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## SMALL CAP SHARE IDEAS: Aircraft leasing firm Avation set to fly higher thanks to new contracts

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The next time you are in a busy departure lounge peering out onto the tarmac, waiting for your flight, bear this tiny pearl of wisdom in mind.

Only half the planes pulling in and out of the stands are owned by the companies whose corporate colours they sport.

The other 50 per cent are supplied by aircraft leasing firms, such as **Avation**, experts in sourcing and financing the work-horses of the sky.



Lease held: Avation has done 29 deals with firms such as Virgin Australia, Flybe and Thomas Cook Airlines

Without these firms the industry would be grounded. For even the big firms, flag fliers such as British Airways-owner IAG, need a little help marshaling their assets effectively.

Avation has a very specific niche – single aisle, twin engine planes such as the Airbus 320 and the French-Italian ATR 72 600, used by 75 per cent of the world's carriers for short-haul trips. The latter makes up two-thirds of the company's fleet.

Aircraft leasing is on the face of it a reasonably simple business.

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Companies such as Avation, and its American rivals Airlease, Aircastle and Avolon, will acquire an aircraft then lease it on – the airline will then take care of all the maintenance.

The skill comes in sourcing the finance, the right aircraft and mitigating the risks involved with the

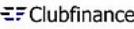
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transaction.

The ATR72-600 – a modest twin prop plane that seats 72 – in round numbers, comes in at \$20million. An Airbus A320 will set you back a tasty \$45million.

So, if you botch any part of the lease or financing of the deal, you are, as they like to say in London's East End, in big shtuck.

That Avation has done 29 lease deals with firms such as Virgin Australia, Flybe and Thomas Cook Airlines means it has more than a degree of competence in this arena.

The model, when stripped down, is a little like the template used by property firms.

Avation finances its acquisitions using 75 per cent senior, secured bank debt. A typical plane might be leased on the basis of repaying back to Avation around 144 per cent of the acquisition price over the 12 years of a contract.

They can then be leased out for another 12 years, albeit at lower rate than a brand-spanking-new airliner.

Somewhat counter-intuitively though (and a quirk of depreciation rates versus lease income), the older models yield more than the new inventory.

The sums involved are massive. Even with a modest portfolio the amount of debt Avation has taken on board is eye-watering for a company capitalised at \$115million, standing at \$330million. That said, its portfolio is worth over \$500million.

The average rate of interest paid on the debt is 4.6 per cent, the interim results revealed, down from 5.5 per cent a year earlier.

Avation mitigates the risk posed by a sharp rise in interest rates by borrowing over the term of the lease, rather than over two or three years and constantly refinancing. That way it always knows it will receive more in lease payments than it shells out to the banks.

The banks, meanwhile, are keen to finance leasing deals because a new plane appreciates in value when it is leased out.

So, an ATR 72-600 worth \$20million might have a net present value of \$25million once it starts generating a monthly lease fee due to the value of the income stream associated with the lease.

This also has a flattering impact on the bank's balance sheet and provides an incentive to finance more of these leasing deals.

### Avation at a Glance

Ticker: AVAP

Value: £76million

Current price: 139p

Year high: 182p

Low: 113p



**Future growth:** Domiciled in Singapore, Avation's results will benefit for the next five years from the 10 per cent tax rate paid by certain foreign businesses that locate in the city state

Now, if your brain is whirring a little at this point, as mine was when I spoke to Avation's finance director Richard Wolanski, consider this: for the last three to four years his company has been growing at 30 per cent plus annually and has announced contracts that will grow the company by 40 per cent over the next 12 months.

Not just that, the after-tax profit margin is 25 per cent - so it isn't sacrificing margins in return for growth. The stock has doubled in value over 24 months as management, led by executive chairman Jeff Chatfield, has delivered.

The plan is to add another 12 planes to its portfolio in the next two years and double its size within about 3 years.

'The beauty of aviation finance is you apply the business model to one plane and you can roll it out to 200 planes. It works exactly the same,' says Wolanski.

'All we are doing is repeating the same thing. We have done it 29 times now.'

It is interesting that even after the sharp rise in the share price in the past two years, the stock is valued at just 6-7 times earnings, where its rivals are valued at 12-15 times.

Avation also trades at a discount to net asset value, where its American quoted peers are usually valued at closer to 1.5 times NAV. So, whichever way you cut it, there is potential for growth either organically, as Avation adds to its portfolio, or via a stock re-rating.

The broker WH Ireland is predicting revenues of \$58million this year, rising to \$70.5million next year and then to \$88.7million in 2017, giving pre-tax profits of \$17.1million, \$23.6million and \$31.2million respectively.

Domiciled in Singapore, its results will benefit for the next five years from the 10 per cent tax rate paid by certain foreign businesses that locate in the city state. The broker reckons the stock, currently changing hands for 140p each, is worth 206p.

Wolanski said: 'That's what's exciting about the company; we have locked in so much future growth and almost eliminated all of the execution risk associated with that growth.'

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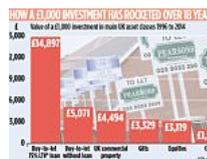
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