Moving to the next phase – an initial but uneven recovery?

Whilst generalisations are always dangerous it is reasonable to take the view that we are moving into the next phase of the COVID-19 outbreak with the first actions being taken to lessen restrictions and an attempt to restart those activities that have been not just locked down but stalled.

We have been consistent in our view that one of the keys to the necessary greater movement is, at the very least, a perception or, even better as a result of testing, an understanding, that the risk has abated or can be managed. Indeed, this has underpinned the opening up of a number of European countries in the first instance to domestic travellers but also, over the next few weeks, to international visitors, albeit not from all countries. However significant and binding constraints to international travel are, and will remain, in place in a number of countries across the world not least in North America but also the Gulf, SE Asia and Australia and New Zealand although in a number of cases it appears that immediate family members will be able to visit, albeit with a need to quarantine[1]. However even if destinations are open, there is still the issue of "destination capacity" where hotels on the Greek Islands will be operating at 50% capacity, each island will have an isolation hotel for COVID-19 cases, and where restaurant capacity will also be materially reduced.

Quite different in all respects

Whilst the "Covid-19 Aviation Health Safety Protocol" published by EASA and The European Centre for Disease Prevention and Control[2] is an important starting point in setting out some operational guidelines it also highlights a number of the key issues arising. Similarly, Airport Council International (ACI) has also released its guidelines[3] and together these give a view on how different the passenger experience will be as well as the conditions that airports and airlines are likely to have to meet. Furthermore, we have also been consistent in our view that there is a need for a set of internationally agreed and enforced standards not least to give the certainty that is currently missing and something that was recently highlighted by AAPA's Director General in its April traffic release when he noted that: "patchy, uncoordinated measures across countries including various screening protocols and often onerous quarantine requirements are deterring passengers from flying and slowing the process of restarting aviation"[4].

[1] A good summary of the current restrictions on entry is provided by IATA at: https://www.iatatravelcentre.com/international-travel-document-news/1580226297.htm

[2] https://www.easa.europa.eu/sites/default/files/dfu/EASA-ECDC_COVID-19_Operational%20guidelines%20for%20management%20of%20passengers_final.pdf

[3] https://store.aci.aero/wp-content/uploads/2020/05/ACI-Airport-Operations-Business-Restart-and-Recovery-May-2020.pdf

[4] AAPA Press Release 2020:13 27th May 2020.

The recent CTAIRA Passenger Confidence Survey[5] highlighted airport testing, followed by a combination of a mask and on-board social distancing (with seats to each side and in front and behind left empty), as the two "most popular" sufficient conditions to give intending passengers confidence to fly again. Indeed, and as we also highlight in the survey report, there are a number of issues arising around airport testing and not only in respect of the capacity required to accommodate the testing as there is a view that it needs to be done at the airport notwithstanding the view of ACI set out in its guidelines. There are also issues of how to deal not only with passengers who test positive and are deemed not fit to fly, but also those who have been in close proximity with them and are also required to self-isolate. There is also the issue of how to deal with passengers on arrival who are suspected of being infectious. Of course there is also a need to have the correct test and one that is supported by medical evidence[6], and clearly not something, including temperature testing[7], that is chosen because it is relatively straightforward, easy to install and it is hoped gives passengers the necessary confidence to travel but where it has demonstrably poor results in respect of "false negatives" and also "false positives" in particular. Another key factor will be the speed at which antigen, or even antibody tests, can be taken, processed, and the results delivered given the impact that this alone will have on the capacity required for testing and "holding" passengers until the results are returned and they are able to travel or are required to be isolated.

Notwithstanding the wide range of views on whether there should be social distancing on aircraft, what should be absolutely clear is that the travel experience will be fundamentally different at every stage than it was before, at least until there is a vaccine and/or herd immunity and we are considered to be "virus-free". We should also be clear that the result will be a fundamental change in behaviours and where one outcome will be that the additional time that is likely to be required at airports for check in and testing will have an impact on short haul business as well as leisure passenger numbers.

The need for a perspective on the pace and extent of the recovery

We have seen a number of airlines set start dates for, in some cases, the resumption of services and, in others, an increase in both the destinations served as well as frequencies; in Europe the dates for this are from the middle of June. To this end the Group CEO of Ryanair has stated that he expects some 40% of its capacity to re-enter the market and where load factors will be at between 50% and 60% which will, if it is the case, result in traffic of some 20-25% of that in the corresponding period last year. Most recently we have also seen management: at SAS announce

[5] CTAIRA Passenger Confidence Survey 19th May 2020 – available on request

[6] A point made in particular by ACI see page 6: https://store.aci.aero/wp-content/uploads/2020/05/ACI-Airport-Operations-Business-Restart-and-Recovery-May-2020.pdf

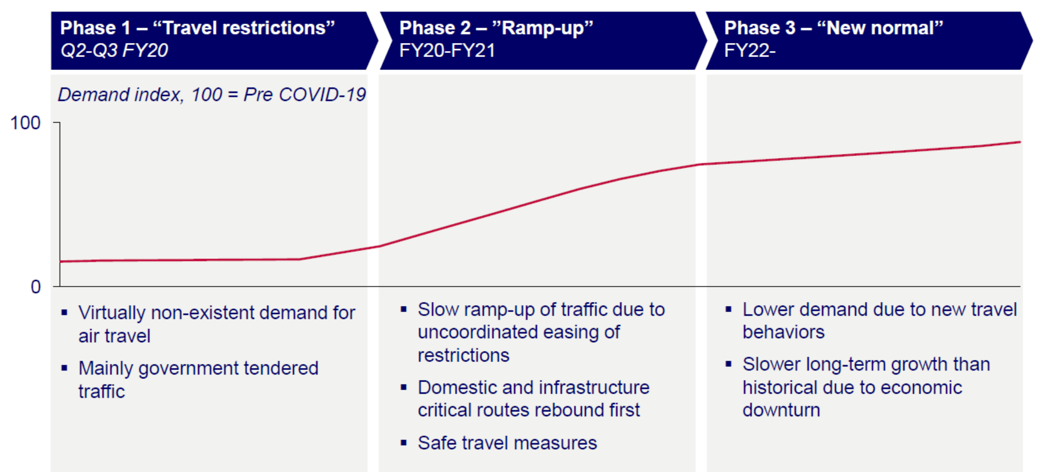
[7] Only 9% of the respondents to our passenger survey would be satisfied with temperature testing alone as a sufficient condition to give them confidence to fly again.

that they are to double the amount of aircraft that they will operate in June from 15 to 30 and equivalent to some 20% of its fleet on the basis of the number of aircraft: at easyJet it was announced that they will be starting flying from the 15th June and that for the July-September quarter management expects capacity to be c30% of what it was in the same quarter in 2019 – they have also made it clear of the importance of the relaxation of government restrictions in realising the latent demand that they consider is sufficient to *"support profitable flying"*; Iberia is planning to re-start operations in July initially with some 21% of its capacity on short and medium haul routes.

Managing the ramp up from almost nothing is a challenge that should not be underestimated. Not least given that 100% of the costs of flying are incurred immediately but where the revenues may well lag and there is a prospect that in some cases more will be lost by flying than by not. Against this background it is likely that there will be a bit of a test and see approach.

In their recent results presentation SAS management was also clear that it expected a slow recovery and that by the end its 2022 financial year (October), although the level of activity would be steady, it would still be below the levels of 2019 as shown in Chart 1.

Chart 1 The view of SAS management on the shape pf the recovery



Source: SAS Q2 Results presentation 28th May 2020

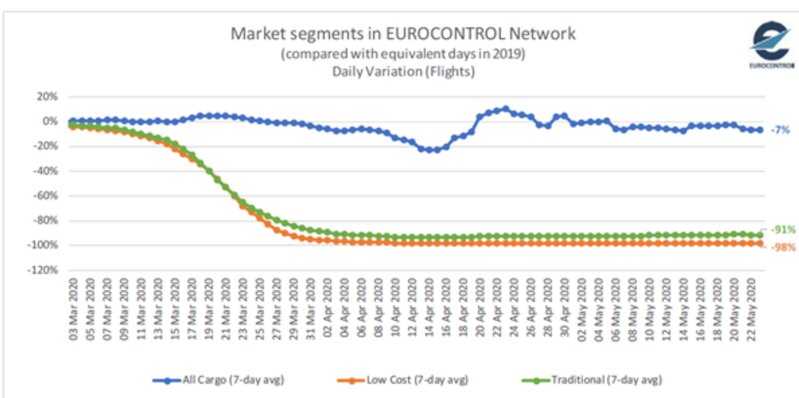
Other airline managements are equally realistic about the time that it is likely to take to recover with the IAG CEO suggesting that it will take until 2023/2024 to get back to the levels of activity seen in 2019.

Consequently, we would expect to see more announcements regarding the restructuring and resizing all businesses in the sector. The latest is from easyJet, involving some 30% of its staff (4,500 people) and where by the end of its 2021 financial year (September) management now expects a fleet of 302 aircraft compared with 331 at the end of its last financial year and an original plan for 353 in 2021[8] . This is not just to ensure that capacity and numbers employed are appropriate for the recovery phase but also for what will be a structurally smaller industry than in was in 2019 for a number of years and for some, not until the middle years of the current decade. What is perhaps inevitable is that we have seen the end of "have metal will fly strategies".

The fact that activity is beginning to start again is a positive development but there needs to be realism in respect of how quickly this able to occur on the supply side. It is not a case of just flicking a switch, like turning on a light. Rather it is dependent on all of the elements of the system functioning and where there is already real evidence of a potentially significant reduction in the capability in some key areas; not least ground handlers, as companies have contracted and the former employees are now working elsewhere in other industries – including working as online delivery drivers and in a much more conducive environment. This is when there is a greater requirement for ground staff not least in getting passengers to and from the aircraft in a "compliant manner "but also in cleaning and preparing the aircraft to the new guidelines, if not rules, between flights.

It is useful to take a view on the starting position from a number of perspectives. In this respect and in terms of activity, the data in Chart 2 shows the number of flights handled by Eurocontrol by broad type and where traditional airlines are operating at 9% and LCCs at 2% of 2019 levels.

Chart 2 Flights by market segment Mach 1st – 22nd May 2020.

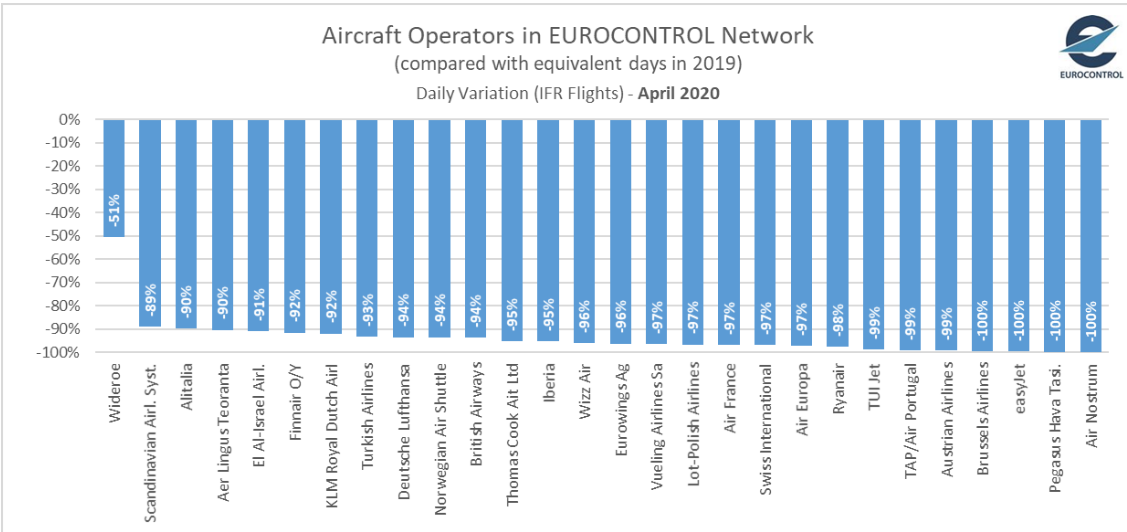


Source: Eurocontrol

Chart 3 shows the variation by airline between April 2019 and April 2020.

[8] This represents an increase on the number mentioned on April 9th when it was announced that they were deferring 22 deliveries in FY2020 and 2021 and had a further 24 aircraft on operating leases that could be returned over the following 16 months. One indication of a business model change is that they will have a buffer of 3-4% of their fleet in the peak season to improve punctuality.

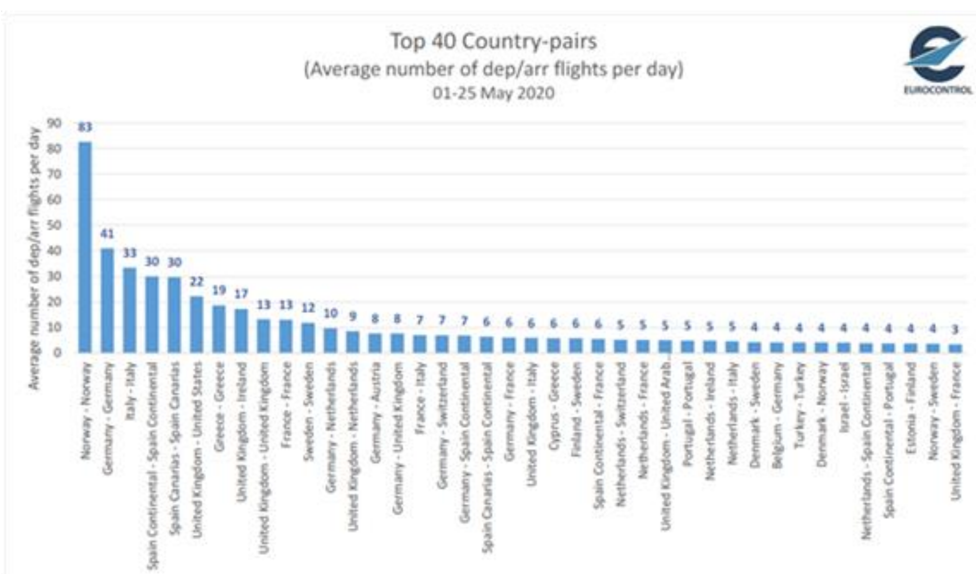
Chart 3 Variation in flights by selected airline April 2020 vs April 2019



Source: Eurocontrol

In terms of the most active "country pairs", shown in Chart 4, there are few surprises and something that also underpins the view that domestic and regional traffic will be amongst the first sectors to recover which will then broaden to "air bridges" and then "zones" or "bubbles". In terms of context, in the corresponding period in 2019 there were 754 scheduled domestic flights each day in Germany compared with 41 at the present time.

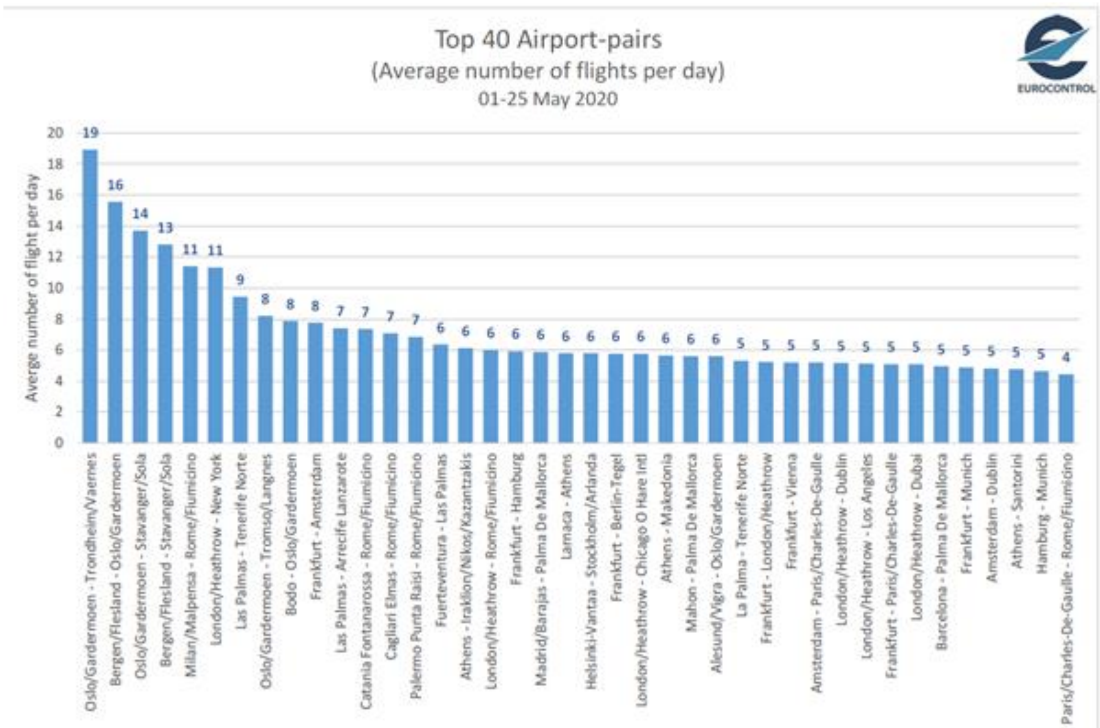
Chart 4 Europe: top 40 country pairs average number of daily flights



Source: Eurocontrol

Chart 5 shows the top 40 airport pairs for the period 1st to 25th May and here the significance of routes in Norway corresponds with the data shown in Chart 4. In terms of a perspective; last year on the OSL-TRD route there was an average of 30 flights a day each way.

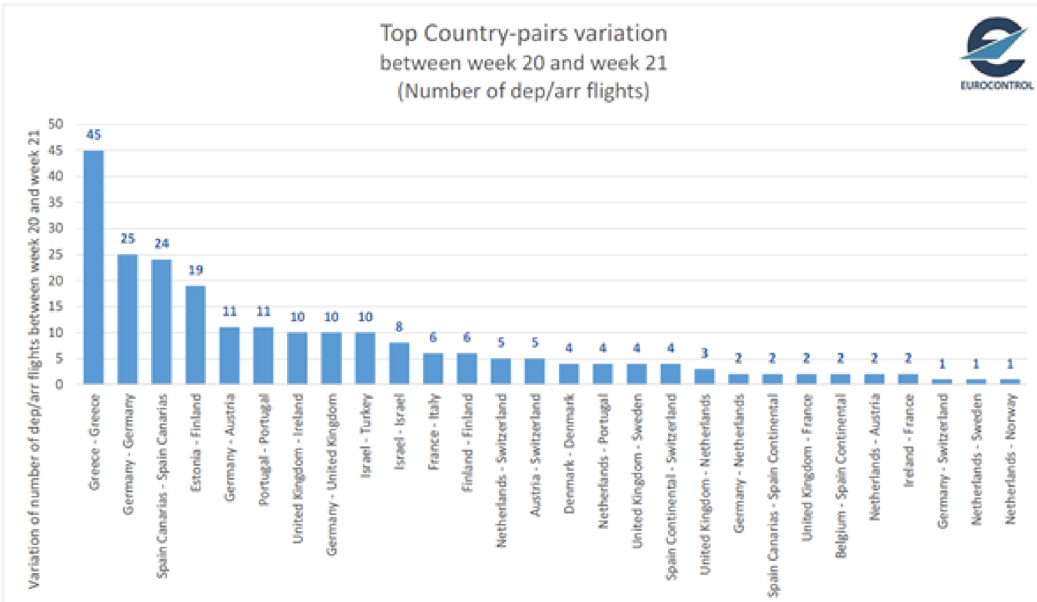
Chart 5 Top 40 Airport pairs 1stMay - 25thMay 2020.



Source: Eurocontrol

Chart 6 shows the inter-week momentum and in this case between week 20 and week 21 and where, apart from in a few cases, the change is “de minimis”. Again, in terms of perspective; in week 20 in 2019 OAG listed 1277 flights between Germany and Greece (639 round trips) and where for 2020 there were 236 (118 round trips).

Chart 6 Country Momentum – comparison of week 20 and week 21



Source: Eurocontrol

In terms of data from other markets: in the US, and as a proxy for airport activity, the number of people screened by the TSA has recovered from a low point of 4% of the 2019 total in mid-April to an average of 11.5% over the last week but where the range for the last seven days, which takes in Memorial Day weekend, was 9.3% to 13.6%. In Asia the latest data from AAPA shows that the number of international scheduled passengers carried by its members in April 2020 was 368,000 and represented just 0.2% of the 31.9m that were carried in April 2019; interestingly the passenger load factor was 69.8% - so no real evidence of social distancing. Given the economic impact of the pandemic, cargo measured in FTKs, was some 28% lower in the month for this group of airlines.

The introduction of new, and now necessary, processes and procedures will slow down the pace of most, if not all, ground based activities associated with air travel. This also includes the time that it will take to turnaround a short haul aircraft with a consequent impact on efficiency, cost and by definition, the available capacity that an aircraft can provide an airline on a daily basis. Taken together the outcome is a reduction in the available capacity of aircraft and airports. Reduced airport capacity may well also have an impact on scheduling limits and by definition the number of flights that can be operated at some airports even though such limits are unlikely to be reached in the near term.

The prospect of new entrants

In the same way that the restarting of flying will not be instant, neither should we expect that it recovers to close to where it was in 2019 in the short or even medium term. We have seen numerous announcements around aircraft being removed from fleets as well as deferrals of deliveries and cancellations of orders including from lessors. The dislocation on the supply side and its consequences are a long way from "playing out" and where this will inevitably give rise to opportunities for some new entrants with different models. Indeed, this was the case both after 9/11, when we saw an acceleration of the "LCCs" as the traditional airlines were focused inward, and similarly at the time of the great financial crisis in 2008, when it was both the LCCs and Gulf carriers that accelerated their growth.

A need for substantial sums of new equity

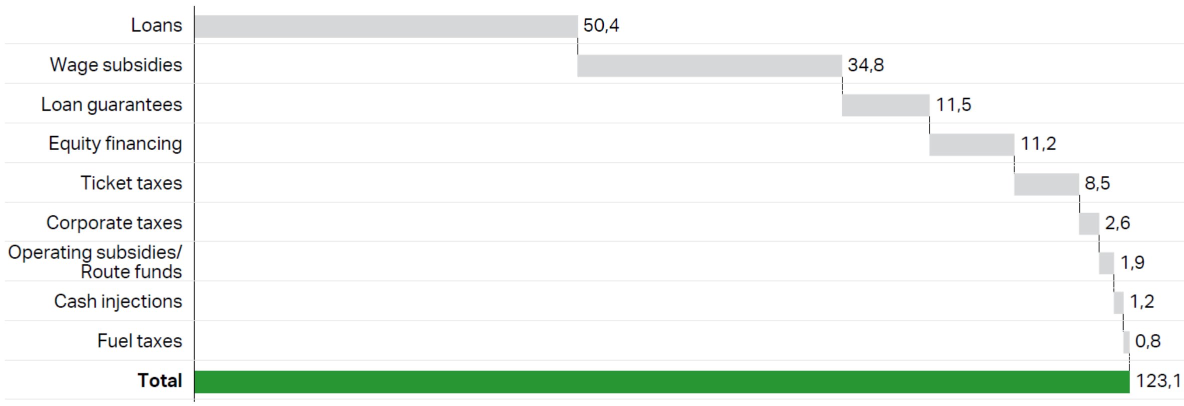
The near-term focus of all airlines is still on liquidity and cash conservation. In addition to reducing operating and near-term capital expenditures, whilst they are in effect a dormant or semi dormant state, management attention is, or should also be, focused on structural reductions in these expenditures against the background of the projected "new normal".

From the outset we have been clear about the importance of cash where, in the near term, it was in fact access to sufficient cash that was the inevitable and necessary focus. To this end we have seen some managements move very quickly to access private and, where available, publicly provided sources of a general or industry/company specific nature and secure what they might need for the near term although this has not always been the case.

To date the majority of what we have suggested is in effect "survival capital" has been in the form of debt which is something that reinforces the view, that we have also expressed elsewhere, that airlines would need to seek and secure new equity within a reasonably short period of time[9]. IATA has estimated that industry debt has increased by some $120bn where governments have provided some $50.4bn directly and some $11.5bn in the form of guarantees. Similarly, IATA estimates that the amount of new equity raised, including $11.2bn from government, is some $30bn.

[9] See CTAIRA "Fundamentally and irrevocably changed" 3rd April 2020 – available on request.

Chart 7 Government financial aid to the airline sector by type (US$ (bn))



Source: IATA

The extent of what is perhaps best described as "balance sheet destruction" will be unprecedented and is already evident; even at the end of 2019 airlines with a particularly strong balance sheet and/or an attractive set of ratios, were in the minority. Even in more normal times we had real concerns over the use of the ROIC>WACC measure adopted by IATA at an industry level given the small number of airlines that were able to achieve such a state for even a short period. Indeed, the reality is that for most airline managers, in such times, a result that is a little less worse or a little better than the previous year is a significant achievement and as a result such considerations around adding or taking away from shareholder value tend to be even more academic than they were before.

On the basis of what we know already in respect of those companies that report to their respective stock markets it is possible to take a view on the key swing factors and a number of the key ratios. In particular the levels and changes in: operating cashflow; net capital expenditure, changes in debt and retained earnings (or more particularly losses) and the movements on shareholders' funds are of fundamental importance. The swings to date in some of these numbers where the March quarter in most cases, apart from China, the COVID-19 impact was two or at most three weeks, are already dramatic. For almost all airlines, "trading their way" to restoring the balance sheet is not a reasonable option given the nature of the likely recovery and the need for a sufficiently strong and compelling investment story in what will be a particularly competitive market for new money.

A need to establish and communicate the right investment case to enable access to new equity

The focus now should not only be on where the new equity is going to be secured from but also on what the investment story needs to be. This in itself feeds into the what restructuring is necessary – one well known airline CEO is attributed with the view "that you should never waste a good crisis" and indeed used one of the previous ones to structurally improve the performance of his company.

Taking the money now and not making the necessary changes for an industry that even over the medium term is likely to be 20-30% smaller than it was in 2019, is not an option. There is also a need for the restructuring, turnaround and rescue strategies to be realistic and implementable, and clearly communicated and even now there are some cases where hope has got beyond likely reality.

Even in the best of times and for airlines with a strong investment story, raising new equity is a challenge; In this case and well before profits are anywhere near those seen in 2019, it will be even more difficult and there is the real prospect of capital rationing and a "phase 2" shakeout. It is also clear that that in some cases there will need to be a role played by the public sector on a short term basis where the case of Lufthansa provides one example (although the final basis of the investment has yet to be agreed); another is SAS, where management has already revised its business plan and has taken the initial steps to restructure the business for the likely future market size and where the recapitalisation that they expect to announce in June will be, and perhaps significantly, underpinned by the Danish and Swedish governments but where there appears to be a view that, although they may end up with a majority stake after the recapitalisation this is only a position, they are participating out of short term necessity.

A final thought

Whilst what should be beyond any doubt is that the shape and size of the industry will be quite different than it was before COVID-19, one important aspect will be unchanged and that is for revenues to exceed costs – something which for many if not most in the near term may be all but impossible. The magnitude of this disruption is a catalyst for fundamental change; whilst travel will undoubtedly recover the economics associated with all aviation businesses are likely to be quite different than they were before.

Important notice