The rising dollar and declining aircraft residual values are proving to be a drag on the industry's recovery

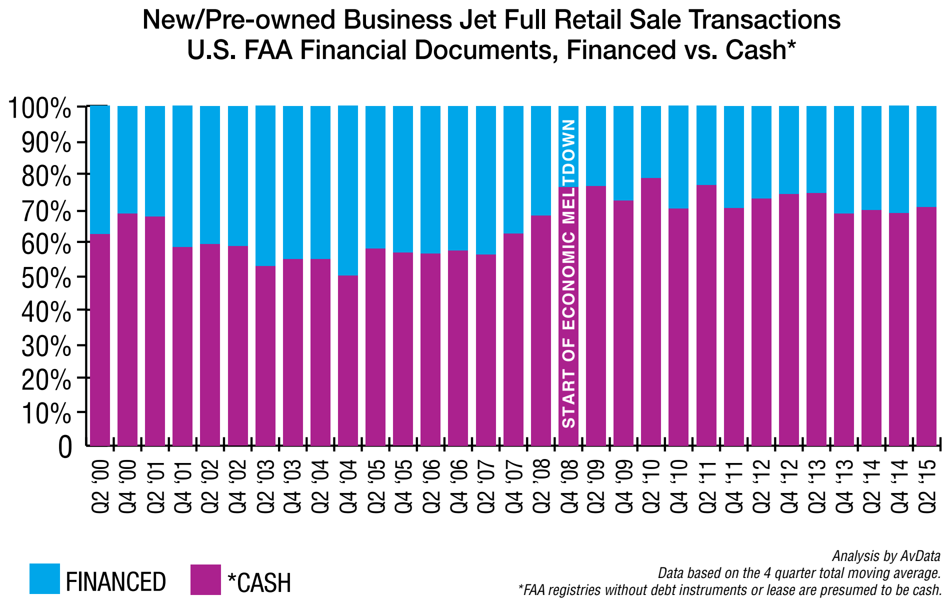
by Curt Epstein

With the economic downturn now seven years in the rear-view mirror, the U.S. economy has continued its slow but steady recovery this year, reaching, in the eyes of most of the world, an enviable streak of 22 consecutive quarters of expansion. But the strengthening of the U.S. dollar has placed a chill on the international business jet market, which is still dealing with the effects of declining aircraft residual values.

Through the first half of the year, the U.S. gross domestic product rose 3.9 percent, a substantial jump from 1.2 percent the previous year. Economic bellwethers such as the stock market indexes reached record levels in late May, when the Dow Jones Industrial Average hit 18,312 and the S&P 500 peaked at 2,131. Likewise, unemployment has dropped from a high of 10 percent in October 2009 to nearly half that now. "We continue to reduce the slack in the labor market that has persisted since the great recession," noted Gus Faucher, senior economist at the PNC Financial Services Group. "I think by the spring we should be back to full employment [defined as 5 percent or less unemployment] in the U.S. economy. With that tightening of the labor market, more competition for workers should translate to rising wages, which would further stimulate the U.S. economy."

Despite the brightening economic picture in the U.S., for many the wounds from the downturn inspire caution in the decision-making processes. In this economic expansion, notes Wayne Starling, senior vice president and national sales manager for PNC Aviation Finance, "companies and individuals have retained more cash, deferred capital expenditures and deferred investment in plant, property and equipment" to a greater extent than in previous recoveries.

However, "that fear is fading and will continue to fade as we get farther and farther away from the great recession," Faucher told **AIN**. "The conditions for



business capital spending overall remain pretty good. We have low borrowing costs, and banks are becoming more willing to extend credit." In the Federal Reserve Bank's July survey of senior loan officers on bank lending practices, more than 45 percent of the large U.S. bank respondents reported they had somewhat eased the spread of loan rates over the bank's cost of funds for large and middle-market companies [those with annual sales of $50 million or more]. Of those that had eased terms for lending, more than 95 percent indicated that more aggressive competition from other banks or nonbank lenders was at least somewhat important in that decision.

"The jet finance and leasing space is more fragmented now," said Joseph DiLallo, head of corporate aviation finance and leasing at BMO Harris Equipment Finance. "Until just a few years ago, two major financiers dominated the leasing market in the U.S.; today that same space is shared more evenly by a half-dozen or so active lessors." With the recent increase in U.S. corporate flight activity, smaller players such as local and regional banks have once again joined the major lenders, though some in the industry lament that the number of lenders and the level of competition for loans still has not recovered to pre-downturn levels. "While I often hear that new lenders have entered the market, I think the reality may be that lenders who pulled back in the [financial] crisis are re-entering," said Ford von Weise, director and head of Citi Private Bank's global aircraft finance division.

While new regulations are forcing the large banks to focus more sharply on borrowers' credit, von Weise said "we are seeing more competition in this end of the market through pressure on spreads, loan-to-values and other deal terms." As some lenders, such as GE Capital (*see article on facing page*), have left the market, others have entered, such as Global Jet Capital and Stonebriar Commercial Finance.

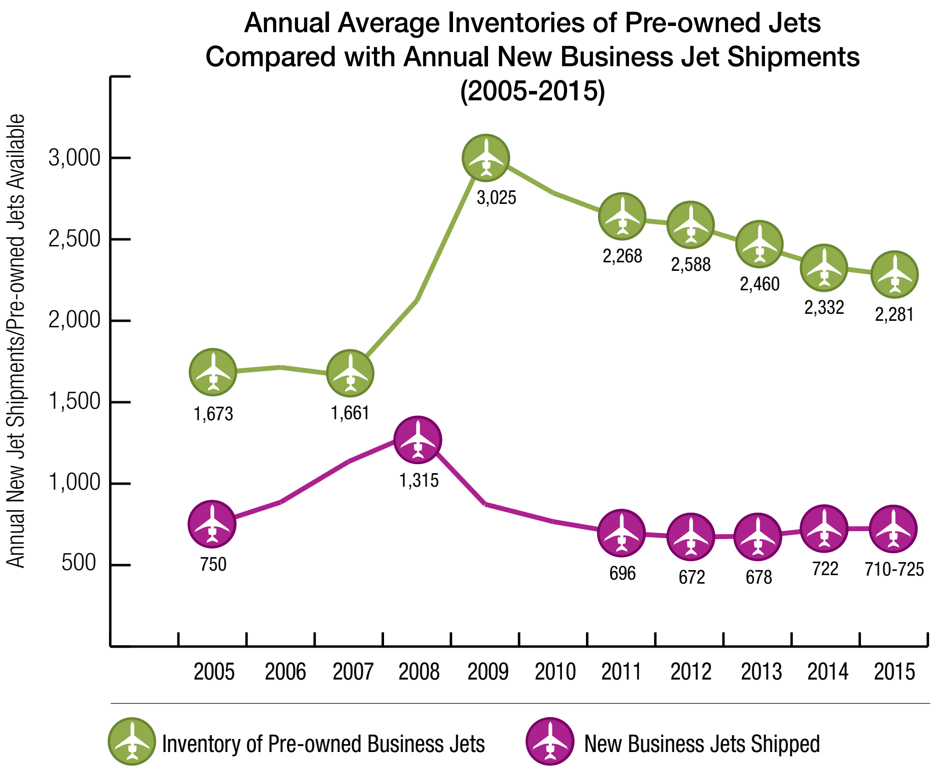
For many of the traditional lenders, the effects of the downturn and the resulting declines in aircraft values are still evident in their portfolios. A 10-year financing deal signed at the peak of the superheated market period of 2007-2008, when the OEMs delivered nearly 2,500 new bizjets and aircraft values reached an apex, will be staining the books for at least another year or two, and the declining residual aircraft values, likely nowhere near where they were predicted to be when the deal was signed, are an enduring concern to both buyers and lenders. "For aircraft leases closed at the peak of the market in 2006 to 2008, asset values have eroded sharply, forcing banks to 'mark to market' aircraft residuals, contributing to embedded losses," said Michael Amalfitano, Stonebriar's executive vice president and senior managing director of business aviation, and the former head of Bank of America's corporate aircraft portfolio.

"Our traditional wisdom used to say that these airplanes lost three percent of their value a year, but that's not the reality any more," said Jay Mesinger, CEO of Colo.-based J. Mesinger Corporate Jet Sales. "A consensus of smart industry people today would say that it will lose 10 percent the day you fly it off the lot and for the next four to five years it will lose seven percent a year." Beyond that he believes the value will drop by 5 percent each year thereafter.

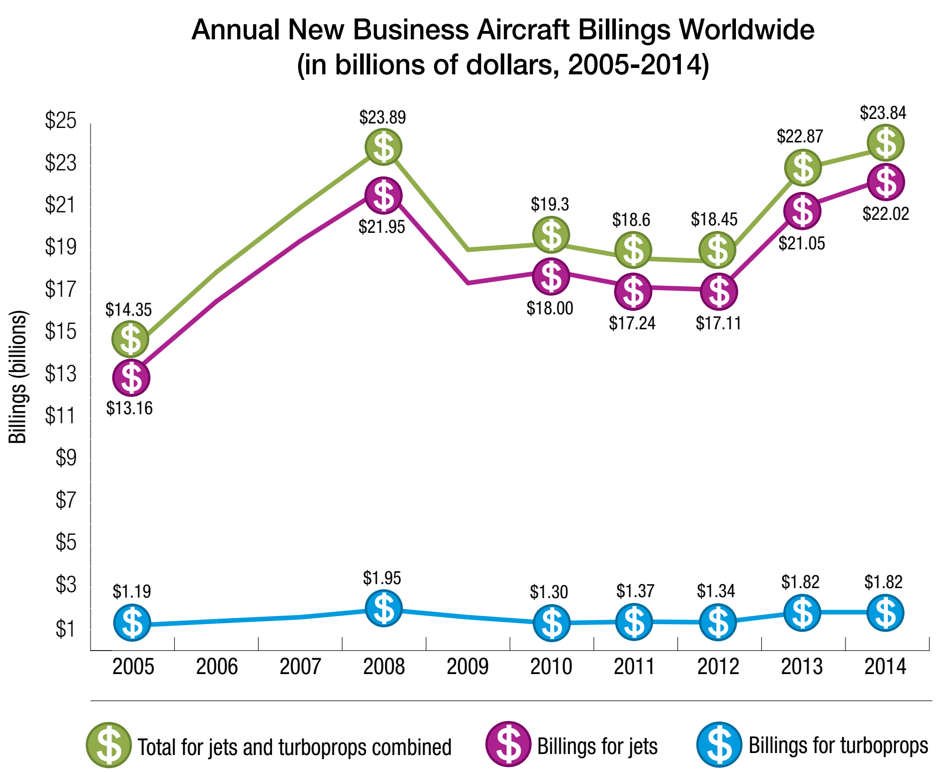
Those dwindling residual values have played a role in operators' holding onto aircraft longer. According to industry data provider JetNet's IQ Survey of operators, the average length of time a buyer of a new business jet will keep the airplane has risen to more than five years today from 3.7 years in 2005. For purchasers of used jets the average term of ownership has grown to 3.2 years from 2.1 years.

Cash Up Front, Finance Later

Roughly 74 percent of all private jet purchases in the U.S. were paid for with cash, according to an analysis of documents filed with the FAA through the first three quarters of the year by JetNet's AvData division. Strict interpretation of the filings shows that number has remained relatively consistent over the years. Many attribute companies' and wealthy individuals' preference for spending cash to a lack of suitable investment opportunities. Stronger economic growth "would provide buyers with proven alternatives for deploying cash in their business," noted Michael Kahmann, managing director and group head CIT Business Aircraft Finance. "Therefore, we think the 'cash is king' phenomenon is closely linked to a lack of good investment alternatives."



Sources: JetNet (Inventory of Preowned Business Jets); GAMA (New Business Jets Shipped); Honeywell (2014 forecast)
Notes: Inventory numbers for pre-owned business jets are averages for the year. New jet shipments are end-of-year totals.
*The total number of jets shipped by the end of 3Q/15 was 464. In the first nine months of 2014, it was 459.



Source: GAMA, 2014 General Aviation Statistical Databook and Industry Outlook
Note: Plot lines show total end-of-year billings.

What is unknown is how many of those aircraft buyers sought and received post-purchase financing that would skew the statistics for cash transactions. “Cash may not be king,” said James Simpson, managing director for aviation and marine finance with First Republic Bank. “As I often tell people, use your cash for appreciating assets, use leverage for depreciating assets like aircraft. By using leverage, the financing process keeps clients close to residual values and asset decay, and gives them a realistic view of future aircraft values.”

In the aftermath of the downturn, as prices of used aircraft tumbled, many buyers have elected to use cash to expedite the buying process on what they believe to be a good deal. “We see some people paying cash and then financing at their leisure so they don’t feel rushed,” said Allen Qualey, senior advisor and president emeritus of 1st Source Bank’s specialty finance group. “Often when we hear of someone paying cash, what they are actually doing is tapping their credit line at the local bank; there is no transparency when this happens.”

Others believe the proportion of financed aircraft to be as high as 85 percent, thanks to low interest rates. Global Jet Capital executive director and industry veteran Shawn Vick holds that opinion. “If you are running a business, or you are an ultra-high-net-worth individual, you are highly likely and highly biased toward using your capital to get a return that meets or exceeds market returns, when you can borrow money to finance this asset that is at significantly lower cost,” he said.

In the third-quarter JetNet IQ survey, which polled more than 550 business aircraft owners and operators worldwide, 58 percent indicated that financing is their preferred funding source for buying new aircraft. That number edged down to 55 percent for used aircraft in the survey.

“More people than ever before are financing,” said René Banglesdorf, CEO of Texas-based aircraft brokerage Charlie Bravo Aviation. “Five years ago almost everyone we were selling to was paying cash." Her company has closed 16 deals this year on small to midsize business jets worth $5 million or less, and all but three buyers received financing. "If I were a bank and I were looking at a $65 million loan on a $75 million airplane, I'd be nervous based on what's happened in the last 10 years with depreciation," Banglesdorf told **AIN**. "But if you are looking at a 10-year-old airplane that is only $2 million, the risk isn't nearly as high from a banking standpoint."

Long-time aircraft buyers have seen loan terms shortened markedly from what was common just a few years ago. While some are still offering terms of 10 years or more, recently enacted economic policies such as Basel III, aimed at strengthening banks by requiring them to keep more reserves on hand *(see sidebar on page 30)*, and know-your-customer and anti-money laundering regulations are making their mark on loan structures. "Loan terms from the regulated banks have reduced greatly, typically to five years," Amalfitano told **AIN**. "Banks are pressured by regulatory capital requirements, cost of capital, low margins and weak aircraft portfolios, which have led to shorter terms."

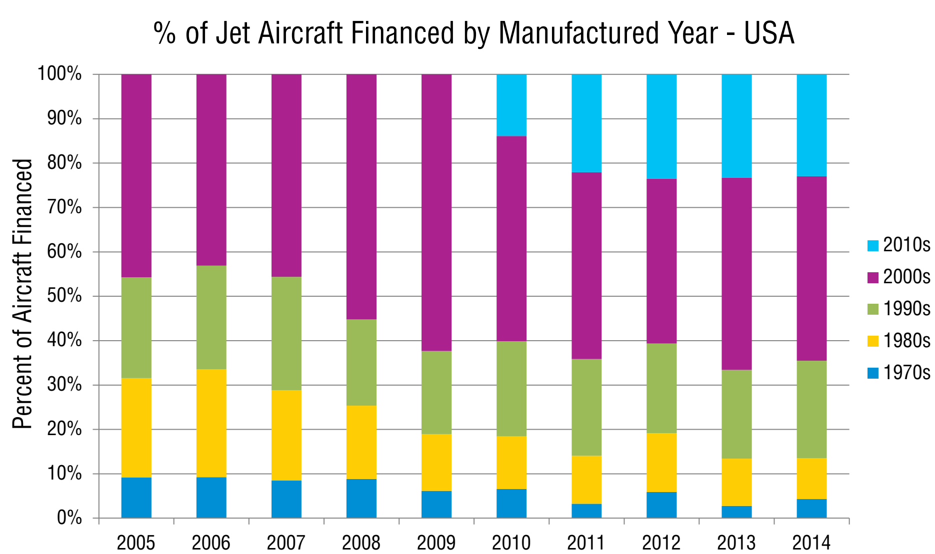
Among lenders, creditworthiness remains one of the key criteria in determining customer funding. "Everybody wants a shorter, medium-dated deal with a really strong investment-grade credit, causing a food fight in that part of the market, which leaves the longer-dated deals, the medium and the lower-tier credit underserved," noted Robert Gates, senior managing director at Global Jet Capital.

What is Old?

Those constraints, coupled with the persistent issue of depreciation, have contributed to an industry-wide change in mindset. "Most folks in business aviation today, including myself, consider a 15-year-old jet to be old in many respects," said DiLallo. "Ten years ago everyone described old as 20 to 25 years, but today's jet buyers want newer, nicer, bigger, faster, farther, safer and greener, and the jet manufacturers gladly oblige. The result is a relentless flow of fabulous new jets into today's already crowded marketplace."

That inflow of derivative and replacement models is also fueling the continuing decline in the values of some models. "It's negatively impacting the aircraft that will be replaced," said Gates. "The Falcon 7X and G550 are under pressure because of what's coming or is being delivered–the 8X and G650."

Lenders have their own particular sweet spot when it comes to the age of aircraft they will consider for financing. Banglesdorf noted that most traditional



Source: Amstat/CIT June 2015

ADD SOME BASEL TO THE RECIPE

In response to the 2008 economic crisis, the Basel Committee on Banking Supervision developed Basel III, a voluntary regulatory framework for bank capital adequacy, stress testing and market liquidity risk intended to make worldwide banking more resilient to stress and surprises. Implementation of the accords, ratified by 60 different federal reserves through the Bank for International Settlements, is under way. One of the main tenets of the agreement is that systemically important financial institutions (SIFIs) must be able to absorb higher losses, to reflect the risk their failure would pose to the financial system. Basel III also aims to improve risk management and governance and strengthen banks' transparency and disclosures. SIFIs are now required to hold more capital in reserve against their loans, and because that held-back capital cannot earn income by being loaned, the bank's revenue falls. "This adversely impacts the cost of capital as it requires banks to address loss given default and collateral risks across their credit products," explained Michael Amalfitano, executive vice president and senior managing director of business aviation with Stonebriar Commercial Finance. "This will result in higher-priced bank loans and leases for aircraft."

"Basel III has had major impacts on our business," said Ford von Weise, director and head of global aircraft finance at Citi Private Bank. "It is no longer profitable for us to offer loan terms longer than five years. Aircraft loans carry longer terms than many other comparable loans, and the reserves required under Basel III have decreased overall loan profitability."

"Basel III will impact the largest banks the most, which will temporarily benefit others, particularly the non-bank lenders/lessors," noted Allen Qualey, senior advisor and president emeritus of 1st Source Bank's specialty finance group. "The net result is that this regulation will push up the cost of money." *–C.E.*

financiers are still shying away from older aircraft, those 15 or in some cases 10 years old, leading customers to seek out other sources. "People interested in financing an older aircraft are turning to their local bank. That's interesting from a broker standpoint because we're having to educate the banks about aircraft financing," she said.

"Our focus continues to be on aircraft that are 10 years old or newer," said Richard Ramsden, vice president and territory manager for corporate aircraft with Wells Fargo Equipment Finance. However, he added, "We do try to accommodate our highly valued clients if they have a need outside this preference."

For some lenders those are strictly established guidelines, while others take a more circumspect ad hoc approach. "Certainly as an aircraft gets old, our comfort with the asset will decrease, but old is not strictly a function of age," said CIT's Kahmann. "There are questions of condition, whether or not an aircraft is on a maintenance program, and whether or not it has been, or can be, economically upgraded for things like Fans and ADS-B." Those looming mandates will clearly play a larger role in financing decisions as the calendars move closer to compliance deadlines. "The poor economics of upgrading these aircraft may further accelerate the retirement of older GIVs and the like," noted von Weise. Lenders will no doubt cast a critical eye even on aircraft that are viable candidates for upgrades. "Aircraft are going to become haves and have nots, and those that already meet the requirements will be worth more than those that don't," offered Mesinger, because of downtime considerations.

Lenders are still expecting buyers to put some "skin in the game," with down payments currently ranging from 10 to 30 percent of the aircraft value, depending on the customer's credit. Those with top-tier credit can still find 100-percent financing if they want it. "Today clients must have invested equity in an aircraft," explained Amalfitano. "For new aircraft it comes in the form of covering the liquidated damages in an OEM contract; for pre-owned aircraft it is the cash down payment to secure the collateral advance on a loan. Even aircraft leases might require cash in the form of a security deposit or letter of credit to protect the lease investment."

Given the uncertainties surrounding residual values and the vagaries of the pre-owned market, leases are becoming a more palatable option for some in that they shift the uncertainty of residual value to the lessor. "They view business aviation as a tool that, ideally, comes with a known cost," said Gates. "They don't want to deal with surprises, either on value or on how long it takes to sell something. The pride-of-ownership phenomenon that we've been seeing overseas is starting to give way to pride of having driven a smart deal and a deal with certainty, an important shift in the market."

An International Snapshot

The old adage "if the U.S. sneezes, the world catches a cold" may no longer hold true in this era of globalization. "It's the reverse today," asserted PNC's Faucher. "Globally we have slow growth, and then among developed economies the U.S. is doing significantly better." That imbalance has strengthened the dollar, complicating trade in global commodities priced in U.S. dollars, such as business jets. People in these weaker currency areas, including Europe, are staring at costs driven up 20 percent just by exchange rates, noted analyst Rolland Vincent.

In the latest quarterly JetNet IQ survey, which Vincent created and directs, 37 percent of European respondents reported the strong dollar makes it less likely they will buy a business jet.

The exchange rate fell to €1.04 to the dollar in March and dropped again in October. As a result, he has seen a "darkening of the skies" by European-based business jets heading west. "They're going to only one place right now: the U.S. That's where all the activity is; it's where all the customer interest is." The exchange rate is giving European sellers an added arbitrage bonus, according to Vincent: "If you took a loan in euros on the airplane and you bought it in dollars, that euro loan got cheap all of a sudden," he told **AIN**. "To pay off a loan with U.S. dollar proceeds makes sense, so airplanes are leaving Europe and moving to the U.S."

The surging dollar and its effects on the business aviation industry are making themselves felt in the rest of the world as well. "Given the currently depressed economies in Europe, the Middle East, Africa and Asia and lower currency values, coupled with the continual decline in used aircraft values, it is quite difficult for an international client to get out of an existing low-value older aircraft to buy a high-value newer aircraft," said Amalfitano.

In the depths of the recession the industry turned to the emerging markets as its salvation, but a chill has since spread across many of those places. Russia faces economic difficulties brought about by sanctions imposed for its involvement in Ukraine, and the tap on aviation financing has all but closed there. "Russians are trying to recreate themselves in the nation's satellite countries, so they don't look like they are in Russia, but it's still almost impossible to finance them because most of their wealth is based there," explained Kirsten Bartok, managing partner of Air-Finance. The slumping energy market has also played a role in stifling demand for business jets there.

While the OEMs hoped Chinese buyers would lead the industry out of the downturn, government-imposed anti-extravagance regulations have cooled that market. Indigenous lenders such as Minsheng and ICBC continue to provide financing for Chinese customers, but according to Bartok their rates are "not inexpensive," and global lenders such as CIT, Global Jet Capital and Bank of America continue to compete there for the shrinking number of deals. "The emerging markets certainly have been the driving factor for recovery in the industry since the crisis," noted CIT's Kahmann, contrasting their recent cooling with a resurgent U.S. market. "The two factors probably counter-balance one another, meaning that overall demand for business jets is basically flat or slightly down," he concluded. ❑

GE Capital exits market, Global Jet Capital steps in

by Curt Epstein

On April 10 General Electric, long a stalwart in the business aviation finance community through its GE Capital division, announced a major change in its corporate direction. The company stated it would divest most of its lending businesses, a move intended to return it to its manufacturing roots and in the process create "a simpler, more valuable company." While it intends to hold on to several "vertical" financing divisions that relate directly to its core industrial businesses–such as Energy Financial Services, Healthcare Equipment Finance and GE Capital Aviation Services (Gecas), its commercial aircraft finance arm–included on the auction block was its corporate aircraft finance division, along with the conglomerate's real estate, commercial finance and leasing, and all consumer lending entities.

"The business model for large, wholesale-funded financial companies has changed, making it increasingly difficult to generate acceptable returns," GE noted in a press release.

GE Capital had been a force in the corporate aircraft finance arena since it established its portfolio during the early 1980s. It eventually became one of the largest funding sources in the industry, providing aircraft financing worldwide, yet the division's pending departure from the market came as little shock to the industry, which had seen the company become less active in the aftermath of the economic downturn.

"After 2008 is when GE started to pull back," said Kirsten Bartok, managing partner of AirFinance, adding that the company had virtually stopped courting international business over the past several years. "So I don't think we are seeing any negative impact to the announcement today; it just formalizes what we had already seen over the years."

On October 5 the news broke that Global Jet Capital, a recent startup that specializes in financing high-end business aircraft, had acquired GE Capital's Americas $2.5 billion corporate aircraft portfolio, which includes Canada, Mexico and South America. The process involves transferring ownership of some 350 aircraft registered in a number of jurisdictions. "We are investing heavily in expanding the business both organically and through acquisitions such as this one with GE," said Shawn Vick, Global Jet Capital's executive director. Initially, the focus had been squarely on larger, longer-range jets, but with the GE Capital portfolio in hand the scope is broadening to include almost any "high-quality airplanes with good credit and in jurisdictions where we should be doing business," Vick said.

Global Jet Capital expects the deal, which will immediately establish it as a major player in the market, to be completed in stages, with two or three tranches closed by year-end. The company launched a year ago at NBAA2014 with $2 billion from three investment firms: GSO Capital Partners, The Carlyle Group and AE Industrial Partners, which manage a combined $500 billion. Soon after the launch, company management began discussions with various institutions about the possible sale of their aircraft portfolios, and within a few months the basis of an agreement was struck with GE.

With the purchase, Global Jet Capital plans to revitalize GE's former business, especially in the international markets. "The acquisition financing that came together to get this deal includes about a billion dollars of a warehouse facility," Vick told **AIN**. "Sometimes you hear it referred to in the banking industry as 'dry powder.' What that really means is that's a billion dollars with which we can go out there and finance new transactions."

While it is prepared to build the business one deal at a time, the company stands ready to make another big splash. "Our appetite to acquire other portfolios is undiminished and we're looking to get to even greater scale if those kinds of opportunities present themselves," said Vick.

In the meantime, the company continues to acquire talent to supplement the 16 experienced former GE Capital staffers who joined the firm. "This is a new dawn," said senior managing director Robert Gates. "For years they were just managing a portfolio; now it's growing again." ❑