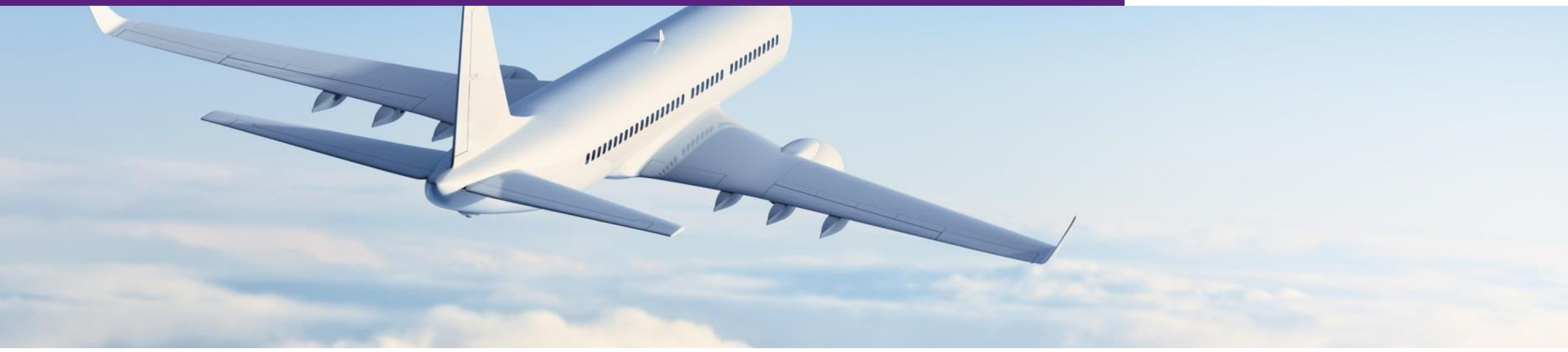
NATIXIS
ASSET MANAGEMENT



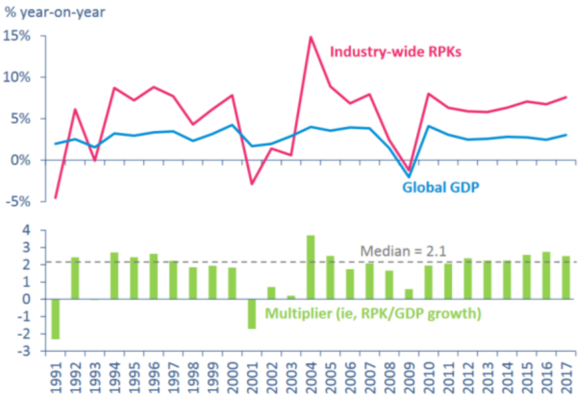
AVIATION LETTER

N°2 – FEBRUARY 2018

2017 GROWTH[1]

+7.6%

In line with recent years, the airline industry continues to show strong economic performance. According to International Air Transport Association (IATA), global passenger traffic increased by 7.6% in 2017 over 2016.



Sources: IATA Monthly Statistics, IMF

This increase is linked to global GDP growth, projected to rise to 3.6% in 2017. It is also the consequence of the record number of cities connected by airlines in 2017: more than 20,000 city-pairs connections, doubling 1996's number. Once again, traffic has also been supported by low fares, thanks to low fuel prices and interest rates.

The slowdown of Chinese growth, which could have been a concern for the aviation market, has been accompanied by a shift from the secondary to the tertiary sector and the expansion of the middle class. This has had a positive impact on traffic and creates opportunities for growth. As confirmation, RPK growth in domestic traffic in China reached 13.3% in 2017. Overall, Asia Pacific traffic grew by 10.1% whereas North American traffic only increased by 4.2%.

Seat capacity, measured by Available Seat Kilometers (ASK), increased by 6.3% in 2017. As a result, passenger load factor reached a record high of 81.4%.

Another year of air traffic growth is another year for the market to debate its cyclicality. As the graph illustrates, the RPK/GDP multiplier, which is a key parameter, varies around 2.1 year after year. In our view, aviation remains a cyclical business and it will continue to be driven by Global GDP. The important question is how passenger traffic would react to a global downturn. In the past, the lack of debt capital amplified the effect of downturns considerably. The large amount of capital now available to the aviation industry has significantly improved stability.

AIR BERLIN, MONARCH AND ALITALIA BANKRUPTCIES

After 8 years of losses in nine years, Air Berlin finally filed for bankruptcy after Etihad, its shareholder, changed its investment strategy and decided to stop cash injections in all its European participations (incl. Alitalia). Air Berlin never settled on a strategy. For a long time, it wanted to be a discount airline focused on attracting leisure customers, but it failed to match its costs to other low-cost carriers in Europe.

The impact of Air Berlin and Monarch bankruptcy has been relatively small in the European airline industry and aircraft finance market, which demonstrates the resilience of the market. Despite the fact that the airlines went bankrupt in a relatively small period of time, all aircraft and routes have been taken up by other airlines: Lufthansa and EasyJet shared Air Berlin aircraft and crew; the Monarch fleet was rapidly repossessed by operating lessors.

Alitalia is currently in administration proceedings and continues to operate thanks to a bridge loan from the Italian government. Its fleet is almost entirely leased from 18 lessors. Alitalia is in the process of being sold.

One lesson that could be learned from these bankruptcies is to avoid relying too much on parental or sponsor support.

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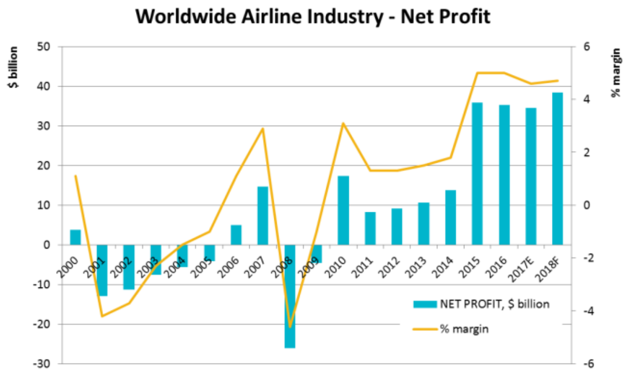
[1] *Defined by RPK : Revenue Passenger Kilometers : measure air traffic. Source IATA-Dec 2016*



Source : Dec 2017 : Historic data to 2014 from ICAO, except fuel detail and global passenger and freight. IATA forecasts 2017 and estimates for some 2014, 2015 and 2016 items. IATA Economic Industry Performance. IATA Economic Industry Performance (IATA E

SIGNS OF MARKET DOWNTURN?

In the past, market downturns have often arisen from exogenous shocks. But travel behavior may have changed, as shown by a recent study from IATA. As an example, the association has measured the impact of terrorist attacks in Western Europe in late-2015 and early-2016: European airlines' international passenger traffic should have been 1.6% higher in 2016. However, the impact was short-lived compared to previous shock events, such as 9/11 or the Global Financial Crisis. This underlines a behavior change by passengers facing shock events and the resilience of demand.

Rising competition for both lessors and airlines could have an impact on market. It is a major issue for lessors, with new entrants pushing down lease rate factors. It is also an issue for airlines. Competition is intensifying between legacy and low-cost carriers, especially on the long-haul segment, and could have an impact on yields.

Since mid-2016, yields have begun to level off, pushed by global economic conditions and upward pressure on some costs, such as oil and labour. A decline would be very detrimental to airlines' profitability and creditworthiness.

Are cost increases likely? Both interest rates and oil prices are expected to increase marginally this year and will have only a limited impact. Brent prices are expected to lie around $65/67 a barrel in 2018, according to Natixis' forecast. This increase can be offset by the possibility to transfer such increase to passenger yield or by the fact that some airlines benefit from hedging arrangements. Regarding wages, many airlines have recently negotiated pilot and flight attendant contracts, during a time of peak profitability and low fuel prices. This could result in an increase in labour costs in 2017.

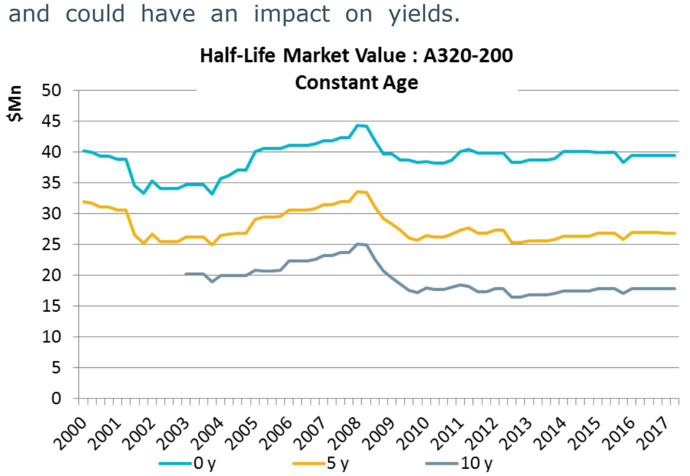
How will aircraft production rate affect the balance between supply and demand? According to market actors, production forecasts are estimated around 8% of the installed fleet annually, 5% towards traffic growth and 3% towards fleet replacement. 5% is clearly below the current pace of traffic growth. Fleet growth is thus resulting in higher demand for used aircraft and low retirement rates. Another key point is the stored aircraft numbers which continue falling (8.5% of fleet in service for narrowbody and 6% for widebody).

In view of this market landscape, a few figures need to be monitored closely, such as yield and Brent. We are close to a market peak, a cautious approach is needed and investment selection is key.

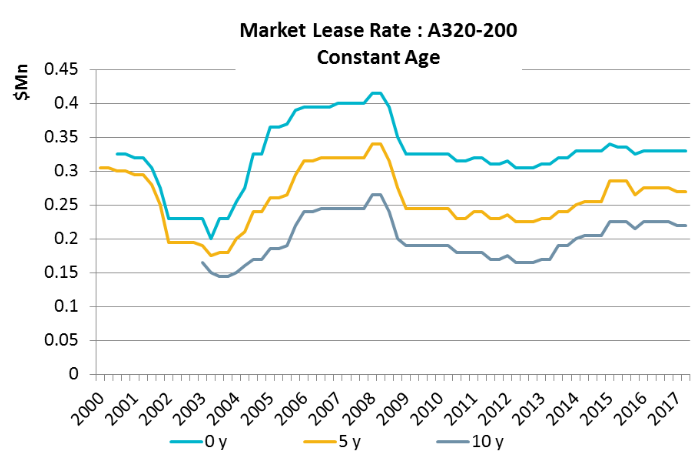
MANUFACTURERS' MOVES

Airbus will acquired a 50.01% interest in Bombardier C-Series program, with the option to fully acquire the C-Series program in 2023. Airbus will provide procurement, sales and marketing, and customer services to the program to boost its global presence. It will add an assembly line next to its Alabama site.
Bombardier needed a solid investor after the US Department of Commerce imposed a tax on Bombardier sales in the US, following Boeing allegations that Bombardier was dumping its C-Series in the US.
The Airbus acquisition is a win-win deal: the C-Series will fill the gap in Airbus's portfolio for a 100-150 seat single aisle aircraft. And Airbus's presence will boost sales and the value of the program.

On their side, in a defensive move, Boeing and Embraer reacted by announcing merger talks. These currently look more like a takeover of Embraer by Boeing and pose a problem for Brazilian authorities, given Embraer's defence business. Overall, this move has less economic rationale than the Airbus/Bombardier partnership.



Source : Ascend



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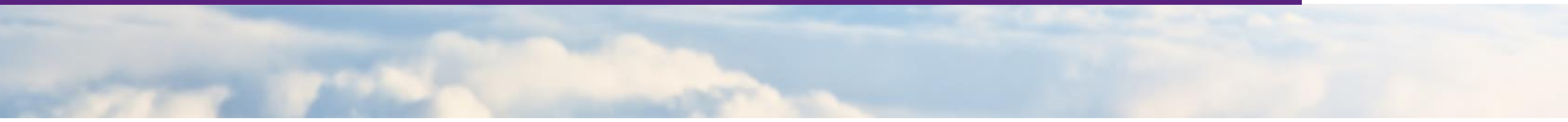


STABLES LEASE RATES

Single-aisle aircraft market lease rates have not rebounded from the last crisis as they did in the previous one (as shown in the chart above). Many factors are pulling in opposite directions. On one side, the number of single-aisle aircraft available for lease or sale has been decreasing since 2010. With availability declining, lease rates should have increased. But increasing competition in the lessor market, and especially from Asian companies, benefiting from low cost of funding, also impacted sale-and-lease-back and, consequently, new aircraft lease and remarketed aircraft lease terms. Low interest rates enabled lessors worldwide to follow such trends. On the other side, recent traffic growth has been well above the long term average of 5%, forcing airlines to seek additional capacities from lessors.

STABLE VALUES

Once again Airbus and Boeing have posted more orders than deliveries, increasing their backlog. The upward trend in aircraft production rates has been masked by GTF engine issues on A320neo and supply-chain problems on the A350. Stored aircraft numbers kept on falling for the 3rd year with stored single-aisle representing around 6% of fleet in service and stored twin-aisle around 9% according to FlightAscend Consultancy

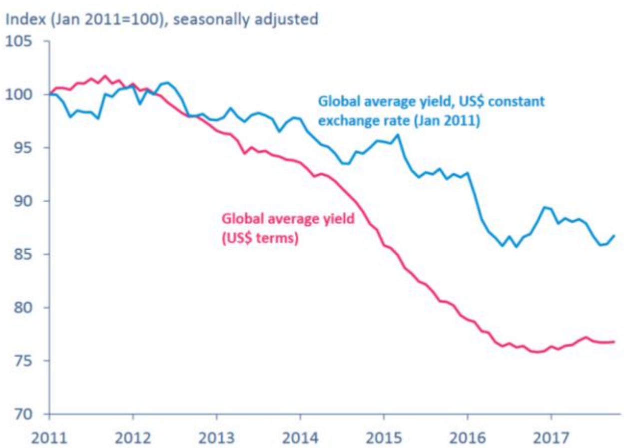
Values remain stable for narrow-body newer types, supported by a strong sale-and-lease-back market. On the widebody market, values are globally stable, but are evolving more heterogeneously, depending on aircraft type and vintage. Newer types (B787 / A350) are evolving more positively than their elders (A330 / B777). **The positive point when looking at aircraft development programs is that many programs are relatively recent** (A320NEO family, B737MAX-8, B787 family, A350 family) with few upcoming entries into service: 737MAX-9 and 7 in 2018 and 2019, Embraer E190-E2 in 2018, B787-10 also this year. Only the B777X, is expected in 2020 or 2021. The market is also contemplating a New Midrange Aircraft (NMA), an aircraft in between A321 and A330 or B737Max-10 and B787.

	Mar-18	Jun-18	Sept-18	Dec-18	Mar-19	Jun-19
Brent spot	65	64	67	68	67	69
WTI spot	57	60	63	64	63	65
EUR/USD	1.17	1.18	1.20	1.23	1.23	1.24
Swap rate $						
5 years	2.36	2.47	2.52	2.68	2.79	2.90
10 years	2.55	2.70	2.75	2.86	2.98	3.05
3M-Libor $	1.65	1.85	1.90	2.10	2.35	2.40
Swap rate €						
5 years	0.24	0.37	0.60	0.78	0.95	1.15
10 years	0.88	0.96	1.14	1.28	1.41	1.61
3M-Euribor	-0.33	-0.32	-0.30	-0.28	-0.13	0.12

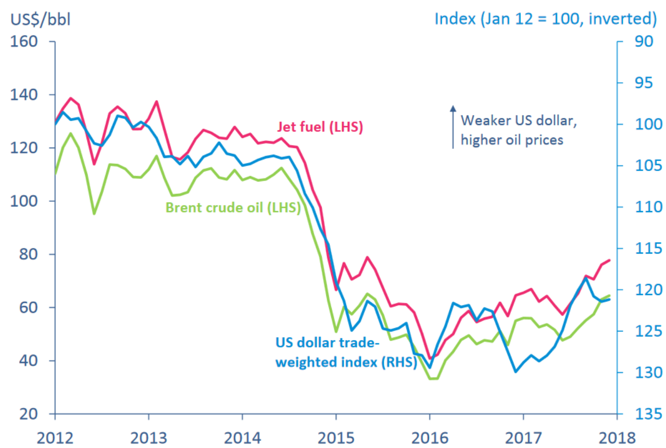
Sources : Bloomberg, Natixis forecast table as of 09 January 2018

GDP	2017	2018	2019
World (PPA)	3.4	3.5	3.4
Developed economies	2.1	1.8	1.7
Emerging economies	4.6	4.6	4.8

Sources : Natixis forecast table as of 09 January 2018



Sources: IATA Economics, IATA Travel Intelligence, Thomson Reuters Datastream



Sources: Platts, Thomson Reuters Datastream

Written on 20 February 2018

Credit photo : Spooh – Istockphoto.

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