

ALAFCO Aviation Lease and Finance Company K.S.C.P.



Quarterly Aviation Industry Performance

(April– June 2016)

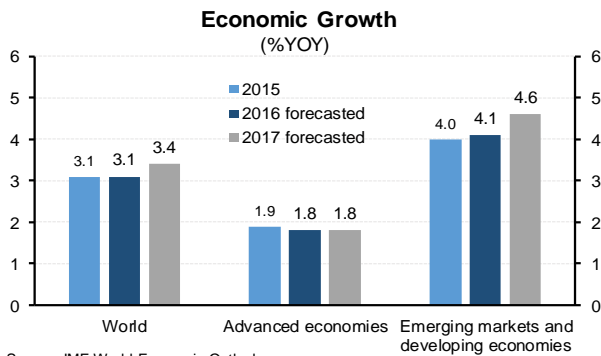
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2016 global growth prospects weaken

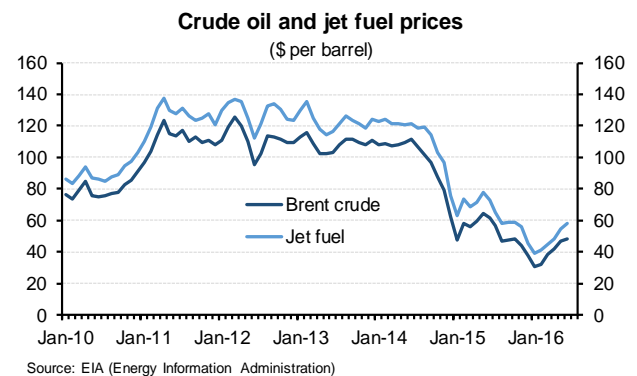


The outlook for the global economy has worsened, despite better-than-expected performance in early 2016. The International Monetary Fund (IMF) has revised down its growth forecasts, in light of the outcome of the UK vote in favor of leaving the European Union and the implied downside risk to the global economy. World economic growth is now expected to stall at 3.1% this year, and to pick-up to 3.4% in 2017.

Growth in most advanced economies is expected to remain weak. The Brexit vote implies substantial increase in economic and political uncertainty, which is likely to have negative consequences – especially on advanced European economies. This uncertainty is projected to take a toll on confidence and investment, including through its repercussions on financial conditions and market sentiment. The IMF downgraded the growth forecasts for the UK, and – to a lesser extent – the EU. Meanwhile, the impact of the Brexit on the US is expected to be muted.

Prospects for several large emerging economies have improved – in particular Brazil and Russia. Both countries are expected to remain in recession in 2016, though the decline in growth is now projected to be less severe. The IMF projects that the two economies will return to positive growth next year. In China, the near-term outlook has also improved due to recent policy support – including cuts in benchmark lending rates and expansionary fiscal policy.

Oil and fuel prices strengthen in 1H2016

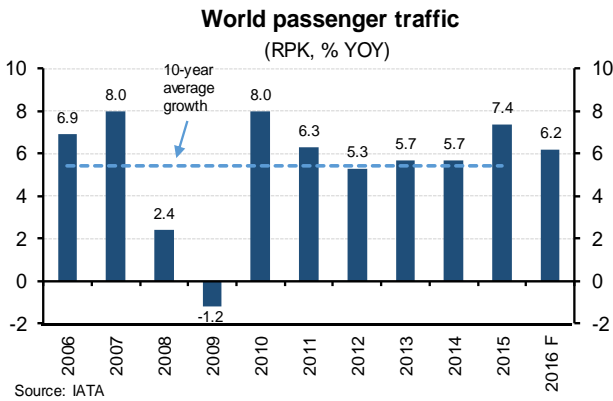


Oil prices strengthened in the first half of 2016, reaching an 8-month high of \$48 per barrel in June. Brent crude prices, an international benchmark, recovered by some \$18 in the first six months of 2016, after having hit a 12-year low at the start of the year. However, oil prices are still around \$13 lower than their levels last year.

Significant outages of global oil supply contributed to rising oil prices. This includes supply disruptions in Canada resulting from wildfires, and in Nigeria – Africa’s largest producer – following militant attacks on oil facilities. A weaker US dollar also contributed to the recent rise in dollar-denominated crude prices. However, concerns over future economic growth and an easing of oil supply disruptions could contribute to downward pressure on oil prices in the second half of the year.

Similarly, jet fuel prices also strengthened in the first half of 2016 – but are still 20% lower than their levels last year. According to IATA (The International Air Transport Association), the share of fuel spend will fall to less than 20% of total operating costs – the first time since 2004. This is compared to 28% in 2015 and 32% in 2014. The decline in fuel prices has also contributed to a 5% year-on-year fall in airfares so far this year. But with the recent rise in oil prices, the stimulus to travel demand from lower airfares is likely to fade in 2H2016.

Global air travel to moderate in 2016

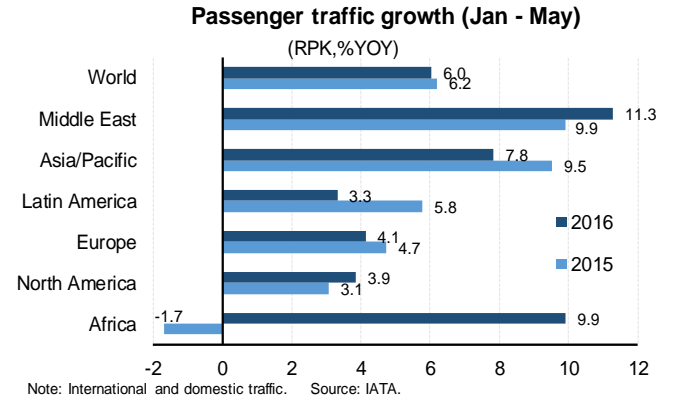


Following a bumper 2015, global air travel is expected to see a more moderated pace of demand growth in 2016. IATA expects growth in world passenger traffic to slow from 7.4% to around 6% this year – nevertheless, this is still above the average traffic growth rate seen over the past decade.

Despite the stimulus from lower air fares, a number of factors have resulted in slower traffic growth. This includes the continuing terrorist activities – as was the case with the deadly airport attacks in Brussels and Istanbul in March and June 2016. More significantly, moderating traffic growth reflects the fragile state of the world economy and lower growth forecasts for 2016.

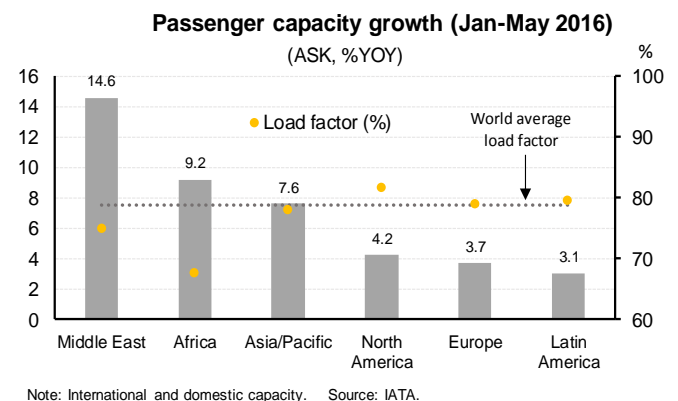
Moreover, downside risks to passenger traffic have increased. Following Britain’s exit from the EU – the fallout of the Brexit vote could affect the air transport industry from both economic and regulatory perspectives. IATA estimates that UK passenger numbers could be 3-5% lower by 2020, driven by the expected downturn in economic activity and a weaker sterling. On the subject of regulation, a post-EU Britain no longer enjoys automatic access to the EU’s single aviation market – which allows its members the freedom to operate anywhere in the EU without restrictions on capacity, frequency and pricing. Not only will this impact UK carriers, but also airlines within the EU for whom the UK is an important market. Nevertheless, the UK might be expected to negotiate with the EU on continued access.

But early 2016 traffic growth still strong

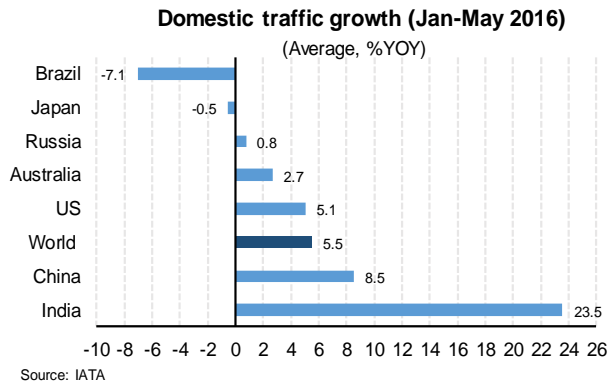


World passenger traffic grew by a robust 6% in the first five months of 2016 – almost in line with last year’s pace. Slower traffic growth in some regions were offset by improvements in other regions. The Latin American aviation market remains under pressure from weak economic conditions, while European traffic shows signs of being affected by terrorist events. Meanwhile, air traffic in Africa witnessed a large improvement – thanks to expansion of international networks by the region’s carriers, particularly Ethiopian Airlines. Air traffic in the Middle-East – the fastest growing region in terms of passenger traffic – has now reached double-digit growth rates.

World passenger capacity also grew by around 6% in the first 5 months of 2016, in line with traffic growth. In the Middle East, despite exceptionally fast growth in traffic, passenger capacity is growing even faster as carriers invest heavily in new and larger aircraft – which has driven down passenger load factors and yields.



Mixed performance in domestic markets



Domestic air travel comprises one-third of the world's total traffic. Growth in domestic passenger traffic around the world averaged 5.5% in the first five months of 2016, compared to 6% in the same period last year.

The US and China hold the largest domestic aviation markets. The US domestic market is by far the largest, with a 15% share of the world's domestic traffic. US carriers have been focusing their efforts on their large domestic market over the past year or so. Domestic China – the second largest at an 8% market share – continues to expand strongly despite slowing Chinese economic growth.

The domestic India market has seen extraordinary growth rates over the past year or so. In 2015, it overtook the Japan and Australia domestic traffic in terms of market share. The double-digit growth in the domestic Indian traffic has been supported by strong economic growth rates and sizeable increases in passenger capacity.

Meanwhile, ongoing recessions in Brazil and Russia have continued to affect their domestic traffic. During the first five months of 2016, domestic Brazil experienced a 7% year-on-year contraction and Russian domestic traffic saw flat growth.

Another year of record airline profits

Airlines Financial performance

Region	Net profit (US \$ billion)			
	2015	2016F	change	margins
World	35.3	39.4	4.1	5.6%
North America	21.5	22.9	1.4	10.8%
Asia-Pacific	7.2	7.8	0.6	3.9%
Europe	7.4	7.5	0.1	4.0%
Middle East	1.4	1.6	0.2	2.5%
Latin America	-1.5	0.1	1.6	0.4%
Africa	-0.7	-0.5	0.2	-3.3%

Source: IATA

Airlines globally are expected to register another year of record profits in 2016. After reaching an all-time high of \$35 billion in 2015, IATA projects that the combined profits of airlines in the world will rise further to around \$39 billion this year – thanks to lower fuel costs.

The improvement in the financial performance is expected across all regions – led by North America. The strongest financial results are expected to be posted – once again – by North American carriers, who have largely driven the improvement in the industry's financial performance in recent years, thanks to consolidations and capacity discipline. Meanwhile, the largest improvement is expected in Latin America which posted losses last year – though profits for carriers in the region remain amongst the weakest. □