AIRLINES FINANCIAL MONITOR

KEY POINTS — OCTOBER – NOVEMBER 2018

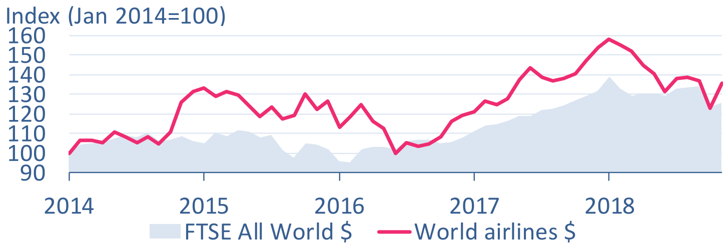
- The ongoing releases of airline financial data for Q3 2018 continue to point to a squeeze on profit margins from higher input costs relative to a year ago, as well as a decline in free cash flow generation over the period too.
- Global airline share prices rebounded by 10.0% in November, which broadly reversed the similar-sized fall seen in the previous month. However, concerns over the impact of rising costs on industry profitability have seen the global airline share price index underperform the wider equity market since the start of 2018.
- Oil and jet fuel prices fell sharply in November as concerns turned towards the oil market being oversupplied. At the time of writing, the Brent crude benchmark is around US$60/bbl – 30% below its early-October peak.
- The premium cabin has provided a useful buffer for airline financial performance over the past year or so, but there have been renewed signs of downward pressure on economy yields (recall that our series cover base fares only).
- The upward trend in passenger demand has moderated over the past six months or so, although the industry-wide passenger load factor remains elevated by historical standards. Meanwhile, despite downward pressure on the industry-wide freight load factor, cargo yields are still rising modestly.

Financial indicators

Global airline share prices bounced back in November, broadly reversing October's decline

Airline Share Prices

US$ indices (Jan 2014=100)	Index Nov 30th	% change on one month	one year	start of year
World airlines	**135.5**	**+10.0%**	**-7.9%**	**-11.8%**
Asia Pacific airlines	113.7	+7.1%	-9.5%	-12.8%
European airlines	108.7	+7.2%	-23.4%	-24.8%
North American airlines	183.3	+12.7%	+4.9%	-1.0%
FTSE All World $	**125.6**	**+1.3%**	**-3.0%**	**-4.5%**



Source: Thomson Reuters Datastream

- Global airline share prices jumped by 10.0% in November, broadly reversing the similar-sized decline seen in the previous month.
- All three regional airline sub-indices posted strong gains in the month, led by North America (+12.7%). The Asia Pacific and European indices both rose by just over 7% relative to end-October.
- The global airline share price index has now fallen by 11.8% since the start of 2018, and by 7.9% relative to a year ago. The sizeable underperformance of airline shares relative to global equities over both periods has reflected investor concerns about higher costs on airline financial performance.

Latest airline financial results from Q3 2018 indicate an ongoing squeeze on profit margins

Airline Financial Results

Number of airlines in sample	Regions	Q3 2017 EBIT margin[1]	Q3 2017 Net post-tax profit[2]	Q3 2018 EBIT margin[1]	Q3 2018 Net post-tax profit[2]
16	North America	14.8%	5,201	11.6%	4,300
28	Asia-Pacific	11.3%	2,316	6.3%	1,284
15	Europe	20.2%	6,901	17.4%	6,827
9	Latin America	10.5%	556	4.6%	-36
6	Others	5.7%	292	1.8%	158
74	**Sample total**	**15.1%**	**15,266**	**11.5%**	**12,533**

[1] *% of revenues* [2] *US$ million*

Sources: The Airline Analyst, IATA

- Indeed, the ongoing releases of airline financial data for Q3 2018 further indicated that the squeeze on airline profit margins that was evident earlier in the year continued into the quarter. The EBIT margin for our sample of 74 airlines fell to 11.5% of revenues in Q3 2018, from 15.1% a year ago, while net post-tax profits were also around $2.7bn lower.
- European airlines posted the widest EBIT margin (17.4%) during the key period of demand over the northern hemisphere summer, ahead of North America (11.6%). However, upward pressure on operating costs means that the EBIT margin fell in all regions relative to the same quarter a year ago.

Decline in industry free cash flow relative to Q3 2017 driven by lower net cash generation

Airline Cash Flow[1]

Number of airlines in sample	Regions	Q3 2017 Net cash flow[2]	Q3 2017 Capex	Q3 2017 Free cash flow	Q3 2018 Net cash flow[2]	Q3 2018 Capex	Q3 2018 Free cash flow
16	North America	10.5%	11.9%	-1.4%	9.4%	9.3%	0.1%
23	Asia-Pacific	16.4%	13.4%	3.0%	13.4%	12.3%	1.2%
12	Europe	10.3%	6.6%	3.7%	6.4%	9.7%	-3.3%
7	Latin America	14.1%	5.5%	8.6%	2.4%	6.8%	-4.4%
4	Others	15.2%	9.9%	5.2%	6.0%	20.5%	-14.6%
62	**Sample total**	**11.9%**	**10.1%**	**1.7%**	**8.9%**	**10.0%**	**-1.1%**

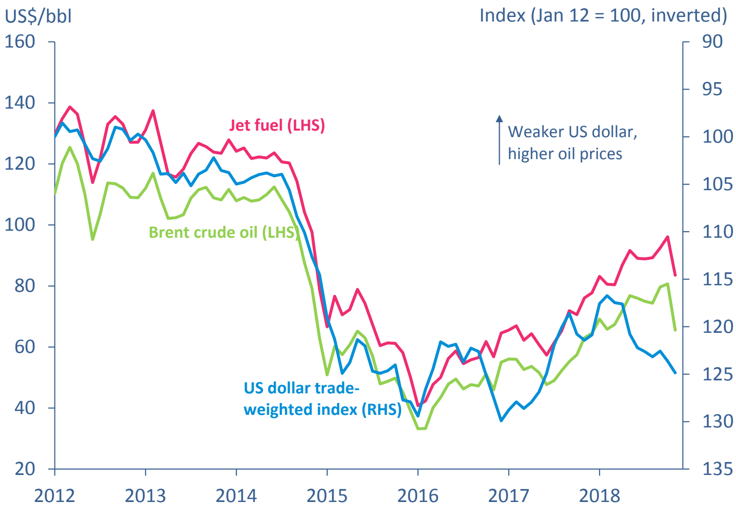
[1] % of revenues *[2] From operating activities*

Sources: The Airline Analyst, IATA

- Our sample of 62 airlines reporting cash flow data from Q3 2018 also showed a deterioration in industry-wide net and free cash flow compared to the same period in 2017.
- In aggregate, airlines in our sample saw free cash flow decline to -1.1% of revenues in Q3 2018, from +1.7% a year ago. This was driven by a 3.0pp reduction in net cash flow generation, offset by a marginal decline in capex.
- Net cash flow declined as a percentage of revenues in all regions compared to a year ago. Airlines in Europe and Latin America increased capex spending.

Fuel costs

Oil and jet fuel prices both fell back sharply in November upon signs of market oversupply

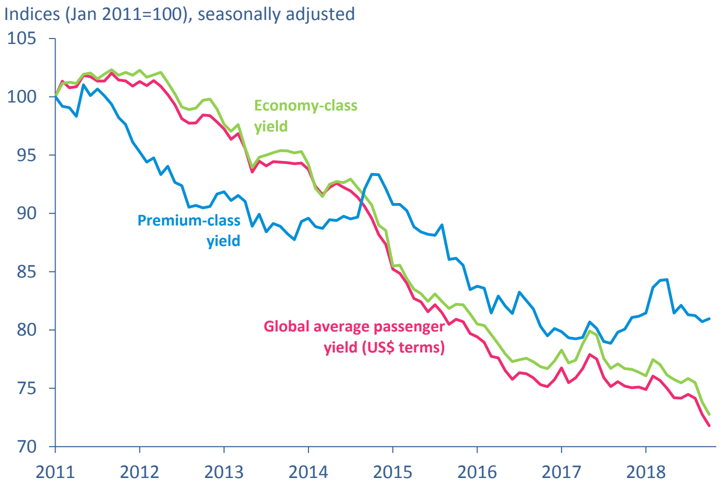


Sources: Platts, Thomson Reuters Datastream

- Crude oil and jet fuel prices have trended upwards in recent years, as rising tight-oil output in the US has been more than offset by supply cuts elsewhere.
- More recently, however, a combination of heightened uncertainty about the demand outlook and higher supply from Saudi Arabia and Russia in response to pressure from the US, has seen market concerns shift towards *oversupply*. This has put intense downward pressure on the oil price.
- At the time of writing, the Brent benchmark is hovering around US$60/bbl, which is 30% below its early-October peak and around 5% lower than it was a year ago. The oil futures curve is broadly flat at this levels for deliveries over the next four years.

Yields and premium revenues

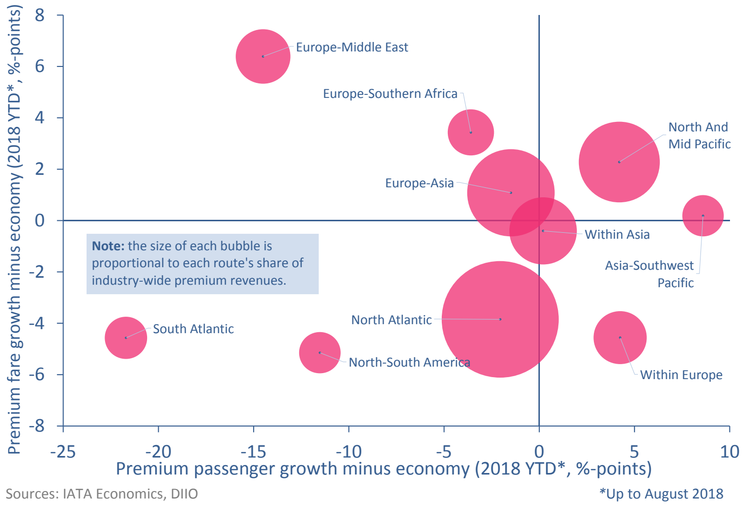
Renewed signs of downward pressure on passenger base yields?



Sources: IATA Economics, IATA Travel Intelligence

- Despite the upward trend in input costs in much of 2018, global 'base' passenger yields (ie, excluding surcharges and the revenue that airlines generate from ancillary services) have fallen sharply in US dollar terms over the past few months.
- These declines may in part reflect distortion in the data owing to a stronger US dollar, which is currently close to a 16-year high. Nonetheless, the declines are consistent with the observed squeeze on profit margins and softening in global economic conditions. We will continue to monitor developments closely over the coming months.
- As we have noted before, yields in the less price-sensitive premium cabin are holding up better than those in the economy cabin.

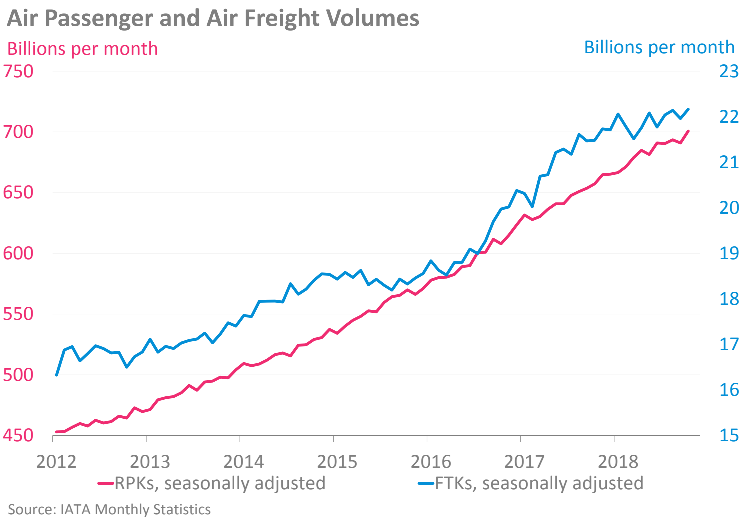
International premium traffic and revenue shares remain stable over the year-to-date



- Premium-class passengers accounted for 5.1% of total international origin-destination traffic in the first nine months of 2018. This proportion was unchanged from the same period a year ago.
- In terms of revenue, premium-class passengers accounted for 29.6% of total passenger revenues over the first nine months of 2018, broadly unchanged from the outcome for the same period a year ago.
- Premium passenger demand has grown faster than its economy counterpart this year to date most visibly on the Asia-Southwest Pacific, Within Europe, and Transpacific markets. The largest outperformance of premium fares relative to economy has been in the Europe-Middle East market.

Demand

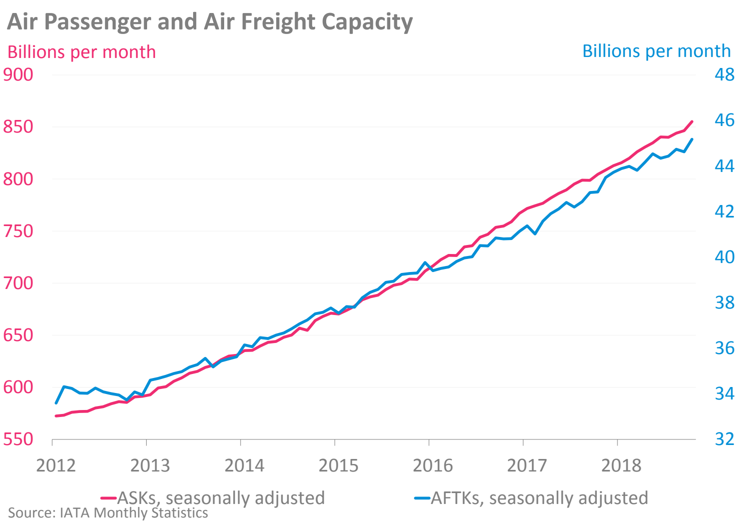
Upward trends in passenger and freight traffic have moderated in recent months



- Annual growth in industry-wide revenue passenger kilometres (RPKs) accelerated to 6.3% in October, up from a weather-affected 5.5% in September.
- The key point is that the upward trend in seasonally adjusted (SA) passenger traffic has moderated in recent months. RPKs have risen at a 6% annualized rate over the past six months – down from closer to 9% earlier in the year.
- Meanwhile, industry-wide FTKs increased by 3.1% year-on-year in October, up from 2.5% in the previous month. As we have argued before, the moderation in the upward SA trend is typical with the pattern normally seen after inventory-led upturns in the past.

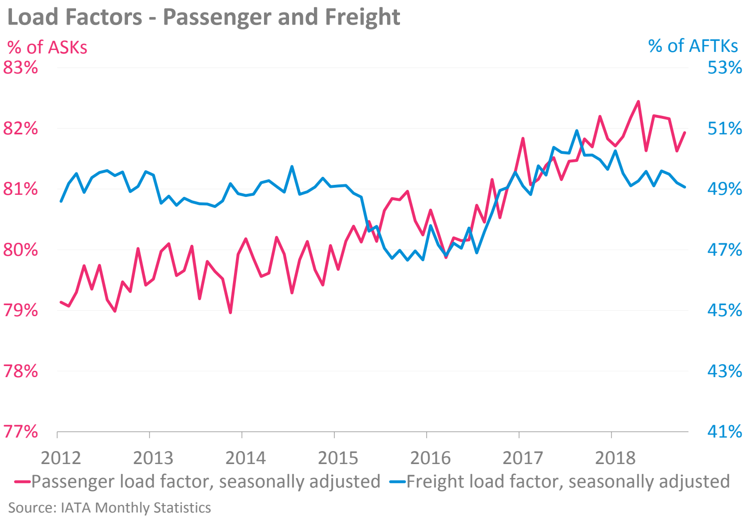
Capacity

Capacity currently outpacing demand for both parts of the business, most notably for freight



- Industry-wide available seat kilometres (ASKs) grew by 6.3% year-on-year in October.
- Following the recent moderation in the SA RPK trend, passenger capacity is currently trending higher at a slightly faster pace than demand.
- Meanwhile, available freight tonne kilometres (AFTKs) grew by 5.4% year-on-year in October, which was the eighth month in a row in which annual AFTK growth has exceeded that of FTKs. Freight capacity has now risen at an annualized rate of 6% over the past six months – around two percentage points faster than demand.

Air passenger and freight load factors have diverged over the past year



- The industry-wide passenger load factor was broadly unchanged in annual terms in October from the record-high for the month recorded last year. In SA terms (as show on the chart), the load factor remains elevated, slightly below the record high levels seen in early-2018.
- Meanwhile, the industry-wide freight load factor fell by 1.1 percentage points relative to October 2017 and is currently trending downwards modestly in SA terms . Nontheless, as we noted in our recent Cargo Chartbook, freight yields are continuing to rise moderately.

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