There are plenty of signs that the industry has reached an economic peak. With manufacturers offering finance support to a lot of potential customers buying aircraft, Jim Smith discusses how adjusted credit ratings are affecting airlines' ability to raise capital on the commercial market.

The growing importance of credit ratings

To say that airlines exist in a different financial reality to most other industries is an understatement. Revenues for non-US airlines operating internationally are generated in the currencies of the countries where they take on passengers and cargo. Major expenses – including aircraft ownership and fuel – are dollar-denominated.

Resulting cash flows – probably the most important element of the credit ratings process – are relevant not only in an intrinsic sense, but also in the context of the strength of those currencies against the value of the dollar.

Aircraft manufacturers that are anxious to move product contribute an element of non-reality by giving financing support to airlines with poor credit. Since the two remaining large aircraft manufacturers, Airbus and Boeing, go head-to-head for virtually every order, financing becomes a major element in the decision-making process. Both plane makers seem to be willing to make major concessions to credit quality. A New York-based official of a major Canadian bank has always contended that "Airbus leads with its financing and Boeing with its product". Still, both manufacturers continue to offer financial support on most orders, according to air finance bankers.

Peak cycle

In a report published by Moody's earlier this year, the ratings agency contends that overall credit quality of airlines will probably remain stable. Most carriers have used the past few years of profitability to rebuild their balance sheets, which were badly damaged during the last downturn. Adjusted for off-balance sheet liabilities, the most dramatic improvement in debt reduction over the past four years occurred at America West (rated A2 by Moody's), Northwest (B1), and Lufthansa.

At year-end 1993, five major carriers had adjusted leverage in excess of 100%. Only Trans World Airlines (TWA) remains over that threshold, although its leverage has also declined. For the few start-ups, the situation will remain bleak, with increasing competition from regional feeder airlines. "There is no money being lent to unrated start-ups," says a Duff & Phelps analyst. The majors have turned over less profitable routes to regional airlines that complement their systems, rather than compete with them as they have in the past. As a result, fewer routes during the next downturn will translate into fewer opportunities for fledgling airlines – and fewer still opportunities to access the bank market.

One casualty?

Indeed, TWA, (rated Caa1 by Moody's and CCC by Standard & Poor's [S&P), which has delayed what some analysts believe is its inevitable demise by settling with its largest union last week after two years of negotiations, and is the only US major not to have made money in recent boom times, placed a mega-order mid-December 1998, and will share in the largesse of both plane makers.

TWA announced its biggest plane order ever, placing firm commitments and options for up to 250 Airbus and Boeing aircraft. The deals are estimated to be worth $7.8 billion. TWA placed firm orders for 75 Airbus jets with options on a further 75, in a deal said to be worth up to $5 billion. In a separate deal TWA confirmed firm orders for 50 Boeing 717 jets and options on a further 50.

Boeing's deliveries to TWA will begin in February 2000, Airbus deliveries from 2003. For the year ended 31 December 1998, TWA reported an operating loss of $65.2 million and a loss before extraordinary items of $107.4 million.

While both manufacturers are said to have committed to providing financing into the deal, speculation is that TWA may not be around long enough to enjoy the fruits of it.

Troubled Brazilian flag carrier Varig, approximately $1.5 billion in debt, is sitting on a $2.7 billion Boeing order, including firm orders for 14 737s, six 767-300ERs and four 777-200IGWs.

While Varig doesn't have a public corporate rating, its recent $100 million 9.6% credit card-backed notes were downgraded by Moody's to Caa1, reflecting the return of aircraft to lessors, cancellation of international flights and deregulation of the domestic airline market.

On 8 March this year, Moody's announced a previous downgrade to B2 for Varig, the originator of the future receivables, in light of the difficult operating environment in Brazil. In spite of Varig's serious financial difficulties, sources say banks – including major players Chase, Citibank and CIBC – had

Northwest Airlines has had one of the most dramatic improvements in balance sheet leverage in the past four years.

had discussions with Varig late last year about lending between $300 million and $400 million for pre-delivery financing.

Moody's noted that while the credit card-backed notes were supported by Varig's generation of future credit card receivables in the US for flights between the US and Brazil, which are still at acceptable levels: "the rating on the notes is not entirely isolated from the credit risk of Varig as a result of the existence of mandatory receivable repurchase events under the transaction documents".

Moody's says the downgrade was the result of the deterioration in Varig's profitability and reported the airline's inability to make timely debt service payments. Affecting the carrier are difficult economic conditions in Brazil, including the January effect of the weakening Brazilian Real on the carrier's ability to service dollar-denominated debt.

The airline hired Bankers Trust in April, with which it has a long-standing relationship, replacing IAMG and Warburg Dillon Read to secure financing. This will probably include sale and leaseback structures. In the meantime Varig is talking with Brazil's national development bank (BNDES) about a $410 million loan, and is said to have landed a settlement following a lawsuit against the national government because of a prohibition against ticket-price hikes during the six years 1986 to 1992.

Moody's senior analyst Robert Jankowitz said that ratings are taking on more importance across the broad spectrum of financing structures. "We are seeing a lot of emphasis placed on rating syndicated loans. Banks are looking for validation. In terms of structured financings, the rated enhanced equipment trust certificate (EETC) – which started out slowly – has now become a core financing tool for the airlines."

Another banker noted, "Air transportation is a cyclical industry and credit ratings on non-investment grade airlines – which means just about everyone – move up and down, but this is predictable. There are also banking cycles. Marketing managers need to put loans on books. This may mean relaxing some of the criteria to do business. This is also true of manufacturers supplying product with financial incentives to airlines, as well as banks lending to those airlines for aircraft, or on a revolving credit or unsecured syndicated loan basis for other purposes."

US carriers

There may be less apparent influences, at least for some deals. Leaks out of US Airways (rated B1 by Moody's, B+ by S&P) some months ago that the carrier would soon come to market with a $500 million revolving credit facility had bankers salivating for several reasons. The demise of the Japanese leveraged lease, and curtailment of other financing structures, created a vacuum. Bankers are still anxiously awaiting this deal.

ABN Amro is said to be the front runner. The bank worked closely with the US Airways financing team when most were at United Airlines. Among those said to be competing for positions as syndication and documentation agents are Bank of America, Chase and Citibank. The deal is expected to price well as bankers seek to get a foot in the door with the new team.

While US Airways has little with which to collateralise the deal (no routes or gates that are especially coveted), there are not many banks with existing US Airways exposure. This means more banks are expected to jump into a probably oversubscribed deal.

However, Chase closed a deal in late April for unrated Oregon-based Evergreen International Airlines, which was a partial refinancing of a $400 million facility from 1997.

Moody's assigned a B1 rating to the company's $200 million senior notes due 2009, and a Ba2 rating to its $220 million of senior unsecured credit facilities, consisting of a $30 million revolver with a five-year term and a $190 million six-year term loan. The senior implied rating was Ba3 with a stable outlook. The revolving credit facility was priced at Libor plus 225bp and the $190 million term loan priced at 250bp over Libor.

The new deal replaced a $400 million deal, which included a $30 million revolver priced at Libor plus 250bp, a $70 million amortising term loan priced at 250bp over Libor, and a $300 million institutional term loan priced at Libor plus 300bp.

In rating the deal, Moody's maintained that the ratings reflect the company's high leverage and pressures on cash flow to maintain older 747-100 and 747-200 aircraft, to upgrade other aircraft to Stage III noise compliance, to replace ageing lift as they go out of service and to fund the growth of the company's aircraft maintenance business.

Moody's recognised Evergreen's low cost of operations, diversity of businesses, including air freight, helicopter services, aircraft maintenance and logistics, and the diversity of revenue sources, including air cargo contracts with companies in Asia and Europe as well as the US Post Office and Department of Defence. Moody's said that cash flow is constrained by the need for ongoing investment in the business.

Northwest Airlines (rated B1 by Moody's, BB by S&P), with the Moody's rating unchanged since 1996, saw a 50bp change from 1997 to 1998. Last month, the airline earmarked $400 million of its cash to be applied against a $1 billion combination term loan and revolver, which closed at the end of December 1997. Final maturity on the deal, which was fully drawn, was December 2002. The balance is now about $585 million.

The deal included a $175 million

364-day revolving credit facility with a four-year term out; a $675 million five-year revolver; and a $150 million term loan priced at Libor plus 150bp. Members of the arranger group included ABN Amro, Chase Manhattan, Citibank, First Bank of Minnesota and NatWest.

Northwest, however, closed a strike contingency revolver on 7 May 1998, which was priced at Libor plus 200bp – a full 0.5% higher than the previous deal – and secured with the carrier's Asian routes. Chase led that deal with a $100 million commitment. The largest commitment came from US National Bank of Oregon, in for $150 million. Also taking $100 million slices of the deal were ABN Amro, Bankers Trust, Bank of America, Bank of Tokyo-Mitsubishi, Citibank, Credit Lyonnais, Credit Suisse First Boston, Fuji Bank, Lehman Brothers and Royal Bank of Canada.

Asia Pacific

On the Asian side, Singapore Airlines (SIA), Air New Zealand (rated BBB by S&P) and Cathay Pacific appear to be among the few airline credits that banks are routinely willing to take a chance on.

While not rated, perception of SIA as good credit has spurred interest among banks looking to make a deal, resulting in debt pricing in the 30–40bp over Libor range. Sources say that some banks are lending to unrated Chinese airlines, expecting the relationship will continue in a better economy after the current regional crisis is over.

While all the major credit rating agencies look at a number of criteria in rating airline debt, these ratings are becoming important for unsecured syndicated facilities. The most important elements in a corporate rating are the financial measures of carrier performance, such as cash flow (which includes an analysis of cash flow divided by total debt, overall industry risk, competitive position within the industry, operations analysis and management evaluation). Also examined are such business elements as profitability, balance sheet analysis and financial flexibility, including the ability to raise capital from alternative sources if needed.

Ratings' importance

While ratings shopping is found on some structured deals, "on the corporate side, coverage is more uniformly focused," said Philip Baggaley, managing director at S&P, which ranks many major airlines. "Ratings are becoming more important for syndicated loans and bank facilities in general. For structured deals, particularly at point of sale, the top five US airlines have ratings grids."

Baggaley said pricing in larger bank deals now reflects the importance of ratings. "As the use of ratings in bank deals has spread, they have become a point of reference. If you disagree with a credit committee, you are free to voice your opinion. Credit committees are made up of people who know banking, but not necessarily airlines."

Fitch IBCA analyst Eric Stephenson maintains that: "Given the cyclical nature of the airline industry, central to a complete credit analysis is the challenge not to mistake cyclical variations with secular trends. If recent negative events are believed to be more lasting – secular rather than transitory in nature – then the misinterpretation could translate into higher perceived risk for airline credits and so higher spreads."

Stephenson maintains that the sixth consecutive year of profitability, measures of traffic growth, load factors and yield trends for the month of May, may indicate that industry profits have peaked and could begin to decline as happened in the 1988–92 period. He notes that: "Whether history repeats itself and this trend becomes secular in nature remains to be seen. It merits noting that the industry is better positioned than it was 10 years ago to adjust to cyclical variations in cash flow and financing needs. The industry also has greater financial flexibility than it did 20 years ago when deregulation was mandated and a profound transformation of the US commercial aviation market began."

That sentiment was echoed late last year in a speech by AMR (rated Baa2 by Moody's, BBB by S&P) chief executive officer Donald J Carty. The American Airlines executive argued that although cyclicality will always mark the airline industry, fundamental changes since the last downturn have produced less volatility in financial performance of carriers than has been the case in the past.

Carty argued that carriers are buffered better to withstand any eventuality because they have built route systems that emphasise their individual strengths. Airlines have begun focusing their attention and resources on their major hubs and other markets where they have performed well.

Carty further argued that the industry has been stabilised by having fewer carriers on the verge of bankruptcy than was the case in the 1980s and early 1990s. Airlines have been recognised by lenders as operating with a long-term focus. While there continues to be a substantial number of new aircraft added to the world fleet, these assets do not constitute additional seats as much as

AIRLINES' SENIOR UNSECURED RATINGS

Airline	Comments	1998 rating	1997 rating	1996 rating
Alaska Airlines	Stable	Baa3	Baa3	Ba1
Air Canada	Stable	Ba3	Ba3	Ba3
AirTran holdings	Weakly positioned	B2	B2	-
All Nippon Airways	Stable	Baa3	A3	A3
American Airlines	Stable	Baa1	Baa2	Baa2
America West Airlines	Stable	B1	B1	B1
AmTran	Stable	B2	B2	-
Atlantic Coast Airlines	Stable	B1	B2	-
British Airways	Weakly positioned	A2	A2	A2
Canadian Airlines	Stable	Caa2	-	-
Continental Airlines	Stable	Ba2	Ba3	Ba3
Delta Airlines	Positive	Baa3	Baa3	Baa3
Lufthansa	Stable	A2	A2	A2
Japan Airlines	Stable	Baa3	A3	A2
Japan Air System	Stable	Ba3	-	-
Midway Airlines	Stable	B2	-	-
Northwest Airlines	Negative	Ba2	Ba2	Ba2
Qantas	Stable	Baa1	Baa1	Baa2
SAS	Stable	A3	A3	A3
Southwest Airlines	Stable	A3	A3	A3
TWA	Weakly positioned	Caa1	-	-
United Airlines	Stable	Baa3	Baa3	Baa3
US Airways	Stable	B1	B3	B3

Source: Moody's Industry Outlook

Despite the WTO ruling that Embraer would have to give up using Proex subsidies, the manufacturer continues to win large orders. It has just launched its latest project with a $4.9 billion order.

replacement capacity. In general, airlines are not squandering their earnings, they are making deals that are flexible and are holding on to older and fully depreciated aircraft that can be used or retired depending on the vagaries of the market.

"We try to assign rated airlines out to five and 10 years. Airlines are volatile, however, unlike investment-grade companies which function in much more non-cyclical and stable environments," according to Mark Oline, airline analyst at Duff & Phelps. "For instance, spreads shot up significantly last October as a function of that cycle". Oline said that in spite of ratings, banks can stretch credit criteria or compromise a rating in lending to an airline or other business. "Banks are in the business of making loans".

Oline continued: "While we emphasise cash flow analysis in assigning a rating, we also put a high priority on capital structure and the quality of management. Is management aggressive or protective?" He added that good management will understand the limits of an airline's business, that is, not mistaking competence as a niche player for the ability to challenge major carriers on major routes. Also intrinsic to good management is the ability to work for mutual benefit with organised labour. Failure to develop a satisfactory strategy can result in a shutdown, even causing irreparable damage to the business.

Manufacturers

The same issues experienced by large aircraft manufacturers migrate to the regional jet market, where the two major players – Canada's Bombardier and Brazil's Embraer – have just finished squaring off before the World Trade Organisation (WTO), the succeeding body of the General Agreement on Tariffs and Trade.

While the incursion of regional jet aircraft into the previous turboprop market has been confined largely to major carriers – the US majors and some better-financed European airlines – the financing issue has reared up on another front, to the detriment of Embraer.

Embraer posted its biggest ever net profit of R$132 million in 1998; the company's first profitable year after eight years of straight losses. The carrier, which was privatised in 1994, exported $1.17 billion worth of RJs in 1998. This made it the second largest exporter in Brazil. This is the genesis of Embraer's recent WTO problem.

Gross sales for Embraer aircraft spiked 90% from a year ago to R$1.59 billion, spurred by a growing reluctance worldwide to fly in turboprops. Said a banker at Chase, "People became gun shy after seeing time and time again news footage of aeroplane crashes with still-attached propellers sticking out of the wreckage".

Embraer's main clients include American Eagle, an AMR subsidiary rated Baa1 by Moody's, and Continental Airlines, rated Ba2. Embraer started 1999 with a backlog of $4.1 billion, of which $3 billion was derived from sales of the popular 50-seat ERJ-145 and 37-seat ERJ-135. Its production rate has jumped from seven to 12 aircraft in a year.

Embraer's WTO problems stem from subsidies from export credit agency Proex, which have been declared illegal by the international body. The Brazilian plane maker has been engaged in a year-long trade dispute with its Canadian nemesis, which claimed Embraer was being illegally supported by its government.

The WTO ruled in March that Brazil must eliminate its support for Embraer via Proex. That support reduced Embraer's financing costs by more than $2 million per aircraft. Brazil's counter-punch resulted in Canada having to scrap two of its three subsidy programmes which benefitted Bombardier. Because of the nature of the appeals process, a final ruling from the WTO will not be given until August or September.

Separately, Embraer is drawing up a final business plan on a new family of jets, a 70-seat ERJ-170, and a 90-seat ERJ-190, the latter of which will go up against Boeing's entry into the 100-seat market, the 106-seat 717-200, priced at $31.5 million to $35.5 million.

Development costs on Embraer's two new aircraft projects are estimated at $750 million, adding credibility to rumours that British Aerospace or another major-league manufacturer is prepared to invest money into Embraer. In addition, Embraer is expected to invest about $150 million in development costs this year for other projects, up from $122 million last year.

The growing importance of regional jets is apparent, as is the issue of manufacturer financing. The ERJ-145 was expected to take a 25% share of world regional jet deliveries this year in terms of dollar value of deliveries.

Further cementing Embraer's role as a regional jet powerhouse, the Brazilian manufacturer landed an order from Crossair at the recent Paris air show, estimated at $4.9 billion. That commitment includes a firm order for 75 ERJ-145s, with 125 options. In addition, Embraer won a six-and-six ERJ-145 order from Bombardier's neighbour InterCanadian Airlines, a six-and-10 for the same aircraft from Italian flag carrier Alitalia, along with a 10-and-five from France's Regional Airlines; already an Embraer customer for the ERJ-145.

Richard Aboulafia, Teal's Group's Senior Aircraft Analyst, said, "In spite of Embraer's bulging order book, there are still some long-term concerns. The company began to turn a profit last year, largely as a result of post-privatisation cost savings, and impressive aircraft delivery numbers. But it is unclear how much this profitability has been a result of Brazilian government subsidies. As with the EMB-120, most ERJ-145s have been sold at a heavy discount. American Eagle is getting its planes at extremely favourable prices, and Continental Express is leasing its planes." AC