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HEADLINE: The Great Airline Leasing Disaster;
The planes are grounded. The leaseholders are going down in flames. For Disney, Whirlpool, and a dozen others, it may be a $ 20 billion problem.

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BODY:

One of the best places to gauge the sorry state of America's domestic airlines is a long gray runway that cuts through the khaki sands of the California desert 100 miles north of Los Angeles. The runway belongs to Mojave Airport, home to one of the country's largest aircraft boneyards--a place where old airplanes come to die. Every week a dozen more jets land here, their services no longer needed by struggling airlines.

Alongside Mojave's vintage DC-9s and old military warbirds, row upon row of shiny 747s, 737s, and MD-11s sit wingtip to wingtip. Almost 300 planes are parked in the temporary storage area, up from just 60 before the Sept. 11 attacks. The number is expected to climb to nearly 400 by midsummer, as bankrupt carriers US Airways and United take planes out of service to cut costs. Worldwide, some 1,500 planes are temporarily grounded, most of them stored in the deserts of the Western U.S.

All those parked planes are more than just bad news for airlines. They also spell major trouble for a host of companies you wouldn't think would have much of a stake in the airline biz--big names like Disney, Whirlpool, Morgan Stanley, and Pitney Bowes. In the past month more than a dozen companies have announced that their earnings will be reduced by hundreds of millions of dollars because of lost lease income from airplanes they bought and then rented to USAir and United. Globally at least $ 1 billion has been lost on airline leases in the past year, which also saw bankruptcies at Swissair and Midway, and a major restructuring at AmericaWest. If some experts are right, these losses could foreshadow an even larger, megabillion-dollar disaster that is quietly waiting to happen on the books at places like Boeing, **General Electric,** and Morgan Stanley. In an era of continuing weak profits, missed targets, and skittish investors, this latest financial surprise might wallop many stocks. In the end, the damage to bottom lines could be $ 20 billion or more.

Even more galling, perhaps, is that it's yet another example of the smart money--in this case, CFOs and accountants--looking for a way to goose profits through sophisticated financial instruments and getting burned in the process.

What's going on here? It may come as a surprise, but many of the planes you travel in aren't owned by the airlines that fly them. Instead, they are leased. That helps frequently cash-strapped airlines avoid large capital expenditures and gives them more flexibility to adjust to changing business conditions.

While the airlines have spent the past two decades trying to get out of the business of owning airplanes, everyone else has spent that time trying to get in. To many companies, owning an airplane or two--or several dozen--seemed like a pretty good deal, even if it meant straying from their core business. For one thing, there was a steady income stream--airplanes are leased for as long as 25 years--that would provide a handsome return on the initial investment, sometimes as much as 12% annually. Then, if you borrowed money to acquire the aircraft, there was a lucrative double tax benefit: Both the depreciation on the airplane and the interest expense on the loan used to buy it could be deducted. "Ten years ago leveraged leases were seen as a prudent way to get stable, higher returns on cash," says Disney spokesman John Spelich.

Truth be told, back when the economy and business travel were booming, owning airplanes didn't seem all that risky. Even if the airline that was leasing your planes went bankrupt and defaulted, U.S. bankruptcy laws allowed you to quickly repossess the plane, which could then be leased to someone else or sold for a decent price.

The problem is that this last proposition is no longer true. The bankruptcy code still gives airlines just 60 days from the time they file for bankruptcy protection to renegotiate the terms of their leases or return an aircraft to its owner. But now the owners don't really want them back. There is no longer much demand for commercial jets. In fact, airlines have too many of them.

Prices for used jets are down as much as 40% since 2000, their lowest level in at least 15 years. Locating new lessees for older planes is about as easy as a coach passenger's gaining access to the first-class lavatory. Finance company CIT Group is still trying to find someone to lease two 757s it repossessed from bankrupt National Airlines last year. There haven't been any takers. GE lost $ 75 million in 2002 from airplane sales and from lower rents on leased aircraft. "The market has never been this tough before," says Henry Hubschman, head of GE Capital Aviation Services, the top player in the airline-leasing business.

The soft market for airplanes gives bankrupt airlines tremendous leverage when it comes to renegotiating their leases. For instance, United has said it is looking to save at least $ 1.4 billion from nonlabor costs, including new lease terms for its airplanes. According to those close to the bankruptcy negotiations, it has asked airplane owners to accept a 50% reduction in monthly rental payments for some less desirable aircraft models, such as Boeing 757-200s. The carrier may also be able to drive a hard bargain for its Boeing 737s. Its 27 leased 737-500s are almost 11 years old on average, while its 91 leased 737-300s average 14 years in age.

In some cases the airplane's owners may not even have a seat at the negotiating table. That's because they don't own the airplanes outright. Instead, they bought subordinated tranches of something called EETCs--enhanced equipment trust certificates. Pioneered by Northwest Airlines in 1994, these are essentially aircraft bonds issued by a trust that enables many investors to pool their money and purchase a larger portfolio of planes. Under the rules that govern such structures, bondholders who purchased the EETC's A tranches control any lease renegotiations if the airline defaults. According to lawyers involved in the USAir and United bankruptcy, in many cases A-tranche bondholders are agreeing to new lease payments that cover only their part of the trust's debt service, leaving bondholders who own the B, C, or D tranches of the debt with nothing.

Already the pain is starting to mount. The Bank of New York announced it will take a $ 240 million charge in the fourth quarter to write down the value of airline leases with United. Walt Disney announced that this quarter it will write off $ 114 million of its investment in "leveraged airline leases" with the bankrupt carrier. Pitney Bowes, best known for making postage meters, will take a $ 100 million charge to write down the value of leases it had with United and USAir. Appliance-maker Whirlpool anticipates taking a $ 68 million charge for airline leases.

The list goes on. Financial-services giant John Hancock is taking $ 95 million off its books; Electronic Data Systems, $ 40 million. More companies are likely to announce hits as lease negotiations proceed. According to SEC filings, Philip Morris has $ 386 million in lease exposure to United Airlines and $ 150 million to USAir. CIT Group has $ 70 million invested in US Air Boeing 737s and another $ 135 million in United aircraft. Ford Motor took a $ 35 million after-tax charge for its five USAir planes and has said it has $ 40 million to $ 45 million in after-tax exposure in 12 jets leased to United.

While these tens and hundreds of millions of dollars aren't nothing, the sums are puny compared with the write-downs big aircraft-lease originators such as Boeing Capital and GE Capital could face. Boeing has $ 1.3 billion in financing to United. The company says most of that is in the form of new 777-200ERs. The planes, all delivered within the past three years, are unlikely to lose too much value and will command competitive rents in a renegotiation. GE may not be quite as lucky. It has $ 1.7 billion in leases with United, more than any other company. While much of this represents leases on newer aircraft, $ 100 million is in four Boeing 767-300s, older planes that may not retain as much value as other models, according to Doug Runte, a Morgan Stanley analyst who tracks EETCs and other transportation industry bonds.

In previous bankruptcies and restructurings this year, GE lost about $ 100 million.

Remarkably, the most anxiety-producing question facing companies with planes on their books doesn't concern their specific exposure to United or USAir. It's about what those bankruptcies mean for the long-term value of their aircraft portfolios. And here is where the numbers start to look truly terrifying.

The fear is twofold. The first concern is that other carriers, witnessing the hard bargains that bankrupt airlines are able to strike, will begin asking for easier lease terms too. This is already happening. United was emboldened to press for big reductions in monthly airplane rents because it saw the savings that USAir gained. Even airlines that are not seeking legal protection from creditors have hinted that they will seek rent reductions. "Anywhere United might get a cost advantage on us, we will try to pursue savings in that area as well," says American Airlines spokesperson Tara Baten. One indication of the trouble ahead is that the Bank of New York, in addition to its $ 240 million write-down, is setting up a $ 390 million reserve to cover potential future losses of lease payments from airlines.

The leaseholders' second great fear is that their accountants will force them to do "impairment tests" on the value of their planes. Evaluating the worth of an airplane is a dark art. "There are lies, damned lies, and aircraft prices," says a Wall Street analyst. It is clear, however, that many planes are now listed on companies' books at inflated prices that reflect their value during the late 1990s boom. Those days are gone--for good, it seems. Owners should have to adjust the value of their aircraft to more reasonable levels.

The problem, of course, is determining what's reasonable. "This is all very subjective," says James Tussing, an aviation lawyer at Fulbright & Jaworski. "Today's asset values are the lowest they will hit for a long time, especially for the newer planes." Morgan Stanley analyst Runte uses a formula to estimate the "distressed value" of an aircraft--what it would go for if you had to sell it right now. Even for aircraft he considers to be in the most demand--such as the latest versions of the Boeing 737 and Airbus 319s and 320s--Runte estimates that values would be shaved 35%. These are $ 40 million to $ 50 million planes, which implies a $ 14 million to $ 18 million write-down for each. For less desirable aircraft--such as old Boeing 767-400ERs and MD-80s--Runte estimates that the reduction in value could be as much as 60%. Morten Beyer & Agnew, an airline consulting firm in Virginia, estimates that a 737-700 might today be worth 16% less than its book value.

To see how a wave of lease renegotiations coupled with declining aircraft values would cripple quarterly earnings throughout corporate America, just consider how much money remains tied up in leased aircraft. GE Capital Aviation Services has a portfolio of $ 27 billion. International Lease Finance Corp., which is owned by insurance titan AIG and is another major player in the aircraft-leasing business, has 600 jets--$ 24 billion in total exposure. Morgan Stanley, which entered the leasing market through its acquisition of Ansett Worldwide Aviation Services, has a $ 4.8 billion portfolio. The CIT Group has $ 3.9 billion tied up in this market. If one assumes a 20% decline in value across the entire leasing market--which is worth perhaps $ 100 billion--then one can easily arrive at $ 20 billion in losses, more if there is a greater decline in aircraft prices and lease terms.

Larger players will probably fare better than those that got into the leasing biz just for the tax write-offs. That's because their portfolios consist predominantly of new, more desirable jets. For instance, GE's average plane is six years old, and 65% of the company's portfolio consists of popular narrow-body models like Airbus A320s, which can be easily reconfigured for new lessees. Even so, GE has taken an $ 85 million charge to write down the value of its older MD-80s and DC-10s. "We would prefer that two of the largest airlines in the world not be in bankruptcy, but we've been through similar situations in the past," says Hubschman.

Some hedge fund managers are so convinced that the United bankruptcy will trigger a season of major earnings hits--even for companies that do not have direct exposure to United--that they are shorting any company with a portfolio of older jets. Others think the shakeout will be less severe and that airplane values --and lease terms--will recover, though not to pre-Sept. 11 highs. Investors would do well to watch how many planes stay parked in the Mojave boneyards. The future will be written in the desert.

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BOX STORY:

Who's sorry now?
Corporate gambling on aircraft financing has already led to some serious write-downs. But the worst is still to come.

Company Impact[1]	Value of leasing arrangements $ billions
GE	$ 26.9

Write-down so far: $ 260 million(2)
GE has taken some hits but its portfolio includes mostly younger airplanes that are likely to retain their value.

AIG (ILFC)	$ 24.0

Write-down so far: None
ILFC has youngest aircraft portfolio of any lender and has found new homes for almost all its leased planes.

Boeing	$ 11.5

Write-down so far: $ 250 million(3)
The glut of jets is bad news for Boeing any way you look at it--in terms of both new orders and leasing.

Morgan Stanley $ 4.8
Write-down so far: $ 74 million(3)
The white-shoe Wall St. firm became a player in airline leasing when it acquired Ansett Worldwide Aviation.

CIT Group $ 3.9
Write-down so far: None
CIT has $ 70 million in exposure to USAir, $ 39 million in exposure to National Airlines, and $ 135 million to United.

John Hancock $ 1.6(4)
Write-down so far: $ 95 million
The financial services giant says it has $ 321 million in additional exposure to United Airlines planes.

Bank of New York $ 0.8
Write-down so far: $ 240 million
Bank of New York has also reserved $ 390 million for potential future write-offs from its portfolio of 69 planes.

Philip Morris $ 0.5(5)
Write-down so far: None
The cigarette maker got burned on its airline investments. It has $ 536 million in exposure to USAir and United.

Pitney Bowes $ 0.5
Write-down so far: $ 100 million
The postal services company began leasing out planes as an extension of its equipment finance business.

Walt Disney $ 0.3
Write-down so far: $ 114 million
Disney invested in a portfolio of 11 aircraft: four with United, five with Delta, and two with FedEx.

[1]Pretax fourth-quarter write-downs unless noted. [2]Various quarters. [3]Third-quarter charge. [4]Domestic airline exposure only. [5]Exposure to USAir and United only. Total airline leasing exposure undisclosed.

It's yet another example of the smart money looking for a way to goose profits--and getting burned in the process.

GRAPHIC: COLOR PHOTO: PHOTOGRAPH BY ETTIENNE DE MALGLAIVE--GAMMA, Idle aircraft in the sands at the Mojave Airport in California; COLOR PHOTO: PETER MORGAN--REUTERS/TIMEPIX, Aircraft leases could mean bad news for GE's CEO Jeff Immelt (top) and Disney's Michael Eisner.; COLOR PHOTO: MICHAEL O'NEILL, [See caption above]

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