

## Forex puts pressure on JOLs

*A possible regulatory change is not the only issue confronting players in the Japanese operating lease market. Anthony O'Connor reports*

The Japanese yen nudged slightly below the JPY100 to-USD1 mark on 13 March taking the green back to a 52-week low against Japan's currency. Breaking below the JPY100 mark was not only positive but also very challenging news for aircraft lease equity arrangers in Japan because many had underwritten equity from April to June 2007 when the Japanese yen was trading at around JPY116 to JPY118.

That foreign exchange (forex) pressure - which became very acute from the start of this year as the US dollar continued to devalue - has placed pressure on equity arrangers. This means that, for some deals that closed in the second quarter of the current fiscal year, there is an immediate forex loss of approximately 16 per cent to 18 per cent to be incorporated. Not all arrangers are left holding unsold equity but some are working around the clock to comply with rules that stipulate Tokumei Kumiai (TK) equity placement has to be completed in the first year of the JOL.

However, going forward, a stronger yen is expected to boost the JOL market - if global economic conditions are not adversely affected by the state of the US economy.

**"I spoke to a number of investors in Japan recently and they are watching closely - as much as we are in Europe - what is coming out [from] the US economy," says David Power, managing director of Orix Aviation Systems in Dublin.**

It is estimated that the JOL market to the end of March 2008 will have notched up some USD4.5 billion worth of deals, based on equipment values for cross-border and domestic aircraft deals, Japanese shipping companies and some shipping container deals.

However, given the current forex benefit for Japanese investors in US dollar-denominated assets, the JOL is forecast to increase in size by approximately 10 per cent in the next fiscal year - to around USD5 billion worth of deals, also based on equipment values.

Japan's investors in the JOL product have developed in sophistication in recent years, which is reflected not only by the aircraft types subject to investment but also the airlines being targeted.

One of the biggest growing areas in the JOL market is the single investor segment. A growing number of investors in the construction, shipping and steel industries are bypassing the traditional Nin-i Kumiai (NK) and TK structures and are actually taking aircraft assets on-balance sheet, with support from trading houses or operating lessors. Industry watchers maintain that a prominent industrialist in Osaka was behind a recently closed JOL financing for a single A320 for India's Kingfisher Airlines, part of the UB Group. The deal, one of the very few for an airline in India, is said to have been done on a pure-asset basis, but a question mark hangs over whether the UB Group provided some kind of guarantee.

"There is a pool of investors in Japan that are more adventurous and are focused on asset type," says Craig Macdonald, London-based head of aircraft finance for Europe, the Middle East and Africa at Sumitomo Mitsui Banking Corporation (SMBC) Europe. "For Indian carriers, there is very small appetite for names like that."

### **Single investor segment**

The size of this single investor segment could account for as much as 20 per cent to 25 cent of the JOL market for aircraft, according to several arrangers. Whether these investors would have the risk appetite going forward to take widebody aircraft on-balance sheet is uncertain - unless there were some generous manufacturer support guarantees involved.

When the new fiscal year starts in Japan in April there is a general consensus view that a robust level of equity will be available.

Not only are investors more clued up about aircraft, they are operating in a domestic economy that is quietly continuing to report positive growth.

In the fourth quarter of 2007 Japan's real gross national product (GNP) grew 3.6 per cent.

"We still think the economy will grow in 2008 and that will be the seventh successive year that Japan will have recorded real growth," says Michael Kramer, managing director at WestLB in Tokyo. The availability of equity is also making the JOL market more appealing to advance rate-wary banks.

"For banks allocating capital on a Basel II basis, the availability of Japanese equity in the JOL market can make it very attractive to banks," says Macdonald.

While good quality airline names with popular-model aircraft are said to be able to secure debt from a single bank, the trend is more towards bank clubs, as is the trend in other forms of asset finance, structured finance and the mid-market buyout sector.

Although more costly for the airline in terms of fees, a recent JOL transaction completed by Calyon, ING and WestLB was jointly underwritten, reflecting a trend that some banks are appearing to take a friendly co-operative approach in these testing market conditions.

Marc Bourgade, senior vice-president and chief financial officer at Natixis Transport Finance in Paris, says that in line with bank liquidity costs having increased significantly, so too have debt margins on JOLs.

However, the credit turmoil at large could still prove to be a boon for asset-based financiers, as many aircraft, shipping and rail financiers have been suggesting over the last few months - especially in light of the low US dollar interest rate environment.

**"I think banks will be keener to lend against airlines with good quality assets compared with other areas of their businesses," says Power. "I think this market will prove to be a safe haven for banks."**

While the deal for India's Kingfisher is reflective of greater investor sophistication, some JOL deals are equally bucking a number of cultural trends and assumptions.

"JOLs are difficult in the US because of the credit risk of the airlines, and those deals are more difficult to structure because of withholding tax on lease rents," says Bourgade.

North America has also been costly for Japanese investors in recent years and particularly complicated for investors that were involved in Japanese leveraged leases (JLLs) for United Airlines - and more so in terms of outright losses many investors incurred in Air Canada deals.

Japanese investors also understand that airlines in the US, more than airlines anywhere else, are being adversely impacted by increasingly costly jet fuel.

However, Virgin America has completed a JOL for one of the carrier's new A320 aircraft in this fiscal year in a deal arranged by SMBC. Other arrangers are suggesting that airlines, such as Jetblue and Southwest Airlines could finance aircraft using any one of the JOL structures, but both have yet to take advantage of the market so far. Another market that is often cited as difficult is China, although JOL deals are being completed there. Air China was able to tap into the JOL market for narrowbody aircraft in a deal arranged by Nomura Babcock & Brown as was China Southern, which also financed narrowbody aircraft with Calyon mandated as arranger.

**Of the 10 JOL aircraft arranged by Orix this year, Power says that deals have been completed in China as well as Africa and Canada.**

China and Japan may still have strained diplomatic ties, but financiers hope that the Beijing Olympics, to be held this year, could provide an olive branch between the two countries, much as the art world has proved to be. A leading Japanese fine-art gallery - Tokyo Gallery - is firmly ensconced in Beijing's burgeoning art scene, representing a whole host of China's fine artists and photographers.

However, for South Korean airlines, it is not just historical discord with Japan that has stopped JOL deals from being done. South Korea remains a difficult market for outsiders to tap into as long as the country's domestic banks are happy to finance aircraft.

Top-tier carriers in the Asia Pacific, such as Cathay Pacific Airways and Singapore Airlines (SIA) are likely to use the JOL market, if they are not distracted by Germany's KG finance market. Yet, Emirates is likely to avoid such a long-term fleet financing approach as the carrier reconfigures its fleet following the A380 delays. Also, Qatar Airways - home to one of Japan's biggest suppliers of natural gas - could become a JOL user if the sovereign guarantee is offered.

By far, Europe remains the darling region for JOL investors.

Prestigious European market

"The Japanese are much more interested in Europe than in Asia Pacific and the US because Europe for them is far more prestigious," says Kramer. Lufthansa has been a serial user of JOL financing in this Japanese fiscal year and is expected to continue using the structure in the near term as the carrier's refueling programme picks up pace.

Likewise, perhaps one of the most revered carriers among Japanese investors, British Airways will return to the JOL market to fund the remainder of the carrier's A320 deliveries through to 2009. Debt will come from the airline's USD1.7 billion umbrella agreement signed in 2007.

Finnair and Scandinavian Airlines (SAS) in northern Europe; Air Berlin and Tui in Germany; Iberia and Air Europa of Spain; Ireland's Ryanair; and UK-based EasyJet have tapped the JOL market this year.

As for aircraft types, the appetite among JOL equity investors is probably more diverse now than ever before. At the top end, the B-777-200ER and B-777-300ER are

acceptable assets, as are the A330-200, A330-300 and A340-600 with residual value support from the manufacturer. A question, however, hangs over the A380.

Extensive manufacturer support or a sovereign guarantee of some nature would be required for the market to see a JOL - simply because there is no secondary market for the aircraft yet.

Conversely, Boeing's new-generation approach has them dancing in the aisles in Japan's pachinko parlours. "We are all looking forward to the B-787: it will be a great operating lease aircraft," says Kramer.

If the size of the A380 is too challenging for underwriters and placement agents - given how large such equity tickets would be - then Japan's new lease accounting rules that come into effect on 1 April could also be of concern to airlines looking to finance Airbus widebodies in the JOL market. The new rules limit slightly the amount of residual value guarantee that can be used.

The regulatory outlook in Japan looks set to remain relatively stable over the next few years, arrangers say. In the domestic market Japan Airlines is expected to continue using JOL financing, coupled with Japan Bank for International Co-operation (JBIC) support. Conversely, unless the strong cash position at All Nippon Airways (ANA) deteriorates in the short term, the carrier is not expected to tap the JOL market extensively.

Japan's new Financial Investment and Exchange Law (FIEL), which became fully effective in September 2007, is causing a few headaches for smaller entities in the JOL market.

"FIEL has probably had some effect on the market," says Macdonald. "Some of the smaller arrangers may not be compliant with the new law, but the larger arrangers are."

Similar to any securities law passed in Europe or the US, FIEL has resulted in much more employment for compliance specialists. Previously, equity prospectuses would typically be about 10 pages long but are now somewhere in the region of 70 pages. The purpose of the FIEL law is to provide more and improved transparency and investor protection.

As market participants assessed the new law's implications on lease equity underwriting and placement the JOL market was dampened for a while in mid-2007. Although most large players have determined how to comply with FIEL's requirements, there is still need for explanation.

Kramer wrote in a presentation: "With securities underwriting normally requiring the registration as a first-class dealer [difficult to obtain - almost equal to the requirements in regard to securities companies] some special cases have been excluded.

"For the underwriting and placement of JOL equity, a registered second-class dealer would be sufficient, as long as such a dealer has share capital of at least JPY50 million and underwrites the equity via its 100 per cent-owned SPC [special purpose company]."

Overall, the FIEL regime should lead to better disclosure levels for investors as well as structure transparency and should lead to more knowledgeable and educated

investors in Japan, which can only be good for more diverse application of JOL finance products, according to arrangers.