EETCs migrate to Europe

Iberia has broken new ground, not only by completing the first EETC financing for a European carrier, but also by having the deal denominated in euros.

The Spanish carrier, Iberia's use of Enhanced Equipment Trust Certificates (EETCs) to finance six A320s may finally signal the acceptance of this financial product by the capital-hungry European aviation market.

For a while now demand for EETCs from US carriers has steadily increased, but this funding source has remained untapped by the European carriers. The absence of straightforward bankruptcy laws, together with lengthy repossession procedures and currency problems, are often cited as obstacles to the introduction of EETCs in non-US jurisdictions. Iberia's successful launch of its EETC, called Iberbond 1999 PLC, has not only addressed these issues, but has also managed to procure some competitive financing terms.

The structural parameters in the EETC for Iberia are almost identical to those found in the standard EETC model used in the US. This was done on purpose to demonstrate the application of the EETC to non-US markets, according to Thomas Cahill, principal at Morgan Stanley Dean Witter, whose firm was the structuring agent and arranger of Iberbond.

Even the loan to aircraft value (LTV) ratio is largely in line with the US market. If the LTV for the C class unrated notes, seems a little high at 72.8%, it helped to improve the ratings for the A and B notes. The appraised values of the six A320s averaged from euro 43.23 million to euro 43.4 million, depending on the delivery date.

Whereas most US EETCs can have terms as long as 25 years, Iberbond has a shorter expected maturity of just eight years to make it appealing to the European investor. Cahill explains that this issue could have gone up to 25 years, but the final term "coincided with the sweet spot of the curve at the point in time of pricing."

The thorny issue of a default situation was handled by including a generous euro 29 million ($31 million) liquidity facility to cover seven successive semi-annual interest payments. By contrast, the liquidity facility in a US EETC typically extends to just 18 months or three semi-annual interest payments. The longer term facility for Iberbond covers the contingency of a long-drawn out court battle for repossession of the aircraft.

Iberia's EETC breaks new ground by denominating the issue in euros, as opposed to the US dollar, which has long dominated global aircraft financings.

It would be near impossible to structure an EETC for an airline in a single European currency, such as sterling, deutschemarks or French francs, but Cahill believes the euro has the critical mass and is quickly becoming a *de facto* world currency.

From Iberia's vantage point, the EETC offers two major benefits. First, the carrier obtained favourable pricing. Iberia's real rate of interest payable within the lease rentals works out to just 5.25% for the A notes, 5.56% for the B notes and 5.90% for the C notes at a fixed rate – well below current market rates.

Second, a next future issue can be replicated quickly and at a lower cost than the first issue. Given Iberia's future aircraft commitments it will likely repeat the EETC structure at some point. Over the next four years the carrier has an aggressive delivery timetable comprised of 39 firm orders (25 A320s and 14 A321s) and 92 options, requiring $4.5 billion of new investment. Iberia is also taking another five A340-300s, seven A320s, nine A319s on operating leases, plus eight more 757s.

Cahill predicts that the non-US EETC market, and in particular Europe, could ultimately be bigger than the US market. Based on appraised aircraft values, US carriers have financed more than $14 billion worth of aircraft in the past five years.

Expectations that airlines, such as Lufthansa and British Airways, will be seeking a debut on the EETC market are probably premature, cautions Cahill, since these carriers can borrow at rates well below the cost of an EETC financing. He suggests that EETC will be attractive to many of the newer entrant airlines in Europe that will be looking to access other sources of funding for aircraft acquisitions.

FSC ruled illegal

Last month the World Trade Organisation (WTO) published its ruling declaring the US Foreign Sales Corps (FSC) aircraft financing structure an illegal subsidy. This decision upholds a complaint brought earlier in the year by the European Union which claimed that the FSC violates WTO trade guidelines.

Simply put, FSCs are a tax incentive for US exporters, whether they sell commercial aircraft or computers. In the

Iberia has completed the first use by a European airline of the EETC financing structure. This facility was for the financing of six A320s, with average values of Euro 24 million each. Predictions are the non-US EETC market could be bigger than that in the US.

A merger of Canada's two major airlines would result in capacity rationalisation in major markets, including the trans-Atlantic.

case of aircraft sales a corporation is created in a foreign country or in a US possession, such as Bermuda, to obtain a US tax exemption on a portion of its earnings generated by the sale or lease abroad of a US manufactured aircraft. At the last count in 1997 there were more than 5,000 established FSCs.

The tax benefits of the FSC are then passed on to the airline lessee in a reduced net present value. Just about every major international carrier at one time or another has incorporated FSC benefits in a cross-border lease of Boeing aircraft.

In Boeing's last annual report (1998) it showed that aircraft sales benefitted from a $130 million FSC tax benefit. In previous years, the tax benefits were $79 million in 1997 and $110 million in 1996.

According to Philip Spector of Watson, Farley & Williams, the "level of FSC activity (for aircraft deals) has perked up quite a bit this year." Spector says that the current furore over the ruling has not dampened enthusiasm for aircraft FSC leases. He knows of at least three different airlines that have recently closed on new widebody transactions.

Spector is not persuaded that FSCs will disappear tomorrow. The FSC programme is part of US tax law and as such will require an act of Congress to declare it null and void. Even the WTO recognises this and in its ruling suggests that the withdrawal of the US FSC programme, if enacted without delay, would be unlikely to take effect before 1 October, 2000.

Candian merger

The alarm bells are ringing in Canada about a prospective airline merger between Air Canada and Canadian that will have ramifications globally. For over 10 years the airline industry has been structurally flawed because of intense competition between Air Canada and Canadian. The latter has suffered intense competition on all fronts, including:

- No-frills carrier Westjet starting services out of Canadian's home city Calgary
- Canadian not being able to match Air Canada on a domestic level and in the trans-border market to the US.

If it were not for the evolution of code-sharing and the help of American Airlines as service provider, financial investor and yield manager, Canadian would long ago have felt the financial pressure to change its operation.

Air Canada and Canadian have been unable to work out a deal between themselves because of pressure from the One World and Star Alliance groups.

In the most recent flurry of activity American stated that it would forgo any ownership rights in the new proposed merged carrier under the original offer, backtracking its role to simply that of a code-share partner. However, it has not necessarily given up its right to contract Sabre services.

Such a move indicates how code-sharing/revenue-sharing has gained an absolute foothold in global marketing and how ownership has become secondary. Ownership of part of an airline means nothing these days. Maybe American should give up its code-sharing rights, but, then again, by doing so it would forgo US$ millions in lost marginal revenue.

If the AA/Onex/CP deal to buy Air Canada proceeds there will be no competition on any route between Canada and the UK through a quadrilateral marketing agreement between Air Canada, Canadian, BA and AA in the One World group. This could be the first phase in trans-Atlantic capacity rationalisation. This would also provide an opportunity to fine-tune yields and marginalise capacity. The same scenario could occur on the trans-Pacific market to Hong Kong, where Cathay Pacific would be the only carrier in operation.

This merger deal in Canada is being influenced stongly by marketing alliances. Air Canada has suggested a poison pill strategy if the AA/Onex/CP deal proceeds. In effect, it will have to divest its interest in Star Alliance by paying a $250 million penalty.

This paints an interesting picture: there is no cross-equity participation in the Star Alliance group, but if you wish to leave you must pay to do so. Thus, membership has an interesting price. Could it be the value of interlined code-sharing traffic has been calculated at the exit clause price? If so, are shareholders of either deal getting the true value of the proposed deal? Are the valuations taking into account the potential capitalisation in revenue sharing between alliance partners in the long term?

Governments and shareholders have failed to understand what is happening here. The airline business is complicated by many external factors. Marketing alliances are placing influences on a deal that needs common sense brought back into the equation. After all, what kind of promise has the chief executive of Onex made to Canadians, agreeing not to raise fares for five years? If revenue management systems are so complex, do shareholders and Canadians actually understand the implication of this statement?

If airlines could not figure out how to rationalise their own business and the government has failed to heed the wake-up call, are shareholders about to decide the airlines' fate? Do they really have enough knowledge about what the long-term effects are going to have in Canada and how it will affect alliances? AC