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FIXED INCOME INSIGHTS

FINDING VALUE OFF THE RADAR IN EETC BONDS

Jon Roiter and Sean Farley | May 2021

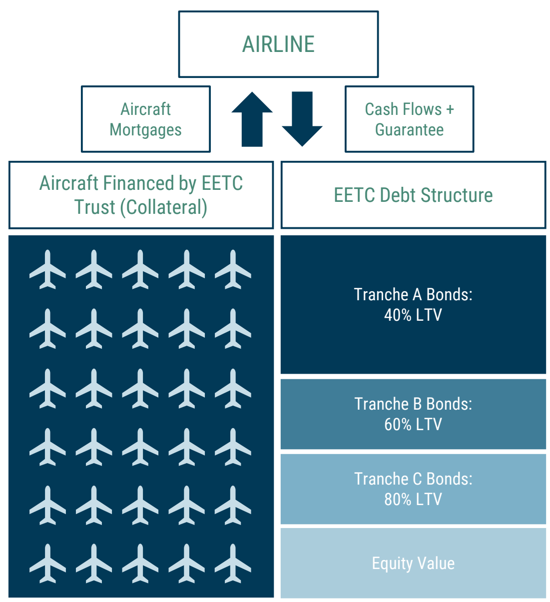
EXECUTIVE SUMMARY

The Covid-induced disruption to air travel was the most extreme in history, with passenger throughput falling by 96% at the depths of the disruption in May 2020 and sending a shock across all airline capital structures.[1] Now, increasing passenger throughput and bookings data point to a return to more normal travel patterns driven by pent-up demand. The market has largely priced this in, with on-the-radar securities flying past pre-Covid levels, leaving little room for future returns. When searching off the radar, we believe opportunities remain. We are constructive in the niche market of Enhanced Equipment Trust Certificate (EETC) secured aircraft bonds, which we believe offer attractive total return potential accompanied by a healthy margin of safety.

EETCs – A Niche Market Worth Investigating

Airline capital structures are complex and require a lot of digging to sort through the different layers including public equity market caps, unsecured debt, and debt secured by a wide range of assets (e.g., loyalty programs, slots, gates, routes, spare parts). One critical tranche of financing is EETC bond debt. A typical EETC structure includes multiple tranches of debt backed by a pool of aircraft. The issuer airline guarantees the EETC debt and retains the equity in the planes, and makes coupon and amortization payments on the debt through a fine-tuned cash flow waterfall. Exhibit 1 shows a common structure.

EXHIBIT 1: TYPICAL EETC STRUCTURE (ILLUSTRATIVE)



Source: GMO

From a creditor perspective, EETC structures have a lot to offer. EETCs benefit from attractive collateral, and issuer guarantees and enhanced legal protections in Chapter 11 provide a further margin of safety.[2] For EETC bonds to become impaired, three things must occur: 1) the airline that issued the EETC goes bankrupt; 2) the airline decides to reject the leases to aircraft securing the EETC and loses access to the planes; and 3) operator guaranty and aircraft collateral valuations decline to a level below the face value of the EETC trusts.

1 Significantly worse than the 33% decline following September 11, 2001.

2 Section 1110 of the Bankruptcy Code.

So, if the bonds are so great why does the mispricing exist? One answer is that investing in EETC debt requires a lot of searching off the radar. The same fine-tuned structuring that bolsters the credits results in a fragmented market with over 120 tranches spread across 15 issuers, each backed by a different package of planes. Each bond is unique, and the underwriting analysis is bespoke. It is also a niche market, with $32 billion of EETC bonds outstanding, a fraction to $250 billion in total debt issued by the major airlines and aircraft leasing companies, itself a small sliver of the $8 trillion investment grade bond market and $1.5 trillion high yield market.

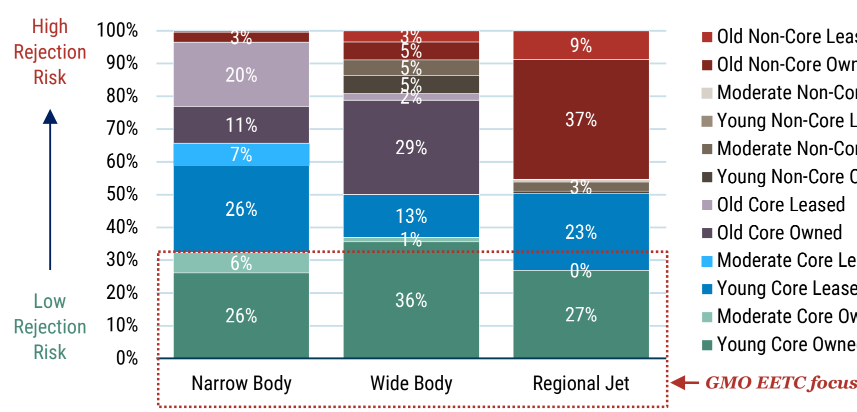
We believe this is an ideal hunting ground to search for overlooked opportunities.

O Say Can You See? American Airlines EETC Value

American Airlines offers a prime example of the attractive investment set-ups we have uncovered in EETCs. Despite the conventional view that things have turned around for American Airlines, EETCs remain priced at deeply discounted levels. The company has increased its liquidity to over $17 billion and just recently announced that it turned cash-flow positive. On the radar, the market has mostly reflected this with the company's enterprise value now *higher* than pre-Covid levels.

Digging into the company's EETCs, we believe it is possible to identify structures with a low likelihood of rejection, even if American Airlines were to file for bankruptcy. Airline fleets are not homogeneous – American Airlines for instance has more than 1,500 planes across 20 models of narrow body, wide body, and regional jets with a mix of low-cost, environmentally-efficient modern planes and planes over 20 years old, approaching retirement (see Exhibit 2). We have examined the fleet and focused on selecting EETCs secured by modern planes that are core to its fleet. Notably, during Q4 2020 95% of the aircraft in these core EETC structures remained in-service despite American's miles flown down 55% versus pre-Covid levels. From a fundamental perspective, we believe these prized assets establish the EETC debt as "top of the stack," or first in line to receive recovery in the event of a restructuring.

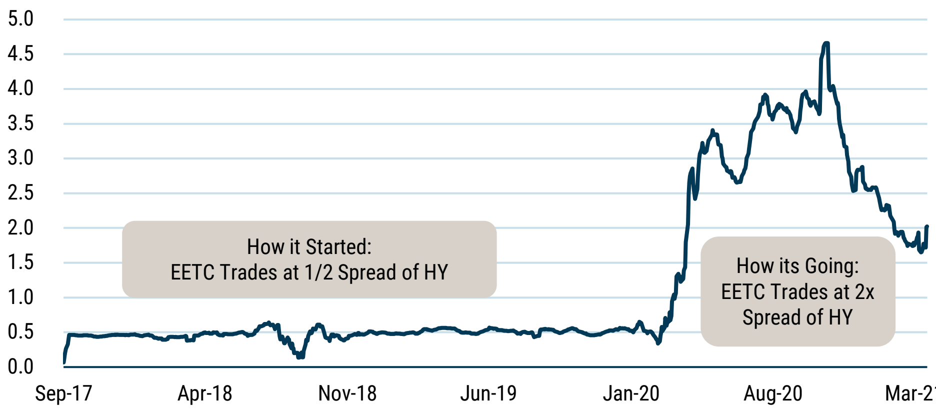
EXHIBIT 2: AAL AIRCRAFT QUALITY MIX



As of 12/31/2020 | Source: Company filings, GMO analysis

So, we like the downside protection, but what about the upside? We see double-digit total return potential for these bonds. For one, despite being top of the stack in recovery, American Airlines EETC bonds are trading as if the odds are uniquely stacked against them. While a full recovery and pre-Covid retracement is priced in for on-the-radar securities, these off-the-radar EETCs are still trading 10-15% below pre-Covid levels. Another way of illustrating the sustained dislocation is to compare the credit spread for an illustrative EETC bond relative to the high yield market. As shown in Exhibit 3, while pre-Covid the bond offered 1/2 of the credit spread of the high yield market, it is now priced at 2x the spread of the high yield market – twice the spread for what we believe remains less than half the underlying risk. We view this mispricing as a significant opportunity.

EXHIBIT 3: AAL JUNIOR CORE EETC SPREAD* VS HIGH YIELD SPREAD (ILLUSTRATIVE)



As of 4/15/2021 | Source: Bloomberg
*AAL 3.7% Class B Notes due 2025

Summing it Up – Attractive Off-the-radar Opportunity in EETCs

The obvious investments are the first to reprice when a market rallies from the bottom. Now it is time to find value in off-the-run opportunities that are cheap due to complexity or idiosyncratic events. We have identified EETCs that offer such an opportunity, providing a combination of fundamental and structural downside protection as well as upside optionality. Surviving the most dramatic disruption in air travel history should strengthen the case for a renewed focus on this market.

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Disclaimer

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