

IATA ECONOMICS BRIEFING

AIRLINE BUSINESS CONFIDENCE INDEX

JULY 2008

KEY POINTS

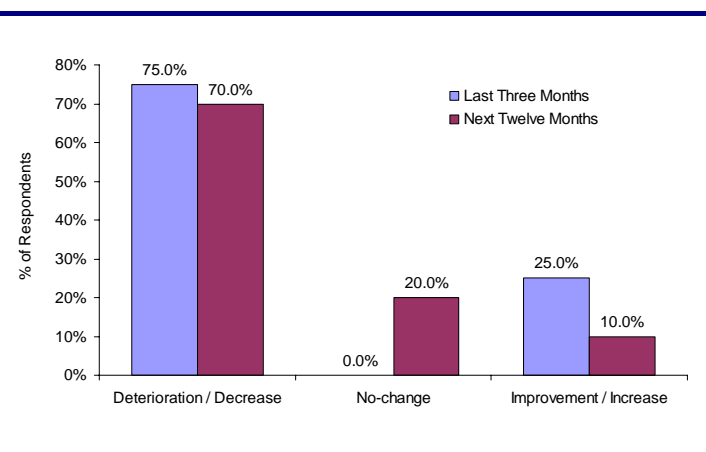
- Airline business confidence in current and future profitability weakened sharply in Q2 2008, continuing the steep decline seen in Q1. Only 10% of respondents expect to see profits rising over the next year, whereas 70% anticipate a further decline (compared to 61% in the April survey and just a year ago no respondents expected a decline). The steep rise in fuel prices is the principle driver of this slump in business confidence, but there has also been an increase in the number of airlines reporting softening demand and intensifying competition.
- The July 2008 responses strongly reflect the severe deterioration in the business environment faced by airlines in recent months (for more details see IATA's [June 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. But market growth outside the US is more than offset by the unprecedented rise in fuel prices, which rose above \$180 a barrel in early July which is 102% higher than a year ago, pushing input price expectations to new highs.
- The reaction of airlines to this deterioration is clear from the survey. Yields are now expected to rise sharply as airlines attempt to recover fuel costs, while employment is now, for the first time since the survey started, expected to fall as part of the necessary restructuring of capacity and cost structures.

PROFITABILITY OUTLOOK

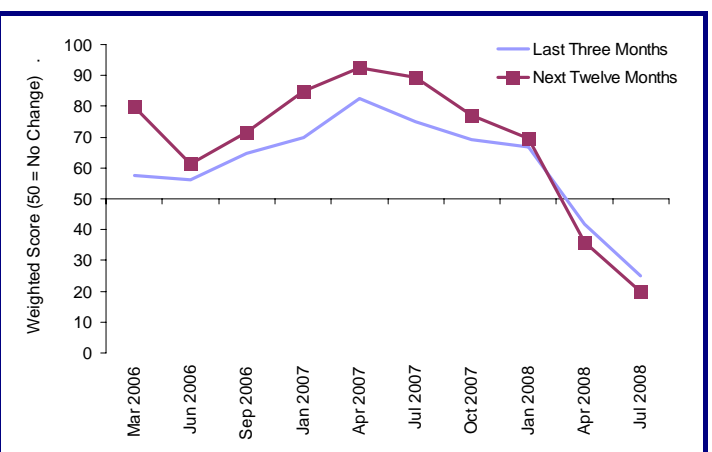
- During the second quarter of this year airline expectations for profitability fell to new lows; the second successive quarter where profits were expected to decline during the year ahead. The July 2008 responses strongly reflect the impact of higher fuel costs and a more uncertain demand environment in recent months. Only a quarter of respondents reported that profitability had increased in Q2 2008, while three-quarters of the respondents said 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 to a new low of 25 in July (i.e. Q2) this year.

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

a) July 2008 survey



b) Compared to previous surveys



Looking ahead, airline confidence has weakened even more sharply. Some 70% of respondents to the July 2008 survey expect profitability to decrease in the next 12 months, while only 10% 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 20 in April 2008.

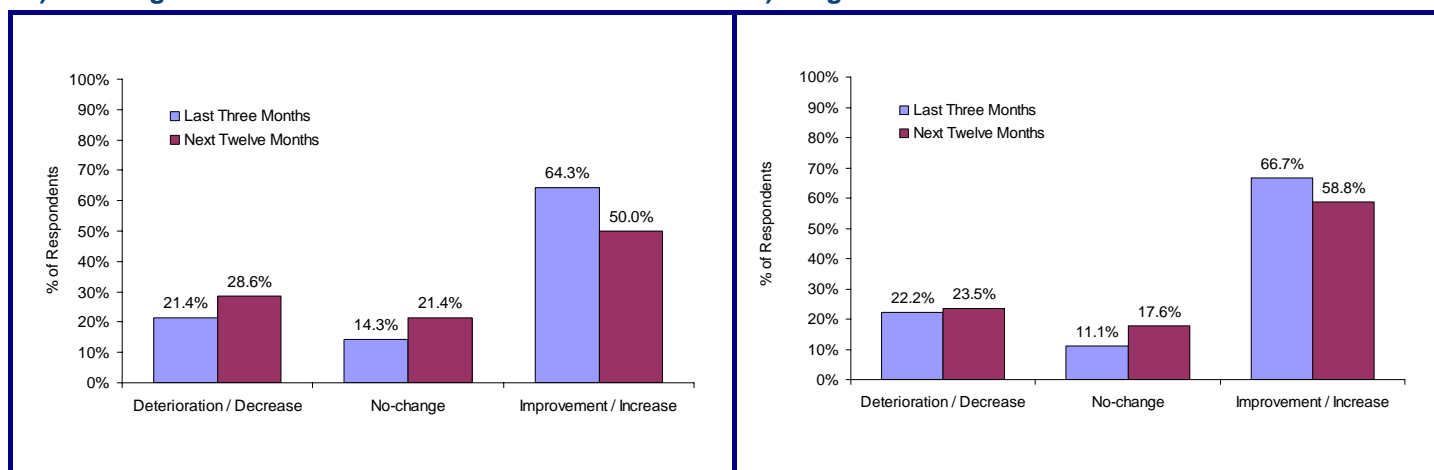
DEMAND GROWTH

- Airlines, on average, remain confident that demand volumes will continue to increase, though that confidence is declining and there is a strong recognition that the demand environment has become tougher in recent months. Two-thirds of respondents thought that passenger volumes had increased in Q2 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, half of respondents still expect to see higher passenger volumes in the next 12 months (compared with three-quarters in the April survey), 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 numbers of new aircraft are delivered.
- Air cargo demand is typically more rapidly exposed to an economic slowdown, but stronger Asian market are more important for cargo than the passenger business. Over two-thirds of the respondents thought that cargo volumes had increased in Q2 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 58% expect cargo volumes to increase over the next 12 months. However, a quarter 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

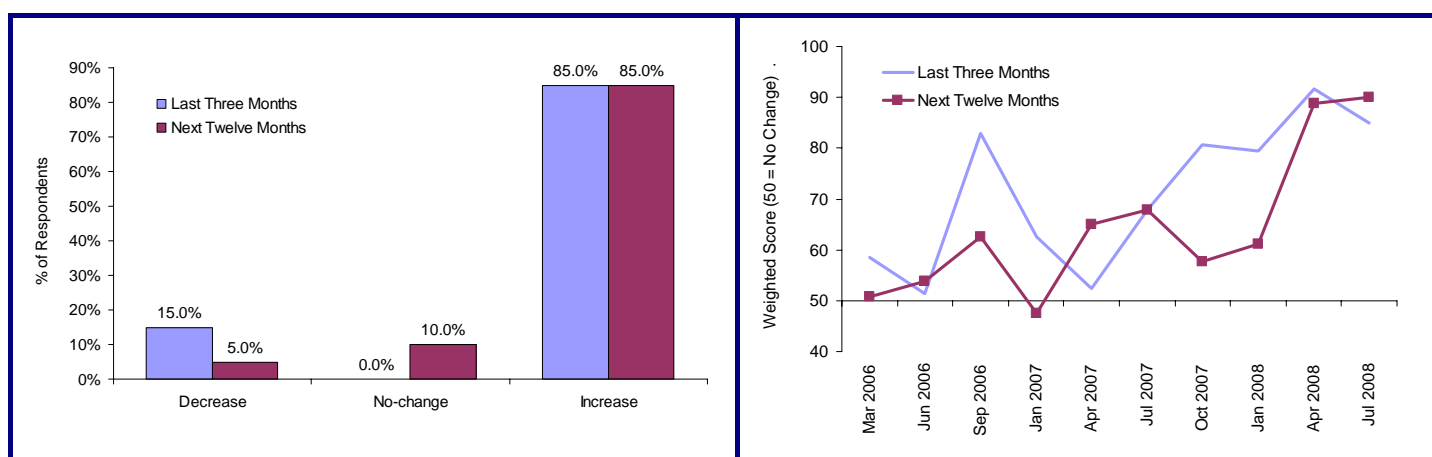
Oil and fuel prices reached new record highs in Q2 2008, with jet fuel increasing to over \$180 per barrel in early July. Fuel hedging and (for non-US airlines) a depreciation of the US dollar can help to offset (at least temporarily) some of the higher costs, but most of the upward cost pressure is beyond the control of airlines. Some 85% of respondents saw higher input costs in Q2, with only 15% 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 spiraling 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 85 in July 2008 (i.e. for Q2 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, 85% of respondents expected to see further increases in input costs over the next 12 months. 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 90 in April 2008. Some respondents cite additional pressures from labour and maintenance costs, especially with 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) July 2008 survey

b) Compared to previous surveys



YIELD ENVIRONMENT

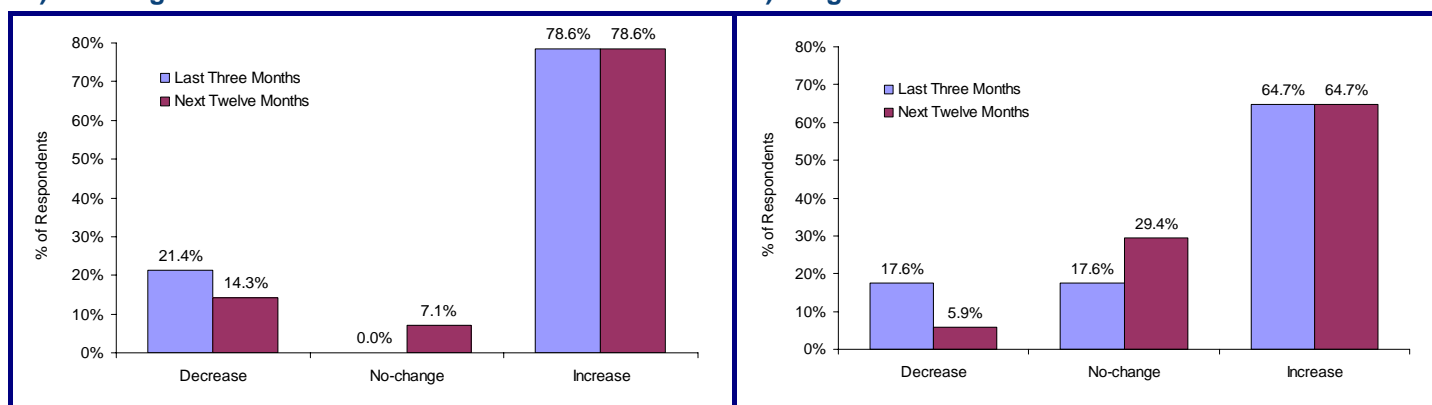
➤ Higher fuel costs are now dominating the impact on yields from intensified competition. On the passenger side, over three-quarters the respondents were able to increase yields in Q2 (50% in the April survey), as part of the higher fuel costs is passed on to passengers. Revenue management techniques and better product mixes have also helped to boost yields while, in some cases, exchange rate movements have provided a positive effect. The need to maintain aircraft utilisation in the face of softer demand and rising aircraft deliveries will constrain the ability of airlines to pass on fuel cost increases. Nonetheless, there has been a significant change in yield expectations from the April survey when only 35% expected yields to rise over the next 12 months to July when over 78% of respondents expected to yields to be higher.

➤ 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. Even so, there has been a marked change since the April survey. In Q2 64% raised yields in an effort to recover fuel costs and a similar percentage expect to raise yields in the months ahead, compared with only 22% and 16% respectively in the April survey.

The actual and expected change in yields

a) Passenger

b) Cargo



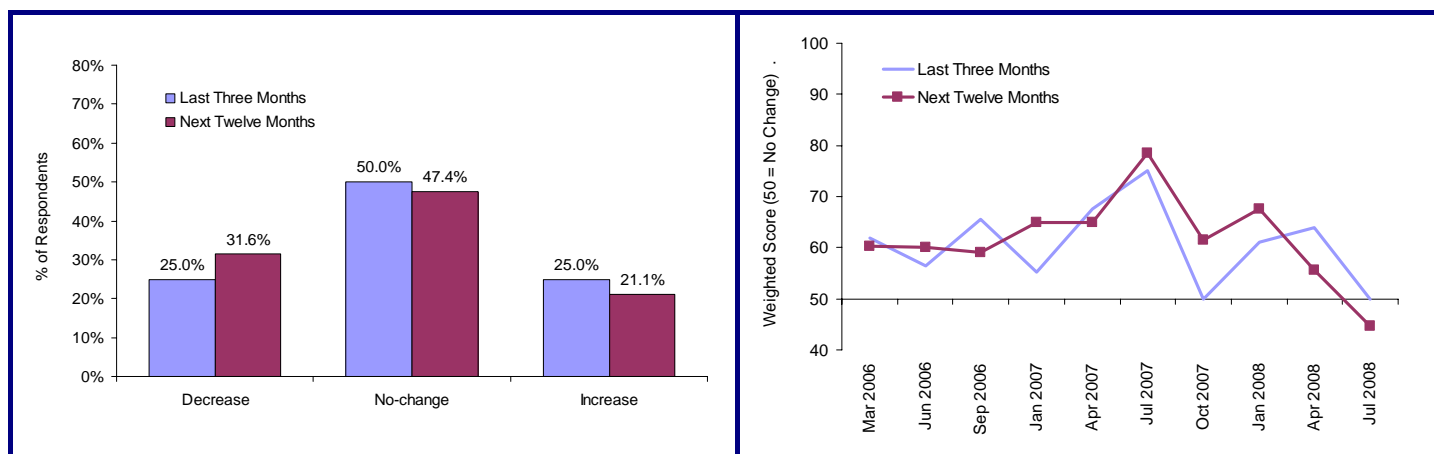
EMPLOYMENT

- 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 had 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 25% of respondents increased their level of employment in Q2, and 25% actually reduced employment levels. On a weighted average basis, the score of 50.0 for the change in employment over the previous three months has fallen back to its low of 50.0 in October 2007 and is now well below its peak of 75.0 in July 2007.
- The outlook for employment levels is now being affected by the urgent need to restructure operations in the face of the fuel price increases. For the first time in the survey there is now a net balance of airlines expecting a decline in employment over the next 12 months; 31% are anticipating jobs cuts while only 21% of respondents expect to increase employment. On a weighted average basis, the outlook for employment has fallen sharply from 78.6 in July 2007 to 44.7 in July 2008.

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

a) July 2008 survey

b) Compared to previous surveys



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