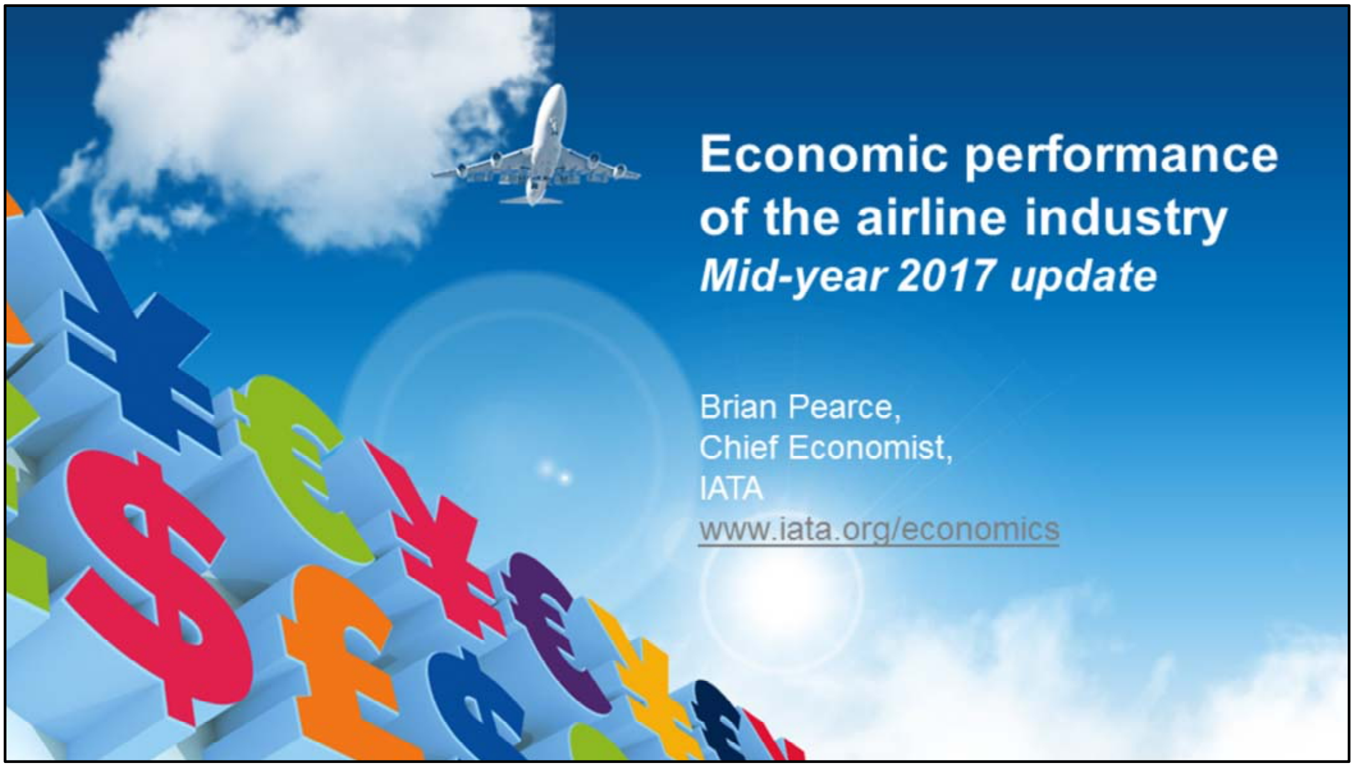
Economic performance
of the airline industry
Mid-year 2017 update
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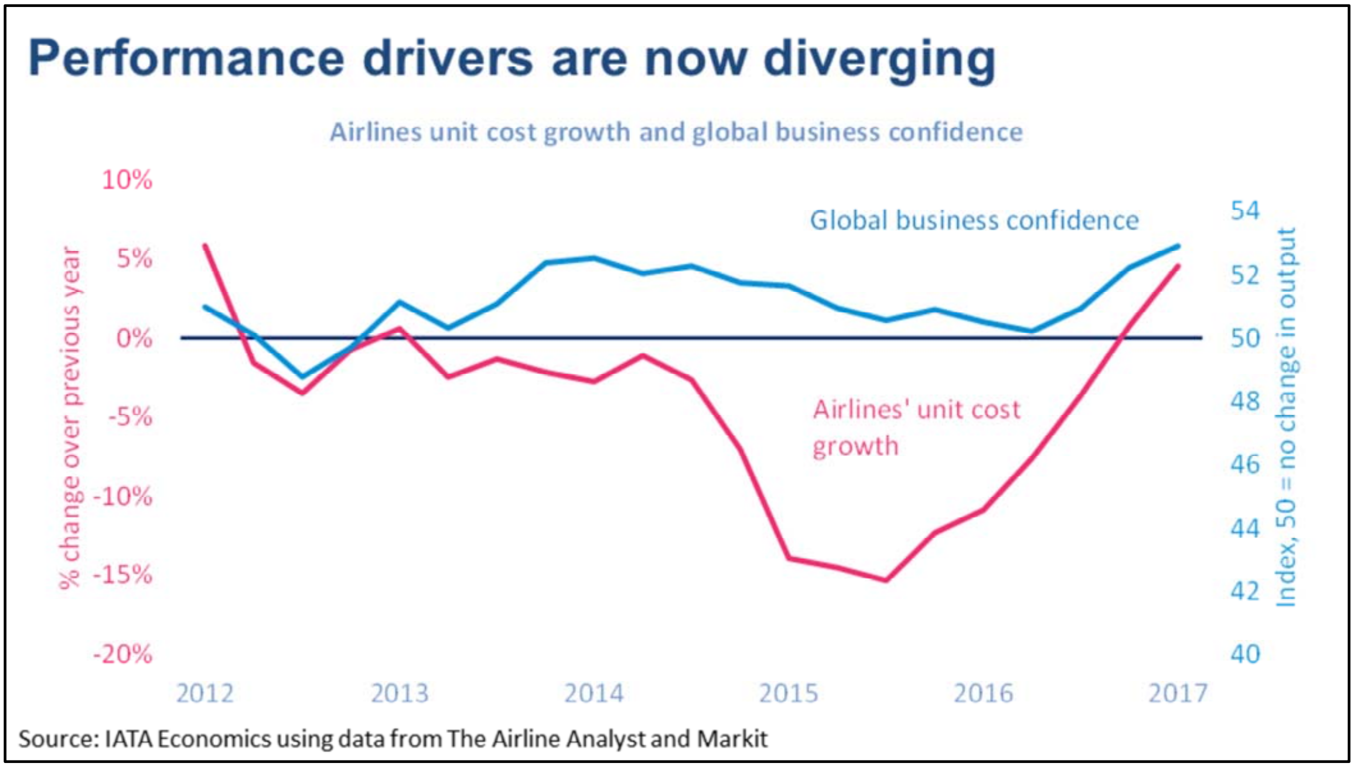
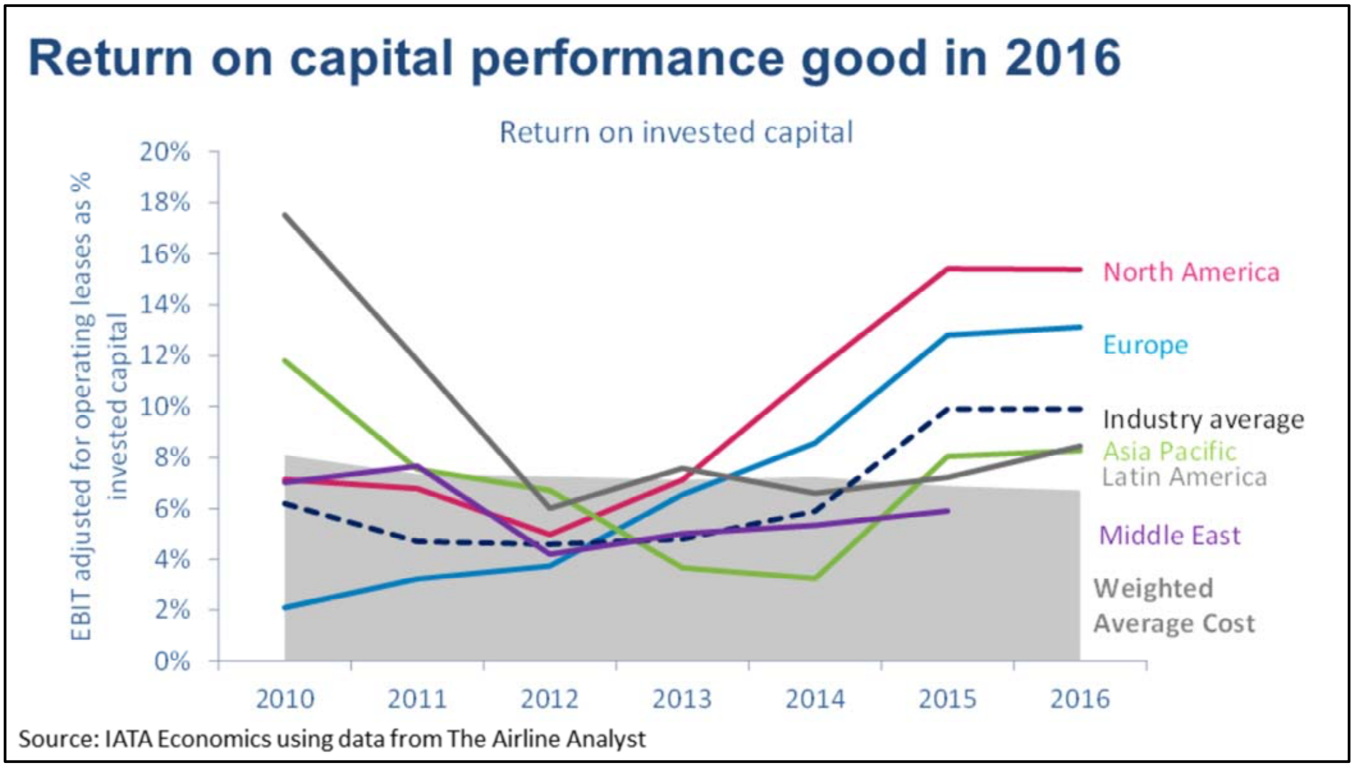


Since the last forecast at the end of December there have been two significant changes in the airlines' business environment:

- A significant rise in business and consumer confidence, strengthening the economic cycle
- A partly related acceleration of unit costs

The first is a positive driver for outcomes for both airlines and consumers. The second is negative. The change in recent developments and in the outlook will depend on how the balance between these two opposing drivers resolves.



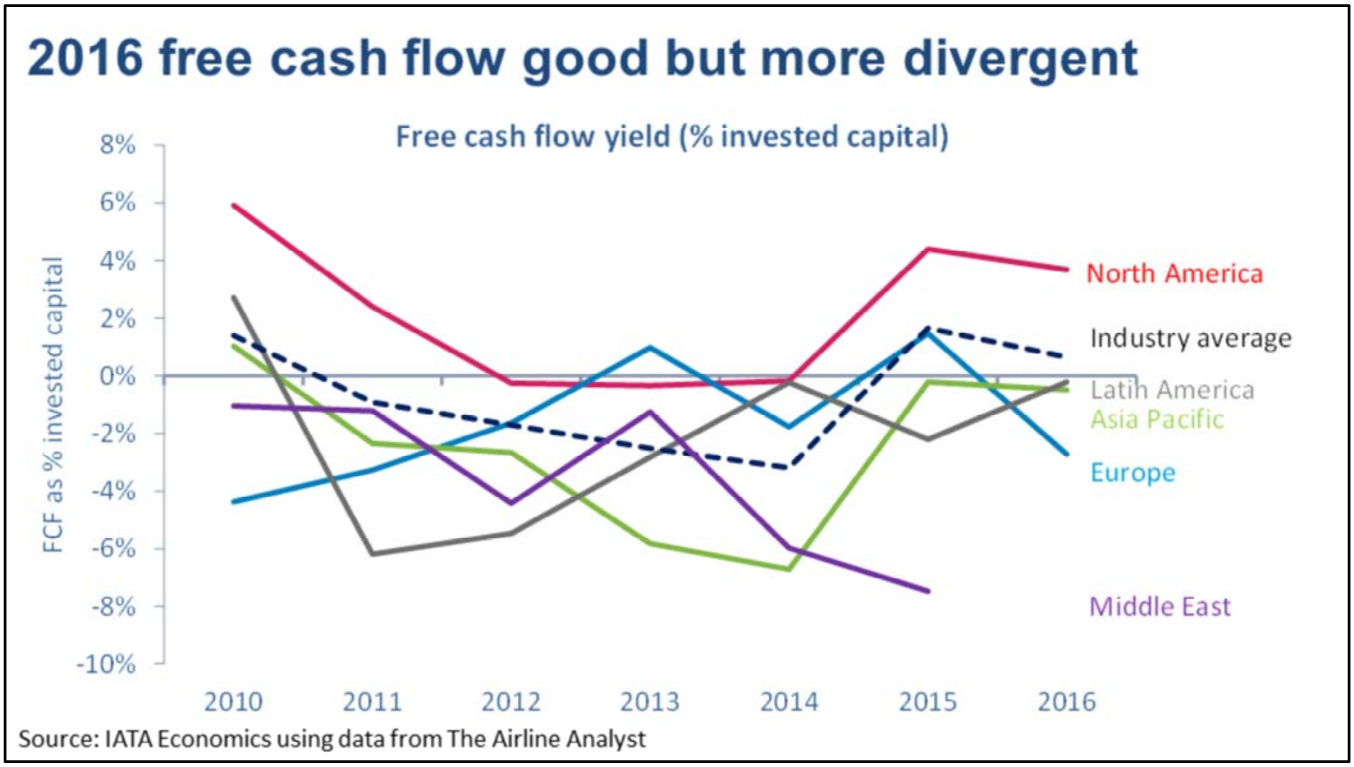
But let's start with a review of 2016.

A key metric of financial performance – certainly in the eyes of investors – is the Return On Invested Capital.

2016 saw a second year of good above-cost-of-capital returns of almost 10%.

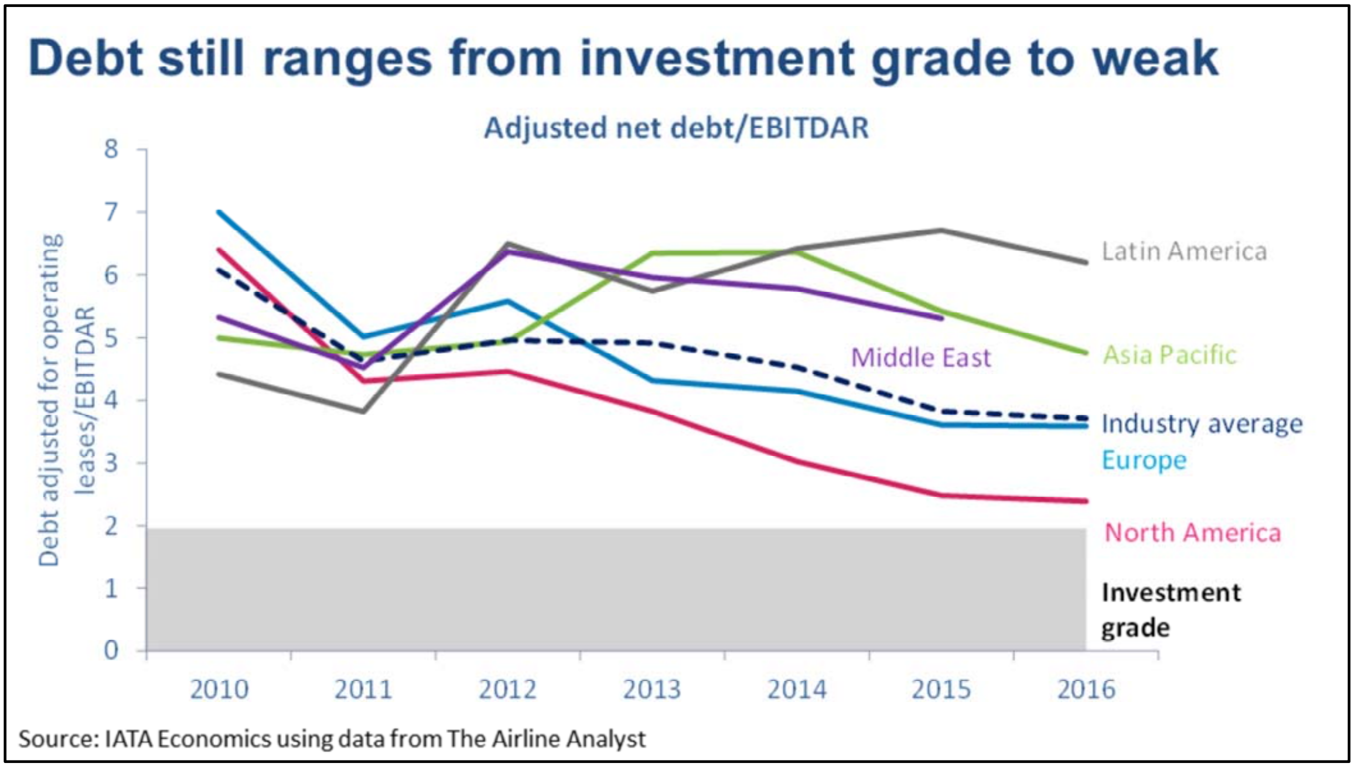
Most regions, with the exception of the Middle East and Africa managed to generate returns at least equal to the cost of capital.

If the industry is to attract capital to finance aircraft purchases it will need to continue to generate cost-of-capital equaling or beating returns.



A second important metric of airlines financial health is Free Cash Flow – the difference between cash generated from operations and capital expenditure. 2016 saw a second year of positive FCF for the industry. FCF is important as it allows airlines to pay investors and reduce debt.

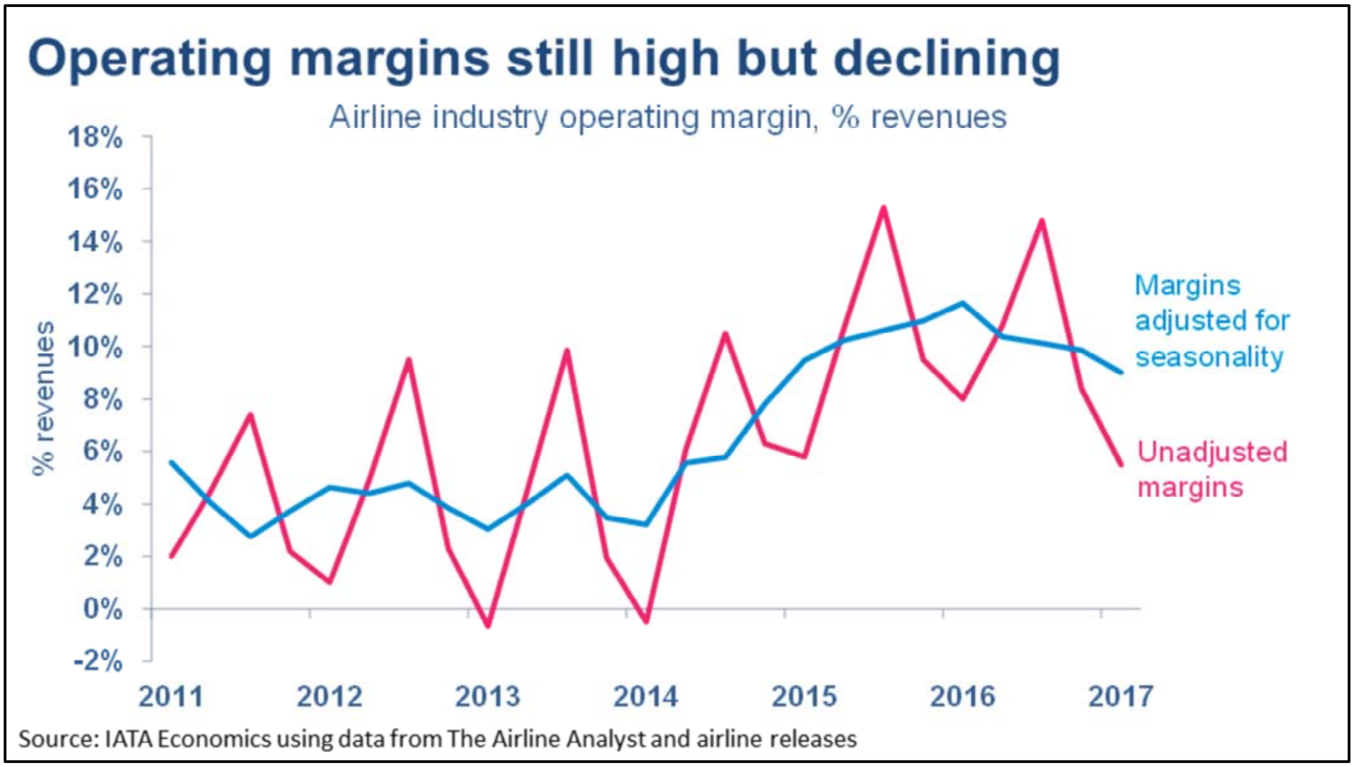
N American airlines generated substantial FCF but other regions did not. In some cases, like Europe, cash from operations is strong but there is a large capex spend. It does mean however that there is less cash to reduce debt.



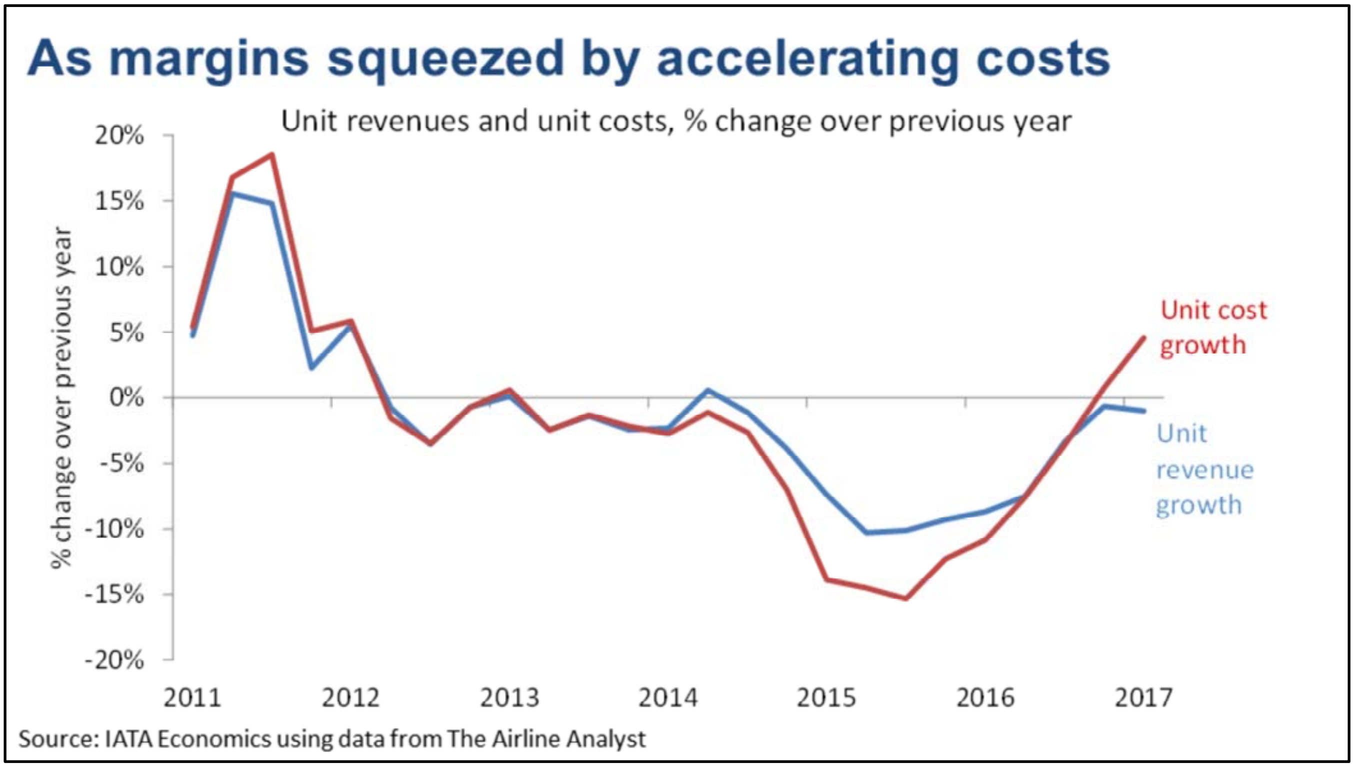
The third metric of financial health looks at debt compared to Earning Before Interest Tax Depreciation Amortization and Rentals. Credit rating agencies usually rate companies investment grade if this ratio is 2x or less.

Remarkably N American airlines on average are more or less there.

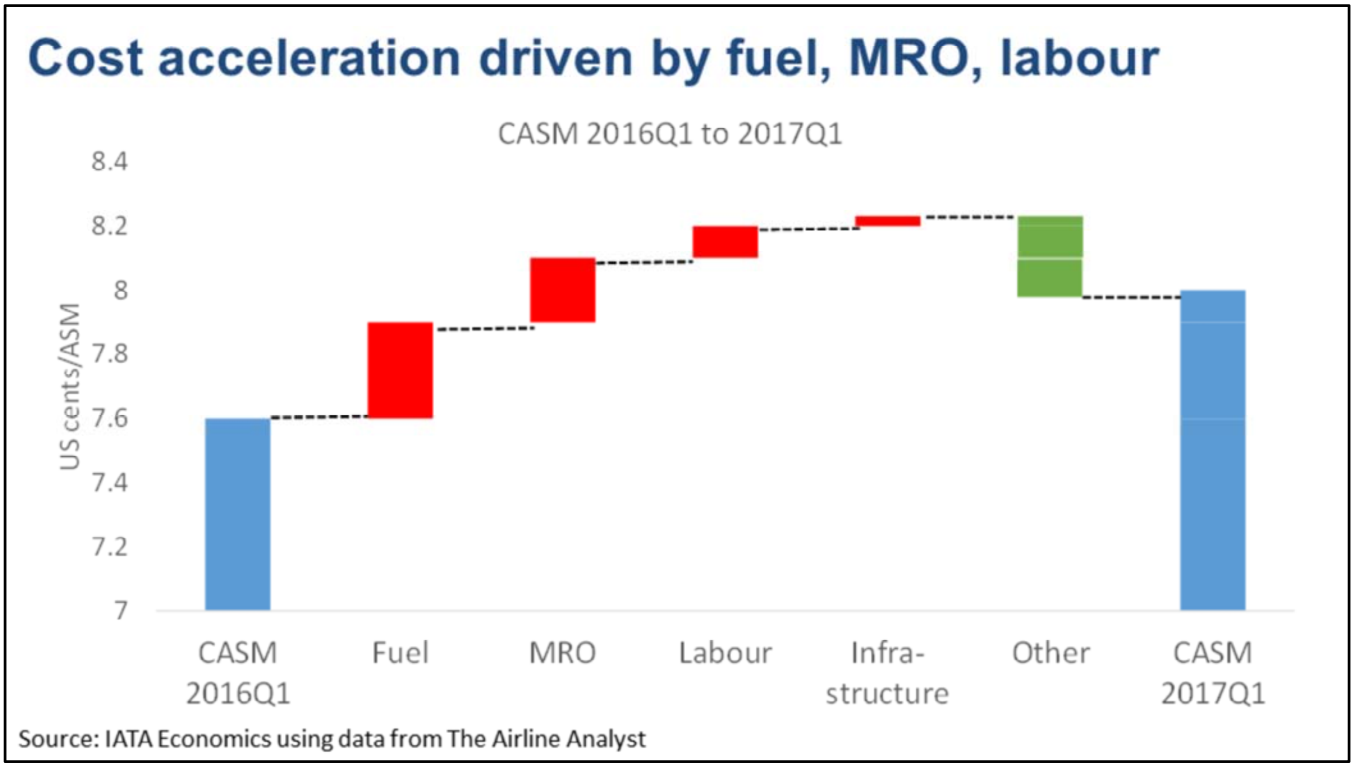
However, other regions – Latin America for example – still have debt some 6-7x EBITDAR. This leaves these regions vulnerable to shocks or a rise in debt servicing costs.



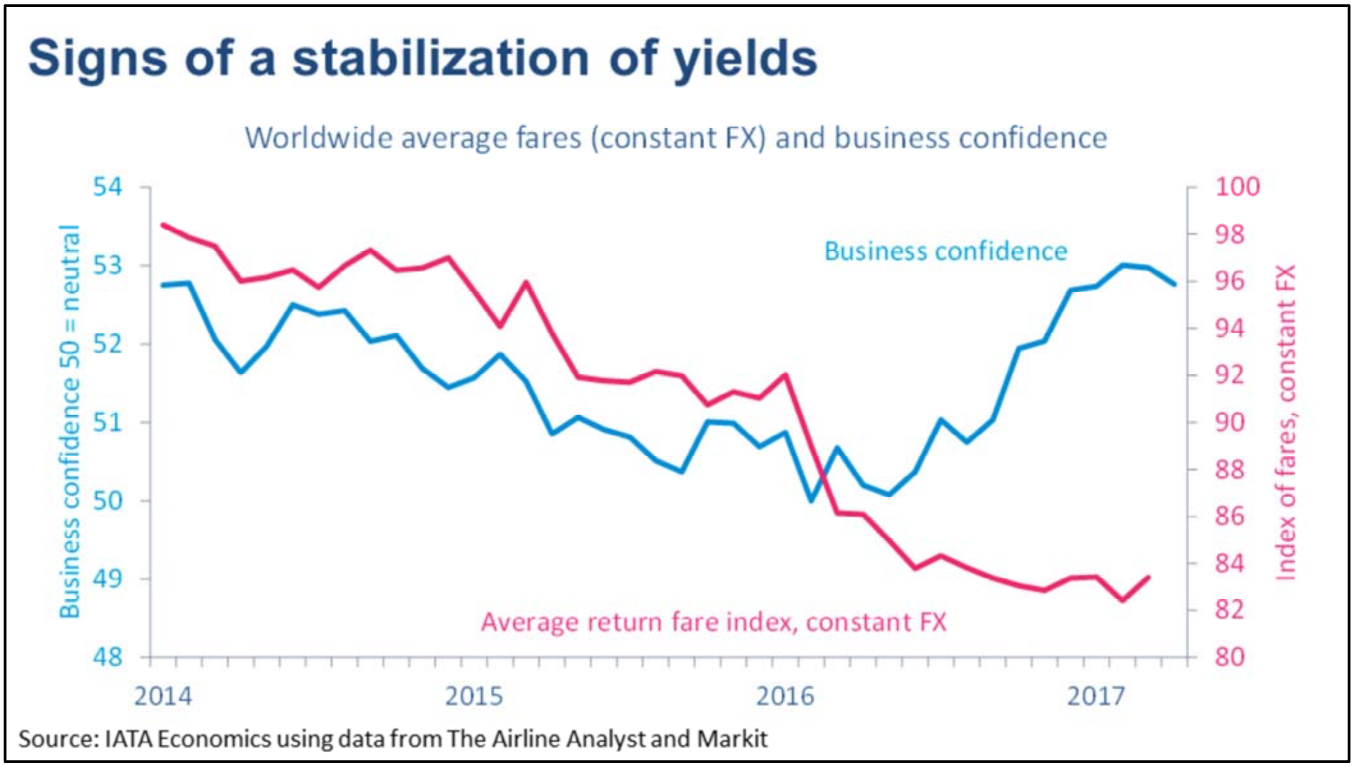
Looking at the quarterly profile for operating margins and stripping out the regular seasonal ups and downs gives a clearer picture of the direction for profitability. Operating margins are still high but they are declining, as we saw in the 2017 Q1 data and earlier quarters.



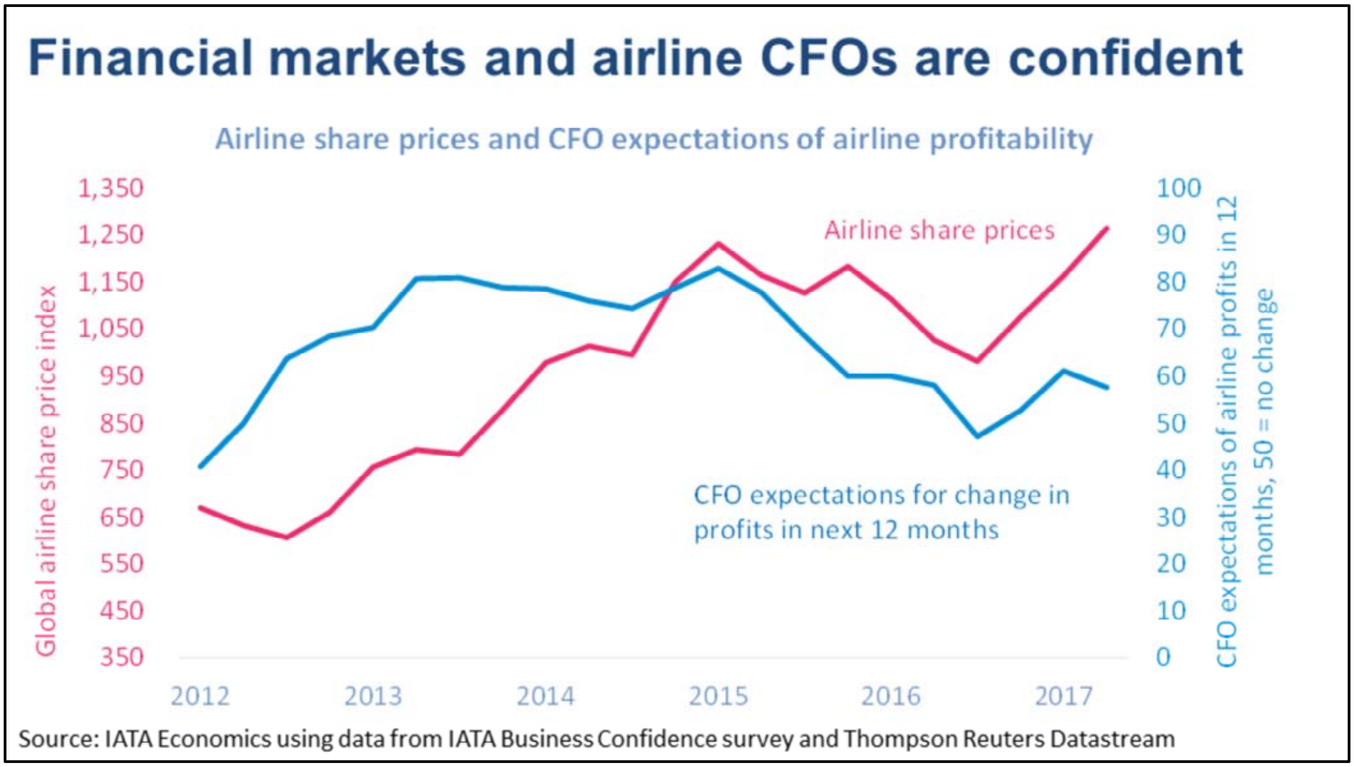
The focus of many has been on unit revenues – and these are now showing signs of stabilizing. But the emerging squeeze on profit margins has come from an accelerating of unit costs. Industry wide unit costs were rising at a pace of 5% yoy in 2017 Q1.



The 5% rise in unit costs at the aggregate industry level between Q1 2016 and Q1 2017 has been driven by fuel (mostly in the US, European airlines still getting hedge benefits), maintenance, labour and infrastructure costs.
The is partly the downside of the upturn in economic activity, which has tightened labour markets in some countries and is adding to upward cost pressures.



On the unit revenue side of the margin squeeze there is better news. Some markets have shown fare and yield stabilization as in the US domestic. But there is now evidence emerging with industry wide aggregate measures such as fares measure using constant exchange rates. After the large falls of recent years there are signs of a levelling out. Fares are still lower that a year ago but they have stopped falling month to month on average. Helped of course by the significant upturn in business confidence and the economic cycle.



Looking ahead from this margin squeeze we can see that both financial markets and airline CFOs are confident that the situation will improve.

Airline share prices – this shows a global average – have risen sharply as investors and financial markets revise their expectation of future earnings higher. IATA's quarterly survey of airline CFOs has also shown that in the past 9 months they have become more confidence, now expecting an improvement in profitability in 12 months time.

We've also upgraded our forecasts for 2017, from what we had expected in our last forecast released at the end of 2016.

First, the world GDP growth forecasts we take from the IMF and other forecasters has been upgraded .

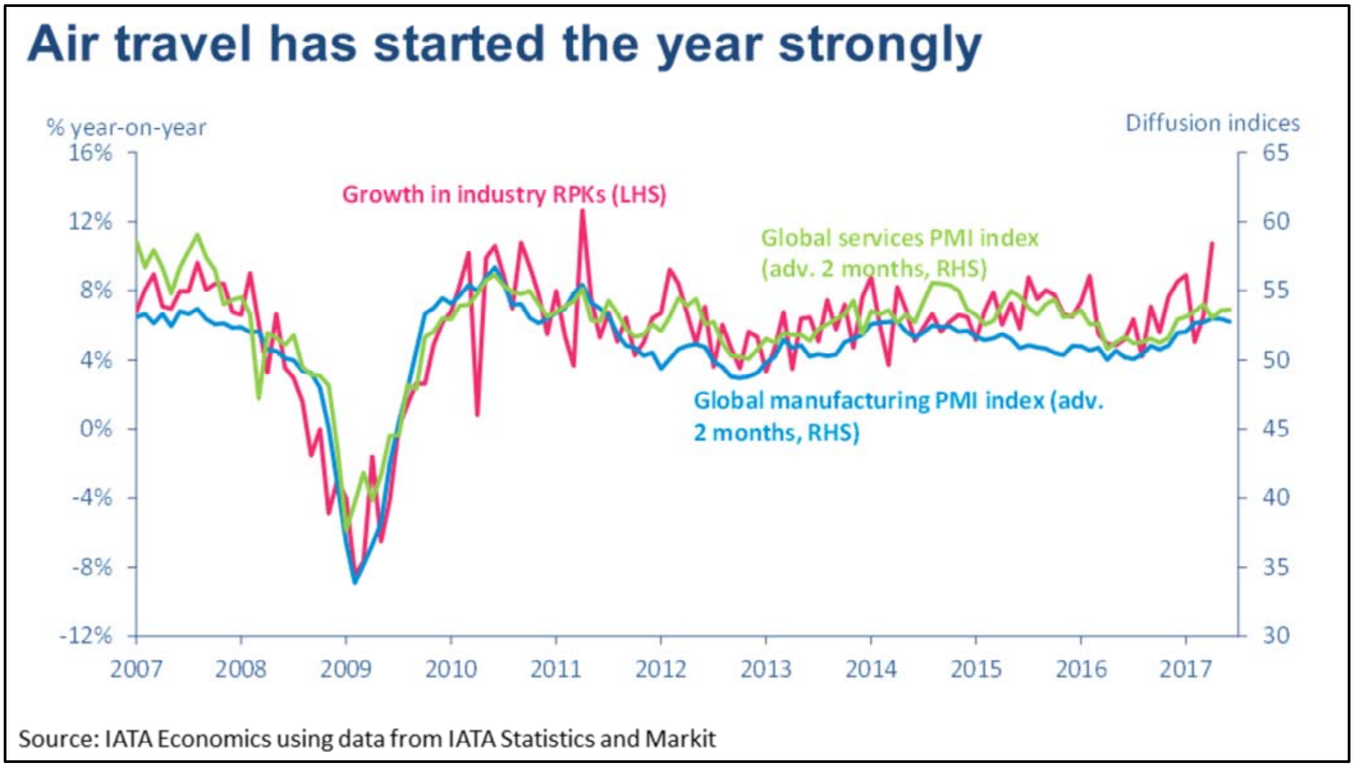
Second, our forecasts for passenger yields takes into account a larger fall in US$ terms at the end of last year. We expect stability from now on but the average for the year will be 2% down on 2016.

As a result – and also driven by the strong Q1 growth – we have significantly revised up our forecasts for RPK and passenger growth and also freight tonnes and FTK growth.

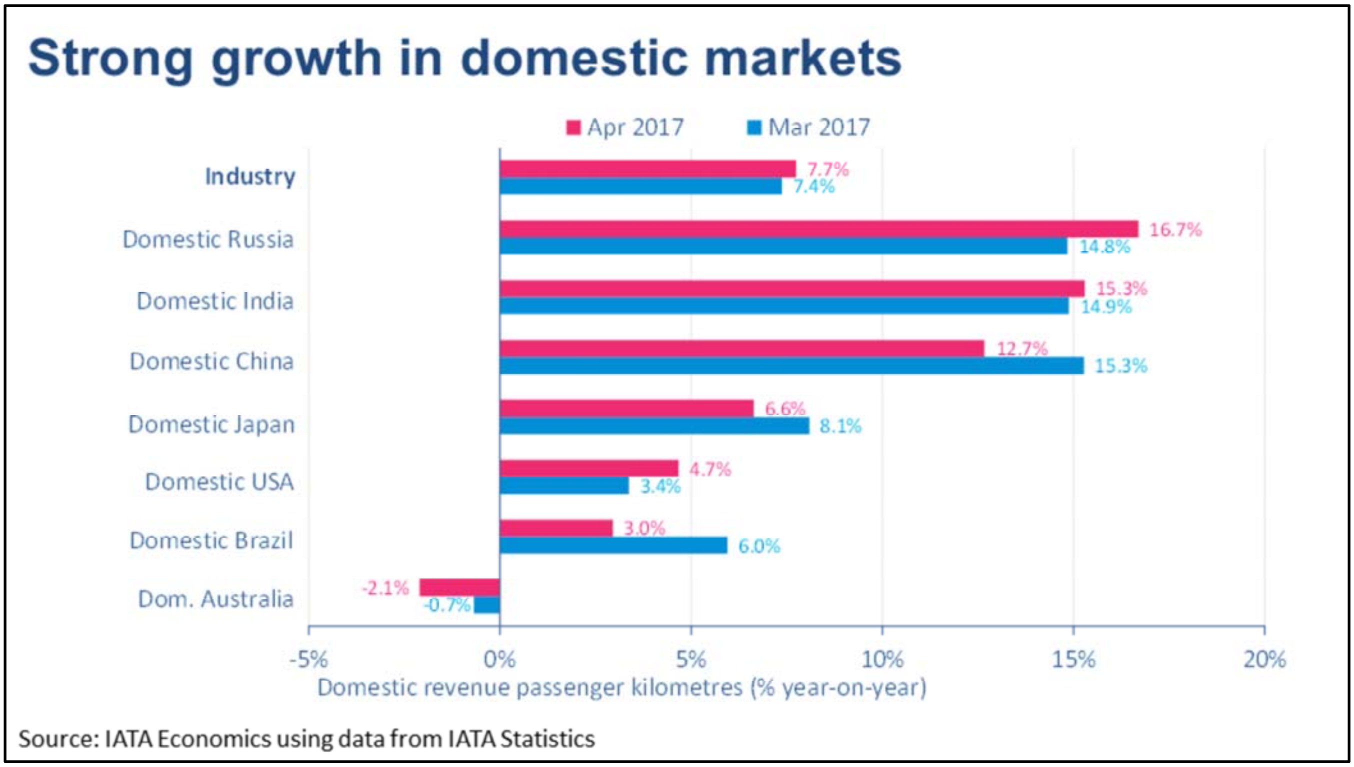
The published schedules show that airlines are now expecting to add more capacity through ASK growth in 2017 than we had expected at the end of December.

Crucially though this is less than the improvement in traffic and so load factors are now expected to rise this year instead of falling.

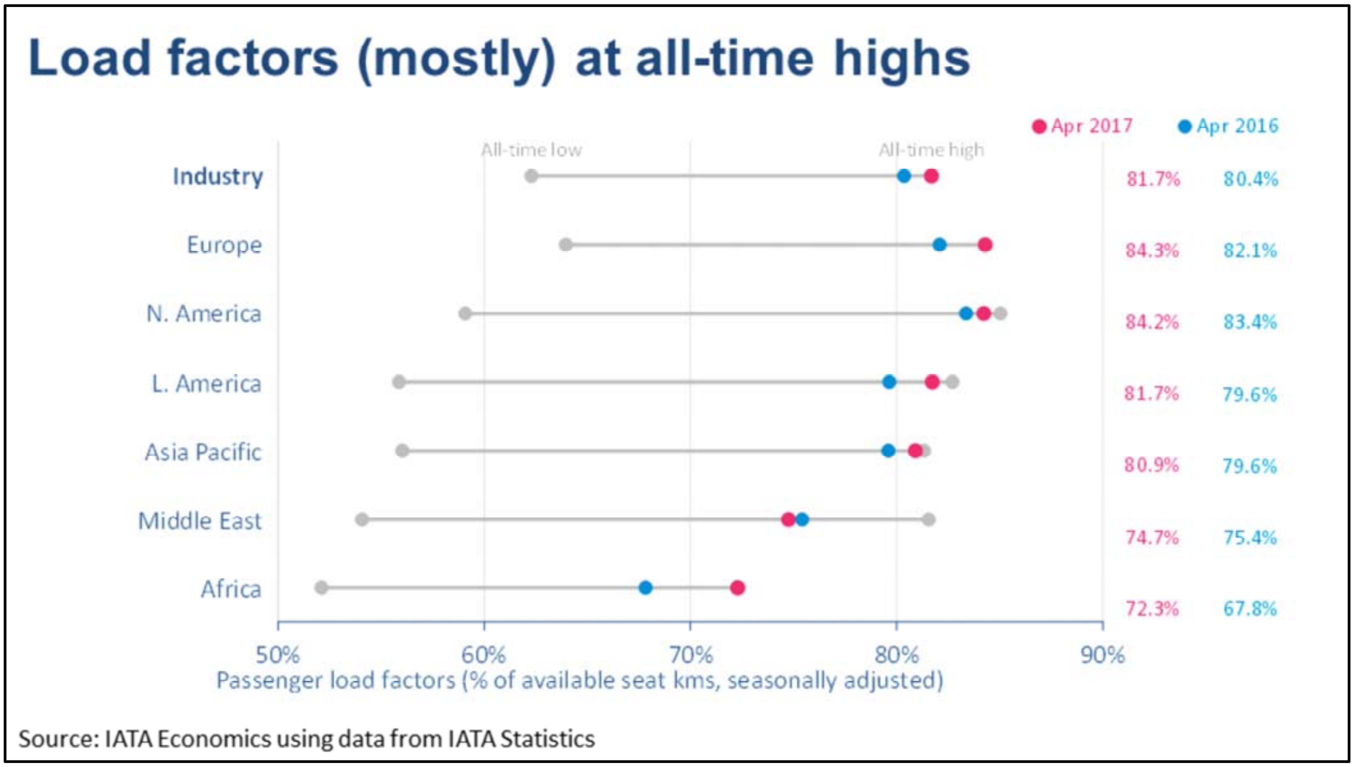
This and a number of other factors – slightly lower oil prices - mean that we have raised our airlines' profit forecast for 2017. Still down on 2016 but we now expect much less of a fall as the current squeeze on margins is offset to some extent by stronger economic growth.



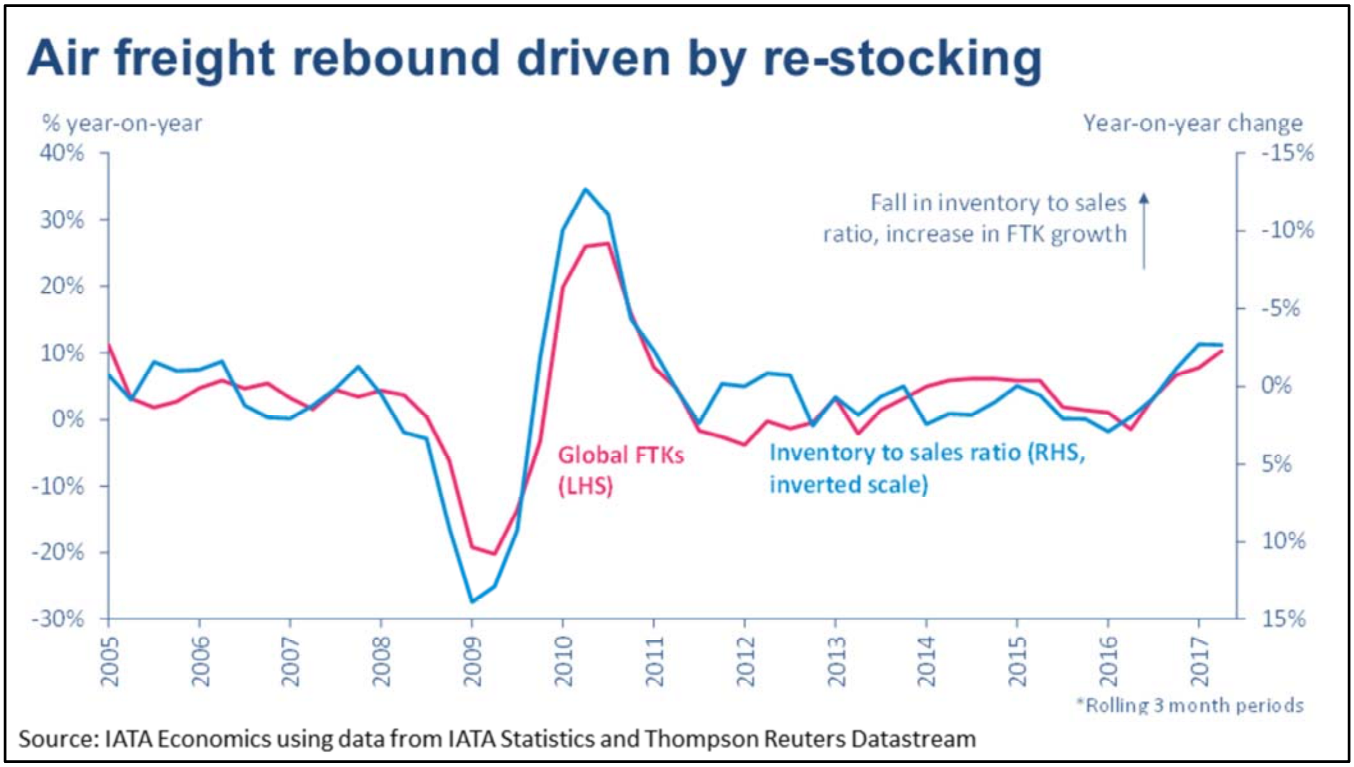
One important change since our last forecast has been the strength of a surge in air travel growth in the first part of 2017. This has been clearly supported by a strong upturn in business confidence. Another important driver has been the cheapness of air travel. Adjusting for CPI inflation shows that average air fares were still around 10% lower in 2017 Q1 than a year earlier, which is providing a significant stimulus to travel along with stronger economic growth.



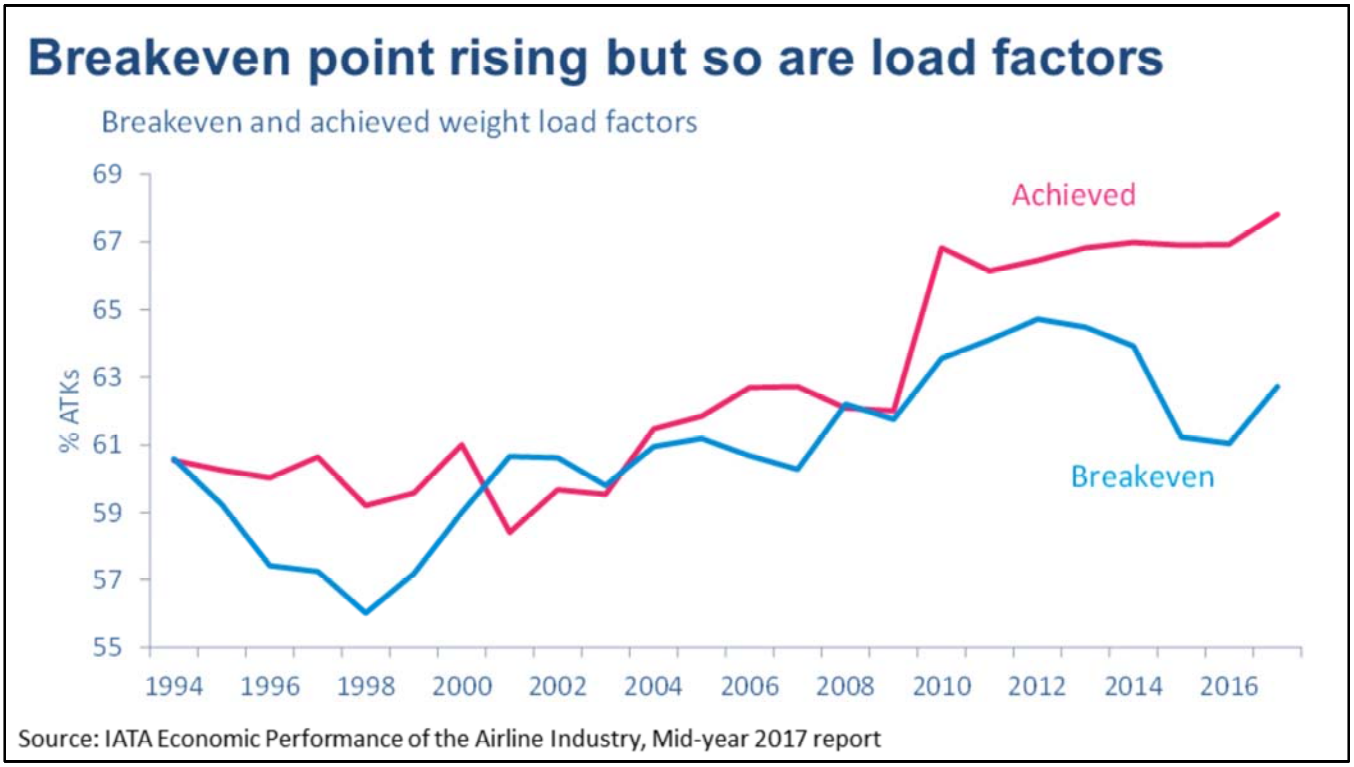
The big travel markets are domestic and we have seen strong recent growth in some of the key countries. It is clear that Russia and Brazil are emerging from the recessions that have been so damaging to economies and airlines performance recently. Russia, India and China in particular are seeing very strong expansion.



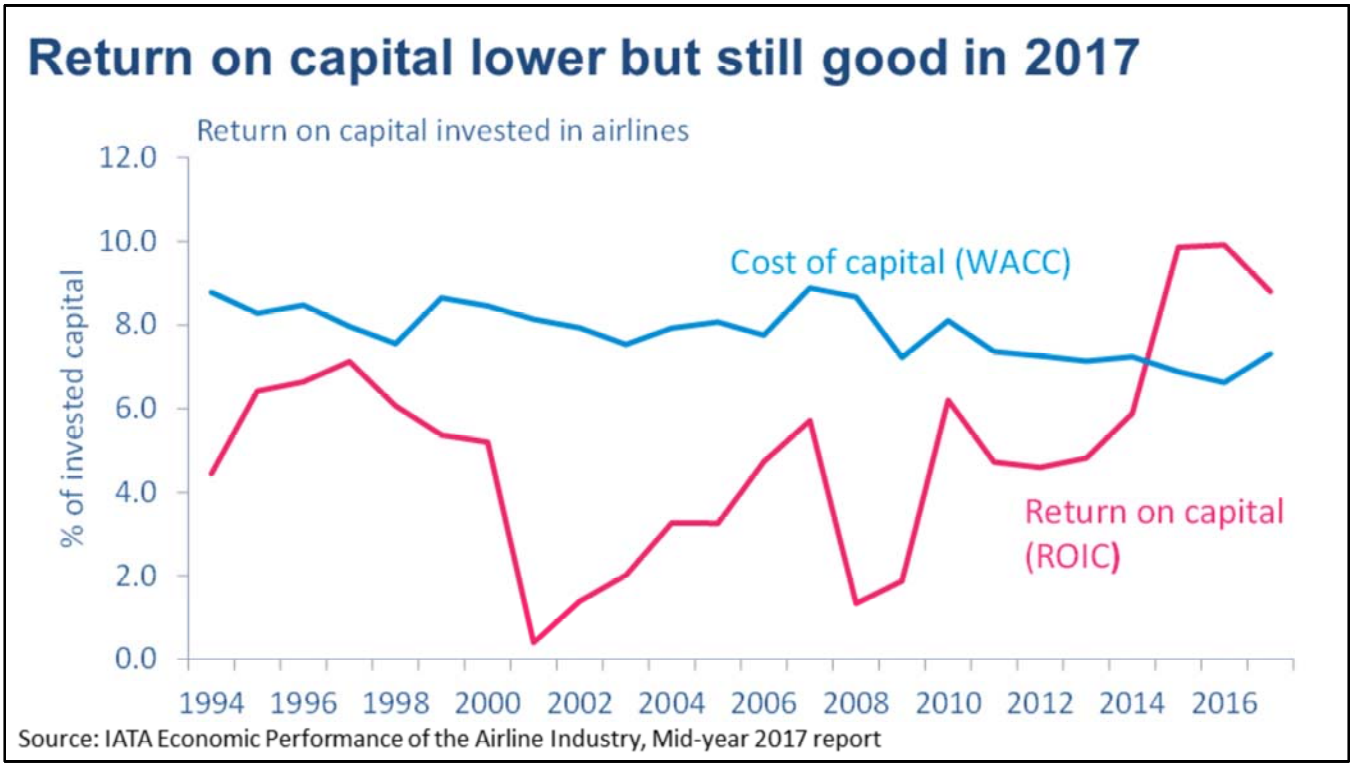
The importance of this surge in traffic growth for airline performance is that it is producing record load factors for airlines in most regions. Even African airlines are seeing the benefits currently. The one region struggling is the Middle East where traffic and load factors have been less than expected, reflecting a number of factors specific to the region – most recently the PED ban.



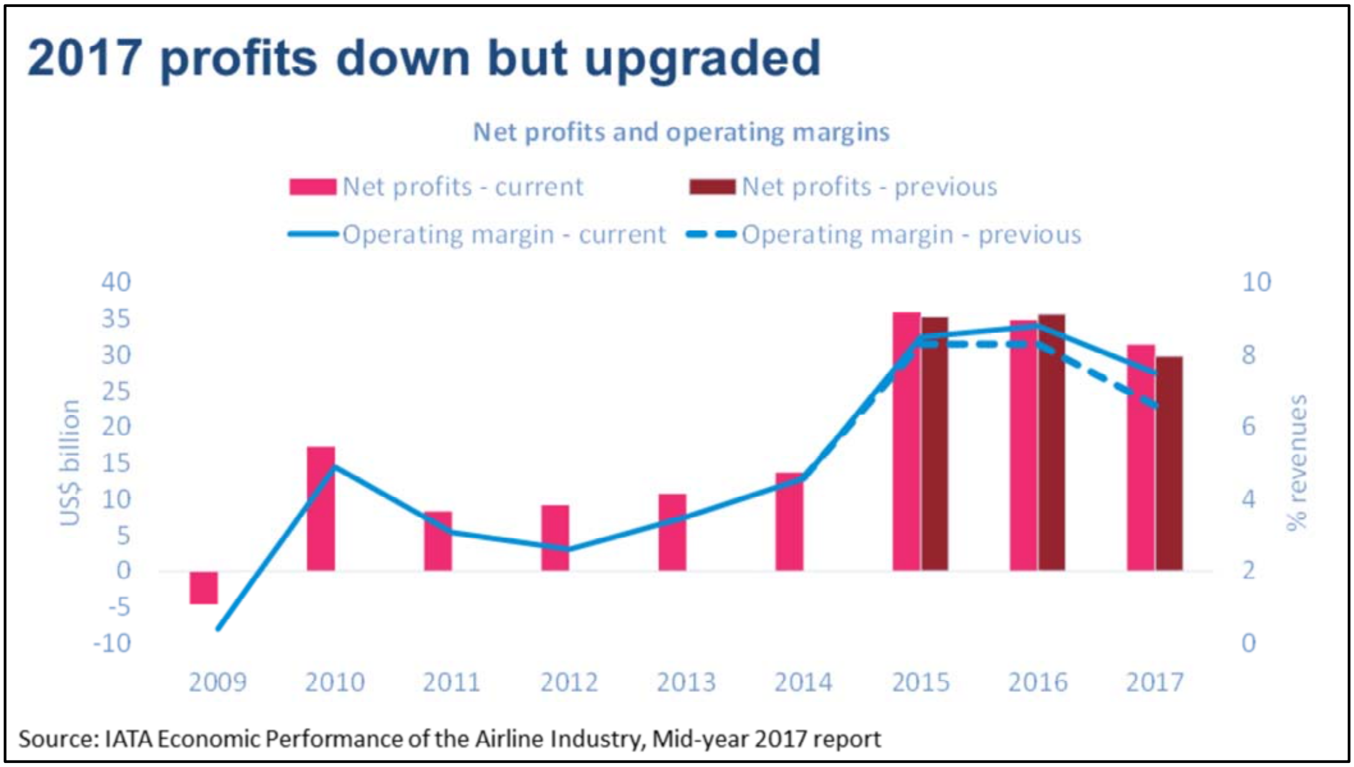
The rebound in air cargo growth also seems to be solidly supported. In this case by a need for retailers and industry to restock their inventories in the face of the upturn in business confidence and economic growth. Whenever, there is a fall in the inventory sales ratio – driven by unexpectedly strong sales – then business turn to rapid air transport to restock components and finished goods. The inventory sales ratio is shown inverted to better illustrate the relationship with air cargo growth.



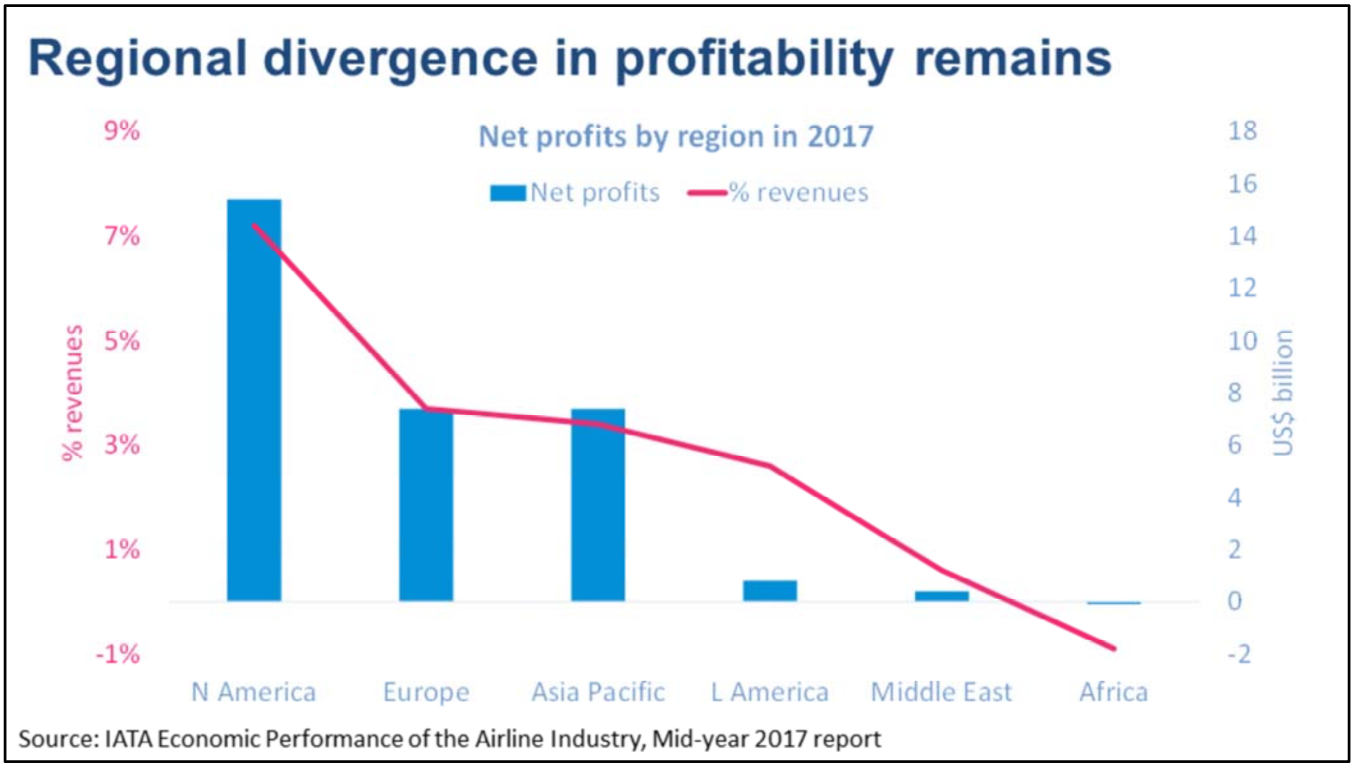
But strong traffic growth do not necessarily mean better airlines' financial performance. Margins on revenues are critical and a key way of understanding what is driving return on capital in such a capital intensive industry is how load factors are developing compared to break even load factors.
The gap between the two measures the improvement or otherwise in ROIC. The fall in fuel prices in 2015 pulled the breakeven level down sharply but it is clear than improving return on capital began before, just after the global financial crisis when airlines raised load factors significantly above break even levels.
This year the rise in unit costs is raising break even load factors. However, the boost to traffic from stronger economic growth has exceed the rise in capacity and so load factors are rising. The gap is narrower than in 2016 so profits and ROIC are down on 2016 but the gap in 2017 is bigger than we had expect in December, so we have revised up our forecasts for 2017 profits and ROIC.



2017 will be the 3rd year in a row when the industry as a whole generates a return on capital above its cost of capital. 2017 ROIC is down on 2016 because of the profit squeeze from rising costs – but it is still above the cost of capital and so is creating value for investors.



The picture is similar for net profits and operating or EBIT margins. Both are down on 2016 but both have been upgraded from end December forecasts.
In absolute US$ terms industry net profits peaked in 2015. But in terms of EBIT or operating margins and ROIC 2016 was the peak year – so far in this cycle.



2017 marks a 3rd year of above cost of capital returns for the industry in total. But that total is being driven a lot by performance of airlines in N America, where over 50% of net profit is generated.

Europe and Asia Pacific are doing well but with profits and margins half the level of N America. Latin America is starting to improve from the recession-driven problems of recent years. However, the Middle East has seen a deterioration of performance while African airlines continue to lag the industry as a whole.

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