

HSH Nordbank Market Commentary

Outlook for Aviation in the Second Half of 2009 and Beyond: Despite Negative Press the Aviation Industry is Successfully Weathering the Storm

The first half of 2009 saw many market participants worrying that a wounded financial system would be unable to provide the capital needed to fund aircraft deliveries, that declines in air travel would continue to accelerate, and that an increasing number of airlines would face bankruptcy. While 2009 has not been an easy year so far, trends to date continue to affirm the belief of the HSH Transportation Finance-Team that the industry is more resilient than many fear and that some of the trends associated with the current difficult economic environment are actually laying the groundwork for a more robust industry going forward.

Leading headlines continue to be quite negative as the IATA forecasts significantly higher industry losses and as demand declines continue to outpace overall reductions in capacity leading to significantly weakened yields. Just as many airlines began to expect a potential improvement in demand as the Northern Hemisphere Summer season approached, fears over H1N1 flu appeared to dampen demand once again. Moreover, even with weaker demand, fuel prices began to increase and are now close to \$70/barrel.

While it is easy to focus on these negative trends and become extremely pessimistic about the aviation industry's future, a broader look at some of the trends now taking shape provides a better sense of perspective. Specifically:

- While airlines are facing weaker traffic, lower yields, and more expensive capital, overall declines in traffic show some evidence of slowing and the global aviation industry may have hit a bottom -- the key question is how soon and how rapidly demand will recover.
- While fuel prices have risen significantly from their lows and could see some spikes, they are still well below peak prices seen last year; it is unlikely oil prices can sustain higher levels for an extended period of time without an improvement in overall economic conditions -- any such improvement should also lead to improved passenger demand.
- The aviation industry has not been standing still – far from it! In response to the difficult environment, airlines have been cutting capacity significantly and will continue to do so and those that can afford to are moving to more modern fleets as a hedge against potentially higher fuel prices longer term.
- Tight capital has increased barriers to entry which appears to be adding to the willingness of incumbent carriers to make unprecedented capacity cuts (several airlines have begun to announce substantial planned additional cuts in the fourth quarter).
- Many airlines have shown a surprising resilience in their ability to find capital with several US carriers pre-selling frequent flyer miles for cash.

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- The so-called aircraft “funding gap” expected by many participants has failed to materialize so far as export credit agencies have stepped in to fill the void, and as manufacturers have juggled production slots and rates to focus on carriers most able to get financing.
- While some airlines are struggling to cover high dollar-based costs for fuel and aircraft in jurisdictions where currencies have fallen, fears that many currencies would collapse as investors sought the relative safety of the dollar have waned.
- Globally, governments have not moved toward significant re-regulation of the airline industry and fears over renewed protectionism appear to have been exaggerated.
- While a weak economy will temporarily affect aircraft values and lease rates, with only about 2-3% of modern in-production aircraft parked, the latest generation aircraft appear to continue to be in overall demand.

For the second half of 2009 and into 2010, the aviation industry will likely see a continuing thaw in credit markets which should slowly increase the availability of financing as well as lower the cost over time. Banks that have been relatively inactive as they put their own houses in order should begin to return to the market by the end of the year. Also, airlines are likely to make significant additional capacity cuts after the Northern Hemisphere Summer peak season setting the stage for higher fares once demand improves. Globally, 2009 will see significant industry losses and some carriers with especially weak funding could fail in the fall. However, with capacity cuts in place, fewer start-up carriers being funded, lower overall fuel prices, improving fleet efficiency, and manufacturer delivery schedule adjustments, the industry will have made significant progress in setting itself up for a robust recovery once the overall economy begins to improve.

By Daniel W. Stone

General Aviation News

World

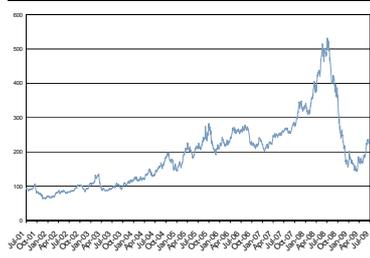
IATA loss forecast increases to 9 billion US-dollars

The International Air Transport Association (IATA), which represents 230 airlines worldwide, revised its airline financial forecast for 2009 to a global loss of 9 billion US-dollars. This is nearly double the industry body’s March estimate of a 4.7 billion US-dollar loss. IATA said carriers in all regions were expected to report losses, although it expects Japan, China and India to be hardest hit. Asia-Pacific airlines will post the largest losses at 3.3 billion US-dollars. Carriers in North America may report a loss of 1 billion US-dollars for the year, reversing a prediction of a profit of 100 million US-dollars for the region’s airlines. That would be a significant improvement over the 5.1 billion US-dollar loss in 2008, when soaring fuel prices hit many airlines there especially hard. Euro-

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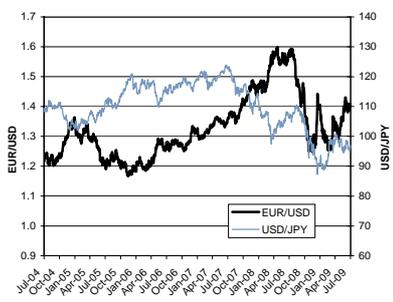
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Jet Fuel Price Index



Source: HSH Nordbank; Base year 1991 = 100; Average of the spot markets US Golf, US West coast, Mediterranean, Rotterdam, Far East Singapore.

Currencies



Source: Bloomberg

pean carriers are expected to post losses of 1.8 billion US-dollars with collapsing demand for premium services in all major markets served by the region's carrier. Middle East carriers, despite strong traffic growth, will see losses deepen to 1.5 billion US-dollars. The region's intercontinental hubs are vulnerable to recessionary impacts in both European and Asian source markets. Latin American carriers are expected to lose 900 million US-dollars and African airlines 500 million US-dollars.

IATA said that global airlines had experienced a "rapidly deteriorating revenue environment". Revenues are now expected to fall 15 percent across the industry, to 448 billion US-dollars this year because of the global economic crisis – a much steeper decline than after the 9/11 terror attacks in the United States. This is the most difficult situation that the industry has faced", IATA Chief Executive Officer Giovanni Bisignani said. "Our future depends on a drastic re-shaping by partners, governments and industry." Passenger traffic may fall by 8 percent to 2.06 billion travelers compared to 2.24 billion in 2008, while cargo demand will slump 17 percent. According to Bisignani, yields, a measure of average revenue per passenger-km, will fall an estimated 7 percent this year as fewer people purchase first- and business-class tickets and airlines reduce fares in an effort to win market share." IATA also revised its loss estimate for 2008 to 10.4 billion US-dollars from the previous estimate of 8.5 billion US-dollars.

Air Show orders down sharply from last year

Airbus came out of the Paris Air Show ahead of the game, netting 58 firm orders worth almost 6.4 billion US-dollars, while Boeing secured only one single order for two 737 aircraft from Japan's MC Aviation Partners. Airbus also reported preliminary commitments – yet to be placed in the order book – for 69 planes worth 6.5 billion at list prices at the biennial show. Most of the customers hail from Asia and Middle East, who bought mainly smaller jets for regional air travel. Qatar Airways placed an order for 24 single-aisle aircraft valued at 1.9 billion US-dollars, comprising the purchase of 20 A320s and four A321 aircraft. Vietnam Airlines signed a 1.4 billion US-dollar firm order for 16 A321s and Air Asia X ordered 10 A350-900s valued at about 2.4 billion US-dollars. Other firm orders came from Cebu Pacific, Aigle Azur and Zest Air of the Philippines. In addition, Airbus received "Memoranda of Understanding" commitments from Wizz Air, Paramount Airways, Turkish Airlines and Vietnam Airlines. At last year's Farnborough Air Show, which alternates with Paris, Airbus racked up firm orders for 247 aircraft and Boeing sold 197 planes. Boeing and Airbus are headed for their worst annual order tally in at least 15 years as struggling airlines cancel or defer almost as many planes as they are buying. Last year both aircraft manufacturers took net orders for 1,439 planes combined. Boeing's orders on June 16 totaled 76 planes this year, but with 66 cancellations its net score falls to just 10. Before the show, Airbus had 11 net orders and 32 gross orders. Its new net score is 69.

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Airline News

U.S. / Americas

Republic Airways to buy Midwest Airlines and Frontier Airlines

Republic Airways Holdings announced it will buy struggling Midwest Airlines from private equity group TPG capital for 31 million US-dollars in cash and debt. Paying 452 million US-dollars, TPG and minority partner Northwest purchased Midwest in January 2008, after Midwest rejected the takeover plan proposed by AirTran Holdings. The deal comes one day after Republic said it would buy bankrupt US regional carrier Frontier Airlines for 108.75 million US-dollars. If the deal is completed, Frontier would exit bankruptcy later this year and become Republic's subsidiary. Republic currently operates a regional airline under its own name as well as Chautauqua Airlines and Shuttle America. It does regional flying for several major carriers, such as American, Delta, US Airways, United and Continental. Republic's three units together have 212 regional jets and employ 4,500 workers.

Europe

Lufthansa proceeds with airline purchases

Lufthansa, Germany's biggest airline, has reached a deal to acquire bmi to become the second largest carrier at London Heathrow Airport. The airline said it had reached an agreement with Sir Michael Bishop, the co-founder of bmi, to buy the carrier in stages – ending a dispute that has simmered for months. The German carrier is to acquire Sir Michael Bishop's stake of 50 percent plus one share in bmi, boosting Lufthansa's stake in the carrier to 80 percent. As part of the deal, Bishop will receive 367.4 million US-dollars. Lufthansa is also in talks to buy the remaining 20 percent of bmi from Scandinavian airline SAS, according to a spokesman for SAS.

Last year Lufthansa took a 45 percent stake in Brussels Airlines, with the option to buy the Belgium airline outright in 2011. Lufthansa has now obtained permission from EU antitrust authorities to buy Brussels Airlines in a deal worth up to 347 million US-dollars after it agreed to let rivals fly on some of its routes.

Lufthansa is also awaiting EU clearance to buy state controlled Austrian Airlines as regulators look into whether debt agreements break government-aid rules.

Virgin Atlantic orders 10 Airbus A330s

British based Virgin Atlantic Airways, has ordered 10 Airbus A330-300 passenger jets worth more than 2 billion US-dollars at list prices. Virgin Atlantic, which currently has 38 aircraft in its fleet, will buy six of the wide-body, twin-engine jets from Airbus and will lease another four from AerCap, the Netherlands-based aircraft leasing company. Virgin said the planes, which each sit up to

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270 passengers, would be delivered between 2011 and 2012. The new aircraft will allow Virgin to fly to new destinations from London such as Beijing, Cancun and Vancouver. They are more fuel-efficient and have lower maintenance costs. Virgin Atlantic, which is 51% owned by Richard Branson's Virgin Group and 49% by Singapore Airlines Limited, said it remained a customer of Boeing and its order for 15 of the 787 Dreamliners remained intact, but it needed the extra capacity while it awaited delivery of aircraft whose development has been beset by delays. Virgin is also in talks with Airbus to buy 50 A350 aircraft from 2014.

SkyEurope to reorganize under creditor protection

Struggling Slovak low-cost airline SkyEurope said it had obtained creditor protection from a Bratislava District Court to restructure its debt, as it seeks new equity investors. The budget airline, listed in Vienna, said in a statement it would continue the full operation of scheduled and charter flights and preserve jobs. The airline announced earlier this year that its business had been hardly hit by the global economic slump and that it had to reduce its fleet to just five planes from the 15 Boeing 737s it operated in late 2008. Previous efforts through Rothschild, the UK investment bank, to find fresh investors or to structure a rescue deal with York Capital Management, the US-based hedge fund and SkyEurope's main shareholder and creditor, have ended without success. The airline, with bases in Prague, Bratislava, Kosice and Vienna never posted a profit in the six years of its existence. In its fiscal year ending Sept. 30, 2008 the company posted a net loss of 18.94 million euros, compared with a 15.68 million euro loss in the previous fiscal year.

Asia Pacific & Middle East

China Eastern and Shanghai Airlines in merger talks

China Eastern Airlines (CEA) will combine with Shanghai Airlines (SAL) after joint losses of 2.4 billion US-dollars last year prompted the government to bail out the two state-controlled carriers. China Eastern Airlines confirmed it is in merger talks with smaller rival Shanghai Airlines, saying the two airlines have agreed on several key issues involved in the tie-up. The airlines have set up a task force to work on the proposed merger. China Eastern's Chairmen Liu Shaoyong is head of the joint task force. The combined group would have 306 planes and more than 600 routes, giving it a 50 percent share of air travel in China's financial capital. According to Liu, the specific merger plan will have to be approved by the boards of CEA and SAL and the relevant government organs first before it can be made public. Liu also said that China Eastern remains open to foreign investors despite the proposed merger, but noted that it isn't currently in talks with potential investors. After years of double-digit growth, China's airlines are facing strong headwinds as the global financial crisis strikes home. Its top three carriers, Air China, China Southern Airlines and China Eastern lost more than 4 billion US-dollars in last year.

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Japan Airlines gets government bailout

Japan Airlines (JAL), Asia's largest carrier by revenues, secured 1 billion US-dollars in emergency funding, after the Japanese government agreed to guarantee new loans to the deeply indebted group. Any loan would be made through the state owned Development Bank of Japan (DBJ). "The DBJ will extend loans, not unconditionally, but on the premise that (the airline) must do its best to improve management," Finance Minister Kaoru Yosano said. Earlier this year, JAL, hit by the global economic downturn, looked to borrow up to about 2.1 billion US-dollars from a government low-interest loans scheme. JAL said it needs cash to roll over debt and to overhaul its ageing fleet. The airline has sold non-core assets, cut jobs and eliminated unprofitable routes, but creditors say more radical measures are needed. Last week, JAL announced plans to cut seven more domestic routes and one international route this year.

Upcoming Events

2009	Organization/Company	Event/Announcement
July		
7	ACE Aviation Holdings	Results of Q1
10	IEA	Monthly Oil Market Report
16	AMR	Half Year Results
21	Southwest Airlines	Half Year Results
	Continental Airlines	Half Year Results
22	Delta Air Lines	Half Year Results
	UAL	Half Year Results
	JetBlue Airways	Half Year Results
	US Airways	Half Year Results
23	Boeing	Half Year Results
24	Alaska Air Group	Half Year Results
27	Ryanair	Results of Q1
28	EADS	Half Year Results
	Singapore Airlines	Results of Q1
29	AirTran Holdings	Half Year Results
30	Deutsche Lufthansa	Half Year Results
	Air France-KLM	Results of Q1
31	Korean Air Lines	Half Year Results
	All Nippon Airways	Results of Q1
	Thai Airways	Half Year Results
	British Airways	Results of Q1

Source: HSH Nordbank, Bloomberg

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