



# Set The Capital Free

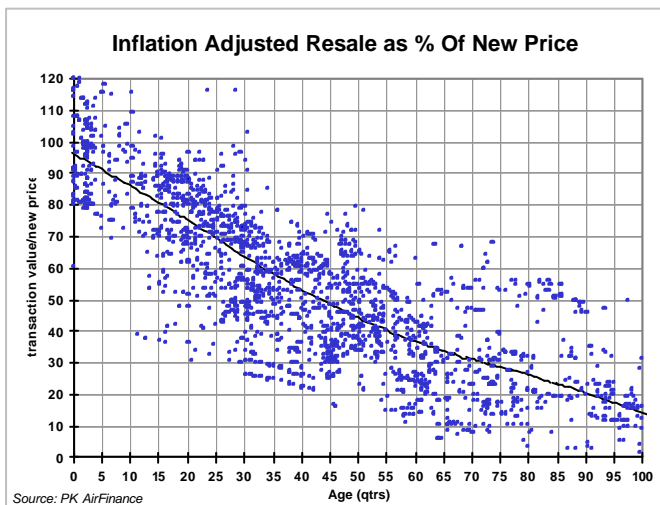
by **Nils Hallerstrom**  
president of PK AirFinance  
– A GE Capital Aviation Services Company  
(n.hallerstrom@pkair.com) [www.pkair.com](http://www.pkair.com)

**While yesterday's CFO was striving for the lowest costs of funds, tomorrow's should strive for the highest return on risk capital – that is how shareholder value is created.**

## Swinging Aircraft Values

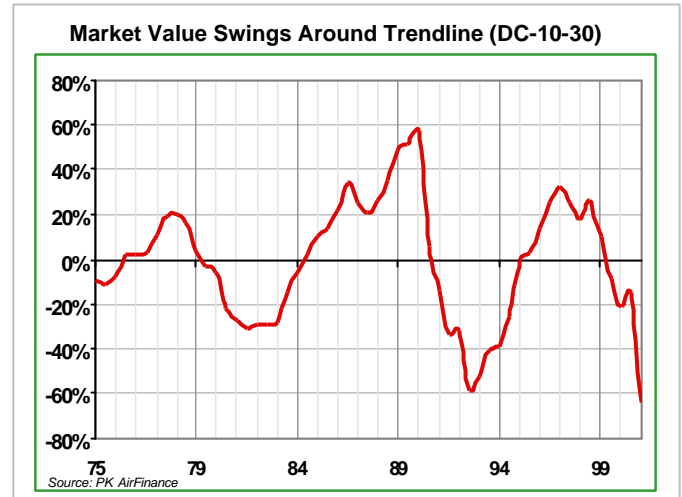
The current industry downturn reminds us that aircraft values are volatile. But it is just a reminder. 1975, 1982, 1991 were sharp troughs in the aviation cycle as well – a cycle that is only partly predictable.

The graph below shows the resale price for narrow body commercial jets in inflation adjusted USD expressed as a percentage of the new price as a function of the age of the aircraft at the time of sale. The data comes from PK AirFinance's data base of historical resale prices consisting of over 6,000 data points.



The graph clearly demonstrates that aircraft values are unpredictable. The drivers are depreciation life, capacity cycle, inflation, and maintenance status. This uncertainty means that if you are in the business of owning aircraft you are assuming financial risk. Lot's of it.

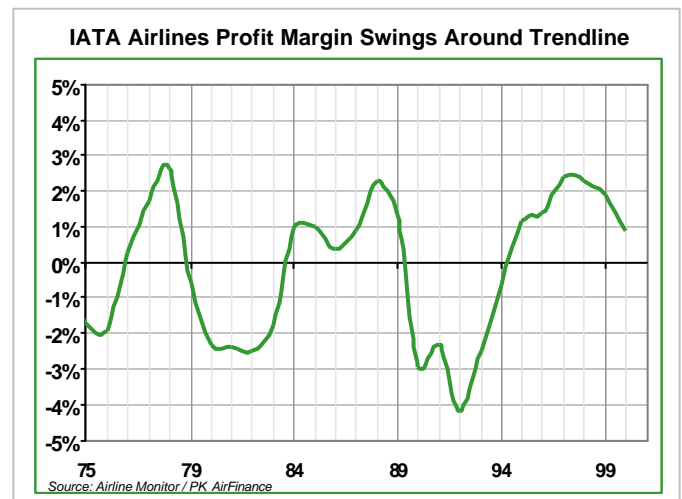
Let us now look at values over time. The graph below shows the cyclical swings around the base value for a 1975 DC-10-30.



It is a typical pattern with swings more dramatic as the aircraft type ages.

## Swinging Airline Profits

We will now turn for a moment to airline profit margins. The graph below shows the cyclical swings around a long term trendline of IATA airlines' operating margin. The chart is derived from data in Ed Greenslet's "Airline Monitor".

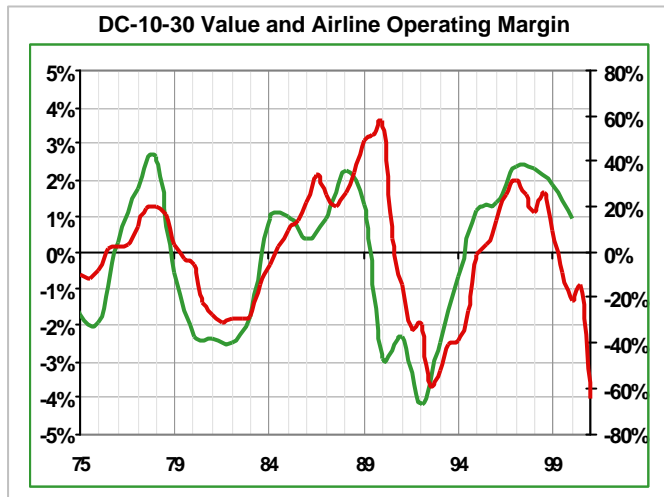




The volatility in the profit margins shows that anyone in the aircraft operations business is assuming financial risk.

### The Curse Of Correlation

Let us now superimpose the two graphs:



You will note a striking correlation between swings in airline profit margins and values of DC-10-30 aircraft. We could have picked any commercial jet, and the picture would look basically the same.

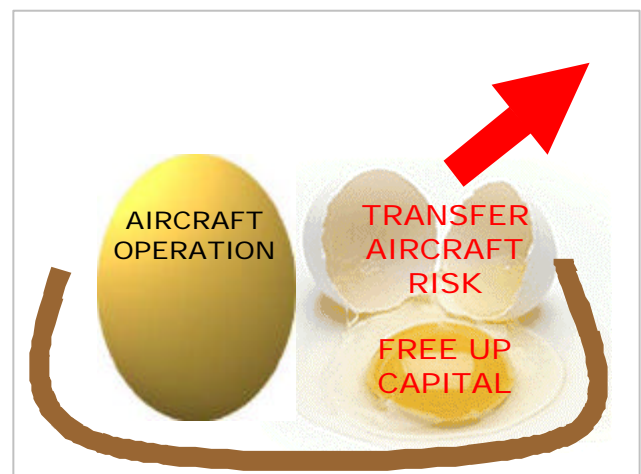
The conclusion is a depressing one for any airline CFO: Airlines are in two businesses – the aircraft ownership business and the aircraft operations business. Both carry substantial financial risk. Moreover, they totally correlate. When one is down, the other one is down. When one is up, the other one is up. That means that airlines have to hold masses of risk capital against this combined risk. That will make it difficult to generate a high return on capital.



Two eggs in one basket could easily end up with two smashed eggs – some of it on the CFO's face!

Why are airline profits and aircraft values so strongly correlated? Our industry goes through sharp capacity shortage/surplus cycles. Aircraft are not built overnight. It takes the manufacturer 12-18 months to produce a finished aircraft. Traffic volume is inherently difficult to predict. When traffic is strong, planes are filled and they fly at high utilization. Fares are high and airlines make money. Available aircraft get absorbed at high prices. And typically, the airlines order more new airplanes. Those tend to be delivered when traffic is down again, and over capacity develops in the market. Ticket prices go down in an effort to fill all the planes. And surplus aircraft are sold off cheaply.

### Free Up The Capital



The key to protecting the airline's core business and optimising utilization of capital is to transfer some of the ownership risk to an outside party – operating lessors and other aircraft backed debt providers. This transfer can be achieved through:



OPERATING LEASING  
SALE-LEASE BACK TRANSACTION  
FINANCIAL LEASING WITH CALL OPTION  
AIRCRAFT VALUE GUARANTEE  
PARTIAL RECOURSE DEBT  
HYBRID LEASING  
AIRCRAFT VALUE RELATED PRICING

All of these solutions may seem more expensive than outright ownership, but on closer inspection, each of the above will free up risk capital that would otherwise have to be remunerated. The chances are that the airline's long-term return on *risk-adjusted capital* will improve.

If this transfer is beneficial to the airline, one would assume it is automatically detrimental to the financier – the one who assumes the ownership risk. That is not necessarily true. For a number of reasons, the financier may be better suited to assume the aircraft ownership risk:

- Broader diversification of businesses
- Greater tax efficiency in holding ownership
- Dedicated organization to remarket aircraft
- Dedicated research into aircraft values and airline credits
- Lower cost of funds thanks to higher credit rating

### Aircraft Backed Financing Solutions

Yesterday's aircraft-backed lending and operating leasing were often the only types of financing available to weak carriers. There was little choice and the pricing, at least in retrospect, was juicy.

Today, aircraft-backed financing is a mature and highly competitive industry. It is no longer the funding source of last resort – it is a formula for capital efficiency. Strong and successful carriers realize the merits of off-loading some of their ownership risk.

The aviation market has also become much more volatile with increasing deregulation. The need for fleet flexibility and for "travelling light" is becoming obvious to an increasing number of successful airlines. Highly

structured deals can get the static funding cost down, but it often comes at a price - inflexibility.

Smart managers see that the winning prize is not for the lowest cost of funds – it is for the highest return on risk capital. That requires finance, fleet planning and marketing to work closely together. Operating leasing, limited recourse financing, asset value guarantees, and other aircraft backed financial solutions should be in their tool kit to achieve maximum shareholder value. ■

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