



ANALYST VIEW

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HANG ON TIGHT

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My view that 2007 will prove to be the peak of the current airline profit cycle is similar to that expressed by IATA Economics in its December 2007 Financial Forecast although I expect the causes of the expected fall in profits to differ slightly, especially in Europe. For European airlines, 2008 will pose significant challenges from a combination of an economic slowdown and significant increases in capacity as the no-frills airlines take delivery of more new aircraft. It will be a bumpy financial ride.

An economic slowdown directly impacts airline revenues

The UK is already feeling the economic pinch. Forecasts point to other parts of Europe being likely to encounter similar weaker economic conditions in 2008. As the corporate sector faces a more difficult operating environment companies will “tighten their belts”. There are two easy budgets to make cutbacks; the travel budget and the marketing budget. For corporate travellers there will be two questions; do you need to travel? and, if yes, in what part of the aircraft?. In this respect, the weaker economic environment will see a combination of downgrading as well as cheaper corporate deals, both of which will put pressure on airline revenues.

An economic slowdown also impacts negatively on the demand for discretionary leisure travel as consumers cut back on spending in response to the more uncertain outlook. For the UK in 2008, this impact will be exacerbated by another factor: sterling’s ongoing depreciation against the Euro. Outbound leisure travellers to the Eurozone will face higher euro-denominated costs of accommodation and other travel costs, which can often account for three quarters of the total trip cost.

In some respects, the ability of an airline to cope with a weaker demand environment will be a reflection of the ability of the business to continue to generate sufficient cash. But this need for cash, in itself, can increase the negative impact on industry profitability during an economic slowdown.

The need for cash is driving cheaper fares

The reality for airlines, whether network, regional or no-frills, is that a very high percentage of costs are either fixed or externally determined. As such, there is a certain inevitability about airlines responding to a weaker economic environment and surplus capacity by reducing fares. Indeed, for no-frills airlines that generate cash from a combination of fares and ancillary revenues it is a logical response. These airlines may be prepared to take a hit on the yield from fares, focusing on volumes not fares in order to maximise the contribution from ancillary revenues.

We are fast approaching February, one of the more difficult months for cash flow for airlines based in Europe. From a UK perspective, the “special offers” by most, and probably all, airlines appear to be at unprecedented levels from offers of 25-35% off in some cases (easyJet and Monarch respectively) to invitations to “buy one and get one free” (Ryanair). Other airlines just quote a “sale” price but neglect to refer to a normal or benchmark price. This is a reflection of demand-related pricing by the airlines and also the existence of a near perfect market for consumers with good information on the prices in the market. What is also evident is that, in many cases, there is an opportunity to book at these “bargain prices” for travel much later in the year, thereby providing the airline with cash now.

But do cheaper fares merely shift demand rather than generate new traffic?

The rules of economics do still apply to the airline industry. Even for no-frills airlines it is not just about achieving volume growth; it is about getting volume growth at a required fare level. In essence, it is still a reflection of the interaction of supply and demand.

Therefore, the real issue for airlines is whether these sale prices do create additional demand or whether they merely bring forward future demand. Given a weaker economic outlook for Europe in 2008, it is likely to be the latter rather than the former, posing some problems for airline revenue management departments. Furthermore, in an environment of weak demand the balance of power resides even more with the traveller. This can result in a redistribution of what level of traffic already exists towards cheaper fares, rather than any expansion of the market – a real sign of market exhaustion. In the near term, given that cash is king, the challenge for airlines is to find the price at which intending travellers are prepared to book and pay. However, given weaker demand and expanded capacity as new aircraft are delivered, this will be tough to achieve. It is difficult to visualise airlines being able to operate in an environment that differs from the general high street retailers where there is a near continuum of sales promotions.

While costs are difficult to adjust

As mentioned earlier, a high percentage of airline costs are either fixed or externally determined. Therefore, adjusting capacity in response to a weaker demand environment is neither easy nor, more importantly, costless. There are still several fixed costs to meet (e.g. ownership costs) even if an aircraft is grounded as part of a seasonal capacity adjustment. For example, although Ryanair stated it was grounding some aircraft this winter, as this represented a better solution than flying them at a loss, this inactivity is not without cost.

The reality is that, in the near term, there is little that can be done. It is a question of hanging on for the financially bumpy ride, with management edicts for departments to reduce costs wherever they can. For European airlines that are set to take delivery of new aircraft there is the possibility of altering the rate or even number of deliveries, but even this is not immediate and could incur financial penalties (e.g. defaulting on the pre-delivery payments already made if the option to flex deliveries had not been built into the contract). Similarly, if the business model is built on selling on 7-9 year-old aircraft there needs to be a market to take those aircraft too or there is a financial consequence. The time taken to move from the peak of the market - measured in new highs for lease rates to a distressed market may not take long and is again a function of supply and demand.

Beyond this the impact on the capacity side will be manifest in a non-conversion of options, a pushing out of future deliveries and then perhaps cancellation. Just a quick look at some simple metrics relating to backlog and the number of years' production that they represent, suggests that an adjustment is inevitable and it will occur just as night follows day. For some the process of adjustment will represent an opportunity, just as the bottom of the last trough enabled both Ryanair and easyJet to place orders at particularly attractive prices, although the likely buyers in the next trough appear less obvious.

For the legacy airlines in Europe there is also the issue of network efficiency; by stopping flying on a route, or a series of routes, there is an impact on the network – even legacy carriers shuffle routes in the normal course of business in the hope that they can deploy the equipment on either a less worse route or one that is positively better. Another issue for network airlines relates to the use it or lose it rules for slots and a need to use the slots for at least 20% of the season or lose them – not attractive at Heathrow where although the prices appear to have fallen back from the highs achieved before the November slot conference there is still a potentially significant store of value in each pair.

Perversely, it is perhaps only when the economic and financial environment gets really difficult that it becomes easier for management to make significant structural changes (though in Europe there is no option to reset an airline's financial position to the same extent as occurs under chapter 11 in the US). Nevertheless, even then management still require sufficient cash to fund the costs of change. "Precipice management", where management is looking "over the edge" and there appears nothing on the way to possible oblivion, is clearly of assistance in

negotiation but is also a dangerous position to be in. It is not always possible to act, particularly if a government is not prepared to provide support.

Summary

The European airline industry is moving towards a weaker operating environment in 2008 that will have a negative impact on profitability. The steps that could be taken in response are reasonably clear, but the outcomes remain unpredictable. In the near term, for many airlines it is a question of hanging on for the bumpy ride and ensuring that there is sufficient cash available. Before this, however, there is a need to be realistic in terms of how bad it could get and to have a clear plan for what you are going to do. Even if in theory this doesn't sound too difficult, experience suggests in practice it will be otherwise.

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