European airline failures despite good industry level performance

- XL Airways of France and Adria of Slovenia are the latest European airlines to fail, following the insolvency of Thomas Cook and the exit earlier this year of Aigle Azur, Germania, flybmi and WOW. Yet data for 2018 show the European airline industry in aggregate with a very healthy post-tax return on invested capital of just under 9%, which is at least 1% point above what investors would expect to earn (the Weighted Average Cost of Capital) i.e. the airline industry in Europe is creating value for investors. So why is the industry in aggregate apparently successful yet a succession of airlines last year and this have failed?

- The chart above provides some insight into what is happening in Europe. We have listed 56 European airlines (the ones whose financials are available; in our view a representative group) in order of their profitability (Earnings Before Interest and Taxation, EBIT which is close to operating profit). The improvement of industry profitability over the past 10 years has been concentrated in a relatively small number of airlines. The large loss-makers at the right-hand end of the chart remained large loss-makers. The substantial group of airlines just breaking even at the EBIT level also remained at break-even level.

- The best hedge against higher fuel costs or the impact of a weaker European economy is a healthy profit margin. That has been the case only for a relatively small number of European airlines. For the rest of the industry the weakness of European economies and revenues, coupled with higher fuel and other costs over the past 12 months, has been difficult to absorb. The result has been the airline failures that we are seeing as cash flows dip in the seasonally weak travel months at the end of the year.

Source: IATA Economics using data from The Airline Analyst

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