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Challenges ahead for Chinese leasing companies’ aircraft remarketing? Not so fast…

Background
Will Chinese lessors overcome the expected remarketing ‘wave’ as their portfolios mature and initial leases expire? This has been a hot topic in aviation finance circles recently. Industry analysts consider Chinese leasing companies will face at least two challenges in remarketing these aircraft. First, given most Chinese lessors have only experienced growth, they have little expertise in remarketing aircraft. The argument follows that Chinese lessor marketing teams are inexperienced in this area and lack the global coverage to source second lease opportunities. Their risk systems may also not be ready for the move down the credit spectrum that second lessees often entail.

Second, Chinese lessor portfolios continue to have significant exposure to onshore PRC airlines which are predominately leased from Chinese free trade zones (FTZs) structures. Another industry view is that Chinese airline lessees only prefer new kit and do not extend leases on current-generation aircraft or lease in older, used aircraft, which sets up a difficult remarketing proposition even for experienced marketing teams. The market for used aircraft is largely offshore outside the PRC, but the aircraft are often onshore in FTZ structures from which extricating and exporting the aircraft are notoriously a struggle.

PwC Aviation Business Services analysis: The concerns held by the global air finance community may be misplaced. The near-term magnitude of the remarketing wave is manageable for PRC lessors, and there is time — three to five years — for the Chinese leasing community to build up teams and expertise before the task becomes materially larger. We note a number of Chinese lessors are actively trading aircraft out of their portfolios, for both profit and risk management reasons, and some have had success in lease extensions. We expect Chinese lessor experience in both will grow in the next few years and the community will continue to close any gaps with international peers.

Our insights
The remarketing task for Chinese leasing companies appears very manageable in 2020, though rises every year from 2021 to 2024, and increases significantly in 2025 when more than 10% of the current fleet will turn 12 years’ old in that calendar year. For 2020, we estimate there are only three aircraft of the circa 1,180 Chinese-managed aircraft which are with their first lessee and where information is not known about a lease extension. All three aircraft are narrow bodies and two are onshore in mainland China while one is offshore. The distinction is important as offshore aircraft can be considered to be more “remarketable” given they will not likely be leased via onshore FTZ structures. Ultimately, there is no remarketing challenge for Chinese lessors in 2020, in our view.

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Lease expiries

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Of which:

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Note: Data reflect estimated lease expiries for mainland China-based lessors based on when aircraft reach 12 years of age, and adjusted for known leases of terms shorter or longer than 12 years as well as known lease extensions.

As Chinese lessors grew aggressively in the early part of the 2010s decade, the number of aircraft reaching 12 years of age will grow as we head into the 2021-2024 period, all things being equal, increasing the expected remarketing exercise required by the aggregate Chinese leasing industry. These numbers can be observed in our table. Further, there is a quantum step up in the remarketing task for Chinese lessors in 2025, reflecting the number of 2013-vintage aircraft which entered the fleet as a result of deliveries, SLBs, and portfolio acquisitions by Chinese leasing companies. We forecast that 124 aircraft will come up for remarketing or lease extensions in 2025, or more than 10% of the current fleet managed by Chinese lessors.

Summarising the aggregate remarketing work faced by Chinese lessors over the next six years, roughly 250 aircraft or over 20% of the entire current Chinese lessor fleet will need to be remarketed — although this is heavily back-weighted with half of the task to be required for 2025 expiries alone. Underlining the challenge of the efforts ahead are two items worth highlighting: 1) 157 of the 250 are currently leased onshore in mainland China, which we note are nearly all expected to be in domestic lease structures, and 2) out of all these 157 onshore aircraft, only two are next-generation aircraft (both 787-8s); the rest are current-generation aircraft. Unless Chinese airline lessees change their behavioural pattern of a predilection for new aircraft, and begin extending leases or leasing used aircraft, the Chinese leasing community can expect to face a remarketing hurdle moving these aircraft outside China. Out of the entire subset of 250 aircraft we examined, only two 787-8s are next-generation aircraft. It is widely believed and accepted that remarketing used, current-generation aircraft will be easier in markets outside China, and for those owned in more flexible offshore leasing structures.
Looking ahead

Despite these difficulties, Chinese lessors have time to prepare. They will focus on the remarketing task for the next 12-18 months, which comprises circa 35 aircraft in total and some might have already found new homes or had their leases extended. The lessors have time to build up their marketing teams, build relationships globally with second-lease profile airlines (though perhaps not quite as much time to firm up their risk framework for these same lesser airline credits), and to trade out some of their exposures to these assets before the wave looms large in 2025. This is already occurring as the number of Chinese lessor portfolio sales offered in the market is increasing. PwC is confident in the growth, development and maturation of the Chinese aircraft leasing community to meet the challenges ahead and is ready to assist Chinese lessors in their efforts.

Methodology and assumptions

To arrive at our conclusion, we examined the fleet profile of nearly 1,180 aircraft managed by approximately 30 leasing companies based and headquartered on the mainland of China. (For the avoidance of doubt, global leasing companies owned by Chinese capital but headquartered outside the PRC mainland were not included in this exercise, such as BOC Aviation, CDB Aviation, and CALC, which are headquartered in Singapore, Ireland, and Hong Kong, respectively.)

As publicly available lease expiry data is scarce, we applied a set of rules and assumptions to quantify the remarketing task ahead for the Chinese lessors. The primary assumption is that the first lease term for new aircraft managed by Chinese leasing companies is 12 years. We then analysed the fleet data using aircraft age as a proxy for lease expiries, with the assumption that aircraft turning 12 years’ old during calendar year 2020 represent the remarketing ask for the Chinese lessors, and repeated the exercise for 2021-2025. We also made adjustments to the data where initial leases were known to be shorter than 12 years e.g. aircraft younger than 12 years are already flying for a second operator/lessee, and assumed all Chinese lessor-owned, factory-built freighters — all 777-200Fs — will be extended by their current Chinese operators as they turn 12, thus reducing the remarketing task.
Financing is one of the most important activities for the aircraft leasing industry.

As aircraft lessors in Asia continue to mature, there is an increasing desire for aircraft lessors to set up aviation investment funds of the type already commonly seen in North America, Europe and Australia.

In the current economic cycle, professional investors (such as insurance companies) in Asia are on the look-out for asset classes such as aircraft which can generate predictable and stable long term returns.

It’s no surprise we have been working on a number of aviation funds, side cars and similar off-balance sheet structures, considering the perspectives of both aircraft lessors and investors alike. Under our global professional services network, we are uniquely positioned to advise from an accounting/audit, tax and legal perspective to a range of participants exploring these types of structures.

We would like to introduce some common structural considerations, and particular issues around consolidation from an accounting standards perspective.

**Legal structure**

Aircraft leasing companies and fund managers often determine their preferred legal structure for their aircraft leasing fund by taking into account the degree of involvement and decision making power of their investors in the fund (that is, whether the investors would like to remain passive, or actively involved).

Common structures for aircraft leasing funds include an incorporated joint venture and limited liability partnership.

An incorporated joint venture and limited liability partnership are different in the following areas:
1. Life span;
2. Number of investors;
3. Decision-making process; and
4. Distribution policy.

**Incorporated joint venture** – by using the corporate structure, it allows investors who want to play an active role and have power on key decisions of the fund (for example, through board seats). The corporate structure will also be regulated by the laws of the relevant jurisdiction applying to companies where it is established. It can give the ability to investors to assert a greater degree of control (or, at least, a perception of greater control) over the fund’s strategy and investments, or be more involved with the fund manager, for example, so as to put themselves in a better position to gain industry knowledge, understand the strategy of the fund, investment choice, and be involved in the management of residual value risk.

**Limited liability partnership** – a Cayman Islands exempted limited partnership which is the most common type of private equity/venture capital fund structure used in Asia. The general partner (that is, the aircraft leasing company/fund manager) is granted with power on key business and operational decision of the fund. It will be suitable for aircraft leasing funds with target investors who play a passive role (the limited partners) as it provides better flexibility compared to a corporate company structure in the provision of how capital is raised, distributed and allocated (e.g., management fee and carried interest) etc. It also provides flexibility for key decisions of the fund to be referred to investors for approval (by way of an investor committee) before the general partner can exercise the relevant power on behalf of the fund. However, these types of structures are typically closed ended unlike a corporate structure that has infinite life. Similar, unlike a corporate structure, a limited partnership does not have a separate legal personality and therefore a limited partner may lose the benefit of limited liability if it engages in the conduct of the business of the partnership which is the domain of the general partner.

Regardless of structure, it is common for the aircraft leasing company, as the fund manager of the aircraft leasing fund, be given an equity stake in the platform. From an accounting perspective, the aircraft
leasing fund manager may need to consider carefully how the investment in the fund/platform will be accounted when setting up the structure and terms (including, whether the fund/platform has to be consolidated).

**Accounting considerations — consolidation assessment under International Financial Reporting Standards (IFRS)**

IFRS 10, ‘Consolidated Financial Statements’, sets out principles for the presentation and preparation of consolidated financial statements where an entity controls one or more other entities.

The assessment of whether an investor or any other party (for example, the fund manager/aircraft leasing company) controls a fund can be complex and depends heavily on facts and circumstances. The assessment has to be made, regardless of the nature of the investee’s involvement with the fund/platform.

An investor controls another entity, where it is: (a) exposed, or has rights, to variable returns from its involvement with the investee and has (b) the ability to affect those returns through (c) its power over the investee. All the three elements of power, exposure to variable returns and the ability to use power to affect returns must be present for control to exist.

While the consolidation assessment under the accounting standards is not straightforward, we have listed some key factors to consider when performing the assessment:

1. Purpose and business substance of the fund/platform;
2. Identify the relevant activities of the fund/platform: Activities of the investee that significantly affect the investee’s return. Relevant activities for an aircraft leasing fund/platform usually refers to:
   - Aircraft acquisition;
   - Leasing of aircraft to airlines;
   - Financing; and
   - Aircraft disposal;
3. Decision making process: who make decisions on the relevant activities and how decisions are made; and
4. Renewal, removal and replacement of fund manager/BoD members — In relation to a fund, the fund manager generally has some degree of power. However, the rights of other parties such as the investors might limit the power of the fund manager. Such rights need to be substantive if they are to have any influence on the decision over who controls the fund.

To evaluate whether rights give an investor power over an investee, the investor assesses whether its rights, and the rights held by others, are protective in nature. Protective rights relate to fundamental changes to activities of an investee, and they apply in exceptional circumstances, such as voting rights that can only decide on the winding up of a fund.

For a right to be substantive, the holder must have the practical ability to exercise the right when the decisions about the direction of the relevant activity need to be made. To determine whether the right is substantive, it needs to be assessed whether there are any economic or other barriers to its exercise.

5. Analysis of return and variability under different scenarios:Variable returns’ is a broad concept under IFRS 10; the standard sets out examples ranging from dividends to economies of scale, cost savings, tax benefits, access to future liquidity and access to proprietary knowledge. Returns for fund manager typically include the investment return from equity interest in the fund/platform, management fee and performance fee/carried interest as fund manager.
How will economic substance requirements impact aviation?

Background

International efforts targeting “no or only nominal tax” (Offshore tax) jurisdictions and harmful preferential tax regimes have gained new momentum as a result of the work under Action 5 of the OECD Base Erosion and Profit Shifting (BEPS) action plan.

The OECD issued a paper requiring Offshore tax jurisdictions to introduce similar substantial activities requirements to those introduced in preferential tax regimes. This will level the playing field between preferential tax regimes and Offshore tax regimes (such as the Cayman Islands, British Virgin Islands, Bermuda, and the Crown Dependencies).

The requirements are aimed at preventing such jurisdictions from attracting profits from certain activities without any corresponding local economic activity and substance.

Additionally, the EU Code of Conduct Group (EU CoCG) expressed concerns that many specifically identified Offshore tax jurisdictions did not have a “substance requirement for entities doing business in or through” the relevant jurisdictions.

Certain non-compliant jurisdictions are included on the EU list of non-cooperative jurisdictions (blacklist) until the EU CoCG view that the affected jurisdictions have taken the necessary steps to effect legislative requirements. The purpose is to ensure mobile business income can no longer be parked in a zero tax jurisdiction without core business functions having been undertaken by the same business enterprise or in the same location.

Satisfying the economic substance test

A relevant entity conducting relevant activities is generally considered as satisfying the economic substance test if it:

1. conducts core income generating activities in relation to that relevant activity in the relevant Offshore tax jurisdiction;
2. is directed and managed from the relevant Offshore tax jurisdiction; and
3. taking into account the level of gross income earned, it, in the relevant Offshore tax jurisdiction, (i) incurs an adequate amount of operating expenditure, (ii) has an adequate physical presence, and (iii) has an adequate number of employees or other personnel with appropriate qualifications.

Timing

The rules have, in most affected jurisdictions, come into force during 2019, with notification and reporting obligations generally required to take place by the end of 2020.

Non-compliance?

Non-compliance typically leads to financial penalties, which escalate...
year-on-year, with strike-off of a non-compliant company typically possible following two years of deemed non-compliance with the rules.

**Spontaneous exchange of information**

If a relevant entity fails to fulfil the economic substance requirements, the authorities in those jurisdictions may be required to exchange information with tax authorities in the relevant entity’s parent company jurisdiction, ultimate parent company jurisdiction and any identified ultimate beneficial owner jurisdiction.

The consequences of this could be significant as they may attract the attention of the tax authorities in other jurisdictions within the wider group, raising questions around the appropriate jurisdiction for the recognition of profits recognised in the Offshore tax jurisdictions.

**Implications for aircraft leasing and other aviation businesses**

The prevailing views of the law and guidance, as relevant to many aviation structures, has been subject to several revisions over the past year. Looking at the issues holistically, many of the common structures used in the aviation industry will now involve the conducting of relevant activities and thus likely need the economic substance requirements to be satisfied.

For many transaction structures, very little local activity might constitute sufficient substance under domestic legislation for the concerned entities, though it will require consideration and potential engagement of local service providers.

Other structures, however, may find it difficult to meet the requirements, that is, it may not be feasible to ensure the core income generating activities (such as, marketing activities, negotiating re-leases, technical services, risk management etc.) of a commercial aircraft lessor are conducted in such jurisdictions.

In addition, as the implementation of the rules will be subject to ongoing monitoring by the OECD and EU bodies, the results of their periodic reviews may result in further changes to the legislation and/or practical implementation of the rules in affected jurisdictions.

What may currently be sufficient to satisfy the local economic substance requirements may not necessarily be sufficient in the medium or long-term.

In our experience, it is more efficient to review the transaction structures and concerned entities and find holistic longer-term solutions.

**What do I need to do now?**

Review your existing structures which may involve Offshore tax jurisdictions owing to historical reasons and assess whether the transaction structures continue to help you meet your business objectives in the context of the increased risk of falling foul of the economic substance legislation.
On 10-11 September, Liu Yi from PwC global network’s Beijing law firm, Rui Bai Law Firm, participated in the Cape Town Convention Academic Project. It’s the 8th conference held at Blavatnik School of Government, University of Oxford. The Project is a collaboration between the University of Oxford Faculty of Law and the University of Washington School of Law. Aspects of the Project are also being undertaken under the auspices of the International Institute for the Unification of Private Law (UNIDROIT).

The Project’s objective is to facilitate the study and assessment of the Cape Town Convention and advance its aims. It will benefit scholars, practising lawyers, judges and government officials. Aviation Working Group (AWG) is the founding sponsor. The Project includes the creation of a comprehensive electronic database, a specialised journal, the creation of teaching materials, and economic assessment.

The conference covered all three (aviation, rolling stock and space) of the Cape Town Convention protocols, including the draft MAC Protocol.

This year, the conference consisted of longer panel sessions (such as the Ocean Air/Avianca Brazil bankruptcy case presentation, where the Cape Town Convention was put to test in the courts of Brazil) and discussion between the panellists and questions raised from the floor.

There was a linguistic panel to discuss the differences in Arabic, Chinese French and Russian versions (each equally binding, under the terms of the Cape Town Convention) against the English text of the Cape Town Convention. Their impact on the interpretation and implementation of the convention, as well as solutions which can be adopted.

As the Chinese practitioner in aviation finance and leasing, Yi presented his views on the Chinese language version on the linguistic panel, along with lawyers from Al Tamimi & Co. UAE, White & Case, Moscow and Prof. Jean-Francois Riffard. Prof Ignacio Tirado, Secretary-General of International Institute for the Unification of Private Law (UNIDROIT) was moderator for the panel.

Yi gave a vivid account on the difficulty of defining and explaining legal concepts in Chinese (and a civil law legal system) brought by Cape Town Convention which was primarily drafted and finalised in English, based on common law. His view is to find more practical solutions to address the resulting substantive and procedural issues. His insight on the different language and legal culture as well as suggested approach were appreciated by the audience. They included Sir Roy Goode of Oxford University (the Chairperson of the Cape Town Convention drafting committee and the author of the Official Commentary of the Cape Town Convention) and Jeffrey Wool, Secretary General of the AWG.
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