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Aviation Debt

Newsletter Q1 2022

Global Aviation Market Q1 2022 - Overview

> During the fourth quarter and the year 2021 overall, air-travel recovery continued gradually despite disruptions from the Delta and Omicron variant.

> Despite rising fuel costs, airline stocks rose in December and January due to renewed optimism, that the Omicron variant will not significantly slow down the recovery in the aircraft sector.

> IATA reports that the latest results from its sample of airlines confirm the pressure on airlines' operating profitability easing in Q3. This is attributed to a gradual improvement in passenger traffic and a still very strong air cargo business.

> Sustainable Aviation Fuel (SAF), is regarded as aviation's most promising pathway to net zero by 2050. While SAF is already produced in small quantities it is still a long way to mass production and sufficient volume to fuel a significant part of the global aircraft fleet.

> Conclusion: The industry continues to recover and the desire to fly for leisure and business remains high. Margins for Tier 1 carriers continue to decrease, even though transaction volume remained low through the end of Q4 2021/ beginning of Q1 2022. We currently see a generic spread for a narrowbody loan at around 320 bps.

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Aviation Debt – Market Summary

During the fourth quarter and the year 2021 overall, air-travel recovery continued gradually despite disruptions from the Delta and Omicron variant. In the absence of Omicron, results would have probably been even stronger and bookings for near-future travel less impacted during the last quarter of 2021. Despite the considerable improvement in air travel compared to 2020 thanks to ongoing vaccination progress and testing efficiency lifting certain international markets and domestic lockdowns, 2021 remained challenging for the airline industry. Next to new variants such as Delta and Omicron leading to travel restrictions, airlines are facing sharply increased fuel costs that surged by +68% YoY as well as a soaring inflation leading to rising labour costs and prices for consumers plus a risk of higher interest rates in the coming year. However, as the new Omicron variant seems to lead to less severe symptoms and hospitalization ratios per case falling in most countries, air travel is expected to recover further. It is expected that the traditionally weak months of January and February will be potentially even weaker due to ongoing travel restrictions. However, with potential further easing of travel restrictions for the traditionally stronger Q2 and Q3, higher demand for international and domestic air travel is expected.

Financing Terms

The last quarter of 2021 has marked one of the busiest quarters within the last three years in terms of lessor capital markets activity. It has to be noted though that the majority of volume is attributed to AerCaps issuance of USD 21 bln, in order to fund the Gecas acquisition. According to Ishka an additional USD 3.5 bln have been raised, including GTLK ICBC and Castlelake. Coupons range from 0.73% to 4.35%. The coupon varies due to issuer rating, maturity and leasing company.

Airlines have been busy as well issuing new debt during Q4 2021 with a volume of ~ USD 12 bln. This is slightly less than in the previous quarter. However, total debt issuance by airlines in 2021 was also the largest in the past three years.

Spreads for top tier airlines have further decreased to just above 1% given a lot of market participants focus on top credits. LTV's slowly crept up to levels above 70%, while there still remains a distinction between more liquid and less liquid aircrafts types. The latter still have LTV's below 70% and sometimes as low as 50% for out-of-favour widebody aircrafts. Also balloon structures have become more popular again with increasing balloon sizes, as some investors are looking for additional premium, while still benefitting from the overall deleveraging of the deal through the amortizing tranche.

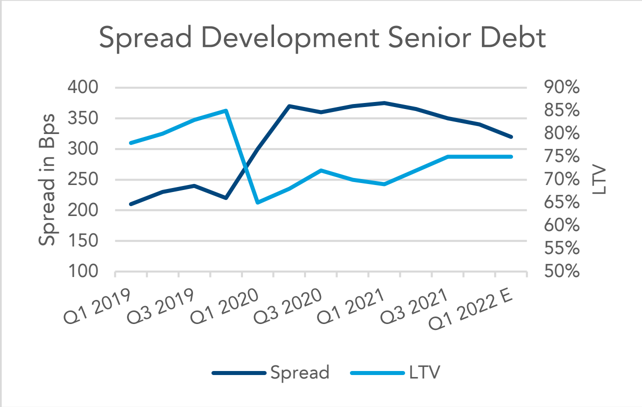

Figure 1, Source: Prime Capital Research

Airline Equity Market

IATA reports that the latest results from its sample of airlines confirm the pressure on airlines' operating profitability easing in Q3. This is attributed to a gradual improvement in passenger traffic and a still very strong air cargo business. According to IATA the industry-wide operating loss reduced to 2.6% of revenues over the July/September period, compared with a 13.6% loss in Q2. Looking at the different regions the EBIT margin improved the most in Europe where airlines benefitted from recovering air travel demand on intra-European routes. The European figure rose from -30% to 3% between Q2 and Q3. The improvement was smaller in North America where the Delta variant's spread delayed the air travel recovery. Asia Pacific region shows the weakest operating result in aggregate (-20% of revenues), notably due to still very restricted international travel to, from, and within the region. IATA states that some of the North American airlines improved their revenue forecast for Q4, stating that travel demand remained robust during the holiday season despite Omicron disruptions. However, at the same time it is expected that cost pressure continues to rise.

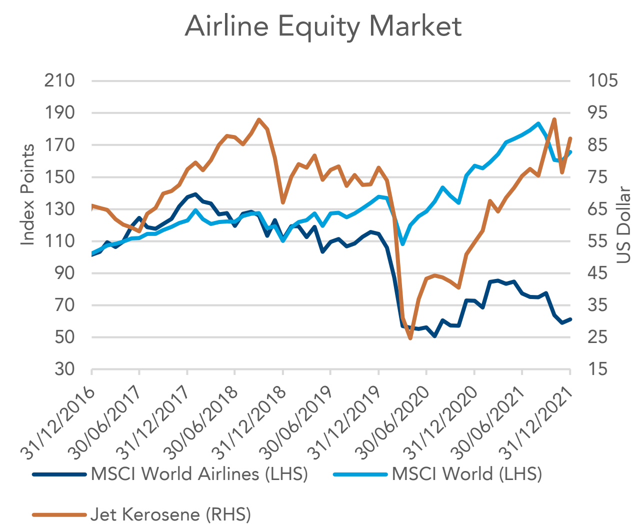

Figure 2, Source: Bloomberg

Jet fuel and Brent crude oil prices bounced back in January 2022, with the former currently at the highest level since late 2018. As with airline stocks, the slight price recovery in December has been driven by rising optimism about the short-lived impact of the Omicron variant on global economic activity, including fuel demand.

Commercial Aviation

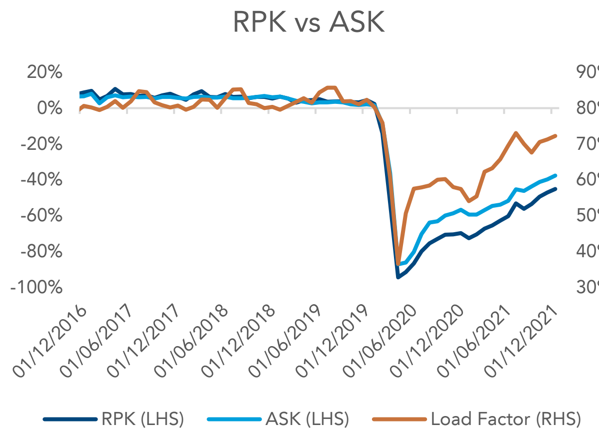

Figure 3, Source: IATA

According to IATA, industry-wide revenue passenger-kilometres (RPKs), an indicator of global passenger demand, in December 2021 were -45% below pre-crisis levels compared to December 2019, while available seat-kilometres (ASKs) recorded a -38% decline compared to 2019. For the total year 2021 RPKs remained -58% and ASKs -49% below 2019 levels. Although RPKs and ASKs still remain subdued compared to 2019, they show a steady recovery trend compared to previous months and especially compared to December 2020 (+80% YoY and +46% YoY respectively). The overall recovery in 2021 was led by domestic markets such as the U.S. (-24% behind 2019 levels in RPK terms), China (-24% behind 2019 levels), Brazil (-27% behind 2019 levels) or Russia (+24% ahead of 2019 levels), coupled with robust global cargo demand. As companies were facing global port congestion and production delays at overseas manufacturing sites, they opted to move goods by air to keep their supply chains on schedule. Recovery in international travel stagnated throughout the first half of 2021 but improved gradually based on the reopening of some short-haul markets such as Europe thanks to the EU vaccine passport and the reopening of the transatlantic market. Inter-Asia traffic however did not fare as well given more widespread travel restrictions imposed by regional governments with such market still being -67% below 2019.

All eyes on SAF

Experts agree, aviation might be one of the hardest industries to decarbonise. Hence the current focus is on transitioning the industry into lower carbon emissions. In its pledge to net zero by 2050 IATA considers different aspects of carbon reducing initiatives, the most prominent being Sustainable Aviation Fuel (SAF). In its forecast for a path to net zero the organisation assumes, that by 2050 65% of the fuel required, will be made up of SAF.

Given the great importance attributed to SAF it is worth taking a closer look on where currently technology stands, its capacity and how realistic the current goal is from today's point of view.

The World Economic Forum (WEF) has identified four different pathways, which mostly rely on waste and feedstock, except for Power-to-Liquid, which uses captured carbon to produce SAF. Of those four technologies only one is currently in production, while the rest is currently only produced in pilot sites. The WEF estimates that globally there are 17 sites producing SAF with 80 additional planned according to ICAO. In theory these should be capable to produce the required volume by 2050.

One of the issues the aviation sector faces, is that it is not the only sector requiring sustainable fuel and it will compete with capacity at the production sites with other sectors. The current technology has the highest output in terms of input of raw material however given it relies mostly on waste oils, the supply of feedstock is limited. The other three pathways/ technologies face much better supply in terms of feedstock. However, they have a much lower yield in term of output. Aircraft Leasing Ireland (ALI) points out that given that feedstock is generally dispersed. It is expected that only 50% of total feedstock will be available for SAF production.

At this point in time SAF is still significantly more expensive than jet fuel but is expected to be more affordable with increased production capacity. On the other hand the available feedstock, which has currently no costs attached is likely to form a market as it becomes a more sought after resource.

At the moment, energy companies focus on producing fuel which has better margin and lower capital expenditures to produce, like renewable diesel fuel. ALI expects as these fuels are replaced in the mid-term, this will shift more focus and resources toward SAF. So far the ecosystem required is not in place yet and hence and is in some areas lacking investment and resources.

In the end several factors need to come together to push decarbonisation of the aviation sector forward, with SAF being a critical element of this path, as alternative propulsion like electric or hydrogen offer no mid-term solutions. Hence the progress will depend on investments in production capacity and infrastructure as well as the willingness of the consumer to accept a premium for "greener" travel. According to ALI more than 70 airlines have already committed to SAF usage until 2030 and over 50% globally to achieve net zero by 2050. It seems that still firmer commitment is required in the form of offtake agreements by airlines to justify further investments.

About Prime Capital's Private Debt Team

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Further information about Prime Capital AG can be found on the web site
www.primecapital-ag.com

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