Capacity adjustments caused by Covid-19: The challenges of accelerated lease returns

When Covid-19 hits a prospering leasing market, the effects will be substantial. It is expected that significant capacity adjustments will lead to a wave of premature lease returns and present unprecedented challenges to aircraft operators (lessees) and leasing companies (lessors).

This article provides a short-list of the most common problems aircraft operators face over accelerated lease returns with recommendations on how to resolve them to ultimately limit the cost of the aircraft transition process.

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In recent years, it was difficult to find used or new aircraft on the leasing market. Why? Because aircraft leasing gained in popularity by allowing aircraft operators to focus on bringing passengers and cargo from A to B while not bothering about complex and capital-intensive aircraft ownership issues. In addition, leasing aircraft is less of a long-term commitment to operating the aircraft compared to a purchase, leaving the operators with more flexibility for capacity adjustments.

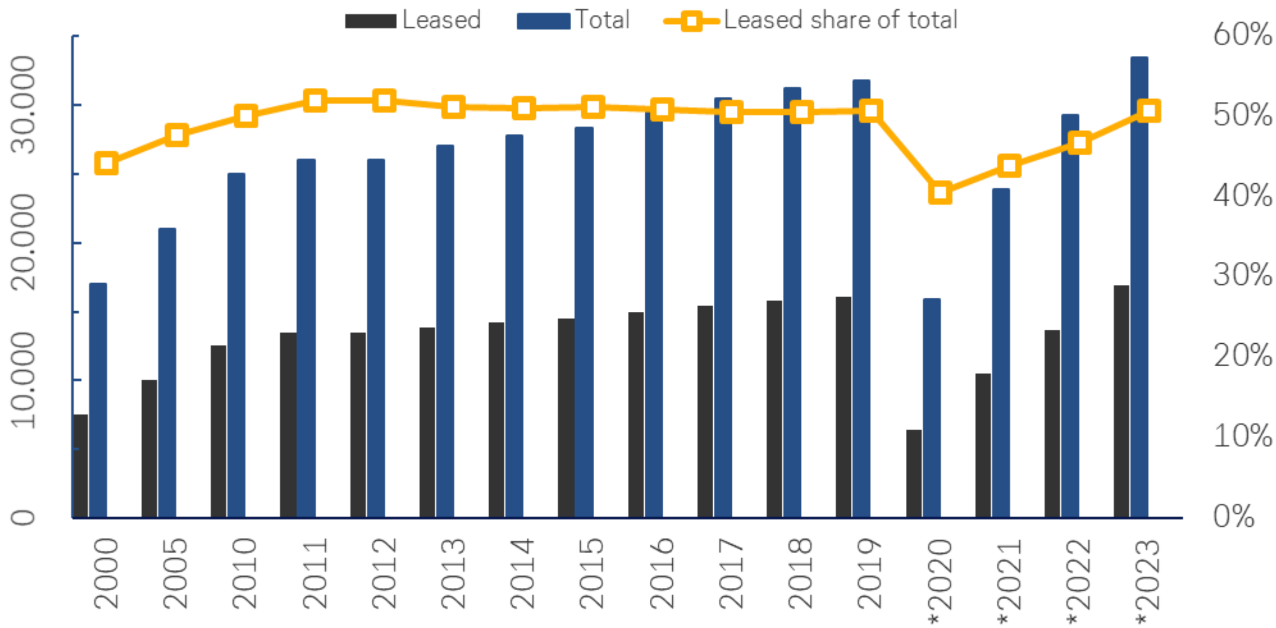
The size of the global leasing market reflects this trend, which has seen a continuous growth over decades to USD 285b[1] in 2018 and passing 50% of the world's commercial aircraft fleet being operated under a leasing agreement in the same year[2].

April 21st 2020 was the air travel turning point

In the wake of Covid-19, the industry expects significant capacity adjustments to respond to the plunge in global revenue passenger kilometers (RPKs) shrinking to -94%[3] on April 21st 2020, which is not forecasted to reach pre-Covid-19 levels before 2023[4]. In response the industry will see a significant amount of early lease returns dominated by the retirement of older and less fuel-efficient aircraft types.

The following diagram depicts the size and share of the 2000 to 2023 world commercial leasing fleet in relation to the total fleet[5]. Combining this historic development with the forecasted development of RPKs for the coming three years[6], it can be assumed that the size of the active fleet will shrink similarly over the next year until reaching pre-Covid-19 levels in 2023.

[1] Source: statista.com 2018
[2] Source: CAPA 2018
[3] Source: measured year-on-year, IATA Economics 03/06/2020
[4] Source: IATA Economics 15/06/2020
[5] Source: CAPA Analysis 08/032018
[6] Source: IATA Covid-19 outlook for air travel in the next 5 years



Source: Lufthansa Consulting analysis from CAPA and IATA data. (*) Lufthansa Consulting estimate

Based on the flexibility aircraft leasing allows, it can be assumed that an over-proportional amount of temporary or permanently phased-out aircraft are lessor-owned, in an effort of airlines to keeping their owned aircraft. Also, it can be assumed that the amount of aircraft phase-outs and later phase-ins will not be linear to the RPK development, more likely operators will choose to lower the utilization of aircraft and keep more aircraft ready to have more flexibility when demand picks up.

While leasing contracts might allow for a premature termination to adjust capacity, the process of returning an aircraft early to the lessor requires the same transition management tasks as if the aircraft is returned after its regular lease period. Regular lease returns normally do not pose a problem to experienced lessees, however a large amount of early lease returns can be a challenge to both parties involved due to the shorter notice period and possibility to prepare the aircraft for the transition.

Many of the returned aircraft will not find their way back into service and will be retired for good, leading to an early write-off of the airframe. Hence lessors will want to reduce their financial burden caused by the loss of lease fees and early write-offs as much as possible, also in the context of the lease return process. In order to be prepared for the transition process, Lufthansa Consulting has identified the six most common problem areas during lease returns to facilitate the preparation of the aircraft and documentation. The most common problem areas include:

- **Unclear contractual requirements**: Complicated lease contracts concluded years ago in prospering times while desperately looking for leasing capacity result in a basic lack of insight into the specific terms and conditions. Comprehensive maintenance requirements combined with hard times and life limited parts further add to the complexity. Often not all the information was correctly tracked and may not be available at the time of phase-out. Getting a clear picture of the various requirements and what these mean for each specific airplane is vital before these can then be translated into a set of plannable actions for each airframe.

- **Weighing non-compliance vs. penalties**: Each non-compliance in the lease return conditions results in a penalty. Weighing such penalties vs. the required maintenance cost is crucial to identify the most cost-effective solution which can save significant subsequent cash expenditure. While airworthiness-related requirements are mandatory, there is room to defer or ignore other defects, for example Minimum Equipment List (MEL) codes B and C items. Such calculation requires quotations from a maintenance, repair and overhaul (MRO) organization and a clear understanding of the penalty scheme in the leasing contract.
- **Lack of contract-compliant components**: An early assessment of the installed rotables and repairable components versus any age restrictions in the contract is recommended. Typically leasing companies ask for an average of 110% component age limit versus the airframe age, allowing individual components up to 130%. Early recognition of non-compliant parts can be addressed by swapping them within the remaining fleet during (scheduled) downtime. Time is key in this process, ideally this analysis is conducted months before the scheduled lease return to avoid expensive short-notice sourcing of parts and a subsequent grounding of the airplane.
- **Lack of manpower**: Lease returns are often not devoted the manpower they would deserve to achieve the most cost-efficient aircraft transition. It is hence crucial to identify and assign manpower requirements comprising experienced personnel in advance, especially in an accelerated wave of lease returns. Neglecting such manpower requirements will ultimately lead to a cost and penalty escalation in the lease return process.
- **Time pressure**: Caused by the lack of manpower or unforeseen and accelerated capacity adjustments increase time pressure on the transition process. In an ideal world six-month pre-notice are desired, in reality however only weeks are available to prepare the aircraft for phase-out. It is hence crucial to kick the lease return process off as early as possible to leave sufficient room for unforeseen problems and to address these accordingly with the ultimate goal of limiting penalty payments to the lessor.
- **Identification of suitable MRO capacity**: Finding an MRO organization which can conduct the required transition maintenance tasks is a challenge in itself. Meeting budget and time restrictions and the required quality of workmanship is not easy and also requires sufficient planning in advance. Once an MRO organization has been contracted, one or more representatives need to be dispatched to observe the maintenance activities and decide on the spot in case problems arise. Volume discounts for multiple aircraft transitions while at the same time reserving future slots in advance to secure the MRO capacity are the benefits of multiple lease returns.

Looking ahead: planning for the future

While Covid-19 will change the fundamentals of the aviation industry, it will also change the composition of aircraft fleets towards newer and more fuel-efficient aircraft. This transition however will challenge aircraft operators and owners over the next couple of years and requires a high degree of attention.

Therefore, transition management will become a very important agenda item in the near future in order to limit the drain of cash towards lessors looking to recover lost lease fees through penalty schemes over contract non-compliances.

The financial exposure of unmanaged lease returns can lead to a loss of millions of Dollars, for example in case an unforeseen engine shop visit or the sourcing of components is required, whereas a transition carefully planned and executed can cost a fraction if engines or parts in question have been swapped earlier in the process. Wherever operators face a lack of manpower, experience and time, Lufthansa Consulting can help to identify and develop such cost-efficient solutions with a savings potential of up to 80%.

While the above problem areas are certainly not applicable to every operator, each lessee would need to develop a tailored action plan for its fleet as it seeks to navigate the crisis and emerge stronger, leaner and smarter.

To learn more and discuss how your organization could benefit from Lufthansa Consulting's expertise on Crisis Recovery, please get in touch at ALcrisis-solutions@LHConsulting.com. ***Together, we can make it through to better days.***

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