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Long Doric Nimrod Air One (DNA.L) – 31 Pence

There is a family of closed end funds listed on the London Stock Exchange whose sole value is derived from owned A380s and their respective lease agreements with Emirates. Run by Nimrod Capital, Doric Nimrod Air has 3 different vehicles (DNA.L, DNA2.L, and DNA3.L) each with different numbers of planes and different lease terms. I see a sizable mispricing in the first of these funds (DNA.L), whose lease ends in Dec 2022, when comparing the implied value for its one A380 to both market rates and implied values of its longer-duration peers.

Background on the A380:

The A380 may be the biggest airliner failure of the 2000s. The entire market was propped up by Emirates, whose offering is centered on luxe international flights, with most other airlines operating the A380 bowing out in recent years until Airbus eventually announced the death of the program in 2019, delivering the last plane this year. As a result of the poor prospects for returning to flight due to operating costs essentially double comparable models, killing a freight future, the dwindling worldwide fleet is being valued at scrap/part-out value. Compared to successful models which may have operating aircraft in the hundreds (like the discontinued 747) or thousands (737 and A320), airlines willing to make use of the A380 are few and far between. Besides a few fringe operators who may continue to use this until they find a 777X or A350, the market will almost entirely be Emirates, who will continue to use the planes into 2030.

The problem with scrap value in this market is that Emirates is entirely capable of creating its own supply for A380 spare parts, most notably landing gear and engines which hold the most value, using their own fleet that is slowly being phased out. An engine would typically be valued at the sum of maintenance costs (~6m) plus some time value for not having to wait months for maintenance to be carried out. If demand is low, and other lessors and airlines are all ready to cease operating – therein flooding the market, the value to parts is diminished.

These planes initially cost over $400mn. With international travel still weak and fuel prices up, the only way this will make any money is with near-full capacity flights, which are far from common.

The opportunity:

These three securities are all spitting out consistent quarterly dividends underpinned by the duration of lease agreements with Emirates. These payments capture any idiosyncratic elements of the lease payment rates and are meant to be consistent until the end of the term. Any maintenance/repair costs are the responsibility of Emirates while under lease. Given their recovery, commitment to flying the A380, and state-backing, we have little reason to suspect that they would not be money-good for the remainder of the lease. In the past, or for a different plane, there would be a re-leasing of the aircraft. Since the A380 are essentially junk, they are valued as scrap, with no probability ascribed to renewing or selling the aircraft (Emirates has a purchase option but let it lapse in DNA1).

Even with this justified pessimism, the first fund, DNA.L, is egregiously mispriced. With a little more than a year remaining on the lease of its 1 A380, after dividends, the market is valuing the plane at $17.2mn USD. Compare this to DNA2, with 7 planes at $27mn each (2.5yr duration), and DNA3, with 4 planes at $32.1mn (4yr duration). Given the gradual saturation of the A380 parts market, we should expect the value of these planes to decrease over time. With 7 A380s scrapped so far, the market is going to be much more receptive to an additional plane in late 2022 compared to a handful in 2024 or 2025. 6 months ago, the A380 was quoted at $18mn, creating a margin of safety at the current price.

Another key factor in determining the price is the strength of the international travel market (since this is where widebodies like the A380 are used). Part-out values are positively correlated with miles-flown. In the time since $18mn was quoted, Emirates, British Airways, Qatar Airways, and Singapore Airlines have each returned the aircraft to service. By the time the Emirates lease ends, sentiment surrounding international travel is likely to have improved. Most estimates are 2023-2024 for a full travel recovery.

The investment case is this: 1 year to a catalyst, market is valuing identical assets at almost 50% off and with a much shorter duration, margin of safety in $18mn scrap value vs $17mn implied by the current valuation, and macro price determinants moving to increase part values. In essence, we have an asset with minimal downside and 58%-87% upside (based on DNA2 and DNA3, whose valuations are still discounted to pre-COVID A380 values). Management has also received 3 independent appraisals of the A380, coming up with an average price of $43.6mn, a blue-sky scenario. Taking that value at 50% still provides meaningful (27%) upside.

On top of this, there is a non-zero chance that the A380 could be re-leased or sold for operation if a particularly bullish airline wanted a cheap widebody. It's much more likely that a return could be earned at a tenth of the list price ($40mn) possibly allowing the economics to work.

Risks:

- Emirates does not pay on remainder of lease
- Scrap value realized is less than $17mn
- Transactional/cooperate costs eat at final aircraft value realization (which is why I do not include GBP .7mn cash balance in EV calculation)