14 April 2020

Global airlines

COVID-19 lessons from the east

Equities
Airlines

- In this thematic report, we contrast the differing challenges for the airline sector by region
- In China, domestic business travel is leading the recovery, some two and a half months after the collapse of demand
- Globally airlines are focussed on cash preservation and seeing government support

A unique challenge: The COVID-19 pandemic places a unique challenge on the aviation industry, far outstripping previous challenges of 9/11 and SARS. The virus is spreading globally and the collapse in travel demand is close to absolute.

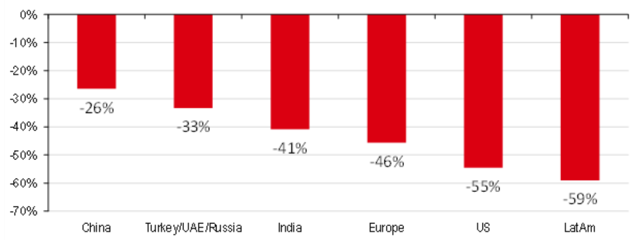
China leads the way into and out of the crisis: The Chinese aviation market collapsed in late January, but is now recovering, with capacity up to 50% of last year's levels, up from a trough of 20%. We see domestic business travel leading the recovery, with international travel lagging.

Europe is a month and a half behind China: Europe appears to be the second region to be impacted by the virus. In Western Europe we see particularly strong government support for labour furloughs rather than redundancies. We expect widespread state aid. European airlines are burdened by significant fuel hedges.

LatAm, India and CEEMEA some three weeks behind Europe: Our other coverage regions are running some three weeks behind Europe with shutdown of aviation. Government support for airlines across these markets is highly varied.

US Airline industry strength is a thing of the past: The government has just agreed significant state aid, yet political debates within the government have added complexity. The industry's record of returning 96% of the past ten year's free cash flow to shareholders has not been strategically helpful.

Regional airline share price performance YTD 2020



Source: Refinitiv Datastream

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China leads in, China leads out

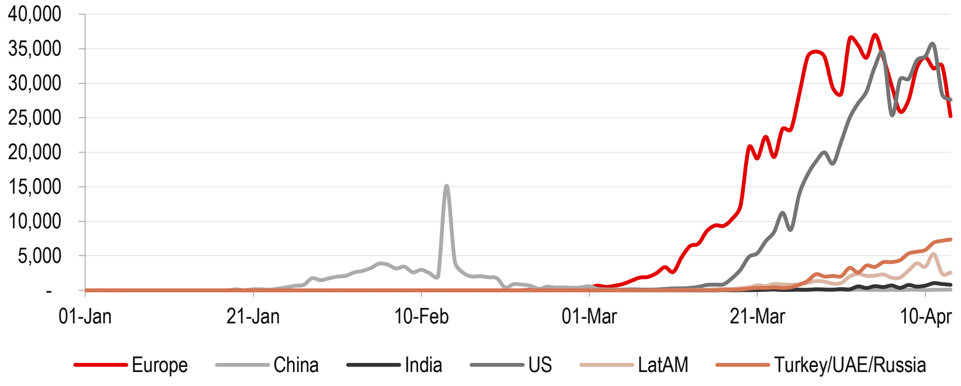
- In this thematic report, we contrast the differing challenges for the airline sector by region
- In China, domestic business travel is leading the recovery, some two and a half months after the collapse of demand
- Globally airlines are focussed on cash preservation and seeking government support

A global airline crisis

The COVID-19 pandemic presents a unique challenge to global aviation, reducing demand for passenger air travel to next to zero and impacted the industry globally.

The pandemic started in mainland China but has spread to Europe, the US and is spreading across the globe.

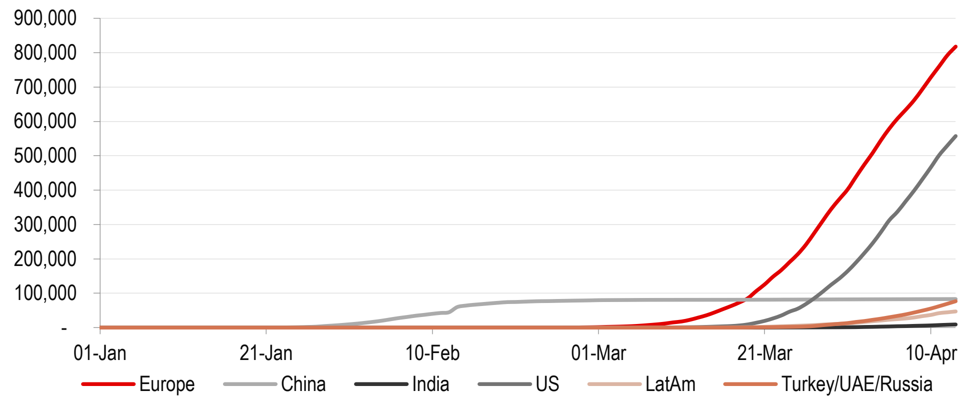
Daily COVID-19 cases across different regions



Source: European CDC, reported as of 13 April 2020

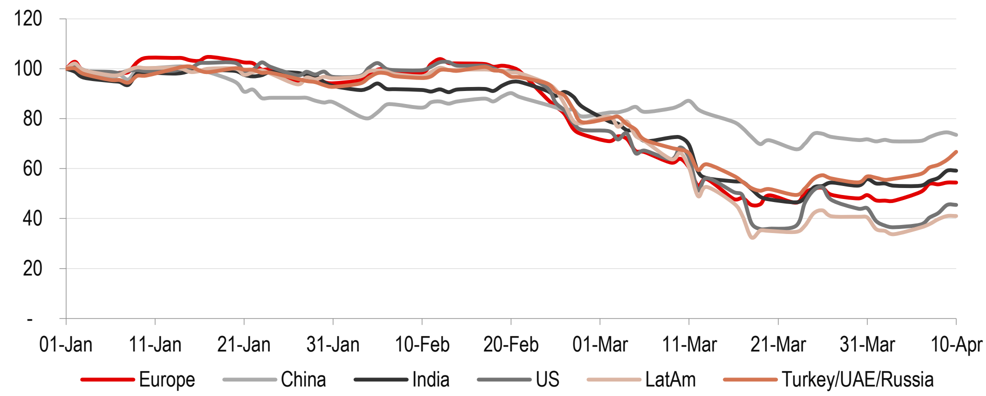
Airline share prices have been directly impacted, with China share prices declining ahead of airlines elsewhere in the world. However from the start of March, airline share prices globally fell broadly in unison, notwithstanding the more diversified timing of the spread of the virus.

COVID-19 cases across region



European CDC, reported as of 13 April 2020

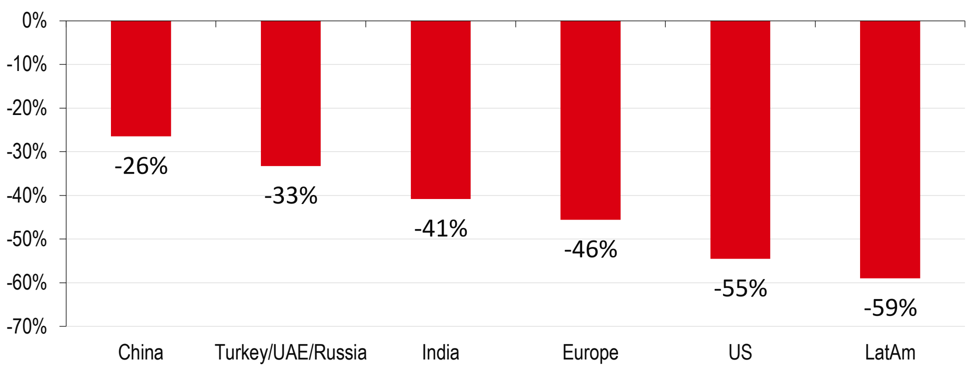
Share price performance



Source: Refinitiv Datastream, as of 10 April 2020

Today it is notable that the least impact is seen in the share prices of the Chinese airlines. Whilst the Chinese airlines are closest to a recovery, it is also notably that they declined less than airlines in other regions.

Share price performance (YTD 2020)



Source: Refinitiv Datastream

Our thematic view: there will be a recovery

We believe that the aviation industry will recover from the impact of this pandemic. In China capacity and traffic are recovering relative to their trough, albeit still significantly down yoy. Capacity is currently down around 50% yoy, with traffic down 70% as load factors weaken. Yet this is far improved on the 80% capacity drop at the trough.

The timing to recover to 2019 traffic levels is hard to anticipate. We do not expect 2021 to recover to 2019 levels, but see 2022 as a likely year when 2019 traffic is achieved globally: three years' growth will have been lost.

Yet we expect growth to continue in the medium term. This pandemic will pose questions over social mobility, over international supply chains and over business travel. Yet overall we think people will want to travel for business and for leisure, people will move around the world. We do expect the burden of recession to weigh in the short term and on a longer-term basis we foresee climate change pressuring the long-term growth rate of travel. But we do not see growth in travel ending: emerging economies to drive growth in air travel as middle classes emerge.

Airline industry will consolidate, in our view

We expect the airline industry to continue its process of consolidation through the current challenge. Whilst government aid delays the failure of some airlines, we expect there will be failures. Some airlines that survive the grounding through aid, will be weak and fail as the industry restarts, some will be financially weak and absorbed by stronger airlines and some will emerge from the crisis smaller. Stronger airlines will find easier access to capital as the industry emerges to fly once again and will find greater leverage towards key suppliers.

We remain of the view that the strong will get stronger through this outbreak period.

Airlines defend cash, secure survival and then plan for the future

We see the key focus for airlines being to defend what cash they have today and then to secure sufficient cash to survive through a conservative assumption for grounding and recovery.

Having secured this, we see the stronger airlines looking to position themselves for the industry recovery as and when it comes. The grounding period offers an opportunity to dispose of surplus inefficient fleet, to extract previously implausible levels of working practice flexibility and to recalibrate contractual relations with key suppliers such as aircraft manufacturers and airports.

Regional power balance likely to change

Prior to the COVID-19 pandemic the US airline industry was very clearly the most profitable market in the world. US carriers were investing globally in other carriers whilst defending their home and international markets from competitive pressures. With the current pandemic, US airlines are battling for government aid, with evolving conditions being placed on that aid, as public scrutiny on the 96% of free cash flows paid in high shareholder returns weighs.

The US airline industry led the world by a huge margin. COVID-19 has laid it low alongside carriers around the world. Meanwhile governments in places such as Singapore, the UAE and Europe are standing clearly behind their airlines.

It is too early to predict the future world order with confidence. Yet it seems clear that the US carriers' lead over the rest of the world will erode.

Considerations for investors

Investors considering buying positions in airlines will want to be comfortable with our thesis that the growth in aviation will return and that the industry will indeed consolidate as we argue. Then among the opportunities for investment, you will want to reassure yourself that the businesses can survive. And after that, as is ever the case, timing will be everything.

Chinese airlines

- COVID-19 stabilises in mainland China, whilst cases escalate globally
- Domestic travel is starting to recover, but international travel is likely to remain constrained in the immediate future
- Chinese majors have stronger balance sheets than at the time of SARS

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Chinese airlines: Domestic traffic earlier and stronger recovery

The COVID-19 outbreak continues to evolve with strong signs of stability in mainland China while cases continue to escalate globally, particularly in the US and across Europe. As a result, international travel continues to face headwinds with many countries still restricting or discouraging overseas travel.

In mainland China as well, the Civil Aviation Administration of China (CAAC) restricted international flights by requiring mainland Chinese airlines to fly only one route to any country and with just one flight per week (Reuters, 27 March 2020). For foreign airlines the CAAC ordered a cut in flights to only one per week and again only one route. These restrictions by CAAC came in to effect from 29 March, implying international traffic growth will remain constrained in the near term. In the table below, we show the trend of international flights in mainland China since the COVID-19 outbreak.

Mainland China: International flights trend since COVID-19 outbreak

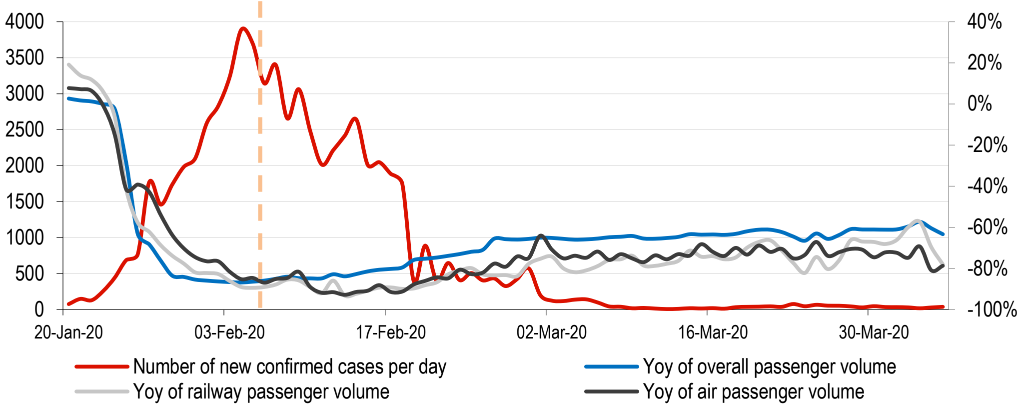
Phase	Period	No. of flights per week	% of pre-COVID-19 level
Phase 1	23-Jan to 19-Mar	1,165	13.0%
Phase 2	19-Mar to 26-Mar	734	8.2%
Phase 3	29-Mar to 4-Apr	108	1.2%

Note: Phase 1 had no restrictions by CAAC. Phase 2: Beginning from 19 March, CAAC instructed airlines that they could only reduce capacity but not increase capacity on international routes and would also need to seek approval for any changes in the international routes schedule or the aircraft. On the same day China announced that inbound international flights will have to divert to other cities first before coming in to Beijing. Phase 3 is following the restriction by CAAC on airlines for one flight per week per country.
Source: CAAC

Air traffic resumption in mainland China

In mainland China, the number of new confirmed domestic cases has tapered to negligible levels in recent weeks with most new cases emerging mainly from passengers arriving from overseas. Aviation traffic continues to improve from the trough levels seen in mid-February but as we discuss below, mostly driven by domestic routes.

Number of newly confirmed cases and y-o-y passenger volume growth in mainland China during the COVID-19 outbreak in 2020

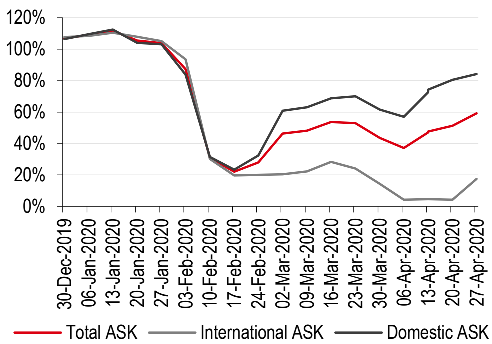


Source: Passenger volume was compared based on the Chinese lunar calendar to adjust for the Lunar New Year holidays' mismatch in different years
Source: National Health Commission of China, Wind, HSBC Qianhai Securities

Domestic capacity is coming back online while international could see further reduction
As per data from CAPA (Centre for Aviation), in mid-March for the week of 16 March, the overall capacity in terms of ASK for the big-3 Chinese airlines had improved to 54% of last year's level (69% for domestic and 28% for international) after troughing at 22% in mid-February. However with CAAC's recent restrictions, international capacity fell further to 4% of last years' level for the week of 6 April, albeit domestic capacity has remained stable.

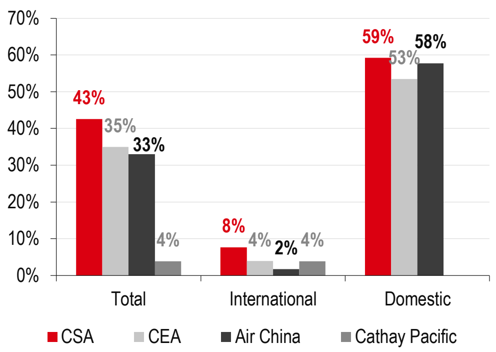
Among the players, CSA which has a relatively higher share of domestic traffic (69% of RPK in 2019) among the big-3 airlines (64% for CEA and 59% for Air China) has seen the most recovery in capacity. Conversely, Air China which a relatively higher share of international traffic (41% of RPK vs 36% for CEA and 31% for CSA) has seen the least recovery in capacity. Cathay Pacific which is entirely dependent on international routes continues to have most of its fleet grounded, operating just skeleton capacity equivalent to 4% of last year's levels.

Big-3 Chinese airlines: domestic capacity recovering faster while international capacity is likely to weaken further



Note: ASK recovery trend measured in terms of % of the capacity during the same period in 2019
Source: CAPA

CSA with its relatively high exposure of domestic routes has most capacity operational; CX is most at stress



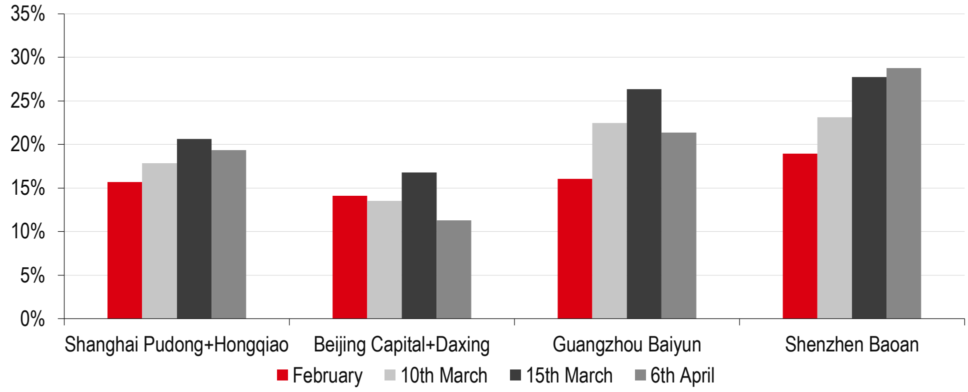
Note: ASK recovery trend measured in terms of % of the capacity during the same period in 2019
Source: CAPA

Air passenger traffic trends: business travel will recover first followed by leisure
We looked at the outbound passenger volumes at Beijing Capital International Airport and Daxing International Airport, Shanghai Pudong International Airport and Hongqiao International Airport, Guangzhou Baiyun International Airport, and Shenzhen Bao'an International Airport, to

gauge business air travel demand. We estimate that business air travel demand has recovered to 20-25% of the level in the same period of 2019, with demand on domestic routes recovering faster to 20-30% of that in the same period of 2019. The pace of recovery was similar to what the air passenger volume had achieved during the SARS outbreak.

Compared with the airports in Beijing and Shanghai, Shenzhen Bao'an International Airport and Guangzhou Baiyun International Airport saw a faster recovery in flight volume and passenger volume, as they receive a smaller share of international passengers and hence have felt a limited impact from the travel restrictions imposed by foreign countries.

Outbound passenger volume at airports in tier-1 cities has recovered to 20-30% of that in the same period of 2019



Source: VariFlight, HSBC Qianhai Securities

Takeaways from FY19 results briefings – Cash is king

During the FY19 results briefing, the listed mainland and Hong Kong airlines stressed their efforts to preserve cash and contain costs. Significant part of the fleet continues to remain grounded despite some recent sequential improvement in traffic in at least the domestic routes for mainland Chinese airlines while for international traffic focussed Cathay Pacific the pain could grow further in 2Q20.

- Some of the common cost control and cash preservation measures on the part of the companies include cutting capacity in response to demand, negotiations to defer new aircraft deliveries and lease payments, reducing variable costs, downgrading cabin services such as magazines and catering services and reducing the number of counters at airports. Separately some airlines are augmenting their revenues by some passenger flights as freight-only services to take advantage of the air cargo demand-supply mismatch. Indeed, China Southern Airlines said that it had removed seats on two Airbus 330 aircrafts to use the aircrafts as freighters.
- Separately, the airlines said that while the government and airports have provided some relief measures, they believe they are insufficient given the scale of the crisis and will continue to press for more assistance. Some of the measures already provided to airlines include cessation of the civil aviation development fee (CADF) from 1 January 2020, reduction in landing fees, waivers on aircraft parking fees and certain other airport fees, and 8% reduction in the premium charged on jet fuel by Chinese fuel importers.
- We also note that forward bookings are very low due to uncertainties from COVID-19 and evolving travel restrictions in different parts of the world. CSA said that about 7% of the domestic seats and 35% of the international seats are booked for the next 28 days compared to booking levels of around 90% in normal circumstances. Cathay Pacific and

few other lines have introduced unlimited rescheduling of tickets for a limited period to encourage more bookings and we see this as a measure to shore up working capital in the interim period.

Airlines are better capitalised now vs past downturns

Barring Cathay Pacific, the big-3 Chinese airlines and LCC players are now relatively better capitalised compared to the previous downturns during the SARS outbreak and the global financial crisis. In the table below, we summarise the leverage ratios of net debt to equity and net debt to EBITDA for our coverage in the fiscal years prior to the respective downturns. So for the SARS outbreak we look at the leverage ratios in 2002 while for the global financial crisis we look at the ratios in 2007. Note that FY2019 is based on IFRS 16 with capitalisation of long term operating leases and yet these ratios are lower or comparable to the previous years.

Mainland China and HK airlines: Leverage ratios ahead of the key downturns

	Net debt to equity (x)			Net debt to EBITDA (x)		
	2002	2007	2019	2002	2007	2019
Air China	NA	1.3x	1.3x	NA	5.0x	3.6x
CEA	1.1x	15.8x	2.2x	2.9x	9.3x	5.1x
CSA	1.4x	3.2x	2.4x	4.0x	6.5x	5.2x
Cathay	0.3x	0.3x	1.3x	1.1x	1.1x	4.4x

Note: Net debt and related multiples in 2019 are post IFRS 16 and include capitalised operating leases
Source: Company data, HSBC

Share price performance YTD 2020

Company	Share price performance
Air China 'H'	-34.4%
Cathay Pacific	-21.5%
China Eastern 'H'	-33.3%
China Southern 'H'	-34.2%
China Express	1.0%

Source: Refinitiv Datastream

Indian airlines

- COVID-19 spread to India relatively late. Air capacity is now grounded
- Share prices have fallen sharply. Indigo's balance sheet stronger than Spice Jet
- The outlook for consolidation in India is hard to predict

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Capacity trends

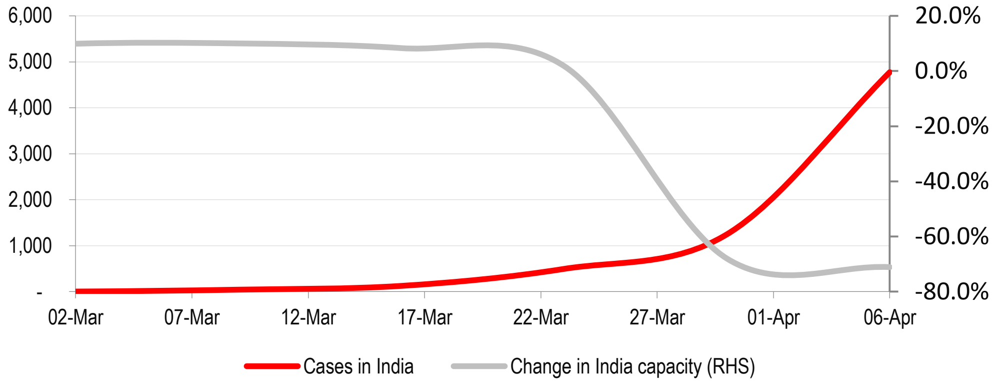
Capacity is on the ground at the moment

Currently all Indian airlines' aircraft are grounded, equivalent to around 14bn of domestic and 9bn of international ASKs per month. While international services have been suspended for the last few months, domestic flights have been suspended since mid-March. At the moment, international flights have been suspended until 30 April and domestic flights have been suspended until 14 April but we expect the domestic suspension to be extended to 30 April.

Early days in the COVID-19 outbreak, recovery timing uncertain

It is unclear when services will resume and the pace at which services will resume. India has been late coming into the outbreak and cases are currently accelerating. There is a wide variety in estimates for capacity in the coming quarters, varying from 10% decline to 35-40% decline over the next few quarters.

Cases in India against capacity change in India

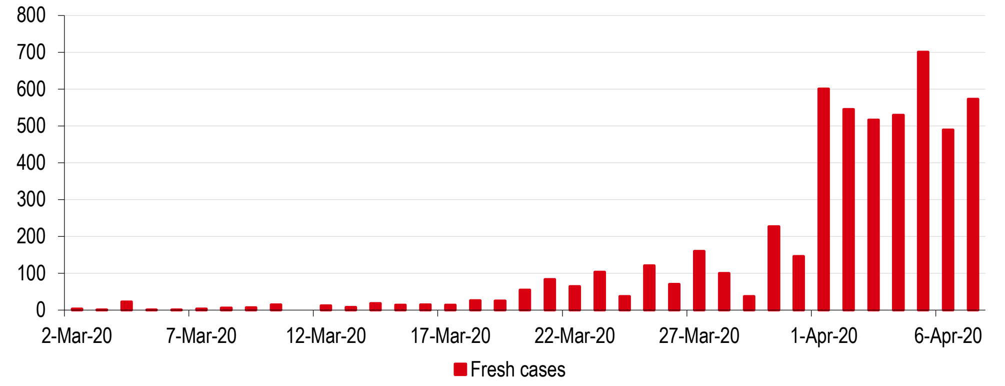


Source: European CDC, OAG

Capacity remains completely on ground. COVID-19 cases started in early March. Domestic services continued thus full capacity was in the air. International operations continued for a few days before it was grounded completely.

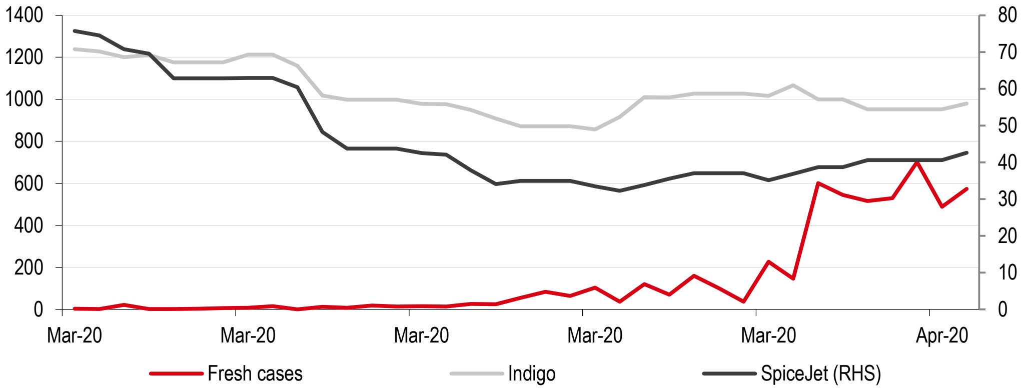
India is about mid- to slightly late in the cycle, falling broadly in line with Europe although the pace of increase in number of cases is much slower. Number of cases have increased recently, as shown in the chart.

Fresh daily COVID-19 cases in India



Source: European CDC

Fresh COVID-19 cases against share price movement



Source: European CDC, Refinitiv Datastream

Strategy to defend cash

- Airlines are not giving cash refunds to customers, they are giving credit which means working capital will be better
- Airlines have not confirmed whether they are in discussion with the lessors regarding lease holidays. However we believe that these airlines must be in discussion with their respective lessors regarding lease holidays.

- Capex and dividend would also be cut, in our opinion to defend cash (SpiceJet does not give any dividend)
- Cost cuts: All airlines are cutting salary costs in the range of 5-30%. Some of the airlines are giving leave without pay to their employees. Although job cuts have not been announced, we believe airlines will cut some jobs. We also believe that airlines will cut some other costs including marketing, G&A costs etc.

Government support

The government has not offered any support for the industry as of now. However government might offer some support in the form of access to some bank funding especially to SpiceJet, just to avoid a monopolistic situation. The government may also announce a further additional package including lower airport charges and taxes.

The key question is whether the government can support the industry other than Air India. Air India will be backed by the government. However does the government have capacity to support other airlines, and whether it can support other airlines politically?

The Indian government decided to lockdown the country early in the cycle which has helped the country to limit the rise in number of cases.

The timing of any recovery post COVID-19 remains uncertain. The outlook for the government's long-standing plans to privatise Air India is also unpredictable, leaving the Indian market particularly difficult to predict.

Middle East, Turkey and Russia

- Turkey was significantly impacted by COVID-19, UAE and Russia less so
- Demand for air travel collapsed throughout the region
- Cash preservation a key target

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Capacity and demand visibility remains poor for EEMEA Airlines

Since mid-February, the rapid increase in travel bans and air space closures on a regional and global scale have brought the capacity cuts for EEMEA Airlines to 90-100% levels currently. Flight bans and frequency cuts were introduced starting from mid-February, disrupting the otherwise rather optimistic start to the year in terms of traffic trends in the region.

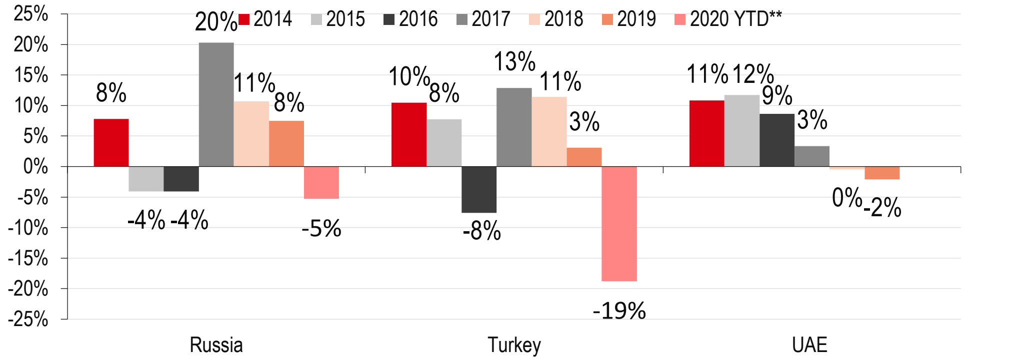
2020 YTD traffic trends

	Domestic			International		
2020 YTD traffic y-o-y	**Pax**	**ASK**	**LF**	**Pax**	**ASK**	**LF**
Turkish Airlines	-24.2%	-17.1%	-4.3	-16.7%	-9.0%	-4.5
Pegasus	3.0%	4.1%	-0.1	17.2%	15.4%	5.6
Aeroflot	2.6%	5.9%	-1.9	-2.9%	0.7%	-2.3
Air Arabia	n/a	n/a	n/a	n/a	n/a	n/a

Source: Company reports, Jan-Feb 2020 for Pegasus and Aeroflot, Data not disclosed for Air Arabia, Jan-Mar 2020 for Turkish Airlines

In Turkey, the overall expectation at the outset of the year was strong international traffic to be driven by tourism (inbound) and a milder currency (outbound) as well as improving traffic on the domestic side. LCC Pegasus was looking to further pursue its strategy of international focus and national carrier Turkish Airlines was preparing to start reaping the benefits of having first full year operations at its new hub, Istanbul Airport. It is now obvious to all industry players that the year will significantly deviate from plans, as March traffic for TK has already signalled for TK (total pax -53%, LF down 18pps, ASK -40%, cargo -8%). As a broader data, total number of Turkey airport passengers reported by DHMI was down 49% y-o-y in March and down 19% y-o-y 2020 YTD. Turkish Airlines stopped all international flights as of 27 March as per instructions from the Civil Aviation Authority and flight bans have been extended until the end of April while domestic routes are suspended until 20 April. Both TK fleet (361 planes) and Pegasus (83) are fully grounded as of the beginning of April, at least until the end of the month. Istanbul Sabiha Gokcen Airport (hub for Pegasus) is also shut down until the end of April. One relative positive to mention is the cargo operations of TK where the airline is largely offsetting the missing belly cargo volumes (50% of the total volumes normally) by the rising volumes carried by the freighters (24 of them within total fleet of 361). General expectation is start of domestic flights first in H2 May and international flights gradually from mid-June onwards.

Development of air passenger traffic in Turkey, Russia, and UAE (pax growth y-o-y)



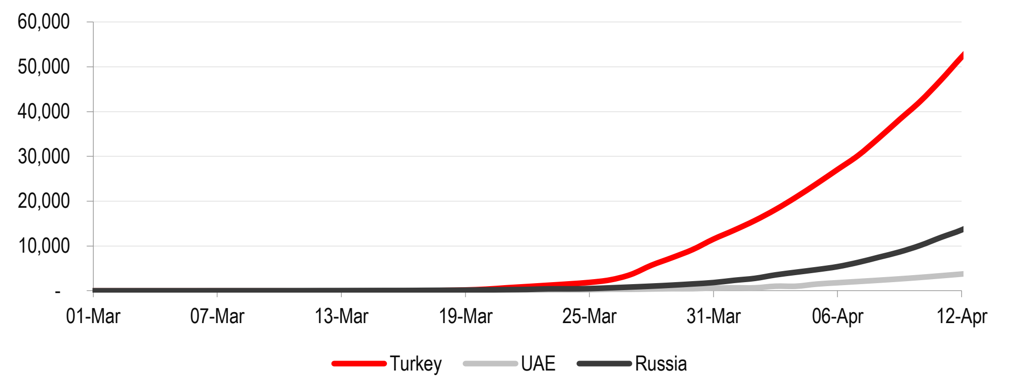
Source: DHMI (Turkey State Airport Authority), Company reports (Emirates, Etihad, Qatar Airways, Air Arabia, flydubai, Aeroflot) ** 2020 YTD data is for 1Q20, UAE data is not available

The UAE Civil Aviation authorities imposed a total ban on all passenger flights for two weeks from 25 March resulting in immediate grounding of fleet for the region's major airlines (such as Etihad, Emirates, Air Arabia and Flydubai). Limited flights have been allowed by the authority from April onwards mainly for repatriation of stranded foreigners and bringing UAE citizens back along with cargo. In order to compensate for losses from suspension of passenger flights, UAE airlines are expanding their cargo destination network and adding more capacity to ongoing cargo operations. Airlines are looking for a normalisation from current situation by the end of Summer 2020. One of the major event for the region, Dubai Expo 2020 (originally to debut in October 2020 and host an estimated 25m visitors during its six-month duration) is under talks for a possible postponement into 2021.

Russian airlines reported 26.6% y-o-y decline for the March 2020 with 6.57m passengers as reported by the aviation regulator (2020 YTD is down 5.3% y-o-y). The goverment announced ban on all international flights from 27 March, excluding flights only for repatriating citizen. National carrier Aeroflot and its group airlines started temporarily suspending flights on multiple international routes since 16 March and the grounding of fleet. Aeroflot continued operating with limited international flights even after the flight ban for few days mainly to evacuate passengers but group low-cost airline Pobeda has suspended all flights starting from April until end-May.

Additionally the fall in oil prices since the beginning of the year, accelerating with COVID-19, has put additional strain on Middle East and Russian aviation via the economic perspective.

COVID-19 cases



Source: European CDC, reported as of 13 April 2020

Total number of COVID-19 cases

Country	Cases
Turkey	56,956
UAE	4,123
Russia	15,770

Source: European CDC, reported as of April 13 2020

Mitigation actions taken by airlines to preserve cash

Cash, liquidity, cost and capex have been main areas of focus for airline managements in this environment of nearly zero or very weak cash flow from operations starting April. Cargo operations have become main activity for full service airlines where they seek some partial cushion against the losses from passenger flights. The various risk mitigation and cost cutting measures adopted some of the EEMEA airlines to conserve cash are:

- Turkish Airlines has 1) cancelled/postponed a major portion of planned investments, 2) staff are being offered voluntary unpaid leave and part-time (along with application to the state part-time wage support scheme), 3) all vendor contracts are being reviewed for a revision of the payment terms, and 4) new financing options are being evaluated to support liquidity
- Pegasus has 1) cut down on capex and admin expenses and defer on significant capex, 2) unpaid leaves in Apr-Jun-Jul, 3) working for deferral of lease payments, due invoices and discounts on exisiting contracts, 4) can ask Airbus to defer deliveries/ early phase out of current Boieng fleet, and 5) will operate commercially viable/cash flow postive flights
- Aeroflot management has expressed that group airlines are facing extreme financial pressure due to current flight restrictions and has 1) deferred lease payment of 67 aircrafts from April 2020 to July 2021,2) asked staff to utilise leaves, and 3) payroll reduction and administrative cost cutting
- In the UAE, airlines have announced major scale-downs on non-essential spending, recruitment and planned salary cuts in the range of 25-50%. Air Arabia (according to Bloomberg) has joined airlines globally to seek state support and considers postponing the launch of its new LCC JV with Etihad Airways (Air Arabia Abu Dhabi) which would normally start flights in June.

Government support includes tax deferrals, exemptions and bail-out packages

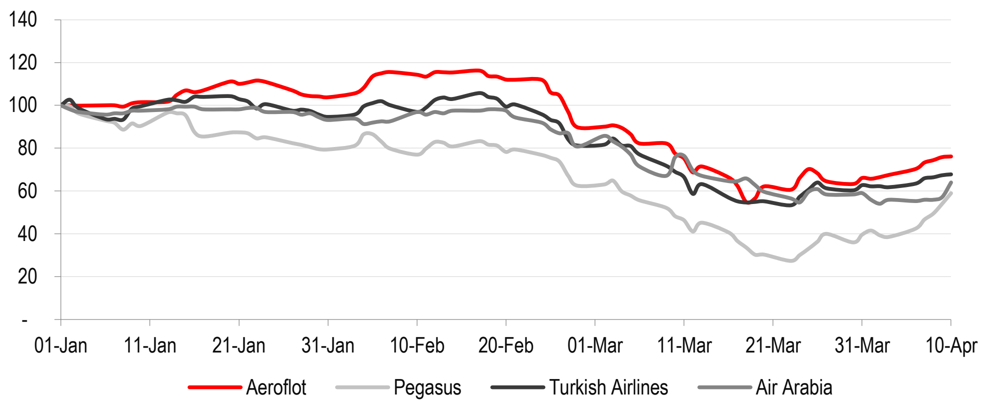
In Turkey, so far the government has introduced a VAT cut in domestic flights in March (from 18% to 1%) valid for the next three months; postponed corporate tax, VAT and social security payments for 16 sectors (among which air transportation) for six months from Apr-May-Jun to Oct-Nov-Dec; and allowed airlines to defer payments on presold tickets until two months after the opening of the corresponding route to flights.

In Russia, the government promised (on Monday 23 March) to unlock the equivalent of USD4bn to support businesses against the coronavirus pandemic, especially in the tourism and aviation sectors, by allowing them to defer tax payments.

In the UAE, the government has been in talks with banks to discuss various funding options and like issuing bonds to provide financial aids to state-owned airlines dealing from financial pressure of coronavirus shutdown. Emirates Airlines (according to Bloomberg) "is reaching out to local and international banks about funding in addition to state aid it received in March".

Share price performance (YTD 2020)

(Indexed to 100)



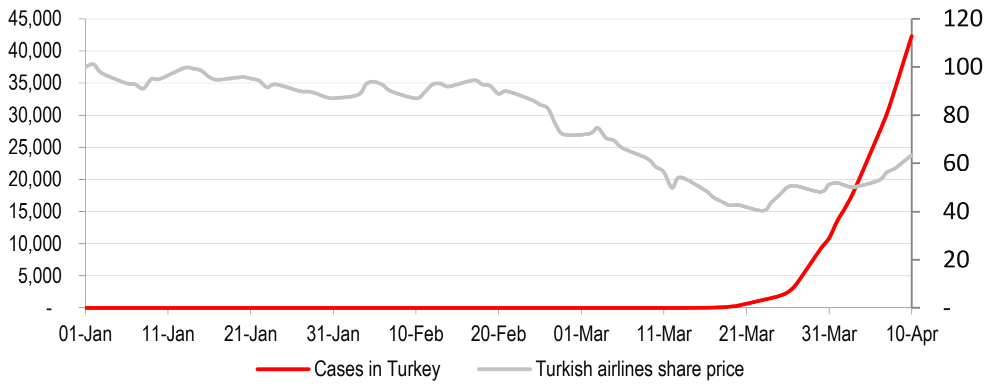
Source: Refinitiv Datastream, as of 10 April 2020

Share price performance

	YTD 2020	Since 21 Feb 2020
Aeroflot	-23.9%	-32.0%
Pegasus	-41.0%	-25.7%
Turkish Airlines	-32.2%	-32.5%
Air Arabia	-36.0%	-32.2%

Source: Refinitiv Datastream

Turkey's airlines performance vs number of COVID-19 cases in Turkey



Source: HSBC, European CDC

*Average of Pegasus and Turkish Airlines, which are indexed to 100

European Airlines

- European aviation currently grounded, with June resumption of operations a plausible outcome
- Airlines defending cash better than we anticipated, though fuel hedging will weigh of profit, balance sheet and cash flow
- Government support for airlines is generally strong across Europe

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European airlines substantially grounded

Aviation in Europe is substantially grounded. A handful of airlines are operating skeleton services providing domestic and international connectivity. Current capacity levels are between 0 and 5% of planned levels.

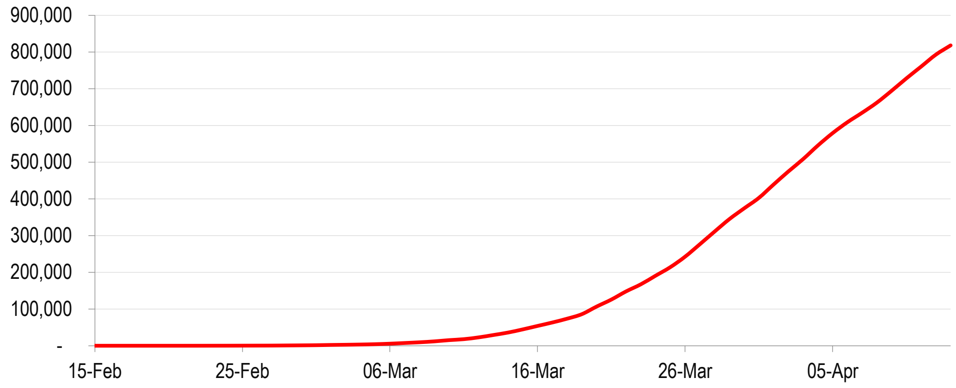
The shutdown of flying took place in the first two weeks of March. February traffic data had been broadly stable for European airlines, albeit with continuing weakness on Chinese routes affected by the COVID-19 outbreak and weakness at the end of February on routes to Northern Italy. Yet the shutdown of aviation played out rapidly in March. In the first week of March Lufthansa cut its capacity by 25%, upping the capacity cut to 50% in the second week. Whilst at the time the Lufthansa capacity cuts seemed dramatic on 11 March air travel broadly ceased to Italy and on the 12 of March the US banned European citizens from entering the US, effectively shutting down the North Atlantic market, except the UK and Ireland. By 16 March, the US had broadened its ban to UK and Irish flights, Poland closed its borders, TUI had shut down operations and most carriers had cut 70-80% of operations, building to 90-95% the following week.

Cargo services are continuing, with particularly strong demand for medical supplies coinciding with the loss of belly hold capacity, which normally provides over half the air cargo capacity in Europe. Airlines are flying passenger aircraft as pure freighters and Lufthansa is removing seats from four aircraft to create new freighter capacity.

The timing of the reintroduction of services is an unknown. The central assumption of European airlines is that services will resume from June, yet there is no clarity over which companies will have opened borders by then and what consumer demand will arise.

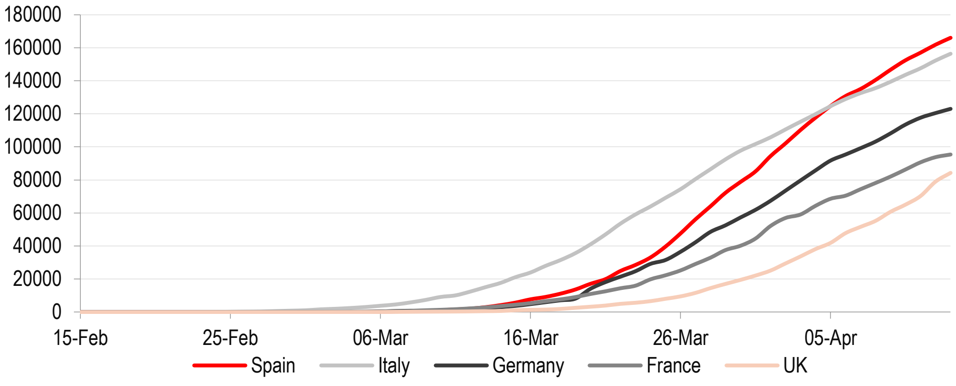
COVID-19 in Europe: Still climbing though potentially close to the peak
In most countries across Europe the rate of infections and daily mortality is rising. With the exception of Sweden, which has not applied a formal lockdown, most countries across Europe are subject to lockdowns which limit mobility to food shopping and essential workers. However, Austria has made its first steps to ease the lockdown. Politicians in France, Italy and Spain are starting to discuss the timing of moves to ease the lockdowns, signalling a view that the countries are close to the peak of infections.

COVID-19 cases in Europe



Source: European CDC, reported as of 13 April 2020

Number of COVID-19 cases in most infected countries



Source: European CDC, reported as of 13 April 2020

Total COVID-19 cases in Europe

Country	Total infection
Spain	166,019
Italy	156,363
Germany	123,016
France	95,403
UK	84,279
Others	192,796
Europe	817,876

Source: European CDC, reported as of 13 April 2020

European airline responses: grounding, cash preservation

In Europe, airlines have cut their capacity to close to zero, operating repatriation services, skeleton services for national connectivity or cargo flights.

As we discussed in our report, *European Airlines: Cash burn revisited – impressive hibernation skills*, 6 April 2020, the key focus for airlines has been to preserve liquidity. To be fair to the airlines, they are actually doing an impressive job at defending their cash positions, actually doing notably better than we had anticipated in our first review of the process three weeks earlier, *European Airlines: Short-term cash scenarios*, 18 March 2020.

Specifically, airlines are defending working capital effectively, delaying the paying of bills and the release of refunds to consumers. On labour costs they are benefitting widely from government furlough schemes which are widespread across Western Europe, though not in CEE, where Wizz has made 1,000 staff redundant. Airlines under our coverage seem to have negotiated two- to three-month lease deferrals and capex has very significantly stopped in the short term. Airlines are not taking delivery of new aircraft, so final payments are not relevant. Meanwhile progress payments seem to be withheld, since delivery dates are extremely uncertain.

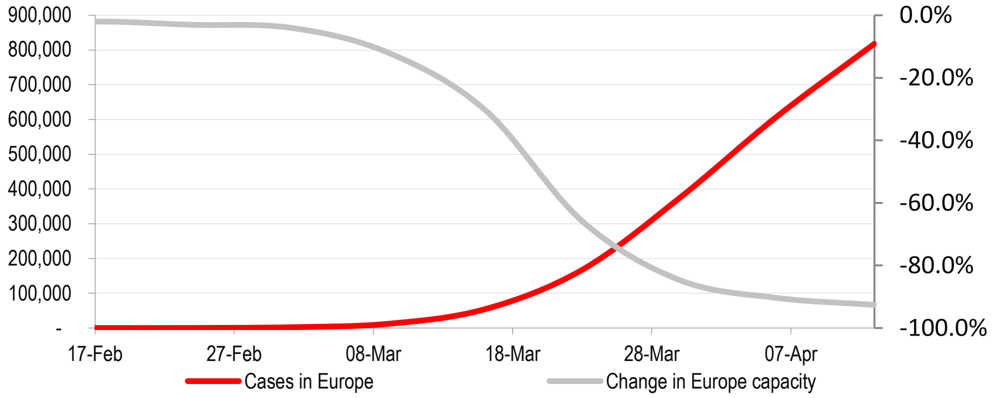
Beyond limiting the cash outflow, all airlines are working on securing additional cash to survive the period of grounding. We find airlines drawing down and or extended revolving credit facilities. Airlines are planning to raise debt against unencumbered aircraft or to undertake sale and leasebacks on these aircraft. Airlines in Europe are looking to their governments for state support. Whilst all airlines are taking advantage of government furlough structures the need for state financial support is not uniform across the sector. However, those companies looking for incremental capital are considering state guarantees on commercial loans, direct state loans, as well as considering rights issues that might be partially or wholly backed by government. Hybrid capital structures, including convertible bonds or preference equity are also under consideration.

Above and beyond the short-term freeze on capex, airlines are also in negotiations with aircraft manufacturers to redefine their order books. We have also seen existing M&A projects facing some uncertainty. The Polish airline LOT has walked away from its planned acquisition of Condor whilst IAG has not officially abandoned its planned acquisition of Air Europa, but this is a deal we expect to either be renegotiated or abandoned.

European airlines face a unique challenge that arises from their higher levels of fuel hedging than elsewhere in the world. The European industry typically hedges 70-80% of the forward 12 months of fuel, with around 90% of the imminent quarter hedged. Coming into the June 2020 quarter most European airlines were hedged at around USD60/bbl. Even if airlines do not fly and burn any fuel, they are typically liable to settle the out of the money fuel hedge, which broadly equates to around halve the originally anticipated fuel bill. This is a unique challenge for European airlines, as they hedge more fuel than airlines elsewhere in the world.

Change in weekly European capacity (yoy) against COVID-19 cases in Europe

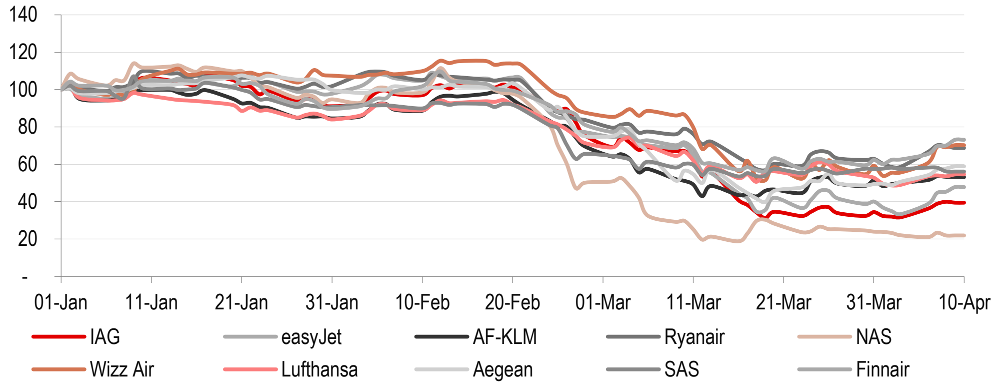
Capacity defined by number of flights departing



Source: OAG, European CDC
* Average of change in capacity from France, Germany, Italy, Spain and UK

European airlines share price chart (YTD 2020)

Indexed to 100



Source: Refinitiv Datastream, as of 10 April 2020

Strong government support for airlines

Airlines across Europe have been major beneficiaries of widespread short-term working structures that see governments pay a share of wages for temporarily furloughed workers. Such schemes are in place throughout Western Europe, and have enabled airlines to reduce their labour bills by 50-70% in the grounded scenario.

Airlines, which were strongly in focus from governments throughout 2019 as targets for taxation in the context of the climate change debate, are suddenly viewed as key pieces of infrastructure justifying national support. Across Europe we have seen governments act to defend their national airlines. Countries including France, Holland, Germany, Spain, Sweden, Denmark, Norway have either announced specific plans to aid airlines or have expressed clear commitments to support their national airlines.

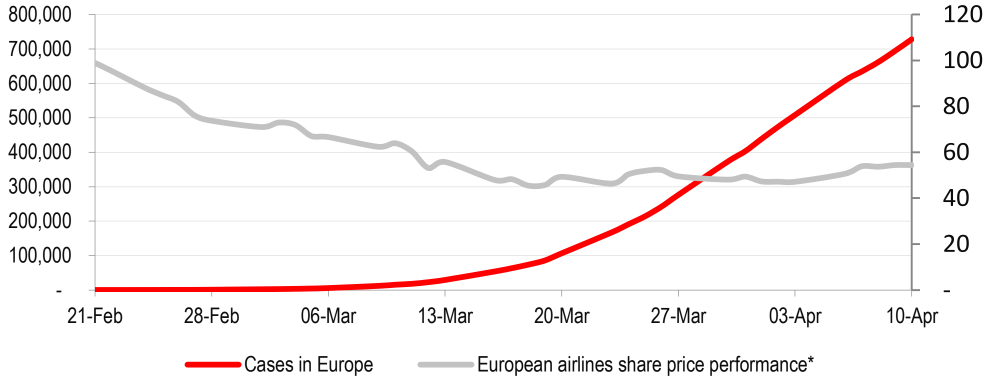
In the UK the government has not committed to supporting the aviation sector above and beyond the widespread furlough scheme and the Bank of England government guarantee structure, which is only available to companies with investment grade credit ratings prior to the virus. Other airlines needing aid have been told to seek support from shareholders first and thereafter to come with bespoke requests for government aid. Virgin Atlantic and the regional airline Loganair are seeking aid.

European airlines share price performance

	YTD	Since 21 Feb 2020
IAG	-60.5%	-60.4%
easyJet	-52.2%	-54.8%
AF-KLM	-46.8%	-41.9%
Ryanair	-31.2%	-34.2%
NAS	-78.1%	-77.1%
Wizz Air	-29.8%	-37.9%
Lufthansa	-45.4%	-39.6%
Aegean	-41.1%	-41.4%
SAS	-43.9%	-37.4%
Finnair	-26.9%	-25.3%

Source: Refinitiv Datastream, as of 10 April 2020

European airline share price vs European capacity



Source: HSBC
*Average of European airline share price, which are indexed to 100

As and when the industry emerges, we expect air travel to both recover and then resume growth. Looking ahead to what will undoubtedly be an extreme global recession, it will inevitably take time to catch up to where traffic was in 2019, but we expect the demand for leisure, visiting friends and relations and business travel to grow. We recall the view that air travel would not grow after the 9/11 terror attacks but it did indeed recover and grow vibrantly.

With this view in mind, we expect the industry to consolidate through this virus period, notwithstanding the intervention by governments. We do expect some airlines to fail. We expect some airlines supported by government through the grounding, to have to shrink significantly, merge with stronger airlines or fail in the aftermath of the grounding. By contrast airlines with strong balance sheets and business models will also shrink, but notably less than peers. They will be better placed to purchase assets from weak or failed competitors and will be best placed to raise equity to support market share expansion. These carriers should also be well placed to benefit from beneficial negotiation positions with key suppliers including labour, aircraft manufacturers and lessors and airports.

LatAm Airlines

- Most LatAm countries have banned domestic and international flight operation with Mexico being the exception
- Key government measures include rescue packages and tax deferrals
- Mexico is not in favour of any government support

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Latin American carriers have grounded the majority of their fleet with grounded capacity ranging from c50% to 100%. While most of the Latin American nations have imposed significant travel restrictions, Mexico has still resisted to implement the same. This is reflected in lower capacity in ground for Mexican carriers like Aeromexico (c50% of its fleet).

Colombia, Panama and Peru have imposed complete travel ban which forced Copa and Avianca to completely suspend their operations. LATAM Airlines has grounded 95% of its passenger fleet, while flying with very limited frequencies in Brazil and Chile. The company has expanded its cargo capacity by 15% for April to sustain transportation of essential good.

March traffic data reported by Volaris and Gol shows a load factor decline of 430bps and 760bps, respectively, compared to Aeromexico's contraction of 1880bps despite only 50% of its fleet has been grounded. We believe the lower contraction for Volaris and Gol is mainly due to their better network adjustments and lower exposure to the international segment.

Capacity grounded by Latin American carriers

Company	Capacity grounded
Aeromexico	50%
Copa	100%
Gol	92-95%
LATAM	95%
Volaris	80%
Azul	90%
Viva Air	50-70%
Avianca	100%

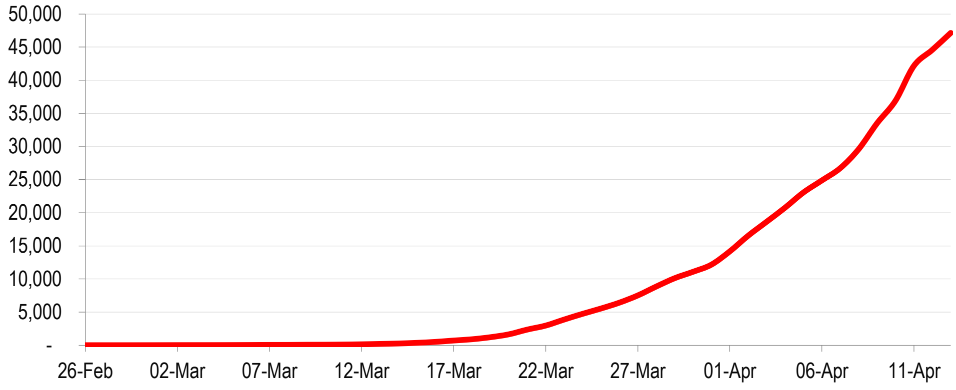
Source: Company reports

Coronavirus travel restrictions in Latin America

Country	Travel restriction status	First confirmed case	First confirmed death
Argentina	Indefinite ban on incoming foreigners	3rd Mar	7th Mar
Brazil	Ban on incoming foreigners till 30th April	26th Feb	17th Mar
Chile	Indefinite ban on incoming foreigners	3rd Mar	21st Mar
Colombia	Complete domestic and international ban	6th Mar	21st Mar
Mexico	Ban on non-essential travel between USA and Mexico	28th Feb	18th Mar
Peru	Ban on international travel till 12th April	6th Mar	19th Mar
Panama	Complete domestic and international ban	9th Mar	10th Mar

Source: NY Times, AS/COA

LatAm: COVID-19 cases



Source: European CDC, reported as of 13 April 2020

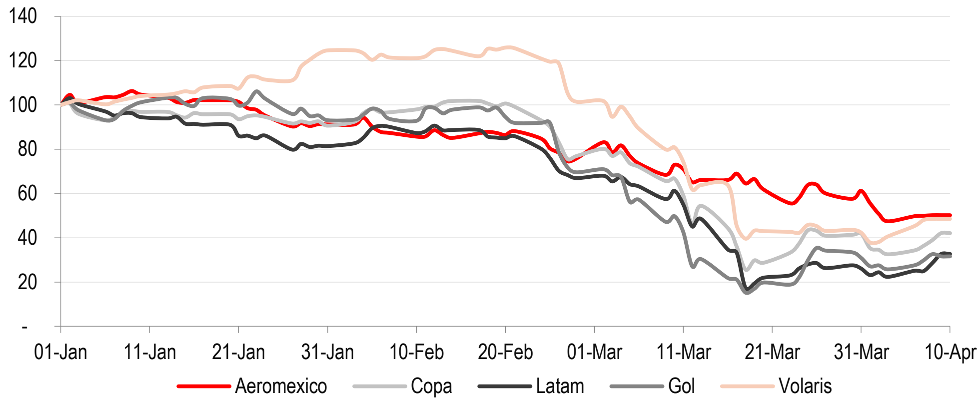
Total number of COVID-19 cases

Country	Cases
Brazil	22,169
Chile	7,213
Ecuador	7,466
Mexico	4,661
Others	5,637
LatAm	**47,146**

Source: European CDC, reported as of 13 April 2020

Share price performance (YTD 2020)

(Indexed to 100)



Source: Refinitiv Datastream

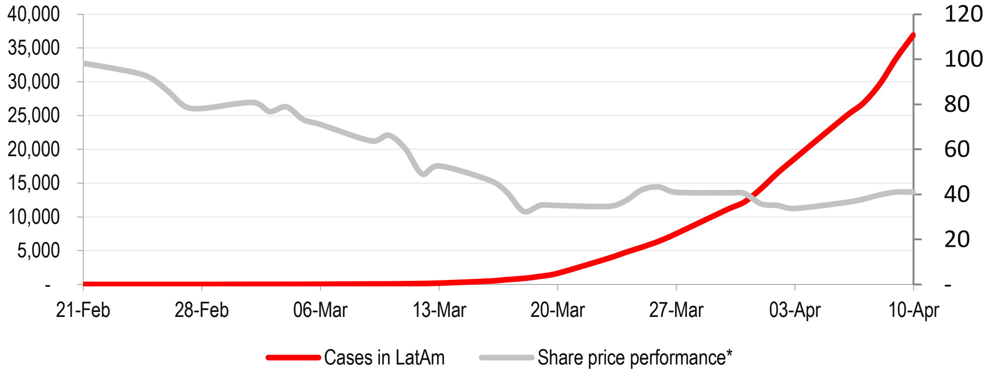
We see the region lagging behind in the coronavirus cycle, relative to global spread. The region registered its first case on 26 February in Brazil, and in other LatAm countries, by the first week of March. Globally, the spread started much earlier with many countries registering their first cases in January or early February.

Share price performance

	YTD 2020	Since 21 Feb 2020
Aeromexico	-49.8%	-43.1%
Copa	-57.9%	-57.6%
LatAm	-67.3%	-62.0%
Gol	-68.4%	-65.6%
Volaris	-51.5%	-61.4%

Source: Refinitiv Datastream, as 10 April 2020

LatAm airlines performance vs cases in LatAm



Source: HSBC, European CDC
*Average of Aeromexico, Copa, LatAm, GOL and Volaris

Actions taken

Companies have announced a range of actions to tackle the liquidity crunch. This includes reduction in payroll costs, voluntary unpaid leave programs, negotiations to waive off or extend payments terms with fleet lessors and airports, suspension of new investments, deferral of all fuel payments and stopping PDP payments to preserve cash. The companies are also under negotiations with lenders requesting for rollovers of the short-term debt and availing new credit facilities.

In terms of government measures, Brazil has already announced the deferral of air traffic fees from March and June for six months, and higher flexibility in refund of the cancelled flights. Brazilian Development Bank (BNDES) also recently announced that it is working on a rescue package to invest in the airlines industry, though details regarding the package have not been finalized yet. Gol has also announced the government support of suspension of all taxes and fees for 2Q20.

On the other hand, Mexican government has not announced any support measure so far, with Mexican president pushing against any stimulus package for the economy.

Once the dust is settled, we believe companies with high domestic exposures will be the first to recover.

US airlines

◆ The COVID-19 virus arrived in the US in late March, with US carriers cutting capacity more moderately than in other markets

◆ Demand has fallen faster and airlines are seeing their world leading profit margins collapse just as fast as elsewhere in the world

◆ Government support significant, but made complex by share buybacks and tension between Congress and the administration

US capacity trends falling late March into April

US airlines were late to see an impact from the COVID-19 outbreak. Whilst Trans-Pacific routes to Asia were weak in January and February, notably impacting United, other international routes were strong into early March. The domestic market responded late, as the spread of the virus into the US lagged other regions.

COVID-19 spreading into spring

The growth of the virus in the US has accelerated strongly in the last weeks of March and continues to rise into April.

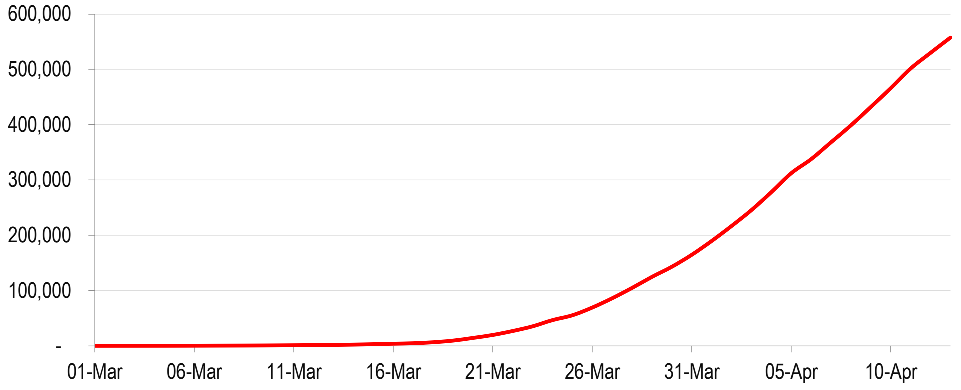
The nature of lockdowns vary by state, as does the scale of the outbreak, which has been seen most clearly in New York and Seattle.

Airline responses

Air travel demand has melted for both business, family and leisure, with US carriers suffering from a more gradual reduction in capacity, but a rapid drop in demand. This means that the carriers face very weak unit revenues in addition to the cost challenges from significant groundings.

US carriers are also working to limit cash outflows managing working capital. At the moment government rules appear to be requiring the payments of refunds, which adds to their challenges.

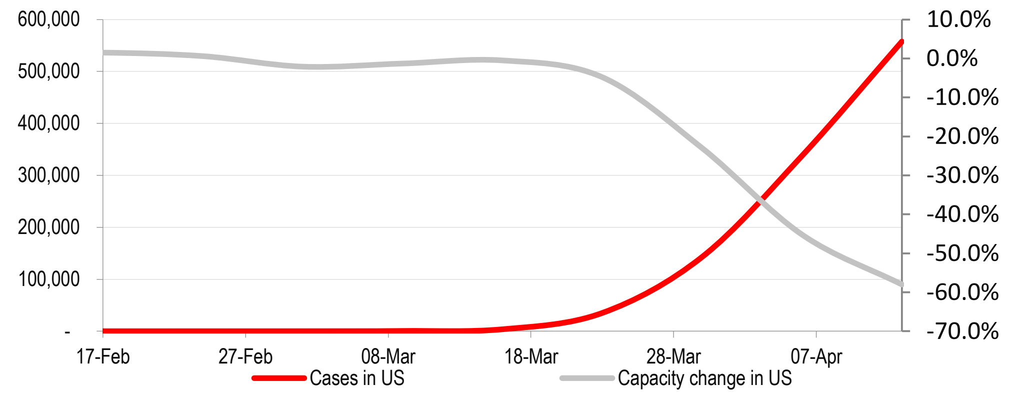
COVID-19 cases in US



Source: European CDC, reported as of 13 April 2020

Change in weekly US capacity (yoy) against COVID-19 cases in US

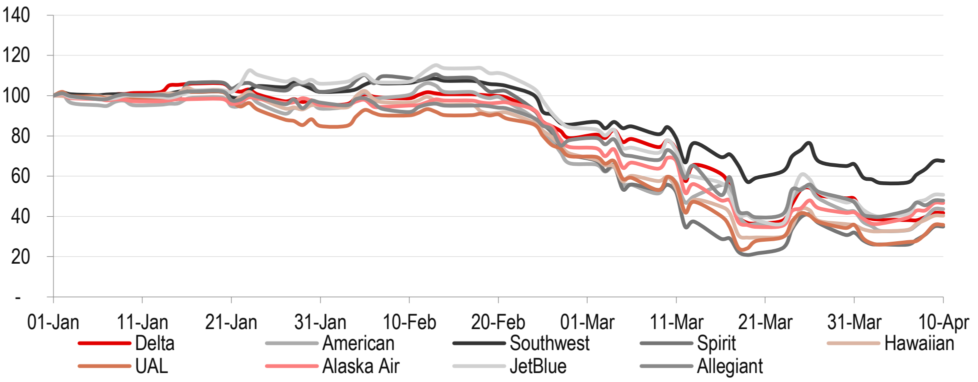
Capacity defined by number of flights departing



Source: OAG, European CDC, reported as of 13 April 2020

US airlines share price chart (YTD 2020)

Indexed to 100



Source: Refinitiv Datastream, as of 10 April 2020

Share price performance

	YTD 2020	Since 21 Feb 2020
Delta	-58.3%	-57.9%
American	-56.4%	-55.0%
Southwest	-32.4%	-35.5%
Spirit	-65.1%	-65.7%
Hawaiian	-59.6%	-55.9%
UAL	-64.2%	-59.6%
Alaska Air	-53.3%	-51.7%
JetBlue	-49.3%	-53.9%
Allegiant	-52.1%	-48.8%

Source: Refinitiv Datastream

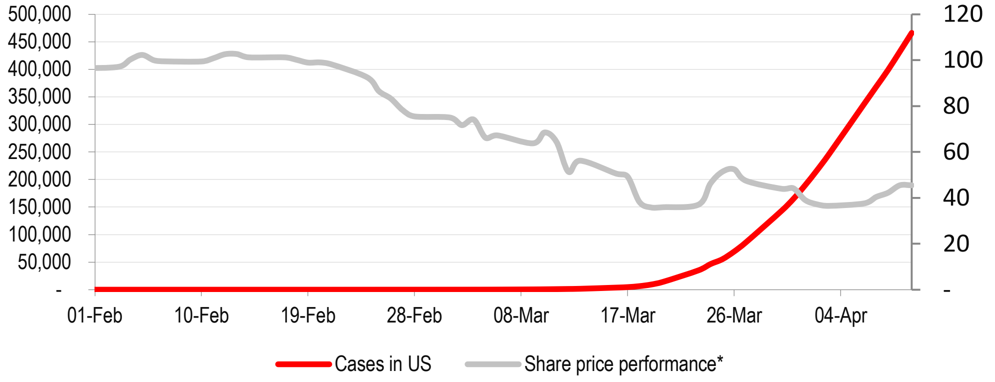
Government support significant yet at a price

The US government has agreed a USD50bn support package for airlines, split between USD25bn loans and loan guarantees and USD25bn payroll assistance received under the Coronavirus Aid, Recovery, and Economic Security Act. The agreement was finalised on 14 April. The airline industry is seen as a key national infrastructure and includes Alaska, Allegiant, American, Delta, Frontier, Hawaiian, Jetblue, United, Skywest and Southwest. The administration has been clear that it wanted to support the industry. Moreover, the structure of that support was debated with vigour through the legislation process. US carriers came under fire for their strategy of share buybacks in recent years: over the past ten years the six largest US carriers spent 96% of their free cash flow on share buybacks. US President Donald Trump has explicitly stated that any financial aid given to airlines should come with prohibitions on share buybacks.

The US government has proposed that the airlines repay 30% of payroll assistance received in the form of low-interest loans due in five years, as well as issuing warrants equal to 10% of the load amount. Companies receiving funds may not lay off workers before 30 September or change collective bargaining agreements.

The industry lobby group said that requiring carriers to repay portions of the grants could hamper the efficacy of the rescue package, noting that workforce grants are "pass-through monies" designed specifically to fund payrolls.

US airline share price vs cases in US



Source: European CDC, Refinitiv Datastream, as of 10 April 2020
*Average of US airline share price, which are indexed to 100

HSBC Global Airline Coverage

	Company	Country	BBG Ticker	Curr	Share Price	HSBC Rating
Asian LCCs	Indigo Airlines	India	INDIGO IN	INR	1,068.40	Hold
	SpiceJet	India	SJET IN	INR	48.7	Hold
European LCCs	Ryanair	Ireland	RYA ID	EUR	10.06	Buy
	Easyjet	UK	EZJ LN	GBP	6.81	Buy
	Norwegian	Norway	NAS NO	NOK	8.27	Reduce
	Wizz Air	UK	WIZZ LN	GBP	27.36	Buy
CEEMEA LCCs	Air Arabia	UAE	AIRARABI UH	AED	1.04	Buy
	Pegasus	Turkey	PGSUS TI	TRY	56	Buy
LATAM LCCs	GOL	Brazil	GOLL4 BZ	BRL	11.45	Buy
	Volaris	Mexico	VOLARA MM	MXN	9.01	Buy
Asian flag carriers	Cathay Pacific	Hong Kong	293 HK	HKD	9.04	Hold
European flag carriers	Aegean	Greece	AEGN GA	EUR	4.95	Buy
	Air France-KLM	France	AF FP	EUR	5.28	Hold
	Finnair	Finland	FIA1S FH	EUR	4.3	Hold
	IAG	UK	IAG LN	GBP	2.47	Buy
	Lufthansa	Germany	LHA GR	EUR	8.88	Hold
	SAS	Sweden	SAS SS	SEK	8.57	Hold
CEEMEA flag carriers	Aeroflot	Russia	AFLT RM	RUB	76.5	Hold
	Turkish Airlines	Turkey	THYAO TI	TRY	10.19	Buy
LATAM flag carriers	Aeromexico	Mexico	AEROMEX MM	MXN	7.93	Hold
	COPA	Panama	CPA US	USD	41.84	Buy

Source: HSBC
Pricing as at 9 April 2020

Disclosure appendix

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From 23rd March 2015 HSBC has assigned ratings on the following basis:

The target price is based on the analyst's assessment of the stock's actual current value, although we expect it to take six to 12 months for the market price to reflect this. When the target price is more than 20% above the current share price, the stock will be classified as a Buy; when it is between 5% and 20% above the current share price, the stock may be classified as a Buy or a Hold; when it is between 5% below and 5% above the current share price, the stock will be classified as a Hold; when it is between 5% and 20% below the current share price, the stock may be classified as a Hold or a Reduce; and when it is more than 20% below the current share price, the stock will be classified as a Reduce.

Our ratings are re-calibrated against these bands at the time of any 'material change' (initiation or resumption of coverage, change in target price or estimates).

Upside/Downside is the percentage difference between the target price and the share price.

Prior to this date, HSBC's rating structure was applied on the following basis:

For each stock we set a required rate of return calculated from the cost of equity for that stock's domestic or, as appropriate, regional market established by our strategy team. The target price for a stock represented the value the analyst expected the stock to reach over our performance horizon. The performance horizon was 12 months. For a stock to be classified as Overweight, the potential return, which equals the percentage difference between the current share price and the target price, including the forecast dividend yield when indicated, had to exceed the required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). For a stock to be classified as Underweight, the stock was expected to underperform its required return by at least 5 percentage points over the succeeding 12 months (or 10 percentage points for a stock classified as Volatile*). Stocks between these bands were classified as Neutral.

*A stock was classified as volatile if its historical volatility had exceeded 40%, if the stock had been listed for less than 12 months (unless it was in an industry or sector where volatility is low) or if the analyst expected significant volatility. However, stocks which we did not consider volatile may in fact also have behaved in such a way. Historical volatility was defined as the past month's average of the daily 365-day moving average volatilities. In order to avoid misleadingly frequent changes in rating, however, volatility had to move 2.5 percentage points past the 40% benchmark in either direction for a stock's status to change.

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As of 14 April 2020, the distribution of all independent ratings published by HSBC is as follows:

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Hold	37%	(31% of these provided with Investment Banking Services)
Sell	9%	(24% of these provided with Investment Banking Services)

For the purposes of the distribution above the following mapping structure is used during the transition from the previous to current rating models: under our previous model, Overweight = Buy, Neutral = Hold and Underweight = Sell; under our current model Buy = Buy, Hold = Hold and Reduce = Sell. For rating definitions under both models, please see "Stock ratings and basis for financial analysis" above.

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