Investec

OUT OF THE ORDINARY

Aviation Market Snapshot Q2 2022

Key market insights

Post-pandemic non-linear recovery continues

The market recovery has continued as anticipated, albeit laced with obstacles. These included government policies (such as Covid-related restrictions), various economic factors, as well as the ongoing war in Ukraine. On the whole, global air traffic figures show a close to 80% YoY growth in April, and are now over 60% of pre-pandemic April 2019 levels.

European summer of growth driven by low-cost carriers

European aviation is heating up for summer as booking numbers surge, reflecting passengers' accumulated demand throughout the pandemic. In particular, low-cost carriers such as Wizz Air and Ryanair, which have experienced large passenger growth already, are expecting further increases during the summer.

Wizz Air carried over 4.3 million passengers in June, up 179% compared to the same month last year. The European budget carrier says it boosted its capacity, as measured in available seat-kilometres, by 107% year on year and has seen load factors increase by 22 points to 86%. Wizz Air expects fares to be 160% of pre-pandemic 2019 levels, resulting in stronger yields, on 140% more capacity than 2019. In June, the Ryanair Group carried 15.9 million passengers, a threefold increase from 5.3 million in June 2021. Ryanair operated more than 88,500 flights in June with a load factor of 95%, compared with 72% in the prior year.

Disruption across several regions

Beyond such growth figures, however, European as well as broader international markets are facing a summer of disruption as staff shortages increasingly impact airports and airlines following the shedding of employees during the pandemic to cut costs.

A tight labour market post-Covid has resulted in many staff leaving the sector altogether, attracted to rival industries by higher wages. Research from Oxford Economics found that by September 2021 the aviation industry in Europe was employing 2.3 million fewer people than pre-pandemic, with contracted staff, such as ground handlers, down by 29%. In April, London Heathrow, one of Europe's busiest airports, warned that it had 12,000 vacancies across the airport, and that it was seeking a further 1,000 security officers to cope with the recovery. It highlighted that immigration control could represent a chokepoint as demand ramps up. Also in April, Swedish airport operator Swedavia noted that staff shortages will in some cases limit summer capacity, whilst Schiphol in Amsterdam has been hit by strikes by baggage handlers disrupting services.

These issues are exacerbated by higher levels of absenteeism due to the pandemic. EasyJet in particular noted an absenteeism spike and delays receiving identification security checks on new staff contributing to the cancellation of hundreds of flights in early June. EasyJet noted that it does not have an overall problem with recruitment and that these issues should not persist into the summer. British Airways, on the other hand, is less confident that the issue is short-term and has reportedly pared back its scheduling for the summer on some routes to reflect weaker staffing levels. Meanwhile Wizz Air, which expanded coming out of the pandemic, has raised staff wages and aggressively campaigned for new staff in order to meet expansion challenges. Despite efforts to increase headcount it is likely that the ongoing staffing issues will result in higher queues, delays and cancellations this European summer.

Such problems are not limited to Europe. In Australia, the country's three busiest airports and its largest airline, Qantas, are warning of crowds during peak travel periods in July. The carrier has trimmed schedules due to high fuel costs and to minimize potential disruptions. In the U.S., it is reported that summer schedules have been reduced by ~15% from plans at the beginning of the year across the industry, due to staffing limitations and that the pilot shortage continues to cause disruption.

Nonetheless, across the industry, including national carriers, charter and low-cost carriers, executives are forecasting strong summer demand. Airlines have not yet experienced adverse financial consequences associated with increased costs and labour disruptions as they benefit from pent-up demand and higher fares.

> "Summer traffic in North America and Europe will be strong, sustained by robust demand for leisure travel during the holiday period despite challenges in ramping up operational capacity. Airlines are bringing back aircraft that have been stored during Covid-19, including some A380s. Aircraft values for types such as the A320ceo, A320neo and 737 Max have seen improvements too. Outlook beyond the summer is less certain given the macro-economic environment marked by high inflation, rising interest rates, fuel price volatility and recessionary concerns. The Chapter 11 filing by SAS is a reminder that not all airlines are out of the woods. As the market enters a new phase of uncertainty, we expect Investec's focus on capital preservation while generating premium returns will continue to yield dividends."

Derek Wong
Head of Aviation Debt Fund

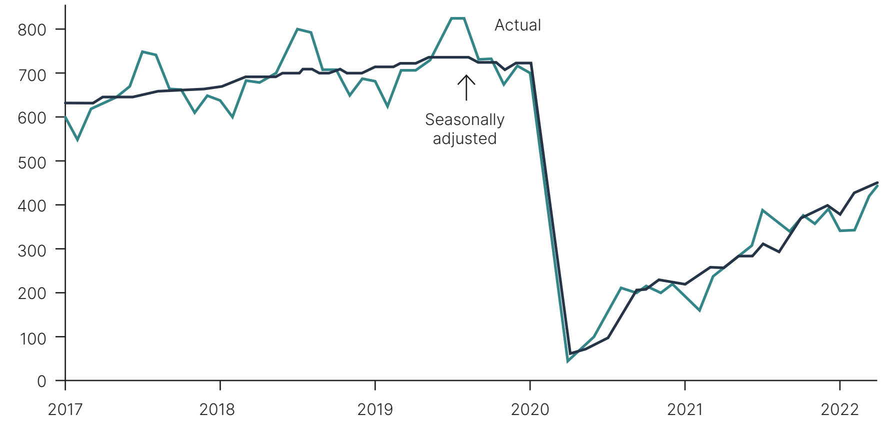
Trends

Global air travel resumed its strong recovery trend in April, despite the impact of the war in Ukraine and travel restrictions in China. Air traffic, as measured by Revenue Passenger Kilometres (RPKs), an indicator of global passenger demand, grew by 79% YoY. Passenger numbers are now ~63% of pre-pandemic April 2019 levels, a circa 4% improvement from March.

Domestic air travel has seen RPKs relatively flat industry-wide, declining 1% YoY in April, driven predominately by China. Domestic RPKs are ~74% of pre-pandemic April 2019. The performance of key domestic markets was mixed across regions. In the US, RPKs were 98% of pre-pandemic April 2019 levels, with capacity decreases resulting in increased load factors of 88% country-wide. RPK growth accelerated in Brazil, India, Japan and Australia reflecting the lifting of travel restrictions and rising consumer confidence. However, the decline in China has deepened, as persistent strict travel restrictions resulted in a RPK decline of 81% YoY.

AIR PASSENGER TRAFFIC (RPKs)

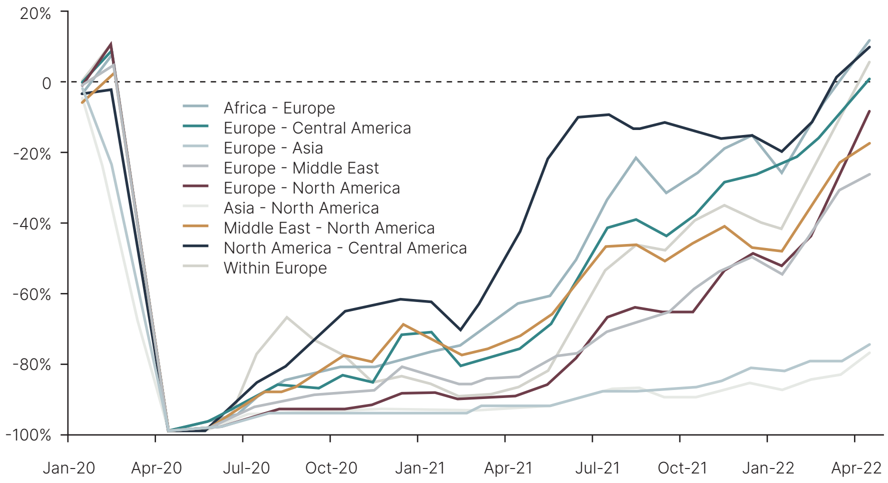
Industry RPKs (billion per month)



Sources: IATA Economics

INTERNATIONAL RPFs BY ROUTE, FROM PRE-COVID 2019

Seasonally adjusted international RPKs YoY% change v2019



Sources: IATA Monthly route area statistics

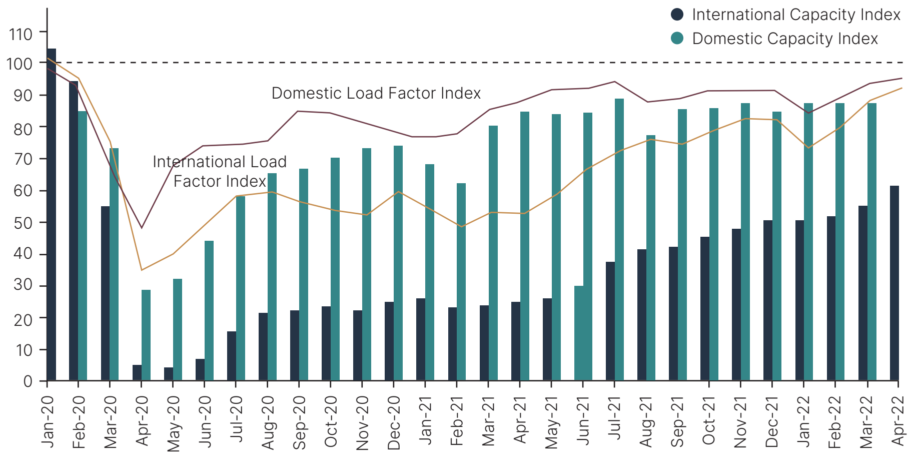
International air travel recovery has continued at pace across all regions, with RPKs increasing 332% YoY in April. Regionally, European airlines continued to lead the international recovery in April, with RPKs ~74% of pre-pandemic April 2019, a 10% increase from March. Airlines based in Europe have not been impacted significantly by the war in Ukraine and international travel within Europe exceeded pre-pandemic levels by ~5% in April. Asia Pacific posted significant RPK gains, up 290% YoY reflecting relaxation of entry conditions for foreigners. Latin America, North America and the Middle East also posted RPK gains.

IATA noted that the recovery has proceeded at a similar pace for both Premium and Economy (including premium economy) classes. Seat capacity, as measured by Available Seat Kilometers (ASKs), has continued to ramp-up, increasing 46% YoY in April. Industry wide passenger load factors are up too, reaching 78% in April, 95% of pre-pandemic April 2019. Whilst domestic load factors have exceeded international load factors during the pandemic, the gap is narrowing. Lockdowns in China have hampered domestic travel growth, while international travel demand has been boosted by the lifting of travel restrictions elsewhere.

IATA has reported an increase in international forward bookings. More flexible travel conditions and a strong desire to travel are encouraging customers to plan ahead for the summer and further. However, high inflation and low consumer confidence in the OECD and Eurozone, coupled with increasing crude oil prices, are expected to negatively impact travel.

LOAD FACTOR AND CAPACITY INDEX, BY TRAVEL

INDEX LINE (2019 = 100)



Sources: IATA Monthly route area statistics

In the news this quarter

- The easing of travel restrictions in Singapore in April 2022 saw traffic surge for Singapore Airlines, and the carrier recently reported that forward bookings for the summer are approaching 2019 levels. Demand quickly rebounded following the opening of the Vaccinate Travel Lane Program, and the airline made profits of $7.2 million for the second half of the fiscal year ended 31 March 2022. Following the decision to drop mandatory testing for vaccinated passengers along with easing restrictions in other countries in the region, including Thailand and Malaysia, load factors increased to over 77% in April 2022. However, key markets in Northeast Asia, including China, and Japan remain constrained.
- In April, it was reported that Air India, which was acquired along with its affiliates by Tata Sons from the Indian government for $2.4 billion in January 2022, has offered to acquire the entire share capital of AirAsia India. The proposal seeks to buy the residual stake held by AirAsia Berhad and would help Tata consolidate its position in the Indian airline market. Tata owned Air India, Air India Express and Vistara together with AirAsia India have a ~25% Indian domestic market share (Cirium April 2022). A merger of AirAsia and Air India Express would heighten competition with market leader Indigo, which has a ~53% domestic market share (Cirium April 2022). The deal comes as two new airlines are set to take to the skies this year, Akasa Air and a revived Jet Airways.
- In May, IAG announced that it had reached an agreement with Boeing to order 50 × 737Max aircraft, with options for 100 more. The order includes 25 of the high-density Max 8-200s and 25 Max 10s for delivery between 2023 and 2027. IAG noted that the aircraft can be used by any airline in the group (British Airways, Aer Lingus, Iberia and Vueling) for fleet replacement. IAG's chief executive commented: "These latest generation aircraft are more fuel efficient than those they will replace and in line with our commitment to achieving net zero carbon emissions by 2050".

- In June, Lufthansa announced plans to fly up to eight A380s again from summer 2023, joining other carriers which have announced a return of the superjumbo. Lufthansa said the move is in response to a rise in demand and delays in aircraft orders. The airline parked its 14 A380s in 2020 announcing them 'permanently decommissioned' and subsequently sold six. The airline's pivot form four-engine aircraft, including A380s, A340s and 747-400s, to more fuel efficient twin-engine A350s and B787s has been hampered by supply chain issues which have delayed new deliveries. Boeing is especially challenged having not delivered a B787 since mid-2021 and the B777X entry into service is delayed to 2025, circa 5 years late. These issues are forcing airlines to find alternative lift, including extending leases and bringing aircraft back from storage.
- In June, the Financial Times reported that US corporates had spent more in 2021 on private jet travel for CEOs and board members than they have at any time since 2012. Total spend of the S&P500 companies was ~$34 million, with Facebook founder Mark Zuckerberg topping the list. The increase was attributed to concerns over Covid-19 coupled with heightened security measures.
- Early July, it was announced that 4 state-owned Chinese airlines have placed a mega order for 292 single-aisle A320 family aircraft from Airbus. The deal at list prices of ~$37 billion, sees deliveries planned between 2023 and 2027 across China Eastern (100 aircraft), China Southern (96), Air China (64) and Shenzhen Airlines (32). The order represents the largest combined order from Chinese airlines since 2019 and is an indication of preparation for an improved operating environment in China. Whilst air traffic in China is currently stymied by the country's severe health restrictions, it is expected to rocket in the coming years, with China's aircraft fleet forecast to triple by 2040 to ~11,000 aircraft, according to Airbus forecasts. The deal is a big win for Airbus, which has been gaining market share from Boeing since the grounding of the Boeing 737Max in 2019. The wait for the restart of 737Max flights in China continues.
- With the increase of belly cargo and freighter capacity, from 31 July 2022, EASA, the EU aviation regulator will cease allowing the transport of cargo in passenger cabins of aircraft. The exemptions had allowed airlines to carry critical supplies to make up for lost capacity when the pandemic closed down most commercial flights. The use of the so called 'preighter' served the industry well during the pandemic and helped bolster revenue while passenger traffic crashed. EASA reported that it "has concluded that the logistical challenges that arose in 2020 as a result of the Covid-19 crisis no longer exist to the same extent"
- During the quarter it was reported that sanctions are impacting Russia's aircraft development programmes. Production of the Irkut MC-21, a single-aisle aircraft with a capacity of 132-163 passengers, is likely to fall two years behind schedule following the need to use Russian avionics and engines. The Russian OEM is targeting deliveries of 36 aircraft by 2025, rising to 72 per year from facilities in Irkutsk. Meanwhile, production of the UAC Tupolev Tu-214, a medium to long range single-aisle aircraft carrying up to 210 passengers, are being accelerated along with production rates for the Ilyushin Il-96 widebody and the Ilyushin Il-76 cargo aircraft. UAC is considering a second site in Kazan as an additional aircraft manufacturing facility from 2023 to produce and supply spare parts for Russian aircraft.

Market responses

- In June, Saudi Arabia's $620 billion public investment fund launched AviLease, a new aircraft lessor, as part of its efforts to diversify the economy and boost non-oil related economic growth. The leasing company aims to be a leading institution across the aviation leasing value chain by maintaining an optimal portfolio of assets concentrating on new-generation narrow and widebody aircraft.
- Recent debt capital market deals include:
  - 9 June, Carlyle Aviation Management Limited priced $522.5m asset backed securities, AASET 2022-1, to acquire a portfolio of 25 aircraft (8×737-800, 1×777-300ER, 11xA320, 4xA320neo and 1xA321). The issuance has a 6% coupon and priced at 350bps spread for an all-in yield of 6.558%. The transaction has a single tranche, rated A3 and A by Moody's and Kroll, respectively.
  - 23 May, BOC Aviation priced $300m private placement notes; the issuance has a coupon of 4.33%
  - 23 May, AVIC Leasing priced $450m unsecured notes due in 2025. The issuance has a coupon of 4.050% and is rated A- and Baa1 by Fitch and Moody's, respectively
  - 8 May , China Eastern Airline priced RMB15bn via private placement bonds to finance 38 aircraft (24xARJ21-700s, 6xA350-900s 4xCOMAC C919s and 4×787-9s)
  - 5 May, Global Jet Capital priced $609m asset backed securities, marking the first aviation ABS in 2022 after a pause of nearly two quarters. The issuance has a coupon of 4.445%, 5.192%, and 6.413% on Class A, B and C, respectively. The Class A was rated A and A- by S&P and KBRA, respectively; the Class B was rated BBB and the Class C rated BB by both S&P and KBRA
  - 12 April, CES Financial Leasing priced RMB500m medium-term notes. The issuance is unrated with a coupon of 3.24% due in 2025
- Capital market activity has slowed amid rising inflation and interest rates. We expect stronger airlines and lessors to return in due course, especially for issuers located in those areas recovering quicker from the impact of Covid and unaffected by the war.

Investec Aviation Debt Funds

$5 bn

aircraft assets under management on behalf of large institutional investors

7-year

track record delivering consistent returns above a defined hurdle rate to Investors across 2 core debt platforms

25+ people

number of professionals that support Investec's dedicated Aviation Funds team

Strong alignment of interest

Investec co-invests in all managed platforms

Proven track record

Strong technical capabilities and proven track record originating, releasing and remarketing aircraft