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

Quarterly Aviation Industry Performance

(October– December 2016)

Prepared by: Strategic Planning department

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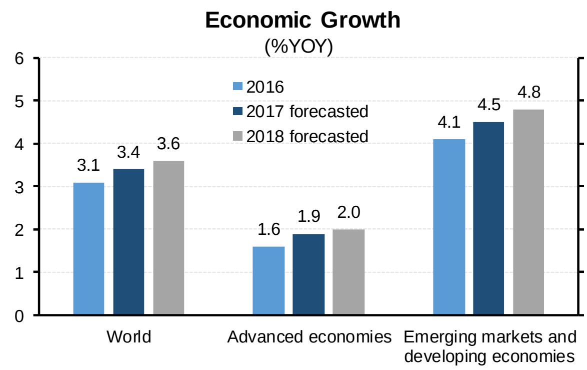
Economic growth picks up in 2017



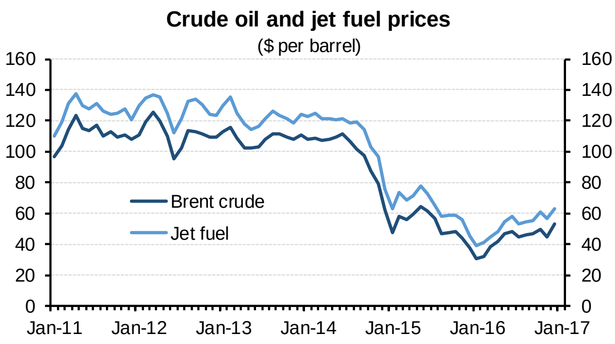
Source: IMF World Economic Outlook (Jan 2017)

Global economic growth is forecasted to pick up pace over the next two years, following subdued growth last year. The IMF projects world economic activity to accelerate to 3.4% in 2017 and 3.6% in 2018, from 3.1% in 2016. The improved outlook is largely driven by expectations of policy stimulus in the world's two largest economies – the US and China.

Growth in advanced economies is expected to recover on the back of a projected fiscal stimulus in the United States. The expansionary policy stance of the new US administration is forecasted to provide a boost to the US economy over the next two years. Meanwhile, growth in the Euro Area and UK is expected to slow – reflecting political and economic uncertainty from Brexit as well as the outcome of the elections around Europe.

Growth in emerging and developing countries is anticipated to accelerate over the next two years. Russia and Brazil are expected to return to positive growth rates, following recessionary conditions over the past two years. Economic growth in India is expected to accelerate to between 7-8% in 2017 and 2018 – the fastest pace amongst the world's largest economies – despite downward revisions to growth resulting from the government's recent currency demonetization. And while economic activity in China is expected to slow, growth prospects have improved based on expectations of continued policy support from the government.

Output cuts to support oil prices in 2017



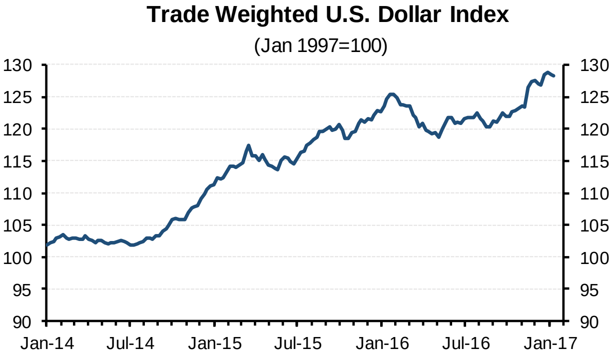
Source: EIA (Energy Information Administration)

Oil prices accelerated at the end of 2016, exceeding the $50 mark. Brent crude prices, an international benchmark, reached $53 per barrel in December 2016 – its highest level in a year and a half and some $23 higher than its level at the start of 2016. Despite strengthening over the past year, Brent prices averaged just $44 per barrel for the year, its lowest annual average since 2004. The US energy agency (EIA) expects average crude prices to recover to an average of $54 this year.

The surge in oil prices at the end of last year was driven by OPEC's decision to curb oil production. In November 2016, OPEC (Organization of Petroleum Exporting Countries) agreed to cut output by 1.2 million barrels per day in 2017 – the first reduction agreed by the cartel in eight years. Other non-OPEC countries, led by Russia, pledged to cut an additional 0.6 million barrels in order to rebalance the market. OPEC's decision should provide support for oil prices in 2017 – given that member countries comply with the agreed cuts. Nevertheless, higher prices could prompt a rise in US shale production, thus capping the climb in oil prices during the year.

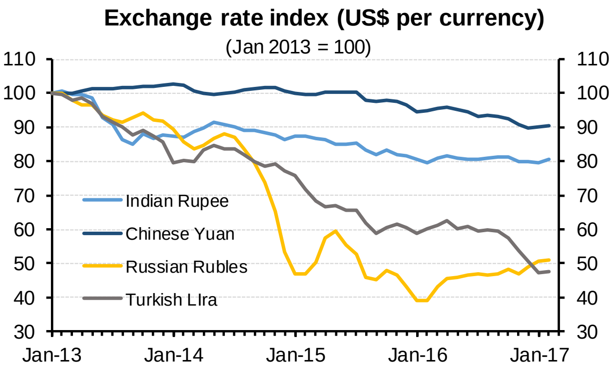
Similarly, jet fuel prices also increased in line with the movement in oil prices. IATA (The International Air Transport Association) forecasts jet fuel prices to average $65 per barrel in 2017, some 25% higher than last year. However, it expects the airline industry's fuel bill to rise by just 4% – as the impact of higher fuel prices is dampened by fuel-hedging contracts.

Dollar continues to strengthen into 2017



Source: Federal Reserve Bank of St. Louis

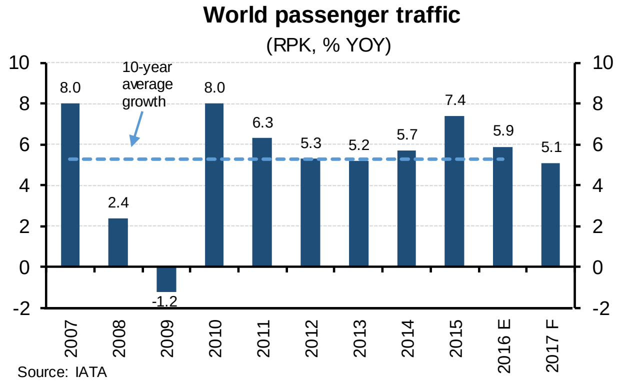
The dollar surged at the end of last year following the US presidential elections and a rise in interest rates. The victory of Republican Donald Trump in the November 2016 elections caused the dollar to rally as expectations that the new administration's promised tax cuts and infrastructure spending would boost US growth and inflation. This was followed by the Federal Reserve's decision in December 2016 to raise interest rates– the first rate increase in a year. The Fed has also signaled the possibility of further interest rate hikes in 2017, which is likely to provide further support for the dollar.



Source: Pacific Exchange Rate Service

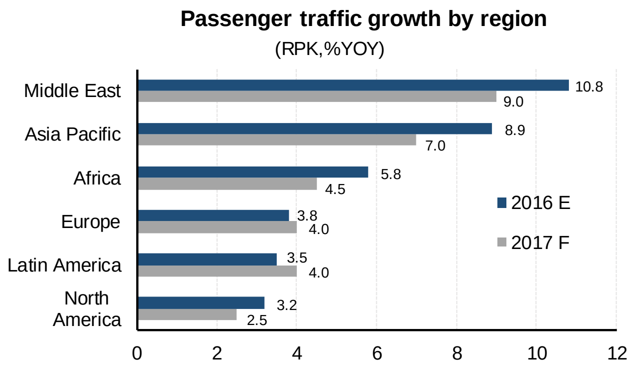
The dollar has also strengthened relative to many emerging market currencies. The Chinese yuan, for example, weakened by some 7% against the dollar in 2016. However, some commodity exporters – most notably Russia – saw a notable recovery; the Russian Rubles appreciated by more than 20% against the dollar in 2016, after several years of decline.

Air travel moderates, but within trend



Source: IATA

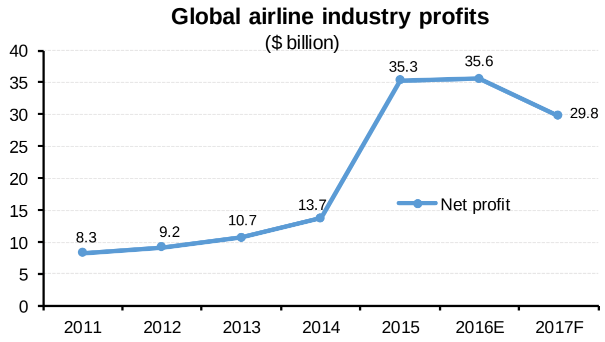
Growth in air travel is expected to continue to moderate in 2017 – though will remain broadly in line with the average pace seen over the past decade. After moderating to 5.9% in 2016, world passenger traffic is projected to slow further to 5.1% this year – but will remain close to the 10-year historic average of 5.3%. IATA expects air travel demand to slow as the stimulus from lower fuel prices and air fares start to reverse. Nevertheless, stronger economic conditions in 2017 should help to at least partly offset the impact of rising fuel prices.



Source: IATA

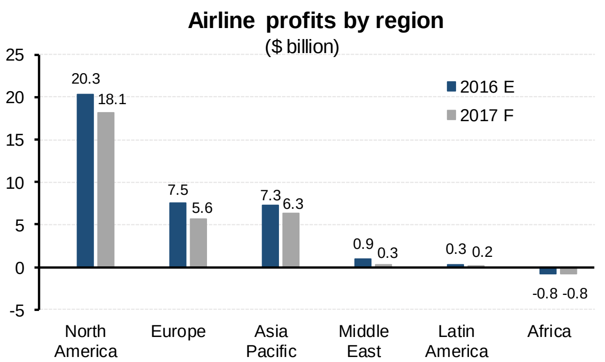
Moderation in air traffic growth is expected across most regions in 2017. However, Europe and Latin America should see a modest rebound, reflecting a recovery from last year's terrorist attacks in the former and improving economic conditions in the latter. Carriers in most regions are expected to curb capacity growth further in 2017 in response to slower travel demand – helping to improve yields after two years of decline that had resulted from lower fuel costs feeding into lower air fares.

Airline profits ease, but remain robust



Source: IATA

After rising to record levels in the past two years, global airline profits are expected to slip slightly in 2017. IATA projects that the combined profits of airlines globally will reach $30 billion this year – down from an all-time high of $36 billion in 2016. The decline in the industry's profits will be primarily the result of rising fuel costs. Though the momentum in the profitability cycle is expected to ease, industry-wide financial performance will remain solid by historical standards.



Source: IATA

Higher fuel prices – coupled with a stronger dollar – are likely to increase airlines' operational costs in 2017. Since a large portion of airline costs – including fuel, aircraft purchase and lease payments – are typically priced in dollars, a stronger dollar will lead to an increase in the cost of servicing US dollar-denominated costs and debt for airlines. Nevertheless, airlines' hedging strategies will partially offset some of the impact arising from higher fuel prices and foreign exchange risks. □