ABS Research

Airline Industry Turbulence Can Elevate Risk for Securitized Leases

Analyst:

Stephanie K. Mah | Vice President | stephanie.mah@morningstar.com | +1 646 560-4571

Analytical Manager:

Rohit Bharill | Managing Director | rohit.bharill@morningstar.com | +1 646 560-4543

Morningstar Perspective

Airline bankruptcies add new wrinkles for leasing companies, especially those that have tapped the securitization markets. Morningstar Credit Ratings, LLC believes investors in such instruments should be aware of nuances related to jurisdiction, the role of the servicer, and rules on liens—all of which can ultimately affect the notes' cash flows.

Amid the boom in air travel, the global aircraft leasing market has enjoyed robust growth and could surpass $62.22 billion by 2023, according to Market Research Future. Leasing companies have increasingly filled the financing void left by the pullback from commercial banks in the wake of liquidity concerns and capital requirements. However, despite the growing demand for air travel, airline companies face numerous headwinds to profitability, including rising fuel costs, escalating landing fees, increasing airline taxes, currency depreciation, and stiff competition, leaving leasing companies more vulnerable to disruptions in payments. Indian airline Jet Airways and Icelandic airline Wow Air are both experiencing financial distress, and we are closely monitoring how these developments may directly or indirectly affect transactions we rate. In addition, new types of aircraft carry risks, even those from a well-established manufacturer like Boeing Co., and a higher concentration of such aircraft can make transaction performance volatile.

Location, Location, Location

Depending on the jurisdiction, local laws dictate how easy or difficult it is for a lessor to repossess an aircraft. Conflicting laws and cross-border issues can also arise during times of insolvency. That makes the timing of the termination notice critically important because it dictates whether the repossession of the aircraft will happen in a bankruptcy-friendly jurisdiction, or not. For example, a court order may or may not be required to repossess an aircraft. In addition, how long an insolvent airline is given to cure its contract defaults before having to surrender the aviation equipment may differ. While the United Kingdom and the United States give airlines 60 calendar days to cure a contract default before having to surrender an aircraft, India and Brazil give a 30-day stay period for aircraft covered under the Cape Town Convention, an international agreement that standardizes transactions involving mobile equipment. Despite the shorter stay period, creditors have historically had more difficulties recouping assets in emerging markets — including India and Brazil — relative to developed markets because of opaque insolvency proceedings and slower adoption of the Cape Town Convention among affected countries.

At the end of last year, the Indian government proposed the Cape Town Convention Bill, which would standardize protocols when dealing with financing aviation equipment. While the Cape Town Convention applies to three different kinds of mobile equipment — aviation, railway, and space — the treaty pertaining to aviation was the first sector signed, in 2001. The convention aims to improve transparency by standardizing the registration of sales, leases, and security interests. In the absence of the asset having a permanent location, the convention also provides more clarity regarding obtainable rights of aviation assets during a bankruptcy. Historically, it wasn't uncommon for retrieving records to be a challenging and time-consuming process, with a Brazilian airline taking roughly six months to produce aircraft records. Today, lessors generally have better access to such documents because of digital storage. However, it's an area that is easily manipulated should an airline choose to be difficult with such proceedings.

The developing story on Jet Airways highlights the challenges creditors may encounter in the face of ongoing financial woes. Jet Airways has struggled amid intense competition from budget airlines, leading to decreasing market share and troubles meeting debt coming due. After once being a leader and capturing as much as 23% market share in 2015, Jet Airways saw its proportion decline to 14% in 2018, according to the Directorate General of Civil Aviation, India's aviation regulatory body. Jet Airways has not only been unable to pay its pilots and lessors, but it also has about one-third (42 out of 120) of its aircraft grounded, all of which are on lease. Its operational woes continued as Indian Oil stopped providing fuel supplies several times this past week in light of unpaid bills.

Moreover, Reuters recently reported that some lessors have petitioned the DGCA to deregister several aircraft leased to Jet Airways. After being taken off the registry, lessors have more flexibility to take the aircraft out of India and subsequently lease the asset to another airline. In fact, one of Jet Airway's aircraft was seized in Amsterdam for non-payment. Again, the location of the actual aircraft in question is critical because of differing laws across jurisdictions pertaining to leasing agreements and the repossession of assets. Another concern is the continuation of payments. If the lessors try to terminate the leasing agreement and repossess, deregister, and export the aircraft, it's typically a long and arduous process. This is familiar territory for India in the wake of the Kingfisher Airlines case.

In 2012, Kingfisher Airlines ceased operating and defaulted on roughly $1.28 billion in loans. At the height of its operations, Kingfisher had 40 aircraft, with 30 of them leased. Many of those lessors suffered losses because they had difficulties in repossessing the equipment and, for those planes that they were able to recover, the equipment was in such poor condition that it was not salvageable. The Kingfisher case also underscored the importance of knowing the exact location of the aircraft records.

Morningstar is closely monitoring all the transactions that may be directly or indirectly affected by the aforementioned issues. The time it takes for the airlines currently going through financial woes to pay back their creditors after default, the time it takes for the lessors to re-lease the aircrafts or sell them, and the potential losses the lessors derive through this process are going to be under scrutiny, and Morningstar will derive its future assumptions from these data points.

Servicing Plays a Critical Role

In addition to jurisdiction, the role of the servicer becomes paramount when an airline is in financial distress. The servicer is typically the front line of information, with its monthly reporting of cash flows and other financial metrics, including terms on outstanding leases. The servicer typically has recent copies of financial records, registration information, and powers of attorney. Morningstar uses these monthly remittance reports to monitor collateral performance in our ongoing surveillance activities. The servicer is often responsible for collecting all principal and interest payments but also usually takes on a more prominent role in times of financial distress, managing the repossession and possible sale of assets. In instances of payment default, the servicer may issue a notice declaring an event of default and demand immediate repayment of amounts past due, such as rents.

Moreover, the priority of payments, both preceding a default and after an event of default, is also outlined in the transaction documents. They provide guidance on which provisions should be paid first, which could include maintenance provisions, air traffic control liens, and operating expenses, to name a few. Rules on liens are important considerations because different regulations may dictate the rights of respective parties in an aircraft transaction.

Portfolio Concentration Risks

Having a concentration of any one model of airplane also poses some risks, as problems with Boeing’s 737 MAX 8 jet have shown. The aircraft has been involved in two fatal accidents in a span of less than six months. We published a corporate credit risk assessment note on March 14, where we identified the developments as credit negative but maintained our A rating with a stable outlook. Morningstar’s rating captures a certain amount of event risk. Since the publication of that credit risk assessment note, Garuda Indonesia, Indonesia’s national airline, has subsequently expressed its intent to cancel its order for 49 Boeing 737 MAX 8s, totaling $4.9 billion, per multiple news sources. It remains to be seen whether Boeing's seven-year book of orders for over 4,600 MAX jets will be in jeopardy if other airlines follow suit. Nonetheless, the issue of portfolio concentration exists in securitizations if a disproportionate share of assets is devoted to any one company or airplane model. A mitigant to this risk has been the fact that most aircraft securitizations, in general, have included older aircraft. Technical issues are more likely to arise in the first few years of an aircraft's life. Currently, no Boeing 737 MAX aircraft serve as underlying collateral in any Morningstar-rated debt.

Fasten Your Seatbelts

As leasing companies take on a larger role in aircraft financings and airlines face increasing profitability headwinds, jurisdictional and servicing issues in times of insolvency assume greater significance. In addition, new types of aircraft in significant concentrations in underlying portfolios of securitizations pose risks. We will continue to monitor market developments and any effects they may have on the cash flows of our rated notes.