CRI Credit Research Initiative
Risk Management Institute, National University of Singapore
NUS National University of Singapore | RMI Advancing Risk Management for Singapore and Beyond
transforming big data into smart data
Weekly Credit Brief
Mar 10 - Mar 16 2020

Global airlines facing challenges as the new coronavirus spreads

by Liu Yuan

The world's airline industry is currently facing one of its greatest challenges due to the rapidly spreading coronavirus in the globe. The new coronavirus (Covid-19), which emerged late last year, has sent demand for travel worldwide tumbling in recent months as coronavirus cases surged outside China, forcing global airline companies to cancel flights, cut capacity and withdraw financial guidance amid growing uncertainty. As presented in a previous NUS-CRI Weekly Credit Brief, credit profile of China-domiciled airlines has been heavily hit by the Covid-19. HNA Group, which was in talk with Chinese authority for a takeover plan, has recently handed its effective control over to the government to resolve its liquidity crisis. In this week's article, we will analyse the credit profile of the global airlines. Tracked by NUS-CRI Aggregate 1-year Probability of Default (Agg PD), Agg PD for globally listed airlines has increased more than threefold over the past two years from 13.96 bps in March 2018. Particularly, it rose from 43.62 bps to 61.59 bps since the lockdown of Wuhan, the city in the Chinese province Hubei where the first case of Covid-19 was reported. Comparing the Agg PD of globally listed airlines with that of Asia-listed airlines, which rely more on traffic to and from China, we can find that globally listed airlines' Agg PD level skyrocketed and recently exceeded the Agg PD for Asia-listed airlines since the Italy lockdown in March 2020 (see Figure 1), though it was lower than Asia-listed airlines' Agg PD in the few months before and after the Wuhan lockdown. This demonstrated the extensive impact of Covid-19 on the credit profile of airline sector from Asia to the world.

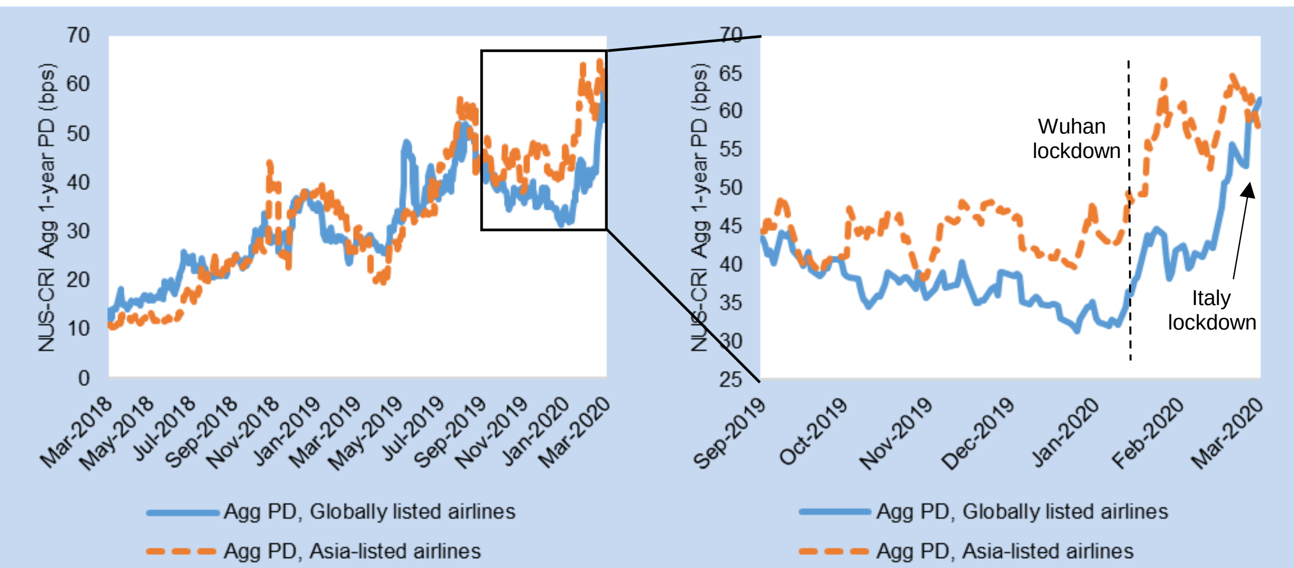

Figure 1: NUS-CRI Agg 1-year PD for globally listed airlines and Asia-listed airlines. *Source: NUS-CRI*

Thousands of flights have been cancelled worldwide as global airlines have encountered the worst demand decline on record due to the outbreak of the Covid-19. For United Airlines, the first US carrier to announce a cut to domestic flights, the financial impact could be even worse than the post-9/11 decline in demand. According to its president, Scott Kirby, the airline's domestic net bookings are currently down 70%, and the company reduced domestic flights schedule by 10% and international schedule by 40%. The new coronavirus is going to have a large near-term hit in its revenue. In Europe, which is the current "epicentre" of the global coronavirus pandemic according to the WHO, the biggest regional airline, UK-based Flybe went into administration on 5 March, 2020 and more airlines defaults are expected to occur around the world in the coming months. The current crisis is exacerbating deep rooted problems in an airline industry grappling with stressed fares caused by overcapacity, mounting environmental pressures on reducing emissions, and the grounding of Boeing's (BA.N) top-selling jet.

Global airlines' high debt level is contributing to their heightened credit risk. Bloomberg data shows that leverage of the global airlines is becoming higher, with net debt (median) surging from USD 1.57bn in 2018 Q2 to USD 7.30bn in 2019 Q4 (see Figure 2a). During the same period, total debt to total capital (median) rose from 47.53% to 62.02% and current ratio (median) dropped from 0.87 to 0.72. According to a credit analysis that carried out using iRAP[1], the most critical factor that led to the PD increase of the global airlines since March 2020 is their Distance-to-Default (DtD[2]), which measures the volatility-adjusted leverage level of the firms.

Fears and uncertainty are also reflected in the global financial markets. Since the outbreak, airline shares prices have dropped nearly 25%, much greater than the decline at a similar point during the 2003 SARS crisis. Fixed income investors have also been demanding higher yields on state and local government bonds backed by US airline companies. The Bloomberg Barclays index of low-rated municipal debt tied to airlines has slid for the past few days, driving it to a loss of 0.88% this month, nearly triple that of the broader municipal junk-bond market.

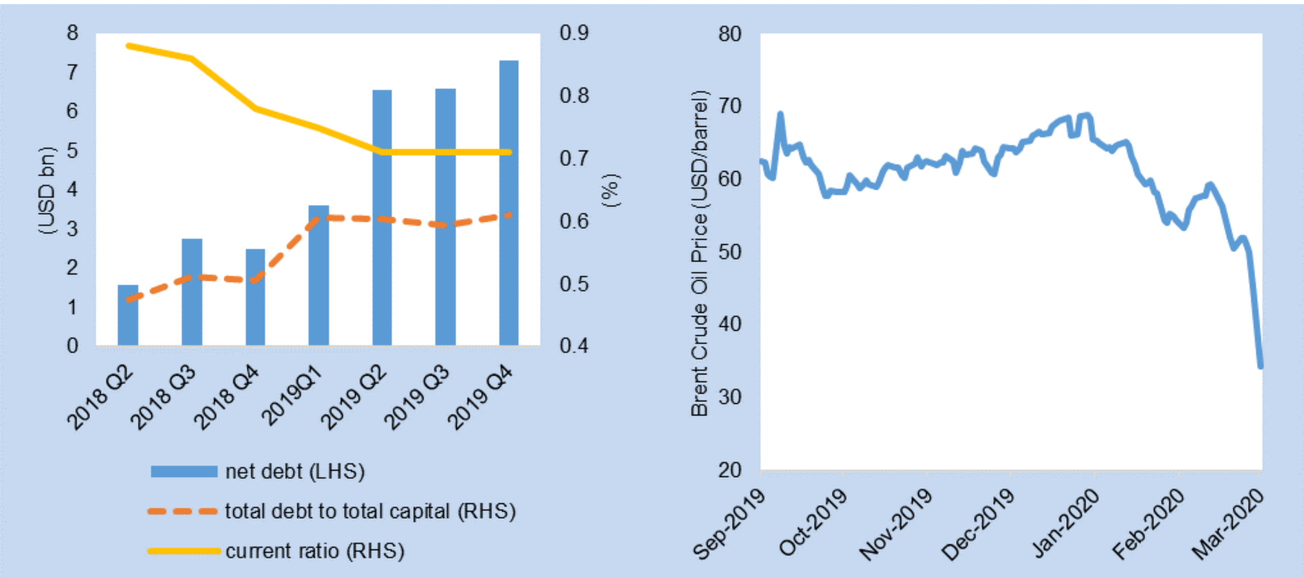

Figure 2a: Financial analysis for globally listed airlines; Figure 2b: Brent Crude Price. *Source: Bloomberg*

Amid the turbulence caused by Covid-19, one piece of good news for airlines is that oil prices have fallen significantly since the beginning of the year (see Figure 2b). Jet fuel has historically been one of the biggest costs for the aviation industry, and this could cut costs up to USD 28bn on the 2020 fuel bill, which would provide some relief but would not significantly cushion the devastating impact Covid-19 is having on demand. As both Asian and global airlines' Agg PD levels show increasing trends after the announcement of the oil price war, we could conclude that flights cancellation is outweighing cheaper fuels in the current stage. It should be also noted that hedging practices could postpone the impact for many airlines. According to the analysis by the International Air Transport Association (IATA), plunging oil prices usually boost airlines by bringing down the cost of their biggest expense. But for carriers locked into buying fuel at higher levels, the drop offers little relief from the coronavirus epidemic that has wiped out demand for travel.

[1] The results were produced with iRAP (intelligent Risk Analysis Platform), which is a software developed by CriAT (https://www.criat.sg/) for conducting both firm-level and portfolio-level credit analysis. iRAP utilizes the NUS-CRI Probability of Default (PD) model and links to the live NUS-CRI database offering PDs on over 70,000 exchange-listed corporates globally.

[2] DtD is the expected difference between the asset value of a firm and the default point, after adjusting for the volatility of assets. A corporate with sound credit quality is expected to have positive and high DtD. As DtD decreases, the standard deviation to the default point gets smaller which results in an increasing credit risk.

Looking into the future, IATA estimated on 5 March, 2020 that the global revenues losses for the passenger business this year will be between USD 63bn and 113bn, which is about four times as it predicted in a previous report last month due to the widening outbreak. We could analyse the credit outlook of the global airlines using the NUS-CRI Agg Forward 1-year PD[3] for globally listed airlines (see Figure 3). For the trend observed from March 2020, we could find that the upward tendency will terminate in late 2020 with the PD level remaining as high as about 65 bps. Compared with the Forward PD curve observed from December 2019, before the outbreak of Covid-19, the Forward PD curve observed three months later is higher in the next three years, but will eventually drop to equal level and below it after that. Hence, we could conclude from the Forward 1-year PD that given the current situation of the coronavirus, credit outlook of the global airline industry will increase until the end of 2020, but it should be noted that credit risk still remains elevated after that.

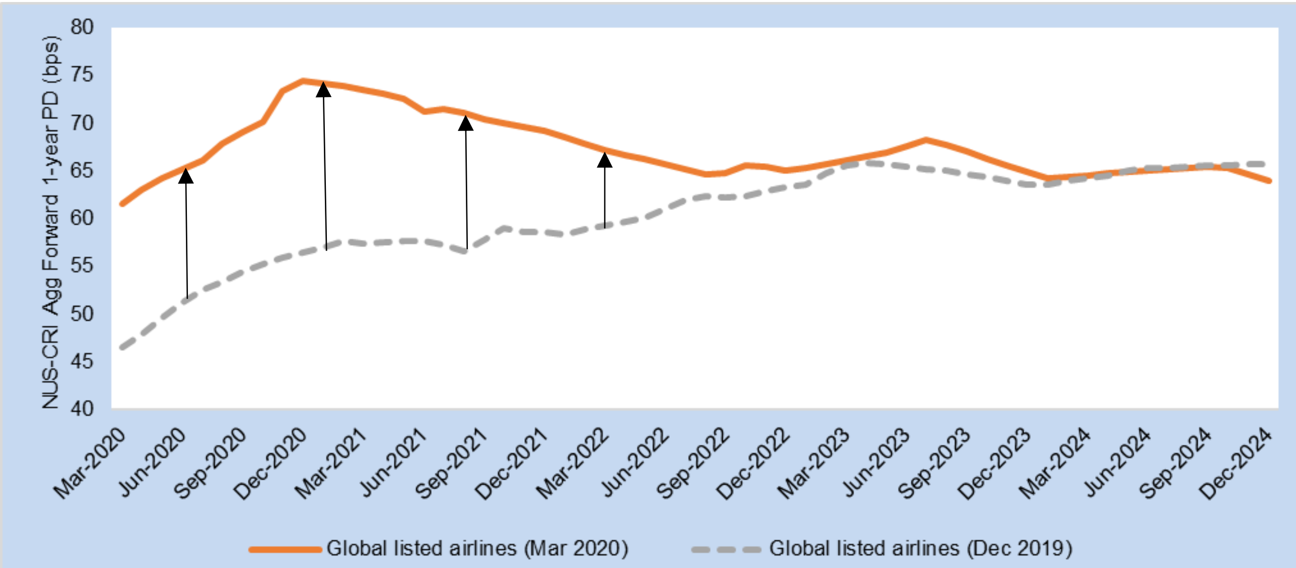

Figure 3: NUS-CRI Agg Forward 1-year PD for globally listed airlines based on information available in Mar 2020 and Dec 2019. *Source: NUS-CRI*

Credit News
Key source of corporate cash seizing up amid credit market rout **Mar 16.** A corner of financial system that provides corporates with short-term funds is seizing up, triggering a scramble for cash elsewhere and fueling speculation that the Federal Reserve will intervene. Yields of commercial paper surged last week to levels last seen during the 2008 financial crisis as the virus continued to spread around the world. Companies have been drawing down billions from credit lines and other bank loans that act as a backstop to markets for short-term funding. The longer the commercial paper market remains stressed, the more companies will look to tap credit lines, and therefore the higher risk for banks that will need to raise funds themselves. (Bloomberg)
Municipal bond issuers halt billions of sales in market rout **Mar 13.** Panic about the spreading coronavirus sends investors pulling out of municipal funds in the US. This caused municipal-bond prices to fall sharply and drive up yields on even the safest 30-year securities by a whole percentage point. Following the worst municipal-bond market sell off on record, state and local governments chose to cancel or delay a total of USD7bn of debt sales as yields soared and underwriters are hesitant to bid in auctions. According to Bloomberg, School districts in Nevada, Pennsylvania and Texas,

[3] The Forward PD estimates the conditional credit risk a firm faces in its future and works similarly to a forward interest rate. For instance, the 3-month Forward 1-year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months.

as well as state agencies in Rhode Island, New York and Virginia, were among those that shelved offerings planned for this week. (Bloomberg)

US companies draw on credit lines, fearing they may lose them

Mar 13. US companies drew on or upsized their credit lines. This is caused by the fear of a pandemic-caused liquidity crunch and the apprehension that banks may not fund credit lines they agreed on in case of a further intensifying market turmoil. Neither the fact that the US banking sector has its strongest capitalization since the last financial crisis, nor banks being required by regulators to have enough high-quality liquid assets to survive a short-term stress scenario reassures borrowers or industry analysts. Up to now, most companies that were hit the hardest by the virus, such as energy and travel, utilized their credit lines. (Reuters)

Corporate credit risk heightens as coronavirus impact spreads

Mar 12. As the coronavirus spreads, investors are worried about corporate credit and companies are starting to draw on credit lines, driving down the prices of bond funds. Closed-end high-yield bond funds fell on last Wednesday as investors wary of risk pulled out of the leveraged products. Investors of relatively illiquid assets might decide to redeem their shares quickly, and higher demand for dollar funding has investors on guard for the kinds of money market stresses that tend to exacerbate cross-border financial crisis. Idiosyncratic shock may become systemic when many corporations draw on their credit lines at the same time. (Reuters)

Coronavirus puts private credit to the test

Mar 11. The coronavirus outbreak that has lowered investor's confidence is putting the private credit asset class to the test as they battle with a challenging fund-raising environment. Private credit investors such as pension funds and insurance companies may need to rebalance their portfolio after equity markets decline to maintain their asset allocation targets. This means they have less quota for investments in the private market after significant equities correction. Moreover, investors are also more hesitant to loan to new private credit managers and prefer to stick to those already in their portfolios. The outbreak also led to the erosion of lender protections in favour of borrowers. The "extraordinary, unusual, or non-recurring charges" clause enables a borrower to add-back losses related to the impact of the coronavirus outbreak and this means they can easily inflate their EBITDA to increase their borrowing. However, despite the downsides of the outbreak on the private credit funds, the volatility also creates opportunities for private credit lenders. Long term sell off in the stock market may reverse the trend of high asset valuations for companies, especially for private equity firms hunting for opportunities in the public markets. This is so as since the onset of the virus, public equity values are decreasing and it is predicted that private equity values will eventually follow. (Reuters)

Giant US banks vow to stop buybacks to aid clients, nation (Bloomberg)

Fixed-income ETFs are trapped in bond market's liquidity crunch (Bloomberg)

High yield bonds suffer more pain as credit woes increase (Reuters)

Regulatory Updates

Fed cuts main interest rate to near zero, vows massive bond-buying program

Mar 16. In order to save the US economy from further consequences of the coronavirus, several fiscal policy actions were undertaken. The Federal Reserve cut its interest rate to a post financial crisis low of zero to 0.25% and plans to boost its bond holdings by at least USD 100bn. Furthermore, the central bank allows banks to borrow from the discount window for 90 days, reduces reserve requirement ratios to zero percent and united with five other central banks to make sure that dollars are available worldwide via swap lines. Two weeks ago, the Federal Reserve already cut interest rates by a half percentage point. However, this action was not accompanied by steps from other policy makers and failed to comfort investors. Now, the Federal Reserve wants to keep these low interest rates until economy recovered and is able to achieve maximum employment and price stability goals. (Bloomberg)

RBA ready to buy government bonds, announce steps Thursday

Mar 16. Following the U.S and New Zealand interest rates cut, the Reserve Bank Australia (RBA) prepares to purchase Australian government bonds in the secondary market, which is the key pricing benchmark for the Australian financial system. By offering more and longer repurchase operations such as weekly repo operations of above six months maturity, the RBA hopes to ensure the smooth functioning of credit markets. Australia's banking regulators will ensure businesses and households take advantage of RBA's monetary easing policies to pull through the bleak economic environment caused by the coronavirus outbreak. (Bloomberg)

China to support trade finance, consumer credit to boost economy (Reuters)

PBOC pumps USD 79bn to banks for virus-weakened economy (Bloomberg)

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