

## Third Generation Narrowbody Freighter Conversions – Golden Opportunity?

The global economic downturn induced by the pandemic, has generated investment interest for 3<sup>rd</sup> generation narrowbody freighters. Feedstock values for 737-800s and A321s are declining and some investors are considering speculative freighter conversions. Additionally, lessors facing the prospect of planned or unplanned aircraft returns with limited prospects for continued passenger lease are considering freighter conversions as a means of putting these idle assets back to work. Although the freighter market looks attractive, is now the right time to make this investment?

Recently, appraisers and other prognosticators have been highlighting the drop in narrowbody feedstock values and inferred that now is an opportune time to consider a freighter conversion investment. Some market analysts have gone further and forecast the pandemic induced surge in Ecommerce and the loss of passenger belly capacity will result in a sustained increase in demand for freighter aircraft.

Given the significant drop in passenger demand, it is natural to assume that narrowbody values have fallen, but given the lack of arm's length transactions, ascertaining current market values with any degree of accuracy is problematic. The more relevant question is – have values fallen sufficiently to warrant acquisition of an aircraft for a speculative conversion? To produce a profitable transaction, feedstock values for conversion age aircraft should be at or close to part-out numbers, but still have a reasonable amount of remaining green time. Even the most aggressive current value estimates do not indicate that pricing level for good conversion candidates. Furthermore, the market downturn is in an early phase and a further decline in values will almost certainly occur. Investors who believe today's values warrant acquisition for conversion may experience an unexpected surprise when a competitor acquires those same aircraft for a steep discount when the market is closer to the bottom of the cycle.

With respect to demand for additional freighter capacity, the lack of belly capacity and increase in Ecommerce demand has resulted in a significant, but likely short-lived increase in air cargo shipments. Passenger airlines have even jumped into this market with “passenger freighters”. This unexpected boon for air freight operators and passenger freighters is unlikely to last for an extended period for several reasons:

- Disrupted distribution channels will eventually return to pre-pandemic conditions which includes less costly surface and ocean transport whenever possible
- As the recession deepens, consumer demand for products typically shipped by air will decline to below pre-pandemic levels and will recover when economic conditions have improved from their current levels. The shift from “brick and mortar” to Ecommerce will mitigate but not eliminate this decline.
- As passenger airlines resume pre-pandemic schedules, belly capacity will return and provide shippers with a cost competitive alternative to main deck freighter capacity.
- 3<sup>rd</sup> generation narrowbody freighter demand has been limited to a small number of large customers (e.g. Amazon and DHL) buying or leasing from a small number of suppliers with GECAS the predominant 737-800 freighter lessor. At this point, there has been limited interest in these newer aircraft from smaller carriers operating outside the high yield integrator and Ecommerce markets.



For a conversion investment to be successful, four key elements must be present:

- Attractively priced investment capital
- Sufficient conversion capacity
- Suitable conversion aircraft available at a price which supports transaction economics
- Creditworthy post-conversion lessees or buyers at a price in line with transaction assumptions

Although investment capital is certainly available, the other three elements look less favorable in the near term. Boeing 737-800 conversion slots are sold out for 24 months or so with existing capacity consumed by a small number of customers. With respect to the A321, there is currently only one certified conversion program (EFW/STAero) which has few conversion slots in 2021. A second A321 program by Precision Conversions should be certificated early next year, but early conversion slots are under contract. It is important to note that an extended wait for a conversion slot will negatively impact deal economics since the investor will need to find interim pax revenue opportunities in a weak market to offset an early capital expenditure.

As indicated previously, feedstock values, while declining, are not sufficiently low to yield a profitable conversion for onward lease or sale. Last, but most importantly, the short-term surge in air freight demand will eventually dissipate and the market will be subject to the economic conditions of a widespread recession.

For those investors who have or are planning to enter this market niche, which is a small fraction of the passenger aircraft space (8%), we would recommend careful consideration of the elements required for a successful investment. Without a clear-eyed assessment of these fundamentals and market timing, the investor may experience an unpleasant surprise down the road.

Fortune Aviation is available to provide its experience in and deep knowledge of many aspects of the freighter and air cargo business for those seeking guidance to successfully navigate the freighter conversion investment space.

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