SNL Blogs

NASHVILLE NOTES

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It pays to wait sometimes

By Jeff K. Davis

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Most of us like gumption. AerCap Holdings NV management appears to have it, and has proven to be adept at buying low and selling high. The company repurchased 26.5 million shares in 2012 for $320 million, or an average price of $12.06 per share. AerCap's shares closed at $24.96 on Dec. 13.

AerCap announced Dec. 16 that it will acquire American International Group Inc.'s aircraft leasing unit, International Lease Finance Corp., for $3 billion in cash and 97.6 million ILFC shares. Based upon Friday's closing price, the deal is valued at $5.4 billion. It is closer to $5 billion if a 10-day average price is used for AerCap's shares, which would be consistent with last week's news stories that initially reported a $5 billion purchase price. News of the deal pushed AerCap's shares up 16% on Dec. 12 and Dec. 13. The Street obviously liked the deal given the 33% one-day move in the shares on the day of the announcement. ILFC, which will own 46% of the pro forma company, saw value unlocked that management had sought to realize for several years.

In a post earlier this year, I noted that AIG President and CEO Ben Benmosche may have felt as though he was bitten by a snake given the difficulty AIG has had in unloading ILFC, which has the second largest aircraft leasing fleet in what is a growing global industry. AIG has been marketing ILFC since the financial crisis hit because it is a non-core asset. Along the way, an S-1 was filed in September 2011 to monetize the asset via an IPO. Later, an agreement was struck with a consortium of Chinese investors in December 2012 who planned to acquire up to 90% of ILFC for $4.7 billion. The consortium was never able to secure financing. Prior to the run in AerCap's shares that began last week, the deal with AIG would have valued ILFC at roughly the same $5 billion amount as did the agreement with the consortium. Whether blind luck, brilliant calculation, or another example of excessive exuberance among equity investors, AIG was rewarded for waiting.

The deal is bold because ILFC's aircraft portfolio approximates 1,000 planes compared to 373 for AerCap, of which 231 are owned. As of September 30, ILFC's flight equipment, net of depreciation, was $32.7 billion, vs. $8.0 billion for AerCap.

There are a number of takeaways from the development beyond the size differential. Two of these are not specific to the aircraft leasing industry.

The first is the performance of AerCap's shares, which had risen 56% year-to-date through December 11, compared to 38% for the SNL U.S. Specialty Lender Index. The shares then rose 16% on the 12th and 13th once the press reported the story and 33% on the day of the announcement. Wall Street seems to be bidding more buyers' shares higher this year on news of a transaction rather than the more normal ethos of selling the shares because buyers tend to overpay. If my observation is not off-base, it may reflect investors rewarding buyers for ensuring several years of growth in an environment where organic growth beyond a modest pace is difficult to achieve in many industries. Or stated differently, sellers should temper their price ambitions when taking the buyer's shares in order to benefit from a shared upside that some deals offer.

The other has to do with M&A. When entering into an agreement to sell, the board and its bankers should have a high degree of certainty that the buyer can close. Presumably AIG's bankers for the consortium transaction (J.P. Morgan Securities LLC, Morgan Stanley and Citigroup Global Markets Inc.) put a lot of effort into answering the question. Or maybe the AIG board and the bankers knew there was a risk that the consortium could not obtain financing, but were willing to take a chance. If it failed, the IPO could be revived as AIG management has mentioned on several occasions.

Although the original S-1 for ILFC Holdings Inc. was filed in September 2011, I think AIG management never pulled the trigger because it did not (then) like the lowly valuation peer companies such as AerCap traded in the public markets. For example, as of year-end 2011 AerCap traded for 70% of tangible book value and 9.6x trailing 12 month earnings. AerCap's shares were valued at 120% of tangible book value and 12.0x trailing earnings on December 13.

An IPO also faced the uncertainty of how equity investors would price ILFC given its weak profitability. ILFC recorded losses in 2010, 2011 and year-to-date, primarily due to heavy impairment charges. But even in 2012, profitability was not great given an ROA and ROE of 1.0% and 5.3%. AerCap posted year-to-date ROA and ROE of 3.5% and 13.7% through September 30.

In the case of AerCap, its shares have performed well this year due to very good profitability and upside earnings surprises the past four quarters. Investors pushed its shares 16% higher last week under the belief that AerCap can extract a lot of value. Investors then confirmed their belief by doubling the increase once the deal and its details were disclosed. Some investors may believe ILFC has been an undermanaged, non-core asset within a refocused AIG that until recently was majority owned by the U.S. Department of the Treasury. ILFC co-founder Steven Udvar-Hazy was sufficiently frustrated that he left in 2010 to found Air Lease Corp.

Though smaller than ILFC, AerCap has advantages via its lower cost of funds (3.9% vs. 6.0%), a much lower tax rate, and a younger fleet. ILFC presents an opportunity to optimize the combined fleets in time, while also contributing a large order book.

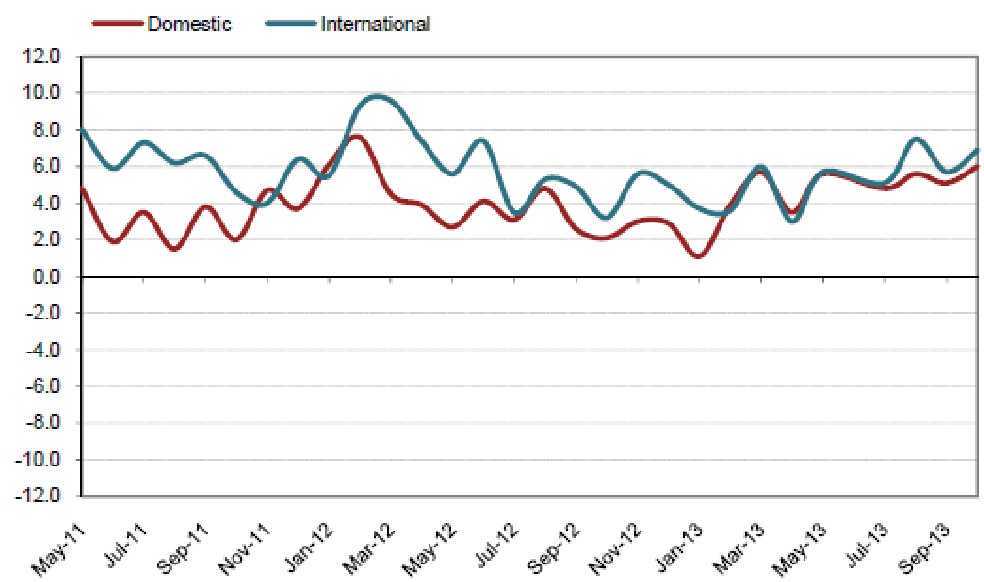
AerCap in time will be able to refinance ILFC's higher cost debt, though so too could AIG. Both AerCap and ILFC are rated BBB- by S&P. A larger company with stronger cash flow may be a candidate for an eventual upgrade after a possible initial downgrade to BB or BB+. And issuing additional corporate debt for a company with a good story such as AerCap in the current yield-starved market should not be difficult even if there is an initial ratings downgrade.

The tax differential reflects, in part, AerCap's advantage of being domiciled in the Netherlands vs. the U.S. ILFC's liabilities include a deferred tax liability of $3.8 billion as of Sept. 30. It appears the liability will be eliminated or offset through tax elections and a step-up in the tax basis of the assets. How this aspect of the transaction factored into pricing is unknown — at least by me.

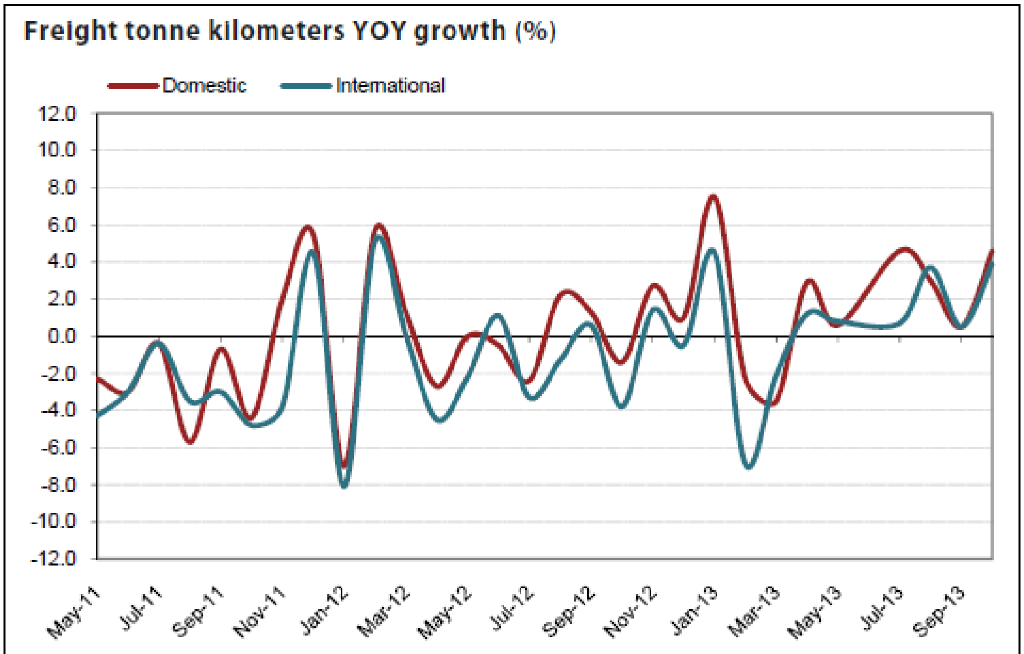
At $5.4 billion, the implied price-to-book multiple would be 73% based upon ILFC's $7.4 billion of equity as of September 30; the implied enterprise value of $26 billion that includes $20.5 billion of net debt equates to about 80% of the net equipment. Maybe both would be closer to 100% with the portfolio marked-to-market. If so, impairment charges that have plagued ILFC since 2010 with about $4 billion incurred on a cumulative basis through the third quarter of 2013 presumably would not be an issue going forward. Units of Sumitomo Mitsui Banking Corporation acquired RBS Aviation Capital in 2012 for $7.3 billion (before the assumption of external debt and working capital liabilities). Pricing modestly exceeded 100% of the net equipment value attributable to RBS Aviation's 206 plane portfolio because gross assets as of mid-2011 were $7.2 billion.

Perhaps the most compelling reason to stretch for ILFC is what greater scale may mean in an industry that has very favorable dynamics. These include global growth in aircraft usage that most years exceeds global GDP growth, an aging fleet in parts of the developed world that will have to be replaced with fuel efficient aircraft, and an increasing preference by airlines to lease aircraft rather than to purchase them. As shown in the accompanying table, global passenger traffic, which accounts for the majority of aircraft usage, continues to trend in a range of 4% to 6% growth on a year-over-year basis. Even the weaker freight market has shown improvement, increasing toward a 4% year-over-year pace from a negative one a year ago. Buyers have a little bit more leeway in M&A pricing if an industry has strong fundamentals that are expected to last. That may apply to AerCap. Equity investors enthusiastically think so, though integrating and operating ILFC may not be so easy.

Revenue passenger kilometers YOY growth (%)



Sources: Monthly traffic report as of Dec. 4 and 5, 2013, per IATA.org.



Sources: Monthly traffic report as of Dec. 4 and 5, 2013, per IATA.org.

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