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REPORT
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Post-peak uncertainty

A fascinating aviation finance picture is emerging for 2017 as a strong market waits for downside risks to play out

As 2016 drew to a close, it looked as though the aviation cycle had crested – a theory reinforced by a slowdown in global traffic growth just as an oversupply of aircraft seems likely, by compressed lease rates and aircraft values, and by an abundance of liquidity.

"The aviation demand cycle does remain strong, but trends suggest we may be close to the peak, and the more I think about this, the more I think we are just past the peak," Flight Ascend Consultancy's chief Rob Morris said at an industry briefing in November.

Over the course of 2016, a number of downside trends – such as in values and operating yields – have all neared critical mass at roughly the same time, creating an apprehensive mood among aviation finance professionals.

The past 12 months have, in a wider sense, been chaotic and fragmented.

Aside from industry-specific factors, there were the unexpected macro events with potential downsides, including Donald Trump's presidential election victory, the Brexit vote and the outcome of the Italian referendum, all posing threats to globalisation – and therefore aviation – in the coming years.

Additionally, concerns over a potential economic slowdown in China, the spread of nationalism and the spectre of terrorism lurk in 2017.

However, while last year brought forth a bevy of black swans – with more waiting in the wings – it also threw up a number of events that suggest an industry in mostly positive transition.

Those events include: mergers, among both airlines and lessors; an influx of new investors; and new vehicles for aircraft investment.

Export credit agencies (ECAs) covering Boeing and Airbus were unavailable for guaranteeing deals in 2016.

Growing appetite for specialised regional lessors

The regional aircraft leasing sector is undergoing a period of transition. Nordic Aviation Capital became the world's largest regional lessor after adding Aldus Aviation to its portfolio in April, gaining 30 Embraer E-Jets shortly after it had bought Jetscape Aviation and its 28 E-Jets.

These acquisitions reflect the increasingly specialised nature of regional leasing, with more mainstream lessors such as Air Lease offloading their regional portfolios.

Turboprop lessor Elix, backed by Oaktree Capital, was reported to have been preparing an asset-backed securitisation (ABS) in 2016 for launch this year.

Regional lessor TrueNoord rebranded from GA-Finance in 2016 after securing investment from the private equity firm Bregal Freshstream. TrueNoord's chief executive Anne-Bart Tieleman thinks the upshot of this activity is that the sector is becoming more professional.

"I think we are seeing the regional leasing sector start to become more professional and more specialised, in much the same way as the mainstream lessors have been doing over the past few years," he says. "Nordic have to an extent led the way, but TrueNoord and others are also going down this path."

[The past 12 months have, in a wider sense, been chaotic and fragmented]

The US Export-Import Bank's absence is mostly political, with the agency lacking the necessary quorum of board members to approve new deals. But this is set to be resolved sooner rather than later, so Boeing aircraft should be eligible for ECA support at some point in 2017.

If Ex-Im Bank does not come back online, Boeing 787 customers may still be eligible for support from UK Export Finance – if they have chosen Rolls-Royce engines.

Airbus's ECA woes are thornier, however. In April, UK Export Finance voiced concerns over historic applications for ECA support involving Airbus, and the agency's German and French counterparts subsequently halted new Airbus deals. In August, the UK's Serious Fraud Office (SFO) formally launched an investigation into the matter.

The SFO is not renowned for speedy investigations, so European ECA support may take some time to return to Airbus.

Discussions on ways of resolving that situation have been conducted by Airbus and the European ECAs, but no timeframe for a reversal of the policy has been disclosed by either side.

As a result of the lack of ECA financing, Airbus itself had to extend some €500 million ($525 million) of aircraft financing to customers over the first nine months of 2016.

LIMITED SUPPORT

But a strong and liquid macro financing market has limited the amount of customer support the manufacturer has had to offer, Airbus finance chief Harald Wilhelm said during a briefing on third-quarter results.

This liquidity spared weaker airlines financial pain, as they could pursue financing options that might have been unavailable in other years.

Credit Agricole's global head of asset finance Jose Abramovici says: "We have got some ECA mandates which have not been consummated because of the ECA freeze. Some airlines have been able to secure commercial bridge financings or have selected to do sale-and-leaseback."

An alternative to export credit could emerge early this year: Boeing Capital, along with advisers Citi, Goldman Sachs and Morgan Stanley, is on the cusp of launching a programme that would allow borrowers to access commercial loans wrapped by a syndicate of insurers – similar to, though more expensive than, an Ex-Im guarantee. Sources indicated in December that the first bank loan using the guarantee was near to closing.

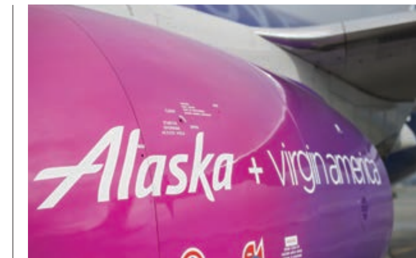
If successful, lenders hope to expand the insurance product to capital-markets transactions, as well as possibly Airbus aircraft, sources say.

This product would also be open to airlines in the home markets because there is no export element.

Moreover, the availability of attractive bank debt has minimised the impact on airlines of the absence of European and US ECAs.

Commercial banking terms remained attractive to borrowers in 2016, especially for airlines looking to finance aircraft with secured debt, providing a very competitive alternative to the capital markets. "The market for airlines right now is extremely well bid," says one investment banker, citing the continuing competition between commercial banks, investment banks and lessors for airlines' business.

Indeed, Abramovici notes that the abundance of liquidity made some deals unappealing for banks in the first half of 2016, in terms of either pricing or structuring, whether due to the leverage, amortisation or balloon demands.



Alaska Airlines

Mergers make a mark

Two milestone mergers happened in 2016. Alaska Airlines agreed to acquire Virgin America for $4 billion in the first half of the year; then, in October, HNA subsidiary Avolon formally confirmed the open secret that it had won the bidding to acquire CIT's aircraft leasing business.

Alaska's merger with Virgin America will make it the USA's fifth-largest carrier, while for Avolon, the addition of CIT takes the "owned, managed and committed" fleet from 429 aircraft to 910, the lessor's website indicates.

Once approved, the merger will give Avolon a place at leasing's top table with GECAS and AerCap, as well as the economies of scale to withstand any headwinds.

However, while the merger has prompted suggestions that further consolidation is likely – with both AWAS and Asia Aviation Capital reportedly on the market – many feel that only Chinese investors will be able to pay premiums for these companies.

Given that Avolon itself only recently merged with HNA vehicle Hong Kong Aviation Capital, lessor Aergo Capital's chief executive Fred Browne thinks Avolon may spend some time working out the implications of the merger.

"Once the deal closes, Avolon may have a tough task assimilating the CIT assets, especially the personnel, into an organisation that has just spent most of this year digesting HKAC," he notes.

Like many in the industry, Browne sees further consolidation as likely, driven by Chinese money (*see feature page 41*).

Abramovici adds that lessors also turned to the unsecured bond market for their funding, a trend likely to continue this year. AerCap, Aircastle and Aviation Capital Group are likely to tap the unsecured markets, one Wall Street banker indicates.

Oversupply of aircraft may be an issue in 2017; indeed, it has already caused lease rate factor pressure in the ATR market, says Fred »

FINANCE & LEASING OUTLOOK

» Browne, chief executive of Aergo Capital.

"A glut of new ATR 72-600s ordered by lessors hit the market [in 2016]. Now, to place these aircraft, those lessors had to reduce their expected lease rates. As a result of this, owners of relatively new ATR 72-500s – say, less than three years old – found their mark-to-market values and lease rates under pressure as airlines opted for the newer aircraft over the slightly older one, despite minimal technical differences between the turboprops," he says.

"With the Neo and the Max coming into service, you could see a similar thing happen there, with newish 737-800s and A320-200s suddenly worth much less than expected."

DOLLAR DYNAMICS

Another issue that European banks faced in 2016 was rising US dollar borrowing costs. This left them slightly less competitive for US dollar-denominated deals versus the capital markets, although numerous carriers, including Alaska Airlines and American Airlines, still closed commercial loans during the year. Borrowers hope these pressures will abate in 2017.

Ted North, managing director of corporate finance at United Airlines, said at the FlightGlobal Finance Forum West Coast in San Francisco in November: "Hopefully, in the back half of 2017 those liquidity costs will be lower and we can continue to use that market."

Many unknowns loom, nonetheless, including the impact of the Trump administration, the lack of export credit support, and the view that the industry is past its peak with regards to both airline profits and funding cycles.

Even with capital reserves changes looming under Basel IV, which would be punitive to those who do secured lending against aircraft, financiers in this market have always been quick to adapt.

The capital markets have provided an alternative to the traditional bank market for certain borrowers, both airlines and lessors; and 2016 was no exception.

SkyWorks

"The fact is that the total need for aircraft financing is many times oversubscribed"

STEVEN GAAL
Managing director, SkyWorks Capital

In November, Air Lease closed its $800 million debut securitisation with Blackbird Capital, pricing at the lowest coupon for a post-financial crisis ABS, with its AA tranche achieving a 2.49% coupon.

The deal introduced new investors to this asset class, which is becoming ever more popular with lessors as a refinancing tool.

Apollo Aviation, Aergen and Castlelake all issued ABS deals in 2016, with GECAS and Aviation Capital Group coming to market to close their transactions during the last few weeks of the year.

Industry sources point to the capital markets remaining open in 2017.

The AA/A EETC structure continues to be popular with both airlines and investors, while lessors continue to see ample appetite for both their unsecured notes and ABS transactions.

This year is already off to a strong start, with American Airlines closing a $785 million EETC in the first week of January. The transaction was not only the tightest for the airline on a spread basis over US Treasuries, but was also heavily oversubscribed, says a banker familiar with the deal, and grew from its original $593 million, allowing the airline to add six aircraft to the transaction.

"The capital markets will still be a major source of funding... and remain strong in 2017," said Betsy Snyder, an S&P Global director who covers aviation, during the FlightGlobal Finance Forum in November.

An investment banker affirms this, saying he expects a "pretty robust year" in 2017.

INVESTOR ENTHUSIASM

Frequent EETC issuer United is likely to tap the same market at some point during 2017, while Delta Air Lines is set to raise some capital-markets financing for a portion of its $2.69 billion in aircraft capital commitments this year.

Previous issuers Hawaiian Airlines and Spirit Airlines have unfinanced 2017 deliveries that could be received well by investors.

At least one new international airline issuer is possible in 2017 as well. While the hurdles to entering the market are high, the influx of new capital from investors makes the EETC market an attractive alternative to low-cost bank debt or sale-and-leasebacks.

However, the investment banker cautions that the number of new international issuers is unlikely to be more than one or two in 2017, saying this rate is a "good number" considering the barriers to entry.

"It takes a lot for a new airline to access the EETC market," the banker says. "You have to have a significant number of deliveries."

Air Canada, LATAM, Norwegian, Turkish Airlines and Virgin Australia have all tapped the EETC market for the first time since 2013.

Given low interest rates, investors have been hunting for opportunities to put capital to work. And as US dollar assets with stable and decent returns, aircraft investments have appealed to new financiers.

Steven Gaal, managing director at SkyWorks Capital, remarks that 2016 saw a surprising number of new investors enter the market.

"In 2016, what really stood out was the number of players looking at entering the aircraft leasing sector, from insurers to pension funds to Korean, Chinese and Japanese investors," he says. In addition to arranging financing, Skyworks advises clients on sourcing capital.

"The industry did not anticipate the extent to which this has taken place, which is likely a reflection of the ongoing hunt for yield, a desire for US dollar-denominated assets, and growing investor recognition that aircraft are relatively low risk assets," Gaal adds. "The fact is that the total need for aircraft financing is many times oversubscribed."

He notes that aircraft as assets have to an extent been commoditised by this wall of liquidity. "There are far more investors who want the core assets. For example, a 737 Max 8 has many more investors willing to look at it than the 737 Max 9. But when you have so many looking to finance the core, it is easy to find the liquidity that wants the assets that are, relatively speaking, on the demand fringe."

Institutional money's attraction to aircraft investment is not new. In 2014, Investec Bank launched its first of two closed-end funds that invest in aircraft debt. The bank closed its second aircraft debt fund last year, and it is now in the process of arranging a third vehicle, FlightGlobal understands.

However, aircraft debt funds did not begin to trend until 2016, when institutional demand ballooned.

A number of new vehicles for aircraft investment emerged last year. French bank Natixis's asset management arm launched an aircraft and real estate fund. Additionally, the former leasing chief of AWAS, Ray Sisson, announced a new asset-focused fund called AVi8 Air Capital in late November.

While AVi8 plans to build a young fleet of mainly Boeing 737s and Airbus A320s, as well as widebodies such as 787s, through traditional leasing deal structures including sale-and-leaseback, it will also aim to attract additional investors into aircraft through separate funds.

In mid-2016, Stellwagen Group announced its plan to launch its StellCap fund.

Led by former Ryanair finance chief Howard Millar, the 10-year closed-end fund plans to have $1 billion-worth of assets under management by the end of 2017. Within three years, it plans to have $5 billion in assets under management, primarily 737s and A320s but also A350-900s and 787s.

"We want to disrupt the aircraft financing market, which is in dire need of innovation," Millar told FlightGlobal in June.

FlightGlobal understands that Brexit-related headwinds put the fund's plans slightly behind schedule. But in early November, Canadian private equity firm Acasta Enterprises bought Stellwagen and committed $100 million to StellCap fund.

New players appear to pose a threat to banks, who may find themselves restricted by Basel IV regulation. However, Credit Agricole's Abramovici remains sanguine: "New players are always welcome, as it will force the existing bank to get smarter in order to survive."

This year is likely to provide the first true test for these vehicles, especially given the fact that their target investor base may flee to more familiar asset classes if interest rates rise.

While unpredictability defined 2016's global political climate, stability was the cornerstone of the aviation market with liquidity providers extending capital even in the stark absence of ECA support.

With both commercial banks and the capital markets open to borrowers, and numerous players still attracted to the low-risk returns offered by aircraft asset financing, a funding gap looks mercifully unlikely to occur, for now. ■

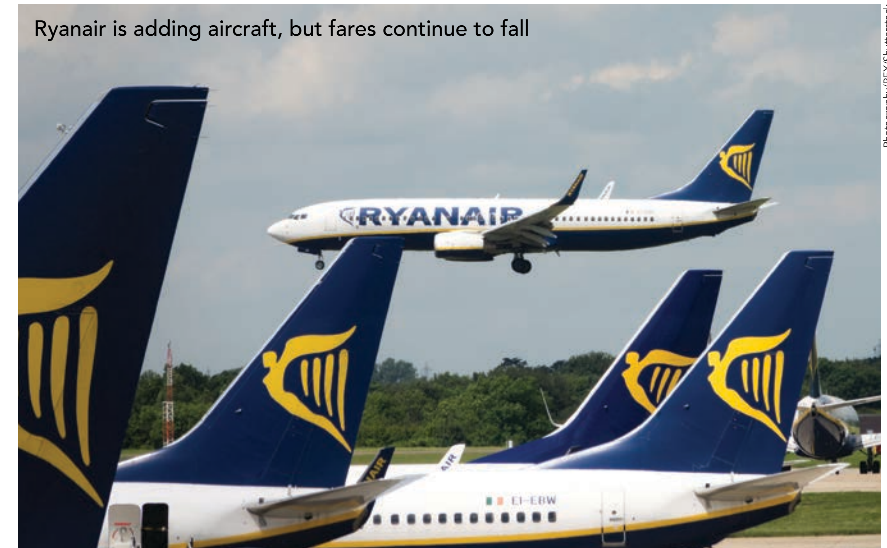
'Artificially low' US interest rates likely to increase

It is unclear by how much interest costs will rise in 2017. While new investors pushed all-in coupons to historic lows in 2016, president-elect Donald Trump has said that the US federal funds rate is "artificially low" and suggested that he intends to push the Federal Reserve to raise rates. That said, the US Federal Reserve operates independently of the executive branch and its chair Janet Yellen's term runs through January 2018.

The Federal Reserve raised rates a quarter of a point from 0.5% to 0.75% in December, only its second such increase in nearly a decade. Further increases are expected in 2017.

"EETC rates have been so low over the past couple years that we can easily afford to have some increment to the interest costs," says United's managing director of corporate finance, Ted North.

United set the current low for EETC coupons with its $920 million 2016-2 transaction in September. The $637 million AA notes due in 2028 priced at 2.875%, the first EETC tranche with an all-in rate below 3%.



Ryanair is adding aircraft, but fares continue to fall

Photography/REX/Shutterstock

Concerns about aircraft oversupply cloud outlook

While liquidity may be easy to come by in 2017, the industry is not looking as robust as it has done in the past two years.

Moody's Investors Service ranks airlines and lessors as stable but expects margins will fall in both sectors and capacity growth will moderate.

The ratings agency forecasts airline operating margins to fall below 10% with yields continuing to face downward pressure as capacity grows faster than demand, especially in developed markets, Moody's says.

"Ryanair has already been lowering their prices for the winter season as they add new aircraft at the rate of nearly one per week for 2017," says Fred Browne, chief executive of lessor Aergo Capital. "You would have to wonder if there will be enough 'bums' to put on all these extra seats coming into the European market during these uncertain times."

In November 2016, Ryanair forecast a 13% to 15% fall in average fares in the quarter ending in March. This comes after a 10% decline during the six months ending in September.

US airlines have also reported significant declines in unit revenues. However, many expect to achieve flat to positive growth in 2017.

Lessor margins are expected to fall below 5%, with the risk of excess capacity for certain aircraft models in 2017, according to Moody's.

"The main factor causing the industry's own imminent downturn is an oversupply of aircraft," says Ray Sisson, executive chairman of AVi8 Air Capital. "This is driven... by the enormous amounts of orders placed a few years ago that are now starting to deliver."

SriLankan Airlines cancelled leases for four Airbus A350-900s with AerCap in 2016, while Gol plans to remove five 737s in 2017 after removing 19 last year. Carriers ranging from American, LATAM and United have all deferred deliveries that were due in 2017 during the past six months.