Capital markets continue to lead aircraft finance

The capital markets have proven that they remain an attractive financing vehicle for the aircraft finance sector, especially for leasing companies. **Olivier Bonnassies** reports.

Capital markets have bounced back this year with ample liquidity available for the sector as aircraft leasing and financial institutions have supported the growth of the industry. Lessors, in particular, have responded positively to airline asset sales, whether new or used, since the beginning of the Covid pandemic.

In the first nine months of 2021, the capital markets remained largely open to aircraft lessors with companies from all jurisdictions retaining access to unsecured loans, which accounted for almost $34 billion of the $65 billion lessors raised in fresh funding from 1 January through 30 September 2021.

Unsecured bond issuances contributed $25 billion to lessor financings in the first nine months, with issuers benefiting from market conditions. Secured loans and asset-backed securitisations (ABS) added $5.8 billion and $3.6 billion, respectively, with some ABS issuances, especially in the second quarter, achieving record pricing levels on the senior tranche.

Some investors have shifted their focus from public term aviation ABS to private credit deals, attracted to the yield pick-up, tailored risk exposure and ease of execution. The lack of deal supply may have prompted a move at the private market in both the loan and note format. And there is the growing role of private credit, which adds further flexibility to how various asset classes can access capital. Drew Fine, a partner at Milbank, says there are a lot of deals in the private market but private credit deals have not taken away from the ABS market.

"Most lessors that are regular issuers in the ABS market are returning to the market. Out of the six issuances that could launch in the final quarter of this year, five of them are past issuers of aircraft ABS," says Fine, who adds that the so-called lessor enhanced equipment trust certificate (EETC) has also been used as a financing/trading tool by lessors in addition to ABS issuances because the lessor EETC is an excellent tool to finance or sell pools of aircraft leased to one, two or three airlines.

The leasing companies are at their best when they are able to operate in the ordinary course of business without interference from lenders/noteholders.

Drew Fine, partner, Milbank

The lessor EETC is a mechanism for lessors to conduct a streamlined Section 4(a)(2) private placement financing for concentrated portfolios.

"Everything lessors can do with an ABS issuance can be done with a lessor EETC but there is no requirement to have lessee diversity," he says.

"Originally, the lessor EETCs were exclusively debt issuances but now they are being used to sell debt and equity and that is unique. We are working on several lessor EETC financings – certain of them are pure financings while the equity portion is being sold on others. These deals are going to continue."

Richard Sharman, a partner at Holland & Knight, says private credit deals can be faster and available for smaller portfolios or individual aircraft and they should be expected to cost a premium versus public ABS deals.

"Public ABSs provide debt solutions for a specific set of transactions where there is a threshold portfolio size and enough diversification and it has to go through a process including rating agencies, etc..."

He adds: "If you have five different lessees, then the ABS market is not open – for ABSs you need at least 15 aircraft and eight, nine or 10 different lessees. Therefore, the portfolio you are able to source will impact your available funding options and, at this time, good-quality assets are not as readily available as they were before the pandemic."

ABS trend – refinancing

The second quarter saw some ABS issuances featuring brand new liquid assets and achieving record low pricings. But Fine says mid-life assets are "definitely feasible" for ABS transactions.

"The ABS portfolios that are being launched in the final quarter of this year include mid-life assets," he says.

He observes that issuers are also refinancing existing deals. "The ABSs closed in 2015-17 are ripe for refinancing since the market is robust and these ABSs can be financed without paying any prepayment premiums to the investors."

Fine explains that prepayment premiums are normally no longer payable after four or five years from the issuance date.

"An ABS becomes less attractive after seven years as it will go into full cash sweep (meaning the equity gets no money) and perhaps have a step-up in interest rate. Once an ABS gets to approximately four or five years from issuance, issuers start to consider refinancing, as they don't want to risk being in a challenging refinancing market as they get closer to seven years."

The Castlelake refinancing transaction showed that there is a strong market for refinancing ABS deals.

Bank market

Banks are active to support lessors and airlines in large facilities, but traditional asset financing on a bilateral basis has been limited over the past 18 months.

Milbank's Fine says there is plenty of bank financing available for strong airlines and seasoned aircraft leasing platforms.

"On the aircraft leasing side, there are several new warehouse facilities being provided by banks, and those will eventually lead to ABS transactions. Many of the new entrants have their new warehouses and some existing leasing companies are entering into new warehouses," he adds.

The banks have also been active providing term loan financings, so it is not only the capital markets providing debt for the industry, he observes.

"Although many traditional lenders have provided financing, the industry has welcomed new alternative lending platforms. These platforms largely consist of aggregators of institutional money acting like banks and becoming a big source of financing for the aviation space," he says.

"Banks are still participating in big ticket facilities supporting the airlines and the lessors, but there are different types of financing facilities for different purposes: the capital markets cannot provide a warehouse facility or a secured revolving credit facility, but banks can. If you want a revolving credit facility, a warehouse facility or a delayed draw, you go to the banks. If you want a long-term, single draw financing like an, EETC or ABS, you can go to the capital markets."

Fine says the capital markets can provide more flexible solutions for lessors.

"During Covid-19," he says, "the industry was hit by lease/financing defaults and deferrals. Lessors with capital markets financings like ABSs were able to restructure their portfolios and work with their lessees in the ordinary course of business without any interference from the noteholders since the noteholders are passive. In many cases, if you do a financing with banks and a lessee defaults, the banks will want to be involved in any restructuring of the lease."

For him, the leasing companies are "at their best" when they are able to operate in the ordinary course of business without interference from lenders/noteholders.

"This is one of the reasons why the large leasing companies have appetite for unsecured debt issuances," he says.

"Post-Covid, bank warehouse facilities have been more restrictive on the types of aircraft which may be financed and the quality of the lessees. Since warehouse facilities lead to ABSs, this should lead to ABSs with higher quality portfolios."

Fine adds: "The financing and ABS market continues to be very robust. Investors are eager to purchase aircraft-secured debt and we are hopeful the trend will continue where we have seen each new issuance top the previous one. I don't know if the pricing will go down even further, but it seems that it will remain quite attractive."

Sharman agrees that there is a strong appetite for capital market transactions.

"More and more investors are looking for yield and investment solutions. As in many cases, traditional bank debt is not readily available for many types of transactions and they naturally turn to the capital markets at this time."

He sees bank appetite coming back, especially lenders which have active capital markets franchises which will support the transaction with limited recourse warehouse debt to be taken out by a capital markets deal.

"Some banks have focused on relationship transactions with first or high second-tier coveted airline credits, often derisked with an insurance wrapper. The bank market for limited recourse warehouse to support an ABS has come back quite strongly as those banks look to support their capital markets franchises. However, limited recourse lending with no capital markets exit is likely to be the last to come back."

Sharman adds: "Over time, there is an expectation that, as the market settles and banks are clearer on what their balance sheet looks like, bank appetite will come back for a wider range of products.

"It may happen, at some point soon, that banks who have a good quality book will realise that the hits they have taken are not that significant, and they will have an asset book which is running down and it will then depend how badly they want to maintain that by doing new deals," says Sharman. "In that scenario, those banks may push for new deals using a wider variety of structures."