The *Return* to a NEW Normal

Preparing for a Post-Recovery Aviation Industry

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During the past five months, many individuals, corporate business partners, bankers, airline executives and associates have asked me, "When do you believe that the financial markets will return to normalcy?"

All of us have been severely tested in the past 15 months as the global financial system proceeded to effectively shut down. This virtual collapse ushered in the grandest scale of global government intervention not seen in 80 years. Few of us have lived through this scale of financial trauma in our business careers, and this question is critically important for a capital-intensive industry. It is my view that the problems that have been exposed in the financial system will not provide for a return to the norm of the past 10 years. The financial system will heal, and there are signs of this now. However, the financial system will be a different functioning entity. It will be stable and functioning but not as forgiving. It will be a "New Normal."

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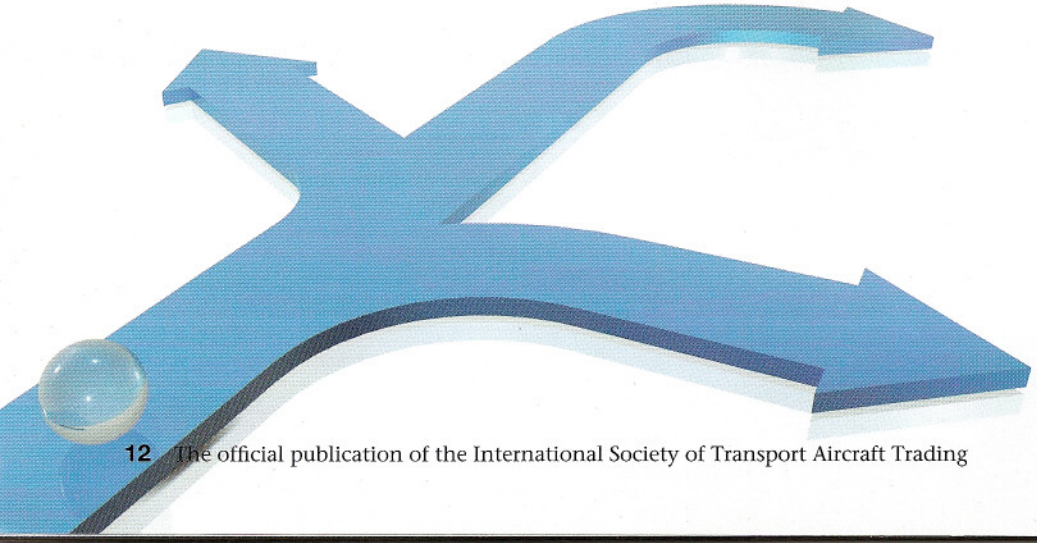


Regulations Galore

The aftermath of all crises typically yields more regulation. As we continue to pick up the pieces and rebuild the economy, there will be extensive modification of the current regulatory system, both domestically and globally. There will be a concerted effort to create international standards and even perhaps a global international regulatory body. This additional regulation will throw aside the view that completely free markets will be self regulating. The belief is now that mankind, left to our devices, will always go too far.

The alignment of mathematics, finance and physics will be called into question. It's clear from the failure of long-term capital in the late '90s, CDOs, CLOs and synthetic CDOs in the early part of this decade and the extensive use of exotic derivatives in recent years that there are more Black Swans than anyone ever imagined. The models that created the various instruments were clearly flawed in their formation. As such, various government regulations will attempt to walk a line between too much and too little. In fact, as I write this article, the U.S. Congress is drafting new regulations for financial institutions.

In this legislation, provisions have been proposed to disassemble even healthy institutions if it's deemed that they have engaged in risky behavior that could be systemic. If

provisions of this nature survive, this will clearly temper institutional behavior.

I do not have much faith that in the near term governmental bodies will get this right; we are destined for more regulation, and perhaps we should be. That companies could issue what was, in effect, an insurance policy—i.e. a derivative (credit-default swap)—for some instrument without maintaining some level of capital is astounding. In effect, this was 100 percent leverage, and it was off the balance sheet.

For companies that routinely rely on the capital markets, borrowing will become more difficult, loans will be more costly, advance rates will be lower, financial covenants will be more onerous, and increased amounts of capital requirements for loans, derivatives, etc., will make achieving a satisfactory return more challenging for financial institutions and financing more costly. All but the strongest financial companies will discover that the financing that was so readily available three years ago is nonexistent. In fact, I suspect that even the strongest companies will have challenges, as well.

Capital-Intensive Industry Challenges

For a capital-intensive industry, some companies will face severe challenges in funding their operations. At a minimum, pricing will become more expensive. Lease and loan commercial terms will be more onerous, and this will result in increased costs. This will ripple through the industry in the form of higher rates and ultimately will either be passed to the consumer or absorbed by the airline's already thin margins. I suspect that the new normal will look more like the 1970s or early '80s when capital was scarcer. However, much of this will be defined by the regulation that will be put in place. Governments will want to avoid the notion that any one financial institution is too big to fail.

This will clearly shape the new normal.

The capacity required to finance the 20,000-plus forecasted new deliveries of the next 20 years will undoubtedly require that the ABS market returns to a degree of health; there are currently some signs of it. These structures provide the proper asset-liability (ALM) match and the flexibility to weather the extreme cycles in this industry. The newer ABS structures, primarily the non-dividend variety, are performing reasonably well compared to the structures developed in the '90s. The newer ABS structures must incorporate more flexibility if they are to provide an enduring solution to aircraft finance. There will be no "wrapped" structures because the credibility of the monoline insurance companies is shot. Hence, there will be greater amounts of collateral protection and, as noted, higher pricing in the structure. The question will then become, "Can the financial community generate sufficient returns to provide capital to finance aircraft?"—capital that will be attractive to an airline or the lessor.

The New Normal and Aircraft Values

Finance and the ease of finance enhance the value of all types of assets, from refrigerators to real estate. Conversely, the opposite is true.

Easy access to low-cost wholesale capital during the pre-crisis era caused many banks to lose sight of sound lending. Capital is now acknowledged as a critical strategic asset and needs to be managed as such. Hence, banks will be more cautious in the structure and provision of loans. This will additionally be impacted by the new regulatory environment.

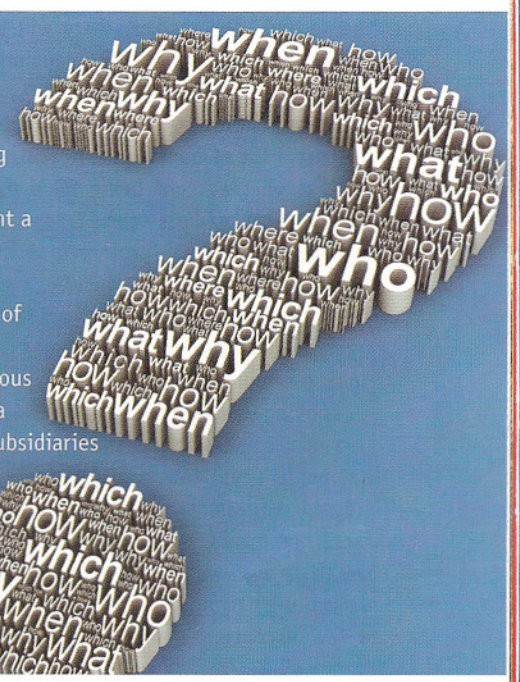
As such, aircraft-asset values will be under greater scrutiny. Appraisers will be challenged in greater numbers, and, generally, aircraft values will not be as frothy. This will be aided by the reduced number of financial institutions providing capital to the industry. For the next 24 months, it will be exceedingly difficult, if not impossible, to raise any amount of finance on the commercial terms that have been available during the past five years. Despite this, I was quite amazed at the recent successful execution of several airline EETCs given the fundamental, underlying credit quality of the various issuers.

Creativity Loves a Crisis

New ideas emerge when old ones fail. The financial crisis has changed the perception of risk—regarding companies, collateral valuation, proper pricing and transaction structure.

The financial crisis has challenged our beliefs in the competence of the models that were portrayed as forecasts for inherent risk. John Kenneth Galbraith once said, "The only function of economic forecasting is to make astrology look respectable."

In summary, this time it's different. The 2008-2009 crises present less intuitive understandings of the changes in finance that lie ahead. Many of these changes will be shaped by new regulation that is still being debated. Many of the changes will be as a result of back-to-basics fear. However, make no mistake—there will be a new normal.

What Could the Future of Aircraft Financing Look Like?

- Fewer banks would participate in the financing of aircraft or PDPs.
- Higher bank funding costs that would represent a protracted period of wider spreads.
- An ABS market, currently in disarray, could be restructured and re-priced with greater levels of equity and higher pricing.
- Unsecured capital markets could be very cautious and ascribe very little value to the quality of a parent company that does not guarantee its subsidiaries obligations.
- The ECAs could eventually be far more selective about those companies that they guarantee.
- Appraisals could be viewed with much greater skepticism.