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Research Update:

SMBC Aviation Capital Ltd. Assigned 'BBB+' Corporate Credit Rating; Outlook Stable

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Overview

- Our assessment of Dublin, Ireland-based aircraft operating lessor SMBC Aviation Capital Ltd.'s business risk profile as "satisfactory" is based on its size, high-quality aircraft fleet, and relatively young fleet age of about 4.6 years. Credit measures that are among the weakest of aircraft lessors we rate are a key factor in our "significant" assessment of its financial risk profile.
- We are assigning our 'BBB+' corporate credit rating to SMBC Aviation Capital Ltd., a midtier provider of aircraft operating leases.
- We consider SMBC Aviation Capital "strategically important" to its parent, Sumitomo Mitsui Financial Group Inc., under our criteria, and thus we rate SMBC Aviation Capital three notches higher than its stand-alone credit profile of 'bb+'.
- The rating outlook is stable, reflecting our view that SMBC Aviation Capital's credit metrics will remain relatively consistent through 2016, with strong earnings and cash flow offsetting incremental debt to fund new aircraft.

Rating Action

On Dec. 2, 2014, Standard & Poor's Ratings Services assigned its 'BBB+' corporate credit rating to Dublin, Ireland-based aircraft operating lessor SMBC Aviation Capital Ltd. The rating outlook is stable.

Rationale

SMBC Aviation Capital Ltd. is among the largest of the second-tier aircraft operating lessors, based on the number of aircraft it leases. It has a relatively young and high-quality aircraft fleet, primarily made up of popular narrowbody aircraft. In our view, inherent risks of cyclical demand and lease rates for aircraft, the often weak credit quality of customer airlines, and credit measures that are among the weakest of competitors we rate all work against these strengths. The company was founded in 2001. In 2012, the Sumitomo Mitsui Financial Group Inc. (SMFG) acquired SMBC from the Royal Bank of Scotland. As of Dec. 2, 2014, the company's fleet consisted of 283 owned and 94 managed aircraft, with an order book for 218 aircraft through 2022. We characterize SMBC Aviation Capital's business risk profile as "satisfactory," its financial risk profile as "significant," and its liquidity as "adequate" under our criteria.

We believe SMBC Aviation Capital's fleet is relatively young, at an average age of 4.6 years, and is concentrated heavily on aircraft models that should enjoy strong demand and resale liquidity. Competitors in the second tier of aircraft lessors include Babcock and Brown Air Ltd. (including Fly Leasing Ltd.), Aviation Capital Group Corp., CIT Aerospace International, AWAS Aviation Capital Ltd., BOC (Bank of China) Aviation Ltd., Air Lease Corp., Aircastle Ltd., and Avolon Holdings Ltd. The fleets of each of these companies is, however, much smaller than those of GE Capital Aviation Services and AerCap Holdings N.V. (after its May 2014 acquisition of International Lease Finance Corp.), in terms of both the number and value of aircraft.

SMBC Aviation Capital's fleet consists of popular and liquid (in resale and release markets) aircraft. Based on net book value, narrowbodies comprise about 98% of the total (A320 family and Boeing 737-800s). The 4.6 year average age of the fleet is among the youngest of the aircraft lessors, which tend to average five to eight years old. The average remaining lease term of 5.5 years is in line with most other aircraft lessors. In our opinion, the airline customer base is less diversified geographically than those of other aircraft lessors. Based on net book value, SMBC Aviation Capital leases about 45% in Europe, about 28% in Asia-Pacific, about 15% in South America, about 7% in North America, and about 4% in Africa and the Middle East. The company's order book consists of 218 aircraft through 2022, including Boeing 737-800s and 737-800 MAXs (successor to the current technology Boeing 737s) and Airbus A320s and A320 neos (successor to the current technology A320s).

SMBC Aviation Capital has funded its growth through debt and equity contributions from its parent. The company's credit metrics are among the weakest of its peers we rate similarly. For the fiscal year ending March 31, 2014, SMBC Aviation Capital's funds from operations (FFO) to debt was 8% (at the low end of the typical 8%-10% range for its rated peers), but EBITDA interest coverage was 3.4x (in line with the average of about 3x for its rated peers). The company's debt to capital was 84.6%, the highest of its rated peers. We currently rate all aircraft lessors in the 'BB' or 'BBB' category. Although we expect the company to continue to add a substantial amount of debt to fund its capital spending plans, we also expect increased revenues, earnings, and cash flow that the company generates from the additional aircraft to result in relatively stable credit metrics through 2016. Similar to other providers of transportation equipment operating leases, SMBC Aviation Capital is more highly leveraged than a typical industrial company with the same rating; thus, credit metrics tend to be weaker. The company is able to support higher leverage because of its relatively stable cash flow, ability to scale back capital spending in response to cyclical downturns, and ability to use asset-based financing for equipment.

We consider SMBC Aviation Capital strategically important to its parent company under our Group Rating Methodology, and thus rate it three notches higher than its stand-alone credit profile of 'bb+'.

Liquidity

We characterize SMBC Aviation Capital's liquidity as adequate. As of March 31, 2014, including all its entities, the company had $407 million of unrestricted cash, access to its revolving credit facility, and funding from its parent to finance new aircraft deliveries.

Principal liquidity sources:

- Cash;
- Internally generated funds;
- Access to its revolving credit facility to fund new aircraft purchases;
- Access to funding from its parent;
- Proceeds from aircraft sales; and
- Potential capital markets transactions.

Principal liquidity uses:

- Debt maturities; and
- Capital expenditures for new aircraft, both committed and opportunistic.

Outlook

The stable outlook reflects our expectation that SMBC Aviation Capital's credit metrics will remain relatively consistent through 2016, with strong earnings and cash flow offsetting incremental debt to finance new aircraft. We expect FFO to debt to remain about 7%-8% and debt/capital to be approximately mid 80%.

Downside scenario

While not likely, we could lower ratings if FFO to debt declined to below 6% for a sustained period of time. This could be caused by global economic weakness, resulting in weaker demand for aircraft, which would likely put pressure on lease rates and cash flow, or by reduced support from its parent, SMFG.

Upside scenario

We don't consider an upgrade likely over the next two years until FFO to debt approaches 10% for a sustained basis, or SMFG chooses to operate SMBC Aviation Capital at a lower level of leverage.

Related Criteria And Research

Related Criteria

- Liquidity Descriptors For Global Corporate Issuers, Jan. 2, 2014
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013

- Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- Business Risk/Financial Risk Matrix Expanded, Sept. 18, 2012
- 2008 Corporate Criteria: Analytical Methodology, April 15, 2008

Related Research

For Transportation Equipment Lessors, Multiyear Leases Aid Cash Flow and Ratings Stability, Oct. 18, 2006

Ratings List

New Rating

SMBC Aviation Capital Ltd.	
Corporate Credit Rating	BBB+/Stable/--

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