

Securitisation financing, particularly EETCs, has grown in popularity in the US. Karen Floersch analyses the structure of securitisations and EETCs and how they can be applied. Although EETCs can now be used internationally, they are still largely confined to the US.

The use and application of securitisations

In 1998 close to \$8 billion in aircraft-related financing transactions were funded in securitised structures, making it one of the most dynamic financing tools available to the airline industry.

Securitisation offers a variety of benefits to airlines, leasing companies and aircraft manufacturers ranging from lower cost of funds to expanding debt capacity. Yet, for all the talk of a new age in which aircraft securitisation will know no international boundaries, remarkably the term, securitisation, is often misunderstood.

What is securitisation?

In its most basic sense, securitisation takes a pool of cashflows and creates certificates or bonds that are marketed to investors. In the case of aircraft-related transactions, these cashflows usually come from aircraft lease payments which get packaged using one of two basic structures: an aircraft portfolio securitisation or enhanced equipment trust certificates (EETCs). An aircraft portfolio securitisation is a transaction involving a portfolio of aircraft to a variety of lessees in several countries. EETCs are used to finance aircraft for just one airline.

Aircraft Portfolio Securitisation is defined in a Standard & Poor's booklet, *Aircraft securitisation Criteria*, as "the issuance of debt securities to fund the acquisition of aircraft from the current owner, usually an aircraft leasing

company or aircraft manufacturer". The owner, either directly or through a subsidiary, will have leased the aircraft to a variety of airlines. The aircraft are sold with the existing leases in place to the issuer, who in turn becomes the lessor. The issuer is a company that has the function to issue the credit notes and lend the airline the money.

Portfolio transactions

Most portfolio securitisations are more complex than the structure described above. One only has to think back to the Airplanes Pass Through Trust completed in 1996, when 229 of Guinness Peat Aviation's (GPA) aircraft were sold to the issuer Airplanes Group for \$4.048 billion. This made it the largest aircraft portfolio securitisation to date. This transaction involved numerous tranches or layers of debt which required a complicated priority of payments system.

In any case, portfolio transactions, while large in volume and complex in structure, are not very common, principally because there are few leasing companies or manufacturers (the potential originators of the deal) with the necessary critical mass of portfolios.

EETCs

The EETC, according to Standard & Poor's criteria, "falls somewhere between simple aircraft debt, akin to a secured corporate bond and a diversified aircraft

portfolio securitisation". Typically, the airline credit is a single carrier that wants to finance one or more aircraft through the capital markets. For example, airline 'A' wishes to finance six new 150-seat jet aircraft. The airline (the borrower) issues debt notes against the value of the aircraft and assigns security interests in the aircraft to a trustee, held on behalf of the note holders, as security for repayment. The note holders are the investors of various layers of debt in the aircraft. The airline then pays debt service over a defined term. Payments are passed through to the note holders.

The EETC is the successor to the original equipment trust certificate (ETC) which has virtually disappeared. The EETC does everything the ETC did, but with the inclusion of a dedicated liquidity facility and the layering of debt. All this adds up to the acquisition of a higher credit rating from the rating agencies and, thus, more attractive pricing.

Pass Through Certificates, another form of securitisation, essentially involve the bundling of two or more ETCs as a means of diversifying the asset pool or increasing the offering size.

Portfolios & EETCs

There are a number of important distinctions to be made between these EETCs and portfolio securitisation. First, the originator/borrower will typically determine which securitised structure is used. If the originator is a leasing company or aircraft manufacturer, the

aircraft portfolio securitisation is used. If the originator is an individual airline, the EETC is used.

In the case of aircraft portfolio securitisation, the pool of aircraft leases involves a large number of lessees. Many of these are unrated carriers and geographically diverse. There is also a range of different aircraft types that can be financed in a variety of ways, from operating lease to tax-oriented finance leases and loans.

The EETC structure typically has just one lessee, the airline/originator, that wishes to finance one or more aircraft using the capital markets. This airline/lessee pays debt service, which is then passed through a special purpose company to the note holders.

The second and, perhaps more significant, distinction between a portfolio securitisation and an EETC is the very different risk profiles of each structure. In an EETC the investor's recourse is to the airline and as such, risk assessment is directly linked to the credit quality of one airline. It is often for this reason that EETC structures are referred to as little more than secured corporate debt. The use of a liquidity facility and other structural enhancements provide further collateralisation, so the bondholders are never worse off than unsecured creditors.

In a portfolio securitisation, with its myriad of airline/lessees, investors do not have recourse to any single airline. Instead more reliance is placed on the portfolio's cashflow generation, as well as the ability to re-lease the aircraft.

Given that risk assessments for the aircraft portfolio and EETC differ, the ratings of these two vehicles start from different points. Tom Cahill, principal of Morgan Stanley Dean Witter explains that in an EETC, the maximum rating will depend on the airline's corporate credit rating. This also means that if an airline has its own rating upgraded or downgraded, the EETC rating will likewise be upgraded or downgraded.

In a portfolio securitisation, the maximum rating assigned will depend on a variety of variables from the aircraft types in the portfolio to the level of over collateralisation.

Standard & Poor's says that when it carries out its ratings assessment of a portfolio transaction it examines how diversified the portfolio is together with a number of 'stress' factors that could affect the cashflow in the deal. These include: the length and severity of an economic downturn in the airline industry, airline default rates, repossession/remarketing time and costs.

While EETCs have been assigned a maximum 'AAA' rating by Standard & Poor's, it says portfolio securitisations of operating leases have never been rated higher than 'AA'. This limit has been

THE MAIN PARTIES INVOLVED IN SECURITISATIONS AND THEIR ROLES

Originator:

In an EETC, the originator is the borrowing airline and in an aircraft portfolio securitisation, the originator is usually an aircraft leasing company or an aerospace manufacturer.

Issuer:

A special purpose company whose main purpose is to issue the notes and lend the proceeds to the airline in an EETC. In an aircraft portfolio securitisation the proceeds are paid to the aircraft leasing company or aircraft manufacturer.

Servicer:

Only used in an portfolio securitisation. The servicer is responsible for tending to the assets in the portfolio to maximise cashflows for the benefit of the note holders. These tasks include collecting rentals, releasing or remarketing the aircraft and ensuring the aircraft are properly maintained.

Rating Agency:

Assesses the likelihood of an issuer making full and timely payment of interest and ultimate payment of principal and assigns a rating based on this assessment. The four main rating agencies used are: Standard & Poor's, Moody's, Duff & Phelps and Fitch.

Liquidity Facility Provider:

Used in EETC structures, the liquidity provider, generally a bank with a minimum short-term rating of A-1, will cover scheduled interest payments (usually up to 18 months) in the event of a default. A liquidity provider typically does not cover scheduled principal payments. In an aircraft portfolio securitisation, a reserve fund is provided to cover shortfalls in rental payments.

Underwriters:

Buyers of the notes/certificates who then sell them on to the public or private market.

Security Trustee:

Holds, on behalf of the note holders, the airline's or the issuer's security interest in the aircraft as security for repayment of the notes.

Note holders or Certificate holders:

The investors in the various layers of debt or notes/certificates. Senior note holders – typically Class A and B notes – have the higher-rated notes. Junior note holders – typically Class C and below – have lower rated notes.

justified by the inherent uncertainty of the subsequent airline lessees.

Another major difference involves the legal issues in the event of a bankruptcy. According to Phil Ogle, managing director of aviation securities at Chase Manhattan International Ltd, "what we most lose sleep over when structuring an EETC is the ability to repossess the aircraft in an event of default". That is why qualifying for Section 1110 Bankruptcy Code is so vital in US EETC issues.

In general terms, Section 1110 of the US Bankruptcy Code gives the right to a secured party with a security interest in an aircraft to take possession of that aircraft from an airline operating under bankruptcy court protection. For Section 1110 to apply, the airline must be a US company holding an air carrier operating

certificate issued by the US Department of Transport, and the aircraft must be capable of carrying a minimum of 10 individuals.

In portfolio securitisations, few aircraft are operating in the US, so Section 1110 protection is irrelevant. What is important in traditional asset-backed securitisations, says Ogle, "is the issuer's bankruptcy-remoteness, from the originator/leasing company." This effectively means that should the originator become insolvent, the assets and liabilities of the issuer will not be combined with the originator's estate in bankruptcy.

Another key legal issue for a portfolio securitisation includes the 'true sale' of the aircraft/assets whereby the valid legal title of those assets is transferred to the issuer. The originator sales, transfers and assigns



all right, title and interest without recourse or obligation to the issuer. A 'true sale' will be supported by a sale/purchase agreement, coupled with appraised values of the aircraft.

Why is securitisation used?

Aircraft securitisation has come a long way from the very first transaction involving a GPA portfolio, known as Alps 1992-1. At that time, securitising aircraft was essentially perceived as a refinancing tool or, in the case of GPA, a relief valve.

The EETC has evolved into the favoured financing tool of lower-rated US carriers to finance new aircraft deliveries. In 1999, about \$6 billion of aircraft-related EETCs were completed, against \$3.5 billion in 1998.

The main driver fuelling the EETC is the low cost of funding. This can be achieved by issuing investment-grade debt, which is lower cost than carriers can usually access elsewhere. For US carriers rated below investment grade, the EETC market is probably the most efficient and liquid market to tap into. Despite structuring costs, the pricing benefits can be significant.

According to Stephan Sayre, senior vice president and head of the global transportation group at Greenwich NatWest, the blended pricing benefit to an airline with a credit rating within the BB/Ba2 range might be about 150 basis points (bp) less than senior secured debt and 100bp less than traditional EETCs.

Sayre adds that "pricing on asset-backed securities have widened considerably since the third quarter of 1998, and the differential between EETC and bank lending rates is still significant".

Until there is a convergence between these two lending rates, the EETC market will continue to grow.

In a study of the debt market environment by Morgan Stanley Dean Witter when comparing EETC tranches against traditional corporate debt, the lower the rating of the EETC tranche, the greater the pricing differential between their corporate debt rate.

A diversified pool of operators, coupled with structural enhancements such as a reserve or liquidity fund, can result in a higher rating and so attract a better financing rate than the underlying rate in the portfolio.

In a portfolio securitisation the transfer of aircraft risk by the operating lessor to a bankruptcy-remote entity does not necessarily mean that it gives up involvement in that asset. In most cases the operating lessor will become the servicer of the portfolio. The servicer is responsible for tending to the assets to maximise cashflows. This includes collecting rentals, re-leasing and re-marketing aircraft and ensuring they are properly maintained.

If a lessee defaults on payment the servicer may be required to repossess the aircraft. Securitised structures also offer longer financing terms coinciding with the economic life of the aircraft rather than the lease term. The average term of the notes of an EETC or aircraft portfolio securitisation can extend to 20 years or more.

Who uses securitisations?

US airlines and operating lessors continue to dominate EETC and portfolio securitisation issues. The list of EETC

Despite the perception that EETCs are prevented in countries that do not have a Bankruptcy Code, there are two factors that limit their use outside the US. The first is that most European airlines can get low interest rates. Second is that EETC financings are rating driven and only four of 104 international airlines outside the US have a credit rating.

issuers includes such names as: Continental Airlines, Northwest Airlines, Federal Express, Atlas Air, American Airlines and America West. Continental dominates US EETC issues; Sayre says it probably accounts for 37% of the total volume of EETCs issued to date.

Not surprisingly, the rise of EETC financing has coincided with the longest stream of aircraft deliveries throughout the 1990s. Although deliveries for many of the previous issuers of EETC may be decreasing, other carriers, such as US Airways, American Airlines and Delta, are poised for significant deliveries over the next few years.

Non-US carriers, also had a significant volume of new aircraft deliveries to finance, but they have for the most part shunned the EETC market. To date, only one non-US carrier, Iberia, has sourced the EETC market.

For some time, it had been perceived that jurisdictions not possessing a bankruptcy code with the clarity and the benefits of Section 1110 was the biggest hindrance to securitised financings being exported outside the US. This argument proved feeble when Iberia successfully completed the first EETC financing by a European carrier. Says Ogle, "if you are determined enough, you can get the deal done. There are many enhancements that can be used to improve the pricing". Sayre agrees, "there is no jurisdiction one cannot structure around, although these may incur greater costs to the originator/airline".

Perhaps the biggest obstacle to the penetration of securitised financing among non-US carriers is simply that many still benefit from very attractive bank lending rates. "European airlines, in particular, really ride the gravy train of export credit and bankers' appetite to provide cheap money," says Sayre. "As long as this remains available there will be little incentive to look for alternative sources of capital."

The second hurdle to overcome is inextricably linked to the essence of EETC financing: it is ratings driven. "An EETC requires you to have an underlying credit rating and these airlines (non-US) have a fear of ratings," says Sayre.

Many European airlines, in particular, would receive poor ratings and so benefit less from the whole process, making it pointless to use the system.

US airlines and lessors dominate EETC and securitisation financing structures. In 1999, \$6 billion of aircraft-related EETCs were completed. Continental Airlines has accounted for about 37% of all EETCs issued to date.

A corporate rating requires some fairly harsh due diligence and often the information a rating agency requires for its assessment is just simply not available from the carrier. The fact is that today, very few non-US carriers are rated. Indeed, only four out of 104 international airlines outside the US have a rating.

Future face of securitisation

Securitisation has evolved considerably throughout the 1990s and it is this ability to be innovative that underpins the success of this product.

The structure of aircraft portfolios has been considerably refined since the first transaction was completed by GPA eight years ago. That deal was predicated on the forced sale of the aircraft before the final maturity date, a structure that could prove problematic if the remarketing period coincided with an economic recession.

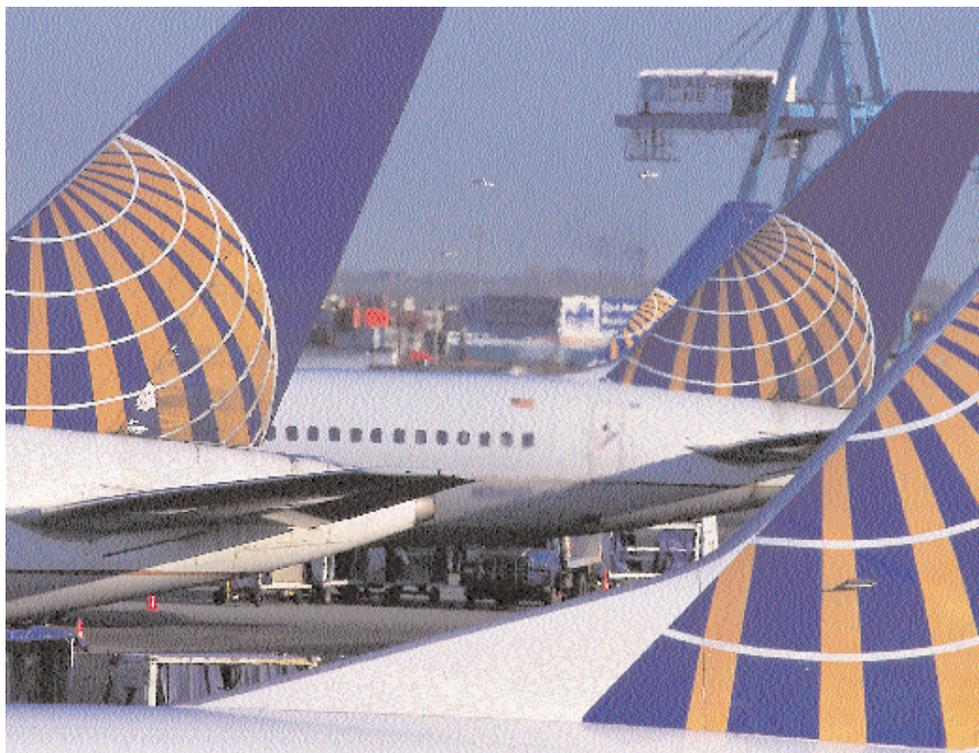
Ogley says that since then successive portfolio securitisations have always added a couple of extra features without throwing away the main premise of the structure, namely more flexibility. Today there is more flexibility in the amortisation of the transaction. Rather than a set maturity date, there are now expected or soft amortisations so that failure to retire the bonds on a date would not result in a default.

In the case of the Morgan Stanley and Aircraft Finance Trust securitisations, the idea that a portfolio can be variable was introduced, allowing aircraft to be added or taken out.

Sayre expects that the day aircraft can be treated as commodities is not far off, bringing the end result of greater market liquidity. Other investment bankers, such as Cahill, are more sceptical and believe commoditisation will not occur for another 10 years.

Another trend on the increase is the blending of securitisation techniques with corporate transactions. Referred to as hybrid structures, securitised techniques piggybacked onto corporate transactions will achieve a higher rating than a corporate bond on its own. According to Standard & Poor's, hybrids exhibit a securitisation structure but have operating assets and leases for ongoing use as their collateral, rather than receivables that will be liquidated.

Even the boundaries between an EETC and portfolio securitisation have



begun to blur with the recent \$1.067 billion Air 2 US deal arranged by Salomon Smith Barney and Lehman Brothers. This transaction involves the securitisation of 41 Airbus aircraft operated by American Airlines and United Airlines and leased from Airbus wholly owned subsidiaries. The manufacturer, in turn, financed these same planes under leveraged leases. This exposes Airbus to risk at both levels: through its sub-leases to United and American and also to its head lessors. The objective of this highly complex securitisation, says John Grier, managing director and head of the transportation group at Salomon Smith Barney, "was to relieve Airbus of its entire exposure, by selling the debt portion and monetising the equity portion".

The arranger devised a structure that kept all head leases and sub-leases in place. In this way Airbus avoided early termination payments on the head leases and the head lease investors would not have to substitute American's and United's credit for that of Airbus'. Nevertheless, Philip Baggaley of Standard & Poor's, points out in his pre-sale report that the credit assessment of this structure, like an EETC, is still very much affected by the two airlines' credit quality and the value of the aircraft.

The real blurring of boundaries comes into play should there be a default or insolvency. If American or United fail to pay rentals under the sub-leases, rather than repossess and sell the aircraft, as in a true EETC, the aircraft are instead released as in the case of a portfolio securitisation. Grier explains this mechanism is "more attractive to the junior classes of note holders because you

are not crystallising the bad impact immediately". In the event of an Airbus insolvency, the issuer calls on an \$805 million promissory note (similar to the liquidity facility in a typical EETC) which will pay interest to each class of note holder.

The future application of this 'synthetic EETC' will probably be limited to aircraft manufacturers, although operating lessors may also benefit from the structure.

The aircraft loan portfolio or Collateralised loan obligation (CLO), is another asset-backed security product poised for future growth. One such example is the \$100 million aircraft-backed CLO originated by CL/PK Airfinance at the end of 1998. In this type of transaction the assets consist of a bank's interests in aircraft loans. These loans may be straightforward secured loans and US leveraged leases, but they may also include the more complicated structures of Japanese leveraged leases and ownership foreign sales corporations or commission foreign sales corporations.

What the rating agencies find attractive about these portfolios is that unlike many aircraft portfolios, which are comprised of operating leases to non-investment grade carriers, loan portfolios tend to include the better credit airlines and flag carriers.

Investment banks predict that the market will see more aircraft securitisation deals this year, with at least one to two deals coming from European and Asian carriers. As opportunities for tax-advantaged, cross-border deals dry up, the airline industry will be forced to look for alternative sources of funding for its ever-growing fleet requirements. **AC**