

Aviation FINANCE

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Lenders and borrowers are charting a cautious course through the roiling economy

by Curt Epstein

Last year when **AIN** took a close look at the aviation finance industry, the prevailing sentiment among industry insiders was that if you were looking for money to finance a business jet, the money would find you. At the time, many of the aircraft finance divisions still felt they were relatively insulated from their mortgage brethren, even within the same company.

At the same time, the price of oil, hovering above \$100 a barrel on its way to a peak of nearly \$150, was beginning to have an effect on the number of flight hours, as operators felt the pain of paying \$8 or more for a gallon of jet fuel. A recent report from UBS Investment Research found 2008's business jet flight activity was down 9 percent through the end of October as compared with last year, with declines of 18 percent in August and 13 percent in September.

Nonetheless, business aircraft sales remained brisk. Cessna's business jet order backlog increased by more than \$4 billion in 2007, while Gulfstream—which reported record results last year—expected even better numbers this year despite the looming financial worries. As the financial institutions wrote off billions of dollars in sub-prime mortgage losses, liquidity began to tighten.

Even though the scent of economic distress was in the air, few Monday-morning quarterbacks could admit to correctly predicting the degree of chaos that struck Wall Street this year. Chastened economic sage and former Federal Reserve chairman Alan Greenspan testified to the House Committee on Oversight and Government Reform, “Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief.”

The foundations of some venerable money houses began to crumble, and first to fall was investment bank Bear Stearns in March, which was quickly absorbed by JP Morgan Chase; in September Lehman Brothers fell into Barclays' hands. Just days later, Bank of America agreed to purchase Merrill Lynch, while Morgan Stanley sold one-fifth of its equity to Japan's Mitsubishi UFJ Financial Group. Capital

lending institution National City was purchased by PNC Bank, while banks such as Washington Mutual and Wachovia were swallowed up by JP Morgan Chase and Wells Fargo, respectively.

After Congress passed the emergency \$700 billion bailout plan in early October, intended to “immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States,” there have been some indications that the \$250 billion thus far disbursed to financial institutions such as Goldman Sachs and Bank of America has had an effect in restoring liquidity to the finance market. A report from the British Bankers Association showed the three-month U.S. dollar London interbank offered rate (Libor—the rate at which banks offer to lend money to each other, and a key index for the basis of other loans) fell at the beginning of last month to its lowest rate in nearly two months.

All of this activity and consolidation has narrowed the sources of financing for customers interested in buying business aircraft. “The recent economic crisis has caused significant changes in the finance market as sources of finance have pulled out entirely from the market, severely cut back their activity, or been acquired by another financial institution and no longer exist,” said Michael Amalfitano, Bank of America's managing director, executive head of corporate aircraft finance. “At those sources that remain, financing terms are more conservatively structured to allow lenders and lessors to protect their investment,” he added.

Among lenders, the theme this year seems to be what a difference a year makes. “A year ago you didn't have to do anything; the money found you,” said Allen Qualey, president of 1st Source Bank's specialty finance group. “This year the market is much tighter; there's still money to be had, but it's going to be more expensive.”

A Federal Reserve Bank survey of finance industry senior loan officials



released last month bears out that opinion. The survey found that roughly 75 percent of foreign respondents and about 40 percent of domestic respondents noted that a deterioration in their bank's current or expected capital position had contributed to a move toward more stringent lending policies over the past three months. Eighty-five percent of domestic banks reported having tightened lending standards on commercial and industrial loans to large and middle-market firms over the past three months,

and all of the banks in the survey said that they had increased spreads of loan rates over their cost of funds on C&I loans to large and middle-market firms, up from roughly 80 percent in the July survey.

Other economic factors are affecting the availability of funds for business aircraft loans. According to Adam Warner, president of Key Equipment Finance, “Interest rates are higher, too, “about 100 basis points [1 percent] higher than just three or four months ago and 200 basis

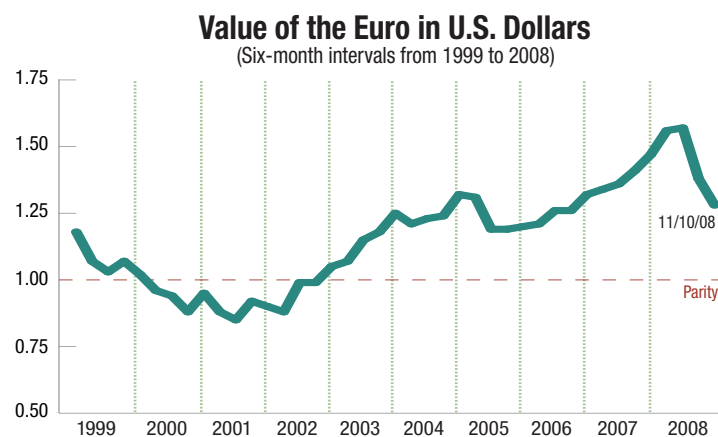
points higher than at this time last year.” That has trickled down to the rate offered to customers, observed Carlsbad, Calif.-based aircraft broker Chuck Collins. “The people who are loaning now are loaning on variable-rate money as opposed to fixed-rate money. Fixed rate is expensive by today’s standards. We can still get loans with variable rates that are priced 130 basis points over Libor. That’s for credit-worthy customers, obviously.”

Such changes in the lending arena have caused some to see differences in the loan options their customers are pursuing. “The economic crisis has contributed to a 75-percent increase in the number of requests for our asset-based loan product,” explained Wayne Starling, senior vice president for sales and marketing at PNC Aviation Finance. “This type of loan requires 20 percent down in cash, but enables the buyer to borrow against the value of select aircraft (up to 80 percent loan to value) with reduced disclosure obligations. Asset-based loans do not require the borrower to put up other valuable assets as collateral, freeing up borrowing capacity for other uses. This is an excellent option for cash buyers because it allows them to spend their capital elsewhere, instead of leaving it parked on the tarmac.”

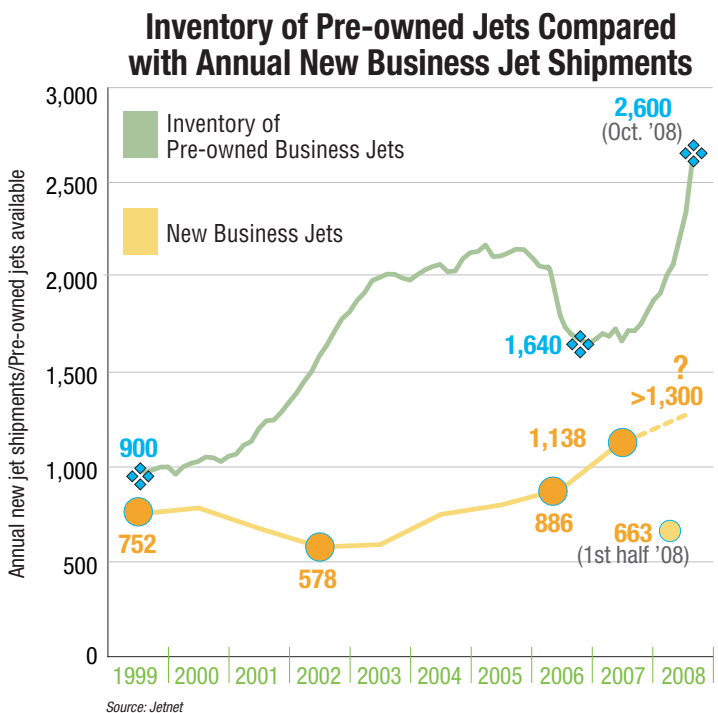
Typically lenders are asking customers to “put some skin in the game,” according to Starling. “Many of those that are still lending are tightening credit, pulling back from doing 100 percent loan to value and requiring more for down payment. They are also shortening the amortization period from 20 years to 15 years.”

Too Many Cooks Spoil the Pie

As the business aviation industry experienced its latest boom, dating back several years, it may have found itself a victim of its own success as many lenders rushed to fill the need for financing clients. “More and more banks were coming to the party because it was a good, stable lending place,” Doug Reinarz, senior vice president at Chase Business Aircraft Finance and president of the National Aircraft Finance Association, told *AIN*. “Having a stable asset that you are lending on for the most part very good credit, that’s a great place to be. Banks like that, finance companies like that, especially when you are able to differentiate your borrower pool a little bit and have high-net-worth individuals and some companies and maybe a little bit of charter operators and maybe a



Note: Number plotted represents the value of the euro in dollars on the first day of each quarter.



Source: Jetnet

broker or two; you get a wider spectrum of borrowers.”

Having that many participants in the business aircraft finance market sparked intense competition, flooding the market with capital, which in turn caused the lending rates to decrease. “Clearly a year ago you had some very aggressive liberal things happening because of the number of players and because of the easy access to capital that was present, and that was making [borrowing] too easy and making terms and conditions too flexible,” said Reinarz. “There will be stories written later about folks who acquired airplanes who frankly shouldn’t have.”

That overarching drive to “close the deal,” which analysts began to notice in 2005, drew some similarities to the sub-prime debacle that clobbered real estate and Wall Street. “You were seeing aircraft loans to high-net-worth individuals or even private companies that were getting priced at the levels of say Libor plus 50 or Libor plus 70, and these individuals or private companies were by no means household names or by no means hyper-high credit quality,” said Reinarz. “These types of transaction were getting

pricing that had historically been reserved for [customer credit ratings of] double As or triple As. If you go back over time and look at where double As and triple As historically have borrowed, it would be in that very low rate range. We had driven down to that range our rates for clients that didn’t meet those criteria.”

Due to the very low rates—resulting in narrowing profit margins—combined with tighter capital as a result of the financial meltdown, many of the newcomers to business aircraft financing are now taking a much more cautious approach, according to many in the industry. “What we are seeing now is that many of the lenders that were in aircraft financing or offering aircraft financing have either withdrawn or changed their approach to aircraft lending,” said Greg Renna, senior vice president of Webster Bank subsidiary Center Capital’s general aviation division. Lenders that might have offered a full gamut of financing options are pulling back slightly, concentrating on one facet of the business. For example, “We’re seeing some of the lenders out there now maybe just operating lease structures,

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The VLJ Market: Still Waiting?

While the VLJ landscape outwardly appears the same as it did for *AIN*’s last financial special report, with only two types currently certified and in operation by customers, beneath the surface an extensive transformation is welling up. Eclipse, the first of the new breed of personal jets to be certified, has not reached its ambitious projected delivery rate, and its profitability is tied to its reaching this goal. A mid-summer change in leadership at Eclipse—dictated as a condition of new funding—appears to have failed to reverse the New Mexico-based airframer’s fortunes, which were dealt a critical blow when primary customer air-taxi operator DayJet folded at the beginning of October and the manufacturer failed to make payroll last month. While Cessna continues to ramp up production of its Citation Mustang with the expectation of delivering around 100 this year, Brazilian manufacturer Embraer is poised to begin deliveries of its Phenom 100 as soon as it receives certification, which could be before year-end. Most lenders expected to have a better handle on the VLJ market by now, but that seems premature. Business aviation moneylenders seem to hold definite biases and still maintain a level of suspicion.

Bob Kent, Scope Aircraft Finance: “We usually like to see a couple of years of production for any all-new aircraft before we become comfortable with long-term collateral value.”

Michael Amalfitano, Bank of America Financing: “We have been very selective in our approach to this sector and the considerable number of new light jets that have been announced over recent years. Many of these models are in the process of certification while others have recently received FAA type and production certification. While certification is the first step in any new aircraft, product support and customer acceptance are equally critical. We will continue to monitor these programs closely and make decisions on the extent to which we continue to selectively invest in this market.”

Wayne Starling, PNC Bank: “If it is not a current aviation manufacturer with a history of developing and supporting an aircraft, then we do not rush to provide financing.”

Dave Labrozzi, GE Capital Finance: “We have not seen an excessive level of interest from VLJ purchasers in financing their aircraft. We have, however, financed a number of VLJs and are interested in financing such equipment going forward. While the number of actual deliveries might be far below the early predictions, VLJs are still forecast to play a significant industry role, and we plan to support the financing of such aircraft.”

Allen Qualey, 1st Source Bank: “We’re very careful, and I think most are doing what we’re doing. We’re not saying no to it, but at the same time we’re being more cautious. We’re looking at the Cessna Mustang no differently from any other Cessna Citation. Cessna is proven. Citations have phenomenal resale value, so there’s no question the Mustang will have a good resale value. Whether it’s the same as the others, who knows? Only time will tell, but the marketplace is comfortable that that airplane will have a good residual value because there’s a worldwide support system to go with it. The Phenom and HondaJet are going to be guaranteed winners, not because of the products themselves but because of the companies behind them.”

Greg Renna, Center Capital: “We’ve taken a wait-and-see approach to the new start-up manufacturer VLJ products, and that is still how we are viewing this segment. However, we are willing and able to finance established manufacturers of VLJ aircraft.”

Mark Wooller, International Bureau of Aviation Group: “We’ve always advised the clients we’ve worked with that the VLJ market is a high-risk market—one, because it is at the entry level, and therefore by definition the people who are trying to get onto the ladder perhaps are not as wealthy as some of the more traditional operators of corporate jets; and two, there was hype around VLJs, and the business model for operating them was never a proven one. We’ve always advised caution to the lenders, so I don’t think their views necessarily changed because of the current economics.”

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others that were lending for all brands of aircraft now lending only for one manufacturer's line of aircraft, so there are many variations now."

That hunkering down means the aircraft financing landscape has changed dramatically since last year, according to Reinartz. "I would have guessed [that at this time last year] there were probably 25 serious larger-end aircraft finance shops. Today there are probably five or six that are active."

Many experienced members of the aircraft finance industry have seen this type of cycle before. "When markets are good, new players come in that don't really understand the industry but obviously see it as an opportunity. As soon as you have a slight downturn, they tend to back-pedal fast, scuttle back into the woodwork and disappear again. In an historic view of, say, 15 years you can see a cycle of the number of financiers increasing and, with a slight downturn, contracting again," said business aviation consultant Mark Wooller of the UK-based International Bureau of Aviation Group.

By some accounts, that change is already having a deleterious

effect on customers contemplating aircraft purchases. "Financing is spotty; there are some who are not doing it and some that are," said aircraft broker Collins. "If my client has a banking relationship and was counting on doing it with them, then obviously if that institution is out of the business it's a showstopper for us. If I can persuade him to go out to the open market, there are institutions that are [offering financing]. There are some that are stopping, not by saying, 'We're not going to make loans anymore,' but by quoting rates that are commercially unacceptable."

According to the Federal Reserve Bank survey of senior loan officers, among banks that reported an increase in demand for loans, nearly all domestic respondents reported that customer borrowing had shifted to their bank from other bank or non-bank sources because these other sources had become less attractive. "Early this year, there were too many lenders/brokers and too much money chasing too few deals," said PNC's Starling. "In the last 90 days that has changed. Today, a borrower might call his current lender or bank for a loan only to be told that they are not lending at this time. Brokers also are encounter-

A New Voice in Aviation Finance

While some banks are exiting the aviation finance field, a newly launched group is looking for ways to bring others in. Announced last month, the Professional Aircraft Lender's Association (PALA)—which hopes eventually to act as the single voice for aircraft brokers within the framework of the National Aircraft Finance Association (NAFA)—believes it can help consumers find alternative competitive sources of funding during this difficult economic period.

"Now that some of the banks have tightened up and some have restricted some of the aircraft lending, part of our goal is to find new banks to get into aircraft lending that have not necessarily been primarily an aircraft lender before," said PALA founding director Wally Zook of Wally Zook and Associates Aircraft Finance, based in Red Lodge, Mont. "We represent about \$250 million worth of business a year with our seven members and we feel that that will get some attention from banks that are looking to do aircraft finance." —C.E.



ing difficulties in finding a bank that will buy loans from them. Money is available, but it is harder to qualify for a loan and much more expensive to borrow."

Spreading the Spreads

Another effect of the intense competition in the market was an unnatural manipulation of the credit spreads. "This competition for deals did drive the spreads to a low point that we had never experienced," said Starling. "Many of these loans barely met the profitability model." Bank of America's Amalfitano agreed. "That competition resulted in compressed spreads and poorly structured transactions, including over advances on loans, interest-only structures, and limited and non-recourse financing. To make matters worse, the aircraft being financed have been selling at premium pricing often in excess of the original cost."

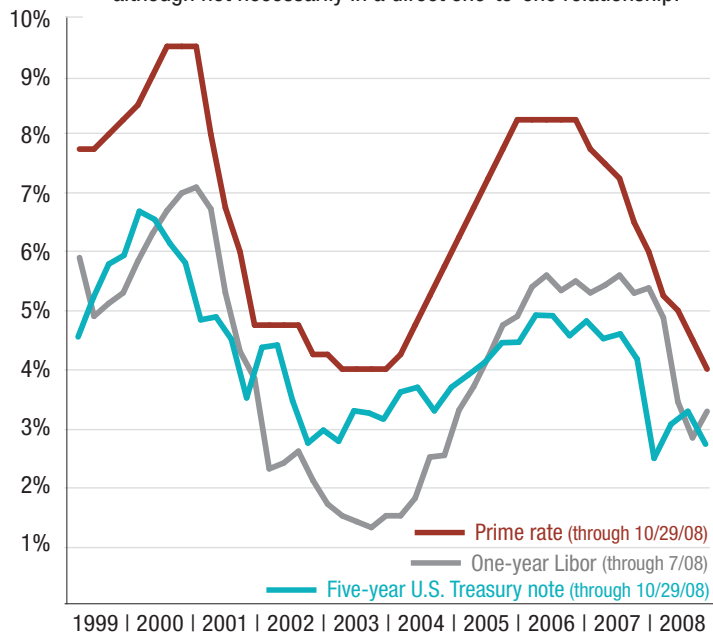
Most of the lenders who spoke to AIN believe the spreads will increase in the coming years,

tipping back in favor of the lenders. "I think what you are going to see for the foreseeable future is a much better spread for banks, with less compression, because the big banks that drive the pricing all have various issues they are dealing with, and with all the write-offs that are being taken in various areas, they need to offset that some way, and this is one of the few areas they have," said Qualey of 1st Source Bank. "When you look at banking for the next year, all of us are going to pay a lot higher premium to the Federal Deposit Insurance Corporation than we have because we have to pay for the other banks that failed, and obviously we have to pass that on." Wells Fargo Equipment Finance v-p Dick Ramsden believes that well capitalized lenders, while fewer in number, will continue to offer competitive rates while "thinly capitalized lenders have to put a high premium on their capital and they have increased their spreads dramatically."

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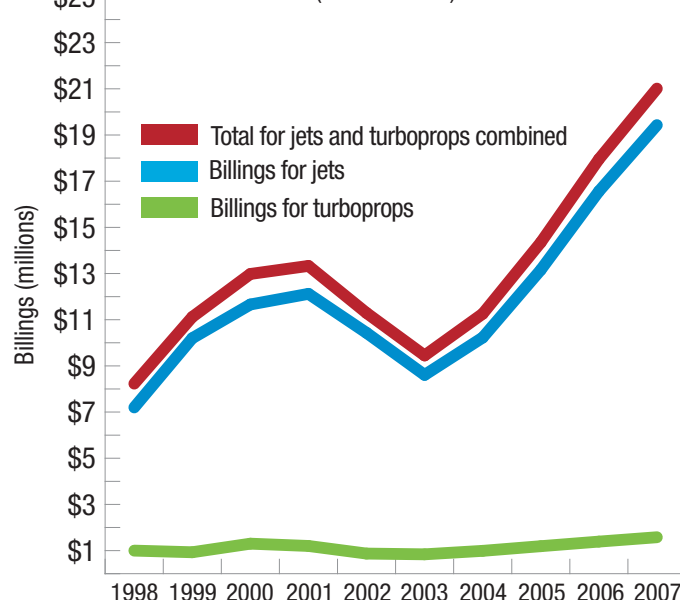
The Cost of Financing

Fluctuations in interest rates influence aircraft finance rates, although not necessarily in a direct one-to-one relationship.



Note: Lenders base aviation loan and lease rates on a number of indices. The prime rate is often the basis for relatively simple domestic loans and one of the several London Interbank Offered Rates (Libor) for the more complex domestic and international loans. Variable-rate loans are often indexed to the prime rate or a Libor rate, while fixed-rate loans are often based on the five- or 10-year U.S. Treasury note rates or the Libor swap rate. The "spread" is the difference in the index rate and the rate charged the client and varies with the lender's estimated risk of the loan.

New Business Aircraft Billings (1998-2007)



When the Axe Falls...

In the midst of the last downturn in the business aviation industry—which lasted from 2001 until 2005—the number of aircraft repossessed and/or seized by financial institutions soared. According to statistics supplied by industry monitor JetNet, during that period lenders reclaimed 230 jets and 152 turboprops. So far this year, 33 aircraft have been foreclosed upon or seized, with the frequency increasing in the latter part of the year.

With business aviation seemingly heading for another such decline, historical perspective suggests those numbers will swell in the coming year. With that in mind, the UK-based consultancy firm International Bureau of Aviation—in answer to requests from its financial industry clients—has released a new guide on Aircraft Repossession and Contingency Planning. "There are signs of distress in the business aviation market. Some charter operators have gone into liquidation. If you look at the percentage of various aircraft models for sale, they've jumped markedly in the last three to six months. All of those are signs that the market is changing," said Mark Wooller, IBA Group's head of consultancy. "If you look at the available aircraft for sale, for example, you'll see a number of aircraft financiers that are now listed as having aircraft for sale. We've been appointed already by some financiers to repossess aircraft."

While many lenders were eager to toss their hats into the aircraft finance arena as sales of bizjets reached record heights, some were not well equipped to deal with the effects of deals that went sour, leaving them owners of foreclosed business aircraft. "Typically the financiers as a general rule don't have a lot of in-house technical capability," Wooller told AIN. "They tend to outsource advice when they are financing the aircraft in the first place, and if they get into difficulties with them, we then act as their technical advisors to help them get out of any particular situation, mitigate their losses and dispose of the aircraft."

Faced suddenly with the potential prospect of managing fleets of aircraft, IBA's customers asked for help, which Wooller and his staff have provided. "It basically is a quick ready reckoning guide to what some of the issues are for owners of aircraft if repossession is required," said Wooller. "It goes into some of the considerations that you will need to take into account: the physical location of the aircraft and all its records; liens with maintenance companies, aviation authorities, fuel suppliers, insurance companies; and issues such as liaising with the aviation authorities to get permission for ferry flights if the aircraft isn't currently in its correct maintenance check state." —C.E.

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Credit Crunch 101

An interview with Dr. James West, chair of the department of economics and business, Moravian College

by R. Randall Padfield

What do economists mean when they talk about the credit crunch?

Banks are highly leveraged, meaning that most of their assets are financed by debt rather than equity, so they don't have a lot of room to see their assets deteriorate. Because the quality of their assets has been called into question, they need to restore capital to avoid insolvency. In their rush to get additional capital to supplement their bad loans, they're unwilling to make loans to each other or outside the banking system.

I tell my students the situation is like having 50 cans of soda that I'm selling for 25 cents each. You think, "That's a good deal." Then I tell you that 10 percent of the cans contain some poison. So the market for all 50 cans disappears, even though only five are tainted—because you don't know which five. Banks just don't know where the poison is in the securities that they and other banks are holding. So there's a shortage of credit, particularly in the short-term markets, but also in the long-term markets.

How did this happen?

Not since the Great Depression have we seen such a decline in equity values and collapse in confidence in the financial markets. What began as a severe financial crisis is now moving into phase two, which is an economic crisis, or recession—a slowdown in the real economy. But this didn't happen overnight—it took decades to materialize. And there's a lot of blame to go around: the government, Wall Street investors, Main Street, mortgage brokers, appraisers, real estate speculators and home buyers who really weren't in a position to own a house.

One aspect is deregulation. In the post-World War II era, the financial decisions of banks were severely regulated. Commercial banks, investment banks and insurance companies were all separated from each other. Coming into the 1980s U.S. banks were so regulated that they were not competitive in the global marketplace. So there needed to be a deregulatory push so that banks

could move into more lucrative markets and obtain economies of scale and scope.

There were a lot of mergers and acquisitions in the 1980s and 1990s, and banks were allowed to do more lines of business, becoming "financial supermarkets" for their clients. Deregulation was needed, but unfortunately the transition presented some problems. One was that the investment banks really stayed outside the realm of the regulatory world. They had pretty much a free rein, as did the new hedge funds. The SEC was fairly hands off.

What are the other causes?

The housing bubble was obviously a huge one. Part of the problem was a lending mentality that encouraged mortgages to people who possibly—probably—should not have gotten them. They were not financially prepared to make a down payment and cover their monthly payments. A lot of people expected housing prices to keep rising and interest rates to stay low forever, so if they became temporarily inconvenienced, they could make money on the sale of their house.

But most critical to the whole problem was that more than half of these mortgages passed through two private institutions, Fannie Mae and Freddie Mac, which had quasi-governmental backing. This backing encouraged credit reporting agencies, such as Moody's and Standard and Poor's, to rate them highly. Fannie Mae and Freddie Mac bought mortgages from other banks, turned the mortgages into securities and then sold these securities to investors in a process known as securitization. When the first mortgage defaults came in, people realized these loans and securities were a lot more problematic than they originally envisioned. And it was hard to tell the good securities from the bad ones.

On top of this, insurance companies, such as AIG, sold a derivative product, called "credit-default swaps," which is actually a form of insurance on the mortgage and other securities. But when the mortgage securities defaulted,

the companies had to make good on the insurance. This then rippled through the short-term money markets. Credit-default swaps and other forms of derivative securities have a useful purpose in the economy, but are a little like fire. Warren Buffett calls them "financial weapons of mass destruction, when used improperly."

Multiple factors played a role in generating this crisis. The easy-money policy following the dot-com bust and 9/11; the failure of Enron in 2001 and Long-Term Capital Management (a hedge fund) in 2000 led to problematic regulations, such as "market to market" accounting rules and Sarbanes-Oxley; and global banking capital requirements under the Basel II accord all contributed technical issues that fed into the crisis.

What do you think of the \$700 billion bailout Congress passed?

The Constitution of the United States gives the government the responsibility to control the money supply. This responsibility was more or less outsourced to the banking system and the Federal Reserve. Through the lending process and extension of credit, the banks themselves create most of what we call "money" in the economy. The Federal Reserve oversees this and to some extent has control over how much money is created. The credit crisis undermined this whole money supply process.

As much as I am a freemarketeer, the federal government, I think, was well within its right to take back the money-control function from the banks, with the \$700 billion buyout and either buying the assets directly or taking equity shares in the banks. Some people are concerned that this is socialism, but it has been proposed as a temporary emergency solution needed until banks can recapitalize themselves and get a handle back on the lending processes. The goal is to restore faith in the financial systems and give better control over the money supply.

Why hasn't the decrease in the price of oil had a more positive effect on the economy?

The fall in the oil price is more a result of the recession than a cure for it. The run-up in oil prices this summer was due to over-speculation and the perception of inadequate supply for growing world demand. Then the shockwave of the financial crisis and the worldwide slowdown brought down the price of oil. Falling prices are part of the corrective pressure that market economies have in them; when things slow down, prices fall. The same thing is happening in the

housing industry. These deflationary changes produce both pain and opportunity.

Why has the value of the dollar relative to other currencies gone up recently?

In terms of the global economy, the dollar is always seen as a safe haven. As bad as things look in the U.S., there is still a degree of confidence that our economy is more stable than others. Of course, the stronger dollar might impinge on our export markets.



Not since the Great Depression have we seen such a decline in equity values and collapse in confidence in the financial markets.

What has to happen for the credit markets to open up again?

The key is stabilization of the U.S. and other economies. What is good is that our leaders recognize there is a role for the government to be the "lender of last resort," or like now "the buyer of last resort," to get the economy back on track. Banks need to be stabilized so that they're lending again. The free market itself has a lot of self-corrective mechanisms in it. Once the cash starts flowing again I think the inherent strengths of the economy will be there. We are in a long wave of innovation, and globalization that will sustain continued growth once the pains of the credit crisis have passed. It's significant that the Asians and Europeans are doing the same thing we are.

I think in the long run people will give credit to President Bush and others in Washington who really tried to immediately restore confidence in the system, which is critical. They recognized that if people lose confidence in the

American economy, it's almost certain to drag down the rest of the world with it. America has to be the leader in pulling the world out of this recession.

The stock market crash of 1929 didn't need to play out into a 10-year depression. A lot of government mistakes—extreme protectionism, tax increases, over regulation—actually precipitated a longer depression than it would have been. So wise and firm government intervention can help avoid this happening again.

What should Joe the Investor do with his 401(k)?

If Joe isn't out of the stock market by now, he may as well sit tight. It's always hard to predict the bottom of a down market and there's still room for it to go down more. But even though the market is gyrating quite a bit, there seems to be some evidence that it's finding a bottom. There are a lot of strong economic factors out there. I still believe that the economy is basically strong and the market will—eventually—bounce back.

What's the silver lining?

I hope this experience will be a wake-up call about honesty for everyone—a cultural transformation. Greed, political expediency and corner-cutting have become endemic to so many levels of the crisis. We can't just lie a little bit to get what we want. Individuals who engage in imprudent personal planning, taking on much more risk than they can handle—that's a form of dishonesty. Government and business practices need to be based on integrity. The government is like a referee in a basketball game; it can't see and penalize every infraction of the rules. If it tries to, it spoils the game. So the government can't regulate honesty, which means that a cultural shift to restore integrity is critical.

My greatest fear is that this crisis will be seen solely as a failure of the free market and that the government will justify ever-growing ownership and long-term regulation of the private sector. This will ultimately inhibit competitiveness and growth. Another lesson of the Great Depression is that too much government contributed to the painful stagflation of the 1970s. Finding the balance in this crisis is the essential task. ■

Dr. James West is a professor of economics and business and chair of the Department of Economics and Business at Moravian College in Bethlehem, Pa. His interests include the role of financial markets in national and international economic development, and issues in international management.

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With the lenders being less aggressive overall, most believe the law of supply and demand will become more evident as aircraft purchasers scramble for financing. For example, Mary Schwartz, global head of aircraft finance for Citi Global Wealth Management, explained, “With balance sheet restrictions, bad earnings reports and capital not readily available for lending, there are fewer lenders searching for deals, spreads have increased dramatically, and terms are not as advantageous as they were a year ago. This has become more apparent in the last two months. We believe that this will continue for at least another year and possibly longer.” RBS Asset president Marc Paulhus agrees with that prediction. “I expect next year that there won’t be as much compression to no compression, where you will actually have commensurate returns for the appropriate risk.”

The Effect on Older Aircraft

With the used business jet inventory currently at an all-time high, the days of their selling at prices above those of new aircraft seem—at least for the near future—to be done. According to statistics from Jetnet, as of October 2,600 jets were on the market, a 47-percent increase from the same month two years ago.

With such growth, lenders not surprisingly are keeping a close eye on pre-owned aircraft values, as well as factoring in other considerations such as costs associated with the possible resale of repossessed aircraft (see “When the axe falls” on page 22). “It’s not purely just looking at the value today and saying OK, what’s the bank’s or financier’s exposure?” said Wooller of aviation finance advisory firm International Bureau of Aviation Group. “It’s also saying actually this could take us six, nine, 12 months to sell, so what are the storage costs that we then have to amortize into our overall exposure before we actually dispose of the aircraft. It follows suit that if, quarter-on-quarter, the trend is going down the two extremes are moving in opposite directions. Your security value is going down, and maintenance and storage costs are driving your exposure up. It’s a nasty equation if a financier gets his numbers wrong.”

Concerns about such equations have caused many lenders to scrutinize more closely the type and age of aircraft they will finance. One rule of thumb currently in play seems to be to avoid deals where the age of the aircraft plus the term of the loan exceeds 25 years. “It is reasonable to expect that older jets—20 years and older—will be difficult to finance as the experienced aviation lenders all remember the significant deterioration in turbine values of older aircraft in our last industry recession, which began in the fourth quarter of 2000,” said Bob Kent, president of

Scope Aircraft Finance.

“Some lenders do not finance older aircraft because in a slow economy, with aircraft values declining, older aircraft values drop first and take the longest to come back,” said PNC’s Starling. “You might have a low-time older aircraft that is in excellent condition, but if 20 percent of the fleet is for sale, [the lender if necessary] will not be able to get top dollar and [the airplane can be expected] to take much longer to sell.”

Older aircraft also might not include the latest in upgrades, generally making them the least attractive to buyers and therefore also unappealing to a lender that might someday find itself owning them, explained Center Capital’s Renna. “One must consider the costs of upgrading an aircraft to operate in today’s airspace and compete with features in later-model aircraft. Add to that a major maintenance event, and you could very likely have an aircraft that’s simply not worth the investment. As a lender you must always put yourself in a position of possibly remarketing an aircraft, and a prudent lender does not want to go to the market with an inferior, older aircraft.”

But while there are such considerations, many of the lenders interviewed still expressed a desire to examine deals on a case-by-case basis. GE Capital Solutions corporate aircraft president Dave Labrozzi said, “When asked to finance aircraft that are more than 20 years old, we tend to be more selective of the entity’s credit, and here our experience with such transactions has been very positive.”

Yet some feel the lenders’ caution is only part of the equation when it comes to hesitation on current used aircraft purchases. “I don’t think the road block is the loan. If someone really wants to do a deal, they can find the money,” said aircraft broker Collins. “The road block is that people really don’t want to do the deal right now. Everybody wants to buy at the bottom of the market, but with the volatility in the stock market and concerns about the economy, they’re not sure if the bottom has come.” He added, “The state of the marketplace has been horrible. The number of calls that I have been getting has been very low, but not because of the quality of my inventory. After this last crunch in the marketplace, when the Dow dropped 800 points, my call volume doubled, maybe tripled. I had a gentleman come look at my GIV yesterday, and I have a guy who I’m working with to put together a letter of intent on my Hawker 800SP. That leads me to believe that the bottom is here. The offers might be lower than I would like, but they are making offers.”

What Does the Future Hold?

The entire industry seems to agree that a slowdown is coming. At this year’s NBAA Convention, staged in October against a backdrop of financial uncertainty, no blockbuster orders—a mainstay of recent conventions—were announced, as sales slowed to a trickle. However, the market has changed since the last downturn in 2001 and this time OEMs are betting their

extensive backlogs will see them through the rough times ahead. Nonetheless, they are beginning to prepare for the worst. Citing “very serious challenges facing the company due to the unprecedented worldwide economic decline,” Hawker Beechcraft last month announced it would be reducing its workforce by 5 percent, while Cessna chairman, president and CEO Jack Pelton informed employees that

“changes to our 2009 production schedules, as well as reduced aircraft utilization, will result in a need to reduce our current workforce level.” The company will increase the number of Mustang deliveries and decrease production on some of the other Citation models next year.

Most of the lenders who spoke to **AIN** expressed belief that there could certainly be some changes ahead for the business

aircraft industry after the surge seen in the last several years. “The market for new aircraft deliveries should remain quite strong through 2010 as the result of strong backlogs enjoyed by the major airframe manufacturers,” said Bank of America’s Amalfitano. “At the same time, new orders have already started to decline as a direct result of rising [used aircraft] inventories. In fact, inventories through the fall of 2008 are at a five-year high and until these inventories are reduced, new orders for business jets will be negatively impacted. Another concern of the OEMs will be the risk of order cancellations by customers unable to obtain financing.”

Labrozzi of GE Capital said, “Historically, there has been a high correlation between corporate profits and aircraft deliveries, so a decrease in additional new aircraft orders, given the current economic turmoil and related corporate profit reductions, is not unexpected. However, with backlogs at an all-time high, the OEMs are in a strong position. Having said that, used aircraft values, which—during the past two years—have exceeded new aircraft values for certain models, will undoubtedly be negatively impacted, and we’re already seeing this take place.”

“The market is not as strong as it was last year,” said Citibank’s Schwartz. “Inventory has increased, prices have come down and aircraft are remaining on the market longer. We see a softening that

will negatively affect aircraft sales, which we believe will continue, at least into 2009. The strong backlogs, some out for three to five years, will help to sustain the market, even if 50 percent went away, which is unlikely, there will still be a backlog remaining.”

Some observers, such as RBS Asset Management’s Paulhus, think there will be a marked differentiation in any possible slowdown. “I don’t know that you will see that much turnover in corporate aircraft; I’m expecting a higher impact on the high-net-worth individual, who has really driven the market. The corporation’s use of a jet is much different from a single individual’s use, whether he’s using it personally or professionally, and so with the impact that the economy has on some of these high-net-worth individuals, I think you will see a difference in these two markets that drive the corporate jet industry.”

“Aircraft are no different from anything else in terms of capital goods,” 1st Source Bank’s Qualey told **AIN**. “People are not buying cars, they’re not buying trucks, they’re not buying houses, they’re not buying airplanes, they’re not buying much of anything, but that’s a very short-lived phenomenon. It’s the health of the bottom line of the operating companies that drives aircraft purchases and liquidations. I do think the market is going to be a lot slower next year, just from what we are seeing in the way of trends.” □

The Cost of Crude Oil and Jet-A Fuel Compared over Time
1999 to 2008



The crude oil price in dollars per barrel (green plot line) is the WTI Cushing price of West Texas Intermediate crude oil delivered to Cushing, Okla. Source: WTRG Economics

The jet-A fuel price in dollars per gallon (red plot line) is the average of the spot prices of jet-A delivered from the three largest refineries in the U.S. (New York Harbor, U.S. Gulf Coast and Los Angeles). Prices at the pump will vary by transportation costs, FBO mark-up and other factors. Source: AML Global