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The Good Life

The state of the commercial aircraft leasing business is sound, but there is some angst among the leading players.

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CIT Boeing 737 MAX
Boeing

As airlines go, so goes commercial aircraft leasing. It is going quite well for both at this time.

A healthy and steady demand for new and slightly used airliners, plus strong revenues due to a spike in domestic and international passenger traffic, has helped transform lessors into a formidable juggernaut in commercial aviation.

Forty percent of all commercial aircraft delivered today are leased, with commercial debt financing assuming 60%, according to the Boeing Current Aircraft Finance Market Outlook 2015.

In the past, a handful of Western-based leasing companies controlled the leasing business. Names like International Lease Finance Company (ILFC) and GE Capital Aviation Services (GECAS) controlled a large part of the leasing market. But ILFC is gone, GECAS has reorganized and there are numerous aircraft leasing companies across the globe.

Boeing forecasts a need for 38,050 aircraft valued at over $5.6 trillion over the next 20 years, which bodes well for the leasing industry. Airbus' Global Market Forecast for 2015-

2034 projects a demand for around 32,585 new passenger and freighter aircraft at a value of around $4.9 trillion. First-tier airlines and lessors will continue to be the primary beneficiaries of increasing competition among banks.

Forty percent of all new aircraft will be delivered to operators in the Asia-Pacific region, particularly China, Boeing said. Twenty percent will be delivered to airlines in Europe and North America, with the rest going to operators in the Middle East, Latin America, the Commonwealth of Independent States and Africa, according to Boeing.

Single-aisle aircraft remain the most popular aircraft of lessors and airlines with carriers needing 26,730, Boeing projects. Even twin-engine, fuel-efficient widebodies are popular with a projected need for 8,830 aircraft. Airbus predicts 22,927 single-aisle aircraft, 8,108 twin-aisle and 1,550 very large aircraft will be needed.

“Leasing is more robust than ever,” Boeing Capital Corp. VP and global head of customer finance Jordan Welton said. “We see new players and capital market structures coming out.”

Leading leasing companies agree.

“I think the market has been relatively stable in the last 12 months, if a little jumpy,” SMBC Aviation Capital CEO Peter Barrett said. “Demands for airlines for narrowbodies have been very good.”

Narrowbody airliners will retain their prominence in the leasing market for the next several years, led by the Airbus A320neo and Boeing 737 MAX, several leasing companies said. At present, there is a seven-year backlog of orders for new narrowbody aircraft, according to aviation consultancy Airinsight.

It is a different story for four-engine widebody commercial passenger airliners. The Boeing 747-8 is not selling well and there hasn’t been an order in 2015 for the Airbus A380. Yet, the Boeing 787 and 777, and the Airbus A330 and A350, are popular and the 777X, due out in 2020, looks promising, Airinsight reported.

Some believe that four-engine widebody airliners will be resurrected. “I think the need for the A380 and 747-8 will be re-sparked,” Boyd Group International’s Michael Boyd said. Boyd referred specifically to the large China market, which US carriers “have barely touched” as one region where the four-engine widebodies could find purchase.

Boyd's view is not shared by his colleagues, who state that four-engine widebody passenger airliners are a thing of the past, except on ultra long-haul, international operations, and then would only be used sparingly.

British Airways' (BA) recent decision to refurbish several 747-400s is more about an airline taking advantage of the low fuel costs to make money with older equipment than a sign that the market for four-engine widebody airliners is recovering, lessors said. BA could not be reached for comment and *ATW* could not find one major lessor that has written a lease on a four-engine widebody airliner recently.

Leasing of twin-engine freighters, however, will continue to improve, but the four-engine freighters remain on life support.

Growing concerns

Interest rate hikes, fuel prices, currency volatility and political instability remain the chief areas of concern for lessors and their airline customers.

There are other concerns to add to the list: increased competition from well-capitalized Asian banks and lessors, regulatory issues, airlines forming in-house leasing units and the possible de-funding of the Export-Import Bank of the United States (Ex-Im), which airlines and leasing companies have used.

China's Bohai Leasing Co. a unit of the transportation conglomerate HNA Group, is acquiring Dublin-based competitor Avolon for $2.55 billion.

The purchase of Avolon by Bohai "is part of a trend of a business that has been stable compared to the airline industry," Aviation Capital Group executive VP, head of global strategy, John Feren said. The fact that Bohai owns one leasing company and has decided to acquire another is a "strong signal that investors are confident in the prospects of leasing companies," Feren said. Bohai also owns Hong Kong Aviation Capital (HKAC).

One analyst said the expanding competition from Asia is logical. "It doesn't surprise me that the Chinese are becoming heavily involved in the leasing business," Frost & Sullivan's director, North America, Aerospace and Defense, Wayne Plucker said. "That is where they are selling airplanes, so, naturally, there are leasing companies coming from that region."

Chinese, Japanese and Middle East banks see aircraft leasing as a good source of predictable revenue and a way to provide local airlines with improved margins, Plucker said.

Asia remains the clear growth and aircraft replacement path for several of the leasing companies interviewed. Some lessors speculate that 50% of the aircraft sold to Asian carriers will soon be leased.

The influx of Chinese and Japanese businesses into commercial aircraft leasing is part of the natural growth and change of ownership of various leasing businesses over the last several years, Air Lease Corporation's (ALC) president and COO John Plueger said.

"It is part of a trend of a business that has been stable compared to the airline industry," Plueger said.

RBS Aviation, formerly owned by Royal Bank of Scotland, was sold in 2012 to the Sumitomo Mitsui Financial Group for $7.3 billion. A similar story occurred at San Francisco-based leasing firm, Jackson Square Aviation, which was acquired in 2013 by Mitsubishi UFL Lease & Finance Co. In 2006, the Bank of China Aviation purchased Singapore Aircraft Leasing Enterprise, now Bank of China Aviation (BOCA). In 2014, Industrial and Commercial Bank of China (ICBC), the country's largest commercial bank, formed their own leasing company. Li Ka-shing, a Hong Kong billionaire, entered the commercial aircraft leasing business in 2014.

While business is good, lessors have other concerns.

Increased regulation: Some regulators are proposing changes to accounting rules that would require operating leases to appear as balance sheet obligations. At present, operating leases are off-book items and such a regulation could diminish the popularity of this leasing instrument.

"I don't think this is a concern of lessors in the near term," Plueger said. Most lenders to airlines and rating agencies of publicly traded companies include operating lease obligations when measuring the credit worthiness of an airline, he said.

Airlines forming in-house leasing units: "We are starting to see a small number of airlines opening their own leasing divisions," Forecast International senior aerospace analyst Ron Joworowski said.

Several in-house aircraft-leasing units have been formed over the years with mixed results. Most established lessors don't view them as an immediate threat, but these interlopers bear watching. Singapore Transportation Partners (TP), the leasing arm of Indonesia's Lion Group, is one of the newer in-house lessors.

"I think there is a big step from an airline leasing out a few aircraft to becoming a full-throated competitor of larger leasing companies, SMBC's Barrett said. "We will follow this [development] closely, but there is quite a bit of a journey to go on that."

Some airlines say forming in-house leasing units is not part of their core business. There is also the potential of close involvement with competitors when creating an in-house leasing unit.

Ex-Im Bank: Most lessors have not sweated the effort in the US Congress to keep the US Export-Import Bank unauthorized, pointing out that the worldwide economy has been stable enough to support aircraft financing in the near term.

"There is a lot of liquidity in the current market. So the absence of Ex-Im Bank doesn't hurt today," CIT Commercial Air president Tony Diaz said. "But there will come a period where liquidity will be reduced and the Ex-Im and other export credit agencies will play an important role, particularly in a downturn."

He added, "It could put Boeing at a disadvantage if they can't offer export credit financing on par with what Airbus can offer."

Ex-Im Bank's authorization lapsed June 30, but the bank could be restored soon. Both chambers of Congress have voted to reauthorize the agency; increasingly, it has become a matter of working out the legislative mechanics of reauthorization rather than finding the votes among lawmakers.

Boeing Capital is working with customers to mitigate any near-term impact they have from the lapse of the Ex-Im Bank funding.

"Boeing Capital is prepared to provide short-term financing if it is needed," Welton said. "However there are limits to how much of that we can provide because capital that is tied up in customer financing is capital that is not available for our development programs."

Fluctuations in fuel prices continue to be an issue lessors and airlines follow. Most agree that low fuel prices will not in the near term alter the buying and leasing of new commercial aircraft.

Fuel effects

“We’re finding more optimism about the future from airlines,” Fly Leasing CEO Colm Barrington said. The carriers won’t change their orderbooks for new equipment, but “they will tend to stick with older aircraft longer because they can make money with the lower fuel prices.”

Others agree. “What I have seen is that the pressure to make an immediate decision [on new aircraft needs] has been relieved,” Diaz said.

Frost & Sullivan’s director of business development, oil and gas, Carl Larry believes oil prices will increase and settle between $55-59 for the next few years.

Around 1.6 million barrels of jet fuel are produced per day, with prices of kerosene hovering at $2.00 per gallon. “This is an opportune time for lessors to try and get more business,” Larry said. “Right now we’re in that ‘sweet spot,’ where fuel prices are relatively low on high supply and good demand. It should give a lot of breathing room for 2016 budgets for airlines looking to lease new equipment.”

That said, Larry expects to see tighter supply into next year for all commercial fuels (gas, diesel, jet.)

Harris Poll, on behalf of CIT Aerospace, surveyed airline executives worldwide. Fifty percent of the airline executives expected oil prices to increase over the next 18 months. More than 80% of the executives said oil prices would rise in the next 3-5 years.

The leasing business has not implemented new leasing instruments to augment the types of leases offered today. But they have formed joint ventures or are offering variations of lending instruments that are currently available as ways to enhance and grow their leasing businesses.

Sidecar investments

Some lessors are creating so-called “sidecar investments” to allow their operations to grow. CIT’s joint venture (JV) with Century Tokyo Leasing Co. is an arrangement where the lessor sells down some of its aircraft to the JV. These sidecar arrangements help lessors grow and diversify their portfolio when they reach aircraft type or geographic concentrations. In this case, CIT maintains a portion of the equity investment while continuing to manage the assets. A commonly held theory is that these sidecar arrangements are created once the lessor's portfolio reaches around $10 billion in value.

A number of non-US airlines have availed themselves to the capital markets under Enhanced Equipment Trust Certificates (EETC), said ACG's Feren. They include Emirates, Air Canada and LATAM Airlines Group, parent of Tam Airlines. EETCs are a broadly used alternative for aircraft financing, used mostly in the US, but increasingly used by non-US carriers. LATAM Airlines Group became the first issuer of EETCs in Latin America, allowing the Group to diversify funding sources and to access a broader investor base in the capital markets.

There are other aircraft leasing offerings worth noting. In June, Fly Leasing announced the sale of 33 mid-life commercial aircraft to an asset-backed securitization (ABS) vehicle for which investors buy bonds. With cash readily available, the ABS market "is quite hot," said Fly Leasing's Barrington.

Aircraft operating leases continue to be the most popular instrument among airlines and could help lessors break into new territory. Feren sees new operating leasing opportunities in Cuba and Iran, two nations with which the US is trying to improve relations.

The present state of the commercial leasing business is good with profits up and portfolios growing. "The market for leasing of aircraft remains high and residual values for most types are forecast to remain in line with normal industry projections, with recent model narrowbodies holding values reasonably well," Airinsight partner Ernie Arvai said.

The near-term prognosis for the aircraft leasing industry might be described aptly in medical parlance. The patient remains fit, but should take steps to maintain a healthy diet and avoid crisis situations when possible.

Less is More

The state of the aircraft freighter leasing market is a "good news, bad news" situation.

The market for twin-engine narrowbody and twin-engine widebody freighters has improved significantly over the last year, while the call for four-engine widebody freighters is barely audible.

A quick look at what the leasing companies and OEMs are doing provide a snapshot of this segment of the business. In June, GECAS launched its Boeing 737-800NG passenger-to-freighter conversion program, with the lessor planning to convert up to 20 of the popular twinjets. AEI Aeronautical Engineers will perform the first conversion in China in 2016.

Boeing Commercial Airplanes VP marketing Randy Tinseth told Reuters recently that he sees a demand for up to 1,000 single-aisle freighters over the next 20-years. The 737-800 is a primary candidate for conversion, he said. Such a projection, if proved correct, could bode well for the leasing industry, which had looked skeptically a few years ago at this segment of the business.

At the Paris Air Show last summer, Airbus launched a new passenger-to-freighter conversion program for the A321 and A320.

Lessors remain unconvinced about the viability of the four-engine freighter market.

“I believe that four-engine aircraft are on the wane,” Air Lease Corporation president and COO John Plueger said, referring to commercial passenger and freighter aircraft.

“Boeing and lessors could benefit if the four-engine freighter market improves, but today there is a glut of 747-400s available at bargain prices,” Airinsight’s Ernie Arvai said.

The large freighter market took a nosedive two years ago and has yet to recover. A 747-400F renting at just under $1 million per month in 2013 now fetches $500K per month, Arvai said.

That said, Cathay Pacific Airways and other operators of four-engine widebody freighters continue to operate successfully, aided in part by low fuel prices. What happens to widebody, four-engine freighter fleets if fuel prices spike is anyone’s guess.

This segment of the market is being helped by the resurgence of the twin-engine freighters. This is good for the leasing companies, which are actively looking for single-aisle, twinjets for conversion.

“We expect to see a continuation of the interest in smaller converted freighters, with a likely demand for 30-40 per year worldwide,” Arvai said.

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