



Air France-KLM faces strong headwinds amid high leverage

by [Liu Hanlei](#)

The share price of Air France-KLM airline group has fallen by 43% since the start of 2018, bringing its market capitalization close to EUR 3.2bn. Facing a competitive European airspace and labor strikes due to pay dispute with staff unions, Air France-KLM's financial performance weakens as it reported an [operating loss of EUR 118mn for Q1 2018](#). The poor operating performance is further dragged down by Air France-KLM's high leverage. Air France-KLM's vulnerable credit outlook can be represented based on Figure 1 below.

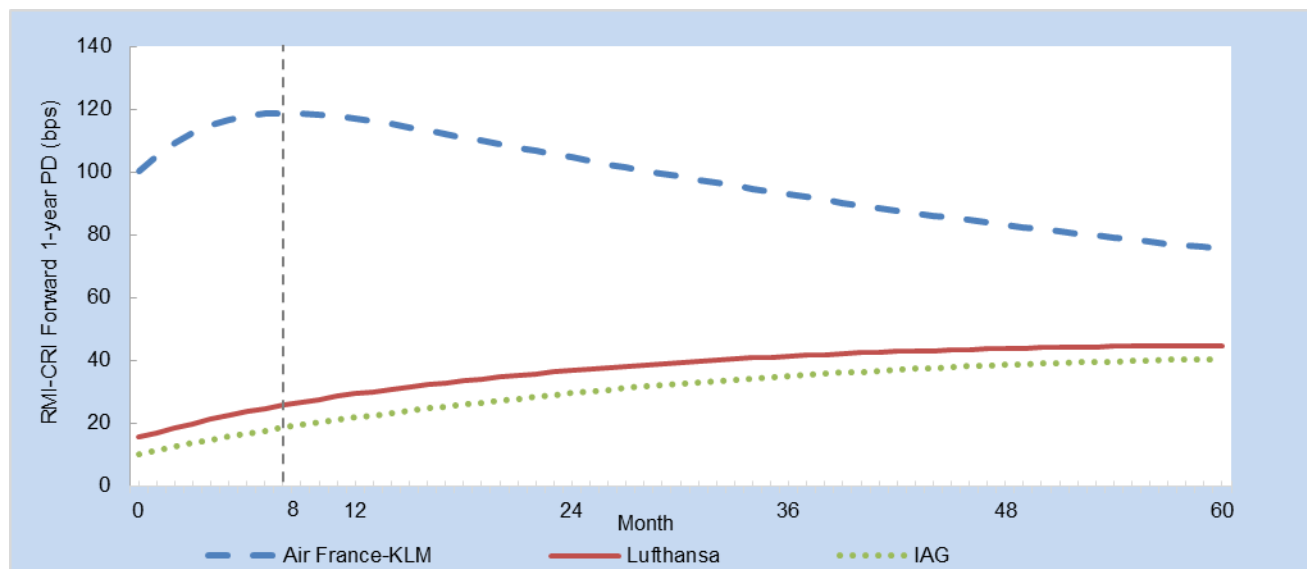


Figure 1: RMI-CRI Forward 1-year PD term structures for Air France-KLM, Deutsche Lufthansa AG and IAG SA on May 11, 2018. Source: RMI-CRI

Figure 1 exhibits the term structures of the RMI-CRI Forward 1-year Probability of Default (Forward PD) for three airline groups, Air France-KLM, Lufthansa and IAG, which is the parent company of British Airways, are shown. The starting point of the curve, month 0, represents the current RMI-CRI 1-year PD. The PD shows that Air France-KLM's credit profile is worse than the credit profiles of the two displayed competitors. In addition, the shape of the term structure shows that, based on the market information on May 11, 2018, the credit profile for Air France-KLM could deteriorate in the following 8 months. The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 8-month Forward 1-year PD is the probability that the firm defaults during the period from 8 months onwards to 1 year plus 8 months, conditional on the firm's survival in the next 8 months.

The poor credit outlook exhibited by Air France-KLM can be partly attributed to its high leverage. Air France-KLM's leverage is the highest among the three airline companies. Net debt including capital lease capitalization to equity stands at a high of 270.7% for Air France-KLM while Lufthansa is at 24.8% as of Q1 2018 and IAG stands at 8.9% as of Q4 2017. EBITDA to interest expense for Air France-KLM is also the lowest at 5.04x compared to Lufthansa at 9.4x and IAG at 23.9x as of Q1 2018. This huge difference in leverage and some further ongoing challenges may account for Air France-KLM's relatively higher credit risk.

One of the challenges that Air France-KLM is facing is the strong competition in the European airspace. In 2017, Europe had seen three airlines, Monarch, Air Berlin and Alitalia, filed for bankruptcy. According to OAG, a company that specializes in air travel data, there are 217 airlines operating in Europe as of 2017, making Europe the region in the world with the highest number of operating airlines. [Low cost airlines have been gaining market share](#), measured based on all scheduled airline capacity in Western Europe, as they grew from 9% in 2002 to 43% in 2017 by focusing on cheap fares. Based on market share of total seats, two low cost carriers, Ryanair

and EasyJet, occupied the top two spots with a total of 22% market share while Lufthansa and British Airways only have a combined market share of 10%. The competitive environment has weakened Air France-KLM's operating margin over the past quarters and it has been the lowest among its competitors, Lufthansa and IAG (see Figure 2a below).

Another operating metric used by the airline industry is the spread between the load factor and the breakeven load factor. The breakeven load factor is defined as the load factor at which the airline's passenger revenue will breakeven with the operating expenses and the load factor itself measures the utilization of the airline's passenger capacity. Therefore a positive spread between load factor and breakeven load factor contributes to excess revenue above the airline's operating costs. From Figure 2b, Air France-KLM's spread works out to be negative most of the quarters and the lowest among its peers throughout the period.

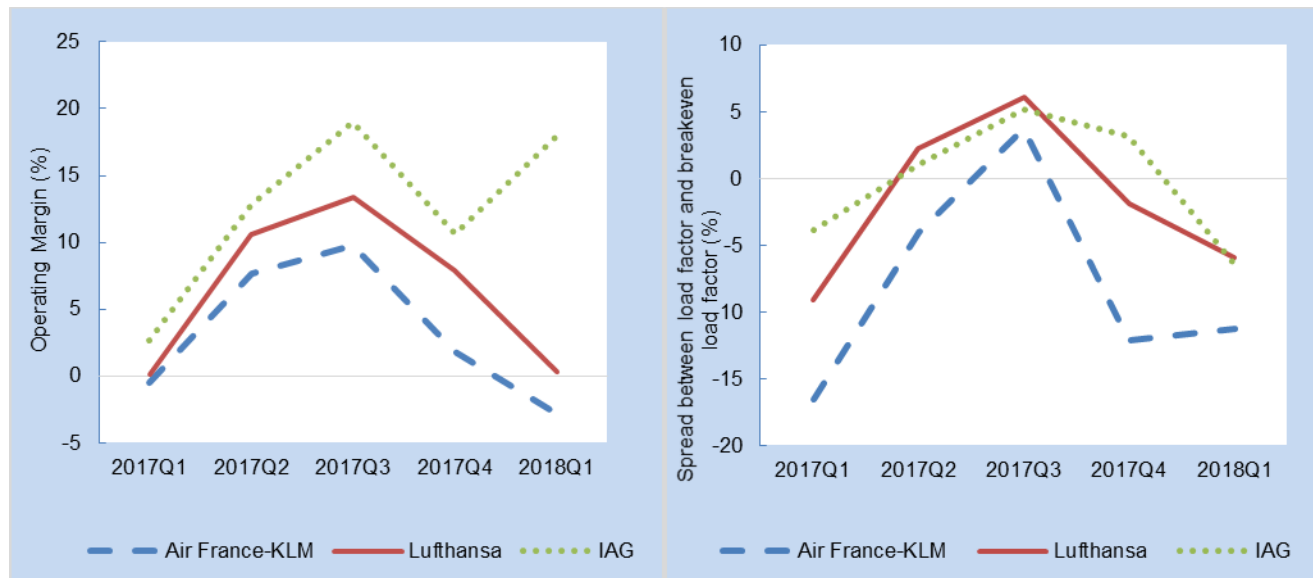


Figure 2a and 2b: Operating margin and spread between load factor and breakeven load factor for Air France-KLM, Deutsche Lufthansa AG and IAG SA. Source: Bloomberg, Company filings, RMI-CRI estimation

The lower margins and load factor spread put the highly leveraged Air France-KLM in a tight spot when crisis such as a surge in jet fuel prices, pandemics or terrorist events occur that negatively affects the airline industry. Currently, Air France-KLM faces a pay dispute between management and the staff union which resulted in [15 days of labor strikes](#) since February 2018. The series of strikes has cost the airline about EUR 300mn and the management has warned that profits for 2018 are expected to be much worse than 2017. The Air France-KLM [CEO resigned](#) after staff rejected a final pay offer of a staggered 7% pay rise over four years with 2% in 2018 and further increases dependent on the airline's financial performance. The unions however wanted a bigger upfront percentage and future raises in salary without any condition attached. This immediate pay rise may not be viable as Air France-KLM incurred operating losses in the latest quarter and weak operating profits for the recent past quarters.

Another potential problem could be the rise in fuel jet prices which have increased close to 50% to USD 720 per metric ton as of 1 year ago. Despite Air France-KLM [hedging 60% of its fuel price](#) at USD 574 per metric ton as of Q1 2018, it still forecast 2018's fuel bill size to increase by EUR 350mn which may pressure margins further.

In order to defend its market share in this competitive environment, Air France-KLM plans to accelerate capacity. It plans to boost seating by 4% in a bid to challenge low cost carriers such as Ryanair, which have targeted to open at least two French hubs and ten new routes from France in 2018. However, expanding capacity represent only one facet as Air France-KLM still faces weak margins, tough competition and financial losses caused by labor strikes. These challenges do not put Air France-KLM in good stead as it is further burdened by the huge leverage as compared to its peers.

Credit News

China's private firms default on USD 2bn bond repayments as Beijing's deleveraging efforts bite

May 14. As profits fall and financing costs rise, China's private sector firms are facing a debt crisis with the value of bond defaults in the sector rising by more than a third in the first four months of the year. According to China Central Depository and Clearing Company, more than 10 companies, with a few of them listed companies, have defaulted on 15 bonds worth more than CNY 12.8bn. In 2017, bond defaults amounted to CNY 38.4bn, more than three times the value in 2015. Analysts are predicting more bond defaults as China's financial regulators are committed to deleverage the financial system, making it harder for companies to get financing. ([SCMP](#))

Takeda smashes Asian loan record

May 14. Takeda Pharmaceutical is issuing a USD 30.85bn loan to finance the Shire plc acquisition, which could make it the largest ever deal in Asia. The loans are expected to be priced in line with the firm's existing bonds that are rated A2 by Moody's Investors Services. Takeda's debt will increase six times after the acquisition but management expects cash flows from the merged entity to improve significantly to enable the combined entity to pay down its borrowings. ([Reuters](#))

Boom in green bonds attracts green rating agencies

May 14. More scrutiny is needed for companies involved in the credit rating of green bonds, as the green bond market is expanding rapidly. In the first quarter of 2018, sales of green bonds rose 9.4% YoY to USD 29.6bn, according to data from law firm Linklaters. Credit rating agencies do not have to abide any particular rules in environmental finance. There are potential conflicts of interest between issuers and rating agencies because the assessment fees for green bonds are paid by the issuer of the bond. These conflicts of interest may not apply to non-profit rating organizations but there are different interpretations of international guidelines among rating agencies. As more investors require a second opinion on green bonds, greater regulation on qualifications of rating agencies and regulations on writing credit opinions are expected. ([FT](#))

Iran faces banking turmoil after US nuclear deal exit

May 13. Conditions in the Iranian banking system had deteriorated over the past year as depositors cashed out their savings due to a loss of confidence. Banks are reluctant to issue loans as economic growth has stalled and unemployment reached a record high. Non-performing loans, according to estimates, could be as high as 15 percent of outstanding loans. Interbank transactions barely exceed USD 240mn every day and US sanctions are preventing foreign firms from doing business with Iranian companies. ([Gulf News](#))

Dana Gas strikes restructuring deal to end sukuk dispute

May 13. UAE-based energy company Dana Gas has struck a restructuring deal with bondholders such as BlackRock and Goldman Sachs. In a year long dispute with creditors over the repayment of a USD 700mn sukuk, a type of Islamic bond, Dana Gas had argued that it would be unlawful to pay as the debt was not compliant with sharia law. On May 13, Dana announced that it has reached an agreement with holders of over the half of the 'exchangeable' sukuk and 30 percent of the 'ordinary' sukuk. The company expects to complete negotiations with the remaining stakeholders by July this year. ([FT](#))

Egypt's sovereign rating raised by S&P on economic revival ([Bloomberg](#))

Record high Japan government debt of nearly USD 10tn ([NHK](#))

African growth picks up but debt a concern, says IMF ([Business Times](#))

Regulatory Updates

HKMA poised to launch HKD 150mn pilot bond scheme

May 10. The Hong Kong Monetary Authority (HKMA) says it will launch a HKD 150mn pilot bond grant scheme (PBGS) aimed at boosting the city's competitiveness in the financial services industry and raising its share of the Asian bond market. In 2017, Hong Kong issued USD 467bn of bonds denominated in various currencies including the US dollar, Euro, Yen and Hong Kong Dollar, which accounted for 10% of Asia's total issuance volume, according to data from the Asian Development Bank. First-time issuers and the issuers that have not sold any bond in Hong Kong during the last five years are eligible for the bond grant scheme. Bond issuers or guarantors with a credit rating will be granted half of the arranger's fee, capped at a maximum of HKD 2.5mn. Issuers without a credit rating will be granted up to HKD 1.25mn. ([SCMP](#))

Chinese firms slow to reduce share-backed loans despite regulator crackdown

May 10. More than 100 Chinese firms have used their shares as collateral to finance company operations, despite efforts by regulators to curb such practices. A Reuters study showed 131 listed companies with a combined market capitalization of USD 320bn breached regulatory limits by pledging more than 50 percent of their shares in exchange for loans. These large share pledges could destabilize equity markets as lenders may be forced to liquidate their holdings if borrowers are unable to meet margin calls. Regulators are concerned that the market may be susceptible to large unexplained price moves, especially in shares of small, thinly traded firms. ([Reuters](#))

Rwanda central bank rolls out Basel III liquidity measurement regime ([Proshare](#))

China's stock exchanges tighten supervision on booming ABS market ([Reuters](#))

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