AVIATION FINANCE overview

Global air traffic and demand for aircraft stays strong in 2017.

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Since 2011, NAB has originated approximately US$4 billion of new lending volume in the aircraft finance sector, participating in the financing of about 400 aircraft to nearly 100 airlines in c.50 countries around the world.

Importantly, and increasingly, a significant portion of NAB’s financing is directed towards new-generation aircraft, such as Airbus’ A320neo and A350 families and Boeing’s 737-MAX and 787 families, which are greener, cleaner and quieter than the aircraft models they are replacing. During 2017 NAB participated in its first financing of an A320neo and Boeing 737-MAX aircraft, as well as its 12th Airbus A350 and 34th Boeing 787: NAB intends to continue expanding its financing for these next-generation aircraft types to support the industry’s long-term sustainable growth.

Favourable aviation industry fundamentals continued throughout 2017 as global air traffic grew strongly, which boosted demand for aircraft, and airlines and aircraft lessors exhibited generally high levels of profitability. This robust backdrop is driving new financier and investor participation from regions around the world and competitive pricing for buyers of large commercial aircraft. The aircraft finance industry remains in a healthy state, with ample liquidity, a wide and growing range of aircraft funding options, and an overall positive outlook for the next few years.

NAB believes the increased interest in aircraft finance from investors has three parts to it:

1. **Steady value and cash flow properties:** Aircraft are generally durable, standardised products, flexible in deployment and limited in supply. Aircraft values have been proven to be generally stable through-the-cycle. Leasing aircraft via long-term operating leases provides for steady and stable cash flows.

2. **Airline profitability:** Airlines in recent years have generally been recording historically high levels of earnings, which lowers underlying credit risk.

3. **Growth sector:** As the diversity of aircraft funding sources grows and as more investment enters the sector, investors are becoming increasingly aware of aircraft as an asset class.

![Airline industry profitability (2005-2017F)](image)

Source: IATA

A defining trend in commercial aviation has been the rise of aircraft leasing over the past three decades. Much of the new financing entering the industry has been directed towards aircraft operating lessors, which are specialist companies that own, lease and actively manage aircraft. Since its beginnings in the early 1970s, the growth of the aircraft leasing market has outpaced that of the global aircraft fleet over the same period. In the 1970s leased aircraft accounted for less than 1% of the global aircraft fleet. Today, leased aircraft represent about 42% of the global fleet, and aircraft leasing continues to grow in both size and importance.

Operating leasing of aircraft increasingly constitutes an important financing alternative for airlines. By leasing a portion of their fleet, airlines are able to improve their liquidity position and their balance sheet. In the face of high competition, most airlines are attempting to finance their aircraft fleet while maintaining as much liquidity as possible.
It allows airlines to respond to short- and medium-term fluctuations in demand without having to make capital-intensive investments in aircraft.

Major airlines are generally making increasing use of the operating lease product. Aircraft lessors account for an increasing portion of the manufacturers’ order books and their share of the overall global fleet is expected to continue to climb steadily.

In 2017, the aircraft leasing industry saw the continuance of recent trends, including industry consolidation, frequent portfolio turnover, high use of bank debt and increasing use of capital markets (including the lessors issuing large volumes of asset (aircraft)-backed securities (ABS) and unsecured bonds) and the spread of innovative structures that have seen public capital markets being used as a source of equity.
Large financial institutions from China and the Middle East, which remain keen to expand outside of their home markets and increase their exposure to long-term, cash-generative and US dollar-denominated assets, emerged further onto the aircraft finance stage during 2017. The strong growth in aircraft financing supply from China and the Middle East region mirrors the growth of the aviation in each region. Chinese financial institutions now own three of the world’s 10 largest aircraft lessors and Emirates has grown to become the world’s largest international airline and Dubai the world’s largest international airport.

NAB conducts the bulk of its aviation financing activity via aircraft lessors. The merits of this financing model were on display during 2017, an eventful year that saw the high-profile insolvencies of several airlines in Europe: Alitalia, Air Berlin and Monarch Airlines. As usual, aircraft leasing companies acted decisively following the Air Berlin and Monarch insolvencies (Alitalia continues to operate), both of whom leased the majority of their fleets. Following the Air Berlin and Monarch insolvencies in August and October 2017 respectively, the various lessors with exposure to the two airlines quickly secured control of their aircraft, re-marketed and then re-leased their aircraft.

Unsurprisingly, many banks are using lessor financing as a low-risk entry point into the aviation finance space. Lessors’ actions following the Air Berlin and Monarch insolvencies not only highlight the strong demand for aircraft but also the expertise of aircraft lessors’ platform in moving aircraft, and the value for lenders and investors in partnering with lessors. NAB believes that lessors are well-placed to continue attracting investment from investors who increasingly see the diversification benefits of partnering with specialist lessors that have a wide mix of airlines and aircraft types in their portfolio, and the capability to actively manage aircraft to ensure they continue to generate cash flows.