

Aviation: navigating the impact of COVID-19

Weathering the storm and overcoming the challenges

2020





Introduction

The aviation industry has been significantly impacted by the disruption and travel restrictions resulting from the COVID-19 pandemic. With a huge portion of the global fleet of passenger aircraft sitting idle and airlines, lessors, airports and support businesses facing a drop in revenues, we look at the steps businesses can take to survive and adapt.

From liquidity to debt and restructuring, we address the diverse and complex challenges faced by airlines, leasing companies and aircraft funds in particular. We also consider implications for employers and how financial planning for the medium and long term will be affected.

We will cover:



Liquidity



Operating costs



Debt and restructuring



Operational changes



What Grant Thornton is doing to help airlines and leasing companies

The challenges posed by COVID-19

COVID-19 is an unprecedented shock to the global aviation industry, affecting all companies and geographies. The dual impact of travel restrictions and lockdown measures in nearly every region of the world has led to a significant drop in airline activity and revenues. The result has been near-empty flights, mass ticket cancellations and a large portion of the global aircraft fleet sitting idle. In mid-April, it was estimated that 14,400 of the 22,000 global fleet of passenger airliners were inactive¹. This shock to airline passenger numbers will have direct and serious implications to all aspects of the aviation value chain, including airport operations and support services.

With the International Air Transport Association predicting that European airline revenues could suffer a 55% fall compared to 2019² and a potential global loss of between US\$63 billion and US\$113 billion³, it is clear that this is a uniquely dangerous situation.

Liquidity

Cash flow management and forecasting presents an immediate and serious challenge for airlines, lessors and support businesses. Those businesses that were well capitalised with strong balance sheets are going to be more resilient to both the short-term drop in revenue and the potential period of depressed demand that may follow in the medium and long-term. Despite a large-scale drop

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in revenues, the aviation sector still has large fixed and operating costs (heightened due to COVID-19), and an immediate priority should be scaling down cash requirements and increasing liquidity.

Several factors are making cash flow forecasting difficult. Firstly, many companies are utilising government schemes to pay wages and other fixed costs, but it is currently unclear how long this will be available and at what scale. Secondly, there is still a large degree of uncertainty around how long current travel restrictions will last and what the effect on consumer and business appetites will be. With some predictions stating we are unlikely to fully recover to pre-crisis levels of activity until 2023, it is clear that the effects will be felt long after restrictions on travel are lifted.

For lessors in particular, COVID-19 represents an unprecedented attack on the industry's business model. With airlines all over the world affected, leasing companies are facing a sharp drop in rental income. In a bid to reduce operating costs and increase liquidity, many airlines are requesting payment deferrals or looking to return aircraft. Lessors are reluctant to take aircraft back, as with every part of the world affected they currently have very limited options of where to redeploy them.

Operating costs

For aviation, the principal way to lower operating costs has been to reduce staff levels. Large numbers of employees across the industry, from engineers to cabin crew, have been placed on government furlough schemes. While this reduced an immediate source of pressure, it is only a temporary solution and could have long-term effects. A number of large airlines have announced the intention to layoff considerable numbers of staff, despite the current levels of government assistance. We are working with managers and owners to ensure that their future ability to operate is not adversely affected, particularly with regards to staff with specialised skills.

While the picture is challenging for airlines, lessors have even less room for manoeuvre. The wide-spread disruption is exposing problems with the industry's underlying business model. Currently, around 80% of lessees are struggling to make their rental payments and will be looking to defer payments or renegotiate terms. Adding to this, leasing companies themselves have large amounts of debt to service and the inability to move their aircraft to other regions or white label operators.

Debt and restructuring

For airlines, the capital debt accrued through the ownership or leasing of aircraft represents a large part of their fixed costs. With lessors unwilling to take their planes back, airlines have an opportunity to renegotiate the terms of their arrangements with both leasing companies and financiers. Depending on their position, lessors may be willing to provide deferrals or rate cuts. While many lessors have already agreed to three month deferrals on their payments, this is not a viable long-term solution for the aviation industry. If consumer and business demand continues to be depressed, the industry will need to take further steps. Some airlines are already taking measures that would have previously been considered extraordinary. Norwegian Air⁴, for example, announced a debt-for-equity swap deal with bondholders in May. It also remains to be seen whether banks will be willing to, or forced to, write off some investments. Another example, Lufthansa Group, published operating losses of USD\$1.36bn for Q1 2020, a combination of operational losses and fuel price and currency related derivative financial hedging instruments⁵. The Group currently estimates they will serve 40% of their capacity in September 2020 and predicts that just over 60% of their aircraft will be operational in 2021.

For leasing companies, which typically have between 70% and 80% debt on each of their aircraft, COVID-19 could result in many filing for bankruptcy or going into liquidation and administration. With such large repayments of principles and interest, and deferred or reduced rent payments, many lessors will be forced to try and draw down funds, secure additional finance or restructure their debt obligations. The reduced travel caused by COVID-19 will make it difficult to initiate secondary market transactions with white label dry- or wet-lease operators or securitisation of slots and agree restructuring or insolvency procedures with all creditors and stakeholders. Joint efforts

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between all market participants are needed to implement innovative solutions appropriate to the COVID-19 disruption. We see derivative restructuring and individual 'automatic stay' schemes, backed with specific securitisation and structured risk mitigation as key instruments to weather short- and mid-term challenges. Synthetic reinsurance structures could also support all stakeholders to more adequately manage operational risk.

Operational changes

The current levels of disruption and lost revenues are uncharted territories for the aviation industry both in speed and severity. But beyond surviving in the short to medium term, there is still significant uncertainty about what a return to business will look like. For airlines, any strategies need to examine what level of social distancing or reduced passenger levels they can feasibly operate with. For smaller companies with shallow cash reserves, the choice may be to exit, significant restructure or consolidation with a larger operator. Creating and retaining a segment of loyal customers will emerge as a key strategic priority, either through enhanced experiences or lower fares.

Leasing companies need to look closely at how exposed they are to creditor's attacks, or potential Chapter 11 or protective shielding procedures under other legislation. If they have the ability to reduce their operations or restructure, these actions need to be clearly expressed to stakeholders as part of the company's strategy going forward. The emergence of regional travel bubbles, such as between Australia and New Zealand, could create some positive news, but this will need to be significant to offset their exposure in other regions. For airlines, new dynamic network and fleet management and pricing modelling can help to overcome the mid-and long-term pressure and enable the operating models to be more resilient to market volatility.

1. Flight Global 2020 - www.flightglobal.com

2. Flight Global - www.flightglobal.com

3. The Guardian 2020 - www.theguardian.com

4. Reuters UK 2020 - <https://uk.reuters.com>

5. Reuters UK 2020 - <https://uk.reuters.com>



Critical considerations for your response

The value chain of the aviation industry is highly interconnected with other industry groups as well as domestic and global economic and social activity. Many of the forces impacting the industry are driven by factors outside of the owner, lessor or operator's control; this complexity has been highlighted by the impact of COVID-19.

Current market conditions are clearly driving liquidity and operational challenges, but can also provide opportunities to those with strong balance sheets and access to supportive lenders and special situations investors. The interconnectivity of the aviation industry drives the need for well thought-through, integrated solutions that critically address the needs of multiple stakeholders. This is particularly relevant where there is a separation between asset ownership, the lessor, the operator and the funders, with added complexity from financial markets regulatory interactions.

The questions on the following page highlight the more important areas to focus on as you assess, protect and restore value - some will be more relevant to your business than others. Wherever you are in the world, our advisors can help you define and build your tailored response.

Key questions to consider





How Grant Thornton's solutions can help you

Our approach in supporting you to assess, protect and restore value in your business starts with helping you to regain control by stabilising the business, whilst developing a robust and realistic turnaround plan. We draw upon our deep expertise across a range of different areas, customised to your specific needs.

Successful turnarounds require the development of a credible plan that has been stress tested against various scenarios, along with a transparent communication strategy that meets the needs of all stakeholders. Building trust, and not breaking promises, will be critical if the plan is to be realised.



Stabilisation, turnaround, and business plan assessment

In the early stages of a turnaround the right support is necessary to create financial stability, assess cashflow and identify opportunities to improve short-term liquidity.

Through independent diagnostic analysis and challenge, we provide you with a clear understanding of the options available, including strategic and tactical opportunities.

This crucial activity provides comfort and support to management teams and can underpin the credibility of the plan as part of the assessment process of financial stakeholders.

Our solutions

Operational and financial restructuring

Our multi-disciplinary operational and financial restructuring specialists provide support to realise significant business process improvement, implement new business strategies, divest noncore businesses and design new capital structures aligned to the dynamics of the business. Our experience also includes design and implementation of leasing platforms and pricing processes.

Contracts management data quality review

Our team have reviewed over 1,000 lease contracts and associated operational data. We use our experience and expertise to provide assurance over the data in your CMS and reduce exposure in divestment and default scenarios. Our CMS subject matter experts are familiar with contract documents, complex cross-border financing arrangements including OTC derivative structures and hedging, technical documents and AerData's CMS, AMT Sybex's Leasepoint and proprietary systems.

Debt advisory

We provide specialist advice on the raising and refinancing of debt, including Asset-Backed (including landing slots) Securitisation. Through our deep understanding of the international funding landscape, including its local regulatory frameworks, and detailed knowledge of the credit process, we devise tailored funding solutions as part of a sustainable capital structure in line with the strategic ambition of our clients.

Aviation financial modelling

We use a best practice, standardised approach for our model build and review engagements. Our deliverables are robust, well-structured and easily understood. Our team has the technical expertise and industry experience to provide transparency on maintenance-related cash flow forecasts, liquidity forecasting models, calculation of intangibles, lease, buy or hold analysis, transfer-pricing models, fleet analysis, optimum fleet deployment analysis and securitisations. We have developed AI technology which can be deployed for COVID-19 real-time AMT management and risk modelling.

Exit strategy services

We apply a tailored methodology and fully project-manage and implement the sale or closure of underperforming or non-core corporate entities at maximum value.

Valuations to support financial reporting requirements, lending decisions and other transactions

We provide valuations to support asset-backed financing, including valuing shares and intangible assets, and provide periodic valuations of assets to confirm that the terms of the loan agreement continue to be met. For mergers, acquisitions, restructuring and proposed financial structures, we provide an independent view on value delivering robust advice within the constraints placed by the deal deadlines.

Accelerated M&A

We provide advice and manage transactions associated with the acquisition or disposal of distressed assets or businesses, frequently to short timescales.

Asset recovery and tracing

Asset recovery and tracing normally form part of formal insolvency processes such as liquidations, or are carried out in support of ongoing litigation or fraud investigations. We use specialised approaches to identify and recover misappropriated assets, including those held in offshore trusts, to provide cost-effective value recovery.

Corporate insolvency

Where a business cannot be saved or where a formal insolvency process is required to affect a restructuring, we provide advice and support to distressed companies, their creditors and other stakeholders in order to protect assets and maximise recoveries. In some situations, we take on the role of Chief Restructuring Officer.

Pension schemes solvency

In many parts of the world, we offer a specialist capability to advise corporates and trustees on the solvency of pension schemes.

Enterprise risk management

Our enterprise risk management (ERM) specialists help organisations implement the leading approach to managing and optimising risk. We are able to tailor the approach to our client's individual challenge and create bespoke strategies that work, enabling them to strategically identify, analyse and monitor potential risk to their organisation.

Cybersecurity

Our cybersecurity solutions are designed for clients seeking to address a variety of complex security requirements. We can help organisations assess their security vulnerability, establish or improve their IT security processes and remediate breaches or compliance failures.

Business Process Outsourcing and Shared Service Centres

Increasingly, large organisations are looking to fully outsource their transactional end-to-end finance and accounting processes, leaving them free to focus their finance resources on important strategic business value. We typically commit to reduce costs and/or improve productivity and quality. We also advise organisations on optimising finance and accounting processes, and can take our recommendations through to implementation, whether this involves building a full-scale Business Process Outsourced delivery capability or setting up a Shared Services Centre.

Back office outsourcing

We provide outsourced accounting, payroll, human resource and tax services to domestic SMEs or local branches of international organisations. Our services are managed centrally to deliver a consistent experience for each of our clients, however widespread their operations. We exploit

innovative digital technology to give our clients access to their data round the clock; the same technology gives our large corporate clients access to new and cost-effective offshore platforms. Where our clients face complex tax and payroll challenges, our tax, global mobility and wealth management specialists provide expert, value-adding advice.

Global compliance partnering

Our global compliance partnering solution delivers all local statutory financial reporting, centralised statutory audits, tax compliance (corporate, sales and payroll), payroll administration and local country filings for multinational organisations through a single point of contact. We are the leading adviser to dynamic organisations delivering a solution that improves reporting efficiency and enhances risk management. By providing full transparency, real-time monitoring and highlighting upcoming deadlines, we enable local and central management teams to ensure full compliance at all times.

Financial reporting advisory

We provide clear and practical solutions to address complex accounting and financial reporting issues. We support businesses in navigating the accounting and reporting of government stimulus packages. We're also able to help navigate the accounting and reporting of complex areas including leases, impairment and going concern.

Restructuring tax

Our restructuring tax teams specialise in providing tax advice in all aspects of restructuring scenarios. In particular, this includes advising on the tax aspects of:

- independent business reviews, options reviews and contingency planning
- business restructuring, eg debt restructuring
- mergers and acquisitions
- disposals of trade and assets or wind down of businesses
- corporate insolvencies
- fraud investigations.



Credentials



Financial Restructuring

Client Business description: Two connected and internationally operating European airlines including subsidiaries in the fields of aviation, aircraft maintenance and in-flight catering. They were hit by substantial economic disruption, high debt and overcapacities which resulted from previous acquisitions. A group insolvency was imminent.

Engagement description: Grant Thornton experts acted as the key turnaround manager and brought in strategic, restructuring and aviation operational expertise. Grant Thornton also acted as debt restructuring advisors and negotiator with many international stakeholders, including: governmental bodies and regulators, shareholders, bondholders, aircraft investors and lessors and the trade unions. The goal was to rapidly stabilise the balance sheet and to enable a prudent restart.

Challenge: The engagement was under immense time constraints and public as well as governmental pressure was continuously increasing. Insolvency threatened on a daily basis.

Solution: Our passionate team of experts brought in their long standing operational aviation expertise and ran an agile, holistic approach covering: financial consulting, audit and tax advisory, finance and capital markets advisory, banking and air law advisory with an initial key focus on liquidity and financial instrument restructuring.

Our specialists significantly reduced the exposure of jet fuel hedging transactions and ensured constant fuel supply for smooth operations. They also restructured intragroup OTC derivative hedging and guarantee schemes and established a less risky balance sheet. Our experts also established landmark innovation for immediate airport slot securitisation, cut the cost of flight routes and reorganised slots under EASA, ETOPS, FAA, IATA, WSG's or ICAO and local airport and aviation regulation. To mitigate intra-year volatilities and market risk, aircraft were transferred to a secondary white label market operator applying securitised wet-lease agreements.

As a mid-term solution, Grant Thornton successfully separated the cargo and in-flight catering activities, partially with a blind auction bidder processes. In addition, Grant Thornton helped to reorganise and adjust the mid- and long-term business and target operating models.

Outcome: Grant Thornton substantially healed and stabilised the short-, mid- and long-term balance sheet and helped to avert insolvency. From this basis the client was able to successfully refocus its brand and could start over with a technically efficient fleet and efficient leasing arrangements.



Pricing model for acquisition of aircraft

Client Business description: The client was an established aircraft trading and leasing company that specialised in narrow-body mid-life aircraft. The company have been actively looking to expand and rejuvenate its fleet.

Engagement description: Our multi-disciplinary aviation team was requested to produce an aircraft pricing model on an Excel platform based off the company's operations and processes.

Challenge: The model was to produce an IRR based off the assumed aircraft purchase price and lease attached to the aircraft. As well as this the model had to use fly forward analysis to predict the maintenance condition of the aircraft upon lease end and this thus the metal value of the aircraft on return, along with the functionality to adjust the IRR should the lease be extended at the lease end date or should the aircraft be sold. Detailed cash flows and debt payment schedules also had to be included.

Solution: Key attributes of our Aviation Advisory modelling team include understanding of opaque areas such as maintenance reserves, reimbursements and redelivery conditions as well as a deep knowledge of contract and technical documents meant we could produce a model that could overcome the challenges presented to this company and see potential pitfalls before they arose during the model build process.

Outcome: Assignment ongoing.



Aviation network and operations optimisation

Client Business description: A leading European airline which was faced by network failures and increasing incident management costs including cost intensive on-ground support and replacement bookings at key hubs. This was aggravated because the client was seeing increased levels of route losses following increased competition from low cost carriers in the intra-European shuttle market.

Engagement description: Grant Thornton's multi-disciplinary aviation team was asked to support our client's specialists in remodeling the aviation network; looking to optimise the key hubs' routes and on-ground operations. The engagement was intentionally designed as a mixed-team programme in order to effectively capture historic flight data and experience.

Challenge: Grant Thornton's experts had to rapidly integrate with the client's teams to support in the assessment of future passenger number projections and the design of an optimal operating model.

Solution: Alongside the management team, Grant Thornton developed new network, LTO, and RPM modelling based on AI based predictive analytics and forecast PROS. Our experts successfully supported the client in implementing an aggressive operational restructuring, in time for an impending slot re-allocation, delivering the right fit of ground-handling and hub operational design.

Outcome: Through team integration and the provision of embedded subject matter experts, Grant Thornton were able to effectively analyse numerous scenarios. We delivered strong expertise which enabled the airline to strategically push a new RPM model which generated higher margin on competitive routes.



Aircraft fund restructuring

Client Business description: Leading European aircraft fund for institutional and private investors with long-term leasing scheme arrangements with global business carriers for high SMO aircraft.

Engagement description: The engagement arose as a result of airlines not being able to reach the expected RPM and the fund for private investors being impacted by a NAV downturn with the risk of closure and liquidation. Grant Thornton's specialists advised the fund in air law, leasing and structured finance restructuring within the aviation and financial markets multi-jurisdictional regulatory frameworks. Our experts also advised on civil laws and regulatory driven litigation, as well as undertake a supervisory risk analysis. In addition, Grant Thornton supported the design of a structured framework for careful and transparent investor communication.

Challenge: In a short timeframe, various laws and regulations had to be reviewed and translated into robust fund administration processes. This work drove the need for various operational changes. Detailed instruments for 35 key jurisdictions also had to be reviewed for litigation risk.

A further challenge was designing a sustainable restructuring plan which met both aviation and financial markets regulation; this included negotiation with various aviation and financial market regulators acting in different jurisdictions.

Solution: Deploying Grant Thornton's global network and our dedicated multi-disciplinary aviation and financial market experts, we rapidly established fund restructuring solutions which were accepted by the airlines and the regulators. Broad regulatory management experience formed the basis for trusted and forward-looking negotiations which brought recovery for all stakeholders. In addition, this enabled our experts to identify and propose the most effective structures for adjusting the SMO and recovering the RPM based on a newly agreed leasing and operating model.

Outcome: We quickly helped our client to initiate valuable negotiations with all stakeholders and establish a model for assessing the impact of changes to the aircraft and route profile. As a result, our client extended their timeframe and mitigated the impact of financial loss, this being the basis for long-term financial recovery.





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