Aviation Finance Outlook 2017
Q&A Follow-Up After Analyst Conference Call

Scope answers some of the questions asked at the end of the analyst conference call following the publication of the aviation finance outlook for 2017, with a focus on the credit risk aspects and implications of the related topic.

Is there a significant difference between narrow-body and wide-body aircraft in the share of a lessor's ownership after 15 years?

Old wide-body aircraft used to pose a greater credit risk to investors, generally because of their lower liquidity. This results in higher residual value risk on both the airframe and engines. Old wide-body aircraft would be those more than 15 years old.

The proportion of old wide-bodies owned by lessors is currently not significant, as the remarketing and repossession costs for these aircraft are quite heavy to handle at the end of the lease. Some exceptions may be found, when maintenance reserves mitigate such high costs at the end of the contract.

Figure 1 shows the current proportion of certain old-generation wide-bodies which have been delivered to operating lessors. The charts proposed in the aviation outlook report for 2017 were provided for a fleet of popular single-aisle aircraft produced in the 1990s (i.e. only narrow-bodies).

Figure 1: Old-generation wide-bodies delivered to operating lessors

	A 300	A 340-200	B 767-300 ER
A/C delivered (units)	816	377	583
A/C delivered to lessors	29	33	121
Lessor´s share of the fleet	4%	9%	21%

Source: Airbus and Boeing historical deliveries

What is your view on the secondary market of B777 in light of the large number of aircraft coming from Emirates?

B777-300ER residual values will be under pressure at the end of their current long-term leases with Emirates, increasing the refinancing take-out credit risk for investors. This is partly due to competition from mid-life, smaller – but fuel-efficient – twin-aisle aircraft such as the A330-300 (21% initially owned by lessors) on specific markets. The combined A330 operator base stands at roughly 100 airlines, approximately double that of the B777.

Competition from the next-generation B777 and the A350-1000 will increase around 2020, as well the downward trend. But the strong presence and 'work horse' positioning of the B777 at some large international carriers such as Cathay Pacific, Air France-KLM, Qatar Airways, Singapore Airlines, or Air China, in addition to its large passenger capacity on key long-haul routes, will remain a differentiating strength on these high-density routes.

This aircraft will not be in a position to compete on thinner, point-to-point long-haul routes, which are currently in high demand because of the greater yield they generate for network carriers. Still, many Emirates routes need a combination of B777s and A380s in order to bring passengers at a low unit cost to its main hub of Dubai, before they connect to more-distant airports (in Thailand, India or Pakistan, for instance).

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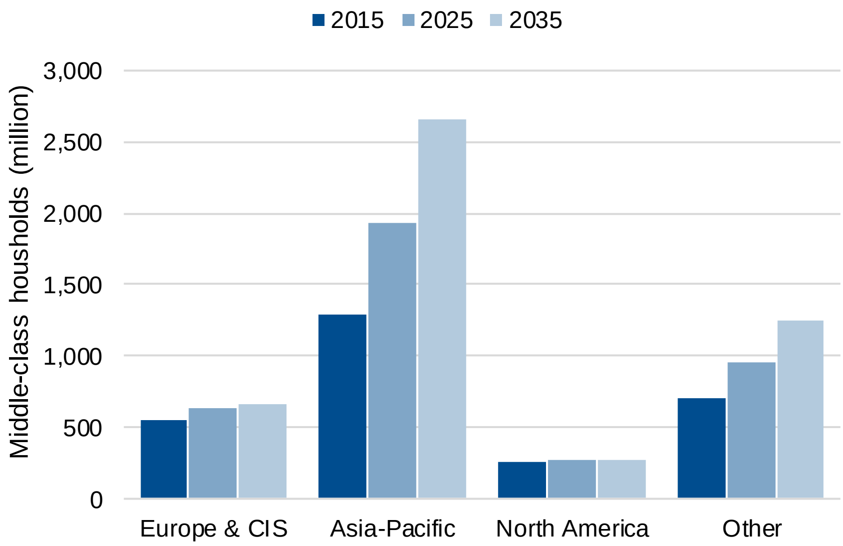
Historically, aircraft in their last half/third of their lives would be sold or leased to airlines in less developed countries. Now that airlines in these countries have access to finance such that they can buy new planes, is there still a natural home for aircraft at this late stage of life?

The competition (passenger yield) for the acquisition of new middle-class customers in emerging regions will lead to a strong focus on the unit costs brought by the core fleet of these airlines. Operating leases with mid-life aircraft may offer more efficient capital costs than the straight acquisition of new aircraft. This enables the carriers to generate free cash flow for capex reinvestments.

Southwest in the US and Ryanair in Europe (two low-cost pioneers on their respective markets) built their network, 30 years ago, with a fleet of mid-life B737-300, which had very low capital costs. The debt leverage (adjusted debt over EBITDAR) of a fast-growing airline in an emerging market is a key credit risk for investors.

The strong need for aircraft in emerging markets (Figure 2) is mainly due to a growing middle class and air traffic catching up with levels in OECD countries. This will not be filled only by national flag carriers or well-established local carriers buying new aircraft directly from the original equipment manufacturer.

Figure 2: Middle-class household projections



Source: Airbus Forecasts 2016

When do you think the increase in US interest rates will lead to higher lease rate factors and higher yields for the operating lessors/investors?

The passing through of higher US-interest rates into higher lease rates may be problematic in the current competitive environment, which translates into low lease-factors for airlines. This will lead to a short-term contraction of lessor's net margins and a temporary credit deterioration, depending on the timing of the lease renewals schedules of each lessors.

In the meantime, a higher inflation rate cannot be ruled out in the coming years, which is a net credit-positive for airlines. Lease residual-value risk will decline as aircraft values will reflect the benefit of inflation, even if aircraft do not provide the same degree of hedge against inflation as infrastructure or property.

What do you think about Comac as a competitor?

The exact positioning of this aircraft is not final at this stage, but it should be an alternative for investors and lessors in the above-mentioned context of increased demand on emerging-market routes, including for leasing to local Asian low-cost carriers. Indeed, the C919 engines (LEAP1-C) are manufactured by CFM International, the largest engine manufacturer for narrow-body aircraft, and have significantly lower fuel consumption than classic versions of narrow-body engines available in the current fleet (classic B737s and A320s). In addition, these engines reportedly have a fuel efficiency that equates to that of next-generation narrow-bodies (A320Neo with the Leap-1A, and the PW1100G and B737Max with the Leap1-B).

Will the new regulation for IFRS balances change the market conditions for lessors?

IFRS regulation does not change credit risk. But the new rules improve transparency by integrating the present value of operating lease obligations into the balance sheet of the airlines.

The new rules do not change the leverage of airlines as considered by aviation banks and investors. Operating lease commitments will continue to be taken into account by aviation analysts, only now avoiding the need of an ‘adjusted debt’ calculation. The new rules will simplify the analysis and enable the comparison of airlines on a consistent basis (ie on the basis of their on-balance sheet liabilities, comprising debt and operating leases).

The new standard is a significant change in approach from current IFRS. It will be effective from 1 January 2019. Operating lease commitments are currently off-balance sheet commitments for airlines.

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