The changing face of business aviation finance

New names, new practices emerge as the industry adapts to the current market.

by Curt Epstein

With the nation and, indeed, the world stunned at the results of the most bizarre and rancorous U.S. Presidential election in history, there are widespread concerns over the stability and long-term confidence of the economy in the largest market for business aviation.

Earlier this year, all the major economic indexes reached all-time highs; the Dow Jones Industrial Average flirted with 18,700, the S&P 500 nudged 2,200 and the Nasdaq reached a peak of 5,340. The U.S. unemployment rate fell to 4.7 percent in October, the lowest rate since August 2007, and the U.S. gross domestic product (GDP), typically a bellwether for business aircraft usage, grew by 2.9 percent in the third quarter, its highest rate in more than two years. However, those numbers do not mean what they used to.

Cycles for the U.S. business aircraft fleet this year are expected to approximate the levels last seen in 2003, according to statistics provided by industry analyst JetNet. At that time, there were 9,500 business jets in service in the U.S.; today there are 12,500.

“There’s been a change in behavior,” noted Paul Cardarelli, the data provider’s vice president of sales. Before the recession, he explained, usage cycles outpaced the growth in GDP. After the economic meltdown of 2008 into 2009, cycles began to rebound, only this time steadily underperforming GDP growth. From a peak of 4.8 million in 2007 to a trough of 3.4 million cycles in 2009, bizjet usage has rebounded to an anticipated 4.3 million cycles for this year, while GDP is expected to exceed 2007’s level by a wide margin.

“In the first several years following the Great Recession, the rise in corporate profits was driven largely by expense cuts, which does nothing to spur demand for business jets,” said Joseph DiLallo, head of corporate aircraft finance and leasing with BMO Harris Equipment Finance. That has led to a slowing of the aircraft replacement cycle as owners held onto their airplanes longer than usual.

“Aircraft owners are less likely to upgrade than during the heated economy leading up to 2008,” said Robert Kent, president of Scope Aircraft Finance. “In 2006 and 2007 we experienced a loan repayment rate of 22 percent, meaning that a fifth of our borrowers sold their aircraft usually—but not always—to trade up,” he noted. “In 2015, that number had dropped to 12 percent.”

“Owners and operators who traditionally turned over their aircraft on average every three to five years are now holding
FINANCIER LAUNCHES ONLINE AIRCRAFT FINANCING MARKETPLACE

San Francisco-based business aircraft financier AirFinance last month launched an online general aviation finance marketplace, FlyFunder, that promises to match buyers of business airplanes and helicopters with aviation financiers, streamlining the current "shopping" process.

According to the company, each participating lender will provide a list of specific attributes for deals that they will consider financing, including aircraft value, age, registration, region of operation and type of deal structure. When the system receives a deal matching those criteria, it notifies the lenders and they can contact the potential customer to express interest in financing the transaction. The process is anonymous initially, and when a deal inquiry is launched, the information presented to the lender is non-specific.

Financiers will gauge their interest by scrutinizing the particulars of the deal rather than the identity of the customer. "Eventually, after we match, then the buyer and financier do meet, but only after the buyer approves the release of his or her identity to the financier," Kirsten Bartok Touw, FlyFunder co-founder and AirFinance managing partner, told AIN. Once a dialog begins, they can communicate and share documentation through the site’s secure messaging and upload system.

"FlyFunder will give financiers greater visibility into more aircraft financing opportunities than they would typically see through their origination teams," said Chris Miller, managing partner of Shrewater Aero Capital, one of the first lenders to sign on. "It is a great platform for buyers looking to access financing and for financiers looking for potential deals they might otherwise not have been exposed to."

The site is free for all users to join, and lenders pay FlyFunder a commission only upon the closing of a deal put together through the platform. Its proprietors are looking to encourage the use of the digital marketplace by the aircraft/broker community as well, and to that end, on any completed financing deal launched by a broker/consultant, FlyFunder will pay them half of the commission paid by the lender.

"We see significant growth potential in both mature and emerging markets," said FlyFunder co-founder and director Paul Sykes. "We believe that a transparent, easy-to-use online marketplace will provide aircraft buyers everywhere with greater access to financing and more options to choose from. All industry participants will benefit from greater connectivity and interaction."

Financing ‘Void’

With recent changes to the aircraft finance market, including the recent or imminent departure of major names such as GE Capital and CIT, and retrenchment of others such as Element Financial, FlyFunder believes it is now more difficult for aircraft buyers to find financing, particularly outside the core areas of North America and Western Europe, as well as for older and smaller business aircraft. Likewise, the company noted, manufacturers are often left searching for customer financing options to close a sale.

"When financing exists, sales of assets grow when they don’t have to be purchased with 100-percent equity," said Touw. "It is our hope that FlyFunder can help increase aircraft sales by working to fill the financing void that has grown in the last few years."

The company says it has been approached by non-traditional funding sources such as hedge funds that are interested in seeking aircraft funding opportunities that historically they would not have known about. FlyFunder says it has already fielded a dozen funding inquiries from the U.S. and from as far away as Sri Lanka and South Africa.
the global situation in which the U.S. is once again seeing the lion's share of business jet deliveries. “Business aviation is a U.S. dollar denominated market,” said Amalfitano, who previously headed Bank of America’s business aircraft finance portfolio.

“As the U.S. dollar strengthens, the cost to purchase a business aircraft by an international client rises in relation to the local currency. Given the currently depressed global economies (Europe, 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 sell an existing low-value older aircraft to buy a high-value newer aircraft.”

He added that devaluing of foreign currencies has led to the importation of a number of used aircraft into the U.S.

As the pre-owned business jet inventory begins to creep up again, industry watchers are concerned about the number of late-model used aircraft (zero to five years) on the market, and the competition they place on new bizjet deliveries. To help alleviate the pressure, most OEMs have scaled back their production rates, but experts believe such curbs will not be an immediate panacea.

“It’s a challenging market because there’s an oversupply of new aircraft by the manufacturers,” said Amalfitano. “The production reductions announced by the OEMs will take at least a couple of years to arrest falling values, especially given the relative lack of pricing discipline on new sales.”

“Eventually discipline works its way into the market,” added Kirsten Bartok Touw, managing partner with AirFinance. “If demand doesn’t grow, supply must fall.” While this year’s edition of the Honeywell business aircraft delivery forecast predicts the industry will be on an upswing by 2018, after further slippage next year, some in the finance industry believe the doldrums will persist. “Market softness and oversupply will be a factor for the next three to five years,” said James Simpson, managing director for aviation and marine finance with First Republic Bank. “We now believe that long-range aircraft such as the G550, G650, Falcon 7X and Global 5000/6000 have an economic depreciation of roughly one percent a month or 12 percent annually.”

**Cash Is Still King**

Aircraft that are finding buyers are being purchased with cash. “The majority of the people I’m working with don’t need financing,” said Janine Iannarelli, president of Houston-based aircraft brokerage Par Avion. “So the options that are available to them are enticing, but it becomes ‘Do I use my own money and simply pay cash?’ For 100 percent of my clients last year, that’s exactly what they did.” She added that the trend has persisted this year, and of all the inquiries her firm has received, just one in 20 has involved some form of financing.

Older, less expensive airplanes account for more of the transactions, said Jay
Mesinger, president and CEO of Colorado-based Mesinger Jet Sales. He added, “In some cases maybe there’s less demand for financing because many people are self financing or pulling it from other credit facilities.”

According to the latest statistics from JetNet, which derives its data from FAA reports, 80 percent of U.S. business jet transactions in the third quarter of this year were conducted in cash, the highest percentage the Utica-based company has seen since it began keeping score in 2000. Some might simply prefer a cash buy because it affords them the flexibility to jump on a good deal. “Practically speaking, a finance or lease closing involves a third party and typically takes more time to close as lenders underwrite, comply with federal ‘know your customer’ requirements and document the deal,” said industry veteran David Labrogetti, COO of Global Jet Capital, another newcomer to the aircraft finance arena. “Many purchasers are paying cash because they feel that the financing will be time consuming and frustrating, which in general is true,” said Sam Harris, founder and owner of Jet Lease Capital. “For those with the patience, aggressive rates and terms are available.”

It remains unclear how many of those cash buyers will then seek to finance their purchase later. “Cash is always king if the buyer can leverage the certainty of closing that it provides to extract concessions from sellers,” said Michael Kahmann, managing director and group head of CIT Business Aircraft Finance. “Once the deal closes, then yes, we agree that buyers should consider whether the optimal use of cash is parking it in the aircraft. If the jet owner’s alternative use of cash (such as investing in his or her business or the stock market) provides a reasonably higher rate of return than the loan rate, then refinancing post-close makes a lot of sense.”

“I think you must first differentiate between jet buyers who want to finance and jet buyers who need to finance. If they can’t get decent financing, they can’t afford to buy a jet,” said DiLallo. “The buyer who depends on financing will benefit if banks loosen their conservative lending standards, or if there are more financiers that focus on higher risk transactions.”

As always, the higher a customer’s credit, the more desirable he is as a customer. That axiom rings true these days more than ever. “As one banker put it to me, those are the people we want, but those are not the people coming to us to ask for money,” said Iannarelli. “Anyone who comes asking for money pretty much needs the help, so they’re a credit risk.”

Monitoring the Banks

The complexion of the business aircraft finance market has changed recently with the widespread adoption of the Basel III Accord, a worldwide voluntary regulatory framework on bank capital adequacy, stress testing and market liquidity risk intended to protect against bank failures. “When combined with the broader, heightened requirements for liquidity and capital in general for financial institutions, Basel III has redefined how banks allocate capital, deploy their balance sheets and how they measure return on their capital,” said Ford von Weise, director and head of global aviation finance with Citi Private Bank. “This has forced and will continue to force banks to re-evaluate each product they offer, including aircraft finance.”

The new regulations have also had an effect on some longtime lenders in the industry. “While some regional banks have either entered the market for the first time or have re-entered it, regulatory reforms have forced some larger financiers to withdraw from the business aviation market,” said von Weise.

“Loan terms from the regulated lenders have reduced greatly, typically to five years,” noted Amalfitano. “Banks are pressured by regulatory capital requirements, cost of capital, low margins and weak existing aircraft portfolios.”

Last year, GE Capital announced it was withdrawing from the corporate aviation finance market to concentrate on finance in its core manufacturing areas. It sold off most of its business aircraft portfolio, worth $2.5 billion, to Global Jet Capital in October last year. CIT first announced it was withdrawing only from the international business aviation finance market but later decided to exit it entirely. According to sources, its 60-aircraft portfolio, estimated at $630 million, will be split among three buyers, likely before year-end.

Spiraling Residuals

“There has been a serious deterioration in business jet values over the last year,” noted Allen Qualey, senior advisor and president emeritus of 1st Source Bank’s specialty finance group. “We’re seeing many models losing half their value in the first five to seven years. This is unprecedented.” Indeed, many aircraft that were signed to a 10-year lease before the downturn in 2008 are reaching the end of their terms, causing continual headaches and write-downs for some long-time lenders. Sharply eroding values have forced banks to “mark to market” the residuals on aircraft in their portfolios. “True lease players are leaving because of alarming declines in aircraft residual values,” noted Simpson. “There is a scarcity of operating lease providers because of alarming declines in aircraft residual values,” agreed DiLallo.

That has left something of a vacuum in the market for buyers seeking leases. “The departure of these two venerable banking sources, especially for middle-market companies, has created a void non-traditional financing sources are starting to fill,” said von Weise. “Firms...
such as Global Jet Capital and Stonebriar Commercial Finance are using non-depository sources of funding to try to capture the very markets in which GE and CIT previously saw great success.” Among the other lenders that have either exited entirely or are retrenching are Guggenheim Partners, which sold its business aircraft finance division to Stonebriar in April, and Element Financial, a Canadian lender that stopped originating new transactions a year ago. Element told AIN it has had discussions regarding the sale of its $971 million (C$1.3 billion) business aircraft portfolio.

Those uncertain residual values can make leasing appealing because the lender shoulders the consequences at the end of the deal. “More clients are exploring leases, which traditional banks are not as willing to underwrite because bank credit standards and capital requirements continue to tighten,” said Amalfitano.

However, “there aren’t many lessors today because most lessors have set residuals so low that buying/financing makes more sense than leasing,” noted Qualey. “Should someone insist on leasing, there are still lessors available, but generally residuals are now being set at a fraction of what they were 10 years ago.”

While conventional lenders might have less appetite for the funding of leases, most remain interested in providing funding for structured debt transactions, and the overall impression is that players in the finance industry have become more specialized. “There are certainly fewer financiers who want to be all things to all people,” said DiLallo. “Nearly all banks have become more selective about the type or age of jets financed, and to whom they provide financing.”

In UBS’s October business jet survey, 27 percent of the financiers polled said they believe the availability of financing has deteriorated, compared with 6 percent of the dealer/brokers queried, yet despite that assessment there appears to be enough money in the finance tank to meet current demand. “I’m finding more people willing to finance,” said Mesinger, who attributes this to the fact that the industry has contracted somewhat, making capacity...
look better than it did. “I’m finding more people willing to finance older airplanes, willing to finance modernization. Whereas in the past, as we came out of our downturn, it was— in my perception—part of the problem, now it’s not.”

“The current level of capital liquidity in the market is high as U.S. banks have unused capital that needs to be deployed to drive loan and asset growth with existing clients,” said Amalfitano, adding that the rising demand in North America for small and midsize jets is affording more aircraft loan opportunities to regional and local banks.

Yet, despite that assessment, according to the Federal Reserve Board’s mid-year 2016 senior loan officer survey, 10 percent of the banks surveyed indicated they have somewhat tightened their standards on commercial and industrial loans to companies. Three percent said they have eased loan standards.

**Age Is but a Number**

Aircraft age remains one of the major concerns among financiers. Aircraft are considered old when their economic value is significantly affected by their utility,
as determined by the aircraft technological and regulatory compliance standards, which define the value and economic useful life of an asset. According to one lender, “business aircraft continue to have a 30- to 35-year economic useful life and have market utilization that far exceeds 40 years in service.” That same lender went on to define “old” as any aircraft older than five years. Financiers’ definitions of “old” stand as evidence of the niches the institutions are beginning to occupy. “Old aircraft are often classified by the age of 10 years,” said Global Jet Capital’s Labrozzi. “We have no concerns about financing these with a structure appropriate to the airplane and relative to the customer profile.”

“We try not to finance jets more than 17 years old and turboprops over 25,” Scope’s Kent told AIN. While BMO Harris will lend on jets between 0 and 15 years old, Citi’s von Weise considers old to be an aircraft built more than 20 years ago.

“Age is less important than the quality of the airplane,” Qualey noted, adding that under the right conditions his company would fund a 30-year-old aircraft purchase. “However, as airplanes age and require more maintenance, the variable costs always rise.”

The value of the airplane as defined by age, operating region and maintenance history is also crucial in determining lenders’ interest. Aircraft that are on maintenance programs are generally more attractive to financiers, and looming compliance deadlines such as ADS-B can also be a concern. “It’s a discussion we have with every new financing request involving aircraft that are not currently compliant,” said DiLallo.

“In some cases the cost to meet the new standards might be greater than the intrinsic value of the aircraft,” noted Amalfitano. “Clients will need to decide whether to keep their existing aircraft and make the required capital investment or dispose of it at the depressed values.”

For foreign operators, jurisdictional management and security are also important because lenders want to know that their repossession provisions will be honored in the event of default. Most will insist the aircraft be placed under a recognized independent management company, which will move it to a neutral location if so instructed by the lender.

Lenders Court Buyers

Some banks will limit financing almost exclusively to existing clients, while others will actively seek out new customers. “We also want to know that we can provide other products and/or services to the client for a long time,” von Weise told AIN. “We are looking for a marriage, not a date.” From a bank perspective, he added, aircraft lending must complement other bank products and should no longer exist as a product unto itself.

For most financiers, the dance between them and a potential borrower typically progresses in the same manner. “Although every client opportunity is different, several common factors are usually present,” explained Global Jet’s Labrozzi. “Our typical interaction begins with an imminent client acquisition decision. Discussions quickly move to client financial considerations, and objectives, anticipated time horizon relative to owning/operating the new airplane and so on.”

“Most customers contact us after they have selected an aircraft, and sometimes after they have put down the deposit,” noted Scope’s Kent. “We can, however, provide a pre-approval pending an aircraft selection.”

“Some clients call at the earliest stage of the acquisition process, requesting guidance on jet selection, broker/attorney recommendations and recommended finance structures,” said DiLallo. “Others email a signed purchase agreement with a specified financing request and need us to evaluate, propose, approve, document and fund within 30 days. For most deals it’s the latter.” Some lenders such as First Republic Bank will even help the client select the aircraft to be purchased, according to Simpson.

“Be prepared to have 30 days from the start of the process to closing, and have a complete financial package,” advised JetLease Capital’s Harris. “Don’t wait until you have an LOI on the aircraft to start, as fire drills for financing don’t go over well in the current environment.”

In most cases, for a domestic buyer the process will take two to four weeks, and roughly twice that for an international transaction. San Francisco-based AirFinance, which helps foreign aircraft buyers arrange funding from the U.S. Export-Import Bank (Ex-Im), says the process typically takes three months: one month to complete the credit evaluation, one month for Ex-Im to approve once they have received the credit memorandum and application, and one month for the attorneys to document the transaction and the customer to get all the conditions precedent that they need to.

Once a lender is decided upon and its rate is accepted, there are other factors to consider, according to aviation attorney Edward Kammerer, a partner with the law firm Hinckley, Allen & Snyder. The company financing an aircraft is worrying about the loan-to-value at all times, he told the audience at the JetNet IQ Summit this fall. “It wants to make sure that whatever it has lent you is there at the outset and wants to make sure that the value is going to be there through the course of the financing term.”

Lenders will insist on periodic inspections for the aircraft, he noted, and how many and who pays for them can be open to negotiation. “They want to make sure that you are doing all inspections, that you’re complying with all airworthiness directives and service bulletins and that you’re basically not letting the aircraft go,” Kammerer explained.