Investec

OUT OF THE ORDINARY

Aviation Market Snapshot Q2 2021

Key Market Insights

The shape of the post-Covid-19 airline sector is becoming clearer.

The impact of the Covid-19 pandemic is far from over. Many countries around the world have found some relief thanks to the scale and success of the vaccinations, but the road to full recovery for air traffic will take several years.

Multiple longer-running trends have accelerated, such as digitisation and the phasing out of less-efficient aircraft. Travel is becoming greener and more efficient. Demand is also increasing as more people are becoming eager to travel again for holidays.

Airlines' operating conditions are driven by the availability of reliable domestic markets and vaccination progress in the main countries in their networks. A stop-start recovery in passenger demand remains a key obstacle to a faster revenue rebound.

There has been a recovery in domestic travel. But, new Covid-19 outbreaks can turn trends fast.

Several domestic markets, such as the US and China, have rebounded strongly. In the US, recovery was driven by the pace of the vaccine rollout. A full recovery is predicted for Q4 2021 / Q1 2022. Positive signs also continue to emerge from domestic markets in Australia and Russia with the support of the leisure markets.

A surge in more virulent waves of Covid-19 cases and a tightening of travel restrictions has resulted in domestic travel in India and Brazil continuing to deteriorate.

International air travel depressed with only marginal/regional improvements.

A large proportion of long-haul international travel remains grounded due to border, quarantine and other travel restrictions. The speed of recovery is dependent upon the vaccine rollout and how countries control Covid-19. International travel restrictions remain tight even in regions with advanced vaccine rollouts, such as North America and Europe. Global International RPKs are 87% down on pre-pandemic April 2019 levels, with all regions contributing to the decline. North America is showing some small improvement driven by 'regional' trips to the Caribbean and Central America.

Bookings for international travel are showing an upward trend (up 25% in May versus April), albeit from a very low base. Booking data indicates an increase in demand for the northern hemisphere summer, noting that passengers are booking trips closer to their departure date. This is a welcome trend for airlines, where international travel accounted for 60% of global passenger revenues in 2019.

Investec Insights

Continued undersupply of air freight – Over the past decade, low cargo rates and the unprofitability of the cargo business have made many airlines scale back their dedicated cargo fleets. Pre-pandemic, cargo contributed ~12% of the sector's total revenue. That percentage tripled last year and cargo has since been a lifeline for the aviation industry during the pandemic. E-commerce sales surged during the pandemic, but much of the global international passenger fleet, which delivers ~50% of air cargo as belly freight, was grounded. As a result, cargo yields increased ~30% during 2020. As international passenger flights gradually return, belly supply will increase. Although, most commentators expect the return to pre-pandemic levels to take three to four years.

Airlines reshaping their organisations - The pandemic has created an unprecedented opportunity for airlines to reshape their businesses. Airlines around the world have cut costs and trimmed their fleets with an eye on a more efficient future. Some airline executives have said they achieved multi-year plans for structural changes in less than a year. At the end of 2020, KLM had achieved most of the cost cuts that it agreed to in exchange for state support. Nearly one in six staff members had left the airline as it sought to cut its staff base by 6,000. And in the first quarter, costs across the Air France-KLM group were down more than 45% compared to a year earlier.

Vaccine driven new normal - Those countries leading the race to full vaccination are already showing the way to the "new normal" – that is living with Covid in the community. The most promising aspect so far is the low and steady hospitalisation, despite quite high rates of infection, clearly demonstrating that the vaccines are working. The uneven rates of vaccination globally will cause the "yield compression" to continue for the time being, however as more countries hit the critical mass in vaccinations, more airlines will join the green list for financiers and investors. Investec is positioned at the front-end of that recovery ready to provide capital to carriers benefitting from the new found freedom to travel.

Paul Da Vall,
Head of Aviation Equity Fund

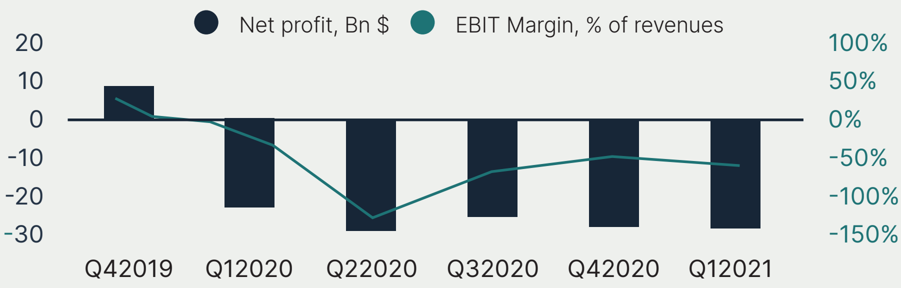
Yield compression for top airline credits - "Capital continues to be attracted to carriers with large domestic markets where the impact of Covid-19 has been well contained and especially to new technology narrow-body aircraft. Yield compression towards pre-pandemic levels for this market segment is expected to strengthen as signs of recovery become ever clearer. Investec is building a pipeline of selective transactions with airline/lessor/ asset combinations that yield superior risk-adjusted returns while mitigating risks through bespoke transaction structuring."

Derek Wong
Head of Aviation Debt Fund

In the news this quarter

- Following a dip in February 2021, the International Air Transport Association (IATA) reported that passenger traffic rebounded in March and continued to improve in April. The improvement is driven by the continued recovery in domestic markets. However, industry-wide Revenue Passenger Kilometres (RPKs) were still down 65% from pre-pandemic April 2019 levels, as international travel remains weak due to tight travel restrictions.
- IATA reported that airlines releasing financial results in Q1 2021 confirmed deep losses at similar levels to those reported in Q4 2020, associated with the ongoing impact of Covid-19. Net losses increased in Latin America and Asia-Pacific, partially offset by reduced losses in North America and Europe.
- Airline passenger revenue has declined 74% in Q1 2021 (versus Q1 2019). Cargo has maintained its strength, increasing 50% versus Q1 2019 as the wider economy rebounds. Despite the efforts of airlines to cut costs, the year on year decline in operating costs was limited to 40%, reflecting a limited reduction in fixed costs.
- Regional variances resulted in some North American carriers reporting positive operating cash flows in March amid the strong rebound in US domestic traffic. On the other hand, Latin American and European carriers reported significant operating cash outflows as rising Covid-19 cases impact demand.
- In the US, United Airlines is bullish about the strength of the post-pandemic recovery, reporting that domestic demand is back to pre-pandemic levels and a return to profitability is expected in July 2021. The airline recently announced a record order of 270 narrow-body jets (200 x B737Max and 70 x A321neos) to be delivered between 2022 and 2026. The order is the largest from any US airline since 2011. Combined with previous orders, United Airlines is expecting to take delivery of 500 aircraft, over the next four years. Of these, 300 will replace aircraft that are retiring, including 50 seat regional jets, B757s reaching the end of their service lives and older A319s and A320s.
- United Airlines' order is the latest in a list of airlines locking in deliveries as the recovery gains momentum. Southwest, Alaska Airlines, Lufthansa and Ryanair have all made double-digit aircraft commitments in the last six months.

IATA SAMPLE HISTORIC AIRLINE PROFITABILITY



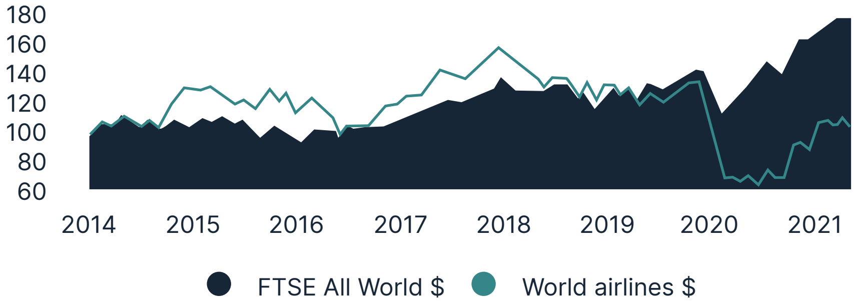
Source: IATA Economics using data from Airline Analyst

- The next generation of Electric Vertical Take Off and Landing (eVTOL) aircraft is gaining support amid an increasing focus on sustainability. The UK-based Vertical Aerospace has recently signed combined deals of ~$4bn for its VA-X4 model if it can certify the four passenger aircraft by 2024. American Airlines has committed to up to 250 aircraft, aircraft lessor Avolon up to 500, and Virgin Atlantic up to 150 aircraft. The aircraft with speeds of over 200mph, near-silent in flight and zero emissions, promise to transform flying by transporting passengers around congested metropolises quickly and quietly. However, the development has a long way to go and none are anywhere close to being certified by the Federal Aviation Administration (FAA) or another global regulator.
- Airbus has announced that it is actively working on a business case for an A350 Freighter. The comments coincide with a revival in air freight during the pandemic. Cargo airlines have performed well compared to their passenger counterparts during the crisis, and passenger carriers with large freight operations have even made profits on the back of their cargo business alone.
- In June 2021, Flyr, a Norwegian low-cost airline founded by the former CEO of now defunct Braathens, was issued an air operators certificate. Operations commenced in July with two B737-800s operating domestic routes. The airline plans to offer a range of destinations across southern Europe. The carrier has launched amidst a boom in start-up airlines, partly driven by discounted operating costs reflecting depressed asset values, lease rates and low-interest rates, coupled with the availability of skilled personnel.

How has the market responded?

- In June 2021, IATA reported that airline shares declined ~4% (month on month), following a rally in the first five months of the year. North American airlines were the worst performer (down ~8%) despite the rebound in domestic traffic. European airlines followed suit, down ~4%. The absence of any meaningful recovery in international and business travel coupled with rising jet fuel prices have dampened investor sentiment.
- The airline index was well below pre-pandemic levels (-22% vs Dec 2019) and lagging behind global equity markets, which are now ~26% higher than pre-pandemic.
- Capital markets continue to remain active for stronger airline credits and investment-grade investments. Examples of recent debt capital market deals include:
- 10 June, Azul priced $600m of senior unsecured notes due in 2026. The issuance has a coupon of 7.25% and was rated Caa1 and CCC+ by Moody's and Fitch, respectively.
- 10 June, SATA Air Acores (Portugal) priced €120m of senior unsecured notes due in 2030. The notes have a coupon of 3.00% and are rated Ba1 by Moody's.
- 18 May, Ryanair priced €1.2bn of senior unsecured notes due in 2028. The notes have a coupon of 0.875% and were rated BBB by both S&P and Fitch.
- 12 May, Air Canada priced $84m Class B EETC due in 2025. The Class B issuance has a coupon of 4.75% and was rated BBB- by Fitch.
- 10 May, Cathay Pacific priced $650m of senior unsecured notes due in 2026. The issuance has a coupon of 4.875% and was unrated.
- 27 April, Pegasus Airlines (Turkey) priced $375m of senior unsecured notes due in 2026. The issuance has a coupon of 9.25% and is rated BB- by Fitch.
- 14 April, United Airlines priced a two-part $4.0bn senior unsecured bond due in 2026 and 2029, respectively. The notes have coupons of 4.375% and 4.625% and are rated Ba1 and BB by Moody's and Fitch, respectively
- As noted in previous quarters, we expect the bifurcation of the market to continue with spreads staying low for strong carriers and significantly above pre-COVD levels for the rest of the market.

Index (Jan 2014=100)



Source: Refinitiv Eikon Datastream

Investec Aviation Funds

$5 bl

aircraft assets under management on behalf of large institutional investors

7-year

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.