



## SOMETHING IN THE AIR

Growing funding pressures and healthy demand are helping to create new investment opportunities in the aviation finance sector. Here, Newton multi-asset income manager, Paul Flood, explores the latest trends in the sector.

In the current low yield, low interest rate environment investment managers continue to explore the potential of ever more diverse asset classes. The growing popularity of multi-asset portfolios has helped extend the reach of managers into areas as diverse as gold, emerging markets, liquid alternatives and infrastructure.

Aviation finance is another area attracting increasing interest from multi-asset managers. Banks which once played a major role in the market face growing pressure to limit external lending under capital adequacy requirements, such as Basel III, increasing the need for third-party investment support of funding in the aviation sector.

While much of the past two decades proved a torrid time for the airline business - with events such as the Gulf War, 9/11 and even volcanic eruptions damaging trade<sup>1</sup> - the industry last year saw buoyant growth and healthy orders placed for new aircraft.

Order books remain robust. In July this year, European aviation giant Airbus said it was poised to win US\$26.8bn in new deals for 197 aircraft, with US rival Boeing separately reporting orders for 182 aircraft.<sup>2</sup>

With aircraft leasing increasingly the preferred choice for many airlines, the aviation finance sector is proving an attractive business proposition for many

investment managers as the number of leasing companies and investment vehicles entering the market expands.

From an airline perspective, operating leasing enhances business flexibility, allows greater responsiveness to changes in passenger demand and can help limit major capital investments in new aircraft by airlines.

For investors, medium- to long-term leasing contracts can provide stable and reliable cashflows over time and the sector holds increasing appeal for institutions such as pension funds, insurance companies and sovereign wealth funds. Investments in aviation finance also hold a relatively low correlation to other asset classes, in some cases making them a useful diversification tool in broader portfolios.

### YIELD POTENTIAL

Commenting on potential investment opportunities in the market, Newton multi-asset income manager, Paul Flood said: "In a world where the search for yield continues and we have limited avenues to attain that, aviation finance is an area in which significant yield can be generated as long as investors are careful about the types of contracts they enter into."

According to Flood there are two main structures for entry to the aviation finance/aircraft leasing market – closed-end investment trust structures which own planes and lease them out and more direct investment in dedicated aviation leasing companies.

Commenting on Newton's multi-asset exposure to the aircraft leasing sector, he adds: "While we hold only a modest percentage of our multi-asset portfolio in aviation finance we like the asset class.

"An important feature of the asset class is that because the dividend yields it delivers are generally high you can get a lot of cashflow back very quickly on

<sup>1</sup> Aviation finance: fasten your seatbelts. PwC. January 2013.

<sup>2</sup> Reuters. Airbus beats Boeing on orders tally at Farnborough show. 14 July 2016.

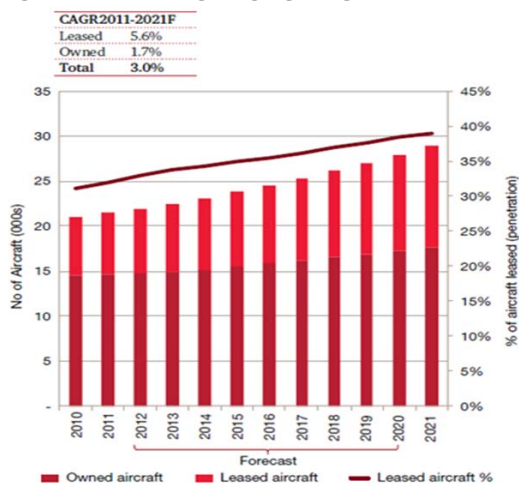




investment and would have to see an extraordinary depreciation level before making a loss.”

Expanding on the types of aviation finance related funds Newton invests in and the way the sector functions Flood adds: “The exposure we have is through closed-end funds. We have agreements where the planes which are leased have to be returned in ‘good as new’ condition through so-called ‘hell and high water’ contracts.”

### GLOBAL FLEET FORECASTING AND PENETRATION



Source: Vision Gain 2011/ Aviation finance: fasten your seatbelts. PwC. January 2013.

“This means all the spare parts have to be returned as new and effectively you end up with an aircraft that is essentially returned fitted out with a completely new set of parts. As an investor, you are compensated for anything that needs to be replaced. Lease contracts tend to be written on the cycle of when a plane goes through its maintenance schedule, which tends to be once every six years.”

### CONTRACT STRENGTH

While no asset class is risk free, Flood says the type of contracts commonly used in the industry are usually comparatively robust.

“The good thing about the aviation finance industry is that contracts tend to be very tight, very specific and fully insured. Because aviation is such a regulated industry regulatory checks take place all the time and

that also delivers a degree of comfort for investors,” he says.

“For anyone looking for income, aviation finance could be a very attractive, sustainable income model, because it centres on long-term leases that will get paid unless the airline involved hits financial difficulties. Investors in this sector are not taking price risk on the cost of airline seats, capacity risk on whether the plane is fully utilised or not - that risk is shouldered solely by the airline industry.”

That said, Flood adds it is important to assess the health of underlying investment counterparties in order to minimise potential risk exposure.

“As with many other investments, the strength of the counterparty is very important in this business, because if the counterparty were to become bankrupt investors could potentially end up having to lease out the aircraft in what would most likely be a weak business environment.

“Given the strength of contracts common in aircraft leasing I am not concerned about income streams in the aviation finance sector,” he adds. “What would worry me is if there were to be a global recession that put the entire airline industry at risk.”

### EMERGING MARKETS GROWTH

One of the key reasons for global optimism in the sector is the growth in emerging markets seen over the past decade. This has increasingly spurred demand for air travel in regions such as Asia and Latin America.

“Air passenger numbers have grown by about four or five per cent a year, with growth driven primarily by Asian emerging markets - in markets such as China - which have seen a steady rise in the number of middle income families. When people earn more they tend to fly more and the growth in tourism is another factor favouring the aviation sector,” Flood adds.

Other factors underpinning the health of the sector include low oil prices - which have also helped extend the life of less fuel efficient planes - growing liberalisation of the aviation sector and the



development of airliners with increased capacity, such as the double deck Airbus A380, currently the world's largest air passenger carrier.<sup>3</sup>

Despite some concerns over European airline 'capacity discipline', and the impact of the UK's recent vote to leave the EU on air travel to and from Britain<sup>4</sup> the longer term industry outlook for aviation finance appears bright.

In its July 2016 Airline Business Confidence Index Survey, the International Air Transport Association (IATA) said expectations for growth over the coming 12 months remained positive for both passenger and cargo businesses and that airline employment activity increased for the sixth consecutive quarter in the second quarter of 2016.<sup>5</sup>

Against this backdrop, leasing demand remains healthy and investment exposure to this sector remains a potentially attractive option for investors seeking relatively stable returns and to take advantage of the diversification it can offer wider multi-asset portfolios.

Consequently, while the asset class remains relatively unknown to some investors, its popularity looks set to rise in the years ahead as the number of players in the market continues to grow and its potential strengths become more widely recognised.

### Important Information

**The value of investments can fall. Investors may not get back the amount invested.**

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<sup>3</sup> Airbus. [www.airbus.com](http://www.airbus.com) as at 22 July, 2016.

<sup>4</sup> FT. Uncertainty drags on airline profits. 22 July 2016.

<sup>5</sup> IATA. Airline Business Confidence Index. 14 July 2016.