Prepare for take-off: aviation leasing

By Lynn Strongin Dodds

It is no secret that institutions are broadening their horizons searching for new alpha generating opportunities. Airline finance may not be the first stop on their journey but it is becoming more than just a blip on the radar screen. Like many other alternative investments, though, it requires a deep understanding of the dynamics, direction and fundamentals of the industry.

This is particularly the case with aviation, which has had a bumpy ride over the past few years. Research from advisory firm Ascend, part of Flightglobal and Reed Business Information, shows around 136 airlines have had their wings clipped during 2007 to 2012 while three major airlines – Japan Airlines, AMR and Kingfisher – underwent bankruptcies and re-organisations.

The recession, increased regulatory costs and fuel price volatility are partly to blame, but the other culprit is the longer term trends that have plagued the industry over the past decade. These include excess capacity, intense competition and the proliferation of low-cost carriers, according to a recent report from PwC *Aviation Finance, Fasten Your Seatbelts*. These challenges combined with unusual external events such as 9/11, SARS and swine flu outbreaks and volcanic eruptions have wreaked havoc on balance sheets as well the returns on equity.

Today, the sector is leaner, with engines revved up on the back of the burgeoning middle and upper classes of the emerging markets who have acquired a taste for travel. Research from Airbus, the world's largest

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manufacturer of passenger jets shows that although over 60% of air travel will continue to take place in the developed countries, traffic growth between advanced and emerging air transport markets is estimated to grow at an average annual rate of 5.1%. This is above the world figure of 4.7% and not far off the 6.6% annual growth rate prediction between emerging markets.

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Demand is flying high

The increased demand has translated into larger orders for aircrafts. Last year, Airbus raised its 20-year industry forecast for aircraft deliveries by about 5% to 28,200, valued at over $4trn. Rival US-based Boeing also increased its predicted order book to 35,280 airplanes for airlines, leasing companies and freight firms from its previous projection of 34,000 over the same period. This is more than doubling the global fleet with the price tag coming at over $4.8trn.

Although this is welcome news for the industry, finding the funding will not be easy. "The banks are pulling back as they de-leverage," says Shamshad Ali, a partner at PwC Financial Services in the UK and co-author of the recent report *Aviation Finance, Fasten Your Seatbelts*.

"Many banks are moving away from financing big assets that require dollar funding, on their own balance sheets. The key challenge for airlines, which have record orders in place, is to find financing at attractive rate in a tougher economic environment."

The same patterns have taken place in the real estate and infrastructure space where the banks have also retreated and institutions are stepping in to fill the funding gap. The picture, of course, was different before the financial crisis. Aircraft finance transactions under Basel II typically required low levels of capital because they were asset-based, fully secured by the aircraft and operating lease rental stream.

The regulatory screws have been tightened with Basel III which has a 3% capital requirement regardless of the quality of the assets and a new net stable funding ratio which requires funding to match lending maturities. The PwC report notes that this will impact future loan conditions for long term borrowing, including for aviation finance. For airlines, the effect of Basel III could translate into higher loan pricing as banks pass on extra liquidity costs. Although it is hard to quantify the exact impact as lending rates are an interplay of bank risk and liquidity costs as well as currency exposure but it is likely that loan pricing will rise.

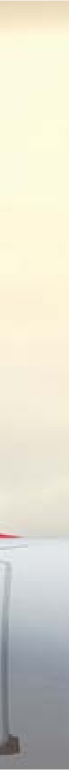
The banks are not the only ones being squeezed. Export credit agencies, which have played a vital role in providing finance since 2008, have their own set of rules to grapple with. For example, the new Aircraft Sector Understanding (ASU) is likely to result in a considerable increase in premiums.

"What we are seeing now is capital markets are financing close to 30% of all deals with ECAs at 20%," says David Treitel, managing director of Apollo Aviation, US-based aviation asset manager. "However, it is becoming more expensive and we are seeing institutional money come in particularly on the private equity side."

No shortage of funding

To date, private equity funds such as Cinven, CVC, Oak Hill Capital as well as Singapore's sovereign wealth fund, GIC Singapore, have been the most active investors. Japanese banks, on the other hand, have been at the forefront of some of the larger deals. These include, the Sumitomo Mitsui Financial Group's $1.2bn acquisition of Royal Bank of Scotland's plane-leasing unit, the sale of DVB's 60% share in TES Holdings to Development Bank of Japan and Mitsubishi UFJ Lease & Finance Co's $1.3bn purchase of Jackson Square Aviation from Oaktree Capital.

There is no shortage of prospects. In the next two years alone, Ascend expects aircraft leasing companies to purchase a total of around



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1,400 aircraft worth about $80bn which will require around $20bn of equity capital to be pumped in. The market is dominated by the so called 'big two', GECAS and ILFC, who both have fleets larger than Delta Air Lines, the world's largest airline by number of aircraft. Smaller upshots such as HKAC, Avolon and Jackson Square are hot on their heels, but they are all in pursuit of insurance companies, pension funds, private equity firms and other long term investors.

The main selling point is relatively predictable and higher than average returns in a low interest rate environment. In addition, the underlying asset – the aircraft – is global, plus it is highly mobile and can easily be reclaimed or redeployed in the case of a default. "There are great opportunities but there are barriers to entry in that it is a less well understood sector," says Ali. "It is not like equities or other alternatives, there is a dearth of coverage and there are very few dedicated funds to invest in."

Funds are taking off

The most recent listed is Doric Nimrod Air Three (DNA3), a closed-end aircraft leasing fund, with £220m in assets. Created by Nimrod Capital with specialist German financer Doric Asset Finance, DNA3 will buy four A380 aircrafts and lease them to Dubai-based Emirates for up to 12 years. The aim is to pay investors 2.06p per share per quarter, equivalent to an annual dividend of 8.25%.

Once the leases expire, the planes are sold and investors paid from the residual value.

"There are a number of attractions," says Shantanu Tandon, fund manager, multi-asset group at Insight Investment. "It displays low correlation to equities, there is an attractive dividend rate and strong income generation from aircraft lease. There is also the potential for capital appreciation. The most important aspect though is to ensure that you have the right combination of aircraft and airline. This means looking at the lease terms, operator, level of debt and strength of balance sheet. These are complicated assets and unlike other investments, there are additional considerations to think about."

The market also saw the launch of Investec Aircraft Syndicate Ltd (IASL) last November which plans to invest $500m in new generation, fuel efficient aircraft on lease to airlines worldwide. It aims to offer a cash yield paid from contracted fixed cash flows locked in for on average five years. Investec's previous offering, the Investec Global Aircraft Fund, is similar and manages 20 aircraft with an acquisition cost of around $1bn.

According to Ramki Sundaram, co-fund manager of IASL, Investec's aviation funds have attracted investments from insurance companies, pension and Australian superannuation funds, private banks and high net worth individuals across different regions. "It is like an investment in infrastructure because these assets generate predictable cash flows with high single digit yield. We are seeing increased interest from institutions looking for diversification and uncorrelated returns. Investors should assess investment opportunity in this sector especially with respect to the construct of the cash flows, the counterparties and the type of aircraft."

There are other structures available to investors; for example, in the first five months of this year, Apollo made $220m of purchases on behalf of SASOF II, an investment fund with approximately $595m in capital commitments that seeks to acquire mid-life in-production aircraft models for lease or immediate disassembly and resale of the systems, components and parts.

Recent purchases included two A320 CEO family aircraft, one A330-200, one A330-300, seven B737NGs, and seven engines and 10 of these are on lease to airlines in Asia, Europe and North America.

"There are different ways to play the market and we think that this area provides attractive opportunities although you do need specialist knowledge," says Treital. "There is slightly more risk but investors are rewarded with higher returns."