

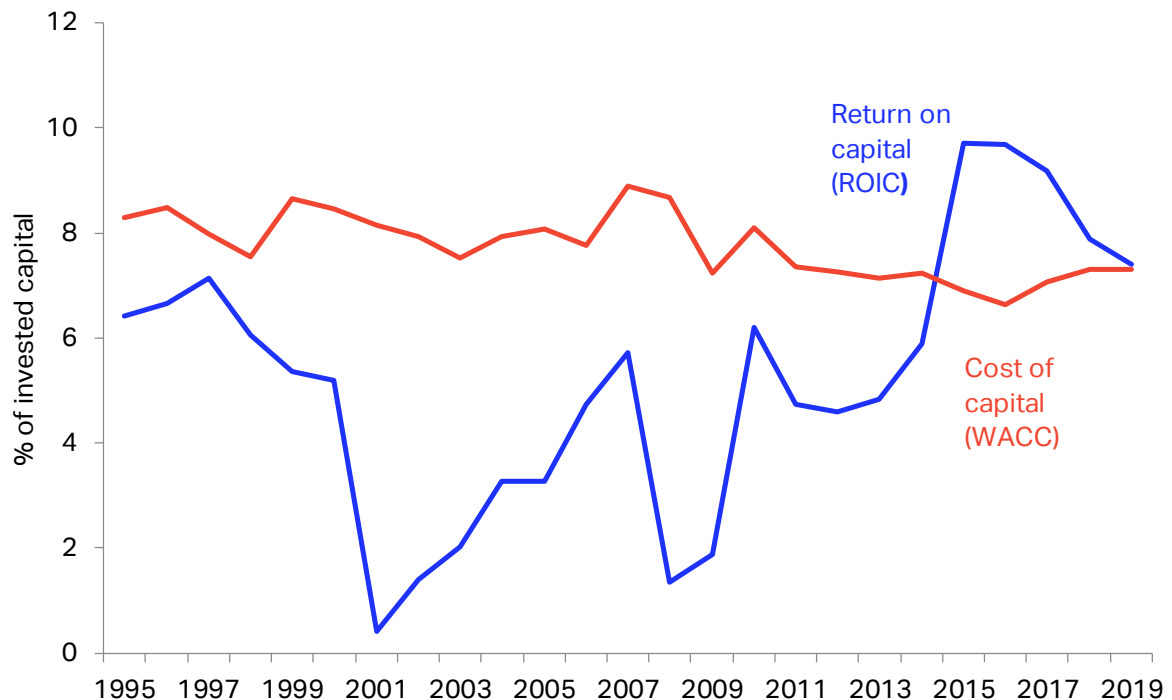


IATA Economics Chart of the Week

14 June 2019

Why it matters that the airline industry stays value creating for its investors

Return on capital invested in airlines and their cost of capital



Source: IATA Economics Performance of the Airline Industry, Mid-Year 2019

- Last week's [revised forecast](#) of airline industry profitability by IATA implied that the average return on invested capital (ROIC) is expected to slip a little further to 7.4% this year. This measure of profitability has earnings before interest and tax as does the operating margin profitability measure (with an adjustment for operating leases), but the denominator is invested capital rather than revenue. This is the measure investors, particularly providers of equity, are interested in. The weighted average cost of capital (WACC) is investors' opportunity cost. It measures what they could earn by taking their invested capital and investing it outside the airline industry but in assets with similar characteristics. If ROIC is above WACC, as it has been for the past 4 years, then the airline industry is creating value for its investors. This year we forecast that returns for investors will remain above their opportunity cost for the 5th successive year, but only just.
- Does this matter? We calculate there is some \$700 billion of capital invested in the world's commercial airlines today. But over the next 20 years [Boeing](#) and [Airbus](#) have forecast that the airline industry will need to finance purchases of another \$6,000 billion of new aircraft to improve environmental performance or meet new demand – either by leasing or by adding new debt or equity to that \$700 billion balance sheet. So, airlines will need to attract a lot more capital. If ROIC stays just above WACC that should be possible. If the industry's return on capital slips below the rate investors can earn elsewhere this will become more difficult.
- Business conditions have become more difficult. Demand is slowing or falling in the case of cargo. Costs are rising. Cost recovery has become more difficult, at least in some markets. Ultimately, the sustainability of above-cost-of-capital returns in the airline industry will depend on the extent of structural change in performance – product unbundling and closer partnerships being two of the most critical of those changes.

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