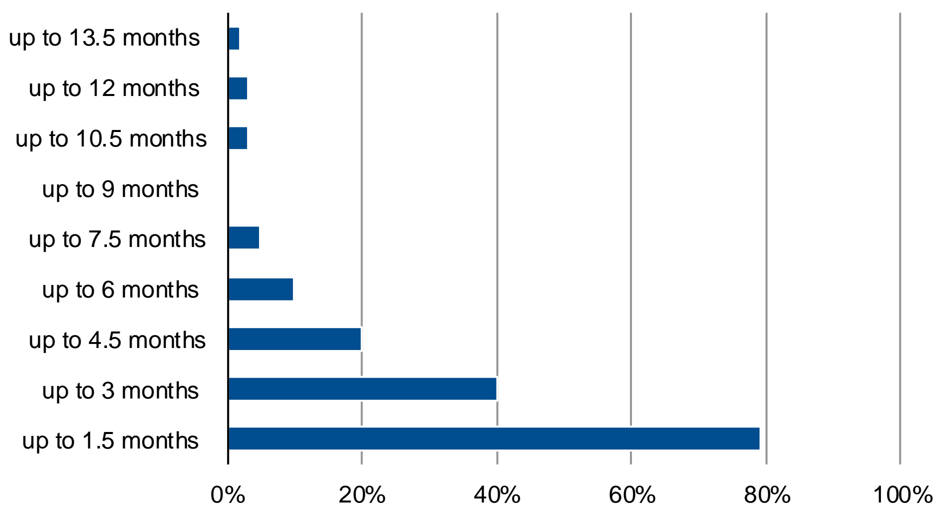
Airlines fight sales slump, cash crunch
Covid-19 hits European carriers hard

Scope Ratings

Mass bankruptcy is hanging over the world's airlines as the Covid-19 pandemic has hit the travel industry hard, with lockdowns grounding fleets and effectively halting operations. Many European carriers are particularly vulnerable.

Liquidity buffers held by the airlines are the keys to their survival, but only for so long. And time is running out fast for many carriers. The International Air Transport Association (IATA), which represents 290 airlines, is urging an accelerated mass bailout to avoid the collapse of many airlines, estimating the industry needs up to USD 250bn in assistance. Much of the industry is simply running out of cash, according to IATA, with 75% of airlines holding only enough to cover at most three months of unavoidable fixed costs. Only 10% can withstand the current situation for six months, on the assumption that the crisis abates by the end of June, with a small minority capable of withstanding zero cash inflows for more than six months.

Figure 1: Number of months cash to cover unavoidable fixed costs



Source: IATA

Assessing airlines' survival prospects

The Covid-19 crisis is proving a severe test for airline strategies of recent years. The industry is divided companies which have pursued conservative financial policies, keeping cash on hand as far as possible, and those which favoured returning cash to shareholders through dividends and share buybacks and/or borrowing to expand fleets.

The airlines' cost structures also vary considerably. Some variable cash-effective items incurred by one airline, through operating and financing lease payments, may not be incurred by another. Companies whose CEOs preferred to own rather than lease aircraft to maximise operating flexibility – such as easyJet PLC, Deutsche Lufthansa AG (**Scope downgraded the company to BBB- from BBB and placed the rating under review for a possible downgrade, 31 March**), Ryanair PLC – are looking relatively resilient during the crisis. Lufthansa, as an example, says that about 60% of its cost structure is variable, meaning 40% of operating expenses are fixed in nature. Non-cash depreciation makes up around 8% of operating expenses, but the balance can be reduced mostly by cutting staffing costs. Some of the fixed costs are currently 'semi-fixed,' helped to a large extent by the introduction of short-term working schemes, effectively providing airlines – and other companies – relief from personnel costs as governments step in to provide short-term work schemes to employees.

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Airline sector's incurable cyclicality

B-rated industry for its 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. Airlines can be rated more highly, of course. But low entry barriers, notably in Europe and visible in the continuous expansion of air travel capacity and the arrival of new entrants, have led to the industry's fragmentation. Price competition is consequently fierce. Most airlines find themselves with little financial headroom to endure a crisis after years of investment in expanding routes and fleets to grab market share by offering lower prices rather than building up cash reserves.

Placing Covid-19 in the perspective of earlier pandemics

Covid-19 not comparable with previous pandemics

The coronavirus will have a more severe impact on global aviation than other virus 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 both events fell a long way short of the widespread travel limitations, social distancing and lockdowns to try to slow the spread of Covid-19, which has reached more than 180 countries.

Global aviation traffic to decline by 35% in 2020

The experience of SARS provides a good indication about the likely decline of passenger air traffic. SARS was mainly limited to China, Hong Kong and the Asia-Pacific region. IATA reported that passenger traffic (as measured by revenue passenger kilometres) declined by about 35% in the Asia-Pacific region when the SARS pandemic peaked around three months after the breakout of the disease. The 35% decline looks to us a useful precedent for estimating the likely fall in air passenger traffic in 2020 in view of the prolonged period of travel restrictions – we expect global aviation traffic to decline by a similar percentage, if not more. We have one caveat: the assumption that airlines will be able to start in-fleeting their aircraft in the second half with a limited flight schedule assuming borders gradually re-open and governments gradually lift travel bans.

Most recent IATA estimates point to 38% decline in RPK

IATA is expecting a global RPK (revenue per kilometre) decrease by 38% for 2020, if not more. Europe will be hit the most with an RPK decrease of 46% compared with the level in 2019.

Air freight is an alternative to traditional transportation

The impact of the pandemic on the air freight sector is less pronounced relative to the near total halt to passenger flights. Lufthansa reported that demand for freight is currently focused on goods that are ordinarily transported through different means (trucks, train). In view of the needs of some industries to maintain their supply chains, air freight is currently the preferred option. The closure of borders (the EU closed its borders on 18 March) is limiting the ability to use other modes of transport.

Wide-body passenger aircraft to expand cargo capacity

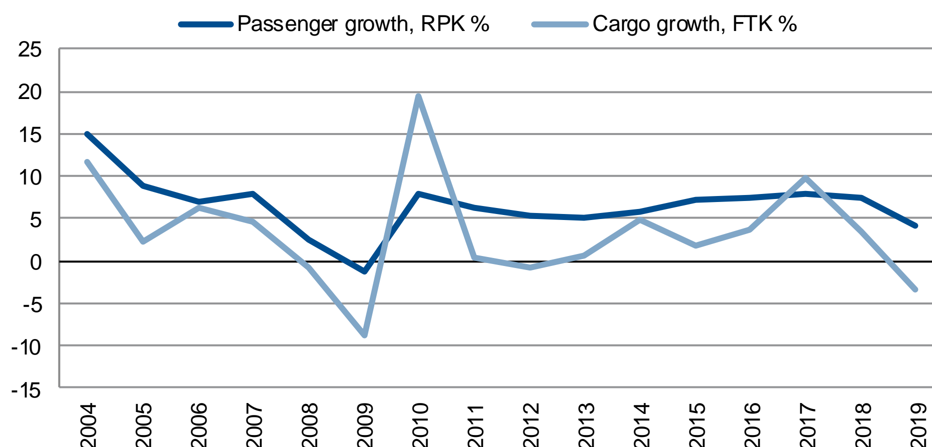
Lufthansa plans to mobilise additional cargo freight capacity. Typically, the cargo freight at airlines with cargo business is split around 50/50, with 50% of air freight capacity provided by dedicated air freighters (such as the B777F or MD-11F) and the remaining half from belly space in passenger aircraft. Lufthansa plans to use passenger aircraft such as the A330 and B747-8 to expand freight capacity given the substantial belly space that both types of aircraft have. The strong demand for air cargo in the short term may alleviate the risk of a simultaneous drop in both passenger and cargo business. Looking back to the economic and financial crisis in 2009, when GDP contracted substantially, we still expect the cargo business to be hit by lower 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.

Air freight demand only partially offsets drop in passenger traffic

While the upturn of demand for freight transportation offers a certain relief to airlines with cargo business (or those airlines that will use wide-body passenger aircraft to offer air

freight services), this development is unlikely to balance the substantial shortfalls from the traditional passenger business. As reference, in economically normal years, Lufthansa's cargo business represents about 8% of group operating income (EBIT).

Figure 2: Global passenger growth and cargo growth



Source: IATA

Important policy measures

Short-term working schemes quickest way to help

There is much news flowing about government support of airlines in the current situation. Certainly, the primary and quickest form of government support is the availability of short-term work schemes and similar policies to provide relief for salaries and wages of airline staff while preserving employment.

In Germany, short-term working schemes were successful at maintaining employment during the economic and financial crisis in 2009. Various countries in Europe have since adopted the approach.

Collateral value plus guarantee provides substantial security

Airlines with unencumbered aircraft could benefit from government guarantees for loans in addition to the value of aircraft collateral, which would effectively make any such loan a 'double-pledge loan' (collateral value of aircraft plus state guarantee). This should result in low interest payments given the high recovery expectations for lending institutions in case of the default and possession/remarketing of the aircraft. In view of the recent jump of credit spreads for the aviation industry as whole, we would, however, suspect that the good times of almost 'zero-coupon' financing of aircraft are over. An overview of the various parameters affecting aircraft financing can found in our **Aviation Finance Rating Methodology**.

Regulations at EU-level adapted quickly

In addition to the various fiscal stimulus programmes currently discussed and most likely enacted across various countries, the EU decided on 18 March 2020 that the European directive on air passenger rights (EU 261) does not apply to compensations for coronavirus-related flight cancellations. This decision will protect airlines from refunds of tickets and/or payment of other forms of compensation to customers, effectively preserving cash at the airline. The European Commission has likewise suspended the EU's 80/20 landing slot regulation (aka, 'use it or lose it'), meaning airlines will not have to fly 'ghost planes' to maintain their landing slots.

Government support can take various types

A last-resort measure would entail governments taking some type of equity stake in the airlines. The German government, for instance, has concluded that taking a temporary shareholding would be an option, with funds earmarked for that purpose. We think that any equity relief provided by national governments can take various forms and would not necessarily have to be completed via equity rights issues. Deeply subordinated loans with

equity characteristics (such as hybrids) are another option for governments to provide support without being involved in corporate governance as a stakeholder. The EU has already relaxed state-aid rules to allow for direct government support given that potential support of companies will come at the national level. The UK government is urging airlines to discuss arrangements with financial stakeholders.

Airlines have hidden ways to preserve liquidity and raise funds

Preserving liquidity is more than lowering operating costs

Airlines have initiated short-term measures to preserve liquidity. On top of governmental support via short-term work arrangements (where those governmental policies exist) and the scaling-back of cash outlays for items such as marketing, non-safety-related maintenance, repair and overhaul of aircraft, or unpaid leave, there are two more decisive levers to preserve liquidity in the current environment.

Managing liabilities from unused flight documents

A key strategy to avoid further cash outflows is the active management of liabilities from unused flight documents. Flight tickets, ordinarily paid in advance, may have to be refunded if the booking is cancelled. To retain this cash, Lufthansa and Air France-KLM, for instance, have offered generous rebooking options and issued rebooking vouchers. These measures should not be underestimated. As a comparison, Lufthansa had EUR 4.0bn of liabilities under 'unused flight documents' at the end of 2019 versus total gross financial debt of EUR 6.8bn, of which EUR 6.1bn were long-term financial obligations. Unused flight documents, however, have no contractual maturity other than providing a flight service paid in advance. Therefore, the management and avoidance of a short-term drain on liquidity through refunds of unused flight documents are key measures for all airlines to safeguard liquidity.

Scaling-back of fleet modernisation or expansion

The second option to preserve cash is the reduction of capital expenditures via the in-fleeting of fewer aircraft and/or a reduction in spare engines. All of this, of course, depends on the ability of airlines to negotiate delays or postponements with aircraft manufacturers as well as reductions in pre-delivery payments. In 2020, around 430 aircraft are expected to be delivered to Europe – even fewer given that some deliveries are in doubt due to the grounding of Boeing's B737MAX aircraft over safety concerns. Lufthansa has announced a drastic reduction in the capex level originally planned for 2020 (EUR 3.0bn) and some of that reduction is very likely to come from the lower number of aircraft deliveries to enter service in 2020/21 than originally planned. We assume that some penalty payments would be due if aircraft deliveries from aircraft makers Boeing/Airbus were renegotiated but, regardless of the size of the penalty, the cash effect would be lower than from taking new aircraft into the fleet.

Aircraft financing with unencumbered aircraft

Airlines with unencumbered aircraft currently have an edge in terms of arranging new funding if needed. Lufthansa pointed out that 87% of its owned fleet is unencumbered, representing a book value of about EUR 10bn. Much of the aircraft financing through the collateralisation of aircraft can be affected quickly but very likely not to the magnitude of EUR 10bn in a short period of time. For most airlines, various banks have committed to providing different types of credit lines (bilateral, syndicated credit facilities) and most financial institutions may be prepared to provide additional funds against collateral, possibly partly supported by government guarantees. Collateral values for the largest share of the aircraft that can be collateralised, namely narrow-body aircraft, are likely to be firm given their short supply following the grounding and suspension of the production of the B737MAX. Lending against wide-body aircraft may prove costlier and/or more limited due to the collateral value.

Unused flight documents pose the greatest risk of cash drain

The table below shows approximate figures reported by the largest airlines in Europe in terms of the respective funding situation. The major sources of cash directly available are cash and cash equivalents in addition to committed credit lines that some airlines have

started to draw upon. In addition, some airlines have unencumbered aircraft that can be used as collateral or for sale-and-lease-back transactions. Short-term cash needs relate to short-term financial debt but also unearned revenues (unused flights documentation). Unused flight documents significantly exceed the contractual financial maturities for Lufthansa, Air France/KLM and IAG Group, thus highlighting the importance for airlines to reduce the cash drain from ticket refunds through active customer management (vouchering, re-booking options etc.).

Further funding needs to arise once free cash flows turn sour

Most airlines suspended dividend payments in 2020 to reduce cash payments. As mentioned, passenger numbers are expected to decline in a magnitude of 35%-40%, depending on the forecast and reference point. For most airlines this will pose the risk of substantially negative free operating cash flow (FOCF) in 2020, i.e. cash outflows that will need some sort of funding. The magnitude of any such negative FOCF depends on three important parameters: i) success in reducing cash costs to match the decline in revenues from sharply lower passenger traffic; ii) the management of unused flight documents; and iii) the ability to reduce capital expenditure through the cancellation or delay of orders.

Additional debt here to stay

The airline industry is not very FOCF-rich. Even when bank loans or funding are increased, it will take time after the crisis to reduce the increased financial liabilities that are helping to bridge the liquidity crisis. Some airlines, such as Ryanair or easyJet, may boost FOCF by scaling back their respective growth plans, thus lowering expected investments into the expansion of the fleet. Here, again, the cash balances and cash flows between airlines and customers through ticket sales (unused flight documents) will play an important role once the crisis is resolved. Once bookings and aviation traffic increase, airlines should feel cash relief from higher prepayments on tickets. Nevertheless, any additional funding currently arranged to bridge shortfalls in funding of operations (negative FOCF) will remain and the low levels of cash flow generation in the industry suggest that post-crisis deleveraging will take time, in particular because all airlines will be operating in a smaller economy in terms of absolute size due to the expected declines in global GDP.

Figure 3: Liquidity situation of the big five European airlines in terms of passenger volume

		Lufthansa Group	Ryanair Group	easyJet	Air France-KLM	IAG Group
Sources of cash	Cash and cash equivalents ~	EUR 4.3bn (as of March 2020)	EUR 4bn	EUR 1.7 bn	EUR 6bn	EUR 7.3bn
	Committed credit lines ~	EUR 774m	none	EUR 463m	EUR 1.8bn (drawn)	EUR 1.9 bn
	Unencumbered aircraft ~	87% of owned fleet unencumbered (book value about EUR 10bn)	70% of owned fleet unencumbered (book value about EUR 5.4bn)	70% of owned fleet unencumbered (book value about EUR 4bn)	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				
	Free operating cash flow (average) in 2017-19~	EUR 0.9bn	EUR 1bn	EUR 0.3bn	EUR 0.5bn	EUR 1bn
Uses of cash	Unused flight documents/ unearned revenue ~	EUR 4.0bn (December 2019)	Not disclosed	EUR 1bn (December 2019)	EUR 3.3bn (December 2019)	EUR 3.5bn (December 2019)
	Short-term financial debt as of last reporting ~	EUR 0.7bn	EUR 0.4bn	Not material	EUR 1 bn	EUR 1 bn
	Dividend payable suspended?	Yes	Share buyback suspended	No	Yes	Uncertain

Source: selected airlines annual reports and presentations

Looking beyond the crisis

Operations to move back to normal only gradually

It is important to note that air traffic will only gradually pick up after the worst of the crisis is over. The in-fleeting of aircraft after the crisis may take weeks and flight schedules will have to be revisited by all airlines. Flight schedules are typically planned six to eight months in advance and in view of the low visibility for the summer flight schedule in 2020, airlines will likely have to reschedule original plans or develop special flight schedules. Bookings for the important summer season normally would have already started (providing the cash benefit of unused flight documents mentioned above) but consumer hesitation, including the lack of clarity on travel bans and border controls, will lead to limited visibility in the coming months.

Low oil prices not a saviour of the industry

Another factor is possible future relief for airlines as a result of lower crude oil prices, which could, in principle, reduce carriers' kerosene bills substantially. We caution, however, that lower jet fuel prices will prove to be a short-lived benefit for the industry at large. Once the aviation industry moves back to a more normalised flight schedule, the benefit of lower input prices (kerosene) will quickly be competed away – as airlines ramp up their operations and try to lure back customers – so it is unlikely that lower oil prices will lead to better operating margins on a sustainable basis. Many airlines also hedge fuel consumption in advance and have therefore not benefitted from the sudden drop in fuel prices this year.

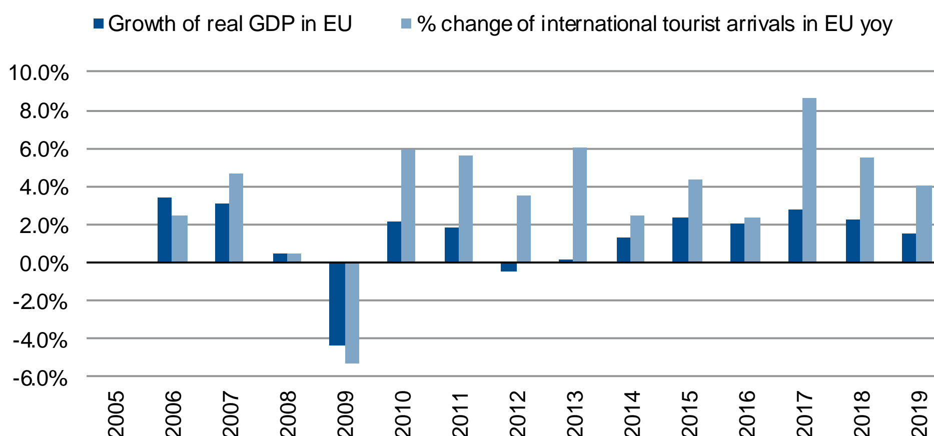
Second-round effects from weakening GDP

Aviation is a GDP-multiplier industry

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.

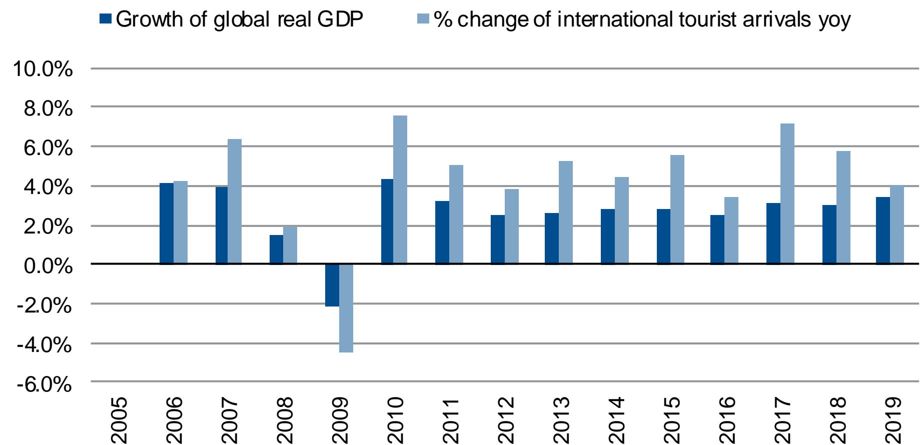
The airline industry is a GDP-multiplier industry. Historically, global air passenger traffic recovered from short-term and long-term shocks and followed a long-term growth trend of about 1.5x-2.0x GDP growth. The secular growth trend in air travel over the past decade was supported by the substantial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

Figure 4: Growth of GDP in the EU versus international tourist arrivals in the EU



Source: Statista, World Bank

Figure 5: Growth of global GDP versus international tourist arrivals



Source: Statista, World Bank

GDP multiplier works both ways

The GDP effect, however, will very likely work in the opposite direction in an economic downturn, i.e. airlines will be faced with a smaller global economy on an absolute scale after the crisis and are very likely to follow the GDP decline with a multiplier of 1.5x-2.0x, exacerbated by the current grounding of aircraft not related to the economic crisis.

Travel and tourism an important part of GDP worldwide

What makes matters worse is the importance of travel and tourism as a key contributor to GDP worldwide in and by itself. In 2019, travel and tourism contributed about USD 9trn to global GDP, up from USD 5.8trn in 2007, the year preceding the global economic and financial crisis in 2008/09. Putting this into perspective: global GDP in 2019 was about USD 86.4trn – so more than 10% of global GDP in 2018 was generated by travel and tourism.

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