Sidecars become a driving force

David Yu, Istat-certified aviation appraiser, looks into the benefits and limitations of setting up a joint venture as an aviation financier.

There has been large growth recently in the number and the sizes of sidecars or joint ventures (JVs) in the aviation investment space. While these structures are not novel and have been in existence for a long time, it has become a structure that is in vogue and has industry insiders and observers taking note.

A sidecar or JV is an agreement to create a separate entity where the parties would co-invest with contributions that include cash, assets, other knowhow or a combination of these. These JV entities generally run in parallel with the existing business scope of one of the partners, hence the sidecar analogy. This is very different to joint ventures with airlines on aircraft operated by the airline partner, which has been around for some time.

Currently, there is a large supply of new capital with little or no aviation experience entering the aircraft leasing industry looking for experienced personnel or partners to do deals. This has created an environment where lease rate factors and returns have steadily been compressed over the past few years.

Given this dynamic, established lessors rightly as risk managers have been happy to raise additional capital through sidecars to pursue more opportunities on a hedged basis. Sidecars enable established lessors to monetise their experience by putting down little equity while retaining benefits such as the sale of the leased aircraft, having more stable cashflows and operating leverage of their staff through servicing arrangements.

Parties involved

In the case of the aircraft leasing industry, sidecars are generally formed with an established lessor and a financial party. While the terms of each agreement differ for each JV, for the most part, the operating lessor would provide a combination of asset management, technical advice and its network of established relationships to source and finance the deals while the financial party would contribute equity, debt or other means to fund the JV and the transactions. The financial party generally provides the majority of the equity capital while the operating party is a minority investor (generally 10% to 40% but more skewed to the smaller side).

The financial party tends to be investors such as investment funds, pension funds, credit companies, hedge funds, private equity and family offices. Other types would include large conglomerates with aviation interests, other financial institutions and trading houses. By and large, these investors are risk adverse and focus predominantly on more modern types and younger aged aircraft.

Usually, the financial party forms one JV while others take a more diversified approach with many sidecars with different established lessors. The latter would include Chow Tai Fook Enterprises and NWS Holdings, which invested along with Investec in Goshawk Aviation and, more recently, both investing with Aviation Capital Group through Bauhinia Aviation Capital. In the first case, Investec sold its entire 20% stake in Goshawk to its two partners.

Sometimes the financial party is also a lessor in its own right such as Tokyo Century Leasing (TCL). It had a JV in aircraft leasing, TC-CIT, formed with CIT (TCL subsequently bought out CIT along with the sale of CIT to Avolon) and another JV focused on engine leasing with GA Telesis. Financial investors sometimes also have minority ownership stakes in the lessor partner such as the case with TCL's 20% equity ownership in GA Telesis and IBJ Leasing's association with Aircastle. IBJ Leasing and Marubeni are both members of the Mizuho keiretsu and through Marubeni own 15.25% stake in Aircastle.

Benefits of sidecars/JVs

In theory, sidecars sound simple and have benefits for both parties. They enable the established lessor to monetise its knowhow and buy and manage assets that it might not have done. It also provides the lessor a platform to become more of a servicer than asset owner, which is more stable.

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> **David Yu**, Istat-certified aviation appraiser

Owners, as the equity holders of assets, inherently have more risk and volatility on their returns because of unforeseeable events that might happen during the course of ownership and the lease. For example, at its most severe, this unforeseeable event can be an airline bankruptcy. During these periods, negative expected cashflow occurs because of additional investment capital needed, the stoppage of lease revenues from the operator, or other scenarios. Instead of these more volatile cashflows, in sidecar structures, established lessors have more certainty because the cashflows are derived from servicing agreements with the financial investor.

These sidecars also enable the established lessor to become more asset-light vehicles. This is one of the main considerations for GECAS, which has formed a sidecar, Einn Volant Aircraft Leasing, with Caisse de dépôt et placement du Québec. The new senior management of GE is more focused on an asset-light model and instead prefers a more stable servicing model.

In addition, established lessors retain certain upside for transactions usually based on some hurdle rates. These hurdles might include a preferred initial return to the financial investor partner and then some subsequent split of profits afterwards. These profit percentages are generally not the same as the equity ownership percentages. The cashflow waterfall sometimes include other variations such as catchups where after the preferred return, the lessor would have all the cashflow until it gets to its determined profit split percentages.

For the financial player, this structure would provide for knowhow from the operating partner that it would not be able to achieve. It can take advantage of the operating partner's geographical presence and more seasoned personnel.

It is arguable whether it is faster in time to form a sidecar versus starting a new lessor company from scratch with a sole party. While most sidecars would take less than a year to establish, a new lessor can be established quicker, when funding is available, within three to six months. While there are many benefits, there are many pitfalls that need to be considered.

Controls and restrictions

There are restrictions on one or both parties which protect the JV from competition with the parent companies. In some instances, the operating party would provide other types of comfort such as guarantees including debt or hurdle rates for the JV entity and partner.

As with any partnership, finding these mechanisms for the alignment of interests is very important. There will be nature conflicts such as the desire for a continued stable management fee versus finding the optimal time to divest an asset, which creates upside for the manager. Sometimes, this is not addressed fully just through the construction of the investment committee or board of directors of the JV. In most cases, the financial investors control the JV entity because they are the majority investor.

Issues and conflict management

In addition, thought needs to be made on how properly to value the contribution of new or older aircraft. Is it at cost or some sort of current market value, especially as the initial batch of aircraft in a JV is generally bought from the established lessor partner's portfolio? Third-party appraisers are often brought in to solve this question.

As with any venture, the mechanisms of the management are important. Will the JV be staffed with full-time seconded management from the lessor or will it have its time split with the continued responsibilities of the parent lessor? Other conflicts that warrant consideration include cherry picking the best assets as well as conflicts over lease initiation, renewal or sales, especially if the established lessor parent has existing aircraft at the same carrier.

Outsourcing is very much part of the aircraft leasing landscape because there are opportunities for every single facet of the business. While most parties tend to retain only the most important services or where they are best suited along with outsourcing, others tend to do all the services in house. The logical follow-up question is whether the operating partner is the most suited in terms of costs, delivery timing, and quality versus outsourced options.

Exits and trends

As with any joint venture, the management of the dynamics between two parties generally lends itself to the eventual exit between the two parties. Over time, partners change strategic directions. Some exits include selling the entire company to one of the partners, an initial public offering, through an asset-backed securities structure, or trade sale to another party, either individual aircraft or wholesale. A prime example would be Waha Capital's sidecar with AerCap in AerVenture. This stake, along with all of Waha's aviation interests and $105 million cash, were sold for a 20% stake in AerCap. There are numerous examples of these sidecar structures with almost every major aircraft leasing player, including AerCap, Air Lease and Avolon.

The continued growth of sidecars is analogous to that of other asset-heavy industries such as hotels, real estate, shipping, among others, which have gone towards a more asset-light servicer model with the distinct separation of the owner and the manager.

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