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# Aircraft finance and leasing in the pandemic and beyond – Moving out of the holding pattern

The COVID-19 pandemic has brought existential threats to the entire aviation ecosystem and has required considerable creativity, flexibility and commercial partnership between industry participants trying to survive. The booking time window for passengers has collapsed from six weeks to six days (on average) and over two-thirds of the global fleet was in storage at the peak of the crisis. As a consequence, airlines, lessors and other groups are facing a perilous cashflow situation. As market analysis shows that the recovery for aviation will be slower and more challenging than originally expected, this paper looks at the medium and longer term issues and solutions for the aircraft finance and leasing industry, including leasing and financing options, and alternative finance solutions for airlines.

## Challenges and opportunities

There have been a number of measures over the summer to shore up airline balance sheets, notably, the EUR 2.74bn rights issue by IAG and the GBP 1.2bn refinance package as part of the Virgin Atlantic restructuring. These actions brought valuable time to businesses that are exhausting their cash reserves and suffering unprecedented losses.

As the Northern hemisphere enters the traditionally difficult winter months, analysts fear that the closure of Cathay Dragon marks the beginning of a series of major airline closures. Further, there is no certainty that government interventions may be sufficient – the c. GBP 3.9bn bailout from the Hong Kong government was unable to prevent the loss of a quarter of Cathay Pacific group staff.

The longer the crisis continues, the more protracted predictions for recovery have become. Optimistic views at the start of the pandemic forecasting a 'V' shaped recovery have now given way to predictions of a drawn out 'U' shaped recovery. A return to 2019 passenger levels is expected to take between 3 and 6 years. The impact of short-term restructuring plans, such as staff reductions of 40,000 and 13,000 by American Airlines and British Airways respectively, will lead to long term issues arising from loss of expertise.

However, restructuring presents opportunities, with airlines choosing to operate their more efficient aircraft. Virgin Atlantic, for example, predicts that its streamlined fleet will be 10% more efficient. The announcement of the return of Flybe – one of the first casualties of the pandemic – in a streamlined form, also sparks another optimistic note for recovery.

### Key considerations

1. **Sustainability** – Market recovery is still uncertain so solutions should be long-term focused.
2. **The risk of compromise** – Lessors should ensure they are protected against the increased risk from agreeing further concessions.
3. **Unencumbered assets** – What other assets does an airline have available to generate liquidity?
4. **Restructuring Plan** – If consensual waivers or amendments will not be sufficient, is it time to consider using a Restructuring Plan?

## Lease restructuring solutions

Lessors responded to airlines' need to defer rental payments with temporary arrangements put in place quickly. Many airlines, particularly in emerging markets, did not have backstop liquidity and the summer saw no real "bounce-back" for revenue. Yet for many lessors, continuing to waive payment defaults and further defer rent is not sustainable long-term, especially if their own debt service is quarterly.

Lessors and airlines need to find solutions to deal with rental arrears and forthcoming rent obligations so that airlines can survive the more challenging winter season where demand is likely to be lower than originally predicted and schedules are, accordingly, already vastly reduced.

— **Security Deposits:** To the extent not done already, lessors can exercise their contractual right to apply cash held as a security deposit (or draw on letters of credit) to satisfy rental arrears. However, airlines may not be in a position to "top up" depleted security deposits and lessors should consider whether an airline can offer up any collateral in its place to protect the lessor's position.

— **Maintenance payments:** Similarly, accrued maintenance reserves can be applied against rental arrears and even used to prepay future rentals that will become due. Since this is a departure from the contractual terms, the parties will need to agree to amend the lease. Airlines are less likely to have available cashflow for maintenance reserves, so parties will likely agree to change to "end-of-lease" maintenance payments. This solution de-risks the lessor's income stream but changes the risk position vis-à-vis the maintenance costs of the aircraft and therefore, its residual value, albeit during a period of low utilisation of aircraft.

— **Lessor protections:** If agreeing concessions or compromises, lessors should look for additional protections to mitigate any increased risk. Lessors with multiple leases to an airline can cross-collateralise and cross-default between leases, including between operating and finance leases. Risk exposure across the lessor's portfolio becomes more balanced and lessees should be discouraged from prioritising performance of obligations in some leases over others, e.g. finance leases (where they have equity in the aircraft).

— **Sale and leasebacks:** A common solution where an airline needs to retain capacity in its fleet – it enters a sale and leaseback to generate a cash injection, boosting short term liquidity and de-risking the airline from residual value. Such benefits will likely outweigh the ongoing rental costs, even if terms are not the most favourable.

— **Early terminations:** Negotiating an early return or replacing an operating lease with a "power by the hour" arrangement (the airline pays for use of the aircraft or engine) may be the best options for some airlines. Although unattractive to lessors, the alternative may be less attractive: repossessing an aircraft out of an insolvent airline, with the risk of a lower return and a longer process.

— **Aircraft disposals:** Some airlines have owned aircraft which could be sold to lessors, generating sale proceeds which can be used to pay rental arrears and some future rentals on their leased aircraft. An attractive proposition for both parties – airlines eliminate significant fixed costs and the disposal may fit with a strategy to reduce fleet, whilst lessors de-risk income stream and acquire an aircraft at a competitive price. If already leased to another operator, the lessor gains a new customer which may have long term strategic benefits.

## Alternative finance solutions

With an increased need for liquidity, airlines are thinking creatively about the potential to use their unencumbered assets and the pandemic has placed renewed focus on alternative finance solutions. In addition to cargo receivables and slots (which had previously been used on a limited basis to raise funds), airlines have begun to use loyalty programmes to generate liquidity. Some of the largest airlines have projected that their programmes are more valuable than the airlines themselves because an airline's most valuable "asset" is its customers.

— **Aircraft use:** With the decrease in passenger markets in 2020, airlines sought other ways to generate revenue from their aircraft. Cargo has been a common use, especially for transport of medical equipment and PPE, either by flying passenger aircraft with only cargo in the hold or flying cargo on the cabin seats and/or removing seats to increase capacity in the main body.

— **Cargo receivables:** These are amounts owed to the airline by a third party and can be used as security for debt financing and/or can be securitised. Airlines mainly generate cargo receivables using the IATA CASS settlement systems – amounts settled by agents/freight forwarders are settled through these systems and amounts are paid out to airlines by IATA. Airlines use the right to receive such payments as collateral for debt financings. However, although cargo may be a key source of income in present circumstances, once air travel begins to increase (and the sale of tickets) airlines may reduce their cargo capacities and the cashflows generated by cargo receivables will decrease accordingly. Further, unless airlines have charter flight agreements in place for cargo transport for a defined period, the fluid nature of the cargo business does not guarantee the level of income it will generate.

— **Slots:** To operate between airports, airlines are allocated pairs of landing slots. In the EU, for an airline to retain such slots from the summer season to the winter season and thereafter into a summer season, the slots must be at least 80% utilised during the period for which they are allocated otherwise the airline loses the slot. This rule has been suspended by the EU until 27 March 2021 as a response to the pandemic. Technically slots cannot be sold but can be exchanged and ACL has facilitated trades by allowing "dummy slots" to be traded for more desirable (valuable) slots. Using slots as collateral has traditionally been complicated but with the right structure and protections in place airlines with valuable slots could potentially use these as alternative solutions to raise liquidity. By way of example Virgin Atlantic successfully raised funds on the value of certain slots through a securitisation in 2015.

— **Loyalty programmes:** If an airline is considered good credit and likely to survive post-pandemic, its loyalty programme could be considered valuable collateral by financiers. Some airlines use separate loyalty entities that are fully or partially owned by the airline and others have their own loyalty programmes built into the airline itself. Those separate loyalty entities pre-purchase reward seats from the airline for future use. Aeromexico and GOL have both used the sale of reward flights to their separate loyalty entities to enhance their liquidity position in recent months. Fully integrated loyalty programmes are however seen as preferable. If the programme is separate there is a risk of loss of contract, lack of governance and loss of direct relationship with customers. American Airlines recently used its AAdvantage programme (valued – as reported by the FT – vastly greater than the airline itself) as collateral for a government loan. United, using its MileagePlus programme, secured a USD 5bn term loan. Loyalty programmes/companies can often offer a greater degree of control over profitability than an airline itself and are scalable, e.g. programme members purchase extra points or use points towards purchases from other businesses.

— **Inventory:** many airlines have an inventory of rotable spare parts held to ensure that they can keep their fleet of aircraft flying. Depending on the scale of the stocks held and the location, it may be possible to raise finance directly against such inventory. This may need assistance from third parties such as landlords of premises in which parts are held and will be subject to rigorous valuation.

## A more drastic solution – the new Restructuring Plan in the UK

Each of the possibilities mentioned so far assume a level of consensus being reached by the airline either with existing creditors or new creditors. Between a fully consensual arrangement and a formal insolvency process lies the new Restructuring Plan. Restructuring Plans require as a qualifying eligibility that the applicant is in financial difficulty affecting carrying on its business as a going concern. They differ from other alternatives by allowing "cram down" of a class of dissenting creditors where members of the dissenting class are no worse off under the plan when compared to the "relevant alternative" – in the Virgin Atlantic case this was insolvent liquidation – and at least one class of creditors with an economic interest must vote in favour of the plan.

A Restructuring Plan is available to any airline that can demonstrate sufficient connection with the UK but as English law obligations can generally only be discharged under English law proceedings and the majority of aircraft leases are under English law, it is likely that connection can be established. This is likely to be a valuable tool for airlines as they try and meet the challenges they have faced with the collapse in air travel. It is, in contrast, an additional risk for lessors. While Virgin Atlantic did not involve a cram down of a class of creditors such as lessors, that possibility exists if the restructuring proposal is not consensual and the relevant alternative test can be demonstrated to have been met.

## Conclusion

The severe challenges that the entire travel industry has faced imply that the current equation is current + new liquidity = possibility of survival into the post pandemic period. Recovery will only then be possible, so no aircraft, engine or slot that can be used to raise finance is likely to be left unsecured. To survive is to win, for now.

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