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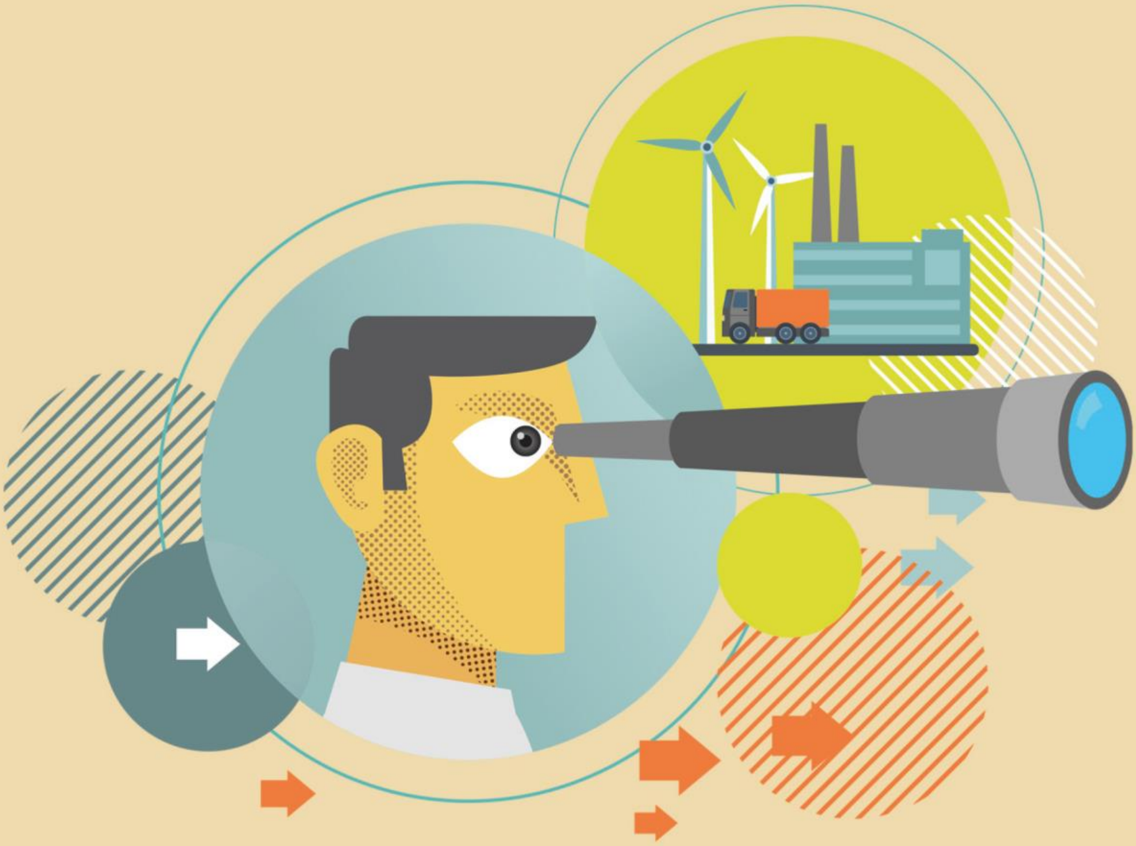

Growth in Latin America

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Sector Research: Aviation

6. September 2022

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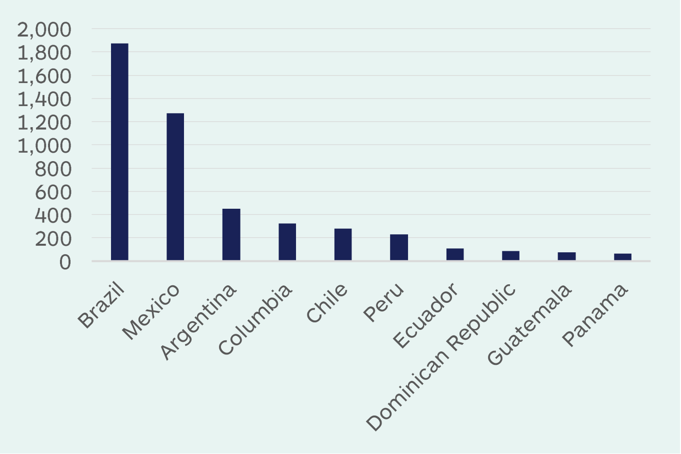
Introduction

Above-average growth in Latin American passenger air traffic, promising prospects
In this study, we look at the growth prospects for passenger air traffic in Latin America. We cover the largest countries and economies (Brazil, Mexico, Colombia and Argentina) in the region and the outlook for their economic development. We then provide an overview of the development of passenger air traffic in Latin America and its future prospects, the market players and their market positions, the ongoing consolidation, the fleets and profitability of the airlines and the future prospects for passenger air traffic. In the past, the Latin American aviation market was characterised by above-average growth. In contrast to other regions, this growth was often independent from the economic development. Thus, passenger air traffic also increases during recessions. The reasons here lie primarily in a continuously growing middle class, long distances, unfavourable topography and poor infrastructure.

The largest countries and economies in the region

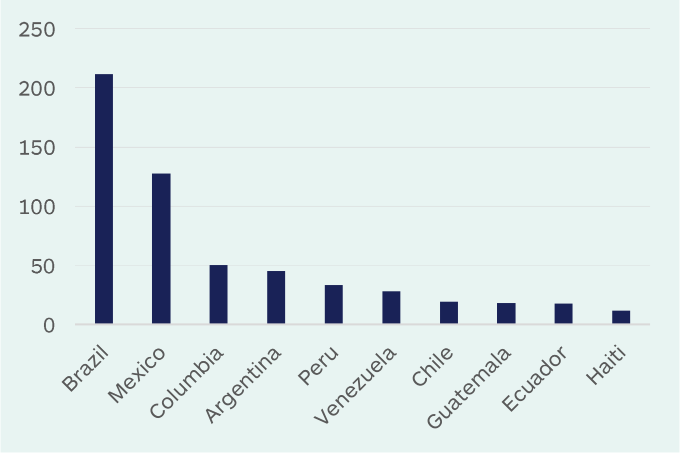
Brazil, Mexico, Argentina and Colombia the most important countries
In terms of both GDP and population, Brazil, Mexico, Argentina and Colombia are the most important countries in Latin America. The focus of this study is therefore on these four countries.

GDP 2019 in bn USD



Source: IMF

Population 2020 in m

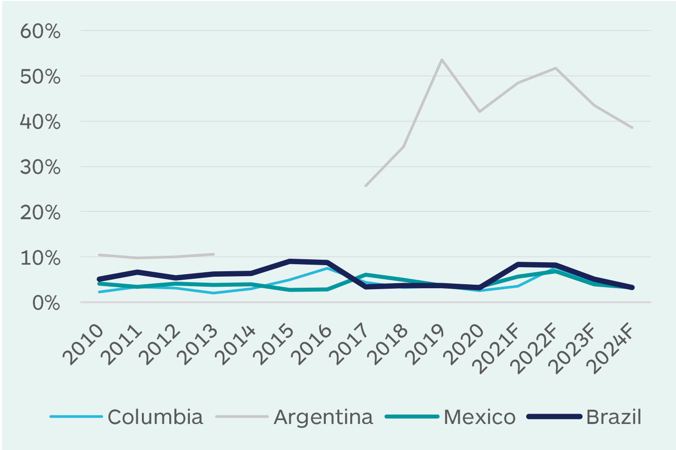


Source: IMF

Development of GDP

Source: IMF

Development of Inflation



Source: IMF

Note: No inflation data are available for Argentina for the years 2014-2016.

GDP development in the past often very different

The GDP of the four largest countries in Latin America decreased significantly in 2020 in the wake of the Covid 19 pandemic. Only in Brazil was the decline less severe, at -3.9%, due to effective fiscal measures. The recovery from the pandemic was uneven across the four countries. Brazil and Colombia had probably already reached their pre-crisis levels last year. For Argentina, the IMF expects it to happen this year, and Mexico will need even a year longer, as the recovery here was comparatively small despite the sharp downturn.

While the four economies showed similar developments during the pandemic, this was not the case in the previous decade. Brazil and Argentina were in recession temporarily. In contrast, Mexico and Colombia had recorded continuous growth.

Brazil: one of the largest countries worldwide, currently low growth

With approximately 214 million inhabitants, Brazil is by far the most populous country in Latin America (number six worldwide). The country's strengths lie primarily in its diversified economy and its growing middle class. In contrast, Brazil suffers from political and social tensions due to corruption and large income inequality.

The growth of the Brazilian economy was fragile before the pandemic, after the country recovered from the recession in 2015 and 2016. Thereafter, the pandemic stopped the sluggish growth (GDP 2019 +1.2%). However, the fiscal measures taken proved very effective, so that the economy contracted less than that of other countries in Latin America in 2020 (GDP -3.9%).

Further economic development is likely to be moderate due to the expiry of support measures and the tightening of monetary policy. After GDP rose by 4.6% in 2021, the IMF expects an increase of only +0.8% this year and 1.4% in 2023. A gradual revival of the economy and higher commodity exports should support the slight upswing. In addition, a slight upturn in private consumption is expected.

Mexico: Economy will not reach pre-crisis level before 2023
With 130 million inhabitants, Mexico is the second largest country in Latin America and the tenth largest in the world in terms of population. In principle, Mexico is still benefiting from the pro-business reforms of the last decade. At the same time, however, the country has to contend with a number of challenges. These include a high dependence on the US business cycle (about 80 % of exports), unequal income distribution, high poverty rates and security problems related to drug trafficking. In addition, the fight against corruption is below the Latin American average.

The Covid 19 pandemic hit the Mexican economy hard. The small size of the government's stimulus package led to a sharp drop in GDP of 8.2% in 2020, after economic growth had already declined slightly by 0.2% in 2019. After GDP recovered by 4.8% last year and an expected rise of 2.0% this year, IMF expects that Mexico's economy will not return to pre-crisis levels before next year.

Argentina: no end of extremely high inflation foreseeable
Argentina has a developed industry and a better-educated workforce compared to other countries in the region. However, political and economic instability has characterised the past. In addition, the country suffers from extremely high inflation (+52% in 2022F). Inflation has not been in the single-digit percentage range for over a decade.

Due to extensive lockdowns, the pandemic led to a deeper recession (GDP 2020F: -9.9%) than the Latin American average (-6.5%). The economic and social impact led to an increase in poverty levels and social unrest. More than 40% of the 46 million inhabitants are now considered structurally in poverty. Argentina was also in recession even before the pandemic. In 2018, Argentina's GDP fell by 2.6% and by 2.0% in 2019.

Nevertheless, the IMF expects that Argentina will return to its pre-crisis GDP already this year. Strong base effects and a recovery in agricultural exports combined with the gradual revival of the economy led to a very strong recovery in 2021 (+10.2%). In the medium term, economic growth should be around 2%. Inflation will probably remain extremely high according to IMF.

Colombia: above-average economic growth
Despite its smaller land size, Colombia has the third most inhabitants in Latin America, as it is more densely populated. The country's strengths are its natural resources, higher medium-term growth (annual GDP growth around 3.5% in the next few years) and a business-friendly environment. Comparatively lower inflation, a flexible exchange rate and the fiscal policy have boosted confidence and provided a degree of stability. In contrast, Colombia continues to suffer from a difficult security situation with protracted insurgencies, drug trafficking, corruption and uneven income distribution.

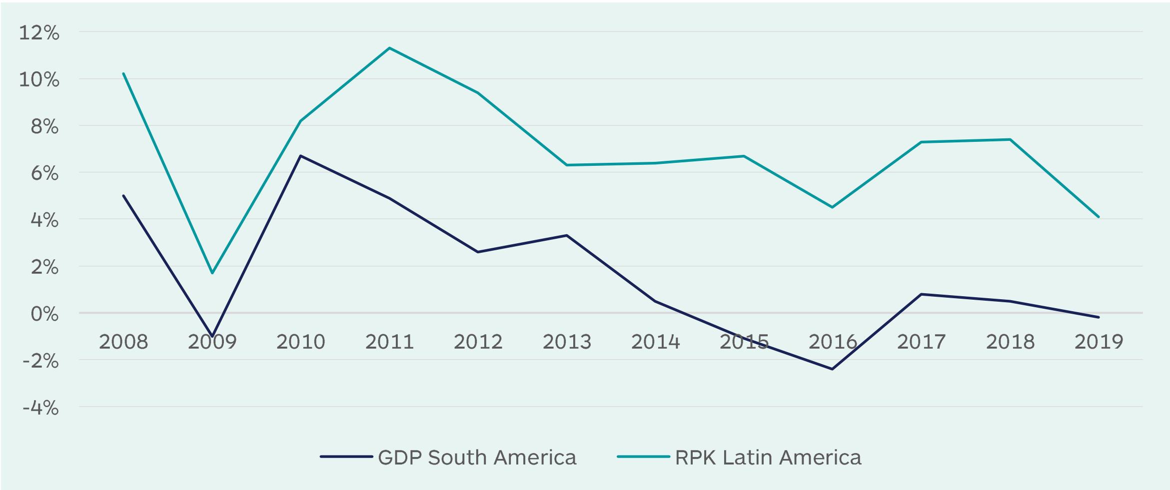
In 2020, the economy shrank by 7.0% due to the pandemic. However, the government quickly responded to the pandemic with a series of measures and a large fiscal package amounting to around 8% of GDP. As a result, the economy began to recover in the second half of 2020. The gradual easing of lockdowns, an upturn in exports, a recovery in the labour market, higher private consumption and a new investment cycle have boosted growth, so that the Colombian economy already returned to pre-crisis levels last year.

Development of Latin American passenger air traffic

Passenger air traffic growth independent of economic development
In the period from 2008 to the last year before the pandemic, 2019, South America suffered several times from negative economic growth. This was the case during the financial crisis, but also in 2015 and 2016 when Brazil, among others, was in recession.

The economic development principally affect passenger air traffic, but at the same time, growth was not negative during this period. During the financial crisis, revenue passenger kilometres (RPK) increased by 1.7%. In 2015 and 2016, passenger traffic was even clearly positive.

Development of GDP and passenger air traffic



Sources: IMF, IATA

Note: While the data for economic growth refer to South America, for air traffic growth they refer to Latin America. However, the different regional focus does not lead to a fundamental distortion of the statement

Air traffic grows twice as fast as the economy - despite challenges
Strong so-called base growth is mainly driving passenger air traffic in Latin America. Additionally, the economic development is also influencing. The reasons for this predominately independent growth are:

- Unfavourable topography
- Long distances
- Poor infrastructure
- No high speed trains
- Growing middle class

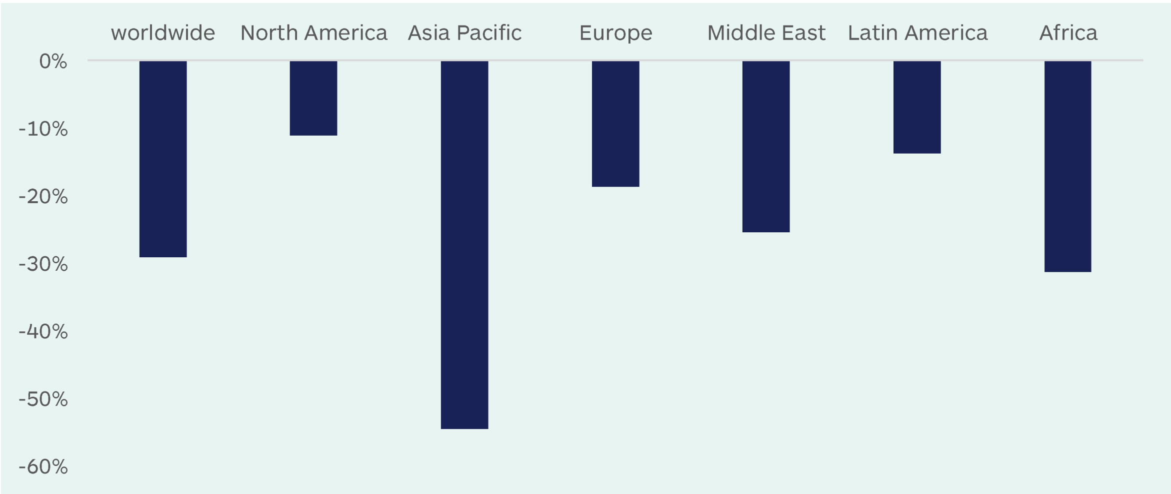
While long-term economic growth in South America is around 2.5%, passenger air transport is growing at around twice that rate, despite political and social tensions and widespread corruption. This positive development is surprising given the challenges the region is facing. However, it also shows the strong influence of the drivers mentioned above.

In our estimation, this development is likely to continue in the future, as some drivers are not changing at all (topography, long distance) or changes are not foreseeable in the future (infrastructure, high-speed trains). Currently, each inhabitant of Latin America travels by air on average 0.5 times per year, compared to two to three times per person in Europe and the US. The middle class in Latin America should continue to grow in future. According to Airbus, the number of people with an annual income[1] between USD 20,000 and USD 150,000 will grow by an average of 1.4% per year to 469 million by 2030. By comparison, there will be no significant changes in the middle class in North America and Europe. Airbus expects the Latin American middle class to continue to grow, albeit at a slower pace, at an average annual rate of 0.6% between 2030 and 2040.

Globally second-fastest recovery in Latin America

Passenger air traffic in Latin America has recovered strongly from the Covid 19 pandemic, supported by large domestic markets and relatively few travel restrictions in many countries. In June 2022, passenger traffic was still 14% below pre-crisis levels. The region has thus recovered significantly better from the pandemic than the overall market (-29%). Only North America has recovered somewhat faster, with a gap of 11% compared to pre-crisis levels.

Development of passenger air traffic compared to pre-crisis level, as of June 2022



Source: IATA

Note: Changes in RPK in June 2022 compared to June 2019.

Regaining pre-crisis levels probably as early as 2023

The development year to date also contributed to this positive development. Revenue passenger kilometres increased by 99% in H1 2022, faster than the overall market (+83%). However, Europe and the Middle East have achieved growth rates above 200%.

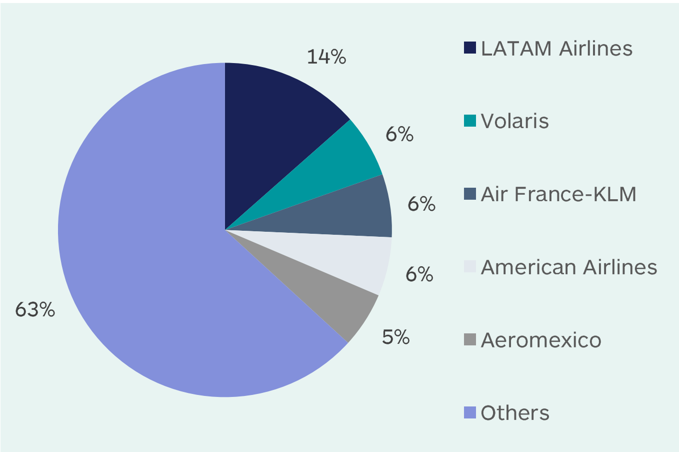
For 2022 as a whole, IATA expects revenue passenger kilometres in Latin America to be only 6% below pre-crisis levels in 2019. This assumes a full-year growth rate of 79% year-on-year, roughly a continuation of the trend seen in H1 2022. For next year, we expect a further recovery while growth rates normalise. We forecast an increase in RPK of around 9% for 2023. Latin America would thus be the only region in the world besides North America to regain the pre-crisis level of passenger air traffic as early as 2023.

[1] Airbus Global Market Forecast 2021-2040: Purchasing Power Parity at Constant 2015 Prices

Market shares in Latin American passenger air traffic

Latin American market comparatively strongly consolidated
Latam Airlines is the largest airline in Latin America with a strong market position in Brazil, Chile and Peru. It is currently one of the 20 largest airlines worldwide (17th[2]). Low-cost airlines play an important role in Latin America with an increasing market share of currently about 27%. They benefit from the strong focus on domestic routes as well as the drivers mentioned above (including unfavourable topography, no high-speed trains).

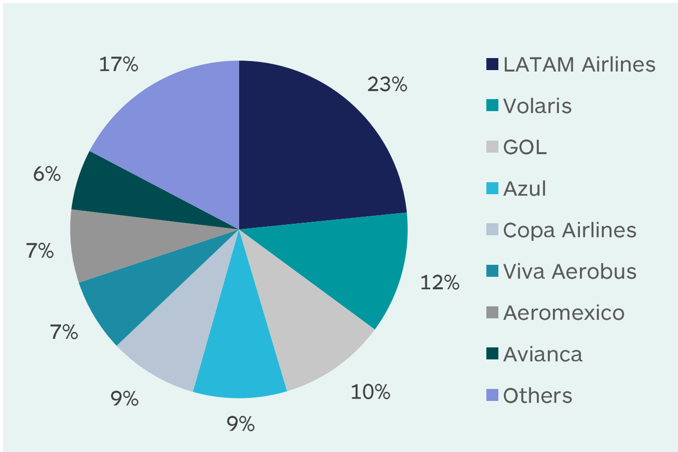
Market shares in Latin America, overall



Source: CAPA – Centre for Aviation

Note: All data refer to available seat kilometres in September 2022

Market shares in Latin America, routes within Latin America



Source: CAPA – Centre for Aviation

Note: All data refer to available seat kilometres in September 2022

There are only three major airlines in Latin America (Latam Airlines, Avianca and Aeromexico) that operate intercontinental long-haul routes. In contrast, many airlines have focused on routes within Latin America or on their respective domestic markets. Nevertheless, this regional market is comparatively highly consolidated. The three largest market players, Latam Airlines (legacy carrier, Brazil, Chile), Volaris (low-cost carrier from Mexico) and GOL (low-cost carrier from Brazil) combine a market share of nearly 50%. Including intercontinental routes, the market is much more fragmented. Although the Air France-KLM group and American Airlines do not principally offer routes within Latin America, they have large market shares due to their strong market position on transatlantic routes and on routes to the USA respectively.

[2] Measured in available seat-kilometres September 2022

Consolidation proceeds with formation of the Abra Group

The last decade has seen major consolidation in Latin America with the mergers of Avianca and TACA (now Avianca) and of LAN and TAM to form Latam Airlines. A new phase of consolidation in Latin America is now beginning. Avianca and the two low-cost carriers GOL (Brazil) and Viva Air (Colombia) are working to create a new airline group under the holding Abra. The three airlines will retain their own brands and operating segments.

The Abra group's market share[3] would be 10% (incl. intercontinental routes), similar to that of Latam Airlines. On routes within Latin America, the Abra group would have a market share of 19%. The three largest market players would combine a market share of more than 50% on routes within Latin America and thus contribute significantly to the further consolidation of the region.

However, there are also unsolved issues regarding the partnership strategy of the Abra Group. Avianca is a member of the Star Alliance. GOL does not belong to any airline alliance. However, American Airlines has taken a stake in the airline, which in turn is a member of the “One World” aviation alliance. Viva Air, meanwhile, has an interline agreement with the Mexican low-cost carrier Viva Aerobus.

Further consolidations seems likely

In early 2022, Brazil's Azul had also attempted its own consolidation approach when the airline tried to take over LATAM Airlines, which was under Chapter 11. However, the takeover did not materialise after Azul considered the valuation for Latam Airlines too expensive.

Consolidation in Latin America should continue in the medium to long term. This should fundamentally benefit the competitiveness and profitability of the major players.

One potential candidate that could be involved in the consolidation process tends to be Azul, in our view. With its focus on the low-cost business model and the Brazilian market on the one hand, and on selected long-haul routes on the other, it is neither a niche player nor a typical low-cost carrier. Conversely, Azul lacks economies of scale compared to Latam Airlines and the Abra Group. In this respect, a merger of Latam Airlines and Azul seems conclusive to us in general. In addition, we consider consolidations in Mexico (Volaris, Viva Aerobus) and Chile (Sky Airline, JetSmart) conceivable in principle.

[3] Measured in available seat kilometres

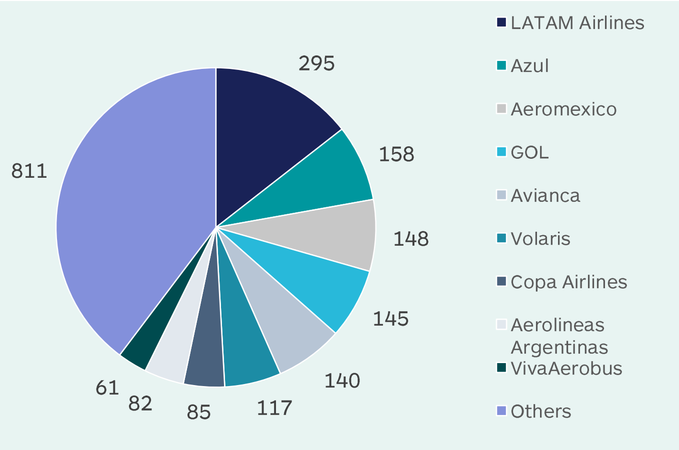
The fleets of Latin American passenger airlines

Latam Airlines has the largest fleet, overall storage ratio slightly below global average
With 295 aircraft in service and in storage, Latam Airlines, the largest airline in Latin America, also has by far the largest fleet. The Airbus A320 family accounts for the majority of this fleet (80%). The airline also operates several wide-body Boeing 787s and Boeing 767-300ERs, as well as a few Boeing 777-300ERs.

Azul, Aeromexiko, GOL and Avianca follow at a considerable distance in terms of fleet size. It is remarkable that the second largest Latin American airline, Volaris from Mexico, has a comparatively small number of aircraft. This indicates that the low-cost carrier uses its fleet much more intensively in comparison.

Currently, 17% of the Latin American passenger aircraft fleet is temporarily out of service, slightly less than the global average. With 26 aircraft or a storage ratio of 18%, the Brazilian low-cost carrier GOL currently has a comparatively large number of aircraft temporarily parked. The other major airlines in Latin America have a much smaller proportion of their fleet currently in storage.

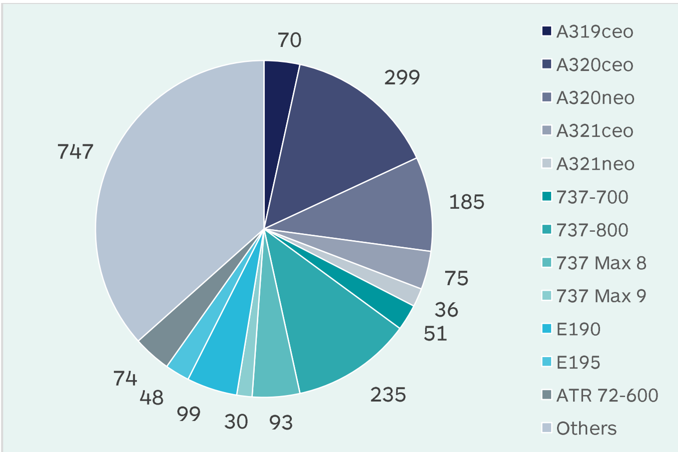
Passenger airline fleets, by airline



Source: Cirium Flight Fleet Analyzer

Note: aircraft in service and in storage

Passenger airline fleets, by aircraft type



Source: Cirium Flight Fleet Analyzer

Note: aircraft in service and in storage

Narrow-bodies widely used, wide-body aircraft of no major relevance
Similar to the global average, the fleets of Latin American airlines are dominated by narrow-bodies (Airbus A320 family and Boeing 737). Wide-body aircraft play a minor role. This is the result of the business models of Latin American airlines, which often focus on continental or domestic traffic. Of the major market players, only the network carriers Latam Airlines, Aeromexico and Avianca offer long-haul flights.

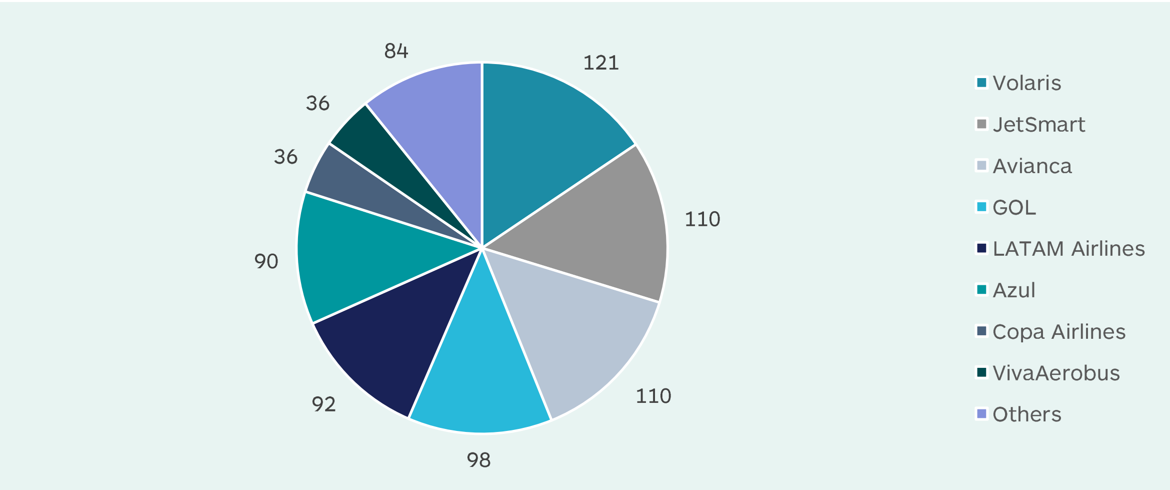
The use of turboprops is above average in Latin America. Apart from ATRs, mainly small turboprops are in operation, which service tiny niche routes. As with the global trend, however, we expect the relevance of turboprops also to decline in Latin America.

Aggressive growth of Chilean low-cost carrier JetSmart
In the past year, Latin American airlines have started to upgrade their fleets to be competitive for the post-Covid 19 pandemic. Airlines in the region continue to focus on the next generation of narrow-bodies (particularly the Airbus A320neo family) to improve fuel efficiency and thus competitiveness.

Low-cost carriers Volaris (Mexico) and JetSmart (Chile) as well as legacy carrier Avianca from Colombia have the largest order books. Their order backlog consists almost exclusively of Airbus A320neo family aircraft.

JetSmart's very large order for 110 Airbus is striking, compared to a current fleet of just twelve Airbus A320 Family aircraft. This large order book illustrates the aggressive capacity growth plan the low-cost carrier is likely to seek over the next few years. The order books of Volaris and Avianca are roughly in line with the current fleet size and are likely to represent a mix of replacement and growth investments. This is also true for the order books from Gol, Latam Airlines and Azul, although Latam Airlines' order is comparatively small in comparison to the current fleet.

Order book of Latin American passenger airlines



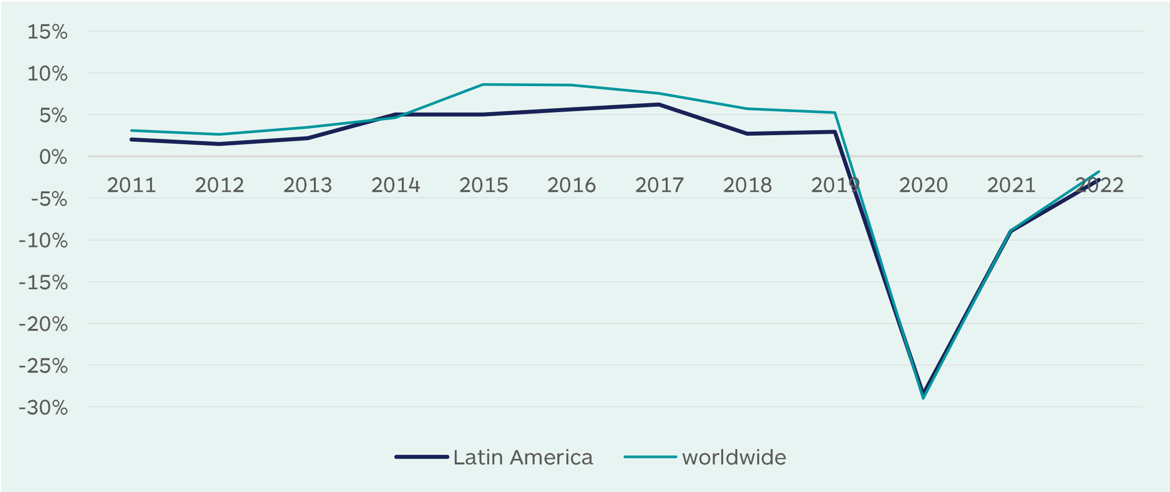
Source: Cirium Flight Fleet Analyzer

Profitability of Latin American airlines

Hardly any government support during the pandemic
The Covid 19 pandemic was particularly tough for Latin American airlines. Even the strongest and largest airlines in the region suffered. Due to little government support, the major legacy carriers have filed for bankruptcy. Several smaller airlines have disappeared from the market.

Traffic in Latin America recovered strongly in 2021, supported by domestic markets and relatively few travel restrictions in many countries. However, the financial outlook for some airlines remains fragile.

Operational performance (EBIT margin)



Source: IATA

Alignment of operating profitability with the global average

Traffic in Latin America has been recovering strongly since 2021, supported by domestic markets and relatively few travel restrictions in many countries. Demand (RPKs) this year should reach 94% of pre-crisis level (2019) according to IATA.

Latin American airlines are passing on much of the increased fuel costs through higher ticket prices. However, the financial outlook for some airlines remains fragile. Challenges such as high fuel costs, currency fluctuations and general cost increases, as well as political uncertainties, remain, as do tax issues.

IATA expects the region to post a net loss of USD 3.2bn this year. The average operating margin (EBIT margin) is -2.8%, only slightly lower than the global average of -1.8%. However, this year's expected net income margin[4] of -8.9% is well below the global average of -1.2%.

In the years before the Covid 19 pandemic, Latin American airlines' operating profitability was below the global average. However, since 2020, it has been at about the same level. Airlines that have completed or are still in Chapter 11 restructuring, as well as those that did not require bankruptcy protection, have taken a variety of measures to become more competitive and efficient. As consolidation progresses and restructurings are successful, the level of operating profitability should continue to converge with the global average in principle.

[4] In contrast to EBIT, net income includes the financial and tax result. Often, non-operating earnings are also not included in EBIT.

Conclusion

Above-average growth independent of the economy and crises
Latin American passenger air traffic is characterised by above-average growth. At least this was the case before the Covid 19 pandemic. This development was often independent from economic development, so that passenger traffic continued to grow even during recessions. The drivers for this development are:

- Unfavourable topography
- Long distances
- Poor infrastructure
- No high speed trains
- Growing middle class

These drivers are so strong that passenger air transport is defying even further challenges such as political and social tensions and is growing on average twice as fast as the economy over the long term. This trend is likely to continue in future, as some drivers are not changing at all or not in the near future.

Restructuring and consolidation strengthen Latin American airlines
The pandemic was particularly painful for Latin American airlines because, unlike other regions in Latin America, there was hardly any government support. As a result, several smaller operators disappeared from the market and all major legacy carriers had to file for Chapter 11, during which they have successfully restructured, however, or are doing so. Other airlines have also made a number of efforts to become more competitive in the coming years.

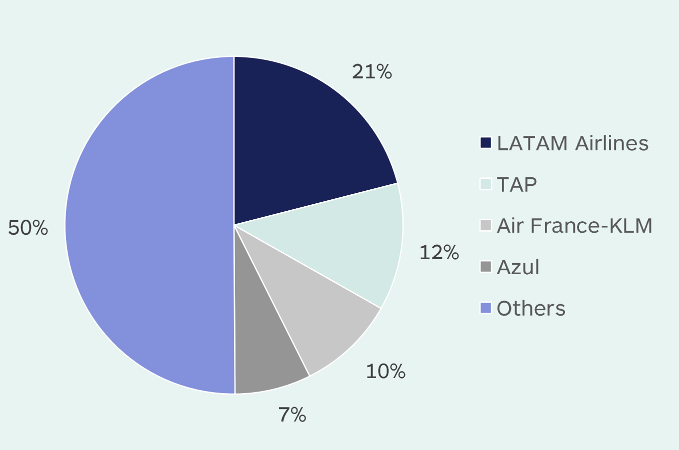
Supported by large domestic markets and relatively few travel restrictions in many countries, passenger traffic in Latin America recovered more quickly from the Covid 19 pandemic than in other regions. Only in North America has the recovery been slightly faster. Latin America will also be one of the first regions in the world to recover to pre-crisis levels. However, the financial outlook for some airlines remains challenging for the time being due to high fuel costs, currency fluctuations and general cost increases, but also political uncertainties.

Meanwhile, there are only three major network carriers in Latin America (Latam Airlines, Avianca and Aeromexico). The regional market is also comparatively highly consolidated. Latin America's airlines strongly focuses on the regional market, so that airlines from North America and Europe also have larger market shares due to their broad presence on intercontinental routes.

The last decade has seen major consolidations in Latin America. This development is now continuing with the creation of the Abra Group, which is to include legacy carrier Avianca and the two low-cost carriers GOL (Brazil) and Viva Air (Colombia). Consolidation in Latin America should continue in the future, leading to a more profitable market. As a result, and due to the successful restructuring, the operating profitability in Latin America should principally continue to converge with the global average.

Appendix: Market shares in the major countries

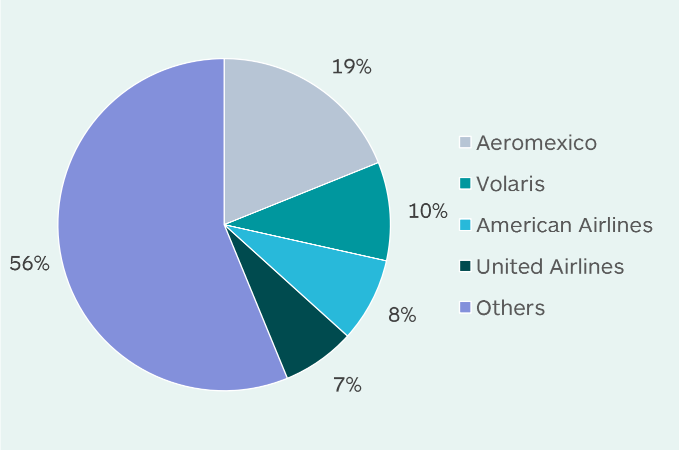
Market share in Brazil



Source: CAPA – Centre for Aviation

Note: All data refer to available seat kilometres in September 2022

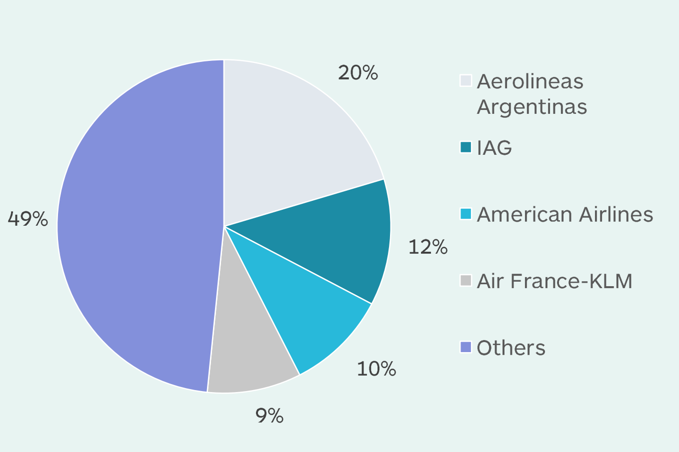
Market share in Mexico



Source: CAPA – Centre for Aviation

Note: All data refer to available seat kilometres in September 2022

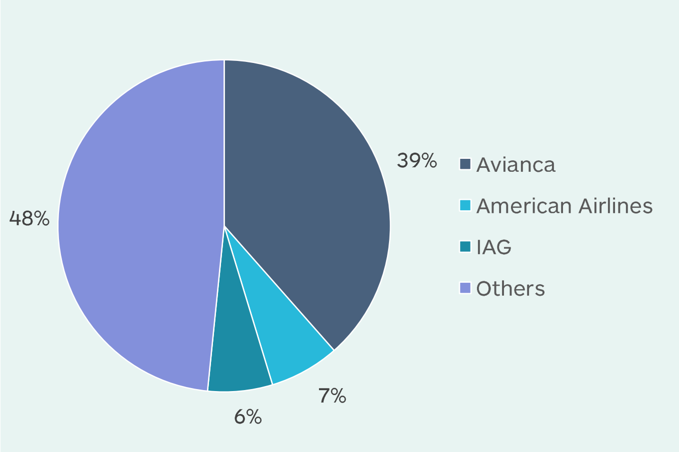
Market share in Argentina



Source: CAPA – Centre for Aviation

Note: All data refer to available seat kilometres in September 2022

Market share in Columbia



Source: CAPA – Centre for Aviation

Note: All data refer to available seat kilometres in September 2022

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