2021

THE ROAD TO RECOVERY BEGINS

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ABL AVIATION

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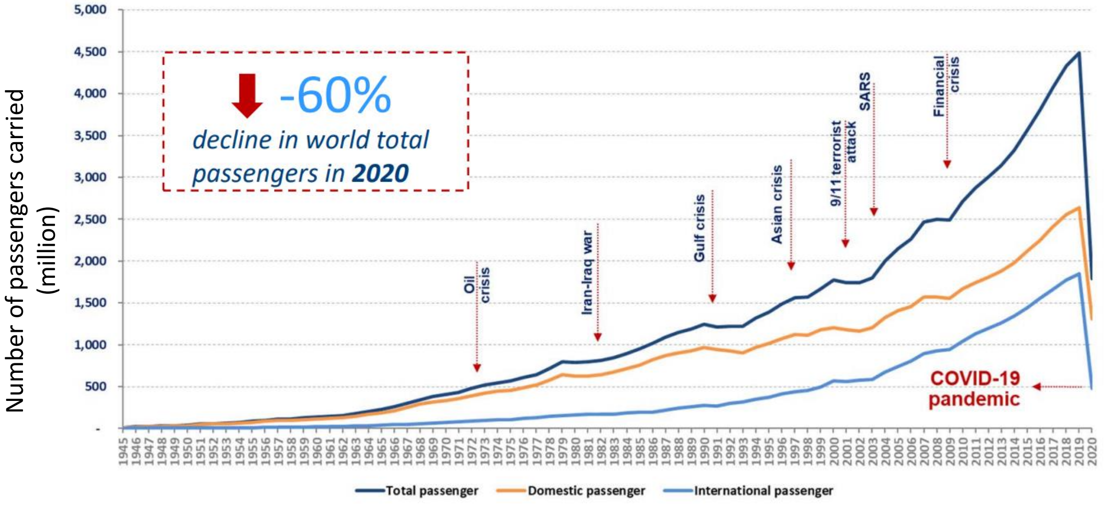
Introduction

2020 was an unprecedented year for the aviation industry. The COVID-19 pandemic has all but brought the world to a standstill, after five years of profitability for airlines. There was 5.2% contraction in global GDP last year, according to the World Bank — the deepest global recession in decades **(1).** The travel sector has been particularly hard hit by the pandemic, along with leisure and retail. In aviation, the whole industry has been impacted, from the manufacturers and supply chains, to workers and global traffic flows. The sector's full recovery could take several years, but, as *Aristotle Onassis, the Greek magnate who amassed the world's largest privately owned shipping fleet,* once said: it is during our darkest moments that we must focus to see the light.

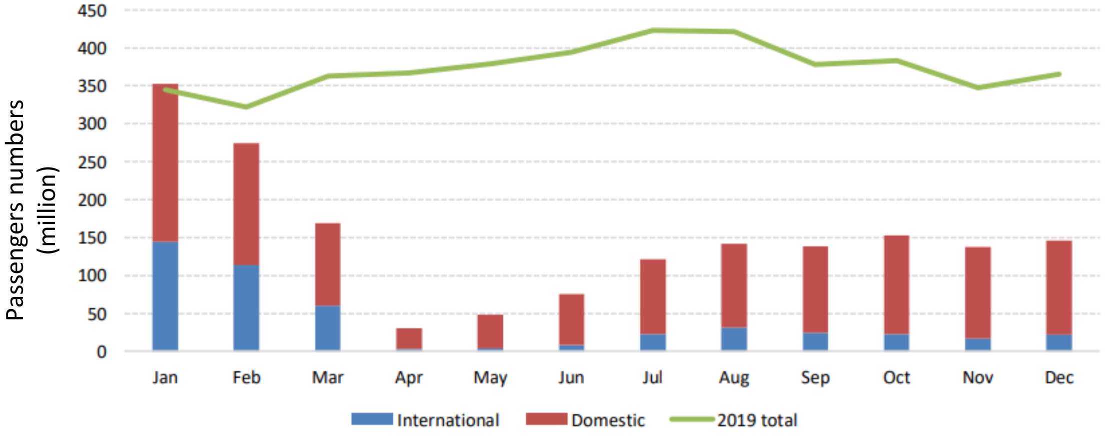
World passenger traffic evolution (1945 – 2020)



Source: ICAO Air Transport Reporting Form A and A-S plus ICAO estimates.

World passenger traffic declined by 60 percent in 2020 compared to the previous year, according to ICAO **(2)**. There was a $371 billion loss of gross passenger operating revenues of airlines over 2020. Between January and June 2021, the pandemic is expected to lead a reduction of 1.19 billion to 1.37bn passengers (between 55 percent to 63 percent less compared to 2019) and between a $166bn to $190bn loss of gross passenger operating revenues.

Monthly passenger numbers in 2020 vs. 2019



Source: ICAO estimates.

As a result, airlines have had to rethink their fleets and financing strategies, and many have turned to governments for financial support. As well as renegotiating lease and financing terms, carriers have had to strike the right balance between filling seats and ensuring flights are COVID-secure. The requirement of presenting a negative COVID-19 test before long-haul flights has led to some passengers travelling again, but most remain cautious.

2021 will also be a tough year, but some recovery is expected, with many countries beginning ambitious national vaccination programmes at the end of 2020 and start of this year. Effective COVID-19 vaccines will be the main driver of recovery in the travel sector in the short-term. The main challenge is being able to vaccinate the majority of the global population quickly enough to achieve some degree of herd immunity, and having vaccines that are effective. Global mass vaccination is unlikely to occur globally in the first half of this year, so carriers in many countries will see at least a double peak season revenue loss.

Liquidity looking for a home

Despite this difficult period, high numbers of investors are reviewing the aviation asset class, looking to find value in distressed assets. During the pandemic, some of the traditional aviation lenders are vacating the market while others have been repricing transactions more conservatively. However, there is a wall of liquidity looking to be deployed, which has been evidenced by the stock markets surging amid the pandemic, investors thinking about increasing their aviation exposure or invest in the industry for the first time.

The U.S. stock market began rebounding quickly in March last year, although the recovery was a choppy one. By the end of 2020, markets had recovered and the S&P 500 had returned more than 12 percent. The tech-heavy Nasdaq soared to returns of over 40 percent. The recovery has been fuelled by expectations of a period of strong growth after COVID-19 vaccines are widely distributed when the economy re-opens. Central banks have enforced policies of quantitative easing to keep the capital flowing.

What form will this recovery take?

In the short-term, the recovery of the industry is entirely dependent on the development of a coronavirus vaccine and the easing of travel restrictions. Air traffic is most affected by travel restrictions and in the best-case scenario, will take until 2024 to recover to 2019 levels, according to IATA **(3)**. This recovery will be a year later than previously projected.

The sector is likely to see a patchy recovery, with domestic travel recovering first, followed by short-haul leisure and then long-haul and business travel. The freighter market has stood strong through the pandemic as it delivers essential items, such as food and medical equipment.

However, aviation is a cyclical industry, and due to a growing propensity to travel, it has been able to recover from previous global shocks. It took more than three years for U.S. passenger numbers and operating revenues to recover after the 9/11 attacks in 2001, according to the ICAO. It took another three years for passenger numbers to recover from the 2008 global financial crisis coupled with oil that was $100 or more. However, recovery was strong, as traffic remained resilient and passenger numbers have continued to rise as flying has become more affordable and the middle-class population has grown.

Where will the long-term growth come from?

Growing income levels in emerging markets have been driving higher air travel volumes. Many of the markets that have propelled this growth are in Asia, where the middle class is on the rise. An estimated 2 billion Asians are members of the middle class in 2020, accounting for 54 percent of the global share, according to the Brookings Institution **(4)**. By 2030, the number could rise to 3.5 billion, or 65 percent of the global share. China and India are expected to become two of the largest global markets due to the stimulation of new traffic and increased accessibility. Since the turn of the millennium, China's commercial jet fleet has expanded sevenfold, and approximately 25 percent of all aviation growth worldwide in the last decade has come from China **(5)**. In its China outlook released in November, Boeing predicted this trend to continue despite the pandemic. The US OEM forecasts China's annual passenger traffic growth to be 5.5 percent over the next 20 years. Unlike other parts of the world, the end of 2020 saw a recovery in China's domestic market, which returned to pre-pandemic levels in November **(6)**. Other highly populated emerging economies, such as Indonesia and Vietnam, will also spur future growth. With its fast-rising population, Africa is also expected to be a significant source of global growth. Boeing forecasts the continent's air traffic to grow by 5.5 percent between 2019 and 2039.

Current market dynamics

Most of the top tier lessors focus on new technology aircraft. Six out of 10 of the major lessors are owned by Chinese or Japanese investors who view aviation as a strategic, long-term investment **(7)**. The other large lessors are seeking to maintain investment-grade ratings, which requires a young portfolio age and high diversity of strong-credit lessees and assets. For those lessors, the focus has been and will remain on leasing new technology aircraft to Tier 1 airlines.

Throughout the COVID-19 crisis, the top credit carriers have continued to execute transactions at unlevered returns in the area of below 4 percent per annum (i.e. EasyJet, Wizz Air, Southwest). An encouraging development in the last quarter of 2020 was the return of airline issuers in currencies other than USD and CNY to the unsecured bond market, with nearly half of all the year's issuances in other currencies taking place over the last three months of 2020. The appetite remains among investors outside China and North America for airline debt, particularly credits that have are able to receive government backing.

There have been a few notable aviation bankruptcies over the last few months due to large drop in traffic, perhaps the most significant being China's HNA Group on January 31. It owns and has investments in several airlines, its most notable being Hainan Airlines. It also owns 46 percent of Bohai Leasing, the majority owner the leasing company Avolon.

Where are the investment opportunities in 2021?

As we start out 2021, we are beginning to see opportunities outside of the new aircraft segment of the market, which has traditionally been the most competitive segment for investors.

Falling asset values

The current downturn in aircraft values will present an attractive entry point for new capital. Our understanding is opportunities will exist to achieve strong risk-adjusted returns through investing in mid-life narrow body aircraft, specifically young (five to ten-year-old) assets from lessors which are no longer core to their portfolios. Other opportunities can be found in sale and leasebacks with solid Tier 2 airlines using unencumbered assets to raise cash.

Aircraft values took a hit during previous downturns and values likely still have further to fall in this crisis. There is often a value 'lag' – book values can often take between 12 and 24 months to fully reflect the impact of a downturn.

ABS and other portfolio sales

There may be other opportunities to acquire older aircraft from distressed sellers through Asset-Back Securitization (ABS) or other portfolio sales. The dominant buyer of mid-life aircraft over the last five years was the ABS market and the industry saw a record number of deals in 2019. The market is now relatively closed and will remain so until the industry begins to recover from the pandemic. The risks have been heightened, due to airlines not paying leases amid the pandemic, high tail concentration risk in ABS transactions, inter alia. Consequentially, ratings agencies have put ABS debt on negative watch and most debt tranches are expected to be downgraded. Kroll Bond Rating Agency reported in September (7) that it had downgraded 81 aviation ABS transactions as a result of the coronavirus crisis. Fitch meanwhile said in October **(8)** that out of the 86 ABS tranches in its portfolio, the agency downgraded 32 across 13 deals and affirmed 54 in 21 deals that year. When some of the ABS notes are downgraded from investment grade to non-investment grade, there will be an increase in number of forced sellers and there are some investors that will take advantage of that.

There have been some signs that the market will return in 2021, albeit in a slightly different form. The ABS market often closes in previous downturns but the first aviation ABS deal of the year was signed in January, raising $595 million. There was significant investor appetite, with the deal being 11 times oversubscribed and the transaction's average weighted yield was 4.15 percent. In that transaction, there were changes made compared to pre-pandemic ABS – such as increases in protections for buyers, many of whom are lured in by the higher spreads.

Until the market fully recovers, ABS deals will consist of stronger airlines credits, lower LTVs, with a focus on just senior A and B debt tranches and such deals will likely only open to experienced servicers.

ABS transactions can also offer investors the opportunity to purchase the E-notes or equity, so that they take on residual risk in the underlying assets. Often the equity is held by the sponsoring operating lessor or asset manager, but non-lessor investors can also hold the E-notes. Gone are

the days where E-note investors could see 20%+ returns, with appraisal valuations for aircraft being extremely high.

Other mid-life opportunities

There are other opportunities for investors in the mid-life space outside ABS deals. Access to non-government capital for non-Tier 1 airlines is currently very challenging and that will provide opportunities for investors looking for higher yields.

The flood of aircraft coming back off lease in the coming months will also present opportunities. ABL Aviation predicts there will be a capital vacuum for Tier 1 airlines for narrow body aircraft of five to 15 years old in the coming years, providing compelling investment opportunities. For example, shorter-term leases at lower prices have become more common during the pandemic. Aircraft may need to be repossessed if lessees fail to pay their lease rentals. ABL Aviation has expertise in repossessions, and has successfully taken back 12 aircraft and has delivered 36. ABL's in-house technical team is able to help investors maximise value through active lease management, transition or repossession management, and consistent engagement with our lessees.

Investing in lessors

Through the public health crisis, investors have continued to value lessors highly, with at least five operating lessors/asset managers having hired banks to advise on equity. The large lessors are still able to access liquidity through the unsecured bond markets. At least seven leasing companies raised a combined $14.9 billion in January, according to Deologic.

There have also been a few new players that have emerged in the leasing space, which also provide investment opportunities. For example, KLA Aviation Finance, a new lessor established in January, will be funded with $1.5bn in equity and will engage in acquiring young, new generation and single-aisle aircraft. Kennedy Lewis will provide the equity financing for KLA, while Arena Aviation Capital will source the transactions and provide lease servicing and asset management services.

ABL's view –

"Due to the long-term growth fundamentals of the aviation industry, investing in new assets remains highly competitive. Although higher risk, in the current downturn, investors looking for high returns will find great opportunities in the mid-life space, particularly in aircraft between 5 and 15-years old."

Ali Ben Lmadani, CEO ABL Aviation

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