



ANALYST VIEW

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GREAT EXPECTATIONS: THE IMPORTANCE OF ADAPTING THE INDUSTRY'S VIEW TO A CHANGED ENVIRONMENT

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Introduction

At the time of the Farnborough Airshow in July 2006 there was a widely expressed view that the fundamental rules of engagement for the industry had changed and that aviation had entered some type of super cycle; however if this is indeed still the upswing phase of some sort of super cycle there will be a corresponding downswing phase. A year on there is not only little evidence of the existence of a super cycle but there is also some increasingly worrying "mood music". In addition, the signs that the wall of money which was a characteristic of the early part of this decade has been replaced by a more difficult financing environment are all too evident. Furthermore, the announcements by a number of airlines making downward adjustments to their previous orders and deliveries combined with some concerns over the ability of the market to absorb "nearly new" aircraft should all attract some attention.

The airline industry is still cyclical

Although at times it appears to be forgotten, the rules of economics apply to the airline industry and economic events – whether changes in the rate of GDP growth or interest rates – do have an impact, although there may be lags. It is also important to consider the expectations and the consequent behaviour of all of the players involved. For forecasters a key question is always whether history provides a good guide to the future; and given that we are not in some type of super cycle, the traditional view is that the aviation cycle has 7 "up years" and 3 "down years". On this basis we appear to be at or close to the peak.

The problem is that as the world is not in effect a "controlled laboratory experiment" market adjustment is rarely perfect, immediate or without cost. At the end of the day, the process of adjustment is to bring demand and supply in any market back into balance. In the event of demand weakening the principal adjustment factors are price and supply. However, in moving from one position of effective equilibrium to another, there will be a series of intermediate points where the market is out of balance. There is almost always an inevitable over-reaction before a more certain, albeit, in a downswing, a more difficult, environment is restored. The importance of expectations and, in particular, the influence of changed or changing expectations on behaviour should not be underestimated, especially in respect of risk. At the end of the day the simple assessment that financial and related markets are driven by fear and greed may not be too wide of the mark.

Aircraft orders reflect current expectations

For Airbus and Boeing the net order intake in the first 9 months of 2007 of 1,723 aircraft is some 70% higher than the corresponding period in 2006. Whilst the Boeing 787 and the Airbus A350 have seen strong demand; the real numbers game remains in the 150 seat segment with over 1,100 net orders placed for the Airbus A320 and Boeing 737 families of aircraft (2006 Q1-Q3: 872). At the present time there are 1,796 "undelivered orders" for the Boeing 737 family and 2,224 for the A320 family. This segment is the swing factor for production volumes and the one where there may be the greatest potential challenges and opportunities – depending upon your perspective.

Table 1: Airbus and Boeing backlogs at period end

Year to Dec 31st (unless stated)	2000	2001	2002	2003	2004	2005	2006	YTD 2007
Airbus	1,626	1,575	1,505	1,454	1,500	2,177	2,533	2,994
Boeing	1,612	1,357	1,152	1,110	1,097	1,809	2,455	3,019

Source: Speednews

At current planned rates of output the combined Boeing and Airbus backlogs represent some 7 years of production. This is a record horizon, but the greater the backlog the more significant the delivery risk. With signs of a changing economic environment questions must arise over the certainty of the aircraft in the order book being delivered to the original customer or indeed delivered at all?

Are record order levels justified?

However, the latest airline financial results for the first nine months of 2007, on both sides of the Atlantic, plus those from Boeing, would if taken at face value appear to add weight to the view that we are in a new environment. But results only tell us what has happened, they may not be very useful in giving guidance for the future. In particular, there have been some significant and perhaps fundamental changes in the economic environment. The consequences of these changes on all aspects of the business need to be considered against the background of the "current fundamentals". Issues associated with more expensive money and changed views on risk apply equally if not more to the aviation industry given its sensitivity and volatility.

The "super cycle" bulls will also point to current high level of lease rates and the general inability to secure near term delivery as positive signs of a continuing strong market. Of late, however, there have been a number of examples of airlines re-considering their delivery schedules or selling on aircraft that they were destined to take delivery of. We would expect more news of this type over the next few months, particularly from the LCC segment of the market.

The industry view

Earlier this year, in late February at the Geneva Aircraft Finance Forum, we posed a number of questions to the delegates. Among other things, we sought their views on the timing of the peak of the cycle; the relative importance of airline profitability and the availability of finance on aircraft ordering; and the peak of the delivery cycle. The answers were interesting at the time and remain so. The conclusions were:

- the profit cycle for the industry was likely to peak in 2008 (no different from the current IATA view);
- that the availability of finance is more important than profit in determining the timing of orders;
- that aircraft deliveries will peak in 2010.

This appears to suggest that an adjustment on the supply side is necessary, against a background of delivery rates rising beyond the point of peak profitability and an increase in the cost of finance. Even taking into account the fact that there will be differential rates of growth in individual markets, there remain enough indications that some form of adjustment is inevitable.

The financing environment

There is no doubt that the recovery from the trough at the early part of this decade has been dramatic. The presence of, in effect, a wall of cheap money has been important. Since 2001, although money has been available to back airlines, the main focus of attention has been on the financing of assets and particularly aircraft in the 150 seat segment. At the simplest level there is a need to ensure that the asset generates a revenue stream. Given that the aircraft is unlikely to remain with the original operator throughout its economic life, it is important to minimise the placement and residual value risks. In a rising and in effect "steady state" environment these conditions are likely to be met. The problems arise when there is a deviation from so called steady state conditions.

It is not only the primary market for aircraft that is relevant. The outlook for second hand aircraft is also particularly important, perhaps even more so given the financing arrangements which in effect require some airlines to turn over aircraft at between 7 and 9 years. This is not a problem if there is demand to absorb it. But if not, then there are a

number of impacts. The timing of an aircraft disposal before the need for a major check may have a positive cash impact on the “disposer”. Although it may have established a maintenance provision it would hope to be able to write it back and pass the responsibility and cost of the check to the acquirer. Although there has been an active second hand market until recently, the first signs of a more difficult market emerging have become evident; with some “stickiness” in terms of the time taken to dispose of aircraft and a gap opening up between the valuations of sellers and potential acquirers.

One of the features of the recovery from the depths of 2001-2002 has been the structure of demand in the 150 seat segment. New start ups have generally begun to operate using brand new aircraft; clearly positive in terms of orders for the manufacturers. However, an issue now is the extent of the likely demand for relatively new second hand equipment given that new airlines have generally been able to acquire new equipment. The absorption of second hand aircraft may become an issue. Ryanair has already announced its intention to dispose of 10 aircraft a year in 2007, 2008 and 2009 and, most recently, Southwest has announced that the 34 deliveries that had originally been scheduled for 2008 would become a net 19 as 5 are to be deferred and 10 are now for replacement.

Summary

The industry needs to be concerned about the emergence of relative excess capacity generally. Even in markets where there is considerable new structural demand excess capacity is an issue. In India, where the capacity so far appears to be absorbed given the growth in passenger numbers, a key issue appears to be ticket prices. Few airlines appear to be generating sufficient or adequate returns. This inevitably raises the real question of the ability of the airlines to absorb capacity and enable the necessary returns to be generated; some 170 A320 family aircraft have been ordered by relatively new airlines in India.

Just now the most important issues may not only relate to the immediate trading outlook but rather the way in which the industry is going to adjust and the scale of the adjustment necessary in 2008 and beyond. In particular, how to pass on or avoid risk in the new environment. However, the hardest thing is the necessary mind set change from a set of circumstances where all of the indications are up, to one where the peak has been reached and the industry is again looking over the edge. This only underlines the importance of expectations and what it takes for them to change.

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