Aircraft deliveries in 2002 are relatively high, despite the traffic downturn. Airlines' own ability to finance aircraft is weak, finance leases are in further decline and debt financing terms are harder than normal. Capital markets and operating leasing will have to finance a high portion of deliveries.

The challenge of financing aircraft in 2002

The current year will be an awkward one for aircraft financing. While deliveries are down on previous years, and will be lower still in 2003 and 2004, there are still about 600 aircraft scheduled for delivery. This comes at a time of low airline profits, and, in some cases, large losses, as well as reduced availability of financing. Normal sources of straightforward debt have dried up for some airlines. Other sources used to finance aircraft will not be smaller in 2002 than in previous years, putting pressure on other financing techniques to account for larger numbers of aircraft. With this as a backdrop, what is the total amount of aircraft financing required in 2002, and what financing structures are available to finance it?

2002 deliveries

There will be 600-660 Airbus and Boeing aircraft delivered in 2002. Their total list price value is up to $60 billion, but with purchase discounts the total value of deliveries in 2002 is estimated to be in the region of $40 billion.

Original deliveries were scheduled to be in the region of 660, but the traffic fall since 11th September 2001 resulted in airlines reducing capacity. This could mean that delivery deferrals will reduce the annual total to closer to 600. The rate at which normal traffic conditions returns will determine actual deliveries. By the end of March 2002 it appeared that normal traffic conditions would have returned by the middle of the year.

Internal financing

There are several options for aircraft financing, broadly divided between internal financing by airlines' own resources and external financing.

Internal airline financing comes from the cashflow generated by profits, depreciation, the sale and leaseback of owned assets and bank debt raised by the airlines. This accounts for as much as 50% of annual financing requirements in some years where airlines have operated under normal circumstances and have good profit performance. The events of 11th September and consequent traffic fall changed this.

"In a year of average airline profitability about one-third of aircraft deliveries are financed with internal sources," says Dick Forsberg, head of strategy at Lombard Aviation Capital. "Few airlines, except carriers like Singapore Airlines and UPS, will generate a profit, and so the amount of internal financing will be close to zero, putting pressure on external sources to fund deliveries."

Not all financiers see that internal financing has totally dried up for 2002. "There will be some cashflow available, despite there being virtual zero airline profitability," says Bob Genise, president of Boullioun Aviation. "Airlines still have the book calculation of depreciation, meaning there will be some cashflow available. I expect cashflow financing will come to about 10% this year, which will account for about $4 billion worth of aircraft."

Other financiers are somewhat more optimistic about the prospects of internal financing. John McMahon, managing director of debis AirFinance expects about one third of the $40 billion of aircraft financed this year to come from internal airline sources. "While profits of some individual airlines have been badly hit or turned into losses, cash flow remains the key to supporting additional debt. In these difficult times, airlines have a greater propensity to look at alternative types of financing compared to straight debt-supported purchases. For example, the sale and leaseback of owned aircraft, both new deliveries and existing fleet aircraft. Such deals are a useful way to raise additional cash and to move the financing burden to another party. As an example, we have arranged sale and leasebacks for four Air Canada A320 family aircraft that are scheduled to deliver this year," says McMahon. "In the recent past, many airlines could go to the debt markets relatively close to delivery, but this is unlikely to be possible this year. A key question is how many airlines have been organised about pre-arranging financing for their forthcoming deliveries. If they have not, then they will feel greater pressure to defer the delivery or to use sub-optimum and/or more expensive financing techniques-assuming such financing is available."

External vs internal

External financing techniques might be regarded as those arranged by specialist financiers, rather than by

While operating leasing will continue to grow in popularity, demand from airlines for sale and leasebacks for new aircraft deliveries will be higher than normal in 2002 because of difficulties in acquiring financing from other sources. Debis concluded a sale and leaseback for four Air Canada A320s.

airlines. External sources include operating leases, export credits, capital markets, US Tax leases, finance leases, manufacturer financing and straight debt.

Some do not view the dividing line between internal and external financing so clearly. "About one third of aircraft financing is clearly external to the airline," says McMahon. "This includes aircraft ordered by operating lessors. They are the clear owners of the aircraft. Operating lessors invest their own equity and cash flow in the aircraft, and also raise debt on their own financial strength. Beyond this, there are some forms of financing which are a hybrid. Some sale and leaseback transactions, for example, are arranged just prior to delivery of an aircraft as an alternative to straight airline debt and the deal may include a purchase option for the airline at the end of the leaseback term. The purchase option may be set at a relatively attractive level that implies a financing of the airline's acquisition of the aircraft, rather than an expectation that the lessor will take it back at the end of the lease. A number of such deals are being arranged in the current economic climate.

"Export credits can also be used by airlines to finance aircraft, and are basically a government guarantee to support the provision by commercial banks of debt to the airline. In this case export credits could be regarded as internal financing, rather than external, since the expectation is that the airline will own the aircraft in the end. The use of export credits and hybrid sale and leaseback structures by airlines are reasons why as high as one third may still be regarded as financed internally," says McMahon. "The capital markets, providing financing through asset backed bonds in securitisations and enhanced equipment trust certificates (EETCs) are clearly external to the airline."

Operating leasing

Over the long term the portion of aircraft financed under operating leases is expected to grow, but the current economic situation may accelerate the growth.

"A large chunk of scheduled deliveries are to the big operating lessors, and they may account for about 25% or more of the deliveries in 2002," estimates Forsberg. "Operating lessors are also likely to do a larger number of sale and leaseback transactions in the current climate than normal. About 25% of airliner deliveries have been to operating lessors, and this portion is expected to increase despite the downturn."

A high demand by airlines for sale and leasebacks in 2002 is likely because airlines will find it harder to finance aircraft through other means. "Operating lessors are doing sale and leaseback transactions for new deliveries, and this may account for $1-2 billion of aircraft. This shifts the onus of finding debt to the lessors. The solid international carriers may still look for $6-8 billion of debt from the bank market," says Genise.

The growth in operating leasing has been spurred partly by the low financing terms the mega-lessors are able to offer, generated by their low internal cost of funding provided by their parent companies. "The same low rates of internal funding still apply to the mega lessors," says Forsberg. "Some operating lessors have been reluctant to finance aircraft deliveries since the fall in traffic, although traffic and airline financial stability seem to be picking up again. The small lessors may find it harder to survive, since they will have higher costs of debt, while the big lessors still have the same low costs of funds and hence more leverage in the market. Besides the large lessors, financiers are becoming more selective about the airlines they provide financing for."

The strength of operating lessors, particularly the large ones, means they are able to take delivery of the orders they had in place. The issue is whether some of their lessees, which had deliveries scheduled, still require the same number of aircraft to be delivered in 2002.

Genise predicts that about 200 deliveries in 2002 (one-third, or $12 billion worth of aircraft) will be accounted for by operating leases. "The operating lessors themselves use a variety of financing techniques for their deliveries. These are internal cashflow and equity, and the remainder from commercial debt and the capital markets."

While operating lessors may be more cautious about financing some of their scheduled deliveries this year, lessors are in a difficult position to make terms harder. The immediate affect of 11th September was for airlines to put pressure on lessors to reduce lease rates for a period while traffic and revenues recovered. The leverage airlines used to achieve this was providing lessors with the alternative of their lessees going bankrupt and returning aircraft that would be hard or impossible to market.

"The terms have to be more attractive for us and we are looking for realistic returns. We are more circumspect in the risk we want to take in the current climate," says Genise. "Sale and

The majority of financing mandates for US carriers has been met with bids for EETCs, since these are currently cheaper than US tax leases and straight debt financing.

leasebacks are opportunistic for us, but not necessary. Sale and leasebacks of older aircraft are another form of funding for airlines, since they generate cashflow for airlines for the purchase of new aircraft. Although we cannot make terms tougher for lessees, we are careful about which airlines we arrange sale and leasebacks for. If we get aircraft returned we have to be flexible about where we can re-market them. Some of these risks can be mitigated with security deposits and maintenance reserves.

"We do not make many adjustments to the terms of the aircraft we are already committed to, unless the airline is in difficulty. We do not see the supply and demand for aircraft recovering to a normal situation until the second quarter of 2003, which is when lease rates will go back up."

The approximate 25% of deliveries accounted for by operating leases equates to about $10 billion of aircraft. This and internal financing estimates of $4-10 billion (10-25%) leave $20-24 billion of aircraft to be financed by other means.

External alternatives

Besides operating leasing, the alternatives airlines have for financing are tax and finance leases, the capital markets, export credits used in finance leases, manufacturer financing and straight debt.

Debt financing

"Financiers will have tougher terms for airlines. This means margins are likely to be higher and the amount of debt advanced will be less. For example, debt provided will be reduced from 85% to 75%, putting pressure on airlines to invest higher equity portions which they do not have. Only higher-credit quality carriers are likely to be financed," predicts Forsberg. "Financiers were very picky about the airlines they financed immediately after 11th September, but have since relaxed a bit as confidence has picked up. Straight debt is still available, but at a premium while some banks are still cautious."

Despite the problems of US carriers, the US government has provided them with financial assistance following 11th September 2001. The US carriers are also under less pressure in 2002 because their delivery schedules are relatively low. The first financial package the US government provided was a loan guarantee of $10 billion. This money can be used by the airlines to finance aircraft. A second package was provided, but the US government stipulated that airlines which subscribed to it would have to provide the government with equity until the loan was repaid. Problems would occur if the airlines which took this second package went bankrupt. America West was one carrier which took the second package, and used some of the loan to pay deferred aircraft lease payments.

Despite these loans, US carriers still have to find substantial sources of financing for aircraft deliveries.

Straight debt financing has also almost dried up for airlines, and is generally tougher for carriers trying to get it. Southwest in the US is one of the few airlines able to get debt financing on normal conditions. The availability of debt has reduced, and airlines are in a bigger queue to acquire it from the major providers. Debt terms are also tougher. Prior to 11th September debt providers offered debt, particularly to major US carriers, on unsecured terms. There was no recourse for the debt and it was provided to major airlines on the strength of their reputations and assumed ability to repay from regular cashflow.

Debt terms are now tougher, and providers are demanding recourse on the assets they are financing. These often include liens on the aircraft, in the event of a default, and higher interest rates.

One form of financing that will certainly account for less of the total this year will be the tax-based finance lease. "Most types of tax lease are in decline, and the US Tax lease is no exception," says McMahon. "However, the US capital markets, finance lease and remaining tax lease base will, however, still meet most US carriers' requirements."

The Japanese Operating Lease, classified as a finance lease for Japanese carries but an operating lease (JOL) for airlines outside Japan, is still alive, and will account for some aircraft. The JOL is now the most prominent of finance leases. Genise predicts that foreign tax leases (that is non-US), including JOLs, German, French, Swedish and the new international operating leases, will account for $1.5-2 billion of aircraft.

Capital markets

This has pushed US majors to look at the capital markets, and most deliveries scheduled for 2003 will have financing arranged by the end of 2002. The capital markets have substituted debt provision for many US carrier aircraft financings, with aircraft being acquired through EETCs and securitisations. All major capital market providers are bidding EETCs to US majors for aircraft deliveries. EETCs are cheaper than straight debt, but the bondholders still have recourse to the aircraft in the event of a default. EETCs are almost exclusively used by US carriers, mainly for narrowbodies. EETCs are also currently cheaper than US tax leases.

"The main reason for the popularity of the capital markets is the depth of the market providing funds at attractive rates

Boeing capital will help many airlines finance new aircraft deliveries in 2002, since a higher proportion than normal will have difficulties in financing aircraft. Many carriers have left financing too late, and rely on manufacturers for back-stop financing. Demand for manufacturer back-stop financing was highest immediately after 11th September 2001.

based on an independent assessment of the risk through the rating agencies- although the capital markets themselves are somewhat volatile sources," says McMahon. "There will probably be a relatively small use of capital markets in 2002 compared to the typical $8-10 billion of liquidity that it can bring annually to the aircraft financing market. The general Euro capital market is still in its infancy but, nevertheless, the capital markets are likely to account for a larger portion of aircraft financings in the long term. However, what has to be remembered is that the use of capital markets is not necessarily for the current year's or future deliveries, but is often related to the re-financing of existing portfolios of aircraft. Still, it represents a very significant and useful source of additional funding for the industry."

This also implies many aircraft delivered in 2002 were already financed through the capital markets, using EETCs, in 2002. The turmoil of 11th September means that some aircraft originally financed with EETCs in 2001 will have to be financed through other techniques. The capital markets are now steady since a large number of deliveries scheduled for US carriers are being financed with EETCs. Genise predicts that the majority of US deliveries in 2002 will be financed through EETCs and US tax leases, totalling $4-5 billion of aircraft in 2002.

Export credits

Export credits, in the form of Export Credit Agencies and Exim bank secured loans can be used by airlines themselves, but can also be applied to finance leases. Airlines, domiciled in Europe and the US which provide export credits cannot officially use them, but they are expected to account for larger portions than normal of aircraft deliveries in Asia, South America and Africa. These continents will have reduced deliveries this year. The mega lessors are also further increasing their presence, and offering new aircraft to airlines with poorer credits that have not had access to the mega lessors in the past. It is estimated by some that export credits will account for 5-10% of deliveries in 2002, accounting for $2-4 billion of aircraft, exceeding those that are financed by finance leases.

Manufacturer financing

Export credits have also been used in conjunction with manufacturer financing. Airbus and Boeing have had to provide backstop financing to several airlines, particularly in the immediate aftermath of 11th September, and have arranged financing for a large number of deliveries. The manufacturers have been aided here with export credits, since they have been able to approach the agencies on behalf of the airlines.

The manufacturers themselves have also provided debt, often as a last resort for airlines. "When airlines have not had the necessary financing in place, the manufacturers themselves have effectively provided the loans," says McMahon. "This is backstop financing for airlines, and the margins they charge vary and, hopefully, reflect the credit quality of the customer. What has to be considered is the manufacturers' desire to see scheduled deliveries completed, and they may be more lenient if the customer is regarded as a strategic one."

Summary

Opinions vary as to the portion of total aircraft financings will be accounted for by each technique. Confidence in airlines' own ability to finance aircraft varies from them being able to finance almost no aircraft to about $15 billion of all deliveries. Operating leasing is expected to account for the largest portion, with up to a full third of deliveries. This, however, includes sale and leaseback transactions which are expected to increase in 2002. Internal airline financing and operating leases could account for more than half the aircraft delivered. This leaves $15-20 billion financed by other techniques.

The techniques all financiers generally expect to see decline are finance and US Tax leases, as well as straight debt financing. Techniques that will increase in use are export credits, manufacturer financing and the capital markets.

Aircraft deliveries are forecast to reach a trough in 2003 and 2004. Financing will reduce to about $34 billion in 2003/04, while airline profits will rise to a predicted peak in the same years. The airlines' own ability to finance will thus rise. Operating leases will continue to increase in popularity, as will capital markets will as the European versions mature. There will probably be a further decline in finance leases, export credits and manufacturer financing. Deliveries are not expected to peak until 2006. Operating leasing could account for as much as 40% of aircraft delivered by this time.