Aviation Debt

Newsletter Q3 2022

Global Aviation Market Q3 2022 - Overview

> The market recovery in the aviation sector continued as anticipated, despite certain disruptions and regional disparities across the globe.

> European as well as broader international markets face disruptions as the industry struggles to recruit enough staff to cope with surging demand, especially during the busy summer season.

> Kerosene prices continued to spike since the start of the war in Ukraine and stood at above USD 150 per barrel mid-Q2 2022. Since the start of the year, jet fuel prices increased by approx. +90% and were roughly +120% higher than in 2021.

> While one crisis is nearly over with airlines seeing an inflow of cash due to the robust demand in summer, it remains to be seen if they can maintain that level of cash and deleverage their balance sheets simultaneously going forward facing an uncertain outlook.

> Conclusion: While the industry continued its recovery as anticipated, new challenges are on the horizon. Margins continued to be low for top tier carriers. Transaction volume remained subdued, with only larger RfP’s in the market. We currently see a generic spread for a narrowbody loan at around 350 bps.

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Aviation Debt – Market Summary

The market recovery in the aviation sector continued as anticipated, despite certain disruptions and regional disparities across the globe. Capital markets activity has slowed down during Q2 2022 compared to the prior year amid rising interest rates and inflation. With stock markets tumbling at the end of Q2, the same applied to airline stocks globally. Industry-wide revenue passenger kilometers ("RPK's") have further improved especially for international air traffic which has driven the recovery in the industry during the first months of 2022. The latest re-opening of the Asia Pacific market is expected to provide renewed impetus to the passenger recovery. Nevertheless, given the protracted Russian invasion of Ukraine becoming reality coupled with a macro-economic environment marked by high inflation, fuel price volatility, rising interest rates and recessionary concerns, the outlook is less certain. In spite of this challenging macro-economic environment, airlines retain a rather positive outlook for 2022 overall.

Financing Terms

Based on the macro-economic headwinds with rising inflation and interest rates, capital market activity slowed down considerably during Q2 2022. Lessors issued a mere USD 1.5bln in Q2, less than half of the debt that had been issued in Q1 with USD 3.2bln according to Ishka. Aircraft lessor Carlyle Aviation Management Limited ("Carlyle") tested the market in June with a USD 522.5m issuance and priced the first commercial aircraft ABS this year. Carlyle's AASET 2022-1 is to acquire a portfolio of 25 aircraft, has a 6% coupon and was priced at 350bps spread for an all-in yield of 6.558%. The airline issuances of unsecured bonds slowed down to USD 4.9bln overall, where just USD 751m has been issued outside China. China Eastern alone issued a private placement bond of RMB 15bln (USD 2.2bln) to finance 38 aircraft. The overall low volume is still likely due to rising interest rates combined with increased swap costs and the rush for financing in the previous quarters, especially Q4 2021, and hence a lower financing need going forward. However, going forward, we expect that stronger lessors and airlines are going to come back to the market.

As deal volume was generally low in the second quarter and during the first half of 2022 overall with many market participants waiting on the side-lines, pricing remained broadly unchanged, with a slight uptick only for now following the general trend in rising interest rates. Though LTV's have not moved significantly, aircraft values especially in the single-aisle market are trending upwards strongly as the demand for aircraft recovers. The reopening of more long-haul markets is likely to support the values of twin-aisles as well, while the B777-300ER is still the overall laggard. Demand for mezzanine financing remains with LTVs close to 100% in order to minimize equity contributions.

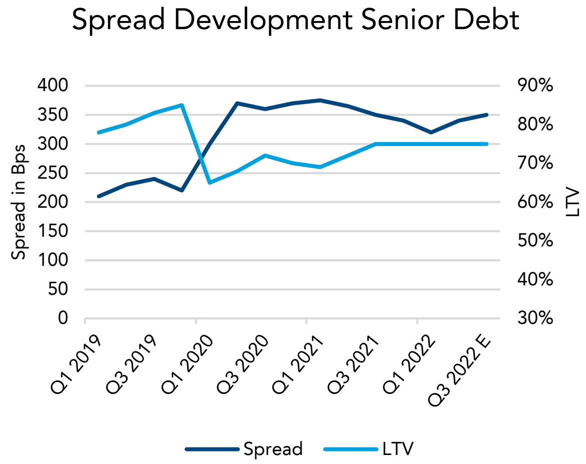

Figure 1, Source: Prime Capital Research

Airline Equity Market

Airlines continued to leverage the strong return of pent-up demand and were able to establish higher fares over the summer season. This resulted in higher revenues and some of the largest carriers have returned to profitability, especially in the US and partially in Europe (e.g. Ryanair). However, some airlines were more negatively impacted than others by industry wide constraints and labour market shortages, such as easyJet and Wizz Air which remained in the red during the second quarter. These staff shortages continued to cause disruptions and led to flight cancellations across the globe as the industry struggled to recruit enough staff to cope with surging demand. The Chapter 11 bankruptcy filing by SAS also reminded the market that not all airlines are over the worst. Investor concerns about an economic downturn and risks of a recession coupled with the industry wide constraints led to a lower trading of global airline stocks during Q2 2022. Nevertheless, this is reflective of the market sentiment with a less certain outlook for the remainder of the year 2022.

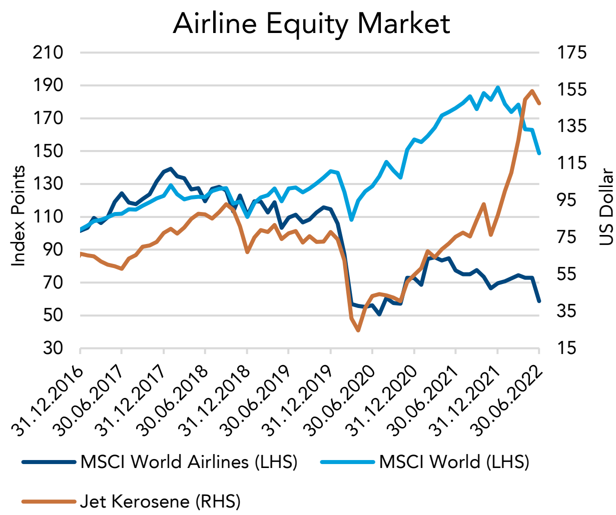

Figure 2, Source: Bloomberg

Kerosene prices continued to spike since the start of the war in Ukraine and stood at above USD 150 per barrel mid-Q2

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2022. However, at the end of June, kerosine prices fell reflecting a fall in international oil prices. As oil prices are a commodity they are expected to fluctuate going forward and might be further impacted by the protracted Russian invasion of Ukraine and additional sanctions applied to Russia. Therefore, airlines could consider options to be more disciplined in terms of capacity deployment as fuel expenses account for around 25% of airlines' operating expenses.

Commercial Aviation

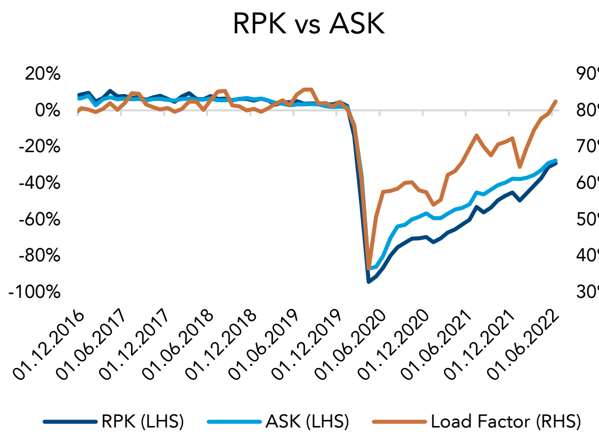

Figure 3, Source: IATA

According to IATA, RPKs improved further and were -29% below pre-crisis levels of 2019 in June 2022, while available seat-kilometres ("ASKs") recorded a -28% decline compared to 2019. Year-on-year ("YoY"), RPK's have increased by +76% compared to June 2021 and up by +83% year-to-date. In terms of capacity, ASK's grew +49% YoY and by +52% year-to-date. Fuelled by a reduction or removal of travel restrictions and the re-opening of markets, international traffic has driven the recovery in the industry during the first months of 2022. RPK's grew by +230% YoY for international flights in June 2022 and ASK's by +118% YoY. While regional disparities persisted throughout recent months with especially Asia Pacific trailing, the latest re-opening of the Asia Pacific markets are expected to provide renewed impetus to the passenger recovery. Regions that pursued a "zero Covid" strategy such as China are gradually reopening to air travel and the expectation is that air travel demand rebounds once restrictions are eased further. Domestic air traffic volumes remained resilient with major improvements in China as mentioned beforehand. Despite the ongoing war in Ukraine, most European airlines did not sustain any major impact and since the start of the invasion in February 2022, this has generally been the case. In fact, the European market remains one of the strongest performers and international travel within Europe exceeding pre-pandemic levels by 7% in June. Beyond such growth figures, European as well as broader international markets face disruptions as the industry struggles to recruit enough staff to cope with surging demand. As Covid-19 and concurrent government-imposed travel restrictions wiped out passenger demand throughout the last two years, many airlines, airports and ground handling companies reduced staff numbers. Despite efforts to increase headcount in the aviation industry, it is expected that the summer is going to see longer queues, cancellations and delays based on ongoing staffing issues. While airlines currently benefit from pent-up demand and higher fares during the summer season, airlines are going to face an uncertain cost outlook through late 2022, with fuel, inflation and increasing interest rates all key drivers to increased costs. Moreover, inflation and higher interest rates may eventually start to alleviate the pent-up demand for air travel during the next quarters while potential new outbreaks of Covid-19 in the winter could lead to a slowdown in demand.

The storm is not over yet

As Covid-19 has been the greatest shock to aviation in its history, RPKs and ASKs plummeted tremendously with the outbreak and the pandemic related travel restrictions. Over the last two years, these have gradually improved despite an uneven recovery across the globe. Concurrently, the financial performance of the airline industry is improving in all regions as well with North America returning to profitability in 2022 already highlighting the resilience of the industry. However, costs are going to be a key industry challenge this year with rising fuel prices and interest rates as well as disruptions at airport infrastructure caused by ongoing staffing issues as mentioned in the prior sections.

Despite the positive signals, the latest Chapter 11 filing of SAS has reminded the industry that not all airlines are over the worst. The Scandinavian airline indicated that the filing is going to enable it to accelerate the implementation of a transformation plan. SAS follows its rival Norwegian that went through bankruptcy and a debt restructuring during the last two years. Prior to the filing, SAS had reportedly been pursuing a restructuring plan to address the financial impact of the COVID-19 pandemic. Regarding such financial impact, SAS is not the only airline that needs to work to deleverage its balance sheet from billions of dollars in debt accumulated during the crisis. This so far invisible impact hangs over the airline industry for the upcoming years notes the Financial Times. The major carriers in Europe and the US such as Air France-KLM, IAG, Lufthansa, Delta, United, etc. have accumulated more than USD 193bln in gross debt (compared to USD 109bln in 2019) between them over the last two years. As of now, these airlines have been shielded with cash provided through a combination of shareholders, debt markets and mostly by national governments such as Lufthansa that received a EUR 9bln bailout from the German government (which has been repaid in the meantime).

While one crisis is nearly over with airlines seeing an inflow of cash due to the robust demand in summer, it remains to be seen if they can maintain that level of cash and deleverage their balance sheets simultaneously going forward facing an uncertain outlook. At least inflation helps to erode the overall level of debt and makes the cost more affordable to service it.

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Further information about Prime Capital AG can be found on the web site
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