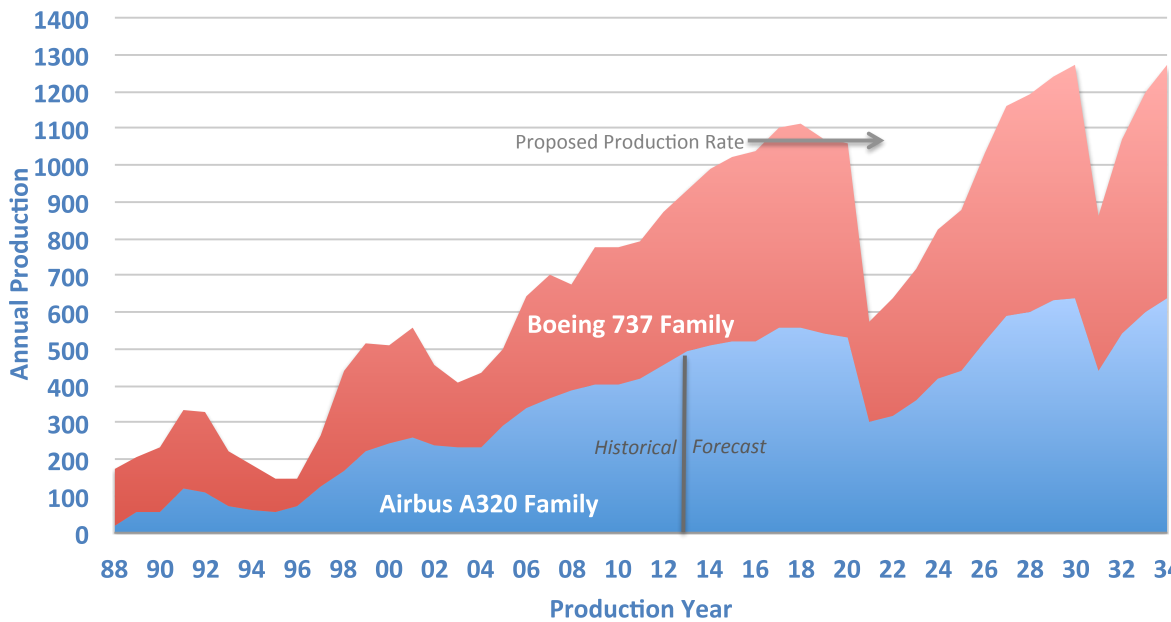
FORTUNE AVIATION

How realistic are aggressive post-2020 Narrowbody residual value assumptions?

Human nature being what it is, people often assume that whatever their current situation, good or bad, it will remain so indefinitely. So it is with the current "frothy" investment environment for young narrowbody leases. Aircraft production rates are increasing, airlines are operating in the black for a change and the economic forecast, although not all blue skies is generally favorable. New money and new players are entering the aircraft leasing market putting downward pressure on yields. With increasing competition, the pressure to increase residual value assumptions to meet financial targets is stronger than ever. When non-leveraged investment yields were in the high teens, investors had enough economic leeway to assume a conservative residual value assumption, typically 50 or 60% of published future fair market value. In today's highly competitive market with razor thin margins, investors are making residual assumptions of 70% or higher to justify the investment and "win" the deal. Are these more aggressive assumptions for post-2020 lease returns realistic?

Recently Boeing and Airbus have signaled their intention to increase narrowbody production rates to meet anticipated demand. In fact, by 2016, manufacturers will most likely have doubled their production rates over the last ten years. Given the capital investment required and the inability to "walk back" an unwarranted increase, the aircraft OEMs as well as the entire supply chain must consider the decision carefully. The OEMs, relying on sophisticated economic forecasting tools, are convinced that a production increase is sustainable and the right decision. However, some seasoned aircraft economists feel strongly that the market is experiencing a bubble and increased production rates will eventually overshoot actual demand. Which market view is correct? The answer should concern any narrowbody aircraft lessor with lease returns after 2020.

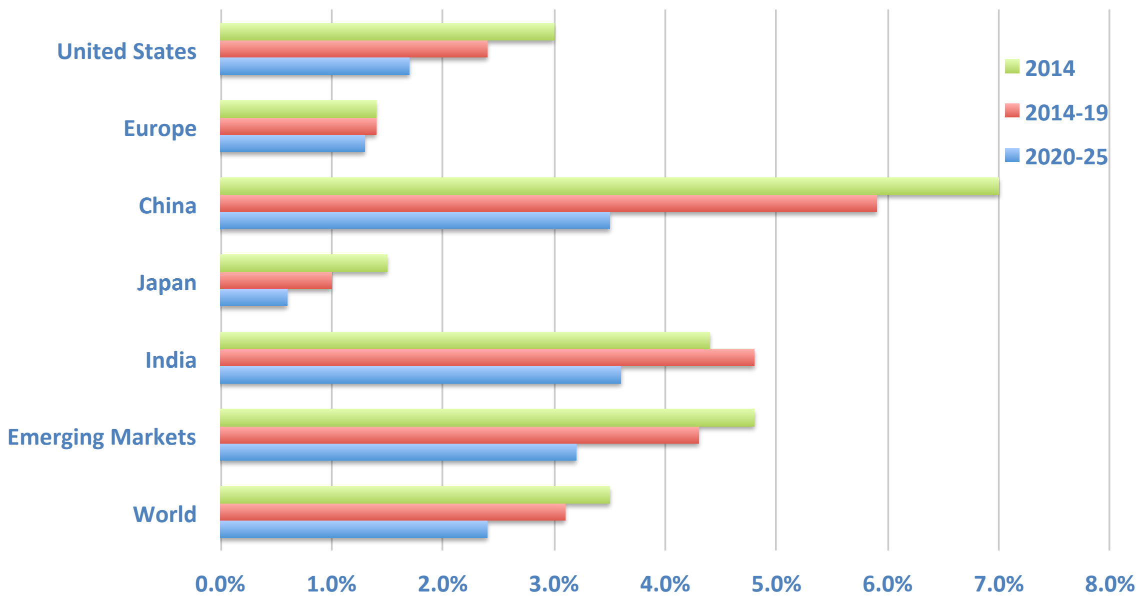
Unfortunately, historical market performance does not support unbridled optimism, as evidenced by previous commercial aircraft market cycles. Ed Greenslet, the noted economist who publishes the *Airline Monitor*, has uncannily predicted the volatility of supply and demand in this market. As indicated in the chart of his historical and forecast data, Mr. Greenslet's believes another market decline will occur in part due to completion of a sustained period of above average aircraft retirements culminating in a dramatic 29% drop in demand for new narrowbody aircraft around 2020. If his view is correct, the anticipated Boeing/Airbus annual production rate of 1,050+ units would only be sustainable for two to three years and followed by a steep decline lasting several years.



Source: *The Airline Monitor*, April 2013 & Feb 2014

While this decline appears precipitous and unwarranted in today's upbeat environment, the reader should bear in mind that the previous two market corrections experienced declines of 27% (2001-03) and 55% (1992-1996). Although the specific reasons for these declines vary (Gulf War, Tech Bubble, 9/11 or excessive retirements), a concurrent large-scale economic recession is always an underlying factor. Therefore, it is no surprise that The Conference Board predicts lower GDP growth in all global market segments in the 2020-2025 period.

Global GDP Forecast*



* The Conference Board February 2014

If narrowbody aircraft production does in fact suffer a decline of this magnitude, it is reasonable to assume that used aircraft will also experience a noteworthy loss in value. Despite rosy predictions from the manufacturers, aircraft investors may want to give some weight to these independent forecasts before assuming aggressive residual values for early 2020s lease expirations.

Fortune Aviation Services provides its clients with timely and accurate guidance to achieve financial goals or profitable investments in commercial aircraft market and related activities. Clients include investment banks, leasing companies, airlines, and MROs.

SFortune@FortuneAviation.com *+1 202-652-4200* *FortuneAviation.com*