Recovering credit profile of global airlines set to potentially upend due to recessionary headwinds

By Amrita Parab

- **NUS-CRI Agg PD for global airlines improves on the back of demand recovery and higher fares, as forecasts suggest double profit for 2023**
- **NUS-CRI Forward PD breakdown by region suggests that recessionary fears, amidst higher servicing costs and supply chain challenges, may stall recovery and worsen the credit risk outlook for the sector, especially in North America**

The International Air Transport Association (IATA) recently doubled its 2023 profit forecast for the global airline industry[1]. A rebound in demand for leisure travel has also led to an improvement in the industry's fundamentals, signaling the recovery in the credit profile of global airlines from the beginning of the pandemic era. As such, the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) of the global airline industry has steadily decreased since the last quarter of 2022, dipping below the BB+ upper bound when proxied by PDiR2.0[2] bounds. However, looking ahead, the NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD)[3] for the global airline industry indicates a deterioration in the credit risk outlook for the industry amidst global recessionary pressures, higher refinancing costs, as well as constraints on capacity expansion resulting from delays in aircraft deliveries from manufacturers such as Airbus and Boeing which are currently dealing with supply chain issues.

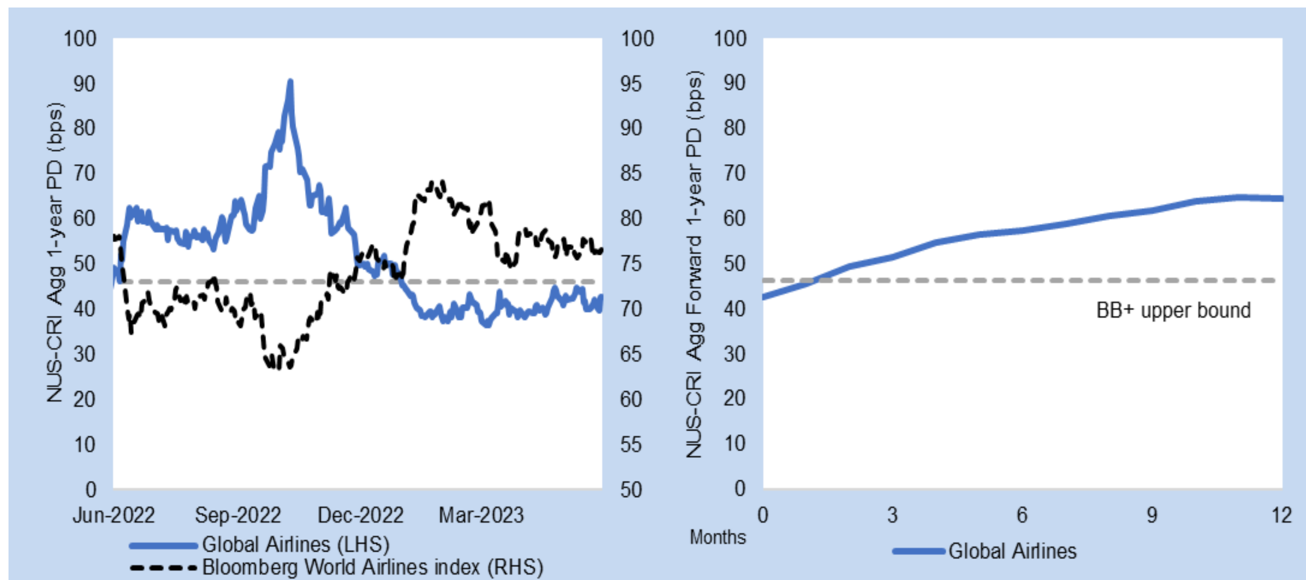

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for global airlines from Jun-2022 to May-2023, with reference to PDiR2.0 bounds; Index value of the Bloomberg World Airlines Index. Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for global airlines as of May-2023 with reference to PDiR2.0 bounds. *Source: NUS-CRI, Bloomberg*

The global airline industry's 2023 revenues are expected to reach USD 803bn, while its 2023 net profit is expected to jump to USD 9.8bn. These expectations are buoyed by a strong recovery in travel demand and a

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[1] The global airline industry revenues are expected to reach USD 803 billion in 2023 (+9.7% in 2022 and -4.1% in 2019), as the passenger demand bounced back with COVID-19 restrictions removed in most countries. Expenses are expected to grow at a slower pace than revenues to $781 billion (+8.1% in 2022 and -1.8% in 2019) mainly because of fuel price costs above the long-run average.

[2] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly 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 18 months – this is conditional on the firm's survival in the next 6 months.

reprieve in jet fuel costs. Although the profit margin is expected to remain at 1.2%, narrower than the 4.2% profit margin enjoyed by the industry during the pre-pandemic period, it does symbolize a path to recovery when compared to the average net profit margin of -11.3% seen during 2020-2022. Despite the improved revenue expectations, the worldwide revenue passenger kilometers (RPKs) metric for the industry is expected to remain at 87.8% of the level seen in 2019. The lagged recovery in RPKs is contributed by a slower recovery in the Asia Pacific (APAC) region. Although China's reopening significantly contributed to the rebound in travel in Q1 2023, the overall recovery in travel for APAC has lagged as compared to other regions, remaining at 74.2% of levels seen in 2019.

Concurrently, travel has almost completely recovered to pre-pandemic levels in North America, denoting that recovery for the global sector depends on travel recovery trends in the rest of the world, specifically APAC and Europe where RPKs lag by 25.8% and 12.2% respectively as compared to pre-pandemic levels. Additionally, the airline industry is witnessing a decrease in cargo revenues, which had previously surged during the pandemic as global exports and demand for consumer goods increased. Surging inflation amidst recessionary pressures is set to weigh on consumer demand, and as such, cargo revenue forecasts have been lowered to USD 142.3bn in 2023, approximately 28% lower than 2022 cargo revenue, however remaining above pre-pandemic levels. Costs to service and operate airlines have also increased. Jet fuel costs increased substantially in 2022, with the price of jet fuel witnessing a 75% jump. However, as travel rebounded and as oil prices declined, airlines are better placed to manage the increased expenses as they are able to pass on the increased costs to passengers.

The global airline industry, which went on a debt binge during the pandemic may now be looking to reduce its debt burden as it returns to profitability. Higher cost of refinancing driven by multiple interest rate hikes undertaken by global central banks may prove to be another driver which may push airlines to deleverage rather than refinance. Bond issuances by the industry are already trending down, with issuances in H1 2023 at USD 3.8mn as compared to USD 5.3mn in H1 2022 (and well below the debt binge undertaken by the industry in 2020) (see Figure 2a). Although improved profitability has placed airlines in a more favorable position with respect to their debt serviceability[4], the rising borrowing costs may have already added to the industry's debt burden as 37%[5] of its total outstanding debt is priced at a floating rate. Additionally, approximately 35%[6] of the industry's total outstanding debt is expected to mature over the next two years, exposing the industry to the prospect of refinancing existing debt at higher costs. Some airlines, such as American Airlines and Delta, have already embarked on a deleveraging exercise in an attempt to reduce debt service costs.

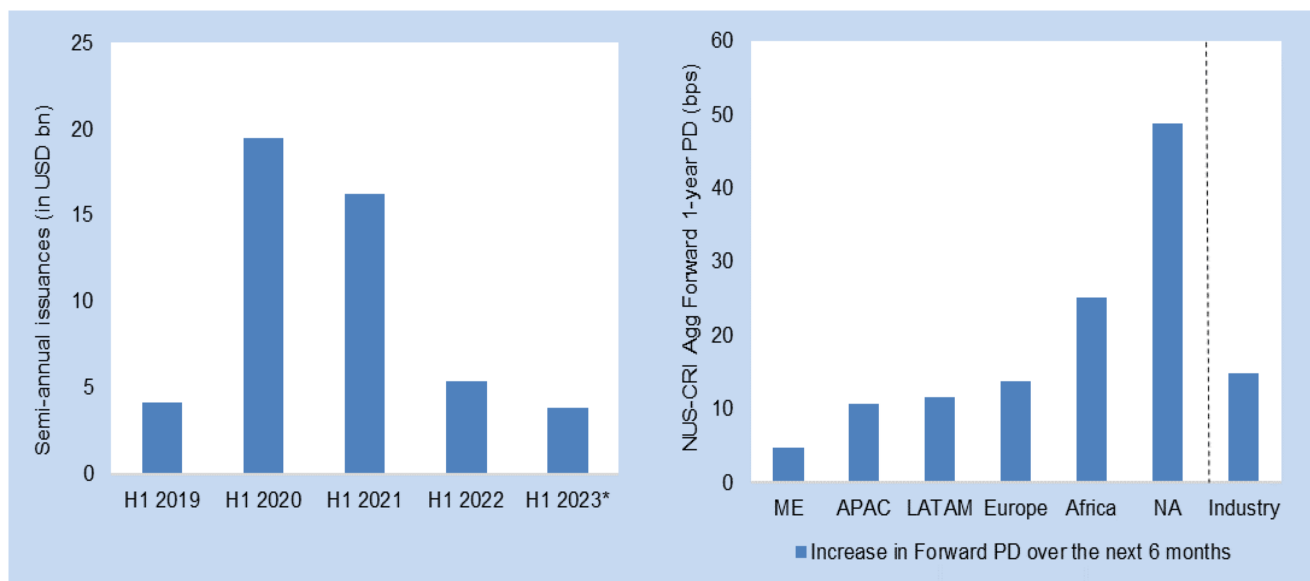

Figure 2a (LHS): Total debt issuances (in USD bn) by companies in the sample. Figure 2b (RHS): Change in Forward PD in the next 6 months for different regions. *Source: Bloomberg*

Another factor that may pose a risk to the industry is the backlog in aircraft deliveries which may delay capacity expansion and limit the industry's ability to capitalize on the rebound in demand. Aircraft and parts suppliers are currently plagued with supply chain issues which have been increasing costs, and slowing production, maintenance, and repair.[7] These disruptions increase costs for airlines as they lose revenue on grounded

[4] The median interest coverage ratio for the companies in our sample stood at 3.18x in Q1 2023 as compared to 0.13x in Q1 2022.
[5] Data from Bloomberg.
[6] Data from Bloomberg.
[7] In addition to creating delays that may stretch to half a decade, supply chain issues are also affecting the current airline fleet as planes may be grounded due to unprocurable parts for repair or maintenance.

planes, delay the retirement of older planes and incur higher expenses to procure parts, pressuring their profitability in the near future.

Looking ahead, the credit outlook for the airline industry may differ on a regional basis. Forward PD in Figure 2b indicates that North America-domiciled airlines may experience a higher deterioration in credit health, as in the face of the recessionary headwinds, the relatively higher indebted consumer may possibly be forced to curtail luxury and discretionary spending more severely than other regional counterparts. Although recessionary fears persist in Europe, the deterioration in the credit health of European airlines may be lower than their North-American counterparts due to their relatively lower household debt burden and also as the cost of living crisis in Europe seems to be ebbing with gas prices coming off their peak. APAC is expected to lead global sector recovery as travel continues to rebound, with any recession impact on the region to be potentially limited. On the other hand, the credit health of Middle Eastern airlines exhibits the least deterioration as the airlines, which turned a profit in 2022, have actively rebuilt international connectivity, supporting cash flow generation. Therefore, even though airlines have improved their credit risk profile as revenue rebounds, an uncertain recessionary environment that curtails this recovery amidst increased costs may drag on profitability amidst lower financing opportunities in the medium term, worsening the industry's credit outlook as shown in Figure 1b.

Credit News

Resilient US junk bond market baffles investors

Jun 01. Investors are puzzled by the resilience of the USD 1.4tn US junk bond market despite concerns about higher interest rates and an economic downturn. Yields have fallen and spreads over government debt have tightened, surprising investors who expected the market to suffer as a downturn hits earnings and interest rates rise. The limited supply of new borrowing has contributed to the market's strength, with companies taking advantage of low-interest rates during the height of the Covid-19 crisis to borrow cheaply and extend payment dates. Most of the recent bond sales have been used for refinancing rather than new fundraising, leading to a shrinking high-yield bond market. (FT)

Investors brace for new law on sovereign debt workouts

Jun 05. A law nearing approval in New York aims to compel commercial creditors, including bondholders, to provide the same relief as lender governments during the restructuring of sovereign debts in developing countries. Proponents argue that it would streamline debt workouts and prevent prolonged negotiations while stopping holdout creditors from pursuing lengthy lawsuits for preferential treatment. However, opponents claim that the bill would make it more costly for developing nations to raise funds and could lead to an influx of legal challenges. The progress of the bill is closely watched in the UK, where similar legislation is being considered. Critics highlight concerns about deterring investors and the potential for ambiguous terms to trigger litigation. (FT)

US banks prepare for losses in rush for commercial property exit

Jun 05. US banks are reportedly considering selling performing property loans at a discount, indicating their desire to reduce exposure to the commercial real estate market. Lenders are willing to accept losses on the true value of these loans due to concerns about the sector's stability given the recessionary pressures the sector faces. Many banks are also making changes to their accounting practices to facilitate the sale of commercial real estate debt, by changing their classification from Held-to-Maturity (HTM) to Available-for-Sale (AFS), increasing their liquidity. While the offloading of performing loans is not as widespread as during the 2008 crisis, market participants expect the volume of such deals to increase in the near future. Loans backed by office properties that have seen reduced demand due to the remote working trend are particularly raising eyebrows regarding the health of the commercial real estate sector. (FT)

Along China's Belt and Road, lenders' problem debt mounts

Jun 01. Chinese overseas loans have faced a higher default rate in recent years due to the COVID-19 pandemic and inflation's impact on emerging economies involved in the Belt and Road initiative. Debt renegotiations or write-offs reached USD 76.8bn from 2020 to 2022, more than four times the previous three-year period. Although the pandemic's first year, 2020, was the worst, 2022 still saw USD 9bn in debt renegotiations, nearly tripling the 2019 figure. This has slowed down the Belt and Road initiative, reducing investment to around USD 60-70bn annually since 2020. China's large foreign exchange reserves are tied up in lending to developing countries, posing financial risks. Italy, the only G7 participant, is considering distancing itself from the initiative, citing sluggish export growth to China. (FT)

ECB warns of hit to top European banks if funds run into trouble

May 30. The European Central Bank (ECB) has issued a warning about the possibility of adverse effects on the eurozone's major banks if their financial clients, including funds, insurers, and clearing houses, withdraw their deposits or encounter difficulties. In its study, the ECB examined the spillover risks between traditional banks and shadow banks, such as non-bank financial intermediaries. The study revealed that the risks were concentrated among the top 13 eurozone lenders, which include the eight globally significant banks. The primary concern highlighted was the potential withdrawal of funds by shadow banks, which could exacerbate funding pressures on traditional banks. The ECB, utilizing confidential data obtained as the main banking overseer, did not disclose specific firms in its report. (Reuters)

India's Adani Group completes $2.65 bln deleveraging program (Reuters)

Sunbelt construction boom threatens top apartment-building owners (WSJ)

Wall Street backs off bets on Fed rate cuts (WSJ)

Regulatory Updates

Big banks could face 20% boost to capital requirements

Jun 05. After the recent banking crisis, US regulators are likely to force large banks to increase their capital requirements by almost 20%. Large banks are likely to be heavily affected by increasing capital requirements due to their heavy reliance on fee-based income from their investment banking and wealth management divisions. It is also possible that this regulatory change might lead to an increase in consolidation within the industry for banks to remain competitive. It is also likely that banks with assets greater than USD 100bn, compared to the current threshold of USD 250bn, might be affected by the new set of toughest rules. The fallout of such an increase could potentially hamper credit extension in the economy, especially in those sectors that are likely to be affected by a potential recession. (WSJ)

Bank of England looks to broaden reform of deposit guarantee scheme

Jun 04. The Bank of England (BoE) is considering expanding its deposit guarantee scheme to provide better protection for depositors in smaller banks following the collapse of Silicon Valley Bank's UK arm in March. The existing regime faced criticism after UK customers were warned of potential losses and faced delays in accessing their funds, while US depositors had immediate access. The BoE's review initially focused on raising the insurance threshold and ensuring quick access to funds. However, officials are now proposing a broader review, including the use of the Financial Services Compensation Scheme (FSCS) to stabilize smaller banks and potentially provide capital to insolvent banks. The Treasury will further examine these long-term plans. (FT)

Sri Lanka unexpectedly cuts key rates by 250 basis points (Nikkei Asia)

Biden signs debt limit bill, avoiding US default (Nikkei Asia)

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