Aviation Market Snapshot Q4 2020

Executive Summary

1. The duration and veracity of the pandemic continues to rock the airline industry. Nonetheless, we support the view that the fundamental investment thesis for the right assets prevail and that long-term demand for air travel exists. Lower aircraft asset prices combined with higher airline liquidity needs present an opportunity to capture better risk adjusted returns. Investec, with its deep market reach and track record is well placed to capitalise on the market disruption.

2. Covid-19 has caused an unparalleled demand shock to airlines. Airlines have shifting their focus from growth to survival mode, coping with a dramatic loss of revenue and high fixed cost base, resulting in an unsustainable cash burn rate for carriers. The ability for carriers to survive will largely depend on their ability to aggressively cut costs, segment exposure (domestic / international) and their ability to generate sufficient liquidity to weather an extended recovery period.

3. The often mentioned multi-speed recovery, across travel segments and geographies, is evidenced by domestic capacity growth in China and Russia. In Europe capacity is at 50% of January 2020 levels although load factors are still low at ~50-60% and RPKs are ~70% down. Different quarantine rules between European countries have hampered recovery despite strong demand, particularly in the UK, the complicated rules prevented people travelling. Latin America, The Middle East and Africa have been particularly hard hit. Although the Middle East benefits from government support, the regional economy has been knocked by low oil pricing.

4. IATA estimates that globally government support packages totalling ~$170 billion have been provided to airlines in 2020, confirming the key role of aviation in economic development. Estimates of airline losses total ~$120 billion in 2020, with another $40 billion forecast for 2021. Continued government support is required to stabilise the industry.

5. During the northern hemisphere summer in 2020, signs of a recovery led by leisure traffic provided hope of a traffic bounce back. Despite another traffic bump over the Christmas holidays, the resurgence of the virus and associated restrictions has severely hindered air travel recovery across many domestic and international markets. It is becoming clear that a recovery to 2019 traffic levels is still some years away.

Investec

Investec Insights:

Domestic and Leisure travel will lead the recovery in 2021 - Disease trajectory and vaccine rollout coupled with uniform testing capability is key to the recovery of the airline industry. Demand will not fully return until the pandemic has been contained. We have seen that domestic travel has bounced back in countries which have contained the disease (e.g. China, Russia, Vietnam, New Zealand and Australia).

Pent up demand was witnessed during the summer and Christmas vacations. It is clear that consumers want to travel; within hours of a quarantine or border restriction being removed, airlines have observed a material increase in bookings for that particular market. Once the vaccine rollout gains critical mass, the surge in demand for leisure travel could be like nothing we have experienced before.

Structural shift for business travel? – History shows that after a recession business travel takes longer than leisure travel to recover. After the 2008/9 global financial crisis, international business travel took five years to recover, compared with two years for international leisure travel. Many commentators are questioning whether the effective use of technology during the pandemic and the economic constraints that many companies will face for years after the pandemic could herald the beginning of a long-term structural change in business travel. However, given the IMF predictions around the size of the global economy in 2021 being slightly larger than in 2019, and assuming continued global economic growth into 2022 and 2023, it does not seem unrealistic to predict that business travel could get back to 2019 levels within circa four years as forecast by IATA.

Investec acquires two B737s for its equity platform - Investec Bank has acquired two, 2010 vintage, Boeing 737-800 aircraft from BOC Aviation on behalf of its equity fund, Investec Aircraft Syndicate 2. The aircraft are on operating lease to Xiamen Airlines and Shandong Airlines.

"We are very pleased to have completed this acquisition from BOC Aviation Limited, acquiring two additional prime narrowbody assets into our managed equity fund. The transaction demonstrates Investec's capability to execute in an extremely challenging post-Covid environment and continues our strategy of deploying the available capital in our managed equity fund," said Paul Da Vall, head of aviation equity funds at Investec.

Increasing appetite for top tier airline credits – Capital market pricing for Tier 1 airline issuances in Q4 2020 have reduced markedly since the previous quarter, demonstrating increasing appetite for aviation investments. Lessor appetite for sale & leaseback (SLB) transactions remains robust and creates opportunities for debt providers. There is still a clear premium to debt pricing compared to pre-COVID and yields are particularly attractive for debt with an element of asset risk. Investors can take advantage of the higher yield market and mitigate relevant risks by enhancing the transaction structure. As air traffic recovers, we expect to see even more opportunities for debt investments.

In the news this quarter

The MAX is back – in November the B737MAX was approved by the US Federal Aviation Administration (FAA) for return to service. Airlines in the US and Latin America have started putting the jet back into service, with a return in Europe expected soon. Whilst there were several questions around whether travellers would board a B737MAX again and if Boeing should rebrand the aircraft, so far, passengers are not avoiding the MAX. American Airlines put the jet back into service on 29 December, 2020 and recorded load factors of ~90% (albeit at one of the busiest holiday periods in the US).

Despite being grounded for ~20 months, the MAX stands to benefit from the accelerated retirement of older less fuel efficient aircraft and is expected to make up a significant portion of airline narrow body fleets over the next decade. The ~395 MAX's delivered to airlines globally and grounded by the regulators are expected to return to service relatively quickly. There are a further ~400 MAX aircraft which have been built but not delivered. Analysist expect these to be delivered and enter service over the next 2 years.

Still with Boeing, the manufacturer agreed to pay a $2.5bn penalty following a fraud charge from the U.S. Justice Department. The Justice Department said that the company knowingly withheld information about problems with the aircraft's flight-control software from the FAA during the certification process. The fine included a cash settlement to the families of the victims of the Lion Air and Ethiopian accidents.

In October, IATA again lowered its expectations for global passenger traffic for 2020 amid a stalling in the global recovery and lower forward-booking indicators. IATA forecasted that passenger traffic, would end up 66% down on 2019 levels (previous estimates were 63% down). IATA has also sharply lowered its 2020 guidance for air traffic in the Middle East and Africa, citing "weaker-than-expected recovery" in each region due to the second wave of Covid-19. For both regions full-year passenger numbers are expected to reach only 30% of 2019's levels, down from a previous projection, in July, of 45%.

IATA has also warned that the world's airlines are currently burning cash at a rate of around $300,000 per minute or $13 billion per month, which has the potential to plunge a number of airlines into bankruptcy within months should they not receive further support. While this is expected to improve over 2021 as capacity and passenger demand recovers, it remains a considerable threat to many carriers.

Governments around the world continue to support the airline industry, with support packages totalling an estimated $170 billion in 2020. Not all governments were willing to continue supporting their domestic airlines, though. Following the news of no further state support, Norwegian has initiated the Examinership process as a way to reduce debt, rightsize the fleet and secure new capital. This includes the divestment of all long-haul operations as they retreat towards their stronghold in the Scandinavian regional market, focusing only on those routes which have been profitable for them in the past. This will see 37 Boeing 787 Dreamliner aircraft returned to lenders and lessors and more than 3,500 employees retrenched globally.

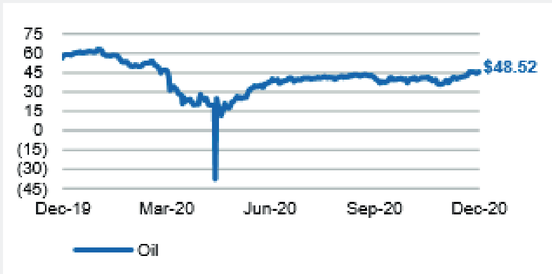
The move back to domestic and regional markets is no surprise. Domestic travel continues to dominate European traffic, with the busiest air transport routes in Europe almost entirely domestic connections as international traffic remains hampered by travel restrictions and passenger unease about crossing borders. Air France announced that it would triple its domestic operations over the holiday period and Wizz Air has also outlined its plans to begin operating on Norwegian domestic routes, spotting an opening in that market as Norwegian struggles to stay afloat.

The global travel downturn is accelerating the retirement of older, less fuel-efficient, and higher maintenance aircraft. Widebody aircraft have been hit particularly hard, including the Boeing 747, B777, Airbus A330 and A380 aircraft, as airline international capacity is not expected to return to pre-pandemic levels until ~2024. These include Delta and Qatar's retirements of 777s, American retiring its A330s, Air France its A380s and British Airways its 747s. This over-supply combined with the depth of the pandemic-driven aerospace downturn, means that aerospace manufacturer build rates will likely be cut even further in 2021.

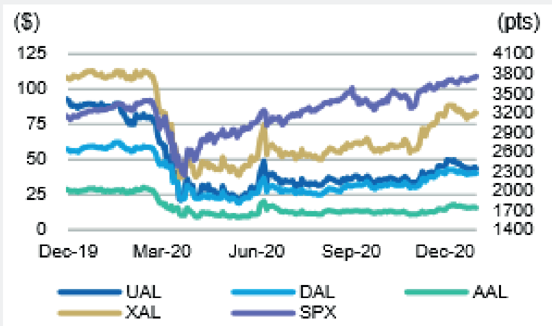
How has the market responded?

- In December, equities ended a turbulent year at record highs reflecting expectations of a widespread vaccine rollout coupled with continued government aid and central bank support to kick start economic growth. The S&P 500 closed 2020 16% up for the year.
- US Airline stocks rallied during the 4th quarter as positive vaccine developments boosted investor sentiment in the sector. The Bloomberg US Airline Index was up 38% for the quarter, the second best ever quarterly performance in 88 quarters (the highest surge recorded was 39% in 2Q 2003, reflecting increasing confidence from the end of the 2nd Gulf War and SARS).
- Year on year share prices of many leading airline groups ended 2020 down 30 – 50% during a torrid year for the sector. Among leading European airline groups, low-cost carriers Ryanair and Wizz Air were the outliers, each ending 2020 in positive share price territory, compared to the start of the year.
- Following a turbulent first half of the year, Oil ended the year slightly down at $48.52. The pandemic wiped out ~7-9% of demand with oil producers cutting production between 7-20% from May 2020 to stabilise pricing. Fuel costs account for between 15 – 20% of airline operating expenses. The reduction of this variable cost benefitted airlines which do not hedge fuel.

2020 Oil Prices (WTI)



2020 US Airline Stocks



- 22 January, 2021, Castlelake priced a $595m Aircraft ABS. This was the first aircraft ABS deal post-Covid and was more than 10 times oversubscribed. The senior tranche of $476m priced at 3.47% and was rated A2 / A by Moody's and Kroll respectively. The mezzanine tranche of $119m priced at 6.65% and was rated Baa2 / BBB.

- 21 December, GOL priced a $200m senior secured bond backed by intellectual property rights and spares, due in 2026. The issuance priced with a coupon of 8.0% and was rated B2 by Moody's.
- 3 December, China Eastern Airlines priced a ¥2bn of senior unsecured notes due June 2021. The issuance is unrated and has a coupon of 2.4%.
- There have been several B737MAX trades during the quarter. In December, CDB Aviation entered into a sale and leaseback with WestJet (Canada) for 9 x B737MAX-8 aircraft and with GOL (Brazil) for 7 x B737MAX-8 aircraft, combined value ~$770m. The demand in the sale and lease back market for the B737MAX is not matched in the Lessor order market however, with leasing companies cancelling orders for 100 aircraft in December.
- 24 November, Lufthansa priced €1.0bn of senior unsecured notes due in 2026. The issuance has a coupon of 3.0% and is rated BB- by S&P.
- 24 November, Singapore Airlines priced SGD500m of senior unsecured notes due in 2030. The issuance has a coupon of 3.5% and is unrated.
- 17 November, British Airways priced a $1.0bn dual-tranche EETC secured by 14 aircraft. The $764m Class A issuance priced with a coupon of 4.25% and initial LTV of 56.6%. The $241m Class B issuance priced with a coupon of 8.375% and initial LTV of 74.2%. The Class A was rated A and A- and the Class B was rated BBB by S&P and Fitch, respectively
- 17 November, Air Lease Corp priced $750m of senior unsecured notes due in 2030. The issuance has a coupon of 3.125% and is rated BBB/BBB/A-at S&P, Fitch and Kroll, respectively
- 16 November, Avolon priced $1.0bn senior unsecured notes due in 2026. The issuance has a coupon of 4.25% and is rated Baa3/BBB-/BBB- by Moody's, S&P and Fitch, respectively
- 10 November, Lufthansa priced €600m of senior unsecured convertible notes due in 2025. The issuance priced with a coupon of 2.0% with an initial conversion premium of 46.7% above the reference share price.
- 9 November, China Aircraft Leasing priced $35m of unsecured notes due in 2025. The issuance is unrated and has a coupon of 5.9%.

Investec Aviation Funds

$5 bl

aircraft assets under management on behalf of large institutional investors

6-year

track record delivering consistent returns to Investors across three 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.

10 years

track record managing aviation equity investment