ECONOMICS BRIEFING

JUNE 2006

PROFITABILITY: DOES SIZE MATTER?

KEY POINTS

- At the operating level, the global airline industry has been marginally profitable for the past two years. In 2005, operating profits were US$4.3 billion – a 1% margin – though the industry still made net losses (after interest, taxation and exceptional items) of US$3.2 billion.
- There was also a very wide divergence in operating performance between airlines. In our analysis, eight airlines made operating profits of more than $500 million, but twenty airlines made operating losses, with nine losing over $100 million each.
- There is no correlation at all between size and profit margins. The divergence of operating profit margins demonstrates the influence of a wide range of strategic, cost and management factors on profits, but no clear link with size. Fifteen airlines enjoyed a margin of over 10%. The highest margins are currently earned by "no-frills" operators, but there are several examples of successful airlines with a network or regional business model. Gol, Ryanair and Air Asia are the top three airlines by margin, but network airline COPA was a close fourth with an operating margin of 17.3% in 2005. There are successful airlines in every region.
- In terms of size, there is some evidence that the larger an airline the higher the level of operating profits it earns. Larger airlines can deploy scale, scope and density advantages to generate a positive return in their markets. However, a number of exceptions ensure that the correlation of size with absolute profits is not a rule. Size has meant bigger losses for some airlines too.
- This does not mean that any future consolidation in the industry will not help to improve efficiency and profitability. It makes the point though that the strategic focus of such consolidation needs to be on identifying ways to boost margins and profits rather than just on capturing market share.

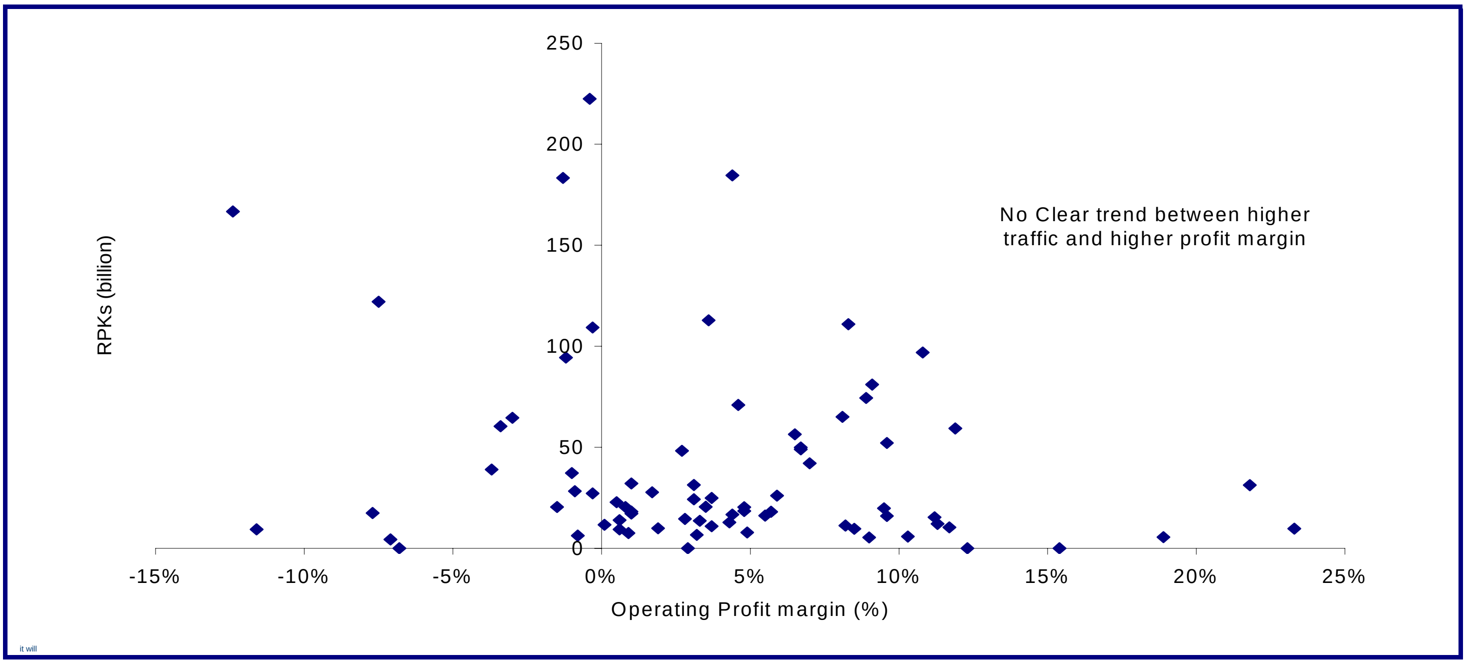
OPERATING PROFITS BY AIRLINE

- An analysis of the latest fiscal year performance of 85 of the world's major airlines– who together account for 85% of global passenger volumes and the vast majority of global freight volumes – shows that:
  - Eight airlines made operating profits of more than US$ 500 million, with three earning over US$ 1 billion (see Appendix). Nine of the ten highest airlines by total profits are IATA members, the exception being Southwest. However, twenty airlines made operating losses, nine of whom lost over US$ 100 million.
  - European and Asia-Pacific network airlines and major cargo airlines are among the highest profit generators. By contrast, nine of the twenty airlines that made operating losses were US carriers.
  - Fourteen airlines enjoyed an operating profit margin (profit as a percentage of revenues) of over 10%, which is around the level necessary for returns to be able to match the cost of capital. No-frills operators dominate this list, with Gol, Ryanair and Air Asia the world's top three airlines by profitability. Six of the 14 airlines with margins above 10% are IATA members.
  - There are airlines with margins of 9.5% or over in every region.

OPERATING PROFIT MARGINS AND AIRLINE SIZE

- There is no evidence that scale brings higher profit margins within the airline industry (see Figure 1). The nine (non-cargo) airlines with the highest profit margins have RPKs of less than 60 billion each, though there are also several small airlines with low or negative profit margins. For airlines of more than 100 billion RPKs there was a wide divergence in profit margin in 2005 from 8.3% for BA to –12.4% for Delta.
- This should not be too surprising. Niche markets will have the highest margins. As airlines deploy their competitive advantages to other markets and grow their network, overall profit margins will fall, as their advantage diminishes in new markets, but it makes economic sense to expand until absolute profits stop growing – if those operating profits are at least covering the airline's cost of capital and tax.

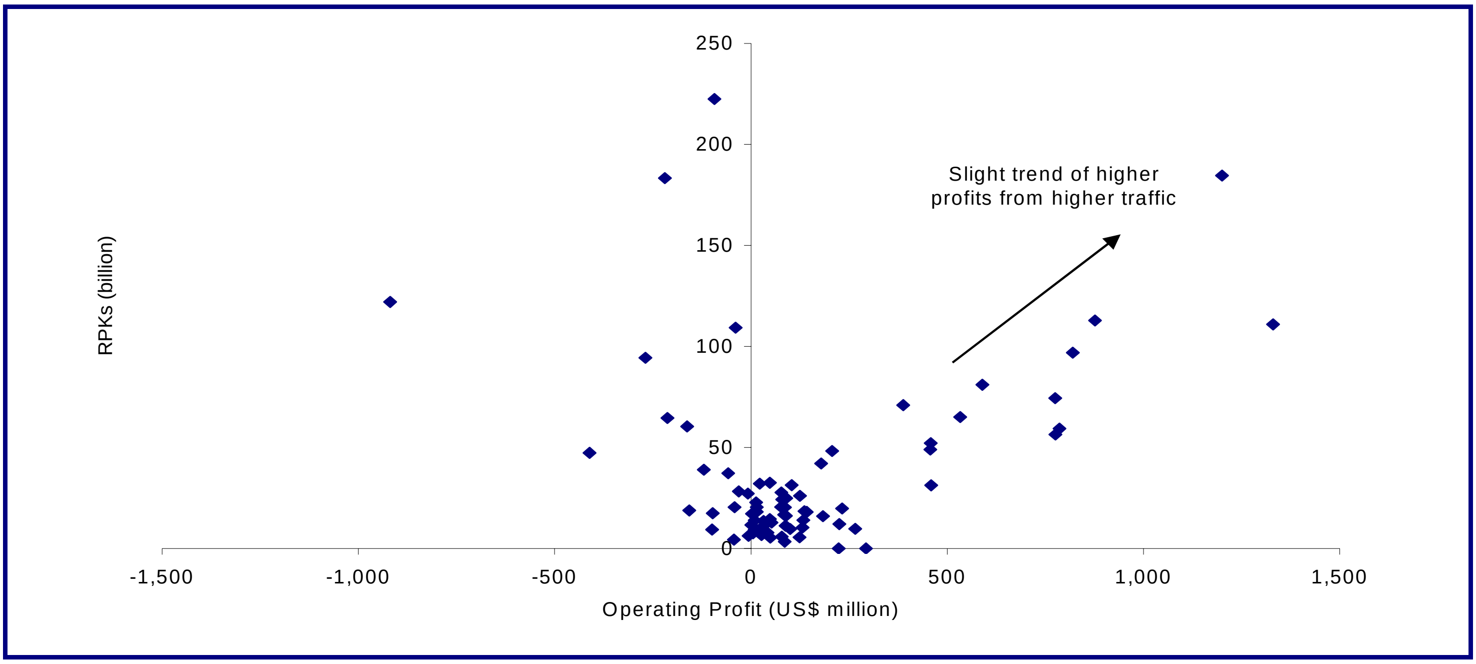
Chart 1: Operating Profit Margins and RPKs



OPERATING PROFITS AND AIRLINE SIZE.

- A bit more surprising is that there is only a slight, and statistically insignificant, positive correlation for airlines between higher levels of passenger traffic and higher levels of operating profits (see Figure 2). It is the case that there are economies of scale, scope and density associated with network airline operations and some of the larger airlines have the larger profits – but there are diseconomies of scale too.
- Four of the five largest passenger airlines (all from the US) made operating losses, while there are examples of larger airlines making losses in most other regions too. The divergence of profits demonstrates the influence of a wide range of strategic, cost and management factors on profits, but there is no clear link with size. This has been the experience in many other industries. Success brings scale rather than scale necessarily bringing success.
- A further point to note is that the cost of debt and equity capital (and taxation) needs to be paid from operating profits. In the airline industry an operating margin of 9-10% on average will be needed to cover these costs of doing business, before the business is creating Economic Value Added or 'investor value'. See 'Value Chain Profitability' on www.iata.org/economics. Out of the top-10 airlines generating the largest operating profits, only Southwest and Emirates clearly generated value for investors last year.

Chart 2: Operating Profits and Revenue Passenger Kilometres (RPKs)



APPENDIX: OPERATING PROFITS BY AIRLINE

Table 1: Top 25 Airlines by Operating Profitability, Fiscal Year 2005 (* = Fiscal Year 2004)

By Total Operating Profit			By Operating Profit Margin		
Rank	**Airline**	**US$ m**	**Rank**	**Airline**	**%**
1	FedEx *	1,414	1	Gol Airlines	23.3
2	British Airways	1,330	2	Ryanair	21.8
3	Air France-KLM	1,200	3	Air Asia	18.9
4	Lufthansa	877	4	COPA	17.3
5	Southwest	820	5	Kenya Airlines	15.6
6	Emirates	786	6	Philippine Airlines	13.7
7	All Nippon	776	7	DHL International *	12.5
8	Qantas *	775	8	Kalitta Air	12.3
9	Singapore Airlines	590	9	Emirates	11.9
10	Cathay Pacific	533	10	Mesa Airlines	11.7
11	Ryanair	459	11	American Eagle	11.3
12	Air China	458	12	SkyWest	11.2
13	Iberia	457	13	Southwest	10.8
14	Air Canada	388	14	Jet Airways *	10.3
15	UPS Airlines	293	15	Air China	9.6
16	Thai Airlines	269	16	Virgin Blue	9.6
17	Gol Airlines	266	17	TAM	9.5
18	TAM	232	18	Singapore Airlines	9.1
19	American Eagle	225	19	Royal Jordanian	9.0
20	SkyWest	220	20	Qantas *	8.9
21	Korean Airlines	207	21	Atlantic Southeast	8.5
22	Virgin Blue	184	22	British Airways	8.3
23	China Eastern *	179	23	Aer Lingus	8.2
24	LAN Airlines	142	24	Cathay Pacific	8.1
25	Asiana*	136	25	FedEx*	7.2

Source: Airclaims Financial Database, IATA

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