Aircraft leasing in a new world

The aviation industry has been on the frontline of the impact of Covid-19 since the early days of March when the world seemed to change overnight. With closed borders and cancelled flights, the industry experienced turmoil not seen since the aftermath of 9/11. But six months later, the aviation financing and leasing sector is beginning to look ahead. Here we've summarized the key takeaways from our webinar held in September.

ADAM BERINGER
Shareholder at Vedder Price

ROSE NEALE
Managing Counsel at Castlelake

PETE O'HARE
Partner at Watson Farley & Williams

DAVE CRULL
Chief Financial Officer at Aero Capital Solutions

ANDREA DEBATTISTA
Senior Manager at Alter Domus

Rent deferrals redefined

The immediate impact of Covid-19 was an unleashed and unprecedented wave of rent deferrals. With everyone in uncharted territory, responses and decisions were often made quickly and under pressure. But with a second round of deferrals already here and a third almost inevitable, how sustainable are they?

Dave Crull, Chief Financial Officer of Aero Capital Solutions notes: "The decisions we face now fundamentally differ from the first round of deferrals because the passage of time has allowed an opportunity to firm-up the playbook of 'what's next'. In March, while we saw certain business plans lose relevance overnight, there was a broad tranche of operators who presented a rational 'ask' which, among the inherent economic relief, also allowed a level of certainty on both sides of the planning spectrum."

Crull sees the sustainability of deferrals as dependent upon a shift in focus and the thought process behind it. "From our perspective, early deferral requests carried a short-term premium on certainty, on cooperation, and on minimizing execution risk. Future requests will naturally have a more informed fact pattern for all parties to consider."

Adam Beringer, a shareholder of Vedder Price and member of the Global Transportation Finance Team, also sees a new perspective emerging in coming rounds as well as a different type of deferral. "In the early days, most deferrals were straightforward rent deferrals," he says. "But some had preparation measures built into them, thinking about the possibility of repossession. There were even some deferral arrangements with weaker credit lessees where the aircraft were required to be grounded."

Beringer believes there will be an increasing number of deferrals in which the lessor is effectively taking control of the aircraft while it remains under lease. "We will see both structural change and a change in approach - who is willing to cooperate with each other?"

So, what's on the horizon?

Changing structure, availability, and attitudes toward impending deferrals are inevitably reshaping the future of the aviation financing industry. New solutions will emerge, and new perspectives will develop over the medium to long term. Rose Neale, Managing Counsel at Castlelake, sees an inevitable period of global consolidation among both lessors and lessees in which top-tier credits are most likely to benefit

“The industry is in the middle of a correction that will narrow the playing field amongst both sides,” she says. “We have a high-touch asset management role now, but with deferrals and the negotiations around them, it becomes a high-touch asset class. Those without broad teams will struggle without the manpower.”

Crull believes a wide range of options exist beyond simple rent deferrals and sees a scenario where an active asset manager can extract significant incremental value. “In many cases deferral requests have been accompanied by a lease extension, or some other form of economic lever rather than the simple deferral or abatement of cashflow,” he says. “There’s actually a win-win scenario in which we restructure a lease, the airline continues to operate the aircraft and fly passengers, and we get to the other side of the pandemic with a stronger partnership.”

From a financial reporting perspective, rent concessions are leading lessors to assess whether they might trigger a modification to the lease contract. Andrea Debattista, Senior Manager at Alter Domus in Malta says: “If a contract modification does arise, the lessor must review the presentation in the books. This might mean a new lease and the cancellation of the old one.”

The situation is less clear with operating leases. However, an exposure draft issued in May 2020 states that any lessee negatively impacted by the pandemic can apply for a practical expedient to avoid overcomplicated accounting and financial statements. Debattista says: “When there is a change such as rent concessions, the lessee can modify, but not reassess the lease, unlike the lessor who needs to reassess and change the lease.”

New capital-raising scenarios

Sale and leaseback transactions have been particularly common recently as airlines scramble to shore up their liquidity, while in the US the aviation industry has seen a surge in EETC issuance. Effectively trading has all but dried up, although some operating lessors are on the market with RFPs, and some other avenues may be opening up. But it is not an easy climate.

Says Beringer: “There are still headwinds, primarily from a pricing perspective, as it is difficult for lessors to price in the Covid effect. While participation may be low, and execution may be difficult, I believe the situation is promising for those that do participate.”

Beringer believes capital-raising will see some interesting developments, with private equity playing an increasingly important role. “We are already seeing private equity showing up on both the equity and the debt side to fill a funding gap created by banks fleeing the market,” he says.

“The downturn following 9/11 was the first time any real material amounts of private equity were drawn into the aviation space. There is a roadmap for climbing out of a downturn, but this downturn is far more widespread.”

With the volume and number of private equity funds in the space, actively and passively investing in the ABS markets, he sees a further evolution. “Investors in the ABS space are educated, they know who the players are that they’ve invested with,” he says. “I think you’re going to see a lot of them teaming up on private deals given the current lack of an ABS product.”

But capital markets have not dried up entirely, with EETC transactions in US airlines continuing and a recent new issue from Air Canada. Beringer expects lessors to turn to EETC-like transactions - products with a single credit leasing structure and attractive to investors seeking traditional EETCs with good airline credits. EETC-like transactions by lessors are not common, but in current circumstances that may change.

Picking up on Beringer’s comment about raising capital in the private market, Pete O’Hare of Watson Farley & Williams said that ‘sunny day’ investors who came to the market fairly recently may be looking for an exit which could provide good opportunities for private equity. For capital markets, he believes that we may see non-US EETCs coming to the market.

While industry-wide measures have been implemented in the US and Australia, this is not the case in Europe and the UK. Support for airlines has been limited to the general corporate schemes available to any industry dealing with the pandemic. While the European Commission relaxed rules on state aid and European countries have committed more than $30 billion, O’Hare believes that sustained government support for airlines is essential but specific support for individual airlines, particularly in the UK, will be a last resort. “The problem itself is just too large and broad in scope,” he says. “I don’t see any universe where you’re not going to have continued government funding and involvement in a meaningful way for some period of time.”

The engine underpinning asset value

One critical question at the top of many agendas elicits different responses from different players: which aircraft are proving more resilient and can expect a speedier recovery?

"The answer depends on the lens in which you're viewing values. Traders are dealing directly in the spot market creating transactions and actually moving metal, while fleet planners are making a decade-long decision and should view the analysis differently from a fundamentals perspective," Crull says.

He believes an important value driver is the historically significant backlog of availability for maintenance, repair and overhaul of engines, which has contributed to the demand for both used serviceable material and green-time engines. "While that has clearly changed in the short term and we need to see exactly how that shapes out in the long term, I don't think that will be a permanent shift," Crull says. "We need time to hit reset on what the equation looks like now that we're seeing a pickup in traffic and demand."

Market correction: opportunity or threat

The question of market correction can also be seen from different perspectives: pressure on one side is often opportunity on the other. Lease rate pressure is likely to increase as the component market looks toward the impact of starting engines again. On the other hand, operators are hoping to preserve cash, possibly through trading engines and conducting transactions.

As the end of the 2020 reporting period approaches, aircraft must be tested and impairment indicators identified. Debattista says Covid-19 has given rise to various impairment indicators: "Multiple flight changes, prolonged governance restrictions, grounded aircraft, bankruptcies and the collapse of lease payments all negatively impact the aviation industry. When aircrafts are grounded, the impairment factor is elevated. Factors such as the landing gear not moving for a long period of time could have future negative implications for the aircraft."

With such uncertainty, some valuation firms are qualifying their reports, and pressure on boards of directors and senior management is significant. They must judge how best to apply these valuations.

Debattista says: "We need to look specifically into each impairment indicators and assess them. What about cash flows if we are using the value-in-use model? It needs to be taken into consideration collectively to assess whether we have the right disclosures and where they are going to be presented in financial statements."

A recovery driven by consumer confidence

2020 is drawing to a close and there is no crystal ball to check out what lies ahead. But Neale believes we are already seeing trends and indicators that a slow-moving recovery is under way. "I think recovery is going to be dependent upon four factors: the timing of a vaccine; the opening of the borders; continued incremental government support and finally, the public, and when they are able and confident enough to fly again."

Beringer believes there is both bad news and good news: we have never seen a problem on this scale before, but there is ample capital available to drive a recovery. He also sees consumer confidence as critical to any recovery. "If I knock on the doors of 20 frequent travellers and half of them say they're comfortable to return to their previous flying habits, maybe we will have turned the corner."

Crull sees loose parallels to past downturns in terms of the effects on global air traffic but warns this correction will be more difficult to predict. "If we look back to the statistics underlying previous exogenous shocks including the Global Financial Crisis, there are clearly similarities. However, their recoveries will be different. In 2008, banks weren't lending, the economy was in recession and consumers couldn't afford to fly. Currently, it's a case of being restricted from flying. The speed of a global recovery will tie directly to the lifting of external constraints."

KEY TAKEAWAYS

What will the future of aircraft leasing really look like? It all comes down to perspective. Deferral requests by lessees—often accompanied by lease extensions—are strengthening partnerships across the board. Private equity is beginning to fill funding gaps on both the equity and debt side left by fleeting banks. And older aircraft are being retired, helping to reduce the industry's carbon footprint as a whole. While the future remains to be seen, the aircraft leasing industry has shown real resilience and a true recovery is only a matter of time.

GET IN TOUCH

If you'd like to find out more about how Alter Domus can help support you through the new landscape emerging in the aircraft leasing industry, please get in touch with Amanda Donohue.

AMANDA DONOHUE
Senior Manager, Alter Domus
+353 21 484 7064
Amanda.Donohue@alterDomus.com

alterDomus*