AIRLINE BUSINESS CONFIDENCE INDEX

JULY 2016 SURVEY

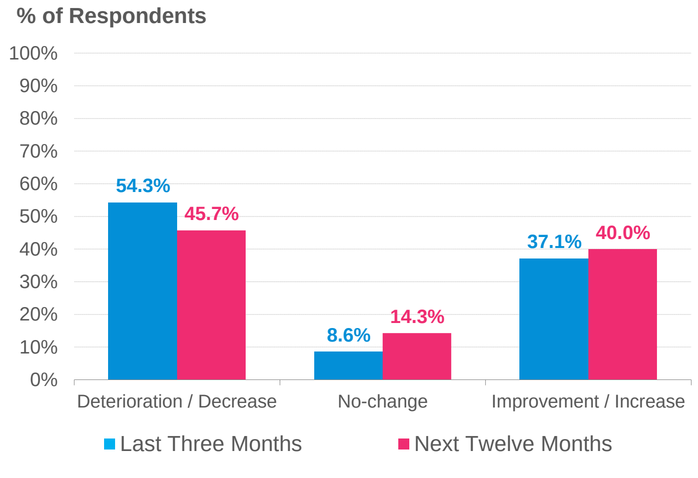
KEY POINTS

- When surveyed in early-July, airline CFOs and heads of cargo reported that they do not expect profits to improve over the next 12 months;
- July's survey results also indicate that industry profitability fell slightly in year-on-year terms during Q2 2016, reflecting the impact of recent terrorist attacks and wider pressure on yields;
- On the demand side, July's survey results were consistent with the robust start to the year for air passenger volumes – albeit with an easing in recent demand conditions – and were in line with the subdued Q2 for air cargo;
- Expectations for growth over the coming 12 months remain positive for both passenger and cargo businesses. But while the latter stabilized in July's survey, the outlook for cargo continues to be held back by structural headwinds;
- Despite the rally in oil prices since the start of the year, the majority of survey respondents expect operating costs to fall further or to remain unchanged over the next 12 months. This relates to hedging practices in the industry, but also in part to the partial recovery in most currencies against the US dollar over recent months;
- That said, in a reflection of strong competition in the passenger market, airline CFOs expect yields to fall by slightly more than input costs over the year ahead. On the freight side, ongoing increases in freight capacity are also expected to continue to weigh heavily on freight yields over the year ahead;
- Airline employment activity increased for the sixth consecutive quarter in Q2 2016. The forward-looking indicator dropped back from April's survey, but remains consistent with airlines adding more staff over the next 12 months.

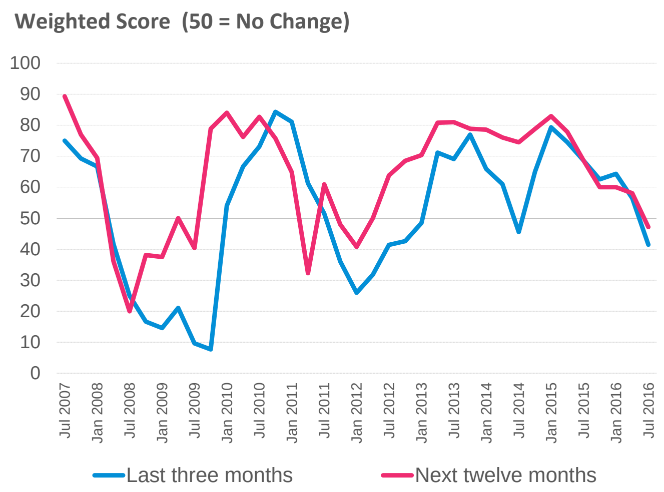
PROFITABILITY OUTLOOK

How has profitability changed? How do you expect it to change over the next twelve months?

a) July 2016 survey



b) Compared to previous surveys



- While the latest financial results from Q1 2016 continue to indicate a robust start to the year for industry profitability, July's survey of airline CFOs and heads of cargo suggests that profitability fell slightly in year-on-year terms during Q2 2016. This partly reflects disruption following recent terrorist attacks, particularly for European airlines. Judging from the pattern of similar events in the past, such negative impacts should prove to be temporary. But the survey results also suggest that profit margins are starting to come under pressure, as falling input costs may now be outweighed by pressure on industry yields. The weighted-average score for profitability over the previous three months fell below the 50-mark in July's survey for the first time in two years.

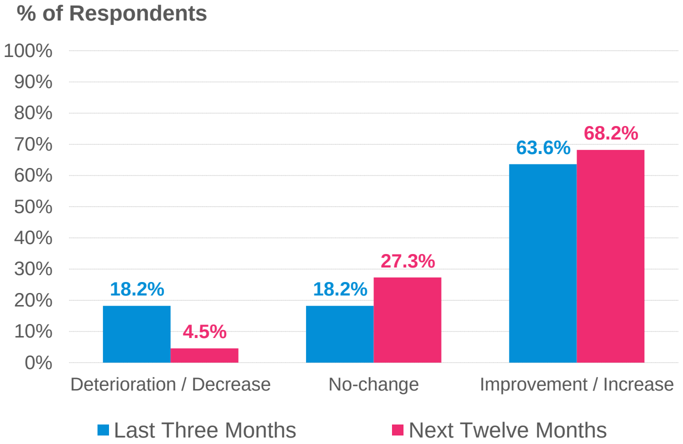
- Airline CFOs and cargo heads do not expect further improvement in profitability over the next 12 months. To be clear, this is not a signal of an imminent drop in profitability: in fact, the result reflects no expected change from what is actually a relatively healthy financial position for the industry. But there has been a turnaround in future profit expectations over the past 18 months, typical of that seen late in profitability cycles. The weighted-average score for profitability over the next 12 months dipped to 47.1 in the July survey – its lowest level in four years – although it is not yet clear whether this is a temporary dip below the 50-mark or the start of a trend.

DEMAND GROWTH

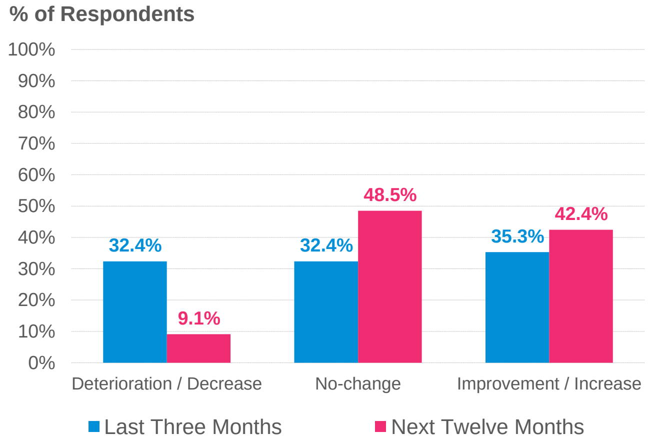
- July's survey results remained consistent with the robust start to 2016 for the passenger market (notwithstanding the modest easing in demand conditions in recent months). Almost 64% of respondents reported a year-on-year increase in traffic during Q2 2016. The backward-looking weighted average score dipped slightly in the July survey, but remained firmly in positive territory and broadly in line with its five-year average.
- The vast majority (68%) of respondents expect passenger demand to increase over the next 12 months, as terrorism-related disruption fades and falling fares help to stimulate demand. Having jumped by more than 10 percentage points in the last survey, the forward-looking weighted average score remained at an elevated level.
- The responses were more mixed on the freight side, reflecting the subdued demand backdrop. The results for the backward-looking component were split broadly equally across the three responses, with the weighted average score dropping to its lowest level since the October 2012 survey. The weighted average score for freight volumes over the next 12 months edged up in July's survey, but the ongoing weak global trade backdrop has taken a toll on expectations of future growth over the past 18 months or so. Just 42% of respondents expect cargo volumes to increase over the coming 12 months – the lowest proportion since the April 2009 survey.

Recent and expected change in traffic volumes

a) Passenger

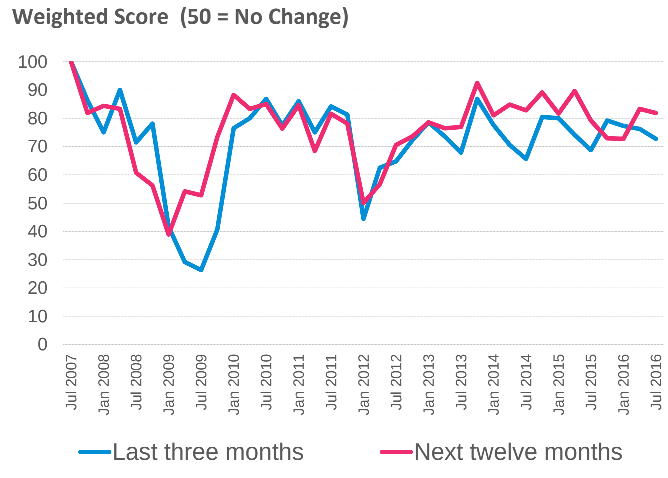


b) Cargo

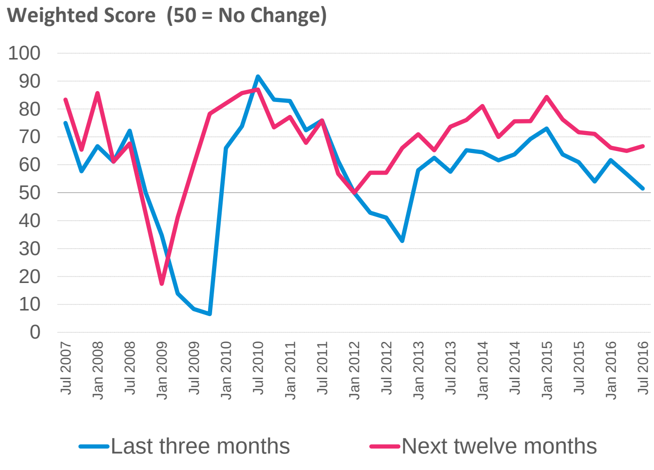


Compared to previous surveys

a) Passenger



b) Cargo

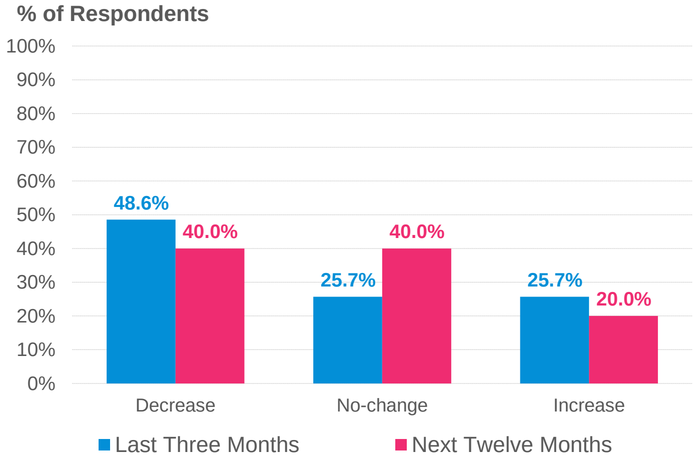


INPUT COSTS

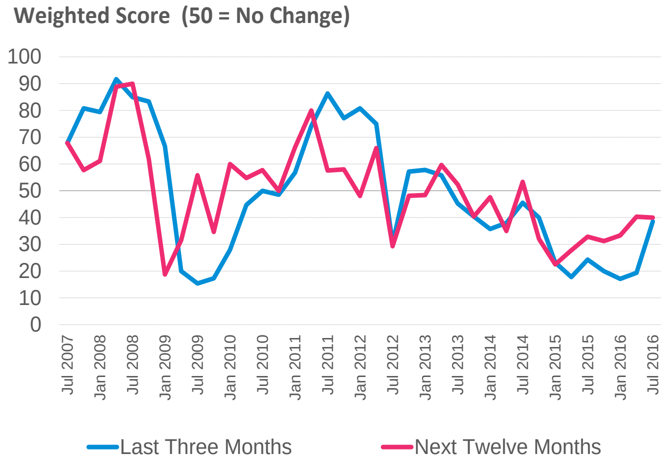
- Just under half of respondents reported an annual decrease in operating costs in Q2 2016, which is consistent with wider developments in the crude oil market. The price of jet fuel, which accounts for around one-third of total industry costs, was approximately 27% lower in Q2 2016 compared to the same period a year ago.
- Despite the rally in oil prices since the start of the year, the majority (80%) of survey respondents expect operating costs to fall further or to remain unchanged over the next 12 months. This relates to hedging practices in the industry, but also in part to the partial recovery seen in many currencies against the US dollar over recent months (which matters because oil and jet fuel are typically priced in US dollars).

How have your unit input costs changed? How do you expect them to change over the next twelve months?

a) July 2016 survey



b) Compared to previous surveys

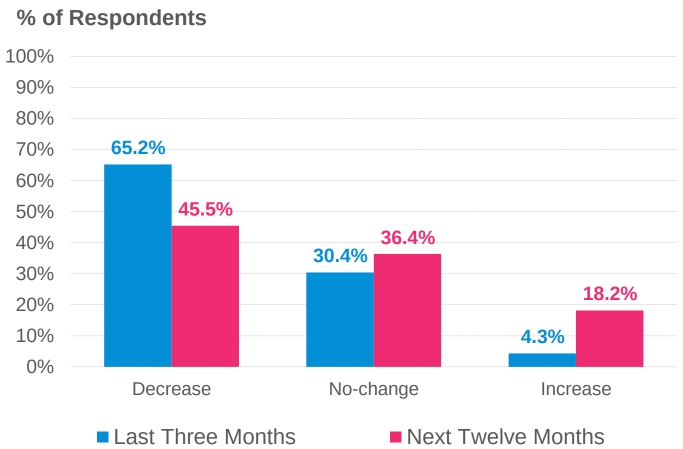


YIELD ENVIRONMENT

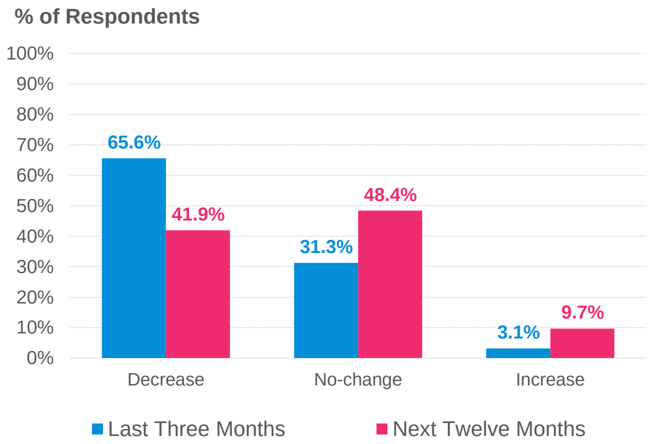
- 65% of survey respondents reported a year-on-year decrease in passenger yields in Q2 2016 – the second survey in a row in which a greater proportion of respondents reported a decrease in passenger yields than a decrease in input costs. Respondents expect further yield declines over the coming 12 months. In short, headwinds to further gains in profits are expected to persist.
- Ongoing strong capacity growth continues to put acute pressure on cargo yields. Almost two-thirds of the survey respondents reported year-on-year decreases in cargo yields in Q2 2016. The weighted average score for yields over the past three months dropped to its lowest level since the second half of 2009. The results of the July survey show that cargo heads do not expect any respite for yields over the next 12 months; a combined 90% of respondents expect cargo yields to remain unchanged or to fall further in the year ahead.

Recent and expected change in yields

a) Passenger

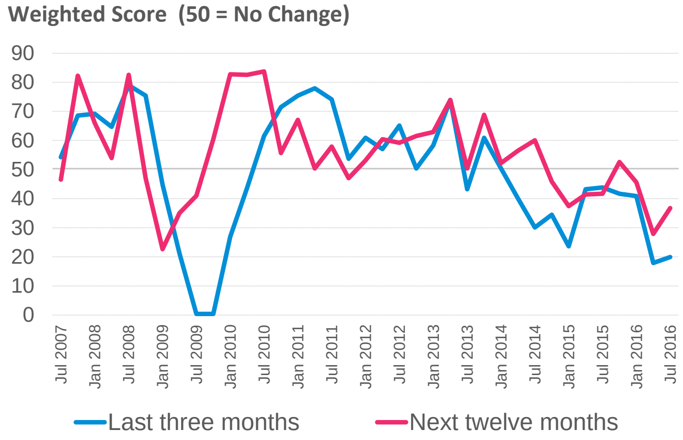


b) Cargo

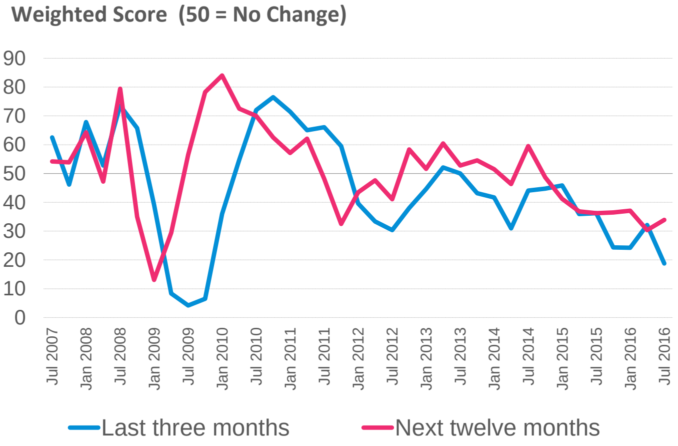


Compared to previous surveys

a) Passenger



b) Cargo

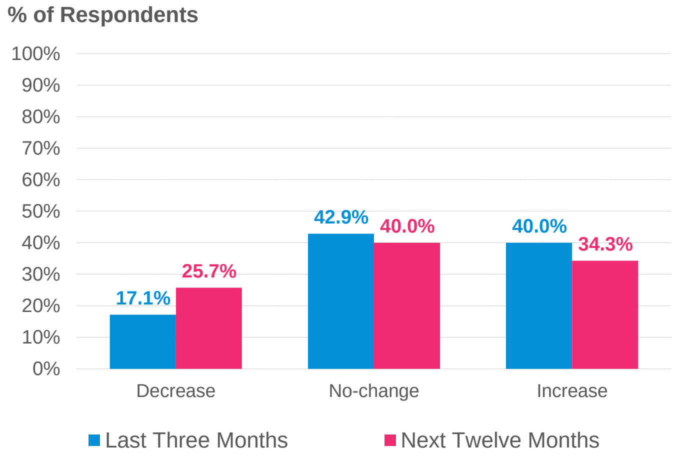


EMPLOYMENT

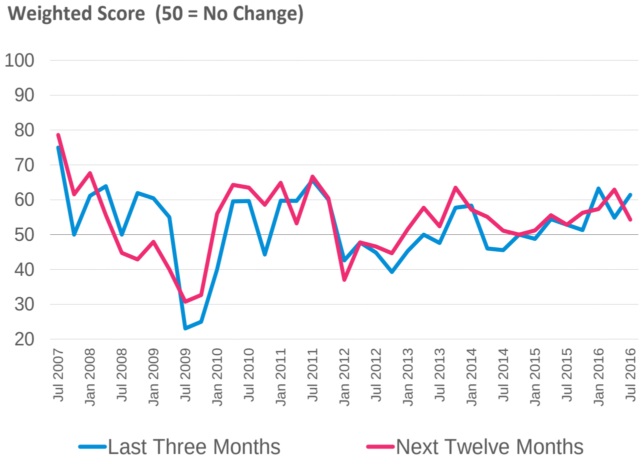
- In a reflection of the current financial health of the industry, airlines have been adding to their workforces: 40% of survey respondents reported an increase in year-on-year employment levels in Q2 2016. The weighted average score for employment activity over the past three months bounced back in the July survey and has now been above the 50-mark for six consecutive quarters.
- The latest survey results remain consistent with airlines expecting to add more staff over the next 12 months, with the weighted average score remaining above the 50-mark. That said, the weighted average score dropped back compared to the previous survey results, driven by a smaller proportion of respondents explicitly expecting to increase employment levels over the year ahead (34% vs. 42% before).

How has your employment level changed? How do you expect it to change over the next twelve months?

a) July 2016 survey



b) Compared to previous surveys



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