## Maintenance Reserves

Hello and welcome to our investor education section. The idea of these videos is to explain topical issues that arise from time to time in no more than a couple of minutes.

Today's video aims to explain the concept of maintenance reserves, which form a critical part of the cash flow associated with leasing aircraft.

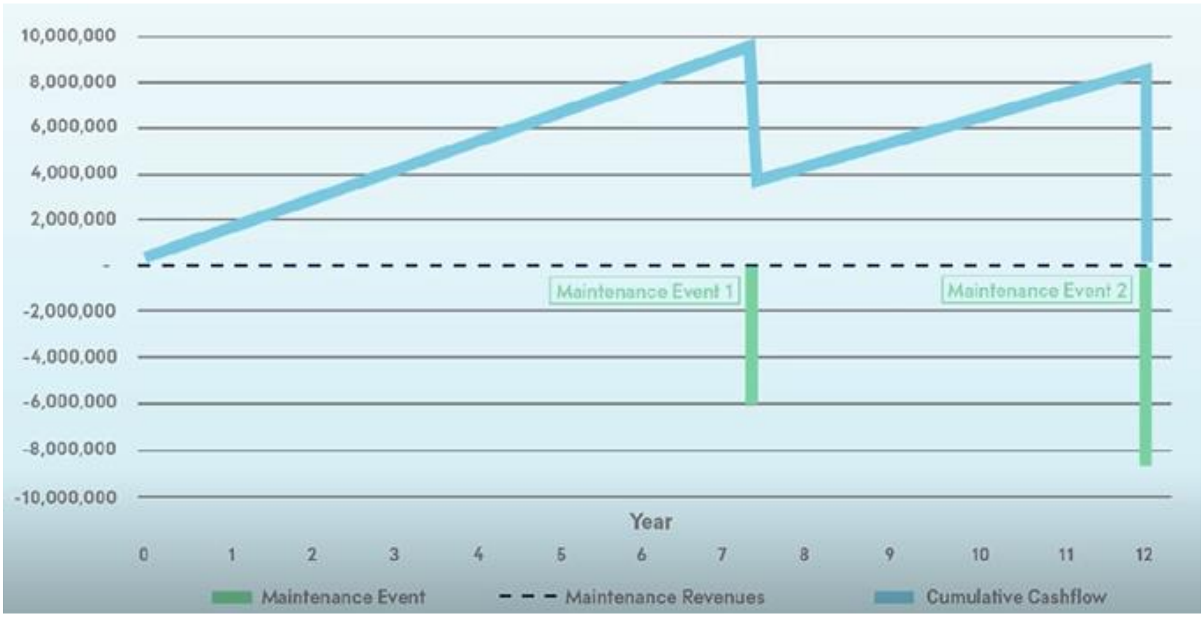
*So, who is responsible for the maintenance of a leased aircraft?*

Once delivered, the lessee takes full responsibility for the aircraft, which includes staffing, insurance, all operations and maintenance. On maintenance, each lease will set out a specific condition that the aircraft must be returned in at the end of the term.

There are two ways in which airlines can pay for this. The first is through supplemental rents most commonly known as 'maintenance reserves', and the second is to pay the difference between the actual return condition and specified condition at the end of the lease, which is known as EOL compensation.

Maintenance reserve payers will pay cash each month, in addition to their lease rents, which accumulate like a sinking fund over the term of the lease. This means funds are readily available throughout the lease contract to pay for any events, like shop visits, which may be required. It also means that if an aircraft is transitioned to a new customer between scheduled shop visits, each airline will only pay for their own utilisation. These payments are usually based on how often and far the aircraft is flown, typically calculated as either flight hours or flight cycles.

**Maintenance Reserve Balance**



EOL contracts, however, do not require monthly payments. Instead, at the end of the lease, the airline will have two options. They can either complete the maintenance work required to conform with the lease's return condition prior to returning it, or they can pay the difference. These arrangements would typically only be offered to better credits.

*And now to the accounting...*

AerCap accounts for the MR contracts under the First-in First-out approach, known as FIFO, which means we only recognize the revenues on our P&L once we've collected more than we expect to spend over the lease term. Imagine a simplified fictional example to illustrate this point, whereby a 12-year lease was signed, with an expected $10m shop visit to occur near the end of the lease, and the lessee agreed to pay $1m/year in MR payments.

For the first 10 years, AerCap would recognize $1m in cash on the balance sheet, and $1m as a Maintenance Liability on the balance sheet each year. After 10 years, $10m would have been collected, and in the subsequent two years, AerCap would take $1m to Maintenance Revenues, and therefore equity, and $1m to cash.

**12 Year Lease: Maintenance Reserve Accounting**

| | Assets | Liability | |
|---|---|---|---|
| | Cash | Maintenance Liability | Equity |
| Year 1 | $1m | $1m | |
| Year 2 | $1m | $1m | |
| Year 3 | $1m | $1m | |
| Year 4 | $1m | $1m | |
| Year 5 | $1m | $1m | |
| Year 6 | $1m | $1m | |
| Year 7 | $1m | $1m | |
| Year 8 | $1m | $1m | |
| Year 9 | $1m | $1m | |
| Year 10 | $1m | $1m | |
| Year 11 | $1m | | $1m |
| Year 12 | $1m | | $1m |
| Total | $12m | $12m | |

So, at the end of twelve years the balance sheet would have $12m in cash, $10m Maintenance Liability and $2m in equity. When any maintenance work is required, for example costing $10m, the lessee will pay for the event and claim reimbursement for the work, reducing both the cash and the maintenance liability.

**Year 12: Maintenance Reserve Accounting**

| | Assets | Liability | |
|---|---|---|---|
| | Cash | Maintenance Liability | Equity |
| Total | $12m | $10m | $2m |

With EOL contracts, the lessee will make an "EOL cash compensation" payment to the lessor if the aircraft is returned in a worse than stipulated maintenance condition. This is recorded as Maintenance Revenues in the P&L, which then flows through to equity on the balance sheet, and also an increase in cash. In subsequent years, if work needs to be completed on that aircraft, that will flow out through leasing expenses.

So, that sums up Maintenance accounting, we hope you found this video useful, and I look forward to adding more content in the year ahead.