

Regional Aircraft Roundtable 2006: Less is more

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Airfinance Journal: Where have regional aircraft been most successful in the past few years and why?

Joao Alfredo Paiva, market strategy, senior manager, Embraer: In terms of numbers at September 2006 we had 914 firm orders and had delivered 859 units, with a backlog of 55 units. Almost 70% of these orders have come from the US. The delivery of these aircraft began in 1996. Today we are mostly involved in the US and European market and new markets such as China and Russia. These countries still require 50-plus-seater units. We have reached maturity in the US and Europe.

Some other markets will happen but not in the way or size of units as the US. The 50-seat regional jet will continue to be important, especially as hub feeder aircraft in the US. For each local passenger, the 50-seater carries three connecting passengers.

It is important to feed these hubs in the US. In the 50-seat market we project that around 1,400 new aircraft will be delivered in this segment in the next 20 years. In the next 10 years we will start the replacement cycle of these aircraft.

Trung Ngo, vice-president, marketing and communication, Bombardier Aerospace Regional Aircraft: I would like to emphasise that today we are into the next phase of regional airlines, particularly regional aircraft. This is happening for two particular reasons. First is the "scope" clauses relaxation in the US, which started last year. This started with US Airways, Delta and Northwest. We would assume that United, Continental and American will follow. We are in the second phase of the first evolution of regional airlines in the US, which has led to increased demand since the first part of 2005. In Europe, which is ahead of the US in terms of the implementation of large regional aircraft, we are seeing pent up demand, both from the current operators of 50 seat regional aircraft such as the CRJ 200. From our perspective we have acquired a significant number of operators of larger aircraft, such as the A320, 737, who are moving into the larger regional jet aircraft such as the CRJ700 and -900 particularly because these operators are targeting the medium sized market, point to point for which the A320 is too large. These large regional aircraft are becoming an attractive product offering for point-to-point services. We also see the regional jet being adopted in developing markets on two fronts; firstly the availability of regional jets such as the CRJ200 on secondary markets via operating leasing and secondly the growth of the point-to-point service offering for poorly served markets. We see this phenomenon developing in Mexico and India.

As long as regional airlines can maintain their extremely competitive low cost, they will be a successful element in the overall airline structure and will be very competitive as the restructuring of major airlines in the US and Europe intensify. A case in point is FlyBe in the UK, this airline has demonstrated an ability to use regional aircraft such as the Q400, a 78 seater turboprops to compete affectively against low cost carriers in the UK. These are new developments, which will be emulated by others.

Ray Tighe, independent aviation consultant: How about the market in the US? Are there opportunities for the large turboprop?

Ngo: We are seeing a greater interest from the traditional turboprop operator who knows the product well. Horizon Air is the case in point. They keep ordering more Q400s. Frontier, on the other hand, has recently created a new entity to operate their newly acquired Q400. There is an RFP for Continental for 20 to 24 70 seat turboprops. This is hopefully a trend that more orders will follow. Each airline will consider its own market to see how a larger turboprop would apply. But it is encouraging to see that the turboprops they acquired 15 or 20 years ago are now due for replacement. Hence we have a replacement cycle coming up. But more importantly, some of them are using the Q400 to develop new markets. I would say Frontier's decision to create a new entity has caused a stir in the US market.

Erik Dahmen, managing director, Europe and Middle East, BCI Aircraft Leasing: As a lessor we differentiate between the 50-seat market and the larger airplanes. The consensus seems to be that the 50-seat market is dead and we should be looking at the larger airplanes. With respect to residual values on the secondary market, what do you predict for the 50-seat airplanes? I've heard that the CRJ100s, built in the 1990s, are being converted into VIP airplanes and the CRJ200s are not holding up values.

What can Bombardier say to investors who are looking at secondary opportunities for the 50-seat jets?

Ngo: There is a much wider base for investors in narrowbody aircraft such as the 737 and the A320. For the CRJ 100 and 200 programme, we are seeing a much tighter base of owners or lessors. There is a lot of discipline in the market with respect to how these aircraft are being re-marketed. This year has been a disappointing one in terms of the bankruptcy filing of Flyl, resulting in the grounding of a large number of aircraft. If you were to discount the Fly-l grounding (which is an unusual event), we have experienced a normal process by which aircraft are being replaced or repositioned in secondary markets. With respect to placements in the secondary market, we have not seen the bottom falling out at all both in terms of rentals and in terms of residual values. Some aircraft have been parted out. Others that are being re-marketed are holding on to the values that we have been forecasting over the last few years.

Paiva: The 50-seater's residual value did suffer with the amount of RJs in the market, but on our side we have less than five RJ units parked. These aircraft are in transition and will be allocated in other regions. From 900 units delivered, we have almost zero units parked. The ERJs are holding their value.

Ngo: Of our CRJs available for re-marketing only around 49 of these are not placed, many others have already been placed. A significant amount of these aircraft were part of the Fly-l bankruptcy. Northwest also began its restructuring program and recently decided to put back into service the grounded 15 CRJ200s. From the major airlines we have not seen any major disposition of those aircraft as part of their restructuring. As soon as a large amount of the Fly-l aircraft are disposed of, we will be back to our normal position of - about 5% or 7% of the fleet being not operational.

Michael Weiss, head of aviation, Investec Bank: Are those placed CRJs going to new or existing operators and where are they going?

Ngo: There is a mixture. Some of them have gone to AirCanada Jazz. We have also seen these aircraft being placed with Alma in Mexico, a new operator. There are a couple in India. We are hopeful that the Russian market will also develop for these aircraft types.

Tighe: Would you like to comment on the cargo conversion for CRJ200?

Ngo: We have recently concluded business for 2 CRJ200s, which will be converted into package freighter aircraft. They will be new applications for the type. We are seeing that aircraft on the market can potentially be converted depending on the age and condition. We certainly see an interest in this new variant. It offers carriers such as West Air in Sweden a point-to-point express service offering.

Terry Fox, sales and marketing director, IBA: Is this conversion a bulk carrier?

Ngo: It is strictly for bulk loading.

Crispin Maunder, chairman, Lease Corporation International: What age are you seeing aircraft enter the conversion programme?

Ngo: These were the earlier aircraft that were delivered to Lufthansa. They were early 1991 or 1992 vintage.

Maunder: Do you feel that their economic lives could stretch beyond 20 years from a technical and operational point of view?

Paiva: We would consider about 20 years. Regarding cargo conversions, we still do not think that we are in the correct lifecycle for this product.

Bert Van Leuwen, head of aviation, DVB Bank: How big will 50-seat converter markets be?

Ngo: The volume will only occur once you have the large freight operators such as UPS, Fedex and DHL embarking on the programme. So far they have not. We are seeing interest from smaller freight operators, but if the bigger companies come in, you will see greater volume.

Tighe: Is it fair to say that part of the problem is that far too many regional jets were ordered in the early 1990s? Are we trying to solve the problem of over-ordering of the 1990s?

Ngo: When you look at how it came about in the first place and the success of the 50 seat RJ, this was a reaction to market development. In the US and Europe in the 1990s there was a significant build up of major hubs and secondary hubs in these continents. With the build up of these hubs, which were costly in terms of infrastructure and larger aircraft being deployed, the need for connecting traffic is highly important. When the RJ became available, certain hubs were flown over and airlines lost connecting traffic. We have not seen new hubs being created. Some of them are being downsized, resulting in less demand for 50 seat RJs. Turboprop, on the other hand, has been constrained in terms of the range and has never been viewed as a competitive threat. It has a traditional use, which involves feeding the hub with a short-range market. The turboprop will come back once the replacement cycle starts.

Tighe: I accept your point about the hub bypass but the CRJ was marketed as an aircraft that was optimized for routes of over 400 nautical miles. This did not happen. The aircraft was applied on shorter routes, resulting in a significant cost to the operator. There had to be a reaction

to that.

Ngo: The 50 seat RJs have about 450 statute miles. This has been fairly stable over the last three years. The average statute length of the 70 to 80 seat RJs is reaching about 650 statute miles. There is a significant difference in terms of deployment and the economics of the 50 seat RJs and the larger types.

Tighe: This is good news for the CRJs and the turboprops. Moving up in [RJ] size is good and opening up the replacement turboprop market is also good.

Fox: Was the unexpected growth in the 50-seater not due to the scope clause? It was not that the aircraft did economically well but due to the restrictions on the use of other aircraft it was the only one for the course. Now that we're moving into larger aircraft, the 50-seater is being disowned. With the relaxation of scope clauses, we are increasing in aircraft size. The 50-seat market grew on an artificial constraint, which has been removed, leaving this aircraft as an orphan.

Paiva: In the beginning 50-seaters were replacing turboprops on the medium-range routes. After 9/11 we had an excess capacity in the market on the narrowbody routes. The airlines needed to be present in more markets and replaced narrowbodies with 50 seats. The scope clause posed a limitation, which drove the airlines to these aircraft. The medium-range routes were allocated to a 50-seat jet. Due to the fuel price and economic conditions, the turboprops fell from favour. The right sizing opportunities that have come from the 100-seat jet is now available for the 70-seat jet because of the scope clause relaxation. The main application for the 50-seat jet is in the medium-range markets, especially in the US where you see 25 to 35 passengers daily in a range of 100 to 400 statute miles. There are probably 150 markets, which are not being operated directly. This is why there are a lot of new routes being opened by the 50-seat jets, because they are reallocating themselves in new markets.

Giovanni Tramparulo, vice-president, sales finance and risk management, ATR: We have seen a good increase in residual values of ATR aircraft over the last few years. For example, if we compare the values in 2006 with the values of the previous year we can observe an increase of between 5% and 12% (12% for the older ATR models and 5% for the newer models). Demand for second-hand and brand new ATR aircraft has increased. Last year we sold 90 brand new aircraft. This year we have sold 57 so far. We suffered during the downturn in 2003 and 2004 but airlines are now seeing the positive value of turboprops. The increase of fuel price has pushed demand up. But there are other advantages in favour of turboprop aircraft, like the purchase price, there is a difference of approx. 40% in the purchase price of regional jets when compared to turboprop aircraft of same capacity. Common sense and fundamental economics have pushed operators to recognize the strengths of modern and large turboprop on short routes. We have seen an increased demand in Asia. We have placed a large number of aircraft in India and Pakistan. Our main geographical zones in recent years have been Europe and Asia. The American market has shown an increasing interest for ATR aircraft this year with Continental Airlines and Delta Airlines. We have also a new type of customer, the low cost carriers like Air Deccan in India and Aer Araan in Ireland, which have purchased turboprop aircraft – the ATR 72-500.

Maunder: Surely elements of the Indian market are reminiscent of the scope clause. The market is artificially structured in that if an airline wants to fly trunk routes it has to provide a certain amount of capacity on the social routes. You need to question whether, should this artificial constraint be lifted, they will still operate such services and therefore have such a great need for turbo props.

Weiss: That is making the assumption that the ATR is not profitable.

Fox: Are we saying that the ATR 72 and the Q400 are competitors against the reuse of the 50-seater regional jet?

Tramparulo: There is no competition between a regional jet and a large turboprop aircraft. The market has clarified their different roles. The market says there is no better aircraft than a turboprop aircraft on short routes.

Fox: What is optimum range for larger turboprop?

Tramparulo: It depends on the specific market, but the estimate is 350-400 nautical miles.

Fox: 400 nautical miles keeps cropping up with the regional jet. It seems that the second-hand regional jet market may be influenced by the availability of the larger turboprops.

If they were fuel efficient and cheaper to buy in the first place, why would you go for the jet?

Phil Seymour, managing director, IBA: The projections for fuel are \$60 per barrel for the end of next year. The airlines are expecting fuel prices to increase. They are planning their routes. It is going to be a tough decision in terms of the 50-seater jets' ability to compete with turboprops.

Paiva: It depends on the range. Especially in the US, as you use the regional jet to fly over certain markets. The turboprop dominates some niche markets. It is great in some regions, less intense in others. The 50-seat regional jet has its operation and proves to have a different operational profile and opportunities.

Seymour: Maintenance costs are an issue for some of them, compared to the early years. An engine's life is based on cycles. Engine maintenance costs are something that regional jet operators are starting to see, if they are operating on shorter sectors, as being a high cost per flight-hour cycle relative to the turboprop. The mature maintenance costs are starting to hit and I don't think some of the airlines like what they see.

Stephane Garcon, general manager product marketing, commercial engines, Snecma: For 30 years Snecma, through CFM has had contact with regional jet operators. This market has changed a lot in this time. At the moment we are not only talking about maintenance costs. Now when you are talking about regional markets more people want to have the same medium-range aircraft. We have to bring this assumption not only to the engine but also to the cabin in terms of capacity. The same applies to engines. In the past we had high-cost engines. When we approached this market we said, when looking at the 60 to 70 pax, it is not easy to find an engine to operate in this segment because it is more correct to compare it to the turboprop aircraft. If you have an engine for the family, you can reduce the fleet costs. We have engine management optimization where we can move an engine from a higher to a lower application and recover it from the number of shop visits. Maintenance costs will be different in the future. The market is big due to the panel of applications that can be used.

Tighe: The operators are seeing increasing focus on engine overhaul and operating costs. That is great for the future but what about today? Regional aircraft and turboprops have high engine costs across the board.

Garcon: We at CFM have immense costs when developing an engine. Of course maintenance costs are high, but you have to balance these factors. Perhaps in 10 years' time, the picture will be different depending on the environmental aspects, including the economic aspects such as fuel prices. This impacts on the engine financially. Maintenance will be high but in keeping with the price of fuel.

Seymour: The manufacturer has to step in at some point. From what I have seen on deliveries of new aircraft, the inclusion of the total maintenance package is becoming fashionable. If you need to move bundles of CRJ100s and CRJ200s, someone has to step in to say, "Operate these and your maximum maintenance cost will be x". Perhaps these costs are too high.

Maunder: That is a concern I have as a lessor. Bombardier and Embraer are much more into their secondary market and I think this is very destabilizing. I feel that they would bite the bullet on maintenance costs because they are investors in their own products.

Rob Morris, director, market analysis and support, BAE Systems Regional Aircraft: This is akin to yield premium, which is increasingly difficult to defend. As a consequence regional carriers are increasingly facing the threat of being squeezed on yield and revenue – in addition to costs. We try to keep maintenance costs down with our regional aircraft cost-reduction programme. We can expect to see more pressure on yields.

Fox: It is interesting that BAE and Saab have exited the marketplace. The manufacturers cannot seem to make a cheap enough airplane to replace the 30-seat turboprop. If you cannot justify a 30-seater at what point do you arrive at when you cannot justify a 50-seater with anything less than 400 nautical miles?

Seymour: 10 years ago, Fokker and Dornier would be mentioned at this discussion. The market has changed massively over 10 years.

Morris: Yes, but we are finding niches. A good example is the ATP aircraft. We expect to have all our aircraft in service by creating the ATPF market.

Van Leuwen: These niches work because they are dirt-cheap.

Morris: I would not say dirt-cheap as we find value in placing those aircraft. It fits the lessors and the market.

Fox: But the new aircraft in that range are not being produced because they are uneconomical. Are we approaching the same situation for the 50-seater?

Ngo: If you look at the total number of 50 seat or less RJs produced so far, the number will probably not grow. If you add all of the CRJ100, CRJ200s and the Embraer RJs we have a population of about 2000 aircraft. But a secondary market for turboprops is developing. The biggest difference between the RJ market and the turboprop market is that with turboprops, certain manufacturers decided to get into the operating lease business and control the market. The RJ market it is an open market and is not controlled by the manufacturers. Their placements reflect real market value, not influenced by the manufacturers. If the RJs continue to work, it is because the economics of the aircraft are viable. According to statistics from the European Regional Airlines association (ERA) in Europe, close to 60% of the fleet are turboprops. That number

has not moved in the last 10 years despite the introduction of new generation regional jets. These turboprops are flown on sectors from 100 statute miles to just below 200 statute miles today. We have not seen huge movement in the direction of small regional jets. For example, Luxair recently evaluated large and small regional jets and turboprops and opted for the Q400 with operating costs that only a large and fast turboprop could offer. The choice is influenced by market application and the yield on these markets.

Tighe: Getting back to manufacturer involvement in the continuing ownership of airplanes and the contrast between the regional jet market and the larger jet market, some manufacturers reacted to the downturn [in 1991] by leasing aircraft. This impacted on the ability of independent lessors to participate in the market and on the value of used aircraft. Manufacturers have also used export credit financing as a way of providing seller financing and letting the various governments carry the can when things turn bad.

Seymour: We have been contacted by a few banks that are looking at financing and operating lease structures for turboprops, including the ATRs and Q400s. I think it's a good-news story. I think there could be higher returns for leasing some of those aircraft, compared to certain commercial narrowbody airplanes. The finance community want this market to work because it is not as mature as the non-regional jet market. The issue is: how quickly do you want your money back? Do you still want to have residual value risk in year 20? If you had your money by year 15, I would have thought it would be a problem in terms of investing in turboprops. We have always been a little bit cautious with the 50-seat regional jet because of the cycles and maintenance issues. I think most appraisers would say that the larger turboprops have fairly robust residual values. You can see why there is scepticism. If you are converting a regional jet in year 12 into an aircraft for another use, it does not inspire a lot of confidence.

Dahmen: I agree. As an investor we acknowledge the renewed interest in the market for turboprops. For a small lessor, the market is big enough to compete against a lot of people. The same applies to regional jets – there is easier contact with the manufacturers than when it comes to bidding for a 737-800 where there are usually about 24 people bidding. But with regionals there is still the question about the yield we would consider, despite the statistics showing that residual values of turboprops hold up quite well. We would consider turboprops but only for a good credit. A 10-year deal would give us enough time to appreciate the aircraft to a level we feel comfortable with.

Paiva: Clearly there is a demand for the turboprop but it is still a niche market. There is a lot of concentration. Replacements will begin in some areas, and Bombardier and ATR will put them to the market. But it doesn't represent the greater market.

Tramparulo: I have to disagree. May be it is the opposite. The regional jets are present in North America and in Europe only. Their presence in other parts of the world is marginal. ATR aircraft are present in 73 countries with 121 operators. Bankers and investors say that ATR's customer base is impressive. But it is true that there are two groups of banks - one is very experienced, professional: for this group to finance turboprop aircraft is not an issue and the other does not do its homework and is easily led by perception. We have suffered from this perception. Nevertheless, when you explain the advanced technology, the economics and other advantages for regional airlines they quickly understand. Someone around this table has said that manufacturers can offer good operating lease terms; I have to say that we do not finance brand new aircraft, we do not want to subsidize the market and our business of second-hand aircraft is managed with the objective to get good financial results for our shareholders.

Tighe: When did the two main turboprop operators last sell an aircraft without any financing support, including ECA, manufacturer financing or manufacturer guarantee?

Ngo: Our deal with Luxair did not have any financing support attached

Tramparulo: First of all an ECA financing is not a subsidy. The customer pays interest rate and an insurance credit premium, which takes into account the country and the credit risks. Secondly, we sell aircraft without ECA financing in many countries. Manufacturer's guarantee for aircraft financing is a falling business for ATR, which is good for all the actors: banks, lessors, investors and last but not least the manufacturer. A lot of discipline guides our daily activity.

Tighe: But Ireland uses export credit financing. The market is moving towards manufacturer financing with inhouse leasing vehicles.

Van Leuwen: If you are involved in this type of support and there is a default situation, you have a good chance of being able to remarket your aircraft. If you're up against 90% of the market, which has support from the manufacturers of regional aircraft, it is difficult. The transition costs associated with taking the aircraft from North America to Europe are very high. You need support from the manufacturers. If you are up against export credit agencies/manufacturers, it is a tough proposition in terms of getting your money back.

Fox: What is the problem with getting help to sell airplanes?

Tighe: Regional aircraft manufacturers seem to have used export credit financing to support higher sale prices, whereas LCCs [low-cost

carriers] have been able to acquire 737-800s for about \$28 million and A319s for less. These prices would suggest a price per seat of about \$150,000. The focus is on costs. If you don't get the costs down for large turboprops, you are out of the market.

Maunder: I think there is muddy water on both sides of the divide. The regional aircraft manufacturers and their governments have been more prevalent in this market, which is still a developing market of which they are trying to obtain a greater share. Boeing and Airbus are in a more mature market.

Tighe: The best thing to do would be to limit the number of aircraft effectively owned and leased by the manufacturers. The more market spread you have, the better. The issue is how to get market spread? Manufacturers should sell aircraft, not lease them.

Fox: With over 150 aircraft I would expect to get a good discount. But how many European airlines are going over 150 units at a time? Air Deccan, which has ordered a number of aircraft, has created an SPC [special purpose company] to handle those airplanes. They did not pay the ticket price.

Tighe: Buyers need to negotiate on the price, but things become difficult when the manufacturer offers export credit agency support and full training and other packages. There is little real competition.

Ian Hosier, head of transportation finance, Banca Intesa: The reason for this combination is that the regional aircraft market is based on a combination of regional credits and less-established aircraft. That is why financiers such as ourselves want something else in the package. This is not true for when people are looking at Boeing aircraft. It is much more prevalent in the regional operator segment.

Tighe: Would a lower price help you?

Hosier: Sure, but when you are in front of sceptical credit committees, they don't tend to look at that. They tend to look at things on a corporate basis and take comfort when they see an export credit package.

Olaf Sachau, head of aviation finance, Europe, HSH Nordbank: The main challenge for banks in the regional aircraft market has been to finance transactions for weaker credits at relatively high advanced levels for assets with limited remarketability compared to narrowbodies, in terms of number of operators and total number of aircraft in the market. That can be a fatal combination, but as long as banks are willing to do this, it is their own risk/return decision. From HSH's point of view, we will continue to do regional aircraft deals. But we want to be a little bit more selective and also not rely on export credit – in particular, since we would not be in the driver's seat in a distressed situation. We like regional aircraft and appreciate the good dialog we have with the regional manufacturers.

Fox: That is probably more prevalent with the regional jet than with the turboprop because of the difference in price. You pay about \$23 million for a jet, which everyone is saying is a niche market airplane. If your first company defaults, where do you put the airplane? With a 737-800 the risk is less.

Seymour: I think export credit is an entirely different roundtable because even regional operators such as Qantas want to use export credit. They don't need it.

Benoit Pineau-Valencienne, vice-president, sales finance, Embraer: Embraer sold 200 aircraft without government and manufacturer support or export credit, only commercial financing. This included US, Europe and Asia.

Paiva: When you look at export credit involvement in the 50-seat jet, 200 units are soon to be delivered and 200 were already delivered without export credit support.

Tighe: How many of those 200 aircraft were sold to a company, which has a relationship with a manufacturer of the airplane or its engines?

Paiva: As of September we had 120 Embraer 170 aircraft delivered. From 120 aircraft, 47 units went to Republic Airlines in the US and 28 went to US Airways. Of the 22 E175 units delivered, 15 went to Air Canada. For the total of 600 units of orders, Gecas have 80 E170s, three E175s, 12 E190s and eight E195s. Some 50% of the Embraer jets are based in the US where we have a varied spread of the fleet. We have 11% of our orders for the E170 and E175 in the Middle East and Africa. Our projection is that the US will make up 50% of our market. This is a decrease from 70% for the 50-seater jets. If you increase the capacity of the 50-seater to 70 seats, the cost per seat of that aircraft makes it viable in terms of the competition. With the regional jet, you normally have about three connecting passengers or more. Even if you drive some of the demand from this flight, the regional jet still has the capacity to fulfil it. The other point is that if you decrease fares, you need to increase the size of the airplane. US Airways is doing this with the E175.

Seymour: Have we not been here before with the Fokker 100, the RJ and the Bae146 fleet. The residual value performance of these aircraft has

not been robust. We are all relying on the change in business models and the economics of operational change.

Paiva: In a more competitive environment, you need to have the right aircraft in order to offer the appropriate service level. Certainly our E jets fit that concept.

Fox: Does this not prove that the E145s have been a totally artificial market from the start and the biggest competitor to the 50-seater airplane is the one Embraer is now building? In the UK, FlyBe is taking over what was British Airways' regional services and the rumour is that the first thing they are going to do is get rid of all the regional jets. I do not know what they will replace them with. Perhaps they will use Q400s.

Maunder: But that is part and parcel of the bigger picture. Regional jets have to go with a completely different concept for the operator. There are two different markets: the flag carrier that often has a regional subsidiary or FlyBe, which is a complete standalone operation but can keep its costs under control.

Fox: Yes, but if FlyBe takes the CRJ or ERJ fleet, why can they not operate them more effectively? When the company was installed by BA, its regional operations were quite successful in their own right. But they have missed out the 50-seat aircraft and gone for the bigger jets. The question now is, will it keep the E145 fleet?

Morris: FlyBe is quite a unique business model as a low-cost regional. It needs the largest of the regionals to give BA Connect that unit cost to play in the UK market space.

Ngo: The fundamental aspect of the 50 RJ market, be it turboprops or regional aircraft, has to do with the network. You cannot compare the missions of FlyBe and BA Connect. If the mission of the airline is to feed the hub you need certain aircraft to do that. If you have a totally different network, for example point to point, the aircraft would change. You need certain equipment to meet network requirements and it may not be the largest aircraft because if the demand is not there and you have to service it three or four times per day, a larger aircraft may not make sense. In terms of Luxair's restructuring, they completely remodelled the network.

Fox: I agree. The 50-seater market was driven by the scope clause. The new E range and C range will be driven by the airlines. With the A350, a number of people have told the manufacturer they have got it wrong and it is not the right design for the airplane. The customer is saying, "This is what I need and I have to be able to make money from it". Buying aircraft cheaply en-masse is one way of getting the price down. These factors are being driven by the market, rather than scope clauses.

Paiva: The scope clause was driven by the airline. This is now being relaxed and we can now operate larger aircraft. We don't need to go to extremes with the 50-seat jet. Everybody recognizes that it is more than what the market needs. The market will make the corrections in the future in order to have a more flexible fleet, but the 50-seat jet will still have a place in the future. It is still an important aircraft in the system.

Tighe: I think it is a good aircraft. If you look at the Boeing new-generation -600, -700, -800 and -900, very few -600s are being made. The base airplane is the -700. The Embraer is coming nicely under that.

Maunder: What is your take on Sukhoi's involvement here?

Ngo: We have been following the development of airline strategies, which is to gain market share or be competitive. They would find the right aircraft to do the job. The 50 seater has an important role. So there is a need for this type of service. These needs have changed because the economics of the passengers' expectation for value has changed. If the airlines adapt to that they will be successful. The next step is to look at aircraft that achieve those lower operating costs. This is a gradual evolution. There is a 20% reduction in narrowbody aircraft. In the post 9/11 market, airlines significantly restructured their fleets on the basis of replacing 100 seater with 50 seaters. Now there is a correction. If you look at the load factor of regional airlines in the last two years, they were typically flying around 60% load factor. Today these airlines are flying close to 80% load factors. The demand is there.

Fox: The question is: is it making money at 80%?

Ngo: Yes, otherwise the majors would not have awarded those contracts.

Fox: But in order to drive their hub-and-spoke system, perhaps they are willing to take the hit and cross that bridge.

Ngo: Northwest and Delta did that and after a very detailed evaluation they both decided to put back the RJs that were grounded. If they were not comfortable with the economics of those airplanes they would not be flying them today. Northwest put back 15 airplanes recently as part restructuring plan

Van Leuwen: Is there any hope that residual values will recover?

Ngo: We are hopeful that the market would conclude all of the transactions at work today and show that the diversification of the market application is there. We have concentrated a significant amount of our delivery in the US market. There will be a displacement of aircraft but this will be taken care of over time.

Tighe: In an oversupply situation you have to look at the possibility of taking airplanes out of the core market. Aircraft can be converted for cargo, executive, or even parted out. When a passenger aircraft is taken out of service, you will find that the values of the remaining aircraft are strengthened. But, most importantly, you have to ensure that the aircraft that are left are being properly maintained. The transition costs or restoring a poorly maintained aircraft to service will be found as uneconomical.

Van Leuwen: Transition costs for CRJs are relatively high.

Dahmen: Percentage-wise, it is the same for the 737.

Seymour: A lot of 737 aircraft were produced as being globally configured rather than being for a particular market. Compared to widebodies, regional aircraft do not have the same branding issues. If Virgin wants to change the branding, you would find that turboprops and regional jets are less heavily branded; hence less transition costs occur from a financing perspective.

Tighe: Operators acquiring used airplanes also want to know their history, which can have a huge effect on transition cost. Time spent in storage is also a factor.

Seymour: Most of the values we are able to provide all relate to a half-life value. There is a huge swing between an aircraft that has been sold and enrolled on a manufacturer's programme and has full life engines and component support compared to one that has been taken out of operation and parked in the desert. We have to be careful when we see numbers thrown around in the market. We have to take responsibility, not just listening to rumours in the market, but considering the condition of that airplane.

Airfinance Journal: Is the market becoming too congested?

Maunder: Sukhoi will become the Bombardier and Embraers of today and these manufacturers will move into the realm of Boeing and Airbus.

Garcon: I see a case of Sukhoi versus Embraer and ATR versus Bombardier, but there is definitely no congestion. n

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