OPERATORS ADDING VALUE

By Aoife O' Sullivan

The general feeling of manufacturers at EBACE this year appeared to be one of cautious optimism. Embraer have stated that they believe the market for business jets will not begin to recover from its post-financial crisis slump until 2012 at the earliest. Almost 14% of the global business jet fleet - around 2,500 aircraft - is up for sale, up from 12% before the crisis, as key reasons for the apparent delivery lag. Smaller aircraft have been hardest hit and as a result, manufacturers will reduce production in 2011 to cope; for example Embraer will cut the output of its Phenom 100 and 300 business jets to 100, down from 126 in 2010.

While industry deliveries are not expected to improve significantly in 2011, key indicators are showing an upward trend, and it is expected that business aircraft deliveries will continue to grow in 2012. In addition, with a widening customer base for business aircraft - especially in high-growth economies - Bombardier anticipates that North America, Europe and China will be the three most active markets going forward and will generate the most revenues over the next 20 years.

ATTENTION
Since the recession financiers have taken much more interest in the training of crew and the correct safety procedures.

Gulfstream President Joe Lombardo echoed this forecast at EBACE, saying that Gulfstream continues to see strong and growing demand from countries outside North America, even as its home market in the U.S. recovers. "Although about 70 per cent of sales in the last quarter were international, with about half of those coming from Asia, corporate customers in the U.S. are returning to the market as well," he said. "Additionally, we are seeing positive market indicators, including Gulfstream fleet hours, which have just about returned to 2008, pre-recession levels. We remain optimistic and are committed to our investment plans, which will position us well for the future."

Zenith Jet sees discernable regional trends taking shape over the next 10 years. "For example, the international market will favor primarily a wide body profile. In terms of narrow body demand internationally, it will be predominantly split between Cessna and Embraer. Also, the percentage of new customers to Business Aviation (primarily coming from emerging markets) will be unprecedented over the next 10 years. Regarding regional unit delivery performance, the trend of emerging markets contributing to growth and favoring the international market for orders over the North American installed base will continue. Latin America, Asia, the US, Russia and Africa will be significant drivers for growth while Europe and the Middle East deal with indigenous issues that may prevent them from realizing their true demand potential".

Zenith Jet believes the fiercest competition between the manufacturers is mounted in the Super Midsize segment. "Virtually every single competitor has a particular value proposition it successfully leverages to secure market share. All six aircraft OEMs will have a product in this segment as of 2017. The segment is arguably the most strategic in Business Aviation as it occupies a "sweet-spot" where manufacturers draw on the installed bases of several segments (up and down the segment scale) to secure orders. In terms of unit delivery and revenue performance for the super midsize segment over the forecast period, it will secure over 1,300 units and approximately $30 billion in revenues".

Summary of Zenith Jet Business Aviation 10 Year Market Forecast (2011-2020)

- Total deliveries over forecast period (2011-2020): 11,103 units
- Total billings (revenues): $240 billion
- Expected compounded annual growth of new aircraft deliveries, 2011-2016: 15%
- A notable increase in demand for long range and large business jets will continue from emerging markets
- Increased price competition will characterize the long range business jet market as OEMs look to capitalize on demand
- Order backlog levels likely to decline in short-term as manufacturers manage the alignment of their order intake and production rates
- Demand for light and mid-size business jets remains weak, but production levels will ramp up quickly as market recovers
- Opportunities exist for OEMs to develop new clean sheet designs as existing airframe platforms are increasingly unlikely to yield successful derivatives

The Financing Requirement

Clearly not all buyers are cash buyers and the ability of the industry to be supported by bank finance is essential to keep order books open and encourage secondary and subsequent sales. 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 again. All the major players (e.g. Credit Suisse, SocGen, Barclays, BAML, GE) were at EBACE this year and all say they are very much back. Some indeed, never left the market, but all in all the approach to aircraft as a credit risk was and has been very cautious and this looks set to continue. 100% non recourse financing is very much a thing of the past (and that's no bad thing). 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. lease with a purchase option) which can have the added attraction of tax benefits and allowances.

Up to recently, financiers have tended to look at aircraft finance from a repossession or loss risk: "what happens if the lessee defaults / what if the asset is destroyed". The knock-on effect of lessons learned through the recession is that the banks and financiers are taking (or should take) a lot more interest in the operation of the aircraft, training of crew, application of correct safety procedures etc. They have noted the effect good operation can have on the credit profile of a transaction towards protecting the current life of the asset through to residual value. So, good news for operators, you are back in demand. A respectful and on-going working relationship between the borrower, operator and bank should assist all three if any issues arise and in many cases, may help to prevent such issues arising at all.

What is an Operator?

The operation of private and business jets tends to be divided into three separate categories:

1. Business Aviation Commercial - aircraft flown for business purposes by an operator having a commercial operating certificate under public transport regulations and an air operators certificate ("AOC");
2. Corporate Private - non-commercial operations by professional crews employed to fly the aircraft; and
3. Owner operated - Aircraft flown for business or private purposes by the owner of the business.

The commercial decision behind the choice of the owner tends to fall not only on cost but also on regulatory restrictions. Private aircraft do not have the same restrictions as those flown for public transport (most notably in respect to flight time limitations and runway length).

In terms of financing risk, there is a very real difference between all three. A valid AOC and operating license is mandatory for companies offering charter flights in Europe. Similar legislation, Part 135, is issued by the Federal Aviation Administration (FAA) for operators doing business in the United States. The licenses certify compliance with regulations, the competence of personnel and flight safety. An operating license is granted if the operator shows, not only sufficient financial strength, but also that it meets all legal requirements put in place including adequate insurance coverage. Aircraft placed « on an AOC » will be subject to an operation or management agreement, an essential term of which will be passing all responsibility for operational, maintenance and regulatory compliance to the AOC holder and away from the owner.

In all other cases, the responsibility for operation of the aircraft rests with the owner to varying degrees. It is possible to contract the services of a private management company but they will rarely take full operational risk and responsibility – they tend to act as subcontractors for various aspects of the operation of the aircraft. The owner operated category is exactly that – the owner takes on operational responsibility himself and does not assign responsibility to anyone else.

A genuine concern in recent times has been a trend for public transport flights being carried out by unscrupulous operators or owners who do not hold AOCs, contrary to regulation. The resurgence of this type of illegal charter flight caused EBAA representatives to issue warnings about the dangers for passengers. The EBAA publication « Is my flight legal » urges passengers to thoroughly check the licensing and other information related to their flight and the company they have chosen, and remind them that in the case of non compliance with the legislation by the operator, the passenger can be taking the risk of flying without insurance coverage.

It is fair to say that operation of aircraft by AOC holders is not necessarily at a higher standard. Some owner operators and private management companies will have undertaken a full conversion course on the aircraft and will be willing to undergo regular refresher training plus the mandatory checks in accordance with regulation.

The problem for the financiers however is that they are usually not well-equipped to gauge the professionalism of the owner operator and the private manager – taking the aircraft to the AOC holder tends to be a way of relying instead on the regulators who issue them their license to operate and keep them under regular audit. Banks who lease instead of finance through loans in legal terms remain the owner of the aircraft – the borrower becomes the lessee. Allowing the borrower to operate the aircraft itself instead of insisting on using a professional management company can put the bank itself at risk – no matter how well-drafted the loan agreements, some civil and criminal liability remains strictly with the legal owner of the aircraft.

For example, it is the aircraft operator's responsibility in Europe to ensure that insurance cover, in accordance with EU regulations, exists for each flight. The regulation defines aircraft operator as the person or entity, not being an air carrier, who has continual effective disposal of the use or operation of the aircraft; the natural or legal person in whose name the aircraft is registered shall be presumed to be the operator, unless that person can prove that another person is the operator.

DUTY
In Europe, aircraft operators must ensure that insurance cover exists for each flight.

Protection Operators Can Give Financiers:

1. The Tripartite Agreement

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 "tri-partite" or "multi-party agreement". Often predicated by certain banks as "standard in the industry", "every other operator signs it", the tripartite agreement is a powerful document in a bank's hands and it should be taken very seriously by Operators. 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 their asset is properly protected and operated to a high standard).

So why do operators sign these agreements? The good news is that professional operators should not have an issue with most, if not all of these covenants, except to note that in signing the tripartite agreement they are now contracting themselves to the bank and not just the borrower. 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.

On a day-to-day level the form and content of these agreements should not trouble operators, provided the agreement has been negotiated sensibly with the bank and does not contain unusually onerous clauses. 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.

Importantly for the financier, the operator will be the person in possession of the aircraft at all times – the AOC does not allow them to part with control save for the purposes of maintenance. In the event of a default under the loan agreements, the operator can become the most useful person in the room to a financier wanting to move the aircraft quickly to a safe and secure location away from an errant borrower.

POSITIVE
Thankfully, financiers are now far more concerned with aircraft operations.

2. Pre-purchase process

A pre-purchase inspection (PPI) should be part of any sensible acquisition process. Incredibly, financiers do not always insist on this, nor do they even seek sight of the report. The PPI report will highlight any issues with the aircraft and will indicate any previous maintenance or damage history. Most good operators will have the facility on hand to carry out the inspection – it is in their vested interested to get the PPI right as they will otherwise have to deal with the issues on that aircraft doing the course of management. Operators will have teams familiar with different types and models of aircraft and in many cases will bring a lot of previous experience and insight to the PPI process.

3. Insurance cover

On April 30th 2005, EC Regulation EC 785/2004 on insurance requirements for air carriers and aircraft operators came into force. The Regulation was subsequently amended on April 6th 2010. The Regulation, as amended, specifies the minimum levels of insurance required by aircraft operators and air carriers in respect of third party cover, passenger cover and cover for risks of war and terrorism. It is a legal requirement that aircraft carry this cover. Keeping the premiums up to date is essential to ensure compliance with regulation but also to ensure the liability of the owner and the financier is protected.

Many operators offer what is known as "fleet policy" insurance. The operator takes out a policy and aircraft under its management can be added to the policy. Due to economies of scale, the operator may be able to obtain better premiums and more extensive coverage that that available to an owner under a single policy.

Operators have a vested interest in keeping the insurance cover current as they themselves are covered in the event of a loss and in many cases the fact that they were the operator at the time of a loss will mean they will be implicated in any claim. There is no benefit to an operator withholding premiums or putting insurance at risk. For banks this is an important issue – many borrowers who are heading into default will often stop paying everyone else before the bank becomes aware there is an issue. Financiers tend to rely on brokers letters of undertaking which promise to inform the bank if the owner stops paying premiums or if the insurance is about to lapse – the security risk however is that the broker is not legally bound by such letters and in any case the letter may arrive too late. Better to rely on the operator's policy in such case.

Conclusion

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 are quickly addressed. Hiring an operator to manage the aircraft should not be about the ability to put the aircraft to charter and earn revenue income against finance: it is also about ensuring the asset is protected to the best extent possible.

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