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Weekly Credit Brief
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European and US airlines face differing credit outlooks amidst operational and financing headwinds

By Aditi Kamath

- **NUS-CRI Forward 1-year PD suggests that US airlines' credit outlook is likely to deteriorate at a faster pace than European airlines owing to larger debt maturing in the medium term, exposing them to higher refinancing costs**
- **European airlines remain relatively robust to surging jet fuel costs due to their hedged positions as seen from a stable NUS-CRI Agg (median) 1-year PD**

Despite the rebound in the demand for global air travel, European and US airlines have axed or delayed thousands of flights as manpower shortage hits the shore. The anticipated recovery in the credit health of European and US airlines[1] on the back of increased demand has been clamped by headwinds such as aircraft delivery disruptions, rising jet fuel prices, and wider inflation-driven monetary tightening, potentially increasing operational and financing costs for the industry going forward. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) shows diverging credit profiles between US and European airlines highlighting the greater degree of credit deterioration faced by the former, possibly attributable to a larger debt burden in the medium term compared to their European counterparts, as well as due to the benefits of widespread cost hedging practices implemented by the European airlines to insulate their margins against fuel price shocks. With the US airline industry navigating these headwinds in an environment where the cost of borrowing and aggregate leverage levels are larger than that faced by European airlines, the NUS-CRI Agg (median) Forward 1-year PD (Forward PD[2]) suggests a worse deterioration in its credit risk outlook.

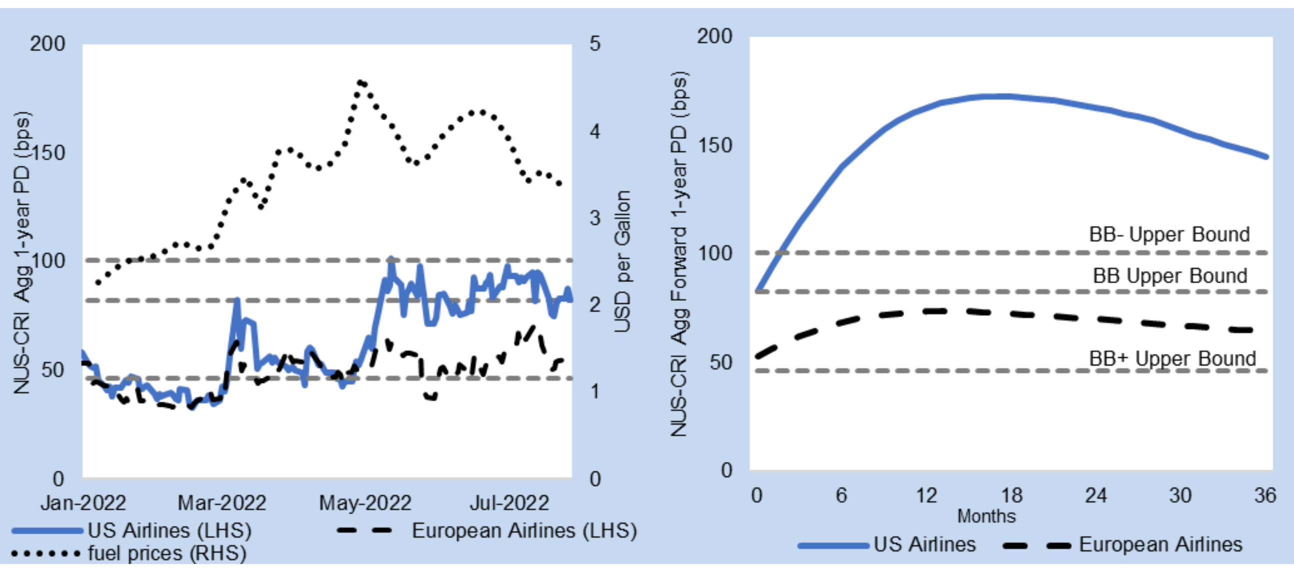

Figure 1 (LHS): NUS-CRI Agg (median) 1-year PD for US and European Airlines from Jan-2022 to Jul-2022 with reference to PDiR2.0[3] bounds; Kerosene-Type Jet Fuel Prices: U.S. Gulf Coast (USD/gallon). Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for US and European Airlines as of Jul-2022 with reference to PDiR2.0 bounds. *Source: NUS-CRI, FRED*

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[1] Europe and US experienced international arrivals increasing by 350% and 112% respectively in the first five months of 2022 compared to the same period in 2021.

[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.

[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

Both European and US airlines undertook large amounts of debt to finance and sustain operations during the height of the pandemic[4]. However, since 65% of US airlines' total debt is set to mature sooner[5] than those of European airlines (See Figure 2a), should US airlines wish to tap into the markets for further financing, they are most likely going to be facing a higher refinancing cost[6]. The higher interest expenses could add to their currently strained margins, which are already at -18.2% as of Q1 2022. Furthermore, the Fed has been more aggressive in combating rising inflation using monetary tightening, compared to the ECB which has lagged behind the Fed in hiking rates, leading to higher costs of financing for US airlines as compared to their European counterparts. With US inflation showing no signs of slowing down and the Fed's commitment to undertake further extensive interest rate hikes, US airlines' refinancing woes may intensify especially as the 2025 debt pile matures. Similarly, if the ECB were to increase the pace of its rate hikes, even with a marginally lower leverage level, should European airlines wish to refinance, they could face higher borrowing costs.

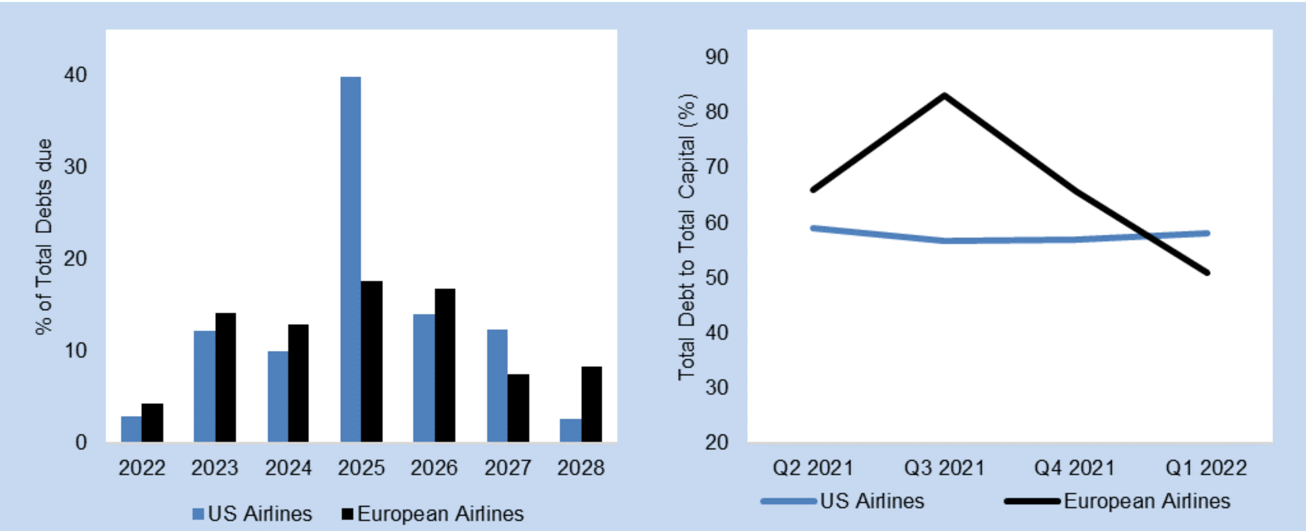

Figure 2a (LHS): Debt maturity as a percentage of total debt due by year for European and US airlines. Figure 2b (RHS): Total debt to total capital ratio of US and European airlines *Source: Bloomberg, Refinitiv*

Jet fuel costs constitute nearly a third of an airliner's operating cost, therefore many European airlines tend to partially hedge against any expected rise in fuel prices through futures contracts. With jet fuel prices skyrocketing by nearly 90% since the start of this year, the value of these hedges increased by close to EUR 5bn, mitigating a potential deeper worsening in the European airlines' bottom line, while maintaining a buffer against rising jet fuel costs. On the other hand, most large US carriers, such as American Airlines, Delta Air Lines, and United Airlines, tend to pass on additional costs to consumers to preserve their margins by raising airfares rather than entering into such hedging agreements. Without the complete cost passthrough, the net profit[7] of the US airlines remains weaker than their European counterparts in Q1 2022. Meanwhile, following the inherent cyclicality in travel trends, demand for leisure travel is expected to drop after the summer period, compounding the impact of potentially subdued consumer discretionary spending due to rising inflation levels in both markets moving forward, thus, simultaneously adding further pressure to the US and European airlines industry's margins and cash flows, as suggested by the initial short-term worsening in credit risk outlook over the next six to twelve months suggested by the Forward PD in Figure 1b.

Severe manpower shortage also dealt a significant blow to the European and US airlines' revenue-generating abilities as, in effect, thousands of flights had to be rescheduled or canceled, translating to unserved demand hampering the industry's operating cash flows[8]. As the airline industry reduced its workforce during the operational slump caused by the pandemic, labor supply at its current levels is unable to sustain the sudden recovery in demand. Moreover, global airlines have been competing to secure labor, driving pilot wages up to as much as nearly 20% of US airlines' operational costs. Companies such as American Airlines have promised up to 17% in wage hikes while some of its subsidiaries are raising temporary contract salaries up to 50%, hurting their bottom line.

[4] The airline industry has been burning through substantial amounts of cash over the past two years in order to sustain operations in the absence of revenue-generating opportunities. For example, one of the largest US-domiciled airlines, American Airlines, spent close to USD 27mn/day to maintain operations at the height of the pandemic.
[5] By 2025, US airlines face a massive USD 13.3bn of maturing debts.
[6] Yields on the Bloomberg High-yield and investment grade Airlines total return index have both increased by close to 3 percentage points since the beginning of the year, highlighting the additional premium demanded by investors in face of the incumbent challenges faced by the industry.
[7] Data from Bloomberg
[8] At present, US airlines are operating at a reduced capacity of 84%.

Although global air travel has experienced a boost from the pent-up travel demand, the airline industry currently faces a multitude of headwinds arising from labor shortages and aircraft delivery delays which have not allowed the industry to take full advantage of the recovery. Moreover, recessionary pressures arising from surging inflation and rising interest rates have also created a somber global outlook as discretionary spending is expected to slow down, at a time when industry firms face higher costs. Although both European and American airlines face similar macroeconomic headwinds, the former manages to remain healthier as it has been able to partially protect itself from surging fuel prices. Monetary tightening policies employed by the central banks have also played a major role, especially for US airlines which expect a substantial portion of their debt to mature within three years. A possible silver lining could be that in the long term, both European and US airlines may face some improvement in credit health as aircraft deliveries and manpower disruptions resolve along with an easing in fuel prices, partially alleviating the pressure on the industry's cash flow generating capabilities.

Credit News

Betting on a recession, U.S. distressed debt funds seek fresh capital

Jul 28. As expectations of recession increase, distressed funds are ramping up efforts to build up capital to boost their capacity to acquire troubled assets, amidst the overall slowdown in fundraising activity this year compared to the previous 2 years. Funds raised are unallocated, but asset managers are looking for opportunities across various assets such as debt, crypto, and real estate. To increase attractiveness to potential investors, fund managers are also keen on including capital call features on their offerings which would only be activated once a target is identified. Last year, distressed fund returns were at 15.6% compared to 10.2% for the broader hedge fund market. (Reuters)

IMF warns rising debt in Asia puts region at risk

Jul 27. According to IMF data, the continued rise in global inflation could significantly slow down growth in Asia, potentially until 2023. At the same time, the region might also feel the significant impact of interest rate hikes of advanced economies. The unfavorable outlook brings into focus the high debt levels in Asia, having sharply increased from 25% before the pandemic to 38% this year driven by inflation and tightening financial conditions, pushing several countries into debt distressed territory. Asia's rising debt level is a concern considering that Sri Lanka had defaulted on its debts for the first time earlier this year, becoming the first casualty in the region in decades. (CNBC)

China banks may face USD 350bn in losses from property crisis

Aug 01. With China's economy descending deeper into the property crisis as mortgage boycotts gain momentum, questions are raised about the impact on the country's banking sector. It is estimated that China's banks will have to contend with losses of up to USD 350bn in the worst-case scenario. As economic growth slows and leads to higher unemployment, the government is keen to take on an active role to maintain financial and social stability. However, consequently, the country's banks are also expected to play an active role in the state bailout plan which further dampens their outlook. (Bloomberg)

Global bonds surge in best month since 2020 on recession fears

Jul 29. Global bonds have registered their highest monthly return since Nov-2020 as the market expects inflationary headwinds to ease. This week, the Fed chief indicated a possible slowdown in rate hikes depending on economic data. Concurrently, a recent report indicating a contraction in the global economy for Q2 2022 gave investors hope that the surge in consumer prices may slowdown. Resultantly, global corporate bonds lead the surge in bond markets with a IG corporate bond index registering record monthly gains of 4.7% in July. (Bloomberg)

EU banks get USD 3.8bn boost from end of negative rates era

Jul 29. The EU's five biggest banks have reported a collective 50% jump in quarterly net income by virtue of their core business lending. BNP Paribas SA had the highest quarterly profit, while UniCredit SpA had its highest net income in almost five years. A large part of this is down to the end of an 8-year era of negative interest rates imposed by the European Central Bank (ECB). The ECB decision came by cause of threat of surging inflation which could rise its deposit facility to 0%. Be that as it may, the ECB decision also implies that banks will be unlikely to have access to subsidized ECB loans, known as targeted longer-term refinancing operations, which have contributed significantly to their revenue in the past few years. (Bloomberg)

Investors wave goodbye to negative-yielding debt as central banks fight inflation (WSJ)

UAE national banks provided USD 190bn credit facilities to business sector (Arab News)

S. Africa set to take over part of Eskom's USD 24bn debt (Bloomberg)

Regulatory Updates

Australia's aggressive policy tightening set to weigh on economy

Aug 01. According to economists, the Reserve Bank of Australia will lift its key interest rate by 50 bps for a 3rd consecutive month to 1.85%. Policymakers are trying to tame inflation which is currently peaking at more than twice the upper bound of the central bank's target range of 2-3%. Looking at the money markets, a cash rate of around 3% is priced in by year-end. The central bank will publish quarterly forecasts on Friday with expectations of downgrades in economic growth and employment. (Bloomberg)

Fed's aggressive rate-hike path bolstered by new inflation, wage data

Jul 30. The personal consumption expenditures price index, the Fed's preferred measure of inflation, leaped 6.8% in June, its steepest increase since 1982. Core prices, excluding food and energy prices, used by the Fed as an indicator of the inflation outlook, also accelerated. The employment cost index increased 1.3% in second quarter while wages and salaries rose 1.4% in the same time period. The data bolstered the Fed's resolve to hike rates, with the Fed chair reiterating that rate hikes will slowdown only if inflation shows signs of cooling down. (Reuters)

Singapore issues ESG funds guidelines to reduce 'greenwashing' risks (Reuters)

South Korea plans financial tool to head off crises (Reuters)

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