

Improving Valuations

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Introduction

Dick Forsberg, Head of Strategy for Avolon, published a challenging [thought paper last year](#) assessing aircraft appraisers. I want to respond to Dick's thoughts wearing two hats – as the CEO of IBA, a leading aviation consultancy with some 30 years' appraisal experience and data, and as the current chairman of the ISTAT International Appraisers' Program. The timing is right for three reasons – Dick makes many excellent points that need to be kept front of mind as our industry develops; 2017 will likely be the most volatile market for years making appraisal opinion even more important; and Dick and I will debate our respective positions at the AFJ conference in Dublin and this serves as a prelude.

Full disclosure – some of Dick's themes sting a little. I'm keen to move the discussion forward rather than simply defending appraisers that, in the main, do an outstanding job in difficult circumstances. ISTAT, IBA and I imagine other leading appraisers are all investing in improving methodologies and it is fair to suggest that improvements are needed.

Dick concluded his paper with a call to arms around seven areas and I will tackle each shortly. Before I do so, there are two overarching themes that I think need addressing for context.

The first is that all large privately owned assets, from a car to a house to an oil tanker, warehouse, skyscraper or aircraft experience a range in values driven by a myriad of internal and external market forces. Aircraft are expensive so a 1-2% fluctuation in values often equals millions across a portfolio. I firmly believe that it is healthy therefore to have a range of opinions to consider, agreeing with Dick that more transparency around the methodology would be helpful.

Appraisals serve a multitude of purposes. They may be used by an insurance company or airline that wants to confirm the insured value is sufficiently high to cover replacement costs or on the other hand may be used by a debt provider concerned with requiring a value in the case of default. The differences are of course significant. By way of example, the insured value of a typical five year old B777-300ER may be \$150mUSD. But for a lender it may be a decision based on lending 70% of the CMV of \$100mUSD. For a lessor placing the aircraft into an ABS structure the value may be \$115mUSD.

Secondly, at IBA we do experience resistance to conducting the appropriate level of appraisal for strategic deals – in essence there is a perception that desktop research will do when, in our view, it is not adequate. Clearly as a commercial organisation there is a perceived desire for IBA to increase revenue and therefore push for extended or full appraisals but in reality that is not the driver. Desktop and online valuations are an essential component of our industry, but are rarely adequate for lease-adjusted appraisals, portfolio acquisitions or capital market activity.

We identified further parallels between due diligence and appraisals when we expanded our transaction advisory offer to include a look at subjective aspects of deals such as management reputation and relationships with stakeholders. Our new hires explained that there was a world of difference between a cursory KYC check of desktop sources and a full-blown review of management styles, negotiating skills, financial robustness etc., yet in the transactional due diligence world there was similar pressure to justify the extra effort and expense of a deeper dive. By all means price shop if you are ticking a box, but if you are investing millions of dollars in complex assets with associated leases, setting aside a relatively small amount to understand the residual value, any maintenance concerns and the operating environment is money well spent, especially in a market where less attractive aircraft are creeping into portfolios.

Lessor contributions to maintenance events and the bundling of assets for deals both need careful, bespoke analysis to fully understand value. We often see portfolios pass hands including unusual aircraft which at the desktop level these are not always apparent. At this generic level you might not identify factors that impact liquidity and values, such as low thrust engines or a high take-off weight.

On the maintenance side, we do see investors underestimating the funds necessary to pay towards maintaining a fleet. You might hear during the sale process that the maintenance of “*aircraft A*” can be covered by “*aircraft V*” as the reserves are available but an event is not due for 12 months. This is fine if you establish the reserves have all transferred with a portfolio. To do that you need to analyse the maintenance requirements of each aircraft and identify if those funds exist. If not, then the valuation is reduced as the new owner will be paying millions of unplanned dollars in maintenance.

If it was our money, we would invest more time and expenditure in building a fully transparent picture of our assets.

Clearly Dick’s report is lessor centric. Avolon, Dick’s employer, is one of the largest lessors so it is natural for their focus to hinge on values of aircraft with leases attached and how they should be appraised. Such appraisals are complex since it is not just the metal that is valued but also the lease itself, including any tangible/intangible aspects such as maintenance reserves and end of lease compensation and return conditions, and the credit of the lessee.

There is a place for all varieties of appraisers but it is fair to say few can provide the historical data and experience that the more established firms provide. With an ISTAT appraiser eye, more needs to be done to help purchasers of appraisals better understand the definitions.

I have little sympathy for experienced investors who buy an online or desktop valuation to suit their specific request and are then surprised or disappointed when a (clearly defined) generic valuation does not stand up to challenge, or is simply inaccurate. When guidance is needed around issues such as depreciation, maintenance, or the quality of records - perhaps as a new entrant - I accept that ISTAT appraisers could do more to explain the differences or subtleties in play rather than providing a number with a set of assumptions.

To Dick’s seven areas then:

1. Appraisers should be able to demonstrate their track record of forecasting accuracy in a verifiable way using approved techniques that withstand scrutiny from experienced capital markets fund managers and investors.

Agreed. There is a view amongst the appraisal community that the need to demonstrate accuracy only appears when the purchaser has a problem down the line, or cannot buy the appraisal value they are looking for. At IBA we would welcome the selection of appraisers based on track record as we are very proud of ours. We are fortunate that as an asset manager and remarketer, we see real trades that bolster our intelligence gathering efforts with solid numbers. Of course specific transactions are confidential but having access to real-world data is invaluable in terms of the knowledge and experience required to develop data points into valuations and trends.

There is no substitute for experience; at IBA we have data stretching back to before the first gulf war, Asian finance crisis, 9/11, GFC and covers many regional distress issues such as the collapse of various

airlines including Aerolineas Argentinas, Ansett and more recent issues at Kingfisher, MAS and Transaero. All of these allow us to mine for patterns and anomalies.

2. Appraisers must become more diligent in ensuring that changes made to current value opinions are reflective of the vintage of the asset and do not rely on the extrapolation of trading data from one age bracket to another.

We agree, real data trumps theoretical data every time. However, where trading data is not shared, or does not exist, then interpolation or extrapolation is an essential technique for appraising data points. In my view, whether a straight line or curve, as long as a methodology is transparent and consistent, the client can decide if a particular appraiser's methodology suits their requirements. For example, IBA never "straight lines", we assess the bottom, mid and top points of the individual markets and use judgement where trading activity is unavailable, and that approach will suit many but not all.

The curve we apply will depend on the vintage and traditional shapes we see in how differing vintage aircraft are linked. We will also assess the favourability of any given vintage in the market place economically speaking. Trading tends to occur in bands once you get over a certain age threshold – it is not an ordered function over time as demand can rise and fall sharply – sometimes you can see it coming, other times external factors play their part.

All appraisers will be faced with a lack of trading data that then require interpolation in order to provide the opinion. Where extrapolation is necessary (particularly widebody trades) then a deeper understanding of how values evolve for these types historically will be important – but the opinion remains theoretical until trades occur, or there is a properly formed market sentiment to build upon.

3. Some valuation methodologies have not changed in 20-30 years. Appraisers must ensure that their skills and IP are at the cutting edge to meet the standards of rigour and governance that a \$100bn+ per annum industry demands.

I partly agree with Dick here. Some methodologies need a refresh however such exercises often result in a partial reset of values which can cause consternation. Again I would ask about the reason for the appraisal. In percentage terms, a minority of appraisal work is strategic, the majority is tactical or regulatory and we do not see the appetite for investment in improving those areas.

Leasing of aircraft, engines and key components is now the norm. This has been a huge change from the early era of appraisal when it was mostly single sale and purchase of aircraft that created the need for appraisals.

That aside, we do feel there is a need to constantly refine methodologies, for instance we are currently reviewing some of our assumptions around useful economic life.

We constantly meet with investors, financiers, airline, lessors and OEMs to discuss our methodologies and how we may need to adapt according to the various needs and challenges that are created.

4. Appraisers should publish their methodologies, core assumptions, sample size and volatility data.

Here we disagree a little. We welcome client requests to lift the lid on how we develop our values and would encourage selection based on such requests, but I see little need to publicise IP in an effort to reinforce credibility.

5. Appraisers must be thought leaders, prepared to raise and discuss challenging issues and to share best practices within the appraiser community.

Again we agree with Dick and with both an IBA and ISTAT hat on we would look to move this forward. There are perhaps too many panels where three or four appraisers debate values and we'd be looking to shake that up a little in 2017. With a toppy market, Brexit, US uncertainty and increasing geopolitical instability making appraisers lives more challenging, we do need to look at alternative means of debate and discussion.

IBA and other firms with large appraisal teams, already participate in public and private discussions around the market and deliver useful thought leadership. Perhaps Dick and I can develop a list of challenging issues that need addressing. Appraisals of intangible and alternative assets will also increase. Dick rightly focuses on aircraft, but engine, rotatable and slot valuations all increased in 2016 and look to continue this year.

6. More industry professionals are needed to step up to the challenge of securing ISTAT accreditation, which would be facilitated by streamlining the ISTAT certification process – without diluting the standards.

ISTAT is making efforts to improve the accreditation process – this year saw the first of the examinations to be held outside of the US. In the past the only opportunity to take exams was in the US once per year. With the availability of exams in Europe this means exams and retakes can be taken twice per year. The process of assessment of the examination process to make it more streamlined without making it easier is underway via a \$25KUSD investment from the ISTAT Board to the Appraiser program. Larger appraisal firms continue to invest in ISTAT accreditation. IBA, for instance, now has seven certified appraisers, the largest amount of any appraiser.

7. Appraisers and their customers must work more closely with one another, developing greater mutual understanding through increased openness, dialogue and transparency.

Absolutely. All sides benefit from increased transparency. I would support any initiatives that promote openness even though IBA might stand to lose out. Our strong network, dataset and intelligence gathering track record underpins our numbers and greater transparency levels the playing field to a degree.

In our experience we gather trading points through various means, but little of it is transparent. At the same time, the very same community that will not share the information protests about the lack

of accuracy and is often unwilling to invest in a deeper dive that far better reflects an asset's current and future value. This is a vicious circle we all need to break.

Indirect customers are equally important. Accountants, lawyers and other advisers all stand to benefit from a demystifying of jargon.

There is lot of work to be done and I hope this has proved a useful read as we take up Dick's call to arms. I look forward to updating the readership in the coming months.

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About IBA

IBA is a leading independent aviation consultancy advising a broad mix of lessors, operators, financiers and investors. Operating globally, we inform decision making and support operations across the aviation spectrum. Supporting strategic investments, managing aircraft, advising on expansion, or driving efficiency improvements, our mix of intelligence gathering, analysis, proprietary data, technical expertise and decades of aviation experience delivers value across aviation opportunities and challenges.