
Masterclass for Principals

“India Aircraft Leasing”

Aircraft Financing Structures

- April 09, 2021 -

Indian Aviation Landscape

India Aviation Landscape

- Ninth largest civil aviation market in the World with total passenger traffic of 341 million in FY 2020.
- The passenger traffic has grown at a CAGR of 12.41% in the past 5 years and it is expected to grow six-fold to around 1.1 billion by the year 2040.
- Key growth drivers of Indian Aviation Industry in the past 10 years are
 - emergence of new carriers to cater to growing middle-class population
 - increased business and leisure travel,
 - modernisation of airports
 - increase in number of domestic/international operational airports.
- India is estimated to have 190-200 operational airports by the end of 2040.
- As per predictions of Airbus and Boeing, in the next 20 years, India will need 1,750-2,100 aircraft valued at over USD 290 bn.

Aircraft Financing in India

- Currently more than 90% of the aircrafts in the country are on import lease basis.
- India has large aircraft order books, virtually all of which are leased through leasing companies located offshore.
- Aircraft leasing/financing is not a specifically permitted activity for banks.
- With the increasing demand and non-availability of own sources of aircraft financing, there is a rationale for India to set up its own structures for the same.
- Globally, within the civil aviation industry, aircraft financing is one of most profitable segment.
- A landscape proving competitive environment to that of existing hubs of aircraft leasing can provide the required boost to Indian Aircraft Leasing.
- IFSC, GIFT-CITY in Gujarat has been identified as preferred destination for initiation of operations in this industry as it offers a competitive tax regime.
- Efforts from various set of stakeholders are being put to promote aircraft leasing in Gift City.

Aviation Financing

Sources of Aviation Financing

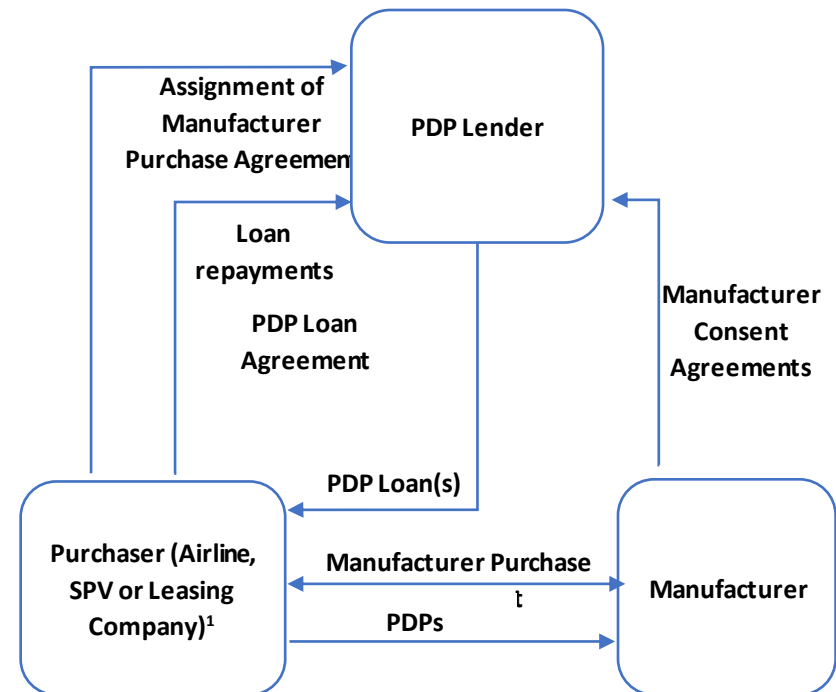
Source	Description
Cash	<ul style="list-style-type: none">• Funded with cash reserve or operating cash flow• Includes cash equity for other financing structures
Capital Markets	<ul style="list-style-type: none">• Secured by structured debt transaction, such as enhanced equipment trust certificates (EETCs) or unstructured debt.• May be issued in the public or private markets
Bank Debt	<ul style="list-style-type: none">• Financed with aircraft-secured or unsecured commercial bank debt that may be used to directly or indirectly finance a delivery
Lessors	<ul style="list-style-type: none">• Leasing Companies typically raise funds through various sources that could include Bank, funds etc.
Export Credit	<ul style="list-style-type: none">• Supported by a guarantee from an export credit agency.• Direct export credit lending also included
Manufacturer	<ul style="list-style-type: none">• Support provided by the manufacturer to aid purchase of their product.
Insurance	<ul style="list-style-type: none">• Backed with a non-payment insurance policy (such as Aircraft Finance Insurance Corporation (AFIC)) through a commercial bank loan or capital markets structure

Aircraft Purchase transaction - An illustration

- Manufacturers receive pre-orders for aircraft from airlines, for delivery at a later date.
- Purchaser required to make periodic PDPs (Pre-Delivery Payments) to the manufacturer.
- PDPs constitute part payment (as much as 30%) of the full purchase price of the aircraft.

Steps in PDP Financing:

- Purchaser of an aircraft (an airline, a leasing company or, an SPV) borrows money for funding all or part of the PDP amounts.
- Purchaser pays interest on the PDP loan throughout its term.
- No principal repayments during the term of the PDP loan.
- Principal repayment made upon delivery of the aircraft by way of various financing structures
- PDP lender obtains a security assignment of the purchaser's rights to purchase the aircraft.



1. If an SPV is used the airline will usually provide a Guarantee to the PDP Lender

Role of Special Purpose Vehicle (SPV)

- Operations typically limited to acquisition and financing of specific assets or liabilities.
- Can take the form of a trust, partnership, corporation or a limited liability company.
- An airline purchases an aircraft and then assigns the purchase agreement to the SPV. The SPV then leases the aircraft to the airline.
- Security interests are issued by the SPV in favour of the financier, and a trust can be set up to cover & take the SPV off the balance sheet, leading to improved financial and capital ratios.
- SPVs - Generally isolated and protected from any bankruptcy of the operator, and the operator is not under any legal obligation to provide additional funds to repay the SPV's creditors.
- SPVs can also provide access to additional sources of funding, by overcoming the internal exposure limits of certain financiers.
- With the SPV holding only one asset on its books and having no other debts, the repayment of a loan is more certain, thereby encouraging financiers to charge lower interest rates.
- SPVs may afford lower financing costs while providing detachment from operators.

Financing Structures

Commercial Bank Structure

- Most common financing structure used by airlines and lessors across the globe
- Lender makes a loan to an airline or leasing company to purchase an aircraft from a manufacturer (if new) or seller (if used).
- Loan is secured by a mortgage or other security interest over the aircraft.
- The airline or leasing company owns the aircraft from the outset. The airline or leasing company may operate the aircraft or lease it to another party.



Advantages

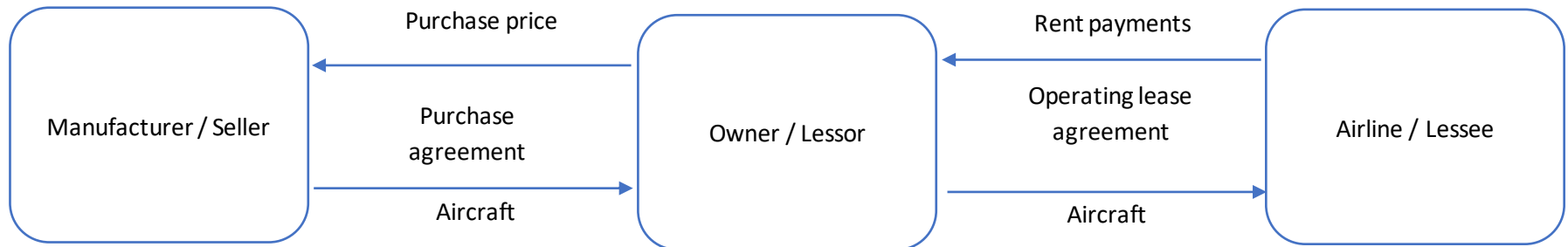
- The commercial bank loan is cheaper as compared to some other financing structures

Disadvantages

- Loan is a balance sheet transaction and has full recourse to the company.
- Loan documents include typical **events of default** which may unduly restrict its ability to operate its business.
- May not be investment grade, resulting in more expensive loan.

Leasing Structures – Operating Lease

- An owner or lessor leases to an airline or other lessee and retains substantially all the risks and rewards incident to the ownership of the aircraft.
- The owner or lessor re-leases or sells the aircraft once it is returned.
- Two types of Operating leases:
 1. **Wet Lease:** The owner or lessor retains operational control of aircraft, operates flight for the airline, maintains and insures the aircraft and provides a crew for the flights.
 2. **Dry Lease:** The owner or lessor only provides the aircraft.



Advantages

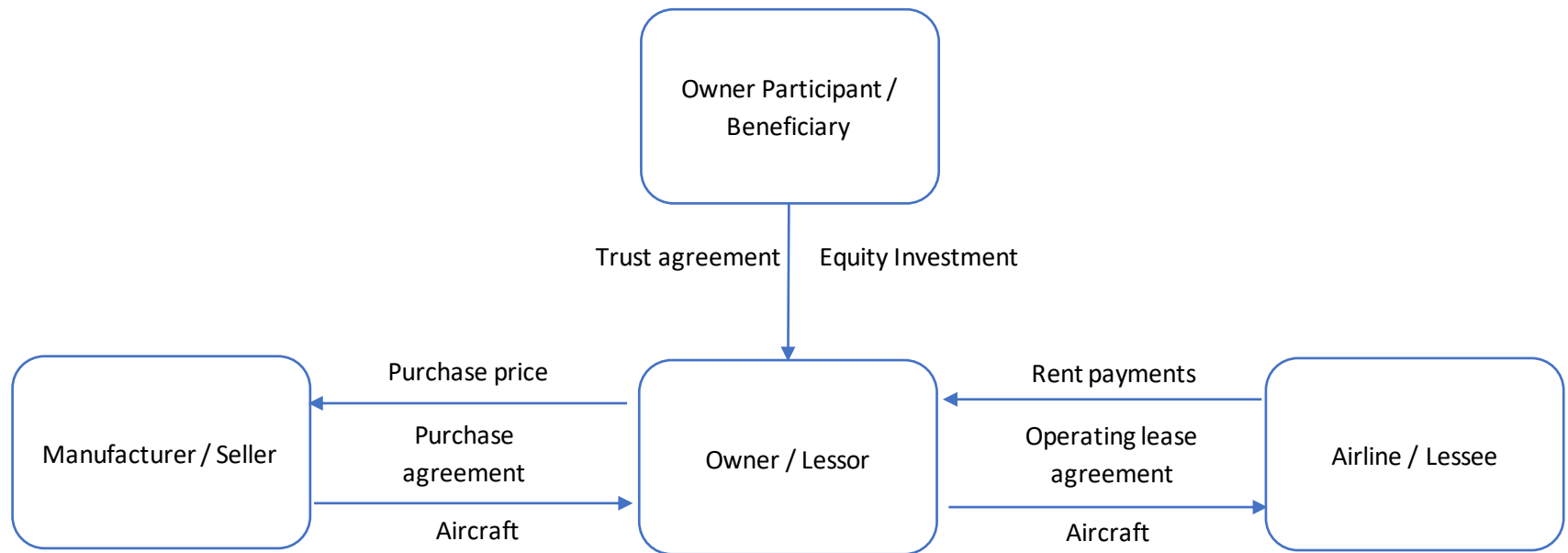
- Greater flexibility in managing the fleet because they can contract for increased capacity only as and when needed.

Disadvantages

- This type of structure can be more expensive relative to other forms of financing.

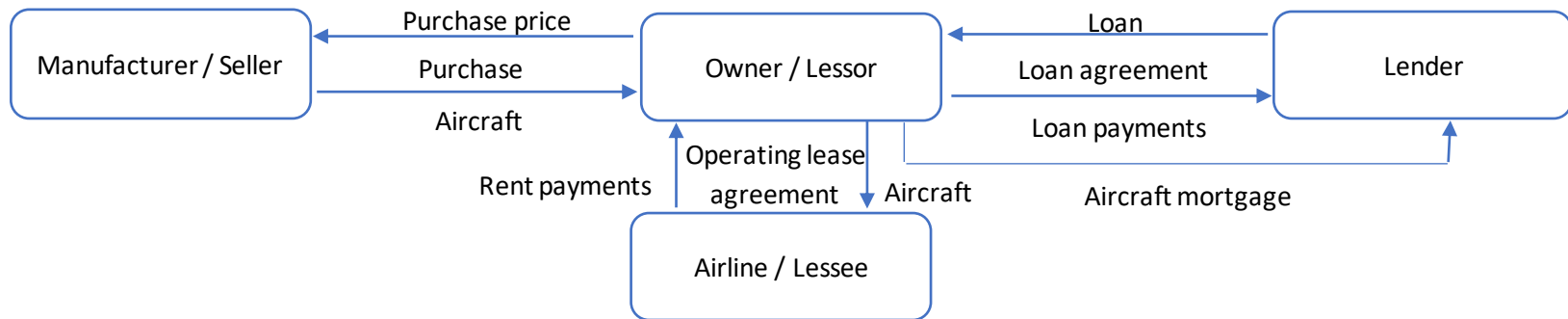
Leasing Structures – Financial Lease

- Similar to operating lease structure.
- Difference being, that the airline or the lessee is required (or expected) to purchase aircraft at the end of the lease term.
- Further, the owner or lessor in these transactions is typically an owner trust established by an equity investor and through which it makes the investment needed to acquire the aircraft.



Leasing Structures - Back Leveraged Lease

- Operating lease with its related aircraft, is collaterally assigned/in favor of the lender.
- Lender provide the owner or lessor with loans to cover a portion (~70% to 85%).
- Rentals from operating lease service the loan availed to finance the aircraft.
- Lender - Secured by first priority lien on the aircraft & rights to receive payment from the lessee.



Advantages

- The owner / lessor retains 100% of the asset's residual value, while providing only a portion of the aircraft's acquisition cost.
- Once the loan is repaid, the owner / lessor owns the aircraft free and clear of any debt, liens, or encumbrances.

Disadvantages

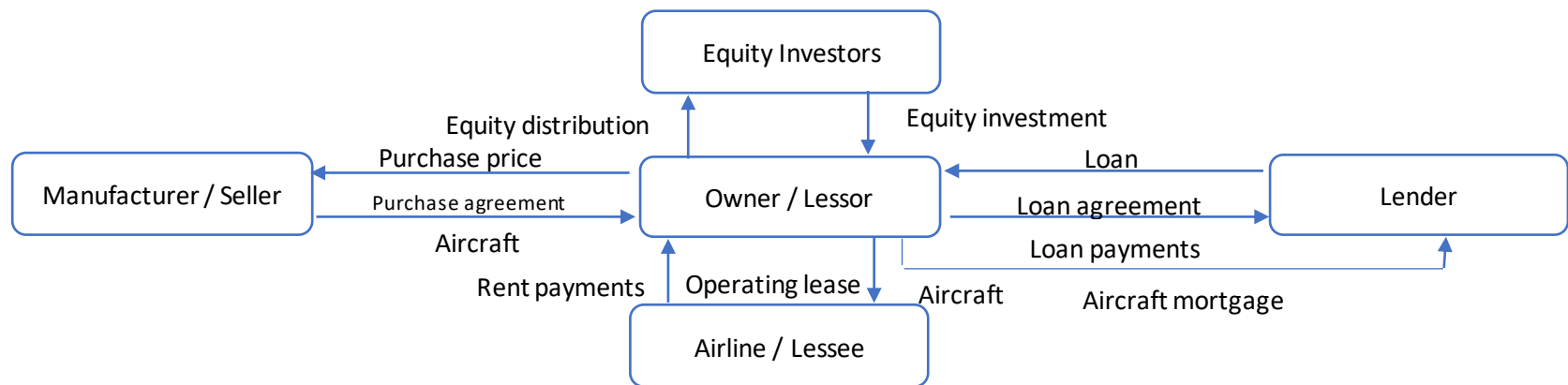
- Lenders have security interest in the aircraft and in the receivables in the form of lease payments.
- The lender may take management of the lease and aircraft away from the owner / lessor upon default.
- It can hamper existing business relationship between the airline/lessee and the owner/lessor.

Leasing Structures – Japanese Operating Lease (JOL)

- An operating lease fully or partly funded by a Japanese investor or equity sourced from Japan.
- Owner / lessor purchases aircraft from the manufacturer by obtaining funds (70% to 80% of the purchase price) and balance from an investor (from Japan in JOL cases).

Two types of JOL:

1. Straight forward lease structure.
2. JOL with call option (JOLCO): Similar to straight forward JOL but contains strong incentives to purchase the aircraft at either the expiry of the lease term or at a specified buy-out date.

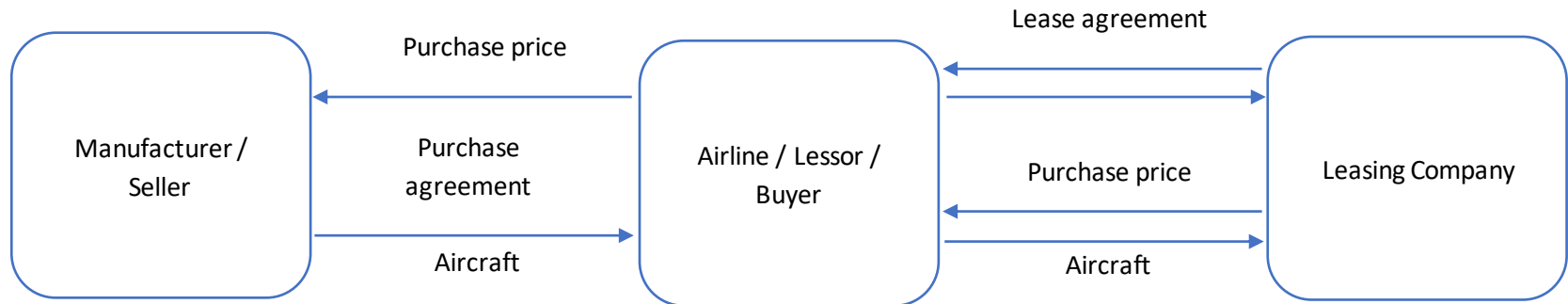


• Disadvantages of JOL and JOLCO:

- Long-term commitment (typically about 10 years' duration).
- Structure is inflexible and difficult to modify or amend.

Leasing Structures – Sale & Leaseback

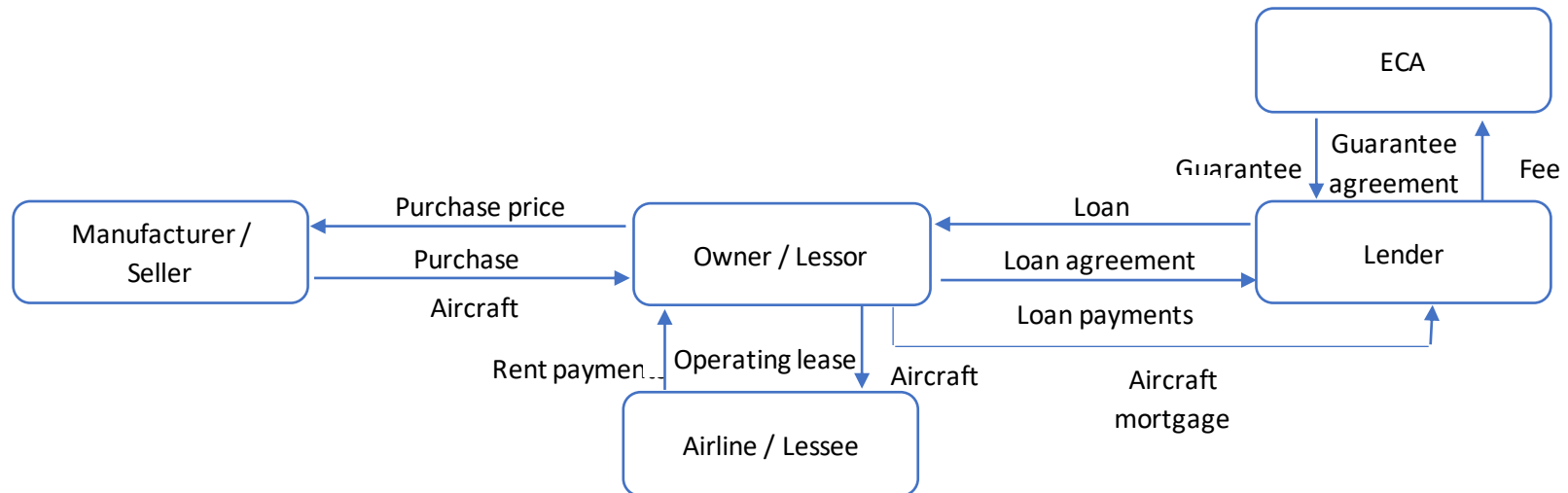
- In a sale leaseback structure, an airline sells either a used aircraft or its right to purchase a new aircraft from a manufacturer to either a leasing company or an SPV lessor.
- The airline then leases the aircraft back from that entity. Sale leasebacks are often used when an airline:
 - Desires flexibility to manage its fleet (which shorter-term leases can provide, unlike ownership of the aircraft).
 - Need to raise capital



ECA Loan Structure

- ECAs provide for a maximum of 85% financing, or governmental-based guarantees to lenders, to support the export of aircraft, engines and other manufactured goods from the home country.
- The remainder of the aircraft purchase price is generally funded by equity investors, leasing company, airline, or lessee.
- ECA financing come primarily in two structures:
 1. Guarantees issued by ECA to lenders (*most ECA financings use guarantee structure*)
 2. ECA provides the financing to allow an owner or operator to acquire the exported asset.

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Insurance Structure

Insurance Backed Structure

- Similar to ECA structure with Guarantee being replaced by Insurance.
- Non-payment insurance policy; i.e. it will pay the insured financier if the obligor to make the due payments.

Key differences between ECA and Insurance structure for aircraft financing:

- Insurers are not sovereign entities. By contrast, the Ex-Im Bank is backed by the full faith and credit of the US.
- Insurers in the consortium have several liability and not joint liability.
- Foreign buyer's obligations are backed by an insurance policy and not a guarantee.
- AFIC financing is not limited to financing aircraft that will be exported unlike in ECA financing. Thus, US airlines can also avail AFIC financing.
- ECA financings are subject to (OECD) regulations and 2011 Aircraft Sector Understanding (ASU) requirements whereas AFIC financing is not.

Associated Financing Needs

- A lessor needs to ensure that the leased aircrafts are always well maintained by the lessee to ensure that the value of the asset is not eroded.
- Accordingly, Lease agreement captures clauses with respect to maintenance reserve etc to be maintained by the lessee.
- Further Security deposits to be maintained by lessee as part of the lease agreements.
- It functions as a protection for any non-payment under the lease agreement.
- It is common market practice for the security deposit to be priced as a two to three times multiple of the monthly basic rent.
- Accordingly, lessee may approach commercial banks to fund the Maintenance reserve / security deposits in the form of Non-Fund based facilities.

Key Consideration in Indian Aviation Space

- **Forex Risks:** As aircrafts are manufactured outside India and there is dollar liability, there is an inherent currency risks involved in the Aviation sector. Further as, lessors are also situated outside India, lease payments have to be made in foreign currency.
- **Fuel Risks:** ATF required for Airlines is still outside the purview of GST. Further as India imports Oil from other countries and any fluctuations in Oil prices abroad results in adverse impact on the fuel cost of the Airline Companies.
- **Closure of major Airlines – Jet Airways & Kingfisher Airlines** collapsed in the past decade due to severe financial stress resulting in low risk appetite for Commercial banks/other lending institutions for funding in this sector.
- **Global spread of COVID-19** has led to curtailment of travel which has significantly impacted the revenues of airline operators.

Thank You