

The options for financing regional jets are minimal compared to larger types. Until now, Export credits have been widely used, but their application is diminishing. Manufacturers provide some support, but the market really requires operating lessors on a similar scale to the airliner market.

Regional jet financing: is the product complete?

The operation of regional jets is now a common feature in most of the world's air transport sectors. With orders and options in excess of 1000 aircraft this market can now be considered a mature one. Does this maturity also apply to the financial services and products that support this market? The answer is almost certainly no.

It is likely that there is at least one example of every known finance product and facility available within the established aircraft markets being used to support the sale and purchase of regional jets. However, the services provided by manufacturers to the likes of Air France, American and Lufthansa are not real evidence that such services are in widespread use throughout the market sector. The real test of this is to see which financing techniques are actually available in developed countries to regional airlines that are not subsidiaries of major carriers, and also to airlines in lesser-developed countries.

Export credits

Perhaps the most obvious source of sales financing support for regional aircraft is government-sponsored export credit agencies. In the regional jet market this seems to have become a means of sales price competition, rather than the provision of finance or risk underwriting.

This is almost certainly because Embraer, one of the key manufacturers in the market, is a Brazilian company whose government does not have the resources to provide the same kind of support as the governments of the other leading aircraft manufacturers.

This is not the appropriate forum for a detailed comparison between the support and services provided by the export credit agencies of Brazil, Canada and Germany, the host countries of the three regional jet manufacturers. Some explanation, however, is necessary as to why this traditional source of credit/underwriting has not thrived in the regional jet market.

As a general rule the export agencies of Canada and Germany provide support by means of insurance or guarantees that cover the risk of non-payment by the buyer under some form of lease or deferred payment arrangement. As a result financiers provide finance at margins that reflect the quality of the underwriting risk, rather than the buyer's risk, which effectively results in an interest rate subsidy for the buyer.

Brazil has been unable to compete directly with such arrangements so, through a system referred to as PROEX, it has, with the help of local financial institutions, passed on to the buyers a similar level of interest rate subsidy. It has done this by means of a one-time front-end payment made directly to the

manufacturer, which effectively reduces the price of the aircraft.

This difference in approach by the agencies has caused considerable rancour between the governments of Brazil and Canada, resulting in complaints being made to the World Trade Organisation (WTO). Both Brazil and Canada have been found to be in violation of the WTO's prohibition of export subsidies, with Canada being the most recent guilty party.

In a release issued by the WTO on 28th January 2002, Canada was found to have provided illegal subsidies to Comair and Air Wisconsin in the USA and Air Nostrum in Spain. The impact of these cases on the level and suitability of the support and benefits to be provided by export credit agencies in the future is as yet unclear. It is, however, probably safe to say that such arrangements will play a lesser role in the future. This is already the case with respect to the benefits of the PROEX facilities to Embraer and its customers. Up to 2000, the PROEX 'subsidy' was equivalent to 12% or more of the invoice price of the aircraft. This has steadily reduced and it is now no more than 5.50%.

In summary, it is reasonable to assume that the export credit agencies have never been a major source of longer-term finance or risk underwriting for regional jets, and that their role will decrease in the future.



Manufacturer support

Probably the most significant sources of support and facilities for buyers and financiers of regional jets are the manufacturers themselves. Although there are likely to be many special arrangements between manufacturers and individual buyers, there are two generally known and commonly used facilities: the First Loss Deficiency Guarantee (FLDG); and the Residual Value Guarantee (RVG).

Although the term 'guarantee' is liberally used, it does not in any way mean or imply that the manufacturer is prepared to underwrite its customer's financial performance. The 'guarantee' is made with respect to the value from time to time of the aircraft that is the subject of the sale/finance.

The FLDG is in place throughout the entire period of the finance arrangement. Through it the manufacturer underwrites the resale value of the aircraft in the event of borrower default and the need for the financier to seek repayment of its advance from the sales proceeds of the aircraft.

The 'guarantee' amount is limited, either to a percentage of the original sales price or to a percentage of the advance, so that the manufacturer pays to the financier the shortfall, if any, between the resale proceeds and the outstanding principal of the advance. Such payment is capped by the amount of the 'guarantee', with the financier forced to bear any shortfall in excess of the manufacturer's

liability under the FLDG.

The FLDG has two main purposes: to provide comfort and support to financiers to encourage them to accept the value of the aircraft as adequate and suitable collateral to support the advance; and to assist the buyer by using the FLDG as an alternative or supplement to the provision of a direct equity contribution by the buyer.

The RVG works in a similar manner to the FLDG, except that the RVG only applies to the residual value of the aircraft at predetermined times in the future. As a general rule, Bombardier caps its exposure under the RVG in the same way as it does under the FLDG. Embraer usually places no limit on the amount of any payment under an RVG, providing of course that it is within the amount set as the maximum liability under the RVG. The position of Fairchild Dornier with respect to capping the payment amount is not known.

The primary purpose of the RVG is to offer a risk underwriting facility. This allows the buyer to take advantage of operating lease arrangements by the manufacturer providing the lessor and its financier with a known residual value at the expiry of the lease.

Bombardier and Embraer have made extensive use of these 'guarantees', but their application and the acceptance of the product by the financial community has been easier for Bombardier. Although these 'guarantees' relate to asset values,

The only mega lessor to get involved in the operating leasing of regional jets is GECAS, and this has only been for aircraft powered by the CF34 engine. Aircraft value assessors' reluctance to give positive or strong valuations for regional jets and a general lack of a track record of transactions has discouraged financiers from providing asset based financing. This will likely remain the case until lessors get involved in the regional market on a larger scale.

they still constitute a financial risk exposure for the financier against the ability of the manufacturer to meet its future payment obligations.

Bombardier is a known commodity to aircraft financiers who will generally consider its payment obligations to be an acceptable risk.

Unfortunately for Embraer and its customers, Embraer is domiciled in Brazil, which means that financiers consider that any payment obligation on its part comes under the category of Brazilian country risk with all that this implies.

The position of Fairchild Dornier is not known, but it is expected that it will suffer similar application and acceptance problems to Embraer, not because of country risk issues, but because its chequered performance history and recent change of ownership makes it an unknown quantity to most financiers.

At present there is a reluctance on the part of financiers to assume the risks presently taken by the manufacturers. This participation and support by the manufacturers with respect to financing seems set to continue to be one of the most significant resources available to buyers of regional jets.

There is a limit to the ability of the manufacturers, however, to satisfy the requirements of the financiers. This has already been seen with the country risk issues that face Embraer. Therefore alternative sources of risk underwriting

The use of PROEX as an alternative to Export credits effectively provided a discount on the price of Embraer aircraft by 12%. This has now reduced to less than 5.5%. It is likely that export credits will play a smaller role in regional jet financing in the future, putting pressure on the regional jet sector to develop financing techniques.

and/or financing must be found, otherwise the development of the regional market will be held back by the lack of financial support for potential buyers.

Some limited success has been achieved in replacing or supplementing the manufacturers' risk position with the use of residual value insurance (RVI) policies and other forms of asset value underwriting.

In many respects the present regional jet financing market, and in particular the role of the manufacturers in it, is similar to the situation of the larger jet market in the 1970s, early 1980s and, to some extent, during the recession of the early 1990s. So what changed in that market, and can it happen in the regional jet market?

Operating leases

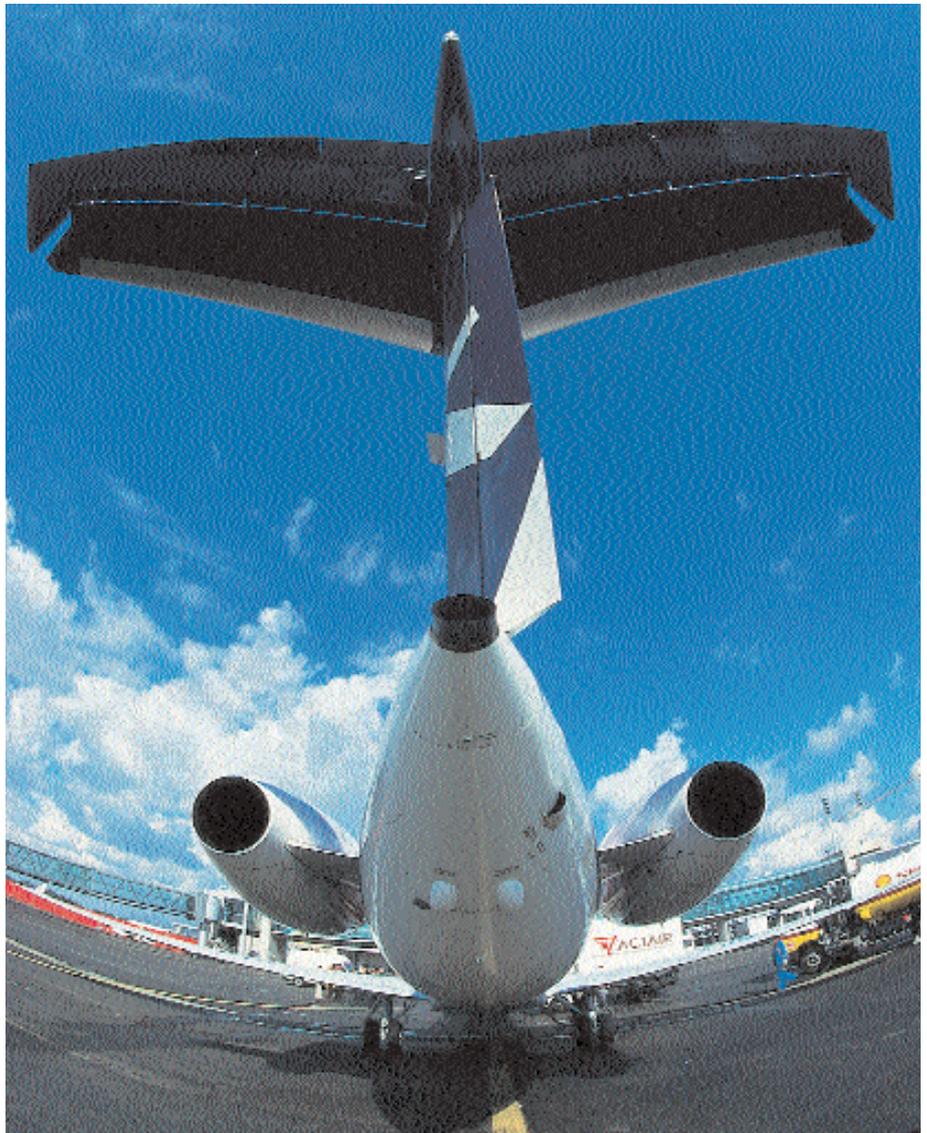
The most significant change in the larger jet market was the advent of the mega-lessors and the support of and participation in the operating leasing market by the financing community. The lessors not only brought to the market a facility that provided the younger or under-capitalised airlines with a source of finance/aircraft, and the flexibility the major carriers demanded, but also a change in attitude towards risk-taking by the major financial institutions. Asset financing became an accepted product to be offered to the aviation industry.

The lessors provided the market and, in particular, the financiers, with facilities and services that were not previously available, including:

1. The lessors became borrowers and leased aircraft to smaller airlines and into lesser-developed countries. This allowed financiers to provide the financial resources without assuming country and other similar risks.

2. The lessors provided a ready market for the sale of used aircraft, thereby easing the concerns of financiers regarding their ability to recover their advance from residual proceeds.

3. The establishment of a pool of aircraft for lease, and therefore a



measurement of asset value through the comparison of market lease rates, provided the financiers with greater comfort in their ability to evaluate aircraft value risk (present and future).

The financial community is currently not prepared to offer asset finance for regional jets to anywhere near the same extent as it is willing to do for the larger jets. The absence of a significant operating lease market for regional jets has a bearing on the financiers' attitudes and other evidence has deterred them from pursuing asset-financing opportunities, in particular:

- 1 With the market being so new, there have been very few sales of used regional jets to establish a track record of values. Those aircraft that have become available have not attracted the interest and prices expected, even before the effects of the terrorist attacks on 11th September 2001 depressed the used aircraft market generally.

- 2 Aircraft value assessors have been reluctant to give positive and strong valuations, even for new aircraft, partly due to early publicity regarding deep

discounts and subsidies (PROEX) for the early aircraft orders. The result has been that assessors often provide valuations below the actual sales prices, because it is assumed that these 'discounts' still exist.

This and the '11th September Factor' will almost certainly discourage the financiers from changing their somewhat negative view of the asset financing of regional jets in the immediate future.

The long-term will almost certainly require the establishment of an effective and significant operating lease market within the sector for the availability of such facilities to match that in the larger aircraft sector. The participation by GECAS with its orders for aircraft from all three regional jet manufacturers is an encouraging sign. Others will probably follow its lead, but it is likely to take some time because lessors are also suffering from the '11th September Factor'.

Until there is genuine participation in this market by lessors, financiers will be reluctant to provide asset finance and manufacturers will continue to bear as much of the risk-taking burden as they can. 