FitchRatings

Fitch Publishes Dubai Aerospace Enterprise's 'BBB-' Rating; Outlook Stable

Fitch Ratings - London - 17 July 2019: Fitch Ratings has published Dubai Aerospace Enterprise (DAE) Ltd's Long-Term Issuer Default Rating (IDR) of'BBB-' with Stable Outlook, DAE Funding LLC's senior unsecured long-term rating of 'BBB-' and DAE's senior secured long-termerm rating of 'BBB'.

RATING ACTIONS

ENTITY/DEBT	RATING		
DAE Funding LLC	LT IDR BBB- ⭘ Publish		
senior unsecured	LT BBB- Publish		
Dubai Aerospace Enterprise (DAE) Ltd	LT IDR BBB- ⭘ Publish		
senior secured	LT BBB Publish		

Key Rating Drivers

IDRS AND SENIOR DEBT
DAE's ratings reflect the firm's materially enhanced scale, following the acquisition and successful integration of AWAS Aviation Capital Designated Activity Company (AWAS), which itself had a long track record of strong operating performance through a variety of commercial aviation and credit cycles. The rating also reflects a diverse fleet profile; solid cash flows, as evidenced by strong contractual lease revenue; robust platform and systems; low leverage; strong technical capabilities; and improved funding profile with access to multiple sources of capital.

Rating constraints include DAE's more modest but improving franchise compared with other investment grade peers, modest governance weaknesses related to its sizeable related party exposure (to Emirates Airline (Emirates)) and the absence of independent members on its board of directors. The rating is also constrained by above-average exposure to airlines in lower-rated jurisdictions (notably the Middle East and Africa) when compared with peers; above peer average weighted average fleet age; and moderate exposure to freighter and turbo prop aircraft, which Fitch considers less liquid asset classes than narrow body passenger planes.

Rating constraints applicable to the aircraft leasing industry more broadly include the monoline nature of the business, vulnerability to exogenous shocks, potential exposure to residual value risk, sensitivity to oil prices, reliance on wholesale funding sources, and increased competition.

DAE is fully-owned (directly and indirectly) by the Investment Corporation of Dubai (ICD, unrated), the investment arm of the Government of Dubai. This ownership structure results in related party transactions (including a USD1.2 billion intercompany loan to one of its minority shareholders, ICD Hospitality as of end-1Q19) and a smaller board of directors compared with public peers. Fitch does not view a meaningfully-sized loan to a hospitality and leisure company as aligned with DAE's business model and core strategic objectives. In 1Q19, DAE reduced the loan exposure to ICD Hospitality to USD1.2 billion (while simultaneously repurchasing USD250 million in common shares held by ICD Hospitality) and management intends to reduce this exposure, maturing in 2022, further subject to DAE complying with its stated leverage target.

Fitch expects that DAE will remain an important long-term holding for ICD, as a means to advance Dubai's policy objectives in aviation, which is a key sector in the economy. However, Fitch does not expect the Government of Dubai to extend financial extraordinary financial support to DAE. Although not presently expected, more explicit indications of ICD's ability and propensity to support DAE in case of need could result in rating uplift.

Related party transactions primarily relate to aircraft lease agreements with Emirates and flydubai, which are ICD portfolio companies. Exposure to Emirates will likely decrease over time due to portfolio growth, but may remain sizeable in Fitch's opinion, given ICD's presence on DAE's board, key management linkages between ICD and DAE and the fact that transportation investments represent the second-largest exposure in ICD's portfolio. Related party transactions of this nature could potentially introduce conflicts of interest related to the economic terms of commercial agreements between the parties and potential remedial actions that may be taken in the event of issuer-specific or market-wide stress.

At end-1Q19, DAE's owned, managed and ordered fleet consisted of 354 aircraft, valued at around USD13 billion, with the largest exposures by type Airbus A320s, Boeing 737s, ATR 72-600s and Airbus A330s. The firm also owns freighters, including 12 B777F and three B747F aircraft. The weighted average age of the portfolio was 5.9 years as of end-1H19, which is slightly improved year-on-year but elevated compared withmost other rated aircraft lessors. However, the weighted average age is partially skewed by DAE's ownership of ATR 72-600s and freighters, which tend to have longer economic lives and less residual value risk than more widely utilised narrow body and wide body jets.

Fitch believes DAE's fleet profile and platform scale have benefited from the AWAS acquisition. In addition to the diversification benefits that come with size, Fitch believes that scale provides certain strategic benefits to DAE, such as increased negotiating power, more available channels to re-lease planes when needed and a platform through which it can grow managed aircraft with institutional partners (Aircraft Investor Services or AIS). However, with broad reach comes increased likelihood of exposure to challenged airlines and/or geographies during periods of stress.

DAE had 110 customers across 56 countries as of end-1H19, with top exposures to Emirates (15% of owned aircraft by net book value at end-1Q19), Gulf Air (8%) and Ethiopian Airlines (3%). DAE's management team, inclusive of former AWAS staff, has a track record of repossessing and redeploying aircraft after customer bankruptcies and payment events, as was the case with troubled airlines like Air Berlin and TransAir. Fitch views this track record favourably, although in some cases, aircraft downtime prior to redeployment has been significant.

Fitch believes that DAE has elevated exposure to weaker growth geographies compared with other lessors. The company had 43% of net book value (NBV) leased to customers in the Middle East, Africa and South Asia at end-1Q19. According to IATA the Middle East and Africa regions have had revenue passenger kilometre (RPK) growth rates of 5.0% and 6.1%, respectively, in 2018, somewhat lagging the global RPK growth rate of 7.4% over the same period.

DAE's ownership of maintenance and delivery hangars evidences its technical capabilities. These hangars are strategically located in Amman, Jordan, which enhances the geographic reach of the company's maintenance, repair and overhaul operations across the EMEA region. The company is certified by various regulatory bodies to maintain and refurbish its aircraft, which creates more of a vertically integrated business model compared with other aircraft lessors. Fitch views this as beneficial to DAE's business because the firm only incurs limited third party maintenance costs and may gain further insight on the value and condition of the aircraft. On the other hand, DAE's maintenance business introduces higher fixed costs.

DAE continues to grow its managed aircraft platforms via AIS. In 2018, DAE sold 18 midlife aircraft to third party investors via a managed investment vehicle funded with asset-backed securities (ABS), Kestrel Aircraft Funding Limited (Kestrel). The Kestrel transaction followed the Falcon Aerospace Limited (sponsored by DAE in 2017) and the Diamond Head Aviation (sponsored by AWAS in 2015) ABS issuances. These investment vehicles allow DAE to grow its managed platform and dispose of mid-life aircraft while also enabling the company to retain customer relationships and generate servicing fees, which Fitch views favourably. The company has plans to grow AIS into a USD5 billion managed portfolio (from around USD1.3 billion at end-2018), which would enhance the company's earnings profile by introducing more fee income.

The company generated lease yields of 12.1% for the three months to end-1Q19 and 2018, indicating strong cash generation and comparing well with peers in the aircraft leasing sector. Fitch expects lease yields to moderate in a stable to lower interest rate environment. DAE had a weighted average remaining lease term of 6.2 years at end-1Q19, which provides reasonably strong cash flow predictability absent lessee credit events.

DAE is targeting a net debt to reported equity ratio of under 3.0x. However, Fitch's assessment of an aircraft leasing company's leverage focuses on gross debt to tangible equity. DAE's intangible assets include goodwill from acquisitions that Fitch believes will be unable to support the equity base in a stress scenario. DAE's gross debt/tangible equity ratio stood at 2.7x at end-1Q19, broadly in line with similarly-rated peers, and Fitch expects this ratio to remain below or at 3.0x in the medium-term.

DAE has access to multiple funding sources, including various export credit agencies, bank debt, and unsecured and secured debt in the capital markets. Fitch has a favourable view of DAE's expanded use of unsecured debt in recent years. DAE's unsecured debt/total debt ratio increased to 54% at end-1Q19 from below 30% at end-2017, which considerably improves the company's financial flexibility. Management is committed to maintaining this ratio to between 50% and 70% in the long term.

Fitch believes DAE has an adequate liquidity position. Cash and cash equivalents of around USD190 million at end-1Q19, around USD1 billion of undrawn revolver capacity and cash flow from operations (USD1 billion on an annualised basis through 1Q19) adequately cover debt maturities, amortisation, and capital commitments over the next 12 months. The company also has extremely limited order book commitments at present, which is viewed positively from liquidity and contingent liability perspectives.

The senior secured debt ratings of 'BBB' are rated one notch above DAE's Long-Term IDR, reflecting the aircraft collateral backing these obligations, which suggests above average recovery prospects in a stress scenario.

The equalisation of the unsecured debt rating with DAE's Long-Term IDR reflects sufficient unsecured debt, as well as an available pool of unencumbered assets, which suggest average recovery prospects for unsecured debtholders in a stress scenario.

DAE is a global aerospace corporation headquartered in Dubai, with offices in Dublin, Singapore, Amman, Miami, Seattle and New York. As of March 31, 2019, DAE had an owned, managed and ordered fleet consisting of 354 aircraft, valued at around USD13 billion.

DAE Funding LLC is the US based unsecured debt issuing subsidiary of DAE. DAE guarantees all debt issued by DAE Funding LLC, therefore, the entities ratings are aligned.

Rating Sensitivities

IDRS AND SENIOR DEBT
Fitch believes that the combination of the aviation industry's increased reliance on aircraft lessors, the competitive pressures in the aircraft lessor space and prolonged favourable market conditions limit the likelihood of upward rating momentum, at least until the company's credit performance can be assessed through a full market cycle. Thereafter, upward rating momentum could develop if DAE exhibits differentiated risk management and asset quality combined with further expansion of its franchise, sustainably lower leverage below 2.5x, improving unsecured debt/ total debt toward the upper end of the targeted range of 50%-70%, and improved corporate governance aspects, such as a reduction in DAE's relative exposure to Emirates to below 10% of NBV and repayment of the intercompany loan with ICD Hospitality.

A sustained increase in gross debt to tangible common equity above 3.0x or a material reduction in the company's proportion of unsecured funding could lead to negative rating action. Credit deterioration of underlying lessees, particularly Emirates, an increase in aircraft impairments; a sustained deterioration in financial performance and/ or operating cash flows; difficulty re-leasing aircraft at economical rates; a reduction in available liquidity or unencumbered assets; and/or an aging fleet profile could also result in negative rating momentum.

The ratings on the secured debt and unsecured debt are primarily sensitive to changes in DAE's Long-Term IDR and secondarily to the relative recovery prospects on the instruments.

Summary of Financial Adjustments

Fitch has adjusted its core leverage calculation by not excluding maintenance right assets and lease premiums from tangible equity. This reflects Fitch's view that these balance sheet items contain sufficient economic value to support creditors.

Date of Relevant Committee

11-Jul-2019

Additional information is available on www.fitchratings.com

FITCH RATINGS ANALYSTS

Primary Rating Analyst
Christian Kuendig
Senior Director
+44 20 3530 1399
Fitch Ratings Ltd
30 North Colonnade, Canary Wharf
London E14 5GN

Secondary Rating Analyst
Johann Juan
Director
+1 312 368 3339

Committee Chairperson
Nathan Flanders
Managing Director
+1 212 908 0827

MEDIA CONTACTS

Louisa Williams
London
+44 20 3530 2452
louisa.williams@thefitchgroup.com

Applicable Criteria

Non-Bank Financial Institutions Rating Criteria (pub. 12 Oct 2018)

Additional Disclosures

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