THE ALLEASING

EQUIPMENT DEMAND INDEX

GROWTH AHEAD, BUT THE DEVIL'S IN THE DETAIL

OCTOBER 2017
AUSTRALIA

BEATING COSTS AND COMPETITORS

Businesses need technology to grow, cut costs, create new products and work smarter. The size and sector of an enterprise clearly influences what technologies are acquired, their impact, and ability to be competitive.

In this edition of the Alleasing Equipment Demand Index (the Index) Australian businesses were asked what the most significant adverse impact of failing to upgrade to the latest technology would be. The most popular response at 27.8 per cent, was the ability to tackle domestic competition.

This drew almost double the number of responses than the next most popular answer, with 15.4 per cent of businesses stating the downside of not upgrading is higher headcount costs. This clearly demonstrates that out of date technology not only has the ability to hinder production, but staff count and their ability to perform.

While the national average for citing ability to compete with domestic competitors was 27.8 per cent, the result for transport was significantly higher at 69.2 per cent, and 64.0 per cent in construction.

In contrast, the issue in the agriculture, forestry and fishing sector is not so much domestic competition (nominated by 6.8 per cent), but higher costs of origination (34.1 per cent). The second most cited issue is being slower to deliver new products (18.2 per cent).

In the mining sector, 55.5 per cent of businesses cited the higher cost of origination as their biggest factor, against an average of 13.0 per cent.

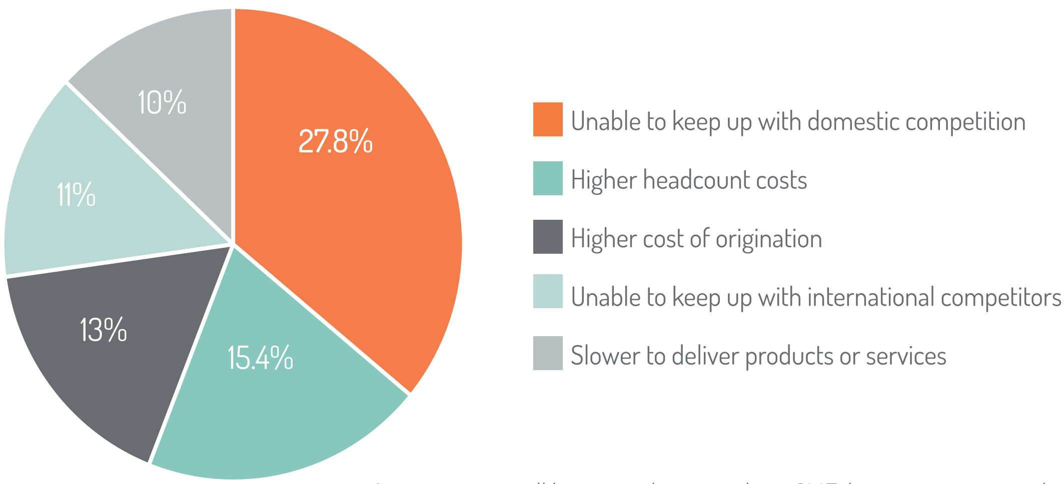
At a national level, Australian businesses are only moderately concerned about international competition, with 11.0 per cent choosing this response.

Manufacturers cite international competition (35.8 per cent) as their biggest concern should they fail to upgrade technology, setting them at a disadvantage against international competitors. Particularly as many manufacturers in China are already rapidly upgrading their own innovative technology.

In regards to the type of technology acquired, 35.3 per cent of manufacturers intend to acquire IT/big data services. The latter of which could be used to implement smarter automation technology and artificial intelligence to drive production.

The agriculture industry, due to see a significant rise in export targets, stands in contrast on this issue, at just 9.0 per cent. Meanwhile, 14.7 per cent indicate they use IT to a "high extent". But while IT/big data may not currently be in demand in the agricultural sector, four in ten said they intend to acquire drones, as the uptake of technology in the sector continues to gather pace.

Top Five Concerns For Not Updating Equipment



Average across all business demographics, SME, lower corporate and upper corporate

WHAT LIES BENEATH

Overall expectations for the December 2017 quarter continue in a tight range, but beneath the surface there are big shifts in the sector data underlining differences across the economy.

A national average of 26.6 per cent of businesses plan to increase their asset base in the final quarter of 2017, by an average of 9.2 per cent. This is down from 28.8 per cent in the previous edition, *2017. So Far, So Good,* but is still on trend with earlier editions of the Index this calendar year showing that on average, 26.7 per cent of businesses are planning to acquire assets.

This figure set the benchmark for the Australian Index this year, and those intentions were reflected in data published by the Australian Bureau of Statistics (ABS), showing an increase in purchases in the three months to June 2017.

The ABS also reported that business plant and equipment expenditure in the June quarter was up 1.1 per cent, with a total of $12.5 billion spent over that period.

Throughout 2017, businesses in Victoria/Tasmania have been more bullish than other regions with 28.8 per cent planning to increase their asset base, the highest of any geography, against a national average of 27.9 per cent.

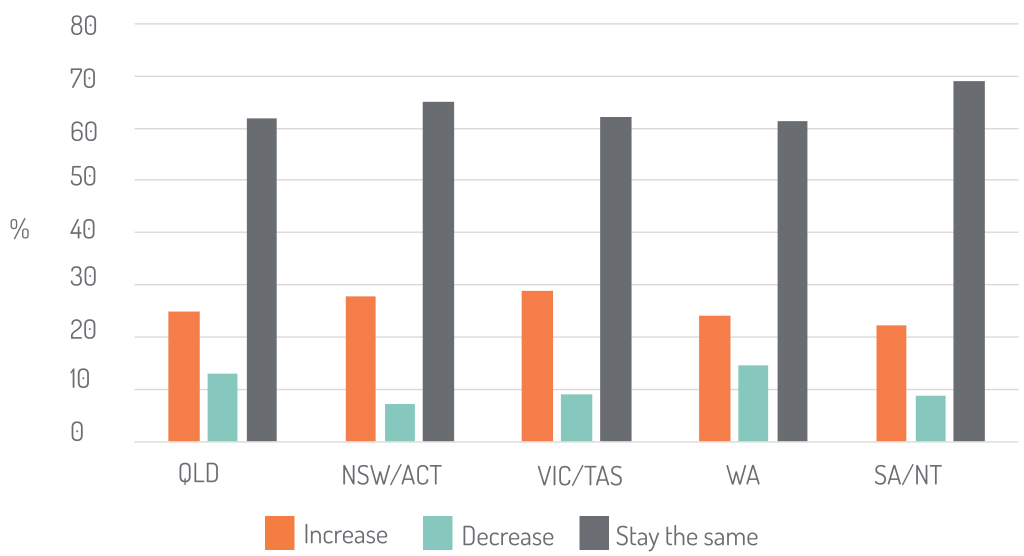
It may be Australia's smallest state, but ABS figures show that Tasmanian businesses spent $1.74 billion on equipment, plant and machinery in the June quarter, up from $1.28 billion in the March quarter, while the figure for Victoria jumped from $2.1 billion to $3.1 billion in the same period.

On closer analysis, the Index and ABS data shows an economy in transition as some industry sectors struggle with disruption and new competition, and others ride more positive waves of demand.

This December quarter, 43.2 per cent of businesses from the agriculture, forestry and fishing sector intend to increase their asset base, while sectors such as construction (28.0 per cent), accommodation, hotels, cafes (50.0 per cent) and transport (28.2 per cent) were also above average. This contrasts with mining industry sentiment, where only 11.1 per cent of businesses intend to increase their asset base.

The mining industry's quarterly expenditure on equipment, plant and machinery fell from $4.4 billion in the June quarter of 2012, to $1.4 billion in the June quarter of 2017, according to the ABS.

Assets Acquisition Intentions by State



RETHINKING ASSET ACQUISITION

With ABS figures showing a 10.5 per cent year-on-year fall in business capital spending over the 2016/17 financial year, it is unsurprising that a growing number of businesses say they have one or more assets hindering their productivity. So far this year, the percentage of businesses experiencing this issue has doubled.

In the first Equipment Demand Index of 2017, *Capital Constraints, a Common Complaint,* 11.6 per cent of businesses said they were struggling with one or more unproductive assets. Results for this quarter have increased to 22.4 per cent, with SMEs as the biggest business demographic suffering from this issue at 27.5 per cent.

This data demonstrates businesses have underspent on equipment, leaving them with unproductive asset(s), which are now inhibiting their attempts to grow.

ABS figures for the last quarter of 2016/17 point to an improvement in business expenditure in 2017/18, with industries including transport, utilities and construction on track to hit $67.3 billion for the year to June, an all-time high in the 30 year history of the survey.

This is causing more and more businesses to re-evaluate the way in which they acquire their assets.

Traditionally, Australian businesses have either used equity or borrowed from a bank to purchase assets outright. In the March 2017 edition of the Index, *Capital Constraints, a Common Complaint,* 56.7 per cent of businesses said they would either buy outright or borrow to buy, but in this current round, this has fallen to 43.5 per cent.

Additionally, 48.6 per cent said they would buy outright in December 2016, which has now fallen to 26.3 per cent.

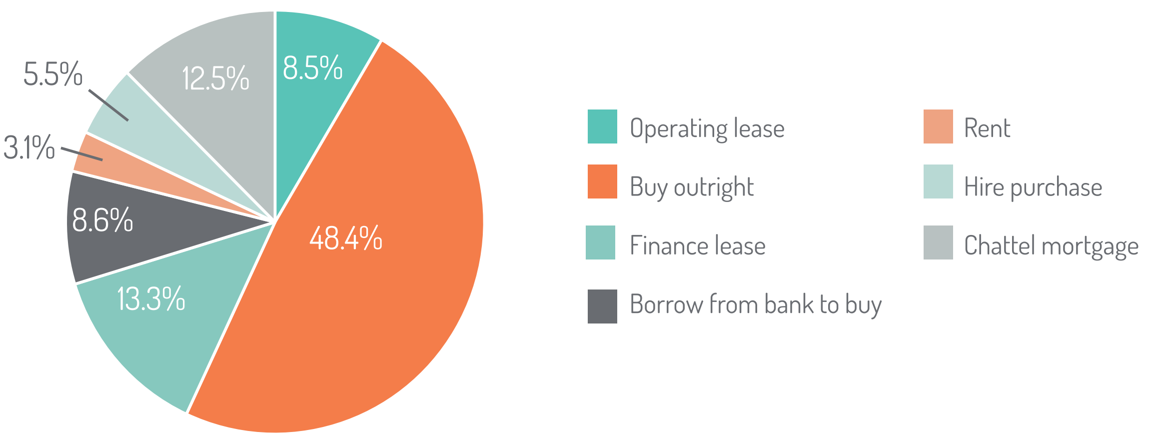
Large increases in the number of businesses planning to acquire assets via a finance or operating lease are evident. This combined figure has gone from 21.6 per cent in January 2017, to 39.8 per cent.

The data reveals a clear and emerging trend away from equity and towards finance for asset needs, and increasingly towards finance which does not involve immediate and outright ownership.

Drivers for this are the potential tax benefits of leasing and cash flow, with more than six in ten businesses nominating these factors as key reasons to lease or finance their acquisitions. Furthermore, one in ten simply saw this type of finance as easier to access than other sources.

Trends in the Index suggest that an increasing percentage of future assets will not be purchased with equity or bought outright, but financed through other means.

How Businesses Intend to Acquire Assets



GROWTH AND HOW TO FUND IT

The Index results have found that although capital expenditure by Australian businesses over 2017 has been down compared to 2016, many businesses are still striving to grow. In addition to this, the number of businesses working with outdated and unproductive assets has doubled over the past year, to 22.4 per cent.

What are organisations doing to fund growth when so many of them plan to decrease or maintain their capex spend?

The Index has found that while 39.4 per cent of all businesses intend to talk to their regular bank about additional finance options, many other businesses intend to take a different approach.

To fund growth, 8.2 per cent say they will seek finance from a non-bank, such as a Peer 2 Peer (P2P) lending platform, while 14.6 per cent will use equity. A further 11.0 per cent will look to re-finance their existing borrowing arrangements.

Comparing business segments, SME businesses are much less dependent on their regular bank and are more likely to look to non-bank alternatives.

Where 28.0 per cent of SMEs (against the 39.4 per cent average) will look to their regular bank, 14.8 per cent intend to talk to a non-bank provider and a higher than average 14.8 per cent will look to re-finance.

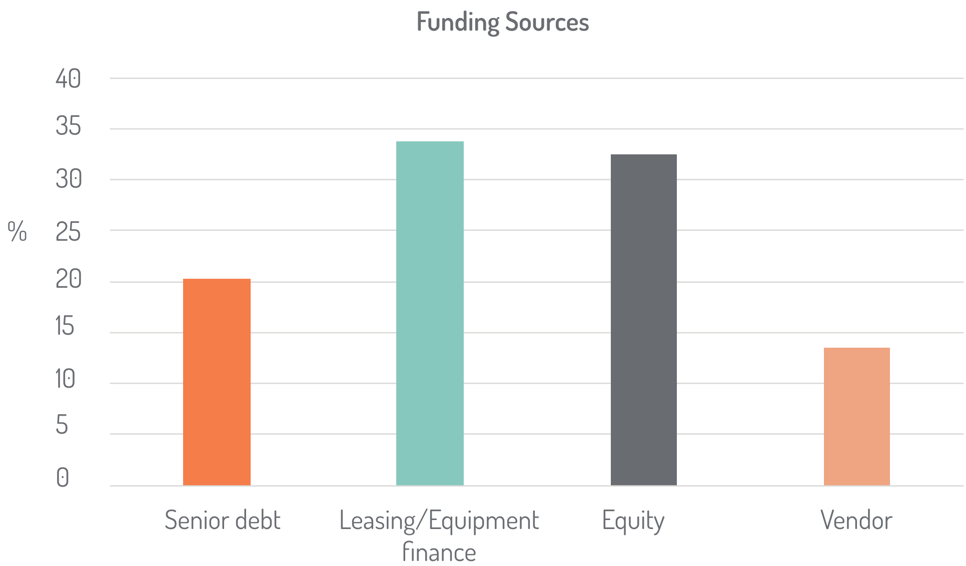
In comparison, 49.1 per cent of lower corporate businesses will look to their regular bank for funding compared to 43.1 per cent of upper corporates.

With new Basel III regulations restricting how much banks can lend, this could be the reason that businesses are beginning to look at alternative sources to fund growth.

Among lower and upper corporates, only 5.4 per cent of lower corporates and 2.8 per cent for upper corporates are considering non-banks as an option. These two sectors are also less likely to re-finance their existing arrangements than SMEs, and are more likely to use equity to fund growth.

In the agricultural, forestry, and fishing sector, 36.3 per cent intend to increase their capex (against the national average of 22.2 per cent). Considering the ambitious target set by Horticulture Innovation Australia to increase the value of fruit and vegetable exports to $315 million by 2020, this isn't a surprising result and indicates that this trend will continue in 2018.

In contrast, the figure in the mining sector stands at 8.9 per cent, and in manufacturing at 14.1 per cent. Index data also shows that 24.4 per cent of miners will look to re-finance if they do not increase their capex, but only 2.2 per cent will approach a non-bank. In contrast, 11.6 per cent of manufacturing businesses intend to re-finance, however, 10.5 per cent intend to approach a non-bank.



SUMMARY

The ABS is expecting higher levels of expenditure on equipment, plant and machinery in 2017/18, with the figure up 2.7 per cent in the June quarter, offsetting a 0.8 per cent fall in spending on buildings and structures.

The Index also continues to point towards growth, with one in four Australian businesses planning to purchase assets in the coming quarter, continuing a consistent trend over the last year.

Those businesses which are adding assets are also planning greater increases. In the March quarter edition of the Equipment Demand Index, *Capital Constraints a Common Complaint,* on average, businesses planned to increase their asset base on an average of 6.5 per cent which has now risen to 9.2 per cent.

At the same time, optimism is unevenly shared as the economy continues to transition out of mining, and the retail and manufacturing industries adjust to ongoing disruption. As positive as it is that one in four businesses plan to increase their asset base, one in ten also plan a decrease.

ABS figures for the retail sector for the June quarter showed volumes rose by 1.5 per cent, a significant improvement but a result which was driven by steep discounting as retail price inflation fell.

What's more, only 8.0 per cent of retailers plan to increase assets, while 9.0 per cent plan a decrease.

Beyond the challenge from online competitors in retail and the impending launch of Amazon and Costco, as well as hi-tech rivals overseas in manufacturing, businesses are concerned about politics, both at home and abroad.

In this sphere, there are many uncertainties, spanning constitutional issues in the Australian parliament to the economic isolationism of the Trump administration to heightened tensions on the Korean Peninsula.

A majority of 54.2 per cent of respondents say their businesses could be impacted by politics. Within that result, 6.8 per cent say they expect a significant impact.

Once again, the detail is telling. Two in ten miners, four in ten electricity companies and six in ten in finance expect politics to have a major impact.

So while some businesses have started the 2017/18 financial year confidently, others appear to have a bumpy road ahead as they seek to navigate a path to growth.

ABOUT

The Alleasing Equipment Demand Index (the Index) is a quarterly index, which examines the current asset inventory of Australian businesses, as well as expectations for future investment. The inaugural Index was run during July and August 2014.

This edition of the Index includes 'Upper Corporate' businesses turning over between $101 million and $250 million each year. The Index comprises research from three segments: SME's turning over $5-$20M, Lower Corporates ($20-$100M), and Upper Corporates ($100-$250M).

This round of the Index was created from interviews with 500 Australian businesses in September 2017.

The Index is executed by Collins Communications on behalf of Alleasing.

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