The state of the airline

The airline industry in Europe today has rarely been so profitable, yet over the past two years numerous airlines have failed or been taken over. Brian Pearce, Chief Economist for the IATA, explains how the prospects for the year ahead will depend on the reasons for this apparent paradox.

One feature of the European airline industry today is that more than half the profits of the European airline industry are being generated by the three large airline groups and Ryanair (the big four) – though the latter is now facing new cost challenges. But IAG, Air France-KLM and the Lufthansa Group are not reliant for the bulk of their profits on intra-European markets.

Long-haul international markets have consolidated in recent years, particularly across the North Atlantic, with the antitrust immunity joint venture for airline alliances providing a structure, allowing much more rational and efficient operations. These structures are only permitted by competition authorities where there are Open Skies agreements, designed to attract new entry whenever yields are good, typically by long-haul low-cost carriers, such as Norwegian and WOW.

It is not clear whether these challengers for the North Atlantic market will be successful, given the losses shown in the chart. Short-haul operations within Europe for the big three airline groups have been much more challenging.

A fragmented market

Within-Europe markets are more challenging because Europe is very different from, for example, North America, in that both markets and the airline industry are far more fragmented.

In Europe it takes 348 city pairs to generate 25 per cent of within-Europe passenger revenues, compared to 167 in North America. There are 195 airlines in Europe offering scheduled passenger services, compared to 98 in North America. In Europe it takes 28 airlines to provide 80 per cent of available seats, compared to just seven airlines in North America.

The long tail of airlines beyond the big four in Europe generate a much more mixed financial performance than seen, for example, in the North American industry. The large and medium-sized airlines (annual revenues of more than US$5bn) are distorting the picture of financial health for the typical airline in Europe, because of their size. The big four in Europe have been generating returns on capital of more than 16 per cent, which is comparable with the top airlines in North America and is creating value for their investors – which is critical if the industry is to attract the new capital it needs.

We estimate that the European airline industry generated just over $12bn of operating profits in 2018, an average operating margin of 6 per cent, which is excellent by historic standards (in the 20 years to 2014 the average was just over 2 per cent). But this average is driven by the results of the big four. The median airline in Europe – the ninety-eighth out of the 195 airlines offering scheduled services in Europe – is doing far worse.

That is the reason why, despite good industry-level profits, there has been a series of airline failures or mergers over the past two years. The most notable of which were Air Berlin and Monarch in 2017, Primera Air and Cobalt Air last year and Germania and flybmi this year. Flybe has been bought by a consortium led by Virgin Atlantic. Thomas Cook is putting up Condor and Thomas Cook airlines for sale. Alitalia is, as ever, looking for suitors.

Challenges

Cash flow problems typically become unsustainable in the seasonally weak period of October to February, and this pattern was repeated with the current series of problems in the European airline industry.

Rising costs over the past two and a half years until the very recent fall in fuel prices has been a key factor precipitating these failures. Over the two years leading up to October last year jet fuel prices rose from $60 a barrel to $95 a barrel. Cash flow pressures from this source were intensified last year as the US dollar rose 10 per cent against the Euro, also increasing aircraft costs in Euro terms for European airlines.

At the same time, business confidence and economic conditions in Europe deteriorated significantly, with wider trade problems, Brexit, Turkey's currency crisis and several other issues. As a result, passenger traffic slowed by about 3 per cent points on most major European markets last year.

Revenue growth was further weakened by yield increases turning negative at the end of last year on almost all major markets. The combination of rising costs and slowing revenues hit cash flows and the damage to the long tail of struggling European airlines, evident in the failures of the past two years, was the result.

But there is also a structural issue for the median or typical airline in Europe. Last year, European airlines achieved a remarkably high average load factor of almost 85 per cent. That's quite an achievement given the seasonal lows in traffic and the fragmentation of the industry. But it has partly been achieved out of necessity.

Our calculations show that breakeven load factors are higher in Europe than any other region in the world. This is partly due to the fragmentation of the industry and the intensity of competition, particularly in the European Common Aviation Area, which has led to exceptionally low yields, to the benefit of consumers and businesses. Average yields or base fares per km flown are 6 per cent lower today than in the US domestic market, where sector

industry in Europe

lengths are 50 per cent longer (yields fall with distance), and 20 per cent lower than in East Asian markets of a similar sector length.

Costs of operations are also relatively higher in Europe, because of congested airports and airspace, and the high cost of regulation and infrastructure use. Unless some of these underlying issues change, the long tail of European airlines will continue to find business conditions challenging.

Looking ahead

The outlook this year has been helped, a little, by the recent fall of oil and jet fuel prices. Having hit $95 a barrel in October, jet fuel prices fell back below $70 a barrel by the end of the year. They have crept higher to the low 80s at the time of writing, with Brent crude oil at just over $65 a barrel.

Fuel prices are always hard to forecast but the expectation is that plentiful oil supplies will keep crude oil prices below $70 a barrel on average this year. Unfortunately for many European airlines, hedging ratios near 80 per cent will prevent this fall in the price of jet fuel from improving cash flows and profits for most of this year. The bulk of this benefit will be felt in 2020.

Meanwhile, intra-Europe revenues look set to come under increasing pressure from a weakening in many European economies. Germany and the EU28 are economies where growth depends significantly on trade, so the weakness on world trade following the series of protectionist measures has damaged these economies. Many of the core EU28 economies only just avoided recession in the second half of last year, and business sentiment surveys point to further weakness this year.

After relatively weak GDP growth of 1.8 per cent last year some forecasts for 2019 are as low as 1 per cent.

Turkey and Russia, which generated good market growth and profits for their airlines back in 2017, face considerable difficulty today and in the year ahead. Turkey's currency crisis last year saw the Lira lose 25 per cent of its value against the US dollar. That substantial loss in the terms of trade and the resulting inflation pressures led to a sharp slowdown of economic growth in 2018 and is widely expected to cause a recession this year. Russia is facing renewed pressures on its still energy-dependent economy from the recent fall of oil prices. In addition, its increase of the VAT rate in January this year from 2 per cent to 20 per cent is forecast to halve consumer spending growth.

The exception to this rather gloomy picture of European prospects are the economies in Eastern Europe, which are continuing to do well, providing rapidly-growing markets for airlines like Wizz. Good demographics and catch-up benefits as they integrate their economies into Western Europe and attract investment from manufacturers and others, have supported strong economic growth in the region of 5 per cent a year for economies like, Poland, the Czech Republic and Hungary. This growth looks set to continue and will provide a bright spot in a largely weakening Europe.

Airlines serving these growth hotspots in 2019 could do well. The larger airlines in Europe are also likely to generate further good performances, albeit a bit weaker, from their strengths on international markets outside Europe. But for the typical airline in Europe the combination of weakening economies, intense competition for that slowing revenue, and structurally high infrastructure and regulatory costs will make 2019 a tough year. ■

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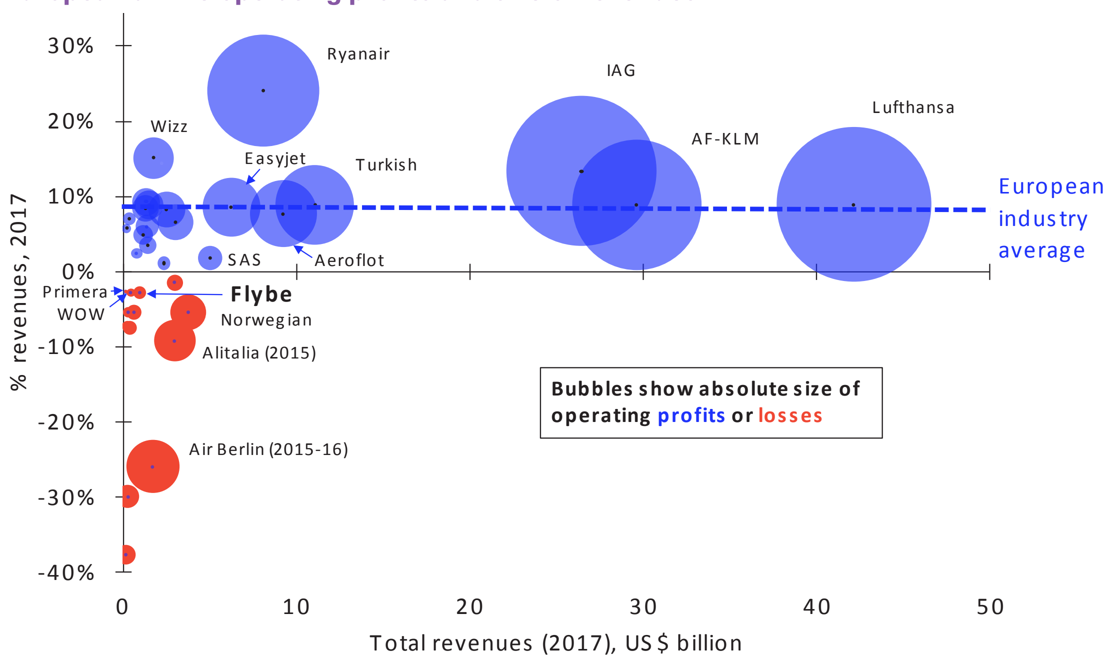
European airline operating profits and size of revenues



Source: The Airline Analyst, CAPA