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Research Update:

SMBC Aviation Capital Ltd. Rating Raised To 'A-' On Shareholder Contribution, Removed From CreditWatch; Outlook Stable

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Rating Action Overview

- With the $1 billion shareholder contribution received on Nov. 28, 2018, Dublin-based aircraft lessor SMBC Aviation Capital Ltd.'s (SMBCAC) debt to capital declined to the high-60% area from the high-70% area. We expect it to remain within the company's stated leverage target of 75% debt to capital over the next few years.
- On Nov. 29, 2018, S&P Global Ratings raised its ratings on SMBCAC, including raising the issuer credit rating to 'A-' from 'BBB+', and removed all ratings from CreditWatch with positive implications, where they were placed on Nov. 26, 2018.
- The stable outlook reflects our expectation that the company's EBIT interest coverage and funds from operations (FFO) to debt will remain fairly consistent through 2020, based on relatively stable earnings and cash flow and modestly increasing debt to fund new aircraft deliveries. We expect EBIT interest coverage to remain around 2x, FFO to debt to remain around 9%, and debt to capital to increase to the low-70% area from the high-60% area at the time of the capital contribution.

Rating Action Rationale

Although SMBAC has one of the youngest (weighted-average age of 4.4 years as of Sept. 30, 2018) and most liquid aircraft portfolios in the aircraft leasing industry, its debt-to-capital ratio had been weaker than that of other aircraft lessors with similar businesses. The $1 billion additional capital from shareholders, comprising $700 million of equity and a $300 million subordinated loan, will be used for opportunistic growth and to fund committed aircraft deliveries. The company is jointly owned by Sumitomo Mitsui Financial Group Inc. (SMFG) and Sumitomo Corp.

The capital contribution has resulted in the company's debt to capital declining to the high 60% area from the high 70% area. We expect it to remain within the company's stated leverage target of 75% debt to capital over the next few years. As a result, we raised the stand-alone credit profile (sacp) for SMBCAC to 'bbb-' from 'bb+', in line with 'BBB-' rated aircraft lessors. However, the company's status as strategically important to its shareholders results in an issuer credit rating of 'A-', three notches higher than the sacp. The company's sacp is in line with 'BBB-' rated aircraft lessors.

The primary leasing vehicle between both companies, Sumitomo Mitsui Finance and Leasing Co. Ltd. (SMFL), became a 50/50 joint venture compared with the previous 60 (SMFG)/40 (Sumitomo Corp.). SMFL will now retain a 68% ownership stake in SMBCAC and Sumitomo Mitsui Banking Corp. (SMBC) 32%.

SMBCAC is among the largest mid-tier aircraft lessors, but significantly behind market leaders AerCap Holdings N.V. and GE Capital Aviation Services (GECAS). As of Sept. 30, 2018, the company owned 231 aircraft and managed 191, and had 241 aircraft commitments (including those on order and through sale/leasebacks). As of Sept. 30, 2018, based on net book value, the company's fleet comprised Airbus A320 family aircraft (40%) and A350 widebodies (12%); and Boeing 737 family aircraft (38%) and 787-8 widebodies (9%), all among the most liquid aircraft. Aircraft on order are scheduled for delivery through 2023 and include all new technology Airbus A320neos and Boeing 737MAXs. There is healthy demand for these modern-technology aircraft, which will put SMBCAC in a good position to negotiate favorable lease terms and, in some cases, to place other less desirable planes in its fleet in package deals with airline customers.

SMBCAC's weighted-average remaining lease term was 6.6 years as of Sept. 30, 2018, in line with that of other aircraft lessors. We see this as an advantage in that it provides long-term revenue and cash flow visibility. Generally, an aircraft lessor that takes delivery of a newly manufactured plane can place it with an airline on a fairly long-term lease (often 8-12 years). However, such orders also entail large and costly commitments, requiring ongoing access to a variety of funding sources, from which SMBCAC benefits.

SMBCAC has a diverse customer base, and such geographic diversity provides useful market intelligence about airlines' aircraft needs and helps a lessor shift planes from countries or regions where airlines are struggling to stronger areas. Based on net book value as of Sept. 30, 2018, the company is well diversified globally, with the largest exposure generated from customers in Asia (42%), Europe (31%), and the Americas (27%). This distribution is fairly typical for aircraft lessors.

Outlook

The stable outlook reflects our expectation that the company's EBIT interest coverage and FFO to debt will remain fairly consistent through 2020, based on relatively stable earnings and cash flow and modestly increasing debt to fund new aircraft deliveries. We expect EBIT interest coverage to remain around 2x, FFO to debt around 9%, and debt to capital to increase to the low-70% area from the high-60% area at the time of the capital contribution.

Downside scenario

While not likely over the next two years, we could lower our rating if FFO to debt declines to below 6% for a sustained period. This could be caused by global economic weakness, resulting in weaker demand for aircraft, which would likely pressure lease rates and cash flow, or by large debt-financed acquisitions.

Upside scenario

We do not consider an upgrade likely over the next two years unless FFO to debt approaches 13%, while debt to capital is maintained below 70% on a sustained basis. This could be driven by stronger than expected demand and higher lease rates.

Company Description

Dublin-based SMBC Aviation Capital is an aircraft operating lease company, providing medium-term (typically 5-12 years) leases of commercial aircraft to airlines worldwide.

Our Base-Case Scenario

Assumptions

- Global GDP growth of 3.9% in 2018 and 3.7% in 2019;
- Global air traffic growth of more than 5% annually;
- Fleet growth due to delivery of committed aircraft orders, partly offset by aircraft sales to maintain its young fleet age;
- Relatively stable lease yields (rental revenues divided by flight equipment under lease) of around 10% through 2020; and
- The $1 billion shareholder contribution received on Nov. 28, 2018.

Key Metrics

- EBIT interest coverage around 2x.
- FFO to debt around 9%.
- Debt to capital in the high-60% area in 2019, increasing to the low-70% area thereafter.

Liquidity

We assess SMBCAC's liquidity as strong. Although we believe that the company's sources will likely be around 3x its uses over the next two years, we don't believe the company has the likely ability to absorb high-impact, low-probability events without refinancing. However, we do believe it would maintain enough liquidity to exceed needs even if EBITDA declines by 30% and that it has prudent risk management.

Principal liquidity sources:

- $240 million unrestricted cash as of March 31, 2018;

- FFO of more than $700 million a year;
- Availability under its various credit facilities from its shareholders and other banks;
- The $1 billion shareholder contribution;
- Potential proceeds from bond issues; and
- Potential proceeds from aircraft sales.

Principal liquidity uses:

- Debt maturities around $400 million in 2019 and around $600 million in 2020; and
- Committed capital spending around $2 billion a year.

Issue Ratings - Subordination Risk Analysis

Capital structure

SMBCAC's capital structure primarily consists of senior unsecured debt, mostly issued at the parent level.

Analytical conclusions

Its unsecured debt is rated 'A-', the same as the issuer credit rating, as no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

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-

Modifiers

- 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)
- Group or government influence: Strategically important (+3 notches)

Related Criteria

- 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
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Group Rating Methodology, 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; CreditWatch/Outlook Action

	To	From
SMBC Aviation Capital Ltd.		
Issuer Credit Rating	A-/Stable/--	BBB+/Watch Pos/--
SMBC Aviation Capital Finance DAC		
Senior Unsecured	A-	BBB+/Watch Pos

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.