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Fight or Flight? Two Deep Value Investments While Air Travel is Grounded

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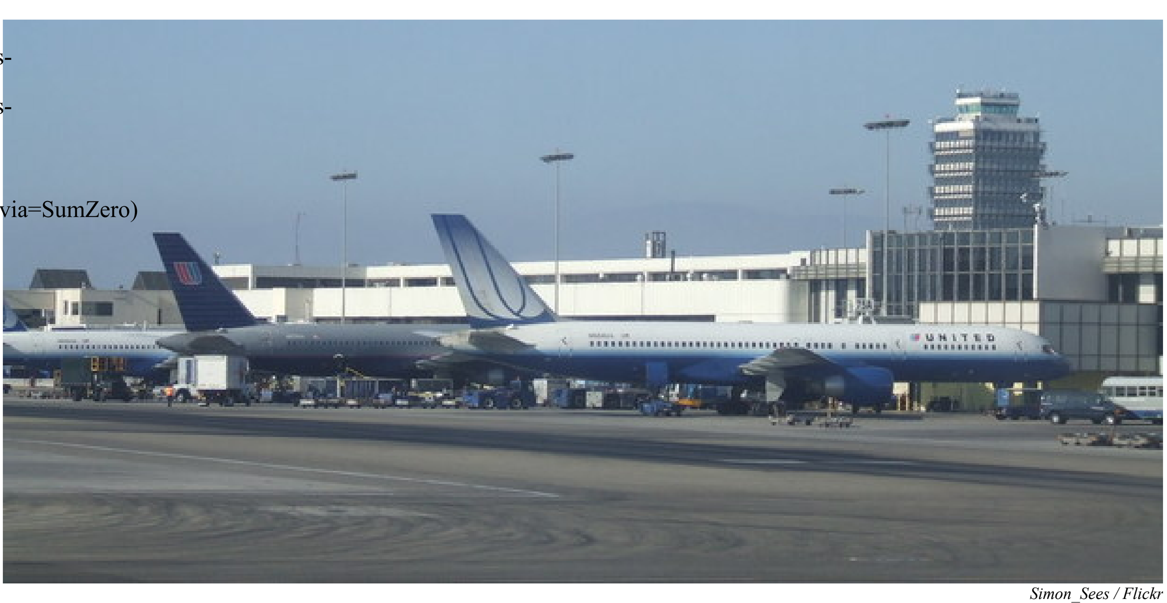

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As the COVID19 virus continues to disrupt the market, contributing to the historical plunge that briefly halted trading on Monday, March 9th and again on Thursday, March 12th, some portfolio and fund managers are looking to the skies for deep value investments. No, they're not experiencing religious epiphanies: they're proselytizing the virtues of buying into various aspects of air travel while the industry – and the market – remains grounded both by uncertainty and the travel ban enacted on March 11th barring incoming flights from Europe. While others steer clear, these investors see opportunities in what some argue amounts to a fear-driven markdown on otherwise strong companies: companies that they believe will make a comeback.

SumZero Manager Commentary

Featuring: David Deuchler (https://sumzero.com/pro/members/profiles/61 (Gilmartin Group) on United Airlines (https://sumzero.com/pro/research/ideas/18427 & Eric Gregg (https://sumzero.com/pro/members/profiles/112 (Four Tree Island Advisory (https://sumzero.com/pro/cap-intro/funds/four-tree-island-advisory-llc)) on AerCap Holdings (https://sumzero.com/pro/research/ideas/13685

United Airlines: Value for the Intrepid Investor

Among those opportunity-spotters is SumZero contributor **David Deuchler (https://sumzero.com/pro/members/profiles/6116#/)**, Managing Director at the Gilmartin Group, who spent half of his twenty year investing career at Goldman Sachs Asset Management. Deuchler's recently-penned long idea on United Airlines (UAL:US) (https://sumzero.com/pro/research/ideas/18427), which has slipped over 45% in two months at time of writing, unpacks both his long-term vision for the company with a modest $80.00 price target over the next 1 - 2 years (UAL's 52-week high was $96.03 and was trading in the high 80s as recently as January) while also lending some insights and predictions for COVID19's effect on the market in the coming weeks. "Given the media, information flow, conjecture and financial leverage in the markets," Deuchler argues, "the markets no longer represent discounting of the future. They are a reflection of the current news cycle and of the immediate emotional response to group think. When today's news is much worse than medium term normal, buy stocks."

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Deuchler's elevator pitch is simple: forget about the immediate future as far as UAL's earnings and revenue expectations. "Coronavirus concerns," Deuchler writes, "have eliminated expectations for 2020." Noting the company's steep trading sell-off, withdrawal of 2020 guidance, and the cancellation of a March investor event, Deuchler reports that UAL has initiated a pricing strategy aimed at incentivizing travel as well as adopting cancellation policy changes that accommodate anxious travelers with ticket purchases through the end of March. He advises investors to "expect sentiment and economic activity to stabilize in 3Q 2020 with 2021 UAL EPS closer to $8-10, stock trades to 10x."

What this is not, Deuchler is quick to point out, is a short-term investment. Should things play out as he predicts – and short of the immediate deployment of a miracle cure, it's reasonable to believe that they will – UAL will likely have an exceptionally weak Q1 and Q2, keeping the price trading below $50.00. That doesn't matter, however. Deuchler's vision is that "over the next two years UAL can print somewhere between $8-10 and the stock will trade at 10-12x."

Whether you're intrepid enough to buy a discounted seat on a UAL flight or to use the market downturn as an entry point, the possibilities here are abundant.

Aercap Holdings: Market Leader Primed for Takeoff

Whether they're headed to Cleveland or Cairo, few passengers pause to wonder whether or not their carrier actually owns the plane taking them to their destination. As it turns out, it's a coin flip: according to the Centre for Aviation (https://centreforaviation.com/analysis/reports/aircraft-leasing-accounts-for-half-of-worlds-commercial-aircraft-fleet-lessors-shun-widebodies-404111), half of commercial aircraft are leased – not owned – by airlines. The number one leasing company in global aviation is Aercap Holdings, with 1035 aircraft serving approximately 200 airlines in 80 countries.

Spotting an entry point into AER is Four Tree Island Advisory (https://sumzero.com/pro/cap-intro/funds/four-tree-island-advisory-llc) founder and SumZero contributor **Eric Gregg (https://sumzero.com/pro/members/profiles/11233#/)**, whose research into the company suggests a deep value opportunity given its robustness under strain. "Stress testing an investment in AerCap in the context of Covid-19," Gregg writes, points to the company's desirability at an attractive price.

According to Gregg's long call on AER:US (https://sumzero.com/pro/research/ideas/13685):

"AerCap is currently trading 35% below its all-time high achieved a month ago, less than 60% of book value and at ~53% of likely 2020 YE book value. Given that AerCap could, in theory, liquidate its aircraft portfolio at least at book (if not a premium to book value) even in this environment, a huge discount to its book value makes its current valuation, seemingly ridiculous."

Keeping long-term risks as well as the market's behavior, Gregg raises some critical questions in assessing AER's value over the coming months. "Is AerCap likely to suffer a liquidity issue that could force it to impair the value of its assets? Or is the market just trading algorithmically/technically and not appreciating the fundamental differences between AerCap and its customers (the commercial airlines)?"

Liquidity, he finds, is not a problem. Citing the company's Q4 ER, Gregg writes that "AerCap has, as of YE 2019, 1.5x the liquidity it needs to cover all debt and capex obligations over the next 12 months."

"This suggests that AerCap has $3.9 billion more liquidity than it needs over the next year. Notably, even AerCap's cash flow were to be cut by 50% vs. AerCap forecasts (highly unlikely), AerCap would still have $2.3 billion of excess liquidity over the next 12 months."

"If AerCap's operating cash flow were cut to $0 (just not happening), the Company would still have $800mm of excess liquidity beyond its obligations for 2020. This excess liquidity is a tremendous asset in this environment. It should allow AerCap to buy aircraft, order new aircraft, step in and do sales leaseback activity at a time when many struggling airlines need liquidity or buy highly undervalued AerCap stock."

But what about the obvious weak link in AER's business model: the airlines themselves? Concentrated contracts or a lack of diversification in the company's portfolio, particularly in these turbulent times, could pose a major threat to AER in the form of airlines going bankrupt. Gregg addresses this in analyzing the company's airline contracts, looking for any potential weak links that could potentially leave them without a customer. In this case, AER's strength is actually derived from a small, but significant, concentration of contracts with Chinese airlines. This kind of relationship, as you may recall, is one of the strengths of Chinese eCommerce firm JD.com (https://sumzero.com/headlines/technology_and_software/JD:US/462-jingdong).

"18.7% ofAerCap's 2019 lease revenues were from China and 'approximately two-thirds of {AerCap's} revenue comes from the big three state-owned carriers' per AerCap's CEO on the most recent earnings call. As it would seem highly unlikely that China would let any of its big three state owned carriers go bankrupt, allowing those carriers to defer rents a month or two seems like smart business and is likely to be highly beneficial to AerCap's market position in China over the long-term. So on 12-13% of AerCap's lease book it should be assumed that rents will be deferred for a month or two, but that bankruptcies are unlikely on those that AerCap is likely to allow some lease payment deferral."

Nevertheless, Gregg remains cognizant of the challenges airlines currently face, stating forthrightly that "we may be shifting to an industry that's overly long aircraft relative to what's needed to satisfy near-term, shrinking air traffic demand. This is likely to have three impacts on AerCap: 1) the disruption this virus is causing global air travel is likely to accelerate the bankruptcies of any already poorly operating carriers and possibly some previously soundly run carriers (flybe the domestic UK carrier declared bankruptcy on 3/5 – AerCap doesn't lease to flybe) 2) placing the aircraft that come out of bankruptcies is likely to take longer than it would have in a normal operating environment and 3) the prices AerCap achieves for the sale of mid-life aircraft are likely to decline from their previously attractive levels (typically 5-10% premiums above AerCap's conservative marked book values for their aircraft)."

With those challenges in mind, Gregg's thesis, like Deuchler's, is that the COVID19 outbreak is an idiosyncratic and transient variable particularly affecting the airline and travel industry. While each day brings cause for concern, it's worth remembering that there are thousands of the world's most highly-trained researchers and scientists working tirelessly for a cure. For SumZero's buyside professionals, every obstacle presents an opportunity. Rather than casting their lot in with fatalists and doomsayers, they are expounding the virtues of buying with an eye on a horizon beyond the next anxiety-stricken headline.

Stay tuned for more COVID-related coverage from the SumZero community and if interested in a warm introduction to Deuchler or Gregg, please reach out to the SumZero team (mailto:access@sumzero.com).

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