AerCap: A Reopening Investment But In The Meantime Profitable

Aug. 22, 2021 5:56 PM ET

Summary

- Low-quality competitors are greatly affected by COVID, which puts AerCap in a better position.
- Effects from the merger between AerCap and GECAS may result in a higher net spread for the company and, thus, higher return on equity.
- The airlines' balance sheet will need to be deleveraged, and lessors are in their best position to take advantage.

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Introduction

AerCap (NYSE:AER), which operates in the leasing aircraft business, is leading within its sector. In my opinion, AerCap is a great investment opportunity due to several reasons. The stock market is currently offering the company at a lower price (28% discount to NAV) than their historical discount to NAV (10% discount). Additionally, the company is also immersed in the merging process with GECAS, which could improve the returns to shareholders in the mid-term.

Source: AerCap website

AerCap's business

Basically, the company owns new technology aircraft (financed by debt and cash) and signs a long-term leasing agreement with airlines. When the leasing concludes, the company usually decides between selling the aircraft in the secondary market or lease it again to another customer. Overall, the company makes a profit by the spread between the leasing yield and the cost of debt. For airlines, the leasing companies are the best option for operating new technology when they don't have any order-book and/or seek to deleverage their balance sheet.

From 2006 to 2019, the company has compounded its NAV at a 13.2% rate, which is an attractive return on equity (ROE) with quite low volatility and cyclicality in their results. However, it doesn't include the additional return from the buybacks undertaken at discount over book value, which has increased the return to shareholders.

The sector is a bit commodity, but with special moats due to sizing and manufacturing oligopoly. I think there is a lot of value in following a couple of peers, and then switch from one to another at the right price. I personally have been a shareholder of Air Lease (NYSE:AL), Fly Leasing (NYSE:FLY), and AerCap.

Furthermore, with the merge between the leader in the business (AerCap) and the second biggest leasing company (GECAS), I believe it is of great value to be positioned in AerCap, compared to other peers. In my opinion, the transaction can change the market structure and reinforce AerCap as a unique leader in the business.

Indeed, although it has been a multi-bagger during 2020-2021, the market still gives a great opportunity by owning AerCap shares. I have a significant position made by a synthetic option.

Situation

Unlike the airlines, the aircraft leasing companies have surpassed the COVID crisis better than expected (especially the top tiers). For 2020, the collection rates were higher than 90%. Although some airlines have gone into a restructuring, most of them have continued to pay the top-tier lessors such as AerCap. On the other hand, tier 2-3 lessors with lower financing capacity, lower customer quality, and size have suffered more during 2020-2021.

Furthermore, most of AerCap's customers are backed by governments. This gives more confidence when investing in AerCap, compared to other leasing competitors. Even though, AerCap has been negatively affected by LATAM and Norwegian Airlines' restructurings. AerCap sold their Receivable rights from LATAM and has reported part of them as Other Income in Q2 2021 and the rest in Q3 2021 and as Free Cash Flow (FCF) during the H2 2021.

First key point: Low-quality competitors are very impacted by COVID

Due to low collection rates, among other reasons, some companies like Fly Leasing had to finance their Notes at 7% to 9% yield, whereas AerCap or Air Lease allocated their Notes at around 3% and some recent notes at almost 0.8%.

Fly Leasing launches additional $100M in senior notes offering

Aug. 03, 2021 9:05 AM ET | **Fly Leasing Limited (FLY)** | By: Khyathi Dalal, SA News Editor

- Fly Leasing (NYSE:FLY) commenced its additional offering of $100M principal amount of its 7.000% senior notes due 2024.
- The additional notes will be fungible with the company's existing ~$290.4M principal amount of 7.000% senior notes due 2024.
- Net proceeds to be used for general corporate purposes.

Source: Seeking Alpha

COVID-19 has increased the fundamental gap between Tier 1 peers versus lower quality ones. Bear in mind that financing interest is the base of the leasing profit, which comes from the spread between their Rental Leases Interest and the Cost of Debt.

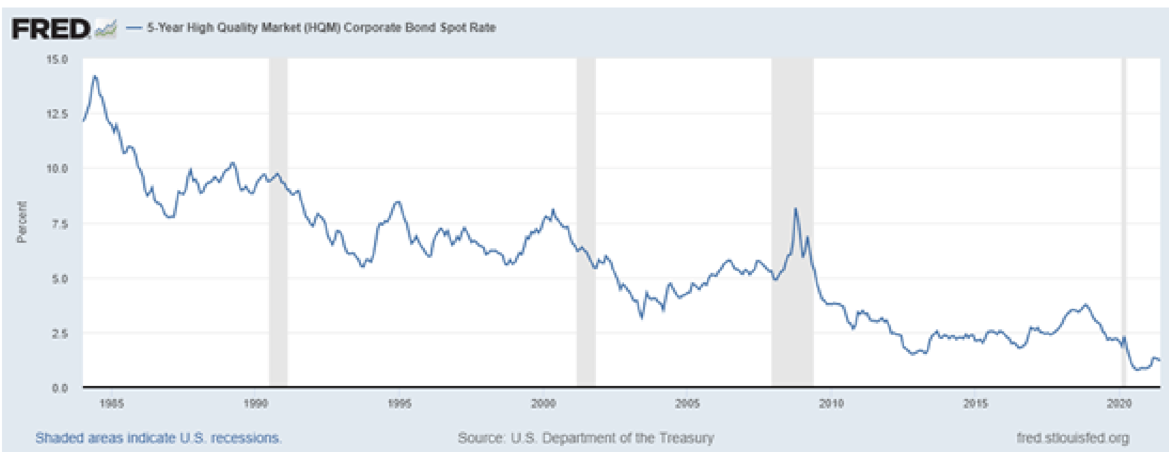
Tier 1 lessors are in a better competitive position relative to lower-tier lessors compared to the pre-COVID period.

Second key point: Effects from the merger between Aercap and GECAS

As previously mentioned, another important event occurred in March 2021, as AerCap agreed to acquire (more accurately merge with) GECAS, a part of General Electric. The transaction will be paid in shares so does not add direct value to AerCap shareholders.

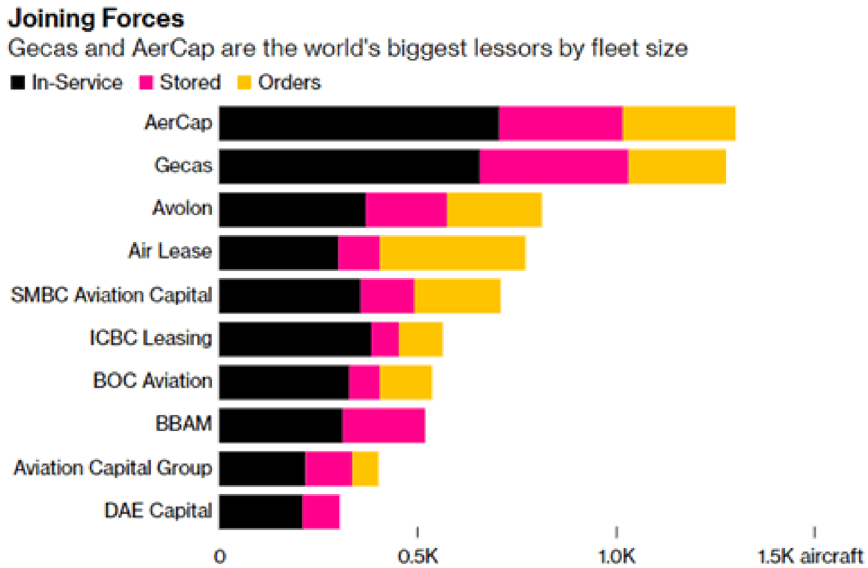
But the merge is not as easy as we may think, due to the fact that AerCap needs to refinance 30B$ from GECAS debt, in other words; Debt needs to change from General Electric ownership to Aercap. The situation is laborious as 30B$ of debt is not easy to allocate, however, it could also be a great opportunity to reset Notes at lower rates.

In the following graph, you can see that the High-Quality Corporate Bonds (includes AerCap Notes) are at their lowest spot rates.



Source: U.S. Department of the Treasury

Both of the companies are, as illustrated in the figure below, huge in the business: top1 and top2. AerCap plans to close the transaction by the end of 2021. The merger can be an ace up the sleeve to increase their spread margin and, thus, the return to shareholders.



Source: [Bloomberg]

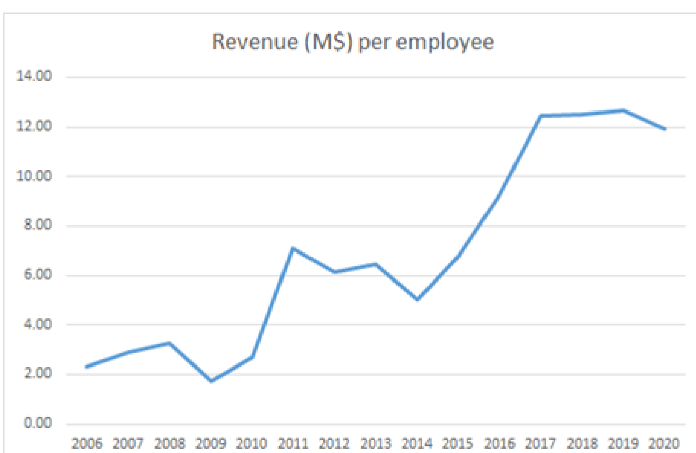
During the last decade, we didn't see much power from the top tier companies as AerCap to increase their market share organically, as the priority was given to buybacks rather than looking for new leases. However, GECAS transaction and the current environment may change this.

In the leasing business, size matters. The bigger you are, the better financing conditions you get (like any financial company) and, at steady conditions, an increase in your net spread and thus, your ROE. Hence, the main reason why Aercap will get involved in the GECAS merger is, in my opinion, sizing.

Pre-COVID AerCap worked on an upgrade of their investment-grade rating, and I am sure that the merge with GECAS points in that direction. The media and management said that this agreement was under negotiations before the COVID crisis and I have reasons to believe that they have had meetings with the credit rating agencies before the agreement.

As well, although most of their costs come from the debt, AerCap could also reduce general, selling, maintaining, and other costs with the merge. This could slightly increase the company's ROE.

AerCap has increased its revenue per employee (In 2014 they acquired ILFC). The labour cost reduction is not very relevant but an example of how sizing may decrease some costs relative to revenues.

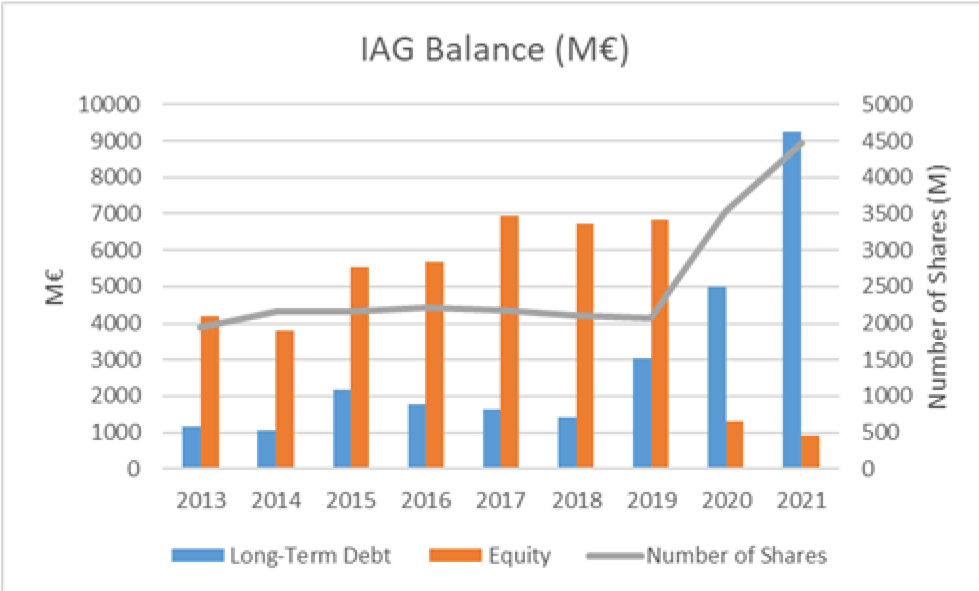


Source: Created by author, data from Aercap's annual report

Third key point: the airline's balance sheet.

In November 2020, I wrote a thread on my Twitter account regarding my (still ongoing) worries about the airlines' balance sheet.

Let's put IAG as an example:



Source: Created by author, data from IAG's annual report

The debt has increased by 3 times (it should be noted that they do have a great amount of cash in the balance) and they have raised capital a few times by issuing shares (the double of common shares in one year). Furthermore, the equity has declined 85%. This doesn't look good and is most likely not about to improve in the short term.

Indeed, most airlines, like IAG, have experienced a downgrade on the credit rating whereas AerCap has maintained its investment grade and lowered its financial leverage. This is the perfect environment for lessors, especially if we consider the advantages of GECAS transaction.

Furthermore, the sale-and-leaseback concept (airlines sell their aircraft to lessors and sign a long-term leasing contract) will gain more and more importance. The airlines will relieve part of their balance by selling their assets.

Airlines have also commitments with Airbus and Boeing that cannot meet, which makes the figure of the lessors crucial. On the other hand, airlines will find themselves in a checkmate position, as they annually pay a deposit to manufacturers for the future delivery of an aircraft. This deposit will be lost if the airline doesn't acquire and pay for the airplane at the agreed period of time. Manufacturers are using lessors for placing book orders. This gives a great opportunity for lessors to own more new technology.

For example, I noticed that in Q2 2021 AerCap has added new purchases to their portfolio. In Q2 2021 results they reported:

- Purchased 15 aircraft, including 10 Airbus A320neo Family aircraft, 4 Boeing 737 MAX aircraft, and 1 Embraer E2.

But actually Boeing 737 Max airplanes were not expected to be acquired, as shown in the following image from AerCap's presentation Q1 2021 results.

Forward Order and Purchase/Leasebacks

Aircraft Type	2021	2022	2023	2024	2025	Thereafter	Total
Airbus A320neo Family	25	29	33	29	25	16	157
Boeing 737 MAX	-	2	17	18	19	15	71
Boeing 787	4	3	1	4	4	7	23
Embraer E190 / 195-E2	1	-	-	11	18	4	34
Total Aircraft	**30**	**34**	**51**	**62**	**66**	**42**	**285**

Source: AerCap's presentation Q1 2021 results

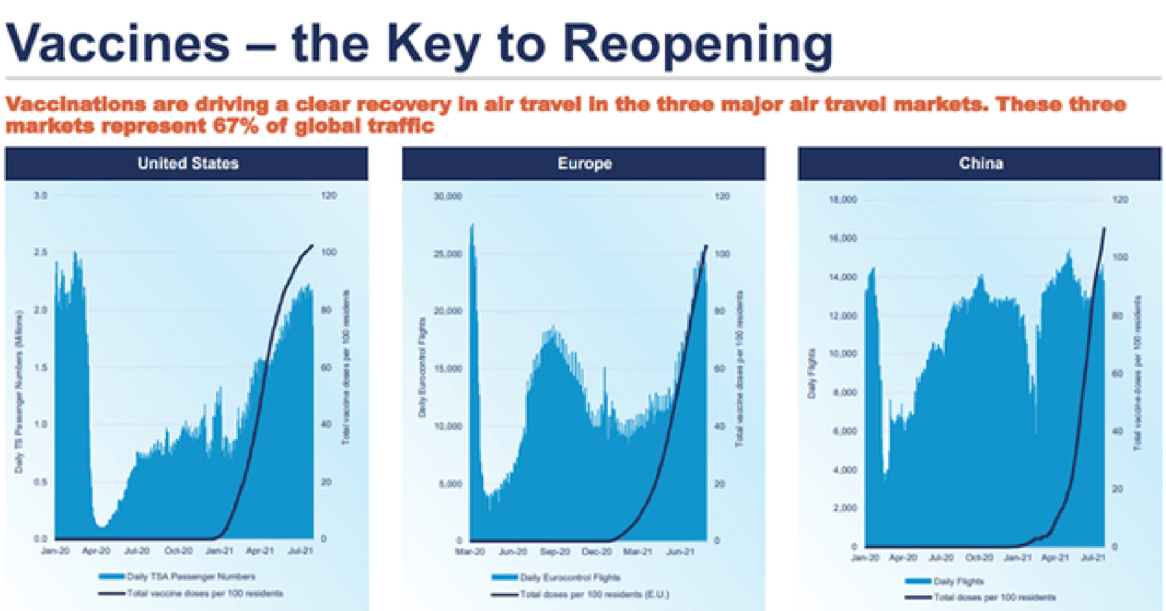
In the call, the analyst from Davy also noticed that the airplanes were not expected, and asked the CEO about them. The CEO confirmed they are leasebacks.

I have also noticed that 8 new Boeing 737 MAX are expected to be delivered this H2 2021, which were also not in the order book earlier this year. This means they are closing more leasebacks without highlighting them on their presentations (- this is understandable because it is bad press for the airlines).

The only thing that matters for a lessor is to recover the air travel, in such a way that there is no overcapacity in the market. Furthermore, a future environment with bankruptcies and restructuring is good for lessors because normal ways of financing (e.g. Banks) will ask for higher interest due to the volatile environment but AerCap, as long as air travel is reestablished, will be able to reallocate the assets if needed and ask for a lower leasing interest than Banks. This is the real moat of these companies versus a normal bank.

Air travel recovery

The air travel recovery is the main risk of the thesis. It is going better than expected a few months ago. The vaccination has helped the recovery, as we are almost reaching levels before COVID. This is also expected to improve over the months.



Source: [AerCap Presentation, Q2 2021]()

However, in this matter, not all the lessors have the same exposition to a slower reopening. We should distinguish between long- and short-distance flights. In my opinion, we will experience a faster recovery on the short distance routes which are mostly operated by narrowbodies and most of AerCap's portfolio.

Aengus Kelly, AerCap`s CEO, commented on the [Q2 2021 conference call]:

In the U.S., Europe and China, which together made up 67% of the world's commercial flights taken in 2019, there has been a marked improvement. TSA data from the U.S. shows passenger throughput is consistently around 2 million passengers a day, which is approximately 80% of 2019 levels. China is flying over 13,000 flights a day, which is more than 105% of the same period in 2019. And in Europe, they surpassed 25,000 daily flights in July, which is around 70% of 2019 levels.

Surprisingly, Chinese air travel levels are higher compared to 2019, as shown in the image above. In this regard, I would like also to quote an interesting comment from Aengus Kelly about the Chinese Market:

So, all of our customers in China are doing well. And I would say about the Chinese carriers, they are not stockpiling airplanes. They're taking all the airplanes they can to satisfy the demand that they see in front of them there.

And the Chinese carriers don't have huge order books of aircraft, they […] So, what that actually means Helane, is that they will need to take airplanes from the leasing market as we go forward.

That can be used airplanes, we have put the first - just signed deals for the first used aircraft to go into China, which is an innovative thing for anyone to have done. And as the leader, that's what we do, we'll be the first to do these things. And then on the forward order aircraft, we are continuing and we are seeing now demand from the Chinese customers for aircraft of the order book. And we expect that to continue as our market continues to grow.

So, AerCap sees great potential growth coming from the Chinese airlines, which do not have order books and are therefore forced to take planes from lessors in order to meet the demand for air travel. Related to other questions, Aengus commented:

… And we think it will be a robust sales market for AerCap as we get into 2022.

With this, it seems that AerCap's growth is just about to start.

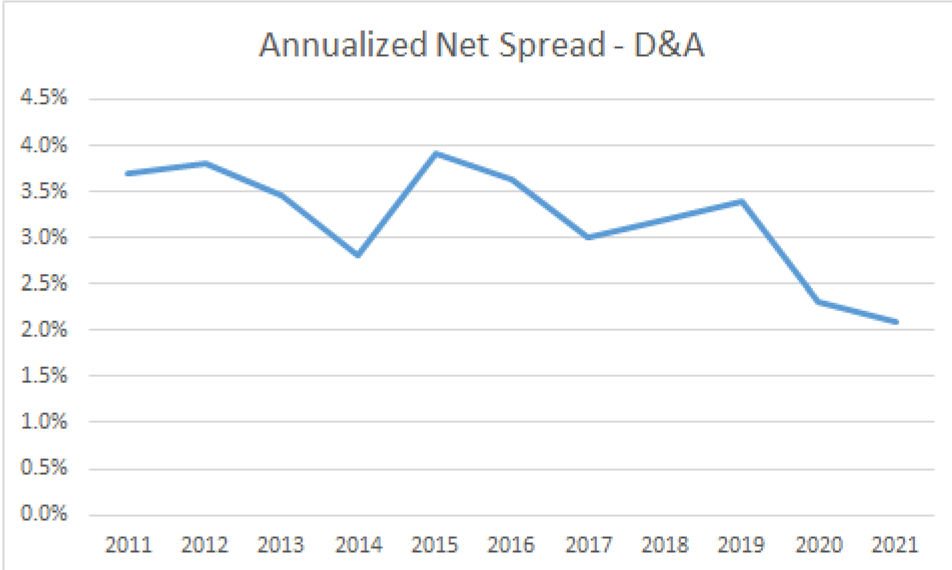
Historical ratios

In contrast to other contrarian or deep value investments, AerCap is in the meantime generating profits, unlike hotels, airlines, manufacturers, etc.

Its current normalized ROE for 2021 would be around 7% due to a decrease in the basic lease rents (excluding extraordinary items as LATAM compensation that has increased EPS). The decrease is primarily a consequence of lease restructurings, transitions, and the impact of airline bankruptcies.

In my opinion, these companies should be valued by the future ROE they could generate for shareholders. To calculate the ROE, it is necessary to split their sources of revenue and cost, the level of leverage, and the Cost of Debt. In this matter, I have done my own model with my own assumptions.

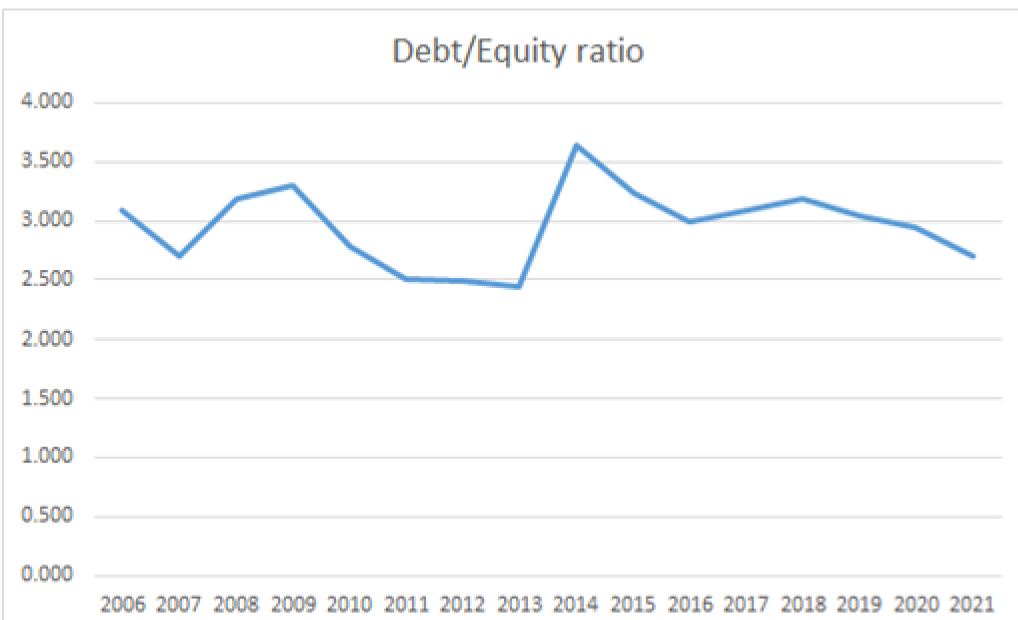
The Annualized Net Spread of AerCap has declined to 2.1% during the first half of 2021. In the long run, the company could reach at least 3.5%, their historical spread. The latest conference call has already stated that the rental numbers will come back to normal, shortly after the restructuring and some aircraft placements.



Source: Created by the author, data from Aercap's annual report

Actually, if air travel recovers to previous levels, we could see a net spread higher than the historical due to the 3 key points mentioned above. As well, the Debt/Equity ratio is almost at minimum historical ratios.

In Q3 2020 results (before the vaccine news), the company declared impairment of 1B$, more than 10% AER's equity. This could be reversed as they were quite conservative with the valuation of their widebodies and declared the impairment before the COVID vaccination. This affects the D/E ratio, which can be adjusted.



Source: Created by author, data from Aercap's annual report

Valuation

Estimation of Aercap's ROE

In the following table, you can find my AerCap's ROE estimations depending on the Net Spread minus Depreciation & Amortization (D&A) and Debt-to-Equity Ratio.

ROE AFTER TAXES								
	D/E							
Net Spread -D&A	1	1.5	2	2.4	3	3.5	4	4.5
1.50%	3.53%	4.17%	4.81%	5.32%	6.08%	6.72%	7.36%	7.99%
1.75%	3.96%	4.70%	5.44%	6.04%	6.93%	7.67%	8.42%	9.16%
2.00%	4.38%	5.23%	6.08%	6.76%	7.78%	8.63%	9.48%	10.33%
2.25%	4.81%	5.76%	6.72%	7.48%	8.63%	9.59%	10.54%	11.50%
2.50%	5.23%	6.29%	7.36%	8.21%	9.48%	10.54%	11.61%	12.67%
2.75%	5.66%	6.82%	7.99%	8.93%	10.33%	11.50%	12.67%	13.84%
3.00%	6.08%	7.36%	8.63%	9.65%	11.18%	12.46%	13.73%	15.01%
3.25%	6.51%	7.89%	9.27%	10.37%	12.03%	13.41%	14.79%	16.17%
3.50%	6.93%	8.42%	9.91%	11.10%	12.88%	14.37%	15.86%	17.34%
3.75%	7.36%	8.95%	10.54%	11.82%	13.73%	15.32%	16.92%	18.51%
4.00%	7.78%	9.48%	11.18%	12.54%	14.58%	16.28%	17.98%	19.68%

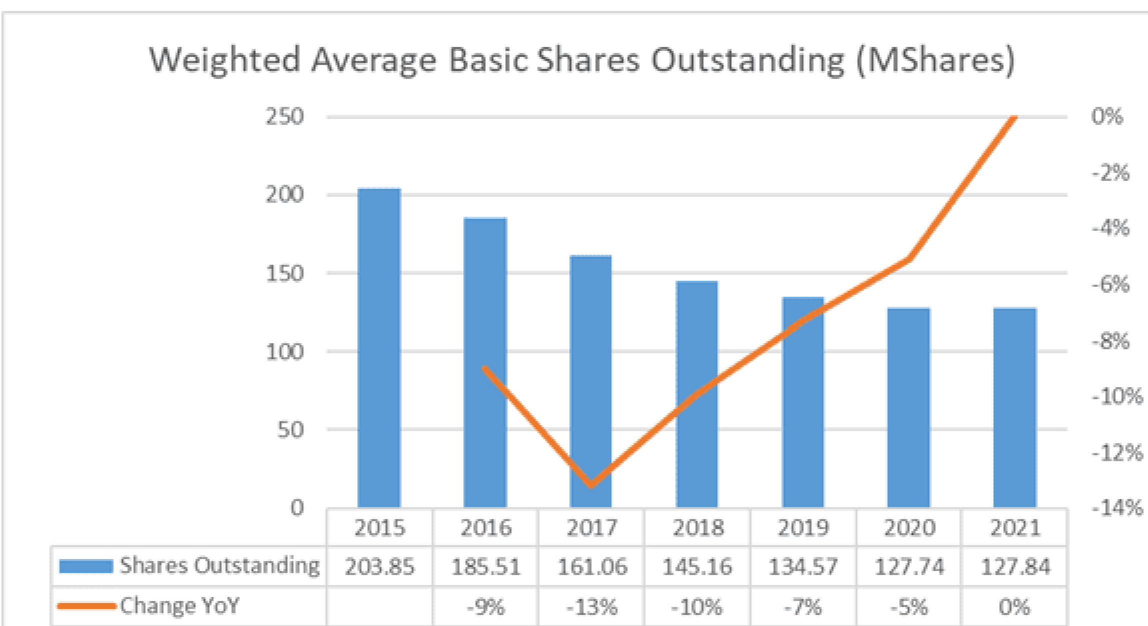
Source: Created by author

We can expect a 6.76% ROE for the following year assuming x2.4 Debt-to-Equity ratio (Adding 50% reversal of Q3 2020 impairment on Equity + 100% of credit long-term subordinated debt on Debt). The current ROE is lower than its historical due to airlines restructuring. I am not considering in the model Other Income like LATAM compensation, a relevant sale of assets over book value, or unsecured claim receivables, which may have a positive and relevant effect on 2021 ROE.

The future ROE may change in 1 to 3 years. I am sure the company will recover its historical net spread or even higher due to the 3 key points mentioned earlier.

Buyback effect

The buyback effect on the Return to Shareholders is also something that needs to be considered. The company was aggressively buying back its own shares before COVID and the current discount to book value is higher (28%) than its historical discount (10%).



Created by author, data from Aercap's annual report

So if we assume that the Income will go to buybacks and considering the discount to NAV buyback effect, the Return to Shareholders per share would be as follows:

RETURN TO SHAREHOLDERS AFTER TAXES - ASSUMING INCOME TO BUYBACKS									
		1	1.5	2	2.4	3	3.5	4	4.5
Net Spread -D&A	1.50%	4.52%	5.33%	6.15%	6.80%	7.78%	8.60%	9.41%	10.23%
	1.75%	5.06%	6.01%	6.97%	7.73%	8.87%	9.82%	10.77%	11.73%
	2.00%	5.61%	6.69%	7.78%	8.65%	9.96%	11.05%	12.13%	13.22%
	2.25%	6.15%	7.37%	8.60%	9.58%	11.05%	12.27%	13.49%	14.72%
	2.50%	6.69%	8.05%	9.41%	10.50%	12.13%	13.49%	14.85%	16.21%
	2.75%	7.24%	8.73%	10.23%	11.43%	13.22%	14.72%	16.21%	17.71%
	3.00%	7.78%	9.41%	11.05%	12.35%	14.31%	15.94%	17.57%	19.21%
	3.25%	8.33%	10.09%	11.86%	13.28%	15.40%	17.17%	18.93%	20.70%
	3.50%	8.87%	10.77%	12.68%	14.20%	16.49%	18.39%	20.29%	22.20%
	3.75%	9.41%	11.45%	13.49%	15.13%	17.57%	19.61%	21.65%	23.69%
	4.00%	9.96%	12.13%	14.31%	16.05%	18.66%	20.84%	23.01%	25.19%

Created by author

Due to the Buyback effect, Return to Shareholders will increase from 6.76% to 8.65%.

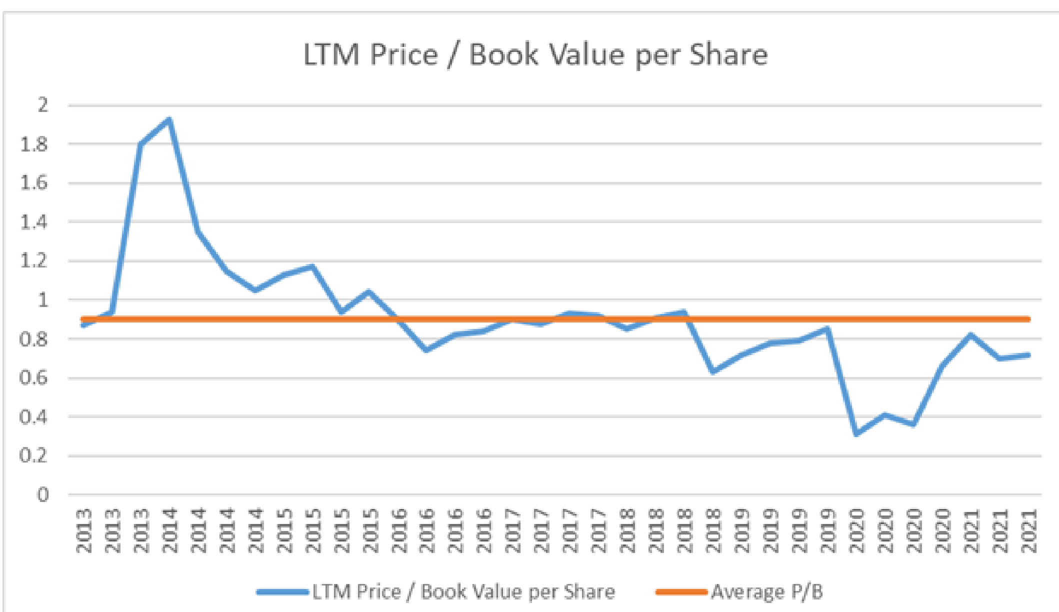
With the merge, GECAS will be the major shareholder. They haven't exited the business to keep an equity position at AerCap and will, most probably, sell their stake during the following years. This will push the stock price downwards and promote buybacks.

Following this, the share price would be kept low if they sell at the market (ATM). This is good news for buybacks.

Price-To-Book ratio

Another important aspect is the Price-To-Book ratio. I don't expect that this ratio will be maintained in the long run, as it most probably will return to its historical average.

Since 2013, the company has traded at an average P/BV of 0.90, 10% Discount. At the moment of my analysis, 2nd of August 2021, the company is trading at 0.72, 28% discount.



Source: Created by author, data from tikr.com

So, by assuming everything else equal, in the long term, the company will reach historical levels. We conclude with a potential upside of 25%, at current prices.

Base Scenario

Taking into account all of the mentioned above notions, I have assumed the following scenario for the valuation:

- The ROE for 2021 will be around 6.76%, which is the ROE that has resulted from H1 2021 so far.
- In 2020, the net spread could reach 2.75%, from 2% in 2020, giving 8.93% ROE.
- For 2023, net spread slowly recovers to historical values, assuming 3.5% net spread and AerCap willingness to reach x3 D/E ratio. This gives a ROE of 12.88%.
- In 2024, we could see a 3.75% net spread, almost reaching the highest historical spread and a steady D/E ratio. Giving a ROE of 13.73%.
- The Price-to-Book ratio is expected to return to x0.9 ratio by 2024.

I have added 3 possible scenarios to reflect the effective Return to Shareholders. One assuming no buybacks, another assuming 50% income goes to buybacks, and the last one assuming 100% buybacks.

The results are summarized in the following table:

	2021	2022	2023	2024	Target Price 2024	IRR(%)
Base Scenario						
ROE	6.76%	8.93%	12.88%	13.73%	$97.98	16.9%
EPS excl extraordinary income	4.69	6.61	10.39	12.50		
P/B	0.72			0.9		
50% Buyback Scenario						
Return to Shareholder	7.71%	10.18%	14.68%	15.65%	$103.29	18.4%
P/B	0.72			0.9		
100% Buyback Scenario						
Return to Shareholder	8.65%	11.43%	16.49%	17.57%	$108.82	20.0%
P/B	0.72			0.9		

Source: Created by author

The investment gives a decent annualized return between 17% to 20% for 2024. Sooner or later, the buybacks will be close the P/B gap. The management is one of the best allocators in the sector, and they will most likely not miss its chance to add higher returns to shareholders (We have already experienced these aggressive buybacks before COVID). Although they haven't announced any buyback program yet, we should consider that they may sell some of GECAS segments that they don't want to keep in the long run (for example the helicopters segment). This could easily finance an aggressive buyback when the business recovers, and at the same time get enrolled in leaseback agreements.

Another alternative is to acquire new airplanes and lease them on good terms. Based on the management history, I am sure they will select the best one for AerCap shareholders.

The financial companies and especially AerCap generate higher returns in periods of market stress (like in the current time-being). I will not be surprised if the GECAS merge generates higher returns than expected.

Lessors are in their best position ever, not only from the demand point of view, but also from the supply side. The valuation assumes just going back to normal fundamental numbers. GECAS merger could improve these numbers and give even higher returns. Imagine if the net spread goes to 4% and they decided to raise D/E to x3.5 levels (which is not that much), ROE will go higher than 15% without counting any buyback effect for shareholders.

As well, returning to their historical Price-To-Book ratio earlier than expected is possible, and will give a higher annualized return.

Conclusion

In the article, I have shortly discussed 3 key points that reflect my optimism in AerCap. Firstly, I have noted how low-quality competitors are affected by COVID-19 which has resulted in an increase in the gap between the top tier companies (such as AerCap) and their low-quality competitors. The second key point reflects shortly upon the merging between AerCap and GECAS and the potential consequences of such a merge. Furthermore, the balance sheets of the airlines are discussed in the third key point by enlightening the positions of lessors and airlines.

Finally, the article also discusses some future scenarios and potential expectations for the company AerCap. In this regard, the stock market is giving a great opportunity for the investors to generate higher returns than the market in the following years just by assuming that AerCap will return to its historical ratios. Additionally, the effects of the GECAS merger give positive optionality to the investment thesis.

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About me and New Vila Equity Research

My name is Rodrigo Villanueva, I am the founder of New Vila Equity Research.

I created the firm to show my analytical skills, passion for investing and the way I analyze/invest in companies. I am looking for an opportunity in the asset management sector, open to discuss investment and working/collaborate with investment institutions. If you are interested, please contact me through email, rvillanueva@newvilaresearch.com.

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