BUSINESS CONTINUITY – ENSURING A SOLID BUSINESS MODEL

THE GROWTH OF JOINT VENTURES IN THE FREIGHTER MARKET: RISKS AND REWARDS

by Simon Spells & Manoj Purush

Takeaways

- Address difficult commercial and legal issues early on
- A lengthy memorandum of understanding is not always a bad thing and can help flush out issues sooner rather than later
- Get your advisors involved from the start and they can help identify key legal issues associated with the sector and the specific venture

With the growth of the freighter market, we are seeing a number of non-aviation industry players looking to invest and/or start new ventures with existing participants or participants within the same supply chain. This mismatch of financial capability and industry capability often requires participants to carefully discuss some of the more difficult questions relating to the new venture upfront. This article discusses the common issues an aviation industry participant needs to consider when making investments in or entering into a new line of business with a third party.

Freighter market focus and joint venture growth

The COVID-19 pandemic inflicted on the aviation industry is a hardship of a magnitude never seen before. Passenger travel has been largely curtailed since early 2020. Borders have been subject to multiple shutdowns and re-openings, and varying levels of restrictions, all of which have negatively impacted demand for passenger travel. The recent discussions on vaccination passports and on the opening of borders in Europe and the United States to vaccinated individuals suggest there is some semblance of demand for passenger travel returning in this part of the world. Other jurisdictions are struggling with opening up regionally. In Asia, the approach resembles a patchwork quilt of different levels of vaccination, and different stages of re-opening and/or semi or full lockdowns. Recent commentary on the forecast for moving "back to normal" suggests that passenger air travel will not return to pre-COVID-19 levels until at least 2024.

Throughout the COVID-19 pandemic, the increase in e-commerce and the need for movement of goods (including medical supplies) from one part of the world to another resulted in another area of aviation shining a bright light in an otherwise gloomy skyline: the air freight market.

Over the past decade or so, low cargo rates and the general unprofitability of the cargo business led to many airlines letting go of, or reducing, their cargo freighter fleets. Many are now changing their tune due to e-commerce sales rocketing after the COVID-19 pandemic started. This demand, combined with much of the global passenger fleet being grounded (which itself is responsible for the transportation of a significant amount of air cargo) led to a significant rise in cargo yields that has been sustained to date. Based on data from the Airline Analyst, only 21 airlines (down from 77 airlines in 2019) globally disclosed that their operating performance achieved positive operating profits for the third quarter of 2020, which is traditionally the industry's most profitable quarter. Cargo revenue accounted for 49 percent of the total revenues, on average.

With e-commerce sales set to continue to rise, and commercial passenger flights predicted to a return only on a graduated basis for some time, the demand for freighter aircraft is forecast to remain high, supporting continued yield and profitability in the freighter sector.

Demand in the freighter sector has sparked interest from lessors, airlines, maintenance, repair, and overhaul (MRO) service providers, investors, funds, and other financial institutions. Many are keen to invest in the area to hedge their existing passenger aircraft exposure, create new business lines around it, and/or build out their existing expertise (in the case of MRO service providers and conversion specialists) to increase capacity and the range of conversion programs on offer. We are even seeing shipping companies come into the space to supplement their existing seaborne freight offerings, especially to help mitigate the current issues of congestion and delays in the container shipping market, particularly on Asia-U.S. routes where there are no land-based alternatives.

Such interest has led to a number of strategic partnerships and joint ventures over the past 24 months, with both new and established market participants entering or building out their freighter sector presence. Recent examples include:

- ST Engineering and Temasek entering into a joint venture to develop a freighter aircraft leasing portfolio.
- Hong Kong Aircraft Engineering Company Limited, an airframe maintenance and modification group, partnering with 321 Precision Conversions to provide heavy maintenance and structural modifications for its Airbus A321 P2F conversions.
- CMA CGM setting up CMA CGM Air Cargo.
- Titan Aviation and Bain Capital entering into a joint venture to develop a freighter aircraft leasing portfolio.

Collaborations often involve the meeting of partners with different industry knowledge and financial strengths. This "mismatch" between skill sets and/or financial powers can push the partners into discussions about strategies, objectives, and alignment before entering into such collaboration. There are certain salient questions that parties should consider before embarking on such a collaboration.

When structuring a new collaboration, business teams will typically meet and undertake discussions and commercial due diligence before deciding whether the collaboration will bring synergies and be financially profitable. This is paramount and is often the fundamental rider for undertaking a collaboration in the first place. However, in the midst of the urgency and excitement of embarking on a venture, parties risk failing to discuss some of the less convenient issues that should nevertheless be addressed. Our experience has shown that laying out this groundwork requires tact and sensitivity – of course, without dampening the spirit of collaboration!

Documenting some initial understandings is a common practice. In addition to this, it may be advisable to spend time addressing other issues at the start rather than during the later documentation stage.

Key considerations

1. Long-term objective. Each party should consider their long-term objective in entering into such a joint venture (the JV). Aviation industry players (the AVP) are often in it for the long term and may view the JV as a new line of business that will bring synergies to their existing business. On the other hand, for a financial institution or fund (the Fund), this would be deemed an investment in a sector that the fund believes has potential for growth and hence returns. The AVP should be mindful that the Fund may ultimately look to exit the JV and consider what would be an acceptable time frame for the AVP to exit. Should the parties agree to a lock-up period (or moratorium) during which both parties are not entitled to voluntarily exit the JV?

2. Exit. There are be a number of ways that parties might exit the JV. Some of the more common forms of exit and the challenges they may raise include:

   a. Trade sale. One of the more common exit mechanisms is through a trade sale with a third party. This in itself raises a number of interesting issues. For example, should the sale to third parties be limited to parties that are not competitors of the AVP? While it may be more common to see multiple funds collaborating with each other, AVPs may be more sensitive to such collaboration. If such sensitivities do exist, what would be the best way to address them? Identify and list such competitors, knowing that the market may change in a few years, that a potential trade sale cannot involve. Alternatively, would it be easier to set out a list of names and the AVP's criteria for determining whether a party is a competitor? This may provide flexibility without compromising on principles, but could potentially lead to disagreements on the interpretation. From the Fund's perspective, this may severely impact the potential market and the liquidity of their shares.

      Often, discussions around rights of first refusal (or rights of first offer), tag and drag rights all play into such discussions. The key consideration parties need to bear in mind is that while these clauses may work well in theory, a party without the relevant financial capability may find that it is unable to take advantage of such rights.

   b. Public markets. An exit in this form may be through a traditional listing on a stock exchange, a back-door listing, or even securitization of the assets of the JV. Should parties agree upfront that if a certain internal rate of return is achieved through such a listing process, neither party is permitted to block such a listing?

3. Control. Who will have control of the JV? Will there be reserved matters? If so, will such reserved matters make it practicably difficult to run the JV? If there are disagreements or resolutions that cannot be passed because parties do not agree, should the parties consider such a scenario as a deadlock? What would be the deadlock resolution mechanism? Should parties be permitted to buy each other out? It could be argued that a persistent deadlock signals that parties' interests are not aligned and that, rather than having a JV that cannot run due to disagreements, parties should dissolve the JV. Of course, it could be argued that parties with deeper pockets will probably have a greater ability to benefit in such scenarios. However, what would this mean without the AVP's presence? Would the Fund have the necessary skill set to be able to run the JV? Or in this scenario, is the Fund in a more disadvantageous position – where it would need to exit but the AVP may not have the resources to fully exit the JV?

4. Tax. When considering forming a new JV, parties often consult tax advisors to determine the most tax-efficient structure for running the business and for extraction of profits. However, for parties based in different jurisdictions, this may raise different tax considerations. Something that works for one party may not necessarily work for the other.

5. Future funding needs. Will parties have an obligation to provide future funding to the JV? If there is no such obligation, future capital calls could potentially lead to the dilution of a shareholder who may not have sufficient capital to meet such equity funding calls. In such circumstances, parties may wish to negotiate a funding waterfall mechanism regarding how the JV will approach funding requirements. It is often agreed that funding through shareholder loans will take priority over funding via equity. But while this seems obvious, it is also important to consider the impact this may have on any tax treaties the JV structure relies on, as well as covenants under existing funding arrangements with third parties.

6. Ancillary support. It was mentioned above that the party with the deeper pockets typically stands to benefit from the various rights provided in JV documentation. However, the Fund should always bear in mind that the AVP has a much deeper understanding of the underlying business and, while the line of business may be new, a much greater capability to navigate the business through difficult times. Potentially disagreeing with the AVP and buying out the AVP means that the Fund will need to find new stewards of the business, and this is often not practical or pragmatic. As is often the case, there may be stand-alone agreements between the JV and the AVP. It is also important to consider how issues arising under those agreements will be dealt with by the JV.

Summary and key takeaways

When entering into a collaboration, it is critical that parties discuss upfront some of the less comfortable issues. Discussing and documenting these key issues upfront and getting your advisors involved from the start will not result in a duplication of work; rather, consider it time and money saved in the long run. A carefully negotiated memorandum of agreement may leave very little room for lawyers to raise new significant commercial points for parties to discuss. Some of these issues are difficult to resolve, and parties often take the gamble that they need to carry some of this risk and find a resolution if and when it arises.

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