



ANALYST VIEWPOINT

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‘SHRINK TO SURVIVE’ IS NOT THE ONLY STRATEGY

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There are perhaps no prizes for suggesting that the airline industry faces what may be its most testing time since the start of the jet age with the prospect of a widening economic slowdown/contraction. In some way the future represents a step into the unknown; whilst we may all have a view on the likely duration and depth of the slowdown/downturn and in broad terms be close to what may happen, the reality is that forecasts are going to be directional rather than necessarily accurate for 2009 if not indeed 2010. Whilst these may be unprecedented times in some ways in other ways there is a rather depressing familiarity about it – over-exuberance and a belief that a number traditional relationships essentially between fundamental demand, capacity, price and ultimately financial performance had changed. Attention is focused both on the nature of the adjustment on the supply side – not just in terms of capacity offered by airlines but also in terms of new aircraft to be delivered – but also on the leading indicators of a turning point. Whilst this downturn is cyclical in origin it will inevitably have a series of strategic consequences. Whilst gloom abounds at the moment the reality is that there will still be a demand for air travel after this downturn and the real issue is what the shape and size of the industry will be and the nature of the adjustment process to get from “here to there”. In this respect against the background of falling demand and revenue the challenge is to take capacity and cost out of the market quicker than the speed at which traffic is falling – but is a “shrink to survive” strategy the only one that will work? The answer is no – as indeed for some airlines such an approach would represent shrinking to oblivion. In economists terms the market has moved away from what was not a particularly profitable position of equilibrium into one of unstable disequilibrium; there will be a whole series of adjustments and movements before the industry is again in balance and each of these steps will provide an opportunity as well as a range of challenges.

In terms of the economic background it is clear that across the world a number of key thresholds have been reached or breached – furthermore the notion that the world’s economies had been decoupled in the upswing phase of the cycle is not the case either – we have recently seen warnings in both India and China that some 20 million jobs are at risk as a result of the reduction in demand from the developed economies. Just looking at some of the key data it is clear that in the US, “Euroland” and Japan the economies are at or close to a technical recession with two consecutive quarters of contraction; in Asia (ex-Japan) growth is forecast to be below the 6% necessary to ensure the absorption of the growing workforce which in this region is viewed as a recession; elsewhere although the oil price remains volatile it at times has already moved close to \$40 a barrel - the price at which economic growth in the Gulf is put at risk.

The latest traffic figures although perhaps not unexpected with passenger traffic down some 4.6% in November; not only is there an increasing volume problem but the decline in premium has exacerbated the revenue challenge with the latest figures showing a 11.5% decline in premium traffic compared to the corresponding month in 2007. There have also been sharp falls in cargo traffic - the latest IATA figures show a drop of some 13.5% in November with ACI's latest figures (which include domestic freight) showing a decline in tonnage of close to 15% in November; clear evidence that despite the expectations or perhaps hopes of a number of observers the economies of different parts of the world have not become decoupled – indeed it shows, if anything, that global manufacturing and sourcing has strengthened the linkages.

For a number of airlines the issue is survival and in an industry where cash is king -the industry's almost insatiable demand for cash is well documented - the need for cash in a declining market is greater however we are now in an environment where cutting fares to generate revenue and cash is more likely to result in the redistribution of existing traffic at lower fares rather than the growth in the market – a somewhat vicious circle. Indeed the latest forecast from IATA suggests that industry revenues will fall in 2009 by some \$35 billion; on the other side of the equation whilst fuel costs are forecast to fall by some \$32 billion; non-fuel costs are forecast to fall by \$5 billion; In the downturn at the start of this decade revenue fell by \$22 billion between 2000 and 2001 and a further \$1 billion between 2001 and 2002; the fuel cost fell by \$3billion in each year non fuel costs were \$6 billion higher in 2001 compared with 2000 but fell \$4billion between 2001 and 2002; the fall in revenue is immediate and most damaging the reduction in “controllable” costs always lags.

It is the inter-relationship between revenues and costs that is of particular importance and in this respect one of the features of the industry over the last 30 years has been the increase in the overall breakeven load factor. This has been particularly marked since the start of the current decade when it has increased from 60.8% in 2000¹ to a forecast of 63.5% in 2008 and an expectation of 62.2% in 2009.

For predominantly passenger airlines the effect has been more dramatic although the outcome is the same – the higher the breakeven load factor the more vulnerable the industry is to variation in traffic and price changes and the more volatile its performance.

The more important figure is the gap between the breakeven load factor and the achieved load factor. Whilst once beyond breakeven the marginal contribution from additional traffic is significant and the gearing effect on profit dramatic, cutting fares to fill aircraft in the current market conditions whilst increasing the load factor is likely to increase the breakeven load factor too unless there is a concomitant reduction in unit costs.

In the “so-called” low cost segment of the industry one of the common features is both a high breakeven load factor (derived from airline operations) and a high achieved load factor – here as has been well documented ancillary revenues are fundamentally important for when added to traffic revenue they produce the positive gap between breakeven and the achieved load factors and as such are a necessary condition for airlines in this segment. In this respect in its last financial year ancillary revenue per passenger at easyJet was equivalent to just over 18% of the average fare (boosted from 10.5% in the previous year by the introduction of bag charges) whilst at Ryanair ancillary revenue per passenger was equivalent to some 22% of the average fare (up from 19%); whilst Ryanair's breakeven load factor excluding ancillary revenues has increased from 70% in FY 2005 to 79% in the last full financial year (to March 2008) including ancillary revenue has resulted in an increase from 63% to 67%; over the FY 2005-2008 period the achieved load factor has fallen from 84% to 82%. The challenge for all airlines in this segment is to boost ancillary revenues but for some there are risks that diminishing returns could set in unless these revenues in effect become non-discretionary for the passenger and here there is already

¹ Source IATA Industry Financial Forecast December 2008 page 4

some evidence that they are becoming unavoidable. Whilst these airlines will benefit from any reduction in the fuel price their scope to reduce cost is limited and as a result they are more susceptible to variations in revenue.

Adjustment to the new set of circumstance is neither instant nor costless – for the airline industry attention is focused on reducing cost to try to counter the downturn as well as taking a realistic view on capacity needs in the near term; Grounding aircraft is one route but unless the associated costs are also removed all that is being avoided is the variable costs and given the fall in the fuel price the economics appear less compelling than they did a few months ago; Not replacing aircraft that “come off lease” is another route but this is relatively limited in effect and is also airline specific. Indeed these aircraft will tend to remain in the system and the owner will seek a price at which they will re-enter service – we have already begun to see a fall in lease rates. The big swing factor is future deliveries and across the world there is evidence of airlines re-evaluating their requirements whether easyJet; Jet, Kingfisher or the CAAC; Our own analysis suggests that some 1600-1800 aircraft orders in the 150 seat segment appear to be at risk from a change in the likely future needs of the customers. In the nearer term there is the risk posed by the non-availability of finance for aircraft which we believe will become a significant issue as we move through the latter part of 2009. One outcome of airline/financing problems is an immediate transfer of risk back to the manufacturers and for them the decisions would appear which deliveries to finance and then how much to cut the production rates by.

In the last downturn the order cycle was padded as the LCCs entered the market taking advantage of particularly attractive prices as they were almost the only customers willing to commit – and also take relatively early deliveries. In the two “trough” years of the last downturn net orders in the 150 seat segment were 372 (2002) and 399 (2003) which compared with -26 (1993) and 87 (1994) in the corresponding years of the previous downturn. Given that a repeat of this order behaviour is unlikely as not only has the LCC sector appeared to have “ordered out” but is also reviewing its requirements we consider that at least a hiatus in ordering will occur with a real prospect that actual or hidden cancellations (long term deferrals) could result in effective negative net orders in 2009 and 2010.

There have been calls not to “talk” the industry into a downturn (or economies into recession) as expectations have a major influence on behaviour and actions. However the reality is that the downturn phase is now established and the expectations of managements in all parts of the system will now have a material impact in determining how quickly the necessary supply side adjustment occurs. However as we suggested earlier adjustment is not instant and in any event it is unlikely to begin to show through before the end of 2010. In the meantime it is still probably a question of planning for the worst even though you may be hoping for something better – the last few downturns have been of three years’ duration but the question perhaps is whether given what has gone on elsewhere is history an adequate guide to the future?

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