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Fasten Seatbelts: Credit Turbulence in US Airline Industry Persists

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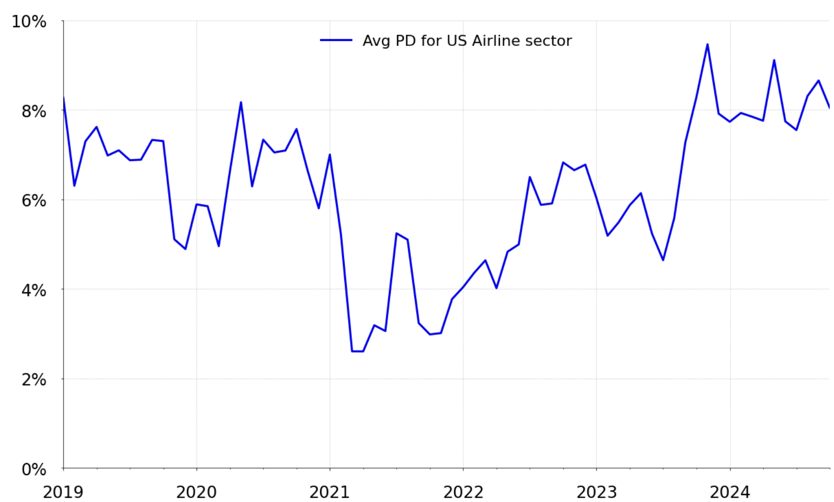
Air travel finally put the COVID-19 shock behind it this year, with TSA data indicating there were more passengers boarding planes in 2024 than there were in 2019. However, despite robust demand, performance has been impacted by overcapacity and rising operating costs, leading to credit stress across the sector, but particularly among budget carriers. Spirit airlines, and its effort to avoid bankruptcy, has been emblematic of the challenges besetting the sector, but is by no means the only carrier facing heightened credit risk.

When a sector is under stress it is hard to know which exposures really require your attention to proactively manage. Moody's Probability of Default (PD) is an important and useful measure of credit risk because it can tell you how individual companies and entire sectors are trending. Figure 1 shows that the relief that the US airlines sector experienced after the pandemic has been erased, with the average PD for the US airlines sector rising to 8% as of October 2024 from 2.3% during the pandemic recovery in 2021.

FIGURE 1 Credit Risk for US Airline Industry Took Off from Post-COVID Low

Average 1-year probability of default (PD), monthly



Data source: Moody's EDF-X platform.

While gauging the trend of credit risk is important, credit measures like PDs by themselves cannot tell you which company to worry about, or when should you get worried. Moody's Early Warning System (EWS) tells you "Which and When" a change in credit risk is significant enough to require your attention.

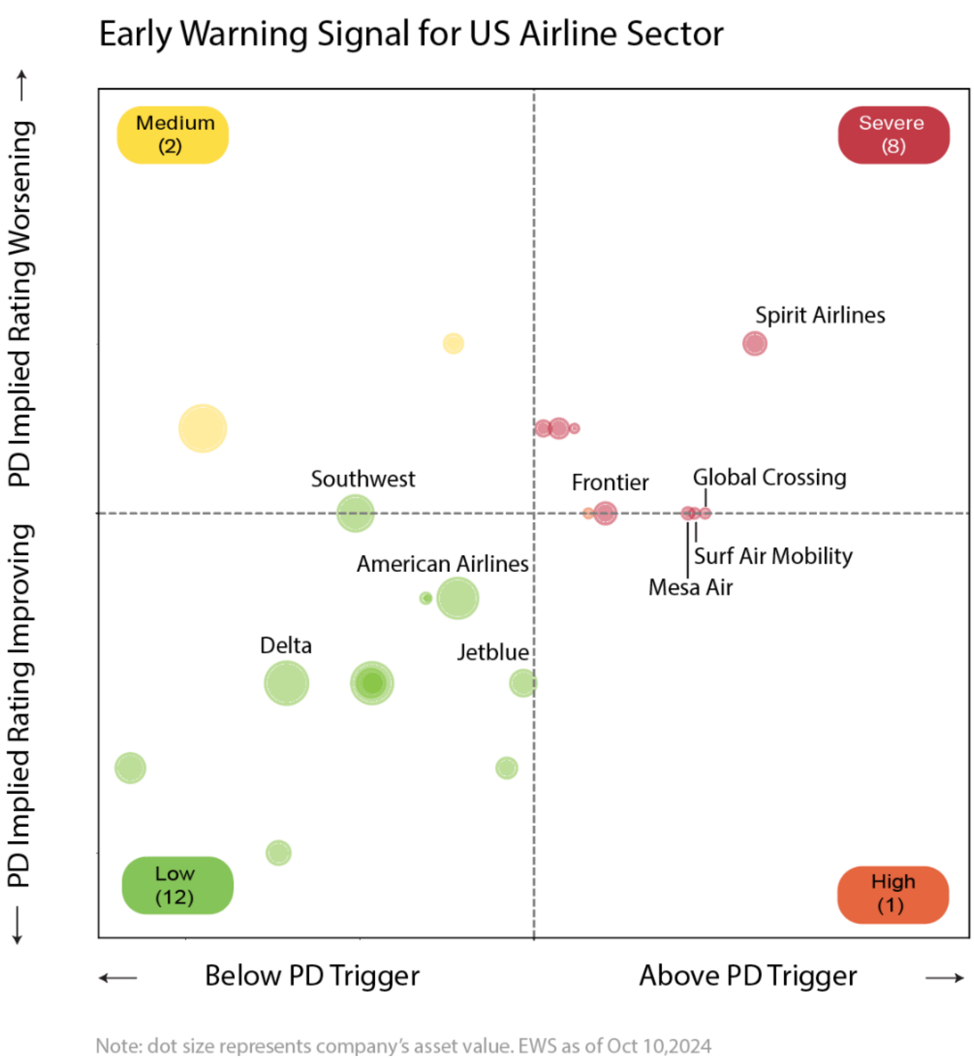
Bird's-eye View: 35% US Airlines Flagged As Severe Risk

Moody's EWS uses two key measures to identify companies as low, medium, high, or severe risk over the next 12 months: (1) whether a company's forward-looking PD measure is above an appropriate sector early warning trigger level; and (2) the change in the company's PD-implied rating. Moody's research has shown that public companies with high or severe early warning signals are 25 times more likely to default over the next year than firms with low early warning signals.

Figure 2 shows the EWS distribution for the US airline sector as of October. The graph shows that risk in the sector is highly polarized: half of the companies in the sector show low risk EWS, and half with medium, high or severe EWS risk. Eight companies, or 35% of the sector, currently fall in the severe risk group, a category that includes Frontier Airlines, Spirit Airlines, Global Crossing Airlines, among others.

FIGURE 2 Spirit Airlines Not the Only US Carrier Losing Altitude

Early warning signals show that smaller, budget carriers most at-risk



Data source: Moody's EDF-X platform.

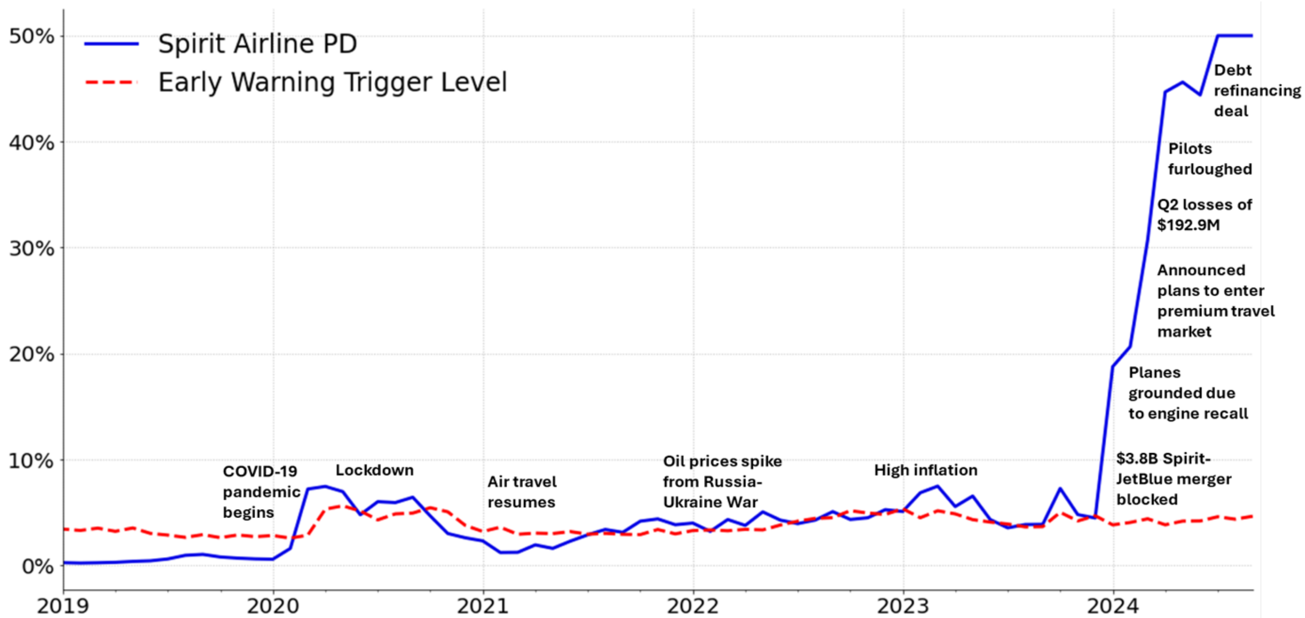
Figure 2 also shows that larger airlines (represented by the size of the bubble in the chart) have been able to weather the sector's challenges better. Higher operating costs – higher fuel price and labor costs – have hit budget airlines relatively harder, with the result that they are struggling more relative to their larger industry competitors. Large carriers like Delta Airlines, United Airlines, and American Airlines have been better positioned to absorb risks.

In our previous research, data shows that larger companies have easier access to deep and liquid pools of capital than those smaller ones. The trend also applies to the US airline sector: although Southwest and JetBlue airlines have had to take aggressive action to manage the industry malaise, they remain in the low-risk EWS category, while Frontier and Spirit are in the severe risk category.

Brace for Impact: Spirit Airlines

Based in Florida, Spirit Airlines has been flying with financial troubles since the onset of the COVID-19 pandemic. Moody's Early Warning System flagged Spirit's increasing credit risk in March 2020 when its PD (7.2%, equivalent to a B3 Implied Rating) breached its sector risk trigger level (2.6%). Figure 3 shows Spirit Airlines' one-year, forward-looking PD as well as the industry sector early warning trigger level.

FIGURE 3 Failed Merger Sparked the Downward Spiral for Spirit



Data source: Moody's EDF-X platform.

Spirit enjoyed a short recovery aligned with the industry rebound in late 2020-early 2021, however it could not sustain the momentum despite consumer demand for the lowest ticket prices. Highly leveraged, with more than one billion in bonds coming due in 2025, the 60-year-old carrier hasn't been able to invest in growth areas like new planes. As travelers have enthusiastically returned to the skies, it recently unveiled plans in July of this year to offer a premium experience with tiered seating and ancillary perks – a stark contrast from its existing bare-bones model.

In July 2021, its PD (2.90%) breached its trigger level (2.5%) again and has been trending upward since. In July 2023, a recall of the Pratt & Whitney engine used in Spirit planes was yet another obstacle, grounding planes, limiting the routes it can take let alone offering new ones. Its PD soared most notably in January 2024 (to 18.8%) and reached maximum altitude at 50% in July 2024, where it sits today. The financial lifeline Spirit was banking on hit a wall at the start of the year when its proposed $3.8B merger with JetBlue was blocked by a federal court due to antitrust concerns. It reported a Q2 2024 net loss totaling $192.9M, compared to the net loss of $2.3M at the same time last year. Spirit has furloughed over 180 pilots as of September 2024, further setting back its turn-around efforts to get off the ground. The winds shifted Spirit's way on October 21, however, when it announced a 2-month extension to refinance its debt before year-end, sending its stock price up 46%. But the news and the rally in its shares has not eased its forward-looking credit risk, and its one-year ahead PD remains at the maximum 50%.

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