



Aviation Debt

Newsletter Q2 2022

Global Aviation Market Q2 2022 - Overview

- > The recovery in the aviation sector continued during the first quarter of 2022, despite the war in Ukraine.
- > The closure of the Ukrainian airspace impacts total air passenger traffic in Europe by roughly 3.3%, and total air traffic globally by 0.8%, as per 2021 traffic figures according to IATA.
- > Kerosene prices rose sharply since the start of the war in Ukraine. They stood at USD 150 per barrel at their peak in March, up +39% on the month and even +121% year-on-year.
- > Due to sanctions against Russia about 500 aircraft were stranded in Russia, of which 41 could be recovered. The future of the remaining aircraft is uncertain. However, no long-term impact is expected on the airline industry.
- > Conclusion: While the industry continues to recover there are new challenges ahead. Margins remain low for top tier carriers. Transaction volume was also subdued, with only several larger RfP's in the market. We currently see a generic spread for a narrowbody loan at around 340 bps.

Aviation Debt – Market Summary

The recovery in the aviation sector continued during the first quarter of 2022, despite the war in Ukraine. In terms of capital markets activity, the volumes have decreased significantly compared to Q4 2021. There seems to be a divergence between the US and European airline stocks while the first continue to rise the latter have not performed as well. RPK's have further improved especially for international air traffic. The exception is China, which continues to impose its zero-Covid policy, enforcing large scale lock-downs. While the direct impact of the war in Ukraine to air travel has been limited, the indirect effects of rising fuel costs impact the airline industry across the board and will only be felt in the coming quarters. Also rising interest rates make it more challenging for airlines and lessors to refinance. This will likely put upward pressure on currently depressed margins for top tier carriers. Despite the challenges ahead airlines remain bullish for the rest of 2022, with especially US carriers expecting pre-Covid revenue levels or even higher.

Financing Terms

After Q4 2021 marked one of the busiest quarters in terms of lessor capital market activity, Q1 2022 posted the lowest volume since 2019. A total of USD 3.2bln have been issued, in Q1 2022, compared to USD 25bln in Q4 2021, according to Ishka. ALC alone has issued USD 1.5bln in unsecured financing of the total USD 3.2bln volume. The low volume is likely due to rising interest rate and the rush for financing in the previous quarter and hence a lower financing need going forward.

Airline's issuances slowed as well to USD 1.8bn for the first quarter of 2022. Only Chinese airlines have been very active issuing an equivalent of USD 11bln bringing the total issuance volume (including CNY issuances) for Q1 2022 to USD 12.8bln, which in Dollar-terms is on par with Q4 2021.

Deal Volume was generally low in the first quarter of 2022 and many market participants waited on the side-lines creating opportunities for active market participants. Hence pricing remains broadly unchanged, with a slight uptick. LTV's have not moved significantly, however aircraft values seem to slowly reverse and start to rise from their lows, at least for certain aircraft types. There has also been an increased demand for mezzanine financing sometimes up to 100% LTV in order to minimize equity contributions.

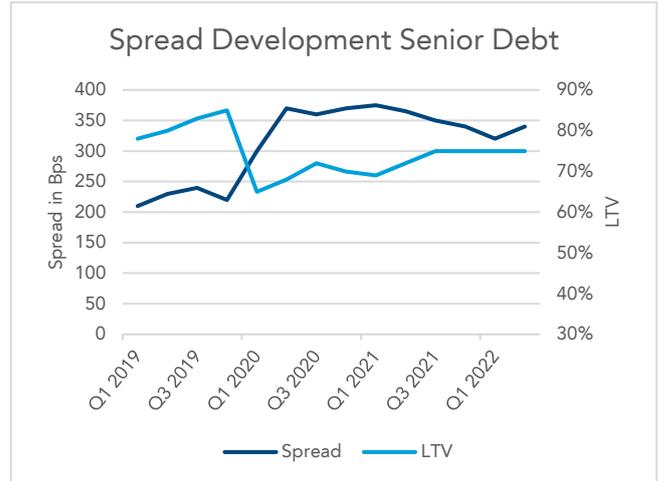


Figure 1, Source: Prime Capital Research

Airline Equity Market

As the aviation sector continues its recovery there seems to be a disparity between US and European carriers. Leading US- airlines such as Southwest airlines, American Airlines and United Airlines have seen an increase in their stock prices during the first quarter of 2022. However, European carriers such as Ryanair, IAG and SAS are lagging behind. Rising fuel costs have impacted profitability and investors seem concerned, but this is only reflected in the stock prices of European airlines, compared with their US counter parts. For Q1 2022, American Airlines reported the first time that total revenue was above 2019 levels based on record sales in March 2022. United Airlines reported that it expects the highest quarterly revenue in Q2 2022 and hence has a very positive outlook for the rest of 2022. Also margins further improved despite cost headwinds. Lufthansa reported a significant increase in its load factor from 59% in January 2022 to 72% in March 2022. Revenues have more than doubled compared to the same period in 2021.

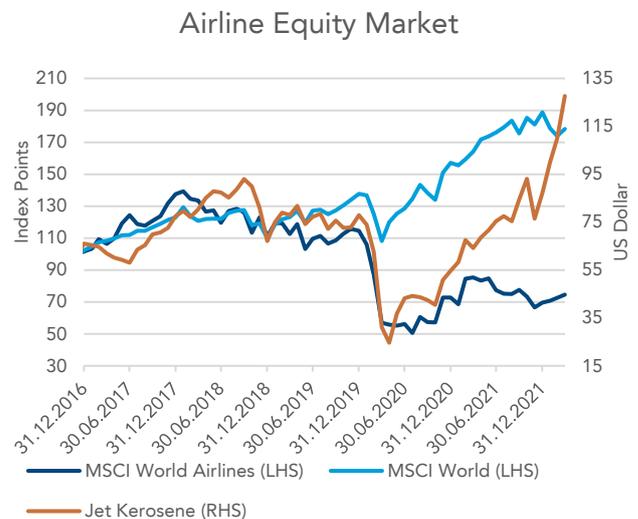


Figure 2, Source: Bloomberg

Kerosene prices rose sharply since the start of the war in Ukraine. They stood at USD 150 per barrel at their peak in March up +39% on the month and +121% year-on-year. It is expected that the upward pressures on prices will continue, especially in case of more stringent sanctions being applied to Russia. According to IATA, fuel expenses made up around 25% of airlines' operating expenses prior to the pandemic, this also included hedging costs.

Commercial Aviation

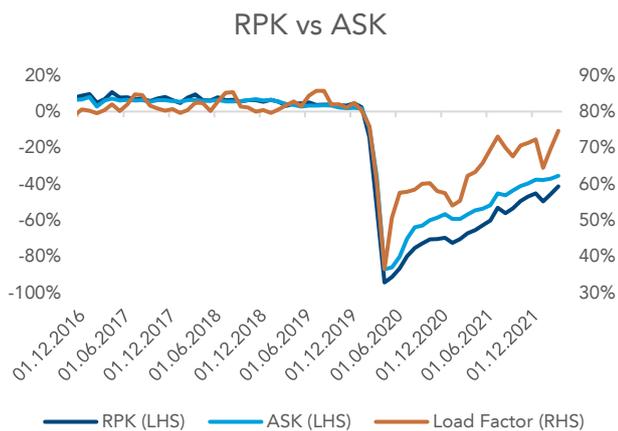


Figure 3, Source: IATA

According to IATA, industry-wide revenue passenger-kilometres (RPKs), an indicator of global passenger demand, in March 2022 were -41% below pre-crisis levels in 2019, while available seat-kilometres (ASKs) recorded a -38% decline compared to 2019. Year-on-year, RPK's have increased by +76% compared to March 2021 and up +2.8% versus February 2022. In terms of capacity, ASK's grew +46% year-on-year. The recovery of international air traffic is apparent looking at the isolated figures compared to March 2021. RPK's grew by +285% for international flights in March 2022 and ASK's by +132%. In contrast, China's domestic air traffic has been heavily impacted by the spread of Omicron in China and the subsequent complete lockdowns of certain cities, with volumes down -59% in March year-on-year. However, this has not translated to a decrease in international RPKs for Asia Pacific carriers. Overall, Covid 19 is becoming less of an issue in countries outside of Asia, allowing the rebound in air traffic to continue. The impact from the war in Ukraine on air travel remains very limited overall, and even travel within Europe as well as travel between Asia and Europe remains strong. The closure of the Ukrainian airspace impacts total air passenger traffic in Europe by roughly 3.3%, and total air traffic globally by 0.8%, as per 2021 traffic figures according to IATA. It remains to be noted that despite the low impact on the aviation industry the conflict has devastating impact on the people living in the affected regions.

The impact of sanctions on Russia

Russia's attack on Ukraine has severely impacted the life of millions of people with far reaching humanitarian consequences and devastating effects for people living in Ukraine and their loved ones. It is still unclear how long the war will last and what the outcome might be. In any case the ripple effects of the war itself as well as the consequences in the form of sanctions and other restrictions will be felt throughout the world economy.

The aviation sector has been impacted directly by the sanctions, which have been imposed on Russia. The sanctions imposed by multiple countries had required aircraft leasing companies that own aircraft in Russia, to have them repossessed by the end of March 2022.

When Russia invaded Ukraine at the end of February, Russia's airlines were operating 861 commercial planes, both passenger and cargo jets, according to Cirium. Just over 50% of those planes, with an estimated market value of USD 9.2bln, were owned by foreign leasing companies. The Russian aviation industry depends on aircraft built in either Europe or the US by companies such as Boeing and Airbus. The United States and most of Europe have closed the air space to Russian airlines almost immediately after the invasion, and most of the aircraft at issue remained in Russia or quickly flew back there.

Leasing companies have been trying to recover several hundred planes, which are operated in Russia. However, Russia's President Vladimir Putin signed a law that allows the Russian airlines to operate the aircraft domestically and to re-register them in Russia, lowering the prospects for their recovery by foreign owners. Hence the roughly USD 10bln worth of foreign-owned aircraft are stuck in the country.

So far lessors have been able to recover 41 planes with an estimated market value of USD 770m since the start of the conflict, according to estimates by aviation consultancy Cirium. In the aftermaths of about 450 aircraft being stuck in Russia for the time being, leasing companies are in discussions with insurance companies on if and how much of their claims are covered. Lessors are also lobbying regulators to allow the 41 aircraft that have been repossessed back into commercial service. The issue here is, that most of the aircraft do not have a full set of records given the extraordinary circumstances the aircraft have been recovered in. For the planes stranded in Russia there is little hope that these can be reintegrated into the global fleet, given that the maintenance cannot be properly performed due to missing parts and service sites.

While the event is unprecedented, the industry so far agrees, that as a "black swan event" it will only have a minor long-term impact on the overall aviation sector. Given the 450 stranded aircraft make up "only" 1.7% of the global aircraft fleet. Also, the majority of leasing companies affected are well capitalized.

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 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

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