The options majors airlines have for financing new aircraft is well documented. Jim Smith discusses the more limited options available to the world's other carriers.

Finance options for non-major airlines

Some airlines clearly have an easier time financing aircraft than other operators, and for good reasons. The top two dozen or so airlines, ranked by revenue, represent about 75% of the operating profitability of the industry. These same carriers, however, represent a far smaller percentage of the aircraft order book for the world's airlines.

The largest carriers have tremendous market power with respect to borrowing. After all, these airlines are flush with cash. They are courted by a plethora of lenders and have the easiest time obtaining financing.

The less well financially-endowed carriers scramble for the scraps. To paraphrase an old saw, those carriers which will have the easiest time borrowing money are those that do not need it.

Major airlines in west Europe and the US have the greatest variety of choices in financing aircraft. They also have the option of acquiring aircraft from first-tier operating lessors.

Export Credit schemes

Among the choices are export credit agency-supported debt, the capital markets, tax and operating leases and a variety of bank products.

Probably the most looked-at factor in assessing whether an airline will obtain financing and good pricing for it, in addition to overall creditworthiness, is the ability of lenders and lessors to repossess aircraft in the event of default. A European Credit Agency (ECA) guarantee for Airbus and Boeing deliveries also guarantees lower pricing, since the manufacturer's government provides an implicit guarantee on the debt.

The US Export-Import Bank (Eximbank) and European export credit agencies, Coface in France, Hermes in German, and the UK's Export Credit Guarantee Department (ECGD), offer financial support for the export of new and used commercial aircraft under direct loan, guarantee, and insurance programmes.

It is big business. Eximbank, for example, devotes about half its resources to commercial aircraft, mostly Boeing, while ECGD commits roughly 21% for mostly Airbus deals.

Brazil and Canada, through their ECAs, Proex and Export Development Corp, provide support for export of regional aircraft. These programmes are currently under fire, and the World Trade Organisation (WTO) has ruled Proex illegal.

The terms and conditions of Eximbank's aircraft programmes are governed by the OECD Sector Understanding on Export Credits for Civil Aircraft, which also governs programmes offered by European ECAs.

The mechanism is basically the same amongst major ECAs. For example, Eximbank typically provides guaranteed loans that have been extended by a financial institution to either directly the borrower, or to facilitate a finance lease.

Used aircraft are considered on a case-by-case basis, with terms and conditions differing substantially from new aircraft. Repayment terms are shorter than for comparable new aircraft.

New large commercial aircraft, which generally have more than 70 seats, are typically financed through an asset-based finance lease structure. The credit decision rests on the creditworthiness of the airline, lessee or the guarantor, plus the additional security provided by the financed aircraft. As stipulated by the OECD, Eximbank offers up to 12-year repayment terms. Repayment may be structured as either a level principal or mortgage-style amortisation. In all cases, the agency reserves the right to make the final determination on the profile of the debt repayment schedule.

The maximum financed amount equals 85% of the US contract price net of all manufacturer credit memoranda. The financed amount may be reduced in cases where the risks are considered significant.

Eximbank assesses an exposure fee for each transaction. The exposure fee charged on a particular transaction reflects Eximbank's assessment of the creditworthiness of the borrower or guarantor and the risks presented by the transaction. The exposure fee may be included in the financed amount supported by the agency.

Eximbank's minimum exposure fee for new large aircraft transactions is 3%. Transactions that present particularly high risks may be assessed by an exposure fee larger than the minimum.

General aviation and used large commercial aircraft will be charged exposure fees according to the bank's

The world's largest airlines have a plethora of financing techniques available to them. This includes tax & finance leases, export credit guarantees, capital markets, operating leases, commercial debt and a variety of other products. Smaller and financially weaker airlines in all parts of the world have limited financing options, and each has to be carefully researched.

general fee system. The interest rate on Eximbank's direct loans is set according to the OECD sector understanding, which utilizes the 10-year US Treasury bond yield plus a margin.

Eximbank also charges a commitment fee of 0.125% on the un-utilised amount for a guaranteed loan and 0.50% for a direct loan. Commitment fees may not be financed under the Eximbank supported loan.

On the European side, UK export credit agency ECGD recently reduced rates on aircraft finance to 35 basis points (bp) from 45bp, with deals over $250 million enjoying a margin of 25bp. The pricing reflects lack of comparable risk of default in the aircraft sector when compared to other sectors.

The common thread running through ECA transactions is that buyers still have to be good credits, either on their own standing or because of sovereign guarantees from an airline's host government.

For example, the 85% Eximbank portion for state-controlled Air China, which includes financing of two 777-200s, was arranged and retained by Barclays Bank, with no syndication planned by the bank. The fact that Barclays will syndicate about $340 million of a total deal amount of about $400 million, along with the give-away pricing of the deal, reflects the comfort Barclays feels with the credit.

Barclays won the highly-contested deal at Libor flat with a commitment fee to the bank of about 30bp. The 15% commercial portion of the bank, the amount not guaranteed by Eximbank, is denominated in Chinese Yuan, and will be guaranteed by China Construction Bank. The pricing on the deal also mirrors intense competition amongst banks for limited deliveries into China.

Barclays also recently served as lender for a sovereign-guaranteed $66 million loan for Azerbaijan Airlines, which featured a separate guarantee from the International Bank of Azerbaijan, and also is secured by a first-priority security interest in the airframes and engines.

Eximbank is also providing a $503 million loan guarantee to support the $584 million purchase of four 777-300 airframes and one 747-400 aircraft to Thai Airways. Financing for the 777's engines is also supported by Eximbank's British counterpart Export Credits Guarantee Department (ECGD). The guaranteed lender on the transaction is Barclays Bank.

The Thai government owns 93% of the national airline. These transactions are representative of the types of government-supported or overcollateralised ECA-supported deals.

Since the beginning of this year, ECA support for Airbus and Boeing has been given only to well-heeled operators such as Air Canada, Flightlease, Thai, China Air and SALE.

The same can be said for US Foreign Sales Corp (FSC) deals, applicable only to US-made aircraft and good credit, such as an Air France 777-200ER recently syndicated by CIC to two German banks, priced at Libor plus 60.

EETCs for everyone

Bond financing in the form of enhanced equipment trust certificates (EETCs) is the way of the future, at least for airlines operating in jurisdictions where aircraft can legally be repossessed by owners and lessors in a reasonable amount of time.

It is generally cheaper than traditional unsecured corporate debt, and focuses on the value of the collateral for repayment rather than the airline. The creditworthiness of the airline still figures into the rating models of all ratings agencies. US deals generally include an 18-month liquidity facility that pays lenders interest on their debt for that period in the event of default and until assets are liquidated.

US airlines are finding EETC financing a cheap alternative to syndicated debt and leveraged lease financing. Wall Street is exporting the structure with varying degrees of success. In the six-year period since the first deal was closed, EETCs have changed dramatically. Initially, manufacturers were the primary liquidity providers.

Now commercial banks and financing institutions have filled that role. Size of deals have shrunk drastically as the costs associated with structuring EETCs have come down and the number of players in the investor pool has increased.

A new ways of supporting the proliferation of EETCs is the pre-funded transaction. This allows aircraft delivery up to a year after the EETC closes. Proceeds, or raided funds, are held by a

Iberia's EETC transaction was the first non-US airline to complete a true EETC. The transaction was unique in that it was Euro denominated, had an extended liquidity facility, and was not rated by an agency.

depositary, which pays interest on the escrowed amount at the same rate.

Deals are now being led by banks other than traditional underwriters CS First Boston and Morgan Stanley. Major US carriers financing aircraft have been joined by regional jet operators and wet lessors as issuers. Until December 31, 1998, EETCs were the exclusive province of US operators. But Wall Street continues to make EETCs more attractive for a variety of operators.

Not confined to passenger carriers, in January, US-based wet lessor Atlas Air placed approximately $217 million in EETCs, which will provide permanent, long-term financing for two new 747-400Fs, for which permanent financing had not been arranged.

The airline's EETC financing completed last year included the other new 747-400F. Placement agents for the transaction were Morgan Stanley, Deutsche Bank and Salomon Smith Barney. An Atlas news release maintained that 'blended financing for the year's deliveries will be about 8.5%, despite an environment of rising interest rates.

Indeed, this year's spread level represents substantial improvement over our prior EETC financings'. Last April, Atlas placed $543 million in EETCs as long-term financing for four 747-400Fs scheduled for delivery during 1999 plus one 2000 delivery. Placement agents on that deal were Morgan Stanley, BT Alex Brown, CIBC and ING Barings. Pricing was an all-in interest rate of 7.5%.

This summer, Morgan Stanley will take Spain's national flag carrier Iberia to the bond market for the second time, this time for a $500 million to $600 million, euro-denominated EETC offering.

Spain is arguably one of Europe's more difficult bankruptcy jurisdictions. Morgan Stanley unseated Deutsche Bank, which ran the first deal, valued at about $195 million. That deal also was euro-denominated and provided financing for six A320 narrowbody aircraft, which began to deliver in August and continued through December.

To make the Iberia deal attractive to investors, Deutsche Bank included a KfW-supplied 42-month liquidity. The term of the liquidity facility on the upcoming EETC is currently undetermined.

Also, Standard & Poor's refused to provide a rating for the first issue and probably will not rate the next one. S&P is concerned with a perceived mismatch between euro-denominated debt and dollar-denominated asset residual value. The absence of S&P is expected to cause Iberia to pay a premium of at least 25bp on each tranche.

The Iberia deal represented the first EETC done for a non-US airline. Qantas also launched a deal which appeared similar to a EETC ,and was backed by existing loans on Qantas aircraft.

Collateral was two recently-refurbished 747-400s manufactured in 1989 and coming out of the liquidated Sanwa portfolio. The Bankers Trust deal for Qantas was rated by S&P and Fitch, and featured a 24-month liquidity.

The Iberia deal also differs from a typical US airline transaction in that the Spanish carrier, like most non-US carriers, has only a shadow rating. That is, credit ratings agencies have not been hired to develop a formal corporate debt rating.

Some European airlines are reluctant to have ratings assigned due to fear of adverse shareholder reaction.

Salomon Smith Barney abandoned the idea of leading a EETC deal for struggling Korean Air. Chase Manhattan also bailed out of a proposed EETC to refinance six 737s purchased by China Airlines in 1999 for cash. Also in 1999, Salvadoran carrier Taca started discussions with ratings agencies aimed at a EETC issue for the carrier's US-registered aircraft. That deal is no longer a priority for Taca. According to most investment bankers, however, it is only a matter of time before the use of EETCs spreads.

Operating leases

Airlines traditionally finance their aircraft either on balance sheet with the use of non-aircraft related debt finance, via finance leases, or on an operating lease basis.

In 1998, about 40% of aircraft built after 1985 were owned, 40% were on capital leases and the remaining 20% were supplied to airlines on operating leases.

The industry standard for aircraft on operating leases ranges from 1% of capital cost per month for younger aircraft to proportionately higher rates for older aircraft.

Recent data from Moody's Investors Service indicates that 50% of the world's fleet has remained in operation beyond an age of 25 years without conversion to freighter.

The uninflated residual value of aircraft at 25 years old averaged 15%, Moody's said. According to a New York-based airfinance banker, 'The key to operating a successful down-market leasing operation is to purchase the cheapest aircraft you can, not necessarily the best match for a particular market, but the cheapest. Lease those planes at the highest rates possible to airlines with limited options. If one-in-four lessees defaults, or even breaks down beyond economical repair, you have still made money'.

Alternatives

The curtailment of major tax-based leasing structures for aircraft finance, particularly the Japanese leveraged lease, which financed one-third of all aircraft delivered over the past decade, valued at about $50 billion, as well as the important German leveraged lease, has not affected third world and start-up carriers. For highly creditworthy names, the syndicated loan market has unlimited liquidity. In addition, a few Japanese operating leases (JOLs) have recently closed for Boeing aircraft being flown by European airlines, with the manufacturer assuming the residual value risk.

For improving credits, there also is ample liquidity. For more troubled credits, including thinly-capitalised regional airlines and new leasing companies and airlines, raising funding will continue to be arduous.

ECA support for airlines in developing regions is almost non-existent. For example, from 1996 to 1999, US Eximbank support for aircraft exports to Asia/Australia represented 58% of guarantees. The Middle East accounted for 18% and Europe 10%. Over the same period, Africa represented 6%, Russia/CIS, 5%; and Central and South America 3%.

Even start-ups such as New York-based Jet Blue, which began with $130 million in backing from investor George Soros and Chase Capital, will have to tap the straight mortgage market for this year's deliveries of six A320s. Pricing on the deal is expected to be about Libor plus 200bp, with US banks staying away from the deal which will feature only European banks.

Operating lessors provide much of the capacity for airlines operating in the developing world. However, these leasing companies are not homogeneous in their strategies. Larger lessors, such as International Lease Financing Corp (ILFC) and General Electric Capital Aviation Services (Gecas), court established carriers seeking either short-term lift or the flexibility to replace aircraft quickly.

The same is true of Airbus and Boeing, with the latter stepping up its activities in the leasing business.

Troubled Greek carrier Olympic Airways will lease four 737-800s from Gecas at an estimated $330,000 per month each for an asset with a market value in the neighbourhood of $38 million.

Other lessors, such as Pegasus Aviation and International Aircraft Investors (IAI), serve carriers that have limited access to the bank or capital markets. But the business is risky in spite of the margins. IAI was recently forced to repossess a 737-300 from Mexico's third-largest carrier Taesa, after the airline was unable to climb out from under $400 million in debt coupled with the crash of a DC-9 aircraft in western Mexico in November.

A 10-year old 737-300 is valued at about $18 million and fetches about $200,000 per month in rental. Brazil's third largest airline, Vasp, recently returned four MD-11s to Mitsui subsidiary Tombo Aviation. A seven-year old MD-11 has a current market value of about $60-62 million, with a monthly rental rate of about $600,000.

Kenya Airways has acquired an ex-Emirates A310-300 from Airbus Asset Management on a 15-month lease. That plane has an estimated value of $25 million, and an estimated monthly rental cost of $265,000. The aircraft will effectively replace capacity lost in the airline's January 2000 crash of an A310-300 aircraft.

The ex-Emirates A310 will be operated until Kenya Airways expects to have received three new 767-300ERs from Gecas.

In 1999 the US Eximbank guaranteed Kenya Airways a loan for a 737-300. That transaction brought to four the number of Boeing aircraft sales to Kenya Airways financed by the agency, totalling about $100 million. The financing was structured as an asset-based full payout lease with the aircraft serving as collateral. Guaranteed lender was PEFCO (Private Export Funding Corp).

Air Malawi has begun a last-ditch effort to stave off bankruptcy by entering into a revenue-sharing partnership with South African Airways and Kenya Airways. The struggling carrier also has been seeking to partially privatise itself, and has asked the World Bank for a bridge loan to restructure and replace its ageing fleet in the absence of interest from the commercial banking sector.

In 1999, Eximbank provided $186 million in guarantees to finance the $212 million acquisition by South African Airways (SAA) of two 747-400s. The guarantees cover two separate $93 million long-term loans, one provided by Citibank and the other provided by NationsBank. SAA is a partially privatised subsidiary of the government-owned Transnet Ltd. The transaction is guaranteed by Transnet and structured as a conditional sale with the aircraft serving as collateral.

Also last year, Eximbank supported a $114 million loan for government-owned Air Namibia to acquire a 747-400 from Boeing. Eximbank is backing $99 million of the sovereign-guaranteed loan made by Citibank. The transaction is structured as a 12-year full payout finance lease with the aircraft also serving as collateral.

While the Eximbank and the UK's ECGD have both committed to assist sub-Saharan Africa's airlines, the commercial banking sector has remained removed from deals in the region. The dearth of aircraft financing in the region means that African airlines will continue to acquire the majority of their aircraft from operating lessors.

Most tax based transactions have now disappeared, and major airlines are having to develop new ways of completing large financings of several $100 million. Operating leasing has grown in popularity, but this is not ideal for large aircraft acquired for use of more than 20 years by big ticket airlines.