UNDERSTANDING RISK TOLERANCE & TRANSACTION ASSESSMENT

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October 18, 2017

Determining Counterparty Risk: Airlines are "Unique"

- Airlines are a unique class of credits and financial statements do not always tell the whole story.
- For instance, sovereign carriers might never have a year in the black, but may always pay for their airplanes. Or they may not.
- To that end, qualitative metrics such as access to liquidity/capital markets, strength/commitment of ownership, strategy and competitive landscape are of paramount importance.
- Still, financial metrics play a meaningful role and should be assessed, measured and subjected to peer comparison – as long as the quantitative factors are taken in cohort with the qualitative.

Determining Counterparty Risk: What Financial Ratios Matter?

- For airlines, counterparty risk determination really revolves around Fixed Charge Coverage. To wit, can the airline pay you?
  - *Fixed Charge Coverage can mean many things, but, in its most basic form, you want to measure an airline's ability to pay for its assets, both on- and off-balance sheet, and tailor your denominator as such (current portion of debt/leases, operating lease expenses, interest expense).*
- Liquidity is of preeminent importance as well.
  - *Cash is king, especially in times of crises, and measuring an airline's unrestricted cash in terms of revenues and operating expense coverage as well as line of credit availability and capital markets access as a mitigant is a must.*
- Leverage, again tailored and calibrated to fixed-asset heavy airlines, is an important measure, effectively, of vulnerability.
  - *Adjusting to account for on- and off-balance sheet obligations, it is basically a means to assess flexibility in down times. Considering cash/capital availability and noting the existence of "friendly" debt (i.e. to shareholders or sovereign-supported obligations) is key to the analysis as well.*

Determining Transaction Risk: The Elements of Risk

- Boiling "risk" in aviation lending and leasing down to simply credit risk neglects absolutely essential pieces of the puzzle.
- Credit and/or counterparty risk is, of course, key, but there is also asset risk, jurisdictional risk and market risk to consider. As such:
  - *Are you financing the right aircraft type?*
  - *Does your counterparty have a sound strategy in general? What about for the asset type itself?*
  - *Can you get it back in a default?*
  - *Will the airline care for it properly?*
  - *Is an above-market rate "real" if the airline never pays it and what of the market post-default?*
  - *Who else operates the type? Are they financially stable?*
  - *What is happening geopolitically and macroeconomically in that region?*
- Proper transaction assessment contemplates all of these in combination so as to inform the optimum structure to pursue and measure whether the "risk-reward" propositions are in balance.

Risk Tolerance: Marrying the Elements

- Considering, measuring and factoring in all of the elements of risk is crucial to aviation lending and leasing.
- But, on top of this, it is critical to determine your risk tolerance.
- Effectively, for each and every transaction, you must decide if you are getting paid appropriately for the risk you are taking.
  - *What is the price when you meet your tolerance?*
  - *What is the price to exceed it – i.e. what does it take/cost to move up the risk curve?*
  - *Is there a point where it is unsafe at any price?*
- This forms the basis of what I call the “Path to Yes” when the easiest course is always to say no.
  - *For instance, you can always go outside the realm of your risk appetite, but you have to get paid to do so and be comfortable that you have protected your downside as much as possible.*
- Mitigate, mitigate, mitigate.