

# ANALYSIS: Aircraft owners gamble on by-the-hour concessions

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Lessors, banks and asset managers have, with varying levels of reluctance, made significant concessions to their airline customers to support them during the Covid-19 crisis.

Immediate concessions came in the form of short-term rent deferrals of approximately six to 12 months as airlines called for support amid demand declines of 90% or more across their networks. As reality sank in that the crisis would be of an unprecedented scale and longer than previously thought, lessors agreed to longer and more complex deferrals in exchange for lease extensions.

The proliferation of by-the-hour agreements – under which, broadly speaking, airlines only pay for the number of hours flown over a specific timeframe – reflect the fact that with supply far outstripping demand, airlines are in a dominant position in the relationship at present.

By-the-hour periods of varying lengths are being agreed either to entice new customers to take on assets or convince restructuring carriers to refrain from rejecting assets.

LATAM Airlines Group, Aeromexico and Avianca have all agreed amended lease agreements, or to take additional units. Documents submitted as part of their US Chapter 11 restructuring processes show all of these leases involve a by-the-hour period usually extending beyond the expected exit from the process.

Such concessions are prevalent especially in the widebody sector, where demand is unlikely to regain 2019 levels for several years. There is an implicit gamble in these arrangements that the the airline will survive the crisis to pay normal rents again in future.

One lessor tells Cirium that they lost out on the bid to place aircraft with new UK start-up carrier Flypop, despite offering a by-the-hour term which included a \$100,000 minimum floor and \$200,000 maximum per month.

Avolon ultimately won the bid, placing Airbus A330s with the long-haul start-up.

In April, AerCap's chief executive Aengus Kelly said a majority of new leases concluded in the first quarter had contained some form of initial by-the-hour arrangement.

In May, Air Lease executive chairman Steven Udvar-Hazy said the US lessor was not in favour of by-the-hour agreements and had only conceded to a "modest" number of such requests, adding: "We are not an Uber-type operator".

In an interview with Cirium on 25 May, SMBC Aviation Capital chief Peter Barrett said the Irish lessor had concluded some leases with a by-the-hour element while others were on a straight rental agreement.

"I wouldn't say it's essential. In some cases, it's part of it; in others it isn't. I think it depends on the customer and their needs," he says.

"We try to be creative and productive in terms of our discussions with customers... It's clearly a challenging market, but there is definitely a better pulse in the market now than there would have been, say, three or six months ago, particularly for narrowbody aircraft. I think the widebody market remains challenged."

A lessor source says that when it comes to new aircraft, airlines are seeking by-the-hour concessions up to the end of 2022 amid what he characterises as a "red hot" market to place aircraft.

"I don't know how many hundreds of narrowbody aircraft are available, whether it's 737-800s, -700s or [Airbus] A320neos. There [are] a lot of aircraft available in all kinds of vintages, all kinds of quality in terms of maintenance status. Certainly if you are an airline and are looking for additional lift and you are fine with, let's say, anything between six- and 12-year-old aircraft, I think you can get a very good deal these days".

"As a lessor if you have had these aircraft on the ground for 12 months you will be more than happy for someone to just take these aircraft under their insurance policy and operate the aircraft a little bit," he adds.

He also points out that airlines are seeking concessions on maintenance reserves and demand aircraft arrive or are put into higher maintenance status.

Fred Browne, chief executive of Aergo Capital, says that by-the-hour arrangements have proved useful for placing naked aircraft with new operators.

"If you look at some of the naked airplanes we have bought, we have definitely built in to tempt customers back... some levels of power-by-the-hour [PBH] and then they go onto fixed deals.

"And that's gone very well. At the price we bought these airplanes at, it's very easy to justify, but we built it into the economics before we bought them. We have no problem starting these airlines off by giving them six-month PBH but then they have to go onto long-term fixed rate leases," he adds.

"That's gone down very well from a marketing tool point of view, and it's fair enough because traffic is down right across the board, so you have to give them a leg up, so to speak."

## **THE IMPACT**

What is the impact of all of these by-the-hour concessions on lessors' balance sheets? Do they lead to impairments?

One accountancy source says: "I would tend to believe that more of the issues will be around the book value not being paid down due to lack of substantive lease payments, which will ultimately cause an issue between market value and book value at some point.

"The lessors will look to their banks to restructure and might or might not get any concessions. A lot of analysis is being done around the overall intrinsic value of the asset given current and future lease assumptions. Younger aircraft should be able to retain their value given the longer-term potential to generate revenue; older aircraft will be hit harder if they are at the end of their economic life and restructured rentals will end up falling short of booked value," he adds.

A banking source sees no one-size-fits-all approach, but describes by-the-hour concessions as essentially "gambling" on where future market values will go.

"If it is a long time, then the problem really is you have no idea how much money you are getting or not. So if you take a worst-case approach and you say, 'Well, the aircraft will be parked the entire time and it's going to be zero [rent]', then it's going to be very difficult because how can you recover the amounts?"

"Say it's two years and you have a repayment schedule that takes 85% of the lease income which was scheduled, and all of a sudden there is none, or not very much income. How will you ever be able to recover that over the back-end? You can only do it by increasing the balloon payment and then it comes again down to the residual [values] expectations that you had."

He says the calculation depends very much on the residual assumptions taken, and on how values recover. "Depending on aircraft type, it's a very tight or sometimes very tough calculation. As a bank you need certain safety cushions.

"If the LTV [loan to value] maturity is of eight or nine years and you come out of it with a balloon [payment], that gives you an LTV of 125%. That is certainly something that is extremely challenging to support."

He says banks have several options, from accepting the concessions to selling the loans on, to working out the cost of parking aircraft for a period in the expectation of higher rents at a later date.

One lessor chief executive tells Cirium that these agreements usually require some sort of approval from banks to tweak loan repayments in relation to the aircraft, and in most cases these have been possible to obtain.

In some cases banks give "blanket approvals" relating to multiple aircraft.

Chris Knight, counsel at Pillsbury Winthrop Shaw Pittman, says by-the-hour agreements are viewed as a "necessary evil" by lessors.

Knight comments that, by and large, lessors have adopted a pragmatic view, in part to ensure that relationship airlines are taken care of, and to assist them in seeing out this period of intense difficulty, and in part to entice lessees to take aircraft on lease that may otherwise remain without a home for months on end, with the objective of saving on (not insignificant) insurance, storage, maintenance and other costs.

In terms of the impact, and also looking forward, Knight notes that "clearly this has had a negative impact on lessor profits (albeit negotiated 'quid-pro-quo' lease extensions will be a source of comfort) and, it follows, lessors will be, and already are, looking to move away from PBH arrangements as soon as possible".

"With many restructurings (be they formal or informal) now complete or well under way, and the Covid situation generally looking a lot more positive (particularly with the increasingly successful vaccine rollout in many countries, and the (admittedly painfully slow) relaxation of international border restrictions), many will believe that, whilst challenges evidently still remain, the worst is now

behind us," he observes.

Where PBH arrangements have been agreed with the lessee, Knight suggests that certain lenders have expected their lessor clients to continue to pay the amounts owed (as originally documented) under their finance arrangements on the basis that (i) deals are often already aggressively priced, with little room for manoeuvre, and (ii) lenders will point to the fact that they do not receive any upside benefit in the good times and so would query why they should suffer any downside in the bad times.

On the other hand, though, Knight comments that other lenders have been willing to "share some of the pain" based on historic relationships, and certain other factors, for example, whether a transaction was limited or full recourse, whether any additional security was required/offered-up, such as additional collateral to improve LTVs, and the size and creditworthiness of the lessor in question.

"These factors, and more, would have played a hand in a lender determining whether to agree to amended amortisation schedules to take account of PBH arrangements, and rent reductions/deferrals," Knight says. He adds that, "ultimately, like a lessor, the very last thing a lender wants to have to deal with (particularly at this time) is an aircraft repossession, and so avoiding this at all costs has also been a guiding principle".

## **RECOVERY**

As aviation markets around the world begin to recover from the effects of Covid-19, the question of how long by-the-hour concessions will be tolerated rears its head. One lessor chief executive points out that these arrangements can work out well in reverse. If an airline decides it needs to use the aircraft more often than expected as demand recovers, they could end up paying more than they would have done under a fixed rental agreement.

Knight expects a "steady decline" in by-the-hour arrangements as the year progresses, albeit he notes this is contingent on, first, the ability of the international community to continue to work together to suppress (or, possibly more likely, manage) Covid-19, second, the further relaxation of worldwide travel restrictions and the re-emergence of a more "normal" operating environment for the aviation industry and, third, the absence of any further shock event.

"For those leases in which the PBH rent is agreed, it may well be that the parties are looking to the summer of 2022 (which some are suggesting will mark the commencement of a travel boom as passengers' pent-up desire to travel is finally realised) as the point at which PBH rent stops and standard fixed/floating rent provisions are reintroduced," he suggests.

Knight cautions though that "the market" (and for how long the strong negotiating position airlines currently find themselves in is maintained) will also play its part here.

Another lessor expects that airlines and aircraft owners who have agreed such concessions are likely to review them towards the end of this year to see if a better arrangement can be put in place as passenger demand recovers.

*Additional reporting by Michael Allen*