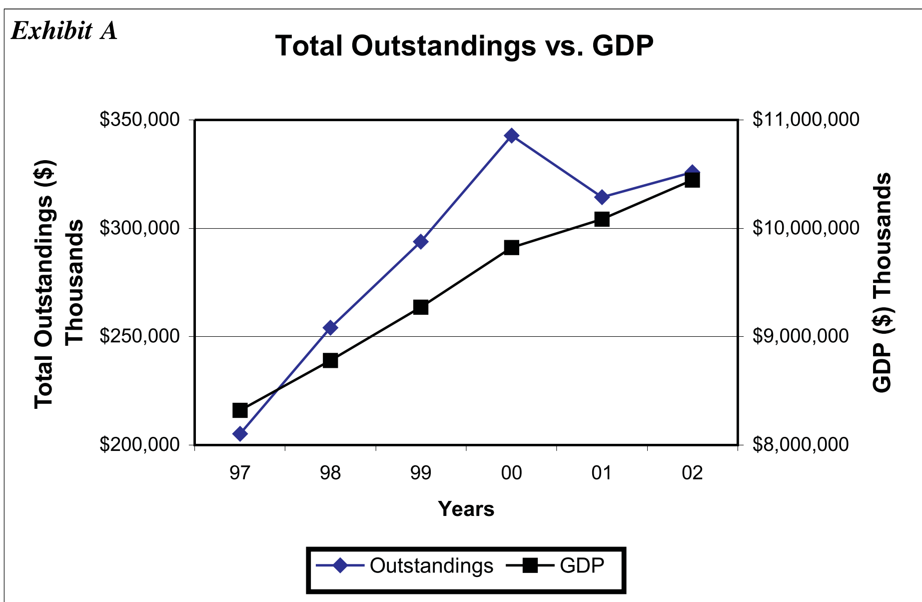
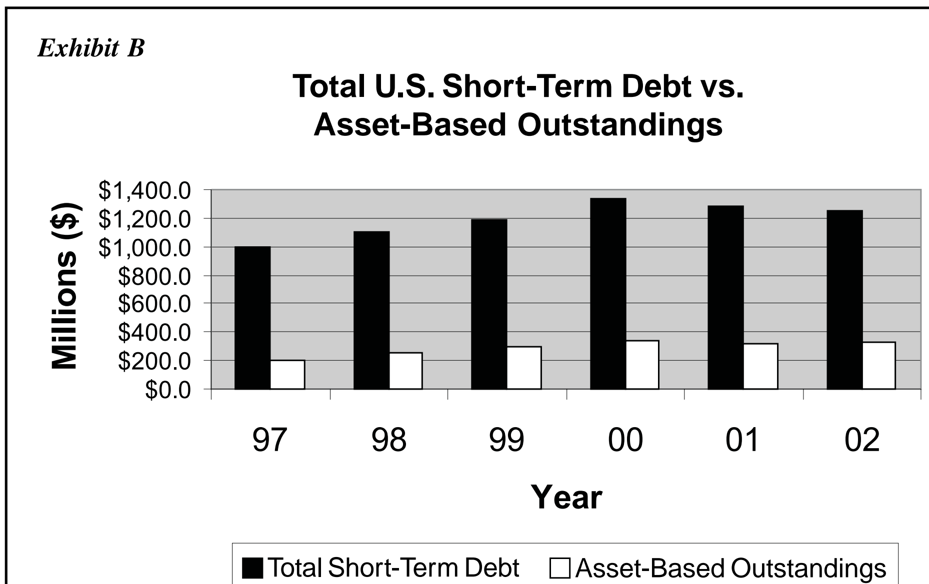
Report of Findings

(1) We continue to compare Real Gross Domestic Product with industry Outstandings because both measures reflect similarly the base from which economic versus asset-based lending growth takes place. During 2002, the U.S. economy grew sluggishly at only 2.45%. For the full year, Real GDP, shown in **Exhibit A**, rose by only $225.4 billion. At the same time, Total asset-based Outstandings increased at a bit higher rate of 3.65%, or $11.5 billion, to $325.9 billion. (**See Appendix Exhibit 1** in the back of this report and **Exhibit A**.) Thus, on a relative basis, the industry's lending base has recovered at a slightly faster pace than has the overall economy. In fact, the illustration, as well as that compared over the last 26 years (not shown herein), indicates that the two measures move coincidentally with each other. This has strong implications for forecasting future industry movements.

Although the volume of Outstandings is still sluggish, as indicated in **Appendix Exhibit 2,** it remains at the second highest level in the industry's history. In fact, it has gained back almost 41% of its loss during the recent recession in 2001.





(2) From a gross short-term lending perspective, the industry continues to provide one of the largest sources of short-term commercial-industrial credit in this country. Despite last year's temporary decline, its percentage of such funding has resumed its upward pace, as pointed out to the left, at 3.65%. In comparison and based on the latest Federal Reserve figures for 2002, Total Nonfinancial Business Outstandings rose again from $6.94 trillion in 2001 to $7.14 trillion in 2002. However, all of this increase has been accounted for by long-term debt which amounted to $5.89 trillion this year. On the other hand, as shown in **Exhibit B**, Total U.S. Short Term Debt continued its three-year slide to $1.25 trillion. This was a decline of 13.4% over 2001. At the same time, and except for 2001, asset-based lending has continued to account for more and more of the volume of short-term debt financing to commercial and industrial enterprises. Although difficult to see in **Exhibit B**, since 1997 asset-based lending has grown from 20.6% of all new short-term lending in the United States to 26.1% this year. However, the recent decline in short-term borrowing in the business sector is obvious.

(3) While Total Outstandings provides one measure of asset-based lending activity, i.e., its volume, Total Advances is an indicator of the velocity at which such lending takes place. As seen in **Appendix Exhibits 1 and 2**, Advances have fallen over the last three years. In 1999, the speed at which asset-based funds were re-lent generated over $2.8 trillion. Since that time, Advances have continued to fall and are now at their lowest

point at less than $2.1 trillion since we started collecting these data in 1997. However, the current rate of reduction of -2.59% is the smallest over this recent period. Coupled with the slight increase in this year's Outstandings of +3.65%, the implications of these are that the industry is at the beginning of a turnaround. The basis for this statement, as illustrated in **Appendix Exhibit 2**, is that changes in Advances appear to lead that of Outstandings. That is, changes in the velocity of lending in one year have a strong impact on changes in the size of the lending base in the next. This has occurred in every year since we began reporting on Advances, but one — this year. Fortunately, the double-digit decline of 16.01% in Total Advances last year was not followed by a downturn in Total Outstandings this year. Instead, the lending base moved upward. In combination, these current movements indicate that 2003 should turn up much more strongly. They further imply a consolidation in lending, i.e., the industry has been collecting more than it has been re-lending.

There has also been some reluctance to re-lend collected funds. This has been due to the higher risks and lower interest rates that have been major disincentives to all short-term lenders including asset-based lenders. With regard to the latter, average rates for the bellwether interest rate indicators, the prime rate and the Federal Funds rate, have continued to decline over the period. Between December 2001 and December 2002, they declined from 1.82% to 1.24% and from 4.84% to 4.25% respectively. Similarly, short-term Treasury yields of up to one year dropped by an average of over one percentage point. With interest rates falling and loan write-offs continuing, there has been a further impetus to the industry to consolidate its loan portfolios and to reduce the supply of asset-based funds to business borrowers.

At the same time, the weak economy has also resulted in business' reduced demand for funds. Just as Advances appear to lead Outstandings over time, they also do so to some extent with respect to industrial production. As shown in **Exhibit C**, changes in industrial production over the last seven years on Total Advances have followed or been coincident with the former. Firms borrow in anticipation of the incurrence of manufacturing costs. Therefore, when the economy is weak, they borrow less (and vice versa). Thus, another reason for the decline in Advances has been the prior funding effects of changes in production in the industrial sector. It should also be noted that loan write-offs have also risen due to the continued weakness in the business sector. The latter has caused the increase in this year's Outstandings to be flatter than might otherwise be expected. As such write-offs begin to recede, Outstandings in the near-term future should move upward more strongly than they have this year.

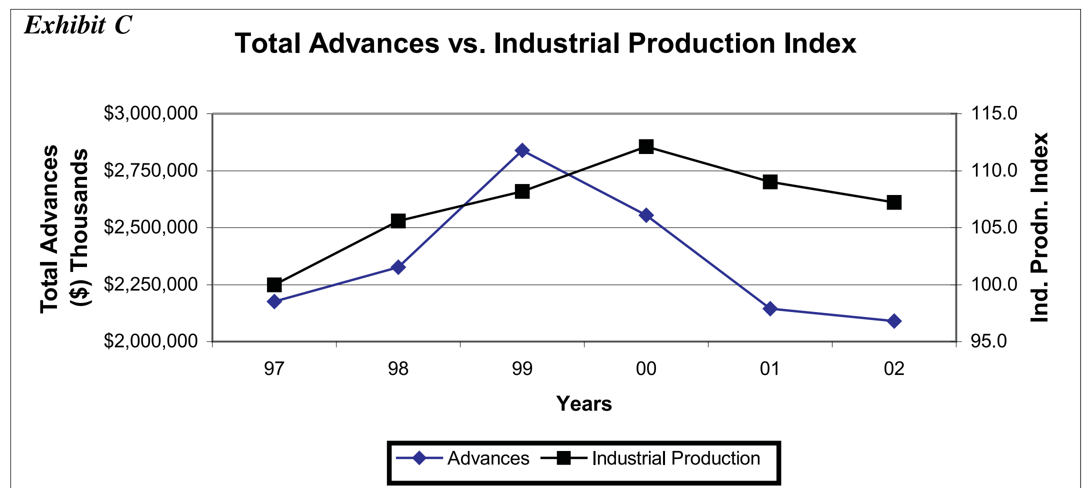
Appendix Exhibit 3 provides a clearer picture of the volatility of the movements of both Outstandings and Advances by showing the annual percentage changes in each.

(4) Next is the performance of the Top Ten States in terms of loans Outstanding. As indicated in **Appendix Exhibit 4** and **Exhibit D**, California, New York, Illinois, and Texas again make up the top four positions, as they have since 1997. While they constituted 32.53% of the total of all locales in 1997 and 41.81% last year, this year they accounted for 36.00 % of the Outstandings of all of the states, provinces, and other regions surveyed. As shown in **Exhibit D**, and given this year's result, their percentage of the total has followed a somewhat general downtrend over the last two years. Still, despite their recent decline in dominance, an examination of **Appendix Exhibit 4** indicates that these four states in 2002 constitute a larger proportion of the asset-based lending base than all of the other locations combined. The bar chart at the bottom of the next page shows more clearly their domination over this six-year period relative to that of the Top Ten States.

Within the total list itself, there was almost no movement among the states since last year. In fact, 2002 reflects the smallest degree of movement among the Top Ten States in terms of Outstandings since 1991. Coincidentally, both are post-recession years. As can be seen in **Appendix Exhibit 4**, Georgia fell three spots, from 5th to 8th, while Massachusetts and Michigan traded positions at the back end of the list. Except for Michigan, no one else moved out of the top ten this year. And none of the remaining states moved their positions by more than one place.

Interestingly, Canada's situation has been the opposite of that of the U.S. The declines in every one of its active asset-based lending provinces has not mirrored movements in its Real GDP as it has in the U.S. Since bottoming out of its two-year weak economy in mid-2001, Real GDP has been moving up briskly. At

Exhibit C



the same time, the lending base in all of these provinces has moved downward even more briskly. We shall discuss the possible reasons for this later in this Report.

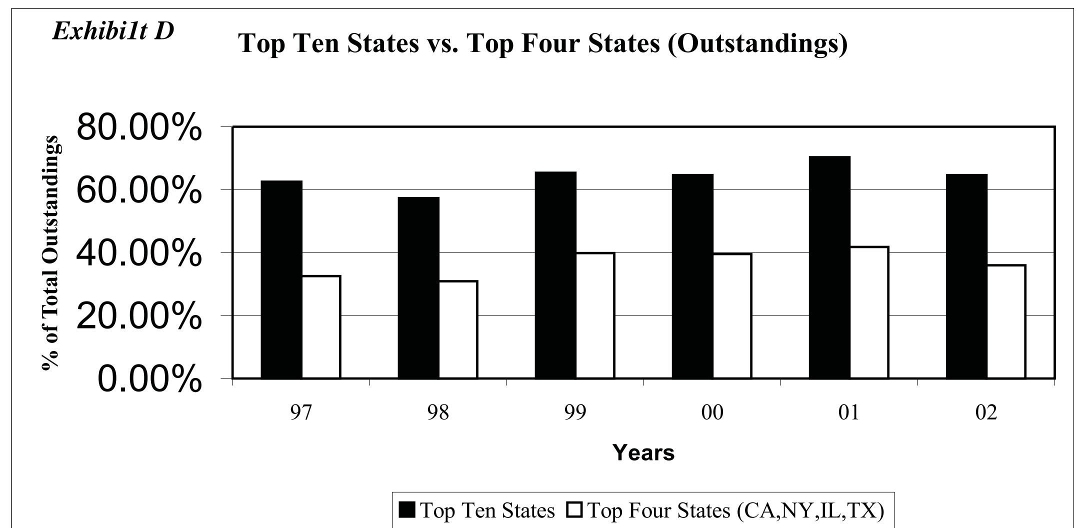
(5) **Appendix Exhibit 5** presents a breakdown of Year 2002 Outstandings as they were generated within each of the individual states in the U.S., within those Canadian Provinces for which such data could be determined, and in all of those other regions in the world for which data was derived. During this period, 38 states, none of the Canadian Provinces, and the All Other category of countries exhibited increases in their volumes of Total Outstandings. In comparison, last year there were only 12 states, as well as 6 Canadian Provinces, and Europe that showed increases in their volumes. In 2002, 17 states and the District of Columbia, all 7 of the reporting Canadian Provinces (2 did not report), as well as Europe and the United Kingdom, exhibited declines in their lending bases. In 2001, in almost the complete opposite manner, 37 states and the District of Columbia, 1 Canadian Province, and the "Other" category of locations reported negative changes in the level of their Outstandings. No data was reported for Mexico and Asia.

The breakdown of these states reflect more clearly the distribution of states that contributed to the overall turnaround in Total Outstandings that was indicated in **Appendix Exhibits 1 and 2**. Nine states experienced triple-digit increases over 2001 while none of the locales in which Outstandings were falling had declines of that magnitude. Nearly all of the former were located in the Midwest and all were smaller states in terms of their volume of asset-based lending.

(6) Next, we turn to the Regional results presented in **Appendix Exhibit 6**. Unlike last year when Outstandings went up in only two of all of the nine regions, this year five of the nine increased. However, in terms of total volume, the rankings remained nearly the same. As shown in this exhibit, only the Eastern Midwest and the Far West switched rankings. In contrast, among the regions tracked in 2001, only the Eastern Midwest and Canada had increases in their volumes of Outstandings while growth in the Southeast was virtually flat. As mentioned earlier in connection with the states and provinces, Canada had an unusually large decline in its volume of asset-based Outstandings. It was the largest among all of the sectors and, in contrast to the U.S., moved in the opposite direction from the country's Real GDP. One important explanation for this is that Canada's Real Effective Exchange Rate averaged 43 percentage points below that of the United States this year. With already low interest rates prevailing in both countries, the added effect of this is to make cross-border lending even less attractive to American-based asset-based lenders.

Economic events also had an adverse impact on the Far West region. Although the recession throughout the U.S. officially ended in the 3rd quarter of 2001, the same has not been true in the western-most states. Given the crash of the high-tech companies that are largely based there, the West has undergone its own particular and more devastating form of recession. In 2001, every one of the nine states there experienced declines in their lending bases. However, this year only four had continued downswings. But these, as might be expected, included California (and Oregon, which is the fourth largest asset-based lending state in the region). As California has declined over the past three years, so has the Far West's role in providing asset-based financing. In Year 2000, it ranked second among all of the regions. In 2001, it fell to 3rd. This year it has dropped to 4th. Over this period, the Far West's fall in Total Outstandings has been at a compound rate of -11.6%.

The pie chart in **Exhibit E** provides a percentage breakdown of the Total Outstandings accounted for by each of the regions enumerated in **Appendix Exhibit 6**. The areas along the eastern seaboard, which comprise the right hand side of the chart, together, still continue to account for most of the asset-based lending done in the United States. These are regions where traditional industries such as textiles, apparel, footware, and other manufactured soft goods are located and have been served for many years by asset-based lenders. However, more and more of asset-based financing is moving outside of the East Coast and more and more of it is being directed to a much greater variety of less traditional industries. As illustrated in that chart, several of the areas outside of the East are large in themselves and, together,



comprise approximately 48% of the total lending base.

Next, we turn our attention to an evaluation of Total Advances. This is done in exactly the same format as is that of Total Outstandings. However, the results obtained for each are often quite different. This is because, while Outstandings measure the volume of asset-based lending, Advances measure the speed at which that volume is re-lent. The lending base of a company may not change, but the number of times it re-lends that base amount could vary widely depending on the rate of turnover of its available funds. Turnover depends upon both the volume and velocity of lending. We will discuss this concept later in this report. At this time we turn to its second component — Advances.

(7) The first area to be examined is the velocity of asset-based lending in the states, provinces and those areas for which information was received. Just as **Appendix Exhibit 4** presents the performance of the Top Ten States with respect to Total Outstandings, so does **Appendix Exhibit 7**, but here it is in terms of Total Advances. As indicated in the latter, the Top Ten States dropped 5.2 percentage points from 2001's 6-year peak of 69.8%. The Top Four States dropped even more, declining by 5.9 percentage points. As illustrated in that table, while New York and New Jersey exhibited increases, California and Texas had much larger declines in their lending velocity. In fact, an examination of the next exhibit, i.e., **Appendix Exhibit 8**, shows that while nearly all of the states in the Northeast experienced lending increases, most of those in the Far West had declines. The lingering effects of the 2001 recession continue to affect the high tech and vacation business atmosphere in the West, while the more diversified sectors in the East began to recover somewhat from it.

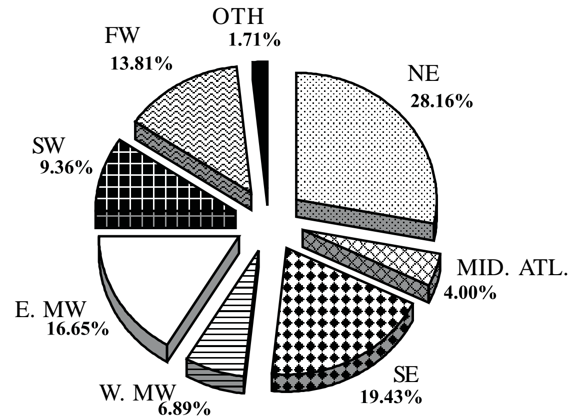
Over time, as shown in the illustration below, there has been an average 4.9-point percentage shift in the concentration of lending by the Top Ten States over the last four years versus the first two. This concentration is even stronger among the Top Four States. An examination of the two sets of periods shows that the increase on average has been 5.6 percentage points. Clearly the dominance of the largest asset-based loan producing states is growing while the rest of the states, provinces, and other locales continues to recede.

PERCENTAGE OF TOTAL ADVANCES ACCOUNTED FOR BY VARIOUS SIZE GROUPS OF STATES & OTHER LOCATIONS

States	1997	1998	1999	2000	2001	2002
Top 10	62.7%	61.7%	68.9%	64.9%	69.8%	64.6%
Top 4	30.8%	34.1%	34.1%	39.9%	42.6%	36.7%
Other Locations	37.3%	38.3%	31.1%	35.1%	30.2%	35.4%

Exhibit E

Total Outstandings By Region (%)



Another measure of leadership among these areas is the stability of the top groupings. A comparison of **Appendix Exhibit 4** for Outstandings with **Appendix Exhibit 7** for Advances in 2002, shows that the leadership states in the two are nearly the same; 9 out of the first 9 are identical. However, both the positions and the change in those positions from last year are not. The states arranged by Outstandings showed little movement, mostly one-position switches. By comparison, the spread of movement among those listed in the Top Ten in lending velocity ranged from +21 positions (Minnesota) to -7 positions (Michigan). However, the large change in Minnesota's ranking appears to be an aberration due to changes in respondent reporting in 2001. We have estimated that had the aberration not occurred, Minnesota's ranking would have changed by only +4 places. Even with this adjustment, the range of variation is still larger than that associated with the list of Outstandings. In fact, over the past six years the composition of the members of the Top Ten States in terms of Outstandings has been far more stable than has been that respecting Advances. However, it should be noted that this greater degree of variation is an outgrowth of the much larger (smaller) magnitude of asset-based lending that can be generated (or withdrawn) by lending and re-lending from the same base of Outstandings than can be by changes in that base itself. As an example, if a firm's lending base increases (decreases) by $100,000, that alone raises (lowers) its financing capability by that amount and no more. However, if its velocity of lending on that original base itself increases (decreases) by $100,000 per month, the total volume of asset-based lending generated will increase (decrease) by $1.2 million per year.

Finally, we have explored the stability of leadership in Advances by examining the composition of the Top Four States over this 6-year period. As discussed and illustrated previously, since 1997 New York, California, Texas, and Illinois have exclusively held these top positions in terms of Outstandings. Their positions within this more proficient group have changed only

slightly over this span of time. However, the following table indicates that the composition of the Top Four States in terms of Advances has been more diversified over this same time frame. As shown there, in three out of the last six years the states that have comprised the Top Four have been different. And in a fourth year, 1999, there was a significant rearrangement among the more traditional leaders of this group.

TOTAL ADVANCES - TOP FOUR STATES (1997-2002)

Rank	2002	2001	2000	1999	1998	1997
1	NY	CA	CA	IL	NY	NY
2	CA	NY	NY	NY	CA	CA
3	*NJ*	TX	TX	CA	*MA*	TX
4	TX	*FL*	IL	TX	*OH*	IL
5	**IL**				**IL**	
6		**IL**			**TX**	

The implications of these results are important both for forecasting future trends in Total Outstandings and Advances, and for doing so within individual locales. We shall have more to say about this after our discussion of the next two aspects of Advances.

(8) **Appendix Exhibit 8** breaks down Total Advances by individual locations. Previously, we briefly discussed some of the implications presented regarding East versus West Coast performance. Here we will discuss additional findings with respect to these national and international locales.

Looking at the data presented in this table and comparing its results with those based on Outstandings in **Appendix Exhibit 5**, one finds additional similarities and differences between these two aspects of asset-based lending at the more local level. Fewer locales showed increases in Advances than in Outstandings. And this is to be expected given the overall movements of both measures. In all, 32 states, the District of Columbia, the UK, and Europe experienced higher asset-based lending. velocity in 2002 versus 2001. By comparison, and as presented earlier, 38 states and Europe increased their lending bases. However, in both cases none of the Canadian provinces did so. Interestingly, while the UK exhibited a small upturn in Advances this year, its volume of Outstandings fell substantially. These findings indicate the importance of examining local short-term borrowing environments rather than just relying on overall measures of these lending components. These results also have major implications respecting asset-based turnover, the most important measure of the industry's overall lending efficiency. We will discuss this topic shortly.

A comparison of the major changes in Advances among the areas that were evaluated in this report provides somewhat unexpected findings. Despite the fact that Advances overall continued to decline, there were 11 states that had triple-digit increases and no locations that had such declines. Not all of these were in locations that do little asset-based lending. Such larger producing states included Arkansas ($10.4 billion); Colorado ($35.1 billion); Minnesota ($62.5 billion); Missouri ($22.1 billion); New Jersey ($182.2 billion); and Utah (13.2 billion). Four of these 11 states are in the Western Midwest — the fastest growing asset-based lending region in the U.S. and elsewhere. Two out of the four states in the Southwest are in this group of high re-lending growth, but are overshadowed by the major decline in Texas' Advances, the fourth largest asset-based lending state in the Survey.

These results and those for each of the locales contained in this report are presented to the reader in **Appendix Exhibit 8**. This provides an opportunity for those who are interested in particular areas to review our findings and to assess the implications of these results in terms of their own company's operations in those places.

(9) **Appendix Exhibit 9** offers regional performance results in terms of Total Advances. This table, in combination with that of **Appendix Exhibit 6,** provides the elements of the Turnover results presented in **Appendix Exhibit 10** and which will shortly be discussed herein.

As pointed out earlier, Advances in the Western Midwest region grew the fastest among the nine sections of the U.S., Canada, and the rest of the world. Nine of the 10 states there had increases in lending velocity. And, as pointed out above, two of them had triple-digit increases in their speed of asset-based financing. This is a region that is often ignored in financial circles because of its location, sparse populations, and barren, unproductive land. But quietly these areas are attracting more and more industry. Seven of *Entrepreneur Magazine*'s Top 100 "Fastest Growing New Businesses in America" and 34 of *Inc. Magazine*'s "2002 List of America's Top 500 Fastest-Growing Private Companies" are located here. This is because many of the states in this region have low taxes and are right-to-work states. Also, many of them have a low cost of living. All offer significant tax and other economic incentives to business start-ups and to firms that are considering relocations. Many of the states have outstanding public education systems and universities. Thus, as more and more businesses develop and/or relocate there, lending growth is not only picking up, but offering further opportunities in the future to do so.

While velocity this year grew at the fastest rate in the Western Midwest, the Northeast continued to lead the world in terms of its absolute level of Advances. Lending there was over 50% larger than was that in the next largest region — the Southeast. And, as shown in **Appendix Exhibit 9**, the rate of growth of such re-lending there was second only to the Western Midwest. The performance of these two regions, in conjunction with the Middle Atlantic states, led to the even greater dominance of the East Coast in terms of Advances versus Outstandings over that of all of the rest of the country. This occurred even though both

the Southeast and the Middle Atlantic states lost some ground in its level of Advances between 2001 and 2002. An examination of **Exhibit F** in comparison with that shown previously indicates that while the East Coast generated 51.6% of Total Outstandings in 2002, it produced 54.1% of Total Advances. In combination, these results strongly imply that the overall demand for asset-based loans was higher in the East than anywhere else in North America and, especially, in Canada.

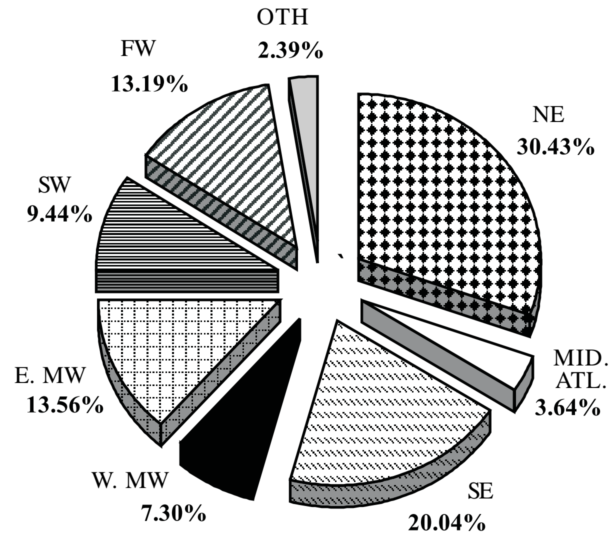
Arguably, the most important measure for assessing asset-based lending performance is that of Turnover Rates. Turnover Rates measure the *speed* at which available funds on the books of asset-based lenders are lent and re-lent to their customers. Turnover Rates are defined as the ratio of Advances to Outstandings. Thus, more specifically, they allow company analysts and others to assess the relative velocity of lending activity (i.e., Advances) to that of the average balance of loans outstanding on the books of asset-based lenders (i.e., Outstandings). A graphic analogy to explain this somewhat elusive, but valuable barometer of asset-based is provided and discussed below.

Let us suppose that the windmills in **Exhibit G** on page 9 represent Turnover. The mill itself provides the base, which is analogous to Outstandings (which itself constitutes the lending base, or volume of available funds), upon which the weather vanes are attached. The vanes are analogous to Advances, both of which in their own way create velocity — the former respecting wind and the latter lendable funds. With a small windmill, the wind is turned over at a 1:1 ratio. However the large windmill, which has a larger base and relatively even larger weather vanes, turns over the wind much faster. The latter is represented by the much bigger arrows on the extreme right. In reality, financial turnover is affected by situations in which velocity changes occur at a rate that is more than in proportion, up or down, to that of shifts in volume.

Higher speeds are associated with increased business activity, loan collections, and funding efficiency. Lower speeds are indicative of reduced performance in these areas. Turnover Rates can also be used to determine the length of the average loan period of such firms. Higher rates reflect reduced loan periods while lower rates delineate more protracted ones. Therefore, an increase in the Turnover Rate either indicates growth in new loans and re-lending activity and/or a reduction in Outstandings. A combination of the two signals improved asset-based loan collections. Movements in the opposite direction are indicative of increased collection problems. This is especially true when Advances are falling and Outstandings are either flat or increasing. While Turnover Rates in conjunction with an analysis of their components, Advances and Outstandings, can also be used to assess the extent of loan writeoffs, the process is much more complex than that discussed above.

Exhibit F

Total Advances By Region (%)



(10) **Appendix Exhibit 10** presents the industry's rates of turnover both on a regional basis and in total for all areas in 2001 and 2002. During this period, overall industry Turnover Rates have continued to fall. Over the six-year period during which we were able to measure Turnover, it has fallen in every year, but one — 1999. However, the decline within this most recent time frame has begun to level off. With Outstandings beginning to increase and the decline in Advances also leveling off, it appears that there is beginning to be a turnaround in industry Turnover. This year's Turnover rate was 6.41 times, a decline of 6.0% over last year's 6.82 times. Thus, while the industry's overall speed of lending continues to slow, it is most likely to have been caused by the leftover economic effects of industry consolidation.

An examination of regional Turnover in **Appendix Exhibit 10** continues to show that internationally the speed of lending has been much greater than in North America. This year overseas respondents turned their funds 12.67 times. This was an amazing 54.7% rate of improvement over 2001's already very high 8.19 turns. It is important to note, however, that the "Other" grouping covers the rest of the world with many diverse business and financial activities and degrees of sophistication and experience. In addition, there is a much smaller degree of homeland reporting there than on this continent.

On this continent both the Northeast and Western Midwest not only had the highest Turnover, but at the fastest growing rates. The speed of lending in these two regions was at 6.93 times and 6.86 times, respectively. The Western Midwest's lending speed rose by 43.5%, not far from the rest of the world's growth rate, while the Northeast improved by 29.5%. The former attests to our earlier comments regarding the increased potential for asset-

based lending in this portion of the U.S. The latter is incredible when one considers the fact that the Northeast far exceeds all other areas examined in terms of both the size of its Outstandings as well as that of its Advances. All of the other regions presented in **Appendix Exhibit 10** exhibited zero to negative changes in their speeds of asset-based lending. Canada, with its substantial declines in all Provinces in both Outstandings and Advances had the largest drop. This was primarily caused by the fall in Advances, which was nearly twice that of the reduction in Outstandings.

(11) What does all of this mean for the industry as a whole? The answer in total and for many of the above regions is that receivables collections and write-offs (along with inventory liquidation) are continuing to worsen — albeit, not as badly as in recent years. Looking at the regions from top to bottom, in general asset-based lenders' overseas operations had the shortest average asset-based loan period. It fell from 44.6 days to 28.8 days. In the Northeast, it improved from 68.2 days to 52.7 days. And in the Western Midwest, the Days Sales Outstandings (DSO) dropped from 76.4 days to 53.2 days. While the Eastern Midwest showed no change, collections and write-offs worsened in the remaining five regions. In Canada, where the DSO started the year at 44.2 days, it finished it at 63.6 days. Overall, asset-based lenders experienced an increase in the time to collection of nearly 3 ½ days to 56.9 days. If 30 days is desired and 45 days is acceptable among lenders, then clearly, improvement is needed in many places.

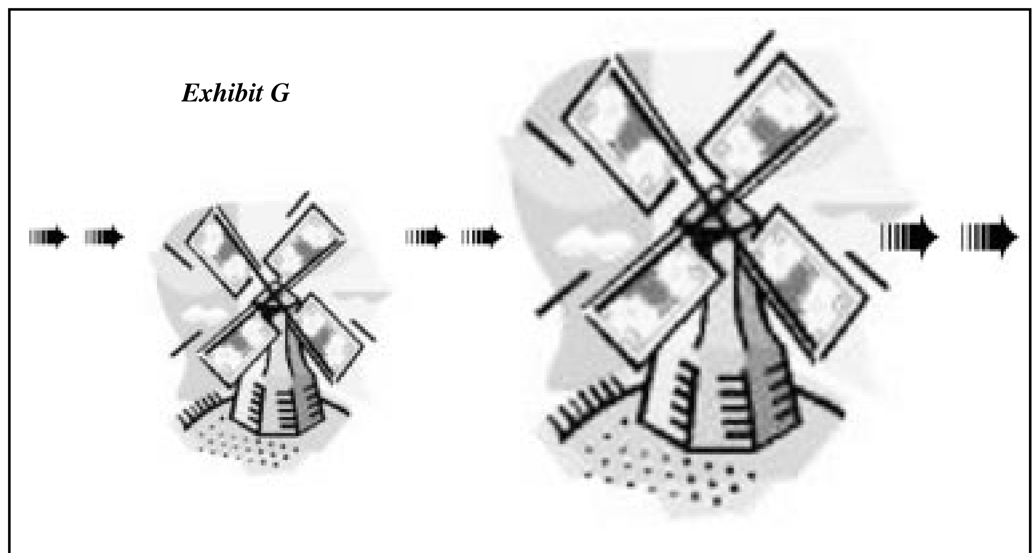
(12) It should be pointed out that the industry is not alone. Between 2000 and 2001, the total nonfinancial business lending base in the U.S. fell by 26.8% (revised). In comparison, this drop was 3 ¼ times larger than that of industry's base. This year, U.S. total Outstandings fell even faster at a rate of 50.5%. Industry totals declined by only 2.6%. However, the U.S. lending atmosphere now appears to be improving. The most recent 2003 quarter-to-quarter changes in U.S. Outstandings rose by 66.9%. In a similar fashion, over the 2001 to 2002 time frame, total short-term business advances in this country dropped by 13.4%, but they were almost constant for the first quarter of 2003 at only -0.2%. As shown in **Appendix Exhibit 1**, the corresponding 2001 - 2002 changes were +3.64% for asset-based Outstandings and only -2.59% for that of Advances. On this basis, short term lending Turnover throughout the United States rose by almost 75% between 2000 and 2001 from 3.34 times to 6.0 times while that for the industry fell by 6.01% to 6.41 times. However, the former took place because U.S. Outstandings fell faster than did corresponding Advances. In our industry, Outstandings improved and the decline in Advances slowed. In terms of loan repayments, on average asset-based lenders collected their outstanding accounts every 56.9 days. At the same time overall U.S. collections took nearly four days longer at 60.8 days. This time difference represents an extra loss in cash flow to U.S. short-term lenders of $13.4 billion in 2002.

Loan participations provide a method for examining the manner and degree to which asset-based and, indeed, all other types of loans are being "packaged." Loan packaging is carried out for a number of reasons. First, it allows smaller lenders to consider funding situations that are generally beyond their individual capacities to do so. Second, it allows such providers to take part in the packages of others. Third, this arrangement also permits larger asset-based lenders to participate out opportunities that are too small for them to handle efficiently or without consuming staff time that is otherwise needed to service much larger borrowings. Finally, participations allow lenders of all sizes to spread their funding risks over a wider and/or more diverse portfolio of borrowers.

In theory, participations should be expected to rise as the economy weakens. Such activity reduces risk exposure as the business environment deteriorates. Similarly, as the economy improves, one should expect the volume of participations to decline. **Appendix Exhibit 11** herein, when viewed in conjunction with **Appendix Exhibit 14** from last year's Annual Report (not included herein, but whose data is extracted for comparative purposes), provides a means for assessing this most recent situation. Both provide regional breakdowns of loan participations for 2002 and 2001, respectively.

(13) The left hand column of **Appendix Exhibit 11** is identical to that presented in the same column of **Appendix Exhibit 9**. How-

Exhibit G



ever, a cursory examination of the remaining columns of the former clearly indicates the dominance of individual versus shared lending in 2002. A comparison of these figures with those appearing in last year's **Appendix Exhibit 14** reveals the opposite situation — lead lender originations were, in general, much larger than that involving sole lending. More specifically, while Advances overall decreased 2.3% this year, financing by single firms went up 33.5%. At the same time, lead originations moved in the opposite direction falling by nearly 60%. Similarly, non-lead participations fell 23.7% from 2001. Clearly, as the economy has begun to swing more positively and write-off risks to be perceived as lower, asset-based providers have been much less attracted to loan diversification. Another view of this can be seen by examining the last two rows of the table below. These illustrate these movements in terms of the portfolio totals for the last two years. As can be seen there, sole lending remains the dominant form of asset-based financing throughout the industry. However, the percentage of single-firm funding increased by 21 points between 2001 and 2002; just about the same portion that lead originations declined.

LOAN PARTICIPATION BY REGION — 2002
(AS A % OF AND RANKED BY AREA TOTAL ADVANCES)

Region	Sole Lender	Lead Lender Originations	Non-Lead Participation
Northeast	77.78%	17.48%	4.74%
Middle Atlantic	77.12%	12.32%	10.56%
Southeast	80.20%	13.37%	6.43%
Eastern Midwest	75.73%	16.40%	7.87%
Western Midwest	78.51%	16.36%	5.13%
Southwest	81.28%	10.07%	8.65%
Far West	82.79%	10.53%	6.68%
Canada	73.53%	21.49%	4.97%
Other	100.00%	0.00%	0.00%
Total—2002	78.99%	14.61%	6.40%
Total—2001	57.89%	34.07%	8.04%

The table also shows non-lead participations to have been a relatively small and declining portion of Total Advances over the last two years. These are most likely reflections of a recent decline in loan sizes. Typically, larger loans necessitate greater participation to achieve successful closings than do relatively small sized lending arrangements. Interestingly, with the exception of last year, non-lead participations have dropped significantly since 1999. In that year they amounted to over $800 billion — 28.2% of all Advances. Large-scale borrowing was created in that year by the then strong economy and falling interest rates; lead lenders accounted for only 10.2% of the total. Since that time, participative lending has declined to $131.6 billion, only 6.4% of Total Annual Advances.

(14) The table in the previous column, along with the loan participation exhibits for the last two years also shed light on the asset-based lending atmospheres among the surveyed regions. On a relative basis, sole lending was strongest in the southern and western portions of the United States. In each of these regions over 80% of the member portfolios were lent out exclusively by individual asset-based firms. Furthermore, the absolute rate of re-lending in these areas was also substantial (see **Appendix Exhibit 11**). Since it takes less time to borrow through a single institution, i.e., there is less time involved than in packaging a loan, both the absolute and relative measures imply that these, in general, were the best regions in which to borrow. From the standpoint of packaged loans, lead lender originations fell in every region but in Canada where asset-based lending overall dropped by over 65%.

Although these areas were the most willing to accept such loans, all of the regions except Canada showed positive growth over last year in this form of lending. As might be expected from our earlier discussion respecting the growth in the absolute size each region's Total Advances alone, the Northeast and Western Midwest also had the largest increases in sole lending as well. In combination, while asset-based lenders in the southern and western portions of the U.S. were the most willing to do individualized loans, loan demand for this type of borrowing grew the most in the Northeast and Western Midwest. This illustrates the fact that loan demand for a particular form of asset-based loans is not always carried out in the same areas where lenders are the most anxious and willing to do them.

The contributions of the asset-based lending industry go far beyond those that directly involve short-term lending. Indirectly, each year the financial effects of their activities affect the thousands of people who work for them, the thousands of companies who are their borrowing customers, and the lives of the millions of people who work for these borrowers. The next sections evaluate the degree to which this has taken place in 2002. **Appendix Exhibits 12 & 13** present the breadth of these impacts.

(15) In 2002, as indicated in **Appendix Exhibit 12**, it is estimated that 19.7 million employees were affected both directly and indirectly by their companies' asset-based borrowings. This represents an increase of over 1.1 million more job holders than in 2001, a 6.0% gain. However, the number of affected personnel may have been even larger than this. As pointed out in last year's Report, the most difficult information for Survey respondents to gather and/or to estimate is that of the number of people who work for their customers. Last year's adjustments led to a revised estimate of 19,754,590 individuals who were affected in various ways by asset-based lenders' worldwide activities. This year's corrections raised the 2002 figures from 19,705,365 to 20,992,318

— a revised net gain of over 1.2 million people, or about 6.3% over 2001. In the U.S. alone, 20.7 million were affected, or about 15.1% of all job holders in this country. Moreover, if one applies the often-used rule of thumb that for every employee of a firm, 2.5 workers in related businesses are needed to support their activities, then in 2002 asset-based lenders affected, both directly and indirectly, nearly 73.5 million wage and salary earners worldwide. For only the United States, the comparable figure was 72.3 million workers. This represents nearly 53% of all the 136.5 million workers employed in the United States this year, up from 49.9% last year. All of this occurred while unemployment in this country rose by 23.2% and its counterpart, employment fell slightly by 0.3% over this same time frame.

(16) Also presented in **Appendix Exhibit 12** is information as to the number of client companies, themselves, that were involved in asset-based borrowing from the industry's members this year. While the number of such firms engaged in this form of borrowing still represents only a small portion of American and, indeed, the world's total, their size does not. On average, each asset-based borrower received Advances of $28.4 million in 2002. Although many of these firms were a great deal larger than average, they were balanced out by many more smaller borrowers. However, an important component of the above average Advance figure is total number of firms that have been using such financing over time. More specifically, as shown in the exhibit, the total number of firms that did asset-based borrowing rose to an all-time high of 73,459 this year. Moreover, this figure has risen to this level from 5,507 client companies in 1976, when the SFNet began publishing such data, at a compound annual rate of growth of 10.48%. However, actual historical data by which to measure the growth based on the size of their average borrowings are not available. These data were not collected until 1997. On the other hand, we are now able to make estimates of Total Advances back to 1976 on a preliminary basis using procedures that have just been developed and tested. Using this process, we have calculated total 1976 Advances to be $683.2 billion. Given this figure, it is estimated that the average borrower received Advances of $119.8 million 27 years ago. The reduction in average borrowings over time is surprising. However, while the number of borrowers grew at 10.48% over this period, the amount borrowed over this time frame grew at a compound rate of only 4.39%. In combination, these growth rates indicate that the industry's client companies are either getting smaller in size or that they are not making use of asset-based instruments to the extent that they once did. The latter is a much more serious problem. As we shall see shortly using other employment data, it appears that it is fortunately the former trend that appears to explain the occurrence of this phenomenon.

First, we shall focus on current client company employment from a regional standpoint.

(17) As can be seen in **Appendix Exhibit 12**, lenders in the Northeast lent to the largest number of companies — nearly 51% more than in the Southeast, the next leading area. However, the companies to whom they provided funds to in 2002 were not necessarily the largest in size. In fact, based on the average number of employees per borrowing company, clients in the Northeast were 4th in size among the nine regions we track. Average employment there was 260.1 employees. Those located in the Eastern Midwest were the largest with 542.2 wage and salary earners per company. Close behind them were those in the Southeast. The average size of their asset-based borrowers was 459.3 employees. Overseas, asset-based lenders had the smallest sized clients with only 42.8 employees. In fact, of the nine regions examined, the Northeast ranked 4th in the average size of the companies receiving asset-based loans. Firms there averaged 260.1 employees. Overall, U.S.-based client companies had an average of 310.0 personnel (using adjusted figures — see Section (15) for an abbreviated discussion of these data revisions). The reason for these differences is that firms located in the Eastern Midwest and Southeast are more likely to operate in labor-intensive, heavy manufacturing industries. Those in the Northeast are more associated with high-tech and other less labor-intensive sectors.

(18) The asset-based lending industry employs far fewer people than do those that borrow from it. The data contained in **Appendix Exhibit 13** presents the details of the industry's direct contribution to the Nation's employment in 2002. Virtually unchanged from last year, asset-based lenders employed 16,425 people in 2002. Even applying the 2.5 times ratio of indirectly affected employees, the total number of affected workers was only 57,488, slightly more than 0.04% of the U.S. work force. However, despite the fact that the asset-based labor force is small, it is very productive. Combining **Appendix Exhibit 13** with **Appendix Exhibit 9**, total and regional differences in productivity can be examined. On average, every asset-based lender employee generated $127.2 million in 2002. While this was down slightly at -2.1% from last year's $129.9 million per asset-based employee, it is still quite an impressive figure. These findings strongly imply that those working in the industry generate the highest rate of value per employee of any industry.

This decline in productivity was due in part to much lower performance rates outside of the U.S. All seven domestic regions generated output per employee of at least $104.2 million. This occurred in the Far West, which was the lowest. The two foreign sectors, Canada and the Rest of the World, produced far less than this at $74.2 million and $51.2 million per worker, respectively. Asset-based lending productivity in the U.S. was highest in the Southeast ($160.6 million per employee) and in the Western Midwest ($157.6 million per employee). Productivity comparisons between 2002 and 2001, however, show a somewhat different story. The Overseas region had the highest gain, 58.5%. This was followed by the Northeast with an increase of 24.7%. At the opposite end, the Middle Atlantic showed the greatest loss at -

46.8% followed by the Far West at -23.4%.

The Northeast, despite its size, had the second highest growth rate in asset-based lending employee proficiency. At the other extreme, the Middle Atlantic states' lenders had the lowest performance rates. The reasons for these wide variations are many. However, part of the difference has been caused by the nature of the industries located in these various regions. Some of these business sectors have been hit harder than others by recent economic and market events, some were hit more quickly by them, and still others were slower to react to these changes. Another factor has been the impact of low market rates of interest that has driven commercial paper rates to an historical low. This has led many larger borrowers to utilize this form of funding rather than that of asset-based short term loans. Productivity declines in the industry have also arisen because some lenders may not have prepared themselves for the degree to which the financial markets, as well as the economy, have declined. Finally, there is the effect of competition by other types of lenders against asset-based lending companies. With low interest rates and the likelihood of them increasing in the near future, many institutions have placed their funds in short-term loans. This allows them to follow the financial ladder upward as their perception of a future interest rate climb becomes stronger over the period. At the same time, these traditionally long-term debt providers have moved away from this form of lending in order to avoid being locked into very low interest rates for a protracted period of time. With all of these factors occurring at the same time and quickly in several regions, many asset-based lenders were not able to adjust their staffs' lending and collection activities fast enough to respond to these changed conditions. It is very likely that the problems that caused the industry's low productivity in several of these regions will be rectified next year as those asset-based lenders that have been adversely affected in some of these areas will now have had the time to make the necessary productivity improvements in 2003. These overall adjustments are borne out by the data on Outstandings and Advances in **Appendix Exhibit 1** and the illustrative movements in them in **Appendix Exhibits 2 and 3**.

(19) Another way in which to examine the industry's productivity is by assessing its performance over time, rather than across the regions at a single point in time, e.g., 2002. Advances provide the basis for doing this because it deals with lending activity, rather than does Outstandings which focuses on the availability of funds. The table below presents some definitive information respecting both the changes in the size of the client companies that have done asset-based borrowing over the last six years and the productivity of the asset-based lenders that have supplied these funds over the same period. The employment figures for them are unadjusted and, therefore, different from those presented in Section (17) above. This table in combination with **Appendix Exhibits 1, 12, and 13** is an important insight into the changing operating conditions of the industry and its client companies.

EMPLOYMENT - PRODUCTIVITY ANALYSIS

Year	Client Employees Per Client Company (unadjusted data)	Total Advances Per Company Employee
1997	310	$160,290,641
1998	329	$167,542,672
1999	306	$150,454,035
2000	291	$121,771,012
2001	269	$129,871,845
2002	268	$127,226,791

The left hand column presents the employment conditions among the clients of asset-based lenders over this period. Since the 1998 economic peak, firms using asset-based funds have reduced their staffs significantly in response to the more difficult economic times. However, these data indicate that this responsive decline in size is leveling off. The implication is that activity in the commercial-industrial climate is stabilizing and that there could be an upward turnaround in 2003 in both the size of these firms and in their short term demand for additional funds.

The right hand column provides information regarding asset-based lender productivity over the same six-year period. Our earlier discussion in Section (18) dealt with their productivity by region and the changes in this performance indicator for them between 2001 and 2002. The preceding table looks farther back and relates the industry's productiveness to the cutbacks in the size of their client firm's response to the worsening economic and operating/overhead cost environment they began to face during and before this period. An examination of this column suggests that the industry has not yet fully adjusted to the conditions that prevailed at that time. However, it also shows that its current level of productivity is not falling as fast as it did between 1998 and 2000, and that overall it is beginning to stabilize. Overall, as shown in the table, the industry's productivity matches up pretty well with its client companies' size reductions. However, there is an underlying problem in the industry's delayed response in recent years to the changes in its lending markets. More specifically, the above table, in combination with **Appendix Exhibit 1**, indicates that the industry's level of employment has not adapted as quickly as it has needed to the downsizing that began to take place among its borrowing customers during that period. As the latter sought to reduce their workforces in response to the wave of downsizing that reached its peak in 1997 and to improve their internal operating efficiency, they also continued to expand their production of goods and services. To maintain this growth, they increased their sales of stock and their level of borrowing on both a short-term and long-term basis. The asset-based lending industry could not have known that the "excessive exuberance"

of consumers and investors, the phrase coined by Allen Greenspan to refer to this phenomenon at that time, was suddenly going to begin to disappear in late 1999. Employee costs were shooting up, prices were skyrocketing, and retail sales were just starting to decline. The asset-based industry reached all-time peaks both in terms of the size of its lending base and in the velocity of their lending and re-lending of those funds. As shown in the table, the industry's efficiency climbed between 1997 and 1998 as its level of asset-based lending outstripped its hiring of employees. However, beginning in 1999 client companies began to reduce their size, as shown in the right hand column of the table. On the other hand, between 1998 and 1999, asset-based lenders' labor force rose by 10.2%. By 2000, it had increased by another 11.1%

It has only been during the last two years that asset-based lenders have begun to reduce their employment levels to those that better match up with their borrower's financing needs and abilities to repay their outstanding obligations. This year, even though Advances continued their decline by -2.29%, the number of industry employees fell only -0.57%. The presumption is that the industry continues to seek out, maintain, and avoid losing a highly specialized and extremely productive workforce.

There is a much deeper recent adjustment process to the weakened economic conditions and reduced demand for financing that is taking place both by lenders' clients and within the industry itself. To see these, we have made analyses of trends in the U.S. alone in order to take advantage of available domestic public data. However, the same tendencies exist throughout the industry. This process is presented in the section below and is focused solely on the adjustments that have taken place between 2001 and 2002. Notwithstanding, it is indicative of the process that has been taking place in the recent past and that is likely to continue for at least the next two years.

(20) First, a portion of the data we have collected indicates that the size of the client companies that are using asset-based instruments is getting smaller. At the same time that the number of U.S.-based asset-based borrowers has risen by 9.84%, employment among them has increased by 7.36%. Thus, while both of these measures are rising, the number of borrowers is rising faster than is the total number of people they employ. Therefore, the number of employees per company is getting smaller. The implication of these figures is that while the number of asset-based borrowers is increasing, these firms are getting smaller in size. Furthermore, the 9.84% growth in client numbers is in conjunction with the smaller increase in U.S. Outstandings of only 5.18% and Advances that dropped by 1.18%. Together, the first two changes indicate that average loan sizes are decreasing. The first and third signal a decline in degree to which these smaller client companies are borrowing and re-borrow asset-based funds.

With more, but smaller borrowers, less lending and re-lending and in smaller amounts, asset-based lenders are moving into an atmosphere of greater competition for smaller and more risky short term lending opportunities. Profitability is also falling as the short-term yield curve continues to fall. This portion of the rate structure declined about 60 basis points across the 1-6 month maturities over this past year. At the same time commercial paper rates for this maturity range remained around 1.55%. The one bright spot for the industry is that the low commercial paper rates have also reduced lenders' borrowing costs.

Overall, 2002, remains a period of slow recovery from last year's recession. None of the major economic indicators have shown much improvement and many continue to remain at their recessionary levels. This further indicates that loan demand has been lower than normal and is evidenced by the small improvement in asset-based lenders' lending base (see **Appendix Exhibits 1, 2, and 3**).

Returning to some of the data contained in the first paragraph of this section, we can see another trend that has developed. While National Civilian Employment fell only -0.33%, U.S. client company employment increased 7.36%. The spread between the rate of growth in lenders' employment and their own growth in numbers indicates that the industry's consumer base of asset-based borrowers is declining.

The last section of this Report examines the industry's performance by size categories and the movements between them this year. As shown in **Appendix Exhibits 14 and 15**, there are four size groups that are arranged from smallest to largest in terms of both Outstandings and Advances. The two sets have been arranged to enhance their comparability.

(21) **Appendix Exhibit 14** presents the size breakdowns of asset-based lending activities in terms of Outstandings. In last year's Report, we pointed out that there has been a strong, continuing upward trend since 1998 in the proportion of the volumes accounted for by the largest sized asset-based companies. This process of agglomeration has continued this year as well. Over the last five years, those firms with Outstandings of at least $500 million have increased their portion from 78.68% in 1998 to this year's 95.41% of the total. Between last year and this, these large asset-based lenders increased their share by 5.5% from $294.8 billion to nearly $311 billion. And, as shown in **Appendix Exhibit 14**, the spread between them and the next largest category continued to widen. In fact, the proportions accounted for by all of the other three segments fell substantially this year, except this one. Thus, it was this group that was responsible for this year's increase in Total Outstandings. Average Outstandings for each firm in this group was $4.6 billion. In contrast, the average for those in the $100 - $500 billion size category was only $204.7 million — over 22 times smaller. The smallest two segments respectively averaged $49.7 million, 4 times smaller than those over $100 million, and $12.9 million — nearly 4 times smaller than this last group. These differentials indicate that there is a huge diversity of firm sizes among asset-based lenders.

(22) We turn now to the size breakdowns of our asset-based lenders based on Total Advances: much of the discussion in this section is based on a comparison of the data in **Appendix Exhibit 15** in this Report with that in **Appendix Exhibit 18** in last year's. As indicated earlier in this Report, the decline in this measure of lending velocity began to level off this year. Between last year and this, every size category but that of the second largest group, i.e., those that Advanced between $915 million - $4.575 billion, declined. Thus, it was only because of the increased velocity among the lenders in this group that this year's Advances did not fall faster. Without their contribution, the flattening out of the decline in Advances would not have occurred. The primary reason why Advances did not increase this year is that lending velocity within the largest size category fell for the first time since 1998. Its rate of descent of -3.81% was larger than the overall decline in Advances of -2.59% and its absolute reduction of -$75.5 billion overshadowed the positive effects of the second tier of asset-based lenders. The latter rose by 36.5% over 2001. However, this very high increase accounted for only $38.5 billion of the change in Advances this year — about half of the fall in the largest sized segment's reduction in Advances. This implies that with only a small increase in the degree of lending of the larger sized lenders, next year could show the first upward movement in Advances in four years.

Like Outstandings, there is a substantial gap between each of the size groupings in terms of average advances per asset-based lender. Average Advances in the largest category was $57.7 billion. The next group had an average level of Advances per company of $2.7 billion. The spread between these two segments was virtually identical to that between these two segments respecting Outstandings — 22 times. The spread between the third and fourth size groups was about the same as that between the same segments respecting Outstandings, i.e., approximately 3.8 times. However, the big difference was between the second and third tiers. The third tier of companies had average Advances per lender of $442.6 billion. This created an even larger, six-fold spread between the second and third groupings than that based on Outstandings. The difference between these groups in terms of Outstandings was four-fold. Had the same spread existed respecting the second and third tier in terms of Advances that did so regarding Outstandings, the second tier would have produced average Advances of $14.0 billion. This would have raised Total Advances in their sector to $ 45.862 billion. Overall, the effect of this would have caused Total Advances to have grown this year to a little over $2.1 trillion. And there would have been virtually no decline in Total Advances this year.

Given this information, we are now ready to examine the rate of Turnover among these classes of asset-based lenders. To do this, we will apply the same procedures as discussed in the preamble to Section (10) and applied using the data contained in **Appendix Exhibit 10**. Again, Turnover is defined as the ratio of Total Advances to Total Outstandings. The data we are using to measure Turnover by sector is embodied within **Appendix Exhibits 14 and 15**.

This is the first time that we have examined industry Turnover from this perspective. The results are quite enlightening. While overall Turnover for the whole industry in 2002 was 6.41 and is almost unchanged from the 6.86 times in 2001, most of the individual sectors vary substantially from this figure. The highest Turnover was 13.65 times among those in the second tier of companies. It was 11.32 times in the first tier and 12.14 times in the third one. On average, these three segments had a Turnover rate that was almost double that of the whole industry. What pulled the average down was the rate of Turnover among the largest firms. Their rate of 6.13 times was 95.6% of that of the whole industry — 6.41 times. However, because of their large size, on average accounting for 93.3% of the Turnover components, their dominance is the primary determinant of industry rates. This does not mean that the latter group is necessarily the best performing segment of the industry. On average, the three smaller sets of asset-based lending companies collected their receivables in 29.5 days, just about the DSO terms of 30 days that is generally set by businesses throughout the U.S. On the other hand, the segment containing the largest asset-based lending firms collects its receivables over a somewhat longer timeframe than the average for the industry. They average 59.5 days while the whole industry averages 56.9 days. In order to make up this difference, this segment would have had to generate an additional $44.6 billion. The effect of this would have been to raise Total Advances to $2,134,281 billion, only 0.52% of last year's figure.

(23) The last facet of the industry's activities in 2002 to be reported upon are the movements among its various size groups. We reported on this aspect of asset-based lenders for the first time last year. This year, we are also examining these movements over the last seven years (six years for Advances).

Respecting the latter, Year 2000 appears to be a major turning point. While most economists and other professionals recognize the official beginning of the latest recession to be Year 2001, many indicators were falling well before this official date. A number of these actually began their descent at the beginning of 2000. The most important of these dealt with investment, inventories and production. Because they represent important economic aspects of the elements that appear to drive this industry, their declines form an important bellweather for its current and future performance.

As mentioned earlier, the trends in Advances in terms of both its total and each of the groups that carry out asset-based lending is not at all like those of Outstandings. In fact, in terms of the velocity of such loans, the movements among the various size groups has been almost in the opposite direction. Nevertheless, the beginning of Year 2000, in terms of this industry performance measure, marks the beginning of the change in the recent direc-

tion of our financial sector of the economy.

In general, there has been a movement away from the top two segments and into the two bottom ones. (No company size data is available for Advances prior to 1998.) The number of firms in the top tier has been dropping since 1999 due, in large part, to consolidations within the banking industry. The size of the second group also fell since 1999, but has leveled off. The number of firms in the two smallest categories, however, has jumped upward.

Many of the results presented in this report have important implications respecting the future of our industry. Some of these will be explored in the addendum to this Report that remains to be completed. This will deal with some of the results presented herein along with those of other influences that could have possible future impacts on the performance of our asset-based lending industry.