Ageing fleets, fuel, maintenance to challenge regionals

Jack Dutton

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Regional operators and lessors face some challenges, including managing their ageing fleets and the corresponding maintenance costs, and volatile fuel prices, according to Kroll Bond Rating Agency (KBRA).

In a report on the regional aviation market, the ratings agency says that in the largest regional market, the United States, airlines must contend with scope clause restrictions and pilot shortages.

It states: "While smaller regional airlines and aircraft lessors exposed to emerging markets could be more prone to market-specific economic or geopolitical risks; on the whole, KBRA believes positive market trends will prevail. That said, KBRA notes that newer regional jets with limited in-service time have untested liquidity in the secondary markets unlike most narrow-body jets. Therefore, KBRA remains cautious as to their value in distressed markets, as well as for secondary and tertiary leases."

KBRA expects continued growth in the regional market globally, supported by strong demand in the emerging economies of Asia-Pacific (particularly China), Latin America, CIS (Commonwealth of Independent States), and the Middle East which will require new regional routes as global connectivity continues to expand. Demand is further underpinned by US and European airlines seeking to maximize capacity utilisation.

OEM consolidation

The agency also notes that in 2018, the two largest original equipment manufacturers (OEMs), Boeing and Airbus, have taken steps to establish dominant positions in regional jet production through acquisitions of Embraer and of Bombardier's CSeries. This has been a significant event for the industry with positive long-term benefits coming from economies of scale. At the same time, new market entrants from Asia and Russia have made strides, with the promise of more competition in the long-term.

KBRA believes that Boeing could help improve production at Embraer, which had previously projected a decline to 85-95 commercial jet deliveries in 2018 compared with 101 in 2017 (only 57 of which had been delivered in the nine months ended 30 September 2018). Despite a cancellation for 24 E190s by JetBlue, which opted to replace its current fleet of E190s with A220s, Embraer's order book remains strong, with US-based Republic Airways the largest customer at 100 orders, followed by Brazil-based Azul at 57.

To the extent these acquisitions entrench a duopoly, there is always a risk of less competition and innovation, as well as higher overall prices for regional airline and lessor buyers. However, KBRA believes that the regional jet markets will now benefit from the much larger network and marketing opportunities provided by Boeing and Airbus, as well as greater aftermarket support — which are positives for the buyers. Moreover, new entrant jet OEMs (including COMAC and Mitsubishi) have observed recent momentum in orders, which portends a healthy level of market competition going forward. KBRA believes the net effect of these partnerships will be overall positive for the industry, leading to improvements in production and technology of regional jets, which in turn will create new routes and lower operating costs for operators.

Asia focus

The regional market comprises around 4,000 jets and 5,000 turboprop aircraft globally. As seen in the broad commercial aircraft market, the global regional fleet continues to shift from its historically western focus toward Asia-Pacific (APAC), mainly driven by China. The International Air Transport Association (IATA) forecasts that routes to, from and within APAC will see an extra two billion annual passengers by 2037, for an overall market size of around 3.5 billion, with an annual average growth rate of 4.6%. The impact of this growth can already be seen in new regional aircraft orders. As of December 2018, North America held 36%.

Leasing

The regional aircraft leasing space continues to be dominated by Nordic Aviation Capital (NAC), with a fleet of 455 aircraft, more than double

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its next largest direct competitor, GECAS. Smaller companies focusing exclusively on the regional market include Falko, Chorus Aviation and TrueNoord, while larger commercial lessors like GECAS, DAE Capital, ICBC, AerCap and Avolon are seeking to reduce or at least not increase their exposure to regional fleets—leaving this segment to more specialised regional lessors. The segment continues to provide attractive risk-return characteristics, which has led to institutional investor interest in regional aircraft of varying ages through ABS structures, which provides market liquidity.

Excluding NAC, other lessors specialising in regional aircraft do not have the capital base to commit to large order books and must grow more opportunistically through the sale-leaseback market. Additionally, regional

lessor customers typically possess lower overall credit quality, which could lead to higher default and re-leasing risk. These factors mean growth and utilisation rates can be more volatile than for their narrowbody/widebody focused peers. That said, recent customer defaults have been isolated and well managed, including US-based Republic Airways, which emerged from bankruptcy protection in 2017 and is now Embraer’s largest customer.

KBRA expects the aircraft leasing industry to remain highly competitive in the short-term, driving further consolidation, particularly as the high-touch nature of regional aircraft leasing is better served by more specialised lessors with appropriate scale. Main risks to the sector include pressure on airline profitability from more volatile fuel prices, regional currency depreciation, and higher funding rates with potential negative impact on lessors. Rising interest rates can both constrain access to healthy, functioning capital markets and also pose a short-term funding mismatch as lease rates generally lag movements in rates by a few quarters.

Financing gains diversity

KBRA expects continued strong demand and financing availability for the 70-150-seat regional jet and 70+-seat turboprop segments, driven by strong passenger growth forecasts, increased demand for point-to-point routes, rapid growth in the global middle-class population and increased business travel in emerging regions. The healthy funding environment for new and used aircraft is expected to continue as more capital market participants become familiar with the embedded value of these aircraft, the ratings agency says. Inherent risks of the regional aircraft market that could hinder expectations include the cyclical nature of the airline industry, overall economic conditions and event risk. Additionally, market-specific factors such as pilot shortages or regulatory constraints with particular impacts on regional markets, could cause market disruptions. However, the regional aircraft markets—particularly for turboprops and jets serving connecting routes to main hubs—were historically less severely impacted during market downturns than long-haul markets. This was proven by lower depreciation of regional aircraft than for narrowbody or widebody jets during market turbulence, as these aircraft are more economical to purchase and operate.

The expansion of capital market financing options remains evident as the market has seen a number of ABS and secured transactions involving both regional jets and turboprops, as more investors become comfortable with the asset type. Importantly, some public enhanced equipment trust certificates (EETCs) have included regional aircraft in their overall pools, which both diversifies portfolios and creates more options for financing of such aircraft. KBRA has both published and unpublished ratings on several ABS and secured recourse transactions involving both turboprops and regional jets, and has developed various bespoke stresses and economic scenarios consistent with factors attributable to both regional aircraft types. For example, KBRA rates Nordic Aviation Capital’s ATLAS ABS and DAE’s Kestrel and Falcon ABS.

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