

# IATA ECONOMICS BRIEFING

## AIRLINE BUSINESS CONFIDENCE INDEX

### APRIL 2008

#### KEY POINTS

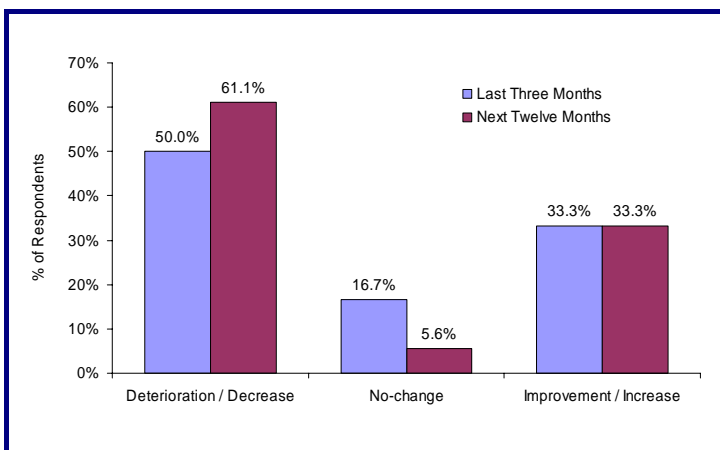
- Airline business confidence in current and future profitability weakened sharply in Q1 2008. For the first time since our survey began in March 2005, expectations of changes in profitability were, on average, negative. Half of the respondents thought that profitability had decreased in Q1, while over 61% expected profitability to deteriorate further over the next 12 months. High and rising fuel prices remain a major concern, but the other half of a damaging “stagflation” scenario, i.e. weaker demand, is also cited as a major worry for profitability.
- The April 2008 responses strongly reflect the more challenging economic environment encountered by airlines in recent months (for more details see IATA’s [March 2008 Financial Forecast](#)). Further expansion in developing markets (e.g. Asia), through new capacity and new routes, continues to provide a boost to demand, though this is increasingly offset by a slowdown in the US economy and by increased competition on many routes.
- Oil and fuel prices reached new record highs in Q1 2008. There is little expectation of any major relief in terms of a fall in the oil price in the next 12 months. Financial hedging and (for non-US airlines) a depreciation of the US dollar can help to offset (at least temporarily) some of the higher costs, but most of the upward cost pressure is beyond the control of airlines. Half the respondents were able to pass on some of the higher costs to passengers through higher yields in Q1. But as the demand environment slows and new capacity deliveries add to competition, any pricing power is expected to weaken over the next 12 months.

#### PROFITABILITY OUTLOOK

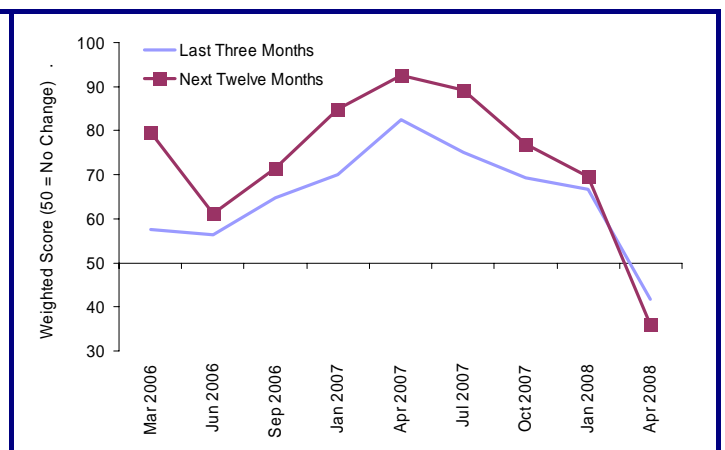
- For the first time since our survey began, airline expectations of changes in profitability were, on average, negative. The April 2008 responses strongly reflect the impact of higher fuel costs and a more uncertain demand environment in recent months. Only a third of respondents thought that profitability had increased in Q1 2008, while half of the respondents thought it had fallen. The high and increasing cost of fuel was cited as the main cause of the decline in profitability. On a weighted average basis (with 50 representing no-change, and values below 50 signalling a greater balance of negative views), the score for profitability over the previous three months has fallen from a peak of 82.5 in April 2007 (i.e. for Q1 2007) to 41.7 in April 2008 (i.e. for Q1 2008).

#### How has profitability changed? How do you expect it to change over the next twelve months?

##### a) April 2008 survey



##### b) Compared to previous surveys



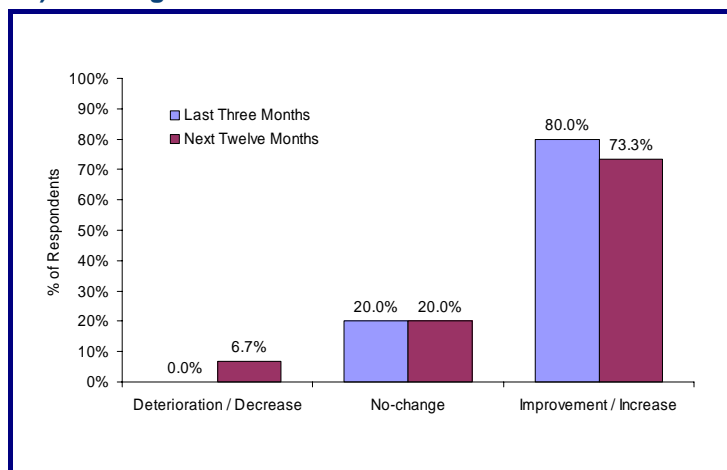
➤ Looking ahead, airline confidence has weakened even more sharply. Over 60% of respondents to the April 2008 survey expect profitability to decrease in the next 12 months, while only a third expect it to improve. The high fuel price remains a concern for respondents, but the other half of a damaging “stagflation” scenario, i.e. weaker demand, is also cited as a major worry for profitability. Any weakening of demand will reduce the ability of airlines to offset the impact of high fuel costs through improved revenues. Concern over the (negative) impact of new capacity on fares and cargo yields is also cited. On a weighted average basis, the outlook for profitability over the next 12 months has declined steeply, from 92.5 in April 2007 to 36.1 in April 2008.

## DEMAND GROWTH

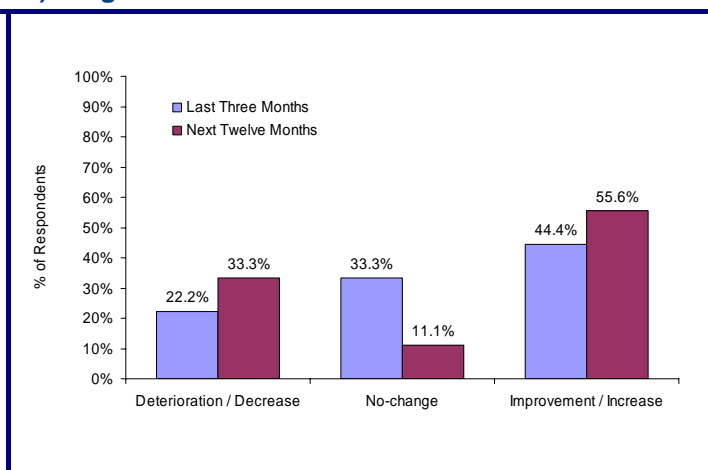
- Airlines, on average, remain confident that demand volumes will continue to increase, though there is a strong recognition that the demand environment has become tougher in recent months. Four-fifths of respondents thought that passenger volumes had increased in Q1 2008, albeit at a slower rate than before. Further expansion in developing markets, through new capacity and new routes, are seen as key drivers of recent demand growth. Looking forward, just under three-quarters of respondents still expect to see higher passenger volumes in the next 12 months, with Asia seen as the key market for further increases in demand. However, there is a general expectation that the rate of passenger demand growth, while still positive, is slowing while competition for new passenger growth will increase as large amounts of new aircraft are delivered.
- Air cargo demand is typically more quickly exposed to an economic slowdown, indeed it is often seen as a leading indicator of wider economic conditions. Less than 45% of the respondents thought that cargo volumes had increased in Q1 2008. Typically, higher fuel costs also have a proportionately greater impact on profitability on the cargo than on the passenger side. Looking forward, there is still confidence that developing economies can maintain strong growth levels, especially in Asia. Constraints in other modes, e.g. container shipping, may also benefit air cargo. As such, over 55% expect cargo volumes to increase over the next 12 months. However, a third of respondents expect to see a fall in cargo demand, as slower growth in the US and global economies have an immediate negative effect on cargo demand.

### The actual and expected change in traffic volumes

#### a) Passenger



#### b) Cargo



## INPUT COSTS

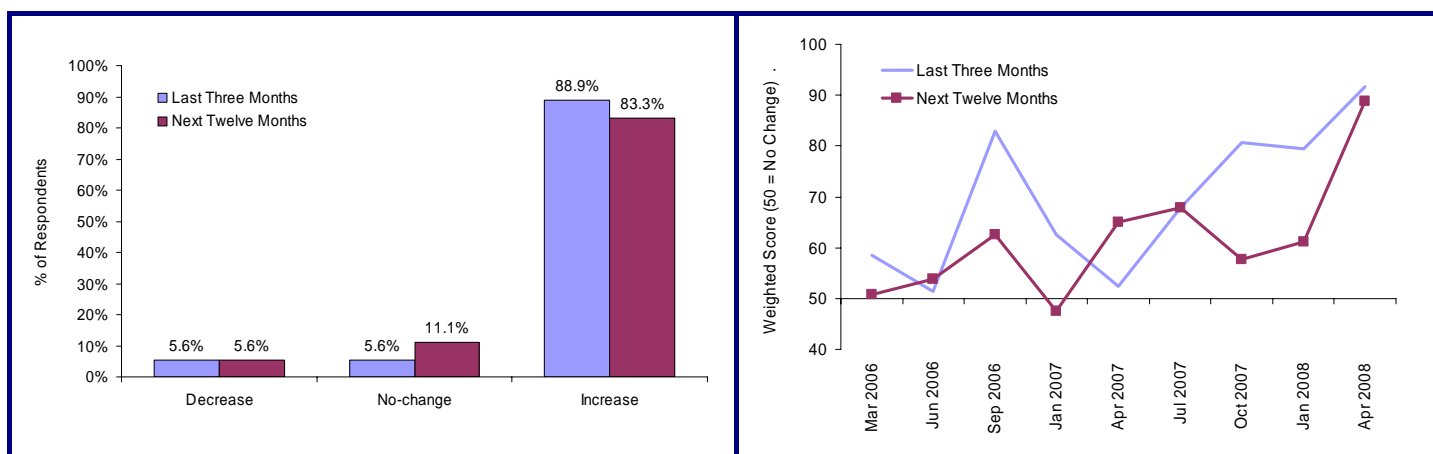
➤ Oil and fuel prices reached new record highs in Q1 2008, with jet fuel increasing to over \$144 per barrel in early April. Financial hedging and (for non-US airlines) a depreciation of the US dollar can help to offset (at least temporarily) some of the higher costs, but most of the upward cost pressure is beyond the control of airlines. Nearly 90% of respondents saw higher input costs in Q4, with less than 6% seeing a decrease. Strong management control and the on-going effects of productivity improvements continue to deliver fuel and non-fuel efficiencies, but in most cases were not sufficient to offset higher fuel costs. On a weighted average basis, the score for unit input costs has risen sharply from 52.5 in April 2007 (i.e. for Q1 2007) to 91.7 in April 2008 (i.e. for Q1 2008), moving in the opposite direction to the weighted average for profitability over the same period.

➤ Though fuel prices are already at record high levels, there is little expectation of any major relief in terms of a fall in price in the next 12 months. Indeed, over 83% of respondents expected to see further increases in input costs over the next 12 months, albeit there is hope that the rate of increase in fuel prices will slow significantly from the sharp jump seen in Q1. On a weighted average basis, the score for the outlook in unit input costs has also risen sharply from 47.5 in January 2007 to 88.9 in April 2008. Some respondents cite additional pressures from labour and maintenance costs, especially with growing shortages in some areas, e.g. labour skills. The focus remains on achieving further fuel and non-fuel cost efficiencies, though they will become increasingly harder to find.

### How have your unit input costs changed? How do you expect them to change over the next twelve months?

a) April 2008 survey

b) Compared to previous surveys



## YIELD ENVIRONMENT

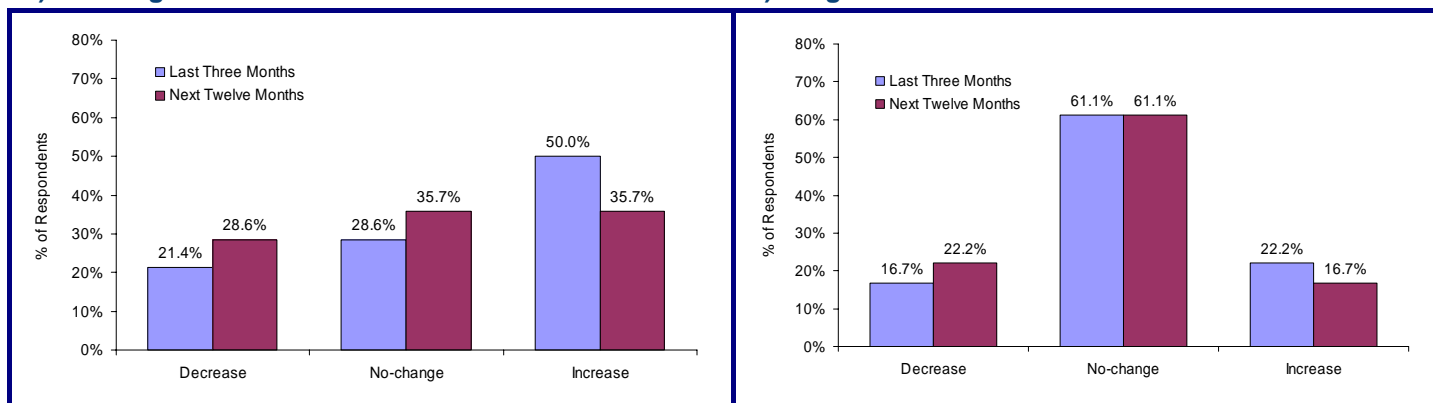
➤ The overall impact on yields reflects the relative strength of opposing pressures from higher input costs (upward) and increased competition (downward). On the passenger side, half the respondents were still able to increase yields in Q1, largely as part of the higher fuel costs is passed on to passengers. Revenue management techniques and better product mixes have also helped to boost yields while, in some cases, exchange rate movements have provided a positive effect. Nevertheless, many respondents expect pricing power may weaken over the next 12 months, with only 35% expecting further rises in yields. A weakening in the demand environment and increased competition through new aircraft deliveries are cited as the key factors.

➤ 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 competition from other modes. Only 22% of respondents were able to increase yields in Q1, with around 60% managing to keep yields steady. Even with expectations of further input cost rises, cargo pricing power is expected to remain weak.

### The actual and expected change in yields

a) Passenger

b) Cargo



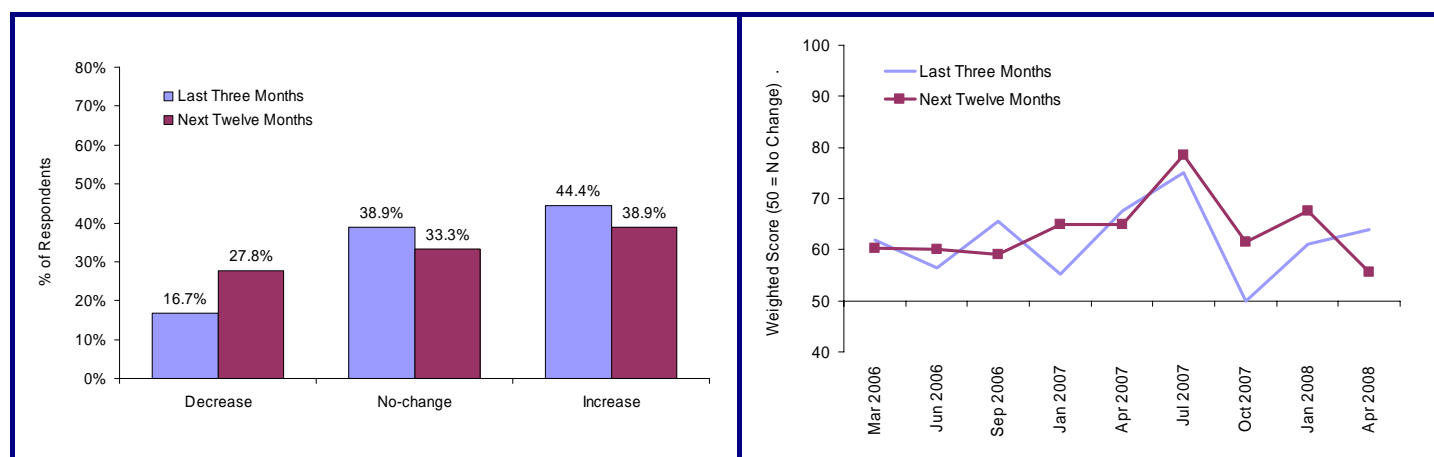
## EMPLOYMENT

- 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 has slowed since mid-2007. Just under 45% of respondents increased their level of employment in Q1, though only 17% actually reduced employment levels. On a weighted average basis, the score of 63.9 for the change in employment over the previous three months has rebounded from a low of 50.0 in October 2007 but remains below its peak of 75.0 in July 2007.
- The outlook for employment levels is affected 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. Airlines, on average, still expect an increase in employment over the next 12 months, though the rate of growth has declined significantly. On a weighted average basis, the outlook for employment has fallen sharply from 78.6 in July 2007 to 55.6 in April 2008.

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

a) April 2008 survey

b) Compared to previous surveys



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