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ALLIANZ RESEARCH

ROUGH LANDING:

2020 WILL BE A TERRIBLE YEAR FOR AIR TRANSPORTATION

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EULER HERMES

Allianz

EXECUTIVE SUMMARY

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- **Global demand in air transport will not return to its pre-Covid-19 level before 2023.** The unprecedented slump in international travel will make 2020 a terrible year for the air transportation industry: We expect airlines' aggregate revenues to plummet by USD310bn to USD525bn and profitability to become negative with a staggering USD60bn operating loss. Though lockdowns are now gradually being lifted and borders are starting to re-open, our central scenario anticipates a progressive exit lasting another six months, leading to a U-shaped recovery in 2021. As a result, demand in global air transport should fall by -37% (4q/4q) in 2020 before rebounding by +39% and +10% in 2021 and 2022, respectively.
- **Up to 30% of the workforce in the sector is at risk of looming layoffs.** Airlines have had no choice but to take urgent measures to curb cash outflows in the short run, including grounding planes, temporary furloughs and postponing ticket refunds for cancelled flights. In spite of these steps, as well as massive state support to the tune of USD125bn, additional restructuring measures can't be avoided in the second half of 2020. In the U.S., for example, deep job cuts are coming after October 1 as the federal bailout for the airline industry covers around two-thirds of overall labor costs through September. Up to a third of the sector's jobs - roughly 750,000 pilots, flight attendants, baggage handlers, mechanics and others - could disappear.
- **The legacy of the outbreak is likely to reshape supply.** The Covid-19 crisis is a major blow to private low-cost airlines, which depend on full flights. Complying with social distancing is likely to hit profitability. We also expect a new wave of consolidation in the industry. Despite sustained financial relief by many governments, already battered players in air transport, especially highly leveraged ones such as those in China, are likely to suffer. As a result, we expect more bankruptcies among air carriers in the next two years, following the recent failures of Virgin Australia, Avianca and Latam airlines.

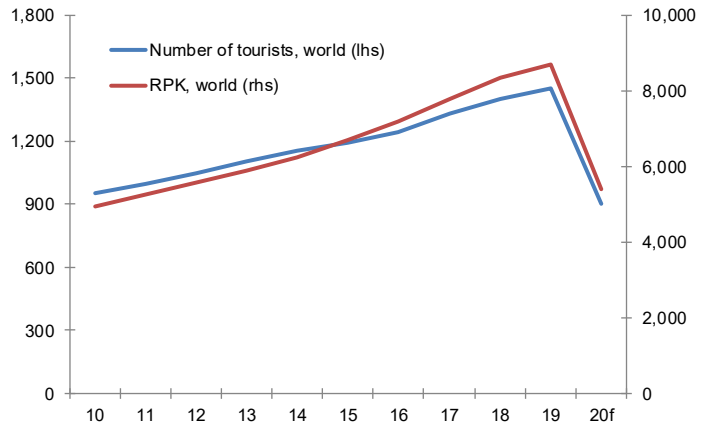
USD60bn

Operating loss forecast for global airline industry in 2020

GLOBAL AIR DEMAND COULD TAKE TWO YEARS TO RECOVER FROM COVID-19

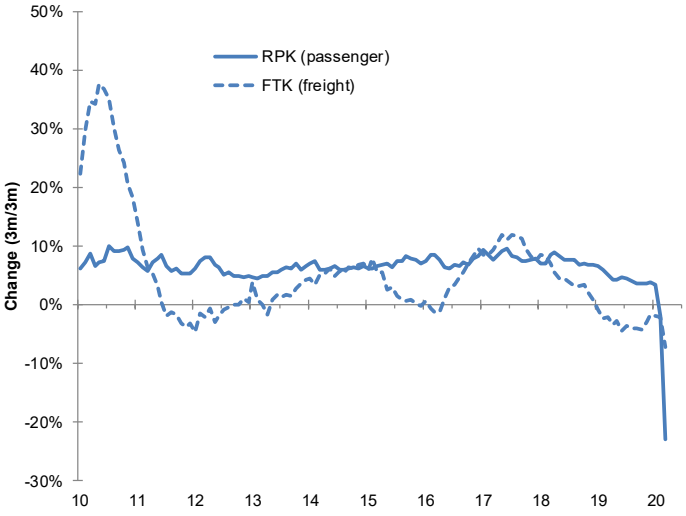
In the first quarter of 2020, Covid-19 sparked an unprecedented slump in international tourism (see Figure 1), throwing the global transportation sector into chaos. Air passenger demand nosedived by -53% m/m and by -22% 3m/3m at the end of Q1. For 2020 overall, we expect global air passenger demand to slump by -38% y/y. Global air cargo has suffered slightly less, (-15% m/m and -7% 3m/3m in Q1 2020), likely helped by the urgent need to deliver masks and medical supplies across the globe (see Figure 2).

Figure 1: Global air passenger demand and international tourist arrivals (yearly data, in millions)



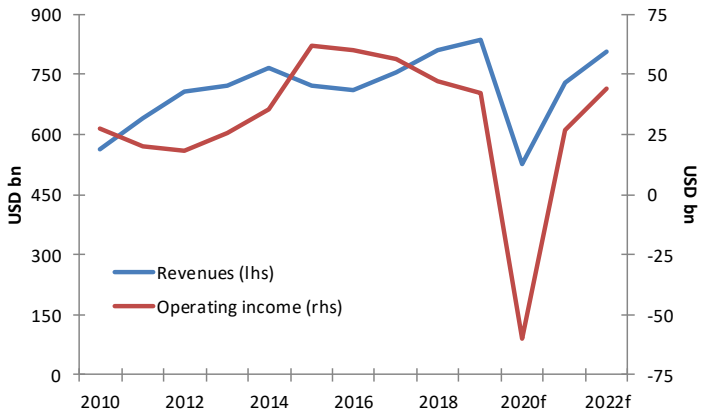
Sources: OMT, FactSet, Allianz research, Euler Hermes forecasts

Figure 2: Global demand in passenger and freight air traffic (monthly data)



Sources: IATA, FactSet, Euler Hermes, Allianz Research

Figure 3: Sales and operating income of the air transport sector



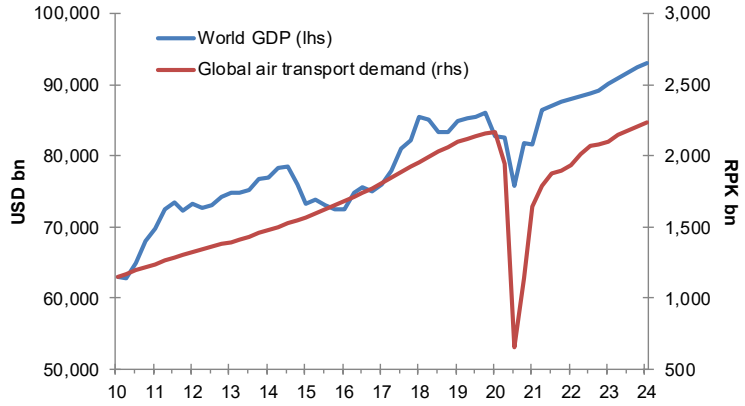
Sources: IATA, FactSet, Allianz Research, Euler Hermes calculations

The year 2020 is expected to be an *annus horribilis* for the air industry. Our calculations made using a panel of around 80 major airlines show a collapse in revenues of more than USD300bn and a tumble in operating income of more than USD100bn in 2020. Even worse, the operating loss could top a terrible USD60bn this year (see Figure 3). We expect the air sector to retrieve USD205bn and USD75bn of revenues in 2021 and 2022, respectively, following the recovery in the world economy and international tourism. However, this will not make up for all the lost sales in 2020 alone.

Though lockdowns are now gradually being lifted around the world and borders are starting to re-open, our central scenario anticipates a progressive exit lasting another six months, leading to a U-shaped recovery in 2021. Combining this GDP trend with historical air traffic data and airlines' poor activity in the first half of 2020, we find that global demand in air transport will not return to its pre-crisis level before 2023.

- In our U-shaped scenario (see Figure 4), demand in global air transport should fall by -37% (4q/4q) in 2020 before rebounding by +39% and +10% in 2021 and 2022, respectively. At the very beginning of 2020, before the pandemic, global revenue passenger kilometers (RPK) reached 2,169. According to our calculations, we expect it to top this level again only by May 2023.
- In the case of a second wave of infections, the global economy would face an L-shaped scenario, in which demand in global air transport would not reach its pre-crisis level before mid-2025. It would take years to catch up after a -50% collapse in air transport demand in 2020 alone (4q/4q), especially since this demand would be expected to rise only by +20% and +24% in 2021 and 2022, respectively.

Figure 4: World GDP and global air traffic (quarterly data, in billions)



Sources: IATA, FactSet, Global Insight, Allianz research, Euler Hermes estimations

AIRLINES HAVE TAKEN HARSH RESTRUCTURING MEASURES TO CURB CASH OUTFLOWS

Airlines have been forced to adjust their costs down to their much lower levels of revenue to mitigate the risk of running out of money and going out of business. The Q1 earnings announcements of major airlines revealed restructuring measures including:

- **Grounding of planes:** In March and April, Cathay Pacific, for example, cut capacity by -65% while United Airlines reduced international schedules to Asia and Europe by -20%. European airlines, such as Ryanair, Lufthansa, EasyJet and British Airways, also stepped up flight cancellations to reduce capacity, slashing more than 400 flights last month to countries including Italy, Germany and the U.S. It is estimated that up to 75% of the world's overall fleet could have been grounded as a result of Covid-19 travel restrictions over the two-month lockdown period.
- **Vouchers for future travel instead of refunds for cancelled flights:** Total refunds still to be paid by airlines were estimated at around USD28bn as of May. It's no surprise that most airlines have urged the European Commission to temporarily suspend the law granting customers full refunds for cancelled flights.
- **Temporary furloughs:** Several airlines have responded to the crisis by imposing unpaid leave and freezing pay to employees. In February for example, Cathay's CEO asked its near-30,000 workforce to take unpaid leave on a voluntary basis to help the airline preserve its cash. About 100,000 workers at the four largest U.S. carriers (American, United, Delta and Southwest airlines) were asked to take voluntary unpaid or low-paid leaves.
- **No dividends or stock buyback programs:** The strings attached to the USD50bn aid package enacted to help America's stricken airlines have forced major U.S. carriers into ceasing any stock buybacks and dividends, their main channels for rewarding investors, which has made their shares less attractive. Other major carriers around the world face the same situation.

The measures taken to withstand the current storm in a longer-term context are equally severe:

- **Massive lay-off plans loom ahead**: Airlines are running up losses partly because they can't furlough or cut their staff more deeply than their bare-bones flight schedules. So, permanent cuts in the well-paying jobs found across the air sector are inevitable and coming soon. British Airways has already planned to remove around 30% of its workforce, while Ryanair could lay off 3,000 employees - mainly pilot and cabin crew jobs - starting next July if Covid-19 restrictions continue to batter the travel industry. In the U.S., deep job cuts are coming after October 1 as the federal bailout for the airline industry covers around two-thirds of overall labor costs through September. Estimates suggest that up to a third of the sector's jobs - roughly 750,000 pilots, flight attendants, baggage handlers, mechanics and others - could disappear.
- **Postponements of rents to aircraft lessors:** Airlines who lease aircraft have approached their lessors for rent or loan payment holidays or waivers in order to preserve cash. Some airlines are looking to enter into loans or sell assets quickly in order to raise cash, for instance by the sale and leaseback of aircraft. Most lessors and banks have sought to work with their airline customers and agree to rent holidays or the restructuring of payments. Indeed, if the fundamental business of an airline is sound, it is better in the long term to ensure an airline's survival than to risk its failure and to have to go through the process of repossession, which typically results in losses such as rent arrears and transition costs. In any event, many lessors consider that it makes little sense taking back aircraft at a time when demand is low, and placing them at all, let alone at a similar rental, will be difficult. More broadly, younger, fuel-efficient narrow-body aircrafts are best positioned to be key for airlines and lessors post-pandemic.

- **Delays (if not cancellations) in new aircraft orders:** This has been the main transmission channel through which airlines' hardships have passed on to upstream aircraft manufacturers. Boeing and Airbus have been forced to temporarily suspend or slow production at many facilities as a result. For example, the A320 production rate has been reduced to 40 aircraft per month, down from an average of over 53 aircraft per month in 2019. The A330 and A350 programs are reduced to a rate of two and six aircraft per month, respectively. Turning to the orders race, Boeing reported 31 gross orders in March and 150 cancellations for a total of -119 net new orders. Year-to-date, Boeing has accumulated 49 gross orders (196 cancellations ð -147 net new orders). On the other side, Airbus booked 60 gross orders last March and reported 44 cancellations for a net of 16. Year-to-date, Airbus has accumulated 356 gross orders (66 cancellations ð net of 290).
- **Fuel-hedging optimization:** Fuel accounted for about a fifth of operating costs on average at the big four U.S. carriers last year. So Brent priced at USD38 a barrel would lower the cost per gallon of jet fuel for U.S. airlines by as much as 55%, according to Moody's calculations. The problem this time is that the revenue falls outweigh fuel savings, while airlines that use hedges to lock in fuel costs cannot cash in on lower prices immediately. With no hedging or change in the crack spread, a 20 USD/b lower fuel price could shave off USD65bn from the industry's 2020 fuel bill, based on our average 41 USD/b oil price forecast. However, many airlines will have hedged 2020 fuel so this benefit could be delayed for some.

It is very difficult to provide a global estimate of these cost savings for the entire air industry, but available information suggests that they could help airlines hold back cash exits for one more quarter once lockdowns end. Although lower jet fuel prices may provide some offset to airlines' extra costs to keep running, the collapse in travel demand over the first half of the year will have a huge impact on profitability.

As of mid-May, governments had dedicated USD123bn to propping up the air transport industry (see Figure 5). Year-to-date, public support to airlines can be broken down into loans (USD60bn), employment aid (USD35bn), secured loans (USD16bn) and public funding (USD11bn). However, this support has been distributed unevenly. Unlike Asia, Europe or the U.S., the Middle East and Latam's airlines have barely benefited, with public support accounting for less than 5% of airlines' yearly revenues. This partially explains why two of the largest Latin American airline companies (AVIANCA, LATAM) recently filed for bankruptcy. They did not receive support mostly because air transport in the region is positioned as a luxury good for people who usually prefer road transport.

The US government struck first with its Coronavirus Aid, Relief and Economic Security Act, better known as the CARES Act. It has provided a total of USD50bn in assistance for passenger carriers, split between a USD25bn Payroll Protection Grants package and a USD25bn Loan and Loan Guarantees facility. This represents 25% of U.S. airlines' yearly revenues. Europe comes in the second position with public support amounting to 15% of the yearly revenues of airlines in the region. Asia is in the third position, with public support accounting for 10%.

The massive scale of state support raises concerns about whether the cash windfall is standing in the way of a a necessary thinning out of the sector by supporting weak airlines – among which some are state-owned or flag carriers – that are highly leveraged or unprofitable.

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Figure 5: State-aid for global airline companies and layoff plans

Carrier	State aid and job cuts
Air France-KLM (Europe)	USD12bn from the French and Dutch governments; KLM plans to cut up to 2,000 posts and has taken advantage of furlough programs. Air France is still discussing layoffs with unions.
Lufthansa (Europe)	USD11bn, shared between the governments of Germany (USD9bn), Switzerland, Austria and Belgium. Germany would own a stake of 20% in the airline. Workforce may shrink by 10,000.
IAG (Europe)	USD2bn of state-supported funding from both the UK and Spain. British Airways plans to slash 12,000 posts or 30% of the workforce.
EasyJet (Europe)	USD0.8bn raised through the U.K. government's Covid Corporate Finance Facility. 4,500 jobs cut.
Southwest, United, Delta and American Airlines (USA)	The biggest U.S. carrier (AA) has secured USD6bn dedicated to payroll support and a separated USD5bn federal loan. Atlanta-based Delta has received USD5bn in U.S. payroll aid. It is also applying for an USD5bn federal loan but has until September to decide whether to take it. More than a third of both airlines' workforce - around 40,000 people - have taken unpaid leave or voluntarily taken time off ranging from one to several months. The U.S. discounter Southwest has received USD3bn in federal aid for payroll support. It will apply for an additional USD3bn US loan but won't decide until the fall whether to use it. About 10,000 workers have taken voluntary leave or partial-pay options. Finally, United has just got USD5bn in U.S. grants and low-interest loans, and has applied to borrow up to USD4.5bn from the U.S. Treasury. Bracing for a more prolonged travel slump than its domestic competitors do, United will cut 30% of its managerial and administrative jobs when government restrictions lift in October.
Emirates and Etihad (Middle-East)	Dubai has said it will provide financial support for Emirates. On the contrary, no bailout has been announced for Abu Dhabi-based Etihad. Salaries have been cut at Emirates but unlike Etihad, it has said there will not be job cuts.
Chinese big three (Asia)	China Southern, China Eastern and Air China are state-owned airlines. A fourth one, Hainan, which belongs to the private failing HNA Group, is being sold apart to the Big Three in order to pay down a staggering amount of debt. They posted a collective USD2bn loss for first quarter of 2020 but have not been offered any bailout from the Chinese government.
Singapore Airlines (Asia)	Government-owned Temasek, the carrier's biggest shareholder, has backed a plan to raise USD9bn by issuing new stock as state aid. Measures include compulsory unpaid leave for pilots on varying days every month. In all, about 10,000 employees should be affected.

Sources: Bloomberg, national sources

THE LEGACY OF THE OUTBREAK IS LIKELY TO RESHAPE AIR TRANSPORTATION SUPPLY

Airlines have favored their liquidity positions over profit to attempt to survive this historic crisis. As travel bans are lifted, we expect increased price competition to revive air demand as airlines, especially low-cost ones, are rushing to get their planes filled and back in the air. Airlines will have to strike the balance between the need to preserve their cash positions and the risk of lost market share because of the extended grounding of their planes. This is particularly true for transatlantic routes considered as the most profitable segment in air traffic.

We expect two changes to take place in the sector in the three years to come:

- A major blow to private low-cost airlines: These companies depend on being able to transport as many people as possible, so complying with social distancing is likely to hit profitability. Besides, they will not escape state pressure to reduce their carbon footprints, while flag carriers might be subsidized to do so. Lastly, they are likely to be the first to suffer from possible postponements of air travel by passengers. More broadly, we expect the low-cost solution to become less attractive when not linked to a flag carrier airline. Companies such as Eurowings (Lufthansa), Vueling (British Airways) or Transavia (Air-France KLM) are able to better take advantage of the growing demand for point-to-point flights with no connecting services.

- A new wave of consolidation in air transport: Except for closing up or filing for bankruptcy, there aren't any other means for highly indebted airlines to escape a market suffering from over-capacity. From this point of view, it is interesting to notice that the most indebted airlines are all Chinese - Air China, China Southern and China Eastern airlines. Taken together, they total an impressive amount of USD70bn of financial debt. The Chilean Latam airline that went bust last week was plagued with USD9.5bn in debt, while Thai Airways and Norwegian Air Shuttle have been struggling against USD5bn and USD6.5bn of debt, respectively. More importantly, Cathay Pacific and Turkish Airlines are both financially indebted to the tune of around USD12bn each. Overall, it is worrying to notice that the level of financial debts exceeding USD10bn applies to the following airlines: American Airlines (USD24bn), IAG, United and Korean Airlines (USD15bn each), Air France-KLM (USD13bn), Lufthansa and Delta airlines (USD11bn). Middle Eastern airlines are to be put under scrutiny as well despite the fact that they cash in on very low jet fuel costs. Indeed, they are facing a problem with their plane fleets being less adapted to the lower air demand in relation to wide-bodied aircrafts, which are no longer preferred for long-haul flights and have too high maintenance costs.

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