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US airline giants American Airlines and Southwest Airlines face differing credit outlooks

by Sean Lau Koon Leong

- **Delay in stimulus and emergence of third wave of COVID-19 threaten sector's already slow recovery**
- **Due to its lower sensitivity to business class demand and better debt management, Southwest Airlines has much better credit health than American Airlines**

In June, we wrote that the global airline industry was facing demand uncertainty and a long road to recovery. In this issue we will be comparing American Airlines versus Southwest Airlines since they have the highest and lowest credit risk in US airline the sector, respectively. The pandemic has affected air travel demand, causing revenue to plummet and forcing airlines to burn large amounts of cash. Probability of default for American Airlines skyrocketed to over 800bps in May as illustrated by the company's NUS-CRI 1-year Probability of Default as seen in Figure 1. American Airlines has still managed to pull through due to the modest recovery of air travel demand, the passing of the CARES Act and the company's rapid cost cutting. Southwest Airlines, on the other hand, has managed to remain rather resilient as it has prudently controlled its debt levels over the years. Nevertheless, the recent delay of further stimulus and the emergence of a third wave of COVID-19 in the US threaten to increase both companies' credit risk in the near future as seen in the NUS-CRI Forward 1-year Probability of Default (Forward PD[1]) shown in Figure 2. However, the arrival of a vaccine in 2021 could provide a huge boost to the credit health of both airlines.

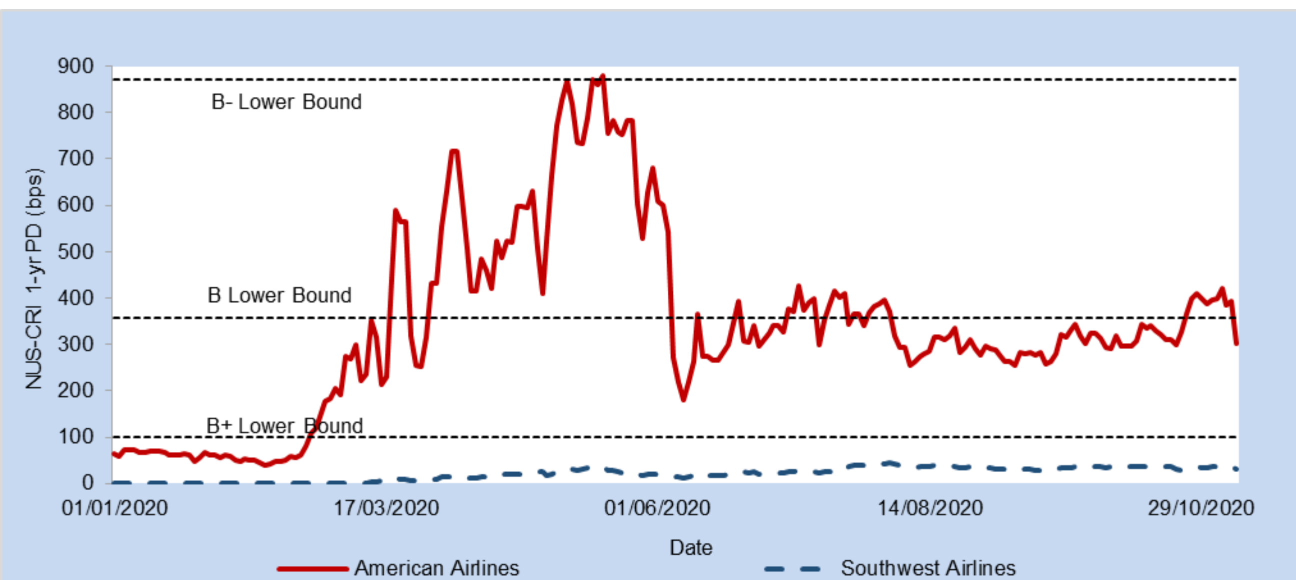

Figure 1: NUS-CRI 1-year PD of American Airlines, Southwest Airlines YTD with reference to PDiR2.0[2] bounds. *Source: NUS-CRI*.

[1] 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 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

[2] 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.

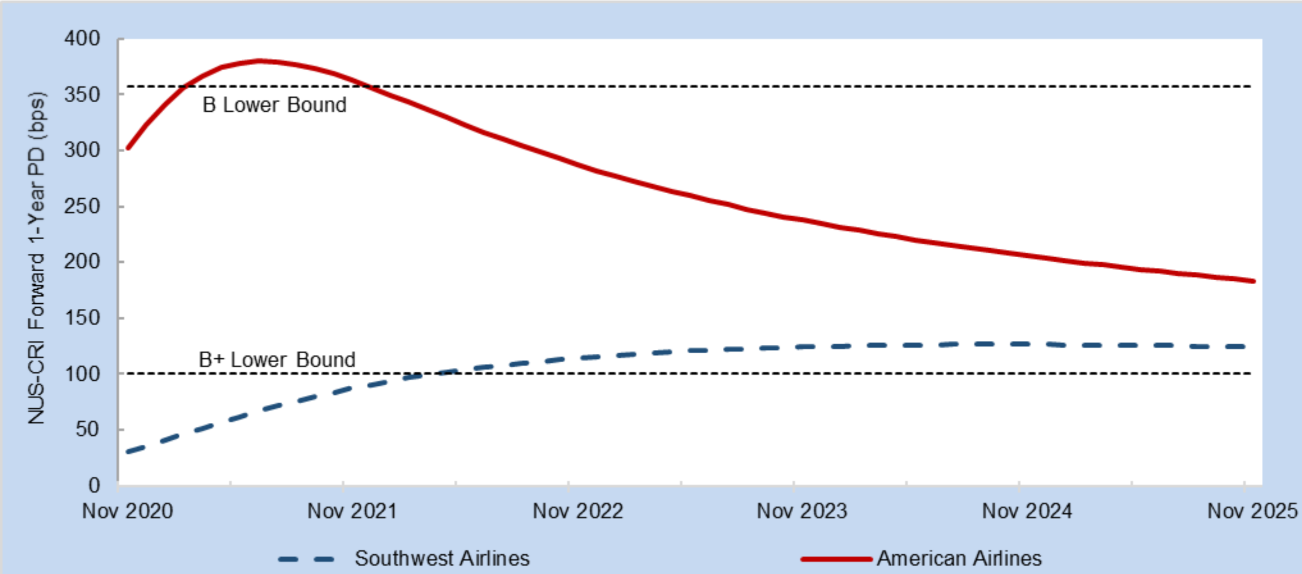

Figure 2: NUS-CRI Forward 1-year PD of Southwest Airlines, American Airlines with reference to PDIR2.0 bounds. *Source: NUS-CRI*

Earlier in October, US airlines were optimistic on the release of further stimulus that would add to the Payroll Support Program in the CARES Act stimulus package that protected airline employees, but the deal fell through in Congress. The delay in stimulus is likely to increase both American Airlines' and Southwest Airlines' default risk as shown in Figure 2. Both airlines' credit recovery hinges on the recovery of domestic air travel demand as they derive most of their revenues from domestic flights. With the third wave of COVID-19 wreaking havoc in the US as well as many countries in Europe, global airline traffic is not expected to fully recover till 2024. However, after the announcement by Pfizer that their vaccine interim data shows that their vaccine is 90% effective, demand could show an uptick once the vaccine is approved and disseminated next year.

	Debt (bn)	D/E	Daily Cash Burn (mn)	Liquidity (bn)	Passenger Load factor (%)	Revenue (bn)	Net Profit (bn)
American Airlines	47.5	4.7	44	13.6	58.9	3.2	(2.4)
Southwest Airlines	10.9	2.6	16	15.6	44.9	1.8	(1.2)

Table 1: Financial figures of American Airlines and Southwest Airlines. *Source: American Airlines and Southwest Airlines Q3 2020 results*

American Airlines' lax use of cash before the pandemic has contributed to its current situation. After emerging from bankruptcy in 2013, the airline merged with US Airways to become the largest carrier in the US market. The company then piled on more debt to buy new fuel-efficient airplanes and build its new Fort Worth headquarters. The company also gave its shareholders and executives handsome pay-outs and aggressively bought back its stock. Coupled with the impact of the pandemic, these factors caused American Airlines' debt, lease and pension liabilities to balloon from USD 38bn in 2019 to USD 47.5bn as of Q3 2020.

In order to issue debt on more favourable terms, American Airlines has used its loyalty programs as collateral. American Airlines' AAdvantage loyalty program is valued at between USD 18bn - USD 32bn whereas the airline's market cap is lower than USD 6.7bn[3]. By posting this collateral, American Airlines was able to raise debt in September at a rate of 10.75%. This along with government stimulus allowed the company to raise USD 13.6bn of liquidity[4]. Southwest Airlines has a total debt obligation of only USD 10.9bn with USD 15.6bn worth of liquidity on hand. The airline also enjoys a much lower debt to equity ratio of 2.6, almost half of American Airlines' 4.7 figure as shown in Table 1. This prudent debt management will enable Southwest Airlines to get through the pandemic and enabled the company to explore growth opportunities. The airline recently added service to numerous airports in America, expanding into popular leisure-oriented destinations from across their domestic-focused network.

[3] Market Cap as of market close 10 November 2020

[4] "Liquidity" refers to the sum of cash, short term investments and portion of CARES Act yet to be drawn down

The pandemic-induced drop in demand forced American Airlines to burn an industry high USD 58mn of cash each day in Q2, far higher than Southwest Airlines' USD 23mn. American Airlines has managed to reduce that figure to USD 44mn a day in Q3 by streamlining its flight operations by suspending service to 15 small cities, furloughing 19,000 employees and removing 150 aircrafts from its fleet. These aggressive cost cutting measures have saved USD 17bn from the airline's operating and capital budget for 2020. Even though operational restructuring and the predicted recovery of air travel demand will improve the credit outlook of the company in the long-term future (see Figure 2), the NUS-CRI 1-year PD remains elevated at around 200bps due to the company's massive debt. Southwest Airlines, on the other hand, has managed to reduce its daily cash burn to around USD 16mn. This was driven primarily by continued improvements in leisure travel demand and booking trends, as well as cost savings from temporary pay rate reductions to non-contract employees in exchange for no layoffs or furloughs through the end of 2021.

The COVID-19 pandemic forced the US airline sector to reduce its average capacity by 60% and ground over half of their fleets. As demand recovered over the summer, American Airlines restored its capacity faster than Southwest Airlines and its other rivals. However, the risky bet on pent-up demand backfired as the slower than expected demand recovery depressed American Airlines' profitability. The company generated USD 1.4bn more in revenue than Southwest but also recorded a net loss of USD 2.4bn, double Southwest Airlines' USD 1.2bn net loss.

Weak air travel demand led to a passenger load factor of 58.9% for American Airlines and 44.9% for Southwest Airlines in Q3 2020. American Airlines was able to record a higher load factor due to the company's controversial decision to reinstate the selling of every available seat despite safety concerns over the selling of middle seats due to social distancing. As most airlines require a load factor of 80% to break even due to the industry's high fixed costs and low margins, American Airlines' decision was geared towards improving the profitability and slowing cash burn. A drop in the average US air fare to its lowest recorded of USD 259, the loss of the high margin business travel and the increase in safety measures have further depressed profitability in the industry and increased the near-term credit risk for both airlines. The loss of high margin business travel has disproportionately affected American Airlines as 50% of its revenue came from business travellers. Southwest Airlines, on the other hand, has been less affected due to its continued focus on economy class clients.

American Airlines' bankruptcy is not out of the question and there could be consolidation in the industry in the coming years. As United Airlines, Delta Airlines, American Airlines and Southwest Airlines account for more than 80% of the commercial air travel in the US, industry consolidation would likely lead to higher prices and better margins, lowering the sector's credit risk. Since Southwest Airlines has the healthiest balance sheet in the sector, there could be an opportunity for the airline to carve off some of American Airlines' assets, take over some of its travel routes or even acquire American Airlines.

Credit News

Negative-yielding debt total hits record USD 17.05tn

Nov 7. Rising on the post-election rally, the Bloomberg Barclays Global Negative Yielding Debt Index indicates that lenders are now willing to pay a high price for debts that will cost them a loss at maturity. This signals great demand for investment-grade debts. According to BlueBay Asset Management, the generous asset purchase programmes by central banks are buying more than that public issuance today can give them. This drove yields down and prices up. With a Democratic president and Republican senate, US Treasuries rallied in lieu of dampened stimulus expectations. While treasury yields remain positive, the rally resulted in negative yields within the Eurozone. (FT)

Development bank loan books risk hit from nature loss

Nov 6. More than a quarter of the world's development finance institution's (DFIs) investments are exposed to nature-related losses as reported by the Finance for Biodiversity (F4B) Initiative, a think tank backed by the MAVA foundation. DFIs, which are often owned by governments, help finance infrastructure, agriculture and other resource-intensive projects in developing markets with weak environmental laws. Despite DFIs being meant to be the leading edge of development finance practice, most DFIs investments often place vulnerable biodiversity resources at risk. F4B saw an urgent need to put in place mitigation plans such as by nature stress-testing DFIs balance sheets. (Reuters)

Muni bonds falter on prospect of divided government in Washington

Nov 6. As muni bond prices fell relative to treasuries, the rates of a 10yr AAA muni were more than 109% of the corresponding treasury bill. These highlighted rising investors' concerns on muni relative to the risk-free proxy. For investors invested in muni bonds, a divided congress diminished the prospects for a large state and local government stimulus package. Specifically, for Illinois, the rejection by voters for a tax hike for the high income meant that the issuance could be rated as junk. Over this period, the lack of Covid-19 budget torn down the prices of some muni bonds as the Oct 2020 data show that new defaults are at an 8yr high since the start of the crisis. (WSJ)

Corporate debt market sees 'relief rally' amid uncertain US election week

Nov 6. Green begets green as both the Investment Grade US corporate bonds and US treasuries were set on the rise. Yields on the 10yr treasury bill jumped by 10bps amidst election uncertainty. These indicated that the debt investors were worried about the Democratic sweep. Coupled with the Republican Senate, the prospects of a large stimulus dwindled. Issuance wise, many corporates have rushed to benefit from the lower cost of borrowing prior to the elections. This period saw a lack of activity with the exception of a few such as Waste Management Inc. (Market Watch)

Asian governments and firms in record sprint to issue dollar bonds

Nov 3. Given the near-zero rates environment right now, many Asian corporates and governments tap on the funding from the debt capital market. Excluding Japan, these issuers have sold USD 354bn YTD. The trend is also supported by China's impressive issuance and economic recovery. The robustness of the internal debt capital market fortifies the market as a support for growing corporates. Moving forward, one could expect issuances to continue post-US elections as there remains a strong push for capital raising. Notably, the Chinese corporates, including Cofco, Sinochem, and Meitun have pushed through big tickets this month. (FT)

Funds cut cash holdings to pre-pandemic levels (FT)

Moody's says US election uncertainty "unlikely" to have big credit impact (Reuters)

Offshore Chinese yuan bond holdings rise in Oct as yield gap boosts appeal (Reuters)

Regulatory Updates

Australian regulator allows USD 25bn reduction in banks' committed liquidity facility

Nov 6. As the quantities of high-quality Australian government bonds being issued and bought by banks increase, Australian Prudential Regulatory Authority (APRA) has lowered the amount of reserves banks are required to hold under the committed liquidity facility (CLF) by AUD 35bn. Regulators expected CLF allocations for 2021 to fall due to increased government stimulus and a surge in government debt issuance. Furthermore, regulators have also raised the possibility that the CLF may not be needed in the foreseeable future if the government securities outstanding continue to increase beyond 2021. (Reuters)

Federal Reserve keeps monetary policy steady as Covid cases rise

Nov 6. During Thursday's FOMC, the Fed committed to keeping the federal funds rate between 0% to 0.25%. This commitment should hold up until the economy reaches full employment and higher inflation. However, Powell raised serious concerns about the rising prevalence of Covid-19. Powell also stated his belief that a stronger recovery can be made possible with more fiscal push. Meanwhile, the asset purchase programme will be continuously adjusted to maintain the board's accommodative mandate towards the US economy. (FT)

Brazil central bank could withdraw forward guidance even if spending cap intact (Reuters)

UK raises asset purchases by GBP 150bn (Reuters)

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