Aviation Debt

Newsletter Q4 2022

Global Aviation Market Q4 2022 - Overview

> The market recovery in the aviation sector continued as anticipated, despite certain disruptions and regional disparities across the globe. Traffic to and from as well as within Asia improved further and is expected to add further momentum to the recovery of global passenger traffic. In particular, an opening of China, which has been impeding a wider global passenger recovery with a continued "zero covid" strategy, would make a significant contribution.

> Despite the continued recovery, both the European and international markets face uncertain prospects in the coming months. While Covid-19 is no longer seen as the primary risk, geopolitical as well as macroeconomic concerns in particular are the biggest risks. Thus, airlines will face an uncertain cost outlook in the coming months.

> The parked aircraft fleet continued to decrease and stands at just over 3,700 parked aircraft during the third quarter. In addition to bringing existing aircraft out of storage and extending leases, new leases for used as well as new aircraft are an option for airlines. As a result, the number of aircraft managed by leasing companies continues to rise and accounts for over 51% of the global fleet, or approximately 11,700 commercial passenger aircraft.

> Kerosene prices have risen sharpy in 2022 since the start of the war in Ukraine and stood at above USD 135 per barrel for most of the first nine months of 2022. Although prices came down due to a slowing economy, the spread of jet fuel versus crude oil prices remains unusually wide, thus airlines cannot benefit from potential further decreasing crude oil prices compared to other industries.

> Conclusion: The industry continued its recovery as anticipated and despite inflationary pressures and geopolitical concerns, airlines reported robust forward bookings and maintained confidence for the recovery to continue into the seasonally weaker fourth quarter and into 2023. Margins remained to be low for top tier carriers. We currently see a generic spread for a narrowbody loan at around 360 bps.

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Aviation Debt – Market Summary

The market recovery in the aviation sector continued as anticipated, despite certain disruptions and regional disparities across the globe. Industry-wide revenue passenger-kilometres ("RPKs") have further improved especially for international air traffic. Global air traffic figures show a +57% YoY growth in September, and are now at 74% of pre-pandemic September 2019 levels. Historically, September provides lower traffic results compared to the previous busy summer months, however further growth has been recorded this year (seasonally adjusted). The parked aircraft fleet continued to decrease during the third quarter and stands at just over 3,700 parked aircraft. This compares to just under 5,000 parked aircraft at the end of 2021 with an increase to just under 5,400 in March 2022 due to the Russia-Ukraine conflict. The ongoing recovery of the market is also reflected in the financial figures of the airlines. In particular, full-service carriers in North America (Delta, United and American Airlines) as well as Europe (Lufthansa, Air France-KLM as well as IAG), which benefited from a strong long-haul market across the Atlantic, reported solid profits in the third quarter of 2022. Despite inflationary pressures and geopolitical concerns, airlines reported robust forward bookings and maintained confidence for the recovery to continue into the seasonally weaker fourth quarter and into 2023. Whether this trend continues and remains through the winter season (as consumers face high energy costs) remains to be seen.

Financing Terms

Based on the macro-economic headwinds with rising inflation and interest rates, capital market activity slowed down considerably during Q3 2022. Lessors issued a mere USD 602m in Q3, less than half of the debt that had been issued in Q2 with USD 1.5bln according to Ishka. Chinese firms being the sole issuers in unsecured capital markets debt during the third quarter. The airline issuances of unsecured bonds slowed down further and Q3 2022 represented a new record low as issuances dropped by another -23% QoQ from USD 4.9bln in Q2 2022. Again, CNY bonds represented the majority (USD 3.3bln) of the total issuances during the quarter. Korean Air issued a USD 300m bond with a 4.75% coupon in September. As the notes benefit from a guarantee of state-owned Korea Development Bank, Moody's assigned an Aa2 rating accordingly. The overall low volume is still likely due to rising interest rates combined with increased swap costs and the rush for financing in the previous quarters, especially Q4 2021, and hence a lower financing need going forward. However, during the coming months, we expect that stronger lessors and airlines are going to come back to the market.

Since spring 2022, pricing has come up by 20bps to 40bps following the general trend in rising interest rates after an initial lag. Though LTV's have not moved significantly, aircraft values especially in the single-aisle market continued to trend upwards as demand for aircraft recovers. The further reopening of long-haul markets led to positive trends in terms of values for twin-aisles aircraft, while the B777-300ER is still the overall laggard besides the A380.

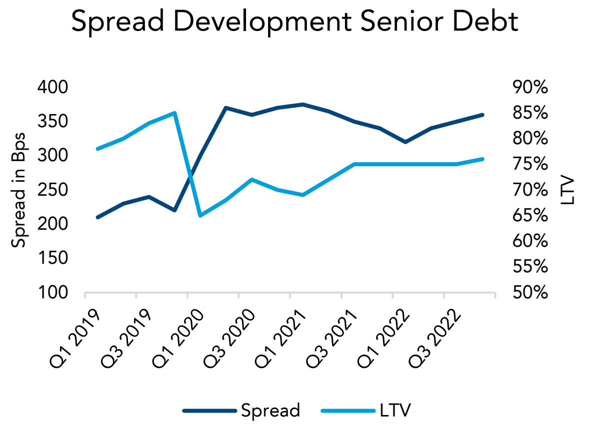

Figure 1, Source: Prime Capital Research

Airline Equity Market

The positive earnings momentum from the summer continued into Q3 and most airlines reported strong results. Pent-up demand with lower flight cancellations coupled with higher fares led to higher revenues, thus most larger carriers have returned to profitability, especially in the US and partially in Europe (e.g. Lufthansa, IAG, Ryanair, etc.). While this is mostly on an operating level, the net profits are expected to be in the offering for the industry for 2023. In terms of consolidation of the market, JetBlue announced the acquisition of ultra-low-cost carrier Spirit Airlines for USD 3.8bln in cash creating the fifth-largest US carrier in July. This helps the airline to compete with its larger rivals and provides significant growth in the short-term. Despite the positive earnings results and consolidation in the market, airlines stocks have tumbled during Q3 2022 as investors priced in an economic downturn and rising cots leading to a difficult winter. Nevertheless, this is reflective of the market sentiment with a less certain outlook for the remainder of 2022 and ahead of the winter.

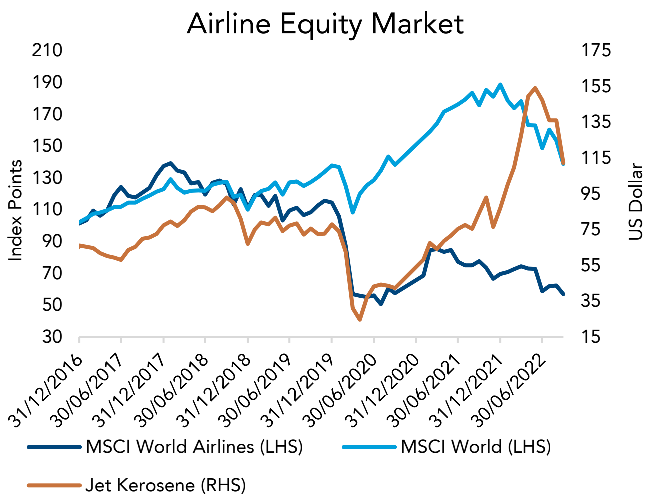

Figure 2, Source: Bloomberg

Kerosene prices have risen sharply in 2022 since the start of the war in Ukraine and stood at above USD 135 per barrel for most of the first nine months of 2022. Although prices came down due to a slowing economy, the spread of jet fuel versus crude oil prices remains unusually wide, thus airlines cannot benefit from potential further decreasing crude oil prices compared to other industries. High refining costs coupled with limited refinery capacity could mean an ongoing wide spread in 2023. As fuel expenses account for around 25% of airlines' operating expenses, airlines are expected to be more disciplined in terms of capacity deployment and reduce fuel burn even further.

Commercial Aviation

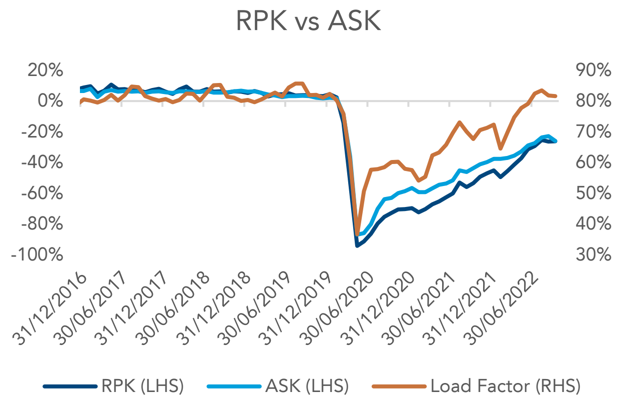

Figure 3, Source: IATA

According to IATA, RPKs continued to improve in Q3 and were -26% below 2019 pre-crisis levels in September 2022, while available seat kilometres ("ASKs") saw a -26% decline compared to 2019. On a year-over-year ("YoY") basis, RPKs are up +57% YoY and +74% year-to-date. In terms of capacity, ASKs were up +29% YoY and +46% year-to-date. The momentum of the long-haul market recovery continued in Q3 2022, as the Asia-Pacific market in particular continued to stabilize. Globally, RPKs for international flights increased +122% and ASKs increased +64% YoY in September 2022. Although Asia-Pacific markets saw the strongest growth in September (RPKs +465% YoY), RPKs on international traffic routes to and from Asia still lag the performance of the largest traffic routes (e.g., Europe-North America). Nevertheless, the continued recovery of Asia-Pacific markets is expected to add further momentum to the recovery of global passenger traffic. In particular, an opening of China, which has been impeding a wider global passenger recovery with a continued "zero covid" strategy, would make a significant contribution. 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, with a slight dip in China, after a V-shaped recovery in previous months, due to newly introduced travel restrictions within the country. Apart from these growth figures, both the European and international markets face uncertain prospects in the coming months. While Covid-19 is no longer seen as the primary risk, geopolitical as well as macroeconomic concerns in particular are the biggest risks. Airlines will face an uncertain cost outlook in the coming months. Fuel, inflation, rising interest rates and a strong U.S. dollar (for non-U.S. based airlines) will be the main drivers of cost increases, potentially leading to higher ticket prices. Coupled with lower economic growth, demand for air travel is expected to be subdued. Nevertheless, IATA expects global passenger traffic to reach the 2019 level in 2024. This development is driven by North America, which is expected to reach the 2019 level as early as 2023, while Africa and China are unlikely to reach this level until 2025.

Evolvement of different Airline Business Models in Europe

IATA has recently published a study[1] in terms of the evolvement of airline business models to meet differentiated air transport demand and its importance in Europe. The study finds that network carrier and Low-Cost Carrier ("LCCs") models and networks serve distinct market segments and are complements and not substitutes. Network carriers for instance have created low-cost subsidiaries to feed their hubs while LCCs introduced new products to catch business customers. Therefore, regulatory policies should not favor a particular business but promote a coexistence of different models as this encourages a healthy competition. Within Europe, LCCs carry more passengers than network carriers while the latter provides an extensive connectivity for Europeans, especially for those living in remote areas. In the segment where both business models compete directly, network carriers were able to increase their market share from 37% to 46% after the Covid-19 pandemic as they maintained a higher service level. Moreover, the aviation industry generates significant social and economic benefits for Europe by creating more than 13.5 million jobs and adding USD 991bln to Europe's GDP. In addition, airlines became more cost efficient over the years due to economies of scale, product optimization and operating more fuel-efficient aircraft, thus these gains were passed on to the consumers. Since the 1950s, the cost of air travel has fallen by ~75%, making it more accessible and affordable to the public. This trend might come to a halt due to the current macro-economic environment and the industry's plan to reach net-zero CO_2 emissions by 2050. In terms of CO_2 emissions, the study also discusses the banning of short-haul flights and purports that such a ban would reduce CO_2 by no more than 5% while a Single European Sky as asserted by the European Union could reduce the environmental impact of aviation by 10%.

The study inter alia concludes that regulatory policies should favor all forms of transport and connectivity to allow for a faster, better and cheaper as well as more sustainable European transport sector that will be more efficient in the future.

[1] https://www.iata.org/en/iata-repository/publications/economic-reports/one-size-does-not-fit-all---airline-business-models/

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 on the web site
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