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Financing the recovery

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Financing the **recovery**

High Ridge Aviation aims to become a $10 billion leasing and lending platform tailored for a new era of aviation financing.

Among the many nasty side effects of the Covid-19 pandemic, airline debt may be the least talked about.

Yet, it weighs heavily on balance sheets and could be cataclysmic.

Total balance sheet debt, including operating leases per IFRS 16 and ASC 842, jumped to $665 billion as of mid-last year from $478 billion in the 2019/2020 timeframe, according to *Airfinance Journal*'s The Airline Analyst in its review of 186 airlines whose most recent last-12-month (LTM) financials range from 31 March 2021 to 30 June 2022.

Moreover, the debt-to-equity ratio was 5.0x, compared with the pre-Covid level of 2.0x.

Fixed charge cover, which best illustrates the affordability of the increased debt service, was only 0.3x compared with the pre-Covid figure of 2.3x.

Unfortunately, there is no magic wand to wave to return to pre-pandemic days and defuse debt burdens as the industry butts up against a climate crisis and a worsening economic outlook.

The head of the International Monetary Fund, Kristalina Georgieva, said on 1 January that "one-third of the world economy" will be hit by recession this year, and the world faces a "tougher" year in 2023 than the previous 12 months.

But, as the sector hurtles toward what could become the next financial shock to hit balance sheets, some relief might be found in an experienced management team backed by a $2 trillion investor and a Rolodex of aviation elite.

Start-up lessor High Ridge Aviation may be only weeks into business, but its ambitions to become a $10 billion business appear eminently feasible given its management pedigree and financial backing.

Safe at home

Greg Conlon, the industry veteran and former GECAS chief executive officer (CEO), launched High Ridge to rekindle the industrious spirit of 12 ex-GECAS and PK Airfinance colleagues with help from the financing bellows of US investment firm PIMCO.

The asset management platform also incorporates a lending arm, LR Airfinance, restoring the GECAS and PK Airfinance business duo of originating and managing loans for airlines, lessors and manufacturers.

While High Ridge is built with a nod to the past, its focus is set on a post-pandemic aviation sector needing to deleverage from the billions of dollars of debt amassed during the pandemic while engaging in a delicate balancing act of achieving net zero agendas and maintaining growth targets.

The sector's challenges are not insuperable, but addressing them – while lessening debt levels – will take years.

"It's a very long path out, and we haven't even started that yet," says Conlon, who spent 20 years with GECAS and two years at its helm.

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>
> **Greg Conlon**, High Ridge Aviation

"Covid-19 meant over a quarter of a trillion dollars in debt came into the airlines, and that's not including the lessors that financed receivables, so another couple billion-plus from there, and that was just to get to the other side of the pandemic.

"Now compare that with just under $30 billion, and $50 billion free cash in the best year since the Wright brothers. It will take five years, at least, of the best year to delever back to where we were."

But the simple answer is that it could be longer because financing is quickly becoming more expensive. Air Lease, which has historically accessed some of the cheapest cost of funds available, came to market in December with a 5.9% financing, highlighting the new funding environment for operating lessors. It issued $700 million of medium-term notes due 15 December 2027 with a 5.85% coupon at 98.96.

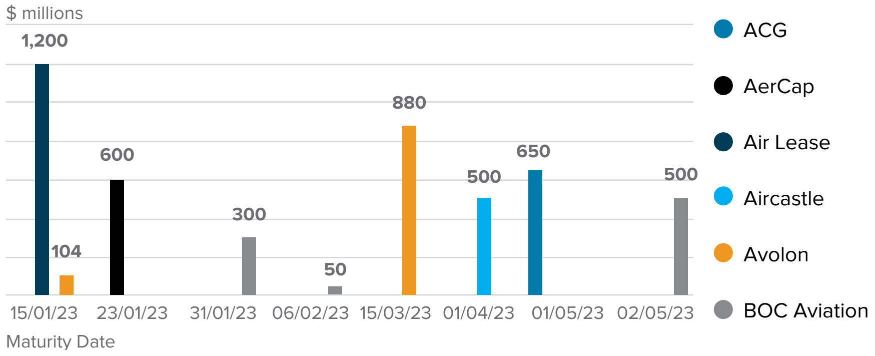
Days later, Marathon Asset Management revealed an inaugural offering of secured notes collateralised by 15 narrowbody aircraft. The $303.7 million offering priced at 6.995% with a 61.1% loan-to-value ratio.

While such levels are hardly a surprise and reflect other transactions – Spirit Aero Systems issued a $900 million private offering at 9.375% in November – they are in stark contrast to those achieved in 2021.

ALC issued its lowest coupon "ever and by far" attached to a $750 million unsecured note offering in January 2021, the lessor told *Airfinance Journal* at the time. The three-year deal priced at 0.70%.

A week earlier, Avolon issued a $1.5 billion unsecured bond. The $750 million five-year tranche priced at 2.125% with a 2.377% yield. The $750 million seven-year tranche priced at 2.75%. The yield was 2.946%.

Investment grade lessors - bond maturities - H1 2023



Source: *Airfinance Journal's* The Lessor Analyst.

Long Covid

The most recent update from *Airfinance Journal*'s The Lessor Analyst shows investment-grade lessors have $87 billion of unsecured bonds outstanding, of which $13 billion is scheduled for repayment in 2023. Non-investment-grade lessors will need to roll over a further $2 billion.

These refinancings will occur during a time of tighter capacity and with the US benchmark interest rate the highest it has been in 15 years. Also, markets expect the Federal Reserve to continue to raise rates in 2023, with the first hike set for February.

Airfinance Journal's data indicates the average coupon per issuer of this maturing debt for investment grade lessors is between 2.50% and 5.00%. The overall average is 3.9%.

If the entire amount is refinanced at the same cost as ALC's recent $700 million five-year bond, the additional interest cost per annum will be approximately $260 million. However, given the range of credit quality among the lessors, this cost would likely be higher.

This is important to note as most aircraft with lease agreements have fixed rentals, so lessors' profitability and cash flow generation could be severely squeezed. Furthermore, long average lease terms are normally considered a positive but, in this context, are a negative as it delays the ability to increase rentals.

Conlon anticipates these bond maturities will result in higher spreads but from few sources. As such, opportunities are ripe for the LR Airfinance business.

"There is a need for someone to step into that gap where the structured finance markets and ABS [asset-backed securitisation] deals have backed away. Also, we've seen commercial banks back away from the space given the reserve requirements they have to hold, and this compresses the returns they have," says Conlon.

On the trading side, activity has stepped up, he notes. "We're seeing many portfolios come to market," he says. "And less now for a regular rebalancing of the portfolio. There was a component of harvesting for gains, some exposure resetting and then recycling the capital for capital expenditure.

I think those priorities have flipped. It's primarily a recycling of capital and less about exposure management and gain on sale. That's just great if you can get it."

High Ridge has no exposure issues as a start-up, allowing it to look "aggressively" at the "many opportunities" coming down the pipeline.

Sources tell *Airfinance Journal* that the dearth of funding sources – stemming from dislocations in the ABS to fewer and more selective bank financings, some because of tighter ESG requirements – has not been seen since the financial crisis of 2007-08.

Given this retreat, will the lending side be the dominant business?

"I don't think we have a predisposed recipe. We can do both. It's more about where the opportunities are," says Conlon. "But I agree that debt opportunities are larger now than they used to be, although we surprisingly see a fair amount of lease opportunities."

High Ridge's LR Airfinance business enters the market as established entities, such as Castlelake, which recently partnered with insurance-backed platform ITASCA, step up their lending efforts.

"It is certainly a space where we see attention coming in. We like our positioning and can go from investment grade to high yield. I think that's a differentiator," says Conlon. "We're not trying to take yield capital and find investment-grade deals and then wedge it in there. The LR platform is a good mix of airline and investor clients."

Following Russia's invasion of Ukraine, certain lessors and banks, particularly those involved in ABS deals, noted a hesitation to take on additional Chinese exposure because of a similar situation potentially occurring in Taiwan.

Even though China ended its stringent zero-Covid policy, the current rapid spread of Covid-19 in the country means it faces economic headwinds.

The IMF indicates that China's annual growth will likely be at or below global growth for the first time in 40 years.

Still, High Ridge is open to business in the region.

"People are a little gun-shy after Russia. Most didn't see that coming, so people are now underwriting downside scenarios they probably wouldn't have underwritten before. And then there is some decoupling with the West that's certainly driving some attention," he says. "There may be limited interest in the near term, but I'm an optimist. We're thoughtful about the region, not necessarily cautious, and we're looking at some opportunities now."

He would not be drawn on details but says "bespoke opportunities" are under review as opposed to large portfolios.

Take the loan

Lessors financed more than 60% of all new aircraft deliveries since the beginning of 2020, based on *Airfinance Journal*'s data, and Conlon expects lessors to continue taking on a more significant financing role. He says this is "evolving" how aviation exposure is managed.

"It's increasingly complex for a single balance sheet to own multiple billions of dollars of aviation exposure efficiently. It's possible, and we've seen it in the past, but it is pretty unique," he says.

"It works best if you are a big industrial that generates a lot of cash, like GE, or an insurance company that generates a lot of investable cash, like AIG," adds Conlon.

> *"I think there are quite a few orderbooks out there if you want one. We have already looked at opportunities."*
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> **Greg Conlon**, High Ridge Aviation

A managed money model makes better sense. "It is efficient for an experienced team to focus on originating and managing assets and team with someone who is very efficient at raising capital. That's the natural progression of our space, and the market has been heading in this direction for some time," he says.

Understanding this shift in management direction made PIMCO the right business partner, adds Conlon.

"The difference between High Ridge and the others is that we are the platform owners. This is the first time PIMCO has invested in a platform. They have deals with GECAS, Gilead and Navigator, but this is truly a platform, and we can do multiple product strategies on both the lease and the debt sides."

No doubt, scale has always been important for lessors, especially for raising capital efficiently. It has arguably become more so following the sale of the world's largest leasing company to Aercap.

However, certain lessor leaders disagree.

In an interview with *Airfinance Journal* following Aercap's takeover of GECAS, Firoz Tarapore, the DAE CEO, clarified that, while he thought the largest aviation merger was a "fantastic deal" for both parties, diseconomies of scale remained a worry.

"There are some legitimate questions about whether our business has real diseconomies of scale. Only time will tell if 2,000-plus aircraft is too big to create the right economic returns for the capital they deploy or the risk they take by deploying capital," he said.

Meanwhile, SMBC Aviation Capital's CEO, Peter Barrett, said scale is essential "to get to investment-grade ratings" and the right cost of capital. "But do you need to be $50 billion or $30 billion? I think that brings some challenges before it brings some opportunity," he added.

According to Conlon, High Ridge will aim for the double-digit mark.

"Eventually, we need to be close to $10 [billion] to have some scale on a long-term basis, and I'm talking between debt and leases. That feels like the right neighbourhood," he says. "But we don't have to be there in 18 months. We have time."

However, High Ridge could end up bigger. "I think it is fine to do so, but it is not necessary to reach $35 [billion] to be relevant," he says.

"And any company that is that size, it was a long road to get there."

But High Ridge will not achieve scale through speculative orders.

"To make that work [speculative purchase], you need three things: a price that you're comfortable with to compensate for committing the capital on the forward risk; some view of scarcity and asset availability; and, finally, you need to have the product people want with the ability to adjust.

"Looking at that model now, our view is that we don't see those three things lining up right now to justify the deployment of capital. We can certainly do a new orderbook, but I don't see it as an investable thesis in today's market," says Conlon.

Airfinance Journal is aware of three lessors which are in discussion with manufacturers about their orderbooks. The portfolios all include Airbus A320neos, with one belonging to ALAFCO after selling 73 assets to Macquarie Airfinance.

Would High Ridge assume any of those positions?

"I think there are quite a few orderbooks out there if you want one. We have already looked at opportunities. The team has bought tens of billions of dollars of aircraft, so we know orderbooks very well. And we know how to underwrite that model and how to price it. We would certainly not shy away from an opportunity to look at orderbooks or portfolios of scale," he says.

However, there are drawbacks. "Orderbooks are challenging in a yield market. You know the PDPs [predelivery payments] are a drag on a yield business when you're just looking for an IRR [internal rate of return]. Also, you have to consider whether there is scarcity out there," he says.

"It takes a fair amount of underwriting on an orderbook to know precisely what you're buying. But we are just in our sixth week and haven't seen the right one yet. We will continue to review opportunistic trades with OEM [original equipment manufacturer] partners. I think the opportunities will come in the next six, 12 to 18 months, so we're excited about the prospects," adds Conlon.

Narrowbody assets are the "most logical" purchase for High Ridge.

"It is the largest part of the market, and it's got return requirements that we understand, but we will look at widebodies.

Transition costs are a considerable challenge associated with widebody aircraft. "It can be punitive, so you need to understand that you are working with good investable assets and have your eyes wide open. But our team has done all kinds of stuff. We've done freighters, we've done midlife."

High Ridge and Voyager Aviation Holdings (VAH), a privately owned aircraft investment firm with about $2 billion in assets, share backing from PIMCO.

VAH has been in the market recently with various aircraft portfolios. Are synergies or an outright sale likely because of the shared financial backing?

"It's certainly something we would look at, just like any other opportunity. PIMCO is one of the world's largest money managers, and they're into a little bit of everything," he says.

"We are not in discussions over the Aercap shares," he says.

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However, Conlon denies any interest in General Electric's equity stake in Aercap as a lock-up period ends.

"We are not in discussions over the Aercap shares," he says. GE's shares are subject to a lock-up period, which expires in stages from nine to 15 months following the sale of GECAS, which closed on 1 November 2021.

As part of the sale, GE received 111.5 million newly issued Aercap shares, about $23 billion of cash and $1 billion of Aercap senior notes.

Climate action

High Ridge has entered the market as the aviation sector is inexorably moving into another financial headwind as the convenient marriage of cheap finance and energy ends.

Global airlines have committed to reaching net zero carbon emissions by 2050. Yet there is no decisive action plan, perhaps because there has yet to be a technological fix.

Furthermore, transparency is lacking, with only 15% of the world's airlines reporting carbon emissions, according to aviation climate group, Impact. To achieve net zero, the International Air Transport Association estimates that $2 trillion is needed to support an industry-wide resolution. Not only will the sector have to invest billions of dollars in sustainable aviation fuel (SAF), air traffic control and infrastructure, but also manufacturers will have to develop newer, more efficient aircraft and engines.

But airlines first need to recover from the debt swell caused by Covid-19 and a costlier operating cost environment.

This tightrope act of building a more sustainable aviation market while emerging from the worst crisis in history is not lost on Conlon.

"There is no doubt that there is a lot of pressure to improve balance sheets," he says. "But, at the same time, you must grow and take more aircraft to heal. The market environment for the next three, four, or even five years will be very interesting. Interest rates will remain elevated."

The consequences of failing to deliver innovative financing solutions to an industry still reeling from the shocks of the pandemic but also tasked with climate action could be profound.

Increasingly, insurers and banks are sharpening their scrutiny of carbon-intensive portfolios with frameworks and structures to support the transition to net zero and re-price such risk. In other words, businesses must manage climate change or expect higher costs.

JP Morgan added the aviation sector to a list of carbon-intensive businesses that it seeks to help decarbonise by 2050, according to a 2022 climate report issued on 20 December.

The Wall Street bank plans to reduce the carbon intensity of its aviation financing portfolio by 36% by 2030 from a 2021 baseline, it stated.

However, Conlon stops short of supporting the idea that financiers or lessors should take on a different role in the path toward decarbonisation, such as being directly involved in SAF production.

"It is an interesting question, and we have had a lot of discussions about who is best to bring that to market. I think there is a strong argument for the petroleum industry, which has gazillions of dollars to invest in refinery techniques, and others will logically take the lead on that.

"It would be challenging for a leasing company to try to take the lead on developing SAF. I could be wrong. At High Ridge, our aspirations are matching the right capital with the return space," adds Conlon.

When will that happen? "We are pleased with our response and are involved in various discussions," he says. "I hope we have something for the *Airfinance Journal* Dublin event in January."