Buying and selling aircraft lease and loan portfolios

The recent acquisition by Sumitomo Mitsui of RBS Aviation Capital from Royal Bank of Scotland is a significant transaction for the aviation finance sector as a whole, and not least for the participants, writes James Cameron, in the first of a two-part article

Milbank Tweed Hadley & McCloy represented five of the bidders for the acquisition of RBS Aviation Capital, including winner Sumitomo Mitsui Banking Corporation (SMBC).

The transaction may prove to be a fillip for the transportation sector generally, including banks looking to dispose of other non-core transportation assets and potential buyers of those assets.

While not particularly complex, the transaction is of unprecedented size and has been closed in very challenging and uncertain times. It would appear likely that, with the success of this transaction, the unsuccessful bidders and other potential acquirers will continue to look to buy aircraft and aircraft loan portfolios that are regarded as non-core, particularly from state-owned banks. Milbank Tweed Hadley & McCloy is currently involved in a variety of these projects.

There is no better time to consider how transactions of this nature and in various derivative forms are closed, as applied to the RBS deal and also others that are in the pipeline.

Why buy or sell?

Notwithstanding that banks, particularly those that are wholly or partially government owned, are under pressure from shareholders, politicians, the public and regulators to dispose of what are perceived to be their more risky and expensive assets – both in dollar terms and also due to the need to set aside capital – there have been comparatively few significant non-core disposals closed in the transportation sector since 2008. Why? This is mainly due to the gap between book value and actual value.

Many of the bidders for RBS Aviation Capital more commonly play in the distressed or quasi-distressed debt markets, and so are less accustomed to paying full value for a strong, well-run business like RBS Aviation Capital. In addition, many of the transportation asset books owned by banks are so large that a seller could not easily absorb even a 10 per cent write-down, which in many cases would be conservative, notably if a seller's obligations are government backed where regulatory issues, such as government consent, may be a factor.

In the case of RBS Aviation Capital, the motivations were clear. RBS first considered selling the business over three years ago, and in doing so has materially reduced exposure to dollar-denominated transportation assets at a time of considerable market volatility and concern over availability of dollars.

SMBC has acquired a strong business that is transformational to its already well-established aircraft finance and leasing business.

Investment bank Goldman Sachs has succeeded in arranging what is yet another ground-breaking transaction by co-ordinating what many commentators thought was a surprisingly large number of serious bidders and bringing the deal to a successful close in a relatively short timeframe.

RBS Aviation goes to a new home that clearly has the financial resources, expertise and industry understanding to assume what is an already very efficient, well-regarded business. For the founders of the company who are still there – including Peter Barrett, chief executive officer, and Catharine Ennis, general counsel – the transaction represents a further phase in the company's history.

RBS's aviation division was founded around 10 years ago, when the bank acquired International Aviation Management Group (IAMG), formerly Lombard Aviation Capital.

The company was rebranded with the RBS name in 2003, by which point it had 108 aircraft, and was a dominant presence in the sale/leaseback market for narrowbody aircraft.

RBS Aviation Capital is scheduled to receive nine A320-family aircraft in 2012, with another eight to be delivered in the first half of 2013.

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Seller goals

There are a number of potentially competing considerations for a seller in deciding what is to be achieved. For example, does the seller want to achieve "true sale", such that it no longer legally or from a tax or accounting perspective owns the business or assets? Or, does the seller want to retain the business and monetise the assets, for example, through a receivables sale? A hybrid might be an asset sale but with a total return swap of part of the debt to the seller with a view to tranching and selling remaining exposure at a later date.

Further, is the seller looking to sell the entire business with the "platform" (that is, the inclusion of staff and goodwill), as in the RBS Aviation Capital sale, or just part of the business or assets? We are seeing consistently in non-core asset disposals, including the RBS trade, initial requests for proposal (RFPs) issued by sellers that provide a variety of options – including, for example, share sale, asset sale and part-asset sale. This may be because sellers are not confident of achieving the sale of all of the business or assets, and so want to garner expressions of interest for less than the whole business. In reality, those bidders that bid for an entire business or assets are likely to make the future bidding rounds, with bidders for part of a business only being held pending outcome of the main bids.

Finally, there may be tension between timing and price. Goldman Sachs and RBS appeared to manage this very well in the recent transaction and achieved fairly quickly what most commentators appear to think is a strong price. But it can be a tactical call. For example, would RBS have taken less to close the deal in 2011? And did the bank risk loss of momentum once year-end had passed? In the end it was moot, but for future transactions the commercial parties may view timing risk differently, particularly in such volatile markets.

The RFP

Having determined what it wants – or hopes – to achieve, a seller issues an RFP against signature of a non-disclosure agreement. RFPs vary in form from the detailed to the fairly bland. It is for the bidder to decide how to respond, but clearly the process is designed to encourage buyers to be more aggressive and descriptive in their responses in the hope of attracting a seller's interest.

The data site

Accompanying the RFP or at the second-round bid stage, bidders may be permitted access to an electronic or physical data room or data site containing information about a target, its business, assets and underlying transactions. In the RBS case, it has been reported that some potential bidders complained about the lack of company information available to them.

The tactical issue for a seller is that it may not want to disclose sensitive information to a large number of potential bidders, some of which may be regarded less seriously than others, and may be bidding to understand the business better as a competitor rather than as a genuine buyer. For example, RBS Aviation Capital has on order a large number of Airbus and Boeing aircraft, purchase details of which would be of significant interest to competitor lessors. While many of the lessors with whom the company has traded aircraft would have some knowledge of the basis and terms on which it is prepared to buy and sell, there would be significant information about the company that remains unknown. So RBS decided, rightly, to delay disclosure of much of the important information about its business until it had a good feel for which bidders

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might buy the company and that their intentions were genuine. Once bids are received, both initially and in subsequent rounds, a seller will undertake price comparisons. This may not be a straightforward process because different bidders may have submitted their bids on different bases. As with timing, a further consideration will be execution risk.

There have been instances on both closed and aborted portfolio sales in which the highest bidder presented the greatest execution risk, for example, the ability to bring the purchase price at completion because of the requirement for external financing or consents under existing facilities.

Another issue is structure in the form of airline consent and involvement on an asset bid compared to a share bid, or the need for extensive merger filings or consents. Execution risk is a significant consideration because however tempting the highest bid may be, an aborted transaction, particularly one of this size, would have far-reaching consequences not only for the seller – which may need to restart the process on a further two to three-year sale cycle but also for the sector and related financial markets.

Buying an aircraft lessor

The main consideration for a buyer will be whether to bid for assets or for an entire company. There are a number of factors to this decision. The most obvious is that, when buying a company, a buyer would be expected to take the business "warts and all", with all previous and future liabilities, whether or not related to the principal activity of aircraft ownership and leasing. By taking the assets only, a buyer is to a degree naturally insulated from such risks. However, with an asset sale comes greater complexity, execution risk and potentially time and cost.

A share sale is, documentarily, relatively straightforward, with the main benefit being comparatively little disturbance to the underlying transactions. However, an asset sale will involve transfer of title and novation of leasing transactions – which, in the RBS case, totalled more than 200 leases. An asset purchase, therefore, involves each airline agreeing to sign a novation agreement, along with diligence and advice on the jurisdiction in which each aircraft is located at the time of title transfer to ensure a valid and tax-free transfer of title. Such issues are minimised and in some cases negated by a share sale.

Notwithstanding that a share sale may appear to be more straightforward, a seller may want to protect itself against buyer non-performance.

It has been reported that exclusivity was not granted to any one bidder in the RBS Aviation Capital transaction, but in most portfolio trades (either by shares or asset) there comes a point in the transaction when it would be. Following such time, a seller is heavily exposed to a number of factors, for example, the state of the financial markets but also to a buyer's acting in good faith, and may want to impose penalties in the form of pre-determined liquidated damages if the buyer fails to complete all but a small number of agreed and well-diligenced and understood circumstances, such as obtaining merger consents.

In either case, a buyer is likely to want to restrict a seller's conduct with respect to the business, assets or leases during the period following signing but before completion of a sale. For example, a buyer will want to prevent lease amendments, aircraft modifications and creation of liens over the assets during that period. The analysis with respect to employees and merger filings may be more straightforward on an asset rather than share sale, unless the acquisition is of the entire business, in which case, there is greater likelihood that protection of employment and merger control laws will apply. ■

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Aircraft lease and loan portfolio market: part two

The RBS Aviation Capital transaction is the largest of its type to be closed in the transport sector and similar deals are likely. However, with more new investors coming to the market, these transactions bring risks, writes James Cameron in the second of a two-part article

The commercial issues on a share sale are to a degree distinct from those on an asset sale. For example, on a share sale there is likely to be significant discussion in the sale and purchase agreement over warranty coverage, indemnities for pre-completion conduct and irregularities and limitations on the ability to claim for breach of warranty.

A buyer will undertake extensive due diligence, but will also want to be told about the business in a manner that gives the buyer recourse if the information and basis on which it buys proves to be incorrect. However, an asset sale and purchase agreement will contain warranties that are likely to be limited to assets and lessees, rather than the business.

A key and often heavily negotiated part of an asset sale will be what happens if a seller cannot deliver the entire portfolio. This is unlikely to be an issue on a share sale. For example, a buyer will want to protect itself against the possibility that a seller really intends to keep the best assets/lessees while selling the rest, or does not manage – for example, due to failure to obtain airline consents – to transfer assets. Often on portfolio asset sales we see assets categorised or 'bucketed', with a threshold either in monetary terms or more likely by airline or asset type below which a buyer can 'unwind', or put back assets it has already taken in the event of a partial sale.

A hybrid situation may arise where a target company keeps its assets in special purpose companies (SPCs). Some leasing companies do so to facilitate ease of transfer, and also to spread liability. If that is the case, a seller can sell each company to a buyer, requiring analysis on both an asset and share sale basis. So, for example, the bucketing described above may apply as the sales will be separate, but with the need for share sale-type protections and warranties. A buyer should also take care to diligence each SPC's liabilities, to ensure that it does not have obligations that are unrelated to the transaction it owns, such as guarantees back to the seller.

Methods of transfer

With an asset sale comes the decision of how to transfer assets and the associated leases. Under English law there are three main options as to how to transfer a lease: novation, assignment and by creation of a trust. The underlying leases will determine what is possible. Novation involves the creation of a new contract, and will require lessee action and consent. It is by far the most certain method of transfer, as a buyer is sure that a lessee knows about and has agreed to the transfer. An assignment may or may not be notified to the lessee, but will be required to be perfected. In any event, the seller will need to remain involved in any future enforcement, as it remains the party through which rights are exercised. So for a seller looking to divest itself fully of its portfolio, assignment is an imperfect solution. If both novation and assignment are prohibited without lessee consent, and the parties do not want to seek that consent (for example, because they want to close quickly) then if the documents permit they could elect to create a trust over the assets and leases. But again this would be unusual as anything other than an interim measure, because the buyer will want commercial as well as legal certainty as to its relationship with a lessee airline.

Due diligence

In conducting its due diligence, the buyer will need to set very firm goals and parameters and also targets for completion. For a business the size of RBS Aviation Capital, failure to do so would have resulted in a costly and lengthy exercise that may not produce the information that is most helpful and necessary to the buyer. On both a share and asset sale the buyer will achieve a degree of protection from warranties, but it will want to conduct its own due diligence in order, for example, to help it to determine pricing as a function of the business, its liabilities, strengths and weaknesses. For example, are there any transactions that the buyer should discount because of legal or commercial imperfection, or would just want to exclude from the bid?

Key issues include third-party involvement (for example, in the leasing chain or through bank debt), the existence of fixed-price purchase options (that may be out of the money), inadequate return conditions and any lessor obligation to contribute to maintenance costs.

The methods and standards of due diligence vary depending on the buyer and its policies. For example, some buyers focus on pricing issues, and others buying the business, having conducted due diligence to a standard that enables it to run the business from closing. In a share sale, pricing issues are more likely to be relevant whereas on an asset purchase, in which the buyer is taking assets only, without the people and process to continue to

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administer the deals, fuller due diligence is often required. In either case, a buyer is likely to require physical inspection, either by itself or by its technical adviser.

Aircraft leasing and loan books are heavily reliant on administration systems, placing significant reliance on a transitional services agreement and the need for quality advice and counsel to negotiate it.

Business integration issues can be some of the most intricate and delicate transactions of this nature. If handled badly, what the parties may regard as largely process, can become a significant commercial issue. Handled well, the talks and agreements work hand-in-glove to respond to the due diligence and to reflect the commercial deal.

Conventionally a buyer would conduct due diligence, but there have been circumstances in which the seller and/or its counsel insist on diligencing the portfolio. If so, a buyer will either elect to ignore that diligence or want to have its counsel conduct confirmatory due diligence of the seller's due diligence. There is a perceived, but not often actual, cost-saving in doing this. A seller may push for a buyer to just diligence a sample of the underlying portfolio, for example, when several deals have been written on similar terms with the same counterparties. However, this is rarely advisable. A buyer will want a full picture of what it is buying, particularly if the seller is looking to disclose the data site fully against its representations.

If, as in the RBS Aviation Capital transaction, there is a forward-order book then manufacturer consent is likely to be required to disclose a purchase agreement and associated documentation. The manufacturers understandably regard their purchase agreements as proprietary and commercially sensitive, so disclosure may be difficult to achieve until a very late stage in a transaction, or possibly not at all, with an agreement governed instead by assumptions in the sale and purchase agreement as to the terms on which an order has been made.

Any secondary trade envisaged (for example, an asset-backed securities (ABS) or a securitisation) may effect the standard of due diligence required. For example, if the intention is to place the receivables or debt into the US markets, then the arranger will want to avoid liability under US law by requiring its counsel to perform extensive due diligence and to issue confirmatory legal opinions (called 10b5 opinions), which diligence will go way beyond what would typically be required for a straight business or asset sale. With many of the non-core disposals we have seen recently, a price debate can become structural, particularly in loan book disposals.

For example, although a seller will usually want a 'clean-break', it may need or want to offer vendor finance. An increased margin on such finance may be a way for a buyer to effectively subsidise the purchase price, giving the buyer access to finance for purchase and the seller, indirectly, the price it needs.

Ironically, the offer of vendor finance may unintentionally (or otherwise) disadvantage those bidders that can pay cash for the business, but which do not want to pay the full price, by providing a bidder that cannot with both finance and the seller with an incentive to take the financed bid.

Aircraft loan books

We are also seeing a number of aircraft loan books come to the market (for example, RBS' aircraft loan book), and many of the principles set out above apply equally to their transfer, in particular, seller considerations, due diligence and methods of transfer.

For example, as with leases it would be conventional for loans to be freely transferrable, and to contain a pre-agreed mechanism for transfer within the loan agreement (for example, signature of the transfer certificate, which is, in effect, a novation of the contract). However, either intentionally or otherwise, lessee/airline involvement or the participation of third parties is often required, so the discussion above about methods of transfer (novation, assignment and trust) becomes relevant.

Some of the non-core loan disposals that are currently in play involve ABS or securitisation-type structures. As with the 'monetisation' transactions referred to above, the asset being transferred is a loan receivable, rather than the 'metal', so particular thought will be given to issues such as whether the incoming lender loses any of the protections in the underlying documentation as a result of the transfer, for example, increased costs and other indemnities. The transaction will also be structured in such a way as to avoid withholding tax on any cashflows between the issuer and bondholder.

Perhaps the most significant structuring considerations on loan book transfers are the new 'skin-in-the-game rules', that is, the collateral requirements directive and, in particular, Article 122a thereof.

These rules present a number of challenges when looking at how to divest whole portfolios of assets using classic securitisation techniques. For example, if the requirement is to ensure a complete divestment of the designated aviation assets, then any structure falling within the collateral requirements directive's broad definition of a securitisation would be unsuitable as the seller would, as a consequence, be required to retain a 5 per cent stake for the life of any resultant transaction.

In a recent transaction we have provided alternative structuring options that permit a sale of the relevant assets to an off-balance sheet vehicle in a fashion that would provide attractive investment opportunities to end-investors, but without qualifying as a securitisation under the terms of the collateral requirements directive, or where the 5 per cent retention requirement can be met by an entity other than the seller.

In respect of the former, techniques focused on avoiding credit-tranching in the traditional sense and in respect of the latter, the key focus was to ensure that the retaining party was structured so as to be compliant with the technical requirements set down by the collateral requirements directive so that sufficient investor protection was maintained.

Conclusion

Portfolio transfers of assets, leases and loan books are surely fertile ground for those with the ability, financial and/or intellectual wherewithal to be involved in the space. The RBS Aviation Capital deal represents the largest transaction of its nature to be closed in the transportation sector, and we know there will be others.

With the potential for secondary trades such as ABS and securitisation, particularly of loan books, or possibly more conventional onward sale of assets, these are interesting and challenging transactions with which to be involved. Aircraft in particular appear to continue to be a very attractive asset class, with many aircraft lessors performing far better than the airlines they serve. However, with more new investors, such as pension and hedge funds, coming to the market, these transactions present significant risks, many of which can be mitigated in an entirely satisfactory way with the help of top-end industry expertise.

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