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Aircraft Financing, Working Capital Loans and Property Control Under Capital Budgeting

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Abstract

An Airline company provides air transport and cargo services. Its main branch for western region finance is in Mumbai. My topic deals with Aircraft financing decisions and how an aircraft needs to be acquired and all the loans associated with it. Working capital is the fund require for a business or an organization to run its day to day expenses.

Capital budgeting helped in valuation of assets and to decide its capital decisions. Some new loans and concepts like spread on a loan, buyers credit, SLB and outright expenses were being studied. The finance of aircraft company is much wide and complex. It has much legality issues.

In this research a detail study of acquisition of an aircraft and its financial procedure and also various loans are being discussed. The company goes with various capital budgeting decisions and the regular or common ones are being mentioned in the report also the Tagging procedure, PDP finance is being mentioned with various other linked topics.

(Key words: Buyers credit, Spread on a loan, PDP finance)

Introduction

Aircraft finance refers to arrangement of finance towards purchase of aircrafti.e. payment of the signing amount, pre delivery payments and the final payments to Boeing through bridge loans. Aircraft financing starts from the moment a confirmed order contract is signed. Tenders are received to carry out activity. Bidder with the least financing cost is chosen for carrying out aircraft financing.

Working Capital loans are drawn to meet the working capital requirements like lease payment, fuel stores aircraft loan repayments, landing, handling, catering etc.The Capital budget committee scrutinizes the proposal in the light of the resources position of the company, government approved outlay as per annual plan allocation and operational needs. The consolidated capital budget is prepared by CBPC section for the submission of the board. After the approval of the capital budget the section, has to advice Heads of departments, the station wise details of the approved budget. This section has to keep a through record off all executive sanctions issued by the department during the financial year. Approved capital budget forms part of the administratively sanctioned projects for items of capital expenditure, which may be incurred by the company in the ensuring year.

II. Literature Review

Working Capital Management Of Cipla Limited: An Empirical Study Mr. Lalit Kumar Joshi; Mr. Sudipta Ghosh

The present paper examines the working capital performance of Cipla Ltd. during the period 2004-05 to 2008-09. Financial ratios are applied in measuring the working capital performance and statistical as well as econometric techniques are employed in order to assess the behavior of the selected ratios. The empirical findings reveal significant positive trend growth in most of the selected performance indicators. Further, the selected ratios show satisfactory performances during the study period. Metals test also indicates significant improvement in liquidity performance during the said period. Finally, there exists significant negative relationship between liquidity and profitability, which indicates that Cipla Ltd. has maintained post optimal level of liquidity (i.e., excess liquidity) during the period under study.In relation to the main objective, it may be concluded that the working capital management of Cipla Ltd. is satisfactory during all the years under study. Moreover, the company has shown significant improvement in liquidity position over the years under study. The study may therefore act as a trend setter for other companies in the pharmaceutical industry. However, there is a need for further improvement in working capital turnover ratio as well as in the current assets turnover ratio in order to generate liquidity efficiently in the coming years. Besides, inventory of slow moving items, if any, should be reduced to the maximum possible extent.

Working Capital Management and Firm Profitability: Empirical Evidence from Manufacturing and Construction Firms Listed on Nairobi Securities Exchange, Kenya

Working capital management plays a significant role in improved profitability of firms. Firms can achieve optimal management of working capital by making the trade-off between profitability and liquidity. This paper analyzes the effect of working capital management on firm's profitability in Kenya for the period 2003 to 2012. For this purpose, balanced panel data of five manufacturing and construction firms each which are listed on the Nairobi Securities Exchange (NSE) is used. Pearson's correlation and Ordinary Least Squares regression models were used to establish the relationship between working capital management and firm's profitability. The study finds a negative relationship between profitability and number of day's accounts receivable and cash conversion cycle, but a positive relationship between profitability and number of days of inventory and number of day's payable. Moreover, the financial leverage, sales growth, current ratio and firm size also have significant effects on the firm's profitability. Based on the key findings from this study it has been concluded that the management of a firm can create value for their shareholders by reducing the number of day's accounts receivable. The management can also create value for their shareholders by increasing their inventories to a reasonable level. Firms can also take long to pay their creditors in as far as they do not strain their relationships with these creditors. Firms are capable of gaining sustainable competitive advantage by means of effective and efficient utilization of the resources of the organization through a careful reduction of the cash conversion cycle to its minimum. In so doing, the profitability of the firms is expected to increase.

III. Research Methodology

Topic of Research: Study of aircraft financing, working capital loans and property control under capital budgeting.

Objectives

1. To study and analyze aircraft financing process.
2. To analyze the working capital loans.
3. To study property control under capital budget.

Scope of Study: I made a research on aircraft financing, working capital loans and property control under capital budgeting and all the topics associated with it like PDP financing, SLB. The study is restricted as it is only the data of western region and also the data had to be kept confidential therefore details are not being mentioned in much detail.

Sources of Data

Primary Data

I. Interaction with the projection section of a company i took guidance from.
II. Interaction with the finance executives.
III. Working under the supervision of deputy manager.

Secondary Data

I. Accounting manuals of Air India,
II. Past agreements,
III. Annual reports.
IV. Auditors report.

IV. Data Analysis & Interpretations

Financial Arrangement of funds for Aircraft Financing

- Aircraft finance refers to arrangement of finance towards purchase of aircraft i.e. payment of the signing amount, pre delivery payments and the final payments to Boeing through bridge loans.
- Aircraft financing starts from the moment a confirmed order contract is signed. Tenders are received to carry out activity. Bidder with the least financing cost is chosen for carrying out aircraft financing.

Steps for carrying out aircraft financing are as follows:

1) Signing amount is paid at the time of agreement

At the time of agreement,1% of the list price of the aircraft is paid.

This 1% is paid out of internal resources i.e. from the profits of the previous years.

For example

Let's assume that the cost of aircraft is 100$.so at the time of agreement 1% of 100$ is paid to the tender.

2) Pre-Delivery Payment (PDP)

What are PDPs?

Pre-delivery payments are the staged partial payments of the aircraft price made by the customer to the aircraft manufacturer pursuant to an aircraft purchase agreement in advance of delivery of the aircraft.

They can account for as much as 30% of the final aircraft price and are used by the manufacturer to provide the working capital needed to fund the aircraft production.

For B787-800 aircraft

PDP is made 12 months before the actual delivery of aircraft.

PDP of 9% is to be paid.

For B777-300 aircraft

PDP is made 24 months before the actual delivery of aircraft.

PDP of 14% is to be paid.

PDP loan (Unsecured loan) is taken for the period of 12/24 months tenure.

The bridge loan is drawn for the entire Invoice value which includes the advance payment of PDP.

Bridge loan amount is used to repay PDP lenders and the balance amount is paid to Boeing Company.

3) Bridge Loan

A Bridge loan is normally a short term, typically taken out for a period of around 12 to 15 months depending upon the arrangement of long term financing.

Bridge loan is drawn for the full amount of invoice. A bridge loan is interim financing for a business until permanent financing or the next stage of financing is obtained. Money from the new financing is generally used to "take out" (i.e. to pay back) the bridge loan, as well as other capitalization needs.

Bridge loans are typically more expensive than conventional financing, to compensate for the additional risk. Bridge loans typically have a higher interest rate and other costs that are amortized over a shorter period, and various fees related to the financing. The lender will also insist for cross-collateralization and a lower loan-to-value ratio. On the other hand, they are typically arranged quickly with relatively little documentation.

<u>For example</u>

If the cost of aircraft is 100$ then bridge loan is obtained for the full amount I.e. 100$ itself.

- Once the bridge loan is obtained the PDP loan is repaid out of it.

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Repayment of loan for a 787 aircraft

PDP loan is repaid
(i.e 1% +9%)

Balance amount is paid to Boeing co.

Repayment of loan for a 777 aircraft

PDP loan is repaid
company (1%+14%)

Balance amount is paid to Boeing

Sale& Lease back

Sale and Leaseback is very often used in commercial aviation to essentially take back the cash invested in assets.

<u>for example</u>, Sale aircraft and engines to lessors, banks or other financial institutions who, in turn, lease the assets back to them. Tax deductions can also be realized by the airline since the asset is no longer owned but leased. Due to the high price of aircraft and engines, especially new, the cash from such a leaseback is used by airlines to improve their financial performance.

Broadly, there are two primary options: SLB (i.e. operating lease) and purchases (i.e. finance lease); with guarantee from GOI..

Working capital loans

Working capital loan scenario in air India

These loans are drawn to meet the working capital requirements like lease payment, fuel stores aircraft loan repayments, landing, handling, catering etc. Loan agreement / documentation are carried out at CAO Mumbai with the bank based in Mumbai. Loan amount are drawn normally in US Dollar and the same are credited into Air India bank account at New York. Payments are also made to the vendors in US $ from

Air India bank account at New York.

Interest an FCNR B loans are normally calculated with the total of bank spread plus LIBOR on the date of drawls taking into the account 360 days in a year

E.g.: if the FCNR b loan of USD 10 million is drawn on 1st April bank's spread at 500 basis points (bps) and the LIBOR IS 4.00 on the date of drawls

Then the total interest % chargeable

Is spread 5.00+ LIBOR 4.00 = 9.00% p.a

Calculation of rate of interest is as follow;

Principal*rate of interest /100*no of days/360

10,000,000*9.00%*30/360

Therefore, interest for the month of April is USD 75000/-

Nature of loan

- **Long term loan**
- **Funded Interest Term Loan (FITL)** is giving a loan for repaying an existing loan. It's a kind of loan restricting mechanism whereby lender would give the borrower money to repay

the interest component of the loan. It is an ingenious tool recently brought out by RBI in order to tackle the growing NPA burden in India. The idea is to give companies breathing space to repay the loan by getting a moratorium. In this way, the pending amount to be recovered could be a recovered and FITL could be considered a blessing.

- **STCL**-These loans are normally taken for a period of 90 days. These loans are without any prepayment penalties. Air India takes short term loans from various bank like bank of Baroda, Canada bank etc. these loans are taken to finance working capital deficits and cash credit. The interest is payable on monthly basis.

Financial Restructuring Plan

Financial Restructuring Plan (FRP) was implemented by the company on 1^{ST} October 2011 to realign Working Capital borrowings of the company as on 30^{th} September 2011 in order to provide relief to the company.FRP provided relief to the company in the form of reduction in interest rate, rates in case of INR loans ranging from 12% to 13% to the uniform floating rate to 11% on short term loan (STL), and Long term loan (LTL),funded interest term loan (FITL) and assessed working capital.

Buyer's credit

Buyer credit refers to loans for payment of imports into India arranged on behalf of the importer through an overseas bank. The offshore credits the Nostro of the bank in India and the Indian bank uses the funds and makes the payments to the exporter bank as an import bill payment on due date. The importer reflects the buyer credit as a loan on the balance sheet.

Note: Nostro account is an account of an Indian bank with a bank outside India in foreign currency. The counter part of it is vostro account which means the account that the foreign bank has with the Indian bank

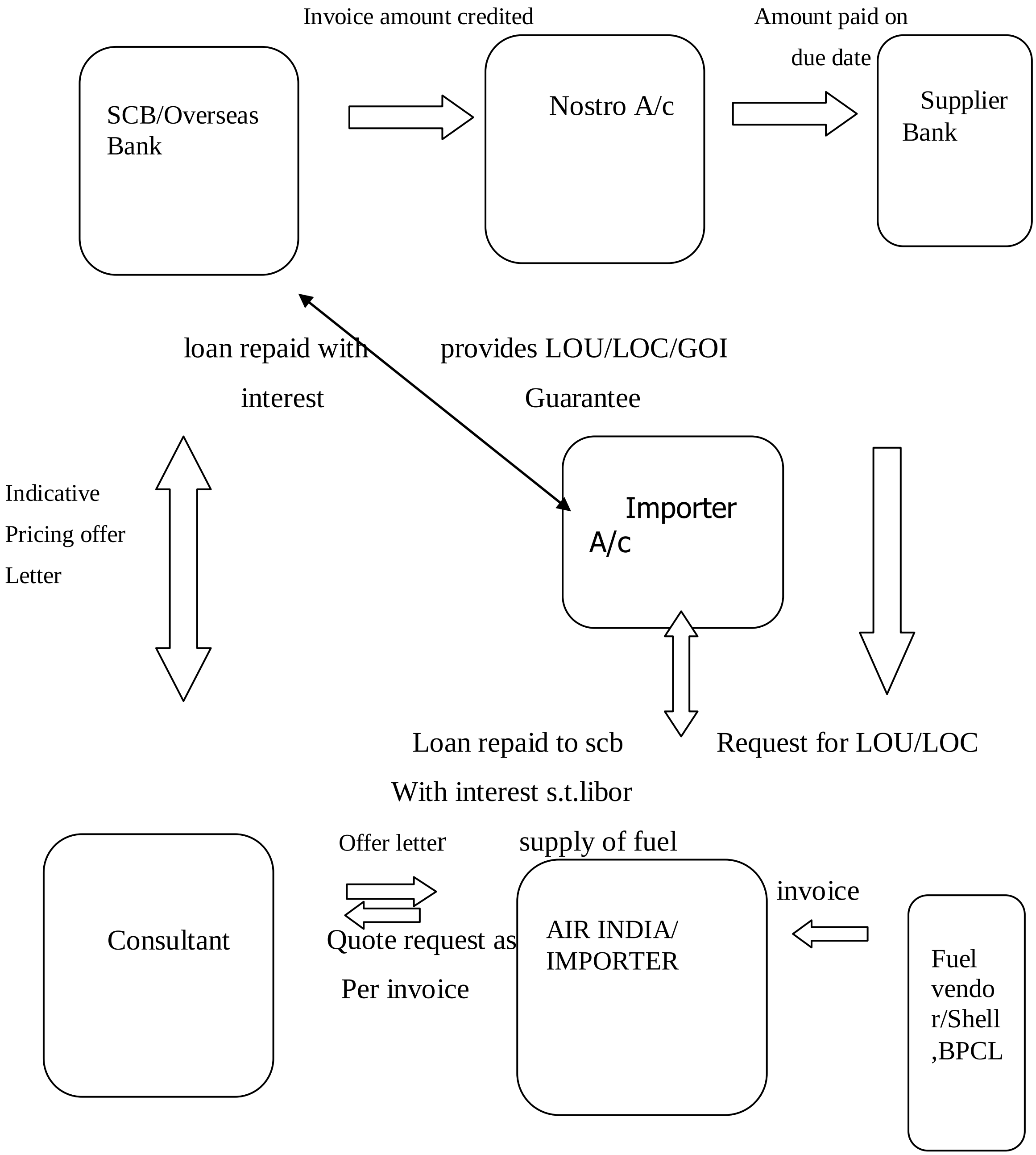
Benefits of buyer's credit

- The exporter get paid on due date, whereas importer gets extended date for making an import payment as per the cash flows.
- The importer can deal with exporter on sight basis, negotiate a better discount and the use the buyer credit route to avail financing
- The funding currency can be in any FCY(USD, GBP,EURO,JPY etc)depending on the choice of the customer
- The currency of imports can be different from the funding currency, which enables importer to take a favorable view of a particular currency

Structure of air India's buyer credit

- Air India has ties with the various fuel vendors of the world. This fuel vendors provides oil to aircrafts of air India and raise an invoice
- Air India and the standards chartered bank have ties up that the invoices which is raised by the fuel vendors will be paid by the standards chartered bank& will raise buyer credit loan for air India
- Air India every month has to pay 25 million used to standards chartered bank. While flying if an aircraft need fuel to fly back to India fuel will be provided

Buyers Credit



BSP payment (billing and settlement plan) inflow of funds

If due date of payment is 31/5 but the BSP date is 2^{nd} June so final payment will be made on the BSP date only i.e. 2^{nd} June

- Payments are made for various reasons
- For loan purpose
- Fuel payment
- AAI-Airport Authority of India(the rent for keeping aircraft in airport while not in use)
- Salary of employees

Fixed

Interest

Variable

If Air India has to pay 10 million to SCB then it will pay 7 million from BSP A/c and 3 million from other bank.

Vendors who are supplying oil to Air India air craft's will raise an invoice to Air India fuel and oil section. It is a liability for Air India. It will be paid my SCB. The SCB will raise a loan which will be paid by Air India.

Steps Involved In Purchase Of Aircraft:

- The acquisition of aircraft is a long process which involves the following activities and recommendation by a committee of senior officials of Engineering, Planning, Commercial and Finance Depts.
- Conducting various internal studies to determine market demand and growth trends.
- Based on the market study and future projections of growth, Air India shortlists the candidate aircraft for acquisition.

- The aircraft manufacturers are then invited to submit their technical / commercial offers for the aircraft shortlisted by Air India and negotiations are held with the aircraft / engine manufacturers to obtain the best possible discounts and terms for the aircraft purchase.
- A Techno- Economic analysis of the candidate aircraft is prepared. Based on the results of the techno- economic evaluation, the Air India Board identifies the aircraft for induction in Air India's fleet.
- After the suitable aircraft type is approved by the Board, a Project Report is prepared and submitted to the government for approving the acquisition of the new aircraft.
- All revenue / cost projections included in any Project Report are based on certain assumptions. These assumptions are clearly specified in the write-up and annexure of the respective Project Report.
- The projections included in any Project Report are based on data available at the time of preparing the Project Report. While revenue projections require estimation of yield and load factors, cost projections require estimation of data of all variable/fixed costs. Both revenue and cost projections are sensitive to any changes in the rate of exchange of the Rupee vis a vis other currencies particularly US Dollar.
- The rate of exchange used for preparation of projections in any Project Report is the rate of exchange prevailing at the time of preparation of the Project Report. All data included in the Project Report is sensitive to fluctuations in exchange rate of Rupee v/s US Dollar.

- While the assumptions in respect of yield and load factors and certain fixed costs like salaries, systems overheads, obsolescence are partially within the control of the management, cash costs like fuel, landing, handling, overflying charges, aircraft insurance etc. are all dependent on rate increase at various stations in Air India network and cannot be accurately predicted at the time of preparation of the Project Report. Hence projections are made on the most recently available data at the time of preparation of the Project Report.

Property control under Capital Budgeting in Air India

The capital budgeting of Air India is handled by the capital budget and property control section of the finance department. Capital expenditure budget is a department budget. The 1st estimates of capital expenditure to be incurred during the next financial year commencing 1st April are obtained annually by the heads of departments classified under major categories such as construction of buildings, workshop equipments, IT Systems and related equipment etc.The Capital budget committee scrutinizes the proposal in the light of the resources position of the company, government approved outlay as per annual plan allocation and operational needs. The consolidated capital budget is prepared by CBPC section for the submission of the board. After the approval of the capital budget the section, has to advice Heads of departments, the station wise details of the approved budget. This section has to keep a through record off all executive sanctions issued by the department during the financial year. Approved capital budget forms part of the administratively sanctioned projects for items of capital expenditure, which may be incurred by the company in the ensuring year.

The capital budgeting of Air India covers the following projects

A. Air craft projects- Buying of aircrafts
B. Non aircraft projects

1. Newschemes-department/unit/region Wise-New projects like buildings/workshops etc. to be started in the budget year.
2. Continuing schemes- department/unit/region wise-previous years projects which continue during the budget year.

Project Evaluation Using Capital Budgeting Techniques

Evaluation of capital budgeting project involves six steps:

1. The cost of particular project must be known.
2. Estimation of the expected cash outflows from the project, including residual value of the asset at the end of its useful life.
3. Risks in the cash flows must be estimated. This requires information about the probability distribution of the cash outflows.
4. Based on risk involved in project, management finds outs cost of capital at which the cash outflows should be discounted.
5. Next is to determine the present value of expected cash flows.
6. Finally, compare the present value of expected cash flows with the required outlay. If the present value of the cash flows is greater than the cost, the project should be taken otherwise should be rejected.
7. If the expected rate of return on the project exceeds its cost of capital, the project is worth taking.

V. Conclusion

Aircraft deliveries over the next three five years will need to be financed at a time when liquidity is scarcer and risk is being re priced. The key challenge for airlines who have record orders in place, will be to find financing at a competitive rate in an exceptionally tough economic environment.

But more of this will need to happen and airlines and lessors will need to be more inventive and work harder to find additional sources of funding and potentially develop new products.

Aviation finance could provide an attractive opportunity to deploy large amounts of capital efficiently in “hard assets”.

As airlines take delivery of new aircraft, owners must be found for second hand aircraft. In the past airlines from developing economies have taken these which has created a natural flow of ownership. This is changing as new and smaller airlines place orders for new aircraft direct with manufactures often taking advantage of export credit agency finance. This together with concern of oversupply of some aircraft types particularly narrow body, could put aircraft values and lease rates under pressure.

VI. Findings

After learning about the capital budgeting we can conclude that when taking capital budgeting decisions whichever method, a manager uses to evaluate project he must prefer to receive returns sooner than later choose the proper discounting rate and realize the risk involved.

Procedures laid down by capital budgeting and asset control are excellent they should change the policies according to the requirement for higher growth.

The cost of equipment and assets used by the company is very high so right and optimum use of it is necessary to gain good returns and exploit resources. If any asset or equipment is not needed, then it should be leased out or sold out to some other company this will help in proper utilization of resources.

If a stimulator used for training of pilots can be utilized by offering it to other airline company for training purpose and can generate good returns also aircrafts are used for training purposes of cabin crew and air hostess.

That means invest in such a way that it earns good returns and the asset also don't stay ideal obsolescing.

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