EXECUTIVE SUMMARY

- With a total loss of USD 126.4bn for the airline industry, 2020 was a year to forget.
- Nevertheless, liquidity cushions of many airlines expanded over the past 12 months and have reached higher levels than before the crisis.
- In 2021 regions with large domestic markets and advanced vaccine rollout programs, such as China and the U.S., are performing much better than others. Domestic RPKs are forecasted to outperform international RPKs this year.
- To believe in the 2021 recovery story, one simply needs to believe in the recovery of both the Chinese and U.S. domestic passenger markets. WE DO!
2020: A YEAR TO FORGET

In the first quarter of this year, the final i’s were dotted and t’s crossed for the airline industry’s 2020 financial results. The final figure came in at a total loss of USD 126.4bn (see chart below). After ten consecutive years of profitability, it is no wonder that analysts are referring to the current aviation industry dynamics as a “Black Swan Event”. With a loss of this magnitude, the reported USD 183.37bn of Corona inspired government financial assistance measures for the global industry¹ becomes more understandable. Financial performance for the year 2021 is now being forecasted at an industry net loss of $47.7bn. The variation in roll outs of vaccination programs and difficulties in controlling virus variants in certain regions of the world resulted in downward forecast adjustments for the first half of this year.

GLOBAL AIRLINE INDUSTRY NET PROFITS

![Graph showing global airline industry net profits from 2008 to 2021F.

Source: IATA. Airline Industry Economic Performance – Data Tables, April 21 2021]

A TALE OF DIFFERENT ECONOMIC DEVELOPMENTS

The first quarter of the year 2021 has been full of contradicting signals. For all the positive signals coming from countries where enough vaccines have already been administered to cover circa 40% or more of the population, there are also unfortunately negative headlines coming from countries lagging behind in their respective vaccine campaigns; especially those who have been very lenient with Covid-19 preventative measures.

With Q1 restrictions in place for most of the quarter across the Eurozone, the EU economy suffered a double dip recession for the quarter. More concerning was the weak short-term outlook for the region as the second quarter² began. But as of the beginning of May, leading indicators suggest the EU Economy will come out of its dip together with improvements in the health situation linked to the acceleration of the vaccination roll-out in Europe.

¹ Ishka. Insights – Covid-19 Bailouts, March 30 2021
² Oxford Economics. Weekly Economic Briefing – Eurozone, May 7 2021
The Q1 news that came out of the U.S. could not have been more different. Propelled by its biggest vaccine campaign in its history, massive fiscal stimulus and warmer weather, it was reported that “an economic mini boom is underway” and, as a result, the real Q1 GDP growth rate was revised upward to 9.0% (from 6.9%).

Conflicting signals were also observed when comparing the Q1 news coming out of Germany to that of the United Kingdom. Rising Covid-19 cases and hospitalisations, as well as a shortage of available vaccines, forced the German government to reverse its earlier easing in lockdown measures in Q1. On the other hand, in the U.K., the strong vaccination rollout to its population resulted in a steady fall in the number of registered Covid-19 cases. With GDP in February of this year only 7.9% below the pre-pandemic level, economists raised 2021 U.K. GDP forecast from 6.8% to 7.2%.

The good news is that based on most recent reports, Germany appears to have passed the peak of its third infection wave. Along with a strong ramp-up in its vaccination programs, both federal and state governments are beginning to discuss a material ease in restrictions. So while Q1 GDP disappointed, talk of additional down-grading is being replaced by much more optimistic tones for the remainder of the year.

**THE CHART OF THE QUARTER**

![Airline Regional Operating Margins](chart)

Why should our chart of the quarter be any different? Regions with large domestic markets and advanced vaccine rollout programs are logically performing much better than others. This was already experienced in Russia, China and Australia and is now being reported in the United States.

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5 Oxford Economics. Country Economic Forecasts – United Kingdom, April 16 2021
In fact, the U.S. is expected to be the best performer in terms of 2021 airline financial operations. Initial Q1 2021 results from North America already indicate that some airlines stopped burning cash in the month of March due to the quick rebound in U.S. domestic travel. Not only the low cost carriers in the U.S., but also legacy carriers such as American Airlines are reporting that advance ticket sales are already close to pre-pandemic levels. As reported in our last industry update, the domestic flight ramp-up will lead the way in 2021. There is currently much to be optimistic about in the North American regional passenger sector and the narrow-body aircraft market.

**LEADING AIRLINES HAVE PUT THE LIQUIDITY CRISIS BEHIND THEM**

Allow us to look back approximately one year ago. The industry found itself in the midst of the worst liquidity crisis in the history of aviation. In March of 2020, industry analysts reported that 75% of the airlines surveyed had less than 3 months of cash to cover costs. As a result, aircraft operating lessors were bombarded with a flood of waiver and consent requests linked to a postponement or extension of lease payment obligations. With very little cash generated from advanced passenger reservations and ticket bookings, the industry’s greatest challenge was finding additional sources of liquidity.

We at KGAL decided to visit our Bloomberg Terminal to gain a better understanding of how the liquidity position of various leading airlines developed over the past 12 months and if there was a recognisable pattern.

### AIRLINE LIQUIDITY RATIO MEASURED AS QUARTERLY QUICK RATIO

![Airline Liquidity Ratio Chart](chart)

Source: Bloomberg March 10 2021, Quick Ratio: (Cash + Cash Equiv. + ST Investments + Account Rec.) / Current Liabilities. Undrawn credit lines not considered for this graphic illustration

The results of our analysis confirmed what we are hearing from airlines and observing through the transactions being executed in the market today. Aviation investors have flown to the safety of quality. The opportunistic (e.g. high-yield) transactions linked to leading airlines we observed

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6 Bloomberg – Associated Press. Airport Crowds, Airline Ticket Sales Show Travel Recovering, March 30 2021

7 IATA. Covid-19 (Airlines’ Liquidity Crisis), March 16 2020
in the U.S. during the first half of 2020 quickly dissipated during the second half of the year. Additionally, the opportunistic transactions we observed (and executed) in Europe, quickly slowed as the year came to a close. The billions of dollars of U.S. Government support that was signed into law on March 27, 2020 (i.e. the CARES Act) began to make a material impact on the U.S. Airlines’ balance sheets already in the second quarter of last year. This extra shot of liquidity confidence reignited the capital markets for many of the U.S. legacy carriers. Similar in Europe, although with a noticed delay, once the respective EU Governments approved the applicable relief packages, the respective transaction’ lease rate factors began to correct themselves downward in line with the perceived risk profiles. As the liquidity cushion of many airlines expanded and the probability of default dissipated, the returns began to mirror the lower risk of the credit side.

### REGIONAL PASSENGER AIR TRAFFIC DEVELOPMENTS

Consistent with the strong economic signals coming from the United States, RPK traffic forecasts predict that North America will be the fastest growing global region in 2021. Moreover, based on the same source of data, approximately half of these RPKs in North America will go to the credit of the U.S. domestic air passenger traffic. Similarly, at almost 40% of the Asia Pacific’s forecasted RPKs, it will be the Chinese domestic air passenger traffic that will drive the 2021 passenger traffic growth in Asia. This is already being witnessed as the Chinese relax travel restrictions imposed in January and February to combat the spread of Covid-19 during the much travelled Chinese New Year season. It was Europe that stumbled in the first quarter of this year. Nevertheless, with the EU now vaccinating at similar rates as the U.S. (circa 2.7 million vaccines administered per day), the second half of this year looks more promising and will be the key to this region’s recovery in passenger traffic. As Latin America, the Middle East & Africa are much more dependent upon long-haul international passengers, the forecasted RPK growth rates in 2021 are negligible. Only once the long-haul international traffic materially ramps up, will these regions be able to profit from any recovery.

#### DEVELOPMENT OF GLOBAL PASSENGER AIR TRAFFIC (IN RPK – TRILLION) BY GEOGRAPHICAL REGIONS

<table>
<thead>
<tr>
<th>Region</th>
<th>2019 – 2021</th>
<th>2019</th>
<th>2020</th>
<th>2021f</th>
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<tr>
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<td>1.04</td>
<td>0.32</td>
<td>0.38</td>
<td></td>
</tr>
</tbody>
</table>

1 Including Mexico
2 Including Emerging Europe and Russia
Source: Oxford Economics Global Data – IATA. March 9 2021

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The second half of this year looks more promising for passenger air traffic in the EU

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8 Bloomberg covid-vaccine-tracker, April 27 2021
THE KEY TO THE 2021 RECOVERY STORY:
DOMESTIC TRAFFIC

Yes to the fact that the Aviation Industry still has a plethora of challenges to overcome before we can report that “business is back to normal”. But also yes to the fact that the recovery story is still on track. As was reported in our February 2021 Aviation Update, back in 2019 roughly two thirds of total global RPKs were attributed to the international passenger market while the remaining one third was attributed to the domestic passenger market. Although it is hard to believe, the domestic market actually came in with higher RPKs in 2020 than the international market (1.53 trillion RPKs versus 1.44 trillion RPKs)\(^9\). Ceteris paribus, we expect to see a similar result for the year 2021 as domestic RPKs are forecasted to yet again outperform the international RPKs. And as can be viewed below, it will be both the Chinese and U.S. domestic passenger markets that will drive the recovery. Interestingly enough, in analyzing the years 2010, 2019 and the forecast numbers for 2021, both the U.S. and Chinese domestic markets make up roughly two thirds of the total domestic RPK market. To believe in the 2021 recovery story of the passenger airline market this year, one simply needs to believe in the recovery of both the Chinese and U.S. domestic passenger markets. WE DO!

USA and China make up two thirds of the total domestic RPK market

GROWTH FORECAST OF DOMESTIC PASSENGER AIR TRAFFIC (IN RPK – TRILLION)
BY SELECTED REGIONS

\(^9\) KGAL. After A Dark Night Comes A Sunrise, February 2021
A CLOSER LOOK AT PASSENGER TRAFFIC IN Q1

Passenger traffic started out weak for Q1 with both January and February recording total market RPKs down at 72% and 74.7% below pre-crisis levels in 2019\(^{10}\). Although material growth was recorded in domestic regions such as the U.S. and Australia during the beginning of the quarter, the Chinese domestic numbers disappointed analysts as the government tightened travel restrictions for its citizens during the important Chinese New Year in response to a rise in new Covid-19 cases. Nevertheless, the Chinese domestic market came back with a serious bang in the month of March with traffic reported to be only -2.6% below pre-Corona 2019 levels\(^{11}\). Even more impressive was Russia’s domestic RPK growth coming in at an actual increase of +8.5% over pre-Corona 2019 levels. Encouraging was also the continued strong March rebound seen in the U.S. and Australian domestic markets. Unfortunately, with Europe’s immunization programs just ramping up and most of Asia Pacific experiencing a sharp rise in new daily Covid cases since mid-February, global growth forecasts for next quarter remain patchy at best. Irrespective of this fact, with domestic traffic and early bookings in key regions showing strong signs of growth, the Covid-19 side-lined narrow-body aircraft capacity is quickly being ramped up to perform.

On the cost side, airlines continue to implement stringent cost cutting measures. It was reported that variable costs (e.g. fuel) declined in parallel to the loss in revenues, but the reductions in fixed/semi fixed costs continue to challenge the industry. Oil and jet fuel prices eased from the peak in March with rising concerns about global Covid-19 cases weakening the recovery in demand. The relief on the cost side of airlines operations has helped many carriers improve their liquidity positions as they enter what many will hope to be a strong spring.

\(^{10}\) IATA. Air Passenger Market Analysis – January and February, March 2 and April 4 2021
\(^{11}\) IATA. Air Passenger Market Analysis – March, May 4 2021
KGAL Group

To date, the aircraft fund investment volume realised by KGAL Group totals more than €7.9 billion. Since the initial aircraft fund in 1979, KGAL has concluded transactions for more than 860 aircraft, 81 private placements and other investment models, as well as 58 retail and three institutional funds. KGAL Group is a leading, independent investment and asset manager with an investment volume of €15.2 billion. The investments focus on long-term capital investments for institutional investors in the real estate, infrastructure and aircraft asset classes.

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