Pleasure Principle vs Reality Principle

DVB was established in 1923 as the Transportation Finance Unit of the German Railways. This was the start of a fascinating story which leads us to where we are today, a Hybrid Institution, lending and investing in the Aviation Industry. DVB has survived a few ups and downs, maintained and even expanded its presence through the bad times, and today still delivers to our clients the right cocktail of Capital and Services that they need at any point of the cycle. But that same year, in 1923, an interesting man named Sigmund Freud published 'The Ego and the Id' which for the first time provided for the basis of most of today's digression on the unconscious. One of the fundamentals of his theory was to explain that an individual can only grow if he/she achieves the right balance and control between the Pleasure Principle - defined as the desire for immediate gratification versus the deferral of that gratification - and the Reality Principle. If he/she does not, them he/she will simply collapse in various forms of disruptive behaviour.

Applying the theory to today's situation, it is obvious that the Airfinance market is not driven by the Principle of Reality but by the Principle of Pleasure. Francis Fukuyama was telling us shortly after the fall of the Berlin Wall that History had come to an End, and I see with pain and sorrow the same (wrong) posture infesting our Airfinance Market. "Apparently" we have moved to a 'different world' and some highly regarded professionals are telling us that the cyclicality of the Industry has disappeared, or that we are moving to a 'super' cycle (Not too sure what Super Cycle means but this is probably to the 'Cycle' what Superman is to the Man .... ?). This theory is built on evidence that we are all too pleased to accept and share in the Industry today : long overdue deregulation in the EU market that has finally created more profitable legacy carriers and has eliminated the others, the emergence of a new business model with the Low Cost Carriers, the opening of new frontiers and momentum in India and China, and as a cherry on the cake, even US carriers seem to be moving away from their Chapter 11 nests where they had continued to operate for too long at the expense of others. Even those who predicted turbulence following the devastating hikes in fuel price must confess that in essence, the industry has done a remarkable job in weathering this challenge through hedging and surcharges (And maybe benefiting from a capacity shortage, resulting from lack of post 9/11 ordering). In this environment and after the post 9/11 trauma, no one should be blamed for taking pleasure in this good news.

It goes even beyond the next few years: for the macro long term picture, the whole community of economists is telling us only good things about the Air Transportation Industry in the next 25 years, except for external shocks. On that point, we even see Airbus and Boeing in close - but still platonic - brotherhood.

As a result, money is flocking to Aircraft and Airlines. At the last Boeing Annual financier's presentation in London, 72% of the audience voted for an increase of exposure to the Industry. Those investors who bought A320s two years ago could have sold last year with a solid profit, and those who bought the same aircraft last year can still find another incoming Investor to give them a bonus for their smart move 12 months ago. Same goes for A330s, 737NG and many others and can even be extended to slots of the 787 that has not yet flown.

On the Lending side, Basel II is helping Banks to limit Capital consumption on all 'secured financing' creating a perception that this type of Lending is safer. European banks have forgotten about the excess of the previous downturn and Asian based Institutions have not yet learnt it. Japanese banks, after years of penitence, want to grow again. Across the Banking Industry, the need to grow, either to provide for a nice IPO story or simply to eat your neighbour before he eats you has fuelled a tsunami of liquidity with margins going south in every compartment of Lending. In Asia, one heart of this growth engine, a new generation of Entrepreneurs has emerged, and memory of mistakes from the Asian Crisis, ten years ago, fades away.

By Bertrand Grabowski

For the Banks, the new paradigm has a sweet name: Asset Based Finance. It allows banks to explain the mistakes of the past and justify all the excesses today in terms of valuation. Appraisers are delivering a consistent message from the data they collect from the market, reflecting back to the market actors the value inflation that the same parties are fuelling.... And Banks competing for business are pushing the LTVs just a little higher next time around in a relaxed atmosphere where there seems no need to confront clients with improved maintenance reserves and return conditions. At DVB, as an Investor in Aircraft and Lender to the Industry, we believe playing the asset value requires a risk and business culture that takes a lot of time and effort to build. At DVB, we have a team of four 'metal' analysts that have built an in house rating model for every single 'western' aircraft in operation. Every quarter the team reviews current values and future values. Earlier this year, we created a Lease Management and Remarketing Team. This just enhances our first hand data collection and analysis.

This is why DVB is unlikely to buy new A320 or B737-800s at current 'market' prices, not because we don't like the aircraft but rather because we are not aware of any viable airline business model which will allow the Lessor/Investor a decent return of capital at such inflated price levels. Of course, we are also able to take 'short' term views and also play on the wave of incoming liquidity, but never at the expense of fundamentals and we believe at current trading levels, for many of the most popular aircraft, Pleasure Principle seems to govern our world.

Whether or not the current inflation of asset values is fuelled by positive fundamentals, the temporary need for interim lift, or rather the result of massive liquidity is not a relevant question. We know that 25 years from now, there will be more aircraft flying more people, and we know roughly by how much, this is hardly news. The question is how we go from here to there. If a Lender or an Investor is prepared to take a 25-year view on the market, or even a 10-year view, and build the infrastructure that goes with it, then money will be made, but the liquidity I see today in this market is, for the most part, less experienced, uncritical, and driven by short term volume pressure and short term goals.

The CFO of a very large Airline in Asia was telling me one day how much he 'dislikes' us, Bankers and Investors, who were flushing liquidity to one of his competitors, admittedly a loss making airline with weak management and a truly deficient business model. All of which was being done on the grounds of an 'Asset Based' approach. 'Those guys should have died ages ago' he said, complaining about the indecent level of lending proposed by some and skyrocketing offers on Sale-and-Lease-Back from others.

This gentleman was telling us a very important point: extra liquidity does not rescue an airline from failing; it just delays it and makes the consequences more damaging.

The current significant book order may sound 'reasonable' in regards of the percentage of the total fleet operated today. But the financing needs are enormous for an Industry that has been, for the last 25 years, destroying capital. When Lenders and Investors realize this, then Reality Principle will prevail, and will trigger a brutal withdrawal of liquidity that would be extremely disruptive on Aircraft Values.

When will that come? Well, industry panels in Geneva and London think we are still good for another couple of years. But even for this short term horizon, I would remain cautious.

Passenger Load Factors are at a record high, but we don't see across the industry a solid and sustainable improvement of yields. China has a tremendous growth potential, but like India, Airlines are still loosing money there. Fuel has not fully taken its toll and Hedges arranged two years ago will come to an end soon. Airlines in the Middle East increase their capacity by double digits every year but high fare passengers will have to be taken from legacy carriers all along the Kangaroo route which will pull yields further down. LCC's in Europe are doing great, but some are hardly making money while this summer may see extra pressure on yields. On top of this, we have little idea today how disruptive for the Industry the new environmental passion will be, that has inspired a growing flock of politicians.

Pessimistic? No, rather inspired by experience and Reality Principle. The Air finance and Leasing Industry is a fascinating Industry, pulsed with battles between giants, big egos and enormous money at stake. But for those who like to ride along, better fasten your seat belt.

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