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Aviation Debt

Newsletter Q3 2020

Global Aviation Q3 2020 Overview

> Q3 2020 has been characterized by a partial recovery of the airline sector, which, however, remains below 2019 levels. The sector is predicted to continue its gradual recovery through Q4 2020, although the course of the pandemic may cause new challenges.

> Based on the latest forecast by IATA, quarterly RPKs should reach Q4 2019 levels between Q1 2023 and Q2 2025. The risk of bankruptcy is high for many airlines, especially those that are not receiving government support, such as airlines in South America and Africa and smaller airlines worldwide.

> Prime Capital closed one transaction in the third quarter. The deal is a shorter term financing for a portfolio of narrow-body aircraft, at an LTV around 65% and pricing of up to 400 bps. The transaction is part of a sale and lease back transaction of a Tier 1 carrier. The pipeline currently consists of 6 opportunities, with Tier 1 names, attractive collateral and conservative terms. Some transactions are secondary market transactions, of investors reducing their aviation exposure. The average spread of the Pipeline is around 400 bps.

> Conclusion: The recovery in air traffic was short lived, given the significant rise in infection numbers across Europe and other parts of the world. The subsequent lock downs have caused more uncertainty among airlines and travelers, providing limited hope for the anyway reduced capacity during the winter season. Spreads remain at elevated levels with some transactions pricing at 400+ bps. Deals for Tier 2 or 3 airlines are currently rare and Tier 1 names continue looking for secured financing. We currently see a generic spread for a narrow-body loan around 360 Bps, but with a significantly improved credit on the airline side and a potential increase in Q4 2020. Our expectation is, that spreads will further diverge given the oversupply for the top tier airlines and the resulting lack thereof for the rest. Leasing companies and airlines struggle to finance balloon tranches, as most lenders focus on the credit risk rather than on residual value.

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Aviation Debt – Q3 Summary

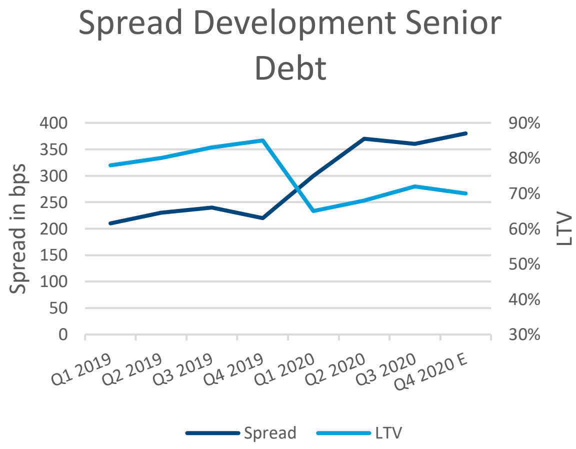
The third quarter of 2020 has been characterised by a partial recovery of the airline sector, which however remains significantly below 2019 levels.

According to IATA, industry-wide revenue passenger-kilometres (RPKs) fell by 82% year-on-year in September, compared with an 87% year-on-year contraction in June. According to the latest forecast, RPKs will continue recovering slowly through the fourth quarter of 2020 and in December they are expected to be 68% lower than they were in December 2019. Quarterly RPKs are expected to reach Q4 2019 levels between Q1 2023 and Q2 2025. The outlook remains uncertain as it is tied to the course of the pandemic, which is difficult to predict. As a reaction to the unpredictability of demand, airlines have made their scheduling process more flexible and have been cutting back winter capacity across all regions. Lufthansa expects available seat kilometres (ASKs) to be at 20-30% of 2019 levels in Q4 2020.

Based on IATA estimates, many airlines remain at risk of bankruptcy as the median airline's cash would last 8.5 months at the estimated H2-2020 cash-burn rate. Given that airlines are not expected to turn cash positive until 2022, it is clear that they depend on government support to survive. Governments have so far provided USD 160bn to the sector, with North America and Europe accounting for 2/3 of the total. Airlines in Latin America and Africa show the highest insolvency risk: LATAM, Avianca, AeroMexico, SAA, and Comair have already filed for insolvency. IATA predicts that net debt to EBITDAR ratios could rise from 4.6x in 2019 to 16x in 2021.

Financing Terms

Q3 was characterised by the return to bond markets of aircraft lessors: Q3 new issuances were the highest over the last seven quarters and double Q2 levels. The bulk comes from USD IG issuances, although CNY issuances quadrupled on Q2. One notable issuance was ICBC Leasing's USD 900m senior unsecured issuance in August, priced at a 1.75% coupon. Although spreads on IG lessor bonds have come down since the highs of late March, they still trade around 100 bps premium to pre-pandemic levels. Meanwhile, airlines managed to raise USD 33bn of publicly-disclosed commercial bank debt between June and September 2020. Top-tier credits continue to attract bank debt. Delta Air Lines and United Airlines raised USD 6bn each, split between bonds and bank loans. JetBlue signed a USD 750m loan at a variable rate equal to LIBOR (subject to a 1.00% floor). Air Canada completed two refinancing transactions in September amounting to approximately CAD 1.52bn, CAD 591.1m of which were used to partially repay a CAD 788m facility arranged in April. On the other hand, LATAM's recently re-organised DIP financing bears an interest rate of 9.75-11% plus the base rate applicable to each tranche.



Source: Prime Capital

In the private debt market, deal activity slowed towards the end of the third quarter, due to rising uncertainties as infection numbers keep rising. Some banks have been seen providing comparably cheap financing to its local airlines, outbidding foreign competitors. This has led to lower spreads on finance leases compared to operating leases, where spreads in high 300s and even well in to the 400+ basis point territory are still the norm.

Compared to pre-crisis levels, deal terms have significantly improved. As prices declined across most aircraft types, LTVs on most deals have significantly decreased to below 75%. On the other hand the decline in appraiser values has countered the decrease in LTV's to some extent. Balloons have been reduced to 20% or even full amortization. Margins have increased to levels between 250 and 350 for Tier 1 airlines. Equity yields have further increased to 10% to 15%.

Airline Market

The gap between airline stocks and other stocks has anything but narrowed during the last quarter: The MSCI World Airlines Index is trading at 54% of Jan-20 levels, whereas the MSCI World Index is at 101% of its Jan-20 level. Investors remain pessimistic about airlines' cash burn rates and the challenges and uncertainty that the sector is facing.

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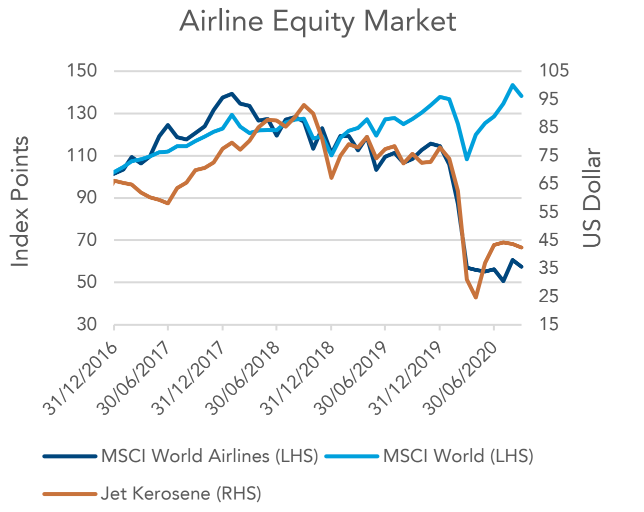
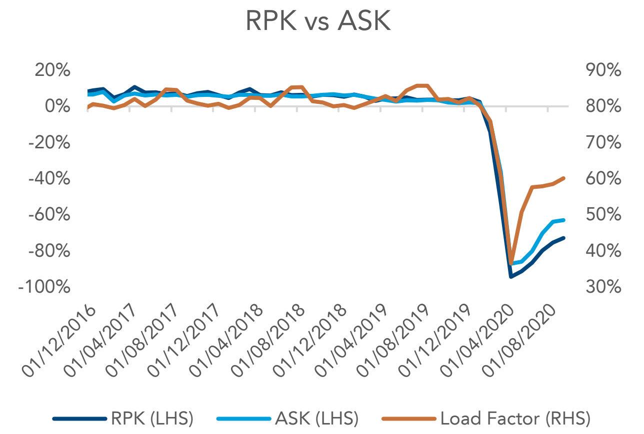


Source: Bloomberg

Fuel prices traded sideways given only the slightly increased demand from airlines. Ahead of the winter season it can be expected, that the divergence within the airline sector will increase and the sector in general will only start to recover once a vaccine is broadly available.

Commercial Aviation

Although Q3 2020 has been characterized by a partial recovery of the air travel market in connection with the summer holiday season, the Covid-19 pandemic continued to act as a strong deterrent to international travel and thus prevented the full recovery of the sector.



Source: IATA

Global RPKs measuring the total demand of passenger traffic fell by -72.8% year-on-year in September down from -86.5% year-on-year in June. ASKs dropped in line with RPK's by -63.0% year-on-year in September, while the load factors decreased to 60.1% down from their all-time highs around 80% during 2019. As in the previous quarter, the performance gap between international and domestic travel is large: International RPKs contracted by close to 90%. A number of airlines have recently announced reductions in capacity plans for the end of the year, in reaction to rising COVID cases and the re-introduction of travel restrictions by a number of governments.

Chapter 11 filings due to Covid-19

The Covid 19 pandemic has impacted airlines across the world, by dramatically reducing capacity, leaving airlines to struggle with large amounts of fixed costs mainly comprised of lease payments, debt service for owned aircraft and wages. While most airlines have succeeded in negotiating more flexible terms with leasing companies, a key support measure has been government support, to provide sufficient liquidity. In some regions governments have been slow or reluctant to provide the necessary support. This has led to a rise in Chapter 11 cases, especially for South American Airlines lately. The most obvious question to ask is, why these airlines decided to file for bankruptcy protection outside of their home countries and what are the implications for debt providers.

There are several reasons, why a Chapter 11 filing can be advantageous for a company: 1. Management stays in charge and is not replaced by a trustee, as it is the case in many other jurisdictions; 2. Chapter 11 provides an automatic injunction against all creditors, whereas in other jurisdictions this is not available or only after a specific ruling by the court; 3. Chapter 11 allows to obtain significant new debt, which can be senior secured to existing financings. Chapter 11 also provides further advantages such as lower voting thresholds for creditor votes. Hence, there are several reasons why a South American airline might decide to file for Chapter 11 in the US. Having a place of business or assets in the US is sufficient to qualify.

The recent cases have shown, that despite the mentioned advantages for debtors, Chapter 11 provides a structured, well known and tested process. Already during the first day motions, the airline is able to reject aircraft in order to adjust the fleet. Especially LATAM used this mechanism to avoid negotiations with its e.g. EETC investors, which consists of a large group with comparably small individual shares. Most airlines used the first weeks of Chapter 11 protection to negotiate Power-by-the-hour agreements and subsequent debtholder standstills to reduce fixed costs and provide flexibility to the airlines operations. In September and October, e.g. Avianca and LATAM were able to negotiate substantial Debtor in Possession (DIP) financing packages, ensuring sufficient capital to restructure and continue operations. Airlines are now working on an adjusted fleet plan in order to increase profitability, once passenger volumes are going to pick up again.

The recent Chapter 11 filings have shown, that it can be advantageous to finance the core fleet of an airline, as these aircraft are unlikely to be rejected in the first day motion and while structured products might provide slightly better liquidity, the restructuring process can be much more cumbersome than for bilateral loans or club deals.

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 1bln. 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.

Prime Capital's Private Debt Team manages in excess of EUR 2bn across these asset classes for institutional investors.
Further information about Prime Capital AG can be found on the web site
www.primecapital-ag.com

Contact:

Julius Hünnemeyer
Investment Director
Private Debt

Prime Capital – Portfolio Management Private Debt
impd@primecapital-ag.com

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

Contact:

Prime Capital – Investment Management Private Debt
mailto: impd@primecapital-ag.com

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