TURKISH AVIATION ACADEMY

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AviationAdvocacy

# Introduction to Finance Contracts: Part I

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# Agenda

- Part A: Financing: Overview
- Part B: Secured Lending
- Part C: Aircraft Leasing
- Part D: Terms & Conditions

# Part A: Financing: Overview

# The Need for Financing

- Running an airline is **very** capital intensive
- Airlines struggle to break even
- Assets must be acquired and maintained as cheaply as possible
- Equity financing is typically difficult for airlines. So debt finance is used to raise capital
- Airlines must raise enough revenue to service the debt

# The Principles of Aircraft Financing (1)

- Overriding principle: **asset value is key**
- The asset is a source of financial gain for the operating lessor or owner
- The economic life of an asset is from 20 to 30 years
- The asset can be an aircraft or engine

# The Principles of Aircraft Financing (2)

- Two types of debt financing used by airlines:

- secured lending

- asset leasing

# Part B: Secured Lending

# Secured Lending (1)

- Secured lending is a loan secured on the asset

- In a secured loan the borrower is the economic owner of the asset, while the asset serves as security for the loan

- Primary type of secured lending is through loans of differing seniority:

- *senior* lending: first claim on asset
- *mezzanine* lending: intermediate claim on asset
- *junior* lending: last claim on the asset (ranks last)

# Secured Lending (2)

- Depending on the credit worthiness of the borrower, senior lenders finance 70% to 90% of price

- Junior lenders trade a lesser claim against the borrower for a higher rate of interest (“yield”): senior secured loans typically attract interest at 0.75% to 1.75%; rates on junior secured loans may range from 3% to 6%

# Secured Lending (3)

- Other types of secured lending:

- Bond financing: eg EETC Securitization: tranches of debt with different rights to claims (US bond market)

- Finance lease: lessee acquires the asset at the end of the lease by exercising an option to purchase it

- Collateral security over the asset enhances credit worthiness: allows cheaper financing than the airline’s credit rating would otherwise permit

# Part C: Aircraft Leasing

# Asset Finance: Overview

- Asset finance is a type of finance used by businesses to obtain the equipment they need to operate
- It usually involves paying a regular charge for use of the asset over an agreed period of time, thus avoiding the full cost of buying outright
- A common type of asset finance is *leasing*

# The Principles of Aircraft Leasing (1)

- Leasing gives the customer access to new equipment by way of renting it for a contracted period, without owning the asset

- *Lessor*: party that owns the asset

- *Lessee*: party that takes a lease of the asset from the lessor

# The Principles of Aircraft Leasing (2)

- There are two main types of lease:
- **finance lease:** the value of the asset appears on the lessee's balance sheet and the rental payments pass through the profit and loss account. The full value of the asset is repaid to the lessor, plus interest, over the lease period
- **operating lease**: appropriate when lessee does not need the asset for its entire working life. Payments are made to the lessor for the use of the asset while it is needed. The asset is not shown on the lessee's balance sheet. The lessor may retain responsibility for maintenance and often takes the asset back at the end of the lease period

# Operating Leases

- Dry lease
  - Aircraft only
  - Goes onto operator's AOC
- Wet lease
  - ACMI
  - Not part of airline's AOC
  - Often time restricted

# The Principles of Aircraft Leasing (3)

- In an operating lease of an aircraft:

- the lessor retains risks and rewards of ownership of the aircraft

- the lessee receives usage of the aircraft over a finite period (usually less than 10 years)

# The Principles of Aircraft Leasing (4)

- Finance leases and Operating leases have different accounting and taxation consequences for lessor and lessee

- 60% of all aircraft leases are made by two services companies:

- International Lease Finance Corporation (ILFC)

- GE Commercial Aviation Services (GECAS)

# Part D: Terms & Conditions

# Terms & Conditions (1)

- The financing or lease document is a *contract*

- It will contain the essential elements of all contracts:

- an offer
- an acceptance of the offer
- consideration
- an intention to create legal relations
- certainty of contractual terms
- capacity of the parties to contract

# Terms & Conditions (2)

- Like any other contract, the financing or lease document will contain terms of varying importance:

- Terms (express and implied)

- Conditions

- Warranties

- Exclusions

# Terms & Conditions (3)

- **Loan to value** ratio: the lower, the better.

- **Maturity**: the shorter, the better: aircraft with an economic life span of 20 or more years typically need 10 to 15 years of financing

- **Payout**: full payout (amortization to zero) required for longer maturities. “Balloon” payments possible for shorter maturities

# Terms & Conditions (4)

- **Security**: ownership of the asset is the best security
- **Maintenance**: aircraft maintenance key to safety, asset value, etc. Lenders require proper maintenance on a regular schedule, and may levy maintenance reserves for upcoming costs
- **Instalments**: the more frequent, the better: semi-annual or quarterly. Monthly instalments allow monitoring of weaker credits
- **Payment denomination**: USD, in line with second hand aircraft market. Only most creditworthy airlines (where collateral asset value is less important) may finance in other currencies matching their revenues

# Terms & Conditions (5)

- **Fixed or floating rates**: unless underwritten by export credit agencies, fixed rate financing for 10 to 15 years available only to most creditworthy airlines, due to potential funding breakage costs

- **Risks**: all operating risks and costs associated with aircraft (operation, maintenance, insurance, etc.) are borne by airline

- **Yield**: the interest paid on the loan (junior lenders typically receive a higher rate than senior lenders)

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