Vietnam Commercial Aviation Market and VALC

Airlines:
1. Vietnam Airlines (VN)
   a. 100% - VASCO (0V)
   b. 70% - Jetstar Pacific Airlines (BL)
   c. 49% - Cambodia Angkor Air (K6)
2. VietJet Air (VJ)

Market share as of September 1, 2013:

(Image credit: CAPA)


- Market dominated by Vietnam Airlines Corporation and VietJet Aviation JSC
- Air Mekong ceased operations in 2013, unlikely to ever resume operations

Vietnam Airlines

VN’s growth plan for 2015 is unrealistic and unattainable. It has already fallen short of its fleet goals for 2013 and will, at most, add another 10 A321s to its fleet by 2015. If VN expects the kind of growth outlined in its 2011 plan, they will need to lease 100% of their aircraft.
According to their plan, VJ will have about the same number of narrowbody aircraft as VN by the end of the decade. And better (or worse) yet, VietJet plenty of eager backers willing to finance its purchase of up to 100 new A320s with deliveries starting next year.

Almost all new narrowbody and widebody aircraft delivery slots are full until at least after 2017. VN will simply not be able to grow at its planned rate without finding early delivery positions or leasing new aircraft. Up until last week, VN had a chance to negotiate an order for somewhat preferable delivery slots for delivery before 2020. Now, after Dubai, VN has few options but to find leased aircraft to grow its fleet until the end of the decade.

VN is the only major airline in Asia without significant outstanding orders for new aircraft or aircraft for fleet replacement. Product and service offerings are inconsistent and their management seems to be completely oblivious to the threat of low-cost carriers and VJ at its doorstep. It has failed to restructure BL or take any action to turn 0V into a low-cost unit. Its repeated failure to launch an IPO puts it at risk of letting VietJet go through with its planned IPO by 2014. With no enthusiasm, funding, leadership, or any whatsoever sense of airline management, VN runs the risk of becoming the next modern-day variant of the historical failures of Philippine Airlines, Malaysia Airlines or Garuda Indonesia.

Jetstar Pacific

Jetstar Pacific is the biggest laggard among VN’s subsidiaries. VN has shown no leadership or any sign of restructuring (as announced in 2012) after taking a majority stake in the airline. BL’s market share has been severely eroded by VJ, dropping from 18% to 13% in just one year.

VN’s neglect of BL and the low-cost model will continue to hurt VN’s dominant position in the market. Even if VN is willing to sustain BL’s continuing losses, it is not unreasonable to expect BL to fold within the next 3-5 years unless VN comes up with a new low-cost strategy to compete with the likes of VJ. BL continues to operate old, inefficient 737-400s (dating back to the 1990s) that cannot compete with the newer A320-staple that VJ and other airlines in the region operate (AirAsia, Tigerair, etc.).

VietJet

VietJet has been the most successful airline startup in the world in recent history. VJ posted a pre-tax profit of 120 billion VND ($5.7 million) in the first seven months of 2013 – an unprecedented achievement to profitability in just one-and-a-half years. New startups typically sustain three to five years of losses before turning a profit.

In September 2013, VJ signed a $9 billion agreement with Airbus SAS for 20 current-generation A320/A321 aircraft and 42 next-generation A320 neo aircraft. Financing should not be an issue for VJ, considering the overwhelming interest in the purchase. Of particular importance is the rise of the use of EETCs as a source of capital. Traditional aircraft lease securitization relied on portfolio securitizations, but airlines around the world now favor
EETCs. This type of financing especially benefits carriers with less-than-perfect credit ratings or new carriers like VietJet to raise funds at investment grade. I emphasize next-gen aircraft for good reason: nearly every major airline in the world has ordered some variant of the 737 MAX or A320neo to replace their existing narrowbody short-haul fleets. AirAsia has 264 A320neos on order. Lionair has 201 737 MAX 9s on order. Delivery slots of these newer aircraft types are full and few slots are left for carriers like VN to replace some of its older, ageing A321s while maintaining growth.

VJ’s remarkable success has quickly eroded market share from VN and BL. VJ has plans to set up a sister airline based in Bangkok in an effort to become the next AirAsia, Lionair, and Tigerair of Southeast Asia.

Aircraft

Next-gen aircraft families:
New narrowbody short-haul (~15% efficiency improvement primarily by new engines)
- Boeing 737-700/800/900ER → 737MAX 7/8/9
- Airbus A319/320/321 → A319neo/A320neo/A321neo

New widebody medium/long-haul:
1. Boeing 767 → 787-8/9/10 Dreamliner
2. Boeing 777 → 777-8X/-9X
3. Airbus A330/A340 → A350-800/900/1000 XWB

Aircraft manufacturers have already launched all of their next-gen aircraft types. There will not be any new launches until after 2020. Likewise, there are no more newer aircraft types to expect.

VALC

In one sentence, VALC can be best described as: a rudderless steep being steered by a train conductor.

The idea of doing a sale-and-leaseback with VN has been floated for some time. But this would be a terrible strategy.

Like Vietnam Airlines, VALC is out of time. By the time a sale-and-leaseback deal is made, VALC is going to be stuck with a portfolio of aircraft that nobody would want, and a portfolio that would be worth nothing by the time VALC even thinks about listing.

As mentioned above, aircraft manufacturers have already launched the next-gen aircraft types. The A320neo will be introduced in 2015, followed by the 737 MAX in 2017. Residual aircraft values for current-gen aircraft types will quickly plummet as a result of the introduction of the new aircraft types. By the end of the decade, Boeing and Airbus will be collectively producing over 100 new narrowbody aircraft a month. As a result, residual
values for current-gen aircraft types (i.e. the A321s VN uses for almost all of its routes) will plummet and scrap numbers for these aircraft types will soar.

In summary:

- The introduction of next-gen aircraft will send residual values and lease rates of current-gen aircraft plunging
- Lease rates of narrowbody short-haul aircraft types will see a greater negative impact as a result of oversupply in the market
- There are already exists an oversupply of narrowbody short-haul aircraft in the market – next-gen aircraft types will only exacerbate this problem
- Aircraft lifespans are shortening and developing countries and new airlines are not buying old-gen or current-gen aircraft – new entrants like VietJet, Thai Lion, Malindo have ordered record numbers of new aircraft
- Changing regulatory conditions and improved safety and maintenance requirements (especially in developing countries) are forcing airlines to keep their fleets relatively young
- Increasing fuel prices will also send lease rates and scrap values of current-gen aircraft down

If VALC does a sale-and-leaseback of the remaining A321s VN has on order, VALC is going to be stuck with nothing more than a pile of scrap metal in less than 10 years. The short-term prospects may look promising, but the medium and long-term prospects of doing a sale-and-leaseback of current-gen aircraft are anything but promising.

Air India is one spectacular example of mismanagement, governmental folly, and the failure of sale-and-leaseback. After losing billions upon billions of dollars, its management decided to sale-and-leaseback its fleet of 27 Boeing 787-8 Dreamliners. Since the transaction, no new orders have been placed. No growth has been recorded. No sign of improved management or a narrowing of losses have been witnessed. VN runs a similar risk. Unless it privatizes and commits to restructure B6 and 0V once-and-for-all, VN management has no incentive to restructure or even attempt to change the way the airline is managed. Until the day VN can pull through on its IPO, expect nothing out of a sale-and-leaseback.

Next steps

A look at the many mergers of the US airline industry points to consolidation in the aircraft leasing industry. Small players like VALC have no outstanding orders for new aircraft, and will be at least 5+ years behind all other players if they order aircraft now. If VALC cannot secure favorable delivery slots (which are now mostly gone) and cannot expand beyond its current single-customer base, an exit strategy should be formed as soon as possible. Even SIA was unable secure Airbus delivery slots before 2020 for its full-service regional subsidiary, SilkAir (who operates a fleet of A320s). Starting next year, SilkAir will receive Boeing 737s, which will gradually replace their entire Airbus fleet. And this is SIA we’re talking about, where timely delivery slots are given greater attention than price.
It's a classic case of technological obsolescence (and bad management).

Three solutions to VALC's messy predicament:

1. Exit now. The aircraft leasing industry has already started to see signs of consolidation. Most recently, in 2012, Sumitomo Corp. acquired RBS Aviation to form the fourth-largest aircraft lessor, SMBC Aviation. Vietnam's aircraft leasing market and aviation market has huge untapped potential. VALC is more important to foreign lessors for its access to the market than its current portfolio. I am sure someone like BOC Aviation would be interested to enter the Vietnam market.

2. Get VN to place a large order of a combination of both current-gen and next-gen aircraft. VALC will engage in a sale-and-leaseback deal for both current-gen and next-gen aircraft, which will stabilize its portfolio for both the short and long-term.
   a. Current-gen aircraft for delivery just before the A320neo and 737 MAX introduction are still generally available in limited numbers. Boeing and Airbus are heavily discounting these slots in an effort to keep production lines running at full capacity before the introduction of their next-gen aircraft types.
   b. Since it is virtually impossible for VN or VALC to acquire any next-gen aircraft types before 2020, the current-gen aircraft order that can arrive as early as 2015 will tie them over until their next-gen aircraft types arrive after 2020.
   c. Deliveries of current-gen and next-gen aircraft will be fairly consistent, thus avoiding the spikes in capacity increases as a result of most large aircraft purchases. Capital expenditures will spread out relatively evenly across the next decade.

3. Shift VALC's focus from narrowbody short-haul aircraft to widebody medium and long-haul aircraft. VN has a definite and growing need for widebody aircraft to keep up with demand and dwindling slot availability in congested airports (and of greatest concern, growing congestion and overcapacity Tan Son Nhat airport).
   a. Lease rates for widebody aircraft hold up far better than narrowbody aircraft. Margins and higher and demand remains buoyant.
   b. VN needs a replacement for their 777s more urgently than any other aircraft type in their fleet. Their 777s are the oldest type (with the exception of their two Fokker 70s) and need replacement by the end of the decade.
   c. VALC will be better off as a niche player with a diversified portfolio of narrowbodies and widebodies. One aircraft lessor, Doric Asset Finance (EDIT 2/15/14: Now known as Amedeo), only leases A380 superjumbos (SIA, for example, has their first five A380s leased from DAF). DAF just placed an additional order for 20 A380s at last week’s Dubai Air Show.

Lastly, new ECA rules this year have greatly diminished the appeal of securing foreign lines of credit for financing. ECA Aircraft Sector Understanding (ASU) rules have, on average,
doubled ECA interest rates. VN and other foreign carriers have strong incentives to do business with lessors like VALC and lease in local currency.

Further reading:  