



Multi-pronged pressures upsetting growing Asian airline operators

By [Benjamin Lau Chang Xun](#)

In recent years, Asia had undoubtedly transformed into a hotspot within the ever-growing airline industry. According to global aircraft manufacturer Boeing, the Asia-Pacific region will be [responsible](#) for 39% of new aircraft deliveries in the next 20 years; and is forecasted to be [accountable](#) for 38%, 39%, and 37% of the global demand for pilots, maintenance technicians, and cabin crew respectively. In order to fuel this high growth, tapping on the credit markets is a commonplace practice in the business – so far in 2019, airlines sold USD28.1bn worth of bonds, where USD15.2bn (55%) came from Asia-domiciled airlines. However, as airline debt issuance increases, we also observe a larger increase in their Probability of Default. In this article, we aim to analyze the effect of growing costs, competition, and global events on the Asian airline industry's credit profile, and to provide a future outlook on the Asian airlines market as compared to the global projection.

From a revenue-generating perspective, Asia has been a frontrunner in Revenue Passenger Kilometers¹ (RPKs) growth. According to the International Air Transport Association (IATA), the global trade association for airlines, Asia clocked in the [highest regional RPK growth](#) for 2 consecutive years – 10.9% in 2017 and 9.5% in 2018 – and is slated to have 6.3% growth in 2019, topping the regional rankings once more. In comparison, global RPK growth was 8.1% in 2017 and 7.4% in 2018, with projections of 5.0% in 2019. On aggregate, operating and passenger revenues both rose by 10.4% in 2018, with the former growing to USD204.7bn and the latter to USD159bn. Cargo revenue also climbed 11.5% to USD21.2 bn. However, even as revenue growth is optimistic, we observe the creditworthiness of Asian airlines performing below other airlines from around the world.

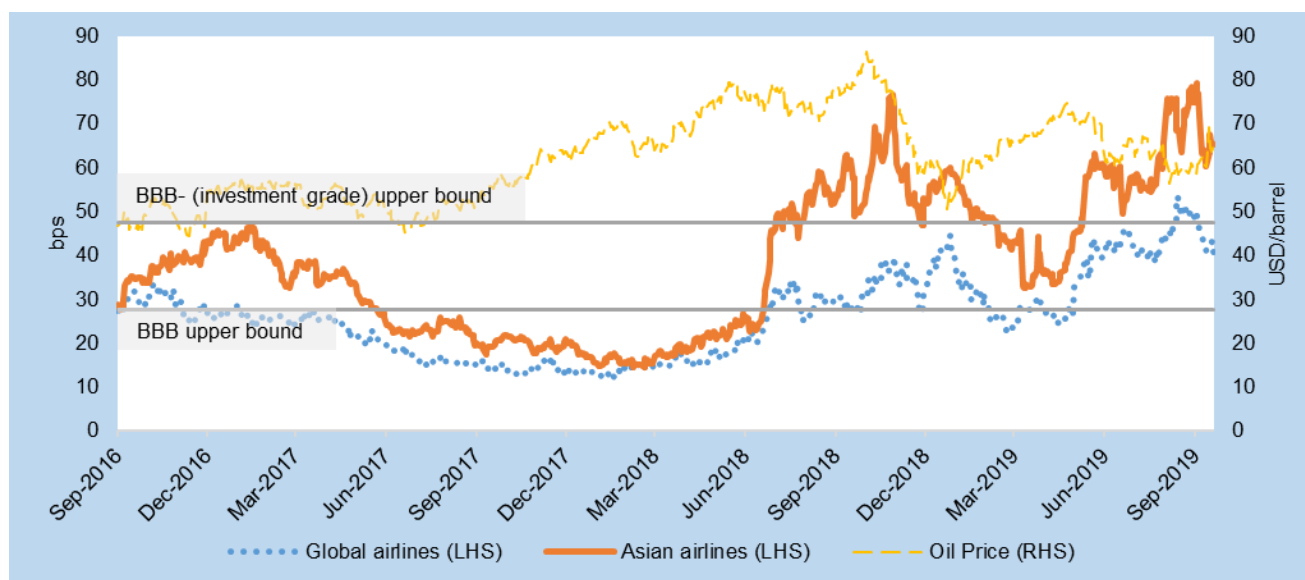


Figure 1: NUS-CRI Aggregate 1-year PD for Asian airlines and global airlines from 2018, NUS-CRI PD implied rating boundaries² and Brent Crude Price. Source: NUS-CRI, Bloomberg.

In Figure 1 above, we compare the time series for the NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for publicly-listed airlines in Asia with the Agg PD for global airlines from Jan 2018 to Sep 2019. We see an overall increasing trend for the Agg PD for global airline firms, implying an industry-wide increase in credit risk within this 1.5 year horizon. Global airlines saw its Agg PD increase by more than twofold, from 17bps March 2018 to 40bps in September 2019. The spike is even more evident for Asian-domiciled airlines – the Agg PD increased from 17bps in March 2018 to a staggering 65bps in September 2019 – a nearly 4x increase.

¹ RPK is a measure where a revenue-paying passenger is flown for 1 kilometer, and is the main metric used to calculate the volume of passengers carried by an airline. The RPK of an airline (or region) is the total number of kilometers travelled by all passengers by that carrier.

² The NUS-CRI Probability of Default Implied Rating (PDiR) provides a more conventional interpretation of PDs – it translates NUS-CRI 1-year PDs to letter ratings by taking reference from the historical observed default rates of S&P's rating categories.

The solution to the discrepancy lies within the other side of the profit equation – Asian carriers had been facing increasing cost constraints, squeezing profits and reducing free cash flow, which ultimately affects airlines’ ability to repay debt and coupon obligations. This issue is amplified in Asia as Net Debt / EBITDA ratios are significantly higher than global industrial averages since 2018 (with the exception of 2018Q2).

Net Debt / EBITDA						
	2018Q1	2018Q2	2018Q3	2018Q4	2019Q1	2019Q2
Asia-domiciled Airlines	16.59x	2.58x	8.02x	8.78x	7.67x	6.35x
All Airlines	7.19x	3.01x	6.00x	4.15x	5.36x	-3.82x

Table 1: Median Net Debt / EBITDA ratios for Asian airlines and global airlines from 2018. Source: Bloomberg

With higher leverage, Asia-domiciled airlines are under more serious threat from cost concerns, such as rising fuel costs. According to the Association of Asia Pacific Airlines, aggregated net earnings in 2018 [plunged](#) by almost 50% to USD4.7bn from USD9.6bn in 2017 due to rising costs. Airlines’ operating expenses grew by 12.5% to USD194.6bn, driven by a significant rise in fuel costs – Brent price steadily increased from USD66.6/barrel in the start of 2018 to a high of USD83.1/barrel, illustrated in Figure 1. On the other hand, 2018 non-fuel expenses also increased by 7.6% to USD140.1bn, a result of higher labor costs, regulatory landing fees and en-route charges. In 2019, the narrative of airlines facing rising cost expenditure continues to sustain, as IATA recently [announced](#) a downgrade of 2019 profit projections for Asian carriers, once again citing rising fuel costs. Their forecast stated that the high price of fuel from 2018 will continue in 2019 with an average cost of USD70/barrel Brent expected. 2019 Fuel expenses will account for 25% of operating costs (up from 23.5% in 2018).

Besides climbing costs, increasing competition in the region and the trade war also placed significant pressure on Asian airlines. In the past 2 decades, Low Cost Carriers (LCCs) have [successfully proliferated](#) the industry, some of them being subsidiaries from their full-service counterparts. In 2018, LCCs held 29% of seat capacity in Asia, flying 600 million seats. [Stiff competition](#) across geographies and customer segments kept passenger yields from rising and profit margins razor-thin. With the emergence of online airline booking portals, there is also greater price transparency, which also contributes to thinning margins from reduced information asymmetry. The US-China trade war also places pressure on global air cargo, where Asian airlines [suffered](#) a 4.9% year-on-year decline of Freight Ton Kilometers³ (FTKs) in July 2019. The damage on the air cargo market was also cited by IATA for their [downgrade](#) of profit projections in 2019.

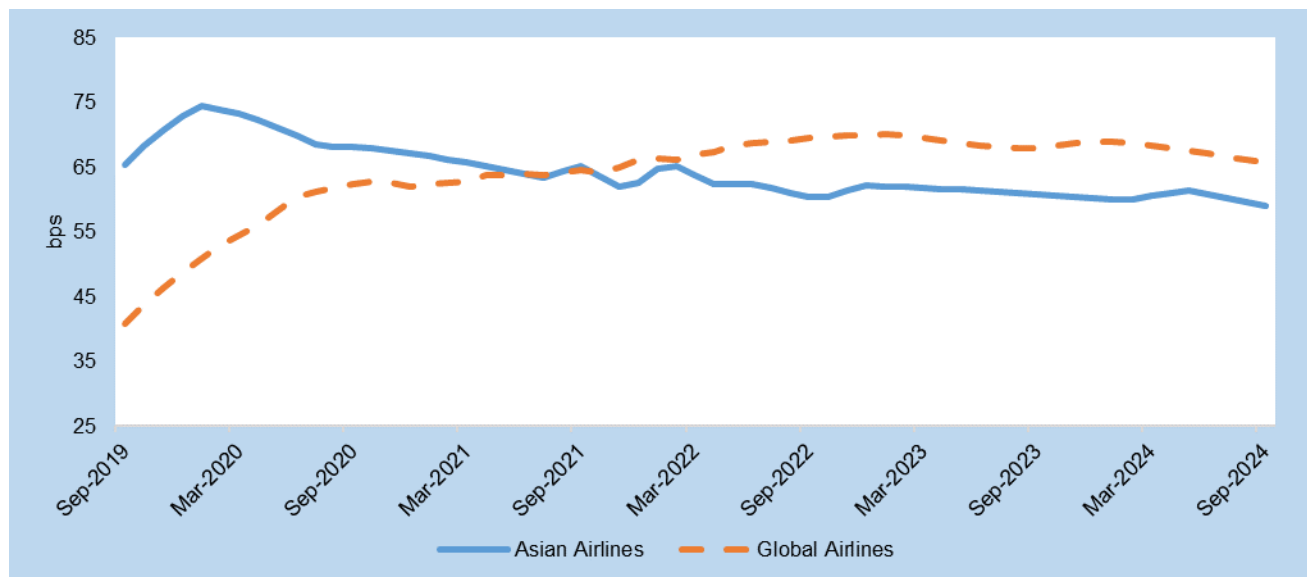


Figure 2: NUS-CRI Forward 1-year PD term structure for Asian airlines and global airlines in Sep 2019. Source: NUS-CRI

Despite the aforementioned ongoing concerns, there is still a silver lining for Asian airline firms. When we look at the NUS-CRI Aggregate (median) Forward 1-year PD⁴ in Figure 2 above, we observe an interesting phenomenon. First, there seems to be an overall credit positive effect on Asian airlines over the next 5 years,

³ FTKs are used to measure the volume of cargo carried by air, and is the freight equivalent of RPKs for passenger flight.
⁴ 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 12-month Forward 1-year PD is the probability that the firm defaults during the period from 12 months onwards to 1 year plus 12 months, conditional on the firm’s survival in the next 12 months.

where the forward PD tightens to less than 60bps in September 2024. This is then juxtaposed by the pessimistic global trend, where the forward PD steadily rises from 40bps to 65bps over the forecast horizon.

The opposing trends between the two PDs in question accurately reflects the economic intuition highlighted over the course of the article. Asia has been consistently identified as a growth region from increasing RPKs, but is currently smothered by a confluence of risk factors from cost, competition and geopolitical tensions. As RPKs in Asia continue to grow, and risks get hedged away or mitigated, the downward trend for the Forward 1-year PD ensues. The intersection point between the two trends during September 2021 elucidates the point where the RPK growth of the Asian airline industry outshines other concerns, and this occurrence seems to sustain over time as its credit risk diminishes.

Credit News

Bonds from down under come back on property, banking rebound

Sep 30. The US dollar bond market Down Under, boosted by the recovering housing and banking sectors, is making a comeback this year. The US-currency notes issued by Australian REITs and mortgage asset firms, and its banking sector are returning 9.1% and 8.4% respectively this year, an increase from the respective -0.1% and 0.2% returns they were making last year. Some factors contributing to the improved sentiment toward Australian bonds include lower interest rates, easing of lending rules for home buyers, and a less tightened yield premiums on its dollar notes than those on debt from Asia excluding Japan. Subdued outlook for the economy, however, remains to be a risk for Australian bonds. ([Bloomberg](#))

Turkish banks get some relief as foreign-borrowing costs drop

Sep 30. Turkish banks are getting cheaper foreign funds as the economy shows signs of avoiding a contraction in 2019 and the government takes steps to deal with bad loans. Although the average credit ratings of Turkish banks are two to three notches lower than a year ago, the recovery of lira helps some lenders to cut interest rates on syndicated loans by as much as 10%. The gradual improvement in the operating environment, as shown in the drop in Turkey's credit default swaps, and a decline in global interest rates also contributed to lower borrowing costs. Moreover, the government is taking steps to overhaul the banking industry by forcing lenders to reclassify USD 8bn of loans as non-performing. ([Bloomberg](#))

Wall Street falls in love again with companies loaded up on debt

Sep 29. For the first time since 2016, companies with weaker balance sheets are outperforming their sturdier peers and the broad market amid the Federal Reserve's rounds of interest rate cuts. The rate reductions are boosting investor confidence in heavily leveraged companies, which are considered to be the most at risk to any economic downturn. Investors are betting that the inexpensive debt financing in the ultra-low interest rate era will help indebted companies to expand and drive future earnings growth. In the bond market, however, riskier companies have been forced to offer higher returns to drum up demand. ([Bloomberg](#))

China defaults may worsen with huge dollar debt

Sep 27. Nearly 40 per cent of total outstanding corporate dollar bonds, totalling USD 8.6bn, from China's troubled companies is due in 2020. Issued in around 2017 with unusually sweet financing conditions, a lot of the debts were sold with a low interest rate not comparable to the credit risk and a swathe of the issuing companies lacked strong fundamentals. Facing the uncertain market condition, investors are taking money out of Asian high-yield debt funds to avoid risk, driving up yields and making issuers harder to refinance the existing debt. Furthermore, China continues to emphasize the need to limit leverage, which also results in a pick-up in default rate. ([Business Times](#))

Tidal wave of emerging market debt setting new records

Sep 27. September has been an exceptionally heavy month for debt issuance in emerging market, amid with a relenting market fear towards a global recession. Both sovereign and corporate side show a breaking records for new debt issued. The emerging market sell over USD 21bn debt in total, more than double the

USD 9bn sold during the last six Septembers on average. The record low borrowing cost following Fed, ECB and Chinese rate cuts, and a relative lull in the US-China trade war could explain this phenomenon. ([Reuters](#))

Europe's bond markets set for cash windfall before QE begins ([Bloomberg](#))

The worst Asia junk bond shows how rapidly fortunes can turn ([Strait Times](#))

Global debt surges to highest level in peacetime ([FT](#))

Regulatory updates

RBA seen cutting rates again as Lowe keeps cards close to chest

Sep 30. Contrary to market expectations, RBA's chief Philip Lowe is giving a mixed-signal whether to cut interest rate for the third time in five months. While Lowe acknowledged further cuts might be needed, he also emphasized that Australia's economy is at a "gentle turning point" and likely to strengthen from here. Australia has also mostly benefited from the US-China trade tension as commodity prices spiked but is unlikely to further escape unscathed from a weaker economy in China. Since fiscal support to reinforce his monetary stimulus seems unlikely for now, the RBA will have to go it alone supporting the Australian economy. ([Bloomberg](#))

Bank of England official flags rate cut

Sep 27. The Bank of England might have to cut interest rates even if UK avoids a no-deal Brexit. Survey data released recently by the European Commission confirms the weakness of economy, and uncertainty remains over the trade relations between UK and other EU countries. Amid the soft growth in economy and persistently high uncertainty of Brexit, it probably will be appropriate to maintain an expansionary monetary policy and may change to loosen policy at some stage. Bank of England official further pointed out that monetary tightening would be limited and gradual even if uncertainty eases significantly and the global economy recovers. ([FT](#))

Banks snap up USD 60bn in two-week loans from New York Fed ([FT](#))

China's central bank says in no rush to ease aggressively ([Reuters](#))