

Following the first stage of asset management as a need to protect asset value, Angus von Schoenburg examines all the warning signs and aircraft lessor or investor should look out for to aid the detection of lessees that may default on their lease rentals.

Asset management part 2: warning signs

The first part of this series explored the importance of asset management in protecting an asset's value. The objective of this second article is to assess the role of asset management in preserving asset value when it becomes clear that airline lessees are beginning to experience financial difficulty.

This starts with an assessment of how active asset management can spot the indicators that lessees' creditworthiness is deteriorating. Most lessors and third-party managers would agree that formal insolvency proceedings are the least desirable outcome in most circumstances. The second part of this article will assess what measures can be implemented by the financing community to help lessees to overcome their difficulties or, if necessary, to take out their aircraft before any formal insolvency proceedings begin.

Warning signs

While a lessee's deteriorating financial performance or cashflow might seem an obvious signal that all is not well, Gary Fitzgerald, vice president of commercial at Avinco, points out that financial statements may not be available until it is almost too late.

Several other signs can often be spotted well in advance. For example, if a regular dialogue with a lessee reveals that passenger load factors are down, routes are being closed, or pressure on yields is growing due to either the general economic climate or increased competition, then this is likely to affect financial performance.

Dick Forsberg, head of risk and strategy at Avolon, points out that valuable financial and airline performance information of this nature, the provision of which is not usually required in standard lease documentation, can sometimes be found during the course of other contact with

the lessee, such as during technical visits. Monthly aircraft utilisation reports, which form part of the technical monitoring process can also reveal significant commercially valuable warning indicators. If, as Bill Cumberlandidge, executive director at KV Aviation, points out, this reveals a trend of reduced monthly usage then it can suggest that traffic is down on a fleetwide basis. Similarly, if there are unusually long periods when the aircraft is parked this may also be a cause for concern. The reasons for parking an individual aircraft, of course, may be genuinely technical and may not indicate reduced traffic at all, but this certainly merits further investigation by the lessor.

Part of any such investigation should also include a deeper analysis of how reduced utilisation compares to other operators of the same type of aircraft, particularly in the local area. This may shed further light on local competitive pressures.

If rental or maintenance reserve payments to lessors are increasingly late then this is obviously an area of greater alarm and would probably have been preceded by at least some of the issues above. If this is anything more than occasional, lessors and financiers will become more worried and an on-going dialogue with the lessee becomes more important.

If it is clear, for example, that payment dates are being missed because the banking payment system has slowed down, or lessees in developing countries are suffering from exchange control-related delays, such technical default type issues are usually resolved. If in parallel with payment delays, however, there is also a breakdown in communications with the lessee, or key staff are leaving the affected carrier, then the problem is more serious. If such a scenario persists, the lessor needs to assess their options as the passage of time rarely improves

communications or asset condition.

While direct payment obligations of rent or maintenance reserves to the lessor are easily monitored, amounts due to third parties are less immediately noticeable. If, for example, fees due to airports, fuel providers or Eurocontrol are increasingly delayed, this should also be a cause for concern. In the case of Eurocontrol, Keith Wilson partner at BLP, confirms that, in most leases, a letter authorising the lessor to access Eurocontrol payment history and amounts outstanding, is now standard practice. The ability to monitor any changes to a lessee's Eurocontrol payment record is therefore an accessible and useful indicator. While other third-party payment records may be harder to establish, certain indicators can be revealing. If, for example, credit terms from fuel suppliers have been tightened, or if providers are demanding immediate payment, this clearly indicates that others are also apprehensive.

Finally, the importance of warning signals that can be provided by good local market intelligence or external shocks should not be under-estimated. Local news articles, as well as the wider industry press can be a valuable source.

Many smaller second- or third-tier carriers are often ill-equipped to withstand a major change in local market conditions. If, for example, a major low-cost carrier (LCC) enters the market on certain key routes previously operated only by a niche operator this can quickly become a major concern for the incumbent and lead to substantial losses on those routes. Any such developments should concern those leasing aircraft to such an incumbent carrier. Occasionally local external shocks can have a similar effect. The Mexican swine flu epidemic in 2010 is often cited as an example of such a shock, which impacted the stability of certain airlines. Any political unrest is also likely to have a serious impact.



Technical warnings

For a lessor, one of the more obvious signals of financial difficulty in relation to technical aspects would be increased delays in maintenance reserve payments.

If this trend continues, it may constitute a default under the terms of the lease, but it may also affect the maintenance performed on the aircraft, thereby affecting its value. This signal may be less immediately obvious if any power-by-the-hour (PBH) maintenance agreements on engines are in place instead of reserves. If any concerns develop, a good relationship and dialogue with the relevant engine manufacturer would reveal if similar problems are appearing.

Part 1 of this series already stressed the importance of regular technical inspections. During the course of such visits any increase in adverse findings could be a cause for concern. If, for example, as Alan Robinson director of Aircraft Leasing and Management (ALM) points out, the list of deferred maintenance items has increased significantly between such inspections, it may indicate that the lessee is attempting to preserve its limited cash.

Robinson stresses that it is common for airlines experiencing cash shortages to minimise maintenance on those items that are mandatory. This might even include a lack of attention to non-mandatory cosmetic items in the cabin or service bulletins (SBs) that operators are not obliged to implement, but should clearly be completed.

Fitzgerald cautions, however, that care is needed in reaching such a conclusion. Some carriers try to minimise maintenance-related cash outlay in their

low seasons to preserve cash and catch up in peak season. So, if one inspection is completed in the peak season and the next is performed in the low season and the latter shows more deferrals then this may not, in isolation, be a matter for concern.

In combination with other findings during a technical inspection, such deferrals may prove more significant. Andrew Carlisle, previously chief technical officer at RBS, and now operating his own consultancy, Aviation-Appraisal Limited in Dublin, suggests that greater causes of concern are if a visit reveals there is less money to purchase spares or that a carrier is cutting back on its maintenance agreement with a third-party maintenance facility (MRO), or if third-party vendors are less willing to supply parts.

Any regular technical visits should verify the status of airworthiness directives (ADs). While a failure to comply with ADs could invalidate the airworthiness of the aircraft, it is unlikely that a cash-strapped operator would simply not comply if it wished to continue operations. Instead airlines might choose to comply on a temporary basis through ongoing inspections of the affected items. Such repetitive inspections can at least, for a period, avoid completing a terminating action on the affected items. Any failure to complete a terminating action on an AD may not only constitute non-compliance with the lease return conditions, but it may also reduce the value of that aircraft. This should therefore be important to any lessor, if such temporary compliance is emerging as a trend.

Since engines constitute such a large proportion of overall maintenance costs

One of the first warnings of a lessee experiencing financial difficulty is delayed payments for maintenance reserves. Airlines with financial problems often try to minimise maintenance.

and aircraft value, any adverse trends that arise during the term of a lease should be a cause for concern. According to Carlisle, engine overhaul costs can often push an airline into insolvency, particularly if several shop visits fall due in quick succession. Early warning signals could include off-wing engines for unusually long periods. While Mike Skinner, chief executive of AMS Aircraft says that an off-wing time of two months is relatively normal, if there is a trend towards engines being in the shop for more than three to four months, while the aircraft continues to operate with short-term leased engines, lessors should begin to worry. Similarly, if the operator is regularly extending its scheduled maintenance intervals on engines (a 10% life extension is typically permitted), this should also be monitored closely.

In the context of engine maintenance, the engine manufacturers can often be a clue to pending financial difficulties. If the relevant manufacturer is experiencing delayed payments under its PBH programmes this would be a concern to financiers, particularly if this is happening on a fleet-wide basis. Most lessors, therefore, agree that a good working relationship with the relevant engine manufacturer is an important warning mechanism. The worst scenario would be if any payment arrears threaten the continued validity of the PBH contract.

If a lessor becomes seriously concerned that the programme applicable to its aircraft may become invalid, such contracts often allow step-in rights for aircraft owners. This is particularly important for engine types where a majority of the powerplants in service are enrolled in PBH programmes. Any which are not enrolled would then suffer in terms of value. The majority of IAE-powered A320 operators, for example, have their engines enrolled in such a PBH agreement. Fewer CFM-powered aircraft are under such contracts.

If this possibility of a step-in exists, it can often be prudent for a lessor to consider exercising such a step-in clause to ensure that their engines remain fully covered in the event of a default. This, of course, assumes that the nature of the PBH contract avoids many of the pitfalls outlined in the previous article and can, for example, be readily transferred to a subsequent operator.



Contingency planning

If a lessor or lender has begun to identify trends whereby the survival of a lessee or borrower is in doubt, most would agree that a contingency plan to deal with a possible event of default is not just prudent, but essential on the basis that under any insolvency proceedings the last financier to take action is likely to be in the weakest position. Depending on the perceived risks of loans or leases to airlines, a contingency plan should be in place from the transaction's inception, rather than when difficulties start to appear.

According to Forsberg, the starting point for any contingency plan should be to determine whether the operator can survive its difficulties and recover, or whether the identified issues will lead to its failure.

Since some airlines in financial difficulty are likely to survive, a contingency plan based on a future insolvency is not always appropriate. It may be that an airline is suffering from excess capacity, or has ordered too many aircraft for delivery at times when they are no longer needed.

A recent example is Air Berlin, which has been seeking to cut capacity by a combination of agreeing sub-leases to other carriers, sale and leasebacks with relatively short-terms and trading delivery positions with the manufacturers.

Forsberg adds that while the manufacturers are likely to be involved in any such fleet restructuring process, the leasing community can assist such carriers in managing their fleets by moving aircraft between operators. Lessors are generally much better at placing excess capacity than airlines

themselves. This then becomes a form of proactive lease management, which helps both airlines and lessors to better manage capacity.

In any event, most would agree that an in-depth technical inspection of the aircraft should be an early component of any contingency plan irrespective of whether you believe the operator can survive. If the chances of survival are good, and part of any restructuring to achieve that plan involves redeploying aircraft, then the aircraft and its associated records will need to be in a condition to allow such alternative applications.

Conversely, if the chances of survival are poor, it is vital for the lessor to ensure that its asset is in as good a condition as is reasonably possible prior to any insolvency proceedings. It is also important to ensure that the carrier does not take components from the lessor's aircraft and install them on aircraft of other lessors or lenders.

According to Robinson, a detailed inspection of the aircraft and associated records at an early stage can be invaluable in protecting the value of an aircraft if bankruptcy is potentially looming. Such a detailed audit can ensure that many of the issues pertaining to a particular aircraft are understood prior to any possible repossession. An early inspection may also allow the airline's technical staff to rectify any defects, while it is still fully operational and engineers are still available. Such an inspection can also be used to identify any deficiencies in the records that can be corrected while relevant licences remain valid. At this point, if it is not already a regular part of the periodic inspection process, a full scan of the records should also be completed.

Contingency plans for the possibility of a lessee defaulting should be made. The last aircraft financier to take action is likely to be in the weakest position.

It may also be advisable to understand how electronic records are stored and managed in case this is required after any insolvency process. This might include an understanding of how to access any third-party computerised records management systems.

Carlisle adds that it may be advisable to use a specialist records management company such as Waviatech to scan the records and arrange a mechanism for their removal to a safe location should this become necessary. He cautions that if airline staff believe the operator is nearing bankruptcy, records can often disappear and this can become very costly if these need to be reconstituted or recovered. Furthermore, he suggests that it may even make sense to offer to employ some of the existing records management employees of the airline for a period of time if the carrier should fail.

Any contingency plan should also include what to do with the aircraft if a repossession becomes necessary. This includes making arrangements with an appropriate storage and maintenance, repair & overhaul (MRO) facility to which the aircraft can be ferried. Carlisle advises that if the endangered airline has a large fleet, suitable MRO facilities can get booked up quickly, so it is in the aircraft owners' interest to act quickly. Such an MRO facility should also have a continuing airworthiness maintenance organisation (CAMO) capability, otherwise this will need to be performed by another organisation if the operator fails and its licences are revoked.

Crews and fuel suppliers will also need to be arranged for any ferry flights. Insurance for ferry flights and ground storage would also need to be arranged as part of any plan. Part 3 of this series will examine some of these elements in further detail.

From a legal perspective, Wilson advises that a short review of the pertinent legal documentation should be a key component of any contingency plan, since the triggers for an event of a default under a lease or loan may vary considerably. While non-payment of rent and reserves will almost always be an event of default, there may be a myriad other clauses that could technically constitute an event of default, but which may not necessarily allow a lessor to act

Contingency plans should include what to do with the aircraft if a repossession becomes necessary. This includes arrangements for storage and ferrying.

under the documents.

A failure to provide financial information within the specified time limit could be such an event, but the same document may require a lengthy period during which the lessee or borrower may provide such information before allowing a default to be called.

Wilson also suggests that a further element of a legal review should be a plan for how to repossess an aircraft if necessary. The lease would normally define the habitual base of the aircraft and, depending on the jurisdiction, this may be an appropriate location for such action. Other locations may be better, so if it is possible to determine which routes the relevant aircraft fly, this may reveal better options. Furthermore, some jurisdictions that do not allow a self-help mechanism in the event of bankruptcy could force lengthy court proceedings. This can prevent aircraft recovery for several months.

Spain is a well-known European example where repossession can take considerable time. In this context, the advice of a local law firm can often be invaluable, so this should be arranged as part of such a planning process. The local advice may include a recommendation to arrange a friendly repossession prior to any insolvency proceedings. In any event Carlisle suggests that the appointment of an administrator and formal bankruptcy proceedings should be a last resort.

Wilson, however, cautions that formal proceedings may not always be the worst outcome. If, for example, a large North American carrier is in difficulty and the lessor's aircraft is likely to be kept in any Chapter 11 type reorganisation, then the appropriate strategy might be to ensure that the restructured airline keeps the aircraft. This would imply that a lessor or lender should plan for such negotiations which may include accepting a cram-down position on rentals, whereby the lessor has to accept a reduction in rentals in return for the aircraft being kept by the airline. This may be preferable to remarketing one of many aircraft that could come onto the market.

Should repossession become necessary, any legal review should include an analysis of what outstanding third-party liens could be triggered by such a process. If the aircraft is in Europe, the



powers of Eurocontrol to exercise a lien for non-payment of outstanding amounts owed is well known. Assuming that the lease documentation includes the appropriate ability to access payment history, the amount of any debts should be established as quickly as possible. Third-party MROs or airports may also have the ability to place a lien. Even if there is no legal right to do so, some may attempt to do so. Accordingly, part of any good plan should be to identify what creditors remain outstanding.

From a lessor's perspective, it is vital to review the terms of the existing financing arrangements. If a lessor has a loan from a lender secured by a mortgage over the aircraft, that party will have the majority of rights and remedies under the applicable loan agreement. The lender may wish to act independently to protect its position. As a lessor, therefore, the relationship with its lenders will be critical to any contingency plan. If the lessor can demonstrate to the lender that its processes and plans for managing its exposure to a struggling carrier are robust, then it is more likely that the lessor can remain in control.

A strategy for remarketing aircraft should also feature in contingency planning. While most lessors can perform this in-house, lenders and some smaller lessors may need external assistance. If an existing asset management service provider is not contracted for this service or cannot provide that capability, a third-party specialist would need to be ready. If this is left too late, good remarketing companies may be unavailable as they may have already been contracted by others and would have a conflict of

interest in acting for different owners of the same aircraft type.

Concluding remarks

The above early warning signals can only be detected if aircraft owners have a suitable asset management mechanism in place. The absence of one inevitably means that a strategy and required support would have to be established if a lessee or borrower is close to bankruptcy. By this time the value of the aircraft may already be seriously impaired, and the right service providers are already booked or would have too many conflicts of interest.

The contingency plans described are not exhaustive and would need to be amended according to the specific circumstances of the lessee concerned. This can be a more seamless and successful plan if it is prepared in advance. If it is then appropriately executed, in the event that aircraft need to be repossessed or financings restructured, there is no reason why investors in aircraft should lose out.

The third and final article will examine how the outlined contingency plans can be applied in the event of default or bankruptcy. This will include further detail on some of the items mentioned above, as well as possible impediments to repossession, de-registration, bridging maintenance and other aspects of a successful placement strategy. [AC](#)

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