International Lease Finance Corporation

As the financial drama has lurched and veered in its unpredictable plot, recent news headlines have swirled around institutions such as new rounds of infusions and bailouts at institutions including Royal Bank of Scotland and BankAmerica. Less visible in the headlines has been American International Group (AIG), a star player in an earlier act of the ongoing melodrama. That will be changing.

(photo from Boeing of 787 Dreamliner)

One of AIG's crown jewels is the wholly-owned International Lease Finance Corporation (ILFC), a titan in the aircraft leasing business. ILFC is now being shopped around for sale, at a less than auspicious time for the airline business and pronouncements of potential buyers are replete with hints at "buy low" type strategies. After the Holiday intermission in the credit saga, disposition of assets will figure prominently in the drama's next act. Oppenheimer & Co. bank analyst Meredith Whitney, now seen as prescient for her cautious investment advice on the financial sector, wrote, in late January: "A clear lesson learnt from this credit crisis has been to sell and sell early." In AIG's case, the definition of "early" is ill-defined.

In the months after the crisis erupted in September 2008, U.S. government aid to AIG ballooned to USD 152 Billion, including loans (USD 60 Billion- down from the initial USD 85 Billion from the New York Federal Reserve Bank), and preferred share purchases (USD 40 Billion). Additionally, the government stepped in to purchase toxic assets insured by AIG (USD 32 Billion) and mortgages (USD 20 Billion). Referring to the Fed loan, ILFC explained that it was not a guarantor but said: "We are, however, as a subsidiary of AIG, subject to the restrictive covenants under the facility…"

At the outset, AIG was under tremendous pressure to sell off assets, after agreeing to the original USD 85 Billion loan (in return for the U.S. Treasury gaining a nearly 80 percent stake in AIG). Two months later, in mid November, as it became clear that potential buyers of AIG assets were facing their own credit difficulties, the Fed loan was scaled back, to USD 60 Billion, and restated at Libor plus 300 b.p versus the original 850 b.p margin. In late December, 2008, AIG's CEO was intimating that it hoped to pay back the loan during 2009. In an interview, the executive suggested the repayment would require the sale of some 70 percent of AIG's assets. Investment bank Blackstone has been tasked with overseeing the asset disposals of AIG. In late 2008, it sold a Canadian insurance company to Bank of Montreal (for around USD 300 Million), and an industrial insurance unit to a German buyer for USD 842 Million. AIG then set to work in finding a buyer for up to half of its Japanese insurance unit (with market talk suggesting the stake's worth at USD 7 – USD 8 Billion).

By mid January, 2009 reports were emerging that potential bidders were reviewing an ILFC book prepared by a boutique mergers specialist, Moelis & Company. Possible acquirers were thought to include top tier buyout firms, and Sovereign Wealth Funds.

In better times and under different circumstances, buyout firms typically found bargains among fundamentally healthy units cast off by industrial or financial firms. Buyout firms have been sitting on committed capital (some analysts have put the war-chests, in the form of committed capital, as high as USD 400 Billion), but debt market turmoil has slowed their activities. Institutional investors have continued to allocate money to this asset class; Apollo Management, one of the largest buyout groups, recently closed on a nearly USD 15 Billion fund- “Apollo Fund VII, L.P.”

Buyout investors have been comfortable with transport assets in the past, A prior Apollo fund had invested USD 850 Million in Oceania Cruises in 2007 and USD 1 Billion in NCL (parent of Norwegian Cruise Line), in 2008. Both were in the midst of financing extensive vessel newbuild programs. At a Private Equity conference coinciding with the closing of the latest fund, Apollo’s founder, Leon Black, summed up the opportunities across all businesses: “For the next two years, there will be huge opportunities in distressed <investing> for those that have capital.”

Peers of Apollo reportedly studying ILFC include Carlyle, Kohlberg Kravis and Roberts (KKR), Greenbriar Group and possibly TPG (formerly Texas Pacific Group). In the past, capital intensive assets have traditionally supported hefty financial leverage, but- in the case of ILFC (or other potential acquisitions), their ability to raise the requisite debt must be tested. Now, complex structures may be out; the art of the deal of the deal is now very much about battering down prices significantly.

Of the firms considering ILFC, Carlyle is well known for successful investments in transport entities. In the maritime sphere, its successes include Horizon Lines (sold onward to buyout firm Castle Harlan) and Seabulk (sold onward to Seacor, another listed company). In the aviation sphere, its close ties with the defense industry have steered it towards a portfolio that includes suppliers ARINC, Vaught Aircraft and Wesco. TPG is also well known in the airline space, having held stakes in Continental Airlines, America West, Ryanair and, more recently, Midwest Airlines (which TPG acquired jointly with Northwest Airlines). A trio of transport veterans, including two ex Goldman Sachs transport bankers and the leader of the 1994 UAL Corporation buyout, sits at the helm of Greenbriar Private Equity. Greenbriar’s investments include the Electro-Motive Division (EMD) once owned by General Motors, and Peterbilt- a well known manufacturer of heavy duty trucks.

Several high profile deals in the aircraft leasing sector reveal the financial alchemy that’s possible when investors from the buyout sector benefit from a favorable investment climate and trajectory of the industry’s cycle. Funds arranged by Cerberus Capital Management (best known for its recent investments in Chrysler Corporation and the finance arm of General Motors) bought out debis AirFinance in 2005, which subsequently emerged as NYSE-listed AerCap Holdings NV. In 2006, Aercap sold shares- a typical “exit” strategy for buyout investors. A Fortress Investment Group fund assembled aircraft lessor Aircastle Ltd. beginning in 2004, and took it public in 2006. Another buyout promoter, UK based Terra Firma Capital, bought lessor AWAS, for USD 2.5 Billion, another financial investor (Morgan Stanley) in 2006. In 2007, Terra Firma consolidated its position, bolstering its capabilities through the USD 5.2 Billion 2007 acquisition of U.S. based Pegasus Aviation Finance from Oaktree Capital Management.

The coffers of SWFs have shrunk dramatically. The SWFs have historically focused on financial assets, and have been gun-shy, following a previous round of 2007 investments in U.S. and European financial institutions that appear, in retrospect, to have been made too early. Their activities have also been slowed by their own reduced inflows, in many cases, as commodity prices have plummeted during the second half of 2008.

A January, 2009 analysis of SWFs tied to oil producers in the Middle East by the Council of Foreign Relations’ (CFR) Brad Setser suggested that an investment shift into equities (rather than financial assets) “…may prove to be a less powerful trend than was widely expected a year or so ago.” The report suggested that at oil prices of circa USD 40/ barrel, internal funding needs at oil producers would mean reduced allocations for oil-fueled SWF’s to spread around.

Still, the transport sector has been attractive to SWF’s in the past. Not surprisingly, a trickle of late January media reports naming SWF bidders included Singapore’s Temasek Holdings (a majority owner of Neptune Orient Lines and ports operator PSA International) and Isthimar Ltd.- tied to the Dubai Government and its ruling family along with Dubai Ports World. Isthimar also owns Inchcape Shipping Services, positioned with a worldwide network of agencies and shipping services.

Closer to the air mode, Isthimar is one of several state-linked shareholders in Dubai Aerospace Enterprises (DAE)- while Temasek’s portfolio includes a majority stake in Singapore Airlines (which, in turn, holds a large stake in Virgin Atlantic). DAE recently closed on a USD 800 Million three year credit, illustrative of the trend identified by CFR’s Brad Setser. Effectively, investments once funded by brimming state treasuries might now need buttressing from capital and bank markets.

SWF involvement in buyouts may take an indirect path; for example, the Kuwait Investment Authority (another potential bidder for ILFC) shows up in the roster of limited partners in Apollo’s newly closed fund (alongside well known pension funds). An Abu Dhabi linked fund SWF (not mentioned in connection with ILFC) acquired a small stake in Carlyle several years ago. The China Investment Fund, reported to be a possible ILFC bidder, has links with two large PE investors who might later be drawn into the ILFC fray, Blackstone Group and JC Flowers.

The devil is often in the details. ILFC, with an end 2008 fleet approaching 980 aircraft, may be too big for any one Private Equity investor to swallow. Its most recently available regulatory filing (at the end of 3Q 2008) shows a nearly USD 51 Billion balance sheet with a book value of USD 7.5 Billion. In late 2008, CEO Steven F. Udvar-Hazy had indicated that the company he founded (in the early1970s) was then worth around USD 10 Billion. Reports at that time suggested that Udvar-Hazy might be part of a then un-specified buyout syndicate.

Not surprisingly, market rumours see PE buyers teaming up in consortia. In a November, 2008 report on ILFC where ratings were maintained, a team at Fitch Ratings said: “There are a relatively limited number of potential buyers that have the appropriate financial wherewithal to support ILFC’s current business model and ongoing funding and refinancing requirements.”

Buyers of ILFC, whether from PE or SWF sectors, will face a number of financial impediments, some tied to the overall environment, and some tied specifically to the capital intensive nature of the leasing business. The value to AIG would be reduced by several USD Billions, because of a substantial “Deferred tax liability” on ILFC’s balance sheet, which stood at USD 4.4 Billion at end 3Q 2008. At end 2008, ILFC had commitments to purchase 160 new aircraft, from Boeing and Airbus, to be delivered out to 2019, worth around USD 16 Billion.

As the largest lessor, and the largest customer for big manufacturers, ILFC’s longer term financing issues reflect those of the industry at large. ILFC, like its peers, must continue to finance its future fleet. Total debt on its end Sept. 2008 balance sheet was a staggering USD 34 Billion, including USD 21.4 Billion of bonds and notes sold in the public markets. In the first nine months of 2008, ILFC raised more than USD 9.3 Billion in debt finance. In spite of the preponderance of very long lived assets, ILFC had also been a heavy user of the markets for commercial paper (short term unsecured notes) on the funding side.

When AIG’s problems in supporting liabilities (tied to credit default swaps) emerged in September, 2008, ILFC was closed out of the commercial paper market (instead drawing down available bank lines of USD 6.5 Billion (USD 2 Billion of which comes due in October, 2009) and garnering a further USD 1.7 Billion from an AIG revolving credit. In late October, a funding window opened up in the form of the New York Fed’s Commercial Paper Funding Facility (“CPFF”, currently set to expire at end April, 2009), where ILFC borrowed USD 1.7 Billion (to repay the revolver) out of an authorized USD 5.7 Billion. These paper is coming due in early February, 2009.

ILFC had already seen its credit downgraded, by Moody’s, in October, 2008. In late January, 2009, ILFC saw a further downgrade of its credit rating, with Standard & Poors (S&P) citing concerns over both a deepening global airline slowdown, and over ongoing difficulties in credit markets generally. When ratings are diminished, borrowing costs under existing facilities rise, and certain facilities may become unavailable. The Moody’s action, where the long term debt was rated at Baa1, ILFC was asked by the Security Trustee of a 2004 Export Credit Agency facility (supporting its purchases from Airbus), to segregate certain accounts related to airplanes funded under the facility. According to

S & P analyst Phillip Baggaley's, "With our downgrade of ILFC's short-term rating to 'A-2', we expect that the company will no longer have access to the CPFF..."

The pincer-like nature of ILFC's difficulties was summed up in S & P analyst Baggely's recent research update, where he wrote: "the current credit market dislocations have caused sharply increased credit spreads (albeit above low risk-free rates) at the same time that lease rates are softening."

In its end 3Q 2008 filing, ILFC suggested a level of comfort in raising finance through the end of September 2009, suggesting that: "…We currently have capacity under our existing debt agreements to enter into secured financings up to an amount equal to….an amount in excess of USD 4 Billion," based on percentages of asset values allowed to be secured under its Bond indentures. Export credit agency debt is excluded from these calculations. Longer term, a quick reckoning suggests further funding needs exceeding USD 12 Billion, based only on its existing book of orders (the 160 planes to be delivered during 2009, and beyond).

For the near term, the report authored by S & P's Philip Baggaley suggests that ILFC will be considering likely funding from ECA (for Airbus planes), Ex-Im (for Boeing planes) and manufacturer sources, suggests that USD 3.5 Billion of fresh debt will be needed during 4Q 2008 and throughout 2009. The report suggests that: "…borrowings to refinance upcoming debt maturities would most likely come from commercial banks and other financial institutions."

The sale of ILFC will add additional complications, given a delicate financing mix in place. Change of control provisions in its existing USD 6.5 Billion of bank debt (with USD 2 Billion coming due by October 2009) is cited by Baggaley as a catalyst for a potential re-shuffle of ILFC's debt mix. S&P's report said that ILFC might seek to amend the existing, unsecured bank lines to waive their change of control provisions, which could be expensive. Alternatively, the company could seek to refinance the bank lines on a secured basis, but doing so may require providing collateral also to ILFC's attractively priced public unsecured debt, which would limit future financing options."

In its report, the Fitch team points out: "ILFC's current bank facilities, which are fully drawn, include a covenant that requires AIG to maintain at least a 51% ownership stake in ILFC. As such, Fitch believes a sale of the company would require either a full pay-off of the bank lines or renegotiation of the covenant."

S & P's report presents a choice of either amending the existing unsecured bank debt to waive the change of control provision, thought to be expensive but more likely, versus refinancing its attractively priced public bonds and notes. Janes asked the S&P analyst, Philip Baggaley, whether a PE buyer or an SWF buyer might fare better in discussions with the group of bank lenders. He told Janes: "It's not clear that one type of buyer would have an advantage in such discussions- many factors would come into play, including the relationships that the buyer may have with members of the banking syndicate." He added that certain banks might have a preference for lending on an unsecured basis, where the credit of the borrower- rather than values of collateral, is the primary consideration. He suggested that a buyer consortium might include PE investors, SWFs or a combination of both.

Throughout transportation finance, the brakes on the supply side growth (whether delayed deliveries of 787 Dreamliners, or cancelled Capesize bulk carriers) is the silver lining of the credit crunch. Irrespective of the eventual structure that emerges, potential ILFC acquirers will be betting on a cyclical upswing, as much as anything else. A January, 2009 announcement by Greenbriar, one of the PE investors said to be looking at ILFC, describing a new venture in the maritime sector, describes the thinking of Greenbriar and a partner. One time shipping banker Anthony Gurney (who later became the CFO at Teekay), whose Seacove Shipping Partners is joining forces with Greenbriar, expressed the view as follows: "…we believe the sector's eventual recovery will afford superior returns on well-timed investments., and that good deals can be found "…when markets are in disarray and traditional capital sources have pulled back temporarily from the sector."

No doubt the same sentiment permeates the thinking at Greenbriar (and of other bidders) in the airline sector. For financiers of all transport equipment, asset appreciation could become an important element in a cycle that will turn upward. A recent conference presentation by consultancy Ascend suggested that: "Low oil prices will aid industry recovery, but weak GDP hits demand." The financing headwinds that ILFC buyers (and others) may encounter will also play an important role in the cyclical recovery of the aircraft sector. ILFC's own orderbook, at 160 planes, is smaller than it was several years ago; an end 2006 regulatory filing showed a book of 254 airplanes to be delivered at that time.

In their presentation, the Ascend consultants, in labeling aviation as a "solid long term business" added that: "Investment Finance constraints will slow capacity growth, but also restore profitability." The view is shared by HSH Nordbank; in a look beyond 2009 in their January, 2009 Aviation Monthly, where they write: "…longer term, increased barriers to entry, continued deregulation, and increased pressures to move to the newest most efficient aircraft will likely lead to renewed stability and promise for the industry." For ILFC, such considerations will be paramount for the existing Citi-led banking syndicates, or a new group of lenders that might take out all are part of the existing bank debt. All eyes are closely watching the asset values of ILFC's fleet, which observers suggest has dropped by some 10% - 20%. New deliveries to ILFC, including its first of 74 B-787s on order from Boeing, scheduled for 2010 but already pushed back to late 2011, may come in at a time of cyclical upturn and rising asset prices. If the cycle does indeed turn upward, then supporting ILFC will have proved to be a good investment.