



ANALYST VIEWPOINT

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EXCESS CAPACITY HEADWIND INCREASING

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There should be no doubt that the rules of economics apply to the aviation industry as well as they do to all other industries. Whilst I will address the consequences of what I consider to be the current and future excess supply of capacity later in this piece, it is worthwhile contemplating the area of economics relating to expectations and behavioural theory. Whether at a personal or corporate level the role of expectations is fundamental in determining our behaviour as how we see the future will have a bearing on our behaviour whether that shows through in terms of a travel budget, a decision to go on holiday or to order new aircraft. Quite often expected outcomes are self fulfilling and in a downturn in particular if the collective view is that it is going to get at least more difficult, this may result in an outcome that is worse than might have been the case although of course there is no real way of telling this as we cannot isolate the effect of “negative expectations”.

In search of a turning point

The season for companies reporting either first quarter or March year end results is now underway. Whilst company results are interesting in their own right, particularly in a rapidly changing environment where there is the greatest scope for a divergence from consensus, any results by their nature only tell us what has happened and in that respect are a snapshot of recent history. Whilst the recent results from the US airline sector have generally been “better than expectations” or perhaps more accurately “less worse than feared”, the outcome in the first quarter has still been a significant loss overall.

If for example we look at the outcomes reported by American and United we can see the movements in a number of the key variables, revenue and fuel much in line with IATA’s underlying hypothesis with reported fuel costs offsetting to a greater or lesser extent the fall in revenue. At American total revenues fell by some \$858m with reported operating expenses falling by some \$851m of which \$752m related to the decline in the reported fuel expense. In the domestic segment RASM¹ fell by 7.2% against a background of a 10.7% fall in ASMs; For American’s international business there was an 11.1% fall in the RASM with ASMs down by 3.3% - suggesting a much greater deterioration in this business – a fact that is borne out in the text of the earnings statement. At United the passenger load factor for the mainline business fell by 1.7 percentage points but this was against a background where capacity measured by ASMs fell by some 13.1% and passenger revenue decreased by some 23.8% with PRASM² falling by some 12.3%; on the other side of the equation the fall in the fuel price (and other costs too) resulted in a reduction in the reported cost per ASM of some 11%; overall at United, operating revenue fell by \$1.02bn with reported costs falling by \$1.2bn within which fuel fell by some \$776m. Whilst the breakeven load factor for the combined mainline and regional businesses fell by 3.4 points, this was to 82.1%, and there

¹ RASM = Revenue per available seat mile

² PRASM = Passenger revenue per available seat mile

was still an adverse gap of some 6.4% points against the 75.7% points achieved³ - with a reported loss from operations of some \$282m compared with \$441m in the corresponding quarter last year.

Looking ahead in almost any area, the nature of the rapid changes in the operating environment means that no matter how well they might be constructed, there may be little confidence in any forecasts as they are, or indeed should be, subject to almost continuous change reflecting the events of the outside world – moreover this may be an exercise where diminishing returns soon set in. The current lack of confidence in forecasts occurs at a time when management need the clearest and most realistic view of what may or may not happen and more importantly what the future is likely to hold for them both operationally and strategically.

As an analyst I have always put store in the “mood music” of management — in other words how they view the future and although this is not without question, I have used this as one source of perspective; changes in the intensity or the “volume” of the messages are particularly telling; but here there is a need to be aware of which market (internal or external) the message is aimed at. Notwithstanding these minor issues of interpretation, this source of perspective can be particularly useful. If for example we take the comments accompanying the latest results from American Airlines the messages in the 10Q are telling although in reality there is little that is surprising as management sees: “a significant weakening of demand”; “a very challenging environment”; “disruptions in the capital markets” and a possibility that “the company may not be able to improve its liquidity position” if the weak demand for air travel persists and financing on “reasonable terms” is not available.

We have seen a number of politicians suggest that we are beginning to see some so-called “green shoots” of recovery, but at best these would appear to be little more than data suggesting that a number of key economic indicators are declining at a slower rate than before – hardly a recovery. Notwithstanding this apparent triumph of some observers’ hope over what most of us are experiencing, there are few airline managers who would have reason to share the view that there are any even early signs of a recovery.

Clearly we are all searching for signs of potential improvement but even if what we are beginning to see is the rate of decline slowing there is little to indicate that once the bottom is reached the upturn will not be some time away; at this stage it remains unclear how long the “trough” will last – in any event it seems reasonable to dismiss the notion that the downturn in the aviation sector will be “V” shaped as the potential for a massive capacity imbalance both in the remainder of the downturn and subsequent recovery and early stages of the upturn remains with the concomitant effects on pricing and financial performance. One of my greatest concerns is the delusions that result from the statistical illusion and confusion that surrounds the use of the terms recovery and growth.

Fundamentals still apply

Turning now to some of the more traditional themes in economics, we have suggested in other e-analyst articles, as well as elsewhere, that the fundamental rules of economics also apply to the aviation industry. In broad terms the financial outcome on the revenue side is determined by the relationship between the demand for travel at any given price and the available supply; the issue now against the background of the fall in demand is how much capacity to take out. As the first quarter results for the US airlines have shown, what we are now seeing is a vicious downward spiral and one that is clearly evident elsewhere and the need is for more and perhaps substantially more capacity to be removed at an industry level and perhaps not just grounded. From a traveller’s perspective this is clearly good news – particularly anybody wanting to travel between Europe and Asia where the growth in capacity by airlines to/from Europe and the Gulf and to/from Asia and the Gulf (weekly seats offered July 2009 some 17% higher than July 2008)

³ Source: UAL Corporation Q1 2009 press release 21st April 2009

has resulted in sharp fare reductions. Reductions are also evident on the direct services between European and Asian points where these airlines have in fact reduced capacity on these routes by some 11% for July 2009 compared with July 2008.

There have already been announcements relating to reduced frequencies between Europe and Asia (most recently from Cathay Pacific); Singapore (SIA) has also sharply reduced capacity; however what the recent and current fare experience shows is the consequences of excess supply and that the actions of individual managements in cutting capacity may be negated if others don't do the same – but this is nothing new. The real risk (if an airline in this region) or an opportunity (if a traveller) is that this will result in a structural resetting of the market – and this must be considered likely.

Our greatest concern over the consequences of excess supply remains in the so-called 150 seat segment of the market. It is important to look at supply comprising at least two components; the current “intra-system” source – that is aircraft already in use but on operating leases where their return to the lessor, without a follow on lease, will be an increased problem - as well as the primary source of new aircraft deliveries. In our January e-analyst article we suggested that some 1600-1800 short haul aircraft in the order book (although admittedly not in the production schedules) were at risk and this reflected the bursting of the exuberance bubble in respect of past orders let alone financing issues for new deliveries. Whilst we expect greater support from governments in respect of funding exported aircraft and from the manufacturers, it seems unrealistic that current short haul delivery rates can or should be maintained.

Whilst history may not be a good guide to the future, there are a number of attributes that suggest that the downturn, at least in terms of “intra-system” supply and the challenges facing some of the lessors, as well as the timing of net new orders, has a number of parallels with the early 1990s rather than that at the start of the current decade. If this is the case then applying the experience of the early 1990s suggests that by 2011/12 deliveries of aircraft in the 150 seat segment should be some 60% lower than the peak reached in 2007. Clearly there are a wide range of “stakeholder issues” that appear to militate against this happening and if they prevail it is important to consider the consequences. There are a range dependent on exactly what happens but they could include the financial impact on aircraft lessors – in particular of shortening the economic life of aircraft currently in service as they are retired earlier to create space for new deliveries and so ensure a reasonable balance between supply and demand at the necessary prices (unless there is a structural shift in the cost of production either from new entrants or from incumbent airlines). If there is no change in the age of retirement, the consequence will be that excess supply continues and the industry enters the upturn in a position where reaching even the peak margin seen in 2007 will be difficult.

One of the things is certain is that the recovery will involve the transfer of risk – but to whom and how much, remains unclear; what is also certain is that although the current environment is particularly challenging, it is also a time of opportunity – but just how much of an opportunity depends on who you are, where you are, what your objectives are and how you can finance your ambition.

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