

# ECONOMICS BRIEFING

7<sup>th</sup> December 2005

## AIRLINE PROFITABILITY: US VS. REST OF WORLD

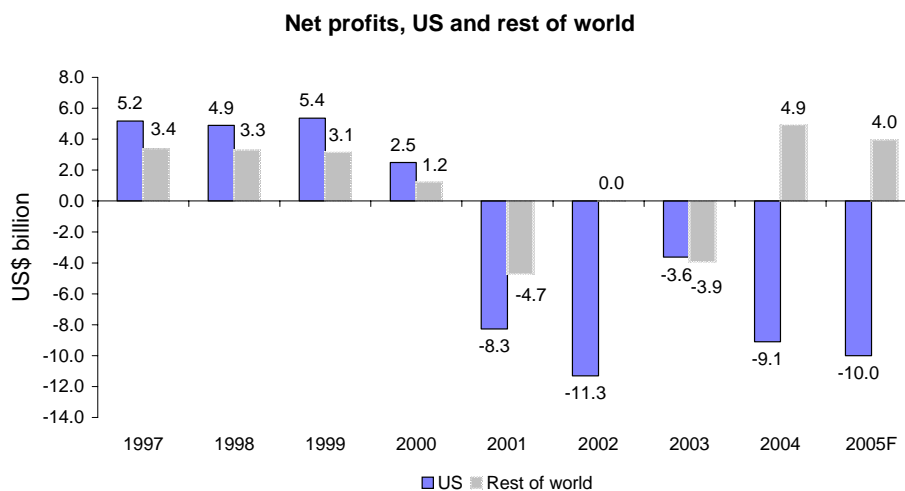
The bulk of the airline industry's losses over the past five years have been concentrated in the US domestic markets, and continue to be so today as the table shows. This disguises two important facts:

- At the operating level US airlines have improved dramatically since 9/11 and are not far from returning to operating profitability;
- Airlines outside the US in aggregate are making money at the net and operating level, but this is insufficient to cover the cost of capital and so insufficient to create shareholder value

There are exceptional problems in US domestic markets, but the key message is that **airline profitability is too low for financial sustainability in all regions of the world.**;

Net profits, US\$ billion	Global	US	Global ex US
Recent performance			
2005 Forecast	-6.0	-10.0	4.0
2004 Actual	-4.2	-9.1	4.9
Cumulated 2001-2005	-42.1	-42.4	0.3
Cumulated 1968-2005	-4.2	-26.3	22.1
- In inflation adjusted US \$	16.9	-18.7	35.6

Source: ICAO, ATA, IATA forecasts. Note there is no adjustment for accounting differences.



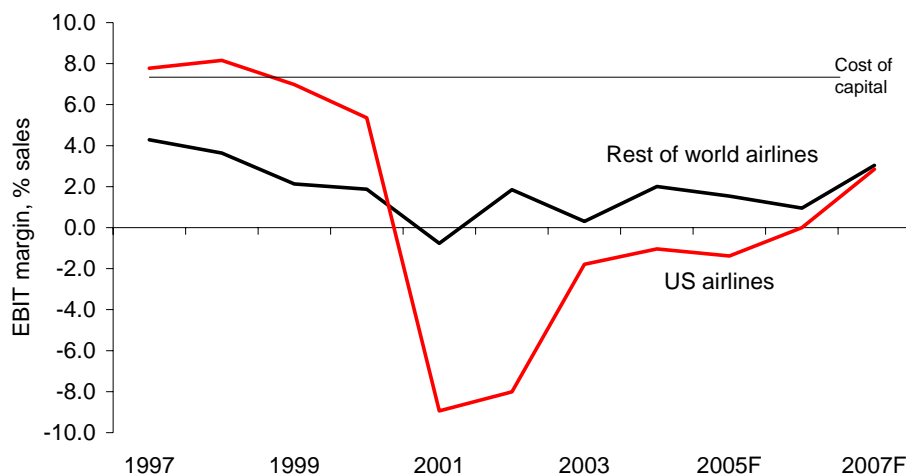
### Key numbers:

- In 2005 we forecast US airlines will make net losses of \$10 billion, while airlines in the rest of the world make net profits of \$4 billion;
- The airline industry has lost \$42 billion over the past five years. All of this is accounted for by US airlines. On average over the past five years airlines in the rest of the world have broken even;
- ICAO started recording the global commercial airline industry's net profits in 1968. The losses of the past five years have now more than eliminated the profits made since 1968;

- However, US losses cumulated over 1968-2005 exceed \$26 billion;
  - Rest of world airlines have made cumulative net profits of \$22 billion;
- ↗ However, a \$ of profit made in 1968 is worth more than a \$ of loss this year, because of inflation. Adjusting the figures for inflation shows that the US still made cumulative losses over this period. But the industry as a whole made net profits in 2004 prices of around \$17 billion. For a \$400 billion revenue industry this is still exceptionally poor;

**Key points on operating performance:**

- ↗ The chart below shows that, at an operating level, airlines outside the US made small losses as a result of 9/11 and faced a reduction in profitability as a result of SARS in 2003. However, for the rest of the period have generated positive operating profit margins;
- ↗ However, an EBIT margin of 8-9% is required to cover the cost of capital and generate value for airline shareholders. Even the better operating margin of 3% forecast in 2007 is well below the cost of capital;
- ↗ The US airlines were creating shareholder value as an industry group in the late 1990s. However, the combined impact of 9/11 and the internet took operating margins from the best to the worst in the industry;
- ↗ In the past three years, partly helped by Chapter 11, US airlines have almost restored the industry to operating profitability;
- ↗ Huge net losses continue, for the present, because of the interest costs that resulted from the big increase in debt and because of substantial restructuring costs;
- ↗ Nonetheless, the operating performance of airlines based in the US and in the rest of the world is closer than the net results suggest;
- ↗ In a normal competitive industry you would expect to see companies making no more than their cost of capital. In less competitive industries companies returns on capital exceed their cost of capital. The airline industry is exceptional in consistently being unable to even get returns that match its cost of capital. All airlines are facing the structural challenges that keep industry profitability too low.



**Brian Pearce**  
IATA Economics  
Email: [economics@iata.org](mailto:economics@iata.org)

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