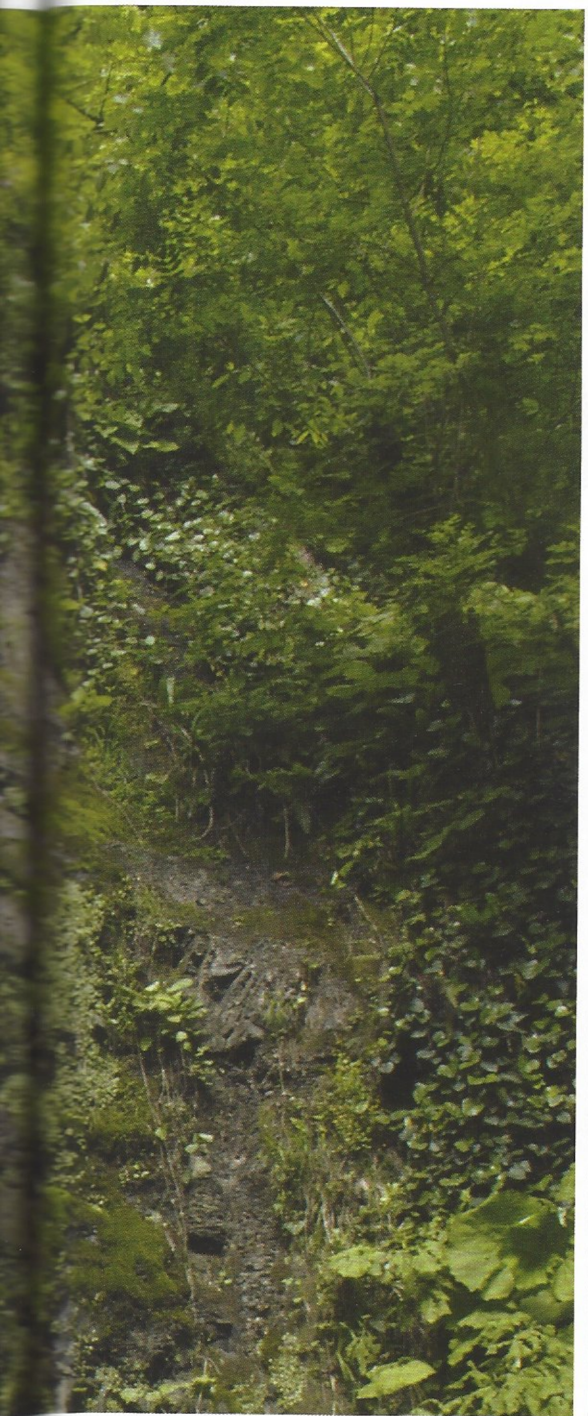
Simplifying waterfalls

Apollo Aviation Group and Goldman Sachs were determined to simplify the complex aircraft asset backed securitisation (ABS) structure to attract more investors, reports *Airline Economics*.

Aircraft asset backed securitisation (ABS) transactions are complex. Seven deals were closed in 2016 – the most since the global financial crisis. This was a great year for aircraft ABS deals but compared to ABS deals in other industries and even other aircraft capital markets products, seven is a minuscule amount. The niche asset type, the relatively illiquid market, and the complexity of the structures, have combined to curtail the growth of the product. The aircraft ABS product has been continually improved over the past few years, with structures shifting between loan and bond format, amortising or non-amortising, and other tweaks to the structures. Although the structures suited the issuers at the time, this constant evolution made the product type even more complex and potentially less attractive for investors. One aspect that hadn't changed, however, was the repayment waterfall, which has always had dual rental and disposition waterfalls. That is until Apollo Aviation Group issued its third aircraft securitization in October 28, 2016, Apollo Aviation Securitization Equity Trust 2016-2 (AASET 2016-2), which was structured by Goldman Sachs, acting as the global structuring agent, global coordinator and the lead left bookrunner.

"One of the big pieces of feedback that we receive from investors in this product is that it is very complicated," says Radha Tilton, Managing Director and Head of



Transportation Structured Finance at Goldman Sachs. "It is never going to be as simple and standardized as people would like because the assets, by their very nature, are more complex, particularly if you're working in the midlife aircraft space. But we have been working hard to make this product accessible to more investors, and Apollo allowed us to use their transaction to introduce what we call the single waterfall structure."

Typically, there are two cash flow waterfalls in ABS transactions – the rental waterfall and the disposition waterfall. Cash flows in via rent into one waterfall to pay for expenses, interest on the debt, liquidity facility cost, maintenance reserves and to repay the principal. The separate disposition waterfall comes into play when an aircraft is sold. For investors, trying to understand how this structure works with some 20-30 steps in the rental waterfall and 20 more steps in the disposition waterfall, many which overlap, is incredibly complicated to understand and to model. For Apollo's third ABS deal, Goldman Sachs questioned why two waterfalls were even needed and worked to identify and eliminate all redundancies and overlaps in both waterfalls to create a simpler structure. In addition to being much simpler, the single waterfall provides additional protections to senior tranches in severe downside scenarios and consequently allows transactions to achieve greater leverage at the same ratings.

With two waterfalls, when debt is behind schedule, the cash flows into the rental waterfall are cut off from subordinate tranches and used to pay down senior tranches until they are back on schedule. However, this mechanism does not exist in the disposition waterfall, which means if one of the aircraft in the portfolio is sold, and the debt is behind schedule, the proceeds from that sale can still leak down into subordinate tranches and in certain transactions, into equity. With a single waterfall structure, there is no leakage into subordinate tranches until senior tranches are back on schedule. All cash flow goes into a single waterfall. And modelling this structure is significantly easier than modelling the dual waterfall structure. This simplified structure using just one waterfall appeals to investors and rating agencies.

"It may be counterintuitive, but this structure is more creditor friendly while also being better for issuers. The simplicity enables you to bring more investors into your deals and the structure allows you to achieve higher advance rates throughout the capital structure, all else being equal," says Tilton.

AASET 2016-2 borrows three tranches of asset backed secured term loans in three tranches: $515 million of Class A loans at 4.25%, $85 million of Class B loans at 6.00%, and $40 million of Class C loans at 8.00%. The Class A loans have a loan-to-adjusted base value (LTV) of 65.0% and are rated A by Standard & Poor's Ratings Services (S&P) and Kroll Bond Rating Agency (KBRA). Class B loans have an LTV of 75.7% and are rated BBB by S&P and KBRA, and the Class C loans have an initial LTV of 80.8% and are rated BB by S&P and KBRA. Apollo Aviation Management, an affiliate of Apollo Aviation, is acting as servicer for the transaction.

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"With our third ABS and second in 2016, Apollo continues to build upon its position as one of the premier aviation focused asset managers," said William Hoffman, Chairman of Apollo Aviation. "Apollo Aviation continues to deliver value through the strength of its access to the capital markets combined with its specialized knowledge of the mid-life commercial aviation sector."

Apollo primarily uses ABS transactions as a permanent source of financing.

"We are an opportunistic buyer and we found enough opportunities over the last period to allow us to go back into the capital markets twice in 2016," says Robert Korn, president of Apollo Aviation Group. "For us, these ABS portfolios are permanent financing; they are not portfolio sales. It is a structure that we think is very efficient and works well for us and for our investors. Any time you can convert a portfolio financing from a short-term debt facility financing to permanent financing it de-risks your business going forward."

Korn and the team were very pleased with the new structure and the pricing. Although pricing these sorts of deals is highly dependent on market conditions as well as the structure, leading some to describe pricing ABS deals is more of an art than science, the structure must have been considered during the pricing, which was tighter than expectation. Likewise, more investors were attracted to the deal. AASET 2016-1 attracted a large book for a midlife aircraft ABS; with a handful of new investors being enticed into the space.

Although this transaction simplifies the structure, it is unlikely to become a standardised structure as in other industry sectors.

"This product is unfortunately unlikely to ever be as standardized as everyone would like," says Tilton. "The beauty of the single waterfall, however, is that no matter how you want to tranche up the cash flows, you can use this structure, which is simpler and more efficient than the precedent dual waterfall structures. We hope as issuers recognize the power and elegance of the single waterfall, it will become more widely adopted."

Air Lease Corporation closed the first aircraft ABS to contain a AA tranche in December, which securitised a portfolio of new aircraft (see page 30). This is a great structure for new aircraft assets but may not be optimal for midlife aircraft portfolios.

One of the major differences in aircraft ABS structures has been the vacillation between loan and bond format deals. AASET 2016-1 was in loan format, while Blackbird issued bonds. Most ABS deals are issued with bonds, which in other industries make them easier to trade in the secondary market. As aircraft ABS investors tend to follow buy-and-hold strategies, the issuers decided it wouldn't affect execution of the AASET 2016-2 and would give the issuer more certainty of execution.

Robert Korn, president of Apollo Aviation Group

"Our traders see no material difference in the trading volume of loan format deals versus bond format deals" says Tilton, "however, there are certain investors that can buy bond deals that can't buy loan deals, or who have greater capacity for bond format deals. We encourage issuers to think about issuance format on a case by case basis to determine what makes sense for them given their objectives and the market environment at the time."

For Korn, the loan format was a tried and tested structure that they followed when they first went to the ABS market in 2014 with a loan structured deal. "As a first-time issuer, there was a question mark over how readily a dual credit rating could be obtained. Also, this was a template set by Castlelake [*Airline Economics*, Issue 24, January/February 2015, pp44-45], which we followed and which was very successful. We delivered a portfolio that was a little bit younger and all in production aircraft to investors, which had a very successful result [see *Airline Economics*, Issue 24, Jan/Feb 2015, pp60-61]."

For the second ABS deal, Apollo Aviation achieved a dual rating for another midlife aircraft portfolio and went to the market with a bond format ABS transaction (see *Airline Economics*, Issue 30, pp6). "As we came back around the second time, it was thought that issuing a bond format ABS would open up the investor base and we would obtain a lower cost of funds. The offset to that was that there was a lot more structural work to be done," says Korn. "When we came back the third time around, we simply felt that loan format was accepted and we didn't see there would be a huge differential in the result."

The ABS product has been an advantageous source of financing for Apollo, the company is likely to return to the capital markets. "We will do so if the market is there and if we have the assets," says Korn. "The investors have been very kind to us. Hopefully, we have done a very good job of managing the assets; had we not, we wouldn't have been able to get this third deal done. We have a dedicated capital market theme that is continuing to look at all types of strategies to efficiently finance our business. When we think about our portfolio, whether it is an ABS structure or it's a more traditional bank structure, we'll have to see. We stay very much in tuned with our banks. You can see from the three securitizations that Goldman Sachs helps us to issue, all three have very significant differences that we think have helped make each of them more investor friendly. The results have improved for each successive deal. Each time, we are continuing to be more efficient and to optimize what we were doing. Whether that means we stay in a rated securitization structure or we find an even more efficient way on a next deal to go forward. We always look to maintain a leadership position in this sector of the business."