AIRLINES FINANCIAL MONITOR

KEY POINTS

August 2016 – September 2016

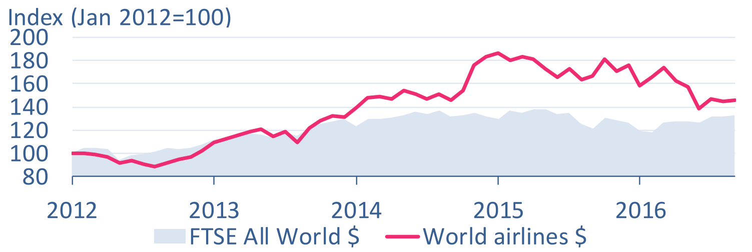
- The latest financial results indicate that industry profitability and cash flow remained solid in Q2 2016, although the industry profitability cycle is showing signs of peaking;
- Global airline share prices rose by 0.9% in September, but remain well below where they started the year;
- Brent crude oil prices rallied towards the end of September following an agreement by OPEC to cut oil output. A rebalancing in the market is slowly taking place, with prices expected to trend upwards weakly in the years ahead;
- The intense downward pressure on passenger yields looks to have eased during the middle months of 2016, in keeping with the change in the trend of oil prices;
- The premium segment continues to offer a buffer for overall airline financial performance. Premium airfares have held up better than those in economy on many of the main premium routes so far this year;
- Developments in passenger traffic continue to reflect the net influence of a number of factors. The upward trend in traffic has eased, but the seasonally-adjusted industry-wide load factor remains at historically high levels;
- Conditions for air freight have improved from earlier in the year, but wider weakness in world trade volumes continues to present a stiff headwind. Low loads continue to keep cargo yields and revenues under pressure.

Financial indicators

Global airline share prices rose by 0.9% in September, with a wide spread in performance

Airline Share Prices

US$ indices (Jan 2012=100)	Index Sep 30th	% change on one month	one year	start of year
World airlines	**146.1**	**+0.9%**	**-12.4%**	**-17.1%**
Asia Pacific airlines	77.2	-4.7%	-9.2%	-12.0%
European airlines	166.2	+0.4%	-25.3%	-28.8%
North American airlines	319.2	+4.3%	-9.4%	-15.7%
FTSE All World $	**132.6**	**+0.4%**	**+9.7%**	**+4.8%**



Source: Thomson Reuters Datastream

- Global airline share prices rose by 0.9% in September. The index of North American carriers rose by 4.3% during the month, while the Asia Pacific index *fell* by 4.7%. European airline shares saw a more modest 0.4% gain, but have fallen the most since the start of the year (-29%).
- The global index has risen by more than 5% since the low reached in the aftermath of the 'Brexit' vote. But economic and market uncertainty, and investor concerns about the impact of lower unit revenues on profitability, have weighed on share prices during much of 2016. Global airline shares ended the month more than 17% lower than their level at the start of 2016 and have lagged behind the wider equity market by a wide margin so far this year.

Robust financial performance, but industry profit cycle is showing signs of peaking

Airline Financial Results

Number of airlines in sample	Regions	Q2 2015 EBIT margin[1]	Q2 2015 Net post-tax profit[2]	Q2 2016 EBIT margin[1]	Q2 2016 Net post-tax profit[2]
40	North America	15.1%	6,272	15.4%	5,080
34	Asia-Pacific	7.4%	2,835	7.4%	2,139
12	Europe	6.8%	1,500	6.2%	1,157
6	Latin America	0.3%	-107	0.9%	59
5	Africa & Middle East	6.1%	62	9.2%	85
97	**Sample total**	**9.8%**	**10,562**	**9.9%**	**8,520**

[1] % of revenues *[2] US$ million*

Note: Includes Air China, Air New Zealand, Cathay Pacific, China Eastern, China Southern, Qantas Airways, Regional Express Holdings, Shandong Airlines & Virgin Australia half-year results.

Sources: The Airline Analyst, IATA

- Net post-tax profits in our large sample in Q2 2016 were around 20% lower in dollar terms than in Q2 2015, reflecting the impact of lower unit revenues.
- The EBIT margin edged up to 9.9%, from 9.8% in the same period in 2015. Margins improved slightly in North America, remained unchanged in Asia Pacific, but dipped in Europe, in part related to the disruption to regional traffic from terrorism.
- Profit margins remain robust by historical standards. However, operating conditions are becoming more challenging and the industry profitability cycle is showing signs of peaking.

Free cash flow edged down in Q2 2016, following increased capital investment

Airline Cash Flow[1]

Number of airlines in sample	Regions	Q2 2015			Q2 2016		
		Net cash flow[2]	Capex	Free cash flow	Net cash flow[2]	Capex	Free cash flow
19	North America	21.9%	13.5%	8.3%	24.5%	14.4%	10.2%
25	Asia-Pacific	18.0%	17.1%	0.9%	17.0%	19.6%	-2.6%
11	Europe	18.6%	11.9%	6.7%	20.0%	18.2%	1.9%
5	Latin America	9.4%	9.6%	-0.2%	8.7%	5.1%	3.6%
4	Africa & Middle East	22.8%	8.5%	14.3%	28.2%	6.2%	22.1%
64	**Sample total**	**19.6%**	**13.7%**	**5.8%**	**21.0%**	**16.1%**	**4.9%**

[1] *% of revenues* [2] *From operating activities*

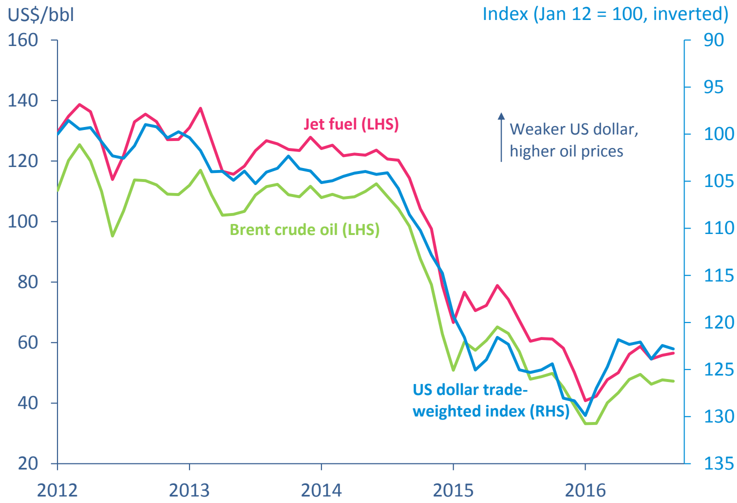
Note: Includes Air New Zealand, China Eastern, China Southern, Comair, Precision Air, Qantas Airways, Regional Express Holdings & Virgin Australia half-year results.

Sources: The Airline Analyst, IATA

- Net cash flow in our sample of 64 airlines rose to 21.0% of revenues in Q2 2016, up from 19.6% in the same period last year. Net cash flow increased in most regions except Latin America and Asia Pac.
- Airlines increased capital expenditure as a share of revenues to a greater extent over the period, most notably in Europe. As a result, free cash flow in Q2 in the sample dropped to 4.9% of revenues from 5.8%. Free cash flow gives airlines the flexibility to return cash to investors or to repair their balance sheets by paying down debt.

Fuel costs

Brent crude prices rallied at end-September following OPEC agreement to cut oil output

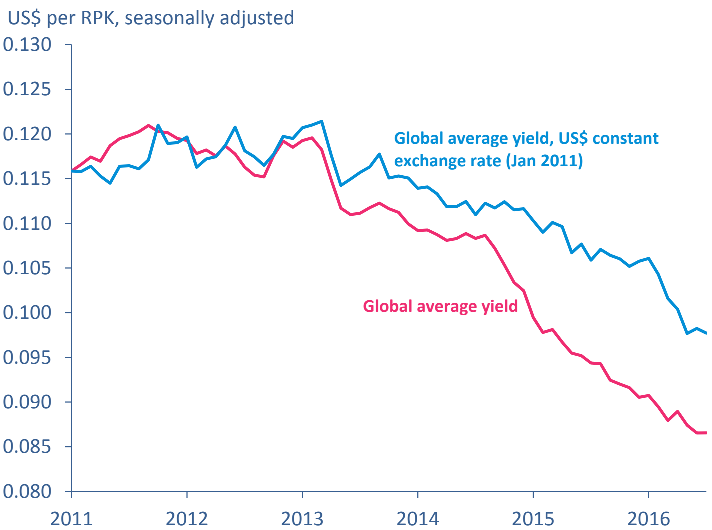


Sources: Platts, Thomson Reuters Datastream

- Brent crude oil prices finished September just below US$50/bbl (and subsequently rose to above $52 in early October). The rally at the end of September followed an agreement by OPEC to cut oil output in the coming months. Nonetheless, the lack of detail surrounding the deal has caused some analysts to question its success in rebalancing the market.
- A rebalancing in the oil market is slowly taking pace and the annual comparison has become less favorable recently; oil prices are currently around 5% higher than they were a year ago. The futures market and oil analysts expect a weak upward trend in oil prices over the foreseeable future, with prices remaining relatively low (below US$60/bbl) until 2020.

Yields and premium revenues

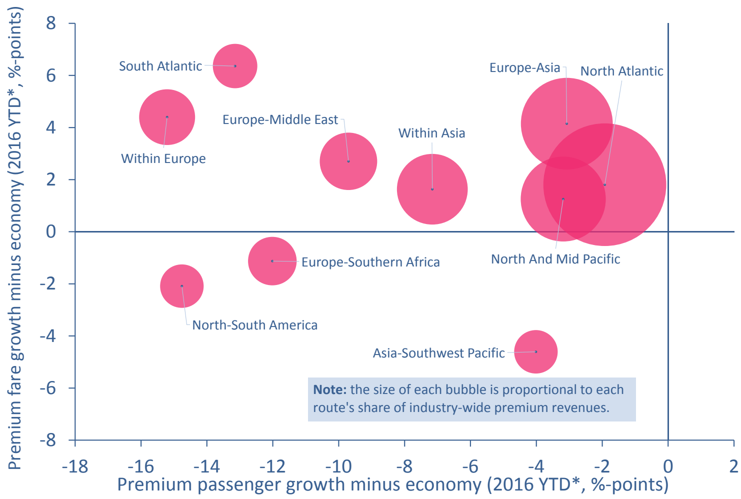
Signs that downward pressure on underlying yields has eased



Sources: IATA Economics, IATA PaxIS+, DIIO, Thomson Reuters Datastream

- The global average yield in reported US dollar terms has trended downwards this year (the latest data go up to July and exclude taxes, fees and surcharges). This trend paused in July, with the seasonally-adjusted yield coming in broadly unchanged from that seen in June. We will be monitoring this closely to see whether this marks a turning point in the series.
- In any case, the latest data provided additional evidence that the intense downward pressure on underlying (ie, constant exchange rate – the blue line) yields seen during the opening months of 2016 eased during the middle of the year. This ties in with the change in the trend in fuel prices seen over the past six months or so.

The premium segment remains an important buffer for airline financial performance

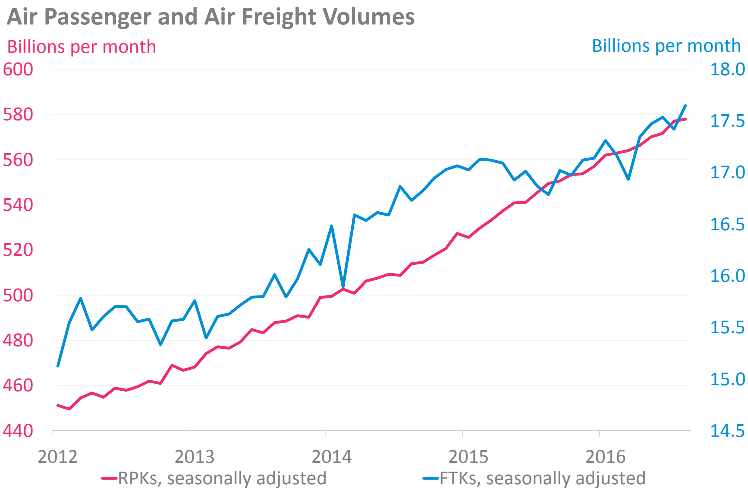


Sources: IATA Economics, DIIO *Latest data up to July 2016

- Growth in premium international passenger traffic has continued to lag behind that of economy. O-D premium international journeys accounted for 5.3% of the total over the first seven months of 2016, down from 5.7% a year ago.
- However, premium fares have held up better than those in economy on most of the top-10 premium routes. In fact, premium's share of revenues has *risen* slightly so far this year on the Europe-Asia markets and was unchanged across the Atlantic (these two routes accounted for nearly two-fifths of industry-wide premium revenues combined in 2015). As we have argued before, in the current environment, the high-yielding premium segment offers an important buffer for airline financial performance.

Demand

Passenger traffic trend has moderated, alongside a modest improvement for freight

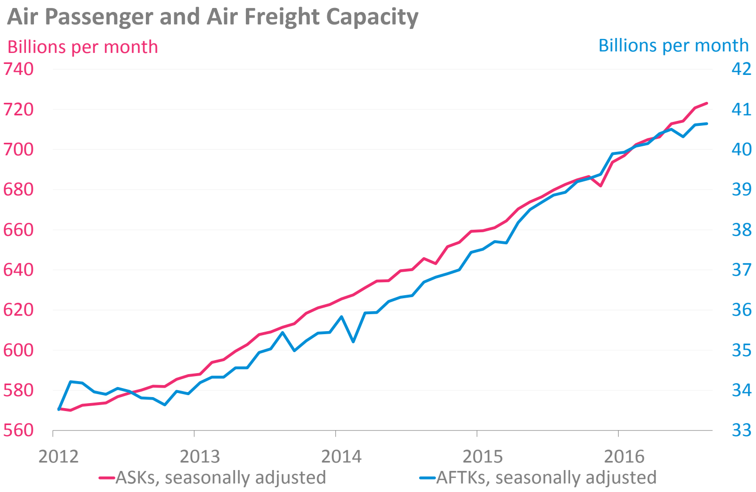


Source: IATA Monthly Statistics

- Annual growth in industry-wide traffic slowed to 4.6% in August, from an upwardly-revised 6.4% in July. Developments in traffic continue to reflect the net impact of a range of competing drivers. Negative headwinds, including from the subdued global economic backdrop, have tended to dominate so far in 2016, although passenger traffic has still grown broadly in line with its ten-year average rate.
- Meanwhile, conditions for air freight have improved since the weak patch seen earlier in the year. But the weak world trade outlook continues to present a stiff headwind.

Capacity

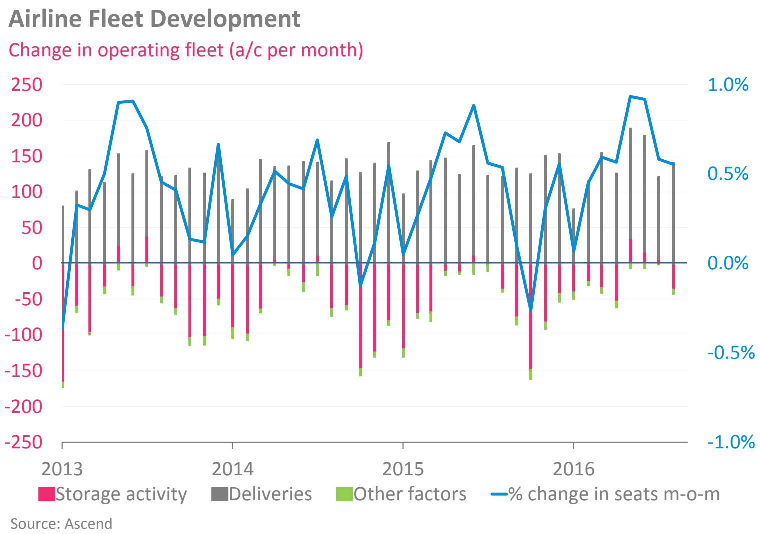
Trends in capacity have moderated in recent months, particularly for freight



Source: IATA Monthly Statistics

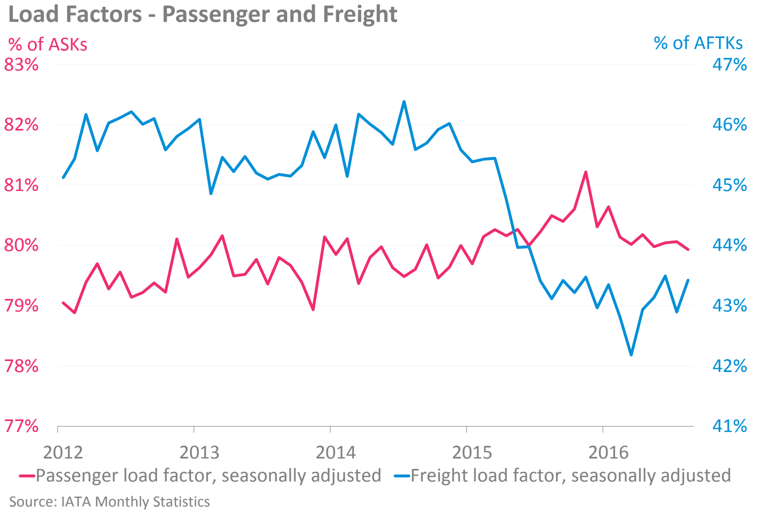
- Available seat kilometres grew by 5.8% year-on-year in August. Airlines have slowed capacity growth somewhat in recent months in line with the wider easing in growth momentum since earlier in the year.
- The upward trend in available freight tonne kilometres (AFTKs) has eased in recent months, in part owing to a slowdown in deliveries to the wide-body passenger fleet in 2016 (particularly in Asia Pacific).

Net storage activity makes a modest negative contribution to fleet growth



- The number of available seats in the global airline fleet increased by 0.6% in August compared to the previous month, and by 5.5% year-on-year.
- 140 new aircraft were delivered in August – higher than were delivered in August 2015 (120). Having contributed positively to the fleet size during each of the previous three months, net storage activity made a modest negative contribution (-37) in August. This was driven in the main by more aircraft going into storage than we saw in each of the previous three months.

Passenger loads remain in a narrow band at a high level, but freight loads remain low



- The industry-wide passenger load factor edged down by 0.1 percentage point in seasonally adjusted terms in August. However, the main point is that the industry has managed to keep the load factor in a reasonably narrow corridor around 80% since February.
- Having fallen sharply during the middle months of 2015, carriers have also stabilized the seasonally-adjusted industry-wide freight load factor over the past six months or so, albeit at a historically-low level. Low freight loads continue to exert pressure on yields and revenues – a particular headwind for Asia Pacific carriers, for whom cargo is a key part of their business.

David Oxley
economics@iata.org
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