CONTRIBUTING ARTICLE

New Aviation Silk Road

Professor David Yu, CFA, Istat certified aviation appraiser, looks at the trends, drivers and lessons in cross-border investments and M&A in aviation.

In recent years, the number and volume of cross-border investments has increased significantly across all industries, especially in aviation. While there have always been cross-border investments between countries, such deals are now more prominent in the news given their increasing size and frequency, as well as the profile of the targets.

There were 1,320 cross-border deals in the second quarter of 2016, worth $214 billion, according to law firm Baker & McKenzie. A total of 798 deals, worth $137 billion, closed across two different geographic regions versus 522 deals worth $77 billion within one geographic region. During the second quarter, a sizeable portion included Chinese companies, which completed 97 transactions worth $40.7 billion. A year ago, they accounted for $17.5 billion.

In a review of the recent activity in the aviation industry, most of the deals in the first half were in the aerospace sector (see M&A charts) and there have been a significant number of aircraft and airline acquisitions in terms of volume (about $3.5 billion) and number (about 15), according to MergerMarket/ICF.

In terms of cross-border investments in the aircraft space not originating from Asia, Danish operating lessor Nordic Aviation Capital announced the acquisition of two leasing platforms, Aldus Aviation and Jetscape, along with a purchase of an Embraer E-Jets portfolio of 25 aircraft from Air Lease. The move confirmed the company's cross-border roll-up acquisition strategy in the regional aircraft sector.

In the airline sector, there have been multiple deals by Middle Eastern carriers such as Qatar Airways, which announced the acquisition of a 49% stake in Italy's Meridiana, completed purchase of a 10% stake in Latam and bought additional shares in IAG, bringing its holding to 20%.

This trend is similar to Etihad's equity alliance strategy of investing in stakes in foreign-operated airlines. Etihad is expected to increase its 24% shareholding in Jet Airways to 49% (the maximum amount of foreign investment allowed in Indian airlines) because of a relaxation of regulations.

During the first half of the year, China Energy Company exercised its option for an additional 39.92% shares of Czech Travel Service Airlines to bring its stake to 49.92% after the initial investment in 2015. In addition, Nanshan Group and HNA Airlines separately invested 20% stakes for $198 million and 13% for $114 million,

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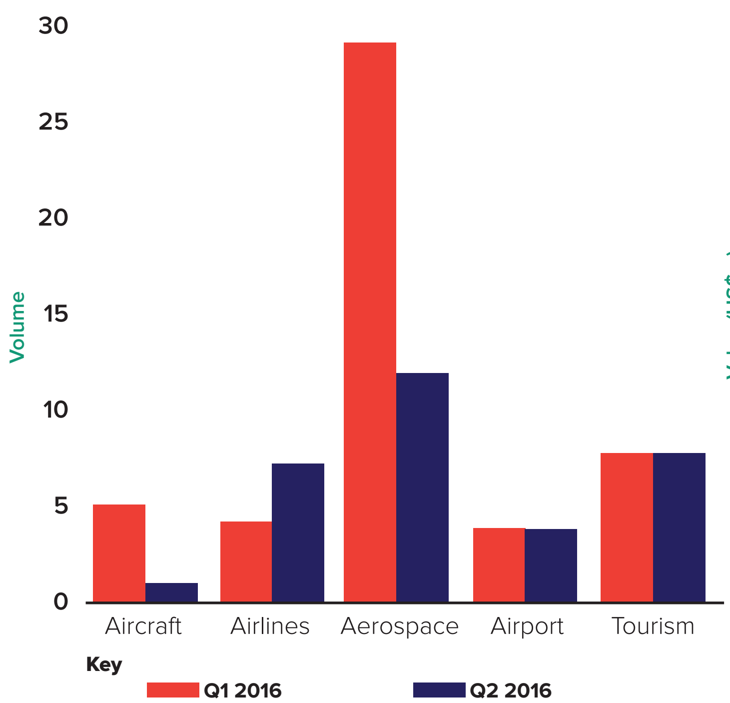
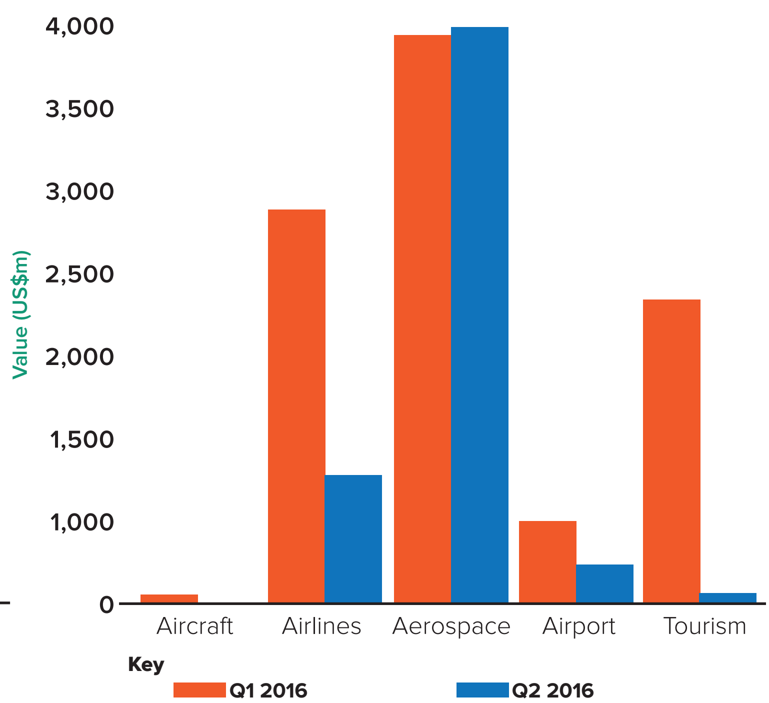
Aviation sector M&A deals 2016

M&A Volume

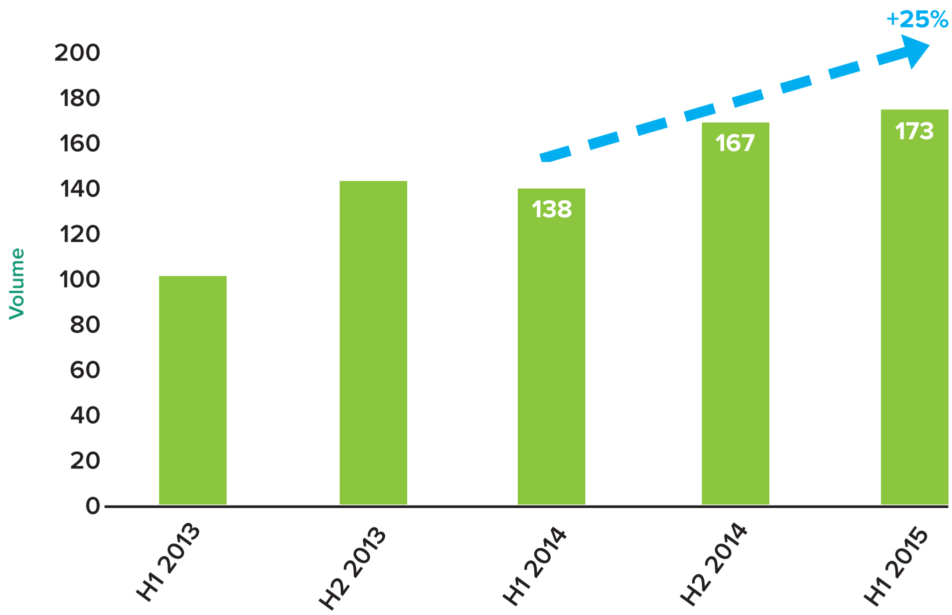


M&A Value

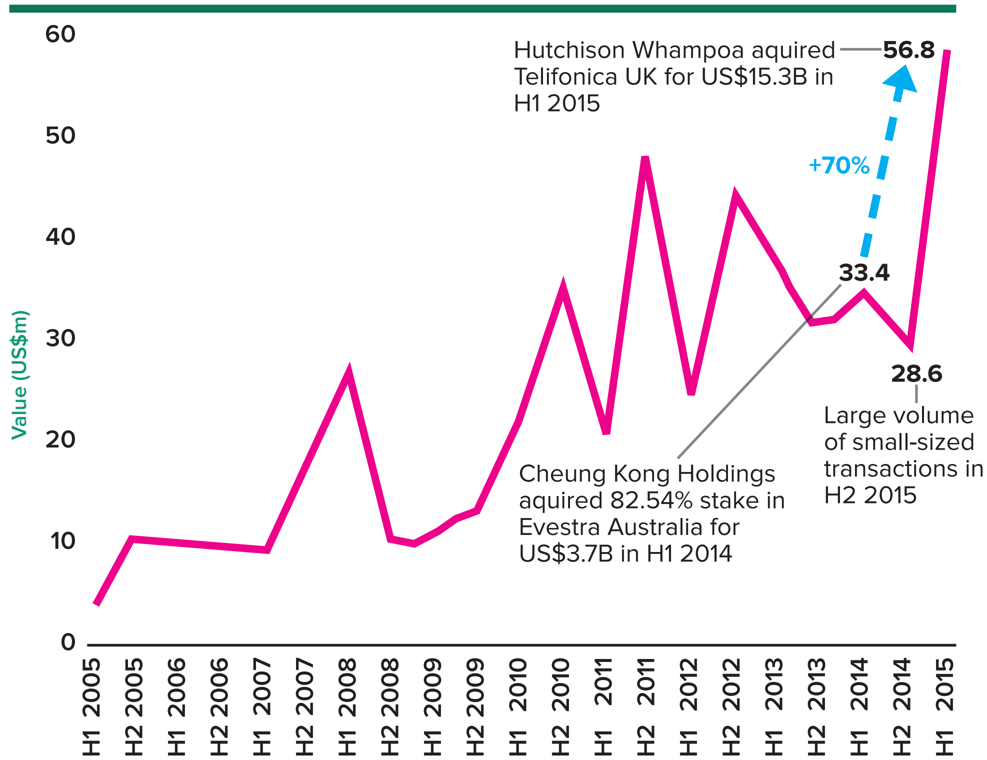


Source: MergerMarket/ICF

Greater Chinese outbound M&A volume



Greater Chinese outbound M&A value



Source: Deloitte

respectively, in Virgin Australia. This continues the acquisition expansion of both groups in the aviation sector domestically and abroad. In South-East Asia, Thailand's King Power Group bought 39.83% of Asia Aviation for $225 million.

In light of all the cross-border investment activity, there have been a growing and significant number of global outbound investments from Chinese investors (see Greater Chinese outbound charts). This can be attributed partially to the global economy and is highlighted by the fact this is a reversal of inbound investment flows that have occurred in the past few decades.

What are some of the drivers of the increased outbound investments from China?

Some of the volume is reflective of the slowdown of the domestic market. While China's gross domestic product has slowed from strong double digits for the past decade and more to a current target of 6.5% to 7% a year growth, this slowdown has contributed to further desire for higher growth outside of China.

While some traditional industries are under pressure, the tourism, aviation and transportation sectors are still attractive as the overall demographics of the population continue to improve (as populations get wealthier, more disposable income tends to be spent on discretionary travel). This has in turn increased interest in travel and related services especially abroad, which has precipitated the increase for international acquisitions because of the investment strategy of following the customer. In addition, there is a trend for increased vertical integration among the Chinese companies, many of whom are conglomerates.

In addition, with low yields in traditional banks, much of the capital is moving towards higher yielding products. This demand is not being fully met by the slower domestic economy and has also driven investments internationally for higher growth and yielding deals, because there are less and less attractive investment opportunities domestically.

The continuing controlled depreciation of the Chinese renminbi currency by the People's Bank of China over the past few years compared to other major economies has reversed the one-way trade of appreciation since the relaxing of the official peg with the US dollar. Aircraft and other real assets denominated in US dollars or other major currencies are prime examples of this flow. This has also affected airline companies because costs and revenues are mismatched and no hedging is allowed by Chinese airlines. While there is a continued push by the authorities to restrain this outflow effect by restricting foreign exchange conversion per person per trip, shutting down grey channels, this trend continues. Another ramification of depreciating currency is more deals are being denominated in local renminbi currency versus US dollars.

Also, the slowing growth and the push for increased efficiencies have also driven the encouragement of consolidation and the creation of national champion companies to look for more expertise both domestically and internationally. One recent example is state-owned enterprise (SOE) Aviation Industry Corporation of China, which finalised the consolidation merger of all of its aircraft engine businesses worth $19.7 billion as part of the overhaul of China's SOEs.

Other national champion businesses are also being formed in other strategic industries such as the $21.9 billion shipping merger of Cosco and China Shipping Group. Another state-owned enterprise, Air China, is rumoured to be behind an investment interest for 49% of LOT Polish Airlines. More activity from this segment is expected in the future.

It is also important to note that the Chinese state can act as an investor, financier or both in certain situations. Policy banks such as China Development Bank and China Export-Import Bank have been key drivers of policy-related lending. Also, SOE banks such as the big four – Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China and Bank of China – have also contributed to this expansion overseas, especially through their worldwide branch system in addition to provincial and quasi non-governmental organisations. Funding also comes from various sovereign funds, including China Investment and many other entities such as China's State Administration of Foreign Exchange, which manages the state foreign exchange reserves.

Insurance companies are also a growing force in terms of financing and investments because they are being allowed to diversify their holdings by the various regulators, mostly China Insurance Regulatory Commission, China Securities Regulatory Commission and People's Bank of China. Traditionally, insurance groups have invested, and still have a bulk of their assets, in conservative fixed income such as local bonds and have expanded to equity as well as more alternative investments such as property and financial leasing.

Insurers enter leasing

Examples would be the formation of aviation leasing arms at Ping An and Taiping insurance groups (the latter in a joint venture with Sinopec, a state-owned oil company). Some reasons insurance companies globally and regionally are attracted to aircraft leasing assets include the benefit of depreciation of aircraft assets, which offset other earnings from a tax perspective; the fact the investment is backed by physical assets with long life and stability of cash flows is attractive. Insurance companies try to increase their investment returns as well as match the duration of their liabilities. In addition, sizeable amounts can be deployed, which can be significant for the insurance groups. All of these rationales apply to Chinese insurance groups because they are also backing the expansion of their financial leasing activities in China and abroad to find higher yielding and lower risk returns. Aircraft leasing's structural characteristics are similar to property, with large transaction sizes backed by physical assets. Debt, which is optional, involves rental returns and the potential of asset appreciation for operating leases.

Another driver is government and regulation, because this is always an important factor in the Chinese business. There are many points in the current five-year plan by the central government that encourages the transportation and tourism sector domestically especially in the western growth regions. There have been multiple signals for the encouragement of companies to grow by going abroad for technology and resources. This has been an important part of the growth driver for cross-border activity. One prominent example of this policy is President Xi Jinping's One Belt, One Road policy and 21st Century Maritime Silk Road, which aims to rebuild the ancient Silk Road trade route between China and Europe and all the intermediate countries and sea routes along with South and South-East Asia. With the purpose of driving economic development, this will inevitably be a driver for more overseas deals by Chinese companies and investors. One example of this resultant investment and development in airlines is in Georgia by the Hualing Group.

Chinese outbound investment, merger and acquisitions have been generally focused on the pursuit of technology, expertise and natural resources. This is overlaid on normal expansion and acquisition growth strategies such as vertical or horizontal integration, as well as conglomerate building activities. Acquirers come from a broad spectrum of backgrounds from private and state-backed companies both having existing industry experience and others diversifying their existing holdings. Cross-border investments come in all shapes and forms whether wholly, majority or minority investments.

While there are many factors that affect the size of the cross-border investment, the main drivers include acquirer's strategy, existing shareholder desires, as well as other external regulatory factors such as specific country regulation. The rationale for minority interests are both strategic or forced upon by local regulation such as the 49% maximum foreign interest in European airlines.

While cross-border appetite, foreign direct investment and minority purchases are generally welcomed worldwide, there are instances where this has created tensions among stakeholders, including existing shareholders, labour unions, governments or local populations. Tensions have arisen by the acquisition of minority shareholdings in the past few years, including Etihad's 24% purchase of Jet Airways by the Indian regulators and its 33.3% stake in the Swiss carrier Darwin Airline, both of which were finally approved. There were also resistances from strong labour unions of state companies.

An example of sustained large acquisition growth strategy is HNA Group, a quasi-private entity, which has had a strong continued appetite for acquiring companies both domestically and internationally in the aircraft leasing, airline and other tourism-related industries. These include airline investments such as a 13% stake in Virgin Australia for $114 million, $450 million for a 23.7% stake in Azul and the 100% acquisition of Avolon for $6.4 billion, along with related investments in airline catering (Gategroup), ground/cargo handling (Swissport) and hotels (Carlson Rezidor Hotel Group and NH Hotel Group). HNA Group also completed the acquisition of Allco Aviation, later renamed Hong Kong Aviation Capital, in 2010.

It is important to understand and appreciate the specific regulatory approvals for foreign exchange and approval of large overseas deals. This has in some instances taken a lengthy period and has been onerous on the investment process because it comes particularly in the way of auction-style sale processes where there are specific timeline targets for each round of bidding and deposits. This has been a particularly sensitive issue to be overcome because it has affected some of the recent industry sales.

Prudent due diligence

Another lesson is to know as much as possible about the counterparty. Not only is it important to know how the investment will be funded, but also other background info on their existing businesses and reputation is key in any potential transaction. While there is never 100% information available, some leap of faith is required. This is not only important for the transaction but also a telling indicator of the post-investment integration and marriage afterwards, if any. An example is the recent failed sale of Frankfurt-Hahn Airport to an unnamed Chinese buyer by the selling German federal state owners, Rhineland Palatinate and Hesse.

Like all acquisitions, prudent due diligence, post-acquisition integration and business planning is necessary, whether done in house or by experienced third-party advisers. There have been multiple examples of cross-border investments that quickly went bust as the expected turnaround situations or synergies were not realised because a lack of understanding of local culture and regulations proved to be too difficult of a barrier for the acquirers to overcome. Even with some of these sensitivities, it is en vogue to mention prospective Chinese buyers because this may be to drum up interest and valuation expectations in company sales. One thing is certain: there is more activity in cross-border investment activity, especially from China. Transactions will have a much more successful path if past lessons are learned and are the most prepared. All in all, signs are pointed to what seems to be a new Aviation Silk Road plan for the aviation industry on the back of the One Belt, One Road policy.

David Yu is the managing director, chief investment officer and co-founder of Inception Aviation Holdings, an aviation investment and financing firm. He is also the executive director Asia of IBA Group, a leading global aircraft appraisal and consultancy, and adjunct professor of finance at New York University Shanghai, where he teaches and focuses on cross-boarder investing and financing and transportation.