Philip Tozer-Pennington **looks at aviation financing thus far during 2009.**

FINANCING IN A HARD MARKET

Summing up the past 18 months in the banking sector!

THERE IS NO SIMPLE LIST OF BANKS CURRENTLY CONDUCTING BUSINESS that can be drafted and shown today; if we were to do this then we would not give a true picture of the current market at all. Instead we should ask which independent banks are the most active in the market at this time?

DVB, as one example, has closed $600m of deals over the past four months for airlines as diverse as American, Philippine, and Korean. DVB also has a further $600m of transactions currently in the pipeline. Many other banks such as Calyon, Standard Chartered and BNP say that they have deals in the pipeline, but you need to look through any deals that are posted in this market with care and ask – are these deal amounts actual dollars at risk?

I have singled out DVB because its deals show real dollars at risk. They are not ECA-backed like many of the other deals that are being flagged-up from banks where the residual risk is well under the posted amount. So when asking which banks are in the market doing business you first need to consider what you mean by doing business, but it is clear that all banks have gone – or are going – back to basics in their approach.

How has the credit crunch affected the availability of aviation finance?

There are two main impacts of the credit crunch on aviation finance: it has caused a de-leveraging race amongst the financial institutions. Even if you do not discriminate against aviation finance versus any other class of business, the banks are required by the regulators and compelled by the deterioration of their capital structure to reduce their assets – this is of course de-leveraging.

More specific to aviation finance though is the fact that it is still not seen as being a strategic activity within many banks. Therefore, when they are pushed to de-leverage and when they have to make some choices they will most likely choose to support their regular domestic strategic customers as opposed to something that can be seen as a little bit more exotic or even dangerous, such as aircraft finance.

So there are a number of institutions around the globe, where aviation finance was not at the top of the list, that have pulled out of the aviation market as one of their first strategic moves after the collapse of Lehman Brothers in September 2008.

There is now another factor: a mostly untold story, mainly with Europe, where governments are taking strategic stakes in the capital structure of banks. They are then asking those institutions to support/put their country before going abroad for exotic transactions.

So what does this mean?

Strictly speaking, for French, German, Dutch and UK banks, it means that they are not permitted to finance a Boeing aircraft for an Asian carrier. The expectation is that a European bank will support Airbus first and second their own country.

The overall tightening of the credit markets has reduced aircraft financing liquidity and increased risk spreads. However, with significant reductions in LIBOR, all in all funding costs are still at very attractive terms. In line with general global de-leveraging, advance rates on aircraft deals have been reduced by five to ten per cent.

Pre-delivery financing has returned to a much more limited availability than we have seen in the pre 2004-2007, high liquidity, era. Overall, while there is less aircraft finance liquidity and the risk premiums are higher, the aircraft portfolios have continued to perform, especially when compared to most other asset classes. Another indicator is that Calyon has seen a surge in customers approaching it, even though it is well known that this bank is far from being the cheapest option on the market. Customers have realised that the "shopping around" option has disappeared for the moment and currently you have to take what you can get.

From 30 banks operating in the sector during the first quarter of 2008, we are now down to about 11 banks actually doing deals with three additional banks ready to move back into the sector, we are told. Of this number, five (in all) banks would fall into the category of known aviation finance house.

Are finance terms and conditions becoming more rigorous and therefore excluding certain airline operators, when this would not have done previously?

Increasingly, there is now a move towards quality and banks want to see this with a good mix of credit/asset with a conservative structure. This does mean that second tier and classic aircraft are no longer attractive.

We are in a world with tighter aircraft finance liquidity - we are therefore in the lender market. This means lenders can be very selective in what aircraft and what credits they will fund. Since the majority of current deliveries are 737 NG / A320 family and 777 aircraft (on the larger side) their customers are clearly in a more advantageous position because these aircraft families are asset gold standards in their respective classes.

As for financier's focusing on stronger credits, this clearly is expanding the need for Export Credit for the remaining carriers. With some 80 per cent of Boeing backlog eligible for ExIM, this creates an important safety valve for airlines who have difficulty attracting the limited commercial financing currently on offer.

There is no doubt that airlines with a C-credit type situation are finding it near-on impossible to find finance. The current prevailing banking policy excludes many airlines, operators and lessors, along with some of the aircraft which are not new, classics are virtually a no go area for all at this time. So many airlines, lessors and classes of asset are on the black list where they would not have been pre-2008.

However, some very good assets are coming onto the market that are priced very attractively, but they are still not able to find financing. There is particular stress in the market at this time for those seeking to refinance 747-400s. The market is very rigorous at the moment in terms of leverage, repayment, asset, and price. Most, if not all, banks are not interested in classics and do not think that anyone in their right mind will finance classics at this time.

That being said, one bank (DVB) financed a deal just last month for four 737-400s at a very good price. On the engine side we are looking at the value in just the same manner, what are the engines, where will they be used and what the outlook is for a particular type. Banks are able to cherry-pick deals at will and this will not change in the foreseeable future. It is not because the banks want to be awkward but because the volatility of aircraft values means that banks must ask for more equity and most of the airlines and lessors understand this.

Does this mean that such airlines will have to seek other funding, or will they have to resort to leasing as the only means available?

In normal circumstances the lessor would play the role of lender of last resort for those too weak to be able to attract financing, but the credit crunch has affected lessors just the same as everyone else. So in this market an airline that cannot find financing on a given aircraft is very unlikely, in most circumstances, to obtain finance through a lessor on sale and lease. Export credit and sale and lease back options are still available we must remember. Leasing will continue to play an important role, but Export Credit will become/is the market maker.

How will OEM-backed finance institutions satisfy the ongoing debt requirement?

The manufacturers are working very hard on this at the moment. There is no doubt that seven or so months ago both Airbus and Boeing were still in a state of denial. Banks were talking to the two big manufacturers about credit crunch and funding gap worries etc, but the manufacturers did not seem to see the problem, or at least if they did, then they were not willing to talk about it to the banks.

Since the turn of the year, however, both Airbus and Boeing have been working very hard indeed with banks and clients to work on solutions wherever possible. The OEMs suffer a general limitation which is something familiar to Boeing, but not so much to Airbus; this is the sole recognition problem, which is pure accounting. For example, on the sales recognition side, if you put a significant amount of money aside to finance your own client to buy your own aircraft it might be that you cannot recognise the sale. This in turn has a detrimental impact on all the ratios of the manufacturer such as revenue and turnover etc, for that reason the contribution by Boeing and Airbus to the finance of their clients will have to be limited; there is no question of this.

So what can the OEMs do?

OEMs are trying to team-up with banks and propose some kind of structure where they absorb the junior trench with the banks doing the senior. This is generally seen as the best way to go in a bad market at this time, it is a win-win situation because from a senior leverage perspective it is probably a very good deal, and it is fair to say that the presence of Boeing or Airbus as the junior in any kind of financing is giving an extra layer of protection besides the number of dollars which are ahead of you as senior lender.

So to make a long story short there is limitation because there is an accounting rule which prevents them from pouring large amounts of cash into their clients. The big manufacturers all understand this as do the banks. So the OEMs have moved from denial to a partnership with the banks that in effect means we shall see junior/senior arrangements as being the way forward in this market.

Boeing Capital and its counterparts here within the EU are confident that they will be able to satisfy the debt requirement during 2009 and into 2010. While the manufacturers anticipate having to directly fund a number of aircraft in 2009 (having not funded any in the last several years), they believe the overall volume requirement will be less than what we saw post 9/11. Boeing

Capital, for example, were financing about $3bn per year for three years post 9/11 and at that time they did not have the depth of infrastructure, or indeed the balance sheet, that they have today, moreover they were financing aircraft such as the 757 and the 767 which are coming towards the end of the lifecycle.

Now, as mentioned before, Boeing Capital find that they are financing 737NGs and 777s – Gold standard aircraft. Even then Boeing Capital state clearly that the level of funding required from them is nowhere near what was required post 9/11. So Boeing is upbeat.

How will export credit agencies react?

These agencies need to double their support from 2008 levels. They are open to capital market funding. All the major ECAs have said that they are prepared to nearly double their support levels relative to 2008.

In the end the export credit agencies have been given the task of supporting the sale of their national manufacturers and in normal circumstances they contribute five six or seven billion per year but, talking with Bob Morin and hearing what his European counterparts have to say it is clear that we could be above the ten billion dollar mark this year for each of the export credit agencies. That is above ten billion for each, which is a significant move.

The challenge for these agencies is great, not due to the amounts of money that we are talking about, but because the different authorities are pouring billions upon billions into the system. But it is a challenge for these agencies on the actual execution because these teams are small and they need to apply for the normal due diligence, credit analysis, etc. So is it a realistic target for these agencies to move from six or seven billion dollars of funding to ten billion? Or even twelve? In terms of work force and resources I think it is a very big challenge for them.

Will there be a reduction in new aircraft deliveries as a result of a shortage of credit?

These are difficult markets, of that there can be no doubt. We know that aircraft demand is correlated against global economic conditions as global GDP has contracted, so aircraft demand has fallen in line.

This said the first half of 2008 saw amazing performance by the aviation industry, the global economy was falling, oil was at $147 a barrel and yet aircraft were still being ordered at record levels – so what does this mean for the industry going forward? We are yet to find out, but it is generally agreed by many of the banks that 2010, not 2009, will be the year when the manufacturers' orders books come under serious stress. Therefore 2010 is the year seen as being the worst for cancellations. Many operators are going to simply say "sorry but I cannot take delivery of this aircraft".

For many it will not be a question of "I can try to defer for one year, two years or three years", or simply "I can try to restructure the agreement". There will be no options for many. We already have one case as an example – that of Lauda Air where they simply said "here is my deposit, I do not care that it is lost, I simply cannot take delivery of this aircraft". We will see more of this!

So the answer is yes, some orders will continue to disappear due to lack of funding which in turn will reduce the financing requests coming in for orders. The cycle has a way to run yet. Boeing Capital, for its part, does not believe capital availability will be the determining factor of their production rates. Traffic and market demand will be the driving force in shaping the delivery skyline. Boeing Captial has chosen to try and keep out of the funding gap debate, instead they have tried to understand for themselves if there is a risk of significant capital requirement that is not being addressed, and their conclusion is that they do not see that being the case today. They are, however, carrying out a top down and bottom up analysis of each aircraft that is on order. The company maintains that availability of financing will not drive aircraft delivery rates. Boeing Capital's European counterparts declined to comment on this.

So are there any additional problems on the horizon that we need to consider when talking about airlines seeking finance?

It is becoming clear that the European Union Emissions Trading Scheme will affect the very core building blocks of aviation finance:

1. **Airline Business models**
2. **Aircraft values**

These will undoubtedly be affected by any "green regulation". The aviation working group has handed the EU a critique of the ETS and its shortcomings. The regional solution that is the ETS will affect all airlines but it is the EU fleet lean issue which causes the most concern.

A simple summary of fleet lean can be thus: if an airline leases and operates an aircraft and then gets into debt and goes bust then any aircraft operated (not owned, by that airline can be seized. Then any costs owed to Eurocontrol or an airport operator can be set against seized aircraft.

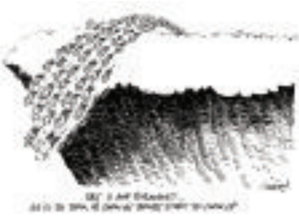
But the most dramatic part of this legislation is hidden in the detail, as always: if an airline goes bust with debts and other banks and lessors manage to take back possession of their assets by getting their aircraft out, but you do not, then all debts of the airline will be set against your aircraft, effectively wiping out the value of the asset. This process obviously has the same overall impact on the engine lessor as it does with the owner of any asset. The overall effect of this legislation will be that only airlines with strong balance sheets, liquidity and good business plans will be able to obtain finance.

But more importantly, this means that lessors will have to take a second look at all assets currently out on lease, and ask 'is the operator and therefore the asset, secure?' Future lease agreements will have to be far more stringent and sale and leaseback may not be a viable option any longer, as this is usually a last resort liquidity boost for an operator.

Investors and asset owners beware – the EU will become a very high risk zone, with some banks likening risk factors to many African countries. Investors in aviation are lobbying the EU for a u-turn on this legislation, or at the very least transparency from Eurocontrol and the like so that investors will be able to see which operators are behind on their payments. As it is, the fleet lean legislation is one of the most barbaric legal implementation issues ever for the aviation industry. The bottom line: airlines within the EU will be a higher risk and therefore financing will be more expensive or non existent for some airlines.

Finally: The message from the banks that have pulled back from the aviation sector?

"We will be back......................"



"Or will they?"

We hope that you enjoy the ***2009/2010 Guide to Financing & Investing in Aircraft & Engines*** and wish you all the very best for the months ahead.