

Business Aircraft: To Buy or to Lease?

There is a common misperception in the business jet industry that high net worth individuals and corporations mostly pay in cash for large private aircraft. Even if the cash resources are at hand, more often than not the preferred approach is to lease or finance assets of this nature. Why? If a new or pre-owned aircraft is acquired for cash – costing tens of millions of dollars – that’s a lot of capital tied up in an asset that typically depreciates each and every year (unlike real estate, which may go up in value over time). As such, many private aircraft users prefer to take advantage of available third-party capital to finance or lease their acquisition.

Private jets can appreciate. The market has experienced times when aircraft have been sold for higher amounts six months or two years after a purchase. But that has been the exception, not the rule. Typically, private aircraft lose value as they age. Technical obsolescence, wear and tear, operator preferences, new model launches, life limits, and other factors contribute to this steady decline in value.

Funding the acquisition of a new or pre-owned jet with cash is 100-percent equity financing – equity capital that the individual or corporation could use to make other investments. Many conclude that the investment in their business is probably a better bet than buying into an asset that will likely lose value each year. The decision that most private jet operators reach is that it’s most efficient to use third-party capital to fully or partially fund the acquisition of the private aircraft they wish to use.

So how does it work? For an individual or corporation seeking to take advantage of third-party capital to finance a private aircraft, the first question is: lease or buy?

LEASE

In an operating lease the private aircraft (new or pre-owned) is purchased by a third-party financial institution (the lessor) and then leased to the operator (the lessee) for a stated term and rent. The lease is documented as a contract between lessor and lessee with both parties having certain obligations to each other, primarily regarding the operation and care of the aircraft. Title to the aircraft resides with the lessor, and the lessee enjoys the right to use the aircraft without the lessor's interference.

The advantages of operating leases are:

1. Reduced upfront cash requirements. The lessee typically only needs to fund the security deposit, which greatly reduces the amount of capital that is tied up in the asset.
2. Fixed monthly rents and typically fixed hourly maintenance costs. The operator (lessee) has visibility on cost of ownership for budgeting purposes. This helps with monthly cash management. The only variable and associated cost is likely to be how many hours are flown in a month, which can also be projected by the operator for budgeting.
3. The operator of the aircraft will enjoy greater flexibility with a lease. A typical operating lease term of five years will allow the operator to make a decision at the end of the lease whether or not to extend the lease. If the aircraft is no longer the best choice for the typical mission profile, the operator can return the aircraft to the lessor without having to worry about trying to sell the aircraft, and can look to another aircraft type to best meet the operator's needs. If leasing the aircraft is a good continuing option for the operator, a lease extension or purchase can often be worked out with the lessor.
4. Asset risk can be managed with an operating lease. The lessor, not the operator, assumes the residual value risk associated with the aircraft. If new technologies emerge, or if there is a drop in demand for that particular aircraft, any impact on value will affect the lessor, not the operator.
5. Potentially favorable "off balance sheet" accounting treatment may be obtained by the lessee. For corporations and individuals, it may be advantageous to not have to carry a multi-million-dollar asset on the balance sheet. Debt-to-equity and other ratios could be negatively impacted by having a high-value private aircraft on the balance sheet*.

The disadvantage to leasing is that the lessor is the owner of the aircraft. This means that any increase in value of the asset is entirely for the lessor's benefit. In addition, as owner of the aircraft, the lessor may enjoy depreciation or tax-related benefits of ownership that the lessee would have been able to use if they had assumed ownership of the asset. It is also important to remember that the owner (lessor) will require the lessee to closely adhere to the terms of the lease. There may be limitations on how many hours an aircraft can be flown, what kind of modifications can be made to the aircraft, and other restrictions such as where the aircraft may be operated, among others.

* Consult your tax advisor

PURCHASE

The alternative to an operating lease is to retain ownership of the aircraft and use third-party financing for a portion of the acquisition cost. This could be a senior secured mortgage loan or other financing structure, such as a finance lease.

In a typical loan structure, the third-party lender advances between 50 percent and 85 percent of the aircraft value to the borrower by way of a secured loan. The difference in advance rate may be a result of the borrower's credit status, the age or type of the aircraft, or other factors. The security interest is typically a mortgage interest in the aircraft, giving the lender a first-priority security interest in the aircraft. This security interest is designed to offer the lender protection in the event of a default by borrower. Proceeds from liquidating the aircraft after a default are intended to repay the aircraft lender ahead of other creditors. Other loans may be available, particularly for individuals that have a substantial private banking relationship with a lender. In such instances the underwriting of the loan may focus as much on the financial assets held by the individual as the aircraft in determining the nature of the financing.

Title to the aircraft typically remains with the borrower in the secured-loan structure. The loan is usually repaid over a multi-year period to a balloon amount (a lump sum payment at the end of the loan repayment schedule). The loan, including the balloon payment at the end, is usually recourse to the borrower, meaning any deficiency the lender incurs (post default and sale of the aircraft) will still be owed by the borrower. In certain non-recourse or limited-recourse loans, the borrower will have fewer obligations of this nature, but typically at a higher rate of interest.

FINANCIAL LEASE

An alternative to the senior secured loan is the finance lease. Unlike an operating lease, the lessee does not return the aircraft to the lessor at lease expiry. In a finance lease, the operator makes scheduled lease payments along with a final balloon payment at the end of the multi-year finance lease term. When the final payment is made, title to the aircraft (which had been held by the lessor) will transfer to the borrower. At this point in time the aircraft is fully owned by the lessee and there are no further financial obligations to lessor.

The advantages of buying and then financing a portion of the purchase price are that the operator retains ownership of the aircraft, and all of the depreciation, tax, and residual-value benefits. Additionally, the owner will typically have greater operational control and flexibility over the aircraft. For example, there may be no hourly use limitations on the aircraft or restrictions on modifying the interior, for example. Additionally, subject to certain early prepayment penalties and/or break fees, the owner may elect to sell the aircraft at any time—unlike a typical lease, which would not allow for an early termination.

A major disadvantage to this option is that the operator assumes the complete risk of any drop in the value of the aircraft. This can result in unexpected losses occurring upon disposal of the aircraft if the book value of the aircraft is higher than the actual market value. The diminished sales price can also create unexpected cash flow planning problems.

Buy or Lease: What Happens Next?

In either the buy or lease scenario, the operator will need to work with a third-party financial institution to enter into a lease or loan agreement. This multi-week process will afford the provider of third-party capital a chance to review the aircraft collateral and assess the credit profile of the lessee/borrower. The lease or debt rate offered by the financial institution will reflect the prospects for both the borrower/lessee, as well as the aircraft. Jurisdiction, aircraft age and type, the aircraft manager (if any), and proposed term of the financing or lease will all be considered as the financial institution makes its leasing or lending indication to the client.