NEED FOR OPERATIONAL FLEXIBILITY May Test Airlines' Stakeholders in Restructurings

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In the wake of the COVID-19 pandemic, the surviving airlines have accelerated cost-cutting efforts, curtailed capital expenditures, and reduced their fleets. Arguably, airlines are in a much stronger operational position to cope with volatile operating environments. However, the highly uncertain waves of future disruption facing the industry require airlines to be nimble and maintain significant liquidity to become more stable and profitable. As described in this article, the participation of key constituencies also will have significant positive or negative impacts on the outlook for airlines.

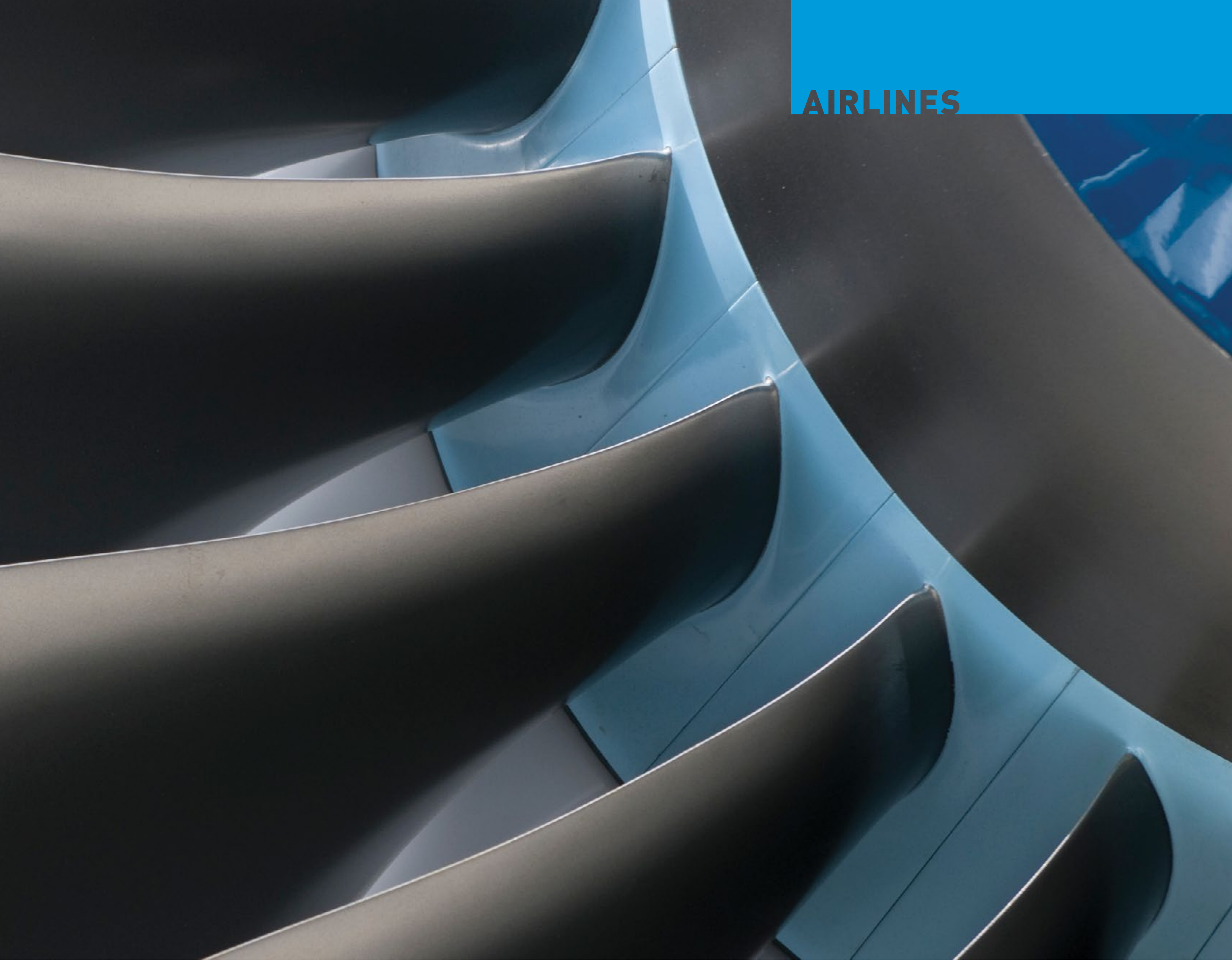
Over the past couple of years, operators have been the beneficiaries of both government support and financial market confidence that assumes that, with enough runway, operational and market issues will self-correct. Near-term inflation and rising operating costs are presenting additional challenges to this premise. While oil price volatility continues to be a concern, wage inflation and increasing interest rates are adding to already stressed profit margins.

Beyond Q3 2022, consumer and business travel demand is hard to predict, as consumers are beginning to grapple with cost-of-living inflationary pressures, and business travel continues to be slow to return. The lower overall demand may also limit airlines' ability to pass on price increases to passengers and thus further lower profit margins.

With this industry backdrop, continued supply chain issues, new COVID variants, and regional conflicts require quicker and more flexible operating structures as operators pivot to start and stop operations, as well as optimize their aircraft mix. These issues will likely test stakeholder relationships in new and potential unforeseen ways. Further complicating these dynamics are new entrants/potential creditors and increased reliance on certain other constituents.

Further shocks could add stress to an already pressured operating environment, which may ultimately lead to a restructurings. In these scenarios, the following stakeholders will be increasingly critical to the reorganization process.

Flexible Labor. COVID-19 related issues and labor shortages are making



it difficult to schedule staff and flight schedules at capacity. Additionally, as COVID-19 restrictions start and stop in various regions, operators may need increased operational flexibility with unionized staff. Labor strikes are already making headlines for major airlines, and the need for additional flexibility may test labor relations in a new operating environment.

Pension Obligations. Pension funds may face serious near-term challenges due to continued market volatility. However, as disclosed in recent quarterly filings, two components are beginning to have a serious impact on the funding status of pension funds: asset returns and discount rates. With the recent rise in interest rates, pension obligations were reduced and have mostly offset the turmoil of recent months. This will need to be monitored closely, as volatile markets are likely to persist.

Aircraft/Part Suppliers. Supply chain disruption could lead to delays in the delivery of new aircraft equipment orders and delay plans for expansion until a more favorable industry climate takes hold. Coming off historic lows in 2020, component and aircraft manufacturers are seeking to increase production rates in line with a recovery. However, manufacturers need to do this in a staged manner, as they grapple with global supply chain issues. Ramping up is proving to be more challenging than winding down operations.

Aircraft Lessors. One of the more positive themes in the airline industry is the resilience of aircraft lessors and financiers, and their support of their airline customers. This support throughout the past two years has deepened and strengthened relationships (and symbiosis) between lessors and airlines. Airline balance sheets have been decimated. As a result, lessors have taken on a greater importance in funding new deliveries, as well as providing flexibility on timing or providing power-by-the-hour or other alternative arrangements.

However, airlines have raised a record amount of debt since the beginning of the pandemic in early 2020. Bloomberg figures show global airlines raised as much as $250 billion in 2020 and more than $340 billion in

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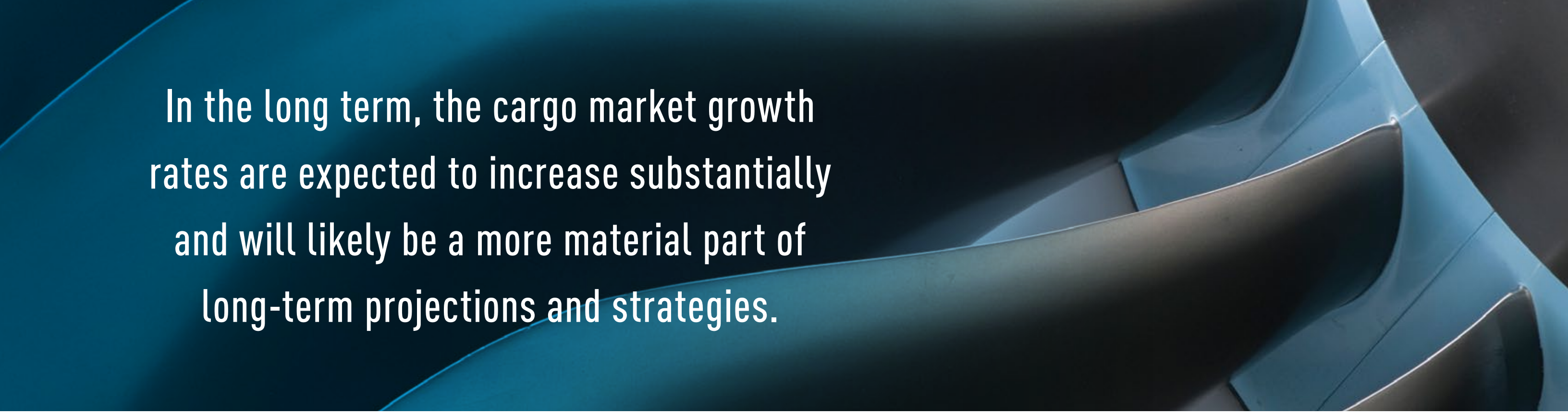

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2021. Aircraft lessor counterparties are keenly aware of the heightened credit risk of their airline counterparties and are scrutinizing credit metrics when taking on new customers.

Diminishing Untapped Collateral. With the creative and more aggressive leverage supported by the private capital markets, excess/leverageable assets are decreasing. Historically, as airlines entered restructurings, debtor-in-possession (DIP) financing would look for credit support from previously unencumbered frequent-flyer programs. However, as evidenced by American Airlines Group Inc.'s recent $10 billion bond and loan, the company's frequent-flyer program was a prominent source of collateral as investors looked for the protection provided by the special structure.

American's record deal surpassed Delta Air Lines Inc.'s $9 billion sale in September 2021 and a $6.8 billion transaction by United Airlines Holdings Inc. in June 2021. All three airlines used a special structure, pioneered by United, that backstops the debt with the company's frequent-flyer program. Extracting value from rewards programs has become a critical lifeline for carriers that have faced disrupted air travel for more than a year due to the COVID-19 pandemic. Loyalty programs carry a lot of value—reported to be $18 billion to $30 billion in American's case—which in part contributes to higher credit ratings on such deals.

Government Aid. Government support has been critical for the survival of many of the large operators during the height of the pandemic. Subsequent

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recoveries in capital markets allowed for the vast majority of these restrictive aid packages to be repaid. As governments become increasingly critical lenders, the availability of future aid packages will likely depend on the nature and severity of the crisis.

Importance of Cargo Revenue. An additional positive outcome during this crisis has been the performance of cargo shipments driven by a surge in e-commerce. This has given rise to a sustainable step change for the cargo market, which is attracting new investors to the space and altering operators' business planning as an alternative source of revenue. However, just as more operators were relying on these growing revenue streams, a consumer-led recession may decrease the volume of goods in the air freight market. As this revenue source begins to level off, pricing and operating margins will be under pressure and may decrease one of the more stable sources of cash flow over the past couple of years. In the long term, the cargo market growth rates are expected to increase substantially and will likely be a more material part of long-term projections and strategies.

Private Capital. The aviation industry has been buoyed enormously by the flood of private, non-bank capital into the space, setting up new leasing platforms and start-up airlines, which has more than offset the withdrawal of certain banks and investors. In the current operating environment, these relationships will likely be tested, as financial performance may significantly vary quarter to quarter. Compliance with financial covenants that are tied to debt obligations may be revisited with increasing frequency.

Novel/Updated Aircraft Financing Structures. With many of the pre-pandemic financing products (such as ABS, EETC, and aircraft non-payment insurance structures) now tested, investors are more conscious about how these creditors fared in bankruptcy processes and where the residual value risk in the aircraft sat. For example, whilst AFIC had significant exposures in some recent airline bankruptcies, it continues to underwrite new transactions but with a renewed focus on credit quality. In addition, while the ABS market is showing green shoots of recovery, investors continue to be focused on the credit profile of the operators, and there is greater scrutiny on how re-marketable the aircraft are, with less room to accommodate potentially difficult credits or less vanilla aircraft types.

Conclusion

Where available, foreign airlines may seek to use U.S. Chapter 11 proceedings to bring various parties to the negotiating table. The maturity of the U.S. bankruptcy process affords carriers the ability to continue operations and seek flexible negotiated solutions as compared to foreign regimes that have less operational flexibility or transparency. This trend is expected to continue for the near future.

Depending on how these processes play out, the participants identified in this article could support or hinder future restructuring dynamics. Either way, airline restructurings are becoming more nuanced and complex. This complexity heightens the need for regular financial and legal reviews to mitigate risk and the examination of a wide variety of strategic alternatives.