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An Investment Grade Opportunity Takes Off: Secured Finance Gives Airline Sector Lift

Secured finance, debt backed by a specific type of collateral, may be less costly for issuers and less risky for investors than unsecured financing. In the airline sector, enhanced equipment trust certificates (EETCs) are a well-established means of financing aircraft purchases. Originating in the post-deregulation 1980s, EETCs have evolved in structure and market size through the present day. They also represent an attractive pocket within higher-rated credit, offering excess spread amid a fixed income market that currently lacks broad anomalous opportunities, in our view. Furthermore, unlike comparable unsecured investment grade corporate bonds, EETCs offer structural protections that provide potential credit de-risking benefits.

The Mechanics of EETCs

EETCs are issued by trusts and supported by payments from their affiliated airline parent, with additional structural benefits generally including: a pool of aircraft and, to a lesser extent, engines and parts; overcollaterization, meaning the pool value exceeds the loan amount by a cushion; sinking structures with a return of capital subject to a schedule through final maturity; and other provisions that offer some protection in the event of bankruptcy. Periodically, the collateral is revalued by third-party valuation companies.

According to the International Society of Transport Aircraft Trading, benefits of EETCs to issuers include:

- Lower financing cost due to higher ratings
- Access to multiple investor bases – deals include investment grade and high yield tranches
- Prefunding – drawdowns to match new aircraft delivery schedule
- Long amortization schedules

Benefits to investors typically include:

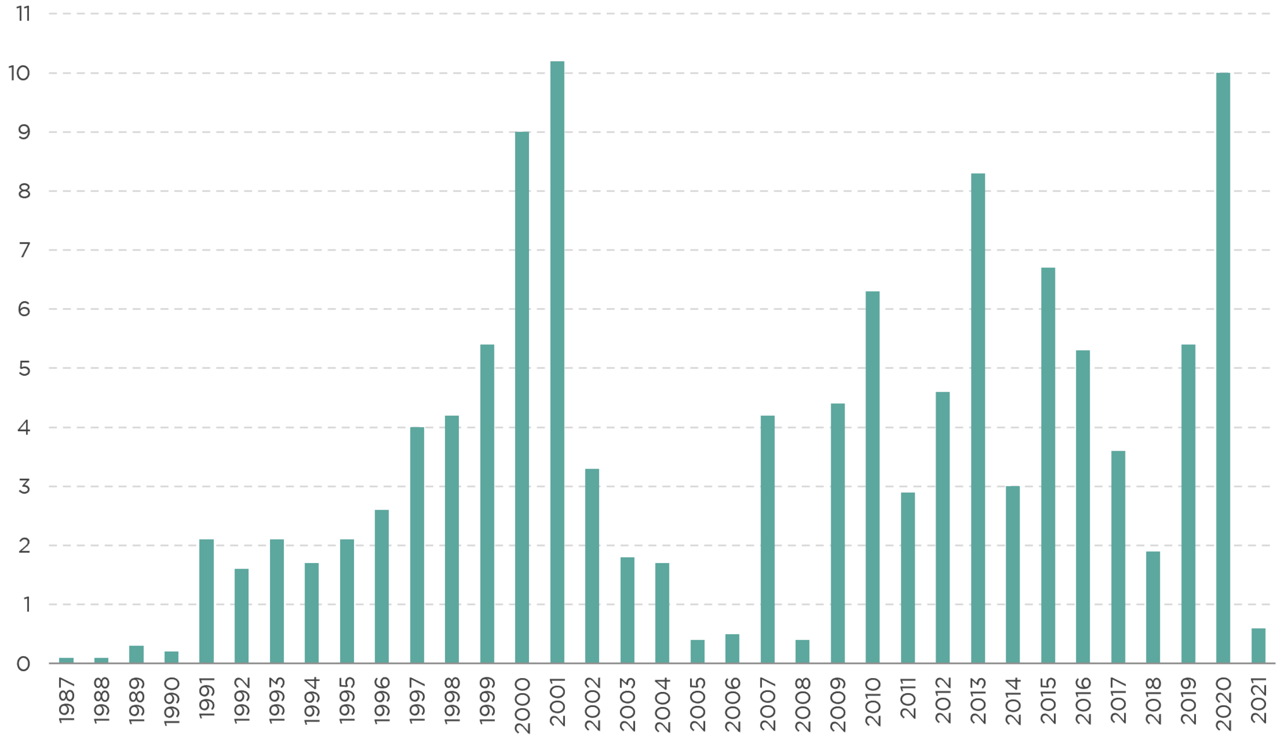
- Secured by new or recent vintage aircraft with long useful lives
- Overcollateralization, e.g., senior tranches 50% loan-to-value (LTV) and junior tranches 70% LTV
- Junior tranches with higher yields, collateral, and shorter maturities than many unsecured comparable bonds
- Legal structures tested through multiple US issuer bankruptcies, with full value recoveries on the senior tranches, which are typically the largest
- Deep investor base, liquid after initial issuance

EETC issuance tends to rise during periods of capital scarcity or high cost for airlines (see Exhibit 1). Recent impetus was the post-COVID reopening of global air travel and the massive fleet upgrade program, associated with improving fuel efficiency, underway in the airline industry. Globally, approximately $30B of EETC debt is outstanding, with the majority from US-based issuers, according to Bloomberg data.

1

Secured Aircraft Issuance 1987 to 2021

$bn, ETC and EETC, Approx. $120.9bn issued since 1987, As of 12/31/2021



Source: Morgan Stanley, Boeing, J.P. Morgan

EETCs Generally Qualify for Upgrades

Ratings agencies have long recognized the structural enhancement and collateralization associated with EETCs as meriting higher credit ratings than the parent issuer. Average ratings are A/BBB+, and only a handful of EETCs are below investment grade. Some of the relative ratings for select outstanding deals are shown in the table below (see Exhibit 2):

2 Comparison of Representative EETC Ratings versus Parent Issuers*

As of 9/8/2023

		AAL	DAL	JBLU	UAL
EETC	AA tranche	A3/AA-	A1/A+	A2/--/A+	A3/--/A
	A tranche	A3/A+/A	A3/BBB+	A2/--/A	Baa3/--/BBB-
Parent	Slots, Gates, and Routes (SGR)	Ba2/BB/BB-	Baa2/BBB/BBB-	N/A	Ba1/BB/BB
	Unsecured	B1/B+/B-	Baa3/BB+/BB+	Ba2/B+/BB-	Ba2/BB-/B-

* Some issuers have multiple first lien EETCs with various vintages and collateral, and ratings may vary. The table reflects ratings for specific EETCs that best represent typical features and characteristics.

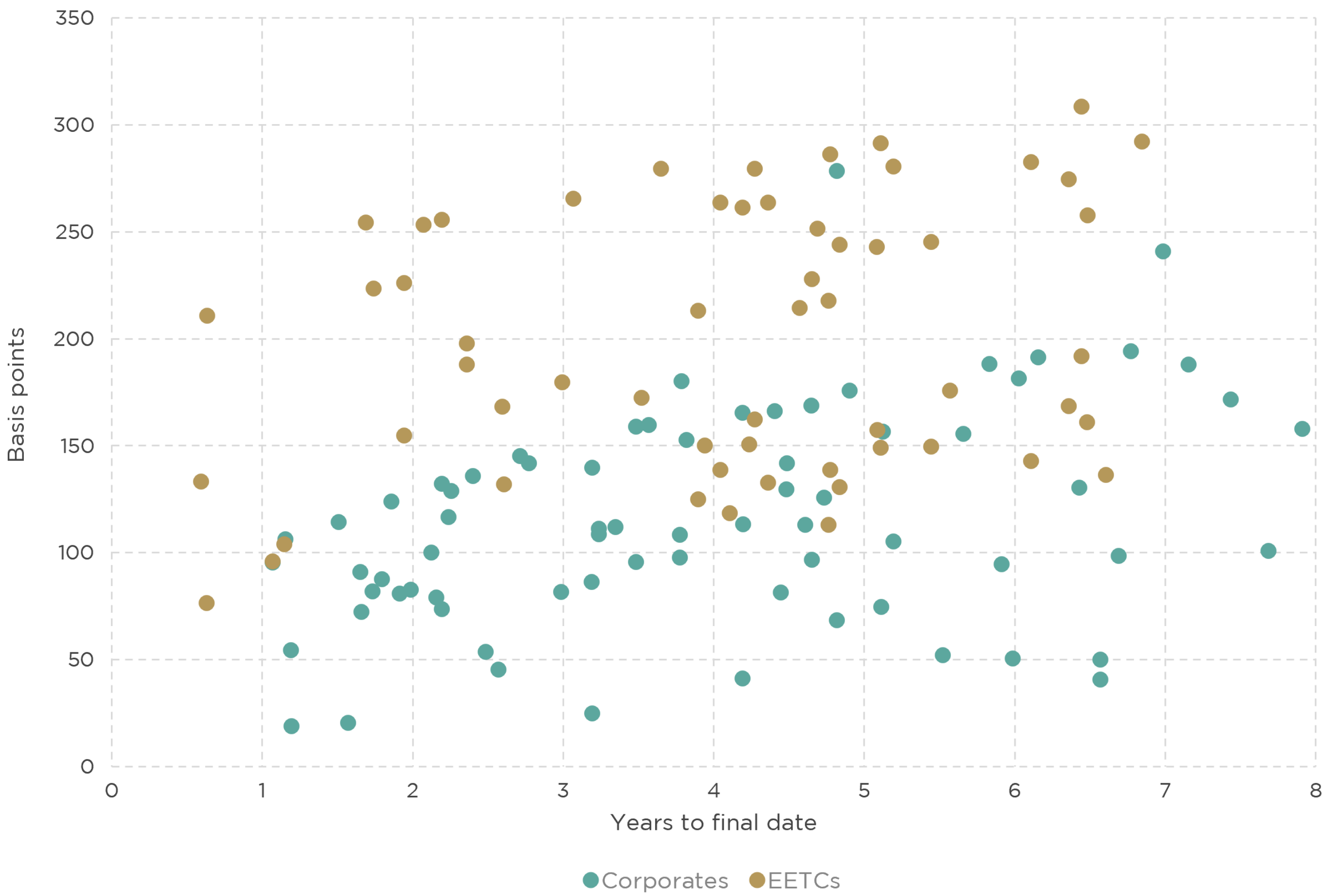
Source: Brandywine Global, Bloomberg (© 2023, Bloomberg Finance LP)

Comparing EETCs with each parent company's unsecured debt is not a like-for-like comparison, given the additional protections offered by EETCs, such as: overcollateralization; assets that are "ring-fenced", or protected in the event a parent bankruptcy; and liquidity to cover interest payments. However, comparing A+ to BBB- rated EETC deals with similarly rated unsecured bonds in the transport sector reveals that EETCs outyield unsecured bonds with similar ratings and tenors. The chart below shows spreads over Treasury bond rates (g-spreads) by maturity for EETCs and comparably rated investment grade unsecured transport bonds (see Exhibit 3).

3

Comparably Rated EETCs versus Unsecured Transport Bonds

Spread vs. Maturity, As of 9/8/2023



Source: Brandywine Global, Bloomberg (© 2023, Bloomberg Finance LP)

Conclusion

With our current preference for credit at the front end of the yield curve, our focus is on US EETC bonds with section 1110 protection, preferring recent vintage aircraft collateral and deals that have partly or mostly paid down. For some of the largest and better-rated carriers only, we might extend beyond the very front end of the curve, but only for the most senior AA or A tranches where LTV coverage is maximum.

The airline sector is not without its share of economic turbulence, and the cloudy recession outlook obscures the longer-term view. However nearer term, we believe the sector is still in a favorable stretch of the business cycle, supported by strong momentum and pent-up demand. Furthermore, the bonds pay down quickly due to their sinking structures, helping to minimize the risk in what we see as a front-end trade. One important consideration to these securities is their reduced liquidity, which makes selection paramount.

Overall, this is a niche area of the capital markets, falling at the intersection of corporate credit and structured products. In this small corner of the fixed income markets, we find decent excess spread relative to comparable unsecured investment grade corporate bonds while gaining the credit de-risking enhancements that come with EETC structures.

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