

European Airlines

10 reasons why we could be at the top of the cycle

- One of our main themes for the European airline industry is that consumer price elasticity has gone into hibernation for the traditional two years per cycle - hence fares/yields could be pushed up by airlines, who thus grew their profits strongly.
- Twenty-five years of industry history say that a third year of rising yields does not happen.
- For the EU majors, the end of the second year of rising yields was Q1 2007 – we therefore expected yields to come under pressure for the summer.
- Right on cue, evidence of weaker yields and softer demand (in the light of further fare increases) has emerged.
- This note lists 10 pieces of data to support our view that the peak of the cycle is passing right now.
- We are not saying that profits fall from here (far from it), but that the upwards momentum for earnings coming from rising yields is evaporating, hence earnings growth from here will be harder to win.
- The Low-Cost Carrier segment has already seen share prices fall back as managements spoke of the revenue environment softness. When demand settles, we still see them as growth stocks.
- However, we believe that it is only a matter of time before the network carrier segment begins to talk the same story of softening demand, which would be likely to put pressure on those stocks.
- We urge investors to be more cautious about holding network airlines than we were in Q1.

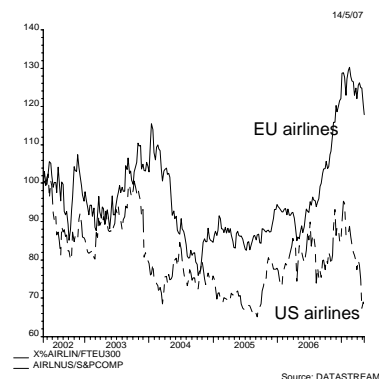
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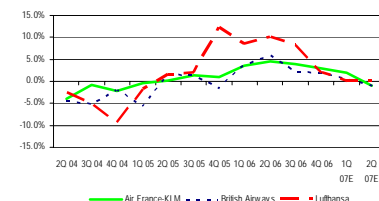
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Airline Sector Performance

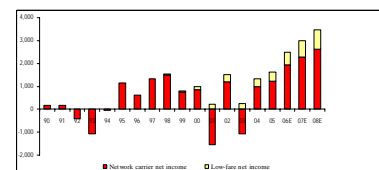


BA, AF and LH yield change



Source: company data and JPMorgan estimates

EU airline profits, €m



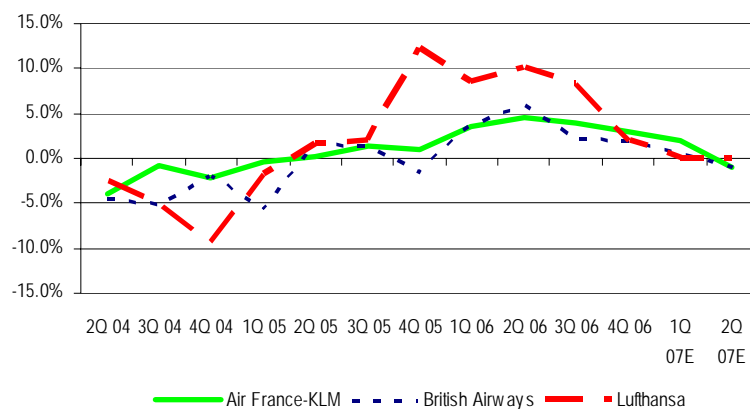
Source: company data and JPMorgan estimates

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Investment thesis

Twenty five years of industry history say that there is not a third consecutive year of rising yields in an airline industry cyclical upturn. Our chart below shows that we are at the end of the second year of rising yields (Q2 05 to Q1 07), thus it is reasonable to wonder whether this stimulus for earnings growth will now fall away.

BA, Lufthansa and Air France yield progression (% change, year-on-year)



Source: company data and JPMorgan estimates

Of course, it is always possible that “it’s different this time”, so we need to find a bit of evidence that the thesis might be valid. In this note, we present ten reasons why the industry is likely to be passing the turning point for yields.

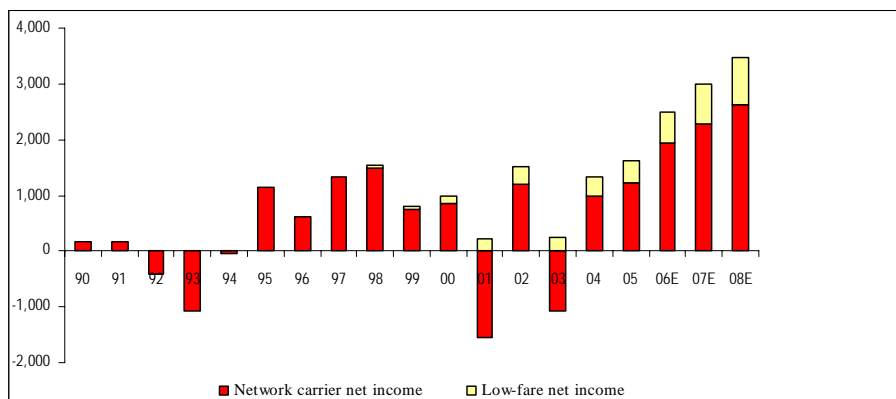
The 10 reasons why we could be at the top of the airline cycle:

1. Industry profits are already higher than the previous cyclical peak
2. Hibernating price elasticity has woken up for LCCs first
3. US airlines are already in a slowdown
4. All-business class LON/NY operators now have 17% share, rising to 21% in July
5. All-business class LON/NY operators are raising equity
6. Fuel surcharges are not being fully replaced as crude rises
7. Network airline yields are starting to soften
8. UK consumer spending is under pressure
9. Consensus view that BA can get record margins
10. Aircraft finance markets are awash with new liquidity sources

1. Industry profits are already higher than the previous cyclical peak

The chart below is prepared by aggregating our airline earnings models, so is not deliberately constructed to show a certain shape. It is clear that the network airlines' net income is now significantly exceeding the peak of the last cycle, with Air France being a significant part of that (privatisation and change in culture since the previous cyclical peak in 1998).

EU airline net income, €m



Source: company data and JPMorgan estimates

In our view, this chart should give something of a warning flag for a deeply cyclical industry (the network segment, not the LCC segment, in our view).

2. Hibernating price elasticity has woken up for LCCs first

Our first chart on page 2 above shows that the network airlines have enjoyed two years of rising yields, and the LCCs have also benefited from this trend. What has happened is that the consumer's normal elasticity of demand goes into some kind of hibernation, with 25 years of industry history showing that the hibernation lasts for two years. Our recollection of past cycles points to no individual, unique circumstance or factor that reawakens the consumer's price elasticity, but that, in general, the passenger base starts to resist price rises in the third year.

What Ryanair and easyJet have just said for April is that demand has softened. In their specific cases, the doubling of Air Passenger Duty (£5 to £10) and the end of discounted deals at Stansted for both of them (£3 to £6 per passenger, we believe) have made them implement relatively large fare increases in order to recover these costs, and clearly these have met consumer resistance – easyJet's April load factor was down by 3.3 percentage points, and it consequently cut lead-in fares for summer in order to rebuild load factors (though it did not change earnings guidance).

Spanish LCC Vueling has just cautioned about yields in domestic Spain for Q2, warning that lower fares and consequent higher load factors may not be revenue-neutral – hence the weakness is not UK-specific.

Ryanair does not report the March quarter until June 5, and easyJet has just reported, hence there will be no fresh data from this area for a while.

However, if price elasticity has been reawakened in one segment of the airline market, we find it hard to see why it will not be similarly affecting other leisure-oriented customers flying with network airlines. We recognise that business demand may have different elasticity (if any) and thus be on a different cycle.

3. US airlines are already in a slowdown

It is clear from the Q1 earnings calls at the US network and LCC majors that domestic air travel markets have experienced material softening in demand in the past months (see Jamie Baker's recent notes, downgrading 6 carrier recommendations on 27 April), with no carrier reporting a recovery in that trend. Our colleague's view is that domestic demand weakness is likely to spread to international markets, and, indeed, BA is already talking of lower demand for US-originating leisure travel. Back in 2001, US domestic demand similarly softened, and it took three months before the carriers saw the contagion spread to the Atlantic markets.

Remember also that US network carriers are taking planes out of US domestic markets (where they face very tough markets against LCCs) and putting those that have the range to fly long-haul onto the Atlantic – B757s and B767s in particular.

Network airline April traffic statistics on the Atlantic

| Atlantic | Capacity ASM (% Chg) | Traffic RPM (% Chg) | Load Factor (Chg in pts) |
|-----------------|-------------------------|------------------------|-----------------------------|
| USA | | | |
| American | -2.4% | -5.7% | -2.7 |
| United | 9.5% | 10.3% | 0.6 |
| Delta | 16.3% | 17.3% | 0.7 |
| Northwest | 0.3% | -2.6% | -2.6 |
| Continental | 12.0% | 12.6% | 0.4 |
| US Airways | 10.8% | 4.8% | -4.6 |
| Europe | | | |
| British Airways | -1.4% | -5.6% | -3.6 |
| Lufthansa | 7.5% | 7.3% | -0.2 |
| Air France-KLM | 9.4% | 6.1% | -2.7 |

Source: company data

This table shows an uncomfortable number of airlines increasing capacity by well in excess of normal market growth – four US airlines growing, on average, by 12%. April is the first summer month, and therefore sets the level of the season's schedule. Bear in mind that this covers all Atlantic operations, including Russia, Middle East and Africa for the US carriers.

4. All-business class LON/NY operators now have 17% share, rising to 21% in July

Now that Eos is operating a third daily service, the all-business class operators now fly 17% of the premium seats on London/New York, somewhat larger than many observers might have thought, and Silverjet's second frequency from the start of July takes this up to 21%.

LON/NY premium market shares

| Carrier | Total Daily Premium Seats | Share |
|----------------------|---------------------------|-------|
| British Airways | 776 | 39% |
| American Airlines | 306 | 15% |
| Virgin Atlantic | 297 | 15% |
| Maxjet/Eos/Silverjet | 412 | 21% |
| Delta | 36 | 2% |
| Continental | 72 | 4% |
| Air India | 103 | 5% |
| Total | 2001 | 100% |

Source: company data

We see this level of share as able to affect market pricing

With this level of capacity, we believe that these all-business class carriers will be starting to affect corporate fares as well as taking market share in the premium leisure market between the two cities. Certainly at a minimum we think they will be preventing any increase in existing business class fares between London and New York, and we have (so far limited) evidence that corporate fares are actually being reduced because of the growing competition.

5. All-business class LON/NY operators are raising equity

Silverjet, the Luton-based all-business class carrier that listed on the London AIM market a year ago, is now raising £26m in an underwritten share issue. It starts its second daily service to New York this July.

Maxjet, the carrier with the lowest-specification business class seat of the three, has announced its intention to list on the London AIM market, raising money for the further expansion of the 5-plane airline, aiming for a sixth B767 later this year and a seventh in a year's time. It currently serves New York, Washington and Las Vegas from its Stansted base, with Los Angeles being added in August this year.

6. Fuel surcharges are not being fully replaced as crude rises

As the fuel price has oscillated, Air France has been moving its fuel price surcharge up and down according to its published formula (Brent 30 days above/below \$5/bbl steps). However, we find it very interesting that its last two increases have not been as large as the previous time.

Air France fuel price surcharges

| AIR FRANCE | Long-haul surcharge |
|------------------------------------|---------------------|
| 30 April 2007 (wef 3 May) | €53 |
| (Brent had been >65 for 30 days) | +€5, 10% |
| 22 March 2007 (wef 22 Mar) | €48 |
| (Brent had been >60 for 30 days) | +€4, +9% |
| 2 Feb 2007 (wef 3 Feb) | €44 |
| (Brent below \$60/bbl for 30 days) | -€7, -14% |
| 5 October 2006 (wef 6 Oct) | €51 |
| (Brent below \$65/bbl for 30 days) | -€7, -12% |
| 8 August 2006 (wef 10 Aug) | €58 |
| (€65/bbl trigger) | €7, +14% |
| 26 April 2006 (wef 28 April) | €51 |
| (€60/bbl trigger) | €7, +16% |
| 29 Sept 2005 (wef 4 Oct) | €44 |

Source: company data

The logical increase in both of the last two cases would have been a €7 at each step. We interpret this reticence to replace the previous full surcharge as nervousness that the consumer might now push back on this latest price rise. BA has done something similar, taking £5 off and then putting only £3 back onto fares for long-haul sectors up to 9 hours.

7. Network airline yields are starting to soften

Lufthansa was the first of the network majors to report the March quarter, and it showed a flat yield performance after FX. However, without the dollar weakness, yields would have been positive for the eighth consecutive quarter. Iberia's yield for the March quarter was down 0.7%, though this was no doubt affected by an increasing stage length (longer haul has lower yield per km, and Iberia's long-haul mix increased).

We were also intrigued by a change in Air France language on yields in the statements accompanying the monthly traffic statistics - these were only started relatively recently to tell the market about how strong yields were.

December – “as in previous months, the group posted a further rise in yield in December thanks to a rise in all segments.”

January – ditto “in January”.

February – “as in January, the group posted a further increase in yields in all segments.”

March – “the group also posted a significant increase in yield across all classes”.

April – “the yield remained at a good level.”

Omitting a yield comment completely in April might have attracted more interest, but we interpret "good" here as no long being an “increase”, let alone "a significant increase". Or perhaps we are reading too much into this? We think not.

8. UK consumer spending is under pressure

The weakness of the UK consumer is well known, and the latest interest rate increase is being seen as likely to cool the rise in the UK housing market and further squeezing consumers' discretionary spending. Obtaining a third consecutive year of rising yields under this scenario looks to us to be a tall order, particularly in the light of Ryanair and easyJet's experiences (noted above) in trying to put through fare increases to recover their cost pressures at Stansted.

9. Consensus view that BA can get record margins

In its 20 year life as a quoted company, BA has never reached 10% operating margin at the three cyclical peaks - it was within a whisker in 1987, and reached 9.4% in 1997, and the company now forecasts reaching 10% in the March 2008 year (subject to confirmation or revision this Friday 18 May), which would be a very creditable

achievement indeed in an industry segment which we see as shareholder value-destructive in the longer term.

However, we believe that the market optimism which follows such a return to the cyclical peak risks overshooting, particularly by those who have not followed a complete cycle. According to Reuters, there are now six commentators who are forecasting that BA goes on climbing to margins of 11.0% or more in the following year as the benefits of Terminal 5 pour in (we have some differing views here, but that is for another day). Two of those forecasts exceed 12% operating margin, more than 20% higher than BA has done in the last twenty years.

On its own, six separate forecasts for margins so far above historical precedent might not be indicative of an overshoot of sentiment on the upside, but, as one of a list of ten, we think it counts.

10. Aircraft finance markets are awash with new liquidity sources

At Boeing's recent financiers' conference in London, 75% of the banking audience felt that there was too much capital chasing aircraft financing business. But, somewhat oddly, 78% of the same audience expected that their own organisation would grow its financing business. The market for physical aircraft is tight (OEMs' production lines are now sold out for years ahead), hence lease rates are cyclically high, and competition to win financing business is very tough, with spreads being driven down. New sources of finance are joining the aircraft market, such as from shipping sources (seeing aircraft as a similar asset class). Manufacturer finance, typically a feature of difficult markets (the OEM as the financier of last resort), is non-existent as a source of funding for today's deliveries.

When deeply cyclical industries start looking attractive to new sources of funding, and traditional players are taking opportunities to sell down (e.g. GECAS/Genesis), we see reason for caution.

Conclusion

We see these 10 pieces of evidence as supporting our thesis that industry yields are about to resume their long-term negative trend, after a two-year cyclical break. We expect earnings growth from network airlines in particular now to slow down, and even turn negative in a year or two. For share prices, however, we see this as a very challenging scenario, though suspect that the market will not make a major downward move on any shares *until management says something bearish*. Both BA and Air France are about to report full year results - if managements remain confident, then we expect the bulls to keep the faith, and the stocks to hold up.

We see the bear case starting to build now, and urge investors to be even more cautious about holding network airlines than we were in Q1.

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Revised March 30, 2007.

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European Equity Research
15 May 2007

