

Pushing boundaries

Primer and pitfalls of expanding beyond home markets for Asian lessors. By David Yu, CFA

In the last few years, there have been many new entrants to the aircraft leasing industry, particularly in regions of emerging growth such as China and Asia. The growth in China is both driven by the demand, the opportunity and the beneficial regulations aiding the industry. While some players are existing investors in other areas of leasing, others are new investors looking at the attractive asset class. All of them share

key similarities in their growing appetite for aircraft leasing and the view that it is a safe, yielding investment backed by physical assets. While a solid game plan when aided by good investment thesis, structuring and financing, all investments carry some inherent but controllable risks. There is an observed increased push to gather assets. This growth is often without a broad plan, a full risk analysis, or the proper technical reviews before entering into

transactions. The emphasis seems to be on growth and the creation of a platform. The easy option is always to buy a ready-made business with an existing team to operate it. The issue with buying an existing business is that one often buys the good with more challenging assets. The view of many is that much of the upside is extracted at this stage by those who have taken the time to create the portfolio. The challenge is to ensure that there is still value to extract when

ownership is transferred.

While some of the players are small and others large organisations, all of them possess one key attribute – home market advantage in terms of location. This article focuses on China but the same principles can be applied to other Asian markets and regions. Both Airbus and Boeing project in their analyses that China will deliver over 6,000 aircraft over the next 20 years. Given the trend of an increasing percentage of leased

aircraft versus the overall fleet size to 40% and beyond, both the increase number and percentage this implies, the industry will continue to grow. In addition, there are new regulations and incentives in some countries that support the growth of the industry. China, Singapore and Hong Kong are looking to attract leasing platforms. All of these factors are increasing demand for additional deals and have increased the demand for more overseas deals and

expansion. This thirst for growth is also where some difficulties might arise.

Where do you begin when you develop the desire to build a new or expand an aircraft leasing company? First, you need the contacts. This takes time and you need to build trust with your suppliers, customers and financiers. Also, regardless of whom your sponsors might be or how much money you have to invest, this still takes time. To be able to make contacts you



need feet on the ground and the ability to travel. Chinese lessors often have no budget for dealing with this step. Unless you are working exclusively with the home market, ie Chinese market, you will need to establish and setup overseas offices or networks which enable you to be closer to customers and create long term legitimacy for that market, thus creating more opportunities. This also allows your organisation to be closer to the pulse of business and creates intelligence to feed the overall strategy. This is a challenge.

CORPORATE AND LEGAL STRUCTURE

One needs to have a corporate and legal structure to enable the office, be it a satellite or full office, to allow for flexibility and access for local customs. This can be achieved easily through using outside consultants or lawyers who have learned from best practices elsewhere. One of the key challenges is not allocating a suitable budget for the office and its operational costs including staff & advisers. Establishing a presence abroad creates increased competition from 'local' home market lessors that now view you as more of a threat. Established offices have cultivated relationships which sometimes take years to develop with the same target

customer base. This is not to say that there are not drawbacks to being a more mature company versus a new entrant but in essence this is an uphill battle in terms of business development.

PEOPLE TALENT

Another challenge is people talent and how to recruit top talent for your office, who can bring the experience and network base to get started more quickly and efficiently. New leasing companies need instant contacts and experience and this can be achieved without buying a platform. That said, often new entrants are shocked by the salaries and perks offered to qualified and experienced personnel in places like Ireland along with the high costs of operation. Some have used the model of moving their employees who have no experience with the market to staff up the new office but over time this is unsustainable as it butts against local employment regulations which generally require a percentage of local hires and employment social contributions and other benefits. Others have opted to hiring recent graduates, which is an interesting policy but while graduates may have superior paper qualifications they lack experience and personal relationships with the airlines and aviation community. Experienced

aviation people trade information and favours developed over time. Purchase, sale and lease deals are done not only on commercial terms but are also based on trust, previous experience and a sense of mutual understanding. In the absence of relationships, favours and information, lower economics is the only way to win deals.

TECHNICAL

Technical areas are often given to former engineers from Chinese airlines but while an engineer may understand one or more aircraft and engine types, they often have a limited knowledge of the market in general and look at aircraft purely from an airline point of view. A technician from a leasing company looks after the interests of the lessor, which may be different. Technicians rely on estimates from parties that publish manuals but have rarely been involved with actually contracting third parties to do the physical work and often have knowledge from only one arena of operation. Getting a permission to travel for inspections and language barriers can sometimes cause problems.

ADVISORS / CONSULTANTS

When there are gaping areas of need, some are often unwilling to pay the



market rate or any amount for outside consultants or contract operatives. The budget for this type of activity seems to be more geared to training their own staff but that assumes you can learn the business remotely from a third party. It is also interesting to see who is doing the training and one questions whether those imparting knowledge actually have any first-hand experience themselves. As one sees in many industries, the experience and professional network cannot be easily replicated. One exception in my opinion is BOC Aviation, which inherited an experienced and international team from its acquisitions that are imparting their knowledge to their new shareholders and their representatives but which appear to have been given the autonomy to do what they do well given their experience and knowledge of the market.

MARKETING

A lack of travel budget and client marketing allocation also creates problems. The need to visit clients and potential partners and speak in person is very important. In the current environment in China, given the hard time of obtaining permission for international travel this really dampens the business and creates no

bond between the lessor and lessee. This makes it harder and takes longer to move up the learning curve especially competing against well entrenched and funded competitors who cultivate their contacts, are very social and visit often.

TRANSPARENCY AND BRANDING

The hierarchy of Chinese leasing companies often means that the bureaucracy is at a level which is alien to the wider aviation community. There are often boards that don't trust what their own management is telling them and this often results in conflicts with airlines, OEMs and the finance community. The sponsors of leasing companies must develop a trust in their management and allow them the authority (within limits) to transact without further recourse. There are ways to make it work under a Chinese corporate system. The current methods of operating will effectively rule out most of the Chinese leasing companies from the wider market as decision making is too cumbersome. Airlines cannot wait months for an answer and most transactions involve sitting round the negotiating table and trading points in real-time. Often there is another leasing company in another board room trying to secure the same deal. Buying new and long leases should

give Chinese leasing companies time to build up their knowledge, procedures and teams but the task will need to be accelerated.

THIRD PARTY PACKAGED DEALS

To augment organic growth, a new investor can buy packaged deals from other leasing companies and investors. Usually these deals allow the selling party to continue as manager without much thought. There are obvious pros to this arrangement including better asset management and know how including systems but there are drawbacks as well to be aware of. This can create conflicts of interest in terms of investor-owned aircraft and the manager-owned aircraft. In addition, some leasing companies will also restrict and prevent new entities from direct contact with the operators. This reduces the exposure of their brand and at the expense of their own team members cementing future relationships for the selling manager. Plus, you also fail to collect market intelligence first hand and real time. Other alternatives include third party managers with no direct ownership stakes. Each firm needs to weigh the pros and cons carefully before making a decision.

As an industry, aviation is a club and full membership takes time to achieve. Also a reputation is everything and new players lack reputation unless they appear with large budgets and recognisable team members. Reputation is something that takes time to develop and getting off on the wrong foot can take years to rebuild.

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