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Aircraft ABS: Waterfalls Playing Catch-Up as Fundamentals Recover

Seasoned Deals May Offer Value, as Aircraft ABS Issuance Poised to Resume

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We see the aircraft ABS sector at an interesting juncture. Seasoned deals are catching up on recovering fundamentals, while a still-dormant primary market is potentially poised to see new issuance in the coming weeks. After facing significant headwinds during the pandemic and after Russia's invasion of Ukraine, as well as a wave of downgrades, aircraft ABS bonds may offer value amid collateral performance improvement. Still, many deals are still grappling with waterfall pressures as cashflows were diverted to exclusively pay class A principal. Subordinate bonds face uncertainty over how quickly principal payments resume. In turn, aircraft ABS deals can be much more sensitive than most US-focused ABS segments to the global geopolitical backdrop, and developments in various regions across the world. More on this below.

ECAF 2015-1A, which popped up on BWIC lists in recent months, is a case-in-point, crystallizing several key parameters we suggest investors should track. All three bonds of the $1.21 billion original balance deal saw downgrades in early 2022. The rating agencies cited at the time ongoing stress and pressure on airline lessee credits, and downward pressure on aircraft values. The bonds were just affirmed last week, reflecting much more constructive outlook. Generally, the global commercial aviation market continues to recover, posting a 47% increase in revenue passenger kilometers (RPKs) in 1H 2023 YoY, the agencies noted. ECAF also highlights a few other improving angles:

- **Fewer off-lease aircrafts.** ECAF has seen a notable improvement in the number of off-lease aircrafts, similar to the experience of other aircraft pools. The ECAF pool currently has only five off-lease aircrafts out of total 22 remaining aircrafts. The pool had 53.5% of the pool (14 aircrafts) off-lease and grounded in early 2022 ahead of the bonds downgrade. Off-lease aircrafts naturally reduce overall lease collections.

- **Declining Russian exposures.** ECAF featured 7.6% exposure to Russia in early 2022, comprising the pool's second top jurisdiction. The two 737-800 aircrafts leased to a Russian operator were seized during the year, according to deal documents. ECAF, like other aircraft ABS deals, should not include leases to Russian aircraft operators going forward, at least until the European Union and other jurisdictions fully remove sanctions against Russian individuals and entities. Notably, EU's Regulation 2022/328 prohibits the supply of aircraft by EU entities to Russian entities or for use in Russia. All told, while currently there is no end in sight to the war in Ukraine, as the latest edition of Around the World with Academy Securities discussed in detail, Russian-driven headwinds to aircraft ABS performance should play a lesser role.[1] Interestingly, rating agencies appear to vary a bit in their approach to Russia-seized aircrafts. At least one agency regards any aircraft previously on lease to a Russian airline as total loss. Others may assume some insurance-driven recovery. For example, in ECAF, Fitch's base case scenario assumes the deal may receive insurance proceeds at 60% of the aircraft value. Overall, Russia has seized about 500 aircraft owned by Western lessors including 70+ aircraft pledged to aircraft ABS structures, according to industry reports.

Figure 1. ECAF 2015-1A Pool Parameters

	December 2015	January 2022	August 2023
No. of Aircrafts	39	27	22
No. of Lessees	NA	12	14
Off-lease Aircrafts	0	14	5
Single Lessee %	15%	12%	21%
Three Largest Lessees	36%	24%	46%
Single Country %	16%	12%	24%
Delivered Aircraft Adjusted Base Value ($MM)	1,403.7	641.2	488.7
Un-Utilized Aircraft Adjusted Base Value ($MM)	0.0	338.3	70.9

Source: Deal documents, ratings agencies, and Academy Securities

- **Track Chinese lessees.** The ECAF pool appears to have reduced its exposure to Chinese lessees. China comprised the third largest jurisdiction of the pool in early 2022, at 5.2%. The deal now has only one remaining Chinese lessee, representing about 4.5% of the pool's adjusted base value, based on the most recent monthly report. We suggest investors closely track aircraft ABS China exposures. Industry trends that Academy's Geopolitical Intelligence Group (GIG) has identified may lead Chinese lessees to reduce their involvement in the aircraft leasing market, or even terminate leases. Specifically, commercial aircraft is a market that China has chosen to compete, according to General Robert S. Walsh, a member of Academy's GIG. General Walsh notes that in his view China has obtained Western IP, forced tech transfer through joint ventures, and its aircraft manufactures are considered a threat to the US aircraft and engine companies:

  "The Commercial Aircraft Corporation of China's C919 looks a lot like a Boeing 737 or an Airbus A320 for a reason. Joint ventures got them to where they are. China's operating model is to gain the knowledge, IP, and capability to build something themselves, scale it first within China, and then sell it outside of China at a lower price with state subsidies and dominate the market eventually putting competitors out of business. The C919 seems like a blueprint of their model." ***– General Robert Walsh***

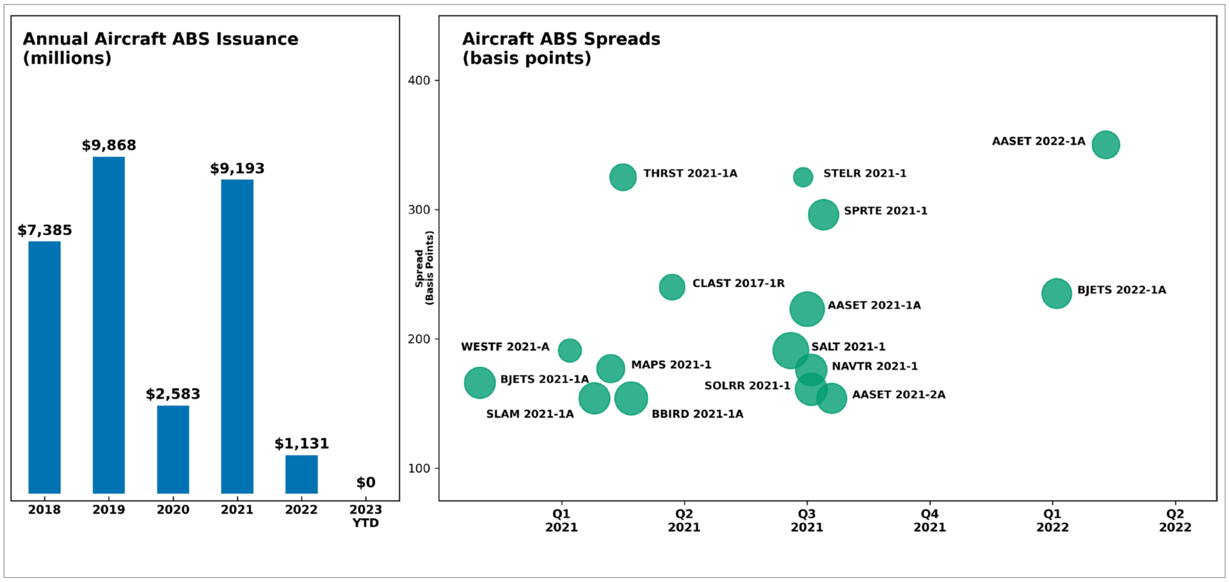
1 Around the World with Academy Securities, Academy Securities, August 30, 2023

Overall, aircraft lessors have become much more proactive managing geopolitical risks following the Russia-Ukraine conflict, Academy's GIG and Macro Strategy note. Anecdotally, the industry may be looking to take various steps such as limiting the number of planes on lease that can be parked overnight in certain jurisdictions, according to Academy's Peter Tchir, Head of Macro Strategy. Lessees with heavy North Africa or Middle East routes may warrant more caution, in Tchir's view.

New Issuance on the Horizon

Public aircraft ABS issuance came to a standstill in mid-2022. This may be about to change. The $522.5 million AASET 2022-1, issued in June 2022 was the last publicly issued transaction (Figure 2). The deal, backed by 25 aircrafts and 12 lessees, priced a single-A tranche to 6.6% yield. Issuers including Global Jet Capital and Willis Lease Financials may be looking to issue in the coming weeks, according to press reports.

Figure 2. Aircraft ABS Issuance and Spread Levels



Source: Bloomberg and Academy Securities

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