

IATA ECONOMICS BRIEFING

AIRLINE BUSINESS CONFIDENCE INDEX

OCTOBER 2007

KEY POINTS

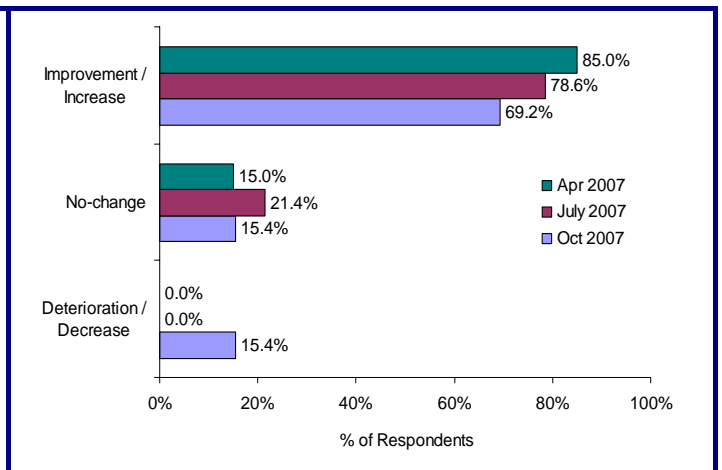
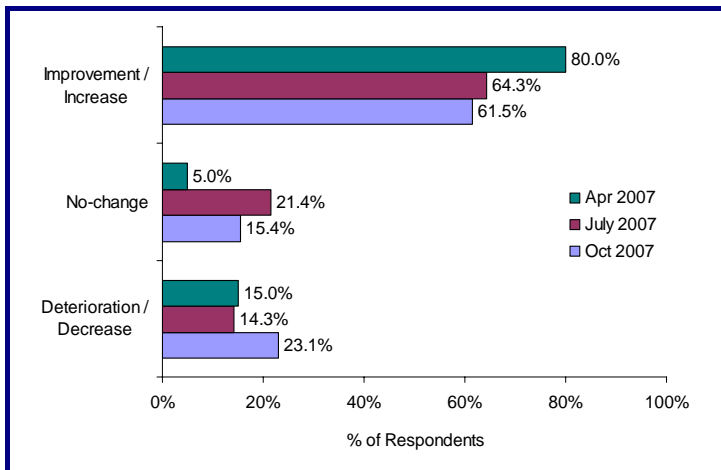
- IATA's latest airline business confidence survey shows a slight weakening in the outlook for profitability and demand growth since the previous survey in July. Underlying profitability has continued to improve in 2007, but challenges for the next 12 months have increased. High fuel prices, a pick-up in new aircraft deliveries and uncertainty caused by recent financial market volatility have contributed to a more cautious airline outlook.
- But overall business confidence levels still remain robust, with the majority of respondents expecting to see positive growth. The industry is thought to be past the peak of its demand growth cycle, but underlying demand-side factors (such as strong GDP growth in developing economies) are still positive. Even with fuel prices rising to \$100 per barrel, further improvements in productivity and efficiency have helped to offset its overall impact.
- Demand has, so far, remained relatively robust in the face of recent volatility in global financial markets. Airlines may face a higher financing premium, but there is no sign of any significant negative impact on demand (see: www.iata.org/economics for IATA's note on the impact of the credit crunch). Instead, it is supply-side changes and cost pressures that are expected to pose the more immediate risks to airline business confidence. Fuel costs are already high but upward pressures may also emerge in other areas (e.g. labour). At the same time, a higher rate of new aircraft deliveries will add to competitive pressures. Passenger operations are confident of partially offsetting higher input costs through increased yields, but cargo operators are more constrained.

PROFITABILITY OUTLOOK

- The airline industry continues to see an underlying improvement in its operating profitability in 2007, even with fuel prices reaching record levels of over \$100 per barrel in October. Hedging, exchange-rate movements and fuel-surcharges can provide some protection against higher fuel costs. In addition, the hard restructuring work of recent years continues to deliver further improvements in fuel and non-fuel efficiencies. However, there are signs that additional improvements are becoming increasingly harder to achieve. Around 60% of respondents saw an improvement in profitability in Q3, down from 80% in Q1, while nearly 25% reported a fall in profitability in Q3.

How has profitability changed in the last three months compared with the same period last year?

How do you expect profitability to change over the next twelve months?



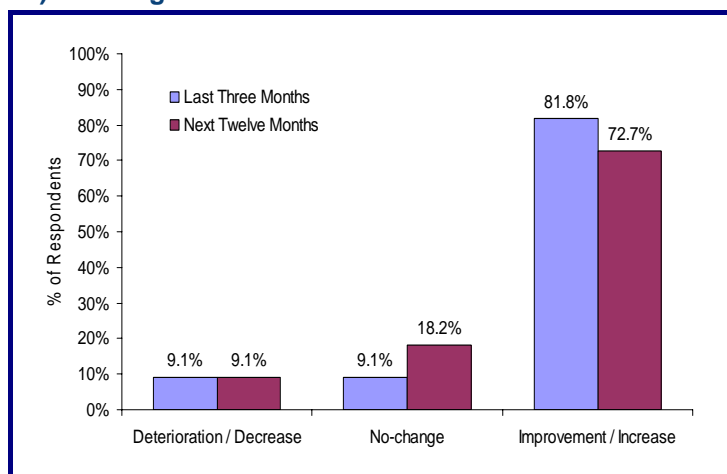
➤ Looking ahead, nearly 70% of respondents still expect to see an improvement in profitability over the next 12 months. However, the share of respondents expecting an improvement has fallen compared to the previous two surveys, reflecting a more uncertain view. For others the outlook is not just more challenging but also negative, with 15% of respondents expecting to see an actual decline in profitability. Confidence is linked to further demand growth, albeit at an expected slower rate than in recent years. However, several respondents expect further pressure from high fuel costs while the pick-up in the number of new aircraft deliveries is also recognised as posing a risk to profitability.

DEMAND GROWTH

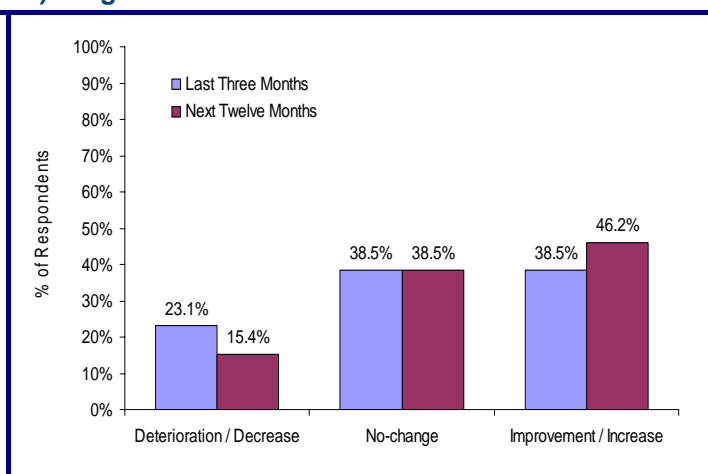
- The airline industry continues to see and expect passenger demand growth, although there is a recognition that the rate of demand growth has passed its peak for this cycle. Over 80% of respondents saw demand improve in Q3, led by fast growth in developing markets but with steady growth in more mature markets too. The majority of respondents (73%) also expect to see a further increase in passenger volumes over the next 12 months, supported by generally positive economic conditions. There was no reference to any negative impact on demand from the recent credit crunch. Nevertheless, there is some recognition of a more challenging demand side environment. Over 18% of respondents saw demand stabilise or fall in Q3, with over 27% expecting demand to stabilise or fall over the next 12 months. This is a significant change on the previous survey, where all respondents expected to see passenger demand growth.
- Demand side confidence is weaker on the cargo side. Air cargo demand continues to receive a boost from global trade growth, but suffers an even greater cost impact from high fuel prices and also faces strong competition from other modes, such as container shipping. Cargo also faces the challenge caused by large global trade imbalances, with demand and profitability often much higher on outbound legs from regions such as Asia than on return legs. Less than 40% of respondents saw increased cargo volumes in Q3, compared with 60% in Q2, while less than half expect cargo demand to increase over the next 12 months.

The actual and expected change in traffic volumes

a) Passenger



b) Cargo



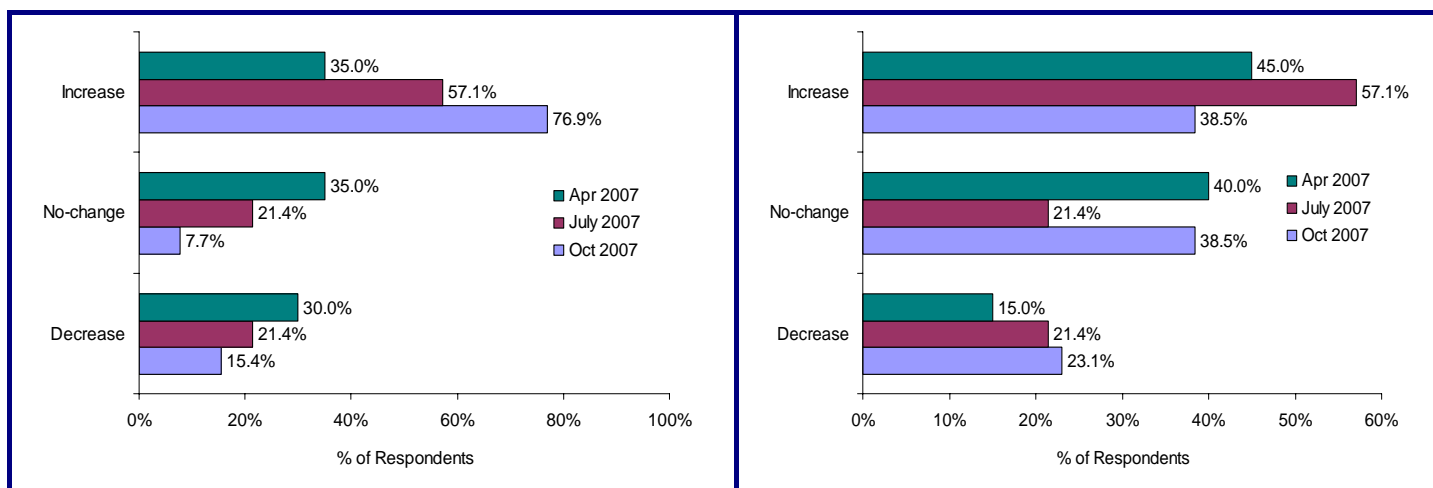
INPUT COSTS

- Oil and fuel prices continued to increase in Q3 2007, reaching record levels of over \$100 per barrel in October. Financial hedging and (for non-US airlines) a further depreciation of the US dollar can help to offset (at least temporarily) some of the higher costs, but most of the upward pressure is beyond the control of airlines. Over 76% of respondents saw input costs rise in Q3, compared to just 35% of respondents in Q1. However, strong management control and the on-going effects of productivity improvements continue to deliver fuel and non-fuel efficiencies, helping nearly a quarter of respondents to stabilise or reduce overall unit costs.
- With fuel prices already at record levels, there is less of an expectation of further price increases in the next 12 months. However, neither is there any expectation of a sharp fall in fuel prices and the need for further fuel efficiencies remains a key factor for future profitability. In addition, nearly 40% of respondents still expect unit costs to increase over the next 12 months. Though this is lower than in July's survey, it is more a reflection of

increased pressure on non-fuel costs than the expected increase in fuel prices in the previous survey. In particular, many of the easier non-fuel cost improvements have already been made while growing shortages in some areas, e.g. labour skills, can add to cost pressures. The global airline industry has achieved impressive cost efficiency improvements since 2001. The focus remains on achieving further cost efficiencies, though they will become increasingly harder to find.

How have your input costs changed in the last three months compared with the same period last year?

How do you expect your input costs to change over the next twelve months?



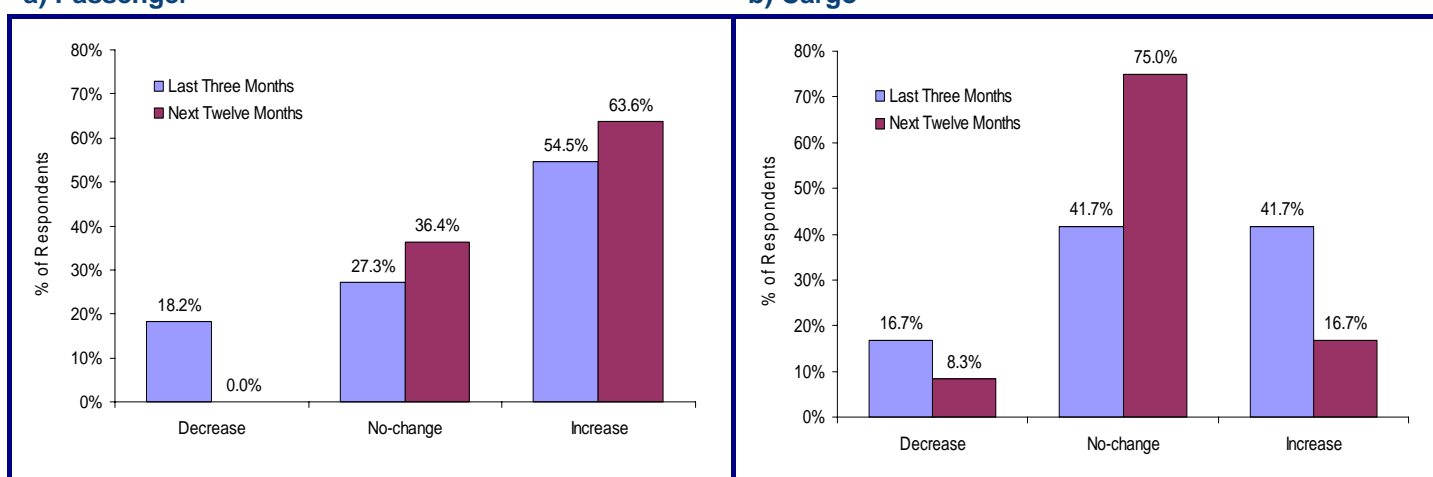
YIELD ENVIRONMENT

- The overall impact on yields reflects the relative strength of opposing pressures from higher input costs (upward) and increased competition (downward). On the passenger side, a still positive demand environment provides some scope for airlines to pass on part of the higher input costs they face to passengers through higher yields. Nearly 55% of respondents were able to increase yields in Q3, for example through higher fuel surcharges, while over 63% expect to push for further increases in the next 12 months. However, this expected pricing power may weaken, especially if demand growth slows while the rate of new aircraft deliveries increases. Airlines still face strong price competition – e.g. from no-frills carriers – and must retain a tight control on the demand-supply balance to ensure that excess capacity does not emerge and that market growth expectations remain realistic.
- On the cargo side, high fuel costs place an even greater burden on unit costs but the ability to pass on part of the higher costs is constrained by a more uncertain demand environment and by strong competition from other modes (especially container shipping which enjoys a significant cost advantage from lower priced bunker fuel). Over 40% of respondents were able to increase yields in Q3, but less than half of these expect to see further yield improvements in the next 12 months, with three-quarters expecting no-change.

The actual and expected change in yields

a) Passenger

b) Cargo



EMPLOYMENT

- Airline labour productivity levels have increased significantly since 2001, with labour used more effectively and efficiently and non-core employment being outsourced. Employment levels were restructured post-2001 but have begun to increase again in the last two years as airlines require additional staff to meet higher demand levels. However, with fuel cost pressures increasing and signs that labour costs may also face upward pressure too, the expansion in employment levels may be slowing. Just over 30% of respondents increased their level of employment in Q3, the same proportion as those who reduced employment levels. By contrast, the majority of respondents increased employment in Q1 and Q2.
- The outlook for employment levels is also affecting by the relative strength of two opposing factors; the need for more staff to serve higher demand levels and the need to offset higher fuel and other input costs through further productivity gains or outsourcing on the labour side. Less than 40% of respondents expect to be recruiting additional staff over the next 12 months, down sharply from 64% in the last survey. Nearly half of respondents expect to maintain current employment levels, a sign of airlines waiting for any uncertainty on any slowdown in demand growth or cost pressures to ease before making decisions on future employment levels.

How has your employment level changed in the last 3 months compared with the same period last year?

How do you expect your employment level to change over the next twelve months?

