



## 2017 Q1 Report

### *Perceptions from the Middle Kingdom*

#### **In Q1 We Saw the PRC Government's Further Tightening and Consolidation of It's Approval Process for The Procurement and Importation of New Foreign Commercial Aircraft, With Likely Resulting Complications for Future Transactions**

In last year's Q2 report, we reviewed developments of potential concern related to the continuing evolution of the PRC Government's traditional central role in the authorization on a transactional basis of the purchase and importation of foreign commercial aircraft. That process has continued, and the related concerns heightened, as further summarized herein.

As Q1 ended, the government was reportedly finalizing and preparing to implement even more centralized measures to regulate the pace of foreign aircraft importation and the resulting aggregate fleet expansion of PRC airlines. Toward that end, PGA Aviation anticipates that that relevant government agencies will soon promulgate additional (and probably even stiffer) regulations for the importation of new commercial aircraft into China, whether by direct purchase or on operating lease. As noted in last year's reports, the government's objective is to promote the healthy expansion of the nation's airline industry, including synchronizing combined fleet growth and ensuring strict adherence to applicable safety, administrative and financial regulations.

More than ten years ago, the Chinese government, acting through China Aviation Supplies Corporation, (CASC), made it possible for several major Chinese airlines to enter into the very first "package deal" purchase transaction with a major foreign OEM to acquire a very large quantity of new airplanes. The current PGA Aviation staff includes representation from that historic negotiation on the OEM side.

The primary benefits of the "package deal" concept for the participating airlines are that, (i) because of the much larger quantity of airplanes being ordered, each airline can expect to receive a proportionate share of a larger quantity based price discount than it could negotiate on its own, and (ii) the Chinese government's approval of the transaction is essentially "baked in" as part of the deal, rather than something that a participating airline would otherwise need to campaign for on its own in the aftermath of a stand-alone purchase. For the OEM, in addition to the same benefit as the airlines related to the de facto "pre-ordination" of eventual government approval, it also gets the very significant benefit of the predictable stabilization of its production lines further into the future. Probably as a result, and probably also with the "strong encouragement" of the PRC Government, the package deal concept has long since been adopted by the other major OEM as well, and is now the standard procedure by which Chinese airlines collectively purchase foreign aircraft.

Over the years, each successive package deal has been at least somewhat unique from the preceding ones, with each participating airline having the right to negotiate certain of its own customized terms and conditions with the OEM, in addition to those standardized across the full participating customer base. The process has evolved into the favored format for PRC foreign aircraft purchase transactions, and the related governmental approval process has evolved to accommodate it, which will likely continue.

We anticipate that the forthcoming new rules will address several fundamental issues while presumably (hopefully?) also promoting harmony, at least in the long run, among Chinese governmental agencies, Chinese airlines, and foreign airplane OEMs. Some of the issues that we think may be addressed are as follows:

1. Whether and how the purchase agreements between Chinese airlines and OEMs will be

- contractually binding between seller and buyer, even if somehow remaining subject to final PRC Government approval;
2. Whether, and to what extent, firm orders (as opposed to options) will impact advance payments (aka "PDPs"), and OEM revenue forecasts;
  3. Whether, and to what extent, the lead time of the customer airline's airplane configuration process and the OEM's "implementation" (i.e., actual design and production initiation) for a particular airplane are actually integrated with the government approval process and the timeline related thereto; and
  4. Whether, and to what extent, the verification, introduction and country-specific regulatory certification process for new types of airplanes are coordinated with the government approval process

We expect that, as is usually the case, all relevant parties will somehow eventually find a way to address their respective concerns, however long that may take. We believe the PRC government aims to regulate its airlines to whatever extent they deem necessary in order to facilitate their smooth and orderly progress and expansion to reach their "destined" prominent place among the world's airlines. Both the government and the airlines of course believe that they deserve and expect to be treated "fairly" by the OEMs under package deals, as well as stand-alone deals, from a commercial perspective. For their part, the OEMs of course feel that they should be able to enter into purchase agreements that they can regard as legally and commercially binding, and to look forward to healthy and stable revenue streams from predictable production lines and reliable customers. All parties must therefore be prepared to take into account and honor all relevant Chinese government rules and regulations, international accounting standards, stock

exchange disclosure rules, and relevant bylaws and board resolutions on both the airline and OEM sides. The resulting framework is therefore a comprehensive and complicated matrix in which each participating stakeholder expects to have its questions answered and its concerns satisfactorily addressed if the process is to succeed.

On a somewhat related note, another new development is that the "Big Three" original PRC government-affiliated (and originally government-owned) airlines, Air China, China Eastern and China Southern, are in the process of forming their own leasing companies. Since this is still a "work in process", it remains to be seen to what extent these new enterprises might be subject to the same regulatory constraints as PRC airlines, including the three "parent" airlines, that purchase and import foreign airplanes for their own fleets. Such regulatory commonality might be expected to be even less for airplanes that such lessors might purchase for placement outside China. We will keep an eye on this situation and report any further development if and as they may develop.

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