



# ANALYST VIEWPOINT

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## RAISE CASH NOW

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At the simplest level the strategy for almost any company should enable it to survive, compete and prosper – all business strategies, even those that only have survival as an objective need to have a supportive financial plan. One feature of the airline industry is that the focus on the survival objective tends to come around more often than in many other industries and this is an issue that is now very real for a number of airline managements and in particular what needs to be done to ensure survival as well as being clear on the likely nature and form of the ongoing business. There is perhaps little value in spending too much time in considering in detail how much more difficult the operating environment is likely to become; in the near term traffic and revenue appear to be continuing to fall in most markets – in the US for example second quarter airline traffic is forecast to be some 7% lower and the year to date yield figures, for the airlines of the Air Transport Association of America, show falls of between 9% (Latin America) and almost 19% (Atlantic). On the other side of the equation at the time of writing, the oil price is again comfortably over \$60 a barrel. Turning to the medium term there is increasing support for the view that the current economic downturn may have a “W” shape with the second dip starting as we move into 2010 – despite this there is a recognition that the financial markets are seeing a type of “bear market bounce” – which at other times has given powerful upward momentum in the short term and the twin forces of fear and greed may act to drive the markets higher before economic reality again sets in. To this end such an event is likely to be helpful given that for many businesses a key pressure point is a shortage of cash and a continuing need to plug the actual and forecast gaps. Any positive sentiment in the financial markets offers a window of opportunity which a (small) number of airlines already have made use of and others clearly will (and should) do so before it closes as it inevitably will.

### **Challenging fundamentals**

Whilst we share the view expressed at the recent IATA AGM in Kuala Lumpur that the “facts do not support the optimists” we do however struggle with the views that all airlines will emerge from the current turmoil in a restructured form and also that consolidation is necessarily a panacea for the current problems. Indeed we consider that realising the benefits that could arise from mergers and acquisitions are even more difficult to capture in the current environment than in more normal times - let alone the consequences of management diversion – unless the acquisition is in effect just a “bolt on”. However the current environment has, and will continue to give rise to opportunities but the extent to which they can be realised depends on a range of factors; we have no doubt that there will be an adequate supply of cheap capacity as we move through 2009 and into 2010 but will there be an opportunity to replicate the events of the last downturn when a number of low cost carriers accelerated their development as the legacy airlines struggled? This is less likely on a wide scale given that reality has replaced exuberance in the LCC sector, with the attendant consequences but clearly there are a number opportunities that do and will exist.

The reality is that international traffic is now trending around the levels last seen in 2004/05 but that the capacity available within the industry and the infrastructure/overhead supporting it is still close to the levels of activity forecast in 2007/8 for 2009. One of the continuing areas of concern is that on current planned rates of delivery, capacity at the end of 2011 will be some 17% higher than at the start of 2009. This is not only reasonably scary in its own right but given that the consequences of excess capacity are all too clear on fares, revenues and cash, the prospect is one where even fewer airlines will be able to generate an adequate, let alone particularly attractive return in the next upswing – although the benefit for travellers from what will be a structural reduction in fares will be very welcome. Whilst there have been a number of deferrals of deliveries/quasi cancellations for aircraft due for delivery in 2010 and beyond, these remain very few in number we would expect a dose of reality in the run up to the summer 2010 slot conference to be held Vancouver between 19-22nd November 2009 – particularly where the aircraft were ordered for growth.

### **Positioning for an upturn**

We should not underestimate the difficulties of making adjustments and a great concern must be that the adjustments made now will have an impact upon the ability of the business to benefit from the upswing. There are two straightforward but broadly unanswerable questions; when will the industry recover? and what form will the recovery take? There is often a tendency to talk about the performance of the industry and whilst it represents the aggregation of the individual airlines there is, even in more normal times, a wide variation in market outlook, market position, financial strength and performance (amongst other things). With this in mind generalisations are always dangerous and in this respect it is even more important to focus on the performance of individual airlines. It is also necessary to distinguish between cyclical and structural events - notwithstanding the fact that cyclical events may result in structural outcomes. There are a number of areas where fundamental growth is evident and the airlines operating in these markets or with meaningful exposure to them are clearly also best placed for the future - as long as the temptation to flood the market with capacity is avoided. The reality of the current environment is that even fewer airlines are likely to emerge as potential winners and not all will survive. Indeed for many that do survive their future financial performance is unlikely to be anything other than linked to the vagaries of the economic cycle and one where the returns at the peak are likely to be markedly lower than in the past and in terms of what investors want; not particularly attractive - an outcome which has implications for the availability and cost of finance.

Whilst cost reduction programmes are important, the reality is that in most cases the effect in the short term is to make the current environment slightly less worse due to the lags in effect and the costs associated with achieving the reductions in cost. Furthermore there is also the issue of the potential damage that an uncoordinated, but headline grabbing initiative, which might save some cash in 12-18 months time, could have in terms of its impact on the ability of the business to recover as well as benefit from any new opportunities that might arise. Most cost reduction programmes result in a reduction in what costs might have been rather than anything more structural. Indeed the most significant reduction in ongoing costs that has occurred in the last few years has been the result of the move to e-tickets, internet booking and the reduction in agents' commissions. Even more so the current and likely future environment highlights the need for both an operational plan as well as a coherent and credible strategy as well as the all important financial plan – hanging on for the increasingly bumpy ride from an operational perspective and more of the same as a strategy are no longer appropriate.

### **How much cash is enough?**

From a financial perspective perhaps the only thing that matters now is cash, and in this respect to have as much as possible; for all airlines the need is to minimise the outflow as well as in many, if not most, cases to seek new sources. The stock market adage that you should only ask for money when you don't

need it isn't very useful just now – as there is now a real need. At the best of times airlines are not particularly attractive investments and indeed they generally tend to be of relatively short term interest only. At the present time, whilst there have been some straight equity issues, all of the indications are that convertible instruments are now particularly attractive to those seeking new funds – but then there is still the issue of how the risk associated with holding any particular instrument is priced and valued. At the present time it appears that market conditions are broadly favourable and at the “right price” it is likely to be receptive – at least in the near term.

A number of airlines have already attracted new money from the market either as pure equity or quasi-equity in the form of convertibles which as the name suggests convert from being a loan attracting at rate of interest. Earlier this year SAS raised some SEK 6.4bn from an issue aimed at both existing shareholders and new shareholders which was to support the implementation of the “Core SAS” strategy; the issue was completed in May 2009 – however given the SAS CEO's comments at the time of the IATA AGM when he admitted that the operating environment had deteriorated further than that expected at the time of the issue. The most recent issues have been from Air France (€661m convertible bond due in April 2015) which will pay interest at 4.97% and from British Airways which will pay 5.8% (£350m convertible debt issue due in 2014).

Given that investors have choices the question then becomes how an airline issue becomes attractive to the potential buyers - at a simple level it is either that the investment story is sufficiently appealing and the upside from the “in price” is likely to produce the necessary return for the risk; In effect an investor is buying into the potential benefits offered by the investment story which needs to be sufficiently strong. However at the present time, no matter how coherent the strategy might appear to be, the more realistic focus will be on the need for the money raised to fill a gap which was clearly demonstrated by the recent BA issue where management stated that the net proceeds are being used “to ensure the Company has strong liquidity consistent with difficult trading conditions”

In the current circumstances the fundamental question is perhaps “how much cash is enough?” – There is unfortunately no straightforward answer other than “as much as possible” - but then this depends on, in effect, all of the above. In the current circumstances there is always a risk that what is raised reflects what is possible rather than what is needed and then the ability to raise more depends on the then prevailing circumstances which in a year's time could well be worse than they are now. The airline business has never been easy and although those which are able to attract new money will at least have a cushion, it looks as if the operating environment will get more difficult yet. For those that need to access new sources of cash, the window is clearly open but if expectations of a “W” shaped downturn increase it may not remain open for long. And then what happens next? What role might government funding play in supporting the airline industry? But that perhaps is a question for another day. In the meantime it is essential that operating plans and the business strategy (even if it only has survival as an objective) are supported by a deliverable financial plan and herein lies yet another challenge.

***The views expressed in this article are the author's and not necessarily those of IATA.***