Costs and benefits

Leasing is often used as a financial control tool, enabling airlines to have money available rather than tied up in an asset. Bernie Baldwin reports on a leasing product that is increasing in popularity with both airlines and lessors.

No airline wants to be considered a high-cost operation. Even those that have premium products want to pay as little as possible to deliver them and thus come away with a profit.

One of the most expensive areas where carriers can aim to keep expenditures down is the cost of finance when acquiring aircraft.

Leasing is, of course, an option that can keep the asset off the balance sheet and is often preferred by airlines in their early stages of operation. Established carriers, too, often like a mix of leased and financed aircraft.

When it comes to selecting which finance option to take, much depends on the state of the money markets, including lease rates and the activity in aircraft acquisitions. At present, for example, despite new aircraft delays, the demand is still strong.

Neil Fraser, Manager – Airline Analysis at renowned consultancy IBA, has been observing the current landscape, particularly for leasing.

“With demand for travel increasing, and IATA estimating that 2024 will be a record-breaking year, the industry has seen worse days,” he says.

“OEMs are struggling to get production

TrueNoord says demand for aircraft is strong, leading to an upward price effect on those airframes available for sale or lease.
Image: TrueNoord

rates up due to labour shortages, and supply chain issues affecting all components provide a domino effect in increasing production rates.

"With massive orders coming in from a litany of operators, the earliest available delivery slots are well into 2030.

"This constraint in capacity and increase in demand has without doubt pushed aircraft values and lease rates up.

"This is evident as operators are extending current leases to avoid being left without capacity.

"Aircraft that are in the open market will command a premium, with the largest increases being seen in older vintages.

"The leasing sector is definitely seeing increased returns. With interest rates rising, however, the cost of capital is of paramount importance.

"With banks having challenges with lending for high residual value assets, the leasing sector must find other sources of 'cheap money' such as the capital markets or equity funds, which are heavily impacted by financial climates."

COMPETITIVE ADVANTAGE

One of the world's largest leasing companies is Avolon, whose Chief Financial Officer Ross O'Connor also believes that the combination of the strong recovery in demand for air travel, plus supply constraints on the delivery of new aircraft, have created a favourable environment for lessors.

"If production levels are maintained at today's rate, the OEMs are sold out to 2035," he says.

"While there is still a reasonable level of competition in the sale and leaseback market, particularly for smaller transactions, we are increasingly seeing only a handful of lessors with the balance sheet capacity, execution credibility, and proven track record to underwrite new business in scale.

"Lease rates rose as much as 35 per cent last year and have continued to grow in 2024. Demand for aircraft has also help drive up aircraft valuations in the secondary market, helping increase portfolio values.

"Our view is that investment-grade lessors of scale like Avolon are well placed to benefit from the current market, with our large order book – which is 90 per cent narrowbody – providing us with a clear competitive advantage in an undersupplied market."

"As aircraft are expensive capital goods, the owners or investors in these assets need higher returns, hence higher lease rates to reflect these higher capital costs."

Anne-Bart Tieleman, CEO, TrueNoord

ESCALATION EFFECT

At the other end of the market in terms of aeroplane size, specialist regional aircraft lessor TrueNoord also sees a vibrant market, according to its CEO, Anne-Bart Tieleman.

"As demand for aircraft is strong there is an upward price effect on available aircraft for sale or lease," he says.

"At TrueNoord, we see the costs of new regional aircraft going up – an escalation effect – and lease rates generally increasing too. These increases are sometimes substantial, in double-digit percentages.

"Another important factor that causes lease rates to go up is the higher cost of capital, which is due to the US Federal Reserve raising interest rates over the last two years.

"As aircraft are expensive capital goods, the owners or investors in these assets need higher returns, hence higher lease rates to reflect these higher capital costs.

"For those airlines financing their aircraft, it is no different. As capital has become more expensive, an airline that wants to finance their own aircraft will be confronted with higher interest rates and therefore higher capital costs to finance their fleet.

"While we continue to see high US dollar interest rates this situation will remain. Higher capital costs seem to be the new reality, especially compared with the low interest rate environment of 10 years ago."

AN EFFECTIVE SOLUTION

One solution in the leasing portfolio is the sale and leaseback (SLB) deal, already mentioned by Avolon's O'Connor. Tieleman explains how such a deal works and its main purpose.

"A SLB is in effect the 100 per cent financing of an aircraft which has originally been ordered by an airline wishing to operate the aircraft," he says.

"A leasing company, like TrueNoord, steps in to take over the ownership of the aircraft and agrees to lease it back for an agreed period to the airline.

"The airline can operate the aircraft as intended, but has put the financing of the aircraft with the lessor.

"For this 'capital' service, the lessor will charge a monthly rental amount which will mainly comprise the capital costs involved with ownership of the aircraft."

O'Connor himself says that the main purpose of an SLB is that it "allows airlines to benefit from the strong balance sheets that lessors like Avolon have, at a time when they may be constrained in terms of financing large scale fleet expansion".

He continues: "Covid put airlines under huge pressure, and as they rebuild their financial strength the SLB market provides a way to fund growth without incurring incremental debt – and for airlines to benefit from the superior financing that invest-grade rated lessors' balance sheets can provide.

"It's notable that lessors delivered all of the growth in the global fleet from 2019 to 2022, through the pandemic period of uncertainty.

"Sale and leasebacks also allow airlines to concentrate on managing customer relationships and selling airline tickets rather than devoting significant time and resources to raising capital to fund aircraft purchases."

"The sale and leaseback channel provides another route for a lessor to increase portfolio size in addition to its own order book or through acquiring aircraft in the secondary market."

Ross O'Connor, Chief Financial Officer, Avolon

TALKING PERCENTAGES

IBA's Fraser says the principal function of the SLB for an airline is to get an immediate cash influx from the sale, enabling it to use the cash on other investments or to improve liquidity.

"For the lessor, it locks in a revenue stream for the length of the lease, typically with a premium over their financing costs as to lock in profit."

In his role as an analyst, Fraser keeps tabs on how often SLBs are used by airlines, including how much low-fare or regional airlines benefit from them.

"Currently, 51 per cent of the global passenger fleet is leased," he says. "There are regional and type discrepancies, with a higher rate of leasing on narrowbodies than widebodies, with leasing used the greatest in Latin America (70 per cent) and least in North America (32 per cent).

"These percentages incorporate both SLBs, as well as the 'speculative' leases where the lessor ordered the aircraft to later find a lessee. According to Airbus, new deliveries are typically evenly split between SLBs, lessors directly, and airlines without SLBs.

"Less liquid types such as widebodies and regional jets have a greater risk of not being placed, so are therefore less adopted by

Helping hand: sale and leaseback deals allow airlines to benefit from lessors' balance sheets. Image: Avolon speculative lessors.

"A key detail of SLBs is that the lessor does not need to take on the asset risk – in terms of being able to place it – as the airline is already there.

"Nonetheless, the credit risk exists in terms of them providing payments. Leasing will therefore be more prevalent among better credits – unless they are in such a healthy financial position as to not need it significantly. Ryanair for example."

Fraser notes that where lessors are involved in regional aircraft – a much smaller market due to the aircraft being less popular – leasing can be attractive where public service obligation (PSO) routes exist, as these reduce the risk through guaranteed revenue.

> "The leasing sector is definitely seeing increased returns. With interest rates rising, however, the cost of capital is of paramount importance."
>
> **Neil Fraser, Manager – Airline Analysis, IBA**

"Low-fare airlines typically employ leasing heavily, as locking in the aircraft cost – and having the immediate cash inflow – is very compatible with a cost-controlled enterprise.

"Further, the US low-fare sector has been suffering in the past year and the liquidity that SLBs provide can help them survive, providing a lessor is willing to take on the risk."

TrueNoord's Tieleman also views the SLB product as a growing and established product/service provided by most leasing companies, and utilised by many airlines.

"At the moment, a growing percentage of the global aircraft fleet is owned by leasing companies, and a large part of that growth has been driven by the SLB market," he says.

"As leasing companies like TrueNoord are becoming established financial

> "In the case of IndiGo, it is believed that they are actually locking in a profit from SLBs, because of the low strike price of their order."
> **Neil Fraser, Manager – Airline Analysis, IBA**

institutions, the cost of capital for these lessors might be lower than for airlines.

"This is because individual airlines will be perceived as a single credit and therefore a concentrated credit risk for financiers, whereas a leasing company represents a multiplicity of credit risks from many airlines, hence a lower credit risk overall, and that structure should drive the costs of capital for leasing companies down.

"Thus, besides other advantages, leasing aircraft may well be cheaper for an airline – as opposed to funding the purchase of an aircraft by themselves."

EMERGING MARKETS

According to Ross O'Connor at Avolon, sale and leaseback volumes remain high.

"It is a financing channel used by airlines of all types, including low-fare and regional carriers," he says.

"Emerging markets, particularly in Asia, are expected to contribute 70 per cent of the growth in passenger traffic over the next 20 years.

"These markets typically have less developed capital markets, which we believe will support a further increase in the percentage of the global fleet which is leased.

"To give a sense of scale, last year Avolon underwrote US$4 billion of new volume in sale and leaseback across 51 aircraft."

While airlines benefit from SLBs in the many ways described, lessors don't offer these deals without the potential to accrue their own benefits.

"The sale and leaseback channel provides another route for a lessor to increase portfolio size in addition to its own order book or through acquiring aircraft in the secondary market," O'Connor says.

"At Avolon, we benefit from owning the largest lessor order book in a structurally undersupplied market that will last past 2030. Our balance sheet and liquidity position continue to be our greatest asset in winning sale and leaseback transactions.

"We continue to see a strong pipeline of opportunities in the year ahead underpinned by our ability to underwrite large transactions and provide execution certainty to our customers."

SUPPLY CONSTRAINTS

Regarding SLB benefits for lessors, IBA's Fraser first reiterates that the current market favours lessors due to supply constraints.

"Another very significant market dynamic is the large number of orders in the market," he says.

"Sentiment among airlines at conferences has been that one needs to place large orders to be able to secure delivery slots. These large orders have allowed volume discounts, which then make more SLB markets as the lessee (airline) can afford a higher rate.

"In the case of IndiGo, it is believed that they are actually locking in a profit from SLBs, because of the low strike price of their order.

"Lessors also benefit from SLBs in that they have visibility of the lease term before the deal so as to match their financing and therefore the lease rate risk.

"This is instead of trying to find a lessee to match that profile after they have financed a speculative order."

On the same theme, TrueNoord's Tieleman states that the larger a lessor, the more aircraft they own, and the more diversified their leasing portfolio becomes.

"As a consequence, diversified exposure to airlines should act as a catalyst to access cheaper capital costs overall," he says.

"This has a positive effect on the price that lessors can offer and stimulates competition in the marketplace.

"At the moment, TrueNoord observes that the increase of capital costs transferred into new agreed lease rates is slowly impacting the total financial 'return' across aircraft lease portfolios. But in the longer term this will have an effect.

"The current short supply of available aircraft will only accelerate increases in lease rates which are likely to happen anyway because of the aforesaid effect of higher interest rates."

IndiGo is believed to be making a profit from sale and leaseback because of the low strike price of their order. Image: Airbus