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AVIATION LEASING AGREEMENTS AS FINANCIAL PROPELLER FOR THE NEWCOMERS

Summary

It is possible nowadays to verify the efficacy of various aviation leasing agreements that have been in use during the last forty years. Hereafter the paper presents the most common of them, highlighting their role as propellers of a new financial strategy in the aviation market.

Key words: *low-cost airline, aviation leasing agreement, leasing aircraft agreement, sale and lease back aircraft agreement*

Introduction

Starting from the 60s and 70s, during the US deregulation process, the aviation network was increased thanks to new financial and company-supporting systems. Small-size air carriers had to face the subsidized presence of the strongest airlines. Under the old-fashioned set of rules concerning air carrier's liability¹, it was difficult for a newcomer to provide for every expense entirely by itself. Considering in particular the huge cost of an aircraft due to the oligopoly system², novel financial issues emerged with the aim of incentivizing new companies. Among such novel financial tools adopted by the airlines, the most common were – and still are – *the leasing aircraft agreement* and *the sale and lease back aircraft agreement*. In this paper these two different financial systems are discussed and experiences of airlines which took advantage of them are compared.

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¹ Currently, it is not easy for an air carrier to directly buy a new aircraft.

²E.g. aircrafts designated to the middle-long haul were and are made and sold by just two stakeholders: the US Boeing and the EU Airbus.

1. Aviation Leasing Agreements

Leasing agreements can be classified into different typologies according to their main goal. Among such different categories, we can differentiate between: 'financial leasing' and 'operating leasing'; and the most recent type, with different characteristics - the 'sale and lease back agreement'. As far as the financial system adopted by the air-carriers is concerned, I will not discuss the 'operating leasing agreement' because it is a contract characterised by the only purpose of granting the aircraft for rent on the condition that the lessee would buy the aircraft at the end of the agreement³. For this reason I consider it not necessary to focus the research on the 'operating leasing'.

1.1. Aviation Financial Leasing

Aviation financial leasing⁴ is a contract by which the **lessor** commits to buy an aircraft from the **supplier** with the only purpose to give, for a certain period of time, the management⁵, commercial use and material availability of such aircraft to the **lessee**, in return for a consideration known as rent. At the expiration date of the leasing contract, the parties could decide either to reconfirm a new leasing agreement or to sell the aircraft to the lessee compensating the residual worth of the aircraft. Commonly the jurists distinguish⁶ between the 'wet lease' and the 'dry lease'. The first one is characterised by the delivery of the aircraft as well as the equipment and the availability of the lessor's employees, that is the cabin crew. On the other hand, in the case of 'dry lease', the lessor delivers just the aircraft to the lessee who, as a consequence, has to provide by itself for equipment and cabin crew.

The lessee is typically an airline which needs to gather its resources (such as the fleet) to create or to enhance its business. As far as the aviation industry is concerned, the supplier is one of the few aircraft-

³ Please note that in this case the lessor and the supplier are one person.

⁴ For a more specific analysis see: Lefebvre D'Ovidio, Pescatore, Tullio, *Manuale di diritto della navigazione*, Milano, 2011, p. 392 ; A. MASUTTI e V. SCAGLIONE, *Il Leasing di Aeromobile*, in *I contratti del trasporto* (a cura di G. MORANDI), I, Bologna, 2013, p. 207.

⁵ Insomuch as the title of " aircraft operator", likewise it happens in hiring of aircraft agreement, is attributed to the lessee.

⁶ Be aware that this classification is related to financial leasing as well as to operating leasing; therefore it is not a prerogative of the financial leasing agreement.

builder companies, applying high prices for the aircraft due to the previously mentioned oligopoly market.

Currently, the two most common aircrafts used in the aviation market to cross middle haul routes are Boeing 737 (with different final series) and Airbus 320 family; the average prices of these aircraft range between 78.5 million USD and 113.5 million USD for Boeing 737⁷, as compared with 93.9 million USD and 102.8 million USD for Airbus 320 family⁸.

Typically the lessor is a leasing company characterised by a wide corporation stock totally dedicated to the purchasing of aircrafts on behalf of the lessee, following the set directives defined by the latter according to its needs⁹. Several leasing companies are operating in Europe, and pursuant to the ongoing financial aircraft¹⁰ leasing, they are currently owners of a high percentage of the aircrafts flying in the European sky. It is not difficult to imagine, on the basis of the numbers above mentioned¹¹, how the aircraft purchasing agreement could be onerous for a newcomer in the aviation market, as well as for an already operating air-carrier without a wide economic capacity. The financial leasing is also characterized by the transfer of 'all the risks and awards of ownership of an aircraft to the lessee'¹²; this is the reason referring to the lessee is actually equivalent to referring to the "aircraft operator". The transfer of risks and awards clearly is the reason behind the rent and

⁷ Data obtained from the following website: <http://www.boeing.com/company/about-bca/>.

⁸ Data obtained from the following website: <http://www.airbus.com/presscentre/pressreleases/press-release-detail/detail/new-airbus-aircraft-list-prices-for-2014/>.

⁹ The exact requirements' specification is more recurring in the maritime leasing.

¹⁰ As above mentioned, the most common typologies of aircrafts operating under the financial leasing in middle-haul are Boeing 737-series and Airbus 320-family. The Aircraft Leasing Company Macquarie AirFinance Ltd, according to its report, is the owner of 128 different aircrafts given in financial leasing to different air-carriers; in particular, of the total 128 aircrafts, the 48% is represented by Airbus 320-Family and the remaining 44% by Boeing 737-series. The related data are available on the following website: <http://www.macquarie.com/mgl/maf/aircraft-portfolio>. One of the most important Aircraft Leasing Company, the AERCAP Holdings N.V. has a fleet of more than 8 different kind of aircrafts, composed for the 50% of Airbus 320-Family and for the 25% of Boeing the 737-series; further information is available on the following website: <http://www.aercap.com/fleet>.

¹¹ See *supra* the average costs of the two kind of aircraft taken in exam.

¹² R. MARGO, *Aircraft Leasing: the Airline's Objective*, in *Air & Space Law*, Vol XXI, n. 4/5, 1996, pp. 166 in which the author refers to the Statement of Standard Accounting Practice (UK).

financial interests' composition and definition during the negotiation phase.

1.2. Aviation leasing agreements in the low cost air-carrier experience

Considering that the best-established air carriers were and are used to strengthen, as well as to revamp themselves, by means of financial leasing agreements, it almost stands to reason that the financial leasing system is widespread among the low cost air-carriers.

One of the most famous characteristics of the low cost philosophy is related to the fleet. The low-fare airlines are outfitted with a really young fleet¹³, an element which on one hand is a reason to brag, and on the other hand gives evidence of a marketing strategy. The use of a young fleet means low maintenance costs.

1.2.1. Case study: Ryanair financial leasing agreements

One of the most famous airline, which currently boasts 303 Boeing 737-800s in its fleet¹⁴, was born adopting this kind of financial incentive. In the dawning of Ryanair's history, in 1987, the starting fleet of aircrafts used by the Irish airline was composed of less than ten units, three¹⁵ of which were used by Ryanair in virtue of a financial full wet leasing¹⁶ in which the lessor was a Romanian airline Tarom. This financial move made it possible to institute new fifteen routes within UK and Ireland. One year later, Ryanair acquired further three BAC One-Eleven through other financial leasing agreements with Tarom, mounting up the number of carried passenger from 82,000 in the previous year, up to 322,000 carried passenger in 1988¹⁷. The early economic outburst was so impetuous that Ryanair, a few years later was able to purchase new aircrafts by itself.

¹³ On average, the airplanes belonging to the most famous low cost air-carriers are about 5 years old. In this sense see: R. ABEYRATNE, *Negligent Entrustment of Leased Aircraft and Crew: Some Legal Issues*, in *Air & Space Law*, Vol. XXXV, 2010.

¹⁴ Ryanair's fleet is increasing because of the last order of new 175 aircrafts.

¹⁵ The aircrafts were three BAC One-Eleven bearing the Ryanair livery.

¹⁶ Basically the Romanian Tarom provided to deliver several aircraft fully equipped and to entrust the necessity cabin crew to operate the Ryanair's flight.

¹⁷ Data obtained by the Ryanair declarations from the following website <http://corporate.ryanair.com/about-us/history-of-ryanair/>.

1.3. Aviation sale and lease back' agreement

The aviation sale and lease back is a more recent¹⁸ and less common¹⁹ form of financial agreement on the market, with particular reference to the aviation market. In this case we have two distinct parties: the **lessor** and the **lessee-supplier**. What makes this agreement different from simple leasing, is its two-sided character and its main purpose.

The lessee, who owns the aircraft, sells it to the lessor (who is a leasing company, as previously observed) and then takes back the aircraft under a leasing agreement for a certain period of time. The reason by virtue of which the lessee sells its aircraft to have it back by leasing from the lessor, lies on two objective conditions which usually occur in the lessee management: the aircraft, which is the object of the contract, is normally old and close to be dismissed, the airline-lessee is experiencing a hard economic period, and the lessee is looking for more advantageous taxation. The results of this business operation are quick availability of current assets during a financial crisis, retention of the whole management, use and control of the aircraft, hence leaving these aspects unchanged, just as they were before the selling. Moreover, other benefits consist of advantageous amortization' parameters and favourable tax regime on the goods that are usually adopted by the countries²⁰.

Now it is important to observe that, basically, this typology of financial agreement is not used to launch a newcomer on the aviation market; in fact, it is a recurring economic manoeuvre in case an airline is in a dreadful state and wants to renovate its economic position.

1.3.1. Case study: IndiGo 'sale and lease back'

The last few years have seen a spread in the use of this kind of contract, especially in Asia. In contrast to the theory by which this would be a typical contract used to avoid economic crisis, it has been observed that the 'sale and lease back agreement' was adopted by one of the wider

¹⁸ As a matter of fact, as it has been curiously observed in A. MASUTTI e V. SCAGLIONE, *Il Leasing di Aeromobile*, Ult. Op. Cit. pp. 208, the Sale and Lease Back agreement retraces the same contractual architecture of the *Constitutum Possessionis* which is a Medieval contract quite similar in purpose and structure than the new Sale and Lease Back.

¹⁹This consideration has been recorded by K. GÜNTHER and P. ERBACHER, *Aspects of Aircraft Leasing In Germany*, in *Air & Space Law*, Vol XVII, pp. 93.

²⁰ See the German case, before the CE interventions adopted during the 90's, in K. GÜNTHER and P. ERBACHER, *Aspects of Aircraft Leasing In Germany*, Ult. Op. Cit., pp. 92.

Asian low cost carriers, IndiGo, which entered as a new player on the Indian aviation market in 2006.

One year before its entry on the Indian aviation market, IndiGo purchased 100 Airbus 320-family planes and leased a part of them to several Leasing Companies such as Q Aviation, Hong Kong Aviation Capital and GECAS²¹. In 2011 IndiGo became popular because it was the protagonist of the largest single firm order²² for large jets in commercial aviation history; IndiGo, indeed, ordered 180 new Airbus 320-family planes. From 2011 to 2013 it has entered²³ into a total of 37 'sale and lease back' agreements, followed just by Virgin America which signed 35 contracts of the same kind.

It is clear that, this countertrend, is due to a broad financial means of the airline; IndiGo decided to invest its assets buying from the European supplier (Airbus) a certain number of aircrafts which were in part sold to several leasing companies, and then it leased those aircrafts back with the purpose to manage them performing its low-fare philosophy²⁴. The facts and the economic budgets adopted by IndiGo made it possible²⁵ for this airline to become the fourth biggest low-cost carrier in Asia.

Conclusions

As it has been outlined, different kinds of aviation leasing reflect the multiplicity of economic scenarios that can be encountered, both in Europe and worldwide. In regulatory terms, these financial tools have gained a broad endorsement both among the aviation stakeholders and the European institutions, insomuch that the European Parliament decided to add to the Reg. (CE) 1008/2008 several rules related to leasing

²¹ Information available from Ascend's website which manages the 'sale and lease back agreements' for IndiGo: <http://www.ascendworldwide.com/2011/02/indigo-set-to-sign-firm-order-for-180-a320-growing-fleet-to-120-aircraft-by-2025.html>

²² Orders like the above mentioned usually take place because the manufacturing company has applied a wide discount on the whole order.

²³ Data recorded by the aviation analysis website here mentioned: <http://www.flightglobal.com/news/articles/analysis-lccs-profit-from-sale-and-leaseback-strategy-386073/>.

²⁴ IndiGo is to all intents and purposes a low-fare carrier considering the basic characteristics of the 'low-fare template'; i.e. suddenly IndiGo has implemented the no-frills policy, that is to say it runs only one kind of aircraft (Airbus 320-family) etc.

²⁵ Data publicized on the Centre for Asia Pacific Aviation (better known as CAPA) website here mentioned: <http://centreforaviation.com/analysis/asia-pacific-2014-outlook-faster-growth-for-low-cost-airlines-as-lcc-fleet-reaches-1000-aircraft-146351>

agreements. It is clear, at this point, that aviation financial leasing and the sale and lease back agreements²⁶ were as promising for the last three decades of the twentieth century, as they are successful and widespread nowadays.

Literature

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UMOWY LEASINGOWE JAKO FINANSOWE KOŁO ZAMACHOWE DLA WCHODZĄCYCH NA RYNEK LINII LOTNICZYCH

Streszczenie

Po czterdziestu latach doświadczeń z różnego rodzaju umowami leasingowymi w przemyśle lotniczym można podjąć próbę oszacowania ich skuteczności. Niniejszy artykuł prezentuje najpopularniejsze formy umów leasingowych w przemyśle lotniczym i wskazuje na ich szczególną rolę w nowej strategii finansowej tego sektora.

Słowa kluczowe: *tanie linie lotnicze, umowa leasingowa w przemyśle lotniczym, umowa leasingowa statku powietrznego, umowa sprzedaży i leasingu zwrotnego statku powietrznego*

²⁶ This assumption is also valid for other kinds of aviation leasing, as well as the franchising aviation agreements.