



2002 USED EQUIPMENT MARKET OUTLOOK MID-YEAR UPDATE

STILL LOOKING INTO THE ABYSS

**Carl Chrappa, A.S.A., C.R.A.
Independent Equipment Company**

Independent Equipment Company ("IEC"), the nation's oldest equipment management firm, annually compiles and rates secondary market outlooks for selected categories of equipment that are commonly financed by leasing and asset-based lending companies. This year, due to extreme volatility in the equities markets, as well as the impact of significant revisions to last year's GDP, taken in combination with recent corporate fraud revelations and SEC investigations, IEC felt a need to re-examine its 2002 Outlook. This article serves as an update to an earlier survey that was published in January of this year. The results of that survey were the worst in the Outlook's 13-year history. For comparison purposes, the (14) equipment types just surveyed had an average score of 4.00 (not satisfactory), while at the beginning of the year they had an average score of 3.93. Thus, there has been virtually no change to January's forecast. The latest results remain considerably below the peak year for the past decade, 1995, which had an overall average score of 6.42.

By way of background, last year's economic downturn in the U.S. was recently found to be worse than originally reported. Revised data show that GDP from last year's first quarter was lowered from +1.3% to -0.6%; second quarter GDP fell from the reported +0.3% to -1.6%; while last year's third quarter GDP decline was less severe than reported and revised from -1.3% to -0.3%. Thus, the three consecutive quarters of negative GDP more than fit the classical definition for a recession. Already this year, 1Q-02 GDP has been revised downward from +6% to +5%. Then, the 2Q-02 GDP report found that the economy's growth had slowed sharply to +1.1% -- with most of that figure coming from inventory rebuilding.

Also, productivity plunged from 8.6% to 1.5% during the same period. What will the future bring? According to the Blue Chip Financial Forecast, a consensus of approximately 50 of the nation's leading financial institution economists has forecast that 3Q and 4Q GDP growth for this year will average about +2.9%. Many economists have pinned their hopes on recent data that shows net consumer income in 2Q increased 3.8% and corporate profits increased by 8% during the same period. This is in sharp contrast to a profits decline of 12% reported in the first quarter. However, other economists seem disturbed by the continuation of the stock market's decline.

This, many feel, will have a negative impact on consumption. They note that consumer debt is at an all time high (\$7.9 trillion) and that just released data shows personal bankruptcies rose to an all time record of 1.51 million for the most recent 12-month period. Furthermore, recent fuel price increases and disappointments in employment, IT, and construction market outlooks have added to concerns. However, most economic forecasting services are nonetheless predicting annual growth rates for the U.S. economy in the range of 2.3% to 2.8%.

Based on the foregoing, and on first-hand knowledge of equipment secondary markets, IEC has compiled the following mid-term outlook for selected equipment types that are frequently financed by leasing and asset-based lending companies. For comparative purposes, a rating is given to each equipment type that is reflective of the expected secondary market conditions for the remainder of the year compared to those expected earlier this year. Since this is an interim report, these numbers will not be reported with the annual results. Ratings for this interim report can range from 10 (outstanding) to 5 (satisfactory) to 1 (very poor).

Automotive (4) Zero percent financing has once again returned to this very competitive and wildly fluctuating market. Dealers are now trying to unload 2002 new car inventories with this incentive, and in some instances have added no payments for a year. Although these inducements are expected to cause a temporary spike in sales -- as they did last December -- it is widely believed they will only add to the secondary market's woes. Used car prices have continued to slump, which has negatively impacted leasing companies. Due to recent promotions, the percentage of customers financing purchases increased from 48% in 2001 to 54% in 2002; while customer leasing fell sharply from 27% to 20% -- the lowest percentage in about 10 years. According to a recent report by Automotive News, wholesale prices at auction have declined 4.5%. Also, residual values have fallen by 5%. Further, the used vehicle inventory as of mid-July was 74 days -- nearly double the ideal 42 days. On the other hand, interest rates remain low. Overall, IEC believes the outlook for the remainder of the year will be relatively unchanged from that projected earlier this year. This segment rated a 4 in January, 2002.

Container (5) New container deliveries plunged 39% during last year. The secondary market has been in a constant state of oversupply, which has caused large increases in the number of stored containers throughout the United States and the world. Per diem rates remain very low, and equipment costs for new containers are expected to remain below 2001 annualized prices. Presently, a new 20-foot container is projected to average around \$1,300, down 10% from the \$1,450 garnered during 2001. Meanwhile, container production is expected to increase by 18% from 2001, but still lie some 26% below 2000's record level. Also, there have been some increases in utilization rates, but the market still remains in an oversupply position. This segment rated a 5 in January 2002.

Marine (4) Conditions in the marine industry remain predominantly unchanged from earlier in the year. This industry continues to suffer from oversupply. The latest report on tanker resale values shows the average somewhat lower than reported earlier this year, while the bulk carrier

index has increased somewhat. Thus, conditions in this equipment segment look primarily unchanged from those reported earlier in the year. This segment rated a 4 in January, 2002.

Computers (5) The domestic PC industry continues to struggle during 2002, as price wars have again returned to the market. Shipments are expected to show a decline of about 3.5% for the second quarter, before finally picking up during the 3Q and 4Q of the year. Overall, intense competition continues to drive margins to very low levels. Shipments from the HP-Compaq combination are now about equal to the worldwide PC shipments of Dell. These two manufacturers will be by far the largest competitors in the market, with Dell now exploring 'gray box' opportunities. Meanwhile, reported unit sales of notebook PCs declined by about 3% from last year's level; personal digital assistants increased by 2.2%; laser printers increased by 17.8%; multi-function printers increased by 24%; LCD monitors increased by 198%; and CD-R/RW drives increased about 2% from last year's levels. Server and "mainframe" markets continue to be sweet spots in 'margin' for manufacturers. Overall, conditions in the secondary market remain unchanged, with resellers struggling to survive with the very little margin remaining in secondary market sales. This segment rated a 5 in January 2002.

Semiconductor (3) Last year was a very poor year for this sector, which showed semiconductor sales plunging 32% for the year. Likewise, semiconductor equipment sales suffered a steep decline of over 40% for the year. For this year, many (depending on the source) expected semiconductor sales to increase by 5% to 8%. Thus far, this projection seems to be accurate. However, the equipment sector will likely continue to struggle for the remainder of the year. According to capital expenditure estimates released by the top ten semiconductor manufacturers, capex is expected to fall about 26% for the year, before returning to robust growth during 2003. SEMI recently reported that 2Q equipment sales fell by 34% from the same quarter last year, but rose sequentially 15% from 1Q02. Also, utilization rates have increased from an average of about 65% earlier this year to over 75%, and are expected to climb to over 80% by year's end. However, most of this increase in utilized capacity has been negated by continued sharp declines in IC ASP's, which are expected to drop by about 12% this year. Equipment markets continue to be out of balance. Therefore, the outlook for this sector remains largely unchanged for the year. This segment rated a 3 for January, 2002.

Aircraft (3) The aircraft industry continues to be severely challenged. Most airlines are in very poor financial shape. Major U.S. airlines have already lost about \$4.1 billion in the first six months of this year, and just recently a few of the majors announced they would significantly stiffen rules governing economy fares and frequent flyer mileage, which may only add to their woes. Meanwhile, the price of fuel is increasing and total aircraft stored continues to exceed 2,000 units. Already this year U.S. Airways demanded that their lessors restructure their existing leases. Then, shortly thereafter, the company filed for bankruptcy protection, the first major to do so since Sept. 11. Three days later, UAL Corp. said it was preparing to file for Chapter 11 this fall unless it wins concessions from labor, lessors, and other stakeholders. Such concessions have thus far not materialized. Meanwhile, American Airlines announced a major reorganization and sweeping overhaul including the layoff of 7,000 employees and reductions in passenger amenities

at its hub airports. Then, Continental announced a major restructuring and hiring freeze. Overall, the near-term outlook for this segment remains grim, which does not reflect well on the leasing community, since about 50% of all commercial aircraft in the world are managed or owned by leasing companies. This segment rated a 3 in January, 2002.

Machine Tools (3) Sales of machine tools in the U.S. plunged by over 35% in 2001, and were predicted to fall by just over 20% in 2002. However, this year's reported sales as of the end of the first quarter showed that U.S. consumption declined by just over 35% on a year-over-year basis, and in the second quarter fell by just over 31%. Thus, conditions in this market seem to be somewhat worse than expected. Meanwhile, manufacturers are applying huge discounts to new machine tool prices in order to spur sales. This has crushed used machine tool values which remain heavily discounted. Dealers have now been pushed to the brink. The current capacity utilization rate in the U.S., which is 76.1%, is still having a major impact on the machine tool sector, which is not expected to recover until this rate reaches about 80%. Last year that rate fell to 74.2%. This segment scored a 3 in January, 2002.

Telecommunications (3) The sales of telecommunications equipment in the primary market fell by about 25% last year, which was about six times worse than the worst year ever. For 2002, the market was expected to fall about 20%. However, the industry's crushing debt load, a surge of corporate bankruptcies, allegations of accounting fraud, and plunging equities values have caused most telecommunications companies to all but cease capital spending. Just recently, one industry expert predicted that capital expenditures for this segment will plunge by over 35% for the year. Thus, conditions in this sector appear to be worse than originally forecast. The numerous bankruptcies have caused further increases in the amount of equipment on the secondary market, which has continued to depress prices. However, there has been a slight improvement in market conditions for used telecommunications equipment utilized by commercial and industrial properties, such as hubs, routers, PBXs, etc. Overall though, the trend for this segment continues to be down. This sector rated a 4 in January, 2002.

Construction (5) For 2001, construction equipment sales in the primary market fell by over 10%. For 2002, sales are expected to remain flat. Meanwhile, the value of construction projects for 2002 was forecast to decline by 0.8% to 1.8% (depending on the forecaster cited), which would be the first decline in about a decade. Prices for most types of used construction equipment have fallen. So far this year, average equipment auction prices have declined by about 4% on a unit basis, while the number of items sold increased by about 5%. Thus, the market is a bit soft, but still stronger than most other markets included in this survey. On a positive note, TEA-21 reauthorization at some level seems to be going well. In addition, government highway funds, which were under attack for spending in other areas -- such as national defense -- have withstood the attack, but nonetheless are expected to be cut by about \$3 billion for fiscal 2003. Meanwhile, the U.S. Commerce Department reported that spending for construction was flat in July and stood at a seasonally adjusted \$834.1 billion. This contrasts with a 2.2% decline in June, and a revised 2.0% decline in May spending (which was originally reported to be a smaller -0.7%). Overall, total spending for the first six months of the year was 0.1% lower than the same period last year.

The report noted that residential demand continued to be buoyed by low mortgage rates, and that the biggest declines in construction spending were in the new industrial and commercial building outlays which fell to 24- and 6-year lows, respectively. Thus, overall conditions within this industry segment are a bit soft, but still holding the line. This segment rated a 5 in January, 2002.

Mining (5) Mining had a mixed year during 2001, and it was widely expected that the industry would continue along the same path for 2002. However, recent declines in the equities markets have caused a flight to safety in precious metals such as platinum, gold, and silver. In addition, duties on imports of steel have also helped. Thus, indicators for domestic primary metals -- steel, aluminum, and copper activity -- have increased to their highest level since October, 1994. Over the past year, the industry has continued to utilize more of its existing capacity and equipment which had been idled has been put back into service. However, utilization of coal by power producers has fallen a bit this year compared to past years. Likewise, the primary metals 'leading index' dropped sharply in July, reflecting the recent weakness in some economic indicators. Underground mining equipment sales continue to remain sluggish and equipment condition remains extremely important in the secondary market, while above ground equipment sales remain mixed. Overall, market conditions have improved somewhat in this segment since the beginning of the year. This segment ratted a 4 in January, 2002.

Truck/Trailer (4) 2001 was a very poor year for the industry, as sales fell by over 35% in the primary market. Likewise, 2002 was expected to be a poor year, and primary market sales were expected to fall by over 10%. However, a recent report showed that Class 8 truck sales for July improved sequentially over June by 9.1% and year-over-year by 26%. This is in sharp contrast to June sales which dropped by 0.5% from a year earlier, and May sales which rose 1.4% from a year earlier. This was the first increase in year-over-year data since March, 2000. Thus far, truck sales have benefitted greatly from the run on equipment caused by the October 1 enactment of EPA rules which mandate new low-emission engines. Most trucking companies have said they would avoid the purchase of these new-design engines due to expectations of lower fuel economy, higher cost, and lower reliability of the (new) engines, which cost about \$1,000 to \$15,000 more than today's standard engine. In addition, there is wide belief that, since these engines will be less efficient, the engine mileage warranties will be reduced by as much as 250,000 miles. Thus, there has been significant activity in the primary and secondary markets for equipment which is "Pre-Oct. EPA 02." This EPA rule has likewise spurred increased sales in the secondary market, causing prices for most equipment -- particularly in the one- to three-year-old range -- to show a marked increases in value compared to a year ago. However, this improvement in demand is widely expected to dry up just prior to October when the new clean engine rules will be enacted. Already, Detroit Diesel and International Truck & Engine are planning layoffs. Also, in a recent ATA survey, respondents (607 companies) said they plan to purchase only 8,419 "new engine trucks" in 2003 -- *less than half of normal*. Therefore, IEC expects that recent gains in production and pricing will turn into large declines later in the year. Overall, the secondary inventory remains in a significant oversupply position, which is expected to remain so through 2003. Furthermore, the recent bankruptcy filing of Consolidated Freightways (15% of the total U.S. marketshare) does not bode well for the near term outlook of this industry. This segment rated a 3 in January, 2002.

Rail (4) For 2001, the rail industry showed a slight drop in total carloadings with a moderate increase in intermodal units shipped. The number of new cars built fell in 2001 and was expected to decline in 2002 by about 40%. The latest information now shows the expected number of new buildings will fall by over 50% from last year's total. Meanwhile, lease rates are expected to remain low. All of the projections made earlier in the year seem to be holding. Thus far, traffic originated has decreased by about 1.3% for the year. Declines have been registered in bulk shipments of coal and grain, while increases have occurred in bulk shipments of chemicals, and motor vehicles and equipment. Also, intermodal shipments of trailers continue to decline by about 4.5% year to date, while container traffic has increased smartly to just under 9.0% year to date. However, this segment remains a buyer's market, with supply imbalances in several widely-used car types. Thus, the outlook for the remainder of the year remains as forecast earlier this year. This segment rated a 4 in January, 2002.

Medical (5) Medical equipment enjoyed a healthy year in 2001, and 2002 looks to be good also. Thus far, earlier forecasts seem to be entirely on track, with capital budgets increasing in this sector, leading to increased sales of x-ray, CT, ultrasound, MRI, etc. The secondary market for medical equipment looks stable, and, in fact, is in better shape than most other industries. This segment rated a 5 in January, 2002.

Printing (3) For 2001, the printing industry turned in a very poor year, due to large declines in advertising caused by the dot-com collapse and recession. Another difficult year for the industry was expected in 2002. Thus far, newspaper advertising is declining faster than U.S. advertising overall. In addition, significant declines have been registered in the area of help-wanted ads, due to the recession. Meanwhile, national magazine advertising has declined by just over 1%. Also, since the economy is fragile and most commercial and industrial sectors are struggling, specialty trade market advertising has declined across the board. These declines, taken in combination with industry consolidation, have led to a continued downturn in both the primary and secondary markets. Several dealers have reported "it's not a matter of price, if no buyers can be found." Therefore, the outlook for this segment remains unchanged from that forecast earlier in the year. This segment rated a 3 in January, 2002.

CONCLUSIONS

As can be seen from the comments above, the overall outlook for the used equipment markets in 2002 remains poor, as originally forecast. This means equipment and portfolio managers will continue to face an extremely challenging year. IEC has found that in some instances, lessees were in such poor condition that they could not afford to return leased equipment, rather, were "compelled" to purchase or renew at the end of a lease. Meanwhile, because markets remain so weak, lessors should actively seek to avoid equipment returns, which most likely will produce poor sales results, which will be further eroded after remarketing fees, storage, insurance, advertising costs, etc., are deducted. About the only encouraging thing to be said is that no one equipment segment seems to be singled out; rather, the downturn is across the board. The results

of this update show overall markets haven't deteriorated further and we can only hope that 2003 will be *less worse* and we can finally step back from the abyss.

BIOGRAPHY

CARL C. CHRAPPA, A.S.A., C.R.A.

Carl C. Chrappa is President and CEO of Independent Equipment Company, the nation's oldest equipment management outsourcing firm, headquartered in Clearwater, Florida. He is a registered auctioneer and tested and accredited senior appraiser with over 30 years of equipment experience.

Mr. Chrappa regularly trades in equipment markets, and provides valuation and technical consulting services to companies throughout the world. He is also a member of the ***National Association of Business Economics***, where he serves on the Association's International Roundtable.

He is a founding and current member of ***The Equipment Leasing Association's Equipment Management Committee***, he also serves on the Board of Directors of the ***Commercial Finance Association, ELA Business Services, Inc.***, and is a past technical director of the ***American Association of Cost Engineers***. He has co-authored a book entitled A Leasing Company's Guide to Equipment Management and is the author of several columns devoted to equipment management. Mr. Chrappa is a graduate of the University of Massachusetts at Amherst.

