GRANT'S
INTEREST RATE OBSERVER®

Vol. 42, No. 12d 233 Broadway, New York, New York 10279 • www.grantspub.com JUNE 21, 2024

Cheap highflier

Evan Lorenz writes:

Worldwide demand for air travel shot past pre-Covid levels for the first time in February, and global bookings for April climbed by 11%. If only there were enough planes to go around. The failure of the supply of jets to keep pace with the demand for jets is just the ticket for aircraft lessor AerCap Holdings N.V. (AER on the New York Stock Exchange). On AerCap, in preview, we're bullish.

A single month's aircraft delivery data almost tells the tale. In May, Boeing Co. delivered only 24 airplanes, 26 fewer than it did 12 months before, but the problem runs deeper than the 737 MAX. Even including Airbus S.E., expected jet deliveries for the year are lagging, with the narrow-body kind expected to fall short of the volumes recorded in 2017 and the wide-body type projected to be less than the total for 2012. Rising demand coupled with sputtering supply is lifting lease rates on increasingly scarce aircraft and playing to the considerable strengths of AER.

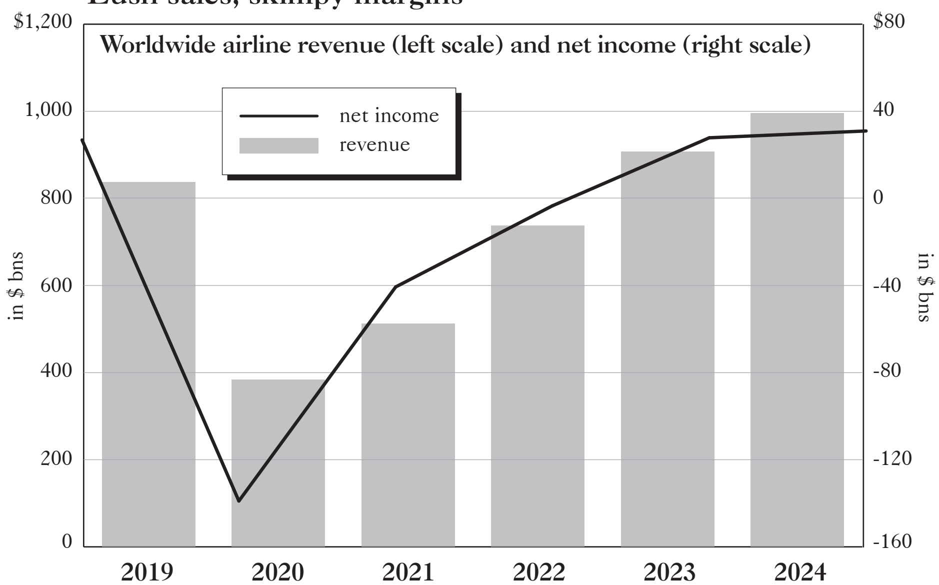
Founded in 1975 as Guinness Peat Aviation, one of the first jet lessors, AerCap today is the world's largest jet lessor. Not that the half-century climb to the top has happened without turbulence. Short of cash in the aviation slump that followed the 1991 Gulf War, Guinness Peat made a bid to go public. When Mr. Market refused its advances, the company turned to GE Capital Corp. for a lifeline. The year was 1994.

Guinness Peat effectively remained a GE subsidiary until Texas Pacific Group bought a controlling stake in the company in 1998. Further changes of control and nameplate followed, until, in 2005, AerCap found a buyer in Cerberus Capital Management. One year later, the p.e. portfolio company became what it had tried to become in 1994, a free-standing, publicly listed stock.

As of March 31, AerCap's fleet encompassed 1,717 passenger and freighter aircraft (including 183 that were managed for third parties), 1,031 engines (598 for third parties, primarily for a 50/50 joint venture with Safran Aircraft Engines) and 313 helicopters (7 managed units). Management buys the latest models of standard jets, thereby reducing both releasing risk and residual risk. The Airbus A320neo, a popular narrow-body plane, accounts for 30% of AerCap's book value; the 787, Boeing's star wide-body, makes up 18%.

AerCap keeps its lessees on a prudently short leash. For instance, it ended the first quarter with receivables equivalent to just two days' worth of sales. "We're monitoring the utilization of our aircraft on a daily basis as well," chief risk officer Anton Joiner told the audience at the May 8 investors' day. "If our aircraft are grounded for more than 24 hours, we'll be asking questions: Is routine maintenance being missed? Are parts being removed? And if we don't like what we're hearing, then we move decisively to take aircraft back."

Lush sales, skimpy margins



source: International Air Transport Association

AerCap did just that in late 2022. Sensing trouble at Indian airline GoAir, the company took back its four aircraft shortly before the Mumbai-based discount carrier filed for bankruptcy protection. Some of AerCap's competitors, slower on the draw, are still trying to lay hands on the 50-plus aircraft that remain impounded in India more than a year later. AerCap's heads-up management style has won it credit costs averaging less than 1% of revenue over the past 17 years, excluding Russia (on which, more below). Apparently, it's a relatively low cost; the competition chooses not to provide comparable data.

The lockdown era aside, demand for air travel tends to track GDP growth. The International Air Transport Association (IATA) estimates that passenger counts will increase by 3.8% per year over the next 20 years, which implies 4 billion more customers in 2043 than in 2023.

Much can go right in 20 years, though there are legitimate grounds for concern about the future availability of aircraft. It's not that the engineers lack ingenuity. Pratt & Whitney's geared turbofan (GTF) engines, for instance, which power the A320neo, constitute a technological breakthrough. Legacy turbofans use a single shaft to connect components, which means that all parts turn at the same speed. The GTF uses a gearbox that allows each section of the engine to operate at its own optimal speed, thus making the engine much more fuel-efficient. Unfortunately, some parts of the GTF also crack under high pressure and hot temperatures, a bug that has caused airlines to ground hundreds of planes and thrown a spanner in Airbus's A320neo production.

At the May 8 AerCap investor event, the lessor's CEO, Angus Kelly, warned about the shortage of MRO shops—maintenance, repair and overhaul facilities—to "meet the demand for repairs."

"Why is that?" the CEO asked and went on to cite Covid and the deferral of maintenance during lockdowns, which led to the downsizing of repair shops and a backlog of work when airline demand bounced back.

"But the greater impact is coming from the assets themselves," Kelly went on to say.

> These aircraft and engines are engineering marvels. They fly farther, they carry more and they burn less fuel than the previous generation of aircraft. However, they're not as durable. They break down more often. They are strained to the engineering maximum they could be pushed to. So they do not last as long in service. So they have to go to the shop, the MRO facility, to be repaired. An MRO facility needs the same parts and skilled labor to repair an engine or an aircraft that the manufacturer needs to build them. And there is a very finite supply of both parts and highly skilled labor.

Cheaper than it looks

source: The Bloomberg

AerCap leads the world in leasing not only aircraft but also aircraft engines. A measure of the tightness of the engine market is the fancy prices that AerCap can charge on the 7% of engines that it holds in stock for short-term rentals (the rest are out on long-term lease).

Strong orders and crimped production mean that Airbus and Boeing are "pretty much sold out until 2030," Hillary Cacanando, who rates AerCap a buy for Deutsche Bank Securities, Inc., tells me. "So we're seeing a lot of older aircraft flying much longer, and we're hearing from airlines that once they get an engine into a MRO shop, it can take a year for them to get it back. There's a lot of bottlenecks."

Such supply-demand dynamics are producing higher ticket prices and bigger load factors for the carriers. Global airline revenues plummeted to $384 billion in 2020 from $838 billion in 2019—but will climb to $996 billion this year, IATA estimates. The experienced investor will take only so much comfort from such projections. For one thing, airlines worldwide have incurred average debt equal to 4.1 times expected 2024 Ebitda plus rents. For another, the carriers earn wafer-thin profit margins; IATA forecasts the sector will earn $30.5 billion in net income this year for a 3.1% net margin.

Lessors deploy better balance sheets and earn fatter margins than their customers do, margins likely to grow thanks to the supply-demand cards they hold. The Street estimates that AerCap will earn a 26.7% net margin this year and do better as the lease book reprices higher. On its first-quarter call, Air Lease Corp., an AerCap competitor, said that overall lease rates have increased by 14%–15% since late 2022.

As aircraft become scarcer, airlines aren't just paying up but are also terming out, with leases averaging seven years in 2023, up from five years in 2019. Historically, customers chose to extend terms on around 15% of AerCap's expiring leases. Last year, they chose to extend 72%. The higher, the better from the lessors' vantage point, given the substantial costs entailed in shifting an asset to one carrier from another (repainting aircraft exteriors, reconfiguring seats, etc.).

Residual value is a key risk for any

AerCap Holdings N.V. at a glance
all figures in $ mns except per share data

	TTM*	2023	2022	2021	2020
revenue	$7,732.8	$7,580.4	$7,013.6	$5,224.0	$4,493.6
Ebitda	6,834.5	6,688.1	6,180.3	4,725.9	4,060.9
Russian recoveries (losses	1,296.6	1,287.9	-2,665.7	0	0
net income	3,308.2	3,136.1	-726.0	1,000.5	-298.6
earnings per share	15.01	13.78	-3.02	6.71	-2.34
shares outstanding	220.4	227.7	240.5	149.0	127.7
cash	1,292.0	1,627.2	1,587.1	1,728.8	1,248.8
debt	45,723.7	46,483.9	46,533.0	50,204.7	28,742.1
equity	16,955.6	16,589.0	16,195.1	16,647.4	8,932.5
total assets	71,105.0	71,274.6	69,726.9	74,569.8	42,048.0

* 12 months ended March 31, 2024.

sources: company reports, the Bloomberg

capital-goods leasing business. Airlines flying older jets at higher rates and for longer terms has dissipated that risk. Accordingly, the prices of such aging assets are on the rise. Last year, AerCap realized an average profit of 22% above book value on selling vintage planes, more than double the average over the past decade and a half.

"If you look at AerCap's existing portfolio, about a third will reprice to new market lease rates over the next three years," Mahmood Reza, the founder and CIO of Panthera Global Investors, L.P., which counts AerCap its second-largest position, tells me. "Then you have new deliveries, which will represent about 20% of the portfolio coming on in this leasing environment. Leases on new deliveries are usually 10–12 years, so they lock in those higher returns."

"The way we look at it, just about half of the book will be at new lease rates over the next three years," Reza continues. "That means AerCap's ROE is going to march higher from 12% to 16% in that time period, possibly higher. Critically, we think these returns can be sustained for many years to come."

AerCap's managers have proven themselves adept stewards of capital over the cycles. In 2014, AerCap purchased International Lease Finance Corp., then the world's second-largest lessor, for $5.1 billion from a struggling American International Group, Inc. In 2021, AerCap, by then the largest lessor, purchased General Electric Co.'s Capital Aviation Services, Inc., then No. 2 by fleet size, for $29.3 billion from a flagging GE.

When there aren't compelling deals on the table, the company likes to purchase stock—its own. Over the past 12 months, AerCap has shrunk the number of AER shares outstanding by 17%, a buying program funded by gains from the sales of older aircraft as well as from the proceeds from a curious set of insurance settlements (on which, more below).

"Right now, we believe that the cheapest assets we can buy are our own shares, our own platform, our own aircraft," Kelly, 50, told analysts on May 8. "You can rest assured that as long as I'm the boss, we are not overpaying for something. We're just not doing it. I mean, I don't care if we grow the business or don't. I couldn't care less. I care about whether we are creating value [and] ... making money. I've shrank this company twice. We've grown it very aggressively. I would say I am the most reluctant buyer of aircraft in the world."

The company, the setup and the CEO have obvious appeal, as we are not the first to notice. In the past 12 months, the shares have rallied by 50.8%, but AerCap's valuation has hardly kept pace. As a percentage of book value per share, the price of AER has risen to 108% today from 91% a year ago. A concurrent 27% jump in book value per share helps to explain the anomaly. AerCap trades at 7.9 times trailing earnings and is priced to a 1.1% dividend yield.

The AerCap balance sheet, as of March 31, showed a ratio of debt to equity of 2.4:1; in the first quarter, operating income covered interest expense by 2.3 times. Moody's Investors Service and S&P Global Ratings call AerCap a lower investment-grade credit (Baa2/triple-B); in both cases, the ratings outlook is positive.

The Street is bullish (10 of 11 analysts say buy), and the bears are respectful (short interest amounts to just 1.3% of the equity float). A Dublin-based business, AerCap makes no disclosure of insider buying or selling.

. . .

There are risks in the stock, of course. In the wake of the 2022 invasion of Ukraine, the Kremlin allowed Russian airlines to seize planes from foreign lessors; AerCap took a $3.2 billion charge for its stolen assets. Somewhat ironically, it was Russian insurers, and not their Western counterparts, that paid $1.3 billion to AerCap to settle some of these claims last year. (The reasoning is simple: The theft had cut Russian airlines off from the parts needed to service these planes, and if the jets touched down in another country, AerCap could instruct authorities to take them back.) AerCap is in the process of suing its American and European carriers for an additional $2.2 billion payout (in addition to requiring customers to insure its planes, AerCap buys its own coverage), a sum which, if realized, would boost book value per share by 13%.

A much bigger problem would present itself if president-for-life Xi Jinping exercised his extraterritorial ambitions for the People's Republic. In 2023, AerCap earned 16.8% of lease revenues from, and had $9.5 billion of assets in, mainland China.

A garden-variety recession does not score high on the lessors' worry list. After all, airlines manage their fleets based on long-term demand trends and not around two consecutive quarters of declining GDP. A deep recession or a return to lockdowns would be a different matter.

Case in point: In 2006 AerCap completed its initial public listing. The supply-demand situation was propitious. Boeing was three years behind schedule bringing the 787 into production, Airbus was two years behind on the A380. Such bullish omens, management predicted on the fourth-quarter 2007 earnings call, would deliver a 20% return on equity in 2008. Nobody mentioned the imminent near-death of the American financial system. While AerCap remained profitable throughout the Global Financial Crisis, ROE went on a downward spiral to 7.4% in 2012 from 14.7% in 2008.

The emergence of a new jet manufacturer capable of ending the Airbus-Boeing duopoly and flooding the market with supply is a nightmare that, from the lessors' point of view, would rank right up there with the keeling over of Lehman Brothers. On that score, Commercial Aircraft Corp. of China Ltd. began commercial production of the C919, its first narrow-body jet, last year. However, it's unlikely that COMAC could disrupt the leasing market for at least a decade. For one thing, the C919 is a technological generation behind such new models as the A320neo. Even then, airlines will want to see years of performance data before incorporating a new manufacturer into their fleets.

A leveraged entity, AerCap would likewise suffer from an upside lurch in interest rates. The average weighted maturity of its debt is just under six years, the average life of a lease contract is 7.2 years. It's a difference that makes an exact duration match of assets and liabilities well-nigh impossible. Besides, one-fifth of borrowings are floating-rate.

Despite these risks, the current under-supply of aircraft is one for the commercial-aviation record books. "We have been in the aircraft-leasing industry since the very beginning," Steven Udvar-Házy, who co-founded International Lease Finance Corp. in 1973 and currently oversees Air Lease Corp. as executive chairman, told analysts and investors on May 6. "So it should be pretty striking for you to hear us say that the current supply-demand imbalance is more strongly in our favor than we've ever seen [in] our long careers. But this is the actual reality of the current environment, and we do not see a realistic way of changing over the short-to-medium term, given the underlying trends in supply and demand."

•