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'Johnny Says' – The evolving Chinese aircraft leasing market

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Since the last issue of Aviation Insider, it has been a dramatic six-month period following which the Chinese aircraft leasing market looks quite different. Perhaps, the structural changes are not huge but the direction and deviation of development has created a lot of food for thought.

A world of diversity

There is an old Chinese proverb that some are rushing to attend the public examination (for a job as a public servant) while some others are resigning to go back to their respective home towns.

We have witnessed the decline of power of Chinese aircraft leasing companies in the global market in the last few years. There have been plenty of rumours that they had to sell all the foreign aircraft portfolio due to regulatory requirements or even completely to abandon the aviation industry.

I had been asked about these matters more than a dozen times by non-Chinese parties in recent air finance conferences. We understand that rumours are based on some facts or thoughts. 'Wind from an empty cave' would prove the sources, at least to a certain extent.

I believe that trading activities are increasing among Chinese aircraft leasing companies because they have been developed to a stage where the necessity to reduce the risks exposed to a particular lessee or aircraft type, probably also the regulatory requirement of single-client limit. However, there are several other reasons.

One being the direction from the financial regulator has been restricting the total size of the portfolio booked under structures that were put in place when the regulatory environment was far different and less certain.

With the new guidelines of setting up special-industry subsidiaries, leasing companies are allowed to apply for a licence to open a platform with approvals to set up SPVs in different jurisdictions. However, before the licence is granted, the original portfolio (mostly within the overseas subsidiaries or associated companies of some forms) cannot be grown. That compels the leasing companies to sell a portion of such portfolio in order to honour the commitments made before the guidelines were issued. Some companies not following those orders were subject to regulatory penalties, and this has affected their application for the licence.

Most of the companies are still working very hard to get licences and hopeful to get one after the recent approval received by a major financial leasing arm of state-owned bank to set up in Hong Kong a combined aircraft and ship leasing subsidiary.

Process is believed to be tedious and will take a long period of time, but all applicants are upbeat and courageous.

Another perspective is related to overall economic-political environment. With recent failures of airlines to pay on time, and the Russian crisis fuelled inability to repossess aircraft (which, as the readers will no doubt know, a basic tenet of aircraft financing and leasing), senior management of these companies and their stakeholders have questioned the fundamentals in the aviation industry.

Ranging from imposing stricter parameters to approve new transactions to freezing recruitment of new team members, difficulties faced by the aircraft leasing companies lead them to strive for survival by selling portfolios.

This can keep the momentum of the retained staff and also generate revenues to justify the team's existence.

Of course, the worst scenario was the complete exit which I was told that management of some leasing companies have, indeed, been seriously considering.

A small number of such companies will definitely end up in the market to sell the whole portfolio. However, we are also happy to see that most companies, particularly the big ones, are still buying and growing.

In the recent post-Chinese New Year visits, trading units of Chinese leasing companies are advising of active acquisition plans. They are very interested in buying portfolios of non-Chinese companies which are concerned of Chinese country risks after the Russian crisis; and at the same time trying to take over those portfolios of local, more conservative, counterparts who are selling. So what we are seeing is a nuanced consolidation process rather than a wholesale exit. The industry should be positive about this development.

Embracing the adversity

Chinese aircraft leasing companies have become very active since 2008 when the first company was established under the guidelines issued by the old-CBRC (China Banking Regulatory Commission, now merged with insurance regulator to become CBIRC) and put internationalisation as a core strategy.

We then welcomed the entries of other state-bank-owned and big SOE-owned leasing companies, which were followed by around 30+ corporations of different sizes into a crowded market using the old-CBRC and Ministry of Commerce regimes. Competition among these companies in the domestic market has already made profitability difficult or even impossible. Financial leasing using the localised SPVs in tax-bonded areas or free trade zones is indirectly subsidised by tax rebates and even bank loans may not be comparable in terms of CNY pricing.

Latest rumour of the bottom is 1.7% p.a. for effective interest rate of financing new aircraft. Operating lease rate has been in sub-0.5% level for a couple of years.

Most companies with a legitimate overseas platform which can still engage in international lessees would prefer focusing on non-Chinese deals. However, a lot of corporate management and/or risk committees do not entertain such rational approach but take a very conservative view on making new deals.

Hence, RFPs from Big-3 airlines or their first-tier subsidiaries are heavily bid and resulted in crazy terms which may lead to a longer-term problem for aircraft leasing companies.

With high purchase prices, low rentals and relaxed return conditions (of course, there is no cash maintenance reserve), the high residual book value of aircraft would impose an extremely harsh position for lease renewal and remarketing.

The rest of the market which is queueing for a licence to explore overseas market or not qualified yet to apply for a licence would end up fighting against all the big boys which have more powerful parents to tap into cheaper funding and better or more sophisticated teams.

Chinese leasing companies are happy to maintain a majority of USD-denominated leases due to matching currency risk between a secured financing of aircraft and the physical asset which are traded in USD. However, they are requested to work on more CNY based transactions and find it more and more difficult to get USD loans from local banks. Airlines are also pleased to get CNY leases as they are obviously long in local currency.

Under the current strong USD market, companies are less concerned of this exchange rate risk and more as to interest rate risk. As the treasury function of Chinese aircraft leasing companies is usually controlled by the corporate team which is not specialised in aircraft financings, they would sometimes fund the aircraft acquisition with short term liquidity and do not fix the interest rates of long term loans. That poses a huge cost pickup in the last two years when USD interest rate has been on the rise. It will have a serious impact on the bottom line of these companies.

Even with such a tough market environment, new investors continue to emerge. Some financial leasing companies with no experience in aircraft leasing are setting up new teams and have interest from investors from other sectors. Aircraft leasing is still considered the best product which the leasing companies can prove that they belong to the stronger section in the industry. Also because the general investment environment continues to be challenging after COVID-19, investors are running out of opportunities.

Aircraft leasing was considered a conservative and low-yielding business. It is now a new interesting subject due to its relatively stable return and comparatively low risks. High net worth individuals and family offices in China are welcoming aircraft leasing as an alternate and balancing investment in the whole portfolio.

Prospects

Chinese aircraft leasing companies are now adopting diverse development approaches facing complex global and domestic markets. Many are doing business as usual. Some are taking a wait-and-see attitude. A few are considering significant changes including exit. Only a small number are really working out of business.

China, with its agenda to become a global player in finance and aviation industries, will not stop investing in aircraft leasing.

The Commercial Aircraft Corporation of China (COMAC) products – ARJ21 and C919 – will become a serious contender on the manufacturing side as commercial aircraft production of other smaller manufacturers slow down or disappear. This will make aircraft leasing an important or even indispensable function for promoting future sales of the Chinese made aircraft. Investors from governments, corporates and family offices would continue to support the growth of aircraft leasing which can yield both economic and political benefits.

Finale

Cycles observed in other sectors in China since its economic success story began in early 1980s can be found in Chinese aircraft leasing market. What is happening is interesting to see if further strengthening or rationalisation will be the final outcome.

Holistic restructuring of the second largest airline in Hong Kong

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Overview

Even before the onset of the COVID-19 pandemic, Hong Kong Airlines ('HKA'), the second largest airline in Hong Kong, was already experiencing a deterioration in its financial condition since 2018. This deterioration was exacerbated initially by the social unrest in Hong Kong, which was then followed by the travel restrictions imposed during the COVID-19 pandemic and the financial condition of the conglomerate HNA Group.

The resulting steep revenue decline, reduced fund raising capacity and extraneous events put HKA in a difficult financial position and triggered payment defaults in connection with its financing and leasing arrangements. As a result of certain payment defaults, it was also set to face to a winding up petition early in the first quarter of 2022.

Against this background, PwC Hong Kong's restructuring specialists advised HKA with respect to its restructuring and rehabilitation. PwC Hong Kong acted as HKA's financial advisor, including to assist the company to explore its restructuring options, seek potential investors, develop a restructuring plan with HKA and its legal advisors and to assist with negotiations with key stakeholders (including potential investors, financiers, lessors, bondholders and numerous operational suppliers).

PwC Hong Kong's restructuring specialists worked in conjunction with PwC's aviation business services specialists, who assisted on commercial and aviation industry sector specific matters (including fleet utilisation, business plans and industry recovery forecasts, as well as assisting with commercial negotiations with aviation industry stakeholders) and Tiang & Partners, who advised from an aviation legal and regulatory perspective.

This ultimately resulted in HKA obtaining new HKD3 billion equity investments and court approval for a HKD50 billion / USD6.5 billion debt restructuring which will allow HKA to rationalise debt to a manageable level and put HKA in a position to be a successful and profitable airline in the future.

The restructuring process

The group-wide restructuring project commenced in around early 2022 with multiple workstreams being undertaken in parallel.

In order to devise a restructuring framework for its negotiation with key creditors, the project team performed a comprehensive review of the financial status of the airline, which included a review of its latest financials, future business plan and future funding needs in order to implement its business plan.

PwC's restructuring specialists discovered that most of the assets of the Group were either leased, mortgaged or pledged, and that there had been difficulties in meeting scheduled debt service since 2019. Given the ongoing difficult trading conditions, these issues made HKA unlikely to be able to continue trading as a going concern without the support of its creditors and investors.

This reduced potential manoeuvring options down to sourcing capital injection from new investors and working to gain the confidence and support of a sufficient majority of HKA's creditors for a debt restructuring plan.

The timeline was tight due to growing pressure from creditors and adjournments in Hong Kong Court required justification in view of the pending winding up petition. Furthermore, Hong Kong law does not contain a formal restructuring process which includes a moratorium or stay on enforcement proceedings as part of the process and creditors were therefore free in theory to take enforcement action without the leave of the court. Without a meaningful restructuring, the future of the company would be bleak, and HKA would be very likely to have gone into liquidation.

On the new equity investment required, the project team provided strategic support to the company throughout the investor solicitation process to identify potential investors with strong financial wherewithal to deliver future growth and who were also willing and able to comply with Hong Kong's licensing rules regarding the management and control of Hong Kong-based airlines. This was run as a competitive bid process and after a series of negotiations with the prospective investors with consideration of feedback from key creditors, the company finally locked-in an investor with the best offer to proceed with the restructuring (with the new investment being committed subject to the parallel completion of the debt restructuring).

With the support from various key creditors, PwC Hong Kong worked together with the company's separate restructuring (legal) advisors to utilise statutory regimes in Hong Kong (a Scheme of Arrangement) and the UK (a Restructuring Plan under Part 26A of the Companies Act) to give effect to the restructuring. The Scheme of Arrangement and Restructuring Plan would allow for a court to sanction a process which would cram down dissenting creditors and effect the restructuring with minimal disruption to the operation of the company during the process, provided that HKA obtained the support of a sufficient majority of creditors .[1] The implementation of the debt restructuring, coupled with the new equity injection of HKD3 billion / USD380 million, will allow the company to recover from its financial difficulties just in time to put HKA in position to capitalise on the revival of regional aviation.

Tiang & Partners provided support on specialist aviation related matters, including providing support reviewing the underlying transaction documents from an aviation and market practice perspective, assisting the PwC and HKA teams to assess the likely outcomes and arguments with respect to the contractual position set out in the documentation (for example, with respect to default positions in aviation financing and leasing documentation) and providing support with respect to the rules regarding ownership and control of airlines in Hong Kong from an aviation regulatory perspective.

The result of these efforts was the approval of a parallel Scheme and Restructuring Plan by the courts in Hong Kong and the UK respectively. The winding-up petition was dismissed in January 2023.

1 We had previously reported on schemes of arrangement and the relatively new (at the time) UK Restructuring Plan as used in other airlines insolvencies in other Aviation Insider editions: https://www.pwccn.com/en/aviation-leasing/aviation-insider-newsletter-may2021.pdf.

Details of the scheme and restructuring plan

The Scheme and Restructuring Plan represents a holistic restructuring that seeks to return HKA to a solvent going concern by addressing over 90% of its indebtedness, introducing fresh equity and streamlining the company's fleet from 53 aircraft to 20 aircraft.

The restructuring proposal presented was relatively straight forward, where the existing shareholders would in effect have their equity diluted down to zero, and the creditors will obtain some upfront cash payment of their claims and potential future profit sharing, in return for having their claims against and the liabilities of HKA compromised and released.

Unsecured creditors will receive an upfront payment out of a cash pool of HKD960 million, which will give them approximately 5% recovery of the debts due to such creditors by the company.

The lessors of aircraft that will be retained (and continued to be used) by HKA post-restructuring are classified as 'critical lessors'. Under the Scheme and Plan, lease payments would be rationalised according to the type of aircraft (as part of a package of proposed modifications). These future lease payments would be offset against the claims of the critical lessors and the critical lessors will be entitled to receive, to the extent they elect to receive an an upfront payment out of a pool of HKD120 million.

On top of the limited short-term cash payouts described above, the restructuring proposal is also designed to make additional annual distributions to creditors in the event that the company meets its pro-forma EBITDA target of the corresponding fiscal year. This will allow creditors to share in any potential upside should HKA benefit from improved market and trading conditions, and will potentially generate a much better recovery than the recovery for the creditors otherwise would get in a liquidation scenario.

Apart from the unsecured creditors and the critical lessors, the Company offered a restructuring proposal to the holders of the English-law governed perpetual notes (the 'Perpetual Noteholders'), which comprise a cash payment of 2.5% of the outstanding principal of the perpetual notes, a restated and amended perpetual notes with a new principal of USD100 million and a performance-linked annual distribution. Despite the fact that such proposal was apparently different to the terms offered to the other classes of creditors, it was designed and constructed with the aim to allow the Perpetual Noteholders to share the economic benefits from the recovery in the performance of HKA and getting similar recovery in such situation.

The negotiation with the Perpetual Noteholders (represented by an ad-hoc group) was not progressing satisfactorily and became protracted. Their position relied on the fact that they, collectively as a group, held a blocking stake (i.e. more than 25% of the outstanding principal of the notes) to any consensual restructuring or a Hong Kong scheme of arrangement. To break the deadlock, PwC worked with Hong Kong and UK legal advisors of HKA to explore the use of the cross-class cramdown provisions in the UK Companies Act in order to implement a UK Restructuring Plan. This would enable the UK Court to exercise discretion to push through and approve a restructuring proposal, even if certain classes of creditors voted against the restructuring proposal. The exercise of such discretion is subject to certain considerations, including meeting a no-worse-off test where the judge would need to be satisfied that the recovery to creditors in the restructuring proposal will not be worse than the recovery in a comparative alternative scenario.

In other words, if the UK cross-class cramdown provisions were utilised, HKA's restructuring proposal could still be approved via a UK Court process to cram down any dissenting creditors (either as a class of creditors or as individuals), notwithstanding that the requisite voting threshold was not met within a class of creditors, provided certain statutory requirements are met. While this was on the table as an option, it was ultimately not necessary to seek approval under the cross-class cramdown provisions in the UK as the objections and concerns of the Perpetual Noteholders were addressed and their objections were withdrawn.

With Cape Town Convention in mind, there were also a jurisdictional question that needed to be addressed over the ability of the English Court to deal with leasing and financing arrangements relating to certain aircraft which were co-leased by PRC companies. [2] In essence the Cape Town Convention provides that where the lessee has suffered ‘an insolvency-related event’ then no obligations of the lessor may be modified ‘without the consent of the creditor’. In this case, as in other cases where the CTC applied, the court considered that the requirements of the Cape Town Convention were met due to the critical lessors having the option to either terminate the leasing of the aircraft and accept an immediate return of the aircraft (and then submit their remaining claims as unsecured creditors), or to agree to continue to lease the aircraft on the leasing terms as modified by the Scheme and the Restructuring Plan. By choosing to accept the modified terms, the relevant lessor would be taken to have ‘consented’ for the purposes of the Cape Town Convention. [3]

In a restructuring, airlines are generally allowed to negotiate new lease terms and lower exit costs, such as a reduction of rent and/or transform fixed monthly rental into power-by-hour basis (as illustrated in the restructuring cases in a number of airline insolvencies, including Garuda Indonesia and Thai Airways). In order to achieve more rationalised lease terms for a rapid turnaround of the business, PwC, including the aviation specialist teams, worked together and provided strategic financial and leasing advice at the right juncture to assist HKA on their leasing negotiations with existing lessors.

In summary

This restructuring showcased the variety of options for distressed corporates to explore at the planning stage to deal with different types of creditors, which includes, in appropriate circumstances, choosing the proper venue or jurisdiction for such potential restructuring proceedings.

Moreover, the situation and the case’s development showcase the seamless collaboration not just among different practice teams within PwC, but also with our external counterparties as well.

In the end, HKA successfully obtained adequate support across all classes of creditors for the requisite sanction from the Hong Kong Court and the UK Court and a cross-class cram down process did not need to be pursued. The restructuring was effective on 26 April 2023.

2 While China and the UK have ratified the Cape Town Convention, Hong Kong SAR is excluded from China’s ratification. The other aircraft which were directly leased by HKA were therefore not subject to the same Cape Town Convention issues.

3 This was examined and discussed by Tiang & Partners in the context of another airline scheme of arrangement in our May 2021 edition. For more details, see here: https://www.pwccn.com/en/aviation-leasing/aviation-insider-newsletter-may2021.pdf.

Analysis of key points for the disposal of non-performing assets in Chinese financial leasing busineses

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How to maximise the value of non-performing assets (NPAs) through asset trading and optimal execution in the PRC has been an issue that PRC financial institutions need to consider carefully. Practitioners generally believe that there is no real NPA, only mismatched assets. As the adage goes, "One man's meat is another man's poison." Through legal compliance and targeted means and methods, value realisation and value enhancement of NPAs can be achievable.

The financial leasing business is different from typical PRC bank loans in that it has the characteristics of creditor's rights in assets as well as responsibilities of asset ownership. The Chinese regulatory authorities do not have specific provisions for the disposal of NPAs by non-banking financial institutions, leaving some unclarified matters in the course of liquidation and disposal of creditors' rights or assets.

This article will present some insights and thoughts on the disposal of NPAs in the financial leasing business from the perspectives of compliance procedures, the industry of the disposed assets, valuation, taxation and cross-border legal regulation, in light of the recent case of PwC's end-to-end participation in a recent disposal of an ultra-long range business jet as a transaction advisor for a domestic financial leasing company.

I. Compliance issues in disposing of leased assets

In the financial leasing business, the title of the leased property is registered under the name of the lessor, and if the lessee defaults, the transaction becomes a bad debt. It is common to dispose of the leased property to offset debts with the recovered amount, provided it is done so in a compliant manner.

In the recent example, the title of the business jet was registered with the Civil Aviation Administration in the name of a financial leasing company, the lessor.

After the lessee defaulted, the lessor filed a lawsuit against the lessee and decided to dispose of the business jet.

Before the disposal, the following matters needed to be considered given that the financial leasing company is a state-owned enterprise:

1. Whether it is a state-owned asset and whether it is required to be traded in a market

The nature of the financial leasing business, the objectives of the lessor holding the leased property, the relevant PRC regulations and the lessor's internal regulations on the disposal of NPAs are all important factors in making this determination. In the recent example, it is clear that the Notice on Regulating Matters Relating to the Transfer of Assets of State-owned Financial Institutions (Cai Jin [2021] No. 102) No. 102) and the Measures for Supervision and Administration of Enterprise State-owned Assets Transactions (SASAC Ministry of Finance Order No. 32) are not applicable.

2. Disposal process

In the case of judicial auctions, courts will generally engage an appraisal agency to evaluate the auctioned property, which will then be auctioned with the first auction price being 30% discounted, and the second auction price being 20% discounted based on the first auction price. Under this type of disposal method, it may take a long period of time for judicial enforcement and the assets may be sold at a significantly discounted price. PwC believes that, when the judge has held that the lessor has priority over the leased property and the ownership of the leased property has been registered in the lessor's name, the law and regulations do not prohibit the lessor from disposing of the leased property in the open market, so long as the disposal complies with the relevant regulations.

3. Determination of the disposal price

Different from general civil aircraft, this type of business jet is limited in the scope of use and each aircraft is uniquely designed. Therefore, even aircraft of the same type and year often have a significant difference in market value due to different parameters. Lessors must engage a professional valuation team to accurately determine the fair value of the business jet at the time of disposal. In addition to the fair value assessment, the market customs in the international aviation industry and the trading activity of the business jet market should be taken into full account for determining the disposal price holistically.

4. Qualifications of a potential buyer

In the NPA industry, in the case of the financial claims of a bank, the counterparty of a transfer is generally a qualified financial asset management company, a financial asset investment company or a local asset management company. There are no restrictive or prohibitive provisions governing the transferee of the debts transferred by a non-banking financial institution. However, some non-banking financial institutions are rather prudent and they prefer to transfer their debts to qualified entities. When disposing of a real right with title free from encumbrances, the transferee can be an individual or a legal person capable of assuming contractual rights and obligations under the Civil Code and its relevant judicial interpretations.

In the present case, PwC advised the financial leasing company to refer to the disposal procedures of banks and asset management companies from the perspective of compliance, and make public announcements, evaluations, due diligence and public bidding. On the other hand, it was recommended that a market-oriented approach should be adopted for determining the transfer price and transaction method given the special nature of ultra-long range business jets. This transaction was finally completed at a relatively high price, and the creditor's rights under the financial leasing business were realised. Openness, fairness, impartiality and compliance are key throughout the transaction process.

II. Industry of the disposed property

In the disposal process of the property subject to a finance lease, an in-depth understanding of the industry of the disposed property will help to select the appropriate timing and method of disposal to maximise the value.

The market development for the business jet industry is observable. On the demand side, business jets' advantages of efficiency, flexibility, convenience and safety have been fully reflected as the commercial route networks have been hampered by the epidemic. In terms of the monthly flight mileage of business jets, it has continued to rebound after hitting bottom in April 2020 (about 50,000 hours), reaching about 260,000 hours in October 2021, a new high in the recent 14 years. Since then, all indicators are that activity will remain high, following 15-20% growth in the past two years.

On the supply side, the epidemic has significantly impacted the global supply chain of business jet manufacturers. The shortage of aircraft materials and components severely affected the production schedule of aircraft completion. During the 2021-2022 period, major manufacturers experienced difficulties delivering new aircraft on time and a six-month delay has become the 'new normal'. Due to the lack of new aircraft supply, the operational capacity can only be filled by purchasing used business jets, which has pushed up the market price of used business jets, creating a 15-20% price premium. The strong demand for second-hand business jets in Europe and the United States further stimulates business jet transactions, drives prices up, and even creates a price bubble.

As countries adjust their epidemic policies and commercial airlines gradually resume their network operations, the opportunities for used business jets have begun to gradually diminish. Recently, the number of private jet charters, the leading indicator of business jet travel, has begun to decrease, and going forward, prices for used business jets are expected to return to real value levels.

III. Valuation of the disposed property

In the process of disposal of non-performing financial leasing assets, the importance of valuation should not be overlooked. Choosing a suitable valuation method and considering all factors can better determine the market value of the leased property.

Since the business jet itself is a specialised asset, its valuation requires comprehensive consideration of the market environment and the aircraft ownership, as well as the performance and maintenance conditions of the aircraft. The following aspects need to be considered for valuation:

1. Choice of the valuation method

To determine the market value of a business jet under a finance lease, the first step is to choose the appropriate valuation method considering their leasing status, market transactions, and production status. For example, it is necessary to consider whether there are currently ongoing or potential lease contracts, whether daily operating costs are available, whether there is a certain amount of the same type of aircraft in the market, whether there is a relatively mature trading market, whether the type of business jet is still in production, and whether there is a replacement full price to refer to, etc.

2. Key factors in determining the market value

There are several key factors in determining the market value of business jets.

One of the key factors is the aircraft's condition. The value of an aircraft can be evaluated based on the actual condition of the aircraft by referring to the value of the aircraft in full-life condition and half-life condition.

The maintenance condition and overhaul of the aircraft are also important factors affecting the value of the aircraft. For instance, the overhaul interval and estimated overhaul cost of each major component of the aircraft should be considered, as well as whether the related overhaul cost is covered by the relevant warranty agreement. The maintenance log or manual can also be taken into account.

Another crucial factor is the market environment, which includes the market demand and the ease of business aircraft handover and inspection.

3. Site investigation considerations

As each business jet has its own uniqueness, a thorough site inspection is necessary to ensure all parts are present and in good condition. For example, it is essential to consider whether the aircraft's main components are complete, whether the nameplate is consistent with the records, and how well the airframe, landing gear, engines, and cabin are maintained. In addition, the completeness of the flight logbook, which is the biography of an aircraft, and the recent flight records should be closely examined during the site inspection.

IV. Tax considerations for the disposal of the leased property

Tax considerations are integral to the price negotiation between buyers and sellers and advance planning for value-added tax (VAT) and other major taxes is necessary. Aside from this, potential offshore tax liabilities need to be considered in advance if the disposal involves inbound and outbound transactions.

There were a number of tax issues considered in the present case of the ultra-long range business jet disposal, including, firstly, the VAT considerations on the income derived from the disposal of the business jet, which was an NPA acquired as a result of a financing leaseback default, and, secondly, the potential local tax liability in the place of delivery if the final place of delivery was confirmed to be outside China.

1.VAT considerations in the disposal process

There are generally two ways of disposing of an aircraft: one is the direct disposal of aircraft assets, such as the sale of aircraft asset portfolio (with leases) or the sale of bare aircraft, which is more common; the other is the transfer of equity in the special purpose vehicle which owns the aircraft.

In the recent case of ultra-long range business jet disposal, the seller was a financial leasing company, and the ownership of the business jet was directly registered under its name. As the seller was not incorporated in any free trade zone in China, it elected to dispose of the aircraft by direct sale of the aircraft assets. Noting that the financial leasing company did not only engage in business with a debt financing nature, but it also involved transfer of real rights. Therefore, the following two aspects were considered from the VAT perspective:

1）The disposal of aircraft assets was regarded as a 'sale of goods' and was, therefore, taxable. The taxation shall be based on the consideration of the transaction, with the VAT rate at 13%. Given that the aircraft assets were transferred to an overseas buyer and the seller is a non-exporting Chinese enterprise, the export of the business aircraft was exempted from VAT under the current Chinese tax law.

2）Given that the real right was disposed of for recovering proceeds to offset the debts, the portion of the final disposal income, which was the interest income from the financial leaseback business, should be treated as 'loan services' for taxation purposes and, therefore, was subject to VAT at 6%.

Considering the high value of business aircraft assets, it is recommended to liaise with the relevant tax authorities prior to the transaction to confirm the specific requirements of the tax authorities and the reporting or filing process so as not to hamper the transaction process.

2. Potential offshore tax liabilities

According to the market practice of cross-border aircraft asset transactions, the buyers and the sellers should each bear their own tax liabilities under the applicable laws, and the buyers should be responsible for the post-disposal tax liabilities related to buyers' business (e.g. aircraft leasing, operation, management, remarketing, disposal). If the final delivery location is outside China, offshore tax obligations may also be triggered by various factors such as the seller's identity, transaction purpose and delivery location. It is advisable that buyers thoroughly consider the impact of the potential offshore tax obligations on the transaction during their competitive bidding process and include protection clauses in their sale and purchase agreement.

V. Norms of international law

If the disposal of the leased property involves cross-border transactions, it is necessary for the parties to agree on the choice of law and the jurisdiction to avoid international law disputes.

In the present case, the following issues were of concern from an international law perspective:

1) It is customary for a cross-border transaction to have a letter of intent to agree on the manner of the prospective transaction and the key terms and conditions of the contract to be executed (e.g. security deposit, aircraft inspection, delivery of the aircraft in its current condition, tax liability). It was suggested that the letter of intent should be made public at the announcement stage so that potential buyers could understand the main transaction structure in advance.

2）As buyers and sellers were from different jurisdictions, it was necessary to agree on the applicable laws and jurisdiction of the transaction contract.

3）The transaction contract was not a simple sale and purchase contract. Given the special nature of aircraft assets, the contract terms must include a detailed agreement on the unique attributes of the aircraft, the place of closing, the closing process, the insurance rights and interests, and the rights and interests related to the Cape Town Convention.

4）To safeguard the assets and funds of cross-border transactions, the parties were advised to engage an industry authoritative custodian to supervise the funds and transaction documents.

Conclusion

PwC believes that the value of the NPAs generated from the financial leasing business can be maximised by the selection of the best disposal solution that is compliant with PRC regulations through comprehensive analysis and targeted due diligence. The process of disposal often involves legal, valuation, taxation and other issues, which requires integrated planning and full coordination, and can be enhanced by choosing a transaction advisor who offers end-to-end solutions and has deep experience in disposal and remarketing activities.

Recap on the inaugural Aviation Insider Conference

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On 1 December 2022, the inaugural Aviation Insider Conference was successfully hosted by PwC Hong Kong.

Positioned as one of the first post-pandemic in-person aviation conferences, the event garnered substantial interest from the Hong Kong aviation community, attracting over 120 aviation industry physical attendees, being the maximum seating capacity under the then applicable COVID-19 rules.

The conference, sponsored by Invest Hong Kong (Invest HK), was also attended by webinar participants from more than 10 countries and regions including Brazil, China, Germany, Japan, Malaysia, Singapore, Taiwan, the United States and Vietnam.

With the theme ‘Resilience – Hong Kong as an aviation hub – present and future’, the 2023 conference featured more than 15 distinguished speakers and subject matter experts from airlines and logistics companies, lessors and financiers, as well as airport and governmental authorities, covering the latest market trends in three areas that continue to transform the industry: (i) cargo and logistics, (ii) Environment, Social and Governance (ESG) and (iii) data, digital and technology.

Welcoming address

Speaking at the conference’s welcoming address, Johnny Lau, Chief Consultant of Aviation Business Service of PwC Hong Kong acknowledged that the aviation industry had suffered greatly over the past three years due to the COVID-19 pandemic, as well as other factors such as an uncertain geo-political environment, rising inflation and interest rates.

Johnny expressed relief that the industry is now showing signs of regaining momentum.

This is also demonstrated by the strong turnover and profit for airlines in the North American and European markets and the merger and acquisitions of leasing companies.

Session 1 - Hong Kong as an aviation hub - cargo/freighter and logistics, P2F and freighter aircraft

The first session began with a keynote address by Kevin Guo, Director and CEO of Inno One Group, Parakou Shipping, emphasising the opportunities for air operators to grow on the back of changing consumer habits around cargo delivery and highlighting the strategic importance for shipping companies to invest in the aviation sector in order to secure the supply chains.

Frosti Lau, General Manager of Cargo Service Delivery at Cathay Pacific Cargo, spoke about the resilience of air cargo during the pandemic and the importance of dynamic solutions during COVID starting with the essential delivery of personal protective equipment and medicines which naturally required the speed and breadth of coverage only provided by air cargo.

Raymond Leung, Vice President of Group Commercial APAC, HAECO, agreed that the freighter market from the leading engineering company's perspective will remain the key to their wider strategy and that the flurry of investment activity in the passenger to freighter (P2F) space was, as a result, needing supply to catch up to demand with some more way to go.

Kaixiang Mo, CEO of Tayon Holdings, in agreement with other speakers, noted Hong Kong’s well positioning as an international aviation and logistic hub due to its favourable geographical location, well-established legal and economic system and rich experience in international business.

Similarly, the survey conducted during the first session revealed that the participants believed Hong Kong’s free port status and the quality of bilateral treaties are the two most significant reasons for its prominence as a cargo hub.

Nevertheless, challenges remain in investing in cargo aircraft/ P2F conversions, such as the lease rate factors being continually driven down by new market entrants, hyper-competition and lack of equity investor appetite/understanding.

Session 2 - Hong Kong as ESG/ sustainable investing hub - airlines, aircraft and aviation infrastructure

The second session was kicked off by the keynote address from Cindy Ngan, Partner of ESG - Climate and Sustainability at PwC Hong Kong.

Cindy shared her thoughts on the 2022 United Nations Climate Change Conference (COP27), reporting that COP27 highlighted the importance of radical collaboration between stakeholders to come up with creative and holistic solutions to decarbonisation.

The panellists, Julia Chen, APAC Partnerships, Avolon-e, Herman Tse, Valuations Manager of Ascend by Cirium and Steven Cheung, Founder and CEO of Seaplane Hong Kong, also shed light on ESG transformation.

The panellists noted the necessity to use transformative technology and sustainable sources of SAF in order to make the aviation industry more environmentally friendly.

Nevertheless, there are challenges in the implementation of ESG initiatives such as the difficulties in complying with various ESG taxonomies and standards, and lack of behavioural change from stakeholders.

During this session, the participants also indicated that the speed of bringing viable green technology of comparable quality to current generation aircraft continued to be seen as the biggest challenge in the ESG transformation of aviation.

Looking ahead, the panellist noted that while the APAC recovery may allow for more resources to be allocated towards ESG transformation, there may be further challenges in 2023 due to an uncertain economic outlook and decreased investor appetite.

To foster ESG transformation, nearly three-quarters of the participants also feel that original equipment manufacturers (OEMs) should do more in increasing investment or the speed of bringing safe and viable green technology to market.

Session 3 - Hong Kong as an international financial centre - data, digital and technology

During the final session of the event, a line-up of contributors shared their experiences and thoughts on their respective digital transformation journeys within the aviation ecosystem.

Aldric Chau, General Manager of Digital at Cathay Pacific Airways, spoke about their incredible journey transforming their digital platform in a customer-centric way, while Mark Arel, Area Practice Manager of Amazon Web Services, spoke about putting the customer at the centre of the aviation ecosystem. Julie Zhu, Director and Head of Innovation of Technology and Sustainability at Clover Aviation Capital, addressed the challenges and opportunities in implementing new technology as a start-up in the digital era, and lastly, Sandy Tan, Executive Director and Digital Ecosystems Head of Institutional Banking Group, DBS Bank Hong Kong, discussed creating technological partnerships and innovative digital payment ecosystems in Hong Kong/ the Greater Bay Area (GBA).

During the follow-on panel session, the panellists discussed the challenges of talent acquisition, training, and retention in Hong Kong and the GBA, and called for more initiatives from the public and private sectors to address these issues.

The session concluded with a survey in which nearly 40% of participants identified 'lack of innovation/labour force/talent shortages' as the biggest challenge in the digital transformation of the aviation, transport, and logistics industries.

Closing remarks

In summing up the conference, Benjamin Wong, then Head of Transport, Infrastructure and Advanced Manufacturing, Invest HK remarked that Hong Kong continues to be an international aviation hub in the post-pandemic era, with the government taking numerous steps to reopen our skies and the air traffic at the airport steadily picking up.

Benjamin highlighted that we have now reached a crucial moment after facing all the enormous difficulties brought on by the pandemic and its aftermaths, adding that the fruitful discussion through the conference has made significant contributions to the continued advancements of aviation in Hong Kong and the region.

Key takeaways

Overall, the conference provided a platform for Hong Kong aviation industry participants to get together in person after a long hiatus, explore new opportunities and discuss emerging challenges in the aviation industry and the region.

One of the key takeaways from the conference was that the cargo and freighter market remains resilient despite the challenges and strain on the global supply chain throughout the pandemic period. The speakers and participants also recognised that Hong Kong has been a top-tier player in the world in terms of airport cargo volume over the last decade due to its free port status, well-established legal and economic systems and high-quality infrastructure.

Another major theme of the conference was the implementation of ESG initiatives and their challenges. The speakers stressed that radical cross-disciplinary collaboration in the aviation industry is the key to coming up with holistic solutions for ESG transformation. Nevertheless, there was a general consensus that the difficulties in aligning viable green technology to the current generation aircraft, as well as complying with numerous ESG taxonomies and standards hampered ESG transformation in the aviation industry.

Lastly, on digital transformation in the aviation industry, the panellists and the participants expressed the need to address talent acquisition, training and acquisition to foster innovation in digital transformation and that more initiatives from both the public and private sectors are required to address these issues.

On behalf of PwC Hong Kong and Tiang & Partners, the undersigned would like to thank the participants and speakers and the sponsor Invest Hong Kong for making the inaugural event a great success, and look forward to opportunities to showcase aviation industry market trends and our special insights in a similar again in the near future.

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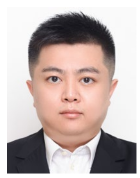

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