

AIRCRAFT FINANCING – ADOPTING THE BRACE POSITION



Russell Clark's
Market Views

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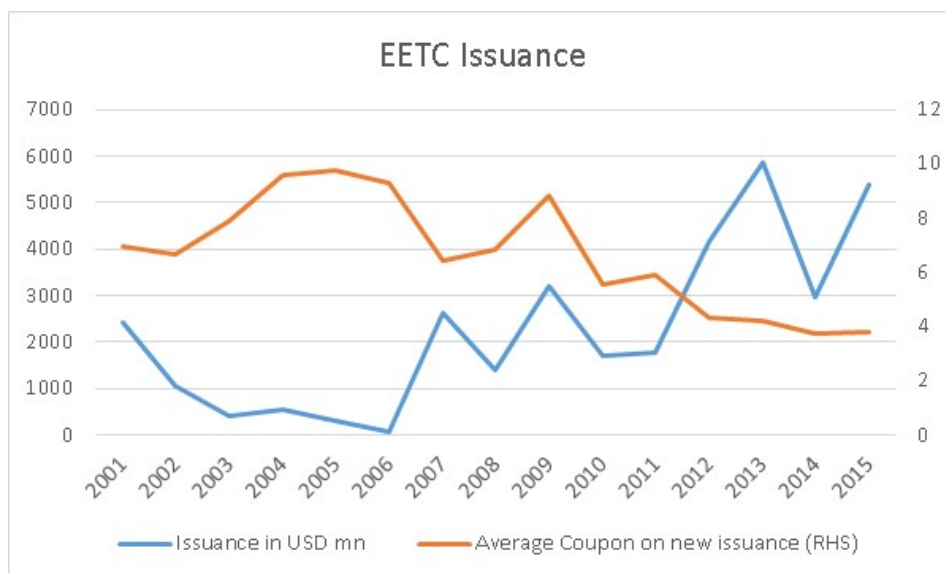
One growth area for the finance sector over the last few years has been aircraft financing. High oil prices encouraged many airlines to upgrade their fleets to the more fuel efficient new aeroplanes, while strong demand from emerging markets had seen huge growth in aircraft orders.

For a long time, the financing of aircraft orders was aided by government owned export credit agencies. However, in recent years, aircraft leasing has come to dominate. Aircraft leasing was given a big boost with the implementation of the 2011 Aircraft Sector Understanding (ASU). This is a complex agreement, but its essential aim was to make the use of government controlled export credit agencies less attractive. The ASU has succeeded and we have seen substantial growth in aircraft leasing as a source of capital for airlines as a consequence. This has also coincided with the growth in capital markets being a source of funding for aircraft. Details of these changes over time can be found in Boeing Capital’s overview of the Aircraft Finance Market Outlook.

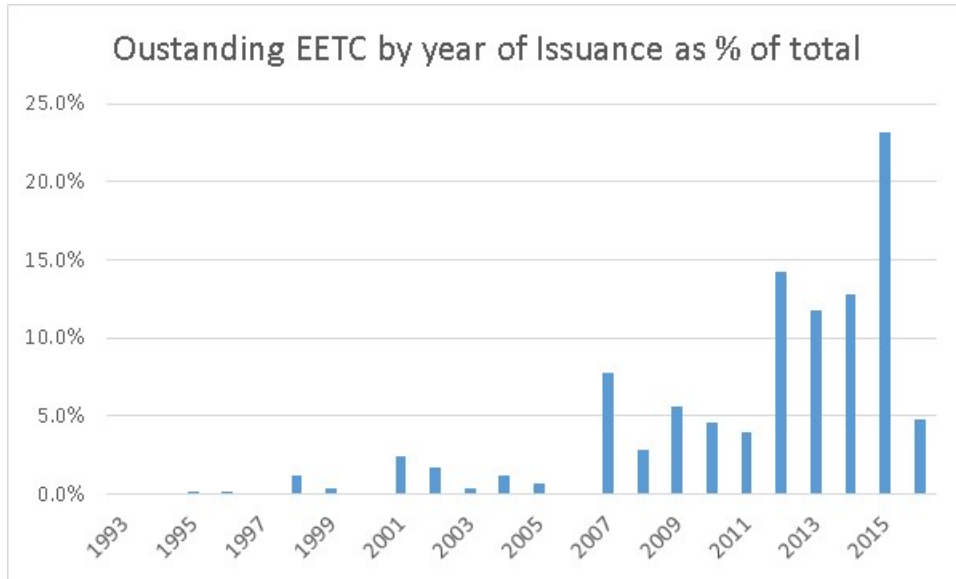
http://www.boeing.com/resources/boeingdotcom/company/capital/pdf/2016_BCC_market_report.pdf.

The growth in capital markets as a source of capital for aircraft financing has had two main drivers. For established airlines, particularly in the US, a form of asset backed securities, the enhanced equipment trust certificate (EETC), has become popular. For smaller airlines, and airlines not based in the US, air leasing companies have grown substantially.

An EETC relies on the credit of the issuer (the airline), but is secured by the collateral (the aircraft). EETCs also make use of tranches and overcollateralisation to reduce risk and lower debt costs. EETC issuance has increased markedly as issuance costs have fallen.



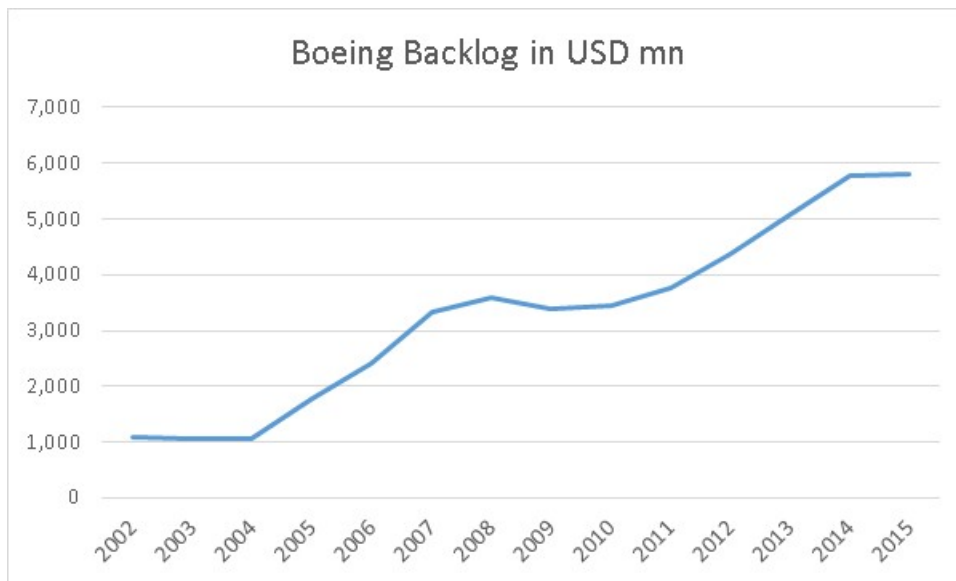
Recent large issues of EETC ensure that outstanding EETC debt is mainly comprised of recent issues. Issues from 2012, when the ASU was implemented make up 67% of outstanding EETCs.



Air leasing companies typically buy aircraft and then lease the aircraft to airlines to operate, usually for a period of two years or longer. The largest aircraft leasing companies are GECAS (owned by GE) and ILFC (formerly part of AIG, but now owned by AerCap). After the big two, there is a long tail of air leasing companies, some listed, some part of large banking groups and a few as captured leasing organisations within airlines. However the biggest growth in aircraft leasing has been in China, where the domestic share of the aircraft leasing market has risen from 7% in 2007 to 40% today. Furthermore, Chinese regulators relaxed leasing rules in 2013 and 2014, with the result that nearly 500 new leasing companies entered the leasing industry. This has led to larger Chinese firms looking to expand internationally, most notably with the acquisition of Avolon Holdings in January this year by Bohai Leasing.

<http://centreforaviation.com/analysis/bohai-leasing-signs-definitive-agreement-to-acquire-avolon-at-an-enterprise-value-of-usd76-billion-245083>

The upshot of the increase use of capital market financing, and the growth of aircraft leasing globally (and particularly in China) is that the backlogs for Boeing and Airbus have grown dramatically.



According to the International Bureau of Aviation, approximately 65% of this backlog is with airlines, 16% with lessors and another 18% unknown (which they consider likely to be Chinese). Lessors typically lease the aircraft to a range of different airlines, including those too small to access the capital markets directly.

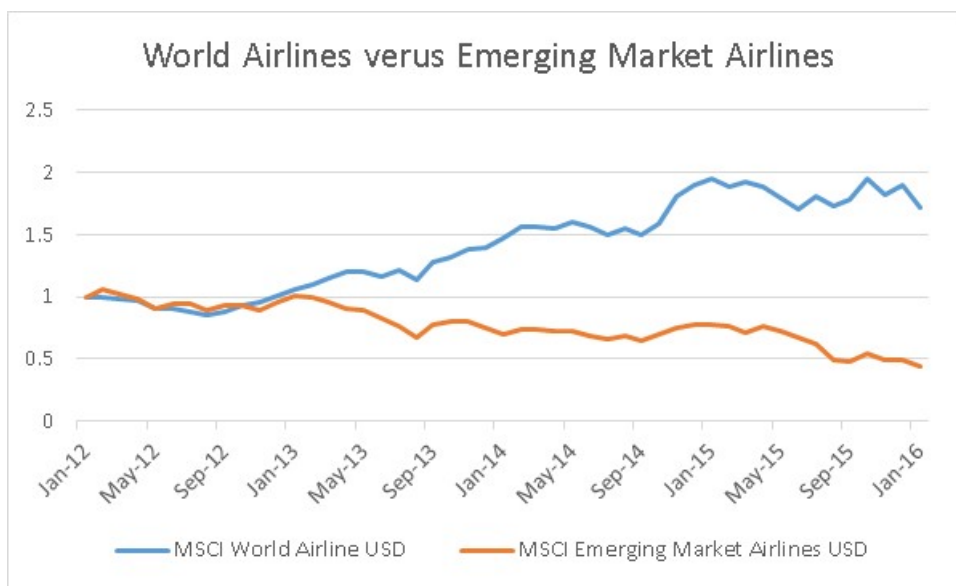
One of the big drivers of the growth in orders for new planes has been the high oil price that has been in place until 2014, which made older planes uneconomical to fly. When oil was at USD125, the cash cost of relatively new Boeing

787 Dreamliner, was 16% cheaper than the B767, a plane that launched in 1982. However, with oil prices now below USD 40, the cash cost difference is relatively small, and when depreciation is included older planes are now cheaper to fly.

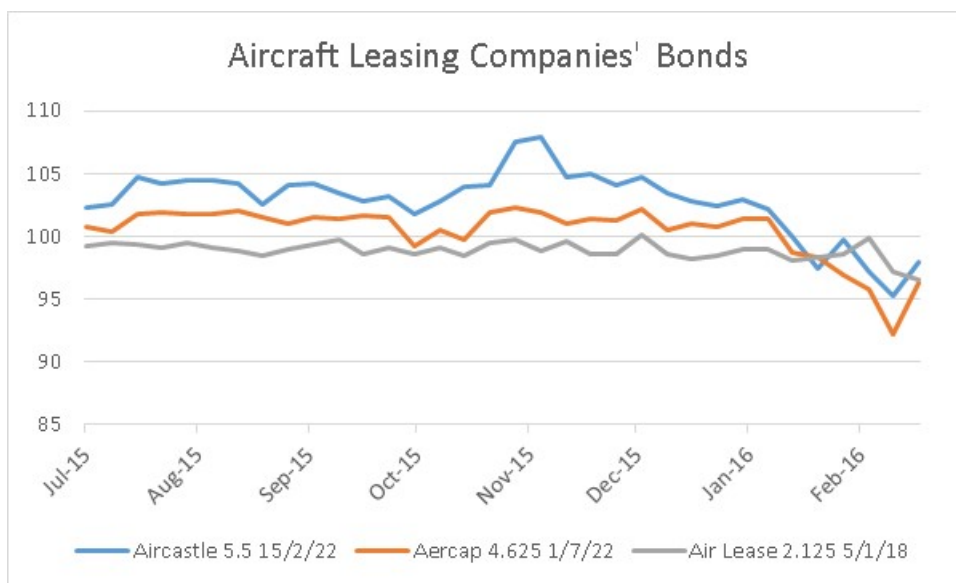
This has two effects in my mind. Firstly, it improves the competitive position of the legacy airlines who are the main owners of older planes. This will encourage them to scrap less planes and reduce their purchases of new ones. Secondly it will greatly increase the supply of planes globally, which is likely to force down the value of second hand planes, and put pressure on newly purchased planes. There are already signs of this. Delta recently purchased a used 777 jetliner for USD 7.7mn. This compares to a list price of USD 277.3m for a new 777.

<http://www.bloomberg.com/news/articles/2015-12-17/why-delta-s-ultra-cheap-used-777-jet-wiped-out-boeing-stock-gain>.

Ultimately the credit worthiness of the EETC and the business plans of the air leasing companies depend on the corporate health of the airlines. In the developed markets, we have seen that the share prices and profits of the airlines have reached recent highs. However this has disguised a much deeper malaise for emerging market airlines, which have been driving the growth in aviation markets.



Recently we have seen some weakness in the bonds of the three biggest listed air leasing companies in the US.



It looks like emerging market airlines might be about to share the pain with both air leasing companies and aircraft manufacturers. The big question to be answered is whether financing conditions for developed market airlines will be affected, possibly via falling collateral values affecting the market for EETCs. Based on the above, great caution should be applied to all parts of the aircraft market.

INFORMATION

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