DeMatteo Research

IDEA NOTE

Justin Venneri ▪ (212) 833-9945 ▪ jvenneri@dmllc.com

AL

S SHORT

Air Lease Corp

Industrial/Transportation, Finance/Real Estate

11/19/2018

PRESENTED

DATE		11/07/2018
PRICE	MARKET CAP	ENT VALUE
$39.78	$4.14B	$15.40B
P/E RATIO	BOOK VALUE	DIV YIELD
5.56x	$43.04	1.01%
SHARES O/S	AVE DAILY VOL	SHORT INT
104.07M	690,158	5.09%

CURRENT

PRICE	$36.32	MARKET CAP	$4.03B

Air Lease Corp. engages in the provision of aircraft leasing business. It focuses on purchasing new commercial jet transport aircraft directly from aircraft manufacturers, and leasing those aircraft to airlines throughout the world with the intention to generate attractive returns on equity. The company was founded by Steven F. Udvar-Hazy in February 2010 and is headquartered in Los Angeles, CA.

Publicly traded companies mentioned herein: AerCap Holdings NV (AER), Airbus SE (AIR FP), Air Lease Corp (AL), American International Group Inc (AIG), Avolon Holdings Limited (Private Co w/ Public Debt), Boeing Co (BA), China Eastern Airlines Corp Ltd (CEA; 670 KH), China Southern Airlines Co Ltd (ZNH; 1055 HK), CIT Group Inc (CIT), Delta Airlines Inc (DAL), General Electric Co (GE), Hawaiian Holdings Inc (HA), HNA Investment Group Co Ltd (000616 CH), Icelandair Group hf (ICEAIR IR), Jet Airways India Ltd (JETIN IN), Norwegian Air Shuttle ASA (NAS NO)

Highlights

The presenter is short shares of the second largest aircraft leasing company, Air Lease Corp (AL). He believes it has been overearning during the “best cycle for airlines and traffic that has ever been seen (in no small part driven by low jet fuel prices).” At $40, the risk/reward appears to favor bears. In his opinion, AL has been going out on the risk curve in terms of its customers base to maintain net interest margin (NIM), and once the excessive gains on the sale of older planes stops (a recent phenomenon driven by favorable industry dynamics), earnings should decline. At the same time, China has made it clear that it wants to see more lessors in the market, and hundreds of new leasing companies have “popped up all around the world” to chase what have been attractive yields (including hedge funds, major banks, etc.). If the value of old planes drops and yields on new leases declines, leaving AL with just the NIM, earnings could come in closer to $3/share in 2019 and book value (BV) would fall. In this scenario, there could be downside to the high $20s.

- The low price of jet fuel over recent years has helped to boost the value of old planes. The presenter described how oil price fluctuations impact the industry, noting that $55 - $65 per barrel is the “sweet spot.” In this range, which he referred to as the “Goldilocks zone,” both old and new planes are valuable, and customers will still take on new planes. If the price of oil goes

- higher, driving jet fuel up, new planes are more valuable, and the older planes decline in value (below that range, the opposite holds true).
    - The price of jet fuel has risen from ~$0.90 per gallon (Jan 2016) to $2.15 today. What had been a huge driver of the value of old planes is turning into a headwind. This can already be seen in AL's earnings, said the presenter, as the company is "not getting a kick from the sale of old planes anymore."
- Hundreds of new leasing companies have entered the global market over recent years, raising hundreds-of-millions to chase aircraft leasing yields. These companies, including Chinese lessors, hedge funds, pension funds, and lately Japanese banks, are using debt to finance planes en masse to gain size/scale. Additionally, new ABS products have "come out of nowhere," and established leasing companies like AL have been participating.
    - These new leasing companies and ABS structures have been "willing to take on massive amounts of new planes," said the presenter. However, the assumptions going into these [ABS] are fairly aggressive (e.g., 3% inflation rates, large jumps in the value of planes, etc.). It is difficult to buy CDS on these products, as the market is very thin.
    - China's drive to become a global powerhouse in air travel is behind much of the demand.
- The presenter noted that there is a fair amount of distress in the global airline industry. India's Jet Airways is troubled, Primera Air and Skyworks have filed for bankruptcy, and Icelandair's acquisition of WOW was a result of WOW's troubles. Many of the issues are with low-cost carriers that were set to grow fleets. These airlines had taken planes and forward orders from lessors.
    - The history of the agreements in place for planes is important, in the presenter's opinion. He sees a heightened risk that deals signed for new 787s when Brent crude was $100 could be cancelled/broken with oil trading below $70. And, obviously, the bankrupt and/or merged airlines won't be on the same fleet expansion course.
    - Both Airbus and Boeing fell behind on deliveries, which helped older planes fetch a premium to what they were being carried at on leasing companies' balance sheets.
- Additional concerns include aggressive underlying assumptions for traffic growth, an uptick in lease expirations this year, competitors' willingness to take an 8% yield (versus AL at 12%), geographic exposure, and airlines starting their own leasing businesses.
    - A recent sell side survey of 24 airline and fleet operators showed that the vast majority of people do not want to pay any sort of premium for "other management services" or the relationship. The presenter noted that one respondent was willing to pay 1% extra. In the current environment, he reasons that growth will be difficult to achieve.
    - If airlines in China and Russia have been placing orders, investors should be aware of things like the Chinese government telling China Southern and China Eastern, which have aggressive expansion plans, to move more planes to people who need/want them such as Avolon Holdings.
        - HNA's Avolon recently announced the acquisition of CIT Group's aircraft leasing unit, which includes >300 owned planes and >100 on order, for $10B (the deal is expected to close in Q1'19).
    - Another big trend has been low-cost airlines buying more planes to keep the margin. For example, Hawaiian was able to borrow at 1% to buy planes (and, the Chinese have a cost of capital advantage as well).

- While AL's younger fleet gives it an advantage over AerCap, and M&A is a risk to the short thesis, the presenter implied that the risk to its $20B order book is something that bulls overlook. In his opinion, it is hard to see who could, or would, be able to buy AL at this time. He noted that GE has its own issues to deal with, and its leasing business is important for the engine business; and, "If anyone starts selling old planes, it could crush carrying values on balance sheets."

- Looking at BV, the presenter said AL has historically traded between 0.9x and 1.2x - 1.4x. With the stock at $40 (~1.05x book), AL looks cheap. He thinks it's a value trap, as earnings and BV could decline meaningfully if his thesis is correct.

    - AL trades at 7.6x and 6.8x EBITDA and EPS, respectively (both on 2019 consensus); AerCap trades at 8.6x and 7.7x 2019 EBITDA and EPS forecasts. If the gains attributable to the sale of old planes is turned off, "a lot" of the earnings and BV disappear.

        - In this scenario, he sees NIM driving $3/share of earnings (2019). Based on either a multiple to BV or earnings, the implied fair value of the stock would be in the high $20s.

For questions regarding DeMatteo Research Events and Services, please contact:

Hans Noering, Co-Director of Research, 212-833-9932, hnoering@dmllc.com

Important Disclosures

This summary has been prepared by DeMatteo Research LLC ("DeMatteo" or the "Firm"). The Firm sponsors events featuring institutional investors ("Presenters"). The opinions, estimates, projections, and views contained in this summary are those of, and exclusively sourced from, the Presenters and may differ from those of the Firm. While the Firm attempts to summarize accurately the comments of the Presenters, the summary is not endorsed by the Presenters.

This summary is provided for information purposes only and does not constitute an invitation or offer to subscribe to or purchase or sell any of the products or services mentioned. It is intended for institutional investors only and should not be forwarded to third parties. Securities, financial instruments or strategies discussed herein may not be suitable for all investors. The opinions and views expressed in this summary do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments, or strategies to particular clients. DeMatteo is not, by making this summary available, providing investment, legal, tax, financial, or accounting advice to the recipient of this summary or any other party. DeMatteo is not acting as an advisor or fiduciary to any client in connection with providing this summary. Past performance is not indicative of future results. This summary has been prepared based on information, including market prices, data and other information, obtained from sources believed to be reliable; but DeMatteo does not warrant its completeness or accuracy. The Firm makes no representation or warranty, express or implied, in respect thereof, and accepts no liability whatsoever for any loss arising from any use of or reliance on this summary or its contents. Information, estimates, assumptions, and/or opinions expressed herein are made as of the date of the Guest Speaker's presentation and are subject to change without notice. DeMatteo assumes no obligation to maintain or update this summary based on subsequent information and events. Further information on any of the securities mentioned in this report may be obtained upon request.

Analysts are compensated through a base salary and an annual bonus. The amount of an analyst's annual bonus is related, among other factors, to the Firm's overall revenues and profitability, and is not tied to any level of investment banking or other similar business in which the Firm engages. Neither the Firm nor any affiliate, in the aggregate, beneficially own 1% or more of any class of common equity securities issued by any company discussed in the report.

- Analysts are compensated through a base salary and an annual bonus. The amount of an analyst's annual bonus is related, among other factors, to the Firm's overall revenues and profitability, and is not tied to any level of investment banking or other similar business in which the Firm engages. Neither the Firm nor any affiliate, in the aggregate, beneficially own 1% or more of any class of common equity securities issued by any company discussed in the report.
- The Firm, the analyst involved in the preparation of this report, and members of the analyst's household do not have a financial interest in securities of any company discussed in the report.
- As of the end of the month immediately preceding the issuance of this Research Report (or the end of the second most recent month if publication date is less than 30 calendar days after the end of the most recent month), no analyst involved in the preparation of this report has received compensation from any company discussed in this report or knows of any other actual, report conflict of interest regarding this report.
- Neither the Firm nor any affiliate has received compensation for investment banking services from any company discussed in the report in the last twelve (12) months.
- Neither the Firm nor its affiliates expect to receive or intend to seek compensation for investment banking services from any company discussed in the report in the next three (3) months.
- No company discussed in the report is, or during the 12-month period preceding the date of distribution of the report, was, a client of the Firm.

- No director, officer or employee of the Firm is a director of any company in which the Firm provides research coverage.
- No analyst involved in the preparation of this report or any member of the analyst's household serves as an officer, director or advisory board member of any company discussed in the report.
- The Firm does not act as a market maker in the securities of any company discussed in the report.
- Neither the firm nor any of its affiliates managed or co-managed a public offering of the securities for the subject company in the past 12 months.
- No analyst received any compensation from the subject company in the previous 12 months.

REG. AC Certification

The opinions, views and / or analyses of the companies and / or industries contained in this document generally consist of a summary of a presentation made by one or more securities professionals at an event sponsored by DeMatteo Research LLC ("DeMatteo") and are not typically the views or opinions of the individual at DeMatteo responsible for the preparation of this document. Where any views or opinions expressed in this document are attributed to the individual responsible for the preparation of this document, then such views or opinions accurately reflect the personal views of the author of this document regarding the subject securities and / or issuers.

No part of the compensation of the individual responsible for the preparation of this report was, is or will be directly or indirectly related to the specific recommendations or views contained in this document.