Time for a **shake up**

Prof David Yu, Istat-certified aviation appraiser, looks into the wholesale changes coming in the Chinese leasing landscape.

The increase in China-owned operating lessors and the growth of the Chinese airline market has been significant since the restart of the leasing sector in 2007, bolstered by the enactment of legislation allowing for bank-owned leasing companies.

These foundation lessors had the good fortune of timing, starting business in and around 2008 at a low point in the aviation cycle post the great financial crisis. While these firms are broader asset leasing companies, aircraft leasing represents a very large percentage of their overall portfolios.

In *Airfinance Journal*'s 2018 Leasing Top 50, Chinese-owned lessors represented two out of the top 10 and overall 12 out of the top 50 by number of aircraft, which represented 23.4% of the top 50 compared with none in 2007. Ranking by market value shows similar results with 11 places in the top 50, representing 25.3% of the top 50 aggregate values.

According to my research, the latest figures show that there are 89 lessor companies with at least one aircraft under lease, registered onshore. While that is a large number, from my conversations there is more potential for new entrants to the space, comprising of mostly of large conglomerates, both state-owned enterprises and private companies.

Some of the reasons given for not entering are the shortage of locally or former patriot skilled labour, technical understanding, perceived lower market returns and ultimately trust given the large asset sizes.

While there is a large onshore lessor presence, the number of parties with offshore subsidiaries (mostly in Ireland, Singapore and now Hong Kong) has grown and they can more readily access the international markets and trade assets. It is limited mostly to the bigger players. There are many Chinese policies that are promoting this increased presence abroad, including the Belt and Road and Made in China 2025 initiatives, among others.

There are challenges to more internationalisation. One particular issue is the availability and ease of accessing foreign exchange because these assets are predominantly dollar based.

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Domestic policies to increase business efficiencies such as decreasing the overall debt burden, especially at the local and provincial levels, is a positive development but might cause short-term liquidity pains creating a balancing act as overall growth slows domestically. Other policies such as the creation of potential industry national champions through consolidation, such as in shipping, are bound to affect leasing at some point as well. The recent implementation of global and local accounting rules causing leasing assets to be brought on balance sheet instead of traditional off-balance-sheet treatment will also cause some dislocation.

Of course, there are not just internal policies affecting these trends but also global and regional issues such as the current US-China trade negotiations, and general cross-border investment receptivity in the other regions such as the EU and Asean (Association of Southeast Asian Nations) will have immediate and longer impacts as well. These are just some of the drivers, which will be discussed in more depth in my other working papers.

With the emergence of large numbers of lessors in China, local (and global) airlines have had more bargaining power but this is not forever. Not just sale and leaseback transactions but more seriously is the issue of large speculative orders by lessors.

There are not many choices for those burdened by near-term deliveries, because the highly competitive market is driving down terms and rates, which results in deals that are highly dependent on the back-end residual values and on the terms of the second lease. The competitive current situation is yielding many deals with returns of about 4% after leverage, which is unsustainable unless the cost of capital is near 0%, creating a risky proposition for lessors which have thin margins throughout their portfolios. These factors have contributed to the global aircraft market just recently turning, which was written about last year. This turn has been especially acute in Europe and for mid-life and older assets.

Even with all the challenges, this continued intense competition onshore will have the following results:

- continued spillover effects forcing lessors to setup and expand internationally for access to additional markets;
- de-risking; and
- market consolidation along with mergers and acquisitions.

The process of expansion takes significant efforts and approvals, which not all parties are able to achieve. De-risking such as selling to public investors through asset-backed securitisation transactions done internationally has not caught on onshore compared with other asset classes. With such low overall returns, there is not much cushion for exogenous and idiosyncratic shocks that might occur such as interest rates, fuel or others that are of the causes for recent European airline bankruptcies.

Reorganisation of the market is quickly around the corner with the recent HNA 30% sale of Avolon to Orix, and more lessors are available for sale. The resulting consolidation is overall net positive for the market and its long-term players, because increasing concentration among fewer players left will hopefully bring a more sustainable market return risk prospects.

The key is orderly processes assuming two or more willing parties involved and it is not because of more dire situations where regulators play a bigger role in matchmaking. The long-term fundamentals are still good, which bodes well for the industry but intermediate corrections through the business and economic cycles are not necessarily bad things.

All opinions expressed are the author's own. The author is contributing editor and Adjunct Professor of Finance at New York University Shanghai, where he teaches and focuses on cross-border investing, financing and real assets. He is also managing director of Inception Aviation, Istat-certified aviation appraiser. David Yu can be reached for comments or suggestions at **david.yu@nyu.edu** *and twitter* **@david_yuda**.