MINERVA

INVESTMENT
MANAGEMENT
SOCIETY

IF IT HAS WINGS, DONôT FLY IT JUST YET: COVID-19 & THE AIRLINES LIQUIDITY CRISIS

by Daniele Tana
BSc in Finance Student, Bocconi
Mkt & Alternatives Research, Minerva IMS
and Maria Vittoria Scino
BSc in Economic and Social Sciences, Bocconi
Mkt & Alternatives Research, Minerva IMS

25/03/2020

WHAT IS HAPPENING? A SHORT RECAP OF THE CORONAVIRUS CRISIS

Since January the headlines of every newspaper are talking about the Covid-19 pandemic, with an ever-changing situation all around the world, but where are we now?

At this moment, March 25th, the most affected countries are, ranked: China, Italy, Us, Spain, Germany, Iran and France, with Europe placing as the continent with the highest number of cases. The first and most important reaction of the countries has been to isolate and to place into lockdown the most affected cities. The isolation process started with travel restrictions and flights cancellations and ended in the worst cases with the full closing of the land borders.

The United States banned the entry of all foreign nationals who have travelled to infected countries, particularly from Europe, which had already restricted all its internal and external non-essential travel. Many more countries around the world have also restricted their flights, for instance Iran, India and China. Moreover, more and more countries are placing their entire population under lockdown, starting from the 60 million Italian people and with similar measures adopted in Spain and then India. Even if not on the whole country, also US imposed stay-at-home orders in 16 states and to more than 158 million people.

MARKET UPDATES: ARE WE IN A NOSEDIVE?

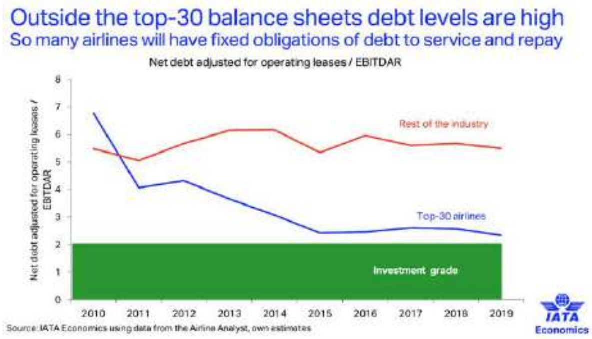
Markets reacted promptly to containment measures, first contagionsô decline, CB slashing rates and favoring dovish pivot to sustain economies, but since the first contagion on Dec 30th 2020, Stock Exchanges have been profoundly red-marked. Similarly, production shutdown and travel lockdowns led Brent and WTI to a nosedive into their all-time lows since the Gulf War, with an average of $27.26 per barrel.

As Air Transport Association (AITA) released, the pandemic covers markets representing 94% of air passengers traffic revenues. Even in those countries where fleet grounding is not implied, social distancing restrictions renders impossible incentives for flying. Moreover, financial assets returns are highly influenced by media and public sentiment, as the sharp drop in demand proves, causing more crippling effects to the unprecedented crisis airline industry is facing. Revealing is The Dow Jones Transportation Index, near to a bear market territory last Friday Mar 20th, 18% below its 52-week high, now surging at 7.302,67.

AS THE LOCKDOWN GOES VIRAL, WESTERN FLIGHTS SHUT DOWN

Despite having been considered over the last 75 years the worldôs worst investment vehicle, by 2017 US carriers steadily consolidated through multiple bankruptcies, largely solving chronic overcapacity, hyper-competition and the huge debt loads. However, airlines remained capital intensive, subject to incredibly high fixed costs, exposed particularly to oil prices soaring and vulnerable to economic downturns, as the current pandemic outbreak could lead to.

From a different angle, it is also a trail index for recovery in an economic cycle, being the last resort where firms will allocate their budget spending when signals of profits enhancements occur. A long tail of weaker airlines are highly leveraged in their balance sheets, especially with respect to service and repayment of obligations. Indeed, even before the infectious spread of the disease, only the top-30 companies have enhanced the sector profitability over the last 10 years. As the Industry trade body underlines, the fragility lies in the warning acknowledgement that liquidity available at the beginning of 2020 will run out within two months, pointing to the fact that cash and equivalents will cover less than three months of expenses and short-terms liabilities restitution.



Key is the revenue per available seat mile, measure falling on last year expected growth of at least 3.5%. Furthermore, AITA forecasted that the crisis could prompt a $113 billion reduction of the 2020 global industry revenue, before the U.S ban on European routes, 19% on the total returns: an all-time high loss in Asia-Pacific and Europe. Middle East is the least affected, with -9% on passengers and a profit reduction of $2.3 billion.

Pursuing on this track with almost 80% of scheduled flights cancelled, the Centre for Aviation warned that airlines with weaker capital structures are expected to go bankrupts or in a substantial breach of debt covenants by the end of May. Grounding most of their fleet, sending staff on unpaid leaves up to 2 months, freezing hiring, halting executive bonuses, saving selling-off older aircraft are common measures taken to preserve cash and defer capital spending in the attempt to survive.

The International Airline Group discloses a 75 % reduction in capacity upcoming, with 14 airlines reducing their flights by as much as 90%. Delta shrunk its capacity by 40%, employing 600 out of 900 jets. Ryanair, Europe largest low-cost, warned to ground all its fleet by March 24th, further reducing it by 80% in April. Air France KLM SA has drawn down $1.2 billion of its revolving credit facility to help sustaining its liquidity shortage, saving costs only up to 200 million euros.

A strong air traffic volume shrink is expected in the US front, who rushed to cut flights in the wake of travel restrictions: American Airline Group, besides retiring is Boeing Co 757, would reduce capacity by 50% in April, whereas a -34% is forecasted for the summer travel season.

Hardly hit was the Asian- Pacific route demand. Virgin Australia, which was downgraded by the S&P from B+ to B-, itôs currently offering discounted fares as well as cutting flights from Sydney. Singapore Airlines Ltd regional flights were likely to spread to long-haul flights, hurting the take-up rate in the lucrative business and first class cabin.

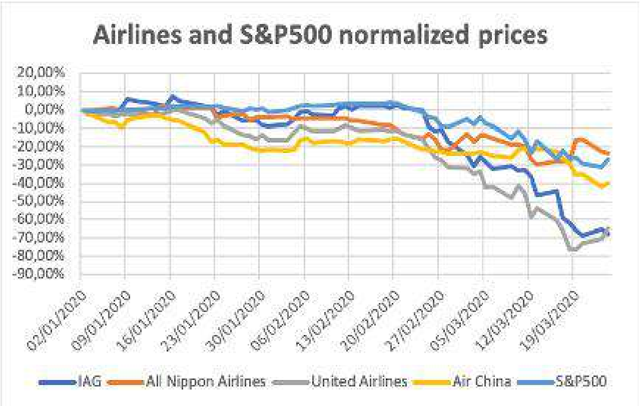
Oppositely, Domestic Capacity in China already doubled from its February lows of more than 75% inbound flights reduction to 8.6 million seats, even if displayed as cautious on international routes.

AIRLINES STOCKS: THE WORST PERFORMERS ON THE MARKETS

On the already distressed stock market, Airlines are among the worst performers, affected by last monthôs extremely heavy losses. Due to flight restrictions, the closing of the borders and the subsequently steep reduction of passengers, the airlines sector has obviously been one of the most rapidly hit by the spread of the virus, and traders noticed that. Starting from the day before the first death in China (10th of January), the 10 biggest airline companies by revenue averaged a -44% change in their stock prices. In the same period, the two most relevant airplane manufacturers, Boeing and Airbus, registered a loss respectively of 63% and 58%.

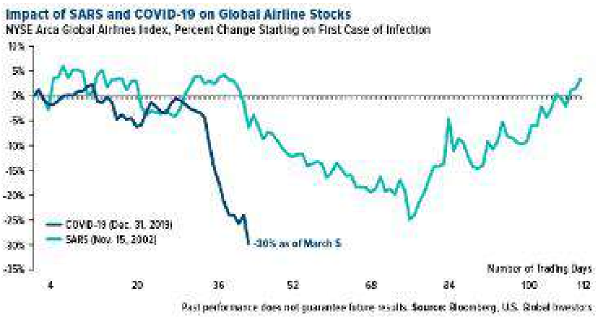
At the beginning, the stock market did not realize the real size of the coronavirus crisis, and limited the losses only to Chinese companies, in particular airlines. Worldwide stocks began falling nearly one month after the beginning of the lockdowns in China, but this time the reaction was more pronounced. The real losses arrived in Europe and US only at the end of February, starting a three weeks long crash, which erased nearly half of the airlines industry capitalization.

The worst performing stock is IAG.L, or International Consolidated Airlines Group, the 6th biggest airline group in the world by revenue, including British Airways, Vueling and Iberia between the others. IAG accumulated a shocking -67,62% in just one month of trading, beginning its fall on February 19th and losing in 30 days nearly £9 billion of capitalization until today, shredding in this way the assets of its controlling shareholder Qatar Airways, which owns 25.1% of the latter. The second hardest hit company is United Airlines, with a total loss of 61% of its market value, erasing close to $13.5 billions of capitalization. Among all the biggest airlines, the least affected has been the Japanese All Nippon Airways, with a loss of only 21,96% of its value. Japan has in fact managed very well the coronavirus outbreak, keeping the number of cases under control (lower than 1200) and rapidly flattening the curve of new cases, and this might have influenced the performance of the stock.



DID WE EXPECT THIS?

The first thing that comes to mind about anything alike is clearly the 2002 SARS outbreak, a similar illness with a similar impact on the economy in the short term, but more deadly and with significantly less confirmed cases and deaths. The main difference is in the dimension of the outbreak: Sars only infected 8000 people, 90% of which were from China and Hong Kong. The current coronavirus outbreak infected 50 times more people, 80% of which out of China. For what concerns market indices, Sars did not strongly affect the major stock exchanges, with the MSCI world index gaining 16,36% three months after the virus and the S&P 500 gaining 14.59% six months after the crisis. In comparison, the MSCI World Index is now losing more than 32% and S&P 500 losing 25% two months after the beginning of the Coronavirus Crisis. Moreover, also the airlines sector did not suffer as much as this time, with NYSE Arca Airline Index reaching a low of -25% two months after the first case, while losing 60% this week after the same two months.



For these reasons, it was undoubtedly very easy to underestimate the Covid-19 crisis, given such small effects of the similar virus shock previously witnessed. For example, the airline sector did not foresee the damages coming from SARS-Covid-19: on February 21st the International Air Transport Association forecasted a $29 billion revenue fall, while on March 5th the same association changed their forecast to $113 billion and, always the same body, on March 18th said the industry would have needed urgent funding (around $200 billion injection in order to avoid bankruptcy).

Therefore, the answer to the question is: no, we did not expect this, and neither did the companies most affected by the crisis. But someone did. Since January 29th there are reports of Hedge Funds betting against the airlines sector when the same industry was only losing 13%. Funds as Citadel, AQR Management and Marshall Wace opened short positions in Air France-KLM, Lufthansa and IAG, stocks now down 49%, 39% and 67%. It is now estimated that Hedge Funds made more than $1 billion only shorting airlines stocks. On the other hand, there have been also many cases of heavy losses to other big Hedge Funds, as with the flagship fund of Bridgewater Associates, with a loss of nearly 20% this year. After all, sooner or later, everyone is now aware of the severity of this pandemic crisis.

INVESTORSô OUTLOOK: AIRLINE AS A BAROMETER FOR SENTIMENT

Notwithstanding worldwide measures implemented, business travels have been easily replaced at corporate level by virtual meetingsô arrangement and video conference calls. Therefore, cutting interest rates will not incentivize people to get back on an airplane in the foreseeable future.

The severity of the slump prompted AITA, together with Oneworld, SkyTeam and Star Alliance - 60 carriers alliances accounting for 50% of worldôs capacity- to call on governments, lessors and airports for a lifeline. Considerations have been made upon extending the line of credit, reducing infrastructure costs, relieving passengersô taxes and further extend the suspension of slotsô usage.

It is estimated that up to $200 billion would be needed to face the cash shortage emergency. Since March 4th, China began offering subsidies to resume international flights. In this regard, the Airline for America will turn to the government this Monday asking for $50 bn in provisions. Similarly, the Australian government will unveil $428 million rescue package for the domestic branch. Meanwhile, being Norwegian Air Shuttle highly indebted, nationalisation has been considered, despite the scepticism surrounding this action in terms of market competition.

Many scenarios can be drawn in terms of asset performances. If investors decide to sell their airline shares now, they will suffer a loss of as much as 25% or close to half its monetary value if the asset was bought near its recent price peaks. On the other hand, holding the position in the belief that the pandemic will act in the same wavelength of previous diseases driven events as in the past 40 years, even if the opportunity costs may be higher, their full recovery may be expected within 12 months.

Selling implies the same risks of holding now. Undoubtedly, its high asset sensitivity in opposite trend with oil price may deliver profits to investors in times of distress, up to $1 billion costs for the airline industry when a $1 rise in oil barrel price occurs. Consistently, some companies hedge their exposures in futures market, speculating on oil price sag when economy is thriving. Accounting for its high volatility, they might be preferred by active traders, changing positions every trading day. Despite their discouraging historical patterns, the merging in major legacies played a crucial role in gaining efficiency increasing routes coverage while reducing labour costs. By these means, investors are offered a premium by acquiring companies to conclude the deal. Lastly, once subsidized the danger, lower fuel costs, rising fees and overall higher ticket prices will improve their financial conditions.

Although many countries are likely to deliver financial aid, investors must still tackle the risks carried with the time uncertainty at the end of the global travel shutdown and the responsiveness of the consumers in recovering the travel demand once it is concluded. Nonetheless, the reopening of the Chinese routes and Italy's declining cases are encouraging signals.