

5 Questions to ask about aircraft financing.

Volume

Insurance Whitepaper Series

5

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The general aviation industry has experienced significant growth in recent years, as more companies find value in operating their own aircraft, and as more individuals and fractional ownership groups find more affordable ways to enjoy their passion for flying. As the changing aviation industry generates more interest in flying, the demand for aircraft financing has increased as well.

There are important considerations in financing your aircraft, and any individual or company should know the answers to these questions before purchasing their next aircraft.

1) What do I need to know about how aircraft are valued?

Aircraft valuation is much more complex than, for example, determining the value of an automobile. Through different websites, inputting basic information on an automobile can provide a reasonably accurate vehicle value. Aircraft valuation complexity is due to the substantial cost of both new and used aircraft, and the many variables that can affect the value of used aircraft.

2) What are the critical valuation factors for aircraft?

- Engine hours – the number of hours that the engines have been flown has the largest impact on aircraft resale value. Aircraft engines need to be overhauled at certain intervals, just like your car engine needs a tune-up. As the cost of the overhaul is significant, the closer the engine hours are to the next overhaul, the lower the value of the aircraft. A high number of engine hours are not necessarily bad if the engines have been recently overhauled.
- Use and maintenance records – Maintaining good records that demonstrate regular use and maintenance is extremely important. Regular use of the aircraft helps keep seals and other engine components lubricated and in good shape.

Scheduled maintenance helps to keep the aircraft operating, and demonstrates the owners' commitment to safety.

- Installed equipment – just like optional equipment in a car, installed equipment in an aircraft affects the value of an aircraft. Some examples include avionics, air conditioning, deicing gear and interior equipment. The age of installed equipment can result in higher maintenance costs.
- Airworthiness directives – Also referred to as “ADs,” these directives are issued by the Federal Aviation Administration (FAA) for safety reasons and require aircraft owners to comply within a certain time period. Evaluate an aircraft's AD history, not just for the number of directives, but also the nature of the directive and whether they require recurrent actions or are

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“one-time compliant.” Make sure the logbooks show compliance with all applicable ADs. Incomplete or missing log books can decrease value by 10% or more.

- Damage history – Major repairs can significantly affect the value of an aircraft. The type of accident, nature of the damage and the degree to which major aircraft components are involved factor into valuation. Any aircraft with a damage history should be closely scrutinized to make sure it has been properly repaired in accordance with the FAA regulations and recommended practices. Damage history typically decreases the value from 5% to 10%.
- Paint/interior – Similar to used cars, sometimes a new coating of paint can give “tired” aircraft a quick face lift. Check new paint jobs carefully for evidence of corrosion under the surface. Interior items should be checked for proper fit and condition. Done properly, paint and interior restoration enhance the value of used aircraft.

3) How do I know if an aircraft is fairly valued?

Prior to purchase, buyers should strongly consider a pre-purchase inspection. Many lenders may require such an inspection.

The goal of inspecting the aircraft prior to the sale is to identify any damage and wear that might not be obvious, and anticipate any future maintenance problems and operating costs. These issues directly affect the value of the aircraft, which affects both the buyer’s offer, and the collateral value of the aircraft to the lender. The seller may resist such an inspection, but it is to the buyer’s advantage to insist upon one. Recourse against the seller for any faulty equipment, hidden damage or lack of compliance with an airworthiness directive will be difficult after the transaction has closed.

The buyer and lender run the risk of over-valuation if they choose not to hire a certified appraiser.

4) Who should I hire to perform a pre-purchase inspection?

There are many people and firms that offer this service. The most recognized authority is the National Aircraft Appraisers Association (NAAA). This trade association provides appraiser certification and has established a code of ethics for professional aircraft appraisers.

Having an NAAA-certified appraisal provides independent documentation of the value and general condition of the aircraft. The appraisal also supports a lender’s collateral position in the aircraft loan, and your lender may insist on a certified appraisal. Certified appraisal fees can range from \$500 to \$5,000 depending on the complexity of the aircraft. The buyer and lender run the risk of over-valuation if they choose not to hire a certified appraiser.

Many airfield fixed-base operators (FBOs) provide valuation services, in addition to maintenance, fuel, flight instruction and hangar services. A buyer may be able to find a local FBO, or an FBO that has previously maintained the aircraft.

5) What do I need to know about aircraft financing?

Because the useful life of an aircraft can exceed 30 years, most lenders offer financing with terms longer than traditional installment loans. Aircraft financing is competitive, with commercial banks competing with dedicated aviation financing companies.

As with the financing for any asset, your lender will need to perform certain procedures and need particular documents from the borrower.

- Title Search - The lender will perform a title search to ensure that the seller has no liens on the aircraft.
 - Loan Transaction - The lender will also facilitate the aircraft purchase closing, escrow and title insurance.
 - Title - Aircraft titles are not held by the aircraft owner, so your lender will need a copy of the bill of sale, which can be obtained from the FAA's website.
 - Lien - The lender will need to record their lien against the aircraft with the FAA. All aircraft are registered with the FAA, and there is a nominal charge to have that lien recorded.
 - Personal or Corporate Guarantee - Your lender may require that the borrower personally or corporately guarantee the loan, in addition to pledging the aircraft as collateral.
- *Hull Damage* - This insures physical damage to the aircraft, and the lender will require a Hull Damage limit in the amount of the value of the aircraft, with the lender named on the policy as a "Loss Payee." Most policies have no deductible, or a very nominal deductible.
 - *Aviation Liability* - This protects the borrower against claims from third parties that are injured or suffer property damage resulting from the borrower's aircraft operations. It also indirectly protects the lender to some extent, from an aviation claim causing a borrower's insolvency and a subsequent loan default.
 - *Breach of Warranty Coverage* - Your lender will require that you name the lender as an "Additional Insured" with Breach of Warranty Coverage. Typical aviation insurance policies have policy exclusions that could void or nullify insurance coverage if the owner does not operate the aircraft as the owner promised, or "warranted," to their insurance company. Breach of Warranty coverage ensures that the lender's interest in the aircraft will be covered by the insurance policy, even if the aircraft owner violates a condition in their policy.

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- Insurance - The lender will require Aviation Liability and Hull Damage insurance from their borrower at loan closing and at each annual insurance policy renewal thereafter, until the loan is paid off. Specific insurance coverage and conditions include:

Summary

By understanding the critical issues of aircraft valuation, financing and insurance, aircraft owners can protect themselves against over-valued aircraft, unanticipated maintenance, financing and legal costs, and protect their personal and business assets.

This information is not intended to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.

For more information, please call Johnson Insurance at 800.477.1FLY (4359). Johnson Financial Group is a premier financial services company offering comprehensive financial solutions in the areas of banking, trust, insurance and investment management through Johnson Bank and Johnson Insurance.

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