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AIRLINE FINANCING

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THE spotlight is focused today on the problems of airline financing. The rapid communication and transportation provided by our airlines are recognized as essential parts of our economy and national defense. The financial health of so vital an industry is therefore a matter of national concern.

The airline companies are still young and their capital structures in most cases are simple. At their inception the airlines were financed almost exclusively with private equity money. Modest numbers of planes were acquired with the funds of the operator or his backer who, generally speaking, was not a lender but a partner in the enterprise. Air transportation was a highly speculative venture and ordinary channels of credit were not available. Furthermore, the reputation of an individual airline was built almost entirely on its operating ability rather than on the quality of its business management. The small size of the operation did not require large amounts of working capital and ground equipment.

As the airlines grew, they required additional capital which few individuals were able to provide from their own resources. It became necessary to look to the public for these new funds, and the tremendous growth possibilities of air transport provided "romance" in the eyes of investors. The public demonstrated a genuine willingness to participate in this growth without immediate compensation in the form of dividends. As a result, it was possible to reinvest an unusually large portion of current earnings in the business. Later the process of equity financing was facilitated in several cases by the use of convertible preferred stocks which, in effect, enabled individual airlines to sell substantial amounts of common stock above then prevailing market prices.

TRENDS SINCE THE WAR

Since the end of World War II, the airlines have entered a new phase in the evolution of their financial structures. They have been

faced with new capital requirements far in excess of anything experienced in the past. For example, between the end of 1944 and the end of 1946, sixteen domestic airlines increased net fixed assets (including flight equipment as well as ground facilities) from \$48.3 million to \$213.5 million. Substantial additional amounts of net current assets were earmarked for capital outlays. Some airlines turned to the long term (10-20 year) debenture for sale to the public or to institutional investors as a means of providing at least a substantial part of the required funds. This access to the long term money market was supplemented by medium term (4-7 year) bank credit. Lenders were willing to provide medium and long term funds because of the assurances of continued solvency for well managed companies provided by the Civil Aeronautics Act of 1938 and the widespread confidence in the persistence of growth in air transportation. Thus for the first time in their history the airlines were in a position to choose among several forms of financing.

In seeking an appropriate balance between long term debt, medium term bank borrowing, and equity capital, the individual airlines have had several important factors to consider. These have related to fixed assets and fixed charges, changes in the performance characteristics of equipment, and what might be called the attitude of investors.

Air transportation is not faced with the heavy fixed overhead expenses which characterize the operations of some surface carriers. The development and maintenance of airways and terminal facilities represent expenses which to date have been borne largely by the public. Although in the future the airlines must expect to assume a proper share of these expenses, they are not the controlling element in costs. More important are those costs which relate to the type of airplane and scheduling of flights. In times of declining traffic variable costs such as gasoline, maintenance, and the wages of flying and operating crews can be adjusted to reduced schedules, thus bringing expenses in line with revenues. This flexibility of the business is greatly reduced, however, if heavy fixed charges in the form of interest and amortization payments are incurred through extensive borrowings.

The principal asset of an airline is, of course, its fleet of airplanes. As more efficient, faster equipment is developed, the purchase price increases but not in proportion to the gains in earning power which can be realized. It is advisable to take advantage of even small improvements in operating efficiency. This calls for a rapid and systematic turnover in equipment and for sufficient capital to enable an airline to pursue the development, acquisition, and introduction into service of more efficient models. The airline which is well equipped with liquid resources is obviously in the best position to assume a leading role in the introduction of new equipment. This advantage will ultimately demonstrate itself in lower operating costs and higher load factors.

Access to the capital market for additional preferred and common stock money is essential and it is evident that the airlines must take into account the attitude of investors and acquire the complete confidence of present and prospective stockholders. Control over expenses is the best evidence which management can offer to stockholders of its ability to meet declines in traffic without incurring serious losses. Interest on debt is one of the important expenses of business. In choosing between long term bonds and shorter term bank borrowing, management must take this factor into account. The circumstances of the individual airline will dictate the type of borrowing to be arranged, but it can be stated as a general proposition that consideration should be given to bank borrowing in the event that the financing problem is created by the necessity of purchasing flying equipment, particularly if the fleet acquisitions are concentrated during a one to three year period. In this type of situation bank credit may be closely geared to requirements, with amortization over the life of the equipment purchased and with minimum interest charges. If the need of the airline is for capital to be invested in ground facilities, additional working capital, or other long term requirements, the long term bond may be appropriate for part of the cost. However, the advantages of equity capital for permanent requirements should be apparent.

PROBLEMS OF FUTURE FINANCING

At this writing, investors are convinced that air transport operations are not on a stable basis. Awards of new routes, changes in competitive positions, problems of expense control, and heavy capital requirements for new equipment combine to establish the still speculative nature of an investment in the industry. The offsetting attractions are the anticipated rate of growth and reinvestment of earnings. Retaining investor confidence in this long range outlook and the creation of a favorable atmosphere for airline equity financing can be accomplished best by conservative financial policies and continued demonstration of effective expense controls.

Thorough financial planning may obviate the need for an airline to carry a permanent debt load. If an accurate estimate can be made of aggregate capital requirements after the passing of the major phase of the expansion program, bank credit can be planned for peak financing while equity securities plus retained earnings provide the permanent funds for the enterprise. There are, of course, times when unfavorable market conditions make it necessary to offer senior securities. If this is a temporary situation, convertible debentures or preferred stock can be advantageously employed. The use of long term debentures in order to appeal to certain types of institutional investors need not conflict with this basic objective if sinking funds are adequate and advantage is taken of subsequent opportunities to retire such debt from the proceeds of new equity issues.

The financial problem of each airline is unique; one formula cannot be applied to all cases. Circumstances will inevitably vary because

of differences in initial financial positions, in equipment programs, and in new route development. Because the rate of turnover in fixed assets is unusually rapid, the timing of all phases of an expansion program becomes of great importance. There can be no substitute for careful planning and control of expenditures in making a financial program work out effectively in practice.

A great deal of controversy exists concerning the percentage of debt than can be carried safely. There is a tendency for fear of debt to force some companies to operate occasionally on dangerously marginal standards of service. On the other hand, creation of debt which cannot be liquidated from depreciation and net earnings with a good margin for contingencies places serious obstacles in the way of an airline's progress. Offering security for the debt or having the R.F.C. as the lender does not change the facts pictured in the income account. Actually, the risks involved may be such that the lender is entitled to the extra protection afforded by specific security but the existence of such specific pledges of assets may create serious obstacles to a highly desirable refinancing or merger program.

Air transport companies must now take all such factors into consideration. Although the industry has not yet had a stable period in its life, there is enough experience upon which to base sound financial planning. This should be undertaken with serious and continuous attention to all of the elements, bearing in mind that stockholders and lenders, both present and prospective, are appraising the airline industry and the individual companies in comparison with other industries whose characteristics are known and whose earnings record is well established. In this comparison the airlines must make a favorable showing if they are to compete successfully in the capital market for the funds which they will surely need during the expansion period which lies ahead.