Airline Business & Law:
Aircraft Acquisition, Finance & Leasing

Airline Business & Law (ASPL 614)
McGill Institute of Air & Space Law

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Pillsbury Winthrop Shaw Pittman LLP
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Introduction: Aircraft as Investments

Q: What is the surest way to become a millionaire?
A: Become a billionaire and start an airline…

- Richard Branson
Introduction: 10 Reasons for Investor Caution

1. Danger and liability = highly regulated industry (SAFETY!)
2. Variable operating costs, mainly driven by fuel and personnel
3. Highly mobile, crossing national borders and subject to expropriation
4. Expensive to maintain even when not in use
5. Value dependent on maintenance status, variant, upgrades, engine type, operating conditions, line number etc…
6. Highly cyclical industry (GDP growth necessary but not sufficient)
7. Long-dated asset (30 + years)
8. Illiquid market, with significant transition costs
9. Residual value risk and obsolescence
10. Capital-intensive, technology-driven manufacturing process
Introduction: Aircraft as Investments

Source: ACAS, December 2006, Forecast: SH&E
Introduction: Aircraft as Investments
Players: The Airline / Operator

Different Types = Different Needs

- Geographic Markets
- Route Distance
- Price/Quality Ratio
- Distribution Channels
- Competition/Elasticity

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<td>Flybe.com</td>
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Source: Pillsbury
Players: The Metal-Heads

**Primary**
- OEMs = Aggregators
- Development costs + Jobs = Politics
- Back-Stop Loans / RVGs
- After-market Support (Razor Blade Model)
- Asset Management and Remarketing

**Secondary**
- Parts and services
- Residual Value

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Players: Sources of Finance

**Evolution of Banking**
- 60s-80s: North America
- 80s-90s: Japan
- 90s-00s: Europe
- 10s+: Emerging Markets

**Evolution of Lessors**
- Asset Risk Arbitrage to Credit Risk Arbitrage
- Capital Consumer/Provider

**Evolution of Capital Mkts**
- US-based in 1990s
- Islamic bonds and other global opportunities

**Evolution of Export Credit**
- “Leveling the field”
- Changing duopoly

### Bank Debt
- ICBC
- Santander
- Deutsche Bank
- BARCLAYS
- BNP PARIBAS

### Capital Markets
- Goldman Sachs
- Teachers' Pension Plan
- J.P. Morgan
- Citi
- MetLife

### Lessors
- Mitsubishi
- Aircastle
- The Royal Bank of Scotland
- ILFC

### Export Credit
- ECA
- EDC
- BNDES
Acquisition Process: Selecting Equipment

- Technical considerations:
  - Range/payload, fuel burn, engine type, training, spares, tech support, BFE

- Economic considerations:
  - Demand, price, load factors, financing, residual values, commonality

- Types of fleeting decisions:
  1. Purchasing aircraft of a type already in the fleet:
  2. Purchasing aircraft new to fleet, but with other carrier
  3. Purchasing a new type of aircraft

- New Aircraft vs. Used Aircraft
  - Technological advances now incremental, though efficiency counts (fuel)
  - Increased capital cost vs. Increased operating cost (depends on utilization)
  - Premium travel (passenger experience) vs. LCC (operating efficiency)
Acquisition Process: OEM Purchase Agreements

- OEMs have “war rooms” and conduct “campaigns”
- Negotiating power of airlines varies, as does discount from list price
- Key airline considerations:
  - Minimizing unit cost for aircraft, engines, spares, ground equipment, training
  - Pre-delivery payments (PDPs), delivery delays, escalation
  - Specification changes, configuration, options, warranties, customer support
- Possible OEM Incentives:
  - Credit memos, performance guarantees (including fuel burn), AD cost participation, escalation caps, maintenance cost protection, promotional support
- Sales Financing and Asset Management
  - Back-Stop Facilities, Residual Value / Deficiency Guarantees, Remarketing
  - Should be dissuasive, yet allow OEM to book sale; must ensure ability to exit
Acquisition Process: PDP Financing

- Credit facility in favor of an aircraft purchaser to finance a portion of the significant progress payments (e.g. 35%) due on an aircraft order
- PDPs are partially funded by the lender directly to the OEM and loans mature on or around the delivery date for an aircraft
- Lender secured by lien on “portions” of the aircraft purchase agreement; has right to step in and purchase if borrower defaults
- Collateral assignment of contract rights, as opposed to a security interest in the aircraft itself; no special filings (e.g. FAA, Cape Town).
- Borrower, lender and OEM enter into consent and agreement defining assigned purchase agreement terms and rights of parties
- The market for PDP Loans has fallen apart, as the security has limited value in a falling market
Acquisition Process: Secondary Market

- There is an aircraft “food-chain”:
  - Carrier Tiers; Freighter Conversion; Part-Out

- Generally active secondary market, especially for narrow-body aircraft, but high volatility and dependent on availability of loans

- Passing of title to an aircraft over time as chain of ownership grows
  - Risk of title defect, e.g. possessory or tax lien, undischarged interest

- Sale “as-is”, w/o representation as to condition (vs. OEM warranties)
  - Rely on due diligence and seller credit to back-up title representation
  - Physical inspection + records; contracts always include rejection rights

- Operational indemnities exchanged for period pre- and post-sale

- Aircraft trading (esp. distressed) = Opportunities + Risks!
Leasing: Finance Leases vs. Operating Leases

- Legal, tax and accounting differences, with large impact on economics
- **Finance (Capital) Lease:** Really a security device used for a loan
  - Lender (Lessor) “owns” aircraft; “Rent” payments benchmarked on LIBOR
  - Usually long-term, based on useful life; purchase option (lease balance or bargain)
  - Economic ownership rests with Lessee; aircraft goes on its balance sheet
- **Operating (True) Lease:** Economic ownership rests with Lessor
  - Capital cost not fully amortized over term of lease, so residual/remarketing risk
  - Shorter term; FMV purchase option is a possibility
  - Aircraft goes on balance sheet of Lessor; rentals are an “expense” for lessee
- Operating leasing has grown from 5%-35% of fleet in last 25 years
  - Flexibility for airlines in terms of fleet planning; requires less capital
  - Lessors require security to protect asset value: deposits, reserves, letters of credit
Leasing: Asset Risk Arbitrage vs. Credit Arbitrage

“Original Lessors”: Asset-risk arbitrage (Capital Consumers)
- ROI based on knowledge of residual values, asset management, and ability to monetize (remarket); capital raised on basis of secured debt
- Funding mismatch = trouble; GPA to GECAS; ILFC to AIG

“Large Lessors” Asset Risk + Credit arbitrage (Capital Providers)
- Using borrowing capacity of parent (cheap unsecured debt) to fund new deliveries
- Tax structuring allows parents to take depreciation credits
- Hard to compete, but difficulties loom when funding issues arise (AIG, RBS, CIT)

Large Portfolio Sales and Future Funding Challenges
- Many lessors rely on capital markets exit strategy
- Increased lessee defaults = cash flow issues (less rent, remarketing expense)
- Private equity stepping in to fill the void, but still need leverage for desired returns
- Lessors are once again capital consumers

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Leasing: Depreciation

- Depreciation is the decline in useful value of a fixed asset due to wear and tear from use, the passage of time or obsolescence
  - It is an actual cost; we can view it as “spending” the capital balance of an asset
  - Since it is an expense, tax rules allow a deduction against expenses

- Two accounting methods:
  - **Straight Line**: 100M aircraft, 20 year useful life = $5M depreciation / yr.
  - **Declining Balance**: 100M aircraft, 10% / yr. = $10M, $9M, $8.1M, $7.29M, $6.56M

- To encourage investment, tax rules permit accelerated depreciation
  - Generally 11 years, sometimes 7 years
  - Tax deferral method results in up front value for taxpayer (time value of money)

- Unfortunately, most airlines don’t make money, so had limited use for the depreciation credit…
Leasing: Leveraged Leasing

- Non-recourse financing allowing for transfer of tax benefits

Diagram:

- Equipment Notes
- Indenture Trustee
  - Debt Service
    - Owner Trustee (aircraft title)
      - Residual Value
      - RENT
      - EQUITY
        - Owner Participant (Flush Cable Co.)
        - Lessee (Dirt Broke Air Lines, Inc.)
Financing Methods: Credit Risk vs. Asset Risk

- Until 1960s, airlines funded aircraft with equity / unsecured debt
- Arrival of expensive jet aircraft required new sources of capital
- Secured lending, but still very dependent upon airline credit risk
  - Credit rating, Risk of Default; based on relationships, often with flag-carriers
  - Government supported airlines = value of collateral secondary
  - Aircraft values always cyclical, difficult to predict
- De-regulation / Legal Protections / Standardization / Liquidity
  - Creates opportunities for lenders willing to take asset risk (Lessor’s terrain)
  - Non-recourse financings; some banks develop remarketing expertise
  - Depends on ability to recover aircraft in a default situation
- Capital Markets = Longer Term and Asset Drive
Financing Methods: Secured Bank Lending

- Historically, important relationships between national banks/carriers
  - Syndicated Deals vs. Club Deals
- Banks have developed significant expertise; can move very quickly and provide committed funding
- Risky airline credits weigh on risk capital allocations; structuring helps
  - Yield protection, withholding taxes, indemnification, security, guarantees
- Liquidity/funding problems have slashed availability
  - Higher margins, lower Loan-to-Value ratios
  - Market disruption clauses allowing loan for “cost of funds” interest
  - Shorter term loans, more rapid amortization
  - Financial covenants, including LTV tests
  - Flight to quality for borrowers and aircraft
Financing Methods: Export Credit Agencies

- A private or quasi-governmental body that extends export financing
  - EDC, Ex-Im Bank, COFACE, Hermes, ECGD, BDNES
- **Benefits**: better borrowing terms, improved balance of trade
- **Polemic**: illegal trade subsidy, welfare for large corporations
- OECD Aircraft Sector Understanding sets out most favorable terms on which export credit may be provided
  - Minimum interest rates and premiums based on risk classification of a borrower
  - ‘Cape Town Discount’ applies if operator has ratified the Cape Town Convention
- ‘Base security package’: 12 yrs. / 85% / mortgage style repay
- Home Country Rule: Applies to US and to UK/FR/GER/SPN
- “Category 1” vs. “Category 2”: (Term and Pricing)
Financing Methods: Export Credit Agencies

Eximbank
- Ex-Im Bank Guarantee

Guaranteed Lenders
- Guaranteed Loan Agreement
- Promissory Note

Lessor Parent
- Declaration of Trust
- (Share Ownership)

Lessor SPC (Aircraft Title)
- Guaranteed Loan Agreement
- Purchase Assignment
- Engine Assignment
- Leases
- Insurance Assignment
- Deregistration

Security Trustee
- Aircraft Mortgage
- Deregistration Power
- Lease Assignment

Lessee Airline
- Purchase Agreement
- Consent to Assignment

Engine Manufacturer
- Engine Agreement
- Engine Consent to Assignment

Boeing
Financing Methods: Capital Markets

- Late 80’s, U.S. carriers sought access to deep and liquid capital mkts
  - Funding source diversification; structure different tranches
  - Ability to fund larger deals; Longer maturities (25-30 yrs.)
  - Rating agencies play an important role for institutional investors

- Credit/Asset-Based Issuance: ETCs, PTCs, EETCs (Section 1110)
  - “Enhancements” put in place to achieve AAA ratings (higher than airline rating)
  - Senior tranches, liquidity facilities, cross-collateralization

- Asset-Based Issuance: Portfolio Securitization (ABS)
  - Special purpose vehicle issues debt to purchase pool or aircraft on lease
  - Used by Lessors to exit certain pools of assets; remain as servicer
  - Assumes that assets will be managed and monetized properly, with stress tests
Financing Methods: Capital Markets

1995A-1 BONDHOLDERS

1995A-1
Pass-Through Trustee

N189UA Indenture Trustee

N189UA Equipment Notes %

N189UA Owner Trustee

Limited Future Rent / Residual Value

N189UA Owner Participant (Bell Atl. Credit Co)

1995A-2 BONDHOLDERS

1995A-2
Pass-Through Trustee

N766UA Indenture Trustee

N766UA Equipment Notes %

N766UA Owner Trustee

Limited Future Rent / Residual Value

N766UA Owner Participant (NCC Key Co.)

Lessee
(United Air Lines, Inc.)
Financing Methods: Islamic Finance

- Islamic funds estimated at over $200 billion
- Shariah forbids the payment and receipt of interest
- Economic similarities (e.g. seeking return), but not simple end run as there are many specific issues (e.g. tradability, yield protection)

1. **Murabaha**:  
   - Trade for mark-up on deferred payment terms (benchmark to LIBOR)

2. **Ijara**:  
   - Lease of aircraft with purchase option for financed amount (with mark-up)

3. **Sukuk**:  
   - Islamic bond allows many investors; leverage achieved through Ijara

- Shariah Board Approval: structural and documentation review
Protections: Perfecting Security in Aircraft

- The operator needs freedom to monetize assets, whereas the lender requires that it remain accessible and in good condition.

- An aircraft is an item of personal property, can be subject to mortgage, conditional sale, lease, trust, possessory liens etc.

- Many countries have special registries for title and security interests:
  - Canada: no central registry for security interests, must make provincial filings
  - US: FAA registry, for recording any instrument affecting title to or interest in A/C
  - Until recorded with FAA, the interest is effective only as to parties, their relatives and heirs and persons with knowledge of the agreement

- Geneva Convention on recognition of rights in aircraft:
  - Basic questions of international law arise – where to file?
  - Contracting states recognize interest recorded in state where aircraft registered

- Cape Town Convention: Creates a central international registry of interests in aircraft (see handout)
Protections: Operation, Maintenance, Return Conditions

- **Operation and Possession**
  - Lawful use, all permits and insurance, restrictions on operations in some countries
  - Subleasing; Pooling and exchange: Customary arrangements with solvent carriers

- **Approved maintenance program compliant w/ FAA/EASA regulations**
  - Shop visits: FAA/EASA approved repair stations; workscope and timescale
  - “Back to birth” historical records in English on all parts
  - Monthly reports of hours and cycles
  - Airworthiness Directives and Mandatory Service Bulletins (Cost-Sharing)

- **Usage Fees/Maintenance Reserves/Other Security**

- **Return Conditions:**
  - Physical inspection, engine borescopes, records, test flight, deregistration etc.
  - Hard-time conditions: Hours or cycles on airframe, engines, LLPs…
  - Financial adjustments: Based on pre-delivery use or agreed threshold
Protections: Insurance

- Creditworthiness is key; main int’l market in London (Lloyd’s)
- Insurance and Re-Insurance (insurer’s spreading risk)
- Hull “all risks”: Physical damage to the a/c (Agreed Value)
  - No replacement, deductibles, excludes “war risk”, spares usually separate
- Hull “war risks”: War, hijacking and allied perils / WMD
  - Completely unavailable after 9/11; slow to come back and expensive
  - US, China, Canada etc. assist airlines; FAA provide full hull/liability cover
- Liability: Passenger, Cargo, Third Party
  - Combined single limit for bodily injury and property; $250M-$1B
  - Need to make sure all appropriate parties are additional insured (your client!)
- Airline Finance/Lease Contract Endorsement: AVN 67B / AVN 67C
  - Financier need not review policy; insurer need not review financing contract
  - Breach of warranty cover; severability of interests; notice of cancellation/change
Default and Remedies: Lease and Loan Defaults

Some Typical Events of Default:
- Failure to pay rent/loan amount within X days of due date
- Failure to comply with covenants remaining uncured for X days
- Inaccuracy of representations or warranties
- Loss of air carrier license
- Voluntary or involuntary insolvency petitions
- Failure to insure
- Loss or invalidity of security

UCC Remedies and Cape Town Remedies:
- Lender: repossess, foreclose, account to the borrower
- Lessor: default must “substantially impair” value of lease contract (UCC 2A-523)

Lessees/Borrowers cooperation is critical to achieving main objectives:
- Protecting the value of the asset; and
- Keeping it in revenue-generating service.

Best way to avoid a default is to see it coming and work around it.
Default and Remedies: Chapter 11 / CCAA

- **Automatic Stay**: Creditor “stayed” from remedies
- **Adequate Protection**: Creditor will encounter difficulty lifting stay on remedies unless there is a risk of harm to the value of collateral
- **Rejection of Executory Contracts**: Loans, leases etc.
  - Come and get it; value of aircraft may be less than debt burden
- **Section 1110**: Mandates the expiration of the automatic stay for aircraft after 60 days, no matter what
  - 1110(a): Airline may elect to assume pre-petition contract
  - 1110(b): Airline and creditor may consensually restructure terms
  - 1110(c): Creditor takes back the aircraft (not to be taken lightly)
- Restructure employment arrangements, pensions etc.
- Polemic: Chapter 11 is a self-fulfilling prophecy
## Default and Remedies: Airline Bankruptcies

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<td>Comair</td>
<td>1/5/10</td>
<td>Mesa Air</td>
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Default and Remedies: Foreclosure and Repossession

- Take legal advice under:
  1. Law governing the lease or loan agreement
     - Contracts, substantive remedies
  2. Law of the lessee’s jurisdiction
     - Bankruptcy
  3. Law of the location of the engine
     - Procedural remedies

- UCC 2A-525: A Lessor may repossess without judicial process if it can be done *without breach of the peace*

- NOTE: Even if contractually mandated, self-help rights may not be available in certain jurisdictions where an engine is located
  - Some require judicial proceedings for a repossession
  - Cape Town Convention allows for Self-Help

- Foreclosure extinguishes interest of debtor; must be conducted in a commercially reasonable manner
Default and Remedies: Transition and Deficiency

- **Remarketing**: trying to minimize down time and maximize price, which is difficult in a “distressed” situation
  - In-house capability and forward market view are advantages

- **Refurbishment**: extremely useful to know where the engine will go before deciding how much to invest
  - Might be a better strategy to part out

- **Deficiency Claim**: this claim can properly be liquidated once the “end-game” is played out
  - $\text{(Old Rent NPV + Old Residual) or (Debt)}$
  - $\text{(Sale Proceeds) or (New Rent NPV + New Residual)}$
  - $\text{Repossession and Transition Costs}$
  - $\text{= Damages}$
Conclusion: Risk and Reward

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<tr>
<th>ASSET RISK</th>
<th>CREDIT RISK</th>
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<td>• Residual Value</td>
<td>• Default Risk (i.e. payment)</td>
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<td>• Repossession Risk</td>
<td>• Financial performance/Cash flows</td>
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<td>• Remarketing Risk</td>
<td>• Business environment</td>
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<tr>
<td>• Maintenance and Operation</td>
<td>• Airline ownership</td>
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<tr>
<td>• Collateral Security</td>
<td>• Quality of Management</td>
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- As for the rewards....
Running an airline is like having a baby: fun to conceive, but hell to deliver.
— C. E. Woolman, principal founder Delta Air Lines

I was engaged in what I believe to be the most thrilling industry in the world—aviation. My heart still leaps when I see a tiny two-seater plane soaring gracefully through the sky. Our great airlines awe me. Yet I know they were not produced in a day or a decade.
— William A. "Pat" Patterson, CEO United Airlines

If we went into the funeral business, people would stop dying.
— Martin R. Shugrue, Vice-chairman Pan Am

People who invest in aviation are the biggest suckers in the world.
— David G. Neeleman, after raising a record $128 million to start New Air (the then working name for what became JetBlue Airways), quoted in 'Business Week,' 3 May 1999.

This industry attracts more capital than it deserves.
— Stelios Haji-Ioannou, founder of EasyJet, reported in Aviation Week & Space Technology, 5 October 2009.

I'm flying high and couldn't be more confident about the future.
— Freddy Laker, Laker Airways, 3 days before the collapse of Laker Airways, 3 February 1982.