HSH Nordbank Market Commentary

A Preview of the Aircraft Financing Landscape in 2010

Not too long ago, many market participants were speculating that there was a large financing gap for aircraft in 2009 with predictions for un-met financing needs running as high as 20 billion US-dollars. Some participants even speculated there would be a significant number of “white tail” deliveries during the year. More recently, the market has come to realize that any funding gap for 2009 appears to have been largely closed by manufacturer adjustments to their delivery schedules (i.e. moving aircraft delivery slots from less creditworthy to more creditworthy customers) and by increased export credit agency financing. With 2010 looming over the horizon, it is only a matter of time before there are renewed predictions of a severe financing shortfall. Indeed, in every year there is theoretical funding gap as not all financing is arranged for that year by the beginning of the year. Nevertheless, given the experience of 2009, we see signs any funding gap in 2010 could be closed by similar efforts to those taken in 2009. There are also some glimmers of hope that capital markets may be improving with US carriers accessing the EETC market sooner than many expected and with new sources of capital apparently beginning to enter the financing markets. With most economists expecting a recovery in 2010 and 2011, one can be hopeful that 2010 will be the last year of worries over a new aircraft funding gap for some time.

The New Aircraft Financing Market

The global market for new production transport aircraft currently amounts to about 68 billion US-dollars annually including aircraft produced by Airbus, Boeing, Bombardier and Embraer. In 2008, banks funded about 40% of the total, or about 25 billion US-dollars. Concerns of a pull back in lending in 2009 led many at the beginning of the year to conclude there was a significant funding gap. However, more recent estimates indicate that banks are on line to support about 18-19 billion US-dollars in funding, or about 27% of total funding needs in 2009. This suggests that the banking industry as a whole has not pulled back from the market as much as some feared, indeed, some new banking players have entered the market. In addition, banks in countries with rapidly growing aviation markets such as China appear to be increasing their interest in the sector although most of their financing to date has been to carriers within their domestic markets.

Most of the gap in funding for 2009 appears to be in the process of being filled by stepped up efforts on the part of the export credit agencies. Recent estimates show the export credit agencies backing some 18 billion US-dollars of large aircraft purchases in 2009 and the Canadian and Brazilian export credit agencies will back an additional 2-3 billion US-dollars in regional jet funding. This represents a significant increase from the 12 billion US-dollars or 20% of the total market financed by the export credit agencies in 2008.

To avoid a funding gap, manufacturers have been adjusting delivery schedules

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to focus on more creditworthy customers. While leasing companies are somewhat in a state of flux, there are still significant players interested in expansion and existing lessors have so far not sought to reduce existing commitments. Nevertheless, the sale and leaseback market for new aircraft is less robust than it was in 2008 leaving lessors to finance about 15% of total new deliveries or about 9-10 billion US-dollars, down from an estimated 12 billion US-dollars or 20% in 2008.

It is still not clear to what extent the manufacturers will have to provide vendor financing for 2009 deliveries although recent trends indicate vendor financing will likely be less than the 3-4 billion US-dollars each manufacturer could provide if they returned to historical maximum financing levels. Both manufacturers appear to be trying to avoid the use of vendor financing to the extent possible and to be keeping vendor financing available as a last resort in 2010 should market conditions warrant. Nevertheless, first half 2009 deliveries were largely covered by previous financing commitments made before the credit crisis so the second half of 2009 will more fully reveal the actual current state of the financing market.

Additional Production Cuts Likely but Not as Significant as Post-9/11 Cuts

On the wide body side the manufacturers have begun to reduce production somewhat in the second half of 2010 with Boeing announcing a cut in the production rate of its popular 777 line from 7/month to 5/month – about 30%. Airbus has cut estimates for the production rate of its A380 already in 2009 with a total of only 18 scheduled to be produced down from the 20 originally forecast. Additional delays in the 787 program also effectively amount to a production cut. Indeed, Airbus is hoping to capitalize on 787 delays and to keep its A330/340 line running at 8.5/month as a result.

The key question is to what degree the manufacturers will cut narrow body production rates. Airbus has scaled back its planned increase in production rates and currently plans just 34 A320s to be produced per month. This is down slightly from the 36/month rate in place for most of 2009. Boeing is holding steady with a 31 aircraft/month production rate on its 737NG family and has publicly stated it does not see a lower rate particularly while Airbus is producing more per month.

Given the complexities in ramping production rates up and down and given both manufacturers' needs for cash flow to finance their new aircraft programs, it is likely Airbus and Boeing will resist significant additional production cuts. If financing remains exceptionally tight it is likely both manufacturers will have to review narrow body production rates but it is likely they would resist cuts of greater than around 15%. This would be a significantly smaller reduction in production than the 30% seen overall after 2001 but may be justified given airline interest in renewing fleets in the face of fears over long-term oil prices once a sustained global recovery is under way.

Overall, manufacturers are somewhat protected today by record order books and the fact that manufacturing lead times on narrow body aircraft have declined over time. Moreover, customer differentiation of narrow body aircraft is significantly less than that in the wide body market allowing increased manufacturer flexibility to adjust order slots between customers without significant lead time constraints. However, if capital markets remain unusually tight, at some point in the second half of 2010 the easy production shifts between less creditworthy and more creditworthy customers will have been made and it will be harder to adjust production slots to ensure financing of aircraft. This increases the likelihood of narrow body production cuts later in 2010 if financing conditions do not improve.

Funding Gap in 2010 Likely to be Filled?

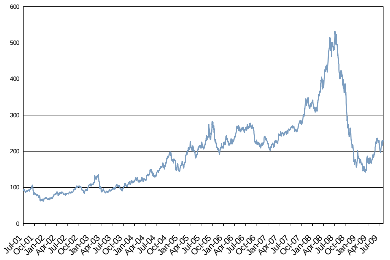
Assuming a roughly 65 billion US-dollar new aircraft funding market in 2010, any funding gap could probably be filled by export credit agencies and new bank participants even if credit market conditions remain similarly tight to conditions in 2009. If financing were to tighten further, manufacturers are expected to have some flexibility and to be able to provide up to 6 billion US-dollars in vendor financing without harming their credit ratings based on rating agency pronouncements so far. Additional production reductions of up to 15% on the narrow body side could also help reduce the volume of financing needs.

There have been several recent hopeful signs on the financing front. In addition to increased interest in financing on the part of Chinese banks, several European airlines have begun to access the bond market and airlines in the US were recently able to access EETC financing despite previous forecasts by many analysts that the EETC markets would be closed in 2009. The terms of the recent EETC offerings were much more onerous than in the past and it is not clear whether the recent issuances represent the beginning of a sustained re-opening of the capital markets to aircraft finance or just a limited time opportunity created by a technical rally. Nevertheless, these recent transactions are a hopeful sign. In addition, several global EETC-type securitizations are in the works offering securitized aircraft debt backed by export credit agency guarantees. While previously export credit guaranteed debt was mostly provided by banks, opening the capital markets to debt carrying such guarantees should widen the availability of capital to the aviation industry and continue to lessen the risk of any significant funding gap. Over the longer term, as credit markets continue to thaw over time, beyond 2010 banks will return to the market and begin to displace the need for export credit financing.

By Daniel W. Stone

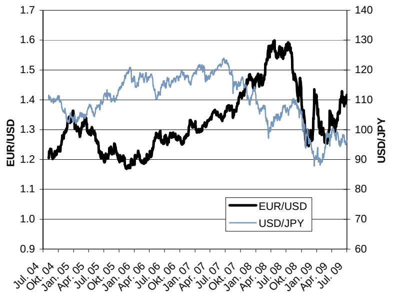
Airline News

Jet Fuel Price Index



Source: HSH Nordbank; Base year 1991 = 100; Average of the spot markets US Gulf, US West coast, Mediterranean, Rotterdam, Far East Singapore.

Currencies



Source: Bloomberg

U.S. / Americas

Continental Airlines to join Star Alliance and wins clearance to join United in alliance within the Star Alliance Group

The US government approved Continental's bid to join the Star Alliance. Continental, the fourth-largest US airline and currently member of the SkyTeam, will join Star, a group of more than 20 US and international airlines, in October. Federal regulators also granted Continental immunity from antitrust laws to work with Air Canada, Lufthansa and United Air Lines in a new joint venture within the group (called Atlantic Plus-Plus) – letting them act as a single carrier on international service. But the regulators carved out several routes where the airlines must continue to compete separately, saying there wasn't enough competition from outside carriers. Those include four routes between New York and European cities, four between the United States and Canada and all flights between the United States and Beijing. The Transportation Department said it could lift the carve-outs – letting Continental and other airlines act together on setting prices and schedules – if new competition arises in any of those markets.

Copa Airlines to buy 13 more Boeing 737

Latin American firm Copa Airlines said it has ordered 13 Boeing 737-800 airplanes, worth about 1 billion US-dollars at list prices and has options for an additional eight. The order represents a mixture of option conversions and new orders and brings to 27 the number of Boeing Next-Generation 737s the Panamanian airline has on order. The 13 newly-ordered planes are set to be delivered between 2012 and 2015. The options for eight more are running through 2017. The national flag carrier of Panama operates passenger and cargo operations. Its main base of operation is Tocumen International Airport (located about 24 km from Panama City), from where its operates approximately 144 daily scheduled flights to 45 destinations in North America, Central America, South America and the Caribbean.

Europe

New Iberia CEO wants to close merger with BA

The chairman of Spanish airline Iberia stepped down and was replaced by proven dealmaker Antonio Vazquez, an appointment seen as boosting chances of a merger with British Airways (BA) as he does have experience bringing companies together. While he was chief executive at tobacco company Altadis, Mr. Vazquez oversaw the sale of the Spanish company to Imperial Tobacco Group for 12.6 billion euros. He also helped to negotiate a joint venture with the Cuban Government to sell cigars internationally. Mr. Vazquez, who was a board member at Iberia between 2005 and 2007, said that his aim was to seal the deal between Iberia and its rival BA. Iberia's top shareholder Caja Madrid, with a 23 percent stake, also supports a merger with BA. In June, Caja Madrid Chairman Miguel Blesa said he hoped the two carriers could reach an agreement about the merger before summer, but added little progress had been made in recent months. The two companies have been in talks for a year, but the merger plans have been hit by a series of complications. BA's pension deficit of more than 1.9 billion euros is seen as a key hurdle in merger negotiations. Iberia has no financial debt and roughly 2 billion euros in cash.

Asia Pacific & Middle East

ANA to raise money for new planes

All Nippon Airways (ANA) announced plans to raise up to141.7 billion yen (~1.53 billion US-dollars) through a planned public share offering to shore up its finances and to help pay for additional 787 aircraft. Japan's second-largest airline has increased its order for Boeing 787 planes and now plans to buy 55 Dreamliners, up from a previous order for 50 planes. Total funds to be raised are about 19 percent less than the amount ANA had earlier hoped for, after the company's share price fell 20 percent from July 1, when it initially announced the share sale plan. The airline is selling stock for the first time since 2006 even as international passengers have fallen the most in more than five years amid Japan's worst postwar recession. In April, ANA announced a net loss of 4.26 billion yen (~46 million US-dollars) for the financial year to March; its first annual loss in six years.

China Eastern to acquire Shanghai Airlines

Finalizing a major consolidation for China's troubled aviation industry, China Eastern Airlines said it would buy its smaller rival Shanghai Airlines in a share swap valued at 9 billion yuan (1.3 billion US-dollars). Under the announcement, each share of Shanghai Airlines will be exchanged for 1.3 China Eastern shares. China Eastern said the merger would help expanding its market share and integrate resources in Shanghai, China's biggest business centre and major transportation hub. The combined carrier will control more than half the Shanghai market and will be the second-largest airline in the country after China Southern. Shanghai Airlines will become a wholly owned unit of China Eastern and retain its brand and independent operations but will be de-listed from the Shanghai stock exchange after the merger. China Eastern also announced it planned to raise about 7 billion yuan, or a little over 1 billion US-dollars, in a new share issue in Shanghai and Hong Kong, where it is already listed. The merger between the two loss-making carriers is intended to create an airline that can compete more effectively with domestic rivals Air China and China Southern Airlines. Chinese carriers have been grappling with weak air travel demand amid high fuel prices and slower economic growth. The country's top three airlines lost more than 4 billion US-dollars in 2008 after years of double-digit growth.

HSH Nordbank News Corner:

HSH Nordbank closes a Pre Delivery financing covering 10 Airbus A330 for AerCap

Hamburg/Kiel, July 2nd, 2009 – HSH Nordbank has closed a PDP financing for AerCap Holdings N.V. covering 10 Airbus A330 aircraft. This transaction, which serves to provide advance financing during construction of the aircraft, is worth approximately USD 221 million. HSH Nordbank is the sole arranger and underwriter of the facility. The aircraft are to be delivered between 2009 and 2012 and will be leased to several aviation companies. “After a USD 270 million PDP financing for AerVenture in 2008, HSH Nordbank continues its large number of successful transactions for the group with this deal. We are particularly pleased to have assisted this key client in financing all their remaining Airbus PDP needs despite the difficult market environment”, says Angela Behrend-Görnemann, Head of Global Aviation at HSH Nordbank. AerCap Holdings N.V., headquartered in the Netherlands, is a NYSE listed, integrated global aviation company with a leading market position in aircraft and engine leasing, trading and parts sales.

Olaf Sachau and Volker Fabian new Joint Managing Directors at Amentum Capital Limited

Hamburg/Kiel, July 3rd, 2009 – Olaf Sachau and Volker Fabian are appointed as new joint managing directors at Amentum Capital Limited. Sachau and Fabian succeed Christian Hatje who led Amentum Capital from 2005. They join Amentum from HSH Nordbank where they both held leading positions in the business unit Transportation Finance.

“I’m delighted that Olaf Sachau and Volker Fabian are joining Amentum Capital. With their extensive managerial, financial and industrial experience they are strengthening our asset management company. Amentum is of significant importance to HSH Nordbank’s Transportation Finance unit. We are planning to further expand the business model from primarily an asset manager for the fund industry to a more comprehensive service provider for the aviation industry”, says Mathis Shinnick, Chairman of the Board of Amentum Capital Ltd.

Olaf Sachau’s previous function within HSH Nordbank was Head of Global Commodity Finance after three and a half years as Head of Aviation EMEA and India. Volker Fabian held the post of Head Aviation EMEA and India within HSH Nordbank London since August 2008.

The Dublin based Amentum Capital Ltd. was established in 2005 as a joint venture between HSH Nordbank and Deutsche Anlagen Leasing (DAL). Amentum offers a broad range of asset management and aviation advisory services to the airline industry and the investment community, delivered by a dedicated team of 14 professionals with extensive aviation and finance experience.

James Paterson becomes new Head of Origination Aviation EMEA at HSH Nordbank

Hamburg/Kiel, July 6th, 2009 – James Paterson has been promoted within HSH Nordbank to Head of Origination Aviation Europe, Middle East, Africa and India (EMEA). He will thus be in charge of HSH Nordbank's aviation business in the EMEA region and will report directly to the Head of Global Aviation, Angela Behrend-Görnemann. Paterson, who joined HSH Nordbank in 2007, was previously Deputy Head of Origination Aviation EMEA and Head of Structuring and Analysis Aviation EMEA. Paterson succeeds Volker Fabian who is appointed as managing director at Amentum Capital Limited.

Upcoming Events

2009	Organization/Company	Event/Announcement
August		
4	Austrian Airlines	Half Year Results
5	Cathay Pacific Airways	Half Year Results
6	SkyWest	Half Year Results
	Fraport	Half Year Results
7	Japan Airlines	Results of Q1
	Finnair	Half Year Results
9	China Eastern Airlines	Half Year Results
12	SAS	Half Year Results
	IEA	Monthly Oil Market Report
14	Frontier Airlines	Results of Q1
19	Mesa Air Group	Results of Q3
24	China Southern Airlines	Half Year Results
	Malaysia Airlines	Half Year Results
25	Air Berlin	Half Year Results
	Air China	Half Year Results
27	Virgin Blue	Full Year Results
28	AirAsia	Half Year Results
	EVA Airways	Half Year Results
30	Shanghai Airlines	Half Year Results
31	SkyEurope	Results of Q3
	Iberia	Half Year Results

Source: HSH Nordbank, Bloomberg