

Aviation is a century old industry. Since its dawn, the industry has evolved from just a few entrepreneurs propelled by humankind's dream of flying to a place where flying became an ordinary routine for many of us. The fact that air transportation is a life-necessity has supported the industry in withstanding many external shocks like the Oil Shock 1979, Gulf War 1990/1991, September 11 events, SARS 2003, and Global Financial Crisis 2008/2009.

This time is no different and the industry will certainly survive its current crisis, albeit with considerable wounds. *Unfortunately, COVID 19 has chosen the aviation industry as the epicenter of its economic damages and chosen to be the industry's black swan, in our opinion.* Aviation industry has a large ecosystem, and in this article, we will reflect on one of the famed pillars of the industry, the aircraft leasing market.



Investing in leased aircrafts is viewed as a passive way to gain exposure to the aviation industry and a way to generate USD income from an investment secured by a durable asset, at a time when global interest rates were racing to the bottom. Those headline advantages have invited naïve influx of capital from all over the world to compete for what was thought as risk-free spread above benchmarks. The market eventually erupted drastically, and *it became no secret for all market participants that the market has reached its peak.* It was extremely

difficult to find value in leased aircrafts (especially in the last 3-4 years) and the only way to catch one of those flying angels is to be the highest bidder regardless of the assumed underlying risk.

Like any stretched market, the cycle had to find a spot (or a reason) to land and that was the virus outbreak and the subsequent global suspension of air travel. *The flying angles had fallen all together in an unprecedented scene, a scene we like to refer to as the Fallen Angels.*



The Fallen Angels sent a wave of alarms to investors that investing in leased aircrafts is not a low risk one. Investors by now are questioning whether the prices they paid for acquiring the leased aircraft, the premium paid for the attached lease contract and the resulted expected returns are actually enough to compensate for the real risk of dealing with such demanding metal that requires greater care measures especially in distressed situation (e.g. lease management during normal course of the business, finding next home for aircraft after its initial lease and any needed reconfiguration measures, debt refinancing events, hefty ancillary costs, etc.).

The signs of the peak were ample. *The first and most intuitive sign was the noticeable contradiction amongst investors/lessors' actions.* On one hand, they all acknowledge that the market performance was too good to live this prolonged cycle (more than 10 years), while on the other hand, aggressive underwriting of aircraft investments was continuing at surprisingly depressed required rate of returns. Returns on new deliveries in the sale lease back

market was comfortably underwritten at the lower end of the single digits with no buffer left for the rainy days. In some cases, investors/lessors have accepted returns on aircrafts leased to some airlines in emerging markets at levels below that offered by the sovereign bonds of the country hosting the airline.

The second noticeable sign was the narrow gap between the equity returns (net of costs) on operating leases of new aircraft and the debt costs required by banks in secured financing. This effectively meant that Investors/lessors were assuming there is no real risk in the residual (i.e. aircraft selling value at exit) and that the assumed residual value published on the databases or valued by valuers shall be achieved with 100% accuracy. Equity returns should comfortably exceed debt costs, not only to compensate for the residual risk, but to build a cushion for the unforeseen events like the repossession risk (a costly risk that was consistently underestimated in the market which includes the process of repossession of defaulted assets, parking and maintaining aircraft in stores, including any unforeseen transition costs for aircraft remarketing, etc.), let alone other risk factors that all market participants are aware of.

The third notice is particular to secondary market transactions. ***Aircrafts were trading in the secondary market at almost the same level of returns, with very little attention paid to important selection criteria*** like the position of the aircraft in its family, engines type, maintenance compensations scheme, in/out of production status, technological obsolescence, changes in airlines business model and product preferences or airline credit strength. Aircraft pricing was broadly based on which group it falls into like narrow/widebodies, full/half-life return condition, and aircraft vintage group (i.e. young/mid/old). A one-year-old aircraft would have very similar expected returns to another three years old aircraft of the same model just because both aircrafts are pooled in the “young vintage” group.

There were several observations that all pointed to the market's irrational behavior and the ultimate landing

of the Fallen Angels. We believe that losers will outnumber winners over the medium term. ***Losers are those who viewed investing in aircrafts as absolute returns generated from an un-demanding low risk asset, while the real winners will be those with strong asset management and remarketing skills.***



Financial investors group are likely to be the first to exit the market with burned fingers specially those who invested in mid-life aircrafts with short term remaining lease terms. That shall be ***followed by small/medium size lessors who were focusing on originations rather than building strong in-house skills capable of placing the expired leases with airline customers.*** We believe that the drastic trace of ominous COVID-19 is not the only to blame, it is all but the confluence of several risk mis-management factors including the ones we summarized herein.

We have a solid faith in the fundamentals of the aircraft leasing and financing industry. Yet, we believe that the previous unbalanced supply and demand of capital has undermined the real economic value of aircraft investments and a ***rebalance started materializing as more and more investors realize that aircrafts are a non-passive demanding investment that requires hands-on risk management.*** Aircraft market participants who worked with Neo Merchants Capital know our diligent approach and our insistence on finding value that strike the risk/return balance. This approach has thankfully worked well in the past and will continue to do the same in the future.