The Doughnut Hole: Will a generation of aircraft be left behind?

s aviation's financial market makes its recovery and heads towards the next up-turn, is it possible that generation of aircraft will be left behind? **Bryson Monteleone**, ISTAT certified appraiser and director of ailwind Capital investigates the potential.

MANY IN THE MARKET REMAIN optimistic that the top credits with new, high quality assets will continue to see the benefit of available funding at reasonable pricing. However, if an operator is not a top credit and is in need of an aircraft that is perhaps seven to 10 years or older, will it be able to access a similar pool of funds, and if so, will it be at reasonable costs and terms?

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The year 2010 started with the anticipated infusion of new equity into the market. These new players, many employing those once working with major leasing companies, have fistfuls of cash and are ready to spend. However, as many of these 'newcos' approach airlines to offer financing opportunities they are realising that everyone else is doing the same. Now airlines, once the victim, are the beneficiary of the leasing companies trying to deploy their orderbook and new entrants trying to compete.

It is estimated that there will be over $3bn of equity available this year and it won't be coming from ILFC, GECAS or ACG. New names such as Avolon and Air Lease Corporation are leading the charge, with modestly capitalised ventures like Greenstone, RPK and KV only a few steps behind. The catch is that their money is not cheap. Internal rates of return are

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expected to hover close to 20 per cent, which is tough for an industry that receives around 15 per cent on a good day. Back leveraging will help, but could cause more headaches down the line. This moderate hurdle will be a tough sell for top credits like Lufthansa who command 'investment grade' financing packages.

Another piece of the puzzle is debt. Those looking to lower their hurdles with large amounts of 'cheap' debt are finding that the historic leverage ratios of five to six times are now more like two to three times, which considerably reduces their available funds. Ironically, with the demise of AIG, and the higher cost of capital for parent companies and banks, everyone including ILFC, appears to be on a more even playing field. Leasing companies are now arranging ECA supported facilities to assist with their aircraft purchases, once a backstop reserved for airlines. These Export Credit facilities do come with strings; they can only support airlines that are not considered part of the consortium of home countries that manufacture aircraft. However, after the termination of the first lease, these aircraft can be remarketed to any jurisdiction. Some might assert that if these companies need to access ECA financing for 'cheap' debt, they should not have an investment-grade rating.

With lots of equity and some debt in place, the last piece of the puzzle is the asset. Ironically, airlines, banks, leasing companies and other owners are doing what their advisors have always told them to do, which is to 'hold their assets' if they can, except in the highest pressure circumstances there are very few distressed or high-yield deals to be seen. Owners are standing their ground and are not marking their asset values down unless they absolutely must, which makes the true distressed purchase even more elusive. Many asset owners that were once in dire straits have pushed their debt obligations giving them more breathing room and fewer requirements for liquidity. The large leasing companies such as CIT and AWAS are beginning to see the market with more clarity and have not placed all their bets on divesting aircraft. The banking community seems to have only tepid interest in lessors' stories and have closed funding facilities giving them either a cash infusion or an extension on current facilities. The recently restructured lessors will find it harder to access buyers due to internal constraints and recalculated debt levels. It is fair to say that without a

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complete surge in market values some aircraft might never be traded. Moreover, if one can attract investor or bank interest it will come with a price.

The 'mega-lessor', ILFC, was able to amend its $2.5bn credit revolver by delaying its expiration for a year, however, the facility was changed from unsecured to secured and cost an additional 150 basis points. ILFC has also closed a transaction with Macquarie for the sale of 53 aircraft for $2bn; a deal that the US Federal Government, ILFC's final decision maker, was on-board with. Even after this sale ILFC remains one of the largest aircraft lessors, however they might be required to sell more of their portfolio in order to recover cash for their ultimate shareholder, the US Taxpayer.

This does not mean there are not readily available aircraft on the market. It is not hard to find older 737 Classics or early-built A320s, indeed both can be found in abundance. Unfortunately, some of these aircraft have already been on the market for over 15 months and in most cases are priced too highly for their current maintenance status.

While there have been some transactions, current market expectations remain miss-matched. Buyers and sellers are not seeing eye-to-eye, which leaves many in a quandary as to who will budge first. Those actively looking to buy must start to close deals soon or risk losing their funding. Sellers, on the other hand, are betting on desperate buyers in anticipation of recovering, if not exceeding, their current book values.

Unfortunately, pricing for new aircraft it is not any easier. While there are operators that would not mind selling their delivery positions or very new aircraft, every new delivery is precedent upon an order date from a period when the OEMs had the upper hand, in addition to any subsequent escalation. It is very possible to have a brand new A319 on the books commanding a premium of $45m if it was ordered five years ago. The one-size-fits-all valuation scheme does not always compute, which makes it very tough for buyers, sellers, owners and especially lessors. However, with new aircraft, particularly those with the greatest market strength, there is still a significant amount of flexibility. Contracts for new aircraft can mitigate current pressures with step-up/step-down rental rates, length of lease, and miss-matched amortisation schedules. Those terms among others can help airlines, especially those with better credit, with their financial conundrums.

Similarly, the case is not as simple for used aircraft, especially as the credits tend to be tougher and the remaining life is dramatically shorter. In some cases for the new equity players, the used aircraft market should be the perfect fit — if they can make the numbers work. On one hand you have an airline looking to lease a used aircraft of roughly five- to seven-years-old, and you have a new lessor that needs to hit an internal investment target of 20 per cent or more. As previously mentioned, many would agree that one would be lucky to get 12-15 per cent in commercial aviation. The ambitious investment returns that exceeded 30 per cent are not likely to return soon. In the current situation airline credit is rated second-tier so to expect a higher rate of return is reasonable — as much as the airline would beg to differ.

However, can a 'newco' get internal credit committee approval for such a hairy transaction? Will it not be undercut by the established leasing firms that can push out older aircraft on very compelling lease terms? The second hurdle is pricing.

Will the recent downturn see a generation of aircraft abandoned?

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It appears that aircraft of 10 years of age or above remain relatively liquid when they are priced appropriately, albeit not at any notable premium. In most cases, the value has fully depreciated, perhaps with some mark-up for maintenance, or the owner is no longer in a position to deal with the technical difficulties that linger on the horizon. These assets tend to move on a cash basis and are purchased by those that offer a level of technical expertise or vertically integrated capabilities for tear-down and/or consignment. Assets can be moved in one-off scenarios but for the best economics they are purchased or sold in-bulk.

In the 'old days' used aircraft were considerably more liquid and malleable, but they were in a different kind of market. Large leasing companies could securitise a pool of assets (similar to the sub-prime transactions that brought the United States economy to its knees) by selling investment-grade bonds that place the residual exposure on someone else's balance sheet. Many of those deals were sold on the cash flow of the leases. Rating agencies sold the argument that everything that flies must be liquid, and so everyone was supposed to win. As with the sub-prime market, so went aviation's asset backed securities (ABS) sector. Many large portfolios with the oldest aircraft took a turn for the worse. The perfect storm had come and defaults became exponential. The older aircraft were permanently grounded and in most cases now cease to exist. Some of these older ABS deals continue to trade but at a fraction of their original value. The ABS market is expected to return, but not for some time. Undoubtedly, the rating agencies will take a harder look at these structures and the advantages that previously existed will be less attainable or will require higher leverage.

New aircraft will be financed mainly because they have to be. There are airlines that need them and many financiers happy to finance them at the customary rates of return. It is also evident that it will be relatively easy to find homes for older aircraft with those that can handle the tougher technical challenges of this asset class. This still leaves moderately attractive aircraft that are too expensive to purchase as their book values are still too high for many and they are too young to be parted out. The pressure for much needed capacity will eventually force lease rates higher as younger aircraft are sought due to jurisdictional age restrictions and demand for quality assets — lessors will be forced to pay more for these aircraft and will try to pass the premium to their customers with gradual success. As cheaper available capacity diminishes, lease rates will ultimately be forced up however, in the meantime good quality younger used assets will have a hard time finding a home.

As with previous cycles, there has always been a modest amount of distressed transactions that have 'primed the pump' for future deals and allowed an increase in financing velocity — in turn allowing the market to return to equilibrium. This does not appear to be the case yet. Those that would and should be selling are not. This lack of transaction velocity could lead to market irrationality as equity pledges and opportunities begin to dry up, spurning deals that otherwise should not have occurred.