LATIN LAWYER

# THE GUIDE TO RESTRUCTURING

Editors
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**CHAPTER 10**

# Latin America's Ailing Aviation Industry

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The global pandemic has affected businesses and individuals in every part of the world. One of the hardest hit industries has been the airline and aviation industry. The Latin American region is no exception to the turmoil. Many borders have remained closed and business travel (particularly international travel) remains anaemic in most countries and regions. Furthermore, vaccine rates vary by country and region, all pointing to a choppy and possibly lengthy recovery period. There are certain schools of thought that suggest travel, and business travel in particular, may have changed forever with the forced advent of videoconferencing that has become the norm since March 2020.

The aviation sector has had its share of exogenous shocks over the years, including the September 2001 terrorist attacks in the United States, the SARS virus in Asia and the H1N1 virus, primarily affecting North America and Mexico. In addition, fuel price increases have frequently affected the airline industry, often tied to political turmoil in foreign oil-producing states. Historically, the industry has been, and will continue to be, tied to the general economic conditions of individual countries and regions, with cyclicality being the norm for the aviation sector. The foregoing exogenous events were largely region-specific or country-specific as to the extent of the negative impact, and generally limited in scope and duration, but the covid-19 pandemic is the first to materially affect the global aviation industry and has hit all airlines (and those businesses that are economically linked to airlines, such as airports, catering, ground handling and maintenance/repair organisations) at the same time and, therefore, is completely

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unprecedented for this industry. In addition, the prior shocks were relatively short-lived, with travel rebounding fairly quickly as viruses abated, cockpit doors were fortified, fuel prices eased and consumer confidence returned. Currently, the travel rebound, including in the short term, has been limited to leisure travel to primarily domestic and regional destinations with the expectation for timing of the business travel rebound (i.e., those travellers buying seats at the last minute and therefore paying the highest fares and disproportionally contributing to many airlines' profits) a genuine unknown at this point in the pandemic.

## Restructuring during the pandemic

The pandemic has caused all airlines to consider restructuring in one form or another to protect and improve the fundamentals of their core business. At one end of the restructuring spectrum, airlines have borrowed money and implemented various cost reduction programmes; at the other end of the spectrum, they are seeking court protection from creditors. Many airlines around the globe have seen government intervention with support in the form of grants or loans. In Latin America, three large airlines are currently utilising the US Chapter 11 court process to restructure their businesses. Figure 1, below, sets out the airlines based in Latin America using a court-supervised process (whether Chapter 11 in the United States or a local insolvency proceeding) to reorganise and restructure their operations or finances with the expected outcome being a continuation of the business. Avianca, Aeromexico and LATAM are using the US Chapter 11 process for restructuring, with the process allowing broad flexibility for the 'debtor' to reject burdensome contracts, abandon or eliminate over-leveraged assets or liabilities, but more importantly creating a forum for renegotiating contracts to right-size the airline or improve the airline's revenue and cost structure. Most airlines using a court process restructuring will also take the opportunity to do a comprehensive review to improve the fundamentals of their businesses, including a review of routes flown, fleet types used, customer offering, labour agreements and virtually every aspect of the airline's operation. Avianca has announced it is on track to reduce its narrow-body aircraft cost structure by 38 per cent. Many airlines are also using this time to evaluate efficiencies that can be achieved by upgrading technology that can further reduce costs. Historically the Chapter 11 process has been used many times over the years in the United States, including the three largest: Delta Air Lines, American Airlines and United Airlines. The process is familiar to most airline creditors and has been used many times by US airlines large and small with a thorough understanding of the rules, procedures and limitations of the process. In fact, Avianca in 2003 was the first non-US-based airline to reorganise under Chapter 11 and, therefore, the current filing is its second use of the court process, often colloquially called Chapter 22.

**Figure 1: Airlines in Chapter 11 and bankruptcies**

| Airline | Status | Date of filing |
|---|---|---|
| Aeromexico | US Chapter 11 (ongoing) | 30 June 2020 |
| Avianca | US Chapter 11 (ongoing) Liquidation of subsidiary Avianca Peru | 11 May 2020 |
| EasyFly | Colombian bankruptcy (ongoing) | 5 August 2020 |
| LATAM Airlines | US Chapter 11 (ongoing) | 26 May 2020 |

Source: Seabury analysis, general research

Globally, many airlines have ceased operations or have been liquidated. Figure 2, below, shows the six airlines in Latin America that have either completely liquidated or have ceased operations, with an uncertain future as to when or if they will restart.

**Figure 2: Latin American Airlines that have ceased operations or liquidated**

| Airline | Domicile | Date operations ceased/liquidation | Fleet size (no. of aircraft) |
|---|---|---|---|
| Austral | Argentina | 30 November 2020 | 26 |
| FlyEst | Argentina | 20 November 2020 | 2 |
| Interjet | Mexico | 27 April 2021 | 25 |
| LATAM Airlines | Argentina | 9 February 2020 | 4 |
| One Airlines | Chile | 28 June 2020 | 2 |
| Tame | Ecuador | 20 May 2020 | 5 |

Source: Simpleflying, general research

The current experience of restructuring using court processes is not unique to the Latin American region as many airlines around the world have used, or are currently using, insolvency proceedings to restructure their businesses.

**Figure 3: Airline court-supervised restructuring processes globally**

| Airline | Proceeding venue | Status |
|---|---|---|
| Air Asia | Malaysia | Ongoing |
| Malaysia Airlines | United Kingdom | Recapitalised and emerged: March 2021 |
| Norwegian Air Shuttle | Ireland/Norway | Recapitalised and emerged: May 2021 |
| Mango | South Africa | Ongoing |
| Virgin Atlantic | United Kingdom | Recapitalised and emerged: September 2020 |
| Virgin Australia | Australia | Recapitalised and emerged: November 2020 |
| Thai Airways | Thailand | Ongoing |
| Nok Air | Thailand | Ongoing |

Source: general research

## A return to normality – when and in what form?

The worldwide industry is grappling with an overarching issue of when the demand for travel and, more importantly, the associated revenues, are likely to return to pre-pandemic norms. Additionally, if revenues do return to pre-pandemic norms, at what passenger yield will they return? Yield is a proxy for the price of an airline ticket and with leisure travel currently dominating the landscape and business travel at universally anaemic levels, in general yield is down significantly across the board. As such, airlines are evaluating their individual cost structures and budgets as applied to their revenue-generating capabilities, with the primary issue being the expected return of business travel (with higher fares and yields). One conundrum affecting all airlines is whether a certain business element of travel has moved permanently to a remote or telephonic environment, or whether the current experience is temporary and, if the latter, for how long?

The return to normality may be several years away and will, as a first step, be tied to vaccination rates, particularly for international travel.

The vaccination rates for Latin America suggest a lag as compared with many parts of the industrialised world, which will most likely be relevant to the return of international business travellers to Latin America destinations. Also, certain countries in Latin America continue to suffer from high levels of infection, further exacerbating the problem for a return to normal travel levels.

In addition and related to vaccination rates, will be the reopening of borders. Figure 4, below, sets out the state of border openings for some of the larger countries in Latin America, as at the time of writing. Confounding both the border openings and vaccination levels is the lack of universality as to the rules for international travel. There are discussions and speculation as to a 'vaccine passport' but there is no current common plan for implementation.

**Figure 4: Current state of border openings for certain Latin American countries**

| Country | Open for citizens | Open to foreigners | Open for tourism | Quarantine period |
|---|---|---|---|---|
| Argentina | Fully open | Partially open | No | 10 days |
| Brazil | Partially open | Partially open | Partially open | None |
| Chile | Partially open | No | No | 10 days |
| Colombia | Partially open | Partially open | Partially open | 14 days (none with negative test) |
| Mexico | Fully open | Fully open (air travel) | Fully open (air travel) | None |

Source: travelbans.org as at 11 August 2021

In Latin America, the full service carriers, particularly those with sizeable intercontinental networks, are expected to be the slowest to recover whereas the low-cost carriers are expected to recover the fastest. The sector that is expected to be last to rebound is long haul or ultra long haul international travel. Currently, the leisure sector of the industry is enjoying a rebound, with certain destinations becoming very popular as quarantine restrictions have started to ease. Figure 5, below, sets out the various full service carriers and low-cost carriers in Latin America.

**Figure 5: Comparison of full service carriers and low-cost carriers in Latin America**

| Full service carriers | | Low-cost carriers | |
|---|---|---|---|
| Carrier | Domicile | Carrier | Domicile |
| Aerolineas Argentinas | Argentina | Amaszonas | Bolivia |
| Aeromexico | Mexico | Azul | Brazil |
| Avianca | Colombia | GOL | Brazil |
| Boliviana de Aviación | Bolivia | Jet Smart | Chile |
| CopaAirlines | Panama | Sky | Chile |
| LATAM Airlines | Chile/Brazil | Viva Aerobus | Mexico |
| | | Viva Colombia | Colombia |
| | | Volaris | Mexico |
| | | Wingo* | Colombia |

Source: general research
* 100% owned by Copa Airlines

With the revenue recovery in question, particularly with regard to business travel and long haul international travel, airlines are focusing heavily on reducing costs.

The analysis set out in Figure 6, below, shows that the low-cost carriers do have a cost advantage versus the full-service carriers but historically the full-service carriers have enjoyed a revenue premium that mitigated the advantage.

The open questions carriers around the globe are asking are whether this historical revenue premium will hold and what the ramifications are for the industry if it does not.

The key for all airlines looking for a return to normality will be the revenue-generating capabilities of these airlines versus their cost structure, and facing the challenge of what the new revenue generating environment will be.

**Figure 6: Comparison of RASK and CASK differential (US$ cents) between FSCs and LCCs**

| | RASK US$ | | CASK US$ | | Differential | | |
|---|---|---|---|---|---|---|---|
| | 2018 | 2019 | 2018 | 2019 | 2018 | 2019 | |
| Aeromexico | 6.9 | 7.0 | 6.9 | 6.8 | 0.1 | 0.2 | |
| Avianca | 9.2 | 8.5 | 8.7 | 9.5 | 0.5 | -1.0 | |
| LATAM Airlines | 6.1 | 6.0 | 6.6 | 6.5 | -0.5 | -0.5 | |
| Copa Airlines | 7.7 | 7.9 | 5.7 | 5.8 | 2.0 | 2.1 | |
| Azul | 8.1 | 6.1 | 7.6 | 6.8 | 0.5 | -0.6 | Low-cost carriers |
| GOL | 6.5 | 6.9 | 5.7 | 5.8 | 0.8 | 1.1 | |
| Viva Aerobus | 4.3 | 4.4 | 4.0 | 4.1 | 0.3 | 0.3 | |
| Volaris | 4.2 | 4.6 | 4.1 | 4.0 | 0.1 | 0.6 | |

Source: General research, Diio

## Fleet plans

With significantly reduced traffic levels, particularly international travel during the pandemic, airlines everywhere are evaluating the short-term and long-term needs of their fleets. Fleet operating costs and ownership costs make up a significant portion of any airline's cost structure. Many airlines have grounded a certain number of aircraft during the pandemic as demand waned. In addition, those airlines that have liquidated as well as those under court protection have returned a number of aircraft to financiers. As a result, there is currently a surplus of aircraft, with many airlines retiring older aircraft permanently and certain units being converted prospectively to freighters. But there continues to be pressure on aircraft values, with twin-aisle wide-body aircraft particularly affected. With capacity not expected to rebound for several years, the expectation is that there will be a surplus of aircraft in the market for several years to come. Furthermore, the original equipment manufacturers (OEMs) continue to build and deliver aircraft to customers.

With a reduction of between 25 and 30 per cent in worldwide capacity in the coming years and approximately 21,000 aircraft in service as of 2019, it is thought there could be anywhere from 5,000 to 7,000 surplus aircraft in the market. Given the slow rebound in international long-haul travel, wide-body aircraft have experienced, and are expected to continue to experience, the largest drop in market values. Many older wide-body aircraft are being permanently retired, again with some being converted to freighter use.

The Latin American carriers utilising the US Chapter 11 process have already rejected or abandoned a number of aircraft to their financiers.

It should be noted that some of the rejected and abandoned aircraft will be, or have been, returned to the airlines' fleet with renegotiated economics or terms. As evidence of the market pressures on values, Seabury has seen recent lease transactions for certain aircraft at levels of between 25 and 50 per cent below pre-pandemic levels. Other significant cost elements that universally affect the airline industry are fuel costs and foreign exchange rates. The latter can be particularly troublesome for airlines when their local currency drops versus the US dollar as many aviation industry costs, such as fuel, OEM purchase contracts and many fleet financings are US dollar-based. Non-US-based airlines that have significant dollar revenues by flying to the United States may have a hedge, while those that do not may be particularly negatively affected.

Although US Chapter 11 filings do not require the non-US-based labour unions to adhere to US Chapter 11 procedures, Aeromexico, Avianca and LATAM have all sought concessions from their respective labour unions to reduce costs.

**Figure 7: Labour union negotiations for major Latin American carriers**

| Airline | Labour union negotiations |
|---|---|
| Aeromexico | • Reached agreement January 2021 with all four labour unions representing pilots, flight crews and other airline workers |
| Avianca | • Reached agreement with pilot union in October 2020 for a four-year agreement<br>• Agreement includes a 15% reduction in salaries and limiting salary increases to the higher of 2% per annum or the annual inflation rate |
| LATAM Airlines | • Reduced labour costs in Peru, Chile and Ecuador by 25%<br>• In negotation with labour unions to reduce labour costs of flight crews by 20% in Brazil |

Source: AirlineGeeks, Aviación al día, Grupo Aeroméxico, Financing related court filings

## Low-cost carriers and new entrants

Currently, with business travel volumes down and leisure travel volumes surging, the low-cost carriers (with a strategic emphasis towards leisure travel) are expected in the near term to do relatively well versus the full service carriers, particularly those with large intercontinental networks.

**Figure 8: Overview of low-cost carriers in Latin America**

| Low-cost carrier | Domicile | Fleet size (no. of aircraft) |
|---|---|---|
| Amaszonas | Bolivia | 15 |
| Azul | Brazil | 166 |
| GOL | Brazil | 127 |
| Jet Smart | Chile | 17 |
| Sky | Chile | 20 |
| Viva Aerobus | Mexico | 46 |
| Viva Colombia | Colombia | 21 |
| Volaris | Mexico | 87 |
| Wingo | Colombia | 6 |

Source: general research

With a large number of aircraft on the market (often at reduced prices compared with two years ago), a number of new entrants have announced their intention to commence operations to serve various markets in Latin America. The strategic question for any new entrant will be: How does it serve its target markets with any risks associated with capitalisation levels and the competitive response from existing incumbents? Historically the competitive response to new entrants has been intense as the world has been littered with undercapitalised start-up airlines that also underestimated the response from entrenched competitors. Many prominent names from the past that may have had a big marketing splash as a new entrant failed under intense competitive responses from entrenched airlines and a lack of capital to weather the storm. There have been start-ups in the past 20 years that have survived and succeeded in various parts of the world, including in Latin America, such as GOL (founded 2001), SKY (founded 2001), Volaris (founded 2004), Viva Aerobus (founded 2006), Azul (founded 2008), Viva Colombia (founded 2009), Wingo (owned by COPA, founded 2016) and JetSmart (founded 2017). However, it is unclear, given the current operating environment, whether any new start-up airlines will be successful or not.

**Figure 9: New entrants on the Latin American market**

| New entrant | Domicile |
|---|---|
| Ecuatoriana | Ecuador |
| Itapemirim | Brazil |
| Nella Airlines | Brazil |
| Star | Colombia |
| Ultra | Colombia |

Source: Simpleflying

## Cargo airlines

The cargo airlines around the world have performed relatively well during the covid-19 pandemic as, in response to strong demand for medical supplies, shipments were accelerated quickly to various medical hot spots as the pandemic worsened. In addition, many consumers switched to online or home delivery shopping services, which resulted in more goods being shipped by air. Furthermore, many wide-body passenger aircraft have been grounded because of the pandemic and these particular aircraft historically carried significant amounts of cargo as belly freight. This phenomenon has added to the demand for all cargo freighter aircraft.

In Latin America, there are a number of cargo airlines domiciled locally in addition to the large internationally integrated airlines, such as Federal Express, DHL and UPS. Figure 10, below, shows the scale of cargo carriers based in Latin America.

**Figure 10: Cargo airlines based in Latin America**

| Cargo airline | Domicile | Fleet size (no. of aircraft) |
|---|---|---|
| Aerosucre | Colombia | 2 |
| Estafeta | Mexico | 5 |
| LAS Cargo | Colombia | 3 |
| MasAir | Mexico | 3 |
| Sideral | Brazil | 15 |
| TOTAL | Brazil | 2 |
| TSM* | Mexico | 36 |
| TUM AeroCarga | Mexico | 12 |

Source: Seabury analysis, general research, PlaneSpotters
* Performs charter services in addition to cargo

In addition, Avianca, LATAM and Azul, as primarily passenger carriers in Latin America, all have cargo freight aircraft as part of their fleets.

**Figure 11: Dedicated cargo fleets in Latin America**

| Full service carrier | Domicile | Freighter fleet size (no. of aircraft) |
|---|---|---|
| Avianca | Colombia | 11 (including five operated by AeroUnion, owned by Tampa) |
| Azul | Brazil | 6 |
| LATAM Airlines | Chile/Brazil | 6 |

Source: general research

## The recovery

The biggest questions facing airline executives today are when the business travel recovery will begin and, more importantly, what it will look like. Will the business traveller return to 2019 levels of flying and at 2019's yield-producing revenues? Will the carriers that have used court processes to repair their balance sheets and reduce their cost structures now have a competitive advantage over those that did not? It appears the recovery has commenced at least for leisure travel, but no one yet has the answers for business travel recovery.

Published by Latin Lawyer and edited by Joy K Gallup and Michael L Fitzgerald, partners at Paul Hastings LLP, *The Guide to Restructuring* is designed to assist restructuring advisers of all disciplines, and affected companies, as they negotiate complicated restructurings.

This guide delivers specialist insight to our readers across the region – advisers, practitioners, corporate decision makers and court officials – throughout the process.

In preparing this guide, we are grateful for the cooperation and insight of the broad range of participating advisers and practitioners, who have contributed a wealth of knowledge and experience.