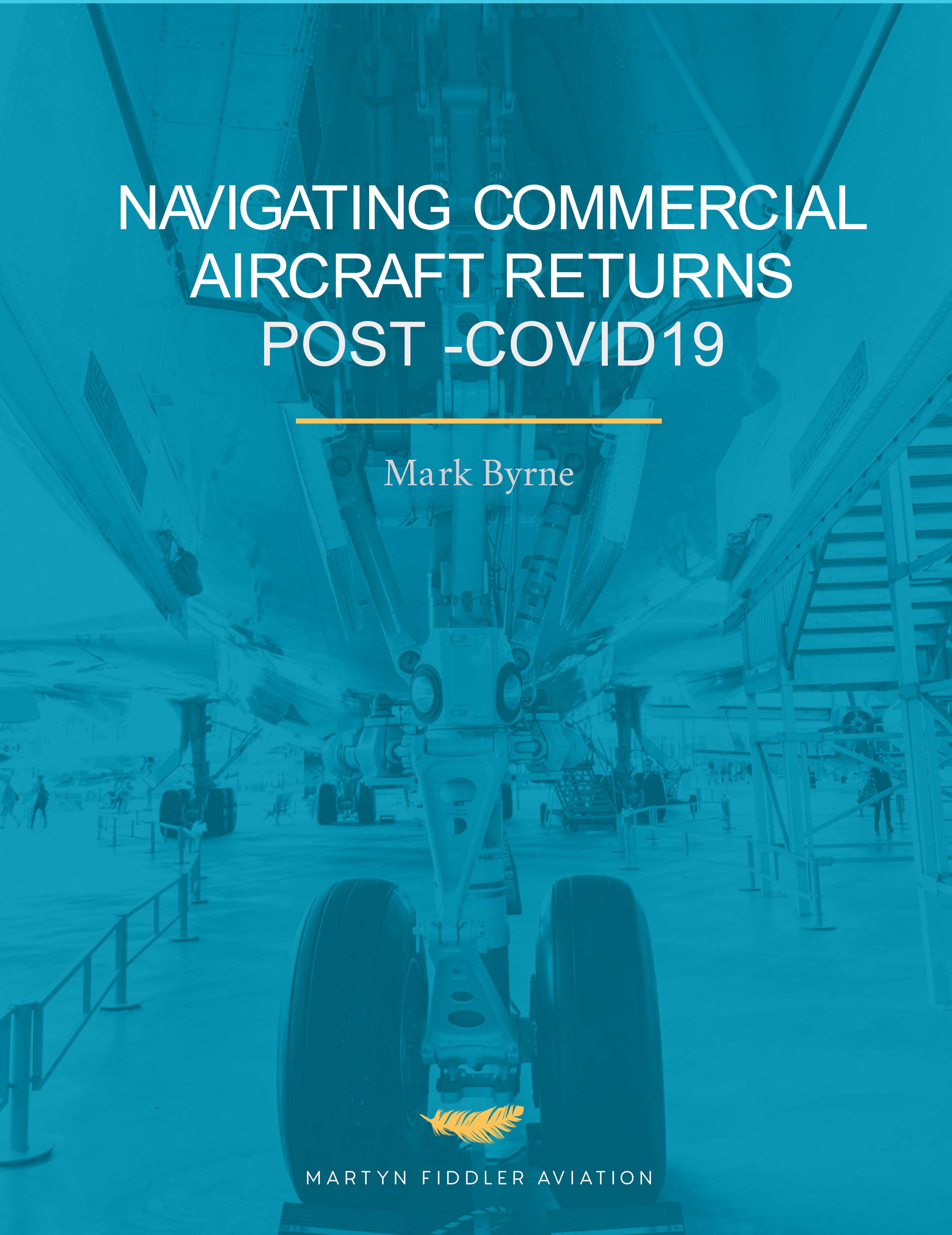
AIRCRAFT LEASE FINANCE SERIES



NAVIGATING COMMERCIAL AIRCRAFT RETURNS POST -COVID19

Mark Byrne

MARTYN FIDDLER AVIATION

NAVIGATING COMMERCIAL AIRCRAFT RETURNS POST-COVID19

Foreword

Just over two years ago, the world was a very different place. Airlines had invested in new aircraft capable of connecting nearly every major city on the globe. AirBnB was one of the most hotly anticipated IPOs of the year. Destination cities like Amsterdam, Venice and Barcelona were groaning at the seams, and all the talk was of how travel could be curbed.

After many years of modernisation through fleet renewal, technology updates and product improvements, many airlines were recording the best results in their history. All of this progress was stopped by a single global event that few could have foreseen.

One by one every country in the world affected by coronavirus closed down its borders, and, as a result, closed down the airline industry. The effect on travel was immediate – and breath-taking. In 2019, Lufthansa were flying on average 350,000 passengers every day. In May 2020, this number was reduced to just 3,000 passengers. Lufthansa CEO, Carsten Spohr said the aviation giant took just €1.9 bn of revenue in Q2 2020 - down from €9.6 billion in the same period last year. Most of the revenue, some €1.5 billion, was generated by Lufthansa Cargo.

There was some hope that the second half of 2020 would be better as the first wave of the pandemic would be over. Of course the bad times have carried on into 2021 and only now are things really beginning to improve.

The reality is that in just 20 months, the majority of people's travel behaviour has changed - both for leisure and business travel. The global demand for air travel will no longer grow as dynamically in the long term as it did in the past years.

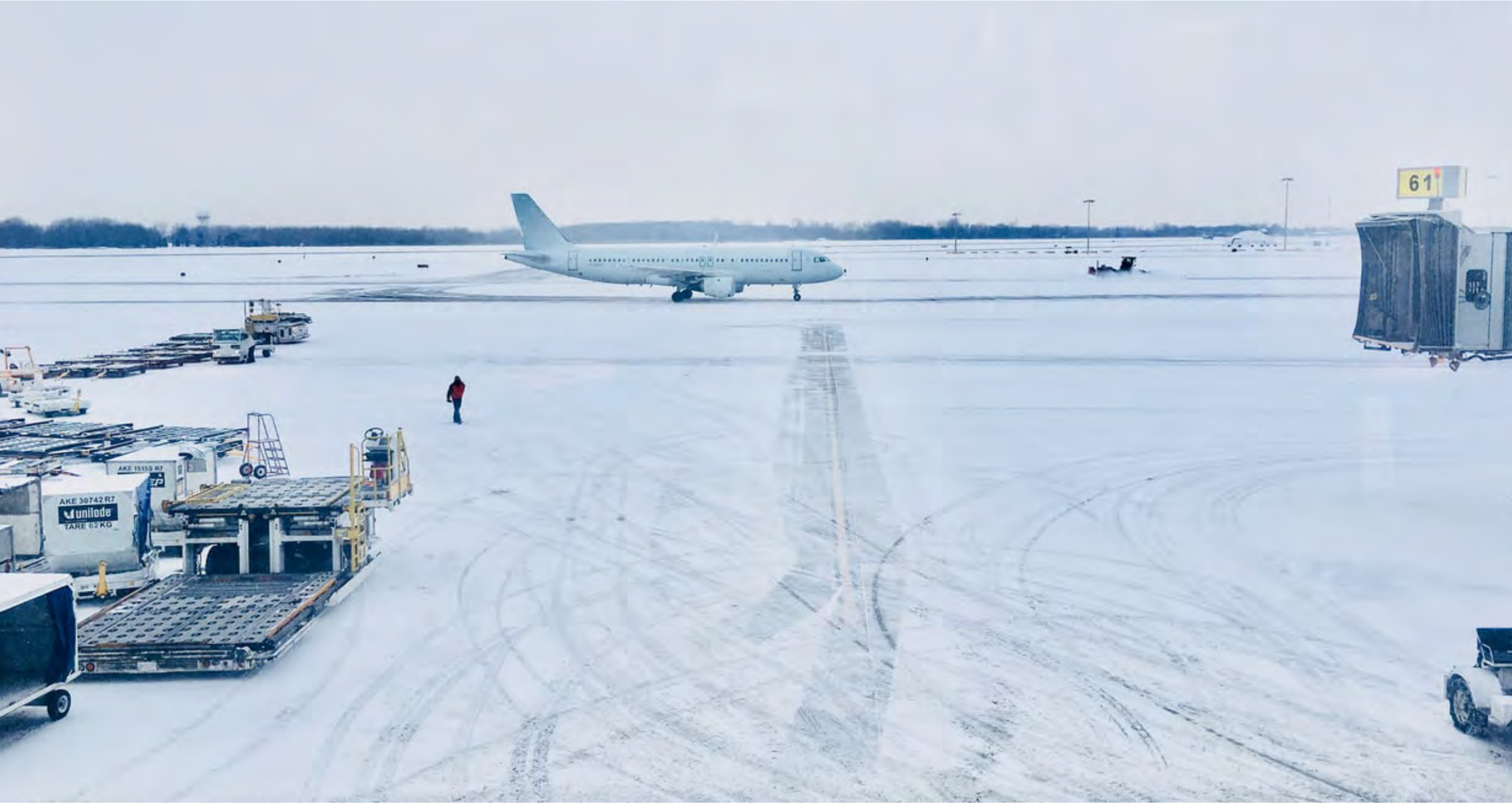
Now what remains are a multitude of difficult decisions around airline fleets. There are few other assets that are as complex or intricate as aircraft. Returning aircraft and changing aircraft ownership status without due diligence can have a serious impact with serious implications for stakeholders as well as their investment, residual values and asset re-marketability.

This eBook will help you think through the challenges ahead for aviation, so you can, hopefully, mitigate your risk, reduce your potential exposure and ensure that you can make robust, realistic decisions about your fleet.

Mark Byrne
Director, Martyn Fiddler

The longest Winter

During the worst of the pandemic, most airlines had practically no earnings, but the costs for staff, rent or fuel hedging continued and aircraft leases still had to be paid. At one stage, Lufthansa claimed they were losing about €1m *per hour* of reserves in operations alone. With all of these costs continuing – but no revenue, the airline industry had no choice but to shrink. In February 2021 IATA revealed 2020 as the worst year in history for airlines, announcing a net loss of $118bn ($33.7bn more than predicted at the start of the year). Continuous net losses of $47.7bm are expected for most during 2021.

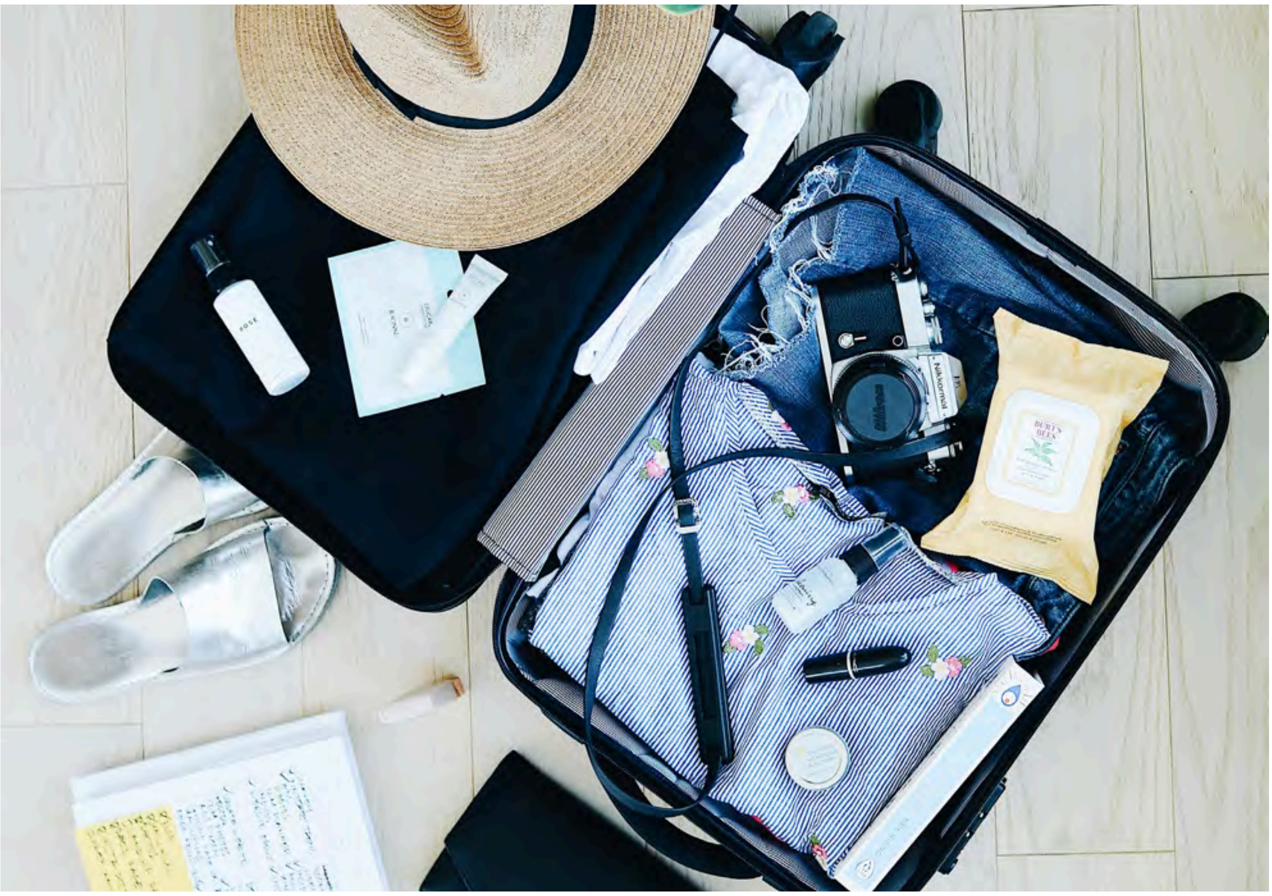


The first item on all airline's agenda at the start of the pandemic was how to reduce costs – immediately. In an industry with high fixed costs, this unfortunately means four things: heavy job cuts, salary reductions for those who stay, route reduction and aircraft fleeting resizing.

Quickly many airlines realised that this was not enough to keep them afloat. Many legacy carriers such as Lufthansa, Air France KLM, Qantas and even the U.S. airlines received government lifelines in various shapes and forms.

> IATA has estimated that government financial aid to airlines now exceeds $225 billion worldwide.

As we approach quarter 4 of 2021 the talk is about the recovery. Talk of V-shaped recoveries is positive – particularly for domestic travel in many countries. Cheap fuel is certainly helping. But while U.S. and Chinese domestic markets are making a nervous recovery, the prospects in Europe look shakier. European airlines have smaller domestic markets, are less profitable than U.S. and Asian rivals' and are more exposed to rail and road competition. This contrasts with larger unified markets in Asia and the Americas.



Any recovery in air travel will likely see more people flying for pleasure rather than for business. The mainstay of low-cost carriers across the globe - "visiting friends and relatives" (VFR) will be an important part of this. These types of passengers mean significantly lower yields compared to business customers.

When airlines think about investing in long-haul routes sometime in the future, many are expected to revert to the sort of network that was in vogue before the 2008 recession. This means funneling passengers through larger major city hubs like Frankfurt, Seoul and Tokyo and making passengers who want to go beyond use connecting flight paths. Smaller second and third tier city routes, point to point, are not likely to make a full recovery until the business traveler returns to the airport.

Fleet Size Reductions

The announcements by many airlines of sweeping 'post-Covid recovery plans' has resulted in the parking of a significant segment of the global airline fleet. This was compounded by issues prior to lockdown: the grounding of the Boeing 737 MAX, and the collapse of many airlines small and large.
At the height of the pandemic its estimated that nearly 17,000 passenger jets were grounded worldwide. Many large and old aircraft will never fly again with entire fleets being scrapped.

Aircraft parked at Hong Kong Airport

The commercial passenger jet fleet in service at the end of 2019 was around 23,700 units including regional jets, single-aisle and twin-aisle. The aircraft fleet operating in May 2020 was estimated to be around 16,350 units; implying more than 7,000 surplus aircraft - in addition to aircraft stored at the start of 2020. As of August 2021, there were still more than 2,500 aircraft in storage in Europe alone.

Even in China, which has had some level of recovery, just over 6,500 single and twin aisle passenger jets remained in storage in May 2021 due to lack of demand in long haul routes.

Negotiations with aircraft manufacturers with respect to postponing aircraft deliveries will be a feature for the foreseeable future. Airlines continue to cancel orders for aircraft with Airbus and Boeing left, right and centre, although new orders have started to come in for the latest narrow bodied aircraft.

> Airlines are using the opportunity to retire or return less environmentally friendly aircraft out of the fleet earlier than originally planned.

The shiny new aircraft purchased in the last year or two are still sitting in storage, and they may remain there for some time. However, most will return to the skies, because they're relatively new and fuel efficient.

Ramifications of Fleet Reductions

Simple economics implies that an oversupply of aircraft will lead to downward pressure on lease rentals, lower utilisation of aircraft portfolio, reduced residual values and increased aircraft redelivery and returns. Large numbers of lease terminations and aircraft re-deliveries are going to happen - this is unavoidable. However, aircraft owners know that poor discipline around re-delivering an aircraft can result in significant valuation impairments and losses.

The standard lease programme of every aircraft (Source: IATA)

1 Background → 2 Pre-delivery → 3 Delivery → 4 Operations → 5 Redelivery

The redelivery process is the final step in the aircraft leasing life-cycle. The redelivery date and the redelivery process are incredibly important because any unnecessary delays are extremely costly. The processes for redelivery of an aircraft upon lease expiry or an airline bankruptcy are clearly defined. According to Aircraft Monitor, these technical redelivery requirements are in four categories:

1. **Physical requirements:**
   assessment of the physical condition of the principal airframe units, its components, systems, and cabin interior

2. **Records requirements:**
   audit of all aircraft records to ensure they comply with terms and conditions set forth by the lease and the regulatory authorities

3. **Performance requirements:**
   aircraft operations and systems are in compliance with the terms and conditions of the lease

4. **Certification requirements:**
   compliance with local regulatory authority requirements and for cross-border transfers, compliance with the next lessee's regulatory requirements, such as EASA in Europe.

Redelivery processes, such as inspecting the aircraft and related documentation to ensure redelivery conditions have been met, ease transferability of the aircraft to a new lessee. The bigger the aircraft, the more challenging the redelivery process will be. For example, a Boeing 767 or Airbus 330 would take a minimum of two months, from the start of the return check until the return acceptance certificate is signed.

However, complying with redelivery operational requirements is just one part of a much larger ‘puzzle’. While every aircraft is different, what is similar are the redelivery implications in terms of aircraft registration (or re-registration), which – in turn, create ripple effects for financing and security, ownership structure, storage location and tax.

Analysing and managing registration choices, aircraft asset financing and security issues, asset storage location options, asset ownership vehicles as well as tax consequences are particularly complex. In-house expertise in this area is not necessarily something every airline or lessor has, particularly smaller lessors and carriers.

However, the cost implications of each of these factors – aside from redelivery operational requirements - can be staggering if managed incorrectly. The numbers are big: in the EU, if the VAT is not managed correctly, tax of up to 27% may be due - immediately. Given the costs of even the oldest narrowbody runs into eight figures, and a redelivery that is inefficiently handled can cost millions – and the bill might have to be paid on the spot. To put that into context, the unnecessary expenditure would be enough to fund months of lease rental for an aircraft or even a Heavy C Check.

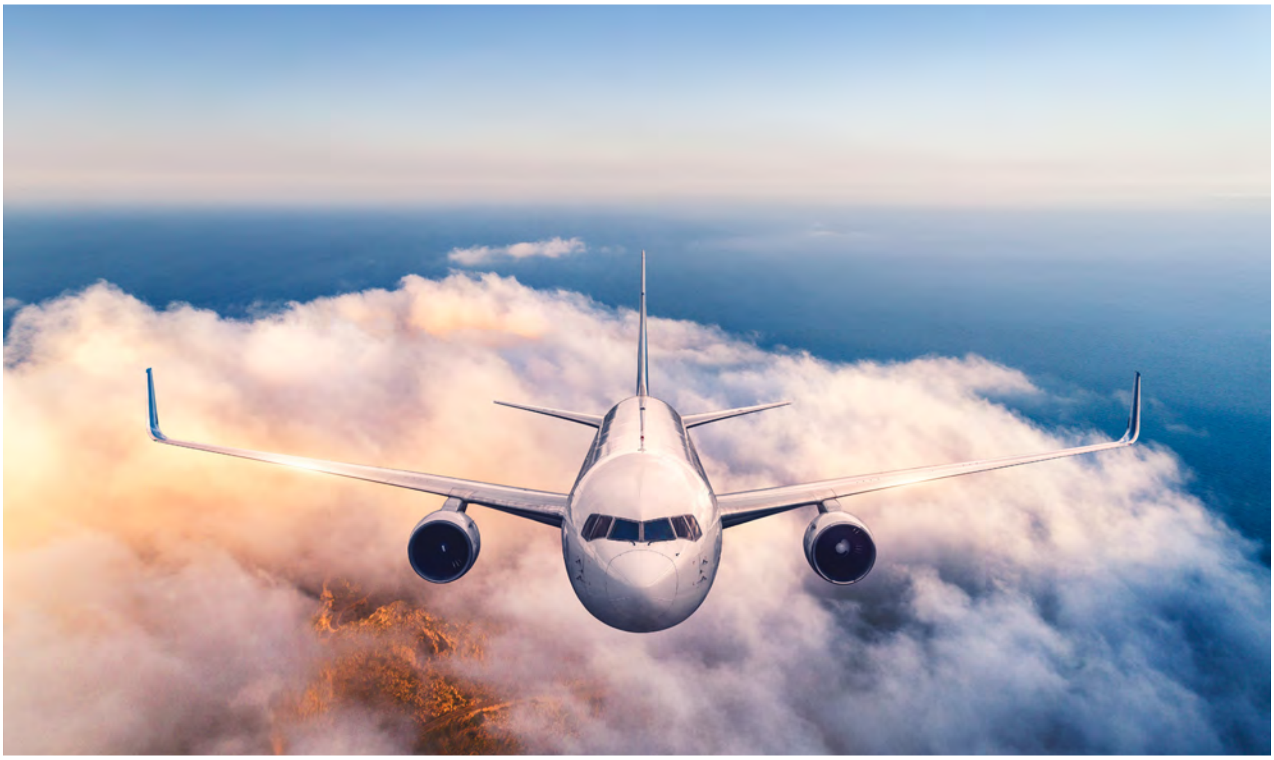
Lack of planning, late engagement or underestimating effort of managing every part the redelivery puzzle can mean unpleasant – and expensive – surprises. Fortunately, there are a number of solutions to address each of these problems.

Emirates COO, Adel Ahmad Al Redha summarises the world view of most airlines:

‘We will need to redefine some of the operating model... because surely what used to work for us in the past is not going to work for us going forward. We cannot sustain long-term operating on that kind of fleet. We need to inject the smaller type’.

Informed Choices: Understanding the Financial Issues for Returning Aircraft

Aircraft are called 'hard, illiquid assets' for a reason: they require large initial investments, financed with a significant level of debt, in return, they offer relatively predictable cash flows. Few assets are more expensive than an aircraft, and, as a result the cost implications are commensurately weighty. Aircraft are moveable. Such expensive mobile assets make assessments a real challenge - even for the experts. Certainty of tax exposure and risk mitigation is the priority.



On return of an aircraft to a lessor, a lessor will (in almost all circumstances) want to change the jurisdiction of registration of the aircraft for the period it is 'off lease', known as a lease transition. This potential change of jurisdiction during transition is a 'trigger' for a whole raft of challenges.

There are lots of options available for aircraft registrations when an aircraft is coming off-lease, and, as a result, there are an increasing range of competing factors. While the choice of registry location is generally flexible, it does remain an important choice. A lease transition is one of the few times that aircraft owners get a choice of registration – and the choices are typically down to speed and cost.

There are four frames of reference that need to be considered when selecting an appropriate location for aircraft registration - regardless of whether the aircraft is being registered for a ‘transitional’ period or a longer period of time.

1. **Aircraft Register Efficiency:**
   The choice of registration should be driven by the speed, efficiency, flexibility and all-round customer-focussed approach. Efficiency varies significantly and as such, is of critical concern to lessors. There are only a handful of aircraft registers (Isle of Man, San Marino, Guernsey for example) that specialise in transitional aircraft and can re-register aircraft in hours rather than days or weeks.

2. **Finance and security:**
   Commercial aircraft are financed either by a single or syndicate of lenders. In both cases the financier is concerned about protecting its security over the aircraft. Moving an aircraft from one register to another means that the registered aircraft mortgage will also need to be moved. This means the selection of transitional aircraft registry will need to be agreed with the financier in advance. Selecting a creditor friendly aircraft register with robust legal protection is an important factor to get the agreement of the lender.

3. **Tax:**
   The removal of a leasee or change in registration can cause unintended tax consequences resulting from the nationality of the aircraft, the lessor and/or the ownership structure. Some EU states are better than others for importation of aircraft, so the choice of jurisdiction means a significant saving could be made and how much tax is payable - or when it has to be paid. The potential to mitigate such tax consequences is a significant factor in selecting one registry over another.

4. **Regulatory and safety standards of a registry:**
   The flexibility of the register to accept aircraft of different certification types, high safety standards and good standing with ICAO are influencing factors. The standards of service provided by the registry will also encourage the choice of one registry over another for reasons of efficiency, helpfulness and ease of access.

Expert Choices: Creating a Solution

Choosing the aircraft registration is just one part of the choices that have to be made in transition. The level of complexity, however, does not stop there. All jurisdictions have tax implications. In Europe, it will likely be sales tax in the form of VAT, however, there may also be issues around corporation tax and capital gains tax. The challenge is that aircraft lessees can never be 100% sure which taxes are applicable or what their exposure is – many of the tax issues are transaction dependent.

For example, aircraft are generally zero-rated for VAT, and, as such, commercial aircraft are zero-rated on importation to a new jurisdiction. However, there are some aircraft for which zero-rate VAT is not appropriate and the VAT has to be paid and reclaimed. Importantly, this would include aircraft that are no longer destined to be flown by an airline. Any aircraft simply held for storage or being flown into a new jurisdiction without a lease in place to an airline would be subject to the full VAT rate for that country. The language becomes part of the challenge: the UK and Ireland use zero rate for VAT but the rest of the EU would probably use exempt to describe the same thing.

Another consideration is not only the country of import, but also where it is flying from. If the aircraft is flying into a jurisdiction for the purposes of importation, then where the aircraft is flying from is also important. It is better to have an aircraft fly into a jurisdiction from a place located outside of the EU or UK if that is where it is being imported.

The Butterfly Effect

The butterfly effect occurs where a small change in starting conditions can lead to vastly different outcomes.

The butterfly effect is the same for understanding the financial issues when making a decision about returning an aircraft. The first decision can trigger a totally different set of tax issues, and no two situations are the same.

> Decisions matter, choice of solutions matter and the structure of the solution matters. Choosing the right solution can result in millions of cost savings.

There are individual structures that are used in the trade. For example, SPVs – special purpose vehicles which are worth examining to understand what's possible.

Special Purpose Vehicle (SPV)

A special purpose vehicle, also called a special purpose entity (SPE), is a subsidiary created by a parent company to isolate financial risk. An SPV is created as a separate company with its own balance sheet. Its legal status as a separate company makes its obligations secure even if the parent company goes bankrupt. SPVs are a very useful structure for aircraft ownership for a number of reasons:

1. **Bankruptcy remoteness:**
   SPVs are sometimes called a bankruptcy-remote entity as they are often used to reduce any negative financial impact upon the parent company.

2. **Limiting liability:**
   Liability rests in the SPV and is limited to the assets within the entity. The shareholders are not deemed liable for the debts of the company. When the company is liquidated the ability to take action against that company is heavily restricted.

3. **Anonymity:**
   Certain jurisdictions hold Beneficial Owner registers that are only accessible to the authorities and those with a legitimate interest.

4. **Restricting actions:**
   Interested parties can influence the ability of the company to undertake certain actions through the construction of its constitutional documents, allowing greater certainty of what is and is not permissible with an asset.

5. **Access to different legal or tax systems:**
   Setting up an SPV in a different legal regime means the entity must comply with the laws under which they are governed. This can mean access to a more favourable transaction or ownership arrangement structure which might otherwise be unavailable. For example, a creditor friendly aircraft register with robust legal protection using an SPV could mean the difference in terms of getting the agreement of the lender or the ability to transfer an aircraft mortgage registration.

SPVs and VAT Deferral

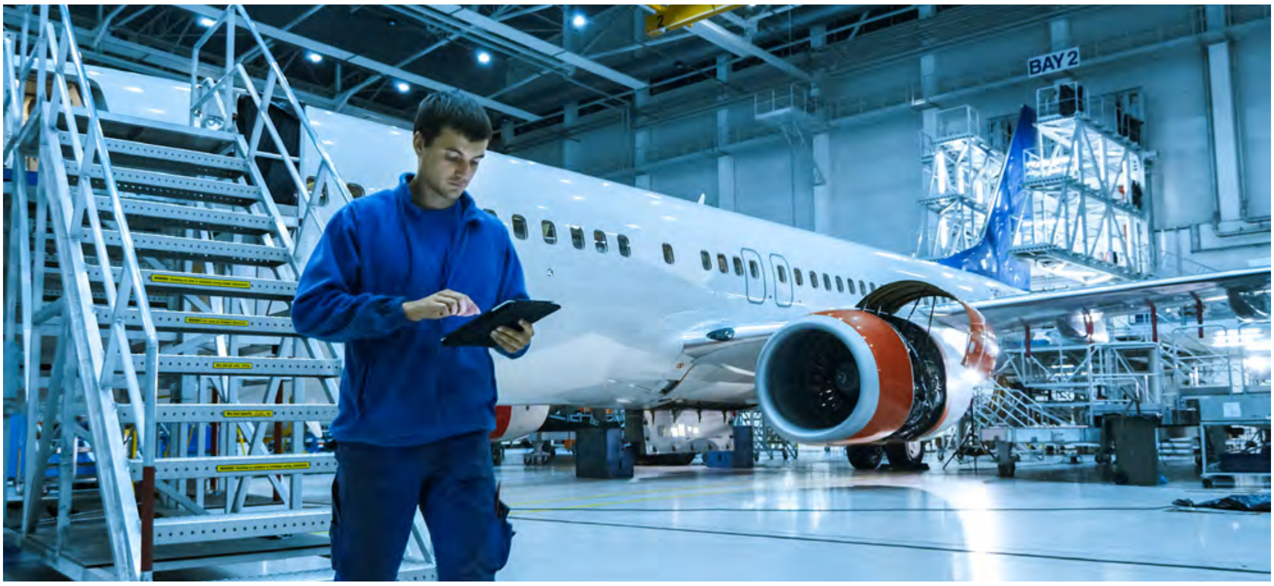
A particularly interesting capability of SPVs is VAT Deferral. For example, imagine the situation where an aircraft enters the EU after being returned at the end of a lease period in Asia; the aircraft will not have a VAT status as it is no longer being operated by an airline. VAT would be due at the time and date of arrival as it would no longer be zero rated for VAT because the aircraft is no longer operated by an airline. The aircraft may be held by the authorities until the VAT is paid.

However, some jurisdictions allow certain VAT registered traders to hold a VAT deferral account which allows the payment of VAT to be deferred until a future date. This can mean a significant cash flow saving as the VAT registered SPV can submit a return to reclaim all applicable VAT including the deferred VAT. The SPV will be reclaiming VAT it has yet to actually pay, and, as a result, the VAT authority will offset one against the other with no VAT payment necessary. This is an elegant method of assisting cashflow for aircraft owners who might otherwise have to fund large VAT payments.

Virtual Customs Warehouse

A customs warehouse refers to a defined area or facility within a specified UK airport under an approved authorisation which enables an aircraft that is not in UK free circulation to be stored or sold in the UK without incurring a VAT or customs liability.

Ordinarily when an aircraft crosses the border into any customs territory the importer is liable to account for Customs Duties including Import VAT.. However this Customs regime allows for Customs Duties, including Import VAT, to be suspended when non imported aircraft are brought directly into a Customs Warehouse.



The EU legislation also made provision for Member States to choose to also relieve such assets, including aircraft, from a charge to local VAT when they are sold while still inside the Customs Warehouse. The UK adopted this relief, thus allowing sales of aircraft inside a Customs Warehouse to be free from UK VAT. The UK has retained this relief post-Brexit. As the UK is no longer a part of the EU, this therefore also means that aircraft can be sold in a UK Customs Warehouse free from both UK and EU VAT, while still able to access suitable tech support on the ground. Post the sale the aircraft can then be imported into the UK or the EU, moved to another Customs relief regime such as Inward Processing, or removed from the territory altogether. This use of a UK Customs Warehouse protects the seller from VAT liability risk and offers the purchaser the option to re-import or not into the UK and/or the EU as required. There are also legal and financial benefits in being able to close on the ground in the UK, and, as an additional benefit, there is no time restriction for how long an aircraft can remain in a UK Customs Warehouse while there is a need for tax free storage.

Consequently, post Brexit, UK Customs Warehouse facilities have become an increasingly popular choice for closing transactions.

Conclusion

COVID-19 has touched the world of aviation in a far more profound way than any other crisis before. The level of groundings, shutdowns, cancellations and aircraft returns mean the industry is in uncharted territory.

The total effect of the crisis is unknown. This certainty is seen by the level of aircraft returns to owners and lessors.

There are many factors influencing aircraft returns - far more than simply the type and condition of the aircraft. Aircraft leasing companies are naturally keen to ensure that their aircraft assets and associated records are appropriate because an aircraft without proper maintenance and records is not worth very much. Whilst the level of expertise around technical redelivery requirements is well known, with very specific processes, the issues of registration, ownership and tax structures are much less.

> Understanding what is possible – and what is avoidable – is incredibly challenging. Reams of paperwork mean an increased risk of mistakes. A VAT bill of up to 27% of a $100 million aircraft asset would be quite a significant mistake to make.

It's important that lessors or lessees don't find themselves with unexpected – and avoidable - tax obligations. In the current pandemic environment, many airlines are going under, leaving aircraft lessees with exposure to tax liabilities that were neither accounted for nor anticipated when taking back the asset.

The volume of aircraft assets being returned as a result of the pandemic means that leasing companies do not have tax and related liabilities uppermost in their minds. The first step to avoid this problem is to do an audit of the aircraft portfolio and identify whether or not matters have been dealt with correctly. If they have been addressed properly, then due diligence and compliance have been addressed correctly. If they have not been addressed, it is still possible to identify and fix the problems before they create a weighty tax bill that must be paid immediately.

The good news is that aircraft owners, lessors and lessees do not have to know all these issues. Indeed, many of these issues are simply too technical (or rarely encountered) for anyone other than a specialist to address. The correct solution can protects lessors and lessees and gives each stakeholder the peace of mind to know that their asset is protected, their exposure is minimised and their assets can continue to earn revenue.