The challenges facing airline lessors

As leasing becomes more popular, more airlines are thinking of forming in-house or joint venture operating lease companies. This path is strewn with both opportunities and problems, writes Stephen L. Vella, Managing Director of Aircraft Leasing & Management Ltd., a part of International Leisure Group plc, UK, which owns Air Europe.

PRIME characteristics of airline deregulation since the late 1980s have been an explosive traffic growth and the introduction of different operating philosophies to handle the competitive pressures and maximise market share whilst windows of opportunity exist.

At least in the USA, much of the competitive positioning and meteoric growth occurred at a time of aircraft surplus induced by economic recession. Obtaining aircraft to satisfy demand was a relatively simple process.

The tide has changed and continuing traffic growth coupled with a scarcity of new or used aircraft has underlined the need for both technical and longer term management of aircraft resources.

Aircraft management

Developed carriers have been practising the art of fleet planning for many years. The process is an extension of the corporate business plan and is essentially strategic in nature, highlighting aircraft requirements within a five or 10-year timescale. Where some airlines have failed has been in the *tactical* management of their resources particularly in the environment of uncertainty resulting from deregulation.

The size of some airlines, and their resulting buying power, has facilitated the acquisition of additional equipment from the manufacturers but the less fortunate or enlightened have had their potential growth constrained or have had to resort to expensive short-term wet or dry leases.

The requirement to manage aircraft resources tactically as well as strategically spawned in-house aircraft leasing and management divisions in various airlines as far back as the mid-1970s. Their principal roles were to maximise the sale price of surplus aircraft and obtain additional equipment for expansion at advantageous rates. This inevitably lead to aircraft trading on behalf of third parties and the provision of ancillary services such as maintenance or consultancy.

ILG Chairman, Harry Goodman.

Proceeds from such activities were generally so healthy that it is surprising that relatively few airlines jumped on the band wagon. Those that did, like USAir, British Caledonian, SAS, American, United and even small carriers like TAT and Maersk, were handsomely rewarded for their efforts.

With the rising popularity of operating leasing, some in-house aircraft leasing and management units are contemplating the transition to operating lessors. This path is strewn with both opportunities and threats. My aim here is to highlight the current role of such in-house units and discuss their possible development.

Arguably, the primary task of an airline's in-house aircraft management unit is to ensure that projected traffic can be serviced efficiently and economically with available aircraft, both on a seasonal as well as a long-term basis. This requires the management of the aircraft count, type mix and timing of introduction and disposal. The task involves both new and perhaps less

ALM's transactions since its formation in October, 1988, include:

- Lease-in of a Boeing 747 for one year.
- Purchase of 6 firm, 12 option MD-11s, with Rolls-Royce Trent engines.
- Purchase of 11 firm, 11 option Fokker 100s, with Rolls-Royce Tay 650 engines.
- Sale of 3 Boeing 757s and 3 spare Rolls-Royce RB211-535C engines.
- Purchase of 4 Fokker 100s, with Tay engines.
- Lease-in of two Boeing 737-300 aircraft.
- Sale of Boeing 737-200 spares inventory.
- Remarketing of one Boeing 737-300.

In addition, ALM has been involved in documenting several refinanced aircraft.

Source: Aircraft Leasing & Management Ltd.

glamorous used aircraft, a fact sometimes ignored by some airlines. Inherent in the process is the requirement to buy resources cheaply and to maximise sale proceeds on disposal.

The aircraft management unit must also reconcile the short-term, often conflicting interests and requirements of the airline's commercial, operations and technical divisions with the realities of aircraft supply and demand in the marketplace.

At the same time, it has to cope with the long term view implicit in the airline's basic fleet plan.

Its working relationships, both in-house and with external suppliers and customers are at a high level. For these reasons, aircraft management units are generally staff functions reporting directly to the Chief Executive, or in some cases are structured as subsidiaries to ensure objectivity and impartiality particularly in the context of an airline group.

The unit is also likely to manage the airline's relationship with operating lessors, co-ordinating commercial, legal, financial and technical aspects of any agreement. In some cases, particularly in medium sized carriers, it will also have the responsibility for evaluating the technical, operational and economic characteristics of the existing fleet against competing or new aircraft types. This may extend to manufacturer negotiations and the eventual purchase and introduction of new aircraft types.

Airline traffic is cyclical, driven largely by the health of world economics. Consequently, aircraft orders and deliveries are also cyclical. The management of the airline's aircraft inventory is therefore undertaken in an environment where the accurate prediction of peaks and troughs can materially affect not only the profitability of aircraft trading but ultimately the financial performance of the airline. In essence, the aircraft management unit is a form of insurance against periods of recession.

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To achieve the stated objectives requires a detailed understanding of the dynamics, economics and politics of the airline industry, total familiarisation with the constituents, location and ownership of the commercial aircraft inventory, and an ability to make very rapid decisions, in order to grasp opportunities as they arise.

A trading mentality supported by thorough research is thus essential, preferably underpinned by long-standing global business relationships. Founding such an organisation is therefore an evolutionary rather than an over-night process, particularly in view of the required mix of personnel disciplines and experience.

The concept of an airline operating lessor is clearly not workable without aircraft availability. Some major European carriers like Lufthansa and SAS view their new joint venture leasing companies as vehicles for the sale and leaseback of Stage 2 aircraft currently in their fleets. Technological and market value risk is thereby diffused and the lessor is assured a flow of equipment with which to launch its business.

Scarcity of production line positions is perhaps the biggest constraint in launching a joint venture lessor. Airlines like Air Europe, with positions stretching into the mid-1990s are ideal candidates for joint ventures. Rapidly growing airlines frequently effect sale and leasebacks to fund high non-recurring route development costs or airline acquisitions.

Financial partner

If structured properly, an in-house leasing company is a good way of maintaining an equity interest in such sale and leasebacks. The financial partner must be a believer in the airline's philosophy as the venture's customer base will be dominated by in-house lessees in the short-term.

Whilst it is unlikely that anything but a small proportion of the airline's orders will be dedicated to the joint venture lessor, this will allow the company to generate operating profits and cash flow to become a buyer of aircraft in its own right. Of course there is also the sale and leaseback of the airline's existing fleet.

The question that is begged is whether with so many willing airlines and with such abundant funds in the financial markets there will be a rush to form such joint venture companies. The answer is that it will be easier to achieve this with Stage 2, older aircraft than with Stage 3 equipment. Whether financial institutions will be willing to invest in such equipment in the context of current concerns with ageing aircraft will determine the rate of emergence of such companies.

Due to the scarcity of new Stage 3 aircraft it seems that the number of new joint venture lessors specialising in these types will remain limited. This may be particularly true in the light of increasing nervousness in the financial community on the potential impact of a recession on the current major lessors. •

Capital is the main constraint

WHILST THE economic benefits to the airline from having an in-house aircraft management unit are difficult to quantify they are very real indeed. Any attempt to diversify the role of the unit is likely to be encouraged only if the existing tasks and responsibilities are not sacrificed. A good management unit is an excellent platform to launch an in-house operating lessor. After all, the airline has the experienced personnel, technical support and relationships with the airframe and engine manufacturers as well as with other airlines.

An important constraint is the capital intensive nature of both the airline and leasing industries and the probable inability of the airline to keep on pumping equity into the lessor to fuel its growth. For that reason alone it is likely that airline in-house lessors may not emerge without a financial joint venture partner.

A solid credit is indispensable as a joint venture partner in view of the level of debt to be raised. Yet the partner must be experienced enough in aviation finance to appreciate the calculated business risks that are part of aircraft leasing and allow the lessor's management some decision-making latitude outside the time-consuming, if essential, constraint of credit committees.

An operating lessor is analogous to a three-legged stool with the legs comprising technical, financial and aircraft management expertise. A marriage between an airline and a financial institution is thus a natural progression. •