Dieser Beitrag ist in ähnlicher Form erschienen in Janßen, S./ Plate, H. (2018): Specific Characteristics, Opportunities and Challenges of Business Aviation Financing, Hilligweg, G./ Kirspel, M./ Kirstges, T./ Kull, S./ Schmoll, E. (Hrsg): Jahresband 2018 des Fachbereichs Wirtschaft – Gesammelte Erkenntnisse aus Lehre und Forschung, S. 73-80, ISBN 978-3-643-14155-2.

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Specific Characteristics, Opportunities and Challenges of Business Aviation Financing

1 Why Should Financial Institutions Engage with the Business Segment of Business Aviation?

Banks and savings banks in Germany are increasingly facing demanding industry environments: growing regulatory requirements, the monetary policy of the European Central Bank, as well as essential investments in the digitalisation of business operations are leading financial institutions to experience a decline in earnings, irrespective of their classification as a cooperative, public or private bank. In the medium to long term such decline in earnings will lead to problems for the traditional business divisions, specifically private customers, as well as business and corporate customers. The resulting need to develop alternative business divisions, expected to deliver additional income, suggests one ought to engage with the niche area of Business Aviation. Niche areas that have been developed in the past, such as the financing of barges and seagoing vessels or the financing of renewable energy sources, are increasingly no longer alternative options due to the changing political and economic conditions.

2 Defining 'Business Aviation'

The International Business Aviation Council (IBAC) defines the term 'Business Aviation' as "That sector of aviation which concerns the operation or use of aircraft by companies for the carriage of passengers or goods as an aid to the conduct of their business"[1]. The early stages of business aviation can be traced back to the beginning of the 20th century, where enterprises such as Shell began to employ discharged military

[1] European Business Aviation Association, 2013.

aircrafts as a means of transporting technical and managerial personnel to different offices and meetings with business partners. Today the key advantage for any enterprise to become active in the area of business aviation lies in independent, fast and autonomous transportation of technical and managerial personnel, which can be arranged between office locations and production units or customer sites[2]. Currently (large-scale) enterprises and governments are some of the main consumers of transportation via business aviation.

Particularly small and medium sized banks and savings banks could wrongly assume that business relations with large companies are not feasible or realistic and therefore, that the subject matter of business aviation would not be of interest. (At this point we shall disregard the governments' demand, as it merely accounts for 20% of business aviation usage according to EBAA[3].) The intensifying international ties between companies, as well as the increasingly globalised procurement and sales markets however ensure that more and more medium-sized companies operate with smaller business jets, which are cheaper in terms of acquisition and maintenance[4]. As such, not only the transport of personnel, but also that of goods and merchandise is increasingly gaining in importance. Since the majority of banks and savings banks are active in the midmarket segment, this offers an opportunity to provide corporate customers with services in this area too.

3 Economic Developments

The business aviation industry presents disproportionate growth.[5] Apart from the aforementioned demands of a globalised and interconnected world, an increasing affluence, as well as the availability of regions with small airports are furthermore cited as drivers of this development. The market for business jets is growing by ca. 3% on average observed over a longer period of time. Nonetheless it should be noted that business aviation is always heavily affected by economic and financial crises: while the

[2] Derudder/Witlox,2010, S. 89.
[3] European Business Aviation Association, 2013.
[4] European Business Aviation Association, 2017.
[5] Conrady/Fichert/Sterzenbach 2018, S. 250 ff.

segment of business aviation achieved significant growth into the double digits with 19% per year until the year 2008[6], the business jet industry suffered a massive drop during the global economic crisis in 2009, the effects of which could be felt until 2013. A return of positive growth rates has only been noted from 2014 onwards[7]. The average annual growth rate between 2008 and 2017 reached an impressive 6.5%.

Over 4,000 business jets are employed in the area of business aviation in Europe, which is the second largest market after North America. The gross value amounts to ca. 25 billion euros per year. The largest fleet of business jets in the world (over 700) is based in Germany and generally the market conditions continue to be deemed favourable, despite the impending Brexit[8].

4 Financial Backers, Financing and Collateral Security

The number of financial actors in the area of business aviation is generally fairly low. The respective market players must be differentiated according to the types of financing they offer, depending on whether leasing or traditional investment funding is requested. The number of banks that have entered the segment and have placed their focus on the area of business aviation so far is modest. The KFW IPEX-Bank, which finances aircrafts ranging from regional to wide-bodied[9], as well as the Swiss Bank UBS, are part of those institutions that offer leasing and financing packages to their clients[10]. The latter provides access to rather detailed financial data. For instance, the financing volume of pre-owned or new private and business jets ranges from 10 to 60 million US dollars (or the corresponding equivalent in euros/swiss francs) and the maximum financing term lies at 10 years. Furthermore, the possible types of financing are aircraft mortgage loans, aircraft finance leases, sale and leasebacks and refinancing. German regional banks such as the Bremer Landesbank (BLB) or the Norddeutsche Landesbank (Nord/LB) were also active as financing partners in this

[6] Roland Berger, 2011.
[7] Happel, 2015, S. 1 ff.
[8] AVBuyer, 2018.
[9] KFW IPEX-Bank, 2017.
[10] UBS, 2018.

segment over the past years and thus demonstrate that it is not just major banks that can act as specialists in the leasing/financing of business jets.

Banks face competition with large numbers of leasing companies that have relevant expertise and experience, such as Raiffeisen-Leasing Aircraft Finance, COMCO Leasing GmbH, FM Leasing Partner GmbH and Avon Leasing AG. As the method of leasing is frequently selected when financing business jets, leasing companies profit from this demand. Still the number of competitors is limited.

Financing is typically secured by a lien on the respective aircraft. Similar to mortgages on real estate and land and ship mortgages on seagoing vessels and barges, rights of lien may equally be established for aircrafts, as soon as these have been included in the aircraft register[11]. An agreement by both the owner and the creditor on the security interest is furthermore required to secure the constitution of the so-called registered lien. Following this, the lien is recorded in accordance with the agreed sum of the claim, the interest rate and any additional services, and is extended to not only the aircraft itself, but to all accessories even if these are not permanently needed for the actual operation of the aircraft. In the event of damage, the agreed lien even covers general insurance agreements taken out by the business with its insurance benefits. Taking out a liability insurance is a legal requirement, and, depending on the maximum (take-off) weight of the aircraft can vary between 750,000 euros and 700 million euros[12]. A comprehensive insurance is an option and the respective insurance benefits will also be covered by the agreed lien. The register has public credence and is accessible to anyone, comparable to the land register[13]. As such, creditors can exercise the right of lien in the case of a default in performance and may initiate enforcement proceedings in accordance with normal procedure[14].

5 Possible Frameworks of Financing

As with any pending loan decisions, credit capacity (i.e. the ability to take out legally effective loan agreements) as well as personal and financial creditworthiness (i.e. the financial ability to make interest payments and redemption payments) and personal dependability and entrepreneurial

[11] § 1 ff. LuftFzgG.
[12] § 37 LuftVG.
[13] § 85 LuftFzgG.
[14] § 100 LuftFzgG.

aptitude must be satisfied[15]. In the area of business aviation, the financing of business jets (depending on type, seats, manufacturer and equipment), can amount to major loans of several million euros. As such a financing plan depending on creditworthiness should be favoured over a project financing plan. This means that aside from the simple security assessment (i.e. the lien for each aircraft), and the expected (imputed) returns from own and third-party use of each aircraft, the customer's or enterprise's profitability (credit rating) also plays a key role. When aiming to secure sustainable creditworthiness, an extension of liability by means of guarantee or a letter of comfort from for instance a creditworthy parent company, are options as viable as the equally conceivable agreement on financial covenants.

When creating a financial model for the financing of business jets, one needs to consider a further aspect. Apart from the mere acquisition of a business jet, high costs are regularly incurred for maintenance and repairs of the aircraft. Not only should the bank carefully consider the businesses' capacity to meet principal payments and hold a liquidity reserve. It should also verify satisfactory maintenance at regular intervals. Besides the fact that a badly maintained aircraft puts at risk the intrinsic value of the loan collateral (residual value, resale value), a worst-case scenario would see the aircraft grounded as a result of their take-off clearance being revoked. As aircrafts are typically depreciated for 21 years, adherence to maintenance intervals is of vital importance.

If maintenance intervals are adhered to and if the aircraft is treated with care, business jets generally tend to have lasting value. The value of the aircraft is determined by the accrued number of hours of flight, as well as by characteristics specific to the aircraft, such as the manufacturer, the model of the aircraft, its size and the amenities. Reviewing the level of insurance for the liability insurance (which is stipulated by the Air Traffic Act) and adhering to premium payments, as well as possibly insisting on a comprehensive insurance, may lower the risk for the creditor in terms of credit and financing negotiations and may elevate the appeal of financing. At the very least the financing value should be insured, if not the object value for each aircraft.

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[15] Olfert, 2017, S. 325 ff..

Investment of equity capital on a scale of 20-30% regarding acquisition cost or total cost (including future maintenance and insurance costs) is common in the sector, making the financing risk more predictable. Credit margins vary according to personal and material creditworthiness, level of equity and respective financing partners, however they are typically around twice to three times higher than those in comparable traditional investment financing.

6 Significance for Financial Institutions and Critical Appraisal

As a high level of competence is required to enter financing in the area of business aviation and due to the high financing volume and the resulting strong barriers to market entry, this subject matter is certainly not the solution to the overall earning problems of German banks and savings banks. Nonetheless it stands as a highly interesting and profitable segment within its own right as a line of business and as such should be considered carefully. Syndicate financing models, whereby a number of financing partners join forces and divide the financing volume and credit risk amongst each other, present an option for smaller and medium-sized banks to successfully enter the business area of financing business jets. As such, sub-participation can create profitable opportunities by means of developing professional expertise or alternatively by building such expertise centrally (and thereby economically) in order for it to be used by affiliated institutes, for instance in the public banking sector (e.g. a partnership between a state bank and savings banks or between the DZ Bank and the respective cooperative bank). A financial institution may furthermore be able to consider business jet financings with lower financing volumes as an addition to its loan portfolio with the purpose of better diversification of risk.

Many factors, such as a stable industry outlook, sufficient collateral (lien), a generally high retention of value (resale value), a standard market financing depending on creditworthiness and a high input of equity (20%-30%), favourable credit conditions (credit margins and banking fees), as well as the opportunity to utilize cross-selling potentials (derivatives of currency hedging or interest rate hedges), are all aspects that should strongly encourage a serious consideration of such forms of financing depending on creditworthiness.

Nonetheless, it should be critically noted here, that extensive expertise is required in order to enter this special segment in financing. If the required expertise is compiled individually as opposed to jointly with other banks (e.g. central institutes in the respective banking sector), this process can be time consuming and cost-intensive. As the industry outlook may be dampened by a deteriorating global economic environment (see 2009), attainable higher credit margins and earnings must be put into perspective.

We conclude that business aviation poses as an interesting financing market and that it may prove profitable to enter the market and invest in the building of expertise, either individually or in partnership with other banks. Furthermore, aside from the opportunity to gain a share of additional earnings, it may also build vital consulting expertise, one of the key advantages in the competitive banking sector.

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