COVID-19: HARD LANDING: HOW THE CORONAVIRUS SHUTDOWN MAY INFECT GLOBAL AVIATION FINANCE

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Aviation Alert

By: Anthony R.G. Nolan, Barry B. Cosgrave, Sidanth Rajagopal

Since 2008/9, the aviation industry has seen the first "super cycle" with unprecedented levels of growth and demand, this however, has come to a grinding halt with the global onset of COVID-19. With international travel restrictions and limits on the size of crowds, airlines have seen entire fleets grounded and staff placed on compulsory unpaid leave. This has had a ripple effect throughout the industry, as lessors face potential lease defaults and challenges of remarketing (repossessed) aircraft in a market with no demand. This in turn will affect the investors in structured products including EETCs, aircraft lease portfolio securitizations and aircraft loan financings. Whilst air travel was curtailed post 9/11, the situation we face today is far more severe and truly unprecedented as owing to the fact that this is a truly global grounding as opposed to the US-specific approach post-9/11.

This article will provide a basic overview of how four main industry stakeholders are affected. These are:

- Airlines
- Lessors
- Banks
- Structured Products

AIRLINES

Travel restrictions and severely reduced demand have led to a severe diminution in revenue. This will impact the ability of airlines to service on-balance sheet bank and capital markets debt as well as to meet their obligations to aircraft lessors.

In addition, airlines closely guard their landing slots, particularly at the world's more desirable hubs, which require them not only to pay rent but also to fly regularly between certain destinations to ensure the slots remain available to them, even if the planes flying those routes are empty.

Airlines will inevitably require reductions in lease payments and/or payment holidays to see them through the worst of this crisis. Very few airlines have substantial cash reserves that will allow them to weather this situation and even those airlines will choose to keep their powder dry. In 2019 -- a generally good year for aviation -- 24

[1] airlines and air operators ceased operation for financial reasons, and Flybe went into administration just before the coronavirus crisis hit Europe and the United States.

In addition to potential aid packages directed specifically at the aviation industry (which are discussed below), airlines may be able to benefit from liquidity provided by government initiatives such as the recently announced commercial paper funding facility [2]. But will these materialize in the volume needed to keep airlines aloft?

Even before the coronavirus the global airline industry was increasingly divided between a small number of large, profitable and liquid airlines, mostly in the United States, and a larger number of less profitable airlines with less financial strength. The coronavirus may well hasten and deepen division into a world of haves and have-nots.

LESSORS

A key dynamic affecting lessors in the current distressed environment is that leases are typically non-recourse obligations to the lessee supported by equity that is generally limited in amount and not subject to margin calls. This set of circumstances means that airlines -- those that are still alive -- will have significant bargaining leverage to negotiate reduced lease payments because they can effectively put the leased equipment back to the lessee if they cannot agree on restructured lease terms. This exposes lessors to two challenges: how to make do with reductions in cash flows and what do with the aircraft when the lessee mails back the keys.

Any reduction in rental payments from airlines through default or restructuring will create potential liquidity challenges for aircraft lessors. The impact of these may be felt more strongly by smaller lessors with smaller fleets or more dependent on secured lending sources that are match-funded to the leases than by those lessors with more robust balance sheets who are not as dependent on the cash flow they are receiving from leases to cover amounts that they are required to pay under the terms of their loan agreements with banks and other credit providers. As with airlines, we may witness a continuing bifurcation between haves and have-nots in the lessor community based in part on the size of balance sheets and access to unsecured debt.

Those lessors who do not have the luxury of renegotiating lease terms may be forced to grapple with the challenge of redeploying equipment that is virtually impossible to remarket on terms remotely like those it previously enjoyed. This may be particularly galling in the case of older aircraft models such as A320 or B737NG that had benefitted from the grounding of the B737MAX, as airlines that are still flying can be expected to take advantage of the opportunity to upgrade to newer and more fuel-efficient aircraft, even when oil prices are at historic lows.

BANKS AND CREDIT PROVIDERS

Banks and credit providers face exposure both to airlines themselves through balance sheet financing and capital markets instruments, and to lessors through limited recourse financings secured on aircraft and/or engines. While financiers retain the right to enforce on, and take possession of, the underlying assets in the event that borrowers (airlines or lessors) default on payment obligations or, inevitably, breach financial and other covenants, the reduced demand for air travel and therefore aircraft will have a severe negative impact on the value of aircraft and engines and also an lender's ability to deal with a repossessed aircraft or engine. Many of the considerations for lessors described above will apply to financiers as well.

STRUCTURED PRODUCTS

A large number of aircraft leases and, more recently, loans to airlines have been securitized in lease portfolio securitisations (ABS), enhanced equipment trust certificates (EETC) and collateralised loan obligations (CLO) issuances.

ABS transactions will be subject to many of the considerations described above for lessors because an aircraft lease ABS is essentially a leveraged finance structure around an aircraft leasing platform. CLO transactions will be subject to the same considerations described above for banks and credit providers because they essentially provided credit facilities to aircraft owners. Some combination of the remarketing agent/ servicer / administrative agent would be engaged on behalf of the securitization issuer with renegotiating or terminating the lease on behalf of the issuer, and if the lease is terminated the remarketing agent would have to try to release the aircraft.

Securitizations represent tranched credit exposures to the underlying portfolio of leases and loans, with the senior classes protected from losses by the allocation of losses and shortfalls to the more subordinate classes and the equity. Therefore, a cash flow shortfall caused by defaults or restructured terms under aircraft leases would run through the waterfall (unless the default triggers a payment under a liquidity or supplemental rental facility in the specific ABS transaction.) Shortfalls are typically borne first by the most subordinate bonds and could also result in an early redemption of senior notes through a turbo. If any portion of the shortfall is made up by a facility the facility provider would have a senior reimbursement right from future collections. Therefore holders of the equity and subordinated tranches will experience losses of principal if the cash flow reductions or other losses on the securitized assets exceed the modelled threshold for each such class. If these transactions perform in a manner similar to that of many securitizations of commercial assets during the 2008 financial crisis, the senior tranches in aircraft securitizations will most likely continue to be money-good despite losses on the portfolio because of the role of subordinate tranches, but they may lose market value as losses on the portfolio increase and the credit enhancement provided by subordination is eroded. Unless the equity loses all value, there is likely to be growing pressure from equity owners in ABS and to seek to re-price ABS and CLO transactions in order to maintain or increase the arbitrage -- i.e. the excess of the return on assets over the cost of debt -- and maintain equity distributions at a time when the assets will yield less cash. Counterbalancing this will be pressure from debt investors to maintain or increase the yields on their notes to reflect the new view of an appropriate risk-weighted yield.

The repossession and remarketing of aircraft owned by an ABS issuer will raise particular issues. The documentation for a particular transaction could provide some class of noteholders with the consent or veto rights in a release negotiation or remarketing. Additionally, to the extent the remarketing agent provides services for others in addition to the ABS, conflicts of interest in remarketing related activity may be particularly sensitive if it is working out its own assets alongside those of the securitization vehicle. Particularly to the extent there will be an oversupply of off-lease aircraft. Lastly, to the extent that aircraft CLO transactions have been executed by traditional corporate CLO managers without specialized aviation expertise it will be crucial to determine how effectively the CLO is set up to take aircraft assets in foreclosure on the underlying loan and "manage the metal."

OPPORTUNITIES AND OUTCOME

In light of the above, the question arises as to what is the likely outcome and what opportunities might there be for our clients? The aviation industry is generally a volatile one that is well-versed in shock events. Airlines remain of strategic and economic importance, and many represent a source of national pride that expresses global ambition. The path forward is thus shaded by political considerations and directed by wider considerations that go beyond the clauses of a loan agreement.

Our view is that airlines, lessors and banks are best served working together in a collaborative manner that ensures the long term survival of the industry over a shorter term period of reduced economics for all stakeholders. We believe that amendments to loan and lease provisions providing for an interim period of reduced payments will allow the industry to find a way past the impact of COVID-19. Alternatively, or in addition, stakeholders may seek additional financing (be that on a temporary or bridge basis, or as a longer term solution) to help airlines to navigate this difficult period. It may be that the dry powder that currently sits in distressed investment funds will be deployed as part of a private credit solution rather than in acquiring adverse positions to airlines.

The potential for government support in the form of a bailout or similar depends on the jurisdiction in question and the scope provided for in the open skies agreement. Bail-outs of national carriers in Europe are particularly difficult owing to the restrictions on state aid; the current challenge to the Italian government's actions in respect of Alitalia is a particular example of this. The $50 billion of emergency aid for airlines that passed the United States Senate on March 19 was structured to overcome resistance among lawmakers concerned that airlines would misuse the funds for corporate purposes such as stock buybacks rather than assistance to their employees and other constituencies, as happened with aid they received after 9/11. Consequently the bill structures the assistance as a lending facility, with airlines required to meet specified thresholds of continuation of service and cap executive compensation until the loans are repaid.

Inevitably, for some airlines the pressure of reduced demand instigated by COVID-19 will prove too much. For those few airlines with substantial cash reserves, this period may present an opportunity to acquire new slots at desirable airports and acquire new routes to add global footprint. However, for the majority of airlines, there will need to be accommodations made on all sides to work through the greatest challenge the aviation industry has ever faced.

NOTES

[1] http://aeronauticsonline.com/which-airlines-stopped-flying-in-2019/ and https://samchui.com/2019/12/26/summary-23-airlines-ceased-operation-in-2019/#.XnSpcYj7SUk.

[2] For a discussion of this, see our client alert entitled "COVID-19: Federal Reserve's Commercial Paper Funding Facility 2020 May Enhance Consumer Lending and Corporate Liquidity."

KEY CONTACTS

ROBERT E. MELSON, JR.
PARTNER

TOKYO
+81.3.6205.3602
ROBERT.MELSON@KLGATES.COM

ANTHONY R.G. NOLAN
PARTNER

NEW YORK
+1.212.536.4843
ANTHONY.NOLAN@KLGATES.COM