

CASH REMAINS KING DURING THE PANDEMIC

TABLE OF CONTENTS

- 01** INTRODUCTION
- 02** THE MAIN TAKEAWAYS FROM THE CAFMO
- 03** THE RISE OF E-DELIVERIES
- 04** ABL'S VIEW

INTRODUCTION

Some airlines were fortunate enough to have shored up significant cash reserves before the coronavirus spread around the world at the beginning of 2020. Their board members will be thanking their CFOs, as these carriers have been able to better weather the pandemic and have not had to rely as much on government loans to stay afloat. Cash becomes invaluable during an industry downturn – it is the main source of financing for aircraft deliveries, it provides more operational flexibility, and it is a saving grace when bank funding dries up.

Two leading players in the industry released their financial outlooks in April, providing a review of financing trends in 2020 and what we are likely to see more of as we move through 2021.

In its Current Aircraft Financing Market Outlook (CAFMO) (1), Boeing Capital Corporation (BCC) highlighted the continued importance of cash when funding aircraft deliveries through the pandemic. Due to many deliveries being cancelled or put on hold amid the pandemic, BCC noted that the industry-wide financing requirements for aircraft were much lower than seen in the recent peak of 2018. There were \$59 billion in aircraft financing requirements for Boeing's customers in 2020, down more than 50 percent from \$126 billion in 2018. What the industry saw last year were similar levels last observed in 2010, where \$62 billion of capital was required.

In terms of the distribution of financing, 2020 was similar to what was seen in 2019 – cash remained king, amounting to 38 percent of the total industry funding, while bank debt accounted for 32 percent, capital markets 23 percent. These three (3) were the main sources of aircraft financing.

Despite the economic damage wrought by the pandemic, BCC did not have to step in to finance any of its aircraft deliveries in 2020, showing that the financier's appetite for aviation credit remains robust.

The International Air Transport Association (IATA) also released its aircraft financing outlook last month. It was slightly less rosy than Boeing's, with the industry body reporting that airlines have had a weaker start to the year due to a surge in COVID-19 cases, tightening travel restrictions and vaccination delays. IATA projected traffic growth in 2021, but not as much as the industry body expected in December last year.

However, IATA did acknowledge the industry was recovering, with airline losses projected for 2021 dwarfing those of 2020. IATA forecasts \$47.7 billion in airline industry losses for 2021, an improvement on the \$126.4 billion estimated loss last year. The organisation also predicted that airlines would burn through \$81 billion in cash, compared to \$149 billion last year (*Figure 1*).

Airline industry cash burn, USD billion per quarter

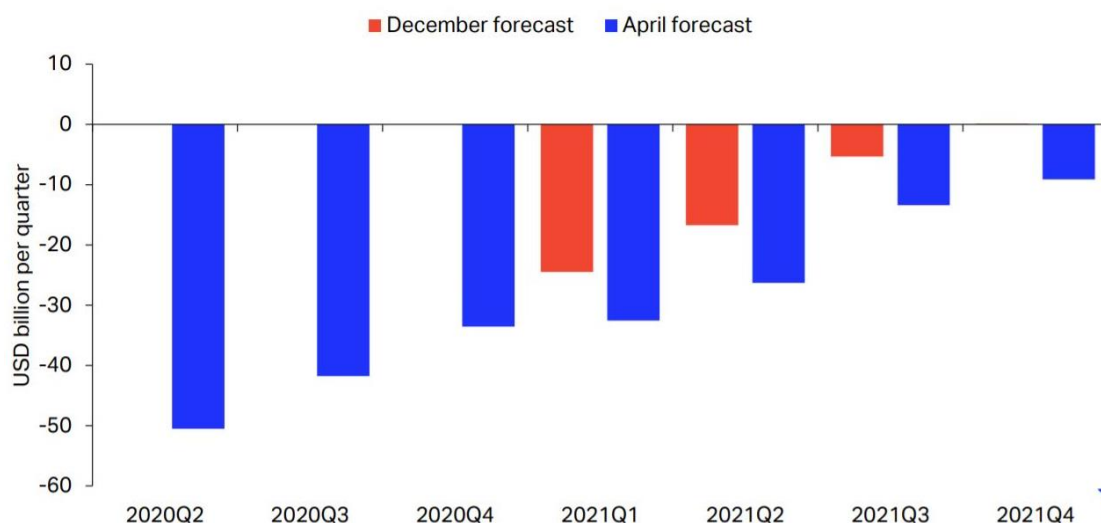


Figure 1. Source: IATA.

THE MAIN TAKEAWAYS FROM THE CAFMO

Recovery began in the second half of last year, but challenges remain in 2021

BCC said that there were clear signs of market recovery in the second half of 2020, with steady interest from institutional investors stemming from the industry's long-term growth credentials and strong, stable returns. Aviation also has a well-established legal framework, with legislation like the Cape Town Convention in place to protect the interest of sellers, buyers and creditors through an international registry.

However, significant challenges remain this year, with load factors much lower due to travel restrictions, and fears around contracting the virus when flying. Also, many countries have not started their vaccination programmes yet and those that have successfully advanced the roll out of vaccines are cautious about opening their borders to countries with higher infection rates. Countries with "air corridor" agreements, enabling free travel with other countries, will benefit.

Buoyant capital markets, with new features

The capital markets are the only financing option that is listed by BCC as being 'satisfactory' right now (*Figure 2*), given the challenging market environment. There were some \$120 billion of new issuances in 2020 – a 70 percent increase compared to the previous year. This was surprising considering the capital markets all but completely closed in the first half of the year.

Airline industry cash burn, USD billion per quarter



Figure 2. Source: Boeing Capital Corporation.

Nearly \$100 billion of that \$120 billion went to airlines. In 2020, lessors went from being the largest issuers to the smallest issuers, with airlines increasingly tapping the market for new financing to provide crucial support amid the pandemic. As the U.S. has the most sophisticated capital markets in the world and many of the American carriers are highly-rated, they were bigger capital markets debt issuers than their counterparts elsewhere in the world. North American airlines were most active in issuing secured bonds. Non-U.S. carriers issued more in the capital markets in 2020 too compared to 2019 – but unlike American airlines, they were more active in the equity issuances, and less so in unsecured debt markets.

More recently, as airlines have had to better manage their cashflows to adjust to the pandemic, the market has seen more equity and convertible debt issuances. The former is attractive to airlines as it requires no repayment schedule and the latter allows the airline to shore up more of its operating income for common stockholders than non-convertible bonds. While the industry navigates recovery, airline stocks are an attractive proposition to many investors right now.

After closing up for the first half of the year, the ABS market rebounded quickly towards the end of 2020 despite pandemic-related challenges. One (1) regional aircraft lessor, who had never previously entered the market, priced its first transaction earlier this month involving all regional aircraft (3). The structure contained several features that had not been seen in any rated ABS deal before 2021. These included a collections test, which ensures the deal will use any excess cash to pay down the series A loans if lease payments are down – offering greater security for investors. The deal also contained a 12-month liquidity facility, a larger facility than typical for such a transaction.

ECAs not hugely active last year, but a steady deal pipeline

Export Credit Agencies (ECAs) have always played an integral role when the industry is going through hard times. But surprisingly, there was less ECA involvement in 2020 (1.1 percent of all financings) than there has been in previous downturns. However, the majority of export credit transactions took place in the second half of the year, when bank debt was drying up, and there was a steady pipeline of ECA-backed deals. BCC predicts there to be a slight uptick in ECA funding and the agencies to play a critical role in the recovery of the aircraft finance sector.

For example, up to 30 percent of Boeing deliveries were financed by US Ex-Im between 2010 and 2012 as markets recovered from the 2008 Global Financial Crisis. The Ex-Im financings dropped to around 10 percent after 2015 when the ECA was unable to support most aircraft finance transactions due to not having a full quorum (4).

Lessors' market share continues to increase

Guinness Peat Aviation, the first commercial aircraft leasing company, was founded back in 1975 to help provide an alternative, flexible source of financing for airlines. Five (5) years later, there were just 538 aircraft owned by lessors, but around 40 years later, there are just under 13,000 – a testament to the growing importance of lessors to the market. 46 percent of all aircraft today are owned by lessors, according to the CAFMO, with the lessors' share growing by three (3) percent in 2020. Many industry experts believe this number will eventually grow to around 50 percent (5).

With airlines having to tend to their balance sheets and alter their fleet plans during the pandemic, lessors have managed to enter a flood of opportunistic sale-and-leaseback transactions, leading to a 130 percent growth for single aisle aircraft in 2020 and a 40 percent increase in widebody aircraft, compared to the previous year.

Tax equity retreated; credit enhanced deals stayed stable

Credit enhanced deals, which provide financing backed by a non-payment insurance policy, stayed stable during 2020 at four (4) percent but have continued to be a popular source of financing since emerging in the market in 2017. The tax equity market – which typically more risk averse – retreated in 2020 as well and remains a concern to BCC.

Private equity filling the hole left by some banks

Commercial debt was critical for airlines in the first half of 2020, where many had to draw additional funds from liquidity facilities or start new ones. There was a slowdown in the number of bank deals over the second half of the year, and some withdrew from aviation, but they will gradually return as the economic recovery continues. North America, followed by Asia Pacific, were the largest markets for bank debt in 2020. Increasing interest from private equity companies in the sector is helping to fill some of the void left by traditional lenders.

THE RISE OF E-DELIVERIES

The pandemic has made conventional deliveries more difficult: due to strict stay-at-home orders and remote working there has been a drop off in passengers, and manufacturers have reported hundreds of order cancellations over the pandemic. Supply chain and staff shortages have also played a significant role in slowing down deliveries.

However, the rise of e-deliveries has allowed manufacturers to continue their order pipeline seamlessly. ABL Aviation marked a significant milestone in April 2020, during the height of the pandemic. Together with Airbus and Pegasus Airlines, as well as ACG and Bank of China, ABL Aviation closed the market's first fully remote e-delivery transaction. The innovative transaction, where the carrier took delivery of one (1) A321neo, was financed under a Japanese operating lease with call option (JOLCO) facility funded with Aviation Capital Group-guaranteed debt, structured and funded by Bank of China, which also acted as facility agent. ABL Aviation acted as global equity and debt arranger for the first ever JOLCO funded with ACG guaranteed debt.

Pegasus has since adopted the remote end-to-end process on several A320neo Family aircraft. E-deliveries have allowed Airbus to continue delivering aircraft on time while complying to the necessary health and safety requirements during the ongoing COVID-19 pandemic. At the end of this month, ABL Aviation closed another e-delivery for a new A320neo with Pegasus, which was the first fully-remote deal.

This trend has caught on quickly and more airlines have used this technique. Airbus says the e-delivery process could become a blueprint going forward in a post-COVID world. The European plane maker originally piloted the idea in 2019 before the pandemic, but the concept became more popular as social restrictions curbed international travel.

In 2020, out of the 566 Airbus deliveries, some 150 were partial e-deliveries, the OEM says. This accounts for more than a quarter of total 2020 deliveries. In the first quarter of 2021, some 33 of the 125 deliveries have been e-deliveries, accounting for just over 25 percent of all deliveries.

How an e-delivery works

E-deliveries comprise three (3) phases: technical acceptance completion, electronic transfer-of-title; and ferry-flight and subsequent reception of the aircraft at the customer's base.

The technical acceptance completion involves the airline delegating Airbus or another third party selected by the airline to perform actions including the ground-check, the acceptance test flight, acceptance manuals and procedures, as well as minor cosmetic rework if required.

To transfer the title of the aircraft, Airbus and the airline use a secure platform "e-SalesContracts". The platform allows the parties to finalise the terms in a real-time virtual environment, such as the paperless drafting and delivery documents, before the transfer-of-title digital signature.

E-deliveries mean that none of the customer's own staff need to be physically present at the Airbus delivery centre, making it more environmentally friendly too. The last stage is the ferry-flight: where the customer's flight crew (or an appointed third party) can pick-up the sanitised aircraft and fly it straight back from the delivery centre to the airline's hub airport.

ABL'S VIEW

Ali Ben Lmadani

Chief Executive Officer

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The pandemic has been challenging for all of us in the industry, but we have learnt that by using new technology we can streamline the aircraft delivery process through e-deliveries. This more efficient, safe and environmentally friendly way of doing business is here to stay, even in a post-pandemic world.

Although some markets, such as the tax equity and commercial debt markets, have taken a hit during the pandemic, we are confident that the additional liquidity is available for airlines and lessors due to the long-term growth fundamentals of aviation.

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