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# *Runway to Recovery in Aviation Debt*

## Executive Summary

The aviation industry has been in the news since the beginning of the Covid-19 pandemic. Headlines of travel restrictions, grounded aircraft, government support, several airline bankruptcies and reorganisations have painted a very dark picture of the current state of the industry, as well as for its short term future. However, airlines have utilised the crisis to restructure their operations and fleets, in order to become more efficient. At the same time the supply of capital has decreased, at least for some parts of the market. This offers institutional investors new opportunities in a sector which has proven its resilience throughout the Covid-19 pandemic. Going forward, Prime Capital expects a structural shift in the market, with a larger market share for long term alternative lenders, as banks continue their slow retreat from financing due to regulatory reasons and shifting risk budgets. Current deals offer a significant premium to pre-crisis levels with yields of 5% to 7%.

## Impact of Covid-19 on the Aviation Sector

The year 2020 was very challenging, if not the most challenging year in the history of the aviation industry. With aircraft being grounded for several months and travellers unsettled by ever changing travel restrictions, passenger numbers dropped and airlines struggled to maintain sufficient liquidity. This led to deferrals on loans, voluntary reorganisations and bankruptcies. According to the International Civil Aviation Organization (ICAO), global airline revenue losses stood at USD 371bn for 2020 and international passenger traffic declined by 60%, while seats offered by airlines were reduced by 50% during 2020, compared to 2019 levels. Airlines had initially remained optimistic after the spring of 2020, but more than half of the flights scheduled for the rest of the year were subsequently cancelled.

The Covid-19 pandemic has severely impacted both sides of the equation – credit quality and collateral values. On the one hand, airlines were not able to fly and generate cash in order to pay leases and debt service. On the other hand, the demand for aircraft vanished with massive overcapacity in the market. This has caused aircraft values to drop significantly, as airlines rushed to reduce their fleets and to shore up liquidity. This is the perfect storm from a financing perspective, as the safety net provided by the collateral could fail to protect the downside, while airlines in many cases did not have cash to honour their lease payments and/or debt service. Lenders had to carefully assess the risks of granting deferrals, while considering possible repossession scenarios. For lenders, this meant in-depth analysis of each individual situation. Some lenders resorted to fire-sales in order to quickly exit the sector at substantial haircuts. Conversely for lenders with the expertise and patience, despite restructurings and bankruptcies, the aviation sector has proven its resilience, with long term restructuring solutions or minimal to no write-offs and recovery rates around 100%.

The significant progress in the vaccination efforts has strengthened confidence for the aviation sector, and since the end of Q1 2021 passenger numbers have been rising. The International Air Transport Association (IATA) has revised its forecast upwards and now expects airlines to be cash positive again during the second half of 2021/beginning of 2022, earlier than originally anticipated. However, there is still a large discrepancy between domestic traffic and international traffic. While domestic traffic has recovered, mostly due to the US and China, more fragmented regions like Europe are still lagging behind. Ongoing lockdowns have continued to curb international traffic, due to restrictions and disparate regulations in place.

As the industry is recovering, there are many opportunities for institutional investors. Banks are still being cautious and demand for debt is rising again. Hence investors can still

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earn a significant premium compared to pre-crisis levels, at more lender-friendly conditions, which we expect will further grow the market for institutional investors. Prime Capital has been active throughout the crisis and has closed attractive transactions for its investors, e.g. with large Tier 1 airlines at a significant premium. Also other large institutional investors start to recognise the opportunity and have started to set up their own aviation debt programs, to profit from the unique set of opportunities.

## Airlines Preparing for Recovery

According to Ishka, Tier 1 airlines have raised approximately USD 200bn through a combination of sale and leaseback transactions and government support - the majority of which has been raised through capital markets. Major carriers and leasing companies were able to tap the capital market at attractive spreads in H1 2021, reflecting the optimism of the capital market for the continued recovery in the aviation sector.

| Transaction | Security | Terms | Coupon |
|---|---|---|---|
| United Airlines | Unsecured | 5 years<br>8 years | 4.375% (USD)<br>4.625% (USD) |
| Ryanair | Unsecured | 5 years | 0.875% (EUR) |
| Dubai Aero Space | Unsecured | 3 years | 1.55% (USD) |
| Air France – KLM | Unsecured | 3 years | 3.00% (EUR) |
| Air France – KLM | Unsecured | 5 years | 3.875% (EUR) |

*Recent debt issuances during H1 2021*

Large airlines have also started to consolidate their fleets by retiring older aircraft early. For example, Lufthansa reduced its fleet by 12%, Delta by 14% and Air Canada even by 35%. Hence some airlines including low cost carriers like Ryanair, WizzAir and Easyjet are well positioned for a recovery in air traffic and expect to profit from gaps that weaker airlines have left in the market.

According to FlightGlobal, based on the global fleet (Airbus and Boeing only), 49% are operated by so called Tier 1 airlines. These are characterised by significant cash buffers and demonstrated government support. These airlines are likely to benefit from the recovery and are set to gain market share from competition. Another 23% of the global fleet is operated by airlines directly owned by local governments. Such airlines are usually critical to the local infrastructure, so the carriers are likely to be bailed out in case of any further issues. This however requires a thorough analysis of the financial and political stability of the relevant government. This leaves 28% of the global Airbus and Boeing fleet operated by "other" airlines. For this group there is an increased bankruptcy risk going forward. In summary, about 70% of the global fleet should be attractive from an operator credit perspective. This provides ample opportunities for investors going forward.

## Fleet Consolidation and Aircraft Values

Since the global aircraft fleet has been reduced by phasing out older aircraft, the focus on new technology aircraft has increased even further. Also fleet restructurings show that airlines are likely to keep younger, more fuel-efficient aircraft and reject or sell older aircraft. Especially in times with kerosene prices at elevated levels, continued low load factors and long term measures to reduce emissions, airlines are particularly focused on the economics of each individual flight. The liquidity of an aircraft type remains impacted by the secondary market, which in turn is based on the number of operators for the specific aircraft (and engine combination). As operators choose to focus on younger fuel-efficient aircraft, it can be expected that values for these aircraft types will provide comparably higher stability.

## Attractive Opportunities for Investors

The Covid-19 pandemic has significantly impacted the airline industry and will likely lead to long-term structural changes. While the aviation debt sector has been historically dominated by the banking market, some institutions have been burned during the crisis by relying on the airline credit rather than on the quality of the collateral, with some banks selling their entire aviation book or simply closing down their aviation desks. This will have a long-term effect on the financing market as this opens up opportunities for alternative lenders. The trend is reinforced by regulatory trends decreasing incentives for traditional banks to provide aviation debt financing. Banks moving towards originate-to-distribute models in order to preserve their customer relationships and at the same time relief their RWA. Losses experienced during the crisis may also trigger a reduction in risk budgets for aviation, shifting the lending focus to other sectors.

Prime Capital has successfully managed aviation debt portfolios since 2014. With exposure around the globe, the year 2020 has also been busy for some portfolio deals. Prime Capital's investment philosophy has always focussed on liquid collateral, in order to be protected in a downside scenario. Given sharply dropping aircraft values (for some aircraft models) and loan deferrals, in some cases LTV's have increased significantly. Due to the investment strategy, the portfolio mainly consists of young and current/new technology collateral, so the overall portfolio has done well throughout the last twelve months. Despite some lessees filing for Chapter 11 or negotiating loan deferrals, there have been no impairments or realised losses due to remarketing efforts.

With this backdrop of a growing, highly attractive market, Prime Capital expects to continue to grow its position as an established lender with a track record in the aviation debt market. Castlelake estimates a potential funding gap of USD 160bn until 2022 alone, providing interesting opportunities for institutional investors. Value can still be found in more complex structures, including residual value risk or higher LTV's. Given that banks have reduced their lending levels, LTV's have decreased and borrowers may require mezzanine debt to close the gap between equity and senior debt. Depending on the mix of senior and junior debt, yields between 5% and 7% can be achieved, which is significantly above the yields seen before the Covid-19 pandemic. Taking into account the strengthened market positions of some airlines and the correction in asset values, such a portfolio should provide institutional investors with an attractive risk and return profile.

In order to properly assess the risk and return of a transaction, it is important that the asset manager is able to perform an in-depth credit analysis of the operator (airline) and potential lessor, as well as assessing the value of the collateral, i.e. the aircraft. Prime Capital has financed more than 200 aircraft operated in more than 40 jurisdictions across the globe. The Aviation Debt Team has a broad network across airlines, leasing companies, advisors and banks to make use of diverse sourcing opportunities. The Team has successfully managed various restructurings in different jurisdictions and structures. Some restructurings have been voluntary, i.e. outside of court, and others within Chapter 11. This included the successful repossession and remarketing of several aircraft. This includes the repossession and successful sale of the loan exposure at par for two widebody jets, as well as loan restructurings and full repayments of the outstanding nominal for other stressed facilities. Hence the Team has proven restructuring expertise as well as a broad network of specialised service providers, like technical service providers, remarketing agents and specialised law firms that institutional investors can access and benefit of via Prime Capital.

## Prime Capital's Private Debt Team

Our Aviation Team, which has been active in the Aviation Debt market for many years, has carried out transactions of more than USD 1bn. The Private Debt Team additionally invests in Commercial Real Estate, Infrastructure Debt and Corporate Lending. We expect significant further asset growth in these areas, while providing highly attractive risk-adjusted returns to our largely institutional investors.

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