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AIRCRAFT FINANCE AND LEASING ARRANGEMENTS:

A LEGAL AND INDUSTRY OVERVIEW

AGENDA

- Background
- Aircraft Financing
- Blue Sky One Judgment
- Aircraft Leasing
- Overview of the Industry

Background:
The Downside

- The demand for financing deliveries of new aircraft peaks at a time when **long term financing becomes unattractive** for some of the incumbent banks.

- The ongoing **global economic uncertainty**, the European Sovereign debt crisis, the recent downgrading of several European banks and increased difficulty of accessing US dollar funding has raised funding pressure.

- A number of predominantly European banks who have historically played a key role have been seen retracting from the market, causing tension in the funding market.

- The ongoing **bank deleveraging process**, which partly reflects the impact of new regulations such as **Basel III.**

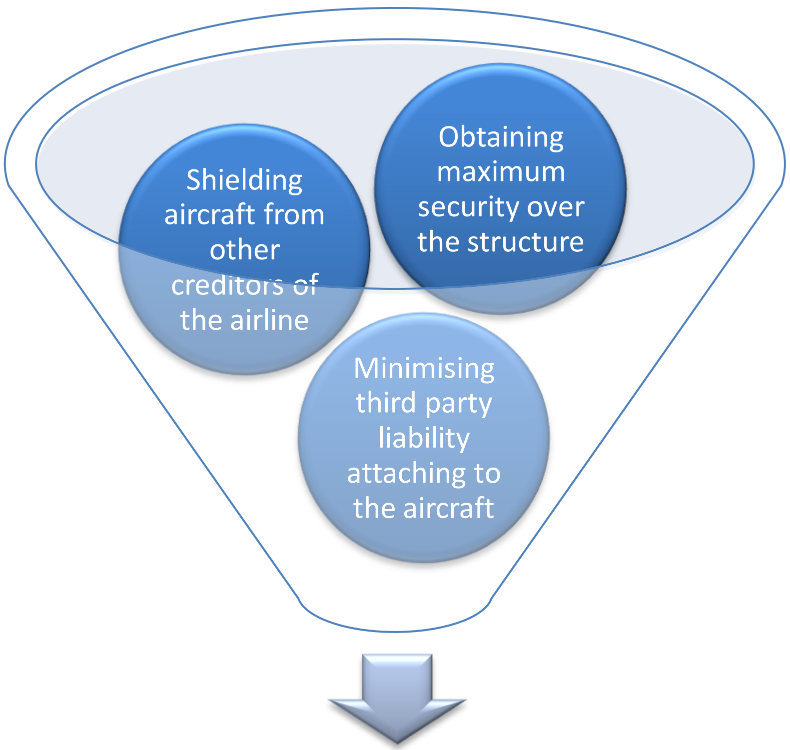
- As risk is re-priced, the competition to obtain financing for aircraft may intensify and the **cost of financing may go up**.

Background:
The Upside

- In difficult economic times where a low interest rate environment prevails, attractive yields are harder to find. **Investors are looking for hard assets with good returns.**
- Within the airline business, **we have seen new investment flowing into this sector** as funds backed by the governments of China, Singapore and UAE have made sizeable investments in this space.
- Other institutional investors such as sovereign wealth funds, insurance companies, pension funds and certain **private equity funds could also be interested in investing in aircraft assets**.
- Acceleration in the ongoing shift of financing from the traditional aviation banks in the West to **new players from the East is expected.**
- The industry as a whole will be able to attract funding but the **new sources of finance** will need to be tapped into.

Aircraft Financing

The Basic Structure



Aim of Banks:

Direct Recourse against the Airline

Aircraft Financing

- Aircraft financing has been **traditionally** obtained through **loans**.

- The soaring prices of aircraft, which was used as collateral to these loans however, caused financiers to lose sight of fundamental considerations, such as whether the loan could be paid back, whether the obligations under the lease could be performed and whether the aircraft could be maintained, resulting in a **liquidity crisis** as soon as the recession hit.

- Following the financial crisis of 2008, banks, in order to preserve their capital, were suddenly **reluctant to give out loans**.

- **Aircraft became suddenly less valuable to financiers** when compared to liquidity, and consequently lenders started imposing more stringent conditions.

- Coupled with the **loss of confidence in banks**, the lengthy negotiations required to obtain financing and the low prices of aircraft, resulted in the increase of cash transactions.

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Aircraft Financing

- Liquidity crisis - **collateral was no longer a substitute** for credit and financiers were more concerned with the financial ability of the borrowers to perform over the life of the loan, which resulted in higher loan prices.

- **One-hundred-percent financing,** which was quite common during the industry peak, was suddenly reserved for the wealthiest individuals or corporations, who had pre-existing relationships with financiers, and therefore cash became an increasingly large source of aircraft financing.

- In Europe, the situation worsened due to the **European debt crisis** which reduced access to USD funds for European banks, resulting in European financiers being even more cautious than their American counterparts. As a consequence, European banks shifted to their core markets, reducing exposure to aircraft finance and other riskier assets.

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Aircraft Financing

- The **three most common schemes** for financing commercial aircraft are secured lending, operating leases and finance leases. However there are other ways to finance aircraft acquisition including:
  I. Operating leases and sale/leasebacks
  II. Export credit guaranteed loans
  III. Tax Leases (Tax leases allow the lessor to accelerate the depreciation of the asset for tax deduction purposes)
  IV. Manufacturer support
  V. Equipment Trust certificates

...but before, a few words on Outright Ownership

- **Some companies pay cash for their aircraft.** Such companies may generally lease, interchange and charter the aircraft to the full extent of the law, use the aircraft as much as necessary or desirable, fly when and where it wants (subject only to legal and insurance limitations), maintain the aircraft in any manner compliant with the law, and when the time comes to sell the aircraft, arrange the sale directly with the buyer without coordinating with a lender or leasing company.

- Outright ownership is not the best option for all companies, for a number of reasons such as:
  - ✓ The **initial cash outlay is the greatest** of all financing options.
  - ✓ The aircraft owner company may dislike that its ownership of the aircraft is **public information** and that the information is easily and immediately accessible on the Internet.
  - ✓ The aircraft is an asset on the company's balance sheet, which may be a **sensitive shareholder issue.**

Aircraft Financing

- The general security **structure for a loan** in the aviation field comprises a number of elements including:
  I. A **mortgage** of the aircraft
  II. An **assignment** of earnings, rights and receivables
  III. An assignment of insurances
  IV. Sometimes a **pledge** on the shares of the company or of other receivables
  V. Special **privileges** on the aircraft, if and when applicable.

Aircraft Financing

Typical Loan Agreement Scenario

- Bank agrees to advance purchase price to lessor
- Loan is repaid from rentals payable under lease
- Lease is assigned to the banks
- Banks can sue airline directly if it defaults

Aircraft Financing

Secured Lending:

An Overview of Typical Clauses in a Loan Agreement

- In many respects, a loan agreement for use in an aviation financing transaction is no different from any other type of commercial loan agreement.

- It should contain appropriate terms relating to:
  - ✓ the **amount** and **availability** of the facility;
  - ✓ specify the **purpose** of the facility;
  - ✓ contain terms relating to **conditions precedent, utilisation, repayment, prepayment and cancellation**;
  - ✓ calculation of interest and default interest;
  - ✓ various **representations** and **warranties**;
  - ✓ events of **default**;
  - ✓ the **lender's rights** following a default

Aircraft Financing

Secured Lending:
An Overview of Typical Clauses in a Loan Agreement

- From the **lender's perspective,** the loan agreement should also contain:
  - ✓ terms relating to the grossing-up of payments;
  - ✓ the ability of the lender to increase payments as a result of the increased cost of funding to the lender.

- Loan agreements for financing or re-financing on aircraft will also contain numerous **specific aviation-related clauses**.

- One would expect the loan agreement to contain:
  - ✓ **detailed definitions** of the aircraft, its engines, parts, the relevant aviation authority;
  - ✓ various **covenants** relating to the operation of the aircraft;
  - ✓ various aviation-related **representations and warranties** such as those concerning the owner's ownership of the aircraft, the owner's possession of all appropriate licences;
  - ✓ **specific covenants and undertakings** in respect of the ownership, use, maintenance, insurance and operation of the aircraft;
  - ✓ clause stating that the **owner will pay monies in respect of maintenance reserves**.

Aircraft Financing

Secured Lending:
An Overview of Typical Clauses in a Loan Agreement

- Regarding the overall form of an aircraft loan agreement, different lenders will invariably have their own form of standard aircraft loan agreement.

- The London Loan Market Association ("LMA") produces various forms of standard banking documents for use in the London Interbank Market. As many financing banks in the London Market may wish to use a loan agreement that is in the LMA's standard form, it is not uncommon for **aircraft loan agreements to be based on one of the LMA's standard forms** (such as the standard single currency term facility agreement). The aircraft specific provisions are then included.

- **Sub-leasing**: The loan agreement will contain clauses relating to the borrower's ability to sub-lease the aircraft to any third party. This language will invariably draw a distinction between the borrower's ability to dry lease and wet lease the aircraft to any third party. Depending on the commercial arrangements, there may be a **complete prohibition** on the ability of the borrower to dry lease the aircraft to any third party, especially if the borrower is an aircraft operator operating the aircraft under an Air Operators Certificate.

Aircraft Financing

Secured Lending:
An Overview of Typical Clauses in a Loan Agreement

- **Indemnities in respect of the aircraft:** general indemnities in respect of the aircraft. Accordingly, the borrower will indemnify the lender in respect of any losses (including any tax liability) suffered or incurred by the lender.

- **Absence of lender's representations:** The loan agreement will state that the lender has not made any representation or warranty in respect of the aircraft, its airworthiness, merchantability, fitness for purpose etc. This language will be very similar to the typical exclusion of liability wording contained in an aircraft sale and purchase agreement or in a lease agreement and would typically be very widely drafted.

Aircraft Financing

Secured Lending:

An Overview of Typical Clauses in a Loan Agreement

- **Maintenance Reserves:** Aircraft must be maintained under an Approved Maintenance Program often called a "Maintenance Schedule". This sets out the various checks, inspections, maintenance and parts replacement that must be undertaken on the aircraft at specific intervals. The maintenance program will be initially produced by the manufacturer and will be approved by the Aviation Authority.
  - ✓ From a <u>lender's point of view</u>, a critical point is that, **as hours and cycles are used on an aircraft, its value will invariably decrease**. It is common practice for a lender to require a borrower to pay a specific amount each month in respect of each hour's utilisation of the aircraft and usually in respect of each cycle into designated maintenance reserve accounts. These payments are called "maintenance reserves". As the borrower utilises the aircraft, payments of maintenance reserves into the designated maintenance reserve accounts will create a fund which the borrower may use for future maintenance. If a borrower did not pay maintenance reserves, the lender could face substantial maintenance costs in the future to make the aircraft airworthy and to comply with maintenance obligations if the borrower defaulted.

Aircraft Financing

Secured Lending:
An Overview of Typical Clauses in a Loan Agreement

- ✓ From a lender's perspective, it is prudent to require amounts to be paid in respect of the various components of the aircraft, such as the airframe, each engine, the auxiliary power unit and other major components such as landing gears. In a typical situation, after the borrower has procured that relevant maintenance has been undertaken, the borrower will request the lender to release from the relevant maintenance reserve accounts an amount so that the borrower can either pay the maintenance organisation, or reimburse itself, for the cost of the performed maintenance.
- ✓ The <u>borrower</u> is invariably required to **deliver to the lender a Maintenance Reserves Certificate** which will, among other things, specify the number of hours and cycles used on the aircraft, the engines in the preceding calendar month. The borrower will pay maintenance reserves based on these figures. A prudent borrower will wish to ensure that, in the case of a total loss, the maintenance reserves are applied to reduce the outstanding amount owed to the lender or, upon repayment of all monies to the lender, any unutilised maintenance reserves will be repaid to the borrower, thereby preventing the lender from obtaining a windfall profit.

Aircraft Financing

Secured Lending:
An Overview of Typical Clauses in a Loan Agreement

- **Cape Town Convention:** a well drafted loan agreement will contain detailed provisions relating to the Cape Town Convention and will contain provisions protecting the interests of the lender.

- **Representations and Warranties:** The lender and the borrower will give appropriate representations and warranties to each other. The basic representations and warranties relate to due incorporation, due authorisation of the **loan agreement and the mortgage and confirmation that the loan agreement and the mortgage will constitute the legal, valid, binding and enforceable obligations of the relevant party.**

- **Covenants:** A well drafted loan agreement will contain covenants on the part of the borrower stating the borrower will not:
  - ✓ **Create any security over the aircraft** other than any security permitted by the loan agreement and/or the mortgage;
  - ✓ **Sell, transfer or otherwise dispose of the aircraft**; and
  - ✓ Ensure the aircraft is **released of any arrest** or forfeiture.

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Secured Lending:
An Overview of Typical Clauses in a Loan Agreement

- **Events Default:** In addition to the “standard” events of default that one would normally expect to see in a commercial loan agreement, an aircraft loan agreement will contain the following events of default that are specific to an aircraft financing transaction:
  - ✓ **Breach of any of the terms** of the aircraft mortgage:
  - ✓ Failure of the **borrower to prepay the loan following a total loss** within an agreed period of time;
  - ✓ The **aircraft ceases to be registered** in the State of Registration;
  - ✓ Any registration of any **international interest is cancelled or removed**;
  - ✓ If the **borrower shall sell, mortgage or execute a bill of sale** in respect of the aircraft or any part;
  - ✓ If the borrower (or the lessee is not in possession and does have the **encumbered control** of the aircraft);
  - ✓ If any **default occurs** under any sublease, aircraft management agreement, aircraft operational agreement or other relevant agreement;
  - ✓ If any relevant certificate permit, licence, consent or approval **ceases to be in full fore** and effect.

Aircraft Financing

Mortgages

- An aircraft mortgage has similarity with other types of mortgage. It is common for aircraft mortgages to contain various covenants by the borrower concerning the registration of the aircraft, its operation and use, maintenance and repair.

- It is also common, for aircraft mortgages to contain **specific provisions relating to insurance**. However, depending on how the documentation is structured, it could certainly be the case that the **loan agreement contains the various covenants regarding these aspects** and, in this case, these provisions do not necessarily also have to be included in the aircraft mortgage.

- **A lender will need to consider the law that aircraft mortgage should be governed by**. By way of example if the aircraft is registered in Malta, Maltese law is likely to be the most suitable governing law. If, however, the aircraft is registered outside of Malta, it may be appropriate for the aircraft mortgage to be governed by the laws of the jurisdiction where the aircraft is registered. It is not unknown for a lender to receive the benefit of dual mortgages, one governed by the laws of the state of registration of the aircraft, and another governed by another applicable law.

Aircraft Financing

What about Mortgages under Maltese Law?

- Under Maltese law, an aircraft constitutes a **particular class of movables forming separate and distinct assets** within the estate of their owners for the security of actions and claims to which the aircraft may be subject.

- In the case of **bankruptcy or insolvency of the owner of an aircraft**, all actions and claims to which the aircraft may be subject, shall have preference on the aircraft over all other debts of the estate.

- When dealing with mortgages an 'aircraft' shall comprise in:
  - ✓ All data, manuals and technical records
  - ✓ The airframe, all equipment, machinery and other appurtenances as accessories belonging to the aircraft, which are on board or which have been temporary removed there from.
  - ✓ Any engines owned by the owner of the aircraft whether attached to the aircraft of not as well as any replacement engines which are designated for use on the aircraft and owned by the owner of the aircraft but temporarily not attached to the aircraft.

Aircraft Financing

What about Mortgages under Maltese Law?

- An aircraft may constitute security for a debt or other obligation either by agreement or by operation of the law in the form of a **special privilege**. A special privilege is subject to registration in the International Registry and such registration is necessary for the continuing existence of the privilege.

- Mortgages and special privileges shall have priority of claims on the aircraft over all other debts of the owner. Once the mortgage has been created or the special privilege arises, the **bankruptcy or insolvency of the owner of the aircraft shall not affect the actions and claims to which the aircraft may be subject.** A registered mortgage or a privilege shall attach to the aircraft (or share therein) until it is discharged, thus when an aircraft has been sold the interests of the mortgagee as well as that of the privileged creditor in the aircraft shall pass on to the proceeds of the sale of the aircraft.

- Pursuant to the recognition by Maltese law of fractional ownership of aircraft, title to such an aircraft may be divided between co-owners in specified fractions or percentages. **Each fractional interest may be financed by a different creditor which takes security over the particular fractional interest it has financed.** Moreover engines and separate items on or in an aircraft may themselves be secured for the payment of a debt and any security over the aircraft does not extend to any engine attached to the airframe which is not also owned by the airframe owner.

Aircraft Financing

What about Mortgages under Maltese Law?

- A registered aircraft may be **made a security for any debt or other obligation by means of a mortgage deed** executed by the mortgagor in favour of the mortgagee and registered in the National Aircraft Register by the Director General of Civil Aviation and is recorded in the order of time in which they are produced to him for the purposes of registration and the day and hour of registration will be indicated on each mortgage deed.

- **A mortgage may be executed and registered in favour of a security trustee appointed or acting under a trust for the benefit of persons** to whom a debt or other obligation is due and such **security trustee** will be recognised as the mortgagee of the particular mortgage and will be entitled to exercise all the rights in relation to that mortgage which are usually accorded to mortgagees.

Aircraft Financing

What about Mortgages under Maltese Law?

- Upon **default of the mortgagor**, the mortgagee, upon giving notice in writing, which notice may be given by means of an electronic communication or served at the registered office of the debtor, will be entitled to a number of remedies including:
  - ✓ taking **possession** of the aircraft or share therein
  - ✓ **selling** the aircraft or share therein
  - ✓ **leasing** the aircraft in order to generate income
  - ✓ **receiving any payment of the price**, lease payments, and any other income which may be generated from the management of the aircraft, and
  - ✓ **applying for any extensions**, paying fees, receiving certificates and generally doing all things in the name of the owner in order to maintain the status and validity of the registration of the aircraft thereby safeguarding its ability to continue to operate the aircraft commercially pending any sale procedure.

Aircraft Financing

What about Mortgages under Maltese Law?

- The above-mentioned remedies may be exercised by a **mortgagee without the need of the leave of any court.**

- **A registered mortgage remains attached to the aircraft until it is discharged by the mortgagee.** Where an aircraft has been sold pursuant to an order or with the approval of the competent court within whose jurisdiction the aircraft was at the time of the sale, the interest of the mortgagees as well as that of any other creditor in the aircraft is shifted onto the proceeds of the sale of the aircraft. The creditor selling the aircraft to enforce his mortgage must act in a commercially reasonable manner and is bound by fiduciary duties towards the debtor and other creditors when effecting the sale of the aircraft.

Blue Sky One Judgment:
Summary of Salient Legal Issues

- The case of *Blue Sky One Ltd. And others v. Mahan Air and another* [2010] EWHC 631 (QBD (Comm) Beatson J.) **involved the enforceability of English law aircraft mortgages**. The facts of the case are complex.

- The Judge considered certain questions of the **validity of aircraft mortgages** which involved determining their applicable law and whether the English law choice of law rule as to the to the determination of title to moveable property refers only to the domestic law of the relevant country or to such domestic law and to its choice of law rules (described by the judge as the *'renvoi'* issue).

- The judge held that, **in the case of a transfer of title to tangible moveables**, such as an aircraft, the reference to the *lex situs* is to the domestic law of the place where the aircraft was situated at the time of the execution of the mortgage and not to its entire law including its conflict of law rules and, according, the doctrine of *renvoi* does not apply. *Renvoi* is French for 'to send back' and refers to a country's conflict of law rules sending back an issue to be determined by another country's law.

Blue Sky One Judgment:
Summary of Salient Legal Issues

- The issue for the judge in this case was **whether the English choice of law rule on this issue referred to Dutch conflict of law rules and permitted the *'renvoi'* of the issue (i.e. the Dutch court would send back the issue to the English court by applying the *lex registrii*), or whether such English law refers only to Dutch domestic law.** As indicated above, if Dutch conflict of laws applied, the Dutch court would hold that English law applied as the *lex registrii* as the case would be 'sent back' to be determined by English law.

- The judge held that, if the asset is capable of registration and it is registered in a different jurisdiction to the *lex situs*, a mortgage which is valid under the *lex registrii* but invalid under the domestic laws of the *lex situs* jurisdiction will be ineffective under English law.

…What are we to make out of this case?

- Aviation lawyers representing a lender in an aircraft loan and mortgage financing transaction should check that **the aircraft mortgage is valid under the law of the *lex situs*, obtain proof as to the location of the aircraft at the time of the execution of the mortgage and check that the location is satisfactory and that the mortgage will be valid under the *lex situs*.** The decision highlights that it is prudent for a lender to require the borrower to sign a Mortgage Certificate confirming the location of the aircraft at the time that the mortgage is entered into.

- The judgment indicates that it would be very unusual for the *lex situs* not to apply. One such case is where an aircraft was in flight over international waters at the time of the creation of the mortgage. **The judge did not make any decision as to how the English court would determine the validity of an English law mortgage created at a time when the aircraft was in flight over international waters.** Logically, the options open to determine the validly of the mortgage in this case are the chosen law of the mortgage and the *lex registrii.*

…What are we to make out of this case?

- PK Airfinance's counsel argues that, although the *lex situs* is the law which an English court will generally apply to determine whether a property interest has been created in movable property, it is not the case. PK Airfinance's counsel submitted that the special position of aircraft as a means of transport which move regularly from *situs* to *situs* means that the **applicable law is the law of the place where the aircraft is registered, namely the *lex registrii*. The judge stated that the position "finds virtually no support in English cases or commentaries."**

- **The judge's decision relating to the applicability of the *lex situs* is at odds with the rules set out in The Geneva Convention on the International Recognition of Rights in Aircraft 1948 and the Cape Town Convention on International Interests in Mobile Equipment 2001.**

...What are we to make out of this case?

- Given the possibility that an English law mortgage of an aircraft might be held to be invalid under an applicable foreign law, in a loan and mortgage structure a prudent lender ought to take additional **security such as a charge of the shares in the entity that owns the aircraft thereby allowing the lender to take over the shares in the aircraft owning company as an alternative to the enforcement of the mortgage.**

- Following the *Blue Sky One* case, it has become practice for lenders to require the borrower (and any other relevant party) to sign a **Mortgage Certificate at the time of an execution of an aircraft** mortgage. The Mortgage Certificate confirms the location of the aircraft at the date and time of the execution of the Aircraft Mortgage.

- In addition to obtaining a Mortgage Certificate, **it is prudent for a lender to independently verify that the aircraft was at the relevant location at the time of the execution** of the Aircraft Mortgage. A prudent lender will obtain suitable evidence to this effect, such as copies of any flight plans, extracts from the aircraft's logbook, fuel receipts and other invoices in respect of charges rendered by an airport authority or any person providing services to the aircraft at the relevant location.

Aircraft Leasing

- A lease is a contract for hire, **whereby the owner leases the aircraft to the airline for an agreed period of time for a specific rent.** The lessee obtains the right to possess and use the aircraft, and profit is generated through the use, rather than the ownership of the aircraft.

- Leasing is referred to as **asset-based financing**, since unlike loan facilities, it is the asset which is made available to the operator, not the funds.

- Whereas loan repayments are based on the cash flow generation, credit enhancements and collaterals of the borrower, leasing **is focused on the lessee's ability to pay the lease rentals without relying on the lessee's other assets or credit history**, and is in fact available to operators who might not qualify for traditional commercial bank lending.

- However, in contrast to a purchasing agreement, leasing also means that certain expenses are due over a longer period without having ownership of the aircraft

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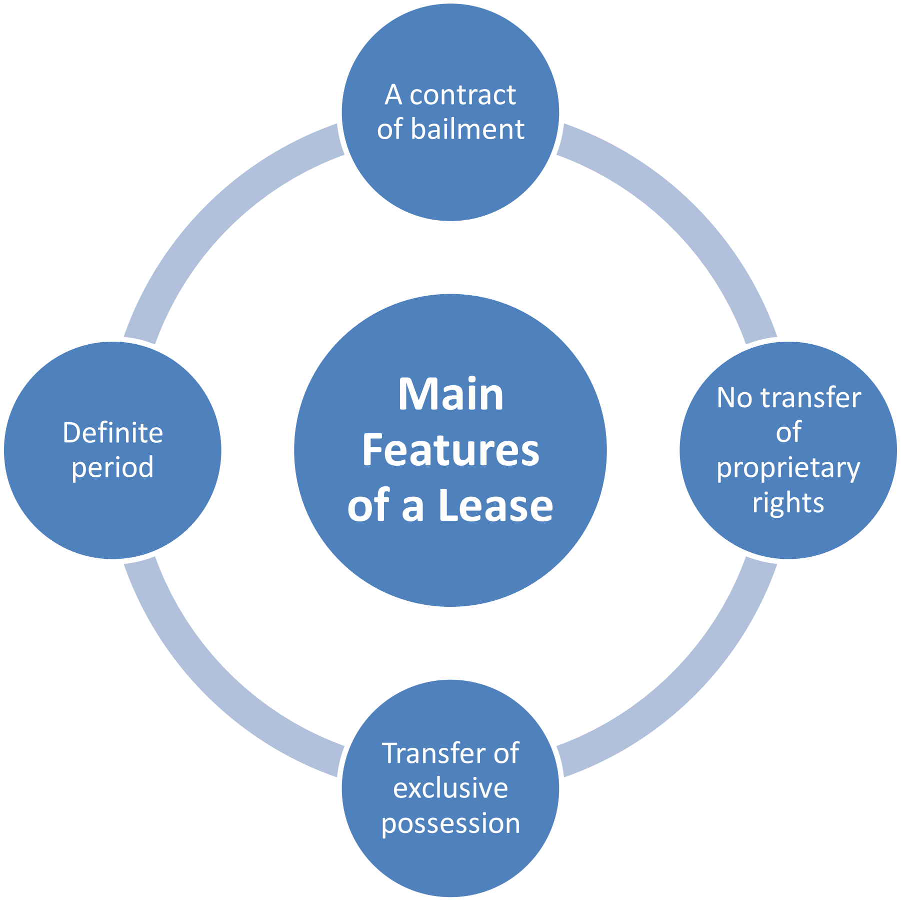
Aircraft Leasing



Aircraft Leasing
Dry Lease

- Dry leasing is generally adopted by **leasing companies and banks**. Usually the lessee puts the aircraft on its AOC and provides aircraft registration etc.

Aircraft Leasing

Operating Lease

- Aircraft hull and machinery possession handed over to the lessee.

- Lessee responsible for all operations and use of the aircraft.

- The lessee assumes all responsibilities for engagement of crew, insurance of hull and machinery and liability insurances.

- Registration obligations are usually seen to by the lessee.

- Often with a **shorter time frame** than financial leasing, operating leasing is more like a regular rental.

- The **lessor** expects to be able to either sell the asset in the second-hand market or to lease it again and will **therefore not need to recover the total asset value through lease paymen**ts.

- May be used if **owners of the aircraft do not have technical competence to operate an aircraft** which will be used for air services and would like to engage a third party qualified operator having an AOC to do so.

- May also be used if **owners do not qualify for the purposes of applying for an AOC** in an EASA state and need to operate an aircraft in Europe.

Aircraft Leasing
Financial Lease

- Lease payments to be **staggered over a period of time** (which is generally calculated pursuant to the evaluation of the life span of the aircraft).
- Residual value and related asset purchase mechanism has to be catered for in the Financing Dry Lease Agreement.
- Under this agreement you effectively acquire **all financial benefits and risks** without actually acquiring legal title.
- The leasing rate is computed to collect the full value of the asset (plus finance charges) during the contract period.
- At the end of the lease, the asset is sold to a third party and you can receive a share of the sale proceeds (if the lease is not being extended).
- Generally, you will not be able to become the owner of the asset at any time - unless a **private arrangement** is made within the contract.

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Aircraft Leasing
Financial Lease

- However, you usually have the option to extend your lease and as you will have paid for almost the full value during your initial lease period, the rental payments for subsequent periods will be minimal (sometimes referred to as "peppercorn rental").

- Finance leasing represents **a threshold that goes off balance sheet financing to debt financing and vice versa**. Once they get onto the balance sheet, aircraft constitute important assets to help secure finance.

- Used principally by **constructors or related entities which dry lease the aircraft/s to operators** on terms which are similar to those contained in a hire purchase arrangement.

- Also used by **financiers who opt to purchase the aircraft in their name and to grant on lease** until all payment for the asset are made by the operator.

- Can also be **used for tax purposes as a method of deferment of payment of tax** (related to VAT).

Aircraft Leasing

Wet Lease

- A wet lease is a leasing arrangement whereby one airline or aircraft operator (the lessor) provides an aircraft, **complete crew / only cockpit crew, maintenance, and insurance** (Hull and third party liability) to another airline or aircraft operator (the lessee), which pays by hours operated.

- The term ACMI is an acronym signifying Aircraft, Crew, Maintenance and Insurance. (The 4 main components of a wet lease).

- Possession is therefore not handed over to the Lessee.

- Responsibility and liabilities for operation rest with the Lessor.

- **Aircraft is usually leased for a 'standing charge'** which will grant the use by the Lessee of the aircraft for a number of hours of use of the aircraft (with option to extend the number of hours).

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Aircraft Leasing
Wet Lease

- Hull and liability insurance are catered for and in the name of the Lessor.
- Maintenance and repair are the responsibility and expense of the Lessor.
- Crew engagement/salaries are the responsibility and expense of the Lessor.
- Ground handling fees, catering costs, cleaning of aircraft, landing/take-off charges, ground handling charges are at the expense of the Lessee.
- Wet Lease (ACMI) solutions are **ideal for startup airlines, new route studies, seasonal or sudden demand peaks**. Wet Lease Aircraft also fulfill the interim needs created by long term fleet expansion plans whilst maximizing market share in the immediate term.
- Also used by aircraft operators needing extra aircraft capacity.
- When an air carrier **offers less than a complete aircraft crew**, the wet lease sometimes is also referred to as a damp lease, especially in the U.K. A wet lease without crew is denoted as a "moist lease".

Aircraft Leasing
Sale-and-leaseback

- Sale-and-leaseback structures are **akin to a loan** and allow the owner to raise capital while retaining the use of the aircraft.
- The aircraft owner **sells the aircraft to the lessor who then immediately leases the aircraft back** to the original owner, without any interruption or disruption of aircraft operations.
- The aircraft is **leased back at a rental rate and lease term based on the financing costs** of the lessor, the lessee's credit rating and a market rate of return, based on the initial cash investment of the lessor.
- The buyer would presumably be interested in making a long-term secured investment whilst guaranteeing a reasonable return on such an investment in the form of rent.
- The buyer/lessor may also be a holding company of the seller/lessee, in which case the seller/lessee would be keeping track of the worth and profitability of the aircraft while raising money by offloading a valuable asset.
- **A sale-leaseback agreement would contain provisions similar to those found in both aircraft loan agreements as well as aircraft lease agreements.**

Aircraft Leasing
Tax Lease

- A **variation of a sale-and-leaseback structure**, known as a tax lease, is a lease which is entered into in order to benefit from **fiscal incentives.**

- The lessor invests only a **small percentage of the aircraft**, with the rest being contributed by a bank (or a group of banks) as a loan, known as **leveraged leases.**

- In such cases, in spite of the relatively small investment, the lessor is able to benefit from the **tax incentives as if he invested the full amount of the equipment**, and may therefore share the benefits with the lessee in the form of lower rental rates.

- In the event of default however, the lender's claim precedes that of the lessor.

- The main types of tax leases are Japanese operating leases ("JOLs"), Japanese Leverage Leases ("JLLs"), French Leverage Leases ("FLLs"), Spanish operating leases ("SOLs") and US leverage leases. JLLs, FLLs and SOLs are however only available to Japanese, French and Spanish airlines respectively.

Aircraft Leasing

Advantages of Aircraft Leasing

- Makes budgeting exercises easier by spreading payments
- Works as well for fractional shares as it does for whole aircraft financing.
- Retaining capital for other expansion opportunities.
- Distinct business advantages for those who don't want to tie up a large amount of capital or can't gain additional tax benefits from depreciation.
- Encourages the leasing of more expensive aircraft
- Provides greater opportunities in terms of technological updates and equipment renewal
- Aircraft leasing is more flexible in relation to the operator's changing needs

Overview of the Industry: Where do we Stand?

- Financing is likely to be found but potentially, **at a higher price.**

- Already attracting **new investors particularly from the Far East**, with a number of banks from Japan and China snapping up aviation assets. Trend expected to accelerate.

- **Airlines and lessors will need to be more innovative** so as to find additional sources of funding and potentially develop new products.

- Recent attempts: for example the Doric II (UK-listed) Emirates financing vehicle and German bond backed by an aircraft mortgage (a new product first used by Nord LB in July 2012).

- **Costs more to arrange financing within the aviation industry** compared to a few years ago, cost of financing could increase further as regulatory changes take shape in particular Basel III and the implementation of the new Aircraft Sector Understanding (ASU) from 2013.

- As the **challenges that the banking industry faces**, and in particular the European banks who traditionally have been dominant in this space, continue to play out, some banks may retreat from this market which will intensify the competition to obtain aircraft financing and the cost of financing will likely further increase.

Overview of the Industry: Where do we Stand?

The Role of Operators in Aircraft Finance

- Reluctance on the part of major banks and financiers to re-enter the market has eased and we are seeing a lot of the **major players open their balance sheets to aircraft finance yet again.**

- All the major players such as Credit Suisse and GE, to name just a few, say they are very much back in the industry.

- **100% non recourse financing is very much a thing of the past**.

- The trend of private wealth banks has been to insist on the borrower placing funds with the investment bank as a condition of lending. Leasing companies such as Milestone are offering **alternative finance structures**: e.g. operating leases and we expect more to enter the market offering genuine finance leases, i.e. leases with a purchase option, which can afford added attractive tax benefits.

Overview of the Industry: Where do we Stand?

The Role of Operators in Aircraft Finance

- Up to recently, financiers have tended to look at aircraft finance from a repossession or loss risk, placing emphasis on what would happen if the lessee defaults or the asset is destroyed.

- The knock on effect of lessons learned through the recession is that the banks and financiers are taking **increased interest in the operation of the aircraft, training of crew, application of correct safety procedures etc.**

- A healthy working relationship between the borrower, operator and the bank should assist all three if any issues arise, and in many cases may help to prevent issues from arising at all.

- An increasing trend in aircraft finance has been for financiers to insist **that both the borrower and the operator sign what is generally known as a "tripartite" or "multi-party agreement".**

- **The Tripartite agreement is, as the name suggests, a three way agreement between the Bank, the borrower and the operator**. In all cases it will seek to impose certain covenants on the operator which will usually mirror those covenants the Bank seeks of the borrower in the loan documents (e.g. to ensure that their asset is properly protected and operated to a high standard).

Overview of the Industry: Where do we Stand?

The Role of Operators in Aircraft Finance

- Breach by an operator of a covenant will not only entitle the borrower to take action against the operator, **it will also entitle the Bank to take direct action against the operator.**

- The challenge can be in **getting both parties to accept that they need each other** and should negotiate on a level playing field – without the finance, there may not be an aircraft for the operator to manage. Without the operator, the bank does not have the added protection for its asset.

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Overview of the Industry: Where do we Stand?

The Role of SPVs

- An SPV is a **vehicle whose operations are typically limited to the acquisition and financing of specific assets or liabilities** and can take the form of a trust, partnership, corporation or a limited liability company.

- Typically an airline purchases an aircraft from an aircraft manufacturer and then assigns the purchase agreement to the SPV. The SPV then leases the aircraft to the airline, which enters into various covenants in favour of the SPV.

- **Security interests, such as aircraft mortgages, are also issued by the SPV** in favour of the financier, and a trust can also be set up in order to cover and take the SPV off the balance sheet, leading to improved financial and capital ratios for the firm.

- **SPVs are generally isolated and protected from any bankruptcy of the operator**, and in turn the operator is not under any legal obligation to provide additional funds to repay the SPV‟s creditors, thereby transferring credit risk to third parties.

- SPVs can also provide access to **additional sources of funding, by overcoming the internal exposure limits of certain financiers**.

Overview of the Industry: Where do we Stand?

The Role of SPVs

- 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**, and are commonly used in export credit financing, ETC, EETC as well as Islamic finance structures.

- Offshore jurisdictions offer an ideal legal framework for setting up an SPV. Malta, in spite of not being an offshore jurisdiction offers an equally investor-friendly legal framework. A beneficial tax regime, different forms of double taxation relief and tax refunds, coupled with the ability of offshore companies to domicile to Malta, comparatively low running costs and a legal framework capable of supporting SPVs through various security interests, enhances **Malta's position as an attractive jurisdiction to operators wanting to set up an SPV in Malta.**

Overview of the Industry: Where do we Stand?

The Basel Accords

- Prior to the financial crisis there was a period of **excess liquidity**, which resulted in the liquidity risk of banks becoming practically invisible.
- When liquidity became scarce, **banks had insufficient liquidity reserves** to meet their obligations, and the regulatory framework in place, proved to be inadequate to deal with the collapse of financial institutions, resulting in a worldwide financial crisis, the repercussions of which are still felt today.
- The Basel Accords are a global regulatory framework which **aim at preventing the re-occurrence of such a scenario by rendering the banking system more resilient through the strengthening of its capital and liquidity standards.**
- These accords acknowledge that lending carries a risk which needs to be recognised and addressed by banks by **holding back capital to cover losses**.
- Basel III, the latest of these accords, has a **tangible impact on loan conditions** for long term borrowing, which could lead to even higher loan pricing as banks pass on higher liquidity costs.

Overview of the Industry: Where do we Stand?

The Basel Accords

- **Aviation finance, though not a target of the Basel III regulations, has been directly affected as the new capital and liquidity requirements made debt more expensive**.

- Under Basel III the **'adjusted leverage ratio'** sets a limit independent of the quality of the assets and the new 'net stable funding ratio' requires funding to match lending maturities. Both will impact future loan conditions for long term borrowing including for aviation finance.

- For airlines, the effect of Basel III could translate into **higher loan pricing as banks pass on higher liquidity costs.** It is hard to quantify its specific impact precisely as lending rates are an interplay of bank risk costs, liquidity costs, access to currencies.

Overview of the Industry: Where do we Stand?

Other Issues

- The hurdles which were faced by the aircraft finance industry in recent years have brought **uncertainty to the market**, which translated itself into more expensive financing deals.

- The **legal uncertainty** surrounding the applicable law was further emphasised by the Blue Sky case which illustrated how the **wrong connecting factor could lead to a particular court not enforcing a security interest created under its own jurisdiction.**

- The **introduction of aviation activities in the EU ETS** and the financial crisis on the other hand, brought about a liquidity problem in the global economy which also had its toll on the aircraft financing industry.

- All these factors led to **banks being reluctant to finance high-valued assets such as aircraft**, which consequently led to an increase in the cost of financing in order to mitigate the increasing risks faced by financiers.

- **Harmonising substantive property laws,** while solving conflict-of-laws issues, would increase legal certainty and encourage banks to provide financing at a lower price.

Overview of the Industry: Where do we Stand?

Conclusions

- The last decade has been a tough one for the airline industry in general. Although there have been some winners, **globally airlines have incurred significant losses.** A number of unusual external events are partly to blame e.g. 9/11, SARS and swine flu outbreaks and volcanic eruptions.

- However, the underlying story of the last ten years has been excess capacity, **intense competition and rise of the low cost carriers** which have all contributed to lower returns. The financial performance has also been adversely impacted by the economic downturn, increases in regulatory costs and fuel price volatility.

- As a result of the above, **many airlines have lost equity and now have weakened balance sheets.** Now, airlines arguably have the lowest margins in their value chain. It is against this backdrop that the record backlog of orders for new aircraft should be considered, in conjunction with the need to finance them.

- While airlines can either defer or cancel orders, both being options used in the industry historically, there is an operational requirement to re-fleet the global aircraft pool with more efficient aircraft.

Overview of the Industry: Where do we Stand?

Conclusions

- Aviation finance could provide an **attractive opportunity to deploy large amounts of capital** efficiently in ‘hard assets’.

- This sector is particularly attractive at a time when investor confidence in stocks and other financial assets is lower. An interesting barometer of demand for investing in aircraft financing is that investor demand for investing in the Japanese Operating Lease (JOL) market is at a near time high.

- **We have already seen a number of SWF-backed funds such as China, Singapore and UAE investing in this asset class.** This is unsurprising given their access to US dollar funding, longer term investment horizon and appetite for deploying larger amounts of capital efficiently.

- At first glance, aviation financing may not be an obvious investment for private equity. But, we have already seen a number of financial investors **backing leasing businesses with recent ventures e.g. Cinven, CVC, GIC and Oak Hill’s investment in Avolon, Carlyle’s investment in RPK, Cerberus Capital’s investment in AerCap.**

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Overview of the Industry: Where do we Stand?

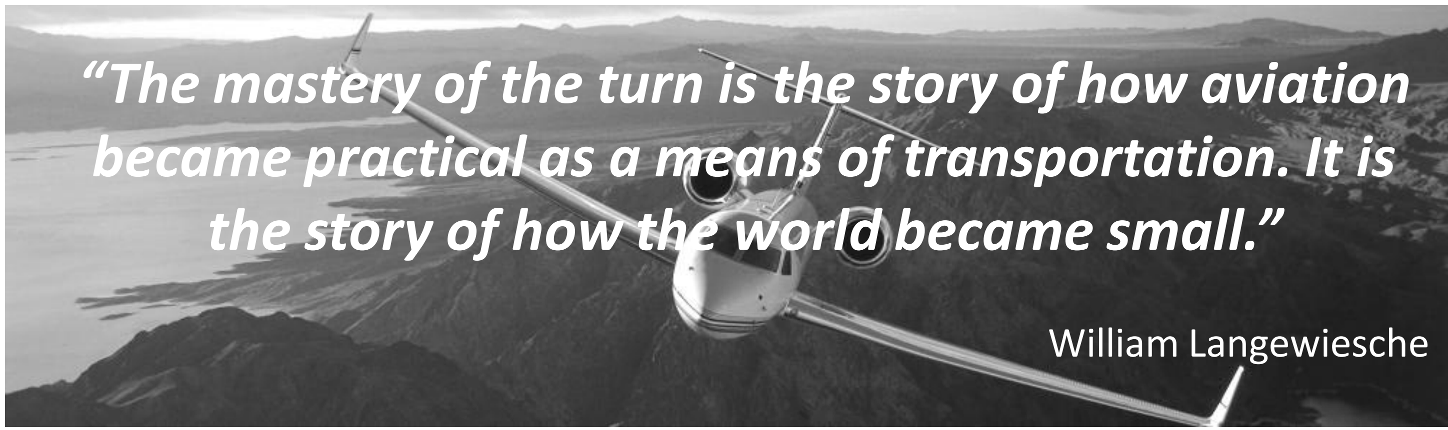
Conclusions

- **Banks from the Far East have been at the forefront of some of the larger deals**, for example, the acquisition of RBS Aviation by Japanese Bank Sumitomo Mitsui, the sale of DVB's 60% share in TES to Development Bank of Japan and Mitsubishi Corporation and the recent acquisition of Jackson Square Aviation also by a Mitsubishi Corporation entity.

- We believe the recent trend of a shift in aviation assets from European banks to the banks in Asia is likely to continue.

- **Concentration by financiers on the operation of aircraft is a welcome change.** It is in every party's interest to have an on-going working relationship so that any issues surrounding the operation of an aircraft is quickly addressed.

- In the business aviation sector, Dave Labrozzi President and CEO of GE Capital Corporate Aircraft Finance believes that 'While the economic downturn had a major impact on business aircraft acquisitions, I think the worst is behind us. NetJets agrees. "The business aviation market is making a gradual comeback that is characterized by increased levels of flying. We are experiencing improved demand for NetJets fractional ownership, and as the economy improves, there are more reasons to travel privately in order to conduct business in a productive manner."



Thank you for your attention

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