Asia Aviation

Private Equity Recovery Play?

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By Michel Brekelmans

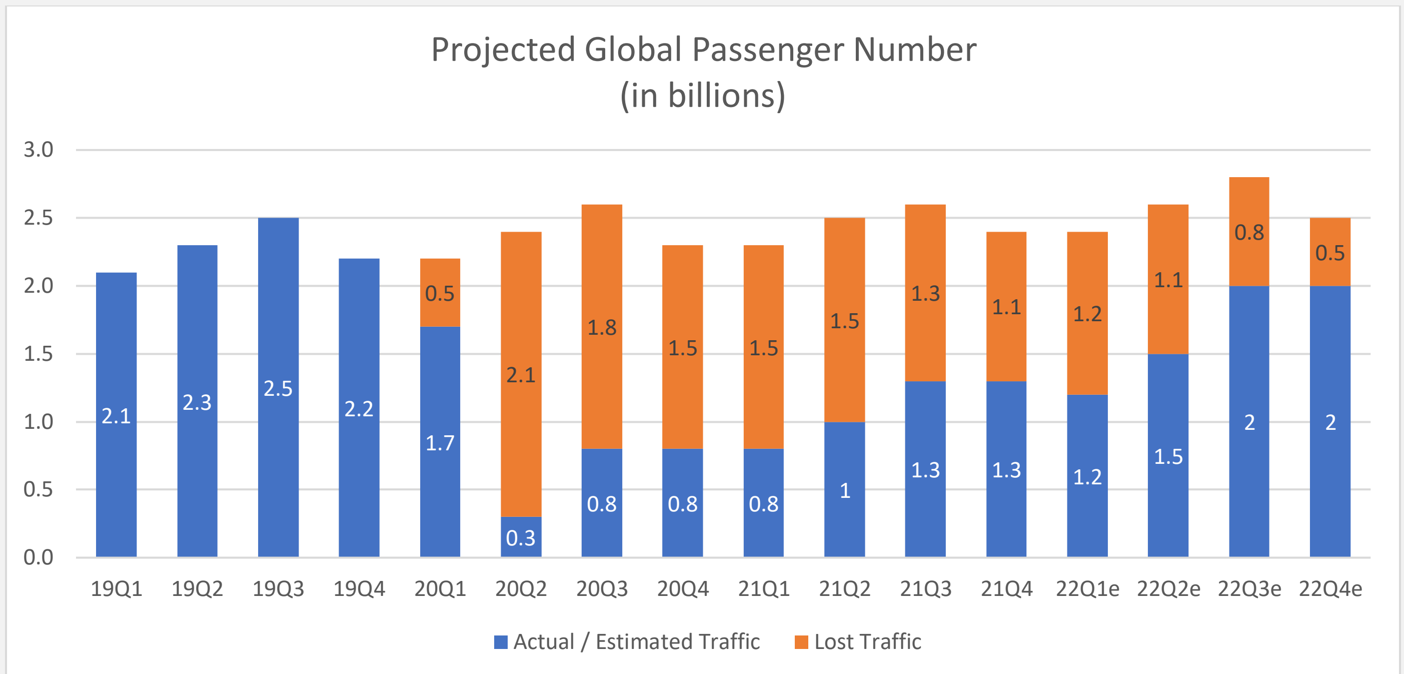
Few industries have been hit as hard by Covid-19 as the travel industry. Private equity (PE) investors are seeing a potential opportunity to step into the sector betting on a recovery. Asia has already seen a number of high profile PE investments, including Bain Capital's acquisition of Virgin Australia and Affinity Equity Partners' investment in airport lounge operator Plaza Premium. In this paper we take a look at the outlook of the aviation sector and potential investment models for PE players.

Covid-19 Impact & Recovery

The airline industry is never short of a major crisis but even by airline-crisis standard, the impact of Covid-19 is unprecedented. For planning purposes, aviation executive typically look at 'extreme' downside scenarios of minus 30% followed by a relatively fast recovery. Nobody ever seriously factored in revenue drops of 90%, which is exactly what has happened at the height of the pandemic.

In 2020, global industry revenues declined 60% putting the scale of the sector back to where it was 20 years ago with a loss of almost 5 million jobs. Furthermore, there have been a massive indirect effects, especially on global tourism sectors, as a result of a loss of 1 billion tourist trips representing a loss of $1 trillion in global GDP.

And whereas previous crisis (think 9/11 or SARS) witnessed relatively fast recoveries back to pre-crisis levels, the recovery out of the Covid-19 pandemic is more gradual and longer compared to before as can be seen from the chart below based on ACI data:



Source: ACI World, SCP/Asia

Most industry observers expect a full recovery back to 2019 levels may not happen until 2024 but the road to recovery is now finally underway. This year, passenger volumes will rise to 6.6 billion, still 28.3% short of 2019 numbers.

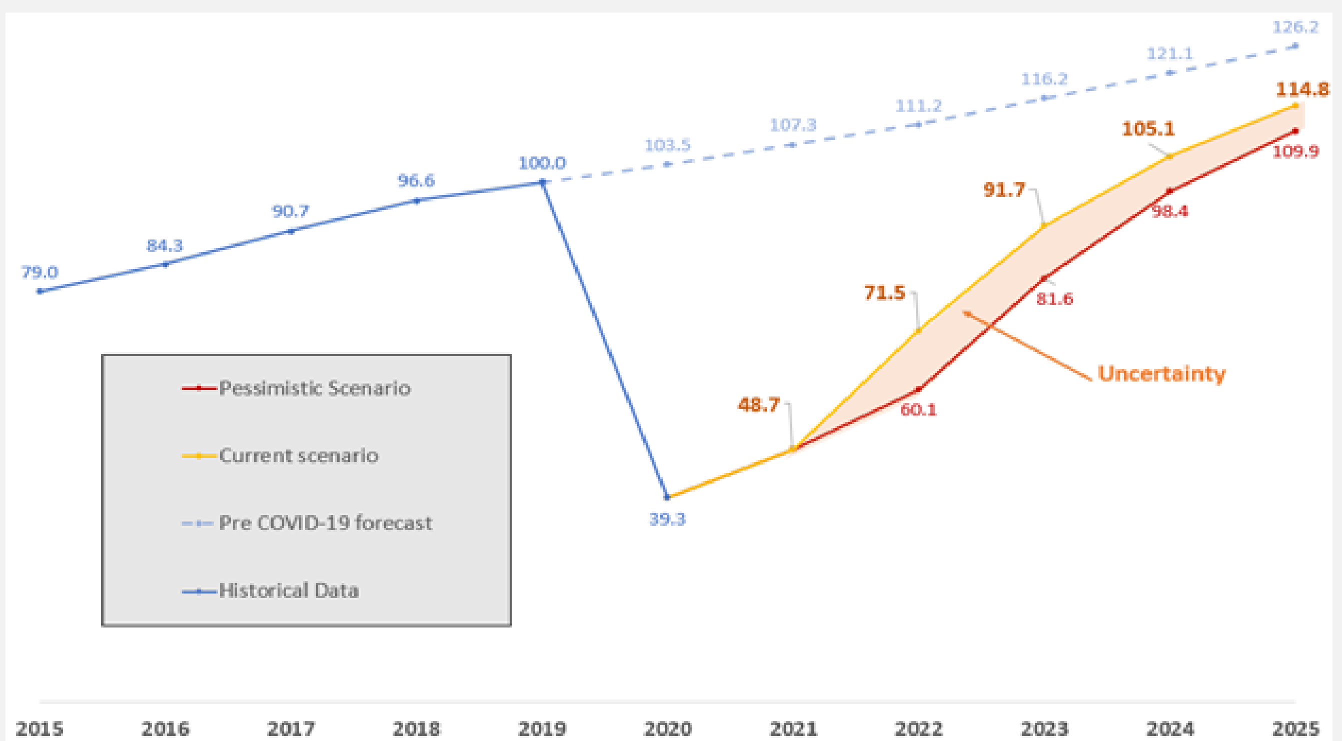
Markets with large domestic demand are seeing faster recoveries. The US and EU have witnessed a surge in demand and China managed a full recovery to pre-pandemic levels already in 2020, solely driven by domestic demand. For 2022, domestic passenger traffic will continue to recover faster than international passenger traffic, though it will still only hit 4.2 billion passengers, or 78.5% of 2019 volume.

The early momentum of the Asia-Pacific region, fuelled by the rapid recovery of the Chinese domestic passenger market, was severely dampened in the second half of 2021 by a resurgence of COVID-19 and the re-establishment of travel restrictions, including in China where strict lockdowns have re-emerged. Nevertheless, several countries in Asia-Pacific have starting to reopen to vaccinated travellers and the international passenger market is also expected to see significant improvement before the second half of 2022.

But much uncertainty still surrounds the recovery in the coming years. Projecting the path to recovery at this point is still an exercise

requiring prudence. A large share of the world's population, mainly in emerging and developing countries, remains unvaccinated and as we saw with the Omicron wave, a less virulent but highly contagious variant can still have a significant impact on daily life and the aviation industry by disrupting supply chains, straining healthcare systems, and contributing to major flight cancellations.

In ACI's latest scenario global passenger traffic are expected to recover to 2019 levels in early 2024 and mainly be driven by a the recovery in domestic travel. Global passenger levels should reach 91.7% of 2019 levels in 2023 and surpass 2019 levels by 5% in 2024.



* The pre-COVID-19 forecast scenario is based on a standard time-series forecast generated using the most up-to-date and complete historical data to December 2019. It also makes use of an adjusted World Airport Traffic Forecasts (WATF) 2019–2040 and considers the latest insights provided by ACI Regional offices and other inputs.
** Estimated passenger traffic volumes scenarios (current projection and pessimistic) are based on a broad range of inputs provided by ACI Regional offices and industry experts.
Source: ACI Wor

War in Ukraine

Just as the sector was finally seeing some light at the end of the tunnel, the next major disruption has already presented itself with the war in Ukraine.   But so far, the impact has been manageable. The Ukrainian airspace is closed, putting a halt to the movements by air of roughly 3.3% of total air passenger traffic in Europe, and to 0.8% of total traffic globally, as per 2021.

Many countries have closed their airspace to Russian airlines and Russia has in turn banned airlines in most of those countries from entering or flying over Russia. Several airlines from countries not directly impacted by sanctions have also temporarily reduced flights to/from Russia, for example in Japan and South Korea. In 2021, international traffic between Russia and the rest of the world accounted for 5.2% of global international traffic, but only 1.3% of global total traffic. International air traffic to and from Russia accounted for 5.7% of total European traffic in 2021.

So far, the impact of the War in Ukraine has been manageable and offset in a surge in recovery demand

With Russian airspace closed, flights have had to be rerouted or cancelled. The most heavily impacted markets are Europe-Asia and Asia-North America. This includes flights between the US and Northeast Asia, and between Northern Europe and most of Asia. In 2021, RPKs flown between Asia-North America and Asia-Europe accounted for 3.0% and 4.5% of global international RPKs respectively, both below their shares prior to the pandemic, due to the slow international recovery in Asia.

International ticket sales have so far held up relatively well. Globally, international ticket sales for future travel fell from roughly 55% of 2019 levels in the days prior to the escalation of the conflict on 24 February, to 50% in early March. That said, bookings made mid-March are already exceeding those prior to the conflict, at around 57% of 2019 values.

Even on routes that are exposed to longer flight times and higher costs following the closure of the Russian airspace see resilient bookings. Bookings for travel between Asia and Europe fell only briefly in early March, while the North America-Asia route has so far been spared any visible impact whatsoever.

Jet fuel prices rose sharply since the start of the conflict. They were at USD 150 per barrel on 21 March (daily closing prices), up 39% on the month and 121% year-on-year. Upward pressures on prices may continue, in particular if more stringent sanctions are applied to the Russian energy sector, and depending on potential increases in production elsewhere.

Fuel expenses – which factor in consumption, hedging and other elements – represented around 25% of airlines' operating expenses prior to the pandemic, globally. The share declined in 2020 and 2021, as airlines' variable costs fell, but in most cases, the share is now back to its pre-crisis level. Asia Pacific carriers, for which passenger traffic is often still limited, are the main exceptions.

What's Next? Environmentalism.

Growing environmentalism is increasingly resulting in consumer and political behaviour that can be detrimental for airlines that are not well prepared. A recent McKinsey survey highlighted that most passengers understand that aviation has a significant impact on the environment. Emissions are now the top concern of respondents in 11 of the 13 countries polled, up from four in 2019. More than half of respondents said they're "really worried" about climate change, and that aviation should become carbon neutral in the future.

Almost 40% of consumers plan to fly less to reduce their climate impact

Nevertheless, travellers continue to prioritize price and connections over sustainability in booking decisions, for now. This may be partly because no airline has built a business system or brand promise on sustainability. Also, some consumers may currently be less concerned about their own impact because they're flying less frequently in the pandemic. But almost 40 percent of travellers globally are now willing to pay at least 2% more for carbon-neutral tickets and 36% plan to fly less to reduce their climate impact.

In some markets consumers may reward airlines that meet rising demands for environmental sustainability—and punish those who fall behind. In 2021 Qantas announced a new "green tier" in its loyalty program designed to encourage, and recognize the airline's frequent flyers for doing things like offsetting their flights, staying in eco-hotels, walking to work, and installing solar panels at home.

Why bother with the aviation industry?

The decade starting 2020 will no doubt go into history as the most challenging the industry has ever seen. Pandemics, geopolitical tensions, and environmentalism are posing massive challenges even by the battle-hardened standards of the aviation industry.

Many airlines have had to borrow huge sums of money to stay afloat and cope with high daily cash burn rates. Tapping into state-provided aid, credit lines, and bond issuances, the industry collectively amassed more than $180 billion worth of debt in 2020, a figure equivalent to more than half of total annual revenues that year. And debt levels are still rising. Repaying these loans is made even harder by worsening credit ratings and higher financing costs.

Almost 40% of consumers plan to fly less to reduce their climate impact

In many cases, airline rescue efforts have come in the form of government bailouts. There has been a re-emergence of, or increase in, the level of state ownership and influence. Some airlines have responded by restructuring for greater efficiency; others are merely muddling through and state-aid programs may have reduced the incentive for cost, organizational, and operational restructuring. Airlines that are not proactively transforming risk failing to set the business up for longer-term success.

Aviation participants, including airlines, lessors and financiers, have quickly sought to adapt and consolidate their position, often seeking alternative sources of financing and investment resulting in a growing interest and investment from PE funds in the sector. But given the turbulence of the past 2 years, the challenges ahead and the capital intensive nature of the sector, we have to ask: why would a PE investor bother? And if the answer is in the line of 'buy low sell high' and 'recovery play' then how can a PE best participate?

PE's getting in on the game

PE is not a new entrant to the aviation sector. PE firms were early investors into aircraft leasing and many of today's aircraft lessors are, or were once, owned by PE funds. Similarly, PE firms have long-been investors in privately- and state-owned airlines.

Distressed markets are a key focus for PE firms and represent a common investment strategy. Investment into a distressed market will often have a higher risk profile which can deter mainstream investors but is also coupled with increased potential returns. The modified risk/return profiles in the aviation sector, since the effects of the Covid-19 pandemic, are more attractive to PE firms and there are a number of potential investment strategies they can consider:

1. *Airline Restructurings:* Covid-19 has had an tremendous effect on airlines, with revenue and cashflow being severely impacted. Most airlines have required new investment, with many needing restructuring, to survive. New capital is often necessary to convince creditors of a proposed restructuring. While PE firms will consider investment into airlines that do not require restructuring, it is likely that investment in the context of a restructuring will provide more attractive IRRs. PE participation in airline restructuring can take place in a number of ways:

    - **Asset-backed debt:** Airlines typically raise financing secured against their most valuable assets, their owned aircraft fleet, while also raising unsecured debt by way of bond issuances and revolving credit facilities. Commonly, this leaves a number of unsecured assets on the balance sheet – the equity value in owned aircraft, various receivables, portfolios of airport take-off and landing slots, frequent flyer programmes, intellectual property, inventory and equipment and, potentially, real estate. For PE funds, this presents an opportunity to provide rescue financing secured against either a specific asset or the airline's assets as a whole.

    - **Equity investment:** With significantly more flexible investment strategies than traditional banks and lenders, PE players are able to invest in airlines by way of equity and take an active role in their management. Often the funds' strategy will involve increasing the operational efficiency or adjusting the business model of the company, divesting of assets, further capital raises and/or mergers and acquisitions.

2. *Aircraft Lessors:* Aircraft lessor exposure to certain distressed airlines increased significantly during the pandemic. For the most part, the lessors with large exposures, some which stood at 100%, were smaller or niche lessors. Opportunities may arise for PE investment in smaller or more niche lessors that (i) have asset and lessee diversification challenges, (ii) are highly leveraged and/or (iii) are unlikely to be able to source new investment from their

existing shareholders. These opportunities could include (i) equity investment, (ii) refinancing existing financing with more flexible payment terms and/or (iii) the provision of debt with an option to convert to equity.

3. *Distressed debt:* Another option for PE would be to invest in portfolios of non-performing loans held by existing lenders looking to de-risk or pivot away from aviation, which is an area that PE has dominated in the shipping industry since 2012/13. Prior to Covid-19 crisis, the aviation industry attracted many passive investors and content with what were deemed the safe, consistent and predictable returns that aviation offered. Since then, these "givens" are no longer the case and there are a number of investors who will inevitably seek to exit the market as it no longer correlates with their risk profile or they are unwilling, or lack the necessary expertise, to manage the distressed debt effectively.

Banks are also looking to sell non-performing aviation loans, either on an individual or portfolio basis. This may be necessary where the bank's internal credit controls or capital adequacy requirements necessitate the off-loading of non-performing loans or where the bank's investment strategy, following the impact of Covid-19, no longer treats aviation as a core business area. Both types of investor might present opportunities to PE investors looking to take on distressed debt and work on extracting value.

4. *Aircraft portfolios:* The larger lessors have routinely sold leased aircraft portfolios, as part of their general business and risk management strategy. To manage diversification risk and free up capital, some lessors will be forced to sell leased aircraft portfolios into a "buyer's market" where PE funds may prove to be willing investors. Furthermore, aircraft will inevitably be returned to lessors in the context of the myriad airline restructurings, and some of these aircraft will be difficult to remarket, particularly older or less in-demand types. PE players with the right experience often thrive in extracting value from difficult assets and so may look to exploit such opportunities.

Re-imagining the Aviation Industry

Most PE investors will look at opportunities in the aviation sector in a rather opportunistic way: a recovery opportunity and, certainly for Asia, attractive underlying macro-drivers in the form of growing economies and growing middle classes that should propel the industry forwards for decades to come.

Structural changes in regulations, industry and technology will shake up the winners and losers in the aviation industry over the next decade

However, profound changes are lurking around the corner that have the potential to significantly disrupt the industry over the coming 10-20 years. Major drivers include the undoing of bilateral airline regulations, cross-border consolidation and dissolvement of legacy flag-carriers to stimulation a more economy- and consumer-friendly attitude towards the operation of international air services.

Joint venture and bilateral partnerships have become enormously important to the success – and even survival – of major airlines. Limited by ownership and control rules, airlines have constantly sought options to expand their global presence. The multilateral alliances have gone some way in that respect, but the intensification of international long haul competition has greatly enhanced the value of close bilateral ties.

There have already been a number of incursions into the sanctity of ownership and control provisions. These include the proliferation of cross-border JVs, which have been particularly functional in Southeast Asia with LCCs looking to establish themselves across the region as Pan Asian airlines; and the revival of significant minority shareholdings in foreign airlines.

Major consumer changes are also likely to disrupt the industry. Earlier we talked about the rise of environmentalism on travel and the potential impact of Covid-19 on long-term business travel demand keeps airline executives awake at night. Technology enables the consumer is becoming a major disruptor. Ancillary revenues and diversifying revenue streams become critically important for survival but many legacy carriers struggle to make the jump from a long ingrained position that their core business is merely flying aircraft from A to B and selling tickets accordingly.

There are so many other "core" activities to deal with: lobbying with government, complex labour relations (pilot unions can seriously constrain an airline's policy options), network planning, treasury functions and aircraft buying and leasing, IT functionality (insourced or outsourced), coming to grips with fast changing markets disrupted by LCCs, Gulf carriers and new entrants, accommodating and influencing intermediary activities, not to mention externalities like oil prices, volcanoes, terrorism and pandemics.

PE investors need to look beyond the short-term recovery opportunity in the post-pandemic new normal of the aviation industry

The most significant disruption that has occurred to date in the aviation and travel industry (and retail generally) is the shift in behaviour of consumers. The app-empowered consumer is more knowledgeable today, leveraging greater transparency, wanting direct control and unwilling to accept arcane rules that have governed airline operations for decades.

Airlines may struggle to come to grips with the intricacies of big data, but the prospects of large, older airlines achieving serious value are small. It will not be for want of trying – although many senior managements remain reluctant to make the necessary (major) commitments in cost and corporate restructuring necessary to achieve results. Burdened by a silo-oriented organisational structure and an absence of the right analytical minds and systems, airlines are in an unequal race with third party information aggregators to capture their own market.

PE investors looking at opportunities in the aviation sectors will need to look beyond the short term recovery opportunity in the post-pandemic new normal. They will need to understand the fundamental longer term regulatory, industry, consumer and technology trends that are shaping the industry over the next 10-20 years. It's likely that the industry landscape as it has existing over the past 3 decades will look very different in the coming decade and the winning players are likely those that are already now actively preparing and investing for that future.

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