Timing the cycle

Even when everybody else has turned you down for finance there is one group of lenders who are still be interested. While others flee, private equity firms are hungry for business.

Newspapers are depressing reading for people involved in aviation. Falling shares, rising oil prices and long labour negotiations are not good for the industry. But private equity investors can be forgiven for getting excited each morning.

Most private equity firms have been waiting for the aviation downturn before they invest in the sector and now they think the timing is right.

"Aviation is a cyclical business," says Rick Shifter, a partner specializing in restructuring at Texas Pacific Group. "We have found that if you invest at the right point in the cycle – and exit at the right time – you can make money. We have been successful in this industry in large measure as a result of timing."

Shifter is being modest. Texas Pacific – and its founding partners – has been phenomenally successful with their aviation investments. When Continental went bankrupt in 1993, Texas Pacific's founders invested $50 million. After successfully turning the airline around, they got more than 10 times their investment back. The fund has also made money investing in American West Airlines and AerFi at the right time – with the founders also helping Ryanair at the start.

But after a break of several years from pure aviation companies, Texas Pacific is back. In January the firm bought GateGourmet, the bankrupt SAir Group's catering business, and along with other firms is looking for further opportunities.

"Today, the industry is clearly closer to the low end of the cycle than the higher end, which makes it an appropriate time to be looking at investments," says Shifter. "It is a tough time for the industry but we expect it to start to recover in 2003. But as a result of several factors, including low-cost airlines and an increased focus by businesses on cutting travel expenses, it will probably never return to the levels that we saw in the mid-1990s."

Michael Peteresen, director at 3i Switzerland in Zurich, agrees. "Aviation is cyclical and now is the right time to invest," he says. Petersen's 3i bought the SAir Group's maintenance subsidiary SR Technics and is also an experienced investor – with its last successful deal being buying 66% of Go for £83.5 million in June 2001 and selling its stake for £231 million in May 2002.

SR Technics' hunt for equity

The good news for private equity firms, such as 3i, looking to invest in aviation is that with other sources of finance closed, companies are keen to talk. After the collapse of the SAir Group in October 2001, SR Technics' management decided not to wait to be sold, and started trying to find a buyer for their division.

SR Technics identified three potential buyers: maintenance companies, including subsidiaries of airlines; manufacturers; and venture capital. Although the sale was ultimately decided by SAir Group's administrator, Georg Radon, SR Technics' chief financial officer in Zurich, says that the management team preference was for private equity.

"We saw lots of advantages, firstly the whole industry is changing – and will continue to change dramatically in the next few years," says Radon. "Private equity gives us the freedom to wait and see how the industry will evolve."

Venture capital also gave SR Technics' management far more freedom to develop its own strategy. Rather than adapting to a maintenance company's or a manufacturer's strategy, they would be able to develop a plan with SR Technics at the centre.

With most airlines and maintenance companies also struggling, 3i's investment gave the airline access to more capital. In total, along with Star Capital Partners, 3i has invested €425 million ($425 million) in SR Technics – making it the largest European transport management buy-out in 2002.

"But 3i is not just looking to support the company with capital," says Radon. "They have given us access to the network of 3i and have strengthened the team working with us on our strategy."

By nature, private equity firms take a far more active role than other investors. Investing at the bottom of the cycle is not enough, firms want to use their knowledge of specific industries or experience they have gained – such as negotiating with unions, or dealing with regulatory constraints – to help develop companies.

"There is a lot of capital in the market and private equity firms need to distinguish themselves. Good firms can bring capital and intellectual capital – including industry specific expertise," says Joel Beckman, managing partner and co-founder of Greenbriar Equity Group in New York.

Shifter agrees. "Whenever we invest in an airline we become active board members. We like to use our experience of the industry to help the management team decide on its strategy," he says.

Once firms have experience of one industry, they like to use it on other companies. David Bonderman, one of the co-founders of Texas Pacific, was a lawyer on Eastern's bankruptcy, and while the firm has invested in a range of companies – ranging from motorcycle manufacturer Ducati to fruit company Del Monte – it has always remained interested in aviation.

Greenbriar, which was founded in 2000, is unique as the only private equity firm dedicated to transportation investments. Along with Beckman, Greenbriar's managing partners are Regg Jones and Jerry Greenwald. Both Beckman and Jones were former heads of transportation at Goldman Sachs, while Greenwald is a former chairman and CEO of United Airline's parent UAL Corp.

"We look to invest in good companies with good business models and outstanding management," adds Beckman. "Price is not a thesis. If people say 'look at this company it's very cheap,' we say that is not a good reason. Obviously we like the opportunity to invest at the bottom of a cycle, but the company needs to be strong – especially since you may not be at the bottom."

Most private equity firms aim for at least a 20% return on each investment with some looking for at least a 30% return – depending on how they perceive the risks.

Venture capital companies measure risk differently to other investors. While buying a stake in a bankrupt carrier may seem like a gamble to traditional investors, firms with experience of restructuring and negotiating with unions may not view it as risky.

Firms also say that large US state pension funds are sometimes willing to take returns below 20%. With SR Technics, the main risks that 3i considered were the general geopolitical risks that could affect the aviation market and also the fact that Swiss – which accounts for about 45% of the maintenance companies' revenues – is a start-up airline.

The need to make these returns means that private equity firms very rarely plan on being permanent investors. Instead, firms will typically aim to sell their share within about five to seven years and selling at the right time is as important as buying at a low.

"If you find at the early analysis stages several exit opportunities – at least in principle – you tend to be fairly relaxed," says Petersen. "With SR Technics, an IPO could definitely be an option in the future and a trade sale is also realistic."

Petersen adds: "However, looking at SR Technics there are two elements to prevent an early exit: the firm is highly operationally leveraged with significant fixed costs and is also highly reliant on people. This means any changes made today will take three or four years to show on SR Technic's profit-and-loss accounts."

Petersen also expects the aviation market to be stronger then. He adds: "You need enough time when you invest – pure price arbitrages don't work in private equity."

There are no shortages of opportunities for firms and they are optimistic for 2003. "Private equity firms look to invest in periods of change and transformation. If you can understand that change better than others – now is a good time to invest either within bankruptcy or outside it," says Beckman.

He adds: "Competition was deregulated in 1978 but business models did not change to the same extent. Now, 25 years on the financial crisis is forcing airlines to complete the process of deregulation and there is a role for private equity to help them."

Possible private equity targets

UNITED AIR LINES is the most high-profile target at the moment and an official at the airline says that a number of firms called both before and after filing for Chapter 11.

However, it may be some time before a deal is announced. "At the moment the airline is more interested in restructuring," says the official, "but will not rule out any sources of finance."

Greenbriar Equity Group does not comment on deals but, with a former UAL CEO, is clearly a possible investor – as is Texas Pacific which had signed a memorandum of interest with US Airways, but lost out to Retirement Systems of Alabama. There has also been increased excitement from firms looking at American Airways, although the airline is not commenting on rumours.

A number of firms have looked at South African Airways, but the size of the investment that the government is looking for is considered too small by some larger firms. At least one firm is believed to have been interested in the Greek flag carrier, although most of the well-known firms are surprised by this.

Firms are also looking beyond airlines. "You don't need to invest in an airline to invest in the cycle," says Joel Beckman, Greenbriar's managing partner. "You can invest in aerospace manufacturing and companies like freight and logistics providers."

Greenbriar and Berkshire Partners, its co-investor, have signed a letter of agreement to invest $78 million in aerospace manufacturer Hexcel and other funds are looking at parts manufacturers.

There is increased interest from investors in distressed aircraft purchases, with several funds looking to buy aircraft to lease. However, bankers say that there is little interest from venture capital firms for traditional aircraft finance deals, as returns are not high enough.

In early 2002, KPMG estimated that the nine-largest ground-handling companies had a market share of just 15%. The sector is certain to see consolidation and, with Candover buying Swissport, other private equity firms are likely to follow.

Venture capital firms are also looking for opportunities with corporate aircraft and fractional ownership schemes.