Ostrum
ASSET MANAGEMENT

FUNDING YOUR TOMORROW

INSIGHT

THIS DOCUMENT IS INTENDED FOR PROFESSIONAL CLIENTS IN ACCORDANCE WITH MIFID

Aircraft private debt: ready for taking off

APRIL 2019

EXECUTIVE SUMMARY

THE MARKET IN 2018

- A 6.5% increase in air traffic in 2018, buoyed by a strong global economy and lower fares.
- The Asia-Pacific region was the strongest driver of growth in international passenger transport.
- Strong liquidity continued, both on the equities and debt markets, facilitating the financing of aircraft acquisitions.

OUTLOOK FOR 2019

- Annual growth of around 4.5% is anticipated for the next two decades.
- Some uncertainty associated with geopolitical tensions, the US-China trade war and Brexit.
- Need to maintain a disciplined approach to cost controls to be ready for potential increases to petrol prices or a stronger dollar.

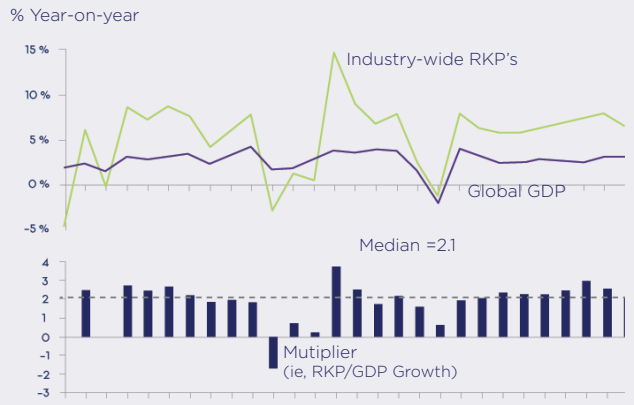
CLOSE-UP ON OUR AIRCRAFT PRIVATE DEBT MANAGEMENT

- A response addressing the need of institutional investors to diversify.
- An asset class decorrelated from traditional assets, and offering predictable, long-term cash flows.
- Historically high recovery on aircraft debt.
- Objective of 6 billion euros by 2020 of AUM in real asset private debt.

2018 MARKET RECAP

In line with recent years, the airline industry continues to show strong economic performance.
According to International Air Transport Association (IATA), global passenger traffic (RPK[1]) increased by 6.5% in 2018, slightly below the 2017 rate. Once again, this increase has been driven by global GDP growth (projected at +3.7%[2]), lower fares (-4%), and improved connectivity (+6.4% in city pairings).

Worldwide Airline Industry - Global GDP



Sources : IATA, Monthly Statistics,IMF, Feb. 2019

> Aircraft private debt meets institutional investors' need to diversify their portfolios.

From a regional standpoint, Asia Pacific as a whole has led in international traffic growth. India and China have led in domestic traffic growth, with India recording its 50th consecutive month of double-digit annual growth in October.

At the same time, the seat capacity, measured by Available Seat Kilometres (ASK), grew at a slower pace than traffic (6.1% in 2018). As a result, passenger load factor (PLF) reached, once again, a record high of 81.9%.

INCREASED PROFITABILITY FOR AIRLINES

The constant growth in demand for passenger air travel, combined with airlines' improvement of their capacity management (as evidenced by PLF), have led to an enhanced profitability of the industry. However, this improvement masks disparities between larger airlines generating most of the industry's operating profits, and smaller or medium-sized airlines making losses or being barely profitable.

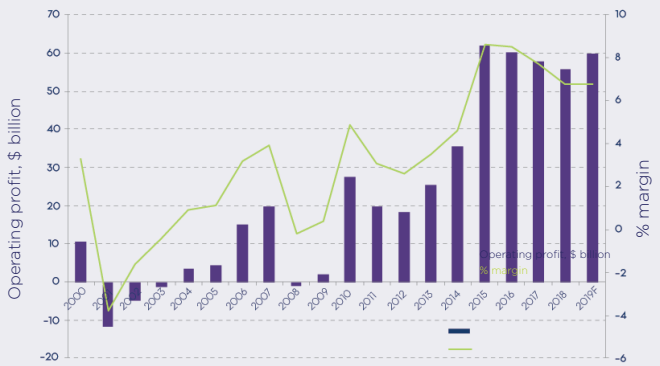
One reason may be the impact of fuel costs that increased unexpectedly in 2018. This increase was likely due to speculative long positions on the fall of the Iranian and Venezuelan productions.
The signs of tightening supply (through OPEC cuts and lower US shale activity) will be sufficient for Brent to trade above $70/bbl in the second half of 2019. These factors will be supported by lower Iranian exports and Venezuelan production.

> **More than 40,000 aircrafts**
>
> **to be financed and delivered over the next 20 years**
>
> Source : Boeing Commercial Market Outlook 2018

ABUNDANT LIQUIDITY

On the financing side, 2018 has been a good year for operators, with liquidity still available, in both equity and debt markets, with many new investors in the leasing market (100 new names on the past decade),

Worldwide Airline Industry - Operating Profit



Sources : ICAO, IATA, The Airline Analyste, Datastream, Fev. 2019

and with banks still eager to lend despite upcoming regulator constraints and capital markets very active last year on unsecured and secured bonds, Aircraft ABS and EETC[3]. Aviation financing is becoming much more mainstream.

1 RPK : Revenue Passenger Kilometers measure air traffic (Source : IATA-Dec. 2018)
2 Source : IMF World Economic Outlook - Oct. 2018

3 EETC : Enhanced Equipment Trust Certificates

A COMPETITIVE LANDSCAPE

Significant liquidity has flooded the equity market in recent years, especially in China. This has created a very competitive leasing landscape, with new entrants forced to offer low lease rate factors[4] (0.5% levels) to win bids on sale-leaseback transactions (S&LB). Airlines, in stronger negotiation positions, have been able to obtain not only high aircraft values in S&LB, but also low lease rents, and additionally, reduced covenants (no maintenance reserve, less restrictive return conditions). In this context, it is very difficult for these lessors to reach acceptable expected IRR, and they rely on optimistic aircraft residual values to improve their expectations. These IRR are marginally above the return earned by the debt providers.

OUTLOOK FOR 2019

The first headwind may be a slowdown of GDP growth. The IMF recently announced another downward revision of their forecast for global GDP growth in 2019. GDP growth for 2019 remains uncertain, but IATA's 2019 forecast shows a 6% increase in passenger demand, marking a tenth consecutive year of above-trend growth in RPKs (4.5% per year over the next 20 years).

> Aircraft debt provides long-term and predictable cashflows.

Evolution of oil prices and interest rates

	Jun-19	Sept-19	Dec-19	Mar-20	Jun-20	Sep-20
Brent spot	69	77	74	72	79	74
WTI spot*	59	67	66	65	73	68
EUR/USD	1.15	1.17	1.2	1.22	1.23	1.24
Swap rate $						
5 years	2.83	2.88	2.80	2.78	2.69	2.61
10 years	3.03	3.10	3.07	2.99	2.92	2.85
3M Libor $	2.72	2.70	2.75	2.70	2.65	2.62
Swap rate €						
5 years	0.38	0.46	0.57	0.76	0.79	0.87
10 years	0.94	1.02	1.12	1.27	1.31	1.38
3M Euribor	-0.31	-0.28	-0.11	0.16	0.34	0.40

Sources : Natixis forecast table as of 28th February 2019
* West Texas Intermediate

GDP	Jun-19	Sept-19	Dec-19
World (PPA)	3.7	3.4	3.3
Developed economies	2.3	1.8	1.5
Emerging economies	4.9	4.8	4.9

Sources : Natixis forecast table as of 28th February 2019

SOME GEOPOLITICAL RISKS

However, exogenous factors may impact the industry in the months/years to come. For example, IATA has produced a low case scenario with a 2019 growth forecast at 4%, in the case of tough protectionist measures resulting from the US-China trade dispute. Further, if a no-deal Brexit scenario were to occur, the European aviation industry could be severely impacted. A stronger USD

4 Lease Rate Factor is the monthly lease rental divided by the aircraft value.

PANEL – 2018 BANKRUPTCIES: A BLOW TO CAPE TOWN TREATY

2018 has been very different from 2017 in terms of bankruptcies. While 2017 saw the failure of few large airlines, such as AirBerlin or Monarch, involving almost 160 aircraft and demonstrating the resilience of the market, 2018 has been a tougher year for smaller or new airlines, due to the impact of fuel costs and exchange rates but with fewer than 100 concerned aircraft.

Avianca Brasil, the Brazilian sister company of the Colombian Avianca, was the largest carrier facing trouble in 2018, filing for bankruptcy in December. The airline still operates its aircraft, but some lessors quickly asked for aircraft returns and the Avianca Brasil faced unexpected court decisions, in view of Brazil's ratification of Cape Town treaty. After its filing on December 11th, the court issued a stay of 30 days, which was the expected Cape Town delay, but then twice granted the airline further relief periods, first for an additional 15 days and then 1.5 months.

After the Indian example in 2012 and the collapse of Kingfisher airline, during which creditors faced troubles with aircraft repossession due to unfavourable judgments, this Brazilian case may create confusion on the efficacy of the Cape Town treaty and may lead to higher costs and less funding for concerned countries.

The Cape Town Treaty, which came into effect on 1 April 2004, establishes a complete international legal framework in view to facilitating aircraft financing and protecting the security and interests of lenders.

> Our goal is to reach 6 billion euros in AUM by 2020 in private debt backed by real assets.

exchange rate is also a concern for airlines that pay their costs in dollars (fuel costs, lease rents) but book revenues in other currencies. Interest rates could be another concern, but the US Federal Reserve will probably bring the current cycle of interest-rate increases to an end after one more hike later this year.

NO VIOLENT REVERSALS ANTICIPATED

In this context, experienced airlines, with better cost management discipline, will be able to withstand rising costs, while weaker airlines may face difficulties during the seasonal down period (winter).

After years of concern over an abrupt turnaround, the industry believes now that the cycle reversal should be relatively moderate.

126 bn$

Deliveries of new planes in 2018

Source : Boeing Current Market Outlook 2017-2036

FOCUS

WHAT ADVANTAGES DOES AIRCRAFT PRIVATE DEBT HAVE TO OFFER?

This asset class offers three main advantages for our clients. First of all, it provides access to the air traffic market, which is a dynamic and robust segment of the economy. Expected growth exceeds 4.5% annually for the next 20 years[1]. This period will see over 40,000 planes delivered[2]. In 2018, total financing needs for the delivery of new aircraft amounted to 126 billion dollars[3]. Thanks to its low correlation with traditional asset classes, aircraft private debt also addresses the need to diversify faced by institutional investors. Lastly, it provides long-term and predictable cash-flows, as these loans are repaid over a 7 to 12-year period.

WHAT EXPLAINS THE EXTRAORDINARILY HIGH RECOVERY RATE?

It is true that aircraft private debt exhibits a remarkable historical recovery rate in excess of 98%[4]. There are two reasons for this. First, a plane is a fungible and mobile asset. It can be repossessed, and leased or sold, in a timely manner, to a different operator if need be, thanks to a strong secondary market.

Second, this asset class benefits from the low volatility of aircraft values over time. Lastly, the aircraft value depreciation is generally much slower than the amortization of the debt that finances it. Nonetheless it is important to conduct close analysis of each transaction prior to investment to reach such recovery rates, particularly given the illiquid nature of the market. Following the investment, it is important to closely monitor the credit risk and the financed aircraft.

HOW IS YOUR INVESTMENT TEAM ORGANISED?

Our team dedicated to real asset private debt comprises 13 professionals in 3 different sector specialisms: infrastructure debt, real estate debt and aircraft debt. We do business on the three main continents, namely Europe, North America and Asia. Currently, the team manages over 1.2 billion in real asset private debt. Our goal is to reach 6 billion euros in AUM by 2020. For my part, I'm a specialist in aircraft debt, with over 17 years' experience spanning coverage of aircraft manufacturers and structured finance for airlines and lessors. I've worked on the financing of more than 70 planes for a combined total of over 2 billion dollars with a recovery rate of 100 %.

Source: Ostrum AM, 31/12/2018.

1 Source : Airbus Global Market Forecast 2017

2 Source : Boeing Commercial Market Outlook 2018

3 Source : Boeing Current Market Outlook 2017-2036

4 Attention is drawn to the fact that security benefits to the loans

Aymeric Angotti
Head of Aircraft
Private Debt

A specialist in aircraft private debt, Aymeric has 17 years' experience in banking, of which 9 in structured finance for aeronautics. In the course of his career he has worked on the financing of more than 70 planes for a combined total of over 2 billion dollars. Aymeric joined Ostrum Asset Management in 2016.

Main risks of the Aircraft strategy
Loss of capital, performance of assets (especially construction risk and merchant revenue risk), illiquidity, risks associated with the deployment of the fund, general counterparty, macro-economic, general taxation, impacts of governmental regulation and legislative changes and risks associated with the deployment of the strategy.

Written in April 2019

Additional notes

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