Babcock & Brown Air Limited Q4 2007 Earnings Call Transcript

posted on: March 26, 2008 | about stocks: FLY

Babcock & Brown Air Limited (FLY)

Q4 2007 Earnings Call Transcript

March 26, 2008 9:00 am ET

Executives

Matt Dallas – IR Manager

Colm Barrington – CEO

Steve Zissis – Chairman, CEO Babcock & Brown Aircraft Management

Gary Dales – CFO

Analysts

Analyst for Mike Linenberg – Merrill Lynch

Daniel McKenzie – Credit Suisse

Rick Shane – Jefferies & Co.

Doug Smith – Fire Tree

Presentation

Operator

Good morning. My name is Tamika and I will be your conference operator today. At this time I would like to welcome everyone to the Babcock & Brown Air fourth quarter 2007 earnings results conference call. (Operator instructions). Thank you Mr. Dales you may begin your conference.

Matt Dallas

Good morning everyone, I'm Matt Dallas and I'm the Investor Relations Manager with B&B Air, Babcock & Brown Air Limited which we will refer to as B&B Air or the company throughout this call. The company's 2007 Q4 and yearend earnings release was issued this morning and it is posted on the company's website at www.babcockbrownair.com. Representing the company on this call are Steve Zissis, Chairman, Colm Barrington, Chief Executive Officer, Gary Dales, Chief Financial Officer and Wesley Dick, Head of Capital Markets for Babcock & Brown Aircraft Management.

I will start by reading the following Safe Harbor statement. This conference call contains forward looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward looking statements may be identified by words such as expects, intends, anticipates, plans, believes, seeks, estimates, will or words of similar meaning and include but are not limited to statements regarding the outlook for the company's future business and financial performance.

Forward looking statements are based on current expectations and assumptions of B&B Air's management which are subject to uncertainties, risks and changes in circumstances that are difficult to predict. Actual outcomes and results may differ materially due to factors that are summarized in the earnings release and are described more fully from time to time in the company's filings with the SEC. We refer to each of these sources for additional information. B&B Air expressly disclaims any obligation to update or revise any of these forward looking statements whether because of future events, new information, a change it its views or expectations or otherwise.

This call is the property of B&B Air, any distribution, transmission, broadcast or rebroadcast of this call in any form without the express written consent of the company is prohibited. A replay of this call is available from today, Wednesday March 26 until Midnight Wednesday April 9th, 2008. A webcast will be archived on the company's website for one year. I will now hand the call over to the company's CEO, Colm Barrington.

Colm Barrington

Thank you Matt and thank you everyone for joining us on this B&B Air's first earnings call. It's been approximately six months since the company completed its initial public offering, private placement and aircraft leaseback securitization. Together these instruments raised total capital of more than $1.5 billion on October 2nd 2007. The proceeds from the offerings allowed us to establish the company, to purchase our initial portfolio of 47 aircraft and left us with more than $120 million of free cash to fuel our future growth. This cash along with a $1.1 billion aircraft acquisition facility that was closed on November 7th 2007 will enable B&B Air to purchase additional aircraft with an aggregate purchase price of $1.2 billion.

The additional aircraft funded by this facility will drive the growth of the company's distributable free cash flow per share. By year end 2007 we have grown our fleet by a further seven aircraft. In 2008 we have already acquired an additional five aircraft that has brought our total portfolio to 59. This represents a 26% increased on our initial portfolio. As a result of these acquisitions, our annualized lease rentals have increased from $153 million at the time of the company's IPO to a current annualized figure of approximately $216 million, an increase of 40%.

We expect that our cash flow will show similar rates of growth over this period. On January 14, 2008 the Board of Directors declared the company's first dividend of $0.50 per share and it was paid to shareholders on February 20th. Annualized, this dividend represents yields of approximately 14% on yesterday's closing share price. The company's Board of Directors has recently reaffirmed this dividend policy on the basis that it is sustainable in the long term. We expect to declare a similar dividend in April in respect of Q1 2008 with payment in May.

Now I'd like to provide you with an overview of the two financing arrangements that currently provide funding for B&B Air's fleet of 59 aircraft and which will support our future growth. The company priced an $853 million securitization in August 2007 at a narrow credit spread over the relevant interest rate benchmarks. This financing provides the company with attractive debt for its initial portfolio of 47 aircraft with little principle amortization being required until August 2012. The company also closed a $1.1 billion aircraft acquisition facility in November 2007.

When combined with more than $120 million of cash raised in the IPO, this facility allows us to acquire additional aircraft with an aggregate purchase price of $1.2 billion. This five year facility has a two year revolving period followed by a three year term period and is priced at attractive credit spreads. We've already drawn on this facility to fund the acquisition of 12 additional aircraft and $687 million of the facility is still available to us. As a result of our relatively long debt maturities and the stable cash flows from our portfolio, we have no immediate need to access the capital markets. However, the management team is looking at several funding possibilities that will allow us to avail of additional opportunities that may arise over the rest of the year.

Banks have been the most significant source of financing for aircraft during the last 30 years and they continue to play a major role in the sector. We've maintained a regular dialogue with this market's key players and are confident that the bank market is prepared to provide debt financing for aircraft such as the ones in our portfolio. While credit spreads on most aircraft debt have generally increased in the last few months, these higher spreads have been offset by declining base rates, leaving overall financing costs generally unchanged. B&B Air has benefitted greatly in its access to financing sources, from its association with Babcock & Brown and with Babcock & Brown Aircraft Management, which we refer to as BBAM, who together are regarded as industry leaders in aviation finance and operating leasing.

Babcock & Brown has 25 years of experience in aircraft finance and has acted as a financial advisor to leading airlines, lessors and manufacturers around the world. BBAM was founded in 1991 is now amongst the world's five largest aircraft operating lessors. The B&B Air portfolio has been forming at or above expectations since the time of the IPO. BBAM has remarketed all our 13 aircraft that were up for renewal in 2007 and 2008 at rentals which are in aggregate 22% greater than rentals earned under the previous leases.

We also expect to see increases in rentals from the four remarketing events that we have in 2009. So the combination of long maturities on our debt, available financing capacity, prospects for additional funding and significant free cash generation from our 59 aircraft positions B&B Air well to continue paying its dividends at the current level over the long term and to grow its distributable cash flows over time to investments in additional aircraft. So now I'd like to hand you over to Steve Zissis, our Chairman and the CEO OF BBAM to give you some perspectives about our interest environment.

Steve Zissis

Thank you Colm. Demand for aircraft remains strong. According to Ascend, the appraisal and forecasting company, in 2007 the manufacturers received orders for over 3,100 jet aircraft as compared to 2,100 in 2006. Meanwhile the supply remains tight with Airbus and Boeing being sold out in most of their lines for over four years from now. Delays in the production of aircraft such as the A380 and the 787 have exacerbated the tight demand supply relationship. This has been positive for aircraft lessors with lease rates continuing to increase.

Demand for leased aircraft from airlines in emerging markets where B&B Air has significant exposure continues to be strong so far and has been resilient to the economic slowdown in the US. The airline industry in the US has been adversely impacted by high fuel prices and the economic slowdown. We are concerned about a possible spillover from the US economic and financial market conditions to other countries. But so far we haven't seen any impact. Increased demand for air travel from growing middle classes in emerging markets such as China, India, Russia and Eastern Europe is one of the significant factors that is helping to keep demand strong.

We expect that this will be a continuing trend rather than a short term cycle. In many countries, the easing of regulations and declining protection for state owned airlines has encouraged the emergence of new privately owned airlines, many of them low cost carriers. This has been a further stimulus to growth in these markets. Airlines operating in these economies have also been protected from higher US dollar denominated aircraft costs, lease rentals and fuel costs by the decline in the value of the US dollar. [Less usable and to] sign up for leases early for longer terms and attractive lease rates. As Colm has mentioned, the re-lease or extension of all 13 aircraft in the B&B Air portfolio whose leases expired by their terms in 2007 and 2008 have been at aggregate rentals that are 22% higher than the rentals under the previous leases.

In addition to these generally positive market conditions, we think it's likely that there will be increasing opportunities for well capitalized companies to benefit from sales of aircraft by airlines and lessors that are driven by the current difficult capital and financial markets. This is one of the other reasons why we are positive about the prospect for well capitalized companies such as B&B Air to increase its fleet and cash flow. All in all, the long term outlook for aircraft leasing and for B&B Air looks positive. I'll now turn the call over to Gary Dales who will provide a review of the financials.

Gary Dales

Thank you Steve. Our financial statements cover the period from our incorporation on May 3rd 2007 through the end of the calendar year. We also present our results for the fourth quarter whose operations effectively began on October 2nd, the date we completed our IPO. During the fourth quarter we generated revenues of $33.3 million. These revenues consist of $26 million of operating lease revenue, $2.4 million of direct finance lease revenue and $4.9 million of interest income.

The fourth quarter lease revenue of $28.4 million reflects on average two months of revenue from 45 of the 47 aircraft in our initial portfolio and lease revenue from the seven additional aircraft we acquired in the fourth quarter. Even though we did not recognize revenue on the aircraft until they were actually delivered to the company, we did receive the economic benefit of all 47 aircraft included in the initial portfolio beginning on October 2nd, the date of the closing of our IPO. Had we recognized a full quarter of lease revenue associated with the additional portfolio, our total lease revenue would have increased by $14.6 million to a total of $43 million.

The interest income of $4.9 million results from investing our cash balances. The proceeds of the IPO and the securitization were received on October 2nd but as previously mentioned it took on average one month to actually transfer the aircraft included in the initial portfolio. In the interim, the cash balances were invested and generated the $4.9 million of interest income. We expect that future quarterly interest income reported by B&B Air will be less than that reported for the fourth quarter of 2007. Offsetting the revenues are $27.6 million of expenses. Interest expense of $14.6 million is the largest component of the total expenses.

Interest expense includes interest on our $853 million securitization notes, interest on the outstanding borrowings under the aircraft acquisition facility and amortization of loan issue costs and debt discounts. It is the company's policy to minimize interest rate risk and we have entered into financial contracts that fix the rate of interest on debt associated with leases that have fixed rental terms. Depreciation expense is approximately $8.6 million and again represents approximately two months of depreciation on the initial portfolio. Selling, general and administrative expenses include the fees paid to our servicer and our manager and other administrative costs of operating B&B Air.

As you are aware, we use an outsource management model whereby the management of B&B Air and the servicing of our leases are provided by subsidiaries of Babcock & Brown. This arrangement leads to a contractual and highly predictable cost structure for the company. Servicing and management fees amounted to approximately $2.9 million. The balance of SG&A expense consists of costs of running B&B Air and its subsidiaries. I should point out however that SG&A expense for B&B Air does not include many of the overhead items that you might expect to see. For example, all management salaries, the company's IT expenses, facilities charges and most other overhead items are shouldered by Babcock & Brown as part of the management agreement.

Income tax expense for the fourth quarter was $1.3 million and reflects a rate that is greater than the Irish tax rate on trading income of 12.5% due to the fact that certain investment income is taxed at a non trading rate of 25%. We expect our non trading investment earnings will not be as great in future quarters and our effective tax rate will decline. At December 31st 2007 B&B Air had approximately $1.6 billion of total assets by book value which includes approximately $1.4 billion invested in aircraft under lease. Total liabilities at December 31st 2007 were approximately $1.1 billion and shareholder's equity was approximately $500 million.

Included in the liabilities are the $853 million of notes payable issued in connection with our securitization and $133 million of borrowings under the aircraft acquisition facility. The securitization notes were issued on October 2nd, 2007 and are non-amortizing until August 2010 when approximately $1 million of principle is due monthly. Beginning in August 2012, the net lease revenues from the 47 underlying leases securing the notes is required to be used for principle amortization after payment of interest and certain expenses. We expect to refinance the notes prior to August 2012, although final maturity is not until 2033. The aircraft acquisition facility we entered into on November 7th features a two year revolving period followed by a three year term period. At December 31st 2007 $133 million was outstanding under this facility.

Through today, $417 million has been borrowed under the facility leaving a remaining borrowing capacity of $687 million. Finally, upon your review of the financial statements, you may have noted our earnings per share for the quarter ending December 31st 2007 is less than the earnings per share for the full period, despite fourth quarter earnings being greater than total earnings. This results from the methodology of computing the weighted average shares outstanding.

For the fourth quarter, the 33.6 million shares we issued on October 2nd are considered outstanding for 91 of the 92 days in the quarter. Whereas in the period beginning on May 3rd 2007, the shares are considered outstanding for only 91 of the 243 days in this period. For purposes of earnings per share, the initial 1 million shares held by Babcock & Brown, our sponsor, are not considered in the EPS calculation. These shares were cancelled when the IPO completed. With that, I'll turn the call back to Colm for his closing remarks.

Colm Barrington

Thank you Gary. Before taking your questions I would like to add that we remain optimistic about B&B Air and its prospects. We have identified a broad range of aircraft acquisition opportunities and have the financing in place to fund these. Our existing assets are financed with long term debt with no near term maturities. We believe that our diversified portfolio of young, high demand aircraft allied to our global lessee base will allow us to maintain our dividend at current levels while we continue to grow the company's distributable cash flows through acquisitions. We're now ready to take your questions.

Question-and-Answer Session

Operator

(Operator instructions). And your first question comes from the line of Mike Linenberg from Merrill Lynch.

Analyst for Mike Linenberg – Merrill Lynch

This is actually Alex [unintelligible] on behalf of Mike. I guess my first question is, you know, given the record level of orders at Boeing and Airbus in 05, 06 and 07, you know there's definitely a view out there that aircraft values and maybe even lease rates are expected to plateau this year and maybe even go into a decline in 2009. Can you guys just comment on this view and what you guys are seeing out there?

Steve Zissis

Thanks, I missed your first name.

Analyst for Mike Linenberg – Merrill Lynch

This is Alex.

Steve Zissis

Alex, alright, thanks Alex. It's Steve Zissis. You know currently what we see occurring out there is that the underlying market is still very strong, especially for fuel efficient and newer type aircraft. We are seeing some weakening in the older aircraft. We should all note that B&B Air only has two of the older aircraft in their portfolio currently. But overall the market continues to be quite strong.

I mean we are a bit concerned about what is occurring in the financial markets and possible spillover to the main economy, especially the emerging markets. So we are keeping a close eye on what's happening there. But in terms of the underlying market, it's still very strong. I can tell you that at the BBAM level, we have over 43 order positions with Boeing and we placed all those order positions out to the first quarter of 2010 and the lease rates that we're receiving and the demand for those aircraft are still very strong.

Analyst for Mike Linenberg – Merrill Lynch

Okay, great and just quickly, could you just remind us of the fixed versus floating rates on your leases?

Colm Barrington

Approximately 75% of our initial portfolio is fixed rate leases and we have hedged the debt related to those aircraft, all of the debt related to those aircraft. The other 25% of leases are floating rate and we have floating rate debt matching those.

Analyst for Mike Linenberg – Merrill Lynch

Okay and then are you able to comment on the 12 additional aircraft that you've taken since the initial portfolio or?

Colm Barrington

What sort of comment would you like? We think they're great. We've very happy with the 12 acquisitions, they are all accretive to cash flow per share. And we think that the leases are good, they run out well into the future, we have some pretty good credits and all of the leases by the way are fixed rate leases and we have matched the funding to those leases.

Analyst for Mike Linenberg – Merrill Lynch

Okay, great, thanks very much.

Operator

Your next question comes from the line of Daniel McKenzie with Credit Suisse.

Daniel McKenzie – Credit Suisse

Good morning everybody. I'm just wondering if you could help investors understand the demand opportunities. You know to try to segment these opportunities, of the various buckets, which do you feel more confident about, which less confident? You know for example are re-fleeting needs a bigger opportunity or you know new startup airlines in emerging markets, is that the bigger opportunity? And then I guess just related to that, wondering if you could comment on what your view is with, or what your biggest worries are with respect to demand impediment?

Steve Zissis

This is Steve Zissis again, thanks Dan for the question. On the demand side, like I mentioned earlier, certainly on the new aircraft orders or the newish aircraft that we have in our fleet, the demand is really across the board, coming from Middle East, Russia, Eastern Europe, parts of China and Southeast Asia. And also aircraft that are available immediately, that is aircraft that are not subject to leases, we see quite strong demand in even in particular cases where prices for those aircraft, both in lease rate terms and purchase prices are above the appraised value in the current marketplace.

And that's just indicative of the kind of the pent up demand that's occurring in the spot market. If you look on the other side of the equation which is the aircraft that are subject to leases which is more of a financial instrument, we're actually seeing some quite good opportunities that are being driven by what we consider liquidity sales. There are quite a few people that got into this business who are not long term players that are looking to exit the business during this financial crisis and we're seeing prices trend down on those type of investments. So we're seeing good opportunities on both sides of the equation.

Daniel McKenzie – Credit Suisse

Okay, great, thanks and then a second question here, you guys have been at this a long time, 25 years, you know you guys have been through a couple of downturns, wondered if you could just help us understand how this cycle might differ from other cycles, either in terms of potential severity or potential non severity or any other perspective that you can provide.

Steve Zissis

Well I think the key thing to remember about this cycle is it's really being driven by two factors, one is that leasing is becoming, operating leases are becoming a bigger and bigger part of every airline's fleet planning opportunities. So if you go back ten years it was 20% of the market was leased aircraft and I mean now we're getting up to 30-40% and we expect that probably to reach 50% in ten years, so a bigger and bigger percentage of the world fleet is being leased.

And the second thing around is that demand is so broad, it's so international and it's not dominated by the western carriers that the demand pipeline if you will is much more dynamic than the prior cycles. So we think that if we do enter in to any softening it's going to be pretty shallow and temporary because I think the medium term to long term outlook is still very positive.

Daniel McKenzie – Credit Suisse

Okay, great, thanks a lot.

Operator

(Operator instructions). Your next question comes from the line of Rick Shane from Jefferies & Co.

Rick Shane – Jefferies & Co.

Good morning guys, thanks for taking my question. The numbers you gave, you have $687 million available on the acquisition facility. Given your current sort of pipeline in terms of what you're looking at in terms of additional acquisitions, how long do you think that $687 million lasts at this point?

Colm Barrington

Well Rick, this is Colm, as you know we've acquired about $500 million worth of aircraft in the first six months. We have $687 million of capacity left. If we keep our present pace of acquisitions going our funds will last us into 2009. Obviously in addition to the $687 million that we have, we are looking at other opportunities and as you are aware there is still a lot of bank debt available for aircraft acquisitions, so combined with free cash which we're generating and new facilities, we expect to be able to increase our funding capability and to fund our growth well into 2009.

Rick Shane – Jefferies & Co.

Got it and that's helpful. Obviously you guys have good capacity now, $687 million in getting through 2008 funding in place, what sort of timeframe should we and you know presumably to be conservative you're not going to run that to the limit, you'll have announcements of additional funding capabilities long before we get to that point, what's sort of your strategy in terms of getting that done, what sort of timeframe should we anticipate?

Colm Barrington

Well as I said, we've said form the start that we didn't envisage having to go back to the markets, particularly the equity markets until 2009. And that's still our strategy.

Rick Shane – Jefferies & Co.

Okay and could we expect announcements about bank deals along the way before you're tapped out on the $687?

Colm Barrington

I hope so, yes, we're certainly working on various opportunities right now Rick and I hope that we'll be able to announce something in the not too distant future.

Rick Shane – Jefferies & Co.

Terrific, great guys, thank you very much.

Operator

Your next question is from Doug Smith from Fire Tree.

Doug Smith – Fire Tree

Thank you for the call. This is just following up on Rick's question, I mean the fact that you do have $687 million of kind of acquisition capacity and you're looking for additional funding, does that imply that you're contemplating doing more than $687 million of acquisitions in the next year?

Colm Barrington

I don't think it implies that necessarily, what I think we've said is we have the $687 will carry us into 2009 and we hope to add to that $687 if we see very good opportunities during the remainder of this year, then we may accelerate the pace, but that's not our core plan right now. We will be opportunistic if we see good opportunities, obviously.

Doug Smith – Fire Tree

Okay and when do you, is there a point at which you think buying back your own shares is more attractive than buying a new aircraft?

Colm Barrington

Yes we are certainly looking at that amongst other possibilities.

Doug Smith – Fire Tree

Okay, thank you very much.

Operator

At this time there are no further questions, please go ahead for any closing remarks.

Matt Dallas

This is Mat Dallas, we would now like to conclude the call, we thank everyone for joining us and we look forward to updating you on the business all again soon.

Operator

Thank you for participating in today's conference, you may now disconnect.