Investec

Return to the skies

Strong passenger traffic growth in aviation markets

OUT OF THE ORDINARY

What's inside:

Key market insights

Passenger numbers recover

The International Air Transport Association (IATA) reported an increase in passenger demand in both January and February 2024.

In February, the airline industry experienced a full recovery in total passenger traffic, surpassing the levels seen in 2019 by 5.7%. This indicates that the industry has successfully rebounded from the impact of the pandemic. The year-on-year growth in Revenue Passenger-Kilometres (RPK) reached an impressive 21.5%.

The passenger load factors (PLF), which measure the percentage of seats filled on flights, showed improvement compared to the previous year and settled around pre-Covid-19 levels. This suggests that airlines are operating more efficiently and effectively in filling their flights.

Lunar New Year boosts domestic flights

In terms of domestic traffic, there was a significant growth. Over the course of the year to February 2024, domestic traffic increased by 15.0% compared with the year to February 2023. This strong performance can be attributed to the robust performance of major markets and the surge in travel during the Lunar New Year period, particularly in China, where domestic traffic reached new highs with year-on-year growth of 31.5%.

The annual growth in international traffic was remarkable at 26.3% in the year to February 2024 compared with the same period in 2023. The Asia Pacific region led the way in terms of growth, as international travel to and from the region continued to recover. Other markets that had already experienced an earlier rebound also showed solid traffic growth during this month.

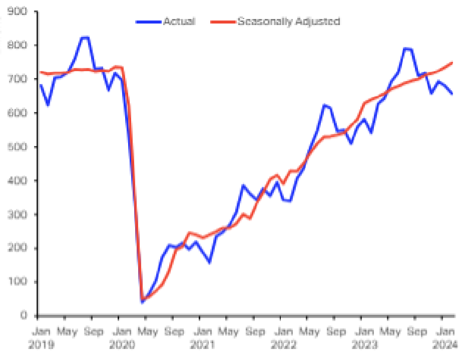
Resilient demand brings ticket sale stability

Ticket sales saw a significant increase ahead of the Lunar New Year, both for domestic and international travel. This peak in demand was followed by a brief slowdown in ticket purchases. However, during March, ticket sales stabilised, indicating resilient demand for air travel. This stability suggests that there is ongoing and sustained interest in air travel, despite the fluctuations in demand.

Overall, these statistics indicate a positive recovery trend in the airline industry, with strong growth in passenger traffic, particularly in domestic markets and the Asia Pacific region. During the Lunar New Year break, domestic ticket sales contracted compared to the previous year, while sales for international travel remained higher than in 2023. Over the month of March, ticket sales for both travel segments remained elevated compared to the previous year, indicating consistent high demand for air travel following the Lunar New Year break.

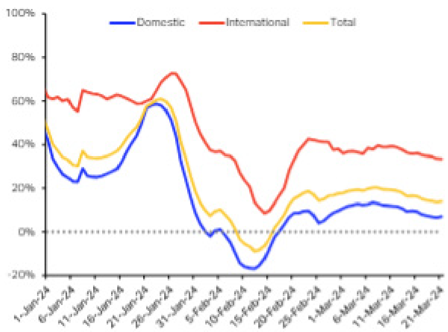
Trends

Global Air Passenger Traffic(RPKs), billions per month



Sources: IATA Sustainability and Economics, IATA Monthly Statistics

Ticket sales by purchase date; 7 day moving average – YOY %



Sources: IATA Sustainability and Economics, IATA Monthly Statistics

Asia Pacific region supports RPK growth trend

In terms of regional contribution to industry annual total RPK growth, the Asia Pacific region played a significant role. The 21.5% year-on-year growth in industry-wide passenger traffic in February was driven by high activity in China's domestic market and the comeback of international traffic from Asia.

At the industry level, domestic traffic grew by 15.0% year-on-year, reflecting improvements in all major markets and record-breaking traffic levels in China. Domestic tourism continued to drive traffic growth in China and seat capacity levels were reinforced by the increased use of widebody aircraft.

In specific markets, Japan experienced a substantial acceleration in domestic RPK growth with a 9.1% year-on-year increase. India saw stable growth with a 5.3% annual increase in RPK, while Australia recorded a 14.9% year-on-year increase in passenger numbers. The US and Brazil also had resilient growth rates of 5.7% and 3.2% respectively, surpassing the pre-pandemic average of 2019.

In terms of international traffic, industry-wide international RPK reached pre-Covid levels in February and displayed uninterrupted momentum with a 26.3% annual growth rate. Positive results were observed across all regions, with higher year-on-year growth rates compared to January. Except for Asia Pacific and Europe, all regions surpassed pre-pandemic levels in RPK. Annual growth ranged from 15.9% in Europe to 53.2% for Asia Pacific carriers.

Asia Pacific carriers led in annual growth as international traffic in the region is still recovering compared to other geographic areas. However, total recovery in international traffic is now imminent for both Asia Pacific and Europe, as they were only slightly below 2019 levels in February.

These statistics highlight the positive growth and recovery trends in both domestic and international air travel, with strong performance in major markets and regions.

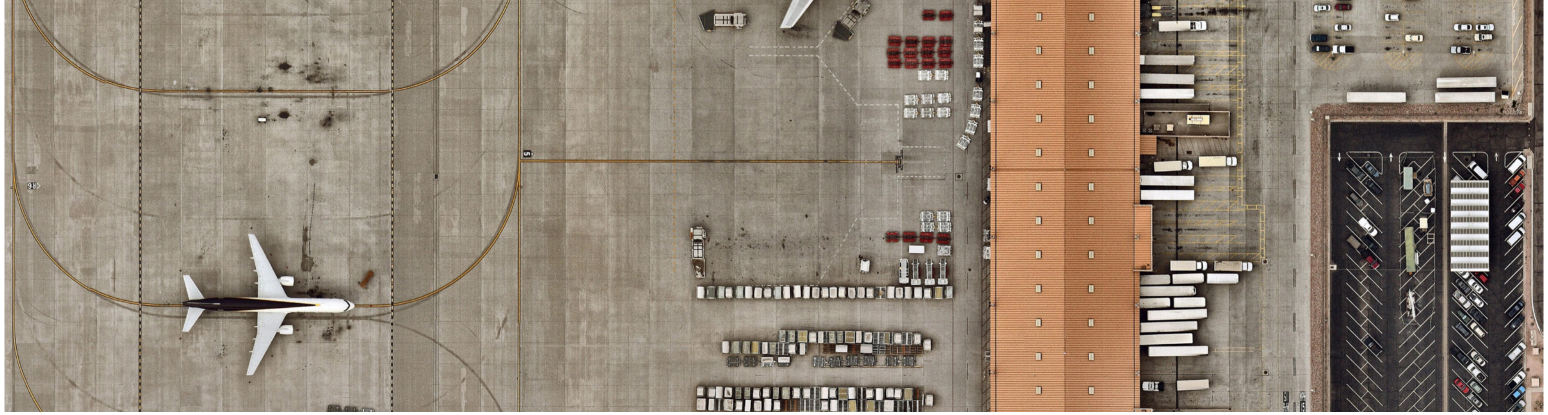
The wider effects of aircraft demand exceeding supply

Traffic levels in the first quarter of 2024 exceeded those of pre-pandemic levels in 2019 and reflect the strong demand for air travel in the post-Covid-19 recovery. There is now a shortage of aircraft, mainly driven by the inability of Original Equipment Manufacturers (OEMs) to produce approximately 3,000 aircraft during the pandemic shutdowns and other recent production delays in 2020-2023. Ramp up of production has been slow and OEMs are still unable to deliver at their intended rates. A key impact of the strong demand is many more lease extensions than previously anticipated, which then has a wider effect on the industries associated with aircraft trading, operation, and leasing.

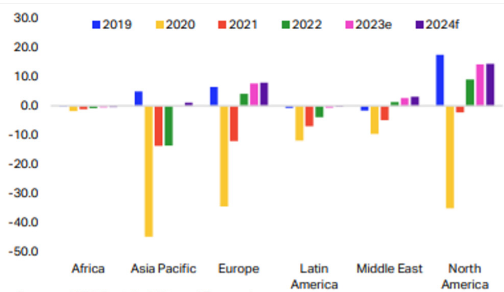
With OEMs still unable to produce aircraft fast enough to keep up with traffic demand, many airlines who have traditionally only operated newly delivered aircraft have been forced not only to extend leases but also to lease in available used aircraft that have transitioned out from other airlines. While this is particularly strong in the narrowbody market, we are also seeing some used widebody aircraft transitioning between operators, with the end user investing in the aircraft to ensure cabin and fleet commonality as they have no other options.

The effects of the strong demand include increased aircraft utilisation and increased time in service which then have a knock-on effect across the industry:

- Engine traders and lessors are seeing high demand for CFM56 and V2500 engines, with, in some cases, lease rates for two engines exceeding the composite lease rate for a whole aircraft
- The traditional supply of 'green time' engines is drying up as airlines extend leases and keep aircraft flying longer
- The sources of used serviceable material are reducing, yet demand for such material is increasing as airlines seek to keep the costs down of retaining aircraft in service longer than planned
- Technical service suppliers who were expecting to provide support to lessees and lessors for a steady flow of lease terminations/transitions in the coming years are finding their workload drying up as the extensions are executed
- Engine Maintenance, Repair and Overhaul organisations (MROs) having full order books, are taking longer to turn around engines and finding it hard to offer slots. This is not just from the increased demand, but also a number of issues, including labour and material shortages, the huge increase on Pratt and Whitney shops from the GTF parts issues and most other new generation engines having parts that do not yet meet intended design life or requiring 'hospital' shops visits to remain in service.



Airline profitability by region, USD billion



Sources: IATA Sustainability and Economics

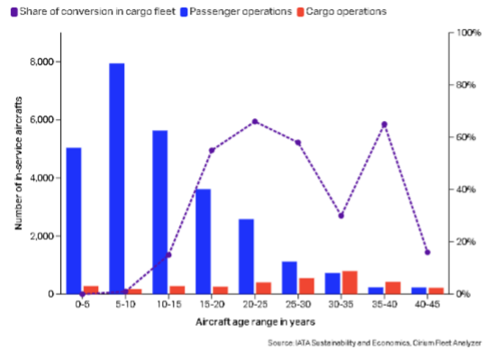
Average age of cargo fleet aircraft higher than passenger aircraft

According to a recent article from IATA, the average age of aircraft in passenger operations is 13 years, while the average age of aircraft in cargo operations is 25 years. However, it is important to note that the cargo fleet represents only about 12.5% of the global in-service fleet, which includes both passenger and cargo aircraft.

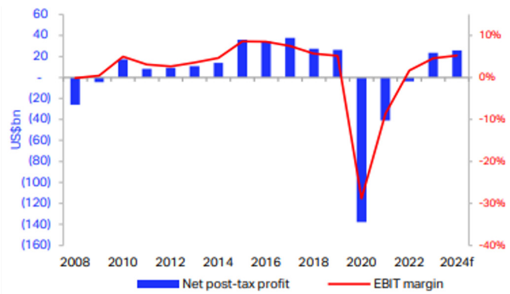
One of the reasons for the higher average age of the cargo fleet is the significant proportion of freight aircraft that are converted from used passenger aircraft. This conversion rate can reach up to 66% for certain age categories, and the average share of conversions is as high as 34%.

In addition to the diverging averages between passenger and cargo fleets, a simple comparison of the most populated age group highlights the stark difference in the age profiles of the two fleets.

Number of in-service aircraft for passenger versus cargo operations by aircraft age

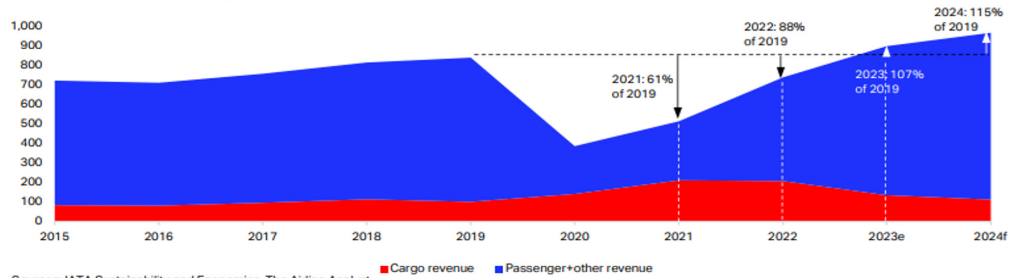


Airline industrynet profit and EBIT margin



Source: IATA Sustainability & Economics, The Airline Analyst

Global airlines revenue, USD billion



Sources: IATA Sustainability and Economics, The Airline Analyst

A word from the Aviation Finance Team

Paul Da Vall
Head of Aviation Equity Funds

"The first quarter of 2024 has seen the supply side problems continue, with OEMs falling behind their delivery targets citing seemingly insoluble supply chain issues. The narrowbody market supply has been further exacerbated by the grounding of PW GTF-powered A320Neo family aircraft for enhanced maintenance checks for powdered metal contamination. While Cirium estimates 546 GTF-powered aircraft are currently grounded, the rolling average is expected to be 350 at a time through to late 2026. This dramatic capacity reduction is having significant knock-on effects, with lease rates on available alternative aircraft (A320 Ceos, B737NGs and CFM LEAP powered MAX/Neo aircraft) rising sharply. In addition, airlines are engaging in lease extension discussions much earlier than they would have in a balanced market, with a very high proportion of aircraft leases being extended. Investec's equity team has been actively deploying its aircraft on extended leases and trading out of assets with extended leases attached at attractive returns for its investors."

David Louzado
Head of Technical, Aviation

"The implications for the industry associated with the surge in aircraft demand will be felt over the coming years as the bow wave of lease returns gets pushed further out. Average retirement ages for aircraft will creep back up as the supply of new aircraft remains below traditional delivery rates and service suppliers, as well as the OEM's and MRO's, will have to adjust their plans and business models to meet the current and future demands."

Derek Wong
Head of Aviation Debt Funds

"Thai Airways, Philippine Airlines and Cathay Pacific are among a good number of Asian carriers that have reported strong operating profits for 2023, signalling a new era of profitability after the Covid-19 pandemic. As the region's aviation rebound gathers pace, appetite for financing recovering Asian carriers and lessees is set to grow. Investec is taking advantage of this window to capture higher yields for such improving credits in the context of conservatively structured transactions."

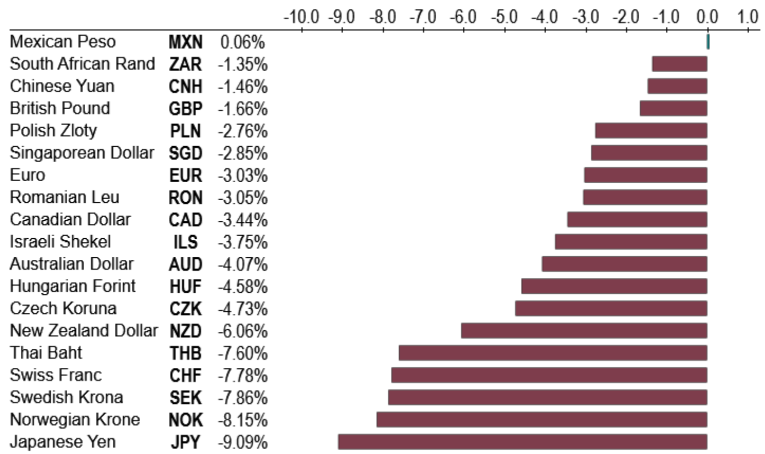
Interest rate and foreign exchange update

The view for global interest rates has changed dramatically during the first quarter of 2024. At one point in January, investors were pricing 6-7 US Federal Reserve (Fed) cuts through 2024, while that now sits at less than two cuts. Similarly, the 10-year US Treasury yield has risen close to 70 basis points (bps) following a series of strong data-points alongside a particularly tight labour market.

While there is strong consensus still for the first cut to come from the European Central Bank in June, this conviction has lessened in recent weeks for both the Bank of England and the Fed, where for these economies it is expected to happen later in the year. With that said, predictions are just predictions at the end of the day, with the major central banks all quick to change tack should inflation materially change from its expected path.

In foreign exchange, the key theme so far this year has been one of US dollar strength. Economic exceptionalism in the US has widened implied interest rate differentials in US dollar-holders' favour, and some flaring up in geopolitical tensions has lifted the greenback in parts, too. Yet in a sense, the moves have been limited, which may remain the case until actual policy rates begin to move. Implied volatility metrics have fallen materially to post-financial crisis lows in EURGBP, for example. But with anticipations of interest rate cuts, a year where 40% of the world's electorate will vote in general elections, and geopolitics posing risks, it's unlikely that Q1's relative calm in the G10 will be maintained through the year.

Spot performance vs USD this year (%)



Sources: Investec, Macrobond, Bloomberg

Jet fuel market update

The oil market has, of course, been following events in the Middle East very closely in recent weeks. Brent touched highs over $92 per barrel ($/b) in the first weeks of April, following Israel's alleged attack on Iranian consulate buildings in Damascus, on worries that Iran's response could lead to a serious escalation. When it came, the retaliation was unprecedented in its scale and in being launched from Iranian soil, but it caused little damage and so Israel's response to that was limited.

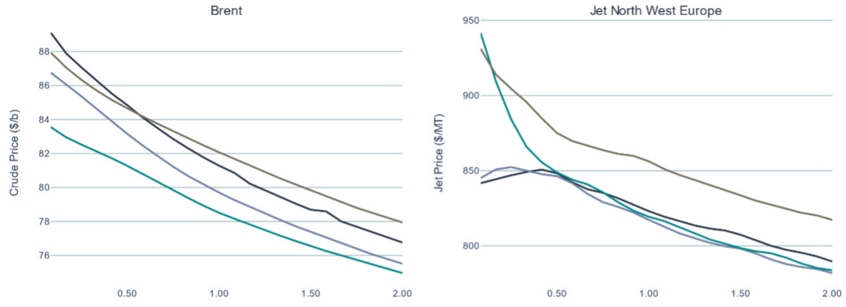
The market seems to have taken the view that this is the end of the matter for now and that the risk of an escalation between Iran and Israel has diminished, eroding the associated risk premium in the price of oil. Brent traded under 86 $/b at one point.

So far as supply/demand fundamentals are concerned, OPEC+ and more particularly Saudi Arabia, agreed to extend their voluntary production limits for a further quarter until the end of June. Based on the International Energy Agency's latest monthly report, this ought to leave the oil market balanced over this quarter, but there are signs of weakness in jet fuel and diesel markets. The premium of these prices over crude oil has declined in recent weeks and the first six months or so of the jet and diesel forward curves are now upward sloping to incentivise storage of a well-supplied commodity.

Brent front contract

European crack spreads

European forward curve history



Until recently, the forward curves have been downward sloping, indicating tightness. This is happening in-spite of disruptions to Russian refined product supply due to Ukrainian attacks on Russian refinery infrastructure. Strong production from Asian refineries seems to be the driver and suggests there might be a disconnect between the recent strength in crude which has been helped higher by renewed interest from speculative investors (as can be seem from position data reported by futures exchanges) and underlying consumer demand.

The key questions now are whether demand increases in the summer can absorb this supply and what OPEC+ decides to do about its voluntary cuts which are currently scheduled to end on 30 June – might they extend it again in full or in part? The next full OPEC+ ministerial meeting is being held on 1 June.

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>
> **Callum Macpherson,**
> Head of Commodities

US$1 billion of capital deployed in 2023

Aviation Debt:

- Closed and mandated US$834 million across 67 aircraft

Aviation Equity:

- Invested US$360 million
- Remarketed and sold US$350 million

Marquee deals included:

- A350 and a B787 aircraft leased to Singapore Airlines
- Portfolio of 23 Airbus and Boeing aircraft for US lessor

Investec Aviation Finance

Aviation specialists

Over $10bn debt origination
(in last 10 years)

Supported by a FTSE 250 financial institution

Dedicated debt managers

Over $500m
assets under management

Proven seven-year track record

Originated $1bn of assets

Dedicated equity managers

$1.3bn capital deployed
(over 13-year history)

Raised $5.3bn of acquisition finance across four equity vehicles three equity funds fully exited

Partnership approach

Full alignment with investors via meaningful Investec co-investment in all managed platforms

About Investec

Investec is a leading UK FTSE 250 financial institution with a dedicated alternative investment platform. Our focus is on Cashflow and Asset Backed Strategies including Aviation Finance, Infrastructure Debt, Real Estate Debt, Private Credit and Fund Finance. The group was established in 1974 and currently has approximately 8.200 employees. Investec Aviation offers an alternative approach to commercial airlines and lessors needing innovative financing solutions.