

Staying afloat – or aloft

The economic downturn continues to pose challenges for airlines, shipowners and their financiers, say David Smith, Tim Elliott, Kevin Young and Dylan Potter from the structured and asset finance group at law firm Allen & Overy

In late 2008, Allen & Overy lawyers wrote an article for *Jane's*, discussing the effects of the credit crunch on the asset markets and how certain standard loan document provisions might change as a result.

This piece follows up on that article with an overview of the current spate of restructurings in aviation and shipping and their main causes. We will also look at the principal legal and non-legal issues that we have encountered and the basis on which successful restructurings have been carried out.

What had looked like great opportunities and certain bets, with hindsight, now look overly optimistic. Financial difficulties are forcing some transport providers into restructuring.

While each of these restructurings has different features, there are common paths that businesses are adopting to navigate to safety.

In the past when shipowners or airlines got into financial difficulties, their financiers adopted one of three basic approaches: do nothing, call a default and enforce security or restructure under the umbrella of a creditor's standstill.

In the current downturn, doing nothing for more than a short period of time has not been an option for many banks and lessors.

The credit crunch has already had a huge impact on them. Their balance sheets are under increasing regulatory and investor scrutiny and so they are reluctant to record major defaults.

Enforcement and repossession are not as appealing as they were in previous downturns due to plummeting asset values, particularly in shipping for recently built or new assets.

Few lenders want to repossess or pay to complete an unfinished asset when on the open market it may be worth less than has already been advanced on the security of the asset. For most, the preferred option is to restructure, in the hope and expectation that things will get better.

However, getting the diverse creditors of what may be a global business

to agree a standstill – let alone a restructuring – is a huge challenge.

Both the shipping and aviation markets are diverse industries – for example, what applies in the container market will not necessarily apply in the tanker market – but we are seeing certain common themes emerge which can run parallel across the two.

Weathering the storm

With hindsight, the roots of current problems in the shipping sector are easy to see. Unrealistic views of the future continued, and prolonged growth in the market along with an exponential increase in the ordering and financing of new vessels on a speculative basis – often, without committed charters in place – was fuelled by a period of freely available debt, historically low interest rates and booming freight rates and commodity values.

These factors left the shipping industry vulnerable when the downturn arrived.

This downturn has been severe, but so far the dire predictions of mass shipping company insolvencies and meltdowns have not come true. While the full effects have still not worked their way through the sector, this downturn is being responded to very differently from earlier ones. By and large, banks and lessors have not rushed to default shipping companies and enforce their security.

Restructuring and problem-solving has been the order of the day. As a result, in the past 12 months, the shipping finance group at Allen & Overy has been involved in a series of major restructurings in the container, offshore oil and gas and other shipping sectors.

For financiers often the first sign that their borrowers or lessees are in trouble has been a request for waivers. Falling cashflows and higher costs have hit shipping companies hard, with some burning cash by taking on work at uneconomic rates to avoid laying up vessels.

These huge outflows of cash put owners in a precarious position, in



● From top to bottom: Tim Elliott, Dylan Potter, David Smith and Kevin Young.

Allen & Overy: 1192088, 1192089, 1192090, 119091

Allen & Overy

breach of their financial covenants and even unable to meet payment obligations under their financings.

Shipping loans also often have loan-to-value (LTV) covenants obliging a borrower to reduce debt or provide additional security if a ship's value falls below a percentage of outstanding debt.

Valuations have dropped so much that, in many cases, vessels are not worth the debt they secure, particularly on a distressed sale and the owner may have no spare cash.

If banks were to enforce LTV covenants, they would not recover losses from sale proceeds and no bank will want to account for defaulting vessel financings in its balance sheet if it can be avoided.

With the larger players in the shipping market, any significant enforcement action could result in a wider market collapse: a default on one ship financing could trigger further cross-defaults in an owner's other financings.

A large number of vessels would then be for sale at distressed asset prices, readily available for investors with low leverage to step in, buy the assets cheaply and then compete with remaining players in the market. These lower capital costs would give those investors a competitive edge and, in turn, may force other owners and operators with higher costs closer to the brink.

The failure of a major shipping company would also have serious consequences for owners of tonnage chartered to it.

Many of these owners themselves have borrowings, from the same banks, which are serviced by those charter payments. Shipping banks are keenly aware of these systemic risks.

Because of systemic risks, the pre-

'Because of systemic risks, the preferred option for many banks has been to restructure loans in the hope that a defaulting borrower will return to financial security as the world economy recovers'

ferred option for many banks has been to restructure loans in the hope that a defaulting borrower will return to financial security as the world economy recovers.

However, some banks who do not otherwise have much industry exposure have seen a request for restructuring as an opportunity to get out of a transaction in which they do not want to continue.

The key for both borrowers and agent banks is to keep these banks in the game or replace them, neither of which is easy.

Struggling shipping companies with large order books are also increasingly looking to their shipyards for deferrals and cancellations.

Shipyards have very few new orders coming in and so are extremely unwilling to allow cancellations; were they to give in to pressure, the flood gates could open, resulting in a wave of shipping companies demanding cancellations.

Export credit agencies (ECAs) likewise are keen to keep transactions alive: the market for repossessed ships will not enable them to cover their losses, the same shipping companies have other orders still in the pipeline and they have a vested interest in protecting the shipbuilding and equipment supply industries in their jurisdictions.

To push through a restructuring with this many players, each with a parochial interest presents enormous challenges for each participant; banks have needed experienced work-out teams with expertise in shipping, and shipping companies have needed to engage all their stakeholders.

On several recent restructurings, we have seen the shipping companies having to work with shipyards, lenders that hold security over relevant purchase contracts and ECAs to rearrange their order books, usually by delaying deliveries and, in some instances, changing vessel types to better suit changing market conditions.

Shipping companies have also had to bring in large amounts of new equity, both from existing shareholders and the owners of those ships that they have chartered-in, by persuading them to reduce the charterhire in exchange for equity.

This immediately improves cash-flow. Some shipyards have provided additional vendor financing if bank lenders have been unwilling to lend more than a certain percentage of new vessel costs.

Ultimately, the goal of each restructuring is to adjust a transaction so that a borrower can cure its defaults and use anticipated cashflows (allowing for new market conditions) to comply with restructured obligations over the remaining lifetime of a transaction. To do this, financial covenants have been reduced with step-ups aligned with a shipping company's business recovery plan. Repayment moratoriums have been granted and/or amortisation profiles have been reset to ease the pressure on cashflows and loans have been reallocated or reattached to reflect a changing order book.

Financiers have simultaneously looked to increase margins and to strengthen commercial and legal protections that are built into each transaction as safeguards if shipping companies' plans for recovery fail.

This has to be balanced against the ability of the borrower to comply. For example, we have seen the implementation of cross-collateralisation between different financings, lower LTV ratios requiring more equity from the borrower, strengthening of information and operational covenants and the provision of additional security.

However, care must be taken when putting in place these additional safeguards. For example, taking security in respect of existing debt from a shipping company on the brink of insolvency requires careful analysis in the relevant jurisdictions to avoid the risk of clawback if bankruptcy follows.

Generally speaking, a deal can often be done if a shipyard, shipping company, financiers and charterers are willing to compromise and reshape the transaction to fit current market conditions, but it requires all stakeholders to pull together.

The restructuring process often results in the various parties becoming even more closely bound together. Shipowners that have leased ships to operators have now become major shareholders in operators.

Shipyards have become lenders and the lenders have had to consider the risk to their entire portfolio posed by one borrower who owes money to their other borrowers. ECAs have worked hard to keep transactions alive; with cancellation or default, they could suffer equal pain.

Aviation: more trouble ahead?

Although the aviation world may appear on the surface to be in better shape than its shipping counterpart, the past two years have been difficult

'However, some banks who do not otherwise have much industry exposure have seen a request for restructuring as an opportunity to get out of a transaction in which they do not want to continue'

Allen & Overy

for the aviation industry, with the record fuel prices of mid-2008 rolling immediately into the financial quagmire of the credit crunch.

Although the much-discussed funding gap and predicted explosion of whitetails have not materialised, the industry has had its share of high-profile casualties, Alitalia, Japan Airlines (JAL) and lessor Allco being the most conspicuous.

While the worst of the turbulence may have passed, the seat-belt sign is still illuminated.

Looking first at the leasing market: those lessors with long-term funding in place and strong cashflows continue to prosper, helped in no small part by the limited number of high-profile airline failures.

Others have struggled due to funding issues at the parent level or too great a reliance on commercial paper markets. Allen & Overy has just completed work on the sale of the 68 aircraft Allco aviation portfolio to the HNA Group.

This transaction required two group companies to be restructured to strip out liabilities and non-aviation assets with the portfolio then sold as a going concern.

Only by proceeding along these lines could value be maximised.

Smaller portfolios have been more quickly taken over but the larger ones remain difficult to sell.

AIG has reportedly taken lessor International Lease Finance Corporation (ILFC) off the market as the best offers would have represented a sale at too low a price.

However, uncertainty remains about the financing of ILFC's order book in coming years, leading to further drops in ILFC's rating from the rating agencies.

RBS Aviation Capital remains for sale, its size perhaps putting off many buyers who cannot raise the necessary finance.

The financial crisis, though, has not only impacted these lessors. Those remaining in the market are tightening up documentation by introduction of more effective early warning signals, such as financial covenants, air navigation charge provisions and the like.

The lessor's goal is to be able to get aircraft returned, ideally by consent, before the onset of airline insolvency or moratoriums.

In this respect it seems the lessors are prepared to take action in a much more aggressive way than debt financiers.

For lessors, the risk is the increased repossession difficulties arising from an insolvency and subsequent loss of potential future revenue from an aircraft if they do not act quickly.

From the airlines' perspective, Allen & Overy's aircraft team has been heavily involved in a number of repossessions, particularly in Russia and other emerging markets.

Nevertheless, most major airlines are still flying, assisted by temporarily low fuel prices and the delays that have plagued new models from Airbus and Boeing, providing the sort of delivery rescheduling for free that the shipping industry has had to fight tooth and nail for.

The airlines have also at times been assisted by their regulatory and political environments. Alitalia and JAL have both been subject of massive state intervention.

The Berlusconi government argued strongly for an "Italian" solution for Alitalia and the government was involved in the restructuring and sale process.

For JAL, the latest restructuring has led to a further cash injection from the Enterprise Turnaround Initiative Corporation and the Development Bank of Japan of JPY900 billion (USD10 billion).

The Japanese government will also face the largest write-offs as an existing creditor.

However, the continuing influence of government over these carriers creates its own issues with state aid, EU competition and antitrust issues needing to be worked through, particularly as competitor airlines become more vocal in pushing these issues – typified by Ryanair's responses to the Alitalia restructurings.

This survival may be short-lived and 2010 will have its own challenges. Fuel prices are rebounding while air traffic remains light.

The recently revised International Air Transport Association (IATA) financial forecast suggests 2010 will be another tough year following a year of falling passenger numbers.

Business travel particularly has slumped, hurting those airlines that

relied heavily on this sector.

There are still new deliveries to finance and the financial weakness of the airlines and the credit markets has seen the virtual disappearance of pre-delivery payment (PDP) and commercial delivery financing (although this is hole has been filled to a large extent by the huge workload that the European ECAs and US Eximbank have taken on).

More radically, as credit markets reopen for business, we may well see more airline tie-ins and full-scale corporate mergers.

While merger activity has been relatively quiet, it does present an opportunity for airlines to reduce costs and expand services. The current efforts of British Airways and Iberia to merge may bear fruit if it can meet both the cost-savings required and regulatory approval.

Additionally, where a full merger is not appropriate, we expect to continue to see airlines strengthen their alliances in the hope of maximising the synergies and cost-sharing arrangements this can bring.

One can be sure that competition and antitrust bodies around the world will again be keeping a close eye on these developments.

From the financiers' point of view, we are seeing a greater prevalence of early-warning signs, such as financial covenants built into loan and leasing documentation, to allow action to be taken swiftly rather than waiting for an operator to die a lingering death.

On existing deals (and, we expect, on future deals), intercreditor issues of control and voting rights are and will be under the spotlight, particularly control of junior creditors and setting appropriate all lender and majority lender consent requirements.

Inevitably different parties will have different agendas. However, with the deterioration in asset values we have again seen a greater differentiation between those banks that are bearing greater systemic risks and those that are able to, or have been forced to, swallow losses to exit transactions or demand prepayment in full as the price for restructuring co-operation.

On account of this, airlines are taking increased care over which banks are in their syndicates and whether these are going to be in the market for the long-haul or whether they might be mere "tourists", there for the short term, but liable to bail out at the first sign of trouble.

Canny borrowers are taking care to

'Nevertheless, most major airlines are still flying, assisted by temporarily low fuel prices and the delays that have plagued new models from Airbus and Boeing ...'

Allen & Overy

control their syndicates as much as they can with "snooze, you lose" and "yank the bank" provisions in their financing documents (or, in case of operating lessees, by including change of control provisions in respect to lessors) that can help them deal with awkward counterparts when the going gets tough.

Ironically, in the long run, it may suit all parties to allow this form of control as it can have the effect of enabling quicker standstill arrangements to be put in place and of streamlining future restructurings.

Conclusions

To complete a successful workout, the interests of the different parties need to be carefully balanced.

The task requires considerable expertise, patience and resources. The future in the aircraft and shipping sectors is still very uncertain and there are no simple solutions.

When predicting how shipping and aviation deals may change going forwards, we should consider affirming the maxim: "When in doubt, predict that the present trend will continue."

So here is both a summary of the main changes we are seeing in the market and also a prediction of what we may see in future transactions:

- a reduction in senior debt cover ratios and a bigger market for mezzanine debt, bond and equity financing;
- less reliance placed on LTV covenants – in the shipping sector in particular – and more reliance placed on backstop credit, with increasing use of financial covenants; and
- finance remaining relatively expensive in comparison to pre-credit crunch times.

We should also remember the truism that the overall economics of the aviation and shipping industries are inextricably linked to the rate of global growth.

As the world's economies begin to show signs of turning the corner, the test is whether the lessons in risk management being learnt and applied at the moment will be remembered and applied as the cycle starts up again.

This is what the long-term health of the sector – and the financing that underpins it – ultimately depends on. ■