Operating leasing has grown to account for 22% of the western jet fleet. This portion is expected to be higher than 30% in ten years. While many of the factors that stimulated the growth in operating leasing remain in place, many lessors have half of their portfolios at risk.

The growing importance of operating leasing

Operating leasing has changed in the past 10 years from a financing mechanism used almost exclusively by airlines without alternatives for acquiring aircraft, to one that accounts for a large portion of aircraft acquisitions by many of the world's major airlines.

The aircraft on operating lease is now about 3,000, equal to 22% of the world's fleet on 14,700 western jetliners. In 1981 less than 5% of the world's jetliner fleet were on operating leases, and 10 years ago about 2,000 aircraft were financed in the same way. Since the last major recession of 1991, world interest rates have dropped to a 40-year low and many of the tax benefits that were available through finance leases have been abolished.

This has forced airlines to seek other financing techniques and reduce lease rate factors for many financing mechanisms. This includes operating lease rates. Prior to the terrorist attacks of 11th September 2001, airlines were able to acquire 737-700s at monthly rates in the region of $225,000. This compares to rates of $325,000 ten years ago for a 737-300. Base interest rates in many countries were in the region of 8-15% in 1991, and are now about 4%.

A third major change has been the evolution of operating lessors. All major lessors have been acquired by financially powerful parent companies, and consequently have access to funds at a cost even lower than base rates of conventional debt. Operating lessors have passed this benefit onto lessees in the form of lower lease rentals. This has brought down lease rate factors, triggering the growth in operating leasing. These lower rates have made new and younger aircraft more competitive against older aircraft types, which have traditionally been leased to weaker credit carriers. Lease rate factors of 2-3% per month for 737-200s, DC-9s and 727-200s have been undermined by lease rates of less than 1% per month for new equipment. Weaker credit airlines have recently begun to take new aircraft for the first time from the mega lessors. This has undermined the 'food chain' of used aircraft, as well as niche lessors, which had cornered the market in leasing older aircraft to weaker credit airlines.

As GECAS explains, operating lease rates are still generally higher than finance lease rates. Airlines are, however, now less interested in taking the risk of owning and disposing of aircraft. Major airlines have also recognised that another benefit of operating leasing is the flexibility it provides to capacity management. Aircraft can be acquired at short-term notice, the residual value risk of aircraft sales is removed and, to a lesser extent, aircraft can also be taken out of the fleet when not required.

As Dick Forsberg, head of strategy at Lombard Aviation Capital explains, operating leases have been virtually unused by major US carriers, but even these operators are now beginning to take advantage of the benefits it offers. Where US majors have used a combination of internal financing from cashflow, finance leases and low cost of funds, they are now using operating leases. Aircraft title is being transferred at delivery to lessors and leased back, thereby releasing the equity airlines have in the aircraft. Airlines can even structure these deals to make an instant profit at title transfer, and the negotiated sale price also means airlines have control over the lease rate.

Expansion

It is generally expected that aircraft on operating leases will continue to increase, but actual predictions vary. The global fleet of western jetliners is expected to increase from 14,700 units to about 32,000 in 2020. The highest predictions are that the amount of aircraft on operating leases by then will reach 40%, but Forsberg thinks that this is too high, and is more likely to be 30%.

Mega lessors have accounted for about one-third of annual Airbus and Boeing orders in recent years, but these manufacturers may feel too exposed to selling too many aircraft each year to lessors that buy the aircraft speculatively.

GECAS's own predictions are that the quantity of aircraft on operating lease will increase to about 30% in 15-20 years. In parallel with the expansion of aircraft on operating leases and lessors being acquired by large and financially powerful parent companies, there has also been consolidation of operating lessors. GECAS and ILFC, the two largest, have a combined fleet of 1,090 aircraft, which is equal to a third of aircraft on operating leases. Each lessor's portfolio is worth about $20 billion.

The third largest fleet is Debis', which has 181 aircraft. Other major lessors are Ansett Worldwide, GATX, Boullioun/SALE and Tyco Capital. These all have jetliner fleets of 100-160 aircraft.

GECAS is owned and internally funded by GE Capital and ILFC is owned and funded by insurer AIG. AIG is now exposed by the terrorist attacks of 11th September, but ILFC also has the option of issuing bonds.

GECAS has about 676 aircraft, the majority of which are Boeing jets. It is the

Lessors have been exposed to the en-masse parkings of certain types. A large number of DC-10s have been parked, and the secondary market for them is likely to remain tight. The same applies to several other older aircraft types.

only major lessor to order large quantities of regional jets and has 150 orders for Embraer, Bombardier and Fairchild regional jets. GECAS owns and manages about 1,200 aircraft, placed with a customer base of more than 200 airlines.

ILFC's fleet is 414 aircraft, 61% of which are Boeing. ILFC focuses on large jetliners, and virtually all its other aircraft are Airbuses.

Debis is owned and funded by Daimler Chrysler, and has absorbed several lessors. It has 181 aircraft.

Ansett Worldwide is owned and funded by Morgan Stanley. Ansett Worldwide has 176 aircraft in its portfolio worth $5 billion, but it is up for sale, so is unlikely to place further orders until its future is clear. The majority of the aircraft in its portfolio are 737s, 747s, 757s, 767s, A300s and A320s. Customers are global, including major US and European flag carriers. Ansett Worldwide also provides aircraft on wet lease, as well as aircraft remarketing and technical support services.

GATX has a portfolio of 118 aircraft, and funds itself by making four- or five-way partnerships with other financial institutions.

Boullioun and SALE are owned and funded by Deutsche Bank and Singapore Airlines. Boullioun/SALE has a fleet of 102 aircraft, which are mainly A320s and 737s, although there are also a few 777s.

Tyco Capital, formerly CIT, was previously a lessor specialising in used aircraft. In recent years it has placed orders for new aircraft, including the A320 family. CIT's portfolio comprises 98 jets, and the recent acquisition by Tyco Capital means it is likely to continue placing orders.

These lessors account for 1,747 of the 3,000 aircraft on operating lease. Many other lessors have small portfolios of aircraft, and also specialise in used types. Examples are Pegasus, Sunrock, International Air Leases and Itochu.

In addition to the top seven lessors, others are emerging in an attempt to take advantage of the expected growth in operating leasing. ING Lease has been acquired by Abbey National, and become IEM. IEM has a portfolio of 20 aircraft, which are mainly A319/20s that have been acquired on sale and leaseback transactions. It has no aircraft on order, but plans to place orders, although the economic state of the business means that this is unlikely to be in the immediate future. IEM has followed other lessors and become owned and internally funded by a financially strong parent.

The Royal Bank of Scotland is Lombard Aviation Capital's parent. Lombard has a business plan to acquire a portfolio of up to 200 aircraft over the next six or seven years, with several billion dollars available. Forsberg adds that lessors are becoming bigger, but he expects no one to ever become as big as GECAS or ILFC.

Recession

Despite the general expectation that there will be a growth in operating leasing, expansion is delayed by lessors dealing with the recession. Mainly because of the terrorist attacks on 11th September, airlines have recently incurred their largest ever financial losses. Several hundred aircraft were parked in the aftermath of the terrorist attacks, although many of these were due for retirement in the following 12-18 months. The largest aircraft type to suffer was the 727-200, but also large numbers of older 737s, DC-9s, DC-10s and 747-400s were parked by airlines in a need to cut capacity drastically.

Airline casualties, which included Swissair, Sabena and Canada 3000, led to about 30 A330s being parked, exposing ILFC to the risk of new aircraft being parked.

A quick analysis of the mega lessors' fleets reveals that they currently all have high exposure. On average, 25% of these lessors' fleets have aircraft that are challenged: DC-10s, A300s, DC-9s, 737-200s, 727s and Fokker 100s. All of these types have highly questionable futures. The market for 727 and DC-10 conversions has diminished and almost disappeared. Another 23% of these lessors' fleets are aircraft types across the board that can be regarded as at risk because of the financial status of their lessors. Another 6% are parked, and so consequently more than 50% of the mega lessors' fleets are currently at risk. This compares to a 5% exposure in a good market environment.

The immediate reaction by airlines to the crisis has been to reduce unit costs, and in particular to renegotiate aircraft financing terms and lease rates with lessors. The basis of an operating lease is to make relatively small margins on lease rentals throughout the lease term, and make the majority of profits on re-sale of the aircraft at the end of the term. A normal risk faced by lessors is that of a minority of lessors defaulting during a lease. This would result in the lessor incurring repossession, maintenance and re-marketing costs, as well as lost lease rentals. To avoid en-masse parkings and defaults by airlines, lessors have had to accept the need for their lessees to renegotiate lease rentals.

Forsberg explains that the typical solution to this is for a lessor to negotiate stepped rentals. That is, they will be prepared to accept a rental of say $200,000 per month for an aircraft that was previously on lease at $300,000. This is preferable to having lessees returning aircraft in large numbers. As demand for additional aircraft from other potential lessees is virtually non-existent, lessors

Although operating leasing has been largely ignored by US majors, some are now transferring title of aircraft to a lessor at delivery and leasing the aircraft back. This allows airlines to release the equity in them, while also having control over the sale price and consequent lease rate.

would incur huge losses and therefore prefer to accept temporarily lower lease rentals. Rentals would then be increased in steps as the industry and lessee recover financially.

In order for the lessors to make the same net present value (NPV) on the transaction, lessors will demand that lease rental step increases go higher than the original rental of $300,000 per month.

These renegotiated lease terms are compounded by the fact that lessors, which had previously placed large orders, have continued to take delivery of aircraft. In some cases this is as many as four or five per month during the ensuing crisis.

Forsberg makes the point that this is relatively easy for lessors to do, in the current environment of base interest rates of 4%, compared to the high interest rates of the recession of the early 1990s. Even if the resulting NPV of the transaction is not as high as it would have been, the lessor incurs a smaller loss compared to the one it would have made had the lessee defaulted. "Lessors are ultimately interested in keeping the aircraft flying," says Forsberg. "It is far worse for a lessor to have assets stuck on the ground. Although renegotiated lease rates are low, they are high enough to continue servicing debt because interest rates are currently so low. Lease rentals can still often be high enough to service debt and lessor's overheads in the interim."

Lessor exposure

In normal market conditions the margins made by lessors from lease rentals are slim, and the lease rental factor that a lessee must pay reflects its credit rating. The principle of a lease is for rentals to service debt, cover lessor's overheads and provide a small margin during the term, and generate the majority of the margin from the re-sale value of the aircraft. This requires good timing for aircraft disposal, as well as good asset management. Poor credit lessees paying high rentals can therefore generate high profits for the lessor during the lease term, although there is a greater risk of default.

Strong credit lessees get such low lease rentals that profits during the term are almost non-existent. Lufthansa, for example, has continuously been able to get financing at 30 basis points, and these low rates have even resulted in problems for debt providers. Aircraft leased to high credit carriers have a higher prospect of strong re-sale value, because of the carrier's reputation for high quality maintenance.

Lessors will assume that a quarter or a fifth of their lessees will default, with the lessors incurring high maintenance and repossession costs. "It actually works out costing less for lessors to take risks in a typical market, since they get rewarded by the upside of most transactions," says Forsberg.

Growth factors

Operating leases have been required by weak credit airlines because they have no alternatives to finance their aircraft. "Airlines also require the liquidity allowed by operating leases to stop them going bust," says Forsberg. "US carriers have not used operating leases until recently. They had good liquidity, and US tax structures mean operating leases do not provide off-balance sheet financing the way it does for European airlines under European accounting rules. US carriers also have access to other financing techniques, such as EETCs, and the capital markets."

Operating lease rates are now so low that major airlines in Europe are using them for a large portion of their aircraft acquisitions. Air France, for example, now leases about 20% of its fleet, and wants to double this amount. The lease rate factor gap between some finance leases and operating leases has closed, making operating lease rates more attractive, although still the more expensive option. Operating leases have the advantage of being flexible and providing off-balance sheet financing. Airlines, however, pass up the potential to make profits on disposing of aircraft if they had acquired them through finance leases or purchases.

Although finance lease rates are still lower than operating lease rates and finance leases have the potential benefit of residual value upside, Forsberg explains that airlines are less interested in the risk of disposing of aircraft. "Airlines will continue to use finance leases for some of their aircraft and get the residual value benefits as a consequence, but they also want the flexibility and liquidity provided by operating leases," says Forsberg. "Because of low inflation there is less inflationary pressure keeping aircraft residual values up when they are sold at 10-15 years, and so the residual value benefits are also diminishing. It has also been consistently difficult to predict residual values, which means that there is less potential for an airline to benefit from finance leasing. This partially explains the increased popularity of operating leasing. The number of leased aircraft will probably reach 7,500-12,000 by 2020 relatively easily. This is because it will be an important part of the aircraft financing mix for airlines, it is a good way of generating liquidity and the continued privatisation of airlines will generate a lot of sale and leaseback transactions because airlines will want to unlock their equity. I do not, however, see the portion of aircraft climbing to 40% by 2020."