

In the last decade, the aircraft investment and leasing industry were in its belle époque status, driven by the benign performance of the aviation industry. Passenger traffic numbers were trending up, outpacing supply, keeping top airlines' bottom-line green for a while. Nevertheless, the current state of the aircraft investment is mind-gobbling even for industry veterans, let alone novice observers, resulting in a clear challenge by a stretch of any imagination to grasp the full outlook with a high degree of certainty. What is a clear grasp, is that the industry is at an inflection point that started with COVID-19 outbreak and continuing to date.



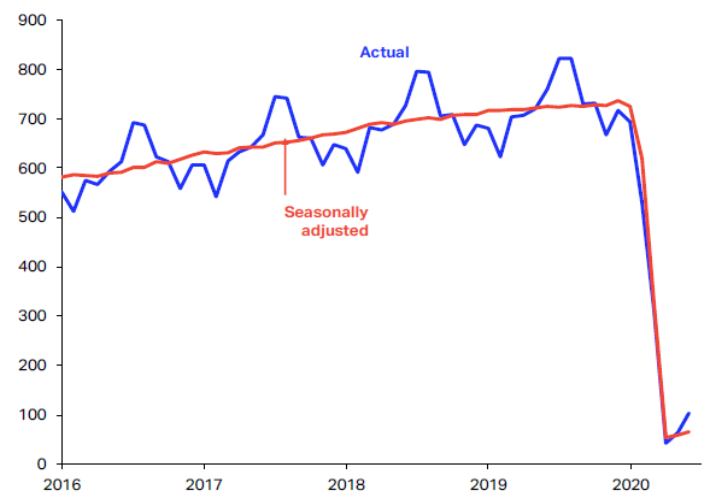
Building future market expectations requires going beyond the mere condemnation of COVID-19 for the derail in the aircraft values and the deterioration in much of the entangled investments during the last two quarters. It requires analyzing the interplay of air travel supply and demand, capital market activities and the effect of both on the outlook of the aircraft investment.

AIR TRAVEL: SUPPLY AND DEMAND

The heavy toll of the COVID-19 had put the industry in a relative dormant, that was to some extent toned down by repatriation flights and air freight for urgent medical equipment. While the market is trying to grapple with the crises, July demand figures is revealing some recovery compared to low bottom of April, global RPKs¹ is -86.5% y-o-y in June vs. -94.1% y-o-y at April.

The domestic RPKs fell by only 67% y-o-y versus international RPKs that fell by 96.8% annually with handful of travel corridors.

Industry RPKs (billion per month)



Sources: IATA Economics, IATA Monthly Statistics

According to IATA, global RPKs in H1 2020 fell by 58% vs. H1 2019. To put it in context, in the six months following 9/11 attacks RPKs declined only by 12%². In Q2 2020, airlines in different regions tried to bring back capacity at faster pace compared to Q1 2020, that is dissipated by sluggish pickup in demand, and airlines cancellation. *With industry load factor hitting a low of 57.6%, it would raise a question of whether this progress would expand, or it is only a respite from this historically unpleasant period for aviation industry.*

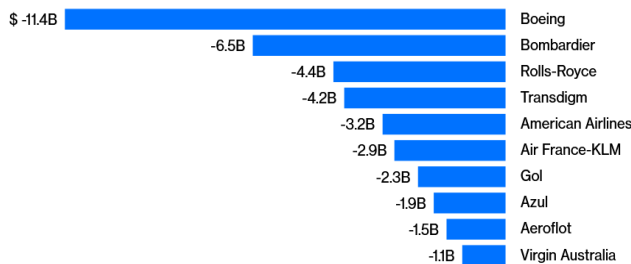
¹Revenue Passenger Kilometers ("RPKs"): is the industry matrices to measure demand, measured as number of passengers multiplied by number of distances flown

² IATA, Air Passenger Market Analysis – June 2020

LISTEN TO THE CAPITAL MARKET

AIRLINES: FINANCIAL HEALTH

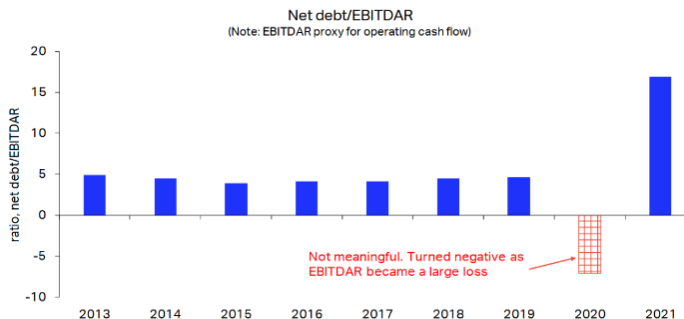
The airlines' landscape post-COVID-19 is certainly opaque. *The airlines' strategy of using low fares to simulate demand and restore air travel passenger, may not help a business that has piled mounting of debt this year.* Being a debt ridden will not help the industry in the foreseeable future. The negative book value for many airlines and aerospace manufacturers is will noted in Bloomberg analysis, citing the importance of raising more equity in order to safely weather the next period.



Source: Bloomberg

Shows shareholders' equity, also known as book value or net assets. In some cases this does not yet reflect the impact of plans to recapitalize the company or sell assets. Search included only companies with >\$1 billion in revenues

Outside the list of top-30 highly levered airlines (even before 2020), so many other airlines are facing an increasing fixed obligations of debt services. The airlines debt burden is expected to rise to unsustainable levels on 2021 where Net debt/EBITDAR may reach a plateau of 16x compared to 2019 figure of 4.6x³.



Source: IATA Economics Economic Performance of the Airline Industry, Mid-Year 2020

From late April to early May 2020, airlines announced \$45.8 billion in new commercial debt, state guaranteed loans from commercial banks and draw-down of existing revolvers. The pace has eased in June to record only \$6.9 billion of fresh debt issuance⁴. The main source of debt was the governments stimulus packages.

The Aircraft asset backed securities (ABS) market is revealing more insight. The market hit a high record in 2019 with a total of \$10bn⁵ worth of assets financed through the known tradable E-Note structure. Leasing platforms also have benefited from buoyant of the capital market when airlines utilized the enhanced equipment trust certificates (EETCs) market capitalizing on one of the ever-historical low interest rate periods.

The imperative measures of COVID-19 put aircraft investors in securitized products in unenviable situation triggered by airlines seeking for lease discount, deferrals, or even restructuring. Rating agencies already downgraded both aircraft ABS securities and puts many airlines in "CCC" rating category coated by many bankruptcies in the market, including Avianca Holding, LATAM Airlines, Virgin Australia, and Thai Airways. While the event of default is a rare given the ABS protective structure, it is only a matter of time to see defaults in junior notes.

³IATA Economics Economic Performance of the Airline Industry, Mid-Year 2020

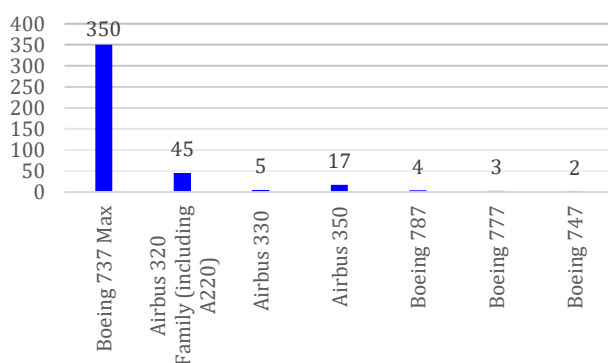
⁴ISHKA Global: How do Aircraft ABS structures perform if cash flows are reduced due to Covid-19?

⁵KPMG and Airlines Economics: Aviation Industry Leaders Report 2020

AIRCRAFT MARKET

Airlines have tapped into different channels to trim down excess capacity. This span from aircraft grounding, order cancellation and the early retirement of vast swathes of aircraft fleet, this is crowned by the retirement of the queen of the sky, Boeing 747 fleet. According to consultants at Oliver Wyman, it expects a roughly 2,000 aircraft leave the fleet permanently over the next 12 months.

Order Cancellation



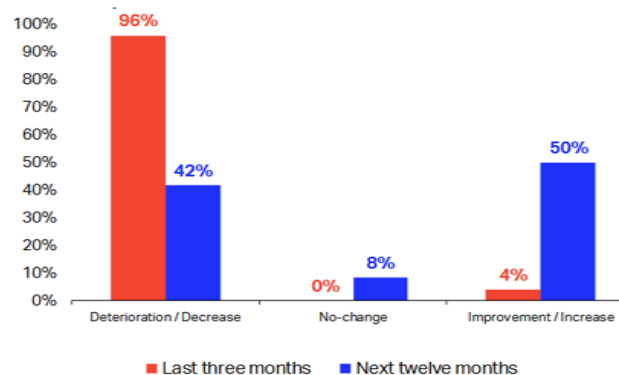
The implication on the industry is devastating for both airlines and manufacturers. According consultants at Oliver Wyman, by 2030 the global fleet will be 12% smaller than what was perceived at the end of 2019. That would amount to 4,700 fewer aircraft.

The slow recovery path and the airline current financial and operational position, have negatively affected aircraft valuations, most noted on the two mainstream asset dimensions: The new aircraft generation of narrow-bodied aircraft have the least decrease in its market value (5%-13%), while older mid-life wide-bodied aircraft generation are one of the most negatively affected (15%-31%)⁶.

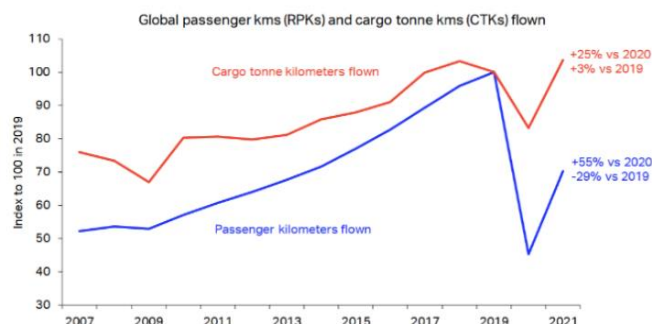
HOW FAR THE MARKET IS CONFIDENT

According to IATA's July Airline Business Confidence Index survey, 96% of the respondents experienced a deterioration in passenger demand in Q2. However, the expectations for next twelve months are largely split between a continuous decline and improvement in passenger demand. The current and expected soft demand, is taking its toll on yield with 57% of respondents are expecting air fares to decrease in the next 12 months due to long slog to recovery.

Recent and expected change in traffic volumes % of Respondents



What will happen post-COVID-19 is still full of uncertainty, but one certain fact that, this crisis has dashed a decade of growth. Although its challenging to gauge the future demand, IATA expects a sharp increase in demand for air cargo and travel in 2021, albeit at low level compared to 2019. Passenger demand is expected to grow by 55% compared to 2020 despite being 29% below compared to 2019 level.



Sources: IATA Economics using data from IATA Monthly Statistics

⁶IBA Airline Failures and Values Update – July 2020 – Values are in Half Life Current Market Value (HLCMV)

NEO MERCHANTS CAPITAL VIEW

The aircraft investment market is by nature dependent on the health and strength of its users, the airlines industry. On the other hand, the recovery path for airlines industry is dependent on many factors, including the release of the vaccine.

Aircraft investors should avoid wrong signals that rings between time to time. Aircraft investors, enticed by the low interest rates and looking to pass this advantage to airlines through low lease rentals and return conditions below prudent market standards, can be in fact underestimating the lessee credit profile weakness and potential transaction risk. That can eventually lead to dissipating investors return or even their initial capital.

The current market is choppy. However, as airlines emerge from the brunt of the current crises, there will be a growing need for aircraft finance and investment. The future decisions for investing in aircrafts must be headed with sensible understanding of interplay of air travel demand, the capital market and the expected inflection on aircraft demand and finance.