How do Aircraft ABS structures perform if cash flows are reduced due to Covid-19?

In a guest Insight Kevin MacLeod, Vedder Price's Head of the New York Capital Markets Group, examines some of the structural protections prevalent in recent aircraft ABS transactions.

Aviation asset structured portfolio transactions, commonly referred to as aircraft ABS transactions, have seen significant growth in issuance over the past decade.

Commercial aircraft lessors look to the aircraft ABS market to finance or sell portfolios of aircraft while retaining the servicing role and commercial relationships.

Investors have looked to the market for comparatively attractive investment opportunities. The Covid-19 pandemic has led to significant revenue decreases for airlines, which has caused some airlines to delay rent payments for leased aircraft or to ask their lessors for rent deferrals, reductions and forgiveness. Moreover, some airlines have filed for bankruptcy proceedings, either to reorganize or to liquidate their businesses, which also has led to lease payment delays and reductions or the return of leased aircraft.

The increased uncertainty about rent payment, rent decreases, rent delinquencies, re-leasing demand and pricing and, more generally, commercial aircraft values has led to significant fluctuations in the value of outstanding aircraft ABS debt and equity instruments. Investors in this market may be looking for information to help them analyze how the structures operate when cash inflows are less than originally modelled or expected.

Structural Credit Protections

Aircraft ABS transactions use debt service coverage ratio (DSCR) tests to regularly evaluate the health of the structure and to protect the senior notes (Class A and B). If the DSCR test is not met, the payment waterfall is modified to either trap cash or to pay down principal on the senior notes (Class A and B).

DSCR cash trap

The DSCR cash trap stops cash payments from being made at lower levels of the payment waterfall if a DSCR test cannot be met. The trap is typically triggered if the DSCR is less than 1.2x. If the trap is triggered, any cash available at that step in the waterfall is held in an account until the next payment date when it can be withdrawn and distributed as part of available cash collections (at which time the DSCR will be tested and cash might be trapped again).

The DSCR cash trap cuts off distributions further down the waterfall, such as (1) distributions on junior notes (Class C notes), (2) distributions on E notes, (3) disposition premiums payable related to asset sales and (4) repayment of cure advances.

Rapid amortization

Rapid amortization is a feature in the payment waterfall that refers to prioritizing and accelerating the principal repayment on the senior notes (Class A and B). If a "rapid amortization event" has occurred as of a payment date, then all available cash remaining at that step of the payment waterfall on that date (after payment of interest and scheduled principal on the Class A and B notes) must be used to repay Class A principal and, if the Class A principal has been fully repaid, then Class B principal.

The typical "rapid amortization events" are: (1) the DSCR is less than 1.15x, (2) less than 75% of the value of the asset portfolio is utilized or (3) notes remain outstanding as of a specified date (the expected repayment date, which is commonly the seventh anniversary of the original notes issuance date).

The rapid amortization feature reduces (or further reduces) the cash available to pay interest and principal on junior notes (Class C notes) or to make distributions on E notes.

EOD Risk?

It is rare for aircraft ABS to experience an Event of Default. To understand why, let's briefly recap the Events of Default and a couple structural features that minimize the probability that an interest payment Event of Default will occur. Aircraft ABS typically have six categories of Events of Default:

1. Failure to pay interest on the senior-most outstanding notes when due (interest is typically due monthly).

2. Failure to pay principal on the Final Maturity Date.

3. Failure to pay other amounts due under the notes to the extent there are amounts available in the Collections Account (or under the Liquidity Facility) to pay such amounts, subject to a grace period.

4. Breach of a representation or a covenant default (other than a payment default under one of the first three categories), subject to materiality and significant cure periods.

5. Bankruptcy events.

6. A judgment in excess of an agreed threshold (measured as a percentage of the adjusted portfolio value) is rendered against the issuer or any of its subsidiaries and not stayed within

a specified period.

Under current commercial air travel business conditions, which have led to substantially decreased revenue for lessees, increased incidence of lessee payment defaults and/or rent deferrals and ultimately decreased cash inflows for lessors, issuers and investors might be concerned about an interest payment Event of Default.

The probability of such a default is low for a few reasons. First, the interest payment Event of Default only looks to payment of current interest on the senior-most class of notes outstanding (Class A). The amount of cash needed to pay current interest on the Class A notes is often a relatively modest percentage of contracted rental revenue. As a result, rental revenue must drop very significantly before there is insufficient cash to pay interest on the Class A notes. Second, even if such a significant drop in rental revenue occurs, two structural features further protect against an interest payment Event of Default: the liquidity facility and equity cure rights.

Liquidity facility

Aircraft ABS are structured with a liquidity facility typically sized to cover nine months of interest payments on the senior notes (Class A and B). If an issuer doesn't have enough cash to pay interest on its Class A or B notes when due, then the facility must be drawn on to make the payment. As a result, an interest payment Event of Default would not occur.

Equity cure rights

If amounts available to distribute pursuant to the Indenture and the Liquidity Facility are insufficient to pay interest on the senior notes, the E Note holder, if there is one, often has the right to make "cure advances", meaning it can advance funds to the issuer to make certain payments, including interest payments.

An E Note holder usually has 120 days from the delivery of a default notice to effect a cure advance and the cures can typically be made on up to six payment dates during a 24 month period.

Kevin MacLeod, Vedder Price's Head of the New York Capital Markets

Duration of interest payment protection

If an aircraft ABS issuer does not have enough cash to pay interest on its Class A notes, the use of the liquidity facility and equity cure rights, taken together, could avert an interest payment Event of Default for a period of nine to 15 months.

The Vedder View

After a recent Ishka webinar there were several queries about the risk of a potential event of default occurring for some recently issued aircraft ABS transactions. The Covid-19 pandemic has indirectly caused widespread disruption to rental cash flows across the aircraft leasing sector which has also impacted the expected cash flows for many aircraft ABS transactions.

Holders of senior notes benefit from a number of protections including the DSCR cash trap and rapid amortization. But if the DSCR trigger is breached, and/or rapid amortization occurs, then this is set to further disrupt the cash available to pay interest and principal on junior debt, such as for Class C note holders, as well as any cash distributions to E note holders.

Due to the structure of aircraft ABS deals, including the structural credit protections, the probability of an interest payment Event of Default scenario is low. To reiterate: current interest on the Class A notes is often a relatively modest percentage of contracted rental revenue and, even if revenue should be insufficient to cover interest, the liquidity facility and equity cure rights, taken together, can be used to avert an interest payment Event of Default for a period of approximately nine to 15 months.