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Revisiting the aircraft lessors

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Tom Garrott, the long-time CEO of National Commerce Financial Corporation that was acquired by SunTrust Banks Inc. in 2004, had a few words for me in December 1999.

During an earlier visit in the summer, he was flipping through the Best Ideas publication from J.C. Bradford & Co., where I was the regional bank analyst. He told me the only stock that interested him was a parking REIT (I was not quick enough to ask him about local competitors First Horizon National Corp. or Union Planters Corp.). I said "sure," even though someone else covered the stock. The company preannounced in early December.

After Garrott asked me — using colorful language — how could it blow up when its business model was based upon collecting rents, he told me he bought more. I always suspected he did so through the Morgan Keegan desk rather than ours.

One of the specialty finance sectors I track is aircraft lessors. Like a rent-collecting property REIT, the business model is simple on paper. Raise equity, lever it and then lease the planes to airlines around the globe. If an airline runs into trouble, the aircraft are returned and released. The group was once known, pre-crisis, as REITs with wings.

None of the companies are a regulated investment company that creates the income pass-through tax structure for REITs, BDCs and closed-end funds; however, the tax attributes of being based in Ireland and elsewhere has resulted in a very low tax rate for some of the companies.

It is a small corner of the investable space for public specialty finance equity, largely consisting of AerCap Holdings NV, Air Lease Corp., Aircastle Ltd., Avalon Holdings Ltd. and FLY Leasing Ltd. among the pure public plays in the sector. Partial exposure can be had elsewhere. Aircraft leases represent about 30% of CIT Group Inc.'s $35.6 billion financing and leasing portfolio. GE Capital Aviation Services Inc. is one of the largest firms in the industry, but it is buried within conglomerate General Electric Co. There also are a number of privately held aircraft leasing companies that are more familiar to debt investors and banks.

There are three industry attributes that I think stand out: Demand for aircraft, lease yields and financing costs. Investors may debate whether the return on capital is sufficiently high or appropriately measured by EBITDA and net income, but I think the fundamentals offer a great backdrop that is absent for most sectors of the financial services industry.

Boeing is projecting that the global commercial fleet will double to about 42,000 aircraft in 2033 from 21,000 in 2013 with 36,770 new planes for growth and replacement of older aircraft. The financing needs are huge at $5.2 trillion. Because of costs and leverage constraints, airlines have increasingly utilized leasing over ownership. About 40% of the global fleet is leased, up from virtually nil in 1973, when Air Lease CEO Steve Udvar-Hazy co-founded International Lease Finance Corp.

If global economic growth has seemed sub-par in the years following the financial crisis, you would not know it from aircraft usage. The International Air Transport Association reported that global passenger traffic rose 5.9% in 2014, which was modestly above the 10-year average of 5.6% and 2013 growth rate of 5.2%. Annual growth typically has been 1x-2x global GDP growth for several decades. Last year was no exception with the increase in aircraft usage 1.8x global GDP growth of 3.3%, according to the IMF.

The other attractive attribute is the lease yield versus borrowing costs. Yields usually range from the high single digits to low double digits depending upon the type of aircraft, length of the lease, credit profile of the airline and the like. Borrowing costs are low. Aircraft lessors are heavy users of credit like REITs and most other asset holding companies. Air Lease's composite interest rate in 2014 excluding borrowing fees was 3.64%. I view the wide spread as the flipside of the gurney that central banks' negative interest rate policies (NIRP) and zero interest rate policies (ZIRP) represent long-term for most banks, insurers and pension plans.

Industry fundamentals are enticing, but what about an equity investor's core question: can you make money in the stocks? The sector is not the unknown that it was prior to Air Lease going public in 2011 and AerCap buying ILFC for $4.8 billion in 2014. Nor is it as cheap as it was when I started covering it in late 2011. Valuations then seemed ridiculous.

For example, AerCap's year-end 2011 closing price was $11.29 per share, which equated to 70% of tangible book value and 9.6x LTM EPS. The stock has risen nearly fourfold since, to $43.79 per share as of March 9, 2015. AirCastle's shares closed at $12.72 per share at year-end 2011, which equated to 65% of tangible book value and 7.8x LTM EPS. The shares closed on March 9 at $22.24 per share. Air Lease's shares have risen from $21.50 per share to $37.79 per share.

Given the run in the stocks, "undervalued" may not be the right adjective today. Nevertheless, aircraft leasing represents a growth industry that is populated with value stocks. AerCap trades for 8.6x consensus full-year 2015 EPS on the low side and Air Lease trades for 13.8x full-year 2015 consensus EPS on the high side as of March 9.

Maybe the moderate valuations reflect investor concerns about the sustainability of margins, geopolitical risk, or the impact that a global pandemic would have on air travel and the demand for aircraft. I do not know how valuation will evolve for the aircraft lessors, but it seems to be the old fixed income saw applies here: There are no bad bonds (or assets), only bad entry prices.

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