AIRLINE BUSINESS CONFIDENCE INDEX

OCTOBER 2016 SURVEY

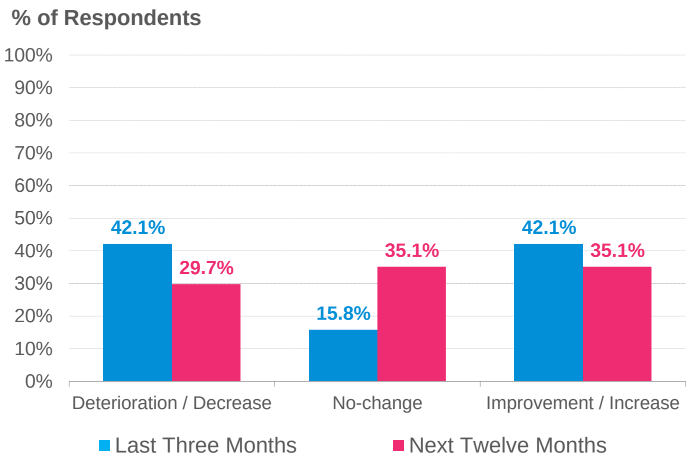
KEY POINTS

- When surveyed in early-October as part of our quarterly business confidence survey, airline CFOs and heads of cargo reported that profitability was unchanged in Q3 2016 compared to the same period a year ago;
- The results from October's survey also showed that industry heads continue to expect very little change in profits over the next 12 months, consistent with signs that the industry profitability cycle may have peaked;
- On the demand side, the responses were consistent with the modest moderation in passenger growth seen during most of this year to date, and were in line with an improvement in conditions for air cargo since early-2016. Expectations for volume growth over the year ahead remain positive for both the passenger and cargo businesses;
- The majority of respondents reported an annual decrease in operating costs in Q3 2016, helped in some cases by the recovery of currencies against the US dollar. But given that oil and jet fuel prices have trended slowly higher since bottoming-out in early-2016, most respondents expect input costs to *increase* over the next 12 months;
- The outlook for input costs contrasts with expectations for yields and points to a more challenging profitability environment. In a reflection of strong competition and the subdued economic backdrop, over 90% of respondents expect passenger yields to remain unchanged or to fall further in the year ahead. On the freight side, ongoing increases in freight capacity are expected to continue to weigh on freight yields over the coming 12 months;
- Airline employment activity increased for the seventh consecutive quarter in Q3 2016. But respondents were more cautious about expectations for employment over the next 12 months than they have been in recent surveys.

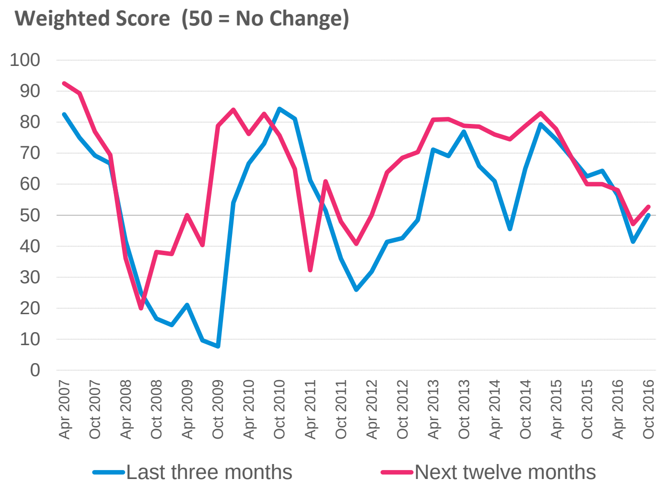
PROFITABILITY OUTLOOK

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

a) October 2016 survey



b) Compared to previous surveys



- When surveyed in early-October, airline CFOs and heads of cargo reported that profitability was unchanged in Q3 2016 compared to the same period a year ago. The results were evenly balanced, with 42% of respondents reporting an increase in profits and 42% reporting a decrease. The spread of responses reflects the business environment becoming more challenging in the second half of 2016, with soft economic conditions, fuel prices trending slowly higher and unit revenues still under pressure. In general, financial performance is holding up best in North America, but is under more pressure elsewhere, including in Europe where terrorism impacts have weighed on operations.

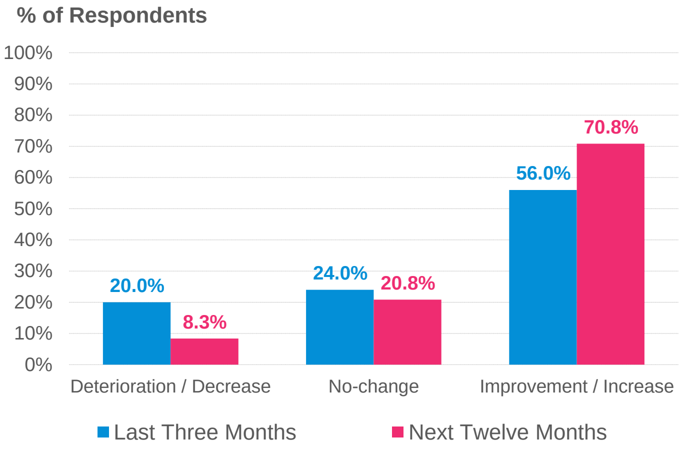
- The weighted-average score for profitability over the next 12 months edged up to 52.7 in the October survey – a slight improvement from July's sub-50 result. But the bigger picture is that airline CFOs and cargo heads continue to expect very little change in profits over the next 12 months. This is 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 the latest survey results are consistent with wider signs that the industry profitability cycle may have peaked.

DEMAND GROWTH

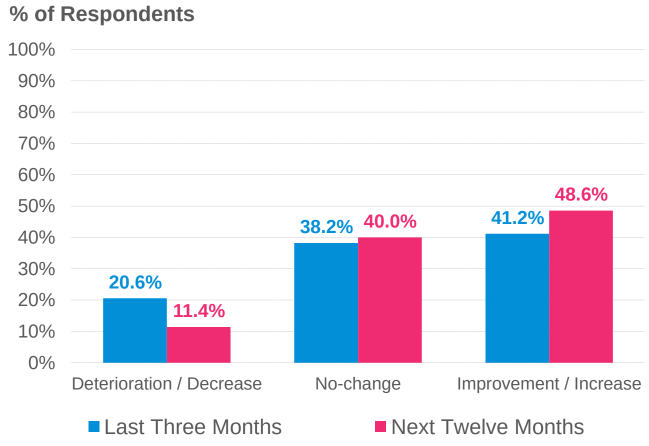
- October's survey results were in keeping with the modest moderation in passenger traffic growth seen during most of 2016 to date. The majority of respondents (56%) reported a year-on-year increase in passenger traffic during Q3 2016, although this was the lowest proportion in more than two years. All told, the backward-looking weighted-average score dropped below its five-year average, and it has now fallen for four consecutive surveys. The impacts of terrorism-related events on demand were a notable theme in the reponses this time.
- A number of respondents noted the heightened uncertainty surrounding the future outlook at present, not least following the 'Brexit' vote in the UK. Nonetheless, the majority (71%) of respondents still expect passenger volumes to increase over the next 12 months, and the weighted-average score remains at a high level.
- On the freight side, the weighted-average score for volumes over the past three months picked up slightly in the October survey, in keeping with signs of an improvement in the monthly data we track from conditions early in 2016. While the broader global trade backdrop remains weak, the weighted-average score for volumes over the year ahead edged up in October, indicating some cautious optimism in the industry. 48% of respondents expect cargo volumes to increase over the coming 12 months – the highest proportion since the October 2015 survey.

Recent and expected change in traffic volumes

a) Passenger

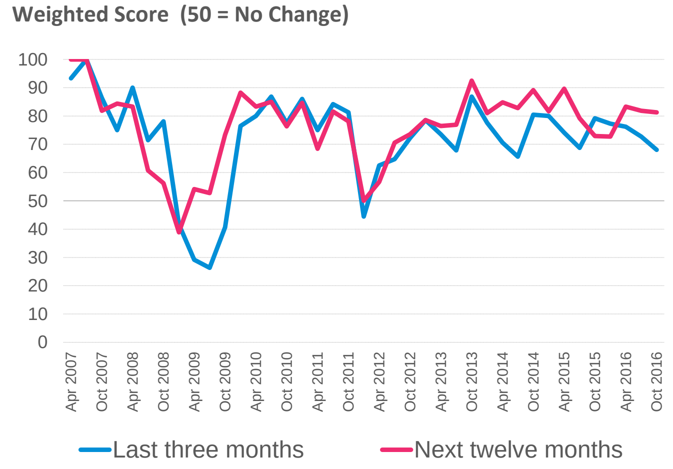


b) Cargo

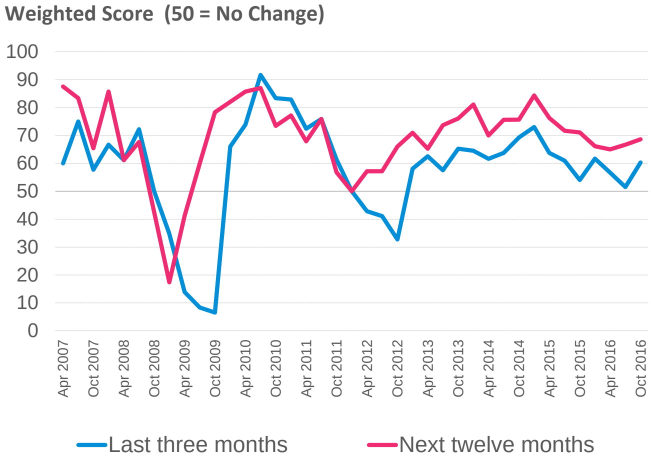


Compared to previous surveys

a) Passenger



b) Cargo

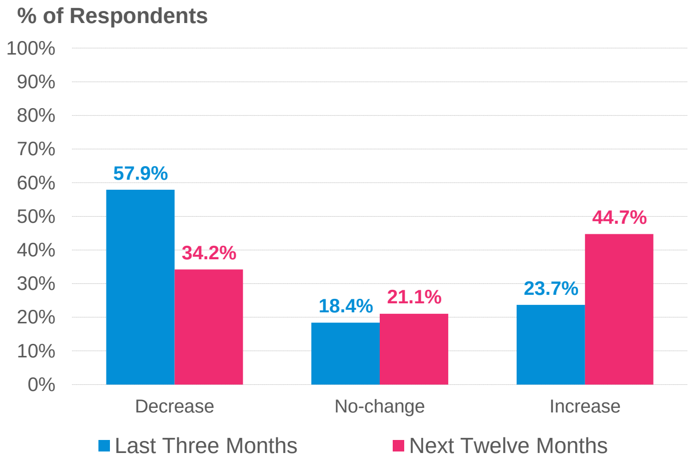


INPUT COSTS

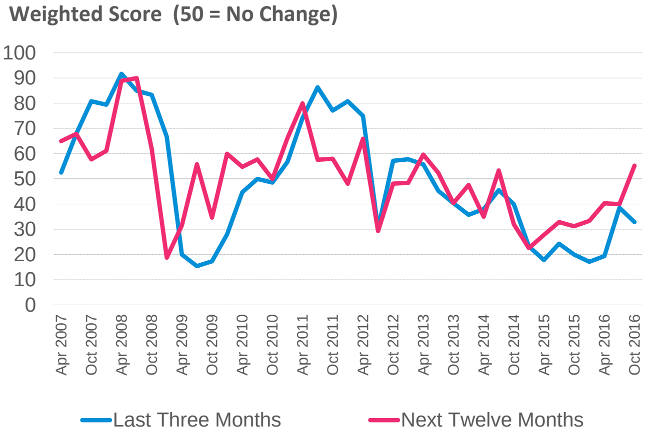
- The majority (58%) of respondents reported an annual decrease in operating costs in Q3 2016. Fuel accounts for just under one-third of total industry costs, and the spot price of jet fuel was approximately 12% lower in Q3 2016 compared to the same period a year ago. The recovery of a number of currencies against the US dollar – notably the Russian rouble and the Brazilian real – will have also helped to reduce input costs in some cases.
- That said, oil and jet fuel prices have trended slowly higher since bottoming-out in early-2016, and 45% of respondents expect input costs to increase over the next 12 months (the highest proportion since the April 2012 survey). The weighted-average score came in above the 50-mark for the first time in more than two years.

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

a) October 2016 survey



b) Compared to previous surveys

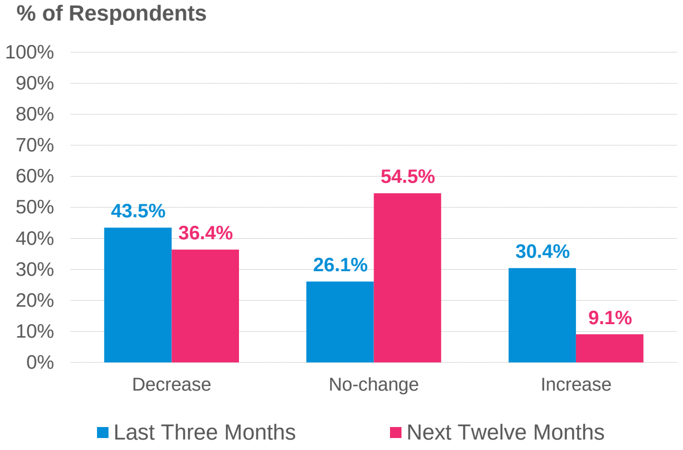


YIELD ENVIRONMENT

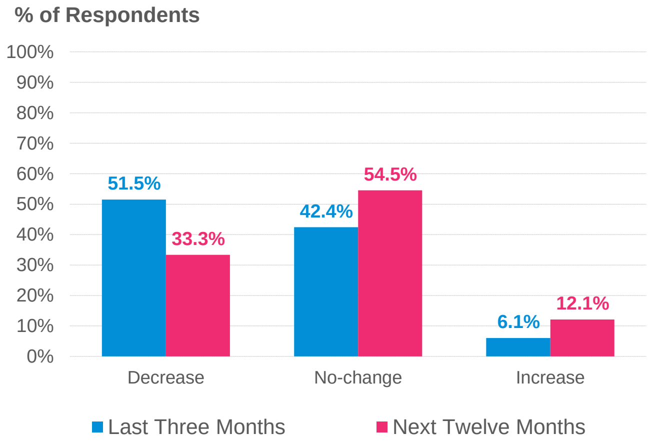
- Expectations for input costs to rise over the year ahead contrast with the outlook for yields. This underlines how the business environment is expected to remain challenging for airline profitability. The majority (55%) of respondents reported that they expect passenger yields to remain unchanged over the coming 12 months. But the weighted-average score remained below the 50-mark for the fourth survey in a row, unchanged from July.
- Ongoing growth in freight capacity, mainly from additional belly-hold capacity in the passenger fleet, continues to put pressure on cargo yields. Just over half of the survey respondents reported year-on-year decreases in cargo yields in Q3 2016, and the backward-looking weighted-average score for yields remained close to a seven-year low. Notwithstanding a small uptick in the forward-looking weighted-average score in the October results, just under 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

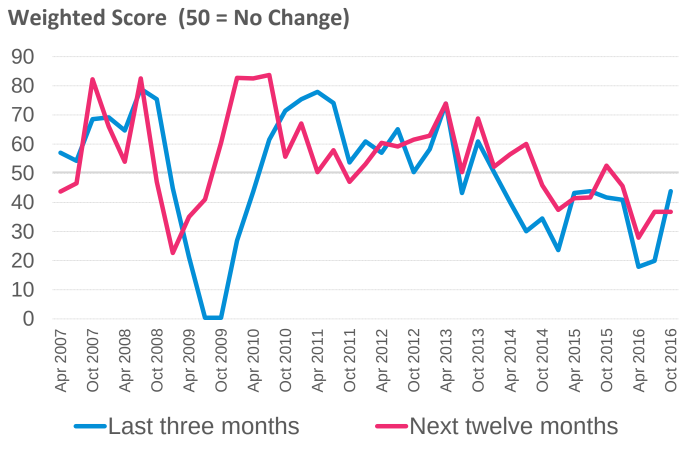


b) Cargo

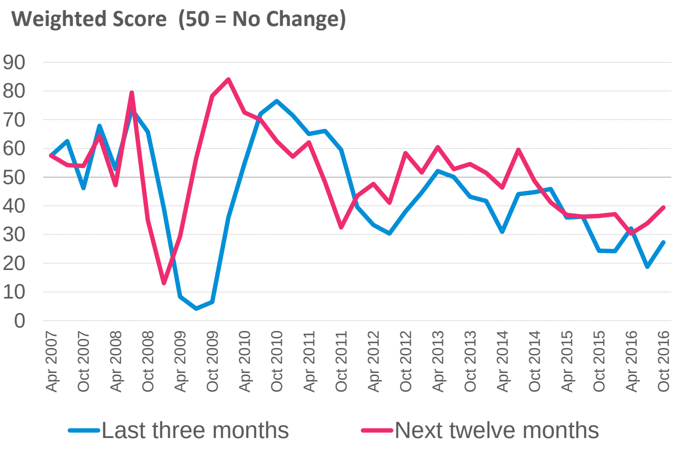


Compared to previous surveys

a) Passenger



b) Cargo

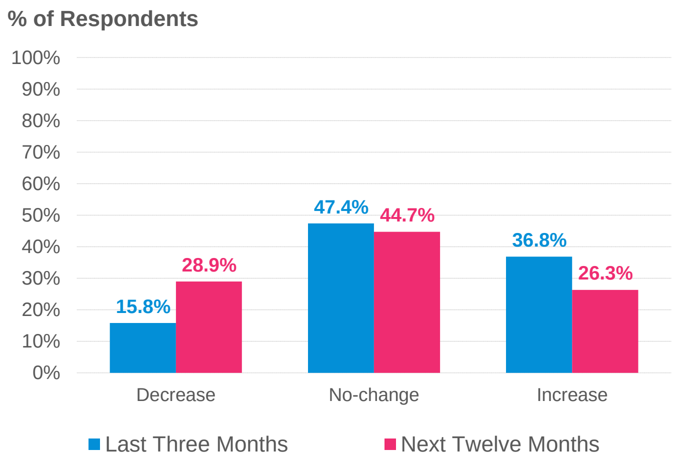


EMPLOYMENT

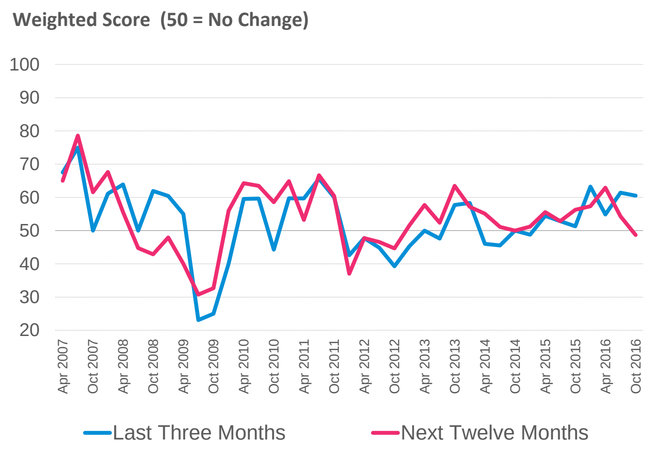
- 37% of survey respondents reported an increase in employment levels in Q3 2016 compared to the same period a year ago. The weighted-average score for employment activity over the past three months has now been above the 50-mark for seven consecutive quarters.
- That said, given the more challenging backdrop for industry profitability, respondents were more cautious about expectations for employment over the next 12 months than they have been in recent surveys. The majority (45%) of respondents reported that they expect to keep employment levels unchanged over the next 12 months. But the proportion expecting to *increase* employment levels fell for the second survey in a row, to just over 26%.

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

a) October 2016 survey



b) Compared to previous surveys



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