With airlines considering all possible ways to save costs and conserve capital, sale & leaseback transactions of rotable inventories is becoming increasingly popular. There are several reasons why this can suit airlines, and there are many advantages to be gained.

Rotable inventory sale & leaseback transactions

All airlines require constant and reliable access to stocks of consumable and rotable components in order to support their operations. While consumable items are disposable and account for a tiny proportion of material costs, rotable components represent investments of tens or hundreds of millions of dollars for airlines. With a constant squeeze on profit margins and finances, it is not surprising that more carriers are taking an interest in sale & leaseback transactions for their rotable inventories.

Rotable inventories

An operator has two basic options available to them to facilitate their requirements for rotable parts: complete ownership of all stock required to support their fleet; or to lease components from a parts supplier as a base stock, or as access to a local pool of components.

The second option may work with an operator's own small homebase stock of components that are used on a frequent basis or are no-go items. "Component pooling is a growing area because airlines want access to components quickly but without large outlays," says Andy Braley, director of business development at AJ Walter.

When an airline owns its own rotable inventory it decides its stock requirements. This often means that over time an airline will collect almost every part it might need, and will hold a certain quantity of the same part number. The number required in stock will be determined by failure and repair intervals and fleet size.

Parts that fail infrequently, or do not affect an aircraft's operation when they do fail, are required in small numbers, so airlines do not need to maintain homebase stocks of such parts. These include items such as air cycle machines.

Owned stock is likely to be kept at an operator's main base. Larger scheduled operators will also need to have regularly used items at some of their larger outstations. For example, the main hub for British Airways (BA) is London Heathrow, but it also has a large stock of inventory at its secondary hub at London Gatwick, as well as at its heavy maintenance stations in Cardiff and Glasgow.

For many airlines, especially smaller and younger ones, owning an inventory is just not economically viable. Jamie Brooks, sales director for the Middle East and Africa at Avtrade, comments that for many new start-up airlines, having access to a rotable inventory is one of the last things they take into consideration when preparing for operations. "They lease the aircraft, but fail to realise the importance of having access to spare parts. Even if they do, they are unlikely to have the finances to purchase stock," says Brooks. In these cases an inventory can be leased from specialist providers, such as Avtrade, AJ Walter and Ansett Aircraft Spares and Services.

There are several ways in which an operator can lease components to support its fleet. If an operator performs its own maintenance & engineering, it may choose to lease an inventory that is kept at its homebase, or to access an inventory pool near its main operation, as well as pools around the world.

For airlines that sub-contract their maintenance, parts could well be handled by a third-party maintenance provider. easyJet, for example, sub-contracts all its maintenance to SR Technics (SRT), which has responsibility, as the maintenance provider, for the fleet's inventory requirements. Airlines have to decide if they need a large owned inventory or access to leased inventory pools.

Increasingly, airlines are looking at ways to improve their operational costs and efficiency. In some cases this can mean considering changing from owning an inventory to leasing stock, in which case an operator will need to look into selling its stock and leasing it back. Sale & leaseback transactions have gained popularity in the airframe and engine markets, but they are now becoming a key feature of the rotable parts market too.

Advantages

As cost-cutting becomes more important, and competition from low-cost operators increases, many traditional airlines are being forced to re-assess how they deal with their assets. Their stores can be full of inventory that has not been used in years, including items that may no longer be of any use, since they support aircraft that are no longer in the fleet, or they have passed their expiry date.

According to Braley, sale & leaseback appeals to the older legacy airlines. They may have large inventory that could be sold, but this can be a problem if the parts themselves are particularly old or are considered part of the airline's value. "The stock could have been part of the original equipment manufacturers' (OEMs') recommended inventory," says Gareth Cunningham, director of contract services at AJ Walter. "As maintenance programmes have developed and intervals increased, some of these items have become obsolete. If they are sold, they could release cash for the airline and improve efficiency." An added bonus is that if an inventory is reduced, the storage space required and its associated rental charges could also be reduced. If an inventory is completely sold and pool access is taken instead, then rent for the storage facilities is further reduced, or these may even be sold, with the potential to free up yet more cash for an airline.

"There are various reasons why an

airline might choose to sell and lease back its inventory," says Brooks. "An airline might be leasing an aircraft type for a relatively short period, or extending the use of one of its older fleets while they wait for new aircraft deliveries. Such is the case for many 767 operators while they wait for their 787 deliveries."

In these cases the airlines need an inventory for a relatively short period, and leasing becomes the obvious solution, with options to lengthen the lease if further delivery delays occur. When the newer aircraft come on line, the market value for the older aircraft's components could well plummet. "Airlines are therefore planning ahead and selling and leasing back the stock while they still need an inventory," says Cunningham, "and they are taking advantage of current (and potentially higher) values, thereby avoiding depreciation. As an aircraft type is phased out, an airline cannot afford to hold on to the original large inventory right up until the last aircraft has gone. They need to realise the value of the stock, before there is a flood onto the market, reducing prices."

The intrinsic value of spare parts is often a major reason why an airline might sell and lease back its required rotable inventory. "The stock can be part of an airline's assets and be liable for tax," says Brooks, "with lots of cash tied up doing nothing. Airlines need cash and chief financial officers now often say that it is better to present an airline's accounts with a show of cash, not assets."

With the global recession, many airlines have merged to maintain their stability, often leading to a doubling of an airline's fleet size almost overnight. The economies of scale that large fleets achieve in rotable inventory requirements mean that this does not necessarily mean the new airline needs to double its inventory. In these cases, some disposal of stock will be required. This in turn could lead to the entire inventory being sold and leased back, if the terms are suitable. An added advantage is that this shores up the cashflow of the newly merged airline, thereby keeping shareholders happy. "Thomsonfly (part of the TUI Group) recently merged with First Choice Airlines," says Cunningham."Both had very different ideas on stock ownership. Thomsonfly followed the traditional model of owning all its inventory, and completing all work in-house, whereas First Choice outsourced as much as possible. After the merger, First Choice took control of the new technical department, and a big change is now taking place as the two fleets and their inventory are being merged and assessed. This will lead to the sale of any surplus stock, and it is likely that the remainder will be sold and leased back."

There have been cases of airlines buying a large number of new aircraft, and being given free components by the manufacturer. An airline could take advantage of this situation by selling these to a parts supplier and leasing back an inventory, thereby generating capital. One added bonus of selling and leasing back an inventory is that parts suppliers offer an optimised stock quantity, due to years of experience and discussions with other airlines. These inventories are often smaller than an OEM's recommended inventory, and therefore cost less.

"When a sale & leaseback transaction has started, an airline will often not lease back the exact same stock. They may just have access to a pool of stock. Or, if the stock remains at the airline's base, a certain amount of streamlining will be undertaken," says Cunningham. "Surplus items that are no longer needed, or at least not in such quantities, are put in the AJ Walter pool. AJ Walter will then assess what it should keep, and what it should sell."

Brooks comments that last year Avtrade completed a sale & leaseback transaction that involved half the stock going to Avtrade's warehouse, and half staying with the airline. This was due in part to a reduction in the fleet, but also due to overstocking by the airline in the

The sale of rotable inventories allows parts to remain with the carrier, and it is just ownership title that changes. Airlines can also use sale & leaseback transactions to dispose of obsolete parts, or when phasing out a fleet.

first place.

The ultimate advantage, other than financial, for an operator is that a parts provider will ensure that all agreed parts are available whenever an operator needs them. This means that, as long as information technology (IT) records are kept up to date, a replacement is available in the warehouse whenever a rotable is sent for repair. This should have a significant and beneficial effect on the operational efficiency of an airline's engineering department.

Disadvantages

It is hard to find any disadvantages in sale & leaseback deals, but there are a few potential problems that airlines and parts suppliers need to be take into consideration.

An airline with many different older aircraft types and the associated stock built up over many years could have a very large inventory, spread over many locations. The process of collating and itemising all their assets could be very labour intensive, although this will be minimised if the parts are tracked using an IT system.

Also, the airline's opinion of the value of their parts could exceed reality. As an asset, an inventory's value could have been carried over, year after year in the assets in an airline's balance sheet. There may not have been any thought given to regular re-evaluations to take into consideration changes in market values. This could mean that when they consider sale & leaseback, the values quoted to them by a parts supplier are significantly lower than their books state. In these cases, an airline may be unable to complete a sale & leaseback transaction, since they would gain no advantage from writing off what could, potentially, be a big chunk of their assets.

For some airlines and engineering managers, ownership is important. "In these cases," says Brooks, "you cannot change a personal opinion, and the security of owning all their own aircraft and inventory is very important to them."

Some airlines, no matter how much they would like to release cash by selling and leasing back their rotable components, are just unable to do so. Their parts could be listed as assets in such a way within the company finances that they are directly related to the airline's value. As a result, the assets cannot be sold without having a direct and detrimental effect on an airline's value and stability.

Values

An airline's stock can vary in value depending on several factors. For example, an airline based in Namibia would need a much larger base kit than one based in Europe or North America, because of the poor access to the carrier in Namibia, and the length of time it would take to deliver parts to them. Brooks adds that management style can also have an effect. If a manager in charge of purchasing believes that the inventory should be well stocked, they will have more value in their inventory than an airline that chooses to run a leaner inventory.

Brooks uses the 737-800 to illustrate the inventory values that are currently held by large carriers. If an operator has five of these aircraft, then their typical inventory could be worth as much as $4 million, falling to as low as $1 million if a minimalist approach to inventory is taken, and a total support maintenance contract is in place. A small national airline could have 20 times that number of aircraft, many of which could be larger than a 737-800.

Airlines that are based at airports where main parts suppliers have their warehouses, may often decide to have no base stock at all, because they are so close to the warehouses that it could take just 30 minutes for an item to be brought to the aircraft. Sometimes it only takes 5 minutes to deliver a part. For many airlines these times would not be any better if they had their own stores. At London Gatwick, many airlines do not have their own stores, but choose to rely on inventory pooling, because Avtrade and AJ Walter, among many other suppliers, are located within 30 minutes of the airport.

Once an airline has decided to sell its inventory stock, it goes through a process of discussion and valuation before agreeing on leaseback terms. The amount paid each month to lease back an inventory can vary according to certain factors. "The lease rate will often be a percentage of the amount the parts supplier paid for the stock in the first place," says Brooks. "This means that if the parties agree on a lower sale rate, the lease rate will be lower, and vice versa. A lease rate will also depend on the airline's financial situation. If it is considered to be a high risk, the lease rate factor will be higher. Virgin Atlantic, for example, has a solid financial background, and can negotiate a low lease rate with aspects included in the agreement that are in its favour."

Braley agrees, and says that lease rates can vary depending on market values, what was paid for the stock and how the negotiations went. If an airline wants to lease a homebase inventory/pack, it will probably be charged a monthly rate of 1.0-1.5% of the stock value.

Process

If an airline wishes to undertake a sale & leaseback transaction, it will need to send a supplier a complete list of all its components, including all their details, such as part numbers, condition and tags. All parts must have traceability and proof of ownership.

At Avtrade the next stage involves the leasing team spending a few days valuing every part against its condition and current market values. They subsequently present their findings to the management team, which will decide a purchase price for the airline's inventory. The management team then discusses with the airline the terms for the deal, such as a like-for-like inventory sale & leaseback, or the leasing of a more streamlined inventory.

The negotiations for stock value and leasing terms can sometimes go on for months, although the usual time is a few weeks. Once the lease terms and stock purchase price have been agreed, it is just a matter of signing the paperwork to legalise both the stock ownership and terms of the agreement. Once the parts organisation has transferred the money to the airline, the airline starts paying the agreed monthly lease rate. The stock itself will not change location during this process.

Future

The airline industry has experienced a number of changes over the past 10 years that have had a significant impact on it financially. Airlines are being called on by both passengers and shareholders to be more cost-effective, to which they have responded by, among other things, reducing personnel costs and outsourcing many functions. Sale & leaseback allows an airline to outsource part of its engineering functions, while divesting itself of high-value assets.

"The sale & leaseback process is definitely growing. Hard times have clearly made airlines more interested in it," says Brooks. "We have had lots of enquiries from airlines interested in learning more, especially those that are in trouble and need a quick injection of cash."

Sale & leaseback fits in with airlines' desire to outsource as much as possible. This is especially true of low-cost airlines. "The future is going to be about cutting costs, as smaller and new airlines (who cannot afford stock) have the lowest costs associated with inventory, so legacy airlines are having to compete and save costs too," warns Braley. "The next five years will see a lot of rotable components on the market as airlines shift their cost model. Even airlines that have third-party maintenance facilities are looking at sale & leaseback as an option in the near future. They want to reduce their inventory, and are looking to AJ Walter to provide packs for their third-party contracts." Monarch uses Avtrade to manage some of its 757 inventory, while it maintains ownership of stock for its younger aircraft. Derek Gibson, sales and marketing director at Monarch Aircraft Engineering, comments that, while they do not themselves offer sale & leaseback services, they will assist their third-party maintenance customers in finding a suitable company to undertake sale & leaseback of their inventory.

Sale & leaseback will also flourish as more parts suppliers decide to offer it. Currently, only a small percentage of the parts supplier market offers true sale & leaseback services, and those that do, tend to be the larger international companies. Many suppliers can buy an airline's redundant stock, or assist in streamlining its inventory. All are able to lease stock to an operator, or give access to an inventory pool, although many are yet to combine all these services as sale & leaseback, and offer them as one process. Currently most parts suppliers such as KG Aircraft Rotables and The Triumph Group offer exchanges and loans. It is only a matter of time, however, before all airlines, without large maintenance departments and with stock not connected to the airline's value, seriously consider sale & leaseback for their rotable components, and take part in this process. AC

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