



Point-to-Point[®]

FINANCIAL TRENDS IN COMMERCIAL AVIATION

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Aircraft Sector Understanding Toward balanced global airplane export credit financing

Since 1986, the Large Aircraft Sector Understanding (LASU) had served as the guideline for export credit agencies (ECAs) to extend credit or guarantees to airlines for the acquisition of civil aircraft. Administered by the international Organization for Economic Cooperation and Development (OECD), the LASU, as its name implies, covered only large aircraft, in effect limiting the agreement's scope to the products of Boeing and Airbus.

Negotiated by the civil aircraft producing countries—the United States, United Kingdom, Germany, France and Spain—during a period of exceptionally high interest rates, the agreement aimed to ensure balanced competition between aircraft manufacturers by establishing financing guidelines for direct loans or guarantees. The participating countries also observed a “Home Market Rule,” which precludes ECAs headquartered in one aircraft-producing nation from extending credits to airlines based in other aircraft-producing nations. Because the LASU did not cover smaller regional jets, ECAs in countries where regional jets are manufactured were not bound by the home market rule.

The OECD had long hoped to extend the understanding to cover aircraft of all sizes and to bring regional jet producing countries—notably Canada and Brazil—into a common framework that would provide for fair and balanced competition among all the world's aircraft manufacturers, airlines, and ECAs.

On July 30, 2007, a new agreement, the Aircraft Sector Understanding (ASU), was signed, establishing new terms and conditions under which the U.S., EU, Japanese, Brazilian and Canadian ECAs can provide export credit financing relating to aircraft and engines. The new agreement expands coverage to civil aircraft of all sizes and gives more focus to loan guarantees, pricing disparities with commercial financial markets and regulation of ECAs in regional jet producing countries. It also provides a mechanism for reviewing the terms of the agreement. This review is essential to address issues as they arise and facilitate necessary changes to the agreement to keep pace with the dynamics of the global marketplace.

Terms vary across aircraft categories

The new ASU is actually two agreements under one title. It establishes three categories of civil aircraft. Category 1 is defined as “Large Aircraft.” Categories 2 and 3, which include regional jets, business jets, and executive jets, fall under the heading of “Other Aircraft,” and will be referred to as “Regional Jets” in this article. It is worth noting that the Large Aircraft category includes all Airbus

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New Aircraft Sector Understanding May Impact Customers Seeking Export Credit

By Scott Scherer

The new Aircraft Sector Understanding (ASU) agreement is intended to “level the playing field” in aircraft financing among manufacturers and minimize competition between government export credit and the commercial financial markets.

While the ASU has brought together valuable perspectives from various governments and contains advantages for the aviation industry, it also creates issues that may have long-term negative implications on export credit financing with respect to airlines. We believe these issues should be addressed immediately since they create setbacks for international airlines as they execute fleet modernization strategies.



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Airlines may have concerns with the following elements identified within the ASU:

- **Higher fees and risk mitigants.** The combination of both of these elements in certain situations can be much more severe than current commercial market practices.
- **Reduced fee discounts for the Cape Town Treaty.** Cape Town is an important international treaty that strengthens the legal framework for aircraft financing by reducing repossession risk for lenders and lessors. The discount has served as a powerful economic benefit for airlines to convince their respective governments to ratify Cape Town. Lowering the discount diminishes the incentive for airlines based in countries that have not yet ratified the treaty.
- **Ambiguity regarding Home Market Rule.** The Home Market Rule precludes export credit agencies from funding airlines based in countries that manufacture aircraft. The ASU lacks clarification on whether or not all countries that have signed the agreement will abide by this guideline.
- **Complex risk assessment process.** The process to classify airlines into risk categories needs greater transparency. Establish-

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ing a consistent method for export credit agencies to classify airlines across aircraft categories is vital.

• **Classification of the 737-600 and A318 as regional jets.**

Other comparably sized jets, such as the 717 or BAE146, are considered large aircraft in the ASU. Singling out the 737-600 and A318 creates distortions with respect to pricing and terms as airlines decide on fleet replacement. The Aviation Working Group (AWG), of which Boeing is a member, believes that it is more logical to have one rule set covering both large aircraft and regional jets given that airlines purchase aircraft in both categories.

On behalf of airlines, Boeing is working toward resolving these and other issues via a number of fronts. We are working with the airlines to understand how the ASU might impact them. As the ASU crosses many government agencies, we are working together with our Washington, D.C. office to assist in coordination efforts. And we're working with the AWG, which is compiling a list of questions and clarifications that we believe require attention

One advantage of the new ASU is that it allows formal government reviews, which may result in adjustments. Boeing is a strong advocate for an early review to address these concerns. Only when these major issues are sufficiently addressed will the new Aircraft Sector Understanding truly be a significant international economic policy achievement that "levels the playing field" for all aircraft manufacturers and airlines seeking export credit agency financing. ■

[Future issues of Point-to-Point will include ASU updates]

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and Boeing commercial aircraft, with the exception of the Airbus A318 and Boeing 737-600, which are governed under Category 2. BBJs and A320-family Executive Jets are listed under Category 3.

The agreement sets minimum premiums, not mandatory terms, based on five new risk categories for Large Aircraft and 15 risk categories for Regional Jets. Risk categories are based on an airline's senior unsecured credit rating. Large Aircraft financing is in the form of loan guarantees, while Regional Jet financing may be in the form of direct lending or loan guarantees.

The basic security package is defined differently for Large Aircraft and Regional Jets. A first priority security interest in the aircraft is required for Large Aircraft categories. Regional Jet security packages may include either a first priority security interest in the aircraft or a sovereign guarantee. The sovereign guarantee package is optional for Large Aircraft, however it is burdened with a separate, higher fee schedule. The maximum repayment term for Large Aircraft is 12 years, with a 3-month repayment interval, while the maximum term for Regional Jets is 15 years (10 years for business and executive jets) with a 6-month interval and an optional 12-month grace period on the principal. The maximum amount to be financed for both categories of aircraft is 85% of the net price.

The ASU, unlike the LASU, defines net price in the agreement. For both categories of aircraft, the net price is the invoiced price after discounts, cash credits, and other credits or concessions fairly allocated. The price of Buyer Furnished Equipment is unspecified. The specifics must be documented as required by the relevant ECA and supported by manufacturer representations.

ASU Fees Differ for Large Aircraft and Regional Jets

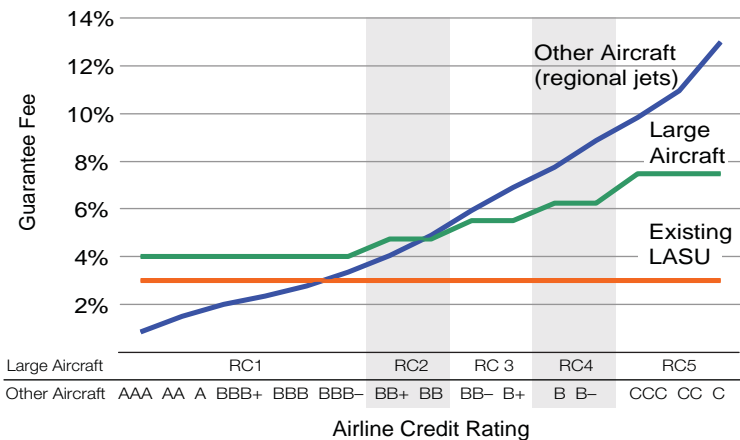
Large Aircraft				Regional Jets							
Risk Category	Base Premium %	Net Premium % (after Cape Town discount)	Number of Risk Mitigants	Risk Classification	Base Premium (basis points)			Net Premium (after Cape Town or Participant's state discount) (basis points)			Number of Risk Mitigants
					Repayment Term (Years)			Repayment Term (Years)			
					15	12	10	15	12	10	
1	4.00	3.80	0	AAA	29	17	12	26	15	11	0
				AA	48	31	23	44	28	21	0
				A	57	41	32	52	37	29	0
				BBB+	68	48	40	62	44	36	0
				BBB	80	57	46	73	52	42	0
2	4.75	4.27	1	BBB-	92	69	57	84	63	52	0
				BB+	107	83	69	97	75	63	0
3	5.50	4.95	1	BB	125	100	86	114	91	78	0
				BB-	147	121	108	134	110	98	0
4	6.25	5.31	2	B+	165	140	127	150	127	115	0
				B	182	157	146	165	143	133	0
5	7.50	6.00	3	B-	202	179	169	184	163	154	0
				CCC	221	198	190	201	180	173	0
				CC	241	220	215	219	200	195	0
				C	276	260	259	251	236	235	0

The Large Aircraft schedule reflects an up-front guarantee fee.

The Regional Jet schedule reflects an annual spread added to a base lending rate.

Comparing ASU Guarantee Fees

12-year term, before Cape Town Treaty discount



A Boeing estimate of the OECD conversion model converting the 12-year Regional Jet annual spread to an up-front fee

Another feature of the agreement is the provision for discounts to airlines in nations that ratify the Cape Town Treaty. Discounts for Large Aircraft range from 5% to 20%, based on the risk category of the buyer. The discount for Regional Jets varies from 9% to 12%, but also applies to buyers based in ASU participant countries, regardless of whether those countries ratify the Cape Town Treaty.

A new element to the ASU is a requirement for additional credit or structural enhancements, called risk mitigants, to improve the credit quality of the transaction. Depending upon an airline's risk classification, risk mitigants are required for Large Aircraft, but risk mitigants are not required for Regional Jets.

To classify airlines into risk categories that establish fee levels and the number of risk mitigants required, ECAs participating in the new ASU will jointly place all airlines on a common rating list maintained by the OECD. The airline rating becomes binding at the time of the ECA commitment. The rating is valid for Large Aircraft until an update is agreed to by the ECAs. Regional Jet risk classifications are regularly updated every six months. Such risk classification quoted to an airline is valid for 12 months and can be extended for another 18 months after an ECA final commitment has been made. If the ECAs cannot agree on a common rating for an airline, they will use an independent rating agency to make a binding determination. This new risk assessment system poses some practical problems. For example, certain ECAs may have more information on a particular airline than others, making it difficult to challenge ratings. In addition, there is currently no procedure for airlines to challenge a risk classification. Additionally, there will be confusion for those airlines purchasing both large and regional aircraft because the validity periods and actual ratings can differ for the two categories.

A dynamic agreement

An important feature of the ASU is that it provides a process for changing the agreement in response to future industry developments and for reviewing issues that arise among signatory nations. Periodic reviews are anticipated to surface and address any need to readjust ASU fees to prevailing commercial market levels or to update the agreement. Additionally, Boeing has requested the Government of the United States to call for an ad hoc review to address several issues that could have adverse effects on airlines.

Changes mandated by the ASU will phase in gradually, as Large Aircraft contracts signed by April 30, 2007, with deliveries through December 31, 2010, are exempt from the terms of the new agreement. For Regional Jets, ECA commitments given by July 1, 2007, with deliveries scheduled through December 31, 2009, are also "grandfathered."

The terms of the new ASU are more stringent in many respects than those of the previous agreement. Boeing is working with airline customers to ensure an accurate understanding of the ASU and its potential impact, and to make certain that customers can make the best use of opportunities under this new agreement. ■

How is Current Market Volatility Impacting Aircraft Financing?

With the recent stock market dip, credit tightening and sub-prime mortgage meltdown, many analysts are wondering how this wave of increased market volatility and risk will impact aircraft demand and financing. Since early August, Boeing has been working with our customers and aircraft financiers to understand and help manage the current market instability.

Aircraft demand is primarily driven by two factors. The first is economic growth and the second is airline profitability. When the market demand is healthy, the availability of capital to fund this growth usually follows. Current circumstances appear to support these assumptions. Despite the rise of sub-prime mortgage defaults and reduced U.S. GDP, the world economic outlook remains positive with growth at or above trend due to strong growth in China, India and Europe, which will offset slow U.S. growth. Airline profitability also is predicted to outpace last year, with many airlines reporting higher second quarter earnings due to revenue growth and decreased cost structures. Load factors and utilization rates are strong as consumer-booking trends remain solid amidst the market turmoil.

The current market volatility has not affected the underlying world economy fundamentals, nor has it materially impacted financing of new aircraft deliveries. During 2007, customers have seen historic low rates in new aircraft financing and, while the current credit crunch will have an effect on risk evaluation and spreads in the market, there is plenty of appetite and liquidity in the market to finance the upcoming deliveries. Of the numerous sources for aircraft capital, only the U.S. capital markets have pulled back. Kostya Zolotusky, Boeing Capital's managing director of Capital Markets Development, explains, "Recent return of U.S. capital markets to aircraft finance has been a welcome source of additional liquidity, but we need to keep it in perspective. In 2007 and 2008, only about one percent of Boeing's deliveries are expected to be funded by the U.S. capital markets. Most aircraft financing is still provided by regional banks, leasing companies, export credit and cash from operations."

Overall, the outlook for airline profitability and global GDP remains strong and as long this remains true, Boeing believes there will be adequate and reasonably priced capital available for aircraft finance. ■

Noteworthy Developments

Boeing Program Update:

787:

- 787 first flight now targeted for mid-November to mid-December
- Boeing premieres the 787 to the world -- www.newairplane.com/787premiere
- 787 completes physical crashworthiness testing
- Rolls-Royce receives certification for 787 Trent 100 engine and order from ILFC (40) and Royal Brunei Airlines (4)
- Boeing 747 Dreamlifter achieves FAA certification; Evergreen International Airlines assumes operation of Dreamlifter fleet
- Boeing, Russia's VSMPO finalize joint venture to machine titanium parts for 787

777:

- 777 Program surpasses 1,000 orders (faster than any other twin-aisle jet in history)
- Boeing celebrates delivery of 3,000th widebody airplane at Everett, a Korean Air 777-200ER
- Boeing delivers first 777-200LR for Emirates (50th 777 for Emirates)
- Boeing begins parts fabrication for 777 Freighter

CAS:

- Six airlines sign for Boeing's Airplane Health Management (AHM) in first-half 2007, bringing to 15 the number receiving the in-flight monitoring and decision-support system. Dan da Silva, Sales and Marketing VP for Commercial Aviation Services, said, "With this tool, airlines can begin working on issues before an airplane lands and arrives at the gate. That kind of lead time can help turn what might have been a costly, disruptive delay into routine maintenance."
- In first-half 2007, 14 airlines sign for Boeing's software maintenance and engineering support system, Maintenance Performance Toolbox, bringing total carriers to 38.
- Thai Airways becomes 11th customer for Boeing's Integrated Materials Management (IMM), in which Boeing manages supplier-owned inventory to significantly reduce an airline's maintenance costs; Boeing signs Honeywell as IMM supplier to provide expendable parts
- Boeing signs agreement to supply GoldCare Material Management services to GE Aviation, providing repair and overhaul services for the 787; and will supply GoldCare lifecycle support services for the Rolls-Royce Trent 1000 engine TotalCare® program.

Airplane Orders:

Recent order announcements since June 1, 2007, include:

- **787s:**
Air Berlin (25)787-8s; ALAFCO (10) 787-8s; CIT (5) 787s; ILFC (52); S7 Group (Moscow) (15) 787-8s; Aeroflot (22) 787-8s; Arik Air (4) 787-9s
- **777s:**
Air France-KLM (9) 777-300ERs, (7) 737-700s previously unidentified; GE Commercial Aviation Services (6) 777 Freighters; Philippine Airlines (2) 777-300ERs; Brazil's TAM (4) 777-300ERs, bringing Boeing total to more than 1,000 777s and 2007's total to 100; Cathay Pacific Airways (5) 777-300ERs; ILFC (1) 777-300ER; Jet Airways (3) 777-300ERs; Air New Zealand (4) 777-300ERs and (3) options; Arik Air (1) 777-300ER previously unidentified
- **737s:**
China Southern (55) 737-800s; Xiamen Airlines (25) 737-800s previously unidentified; Air France-KLM (7) 737-700s previously unidentified; Norwegian Air Shuttle (42) 737-800s with 42 purchase rights; Lion Air (40) 737-900ERs, bringing total orders to 100; Moscow-based Atlant Soyuz (4) 737-700s previously unidentified; ILFC (10) 737s; Aviation Capital Group (15) 737s; AeroSvit-Ukrainian Airlines (7) 737-800s plus (7) purchase rights ; Arik Air (10) 737-800s



Boeing unveiled the 787 Dreamliner during a ceremony at its Everett, Wash., final assembly facility, attended by nearly 15,000 employees, airline customers, supplier partners, government officials, and the financial community.

Please direct questions or feedback to the following:

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