ANALYST VIEWPOINT
JANUARY 2012

BACK TO WHERE WE WERE – BUT IF SO THEN WHAT NEXT?
A TIME OF CONTINUING CHANGE
CHRIS TARRY¹, CTaira

Overview
It has often been suggested that the only constant in the airline industry is change and indeed we
would not wish to argue with that view. In this respect it may also be a case of “what goes around comes
around” too. For many airlines the outlook for 2012 is perhaps depressingly familiar and reflects the
combination of external events and the outcome of management action (or indeed inaction). Indeed for at
least the next twelve months the assumptions underlying their forecasts are likely to reflect preparations
for the worst, but with at least some hope that the outcome may indeed be better. Even or perhaps
particularly against this background it is important to keep a sense of perspective.

Whilst there is a tendency to talk about what is going on in the airline industry it is the outcomes at a
company level that are more relevant and important; after all the industry outcome is the summation of all
(or most) of the identifiable performances at a company level.

Airlines are not homogeneous and although they face some “universal” impacts - for example the price of
fuel - their exposure to the economic factors clearly depends upon location and route network. Similarly
not all are at the same “starting position”, and furthermore, whilst the “moving market” clearly may provide
significant challenges, it also gives rise to opportunities.

The record profits reported by the airline industry in 2010 reflected the combination of a number of
fortuitous circumstances. In particular, a sharp recovery in cargo and premium traffic against a
background of rigorously controlled capacity (reflecting decisions taken in the darker days of 2009) and
sharply lower fuel prices (reflecting the view that demand for oil would fall as a result of the economic
slowdown) compared to 2009. Throughout 2011 the main discussion over the likely outcomes for that
year, and indeed 2012, centered on how much lower the reported results would be than the $21.7bn
operating profit of 2010. The major differences between the position now and 2008-09 are firstly that
many airlines are still profitable and secondly that the decline in the operating environment has been
progressive rather than a step change; however that is all history.

In the latest IATA Airline Financial Monitor the view is that the airlines in its sample have done “quite well”
in the third quarter of 2011 and that the “annual decline in EBIT has been contained”. Results are
however backward looking and if anything the main conclusion from these results are that cash from

¹ Corresponding author: christarry@ctaira.com

IATA Economics: www.iata.org/economics
operations from this sample of airlines is close to $5bn less than it was in the corresponding quarter in 2010.

We all have our views on what the economic and operating background might be and again, some may use letters of the alphabet to describe the shape of the path taken. There is certainly no shortage of data and information to enable a view to be formed but as ever it is the interpretation or “so what” that matters more. To this end I am reminded of an undergraduate essay topic of almost 40 years ago where I was asked to consider “whether it is better to be half right or completely wrong” – I must admit I cannot remember what my answer was then.

It is possible to categorize the main issues under the following headings:

- **Economics factors and outlook**
  - The direct and indirect effects on airlines and the wider aviation sector - key impacts from reduced consumer and corporate spending in the northern and western parts of the world in particular.

- **The airline operating environment**
  - Fuel
    - Remains the big “swing factor on the cost side with a current expectation that the industry’s fuel bill will be higher again in 2012. Beyond this the key issues, even before taking into account “geopolitical concerns”, are whether the oil price will rise as optimism increases around an economic recovery or will fall as concerns grow over the extent of the slowdown or downturn?
  - Capacity
    - New deliveries, and now with rates reaching new highs there is the prospect too much capacity entering at the wrong time. The placement risk likely to increase, but with a lag, and there are also increasing issues regarding the availability of affordable finance.

- **Managerial issues**
  - Cost cutting - whilst the more difficult environment focuses attention on this, structural cost reduction should be an ongoing activity
  - Aircraft Utilization - the key question is whether this will be the near term “safety valve” to adjust capacity by season and “protect” yields in the way that we saw in 2009/10
  - Cash generation - there is inevitably an increased focus on cash generation and retention and in particular on the size and availability of the “necessary” liquidity buffer
  - Consolidation - there will inevitably be an increase in the number of views expressed that this is the way forward, however there is a real need to keep a sense of perspective. Even putting a strong and weak business together can have significantly negative consequences for value, and despite the temptation, M&A alone is rarely the panacea to problems and can be a damaging diversion.

A year ago there was what, even then, appeared to be a misplaced sense of optimism that the trends seen in 2010 would continue. Indeed what has appeared to be a more or less set of unchanged buy recommendations on airline shares seems more relevant and realistic now than they did at around this time last year. However, even though share prices have fallen there is a real need to apply the “Emperor’s New Clothes test.” In particular where managements have attempted to focus attention on the medium and longer term against the background where there is little certainty in terms of how their businesses are likely to perform in the near term - given the absence of confidence in the associated forecasts. Investors are particularly unforgiving of a management that fails to deliver even against modestly optimistic
promises, and the resulting lack of interest in the shares and the impact on the share price can have far wider consequences.

Notwithstanding all of this, the question of whether airlines are that necessary element for most if not all others in the aviation value chain to make an adequate return remains to be answered. However, it may well be that the current and likely future environment will result in changes (at least in some areas) which may result in what some might see as a fairer sharing of risk and reward.

**Economic factors and outlook**

Since 2009/10 there have clearly been a number of false hopes, and indeed false dawns, as policy makers have attempted to buy time by their actions - mainly through what is now known as quantitative easing (formerly known as printing money). However in most cases there has been a failure to really address, let alone solve, the fundamental and underlying problems. The inevitable result has been that there will be at best only a slow recovery or at worst another downturn.

When looking at the influence of the economy it is important to separate cyclical from structural factors. However given that the “traditional” economic cycle appears to have been at least disrupted if not broken, at least in the medium term this inevitably raises questions around the extent to which history may in fact be a guide to the future and by association, the confidence that there should be in forecasts. The usefulness of a significant number of forecasts now is probably limited to the direction of the change rather than the quantum. Whilst the causal chains between the various factors may still hold it is clear that the calibrations within the relationships have changed. At best the influence of GDP will be directional – the actual outcome for the industry in terms of traffic (and revenue) will be even more a consequence of capacity and pricing decisions.

The experiences of the last two or three years have provided additional evidence, if any was needed, of the role played by expectations and their impact on our behavior whether corporate or personal. In particular, after the first shocks the key focus appears to have been on re-building balance sheets whether personal, corporate or public sector with the inevitable consequences on expenditure and growth. Where consumer and business expenditure is constrained the travel market effects are clear cut. In the leisure segment the demand side will be characterized by lower fares, less volume and later booking. In the business segment it is almost inevitable that most corporate travel budgets in 2012 will be lower than in 2011 which amongst other things will show through in lower premium revenues -we are already seeing a number of attractive deals for this part of the airplane.

Many businesses, and not only airlines, in effect “ride the cycle”. Indeed the most obvious examples of this are those which have a significant dependence on transfer traffic, which have tended to do better relative to most others in the upswing and conversely underperform in the downswing. The disruption or dislocation of the “traditional” cycle clearly has implications here. In Europe the continuing increase in the capacity deployed by the Gulf based airlines and the inevitable price driven re-distribution effects on traffic means continuing attractive fares for intending travelers on competed routes.

There is certainly no shortage of freely available economic data and information to assist in forming a view on what the prospects are for the world’s economies. We have focused our attention here on a range of survey data as in many areas, for now, it is the perception of what might occur, as that will condition behavior, rather than an attempt to quantify it in statistical terms, that matters more.
Table 1, which is from Ipsos-Mori’s latest Economic Pulse series, provides a not unsurprising series of perspectives on how the respondents would describe the economic situation in the listed countries and compares the outcome with the previous survey. The score reflects the percentage of those considering the position to be at least “good”.

Table 1 - Current economic perspective

<table>
<thead>
<tr>
<th>Those Countries Where the Country Economic Assessment...</th>
</tr>
</thead>
<tbody>
<tr>
<td>is HIGHEST this month</td>
</tr>
<tr>
<td>-----------------------</td>
</tr>
<tr>
<td>Saudi Arabia</td>
</tr>
<tr>
<td>Sweden</td>
</tr>
<tr>
<td>India</td>
</tr>
<tr>
<td>Australia</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>Canada</td>
</tr>
<tr>
<td>China</td>
</tr>
<tr>
<td>Brazil</td>
</tr>
<tr>
<td>Russia</td>
</tr>
<tr>
<td>Argentina</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Hungary</td>
</tr>
</tbody>
</table>

Source: Ipsos-Mori

Table 2 sets out the views of citizens of the individual countries on how they see the outlook for the next six months using the same scoring system as in Table 1.

Table 2 - View of the next six months

<table>
<thead>
<tr>
<th>Countries where the Assessment of the Local Economic Strengthening ...</th>
</tr>
</thead>
<tbody>
<tr>
<td>is HIGHEST this month</td>
</tr>
<tr>
<td>-----------------------</td>
</tr>
<tr>
<td>Brazil</td>
</tr>
<tr>
<td>Saudi Arabia</td>
</tr>
<tr>
<td>India</td>
</tr>
<tr>
<td>Argentina</td>
</tr>
<tr>
<td>China</td>
</tr>
<tr>
<td>Mexico</td>
</tr>
<tr>
<td>Indonesia</td>
</tr>
<tr>
<td>China</td>
</tr>
<tr>
<td>Australia</td>
</tr>
<tr>
<td>Saudi Arabia</td>
</tr>
<tr>
<td>Great Britain</td>
</tr>
<tr>
<td>Hungary</td>
</tr>
</tbody>
</table>

Source: Ipsos-Mori
The two key issues are perhaps what will happen in the Eurozone and the nature of the recovery in the US.

Clearly 2012 will be a make or break year for the Eurozone where the rendezvous with reality, which has been increasingly evident over the last twelve months or so, has clearly identified the fundamental shortcomings of the “project”. GDP growth in the Euro area is now forecast to be no more than 0.5% in 2012 and some 1.2% in 2013 - compared to an expectation of some 1.6% for 2011. Most recently at the aggregated Euro zone level we have seen declines in output in Spain and Italy offset the impact of what had been interpreted as a recovery in Germany for 2011 overall – although the latest data seems to suggest that this may have stalled with a contraction in the final quarter – only serving to highlight the difficulty of establishing a meaningful trend.

Unsurprisingly a third of the respondents to the recent Deloitte UK CFO survey cited that the collapse of the Eurozone leading to a renewed credit crunch represented their greatest concern in 2012. Close behind were the 31% of those who were questioned suggested that their greatest concern was a “recession and demand destruction”.

Moving to the other side of the Atlantic, there are clearly some positive signs on the economic front. Production in the US in December reached an eight month high and this was accompanied by a recovery in consumer confidence and a further fall in unemployment – suggesting that it has passed through a turning point and that recovery may be underway.

Although there are regular reports about Asia weakening there is a need to keep this in perspective - undoubtedly the problems of the “receiving economies” for goods produced across the region have had an effect. This is also particularly evident in the air freight statistics. Overall forecasts for underlying growth remain broadly unchanged compared with previous estimates and indeed in the case of China there is a widely held view that the process of rebalancing and building domestic demand will continue.

The airline operating environment
Over the last 12 months or so the operating environment has gone from one that although not without challenges, was relatively favorable, to one that as a result of mainly external factors, but also internal events and actions, has become “challenging”.

If we were to take a view that the strategic objectives for any company, and not just airlines, they are defined as an ability to survive, compete and prosper. Although there are inevitably a few airlines where survival is the issue and it is not assured, for most airlines the objective is to be able to compete effectively with prosperity (yet again) having to wait for another day. Additionally, there are some airlines where managements need to meet stakeholder rather than shareholder objectives and here the actual objectives, as a result, are often a little different.

We have often argued in the e-analyst series and indeed elsewhere that generalizations can be dangerous and just as the airlines themselves are not homogeneous, neither are the operating environments that they face. In addition to the change in the prevailing economic background we consider that there are two other factors that have a direct impact upon the operating environment; namely fuel and capacity

One of the features of the 2010 recovery was the relatively low fuel price compared to 2008. For 2011 IATA’s Economics team estimates that the fuel bill will be some $39bn higher than in 2010; in its “central
forecast" for 2012 fuel is shown as rising by another $20bn a change that is broadly similar to the increase forecast for revenue.

Fuel of course remains the great unknown and whilst hedging may provide short term relief (if the in-price was satisfactory) the real objective of hedging is to give some certainty over costs.

Chart 1 - Brent price trends 2011

The chart suggests that since June 2011 there has been a floor of some $105 a barrel for Brent and most recently that the difference between the floor and the peak price has reduced; however this is now history and there are a number of economic (US recovery in particular) and geopolitical (Iran and related tensions) that could push the oil price higher than currently expected in 2012. Furthermore given the demand and current capacity outlook in the key regions the scope for recovery through fares and surcharges may be limited.

We have commented numerous times in the past that the airline industry is not immune from the rules of economics and have highlighted issues related to capacity -particularly where there is the existence of what might be defined as excess capacity and where, as a result, there is a failure to achieve the necessary or hoped for fare levels. We will consider inter-seasonal adjustments later but for now our focus is on new capacity entering the marketplace.

The launch of the A320Neo and the Boeing 737Max resulted in what might be described as an "order fest" and a significant inflow of orders and statements of intent. Indeed at the end of November Airbus had a backlog of some 3348 A320 family aircraft having taken 1307 net orders in the first eleven months of 2011. By comparison it had taken 71 net orders for twin aisle aircraft over the same period. For 2011 overall Boeing announced net orders for 551 Boeing 737 aircraft and 254 wide body aircraft of which 200 were for the Boeing 777.

Chart 2 shows the number of aircraft delivered by broad type by month in 2011.

Chart 2 - New aircraft deliveries by broad type by month 2011
The net change in capacity taking into account aircraft moving in and out of storage is shown in Chart 3.

Chart 3 - Net Fleet change May 2010 – November 2011

Even in the best of times fleet planning is challenging but against the current background it is particularly difficult and is not made any easier by the increasing gap between placing an order now and the expected delivery date. There is also the issue of financing which at least in the near term will be more difficult and will indeed require more to be forthcoming from new sources which indeed provides new opportunities.
Not only have we seen a continuation of historically high rates of production of narrow body aircraft but rates here are planned to go higher. This should focus attention on the adjustment mechanisms in the market and raise, amongst other things, some questions over economic life and also over the amount of value that may be assumed as the realizable residual value in an aircraft at an end of its lease. This clearly has implications for the depreciation policy and also how it feeds into lease rates. For some lessors their most recent issues suggest a rising cost of capital. The only possible conclusion is that future underlying returns for operating lessors are likely to be lower than those in the past.

We are also now seeing some softening of lease rates not only to prevent unwanted turn-backs but also in respect of new aircraft. There is an inevitability that there are “deals to be done” and in particular those airlines that want/need newer aircraft over the next 12-24 months will be able to capitalize on the current and emerging environment.

Managerial issues
In simple terms these are best probably summed up as “more of the same” although it is clear that “business as usual” is not an option. However just in the same way that the operating environment differs amongst airlines so will the main focus of management’s attention. Essentially there is a spectrum of issues ranging between those which relate to addressing challenges and those that are focused on benefitting from opportunities.

At the risk of being boring it is worthwhile reiterating that “cash is king” and that if airline CFO’s are realistic when asked “how much cash is the right amount” – the answer is “more”. Whilst there may be fixations on balance sheet efficiency, survival and the route to what might be described as “sustainable prosperity”; reflects access to liquidity where, in addition to determining “how much”, the key is to determine “where from”. The more challenging outlook for 2012 will clearly put pressure on cash generation from operations. This is a position which is also exacerbated by signs that not only is credit becoming more difficult to obtain and in many cases more expensive too.

Drawing again on the results of the Deloitte survey, which despite being UK centric provides some conclusions which have a wider geographic application and suggests that the main focus of CFOs will be on cash generation (challenging if revenue is under pressure and costs are rising) and also seeking to cut costs.
Table 4 - CFO priorities Q4 2009-2011 compared

<table>
<thead>
<tr>
<th>Priorities</th>
<th>Q4 2009</th>
<th>Q4 2010</th>
<th>Q4 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reducing costs</td>
<td>32</td>
<td>29</td>
<td>42</td>
</tr>
<tr>
<td>Increasing cashflow</td>
<td>32</td>
<td>31</td>
<td>37</td>
</tr>
<tr>
<td>Introducing new products or expanding into new markets</td>
<td>28</td>
<td>37</td>
<td>34</td>
</tr>
<tr>
<td>Increasing capital expenditure</td>
<td>9</td>
<td>22</td>
<td>16</td>
</tr>
<tr>
<td>Expanding by acquisition</td>
<td>20</td>
<td>20</td>
<td>15</td>
</tr>
</tbody>
</table>

Source: Deloitte CFO surveys

Cutting costs should be an ongoing activity and it should be structural and not rely only on increasing capacity as a route to reducing unit costs. However there has also been a change in traditional reference points and to this end, particularly in the Northern hemisphere, the focus is more on “less worse” outcomes where grounding aircraft is a more attractive outcome than flying where there is no prospect of recovering the variable costs of the flight. In this respect Ryanair has grounded the equivalent of 80 aircraft during the winter – a course of action which also highlights pronounced difference between summer and winter demand and has implications for the future focus of so-called “LCC” airlines.

Inevitably there are lags between taking decisions and the effects of the action showing through and furthermore markets and economies do not adjust either instantly or precisely to the new set of circumstances. The rigorous control of capacity that was evident in at least the early part of 2010, reflected decisions taken in the difficult times of 2009, we also saw the reverse in 2011 and the inevitable consequences. Given the current outlook it is reasonable to expect “restrained” capacity for the summer of 2012 given that at least the initial decisions were taken in the final quarter of 2011.

Chart 4 - Aircraft utilisation 2007 - 2011 – single aisle

Although we have tended to focus on the challenges that are likely to need to be addressed, it is important not to neglect the opportunities and here again the Deloitte’s survey provides a useful “check list.” Indeed we would expect to get similar results if such a survey was conducted amongst airline CEOs.
Table 5 - CFO opportunities Q4 2011 vs. Q4 2008

<table>
<thead>
<tr>
<th>Growth opportunities (% of respondents)</th>
<th>Q4 2008</th>
<th>Q4 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acquire companies or other assets at a discount</td>
<td>74</td>
<td>33</td>
</tr>
<tr>
<td>Take advantage of weaker competition to expand share</td>
<td>74</td>
<td>30</td>
</tr>
<tr>
<td>Build long term presence for recovery</td>
<td>65</td>
<td>24</td>
</tr>
<tr>
<td>Take opportunity for overdue changes</td>
<td>55</td>
<td>19</td>
</tr>
</tbody>
</table>

Source: Deloitte CFO surveys

In the almost 30 years of following the aviation industry we have not been aware of as many “acquisition opportunities” as appear to exist today. Of course just because something is available and is perceived to be a bargain doesn’t mean that it is a good deal. Putting two weak companies together will not result in the emergence of a strong one. Indeed even combining a strong company and weak company may have damaging consequences for shareholders.

The calls for greater consolidation are unsurprising but across the airline industry there are very few examples where bigger is necessarily better. If we take the most significant examples in Europe then IAG’s share price has halved over the last year since its formation (although it is not the worst performer). Elsewhere the share price of Air France/KLM (which came together in 2004) has fallen by some 75% in 2011 and is now close to an all-time low.

In the case of Lufthansa where Austrian and Swiss are members of its group, the decision to dispose of Bmi reflects a change in strategy since the initial stake was originally acquired in 1999. Although the timing is clearly not the best, as evidenced by the reported consideration compared with previous valuations, the disposal should have a positive impact on Lufthansa’s market value given the resulting loss elimination. Conversely for IAG the acquisition of bmi gives a store of slots to grow BA’s long haul business but even with this there are a number of post-acquisition issues to address.

In respect of increasing market shares there are two key battlegrounds - firstly with the expansion of the Gulf carriers which will inevitably result in better value fares for intending travelers in the markets served by these airlines. Secondly in the short haul market as a result of what is best described as “competitive convergence.” The so-called LCCs are seeking higher underlying fares by enriching their traffic mix with more business passengers - in this case there is an even greater need to move away from a fixation relating to supposed business model terminology. The need for any airline management is to apply the best practices that it can - whether in terms of financing, operations or market reach. Whilst new entrants might have had a degree of first mover advantage even in mature markets, for a variety of reasons this is not and never will be sustainable unless the competitors exit rather than compete.

In the past we have referred to what we call “precipice management” which is perhaps the extreme case of using the tougher operating environment to make “overdue changes”. In the US filing for Chapter 11 sets a similar background for change. There have been a number of notable examples where significant change has been achieved with Aer Lingus being one of a number of examples. However the key need is not just to make the change but to hold on to the benefits and this has not always been the case as the balance of power, between management and the employees, changes. The idea that exercising the management prerogative is costless is not borne out by the real world experience. It remains tough for management to make changes no matter what the operating environment might be as the recent experience of Qantas illustrates quite clearly following the grounding of their fleet. In this case whilst management has reached an agreement with the engineering group the outcome of the full arbitration process is still a few months into the future. In Europe Iberia, which is expected to lose a sum up to
€100m in 2011, is encountering a series of strikes against its decision to set up a low cost carrier, provides another example between management hopes and the reality.

**Concluding observations**

Whether a management team sees the outlook as “depressingly familiar” or one where there is considerable opportunity, in a single word answer; “depends”. Expanding on this, it depends on where they are and what their starting position is. This in large part will be a reflection of the actions that they have taken in the better times. However if we want to sum up the current environment, the outlook statement in the latest SAS Group traffic release does it quite well setting out both hopes and expectations -

“Overall, the market growth continues to be good, but remains unpredictable due to added capacity in certain markets, risk in the global economy and continued high jet fuel prices. This adds uncertainty to the yield and RASK outlook going forward”.

As we suggested at the start – perhaps we are back to where we were, but this time will it be any different?

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