Although aircraft deliveries are fewer in 2003 than they were in 2000 and 2001, the portion financed by operating leasing is expected to be high. Lessors face the problems of reduced residual values, an oversupply of aircraft, pressure on lease rates and diminished debt availability.

The outlook for operating leasing

The aircraft financing market has been badly affected by aircraft oversupply, poor airline financial performance, lack of liquidity and high interest rates, and weak aircraft residual value prospects. Although aircraft deliveries in 2003 and 2004 will be a third lower than they were in 2001, many forms of aircraft financing have dried up. This has left operating leasing as the only option for many carriers, but does this strengthen the operating lease market?

General situation

Prior to the SARS outbreak, airline profit performance could generally be linked to geographical status. The losses incurred by the US majors in 2002 (Chapter 11 filing by US Airways, United and Air Canada, and continuing losses by US majors in 2003) have given the impression that the whole industry was making losses. The US's four main low-cost carriers continue to make profits.

Many European airlines, such as like Lufthansa, Air France and British Airways, are generating reasonable profits considering the circumstances. Others, such as KLM, SAS and Alitalia are making losses.

Airlines in the Asia Pacific and Australasia generated impressive profits in 2002, in particular Cathay Pacific and Qantas. Performance in the next few years depends on the length of the SARS problem and following rate of recovery.

Many traditional airlines are implementing long-term cost reduction plans, which will have to be successful in the face of increased competition and lower average fares for the industry to stabilise. Expectations are that parts of the industry and some airlines will stabilise in 2004 and return to profit in 2005, which should lead to a return of stronger order numbers.

The downturn in traffic and rate of recovery is worse than the last slump, which followed the 1991 Gulf War. The current recession has eroded traffic volumes and growth rates that were predicted prior to 11th September 2001, and will only be recovered in the long term.

This comes after a large number of deliveries in 2000 and 2001, and with large numbers of new aircraft yet to be delivered.

Aircraft deliveries

Jetliner deliveries peaked in 2000 and 2001 with about 850 delivered annually. These had a value of about $55-60 billion. About 570 jetliners are expected to be delivered in 2003, with an estimated value of $35 billion.

The difficulty facing airlines accepting these aircraft is that they have reduced profits and external financing sources. Reduced airline profits and losses have eroded cash reserves and the ability by many airlines to internally finance aircraft.

Many external sources have also dried up, including straight debt financing, finance leases, enhanced equipment trust certificates and export credit agency debt. This puts pressure on airlines to get aircraft on operating leases, and for some there is no other option.

Straight debt has dried up for airlines because of their reduced credit ratings, but also because many debt providers have pulled out of the aerospace and aircraft financing market.

Operating leasing has accounted for 25-30% of aircraft deliveries in recent years, but this is expected to increase in 2003. "Operating leases will probably account for about $10 billion of aircraft financings this year," claims John Willingham, chief operating officer at Boullioun. "This includes stronger demand for sale and leasebacks, and overall a significant number of airlines are taking deliveries of aircraft from the operating lessors." Airlines that normally do not take aircraft on operating leases are approaching lessors, highlighting the lack of financing options.

Lessors' positions

High demand for operating leasing does not necessarily put lessors in a strong position. Many are faced with a combination of problems, including an oversupply of parked and unused aircraft, downward pressure on lease rentals from lessees, a number of aircraft due to be delivered that are unallocated to lessees, reduced debt availability and higher interest rates.

Many lessors ordered large numbers of aircraft prior to 11th September 2001 in the expectation that demand for operating leasing would grow. Deliveries of aircraft extend out until 2005 for some lessors, and there are still large numbers to place with lessees.

Harry Forsythe, vice president of marketing at Ansett Worldwide estimates that 205 aircraft being delivered in 2003 are for lessors, and about 70% of these have been placed with lessees. About 170 of aircraft for delivery in 2004 are for the lessors, and about 37% of these are already placed. Forsythe estimates that less than 13% of deliveries due in 2005 to lessors have been placed with lessees. ILFC has the largest delivery backlog, with 250-300 aircraft due over the next

Debt terms have been made harder partly by a reduction in residual value forecasts. Debt now has to be amortised harder and paid at higher interest rates, while lessors also usually have to accept lower lease rentals. In many cases the debt terms are making transactions uneconomic and preventing them from going ahead.

four years.

Deliveries due in 2003 and 2004 may cause problems for some lessors, since aircraft are normally placed 18-24 months prior to delivery. Some lessors with large delivery schedules have not placed all their aircraft, and are being forced to park new aircraft straight from the production line. In particular lessors have an overcapacity of Airbus narrowbodies.

"There are few 737NG positions left among the lessors, while there are still numbers of Airbus aircraft not yet placed," says Dave Thompson, managing director of marketing at GATX Capital. This is partially explained by the large cutbacks in production Boeing made.

The problem of oversupply means that some lessors are prepared to place aircraft with second and third tier airlines with poor credit quality that they were not prepared to lease to before. Moreover, these aircraft are being placed at low lease rates. The surplus of new aircraft is exacerbated by 5-7 year old aircraft coming off lease or due to come off lease in the short term. Returned aircraft and new aircraft are being sold or placed with airlines that have previously not been able to acquire new or young equipment. This has distorted the used aircraft market, since these carriers were traditionally buyers or lessees of used equipment. "This has then put downward pressure on lease rates of older aircraft, further distorting the market," says Forsythe. "It also causes problems for other lessors, since the rates being offered by some are so low it makes it hard to compete."

"In some cases airlines are taking new generation narrowbodies on lease because they are being offered at very attractive lease rates they cannot refuse," explains Bill Cumberlidge, managing director of Pembroke Capital. "These aircraft are being used to replace old aircraft, and some lessors are having to offer airlines a credit to take them out of service to cover the introduction costs of the new type. The airline still has the old aircraft to sell, but suffers no other costs than attractive lease rentals for the new equipment. Although lessors are having to extend themselves to place aircraft, it is preferable to not placing and parking them."

Lessors' exposure depends on where their portfolio is placed. Some lessors are fortunate to have placed the majority of their aircraft with carriers in the Asia Pacific, but others have a large portion of their portfolios in the US. GECAS, for example, has 45% of its aircraft placed with US airlines. Lessors with aircraft in the US are exposed to high risk. Many transactions were completed with very thin margins, which is dangerous given that several carriers are already in, or have a good chance of entering, Chapter 11.

Debt availability

Institutional lessors are owned by large corporations that usually have high credit ratings. This gives them access to the bank and capital markets on their own right and a ready source of funding from the parent. Private lessors do not enjoy that benefit and have to source debt from the market. The availability of debt for aircraft transactions has collapsed in the past two years.

Many banks that provided financing for lessors have simply left the business, having been scared off by returned aircraft and airlines experiencing financial problems. "Debt terms have become tougher for those banks still financing aircraft," says Craig Papayanis, managing director or BCI Aircraft Leasing. "Advance rates have been reduced, weaker credits are no longer considered, age of aircraft is more a factor, as are residual value balloon positions. Debt terms rely on equity investments of 10-20% or more of the purchase price, up from a typical 5% before."

"The smaller debt balloons are particularly a problem because they require the diversion of much of the rent to pay the debt. Banks that underwrote on older 737-300s two years ago will not offer for mid-life A320s. Meanwhile, rents are collapsing." Interest rates are also higher, with some banks asking for Libor plus 250-300 basis points for high quality credits and equipment. Equity investment has to be serviced from these rentals, making the transaction harder to support. The moment of truth comes when lessees negotiate the lease rentals they are prepared to pay. "It is not so much that banks do want to do business, but their terms cannot be supported by market rents," says Papayanis. "Only a restored faith in residual values by banks and appraisers, which is likely to take a long time, will reverse this situation. In the meantime, the few deals that are being done are relationship driven and more one-off in nature."

The banks that still finance transactions are more cautious, and some take a long-term view of the market. "We look at specific projects and examine each transaction on a case-by-case basis. We have recently supplied debt supported by European Export Credits Agencies to debis AirFinance and GATX Aviation Capital Group for A320s," says Jose

Although deliveries are lower than two years ago, a high proportion have yet to be placed with lessees. This is one factor causing a surplus of aircraft and leads to downward pressure on lease rates.

Abramovici, head of global transportation group at Credit Lyonnais. "We would also consider financing other narrowbodies, such as the 737NG, if the project was well defined with strong credit involved as lessee. We do not think we should reject the aircraft market in principle, since by staying in the market we may be able to take advantage of some of the better transactions that come available. We regard the business with a long-term view, and consider all aspects including lessee risk, pricing and aircraft type. I believe there will an oversupply of aircraft for another two years and so banks and lessors will have to be patient. Libor rates are low, meaning that low lease rates are mitigated."

Lease rate reductions

Lessors are also under pressure from an oversupply of aircraft in the market. The large number of parked aircraft is one factor pushing down lease rates in the market. Airlines were already getting good rates because of low interest costs, but many are asking for even bigger lease rate reductions. The carriers looking for rate reductions are those with economic problems. This raises the issue of whether lessors should offer these reductions. Airlines with economic problems have a higher risk of defaulting, meaning rate reductions in the early part of the lease would not be worth making.

All temporary lease rate reductions are accompanied by mechanisms to claw back these cuts. This is usually either with an extended lease term or a step up in lease rentals later in the lease to maintain the net present value of the transaction. Temporary reductions are only usually given by lessors if the airline is strong, but these carriers do not usually need a rate reduction. The other difficulty is that lessors have to treat all customers as equal, and rate reductions for one will lead to requests for reductions by others.

The pressure from lessees to temporarily reduce lease rates has eased since the initial period after 11th September 2002. "Most restructurings are complete," says Forsythe. "Demand for reduced rates and restructured leases was high, but the pressure has tailed off."

The airlines trying hardest to get concessions are those which have exhausted their cash reserves. Several US majors and other airlines are attempting to restructure, and are seeking to renegotiate lease terms and rates. United has sought much lower rates while it is reorganising under Chapter 11. Most lessors will only consider this if they think the lessees are viable, or in extreme cases need to keep the aircraft with the lessee.

Sale & leasebacks

In addition to lessors having to place new aircraft and others coming off lease, there has also been a high level of demand for sale and leaseback transactions in recent years.

These have been used by airlines during the phase-out period of a fleet, and have the advantage of generating cash. Historically lessors have paid good rates for aircraft, often several millions of dollars above their book value. The economics of these transactions have had heavy reliance on the residual value of the aircraft at the end of the transaction. Benefits to airlines are clear, but risks to lessors are high, and some transactions have made high losses following the collapse in residual values of certain types.

"Some airlines are still using sale and leasebacks to improve their financial performance, but more lessors are realising that they are in fact giving airlines a capital loan, and this is not the lessors' business," says Klaus Heinemann, managing director of sales and marketing at debis AirFinance. "There is growing demand for sale and leasebacks, and in many cases airlines are trying to use them to generate the cash they badly need. There is also high demand for sale and leasebacks for aircraft yet to be delivered, and this is basically due to a lack of funding alternatives for airlines. Airlines with purchase obligations often only have sale and leasebacks left as a financing option."

Like external financing options, it is hard for lessors to get funding to meet the current demand for sale and leasebacks. It is hard enough to fund new deliveries, for many lessors to have an appetite to additionally fund sale and leaseback transactions. Lessors have also lost their appetite for sale and leasebacks. There is, however, lots of opportunity for lessors to get attractive pricing for new deliveries. This is because the current downturn has led to orders being made at deep discounts. Lessors can thus acquire aircraft at low rates, which could generate good returns in respect of their residual values at the end of the transaction. "We would consider sale and leasebacks if we think an aircraft type is worth getting into, such as the A320 and 737NG," says Forsythe.

Willingham continues: "A few deals will be done, but the number of viable lessors has shrunk and the remaining ones are critical about aircraft types, purchase prices and residual values. We have done deals on young aircraft. The number of deals being done in the market is about the same as two years ago. Demand is higher but there are fewer lessors."

Cumberlidge points out that lessors are cautious about cashflow, and many would prefer to do straight leases for their own portfolios. "The purchase price would have to be low, the aircraft have good residual value and airlines be of good credit. Overall, lessors are conscious to avoid airlines that are doing fire sales to generate cash. Most lessors do not consider it worth speculating." There is also little debt available for the transactions, and a lack of interest from the banks. The reduced value that lessors are prepared to pay for aircraft means it is actually uneconomic for the seller. AC