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Ireland: Trends & Developments

Maria McElhinney, Keith Mulhern,
Laura Gallagher and Andrew Dixon
A&L Goodbody LLP

Trends and Developments

Contributed by:
Maria McElhinney, Keith Mulhern, Laura Gallagher and Andrew Dixon
A&L Goodbody LLP

A&L Goodbody LLP is one of Ireland's leading Irish corporate law firms. The Aviation & Transport Finance team is led by partners Marie O'Brien, Séamus Ó Cróinín, Maria McElhinney and Keith Mulhern. Collectively the team has unparalleled experience when advising on financing structures, including significant experience in the establishment of new aircraft leasing and financing platforms, joint ventures and sidecars, mergers & acquisitions, asset backed securitisations, aircraft CLOs, aircraft portfolio sales, acquisitions & financings, aircraft leasing transactions and high-profile restructurings. The lawyers work closely with clients in Asia, Europe, the USA and the Middle East to start or expand their business in Ireland, helping them navigate the Irish legal, tax and regulatory environment. As the largest aviation team in Ireland, it has the experience to advise on the largest and most complex transactions, with a focus on delivering client-first, solution-based Irish legal advice.

Authors

Maria McElhinney is a partner with the Aviation & Transport Finance group. Maria has extensive experience in a wide variety of international financing and corporate transactions, particularly involving aviation assets. Maria has advised many of the world's leading financial institutions, aircraft leasing organisations and private investors on transactions involving the financing, acquisition and securitisation of aviation assets.

Keith Mulhern is a partner in the Aviation & Transport Finance group. Keith has acted for a wide range of aviation clients including leasing companies, airlines, banks, manufacturers, funds and credit support providers. He has extensive experience acting on a variety of aviation financing and leasing products and structures including operating leases, finance leases, sale and leasebacks, JOLCO structures, debt finance (bilateral, syndicated and warehouse facilities), capital markets issuances (secured ABS and unsecured perpetual bonds), pre-delivery payment financing, Islamic financing, joint ventures/side cars, export credit agency supported financing and AFIC/Balthazar supported financing.

Laura Gallagher is a senior associate in A&L Goodbody's Aviation & Transport Finance team advising on the acquisition, leasing, financing and securitisation of aircraft and other equipment and has acted for many of the aircraft industry's leading financial institutions and private investors. Laura joined the firm in 2023 having previously worked in another leading Irish law firm's Aviation Finance team.

Andrew Dixon is an experienced senior associate in A&L Goodbody's Aircraft Finance group and has acted for many of the aircraft industry's leading financial institutions, aircraft lessors and private investors on transactions involving the acquisition, leasing, financing and securitisation of aircraft and other equipment.

A&L Goodbody LLP

3 Dublin Landings
North Wall Quay
Dublin 1, D01 C4E0

Tel: +353 1 649 2000
Email: mmcelhinney@algoodbody.com
Web: www.algoodbody.com

Contributed by: Maria McElhinney, Keith Mulhern, Laura Gallagher and Andrew Dixon, **A&L Goodbody LLP**

Introduction

As the global hub for aircraft leasing, Ireland enjoys a wide perspective on the trends and developments in the industry with the Irish aircraft leasing industry continuing to be a significant and rapidly growing sector. During 2022, the aviation sector began its recovery from the unprecedented market collapse during the COVID-19 pandemic. Global passenger numbers rebounded in 2022 by more than 55% according to IATA and the expectation in 2023 is that air travel numbers will continue to close in on pre-pandemic levels. This increase is being driven largely by a strong rebound in international travel, attributable to pent-up demand for leisure travel following removal of COVID-19 restrictions combined with accumulated consumer savings following extended global lockdowns. Significant new challenges also emerged including the ongoing war in Ukraine and the resulting macroeconomic impact on the global economy. The global aviation industry was called on once again to demonstrate its remarkable resilience and it has regrouped and pushed towards a recovery despite such setbacks including rising interest rates, inflation and fuel prices.

The Irish aircraft lessor community continues to play a vital role in the recovery of the global aviation sector. Demand for aircraft leasing services remained high through 2022 despite the setbacks mentioned above and will continue to do so going forward with the percentage of leased aircraft within the global fleet exceeding 50% for the first time. In this article, we examine some of the key developments and latest trends in the aviation finance and leasing sector in Ireland, and how aircraft lessors will continue to navigate a post-pandemic industry.

Market Volatility and Inflation

The aviation industry is expected to return to profit this year. The latest forecast from IATA predicts a global profit of USD9.8 billion on revenues of USD803 billion in 2023. This is the first time industry revenues will top the USD800 billion mark since 2019 and will be a significant achievement for the industry demonstrating its resilience following the impact of the pandemic. Unfortunately, the recovery continues to be fragmented. It has been linked to the consistency and pace at which travel restrictions were eased with the Asia-Pacific market being slower to recover during 2022. There are also significant macro factors at play for airlines including inflationary pressures, the heightened interest rate environment and the rising price of oil.

Over a year on from the invasion by Russia of Ukraine, the global economy as a whole has been shaken and this has been seen particularly within the aviation sector in Ireland.

Sanctions

The EU and its global partners were swift to impose sanctions following the outbreak of the war. These took the form of rapid waves of sanctions packages which at an early stage included an EU prohibition on the sale, supply, transfer or export, directly or indirectly, of aircraft assets to Russian persons or for use in Russia. Similar EU prohibitions were also imposed on providing insurance, reinsurance, financing and financial assistance for such activities, one of the results of which was the immediate cancellation of insurance policies over leased aircraft operating in Russia.

Those sanctions had a significant impact on the Irish aircraft lessor community with aircraft on lease to Russian airlines. Approximately 500 Irish-owned aircraft operated by Russian airlines have been unlawfully appropriated by Russia. Over 200 of these aircraft have since been unlawfully re-registered in Russia following the decision by Bermuda and Ireland to suspend certificates of airworthiness for Bermudan and Irish registered aircraft currently in Russia. As a result of lessors' inability to recover their assets from Russia, a number of the affected lessors have initiated legal actions against their insurers. Payout has not occurred on the grounds that recovery of the aircraft may still be possible and even lessors with no exposure to Russia have been indirectly impacted with strong upward pressure on the cost of insurance premiums across the market.

This litigation is expected to take years to resolve. For a number of Irish lessors this has had a long-lasting impact on their balance sheets resulting in asset write-downs together with increased costs as lessors continue their efforts to counteract such losses. The pace and broad scope of sanctions regulations (together with the potential for variance between different jurisdictions) has left financiers, lessors, airlines and other industry stakeholders grappling with complex legal issues and uncertainty.

Rising Costs

Increased costs have also affected aviation lessors from a financing perspective with interest rates rising swiftly which have caused issues for the industry and the expectation is that these will continue. Global inflation fighting measures are maturing at different rates in different markets with Central Banks searching for the best levels for interest rates to have a cooling effect on inflation without tipping their economies into recession. Rising rates have pushed up borrowing costs, purchasing costs and maintenance costs. The market is adapting and seeing an upward movement of lease rates but it will take some time for these to catch up with rising interest rates. There is still come catching up to do as some pockets of idle aircraft remain from the pandemic when lessors found it more difficult to place aircraft owing to low demand as a result of air travel restrictions. This is resulting in lease rates lagging behind values and while we have not seen interest rates and inflation filter through to lease rates at the same pace, the trend is upwards.

New aircraft deliveries have gained pace but airframe and engine manufacturer delays continue with deliveries in 2022 remaining well below pre-COVID-19 levels. Global supply chain challenges are further hindering aircraft production rates with engines and other parts being short on supply. There is a consensus emerging that the industry's supply chain will have to be substantially remade in the wake of the pandemic before the industry can fully recover, a process which may take years. Many Irish lessors are predicting a shortage of aircraft in the short-term and these challenges are likely to increase demand for leased aircraft. Due to the shortage, lessors should have stronger bargaining power when it comes to negotiating lease rates both for lease extensions and new leases.

Recent trends have seen an increase in trading activity in the secondary market with an increase in asset values as a result of the rising inflationary environment. However, asset sales are being constrained by a lack of capital driven by the effective closure of the ABS as a means of financing aircraft as well as rising interest rates affecting the cost of funding, and we are yet to see a return in this area to pre-pandemic levels of activity. With improved performance in many leases which were restructured in 2020, lease contract volatility is decreasing and increased predictability around revenue streams may contribute to an increase in trading activity.

Sources of Finance

Only a few transactions closed in a muted aviation ABS market in 2022, amounting to less than USD1 billion in volume, among them Carlyle Aviation and Airborne Capital. High interest rates and market volatility make it a market for the brave, although given the popularity of the ABS product many will be preparing behind the scenes and will be ready for its return.

Investment grade lessors have looked to the unsecured bond market notwithstanding the high interest rates and volatility. Aircraft lessors issued USD3.373 billion in unsecured capital markets debt in the first quarter of 2023, which exceeds the amount of any quarter in 2022 but remains relatively low in comparison to other years. These types of bond offers are limited to only a number of Irish lessors with the majority looking for other means to avail itself of financing.

Export credit agencies and the aircraft non-payment insurance products offered by AFIC and Balthazar may step up to provide financing to bridge the gap left by the traditional aviation banks and the closure of the ABS market. It is likely that we will see an increase in export credit lending to assist with financing requirements in the short-to-medium term and recently the board of directors of The Export-Import Bank of the United States voted unanimously in favour of renewing a 90% guarantee of a USD500 million facility for Citibank, N.A. under EXIM's Supply Chain Finance Guarantee Program.

Many lessors have also turned to the new entrant alternative lenders such as Volofin, Ashland Place, PK Finance or Av AirFinance to meet financing requirements for their commitments. These lenders are able to react quickly and be nimble which is appreciated by the industry. There has been a growing trend in new alternative lenders coming to the aviation space with LR AirFinance and AIP Capital being recent entrants. Alternative lenders are quickly building up a loyal customer base and their strategy has been welcomed by many lessors.

Traditional aviation bank lenders scaled up commitments during 2022 on the back of the recovery in the industry. The value of strong relationships will be realised as many will revert to existing financiers and agree refinancing and extensions where possible. For some the current cost of financing means that they will seek to delay financing as long as possible; however other commentators would argue that if you need financing in the short-to-medium term then now is the best time as the market is unlikely to improve quickly. Those with strong trusted relationships with their lenders are engaging early to agree refinancing terms as soon as possible. However this reliance on the aviation banks may only be available for the top-tier credits and those with pre-exiting banking relationships.

From an airlines perspective, the sale-leaseback structure will be attractive for funding deliveries in the current volatile market. Using sale-leasebacks shores up liquidity for airlines and is a useful tool for hedging residual risk. Sale-leasebacks are also attractive options for new entrants to the leasing market as an alternative strategy to building scale alongside portfolio purchases.

Fragmentation and Consolidation

Recent years have seen something of a correction to the previous trend of fragmentation through new entrants into the aircraft leasing market. This fragmentation often took the form of new investment from sources like private equity firms partnering with experienced aircraft lessors or lessor-based talent in launching new aircraft leasing platforms, joint ventures or investment sidecars. There has recently been a number of high-profile examples of consolidation among aircraft lessors led by those at the top of the market.

2021 saw a monumental market event in this sector with the USD30 billion merger of AerCap and GECAS, at the time the two largest aircraft lessors in the world. AerCap emerged from that transaction with a staggering portfolio of approximately 1,900 and a further 423 aircraft on order. The transaction signalled the beginning of a trend toward merger and acquisition activity in the sector and bidders with capital to deploy have seen opportunities in that environment. Many are seeking to achieve growth and scale which has a number of key advantages to an aircraft lessor in terms of strengthening its leverage when negotiating key transactions such as orders with manufacturers, financing terms or more generally their suppliers including maintenance providers. It can also facilitate the opening of new sources of funding for larger deals evidenced by the access of a number of larger and investment grade lessors to the unsecured bond markets. Access to diverse sources of funding can be a key differentiator in a leasing business strategy in a market that has seen significant volatility in the cost of debt through the pace of interest rate hikes in 2022. Others see these types of acquisitions as an opportunity to acquire key talent, attractive portfolios or order books which would not otherwise be available to it.

In December 2022, the USD6.7 billion acquisition by SMBC Aviation Capital of Goshawk brought SMBC's portfolio to 700 owned and managed aircraft with approximately 220 more on order. The transaction was initially financed using a USD1.83 billion term loan together with a USD710 million revolving credit facility which was later increased by USD815 million as a result of strong demand. Carlyle Aviation Partners, following its earlier purchase of FLY Leasing, completed the purchase of AMCK's aircraft portfolio of 125 aircraft valued at USD4 billion and a further 20 on order through its Maverick Aviation Partnership with funding through a USD2.5 billion bridge loan. Other examples include the acquisition by Chorus Aviation of Falko Regional Aircraft in May 2021 and, more recently, the acquisition by Aergo Capital of Seraph Aviation Management in November 2022 under which it assumed the management of 88 aviation assets spread across 38 lessees with a combined asset value of USD2.5 billion.

The trend towards consolidation is predicted to continue with reports indicating more rumoured transactions will be announced and close in 2023.

In contrast, there are a number of examples of new investment and platforms launching in the current market. The GECAS/AerCap transaction indirectly paved the way for the founding of High Ridge Aviation and LR AirFinance by a number of high-profile ex-GECAS officers led by Greg Conlon (the former GECAS CEO) partnering with PIMCO to offer a mix of traditional operating/finance leasing and debt solutions to customers, with a recognised focus on managing (rather than owning) assets on behalf of institutional investors with access to diverse sources of funding. Another example is the Kingdom of Saudi Arabia's high-profile investment in aviation through its Public Investment Fund – with a planned commitment of USD100 billion to aviation through the launch of a new airline and the founding of new leasing platform, AviLease with Ted O'Byrne as CEO.

Investment into the aircraft leasing industry is driven by performance of the industry itself and by the performance of aircraft as an asset class relative to other assets classes. The aviation industry may be under pressure from a number of factors, but it remains a solid investment and competitive with other assets classes in uncertain times. The availability of highly experienced and talented senior aviation executives in Ireland continues to help new entrants hit the ground running with new platforms.

Green Aviation

Green aviation and environmental, social and governance (ESG) factors are no longer in the background for credit committees as boards and senior managements are beginning to factor ESG into investment strategies and overall portfolio management, and considering how these risks are positioned within the business's risk framework.

Whilst the industry has committed to "net zero" carbon emissions by 2050, the path is very challenging and will require the major aircraft manufacturers to deliver fundamental technological change in the coming decades. The likely absence of credible electric and hydrogen energy alternatives to traditional jet fuel in the short-to-medium term means that to help achieve net zero by 2050, the development and use of sustainable aviation fuels is essential together with fleet renewal using more fuel-efficient aircraft.

The decline in the availability of finance from traditional sources like commercial banks, coupled with rapid interest rate hikes in 2022, volatility in fuel prices and the backlog of fixed-rate leases, necessitates more innovative methods of securing debt. This combination of market conditions has the potential to lead to further sustainability-linked financing in the aviation sector. Different sectors are seeing financial institutions offer green financing products in light of regulatory and public pressure to consider ESG issues in their investments.

Green Bonds and Green Loans require that funds are used for projects with a positive environmental impact whereas sustainability-linked financing allows the borrower much greater flexibility as to how loan proceeds are used; the borrower's overall corporate performance being assessed against ESG targets. The extent to which the borrower meets its sustainability targets determines the loan's pricing, an attractive opportunity for aircraft lessors and airlines focused on carbon reduction while also providing financiers an opportunity to meet their own ESG objectives. This type of product has been seen more frequently in airline financing transactions. Recent years have seen airlines such as Etihad, JetBlue and British Airways entering into sustainability-linked loan transactions. 2022 saw the first sustainability-linked aircraft-secured loan provided to an airline by Air-France-KLM and SocGen. In addition, Rockton, a Swedish regional-focused boutique aircraft asset manager, launched the industry's first sustainable aviation fund.

The corollary of the growth of sustainability-linked financing the aviation sector has been the development of the Sustainability-Linked Leases where lease rates are subject to a two-way step-up/step-down pricing mechanism linked to ESG scoring with Korean lessor, Crianza Aviation announcing the first ever sustainability-linked operating lease with an undisclosed airline in November 2021 and Air France announcing the first ever sustainability-linked JOLCO in April 2022.

Carbon credit programmes are also being developed as another strategy to facilitate carbon reduction. SMBC Aviation Capital is leading the way on the lessor side of the market, having invested in a project in Burkina Faso to provide energy efficient cookstoves to 28,000 families and forward purchased carbon credits from a range of cookstove projects in Africa, Asia and Central America. In March 2023, Southwest Airlines agreed to purchase over 400,000 carbon credits from SMBC to support its operations and meet CORSIA requirements. Under the programme, carbon credits can be acquired from SMBC by airlines as part of a lease contract or independently.

Increased environmental regulation in the sector will become more of a factor for the aviation industry with requirements under CORSIA, EU ETS and EU Taxonomy all increasing or coming into play in the coming years. The cost of complying with these regulations means that lessors are coming under pressure from airlines regarding their ability to meet lease rates. Shorter aircraft life cycles may challenge lease structures and aircraft recycling is undergoing further research and implantation.

Conclusion

The industry continues to attract new investment while demand for scale, talent and attractive portfolios is driving consolidation at the other end of the market. New structures and new business modelling are likely to follow as financiers, airlines and lessors adjust to the challenges faced in inflationary pressures, market volatility, geopolitical developments and the increasing focus on decarbonisation. Innovation, experience and agility are key to navigating this market and the industry is well placed to respond having demonstrated incredible resilience in recent years. One guarantee is that Ireland will remain a reliable and trusted jurisdiction that will continue to support the industry in its future success.

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