PHOENIX AMERICAN

TRENDS OUTLOOK REPORT
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2021 Trend Report for Aviation Asset-Backed Securitization Industry

A Portrait of Resilience, Stability, and Future Growth

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Joe O'Mara is the Head of Aviation Finance in KPMG Ireland, the leading and largest transaction advisory firm in the global aviation finance market. He heads up a team of over 150 aviation finance professionals across their audit, tax and advisory functions. Over the last two decades, KPMG has advised on almost all major transitions that have taken place in the aviation finance sector and are viewed as industry experts in the field. He is a tax partner in KPMG, advising some of the largest aircraft lessors in the world, as well as major investors into aviation. He has extensive experience in the tax structuring of capital market ABS transactions in aviation

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Brendan Crowley is a Director in KPMG Ireland's Aviation Advisory practice. He is particularly active in the ABS due diligence space, having worked on the majority of ABS 3.0 and ABS 3.5 transactions (per report) that have come to market. He specializes in financial modelling and helping aviation clients make the best use of their data to support transactions and decision-making. He also advises clients on operational matters including establishing best-in-class functions, systems, processes, and governance procedures.

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Dr. Stuart Hatcher is Chief Revenue Officer at IBA Group, an aviation intelligence and advisory company providing data solutions, valuations and asset management. He oversees all company activity. Previously as Chief Intelligence Officer, he was responsible for IBA's valuations, modelling and intelligence activity. He has also been responsible for developing InsightIQ, an online analysis platform offering market intelligence for aircraft operators and the global aviation leasing and finance community. He holds a Ph.D. in Chemistry from King’s College London and is a Senior ISTAT Certified Appraiser. He is a regular speaker at industry conferences and a respected author.

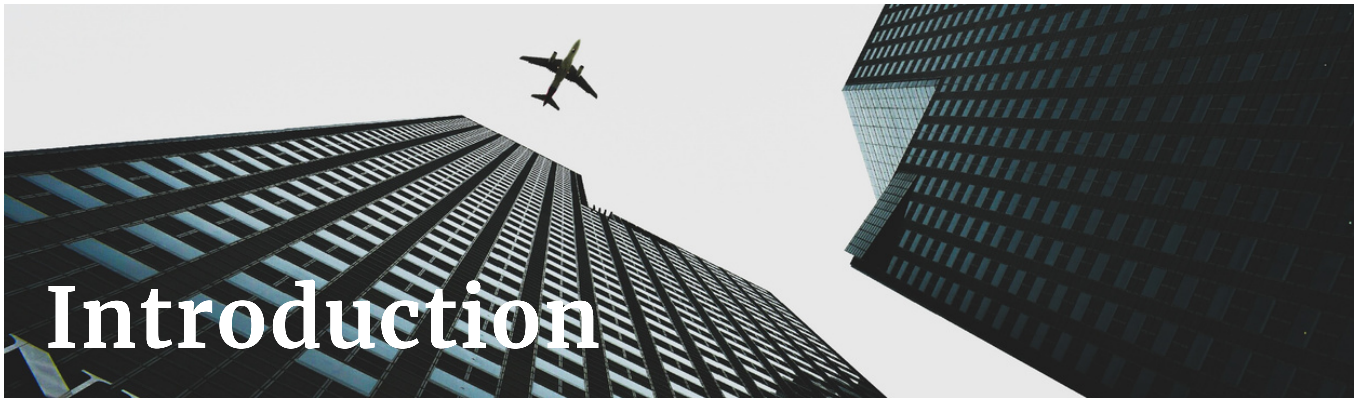
Executive Summary

- **Aviation ABS Shows Resilience to Covid-19 Market Shock:** The aviation industry felt the worst shock in its history when Covid-19 hit. As countries shut their borders, passenger numbers fell dramatically. While domestic markets are showing signs of recovery, the international long-haul market will take years to recover. Aviation ABS deals saw revenues from airlines drop precipitously, more than predicted by even the most pessimistic models. Yet, aviation ABS deals held firm. No deal defaulted as a result of the pandemic. The structures did their jobs and debt protections worked as designed.

- **Three Distinct Life Cycles of Aviation ABS:** Before Covid-19, there were three distinct lifecycles of aviation ABS. The 1990s was aviation ABS 1.0 with billion-dollar issuances and billion-dollar portfolios of aircraft. Post 9/11, referred to as ABS 2.0, was a more cautious market with smaller issuances and insured (wrapped) deals and saw the advent of third-party equity investors. Following the Great Recession, ABS 3.0 saw the aviation ABS structure honed for greater investor protections and saw record numbers of issuances year after year. Equity issuances evolved into tradeable equity notes as more and more investors entered the market.

- **Aviation ABS Post-Pandemic:** Aviation ABS 3.5 is the vehicle emerging from pandemic. While there have been some adjustments and added investor protections, there has not been the raft of wholesale changes one might expect following the biggest market shock in aviation history. Lessons were learned from previous shocks with only tweaks needed to make the structures more responsive to cash flow disruptions.

- **Aviation ABS Today:** Post-pandemic there has already been deal flow in aviation ABS that not even the most optimistic industry experts foresaw. In the first six months of 2021, seven new airline leasing ABS deals closed and issued debt of approximately $3.7 billion. Aviation ABS bounced back more quickly than after any other downturn. Aviation ABS is back stronger than ever, a proven mature structure in aviation finance.

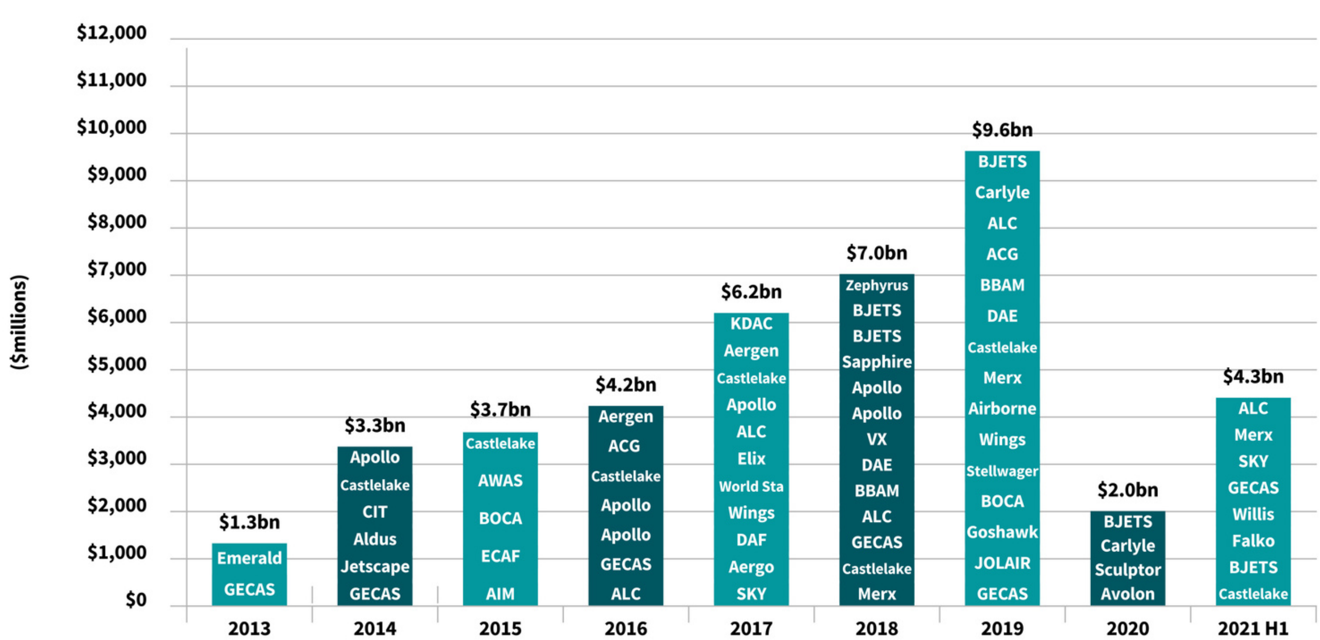


Introduction

Phoenix American Financial Services is the industry-leading Managing Agent for aviation asset-backed securitizations (ABS) in the global aviation leasing industry. In this role, at the crossroads of issuers and investors, we offer a unique perspective and a depth of insight into the forces and trends in aviation ABS. In this paper, we provide insight, data, and perspective on where aviation ABS has been, what it has just been through, and where it is going.

The aviation ABS market, rocked by the onset of the Covid-19 pandemic, faced a very uncertain future a few months ago. Few expected a quick return to anything like the breakneck pace of issuances in 2019 and early 2020. Yet, aviation ABS has bounced back with surprising strength. In response to the pandemic-induced economic downturn and the precipitous decline in passenger traffic, the aviation ABS market has displayed remarkable resilience.

Aviation ABS Debt Issuances in Millions



The aviation ABS market, rocked by the onset of the Covid-19 pandemic, faced a very uncertain future a few months ago.

Recoveries from past market downturns have strengthened aviation ABS to a degree that made a radical reinvention of the vehicle unnecessary for the initial deals closing post-pandemic. Looking at the first six months of 2021, a stunning seven ABS deals (excluding Business Jet transactions) have launched, a pace reminiscent of the record pace of 2019 and early 2020. In this paper, we will look at the history of the aviation ABS market, the forces that shaped it into what it is today, and the shift that has taken place as a result of the pandemic. Comparing the profiles and statistics of the seven post-pandemic ABS deals with seven similar deals launched in a six-month period before the shutdowns, demonstrates how this recovery required only marginal adjustments to the features of aviation ABS deals for issuers and investors to feel confident in re-entering the market.

Asset-Backed Securitization for Commercial Aviation

Structure

An asset-backed security is a transferable financial instrument created around a pool of illiquid cash-flowing assets. Securitization allows the Issuer to raise funds from otherwise illiquid assets.

An aviation ABS is a security representing a pool of typically 20 to 30 commercial aircraft or engines (“assets”) in a portfolio created by an Issuer or sponsor, which is then securitized. A governing document called a Trust Indenture is entered into upon closing of the deal.

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A typical structure for aviation ABS deals is a Cayman or Bermudan Orphan Charitable Trust. This Trust owns the company that issues the debt. Typically, for tax purposes, subsidiary Irish and/or U.S. companies own and lease the aircraft.

Since an aviation ABS takes the form of a trust, a Trustee is appointed to preside over its operation and protect the interests of the investors. The Trustee is usually the operating bank and is the entity that makes all payments on behalf of the ABS at the instruction of the Managing Agent, an administrator appointed to perform the back-office functions of the deal in accordance with the Trust Indenture. A Board of Directors is appointed ahead of the closing of the securitization. Typically, the Board consists of two equity appointees and one independent director. The portfolio aircraft are managed and maintained by an aircraft leasing firm, acting in the role of Servicer.

Debt and equity interests in the portfolio are sold to investors, typically pension funds, insurance companies, and other large institutions. The Trust Indenture governs the repayment of debt and all operations of the ABS deal.

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The aircraft are leased to Operators, passenger airlines and air freight carriers, that will make agreed-upon lease payments throughout the life of the deal. There is typically a targeted seven-year repayment window for the debt. To mitigate risk, the portfolio is usually diversified by aircraft type, age, region of the leasing Operator and other factors.

Typically there are three tranches of debt issued at the closing of an aviation ABS: Series A, B, and C. The Trust Indenture details a priority of payments, called a waterfall, in which monthly cash flows received are paid out for expenses and to investors in order of priority.

Series A and Series B debt are higher in priority than Series C debt. As a result, Series A and Series B debt are considered lower risk than Series C debt. This is reflected in the lower interest rate coupon attached to the higher priority tranches of debt.

An E-note for equity interest is issued at closing and typically receives the lowest priority in the waterfall. E-notes typically have a high interest rate coupon attached, reflecting higher risk. Equity investors tend to be interested in the long game, looking to benefit from the residual value of the aircraft at the end of the ABS cycle, once the debt has been serviced and paid.

Aviation ABS notes are listed on secondary stock exchanges in Ireland, the Cayman Islands and Bermuda and are regularly traded.

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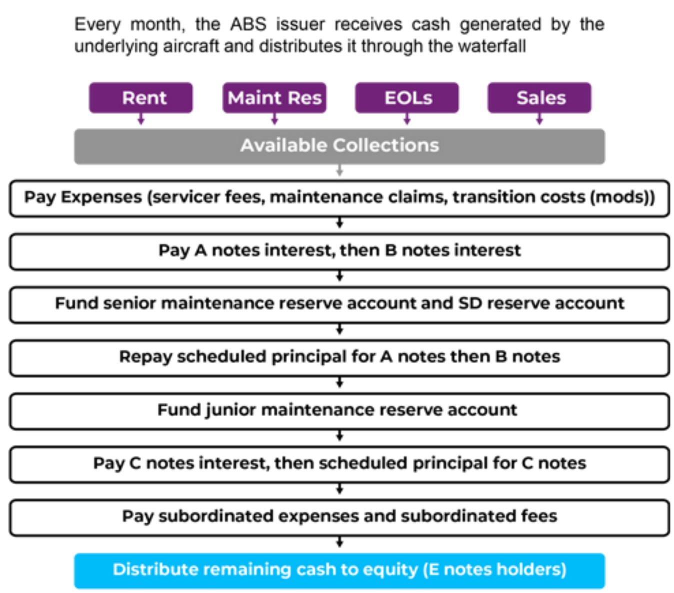
Typical Waterfall



Cash Flow and Investor Income

Investor capital in an aviation ABS may total anywhere from $250 million to $1 billion. The securitized pool of assets is leased to passenger airlines or cargo carriers. The investors receive proceeds from the monthly lease payments for the assets through the waterfall dictated in the Trust Indenture. When assets are sold, the proceeds also flow down the waterfall. Typically, expenses are paid first, then Series A and B interest, maintenance costs, A and B principal, Series C interest, and Series C principal. At the very bottom are the equity investors.

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Through the life of an aviation ABS deal, the Servicer is continually interacting with the commercial aircraft market. As an aircraft approaches the end of its service life, the ABS Servicer will consider the maintenance or reconfiguration costs involved in retaining the aircraft. If an attractive purchase proposition is available, the Servicer may propose the sale of the aircraft to the ABS Board. If the aircraft is on a good lease to an Operator with good credit—Delta Airlines or Emirates, for example—so that a proposed purchase price is enough to repay the aircraft's associated debt, the ABS Board may decide to liquidate that aircraft from the portfolio rather than retain it through the term of the lease.

This is the case with most portfolio aircraft. Normally, very few aircraft remain in the portfolio to the last stage of an ABS deal. Those assets that are left are sold, parted out, or scrapped, depending on their market value.

On the finance side of an aviation ABS deal, investors benefit from a predictable, safe, and steady return on invested capital from lease payments and aircraft sales. Issuers benefit from the proceeds of the deal, a monthly servicing fee, sales fee, and an end of lease compensation fee for managing the aircraft.

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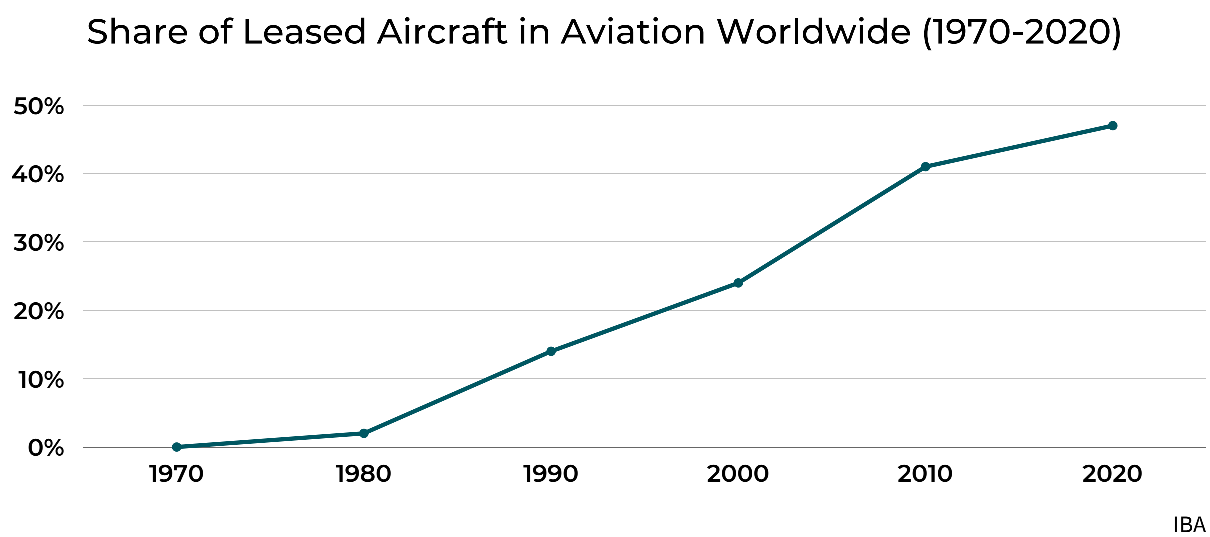
Flexibility for Airlines and Air Freight Operators

Operators of commercial aircraft benefit from the financial flexibility that leasing aircraft offers. Airlines and Air Freight Operators have several options for acquiring aircraft. They can buy the aircraft outright, lease them from a leasing company, finance their purchase through banks, or finance them directly with Boeing or Airbus. Purchased aircraft may be new from the manufacturer or used—purchased on the secondary market. Airlines may also purchase aircraft as they come to the end of a long lease. An aircraft may have expensive maintenance costs due at the time a lease expires, making it more cost effective to buy the aircraft than to perform the needed maintenance before returning it to the Lessor.

Rather than continuing to own and depreciate the aircraft in its existing fleet, an Operator may decide to enter into a sale-leaseback transaction. by selling a selection of owned aircraft to an aircraft leasing firm which creates and ABS with the aircraft as the assets. Debt and equity notes in the ABS are sold to investors. The portfolio aircraft are leased back to



the Operator. The Operator's lease payments are distributed to the investors. The Servicer manages and maintains the aircraft on behalf of the Issuer.

A sale-leaseback to a Lessor (who may then create an aviation ABS) takes owned aircraft off the Operator's balance sheet, along with any associated debt, without any change in the appearance or operation of the aircraft. This type of transaction allows the Operator to raise funds and de-lever its balance sheet in favor of fixed deductible lease payments.

Operators may or may not own the aircraft for a sale-leaseback. If aircraft are on order with Boeing or Airbus, the Operator may arrange with a Lessor to take over the order for the purchase price.

The Operator could also have the Lessor purchase the aircraft itself and lease the aircraft at a guaranteed lease rate, typically over a nine or ten year term. If the Operator is stable and has a good credit profile, this kind of sale-leaseback arrangement is very attractive to the Lessor and investors in the ABS.

The Managing Agent

Third-Party Administration

Each aviation ABS deal is its own group of companies and every group needs management. Since, as a group, an ABS deal has no employees other than the appointed members of the Board of Directors, an administrative agent is necessary to execute the provisions of the Indenture. This has come to be known as the Managing Agent role.

The Managing Agent—or administrative agent—looks after every operational concern of the aviation ABS. This includes the administering of the waterfall, tax preparation, accounting, cash management, company secretarial services, and every other back-office process. While doing so, the Managing Agent is also ensuring the Trust Indenture is followed at all times.

The Managing Agent does everything involved in the running of a normal company, adhering to all local and national laws and guidance, with the exception of managing the aircraft themselves.

The original seller, in the role of Servicer, manages the aircraft and maintains the working relationship with the Operators. This includes interfacing with lessees, remarketing assets for sale or lease, and arranging for maintenance providers when necessary.

The Managing Agent does everything else, including the critical function of investor reporting. Every month, the Managing Agent reports to investors on the cash that has come in from lease payments and sales, calculates the flow down the waterfall and allocates that cash to the investors.

Adherence to Trust Indenture

The role of the Managing Agent is to ensure that everything that occurs is in adherence to the Trust Indenture of the deal, the governing document of the aviation ABS. The Indenture dictates what can and cannot happen in the operation of the aviation ABS. It is a highly restrictive document with debt covenants and restrictions on how funds received can be applied. The Managing Agent must monitor and comply with all the provisions of the Indenture on an ongoing basis.

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The Managing Agent must be extremely accurate in every aspect of operations, calculations, and interactions with investors. Knowledge of the eccentricities of the aviation ABS landscape and the intricacies of adhering to the provisions of a Trust Indenture are key. A Managing Agent's experience and longevity in the role is the paramount consideration for the Issuer who engages them.

The Managing Agent must operate within a robust controls environment. The International Standard on Assurance Engagements 3402 (ISAE 3402) is an international assurance standard that provides assurance to a service organization's customers that the organization has adequate internal controls. Phoenix American is the first ISAE 3402 Type II audited Managing Agent in aviation ABS through its Irish subsidiary, PAFS Ireland Ltd.

Division of Labor

The Managing Agent enables an optimally efficient division of labor for the aviation ABS in which each participant does their best and highest job.

The Issuer—the creator of the securitization—knows about aircraft, the needs of aircraft Operators, and how large volumes of aircraft must be managed over long periods of time.

The investors—the providers of capital to finance the securitization—know the needs of their stakeholders, the rate of return required to make the transaction worthwhile, and the transparency they need to have confidence in the deal's success.

The Managing Agent is the operational connective tissue that makes the other participants able to work together effectively.

The Managing Agent is the operational connective tissue that makes the other participants able to work together effectively. In creating a Trust Indenture with inexorable processes proven to produce returns, the Issuer creates an attractive financial instrument for investors. The choice of a proven Managing Agent to execute the provisions of the Indenture is essential in fostering predictability and the assurance investors need to participate.

When aviation ABS first emerged in the 1990s, Phoenix American was already a leading provider of outsourced third-party financial and investor services to aircraft leasing portfolios and was the obvious choice for the role of Managing Agent. From the very beginning of aviation ABS, Phoenix American has been considered the industry-leading specialist in this area.

A Brief History of Aviation ABS

Early Players

The first asset-backed security was a mortgage-backed security (MBS) created in 1968 by the Government National Mortgage Association (Ginny Mae).

With the rapid growth of this investment vehicle in the 1970s and 1980s, the ABS concept was soon applied to other classes of illiquid cash-flowing asset, such as equipment leases, auto loans, and credit card receivables.

The leasing of commercial aircraft only became common in the early 1990s. Once there was significant transaction volume, it was not long before ABS deals began to emerge in the aviation industry. These deals serviced the same market that was investing in mortgage-backed securities and expanded the universe of securitizations backed by other assets

The history of aviation ABS begins with the downfall of one company. Guinness Peat Aviation (GPA) was a commercial aircraft sales and leasing company founded in 1975. The company's founders were the Guinness Peat Group, a financial services firm based in London—Aer Lingus, the flag carrier of Ireland—and Tony Ryan of Ryanair fame, who was an executive at Aer Lingus at the time.

Based in Shannon, Ireland, GPA was the world's largest lessor of commercial aircraft in the 1980s. With ambitious plans for rapid growth, the company attempted an initial public offering (IPO) in 1992. Its dramatic failure resulted in the company being disbanded. The company's senior management team went on to set up their own individual aviation leasing companies. Those companies are now some of the biggest players in the aviation ABS industry.

An Ireland-Centered Industry

It was Irish aircraft leasing companies that were the lessors stepping into the emerging aviation ABS industry from the very beginning. The first was International Lease Finance Corporation (ILFC), co-founded by Steven Hazy, known as the godfather of aircraft leasing. ILFC would go on to become AerCap. GPA and GE Capital Aviation Services (GECAS), which was set up to manage aircraft assets purchased from the restructuring of GPA, were also early players.

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From the industry's outset, aviation leasing has always been centered in Ireland. What began as an enterprise that grew out of relationships fostered at the Lahinch Golf Club has since become an international industry, still centered in Ireland. Today, however, Ireland's aviation prominence is primarily due to the country's appealing corporate tax rate and double taxation treaties. Aviation ABS deals have been a feature of lease finance for almost three decades.

The evolution of the industry can best be understood as occurring in a series of four phases, each pivoting around a great economic crisis.

Commercial aviation, dependent as it is on passenger travel and the movement of freight, is particularly sensitive to international economic shocks. Each global downturn since 1992 has given rise to a new iteration of aviation ABS.

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Aviation ABS 1.0 Pre-9/11

The Early Structure

Only a few companies were involved in the first aviation ABS deals: GPA (before its failure), GECAS (which managed GPA's assets after its failure), Pegasus, Triton Aviation, and GATX. Aviation ABS was a new phenomenon with only a handful of deals launched per year on average.

A typical deal in the 1990s was of high value in terms of both debt issued and the valuation of the aircraft in the ABS. Values were in excess of $1 billion in some 1990s issuances.

The portfolios were of strong quality, usually heavily concentrated in developed Europe or North America and leased to airlines with strong credit profiles.

These deals were typically floating rate debt issuances tied to the London Interbank Offered Rate (LIBOR) with the beneficial interests typically associated with an E-note.

That E-note was held by an affiliate of the sponsor of the deal or in tandem with one or two third-party equity participants. These beneficial interest holders were interested more in the tax benefits of aviation ABS deals than the returns available.

There were many more tranches of debt issued than seen today. In addition to Series A, B, and C notes, Series A-1, A-2, B-1, B-2, and D notes were typically issued.

The interest rate coupon on these deals was attached to LIBOR and the principal repayments were a calculation based on the funds received and the current valuation of the portfolio. Investor protections in these deals took the form of cash reserves to be maintained at varying levels of the waterfall, according to the priority of repayment of that level of debt.

Maintenance expenses and reimbursement payments were generally accrued to the expense account based on approved annual budgets and other information obtained from the Servicer.

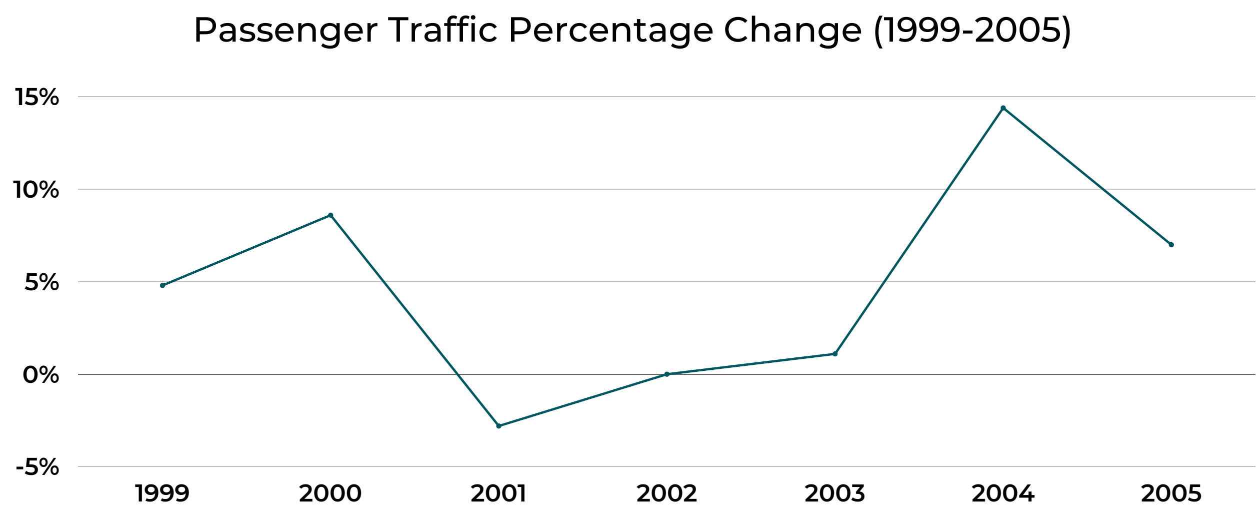
A typical monthly investor report ran for two to three pages and summarized the cash receipts, the waterfall, and the status of the repayment of principal on the debt.

Investors in the 1990s saw what funds were received, how they were distributed, and the status of amounts owed. Today, monthly investor reports have become much more robust and provide far greater transparency to investors.

Aviation ABS 2.0
Post 9/11 to the Great Recession

Aviation in Crisis

In a 2006 briefing, the International Air Transport Association (IATA) said 9/11 had created a "large temporary impact" that reduced travel demand by more than 31% in the five months following the attacks. It also estimated that airline revenues from domestic U.S. flights fell by $10 billion per year between 2001 and 2006. Passenger traffic would take five years to recover as the graph below shows.



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The economic crisis that followed the 9/11 attacks was not only a financial crisis but, due to the nature of the attacks, a specific shock to the aviation industry. The downturn that followed 9/11 was a catalyst for a number of airline bankruptcies which may have played a part in the long delay in new aviation ABS deals. It took until the mid-2000s for deals to start launching again. During the post-9/11 recovery, GECAS and ILFC were still responsible for the majority of the aviation ABS deals although other players were beginning to show interest.

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Post-9/11 ABS Deals

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To address this, risk wrap providers (insurance protections) were added to aviation ABS deals as a protective measure for investors. Premiums were paid to an insurance provider who would guarantee the payout of the senior debt through the final legal maturity of the note.

As it happened, however, in the Great Recession of 2008 and 2009, many wrap providers faced severe financial distress. Although premium payments had been made, these providers lacked the ability to make good on their policies. The guarantees were worthless but aviation ABS deals still had an obligation under the Indenture to continue paying the premiums at the top of the waterfall. What had been intended to be a safeguard for investors instead became a drag on the vehicle.

As new aviation ABS deals began to launch in 2005, changes that reflected a new caution were evident. Debt interest was still attached to LIBOR, but principal repayments became fixed to offer a more steady return to debt investors.

An attempt was made to regularize debt interest. LIBOR, which reset every month, reset the senior debt rate.

Because of the variability, hedges were used in the hopes of achieving revenue neutrality. This never worked out with any reliability and only became another drain on the vehicle with the advent of the Great Recession.

During the financial crisis, Lehman Brothers, which held many of the hedge positions, went into bankruptcy. Not only were the aviation ABS hedges worthless, but it cost money to get out of them.

Deals were smaller. Debt issuances dropped to the hundreds of millions of dollars and more diverse portfolios were offered. Engines, as well as aircraft, were securitized. Debt tranches issued were simplified to Series A and B notes. Asset concentrations were still in North America and Europe but diversification to Asia and Latin America was starting to grow.

One of the major changes was the sale of E-notes to third-party equity investors. These sales were initially only to a small pool of five to ten institutional investors, but it would pave the way for the evolution of equity investing after the Great Recession.

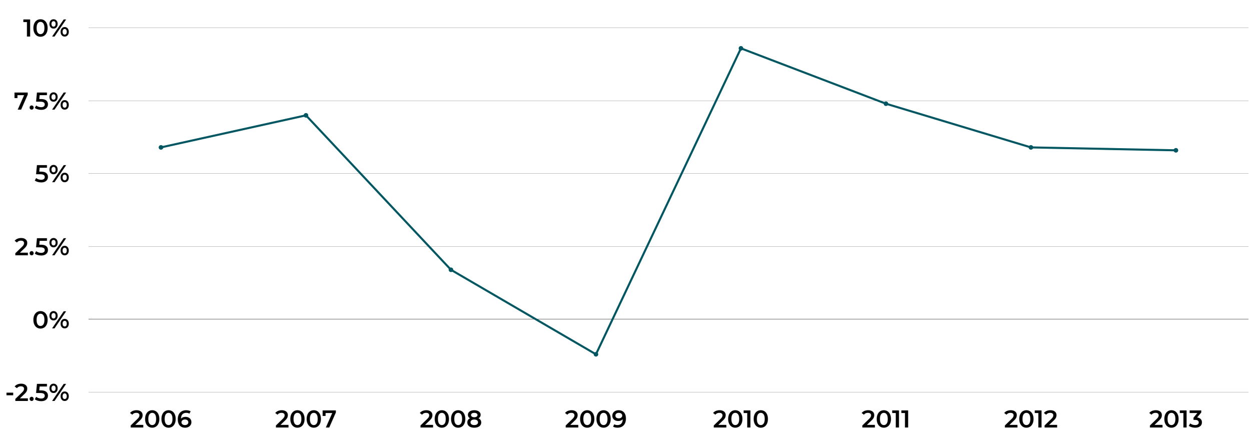
Investor reporting remained the same as pre-9/11, though there were changes to the waterfall which moved closer to the priority of payments of today. There were still some cash reserves used as an investor protection, but third-party liquidity facilities became more prevalent.

Due to the greater diversification of assets and the increase in lessees making maintenance contributions, a maintenance reserve line was built into the waterfalls. The amount reserved was based on a Maintenance Support Evaluation (MSE) performed annually by a third-party expert.

Aviation ABS 3.0
Post Great Recession to Pandemic

Securitizations were slow to recover from the Great Recession. In the wake of the global financial crisis, there were only a handful of deals done between 2008 and 2014. Though the 2008 downturn was real estate-led, it became a global downturn in all financial aspects and across business sectors. This affected aviation as every business felt the effects. IATA reported that 2009 saw the largest decline in airline passenger demand since World War II. The graphs below shows the dramatic impact on airline revenue and passenger traffic for the period.

Passenger Traffic Percentage Change (2006-2013)



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A Major Downturn

When economic activity declines broadly, it disproportionately affects aviation. People stop going on leisure trips. Downsizing companies cut down on business travel—a major revenue generator for the aviation industry. Business-class and premium economy tickets paid for on corporate expense accounts are vital revenue streams for passenger airlines. With declines in retail and business purchasing, air freight volumes declined. When business suffers generally, aviation suffers all the more.

The depressing effect on aviation was reflected in investor appetite for aviation ABS deals. It took until 2014 for deal flow to recover. However, when it did, the strength of the product became clear. Aviation ABS had come into its own. From 2014 to 2020, volume ramped up to over 50 deals in that six-year timeframe. Investor demand was high and aviation ABS had become a mainstream investment vehicle in the corporate finance world.

Mainstream Investment Vehicle

From 2014, there was a significant evolution in not only the quantity but the character of the deals that followed the Great Recession. As a result of its experience, aviation ABS had become more mature, investors had become more sophisticated, and, therefore, investor reporting had become more transparent. Investors were more knowledgeable about the ABS structure, better understood its behavior during downturns and now required more built-in investor protections.

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Investors needed to be reassured about the stability of aviation ABS deals to come back into the market. The essential nature of aviation ABS deals remained the same, but there were significant changes.

There would be no more floating-rate debt. Interest rates and principal repayments became uniform so investors could rely on fixed levels of returns.

Debt service coverage ratios (DSCR), measuring the ability of an ABS to use its operating income to repay all its debt obligations, were introduced for the first time. Changes in the waterfall were made to protect the senior debt investors. Flexibility was built into maintenance reserving, which, in previous deals, had trapped cash based on an annual look forward. Look forwards became bi-annual, with the servicer having the ability to update the maintenance forecast for current technical information. Where there were over reserves for maintenance, this led to large releases of funds on an annual basis.

In older deals, maintenance funds were locked up for a year. But starting in 2014, there was a real shift to reserving based on what was happening in real time in terms of the maintenance profile of the assets.

Dispositions (any disposals of assets) and lump sum cash receipts had previously favored the E-note through a separate waterfall. But from the mid-2010s on, it was built into Indentures that disposition proceeds would flow down the regular waterfall. Noteholders would receive a greater share and be better protected.

These provisions were refined from 2014 to 2016. Starting in 2017, there was very little change in these protections. The 2017 Indenture was the one that formed the basis for the raft of deals leading up to 2020.

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The new sophistication of investors was evident in the reporting they now required. Investor reports, which had previously been a cursory two to three pages, were now a comprehensive eight pages with thorough portfolio analysis and in-depth data behind every aircraft. More seasoned investors now insisted on a level of transparency that had never been seen before.

By 2014, Issuers had not only learned to build protections for investors into deals, but had become smarter about building the portfolios. Aviation ABS was becoming a stable and established investment vehicle. No wholesale transformation of aviation ABS had been necessary but the structural recognition of the possibility of a major global downturn had to be addressed in the deals. The 9/11 attacks had been a major shock to aviation and ABS deal flow had taken four years to recover. The real lesson of the Great Recession was how much worse it could be.

Equity Investments

Another major innovation was the E-note or equity investment. Traditionally, equity was held by the Issuer or sold to a very small pool of investors with one investor from this pool taking the whole E-note. This changed in 2014 and beyond. The market was opening up to a much wider field of investors who would share the E-note and the risk.

Another major innovation was the E-note or equity investment.

This led to the tradeable E-note, which was a feature in most new deals starting in mid-2018. The tradable E-note allowed many smaller players to buy into the note at a price point unavailable before. An anchor investor typically took a majority stake in the E-note.

E-notes were traded, like the Series A, B, and C debt, in the secondary market. Although, in reality, very few E-note trades have ever been made, their availability in this period gave a level of comfort to investors that effectively blew the pool of investors wide open.

‘Sweet and Sour’ Portfolios

One weakness of aviation ABS deals in this period emerged as the recovery continued to heat up in 2016. With the abundance of deals and enthusiasm for the product, portfolios began to show a mixture of asset quality and concentrations started to skew toward emerging markets. The newest and best aircraft would headline a deal with middling and lower quality aircraft drawing much less attention. These were the ‘sweet and sour’ portfolios.

The average age of certain portfolios in this era tended to be older. With older aircraft came less guesswork on the cash flows over the remaining service life of the assets in the portfolios. This was reflected in the interest rate coupon attached to the debt, which reached its lowest fixed-rate percentage in aviation ABS history (pre-pandemic) in February of 2020 at 3.23% for Series A Notes.

In the years leading up to 2020, fierce competition among Lessors had resulted in aircraft prices going higher and higher. It was a good time to be a seller. As a result, many aircraft were sold out of aviation ABS portfolios and new aviation ABS deals were being created. By 2019, with 20 aviation ABS deals launching that year, the talk at industry conferences was of a bubble waiting to burst. The accelerating pace of issuances could not be sustained.

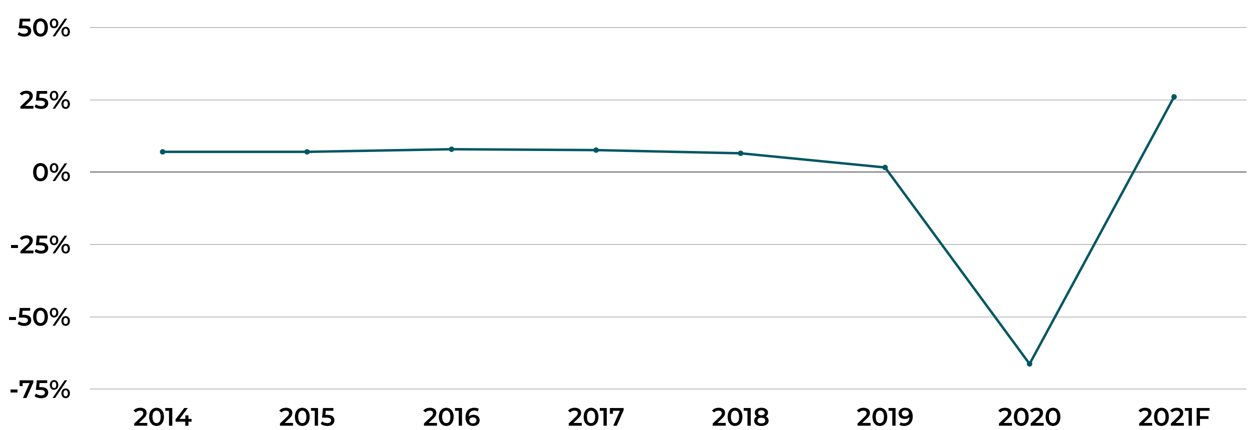
In the years leading up to 2020, fierce competition among Lessors had resulted in aircraft prices going higher and higher.

Aviation ABS 3.5 Post-Pandemic

Challenge to World Aviation

The Covid-19 pandemic shutdowns dealt a devastating blow to passenger air traffic worldwide. Stay-at-home orders and the shift to remote work put a global pause on business and vacation travel. Overnight, international passenger traffic was down 74% compared to 2019 and seats offered by airlines were down 66% according to the International Civil Aviation Organization (ICAO). Only air freight volumes benefited from increased orders from homebound customers. While the Great Recession had shown how much worse than 9/11 a crisis could be, the Covid-19 pandemic simply stunned the industry with its proportions. The graph below shows the precipitous drop in passenger traffic.

Passenger Traffic Percentage Change (2014-2021)



IBA

Despite this unprecedented crisis, aviation ABS deals held up well. Because of the evolution driven by the experience gained from two previous economic crises, the structure was well engineered and performed as intended under devastating circumstances. In the deals now emerging in 2021, it is clear there was no need for an aviation ABS 4.0.

With some minor tweaks, aviation ABS 3.0 is back. Aviation ABS 3.5 demonstrates the maturity of this structure, gained by hard experience.

The Covid-19 pandemic has been by far the worst of the three great shocks to the global economy and aviation in the last 20 years. But no major revisions were needed to bring investors back to the aviation ABS market.

The Covid-19 pandemic has been by far the worst of the three great shocks to the global economy and aviation in the last 20 years.

A Model That Worked

There were several factors that worked to sustain aviation ABS through the pandemic. For an aviation ABS deal to default, it must miss an interest payment on the most senior series of notes, Series A in most cases. The structure of the deals and the built-in debt protections meant that no deal defaulted during the pandemic and all structures reacted as modeled—though no model had contemplated a downturn of this magnitude.

The availability of liquidity facilities had been designed to cover nine months of senior interest payments, usually Series A and Series B. Despite the availability of these liquidity facilities, very few ABS deals required them, and those that did repaid what was drawn in full.

Government assistance to the airline industry certainly played a role in maintaining cash receipts for the aviation ABS structures. The pandemic showed that if broad economic conditions reached an extreme that could challenge the aviation ABS structure's many built-in protections, governments would act as funders of last resort.

We now know it takes a very long time, with very little cash coming in for Operators, for an aviation ABS deal to default, and none did. From the aviation ABS point of view, what matters is income that comes from the Operators leasing the assets under contract. Depending on their overall financial stability, they either continue making lease payments or they do not. Without substantial passenger travel, airlines were largely able to continue making lease payments due to a combination of the airline's financial depth, government relief, access to liquidity facilities, and requests for temporary accommodations. There were enough safety valves in the system to sustain aviation ABS through a long spring, summer, and autumn with extremely low passenger traffic income.

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Government relief in the U.S. included forgivable loans made under the Paycheck Protection Program (PPP) and The Coronavirus Aid, Relief, and Economic Security (CARES) Act. Accommodations negotiated by aviation ABS deals included:

- Restructuring of leases
- Deferral of lease payments
- Credit facilities - borrowing power to get ABS deals through the crisis
- "Power-by-the-hour" agreements - whereby lease payments are paid only for the time aircraft is actually operating
- Hand backs - aircraft returned to the Lessor ending lease payments

Air Freight

One bright spot was that the Covid-19 shutdowns induced an increase in airfreight. With millions of people under stay-at-home orders worldwide, unable to travel, attend large events, or even, in many cases, go out to dinner, excess household cash fueled an unprecedented amount of online shopping. Consumers, forced to stay largely at home for months, sought to improve their surroundings by ordering large furnishings, appliances and other consumer goods.

Cargo traffic was up 4.4% in Q1 2021 from where it was pre-pandemic

Cargo traffic was up 4.4% in Q1 2021 from where it was pre-pandemic. To meet the demand and use grounded aircraft, some passenger planes were temporarily modified to accommodate freight. Still, the business and vacation passenger traffic that sustains the aviation industry was all but shut down. Money that was normally spent on travel was being spent on homes, cars, and expensive creature comforts or was simply piling up in bank accounts.

Quick Recovery

Airline revenues, which had hit rock bottom in April and May of 2020, are now recovering as passengers are back to flying, especially domestically, in the U.S. China is also back to flying, as well as Russia. Europe started loosening up travel restrictions in July for passengers either vaccinated or with negative PCR tests. The U.S. is back up to 93% of pre-pandemic traffic. Southwest Airlines leads the way, serving pent-up demand for domestic travel.

Airline revenues...are now recovering as passengers are back to flying, especially domestically...

Unlike in previous recoveries, everyone wants to fly. With vaccination rates rising, though unevenly around the world, everyone is increasingly able to do so. In the downturn that followed 9/11, passengers were reluctant to travel because of safety concerns. The Great Recession financial crisis created a monetary hurdle to flying. All throughout the pandemic, however, travelers have been waiting for the green light, eager to fly and with money to spend. As soon as various government officials said it was safe, consumers started to fly again.

It only took nine months for the aviation ABS market to start coming back from the effects of the pandemic.

It only took nine months for the aviation ABS market to start coming back from the effects of the pandemic. The last pre-Covid-19 issuance was in March of 2020 and the first post-Covid-19 issuance was in January of 2021. On the secondary market, where aviation ABS notes were traded, senior notes in some aviation ABS deals were trading at, and in excess of, book value all through the pandemic. This showed that investor confidence remained in the market.

There were seven new aviation ABS deals in the first six months of 2021 (excluding Business Jet transactions), a brisker pace than any year except 2019. In December of 2020, leading industry experts thought three or four deals in 2021 would be a good showing. Seven in the first six months (with several more deals likely this year) is a revelation. The recovery has been far quicker than anticipated, showing investor confidence in a solid structure, honed by the previous crises and now seemingly impervious to the worst effects of downturns.

Seven in the first six months (with several more deals likely this year) is a revelation.

The Long Game

Long-term investors, like pension funds, looking for a steady return with low risk, understand aviation ABS is a long game.

Typically, the payback period is targeted at seven years. Aviation ABS has shown that, over the long term, it is an investment that can be expected to perform even through a major economic disruption. The interest coupon pricing on the seven deals of 2021 has, in some cases, surpassed the February 2020 pricing.

Now, debt is being issued at record-breaking low interest rates. The current record being 2.43% for Series A. One significant factor in the first seven deals to close in 2021 is that they are all debt-only deals with no external equity investors. This is one aspect of ABS 3.0 that will take some time to reappear if it does at all. In ABS 3.5, the E-note is the bottom line in the waterfall. Previous equity investors are watching how the aviation ABS market recovers before investing to their previous extent again. It will likely be a few years before tradeable equity returns as a common feature.

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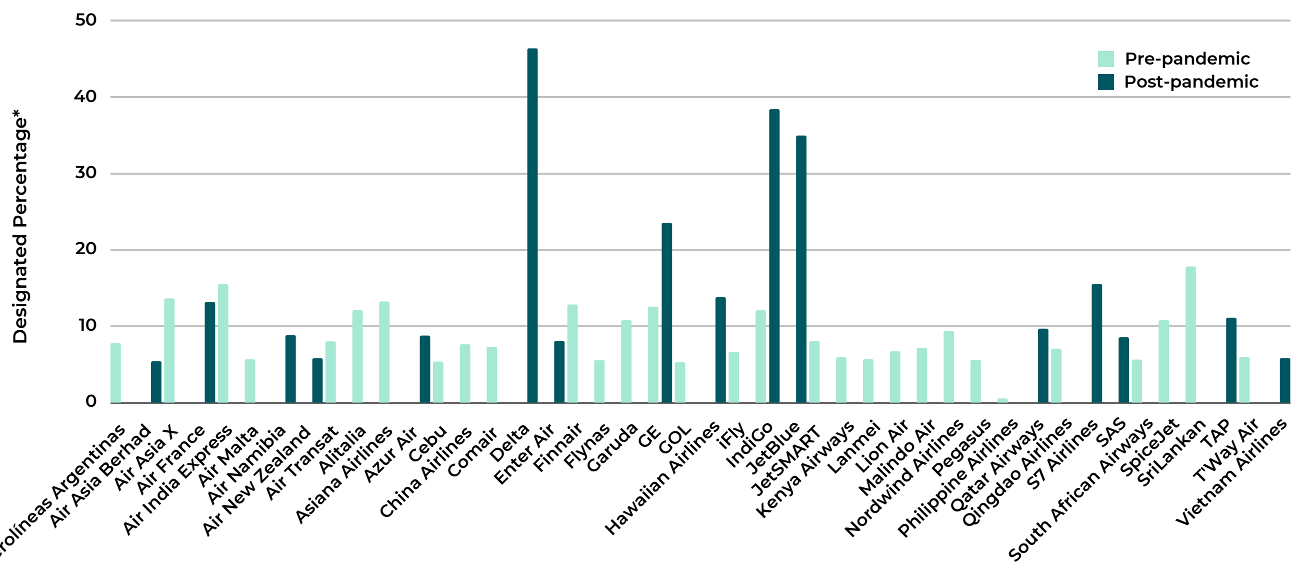
Comparative Analysis
Pre and Post-Pandemic

The seven aviation ABS deals in 2021 show only minor changes from the equivalent seven deals leading up to the shutdowns in March of 2020. Major structural changes were not necessary but marginal adjustments in light of new realities were applied.

The data for this analysis was sourced from Pre-Sale Reports from KBRA, Moody's, and S&P. The principal differences that do exist from aviation ABS 3.0 to 3.5 are in the following seven categories.

Share of ABS Portfolios by Airline Before and After Pandemic



1) Move to Lessees With Stronger Credit

Lessee’s credit strength improved greatly in ABS 3.5. Delta Airlines, which had not been featured in any of the pre-pandemic deals analyzed, now makes up the most concentrated airline in terms of value in a portfolio. This trend had the opposite effect on Philippine Airlines which is now understood to be strained financially. The movement toward better credit lessees shows that there is a strong portfolio of assets to gain the confidence of investors. Gone are the ‘sweet and sour’ portfolios. Today, every airline must have an acceptable credit profile to be worth the investment.

*Designated Percentage is defined as the appraised value of an asset divided by the total appraised value of the portfolio of assets to which it belongs. Assets with a Designated Percentage below 5% have been omitted for clarity.

2) Younger, Higher-Quality Portfolio Aircraft

In aviation ABS 3.0, the assets put into deals were typically mid-life aircraft, ten years old on average. Mid-life aircraft not only are of lower value, but usually require more frequent and costly maintenance than newer assets. Mid-life assets tend to be on their second or third lease, which means a weaker credit Operator is leasing the aircraft representing greater risk.

Aviation ABS 3.5 assets are six years old on average, reducing the required maintenance outflow. Newer aircraft are also normally on lease to better credit Operators. There are also more modern, fuel-efficient technologies in the aircraft of aviation ABS 3.5 portfolios.

3) Decline in Average Number of Lessees per Deal

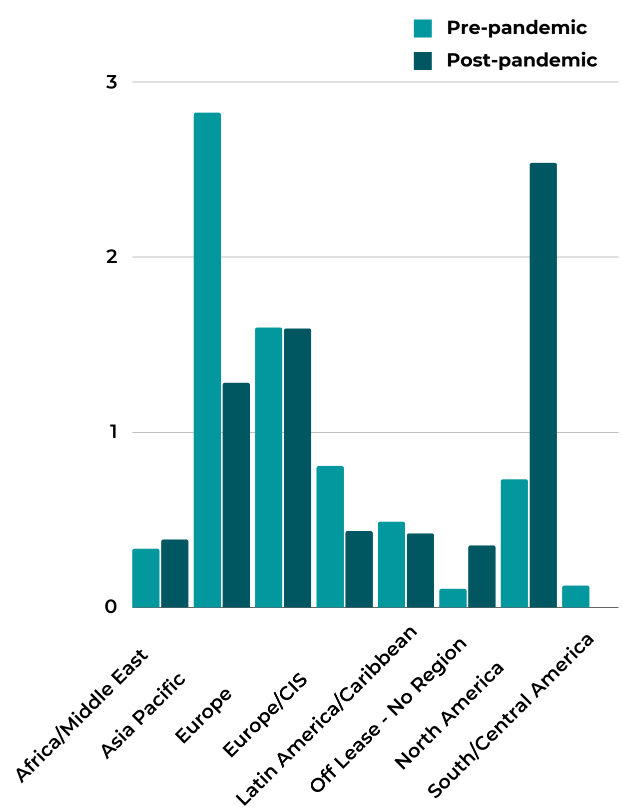
Concentrating the number of lessees by focusing on better quality credits in more developed regions has been a factor in ensuring that these deals were attractive to investors. In aviation ABS 3.0, the argument was the more lessees, the more diverse the risk. For that reason, pre-pandemic aviation ABS transactions averaged 18.43 lessees per deal.

The opposite thinking has been applied to aviation ABS 3.5. By keeping down the number of lessees, the risk is concentrated with lessees who have performed well during the pandemic in regions that have shown signs of recovery or governmental support. Today's aviation ABS deals average 8.86 lessees per deal.

4) Western Shift of Region Where Airlines Are Based

The concentration of the lessees in aviation ABS 3.0 had skewed toward developing Asia Pacific, as indicated in the graph below. These markets are taking the longest to recover post-pandemic due to a number of macroeconomic issues and low vaccination rates. In aviation ABS 3.5, the concentration has shifted back toward North America, where domestic airline traffic has recovered to 90% of pre-pandemic levels. The current region concentration is actually a shift back toward the concentration of aviation ABS 1.0 and aviation ABS 2.0 to win back investor confidence.

Region Where Portfolio Airlines Are Based Before and After Pandemic

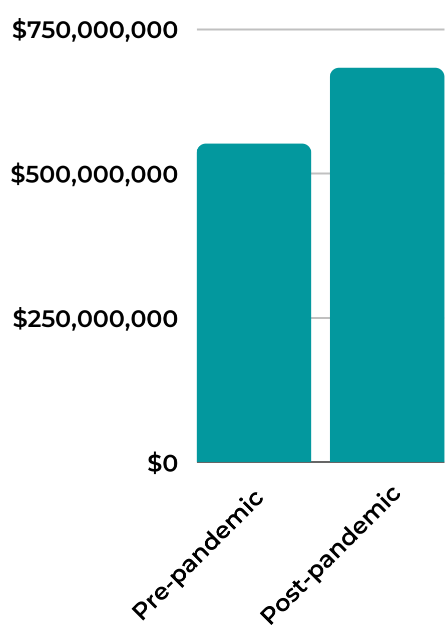


5) Increase in the Average Value of Portfolio Aircraft

The value of the portfolio has increased due to younger aircraft, better quality lessees, and the need to show value to investors. A key point on this graph is that the post-pandemic valuations include a haircut to valuations made by appraisers.

The gap, in reality, would be larger if we were to use the pre-pandemic valuations of the same aircraft. It is worth noting that aviation ABS deals are still far from the $1 billion valuations that were commonplace in aviation ABS 1.0.

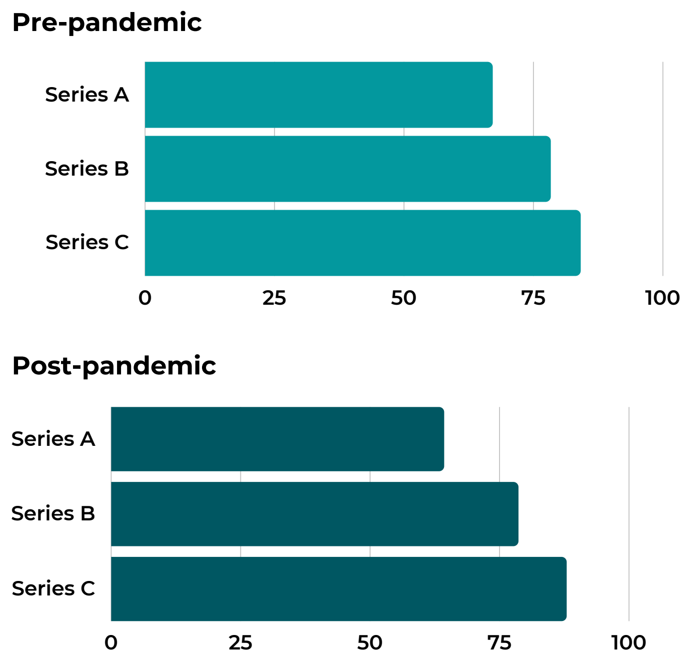
Average Value of Portfolio Aircraft
Before and After Pandemic



6) Suprisingly Little Change to Loan-to-Value Ratios

Interestingly, the LTV ratios remained consistent, apart from a slight change in Series A. One would have expected the LTVs to decrease to the 50% range of aviation ABS 1.0, giving more comfort to investors. This goes to show that aviation ABS 3.0 deals were positioned correctly for LTV and little change to this factor was required by investors.

Average Loan-to-Value Ratios
Before and After Pandemic

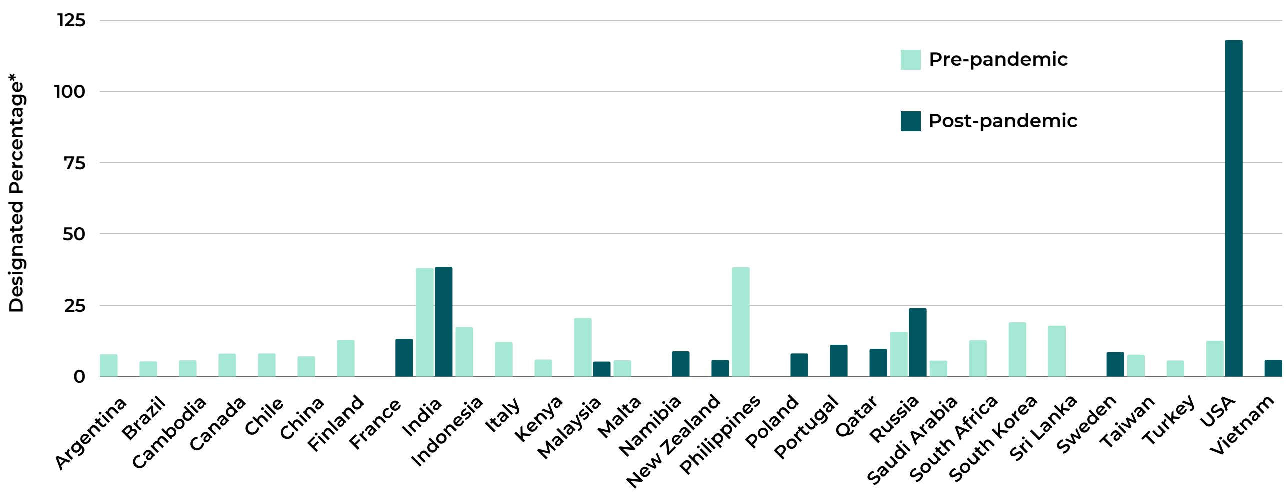


7) Shift Toward U.S. Airlines and Away From Weaker Credit Countries

In aviation ABS 3.5, there has been a sharp swing toward the U.S. and away from Asia Pacific countries. The U.S. is the dominant country in aviation ABS 3.5.

With U.S. domestic traffic recovering well, government support in place, and a number of institutional investors based in the U.S., portfolios weighted in the country give comfort to investors. Few other countries can currently offer this comfort.

Country Where Portfolio Airlines Are Based Before and After Pandemic



Some Tweaks to the Structure

There were other structural changes made in aviation ABS 3.5. One common across all seven deals so far is the DSCR test frequency reducing from six to three months.

This offers greater protection to the debt investors as a more frequent DSCR test reacts quicker to a strain on cash flows than the six-month test prevalent in ABS 3.0. Crucially, if an aviation ABS is in a DSCR event, with the three-month test, it also exits more quickly, freeing up the waterfall. Another common new feature is the collections test. If a certain percentage of collections is not received, the cash sweeps to Series A after the Series A scheduled payment line in the waterfall.

In aviation ABS 3.0, most deals after 2014 had a funding mechanism in the waterfall to top up the security deposit account with only a small deposit upon closing. This was for security deposits refundable to lessees at the end of a lease. This was a change from aviation ABS 1.0 and aviation ABS 2.0, where the Security Deposit account was fully funded on closing. The original feature has returned in aviation ABS 3.5. The Security Deposit is taken from the proceeds on closing and the reserve account is fully funded.

Another new feature in some of the aviation ABS 3.5 deals is a minimum asset requirement. This provision states that after the delivery period, the deal must own at least a minimum number of assets. If the threshold is not met, a Rapid Amortization event is triggered. This offers protection to debt investors; if there is a reduced pool of assets, the Senior tranche of debt gets the benefit of the cash received until that tranche is repaid.

The Covid-19 pandemic was said to be the worst shock that has ever hit the aviation industry and the world's economy. Nearly every government has stepped up to support airlines and jobs, and aviation ABS held up well. Now, the aviation ABS deals are coming out the other side, adjusted for a new reality, and stronger than ever.

*Designated Percentage is defined as the appraised value of an asset divided by the total appraised value of the portfolio of assets to which it belongs. Assets with a Designated Percentage below 5% have been omitted for clarity.

The Aviation ABS Market Today

Favorable Trends

Aviation ABS has played an important role in aviation finance that is only going to expand moving forward. Since the advent of aviation ABS, the ratio of aircraft owned versus leased by airlines has shifted dramatically. In the early 2000s, it was typical for airlines to own the majority of their aircraft outright.

Today, most of the world's fleet is closer to a 50/50 split of owned versus leased and trends strongly toward predominantly leased fleets in the future.

Today, most of the world's fleet is closer to a 50/50 split of owned versus leased and trends strongly toward predominantly leased fleets in the future. Because of the abundance of investment-grade rated lessors with access to cheap capital and investors with experience and familiarity with aviation ABS deals, the incentive for airlines to own aircraft for any length of time continues to erode.

Emerging from the pandemic downturn, aviation ABS deals only needed refinements of an already stable structure to interest investors again.

The most significant changes were some additional investor protections, the makeup of the portfolios, the airlines, and the regions responding to a new perception of risk in the industry. The deals closed to date in 2021 have been 'debt only' deals in which the Issuer retained the E-note. It may take some time for an 'equity deal' to emerge and even longer for the return of the tradeable E-note, which was prevalent from 2018 to 2020.

Stronger Portfolios

Before the pandemic, aviation ABS portfolios could contain 20 airlines in 18 different regions with the risk thought to be mitigated by country concentration diversification. Today, portfolio assets are more concentrated in North America and Europe, where the airlines are considered to be better credits. American Airlines and Delta Airlines in the U.S., and the flag carriers of Europe including Air France and KLM, are heavily favored in today's aviation ABS deals.

There is no tolerance for the 'sweet and sour' portfolios of the past. The whole portfolio has to be quality assets leased to good credit carriers. More engaged and better-informed investors are more familiar than ever with individual portfolio assets.

Every aircraft in the deal has to be worthy of its investment. The aircraft today's deals invest in are

More engaged and better-informed investors are more familiar than ever with individual portfolio assets.

noticeably younger, averaging only six years old. Prior aviation ABS deals generally invested in aircraft that were ten years old.

Fewer wide-body aircraft are contained within today's aviation ABS portfolios with international travel still a challenge for many. Trans-Atlantic and Trans-Pacific routes will be the last to return from the pandemic. With varying Covid-19 restrictions and entry requirements from country to country, 'hub and spoke' traveling internationally is still a lot more difficult than traveling domestically. An American traveler still has to worry about vaccine verification documents, Covid-19 test requirements, and the possibility of being unexpectedly quarantined in a foreign country.

For aviation ABS portfolios, wide-body long-haul aircraft are considered riskier assets and are less prevalent than before.

Narrow-bodies are in high demand as low-cost carriers like Southwest and Ryanair lead the recovery with short-haul service within the U.S. and Europe. Aircraft with newer technology is especially favored for their fuel efficiency and because of an increased focus on environmental, social, and government (ESG) concerns in the aviation industry.

GECAS/AerCap

Major news in the aviation leasing market is the proposed merger of GECAS and AerCap, the two largest lessors in the industry. Their combined fleets would include 2098 aircraft, roughly 16% of the current global leased passenger jet portfolio, with 531 additional aircraft on order.

The $30 billion combined company would have 266 airline customers representing over 25% of the world's 970 airlines. Since there are more than 100 other operating Lessors globally to manage the remaining +80% of the global portfolio, anti-trust considerations are not considered likely to derail the merger.

A combined GECAS/AerCap, with unmatched pricing power and efficiencies, could achieve economies of scale significantly affecting aircraft pricing and the cost of financing as well as overhead costs.

The merger could also force further consolidation. Other Lessors may be forced to consider acquisitions and mergers to remain competitive. How these market factors will affect aviation ABS in the years to come remains to be seen.

The $30 billion combined company would have 266 airline customers representing over 25% of the world's 970 airlines.

Joe O'Mara, Head of Aviation Finance, KPMG in Ireland
Brendan Crowley, Director, KPMG in Ireland

The Expert View from KPMG

KPMG has been a mainstay of the ABS market since it first supported the GPA ALPS 92-1 public offering almost 30 years ago. Having witnessed the highs and lows of the market over the intervening years, KPMG's Joe O'Mara (Head of Aviation Finance and Tax Partner) and Brendan Crowley (Director, Aviation Advisory) give their assessment of the current market below.

The Year-to-Date

Post pandemic, the main question for ABS Issuers and stakeholders was whether the existing structures would be robust enough to survive in their pre-pandemic form. Since Castlelake launched its CLAS 2021-1 transaction, the investor community has provided robust support for new issuances and this momentum has continued to gather pace throughout the year.

Initial transactions were characterized as having exceptional credit or asset quality (illustrated by the Delta Airlines concentration in the CLAS 2021-1 portfolio and the SLAM 2021-1 average fleet age of only 1.6 years). Since then investors have shown more appetite for "traditional portfolios" that include off-lease assets and restructured PBH leases.

"Investors are signaling their backing of Lessors and Servicers ability to re-lease assets at commercial rates and deal proactively with their airline lessees."

O'Mara points to this as a sign of confidence in the future market trajectory. "Investors are signaling their backing of Lessors and Servicers ability to re-lease assets at commercial rates and deal proactively with their airline lessees."

One of the question-marks during the pandemic was how to accurately predict asset valuations and re-lease rates. The resurgence in the ABS market suggests that investors are more comfortable with this topic but have a lower risk appetite. We have not yet seen the equity E-Note market being tapped in 2021 and O'Mara points to the re-emergence of this market as one of the remaining factors that will signal a return to "business as usual."

On the topic of enhanced credit features, Crowley regards this as "evolution, not revolution." Pre-pandemic features like cash traps and cash-sweeps to senior Noteholders are still prominent features of deals but have evolved so that they can be implemented quicker than before in response to market shocks.

Loan-to-Value metrics, provision accounts, and repayment profiles may be marginally more conservative, but the ABS 3.5 structure looks very similar to the ABS 3.0 structure. Crowley posits that this is no accident.

“Investors want the ability to compare transactions and standardized structures facilitate this. Complexity and esoteric features are frowned upon as investors are wary of surprises.”

“Investors want the ability to compare transactions and standardized structures facilitate this. Complexity and esoteric features are frowned upon as investors are wary of surprises.”

Investors are increasingly looking to contracted revenue cover and “breakeven metrics” to evaluate deals but are showing strong confidence in the market to date.

The Aviation ABS market has long benefitted from a robust due diligence process. Being on the front lines of providing tax structuring advice, plus lease and model due diligence services, O’Mara reflects that these activities will remain more important than ever in the post-pandemic environment. “Investors want transparency. They need to have confidence in the accuracy of information provided

"Investors want transparency. They need to have confidence in the accuracy of information provided and have proven astute in forming their own views of the market with this.”

and have proven astute in forming their own views of the market with this.”

This drive for transparency is expected to continue into the future. DealVector and bespoke ABS platforms help remove some of the uncertainty previously associated with structured products and while the demand for “more information” may continue to grow, investors do benefit from quarterly reports that need to balance full disclosures with commercial sensitivities.

O’Mara welcomes this trend and notes how far we have come from that original ALPS 92-1 deal almost 30 years ago.

For many Lessors, KPMG is their first sounding board when looking for background on the market and advice on the wider ABS process, O’Mara and Crowley are enjoying the chance to re-engage with investors and clients, helping them navigate the process as the aviation ABS market recovers and thrives, hopefully in line with the aviation sector as a whole.

Conclusion

Judging by the first seven deals of 2021, the aviation ABS product has proved to be resilient. Honed by hardship, this investment vehicle has become better structured for downturns, a better investment for investors, and a better financing option for lessors and airlines.

...the aviation ABS product has proved to be resilient.

And the structure has held up. With some refinements to terms, a stronger pool of assets, and better concentration in certain jurisdictions, aviation ABS is primed for the kind of success it enjoyed leading into the pandemic.

Sophisticated investors know what they're getting into with aviation ABS and know what to insist upon in order to have confidence in a product. Approximately $3.7 billion was raised in the first six months of 2021, even while the pandemic was still raging globally. Investor confidence in the aviation ABS product is strong.

Approximately $3.7 billion was raised in the first six months of 2021...

The deals being brought to market now are still only within a narrowed field of airlines, with the Deltas, Air Frances, and KLMs of the world. As time goes by, more routes will open and the weaker airlines will re-enter the market.

As this happens, there will be an ever-growing appetite for aviation ABS deals. With vaccination campaigns ongoing, Covid-19 restrictions still loosening among high-traffic markets, and the foreseeable return of international wide-body travel, the best days of aviation ABS are still to come.

Aviation ABS is an investment that has demonstrated an ability to survive, endure, and bounce back.

The promise of 2020 issuance volumes, interrupted by nine months of global pandemic shutdowns, is already back in 2021.

Several of the interrupted 2020 deals, following slight modifications, will likely re-emerge in 2022. As governments and passengers become more confident in flying and the aviation market as a whole recovers, aviation ABS will be right there, stronger than ever.

Phoenix American
Managing Agent and Accounting Services

Phoenix American Financial Services has extensive experience providing Managing Agent services to aviation leasing financial structures of every size, scope and complexity. Serving aircraft and engine leasing transactions since 1993, we have a robust team of seasoned professionals and industry-tested processes, procedures and controls to deliver the timely and accurate information our clients have come to expect.

In the Managing Agent business, excellence requires a corporate commitment to serving clients for the long run. Phoenix American has been providing Managing Agent services to aircraft ABS transactions since the emergence of the vehicle in the 1990's. The Phoenix American team has unparalleled depth, knowledge and commitment to client service for the entire life of an aviation ABS transaction.

For more information on how Phoenix American can assist your firm with its next transaction, please contact:

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