



2016 Q1 Report

Perceptions from the Middle Kingdom

New PRC Government Regulatory Requirements Will Complicate Used Aircraft Transactions

The past few years have seen a robust purchase and expansion phase for both mainland China network carriers and China's newly developed bank-owned operating lessors.

The Chinese airlines are continuing to place large orders with western OEMs, whether through stand-alone deals or by participation in a multi-airline "package" deal under PRC Government supervision. Their motivation to expand their fleets is a combination of the continuing high GDP growth and the sustained high yield on domestic routes, especially those keyed to the major gateways and trunk routes of the most lucrative Metro areas. Interestingly, the airlines' aircraft buying trend is also further incentivized by their aged fleet replacement needs, especially those pertaining to legacy wide-body replacement situations and the challenges therein regarding specific aircraft sub-fleets.

By comparison, the new bank-owned leasing companies' aggressive expansion plans have evolved mainly based on their respective parent banks' ambitions to include profitable leasing arms in their respective corporate portfolios, together with their optimistic long-term estimates on the world-wide industry needs (with primary focus on those of China). These bank-owned leasing companies' purchase and growth plans also have the "double jeopardy" of being subject to oversight and regulation by two government agencies, those responsible for both the banking and aviation sectors, as compared with the airlines, the scrutiny of which is primarily based on the PRC government's airline industry 5-year growth plan.

Some recently announced major new aircraft orders between the two primary OEMs and Chinese airlines are also, to some extent, to address aged airplane phase-out and replacement needs. Only the "Big Two" OEMs have the capability to directly take out on trade-in the legacy aircraft from each carrier's fleets, especially dealing with their own

previous products, and especially wide-bodies, which have narrower follow-on customer pools. The newly executed rules placed by the relevant PRC government supervisory committees directing how to dispose of state-owned assets, including aged aircraft and engines, seek to add more transparency to the transactional process at each wholly or partially state-owned Chinese airline, including those listed on stock exchanges.

The new administrative rules require state-owned assets be traded through government-authorized trading and bidding platforms under a newly established procedure. This not only adds still more caveats to the new aircraft procurement process at the airline level if aged aircraft trade-in is part of the deal, but also will have a direct impact on new aircraft operating lessors' deals with Chinese carriers if the deals trigger a trade-in. The full scope of the impact of the new rules on the state-owned asset disposal side for Chinese airlines still remains TBD at this point.

PGA Aviation doesn't expect the traditional government-mandated industry practices regarding new or used Chinese aircraft transactions will change substantially anytime soon. However, the new rules regarding phase-out transactions for state-owned airlines may still add a considerable amount to the total transaction time and cost of each such deal, both direct and indirect, for all participants on either side, the details and impact of which should become more apparent in the coming months. However, for those vendors who business is oriented toward helping airlines to keep operating their existing fleets safely, efficiently and profitably for longer periods of time, there might be a "silver lining", in that the Chinese airlines and leasing companies may be inclined to do so in order to avoid incurring those additional transaction costs for a while longer.

We understand the goals of the government's new regulatory requirements with respect to such aircraft transactions and, we expect the rules and procedures will be periodically re-defined from the time to time, both to improve the transparency of the particular transaction and also to promote the liquidity of the asset when dealing with mid-life and end-of-life aircraft and engines. Stay tuned to this column for information about further key developments on this significant evolving issue.