BUSINESS CONTINUITY – ENSURING A SOLID BUSINESS MODEL

FINANCING FREIGHTERS AND CONVERSIONS: NO LONGER A NICHE CONCERN

by Adam Longney & Ashleigh Standen

Takeaways

- The passenger-to-freighter conversion market is growing, with roughly 750 conversions projected over the next 20 years
- Major industry participants, including ST Engineering, Avolon and Fortress, are backing conversion projects
- Post COP26, financiers are under more scrutiny and green credentials could be brought into question

With the continued growth in demand for cargo capacity, there is an increasing need for financing and leasing freighter aircraft and passenger-to-freighter (P2F) conversions.

While financing P2F conversions, in particular, requires a slightly different analysis from more traditional aircraft financing products, the good news is that there is an expanding pool of investors and financiers with the expertise – and appetite – to support this growing segment of the market.

The case for cargo and conversions

In its World Air Cargo Forecast 2020-2039, Boeing predicts that world air cargo traffic will grow at 4 percent per year over the next 20 years. Coupled with the increasing need for freighter capacity, Boeing projects that this will result in a 60 percent larger freighter fleet over that same period. In absolute numbers, that is an increase from 2,010 to 3,260 aircraft and, interestingly, Boeing's view is that more than 60 percent of the freighter aircraft to be delivered during that period, around 750 aircraft, will be P2F conversions.

If these forecasts prove to be correct, that translates into roughly 37 conversions per year over a 20-year period.

Out of the shadows and into the mainstream

While once viewed by some as a niche segment of the commercial aircraft financing and leasing market, freighter financing and leasing may be heading into the mainstream. A brief snapshot of recent high profile announcements illustrates this:

- In July 2021, GECAS Cargo announced the addition of a further six Boeing 737-800BCFs to its fleet, bringing its fleet of P2F-converted 737-800NGs in operation to more than 40.
- In October 2021, Avolon announced that it had signed an agreement with Israel Aerospace Industries (IAI) to become the launch customer for IAI's Airbus A330-300 freighter conversion program, taking 30 conversion slots between 2025 and 2028.

Fueled in part by the COVID-19 pandemic, and also by the growth of the e-commerce market and consumers' increased expectations of next day delivery, this reflects a pattern that we have seen over the last 12 months or so: an increase in interest in the freighter and P2F conversion market among investors, aircraft owners and operators, as aircraft owners and operators consider how best to optimize their fleets in light of continuing demand for air cargo capacity, the potential increase in availability of feedstock for conversion programs and travel restrictions affecting passenger flights.

The multimillion-dollar question

However, converting passenger aircraft is not a straightforward process. Technical and economic expertise is required to identify suitable candidate aircraft for conversion. The process of obtaining the necessary certifications to undertake the conversion is complex. There are important logistical considerations, such as whether there are sufficient conversion slots available at authorized conversion facilities. Alongside all of this is the significant question of cost and how the conversion can be financed.

According to IBA, a narrowbody P2F conversion could cost in the region of $4.2 million for a Boeing 737-800 and $6.1 million for an Airbus A321-200. A widebody P2F conversion could cost in the region of $14.7 million for a Boeing 767-300ER and $18.4 million for an Airbus A330-300. Clearly, this is a significant investment.

Conversion risks

Beyond standard asset, debtor and jurisdictional risks, financing a P2F conversion brings into play considerations that are not ordinarily found in a typical aircraft financing. For example:

- Is the conversion program fully developed or a work in progress which remains subject to obtaining the necessary approvals, including the critical supplemental type certificate (STC)?
- What is the pathway to obtaining any outstanding approvals and the STC, and what happens if they cannot be obtained in the form expected, or at all?
- In the event of a default under the conversion contract, does the financier or another third party have step-in rights?
- What about the conversion contractor? What is their financial health and performance risk? If they fall down, who owns the intellectual property in the program and the STC, and can the financier access it?
- What is the contractor's track record? Do they have sufficient resources to fulfil the conversion contract on time and on budget, or have they overcommitted?

Environmental considerations and the availability of finance

In the post COP26 landscape, there will be more scrutiny than ever of the activities of businesses, financiers and investors. Aviation has received a significant amount of attention, both as an industry responsible for a proportion of the world's greenhouse gas emissions and as a critical component of the pandemic and post-pandemic supply chain.

There have been various sets of green lending frameworks and initiatives, such as the EU Taxonomy and the Chancery Lane drafting project, which are creating linguistic and drafting tools to help implement greener lending practices. A new category of financing, transition financing, has also emerged to help industries like aviation find funding to begin the re-fleeting and other projects which are needed to replace older equipment with newer, more efficient and environmentally friendlier equipment.

Nevertheless, the environmental impact of converting older, less efficient passenger aircraft into freighters may in some instances limit the pool of financiers and investors able and willing to fund such projects. In particular, financiers with regulators, investors or shareholders who are actively engaged in environmental issues may find it hard to justify financing P2F conversions of older, less efficient aircraft, instead of financing newer and more efficient aircraft or projects based on sustainable aviation fuel production or other green technologies.

An expanding, specialist financing market

In light of the points outlined above and the different market dynamics that typically affect cargo operations, it is perhaps not surprising that some of the more traditional aviation finance providers have tended to avoid financing cargo aircraft and P2F conversions.

The good news, however, is that there is a pool of financiers and investors with the required specialist asset and market knowledge who are prepared to invest in this segment of the market, and with the projected growth and resulting need for capital, that pool is expanding with new participants who have the appetite to finance these projects.

A small sample of the publicly announced deals in 2021 that reflect this appetite (in addition to those already mentioned above) include:

- The freighter aircraft leasing joint venture between ST Engineering and Temasek, announced in May 2021.
- The launch of Mammoth Freighters' Boeing 777 P2F conversion program, backed by a major American investment management firm, announced in September 2021.
- The P2F facility provided by volofin Capital Management to KV Aviation in January 2021 in respect of six Boeing 737-800s.
- The announcement in June 2021 that Aero Capital Solutions had signed up to a further seven Boeing 737-800 conversions, in addition to the 14 it had already committed to.

While cargo and P2F conversion may remain a small segment of the overall commercial aircraft market, it is nonetheless a growing segment where there is an undeniable call for investment and financing and, based on what we have seen over the last 12 months or so, significant participants in the market look to be stepping up to answer that call.

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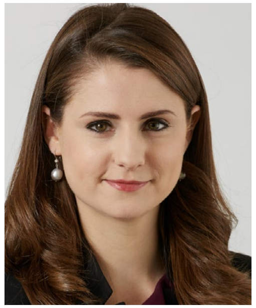
Adam, a partner in our Transportation Industry Group and based in London, advises clients in connection with a broad spectrum of domestic and international financing and leasing transactions, with a particular focus on transactions in the aviation industry where he advises airlines, lessors, financiers and investors on the procurement, sale and purchase, financing and leasing of fleets of aircraft, aircraft engines and helicopters. Described as "very bright and technically strong" (Legal 500 UK, 2017), clients have commented that Adam's "…calm, methodical, practical and commercial approach to matters is exactly what we require and appreciate. His client service is excellent" (*Chambers & Partners UK, 2022*).



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