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Aviation Debt

Newsletter Q1 2023

Global Aviation Market Q1 2023 - Overview

> The aviation sector continued its recovery trend.
> Many of the headwinds that were already current in 2022 are expected to remain in 2023.
> IATA continues to expect global passenger traffic to reach the 2019 level in 2024.
> The ongoing recovery of the market is reflected in the financial figures of airlines.
> The parked aircraft fleet continued to decrease to under 4,000 parked aircraft at the end of 2022.
> The lessor market remains attractive for investment and has seen another round of M&A activity alongside new entrants.
> Conclusion: The industry continued its recovery as anticipated with airlines reporting robust forward bookings and maintaining confidence for the recovery to continue into 2023. Debt margins remained to be low for top tier carriers, but a general rise in margins has been observed over the last months of 2022. We currently see a generic spread for a narrowbody loan at around 375 bps.

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Aviation Debt – Market Summary

The last quarter of 2022 ended as expected with a further recovery in the aviation sector. Industry-wide revenue passenger-kilometres ("RPKs"), an indicator of global passenger demand, increased from 42% in 2021 to 69% in 2022 compared to pre-crisis levels in 2019. Over the year, the parked aircraft fleet continued to decline, but saw a slight increase from mid-September consistent with seasonal trends and stood at under 4,000 parked aircraft (compared to nearly 5,000 at the beginning of the year) at the end of 2022. While OEMs such as Airbus and Boeing continue to deal with supply chain issues and resulting delays in aircraft deliveries, airlines face bottlenecks for MRO and engine shop capacity to reactivate parked aircraft. Therefore, airlines are increasingly turning to leasing companies to respond to increased demand. Despite the past "Black Swan Events" such as Covid and the Russia-Ukraine conflict, which showed the resilience and adaptability of the sector, the aircraft leasing market remains attractive for investment and sees further consolidation of the market alongside new participants. With the majority of lease restructurings completed and airline's revenues back on track, lessor profitability has mostly returned.

Financing Terms

During the fourth quarter of 2022, capital market activity of lessors picked up compared to the previous two quarters with USD 2.1bn issued in unsecured capital market debt throughout the quarter. This represents an increase compared to USD 602m in Q3 and USD 1.5bn in Q2 of 2022, but a significant drop compared to Q4 2021 which saw USD 25.67bn in issuances according to Ishka. Air Lease Corporation opened the public markets with its issuance of USD 700m five-year 5.85% unsecured notes as the only western lessor in December while the remaining issuance of USD 1.4bn came from Chinese firms such as Avic, Bocomm Leasing, CMB, CALC or ICBC.

The airline issuances of unsecured debt spiked to USD 16.2bn in the last quarter of the year (+36% year-over-year ("YoY")) and exceeded every other quarter of 2022. USD issuances made up the most of the issuances and even exceeded CNY issuances, which is rather atypical compared to the previous quarters. Approximately USD 9.5bn were coming from LATAM's issuance of three classes of convertible notes as a part of its capital raise in order to emerge from the Chapter 11 process. 99.8% of these convertible notes had been converted into shares at the end of December 2022. Besides the unsecured bonds, several airlines issued secured bonds such as e.g. Spirit Airlines, LATAM and GOL. During the coming months, we expect to see further issuances amongst the stronger lessors and airlines. In January 2023 for instance, Air France-KLM issued a two tranche EUR 1bn sustainability-linked bonds with coupons of 7.25% and 8.125%.

During the last quarter 2022, pricing has come up by another 25bps to 50bps following the general trend in rising interest rates. This trend continues to put pressure on LTV's. Lenders tend to accept higher LTV's on new-tech while current generation aircraft LTVs remain more conservative based on residual value and remarketing risk.

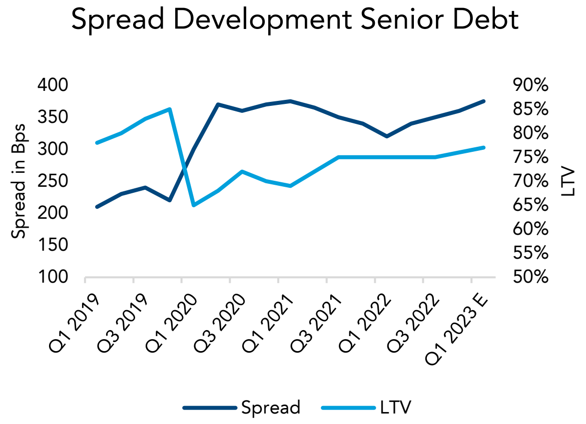

Figure 1, Source: Prime Capital Research

Airline Equity Market

The ongoing recovery of the market is reflected in the financial figures of airlines. Despite significant headwinds, some airlines have already been able to show profits. Based on robust advance bookings and cautious optimism for 2023, IATA projects a USD 5bn profit for the airline industry. In comparison, for 2022, IATA estimates a narrowing industry loss to USD 7bn.

While robust demand for air travel has boosted the top lines of airline financials, especially high fuel-costs have limited the bottom-line growth. Airline stocks have mostly moved in line with the general market trend during Q4 2022 as can be seen in Figure 2. While IATA expects an industry wide profit for 2023, the profitability is not likely to be shared evenly across all regions as only Europeoy, North America and the Middle East airlines are expected to post a net profit for 2023.

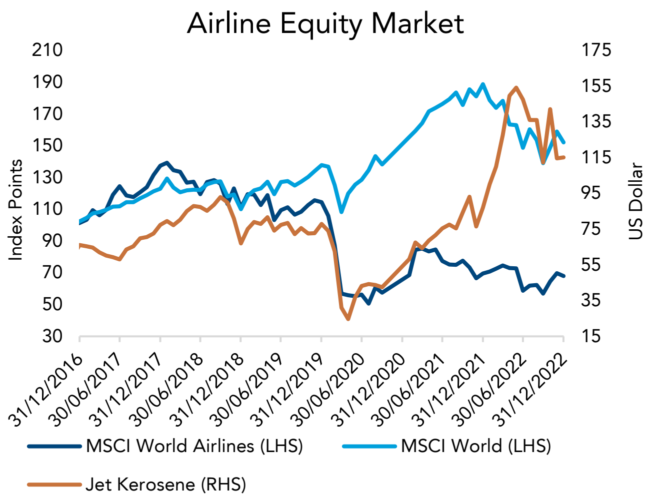

Figure 2, Source: Bloomberg

Besides the airline market, the lessor market remains attractive for investment and sees further consolidation of the market alongside new participants. Maquarie AirFinance, for example, will take over a large part of ALAFCO's portfolio with 53 aircraft as well as the order book for 20x B737 MAX. Aergo acquired Seraph Aviation and was thus able to expand its portfolio by 88 to 304 aircraft. In addition, DAE expanded its portfolio to nearly 500 aircraft with the purchase of Sky Fund I. This was followed by the announcement of Standard Chartered in January 2023 to put its USD 3.7bn leasing arm Pembroke up for sale.

Commercial Aviation

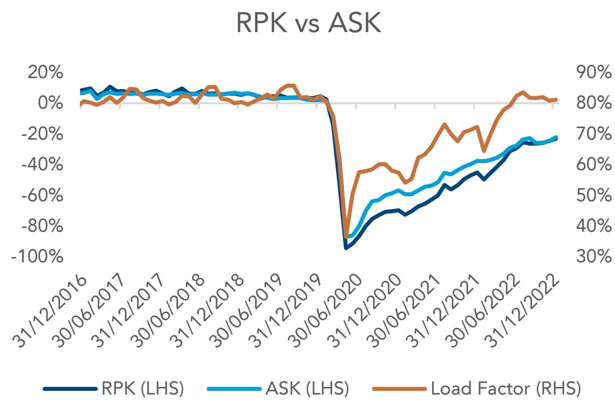

Figure 3, Source: IATA

According to IATA, passenger traffic recovered significantly in 2022. On a YoY basis, passenger traffic registered strong momentum, such that RPKs increased +64% YoY and Available Seat Kilometres ("ASKs") increased +40% YoY. While domestic air traffic was the main driver of the recovery, the long-haul market also continued to recover, registering a doubling of traffic at +153% YoY. This was driven by global easing of restrictions and a substantial pent-up demand for air travel. With a continued recovery in the Asia-Pacific market, especially in light of China's opening up from January 2023, global passenger traffic is expected to see a further upswing. Flights originating in China represented about 14% of all global flights in 2019, so there is still huge potential to be tapped here. Domestic air traffic remained stable globally, while China saw a volatile trend in 2022. This was dependent on the travel restrictions introduced and lifted in each case.

Apart from these growth figures, airlines face an uncertain cost outlook in the coming months, in addition to geopolitical as well as macroeconomic risks. Many of the headwinds that were already current in 2022 are expected to remain in 2023. Fuel cost, inflation, further interest rate increases and a strong U.S. dollar (for non-U.S. airlines) will be the main drivers of cost increases, potentially leading to higher ticket prices. To date, passenger price sensitivity has been low and airlines continue to report strong demand for air travel in 2023.

IATA continues to expect global passenger traffic to reach the 2019 level in 2024. In December 2022, RPKs continued to register a -23% backlog compared to 2019 pre-crisis levels, while ASKs registered a -22% backlog. It is expected that for the next years, North America is going to remain the main driver for the recovery.

Continued advance of Private Debt

Kroll Bond Rating Agency ("KBRA") recently published a research report[1] on the private debt market in aviation. The trend of private debt markets complementing bank lending and public markets began shortly after the financial crisis, providing a steady, diversified and competitive funding source across the aviation industry. With banks facing higher capital charges and bond markets seeing increased volatility, private debt markets saw significant growth in recent years as other sources of financing became more expensive and difficult to access. Especially the private placement market, which is particularly active in the US while Europe, Asia and other jurisdictions become more active these days, saw significant growth. Besides a wider pricing, lower execution risk, bespoke transaction structures providing flexibility to issuers/ borrowers, private markets do not have the volatility of public markets and cater to buy-and-hold investors. Investors benefit from a yield enhancement (up to 50bps) to cater for the lack of liquidity in the secondary market, structural downside protections such as covenant packages (e.g. leverage or liquidity ratios on corporate level or LtV floors or sale restrictions on asset level), and an asset-liability matching via e.g. strong call protections.

KBRA notes that airline issuances surpassed lessor issuances in the private placement market as lessors typically turn to banks and the public unsecured markets for the majority of their financings or utilize the ABS markets for portfolio sales. Besides traditional aircraft financings, the private placement structures have seen non-traditional portfolio financings of freighters, older aircraft, engines and business jets. Over the last years, financings backed by intangible assets including routes, gates, slots as well as loyalty programs or brands have become more common in the private sector. Proceeds of the issuances are typically used for the refinancing of debt, cater for fleet expansion or recapitalization programs. With the outbreak of the pandemic, the private placement market offered a consistent and reliable source of capital to be raised against intangible assets and aircraft. Transactions range from USD 100m to more than USD 1bn and KBRA estimates the total outstanding market volume of aviation related private placements to be around USD 30-40bn.

The report inter alia concludes that with ongoing volatile public debt markets and ample liquidity in the private market, especially private placement investments are expected to provide a growing source of funding across the aviation industry and is therefore expected to grow further.

[1] https://www.kbra.com/documents/report/169198/private-credit-a-boon-for-private-credit-and-private-placements-in-aviation

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 1bn. The Private Debt Team additionally invests in Real Estate Debt, 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. Prime Capital's Private Debt Team manages assets in excess of EUR 2bn across private debt segments on behalf of institutional investors.

Further information about Prime Capital AG can be found at
www.primecapital-ag.com

Contact:

Niels Klindt
Director
Private Debt

Prime Capital – Investment Management Private Debt

Contact

For questions or further information please contact your relationship manager at Prime Capital or our Private Debt team at

impd@primecapital-ag.com

+49 69 9686 9840