China has evolved steadily over the past 20 years into a stable and promising market. Despite government regulations and import duties, the Chinese market provides opportunities for aircraft lessors and financiers. Yong Qiu analyses China's future aircraft financing requirements.

Financing China's aircraft bonanza

The past two decades have witnessed a dramatic growth in China's air transport market. This has led to a transformation in aircraft ownership and their allocation to airlines.

Two years ago three major Chinese airline groups, Air China, China Eastern and China Southern, were transferred from the Civil Aviation Administration of China (CAAC) to China's State-owned Assets Supervision and Administration Commission of the State Council. China's airline industry entered a new era during which aircraft financing will consequently change. This article reviews the history of aircraft financing in China, and examines probable techniques and future suppliers.

Development history

There are three milestones in the development of China's airline industry. The first of these is the transfer of the CAAC from the military to the State Council in 1980.

Deng Xiaoping, China's former highest leader, required that the industry be commercialised rather than militarised. Consequently the Guangzhou operational unit of the CAAC was commercialised as an experiment and renamed as China Southern Airlines. It was granted limited rights to make profits.

The second milestone was to establish other airlines, like China Northern, China Eastern and Air China in the late 1980s. Smaller airlines such as Shanghai Airlines, Hainan Airlines and Xiamen Airlines were established in later years. The third milestone was the consolidation of the airlines into three groups starting in 2002.

Aircraft acquisition process

So far China has not developed an ability to manufacture its own commercial aircraft larger than 100 seats. Commercial aircraft are seen as strategic goods, and their purchase is regulated firmly by the central government.

Airlines intending to purchase aircraft must first hand in their requests to the State Development Planning Commission (SDPC), a department regulating the import of strategic materials. Airlines then hand in their proposals to China Aviation Material Import and Export Company (CAMIEC), a state-owned and plan-economy-oriented company controlled by CAAC. CAMIEC negotiates prices, delivery dates and other contract features with foreign aircraft manufacturers to ensure favourable prices. "Pooled orders allow favourable purchase prices to be agreed, and also improve China's diplomatic relations with the US and Europe," explains John Willingham, president of Boullioun. "Placed orders are then allocated to airlines, but the airlines have considerable influence over their fleet plans."

Aircraft that are ordered from the manufacturers by the CAAC are either purchased or acquired with finance leases.

The aircraft ordered by the CAAC are not usually enough to satisfy airlines' capacity requirements and additional aircraft are then acquired direct from operating lessors. The leased aircraft can quickly be operated in China, once the CAAC's technical requirements are satisfied and Chinese Customs' regulations are met. Chinese airlines prefer to lease aircraft, for the sake of simplicity to meet their short-term needs.

"Lessors work directly with Chinese airlines to identify their fleet and capacity requirements. The airlines then seek approval from the government, while the lessors have a direct relationship with the airlines, but little dealing with the CAAC," explains Nigel Leisham, regional sales director at AWAS. "The Chinese market is opening up to used aircraft, and government approvals for operating leases are coming through more quickly. The government's standards for noise and safety standards meant that there used to be a strong desire for new aircraft, but the government has understood that growing demand cannot be satisfied by new aircraft alone. As an example, we leased a 737-300F into China to Shanghai Airlines. We have also leased some used 767-300ERs to Air China in recent years."

Willingham estimates that operating leasing now accounts for about 20% of aircraft acquired by Chinese airlines, and so lessors are effectively acting as a source of capital for the carriers. "The aircraft acquisition system is evolving, and airlines are becoming more independent."

China imposes several import duties and taxes on western aircraft. The first of these is value added tax (VAT) applied at a rate of 17%. The second is a withholding tax imposed for aircraft on operating leases. There is also a customs duty of 1% on the value of the aircraft or monthly lease rental, as well as a stamp duty. "The stamp duty is a nominal amount, and therefore small," says Leisham. "Withholding tax is 10% of lease rentals. The import VAT and withholding taxes can be circumvented. It is advisable to pay lawyers to advise on this, but as the basic requirement is that a lease of 364 days is exempt from some of

While China's major airlines have acquired the majority of their aircraft through orders placed by the CAAC, smaller carriers are more independent and have acquired large numbers through operating leases.

the tax and duties, they can be avoided by having multiple one-year leases."

Willingham explains that the various import duties and taxes do not obstruct business, and the airlines deal with circumventing or minimising them. China is not a protectionist market and the multiple one-year lease structures are perfectly legal.

First financing transactions

The first problem facing China Southern Airlines in 1980, the first carrier free from the handcuffs of a planned economy, was how to replace ageing Russian aircraft and enhance the company's capacity efficiently and effectively to meet the surging air transport demand that followed the liberalisation of a planned economy.

In the early 1980s it was much harder for China Southern Airlines to get approval from the government to purchase aircraft. The airline also had poor finances. Yu Yan'eng, the first president of China Southern Airlines, had a deep understanding of the international aircraft leasing market at that time. Despite its financial constraints, China Southern was the first Chinese airline to use finance leases to improve its capacity over a short period without annoying the central government.

The first finance lease in China was used in 1984 for a 737, and opened China's airlines to unprecedented aircraft leasing markets. Thereafter, finance leases, operating leasing, and sale and leaseback transactions have all become as popular as straight purchases.

Operating leasing has become one of the most popular financing techniques since the mid 1990s. This has been since Chinese airlines experienced declining profit margins due to increased competition. The first lessors to secure leases in China were GECAS and International Lease Finance Corporation (ILFC). They have had a presence in China since the late 1980s. Boullioun, RBS, AWAS, CIT and SALE have all since penetrated the market.

AWAS signed its first deals in the early 1990s, which included the lease of A300-600Rs to China Northern. Other leases include 737-300s.

Chinese airlines still also purchase aircraft. China's aircraft orders have a cyclical nature, with a surge every two or three years. The high rate of expansion suggests that Chinese airlines have several financing sources, since airlines would not have been able to expand during the years of deflation from 1998 to 2002.

Three characteristics should be remembered in terms of China's aircraft orders. The first is that the orders are always large. The second is that orders are generally not cancelled or delayed, as is the case with carriers from other regions of the world. The third is that they often coincide with this visits of China's leaders to host countries, such as the US and France, which get the orders easily approved by the Chinese central government.

Historic financing

By the end of the 1990s, China's airline industry had entered a period of low profit margins, but still maintained high capital expenditure for aircraft.

These large orders and investments in aircraft required several forms of financing. The first finance source was from central and local governments. The three major airline groups were profitable enough to finance themselves before the mid 1990s, but other airlines got various subsidies from the central or local governments. Zhong Yuan Airlines, an airline merged by China Southern Airlines in 2000, got financial allowances of more than $10 million from the He Nan Province government to support its aircraft purchases.

The second source was the airlines' own cashflows. Before 1998, when the Asian financial crisis and China's unprecedented deflation damaged the airline industry, Chinese airlines' balance sheets were all strong, and they had an average annual operating profit margin of more than 10%. The financial results of incumbents like China Southern, China Eastern and Air China beat the average, and so were confident about acquiring more aircraft.

The third finance pipeline came from foreign banks. Before 1998, when the Chinese airline industry recorded its first loss since 1982, foreign financial organisations, such as the Exim Bank of the US, regarded major Chinese airlines as low-risk, high-growth companies. Foreign banks were consequently willing to guarantee the loans for aircraft purchase.

Chinese airlines also benefited from low-interest loans provided by the Japanese government before the early 1990s. In 2003 China Southern Airlines still had 74% of its finance leases denominated in US Dollars and 26% in Japanese Yen.

China's fleet is forecast to require 2,000 aircraft over the next 20 years. The consolidation of nine airlines into three main groups will lead to a high demand for the A320 family and 737NG.

Financial distress

The loans from foreign banks were a double-edged sword for Chinese airlines. The loans sustained high growth and enhanced their financial leverage and foreign exchange risk, but magnified their financial distress in economic downturns.

China Southern Airlines incurred foreign exchange losses of 164 million Chinese Yuan in 2003 and another 175 million Chinese Yuan in 2002 because of the Japanese Yen's increased value.

The Asian financial crisis and Chinese airlines' unprecedented losses from 1998 to 2002 reminded these foreign banks of the high potential risks facing these airlines. Foreign banks consequently shrank their loans or increased interest rates on outstanding loans to China's airlines. On the other hand, Japan was in a dreadful recession from 1992 and the Japanese Yen correspondingly lost attraction to China's airlines.

These companies had to look for domestic financial sources: China's banks. Among China's banks, Bank of China and the China Industrial and Commercial Bank give the strongest financial support in terms of aircraft acquisition. From 1998, China's economy was mired in deflation, which caused a high level of bad debts. While the airlines had stable cashflows, few other companies could get loans from these banks. More importantly, because Chinese airlines are substantially controlled by the government, and aircraft acquisition partly resulted from the government's diplomatic needs, the banks did not have to worry about the airlines' creditworthiness. The benefits of borrowing from local banks include lower interest rates than those offered by foreign banks and no exchange rate risk.

China's banks are not enough, however, to sustain these airlines' high growth rates. Some airlines like Shan Dong Airlines and China Eastern Airlines therefore issued shares twice to raise capital for aircraft purchase. The similarity and difference of the two share issues were worth noticing. The similarity is that both issuings were to purchase new aircraft. The difference is that the first share issue was against the backdrop of the industry's high growth with modest profits, while the second was to get these airlines out of financial trouble and to finance aircraft acquisition.

Future developments

The implications of China's ongoing consolidation and deregulation need to be understood before talking about how airlines finance aircraft in the future.

Major Chinese airlines started consolidation in 2002. This process is due to finish by the end of 2004 or early 2005. The three groups' fleets will become more complex because the six merged smaller airlines have different fleet planning requirements.

Meanwhile, the three groups all have large numbers of aircraft due for delivery up to 2009. The three groups' fleets are short of commonality to achieve the economy of scale that is believed to be one of the aims of consolidation.

Market potential

More significant impacts come from the ongoing deregulation of air transport. Total capacity in available seat-miles (ASMs) generated by China's airlines have already increased from about 30 billion in 1984 to about 90 billion in 2004. The number of passengers, and so required capacity, in the Chinese market is expected to treble again during the next 20 years. China's fleet will consequently reach about 3,000 units. If manufacturers consider China's ongoing deregulation, which has significantly changed this country's air transport profile, the future for aircraft manufacturers will be more promising.

The probable effects of deregulation include: lower air fares, which have stimulated the country's pent-up air demand, an increasingly liberalised market, which has attracted more foreign carriers to China; and the establishment of new airlines.

Significant growth is expected in the Chinese market over the next 20 years. The economy is forecast to grow at about 8% per year, leading to an annual growth rate in air transport as high as 15-16%. "A double digit growth rate is expected in 2004. There are many cities with populations exceeding one million and there is high economic growth in the rest of the country," says Leisham. "The Chinese government has had a building spree of airports in recent years, suggesting it is gearing up for growth. It is estimated that up to 2,000 aircraft could be required over the next 20 years; an average annual addition rate of 100 per year. We expect 20-30% of these will be supplied on operating leases, and split between several lessors."

Short-haul types, like the 737NG and A320, are more ideal for the carriers since so far only short-haul aircraft and domestic routes are lucrative for these airlines. For example, China Northern Airlines, a subsidiary of the China Southern Group, is adding 23 A320 family aircraft on lease from International Lease Finance Corporation (ILFC) to replace its fleet of MD-82s and MD-90s.

"We have seen good demand for 737NGs and A320 family aircraft," says Willingham. "We have been in the Chinese market since 1996, and have 12 aircraft with China Eastern, Hainan

The entry of several start-up carriers, tightening of some traditional finance sources, exemplary payment performance by Chinese airlines of lease rentals and scope for development of the Chinese air transport market indicates China will be a strong market for operating lessors.

Airlines, Xinhua and Shandong Airlines. China can absorb 60-70 aircraft per year without a problem, and about 30% will come from operating lessors. This suggests that up to 30 aircraft a year could be supplied on operating leases."

Start-ups

The emergence of new airlines will have a knock-on effect on aircraft financing in China. Attention should be paid to three features of these start-ups (Aokai Airlines, Spring and Autumn Airlines, Eagle United Airlines and Shilin Airlines). The first is that they focus on different market segments and have a strategy of avoiding competition with the incumbents. The second is that the four start-ups are all privately owned companies, which implies that their aircraft acquisition model will be significantly different from those state-owned or state-major-controlled airlines. They will pursue economic rather than political benefits in terms of aircraft acquisition.

The third is that, as start-ups, they are not expected to have strong finances to purchase aircraft, and so leasing will be their first choice. For example, Aokai Airlines, a cargo airline, intends to lease between three and five 737 QCs. Spring and Autumn Airlines, a charter carrier, is poised to acquire aircraft through operating leases at the start of operations.

This raises the question of who will finance these start-ups to acquire aircraft. The first source is their shareholders and internal capital. If every start-up only leases three aircraft, which is traditionally the minimum required for a start-up to reach sufficient economies of scale, their current capital is enough to sustain the business. More important, because they have strong local backgrounds and their shareholders are all influential local companies, these start-ups should find it easy to get financial support from local banks. After two years of operation they will call for more capital to enlarge fleets, assuming that they can survive in the first year's money-burning operation, which is believed to be a necessary period according to European and North American experience. Because these start-ups are all based in China, however, where air transport is underdeveloped and competition is not so fierce, they will probably avoid competing with existing airlines. The start-ups will have more promising futures than their European and North American peers. Consequently, start-up airlines are good candidates for aircraft leasing.

Major airlines

While major Chinese airlines will continue to be the leaders in acquiring aircraft, their operations have become less profitable, so what are their future financial sources?

"Chinese airlines have not had much of a problem raising financing," comments Willingham. "They have been exemplary payers to lessors and there has never been a repossession of an aircraft from a Chinese airline. Chinese carriers are generally viewed as a good credit risk, and it is a good market for lessors. Chinese airlines have bounced back well after the SARS epidemic in 2003, and they have good economic control. The CAAC of course is an economic regulator which ensures growth by China's airlines is sustainable."

Under the existing banking system, China's banks will continue to be engines to power the airlines' aircraft acquisition. Chinese banks have built up large reserves of US Dollars and so can provide cheap debt for airlines. They are also aggressive in bidding for debt provision contracts to airlines, but they are being told to reduce the level of lending.

Besides debt from domestic banks, foreign debt linked to export credits is another source used. "China uses financing techniques similar to those used in other markets, " says Leisham. "This includes export credits, and 19% of Exim Bank's aircraft deals are done in China."

One possible finance source is to issue bonds. Because most of China's airlines still have good credits in the domestic capital market and China's investors have limited investment opportunities apart from the gloomy stock market, these airlines' bonds will be welcome.

Another possible source of finance is to sell state-owned shares to strategic investors, which has long been a consideration of the Chinese government to improve the airlines' corporate governance. Airlines can finance their fleet expansion this way.

Just like the surging air transport demand causing the CAAC's deregulation, the rising demand for aircraft will provide an incentive to change China's VAT policy for aircraft leasing and other policies that constrain the industry's future development. The recent decline in Chinese airlines' financial performance and poor balance sheets of the start-ups will provide a lobby to the central government to remove the policy. It is hard to predict when the reform will come into effect, but the timing depends on the degree of financial distress of the whole industry and tolerance of the incumbents.

Another derivative from the surging aircraft demand would be the emergence of a local aircraft leasing company. Apart from Shenzen Finance Lease Company, so far no aircraft leasing company has been formed due to the lack of modern regulations regarding finance leases. It is expected, however, that a number of aircraft leasing companies will emerge following deregulation and the anticipated surge of start-up airlines, since China's tycoons, who are short of investment opportunities, have very strong enthusiasm for this industry. The only problem for them is experts and expertise. AC