Market still in **fragile state**

David Yu, a senior Istat certified aviation appraiser and chairman of China Aviation Valuation Advisors, looks at recent aircraft financing trends and developments.

Covid has resulted in new financing trends and developments by banks and other financial institutions. We have moved from the extreme initial shock, where the industry essentially closed for new deals, while deals that were already too far along were completed. This can also be seen by the slew of asset-backed securities (ABS) deals finishing before the market took a pause.

Aircraft transactions are not easily processed and those who talked about no impact at the start of the crisis failed to mention that the start date on those completed deals was before the aviation world had heard of the word "Covid". Financial institutions in Asia and elsewhere took the time to conduct a comprehensive review of their aviation portfolios and underwriting policies.

These decisions had ultimately made all underwriting committees more conservative. Some decided that this market was too much and took a pause in underwriting new deals, while others decided to exit the industry or eventually reached that decision by selling their portfolios (National Australian Bank, etc); others decided to move forward initiating new deals.

From those highly distressed initial months, the market has moved slowly towards a rebound along with the increased global vaccination rates, although country entry restrictions still stifle the market.

While the aircraft deals market is still alive, the frequency is not as high as it was before Covid. The market has split where the freight and cargo aircraft segment is doing well and is in demand. Regional and narrowbody passenger aircraft are still seeing active trading but are still subdued and are at discounted values, while the bigger widebody aircraft transactions have slowed. There is still a disconnect between what parties are willing to sell and the realities of the market.

Apart from sale and leasebacks, transactions appear to be largely at values lower than appraisals and not as frequently reported. These slower amounts of transactions are also evident by the large number of new equity funds that have been raised and that are mostly waiting on the sidelines. Some deal terms have been increased back to as much (if not more than) pre-Covid robust figures such as lease rate factors, etc. The market has semi-recovered but is still very fragile with some way to go to a more sustainable recovery.

We have seen numerous but very uneven industry support by governments around the world with a stimulus of $243 billion as of October, according to the International Air Transport Association. Asia, unfortunately, is still lagging in this compared with other regions. This support has propped up our industry in the time of one of its greatest needs but, at some point, when the industry is sustainable, it will be time to exit. The current environment is still fragile, so governments should wait for more stabilisation before withdrawing these support systems.

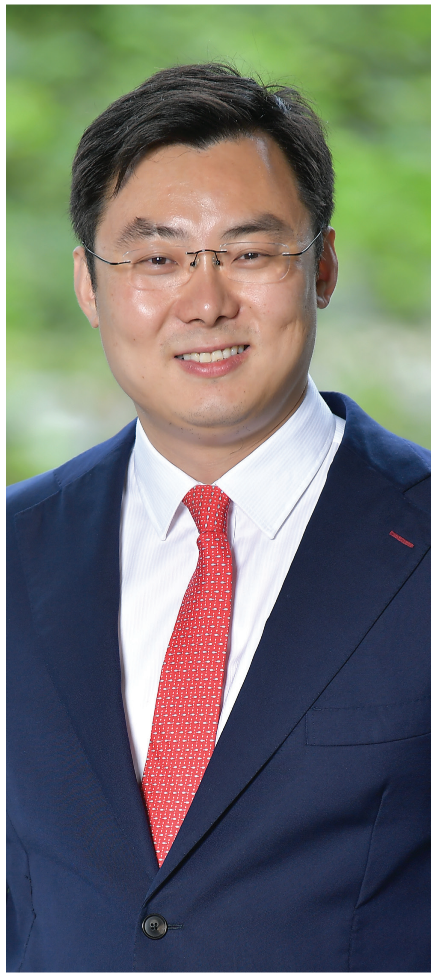
Another stimulus that is working through the financing system is the side effects of the January 2022 implementation of the Basil IV banking requirements. While the rules have been implemented for greater transparency, they are having the unintended effect of guiding banks to divest defaulting aircraft loans rather than to work out the problems. I have seen several banks which have sold at less than par because of this issue.

Airlines' recovery performances over the summer have been very uneven, with North American carriers having had a good summer while European airlines experienced starts and stops. Asia did not have a good summer, with Covid flare-ups in China in prime February and later summer periods that significantly affected domestic travel, and international traffic is abysmal.

Similarly, the rest of Asia exhibited low international traffic, with some countries just recently getting past zero Covid regimes and opening up, such as Australia, Singapore and Thailand.

Unlike US carriers, some airlines have not had the luxury of building up a cash reserve heading into the upcoming second low winter months in operations. This will add additional pressures on airline financiers who have already restructured lease and financings with longer tails. It can be questioned whether those parties are still willing to undertake a second round of support and if their lenders and sponsors will support such action.

Additionally, one of the more stressed initiatives in aviation is an increased focus on



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David Yu, senior Istat certified aviation appraiser and chairman of China Aviation Valuation Advisors sustainability. Emphasis on sustainable fuels, electrification and hydrogen technologies will require significant amounts of cash and financing to develop the initiatives. This will be a difficult additional pressure on the airlines and the aviation ecosystem at a time when there is greater cash needs to be used to strengthen balance sheets and replenish reserves. This is an added argument for not withdrawing government support so quickly.

Environmental, societal and governance, or ESG, is an increased focus on investors and, in turn, driving more emphasis by banks. Modern equipment is preferred to older, less-efficient aircraft with its more sustainable characteristics. This emphasis is putting pressure on older technology aircraft and the ones that are less desired by the market. These are the very aircraft that are mainly used by lower credit airlines and lessors which need the financing the most. The focus on new sustainable initiatives, while well intentioned, will also put additional pressures on airlines and banks to spend additional capital. In some instances, I have seen values collapse.

The first wave of restructurings of airlines and leases have already occurred and are ongoing but we are in a position where we will see more increased pressure on airlines' cash needs in the upcoming winter months. Lessors and banks have taken the brunt of these pressures given the lack of options available.

I am seeing more banks take the painful decision to call in loans or accept losses. Many loan books have been traded, although there have been some encouraging results for more supported airlines. When there are fewer remarketing options for non-performing aircraft, restructuring the leases is the best alternative. In the meantime, lessors are taking the brunt of delayed or lack of rental payments by stepping up and filling some of those funding gaps.

The level of borrowing among lessors is truly worrying. While headlines boast of the millions raised in liquidity and this will ensure no immediate defaults, the level of debt is probably unsustainable and merely pushes the problem to a future date.

Those with older assets have a shorter period in which to get their houses in order and, in some cases, the values and earning potential of their aircraft will not be sufficient to justify the debt raised. This is the same dilemma from the banks' perspective because there are not many other alternatives for homes. The problems are just being postponed but banking regulations, such as Basel IV, may yet bring the house down.

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How deals have been restructured may also raise some alarm bells. There are rumours of security deposits having been converted to rent, maintenance reserves recategorised as rent and leases reworked to allow for end-of-lease compensation.

Lease extensions may also only work when assets continue to have a positive outlook in terms of future employment and, where old assets have been extended, there is a serious risk that the obligation may outlast the usefulness of the asset. Some lessors may have spent the maintenance reserves received (especially if these are termed "additional rent") and may now struggle to repay lessees for works accomplished.

One of the main questions facing banks is, can they continue to kick the proverbial can down the road and reschedule payments for lessors and airlines as the need for cash in the winter months intensifies?

Traditionally, a banker had a close relationship with his borrower to obtain both a deal and also to work through some of the issues. Now procedures often dictate after these loans are under or non-performing, they are transferred to a separate workout team. This would diminish the role of the relationship and focus more on the hard facts of each case. I have seen examples of this in action and my view would be that this may take a perfectly workable situation and label it a distressed deal. The solution may be as simple as allowing the current team to continue managing the transaction.

The banks are still active and have continued to fund the loans of high-grade credits of both airlines and lessors. These higher-grade credits typically have rated debt and are publically listed. They have access to the banking markets as well as the syndicated structured finance markets. This includes enhanced equipment trust certificates and ABS markets, which have bounced back and continued to see new issuances at attractive funding levels and rates such as the recently issued $894 million aircraft loan ABS SALT 2021-1 sponsored by Stonepeak and Bellinger, and the Sky Leasing-sponsored SLAM 2021-1, among others.

This has extended to granting new blind warehouse facilities and revolvers to lessors. Some of the recent ones include Goshawk's extension of its $500 million warehouse facility in August, Griffin Global Asset Management's $1 billion deal in April 2021 and Sky Leasing's $600 million warehouse facility in January 2020, completed at the edge of the crisis.

Higher yield credits, on the other hand, have had more difficulties in the financing market. Only top-notch airline and lessor credits are being considered by bank loan committees. Will the banks live to regret their decisions? Time will tell.

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