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Research Update:

Dubai Aerospace Enterprise Ltd. Upgraded To 'BB+' On Successful Integration Of AWAS Aviation Capital, Outlook Stable

Primary Credit Analyst:
Betsy R Snyder, CFA, New York (1) 212-438-7811; betsy.snyder@spglobal.com

Secondary Contact:
Philip A Baggaley, CFA, New York (1) 212-438-7683; philip.baggaley@spglobal.com

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Research Update:

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Overview

- We believe Dubai Aerospace Enterprise Ltd. (DAE) has successfully integrated AWAS Aviation Capital Ltd.'s operations, which it acquired in August 2017.
- The combined company has reported solid financial results since the acquisition.
- Therefore, we are upgrading DAE to 'BB+' from 'BB'.
- The stable outlook reflects our expectation that DAE's credit metrics will remain relatively stable through 2019, with EBIT interest coverage of around 2x and a funds from operations (FFO)-to-debt of about 10%.

Rating Action

On July 26, 2018, S&P Global Ratings upgraded Dubai Aerospace Enterprise Ltd. (DAE) to 'BB+' from 'BB'. At the same time, we raised our issue-level rating on the company's unsecured debt to 'BB+' from 'BB'. The '3' recovery rating remains unchanged, indicating our expectation for meaningful (50%-70%; rounded estimate: 65% capped) recovery in a default scenario. We revised our rounded recovery estimate on the unsecured debt to 65% from 55% due to an increase in DAE's pool of unencumbered aircraft. We also raised our issuer credit rating on AWAS Aviation Capital Ltd., an operating subsidiary of DAE, to 'BB+' from 'BB' and affirmed that entity's secured debt rating at 'BBB-', with an expectation of very high recovery (90%-100%; rounded estimate: 95%) in a default scenario. The outlook on both entities is stable.

Rationale

Dubai-based aircraft lessor DAE acquired the larger aircraft lessor AWAS Aviation Capital Ltd. (AWAS) in August 2017. Mergers between aircraft lessors generally face limited integration problems; however, at the time of this acquisition, we felt that it could pose a greater-than-usual level of risk. This is because the combined entity would continue to have most of its operating staff in Dublin (where AWAS is based) while certain executive functions would be based in Dubai. Almost a year later, the integration appears to have been successful despite DAE's decision to shift more functions and personnel to Dubai.

The combined entity's fleet comprised 315 owned and 40 managed aircraft as of March 31, 2018, which places DAE in the mid-tier of rated aircraft lessors. The average age (weighted by aircraft book value) of the company's fleet is six years old and the remaining lease term is 5.9 years, which is comparable with the fleets of other aircraft lessors. Although DAE's fleet is more diversified based on net book value, it has a larger percentage of widebody aircraft, including freighters (37%), and a larger exposure to Middle Eastern and African airlines (35%) than is typical for aircraft lessors. The company's top 10 customers account for 39% of its net book value (with Emirates being the largest), which is a higher percentage than we typically see for aircraft lessors. In addition, widebody lease rates have been pressured by oversupply while the demand for freighters has recently improved along with strong demand for air cargo, which has constrained capacity. The company has only a modest number of aircraft on order and, accordingly, is reliant on opportunistic acquisitions through sale-leasebacks to grow its fleet. The market for such sale-leasebacks is currently very competitive, which often results in low returns on investment for aircraft lessors.

Our assessment of DAE's business risk incorporates our expectation for continued moderate global GDP growth, which should support increased airline passenger traffic (we expect traffic to grow by more than 5% annually, on average, over the next several years). That, along with the need to replace older aircraft, should support continued healthy demand for new planes. Our assessment also incorporates the medium to long lease terms that are typical in the aircraft leasing sector, which mean that the company's leases would come up for renewal over a period of years during a recession (absent customer defaults), limiting its exposure to lower rates on new leases. The proportion of global aircraft provided by lessors has gradually increased to around 40% and we expect this percentage to continue to rise. DAE's customers, the airlines, have volatile revenue and profitability and generally low credit quality, though their need for aircraft tends to be much more stable than their earnings. Aircraft lessors' lease rates exhibit moderate volatility in downturns but their utilization remains high, which has provided industry participants with relatively stable cash flow.

Our base-case scenario foresees relatively stable credit metrics in 2018 and 2019 (the 2017 credit metrics are not indicative due to the August 2017 acquisition of AWAS; they include the full consolidated debt amount but only a partial year's worth of earnings and cash flow from AWAS). We expect EBIT interest coverage of around 2x, a FFO-to-debt ratio of around 10%, and a debt-to-capital ratio in the low 70% area over this period. These credit metrics are in line with those of similarly rated aircraft lessors.

Our base-case assumptions include:

- Global GDP growth of 3.9% annually in both 2018 and 2019;
- Global passenger traffic growth exceeding 5% annually;
- Committed capital spending of around $1.1 billion in 2018 and only a minimal amount in 2019;

- Relatively stable lease yields (revenue as a percentage of the book value of lease equipment) of around 11%; and
- Relatively stable margins.

Key metrics

	2017A	2018E	2019E
EBIT coverage	1.8x	Around 2.0x	Around 2.0x
Debt to capital	76%	Low 70% area	Low 70% area
FFO to debt	5%	Around 10%	Around 10%

FFO--Funds from operations. A--Actual. E--Estimate.

Liquidity

We assess DAE's liquidity as strong. We believe that the company's sources of liquidity will be around 1.9x its uses in 2018 and around 2.5x in 2019. In addition, we expect that the company's net sources will remain positive even if its EBITDA declines by 30%. However, we don't believe that DAE has a generally high standing in the credit markets, as evidenced by its intent to repurchase $300 million of its unsecured notes, which the company believes are undervalued. The only financial covenant in the company's credit facilities is a minimum net worth of $300 million, which the company is comfortably in compliance with (over $3 billion) and we expect it to remain so over the next several quarters.

Principal liquidity sources:

- $252 million of unrestricted cash as of March 31, 2018;
- FFO of $800 million-$900 million per year through 2019;
- Revolver availability of around $1.3 billion, including the new $800 million unsecured credit facility it entered into in May 2018;
- Potential proceeds from capital-market transactions; and
- Potential proceeds from aircraft sales.

Principal liquidity uses:

- Debt maturities of around $1.4 billion-$1.6 billion a year through 2019; and
- Committed capital spending of around $1.1 billion in 2018 and only a minimal amount in 2019.

Outlook

The stable outlook reflects our expectation that Dubai Aerospace Enterprise Ltd.'s credit metrics will remain relatively unchanged through 2019. We expect the company to take advantage of market opportunities to both acquire and sell aircraft, which should result in a relatively stable asset base, revenue, cash flow, and debt levels. We anticipate that DAE will maintain EBIT interest coverage of around 2x, a debt-to-capital ratio in the low 70% area, and a FFO-to-debt ratio of around 10% over this period.

Downside scenario

Although unlikely, we could lower our ratings on DAE over the next year if its EBIT interest coverage declined below 1.5x and its FFO-to-debt fell below 6% on a sustained basis. This could occur if the demand for aircraft softens due to weaker-than-expected airline passenger growth that leads to customer defaults by weaker airlines, potential aircraft repossessions, and lower lease rates and aircraft utilization.

Upside scenario

Although unlikely, we could raise our ratings on DAE over the next year if the company materially increases the size and diversity of its fleet (in terms of both geography and aircraft) while improving its financial profile. Specifically, we would need the company to increase its EBIT interest coverage to 2.4x and its FFO-to-debt ratio to 13% for a sustained period. This could occur if stronger-than-expected demand for aircraft leads to tight aircraft supply and higher lease rates, improving DAE's earnings and cash flow.

Ratings Score Snapshot

Issuer credit rating: BB+/Stable/--

Business risk: Satisfactory
- Industry risk: Intermediate
- Country risk: Intermediate
- Competitive position: Satisfactory

Financial risk: Significant
- Cash flow/leverage: Significant

Anchor: bb+

Modifiers:
- Diversification/portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Neutral (no impact)

Issue Ratings--Recovery Analysis

Key analytical factors

- Our simulated default scenario assumes that a severe downturn in the world economy in 2022 leads to weaker market lease rates and a number of aircraft being returned by airline lessees. This results in DAE's hypothetical default in 2023.
- We maintained our 'BBB-' issue-level rating and '1' recovery rating on AWAS' 2014 term loan that remains outstanding.
- We maintained our '3' recovery rating on DAE's senior unsecured notes and revised our rounded recovery estimate to 65% (capped) from 55% in view of the estimated increase in unencumbered assets at default due to AWAS' secured term loan maturities.
- We have assumed that the value of DAE's new aircraft on order, net of purchase deposits, are financed on a secured basis at 70% loan to value. In addition, we depreciate the market value of all aircraft to the 2023 assumed default year and then apply a distressed market realization assumption to the aircraft.

Simulated default assumptions

- Simulated year of default: 2023

Simplified waterfall

- Enterprise value (discrete asset values): $7.655 billion
- Net enterprise value (after 5% admin. costs): $7.273 billion
- Valuation split (encumbered/unencumbered): 97%/3%
- Secured debt claims (DAE/AWAS): $2.128 billion/$167 million
- Value available to senior unsecured debt claims: $3.670 billion
- Secured unsecured debt claims: $3.701 billion

--Recovery expectations:

- AWAS 2014 term loan: 90%-100% (rounded estimate: 95%)
- DAE senior unsecured notes: 50%-70% (rounded estimate: 65% capped)

Note: All debt amounts include six months of prepetition interest. Collateral value equals asset pledge from obligors after priority claims plus equity pledge from nonobligors after nonobligor debt.

Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Operating Leasing Industry, Dec. 14, 2016

- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

Upgraded; Outlook Action		
	To	From
Dubai Aerospace Enterprise Ltd		
AWAS Aviation Capital Ltd.		
Issuer Credit Rating	BB+/Stable/--	BB/Positive/--
Ratings Affirmed		
AWAS Aviation Capital Ltd.		
Senior Secured	BBB-	
Recovery Rating	1(95%)	
Issue-level Ratings Raised; Recovery Expectations Revised		
	To	From
DAE Funding LLC		
Senior Unsecured	BB+	BB
Recovery Rating	3(65%)	3(55%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of

RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.