April 2018

Aviation Finance: Navigating Executive Pay Programs

Second only to the weather, travel woes are the friendliest form of small-talk. Unexpected delays, airport congestion, and shrinking seat size are universally relatable for air travelers. However, it may come as a surprise that many aircraft are leased and not owned by the operating airline. In fact, a small group of organizations purchase, maintain, and lease aircraft to airlines. These aviation finance firms provide an interesting case study of compensation programs, reflecting the realities and forces that shape a specialty finance sector. The following article discusses the unique demands placed on executive management teams in aviation finance, why it is challenging to recruit and retain these individuals, and considerations for setting an effective pay strategy.

What is on the Horizon for the Industry?

As a global industry, all geopolitical, financial, and economic trends influence the aviation finance business. A few themes that are particularly noteworthy for shaping current practices include:

- **Rise of Asia:** China's rising middle class will create enormous demand for aircraft in the Asia Pacific region, particularly for single aisle aircraft. To provide a sense of scale, the International Air Transport Association (IATA) estimates that China will add 921 million annual passengers by 2036 – that's 222 million *more* than the current U.S. total. As a growing percentage of global air travel occurs in Asia, we expect executives and boards to see changes in industry pay practices and levels that reflect the norms in these new markets.

- **Low Interest Rates:** Low interest rates make aircraft lease yields more attractive, supporting the industry's expansion post-financial crisis. However, despite a rising rate environment, aircraft assets will still produce strong yields, be in high-demand, and have a long and predictable useful life. Investor appetite for the higher yielding, relatively stable, and longer maturity is unlikely to wane.

- **Capital Rich from Diverse Funding Sources:** The aviation finance market has attracted increased capital in recent years from a diverse set of sources. Banks, pension funds, private equity, and insurance companies are among current capital providers to the industry. Because capital providers bring with them their own philosophies on pay practices, executive management teams should expect some adoption of shareholder views, including longer-term incentive plan design.

- **Mass Urbanization:** Globally, there is continued mass migration to urban environments. Airplane travel is crucial to a functioning city, both economically and socially. Increased population in cities will create more aircraft demand, fueling future growth.

- **Trade and Tariffs:** It is too early to separate fact from bluster, but given aircraft delivery backlogs, any tariffs implemented will likely have limited impact on financing.

Executive Management Teams Require a Unique Set of Skills

To state the obvious, aircraft are a strategic asset for airlines, and place significant demands on executives and marketing staff at aviation finance companies. Deep expertise about the aviation industry, including the makes / models / configuration options of planes, is mandatory. Because of the nature of the industry, we see the following as unique areas of competency, beyond typical executive skills, which executives must master to lead a successful aviation finance operation:

- **Aircraft Expertise:** Aircraft have a longer useful life than most capital-intensive equipment. As a testament to the engineering complexity and required capital for building modern airplanes, there are only four large airplane manufacturers of commercial aircraft (Airbus Boeing, Bombardier, and Embraer). In order to compete on a global scale, no single country supports competing manufacturers. Executives in this space must have a refined point-of-view on aircraft topics ranging from energy efficiency to window size.

- **Ability to Manage Global Teams:** Unlike most leasing companies, aviation finance firms support several geographies with marketing teams in multiple locations in order to best meet client needs. As a result, executive management teams must be culturally sensitive while reacting and anticipating political and economic trends on a global, regional, and national level. For a relatively small operation (often <200 employees), successful firms require executives with the expertise and judgment to navigate international events and distractions.

- **Capital Markets Structuring Knowledge:** For most roles, financial services experience is a necessity. Not only do firms coordinate complex leasing transactions, but, increasingly, firms are issuing asset-backed securities of aircraft transactions to investors. Both structured leases and asset-backed deals bring with them complicated accounting, tax, and financial rules that can vary between locations. Since this expertise cannot be fully off-loaded to a third party (e.g., law firm, tax accounting firm), knowledgeable talent must be recruited, retained, and motivated.

How do Firms Compete for Executive Talent?

The global nature of the business, combined with the relatively small headcount of these types of organizations, places unique demands on finding executive management individuals and teams. Aviation finance firms are typically globally managed by a small team of industry experts. A team of legal, technical, finance, and other support roles manage the ongoing maintenance and financial reporting requirements for the aircraft. A marketing team solicits interest from airlines and other lessors on aircraft in the company's portfolio. An executive management team orchestrates the business operations, including relationships with shareholders, airline executives and financial leadership, and aircraft manufacturers.

Small firms do not have the luxury of maintaining a deep bench of executive leaders. Large aviation finance firms with bench strength must protect against individuals exiting the organization to work with the long list of capital providers willing to fund a new venture. In short, talent can move quickly between new and existing organizations.

Finding teams or individuals with corporate finance and financial markets acumen, global perspectives on business and relevant economics, deep aircraft experience, and sales and business development experience is no small feat for recruiters. As expected, firms often look within their own industry, recruiting up-and-coming industry talent, or experienced teams looking to start a new venture. However, given the growing global demand and short list of firms, this approach has its limitations. As a result, there are many cases where executives are moving to airline manufacturers of aircraft or aircraft parts, banking and private equity firms, and other closely related industries, such as helicopter and engine leasing. Demand for executives is clearly high, while supply is limited.

Designing an Effective Compensation Program

Compensation programs, including pay levels and pay design, vary significantly firm-to-firm in the aviation finance space. A few key themes should be front-of-mind for executives and compensation committees setting pay strategies:

- **Emphasize Employee and Shareholder Friendly Long-Term Vehicles:** Salaries and cash bonuses are a universal practice, but long-term vehicle types vary firm-to-firm. Participants value the upside of carried-interest and other performance-based vehicles. The industry has seen an increase in "leveraged" plans that provide sizeable outcomes for shareholders and plan participants upon exit events, requiring more effort in setting multi-year performance metrics.

- **Recognize Limitations of Short- and Long-Term Measurements:** While executives must achieve short- and long-term results, balancing both is key to the firm's success. Short-term results can be impacted by both windfall revenue events, such as asset-backed security issuance, and cost events, such as impairment charges on equipment. Long-term successes, like securing new airline relationships or attracting additional capital, may not be appropriately reflected in annual earnings. A successful executive compensation program will have considerable weighting towards long-term performance, appropriate recognition for annual results, and include a suitable level of discretion to account for unexpected events, both positive and negative.

- **Use Absolute and Relative Performance Metrics:** Executives want to be rewarded for the outcomes they can control – annual profits, portfolio growth, and return on equity are popular annual metrics. However, relative performance is important for recognizing contribution that is adjusted for industry headwinds or tailwinds. Tying compensation to industry benchmarks (e.g., total shareholder return relative to an index) is popular. Comparisons to other aviation finance firms, both public and private, are less commonly used but could provide another view of relative performance.

- **Set Pay Levels Relative to Firm Size:** Larger firms tend to pay more than smaller firms. Why is this? In addition to scale efficiency, the larger firms must manage matrixed organizations with broader geographic footprint and, in some cases, the demands of being a publicly traded-entity. Said differently, larger organizations require advanced leadership capabilities and deep technical expertise on financial, operational, legal, marketing, human resources, etc. Analyzing a firm's size relative to peers is a critical step in setting market-competitive pay levels and pay targets.

How can Firms be Leading-Edge?

The industry is growing with an increasing number of publicly-traded firms. As a maturing industry, there is an opportunity to incorporate market-leading practices in pay design. We recommend that firms:

- **Use Financial Benchmarking to Test Assumptions:** Given the increasing number of firms in the space, there is an opportunity to compare normalized financials between organizations. Analyzed over multiple years across a broad dataset, financial benchmarks could be used to set goals that reflect the industry's opportunities and risk. Examples of metrics that establish and test overall reasonableness of pay programs include:
  - Compensation and benefits as a % of revenue
  - Revenue per marketing officer
  - Return on assets / return on equity

- **Emphasize Performance-Based Pay Vehicles:** Performance shares and carried interest programs can be designed with appropriate upside and downside risk for shareholders and participants.

- **Look Beyond Traditional Peers for Benchmarking:** Large ticket equipment leasing companies (e.g., engine leasing, helicopter leasing) are relevant comparisons and part of a broader talent pool. Roles in aircraft manufacturers represent realistic employment opportunities.

In our experience, pay programs are vital to the success of an organization and require careful consideration of business strategy, economic climate, and external practices. The aviation finance industry will experience material changes in pay programs as it grows and matures with more firms going public.

The industry has an opportunity to help shape our globally connected world through increased travel and connections – a mission worthy of highlighting in your next opportunity for small-talk.

To learn more about McLagan's Specialty Finance products and advisory services, please contact Kevin Raynes at kraynes@mclagan.com.

Author Contact Information

Kevin Raynes
Director, McLagan
Aon
1.203.602.1286
kraynes@mclagan.com

About McLagan

McLagan provides tailored talent, rewards, and performance expertise to financial services firms across the globe. Since 1966, we have partnered with the largest and smallest financial services firms to help them make data-driven decisions to hire, retain, and engage the top talent for keeping the global economy running. Our compensation surveys are the most comprehensive, in-depth source of rewards data covering over 150 countries from more than 2,500 clients. Our consultants work with hundreds of firms annually to design total rewards programs and benchmark financial performance for boards of directors, executives, employees, and sales professionals. McLagan is a part of Aon plc (NYSE: AON). For more information, please visit mclagan.aon.com.

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance.

For further information on our capabilities and to learn how we empower results for clients, please visit http://aon.mediaroom.com.