Lessors have spent the past two years dealing with troubled lessees and restructuring leases. Airlines are now beginning to recover and the supply of aircraft is reducing. With a recovery in sight, what strategy will lessors follow?

Which way forward for lessors?

The ordering and buying activity of aircraft lessors naturally follows the economic cycle, so with reduction in the number of younger aircraft available, lease rates and values of some types firming up and a recovery now under way, is there any sign what strategy lessors are going to take?

Lessor analysis

The portfolios of the top 10 or 12 lessors have changed little in size since 11th September 2001, although in some cases they have decreased in size. Most lessors have spent the past two years restructuring leases and remarketing aircraft. A few, however, have been proactive in increasing their portfolios and have followed a clear strategy of expanding their share of the market.

The top 12 lessors, in terms of size of portfolio of aircraft larger than the BAE 146, are listed. The portfolios of some lessors have diminished over the past 18 months. These include CIT Aerospace, Ansett Worldwide, debis Airfinance, Babcock & Brown and GATX Air *(see Top 20 operating lessor survey, Aircraft Commerce, June/July 2002, page 6).* Some of these have concentrated on selling their older aircraft types and focusing on younger generation aircraft.

Other lessors, include Lombard Aviation Capital and Boullioun, have grown their portfolios.

The top 12 lessors have a combined portfolio of more than 2,800 commercial jetliners. Not only do they have the largest portfolios, they also concentrate on the youngest generation aircraft. Other smaller lessors of younger generation aircraft have a combined portfolio of about 300 young generation jetliners. These include Deutsche Structured Finance (DSF), Bavaria, GOAL, Itochu, Mitsui, Orix, Safair and SALE.

GECAS and ILFC still have the largest portfolios, with almost 1,700 aircraft between them. In addition to GECAS' 1,041 aircraft that are larger than the BAE 146, GECAS also manages about 300 more aircraft and also has a portfolio of about 230 regional jets.

These two lessors have led the way in offering aircraft to a wider variety of airlines than other lessors were prepared to approach in the past. With low cost of internal funding and high volume purchases and discounts, these lessors have been able lease aircraft to airlines that may previously have been regarded as having unacceptably high credit risks. Moreover, the ability to provide aircraft at low lease rentals means GECAS and ILFC are able to market aircraft a long before they are due for delivery. Lessors that are unable to offer aircraft at lease rates as low as GECAS or ILFC may be forced to market aircraft closer to delivery, when airlines have fewer available deals to choose from.

GECAS' fleet of 1,041 aircraft includes 781 new generation narrowbodies, of which 503 are 737s, 39 are 757s and 239 A320 family types. The rest of the portfolio is mostly made up of MD-80s, A330s, 767s and 777s.

GECAS has also followed a policy in recent years of converting older aircraft in its portfolio to freighters when they have been returned off lease. The types that GECAS has already started to convert are the 737-300 and 767-200.

Unsurprisingly, GECAS has placed few or no orders for new aircraft in the past two years, and instead has concentrated on placing aircraft that were due for delivery with lessees so as to limit its risk exposure during the downturn. GECAS currently only has delivery positions available for 16 A320 family types in 2005, with all aircraft due for delivery in 2004 already placed.

ILFC also has a majority of young generation narrowbodies. Out of a total of 635 aircraft, 428 are A320 family types, 737s and 757s. The portfolio has another 88 767s/777s. ILFC still has several aircraft available that are being delivered in 2004.

Boeing Capital has the third largest portfolio with 348 aircraft. These are mainly Boeing and McDonnell Douglas types, but it also has a small number of A320s and A330s.

With the reduction in Ansett's portfolio, CIT Aerospace has the next largest portfolio after Boeing Capital. Like several other lessors, CIT increased its market share and modernised its fleet with speculative orders for A320s and 737NGs in the late 1990s and 2000.

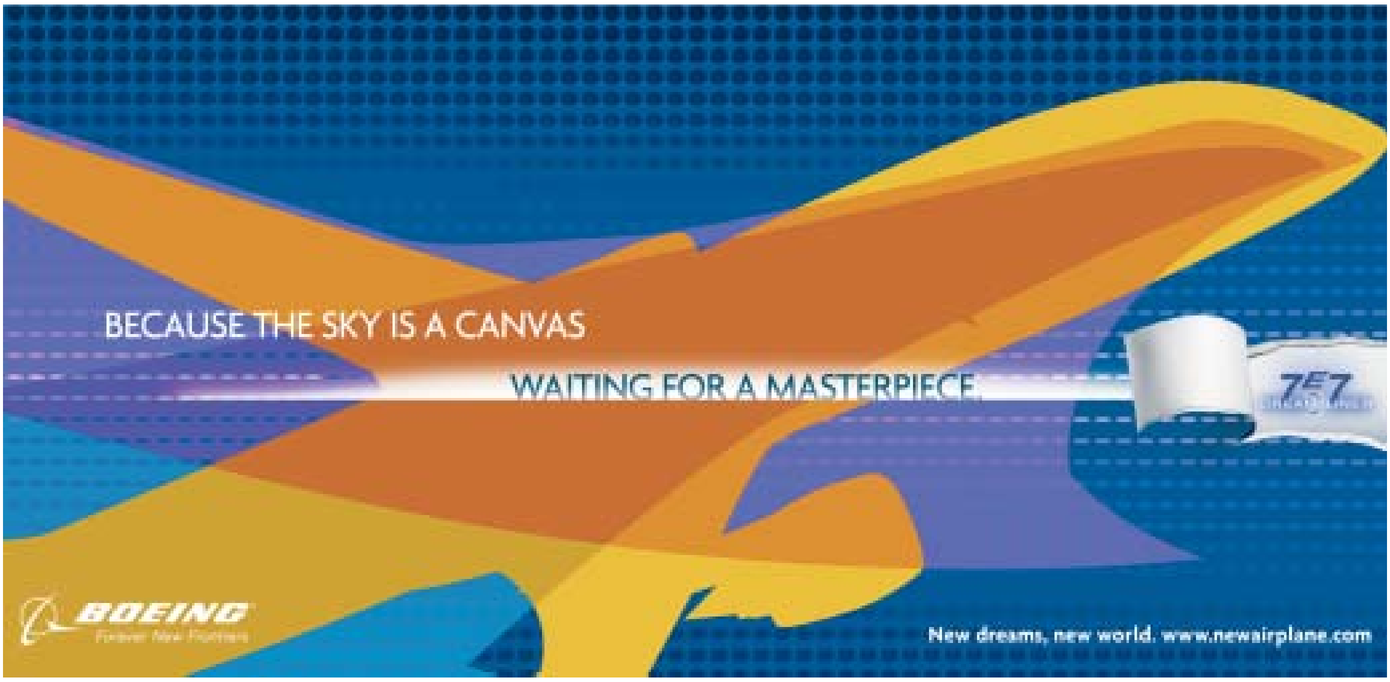
CIT currently has 162 aircraft larger than the BAE 146, although it also has some regional aircraft. More than 100 of these are younger generation narrowbodies, with 40 A320 family types, 60 737s and nine 757s. CIT also has six A330s and six 767s/777s. The remaining 41 aircraft in its portfolio are mainly older types like the DC-10.

CIT is one of the few other lessors to have aircraft being delivered in 2004 available for lease, as well as others being delivered in 2005.

Ansett Worldwide and Boullioun have similar sized portfolios now that Boullioun manages IEM's portfolio.

Ansett has 108 aircraft and the lessor's debt is all internally provided by parent company Morgan Stanley. Like most other lessors Ansett has concentrated on modern narrowbodies, and has 49 737s and 11 757s, but only a small number of A320s. It also has 19 767s.

Ansett has no outstanding orders, and prefers to market aircraft due for delivery six to nine months ahead, although the lead time is often reduced to three to four months. Ansett has placed speculative orders in the past, although it last ordered



new aircraft in 2000. It has also acquired aircraft through purchase and leasebacks.

Boullioun, a wholly owned subsidiary of West LB which provides the majority of Boullioun's debt, has a portfolio of 121 aircraft when its own portfolio is combined with IEM's. Boullioun's own portfolio almost entirely comprises A320s and 737s, although it has a small number of 757s and 767s. Boullioun's lessees include a number of successful European low cost airlines, such as Air Berlin, Air Europa and easyJet.

Boullioun still has 22 737NGs and eight A320s on order, although these are due for delivery between 2005 and 2007 when the supply of aircraft is expected to have reduced and the market improved. Boullioun typically markets aircraft six to 12 months ahead of delivery, which gives interested lessees time to consider Boullioun's aircraft due for delivery over the next two years.

IEM's portfolio consists of 27 aircraft, which are mainly 737s and A320s, but in addition some 757s, 767s and a 777. Most were acquired by IEM through sale and leasebacks.

debis Airfinance has the next largest portfolio, with 144 aircraft, 70 of which are A320s and a few other Airbuses, and 74 Boeings, most of which are 737s. Its portfolio of jetliners also includes 33 Fokker 100s, and some regional aircraft.

debis is 45% owned by Daimler Chrysler, 10% by DZ bank and 15% each by Bayerische, HVB and Dresdner banks. These shareholders provide some debt, although debis uses some ECA funding on a large scale, as well as placing itself as the lessee in Japanese operating leases and US-based tax leases.

It leases aircraft to a variety of lessees. debis expanded its portfolio by placing speculative orders, and is one of the few lessors still to have a significant number of aircraft available for airlines during 2004 and 2005, with a total of 30 A320 family aircraft due for delivery.

GATX Air has 134 aircraft and manages another 70, some in a securitisation portfolio, taking its aircraft to 204. The number of jetliners totals 196. GATX is 50% owned by Rolls-Royce and 50% by Pembroke Capital.

The majority of the main portfolio includes modern narrowbodies, comprising 30 737-800s and 62 A320 family aircraft. It also has another 45 737 classics, 19 757s, four 767s, and 21 MD-80s.

This portfolio is spread with lessees over all main continents, with the majority in Europe and North America, but also with large numbers of aircraft in Africa, the Asia Pacific and the Middle East.

GATX Air is one of the few lessors still to have aircraft available in 2004 and 2005. It has five A320s due for delivery. These aircraft are the remainder of a larger order that was originally placed by Flightlease, some of which were intended for the SAir Group.

GATX is 100% owned by GATX Financial, which provides most of its debt, although GATX Air also uses ECA debt.

Babcock & Brown has 105 aircraft, the majority of which are A320s and 737s, but it also has 757s, 767s, a 777, DC-10s, MD-80s and some A300s.

Aviation Capital now has a portfolio of 86 aircraft, which includes a number of A320 family types, several models of the 737 Classics and 737NG family, the 757, 767-200/-300 and MD-82. It also has a small number of MD-82s. Lessees include a number of first-tier operators.

Aviation Capital is funded externally, and recently completed a second ABS transaction, although it is a PacificLife company.

While most lessors have maintained their portfolios in the past two years, Lombard Aviation Capital has been proactive in expanding its portfolio, and has done this mainly through sale and leasebacks and portfolio purchases. Lombard's portfolio of aircraft larger than than the BAE 146 now numbers about 72 aircraft, and more acquisitions are expected to increase this before the end of 2003. The portfolio almost entirely comprises 737NGs and A320s.

"We have a planned portfolio over the next five years that will make us one of the most significant players in the operating leasing market, and we have set ourselves the target of achieving this in three years," says Dick Forsberg, head of strategy at Lombard Aviation Capital. This implies a portfolio increasing to at least 200 aircraft.

Lombard is owned by the Royal Bank of Scotland, which provides all debt for Lombard's acquisitions. "This will continue to be the case, and Royal Bank of Scotland has committed to finance acquisition of 100 plus more aircraft for our portfolio. Our target is to grow our portfolio to a value of about $5 billion, which is similar to Ansett's. Our current portfolio is about $3 billion, so we are just over half way to our target."

Lombard is also getting into the

Supply of 737NGs has remained the tightest of all young generation aircraft, and this has kept their market values and lease rates high compared to other types.

engine leasing market, and has already acquired a small number of engines through sale and leaseback transactions. "We will offer engines on medium-term leases, as well as provide debt financing for airlines. Our entry into engine leasing is natural, since there is synergy between aircraft and engines and we have the technical expertise required to manage engines," explains Forsberg.

In addition to lessors with portfolios of about 100 aircraft or larger, there are several prominent companies with portfolios of young generation aircraft. These include lessors such as Bavaria, Orix, Mitsui and Singapore Aircraft Leasing Enterprise (SALE).

SALE is owned by Singapore Airlines, Boullioun, Temasek Capital and Singapore Investment Corporation. The lessor has a portfolio of 47 aircraft, the majority of which are 737NG and A320 types. The portfolio also includes A330s, 767s and 777s.

SALE also has 21 aircraft on order, all of which are A320 family variants. These are due for delivery up to 2007, with aircraft available between 2005 and 2007. SALE's lessees include major carriers around the world.

SALE is funded externally, and it uses 40 different commercial banks around the world and export credit agencies.

Orix has a portfolio of 57 aircraft, mainly A320s and 737s, but also including A300-600s, 767s, 777s and DC-10s.

Mitsui's portfolio of 64 aircraft comprises A300-600s, A320s, 737s, 757s, 767s, DC-10s and MD-80s leased to a variety of lessees that include Korean Air, All Nippon Airways, Japan Airlines, United, British Midland, easyJet, Excel Airways and China Southern.

Bavaria is one of the larger lessors among the group of smallest portfolios of young generation aircraft. Bavaria has 27 aircraft, mainly A320s and 737s that are leased to a variety of airlines in China, Europe and South America.

Cycle point

The past few months have indicated that a recovery is under way, even though recovery after 11th September 2001 has been hampered by the Gulf War, the SARS outbreak in the Asia Pacific region and the late rebound in the US economy.

Traffic of Asia Pacific airlines worst affected by SARS has recovered fast to normal levels. Most airlines in the US finally posted encouraging results in the quarter ended 30th September, having been boosted by a surge in passenger numbers and improved yields. This follows reports of huge first quarter 2003 losses. Traffic and passenger yields in other parts of the world have also improved, leading a recovery by other airlines.

This should eventually lead to an increased demand for aircraft. Not only is a recovery in values and lease rates expected, but also a reduction in the supply of available aircraft. This would be a reversal of lessors' experiences in the past two years, although it is not clear when lessors would feel it would be necessary to start placing orders for new aircraft again.

The supply and demand situation is different for each aircraft type. The supply of 737NG types has reduced in recent months, partially due to a cutback in production by Boeing. The supply of A320s is still relatively high, especially following the failure of Aero Lloyd in Germany.

"The large number of speculative orders placed by lessors in 2001 caused an imbalance in the aircraft supply," says David Thompson, managing director at GATX Air. "Most lessors are therefore not considering placing speculative orders at the moment, but several are acquiring aircraft through sale and leaseback transactions, which is currently more appropriate because of the certainty they provide. The supply of different aircraft types is reflected by their lease rates. There are few 737-800s available, and so lease rates are firming up. Rates for MD-80s are languishing with large numbers on the market. In terms of the supply and demand of aircraft, I expect a balance to return to the market over the next few years. The recovery is not yet steady enough for speculative aircraft orders to make sense and many lessors do not yet have the confidence to place new aircraft at sensible lease rates. Lease rates for the 737-800 never fell too low, and the 737-700 seems pretty good with few available also. Rates for A320s are still challenged with supply continually being topped up as fast as aircraft are reabsorbed into the market."

Other lessors are seeing a similar pattern of values and lease rates for different types either firming up as supply diminishes or staying level as numbers on the market remained mostly unchanged. "We are definitely at the bottom of the cycle, although there are variations in the rate of recovery between global regions and aircraft types," says Forsberg. "There are still more than 45 A320s available, which is better than after 11th September 2001, but still quite high. Current values and lease rates are probably 10% lower than base values and lease rates. Rates for 737s are strong, however, although the whole situation is helped by low interest rates. There is still, however, a lot of overcapacity and this could last for another two years. Only the best aircraft are going back into service."

GECAS also takes the view that it will take until at least 2006 before a balance in the supply and demand for aircraft is reached. The oversupply of aircraft is exacerbated by the continued production of new aircraft by Airbus and Boeing and whitetails being temporarily parked. Higher demand for aircraft is dependent on growth in passenger traffic.

"We do not see a balancing of the supply/demand situation until 2005/2006, then a reversal," says Klaus Heinemann, managing director at debis AirFinance. "There will still be too many aircraft available in 2004, even if there is significant traffic growth. I expect there will be a supply/demand balance for modern types between the A319 and 777 by 2005, but other types will still be in oversupply. There will be some demand for MD-80s, since they will replace DC-9s. MD-80s are also being placed with low-cost, start-up airlines, which are absorbing an appreciable number.

"There will still be an imbalance in supply of certain types by the end of 2004. There is still a surplus of A320s, for example, but several operators have gone out of business, including Khalifa, Aero Lloyd, ACES and Shorouk. The current rate of parking exceeds the rate at which they're being absorbed by airlines," continues Heinemann. "I suspect we are close to the bottom of the downturn, but if lessee interest is greater than lessor marketing activity lease rates tend to rise. Rates are not going up now for most types."

Recovery strategy

Once recovery is more evident and stable, lessors will have to change from dealing with distressed leases to considering new orders and emerging markets. Operating leasing has expanded across all continents in the past 10 years, including the US which previously shunned the use of operating leases. There are emerging markets, however, for lessors to consider. These include India, China, the CIS, East Europe and parts of the Asia Pacific.

"We see China and India as having potential, but are more optimistic about Eastern Europe and the CIS because of their positive economic growth and increase in middle class incomes," says Heinemann. "Some Eastern European countries are also due to join the European Union, and this will make it easier to market aircraft because import taxes and other issues will go. We have also already got some A320s into Indian Airlines."

Ansett sees China as a major emerging market and has placed aircraft with Chinese airlines since 1991, although the market is small compared to the population. "The CIS is expected to be good for older Stage 3 aircraft like the MD-80 and 737-300," says Forsythe. "There is also hope with large established airlines. Their balance sheets were harmed during the downturn because of the fall in aircraft values. These carriers may be more willing to consider a higher level of operating leases in the future. In terms of lease rates and demand for aircraft, younger types are experiencing a more pronounced recovery as might be expected."

Lombard also sees China, India and Russia as some of the regions with high long-term potential. "China has double-digit growth, while India and Russia will take longer to develop," comments Forsberg.

With such opinions about the market, few lessors are likely to place speculative orders for the next few years. Lessors are still doing sale and leasebacks as good opportunities arise, but with aircraft coming off lease that have to be re-marketed most want to keep marketing activity to a minimum, and so will not place speculative orders. "We will continue to acquire 737s and A320s on sale and leaseback transactions, and have been doing several hundred million in sale and leasebacks each year," says Thompson. "Most lessors are looking for sustainable and stable growth. For example, we are selective and careful about acquiring widebodies because it can cost up to $10 million to reconfigure them for a new lessee."

Besides an imbalance between supply and demand for aircraft, several lessors still have aircraft due for delivery that require marketing over the next two to three years, which makes it risky for most other lessors to order new aircraft. "We still have 30 A320s being delivered over the next few years, and so will not consider new orders," says Heinemann.

In addition to new geographical markets, there is also the possibility of increased activity in regional jets (RJs). While GECAS has large portfolios of large Bombardier and Embraer RJs, few other lessors believe the market is worth entering even if demand for these aircraft could be high. "It is not worth placing speculative orders for aircraft. Airlines have opportunities to finance them at better rates than the lessors can afford to offer them at," says Forsberg.

Other lessors feel that the purchase discounts secured by GECAS gives them an advantage with which other lessors cannot compete, and few have plans to enter the RJ market. "RJs are dominated by General Electric and GECAS has the advantage with low lease rentals, and low lease rate factors that effectively make the engines on the aircraft free," explains Forsythe. AC