There is an old adage in financial markets that an economy is only as good as its banking system. While a weak economy can coexist with a strong banking system, it is nigh on impossible for a strong economy to coexist with a weak banking system. Parallels for the airline industry provide interesting food for thought – that is that an economy is only as good as its airline industry. Unfortunately, when taken to extremes, this airline theory is not robust. Turning back to the banking sector, its current stresses and strains – covered daily in the media – suggests that the world economy faces many challenges. In our view, this is not reason enough to despair over the outlook of the airline sector.

Yes, there are many conflicting signals in the world around us right now. But we should not let this confuse or unsettle our thinking – it merely confirms the broad lack of confidence or trust that many developed economies have in their governments and in the global banking industry. A simple example of such uncertainty is that with US$ interest rates are at all-time lows, logically, no one should want to hold US$ cash. In reality we find that the corporate world is holding record levels of cash and liquid assets, which they would not part with for anything. The important point of this is that the airline industry is operating in a two speed economy, where excessive pessimism or optimism is ill-placed. So, amid the chaos, where does this leave the airline industry?

The airline industry always faces major challenges, it is often a matter of what issue is more important. Here we will focus on a number of major problems for the industry, which will grow in importance over the coming 12 – 24 months.

**Orders and deliveries**
Over the last year or so, the global aviation industry has welcomed major advances in aircraft technology – new aircraft types or programs, more fuel efficient engines, etc. Before the airline industry can enjoy the fruits of this innovation, a bigger, more immediate challenge lies ahead. Major aircraft manufacturers (especially Airbus and Boeing) are currently committed to ramp production rates from 2012 onwards. Based on announced production rate
increases, annual single aisle aircraft deliveries (100+ seats) are due to rise by 20% from 2010 to 2013. More alarmingly, annual wide-body aircraft deliveries are due to rise by 91% over the same period – due in part to previous delays in the programmes for the B787, B747-8 and A380. Together, this 33% jump in annual production over the three year period equates to an extra 350 aircraft deliveries per year. More worryingly, the growth in production rates does not stop in 2013 (see the chart above). Here, we are going to focus on the near term impact of this additional capital expenditure, although it will take time to know whether the market generates enough additional traffic to render this investment profitable for the airline operators - a potential longer term risk for the airline industry.

This year, we have seen a ferocious appetite for new, fuel efficient aircraft driven by high oil prices, fears of a protracted period of US$ weakness and replacement aircraft demand in the United States. Such orders, especially on the narrow-body side, are well above their previous peak in 2007.

Aircraft order rates are a good indicator of confidence among airline industry management. The previous order peak in 2007 was of particular concern, coming on the back of a huge global liquidity bubble, but also as the orders involved near term deliveries from 2008 onwards. The 2011 order peak is driven mainly by demand for greater fuel efficiency offered by the manufacturers in the form of the A320Neo family and B737MAX, both of which are not due to deliver in meaningful numbers for another five years or so. United States’ replacement demand, often capacity neutral, also forms close to 15% of this year’s orders. To a large extent, airlines have placed these orders in expectation that oil prices will remain high, driven by demand-supply dynamics in the oil markets and/or some fear of persistent US$ weakness (which feeds back into a higher oil price). Recent price action in financial markets is now challenging the urgency of these motives.

The check, please!
Given the planned production ramp discussed previously, it is not hard to realize that the airline industry will be challenged to finance all these new aircraft deliveries. Based on BOC Aviation’s estimate, the value of annual commercial aircraft deliveries that BOC Aviation is interested in is due to increase 47% from 2010 to 2013 – or US$ 30 billion in additional annual capital expenditure (CAPEX) over this period. Again, the growth does not stop there – we estimate that annual CAPEX spending will double from 2010 to 2018.

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* Assumes 496 orders for the B737Max are confirmed in 2011.
Source: Airbus, Boeing, Bombardier and Embraer

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Source: BOC Aviation
And sources of cheaper funds?
There are substantial changes afoot on the regulation of the global banks, with part becoming effective before the end of 2011 and further changes imposed from 2013. This year, major global banks – this with global footprints and very active in key areas of trade finance, etc., will be defined as Global Systemic Important Financial Institutions (G-SIFIs). These banks have to have higher levels of capital reserve, which means less leverage or available credit to supply the global economy. In 2013, new Basel III rules come into effect which will further contain the leverage of the global bank industry. In all, these initiatives, both G-SIFIs in 2011 and Basel III from 2013 on, will constrain credit availability, which will force the airline industry to fight for increasingly scarce asset finance alongside the rest of the economy. Higher interest costs, or funding spreads, appear all but inevitable over the coming years.

More taxes on the airline industry
From the start of 2012, the European Union (EU) plans to introduce its Emission Trading Scheme (ETS) with an estimated cost to airline operators over US$ 1 billion per annum. There is a distinct irony in that the EU, under the auspices of the Organization for Economic Cooperation and Development (OECD), played a major role in negotiating a dramatic increase in export credit financing costs from next year onwards. While the airline industry is prepared to pay for its carbon emissions (as part of a global ETS, not a regional scheme), the airline industry now faces a penalty for buying more fuel efficient aircraft. This is an unfavourable predicament – the airline industry has to grapple with attracting significantly more funding at structurally higher debt costs.

What’s possible and how should airlines react?
The simplest outcome is that the global economy begins a sustainable recovery, which would follow recapitalisation of European banks and a successful outcome to major elections (France, United States) and political transitions (China) next year. This would see the banks resume their role of credit creation, credit pricing would normalize, employment would rise, thus putting a floor under the oil price. Such an outcome is heavily dependent on politicians acting responsibly. Nevertheless, the airline industry must face the real world, run by politicians whose primary objective is to get reelected, which is not always logical nor predictable.

More rational behaviour, but room to improve even further
In summary, at BOC Aviation, we maintain a relatively sanguine outlook for the global airline industry. This is inspired by growing financial discipline, rising industry rationalisation and a lack of new entrants. Taken together, this should allow the industry to contain margin pressures, largely by taking back pricing power – something the airline industry has historically not been able to enforce on the consumer. But the following are some other elements in favour of the industry right now.

↗ Peak cash levels – further to our earlier point about corporates hoarding cash, the airline industry has also done a good job in this regard. Our estimates show that the global airline industry has grown cash levels by more than 50% over the last two years. With more than US$ 100 billion in cash, the global industry currently has coverage for three months of cash operating costs. In the event that financial market liquidity tightens here, the airline industry is better prepared to cope this time round.

↗ A strong focus in recent financial statements among leading carriers over the unit revenues improvements (PRASM) confirms that airlines are now well aware of the need to preserve margins as well as their cash balances. This improved financial strength should support the following issues of industry rationalisation and limited new entrants.
Industry rationalisation – close to half of the mergers and acquisition (M&A) activity in the global airline industry has occurred since 2000. Interestingly, these transactions have taken place primarily on a domestic basis, which leaves one to ponder how much further industry rationalisation can occur without governments supporting bold deregulation.

Limited new entrants – based on our analysis, the number of airlines operating scheduled services has declined by close to 10% over the last decade. This decline is partly due to the M&A activity described above, but also reflects the improved financial strength of the industry as a whole.

It would be misleading to suggest that the airline industry is not exposed to the vagaries of the global economy. But there are clear signs that the airline sector is better placed to handle near term risks within banking markets and to protect profit margins over the longer term. Management teams globally have done a good job of controlling non-fuel costs and capacity particularly in the US market. Much rests in the hands of politicians – such as industry deregulation and the contradiction of promoting environmental awareness while raising the cost of debt financing for new, more fuel efficient aircraft. Still, it is within the realm of key industry bodies like IATA, to continue to fight on behalf of the industry on these key issues.

The interesting conundrum is how the industry absorbs all the current capital expenditure commitments if some of these prevailing economic uncertainties are not resolved in a timely manner – and the consequences of tighter credit availability persist beyond 2013. An improved partnership between the airline industry, key airframe and engine manufacturers and their respective governments is now in order. Meanwhile, airlines need to plan ahead for their funding requirements through to end of 2013 while we wade through this uncertain period in financial markets.

*The views expressed in this article are the author’s and not necessarily those of IATA and BOC Aviation.*