European airlines: brace for more turbulence What's next after demand shock, bailouts?

Government support has helped large European network carriers avert a liquidity crisis, with air traffic to fall at least 50% in 2020. Deleveraging after the Covid-19 crisis will be a challenge for a sector not known for rich free cash flow generation.

European airlines secured direct financial government support of more than EUR 25bn after the onset of the coronavirus crisis earlier this year. The liquidity buffers most airlines had in place were insufficient to cope with a crisis of the magnitude brought on by the pandemic which led to the grounding of almost all aircraft in April and May.

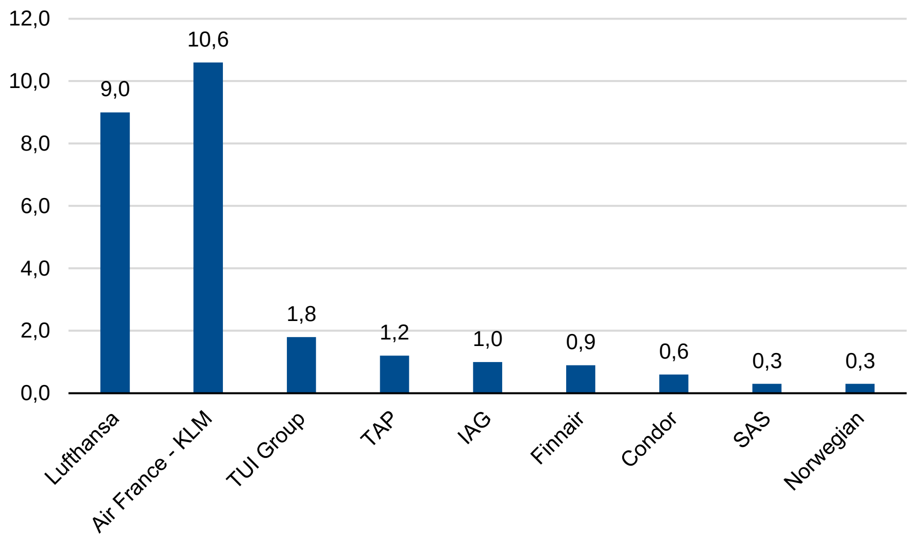
The funding situation is now stabilised due to state aid. However, future deleveraging and operational restructuring - including the downsizing of operations - will prove challenging for some industry players. Visibility on traffic recovery is low. Customers for long-haul and short-haul traffic continue to book on very short notice. Business travel is recovering only slowly. Air freight is one sector that has done comparably well, but with gradually rising passenger traffic comes increased freight capacity on passenger aircraft. Such an increase will compress elevated cargo yields. The air freight business is also too small to offset shortfalls in revenue from passenger travel.

A recovery of air traffic to pre-Covid-19 levels is unlikely before 2024 and the industry will have to downsize its capacity accordingly. The Covid-19 crisis had led to a closure of some airlines including Flybe, a UK-based regional operator, and an end to operations at others, such as Deutsche Lufthansa AG's Germanwings unit.

Direct financial state aid provided to large network carriers - such as Lufthansa, Air France-KLM SA and British Airways-parent International Airlines Group PLC - should provide breathing room for management to adjust operations to the new market environment and to arrange alternative sources of funding to repay shareholder or government loans. Lufthansa and AF-KLM may not have to use all the state funding arranged in 2020-21, assuming that a rebound in air traffic materialises next year.

State aid provided via subordinated shareholders loans is treated as a debt-like obligation in our analysis given the lack of permanence of these funds in the capital structure.

Figure 1: State aid (debt & equity) provided to European airlines (EUR bn)



Source: Company data

Analysts

Werner Stäblein
+49 69 667738912
w.staeblein@scoperatings.com

Sebastian Zank, CFA
+49 30 27891 225
s.zank@scoperatings.com

Azza Chammem
+49 30 27891 240
a.chammem@scoperatings.com

Media

Matthew Curtin
+33 1 87 40 57 05
m.curtin@scopegroup.com

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Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Airline sector's incurable cyclicality

Airline credit quality long hostage to industry's cyclicality

We emphasise that the airline industry's creditworthiness has long been viewed as below investment grade at best – intrinsically in the B category – because of its high cyclicality and vulnerability to adverse economic changes. Individual airlines within this industry can be rated more highly, of course. However, low barriers to entry, notably in Europe where the arrival of new entrants has led to the continuous expansion of air travel capacity, has ensured the industry's fragmentation. Price competition is consequently fierce. Most airlines found themselves with little financial headroom to endure a severe crisis after years of investment in expanding routes and fleets to grab market share by offering lower prices rather than building up cash reserves.

Covid-19 more severe than earlier pandemics

Covid-19 not comparable with previous pandemics

The rapid spread of coronavirus had a more severe impact on global aviation than other virus-related events in the past such as the swine flu (H1N1) in 2009 or the Severe Acute Respiratory Syndrome (SARS) outbreak in 2003. Authorities' reactions to those events fell a long way short of the widespread travel limitations, physical distancing and lockdowns put in place to try to slow the spread of Covid-19.

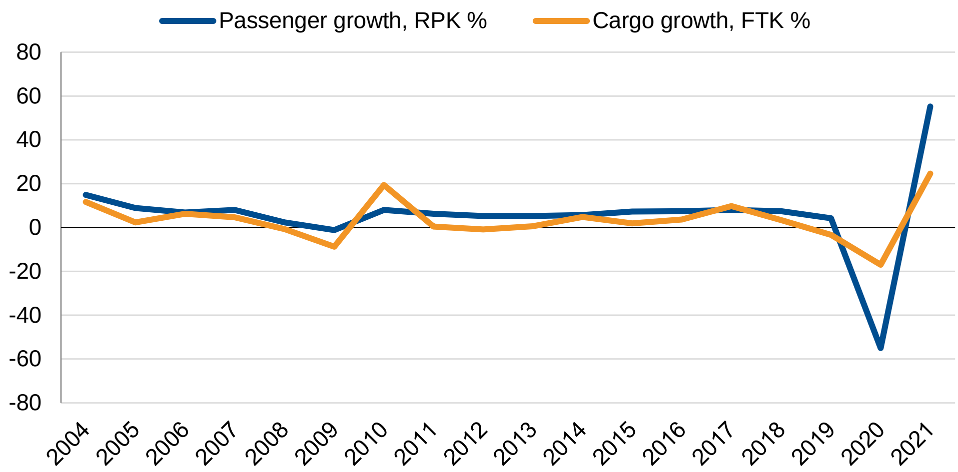
Global passenger numbers expected to decline 50% in 2020

Air travel demand was down 58% in H1 compared with the same period in 2019. Global RPK (revenue passenger kilometres) will decline by more than 50% in 2020 in IATA's latest economic review (July 2020), compared with a previous forecast of 38%. IATA expects that capacity in the global airline industry in 2021 will fall back to the level of 2014, equivalent to a decline of 26% compared with 2019. Similar statements by Air France-KLM suggest that available seat kilometres (ASK) will fall by at least 20% in 2021 compared with 2019. The result is that the airline industry will have to downsize its operations markedly to cope with the longer-term effects of Covid-19. Large network carriers such as Lufthansa, Air France-KLM, and IAG experienced RPK declines of 95%-99% in the second quarter due to the grounding of all aircraft. IATA expects travel demand to return to pre-Covid levels not before 2024.

Airlines offering 70% of originally planned flights in Q3

Lockdown restrictions in most EU countries and worldwide eased somewhat so far in Q3. All airlines have resumed flight operations with limited flight schedules. As expected, air traffic will pick up only gradually. In-fleeting of aircraft with scaled-back flight schedules will lead to a significant drop of air traffic and revenue even if aircraft operate at high load factors. The European airline industry has lost most of the important summer business in 2020 in addition to the revenues lost from grounding aircraft in April and May this year. Lufthansa initially expanded its flight schedule mainly to short-haul tourist destinations, achieving load factors of 70% after the Covid-19 lockdown period. Travel restrictions have limited airlines' long-haul flight operations. Lufthansa's flight schedule foresees that 90% of all originally planned short-haul destinations and 70% of long-haul destinations are being served this September. This is identical to Ryanair's plan to operate about 70% of all originally planned flights in September. Flight schedules and traffic assumptions are heavily dependent on no material second wave of Covid-19 infections until the end of 2020 and in 2021. The gradual increase of capacity offered is likewise linked to a complete lifting of travel restrictions such as border controls.

Figure 2: Global passenger growth and cargo growth



Source: IATA

Covid-19 and the air freight sector

Air cargo relatively resilient in H1

The impact of the pandemic on the air freight sector was less pronounced than for passenger travel, considering the near total halt of passenger flights. First-half cargo revenue rose at Lufthansa (+7% y-o-y) and IAG (+10%) while Air France-KLM reported a comparably low revenue decline (-4.5% y-o-y). Demand for air freight was considerable in the Q2 as the temporary closure of borders limited freight transport by road and rail while the grounding of so many passenger planes reduced available air freight capacity.

A new aircraft type, the "preighter" was born

Rising H1 air cargo revenues reflected the increase of cargo yields of up to 70% in Q2, suggesting a very favourable pricing environment. Typically, the cargo freight at airlines with cargo business is split around 50/50 with 50% of air freight capacity provided by dedicated freighters (such as the B777F or MD-11F) and the rest from spare belly space in passenger aircraft, or so-called "preighters." The grounding of most passenger aircraft removed most of the this second category of air cargo capacity, so overall, available cargo capacity in Q2 was cut roughly in half – providing airlines with a pricing advantage. Airlines added only limited additional air freight capacity in Q2 even though some converted wide-body passenger aircraft such as the A330 and B747-8 into freighters given the substantial belly space that both types of aircraft have to accommodate demand.

Cargo capacity to expand with more aircraft flying in H2

In view of the planned gradual in-fleeting of passenger aircraft until the end of the year, we would expect belly space air cargo capacity to increase in line with a higher number of passenger aircraft in operation. As a result, cargo yields should come down substantially in H2 with resulting negative effects on cargo revenues for the remainder of the year (open borders = lower air cargo volume, more belly space = more market capacity leading to lower yields). In our view, the cargo business is very likely to be hit by the economic contraction worldwide for the remainder of the year by lower cargo volumes. Once economic activity picks up, the cargo business should be the first to benefit, particularly if companies resort to overnight/fast deliveries by air to avoid supply-chain bottlenecks as economies recover.

How did airlines react to Covid-19 effects so far?

Drastic measures taken before state aid was negotiated

At the onset of the Covid-19 crisis, airlines initiated quick short-term measures to preserve liquidity by drastically reducing the number of flights, cutting back non-essential spending and renegotiating deliveries of new aircraft. The sector also benefited from government support such as short-time work arrangements, providing relief for salaries and wages of airline staff while preserving employment where those governmental policies exist. However, as the economic impact of the measures to contain the pandemic spread, European carriers required more significant government support.

EU paved the way for support but equity share was low

The EU relaxed state-aid rules to allow for direct government support for airlines as laid out in its "Temporary Framework". Government support provided to European airlines was mostly in the forms of (i) debt including subordinated loans, (ii) short-term liquidity funding and only to a small extent through direct equity injections. Lufthansa received EUR 300m of fresh equity in return for a 20% stake acquired by Germany's Economic Stabilisation Fund (Wirtschaftsstabilisierungsfonds, WSF). Finnair, 55%-owned by the Finnish state, raised EUR 500m equity backed by the Finnish government which made a EUR 286m capital injection. UK budget airline easyjet PLC secured shareholder approval to increase its share capital by as much as 15%. The airline received gross equity proceeds of GBP 419m, without any UK government participation in the equity capital raising.

Short-term standy liquidity provided for UK carriers

European governments subsequently put other short-term liquidity schemes in place. For instance, the UK government arranged the "Coronavirus Corporate Finance Facility Support Scheme" providing short-term liquidity support to eligible companies. Easyjet issued GBP 600m of commercial paper through the scheme while British Airways tapped the facility for GBP 300m and Hungary-based WizzAir for GBP 300m. To be eligible for a short-term loan under the scheme, companies had to have an investment-grade rating as of 1 March 2020. The UK government support scheme is different from the government support programmes provided by other European governments for domestic airlines - such as Germany's Lufthansa and charter airline Condor Flugdienst GmbH, Air France-KLM, Portugal's TAP, and Scandinavian carrier SAS among others - given the short-term nature of the funds provided. Easyjet, for instance, has refinanced the short-term government funding through its equity issuance, the arrangement of a new GBP 400m term loan and the completion of a GBP 608m sale-and-lease-back of 23 aircraft.

Bail-out based on state-backed and subordinated loans

The bulk of government support for European airlines was provided via state-backed bank loans and subordinated shareholder loans, notably the subordinated silent participation of up to EUR 5.7bn provided to Lufthansa (the remainder of the state aid package of EUR 9.0bn being a bank loan secured by aircraft and a government guarantee plus the EUR 300m equity capital increase) and EUR 3.0bn four-year shareholder loan provided to Air France by the French government (with the remainder of the French state aid package of EUR 7.0bn being bank loans guaranteed by the state). The state aid packages provided to Lufthansa and Air France should allow time for the airlines to adjust operations and to tap alternative funding sources.

State-backed loans may not become fully drawn

Lufthansa and Air France-KLM may not have to use all of the state aid at their disposal notably the subordinated shareholder loans. The support packages amount to EUR 9.0bn for Lufthansa and EUR 10.4bn for Air France-KLM including the EUR 3.4bn provided by the Dutch state.

Medium-term cash preservation already in place

Airlines have also taken steps to preserve cash in the medium term, in addition to taking advantage of short-term measures taken short-time work schemes, the given the difficult context: steep H1 revenue declines - 52%-56% reported by Lufthansa, Air France-KLM, IAG in 1H20 - and the expectation that airline traffic may not return to pre-crisis levels before 2024. The recipients of state aid can now settle liabilities from unused flight documents – customer reimbursements – which represent a substantial cash outflow that is unlikely to reverse soon given the lower expected air traffic bookings in the future. The three largest European network carriers have announced a combined cut of capital expenditures of more than EUR 4.0bn for the next few years, mainly achieved through cancellations or deferrals of aircraft orders and via the in-fleeting of fewer aircraft and/or reduction of spare engines. Air France-KLM, for instance announced a capacity cut of 20% for 2021 while IAG reduced the expected deliveries of short-haul aircraft for the period 2020-2022 by 57 aircraft. Lufthansa's capex cut of 50% until 2023 should help to save the airline more than EUR 1.5bn in cash outlays a year. Pre-crisis capex plans were around EUR3.0-3.5bn a year. Low-cost carriers, easyjet and Ryanair, have scaled back their respective growth plans to reduce capital expenditure in the medium term while easyjet has monetised some its owned fleet through a sale-and-lease back transaction.

Credit lines were drawn to bridge the gap to state aid

The liquidity situation of European airlines has improved mainly through the stand-by financing agreements with the respective governments. The table below shows the most recent figures reported by the largest airlines in Europe in the terms of the respective funding situation excluding financing facilities provided through state aid. Lufthansa, Air France-KLM and easyjet have drawn their committed credit facilities in the midst of the crisis (Air France-KLM's previous committed lines have now been replaced by the EUR 2.4bn credit line guaranteed by the Dutch state) and mainly benefitted from the short-term measures to preserve cash.

Negative free cash flows in 2020

The airline industry has a poor record in generating free operating cash flow. The three large network carriers (LH, Air France-KLM, IAG) had combined revenues of about EUR 90bn before the Covid-19 crisis, yet their combined pre-crisis free operating cash flow was only about EUR 2.5bn, a reflection of low margins and high investment needs in the industry.

Cash needs in 2020 influenced by unused flight documents

Looking at 2020, negative H1 free operating cash flows (i.e. cash funding needs) suggest that the cash burn for the entire year may prove to be less "catastrophic" than envisaged during the Covid-19 crisis. Of course, much of the cash needs in 2020 depend on the final settlement of unused flight documents (unless vouchered), a continuation of short-time work agreements (as extended recently by the German government) and a pick-up in air travel demand until the end of the year.

Earnings guidances for 2H20 suggest further negative

Lufthansa has guided for negative adjusted EBIT in the second half of 2020 while Air France-KLM says it expects negative EBITDA in the same period. We expect the adverse trend in earnings to continue for the rest of 2020. Airlines have already used the main levers for preserving substantial amounts of cash in 2021, namely the reduction of expenditure on new aircraft. Much of the cash preservation will now depend on the scaling-back of operations in 2021 and beyond. This may include the reduction of staff in all functions. The hard truth is that industry is unlikely to experience sufficiently high demand for air travel in the medium term to justify a return to the capacity airlines were operating before the Covid-19 crisis.

Post-crisis deleveraging will take time

European airlines are set for break-even free operating cash flows in 2021 depending on the air travel demand, but post-crisis deleveraging will be a challenge in the medium term. Cash payouts for dividends are restricted given the constraints of state aid, but in view of the network carriers' conservative financial policies before the pandemic, we would not have expected a preference of shareholder remuneration over deleveraging.

Figure 3: Liquidity situation of the big five European airlines excluding government support

		Lufthansa Group (EUR)	Ryanair Group (EUR)	easyJet (GBP)	Air France-KLM (EUR)	IAG Group (EUR)
Sources of cash	Cash and cash equivalents ~	3.6bn (30 June 2020)	3.9bn (30 June 2020)	2.6bn (30 June 2020)	5.4bn (30 June 2020)	6.0 (30 June 2020)
	Committed credit lines ~	all lines drawn in 2Q20	none	US$500m credit line drawn in April 2020	2.4bn credit line by the Dutch State (other lines that existed before cancelled)	undrawn general and aircraft facilities of 2.0bn (30 June 2020)
	Unencumbered aircraft ~	87% less aircraft pledged for KfW loan	7.0bn unencumbered (30 June 2020)	68% of aircraft (30 June 2020)	Not disclosed	Not disclosed
	Measures taken	Fleet grounding and capacity cut, short-term work, temporary layoffs of employees, marketing stop, unpaid leave, reduction in capex and growth plan				
	Capex plans	Capex cut by 50% until 2023	cut of aircraft deliveries for 2020-2022	reduced capex by 1.0bn in 2020-2022	reduced capex by 1.2bn in 2020	reduced capex by 1.5bn in 2020
	Free operating cash flow (average) in 2017-19~	0.9bn	1bn	0.3bn	0.5bn	1bn
Uses of cash	Unused flight documents/ unearned revenue ~	4.5bn (30 June 2020); LH refunded 2.0bn in 2020, partly after 30 June 2020	not disclosed	unearned revenue of 974m	deferred ticket sales 3.6bn o/w 920m vouchered	deferred revenues on ticket sales 4.6bn, down from 5.5bn (Dec. 2019)
	Free operating cash flow 1H20 for CY reporting companies	-0.5bn			-1.5bn	-2.2bn
	Short-term financial debt as of last reporting ~	EUR 2.8bn (30 June 2020)	EUR 1.9bn (30 June 2020)	Gross debt including leases was 3.4bn (30 June 2020)	Short-term debt of 1.1bn in 2H20 and 1.1bn in 2021 (30 June 2020)	Short-term debt 2.8bn (30 June 2020)
	Dividend payable suspended?	Yes	Share buyback suspended	Yes	Yes	Yes

Source: airlines interim reports and presentations

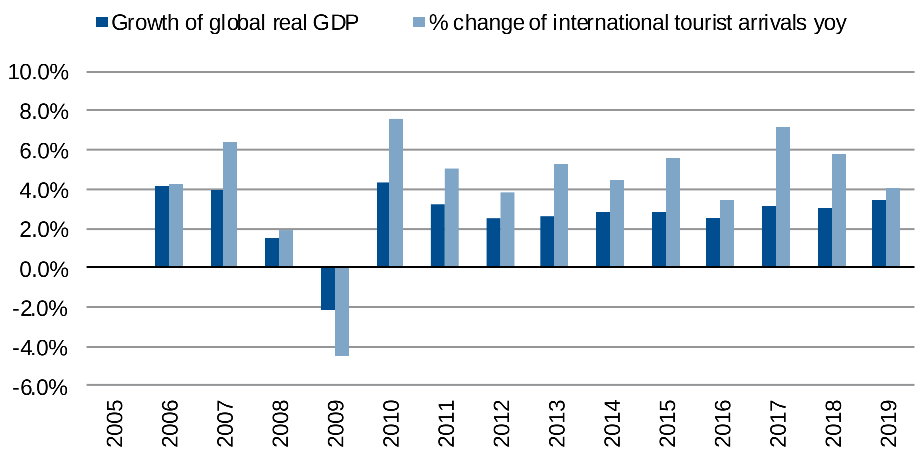
Smaller GDP = smaller free cash flows

It will take the airline industry several years to recover from the Covid-19 shock. Airlines will emerge from the crisis to find a smaller economy in absolute terms due to the expected severe declines in national GDP worldwide. Surviving carriers will be under pressure to shrink.

GDP multiplier works both ways

The airline industry is a GDP-multiplier industry. Historically, global air passenger traffic recovered from short-term and long-term shocks and followed a long-term growth trend of about 1.5x-2.0x GDP growth. The secular growth trend in air travel over the past decade was supported by the substantial declines in the real cost of air travel, in turn a reflection of the fiercely competitive nature of the industry. The GDP-multiplier effect is visible regionally – including Europe – and globally.

Figure 5: Growth of global GDP versus international tourist arrivals



Source: Statista, World Bank

Treatment of shareholder loans/government aid in Scope's analysis

No equity credit for subordinated government loans

In our analysis of the financial risk profile, we have treated subordinated loans provided by governments as debt-like obligations with zero equity characteristics and likewise no equity credit assigned when calculating key financial credit metrics. As an example, we have treated as debt-like the silent capital contribution of up to EUR 5.7bn provided by the Germany's WSF to Lufthansa. While we see certain equity characteristics in the silent participation - such as, in principle, unlimited maturity, subordination to other debt and deferrable coupon payments - we do not view the important criterion of "permanence" to be satisfied. Lufthansa can, in principle, repay the amounts under the silent partnership any time which speaks against a permanence of the funds provided to the capital structure. In addition, Lufthansa's management has likewise clearly stated that the payback of state aid is a priority.

In addition, the state aid provided to airlines is governed by state aid regulations within the European Union. The European Commission has allowed member countries to provide state aid to companies but the framework for state support was clearly designed for only temporary relief (see European Commission "**Temporary** Framework For State Aid Measures To Support The Economy In The Current Covid-19 Outbreak").

Coupons on subordinated loans likely to exceed ROIC

The silent partnership between Lufthansa and the WSF also provides an incentive to repay the silent participation quickly which speaks against the permanence of this funding in capital structure. Lufthansa's coupon payments for the silent partnership have step-ups rising from 4% in 2020 and 2021 to 9.5% by 2027. Similar step-ups exist for the subordinated shareholder loan of EUR 3.0bn that the French government provided to Air France with EURIBOR (floored at zero) plus margin of 7% in the first four years, a step-up to 7.5% in the fifth year and 7.75% in the sixth year. The step-ups in and by themselves already provide a sufficient incentive for the receiving entities (Lufthansa, Air France-KLM) to replace these financings in the future which also speaks against the permanence of the funding provided.

In addition, the coupons agreed between the respective countries and supported airlines suggest that interest payments on the state aid may very likely exceed the return on invested capital. Return on invested capital is fairly low in the airline industry. According to IATA, the global airline industry's ROIC in the period 2014-2019, i.e. in economically prosperous times, was 6.7% on average, up 2.5 percentage points from prior periods. In view of the expected decline of business and underutilised capital (notably aircraft) being tied up in operations in the post-crisis period, we would expect ROIC in the industry to decline further. Lufthansa, for instance, reported a ROIC of 6.1% for 2019. With the likelihood of declining ROICs until the industry has recovered from the coronavirus crisis, we would see interest payments on state aid to exceed the likely ROIC at Lufthansa and Air France-KLM. In other words, the airlines would run the risk of paying more interest for the subordinated state loans than the return on the capital invested would generate.

Asset sales, refinancing with bank loans are options

The solution to the refinancing of state aid will depend on the specific situation of each airline. Lufthansa, for instance, has strategic financing levers such as full disposal of its European catering business (the sale of the unit was agreed but not closed before the onset of the Covid-19 crisis), a partial sale and/or IPO of its MRO unit Lufthansa Technik and/or an equity capital increase. Smaller amounts may be raised from the disposal of de-fleeted aircraft. Some refinancing of subordinated state loans is likewise possible at more favourable rates using the unencumbered aircraft as a pledge for bank loans.

Conditions for state aid

No onerous strings attached to state aid other than coupon

Airlines that have been granted state aid did not have to provide much compensation in return for receiving the liquidity support to bridge the time until the post-crisis period. According to Brussels' "Temporary Framework", beneficiaries of state aid can not make dividend payments or buy back shares. Management remuneration is limited until state aid is repaid. The conditions imposed on Lufthansa to become eligible for state aid are fairly moderate in our view. The EC obliged Lufthansa to transfer to one new competitor each at the Frankfurt and Munich airports up to 24 take-off and landing rights (slots), i.e. 3 take-off and 3 landing rights per aircraft and day for stationing up to 4 aircraft. It is far from certain that new competitors (i.e. airlines that have not served the Munich or Frankfurt airport before) will pick up these slots in our view.

Environmental strings attached to state aid for Air France

The conditions linked to the French state support for Air France have an environmental element with an effect that is more lasting than the obligation imposed on Lufthansa. Air France must reduce domestic flights over very short distances to support governmental goal that Air France should become one of the "most environmentally friendly" airlines.

No quick fix for industry to reduce debt burden

Of course, the subordinated government loans carry a substantial coupon and reflect the credit risk that airlines had once the when state aid was arranged, but airlines have the option - and have made public commitments - to refinance state loans at more favourable rates in the future. However, the high level of borrowing in the industry represents a significant financial burden most of the recipients of state aid. The reduction of incremental debt incurred from the grounding aircraft amid the expected shrinkage of air traffic in the medium term will take time.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan
Regus Porta Venezia
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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