Investec

Aviation
demand soars to new heights

OUT OF THE ORDINARY

What's inside:

Key market insights

Demand and capacity up in May

The International Air Transport Association (IATA) reported that in May 2024 total aviation demand, measured in revenue passenger kilometres (RPKs), was up 10.7% compared to May 2023. In addition, total capacity, measured in available seat kilometres (ASK), was up 8.5% year-on-year and the May load factor was 83.4% (+1.7ppt compared to May 2023), which is a record high for May.

Breaking that down, international demand rose 14.6% compared to May 2023 with capacity up 14.1% year-on-year and the load factor improved to 82.8% (+0.3ppt on May 2023). Domestic demand rose 4.7% compared to May 2023, capacity was up 0.1% year-on-year and the load factor was 84.5% (+3.8ppt compared to May 2023).

Air navigation service providers under pressure

These statistics led IATA's Director General, Willie Walsh, to comment: "Strong demand for travel continues with airlines posting a 10.7% year-on-year increase in travel for May. Airlines filled 83.4% of their seats, a record for the month. With May ticket sales for early peak-season travel up nearly 6%, the growth trend shows no signs of abating. Airlines are doing everything they can to ensure smooth journeys for all travellers over the peak northern summer period."

"He added: "However, our expectations of air navigation service providers (ANSPs) are already being tested. With 5.2 million minutes of air traffic control delays racked up in Europe even before the peak season begins, it is clear that Europe's ANSPs have unresolved challenges. And the 32,000 flight delays over the Memorial Day weekend in May show that challenges persist in the US, too. Airlines are accountable to their customers; ANSPs must be as well. ANSP performance matters to their airline customers and to millions of travellers. We all need them to do their job efficiently."

Trends

Regional breakdown – international passenger markets

All regions showed strong growth for international passenger markets in May 2024 compared to May 2023. The load factor increased in all regions except North America.

Asia-Pacific airlines continue to lead the way, with a 27.0% year-on-year increase in demand. Capacity increased 26.0% year-on-year and the load factor rose to 81.6% (+0.6ppt compared to May 2023). This performance maintains Asian carriers as the largest contributor to industry-wide growth in May, accounting for 42% of the year-on-year increase.

European carriers saw an 11.7% year-on-year increase in demand. Capacity increased 11.3% year-on-year, and the load factor was 84.7% (up 0.3ppt compared to May 2023).

Middle Eastern airlines saw a 9.7% year-on-year increase in demand. Capacity increased 9.0% year-on-year and the load factor increased 0.5ppt to 80.7% compared to May 2023. Asian routes to the Middle East are particularly strong, now standing some 32% higher than in 2019. Another notable development is the Europe-Middle East route, which saw an April-May RPKs increase for two years in a row, reversing the previous historic pattern of a decline between these months. In the coming months, it will become clearer to what extent these trends could be related to the Russia-Ukraine war.

North American carriers saw an 8.1% year-on-year increase in demand. Capacity increased 9.7% year-on-year, and the load factor fell to 84.0% (-1.2ppt compared to May 2023).

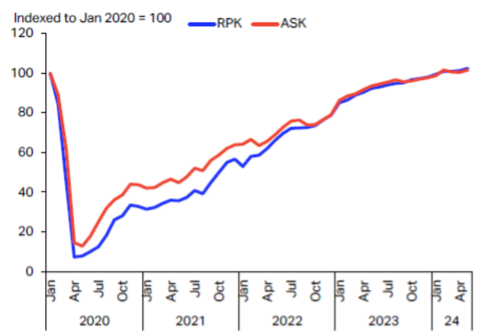
Latin American airlines saw a 15.9% year-on-year increase in demand. Capacity climbed 14.3% year-on-year. The load factor rose to 85.1% (+1.2ppt compared to May 2023), the highest among the regions.

African airlines saw a 14.1% year-on-year increase in demand. Capacity was up 8.2% year-on-year. The load factor rose to 72.3% (+3.7ppt compared to May 2023). This was the fastest increase in load factor among all regions, although Africa still has the lowest load factor overall.

Domestic passenger markets

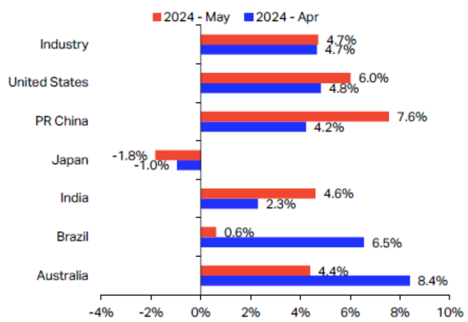
Domestic demand increased at a stable pace in May. China's growth rate surged in line with the post-Labour Day holidays with Japan's decline of -1.8% possibly reflecting low business and consumer confidence.

Airline profitability by region, USD billion



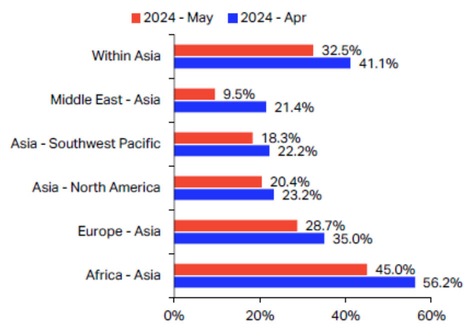
Sources: IATA Sustainability and Economics, IATA Monthly Statistics

Domestic RPK growth by market, YoY%



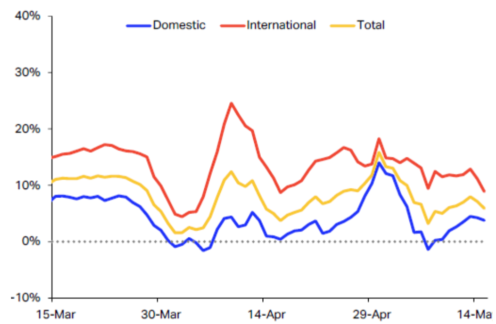
Sources: IATA Sustainability and Economics, IATA Monthly Statistics

International RPK, YoY% - Major route areas



Sources: IATA Sustainability and Economics, IATA Monthly Statistics

Domestic RPK growth by market, YoY%



Sources: IATA Sustainability and Economics, DDS

Air cargo traffic

In 2023, geopolitical tensions, continued inflation, impaired supply chains and rising cross-border trade restrictions weighed heavily on the world's trade in goods. Even though many of these headwinds have carried over to 2024, the World Trade Organization expects merchandise trade volumes to grow by 2.6% year-on-year this year, after falling by 1.2% in 2023. This would be just above the historical (2010–2023) average of 2.5% year-on-year, but there is considerable downside risk to this forecast.

With the disturbances in global supply chains in the aftermath of the Covid-19 pandemic, both sea freight and air transportation rates were very volatile. Disruptions in ocean container shipping have reemerged since late 2023, linked to the Red Sea, the Panama Canal drought, and the accident at the Baltimore Bridge. This has again brought about a sharp drop in relative air cargo rates over maritime shipping in the first quarter of 2024 radically increasing air cargo's competitiveness. It is crucial for the air cargo outlook to ponder whether the shift in global supply chains could be a lasting phenomenon.

Airline financial performance

Considering the relatively high crude oil prices, the strong US dollar against many other currencies and persistent inflation, as well as higher interest rates, the aviation industry has demonstrated a remarkable ability to adapt to the changing market environment. In 2023, revenues exceeded the 2019 level and operating profits rebounded to a level last seen in 2018.

Thanks to higher-than-anticipated yields, 2023 profit forecasts for all regions have been revised, most notably in Asia Pacific, Latin America and Europe.

At the industry level, expectations are now for 2023 net profit stands to reach US dollar 27.4 billion and the current operating margin should climb to 5.7%. In 2024, expectations are for further growth in traffic, though at a slower pace than that seen in 2022 and 2023. This should allow net profits for the aviation industry to reach USD30.5 billion, with a 3.1% net profit margin and a 6.0% operating.

The operating margin is expected to continue its upward trend, driven by sustained demand and further gains in fleet utilisation and load factors. These factors should help dilute the unit cost (specifically, the non-fuel unit cost measured per available tonne-kilometre (ATK) and boost the profit margin.

Delays in aircraft deliveries can have contrasting effects on airlines and their network. On the one hand, limited seat availability may prevent the maximisation of anticipated revenue growth. On the other hand, delays can enhance profitability if higher load factors lead to higher yields, potentially improving margins.

High interest rates tend to have a negative impact on net margins and typically impact airlines' financing costs with a lag. The full effect of the tighter monetary policy is likely to be felt in 2024 and 2025. Furthermore, delays in aircraft deliveries have already driven operating lease prices to record highs, which could also impact profitability this year.

Despite these challenges, expectations are that 2024 will see a relatively stable macroeconomic outlook and strong passenger demand. These factors should enable the airline industry to improve its operating margin compared to 2023.

However, it is essential to consider that higher aircraft ownership costs may keep the net margin broadly flat year-on-year, despite an increase in operating margin.

The improved financial health can also be observed on company balance sheets. First reads of industry financials this year indicate nominal debt levels falling to a level just a notch above 2019 and a rough estimate of the adjusted net debt/EBITDA ratio of 4.1x compared with 2017-19 average of 4x. On the other hand, debt levels now imply higher interest burdens, given a sharp increase in interest rate, which may put pressure on net margins.

Freighter aircraft demand

With the global softening in demand for air freight compared to recent years, partly driven by the faster-than-expected return to operation of large aircraft with belly hold capacity, there were concerns about an oversupply of narrow-body-sized freighter aircraft. Some recently converted 737-800s are now understood to be parked, awaiting deployment.

As noted above, conflicts, accidents and weather are all impacting global sea freight. The desire for 'just in time' logistics in supply chains and other limitations in supply chains, in general, are driving more manufacturers towards air rather than traditional sea freight. This is especially the case in technology markets, where assembly of consumer goods relies on the supply of essential microchips from Far East manufacturers.

With aircraft manufacturers still unable to ramp up their passenger aircraft production to planned levels, demand for used aircraft is taking up some of those positions. This is leading to adjustments in the flow of passenger aircraft being converted to freighters, with many lessors choosing to redeploy aircraft out of their conversion programmes back onto extended or new passenger operation leases. When the programmes were first put together, they included some very young aircraft that bucked the traditional 20-plus years before conversion trend and began to lower the average age of a converted freighter, but this age reduction is now likely to slow down.

A word from the Aviation Finance Team

Paul Da Vall
Head of Aviation Equity Funds

"In recent days, several mega-lessors have told us they are experiencing 90%+ lease extension rates among their airline customers which is an unprecedented level. The consequence of this is outperformance by aircraft owners and lessors as downtime during aircraft transition is all but eliminated and lease rates are rising, while lessors have the advantage of multiple alternative airlines chasing their equipment. The SLB market is somewhat the opposite, given the scarcity of new aircraft delivering, the airlines can drive down the initial lease rate due to the competitive marketplace created by an abundance of lessor liquidity and a lack of new aircraft deals, this is despite relatively high but stable interest rates."

David Louzado
Head of Technical, Aviation

"Geopolitical events, accidents, weather phenomena and the retention in service of used passenger aircraft have conspired to rebalance some of a perceived oversupply of freighter aircraft, with air freight taking some of the traditional sea freight market. The passenger to freighter (P2F) programmes for some aircraft are now going to be pushed out further into the future, leading to a reset of the more traditional age points for entry into conversion. The long-term demand for freight aircraft remains healthy and the conversion slots are still being booked with expansion of the global P2F operations, but for some there is a slight rebalancing of orders."

Derek Wong
Head of Aviation Debt Funds

"Investec pays close attention to engine green time when assessing aircraft residual values and sizing aircraft debt balloons. We have seen engines contributing to an increasing portion of an aircraft's residual value. In line with our expectations, Cirium has recently adjusted its base value curves such that they generally have a shallower depreciation profile and higher floor. With our in-house technical expertise, Investec's bottom-up analysis allows us to capture the value in aircraft assets and offer competitive solutions to airlines and lessors. With current supply/demand dynamics persisting into the medium term, we anticipate asset values to remain robust. On a more cautionary note, various carriers have flagged softer than anticipated demand/revenue trends for the second half of 2024. Following large cost increases during the post-Covid travel boom, cost management should again come into sharp focus for airlines, especially carriers that had relied on fleet growth to manage unit costs."

Jet fuel market update

The OPEC+ meeting in early June was the first of its two full ministerial meetings this year. Instead of being held in person in Vienna, most members stayed at home and joined a virtual meeting, while those OPEC+ members that have signed up to additional voluntary cuts, met in person in Riyadh. This further delineated the core group of eight members (Saudi Arabia, Russia, Iraq, the United Arab Emirates, Kuwait, Kazakhstan, Algeria and Oman) with Saudi Arabia at the helm, from the other members of OPEC+.

The main OPEC+ member meeting agreed to 2025 compulsory production targets that included an extra 300,000 barrels per day for the UAE's quota. Meanwhile, the core members that signed up to additional voluntary cuts agreed that while those cuts will be rolled to the end of September, they will then be phased out over the following 12 months until September 2025. Oil sold-off following the meeting on scepticism that the market could absorb such an increase and Brent reached a low around $77 per barrel ($/b). There followed an abrupt recovery after Saudi Arabia's energy minister pointed out a caveat in the press release which made clear that members might slow down or stop planned production increases. Since then, Brent has hovered around 85 $/b.

For now, the relative tightness in the market due to strong summer demand combined with messaging from OPEC+ suggesting that it will increase output if it can, but won't if the market can't take it, is a recipe for low volatility. Brent has been rangebound as a consequence and volatility implied by the options market has fallen to its lowest level for many years.

Brent front contract

Sources: Investec, Bloomberg

OPEC+ members face post-summer challenges

Once the summer demand peak is over, the asymmetry in OPEC+'s ability to manage the market could be exposed. It is much harder for OPEC+ to cut further to deal with an oversupply than it is to increase output if demand surprises on the upside. OPEC's own supply/demand estimates are far more bullish than, for example, the International Energy Agency and if they prove to be right, OPEC+ will be in a good position.

Such a rosy view does seem hard to reconcile with the less-than-optimistic growth outlook for China though – a vital market for most OPEC+ members. China's Third Plenum, the latest of a five-yearly conclave that can lead to significant strategic shifts, was held recently, but did not have much to inspire markets and the quarterly growth numbers published this week came in lower than expected at 4.7%.

September could be a critical month for the core members of OPEC+, as summer demand will be over, and they will have to decide whether to go ahead with unwinding voluntary cuts as they pencilled in for October. Brent is currently treading water around 85 $/b and recent downside has been limited to the 100 and 200-day moving averages around 83.50 $/b. A break below that could open up further downside with potential to break 80 $/b and test the June lows around 77 $/b. On the upside, there is trend-line resistance around 87 $/b and the high of this month is just under 88 $/b.

Interest rate and foreign exchange update

The global outlook for interest rates continues to be volatile with the market reforecasting rate cut probabilities at most major data point releases. At the start of the year, investors were pricing six to seven US Federal Reserve (Fed) cuts through 2024. That now sits at three cuts totalling 100bps for the remainder of the year. Similarly with the UK, rate cut expectations have been lowered from the start of the year to just three by the end of the year. The move higher in rates volatility has been a key feature in markets amid poor visibility around the macroeconomic outlook in the G10 specifically.

Inflation trends and central bank decisions continue to shape the currency and swap markets

The European Central Bank (ECB) reduced its interest rates by 25bps in June, the Bank of England (BoE) decided on a 25 basis point (bps) rate cut in its July meeting while the Fed kept rates on a dovish hold in July. This, together with weak US jobs data led to a turmoil in the market, with 5-year swap rates moving lower by about 60bps in the US and about 30 bps in the UK in early August.

Market rate forecasts have changed over time as inflation data from the eurozone, the UK and the US were published, which suggests that the monetary policy decisions are mainly influenced by inflation trends. The Fed is expected to cut rates in its next meeting (in September) by around 50bps, 25bps for the ECB and a hold is expected from the BoE. Inflation figures, as well as recent market reaction to the monetary policy decisions, may affect the timing and magnitude of the interest rate cuts by the central banks going forward, as they balance the need to support the economic recovery from the pandemic and the risk of overheating the economy.

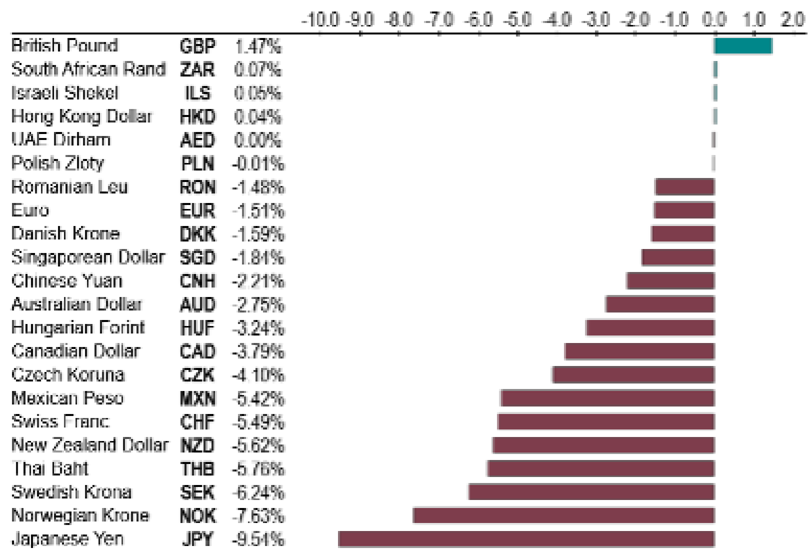
In the currency market, the US dollar appreciated at the beginning of the year but rapidly depreciated in July, with GBP/USD reaching new peaks of +1.29. The main driver for this was the June US consumer price index (CPI) data, which was lower than expected at 3%, compared with 3.1% anticipated. By the second week of August, post the monetary policy decisions, GBP/USD had done a full reversal on the July gains to near the start of 2024 US dollar strength.

Geopolitical uncertainties unsettle markets

The presidential election in the US is in the spotlight with the recent assassination attempt on Donald Trump being the latest event shifting the odds in the former president's favour. Markets traded higher odds of Trump winning after the attempted assassination. However, the US dollar continued to sell off, marking a mismatch in the expectation of a Trump rule resulting in a stronger dollar.

The second quarter of the year has been far more volatile than the first quarter, something much expected given a global politically uncertain landscape. Election turmoil in India, Mexico, South Africa and France have encouraged 'safe haven' flows into the US dollar.

Spot performance vs USD this year (%)



Sources: Investec, Macrobond, Bloomberg

US$1 billion of capital deployed in 2023

Aviation Debt:

- Closed and mandated US$834 million across 67 aircraft

Aviation Equity:

- Invested US$360 million
- Remarketed and sold US$350 million

Marquee deals included:

- A350 and a B787 aircraft leased to Singapore Airlines
- Portfolio of 23 Airbus and Boeing aircraft for US lessor

Investec Aviation Finance

Aviation specialists

Over $10bn debt origination
(in last 10 years)

Supported by a FTSE 250 financial institution

Dedicated debt managers

Over $500m
assets under management

Proven seven-year track record

Originated $1bn of assets

Dedicated equity managers

$1.3bn capital deployed
(over 13-year history)

Raised $5.3bn of acquisition finance across four equity vehicles three equity funds fully exited

Partnership approach

Full alignment with investors via meaningful Investec co-investment in all managed platforms

About Investec

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