

# Fasten your safety belts

The fallout from the Ukraine crisis is likely to affect the entire aircraft ABS market, rather than simply those deals with exposure to Russian assets. **Simon Boughey** outlines why the sector is bracing for a bumpy ride.

**T**he Russia-Ukraine conflict has exposed fault lines in the aircraft ABS market that participants had hitherto tended to discount. Future aircraft lease securitisations are now expected to be not only priced more generously than in the past, but also incorporate structural changes.

“These types of events highlight concerns about transactions, and there will be a spill-over to the wider market. In the next round of deals, we could see not only wider spreads, but more importantly structural differences,” says Theresa O’Neill, head of ABS strategy at Bank of America in New York.

Generic five-year single-A rated aircraft ABS notes without significant Russian exposure were trading at the time of writing in the region of plus 500bp. They have widened some 110bp since the start of the year and 50bp month-on-month, thus demonstrating that the damage is not limited to those with Russian exposure.

Those deals with Russian exposure see no trading, but have dollar prices quoted in heavy discounts to par, say dealers. No new aircraft securitisations have been issued since the start of the year.

The structural changes envisaged may incorporate such features as enhanced credit enhancements, different insurance provisions, reserve accounts and different triggers. Some jurisdictions and lessors could also be excluded from deals in favour of stronger lessors.

The limitations of current insurance documentation have been demonstrated by the crisis. Sanctions imposed by the EU at the end of February prevent EU-based insurers from providing coverage to Russian airlines. ►



Inga Smolyar, Moody's

“They are obliged to terminate the policy, which impacted our analysis of exposure,” says Inga Smolyar, senior credit officer at Moody's in New York.

Coverage from other insurers is also far from certain. It is possible that assets sequestered in Russia may be covered by insurance policies as ‘an act of theft’ rather than ‘an act of war’, as Russia never formally declared war. This gives insurers a way out.

Pursuing the insurers through the courts will be an arduous and time-consuming procedure. As Michael Husemann, senior analyst for Prytania Asset Management, noted in a recent briefing: “This path is far from certain and will definitely lead to long, complex and expensive litigation. This last point is important for aircraft securitisation noteholders, as litigation costs would come out of a deal's cashflow, ahead of even senior note interest.” Neither is it clear where such cases would be heard.

There is a trade-off between wider spreads and structural changes, notes O'Neill. Enhanced structural protections, possibly alongside better quality underlying collateral, will be required in order to minimise prohibitively costly spread widening.

Some 5.7% of total aircraft ABS issuance incorporates exposure to Russian or Ukrainian lessors in terms of dollar value and 6.4% (or 80) by number of aircraft. The exposure varies considerably, with some of these transactions having

only one Russian asset, while one (AASET 2019-1, sponsored by Carlyle Aviation Management) comprises almost one-third Russian and Ukrainian aircraft leases.

AASET 2018-1 has 24% of its value tied to Russian and Ukrainian assets, while Castlake Aircraft Structured Trust 2021-1 and Castlake Aircraft Structured Trust 2017-1 both have 21% of their value exposed to Russian assets.

On 13 April, Moody's downgraded three notes from one deal – Castlake Aircraft Structured Trust 2021-1 – which it had placed on negative watch on 7 March, and says the notes remain on negative watch. The three classes were the A, B and C tranches, rated A2, Baa2 and B2 respectively.

In its original negative watch action of 7 March, Moody's also cited the C tranche of

that lessors will get their planes back. Even if they do manage to secure aircraft, it is unlikely that they will be worth much, say analysts.

Lessors face two major problems. First, according to the widespread sanctions imposed by western governments at the end of February, lessors must terminate leases with Russian airlines and deregister the aircraft. This will cause an immediate disruption of payments and interrupt the cashflow of ABS deals.

In normal conditions, lessors would attempt to repossess aircraft upon termination of a lease to maintain capital value in ABS trades. But these are not normal conditions.

Getting to the aircraft in the middle of a war presents unique challenges, and Russian airlines are unlikely to be fully co-operative. So, for the time being, the planes stay on the tarmac in Russia.

## “THIS PATH IS FAR FROM CERTAIN AND WILL DEFINITELY LEAD TO LONG, COMPLEX AND EXPENSIVE LITIGATION”

MAPS 2021-2. Fitch took similar action against 27 classes of aircraft ABS on the same day, citing “the presence of collateral assets in Russia and Ukraine, the impact of military actions and sanctions, and the uncertainty of enforcement and recovery timing.” This represents about 30% of the aircraft ABS deals Fitch rates.

Moody's states that the aircraft lessors it rates have reported that their exposure to Russia-based airlines is about 1.6%- 7% of net book value of their overall fleet.

Though present conditions are very concerning for aircraft ABS deals with Russian exposure, the future could be a lot worse, as it is highly dubious

Out of the 80 aircraft on lease to Russian or Ukrainian airlines, 83% by value have last known locations in Russia or Ukraine and 17% have last known locations outside of Russia or Ukraine, according to Bank of America research.

Even if the lessors are able to get their hands on the aircraft at some date in the not too distant future, their condition is unlikely to be pristine. Analysts suggest that there is a good chance they will have been cannibalised for spare parts, and will not be airworthy.

“Even if you do get your planes back, who knows what you're going to get? It is unlikely that reliable records will have been kept and without





Mark Hirshorn, DBRS Morningstar

those, it is hard to predict whether an airplane would be deemed airworthy,” says Mark Hirshorn, svp, US ABS at DBRS Morningstar.

According to a presidential decree of 14 March, Russian airlines can now re-register aircraft domestically, rather than in Bermuda or Ireland. So, even if the lessors are able to get their planes back and they are still in one piece, the required paperwork to say they are air-worthy will not be intact.

Lessors might also attempt to sell the aircraft to states which have taken no part in the sanctions, like China. But their bargaining position is not strong and only knock-down prices will be on the table.

In the rationale for its downgrade of 12 April, Moody’s was quite specific about the dangers to ABS transactions with Russian exposure. The notes were placed on review on 7 March “as a result of expected reduction in cashflow, due to foregone lease income tied to early termination of leasing activities,” it explains.

Since then, the adoption of the re-registration ruling has made the situation more complicated, “effectively creating uncertainty about their upkeep and therefore the ability of the foreign lessor to release the aircraft, should they be able to repossess them – thereby forcing them to resort to insurance coverage to recoup aircraft losses,” says Moody’s. According to transaction documents, there are lessor contingency insurance policies and the servicer has already submitted claims in connection with these aircraft.

“However, currently, there is a high degree of uncertainty around potential recoveries from insurance claims and the process will likely take an extended period of time,” the agency concludes.

The damage could also extend well beyond aircraft currently on lease to Russian and Ukrainian airlines. Airlines which have routes into Russia or fly over Russian airspace could be affected as well. Aircraft operating these routes will be grounded and lessors unable to receive payments for as long as sanctions prevail.

Another problem besetting aircraft lessors and one unconnected to the Russian crisis is that older widebody aircraft have lost value lately. This is partly as a result of the Covid-related reduction of air travel, but also due to the increasing popularity of smaller, more fuel-efficient airliners. As such, widebody aircraft are likely to be sold at reduced prices, also affecting the value of ABS deals which feature such planes.

Leasing aircraft by airlines has become increasingly popular over the last two or three decades. A little over 50% of aircraft in the skies

## “EVEN IF YOU DO GET YOUR PLANES BACK, WHO KNOWS WHAT YOU’RE GOING TO GET?”

Events in Ukraine follow a very testing time for the aircraft ABS industry, as air traffic diminished sharply during the pandemic. Only North American traffic has recovered to pre-pandemic levels, while, at the end of February, passenger numbers in Europe, the Middle East and Asia Pacific were respectively 25%, 36% and 19% below 2019 numbers.

The aircraft ABS market currently has a value of US\$32bn in terms of outstanding principal. This puts it broadly alongside the equipment leasing market, which is worth US\$31bn, and the franchise ABS market, which is worth US\$40bn.

Collateral is formed by the lease agreements and the aircraft. The leases are generally for five to seven years, so do not cover the useful life of an aircraft, which is generally 25-30 years.

Consequently, upon expiry of the lease and the ABS deal, it is customary for the lessor to refinance the debt or sell the aircraft. The proceeds are then used to pay down the principal on the old deal. Clearly, in the case of lessors with aircraft in Russia, neither of these options is open.

are now leased rather than owned outright by airlines, according to Statista.

Investors vary according to what portion of the capital stack is on offer. Insurance companies, banks and hedge funds are typically drawn to the equity tranches of aircraft ABS, while senior notes tend to attract a wider investor base, says O’Neill.

The two largest lessors are Irish-American GECAS, which has a fleet of 1074 planes, and Irish AerCap, which has a fleet of 1024 planes. The popular Airbus 330 family of aircraft cost between US\$230m and US\$270m, depending on model, while the new Airbus 350-1000 comes in at US\$355m. ■

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