



Nils Hallerstrom

ISTAT PDP Program Director, Member of the Boards of Novus Aviation Capital and Rockton Aviation



Jetrader spoke to Nils Hallerstrom, ISTAT PDP program director and member of the boards of Novus Aviation Capital and Rockton Aviation, about his career, changes he's seen over the years, COVID-19 and more.

Jetrader: Where did you begin your career, and what do you spend most of your time doing now?

Nils Hallerstrom (NH): I decided to get into aviation when I was 4. My neighbor was a flight attendant on the Douglas DC-7C flying to New York and Tokyo via Anchorage. She was like a movie star in my mind. I built and flew model airplanes and then went on to study aeronautical engineering in Stockholm at the Royal Institute of Technology. After a stint at SAAB on the SAAB 340 program, I attended the London School of Economics to study Finance. In 1984, I joined PK Finance in Luxembourg, and in 1988, the aircraft finance arm went with Credit Lyonnais and became PK AirFinance. One of my teammates was Jep Thornton; he tried really hard to take me out of the “nerd zone” — with mixed results. After a few years in New York, I came back to Luxembourg to run the company — in 1991 — in a terrible downturn. That was an expensive education in aircraft financing for all of us. We were sold to GECAS in 2000, and with their clout and footprint, the company grew and prospered. I retired at the end of 2018 and began serving on the board of

Novus Aviation Capital and Rockton AB. In addition, I run the ISTAT Professional Development Program.

Jetrader: When did you first get involved with ISTAT?

NH: I think I was at the very first conference in either 1984 or '85. I joined PK in '84. It was a really small group then. One of my compatriots, which is very unusual, because there are few of us in Luxembourg, was Johannes Einarsson, who was the chief operating officer of Cargolux; he was one of the founding core members of ISTAT, and he later became its president. I think it was his initiative to start ISTAT's conferences in Europe. It began as a small and cozy gathering. There was a wave when things started to pick up in the mid-'90s, and certainly after 2009 and the financial crisis, there's been tremendous growth. Everybody started to get into aircraft financing. In the beginning, it was mainly a few appraisers and a few fleet managers at the airlines who met to discuss trading aircraft. The appraisers were there to help with the valuations, and then bankers, lessors, lawyers and analysts joined the ranks.

Jetrader: You have seen the air finance market develop over the last 30-plus years. What is the main difference between 1990 and 2020?

NH: In 1990, aircraft financing was a highly specialized and exotic undertaking, with few competitors, high inflation and attractive tax benefits. Today, the market is hyper-competitive with numerous players around the world. You can't win today without tons of data, sharp tools and efficient processes.

Jetrader: You have always been a strong believer in mathematical modelling of aircraft portfolio/value risk. Do you still believe in this approach?

NH: You need a method to the madness. Collect and mine the data, analyze it, and use it to calculate risk and reward. The HP-12Cs or Excel spreadsheets will give you an IRR, but it assumes everything goes according to plan. No default and hitting an aircraft value at maturity spot to your booked residual. Use the speed of your PC to calculate zillions of possible outcomes, all calibrated to your data, and look at the IRR (or NPV) as a probability distribution rather than a static number. This will give you meaningful metrics for reward and risk and help you make better decisions. Nobody could have predicted the coronavirus outbreak, but that outcome would have been among the many scenarios you accounted for. A model will never replace experience, insight and sound business judgement, but it can be a useful tool to run your business in a more coherent and efficient way.

Jetrader: There used to be basically three tiers of airlines to provide debt or lease financing. As an aircraft aged, it moved to the lower tiers: the first tier being the major airlines, and so on. How many tiers are there today, and how would you describe them?

NH: As an aircraft ages, it will be less about understanding the performance and more about understanding maintenance condition and planning the maintenance events. An increasing proportion of the variation in value will derive from the maintenance condition. It used to be that top-tier airlines took the new aircraft and then they trickled down the chain as deregulation took off in the late 1970s, and many startups came along that couldn't afford the new kit. That is not true any longer. Top-tier airlines have the capability to maintain older aircraft and deploy them optimally. But, it may well be that lessors need to specialize in the phase of the aircraft. Tier 1 orders from the OEM and places on a first lease; Tier 2 buys from Tier 1 and handles lease return and second lease placement; and Tier 3 handles end of life and part-out. It is hard to be the best at everything. Some tried the cradle-to-grave concept, but I don't think it worked out so well.

Jetrader: Under the current COVID-19 crisis, we expect increasing pressure on aircraft values. Which aircraft do you see recovering their values once the crisis is over, and which will be permanently impaired?

NH: This hurricane will hurt airlines and lessors first and foremost — anybody with leverage. Even when the pandemic is behind us, the return to normality will take time. There will be fear and reluctance to fly, restrictions around boarding procedures and border crossings. Disposable income will be dented both for individuals and corporations. Some people will get used to "Zooming" or "Skyping" or "Teaming." The price of risk is shooting up, so leasing or financing aircraft will

be more expensive. This will be the deepest down cycle so far in the jet age, and the upturn will be slow and gradual. Many airlines and lessors will go through restructuring either in bankruptcy or outside, and some without a viable business model will liquidate. I pity those who make it through by piling on debt or deferrals; they will face fierce competition from the restructured ones. The oldest, oddest and biggest planes will be retired early, and the order backlog will suffer. Production rates will be cut. But people want to travel, and aircraft will be back in demand and the capacity balance restored. I am not sure that aircraft that avoided the graveyard will be impaired permanently.

Jetrader: Some industry observers suggest that large twin aisles are less suitable for operating lessors or asset-based financiers. Residual values of this category have often disappointed. Do you agree? Why?

NH: There are two things: Cyclical and reconfiguration costs. You can cram a lot of pax into a big plane when the market is hot, but in downturns, they are hard to fill. So,

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you get hit hard in a down market, and then the cost of reconfiguring the widebody aircraft and its interior for the next operator can be prohibitive. On top of this, new narrowbodies are getting great range, displacing widebodies with superior economics and attractive point-to-point routes.



PERSPECTIVES

Jetrader: What are your thoughts on the current ABS market and the existing ABS transactions?

NH: I am not an expert on tradable securities, having spent most of my working life on private loans. But the enormous spike in spreads bears witness of falling aircraft values, eroding airline credits, less reliance of regional and aircraft type diversification, and higher risk premia.

Jetrader: We are experiencing currently (and maybe extended) lower fuel prices. What is the impact on the economic useful life of aircraft and deliveries of new aircraft?

NH: Low fuel prices favor older planes, but low interest rates favor newer kit. So, then you need to figure out where oil prices and interest rates will go. Oil may stay low in the wake of economic weakness, and so may interest

Jetrader: Do you expect fundamental/structural changes in the commercial aviation market/the air finance market as a result of the current crisis, or will it be business as usual once it is over?

NH: I think that we will see consolidation. Many smaller lessors that never lived through a downturn will not make it, and their portfolios will be picked up by others. Scale is an advantage, asset prices don't show on the Bloomberg screen and most airlines are not rated, so you need to see a lot of trades, lease placements, and know a lot of airlines from the inside to get enough data to make smart decisions. Generally, risk will be repriced, and that is not going away for a long time.

Jetrader: Unfortunately, ISTAT PDP has been postponed until next year, but can you tell me about your role as program director and the goal behind the program?

NH: I keep my fingers crossed that we

Jetrader: There's a lot of uncertainty in the world. What wisdom can you impart on the industry?

NH: There is a tendency where every time we are at a peak in the cycle a lot of people say it's a sea change — that things have really changed and this is going to last forever with no clouds on the horizon. "The cycle is dead." But, that never happens. So now, on the other hand, when we are at a trough of the cycle, a lot of people say "This is it. It's never going to be the same again." I remember this from 9/11. People who were quite experienced in the industry said "People are never going to want to travel to the same extent again."

It's very important to remember that this is a cyclical industry, and it is a fragile industry, but there is an inherent desire for people to travel, and I don't think desire is going to go away. This is not the end of aviation. I've read a lot of gloomy articles lately about how this is completely changing the face of aviation forever, and I don't think that's true.

This is the worst downturn that we've experienced in the jet age. We've never seen this type of decline in air traffic. But the planes are there, and the pilots still have their skills. Only the coronavirus knows when, but gradually people will start traveling again.

I think this downturn started slowly before the virus broke out. We had a phenomenal spell of traffic growth from 2014-2018 that was fueled by the emergence of a lot of people in Asia who became rich enough to fly. That created growth and the need for airplanes. There was also a step up in technology of airplanes with new models being offered with 15% better fuel burn. These planes were launched at a time when oil prices were US\$120 a barrel. A lot of airlines said, "We cannot miss this train. We have to order airplanes." The manufacturers started to build like crazy and had a high production rate and an enormous backlog of airplanes. This has been a concern, that this backlog is a little bit oversized. Then, this event happens,

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rates. Airlines will undoubtedly strive for streamlining their fleets and concentrate on keeping only the core aircraft types.

Jetrader: Aircraft finance used to be a specialized niche activity. Has it become mainstream now and, if so, what does this mean?

NH: Yes, it really became mainstream — what could possibly go wrong? I wonder if it is not going to get a little more niche and specialized again for a while.

can run this in 2021 and also launch the Americas version of the program. We have 31 very qualified professionals signed up for Europe, and I hope they will all have the opportunity when we can kick this off. The idea is to develop promising talent with one to five years in the business and transfer some of the deep knowledge and experience from instructors drawn from the ISTAT membership. At the same time, the students will have an opportunity to network and meet several exciting dinner speakers.



people who say everything is hunky dory and nothing can go wrong, and then you have some people who are “Dr. Doom.” When there is a downturn, Dr. Doom can say “Didn’t you listen to me last year?” The reality is nobody knows when these events will strike. But there was a general uneasiness about how many years this upturn from 2009 had continued. Normally, the cycle is 10 years. It would be about two or three years from peak to trough, then seven or eight years for the market to build back up again to the next peak phase. So, on year eight or nine, people started to say “This is where the cycle is supposed to turn down.” In 2019, there was less traffic growth than we saw in 2018 and 2017. It should have been matched by lower production rates, but what happened in March 2019 was the MAX was grounded and Boeing stopped delivering them. So, that corrected the capacity imbalance that was emerging, which made 2019 look OK even though it shouldn’t have. A lot of people were concerned that, come 2020, Boeing was going to get the MAX back in the air and then 700 aircraft would be delivered in addition to the very high production rate Boeing planned, so there was going to be a flood of

so the manufacturers are going to cut back production, and that will be part of the solution. We’re going to return to a balance between the number of airplanes we have in the fleet and the number of people who want to travel.

ISTAT conferences are fun because you have

airplanes, and people wondered who was going to need all those airplanes. Then the virus happened, which made everything worse.

Jetradar: What advice would you give to someone just coming in to the field?

NH: Unfortunately, some of the kids now looking for jobs in this market will have to be patient, because there’s going to be some sorting out to be done in the coming years. But, eventually, we’re going to need a lot of young and bright people out there. I started in this business in its infancy when I came out of school, and so did many others in the business. It’s encouraging for people coming into the industry now. They have the benefit of learning from the current downturn. I started in 1984, right in the middle of a deep cyclical trough from the second OPEC crisis. It was a very expensive education, but the lessons were valuable. Here we are at such a teaching moment again! 🚀