Navigating Uncertain Waters

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# Table of Contents

- Management Summary ................................................................. 3
- Key Statistics .............................................................................. 4
- Country Background ................................................................. 6
- The Study ..................................................................................... 8
- Key Findings ............................................................................... 9
- Cost and Availability of Bank Credit ........................................... 11
- Alternative Financing and Asset Finance ................................. 13
- Sector Variations ......................................................................... 15
- Conclusions ................................................................................ 16
- Methodology ............................................................................... 16
Management Summary

Credit availability remains tight in 2010. Challenges being experienced in the Eurozone have introduced further economic uncertainty.

As a result, there is universal interest in the greater use of alternative financing techniques generally, and asset finance in particular, firstly to align costs to outputs/earnings and secondly to have sufficient access to working capital to take advantage of the economic upturn. In the UK, France and Germany, around 50% of companies are actively exploring financing methods outside of traditional lines of bank credit. In Poland and China, this figure rises to 75% and 85% respectively.

Specifically looking at asset finance techniques, such as leasing, around 35-40% of companies in UK, France and Germany expect their usage to rise in 2010 - around three times the levels researched in 2008. Poland (74%) and China (92%) are even more bullish. This suggests that interest in asset financing has undergone a long-term change, with companies utilising a wider range of financing techniques to manage their growth and efficiency finance requirements in the second decade of the 21st century.
Key Statistics

- Companies in Europe expect the cost of credit to rise during 2010; UK (65%), Germany (52%) and France (47%). Even higher proportions are seen in Poland (74%) and China (68%).

- Credit availability also remains tight, with expectations of credit limit reduction from a significant proportion of companies in UK (49%), Germany (34%), France (45%), Poland (50%) and China (61%).

- The advent of the Euro crisis, which has caused a major drop in stock and bond markets, has created further global uncertainty about the direction and pace of economic recovery.

- As a result, companies appear to be looking to diversify their financing sources to be best placed to deal with this economic uncertainty, to align their costs more closely with outputs and revenues, and to have sufficient access to working capital to take full advantage of economic recovery when it happens.

- In Europe, the exploration of alternative financing tools (to traditional lines of bank credit) has at least doubled between 2008 and 2010, with around 50% of companies in the UK, France and Germany now actively considering these techniques.

- Also in the UK, France and Germany, 35-40% of businesses expect their use of asset finance to increase in 2010, triple the levels researched in 2008.

- In terms of particular sectors, industry and healthcare are markedly above average in expecting an increase in the use of asset finance.

- The levels of expected increase in the use of asset finance have remained broadly consistent at 40% across 2009 and 2010, implying that companies have made a long-term decision to utilise a wider range of financing techniques.
• In Poland, a higher proportion of respondents report interest rate rises compared with Western Europe, a finding that is consistent with analysis by other EU institutions.

• However, Poland’s experience and future outlook around tightened credit availability is largely coherent with the other EU economies studied.

• In contrast, active exploration of alternative financing tools and expectations of an increase in the use of asset finance are extremely strong in Poland, with three in every four firms expecting growth in both areas.

• This is indicative of the critical role that asset finance is increasingly playing in Polish business and industry, particularly in providing dependable finance for infrastructure renewal and development.

• In China, liquidity does not pose the challenge experienced in the West. However, the authorities are becoming concerned about aligning lending with viable business development, and have started to gradually increase the price of business credit.

• Nevertheless, funding is being sought by Chinese businesses from multiple sources to fuel very rapid growth, while at the same time trying to intelligently align investment costs with income production.

• In China, the fixed payments typical of leasing arrangements are particularly conducive to predictable cost-per-use, that can be clearly offset against production cost-per-items.
Country Background

The availability of standard lines of bank credit for business across Europe has continued to tighten into 2010, although the net rate of tightening has slowed. According to the European Central Bank\(^1\), there has been “an unchanged net tightening of credit standards (3%), broadly in line with expectations in the previous survey round...... Looking forward, euro area banks expect the net tightening of credit standards on loans to enterprises to remain broadly unchanged.... While banks’ liquidity position continued to contribute to an easing of credit standards, the cost of their capital position and their ability to access market financing contributed to a tightening of credit standards.”

The Bank of England paints a similar picture\(^2\), remarking that, “Net lending to businesses has remained weak, with new facilities granted reported largely to reflect the refinancing of existing lending... consistent with efforts by some businesses to diversify their funding sources. Businesses continue to report higher spreads and fees on the renewal of facilities...”

These trends are emphasized in each of the three main European economies – Germany, the UK and France. The latest forecast from the EU\(^3\) notes that, “The economic recovery is underway in the EU, although it is set to be a gradual one.” The same report puts the UK at the forefront for GDP growth at 2.1%, compared with Germany on 1.6% and France on 1.5%. The UK and Germany are roughly parallel on unemployment, at 7.4% and 7.8% respectively, compared with France which languishes on 10.1%. On the other hand, the burden of high public deficits are felt in the UK (10% of GDP) and France (8.2% of GDP), compared with the much healthier figure in Germany of 4.7%. At the same time, there may be some rays of hope. Some property markets seem to be picking up. And commentators are predicting renewed vibrancy from the manufacturing sector as it finishes running down stocks, and starts production growth again in the UK\(^4\), France\(^5\) and Germany\(^6\).

However, a new and unwelcome note has been introduced by the call from Greece for fiscal stimulus from its EU partner countries, and the resulting crisis of confidence in the Eurozone and the Euro itself. Stock market indices around the world have fallen by between 9% and 13\(^7\) in a matter of weeks, showing that in our globalised economy; even the most vibrant of emerging

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\(^1\) ECB, Euro Area Bank Lending Survey, April 2010, 28th April 2010
\(^2\) BoE, Trends in Lending, May 2009
\(^3\) European Commission (Economic and Financial Affairs), European Economic Forecast, Spring 2010
\(^4\) Markit UK Economy, Q1 GDP boosted by output, investment and inventories, 7th April 2010
\(^5\) Business Week, France business confidence, manufacturing increase, 9th April 2010
\(^6\) World Bank, Prospects Daily, German manufacturing orders strengthen, 6th May 2010
\(^7\) Sources: FTSE, S&P500, Eurofirst 300, Shanghai Composite
markets has been ‘coupled’ to, and affected by, the Eurozone difficulties. Furthermore, repayment of a €440 billion European bail-out fund is predicted to put added pressure on European business and lead to a further rise in the cost of credit. An immediate victim of the crisis has been company liquidity, with bond issuance virtually halting.

As a result of these conditions in the Western World, businesses are having to accept that they will not be able to raise capital with relatively generous credit limits, for some time to come. Even if we see an economic upturn by the latter part of the year, banks have tightened credit policies to the extent that any future relaxation will be cautious and gradual. In any case, banks have a duty to regulators and shareholders to shore up their balance sheets and lend both prudently and cautiously from here on in. Inevitably, compared with the years of inexpensive credit running up to 2007, when the spreads had become extraordinarily narrow, the amount of new lending business taken on by the banking community is likely to remain suppressed for some time.

In the meantime, businesses have to invest to remain competitive and, in some cases, survive. A number of well known examples exist that show firms who invest in a downturn can gain very substantial competitive positions. The question is, where can companies turn for alternative sources of finance? There are several options, including factoring, invoice debt securitisation, leasing and renting, to name just a few.

In Central Europe, the world financial crisis has had some effect, even though economic growth has continued. Although Polish financial institutions were not involved in the purchase of “toxic” international assets, the high incidence of foreign ownership made them vulnerable to the outbreak of the global financial crisis, which has mostly affected Poland via the capital markets and the collapse of world trade.

One key EU economic analysis notes that a clear weakening of the macroeconomic situation, deterioration in consumer and business sentiment, as well as continuing uncertainty on financial markets, has resulted in a severe contraction in banking activities in Poland. This report reflects on hikes in corporate lending rates, observing that “Since the outbreak of the financial crisis, more than 80% of banks have raised their margins to corporate clients and nearly 60% expect higher guarantees to cover risk, while a third of them have reduced the maximum credit amounts available. Consequently, credits granted to the corporate sector decreased by 13.8% in the three quarters of 2009.”

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8 Les Echos, La Peur des Banques, 8th June 2010
9 Financial Times, Bond issues stall as euro crisis bites, 24th May 2010
10 Examples: Tesco, Nike.
11 ECFIN, M Strojwas, The Polish Banking System, 5th March 2010
China, whose growth merely slowed to around 9% in 2009\textsuperscript{12}, presents another scenario again. Liquidity and access to funds is not a problem. In fact there has been a major boom in corporate lending in recent times\textsuperscript{13}. However, the Chinese authorities are concerned that this boom may overheat the economy, and result in inappropriate levels of credit being available to organisations that cannot sustain those borrowings in the long term\textsuperscript{14}. This is also exemplified on a broader level by China’s central bank raising interest rates at the beginning of the year\textsuperscript{15}, and by keen expectation of further interest rate rises to come\textsuperscript{16}. As a result, there has been growing number of companies exploring alternative financing tools, particularly asset finance, in a bid to employ financing techniques that are more aligned to business usage and performance, as is shown by the research statistics in this report.

The Study

The main subject of this study is the impact that tightening credit availability and economic pressures are having on organisations’ usage of equipment finance and leasing. The reason for this focus is, that previous Siemens Financial Services studies have revealed, literally billions of Euros are ‘frozen’ in European organisations’ balance sheets because they are not making the most efficient and effective use of finance for their capital equipment acquisitions and upgrades\textsuperscript{17}. Yet without the most up-to-date technology and facilities, organisations are exposed to the danger of not being able to fulfil their customers’ developing needs nor respond to competitive pressures, and therefore are putting themselves at risk of sustaining serious commercial damage.

Uncertainty is the greatest challenge for business management, currently sitting between a double dip recession (or slowdown in emerging economies), the Euro crisis, and a possible economic recovery. Diversification of funding sources is a priority activity in these circumstances, especially the search for funding arrangements that are more closely aligned to outputs, revenues and profits.

Over the last decade, Siemens Financial Services across Europe has observed burgeoning activity in equipment finance and leasing from a number of industries and company types. The purpose of this research report is further investigate global interest in such asset finance techniques, and to identify

\textsuperscript{12} China, National Bureau of Statistics, January 2010

\textsuperscript{13} Financial Times, Chinese rivalry outweighs regulation, 4th May 2010

\textsuperscript{14} PwC, Foreign Banks in China, May 2010

\textsuperscript{15} New York Times, To slow growth, China raises interest rate, 7th January 2010

\textsuperscript{16} People’s Daily, Economist: China may raise interest rates in Q3, 22nd April 2010

\textsuperscript{17} Siemens Financial Services, Putting Capital to Work, June 2008
whether the areas of growth over the last ten years will be sustained over time.

**Key Findings**

In order to illustrate the nature and scale of challenges faced by organisations in Germany, France and UK as they strive to generate economic growth, Siemens Financial Services commissioned research into the availability of credit, along with the level of exploration and utilisation of alternative sources of credit such as asset finance. This research study repeats the themes of a report issued in the midst of the financial markets crisis in early 2009. However, for the first time, the study has also been extended to Poland and China. Poland is representative of the developing former Eastern European countries, which have in large part managed to escape actual recession but have still felt the adverse effects on liquidity and cost of credit in their banking systems as a result of the crisis. China has been included to represent the rapid growth ‘new world’ that is forging ahead to become a global economic powerhouse. Here, alternative credit sources such as leasing are being seen as a means to keep equipment investments in step with business growth, so that payments for equipment usage can be kept in alignment with production rates, revenues and profits, ensuring that Chinese firms do not take on inappropriate borrowings and get into business difficulties.

3,250 firms, representing the range of company size and sector, were interviewed between December 2009 and May 2010. Respondents comprised finance directors and managers in these firms – namely those most competent to answer questions on their own company’s experiences, and on the impact of a bank credit availability on their sector as a whole. The results were compared with statistics from the same study conducted over a year previously.

In the West, the purpose of this study was to understand how the reduced availability of bank credit was affecting companies’ ability to invest in capital equipment. What experience were companies having in terms of credit pricing and availability? How many were turning to alternative sources of credit such as asset finance? Was usage of alternative finance, especially integrated financing options for acquiring new equipment, expected to rise in the next year or two? And perhaps most importantly, how did companies perceive such equipment investments affecting their competitive edge? In Eastern Europe and the Far East, two quite different parts of the world that, for very different reasons, have escaped recession, the study was designed to investigate how, and why, attitudes to borrowing, finance and investment differed from Western Europe.
The results across the five countries may be summarised into a few clear trends:

- Bank credit was reported to have remained tight in all three Western economies of Germany, the UK and France
- Of the three Western nations, the UK seems to have gone through the most pain at the earliest point
- Poland’s expectations for the price and availability of business credit are broadly consistent with the other EU economies studied
- In China, funding is being sought from multiple sources to fuel very rapid growth, and to try and intelligently align investment costs with income production

The next section illustrates the report’s findings in more detail, accompanied by possible reasons and interpretations of the trends observed.
Cost and Availability of Bank Credit

In Europe, it appears that the worst may be over. The overall proportion of European firms experiencing a rise in the cost of credit has fallen since 2009, in line with ECB and Bank of England indications. The evidence-based future outlook for borrowing costs – where the bank has already indicated that costs will rise - follows the same pattern with the UK and Germany having seen a highly stressed 2009 which has now ameliorated somewhat. In France, some 6% growth is predicted for industrial investment in 2010, compared with a 23% fall in 200918.

Poland shows a similar level of definite credit cost rises to its counterparts in Western Europe. In China, however, the certainty of credit cost rises in 2010 seems much higher, in line with expectations for overall interest rate increases this year19.

Interestingly, in contrast with actual experience so far this year, the sector and national future view of the cost of credit across 2010 reveals forthcoming pressure on companies in all the geographies studied. In Europe, around half of French and German companies expect a rise in the cost of credit during 2010 for companies in their sector and nationally. The UK shows a fall from its 2009 peak, but still remains highest among the three Western European countries. Poland shows a future outlook in line with that of the UK in 2009, no doubt a continuation of the tightening experienced last year. China is at a similarly high level of expectation.

18 Insee, Industrial Investment Survey, April 2010

19 People’s Daily, Economist: China may raise interest rates in Q3, 22nd April 2010
Availability of business bank credit in Europe shows a more positive picture. Around one third of firms experienced a downward credit limit adjustment in the previous year, significantly down on the early 2009 survey figure. Although data is available for previous years, it may be safe to suggest that the Polish experience was similar, as its economy is closely intertwined with that of Western Europe. A significantly larger proportion of Chinese companies, however, expect restrictions in credit availability. This is in line with concerns expressed by the Chinese authorities about the escalating volume of lending to the business community, along with official noises about restricting the ‘too loose’ availability of credit. 

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20 Telegraph, China alarmed by US money printing, 6th September 2009
Clearly, bank credit has remained less available for most companies in Europe, compared with 2008. And this tight borrowing environment looks likely to continue throughout the year. In China, economists are concerned that borrowing is kept in line with growth in outputs, so that debt does not become misaligned and cause future problems for debtors.

Therefore, this study also investigates the interest and activity of respondent firms in seeking to obtain their credit from alternative, more diverse, sources – particularly asset financing techniques.

Alternative Financing and Asset Finance

The respondents to this study actively confirmed their exploration of alternative sources of finance for essential investment into 2010. In Western Europe, around 50% of all companies are actively exploring alternative financing techniques, maintaining the significant rise seen between 2008 and 2009. This would seem to indicate that a long-term change of perspective has occurred, possibly influenced by the uncertainty caused by the Euro crisis, where companies utilise a broader mix of financing techniques than in the past. In Poland, three quarters of respondents are exploring alternative financing tools, presumably to provide the widest range of sources to fund the country’s rate of economic growth. Even higher interest in alternative techniques is found in China – over four fifths of respondents – no doubt to help firms take advantage of the country’s rapid economic development, which posted 9% growth in 2009.

Specifically looking at asset finance, Western Europe sees substantial net growth over 2008 maintained, although a slight fall-off has occurred since last year. Future studies will show whether this escalation of interest in asset financing as a key financing tool is maintained over time. However, given the maintained interest in alternatives to relationship bank credit would seem to provide early indications that we are seeing a long-term change in the financing mix.
Volatility in world markets, the experience of a recent severe downturn, and the uncertainty of when or how fast economic recovery will occur, may be highly influential on this maintained level of interest in asset finance. Greater use of asset finance proportionately reduces reliance on relationship bank credit. It is generally secured against the equipment acquired and if payments are maintained, cannot trigger foreclosure. Finally, it usually provides a fixed level of payments across the financing term, giving the business security that their cost of finance will not go up and down with the short-term markets. In these ways, asset finance provides a more secure basis for business planning.

When acquiring new or upgraded equipment and plant, businesses can either look for the financing element themselves, or can seek out integrated solutions from the vendor, where the financing option is already pre-packaged with the equipment or technology. Most frequently, this takes the form of some kind of leasing or rental agreement, where the business is effectively paying a fixed monthly amount for usage of the equipment over a given period. At the end of that period, the equipment usually returns to the finance or rental company, who accordingly disposes of it through their own asset management channels. Many leasing or rental arrangements are constructed to allow the client to upgrade at certain points in the agreement, which is particularly useful for companies in markets where their key supporting technologies are developing very rapidly.

Integrated finance options have the benefit of saving the acquirer time and effort of seeking their own financing arrangement. Moreover, the financier for such integrated options are often the finance arm of other technology firms who, with their expert understanding of technology markets, are often able to make more knowledgeable risk assessments of the buyer’s needs and markets, and thereby provide finance where a generalist financier would not do so in the current climate and could not offer the same level of specialised support.

In Western and Eastern Europe, increasing use of asset finance is largely motivated by the lack of availability of relationship bank credit, providing an alternative financing source secured on the equipment being acquired. In China, the key driver for asset finance is less to do with credit availability,
where there is currently no lack, but is rather to do with seeking appropriate financing where payments are closely aligned to outputs. Chinese businesses do not want to ramp up capital debts without good reason, and are in an ideal position to take advantage of today’s range of financing tools, thereby avoiding systemic and historical business debt which the West is now attempting to gradually run down. In Poland, which is closely linked to the Eurozone, but has avoided GDP shrinkage over the last two years, the motivations for increased use of asset finance are a combination of these two perspectives.

Sector Variations

In each of the countries studied, the interest and enthusiasm expressed for asset finance usage does vary between sectors. The one overriding common theme across all countries studied is the very high levels of interest in asset finance in the manufacturing and healthcare sectors. In the UK, France and Germany, the manufacturing sector is most actively exploring the use of asset finance; in Poland and China, 100% of healthcare respondents are looking to utilise asset finance techniques.

Other high scoring sectors for asset finance usage include: the UK media industry; the German leisure industry; the transport and construction sectors in France; and the leisure, transport and retail sectors in China. For each country studied, sector variations were approximately 10-15 percentage points around the country average.
Conclusions

This latest research report from Siemens Financial Services firmly underlines the pressure that companies in the three main economies of Europe are continuing to experience. The Euro crisis has perpetuated economic uncertainty. Credit availability continues to tighten across the globe, whether because of rate-for-risk policies in the West, or to prevent overheating in the East.

In both East and West, the authors of this report believe that companies are anxious to be able to access sufficient finance to make the most of the economic upturn in Europe, or the return to double digit growth in China. In China, the role of asset finance is more a matter of appropriate pay-per-use techniques where costs are closely aligned to outputs and earnings.

The proportion of firms actively exploring alternative to relationship bank credit, and in particular the greater use of asset financing, appears to have made a long-term shift, remaining at around double the rate seen in 2008. The main motivation for an increased interest in asset finance may be the security (in a volatile environment) that payments are fixed throughout the financing term, and that foreclosure can only happen if payments are missed.

In this period of uncertainty, businesses are proactively finding financial workarounds. The companies who make the most use of available financing tools to invest in their equipment, their capabilities and their client offering, know that they will be best placed to take advantage of economic recovery when it occurs.

Methodology

3,250 companies in the UK, France, Germany, Poland and China, were interviewed between November 2009 and June 2010. The research sample provided representation by business size and sector. The total respondent sample comprised: 1-50 employees – 52%; 50-250 employees – 12%; 250-2,500 employees – 15%; 2,500+ employees – 21%. Sectors represented include: industry, property, financial services, media, leisure & catering, transport & communications; IT & telecoms, retail, healthcare & pharmaceuticals. Respondents were asked about their experience and future view of credit availability, as well as their usage of alternative financing techniques such as asset finance.