JOL/JOLCO: Down but not out

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Over the past 12 months, the big wigs in aircraft financing have decried that demand for Japanese operating lease with call option (Jolco) and Japanese operating lease (Jol) financings was “gone” and that the market was all but “dead”.

The latest data, however, suggests otherwise. While there have undoubtedly been steep cuts in the volume of aircraft equity underwritten by Japanese investors, Jol and Jolco transactions did still see deals in Covid-dominated 2020, and more closes are expected in the ongoing Japanese fourth fiscal quarter ending 31 March.

Jol and Jolco heavyweight, JP Lease, saw its number of aircraft deals structured in fiscal 2020 drop to 13 deals worth ¥92.9 billion ($879.5 million), from 44 deals valued at ¥311.2 billion the previous year. Similarly, the balance and number of equity underwritten in aircraft deals through 31 December dropped to 11 deals worth ¥27.7 billion, from 31 aircraft deals valued at ¥72.5 billion in 2019.

The numbers at Tokyo-based Financial Products Group (FPG) look similar. The company’s equity placed in aircraft assets dropped 22% year-on-year in its first fiscal quarter ended 31 December, while equity placed in marine containers ballooned 1,100% over the period.

Equity placed in aircraft amounted to 35% of FPG’s leasing fund’s total equity placed as at 31 December, down from 51% a year earlier. The fund’s total amount of assets arranged in the first quarter dropped to ¥21billion from ¥51 billion a year earlier. The total inventory amount decreased 32% to ¥59 billion.

“Looking at the numbers disclosed by JP Lease and FPG, the amount of new equity they have underwritten have fallen below 30% of their previous year,” says Marito Takamasa, joint general manager and head of global marketing of Tokyo Century’s aviation finance division.

He adds: “Our year-on-year numbers are not that bad percentage wise but that is because we only underwrite a fraction of the two companies. We have not seen the market pick up in the second half of the year, despite our hopes. While there still are a couple of deals being closed due to prior commitments or long-term relationships, generally the market is not seeing much activity especially after the new calendar year.”

Other experts in the field agree, including Thierry Pierson, chief executive officer and co-founder of Geneva-based Asset Brok’Air, who notes that airlines continue to be preoccupied with securing hefty government bailouts rather than structuring new aircraft deals.

“While there are still some Jol transactions going forward, the Jolco market is pretty frozen for the time being, save for very few exceptions such as pre-Covid mandates. This is due to the lack of equity underwriting appetite, but equally or more importantly the lack of qualifying commercial debt,” says Pierson.

“To some extent, currently the typical Jolco airline is also more focused at raising *billions* from governments rather than raising *millions* from Jolco equities. This is not to mention that the flow of aircraft deliveries has dried up significantly and that the large operating lessors have swallowed most of it, whether under operating lease[-backs] or by way of straight finance transactions,” says Pierson.

Asset Brok’Air does not expect a meaningful market recovery in 2021 as the airline industry processes ongoing restructurings and prepares for potentially more carrier liquidations.

“The Jolco market is still digesting the various restructurings, including returned/rejected aircraft and equity inventories. No rebound of the Jolco market is expected in 2021 save for a few exceptions. The focus of investors has shifted to maritime assets and the home market in Japan,” explains Pierson.

Asset Brok’Air closed two Jolco transactions in 2020, one covering an Airbus A320neo narrowbody and an A350-900 widebody. Both are in operation with Scandinavian carrier SAS. Other Jolco financings that closed last year were deals with aircraft operating for airlines which included Lufthansa, British Airways, Cathay Pacific, Wizz Air and Turkish carrier Pegasus Airlines, *Airfinance Journal* data shows.

Sumitomo Mitsui Finance and Leasing (SMFL) has seen demand for Jol and Jolco transactions shift to shipping assets from aircraft holdings amid the ongoing pandemic, says Shinichiro Watanabe, its managing executive officer and head of transportation.

“Typically, about 70% of the year’s total Jol/Jolco equity gets transacted in the second half of the Japanese fiscal year, so from October to April. Through the end of the third quarter, we saw volumes of about 50% of the previous year, so it was not too bad I would say. As we close the fourth quarter at the end of March, we of course hope to show a number much higher than that. The equity demand is obviously smaller, but it is still there, although, to be honest, for us at SMFL it was mostly focused on shipping, not so much on aircraft during the pandemic,” says Watanabe.

The recovery of the Jol and Jolco market will take time, but the market will bounce back for lack of alternative tax solutions in Japan, says the SMFL transportation head.

“It will probably be at least another six to eight months until we see a real improvement with the Covid situation and that will then coincide with the beginning of the second half of the fiscal year here in Japan when hopefully investors will be looking for more tax solutions again,” says Watanabe.

“I’m hopeful that the second half of 2021 will see a real revival of the aircraft equity demand market. Investors will come back to Jolco deals, they will need to. We do not have many other attractive tax solutions in Japan. We have no choice but to pay tax, so we need efficient solutions for that,” he adds.

Listening to recent panel discussions and industry talk, investors are said to be “quite afraid” that a number of airlines will not exercise their call options, some because they are in the midst of Chapter 11-style restructurings, and others because they say asset values have dropped so much that exercising makes no business sense for them.

“This case may happen, obviously, but airlines are facing a strategic/economical decision: either being rejected from the market for a while when Jolcos will restart or complying with the ‘gentlemen’s agreement’ of the Jolco, meaning exercising the purchase option. Returning an aircraft under a Jolco is not as easy as with an operating lessor,” says Pierson.

“For those airlines that will survive, I strongly suggest balancing the decision in favour of the Japanese investors by seeking satisfactory outcomes for both sides. At Asset Brok’Air, we keep working to ensure that purchase options will be exercised in due course and on time,” adds the firm’s chief executive officer.

“We explained to our airline customers that if they do not exercise their call options they will be ostracised and banished from the market for many years – they cannot come back, nobody will accept their deals – so for us we haven’t seen any of our airline credits decline the call option,” says SMFL’s Watanabe.

“Some of the discussions are still ongoing but so far it has not happened. Of course, the situation with under bankruptcy or Chapter11 proceedings is different, and those are painful and memorable experiences for Japanese investors, especially those in South and Latin America, to which we have some exposure,” he adds.

“We are not aware of any Jolco deal where the purchase option was not exercised except for deals where the lessee has sought legal protection. We are, however, aware that there are pseudo Jolco deals (the intention of this being a Jolco was not shared among all parties, especially the lessee) where purchase options were not exercised. Where the investors cannot prove that the underwriters ran afoul of the regulations when selling these products, the investors will need to take a hit, and this will no doubt negatively affect the market,” says Tokyo Century’s Takamasa.

“Before Covid, many airlines differentiated Jolcos with other financings and chose to honour obligations in full, even when they were under legal protection. This certainly has changed, and we are now seeing airlines seeking to renegotiate terms for Jolcos also,” adds Takamasa.

Tokyo Century says negotiations with airlines remain ongoing and so far none of its Jol and Jolco aircraft have been terminated or repossessed.

Japanese investors are notoriously cautious and risk averse. They do not easily trust new financial products and require a lot of “warming up” to all things new. Nevertheless, over the past five years Japanese taxpayers have become more open to agreeing aircraft Jol and Jolco deals with lesser-known and established airline credits, some would say particularly in Latin and South America. Will investors now shy away again from less-proven markets and carrier credits?

“The wave of new faces entering the Jolco market is fairly recent and we believe deals arranged for those names have not reached the stage where purchase options is an issue. The exceptions are, of course, where lessees have filed for legal protection and are negotiating lower lease rates with all lessors including Jolco lessors. With sufficient airlines filing for bankruptcy already, we believe the market will refocus on the traditional names, and as of now it is not easy even for traditional household names to tap the Jolco market," says Takamasa.

He adds that now is a good time "to remind everyone" that "the Japanese market has a very good and very long memory", so attention must be paid to protecting investor interests.

His colleague at SMFL agrees.

"Some of the deals we have seen in recent years, especially with carriers from South and Latin America, have focused on used aircraft, vintage aircraft. Of course, the lease terms here are shorter so the Japanese investors thought they could receive their tax benefits in a much shorter time. Unfortunately, these are aircraft now subject to Chapter 11 proceedings so you could say the deals did not work out," says Watanabe.

"The investors traded faster returns for greater risk, by sacrificing on the quality of the asset and lessee, but in this case that backfired. The investors and their advisers paid more attention to the tax benefit rather than credit or asset risk. Those arrangers are also very disappointed and will have learnt their lesson after having to face unsatisfied investors. It was a good warning to the arrangers. Of course, in the case of Jol, it is mostly fine now after the situation calmed down from the third quarter, but, in the case of Jolco, it is totally different, some investors are devastated and may not come back to the market," adds Watanabe.

"Clearly, the Jolco market will face, like any other market, a new environment with new economics. That was the case post-September 11, post the subprime mortgage crisis. In the current environment, the market will focus on survivors. The Latin American Jolco market is always up and down. Maybe the down period will be much longer this time as those airlines involved in Jolco deals broke the trust," says Brok'Air's Pierson.

The three Jol and Jolco financiers stress that key to a revival of the market is spending a lot of time with the customers, both on the Japanese investor side and the airline lessee end, to maintain the trust.

"Investor appetite for passenger aircraft has dwindled over time as bankruptcies increased and airlines continue to announce depressive results. We are searching for the few who do take a more long-term view, but this is not proving to be an easy task," says Takamasa.

"Japanese banks, not just the regional banks but also the megas, are not writing new aviation loans now. My personal view is, there is very little we can do when the knife is still falling and until vaccines become available to the larger public and airlines start scheduling cancelled routes again," he adds.

"We need to immediately remedy any issues to maintain investors' confidence in Jol and Jolco products. The Japanese leasing houses are doing an outstanding job protecting the interests of their investors. Jolcos will come back," says Pierson.

Some involved in Jol and Jolco transactions believe that a safer way forward for Japanese investors could be doing deals directly with big leasing credits rather than more volatile airline credits. Has Covid reinforced that thinking? Has the market seen new Jolco transactions closed with lessors?

"Some underwriters have expressed these views too. While this may be true from a Japanese perspective, we are not convinced that there is sufficient demand from the big lessors as financing their aircraft with Jolcos will require the lessor to set aside these aircraft from their trading inventory and hold them for 10 to 12 years. We may see a couple deals, but this will never be a big wave in our view," says Takamasa.

"Personally, I believe lessor Jolcos can be a very useful product for both lessors and investors. The Japanese investors may prefer a lessor's credit risk profile compared to an airline. This also goes for our affiliate SMBC Aviation Capital. I think there are good opportunities for us ahead in this segment," says SMFL's Watanabe.

Asset Brok'Air's Pierson agrees.

"Jolcos for operating lessors are performing very well and this is indeed a very good solution for the lessor and a great outcome for the investors," he says, adding: "The market is realising how much more secure/safer this can be for investors. I do anticipate much more activity in the coming months for such operating lessor financings. We have done three transactions since the last time we spoke, and 10 deals in total."

