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# U.S. Structured Credit Roundtable: As Airlines' Financing Needs Increase, Aircraft ABS Has Been Taking Off

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# U.S. Structured Credit Roundtable: As Airlines' Financing Needs Increase, Aircraft ABS Has Been Taking Off

In 2014 alone, an estimated $110 billion-$125 billion of new aircraft will need to be financed. While owners will pursue a variety of financing options, securitizations will likely have a significant piece of the pie. To discuss the recent trends in aircraft securitization, Standard & Poor's Ratings Services recently hosted a roundtable, where participants shared their thoughts on the sector's key risks and opportunities, among other topics.

## Panel Discussion

Credit analyst Jing Xie, a Director in Standard & Poor's Structured Credit group, and credit analyst Betsy Snyder, a Director in Standard & Poor's Corporate and Government group, conducted the roundtable. The other participants were:

- Jessica Gray, Managing Director, Wells Fargo Securities LLC
- Paul Rofe, Group Treasurer, AerCap Holdings N.V.
- Domhnal Slattery, CEO, Avolon Aerospace Leasing Ltd.

What follows is an edited excerpt of the discussion. The opinions expressed in this article are those of the individual participants and not necessarily of their employers or Standard & Poor's.

***Standard & Poor's:*** In your view, where are we today in the aviation transportation industry cycle globally?

***Jessica Gray:*** I think things look fairly good. I focus on the passenger aircraft segment, not so much on cargo. Year-over-year growth in passenger aircraft revenue has been about 5%; I think it was just over that--something like 5.3%--in 2012. This level of growth is consistent with the historical average. The growth areas are Asia-Pacific, the Middle East, Africa, and Latin America--no great surprise there. Load factors in these areas are high, about 80%, and utilization of aircraft is reasonably high.

The airline industry is profitable, but its margins remain very, very slim. Some of the carriers, particularly in India, have had financial difficulties. But overall, we think things are reasonably good.

***Paul Rofe:*** I echo what Jessica said. My firm also doesn't participate in the cargo market. We lease aircraft in the passenger market. We're seeing fairly good results from the airlines themselves as well as attractive interest rates. The prevailing low interest rates have helped the industry tremendously. Oil prices have also been favorable. I'm reluctant to use the word "stable" in this context, but lately there have been no nasty oil price shocks that threaten to disrupt the industry. We think the industry is pretty sound right now.

***Domhnal Slattery:*** I think that we are currently about halfway through the recovery phase of this cycle. When Avolon entered the market in 2010, the recovery was already underway, and we expected to have a 12-18 month window in which we could exploit market weakness. As it turned out, the eurozone crisis in particular put the recovery on hold and threatened the stability of the financial markets once again. As a result, we have seen the timeframe for recovery prolonged by about 18 months. Nevertheless, we do feel that we are finally engaged in real recovery and heading toward the next cycle peak in the latter part of the decade.

Over the course of this year, we have seen tangible evidence of recovery, with demand for our core aircraft types strengthening and lease rates and values increasing as a result. We are also seeing the airline industry as a whole generating stronger profits, which is always a good sign of their future ability to take delivery of what remains a record backlog of new deliveries. I think that one of the most important structural changes to our industry since 2001 is the transformation of the airlines into a sector that is now highly resilient to external shocks and has figured out how to earn profits when its highest-cost item--fuel--remains very expensive with no real prospect of prices falling.

Sustained high fuel prices have been driving demand for new fuel-efficient aircraft and led to the launch of new-generation aircraft, such as Max and Neo. As such, we have seen airlines order new aircraft in record numbers, which has sparked concerns that we will see over-capacity through much of the rest of the decade. However, we believe that as long as the OEMs maintain supply discipline, supply and demand will remain in balance over the coming years.

More than 40% of deliveries will be replacing older and less fuel-efficient fleets that the airlines will be retiring. This will not result in a wave of prematurely retired aircraft. Rather, the surge of aircraft ordering and deliveries in the late 1980s and early 1990s has led to a growing number of aircraft that are now approaching 25 years of age.

In my view, the economies and demographics of emerging markets will support aircraft market growth. In these markets, aviation is a central element of growth and economic prosperity. The aircraft industry is developing with the support of new low-cost carrier business models and steady liberalization.

We see the Asia-Pacific region, which is already the largest market in the world in terms of revenue passenger kilometers, growing to the same size as North America and Europe combined within 20 years.

***Standard & Poor's:*** The aircraft ABS market is coming back. This year, we rated three ABS transactions backed by aircraft and engines. The Emerald deal, which was aircraft ABS, was priced favorably. In your view, what has caused the increasing interest in aircraft ABS, and what changes have you seen in the sources of investor demand?

***Domhnal Slattery:*** The increased interest has three parts to it: First, investors see this as an attractive asset class; second, values are stable through the cycle; and third, investors are becoming more aware of this asset class, and their understanding of aircraft leasing is increasing.

The main change to the sources of investor demand has been a move to fixed-income investors versus the pre-crisis reliance on monolines. There are also currently more long-term take-and-hold investors than those who invest to trade.

The esoteric ABS market has been very active in a number of sectors (container, rail, etc.) over the last few years. The risk/return profile of aircraft ABS relative to these sectors is attractive to such ABS investors. Transactions that can offer high-quality liquid aircraft with strong credits (airlines and lessors as servicer) are finding favor with fund and money managers in pursuit of relative returns. Furthermore, competing commercial debt, export funding, and high-yield market appetite over the past couple of years have diverted interest away from aircraft ABS deals, which were generally deemed a harder route to market. Issuers are now looking at ways to diversify their funding sources, and aircraft ABS now provides an attractive alternative.

Funds, pensions, and insurance managers--and not just the traditional high-yield players--are now participants in aircraft capital market transactions, where competing investments and sovereign bonds yields have collapsed to record levels. These managers are choosing to allocate capital to sectors where lending is longer term and deemed less risky.

***Paul Rofe:*** From our perspective, our interest in ABS never went away. It's a market we like, and it's an important market. The beauty of aircraft ABS is that you have a 25-year asset and a 25-year liability in there as well, and so there's a great duration-matching opportunity.

From the discussions I've had, I think investor demand narrowed quite a bit quite some time ago, but it seems to be broadening again. Investors are out there looking for something a little bit different, something where they can get a little bit of yield. In terms of the issuer perspective on this, the low interest rates have really helped make some of these deals a reality. If we looked at this 12 to 18 months ago, we probably would have been talking something like a 5% fixed coupon, and the Emerald deal priced inside of that. I think that certainly sparked a little bit more interest out there for those issuers.

***Standard & Poor's:*** You said that demand has come back from a few years ago. Was that just because after the financial crisis and some of the banks pulling back, there was some negative news out there about the aviation industry?

***Paul Rofe:*** I think it's probably a mixture of things, though that may have been a part of it. I think there was quite a dislocation between bank financing pricing and ABS pricing as well. As such, we were able to lock in some extremely low-cost bank financing as well. The export credit arrangements were pumping money into the industry fairly well at relatively low pricing overall. Of course, that has changed to some degree with this new ECA sector understanding, which went into effect the beginning of this year. I think it's a number of factors. Certainly, pricing pushed a lot of people toward the bank market. I think some of the ABS investors themselves kind of take stock of how they felt about the industry as well, in my view. I think Jessica's probably much closer to the investors than I am.

***Jessica Gray:*** That's right. I think it's as simple as a flight to quality when times are scary and then chasing yield in this environment today. When it's easy to get an attractive spread for auto or car deals, that's probably the safest bet. Then the container space gradually came back and we saw new issue in the market, and then spreads became quite tight. Now, coupled with the rate environment, if the issuers can make sense of a deal and investors are getting comfortable with the asset class once again (under much simpler structures, admittedly), there's real considerable appetite. It's quite an attractive environment, and we're trying to encourage Paul and his team to do a deal as well.

***Standard & Poor's:*** Jessica, is there anything else you want to say about the Emerald transaction in particular because you were the banker on this transaction?

***Jessica Gray:*** Absolutely. I don't want to speak for Domhnal, but I think they were very, very pleased with the execution there. It was a terrific transaction for both Avolon and the investors. The structure of the deal is great. I think it's a very efficient structure for Avolon, and it was the first capital market ABS transaction since 2009. We were really pleased to be on that transaction and assist Avolon in getting into the broader capital markets with an issuance.

***Standard & Poor's:*** Thanks. In the first generation of aircraft ABS transactions, investors lost a lot. Then the second generation of aircraft ABS transactions--for example ALS, Castle, and the CIT deals--performed well. And now come the third generation of aircraft ABS transactions. When you talk to potential aircraft ABS investors these days, what are their major concerns?

***Jessica Gray:*** I think the biggest concern is the alignment of the interests of the noteholders and the seller (which usually is also the servicer). Other concerns are the retention of equity, making sure that there's no cherry-picking of assets (which arguably is easier with a big asset like an airplane than it would be with a container in a stack). The other thing that is of concern is this so-called soft-bullet concept, which addresses what happens if investors are not paid out at the end of the anticipated refinance date. In the Avolon deal, if the debt is not repaid at the Year Seven anticipated refinance date, there is a very punitive 500-basis-point (bp) step-up in the coupon. Unlike the old days, when the step-up in coupon after an anticipated refinance date (ARD) was typically about 50 bps, it's hard not to view today's much higher step-up as punitive to the issuer.

I think those are the biggest concerns, and then there are always the general concerns around valuation of collateral over time, generally weak airline credits on the whole, and the macro and geopolitical risks on the asset side.

***Paul Rofe:*** I would like to add to that a little bit. We are finding that some of the people we speak to are considering entering this market for the first time, or they've been out of it for a long time and need a refresher. Generally, as we talk to the other investors, I think I'd agree with Jessica that the questions they've got are really focused around what we would sell out of the portfolio and when would we sell it. It's really the cash leakage versus full turbo type of discussion, which inevitably leads to Jessica's point about the step-up. Some of them don't want to be paid down too early, and others don't want to be paid down too late, so there's often some discussion around that.

***Domhnal Slattery:*** There are two main issues that investors consistently raise. First is understanding the structural differences in the industry and the specific transactions versus the previous generations of transactions. Historically, the original 1990s vintage aircraft ABS were over-leveraged, had poor interest rate risk management, and were not refinanced on the anticipated refinance date. More recent transactions--from 2007 to 2009--performed ahead of expectations due to superior structures and collateral pools, though the crisis severely affected monoline providers. The second concern is, of course, understanding the relative risk/return of the asset class compared with other asset classes.

***Jessica Gray:*** One other thing I'd like to add is that the old deals were very, very complicated, with multiple fixed and floating tranches. I think everybody thought that diversification among different types of aircraft was the name of the game. What we found, though, was that aircraft that only serve narrow, niche markets actually don't perform as well in a down cycle. With passenger aircraft, when you want diversification, you want diversification among operators rather than diversification by type of aircraft. In addition, the most commoditized planes tend to be the most attractive because they're the most likely to be used. Railcars and containers are different in that diversification by type is usually desirable.

***Standard & Poor's:*** The recent aircraft ABS transactions have much simpler structures, faster note amortization, and more operational flexibility compared with many older transactions. Do you see this as a trend?

***Jessica Gray:*** I think simpler structures are the name of the game without a doubt. I just mentioned some of the factors that soured investors on some of those older deals. Issuers learned their lessons the hard way and now generally focus on simplicity. Deals might have a senior sub tranche, for example, but their structures are certainly not nearly as complicated as their predecessors' were.

***Paul Rofe:*** I'm inclined to agree. I think the investors are not looking for anything too complex there. Certainly in terms of operational flexibility, I think everybody has learned from some of the older structures. I think the ability to transfer aircraft in or out of these portfolios is important. You don't want a structure to be stuck with something that is really hard to be taken out later on, and so I think operational flexibility is really important as well. In these deals, I think having the flexibility to move assets in or out is vital, particularly for platforms that are accustomed to doing this and making sure they're not retaining any residual risk.

***Domhnal Slattery:*** The trend towards simpler structures will certainly stay. Greater operational flexibility is a critical part of increasing the appeal of ABS to the issuer and in time will prove to enhance the overall performance of the facility.



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Faster amortization is a feature of this early-stage resurgence, and I would expect to see an easing over future transactions. For now, though, investors expect an ABS structure to be more investor friendly, with faster amortization profiles, overcollateralization features such as a liquidity facility, and step-up coupons at the anticipated refinance date that enhance the certainty of repayment.

***Standard & Poor's:*** Recently, many European banks have increased their lending to the sector after having pulled back for a few years, and banks in other regions of the world, particularly Asia, have increased their lending or entered this sector for the first time. In your view, what is the major driver for issuers seeking bank loans, corporate debt, and ABS debt, and do you think the ease in bank lending will slow down the ABS market?

***Paul Rofe:*** I think some diversity in aircraft financing is the key behind that. We know that periodically, various sectors of the market may shut down or be unavailable, so as a lessor, we need to have that diversity. We've got to be able to have the access to the various markets that are available to us. The ABS market is great because you need a certain stage to be able to achieve it. It just doesn't happen overnight so you've got to try to build and attain that particular stage. Likewise, you can't go to a bank today and then go back in 10 years and expect them to remember you. We need to be able to feed these different parts of the investor market from time to time as well to maintain diversity of funding.

I think the Asian markets are a little interesting. The Japanese are starting to put cost and money to work at the moment as well. Very often they start looking for leases at the very top end of the lessee structure. They're looking for top-quality airline credits underneath. Occasionally, we've seen the Japanese pull back again as well, so this may or may not be a temporary phenomenon.

The other Asian lenders tend to be very Asia-focused, though there are some exceptions. DBS and ICBC, for example, are quite prepared to lend outside the region. But I would have to categorize Bank of China slightly differently because Bank of China has its own aircraft leasing subsidiary: the Bank of China Leasing Co. In that regard, Bank of China is certainly willing to look at something beyond Asia.

***Domhnal Slattery:*** You are right to note the recent increase of commercial bank lending, the health of which had been a concern for the industry throughout 2012, as the European aerospace banks, in particular, continued to struggle with structural issues, exposure to Greek debt, and the new and evolving Basel 3 requirements. Since the start of 2013, however, we have indeed seen a veritable flood of interest from these banks, almost all of which are now back in scale and with significant budgets for 2014.

At the same time, we continue to see a gradual expansion of activity from regional banks, especially those in parts of Asia and the Middle East, that are moving from their traditional role as relationship lenders to local airlines to a wider and more global role.

Banks are also increasingly seeking to spread their risk by committing much larger proportions of their exposure to lessors rather than directly to airlines. They like the alignment of interests that this brings, with their obligors focused on managing the condition and value of their collateral, as well as the benefits of portfolio diversification, with their eggs spread across a global distribution of risk baskets.

The capital markets have been a core source of financing for a select group of customers--namely U.S. airlines--for some time. The U.S. enhanced equipment trust certificate market continues to expand, but we are now seeing the gradual globalization of the product as more jurisdictions sign up to Cape Town Convention and we expect this trend to gather a lot more momentum. We are also seeing lessors tapping the bond markets in increasing volumes, with both secured and unsecured issuances, and I think that more lessors will be seeking corporate ratings over the coming years. The bond market's support of the export credit agencies is also an important development that will help to sustain their competitiveness, though we do see the ECA's share of the total financing pie diminishing quite rapidly over the coming years, but its share in terms of volume won't necessarily be declining.

The re-opening of the ABS market, which was initiated by Avolon, signals another milestone on the cycle recovery road. I expect a substantial volume of ABS activity to be transacted going forward, with two or three more transactions likely to close before the end of this year.

The bond markets generally, of course, are sensitive to yields that can be obtained by investing elsewhere, so we should not take any of these investor-driven funding channels for granted. But remember that the industry will have to finance an average of $125 billion of new deliveries annually over the next 10 years, so we will need to attract all the support and creativity we can get from a much wider range of funding sources than we have relied on in the past.

***Standard & Poor's:*** Jessica, you have a different perspective as a banker. Why don't you give us your thoughts on this because we're hearing that Wells Fargo has really stepped up its lending to the aviation industry. Maybe you can spend a few minutes discussing the joint venture that Wells Fargo and Avolon have.

***Jessica Gray:*** My first comment would be that it seems to me--and I don't want to speak for Paul or Domhnal or anybody else in the sector--but the number one goal is getting capital at the lowest cost, followed by flexibility and then the capital structure. I think that's why the bank market was so attractive for so long. So many unsecured issues in the sector have very, very compelling spreads for the issuer. I think what's driving that is that the capital is there, and it's very flexible for the issuers. I think ABS is compelling because it takes issuers to an entirely different universe of capital providers. In this market, if there is the scale and the diversification in your fleet that permits you to do ABS, that's going to be a very attractive way as part of an issuer's overall capital structure.

Wells Fargo is very, very fortunate to be part of a big balance sheet, and as a legacy Wachovia person, I value that. We are very focused on the way we lend to the commercial aircraft leasing sector. We are quite capable of being a large ticket. We typically do bankruptcy-remote structures that are safe and fairly structured and tailored. We are pretty specific about a couple of structural nuances that we like to see, bankruptcy remoteness being one of them. We are very, very eager to lend to select customers in the sector, but we do it in a very specific way that doesn't suit everyone.

We are quite pleased with the Avolon joint venture. Today, I believe it owns two aircraft, and there are others in the pipeline. That's really an extension of a way that we'll partner with this balance sheet for a customer that we value and very significantly getting enhanced yield in a fairly passive way, with our partner Avolon being the related servicer. It is expected to grow and ramp up, and we're quite pleased with it.

***Standard & Poor's:*** It definitely is an interesting concept. Let me ask you this, Jessica: Let's say AerCap came to you. As an advisor to them and as a bank offering a lot of these products, how do you determine which is the best financing vehicle for AerCap as your client, even though there might be some conflicts there with your lending? For example, if AerCap thought that it would be good for them to do an unsecured capital markets transaction, what kind of advice do you give them in terms of financing alternatives?

***Jessica Gray:*** I am part of the asset-backed finance group. We have a broader coverage effort with the sector, which includes investment bankers that talk about the merits of other debt products. Others who are on the investment banking side have been talking about unsecured or term loans as well as all kinds of issuance other than structured ones. I'm a product specialist, so I would be predominantly talking about structured/asset-backed alternatives.

***Paul Rofe:*** I think our job is to listen to people like the Wells Fargo team and find out what they've ultimately got to offer. We'll look and see how it fits within the organization, but very often I think it would then be us going back rather than seeking advice on a product saying here's what we want to do. I think we'd be looking at some proceeding in that direction. We listen to what everybody's got to say, what's out there, and what's available, but very often, with knowledge of our capital structure and what we're looking for, it's a question of me just turning up on Jessica's doorstep one time and saying we want to do this.

***Standard & Poor's:*** That's why I asked you. As I said before, you have a diverse funding structure.

***Paul Rofe:*** I think to Jessica's point, there has also been a lot of secured issuance among lessors. I think about $21 billion has been issued in the public markets, and there have been some private deals as well. A few years ago, there was nothing, so that's been a significant change in the market with the lessors. We're seeing lessors going out getting themselves rated. To some degree, the lessors are also trying to make sure we can maintain that diversity so that we've got options available to us but also with one eye on how different parts of the banking community will react, respond, and behave when the Basel III implementation is in place as well. We are anticipating there will be some element of change at that time.

***Standard & Poor's:*** Do you think the change will be positive or negative?

***Paul Rofe:*** As a borrower, I think it will probably be slightly negative for us. We're looking for term, pricing, and leverage, and those things will not necessarily fit particularly well with the lenders.

***Standard & Poor's:*** What are you seeing in terms of aircraft lease rates and residual values? Some lessors have recently taken large impairment charges. Do you see that trend continuing, and what aircraft types are under pressure, in your view?

***Paul Rofe:*** I always like to talk about residual values first. To some degree, input price drives the residual value for a lessor. If the input price isn't right in the first place, then residual is more of a concern as well. We've definitely seen stabilization in lease rates. It's important to look at lease rates in the context of the low interest rates, so we tend to look at margins. That's far more important to us to understand what the margin is as much as anything, so we tend to look at the margin of the three main types that we have.

We have the 737, the A320 family, and the A330. The A330 is in a great place at the moment and can garner some pretty good lease rates. The margins there are pretty good compared with the peaks. The margins on the A330s are pretty good, and they are in high demand.

With 737s, there is a bit of a split between the 800 and the 700 series. We certainly see returning demand for the 800, and then the A320 family market is sort of broken down a little bit there. Most of the discussion is usually around the A320 firming. There is still a long way to go to get back to levels that probably could or should be had, but over the last 12 to 18 months, there has been good firming on the lease rates for those. Lessors taking impairment charges appear to principally have been on a large cargo aircraft.

***Standard & Poor's:*** Or A340s?

***Paul Rofe:*** A340s as well--unsurprising in that regard. If you've got real challenging types, then I think there is a wish that that trend could continue. I think as the 787 starts to slowly get more of a foothold on the market, perhaps those A340s might come under a bit more pressure as well. There are people still flying them around and still seem to be doing okay with them, but there are those who can't afford to fly them. We've certainly seen cargo aircraft and 747 freighters come to mind in the latter scenario, but that could be a function of when the cargo market starts to come back again.

One of the points that I always make here is that while to some degree the airlines are a little bit of an inflation hedge as interest rates rise, which we all know is going to happen at some time. As we come back into that higher interest rate environment it'll start to push rates back up again or at least hold rates depending on where they are, and that will have an impact on valuations as well.

***Jessica Gray:*** I think in terms of lease rates, I'd agree with everything Paul said. A year ago, I think the gap between the B737-800 and the A320 was even worse than it is today, so I think we've seen a bit of improvement, but that is mildly encouraging from our perspective. Our strategy, with which we get comfortable with owning commercial aircraft, is really focused on younger assets because even though that is a very competitive market and the returns are competitive, they're a safer bet than older aircraft. We're also watching the huge volume of delivery--1,400 planes this year. Those planes are all fuel efficient and are attractive to take into fleet for sure, but what that does is it creates tremendous pressure on retirements and so that brings into question the whole depreciation and the appropriate rate of depreciation. I'm sure we could talk another hour about that alone, and I'm sure many of us would agree to disagree. Our strategy is to trade out assets before they get to that later stage. That provides a source of comfort in terms of equity ownership.

Even from a debt perspective, I think we clearly focus on the younger stuff. When we do look at older stuff, it's adjusting the leverage and the structure to accommodate what we think is more volatility around the later stage of the life of these aircraft.

***Domhnal Slattery:*** As always, the pressure is mostly limited to older vintages and less-efficient out-of-production aircraft types. Avolon's business model is focused on the very new end of the market, and we invest only in the most liquid assets, so frankly we have not seen any distress in the market. Yes, clearly values and lease rates are still in the lower half of their cyclical ranges, but there has been no let up in demand for SLB of aircraft delivering into the market, with acquisition prices remaining firm and, often, above the level at which we are comfortable participating. We are not alone in preferring to source aircraft through off-market transactions where we can find them, which tells you that investor appetite for best-of-breed aircraft is as strong as ever. On the trading side, where as I said Avolon has been very active, we also see consistent demand for good-quality assets, for which investors are prepared to pay sensible prices. We see no distress here, and although there are always going to be bottom fishers looking for bargains, they will generally not find them in aircraft that are less than five to seven years old.

Impairments per se are not necessarily bad or a sign that values have moved significantly against expectations. Where done on prudently and consistently, impairment can be a useful tool for managing the balance-sheet risk in a proactive way. In recent years, the very large lessor impairments we have seen have mostly been after a long period where no such regular exposure management had been taking place, and in many cases there was no trading either. All of the impairments are to older and out-of-production aircraft types that have fallen out of favor with the airlines or to freighter aircraft, where the market has been significantly less kind over the past four to five years, resulting in an enduring surplus of widebody capacity in particular. Also, value shortfalls that trigger an impairment might not just be a result of falling aircraft value; there could also be an element of value loss elsewhere, particularly in the level of maintenance reserves available, especially for older aircraft. This can be an issue where a lessor's accounting policy is to take a large proportion of reserves to profit early in the lease.

***Standard & Poor's:*** Do you see continuing sale-leaseback opportunities for the lessors? Paul, let's start with you because you have had some high-profile sale-leaseback transactions over the last two or three years with American Airlines and the LAN/TAM transaction. Do you see more opportunities similar to those transactions, or is it becoming more competitive?

***Domhnal Slattery:*** Yes, absolutely. Despite that we are supposedly in a weaker part of the cycle, there has been no let-up in the volume of RFP activity coming from the airlines or in the level of interest from lessors in taking up that capacity. As I have said, the industry has to find $125 billion a year to finance new deliveries at a time when the mix of funding sources is changing. I think that, notwithstanding the strength of the commercial banking market at present, that they will have difficulty in keeping up with demand and that their share will decline--along with that of the ECAs. The lessors are extremely well-placed to step into the breach, and we see leasing increasing its share of the market to 50% from 40% within 10 years.

We will be able to do this in part through the strength of our collective balance sheets, and we have seen a number of consolidation moves that give lessors very extensive internal funding resources. However, the leasing business model can also generate very attractive, low-risk, low-volatility returns for investors through the cycle. I believe that fixed-income investors will increasingly be attracted to the sector, providing lessors with significant new pools of capital to grow their activities significantly.

***Paul Rofe:*** Indeed, we see the opportunities. I think there is serious competition for the opportunities, particularly when you're dealing them when there are only one or two opportunities. They can be fiercely competitive with pricing, and we're not prepared to compromise our underwriting standards to go to some of the pricing levels we've seen. I think where we have been able to perform best, such as with the American and the LAN/TAM transactions, is doing something of scale. When you can go and do something of scale, that's encouraging for the airline themselves. They don't have to deal with four different sale-leasebacks here. Rather, they can deal with one in one single go, so I think that's been a good sign. The airlines seem to like that, but going forward, at the moment I don't see any relief in sight from having to do multiple small-scale transactions rather than one large transaction. I think that's going to continue. I think the airlines themselves have been adapting their behaviors over the last few years and are starting to realize that a bit of flexibility with leasing the aircraft is probably helpful for them.

***Standard & Poor's:*** Jessica, as a banker, do you get involved in financing some of these sale-leaseback transactions for some of the leasing companies, and do you see a lot of opportunities on the banking side?

***Jessica Gray:*** Many of the planes in our financed portfolios have been acquired by a sale-leaseback opportunity. We're not necessarily financing one-off transactions like a large sale-leaseback of multiple planes. A deal like that might be fantastic for an airline leasing company, but that's not the way we finance aircraft because it would give us exposure to just one airline. We wouldn't do that, but we would certainly finance it as part of a broader portfolio.

***Standard & Poor's:*** So you see more opportunities here as well?

***Jessica Gray:*** They're extremely competitive. I am sure Lion Air is going to be showing an aircraft or two for a sale-leaseback opportunity. There's no way they can't. I think that because of the volume of orders, as Paul said, there will be opportunities to continue to offer sale-leaseback.

***Standard & Poor's:*** What are you seeing in terms of competition among aircraft leasing companies, and do you see more M&A activity? What are you seeing from competitors in terms of aggressiveness in lease rates and such?

***Domhnal Slattery:*** The market has always been competitive. We have seen a significant increase in activity from the Asia-Pacific region, which has fuelled competition over the past couple of years.

Japanese banks and trading houses have been on the acquisition and growth trail, and of course the presence of very large Chinese financial institutions has also been increasing and becoming more global in reach.

We think that genuine M&A opportunities are quite limited, but there is more consolation to come, that's for sure. This is because of sustained interest from Asia in particular, but also in other parts of the world where, there is a growing awareness of the levels and quality of returns available from investment in the leasing sector.

***Paul Rofe:*** Let's talk about the competition among the lessors. As far as we're concerned--and you hear Gus Kelly talk about this from time to time--there are about seven to nine top-tier lessors that compete with each other to a great degree. We don't bump up against some of the other parties very often, but certainly when we look at pricing, there are still lessors that are trying to be very aggressive, perhaps because they need to put some equity to work. Chinese lessors in particular have tended to be fairly aggressive. It appears that they're all trying to out-buy each other.

Very often when we come up against a sale-leaseback contest or a regular leasing sort of contest, we're coming up with a regular asset. It's not often that we run up against six, seven, eight competitors at the same time. Sale and leasebacks are really where we're seeing some of the other competitors. The top seven to nine lessors haven't tended to compromise underwriting standards.

In terms of M&A activity, we saw the acquisitions of Jackson Square and the SMBC transaction. On the merger side we were probably the last one to do anything when we brought Genesis in there. It's pretty hard to do, but it can be done. We've all watched this Chinese situation with the ILFC with interest. Who knows how that's going to shake out?

***Standard & Poor's:*** You mentioned some of the Chinese leasing companies. ICBC and DBC are both adding to their fleets; they have orderbooks. Are you concerned about that?

***Paul Rofe:*** No, I think they'll possibly reach a certain size, a certain diversity. From our perspective, we're shareholders in the Chinese lessors ourselves anyway. We lease aircraft into China, and we're doing fine there. I'll be interested when one of these new leasing companies has to take back an aircraft for the very first time as well--whether it's a scheduled or unscheduled redelivery. But at the moment, we're not too concerned about them.

***Standard & Poor's:*** Jessica, as a lender to many of these lessors, what do you think about competition amongst themselves and M&A activity?

***Jessica Gray:*** I think in the areas where we're focused--the younger planes—it is very competitive. Some players are deciding not to go there in terms of the lease rate you need to accept for some of the opportunities because the returns may work for some and they may not work for others.

On the M&A side, the most recent news is that there's some private consortium looking for $2.1 billion of debt to take 80-some odd percent of ILFC, priced at 500 bps or so over LIBOR. If that's where it's at, that's a dramatically different valuation than what the Chinese were talking about, so it's a big mystery. I do think we're seeing increasingly different pockets of equity capital that are interested in aircraft. Most recently, it's been passive money that wants to be an asset owner but not necessarily own a platform, which is very interesting for a lot of the players that are in their growth mode. I don't necessarily see pending M&A. I'm sure it's conceivable, but I do think it's going to be interesting to see the way the industry evolves over the next couple of years.

***Standard & Poor's:*** What is your outlook for new issue volume and pricing in 2014 in terms of banks loans, EETC, and ABS, and what are the factors that will affect it?

***Jessica Gray:*** Clearly, interest rates are really important in thinking about what's going to transpire in terms of debt issuance. When you have deliveries that we've talked about $125 billion or something like that need to be financed, there's no question that there's going to be debt issued. Airlines that traditionally access the EETC market, which has been very attractive, will probably continue to do so. Leasing companies are looking at all forms of debt: unsecured, secured term loans, and then ABS. I think we're quite encouraged in the near term because of the relatively low interest rate environment. Some of the investors we've talked to are really getting their arms around aircraft once again and understanding that the structures are simple and easier to understand. The structures now also amortize reasonably well and have modest amounts of leverage. I think there will be other ABS transactions, though of course I'm biased and hope that it happens.

***Domhnal Slattery:*** Avolon has just posted a discussion paper entitled "Funding the Future" on our Web site. In the paper, we address both the requirements for aircraft financing over the next 10 years and the likely sources of that financing.

For 2014, we anticipate a total dollar requirement for new deliveries in the region of $110 billion. Close to $30 billion of this (well over 25%) will be sourced from commercial banks, more than $40 billion (approaching 40%) will come from the lessors, and just under $20 billion (16%) will be from the ECAs. About 10% will be cash financed by the airlines, with much of the remaining $10 billion coming from the capital markets.

***Paul Rofe:*** ABS is a market we are interested in. We've been a significant ABS issuer over the years anyway going through the life of AerCap and our predecessor companies as well. In terms of the total outlook, my view is straightforward and very similar to Jessica's. A certain number of planes are going to be delivered next year, and they're going to be financed through the various resources available to everybody. The taper is going to be a significant part of this--how it's going to be financed and when, where, and how much it's going to cost the various parties.

Right now, it seems that the bank market is there and available. I think you said earlier the European banks are returning there. I'm not sure the Germans ever went away, but certainly the French are starting to come back to certain levels. The EETC market has been hot and interesting in terms of foreign issuers now finding their way in. It was also interesting to see a non-household name like Virgin Australia being able to put a deal out. ABS is a really helpful market. I know as a lessor we'd have a slightly different view than others in our peer group, who don't feel that ABS is for them. We're very much in the same similar place as Avolon, who think it is a good product. With the environment in the right place for it, chances are you'll see us issue ABS in the not-too-distant future.

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