Hedging its bets

Joon-Ho Lee, senior vice-president at Burnham Sterling & Co, explains the benefits for Hawaiian Airlines of refinancing six aircraft with Yen-denominated loans.

When Hawaiian Airlines decided to refinance four Airbus A330-200s and two A321neos in 2019 it chose to do so with yen-denominated loans because of the natural hedge benefits that such an approach afforded the carrier.

With Burnham Sterling acting as exclusive financial adviser, the airline structured and placed the transaction with eight institutional investors in Japan, all of which were first-time investors in Hawaiian.

The financing tenor of the deal was 12 years for the A321neos and approximately 5.5 years for the A330-200s.

Joon-Ho Lee, senior vice-president at Burnham Sterling, says the natural hedge provided by yen, a currency that was becoming increasingly important to Hawaiian, plus the lower financing costs made it a compelling offer for the US carrier.

Natural hedge

"The premise of doing a non-US dollar transaction is that while forward expectations of real interest rate around the world should be the same, at least theoretically, ex-post results do not always reflect this outcome," Lee tells *Airfinance Journal*.

"So if your borrow rate in dollars is, say, 2% and your borrow rate in yen is 1%, well, that's great, but in that case the yen is expected to appreciate (over the course of the financing term) the equivalent of 1% per year to bring the net (of currency appreciation/depreciation) cost of borrowing in dollars or yen to be the same," he notes.

Lee says that by issuing debt in the Japanese currency Hawaiian was effectively "shorting yen" and going long (buying) dollars at closing.

When Burnham Sterling first began consultations with Hawaiian over the refinancing, Lee says the airline's yen-denominated currency revenue stood around 10%, but had, pre-Covid-19, grown to around 13-15% to become the US carrier's biggest source of foreign currency sales. "And it is probably fair to say Japan is one of or the most important international market for Hawaiian today".

"In the case of Hawaiian they have yen revenues that are expected to come into the company over the course of the financing term, so yen appreciation doesn't really matter for Hawaiian because although they are short yen at closing, they earn yen back throughout the financing term in yen ticket sales that it can use to pay yen debt service," he says. And they can also save on costs related to yen hedging, which also reduces the derivative mark-to-market fluctuation in the airline's financial reporting.

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If yen were to depreciate, Lee says the Honolulu-based airline benefits from a mark-to-market decrease in the US dollar value of yen debt outstanding, as they are a US dollar-reporting airline. "The obvious benefit in a yen depreciation case is that Hawaiian would be paying back the yen that's worth less in the future (in dollar terms) so they reap the benefit not just of the low Yen borrow rate but also the overall depreciation of the currency," he says.

"In a yen depreciation case, Hawaiian's yen ticket sales should also increase in yen terms, reflecting higher than expected inflation in Japan."

Lower pricing

The transaction achieved record low pricing for Hawaiian Airlines, in both Japanese yen and on a swapped equivalent basis in US dollars, against the airline's US dollar debt pricing.

Lee explains that on a fully hedged basis, if Hawaiian were to borrow yen and then enter into a series of forward currency transactions to buy yen at a locked-in rate in the future to make their yen debt service payments, the resulting US dollar equivalent return would be "about half the margin" that they would pay to naturally borrow in dollars, using market pricing of their EETCs at the time.

This is possible because the credit spread the carrier was able to place the debt with yen investors with was, in dollar coupon terms, half of what US dollar lenders would require, Lee says.

So how was this achieved?

Lee explains that one reason was that rather than approaching large domestic or international underwriting banks, it placed 100% of the debt directly with Japanese regional banks and institutional investors in Japan.

By working directly with buy and hold institutions and lenders, Hawaiian captured fees that would have been paid to large underwriting institutions," he explains. We are particularly grateful to the eight lending partners we worked with on this transaction.

"So we were able to get good pricing in dollar coupon terms by working directly with the most attractive source of yen capital in Japan," Lee adds.

This was not only the first Hawaiian deal for the regional banks involved, but for some, it was an opportunity to directly participate in a transaction with the airline.

Lee explains that numerous roadshows by Hawaiian in Tokyo and one-to-one meetings with potential investors helped to convince them of the merits of the deal.

Collateral

Of the two aircraft types that made up the collateral in the deal, Lee says that there is a "very unfair view" that the A330s are "always tough collateral to finance".

He points out the aircraft type's significance for Hawaiian, noting that "there is no other aircraft in HA's fleet capable of Asia routes or East Coast flying" from Hawaii.

"That's the key thesis, while market values may be challenged the airline has been investing a significant amount of capital into its A330-200 fleet," he adds.

The financing faced potential obstacles such as loan-to-value (LTV) under currency volatility. A potential Japanese yen appreciation over time may result in LTV volatility. The financing LTVs at closing were typical.

Lee says that in the yen-dollar case "if you look historically 95% confidence range is plus or minus 20%. So when you are advancing an 80% LTV, you are looking at an effective LTV that could blow out to 100%".

He explains that a way to mitigate this is to have "really strong collateral" like the A321, with the A330 case able to mitigate that through a "shorter tenor of financing term, and slightly lower advance rate at closing".

"The merits of the transaction is really on the credit strength of the carrier, which really mitigates risk from asset values not holding up to expectations," he adds.