Investec

OUT OF THE ORDINARY

Aviation Market Snapshot Q4 2021

Key market insights

1

Continued non-linear global recovery – Demand recovery has continued throughout 2021, with positive trends emerging across most regions. Despite Omicron-related flight cancellations, there is increasing industry optimism; some commentators are now projecting global traffic will achieve pre-pandemic levels by the end of 2023 – an improvement on previous projections, which were looking towards a 2024-25 recovery horizon. The pace of the recovery is largely determined by government health and travel policies worldwide.

Amongst key regions, Chinese and Russian domestic demand have already surpassed 2019 levels (albeit China has recently dipped again due to localised lockdowns). North American domestic and intra-European markets are also closing the gap on pre-pandemic levels. Growth in the Asia-Pacific region continues to lag, suppressed by relatively low vaccination rates, ongoing travel restrictions and other COVID-related government policies.

The key segments driving growth are domestic travel as well as holiday and visiting family and relatives (VFR) traffic.

2

Airlines gearing up for bumper summer schedule – Airlines are publishing bumper schedules ahead of summer 2022. These include new destinations and frequency additions that aim to take advantage of what many hope will be robust international demand, particularly across the North Atlantic and intra-Europe.

Whilst COVID-19 has provided numerous false dawns and setbacks, it is easier for airlines to pare back schedules than to add flights quickly if demand is strong. The forecast pent-up leisure demand, including from premium travellers willing to pay extra for larger seats and a superior service, has airlines favouring destinations popular with holidaymakers.

Investec insights

Non-linear traffic recovery dissected

By geographic region

Whilst we continue to face different challenges of new COVID-19 variants and outbreaks by region, travellers are progressively returning to the skies as vaccination levels increase, travel restrictions decrease and international corridors reopen. North America, China and Russia, with their access to large domestic networks, led the traffic recovery in 2021. European carriers gained momentum following the vaccination roll-out and the opening of transatlantic routes, whilst traffic recovery in Asia-Pacific has lagged due to rigorous travel restrictions restraining pent-up demand.

Transatlantic demand is forecast to fully recover by summer 2022, which will positively impact US and European network airlines. The Asia-Pacific region will continue its slower recovery path, which will have a negative impact on airlines in the region and the Middle East super connectors (IBA 2021).

By market segment

Domestic market as well as holiday and VFR traffic are expected to continue to lead the recovery, with a slower bounce-back of international traffic and business travel to follow. Worldwide domestic traffic is forecast to be back to pre-pandemic levels by the end of 2022, whilst international passenger traffic is forecast to reach two-thirds of 2019 levels over the same period (Cirium 2021). However, there are also notable headwinds, such as rising fuel prices, increasing interest rates and pressure to reduce carbon emissions. Albeit not as fast as the holiday and VFR segment, the business travel segment is also forecast to accelerate in 2022, fuelled by economic growth and easing restrictions.

By airline business model

The total in-service aircraft fleet is expected to return to near pre-pandemic levels by the end of 2022, driven by overall passenger growth across geographies and market segments. However, the divergent recoveries of areas and segments will also lead to different rebound paths of airlines with different business models. Low-cost carriers in the US and Europe are forecast to lead the recovery in 2022, given their greater exposure to domestic or intra-European Union travel, where there are fewer travel restrictions.

In line with changing global sentiment, all airlines will have to place an increasing focus on climate change and more environmentally friendly aircraft. Accordingly, the replacement of older generation types with higher fuel burn will become more important for fleet planning, with obvious cost implications for airlines.

"The volume of trading in the secondary market rebounded strongly in Q4 2021, as multiple lessors kick-started their asset sales programmes following a quiet start to 2021. The primary market, however, remains subdued as the widespread deferral of new deliveries from 2021 and 2022 to later dates leaves a reduced number of aircraft to be financed by airlines. Investec continues to invest in aircraft transactions in an opportunistic way and is building its portfolio of leased aircraft at or above the target returns, notwithstanding the challenging seller's market we saw throughout 2021."

Paul Da Vall,
Head of Aviation Equity Fund

"While the Omicron variant of COVID-19 posed fresh challenges to commercial aviation in Q4 2021, the industry continues to adapt and various indicators suggest aviation's recovery will pick up the pace again in 2022. Traffic volumes, booking demand, airline revenue, aircraft utilisation, new orders and production rates are all pointing to a more positive outlook. Investec has ramped up capital deployment in H2 2021 and there is a strong pipeline of over $400m of debt transactions due to close in H1 2022. With more lessor trading activity and increased aircraft deliveries, there is an attractive window in 2022 for investors to gain exposure to the sector through a seasoned aviation originator and asset manager."

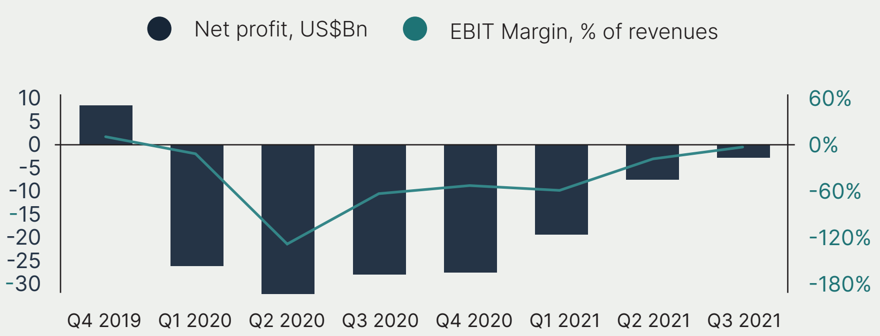
Derek Wong
Head of Aviation Debt Fund

In the news this quarter

- The International Air Transport Association (IATA) reported that global air travel continued to recover in November ahead of the Omicron outbreak, but that traffic improvement had slowed compared to previous months. Industry-wide Revenue Passenger Kilometres (RPKs), an indicator of global passenger demand, were down 47% from pre-pandemic November 2019. International air travel continued its upward trend with improvement across all regions as more markets re-opened prior to Omicron, whereas domestic travel deteriorated due to new lockdowns in China.

- In domestic air travel trends, China in particular continued to tighten its domestic travel restrictions to contain localised outbreaks of COVID-19. Russia's domestic market, 17% ahead of November 2019 RPKs, slowed, reflecting the start of winter and the impact of a new COVID-19 wave. Positive developments continued in the US, which saw high demand around Thanksgiving, and in Brazil, where vaccine roll-outs increased and infections fell, whilst Australia's domestic recovery continued to lag.

IATA SAMPLE HISTORIC AIRLINE PROFITABILITY



Source: IATA Economics using data from Airline Analyst & Refinitiv Eikon

- International travel continues to recover, driven by growing vaccination rates and a relaxation of international travel restrictions in certain regions. All regions are showing slight improvement, with Europe and North America leading the pack, benefiting from the re-opening of the North Atlantic corridor on 8 November. Asia-Pacific remains the worst performing region, with international RPKs 90% below November 2019 levels, reflecting stringent travel restrictions holding back pent-up demand.

- The IATA has cautioned that despite positive November RPK data, uncertainty around the recovery through the northern hemisphere winter is rising due to outbreaks of the more contagious Omicron variant, which is resulting in enhanced travel restrictions once more. Booking data shows the new Omicron wave is affecting travel demand.

- Airlines releasing financial results in Q3 2021 showed continued improvement, with some carriers reporting their first profitable quarter since the start of the pandemic. The improvement reflected the easing of travel restrictions on domestic and short-haul routes during the traditionally busy Q3, which boosted the recovery in passenger travel.

- North American, European and Latin American airlines posted the best results, benefiting from their large domestic markets and short-haul routes (intra-Europe and North-Central America).
In contrast, operating losses increased in Asia-Pacific versus Q2 as new outbreaks and the resulting lockdowns hindered the recovering demand in many key markets, such as China, Japan and Australia. Downside risk remains high, with several countries introducing new Omicron driven travel restrictions, and bookings for future travel have fallen sharply since late November.

- The IATA reported that airline passenger revenues declined 34% in Q3 2021 compared to the same quarter in 2019. Cargo maintained its strength, increasing 65% versus Q3 2019 as the wider economy rebounded. Total revenues, including passenger and cargo, were down circa 30%, a significant improvement from the 46% decline in Q2. Despite the efforts of airlines to cut costs, the year-on-year decline in operating costs was limited to 18%, short of the decline in revenue. Rising jet fuel prices are increasing pressure on costs, coupled with additional challenges from rising infrastructure costs and staff shortages in the US.

- Airbus reported deliveries of 611 commercial aircraft in 2021, up 45 on the previous year and dominated by the A320 family, which accounted for 79% of all deliveries. Net orders stood at 507 aircraft sales during 2021. Airbus chief executive Guillaume Faury stated that the order and delivery results are a signal of "confidence in the sustainable growth of air travel post-COVID", adding: "While uncertainties remain, we are on track to lift production through 2022 to meet our customers' requirements." By comparison, Boeing delivered 340 aircraft during 2021, up 183 on the prior year. Deliveries of the 787 halted for most of 2021, as Boeing addressed manufacturing quality issues. Net orders totalled 535 aircraft, dominated by the 737 MAX representing 74% of orders and freighters accounting for 16%.

- The Boeing 737 MAX came one step closer to flying in China again, after the country's civil aviation regulator mandated fixes to the aircraft's flight control software. Following implementation of the fixes and associated pilot training, the aircraft is anticipated to resume operations in one of Boeing's largest markets. Boeing has a backlog of circa 100 built aircraft ordered by Chinese airlines that have not been delivered. To date, 180 out of 195 countries have re-approved the MAX. Airlines around the world have returned Boeing's best-selling jet to service, pointing to its operational economics, range and payload improvements over previous 737 types.

- On 1 December 2021, over 18 months after filing for bankruptcy, Latin American carrier Avianca announced it is emerging from the US Chapter 11 bankruptcy restructuring. The airline stated it has successfully achieved agreements with its creditors, raised $1.7bn in investments, and received approval for its plan of reorganisation. Exiting Chapter 11, the airline now has a stronger balance sheet, additional liquidity and a lower debt burden. Under the revamped business model, the airline will pivot towards a future with far fewer business travellers and one where it flies denser planes on more point-to-point routes from its geographies of strength, under a broad partnership with United Airlines.

- UK low-cost carrier easyJet is accelerating its growth strategy outlined as part of its £1.2bn rights issue in September. The airline is securing additional slots at European hub airports, particularly in Southern Europe and at its London Gatwick base. The airline is planning a robust summer 2022 schedule, where it plans to operate at pre-pandemic 2019 capacity levels. CEO Johan Lundgren noted that whilst Omicron has softened near-term travel bookings, they remain unchanged for the holidays. The airline has boosted its firm order book by an additional 19 Airbus A320neos to 118 aircraft. The recovery in capacity is possible by the replacement of 156-seat Airbus A319s with larger A320neo and A321neo aircraft that seat 186 and 235 passengers, respectively.

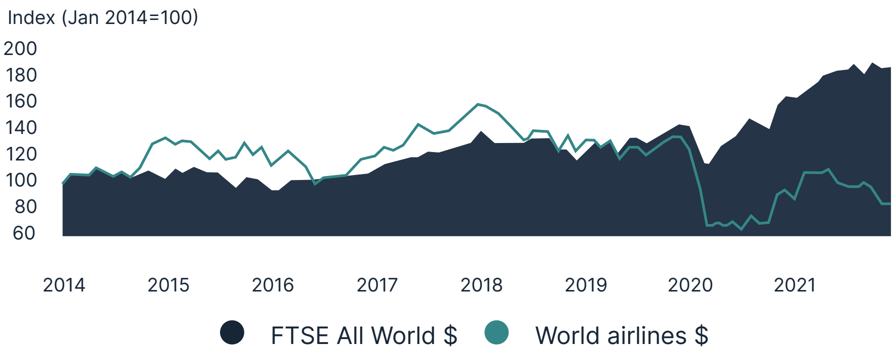
- Australia's Qantas forecasts robust international traffic through 2023 amid strong demand for the long-haul flights it resumed in November. Australia closed its borders to keep COVID-19 at bay for about two years until vaccination rates hit an 80% national threshold. Two years of pent-up demand sold out many of the flights Qantas has resumed. Subsequently, first quarter capacity was pared back amid a sudden COVID-19 spike that resulted in increased travel restrictions in Japan, Thailand and Indonesia amongst others. However, no material adjustments have been made to capacity expectations for the April-June quarter, with Qantas noting that early bookings for the Easter holidays in April are "looking promising for both domestic and international" flights.

- Lufthansa is targeting the roll-out of sharkskin technology on its Boeing 777 freighter fleet during 2022. Using nature as a role model, Lufthansa Technik and chemicals giant BASF have developed a surface film that reduces aerodynamic drag by mimicking the fine structure of a shark's skin. Lufthansa Technik estimates a drag reduction of more than 1% on a B777F. For the entire fleet of ten aircraft, this translates to annual savings of circa 3,700 tons of kerosene and about 11,700 tons of CO_2 emissions, which is the equivalent of 48 individual freight flights from Frankfurt to Shanghai.

How has the market responded?

- During Q4, the IATA reported airline shares were negatively impacted by concerns over the emergence of the more contagious Omicron COVID-19 variant and the resulting travel restrictions adversely affecting air travel recovery, coupled with the impact of rising jet fuel prices on airline operating costs.
- The recovery in airline shares stalled in 2021. As of mid-December, the global airline share price index was 37% below pre-crisis levels, while wider equity markets rose by 30% since the start of the pandemic.
- Capital markets continue to remain active for stronger airline credits and investment grade investments. We anticipate the bifurcation of the market to continue, with spreads staying low for strong carriers and above pre-COVID levels for the rest of the market. Recent debt capital market issuances include:
  - 16 December, China Aircraft Leasing Company priced $100m notes due in 2024. The issuance has a coupon of 4.85% and was rated BB+ and Ba2 by Fitch and Moody's, respectively.
  - 19 November, Carlyle Aviation Management Limited priced $620m asset backed securities (AASET 2021-2). The issuance has a coupon of 2.80% and 3.54% on class A and B, respectively. The issuance was rated A1 and Baa2 on class A and B by Moody's and A and BBB by Kroll, respectively.
  - 12 November, World Star Aviation priced $633m asset backed securities (SPRTE 2021-1). The issuance has a yield of 4.00%, 5.70% and 9.125% on Class A, B and C, respectively. The issuance was rated A-, BBB- and B+ on class A, B and C by S&P and A and BBB on class A and B by Kroll, respectively.
  - 9 November, Lufthansa priced €1.5bn unsecured notes, with €600m notes due in 2023 and €900m notes due in 2027. The issuance has a coupon of 1.625% and 2.875% on the 2-year and 5.5-year tenor, respectively. The issuance was rated Ba2 on both tranches by Moody's and BB- on both tranches by S&P.
  - 5 November, Sculptor Capital Management priced $707m asset backed securities (SOLRR 2021-1), serviced by Stratos. The issuance has a coupon of 2.64%, 3.43% and 5.68% on class A, B and C, respectively. The issuance was rated A1, Baa2 and Ba3 on class A, B and C by Moody's, respectively.
  - 2 November, Carlyle Aviation Management Limited priced $818m asset backed securities (AASET 2021-1). The issuance has a yield of 3.236%, 5.110% and 8.000% on class A, B and C, respectively. The issuance was rated A, BBB- and B on class A, B and C by Moody's and A, BBB and B on class A, B and C by Kroll, respectively.
  - 25 October, American Airlines priced $959m of secured notes due in 2034. The issuance has a coupon of 2.875% and 3.950% on Class A and B, respectively. The Class A was rated Baa1, A- and A by Moody's, S&P and Fitch, respectively; the Class B was rated Baa3, BB+ and BB+ by Moody's, S&P and Fitch, respectively.
  - 18 October, Stonepeak priced $893m loan asset backed securities due in 2028. The issuance has a coupon of 2.30%, 2.68%, 3.82%, 5.93% and 7.14% on the Class AA, A, B C, and D, respectively. The issuance was rated AA, A, BBB, BB and B on Class AA, A, B, C and D, respectively, by KBRA.

AIRLINE SHARE PRICES



Source: Refinitiv Eikon Datastream

Investec Aviation Debt Funds

$5 bl

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