Closed-End Aircraft Funds
Quo Vadis A380?

In Germany over EUR 1.6bn has been invested in closed-end funds with Airbus A380 aircraft as assets. The first leases agreed with airlines are due to expire shortly. It will then become clear whether the A380 was a good investment or not. Prices for A380 funds on the secondary market do not inspire great optimism, with investors facing large discounts on nominal value.

The aviation industry is booming, the number of passenger-kilometres flown is rising steadily and the production of new aircraft is almost at full capacity. Aside from buying shares directly in the manufacturers or airlines, the main option for retail investors seeking to take part in this growing sector is to invest in closed-end aviation funds.

For many years, aircraft were among the most popular assets for closed-end investments. From 2006 to 2016, 70 aircraft funds with a combined equity volume of around EUR 3.2bn were launched. Investment stood at EUR 7.6bn, and 86 aircraft were purchased.

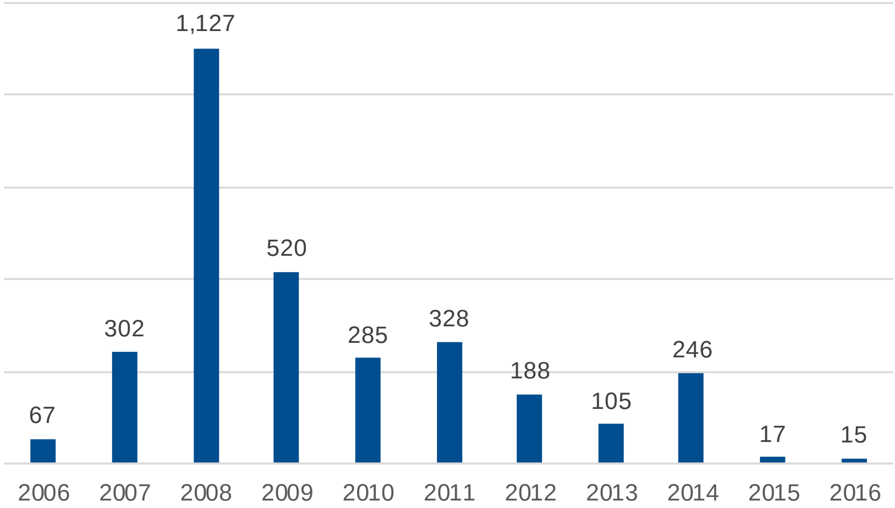
From 2006 to 2010, aircraft investment was especially popular among issuers and investors: over 70% of equity issued since 2006 occurred during these five years. 2008 was a record-breaking year, with over EUR 1bn in equity issued (see Figure 1).

Almost no issuance activity for aircraft AIFs at present

In the past two years issuance activity has almost come to a standstill. The general market slump in closed-end alternative investment funds (AIFs) has also taken its toll on aircraft funds.

But there are signs of a closed-end AIF revival. Now, however, distributors are offering mainly mixed-risk funds investing in several assets – for the aircraft sector, such a concept is generally only realised via funds with very large volumes. Such volumes require considerable pre-financing, a risk that many issuers are not willing to take right now.

Figure 1: Issuances of closed-end aircraft retail funds (equity volume issued in EUR m)



Source and chart: Scope Analysis

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Over half of investor capital directed towards the A380

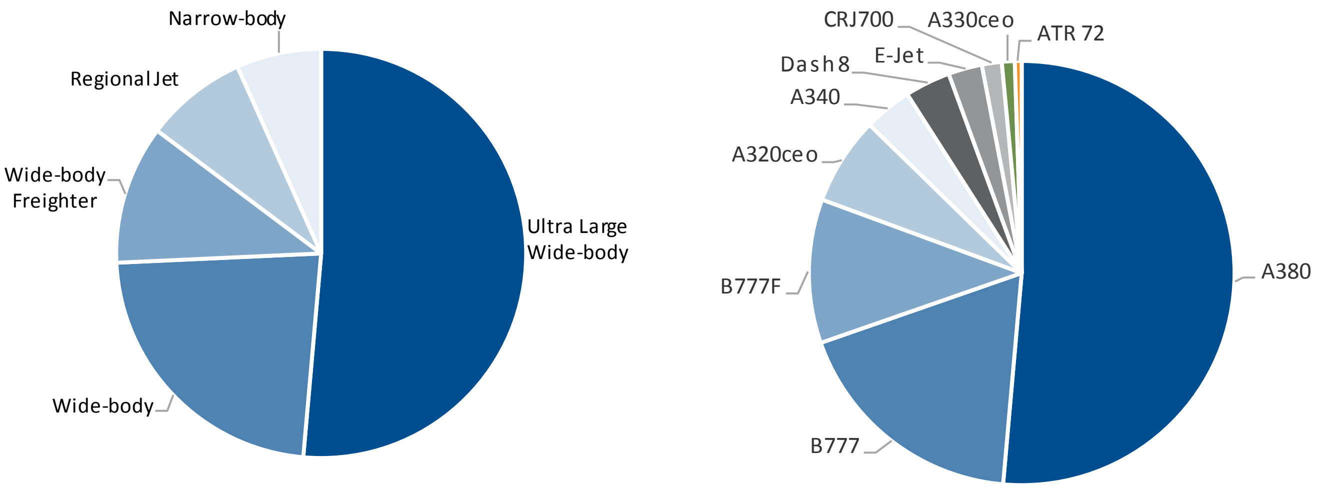
From 2006, issuances had one striking feature – the Airbus A380 was at centre-stage. A total of 20 funds raised EUR 1.6bn in equity capital, which was then used to finance 21 A380 aircraft.

Around EUR 1.6bn in equity capital directed towards A380 funds

Therefore, in the last ten years more than half of retail investments in German aircraft funds were devoted to the A380 (see Figure 2). Relative to the role played by the A380 in global aviation, German investors have allocated a much higher share.

The question is whether the world's largest passenger aircraft was a good investment and whether this focus will pay off for German investors. Although it is still too early to provide a definitive answer, there are clear indications.

Figure 2: Equity issued from 2006 to 2016 according to aircraft size and family



Source and charts: Scope Analysis

Steady yields – high payouts

The yield on a closed-end aircraft fund is essentially derived from two sources: i) the income generated from aircraft leasing, and ii) the disposal of the asset once the fund matures.

Long-term leases with established airlines

All the funds have leased the A380 to large, established airlines such as Air France, Emirates and Singapore Airlines. The leases were agreed for a period of at least ten years.

So far, this strategy has served investors well. None of the lessees have defaulted and all lease payments have been made. Also, under normal circumstances no defaults are anticipated for the remaining term of the leases.

This results in high pay-outs both in the past and future: 7-8.5% each year over 10 years, meaning investors have already recouped most of their capital.

In addition, the loans used to finance the aircrafts' purchase will have largely been repaid after 10 years. Therefore, once leases have expired, the aircraft will practically be the unencumbered property of investors.

A380 fungibility dampens performance expectations

Alongside recurring income, disposal proceeds represent a decisive performance factor. If the A380 can be sold at a good price upon the lease's expiry, investors will receive a high final pay-out. (Alternatwively, it may be possible to agree to a follow-up lease at favourable terms). Failing this, anticipated yield targets will not be met and investors may even make losses.

Liquid secondary markets for the A320 and Boeing 737 …

The sale of used aircraft stands or falls on its fungibility. Fungible models are chiefly characterised by a broad operator base, i.e. they can be used by numerous airlines. A brisk second-hand market exists for the most fungible models like the A320 or Boeing 737. Almost every airline operates these models. The secondary market is just as liquid.

… but not yet for the A380

This does not apply for the A380. Meanwhile, by now around 200 such models have been delivered by Airbus. The market for used A380s is still to develop as the first leases are yet to expire. How much a used A380 can be sold for will only become clear with the first transaction.

The fungibility of the world's largest passenger plane is curtailed by one other aspect: only few airlines are willing customers. Currently just 13 airlines are flying the A380 and have the personnel to operate them. Whether more airlines will be using the A380 in future is still in doubt.

Adding to this is the uncertain future of the A380 itself. Its customer base is stagnating, and production is expected to reduce from only 12 in 2018 to eight in 2019.

Some A380 funds are heavily discounted

There have been increasing reports of late that airlines operating the A380 will not extend current leases. This will immediately affect many fund investors, as this lessens the chance that aircraft can be let or sold at good conditions once the first leases expire.

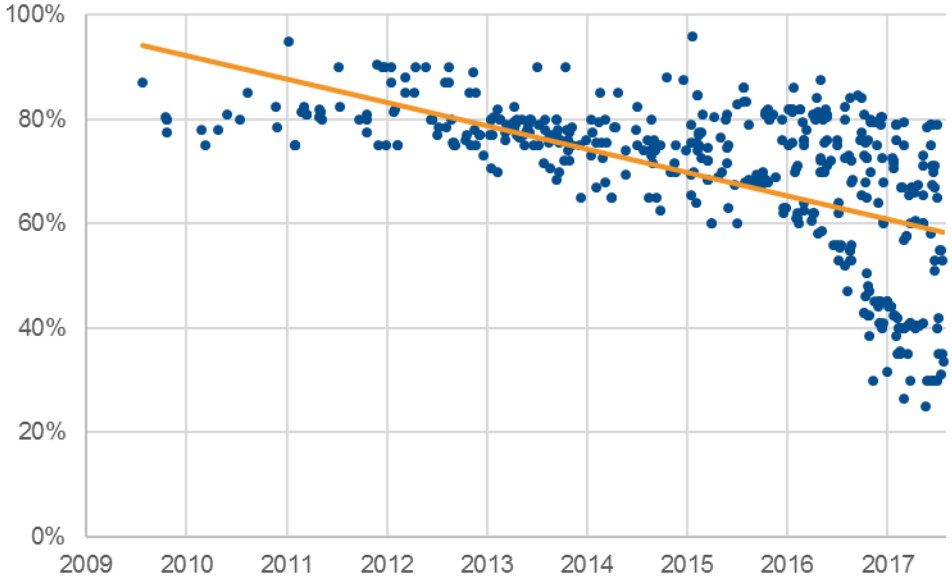
Figure 3 shows investor expectations and the weakening prospects for the A380. Between 27 June 2009 and 24 July 2017, 475 fund shares were traded on Fondsbörse Deutschland, a secondary market in Germany for closed-end funds.

Average rate this year is around 50%

The orange line represents the trend in average fund price over the period in question: around 80% of nominal value during 2009-2012, sinking to 66% in 2016, to just over 50% this year. (Note: discounts of up to 20% on the secondary market are the norm even if the fund performs in line with its prospectus.)

It is worth noting that many funds whose assets are nearing the end of their initial lease terms have had to accept very high discounts on nominal value, trading at just 25% – a discount of 75%. In other words, many investors are viewing the A380's prospects after the normal 10-year lease period as uncertain or even negative.

Figure 3: Price history, A380 funds



Source: Fondsbörse Deutschland Beteiligungsmakler AG; Chart: Scope Analysis.

Conclusion: yields fall short – but losses are unlikely

So far, the A380 has not lived up to expectations and its market acceptance is not meeting forecasts. This is bad news for closed-end fund investors. Over the next few months the fund's first leases will expire. This will indicate whether and under what conditions leases will be extended, whether aircraft will be sold, or, in the worst case, whether the A380 will only be used as spare parts.

Up until now, the leasing income of all A380 funds have been in line with prospectuses and investors have received high annual pay-outs. However, once the normal 10-year lease term ends, prospectus targets are unlikely to be reached. From the beginning, the A380 fund concept wagered that these aircraft would be received well on the market. The bet does not seem to be working out, however, as indicated clearly by transactions on Fondsbörse Deutschland.

Even so, the pay-outs made so far means investors will most likely not make losses, even if disposal proceeds prove disappointing. For example, if an A380 is sold for only 50% of the original price, a positive yield is still very likely on the investment.

However, the yields envisaged in the prospectus will clearly miss the mark. They can only be achieved if the aircraft are leased for another five to eight years at favourable terms, or sold at a high price. Right now, both scenarios are looking unlikely.

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