INSIGHT

Paper planes: the financing of aircraft pre-delivery payments

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There has been a notable upsurge – or, rather, resurge – in commercial aircraft pre-delivery payment ("PDP") financing over the past 12 to 18 months. This is in no small part thanks to the emergence of new PDP financiers, the most notable of which being aircraft lessors. It is also thanks to billions of dollars of new aircraft orders, representing what is likely now the largest commercial aircraft order book (and PDP bill) in history. Often viewed through the eyes of a financier as riskier in many ways, PDP financing can, if executed right, actually be less risky than traditional aircraft finance in many other ways. PDP financing is a study in the idea that where there are rewards, there are often risks; and where there are risks, there are often rewards, especially when the risks involved are understood and mitigated.

The consideration of select topics concerning PDP financing in this article is not exhaustive - and therefore, hopefully, not exhausting. It is intended to serve as a pathfinder in a market that is in a state of flux, yet relatively mature. This market warrants participation and investment, especially by those who can understand the complicated interrelationships and dynamics between aircraft/engine manufacturers ("OEMs"), their customers and their customers' PDP financiers. As with any elephant in a room, there is almost no way to get around, over or under an OEM in a PDP financing – nor is it advisable for one to try. Still, to imagine the words of one famed comedian were he to consider the typical dynamic between OEM and PDP financier in relation to complex questions of risk allocation today: whereas an OEM sees a glass as half full, and a PDP financier sees it as half empty, a pragmatist sees a glass that is already twice as big as it needs to be.

Paper planes

Commercial aircraft production takes a relatively long time, from several months to several years, even in relation to long-running production programs like the Boeing 737. As to why this is the case, it may be helpful to take the Boeing 737 as an example and consider that there are approximately 600,000 parts to be manufactured and installed on such an aircraft. The production process requires large expenditures of working capital by the OEMs, (such as Boeing, Airbus, Bombardier and Embraer) on account of facilities, materials, labor and sub-contracts. To mitigate their exposure and offset high ongoing pre-delivery costs, OEMs require their customers (whether airlines or lessors) to make periodic progress payments in the months prior to the delivery of the aircraft.[1]

PDPs are payable on the signing of the purchase agreement and on other dates in the run up to the scheduled delivery date of the aircraft in what is typically known as a “hard landing” (increasing) or a “soft landing” (decreasing) payment profile. These payments typically range between 15% to 30% of the total aircraft list/base/gross purchase price – i.e.: the price before discounts, credits, et cetera, which always serve in effect to reduce the aircraft’s list/base/gross price to varying degrees.[2] PDPs represent a significant commitment and outlay of cash by the airline or lessor customer, especially in the case of multiple aircraft orders which, depending on the aircraft type(s) in question, can easily reach into billions of dollars. These payments function to decrease liquidity for months (or years) without increasing revenue, and so PDP financing is often sought to help maintain accounting liquidity.

PDP financing most typically takes the form of a short to medium term secured loan facility, made available by a PDP financier to an aircraft purchaser to finance the payment of PDPs owed by to the OEM under the relevant purchase agreement. The loan disbursements are typically made by the PDP financier directly to the OEM. Repayment terms available in the market may vary, though they typically require that the loan be serviced quarterly, with a balloon or bullet repayment on the aircraft delivery date.

An impediment to a financing of this nature is that there is no aircraft, yet, that can be used as security. Indeed, there is little more than a "paper airplane", insofar as the main security available to a PDP financier is an assignment, by way of security, of the aircraft purchase agreement (which is not the same as, for example, a mortgage over an actual existing aircraft). In light of the foregoing, one can imagine that PDP financing is often viewed as much of corporate credit risk than the traditional modes of financing actual existing aircraft. Therein is the fundamental discomfort and risk for most would-be PDP financiers.

The way we were

The fundamental concepts of PDP financing are not new. A traditional form of PDP financing is one where the PDP loan is secured by an assignment by way of security (rather than outright assignment) of the rights of the customer under the purchase agreement as it relates to the aircraft/delivery positions whose PDPs are subject to the loan. The theory – and, indeed, historic position – was such that in a PDP loan default and enforcement scenario a PDP financier could simply step in and, upon payment of the remaining balance of the original purchase price, take delivery of an aircraft as if it were the original customer in all respects. The crux of this benefit would be the attractive purchase price at which the PDP financier could take delivery of the aircraft. Insofar as customers often receive significant discounts to the list/base/gross aircraft purchase prices, this right of the PDP financier to obtain delivery of an aircraft at below market prices and thereafter sell the aircraft at a higher price could, in theory, enable the financier to at least recover its loan. In addition, the PDP financiers did not typically offer 100% PDP funding, and so there was equity of the customer/borrower in the aircraft, which theoretically further improved the PDP financier's position. This is now mostly past, relegated to the category of "theory".

The elephant in the room

Past or present, the participation and "support" of the OEM in any PDP financing is mission-critical. To begin with, new aircraft purchase agreements are generally not assignable, even by way of security, without the express consent of the OEM. Further, long gone are the days when the OEM would provide a simple "yes" consent. No OEM will allow the entirety of the original purchase agreement to be assigned to any PDP financier. The nature and extent of such consent – and, therefore, the rights of the PDP financier to realize its security in the event of a borrower default – are almost certain to be subject to negotiation, and conditions. Unfortunately, such negotiation tends to be on an ad-hoc and case-by-case basis in a market that remains in flux insofar as customary practices and anticipated outcomes are concerned.

In fairness to the OEMs, it must be noted that the traditional forms of PDP financing often left the OEM on the short end of the bargain in a customer default scenario. This, in turn, led to a fundamental re-assessment by the OEMs of the commercial and legal issues that arose, potentially to their detriment, as a result of the need for a third party to be introduced into their otherwise bilateral relationship with their customer. The real tension centers the PDP financier's realisation of its security concerning the aircraft purchase agreement. PDP financiers may want flexibility to assign and should be able to do so without the OEM's consent provided certain conditions agreed with the OEM are met. OEMs, on the other hand, generally seek to control those assignments on the basis that they need to control the market for their products and prevent interference by lenders in manufacturers' legitimate marketing efforts. OEMs may (including for things like export control and sanctions) also have an interest in the identity of the end-users of their products.

The major OEMs are, on the whole, fairly cooperative – at least on account of the fact that the funds in question are, after all, being paid to them. The fact, however, is that they have certain interests (and preferences) that are not in-line with those of PDP financiers. As a general theme, these diverging interests are premised on the fact that OEMs prefer to have airlines and lessors as their customers, not their defaulted-on PDP financiers (who will likely re-market the aircraft in question, in competition with the OEM's sales efforts). Meanwhile, PDP financiers prefer to obtain maximum security, ideally all of the aircraft purchaser's rights (though not necessarily all of its obligations) under the purchase agreement. They also place significant reliance on the OEM's option – note: option, not obligation – to "buy-back" or, rather, buy-out the PDP financier.

A glass half empty and half full

There is no universal list of perennial issues between OEM and PDP financier. This is especially true in light of the changing cast of characters in the PDP financier community, namely the shift from banks to aircraft lessors. In the above light, the following is a list of headline issues typically available for negotiation between OEMs and PDP financiers in agreeing the terms of the OEM consent:

1. The disclosure of, and restrictions on amendment to the purchase agreement(s) and related documentation (including credit memoranda and side letters).
2. The PDP financier's "step-in" option price, including applicability of credit memoranda and price escalation caps.
3. The PDP financier's assumed ("stepped-in") rights in respect of matters of ranging from warranties to

service life policies to intellectual property indemnities.

4. The commercial and legal terms of the OEM buy-back option.
5. The availability of security over any buyer furnished equipment agreements that may affect the marketability of the aircraft in question.
6. The applicability and nature of standstill periods and cure option following default under the PDP loan and/or the aircraft purchase agreement.
7. The forward assignment (either absolute or by way of security) of its step-in rights by the PDP financier.
8. Waiver or limitation of any rights of set-off rights by the OEM.
9. The obligation to notify the OEM or the PDP financier in the event of a material breach, default or termination under the aircraft purchase agreement or the PDP loan respectively.
10. The "burden" of clawback risk, as discussed below.

Beware of the claw?

Of the list above, clawback risk is often the legal issue that causes the most (mis)apprehension. As such, it is helpful to devote some time to consider what exactly clawback is, and what it is not.

In bankruptcy and insolvency parlance, "clawback" generally refers to the risk that a liquidator or judge can claim back payments that were made by a company to a third party during the "hardening period" shortly preceding the company's bankruptcy. It is a means for the company's bankruptcy estate to regain monies in order to repay other creditors. The primary legal regime governing a company's bankruptcy will typically be its jurisdiction of incorporation, and in most jurisdictions clawback only applies to preferential, undervalue, unfair or fraudulent payments and transfers. In some jurisdictions, namely those based on Napoleonic systems of law (such as France, Italy and Argentina), there may be no such requirements, meaning that any payments made during the hardening period are at risk of being subject to clawback. Added to this is the fact that many jurisdictions, including the US, consider security deposits as a form of "cash collateral" paid by buyer to seller, and potentially refundable in certain (often, court-directed) instances during bankruptcy proceedings. If left unaddressed, clawback risk could prove to be fatal for the OEM or PDP financier. It is, therefore, a risk that must be properly mitigated – and it certainly can be.

First, it is worth noting that, to our knowledge, there have been no reported bankruptcy cases, anywhere, where aircraft PDPs have been successfully clawed back. Any airline/lessor (or liquidator thereof) requesting bankruptcy court approval for the clawback of PDPs faces significant legal challenges and likely bears the burden of proving that each payment was on a preferential, undervalue, unfair or fraudulent basis.

Second, OEMs seek to protect themselves from clawback risk by expressly stating in purchase agreements that the OEM will generally receive PDPs as the absolute owner thereof, and that the parties expressly agree that PDPs do not constitute any form of deposit. The language in question is often simple and precise, with a view to ensuring that it cannot be misinterpreted on adjudication.

Third, both OEMs and PDP financers can seek to protect themselves from clawback risk by working with the customer/borrower to employ some basic structured finance techniques in order to put in place a bankruptcy remote – note, not bankruptcy "proof" – structure. This is often done using special purpose vehicle(s) and trusts in jurisdictions with clawback risk. The key feature is the structural isolation or "de-linking" of the underlying pool of assets from the customer's/borrower's potential bankruptcy estate and potentially unfriendly bankruptcy regime.

Finally, if (for some remote reason) PDPs are ultimately required to be clawed back from the OEM, especially after the delivery of the aircraft in question, then the PDP financiers may (under the terms of an indemnity contained in an OEM consent agreement) be forced to pay the pre-delivery payments to the OEM. OEMs typically argue that the money was pledged to the PDP financier and it should therefore assume the risk of clawback. They argue that in most bankruptcy procedures the PDP financiers should have a successful prior claim to the OEM, though there could be a delay in recovering the monies. The OEMs are generally of the view that the PDP financiers are the appropriate parties to bear this structural risk, as they determine the structure of the loan transaction and manage the perfection of their security interest. In addition, the PDP financiers can price any remaining (remote) risk not addressed by the structure into the financing.

In short: beware of "the claw", but do not fear it.

The search for yield: new players and structures

Recently, commercial aircraft lessors have together become a major participant in the PDP finance market, especially in Asia. Emerging at a slower pace is another new funding source: private equity and special capital funds. The phrase "funding gap" is often over-used, but the availability of PDP financing has in the past been limited for all but the top airline and lessor credits by a handful of experienced banks, and rarely as a stand-alone product. Airlines have been quite vocal on this topic, while banks decried banking regulations that, rightly or wrongly, limited the institutional appetite for PDP financing further. This presented an opportunity for new entrants operating under different regimes and investment cases in their search for yield.

In regard to structures and products, the most notable development is that some aircraft lessors with their own aircraft orders and relationships with OEMs have been able to introduce a new PDP "financing" product through novation and slot sale structures that include pre-delivery leases. In such structures an airline's aircraft delivery position is effectively sold to a lessor, such that the airline is discharged from future PDPs and refunded any PDPs already made. The lessor will then make all future PDPs, while the airline enters into a pre-delivery operating lease with the lessor, under which the airline makes payments – often styled as a commitment fee - matching the PDPs payable by the lessor to the OEM. These types of structures are relatively new, and a significant issue at present is the absence of any discernable customary practice in relation to the new issues that arise in this context, especially involving termination of the original purchase agreement (or portions thereof) and assumption of relevant aircraft positions within the lessor-turned-PDP financer's own purchase agreement.

Aircraft lessors have also brought about variations to the typical PDP financing structures offered by banks, while often providing what is in effect still a loan facility for legal and accounting purposes, secured by the same style of assignment of the purchase agreement as discussed above. The OEMs are still becoming familiar with the concept of lessor-as-PDP financier, and the commercial consequences thereof. This has led to differing treatment by OEMs of different PDP financiers supporting different airlines, occasionally resulting in negotiated positions and outcomes that are counter-intuitive and otherwise unhelpful to the development of the PDP finance market – a market which may rightly be said to support the OEMs as much as it supports their customers.

As far as investment cases go, it can be argued that the shorter loan tenures, potential availability of full recourse corporate guarantees as credit enhancement, availability of traditional aircraft financing at aircraft delivery (i.e.: as built-in “take-out” financing), and potentially lower enforcement and remarketing costs, actually make PDP financing a rather attractive proposition for a financier when compared to traditional aircraft financing. This is especially true given the potentially higher margins. Added to this, in the specific case of aircraft lessors, is the fact that offering PDP financing provides a competitive edge in the context of sale and leaseback – allowing an aircraft lessor to secure a potential sale and leaseback transaction long before the competition for such a transaction even begins (typically, a year before delivery). Regardless of the prospective investment case or search for yield, PDP financing should not be viewed as an unsecured or pure corporate credit financing. It is properly viewed, and executed, as a form of secured aircraft financing, structurally superior to unsecured or pure corporate credit financing in many respects.

[1] While it is the case that most customers will try to have PDPs as a fixed percentage of the final (i.e.: well-discounted) price, they are very seldom, if ever, successful.

[2] Moreover, the agreed base price per aircraft in the purchase agreement will also then, subject to an agreed escalation formula – and, hopefully, a cap thereon - be escalated to increase in line with inflation from the date of the purchase agreement until the aircraft delivery date.

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