

## Capital Takes a Holiday

**The liquidity crisis is likely to have a major impact on the availability of aircraft financing in 2009, as will the looming recession.**

*By Perry Flint*

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HERE'S A FAMILIAR STORY LINE: The airline industry is bracing for what it expects will be a serious traffic downturn in 2009 as it prepares to accept a record number of new aircraft at the very point at which the global credit crisis means that capital to finance those aircraft is on indefinite holiday. To paraphrase Yogi Berra, "It's deja vu all over again."

But while the setting seems familiar, the roller coaster ride of oil prices and the unprecedented governmental intervention aimed at halting the avalanche of private sector financial failures have brought new twists to an old plot. There is, for example, uncertainty surrounding the fate of International Lease Finance Corp. and its fleet of more than 1,000 aircraft and firm backlog of 150 planes now that insolvent parent AIG has been forced to put ILFC on the market following AIG's rescue by the US government. The crisis is affecting even the strongest of companies: Uncle Sam had to purchase GE's commercial paper in late October because the Triple A-rated conglomerate and parent of GE Commercial Aviation Services could find no takers in the private sector.

"In my 35 years or so in business I've been through Nixon taking us off the gold standard, the hyper-inflation in the '70s, the 21% prime rate in the early '80s . . . the stock market crash in '87, [the collapse of] Long Term Credit and Capital, the Asian currency crisis, 9/11, and I don't think I've ever seen anything like this," Aviation Capital Group MD and CEO R. Stephen Hannahs tells ATW. ACG is a unit of US insurance giant Pacific LifeCorp.

Indeed the aircraft finance sector, which had enjoyed a resurgence since the 2001-04 downturn, now is facing what IATA DG and CEO Giovanni Bisignani might call "a perfect storm." Access to capital is severely constrained and there is a high level of uncertainty as to when bank vaults will reopen. Additionally, a number of banks that formerly financed aircraft have left the sector. Meanwhile, the likelihood is strong that asset values and lease rates will come under pressure as airlines downsize or go out of business. One analyst is modeling for a 25% drop in lease rates, with a quarter of leases going into default next year.

The first hurdle is unlocking the credit markets, a challenge not limited to aerospace financiers. "What we are seeing is basically a freezing of the banking market between now and the end of the year. It's nothing necessarily to do with the aviation industry; it's just a general issue with banks which are trying to hoard cash," says BOC Aviation MD and CEO Robert Martin. BOC is owned by Bank of China, which had a market capitalization of \$124 billion at the end of the third quarter, ranking it sixth in the world in that category.

Assessing the impact of the credit freeze on future aircraft financing is difficult because financing typically is arranged several months in advance, as AerCap Executive Director and CEO Klaus Heinemann notes. "At this moment most banks, [with] very few exceptions . . . at least until year end have their foot firmly on the brake. But the effect of that should not be seen too dramatically

because most responsible players in the market will have lined up funding for deliveries over the next three to nine months well before the credit crisis happened."

According to a recent report by J.P. Morgan, banks will provide around \$25 billion in financing and lessors about \$12 billion this year, representing about 60% of the 2008 market. The big question is what happens in 2009, when Airbus and Boeing are expected to deliver around \$65 billion worth of new aircraft. Should leasing companies and banks pull back from this year's level, say by 25%-50%, "it could create a \$10-\$20 billion funding gap," wrote J.P. Morgan analyst Joseph Nadol III. Availability of capital "could be an issue" starting in the 2009 first quarter and increasingly in the second quarter and beyond, the author stated.

Hannahs suggests that the funding gap could be even bigger between \$22 and \$29 billion. "There are a lot of deliveries out there that some folks are going to have some challenges with," he says. He and other lessors with whom ATW spoke say they have financed and placed all their 2009 deliveries. ACG expects to take advantage of the tough times to acquire additional aircraft for its portfolio.

### **Opening the Spigot**

"The first question is how long will the liquidity crisis continue for?" asks GECAS President Henry Hubschman. "Could it go on for a couple more months? Yeah, but I think that the actions that have been taken by European and US governments will start opening the spigot of liquidity."

Some traditional markets, however, are simply off limits for the foreseeable future, in particular those involving securitized debt, which has fallen out of favor since the subprime mortgage meltdown. "The EETC market [is] totally dysfunctional," says Chris Chaput, MD-structured finance with New York-based Seabury Group.

"There are really only three games in town," Martin argues. "The first one, which is mainly for non-US airlines, is export credit. The European ECAs and [US] Eximbank are inundated with proposals" for financing next year, he says, adding, "The price of those [deals] in a bad market makes it attractive relative to the alternatives."

Separately, J.P. Morgan estimates that US and European export credit agencies are providing \$11-\$12 billion in loan guarantees this year and suggests they could raise that figure by up to \$5 billion next year.

Martin continues: "The second sort of people who are involved in a market like this are people like ourselves the large lessors who still have access to money or who raised money last year. We raised \$1 billion because we thought there was a financial crisis coming. And then you have the third set of people who I would call the lenders of last resort meaning who are very reluctant to finance aircraft which are the manufacturers themselves." Airbus and Boeing played a crucial role following 9/11, with Airbus providing \$2 billion in financing between 2001 and 2004 while Boeing provided \$2-\$3 billion per year over that period, according to J.P. Morgan, which notes that both OEMs have been unwinding their positions over the past few years. Airbus Finance Co. has cleared its balance sheet of most of its post-9/11 financings, which peaked at \$4 billion in mid-2004 and stood at \$701.5 million at the end of the 2008 second quarter. Similarly, Boeing Capital Corp.'s asset financing portfolio declined from \$13 billion in 2003 to \$7 billion at year end 2007.

If ECAs and OEMs cannot fill the void created by any cutbacks in the banking and leasing sectors, and sovereign wealth funds such as those in the Gulf region decline to step up in sufficient strength, the choice facing manufacturers is to reduce production or accept that they will have some whitetails until markets return.

## **The Demand Side**

Availability of financing call it the supply side of the business is only part of the story, however. There is the demand side, where the outlook is uncertain as well. The wild upward spiral of fuel prices in the first half of 2008, coupled with the resulting slowdown in the economy, caused many carriers, particularly those in North America, to reduce capacity. These reductions, combined with airline failures, have resulted in a large number of aircraft leaving the skies.

Ascend recently calculated that by the end of next year a total of 1,083 additional aircraft will join the desert air force, which numbered 2,100 in late October. Most of these aircraft are older types that are unlikely to return to the skies in large quantities, such as the 737 Classics and MD-80s being parked by United Airlines and American Airlines respectively. Ascend data show that among aircraft currently in storage, 1,400 are more than 20 years old. However, a total of 320 built in 1998 or later were on the ground as of late October.

Although capacity reductions historically have enabled carriers to boost pricing power and better balance seat supply with demand, they usually have an inverse outcome for aircraft investors, since a surplus can reduce asset values and lease rates. Despite the dramatic fall in fuel prices since last summer that has brightened the outlook significantly for carriers, consumer spending is down and the expectation is that the looming recession could lead to more failures and more groundings, further weakening lease rentals.

The industry got an inkling of what 2009 may portend in the IATA September traffic figures showing that international passenger RPKs declined 2.9% compared to September 2007, the first monthly drop since the 2003 SARS crisis. In the heretofore fast-growing Asia/Pacific region, the decline was more severe, down 6.8%, and even Middle East airlines reported a 2.8% drop. That month also saw the failure of three more small airlines: Zoom, XL Airways and Futura International. Such events have thrown a modest but growing number of aircraft back into the market. More recently, the collapse of Sterling in late October means that new homes must be found for the 27 leased 737s that the Danish leisure airline operated.

Adding to the challenges, airframe OEMs may produce around 950-1,000 aircraft next year depending on how quickly Boeing is able to ramp up following the strike. "With capacity being taken out, market forces are coming more into play and if there's two aircraft available for every buyer it's only going to soften prices," says Ascend Director of Consultancy Eddy Pieniasek. The impact will be lessened if groundings mostly involve elderly jets, notes Hubschman. "The issue is how many retirements will there be of MD-80s, DC-9s, 727s, 737-200s, freighter DC-8s?"

In a Sept. 30 webcast, Ascend said that lease rates for out-of-production narrowbodies were down 20% since mid-year while rates for in-production narrowbodies had fallen 10%, with underlying market values declining 5%-10%. J.P. Morgan is modeling for even bigger drops. "Beginning in [the 2009 first quarter] we assume lessors will witness 25% defaults followed by 25% discounts in order to keep their aircraft flying," analyst Jamie Baker wrote.

## **Margin Call**

Yet the news is not all bad. Heinemann points out that lease rates tell only half the story. "As a lessor, what really matters to me is the net margin, in other words lease rentals minus interest costs. And obviously with interest costs coming down significantly, that margin at this moment is not under pressure." He provides an example: "If I have at funding cost of 6% a lease rental of \$400,000 and now I have funding cost at 4% and lease rental at \$350,000, actually my margin my differential between rentals and interest cost has gone up, not down."

One of the biggest unknowns in forecasting how the market will behave next year is the fate of ILFC. "A potential sale of ILFC is expected to significantly affect aircraft values," Baker stated. ILFC co-founder and CEO Steven Udvar-Hazy is known to be leading an effort to acquire the company from AIG. In a report, Baker suggested other possible suitors could include certain Chinese or Japanese banks, Warren Buffet's Berkshire Hathaway and Middle East sovereign wealth funds. While he expects Udvar-Hazy to remain at the helm through any change in ownership, a sale by AIG "will likely diminish the pool of capital that might have helped to fill the aircraft funding void" anticipated in 2009.

Most lessors declined to comment on the ILFC situation, but Martin says, "It's in nobody's interest that ILFC get into difficulties because they are such a large component of the market."

A positive development cited by everyone is Airbus's decision to suspend plans to increase production of the A320 and A330/A340 families. "I think Tom Enders and his team are showing outstanding judgment," Hubschman says. Continuing delays with the A380 and 787 programs and the Boeing strike, while huge setbacks for both OEMs and the aerospace supply chain in general, also have acted as a brake on surplus capacity.

"If Boeing and Airbus had delivered the 787 and A380 on time, we'd have almost 200 additional widebodies flying at the end of next year than we are going to have and that could have really messed up the picture," says one insider.

Notwithstanding the absence of these aircraft, 2009 will be a challenging year for the industry, one that should see additional airline failures and perhaps some lessors departing the scene or being acquired. Yet the situation, however dire, is also familiar, attributable in part to the air transport industry's inevitable tendency to overexpand and the unfortunate fact that airplanes take a relatively long time to build and the economy doesn't always wait. "In the fall of 2006 we were already predicting that by the end of 2007, early 2008, there would be a cyclical downturn," says Hubschman, who emphasizes, "It had nothing to do with the economy; that just compounded it. [It was] too much production as against what was anticipated demand."

Heinemann offers a note of optimism for the eventual recovery. "If you look at the movement of parked aircraft you will see that as quickly as they built up they came down." And AerCap and other lessors with whom ATW spoke will be looking for bargains in a down market.

## **COUNTERROTATING ASSETS**

Although both involve leasing assets to airlines, the engine and aircraft leasing businesses bear little resemblance to one another (ATW, 12/06, p. 40). For example, while downturns tend to affect airlines and operating lessors in a similar fashion, the engine leasing business is somewhat countercyclical and tends to pick up in times like this, says AerCap CEO Klaus Heinemann. "The short end of the engine lease market is at this moment doing very well." Through its AeroTurbine subsidiary, AerCap has a portfolio of 80 engines for both long- and short-term lease.

He explains that "if airlines are in a cash squeeze, they often prefer to lease in short-term engine capacity rather than pay \$2-\$2.5 million to have a complete performance restoration done."

Typically, engine lessors do not enjoy much clout with OEMs when it comes to buying assets because when they are not part of an aircraft negotiation, engines are sold at the catalog price without discounts. Additionally, engine-makers prefer to dedicate nearly all of their production to meeting their own delivery commitments and spares and leasing requirements. AerCap is well-positioned in this regard owing to its core activity. "If you buy, like we do, 50-100 aircraft and then 100-200 engines en bloc, obviously you have the necessary negotiating power to extend that purchase commitment to also include engines for the spares pool," Heinemann says.