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Aviation Debt

Newsletter Q2 2023

Global Aviation Market Q2 2023 - Overview

> The aviation sector continued its recovery trend, boosted by the reopening of China's borders on 8 January.

> 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 and lessors.

> Various airlines placed significant firm or provisional orders with Boeing and Airbus over the last months to secure declining supply slots of narrow and wide body aircraft later this decade.

> Conclusion: The industry continued its recovery as anticipated with airlines reporting robust forward bookings for the upcoming summer 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. We currently see a generic spread for a narrowbody loan at around 380 bps.

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Aviation Debt – Market Summary

The new year and the first quarter started on a strong note with a further recovery in the aviation sector, boosted by the reopening of China's borders on 8 January. Industry-wide revenue passenger-kilometres ("RPKs"), an indicator of global passenger demand, increased by +58% YoY and to 86% in Q1 2023 compared to pre-crisis levels in 2019, signalling a tremendous improvement from the previous year. As China/ Asia aircraft returned to service throughout the last months, the stored fleet continued to fall further. Due to ongoing supply chain constraints at OEMs, airlines are also expected to increase the utilization of their current fleet or seek interim lift from the secondary market. In addition, various airlines placed significant firm or provisional orders with Boeing and Airbus over the last months to secure declining supply slots of narrow and wide body aircraft later this decade. Air India ordered 470 aircraft with both manufacturers, Ryanair secured an order for 300 B737 MAX10 aircraft, Lufthansa has ordered another 22 wide bodies from Boeing and Airbus and two Saudi Arabian airlines secured an order for 121 B787 jets.

Financing Terms

During the first quarter of 2023, capital market activity showed a mixed picture in the aviation industry. Lessors issued USD 3.4bn in unsecured capital market debt, thereby exceeding the volumes of any quarter in 2022. However, compared to previous years, this remains low at around half of the previous five year's first quarter average. Air Lease Corporation opened the public markets with its issuance of USD 700m five-year 5.3% unsecured notes and a USD 600m five-year 5.85% unsecured sukuk note as the only western lessor. The remaining issuance of USD 2.1bn came from Chinese firms such as Bocomm Leasing, CMB or ICBC.

The airline issuances of unsecured debt had a slower start into the new year compared to a busy Q4 2022. Issuances inside and outside of China dropped back to mid-2022 levels with around USD 4.7bn in total issuances. Air France emerged as the non-CNY issuance leader in this market segment during the first quarter as the airline issued a two tranche EUR 1bn sustainability-linked bonds with coupons of 7.25% and 8.125%. The remaining issuance came from two Chinese carriers and an Indian aircraft operator.

Besides the unsecured debt, airlines and lessors tapped the market with secured debt. Atlas Air issued a 7-year senior secured note over USD 850m with a yield of 8.5% and secured a 7-year term loan over USD 800m with SOFR plus 425bps. American Airlines issued a USD 750m 5-year note with a coupon of 7.25% whereby the notes are secured on a first lien basis by certain slots, gates, and routes collateral. On the lessor front, Castlelake secured a USD 635m term loan with a 4.5-year tenor and SOFR plus 275bps rate.

During the first quarter of 2023, pricing has moved further upwards as higher funding costs are passed on to aviation borrowers and follows the general trend in rising interest rates over the last quarters. 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.

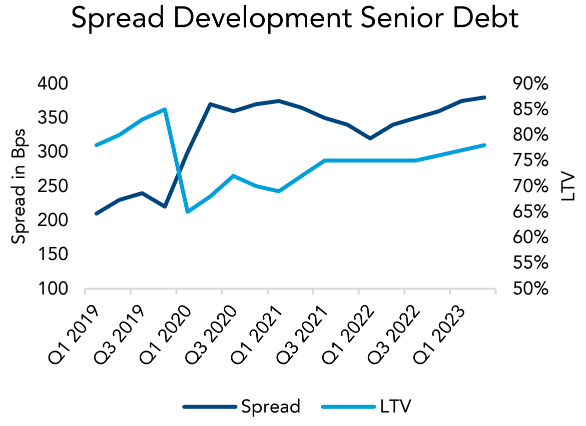

Figure 1, Source: Prime Capital Research

Airline Equity Market

The ongoing recovery of the market is reflected in the financial figures of airlines. Travel demand has stayed strong even amid worries of a looking recession. Therefore, some airlines have already been able to show net profits during the first three months of 2023. Airlines note that pent-up demand from the coronavirus pandemic continues to foster strong booking rates, especially for the upcoming summer season. Based on such positive travel demand and lower jet fuel costs, bottom-line growth is expected to improve throughout the year.

Airline stocks continued to move in line with the general market trend as can be seen in Figure 2. While IATA expects an industry wide profit for 2023 of around USD 5bn, the profitability is not likely to be shared evenly across all regions. In addition, airline bankruptcies have been seen across the globe during the first months of 2023 with e.g. Flyr in Europe or Viva Air in Latin America. However, the free-up capacity has been absorbed by other airlines quickly.

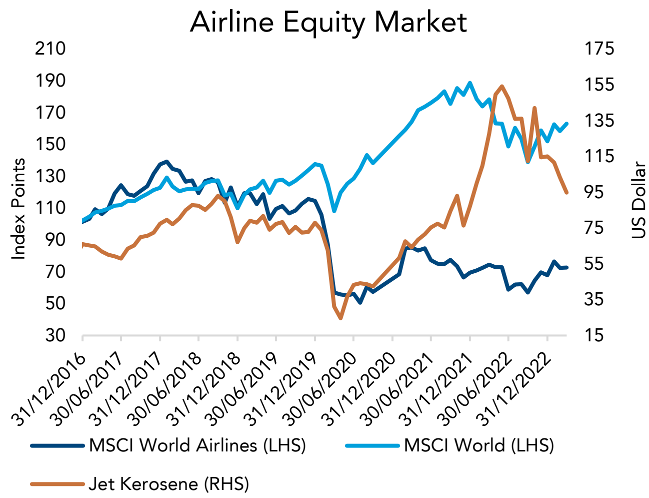

Figure 2, Source: Bloomberg

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Commercial Aviation

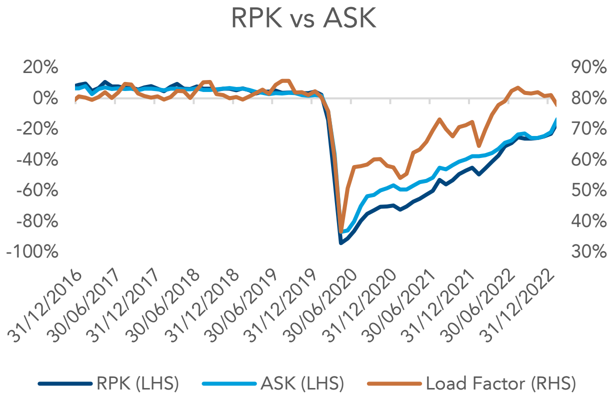

Figure 3, Source: IATA

According to IATA, passenger traffic accelerated its recovery trend during the first three months of 2023, fuelled by the gradual lifting of travel restrictions in China. Therefore, in March 2023 RPK levels registered 88% compared to 2019 pre-crisis levels, while Available Seat Kilometres ("ASKs") registered 89%. On a year-over-year ("YoY") basis, passenger traffic registered strong momentum as noted above, such that RPKs increased +52% YoY and ASKs increased +41% YoY. Domestic air traffic saw a strong growth driven by China, Europe, and the US, being back to 99% of pre-covid levels from a global perspective in March 2023. The international traffic continued its steady growth trajectory and was back to 82% of pre-covid levels and +69% ahead of March 2022. After three years of severely restricted travel regulations, China finally began to ease its zero-Covid policy with a re-opening of its borders on 8 January. Thus, carriers in the Asia Pacific region continued to show strong signs of recovery and international traffic flows from and within the region saw further recovery. Following the peak in total ticket sales driven by the Lunar New Year celebrations, bookings for domestic air travel continued to increase and surpassed their 2019 level by 20% globally in mid-April.

To date, passenger price sensitivity has been low, and airlines continue to report strong demand for air travel, especially for summer 2023. IATA continues to expect global passenger traffic to reach the 2019 level in 2024, with North America being the main driver.

EU Taxonomy and Aviation Investments

The aviation sector is considered one of the hardest to decarbonize due to the challenges and limitations of alternative fuels. It accounts for about 2 percent of global CO_2 emissions. Industry executives argue that sales of more fuel-efficient aircraft are necessary to fund investments in zero-carbon options like electric or hydrogen-fuelled aircraft. Therefore, the aviation industry is pushing to have new aircraft powered by jet fuel classified as a green investment under the European Union's rules for sustainable finance. The debate over including aviation in the sustainable finance taxonomy comes as European policymakers consider how to respond to the US Inflation Reduction Act, which includes incentives for green technology investments. The aerospace trade industry body in Europe, the ASD, emphasizes the importance of including civil aviation in the EU taxonomy, especially when the US is providing substantial support to its own industry.

During the first months of 2023, the European Commission signalled it intends to include technical screening criteria ("TSC") for aviation activities including leasing and manufacturing into the EU Taxonomy for sustainable activities. The lack of zero-emissions aircraft and limited availability of sustainable aviation fuels ("SAF") necessitate rules that incentivize the transition to more efficient aircraft in the near term, while awaiting CO_2-free technologies to emerge. However, climate campaigners have criticized the proposed rules for allowing aircraft running on fossil fuels to be labelled as climate friendly. In fact, research shows that a significant share of existing aircraft complies with the proposed EU Taxonomy criteria. This dispute over aviation follows a previous controversy surrounding the taxonomy last year when the EU labelled certain gas and nuclear investments as green, leading to two lawsuits against the Commission.

The proposed TSC to classify aviation as a climate transition activity aim to:

i) Incentivize the replacement of old, less efficient aircraft with new, more efficient ones without increasing the aircraft fleet and emissions.

ii) Set aircraft efficiency requirements based on the International Civil Aviation Organization New Type CO_2 standard to identify "best-in-class" new aircraft for taxonomy purposes.

iii) Require aircraft to be certified to run on 100% SAF from the beginning of 2028, ensuring a long-term decarbonization perspective for included assets.

iv) Encourage the progressive increase in the use of SAF by operators to further reduce CO_2 emissions.

v) Take into account efforts to improve fleet energy performance in calculating taxonomy-compliant revenue for air passenger transport but excluding fleet expansion and pre-criteria growth in CO_2 emissions.

The inclusion of aviation criteria in the European Commission's upcoming delegated act is expected to be positively received by aircraft investors and European aviation financiers. However, certain criteria, such as the requirement to scrap or decommission aircraft, may pose challenges for airlines and leasing companies focused on fleet growth and seeking taxonomy compliance. Nonetheless, these criteria serve as an essential safeguard to prevent Taxonomy-compliant revenue or expenditure from leading to increased CO_2 emissions.

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
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