STEPHENSON HARWOOD

Transportation and Trade newsletter

2nd Edition – Transportation Finance
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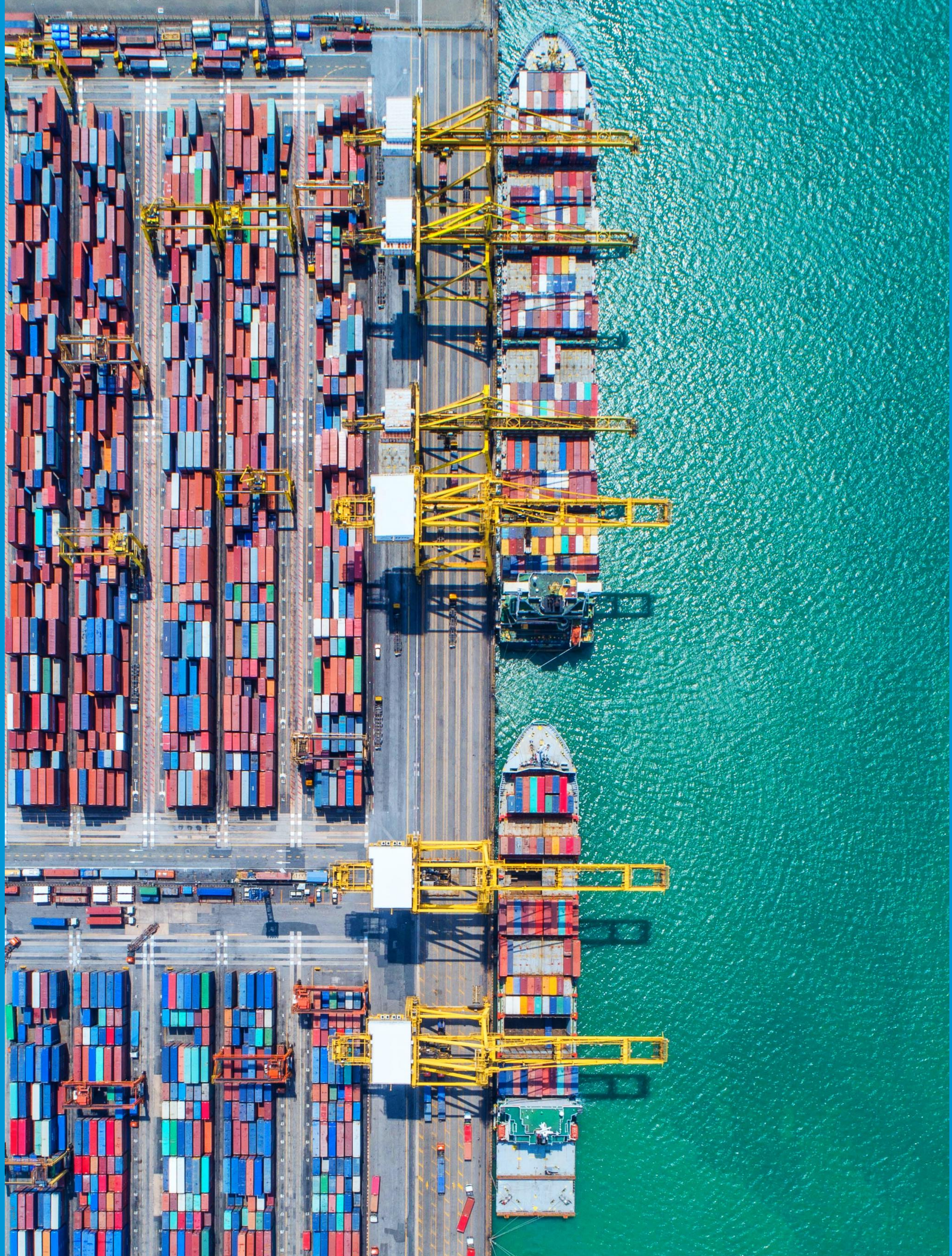

Introduction

Welcome to the first edition of Stephenson Harwood's transportation and trade update – our specialist newsletter for clients engaged in the aviation, marine, rail and trade sectors.

This edition focuses on transportation finance, with our aviation and shipping team joining focuses to collaborate on a comparison between the JOLCO financing product in the aviation and shipping markets. This piece is then followed by a rail update, with our rail team taking a deep dive on financing and investing in rail and the challenges the industry faces.

As always, if you have any questions, please do not hesitate in contacting me or one of the team members listed within the document.
If there are any topics you would like the team to cover, please also get in touch!

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Aviation and shipping: Transportation finance

Welcome to the second edition of Stephenson Harwood's transportation and trade update, with this edition focussing on transportation finance. My name is Charlotte McNeilly, a managing associate in Stephenson Harwood's aviation finance practice and today I am joined by aviation finance partner, James Collins and ship finance partner, Jon Cripps to compare the JOLCO financing product in the aviation and shipping markets. Let's get started!

Charlotte: a common feature of the aviation finance market for decades, the Japanese Operating Lease with Call Option (or JOLCO) structure is a relatively recent addition to the menu of finance products available in the shipping market.

To help explain the product and points of difference between its use in the shipping and aviation markets I am pleased to be joined by James Collins and Jon Cripps, partners in our aviation and shipping practices respectively. James, can you start us off by giving a brief overview of the JOLCO product.

James: thanks Charlotte. Let's assume for now that the reader is an airline or a ship owner that wants to finance a new asset and is looking at its options. The JOLCO – a tax-driven leasing structure – may be an appealing pick. Unlike most conventional financing products, JOLCOs commonly offer 100% financing.

Typically, under a JOLCO structure a lessor SPV will be incorporated by a Japanese equity arranger to act as the purchaser and lessor of an asset. The purchase will be funded 100% by a mixture of debt (provided by one or more lenders) and equity (provided by Japanese investors). Because most other finance products would require the operator to self-fund or independently source the 20-30% equity portion, JOLCOs have proven a popular source of financing in the aviation market for many operators.

Jon: that's a trend we have seen developing in the shipping market too. We are increasingly advising on JOLCO deals as shipowners look to make use of both 100% financing on the asset purchase and cheaper blended pricing through the life of the deal.

Charlotte: that's interesting. How does the cheaper blended pricing feature?

Jon: as James mentioned, the JOLCO is a tax-driven lease structure. Japanese equity investors are able to access tax deferral benefits against the asset purchase. A portion of these benefits are then shared with the operator – for example by way of lower rent.

To qualify for these tax deferral benefits under Japanese tax rules, the equity investors have to be seen to take real asset value risk.

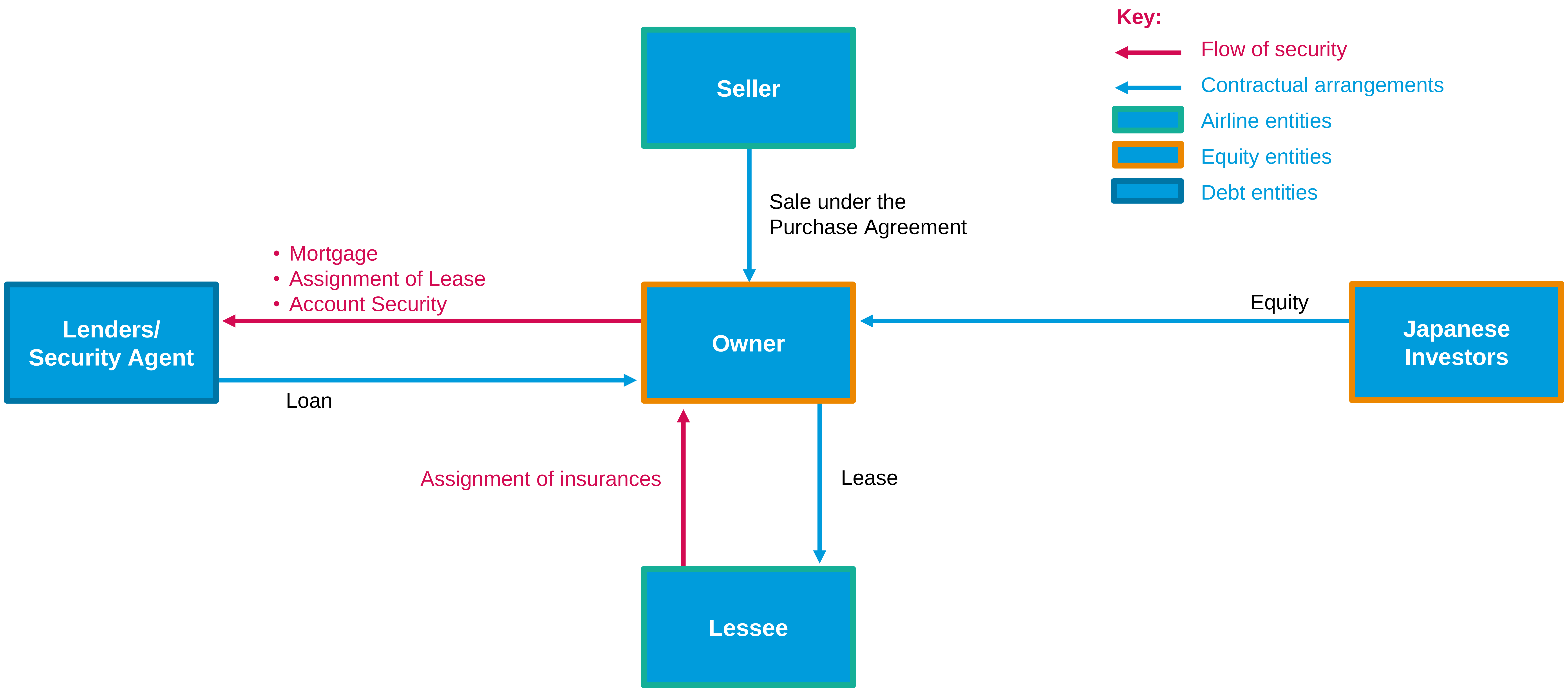
Charlotte: How is the structure typically set up?

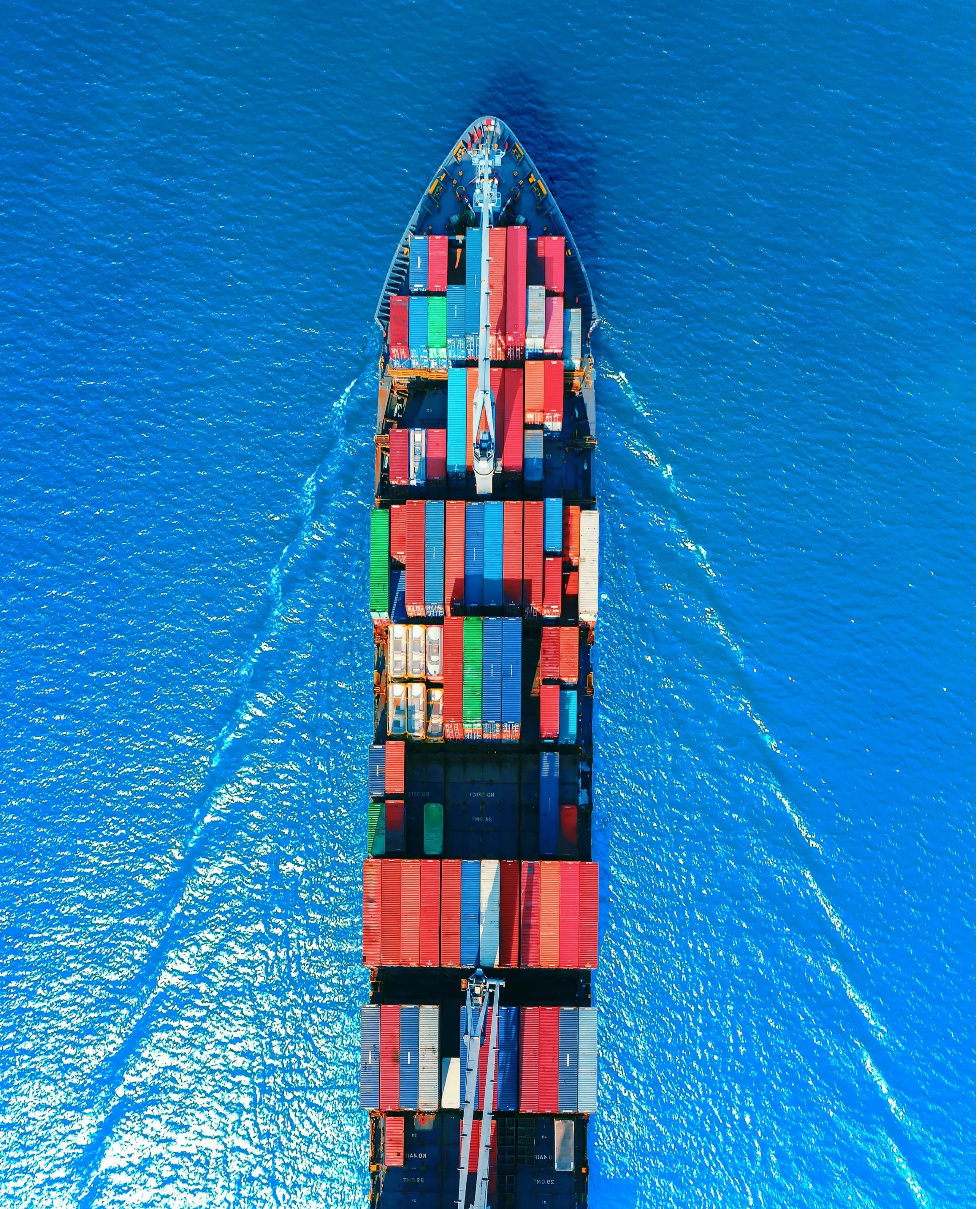
James: it will differ slightly from deal-to-deal and among asset classes, but as you will see from the diagram below under a typical *tokumei kumiai* (TK) structure:

- a Japanese lessor SPV will be set up by the Japanese equity arranger to purchase the asset from the operator or directly from the manufacturer
- the purchase will be funded by a mixture of:
  - loan monies from the lenders; and
  - equity from the investors, which is collected by the Japanese equity arranger
- the operator will take the asset on lease. Under a JOLCO, the lease will include a call option allowing the operator to purchase the asset for an agreed price at a certain pre-determined date
- the lessor will provide common security in favour of the lenders including an asset mortgage, a lease assignment and account security
- the lessor's obligations under the lease will be supported by parent comfort letters from the Japanese equity arranger in favour of both the operator and the lenders

I should explain that TK arrangements are profit and loss sharing agreements that are used under Japanese law to effect the investment of equity into the structure. There are other types of structures used, but TK is in our experience the most common outside of the US.

JOLCO – basic structure (aviation)



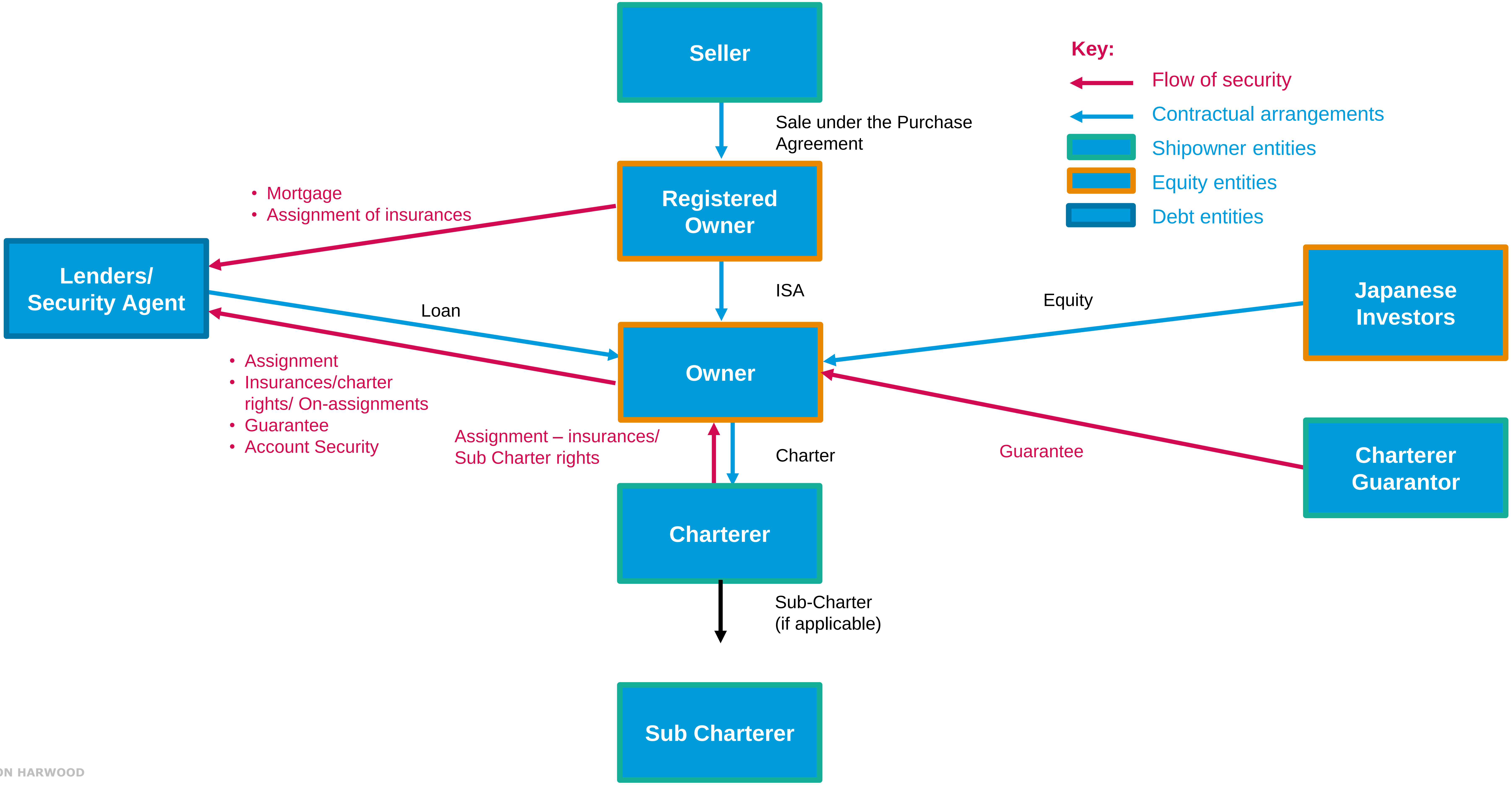


Jon: a similar structure would apply on shipping deals, albeit that the lease takes the form of a bareboat charter with the obligations of the charterer commonly then guaranteed by an entity of financial substance from within the shipowner group.

Shipping deals also commonly include an additional party in the structure – the 'registered owner'. This entity will be incorporated in one of the jurisdictions familiar to shipping – such as Marshall Islands, Liberia or Panama. The registered owner will purchase the vessel from the shipowner or shipbuilder and immediately sell beneficial title to the vessel to one or more Japanese SPV lessors on an instalment sale basis. The lessor(s) will then bareboat charter the vessel to an entity within the shipowner's group.

As such, the registered owner remains the legal and registered owner of the vessel for the tenor of the transaction, with the beneficial title sitting with the Japanese SPV lessor, allowing the latter to claim the required tax benefits. This separation of legal and beneficial title does not impact the shipowner and is essentially required to facilitate the vessel registration with a usual shipping flag state such as those mentioned above, which a Japanese company might not be able to do.

JOLCO – basic structure (shipping)



James: good points Jon. This separation of legal and beneficial title is however not generally required in aircraft deals.

Charlotte: and how do the payment flows work?

Jon: rental payments under the lease (or charter) will be made up of debt and equity portions.

The debt portion will be used to service debt on a dollar for dollar (or other loan currency) basis covering both interest and principal repayments. The lease will also include a 'pass through' indemnity requiring the airline or shipowner to cover indemnity and tax payments payable by the lessor under the loan, albeit with negotiated exclusions for lessor recourse events and other lessor risks such as change in Japanese law. In this way the arrangement is similar to a conventional finance lease.

James: the equity portion is intended to provide returns to the equity investors. In aviation deals, this will often be denominated in in yen. The payment of the equity amounts may be subject to certain conditions, such as the absence of lessor default or other lessor responsibility events. As the lessor has a legitimate interest in the maintenance and operation of the asset in return for the equity portion payments, it is in this way similar to an operating lessor.

We should also mention that on some deals there will be a third portion to cover de minimis running costs of the structure.

Jon: there are also the termination payments and call option payments to consider.

Termination payments are the sums that fall due on the early termination of the lease, for example as a result of an event of default (a fault event) or illegality (a no fault event). As with a typical financing, the debt portion will correspond to the aggregate of the outstanding principal, interest due and other costs and expenses payable on early termination under the loan.

James: the equity payment amount will depend on the cause of the termination event. These are often heavily negotiated between the operator and the lessor, but can broadly be split into three categories reflecting the risk allocation for the lessor as owner of the asset:

- operator responsibility events, for which the highest equity payment amount will apply; and
- lessor responsibility events, for which the lowest equity payment amount will apply.

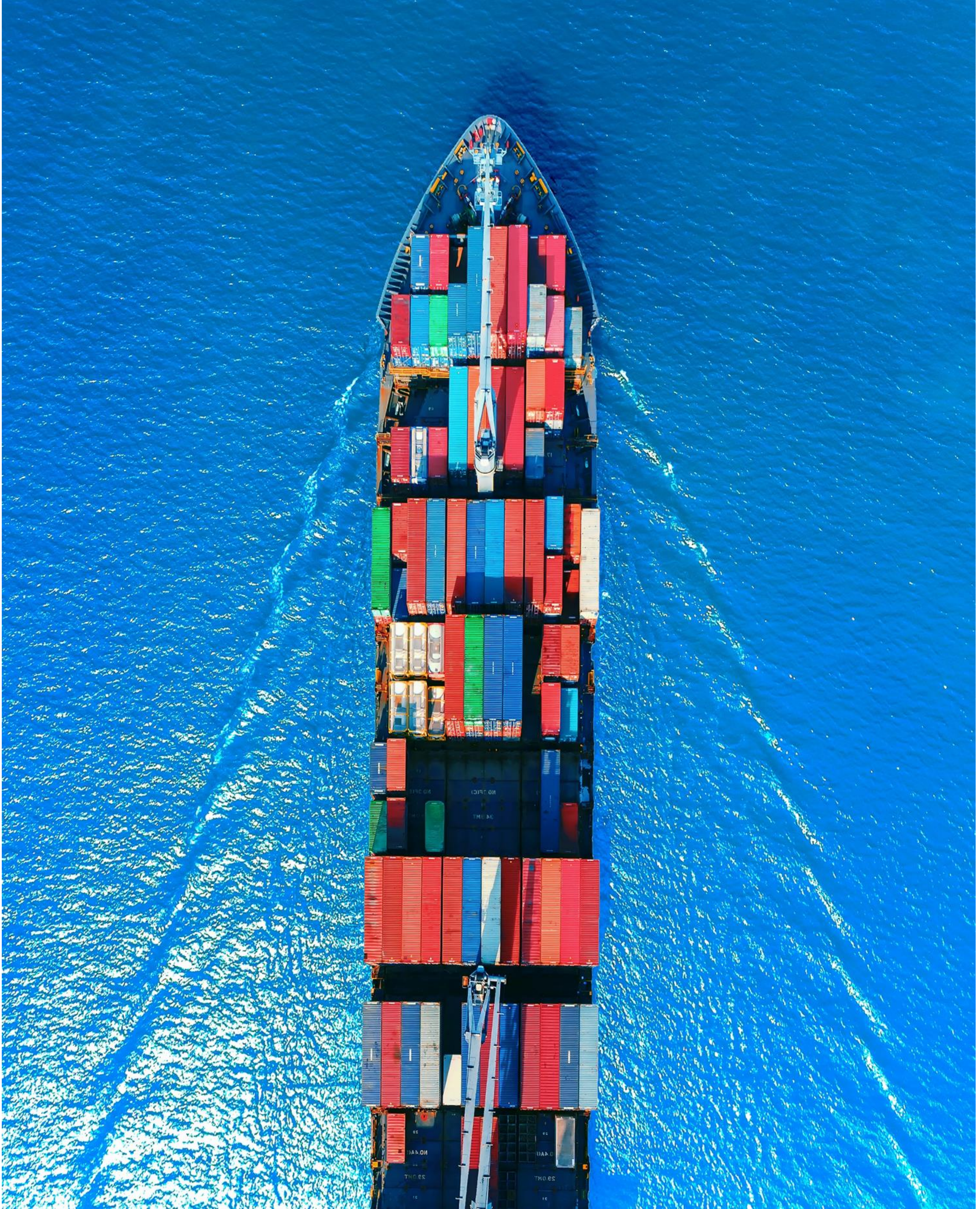
In aircraft deals there is sometimes also a neutral responsibility allocation, for which a mid-point equity payment amount may apply.

Charlotte: that covers normal payment flows and early termination, but a key feature of the JOLCO is the call option. How does that work?

Jon: the inclusion of a call option allows the operator to purchase the asset at a pre-agreed time. The option price payable for the asset will be an amount equal to the future fair market value (or FFMV) of the asset as at pre-agreed date. This FFMV will be determined by one or more independent third party appraisers at the time the lease is entered into and will be sufficient to discharge the balance of the loan monies due to the lenders and deliver the equity returns required by the deal to the lessor.

Upon payment of the option price, the lessor will transfer title in the asset to the operator.

Charlotte: is there anything else someone new to this product should be aware of?



James: as a tax-driven structure, the JOLCO can be said to lack the flexibility afforded under an operating lease or vanilla finance lease.

For example, the operator will generally need to obtain the consent of both the lenders and the lessor to any waiver, deferral or amendment to the JOLCO documents. While this can look like a potentially time consuming exercise, in practice we have seen lenders and investors act quickly in unison to take actions and grant consents.

In addition, in order to protect the tax treatment for the lessor and investors on a JOLCO transaction, it is difficult for operators to voluntarily exit or wind-up the structure early. Consequently, the selection of assets for JOLCO deals needs to be made carefully with a long-term holding of the asset chosen in mind.

As a final note, we should say that while the JOLCO is slightly more restrictive than a conventional vanilla financing, it is no more onerous (and in many ways is less onerous) than an export credit backed or capital markets financing structure.

Jon: I would add that given the nature of a 100% financed product involving both debt and equity investments, there are some additional layers of nuance to factor into negotiation between the parties. In addition to the lender / operator dynamic the allocation of equity risks and rewards need to be looked at closely and dealt with carefully given the equity investors' sensitivity to protecting the tax treatment of their investment.

Conclusion

Stephenson Harwood LLP has a long track record of advising on JOLCO transactions in the aviation and shipping sectors, for financiers and operators across the world. The volume of transactions on which we advise, as well as the range and complexity of these transactions, mean that we are well placed among our peer to provide expert legal advice on this complex structure.

That's all for today. Please keep an eye out for our next transportation and trade update in the New Year. As always, if there are any topics you would like us to cover, or questions you have for the team, please get in touch!

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Rail: Financing and investing in rail and the challenges

The finance and investment landscape of the UK rail industry is continually evolving to meet the demands of modernisation, sustainability, and increased capacity. The recent high-profile cancellation of the northern leg of the High Speed 2 railway network included a separate announcement that the government would seek private sector funding for the stretch of line between Old Oak Common and London Euston. So financing and investment of the railway is back to the top of the political agenda. As the gap between public funding and the investment required grows, the need to consider private investment develops. Facilitating private investment in the railway is likely to become a hot topic once again.

To date, there has been only a limited amount of private finance in the railway industry: rolling stock companies being the most significant example of private funding, with some specific investments in stations, depots and track in addition. This is despite repeated public statements by the Department for Transport (DfT) and Network Rail about involving the private sector.

Issues and challenges in rail finance

Gap between current levels of investment in rail and what is needed

The need for investment in rail is increasing due to the need for:

- Climate resilient infrastructure
- Sustainable infrastructure
- Increased capacity due to growing usage post-pandemic
- Upgrades to existing infrastructure

However, whilst the need to keep the railway safe will always be paramount, there will likely be insufficient public funds to maintain the assets in a resilient condition. The appetite for investing in rail as a relatively low carbon industry with green credentials seems to be growing globally. Current challenges and barriers to investment include:

Challenge 1:

Lack of clear government policy

- In 2018, the DfT called for market-led proposal (MLP) ideas that would be privately funded. The idea was to depart from the traditional procurement approach by encouraging private entities to propose and lead rail projects and unleash innovation. The approach was not well-received by the market for a number of reasons, including as it could involve the DfT taking good ideas and tendering them to others. Very little progress has been made with MLPs and it does not seem to be a core priority for the government.
- The DfT's rail network enhancement pipeline (RNEP) was intended to give the private sector visibility of forthcoming projects in the rail industry as well as considering opportunities to involve private funding. The RNEP was supposed to be an annual publication but there has been no update since 2019.
- The unused potential of the UK Government Green Financing programme used to attract private funding as rail projects have been defined as green.

Challenge 2:

Complexity of projects and how the private and public sectors interact

- The complexity of rail projects and contracts mean that different parties have different interests in assets ultimately owned by Network Rail. This means complexity in ownership, with safety and risk allocation needing to be tailored accordingly. Changes in risk allocation proposals create more complexity and prevents easy private funding.
- Issuing procurement notices that are unlikely to proceed, such as MLPs, incurs substantial costs and utilises significant resources. There is a significant space for improvement in the way the public sector engages with the private sector including ensuring that revenue streams and risk profiles are appropriately calibrated so it is investable.

Encouraging investment: there is still appetite for investing in the rail industry

The Stephenson Harwood Rail team holds a series of "top table dinners" each year where senior professionals from various parts of the rail industry get together to debate key topics for the industry. We regularly hear from financiers and investors that they have big appetites – not only for the dinner but for investing in the railway. However, to date, there have been limited opportunities for the private sector to contribute much-needed investment to the railway.

Potential options for investment include:

Direct investment:

Rolling stock companies – both the traditional providers and more recent entities set up to finance and lease rolling stock – are the obvious example. Whether funding is provided directly into the rolling stock company or a financing structure is set up for a particular fleet, there has been plenty of investment in rolling stock. Investing in rolling stock provides a distinct advantage due to its representation of a long-term financial commitment, with this rolling stock typically having a lifespan of over 30 years. This extended duration ensures a reliable and continuous flow of income over time. There have also been examples of the rolling stock companies themselves being bought and sold. More recently, we have also seen the sale/purchase of train and bus owning groups such as Go Ahead and Abellio/Transport UK in 2022. Investing in train operating companies is also an alternative, described as an investment with bond-like qualities, it appeals to long-term investors due to the stable profit margins.

Property

One option for investment is to acquire a property right, such as a leasehold interest, in a particular asset such as a station or depot or stretch of track. The investment company invests in, for example, upgrades or the development of the asset in the first place and recovers that investment and a rate of return in-life as the asset is used.

Investment recovery charge

This refers to a fee or charge imposed on entities involved in using the outputs of a particular project to develop railway track (and generates a revenue stream). It is a mechanism whereby investments can be recovered over time through a track access charge supplement paid by the user. For regulated pieces of railway infrastructure, this means that the Office of Rail and Road, as regulator, will need to approve the charge. There are very strict requirements that need to be demonstrated for an IRC to be permitted and early engagement with your legal team is needed, allowing enough time for regulatory engagement before the project is given the go ahead. So the tip here is to incorporate this strategy into the planning phase to maximise the chance of success. Guidance issued by the ORR sets out how investors should approach this – it has been successfully used for HS1. Heathrow Airport was found not to have met the relevant test for the stretch of railway it manages.

Conclusion

In conclusion, the UK rail industry stands at a critical juncture, demanding increased investment to address modernisation, sustainability, and capacity challenges. Despite past efforts, private funding faces hurdles such as unclear government policies and project complexities. Bridging the gap between public funds and industry needs requires addressing these challenges, offering the potential for private investment to play a significant role in shaping the future of the UK rail sector.

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> The Stephenson Harwood team has many years of experience in their team. Understanding not just the legal aspects of the industry but also have a good engineering and operational understanding.
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About us – transportation and trade

Our world leading transportation and trade practice offers a breadth of services to clients in the aviation, shipping, trade, rail and road sectors. Our clients include many of the world's largest airlines, airports, shipowners, shipyards, financiers, lessors, commodities traders and private sector rail operators and owning groups.

We work with a wide range of clients from the transportation and trade sector and advise on the following areas: Aviation, Marine, Trade and Rail and Road.

We can support clients throughout the full lifecycle, from financing and construction, through to operations and dispute resolution. Whether it's a complex matter affecting your entire business or a more routine matter, we have the knowledge and expertise through our international network to assist you.

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> Stephenson Harwood shows a hands-on approach across all complex matters. The firm knows what the client wants and needs, and at the same time it is also aware of market practice.
>
> It's a diverse and well-experience team.
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