AlixPartners

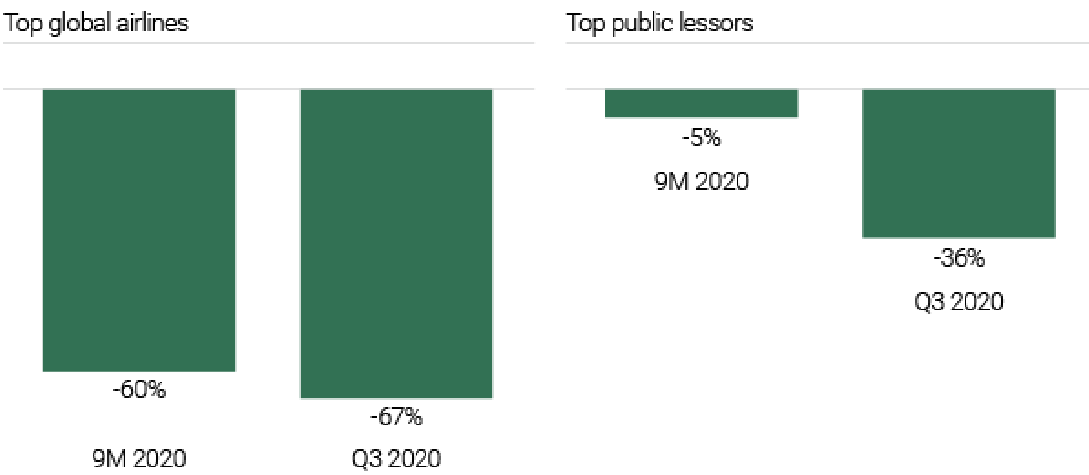
COVID-19'S IMPACT ON AIRCRAFT LESSORS: ARE THE DOMINOES STARTING TO FALL?

The AlixPartners A&D Minute

Aircraft lessors have been one of the biggest beneficiaries of the air travel boom of the last three decades, becoming a powerful force and an essential link in the aviation value chain. In 2019, lessors made up 50% of Airbus and Boeing deliveries through either direct contracts or sale-and-leaseback transactions. Lessors provide airlines aircraft financing in various forms and act as a buffer between aircraft OEMs and operators. This position helped them weather some of the initial shock of the pandemic – until now.

By the third quarter of 2020, year-to-date revenues were down only 5% year-over-year for lessors while falling dramatically for airlines by 60% (Figure 1). In Q3 alone, however, revenues went down sharply for lessors as well – 36% year-over-year compared to 67% for airlines – as the cumulative impact of payment holidays to distressed airlines and rate negotiations started to hit.

FIGURE 1: COMPARISON OF REVENUE DECLINE BETWEEN AIRLINES AND AIRCRAFT LESSORS



Note: 9M 2020 and Q3 2020 revenues for select airlines and lessors
Source: Cap IQ, company press releases; AlixPartners analysis

Poor prospects for any significant air traffic recovery over the next several months mean that cash will still be in short supply for airlines for most of 2021. As aviation financing tightens and government support declines, a major threat to airlines reaching cash breakeven is the risk of weakening yields as capacity is brought back faster than demand. Airlines are expected to burn another $95 billion before a potential return to positive cashflow in late 2021.

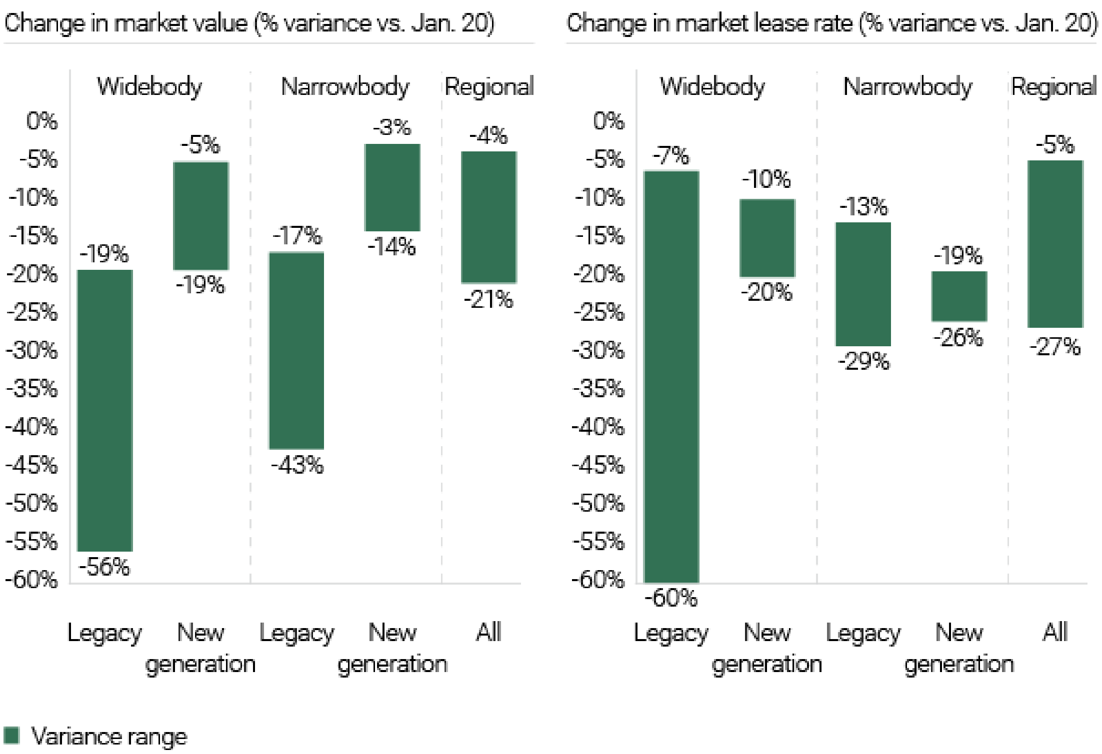
All airlines are implementing steep fleet reduction strategies, including those filing for bankruptcy and those not yet near insolvency. To generate much-needed liquidity, airlines will also continue to resort to sale-and-leaseback deals with lessors for attractive unencumbered assets, such as the A320neo family.

But rising numbers of stored, retired, and off-lease aircraft mean that the pressure will rise dramatically for some lessors.

To complicate the situation, Chapter 11 and other administrative proceedings can give airlines significant leverage to break leases and renegotiate contract terms. At any other time, lessors would have the leverage of being able to lease returned or repossessed aircraft to other airlines willing and able to pay. However, this is not a viable option in the current scenario with overall traffic down more than 50% worldwide and long-haul traffic down more than 85%. In fact, well-managed airlines will actively leverage the current environment to lock in lower lease rates (such as power-by-the-hour lease agreements) to improve their own cost structures and cost flexibility.

The relationship between aircraft OEMs and lessors is also likely to get more complicated because of excess aircraft supply and increasing price competition. OEMs will compete fiercely for new orders as airlines start emerging from the crisis. At the same time, lessors will work hard to push their assets into the market. This will likely lead to prices falling, and the entire supply chain feeling the heat. This will likely heavily impact the leasing and secondary market for midlife and older aircraft such as the 737NGs and A320ceos.

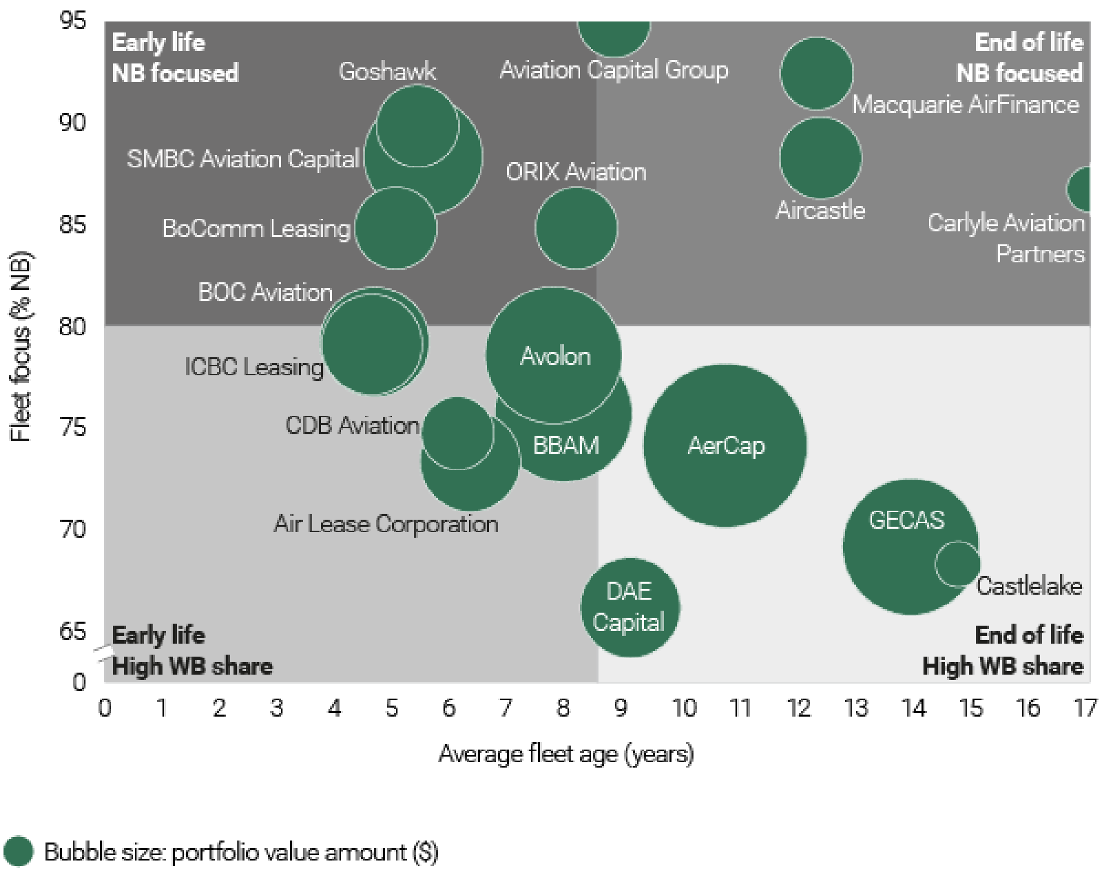
FIGURE 2: CHANGES IN MARKET VALUE AND MARKET LEASE RATES BY CATEGORY



Widebody new gen: 787, A350, narrowbody new gen: 737 MAX, A32x Neo, A220
Source: IBA (February 2021); AlixPartners analysis

Lessors assume significant risk when forecasting future demand as new aircraft are traditionally ordered years in advance. Newer generation aircraft and narrowbodies are undoubtedly the least risky assets in the current market (Figure 3). Lessors most at risk are those with concentrated customer portfolios or those with aircraft at weaker airlines, such as regional players, highly leveraged operators or players who already were in a difficult position pre-COVID-19.

FIGURE 3: FLEET COMPOSITION FOR THE TOP 20 LESSORS



Note: NB = narrowbody; WB = widebody
Source: Cirium; AlixPartners analysis

Older fleets except freighters – in high demand since the pandemic outbreak – also represent a risk, which can be partially mitigated by lessors' management capabilities or ability to monetize end-of-life assets (e.g. part-out).

Shareholders, potential investors and financiers, and other players with exposure to lessors should pay attention to the following factors and risks when assessing current investments or potential opportunities:

- Know the lease book inside out: Get a complete understanding of all lease modifications and deals struck, aircraft by aircraft, with particular attention to payment records of each lessee. Ensure that your own plan is based on reasonable scenarios for lessee bankruptcy risk, remarketing time, lease rates, market value depreciation, terms for new leases, etc. All these parameters are significantly worse at times like these. Ideally use a full Monte Carlo simulation to understand the shape of the risk distribution for potential future income.
- Monitor risk to leased assets: Understand the risks to the value of your assets that are still at airlines under financial pressure and that may not be operating. Ensure asset monitoring programs are vigorous and aggressive. One regional aircraft lessor had to replace an entire wing on one of their aircraft after it was returned from a distressed lessee due to poor upkeep. Ensure that the lessor or asset manager has aggressive but realistic plans for older aircraft and more difficult assets such as

widebodies and regional aircraft. If aircraft are managed by an asset manager, ensure the assets are receiving equal treatment compared to those directly owned by the asset manager.

- Actively monitor liquidity and balance sheet risks: Monitor the cash impact of renegotiations with airlines, a rising number of off-lease aircraft, and a weaker secondary market. Also monitor your debt profile, related covenants, and upcoming maturities. Thoroughly understand the underlying mechanisms of some of the more complex financing instruments such as aircraft-backed securitizations that may be particularly impacted by revaluations of portfolios.

Aircraft leasing will continue to be a major part of the aviation industry, and the role of lessors will grow as they continue taking on more aircraft through sale-and-leaseback deals with airlines. But in the near term, lessors will face heavy turbulence and a bumpy road before the industry begins to recover.

FOR A DEEPER DISCUSSION ABOUT THE CHALLENGES AND SOLUTIONS ASSOCIATED WITH LESSORS, CONTACT:

Eric Bernardini
Global Co-Lead, Aerospace, Defense, and Aviation
ebernardini@alixpartners.com

Pascal Fabre
Managing Director
pfabre@alixpartners.com

CONTACT THE AUTHORS:

Greg Donat
Managing Director
gdonat@alixpartners.com

Pascal Fabre
Managing Director
pfabre@alixpartners.com

Stelios Fragkos
Managing Director
sfragkos@alixpartners.com

Pablo Wangermann
Director
jwangermann@alixpartners.com

ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.