Financing is available, but buyers must meet stringent requirements

by Curt Epstein

For the business aviation industry, the past year has been a trying one, to say the least. Aircraft sales and usage declined steeply as the economic downturn tightened its grip, forcing operators to cope with the new financial realities, and in some cases with disparaging views of the industry.

While the business aircraft industry experienced a record-shattering year in 2008, with deliveries of 1,313 jets and 535 turboprops, the seeds were already planted for a steep decline. At an industry seminar in June this year, Dave Labrozzi, president of GE Commercial Finance's corporate aircraft division, traced the roots of the current credit situation back to the sub-prime mortgage collapse that began in summer 2007. "The day the earth stood still was in October 2008 when [all the] money markets just froze," said Labrozzi. "You could not buy or sell a one-month Libor note; you could not buy or sell a corporate trade."

The resultant tightening of credit spilled into the aviation financing market, which began experiencing its own difficulties when some companies grounded their aircraft, saturating the used aircraft market and eroding aircraft values. "When the asset valuation bubble burst, many banks and captive finance companies suffered severe reductions in capital, some to the point of insolvency," said Bob Kent, president of Scope Aircraft Finance. "Bank capital evaporated as they took asset write-downs, mostly related to commercial and residential real estate finance."

Some companies that had been active lenders withdrew from the market, while others—such as National City, Merrill Lynch, Wachovia and Washington Mutual—were absorbed entirely. Many of the major companies that remained—such as Bank of America, JPMorgan Chase, PNC and Citigroup—were so damaged by the downturn that they required an infusion of some of the more than $454 billion the government spent through its Troubled Asset Relief Program (Tarp).

By this past August, the number of troubled financial institutions on the Federal Deposit Insurance Corporation's watchlist—those whose regulatory rating has been downgraded due to dwindling liquidity or asset quality—rose to more than 400, while regulators closed more than 80 banks. Last month, major lender CIT—which had received $2.3 billion in Tarp funds—filed for Chapter 11 protection.

But of late there have been glimmers of a recovery. On October 14 the Dow Jones Industrial Average rose above the 10,000 mark for the first time since October 2008, when Wall Street and the finance industry were shaken by the collapse of venerable money house Lehman Brothers and a round of mergers and consolidations on an unprecedented scale. At the October annual meeting of the Equipment and Leasing Finance Association, keynote speaker economist Mark Zandi told the audience that the recession had likely ended in August. That assessment coincided with the recent Aviation Research Group/U.S. report that showed Part 135 flight activity in September reaching its highest level since October 2008.

Another important indicator is the decline in used jet inventories as brokers and resellers report an uptick in interested customers. According to market research provider Amstat, the inventory of used business jets decreased from 18 percent to 17.2 percent in September. By the end of the following month, according to JPMorgan, inventory was down to 13.3 percent of the active fleet. "We’re all a lot busier than we were four or five months ago," said Mark Smith of Gantt Aviation Sales. "I’m just keeping my fingers crossed that things keep going the way they are."

For most purchasers re-entering the aircraft-buying arena after recent boom years, things are now different in the financing market. "We were seeing down payments that were absurdly low, terms that were too long, deals that should have had guarantees and/or covenants that had neither and just what we thought were ill-advised loans," Allen Qualey, president of the specialty finance group at 1st Source Bank, told AIN. "That’s what the market demanded, and there were plenty of willing lenders doing those types of things when values were at their peak."

When the economy turned south, many of those lenders found themselves in trouble as aircraft values dropped. "As the recession set in, valuation guide publishers struggled to evaluate categories of aircraft where there were few transactions," said Kent. "When transactions did occur, they were frequently sales where the seller was desperate to unload the aircraft and the buyer was bottom fishing. Many models, on paper, lost half of their value in a matter of months."

"In my past years in aircraft sales, I can’t begin to tell you how many free lunches I’ve had from aircraft lenders coming in and wanting to wine and dine me to swing me their way as aircraft deals come along. I haven’t had many free lunches lately."

Today the number of active business aviation financiers has diminished dramatically, by some estimates to as few as six. "The number has dwindled from almost any bank or financial services company to a handful of banks that had experienced aircraft lenders and a large diversified customer base," noted Dick Ramsden, vice president at Wells Fargo Equipment Finance. "I believe there are now fewer lenders able to or willing to commit to transactions in excess of $10 million."

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For the business aviation industry, the past year has been a trying one, to say the least. Aircraft sales and usage declined steeply as the economic downturn tightened its grip, forcing operators to cope with the new financial realities, and in some cases with disparaging views of the industry.
Few firms have publicly declared their retreat from aggressively seeking deals on the open market, choosing instead either to hold their financing capital solely for existing high-credit customers or to offer overly restrictive terms to deter hopeful but less well qualified applicants.

This relative scarcity of active lenders has led to some changes in current loan structures. “The market is such that it’s not that competitive,” Bill Quinn, aviation consultant and chairman of Aviation Management Systems, told AIN. “You’re not going to have lenders falling all over themselves trying to get you to do deals.” With less competition driving the market, remaining lenders can step back and thoroughly examine each potential loan before committing to financing. The pace at which deals are completed has become more deliberate, with some transactions taking more than a month-and-a-half to complete.

One of the major differences is what was considered creditworthiness as recently as last year may no longer be so. “The feedback I am getting from brokers and clients is that there is much tighter availability,” noted Groom. “Perhaps a customer who might have been able to obtain financing two years ago just cannot get it today because of either a creditworthiness issue, just tougher standards or because he is required to give a larger down payment than he really wants to for the particular transaction.”

Matthew Huff at O’Gara Aviation in Atlanta made a similar observation. “Early this year we lost a couple of deals because a buyer couldn’t get the financing that he thought he was going to be able to get. A year ago he was perfectly qualified and now he’s being told he’s not.” According to Joe Dini, senior vice president of Sovereign Bank, financing is now a much simpler equation. “Rate and terms are not the question now; it is strong credit, stronger credit and strongest credit as a requirement to get funded.”

While some have complained that there is little financing available, many lenders believe there is still enough capital in the aviation finance market to cover all the deals—although perhaps not at the easy terms seen recently. “I summarily reject the comment that we still hear by a lot of people in the industry that lenders aren’t lending and credit is too tight.” 1st Source Bank’s Qualey told AIN. “The simple fact is if the buyer of an airplane is qualified, meaning he can comfortably make the payments, is reasonable in his terms and expectations, and reasonable in his pricing [of the aircraft], credit is readily available.”

A mid-year report by the Federal Reserve Bank showed that in a survey of senior bank loan officers only about 30 percent reported tightening standards on commercial and industrial (C&I) loans, compared with a peak of 85 percent in November 2008. The uncertain economic outlook and a reduced tolerance for risk were the primary reasons cited for the tightening of credit standards for C&I loans.

Many domestic firms also noted a worsening of industry-specific problems as a factor. Asked to describe the reasons for the decline in commercial and industrial loans this year, banks listed lower loan

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Loosening the Purse Strings?

The term “tightness of credit” means different things to buyers and lenders. For brokers and buyers, it means stricter credit standards and tighter terms under which financiers will lend money. For the lending institutions, it generally refers to the available capital or liquidity they have available to lend. Whether or not credit has loosened over the past few months is subject to debate even among industry leaders:

Mary Schwartz, Citigroup: “I think that to some degree there may be some loosening of credit. Banks have strengthened, which has allowed them to lend again.”

Dick Ramsden, Wells Fargo: “I haven’t seen credit loosening but rather buyers becoming adjusted to today’s requirements. The market always adjusts to the cyclical events created by the economy, and buyers have refocused on the benefits of ownership and how it may help them improve their productivity.”

Michael Ambrosiano, Bank of America: “There has been an increase in credit capital for lending. This is associated with the bond markets beginning to open back up for large publicly traded companies, and investment-grade equivalents, as well as financial institutions now having contained any material portfolio concerns so that they can once again focus on new investments.”

Bob Kent, Scope Aircraft Finance: “Some instability has returned to the aircraft finance market. The initial panic in capital markets has subsided as bank mergers and government assistance have provided stability.”

Wayne Starling, PNC Finance: “We have not seen any loosening in credit and believe that many lenders will remain conservative for some time until prices rebound and repossessions are cleared out of their inventories. We believe that it will be 12 months or more until there is more liquidity in the market.”

Allen Qualey, 1st Source Bank: “We haven’t noticed much change. Reasonable deals are getting done, but that’s been the case all along.”

Marc Paulhus, RBS: “I don’t think it is a loosening of credit as much as a return of some liquidity. Credit standards remain reasonable for the qualified borrowers and the right structures.”

Keith Graham, Salem Five Bank: “I have generally not seen an increase in the availability of credit. I think bank CFOs are still cautiously evaluating where and when and what increments to invest in capital resources into the market. I think that they have the capital and access to capital so they could put that to work and they are looking at certainly putting that out to earn greater yields.”

Joe Dini, Sovereign Bank: “I see a loosening of money but not a loosening of credit standards. In fact, I see even more tightening of credit standards for a long time to come.” –C.E.
Another Source of Funding

The tightening of financing has also been of concern to the aircraft manufacturers, which have seen their shipments and order books shrink. For the first time in its existence the General Aviation Manufacturers Association (GAMA) convened an ad hoc finance committee to make recommendations on areas of possible industry involvement. As the percentage of aircraft delivered outside North America has grown in recent years, OEMs have taken a greater interest in government-backed export-import banks, which facilitate the export of a nation’s manufactured products. Last year, in its role as the official export-credit agency of the U.S., the U.S. Export-Import Bank (Ex-Im) authorized more than $5 billion to support the export of airliners. In the past business aviation manufacturers have used it infrequently because its terms are generally more restrictive than those of mainstream lenders.

“It’s not necessarily the bank of last resort but it’s not always the most competitive as some of the traditional financing markets,” said Jens Hennig, GAMA v-p of operations. “What we’ve seen in the traditional financing industry is that as [bank] terms get tightened up, for a lot of these deals, opportunities with Ex-Im have increased.” According to Hennig, while aerospace and transportation is one of the biggest areas for Ex-Im, in the past it handled only a few business aviation deals. That changed in May when Textron secured a $500 million loan from Ex-Im to assist Cessna and Bell’s international customers with financing. According to Ex-Im Bank transportation v-p Robert Morin, “Ex-Im Bank’s mission is to assist in financing U.S. exports to help companies create and maintain jobs in the United States, and [this deal] will help Textron to continue exporting Cessna aircraft and Bell helicopters and support the jobs of thousands of U.S. workers at these companies.”

Similar agencies exist in other countries known for producing business aircraft such as Canada, France and Brazil. “While in the past they did not necessarily play active roles for general aviation, they are already stepping up, so the task for GAMA and our members is to look at how we can work more closely with these agencies,” said Hennig. “The consensus is that there’s an opportunity to really educate the financial community about business aviation. The industry has grown from $3 billion a decade-and-a-half ago to $25 billion now, so it’s a real market for them to pay attention to.”
How do you see the condition of the U.S. economy now as compared with last year?

Last year we were concerned about the financial stability of the major banks, the credit freeze and the subsequent decline in the GDP [gross domestic product]. So it was a much bleaker outlook than it is today. We’ve endured a year of tough economic restructuring, high unemployment and industry cutbacks across the board. The third quarter registered growth in GDP—3.5 percent—so we may well be in the upswing now. Equity values [stock prices] have risen 50 to 60 percent over the last eight months. There is cause for optimism. That does not eliminate the possibility for corrections in the market, especially because the recent rise was so rapid. Many investors and business people are being cautious and sitting on the sidelines. But overall it looks pretty good. There will continue to be a lag in employment recovery and large purchases such as business jets.

Have the government’s bailout efforts had the intended effect on the economy? With the credit crisis last year and the virtual freezing of money markets we had a genuine financial crisis on our hands. A complete financial meltdown and collapse of the money supply were real possibilities. Intervention of the government into the marketplace, while unfortunate, was essential to restore confidence and help the banks to get back on solid footing by reestablishing their capital base and reserve capabilities. But once this intervention was in place, the additional stimulus may not have been as wise. I am a bigger fan of TARP than of TARP II and the stimulus plan.

There’s no doubt that stimulus packages help in the short run, ease some household pain and create spending, but a lot of that spending impact is short-lived, delayed and targeted to preferred industries, such as automobiles and housing. Cash-for-Clunkers, for example, created a flurry of activity and then sales decreased significantly when it ended. While it helped the auto industry for a short time, it was also more of a nod to the environmentalists as a way to get more fuel-efficient cars on the road.

On the monetary side, the Federal Reserve has increased stimulus packages by about one trillion dollars. This has helped the banks stabilize, but has not increased lending as much as expected. Banks are now more cautious about lending. Borrowers are also more wary.

Monetary policy [designed to accommodate the deficit-financed government stimulus packages—what economists call “monetizing the debt”] is generally unacceptable in Treasury/Fed relations. When the government goes into debt, it has to sell its bonds in financial markets. But because there is a dearth of buyers of U.S. bonds, especially in foreign markets, the Fed has been buying them instead. This has helped keep interest rates low by pumping money into the economy, but has weakened the dollar substantially and could create inflationary problems down the road as it did in the stagflation of the 1970s. An independent central bank is the best insurance against inflation.

I’m also concerned about the government taking an equity position in the banks and other companies, such as GM, and then getting involved in the internal management. This practice has a chilling effect on the private sector. It was unfortunate but necessary for the government to provide equity for banks at the beginning of the crisis, but such temporary solutions should not be made permanent and certainly not be micromanaging the companies. Two economic wrongs don’t make a right. We will ideally try to ease the financial pain in a way that does not permanently alter the way free enterprise operates.

Why have banks become more restrictive in their lending requirements?

The banks have reserves at unprecedented levels, but the effect of the recession and the fact that there was a lot of loose lending in all the markets—real estate, consumer finance, commercial loans, airplane finance and so on—has chastised lenders into appraising collateral more prudently and making loans more carefully. They are going back to the old standards of good credit: considering the character of the borrower (not lending to unknowns) and looking at economic conditions.

It’s going to take time to regain that business confidence to take risks. And as I mentioned, borrowers are also leery about taking on big loans, so there is both supply-side and demand-side trepidation.

Finally, prices are a form of economic communication. When there is too much manipulation of prices, it confuses the market. When we artificially set prices either by government action or union action it creates an imbalance in the economy. We have to let prices fall where they will and then make economic adjustments to the prices, not adjust the prices to our economic wishes.

What are your thoughts about the “No Plane, No Gain” campaign that NBAA and GAMA are running to counteract the negative publicity about business aviation?

It is not unlike what the Chamber of Commerce is doing in its “Campaign for Free Enterprise,” which aims to create 20 million jobs in the next 10 years and will be spending up to $100 million to educate people about the benefits of a free-market economy and a free-enterprise system.

It is important that the business aviation industry makes its case, rather than sit back and allow critics to malign and stereotype business practices as self-serving and greedy when in fact they are just the opposite. You can’t leave charges unanswered. There are obviously a lot of misconceptions about what business jets are, how they are used, why they are important and how many private-sector jobs are at stake.

You said last year that if Joe Investor still had his 401K in the stock market, he might as well keep it there. That turned out to be good advice. What advice do you have for him now?

I think that a lot of the financial storm has passed. There may be some other things on the burner that we don’t know about yet, but the market has largely stabilized. The credit crisis and the media-induced frenzy turned a business-cycle movement into a much sharper downturn. So now we know the sky isn’t falling, lending and financing are going on again and the economy is strengthening and growing. In the long run, stocks will continue to make gains. Growth will be on more solid footing, because the lenders will be much more circumspect about whom they lend to and all sorts of investor will be more attentive to the fundamentals of asset valuation. It will slow things down but will be more sustainable. Governments will be more cautious, more moderate, turbulence.

Footnote: As part of a deficit-reduction plan, Congress in late 1990 passed and President George H. W. Bush signed into law a 10-percent excise tax on the sales prices of specified luxury goods: furs and jewelry (the price above $10,000); automobiles (above $30,000); boats and yachts (above $100,000); and airplanes (above $250,000). A subsequent study for the Joint Economic Committee found that the tax caused the loss of 9,400 jobs in the industries manufacturing these products and cost the government $24.2 million in unemployment benefits and lost income taxes. The government’s net revenue from this tax in 1991, after subtracting expenses and lost revenue from the taxes received, was minus $7.6 million.
Lenders exercise renewed vigilance in defaults on aircraft loans

by Ian Sheppard

The Isle of Man Aircraft Registry has agreed to work with aviation recovery experts IBA and leading London-based aviation law firm Gates & Partners to help facilitate rapid repossession of aircraft anywhere in the world when owners fall behind with mortgage payments or break other terms of their financing.

The team is offering aircraft financiers thorough preparation and fast recovery action to prevent a long battle where aircraft are increasingly difficult to recover and remarket. “It is a bit like preparing for a war,” said Aoife O’Sullivan, a partner at Gates & Partners.

Isle of Man director of civil aviation Brian Johnson said that although corporate aircraft repossessions have been relatively rare in the past, the Registry wanted to provide a stable, tax-efficient environment to re-register aircraft temporarily in such situations. Isle of Man-based ICM Aviation and Martin Fiddler & Associates will provide additional advisory services.

The Registry has grown rapidly since its establishment in May 2007 and has made no secret of its goal of becoming the world’s leading corporate aircraft registry. The new arrangement will also extend to aircraft on air operator’s certificates, which can be registered in the Isle of Man only temporarily (while they are remarried, for example) due to an agreement with the UK CAA.

The Isle of Man is a tax haven with considerable advantages for aircraft owners, not the least of which is stability and a customs union with the UK (meaning no import duty). However, the main point of the new initiative is to give those with an interest in aircraft as assets a risk-management strategy if things go wrong with the operator, with experienced aircraft recovery experts backed by sound, ongoing legal advice.

Legal Pitfalls

At a seminar at the Royal Aeronautical Society in London in late summer, O’Sullivan urged banks not to act too hastily, as there are various potential legal pitfalls surrounding the repossession procedure, such as being certain there is a clear event of default before taking action. However, she clearly endorsed planning for the worst case.

O’Sullivan said that if a mortgage does not give a lender a right to repossess, it cannot take the aircraft. She also said that an event of default must be established, lenders must observe any required “grace period” to allow the breach to be corrected, and clear notices must be served on the owner/operator.

Because the operator of a business aircraft is often not the owner, banks would be well advised “to work closely with the operator to repossess an aircraft in the business aviation world” – in the event the owner fails to come to a suitable arrangement.

For aircraft operating in Europe (which extends beyond the EU), aircraft owners, operators and lenders need to be wary of the power Eurocontrol has to retain and ultimately sell aircraft for unpaid charges, she said. The agency also has the power to exercise a “fleet lien” so that any aircraft on the same AOC can be detained and sold to clear arrears.

O’Sullivan also warned that maintenance providers could exercise a lien for unpaid work, but only in cases that the work actually added value to the aircraft. It therefore does not include—as many erroneously believe–routine maintenance and checks. “A lien can defeat the best mortgage, even if there is nothing in writing,” she concluded.

A Move of Last Resort

Owen Geach, IBA commercial director, agreed that acting quickly is important but also emphasized the importance of making repossession a last resort, especially in the current poor market where remarketing is difficult and costs of storage and maintenance, among other things, could quickly become high.

Geach also pointed out the danger of airports and other creditors preventing aircraft from moving until their bills are paid–and suggested that in IBA’s experience it is best to pay them so matters are not delayed further. Noting it is not uncommon for parts of an aircraft to be removed or for things to go missing, Geach advised hiring security personnel to protect the aircraft and its records if possible. These are all issues a defaulting business aircraft owner could face if a lender starts to take action against it.

Geach suggested that banks are showing increasing interest in the condition and whereabouts of aircraft, although in some cases they have little information. For example, they may not be aware of the whereabouts or condition of technical records, without which the aircraft value could be severely impaired. It seems that struggling owners will be subject to increased scrutiny and possible rapid-fire action, of which they may have little or no warning.
do not have the room to make additional bad loans.”

According to Bank of America’s Amalfitano, “The most important factors [for potential buyers] are in-depth current financial statements, forward-looking business projections, brokerage statements for high-net-worth individuals that show unencumbered liquidity and cash flows, data on the aircraft asset and how it will be used, and cash for required down payment in the case of loans or security deposit for leases.”

Extra due diligence now also extends to how lenders perceive the customer’s use of the airplane, according to Aviation Management Systems’ Quinn. “Lenders are going to be a lot more inquisitive about why you are buying it, how much you are going to fly it, where you are going to keep it, who is going to maintain it, whether it is going to be on an engine program, an airframe program; if you hit all those little touch points and you’re buying into all the new concepts for owning and operating aircraft, I think the lenders will be really comfortable,” he said, adding that brokers and resellers now need to do some extra homework with their clients before making a call to a financier.

A Long Road to Recovery

Of the recently increasing number of used jet and turboprop transactions, many of the deals have been cash purchases driven mainly by the low pricing currently in the market. “There are a lot of people out there paying cash for airplanes,” noted Smith of Gantt Aviation. “They don’t have to wait in the financing process, and a lot of people with cash feel they are going to get a better deal on the airplane if they say, ‘I’ve got cash right now.’” That trend may once again be on the decline. In its September business jet industry survey, UBS reported that nearly a quarter of its North American respondents thought that customer financing has improved recently while 72 percent believed it had remained the same, representing a slight improvement since the previous survey in June, and continuing the overall upward trend that started near the beginning of the year. “It’s a tough market, but I think the lending is stabilized,” said Bristol Associates’ Lancaster. “Not that it’s easier to get credit but in that the rules are finally set. We have a set of requirements