Recent Trends in Commercial Aircraft Finance

This article was originally published in *Financier Worldwide* on April 7, 2015.

by Graham Tyler and Adam Beavill

Graham Tyler
Finance
+44.20.7847.9562
graham.tyler@pillsburylaw.com

Graham Tyler is the leader of Pillsbury's Finance practice in the firm's London office and is a member of the Transportation Finance team.

Adam Beavill
Finance
+44.20.7847.9586
adam.beavill@pillsburylaw.com

Adam Beavill is an associate in Pillsbury's Transportation Finance Group and is based in the London office.

Since the financial crisis, the aviation finance market has been through much change with the initial heavy reliance on export credit financing from US Export-Import Bank (Ex Im Bank) and the other export credit agencies (ECAs), the support of which was needed at the time to ensure that there was financing available for new aircraft deliveries, shifting more recently to a focus on the capital markets and commercial debt, in relation to the latter particularly from new entrant banks in the Asian market.

Lessors and strong credit airlines have been particularly active in the bond markets in the past year or so, taking full advantage of heavy investor demand which, together with increased liquidity and new entrants to the market, has been driving margins to near record-low levels whilst reducing the role of Ex Im Bank and the ECAs and putting pressure on traditional lenders.

Less reliance on export credit financing

It was widely reported between 2009 and 2012 that approximately 30- 35 percent of new commercial aircraft deliveries were being supported by export credit financing—a significant increase from previous averages of around 20 percent. Not only that but, whereas export credit financing was traditionally intended to support exports to highrisk airlines, it became increasingly available to low-risk airlines, such as Ryanair and the Middle East carriers, and at much lower margins than were then available in the commercial market.

In 2011 though, with greater liquidity coming back to the market, the Aircraft Sector Understanding (ASU), which established the terms and conditions under which countries and their manufacturers could provide financing for commercial aircraft, was modified to bring export credit financing more in line with, and to allow greater competition from, commercial markets.

The export credit agencies have always acknowledged that their remit is not to compete with the commercial markets, but to provide support for the manufacturers when commercial lenders are not able, or not willing, to accept the risks of the underlying transaction. Whilst they still provide an important role—for example, to support exports to African airlines given the perceived risk and lack of funds available from African banks—it appears that the new ASU is working as it is now more expensive than commercial debt for good credit airlines, and so the percentage of new commercial aircraft deliveries requiring their support is now much less than at its peak.

Use of bond markets in 2014

The buoyant conditions in the bond markets in 2014 with heavy investor demand, including for bonds with longer maturity dates, and low interest rates have seen a number of lessors and good credit airlines tap into this market in the past year or so.

In September, AerCap priced $800m of seven-year notes via a private placement to qualified institutional investors and global investors. Just two weeks before that, Air Lease Corporation priced a public offering with the US Securities and Exchange Commission of $500m. These are just two examples of a number of bond market transactions in the aviation industry last year.

To show how far rates have fallen, in July 2009, Lufthansa sold a seven-year bond at 6.5 percent. The same airline recently priced a €500m five-year bond at only 1.125 percent.

Ryanair's debut bond issue in June last year also allowed it to borrow €850m at an effective interest rate of 1.875 percent with its former CFO, Howard Millar, saying that he expected bond issuances to fund at least 50 percent of the company's then current order of 180 Boeing aircraft, market conditions and pricing permitting. On 3 March 2015, it was announced that Ryanair had priced a further eight year €850m unsecured Eurobond with a coupon of only 1.125 percent.

Secured vs. unsecured debt

A benefit of utilising the unsecured bond markets is that ratings agencies tend to favour flexible unsecured debt and penalise companies that have too many of their aircraft tied up as collateral against secured bonds or loans or placed in ABS or EETC structures.

Of course, in order to benefit from lower interest rates or non-recourse structures that can come with secured financing, secured debt remains a key part of any funding portfolio. ABS transactions, for example, remain an important source of funding, with Deucalion having recently priced a $667m securitisation which, according to the press release issued by DVB on 23 February, achieved the "tightest pricing on an aircraft Asset Backed Securitisation (ABS) transaction since the most recent financial crisis" with a pricing of 4.25 percent for the A notes.

In order to increase their financing options, many lessors are now looking for an investment grade rating from the ratings agencies. Cheap unsecured debt is therefore very attractive to these companies, especially with the current investor appetite. The key though is to find the right balance between secured and unsecured debt. This will ultimately depend on the particular company in question and its business strategy and is certainly not one-size-fits-all.

New entrants to the market; pressure on traditional lenders

As well as the increase in competition from the capital markets, traditional lenders in the commercial aircraft space are facing increased competition from Asian banks, such as China Construction Bank and Development Bank of Japan, and leasing companies, such as Mitsubishi UFJ, which completed its acquisition of Jackson Square in January 2013 (and its acquisition of ELFC last year), and Cheung Kong Holdings, which has also been very acquisitive and recently announced a joint venture with MCAP, which, combined with the buoyant market conditions mentioned earlier in this article, is squeezing margins and creating the most competitive conditions in aviation finance since before 2008.

Many Asian banks are being drawn to the market by an increasing number of aircraft orders from new low-cost airlines in the region and, in a lot of cases, traditional lenders are simply unable to compete with the low margins being offered. One bank commented at the Airline Economics conference in Dublin in January that it had seen margins drop by 35 percent in the previous year.

Chinese Renminbi

Growth in the Asian market is also being driven by the emergence of the offshore Chinese Renminbi (RMB) bond market. In February 2014, BOC Aviation priced a 10-year ¥300m offshore RMB-denominated bond, the first to be issued by an aircraft operating lessor, which was arranged by Singapore's DBS Bank. It then followed this up with another ¥1.5bn private placement later in the year. British Airways also recently completed a RMB financing of two A380 aircraft with Bank of China.

The RMB is already the second most used currency in trade finance after the US dollar, and last year UK Export Finance adopted the RMB, which allows it to provide medium and long-term guarantees to support RMB-denominated transactions to aid British exporters in doing business in China.

What next

According to the aircraft manufacturers, the Chinese aircraft market is expected to be worth in excess of $600bn over the next 20 years and it's anticipated that an increasing proportion of those transactions will be RMB-denominated, especially if it finally achieves full convertibility. There is also speculation that it could eventually replace the US dollar as the base currency for commodities (much as the US dollar replaced sterling). It therefore seems inevitable that the Asian financial markets will continue to grow and play a major role in the future of the industry.

It is also expected that the capital markets will continue to be a key source of financing for the industry in 2015. A note of caution is that there are concerns about a possible bond market bubble if too many investors seek to sell-off their positions at the same time, which could potentially lead to volatility in the market. Only time will tell if these concerns will be realised but, in the meantime, it seems that the current trend is towards accessing new and diverse sources of funding in this period of low interest rates, high demand from investors, increased liquidity and new entrants coming to the market.

Pillsbury Winthrop Shaw Pittman LLP | 1540 Broadway | New York, NY 10036 | +1.877.323.4171