NOVEMBER 2019

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UPDATE

#World-traveller #Aviation-investor

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The Cayman Islands as a destination for aviation investment funds.

Many a traveller of a certain age will talk of the 'glory days of air travel' as if it were a bygone era which was at once glamorous and adventurous. It may well be that, for the average traveller, the evolution of air travel and its becoming commonplace has rendered it all rather humdrum. But it is precisely this evolution which has tipped the balance from the traveller to the practitioner – never before has the aviation sector been such an exciting place to work.

It is not just the usual suspects who are excited by aviation: the sector has been attracting increasing levels of attention from an investor community seeking exposure to ever-more-interesting alternative assets within their investment portfolios. True, the investment funds industry has long been interested in the aviation sector with fund managers such as Fortress and Terra Firma leading the way a decade ago when we saw a trickle of private equity money funnelling into the aviation industry. That trickle of money has grown in volume significantly in the past few years, as has the breadth of investment focus.

The route and destination

Much as the aviation sector is divided by the specialism of participants – whether financiers, operating lessors or airlines – so too is the focus of investment funds. Fund structuring is rightly informed as much by the needs of investors as it is by the needs of the relevant investment strategy. An investment fund which is looking to acquire an operating lessor will have different structuring needs from a fund which is focussed on asset investment, or a debt fund seeking to finance the acquisition of aircraft. Similarly, longer term investment horizons invite interest from different investors compared with shorter term investment horizons, and accordingly the fund terms will vary one end of the spectrum versus the other.

Traditionally, private equity funds invest with a longer time horizon than hedge funds and the nature of private equity investments in the aviation sector illustrates this. In the early days, private equity tended to invest in aircraft lessors with buy and build strategies at the fore: a notable early stage example of this is Terra Firma's acquisition of AWAS in 2006 and Pegasus in 2007, and their subsequent merger to create a top three global lessor (at the time). The private equity firm held and actively managed the AWAS Group before selling it to Dubai Aerospace Enterprises in 2017. This ten to eleven year investment horizon is long even for private equity, and illustrates neatly the requirement for patient capital to be invested in private equity, with investors not expecting to see returns for some time after they make their commitment to invest.

By contrast, hedge funds have tended to take a shorter term investment horizon. More often associated with investments in public rather than private equities, hedge fund participation in the aviation sector has been more limited but nonetheless attracting interest from headline writers. The frequent coverage of hedge fund opportunism in respect of Aircastle or BOC Aviation's shares and market volatility in those stocks, illustrate the hedge fund investor's relative short-termism, and their focus on yield and relative liquidity of the underlying investments rather than a long-term buy and build strategy.

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Somewhere in between traditional private equity investing and the investment activities of hedge funds lies investment in private debt. This burgeoning 'space' is often occupied by investors within both camps, each pushing out from their core and into new and interesting areas which tie-back to their core expertise. These investors provide new sources of finance versus the commercial banks which are facing increased regulatory rigour and competition in the market. Asset-backed loans are very attractive to investment fund investors for their yield and stable cash flow, as much as for the capital value in the asset collateral which underpins the debt. Indeed, in a geo-political climate which is volatile and frequently uncertain, investors welcome the relative predictability of lease rentals and asset value, which is underpinned by an industry which must keep up supply to deal with the ever-growing demand for air travel.

Long haul vs. short haul

It is key to successful fund structuring that the liquidity of the fund's investments is well understood and accepted, for a liquidity mismatch could invite problems in difficult market conditions. This stands to reason, for if the bargain between investors and the fund is that an investor can redeem some or all of its investment in the fund then the fund must be able to liquidate a proportion of its investments in order to fund the redemption payment. Failure by the fund to meet redemption payments on time would invite litigation and potentially the fund being put into liquidation on the basis that it is unable to pay its debts as they fall due (such is the solvency test in the Cayman Islands, though other jurisdictions may also test solvency against a balance sheet measure). This would also inevitably erode confidence in the investment manager, perhaps with terminal consequences for its business.

Funds employing a liquid strategy and offering investors a right of redemption (often referred to as "open-ended funds") fall squarely within the Cayman Islands' regulatory framework for investment funds. Attendant with this is appropriate (but not suffocating) regulatory oversight of the fund by the Cayman Islands Monetary Authority: a regulated fund will have to observe certain requirements around fund terms, service providers to the fund and adherence to certain standards of good governance. The regulatory framework that applies to regulated funds in the Cayman Islands is pragmatic and it is policed by a commercially constructive regulator – these are key elements which make the Cayman Islands a leading location in which to establish investment funds for a global investor community.

Funds which operate on a longer term investment horizon will often be structured differently, so that investors' capital is returned to them following the disposal of the fund's underlying investments rather than at a time of the investors' choosing. These so-called "closed-ended funds" fall outside the scope of regulation in the Cayman Islands but they often observe similar high standards of governance as their regulated equivalents.[1]

Manufacturing the right model

Investment funds in the Cayman Islands are most often structured either as companies (which issue shares to investors and which are operated by a board of directors) or as limited partnerships (which issue limited partnership interests to investors and which are operated by a general partner – usually a company which will also be established in the Cayman Islands). Open-ended funds have tended to be established as companies whereas closed-ended funds tend to be set-up as limited partnerships; both forms derive from a statutory framework which affords flexibility for the fund and protection for investors and other counterparties. Underpinning the statutory framework is a body of established common law which is upheld by an inscrutable judicial system thereby allowing investors in Cayman Islands funds high levels of confidence.

Although market tendencies for funds to be established as companies or as limited partnerships is as outlined above, there are better reasons than merely following precedent for the structuring of an investment fund: the tax and regulatory position of investors and the fund manager may impact the form which a fund takes, as much as the nature and location of the underlying investments of the fund. Ultimately, though, the Cayman Islands offers a sound legal and regulatory framework within which to root and build an investment fund, and it is a popular and familiar domicile within a global investor community.

[1] This statement is true at the date of writing, but it is worth noting that it is anticipated that closed-ended funds will be brought within the regulatory framework in 2020.

Flying high(er)

With the aviation industry's familiarity with the Cayman Islands (including with the Civil Aviation Authority of the Cayman Islands) for aircraft registration, financing structures and structuring of leasing companies, alongside the Cayman Islands being one of the world's leading fund domiciles, it is no surprise that aviation funds are being structured in the Cayman Islands. We expect continued growth in the number of aviation funds, and diversity of trading styles adopted by those funds to meet investor needs. The demand for air travel is only likely to increase, and the aviation sector boasts exciting opportunities and destinations for #World-travellers and #Aviation-investors alike.

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