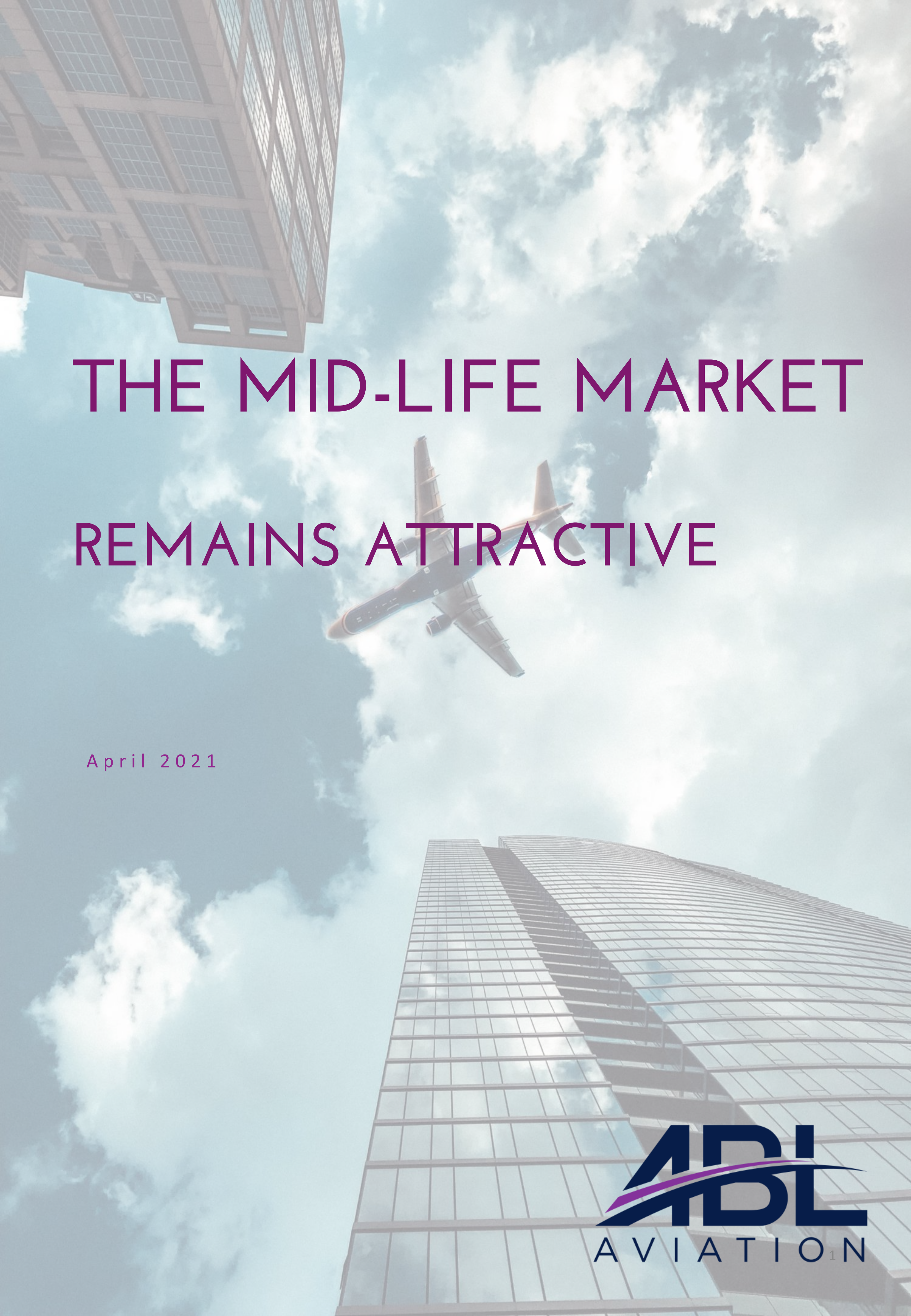


THE MID-LIFE MARKET REMAINS ATTRACTIVE

April 2021

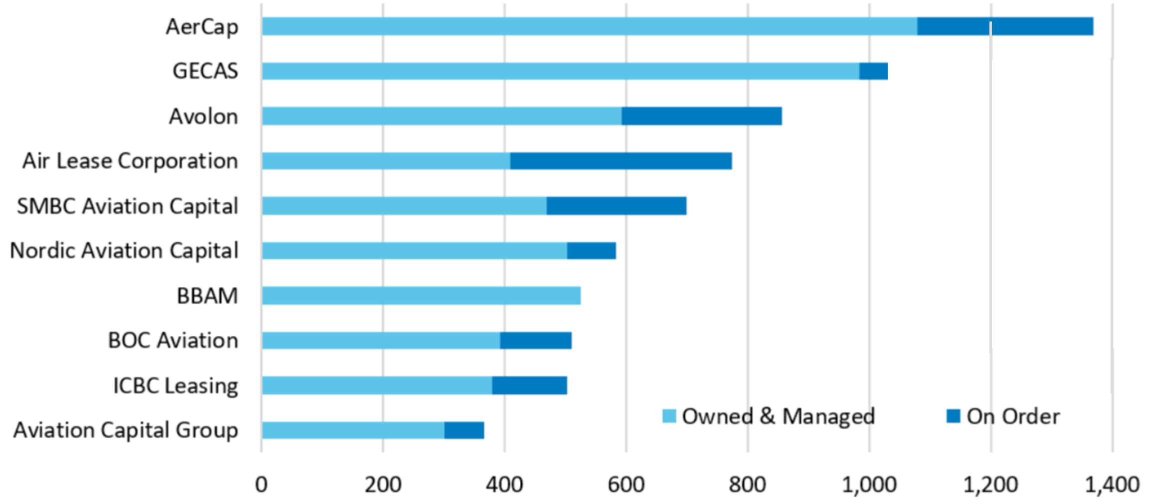
ABL AVIATION

M&A wave

The leasing industry looks very different today to what it did this time last month, when our previous report came out. There has been an unwavering interest in acquiring leasing platforms, though unfortunately there have been some casualties elsewhere in the market.

Two of the industry's largest lessors, AerCap and GECAS, announced on March 10 a $30 billion merger that will form a new "super lessor", which will have more than 2,000 owned and managed aircraft in total – accounting for nearly 17 percent of the total market share of leased aircraft. The combined entity after the purchase by AerCap, will operate under the Dublin-based lessor's brand, and will have over 900 owned and managed engines, and over 300 owned helicopters. The deal, which will shake-up the leasing market, will make AerCap by far the largest aircraft lessor, with the second largest being Avolon, with 593 aircraft owned or managed, and 263 more on order. BBAM is the world's third largest lessor, with a fleet of 526 aircraft on lease to more than 90 airlines, according to the company's website.

In-service fleet and order backlog by top lessors

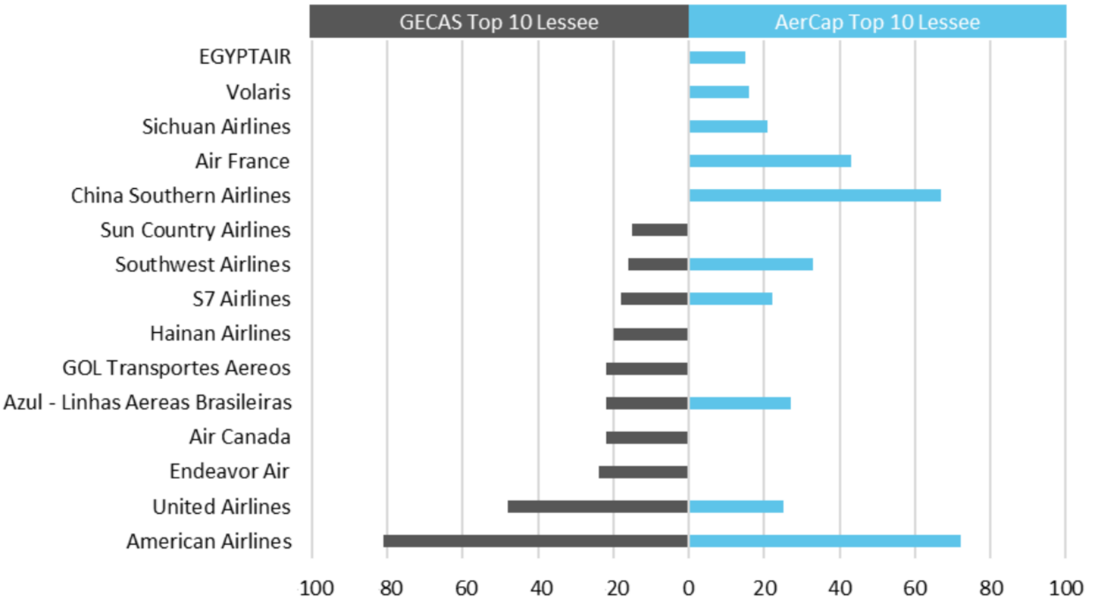


Source: IBA Advisory, InsightIQ

No doubt there will be some portfolio sales to follow in the coming months as the new leasing giant manages its exposure and risk. Such portfolio sales may create opportunities for the smaller leasing players looking to build their portfolios. Although any offloaded narrow bodies from the combined AerCap and GECAS portfolio will quickly be hoovered up by other lessors, AerCap will find it more challenging to shift widebodies if it wishes to, such as the 40 additional 777s from GECAS's fleet **(1)**. The average age of the combined fleet 6.9 years, AerCap CEO Aengus Kelly said in a recent interview with CNBC **(2)**.

The chart below compiled shows the overlapping lessees with the largest concentrations in the new AerCap fleet:

Top 10 lessee list from AerCap and GECAS



Source: IBA Advisory, InsightIQ

Another leasing platform was sold to a joint venture of investors in March. Blue Sky Aviation, a platform managed by EnTrust Global, an alternative asset management firm, and funds managed by investment firm SVP Global, agreed to acquire Deucalion, the aviation investment and asset management business of DVB Bank Group. The transaction is expected to close during the first half of this year. Deucalion Aviation manages around 160 leased aircraft, accounting for approximately $5 billion in total asset value.

The appetite remains for leasing platforms, which can provide solid and stable returns. A diverse lessee base can ensure that there are different sources of income even if some airlines are struggling to pay their lease rentals during the pandemic. Meanwhile, on 29 March, private equity giant Carlyle, beat Pimco/DAE and Castlelake to acquire the Fly Leasing platform, comprising 86 aircraft.

Airline-owned or “captive lessors”, which tend to have higher concentration risk than traditional lessors, have been finding life more difficult. Norwegian Air Shuttle began quietly winding down its leasing business Arctic Aviation Assets, after the Norwegian government decided to withhold further support. In mid-March, the airline’s shareholders, group of creditors and customers held meetings to agree a rescue plan for the airline group, which is expected to be approved by an Irish court on March 26. Norwegian chief financial officer Geir Karlsen told Norwegian business newspaper E24 earlier that month **(3)** that the company expects to remove the remaining 737 MAX aircraft from its fleet, much of these leased back to them from Arctic Aviation Assets. Before the regulators grounded the MAX in March 2019, Norwegian had already received 18 aircraft of the type. However, in July last year, Norwegian moved to cancel the rest of the order with Boeing, which initially was for 100 aircraft, but the parties have not yet finalised the terms of the cancellation. Instead, the airline will operate with a fleet of all Boeing 737NGs. Being liquid and new assets, the MAX aircraft will present opportunities for lessors looking to expand their portfolio or alternatively new investors looking to enter the sector.

Industry status

In the regional aircraft space, Nordic Aviation Capital issued an investor update on March 15 saying that its founder and chairman, Martin Moller, is looking to increase his equity in the company after two shareholders refused to further fund the business, EQT VI and GIC. The company's business plan on how it moves forward without that equity investment will be decided in the coming weeks **(4)**.

Some funds are struggling from lessees not being able to pay their lease rentals. Aircraft funds are usually a good destination for investors to park their money if they are looking to make a sizeable return. Such funds often buy jets from the aircraft manufacturers and lease them back to carriers.

Towards the end of February German newspaper Fons reported that "Flugzeugfonds 2" was planning to file for bankruptcy as soon as possible **(5)**. The fund, launched in 2007, consists of one A330-200 that is leased to Air Mauritius, a mainly state-owned airline that has been restructuring since April last year, due to the drop off in passenger numbers due to the coronavirus pandemic. Doric told the newspaper that due to Mauritian bankruptcy law, the airline has to suspend lease payments while keeping the aircraft during the restructuring, which is set to continue until at least June.

The German lessor secured a standstill agreement on the loan of €33 million last year with a bank consortium led by the Norddeutsche Landesbank and has since paid lower repayment instalments. But this agreement expired at the end of February 2021. Since April last year, the debt financing has been provided for the aircraft, but the lessor could not sell it to a carrier that would pay its leases.

The 2007 prospectus assumed proceeds from the sale of the aircraft in 2024 would be around €27 million, around 40 percent of the asset's purchase price. But even if Doric was able to sell the asset now, the widebody's value has significantly dropped due to the pandemic and dampened demand for twin-aisle aircraft. Doric said the fund had around €9 million in debt. In 2007 when the fund was established, €31.3 million was injected in equity from the fund investors. For eleven years, the fund paid out seven percent each time, leaving around €7.2 million of investor capital are still available today. The aircraft would need to be sold by Doric, for at least €16.2 million, to make up that loss in capital.

Widebodies, even those that are relatively new generation A330s and 777s, may prove a headache for lessors to place with other lessees while satisfying investors during the pandemic, where load factors are significantly lower than average. But airlines with good access to government capital and strong balance sheets will be able to make payments and offer guarantees to lessors and investors in these funds. New and liquid aircraft that are easy to remarket are also a plus. Funds with a single asset or single lessee will be more vulnerable, especially those with illiquid widebodies in, such as A330s and 777s.

Opportunities for investors to invest in aircraft

Funds, if priced appropriately with liquid assets and strong credits, can often be an attractive option for investors looking to invest in aircraft. They offer investors flexibility, as additional capital can be injected further down the line and additional assets can be acquired. Some of these funds may list on a stock exchange, providing access to other investors in the public markets.

Outside of funds, there are other opportunities for investors to enter the space. Opportunities for equity investors that offer returns in the very high teens are now very hard to come by and yields continue to tighten as more institutional investors move into the market. Many investors are looking to buy aircraft now at the bottom of the cycle, before selling them off as the cycle reaches its peak.

Equity returns range depending on the airline risk profile, but according to our research, unlevered returns for narrow bodies between zero and five years old are hovering at around the 4 and 6.5 percent ballpark. Narrow bodies between 8 and 12 years old tend to be between 6 and 8.5 percent and end-of-life narrow bodies are between 8 and 13 percent. Regarding widebodies, the return is more variant: liquid 787-9s with top tier airlines can yield close the narrow bodies, but older A330s or 777s yield more than the narrow bodies, sometimes in the double digits. The new players in the market are targeting new aircraft with top tier airlines in ESG-compliant transactions, offering a 6 to 7 percent return while competing with a much lower cost of capital from Asian investors.

Returns depend on a number of factors, including the credit, the structure of the deal, the type of investor and the region of the world the investor is based in. For example, equity investors in Greater China region tend not to differentiate aircraft type, age, and credit for expected return. For these investors, the IRR rate ballpark for widebodies is often between 12 and 15 percent, according to our research. For narrow bodies, expected IRR tends to sit at around 10 percent. Given the return in aircraft even before the COVID-19 pandemic, it is difficult to meet the return expectation from institutional investors (e.g. pension or insurance funds) in the region. However, these investors tend to only finance young narrow body aircraft with top credits. Of course, Chinese lessors are very different investors in aircraft in relative to the pension and insurance companies and will often have different return expectations.

More generally, investors are less attracted to widebodies given concern around their residual values, as they are too dependent on large traffic volumes rarely seen during the pandemic. Because of that, there is more uncertainty in demand for them. Narrow bodies have significantly better prospects. Now may be a good time for investors to acquire these assets and wait until lease rates and values begin to recover before placing them mid- to long-term contract.

In addition to funds, here are some other examples of ways to invest in aircraft:

JOL and JOLCO

Japanese Operating Leases (JOL) and Japanese Operating Leases with Call Option (JOLCO) are Japanese-sourced lease transactions that provides for 100 percent financing from Japanese investors. JOLs are typically used for financing used aircraft from an airline via sale/leaseback or from a third-party lessor with an operating lessor attached.

JOL lease terms tend to be up to 12 years and JOLCOs, which include a call option or early buyout option, tend to have a minimum lease of 10 years. JOLCO investors typically gravitate towards blue chip credits JOL and JOLCO investors tend to only target “clean deals”, often at extremely competitive rates. ABL Aviation has structured several JOLCO deals, including a $150 million Development Bank of Japan-funded, Sompo Japan Nipponkoa Insurance-fronted, AFIC-supported deal for Israeli airline El Al. The transaction, which marked the first time an AFIC-supported financing was combined with JOLCO equity, won AirFinance Journal’s 2019 Guaranteed Financing Deal of the Year.

Structured operating leases

Equity and debt investors can invest in aircraft via other types of structured operating leases, providing some or all the financing for the sale and leaseback of an aircraft to a lessee. Such deals have allowed parts of the equity to list on a stock exchange or introduced new aircraft funds.

Investment vehicles – e.g. sidecars

A sidecar is a strategy where one investor allows a second investor, a lessor or an asset manager, to control how to invest its capital. Equity and debt investors may feel their money will go further in the sector if they can invest in aircraft via sidecars managed by a trusted asset manager, with deep knowledge of the aircraft.

E-notes in an ABS transaction

Investors can take residual risk in the underlying assets via E-notes (equity) in an asset backed securitization (ABS) transaction, deals which typically have the flexibility to finance mid-life or older aircraft. The E-notes provide investors the economic equivalent of an equity return and typically give them the right to elect the directors of the Issuer. However, they are not usually structured to offer investors the same rights as the owner of the portfolio of aircraft would have under a non-ABS deal **(6)**. The control rights are instead given to the servicer or sponsoring operating lessor.

ABL's view –

"Equity returns in the market are extremely variant right now. Many parties are raising capital, mainly focused on new aircraft and ESG-compliant investments. Given how competitive pricing is among some of the new equity players and in the JOLCO market, we believe that many of the compelling opportunities are in the mid-life space.

Although the returns are varying, we believe the market is hovering at around 6 to 7 percent unlevered (10 to 13 percent levered) equity returns for mid-life aircraft with top tier airlines. We believe up to 15 percent levered return on mid-life narrow body aircraft is reasonable for investors. Offering a significantly lower return than that on mid-life equipment will fail to meet many investors' return thresholds.

We believe the new aircraft space is too competitive, because you may be competing with a 3 to 4 percent equity return expectation on a JOLCO or a slightly higher expectation on an ABS transaction. But of the wave of capital investing in our industry, some will have better financing conditions than others."

Ali Ben Lmadani, CEO ABL Aviation

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