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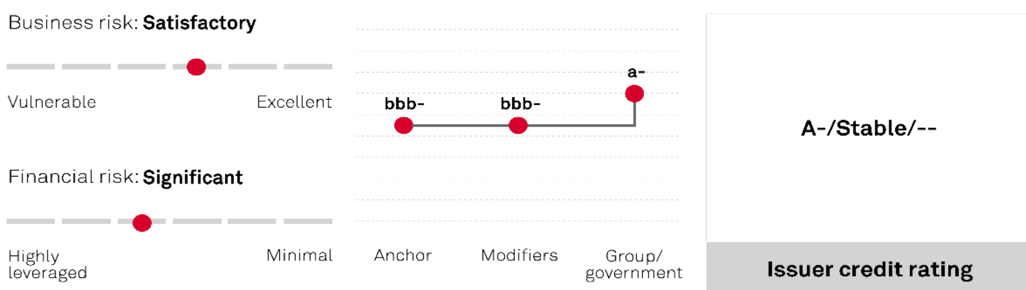
SMBC Aviation Capital Ltd.

September 11, 2023

Ratings Score Snapshot



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Credit Highlights

Overview

Key strengths	Key risks
Position as second-largest aircraft operating lessor, with a fleet of modern, widely used, and liquid aircraft.	Slowing economic growth could constrain global air traffic recovery.
Strong order book with modern technology and popular, in-demand aircraft.	Higher interest rates will result in higher borrowing costs.
Strong liquidity, with access to capital from its parent and capital markets.	Elevated debt leverage after its 2022 acquisition of Goshawk Aviation.

We expect SMBC Aviation Capital Ltd.'s operating performance, similar to other aircraft lessors, to be influenced by the opposing trends of continued post-pandemic air travel recovery and weaker macroeconomic conditions. We expect continuing strong demand for aircraft amid ongoing manufacturer delivery delays to mitigate the impact of higher interest rates on SMBC Aviation's operating results (and its aircraft lessor peers'). Short-haul domestic leisure airline traffic has recovered over the past two years as the effects of the COVID-19 pandemic on global air travel have declined. As a result, demand and lease rates for narrowbody aircraft recovered sooner than those for widebody aircraft, which are used mostly on international routes. SMBC Aviation has benefitted from this, as 83% of its portfolio comprised narrowbody aircraft as of June 30, 2023, based on net book value. In addition, delayed deliveries from aircraft manufacturers (which began before the pandemic and have since worsened due to supply chain issues) have created an aircraft shortage amid a period of stronger demand. In our view, these trends will lend support to higher prospective lease rates for SMBC Aviation and the broader industry.

On the other hand, we expect somewhat lower lease yields on at least a part of the company's fleet for a few years. This reflects the negotiation, restructuring, and extension of leases completed at lower rates during the pandemic, along with leases previously signed in a lower interest rate environment. We expect the sector to gradually pass along a portion of this incremental cost through higher lease rates, mainly due to the shortage of more environmentally friendly, new-technology narrowbody aircraft.

However, higher interest rates (which have materially increased over the past year) are a key risk to SMBC Aviation’s margins (and the broader industry). Moreover, while uncertain, we believe some airline customers (particularly those in developing countries) will face weaker macroeconomic conditions and a strong U.S. dollar (the currency in which airlines typically make lease payments) that could limit their ability to fund lease payments, which could hinder the sector.

We expect the company to maintain its position as the second-largest global aircraft leasing company, with an attractive portfolio that is relatively young and well-diversified, as airline customers prefer access to younger, new-technology aircraft that are more cost efficient. As of June 30, 2023, SMBC Aviation’s fleet was the second largest among the aircraft operating lessors after its Dec. 21, 2022, acquisition of Goshawk Aviation. This places it second only to AerCap Holdings N.V., with a fleet of 1,733 aircraft as of June 30, 2023. SMBC Aviation’s fleet comprises 502 owned and 209 managed aircraft, with an average age of 5.2 years, which is relatively young compared with the typical five- to eight-year average at many of its peers. It also comprises a higher percentage of new-technology aircraft (64%) based on net book value than many peers. Based on net book value, 83% of the portfolio comprised narrow-body aircraft as of June 30, 2023. These include mostly new-technology Boeing 737 MAXes and Airbus A320 new engine option family aircraft with well-diversified exposure, both in terms of customers and geographies. Widebodies comprise primarily Airbus A350s and Boeing 787s.

Although widebody aircraft values and lease rates have fared worse than narrowbodies, they are beginning to recover along with the recovery in long-haul international traffic. Considering an order book of 183 (all new-technology narrowbody aircraft, to be delivered through 2027), along with the continued sales of older aircraft, we expect the company's fleet to remain relatively young. The average remaining lease term of 6.5 years is in line with the typical five- to eight-year period among its peers and provides more certainty of future cash flows. In addition, the fleet is well diversified geographically: as of June 30, 2023, Europe, the Middle East, and Africa accounted for 36%; Asia, 34%; and the Americas, 31% based on net book value.

SMBC Aviation’s acquisition of Goshawk Aviation resulted in higher debt leverage, which we expect will remain elevated for the next few years but remain acceptable for the rating. On Dec. 21, 2022, SMBC Aviation completed the acquisition of Goshawk Aviation for $6.7 billion. This, along with $1.6 billion of impairment charges taken on 34 aircraft stranded in Russia in fiscal 2022 (ended March 31, 2022), resulted in debt to capital of 79% as of the end of fiscal 2022 after peaking at 81% a year earlier, compared with 75% as of March 31, 2021. This is higher than similarly rated aircraft lessors, and we expect this level to decline gradually but still remain elevated for the next few years. We also expect its other credit metrics to remain below previous levels over the next few years, with EBIT interest coverage in the high-1x area compared with 2.4x in 2022 and funds from operations (FFO) to debt 6%-7% compared with close to 9% in 2022.

The company's revenue growth is due to improving air travel demand as airlines recover from the COVID-19 pandemic, as well as the Goshawk Aviation acquisition, which added 154 aircraft. This was partially offset by reduced revenues from the aircraft stranded in Russia. At the same time, the company will be adding incremental debt to fund new aircraft deliveries, and debt maturities will be refinanced at higher rates than previously expected due to rising interest rates.

We expect significant proceeds from insurance claims for the aircraft stranded in Russia. We understand there are several layers of insurance protection against potential loss due to confiscation or similar situations that make it impossible to repossess a plane. However, we believe these claims could be subject to lengthy negotiations and litigation. On Sept. 6, 2023, AerCap Holdings N.V. announced it received cash insurance settlement proceeds of $645 million, a portion of their claims, making it the only aircraft lessor thus far to have received anything. However, any recovery is not included in our forecast.

We expect SMBC Aviation to maintain strong liquidity. As of June 30, 2023, SMBC Aviation had $496 million of unrestricted cash. It also had $9.1 billion available under its various credit facilities. We expect liquidity sources to cover uses by about 3x over the next 12 months and remain about 3x over the following 12 months. We expect debt maturities of $1.1 billion-$1.3 billion a year, with capital spending of $4.0 billion-$4.5 billion a year. However, we believe the amount could be lower due to ongoing delivery delays from the manufacturers. SMBC Aviation's $24 billion of assets are all unencumbered. This provides a potential source of collateral should market conditions make unsecured borrowing more difficult.

Outlook

The stable outlook reflects our expectation that SMBC Aviation's credit metrics will improve modestly from their depressed levels due to incremental debt from the Goshawk Aviation acquisition and the $1.6 billion impairment charge related to its aircraft stranded in Russia. We also expect the company to benefit from continued recovery in demand, especially for narrowbody new-technology aircraft, which comprises most of the company's fleet, even with weaker global economic growth. We expect EBIT interest coverage in the high-1x area in fiscal 2024 compared with 1.8x in fiscal 2023; debt to capital in the mid- to high-70% area compared with 79% in 2023, and FFO to debt of 6%-7% compared with only 5% in 2023.

Downside scenario

We could lower ratings over the next two years if we believe the company's ratio of EBIT to interest expense will remain below 1.7x and FFO to debt will remain below 6%, both on a sustained basis. We could also lower ratings if we revise our assessment of the company as less strategic to its parent.

Upside scenario

Although unlikely, we could raise our rating over the next two years if the recovery in the global airline industry exceeds our expectations such that we expect EBIT coverage of at least 2.4x and FFO to debt approaching 13% on a sustained basis.

Our Base-Case Scenario

Assumptions

- Global GDP grows 3% in 2023, 3.1% in 2024, and 3.4% in 2025;

- Global air traffic recovers over the forecast period;
- Capital spending of $4.0 billion-$4.5 billion a year through fiscal 2025;
- Proceeds from asset sales of about $2 billion a year through fiscal 2025;
- Lease yields (lease revenues divided by aircraft value) of about 9% through the forecast period compared with 11% in 2020 (prepandemic); and
- Revenues grow close to 50% in fiscal 2024 due primarily to a full year of the Goshawk Aviation acquisition and in the low-single digit percent area annually thereafter.

Key metrics

SMBC Aviation Capital Ltd.--Key Metrics

(Mil. $)	2022a	2023e	2024e	2025f
EBIT interest coverage (x)	2.4	1.8	High-1.0x	High-1.0x
FFO to debt (%)	8.6	5.4	6.0-7.0	6.0-7.0
Debt to capital (%)	81	79	Mid- to high-70	Mid- to high-70

All figures are adjusted by S&P Global Ratings, unless stated as reported. a--Actual. e--Estimate. f--Forecast. FFO--Funds from operations. $--U.S. dollar.

Company Description

Dublin-based SMBC Aviation is the second-largest aircraft operating lessor after its Dec. 21, 2022, acquisition of Goshawk Aviation. As of June 30, 2023, its fleet comprised 502 owned and 209 managed aircraft, with an order book of 183 aircraft to be delivered through 2027. It is a joint venture between Sumitomo Mitsui Banking Corp., Sumitomo Mitsui Finance and Leasing Co. Ltd. (both of which are subsidiaries of Sumitomo Mitsui Financial Group), and Sumitomo Corp. (a separate conglomerate).

Liquidity

We characterize SMBC Aviation’s liquidity as strong. We expect the company's liquidity sources to be about 3x its uses over the next 12 months and remain about 3x over the following 12 months. We also expect the company's liquidity sources will exceed its uses even if its EBITDA declines 30%. In addition, we view the company’s bank relationships as solid and its risk management as generally prudent.

Principal liquidity sources

- Unrestricted cash of $496 million as of June 30, 2023;
- $9.1 billion of availability under its revolving credit facilities;
- Our forecast of FFO of at least $1 billion per year; and
- Proceeds from aircraft sales.

Principal liquidity uses

- As of June 30, 2023, debt maturities of $1.3 billion over the next 12 months and $1.1 billion over the following 12 months;
- Capital spending for new aircraft of $4.0 billion-$4.5 billion annually for the next two years; and
- No expected dividends.

Covenant Analysis

Requirements

The company has few financial covenants in its borrowings; the most consequential is EBITDA interest coverage of at least 1.5x in some credit facilities.

Compliance expectations

SMBC Aviation was in compliance with its covenants as of June 30, 2023, and we expect it to remain in compliance over the next year.

Environmental, Social, And Governance

ESG factors have an overall neutral influence on our credit rating analysis of SMBC Aviation. We view the company as better positioned to withstand climate transition risk than its airline customers, with a relatively younger aircraft fleet (5.2 years) than the global commercial aircraft fleet (11 years) and most aircraft leasing peers.

We view social risk as a neutral consideration in our credit rating analysis. Earnings and cash flow have been pressured by lower global air traffic due to COVID-19, though much less so than for airlines. We expect earnings and cash flow to continue to recover over next few years.

Issue Ratings--Subordination Risk Analysis

Capital structure

SMBC Aviation's debt capital structure consisted of $17.1 billion of debt as of June 30, 2023, all unsecured. This comprises loans from parent entities and third-party bank and capital market financing. Third-party unsecured notes are issued by SMBC Aviation Capital Finance DAC, a financing subsidiary, and are guaranteed by SMBC Aviation. We count $300 million of subordinated debt from parent entities as equity in our analysis.

Analytical conclusions

We equalize our issue-level rating on senior unsecured debt issued by SMBC Aviation and its subsidiaries with our issuer credit ratings on those subsidiaries and on SMBC because no significant elements of subordination risk are present in its capital structure.

Rating Component Scores

Foreign currency issuer credit rating	A-/Stable/--
Local currency issuer credit rating	A-/Stable/--
Business risk	Satisfactory
Country risk	Intermediate
Industry risk	Intermediate
Competitive position	Satisfactory
Financial risk	Significant
Cash flow/leverage	Significant
Anchor	bbb-
Diversification/portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Strong (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	bbb-
Group credit profile	a
Entity status within group	Strategically important (+3 notches from SACP)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | Industrials: Key Credit Factors For The Operating Leasing Industry, Dec. 14, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011