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Valuation Issues in Airline and Aircraft Restructurings

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May 12, 2022

Moderator: Brad M. Kahn

Panel: Hon. Lisa G. Beckerman, Brent Herlihy and Joshua Nemser

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I. Macro-Economic Issues Impacting Business Plans and Valuation

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A. Impact of COVID and View on Recovery

- Future of Business Travel
- Narrow Body vs. Wide Body
  - Narrow-body: single aisle between seats
  - Wide-body: two or more aisles between seats
- Modern vs. Previous Generation Metal
  - Modern examples: Airbus A320neo, A319neo, Boeing 737 MAX and Boeing 737 MAX 8/9
- Bullish case for a recovery based on a view of normalized demand?

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Future of Business Travel

- What is the post-pandemic business travel outlook?
- Impact of diminished business travel demands on fleet composition:
  - Reshaped demand between business vs. vacation travel affects destination mix.
    - Current decreased demand for long-haul destinations, which were more profitable.
  - Airlines shifting to a narrow body vs. wide-body fleet, to accommodate higher proportion of short-haul travel.
    - Wide-body supply outpaces demand.

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A Bullish Case for Recovery (?)

- Can airlines make up for the decrease in high-margin business and international long-haul travel with greater cost discipline and higher low-margin demand?
- Demand for leisure/vacation travel is strong both domestically and on short-haul international trips.
- The pandemic provided airlines with an opportunity to implement significant cost efficiencies and improve labor dynamics.
- Will airlines optimize their fleets for the new normal?

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Demand Recovery Worldwide

CHART 8: TOTAL MARKET AIR PASSENGER TRAFFIC GROWTH

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B. Fuel Costs and Current Global Political and Economic Environment

Passing the Costs on to Customers

- The cost of domestic flight travel for customers has increased by 40% since January.
- Airlines are seeing a material impact from increased costs, particularly fuel costs.
- Elasticity of demand for leisure travel could be tested by passing through increased fuel costs.
- Likelihood that current surge in fuel costs will remain at this level long term?

Pilot and Labor Shortages

- This has shown to be more of a United States specific issue.
- Contributing factors include:
  - Early retirement resulting from COVID, cost of education, larger airlines poaching regional pilots, pause of new pilot hiring and training during 2020, mandatory retirement age, etc.
  - Likelihood labor shortages will be a long-term issue?

Rising Rates

- Increased cost of capital.
- What indirect consequences could airlines face from higher interest rates?

Other Inflationary Factors

- Fuel costs make up between 20% to 25% of an airline's operating expense.
- Lack of long-term fuel contracts to shield airlines from spikes in fuel.
- Generalized inflation could exacerbate labor shortage issues.

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C. Maturity of Industry

1. **Can LCCs and ULCCs co-exist with legacy carriers?**

LCC
- LCC = Low Cost Carriers
  - Examples:
    - Southwest and jetBlue

ULCC
- ULCC = Ultra-Low Cost Carriers
  - Examples:
    - Allegiant, Frontier, Spirit and Sun Country

Legacy
- Examples:
  - American, Delta and United

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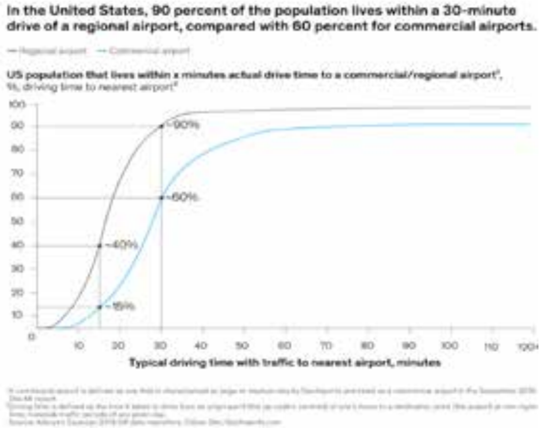
C. Maturity of Industry (continued)

2. Future Growth Areas:

- Regional airlines
  - Airlines have largely expanded recently through acquisitions of minority stakes in regional airlines, rather than change of control airline transactions, with certain exceptions (*e.g.*, ongoing developments with Frontier).
  - Examples: Alaska Air Group, Air Wisconsin, Endeavor Air, etc.
- Regional foreign airlines
  - Examples: Bangkok Airways, Aegean Airlines, Air Matla, etc.



Source: McKinsey & Company

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II. Valuation Issues in Airline Bankruptcies

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A. Allocation of Value

1. Valuing Different Kinds of Assets

- Equipment
- Slots, Gates and Routes
- Loyalty Programs
- Intellectual Property
- Airport Lounges and Clubs
- Cargo Operations
- Other Assets (real estate, MROs)

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A. Allocation of Value

2. Allocation of value among different entities in a corporate structure

- Specialized entities within overall enterprise of each airline:
  - Aircraft-owning entities
  - Carriers/operators
  - Leasing entities
  - Service entities
  - IP holding companies
  - Government license holders
  - Joint ventures
- Capital structure implications:
  - Variety of debt structures, debt silos, equipment financing, etc.

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B. The Benefits of Chapter 11 to Airline Valuations

Operational and fleet restructuring tools such as:

1. Rejection of contracts and leases
   - Aircraft creditors with a security interest in aircraft equipment have extraordinary rights under section 1110(a) of the Bankruptcy Code to repossess collateral notwithstanding the automatic stay in the absence of receiving the benefit of their bargain during the pendency of the bankruptcy case.
     - Section 1110 only applies to debtor airlines with Air Carrier Operating Certificates issued by the Federal Aviation Administration.
     - If the airline has no such certification, the Cape Town Convention usually applies.
   - Despite a debtor's performance under section 1110(a), the debtor still has power to reject the applicable equipment lease prior to confirmation.
2. Renegotiation of leases
   - Airline debtors may leverage their right to reject leases under section 365 of the Bankruptcy Code.
   - When faced with potential rejection, lessors may be more amenable to renegotiation.
3. Renegotiation of labor deals
   - Section 1113 of the Bankruptcy Code imposes a heightened standard on rejection of collective bargaining agreements.
     - While section 1113 and 1114 are not limited to airlines in the United States, these sections are not commonly utilized in chapter 11 cases of foreign airlines.

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C. Valuation Methodologies in a Post-COVID world

How do the 3 traditional valuation methodologies translate to airlines?

1. Precedent Transactions
   - Insufficient number of change of control transactions in the industry?
   - Can minority investments in regionals shine any light?
2. Comparable Companies
   - Do you throw out 2020/21 EBITDA or EBITDAR?
   - Compare the debtor's projections to 2019 EBITDA and EBITDAR performance?
   - Use of equity research reports as a guidepost for multiples?
3. Discounted Cash Flows
   - What is the cost of capital in this environment?
   - Would you consider the use of a risk premium given the current recovery environment?

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III. Valuation in Analysis of the Investment and Negotiation of the Deal

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III. Valuation in Analysis of the Investment and Negotiation of the Deal

1. **Investor viewpoints on the initial investment, taking into account a potential restructuring.**
   - How to underwrite enterprise value in the midst of tremendous uncertainty?
   - Application of a risk premium to account for uncertainty?

2. **How valuation impacts the negotiation of the restructuring.**
   - New money opportunities.
   - Debt capacity.

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Faculty

Hon. Lisa G. Beckerman is a U.S. Bankruptcy Judge, sworn in on Feb. 26, 2021. From May 1999 until she was appointed to the bench, she was a partner in the financial restructuring group at Akin Gump Strauss Hauer & Feld LLP. From September 1989 until May 1999, she was an associate and then a partner in the bankruptcy group at Stroock & Stroock & Lavan LLP. Prior to her appointment, Judge Beckerman served as a co-chair of the Executive Committee of UJA-Federation of New York's Bankruptcy and Reorganization Group, as co-chair and as a member of the Advisory Board of ABI's New York City Bankruptcy Conference, and as a member of ABI's Board of Directors of from 2013-19. She is a Fellow and a member of the board of directors of the American College of Bankruptcy and a member of the National Conference of Bankruptcy Judges (NCBJ) and the 2021 NCBJ Education Committee. She also is a member of the Dean's Advisory Board for Boston University School of Law. Judge Beckerman received her A.B. from University of Chicago in 1984, her M.B.A. from the University of Texas in 1986 and her J.D. from Boston University in 1989.

Brent Herlihy is a managing director in the Restructuring and Special Situations Group at PJT Partners in New York. Since joining PJT Partners' predecessor firm Blackstone in 2013, he has advised companies, creditors and sponsors in restructurings, special situations, financings, and mergers and acquisitions. Mr. Herlihy has worked across numerous industries, including airlines, retail, industrials, power and energy, shipping and telecom. Prior to joining Blackstone, he worked as an investment banker at Lazard, providing M&A and corporate finance advice to consumer, food and retail clients. Mr. Herlihy received his B.A. *cum laude* in politics from Princeton University, his M.B.A. from Harvard Business School and his J.D. *cum laude* from Harvard Law School.

Brad M. Kahn is a partner with Akin Gump Strauss Hauer & Feld LLP in New York, where he advises clients in complex corporate restructurings and bankruptcies, including multijurisdictional and cross-border matters. He also represents creditors, debtors, bondholders, hedge funds, institutional investors, and ad hoc and official creditors' committees. Mr. Kahn focuses on large, complex in-court and out-of-court corporate restructurings in high-profile chapter 11 cases. He also advises clients in multijurisdictional and cross-border insolvency proceedings. Mr. Kahn's restructuring matters encompass a variety of industries, including aviation, energy, telecommunications, shipping, technology and printing. He was listed as a *Turnarounds & Workouts* "Outstanding Young Bankruptcy Lawyer" in 2019 and as a *New York Super Lawyers* Rising Star from 2016-18. Mr. Kahn received his B.A. in 2004 from Yale University and his J.D. in 2007 from New York University School of Law.

Joshua Nemser is a senior portfolio manager at VR Capital Group in New York and leads the firm's aviation and maritime investment efforts. He also covers value, distressed and catalyst-driven/special situations investments in North America and Latin America across a range of industries. Previously, Mr. Nemser was an investment banking associate at Moelis & Company, where he advised on a range of mergers, acquisitions, recapitalizations and restructurings. Prior to Moelis, he was an associate in the Business Finance & Restructuring department of Weil, Gotshal & Manges, as well as a vice president and chief pilot of a federally certificated air carrier. Mr. Nemser is a licensed airline transport pilot with more than 2,000 flight hours. He currently serves as a director of Okeanis Eco

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