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2017 Q3 Report

Perceptions from the Middle Kingdom

Fleet Phaseout Plans of Chinese Airlines and Exit Strategies of Chinese Leasing Companies

The recent multi-airline "package deal" for a large quantity of new aircraft, announced during the U.S. presidential visit to China, is another example of the existing triangle relationship between Chinese Airlines, both major western OEMs and the PRC government. It is a necessary validation process for pre-existing firm orders from the OEM perspective, and a required part of the procedure for governmental approval and import quotation purposes from the airline perspective. It also demonstrates good will from the government's perspective, aimed at addressing issues related to the bilateral trade balance situation. PGA Aviation has elaborated on the new aircraft procurement procedures in China in a prior quarterly report, as well as in a recent industry conference call.

The disciplined procurement procedures in China for new aircraft has both direct and indirect impact on each airline’s fleet phaseout plans. Each airline, whether state-owned or private, must ensure that its future fleet size justifies its government quota status in package deals or stand-alone approved deals. Of course, there are also many other factors that impact an airline’s phaseout plans, such as its own network plans, pilot resource constraints, forecast aircraft utilization rates and leased aircraft return conditions. In addition, each airline's decision may be impacted by its accounting practices for depreciation and amortization. In summary, each airline's phaseout plan partially serves to justify its network and fleet growth plans, which are subject to governmental approval. In that sense, the phaseout plan at the airline level reflects the government's directions.

We continue to see good quality mid-life and end-of life used aircraft on offer from the major Chinese airlines, who seldom use PMA parts and fully comply with all ADs and the most expensive service bulletins. We see significant improvements in the repair records and other documentation. B2B records availability is not an issue at major airlines. Overall, we believe that the China market presently provides, and will continue to provide, good "naked" mid-life aircraft that are close to retirement within China, but suitable for most markets outside of China due to the PRC government requirement for retirement of used aircraft with what non-Chinese airlines would consider to be significant amounts of operating life remaining. The real issues are timing and pricing, from the perspective of sellers, buyers and investors.

The new order books of Chinese leasing companies are a different story. Such orders are subject to Chinese governmental approval if the aircraft will enter the China market for Chinese operators. We see several unique practices by such PRC lessors. First, the major leasing companies all buy aircraft at the same time and at the same cycle or phase of the specific production line from the western OEMs. They also typically did not require maintenance reserves from Chinese lessees. The latter typically do not make MR commitments, and may only present a letter of credit from an issuing bank for re-delivery compensation commitments. Chinese leasing companies also typically set up onshore SPVs within one of China's tax-free zones in order to obtain tax rebates that can be forwarded to their Chinese lessees. Some such tax rebates are negotiable on a case by case basis, but are not transferable. Some of the major agreements are in Chinese, between Chinese lessors and Chinese lessees, and are governed by Chinese law. All in all, because of factors such as these, the portfolios of Chinese leasing companies are not easily traded with outside investors (although such trading activity seems very popular among smaller domestic investors). Since all leasing companies would have essentially placed their orders from the same skylines of the OEM's production line, the eventual result will be competition among the lessees for such portfolio sales, i.e., the same potential buyer pool. By the same token, they will also be searching and competing for the same second-tier or third-tier airlines outside of China as new lessees, to replace those current PRC operators whose leases are about to expire. In that regard, it should be noted that the China market is not generally one for first lease term renewal. Neither does it serve as a destination for mid-life aircraft. Rather, it is first and foremost an "origination" market, as explained in some of our previous reports.

Meanwhile, we are encouraged by what we see as good signs that the Chinese government intends to codify the tax benefits that will make onshore assets more liquid. As a result, some major Chinese leasing companies will differentiate their market practice by setting up Irish offices and hiring western professional advisory teams. The heavy Chinese operator density exposure, and heavy exposure with certain OEM's transitional production lines, will put heavy pressure on aircraft residual values when that time comes, given the current low lease rate factor under Chinese airlines lessees. PGA Aviation expects that the Chinese leasing companies will need to expedite their efforts to address related issues within the next three years. In this regard, we believe that those companies are better prepared on the narrow-body side, but will need to do more to address the mid-life wide-body aircraft. This is a significant shortcoming, because the Chinese market currently includes one of the world's biggest populations of some mature wide-body aircraft from both major OEMs. We expect this situation to only increase in conjunction with the China's expanding economy and commensurate need for commercial aircraft.

PGA Aviation is an aircraft re-marketing firm with focus on the Greater China market. We work closely with many airlines in the Greater China region. Our goal is to provide profitable solutions to our clients, especially working with Chinese airlines that are phasing out mid-life and end-of-life aircraft, and Chinese leasing companies that are leasing and/or selling aircraft assets. PGA Aviation can also provide PRC Aviation Policy advisory services by interacting with Chinese governmental agencies on behalf of its clients.