



Fundamentally and irrevocably changed

Identifying the “new norm” and what it will take to get there

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Talking points

- Key Covid-19 issues and impacts:
 - Adjustment to the event
 - Adaption to the expected new operating environment
 - Recovery and in particular its timing, speed and shape
- The risk to the system given that airlines are generally seen as the necessary element for all others to make money.
- The position of, and outlook for, individual participants
- The role of government support and issues around:
 - Moral hazard
 - Direction and focus
 - Market distortion
 - Conditions attached
- New regulations to address:
 - More binding environmental targets which will be introduced earlier than previously expected
 - Rights to slots and airport access in the recovery phase and indeed beyond
 - Economic regulation in a structurally changed industry.

COVID-19 – an extreme and unprecedented event

- Whilst airline managements' responses are similar to those when faced with event related disturbance in the past, the extent and duration of what are, or are in effect, market closures make it materially different this time and pose an existential threat to numerous businesses across the whole aviation sector.
- Whilst IATA is now expecting the impact on passenger revenues to be some \$314bn compared to 2019 (was \$252bn in early April), there is still significant downside risk to this latest forecast.
- Immediate and direct effects across the system other than for airlines:
 - Airports and all support activities
 - Real risk that some airports may be closed permanently
 - Manufacturers and their suppliers
 - Deferral and cancellation of deliveries and orders – already significant evidence but much more to follow –production rates already cut.
 - Supply side dislocation due to sharp increase in “pre-owned” narrow bodies in particular.
 - Lessors
 - Already seeing large numbers of their customers (+/- 80% in the case of Avolon) looking for relief from payments
 - Prospect of real pain around values however evidence of value risk even before Covid-19 – history not really a guide to the future
 - Will see some who entered the industry over the last few years exit and not return.
- The industry will recover but it will be smaller than previously expected with all of the attendant consequences.

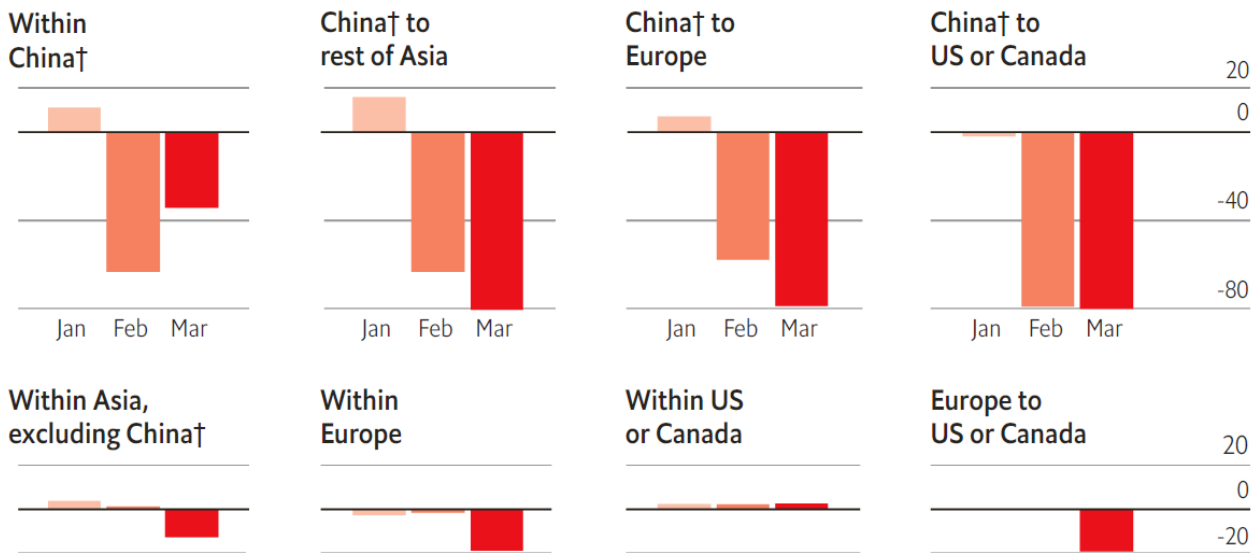
The adjustment phase

- Cut back to an irreducible minimum and retain capability to return to more material operations when possible.
- Lay offs, (30,000 at BA and 90,000 at Lufthansa), cessation of spending, deferral of capex etc.
- Monthly cash outflow quantified.
- Review of sources of liquidity:
 - Cash on hand
 - New debt
 - New equity.
- Only cash matters – we have reviewed and analysed participants to determine survivability where at one end of the spectrum there are those with:
 - Cash, low gearing and unencumbered assets (even allowing for distressed values) and at the other
 - Little cash, high gearing and few or no unencumbered assets



Capacity changes

Number of available airline seats, % change on a year earlier, selected weeks*



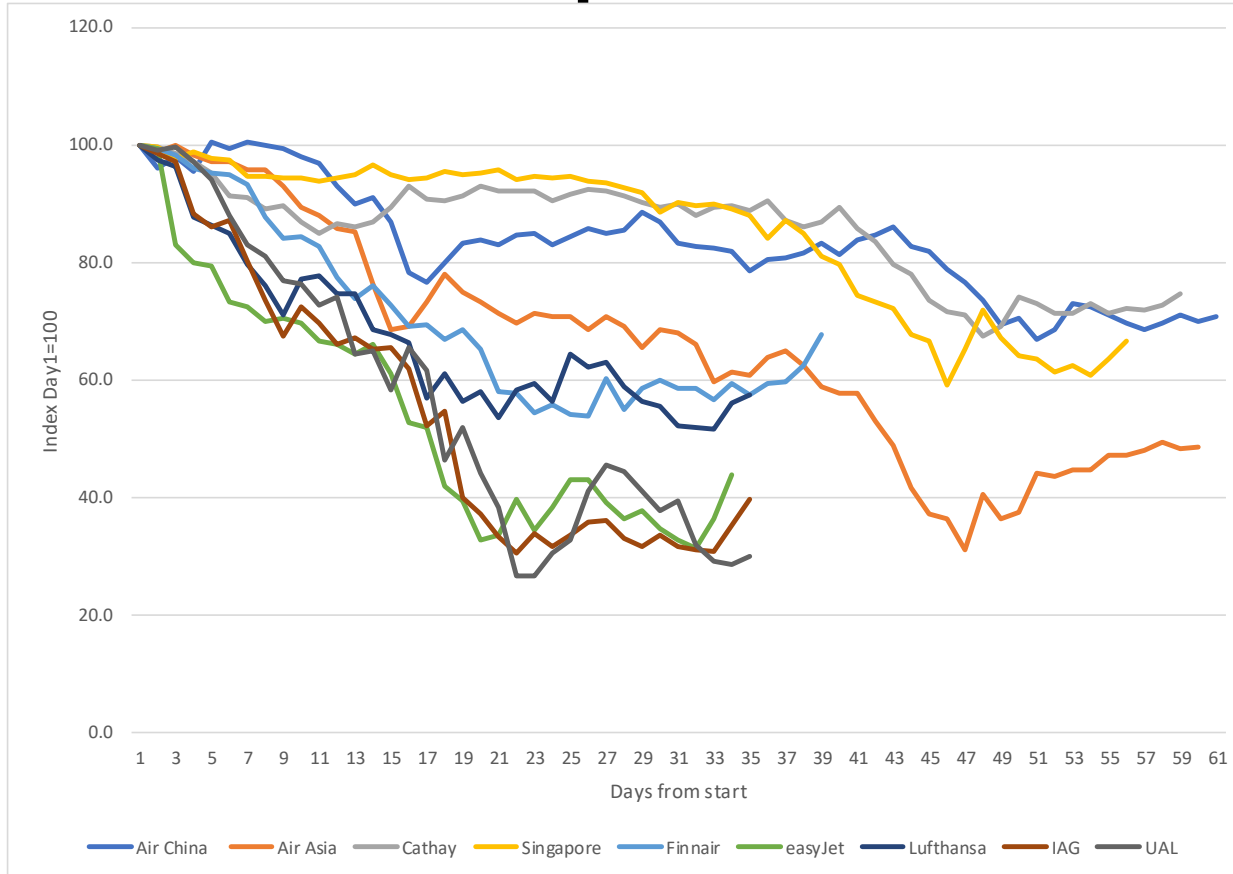
*Weeks starting: Jan 13th, Feb 10th and March 16th †Mainland airports

Source The Economist

- China capacity will still be 40% lower in the last week in June 2020 vs. same week in 2019 – less worse but not better.
- Some European airlines have effectively stopped flying.
- Statements from Lufthansa, decommissioning 40 aircraft, give a clear view in terms future shape and size and time to recover 25% of total capacity by end October and 75% by end of the year.
- Emirates has restarted its flights to London; 4 a week vs 70 a week in the same week last year where seats offered will be just over 4% of what they were flying.



Selected airline share prices



Source CTAIRA ft.com

- Indexed to first day Covid-19 recognised as having an impact and given the forward looking nature markets and the role of expectations, different turning points.

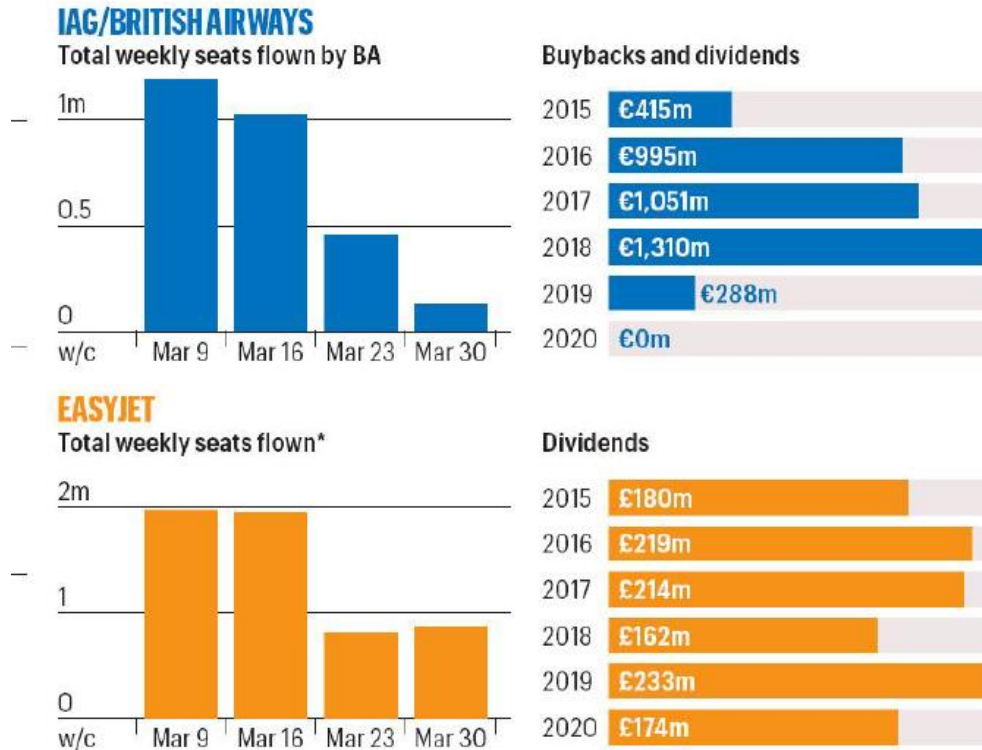


The role of government support

- Key issues and not just for airlines but across the sector:
 - Selection criteria:
 - Picking survivors and identifying sustainable businesses?
 - Moral hazard:
 - Including around not sustaining the unsustainable other than in particular circumstances (e.g. meaningful or total loss of air services)
 - Approach:
 - Debt/equity/guarantees
 - Direction and focus:
 - To ensure that citizens of the country of government benefit; issues around ownership and leakage as well as airlines where the majority of traffic is outbound leisure (notwithstanding the societal benefits)
 - Market distortion arising from amongst a range of circumstances including:
 - Grant funding with no need for, or prospect of, repayment for one, or more groups of airlines (or other businesses) operating in a competitive market
 - Governments buying in aircraft either as a “scrappage scheme” or new off the production line will have a significant range of issues to be considered and whether in the case of new aircraft the government activity is effectively providing a warehouse or whether it will compete with other suppliers of new aircraft when disposing of them.
 - Conditions attached
 - Wide ranging from demonstrating that there is a credible business to preventing (albeit only for a short period), special dividends and share buy-backs
- There will still be a significant need for new equity from other sources.
- Will see capital rationing in this second wave which is likely to result in further failures.



The issue of dividends and buy-backs



Source The Sunday Times

- A useful chart – in the past airlines didn't pay dividends and until the Covid-19 event the vast majority of the total return to an investor was from the movement in the share price – perhaps a time to return to previous ways?

The adaption phase

- Almost an opportunity to start from first principles and adapt capacity to what should be a more profitable network in the times of the “new normal”.
- An opportunity to move away from what was for some, a “have metal will fly” strategy, and where at best, in the case of too many flights, the contribution to overheads and fixed costs was minimal if not illusory.
- Will use the event to resize the workforce and also increase the use of technology which is available, and already used by some airlines, and which can significantly improve processes.
- We are seeing and will continue to see an increased rate of earlier than previously planned retirements of aircraft; IAG management has for example brought forward the retirement of 67 aircraft and a view that the US industry will retire 800-1000 aircraft this year.
- Should form the basis for a more efficient and sustainably profitable industry although it might not look like it at the moment.
- Real consequences for airports and regulation including those around slots.



Recovery

- Our view is that it will be slow; the best letter of the alphabet to describe it is a “recumbent L” but even then it will not be a straight line beyond the turning point.
- Concerns over a “second wave” and emerging concerns over a “third wave”.
- Issues not only about lifting of restrictions but also around:
 - Passengers’ concerns and the need to demonstrate the certainty “virus-free” airports and flights which has significant implications for testing and the communicating the results -cannot be done at the airport as need to rule out infection before arrival.
 - Social distancing on aircraft implies compliant load factors of 20-25% - keeping the middle seat free is not enough
 - The availability of accommodation and restaurants in destinations given the decimation seen in that sector too and the pace of its recovery and its size and shape
- The all important northern hemisphere summer season already lost to a greater rather than lesser extent with consequences for cash from other sources for the winter. Exacerbated by the impact of the measures to counteract the virus on household budgets
- A very slow recovery in prospect for business travel; not least given the state of the economy and company profitability where travel is seen as one of the most controllable expenses.
- VFR passenger numbers will represent the only real area of pent up demand.
- The notion that traffic will recover to previous levels by the end of 2021 reflects greatly misplaced optimism. After the great financial crisis in 2008 which will be seen to be far less damaging economically, it took until 2016 for the number of intra-European flights to reach 2007’s levels.



Concluding remarks

- We are still several months from reaching a series of country and regional turning points which will be non-coincident.
- The future shape and size of the aviation industry, over at least the near and medium term, will be markedly different from that in 2019.
- Future growth, even when more normal times return, will be slower than previously expected.
- There is a range of traditional economic, behavioural and policy factors that will impact not only in the near-term “re-start phase” but also over the medium and longer term.
- These will include what we would expect to be new and more binding environmental regulations (where the focus will be on “just how much travel does there need to be”), and will also have a material and determining influence on future demand as well as supply.
- There will also be a need for change around the economic regulation of, amongst others, airports and ANSPs.
- It would be dangerous to underestimate the transformational consequences of this event and where many metrics are being reset.



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