Despite the current downturn, deliveries of new aircraft to Europe's airlines will exceed 150 annually for the next few years. This comes at a time when securing debt is difficult for airlines, and the benefits and availability of finance and tax leases have been reduced.

Europe's airlines ponder aircraft financing options

European airlines are currently facing a combination of difficulties: deferred deliveries from late 2001 and 2002; extensive fleet renewal programmes; and reduced options for financing new aircraft over the next three years. Several major European carriers have been presented with the challenge of sourcing efficient financing for deliveries of large numbers of new aircraft, despite the fall in traffic in late 2001 and 2002 due to the effects of September 11th, 2001 and increased competition.

Fleet development

Airbus and Boeing deliveries totalled about 850 aircraft in 2001 and will be in the region of 655 for 2002. Deliveries to European carriers account for about one-third of these aircraft. Many deliveries were deferred from 2002 to 2003 and 2004. Airbus and Boeing deliveries to European airlines will be at least 160 in 2003, with more once deliveries to US lessors have been allocated to European airlines. These 160 aircraft probably have a total value of about $10 billion, equivalent to one-quarter of global financing requirements for jet airliners. At least 150 aircraft are scheduled for delivery to European airlines in 2004, but this number will increase as new orders being placed and lessors' aircraft are allocated.

September 11th led to a general fall in traffic for European carriers, which recovered to normal levels after about six months, along with profitability. The airlines worst affected were those with large volumes of transatlantic traffic and routes to the Middle East and Africa, such as British Airways (BA), Lufthansa, KLM and Air France.

The period immediately after September 11th was also affected by the failure of two European majors: Swissair and Sabena. Although the two airlines were already in a bad shape, the events of September 11th played a partial role in triggering their eventual collapse. However, their failure enabled the traffic volumes of closely located airlines to recover relatively quickly from the industry downturn. Swissair has since resumed operations as Swiss, although not yet on the same scale .

The profitability of other European airlines has also been under pressure for up to three years prior to September 2001, partly due to a softening economy, but also to increased competition from low-cost airlines.

The large slump in traffic, and the glut of relatively young aircraft that followed September 11th left debt providers cautious about advancing further loans for new aircraft that were arguably no longer required.

Prior to this date orders for aircraft had been placed by virtually every European major, including SAS, Air France, Lufthansa, Finnair, KLM, BA and Iberia. These carriers had two requirements for new aircraft: replacement of older fleets to increase fleet simplicity and efficiency; and growth in traffic (although this accounted for less of the aircraft orders).

Air France, for example, implemented a fleet renewal programme in 1997. At this time it had more than seven different aircraft types, including the 737-500, A320, A310, 767-300, A340, 747-200 and 747-400. "Our objective was to simplify the short-haul fleet around the A320 family, and the long-haul fleet with the A340, 777 and 747-400," explains Pierre Vellay, vice president new aircraft and corporate fleet planning at Air France. "This meant we would go from eight to four aircraft types over five years, and by 2006 we will have increased our A320 family fleet from its current level of 130 to 160. The A320 family types will replace the 737-200s and -500s. We have also replaced the 747-200s, A310s and 767-300s with the 777 and A330-200. This means we have had a large number of disposals and acquisitions to go through between 1997 and 2006."

KLM is also simplifying its fleet and going through a high volume of aircraft in a fleet replacement programme. "We have two phases to our renewal programme, and the first is the replacement of our 12 747-300s with 10 777-200ERs and three 747-400ERFs," explains Robert Makkelie, director of aircraft sales and asset management at KLM. "The eight passenger/combi 747-300s will be replaced by eight of the 10 777s. Another two 777s will be used during the second phase of the programme.

"We also have a fleet of eight 767-300s and 10 MD-11s to be replaced. The first two MD-11s will be sold and leased back as part of the fleet phase-out programme. These will be replaced by the other two 777-200ERs. The first stage of replacing the 12 767-300s and eight MD-11s is with six A330-200s. The complete phase-out is still being reviewed, and this will lead to more A330 or 777 orders. This will eventually lead to A330 and 777 orders totalling 30 aircraft. These orders are required without any traffic growth," explains Makkelie. "It is economically difficult to justify the replacement of aircraft with new ones, however, because of the capital cost of new equipment. We also require new aircraft to cater for traffic growth in the 250-300 seat size, so these will be either the A330-200 or 767-400. Overall, our planned deliveries will be six widebodies in 2003 and five in 2004. Others will follow in later years, including the first A330-200".

Now that the Netherlands no longer manufactures aircraft, Dutch airlines can use Exim financing for aircraft. KLM has purchased many of its aircraft in the past, and could use equity and Exim financing for its 10 777s and 3 747-400ERFs.

Iberia will take delivery of 10 widebodies and six A320 family types over the next three years. SAS has 28 aircraft scheduled for delivery over the next four years, including four A330/340s, 12 A320/21s, five 737s and seven Q400s.

Other European operators implementing large fleet replacement programmes are Finnair, BA and Lufthansa. Finnair is taking delivery of a large number of A320s over the next few years to replace MD-80s. BA is also taking delivery of a large A320 fleet to replace 737s and 757s, and 777s to replace 747s. Alitalia has also placed 777 orders to replace 747-200s and MD-11s, while Lufthansa is also simplifying its fleet and taking delivery of A330s to replace A310s and 747s.

Low-cost carriers now also account for a large portion of European deliveries. Ryanair placed an order for 100 737-800s at the start of 2002 for delivery between 2003 and 2008. It will take delivery of 14 aircraft in 2003 and a scheduled 13 in 2004. EasyJet recently placed an order for 120 A320s, with the main deliveries between 2004 and 2007.

Available financing

Funding for airlines is available from internal or external sources. Internal financing comes from profits and cashflow, and other sources of funding arranged by the airline. Which include the sale of assets. Sale and leasebacks of both new and used equipment are therefore one source of internal funding for aircraft deliveries. Airline-raised debt can also be regarded as internal funding.

The reduction in profits and, therefore, internal funding is one challenge facing airlines. Not all internal funding has completely disappeared, however, and some carriers are still financing substantial portions of their fleets. "We have always been cash positive in most years and therefore had the option of using cash to purchase aircraft," says Robert van der Burg, managing director of KLM Financial Services. "We use this if we cannot get financing or other techniques are too hard. We purchased our whole MD-11 fleet between 1991 and 1996, as well as the first eight 747-400s. This was done with a combination of cash and debt. We have purchased four of the 10 777s we have on order and all three of the 747-400ERFs. Debt, however, is becoming more difficult to obtain."

Terms for internally raised debt are harder, since advance rates have fallen and interest rates have increased. This is explained by the reluctance of banks to provide debt to airlines that appear to be a higher risk than a few years ago, and for aircraft that may not be required or difficult to fill given the current glut of aircraft and unpredictable state of airline traffic volumes and profits. "The collapse of Swissair and Sabena made banks nervous about providing debt to airlines," explains van der Burg. "Many banks lending to Swissair had debt owed on MD-11s and the value of these aircraft has fallen. One problem we have with raising debt is that our competitors were using the same sources of debt as airlines that have collapsed or are unprofitable, and this has made banks reluctant to loan."

Howard Miller financial director at Ryanair, explains that banks now prefer to provide debt to lessors than airlines, because lessors have a low failure rate. "This is especially since the failure of two major European airlines. We have always purchased our aircraft, and put 15% equity in and use US Export Credits (Exim) to secure the debt of 85%. This so far has always been pour cheapest form of financing, since Exim allows us to get debt at the same cost as the US government. We have always had sufficient cash and tax capacity to make these purchases and equity inputs. The tax advantages in Ireland are fairly good, since we get 15% straight line tax depreciation, but the corporate tax rate has recently been reduced to 12.5%. We have the tax capacity to make full use of these tax benefits. Net profit for the year end March 2002 was Euro 150 million ($150 million), equal to 24% of turnover. Net profits are forecast to be Euro 200 million ($200 million) for the year end March 2003."

The fall in profits of some airlines, however, has increased demand for sale and leaseback transactions. "Operating leases are flexible for phasing out aircraft, since old ones can be disposed of using sale and leaseback transactions, and have used them for the disposal of the 737-200s, 737-500s and A310s. This has increased the portion of aircraft on operating leases, thus increasing the number of aircraft using off-balance sheet financing," explains Vellay.

External financing

External financing techniques can be divided into several categories. These are operating leases, export credits, capital market financings, US tax leases, tax and finance leases and straight debt and loans. In some cases there is a blur between internal and external financing. Export credits, for example, are secured by an airline arranging its own financing, but they are US and European government guarantees on debt.

Not all of these are readily available to European carriers.

The most noticeable decline has been in the use of finance and tax leases, simply because of the dwindling tax benefits on aircraft assets.

"In the past we had interesting finance structures like the Japanese Leveraged Leases (JLLs). There was a

Ryanair has never used operating leasing, and always purchased its aircraft using equity and debt. It has always had a strong cash position and has the tax capacity to justify ownership of its aircraft. It already has commitment from the US government for Exim financing for the first 33 of 100 737-800s it ordered in January 2002.

large capacity available for these, and once we had equity committed it was relatively easy to get banks to commit to providing debt," says van der Burg. "A more difficult market was O-FSCs, and these were theoretically replaced by the ETI, but this is almost dead since the World Trade Organisation (WTO) was pushed to abolish this tax structure since it only applied to US manufactured aircraft."

This has put increased pressure on airlines to use other techniques.

Export credits are only available to airlines which are domiciled in countries that do not manufacture aircraft, which rules them out for many European majors, including carriers like Iberia, Air France, Lufthansa and BA. KLM can now use export credits, since Fokker no longer manufactures aircraft. "Exim financing is an option to us, because it means we do not use our own credit lines. The absence of Fokker now makes it one option for financing in Euros," says van der Burg. "Exim financing is the most likely type of finance we will use for the 747-400s and 777s. Exim provides 85% of the ticket value, and so 15% of equity is required. It is inefficient to put the equity in ourselves, since Dutch tax depreciation is low. It is straight line depreciation over 18-25 years, and is the same rate as book depreciation which means we get no benefit. We therefore get the equity put in by a provider from another authority which gets a tax benefit, while KLM gets 100% funding."

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Even the French tax lease has reduced tax benefits. "The tax advantages of this structure are reduced, and aircraft financing is no longer an issue of the efficiency of the financing technique itself. Better financing comes from a good aircraft type with a good residual value performance and strong airline credit rating," explains Vellay. "We still use all types of finance and tax lease that are available to us, but a reduced portion of our fleet is financed this way."

Operating leasing now accounts for a larger amount of aircraft deliveries. Traditional users of operating leasing are airlines that found it hard to get other types of financing. Users of operating leases have increased to include major carriers which have reduced options for aircraft financing. Air France now uses three types of financing: operating leases; finance leases; and straight ownership. "Having about one-third of our fleet under operating leases gives us flexibility and allows us to return a portion to lessors at short notice. It also means we can introduce a new type in a shot period; that is in just one or two years," says Vellay. "The next two years of deliveries have a priority for operating leases."

Ryanair finds operating leasing too expensive compared to putting its own equity in, and using Exim financing for the debt portion of its cash purchases. "We have never used operating leasing, since it is too expensive compared to Exim financing, which provides us with low cost debt," says Miller. "The reason many other carriers increasingly favour operating leasing is that it is becoming harder for airlines to finance aircraft with other techniques, especially acquiring debt. Banks are preferring to lend to lessors."

The Japanese Operating Lease (JOL) its technically an operating lease for airlines outside Japan. This has been used fairly extensively by European airlines in recent years, but is limited in its scope. "The JOL is difficult to get for widebody financing, since the Japanese find the risk too big and will only do it when a residual value guarantee is used," says van der Burg. "We used these for 737s, but will not be able to use them for the widebodies we have on order."

Besides finance and operating leases and straight debt, one other major source of finance is the capital markets. These include securitisations and enhanced equipment trust certificates (EETCs). These have been mainly confined to the US market but Iberia, alone among European users, has used them to finance A320s. There are no other European users, however. "EETCs are still relatively expensive compared to other techniques, and they are also difficult," says van der Burg. "They require a whole bunch of aircraft, which is why they are often used by lessors. It might be possible for us to use them for our 777 and 747 deliveries which are fairly close together."

KLM, however, prefers financing in Euros, and EETCs are priced in US Dollars. "Our Dollar surplus has reduced because of the oil price rises and reduction in our US operation," says van der Burg. "This means it is more difficult for us to handle a Dollar loan on our balance sheet, and we always have to re-evaluate a Dollar loan with fluctuating exchange rates, and losses have to be shown on our profit and loss account. This all means financing in Euros is more efficient. Financing in Euros narrows our choices to Exim, which does not affect our own credit lines, a few tax leases and straight debt." AC