



# Aviation Debt

Newsletter Q1 2021

## Global Aviation Q1 2021 Overview

- > The recovery of the airline sector continued through October 2020 but stagnated in November and December due to the deterioration of the pandemic situation across the world.
- > Based on the latest forecast by IATA, 2019 global RPK levels won't be regained until around 2024. IATA however expects, that airlines will stop burning cash towards the end of 2021. Forward bookings for Q1 2021 remain muted.
- > Prime Capital committed to one transaction in the fourth quarter of 2020. The deal is a shorter term financing for a new technology narrowbody aircraft, at an LTV below 65% and pricing in the high 300 bps. The pipeline remains strong, mostly consisting of operating leases for Tier 1 airlines with strong leasing companies. In some cases the transactions include additional protection in the form of full recourse or additional guarantees. Some transactions are secondary market transactions, of investors reducing their aviation exposure. The average spread of the Pipeline is around 400 bps.
- > In 2020 approximately 45 airlines have filed for bankruptcy due to Covid-19 globally, this includes large carriers like LATAM, Norwegian and Avianca but mostly smaller local airlines. The majority of the airlines in our portfolio remain resilient and airlines, which had asked for deferrals are starting to catch up on missed payments. According to Fitch the average default rate for 2020 was at 5.2%, which is below the average from 2001 to 2020 of 6.8%.
- > Conclusion: The summer recovery in air traffic came to a halt in November with the rise of second pandemic waves around the world. The outlook for airlines is unlikely to return positive before Q3 2021, once Covid-19 vaccines will have become widely available. Spreads remain at elevated levels with some transactions pricing at 350+ bps. Deals for Tier 2 or 3 airlines continue to be rare while the market for Tier 1 names remains active. We currently see a generic spread for a narrow-body loan around 370 bps, but with a significantly improved credit on the airline side. Spreads for top names have slightly tightened, due to vaccination news that offer cause for optimism. More complex structures remain attractively priced, with a limited increase in risk. Leasing companies and airlines still struggle to finance balloon tranches especially on longer term transactions, as most lenders continue to focus on the credit risk rather than on residual value. It can also be expected, that mezzanine tranches will become more relevant, due to more restrictive LTV's across banks.

## Aviation Debt – Market Summary

The fourth quarter of 2020 has been characterised by a partial recovery of the airline sector, which however stagnated in November and December due to renewed travel restrictions imposed by governments to slow down contagion caused by the so-called second wave.

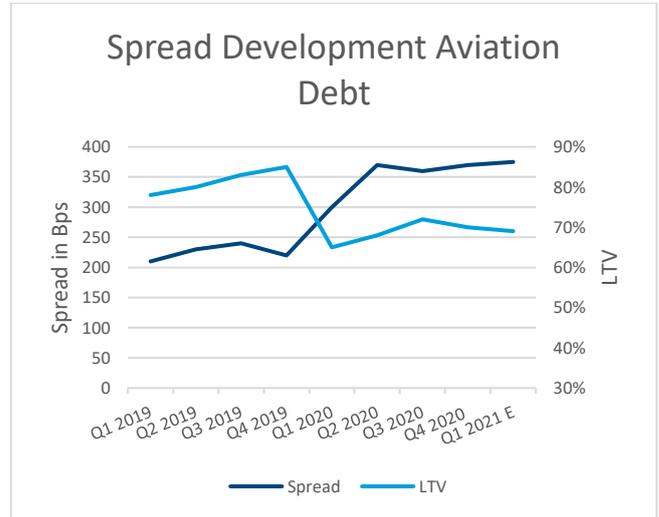
According to IATA, industry-wide revenue passenger-kilometres (RPKs) fell by -70% year-on-year in December, compared with an -73% year-on-year contraction in September. In 2020 as a whole, passenger traffic fell by -66% – the sharpest decline in the aviation history. Looking ahead, the first quarter of the year 2021 will remain challenging for the airline industry. The number of confirmed cases reached record levels in January. New and more aggressive virus mutations resulted in travel bans in several key markets including the UK. Although the vaccine rollout is good news for air travel, the immunization has been slow so far, and it will take time before its impact is reflected in passenger numbers. For now, willingness to travel is low – at least based on the evidence from bookings for future travel which were down -70% year-on-year in January. According to IATA’s latest forecast (October 2020), the full-scale deployment of Covid-19 vaccines will allow air travel to rise back substantially in late 2021 and in 2022. On this basis, 2019 global RPK levels won’t be regained until around 2024. The outlook remains uncertain as it is tied to the course of the pandemic, which depends on virus behaviour, vaccine effectiveness and government responses. Airlines had been cautious about adding capacity back to the market during Q4 amidst slowing demand recovery. The industry-wide available seat-kilometres (ASKs) fell by -57% year-on-year in December – a similar decline as in the previous two months. In 2020 as a whole, seat capacity was down -57% year-on-year – about 9ppts smaller contraction than in RPKs.

IATA currently estimates that the global airline industry will turn cash positive in the second half of 2021. The forecast is based on the expected vaccination progress allowing passengers to plan trips with a higher certainty. IATA expects cash burn of the airline industry to gradually decline from around USD 30 bln to USD 0+ bln in Q4 2021. Forward bookings for Q1 2021 remain muted, given continued travel restrictions due to new virus variants. In its optimistic case, IATA expects a +50% year-on-year growth in passenger numbers until December 2021. The downside case is based on the expectations of new virus variants and expects a +13% year-on-year growth.

## Financing Terms

According to Ishka, airlines issued unsecured bonds of USD 10.6bn in Q4 2020, which leads to an overall increase of +78% year-on-year for 2020. The market pricing for Tier 1 airline issuances in Q4 2020 has been impacted by expectations for a quick vaccination where spreads have

slightly decreased. However prices still remain at elevated levels compared to pre-Covid pricing. Lessors continue to be active in the Sale and Leaseback space, which provides continued deal flow for aviation debt. Some banks have retracted from the market, offering opportunities for investors, who are able to analyse asset risk appropriately. Overall, there seems to be a lack of supply for tranches involving residual value risk and structures with higher LTV’s.



Source: Prime Capital

The private market deal activity was below the usual fourth quarter volume. While the secondary market has become more active, with some banks offering their entire aviation exposure for sale. However the pricing does not seem to reflect significant discounts. The market continues to distinguish between finance leases for local airlines and operating lease structures, with the latter offering higher pricing. Spreads remain in the 300 to 400 range at conservative LTV’s.

The decrease in aircraft values in the second half of 2020 was moderate compared to H1 2020 valuations. New technology aircraft continue to show a more resilient value compared to older out of production aircraft, where value declines can be in the double digits.

## Airline Market

The gap between airline stocks and other stocks remained wide through Q4 2020: The MSCI World Airlines Index is trading at 69% of Jan-20 levels, whereas the MSCI World Index is at 115% of its Jan-20 level. Investors remain pessimistic about airlines’ cash burn rates and the challenges and uncertainty that the sector is facing.

### Airline Equity Market



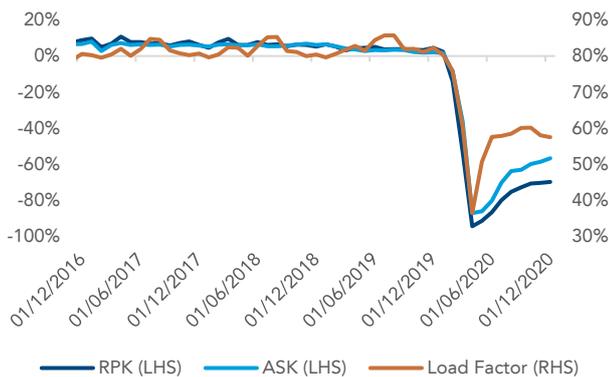
Source: Bloomberg

Fuel prices increased during Q4 but remained well below pre-pandemic levels given only slightly increased demand from airlines. As the pandemic will most likely only start to recede once vaccines become broadly available in the summer of 2021, we can expect that the performance gap between the airline sector and the world index will only begin to narrow in Q3 2021.

## Commercial Aviation

Due to the emergence of “second waves” of the Covid-19 pandemic starting in October 2020, air passenger traffic has improved only slightly during Q4 2020.

### RPK vs ASK



Source: IATA

Global RPKs measuring the total demand of passenger traffic fell by -69.7% year-on-year in December down from -72.8% year-on-year in September. ASKs dropped in line with RPK's by -56.7% year-on-year in December, while the load factors decreased to 57.5% down from their all-time highs around 80% during 2019. As has been the case since the start of the pandemic, the performance gap between international and domestic travel is large: International RPKs contracted by more than -80% year-on-year.

## The Boeing 737 Max returns

The Boeing 737 Max was recertified in November 2020, by the US Federal Aviation Administration (FAA) for return to service. Airlines have already started putting the aircraft back into service, with a return in Europe expected soon. Despite the discussion around the perception of the aircraft by passengers and initiatives to rename the model, passengers have not shied away to travel on the recertified plane. American Airlines' first flight with the aircraft achieved a load factor of around 90%. Meanwhile Ryanair now only refers to B737-8200 (formerly known as Boeing 737 Max 200), which is a larger variant of the B737 Max8, with a maximum capacity of 200 passengers instead of 189.

The aircraft had been grounded for almost 20 months following two crashes by Lion Air and Ethiopian Airlines. At the date of the grounding, about 395 aircraft had already been delivered. Since the grounding, further 400 aircraft have been produced and are now waiting for delivery. The Covid-19 pandemic has caused many airlines to retire older aircraft earlier than expected and to focus their fleet on new technology, fuel efficient aircraft. This should help the B737 Max, as many airlines still rely on the aircraft to form core of their narrowbody fleet going forward. It is expected, that the delivery of the 400 aircraft may take up to two years.

The appraiser values of the B737 Max variants are expected to improve with the return to service. The market had continued to support the aircraft despite the grounding, with several debt transactions agreed during the past 20 months, based on the condition that the aircraft is re-certified.

Boeing continues to feel the repercussions of the two tragic incidents. The company entered a USD 2.5 billion deferred prosecution agreement with the Justice Department to resolve a criminal allegation of conspiracy to defraud the U.S. The agreement includes a criminal penalty of nearly USD 244 million, USD 1.77 billion in compensation to Boeing's airline customers, and USD 500 million for the heirs and beneficiaries of the 346 passengers who died in crashes of the two Boeing 737 MAX planes.

### About Prime Capital's Private Debt Team

Our aviation team, which has been active in the Aviation Debt market for many years, has already carried out transactions of more than USD 1bln. The Private Debt Team additionally invests in Commercial Real Estate, Infrastructure Debt and Corporate Lending. We expect significant further asset growth in these areas, while providing satisfactory risk adjusted returns to our largely institutional investors.

Further information about Prime Capital AG can be found on the web site [www.primecapital-ag.com](http://www.primecapital-ag.com)

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