STRUCTURED FINANCE ASSOCIATION

Research Corner

October 13, 2020

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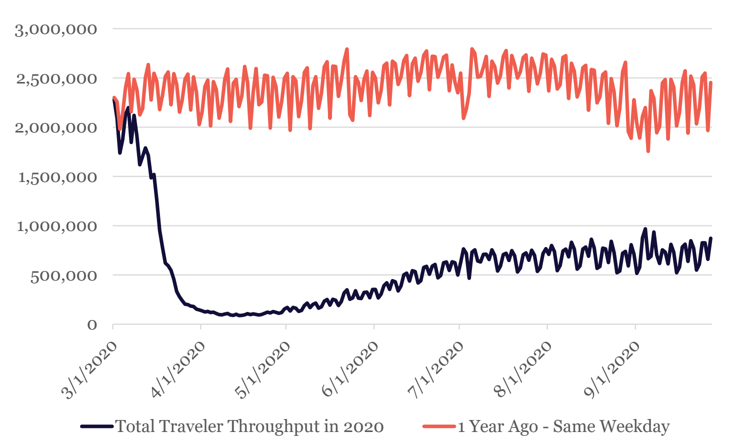
SFA Research Corner: Aircraft ABS Buffeted by COVID-19 Turbulence

What We're Watching

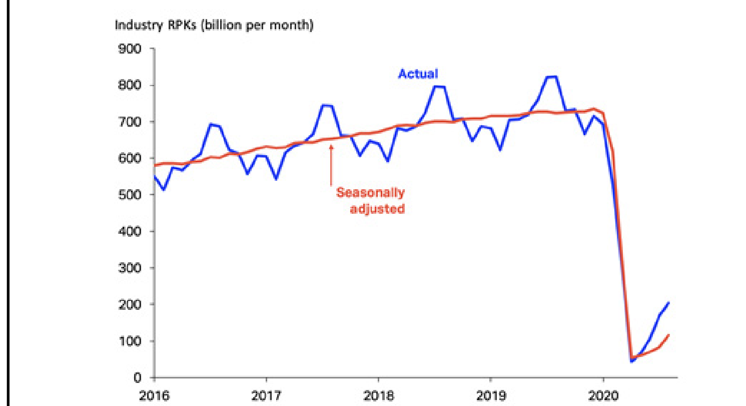
The airline industry has been one of the hardest hit industries since the onset of the pandemic. U.S. air travel, as measured by TSA checkpoint data, plummeted 96% year-on-year during the early days of the pandemic amidst widespread stay-in-place orders. While air travel has recovered from this low point, demand, and subsequent passenger revenue, have remained depressed as passengers, airlines, and governments navigate quarantine mandates, staggered re-openings, and still rising COVID-19 cases. By September, the same TSA data shows U.S. passenger traffic down 64% from one year ago. Demand for global air travel, as measured by the change in the number of kilometers flown by a paying passenger, varies regionally but overall had contracted by 75% in August.

Passenger Volumes Recovering Slowly From April Low



Source: TSA Total Traveler Throughput

Global Passenger Traffic Contracted 75% YoY in August (as Measured by RPK)*



**RPK is revenue per kilometers, an airline industry metric that shows the number of kilometers flown by a paying passenger.*

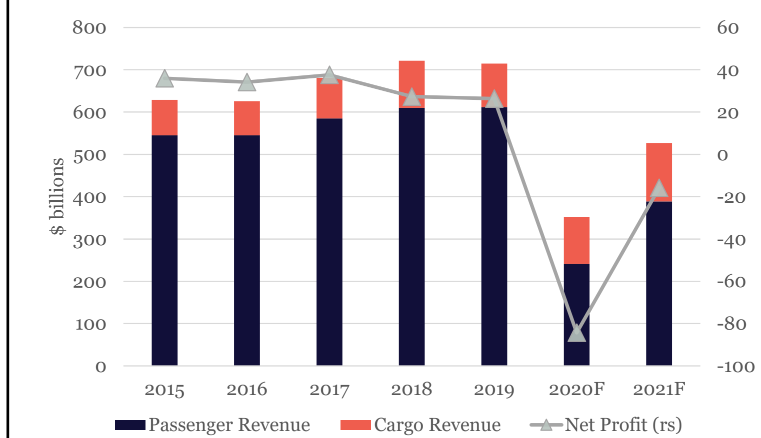
Source: IATA

Quarantine rules have been a particularly difficult. In September, United Airlines became the first U.S. carrier to make COVID-19 tests available to customers entering Hawaii, a state with a 14-day quarantine rules. David Yu, finance professor at New York University in Shanghai and the only Senior ISTAT Aviation Appraiser in N. Asia and China remarked that "[s]ince the start of the impact of COVID in late January in the Asia Pacific markets spreading to the rest of the world, there have been many attempts to jump start confidence in air travel and demand back towards recovery profile. These attempts were responses to mitigate temporary dampening effects of a lack of confidence caused mostly by a series of reignited regional outbreaks and respective governmental responses. This has severely constrained airlines, its finances and their business models with a large fixed cost basis." Yu concludes, "[a]viation financing all across the board including bank debt to structured products including aviation ABS and EETCs, will experience short term pressures and long-term implications as the pandemic resolves itself over time."

What We're Watching

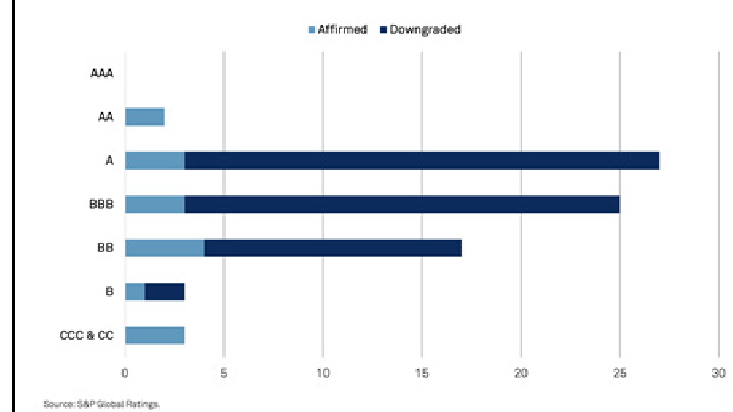
So far, at least 13 non-U.S. airlines and five U.S. airlines have filed for bankruptcy protection or shut down completely since March. The Air Transport Action Group expects that the severe downturn could cut global aviation and air travel related jobs by roughly half from current levels or up to 46 million jobs.

Revenue From Pullback in Passenger Demand Has Dropped by 60% From 2019



Source: IATA

Since the Onset of Pandemic, S&P Has Downgraded 61 Aircraft and Aircraft-Engine ABS



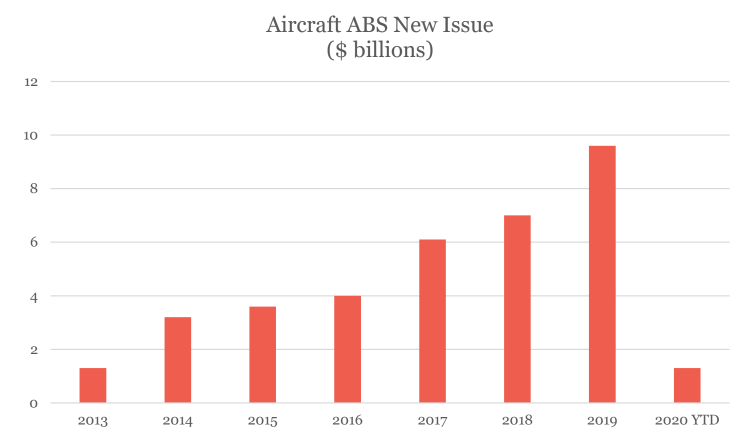
Source: S&P Global Ratings, U.S. And Canada Structured Finance Surveillance Chart Book

The pressure has appeared in securitized transactions and the rating agencies have taken note. In September, S&P downgraded 54 aircraft and aircraft engine ABS, bringing total downgrades in the sector to 61 since March. The rating actions were driven by deteriorating cash flow as well as "qualitative factors, including exposure to engines off lease, lack of principal payments, and the resulting increase in overall loan-to-value and imbalances in the market between supply and demand, which has led to longer off-lease periods." Further, S&P expects that over the next 12-months collateral performance will continue to weaken and rating trends to remain negative for this sector. Also in September, KBRA downgraded 81 global aviation ABS bonds, citing the impact of markedly declining cash flows and cash flow interruptions. The rating agency noted that 22 transactions had delinquency rates between 24% to 77% and that 35 transactions triggered their rapid amortization event by a breach of threshold debt service coverage ratios.

What We're Watching

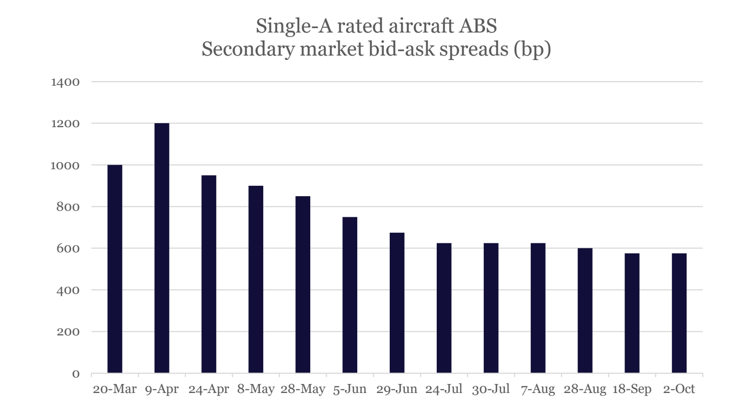
Aircraft leasing companies issue ABS to fund their commercial aircraft leasing programs. (For more on aircraft ABS see here.) The supply of new-issue aircraft ABS had risen steadily between 2013-2019. So far in 2020, $1.3 billion of aircraft ABS has been issued, a meaningful drop from the $9.6 billion issued in 2019. The pullback in ABS supply has been directly impacted by the drop in passenger, and subsequently aircraft, demand. However, as the broader securitization market recovered, constrained new issue supply has supported secondary market bond prices, a phenomenon that has occurred across most of the securitization market. Demand for aircraft ABS has pushed prices higher since plummeting in April, pushing bid-ask spreads tighter by 52%.

Supply of Aircraft ABS Had Risen Steadily Between 2013 and 2019 as ABS Became a Reliable Source of Funding



Source: Bloomberg

Since April, Demand for Aircraft ABS has Pushed Prices Higher; Bid-ask Spreads Tighter by 52%



Source: Market Compilation

Market Signals

Market summary – New issue volume in September reached $51.4 billion, edging out the activity recorded in September 2019 of $49.8 billion. YTD 2020 supply now stands at $310 billion, a 29% contraction from the same period in 2019. Our data shows that for the first two days in October, two non-agency RMBS, four ABS, and two CLO deals came to market for a total of $3.4 billion. While a healthy start to the month, to match October, 2019's activity, we would need to see $74 billion of new bonds in October 2020. While a tall order indeed, we could get close to that as issuers remain incentivized to issue debt before the November election, and if possible, before any chance of another "October surprise."

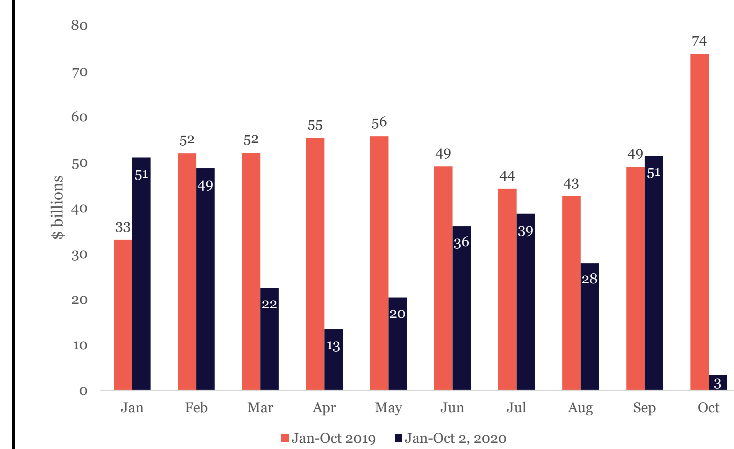
As the surge of new issue abated at the end of last week, investors turned once again to the secondary market for inventory. Demand pushed bond prices higher. Bid-ask spreads tighter on benchmark cards an auto ABS were-1 bp tighter on the week.

New Issue Activity

September Issuance at $51bn Tops Year-Ago Level of $49.8bn

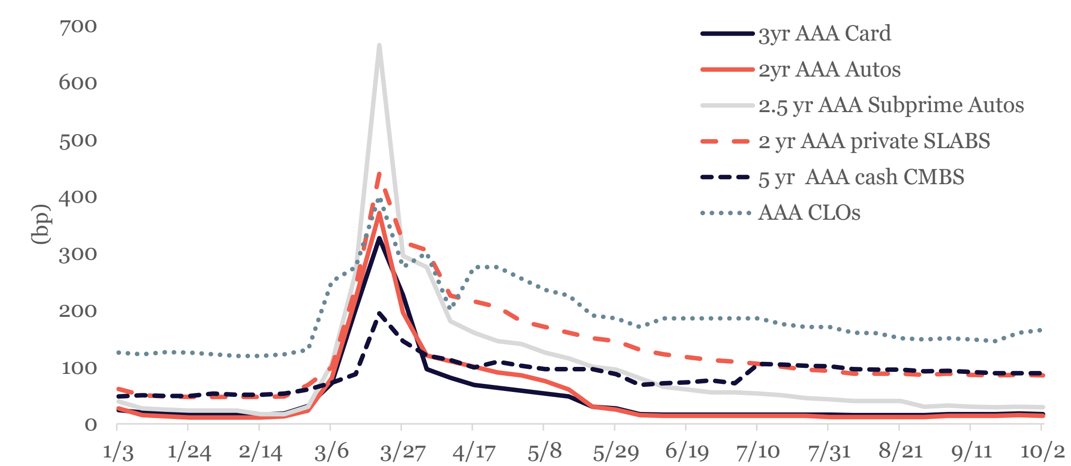
Source: Bloomberg, Deutsche Bank Research

2020 Issuance 29% Below 2019 at This Time

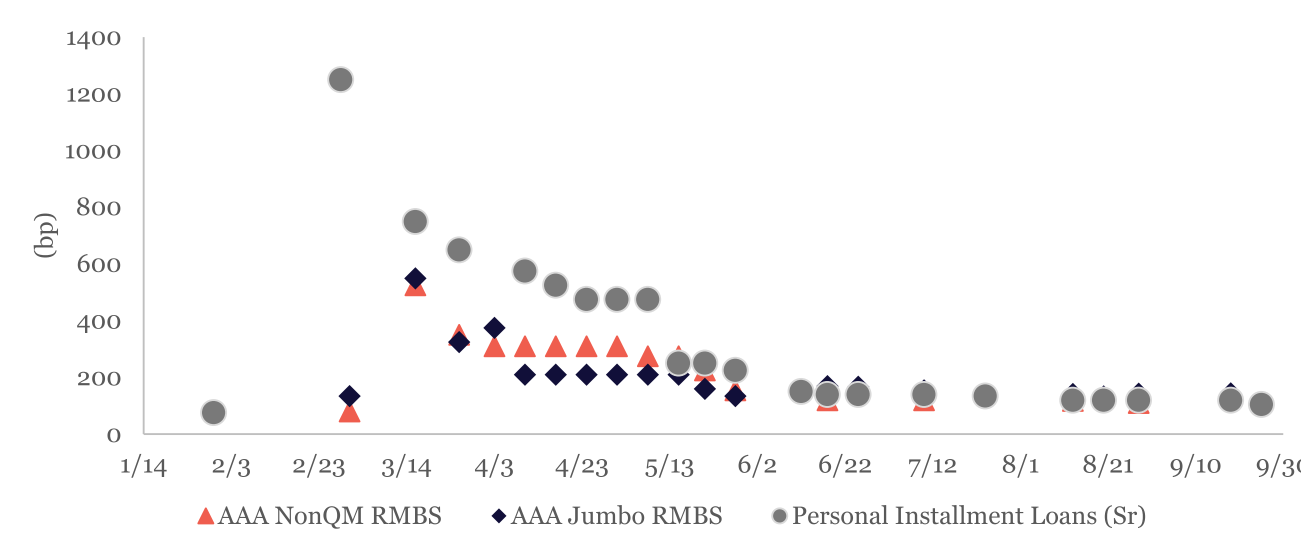


Source: Bloomberg, Deutsche Bank Research

Secondary Market Spreads



Source: Deutsche Bank Research



Source: Market Compilation