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Aviation Debt

Newsletter Q3 2021

Global Aviation Market Q3 2021 - Overview

> The airline sector further recovered in the second quarter of 2021, with improvements in traffic figures and stored aircraft being brought back into the active fleet.

> Airlines are starting to plan long-term again, with orders and deliveries rising significantly in the first half of 2021.

> IATA currently expects carriers to be cash positive again at the beginning of 2022. Some carriers have already achieved the return to positive cash flow and passenger numbers close to pre-Covid levels.

> The recovery may be dampened by further lockdowns and travel restrictions during fall as Covid cases are on the rise again. The aviation industry is still waiting for a harmonized testing and documentation framework across continents to allow international travel.

> Conclusion: The airline sector is still in recovery mode, even with possible further restrictions in the short term. Senior spreads have further tightened due to continued competition for good names and lenders cautiously looking at the credit risk. We currently see a generic spread for a narrowbody loan at around 350 bps. The market seems to have appetite for higher LTV's, while the supply remains low, due to cautious lenders, especially banks. This offers the opportunity for either whole loan or mezzanine structures, providing a significant premium, compared to lower-LTV-senior Loans, with top tier counterparts.

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Aviation Debt – Market Summary

In the first half of 2021, the global air travel sector continued its recovery from a long hibernation. Passenger traffic saw continued modest improvements and the stored global aircraft fleet was steadily reduced during the second quarter, but traffic remained well below pre-Covid-19 levels in 2019. Nevertheless, international travel sustained its moderate recovery while the domestic markets continued to see further gains with a mixed performance across the main domestic markets. Brazil, Russia and the US saw positive developments, with the US market being back to 85% of the pre-crisis level in terms of passenger traffic, mostly based on the successful Covid-19 vaccine rollout. Within China's and Australia's domestic market, passenger traffic declined at the end of June amidst new virus outbreaks and the resulting travel restrictions. Nevertheless, China saw a domestic recovery to above pre-crisis levels during the second quarter. Looking forward, the potential spread of new variants and associated lockdowns are going to remain the main risk for the air travel recovery while ongoing vaccination programmes offer cause for further optimism during the second half of the year 2021.

Financing Terms

According to Ishka, Tier 1 airlines have raised approximately USD 200bn through a combination of sale and leaseback transactions and government support. The majority of which has been raised through capital markets. Major carriers and leasing companies were able to tap the capital market at attractive spreads in H1 2021, reflecting the optimism of the capital market for the continued recovery in the aviation sector.

Transaction	Security	Terms	Coupon
United Airlines	Unsecured	5 years 8 years	4.375% (USD) 4.625% (USD)
Ryanair	Unsecured	5 years	0.875% (EUR)
Dubai Aero Space	Unsecured	3 years	1.55% (USD)
Air France – KLM	Unsecured	3 years	3.00% (EUR)
Air France – KLM	Unsecured	5 years	3.875% (EUR)

Recent debt issuances during H1 2021

Spreads for Tier 1 airlines further decreased, while LTV's moved slightly higher. However, there seems to be a limit to LTV increases as most lenders remain cautious regarding LTV levels. Especially on the bank-side, regulation and risk budgets may restrict the lending activity for aviation debt.

For lenders able to accommodate higher LTV's this provides ample opportunity, as borrowers are looking to close the gap between equity and senior debt. This is a development, which could be observed in other parts of the private debt market as well, e.g. in Commercial Real Estate. Some alternative lenders stand ready to fill this gap, benefitting from higher margins due to the limited supply. However, this requires in depth knowledge of the asset risk, as the risk buffer is reduced.

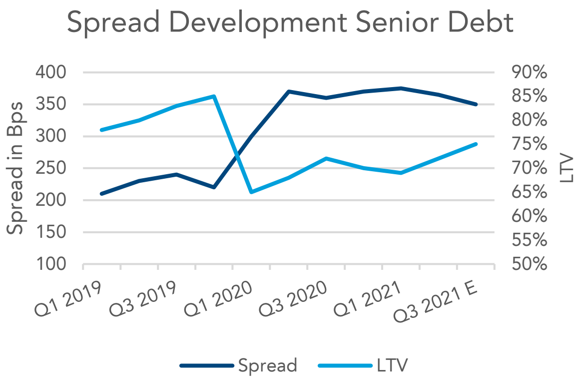

Figure 1, Source: Prime Capital Research

Airlines also started to cautiously place new orders requiring additional financing for the new deliveries (see below).

Airline Equity Market

IATA reports that the initial Q2 2021 results show significantly diminished net losses in North America and expects a return to profitability possibly in H2 2021. The operating environment in the region has been improving; US domestic air travel is close to pre-crisis levels and there are also signs of recovery in international and business travel – which is an important income source for the airlines.

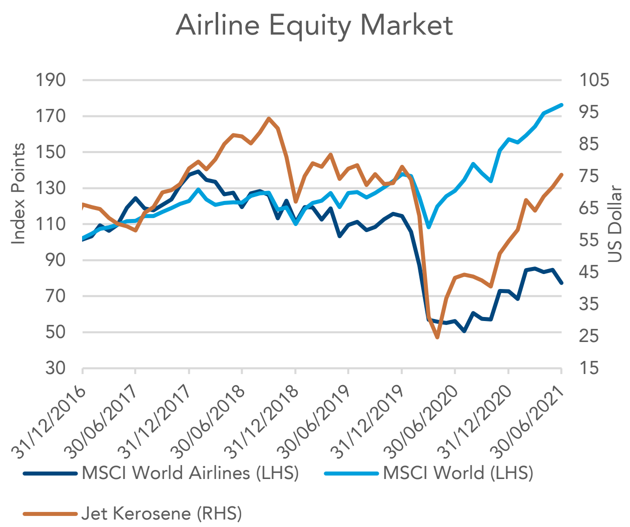

Figure 2, Source: Bloomberg

Oil and kerosene prices remain at elevated levels, which puts more pressure on airline profitability. The price increases are mainly driven by increased economic activity as countries slowly eased lockdown-measures. Additional upward pressure was created by Opec+, due to failure to close the deal over increasing oil output. If the disagreement continues, prices could increase even further. Airline stocks edged downwards at the end of Q2 2021, due to worries of further lockdowns in fall 2021. During the same period, the general stock market has continued its upward-trend.

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Commercial Aviation

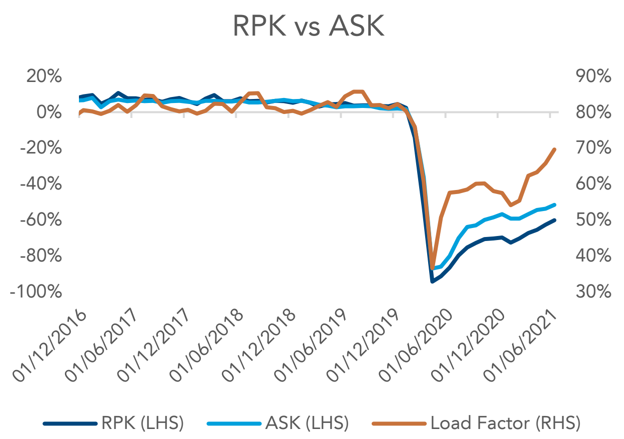

Figure 3, Source: IATA

According to IATA, industry-wide revenue passenger kilometres (RPKs), as an indicator of global passenger demand, were -60% below pre-crisis levels compared to June 2019, with available seat kilometres (ASKs) showing a -52% decline compared to 2019. Though RPKs and ASKs remain subdued compared to 2019, they show improvements compared to the prior months. While an expected continued recovery throughout the second half of 2021 is going to reduce the cash burn within the airline industry, IATA predicts in its latest update that industry-wide positive cash flows are going to be delayed to the beginning of 2022. Although steady vaccination rollouts in e.g. Europe and North America raise hopes, the pace of the rollout is very slow in others, particularly in developing economies and airlines will be challenged by higher fuel costs going forward. On the financing side though, major carriers and leasing companies were able to tap the capital market at attractive spreads in H1 2021, reflecting the optimism of the capital market for the continued recovery in the aviation sector. So even as countries around the world continue their battles with the variants of Covid-19, the mood of renewed optimism in the aviation finance sector is palpable. The range of new aircraft orders now being placed or contemplated (e.g. Air France-KLM, Condor, United Airlines, etc.), too, reflects an industry increased optimism in the airline sector.

Aircraft deliveries on the rise again

The Covid-19 pandemic has significantly reduced the appetite for new aircraft in the short term. With thousands of planes grounded due to travel restrictions, airlines have been cautious to bring back aircraft from long term storage, let alone taking deliveries or ordering new aircraft.

As Airlines are starting to plan long-term again, the carriers are making new orders for long term fleet replacements. The orders in June 2021 were the highest monthly total seen since the start of the pandemic. In total, orders for the first six months of 2021 were +64% higher than for the same period in 2020 and even +56% higher than in 2019, according to Aviation Week.

Airbus announced in July that the plane manufacturer had a very successful first half 2021, with a profit of EUR 2.2bn for the first six months of 2021. In this period, Airbus has delivered 297 commercial aircraft to airline- and leasing customers. Rival Boeing has delivered about half of that during the same period, with 156 aircraft deliveries.

This is another indication for a recovery in the aviation sector, as Airbus has delivered +50% more aircraft compared to H1 2020.

Despite the increase in aircraft deliveries during the first half of the year, Airbus still holds thousands of undelivered planes. The aircraft delivered clearly reflect the current market environment, with domestic air traffic recovering significantly faster than international travel. Hence the majority of the 297 aircraft delivered are comprised of narrowbody planes: 21x A220s, 237x A320 Family, 7x A330s, 30x A350s, and 2x A380s. The manufacturer's backlog did drop slightly with a net increase in orders for the period of just 38. In 2020 net orders stood at 298.

While deliveries for Boeing have been slower during the first half of 2021, the aircraft manufacturer was able to receive significantly more orders. Orders totalled 599 through June 2021 and 356 cancellations, bringing the net orders to 243 for the first half of 2021.

Airbus currently reports a backlog of 6,925 aircraft. While Boeing states a backlog of 4,100+ aircraft, which is valued at USD 285bn.

The significant increase in aircraft orders and the ramp up of deliveries is yet another indication for increased optimism in the aviation sector. This also once again highlights the relevance of new technology aircraft as airlines continue to replace old aircraft in their fleet.

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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