



ANALYST VIEWPOINT

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INDUSTRY CRISIS: WHICH ROUTE TO SALVATION?

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Background

At the recent IATA AGM held in Istanbul in early June, Brian Pearce, Nawal Taneja and I were going to discuss the issues of the world as they apply to airlines, however events overtook us and we were unable to have our debate. As a substitute Brian has asked me to consider the issues he would have raised – my thoughts and observations are set out below.

Setting the scene

In the 25 or so years that I have been following the aviation industry there have been numerous events that have interrupted and impacted the performance of the industry – perhaps none of them quite like this. The one common factor affecting all airlines is the fuel price. We may debate what we think the price of oil and fuel should be but we “are where we are” and it is these circumstances that need to be responded to. At the present time there appears to be a broad split between those who think we are looking at oil falling to \$85 a barrel with those expecting that it might rise to \$200. There are, depending upon location and the areas of operation, a number of other factors that already have or will have an impact on the financial outcome. Whilst there is a temptation to say that it is different this time and in some respects it is, the reality, and the focus of attention should now be on the ability and way in which airline managements adjust to the current and likely future environment. Over the near and medium term attention will be on the nature of the adjustment process as the industry in effect re-sizes itself and transfers risk.

The events, the responses and the challenges

Although generalisations are dangerous it is perhaps possible to sum up the key issues facing airline managements as: the fuel price; cash conservation and generation and for some, their ability to survive and the actions that they are going to take to ensure it. The fact that each \$1 variation in the price is reflected in a \$1.6 billion change in operating profit and cashflow for the airline industry gives a clear indication of the magnitude of the shock. At the time of writing¹ (late July 2008) the jet fuel price was \$166 a barrel having fallen 7.1% in the previous week but one which results in a forecast for the year of some \$141 a barrel and a fuel bill almost \$90 billion higher than in 2007 leaving a gap of almost \$80 billion to be filled to reach breakeven from a combination of hedging benefits, higher fare revenue and lower costs; however it is not just 2008 that is the issue; the impact on profits and cash are likely to be even more significant in 2009.

¹ Source: IATA Jet Fuel Monitor - date of price 18th July 2008 <http://www.iata.org/fuelpricemonitor>

Although in inflation adjusted terms the fuel price may well have been higher in the oil crisis of the 1970s, part of the problem has been the speed at which it has increased and the fact that a large proportion of airline revenue is pre-sold and the recovery of higher costs either through overt surcharges or just higher fares lags the increase in cost.

Whilst the performance of the fuel price will impact all airlines, the operating environment faced varies region by region; In Europe and North America there is in addition an economic slowdown and the prospect of a recession with concomitant effects on the demand for both business and leisure travel; In Europe and India (in particular) there was already significant excess capacity; In most of the world there is now also the threat of inflation which will feed through into reduced travel demand. The industry faces what appears to be a structural change in its cost structure whilst at the same time in a number of markets a demand squeeze.

A template for survival

Cash has always been “king” in the airline industry and anything that increases the demand for cash (in this case sharply higher fuel costs) or compromises an airlines ability to generate cash (weaker demand and fares), makes life difficult very quickly. The need for all airlines is to conserve more by avoiding unnecessary expenditure.

A number of airlines are still able to increase their fares to offset the higher costs without a material impact on traffic; however for most this is not the case and increases in fares inevitably will result in less traffic and less revenue overall; the price elasticity of traffic is not uniform nor constant; it varies with the type of traveller and also with the prevailing fare level.

However for many airlines the route to more cash is to cut fares to stimulate the market – certainly in the UK most airlines have run “summer sales” with the advertised prices for long haul flights generally lower than last year despite fuel surcharges increasing.

Where there is the added pressure of an economic slowdown and a squeeze on discretionary income and consequently on consumer behaviour for leisure travellers, the decision to travel or not will be based on the total cost of the trip and not just the air fare which is likely to account for less than a quarter; in such an environment, reducing fares only acts to redistribute traffic.

Even a cursory glance of the balance sheets and the cashflow statements of the airlines that publicly report figures show a wide variation in financial strength. There is a simple answer to the question; how much cash do you want or need – the answer is “more”. Similarly there are a number of individual measures that will give a more rounded view on the stresses and ultimately the probability of survival.

CTAIRA has established a very simple template to track what we consider are a number of generally observable factors which we consider will have a bearing on the survival (and perhaps prosperity) or the failure of an airline. In addition to the cash related measures, which should also include the ability of the airline to cover its cash operating costs, these are; future capital expenditure commitments and in the near term the exposure to pre-delivery payments (which are in cash) - let alone the placement challenge which depends upon the local market conditions; the level of the breakeven load factor, which for a number of so called LCCs appears to be unsustainably high, and the gap between this and the achieved load factor; the traffic mix and in particular the dependence on leisure travel to/from economies where discretionary spend has come under pressure.

The route to salvation and success

Of course the main route to salvation is to generate sufficient revenue for the size of the business and make the necessary returns; which in itself raises a number of issues as the rules of economics apply to the airlines just as they do to any other company. Even at the simplest level the consistently low returns for the overall industry suggest that there is too much capacity to enable it to generate the returns that it needs although some airlines clearly succeed in this respect. In broad terms it is possible to argue that in order to reach a satisfactory return the industry overall already needed to reduce capacity by 20% - however this was never going to happen. The main driver for capacity reduction now is the avoidance of cost and cash outflows. On the other side of the equation less capacity, at least in theory, gives a better opportunity to improve revenue through higher fares but this depends on sufficient demand being available at these high fare levels which will depend upon the rate at which underlying traffic may slow. For “low cost carriers” where growth has been largely a function of the rate of new route openings and where routes may not be immediately profitable, there is also the issue that their performance will increasingly dependent upon growth through their established network which will be subject to the economic pressures. However the failure of one or a number of low cost carriers may provide an opportunity for others in the sector to enter the market. This is unlikely to be through the acquisition of the failing or failed airline. Rather it will be through the redeployment of some of their own equipment although the success here is likely to reflect how well the brand is already established.

The rise in the fuel price has fundamentally changed the relative cost structure of all airlines and this has a consequence on the nature of the adjustment process. For some airlines grounding equipment results in the avoidance of some 60-65% of the costs incurred. A number of airlines have already announced that they are reducing flying in the winter season in the Northern hemisphere. Ryanair has announced that it is grounding aircraft at both Stansted and Dublin, withdrawing completely from some airports, whilst at others retaining its network but reducing frequencies. At the very minimum this route represents a “less worse outcome”. Expect a stream of announcements over the next few weeks as airlines firm up their schedules for the next operating season - winter 08.

For capacity adjustment to have a more meaningful effect there is a need to remove the fixed costs too and here a number of US airlines have embarked on this route (Ryanair too has announced that it is reducing numbers employed). There are however costs associated with such changes and to the extent that they are more than balance sheet write-downs they add a near term demand for cash and one where the hoped for payback materialises in terms of timing and amount.

The broader question of capacity adjustment

There some additional dimensions that are important to consider; the manufacturers’ future delivery schedules; the ability of at least some airlines to fund their pre-delivery payments; that lessors will always seek to find the price at which they can get a returned aircraft back into the air and at least earning a return – albeit it lower than before.

There is no doubt that there is demand for more fuel efficient aircraft but the existence of the demand is not enough as it still has to be financed at a time when the need is to avoid cash expenditure and balance sheets are likely to come under increasing pressure. That said the strong airlines are always likely to have access to capital although given the pricing in of increased risk it will be more expensive. As ever the issue is perhaps whether it is the airline that is being financed or the asset and certainly in the period from 2002 as the cycle reached its low point, there was a greater focus on the asset and the ability to place it with another operator.

In the last downturn the manufacturing cycle was padded by the accelerating demand from a number of low cost airlines who were able to acquire aircraft at what were reported to be very attractive prices which

gave them a meaningful cost advantage over some of their mainline competitors – given that a significant proportion of the 150 seat order book is accounted for by airlines of this type it is difficult to see where the new net orders will emerge from. We have already begun to see “re-directed orders” and whilst there are clearly a number of airlines that are still able to take earlier delivery than they had expected, this group will diminish in number and as far as the 150 seat segment is concerned the manufacturers will have to decide on the issues of providing finance to support deliveries and cutting production rates.

Consolidation

For some time now it has been suggested that consolidation may provide at least some answers to the problems facing the industry – undoubtedly true if it results in a reduction in capacity. However whilst CTAIRA expects consolidation through exit to increase, which may or may not result in a reduction in capacity overall, the reality is that in the current environment the risks to the acquiror have increased. At any time one of the most important things following an acquisition is to ensure that the acquiror’s business operates well and is not put in jeopardy as a result of the acquisition - even resulting from the diversion of management time and effort. The current environment means that the pressures on the management of all airlines, potential acquirors or not have increased. Add to this the need to operate, and where necessary change the acquired business; the outcome is one where there is a adverse change in the risk profile. We believe that any acquisition must achieve a set of clear industrial objectives. Indeed more important than this there must be reasonable certainty that the identified benefits can be realised within a sufficiently short time period to justify the acquisition – something that will be more difficult in a declining market. Whilst prices of target companies may have fallen so have their values, and probably by more than the fall in price. However this doesn’t mean that we won’t see more acquisition activity although it will continue to be constrained by regulation – one thing is for sure and that is that it will be necessary to look even more closely to determine if and where the benefits might arise and particularly how quickly and at what cost they are realised.

Conclusions

At the risk of stating the obvious, this is an unprecedented period for the airline industry; it is undoubtedly a pivotal moment for the airline industry and attention should now focus on the shape and size in which the industry will emerge from this period of turmoil for whilst this is a period of exceptional challenge for airline managements almost by definition it is also a period of opportunity in a number of areas.

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