



KEY POLICY ISSUE

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AIRCRAFT FINANCING: THE EMERGENCE OF CHINA

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From 1980 to 2008 the number of aircraft under operating lease increased by over 13% per year to 6,500 aircraft equivalent to 35% of the world fleet¹. Aviation is a highly cyclical/GDP correlated industry so the current economic “finance driven” crisis has directly affected aircraft leasing providers (Lessors) by way of a double whammy: lessor financing and their finance and leverage driven parent companies. Nevertheless, economic data shows that China is in a better position of liquidity than most of the Western economies. The question is, could a country like China help to “weather the current storm” and turn this crisis into an opportunity by paving the way to become a key player on the leasing markets?

During the past 10 years the Chinese economy has been growing at an impressive average yearly rate of 9.03 % and had increased its foreign currency reserves to US\$1.95 trillion by the end of 2008. China could become the world’s largest economy by 2041² Chinese Banks are among the top 20 world companies having substantially improved their balance sheets. In fact, China Banking Regulatory Commission (CBRC) issued new management rules for financial leasing companies, allowing local and overseas banks to set up financial lease companies. This initiative could help to provide close to the US\$ 400 billion required to buy and/or finance more than 3,000 aircraft, required by China over the next 20 years³

Why China should emerge as a key player on the market?

The main reasons are⁴:

- *China’s macro economic situation*

China is the second largest economy in the world with a GDP of US\$10.8 trillion at purchasing power parity (2007) and, according to the IMF, it accounts for 11% of the gross world product. China’s explosive GDP growth which led its big trade surplus and direct foreign investment inflows together created a continuous foreign reserves growth that totalled US\$1,945 billion (2008). This could be used as a powerful economic tool to counterbalance global recession by way of supporting the Chinese banks’ credits. On the other hand, due to the recent GDP growth in China, the People Bank of China’s overnight reference rate has been going down.

¹ Ascend 2008

² Goldman Sachs 2003

³ Airbus GMF 2009 (Passenger aircraft)

⁴ Darcy Olmos - ATRS World Conference 2009, Financial crisis & leasing markets: The emergence of China



- *China financial regulatory changes: leasing*

The CBRC issued new Management Rules for Financial Leasing companies in January 2007 lowering the minimum required registered capital for financial leasing companies from Rmb500m to Rmb100m. This permitted local and overseas commercial banks to set up financial leasing companies, provided they complied with a set of requirements, including a capital-adequacy ratio of no less than 8%, total assets of no less than Rmb8bn, and being profitable for two consecutive years.

The Ministry of Foreign Trade and Economic Co-operation also issued regulations for foreign-invested leasing companies in 2001. Under these rules, all foreign-funded leasing concerns must be set up as businesses carrying limited liability and be classified as financial leasing companies or non-financial leasing companies. A foreign financial leasing company must have a registered capital of at least US\$10m (lowered from US\$20m). In a joint effort to form foreign-funded companies, the Chinese partner must have total assets valued at no less than Rmb400m one year prior to its application. The foreign partner must have assets valued at a minimum of US\$400m and must have been engaged in business for at least five years.

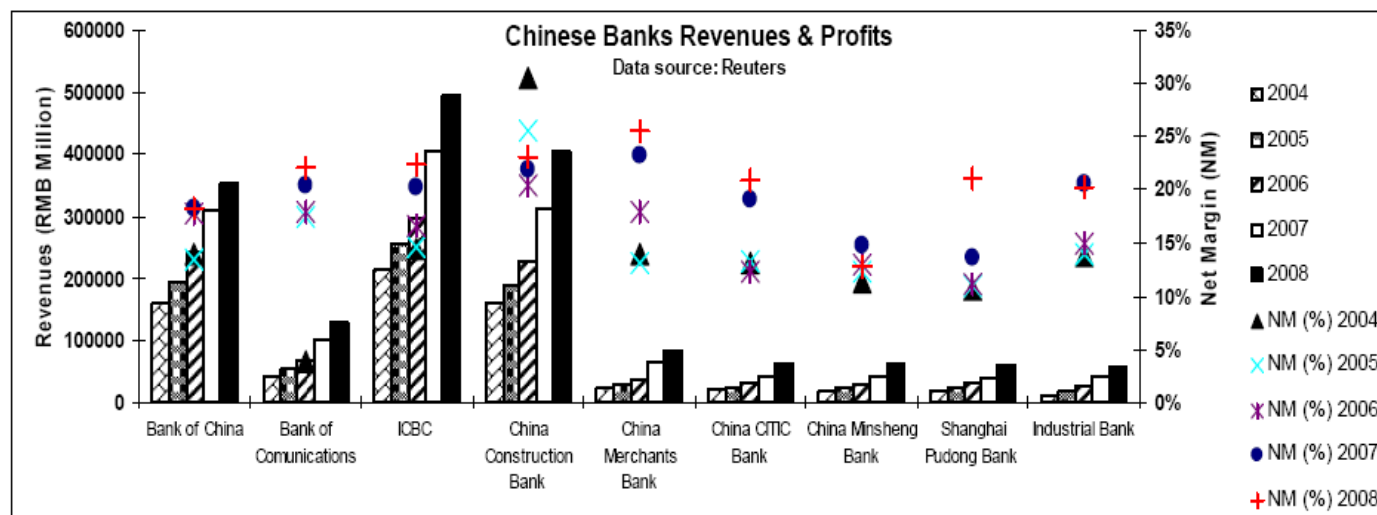
- *Chinese banks: financial situation*

China's financial system is dominated by a large but underdeveloped banking system. China's domestic banking system is made up of five state-owned commercial banks, two private banks, 12 joint-stock commercial banks, and urban and rural co-operative banks. According to the CBRC, the five large banks dominate the sector, accounting for 52.6% of total assets (Rmb52.6trn) of all banks and financial institutions and also 52.6% of all deposits (Rmb49.6trn) at end-March 2008.

In terms of sector activities, consumer lending has seen strong growth in recent years. The share of consumer loans in total loans is estimated to have approached 20% in 2007. The largest component of consumer loans is mortgage loans, which account for more than 80% of consumer loans and the sector has reported rising profit growth in recent times. Fee-based income from credit cards and wealth management products has been growing but still makes up a small portion of the banks' earnings only. For instance, the non-interest incomes for the Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB) and Bank of China (BOC) are 12.8%, 12.7 % and 19.9% respectively while US counterparts such as the Bank of America and Citigroup are 50%. Non-interest income is estimated to contribute to around 20% of the total revenue for Chinese banks; therefore there is lots of potential to move to other "less explored" business such as transport finance as a way of improving diversification and profitability.

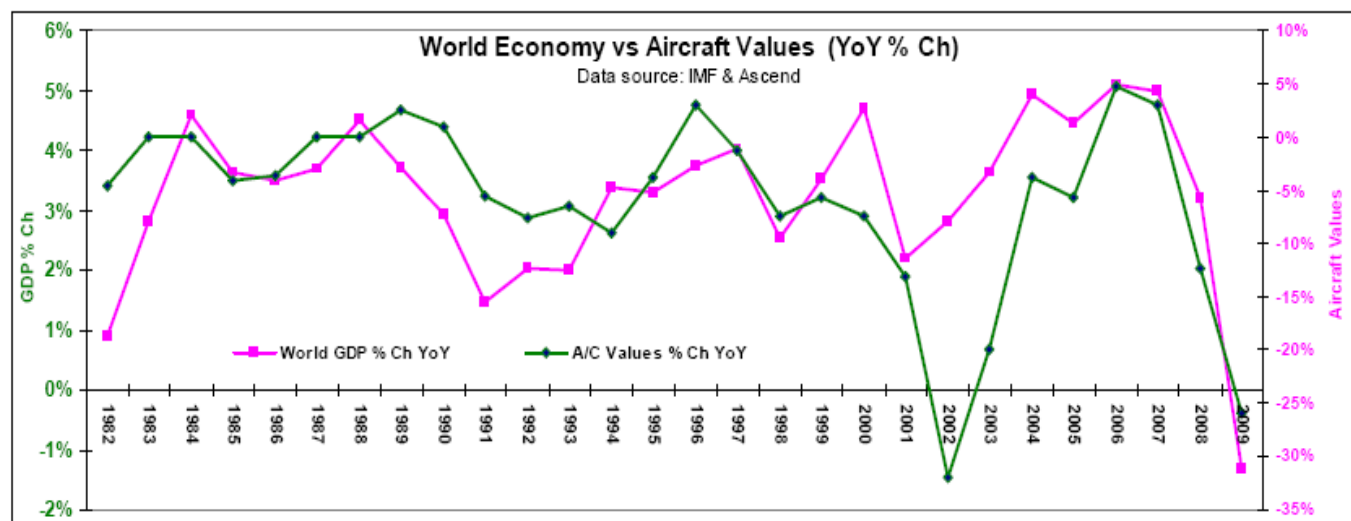
ICBC and the Bank of Communications set up financial leasing firms in November 2007. The following month, CCB launched CCB Financial Leasing Corp, a joint venture with Rmb4.5bn in registered capital,

with CCB holding 75.1% and the Bank of America holding the rest. The China Minsheng Banking Corp established a Rmb3.2bn leasing firm in April 2008, holding an 81.25% share, while the investment unit of the Tianjin Free Trade Zone, in the northern port city of Tianjin, held the rest of the company. Also in April 2008, the China Merchants Bank established a Rmb2bn leasing company in Shanghai. In June 2008, the China Development Bank set up a Rmb7.5bn financial leasing company in Shenzhen, the largest player in the field so far. BOC did not immediately consider a domestic leasing company, focusing instead on overseas expansion after it acquired the Singapore Aircraft Leasing Enterprise, Asia's largest aircraft leasing company, in December 2006.



- *Aircraft Price Trend*

The current crisis is affecting aircraft values which follow world economic trends. A correlation coefficient of 0.53 between a pool of “representative aircraft” values (Boeing 737/300/800, 767-300ER, 747-400, MD 82, Airbus 320-200 & A330-200) and the world GDP was found in my recent research



Conclusion

The has recently been a deterioration in the main aircraft current market values, in line with the high correlation found between GDP growth and aircraft values. However Chinese banks and/or Lessors could find a long term incentive to focus on aircraft rather than on other types of goods. The main reasons for this are that aircraft retain their residual value better through their mobility and earning capability and act as a good hedge against inflation. It is also worthwhile to note that manufacturers, such as Airbus,

have decided to build an assembly line in Tianjin motivated by the big backlog of A320/330 with Chinese airlines.

A number of factors, such as aircraft needs for the next 20 years, a good liquidity position, profitability trend, more market oriented regulation trends, lowering interest rates, aircraft prices and aircraft investment benefits place Chinese banks in a strong position to weather the storm and to turn the crisis into an opportunity thus becoming key players in the aircraft financing and lease market.

The current crisis could be used to gain markets and also to build necessary technical expertise. Nevertheless, although aviation is an international industry, there is a likely world tendency for banks to refocus on national interest due to government pressure that could come after big bailouts, which used tax-payers' money. The Chinese Government could follow this behaviour due to its presence in the main banks and its aim to stimulate the local economy and state owned businesses. Hence, it is quite likely that the Chinese aviation finance industry will be focusing, at least in the short term, on aircraft financing deals mostly for Chinese carriers, for example ICBC leasing finance lease deals 2009: 3 A320s for Spring Airlines and 3 A320s for Shenzhen Airlines, which doesn't exclude using the strong funding potential for foreign carriers/deals in the long term - probably as part of the Chinese long term leasing /financing strategy. For instance, the Bank of China bought the Singapore Aircraft Leasing Enterprise (now BOC Aviation), beating strong bids from Allco, DAE capital and Standard Chartered. Chinese banks can also be found on several different consortia bidding for ILFS and RBS Aviation and are one of the few capable of closing large sale and leaseback deals (e.g. BOC with Air France and Southwest).

In the early 1980s French, German and British banks were key to aircraft financing. In the late 1980s and 1990s Japanese and German banks led the market. French banks have dominated much of the start of this century but in the years to come the emergence of China in the aviation leasing and aircraft financing markets is a key trend that should be taken into account by airline managers and aircraft manufacturers who want to secure deliveries in the current liquidity crisis environment.

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