July/August 2018

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Recent structural developments in **aircraft ABS transactions**

David Berkery, partner at A&L Goodbody discusses the increased liquidity of E-notes, co-issuer structures and other changes in asset backed securitisations.

Since 2013, the demand for aircraft ABS (asset-backed securitisation) transactions has gone from strength to strength. Last year saw a record number (14) of ABS deals close and 2018 is on course to at least match that number.

For many aircraft lessors, access to the capital markets is a crucial component of their capital structure.

The model of raising equity capital, using a warehouse facility to acquire a portfolio of aircraft, refinancing the expensive warehouse debt through an ABS take-out (and repeat) has proven to be very successful and has allowed mid-sized lessors especially to grow rapidly.

The ABS product has shown incredible versatility in recent years in terms of the age and the types of assets in the pools, as well as the willingness of the market to allow for high concentrations of emerging market exposure. Also, in terms of how the vehicle has been structured in order to maximise tax efficiencies and to meet the specific needs of the equity investors and/or potential future equity investors.

> *"The challenge was to create a truly diverse, amalgamated collateral pool without disturbing the tax structuring of the equity in the portfolio on the CLAST 2014-1 deal."*

Ground-breaking deal

The *CLAST 2014-1 (Castlelake)* deal was ground-breaking for a number of reasons. The number of aircraft in the pool (79) and their weighted average age (17.5 years) were some distance beyond what the market had seen at that point. The transaction repurposed the ABS product as not just a means of moving aircraft off-balance sheet, but as a new and inexpensive financing source for mid-life and end-of-life aircraft.

The deal was also ground-breaking from a structuring perspective. The nature of the sponsor as a fund manager, rather than a more traditional aircraft lessor, meant that the equity in the ABS vehicle needed to be held by multiple different funds, each with its own tax and structuring considerations.

The challenge was to create a truly diverse, amalgamated collateral pool without disturbing the tax structuring of the equity in the portfolio. In particular, ensuring that US-sourced income in the structure was not used to pay dividends to non-US persons, for which a 30% withholding would apply.

Borrowing heavily from enhanced equipment trust certificate technology, the dual-level issuer structure was created. The assets would be held in separate silos depending on their lessee locations and expected flight patterns. Each silo would sit beneath a sub-issuer, which would issue cross-collateralised and cross-guaranteed notes to a single master issuer, a pass-through trust, which would amalgamate the debt cash flows and issue master notes to the debt investors.

The individual sub-issuers had separate equity investors, so there was no cross-contamination from a tax perspective of the residual cash flows from the portfolio. The structure has been replicated a number of times since – *CLAST 2015-1, CLAST 2016-1, CLAST 2017-1, CLAST 2018-1 (all Castlelake), AASET 2014-1, AASET 2015-1, AASET 2016-1, AASET 2016-2, AASET 2017-1 and AASET 2018-1 (all Apollo Aviation).*

Initial preferences for Luxembourg-based holding structures for non-US assets have largely been replaced by Irish based sub-issuers, particularly since the Luxembourg transfer pricing rules came into effect.

Co-issuer structures

More recently, similar tax considerations have been addressed by way of a co-issuer structure. These involve an entity that is Bermuda or Cayman incorporated but Irish tax resident, and a Delaware limited liability company subsidiary. They act as co-issuers of the ABS notes on a joint and several basis – *Blackbird 2016-1 (Napier Park/ALC), Labrador (GECAS), Thunderbolt (ALC), Falcon (DAE), Sprite 2017-1 (World Star), KDAC (DVB), METAL 2017-1 (Aergo) and MAPS 2018-1 (Merx*).

Aircraft deriving US-sourced income are held by subsidiaries of the Delaware co-issuer with cash flow from those assets held in separate (US) sub-accounts and the non-US aircraft are held by subsidiaries of the Irish co-issuer. This structure isolates the US-sourced "fixed or determinable, annual or periodical gains, profits and income" so that dividends paid from such amounts are paid only to US-persons. If such dividends were paid to non-US persons, withholding tax of 30% could apply.

The co-issuer structure has become the most frequently used structure for the product, with the US co-issuer seen as adding some flexibility in the event of a secondary trade of the equity interests (or E-notes) and/or re-leasing of assets to US-based lessees. This is true even for transactions in which the sponsor has retained the equity in the vehicle at closing and does not need a blocker to capture the US-sourced cash flow and for transactions which do not involve any US lessees at closing – eg, *MAPS 2018-1 (Merx*).

That said, the single issuer structure is still used from time to time in retained equity ABS deals – *HAIL 2017 (Aergen), Prop 2017-1 (Elix), S-Jets 2017-1 (Sky).* Such a structure could limit the universe of third parties to which the sponsor could potentially sell the E-notes. This is the case particularly in circumstances in which the E-note investors do not have the ability to appoint a majority of the directors on the board.

Recycled entities

Another significant structural change which has developed in recent years stems from the more pragmatic approach the rating agencies have been willing to take to the use (under certain circumstances) of what previously would have been deemed to be "stale" aircraft-owning special purpose companies as "recycled entities".

The logic behind the approach is sound. An entity which was previously used in a warehouse or acquisition finance facility, and subject to special purpose covenants in the transaction documents to which it was a party and/or in its constitutional documents, should not be materially more likely to have incurred unknown third-party liabilities than a new entity formed specifically for the aircraft ABS.

The efficiency created by this is difficult to overstate. Fewer or no lease novations and reduced lessee interaction allows aircraft to be transferred into the structure in a much shorter period. This means sellers receive their purchase prices a lot quicker. They are not all fortunate enough to have the benefit of a parent as creditworthy as GE, which can guarantee return of the purchase price (with interest) in the event of failing to transfer the aircraft within the purchase period and therefore allow them to receive almost all of the purchase price within days of closing the note issuance.

This means that the vehicle does not suffer from too much negative carry on the debt between the date of note issuance and the aircraft delivery date. Such negative carry can be mitigated somewhat in any event, in a loan format aircraft ABS at least, through the use of a delayed draw mechanism whereby only a portion of the debt proceeds are raised at closing and the remainder are committed but not funded until a later date – eg, *CLAST 2017-1 (Castlelake).*

Liquid E-notes

Although aircraft ABS debt has been in high demand in recent years, the E-notes in these vehicles have been a lot less liquid. The market for third-party equity in aircraft ABS vehicles in recent years has been limited primarily to hedge funds and private equity funds with different return expectations and different views of control rights to those of more passive institutional investors.

For most E-note investors, an ability to appoint a majority of the directors of the board of the issuer is a prerequisite for their investment. This placed pressure on the non-consolidation analysis for issuers which had their centre of main interests in Ireland after the enactment of the Companies Act, 2014 in Ireland. This Act included a change to the definition of a "subsidiary" under Irish company law from a share capital-based test (easily addressed through the use of a charitable trust holding the issuer's share capital and the issuance of E-notes mirroring the economics of equity ownership) to a test of "dominant influence and control".

"Aircraft ABS debt has been in high demand in recent years, the equity interests (or E-notes) in these vehicles have been a lot less liquid. The market for third-party equity in aircraft ABS vehicles in recent years has been limited."

Nonetheless, A&L Goodbody, working with a number of frequent arrangers of these deals, has managed to mitigate the consolidation risks in a manner which has been accepted by the market and each of the primary rating agencies active in the industry. This is notwithstanding the equity's ability to appoint a majority of the board.

Very recently, the *STAR 2018-1 (GECAS)* deal came to market featuring listed, tradeable, equity interests. The structure used involves the parent co-issuer issuing E-notes to an orphaned, special purpose vehicle, the E-note holder. That E-note holder then issues equity certificates to multiple investors. While it remains to be seen, the early indications are that these liquid equity certificates will attract a new class of investor to the aircraft ABS product. For example, those with a greater risk appetite and higher yield desire than the current investors on the BB/B rated tranche of debt but which do not have the same control expectations as the traditional private equity investors in E-notes to date should be receptive to this product.

At the time of writing, at least one other deal is preparing to come to market with the same tradeable equity feature and it is likely that more will follow.

Overall, the trends for aircraft ABS look good. Each year brings new first-time sponsors and new investors. The structures have proven to be dynamic and malleable, while the transaction documentation has been simplified and is more approachable for new investors than it was just a few years ago.

The introduction of a more liquid E-note shows the continued drive towards innovation among the arrangers of these transactions and, market conditions allowing, could give rise to the next wave of aircraft ABS transactions.