Aircrafts Market | Dragged by Airlines Recovery Path

Investor reflection (2) – July 2020

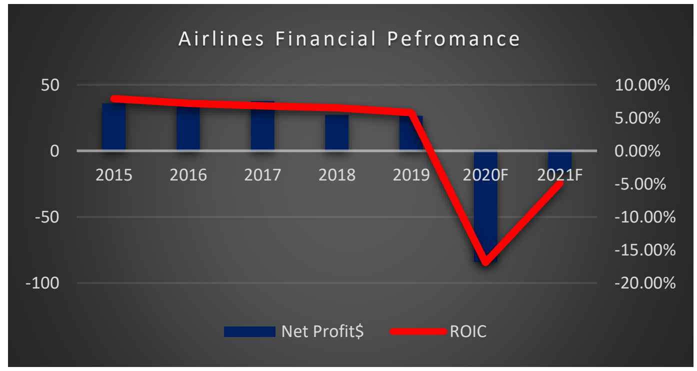
Unlike other conventional investments, ***the aircrafts investment market lakes the virtues of price disclosures or practical mechanism for price discovery directly from the market.*** Considering an investment in leased aircrafts requires extensive know-how by investors. Investor's decision must be backed by comprehensive coverage of important aspects including the aircrafts type, vintage, lease structure, risk factors, and most importantly the lease manager and its platform management quality.

Yet, one of the main aspects that is overlooked by many investors is the right criteria to reach unbiased asset pricing using the information collected. Investors are generally dependent on aircrafts appraisers and their bullish residual value estimations which are used as a role of thumb in valuing most of the transactions that comes across. This lead some aircrafts investors' returns to be easily embattled in the wake of any market correction or restructuring.

During the last 3-4 years, the fierce competition in the market has pushed market value for aircrafts aggressively high, in both the primary market (Direct placement & Sale-Lease-Back) and the secondary market for trading, this is cited by many bidders who have participated in driving the monthly Lease Rate Factors (LRF) to sub-0.6% level and in some cases sub-0.5% level[1].

Under the onslaught effect of COVID-19, such pricing levels did not hold for long and appraisers swiftly revisited the estimated market values across the full gamut of the asset types and vintages, while others have gone a step further, by projecting a decline in the future base value, for some asset types.

Drawing on our reflections in our earlier article (Aircrafts Market | The Fallen Angles) and the notable change in appraisals, we believe that the worst is yet to come for aircrafts markets. ***The positive correlation between the aircrafts market and the badly hit airline industry is likely to keep the performance of the aircrafts in check.*** It is no secret that some airlines will fail and for those who would survive, the recovery road post-COVID-19 will be lengthy and bumpy for an already thin profitable industry.



Based on the latest IATA release, the airlines are expected to lose $84.3 billion in 2020 with a net profit margin of -20.1% and a return on invested capital (ROIC) of -16.9%. Revenues forgone is expected around $419 billion, around 50% of what was achieved in 2019. The outlook for 2021 is neither rosy.

Aviation has been always considered a thin margin industry, and it was only in 2015 when IATA declared the industry landed on the investment-grade space and the ROIC achieving 7.9%. In 2016 and beyond this figure took its downward trajectory reaching 5.8% by 2019, fueled by uncontrolled factors such as fuel, currency devaluation, and political risk, coupled with airlines price wars, while vying for larger market shares.

IATA has forecasted that the cash burn during the second quarter of 2020 would be $61 billion, adding that to the fact that the global airline liquidity by end of 2019 stood at $112 billion[2] (including disclosed liquidity facility). The first quarter of the year was not glowing, and this is overlaid by the fact that this financial crisis started sever effect early in February and March in China is asserting that the industry has started with depressed liquidity position in the second quarter.

[1] KMPG: The Aviation Industry Leaders Report 2019

[2] Air Finance Journal

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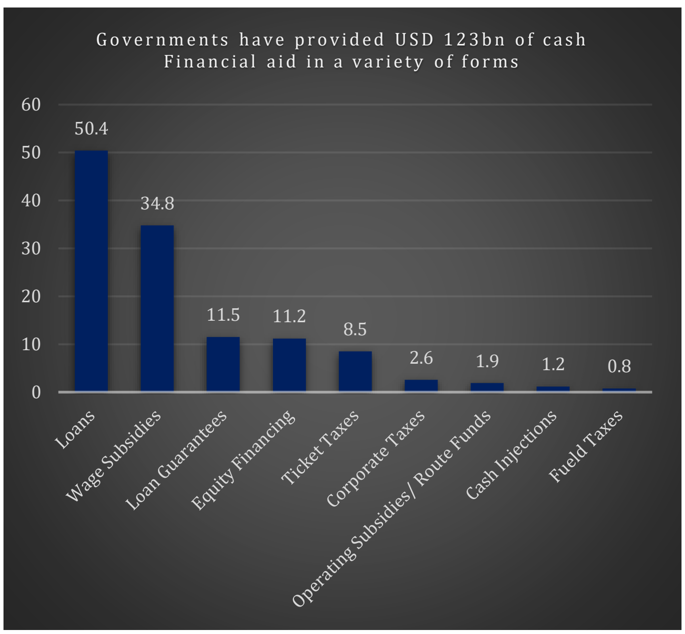
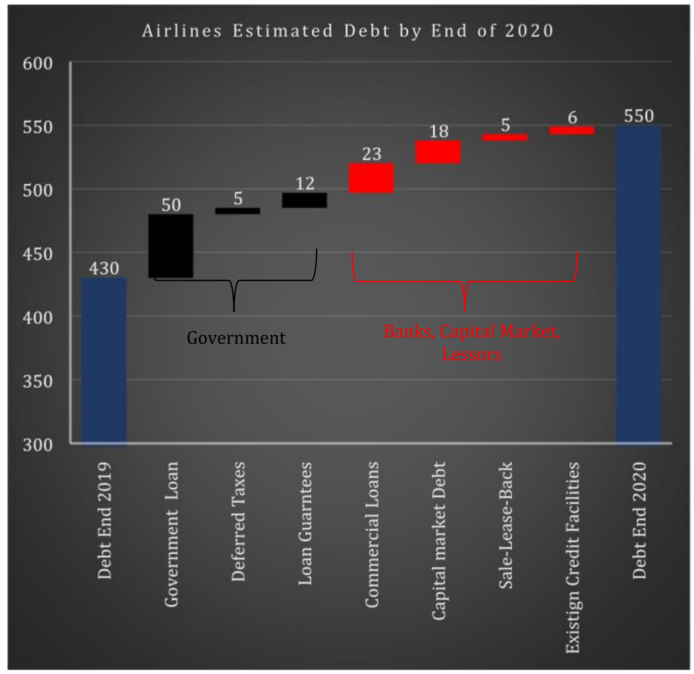
Since the start of virus global events, aviation industry tapped into several channels to shore up their liquidity, such as lease rent deferrals in amount of $5 billion[3] and sale-lease-back transaction in an amount additional of $5 billion[3]. On the top of that, global governments stood attentively to support the airlines sector crossed circa. $123 billion[4] with the highest value of $58 billion has been granted by the United States to the American carriers, which was followed by European carriers who received more than €25 billion[5], tailed by Lufthansa bailout package approved by the European Commission. The following graph summarizes airlines liquidity financial aid channels provided by governments.



These stimulus packages would certainly be positive for the short-run by boosting liquidity, saving jobs, and boosting economic confidence. Yet, its medium to long-term effect is likely to have different consequences, as some of these aids include stringent financial criteria that may hinder airline companies` growth or dilute current equity investors. It can be even more aggressively detrimental, such as in the case of Norwegian Air Shuttle, where the government attached its support by a requirement for swapping creditors/lessors debt with equity, let alone most aids come in a form of loans or guarantees that increase leverage and thus, future debt burdens rather than decreasing it for the lackluster future demand. IATA estimated debt will surge from $430 billion to $550 billion by the end of 2020.



Numbers tell everything but the tedious image is not peculiar for aviation industry only, it extends to the whole state of the global economy. In June 2020, IMF predicts that the global growth for 2020 will be -4.9%, revised from April forecast of -3%. Consequently, we believe that the short-term effect of government support/stimulus will turn unpleasant after chewing the expected negative consequence of those bailouts.

The low-interest-rate environment, and the aggressive growth strategy of many airlines have previously encouraged many financial investors in accepting thin margins on their investments with low-risk buffer. The current complicated picture for the aircrafts market is likely to keep those investors away for the foreseeable future until their realized losses are fully digested.

[3] Air Finance Journal

[4] IATA, Government Financial Aid for Airlines – 26 May 2020

[5] Fitch Ratings: Airlines' State Aid Risks Altering European Aviation Landscape