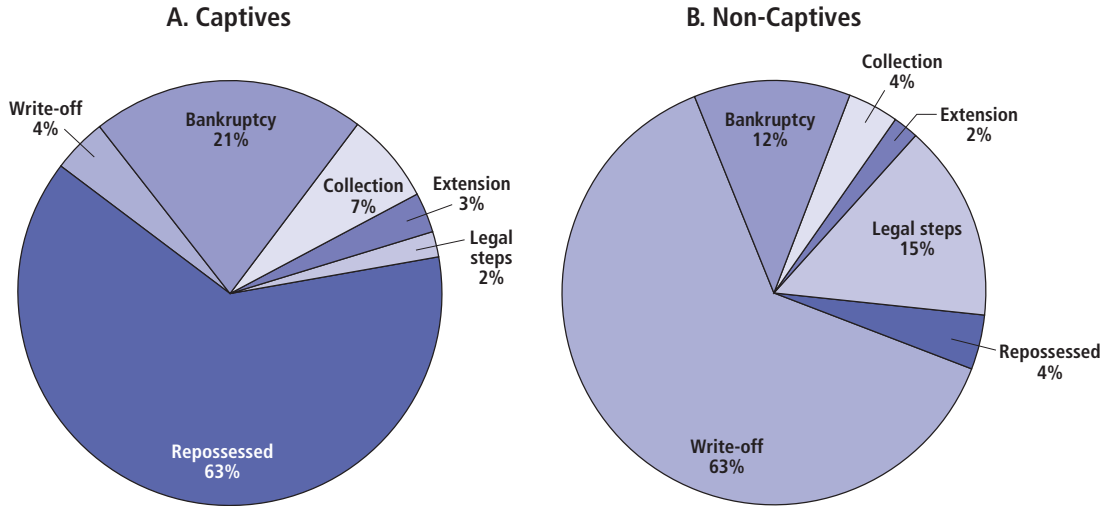
- bankruptcy
- collection
- extension
- legal steps
- repossession
- write-off

For the contracts identified as in-default, and in which the procedure is also identified, we calculated the percentage of contracts in each category by type of lessor. Figure 1 shows the results.

Parts A and B of Figure 1 offer overwhelming evidence regarding the differences in default procedure between captive and non-captive lessors.

Figure 1

Default Procedures for Captive and Non-captive Lessors



In strong support of the study’s hypothesis, 64% of the default contracts for captives used repossession as a default remedy, compared to only 4% of the default contracts for non-captives.

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Other differences in the default procedures of captive and non-captive lessors are evident in Figure 1. Non-captives are writing off bad debts at a much higher percentage than captives (62.5% vs. 3.8%). Non-captives are also instigating legal action at a rate of 15% of default contracts, with captives reporting less than 2%.

Lastly, the data show that the lessees of captives are filing for bankruptcy at a much higher rate than the lessees of non-captives (21% versus 12%). The bankruptcy numbers are consistent with the idea in the corollary that captives are offering leases to less creditworthy customers.

In the following sections of this article, we examine more details of the contracts, as compared to default procedures, and we summarize the results of examining asset type, contract size, contract term, and core assets.

database, we categorized the equipment into 13 asset types: forklift, manufacturing, medical, office equipment, printing and photographic, railroad, real estate, retail, telecommunications, trucks, vending and restaurant, waste and refuse-handling, and other.

In the sample, both captives and non-captives had concentrations of more than 30% of their contracts in waste and refuse-handling equipment. Captives had concentrations in manufacturing (20%), medical equipment (19%), and printing equipment (16%). Non-captives showed more diversity of equipment than captives, with concentrations in vending and restaurant equipment (22%) and trucks (9%).

Focus on the default contracts revealed that captives had the largest number of defaults in manufacturing equipment, with 71% of default contracts falling into this category. Non-captives, in contrast, showed the largest number of defaults (38%) in trucks.

CONTRACT SIZE

Size appears to be a highly important determinant of default and default remedies. The entire sample was divided into three nearly equal size categories. We then examined the default contracts within each category.

ASSET TYPE

One of the most important characteristics of the lease contract is the type of equipment or asset that is under lease. Using the PayNet

Asset write-offs are most prevalent for short maturities, while repossession by captives is more common for medium- and long-term maturities.

The repossession rate among captives was found to increase with size. Larger leases showed that repossession was used in 74% of default cases. Non-captives also showed repossession as the response most often used for their largest contracts, although the response occurred at a much lower rate (12%).

Greater repossession rates for large contracts are probably related to large residual values that likely exceed the transaction costs incurred to repossess the assets.

Also consistent with transaction costs, we found that the small captive leases had a higher rate of write-offs (11.5%). As contract size increased, captive lessees were less likely to file for bankruptcy. By comparison, the data revealed that non-captive lessees showed an increase in the likelihood of bankruptcy as contract size increased.

Interestingly, for the largest leases, the bankruptcy rates among lessees of captives and non-captives were almost identical (around 15.5%). Although non-captives wrote off a large number of small contracts (62%), they also took legal action at a higher rate for small contracts (23%).

CONTRACT TERM

The maturity period of the contracts was divided into three categories. For the entire sample, the lowest contract terms averaged around two years, the medium group averaged 46 months, and the highest group averaged a little more than five years. Leases produced by captives tended to have a longer maturation period than those produced by non-captives.

The breakdown of data according to the term of the contract continues to support the main hypothesis: that captives are much more likely to repossess in response to default, whereas non-captives are much more likely to write off the debt. Another observation from the terms of the contract is that asset write-offs are most prevalent for short maturities, while repossession by captives is more common for medium- and long-term maturities. If asset lives are correlated with contract maturity—which is likely—the higher

repossession rates for longer-term contracts is probably due to the longer remaining economic life and value for these assets.

CORE ASSETS

Captive lessors were concentrated in an equipment category by definition. Non-captive lessors may concentrate in a special equipment type as well. Lessees were also likely to have “core assets” that were prominent in their businesses. As an example, trucking companies use trucks as core assets.

Lessee core assets are defined as those that generate income for lessors instead of supporting their administration and peripheral logistics. For example, trucks and forklifts were classified as core assets for farms, but copier machines were classified as peripheral or non-core. The core, or specialized, assets of *lessors* was also examined, along with their behavior when lessees defaulted.

Captive core assets were defined as holdings of more than 60% of the same asset. Because non-captive lessors were more diversified, their holdings of more than 20% in an asset group were defined as core assets. (For details, see the full “Captives vs. Non-captives” report.)

For captives that leased the lessee’s core assets, there was a much higher rate of repossession (64.5%) than for the lessee’s non-core assets (28%). There was also a higher rate of repossession of lessees’ core assets by non-captive lessors (10%) than for lessees’ non-core assets (2%). Evidence also showed that captives experience greater repossession rates for their core assets (67%) compared to non-core assets (48%), whereas non-captives are more likely to write off their core assets (66%) than non-core assets (50%).

This evidence is consistent with the idea that both lessees’ and lessors’ core assets are valuable in default and thus experience increased rates of repossession. Nevertheless, the main hypothesis still holds, that captives are more likely to repossess in the case of default, whereas non-captives are more likely to write off the default.

SUMMARY

The main result of the study is clear: More than 60% of captive contracts were repossessed when in default, whereas only 4% of defaulted contracts were written off. In contrast, more than 60% of non-captive defaulted contracts were written off, while just 4% were subjected to repossession. These results support the hypothesis that captives are more likely to repossess in default. The hypothesis continued to hold when sample data was divided into categories based on size, contract terms, and core assets. Larger contracts and longer contracts had greater repossession rates than contracts that were smaller and shorter-term, requiring more payment frequency.

Greater rates of repossession also occurred for core assets of both the lessee and lessor. Still, captives use repossession in default at much greater rates than non-captives in all segments of the sample.

The results of the study point to these important differences between captives and non-captives.

- Non-captives usually are not in the equipment business, and thus repossession is a costly default remedy for non-captives. As a non-captive member of ELA commented, “We do not have the wherewithal to evaluate condition, refurbish, and remarket equipment in order to obtain the best price.”
- But in case of default, non-captives prefer to recover their investment as quickly as possible, and thus are more likely to litigate.
- Non-captives also are more likely to write off a bad debt. For example, many non-captive

lessors are financial institutions and therefore subject to regulatory requirements such as faster write-off policies.

- Captives, which are much less regulated, enjoy greater freedom in default response.

One final observation, in the form of a comment made by a non-captive ELA member, is pertinent: “A captive/manufacture is selling equipment with a huge gross margin, while the lease company is dealing in a small money spread. Clearly, the captive has much less to lose. We [non-captives], on the other hand, are desperate to recover our investment.”

Endnotes

1. Headquartered in Alpharetta, Ga., PayNet Systems provides custom credit-card processing services to retail, wholesale, mail and phone order, and e-commerce businesses.
2. ELA (now known as the Equipment Leasing and Finance Association) conducts the annual Survey of Industry Activity. In 2005, it tabulated responses from approximately 130 leasing companies (out of 435 eligible companies).
3. PayNet classifies contracts as leases or loans. Our sample includes 22% loans. The rest are classified as different types of leases.

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