Institutional investors are looking for profitable investments with stable, predictable cash flows. In traditional bond markets, these goals are difficult to achieve at the moment. Aircraft financing can serve as a safe and worthwhile alternative. Aviation leasing investments have long been a firm and stable portfolio building block for Anglo-American investors. German institutional investors, however, have only recently begun to show an interest in these alternative investments.

The investment pressure on institutional investors is growing. Insecure times, low interest rates, rising inflation and regulatory uncertainties feed the search for security and adequate returns worldwide. One thing to note is that investing in a well-known investment universe is not enough, and if you wish to diversify your portfolio with alternative investments, you need to approach new asset classes in a selective and knowledge-based way and rely on experienced specialists. Historically, aircraft financing has rarely not been the focus of German investors, in contrast to those in the Anglo-Saxon world. Nonetheless, there are good reasons to take a closer look at this alternative type of investment.

Contribution to diversification

In an investor’s strategic asset allocation, aircraft investments make an important contribution to diversification, as their investment-specific risks are only slightly correlated with the risks of traditional assets. They lead to increased portfolio efficiency in a balanced investment portfolio and should therefore be an integral part of a long-term portfolio strategy. They supplement, for example, real estate and infrastructure investments, for which in many cases the risk budget has already been exhausted, or for which there is no sufficient or appropriate deal flow. Regarding “Solvency II”, this is likely to be of particular interest to institutional investors, especially given these diversification effects. By absorbing illiquidity, complexity and structuring premiums, aircraft investments offer attractive risk/return profiles, which are difficult if not impossible to achieve with many traditional bonds in the current market environment. In credit assessment, first priority debt tranches are usually investment grade while subordinated tranches bear interest on a level comparable with high-yield bonds, while benefiting from the aircraft asset as collateral.

The value of mobile real assets

Aircraft are mobile assets which can be flexibly deployed worldwide in line with demand. As part of a leasing transaction, market-specific risks such as cyclical downturns are mitigated by long-term contracts, while operating and cost risks are borne by the lessee – in this case the airline. Commercial aircraft are highly fungible thanks to high levels of standardization amongst aircraft types, and a broad user base amongst aircraft operators. A good example of the value of aeroplanes is the takeover of up to 40 aeroplanes from the now insolvent Air Berlin by Lufthansa. In case of an unplanned exit from an aircraft investment, even in a difficult market environment, shorter turnaround times can be expected than in real estate or private equity investments. Aircraft leasing investments therefore offer bond-like, predictable and secure cash flows.
Good data base

Large amounts of data are available to assess both the value of aircraft and their engines, and the creditworthiness and business performance of airlines. The data provides key parameters and serves as a sound basis for investment decisions. In addition, the form of financing is of great importance. ASCEND, a globally recognised aircraft expert, has calculated an index on aircraft lease transactions. The index records average lease yields and serves as a very good benchmark instrument. The long-term performance of the ASCEND (unleveraged) “Ascend Aircraft Investment Index” (AAII) averaged 6.2 percent p. a. – a value comparable to equity investments in the period under review (e.g., S & P 500: 6.9 percent or MSCI Equity World, in USD: 5.8 percent). The return on the AAII was achieved with significantly lower volatility, as expected. In other words, the AAII has experienced a relatively steady increase from 1991 to 2012 and beyond. At the same time, the volatility of aircraft yields was low compared to other yield indices, such as the ship or airline stock index. The development of the Ascend Aircraft Investment Index since 1991 shows that aircraft investments have outperformed other crises, such as in 2007-2008. Investments in aeroplanes proved to be particularly successful in the recessions of 2001 and 2008. As a result, aircraft investments provide an attractive yield-risk profile.

Stable forecasts

The demand for commercial airliners is driven by the steadily increasing demand for transport. For decades, the world’s passenger kilometres have grown steadily. In 2015, global aircraft utilisation exceeded the 80 percent mark for the first time. The opening up of air traffic markets, a growing middle class in emerging markets and the IMF’s forecasts that the global economy will grow by an average of 3.1 percent annually up to 2035 are good reasons to be optimistic. This is especially true for the Asia region. For example, China could become the second largest economy by 2024, replacing the US as the country with the world’s highest passenger volume. In addition, the International Civil Aviation Organization (ICAO) recently announced that 28 percent of regular air traffic has already been allocated to low-cost carriers. New customer segments will be opening up as well. It is already clear that the civil aviation sector is already generating billions in profits. According to the estimates of the International Air Transport Association (IATA), airlines worldwide will be able to record a profit of approximately US $35.6 billion for 2016. This is an all-time high, as is the 1,700 billion for 2016. This is an all-time high, as is the 1,700

Development Passenger Volume

Aircraft financing typically involves long-term investments, with a buy-and-hold strategy. Those wishing to invest as much as possible in a risk-averse way are well-served with investments in debt capital. They are well protected by highly standardised contracts. The average risk of default and loss is low. For example, one of the large aircraft financing banks in Germany estimated the losses in their portfolio to be 0.03 percent. This can also be verified by means of historical data from so-called Enhanced Equipment Trust Certificates (EETCs). Although an EETC is a special form of bond, it is collateralized in the same way as credit financing with an aircraft, and also has certain borrowing limits. EETCs ensure first access to the aircraft in the event of airline insolvency. They are valued and monitored by rating agencies.
The US rating agency Kroll Bond Rating Agency (KBRA) cites, among other things, the historically very high recovery rate in the event of a default by an American airline as an argument for the good ratings. The period from 1994 to 2014 was investigated. Even in the lowest-yielding tranche (the so-called C-tranche), which comes with a corresponding risk premium, the airline still recovered 92.7 per cent of the invested amount if an airline defaulted (e.g., application for insolvency). This demonstrates the value of the underlying assets.

For the highest-ranking A-tranche, the risk of loss can be practically ruled out. Shareholder equity is riskier, however, and projected earnings are higher than for debt capital tranches. The returns for the investor are therefore dependent on the rank of their tranche. This is because debt capital must be served first. The equity tranche will receive cash flows on an ongoing basis, but only once scheduled debt payments have been made on time and in full. Consequently, a low-risk investor will tend to prefer debt capital while a return-oriented investor will tend to prefer equity capital or mezzanine tranches. In both cases the investor benefits from the value and durability of an aircraft asset.

**Solid financing structures**

Leasing structures form the basis of EMP’s business, be it as finance leases or operating leases. In both cases, all operating costs are borne by the airline, the investor acts solely as the financier. In the case of a finance lease, interest and principal are fully repaid by the end of the term (after approximately eight to twelve years) and the aircraft is transferred to the lessee (airline) at a fixed price. This is a pure financing model, with the aircraft simply acting as additional security. In the case of an operating lease, the investor capital (usually equity) is not completely repaid at the end of the lease term when the aircraft is returned to the lessor, who then either rents it again or sells it. In this case, the market value of the aircraft is the decisive factor regarding the return on invested capital. However, in both cases the value-over-time of the aeroplane to be financed and the amortization schedule remain important elements for developing sustainable and conservative investment products. A good example of this is a typical EMP wide-body operating lease investment. Even in a so-called “soft value” scenario, in the event of a drastic downturn in the global aviation market, all financing tranches can be successfully served. The forecasts already take into account possible market declines, which can be accurately assessed thanks to historical data.

**Sustainable Investment Structures**

An experienced asset manager knows how to assess the interplay between airline credit and aircraft collateral as well as how to select the financing form and how to structure sustainable investments. As with many new asset classes, an investor will not find it cost-effective to build the appropriate in-house capacity. However, the necessary know-how can be purchased efficiently and reliably. Collaboration with specialised boutiques is often of particular benefit as the start-up culture, entrepreneurial thinking and many years of experience produce innovative solutions. A team’s verifiable track record is a crucial component. In collaboration with such partners, investors can quickly identify important steps such as an airline’s credit assessment, define their own investment guidelines and make sound investment decisions. The aircraft financing asset class provides all the parameters needed to play a long-term role in the portfolio of institutional investors.