PGA Aviation LLC
244 5th Avenue, Suite 2708
New York, NY 10001
+1 (212) 726-1051 | www.pgaaviation.com

2016 Q2 Report

Perceptions from the Middle Kingdom

Q2 Government Approvals of Pending Deliveries Continue On Pace But May Be Impacted By Evolving Circumstances Going Forward

We continue to witness steady growth within China's airline industry, despite a challenging business climate in other industries, in China as well as worldwide.

There was recently a smooth transition to a new "team leader" at CAAC, the Chinese regulatory agency which, in China, serves substantially the same functions that the US DOT and FAA serve in the United States. We also see a clear trend towards the transfer of certain regulatory powers from CAAC to the Ministry of Transportation. This, we believe, will result in increased efficiencies.

There are presently many outstanding firm orders for aircraft, with the biggest two OEMs holding orders for a significant number of near-term deliveries. Although the orders are truly firm and not subject to governmental approval, applicable regulations still require each Chinese airline to obtain clearance from relevant governmental agencies prior to delivery.

We are also aware of a number of aircraft within the delivery pipeline that still lack governmental approval. The responsible Chinese airline or other purchaser will nevertheless be compelled to make the requisite PDP payments and take delivery (or perhaps adjust their delivery positions in lieu thereof) due to the fact that they are under firm contracts which would otherwise generate significant financing and other associated costs or penalties.

In our assessment, Chinese governmental agencies are trying their best to promote orderly growth of their airline industry. They exhibit serious concerns for safety as a whole, but also specifically within the context of an industry-wide pilot shortage. Overall, Chinese airlines enjoy a world-class safety record, and the government aims to maintain this high standard. Some airlines have experienced serious safety incidents within the past six months, which has caused CAAC to call for enhanced pilot training and fatigue risk management.

The overall aircraft utilization rates of some Chinese airlines have declined to such an extent that governmental agencies do not feel justified in granting them the applicable approvals for additional acquistions. By the same token, approvals for new start-up airlines have been largely "on-hold" during the quarter, or are being processed at an extremely slow pace. Overall, new Air Carrier Permits (“AOC”s) are rarely being granted. This is mainly driven by safety concerns and other such factors.

The slow Chinese governmental approval of new aircraft deliveries, some observers suspect, may be at least partly due to the country's ambitious plan to promote its own C919 aircraft within the domestic airline industry. It is believed that Chinese carriers are seriously examining the need to accommodate this new "home grown" model in their fleets, per the country's current five-year plan. This will likely impact all industry participants in the long run.

On the cargo side, several Chinese network carriers have introduced some brand-new 777F aircraft into their respective fleets. All such network carriers are also operating the 777-300ER passenger aircraft, using it's ample cargo capacity as part of their fleet's overall freightoperation. The latter model offers unbeatable cost and operational benefits for long-haul activities. The bottom line is that each airline is seeking to generate significant revenues through the operation of one particular type of aircraft. There is a related learning curve for Chinese long-haul carriers in operating new main-deck freighters like the 777F, as this type of aircraft is more suitable for high-yield/high-end cargo operations. We are confident that these airlines will adapt quickly in this regard.

Another looming and potentially significant issue as the quarter ends is the prospect of a PRC economic slowdown, coupled with the emergent and as yet "TBD" ramifications of the prospective UK "Brexit" from the EU and its possible impact on worldwide trade patterns and international currency valuations. While it's of course too early to predict what the effects of these rapidly evolving situations might be on the Chinese aviation industry, we will continue to monitor them closely from our "in country" prospective for possible inclusion in future reports.

Finally, we anticipate an increased number of "asset management" type of aircraft transactions within the region during the next quarter or two. Such transactions may be easier to consummate, as compared to the more typical straightforward sale, since the latter deals are usually subject to restrictive governmental scrutiny and regulated bidding processes. PGA Aviation LLC, whether by itself or in collaboration with its partner company, has extensive experience in this area, particularly with Chinese airlines, and stands ready to help our clients address their full spectrum of aviation asset management requirements .

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