ANALYST VIEWPOINT

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MANAGING THE AIRLINE ECONOMIC CYCLE

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David Bonderman, founding partner of private equity firm Texas Pacific Group and chairman of Ryanair, told IATA's recent annual conference that the airline industry cycle was already "as good as it gets", even though the global industry is still expected to see net losses of $3 billion in 2006. His view, in particular, is that continuing high fuel costs and large capacity growth – as record aircraft orders are delivered over the next few years – could mean that the airline economic cycle has already peaked. In essence, for most of the industry it is now a question of "riding the cycle" rather than finding a new source of structural growth that will materially and positively impact their financial results. It is perhaps worthwhile taking a minute or two to consider some of the signs.

Against a background of continuing mixed messages from hard economic data, confidence surveys and forecasts the outlook is perhaps as clear as mud. Whilst long term plans and strategies are fundamentally important, the reality is that airlines operate in an environment where revenues and the majority of costs are determined by external events. Notwithstanding this, the latest IATA Airline Business Confidence Survey shows that out of the group surveyed there are still more who expect profits to rise than those expecting profits to fall.

The airline industry is not immune from the rules of economics and indeed the ability to recover either implicitly or explicitly at least part of the rise in the cost of fuel is a function of the relationship between traffic volumes and capacity - in essence the extent to which the change in capacity is greater or less than underlying demand. Whilst it is clear that several airlines have had some success in this area, it is important that this does not result in some form of yield illusion. Furthermore, it is also important to consider the rate at which 2005's record order intake will materialise into deliveries and where.

Over the long term it is possible to demonstrate that traffic grows at some 1.5 times real GDP and that airline revenues grow at a similar rate to money value GDP. Similarly it is also possible to demonstrate that these revealed multipliers vary over time and with the structure and maturity of the industry and the relevant economies.

Since the start of the decade the seemingly never ending mantra has been that only those airlines which have a low cost model will survive, let alone generate the necessary returns to attract investors. However it is important to be clear what we mean by low cost airlines.

Generally the term low cost airline has been synonymous with the term low/no-frills airline but herein lies somewhat of a problem. To have any chance of making profit any business needs to have the lowest costs possible – its costs need to be "appropriate" for its current and likely future revenue streams. Indeed, new entrant, new model airlines start with an immediate advantage and some – but by no means all – have a cost base that is appropriate to their revenue stream. There is increasingly clear evidence that in highly competitive markets price is only one of a number of "product attributes" that potential customers consider when making their decisions.

As with most things it is important to view the airline industry as a dynamic system. Generalisation is dangerous and selectivity is particularly important. There is no one size fits all template for success in this industry – rather there are a range of options that it is possible to bring together to try to ensure success – but the ability to do this depends in large part upon the staring point and the extent of costs associated with transition and the ability to make change. Furthermore, IATA's recently published report on profitability in the aviation value chain[1] shows that the rate of return for the top 9 "no frills" operators as a group fell short of their combined weighted average cost of capital.

The latest IATA financial forecast suggests that – in the absence of any further external shocks – the global airline industry will see an EBIT margin of between 3 and 4% in 2007. However, while this is an improvement on recent years, it is still well below the cost of capital of the industry. It also results in financial returns that are far short of what is needed to appropriately reward stakeholders for the risks they take and to attract sufficient new capital for investment and growth. Whilst it is has been broadly the case that over the last couple of years there has been no shortage of money to finance aircraft purchases there is a difference between making an investment in an aircraft and making an investment in an airline. Consequently if confidence on the part of those either directly or indirectly funding the purchase of aircraft falters - which is likely to result in or result from adverse trading for the airlines - life would inevitably become more difficult. Conversely, if there was such a hiccup it might remove concerns over the prospects of too much capacity entering the market following the record order intake in 2005 and what appears a still strong level of ordering in the first 5 months of 2006.

It is important to be clear on a number of things – for airline managers it is generally not a question of not knowing what to do in adversity. The constraint is the ability to act sufficiently quickly and radically enough. On the one hand change is not costless, whilst on the other these actions will need to be taken against the background of falling revenues and pressure on cash inflow and cash balances. In the short term airline costs are effectively determined by the scale of operations planned at the start of the season and by external factors – particularly in the case of fuel. As a consequence, there are limits to the amount of change that can be effected by management. Over the medium term it is possible to make change but there is inevitably a cash cost associated with it and given that this is still not an industry where there is "free exit" it is quite possible that, despite taking action, little improves as the apparently unsustainable position of a competitor or competitors has been allowed to persist through direct or indirect government support.

The key question is perhaps whether anything has fundamentally changed – the answer in some areas is yes, in that the industry overall is profitable at the operating level with fuel at some $80 a barrel. However the gap between the achieved load factor and the breakeven load factor remains wafer thin. Furthermore, although the contribution to profit for every percentage point of load factor beyond breakeven at the industry level has increased markedly over the last ten years from $4.0 billion to $6.2 billion, when measured in margin terms it has remained constant at 1.7%.

It is often said that the only constant in the airline industry is change. In this respect it is clear that whilst considerable progress has been made the outlook is one where, in effect, management teams will be running very hard to do not much more than stand still in financial terms even against a generally still favourable economic background. The even greater challenge is to sustain a profitable performance when economic turbulence kicks in – an event that is unfortunately inevitable.

[1] IATA, "Value Chain Profitability", June 2006.