

# ANALYST VIEWPOINT

**JULY 2010**

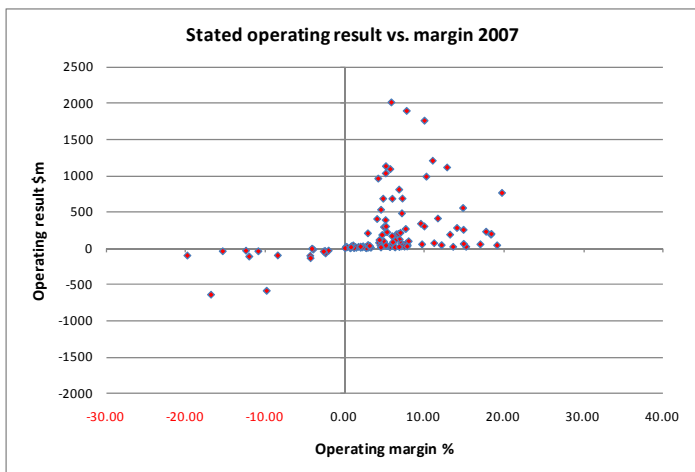
## SHAPING THE UP-CYCLE

**CHRIS TARRY,  
AVIATION INDUSTRY RESEARCH AND ANALYSIS (CTAIRA)**

The increase in IATA’s industry profit forecast for 2010 which was announced at the time of the AGM in early June was not a surprise and clearly reflects; the strong recovery in the operating environment in Asia with structural growth now taking over from a sharp bounce back from the global economic crisis; a recovering economy in North America, where against a background where capacity is currently back to levels last seen in 2000, there are signs of a dramatic improvement in the financial performance of most airlines; in Europe for many airlines the outcomes are “less worse” rather than necessarily much better. Whilst there is a wide disparity between the rates at which the world’s economies are recovering there is at least one common factor chiefly the still rigid control of capacity at least on the part of the managers of network carriers. Despite this the progress from where we are now to the next cyclical peak is unlikely to be without its challenges,

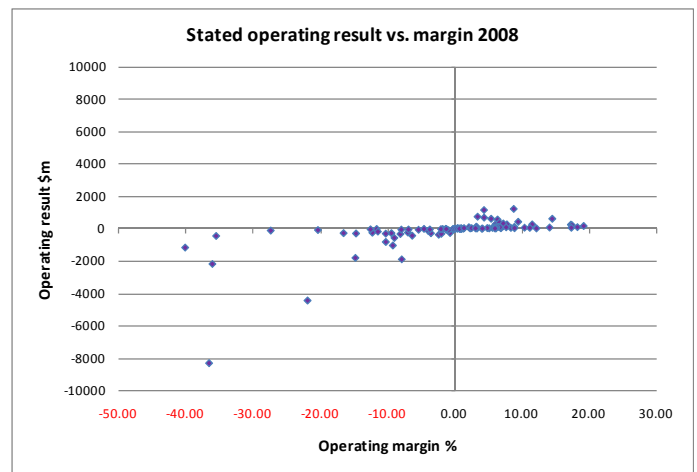
As we move into the second half of 2010, attention has become focused on 2011 and beyond and whilst the raft of new order announcements at the Farnborough Airshow are seen in some quarters as providing a further positive boost to sentiment for the sector (despite the fact that some 160 of the aircraft involved represented existing orders or option conversions and others were from new lessors acquiring stock), it is necessary to keep a sense of perspective. Generalisations are likely to be even more dangerous than usual given the wide variation in the underlying operating environments and the nature and cause of the improvement, or otherwise, in the financial performance.

**Chart 1 Operating result vs. margin 2007**



Source CTAIRA from RATI data

**Chart 2 Operating result vs. margin 2008**



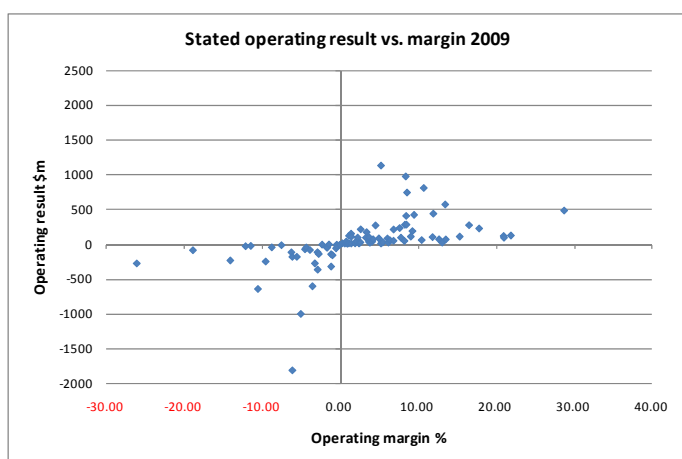
Source CTAIRA from RATI data

Even the most cursory examination of the distribution of airline earnings is very revealing and confirms what we all probably knew; in particular that the majority of airlines occupy what is best described as the “middle ground” and display a reasonably modest variation between good and bad years. In chart 1 we show the distribution of earnings for just over 90 of those airlines reporting results and even in the peak year there were 12 loss makers within our sample.

The reality is that the large swings in the profitability of the industry result from the performance of a small group of (inevitably large) airlines (mostly based in the US). However this time around there have been some significant swings elsewhere and in particular in Europe and here, for example, BA reported an operating profit of £878m in its financial year to March 2008 followed by an operating loss of £220m in the following year and loss of £231m in the latest year.

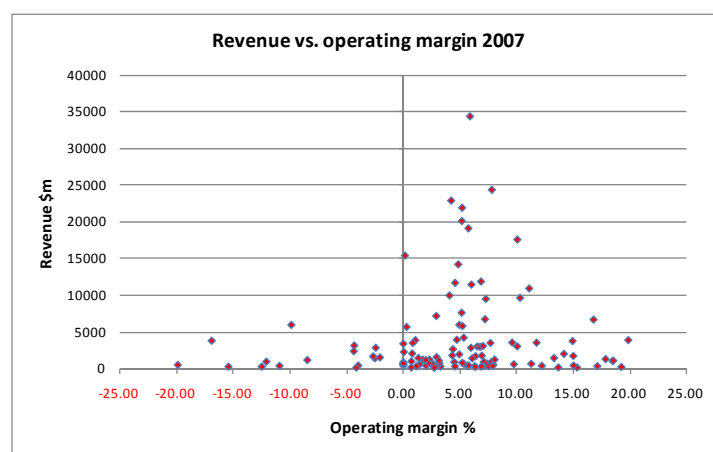
Chart 2 shows the distribution of earnings in 2008, generally regarded as the trough year in the cycle. The pattern made by the earnings scatter appears to rotate around the axis as in 2009 (Chart 3) the shape is again closer to that of 2007 and of a letter X.

**Chart 3 Operating result vs. margin 2009**



Source CTAIRA from RATI data

**Chart 4 Revenue compared to reported operating margin 2007**



Source CTAIRA from RATI data

The key issue for the future is how many airlines will move towards the right and top right part of the upper right hand quadrant of the chart reflecting better margins and higher profits. It is also worthwhile taking a look at the distribution on the basis of the reported operating margin against revenue at the peak of the last cycle which is revealing in its own right (Chart 4).

The conclusion appears reasonably evident and appears to suggest that size and margins are inversely related – in effect demonstrating that diminishing returns set in - it also underlines the influence that a small number of bigger airlines have on the industry result. Although we may talk about what is going on at the level of the industry it is in fact the performance of an individual airline or small group of airlines that is of interest to us for whatever reason, whether this is from the perspective of competition or partnership (if we are at an airline) or as a customer (if we are at a supplier).

Although the bounce back in economic activity in some parts of the world has been dramatic and is clearly evident from the current reporting season from corporate America in particular - despite some quite stark exceptions to the trend and indeed some profit warnings (not least from the IT/ communications industry with most recently one from Nokia), experiences are not universally positive. Despite the tendency of many observers to take the “glass half full” view of the world, there is no escape from the fact that economic and related news remains mixed and there seems to be no consistent trend even over the relatively short term. Notwithstanding the expectation that US GDP will increase by some 3% in 2010 vs.

2009 there are increasing signs that the recovery here may be at the edge of the stall. Indeed the comments from the Chairman of the US Federal Reserve that the outlook was one where there was “unusual uncertainty” is, at the very least, a frank assessment of the lack of clarity that currently exists and the one thing that none of us likes is uncertainty.

At the simplest level, the behaviour of the Dow Jones stock market index (and indeed most others) since the start of the year, which has exhibited significant volatility and regular reverses, provides a near compelling perspective on the future (given that markets are supposed to be forward looking)<sup>1</sup>. There is also a range of “mood music” emanating from airline managements - depending upon both location and geographic exposure. Continental’s management made a very telling observation when they commented that although they were pleased with the results of the second quarter there is “*still a lot of work ahead in order to sustain profitability*”:<sup>2</sup> In Europe the view of Ryanair’s management on the outlook for the rest of its financial year was that it “remains cautious and unchanged”<sup>3</sup>. Whilst management at Cathay Pacific states that its business is much improved since 2009, and that it is committed to growth, it has concerns over the debt crisis in Europe and the fuel price<sup>4</sup>.

Our own expectations and the impact that they have on our behaviour, either at a personal level or in the corporate world, are an inescapable fact of economic life and will have a significant collective impact on at least near term outcomes. However, contrary to the view expressed in economics textbooks, the process of adjustment is not instant, continuous or costless, whether this relates to decisions taken in the previous autumn for the next summer season or indeed over longer periods. In this respect the last thing that the aircraft manufacturers wanted to do in the downturn was to cut production rates given the cost and dislocation on the one hand and reduced delivery dollars on the other; indeed the strength of the backlogs and the successful order shuffling in the 150 seat segment resulted in no reduction in rates but rather plans for an increase (at least for now). We remain concerned over the ability of the industry to absorb the new equipment over the medium term as there are some significant issues relating to what will happen to what are best described as “middle aged” aircraft. In time this may well feed back into lower rates of production. We expect that there will be an increase in the availability of such aircraft as the normal/natural correction mechanisms, where older aircraft “cascade” through the industry creating space for at least some new deliveries, are even less evident than in the past; this set of circumstances is also exacerbated by the current difficulty in financing aircraft of this vintage. If this situation persists then there may well be a number of associated events and actions that will be both necessary and evident as the market seeks to adjust:

- An accelerated fall in the values of these aircraft and a corresponding increase in depreciation to reflect this (through a combination of impairment charges and the shortening of useful lives) – we have already seen Qantas reflect this in its last half year earnings statement.
- Lower disposal proceeds and the cash consequences of this
- Opportunities to acquire cheap capacity (but only after the correction in values) which will reinforce this as a source of supply to compete with new build aircraft and also
- The parting out of younger aircraft with a concomitant effect on OEM spares revenue – there is already anecdotal evidence of 16 year old aircraft being parted out where the disembodied value is greater than the projected lease stream from this point and the future residual/ breakup value

All of the above provide both challenges and opportunities.

<sup>1</sup> Indeed the Dow Jones is currently lower than it was at the start of the year (22<sup>nd</sup> July 2010 compared with 4<sup>th</sup> January 2010)

<sup>2</sup> Continental Airlines 2<sup>nd</sup> Quarter earnings release 22<sup>nd</sup> July 2010

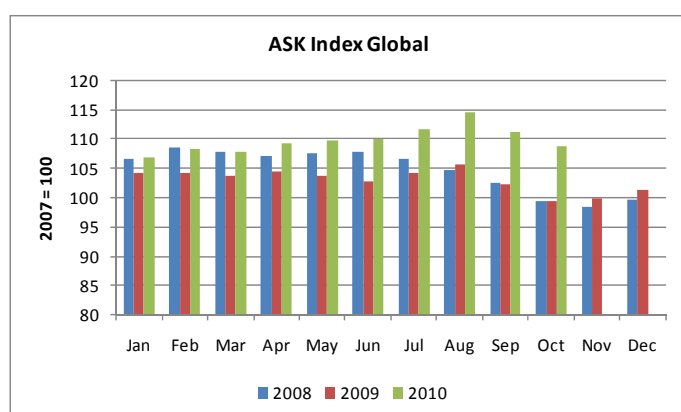
<sup>3</sup> Ryanair first quarter results release 20<sup>th</sup> July 2010

<sup>4</sup> Investor Briefing 29<sup>th</sup> June 2010

Taking a shorter term perspective for now and the likely developments over the next 18-24 months; The seasonal nature of the industry is well known in that it operates in 5 and 7 month segments corresponding to the winter and summer seasons. Against this background expectations and the behaviour resulting from those expectations is of paramount importance. If individuals consider that the outlook is going to become “challenging” they will act as if it is and in fact it is possible that this will result in an even worse outcome than forecast through a self-reinforcing decline (the converse case is also true). In any productive industry (and here we include the airlines) the issue when facing a downturn is in effect how much capacity needs to be taken out of the system to get as close as possible to likely levels of demand and to protect the downside by minimising the amount of excess capacity

In this respect forecasts and decisions for capacity for summer 2009 were made in late 2008 at a time when the outlook was beginning to deteriorate. Similarly capacity decisions for winter 2009 were taken in late spring 2009 when the outlook was still declining and for summer 2010 in autumn 2009 when it seemed that the outlook was about as bad as it might get. Chart 5 shows that capacity in 2009 was cut back compared to 2007 levels but is now (summer 2010) some 10-15% above the “baseline”; just as the challenge was not to have too much in a downturn the same applies in the recovery phase and beyond.

**Chart 5: Global capacity index**



Source CTAIRA from SRS Analyser

financial outcomes. Over the medium and longer term, decisions relating to the introduction of capacity will have a major impact upon financial performance. Indeed if we look at the capacity potential that exists through the restoration of previous utilisation rates combined with the planned deliveries, the productive potential of the industry could increase by almost 10% over the next twelve months. This would move the industry from one where the benefits of relative excess demand are evident in the results to one where the consequences of relative excess supply are all too painful despite the apparent attraction of growing unit costs down by adding capacity. We are watching closely to see who yields to temptation in an environment where given the uncertainty discretion rather than valour might be a less risky approach. At the end of the day decisions taken during the recovery will also have an impact on the performance during the next downswing and sometimes less may be more.

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