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Jet Lessors, Hit by Credit Crunch, Head Toward Industry Consolidation

By DANIEL MICHAELS

CIT Aerospace, a profitable division of struggling [CIT Group Inc.](#), faces a problem plaguing much of the \$147 billion airplane-leasing industry: The business model that underpinned it and a handful of rival giants is broken.



Steve Udvar-Hazy

Their approach, built on short-term debt, was shattered by the financial crisis. Turmoil in credit markets has hamstrung most of the biggest lessors, including CIT, [American International Group Inc.](#)'s International Lease Finance Corp. and [Royal Bank of Scotland Group PLC](#)'s RBS Aviation Capital. They have dramatically slowed their plane orders, are using cash to pay down debt and face rising borrowing costs. It has also cast a shadow over the world's biggest plane lessor, [General Electric Co.](#)'s GE Capital Aviation Services, although Gecas says its credit crunch has passed.

Dozens of smaller players also face a reckoning because the liquid credit markets they long relied on have dried up. To adapt, they are tapping pricier sources of capital, such as bank loans. Problems are intensifying now, as a growing portion of the debt that lessors incurred before the financial crisis hit comes due and the airline industry faces its deepest losses in years.

Gainers in the current shake-up are likely to be smaller lessors with parents that remain healthy, industry officials say. They include Bank of China's BOC Aviation, Pacific LifeCorp Inc.'s Aviation Capital Group, and Pembroke Group, a unit of Britain's [Standard Chartered PLC](#), although analysts caution financial solidity remains far from certain for any firm these days.

"The aircraft-leasing business will go through a period of maturity, adjustment and consolidation," said ILFC Chairman and Chief Executive Steven Udvar-Hazy in an email. ILFC posted record revenue and profit through the year's first half, but AIG's efforts to sell it have stumbled recently in part because potential investors balked at assuming more than \$30 billion in debt ILFC carries, according to people familiar with the talks. Buyers of ILFC's bonds had long taken comfort in the strength of its corporate parent, but AIG last year fell into the government's hands as it faced possible bankruptcy.

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Like ILFC, the world's top lessors expanded over recent years thanks to big parents with strong credit ratings. Previously, airplane lessors had borrowed using their fleets as security, which limited growth. But linked to corporate titans, lessors could issue debt without collateral based on their parent companies' credit quality. The shift drew new capital into the aviation sector and allowed these players to balloon.

That ended when their parents' credit ratings crashed last year. CIT, for example, is now trying to avoid a bankruptcy filing brought on by its inability to access the credit markets when they seized up and its bonds were downgraded. CIT Aerospace, the No. 3 player after Gecas and ILFC, "continues to take deliveries and service its more than 100 customers around the world," a CIT spokesman said.

The giants' problems are now aggravated by a deliberate mismatch in debt duration that was profitable for many years. To cut costs, they bought planes using inexpensive short-term debt. Rates they charge on multiyear leases, meanwhile, are linked to long-term interest rates, which are generally higher than short-term rates. Lessors made profits on the difference in interest rates, or spread.

Last year's financial meltdown upended credit markets, meaning most lessors can't keep rolling over their mountains of short-term debt. While low interest rates help temporarily as lessors shift to pricier borrowing, their rates look set to rise, hurting margins. ILFC, for example, this year borrowed \$1.7 billion from AIG --

now 80% owned by the government -- according to regulatory filings. ILFC warned that if funding fails to materialize, it could be forced to sell planes. Amid the current airline slump, jetliner values have nose-dived.

"Many big leasing companies had a fundamentally unstable business model focused on spreads," says Stephen Hannahs, CEO of Aviation Capital Group. "They needed constantly to roll over liabilities, which worked well as long as nothing was wrong with the parent company," Mr. Hannahs said.

ACG, one of several second-tier lessors, matches the term of its debt and leases, company officials said, which slightly increases its cost of funding but limits credit risk. ACG's owner, Pacific LifeCorp, is privately held, which reduces pressure for constant growth, executives said.

The fallout from this financial shock is already affecting airlines, plane makers and investors, say aviation industry officials. Leasing companies are among the biggest customers of Boeing Co. and Airbus, a unit of European Aeronautic Defence & Space Co., and orders from them this year have plunged even faster than those from airlines.

Airlines, meanwhile, have become increasingly dependent on lessors for airplane rentals and financing to expand despite thin profits. Lessors order planes and then rent them out to airlines for several years at a stretch, meaning those carriers don't have to bear the expense of buying jetliners.

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