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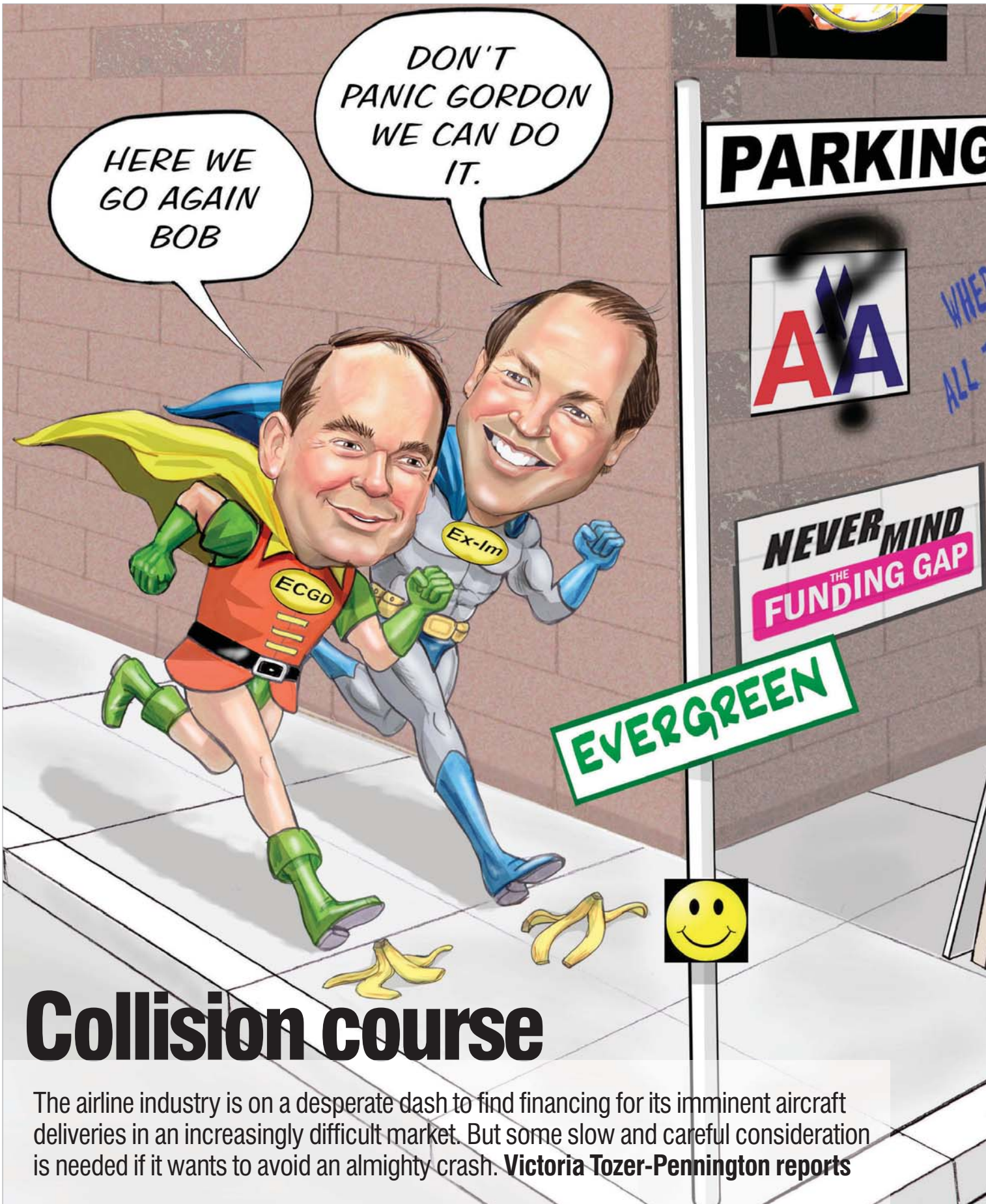
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THE DESPERATE DASH FOR FINANCE



Collision course

The airline industry is on a desperate dash to find financing for its imminent aircraft deliveries in an increasingly difficult market. But some slow and careful consideration is needed if it wants to avoid an almighty crash. **Victoria Tozer-Pennington reports**



The world economic situation is changing so rapidly that this article will probably be out of date by the time it is published. But several factors now seem certain: the western world is heading for a double-dip recession; banks are experiencing increased regulatory scrutiny with tougher capital and liquidity requirements under Basel III; the eurozone and sovereign debt crisis has affected European bank ratings and access to short-term funding markets, particularly to US dollars; and the US dollar itself is poised for depreciation if the country's debt deficit is not addressed, which will lead to a higher interest rate environment. These converging pressures leave the western world open to an almighty crash and prolonged recession. To quote Howard Miller, Ryanair's head of finance, speaking at the ISTAT conference in Barcelona in September: "We are heading for a car crash in terms of financing."

Admittedly this is the worst-case scenario, but even so this is still not the best time for the aviation industry to be expecting record deliveries of new aircraft. Airlines and lessors need to secure funding of \$77 billion to fund deliveries for this year, according to Boeing Capital's estimates, while the value of deliveries in 2012 is estimated to top \$100 billion.

There have been many reports in the world's media commenting on the dire situation for commercial banks in the eurozone. French banks in particular, due to their prolific financing of aviation assets, have been the target of many headlines, with some newspapers suggesting the exit of some banks from the aviation business altogether. So far Société Générale (SocGen) is the only French bank to have publicly stated it is selling off the bulk of its aviation assets. But BNP Paribas, Credit Agricole-CIB (CA-CIB) and Natixis – all active aviation financiers – have been tarred with the same brush, prompting many to issue statements that they intend to remain in the aviation business.

Some banks are looking to free up portfolio space by selling assets (for now at par) in order to meet their existing obligations, and any sale of long-term assets often sends a red light to the markets as a sign of

distress. This might be true in some cases, but most banks regularly trim portfolios as part of their management strategy. However, this has not stopped rival banks from calling it like they see it. One non-French banker told *Airline Economics*: "SocGen and BNP Paribas are offering out parts of their aviation portfolios, but it is not just French banks – German banks are doing the same thing. This goes across shipping and aviation. What was initially just a slowdown or an indication of concern about the rest of the year has now accelerated into concern about prior commitments and also next year."

Bertrand Grabowski, managing director of aviation at DVB Bank, says there is a specific problem with the French banks. "A recent review by Barclays Capital explains French banks have a liability structure that is unbalanced towards short-term refinancing. They are dependent on the short-term funding market," he says. "For Société Générale, BNP or CA-CIB, about 60% of their liability structure is maturing within the next six months. For banks such as Deutsche Bank, Unicredit and HSBC, this is more like 40%. Short-term financing is fine as it is very efficient, but when there are supply issues, it tends to dry up immediately. This problem is also

"There are a lot of sellers and not many buyers; there is confusion on liquidity in the market; and a huge number of aircraft due for delivery in the next few months. This creates a deadly cocktail. In this sort of market, it is easy to trigger panic."

stressing out some other euro-based lenders, and as a result, assets are up for sale in project finance, shipping and aviation finance, mostly US dollar-denominated assets. On top of that, RBS is selling its aviation portfolio. So there are a lot of sellers and not many buyers; there is confusion on liquidity in the market; and a huge number of aircraft due for delivery in the next few months. This creates a deadly cocktail. In this sort of market, it is easy to trigger panic."

Speaking at the ISTAT conference

in Barcelona in September, Christian McCormick, chief executive of Natixis Transport Finance, stated firmly that the French banks were not gone from aircraft financing. “Don’t put us down, we are going to be here next year – Natixis will be here, BNP, CA-CIB and Société Générale we are hoping. We will find solutions. We are not giving up but we are counting on the industry to help us find the funding. Today we don’t have so much short-term money because we are not being given that short-term liquidity, but if it comes back to us, we hope to be able to resume the transformation process and turn that short-term money into long-term money. The best way to make sure we are here next year is to place your funds, your treasuries with us and we will return that to you with long-term loans.”

McCormick pointed out that French banks are not the only aviation finance houses out there. “There are many German banks in aircraft financing, and they are not facing the liquidity crises we are facing, so this is a great opportunity for them, next year perhaps, to step in,” he said.

That panel was held in September, and the economic situation since then has worsened to such an extent that Emirates reports one bank has walked

away from a prior commitment because it can no longer fund the aircraft it committed to financing some months ago. “We had mandated a bank some time ago, and around two-and-a-half weeks before delivery it pulled out, which was very disappointing,” says Brian Jeffery, senior vice-president, corporate treasury, at Emirates.

While not being prepared to go into detail on the issue, Jeffery did say the bank that withdrew from the mandate claimed European banking institutions were having a tough time at the moment. However, Emirates managed to secure a replacement loan immediately through another European bank, as well as separately mandate another French bank for two other aircraft. “It is certainly not the case that every European bank, even in France, is having problems funding; there is funding out there, at least from those banks that truly understand the value of long-term relationships,” says Jeffery. “I don’t blame the individuals involved, as they are probably under pressure from their credit or risk-return people, but the incident doesn’t reflect well on them as a banking institution at all.”

“This is a huge step because it means the bank is taking itself out of that relationship with an important client for years

“It is certainly not the case that every European bank, even in France, is having problems funding; there is funding out there, at least from those banks that truly understand the value of long-term relationships.”

to come,” AE’s banking source says. “Emirates has \$4 billion of aircraft delivered every year, it needs to fund aircraft deliveries every month. So for a bank to come to it a month before the aircraft is due is a huge problem. In my view, that bank will never do business with Emirates again.”

The bank might have sought to renegotiate the deal, which is not unusual in times of extreme market stress. In 2008–9 banks and airlines renegotiated several mandates to work together to address the stress in the market for the good of the industry. One banker says this is part of a normal bank-client relationship when a financial crisis hits and credit tightens. “The mandates that are given to clients include provisions that, when certain situations occur, the bank can ask for a change in conditions. There is a big difference from saying a bank has ‘walked away’ from a mandate and that one has applied the terms of its agreement. I know of no bank that has walked away from a mandate, but banks are telling their clients there is a crisis. When jet fuel rises, airlines do not hesitate to pass that cost onto their customers, and when there is a crisis that affects banks’ liquidity, all mandates and even signed contracts indicate that when certain things occur, certain things might need to change. Call them material adverse change clauses, market flex clauses or market disruption, all the term sheets have them. When banks go to their clients with new conditions for deals once these clauses have been activated, the airline decides whether they want to accept that or not and conclude the mandate.”

‘Market disruption’ is a grey area. If interbank lending dries up, banks can claim market disruption to withdraw from future funding commitments, but banks try to avoid this in an effort to maintain relationships.

AIRLINE AND AIRCRAFT LESSOR RATINGS			
Company	S&P	Fitch	Moody's
AMR	B-	CCC	Caa1
Air Canada	B-		B3
Air New Zealand			Baa3
Aircastle	BB+		Ba2
Alaska Airlines	BB-		
All Nippon Airlines			
Aviation Capital Group	BBB	BBB-	
AWAS	BB		Ba3
British Airways	BB-		B1
Delta Air Lines	B	B-	B2
ILFC	BBB-	BB	B1
JetBlue	B-	B-	B3
Lufthansa Airlines	BBB-		Ba1
Qantas	BBB		Baa2
SAS	B-		Caa1
Southwest	BBB	BBB	Baa3
United Continental	B	B	B2
US Airways	B-	CCC	Caa1

“We understand that some banks will have limited appetite to fund transactions themselves if they are in US dollars. [But] there are active dollar-based institutions that have seemingly increased their appetite for ECA. So we can point to a changing market presence for some but not all, and transactions continue to be closed on time.”

However, one banker says withdrawal doesn't necessarily affect relationships in periods of stress. “In 2008, a lot of banks renegotiated their deals and most clients understood that conditions had changed, they were unexpected but they had to live with them. Those that don't accept this are not being realistic, and are not really clients most banks want to work with.”

Four other airlines have experienced banks from Europe and the US pulling out of export credit mandates and future funding commitments such as warehouse facilities or revolvers.

“We are aware of recent situations in both North America and Europe where financially stable airlines and aviation service providers have faced a significant repricing of their loan commitments,” says Steve Gaal, managing director of SkyWorks Capital. “At the same time, we have seen other companies attaining new facilities at attractive terms, meaning the repricings that have occurred have largely arisen due to the specific circumstances of the financial institutions involved.”

But this could be a sign of things to come. “The potential fallout will be mostly on airlines or leasing companies that have facilities in place that represent future funding commitments such as pre-delivery payment or warehouse facilities,” Gaal says. “Airlines and lessors with those types of facilities will have to carefully examine their counterparty risk. While aviation bankers will be loath to risk their customer relationships through calling on market disruption



GORDON WELSH, ECGD

clauses, the political realities that underlie how the eurozone crisis ultimately unfolds could put relationships at risk.”

Emirates' Jeffery says he will naturally find it difficult to trust any commitment from the bank again and that these events “beg the question: when is a mandate really a mandate?” He says: “We do rely on the commercial banks for our aircraft financing and although we can't foresee another bank pulling out of a mandate, it could happen. So even though we have mandated financing for 14 of our remaining 15 aircraft deliveries until March 2012, and also have offers covering all the 31 aircraft being delivered during the next fiscal year, we are

always keeping a close watch on what is going on.”

The amount of banks claiming market disruption will have to be watched closely, and if the problem becomes too widespread, aircraft manufacturers might need to consider selling aircraft in different currencies (*see box, the 'Great dollar debate'*). But before it gets to that point, the bulk of the financing burden will fall on the world's export credit agencies. The European Export Credit Agencies (ECAs) – the UK Export Credit Guarantee Department (ECGD), France's Coface and Germany's Hermes – and the US Export Import Bank (Ex-Im) could be called on once again to

support the industry for the rest of the year, and the next two years, as lending continues to tighten.

ECAS TO THE RESCUE, AGAIN

At the height of the last downturn in 2009, Ex-Im Bank financed 143 Boeing aircraft with a value of \$8.6 billion while the European ECAs financed 168 Airbus aircraft valued at \$12 billion. Now, the export credit agencies would need to guarantee significantly more loans to fund the estimated 30% of deliveries that need it. The aircraft manufacturers have already stated they are committed to helping their customers find the finance they need, and it is hoped the aircraft lessors will take up the rest of the slack, while the banking sector restructures liabilities and frees up portfolio space by trimming assets. It sounds like a simple solution, but it is one that neglects a multitude of problems. The ECAs have the money to support their respective manufacturers but they don't lend money – they only guarantee debt arranged by banks. This could be a problem as banks go into survival mode and some lenders walk away from previously agreed export credit mandates.

One source says: "The European ECAs don't put dollars on the table, they can provide more guarantees but not if there are no dollars to fund those guarantees. It's a little different on the Ex-Im side because it is a bank; it can fund deals in dollars if it wants to in the event of a liquidity crisis, which might give Boeing a slight advantage in this coming crisis."

But deals will get done. "We recognise the concerns, and understand that some banks will have limited appetite to fund transactions themselves if they are in US dollars," says Gordon Welsh, head of aerospace at ECGD. "Banks that have traditionally arranged ECA transactions also have excellent relationships with their banking colleagues, and will no doubt be organising syndicates of funding banks in support of their mandates. There are other banks, which have not been so active in the ECA space over the past few years, that might well return to the market. There is evidence of this happening. There are active dollar-based institutions that have seemingly increased their appetite for ECA. So we can point to a changing market presence

for some but not all, and transactions continue to be closed on time."

The European ECAs might need to focus on working on more capital market ECA-guaranteed products. Although the ECGD has closed on ECA bonds, Coface has yet to and Hermes says it has no desire to. This might change should the banks' access to dollars dry up further. "ECGD has a bond scheme and we have been willing to do more of these sorts of transaction," says Welsh. "We have recently renewed our policy and have explained to as many people as possible that we are ready to provide this sort of instrument in support of the Airbus and Rolls-Royce product range. We have taken steps to look at other capital markets-based products in conjunction with the banking community and airlines, and will consider these variations on the original bond approach as proposals are made to us. This includes Islamic

"In 2008, a lot of banks renegotiated their deals and most clients understood that conditions had changed, they were unexpected but they had to live with them. Those that don't accept this are not being realistic, and are not really clients most banks want to work with."

solutions as well as US- and Europe-based capital markets investments. It is important that we approach this difficult time with an open mind towards what is being proposed by the market that solves the market's problems. We wish to work with the market and find the right solutions for our customers."

Export credit financing in whatever guise will help to support the industry, and will remain an attractive funding source for those that can access it, at least until the new Aircraft Sector Understanding (ASU) agreement comes into force in 2013. When it does, the pricing and fees of export credit transactions will increase considerably (although the impact of this will not be truly felt until the grandfathering and great-grandfathering provisions run out).

DVB's Grabowski warns the effects

of the new ASU will be felt during 2013, when demand for aircraft financing will be at its highest. "2012 and 2013 are going to be the worst for aircraft finance," he says. "We are facing the risk of a double-dip recession in terms of the macro-economy, and correlation of the airline business and GDP growth is obvious. There are massive deliveries and a lot of money is needed. ECAs are going to provide a lot of financing, but the new ASU pricing will double or more, and the differential between commercial and ECA pricing will not be that significant. The current crisis will have severe, long-term implications because we are moving to Basel III, which means lending long-term money is going to be more costly. Borrowing money for financing long-term assets is going to cost much more, and I don't see pricing going south."

2013 was touted as the year when airlines would see pricing rise – due to the new ASU but also because the Basel III capital and liquidity requirements would start to affect bank lending. But one banking source says the fallout from Basel III is already being felt. "People have been wrongly assuming 2013 would be the year in which the aircraft finance market would hand some of its volume to the capital markets, because that is when Basel III really begins to take hold," he says. "However, most banks have been building in a premium for any current commitments in anticipation of the higher capital requirements under Basel III, leading to a pricing creep. As banks move away from mandates and don't make any new commitments, they also appear to be restating their entire pricing."

Over the past 18 months, pricing has been coming down consistently, and secured deals were being made at Libor +400 basis points, L+350bps, L+315bps. A few secured deals funded by Chinese banks came close to Libor +200bps. However, pricing is now moving in the other direction. New commitments today start at the L+400bps mark. This is the pricing level seen back in early 2010, and is due to fewer banks being active in the market. Banks are pricing in a premium for Basel III, and the competitive environment has suddenly changed.

Such an environment makes the capital markets seem more attractive and, in a high-pricing environment, more cost-effective.

“CAPITAL MARKETS WON’T SAVE THE WORLD”

Capital market products, in particular enhanced equipment trust certificates (EETCs), have been used extensively by US airlines for the past decade or more, but the constraints placed upon the asset makes them unpopular for aircraft lessors. In an attempt to retain maximum flexibility of their metal assets, aircraft lessors have been issuing a lot more unsecured debt in the capital markets. Aviation Capital Group in particular has diversified so far that it has recently secured a tactically priced Singapore bond that can be drawn on in many currencies. This demonstrates the innovative ways in which aircraft lessors are approaching their own financing needs, ensuring they are able to fund airline deliveries in sale-leaseback transactions, which are expected to shoot up in volume over the next two years as the economic crisis plays out.

Capital markets will increase in importance for airlines in the next year and beyond. Emirates’ Jeffery says: “We have been to the capital markets in the past and I think we will have to use them in the future, given the amount of aircraft we have delivering. But it is a matter of timing for us, and finding an acceptable structure.”

“The only capital market product we could use currently for aircraft financing is an EETC,” he adds. “We could issue a bond, but they are generally unsecured and non-amortising, which we don’t want, and a 10- or 12-year bond would be more expensive than traditional aircraft financing, provided the latter is available. But the EETC structure is unproven outside of the US, apart from Air France [Air France’s FRANs issued in 2003] and Iberia [issued in 1999 to a mixed reaction] and typically it would bring along unwanted baggage. Everyone is aware of our reluctance to have a disclosed credit rating.”

US carriers have been prolific issuers of EETCs, and it works well for them. The latest deal to close was for American Airlines at the end of September. Deutsche Bank and Goldman Sachs led the \$726 million deal, which was a standard EETC secured by a pool of 43 Boeing aircraft with an average age of 10 years. There was concern at the time whether the deal



BRIAN JEFFERY, EMIRATES

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would get done, as the debt markets had been under pressure, the high-yield market had shut down, and American Airlines had a weak underlying credit rating (American’s parent company AMR Corp is rated B- by Standard & Poor’s, Caa1 by Moody’s and CCC by Fitch). However, the Class A bonds were rated AA- by S&P because of the CDS product protection. The concern was that there was significant bankruptcy risk priced into the CDS for American Airlines. But when it went to market, there was a \$2.4 billion order book for the deal. Financing old aircraft over 10 years for a client that is facing bankruptcy within a pressured debt market was a big challenge, but the deal was oversubscribed and included some top-tier institutional investor names.

The interest in the deal shows there is a dearth of supply to the debt capital markets and hunger for aircraft assets. “There are only four airlines that are active in this market – American Airlines, Delta, US Airways and United Continental,” says one banker. “The only lessors to issue

unsecured debt are ILFC, AWAS, Aircastle and ACG. There is a desperate need for new aviation issuers into the market. If you are an institutional investor running an aviation portfolio, you need to have a diversity of issuers. If a non-US airline were to come to the market, it would find a very strong reception.”

He adds: “There is broad support for the sector and a belief that aircraft assets perform well in a downturn. The performance of secured deals though the last cycle has been fantastic. In a world where people are searching for yield, when interest rates are a zero, if you can get a single-A or triple-B rated piece of paper that yields 600bps over US Treasuries, then that’s as good as it gets.”

EETC structures are mostly suited to pools of older aircraft, and new aircraft should find an eager reception from investors in this market. But not everyone is convinced. “Capital markets are not going to save the world [for new aircraft] this year, as they are too unpredictable,” says DVB’s Grabowski.

The US banking source disagrees. “If a non-US airline issued into the US capital markets, it would ideally be better rated than the US airlines because the competitive environment in the US is so much stronger than abroad. And non-US aircraft fleets tend to be younger, which is more attractive collateral,” he says. “All of that, coupled with the benefit of being a new aviation issuer, means a non-US airline EETC would find a strong response in the US. And it would probably price much better than American Airlines right now. If you look at more stable credits like Delta and United Airlines, who are single-B rated and have a strong cash position, they are more like a BB credit and would price 300-400bps tighter than American.”

Capital market products are known to be more expensive than more traditional aircraft financing, but as bank debt dries up and pricing heads north, they could prove more cost-effective. How expensive capital market products are depends on what the issuers’ options are. “American Airlines had tapped all other avenues for financing – it had an \$800 million maturity on the market, it did not have access to the bank market, and it had done a large sale-leaseback with GECAS a couple of years ago,” says one

banker. The airline has closed three capital markets deals – one in June 2009, one in January this year and one in September. They were more or less the same structure with 10-year old aircraft. The June 2009 issue priced with a coupon 10.375%; the January issue priced with a 5.25% coupon; and the latest deal with a coupon of 8.625%. “This demonstrates just how much volatility there is in the market for this specific issuer, especially since its CDS spread has gone through the roof in the past four months. This is how the capital markets work.”

The capital markets are an efficient market in terms of pricing risk, and for good credits, which are aligned with a high-quality airline peer group, certain airlines issuing EETCs will not have the issue of pricing out in the bottom of the range. But it does happen. “In mid-2009, a US carrier closed a spare parts financing at 17% yield,” says the banker. “There is not a person in the world who thinks that was a good deal. But that is an extreme example.”

He concedes: “If there is an alternative form of funding that is freely available, you probably don’t want to go through the process of getting rated, increasing disclosure and accepting the wider pricing. That is what you need to do to issue capital market products, so you probably wouldn’t want to access this source of funding. But with airlines that have a massive order book, can they really rely on funding aircraft one at a time and hoping the bank market will be there to take the aircraft as they deliver? For example, Emirates did a sale-leaseback on a 777 that delivered mid-year, but at the time of delivery the funding for the lessor was not in place, so Emirates had to take delivery of the aircraft and do a sale-leaseback a few days later. And the latest bank walking away from a pre-agreed mandate is a wake-up call. The capital markets will be there, they might be more expensive on an interim basis, but they will be there. And you can do larger sizes, which is tough to do in the bank market.”

All the signs are pointing towards a non-US airline EETC closing next year. However, some still doubt the efficiency of such structures. “If you have a portfolio of used aircraft, you can do a capital markets transaction,” says Grabowski. “Because it is unconstrained, the execu-

tion risk is high and pricing is north of what commercial banks would do. But the market is unpredictable – when there is bad news, the investors disappear.”

Leasing heads for world domination

Aircraft lessors will come into increasing prominence as the economic situation worsens. They account for 35% of the world aircraft fleet today, and that percentage is already moving rapidly towards 40%. So lessors will be forced to support airlines much more than they do now. “With airline concerns not only on access to funding but also on flexibility of balance sheets and fleets, as well as the uncertainty of the impact on values in respect of technical advances, I believe that by 2025, leased aircraft will account for at least 50% of the world fleet,” says David Power, chief executive of Orix Aviation.

Operating leases are popular for airlines as they provide greater flexibility. Emirates’ Jeffery says: “For our aircraft deliveries from March 2012, the big operating lessors are showing a lot more interest in doing some aircraft with us. We have a general policy of having a long-term average of 50% of our fleet on operating lease, because of the flexibility and to offset the residual risk. We have so many aircraft coming that it is a simple matter of prudence not to take the full residual risk on brand new aircraft types, however much confidence we have in their future values (which we do, of course).”

Aircraft lessors are already ramping up activity, with existing lessors bolstering their asset books and new lessors being created. But they access to financing too, to fund their bumper aircraft order books. Here, lessors have an advantage over airlines. They tend to be more stable businesses and so are better rated, meaning they have access to capital markets and other more diversified forms of funding. Orix Aviation’s Power is well aware of the coming storm, and has prepared appropriately. “Generally, our expectation is that US banks with access to US dollars and other non-European banks will strengthen their market position, as sources of funding from many of the traditional European banks will (temporarily) dry up in the wake of the eurozone crisis,” he says. “Also set to come to the fore will be the use of capital market

structures as alternative funding sources. I believe capital market structures will play a much more significant role than they have done in the past, and undoubtedly some of these structures appear quite robust. However, these structures do cause concern when considering the absolute necessity for operating flexibility for the lessor.”

SkyWorks’ Gaal says the lessor market is ready to play a role in bridging the funding gap. “Right now there is a lot of money that has been funded into the leasing sector that is ready to take on significant quantities of aircraft,” he says. “Leasing companies are also actively seeking to get rated and to fund partially unsecured, which is another outlet for the potential banking issue. Leasing companies such as ACG and BOCA among others are also becoming increasingly active in diversifying their funding sources from a regional perspective. For instance, BOCA stated at a recent leasing industry conference that most of its bank funding for the year would come out of Asia.”

Asian banks might be poised to take a more active role in aircraft financing, but doubts are starting to creep in as to what extent this will help alleviate the current situation.

“There has been a lot of talk for many years now about the Chinese banks coming into the market in size and providing lots of large, long-term funding, but that hasn’t happened,” says one US banker. “While they might have cheap dollars, they don’t have the sophistication in aviation knowledge needed to become a really active player. When Asian banks do take part in a transaction, for the most part they don’t have the ability to put in a sizeable amount. And when they do a

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The great dollar debate



If the banking crisis becomes too widespread, aircraft manufacturers might need to consider selling aircraft in different currencies. This is not a new idea, and one the aircraft manufacturers, specifically Airbus, which is priced in euros, could be open to. However, Boeing has categorically quashed rumours it has already sold some aircraft in other currencies and says selling aircraft in any other currencies simply won't work.

"I can unequivocally say Boeing has

never priced deals in any other currency but US dollars," says Kostya Zolotusky, managing director of Boeing Capital. "I can understand why the issue has emerged again given the pressures on European banks. Their US dollar funding costs have gone up significantly and their existing dollar portfolios are a valuable source of liquidity to raise capital and reduce the size of the balance sheet. This is not a surprising debate and it consistently surfaces during times of distress. Pricing aircraft in any

currency other than US Dollars is not realistic, because the entire global fleet is dollar-denominated. Financing dollar reference assets in other currencies would add currency mismatch risk to those transactions. The primary value of an aircraft, as an asset, is its relatively stable long-term profile of values – aircraft residual values have a relatively predictable curve, with a modest variation. If a foreign exchange variance is added to that model, you greatly compromise the value and stability

bilateral, it is a lengthy and cumbersome process. If you need funding immediately, it is not the market you can rely on."

Grabowski goes one step further: "The Chinese banks' involvement in aviation finance has a much larger interest, which is dictated by the Chinese public authority," he says. "What matters for them is controlling money supply and inflation. Of course, they will supply their own airlines, but their investment in aviation assets outside of China is subject to how much liquidity is left once 'China Inc' is served."

Japan is a different story. Japanese banks have the core intellectual infrastructure to participate in aircraft financing, and they have been major players in the past. Japanese banks are saying they are being pressured to put money to work overseas more so than at

any other time in the past 20 years.

"Japan is an interesting case because Japanese institutions have suffered a lot for the past two decades," says Grabowski. "As they were in a frugal mood, they haven't bought many of the toxic assets the rest of the world did. The yen to the dollar is at the top, and banks in Japan are realising they can buy cheap assets. I see more Japanese institutions taking strategic positions in the aircraft finance market. That said, the Japanese operating lease (JOL) and JOL Co markets are still slow. There are few investors out there, but nothing on the scale it was four or five years ago."

TAPPING THE RETAIL MARKETS

In recent years the retail markets have opened up to aircraft financing, and

although small, are a growing source of funding for airlines. But they're only an option for good credits, recognisable brands and iconic aircraft, specifically the A380.

Emirates has been a prolific user of KG funds and the UK Doric Nimrod Air One and Two equity structures. The KG-fund is a special corporate form of partnership, where the investors are shareholders of the funds. "The KG funds have been good products for us," says Jeffery. "In addition to providing another source of funding, it is one of the very few options we have currently to finance A380s on operating lease. Long may it continue. The UK structure is an interesting and welcome extension of that."

Jürgen Salamon, managing partner

of an aircraft as an investment.”

The main problem of introducing a new currency into the aircraft trading and finance market is that it introduces a new element of currency risk. Christian McCormick at Natixis Transport Finance explained the problem at ISTAT Europe in September. “The problem that we see with euro financing is that as long as the future value of the aircraft is pegged to the dollar there is going to be a swap risk. When we analysed transactions on used aircraft over time we found you end up with a 50% LTV ratio, the loan becomes based on the quality of the metal, not the quality of the corporate. The quality of the metal is usually good, provided the currency of the metal matches the currency of the loan. If the currency changes too much, we introduce a new level of risk between what the euro would have been worth five years ago compared with today. There are ways around that, there are cross-currency swaps that can be put in place, and I suspect we will see an awful lot of transactions being made in euros by the European banks, with cross-currency swaps into dollars. The problem is there is a limited market for that because you have to find counterparties for these swaps, and even if you can find them – and I doubt you could find enough to cover the entire industry – eventually banks would be taking too concentrated, heavy counterparty risks

on the euro-US dollar basis. This is only expected to be a temporary measure. The real question is whether we can find a way to peg the future value of these aircraft so that they are in euros and instead of dollars... We haven’t yet found a way to do that. How do you convince the world to look at an aircraft now in euros five or ten years down the road?”

Also, the advent of Basel III means there is pressure to use currency swaps when they are not needed.

“The idea of paying for aircraft in euros is being floated by some banks because they have difficulties in funding in US dollars,” says DVB Bank’s Bertrand Grabowski. “I doubt this is a practical solution for the industry. For Lufthansa, Air France or Iberia, however, who are planning to keep the aircraft on their balance sheet for its entire useful life, it makes sense to borrow in euros. For airlines outside of Europe or aircraft lessors, they have no choice but to pay in dollars. The aircraft is valued in dollars, purchased in dollars, sold in dollars, lessors trade in dollars. So paying in euros doesn’t make any sense. To think there will be a major shift is a dream.”

Depending on how the economic situation plays out, the market might well see a lot more euro-denominated aircraft financings, but they will have expensive cross-currency swaps attached.

of Dr Peters Group, which now closing a KG fund financing an A380 for Air France, says: “We are in a difficult environment and there is a lot of risk in the market. We don’t want to end up with a lot of aircraft on our books that we can’t place, so we are very careful when we decide on a new product. With a product like the A380 leased to Air France, we are comfortable there is still a very good appetite on the investor side.”

Most KG funds are adjusted to the specific transaction but they are generally fairly standard. It is usually one fund per asset, although DNA2 includes two A380s and Dr Peters has one fund that contains two aircraft. Salamon says it is the low leverage of Dr Peters’ funds that puts it at an advantage with the banks right now. “We put about 40% of equity

into the transaction as the banks’ willingness to have a long-term investment is limited right now. Having such a lot of equity keeps the loan-to-value low and allows us to continue to find financing capacity in the bank market today.”

Salamon is quick to point out that so far the firm hasn’t had any problems securing long-term bank financing for its products, but even so Dr Peters is looking to have a lot of banking relationships in different markets to ensure future access to funding.

Although they have been successful for recognisable airlines such as Emirates, Air France and Singapore Airlines, these funds are unlikely to become a source of funding for all airlines. Salamon explains: “On an A380 fund we have between 3,000–4,000 investors. It

“We still see a lot of A380 deliveries being financed through the ECAs and it is difficult to better that pricing. But with the banking market getting much more difficult, airlines and lessors will need to diversify their sources of funding.”

is a huge number and we have an average investment size of €25,000, so the investors are unsophisticated retail investors and we do not communicate directly with them in the sales process.”

For retail investors, KG funds provide stable, constant annual returns of about 7.5% over the term of the transaction. Following the subprime crisis, investors are wary about buying paper, and aircraft are attractive as tangible assets. Financing the iconic A380 is also appealing to investors.

“We still see a lot of A380 deliveries being financed through the ECAs and it is difficult to better that pricing,” says Salamon. “But with the banking market getting much more difficult, airlines and lessors will need to diversify their sources of funding. KG financing will be available, although only on a small scale. The volume of all the KG markets is limited, but it will play more of an important role when it comes to wide-body aircraft.”

It is not just Germany and the UK that are ripe for investment products such as this. Mark Lapidus, managing director of Doric Asset Finance, says it is working on new jurisdictions, where there are the pools of investors interested in investing in products like these. He says pension funds in continental Europe tend to invest habitually and it is hard work to get them to look at new things, but Doric is trying. Germany, France and Holland are all possible targets with pools of such investors. The US is the largest market, but the problems there are different – large pension funds invest considerably into private equity deals, and it is difficult to convey to them where these sorts of structures fit. Japan too, is a large potential market.