Value Chain Profitability

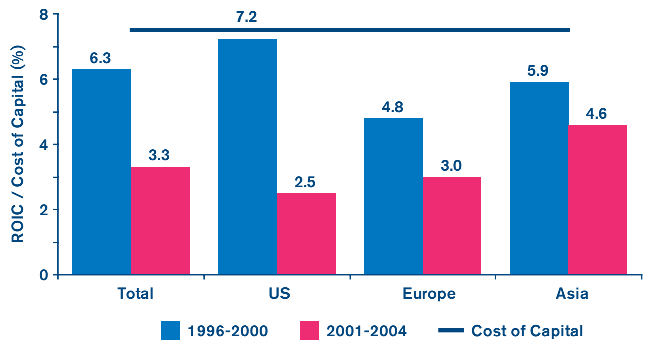
IATA ECONOMICS BRIEFING Nº 04

Structural changes are required to deliver a higher return for airline investors. This will benefit all stakeholders in the aviation industry. Without it, billions of dollars of potential value for customers, investors and the wider economy will be lost.

Airlines and the wider aviation industry generate substantial value for their customers and the wider economy. But airlines have not able to retain enough of that value to pay a normal return to their own investors. Returns on capital invested in the airline industry have been depressed to unsustainable levels by government interventions and by excessive market power in some parts of the supply chain. Unless governments liberalise outdated regulatory constraints over airline operational and ownership decisions, future investment will either be constrained or delivered inefficiently or both.

Airlines – including "no-frills" airlines – have been unable to generate sufficient investor returns.

For the global airline industry, there was an average annual shortfall of $11.7 billion between the actual return on invested capital received between 1996 and 2004 and the level of return expected by investors (i.e. the cost of capital). Some individual airlines generated high returns, but on average the sector was unable to deliver a sufficent return for investors. "No-frills" airlines were also, on average, unable to meet their cost of capital.

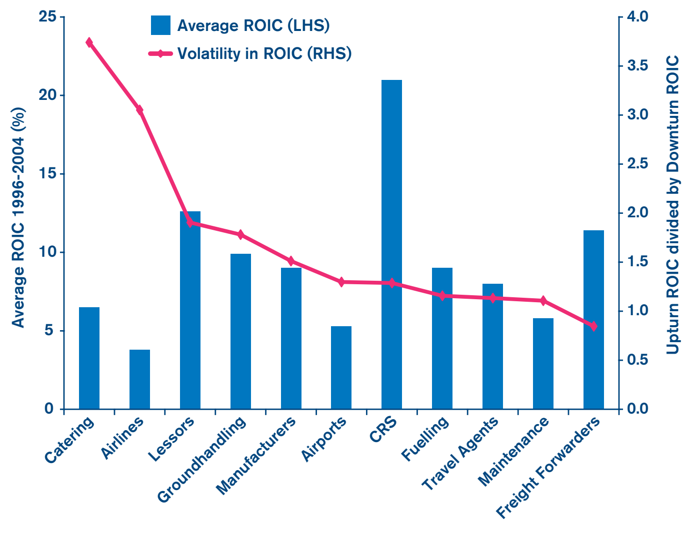


The Aviation Supply Chain does meet investor returns, with large differences between sectors and regions.

By contrast, the aviation supply chain generated an average annual surplus of $0.7 billion above their cost of capital – though within this total there were significant differences between sectors and across regions. Risk is distributed unevenly across the industry, but higher risk does not equate to higher average returns as it should.

IATA does not oppose surplus returns – but they must be justified by productivity, efficiency or a share of risks.

Airports have a strong regional difference in returns. European and Asian airports have relatively high returns, pointing to a degree of unregulated monopolistic pricing power. Other sectors with high returns include specialist niche areas (e.g. CRS), intermediaries with strong pricing power (e.g. freight forwarders) or those with high barriers to entry (e.g. aircraft manufacturers).



WHY MUST WE IMPROVE AIRLINE INVESTOR RETURNS?

For the airline industry to deliver its full potential value for customers and the wider economy it will need to attract new investment capital on a sustainable rather than speculative basis. Retaining the status quo structure of the industry means that past experience of insufficient investor returns will be repeated in the future. In an increasingly deregulated and privatised industry this will either raise the cost of attracting new investment or deter some much-needed investment. Billions of dollars of potential value for customers and economies would be lost.

HOW CAN WE IMPROVE AIRLINE INVESTOR RETURNS?

This report identifies three main routes through which airline investors would be able to improve the efficiency of their invested capital and achieve a higher share of the value the industry creates:

1. Liberalisation and deregulation.

Governments must allow airlines to have greater freedom over operational and ownership decisions. The current regulatory structure, and the excess capacity it creates, is one of the principal reasons why investor returns are low. Liberalisation and deregulation will reduce the current high barriers to exit or restructuring, allowing capacity to adjust towards levels appropriate for individual markets. Financial intervention must also be reduced, by removing ineffective subsidies – for parts of the supply chain as well as airlines – and by reducing the already high burden of taxation.

2. A greater sharing of risk and reward within the aviation industry.

Airports and other parts of the supply chain cannot look for comfort in monopoly or niche positions. The industry as a whole must seek productivity and cost-efficiency improvements if investor value is to increase for all. Where monopolistic pricing power exists, for example at major European airports, IATA seeks sensible and effective regulation. Where inefficiency exists, IATA seeks clearer benchmarking and transparency of costs and will work in partnership with others to improve cost efficiency for all. Where protected markets exist, IATA will seek greater competition and a fairer share of the risks borne by airlines.

3. Further improvements in airline productivity and cost-efficiency.

Great progress has already been made in reducing unit costs, but it remains an on-going process. Airlines must seek a more sustainable approach in their cyclical management strategies. Customers and employees are fundamental to the business – but have sometimes received value that is unsustainable for airlines to provide. Greater control in matching aircraft capacity to demand will help to avoid unsustainable price competition. Airlines will also continue to adjust their labour costs and productivity levels as a major part of helping to improve returns in a highly competitive market.

FULL REPORT

For a copy of the full report and further economic analysis of the airline industry, visit: **www.iata.org/economics**