FitchRatings

FITCH UPGRADES AVIATION CAPITAL GROUP TO 'BBB'; OUTLOOK STABLE

Fitch Ratings-New York-26 July 2016: Fitch Ratings has upgraded the Long-Term Issuer Default Rating (IDR) and senior unsecured debt ratings of Aviation Capital Group Corp. (ACG) to 'BBB' from 'BBB-'. The Rating Outlook is Stable. A full list of rating actions follows at the end of this release.

These actions were taken in conjunction with a broader aircraft leasing peer review conducted today by Fitch, which includes five publicly rated firms. For more commentary on the broader sector review, please see 'Fitch Completes Aircraft Lessor Peer Review', available at www.fitchratings.com'.

KEY RATING DRIVERS

IDR AND SENIOR DEBT
The rating upgrade is supported by ACG's improved standalone financial metrics, most notably, a reduced leverage appetite of 3.0x to 3.5x, consistent operating margins and profitability metrics over time, as well as a favorable funding profile and strong balance sheet flexibility relative to peers.

Rating constraints specific to ACG include modestly weaker net spreads relative to peers given the company's focus on narrowbody aircraft in the first quarter of their useful life as well as its strategic focus on longer-duration funding, which together generate lower yields and a modestly higher cost of funding relative to peers. Rating constraints applicable to the broader aircraft leasing industry include the monoline and wholesale funded nature of the business model and its susceptibility of air passenger traffic levels to economic cycles and other exogenous shocks.

Fitch considers ACG's standalone credit profile to be 'BBB-' without institutional support. Based on the 'Global Non-Bank Financial Institutions Rating Criteria', Fitch views ACG as having limited importance to its parent, Pacific Life Insurance Company (PLIC; IDR 'A'/Stable Outlook), a subsidiary of Pacific LifeCorp (PLC; IDR 'A-'/Stable Outlook). Limited operational and financial synergies between PLIC and ACG, as well as a lack of common branding across the two entities, support Fitch's view. Therefore, future support may be uncertain, particularly in a stress scenario. Other aircraft lessors with shared branding and longer-term strategic alignment with their majority-owner parent companies benefit from more rating uplift and are more highly rated, inclusive of parent support considerations.

However, Fitch believes PLIC maintains a sufficient level of commitment to ACG to support one notch of rating uplift from its standalone credit profile. This is evidenced by PLIC's $150 million capital injection into ACG March 2014, as well as current 100% ownership of ACG's equity, which amounted to $1.78 billion as of March 31, 2016.

The Stable Rating Outlook reflects Fitch's expectation that ACG will generate consistent operating cash flows, maintain sufficient liquidity, and a strong funding profile over the Outlook horizon. The rating actions and Outlook also reflect ACG's solid franchise and competitive position as a global lessor and manager of commercial aircraft, experienced management team, and Fitch's assessment of the ownership by and the strategic relationship with PLIC and PLC.

Ownership Dynamics Potentially Evolving

On Dec. 10, 2015, PLIC announced that it was considering a registered initial public offering of ACG common stock primarily intended to give ACG access to additional capital to execute its growth strategy. While the magnitude of the offering remains unknown, PLIC has publicly stated that it intends to retain a majority equity stake in ACG after the offering and that ACG will remain an important component within PLIC's diversified portfolio of businesses. Regardless of the specifics of the offering, Fitch will also consider the potential impacts of public ownership on ACG's operating strategy, risk appetite, and financial parameters such as leverage and dividends. The pace of potential growth will also be considered relative to the currently competitive environment.

Fitch views the majority equity ownership and control of ACG by PLIC, combined with a public commitment to the aircraft leasing business, as key underpinning factors for the one notch of uplift afforded to ACG's ratings. Ratings could be adversely affected under a scenario where PLIC no longer retains a majority and controlling interest in ACG, whereby Fitch would remove the one notch of support uplift and ACG would be rated on the basis of its standalone credit risk profile.

Appropriate Risk-Adjusted Leverage Target

Starting in 2015, ACG began managing balance sheet leverage to a target of between 3.0x and 3.5x, which is lower than ACG's historical levels, and viewed favorably by Fitch in the context of ACG's risk appetite, active portfolio management, and current and expected fleet profile. Balance sheet leverage, on a total debt to tangible equity basis, was 3.1x as of March 31, 2016, down modestly from 3.2x as of March 31, 2015. While leverage is currently at the lower end of ACG's targeted range, it is not yet clear what impact a partial IPO could have on ACG's leverage, in terms of the long-term average level within (or outside of) the articulated range. Any changes in risk appetite as a result of a partial IPO would also influence Fitch's view of the appropriateness of leverage relative to assigned ratings.

ACG's aircraft portfolio remains broadly used by global airlines, supporting consistent and stable cash flow generation that reduces the impact of market volatility through various economic and market cycles. Approximately 96% of the portfolio was comprised of Airbus A320 and Boeing B737 family aircraft at March 31, 2016, which Fitch views favorably given the tradability of the aircraft, broad user base and relatively low transition costs. The aircraft portfolio had a weighted average age of 6.1 years, as of March 31, 2016 generally in line with industry average fleet age. Approximately 80% of the aircraft was younger than 10 years, by net book value (NBV) as of the same date, consistent with ACG's focus on aircraft in the first quarter of their useful lives.

Managed Portfolio Growth with Modest Order Book

Portfolio growth has been relatively measured over time and ACG has a modest order book relative to peers, which is comprised primarily of new technology narrowbody aircraft, which reduces the potential volatility in future pricing and market risk as ACG undertakes aircraft deliveries. As of March 31, 2016, ACG had firm orders for 105 aircraft with deliveries scheduled through 2021. Given ACG's operating strategy to invest in narrowbody aircraft with broad customer appeal, Fitch expects ACG's overall portfolio attributes to remain relatively consistent over the medium-term.

Stable Operating Margins Over Time

Total revenues grew nearly 16% year-over-year, while pre-tax income grew 46%, as portfolio growth and gains on the sale of aircraft more than offset increased operating expenses. This translated to annualized pre-tax return on assets (ROA) of 2.3% in 1Q16, which is relatively consistent with the peer average of 2.2% during the same period.

Annualized net spread, defined by Fitch as lease yields less funding costs, amounted to 6.4% in 1Q16. Lease yields are derived from operating lease revenues as a percentage of average aircraft NBV, while funding costs are calculated as interest expense as a percentage of average debt outstanding. ACG's net spread is below the peer average of 7.6%, but has been relatively stable over time, averaging 6.6% since 2008. ACG's net margins are comparatively lower than peers in part given the company's fleet strategy and funding profile, which together generate modestly lower yields and higher funding costs.

Sufficient Liquidity and Cash Flow Generation

Liquidity is sufficient given ACG's consistent cash flow generation through various cycles, unrestricted balance sheet cash, and availability under its funding facilities to meet upcoming debt maturities and aircraft funding commitments. However, on a relative basis, the company has maintained relatively lower cash balances compared to peers in an effort to deploy its capital in revenue-generating aircraft assets.

Favorable Funding Profile with Strong Balance Sheet Flexibility

As of March 31, 2016, unsecured debt including senior unsecured debt, term loans and revolving credit facilities, represented 77.8% of total debt. ACG has among the highest proportions of unsecured debt as a percentage of overall funding, which enhances ACG's financial flexibility.

Consistent with its funding strategy, ACG has made significant progress in diversifying its funding sources and broadening its capital markets access. Most recently, ACG announced in April 2016 that it amended and extended its $1.5 billion revolving credit facility, extended the maturity date to April 2020 and commitments increased by $555 million. Together with another four-year unsecured revolving credit facility, ACG has $1.72 billion of revolving commitments from 23 financial institutions, globally. Fitch views the increased contingent liquidity positively.

Due to its predominately unsecured funding profile, ACG has a significant pool of available unencumbered assets, which provides material support to the unsecured noteholders and is viewed positively by Fitch as it provides additional balance sheet flexibility in times of market stress. ACG is required under its debt agreements to maintain a minimum level of unencumbered assets to unsecured debt of 1.25x. As of March 31, 2016, this ratio amounted to 1.56x on a reported basis. The ratings of the unsecured debt are equalized with the long-term IDR of ACG, reflecting sufficient level of collateral to support average recoveries in a stressed scenario.

RATING SENSITIVITIES

IDR AND SENIOR DEBT

Fitch does not envision positive rating momentum in the near-term. However, an upgrade of the standalone credit profile over the long-term could be driven by a demonstrated ability to manage balance sheet leverage below 3.0x, while maintaining an above-industry peer average earnings profile. Fitch will continue to monitor the consistency of ACG's fleet age, unencumbered assets, operating cash flow generation, liquidity and funding diversity, while managing the additional expectations and demands of a publicly traded company. Positive rating actions could also be driven by more explicit forms of support from PLIC, though this is not currently anticipated by Fitch particularly in light of the partial IPO under consideration.

Conversely, negative rating momentum could be driven by significant deterioration in ACG's operating performance or net margins, or a material decline in operating cash flow generation resulting from a significant weakening of sector or economic conditions. A material shift in current fleet or funding strategy, a sustained increase in balance sheet leverage above 3.5x and/or a reduced commitment by management to manage leverage below 3.5x could result in negative rating momentum. Negative rating momentum could also arise if Fitch's assessment of PLIC's willingness or ability to provide timely support to ACG changes. More specifically, ratings could be adversely affected under a scenario where PLIC no longer retains a majority and controlling interest in ACG, whereby Fitch would remove the one notch of support uplift and ACG would be rated on the basis of its standalone credit risk profile.

The ratings of the senior unsecured debt are sensitive to changes in ACG's long-term IDR and the level of unencumbered balance sheet assets in a stressed scenario, relative to outstanding debt. A decline in the level of unencumbered asset coverage combined with a material increase in the use of secured debt could result in the notching between the long-term IDR and the unsecured debt.

ACG is a privately held, wholly owned subsidiary of PLIC, and a leading global lessor and manager of 261 commercial aircraft to 100 airlines in over 45 countries. The aircraft portfolio totaled $8.1 billion in NBV, as of March 31, 2016.

Fitch has upgraded the following ratings:

Aviation Capital Group Corp.
--Long-Term IDR to 'BBB' from 'BBB-';
--Senior unsecured debt to 'BBB' from 'BBB-'.

The Rating Outlook is Stable.

Contact:

Primary Analyst
Johann Juan
Director
+1-312-368-3339
Fitch Ratings, Inc.
70 West Madison Street
Chicago, IL 60602

Secondary Analyst
Sean Pattap
Senior Director
+1-212-908-0642

Committee Chairperson
Nathan Flanders
Managing Director
+1-212-908-0827

Media Relations: Hannah James, New York, Tel: + 1 646 582 4947, Email: hannah.james@fitchratings.com.

Date of Relevant Committee: July 25, 2016

Summary of Financial Statement Adjustments: Fitch has made no adjustments that are not disclosed within the company's financial statements.

Additional information is available on www.fitchratings.com

Applicable Criteria