A VARIATION OF THE FOLLOWING ARTICLE WAS PUBLISHED IN *AIRLINE FLEET MANAGEMENT*, SEPTEMBER-OCTOBER 2010

****

Back-Leveraged Operating Leases: Recent Developments

by

Ronald Scheinberg[*]

Operating leasing is one of a handful of techniques by which airlines finance aircraft in their fleets. Over the last two years, there has been a wave of new entrants as lessors in the aircraft operating leasing markets. Air Lease Corporation (Steve Hazy (ex-ILFC)'s new venture), Avolon (Domhnal Slattery (ex-RBS)'s new venture), Greenstone Aviation (John Slattery (ex-RBS)'s new venture) and Jackson Square (Rich Wiley (ex-Pegasus)'s new venture) are some of the brand new names in the operating lease market (new names, old faces). These new ventures join an industry of other existing operating lessors such as General Electric's GECAS, ILFC, CIT, Royal Bank of Scotland's RBS Aviation, Aircastle, ACG, BOCA, AerCap, RPK, AWAS and Jetscape, to name but a few. The new operating lessors (as well as existing lessors) are supported by, in the aggregate, many billions of dollars of new venture capital poised to invest in aircraft assets. Some industry observers have expressed a concern that these new entrants create a glut of operating lessors, the effect of which will be to depress rentals and raise aircraft prices. However, it would appear that the new entrants may not necessarily be creating increased operating lessor capacity, but rather are filling the shoes of the likes of GECAS, RBS, CIT and ILFC, some of the largest of the operating lessors, who have significantly pulled back from their participation in the operating lease market.

A marked difference between the new entrants and existing lessors whose shoes they are filling is that many of those "old" lessors were owned by corporate parents that historically had very high credit ratings. These corporate parents were therefore able to finance their operating lease subsidiaries on an unsecured basis in the bank and public markets at very advantageous interest rates and credit terms. However, in the aftermath of the economic collapse of 2008, these very same corporate parents suffered, in varying degrees, large reversals of fortune with a concomitant inability to continue to support their respective operating leasing subsidiaries.

The new operating lessors entering into the market, we are finding, are largely being funded by hedge funds who are dedicating substantial, but finite, amounts of capital to finance these new operating lease ventures. With limited support available to existing operating lessors from their parents, and with the new operating lessor entrants by and large not being able to rely on strong corporate parents or sponsors for credit support and/or financing, both the existing lessors and the new entrants are increasingly turning to secured financial markets for the leverage they require to finance aircraft acquisitions.

[*] Shareholder, Vedder Price P.C. Ron may be reached at rscheinberg@vedderprice.com.

Since the economic crash of 2008, the primary source for secured financing for the operating lessors has been the bank market. The bank market is dominated by European banks such as DVB Bank, Credit Agricole, BNP Paribas, Norddeutsche Landesbank, Credit Suisse and Deutsche Bank. The basic type of secured credit facility for the operating lessor is commonly referred to as a back-leveraged operating lease where the bank would obtain a mortgage (or its equivalent) on an aircraft and an assignment of the related operating lease. Typically, the operating lease rents so assigned pay the debt service (principal amortization plus interest) on the bank's loan, and the aircraft serves as collateral securing repayment. Importantly, in these structures, the principal and interest obligation in respect of the financing are usually non-recourse to the operating lessor, with the bank relying exclusively on the credit of the lessee by way of assigned rental payments for repayment of the ongoing debt service.[1] Where the debt service is insufficient to amortize the loan to zero, the bank lender is looking at the aircraft collateral to repay the resulting balloon payment. Insofar as the banks attempt to have unfettered access to their collateral in a default situation, they also seek to bankruptcy-proof as best they can the risks associated with a bankruptcy of their operating lease clients, and accordingly, often employ various devices to make the financing as bankruptcy remote as possible.

Back- leveraged operating lease financing structures take two basic forms. The first is where an aircraft is financed on a one-off basis, where there is a dedicated loan earmarked for that aircraft and the related lease. The second form is where a pool of aircraft and their related leases are financed, where the financiers may get the benefit of a diversity of lessees and aircraft types. In the context of a pooled transaction, one would expect to see debt service coverage ratio tests and loan-to-value tests insofar as the pool of lessees is more fluid (and the operating lessor has more leeway to manage aircraft that may go into default).

From an airline perspective, the back-leveraging of an aircraft on which it might have an operating lease should not be a highly monumental matter since, other than a redirection of rental payments and amending the insurance certificates (and confirming certain factual matters as pertain to the lease), the relationship between the operating lessor and the airline does not change (at least initially). Where there might be some change in the relationship is in three circumstances:

- where the lessor defaults to the lender
- when the airline defaults under the lease
- on lease expiry if the debt balloon is not refinanced by the lessor.

In each case, the lender may be taking over from the operating lessor in the management of the lease and the related aircraft. The consequence of this shift is that the airline might lose a business partner with whom a larger relationship exists and, therefore, for which sought waivers, workouts or management of aircraft returns might yield a different result than with a lender who has a very different agenda.[2] Of course, the ultimate identity of a lessor is never cast in stone insofar as lessors always retain the right to trade their aircraft positions.

---

[1] In point of fact, having recourse to one of these new entrant operating lessors may not be very valuable if capital is dribbled out to them by their hedge fund sponsors on an as-needed basis, or they are compelled to dividend to their owners the bulk of their earnings.

[2] The matter of knowing your counterparty may be further exacerbated if an airline's lease is placed in a securitization, where the holders of the back-leveraged debt may be an amorphous pool of investors.

Another consequence of back-leveraging from an airline's perspective is that the tapping of bank financiers for the back-leveraging of aircraft on lease to a particular airline may use up credit capacity at those banks for bilateral transactions the airlines may want to do with the very same banks. Finally, airlines should be mindful that certain bankruptcy-remote protections sought by the bank financiers that achieve a distancing of relationship between the actual owner/lessor of the aircraft and the operating leasing company with whom the airline is doing business, may conflict the airline's interest to have the operating leasing company guarantee the obligations of the owner/lessor.

From a bank's perspective, beyond the assessment of the airline lessee as the "credit" behind the deal, the bank must assess the projected value of the financed aircraft at the end of the lease term if the bank is taking balloon risk at the backend; that is, whether such value will be sufficient (i) in the best case, to compel the nonrecourse borrower to refinance so as not to lose its equity or (ii) in the worse case, to repay the balloon payment if the lessor walks away from the asset (as it is entitled to do) at the backend. This phenomenon of a bank's being willing to rely on the aircraft asset for its ultimate satisfaction of the loan balance at the end of the loan term is a fairly recent one. This would appear to be the natural progression for asset-based financiers, who were already relying on aircraft collateral in making secured loans to support airline and lessor credits. Even if the lender is satisfied with the back-end valuation of any particular aircraft, it still must be in a position, logistically speaking, to *realize* on its collateral. So, mechanics are typically worked into the back-leveraged financing documents that require the lessor to advise the bank of its intentions well before the end of the loan term/final maturity, in order that the lender may prepare to take possession of the aircraft (and negotiate return conditions) on its return from the lessee.[3]

Another somewhat difficult issue for a lender in a back-leveraged operating lease financing is how its nonprojected costs for the transaction will be covered. When a lender does its cash flow and LTV analysis, it typically does so focusing on its principal and interest exposure. This leaves out things like swap and LIBOR breakage, enforcement costs, increased costs and a host of other yield-protection items.[4] Lenders, therefore, may require that the otherwise nonrecourse lessor be personally liable for these costs. This exposure may be further mitigated if there is ample "free cash" (i.e., cash net of that required to pay debt service) in the deal.

The ascension of back-leveraging in the aircraft leasing market has largely focused on newer aircraft, and primarily narrow-body Airbus and Boeing aircraft. This concentration on new narrow-body aircraft has been very much to the exclusion of older aircraft and those outside the narrow-body class, and it likely has a negative effect on those aircrafts' values. What will be interesting, then, is if trends continue as they do, as to how values will hold in the future for 12- to 15- year-old aircraft (originally financed new in a back-leveraged operating lease structure with a back-end balloon payment) coming off lease and earmarked to repay their related loan balloons, and whether there will occur a "funding gap" for these used aircraft after they come off their initial operating leases.

---

[3] Of course, operating lessors are, on the flip side, highly fearful that the banks may take away their asset on lease/loan maturity, and they seek to employ mechanisms in the transaction documents to allow for extension (i.e., remarketing) periods during which they can dispose of the aircraft without being foreclosed upon.

[4] Interest rate swaps are a perennial element of back-leveraged operating leases insofar as most operating leases are done on a fixed-rate basis, and banks (typically funding themselves in the floating rate LIBOR markets) must hedge themselves against the risk that short-term rates will go up, leaving them insufficient fixed-rate rent cash flow from the operating lease to service its debt.