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Globally listed airlines' demand uncertainty and piles of debt mean a long road to recovery

by Anna Sophie Wupper

The airline industry is one of the most severely affected industries in this Covid-19 crisis and is expected to lose a record of USD 84bn this year, which is more than three times higher than the losses it sustained during the last financial crisis. However, after publishing our last Weekly Credit Brief on this topic in March, the overall situation of the global markets improved and the airline industry can breathe a small sigh of relief since international shutdowns and lockdowns are eased, some borders reopened, and flights are set to resume again step-by-step. This leads to the general expectation that the industry will be soon on the road to recovery. Nonetheless, the large amount of debt that the industry took on to survive the crisis and uncertainty in future demand could hinder globally listed airlines' recovery.

April marked a turning point for air travel in the current crisis as business confidence edged up in key economies and the increase in number of flights (though still down by 73% since the beginning of the year) suggests that the lowest point was already reached for the industry. This improvement is in line with the industry's credit profile (see Figure 1), which shows the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of publicly listed airlines worldwide. It was in March 2020 when the industry was hit the hardest as its Agg PD jumped from 46bps in the beginning of the month to 187bps only three weeks later. After the rapid deterioration of the industry and traffic falling by 94% in April 2020 as compared to April 2019, globally listed airlines now follow an overall path of improving credit profile with its current Agg PD amounting to 93bps.

Figure 1: NUS-CRI Agg PD of globally listed airlines, bounded by PDiR 2.0[1]. *Source: NUS-CRI.*

In order to survive through the pandemic, airlines accepted government support and turned to a variety of sources for funds. These actions mitigated the consequences of airlines burning through large amounts of money every day due to their relatively high share of fixed and semi-fixed costs with no corresponding streams of revenue. As in the case of German Lufthansa, government support in the form of a EUR 9bn bailout was

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

necessary to help with the company's severe financial stress. The comprehensive government support also includes taking a 20% stake in the company. In general, global government aid for airlines included different streams (see Figure 2a) with loans and wage subsidies accounting for the biggest chunk. However, USD 67bn of the total USD 123bn government aid will have to be repaid by the airlines. This includes loans provided directly by governments, loans provided by the private sector but guaranteed by governments, and the deferral of various tax payments. Repaying this debt is going to be a substantial burden on the industry and could lead to governments becoming more involved or further airline failures.

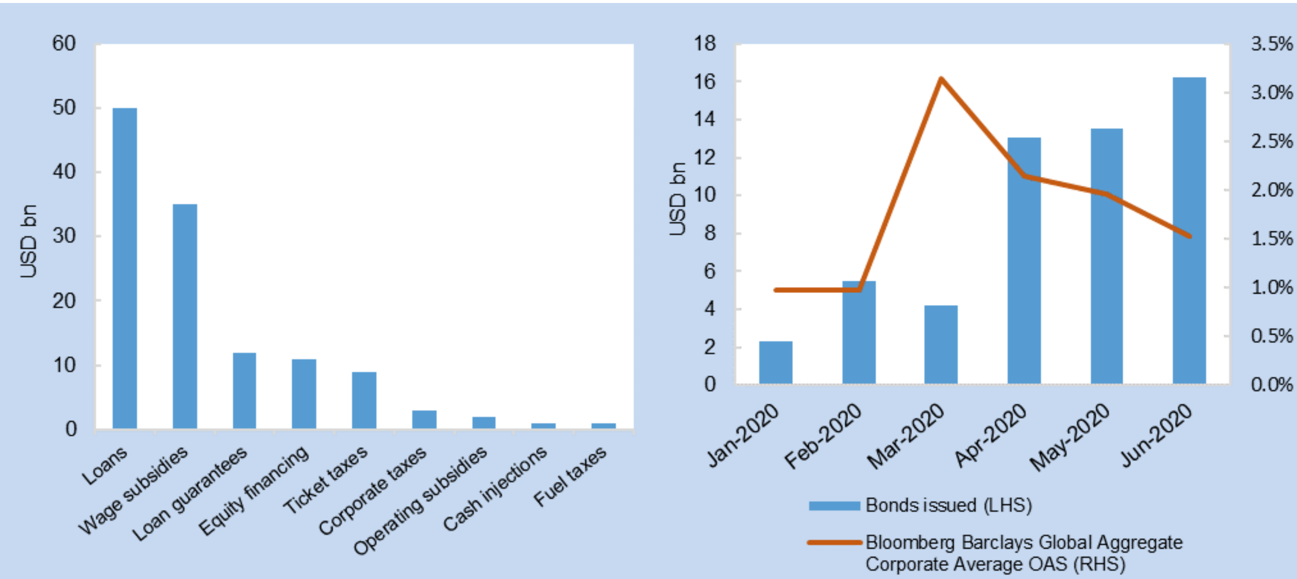

Figure 2a (LHS): Global government aid made available to airlines due to Covid-19. Figure 2b (RHS): Amount of bonds issued by globally listed airlines and Bloomberg Barclays Global Aggregate Corporate Average OAS. *Source: IATA, Bloomberg.*

Last quarter, globally listed airlines managed to issue a total of USD 42.8bn in bonds (see Figure 2b). The airlines' success in raising new debt might be influenced by the recovery of global markets. The Bloomberg Barclays Global Aggregate Corporate Average OAS, which measures the global aggregate corporate bond spread, showed a declining trend after peaking in March (see Figure 2b). For example, US airlines, accounting for half of global airline profits, were the largest issuers of debt. Recently, American Airlines and Alaska Airlines issued USD 3.5bn in bonds, which are backed by airplanes, routes, slots and gates across the globe and United Airlines raised USD 3.8bn in bonds, pledging member data and cash accounts of their frequent flyer program as collateral. Overall, the airline industry's net debt is estimated to increase from USD 430bn at the end of 2019 to USD 550bn by the end of 2020. These large amounts of debt and their repayments could prolong the recovery of the indebted airline industry (net debt to EBITDA of 4.6x in Q1 2020 as per Bloomberg) even though they helped them enormously to address their acute liquidity needs and sustain through the uncertain environment.

In addition to the large amounts of debt, demand uncertainty is a major factor affecting the airline industry. The airline industry's recovery depends on three key elements: the containment of the crisis, the loosening of travel restrictions and critically, the restoration of passenger confidence. While the first two elements cannot be influenced by the industry directly, airlines' measures can help to gain the confidence of their customers (e.g. aircraft staff wearing personal protective equipment as well as facilities being cleaned and sanitized regularly). Nevertheless, this will be a challenging task as many airline customers want to wait for six months or longer before resume travelling although the industry recovery is expected to begin in Q3 2020. Additionally, airlines have little visibility of demand for the next season beginning in Oct 2020 since passengers book their flights much later than usual (41% of customers only book a maximum of three days ahead). Under normal circumstances, airlines would have already sold about 14% of their tickets for the next season by now, but this demand is 59% lower this year. This elevated level of uncertainty for the airlines' revenue streams caused by customer behaviour entails difficulties for the corporates to plan ahead.

Next year, airlines will most likely still have to deal with the direct consequences of the Covid-19 crisis. Like in the last financial crisis, industrywide losses are expected to extend into the next year as well. This is in line with the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) of globally listed airlines (see Figure 3), which shows a deterioration of the credit profile by a manageable 31bps until Mar 2021. However, the losses in 2021 are expected to moderate to an estimated USD 16bn as revenues are set to increase and EBIT margin is estimated to improve from -23.4% to -4.2%. During this time, the airlines' ability to adapt to the new normal is critical to counteract the uncertainty within the industry. From Q2 2021, the Forward PD shows an improving trend. Nevertheless, hampered by the large piles of debt and the high level of uncertainty within the industry, airlines have a long road to recovery ahead.

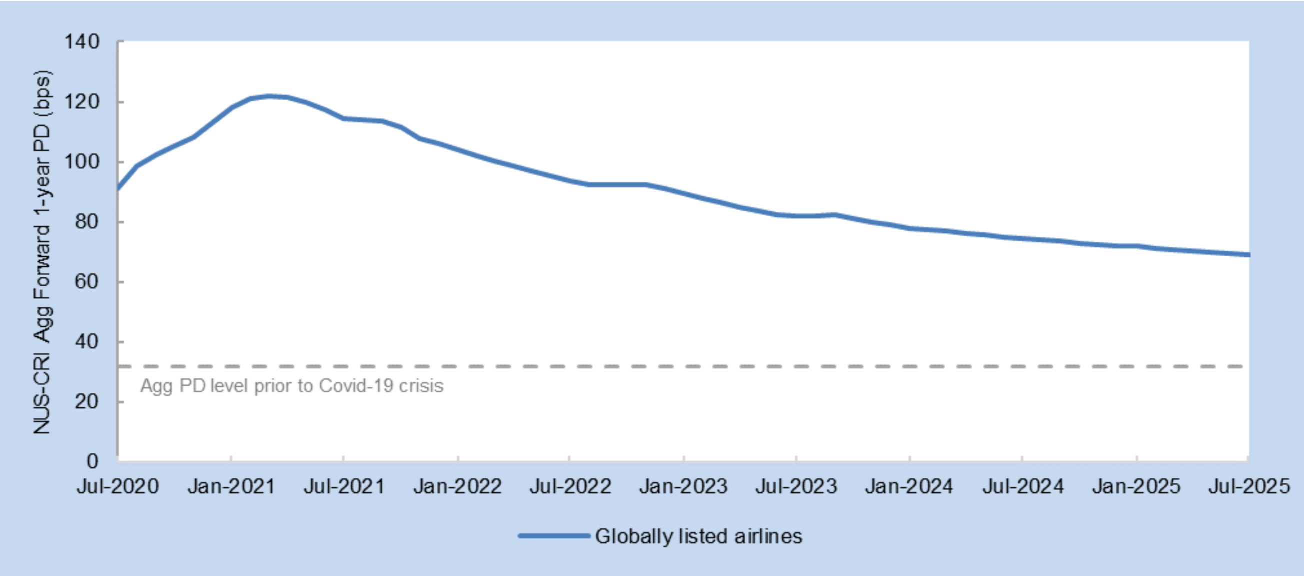

Figure 3: NUS-CRI Aggregate Forward 1-year PD of globally listed airlines. *Source: NUS-CRI.*

Credit News
Fed stress tests predict European banks' high rate of loan losses **Jul 5**. The Federal Reserve expects European banks to suffer the sharpest losses in key sectors hit by the pandemic. The annual stress tests predict HSBC and Santander to experience the largest losses in their credit cards and consumer lending in the US markets. Specifically, HSBC's US credit card business would suffer losses of 26.4% of its total loan balance in the crisis while Santander's loan losses accumulated to USD 8.6bn across its US book. Meanwhile, Credit Suisse and Barclays are predicted to have the highest loan loss rates in the commercial real estate and commercial loans, highlighting increased lending risks. Deutsche Bank is also expected to burn through 780 basis points of high-quality equity, the highest out of all the other banks. Compared to US banks, European banks have weaker knowledge of the US markets and hence are greatly disadvantaged. (FT)
Junk bond funds see biggest withdrawals since March **Jul 3.** Last week, junk bond funds saw a USD 3.4bn withdrawal, which broke a 13-week streak of inflows and marked the biggest weekly outflow since the middle of March. Investors attributed the exodus to rising concern over the US economic outlook as cases of Covid-19 started to mount again, coupled with an eager-ness to secure profits after a ferocious rally sparked by Fed's historic intervention. Furthermore, the record

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

amount of debt issued by high-yield rated companies in June could also play a part in the recent weakness of the bond sales as the markets got fatigued after an overtly successful month. (FT)

Coronavirus surge strains municipal bond market, but investors still pile in

Jul 2. The global pandemic has resulted in a systematic shut down of economic activities. The sudden drop or cut off in firms' revenue streams have brought about issues with liquidity and insolvency. Of late, many municipal borrowers in the United States are facing financial strains and risks of defaults. May and June 2020 saw all-time highs of municipal bond defaults since 2012. Nevertheless, investors remained optimistic. Given the recovery since March, many investors remain on the hunt for yield. Refinitiv noted that more than a third of the initial withdrawal in late March has returned to the muni mutual funds since mid-May. However, the risks of debt are not limited to default. A credit downgrade to junk can result in a 25% drop in market value. The debt market has been through a rather turbulent period as the high yield muni funds saw an 11 weeks outflow of USD 14bn since March. (WSJ)

Speciality lenders face funding challenge as Covid-19 boosts defaults

Jul 1. Companies that are specializing in lending to midsize businesses are facing funding squeeze amid the pandemic. The two prominent specialty lending companies, Bain Capital Specialty Finance and Golub Capital BDC, have both completed stock sales at significant discounts to their net asset values to raise money. In stressed environments, middle-market lending companies could see their borrowing limit cut or even face additional demand for collateral from banks if their assets lose value. To make matters even worse, their own portfolio companies could rush to draw down credit lines, thus squeezing the lenders from both ends. (WSJ)

Rise in Covid-19 bond issuance fans fears over 'social washing'

Jun 30. Analysts in the sustainable investment sector warn the market of "social washing", as firms and governments have issued a huge amount of social bonds since the Covid-19 began. According to some analysts, the social segment of the market, which is based on environmental, social and governance (ESG) principles, is at an early stage of its development and is still light on rules about how to structure the products and measure results. This vagueness makes it very difficult to track the proceeds and decide whether the money will be put to socially useful ends. (FT)

McLaren averts court battle after striking deal with bondholders (FT)

Wirecard bonds set to join infamous 'no coupon' club (FT)

Thyssenkrupp backers improve EUR 7.6bn debt terms after lenders balk (FT)

Regulatory Updates

Indonesia considers putting banking regulation under central bank

Jul 2. Historically, Bank Indonesia (BI) assumed the role of the gatekeeper for financial institutes in Indonesia. By the end of 2013, however, BI was replaced by the Financial Services Authority (OJK). Covid-19 proved to be a test of OJK as a financial regulator. Earlier this year, Indonesia's supreme audit board managed to highlight the loopholes in OJK's oversight of seven banks which it claimed to show OJK's supervisory role to be "weak". In light of OJK's less than satisfactory performance, the president is looking into the possibility of reverting to the old model under the BI. (Reuters)

Pandemic must not stop move to scrap Libor, say regulators

Jul 1. Despite the disruptions in the markets caused by the pandemic, the Financial Stability Board stressed that banks must not stop ending their use of Libor by the end of 2021. As the ability of Libor's measurement is already not enough to reflect the underlying markets, the unresolved status of Libor transition issues has made manageable problems like inadequate hedging more material and make it difficult to quantify risks. Although officials are pushing to drop Libor, some such as those in the US still use Libor for its recently USD 600bn Main Street Lending Program. (Reuters)

China central bank makes biggest weekly cash drain via OMO since February (Reuters)

Swedish central bank boosts QE programme to fight pandemic downturn (Reuters)

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