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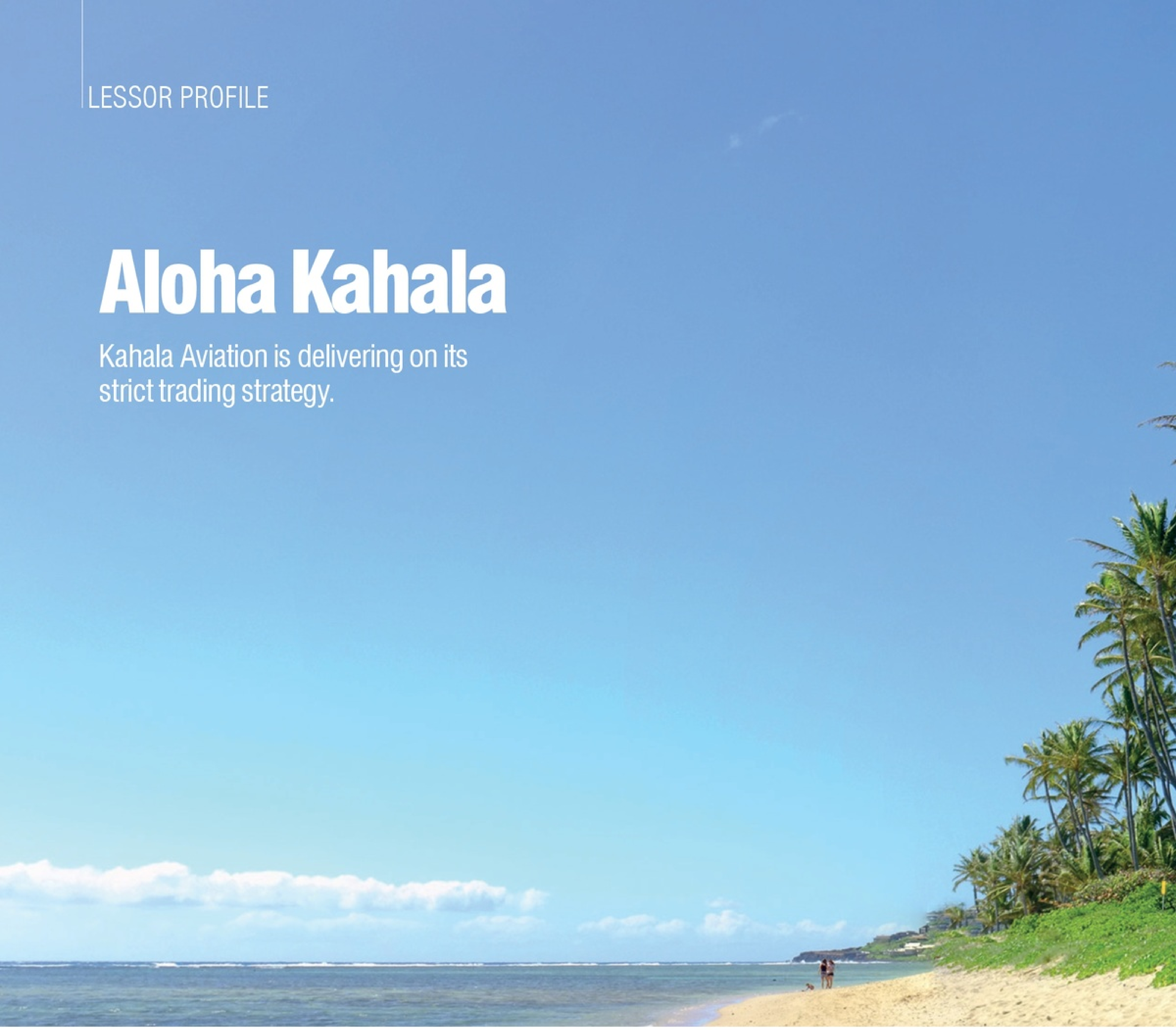

Aloha Kahala

Kahala Aviation is delivering on its strict trading strategy.

Mid-to-late-life aircraft leasing company, Kahala Aviation, is an active aircraft trader. The company made headlines last year when it bought 30 aircraft from AWAS via the Diamond Head asset backed securitisation (ABS) but it has been consistently buying and selling assets all over the world since its creation in 2004. In the past quarter, Kahala has been busy selling 737 Classic freighters. It has sold a 737-300F into Asia and a 737-400F back to lessee West Atlantic. The company's current portfolio has a range of aircraft types on lease to 22 airlines around the world. Kahala also manages aircraft for one US business development company (BDC), the Business Development Corporation of America, and the lessor has a healthy balance sheet of close to $425 million on approximately $200 million of shareholder funds.

"If you looked at all of the $1 billion or so of aircraft we have bought over the last 12 years– there is everything from 777s to 50-seat regional jets and turboprops," says Bradley Smith, managing director and co-founder of Kahala Aviation. "You could say that this portfolio doesn't have much strategy or much commonality behind it, but the commonality and the strategy is defined by the fact they are all unusual transactions, such as certain special situations, difficult aircraft types or jurisdictions. We are very comfortable with our end-of-life residual values, which drives a lot of out economics."

Given the experience of its founding partners, Kahala has been particularly successful in the more challenging jurisdictions and in special situations. Founded just a few years after a series of events impacting the aviation industry from 9/11, SARs, the Gulf War and a number of US airline bankruptcies, Kahala Aviation built up its portfolio out of stressed scenarios.

"When we started we were showing up to bid on aircraft where there were only two or three other bidders; today there are usually two dozen," says Smith. "What made us successful was the unique combination of skills set in our company, which we didn't plan or realise we had in the beginning."

Co-founder Mike Garland's deep industry and asset knowledge and the trading and technical expertise

of another founder Mark Thatcher, combined with Smith's financial know-how and investor relationships, to enable the business to take off during a period where many investors were reducing their aircraft exposure.

"Although in the beginning I had little aviation experience, I had relationships in the financial community who were now running major hedge funds as well as relationships among the Japanese leasing companies that were looking to sell aircraft when the US majors were in bankruptcy," remembers Smith. "I understood those companies and Chapter 11 situations well. This combined knowledge enabled us to raise capital to purchase 40 aircraft by 2006 from every US bankruptcy except for American."

"We focused on aircraft that we were confident would be in demand," he adds. "We also picked up the unsecured claims out of the prior leases, which was very successful."

By 2006, however, the aviation market became overheated once more, causing Kahala to seek other special situations. "We started acquiring and trading regional jets and turboprops, as well as focusing on special situations in terms of more challenging jurisdictions like Eastern Europe, Ukraine and Russia, Mexico etc."

At the time, the majority of the competition focused on the US market and shied away from those jurisdictions. "One of our advantages is our ability to work all over the world and to do so comfortably. Despite the Hawaiian name (Kahala is a neighbourhood in Honolulu), the company is non-US focused and based in Dublin."

The founding partners each have experience trading and repossessing aircraft around the world. From restructuring leases in Mexico and Ukraine, to pulling aircraft out of Serbia during the war, such experience has given the company the confidence to put more aircraft into new jurisdictions.

It was not all plain sailing for Kahala, however. Post Lehman Brothers and the subsequent global financial crisis, funding for the company dried up, which in part led to the decision to float in 2011 in a blind pool initial public offering. Kahala had planned to sell 15 million shares in the form of American depositary shares (ADS) for

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> *Bradley Smith, managing director and co-founder of Kahala Aviation*

$12 each and raise up to $180 million. At the time, however, the lessor owned just one 757 and planned to use the net proceeds from the IPO to buy and lease more aircraft. In March 2011, the IPO was pulled due to a number of market stresses.

"When we came to market Libya was starting to fall apart," says Smith. "And, even though we had a great track record, we were raising a lot of money and investors were concerned about putting money into a company without any substantial assets."

It was not an entire loss, however. The IPO enabled the company to publicise its story and the founders succeeded in attracting new investment to finance future deals.

A DIAMOND DEAL

Kahala Ireland Investments Designated Activity Company, an affiliate of Kahala Aviation, bought the unrated E-notes of the $260.75 million, two-tranched Diamond Head Aviation 2015 Limited ABS, serviced by AWAS Aviation Capital in July 2015. The deal secured a fleet of 29 aircraft comprised of eight 737-300s, four 737-700s, four 737-400s, four A321-100s, two 737-800s, one A319-100, one A330-300, one 757-200F, three 767-300ERs and one 777-200ER. The aircraft were leased to 16 lessees located in 14 countries. The top five airlines of the 16 total lessees represent 50.4% of the pool, included strong, well-capitalized airlines like Korean Airlines (10.6%), Southwest Airlines (8.0%), Hawaiian Airlines (7.5%) and Air Canada (11.6%).Wells Fargo was the sole structuring agent and lead arranger of the transaction.

The pool of aircraft had a weighted average age of 16.4 years, which was significantly older than the younger vintages included in the other aircraft ABS closed before it. The comparable Castlelake 2014-1 ABS deal was secured on a portfolio of 79 aircraft with an approximate weighted average age of 17.5 years.

Although GECAS, Castleake and Apollo Aviation have issued aircraft ABS using older aircraft assets, this deal was the first aviation ABS to include mid-to-end-of-life aircraft and which raised new equity. The collateral was also unique in the sense that at least 20 of the 30 aircraft in the pool are in the stub lease-to-part out phase of the lifecycle of the asset. As a result, this deal included little remarketing risk but carried heavy part out and residual value risk. Kahala was able to leverage its position as the equity buyer to secure a number of unique aspects in the deal.

"We negotiated much more expansive rights to the equity vis-a-vis the servicer than has been done in previous ABS deals," says Smith. "We have the ability to approve most significant economic decision taken on our aircraft from new leasing deals, to sales, to part out. In most ABS deals, the servicer can do pretty much whatever it wants, but in our deal we have a substantial amount of say in what happens to our aircraft."

AWAS is the servicer of the Diamond Head pool. "We have a great deal of respect for AWAS and for its ability to remarket aircraft but at the same time that is what we are good at so we weren't prepared to carte blanche to any servicer."

The gritty nature of this deal, primarily caused by the presence of the 20 aircraft stub lease to part out, attracted Kahala. "Because this was such a complicated deal, there were very few natural buyers for the equity in a deal like this, which enabled us to be the price maker as the equity provider," says Smith. "The economics were very attractive – the A notes price at 4% and the B notes at 6% on a blended basis was a very attractive cost of debt financing."

Kahala was also attracted by the scale of the deal. "We felt that we needed a little more scale to increase our balance sheet substantially," he adds. "This deal also gave us our first exposure to widebody aircraft, which gave us the ability to learn more about the widebody market."

BUSINESS STRATEGY

Although its focus is on mid-to-end-of-life aircraft, Kahala has no interest in acquiring an MRO or parts company. "We are not apart out shop and we don't own an MRO," says Smith. "Many people in the leasing market think that running a part-out or MRO shop is a great business to be in but the truth is that those businesses have too much supply, too much overcapacity, and it is not a value added end of the business. We have looked at buying an MRO but it didn't make sense for us as a business. We have determined that we are much better off contracting that section of the business out to third parties and focusing on the higher value added end of the market."

Starting in 2004, the Kahala partners are used to aviation cycles. Today, the market is overheated again and a lot more competitive. "From when we started in 2004 to 2016, returns have shrunk dramatically," says Smith. "There has been a lot of new money coming into this space with people bidding up transactions to levels that we consider to be totally unreasonable. You need to have a special edge to really make money. A lot of these new entrants are going to find it difficult to be successful over the longer term. If there is any substantial economic downturn, some of these new players that have bought aircraft over the past few years may end up having pretty unhappy outcomes on some of their transactions."

Today, Kahala is focusing on trading and converting 737 Classics into freighters. Indeed, Smith says, Kahala was the first leasing company to get in actively to converting 737 classics back in 2007.

"We have been buying up 737 passenger aircraft, converting them and then lining up the customers," says Smith. "A lot of work goes into converting these kinds of aircraft and you need deep technical knowledge of the assets to be successful at it. You need to project manage an aircraft conversion – it's not as simple as just handing the aircraft to the conversion shop. This is where we have a competitive advantage."

Having that deep asset expertise allows the team to take more substantial remarketing risk, and win deals over its competitors: "Everyone in the world right now wants to buy an aircraft with two or three years remaining on the lease," says Smith, " and it is those assets that are being offered for sale at increasingly unreasonable levels. We are buying aircraft forward to where they actually come of lease and take the remarketing risk when we may not have a deal lined up at the time. We can do these deals because of our strong technical expertise; and these deals give us the edge in certain transactions in a crowded marketplace."

Equally, the team is comfortable repossessing aircraft when it needs to and finds most value during downturns. "We would be very happy if there was some dislocation in the market as it creates a great buying opportunity for us," says Smith. "Although we take more jurisdiction and credit risk than some other lessors, we don't have a high repossession rate. That said, our experience in successful repos makes us more comfortable going into jurisdictions others may not."

Many jurisdictions have put in place age restrictions for aircraft, which does impact mid-to-late life aircraft lessors. "Bit by bit more countries are imposing age restrictions on used aircraft and there are fewer and fewer countries where you can put 16 year old aircraft," says Smith. "This is increasingly affecting residual values on older aircraft, which is contributing to the debate over whether the useful life of an aircraft is still 25 years."

The mid-to-late life aircraft leasing business is very different from leasing new aircraft. Few lessors have succeeded in this space but this is where much of the new entrants are coming into, attracted by the higher yields. Smith doubts many will be successful. "I'm amazed that lessors that have spent their entire careers leasing new aircraft and then decide to invest in leasing used aircraft. What we do is very, very different. Our model is much more commercially orientated as opposed to a finance business where the focus is on net margin and cheap funding."

Looking ahead, Smith recognises that the used aircraft market is very different than it was when Kahala was created. Indeed, the commercial aircraft fleet has grown from 15,000 in 2004 to more than 50,000 today and is increasing. "As the used aircraft market continues to mature and expand, there is less room for small individual players," says Smith. "To be successful in this business you need to have scale and a reasonable amount of infrastructure. We are now at a size where we can raise more equity to acquire more assets and grow to be one of the top half dozen players in the space."

KAHALA AVIATION FLEET LIST

Aircraft Type	Lessee
A320-200	Aerovista
737-400F	Atlantic Airlines
CRJ-200	Belavia
737-800	Eastar
737-800	Eastar
737-400SF	Jet Time A/S; Denmark
737-400F	Jet Time A/S; Denmark
A320-200	SkyAngkor
737-300F	Texel
737-300F	Texel
757-200	United
757-200	United
A330-300	Air Asia X
A321-100	Alitalia
A321-100	Alitalia
A321-100	Alitalia
A321-100	Alitalia
A319-100	Air Canada
B757-200F	TNT
B737-400	Mistral Air
B737-300	VivaAerobus
B737-300	VivaAerobus
B737-300	VivaAerobus
B767-300ER	El Al
B737-300	VivaAerobus
B737-400	LOT
B777-200ER	Korean Air
B737-700	GOL
B737-700	GOL
B737-800	Corendon
B737-300	Surinam
B737-300	Surinam
B737-400	LOT
B737-400	LOT
B737-800	Ukraine Int'l.
B737-700	Southwest
B737-700	Southwest
B767-300ER	Air Canada
B767-300ER	Air Canada