

Update 1: Avolon defends 26-year life claim

23/10/2012

Dick Forsberg, Avolon's head of strategy, and Dómhnaíl Slattery, its chief executive officer, recently defended a report claiming that the average retirement age for all commercial jet aircraft is close to 26 years.

In a conference call the pair said that after analyzing 6,800 retirements from more than 30,000 deliveries they were convinced that the average retirement age of all jet aircraft is 25.9 years.

"No significant adverse trends of retirement age were apparent from the historical data, in light of recent fleet activity or in the outlook for the next 10 years. Consequently, we believe there is no reason to change existing depreciation policies due to changing retirement patterns or a reduction in aircraft economic life," said Forsberg.

Why it matters

The useful economic life of aircraft is vital for lessors which use the assumptions to model their depreciation policies. If these assumptions are wrong then the business models by which lessors rely on to secure their profits may also be wrong - potentially devastating news for lessors and their investors.

The imminent introduction of new aircraft types such as Boeing's 737 Max and the A320neo by Airbus has prompted many industry sources, including *Airfinance Journal*, to question the widely adopted assumption that the average aircraft age is 25 years with a 15% depreciation policy.

Forsberg attacked media coverage of the issue as "sensationalist" and said sound bites likening aircraft to computers or cars were not helpful to the debate.

Avolon expects 8,000 aircraft to be retired over the next 10 years, more than all of the retirements that have taken place since the 1950s. Forsberg said that the major reason for most retirements remained the age of the aircraft. Taking the A320 as an example, Forsberg said that the vast bulk of the world's narrowbody fleet was still relatively young and would follow the 25-year life expectancy.

"The first A320 delivered in 1988 so none of the A320s are yet 25. We have only seen 124 retire in total. As the next 10 years develop we will see that profile develop," said Forsberg, who added that 3% of retired A320s were mostly older variants with less capabilities.

Lack of spare engine prompting part outs

One reason Forsberg attributed some early retirements to was due to opportunistic part-out for aircraft for spare engines.

Engine manufacturers such as CFM, stated Forsberg, were using nearly all their production capacity to keep up with the production of new aircraft as aircraft manufacturers increased their production rates. This caused the price of old engines and engine parts to increase, stated Forsberg as fewer spare engines are being manufactured, particularly for CFM56 parts, providing an incentive to part-out older aircraft.

Slattery stated that he expected there would be an incremental supply of spare engine to counteract this problem as engine OEMs rely on the present value of spare engines and spare parts for their profitability over 25 years and therefore do not want early part outs. "They (engine manufacturers) are very much focused on insuring they do not fall into this trap for the Neo or the Max", stated Slattery.

However, CFM insists that it has enough excess capacity in their production line to continue producing spare engines and states it was "surprised" by the Avolon comments. The engine manufacturer stated it built on average between 50 – 100 spare CFM56 engines each year for the past decade and had "enough capacity in our system to keep pace with demand for both installed engines, as well as spares."

"We believe that the aircraft part out is an economic decision, rather than the result of a lack of spare engines. The reality is that engines hold their value much better and longer than the airplanes; it is simply less expensive to take an engine off a parked airplane – or a parted out airplane - than buy a new spare engine. Our engines have very long service lives and, depending on where the engine is in its overhaul life, it could have thousands of hours remaining before it needs any maintenance", says a CFM spokesperson when questioned by *Airfinance Journal*.

One CFM employee quipped: "If there is an airline out there that needs a spare CFM engine, tell them to call their sales director. We will take care of it."

Curved residual values

One criticism of the presentation is that it merely examined the number of active aircraft being operated but did not address the conventional 15% residual value assumption used by lessors. Existing residual value rates have been questioned as next-generation aircraft are set to arrive in the next decade. Many believe that popular aircraft types will continue to be operated by airlines but do question whether these aircraft will retain the 15% residual value.

Avolon's Slattery said he was still confident of the 15% figure. "We are comfortable that a 25-year and 15% residual value is an appropriate policy going forward. There is debate in the industry as to whether that is a straight line or more of a curved line over time. I think that time will tell what is the right approach over the next decade or so. Right now we remain comfortable with the 25-year residual value," he added.

Reading between the lines Avolon is clearly confident of its long-term prognosis on the market when it states it is comfortable with depreciation policies being about 15%. One appraiser says that depressed lease rates for A320s – typically \$300,000 a month – strains the credibility of the 15% standard depreciation policy. However, he notes that you would be unwise to set a depreciation policy during a downturn.

"One thing you cannot do is form policy in terms of a depreciation policy in a down market. It doesn't work. You are not looking at the full picture. We don't know when aircraft values will necessarily go up, and lessors and leasing companies do not know either. If we had set depreciation policies back in 2002-2003 we would have been completely wrong about the large build in 2007 and 2008," notes the appraiser.

Slattery said that one of the leasing industry's biggest concerns – the overproduction by airframers – was easing as "sanity" had returned and manufacturers had shelved their more aggressive production targets, with the oversupply of narrowbodies likely to correct itself by the middle of next year.

A separate issue that lessors face is what to do with their mid-life aircraft. Airlines can secure relatively cheap debt for new aircraft because of historically low interest rates. Perversely, it is also extraordinarily difficult to secure financing for mid-life aircraft with so few secondary market capital providers. Slattery said that when interest rates rise again, as they have to at some point, new aircraft will suddenly appear much less attractive, which will help to extend aircraft operating lives and, say financiers, will help push lease rates.

Similarly, high yields in the secondary market will attract alternative finance providers, such as pension funds and insurance firms. Both factors will ease the pressure that lessors face on their mid-life fleet.

dharris@euromoneyplc.com

Thank you for printing this article from Airfinance Global, your essential intelligence resource for aviation finance. If you have been given this article by a subscriber, you can contact us through email at accountmanager@airfinanceglobal.com or call us on +44 (0)20 7779 8015 to discuss our subscription options.