The enhanced equipment trust certificate (EETC) has become the most popular method of financing new aircraft in the US over the past two years. Jim Smith analyses the EETC's evolution and examines how it has started to be used internationally.

Globalising the EETC

In the US, enhanced equipment trust certificates (EETCs) have emerged as the product of choice for financing aircraft. In addition to providing the opportunity to access cheaper capital, use of the bond structure has been spurred by a number of peripheral developments, including the shutting down of the Japanese and German leverage lease products, as well as reduced benefits under the US leverage lease. The elimination of those structures also has expedited efforts to move the EETC from the US into the global aircraft finance arena.

EETCs in summary

Through diversification of risk across aircraft type and airlines, or decreased loan to value ratios and liquidity facilities, access to the investment grade market is now provided to the below investment grade issuer through the EETC. On a blended yield basis, these securities allow maturity, lease payment matching and pricing at much more attractive rates than possible on an unsecured basis.

With EETC deals becoming somewhat routine, transaction costs have reduced, allowing smaller deals to be done economically. The market is still dominated by goliaths, with Continental Airlines issuing over $1.5billion in EETC debt this year alone.

While the appeal of leveraged lease financing is measured in tax and net present value (NPV) benefits, these concepts are not germane to the use of EETC financing because the structure does not have its basis in accounting.

An EETC is an instrument which divides total debt into classes or tranches carrying different interest rates and different claims on collateral, namely the aircraft underlying the transaction. EETCs allow below-investment grade carriers to achieve investment grade rating on part or a tranche of the debt.

Rather than borrowing as an unsecured corporate entity to finance aircraft acquisition, aircraft operators, airlines and lessors, generally achieve cheaper financing by having the debt carved up into classes or 'tranches'. In essence, recourse is to the collateral, the aircraft rather than the corporate entity being financed.

US application

For example, early this summer, Northwest Airlines closed a $555.2 million EETC transaction, referred to as 1999-2. Bookrunner Salomon Smith Barney and Credit Suisse First Boston led the deal. Managers were ABN Amro, Credit Lyonnais and Bankers Trust (Deutsche Bank.) The bond issue covered the financing of 20 Airbus narrowbody aircraft. This was split into three tranches.

The $343.25 million 'A' tranche carried a 7.575% coupon, a 41.1% loan-to-value (LTV), was rated AA3/AA and had an average life of 13.3 years.

The $109.9 million 'B' tranche carried a 7.95% coupon, featured a 54.3% LTV, was rated A2/A and had a 11.45 year average life.

The $102.05 million 'C' tranche carried an 8.304% coupon, featured a 65.1% LTV, was rated BAA2/BBB+ and had an average life of 6.60 years.

In the event of default and liquidation, investors in the 'A' and then the 'B' tranches would be compensated in that order, followed by the 'C' tranche investors.

The hierarchy of risk and reward is demonstrated with the lower coupon on tranches with a lower LTV ratio and a higher credit rating. Senior debt is the first to be repaid in a bankruptcy situation and is usually rated more highly by financial rating services.

The same risk-reward trade-off is illustrated by the $543.6 million advance funding EETC transaction for freighter operator Atlas Air, which was completed this spring. Collateral in this deal consists of five 747-200F aircraft, slated for delivery between April 1999 and February 2000.

The transaction features two classes of 'A' tranche. The $268.2 million 'A-1' tranche features an interest rate of 7.20%, a 39.0 LTV, and is rated AA-, AA-, AA- and A3 by S&P, Fitch, Duff & Phelps and Moody's, respectively.

The $43.5 million 'A-2' tranche carries a 6.88% coupon and the same LTV and ratings as the 'A-1' tranche.

The $111.9 million 'B' tranche features a 7.63% coupon, a 52.8% LTV, and is rated A-, A-, A- and Baa3.

The $119.9 million 'C' tranche boasts a 8.77% interest rate, a 66.9% LTV, and is rated BBB-, BBB-, BBB- and Ba3.

The rapidity with which the investment community responded to the opportunity to invest in EETCs is demonstrated by the fact that three

The collateral in the EETC structure is the aircraft being financed. Finance is made cheaper by dividing the debt into tranches, which have different levels of risk, charged interest and claims on collateral. This has allowed below-investment grade carriers to achieve investment-grade rating on tranches of debt. The EETC has more than doubled in popularity in the past year. Northwest recently closed a $555 million transaction to finance 20 Airbus narrowbodies.

Continental Airlines transactions were completed in a 15-month period between 1996 and 1997. At the time the 1996-series issues were rated, the airline's senior unsecured rating was B-/B2. With peak LTVs of 43% and 38%, the 'A' tranche notes in each transaction achieved ratings nine notches above the airline's senior unsecured rating. Later in the year, when Continental was upgraded to B+/Ba3, the rating spread above the senior unsecured level was reduced to eight notches. In 1997, Continental achieved an eight notch improvement in its 'A' tranche notes as part of a $707.3 million EETC issue.

With peak LTV of 40%, the 'A' tranche notes were priced at 85 basis points over the 10-year Treasury – a 1 13 basis point improvement from an EETC issue launched only 10 months prior.

EETC evolution

The usually three- or four-tranche structure is enhanced through subordination, liquidity facilities and Section 1110 US bankruptcy code protection. Credit risk is not shared equally by all classes, but the default risk is concentrated in the lower classes. The structure is a zero-sum game, in which an increase in the credit rating of senior classes is achieved at the direct expense of the lower-rated classes.

Since the first public EETC issue in 1994, there have been 39 transactions, financing 431 aircraft valued at $14.1 billion. In addition, there have been private placement EETC deals, such as a 1990 Boeing deal.

By next year, it is expected that the total dollar volume of aircraft financed through EETCs will break the $20 billion mark. So far this year, the volume of deals exceeds those completed over the past two years. The investor community also has jumped from an initial 50 players to a current level of about 350. Additional investors are being drawn to the market as the comfort level rises.

The biggest underwriters in the EETC community are Morgan Stanley and Credit Suisse First Boston. Chase Securities has begun to expand its formidable presence in the syndicated debt market of aerospace finance to developing a niche among the EETC top tier. Clearly, the EETC's position of importance has allowed investment banks to take a portion of the air finance market previously held by commercial banks.

The EETC structure is based on the traditional single-class equipment trust certificate (ETC) structure which has its origin in the US railroad industry.

ETCs, enhanced or traditional, have been confined to the transport industry where assets are interchangeable. Because assets financed by EETCs are interchangeable, if those assets are liquidated in a bankruptcy proceeding, theoretically there is an ample universe of potential buyers.

While the added cost of credit enhancement pays off for all but one or two US airlines which have attained investment-grade credit levels, most US railroads have already achieved investment-grade status and are not in need of the enhancement.

Enhanced ETC structure

The EETC structure is principally used in the airline industry where, with the exception of a handful of regional aircraft manufacturers, the world's major airlines fly aircraft manufactured by either Boeing or rival Airbus. There are some older Lockheed and McDonnell Douglas large aircraft flying over developed countries, as well as smaller orphan aircraft from manufacturers such as Fokker. In the event of liquidation and re-sale of the assets, there is a large pool of potential buyers of the assets.

What 'enhances' ETCs is a provision in the US bankruptcy code, referred to as Section 1110. That section of the code mandates that 60 days after filing for bankruptcy, an airline must return its aircraft to respective owners unless defaults are cured. The owners therefore have the aircraft to sell and so tranches of debt can be repaid. That Section 1110 protection extends beyond the EETC structure, covering lessors and other aircraft owners.

Also intrinsic to the EETC is provision of a liquidity facility for each investment-grade tranche which provides assurance that aircraft can be liquidated to provide full value of the asset. Typical terms of the liquidity facility are 18 months' payment of interest. This happens to be what rating agencies believe to be the time necessary to repossess and re-market aircraft in an orderly fashion.

It is the repossession issue and differing bankruptcy rules outside the US which are cited by most, but not all, bankers and ratings agency analysts as the major hurdle to exporting the structure beyond the US.

Globalising the EETC

It had been expected since the first public EETC came to market in 1994 that the first non-US EETC would involve a Canadian carrier, probably Canadian Airlines. In fact, in 1996, some $7.7 billion of ETCs were launched into the market by powerhouses such as Northwest Airlines, Irish leasing company GPA, USAirways and United, most in the first half of the year. When this happened at least two banks presented Canadian with the possibility of issuing EETC debt as an alternative to the airline's more conventional debt and sale and

The first non-US EETC was completed for Qantas for $198 million. The aircraft collateral was for two 10-year old, recently overhauled 747-400s. After Canada, Australia's bankruptcy procedures are closest to the US.

leaseback transactions.

Bankers were banking on a provision of Canada's bankruptcy code, Section 1168, which extended the approximate equivalent of Section 1110 to the Canadian rail sector. However, Canada's passage of Section 1168 is now generally perceived not as a move toward a more open capital market, but was a parochial measure used to sweeten the oversubscribed 1995 privatisation of Canadian National Railway.

Another reason why Canada was not the venue of the first non-US EETC may simply be that delivery schedules for aircraft to Canadian airlines mitigated against it.

Qantas

Although subject to dispute, Australian carrier Qantas Airlines is generally attributed with issuing the first non-US EETC. Qantas Airlines closed the issue on 31 December 1998 through arranger and lead manager BT Alex Brown (Australia). Issuer of record was Phoenix Finance No 1 Ltd. Japanese leveraged lease defeasement providers were ABN Amro, ANZ Banking Group and State Bank of New South Wales. Bankers Trust was liquidity provider. First Chicago Tokio Marine Financial Products was basis swap and cap provider.

The private placement deal was valued at about $198 million. The aircraft collateral is two recently overhauled 747-400 passenger aircraft manufactured in 1989 and coming out of the Sanwa portfolio, with one additional spare Rolls-Royce engine per aircraft. The deal was rated by S&P and Fitch IBCA.

Pricing on $122.2 million floating-rate 'A' tranche, which was rated AA- by Fitch, was Libor plus 50 basis points to 75 basis points.

The $11.1 million 'B' tranche was rated A+ by Fitch, and priced at between 65 basis points and 75 basis points.

The $65.8 million 'C' tranche was rated BBB+ by Fitch and priced widely, including a three-month term priced at Libor plus 30 basis points, with additional maturities increasing pricing to 100 basis points.

European investors as well as an Australian special purpose company are understood to have invested in the $122.2 million senior tranches, while the class 'B' notes attracted European investors. About 25% of the issue was bought up by banks.

Qantas in detail

Fitch noted that the AA- rating on the class 'A' certificates was based on a 55% advance amount of the initial appraised value of the aircraft.

The A+ rating on class 'B' was based on the 60% cumulative advance rate for the combined classes 'A' and 'B' certificates. The advance rates for the class 'A' and 'B' notes assume that in the event of a Qantas bankruptcy, the aircraft would have to be liquidated under adverse market conditions to repay certificate holders. The BBB+ rating of class 'C' certificates was based on the current credit strength of the carrier.

Each class is supported by the integrity of the legal structure, Qantas guarantees of lease payments, a facility providing liquidity for classes 'A' and 'B' in the amount equal to approximately two years of interest payments at the then-current interest rate, a $2.5 million trigger reserve, and a transaction expense reserve. Both S&P and Fitch assume that in an insolvency scenario Qantas would not go into liquidation, and the debt would be restructured rather than having the aircraft repossessed.

The trigger reserve covers expenses which might be incurred in the repossession and re-marketing of the collateral, including legal fees, transport of the aircraft, repayment of liens, and refurbishment of the aircraft. The initial expense reserve is $20,000 to cover any unexpected expenses.

Qantas purchased both aircraft from Boeing in 1989 and immediately transferred title to two Japanese special purpose companies, which then leased the them back to Qantas. The Australian carrier can purchase the aircraft for one dollar when the leases terminate in 2001. To ensure that Japanese lessors comply with the Qantas purchase options, Qantas has placed first priority charges on the aircraft. Therefore, Qantas currently has a beneficial interest in the aircraft while, technically, little remains with the Japanese lessors.

Under terms of the JLL, a default by any party, including Qantas, will result in

Iberia is rumoured to be close to finalising a European EETC arranged by Morgan Stanley to finance six A320s. Taca and China Airlines may also be about to complete non-US EETCs.

the transfer of title to the aircraft to Qantas. Qantas has then assigned these beneficial aircraft interests to the owner trustee.

All of Qantas' debt obligations under the JLLs have been fully defeased through ABN Amro and State Bank of New South Wales. Fitch has determined that while the parent of one lessor is in bankruptcy, neither that circumstance nor the bankruptcy or default of either Qantas, a defeasor, or a Japanese lessor will prevent title to the aircraft from passing to Qantas.

Immediately subsequent to the JLLs, Qantas sold its beneficial interests in the aircraft to Meridian Trust Co, the owner trustee, as trustee of a special purpose vehicle. The owner trustee financed the purchase of the aircraft with the loan from the mortgage seller. After purchasing the beneficial aircraft interests from Qantas, the owner trustee then leased the aircraft to sub-lessors Covington Leasing Ltd and Boronia Leasing Ltd, which on-leased the aircraft back to Qantas. Fitch noted that the terms of the US leases and sub-leases are materially identical.

Fitch determined that an insolvency event in relation to the sub-lessors will not affect the transaction. Qantas has guaranteed all payments under the primary leases to the owner trustee. Payments under the leases received by the owner trustee will pay the interest and principal on the notes. For both aircraft, there are separate US leases, sub-leases, Japanese leveraged leases and financing arrangements.

As collateral for its obligations under the loan from the mortgage seller, the owner trustee granted a mortgage over its beneficial aircraft interests and other related assets to Wilmington Trust Co, acting in trust for the benefit of the mortgage seller. In the event of a default by Qantas, Wilmington Trust as indenture trustee will take possession of and liquidate the aircraft. These rights will pass to the issuer under this transaction.

Proceeds of a liquidation will be used to repay the note and TLC holders in order of priority. Fitch believes that in all cases the indenture trustee can obtain title to and liquidate the aircraft within two years of a Qantas default.

Over the life of the transaction, noteholders will receive principal and interest payments based on the lease payments made by Qantas to the sub-lessors that are passed on to the owner trustee. Lease payments made by Qantas increase or decrease directly with any change in the six-month Libor rate, eliminating the need for a fixed/floating swap for the transaction. The issuer, however, must still enter into a basis swap, because Qantas makes semi-annual lease payments based on the six-month Libor, while noteholders are paid quarterly based on the three-month Libor.

Bankers Trust Australia is liquidity facility provider, with an obligation to provide approximately 24 months of interest payments to Class 'A' and 'B' noteholders. Specifically, the liquidity facility is sized as two times the capped interest rate times the outstanding principal of class 'A' and 'B' noteholders. The liquidity facility currently is capped at $28.79 million.

However, that amount will decrease according to a set schedule as class 'A' and 'B' notes amortise. To prevent a shortfall in the liquidity facility, concurrent interest rate caps will be put in place to ensure that, if there is a default, there will be at least adequate liquidity to cover 24 months of interest payments to the Class 'A' and 'B' noteholders regardless of the then-current interest rate. To ensure that the transaction has adequate cashflow coverage, Bankers Trust will provide a guaranteed investment contract (GIC) that will guarantee a return on investments of Libor minus six basis points. The deal is said to have required about nine months to structure.

While some bankers have dismissed the deal as not being a true EETC because the debt was sold back into the bank market, others maintain that the destination of the debt is not so important as the underlying structure.

Other bankers and analysts note that the deal differs from the usual EETC in that the underlying financing is complicated so that it is not as clean as one involving unencumbered new aircraft.

Australian sources maintain that, excluding Canada, Australia probably represents the next closest venue in terms of bankruptcy procedure. The fact that Australia is more creditor friendly than other jurisdictions made the deal easier to fly from a ratings agency perspective. Australia's airline regime is deregulated and its legal system is based on English law, making Australia an easier place to structure a deal than many other venues.

While the Qantas deal has broken the ice, at least three other non-US EETCs are in various stages of completion. Spanish flag carrier Iberia is said to be putting the finishing touches on a Euro-denominated EETC deal to finance six Airbus A320s. Morgan Stanley is rumoured to be leading the deal. Chase is also said to be arranging a three-tranche $180 million deal for China Airlines to finance six 737-800s. Salvadoran carrier Taca is said to have been preparing a EETC deal to finance eight US-registered aircraft.

Chase is also said to be arranging that deal which, according to rumours, has been with at least two ratings agencies since earlier this year. The Taca deal may be in a holding pattern as carrier officials concentrate on the expected division of the company into an airline and a leasing company. In addition to providing that airline with aircraft on operating lease, the new leasing company is expected to look to other airlines in the region as customers.

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