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Assessing the structure and resilience of aircraft portfolio securitisations

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The issuance of debt and equity securities backed by a diversified portfolio of leased aircraft ("Portfolio Transactions") was reaching record levels before the COVID-19 pandemic, with a record-setting five-year streak measured by both value and number of transactions, with over US$30bn in debt issuance.

The popularity of the product stems from its benefits to both originators and investors. Originators can obtain long-term, fixed rate financing for large portfolios of aircraft while maintaining customer relationships and earning fees for servicing activities. Importantly, Portfolio Transactions can serve as attractive staple financing to facilitate a disposition of the assets themselves. Investors, on the other hand, gain exposure to a real-world asset backed by dollar-denominated cashflows derived from a diversified cross-section of geographic and airline credit profiles in a high-growth industry.

This article examines some of the key structural innovations and characteristics that have evolved since 2013 to facilitate issuance and achieve more predictable results notwithstanding the general volatility which has always characterised the air travel industry. These include a risk retention carve-out, an optimised tax structure, a streamlined priority of payments, more predictable amortisation, increased operational flexibility to monetise assets and increased liquidity for equity tranches. These developments have led to a more standardised approach that has made the product attractive to a wider set of investors and which will, it is hoped, show greater resiliency than prior generations of Portfolio Transactions in the face of a crisis in aviation that is proving to be as severe and lasting as it was unexpected.

Basic structure

A typical Portfolio Transaction involves between 15 and 30 aircraft on lease to airlines worldwide. The portfolio of aircraft is fixed, with only limited ability to substitute aircraft after closing. Each portfolio aircraft is sold to a special purpose vehicle (the "Issuer") subject to an existing lease during the nine to 12 months following settlement and thereafter owned by special-purpose subsidiaries of the Issuer. Notes are issued for each tranche of debt securities with noteholders generally participating through the DTC/ Euroclear system, though there have been several loan format transactions. The investment grade Class A tranche ("A" rated) and Class B tranche ("BBB" rated) have the benefit of a liquidity facility covering up to nine months of interest, while the "B" rated (or occasionally unrated) Class C tranche will often have a non-replenishing cash interest reserve account. All assets of the Issuer and its affiliates and the equity in the Issuer are pledged as collateral.

A board of directors including at least one independent director directs the vehicle's affairs. Most actions reserved for Issuer approval are subject to majority approval, but certain material corporate actions, including bankruptcy, require unanimous consent. Non-independent directors are appointed and controlled by equity holders. The Issuer engages third parties to perform core business functions. The lease servicer (typically the originator of the transaction and the seller of aircraft to the vehicle) is engaged to perform all functions relating to the aircraft, including lease and sale marketing and collections. A managing agent is engaged to perform day-to-day functions including financial accounting, record-keeping and investor relations.

Equity in the portfolio is issued by way of hybrid "E Certificates" with equity characteristics, which are acquired either by an affiliate of the originator or by third parties in a sale that is exempt from securities registration. In a private placement, the E Certificates are issued to a limited number of purchasers who are responsible for conducting their own due diligence, consistent with a typical M&A process. In a Rule 144A-compliant equity issuance, the debt issuer issues an E Note to an equity certificate issuer that in turn issues DTC-listed tradeable equity certificates to qualified institutional buyers in a process that is fully underwritten by one or more investment banks.

Debt instruments issued in a Portfolio Transaction are rated based on the current contracted and projected cash flows that can be generated by the asset servicer in the worldwide aircraft leasing market, as well as the projected residual or disposition values of the assets in the portfolio. These cash flows are subjected to modelling stresses by rating agencies, which require some form of credit support in order to smooth payment profiles achieve the desired ratings. The debt securities have a long-dated final maturity, which can extend well beyond 20 years to allow long-lived aircraft assets to achieve ultimate repayment of principal as required by ratings criteria.

Despite this long theoretical maturity, transactions are modeled using expected repayment dates that are usually 7-8 years out, based on a soft bullet that corresponds with an anticipated refinancing date. Accordingly no event of default occurs if the Issuer fails to refinance the portfolio on the expected repayment date; instead, the transaction goes into full cash sweep mode, which entails sequential paydown of notes by class and a freeze on all equity distributions. In addition, the notes accrue additional interest at a step-up rate. These features are put in place to incentivise the Issuer to refinance on the expected repayment date. However, it is essential to understand that the expected repayment date is not guaranteed, especially when market conditions change.

Risk retention regulations

While Portfolio Transactions are often referred to colloquially as "securitisations" or "ABS" transactions, it is important to distinguish securities issued in a Portfolio Transaction from what financial regulators define as "asset-backed securities" under Section 15G of the Securities Act of 1933, and the credit risk retention rules promulgated thereunder (the "CRR Rules"). The CRR Rules apply to issuances of securities that are collateralised by "self-liquidating" financial assets, whose repayment depends "primarily" on the contracted cash flows generate by such financial asset. In a typical Portfolio Transaction, however, the contracted lease cashflow at the time of settlement is insufficient to repay the notes, with each individual lease being expected to terminate prior to the final maturity date. Repayment thus requires active asset management resulting in a satisfactory lease rate or sale price, which distinguishes securities issued in Portfolio Transactions from typical "asset-backed securities" and renders the CRR Rules inapplicable.

A similar analysis takes place under European rules, where issuers and their advisors typically conclude that the debt securities do not constitute an exposure to a "securitisation position" because, among other things, the transaction is used to finance physical assets, and payments on the notes are dependent on the on-going business of the Issuer during the life of the transaction.

Accordingly, 100% of the Issuer's equity can be sold without a "sponsor" being subject to risk retention rules.

As a matter of market practice, however, originators will typically retain up to 10% of the equity in a Portfolio Transaction where the equity is sold to third parties. This alignment of interest, also referred to as "skin in the game", is to facilitate the sale of the equity and to demonstrate to rating agencies that the servicer is financially incentivised to maximise performance at the bottom of the capital structure. In contrast, aircraft debt "CLO" transactions, which are collateralised by a pool that may include finance leases and secured loans, would likely constitute "self-liquidating" assets and therefore trigger application of the CRR Rules.

Prior generations of Portfolio Transactions

Before the recent bull run of issuance stretching from 2013-20, analysts distinguished between "pre-9/11" and "post-9/11" transactions. The pre-9/11 issuances typically had multiple tranches and high initial leverage, with the class A notes often split into a first amortising class and a second-pay security with a soft bullet. Cash reserves made up the primary credit support. Amortisation requirements were hard-coded based for the life of the deal with limited mechanisms to catch up on shortfalls, which resulted in leakage when unexpected and lumpy cashflows arose. Issuers were not permitted to sell more than a small percentage of aircraft in any given year for less than the amount required to repay all debt pertaining to the aircraft being sold.

Following the post-9/11 aviation downturn, junior cash reserves on pre-9/11 deals dried up and junior classes ceased receiving cash flows. The expected refinancing of several transactions never materialised, resulting in a cash sweep and step-up interest on the senior notes of 50 or more basis points. The notes on many of these deals suffered serial downgrades.

Second generation, post-9/11 transactions were more straightforward, often with a single senior tranche that was wrapped by a monoline and rated AAA, which made it a different product offered to a different market. Leverage was lower and financial triggers such as debt service coverage ratios and utilisation triggers were emphasised.

The somewhat slower amortisation of the senior classes allowed for free cash flow to the equity prior to the anticipated refinancing date, while step-up coupons after expected maturity were more prevalent. Liquidity facilities were favoured as a more efficient form of credit support to cover potential interest shortfalls, though cash reserves did not altogether disappear. Financial guarantees aside, these structures generally performed better than first generation pre-9/11 deals in terms of aggregate cash flow and value retention.

Current generation of Portfolio Transactions

Transaction structures have continued to evolve significantly since the first post-financial crisis deals hit the market in 2013. Below is a review of certain key developments.

Optimised tax structure

Ireland has become the centre of the aircraft leasing world due its corporate taxation regime and advantageous network of double-tax treaties allowing for cross-border rental payments to flow free of withholding tax. Since aircraft are moveable assets, it is possible with the right connective factors, including for example Irish residency of

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the board of directors and the various service providers, to locate a special purpose aircraft owner in Ireland for tax purposes, even where the owners are organised in a different jurisdiction. This is not mere paper arbitrage; it requires a legitimate Irish management and operational structure for the life of the deal.

On the other hand, due to certain particularities of the US-Ireland tax treaty, many third-party equity transactions will not qualify the issuer for the US-Ireland tax treaty. Accordingly, it has become standard to set up a Delaware LLC subsidiary of the Issuer which is taxed as US corporation to act as a co-issuer of the debt for portfolios contemplating leasing to US airlines. This creates a separate US-tax silo within the structure, which is not without complexity, but which creates additional flexibility for leasing to US carriers.

Streamlined priority of payments

Historically, Portfolio Transactions featured separate pre-default waterfalls for the distribution of ordinary course collections (such as rents) and for the distribution of disposition proceeds. The collections waterfall featured cash traps and cash sweeps to cut off distributions to subordinate tranches based on deal performance. However, these triggers did not feature in the disposition waterfall, which essentially provided for a proportionate return of capital with premiums to the relevant classes and the equity. This resulted in potential leakage to equity, which could be accentuated where the transaction only permitted the more valuable aircraft (i.e. those generating sufficient proceeds to repay all debt) to be disposed of. This leakage, as well as a perceived complexity and overlap between the two waterfalls, led to adoption of a streamlined "single waterfall" beginning in late 2016. Recent transactions have all followed this construct.

As the name suggests, the single waterfall runs disposition proceeds and ordinary collections through the same payment date waterfall. In this way, all amortisation requirements, including disposition pay-down amounts, must be fully caught up before any proceeds flow to lower tiers of debt or equity. In addition, where financial covenants are breached, cash traps and cash sweeps cut off distributions to lower tranche notes and to equity. These features naturally appealed to debt investors and to rating agencies, which in turn allowed issuers to achieve greater participation and better economics.

More predictable amortisation

Amortisation profiles are not a "one-size-fits-all" matter in Portfolio Transactions. The amortisation profile must be optimised depending on the advance rate and specific cash flows for the portfolio. The lumpy character of certain cash flows can make this challenging, especially for older aircraft portfolios which are more likely to undergo re-leasing and refurbishment, or to rely on aircraft sales for cash flow. To address this, some third-generation deals used a "saw-tooth" amortisation profile to capture expected cash flow bumps. Investors, however, generally prefer straight-line amortisation profiles, which can generally range anywhere from 9-13 years depending on portfolio characteristics.

The lumpiness issue needed to be addressed head-on as a spate of mid-life aircraft portfolios came on to the market in 2014-15. Mid-life aircraft are more likely to be parted out prior to expected maturity, which generates excess proceeds. This can also entail substantial end of lease/return compensation payments from lessees that may not be reinvested in the aircraft. In those cases, a substantial portion of the collateral value is converted to cash and would, to the extent in excess of amortisation, flow to the equity. This is also the case under finance leases, "green-time" leases and leases where cash payments are substituted for maintenance obligations, which reduce the residual value of an aircraft.

For this reason, modern Portfolio Transactions treat these "excess proceeds" payments as if they were a mini-dispositions, requiring a special prepayment with a premium (generally 5% of the payment amount) on excess proceeds to be paid, positioned in the waterfall immediately after principal payments on the senior tranches, with a full catch-up until paid. Crucially, following the application of any excess proceeds, or indeed any cash sweep amounts following a DSCR or utilisation trigger, the amortisation schedule is automatically adjusted to maintain the agreed previously required amortisation going forward.

Additional operational and disposition flexibility

As we have seen, earlier generation Portfolio Transactions harboured the potential for leakage of collateral value to equity holders, notably through the separate disposition waterfall, the treatment of excess proceeds as regular collections and the absence of amortisation catch ups and profile maintenance in certain key areas. But bankers and investors were not blind to these risks. Rather, they tried to address the leakage issue by restraining the ability of issuers to dispose of assets, including through part-outs. Issuers were not permitted to sell more than a small percentage of aircraft in any given year for less than the amount required to repay all debt pertaining the aircraft being sold (such required amount is called the "Note Target Price").

While this can seem a logical investor protection, it significantly limits an issuer's ability to dispose of non-performing assets, which can carry an inordinately high expense load. Many deals had to conduct costly consent solicitations to facilitate otherwise normal course monetisation activities.

The elimination of the leakages allowed the introduction of significant additional flexibility for issuers to monetise the portfolio, which is crucial for mid-life portfolios. Because there is a mechanism to ensure the pay-down of debt, Portfolio Transactions now allow for the parting-out of assets, the leasing in and out of individual engines, finance leases, green-time leases and power-by-the-hour arrangements. Most notably, there is also generally no meaningful limit on the number of dispositions below the Note Target Price so long as they are authorised by the board (which is composed of industry professionals acting in accordance with their fiduciary duties).

This flexibility is crucial to maximise value and cut expense loads in an economic downturn and will undoubtedly help avoid the types of "stranded" or "zombie" transactions that came about from the pre-9/11 vintage Portfolio Transactions.

As more and more transactions came to rely on dispositions and excess proceeds to generate cash, significant baskets were introduced to allow for these partial debt redemptions in early years without paying disposition make-wholes. Most recent deals eliminate disposition make-wholes altogether starting on the fourth anniversary of the closing date in order to facilitate repayment of the debt at expected maturity through sales.

More liquid equity structures

Portfolio Transactions are often used as a type of staple financing to sell down equity in a variety of formats. Equity securities in Portfolio Transactions may be sold in a private placement to a small number of institutional investors. A private placement, while less liquid than a 144A transaction, permits the servicer to partner with one or a small number of buy-and-hold investors, allowing for long-term strategy planning. Each private placement equity investor receives a seat on the Issuer board and a prorated portion of the equity return, along with any negotiated returns. This is a great way for financial investors to gain exposure to the aircraft leasing space and to educate themselves about the ins and outs of the aircraft leasing industry and subsequently launch their own platform.

However, this type of investment typically requires an M&A-style auction/bid process, and what can often be a protracted business negotiation more befitting a joint venture. More recently, originators and bankers have moved toward a fully underwritten equity issuance process that complies with Rule 144A under the Securities Act. In this format, the debt issuer issues an E Note to an orphan special purpose vehicle formed for the purpose of issuing equity certificates. The equity certificates represent a prorated beneficial interest in distributions to equity and are sold to qualified institutional buyers in a Rule 144A offering process.

Rule 144A-compliant equity offerings typically feature an anchor investor that agrees to hold a minimum percentage of the equity certificates for up to three years post-closing and obtains board appointment rights. The anchor investor will work with tax, legal and investment professionals to analyse the model and conduct due diligence, a process that is intended to provide comfort to other more passive investors that the investment is sound. For this work and agreeing the minimum hold, the anchor investor often

purchases its interests at a negotiated discount. These transactions also feature an asset manager for equity investor relations, which can be either the anchor investor or the servicer. The equity certificates are then offered through a separate equity marketing process undertaken with a full equity offering document that incorporates the debt offering memorandum by reference.

Legal documentation had become fairly standardised by the end of 2019, but the relative novelty of the product has constrained the number of participants that are able to compare a model with historic performance. The market for 144A-compliant equity had thinned prior to the COVID-19 pandemic, and new transactions are now at a standstill. Trading on the secondary market has continued at a discount, notably featuring investors actively seeking board membership, particularly for transactions at stages where material actions may be anticipated.

Resilience of Portfolio Transactions

Although the market for new Portfolio Transactions is paused, it is worth examining some additional features that enhance their general resilience and ability to avoid a default scenario. One such essential feature relates to the composition of the initial portfolio, which is structured to diversify aircraft model and age, lessee geography and credit profile and lease maturity date. Rating agency and investor models apply haircuts both in resale values and lease rental rates across portfolio characteristics, as well as global haircuts, while ongoing covenants prevent overconcentration so that a regional downturn does not have an overly broad impact.

This diversification remains essential, even if COVID-19 has challenged the assumption that it is highly unlikely that all countries in the world should be hit simultaneously by an economic downturn. The pandemic has drastically reduced cash flows, but it has certainly not eliminated all difference between aircraft types, geographies and airline credits. Some airlines are faring better than others in the crisis, and as the market recovers, the make up of a portfolio will be critical to maximising cashflows. Since aircraft assets are depreciated through usage, and many assets are not currently being used, it is fair to expect that over time a significant portion of any missed cashflows will be recovered with the useful life of an aircraft extending accordingly. This is precisely why these structures are rated based on principal payment at a long stop date.

Recent Portfolio Transactions have featured a liquidity facility to support investment grade notes, taking the form of a committed revolving credit agreement sized to nine months of interest (without amortisation). The facility is typically available to pay expenses, hedging obligations (if any) and interest (but not principal) on the senior tranches of notes. This liquidity facility permits a transaction to continue paying expenses and interest for a reasonable period of time even with zero collections, mitigating the chance of remedies action even in the case of an extended cashflow crisis. It is really only if accrued interest is not paid on the senior-most class of notes in accordance with the waterfall that a payment Event of Default would occur. Regular amortisation is not required to avoid default; failure to pay principal only becomes an event of default on the legal final maturity date.

The vehicle is also required to reserve cash in pledged maintenance, security deposit and expense accounts to fulfill projected obligations to lessees and other third parties. The servicer periodically sets, and the board approves, a lease budget, including reimbursements for maintenance performed by lessees, security deposit reimbursements and other expenses. A typical transaction features a reserve for several months of anticipated outflows, which is topped up from the payment date waterfall, with the required reserve increasing as the event comes closer in time. If a period of high expenses is anticipated and depressed cashflow is anticipated, the vehicle can still reserve to pay amounts owed to third parties.

Even in the most extreme distress scenarios, where all liquidity is exhausted and the senior interest payments are missed, several measures prevent a bankruptcy from occurring. First, the constitutional documents of the issuer group require unanimous director consent, including the independent director to file for bankruptcy. The trust

indenture also contains non-petition covenants on the part of all secured parties. Bankruptcy opinions are delivered at closing to provide comfort that the vehicle would not be consolidated into a bankruptcy of the servicer or the equity owner. For these reasons, where an event of default is not due to poor performance on the part of the servicer, the noteholders have little incentive to exercise repossession or foreclosure remedies, which would needlessly destroy asset value. A much more efficient exercise of remedies would typically involve the noteholders directing the existing servicer to monetise the pool in an orderly manner.

The current state of aviation provides a difficult challenge for the industry, but the current generation of Portfolio Transactions has been structured to balance debt investor protections with the flexibility for the servicer to maximise overall cashflows for the benefit of the equity. Investing in aviation, which is a very cyclical industry, has always entailed risk. However, the current crisis presents an opportunity for these investments to prove their resilience and ability to maximise value over the long-term, which should render them more attractive after the crisis fades.

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