Valuation practices in Aircraft Leasing

Hello and welcome to our investor education section.

The idea of these videos is to explain topical issues that arise from time to time, in no more than a couple of minutes.

Today's video will explore the concept of equity valuation within the aircraft leasing sector.

Which method to use?

Aircraft leasing is a relatively niche sector, with only a small number of publicly-listed companies, so investors tend to rely on approaches that work well on other sectors and apply them here.

The most commonly used industry categories are industrials and financials, as aircraft lessors share elements of both.

Industrials companies tend to generate significant free cash flows and regular, predictable earnings, driven by strong products and large order books, but with lower leverage and high R&D costs.

On the other hand, financial companies tend to run at higher leverage, with lower revenue visibility, due to their loan books turning over more frequently. They also look to add value through counter-cyclical capital allocation through the cycle.

Aircraft leasing touches on a number of these things and, as a result, tends to attract both types of investors.

How do these sectors differ in approach to valuation?

Industrial analysts typically focus on the Price/Earnings ratio, or P/E ratio, as companies are differentiated through their monetization of their products, with long production cycles and high barriers to entry. Outperformance here is usually as a result of strong investment decisions, prudent cost control, and high cash conversion rates.

On the other hand, financial analysts tend to focus on Price-to-Book value and Return on Equity. Periods of outperformance here tend to be as a result of strong lending activity, good outcomes from interest rate hedging, or from well-timed acquisitions, all of which are more difficult to repeat.

Price-to-Earnings vs Price-to-Book: which do we prefer?

We believe the P/E ratio is a better model for the aircraft leasing sector, as the long lease terms, stable aircraft supply, and low volatility in asset pricing, result in a high degree of predictability in both earnings and cash flows.

P/B on the other hand assumes that all book values across the aircraft leasing industry are created equal. Iin practice, however this is not the case.

Assets are brought onto a lessor's balance sheet at depreciated cost and, in inflationary periods in particular, the disconnect between depreciated cost and observed market values grows wider. There is no mark-to-market of assets in this period of time, outside of asset sales.

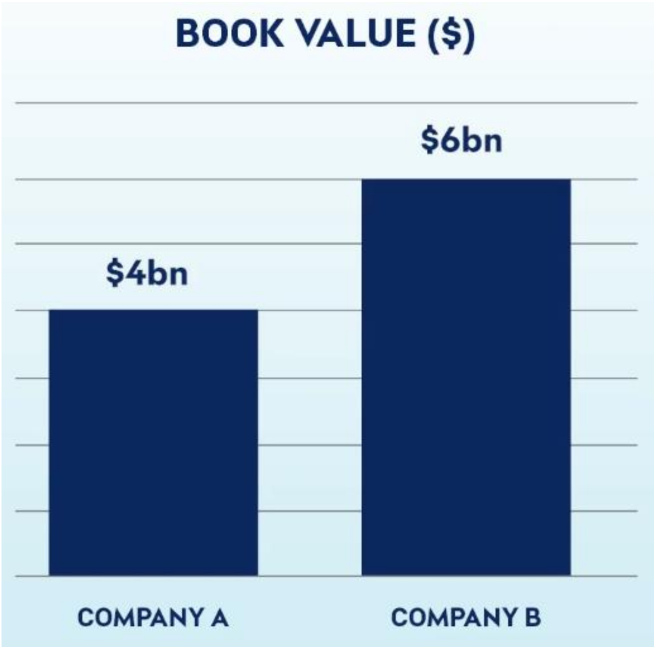
Where this becomes even more relevant is where aircraft are acquired through M&A, as the discounts or premiums can vary dramatically, and they tend to be completed at large scale.

Book value in practice

This is best illustrated through a somewhat extreme example.

Imagine two newly created leasing companies, Company A and Company B.

Company A buys 100 narrowbody aircraft for $40 million each, while Company B buys an identical 100 narrowbody aircraft for $60 million each. And let's assume that both companies are publicly listed. On day 1, Company A's book value would be $4 billion, while Company B's book value would be $6 billion.

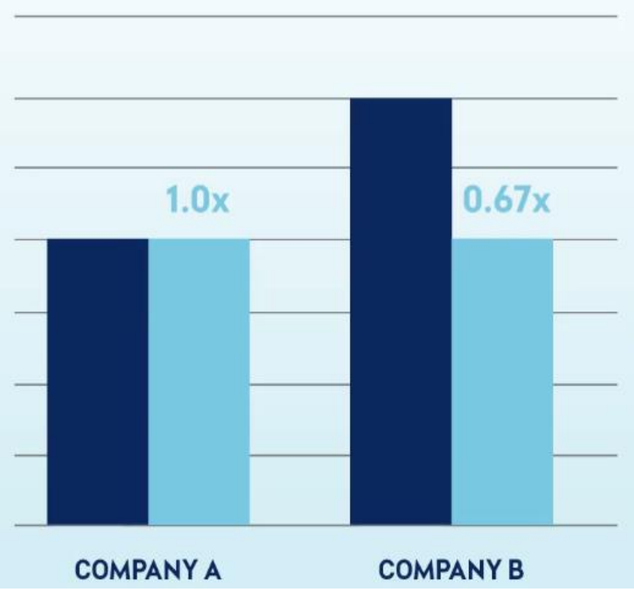


So, despite their identical fleets, Company B's book value is 50% larger than Company A's simply because Company B overpaid for its assets.

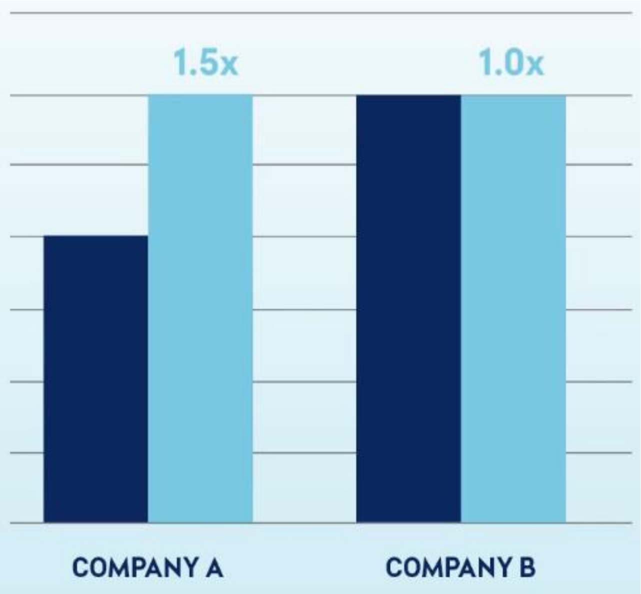
It is clear, therefore, to a rational equity investor, that these businesses should not trade at the same book value multiple. If Company A trades at 1.0x times Book Value, implying those assets are worth $4 billion, then Company B should trade at 0.67x its Book Value.

Or, if Company B trades at 1.0x Book Value, implying the assets are worth $6 billion, then Company A should trade at 1.5x its Book Value.

Scenario 1: Company A trades at 1.0x BV



Scenario 2: Company B trades at 1.0x BV



In practice, however many investors anchor around 1.0x book value for all business in the sector regardless of how their assets were acquired or how their businesses are performing. To an investor using book value alone, anchoring Company A and B to the same multiple would likely be undervalue Company A despite it being more efficient and profitable.

Now if we look at the earnings instead. If both companies have the exact same assets, they should generate the same earnings. Let's assume this is $600 million/year.

If leasing companies in the sector were trading at 10x earnings, then both Company A and Company B would have a market cap of $6 billion, which is 10x their $600m of earnings.

This would still equate to 1.0x Book value for Company B, but it would be 1.5x Book value for Company A, justified by Company A's 15% Return on Equity Compared to Company B's 10% return.

So, in summary when looking at aircraft leasing companies, it's important to dig deeper than just book value, as the earnings stream can vary dramatically leading to mispricing and opportunity.

I hope you found this useful, and I look forward to sharing more with you in the months ahead.