SNL Blogs

Wednesday, July 10, 2013 10:40 AM CT

ILFC's year of the snake may yet make a decent IPO

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group. Davis holds long positions in Aircastle Ltd. and FLY Leasing Ltd.

After attempting to sell International Lease Finance Corp. for a number of years, it remains uncertain if American International Group Inc. will sell ILFC to a consortium of Chinese investors, who agreed to pay $4.2 billion for 80% of ILFC on Dec. 9, 2012. If some portion of ILFC was publicly traded, arbitrage traders would feast on the decision tree that is in front of it: a pending deal for 80% of ILFC with a consortium of Chinese investors that cannot get their ducks in a row versus AIG walking from the deal and unloading ILFC via an IPO as originally planned. I assume AIG CEO Robert Benmosche feels as though he has been bitten by a snake with ILFC. Hank Greenberg may be laughing given his bitterness that AIG was at its zenith when the board booted him in 2005 as a result of political pressure.

In Century City (west Los Angeles) a few hundred yards from the ILFC headquarters, I suspect the executives of Air Lease Corp. are laughing too. Many were past employees of ILFC, including Air Lease CEO Steven Udvar-Hazy who founded ILFC in the 1970s, took it public in 1983 and then sold it to AIG in 1990 for over $2 billion. He then made billions for Greenberg's AIG over nearly 30 years before parting ways in early 2010 after electing not to acquire ILFC in a private-equity backed deal. Instead, Air Lease was capitalized in 2010; its IPO occurred in April 2011. AIG and ILFC subsequently sued Air Lease, Hazy and other executives during April 2012 for allegedly diverting opportunities from ILFC.

AIG's path to unloading ILFC has been marked by nearly $3 billion of (noncash) impairment charges and the filing of an S-1 for an IPO in September 2011. ILFC was shopped over several years before Jumbo Acquisition Ltd., which is the moniker for the acquisition consortium, agreed to acquire ILFC. Jumbo missed a May deadline to make a deposit, then made it in early June, and got AIG to extend the required closing date to July 31. ILFC subsequently refreshed the S-1, as SNL noted in late June.

The delay points to a check list of questions for a board that is seeking to sell a significant asset or a whole company: can the buyer close? The late posting of the deposit, the extension of the required closing date and AIG's ability to terminate the agreement before July 31 if it determines that regulatory approval will not be obtained indicate that Jumbo may not be able to close.

AIG investors will find out in the next few weeks unless the definitive agreement's termination date is extended again. ILFC does not fit in AIG's refocused business plan that has seen it sell jewels to repay the U.S. government with a considerable profit. Also, ILFC's $24.1 billion debt load — though comparable to other aircraft lessors with a net debt-to-equity ratio of 2.6x at March 31 — may not sit well with AIG management.

Every stock has its bull and bear case that is overlaid on the current and prospective valuation. ILFC has its issues, given an older fleet with an average age of about eight years based upon weighted net book value and a cost of funds that has approximated 6.0% since 2011. Air Lease's cost of funds was 4.05% in the first quarter. In a business where the cost of funds matters, ILFC is split-rated with the lowest investment grade rating from S&P (BBB-; negative watch) and a non-investment grade rating from Moody's (Ba3; positive watch). There also is a $4.1 billion deferred tax liability that will require a cash outlay in time unless the fleet grows sufficiently to produce ever higher levels of tax-basis depreciation.

Further, there is the noncash matter of potential impairment. AIG took a $6.7 billion pretax and $4.4 billion after-tax charge at year-end 2012 to write-down its investment in ILFC as part of the pending sale and reclassification to a discontinued operation. None of the write-down is reflected on ILFC's balance sheet. If an IPO occurs, then the June 30 10-Q (ILFC still files with the SEC due to registered debt offerings) and revised S-1 may reflect equipment impairment to bring the carrying values closer to what the pending Jumbo acquisition seemingly implies. Otherwise, Jumbo negotiated what the accountants term a "bargain purchase price"—at least from an accounting perspective. I do not think prospective IPO investors will care much; besides they should prefer a clean-up before the IPO rather than after. Also, the differing values seem to lend credence to one knock against ILFC that I occasionally have heard from competitors and investors —that some of its aircraft have not been depreciated enough.

On the other hand, the bull case for ILFC is pretty good. The company is well established with a global client base and the second largest owned fleet (918) behind General Electric Capital Corp.'s GE Capital Aviation Services. It also has a pipeline of nearly 300 new aircraft on order. One of the attractions to the aircraft leasing industry is its secular growth that is driven by an increasing share for the lessors versus airline ownership (40/60%) and growth in commercial aircraft usage that approximates 2x global GDP growth most years. For example, the International Air Transportation Authority reported on July 2 that year-to-date global passenger traffic through May rose 4.3% in spite of a global slowdown that freight traffic (-0.2% year-to-date) seems to confirm. Further, thousands of less fuel efficient aircraft in mature markets such as the U.S. will have to be replaced over the next decade.

There are two primary industry risks. One is pressure on lease rates if the global economy were to slow sharply in a few years as an increase in production by Boeing, Airbus and other manufacturers occurred. Also, a sustained increase in short and intermediate interest rates at the same time could pulverize margins in a manner similar to that of thrifts in the early 1980s. Individual company risk has usually been associated with liquidity and leverage when short-term funding cannot be rolled-over. All of the public lessors have reduced leverage since 2008.

So, would an ILFC IPO be well received? I think it would if priced correctly, and if investors were comfortable with the carrying value of the aircraft. Also, I think ILFC would have to institute a modest dividend as did Air Lease to broaden the potential investor base. The bond investor adage should apply: there are no bad bonds, only bad bond prices.

The primary publicly traded comps are AerCap Holdings NV, Aircastle Ltd., Air Lease, CIT Group Inc. and FLY Leasing Ltd. As of July 9, these companies traded in a range of 80% (Aircastle) to 117% of tangible book value per share (Air Lease), while the enterprise value excluding CIT ranged from 88% of net flight equipment (Aircastle) to 113% (Air Lease). P/Es based upon 2014 consensus estimates range from 7.0x (AerCap) to 12.3x (Air Lease). CIT is a hybrid comp because about 30% of its commercial assets are attributable to aircraft leases and loans; however, its valuation is similar at 12.2x consensus 2014 EPS and approximately 100% of tangible book value per share excluding fresh start accounting that was adopted upon its exit from bankruptcy in late 2009.

Both equity offerings (for minority interests) and acquisitions imply moderate multiples too. Air Lease priced its April 2011 IPO at $26.50 per share, which equated to 125% of June 30, 2011, tangible book value per share. The shares then rose 5% versus 55% for the SNL Specialty Lender Index, 36% for Aircastle Limited, 26% for Fly Leasing, 25% for AerCap and 23% for CIT through July 9. Respective total returns for dividend payers Aircastle and Fly Leasing were 54% and 45%.

Air Lease's IPO was well received given management's reputation (from ILFC) and lack of legacy issues as a newly capitalized company with new aircraft and customers; however, investors may not have appreciated the time required to leverage the capital and the valuation differential versus competitors. More recently, Aircastle raised $209 million in June through selling 15% of the company to Marubeni Corp. for $17.00 per share, which equates to about 80% of March 31 of tangible book value per share. Fly Leasing announced a follow-on offering of ADRs on July 9. Assuming that pricing occurs at a slight discount to the $17.17 per share closing price, the offering also would approximate 80% of tangible book value per share. Unlike AerCap and Air Lease, both Aircastle and Fly Leasing operate older fleets like ILFC.

Jumbo's acquisition of ILFC, which valued 100% of the common equity at $5.3 billion, equated to 67% of ILFC's year-end equity and 152% if AIG's $4.4 billion write-down of its investment is applied to ILFC's equity. The enterprise value multiple equated to 77% of ILFC's $34.9 billion of net equipment, and 88% on an adjusted basis. Sumitomo Mitsui Financial Group Inc.'s $7.3 billion purchase of RBS Aviation Group's assets in January 2012 equated to 110% of RBS' $6.7 billion of net equipment value.

I do not know how much, if any, equipment impairment ILFC might incur prior to launching an IPO. To the extent flight equipment is marked down, the company's prospective margins (9.1% LTM pretax margin) and ROE (4.6%) would increase. Air Lease leads the group with an LTM pretax margin of 41%, while Fly Leasing leads with an LTM ROE of 12.0%. Investors should not (but may) care about profitability improvement from less depreciation and less equity, but profitability should improve all else equal because the 6.0% cost of funds can ease if rates do not grind higher given recent borrowing rates.

The net is that I think AIG can execute a successful IPO, but pricing will value the company somewhere below Jumbo Acquisition given the differentials between control and minority interests. The caveat is that the air lessor stocks have had good runs this year, so pricing may not reflect a heavy discount vis-à-vis Jumbo's December deal that valued ILFC's equity at $5.3 billion. Would AIG's Benmosche let ILFC go via an IPO if its valuation was around $4.0 billion? I do not know. The answer may depend upon whether the Chinese consortium can pull the deal off with more time if needed or if there was a cover bid that materially exceeds prospective IPO pricing. If an IPO occurs, it should be one of the larger U.S. and global FIG IPOs of the past few years if AIG sells its entire position. And a larger company in a sector that is comprised of small- and mid-cap companies would improve sector visibility with investors and perhaps the group's seemingly pedestrian valuations.

Published with permission.

Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial.
He can be reached at jeffdavis@mercercapital.com or 615.345.0350.