Sector update

Aviation – 2021: A year of recovery

Global | Airlines

Chu Peng
Equity Research

Investment summary

Given the positive progress on vaccines, we have turned more positive on the aviation sector and expect a gradual recovery in 2021, particularly strong in 2H21. However, according to International Air Transport Association (IATA), industry losses are expected to continue into 2021 with a net loss of USD38.7b as compared to the initial forecasted net loss of USD15.8b, underscoring a protracted recovery. Global passenger traffic measured by revenue passenger kilometers is not expected to return to pre-Covid-19 levels until 2024 at the earliest. In terms of regions, Middle East, Europe and Africa are estimated to be the worst-hit regions in 2020 with Europe expected to remain the weakest region in 2021. On the other hand, Asia-Pacific and North America are expected to lead the recovery ahead.

We believe that (i) the recovery in 2021 will be led by leisure travel due to strong pent-up demand, but remain cautious on business travel; (ii) domestic travel will lead the recovery while international travel will take a longer time to recover due to headwinds from border controls and travel restrictions. Weak consumer sentiment amid economic weakness, rising unemployment rate also limit people's ability to travel and choices of destinations.

Airlines stocks under our coverage rallied 20-30% over the past 3 months, in line with MSCI World Airlines Index. **Delta Air Lines* [DAL US; HOLD; FV: USD43.0]**, while HOLD-rated, still has some upside and remains our preferred pick among the U.S. airlines under our coverage. As international borders reopen and international/business travel slowly resume, **United Airlines* [UAL US; HOLD; FV: USD41.0]** is likely to benefit the most given its large exposure to international market. As we believe China will continue to lead the recovery in 2021, we remain constructive on Chinese airlines given China's large domestic market and China's vaccination program which is underway. **Air China* [753 HK; HOLD; FV: HKD6.50]** could potentially benefit from the early recovery in China and resumption of international travels, although we are cognisant of the risks of new waves of Covid-19 cases.

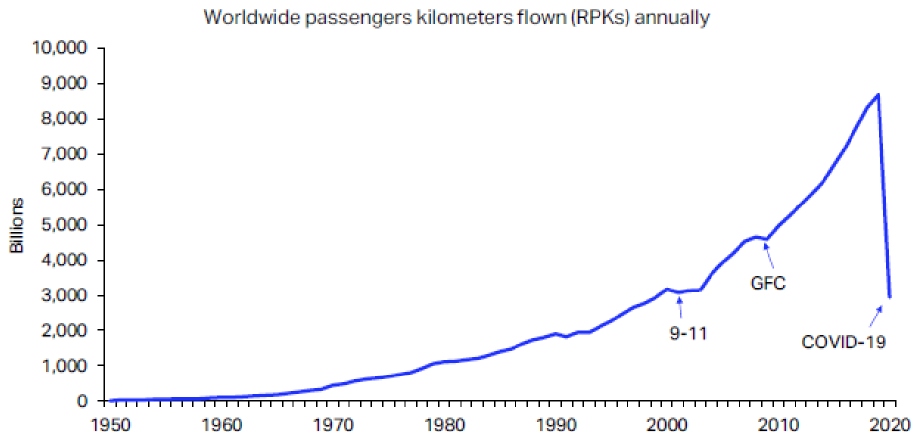
- Vaccines and easing travel restrictions the key drivers to resume travel
- 1H21 remains challenging but expecting stronger recovery in 2H21
- Domestic leisure demand leading the recovery

Brighter outlook but losses likely to continue into 2021

The International Air Transport Association (IATA) released an updated outlook for airline industry performance in 2020 and 2021. According to the latest estimates, the global airline industry is expected to lose USD118.5b in 2020, which was deeper than their initial projection of net loss of USD84.3b. Despite a recovery in 2021, on the back of availability of vaccines, industry losses are expected to continue into 2021 with a net loss of USD38.7b as compared to the initial forecasted net loss of USD15.8b, underscoring a protracted recovery.

Moreover, global passenger traffic measured by revenue passenger kilometres is not expected to return to pre-Covid-19 levels until 2024 at the earliest, with domestic market recovering faster than international services. In terms of regions, Middle East, Europe and Africa are estimated to be the worst-hit regions in 2020 with Europe expected to remain the weakest region in 2021. On the other hand, Asia-Pacific and North America are expected to lead the recovery ahead.

Exhibit 1: Covid-19 is the biggest hit to aviation since World War II



Source: IATA

2020: A year of turbulence

2020 was one of the worst years in airline history with air travel almost at a standstill due to strict travel restrictions, border controls and weak travel demand. As one of the hardest-hit sectors, airlines is estimated to lose USD510b of revenue to merely USD328b in 2020 (-61% YoY vs. -50% YoY in earlier projection). Despite massive cost reduction of USD365b or -46% YoY and USD173b of supports from governments worldwide in 2020, over 40 airlines completely ceased or suspended operations based on data from Cirium.

Operating statistics relating to passenger business such as passenger numbers, passenger revenues, yields and load factor etc are expected to be negative in 2020 as they were severely impacted by Covid-19. Passenger numbers are estimated to fall 61% YoY while passenger revenues are expected to fall 69% YoY, driven by 66% fall in travel demand measured by RPKs (3 ppt down from previously forecast of -63% YoY). Passenger yields and load factor are estimated to fall 8% YoY and 17 ppt respectively in 2020.

(i) Air travel recovery stalled in 4Q20 due to resurgence of Covid-19 cases in key markets

Air passenger demand recovered from the trough levels in April, largely driven by recovery in domestic markets. However, overall passenger demand remained highly depressed and the recovery of travel demand appears to have slowed down in 4Q20. The resurgence of Covid-19 cases, new strain of the virus and re-implementation of strict border controls and lockdowns have stalled momentum towards re-opening. As seen from Exhibit 2, RPKs in November 2020 fell 70.3% YoY, which was relatively unchanged from the decline of 70.6% in October and only improved marginally from the decline of 72.8% in September.

(ii) Domestic travel led the recovery

Domestic travel continued to lead the recovery as international travel was hindered by resurgence of Covid-19 cases in several countries such as Europe, UK, the U.S., Japan etc. As such, international passenger traffic remained close to record lows in Nov, with a decline of 88.3% YoY in RPKs as compared to -87.6% YoY in Oct 2020. As seen from Exhibit 3, Latin America outperformed other regions due to less strict travel controls while Asia-Pacific remained the laggard. Generally, demand for international travel would largely depend on border controls, quarantine measures and effective containment of Covid-19 cases in the countries.

For domestic travel, the recovery has been uneven among countries with China and Russia leading the recovery. Domestic RPKs in China were only marginally down as compared to 2019 levels (-4.8% YoY in Nov and -1.4% in Oct YoY 2020). However, recovery in other regions remained subdued due to high infection cases (Exhibit 4).

Exhibit 2: Passenger demand measured in RPKs

RPK % YoY	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov
Global	2.4%	-14.1%	-52.9%	-94.3%	-91.3%	-86.5%	-79.8%	-75.3%	-72.8%	-70.6%	-70.3%
Africa	5.2%	-0.7%	-44.6%	-98.3%	-97.9%	-96.5%	-93.7%	-87.4%	-85.6%	-76.3%	-75.6%
Asia-Pacific	0.4%	-41.3%	-59.9%	-88.5%	-82.7%	-74.4%	-72.2%	-69.2%	-63.5%	-61.6%	-61.6%
Europe	1.6%	0.7%	-51.8%	-98.1%	-97.7%	-93.7%	-81.3%	-73.0%	-75.8%	-77.6%	-82.2%
Latin America	0.4%	3.1%	-39.3%	-96.0%	-95.4%	-91.2%	-87.5%	-82.8%	-76.2%	-68.0%	-59.8%
Middle East	5.9%	1.7%	-46.0%	-97.3%	-97.9%	-95.5%	-92.5%	-91.3%	-88.9%	-85.5%	-84.5%
North America	5.7%	5.5%	-49.8%	-96.6%	-92.5%	-86.3%	-80.6%	-77.8%	-74.7%	-70.1%	-67.6%

Source: IATA

Exhibit 3: International RPK growth YoY

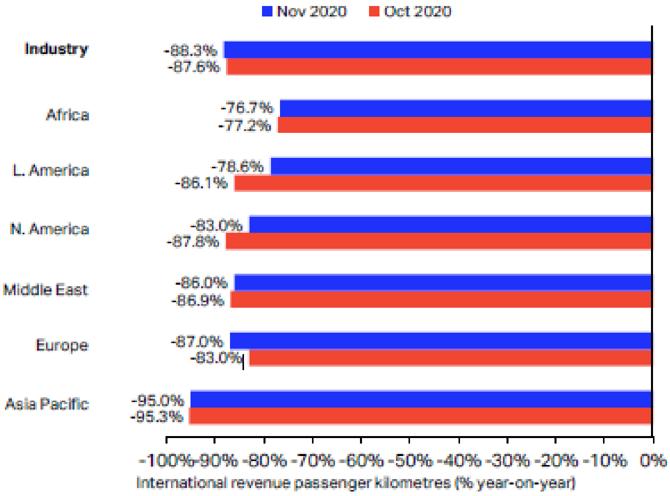
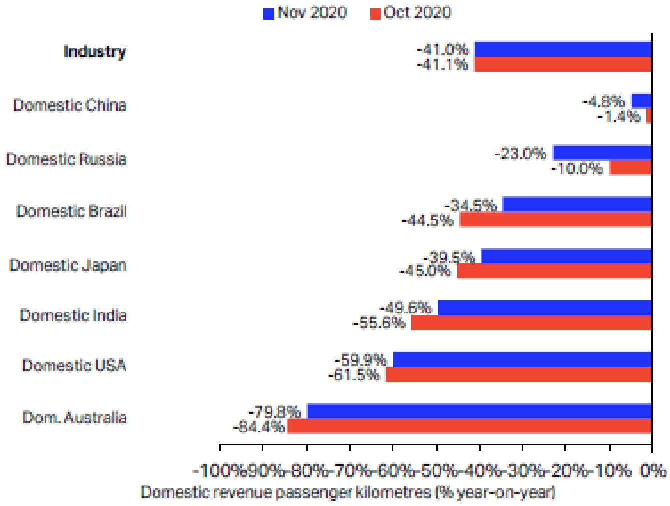


Exhibit 4: Domestic RPK growth by market



Source: IATA

(iii) Performance of cargo was more resilient than passenger business

Despite capacity constraints, cargo outperformed passenger business in 2020. Cargo revenue is estimated to grow 15% YoY to USD117.7b in 2020 while capacity will fall 45% due to loss of available belly cargo space. Based on IATA's latest figures on cargo, global demand for cargo measured in cargo tonne-kilometres (CTKs) fell 6.6% YoY in Nov (vs. -6.2% YoY in Oct 20) while seasonally adjusted CTKs continued to improve MoM (+1.6% MoM) and is expected to return to 2019 levels in Mar or Apr 2021.

Cargo revenue is making up a greater portion of airline revenues which is estimated to increase from 12% in 2019 to 36% in 2020. While the resilient performance of cargo could provide some buffer to airlines' income losses, it is unable to compensate for the fall in passenger revenue.

2021: A year of recovery; vaccines roll-out the key driver

Given the positive progress on vaccines developments and distributions, we have turned more positive on the aviation sector and expect a gradual recovery in 2021, particularly strong in 2H21. We believe that (i) the recovery will be led by leisure travel due to strong pent-up demand, but remain cautious on business travel; (ii) domestic travel will lead the recovery while international travel will take a longer time to recover due to headwinds from border controls and travel restrictions. Weak consumer sentiment amid economic weakness, rising unemployment rate also limit people's ability to travel and choices of destinations.

While we expect a better 2021 on the assumption of successful vaccines roll-out and less strict travel restrictions by mid-2021, near-term challenges remain, and a full recovery may only happen in 2024. Having said that, industry losses are expected to continue into 2021 with a net loss of USD38.7b. Despite some improvement in major passenger operating statistics in 2021, performance would still lag behind 2019 levels. Passenger numbers are expected to grow 56% YoY to 2.8b passengers in 2021, but still 62% down as compared to the 2019 levels. Passenger yields are estimated to be flat while load factor is expected to grow +7.2 ppt to 65.5% in 2020, which is still far below the level of 82.5% seen in 2019.

Cargo expected to perform better

We expect air cargo to benefit from the recovery of global economy, e-commerce and shipment of vaccines in 2021. Cargo revenues are forecasted to increase 19% YoY to USD139.8b, at its historical high levels. Cargo volumes are projected to recover back to the levels in 2019 and grow 13% YoY to 61.2m tonnes in 2021. In addition, we expect yield to further improve given continued capacity crunch as it needs time for passenger travel to restart and to restore belly capacity.

Exhibit 5: Forecasted growth in 2021

Region	Demand YoY	Capacity YoY	Profit US$ b	Demand vs. 2019	Capacity vs. 2019
Global	50.4%	35.5%	-38.7	-50.0%	-43.0%
Africa	35.0%	21.5%	-1.7	-62.0%	-55.0%
Asia-Pacific	50.0%	38.4%	-7.5	-43.0%	-38.0%
Europe	47.5%	35.5%	-11.9	-56.0%	-49.0%
Latin America	39.0%	34.3%	-3.3	-50.0%	-46.0%
Middle East	43.0%	23.6%	-3.3	-61.0%	-56.0%
North America	60.5%	36.4%	-11.0	-45.0%	-34.0%

Source: IATA

Key highlights of regional performances:

China expected to lead the recovery in 2021

China: China is one of the few countries where passenger load factor has recovered from record lows and moved ahead of the recovery processes. However, the recent lockdowns and travel restrictions imposed in several cities after the resurgence of Covid-19 cases in Shijiazhuang, the capital city of Hebei province, could weigh on travel sentiment in the near-term. With Lunar New Year coming in Feb, which is typically the peak travel period when people return to hometown to celebrate the festival, the authorities have encouraged people to stay put during the Lunar New Year holiday and announced bans on large scale gatherings and events to prevent the spread of virus.

We believe that China will continue to lead the recovery in 2021 given China's large domestic market and its vaccination program which is underway and aims to inoculate 50 million people before Lunar New Year. We remain constructive on Chinese airlines which could potentially benefit from the early recovery in China, although we are cognisant of the risks of new waves of Covid-19 cases.

The domestic market made up about 65% of **Air China* [753 HK; HOLD; FV: HKD6.50]**'s total passenger revenue in 2019, with the remaining 35% came from international travel. Consolidating Air China's shares in Cathay Pacific, its total international revenue exposure is estimated to be 44%. Business travel only made up ~12% of Air China's FY19 revenue. As mentioned earlier, we are unlikely to see significant recovery in international travel and business travel until late 2021or early 2022. Should the pandemic situation improve and the government decide to ease travel restrictions earlier, e.g. lifting of quarantine measures from specific countries, these could come as positive surprises. As international travel recovers, Air China could see the most earnings upside, followed by China Eastern Airlines, and China Southern Airlines.

Singapore poised to benefit from border reopening as a regional transit hub

Singapore: **Singapore Airlines [SIA SP; SELL; FV: SGD3.70]**'s Dec 20 operating statistics recovered from the trough levels but remained sluggish due to weak international travel demand. Passenger capacity as measured in available seat kilometers (ASKs) fell 81.3% YoY in Dec which showed marginal improvement from the decline of 86.4% in Nov. SIA's capacity was 78.0% lower YoY which saw a marginal improvement from 83.5% in Nov as SIA resumed 3 routes in Dec, connecting to 39 metro cities. Given the positive developments on vaccines, SIA is prepared for a measured expansion of network and expects passenger capacity to reach 25% of pre-Covid-19 and resumed 45% of its network by Mar 21. While we expect domestic travel to recover first, followed by regional, and international travel, SIA is poised to benefit from Singapore's progressive re-opening and the roll-out of vaccines in 2021, in our view.

On 20 Dec, SIA disclosed that it had used ~SGD7.1b of the SGD8.8b raised from a rights issue in Jun. SIA has the option to raise another SGD6.2b in additional MCBs with decision likely to be made by 1Q 2021. SIA's share price rallied over 24% over the past three months and is currently trading at 1.7x s.d. above its historical 5 years mean of 0.88x P/B. While we believe SIA could benefit from Singapore's progressive re-opening and the roll-out of vaccines in 2021, there could be risk of potential share dilution. The company will be issuing an earnings update in Feb.

Domestic travel to drive near-term demand in Australia

Australia: Australia's domestic RPKs growth underperformed the other key regions. Despite some recovery in domestic travel demand due to reopening of some state borders in late-Nov 2020 and resumption of certain routes, domestic RPKs were significantly lower which declined 79.8% YoY.

Qantas Airways* [QAN AU; HOLD; FV: AUD5.0] is Australia's largest domestic and international airline. The industry in Australia is practically a duopoly between Qantas Airways and Virgin Australia, which in the past has proven profitable for Qantas. However, we expect competition to increase as demand recovers. While recovery is likely to be lumpy, Qantas is well-positioned to benefit as domestic restrictions progressively ease and international borders reopen in 2021. We expect Qantas' domestic capacity to recover to its pre-Covid-19 levels in FY22 while international recovery to be more gradual and will not recover until FY24.

Qantas' balance sheet is healthy and boasts a debt book with no covenants. After equity fundraising in Jun 2020, total liquidity stood at AUD 4.5b, which places Qantas in a comfortable position to navigate near-term challenges. With weekly cash burn of around AUD 40m, Qantas will have plenty of liquidity through FY21, and we expect a return to profitability from FY22.

Sentiment was dampened by high pandemic cases but vaccines roll-out likely to boost demand

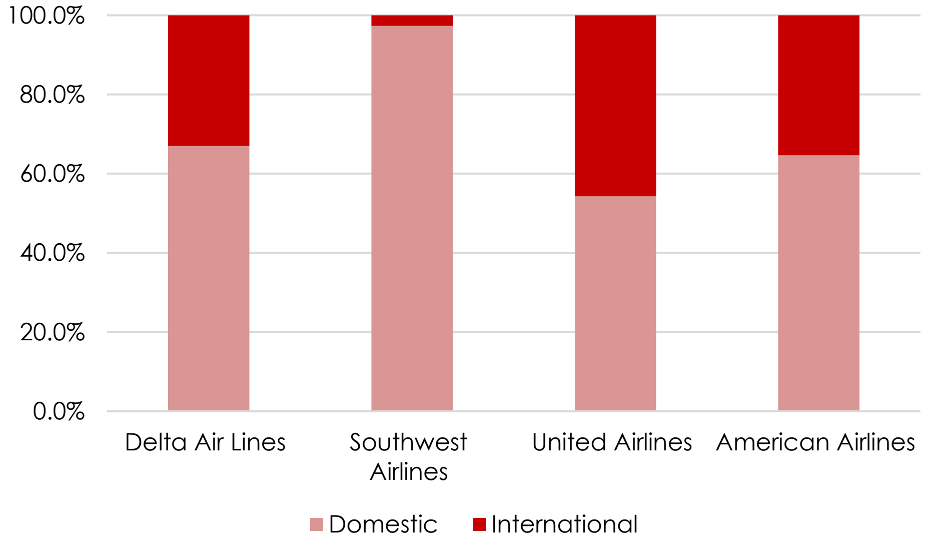
United States: In the U.S., the recovery was hindered by resurgence of Covid-19. Latest data from IATA show that domestic RPKs were 61.5% YoY lower in Nov, a slight down from 59.9% decline in Oct. On the other hand, international RPKs saw a slight improvement from -87.8% in Oct to -83% YoY in Nov. With the largest domestic market, we believe the U.S. airlines are poised to benefit from the recovery in domestic travel. Within the sector, our top pick remains **Delta Air Lines* [DAL US; HOLD; FV: USD43.0].**

In terms of domestic travel exposure**, Southwest Airlines* [LUV US; HOLD; FV: USD44.5]** and **Delta Air Lines* [DAL US; HOLD; FV: USD43.0]** have the highest exposure to domestic travel by FY19 revenues. This is followed by **American Airlines* [AAL US; HOLD; FV: USD13.50] and United Airlines* [UAL US; HOLD; FV: USD41.0]** (Exhibit 6).

Separately, Southwest has the largest exposure to leisure travel (~90%), while Delta, United and American Airlines typically account ~50% of the revenue from leisure travel (Exhibit 7).

We expect Southwest, Delta and American Airline to recover to their pre-Covid-19 levels in 2022 given their higher exposure to domestic market while United Airlines is estimated to experience a slower recovery and would only see the full recovery in 2023 due to its high international travel exposure. As international borders reopen and international/business travel slowly resume, United Airlines, however, is likely to see the most upside in earnings.

Exhibit 6: Exposure to Domestic and International travel by % of FY19 revenue



Source: Company, BOS-Morningstar

Exhibit 7: Exposure to Leisure and Business travel by % of FY19 revenue

Source: Company, BOS-Morningstar

** Stock under BOS-Morningstar coverage*

ANALYST DECLARATION:

For analysts' shareholding disclosure on individual companies, please refer to the latest reports of these companies.

DISCLAIMER FOR RESEARCH REPORT

RATINGS AND RECOMMENDATIONS:

- OIR's technical comments and recommendations are short-term and trading oriented.
- OIR's fundamental views and ratings (Buy, Hold, Sell) are medium-term calls within a 12-month investment horizon.
- As a guide, OIR's BUY rating indicates a total expected returns (excluding dividends) in excess of 10% based on the current price; a HOLD rating indicates total expected returns (excluding dividends) within +10% and -5%; a SELL rating indicates total expected returns (excluding dividends) less than -5%. For REITs and Business Trusts, total expected returns including dividends apply.
- For companies with market capitalisation of S$150m and below, OIR's BUY rating indicates a total expected returns (excluding dividends) in excess of 30%; a HOLD rating indicates total expected returns (excluding dividends) within a +/-30% range; a SELL rating indicates total expected returns (excluding dividends) less than -30%. For REITs and Business Trusts, total expected returns including dividends apply.

Co.Reg.no.: 198301152E
Published by OCBC Investment Research Private Limited