High credit risk airlines are increasingly finding it easier to finance new aircraft. Until a few years ago few of these carriers could get debt or finance leases for new aircraft, and relied on export credits. Operating lease rates have now fallen so far that many airlines are able to finance new aircraft at rates similar to those achieved by the major carriers.

Weak credit carriers bypass used market for new aircraft

Financing aircraft for weak credit airlines is now easier than it ever has been, mainly because of the low lease rates that some lessors are able and prepared to offer airlines. Weak credit airlines are those with few choices for aircraft acquisition financing. There are several methods they can use to acquire aircraft, but these are more limited than the options available to major carriers.

Weak credits

Weak credit airlines generally those with weak balance sheets. This limits or prevents their ability to raise debt to self-finance aircraft, which is why banks will be averse to arranging finance lease structures for these airlines.

Assessment of an airline's creditworthiness is subjective. Some banks and lessors regard certain major US and flag carriers as high risk, while others view the same operators as low or acceptable risk. These airlines form the middle ground between those with high credit ratings and the weakest finances.

Airlines with the weakest finances will have few or no cash resources with which to purchase aircraft. The weakness of these airlines' balance sheets and cash reserves means they are generally viewed as being likely to default on leases, leaving debt providers or legal owners with the costs of repossession and the risk of financial loss. These losses can amount to several million dollars for a single aircraft in several months of lost lease rentals, mounting and unpaid maintenance charges and repossession and re-marketing costs.

Many airlines viewed to have these attributes are generally those in Central and South America, Africa, Eastern Europe and parts of the Asia Pacific. High-risk airlines in the Asia Pacific include some in Indonesia, China and India.

There are also some niche operators in Western Europe and North America, such as small freight airlines, which have low funding and low revenue streams.

Airlines regarded as risky are also those entering into markets for the first time in competition with established long-term incumbent carriers. These new entrants may be established in other markets, but will be high-risk operators in their new ventures. Virgin Atlantic, for example, was regarded as a high-risk airline when it first started operations in the mid 1980s.

Other airlines regarded as high risk are ad-hoc charter operators and all-new entrants. This applies especially to those that lack parent companies with large cash reserves. Ryanair, for example, was not regarded as a high-risk airline when it first stated operations. Similar start-up airlines in Europe operating similar types of aircraft would not have the same creditworthiness and would probably have to pay monthly lease rentals as much as $100,000 higher.

Financing options

The implications of high risk and weak credit are that airlines will have to use financing techniques which rely on the balance sheet strength of external finance providers, transferring the risk from the airline.

The techniques available to weak credit airlines generally fall into two or three categories. "First, the definition of weak credit has to be examined," says Domhnal Slattery, chief executive at Lombard Aviation Capital. "If airlines are in the market to acquire new aircraft and have ordered the equipment themselves the manufacturers will have taken a view on the carrier's capability finance the aircraft. If the airline is strategically important to the manufacturer it will provide back-stop financing if the airline is unable to get financing from any other methods."

Airlines must resort to other methods if they do not have the capability to self-finance. The first is operating leasing, which relies simply on the lessee paying monthly lease rentals. The lessee is therefore not required to invest equity. Lease rental payments rely only the airline's cashflow. This does not weaken the airline's balance sheet by adding the burden of debt and consuming cash for equity investment, as would be the case with some finance lease or debt financing structures.

The second method involves the use of export credits in conjunction with financing structures used by higher credit airlines. These are US, UK, French and German government guarantees used in finance leases and debt structures, which guarantee the debt. These guarantees are generally provided for airlines viewed to be deserving cases. Should the lessee default, the export credit guarantee covers any outstanding debt not

The large lessors have such low rates of internal funding and price discounts that they are able to offer any airline, almost irrespective of credit risk, aircraft at rates close to which high credit carriers can finance equipment. This has allowed weaker credit carriers to acquire the latest technology aircraft and benefit from their operational efficiencies.

recovered by the re-sale or re-lease of the aircraft.

There are restrictions on the use of export credits. This includes a limit on the annual amount of export credits that each government is willing to provide each year. Other limitations are the financing terms over which export credits can be used.

Operating leasing

Operating leasing is used for airlines that have other financing options, but require some off-balance sheet transactions. It is also used by weaker credit carriers that cannot self-finance aircraft. "Some of these airlines are known not to have the capability to finance aircraft, and get lessors to purchase the aircraft for them and then lease the aircraft to them," explains Slattery. "Airlines without an ability to self-finance can also order the aircraft and get the lessors to buy the aircraft and lease them back. The manufacturers are aware of the deals between the airlines and lessors. The manufacturers are happy about these deals, since it helps sell aircraft. GECAS was the market maker in this type of transaction, and has been followed by other major lessors."

The increased use of operating leasing is explained by the fall in interest rates over the past decade and lower cost of funds that many large lessors have. These lessors became acquired by large and financially strong parent companies. They have been able to lower their cost of funding by several percentage points. "Costs of lessors' funds have dropped sharply. Six-month Libor has dropped by 200 basis points in the past eight months alone," says Slattery. "Because many lessors are now self-financing they are able to offer airlines cheaper rates of financing than they would be able to achieve themselves."

Lease rate factors on operating leases have in turn fallen by as much as 50 basis points over the past decade. This is further aided by the high purchase discounts these lessors are able to attain.

The overall effect has been for the lease rates of new generation 737s to be more than $100,000 lower per month than the previous generation aircraft 10 years ago.

Historically, many secondary airlines in Central and South America, Africa and the Asia Pacific only had the option of getting the oldest aircraft on operating lease from specialist lessors. An example is International Air Leases. The lease rate factors for these deals were typically in the region of 2.5-3.5% of capital cost per month. Airlines taking aircraft under these deals would be second and third tier passenger and freight operators. The aircraft types most commonly acquired under these deals were DC-8s, 707s, 727s and some early DC-9s and 737-200s.

Lessors will typically invest 15% equity, but this level would have to be higher, or even 100%, in the case of old aircraft being leased to airlines with the weakest finances. Many of the aircraft types above can be acquired for a maximum of $3 million. Lessors would take high risks in terms of the lessees they leased aircraft to. The lease rate factors were high enough, however, for a 100% equity investment to be paid off in a few years. An aircraft acquired for $2 million with a lease rate factor of 2.5% would have a lease rate of $50,000. The investment would be paid off in 49 months with a 10% annual return on a 100% equity investment. If a lessee defaulted after 20 months, the lessor would still have a good chance of re-leasing the aircraft and paying off its investment within five years.

This is, in fact, a conservative example, since 737-200s acquired in recent years for about $2 million have been leased out at rates in the region of $85,000 per month. A target of a 10% annual return on a 100% equity investment would require just 27 months of lease rentals. Lease rentals for the remaining term and from another lease would provide pure profit until the aircraft was unable to continue in operation.

Even though the lessees are regarded as high risk, specialist lessors have had the market left to them, since other financiers have not been prepared to do business with these weak credit airlines. This has allowed specialist lessors to charge high lease rate factors on equipment that had few or no other market prospects.

While specialist lessors provide aircraft to the weakest airlines, operating lessors with younger or new equipment have charged lease rate factors in the region of 1.1-2.0% per month for aircraft. These are new and mid-life aircraft, with high market acceptance. Examples of mid-life aircraft are passenger aircraft converted to freighters on their first lease. The market values and lease rate factors for these types have been too high for weaker credit airlines.

Financing of old equipment by specialist lessors to third tier airlines required high equity investment. In return the lessors charge high lease rate factors, take high risks and make high returns.

Lessors with mid-life aircraft converted to freighters would be looking for lessees with reasonable credits. Thus, the A300B4, A310 and DC-10 converted freighters would still only be leased to first or second tier freight operators. Lease rate factors would be in the region of 1.5%.

Similar lease rate factors would be charged for mid-life passenger aircraft. For example, younger 737-200s command lease rates in the region of \$100,000 per month, and MD-80s in the region of \$150,000 per month. Until recently, younger 737-300s have been able to command rates in the region of \$300,000-350,000. These rates are higher than those charged by lessors leasing older aircraft of a similar size to the weakest credit carriers.

New equipment

Until three to four years ago, medium credit quality airlines leasing mid-life aircraft at rates in the region of 1.3-1.5% per month were not been able to afford or acquire new equipment. Lease rate factors for new aircraft were 1.0-1.2% per month, depending on credit quality. A new 737-700, for example, would have a monthly rental of \$400,000 or more. These could only be afforded by first tier and high credit quality airlines. This includes major US airlines and Western European and other senior flag carriers.

Historical lease rate factors have therefore made a clear three-tier sub-division of airline credits and lease rate factors. New aircraft with the highest capital costs have been leased to the highest credit quality airlines at lease rates factors of 1.0-1.2%. As these aircraft are returned after 12-15 years by these airlines they have been leased to second tier operators at rates of 1.2-1.5%, and, in extreme cases, up to 2% per month. The oldest aircraft are then leased at rates exceeding 2.5% per month.

Although the lease rate factors increase with age, the actual dollar lease rates have fallen compared to those for younger aircraft of a similar size. The oldest 737-200s have been leased at about \$85,000 per month, mid-life aircraft at \$100,000-200, depending on age, and new similar sized aircraft at \$250,000 and above.

This three-tier structure has been distorted in recent years by the fall in lease rates that major lessors are able to offer airlines for new aircraft. Lease rate factors for new aircraft have dropped below 1% to as low as 0.7%. In some cases 737-700s are now being offered to airlines for as little as \$250,000 per month. Some airlines are being offered aircraft at even lower rates. The major lessors not only have low cost of funds, in the region of 3-4%, but also get substantial price discounts. Lessors now account for more than 20% of Airbus and Boeing orders.

This has caused problems for lessors of older aircraft, since the rates for new aircraft have fallen below similar sized types 10 years younger. For example, rates for a 737-300 were steady in the region of \$350,000.

Not only have rates come under pressure, but the large lessors, particularly ILFC and GECAS, are prepared to offer aircraft at these rates to airlines irrespective of their creditworthiness. This is previously unheard of. Airlines in South America and Africa, for example, are able for the first time to acquire new, latest technology aircraft. In many cases this is at knock-down rates.

Indeed, the majority of the mega lessors' customers are weaker credit airlines, rather than blue-chip airlines. ILFC's customers include TACV of Cabo Verde, Lotus of Egypt, Yemenia, several Chinese operators, Garuda Indonesia, Sahara Airlines of Indonesia and Air Alfa from Turkey. The majority of the equipment leased to these airlines was built after 1994.

The advantages of these new aircraft are maintenance honeymoons, lower fuel burn and reduced cash operating costs. Many weak credit airlines have not previously benefitted from low finance charges and the operating efficiency of new equipment.

The low lease rates of new equipment have pushed down lease rates and market values of older aircraft. This has caused a trickle-down effect right through the aircraft re-marketing and retirement chain.

A lease rate of \$250,000 per month for a new 737-700 puts a lot of pressure on lessors that have been able to command rates of \$150,000 per month for younger 737-200s. At one time weak credit airlines provided the market for used mid-life and old aircraft. This is now being changed by the mega lessors providing new aircraft at low lease rates.

Many weak credit airlines are now bypassing the used aircraft market and going straight to the front of the queue for new equipment. The low lease rates on offer from mega lessors to a wider variety of airlines means the differential in lease rate factors between strong and weak credit airlines is reduced.

While rates for older types will have to bend to market conditions, the inevitable consequence has been a large retirement of older aircraft. The rate of

The provision of low-cost financing by mega lessors to a larger number of high credit risk airlines has distorted the traditional trickle-down process of used aircraft being marketed to second- and then third-tier airlines at progressively higher lease rate factors. Many second- and third- tier carriers are now acquiring new equipment for the first time. This has put a lot of downward pressure on used aircraft values and lease rates.

retirement in recent months has been unsurpassed, and the number of aircraft parked has reached about 1,400 units.

While specialist mega and lessors do business with weak credit airlines, some lessors are unable to get debt financing to do business with weak credit airlines or compete with lessors that have lower costs of funds.

While weak credit airlines benefit from not having to invest equity in aircraft and transferring the risk to lessors, the lessors have to protect themselves from lessee defaults. Items such as 3-6 month lease rental security deposits, political risk and repossession insurance, and maintenance reserves are standard.

Export credits

While lessors are prepared to lease aircraft to secondary airlines, flag and first tier carriers with weak finances also often use export credits.

Export credits have essentially been used by the governments of the US, UK, France and Germany to aid the selling of more Airbus and Boeing aircraft by providing government guaranteed debt.

Export credits typically cover 85% of the financing. The remaining 15% has to be provided by banks without a guarantee. Export credits are therefore used where debt is otherwise hard or impossible to raise because of the credit risk of the end user. Without export credits, new aircraft could not be financed for a large number of airlines.

"Export credit agencies will guarantee the majority of debt, but banks have to put in a percentage that is not guaranteed. Banks are willing to take a risk with weak credits to some level," explains Paul Newrick, chief operating officer at XS Aviation. "In the event of a default, banks providing the un-guaranteed finances are usually the first to lose and so carry the highest risk tranche. More recently, banks and export credit agencies have been more willing to share the risk. That is, export credit agencies have become more flexible to aid the sale of more aircraft."

Export credits can be applied to straight debt financing and finance lease structures. This does not mean export credits are unlimited and can be used in any circumstances. "Export credits have strict guidelines regarding their application," explains Ian Hosier, global head of transportation at IntesaBci. "These are known as the large aircraft sector understanding (Lasu). The term for export credits cannot be longer than 12 years and full repayment of debt has to be made in this time. Interest rates used are calculated to an established formula. There is some flexibility to their use. The agencies, the Exim Bank in the US, Coface in France and Hermes in Germany can determine what they charge for the guarantees. There are, however, fairly tight rules regarding their application. The strict guidelines of 12 years and full repayment means it can be difficult to attach export credits to tax lease structures."

Examples of this are US tax leases, which have terms of more than 12 years. The Japanese Leverage Lease (JLL) is not longer than 12 years, but debt repayment under the structure is longer than 12 years, which optimises the technique. Hosier explains that the requirement to fully repay the debt with an export credit within 12 years means the JLL is not so optimised . The strict guidelines of Lasu can sometimes mean it is impossible to complete a financing structure with an export credit.

There are other guidelines in addition to Lasu. "These are agreements made by the four export credit providers. They include that the export credits will not be allowed for aircraft manufactured in one of the providing nations to be used by a lessee in another export credit providing country. This is because lessees in these countries are not regarded as deserving cases. "The German export credit agency has also stated that export credits cannot be applied to a German Tax Lease," says Hosier.

There have been occasions where these guidelines have been circumvented. This is commonly achieved by structures which use a 'dog leg' approach. Aircraft manufactured in one of the European countries, for example, have been financed with export credits for a lessor in Ireland. The aircraft have then subsequently been leased to lessees in the US. To achieve this the intermediary has to be justifiable. That is, it has to be an airline or lessor, rather than a company set up for the sole purpose of making use of tax benefits.

Each export credit provider has ceilings in the amount of export credits it is able to provide each country, and also a limit on the amount it is willing to provide each industry sector.