Avolon: Growing, Underfollowed Business At Steep Discount To Comps, 40%+ Upside

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Summary

- AVOL, a medium-sized aircraft leasing company, is under-followed and unappreciated, despite a young, high-quality fleet and strong growth prospects.
- Recent Q4 results solidly beat expectations and FY15 guidance was good, with top line growth expected to continue apace and adjusted RoEs rising to mid-teens in FY15.
- AVOL is rapidly growing its fleet, and with average age already at a best-in-industry 2.5 years, there is a substantial margin of safety built into the stock at current levels.
- If we were to value the stock in line with its closest peers, AVOL would trade closer to $28 (40% upside). The downside looks limited, given its young fleet and conservative valuation.

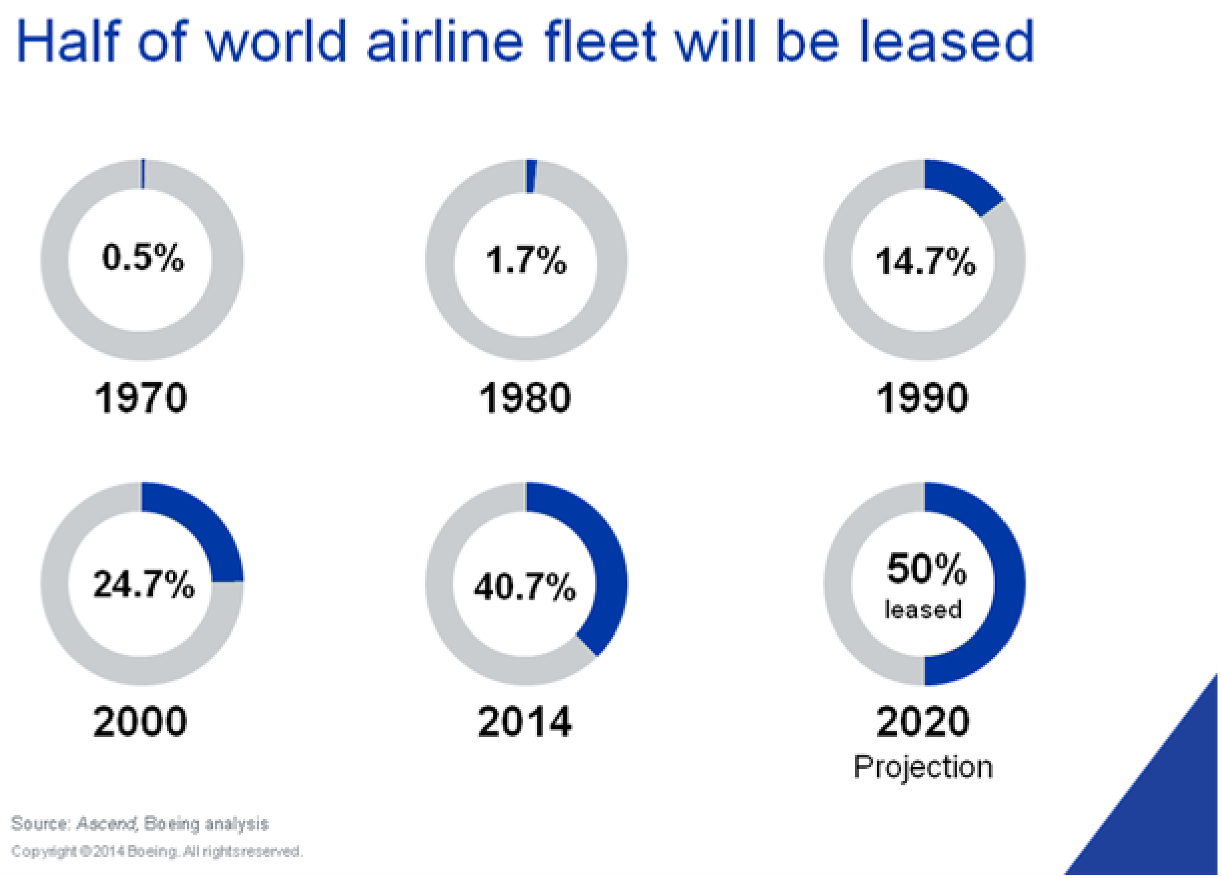
Oftentimes, the best places to look for interesting long ideas are recent IPOs, generally middling in size, that seem not to "fit" the Street's expectations in some way, or are simply too new to be fully noticed and appreciated yet. Avolon Holdings (NYSE:AVOL), a medium-sized aircraft leasing company, appears to fit the bill: it is based in Ireland, but recently listed on the NYSE in the very quiet lead-up to the year-end holidays (mid-December '14). At the moment, it is relatively under-covered, and was only reported for the first time as a public company yesterday (the numbers were good, as discussed below).

Given the company's solid performance, visibility on forward business, strong growth potential, favorable industry outlook and its striking undervaluation versus peers, AVOL looks to me a fairly compelling long opportunity around $20. Let's take a look at why.

Industry background

Conditions in the aircraft leasing business are dependent, variously, on the overall growth of air traffic, the growth of leasing (versus direct ownership) by major global airlines, and the supply/demand of new aircraft production by the major OEMs (principally Boeing (BA) and Airbus (OTCPK:EADSY)). With regard to air traffic, the International Air Transport Association (IATA) reports that global passenger traffic demand grew 5.9% in 2014 (after growing 5.2% in 2013) - levels in line with average growth rates over the past 30 years. In general, the long-term outlook for aircraft demand is robust due to increased passenger traffic (especially in emerging markets), the growth of low-cost carriers, and the need to replace aging aircraft with newer, more fuel-efficient planes.

As for aircraft leasing in particular, Boeing estimates leasing as a % of total aircraft fleet will rise to 50% in 2020 (from 41% in 2014 and just 0.5% in 1970). The increasing attractiveness of the leasing model is a function of the growth in younger, less capital-rich, new emerging market airlines; lower interest rates; and the favorable after-market for leased aircraft due to disciplined new production from OEMs:



(Source: Boeing.com)

Company Overview: Young and growing fleet of versatile, popular aircraft

Avolon was formed in 2010, is run basically by the former RBS leasing unit's management team, and has consistently grown its fleet since launch. As of December 2014, its Owned/committed portfolio looks like this:

Aircraft Type	Owned	Managed	Committed	Total
A319	1			1
A320ceo	46	3	10	59
A321ceo	7	1	3	11
A320neo			20	20
A330neo			15	15
A330-200/300	11			11
B737-800	51	3	19	73
B737 MAX			20	20
B787-8/9	1		11	12
Boeing B777-300ER	3			3
B777-200LRF		4		4
E190	6			6
Total aircraft	126	11	98	235

(Source: Company Filings)

The Airbus 320 family and Boeing 737 family aircraft make up the majority of the owned fleet and committed fleet - historically, the two most popular type of aircraft in demand from global airlines. Both are narrow-body jets (as opposed to wide-body), the main benefit of which is fungibility, depending on airline needs. This supports secondary market valuation (and implies lower lease yields, given the lower asset risk). For AVOL, both owned and committed aircraft have grown sharply in the past year, as the below chart demonstrates (27% growth in owned aircraft, 34% growth in committed aircraft). This growth in both owned fleet and commitments is predicted to continue in the coming years.

It is also important to note that average fleet age (weighted by book value) is very young, at 2.5 years (key comps have average fleet ages in the 4-8 year range), while the average remaining lease term of 7.1 years provides solid visibility into future aircraft utilization at current good lease rates. The book value of the owned fleet has grown in line with the delivery of new aircraft (though note, this figure understates saleable fleet value; more on this below):

	2013	2014
Owned aircraft	99	126
Managed aircraft	10	11
Committed aircraft	73	98
Total	**182**	**235**
Average age of owned fleet (yrs)	**2.4**	**2.5**
Average remaining lease term (yrs)	**7**	**7.1**
Net book value of owned fleet ($bn)	4.26	5.61

(Source: Company Filings)

Both AVOL top and bottom lines have grown rapidly due to robust leasing conditions, aggressive ramp-up of aircraft deliveries, and favorable aircraft trading results. No single customer represents more than 10% of revenues, and roughly 1/3rd of revenue comes from each of the Americas, Europe, and Asia. The below table shows adjusted net income the last four years. Note: Share-based compensation was a large hit to GAAP numbers in 2014, due to the issuance of incentives around the IPO (roughly $49mm of the $54mm share comp cost was a one-time grant - so this number should decline appreciably going forward):

(in thousands)	Year Ended December 31, 2011	2012	2013	2014
Net cash provided by operating activities	$ 65,970	$ 179,194	$ 242,834	$ 284,841
Depreciation	(46,615)	(110,957)	(145,615)	(182,437)
Deferred income tax provision	5,920	1,663	101	(5,837)
Amortization of debt issuance costs	(9,444)	(9,457)	(18,766)	(24,277)
Share based compensation	—	—	—	(53,733)
(Gain) on disposal of flight equipment	—	11,267	31,051	64,409
(Loss)/earnings from unconsolidated equity investees	1,395	—	(46)	307
Unrealised gain/(loss) on derivatives	(3,959)	(2,199)	6,390	(12,240)
Changes in operating assets and liabilities:				
Increase in receivables	1,193	3,010	957	4,217
Increase in other assets	5,961	3,245	16,114	22,396
(Increase) in deferred revenue	(6,725)	(7,906)	(9,993)	(7,721)
(Increase)/decrease in accounts payable, accrued expenses and other liabilities	(16,677)	(6,699)	(10,227)	1,178
Net income (loss)	**$ (2,981)**	**$ 61,161**	**$ 112,800**	**$ 91,103**
Amortization of debt issuance costs	9,444	9,457	18,766	24,277
Share based compensation	—	—	—	53,733
Unrealized (gain) loss on derivatives	3,959	2,199	(6,390)	12,240
Tax effect	(7,559)	268	(25)	(2,359)
Adjusted net income	**$ 2,863**	**$ 73,085**	**$ 125,151**	**$ 178,994**

(Source: AVOL 20-F)

Two sources of revenue: Lease revenue and aircraft trading

While rapidly growing its fleet, AVOL has shown a consistent ability to "trade around" its aircraft at a substantial premium to stated book value: in 2014 alone, it **sold 9 aircraft at a net gain of $64.4mm above book value** (see below). This is positive in two ways: it suggests stated book value is a good "margin of safety" for investors in that AVOL is able to find a liquid market for its planes at above-book rates. Secondly, given lease yields are correlated with fleet age (the older the plane, the more accumulated depreciation, hence, the higher the yield (and also asset risk)), it allows the company to either selectively allow its fleet to age (thereby generating higher lease yields with more risk), or to continue selling down aircraft to maintain industry-leading fleet age and a safer portfolio.

Indeed, AVOL has its fleet independently valued by third-parties, and as of the latest 20-F, the company estimates that "the current market value of our portfolio as of December 31, 2014 exceeded the Aggregate Net Book Value by $568mm" (p 67 of the 20-F) - **this equates to $7 per share of embedded value not captured by the fleet book value measurement.**

Comparative Results from Operations

Year Ended December 31, 2014 Compared to Year Ended December 31, 2013

	Year Ended December 31,	
	2013	2014
(in thousands)		
Revenue		
Lease revenue	$ 415,006	$ 537,547
Management fee revenue	2,468	3,366
Net gain on disposal of flight equipment	31,051	64,409
Interest income	1,248	696
Total revenue	**$ 449,773**	**$ 606,018**

(Source: AVOL 20-F)

Recent Q4 results and 2015 Outlook

AVOL reported Q4 (and FY14) results yesterday, and there were no real surprises: the company beat on both lines (on an adjusted basis), and gave solid guidance for 2015, highlighted by 100% of aircraft deliveries already placed (93 aircraft), 69% growth in commitments to $1.6bn, $700mm of aircraft trading sales, and adjusted Return on Equity of 14.7-15% (including the add-back of stock comp and amortization of debt costs). Hence, the stated fleet book value is likely to grow ~$900mm (delivery of committed planes less trading sales), while perhaps ~$50-60mm of trading gains will flow through the income statement.

With this guidance, and assuming roughly constant lease yields (of ~11%) and debt/equity ratio (of 3x), I expect 2015 will look something like this (with prior years for comparison):

Income Statement	FY 2013	FY 2014	FY 2015
Lease revenue	415	537.5	635
Gain on aircraft sales (net)	31.1	64.4	60
Other revs (mgmt + interest)	3.7	4	5
Total Revenue	449.8	605.9	700
Depreciation	145.6	182.4	214
SG&A (including stock comp)	36.7	119.9	86
Interest Expense	154.4	206.6	201.8
Pre-tax Income	113.1	97	198.2
Taxes	0.2	6.3	12.9
Net income	**112.9**	**90.7**	**185.3**
Fully Diluted Shares out	78.241	78.4	78.6
Diluted EPS	**1.44**	**1.16**	**2.36**
Add-back debt costs, stock comp	18.8	78	29
Adjusted Pre-tax income	131.9	175	227.2
Taxes	0.2	6.3	14.8
Adjusted Net Income	131.7	168.7	212.4
Adjusted EPS	**1.68**	**2.15**	**2.70**
Ending net book value of fleet	4133.2	5606.6	6506.6
New purchases			1600
Sales (at net book value)			700
Actual proceeds ($)			760
End of period debt	3442.7	4465.2	5310.2
End of period book equity		1433	1618
Debt/equity(x)		3.1x	3.0x
Return on Equity		**6.3%**	**12.9%**
Adjusted Return on Equity		**11.8%**	**14.8%**
Stock price		20	20

Market cap	1568	1572
Price to Book Value	1.09x	0.97x
Price/GAAP EPS	**17.3x**	**8.5x**
Price/Adjusted EPS	**9.3x**	**7.4x**
Adjusted book value (incl embedded fleet value)		**2186**
Price/Adjusted book value (x)		**0.72x**

(Source: Company Filings, My estimates)

Note: These estimates are more conservative than the street. But even so, AVOL trades at ~7.4x FY15 Adjusted EPS, less than stated book value, and just **0.7x adjusted book value** (including the embedded gain on fleet held below market value). For a company generating sustainable mid-digit RoEs and growing, this is optically cheap. But how does it compare to other aircraft lessors?

AVOL versus comps

In assessing the various merits of aircraft lessors, there are a number of factors to consider: age, quality, and composition of fleet; lease yields and visibility of forward yields; leverage and available liquidity; diversity of lessees and credit risk of customers; and, of course, the growth opportunity.

We have already discussed how AVOL has amongst the youngest fleet of predominantly popular narrow-body jets; we should also mention that the company primarily sources its planes through sale leaseback transactions with airlines or purchasing from other lessors (and is less reliant on direct purchases from OEMs). In strong markets - the current period can be characterized as such, with demand generally outstripping supply - direct purchases ("spec orders") from OEMs may generate higher lease yields by having a new aircraft available at the right time. However, this is also more risky, as the lessor could get stuck with unleased inventory when the market turns.

This, combined with the focus on newer narrow-body jets means AVOL lease yields currently run a few % below some of its competitors' (see below). However, this is very much a risk/reward trade-off, and the company should be in a much better position to ride out cyclical volatility in the business with a younger, more fungible fleet. Given the likely lower volatility of earnings throughout cycles, **you could, in fact, argue AVOL deserves a premium valuation** versus peers, given the firmer asset support and attractive fleet characteristics.

With regard to diversity/credit risk of customers, all the major lessees are quite diversified by client and geography, so there is not a major differentiation there. The debt levels/leverage picture at key comps is also not dissimilar to AVOL, though AerCap (AER) is a bit more levered post the ILFC acquisition, and so will be in deleverage mode for the next couple of years. Meanwhile, as for earnings growth, AVOL clearly has best-in-class growth prospects.

Summary of key characteristics across comps:

Comp Key Metrics	AER	AL	AYR	AVOL
FY15E avg lease yield (%)	13.80%	12%	12.80%	11.20%
FY15E consensus EPS growth (%)	7.60%	16.80%	-4.30%	39.20%
Avg age of fleet (yrs)	7.7	3.5	8.4	2.5
Avg remaining lease term (yrs)	5.7	7.3	5.4	7.1
FY15E net debt/equity (x)	3.6	2.3	2	3
FY15E gross debt/fleet book value (%)	85%*	75%	63%	81%

*Including AER maintenance premium in fleet book value post ILFC acquisition

(Source: Company Filings, My estimates)

AerCap is much larger, possesses a much older fleet, and, as you might expect, exhibits better lease yields given the lower relative fleet book values as more value has depreciated. Aircastle (AYR) is closer in size to AVOL, but again, the fleet composition, age, and leverage picture is different. The closest comp for AVOL is Air Lease Corp. (AL). Despite being roughly twice the size of AVOL in terms of fleet and balance sheet, AL has similar characteristics in terms of fleet age, remaining lease term, and leverage. While AL exhibits slightly higher lease yields, this is mainly due to the increased age of the portfolio. **It is highly likely that AVOL could achieve similar yields if the company allowed its portfolio to age.** AVOL also possesses superior earnings growth due to a more rapid ramp-up of aircraft growth.

So, how do all these comps trade?

Comp Key Metrics	AER	AL	AYR	AVOL
Price/FY15E Book Value (x)	1.07x	1.30x	1.05x	**0.97x**
Price/FY15E Adjusted EPS (x)	8.50x	12.40x	12.00x	**7.40x**
Price/Pre-tax FY15E Profit (x)	8.40x	8.50x	11.60x	**7.90x**
Price/Adjusted Book Value (x)	1.00x	1.05x	1.05x	**0.72x**

(Source: Company Filings, Bloomberg consensus, My estimates)

As you can see, **AVOL trades cheap to all comps on most all metrics**, even when you adjust for the company's favorable tax location (Ireland) by looking at pre-tax profit ratios. When you consider AVOL's closest comp, AL, trades at a premium to adjusted book value, while AVOL trades at a ~30% discount - with a younger fleet and growing more quickly, to boot - you get a sense for the cheapness.

I think the valuation gap versus peers will decline in time as the street becomes more familiar with the company and more comfortable with its growth story. **If AVOL traded at just 1x adjusted book value, this would imply a stock price ~$28 (40% upside).** Even if it just traded up to 1.15x year-end '15 book value (still a 10%, largely unjustified, discount to Air Lease), the stock would rise to $24.8 (24% upside). And with the stock currently implying barely 70% of adjusted book value and the AVOL management team having shown to be adept at growing fleet value, there seems to be minimal downside in the current leasing market environment.

Why does the opportunity exist? And other risks

There are a few reasons for why AVOL trades so cheap to peers. Other than those already discussed (namely, it is a new listing, under-followed, with a very limited history of public reporting), I think the other main reason is the fact that shareholder returns (in the form of dividends or buybacks) are non-existent for the moment: other large aircraft lessors tend to buy back stock and/or pay dividends with their ample cash flow. AYR, for example, pays a ~3.7% dividend. Additionally, other aircraft lessors screen much better on a cash flow basis, while AVOL currently screens as FCF-negative (despite strong operating cash flows), which may worry some investors.

However, AVOL management has clearly delineated an aggressive fleet growth strategy, with all cash generated by the business being plowed back into growing the fleet. As such, the company is likely to remain dividend-free, and indeed, cash flow-negative for the foreseeable future. This shouldn't worry investors, who have good visibility into the growth trajectory, as well as the aforementioned ample support from both reported fleet values and the embedded value of higher market prices for that fleet.

Other risks involve those more broadly applicable to leasing or other finance businesses. AVOL is significantly levered and dependent upon access to capital markets and/or bank lending at tighter rates than those it receives on leases (the "net spread"). With cost of debt currently 4% and heading lower, and average lease yields north of 11% (along with full fleet utilization and over 7 years average remaining lease term), this risk is minimal in the short term. But AVOL would be affected in any sustained market downturn or spike in the cost of funding.

Perhaps a greater risk, at least in the mind of some investors, is that prolonged lower oil prices will dampen demand for newer, fuel-efficient aircraft - the very type that AVOL has plenty of. However, the CEO recently commented on the earnings call that AVOL has seen no change in airline leasing behavior since oil prices crashed, suggesting that airlines manage their fleets on a long-term basis and generally expect the benefits of more fuel-efficient aircraft to be substantial, even in a lower oil-price environment.

Conclusion

Avolon trades at a ~20-40% discount to comps, despite the youngest fleet, the most forward visibility in its lease book, and amongst the highest earnings growth rates. Returns on equity and fleet yields are slightly lower than comps due to design, not accident: the fleet quality is better both in age and composition, supporting secondary market valuations and providing a significant margin of safety. As the street becomes more familiar with the story, the valuation discount will contract, and the overall market environment for aircraft lessors remains robust in general. **BUY AVOL.**

This article was written by

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