European Airlines Outlook 2021

The credit outlook for European airlines remains negative. The sector is among the worst hit by the pandemic. No carrier has escaped the severe downturn, but there will be big winners and losers in the industry shakeout.

European Airlines, Scope Ratings GmbH, 27 January 2021

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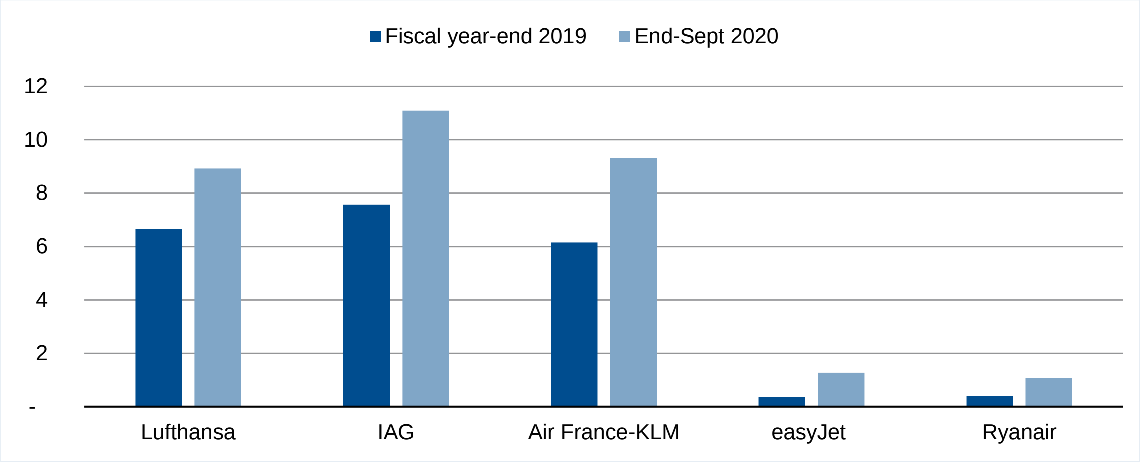
Executive summary

The European airline industry's credit outlook remains negative. Few sectors in the battered global economy were hit as hard as this sector in 2020. The shock of the pandemic was especially severe in Europe where airlines have for years struggled to generate sustainable cash flow amid overcapacity and fierce competition. The Covid-19 crisis has damaged the credit quality of the majority of airlines. Every month that passes without a return to more normal operating conditions puts more carriers at higher risk of bankruptcy.

The main trends we expect for 2021 are:

- Harsh operating conditions for airlines in Europe given the variety of travel restrictions within the region whose duration depends on how well the authorities can contain the pandemic as vaccination accelerates.
- Short-haul travel will recover before long-haul, but airlines cannot expect a return to pre-pandemic traffic volumes before 2024.
- Many airlines face several months of extreme uncertainty, with the risk of collapse or entering administration.
- Airlines with the strongest balance sheets and best market positioning - led by Ryanair PLC, Wizz Air Hungary Ltd. and easyJet PLC - will spearhead the sector's recovery, reinforcing their competitive positions as rivals struggle. Government-backed airlines such as Deutsche Lufthansa AG (BBB-/Negative) and Air France-KLM SA will take longer to recover but will do so faster than smaller rivals.
- Reducing costs and conserving cash remain priorities as airlines have had to tear up pre-pandemic growth strategies. Executives face a dilemma: getting back to break even while selling fewer seats implies increasing fares. That, in turn, risks sacrificing an airline's share of a shrunken air-travel market – particularly at important hubs and on more lucrative routes. The industry faces chronic overcapacity.
- Conserving cash may require airlines to take on more debt and seek further government support. This may be forthcoming if the crisis extends to the second half of 2021 but will have long-term consequences for credit ratings as airlines may remain heavily indebted for years. More state aid would lead to regulatory scrutiny.
- The entire aviation value chain, including businesses which were previously more reliably profitable such as regulated airports, is under extreme pressure, which is likely to lead to more intra-industry cooperation.

Figure 1: Financial net debt increasing for most players (on a reported basis, in EUR bn)



Source: Scope, companies' interim reports

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Key trends for 2021

The majority of the world's airlines face a difficult 2021 with weaker balance sheets and uncertainty about when air traffic will recover. With vaccination programmes against Covid-19 now underway, the industry can expect a transition year on the way to a slow recovery thereafter.

It is worth remembering the sheer scale of the shock the coronavirus pandemic represents for airlines. Air passenger traffic slumped by more than 90% in April 2020 when airlines in Europe had to ground most, if not all, of their aircraft.

Europe's airlines have had a measure of relief from the slide in passenger traffic from their air-cargo business due to increasing demand from suppliers of medicines, medical kits, foods and other goods. However, rising cargo yields can only partially compensate for lost passenger traffic.

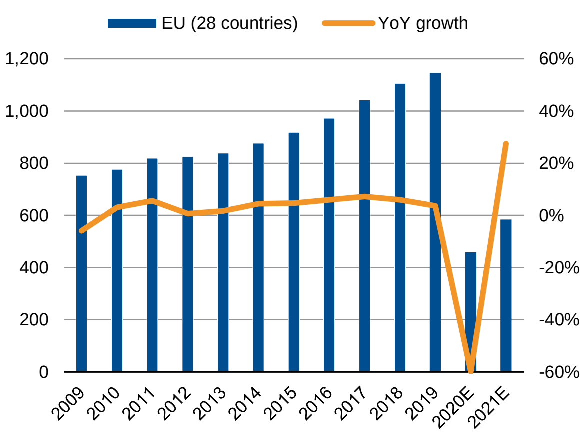
Cash-strapped carriers have struggled to recover from the first series of lockdowns and travel restrictions, hampered by further waves of infection and strict curbs on travel.

In Europe's fragmented market, carriers face existential questions this year: which companies will, first, survive the crisis, and second, emerge in a sufficiently strong position to benefit from the eventual upturn?

Impact of a slow recovery on Europe

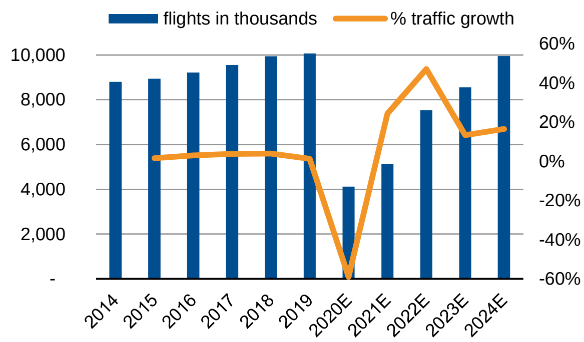
Passenger traffic fell by more than 55% in 2020 from the year before. The International Air Transport Association (IATA) and Eurocontrol only expect a recovery to pre-pandemic volumes in 2024. The current scenario is based on the recent start of vaccination programmes in many countries and assumes that all countries will ultimately receive vaccines. According to our estimates, air traffic will return to 51% of pre-pandemic levels in 2021, up from 59% in 2020, before rising to 75% in 2022, 85% in 2023 and 99% in 2024.

Figure 2: Passenger traffic at EU airports (in m) and passenger growth rate



Source: Scope, Eurostat

Figure 3: Flight traffic for Europe assuming recovery in 2024



Source: Scope, Eurocontrol

Airlines worldwide are under severe financial stress given the slump in demand due to pandemic-related travel restrictions that have shrunk business and holiday traffic. The Covid-19 crisis will accelerate consolidation as Europe's airlines sector remains highly fragmented. More than 55% of European capacity was controlled by the five largest airline groups in 2019. That proportion will increase in the future if we add Hungary-based Wizz Air to the list of dominant carriers.

Direct state aid, emergency borrowing, payment deferrals and staff furloughs have contributed to the survival of many European airlines in the depths of the crisis – but not all. Some carriers went under or faced potential bankruptcy, notably those dealing with financial difficulties before the pandemic, such as UK-based regional operator Flybe. Some airline-holding companies have been unable or unwilling to support individual subsidiaries, such as International Airlines Group (IAG) PLC and its Austrian unit LEVEL Europe, Lufthansa-Turkish Airlines joint venture SunExpress Airlines and its German unit SunExpress Deutschland, as well as Lufthansa and its Germanwings unit.

Figure 4: List of airlines that went bankrupt or under creditor protection in Europe

Airline	Category	Status
Ernest Airlines	Italian carrier	ceased operations pre-crisis
AtlasGlobal	Turkish charter carrier	ceased operations pre-crisis
Air Italy	Italian carrier	ceased operations pre-crisis
Flybe	UK regional airline	ceased operations
LEVEL Europe	Austrian subsidiary of IAG	ceased operations
SunExpress Deutschland	German subsidiary of SunExpress	ceased operations
CityJet	Irish regional operator	under creditor protection
Germanwings	German subsidiary of Lufthansa	ceased operations
German Airways	German wet-lease carrier	ceased operations
Jet Time	Danish charter operator	ceased operations
Go2Sky	Slovakian charter carrier	ceased operations
Montenegro Airlines	National carrier	ceased operations
Norwegian Air Shuttle	Norwegian budget airline	under creditor protection

Source: Scope Ratings

Examples of the pressures facing smaller airlines in Europe include the revised price paid by Iberia, one of IAG's Spanish units, for Air Europa. At EUR 500m, with payment deferred for six years, the price was half the pre-pandemic price tag when the deal was first signed in late 2019.

Another is long-haul, budget carrier Norwegian Air Shuttle's decision to seek creditor protection and agree to refocus its business on short-haul routes in an effort to survive with Norwegian government support. Norwegian's reorganisation will impact the European aviation market as the airline was among the top 10 carriers in 2019 in terms of passenger volume. For the time being, its decision to cease long-haul transatlantic routes will benefit British Airways and Lufthansa, which are likely to grow market share once a sector recovery starts.

Competition in the European sector will remain fierce in 2021 given weak demand expected in the first half of the year. The battle between budget and legacy airlines on point-to-point routes will intensify. We expect to see more airlines fail.

The agility of no-frills airlines is proving to be an advantage, enabling them to adapt to the rapidly changing environment and seek out pockets of passenger demand.

In this context, any growth in the transition phase for Europe's airlines will likely come from Ryanair and Wizz Air. These carriers had robust balance sheets at the outbreak of the crisis, allowing them to be more aggressive in seeking growth opportunities.

Ryanair and Wizz Air, together with easyJet, also have lower cost bases, which could also help them increase market share when traffic volumes rebound. Maintaining low ticket prices will be key. Many carriers face a dilemma: to break even, while selling fewer seats due to the pandemic, implies increasing fares. This could be difficult without sacrificing market share.

The legacy carriers which received state support will rethink strategy: traffic on short-haul routes is likely to recover before that on the typically more lucrative long-haul, intercontinental routes which they dominate.

Revised fleet plans by some airlines confirm our view that demand will take considerable time to get back to 2019 levels. EasyJet PLC is one example, having agreed with Airbus to defer the delivery of 22 aircraft from 2022-2024 to 2027-2028. Lufthansa Group is also slowing deliveries of new aircraft and phasing out older models.

The eventual recovery in air traffic will benefit Europe's biggest airlines: Ryanair, Lufthansa Group, IAG, Air France-KLM, easyJet PLC and Wizz Air.

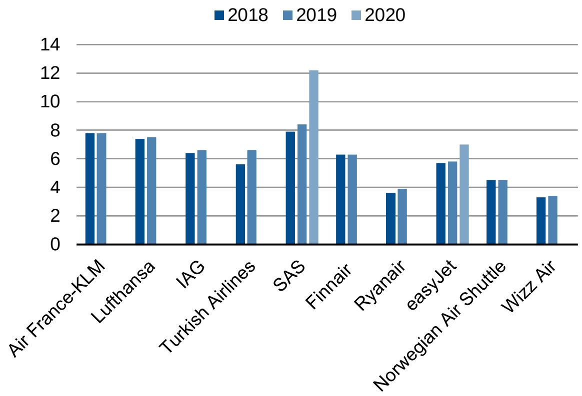
Focus on cost control: labour, fuel

Airlines have taken drastic steps to reduce costs, but around 50 % of their costs are fixed or semi-fixed. Expenses have not fallen as fast as revenues.

The problem is more acute for legacy, network carriers with relatively high fixed costs compared to budget carriers.

As airlines have reduced capacity in response to the collapse in travel demand, unit costs (cost per available seat kilometres, or CASK) have risen, since there are fewer seat kilometres to spread the costs over. This is visible in the latest results reported by Scandinavian carrier SAS and easyJet (see **Figure 5**).

Figure 5: Cost per available seat kilometres in cents



Source: Bloomberg, Scope Ratings

Airlines will continue to strip out costs as quickly as they can to compensate for the cash burn.

Reducing labour costs is a challenge for legacy airlines due to the bargaining power of their typically unionised staff when it comes to negotiating furloughs and redundancies. In addition, recipients of government aid may find it politically difficult to justify job cuts. We expect the budget carrier subsidiaries of network carriers to bear the brunt of redundancies: Lufthansa's Eurowings; Air France-KLM's Hop and Transavia units.

Jet fuel prices fell steeply in 2020 but airlines did not fully benefit despite consuming far less fuel as they fully or partially grounded aircraft fleets before a slow, limited and uneven recovery in demand. Many airlines found they had over-hedged fuel prices. In the past, European airlines focused on reducing fuel-price volatility by hedging a proportion of future consumption up to two to three years ahead. Caught out during the pandemic, having locked in higher prices, the airlines are reviewing their hedging policies to better factor in the risk of falling as well as rising prices. This year may see jet fuel prices increase as the global economy recovers but some airlines will still be paying for fuel at a premium because of old hedging contracts.

We forecast an average Brent crude oil price in 2021 of USD 50 a barrel, up from USD 42 in 2020. (See our Integrated oil & gas outlook 2021) The rise reflects a moderate recovery in overall demand and commitments by some oil-producing countries to rein in production. However, spreads between crude oil and jet fuel prices will probably remain under pressure with jet-fuel demand weak compared with other oil products.

Airlines will continue to phase out older aircraft in favour of more economical models, improving fuel consumption.

Reducing other costs will depend on airlines negotiating new deals with counterparties such as airports, lessors, and providers of services such as aircraft maintenance.

Turbulent financial outlook

To counter losses, European airlines have boosted liquidity by raising equity, debt and relying on different forms of direct and indirect government support. However, European governments' decision to re-impose and prolong restrictions on travel to contain the spread of Covid-19 and its new variants has created extra uncertainty for the outlook this year. The uneven roll-out of vaccination programmes is another complicating factor.

Larger carriers in Europe have better access to financing and are supported by home governments, wary of impairing vital transport infrastructure and services.

Airlines have resorted to banking loans and credit lines as the easiest way to secure near-term liquidity given the possibility of putting up exisiting unencumbred assets as collateral.

However, investor appetite for airline debt has also returned, luring European issuers back to the market in late 2020, including Finnair, with a hybrid bond, and Lufthansa and Ryanair, which opted for conventional bond issues. Wizz Air was quick to market in 2021 with a bond to secure cash for future growth. Such investor demand confirms our view that some airlines are much better placed than others to see the crisis through.

Airlines' priority is still to conserve liquidity given the severity of the downturn for the sector. However, given the slow recovery and consequently meagre future cash flows, indebtedness will be a burden for most of the airlines in the years ahead.

The 'new normal' that airline executives have to contend with is the aviation sector's huge overcapacity, given the sluggish recovery in traffic, hundreds of mothballed aircraft, and empty airport terminals. Hence, a fundamental reassessment of the industry's cost structure and growth prospects is required. The problem extends to aircraft manufacturers given the likelihood of much lower-than-expected future demand for new aircraft.

Consolidaton of the sector looks inevitable as smaller operators find they can no longer compete, particularly if we consider other pressures that airlines and airports face beyond the problems posed by the pandemic, notably the investment necessary to create a more sustainable, environmentally friendly industry.

Future government intervention and stimulus needs to be finely judged so that it does not distort the business dynamics of the sector. Weaker players will have to exit the market to make room for stronger ones able to build back revenue and profit based on durable business models.

Annex I: Related research

European airlines outlook: travel slump, extra debt test sector's poor cash-generating capacity published Sep 2020 available here

Covid-19: Europe's leading airlines have self-help options to survive industry's cash crunch published Apr 2020 available here

Outlook on European airlines negative as cost squeeze, slowing traffic pile pressure on carriers, published Feb 2020 available here

Steady consolidation of Europe's fragmented airlines sector continues with IAG, Air Europa deal, published Nov 2019 available here

Europe's big five take more than half of region's air travel market as small airlines struggle, published Jan 2019 available here

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