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Agriculture-Construction Equipment Sector: Is the Boom Busting?

Over the last few years, equipment manufacturers and their captive finance divisions have benefited from higher livestock prices, large crops, sweetened federal agricultural subsidy programs, strong spending on residential construction, and increased federal spending on roads. Going forward, whether players in this cyclical industry continue to profit under a more challenging backdrop of rising raw material prices and moderating GDP growth rates is uncertain.

As U.S. livestock prices decline from current levels and droughts reduce the yields of soybean and corn crops, equipment manufacturers may find their profit margin squeezed. According to the Association of Equipment Manufacturers, July sales of farm tractors fell about 16% throughout the United States. As expected, the drought has curtailed farmer's current purchases and eagerness to place near-term orders. This slowing demand may reduce equipment valuations and increase loss severities in equipment transactions as secondary market values also decline.

Many North American agriculture equipment players have sharpened their focus on improving profit margins. Lower fixed costs, reduced manufacturing capacity, more efficient centralized financing operations, and closer relationships with dealers have all served to improve profits and reduce earnings volatility in this cyclical business. However, despite these improvements, steep increases in commodity prices, such as oil and steel, will pressure margins; manufacturers may not have the ability to pass on the full price increase for their raw materials to the end users of their products.

Although the agricultural sector faces challenges, such as the drought, 2005 will likely see the second largest corn crop in U.S. history. This should help sustain demand for farming equipment over the next 18 months. Furthermore, demand for construction equipment remains robust. U.S. spending on construction equipment continues to grow. Historically low interest rates, coupled with speculative investment in real estate, continue to fuel the all-time high level of residential construction as well as moderate activity in the commercial construction sector. Overseas demand, primarily from Asia, for equipment used in industrial and commercial construction has also provided profit opportunities for manufacturers.

Within the equipment ABS sector, deal performance has improved over the last few years. The sector has benefited from a more robust economy as well as improved underwriting standards and servicing procedures implemented by major market originators/servicers. Credit enhancement levels for securitizations backed by a mix of agriculture and construction equipment originated in 2000-2003 have increased as the transactions de-lever. The recent strong sector performance could precipitate a reduction in credit enhancement levels for future transactions.

Hurricane Katrina's impact on the equipment sector will provide a basis for an increase in demand for construction equipment as the rebuilding process gets underway. Agricultural activity will decline in the affected areas given the regional devastation.

In a follow-up newsletter, DBRS will address the composition of manufacturers' production mix between agricultural and construction equipment and the associated impact on ABS transactions.