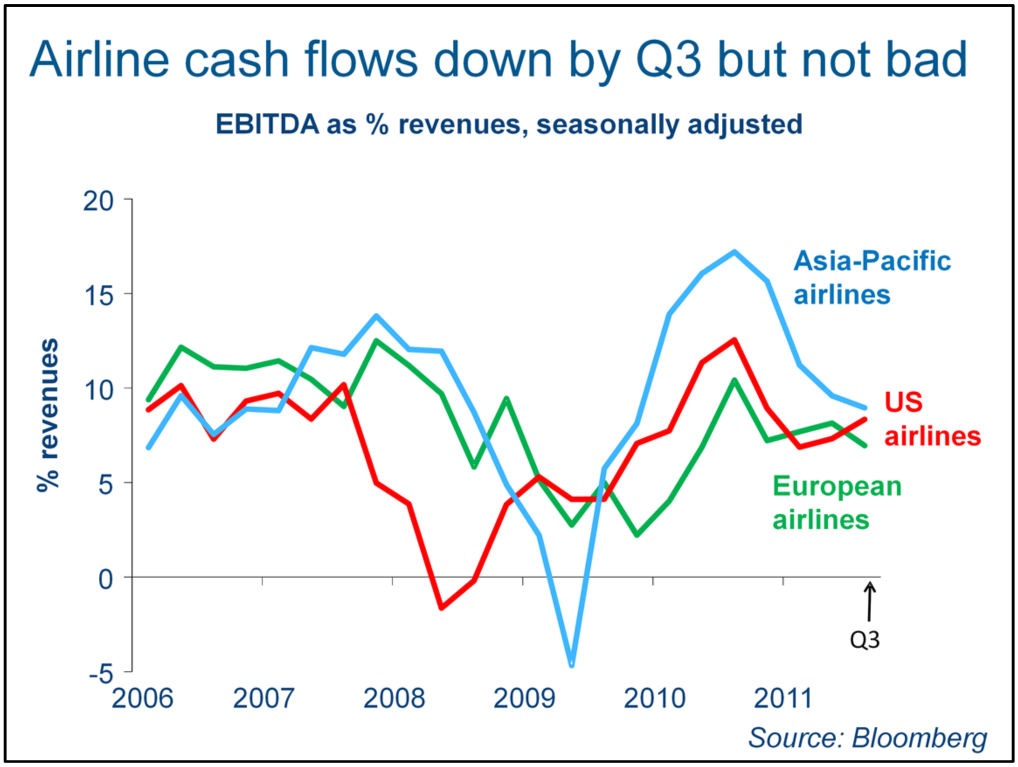
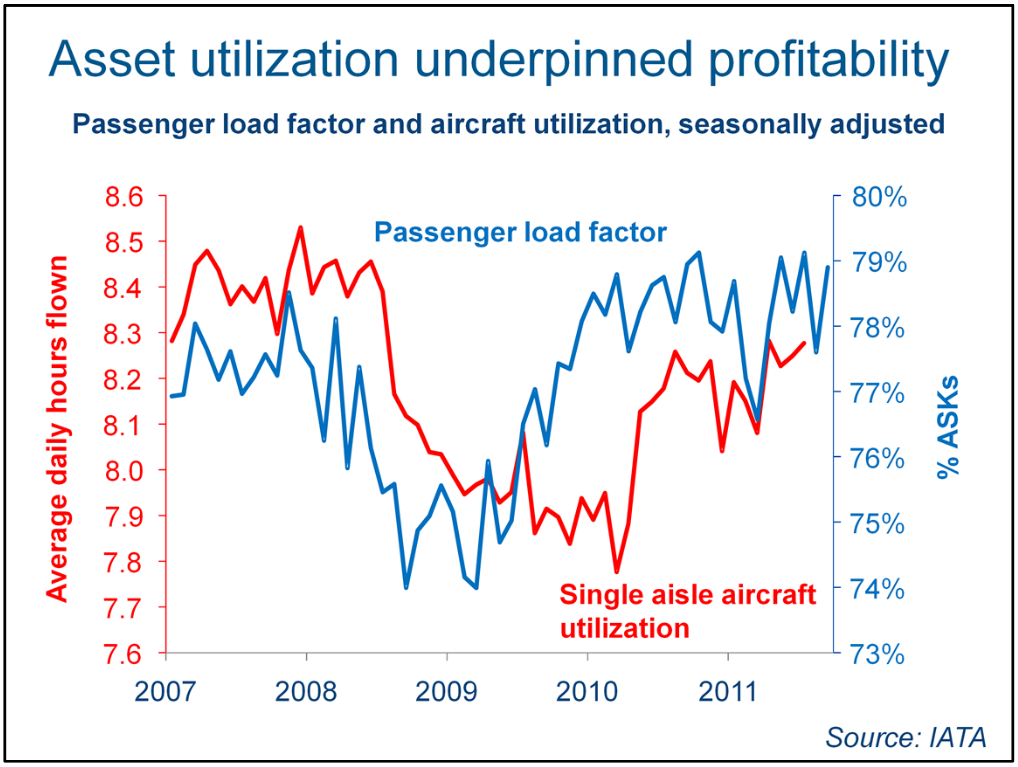
The outlook for air transport markets and the industry

Brian Pearce
Chief Economist

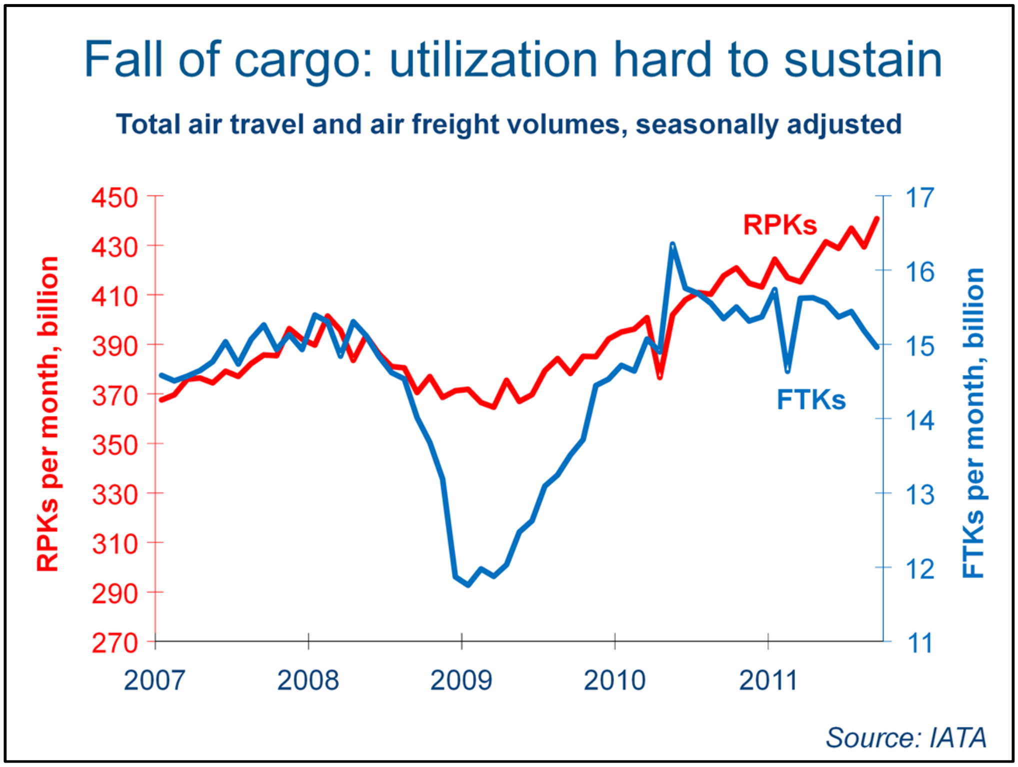
To represent, lead and serve the airline industry



By the third quarter of 2011 airline cash flows (as proxied by EBITDA as % revenues) had fallen from the peak of financial performance in the third quarter of 2010.
However at 5-10% of revenues cash flow performance was not bad given the still high price of jet fuel and the economic uncertainty resulting from the eurozone crisis.

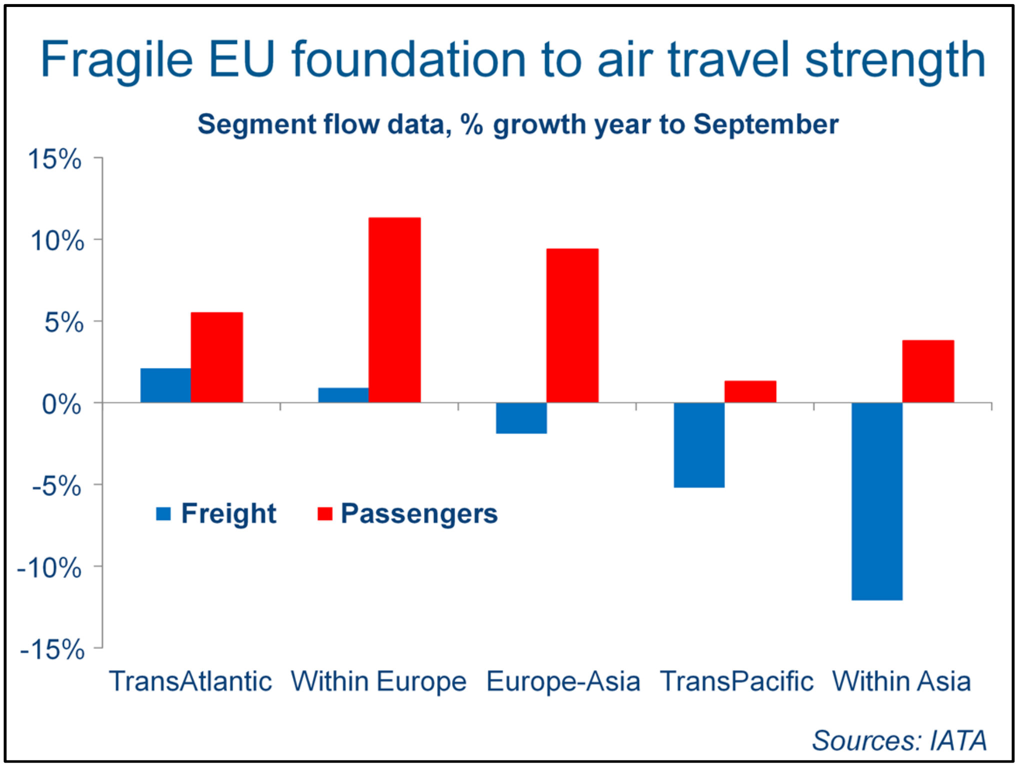


One of the key reasons why airlines have managed to prevent cash flow and profitability from falling further is good asset utilization, at least in the passenger business.
Passenger load factors remain close to all time highs. Aircraft daily hours have been kept up at the levels reached in early 2010, though this remains less than pre-recession levels.



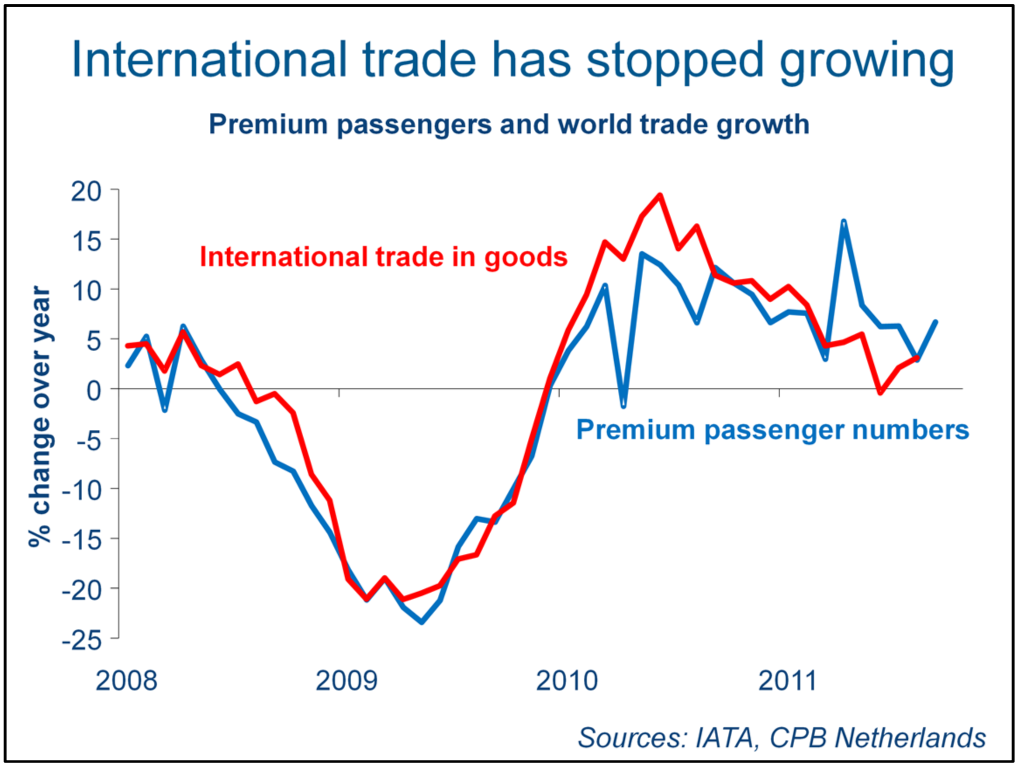
A key question is whether air transport demand will remain strong enough to sustain asset utilization.

Air travel continued to trend upwards through to the end of the third quarter. However, after adjusting for seasonal fluctuations, it is clear that air freight market volumes have been shrinking since the middle of the year. By October FTKs were 5% lower than in May.

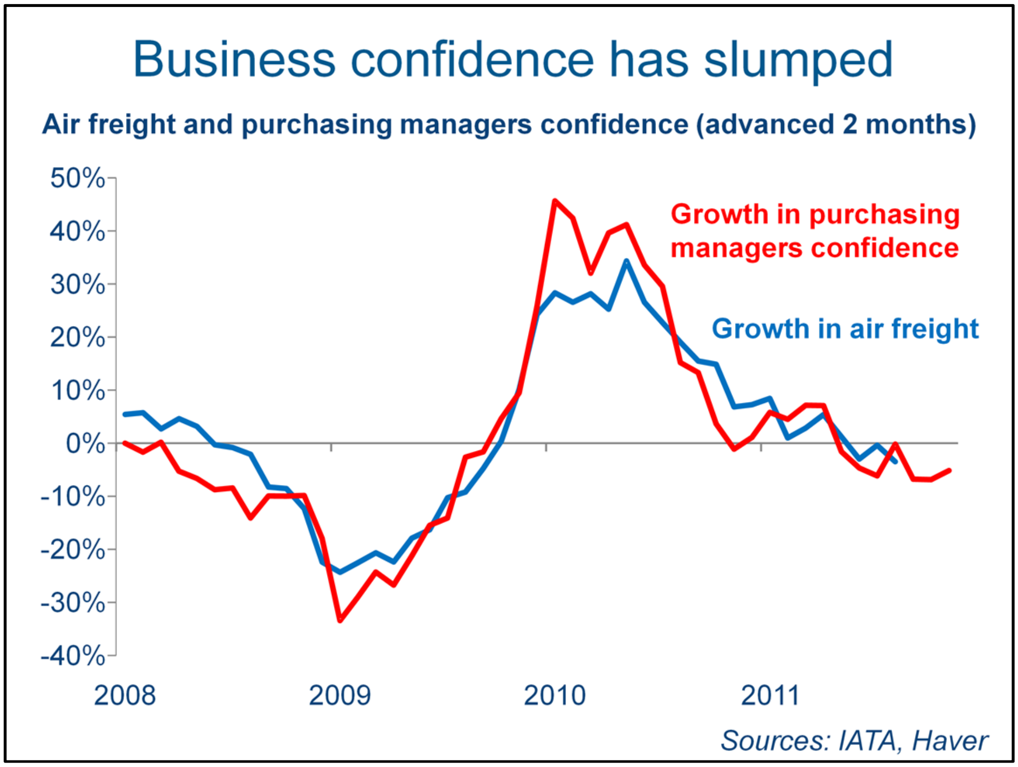


The weakest air freight markets this year are in or connected to Asia, which reflects the fall in demand from developed economies for the goods manufactured in Asia.

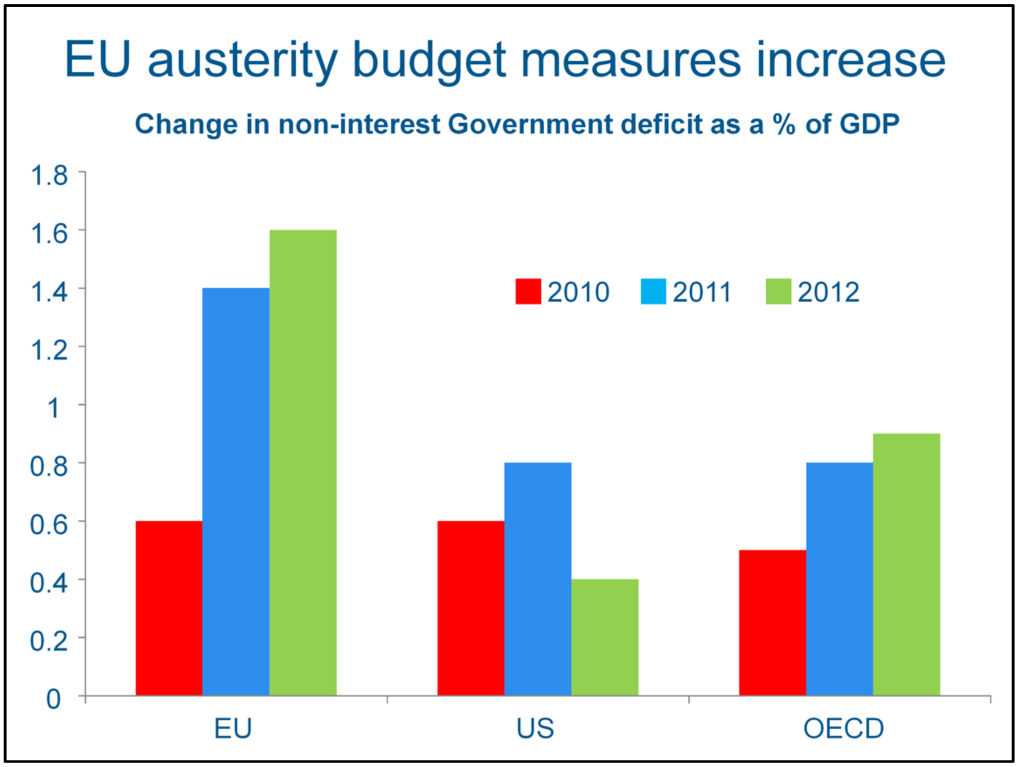
The pattern is very different for passenger markets. The markets that have kept aggregate air travel increasing this year have been in Europe. Given the economic situation this is a very fragile foundation for future air travel growth.



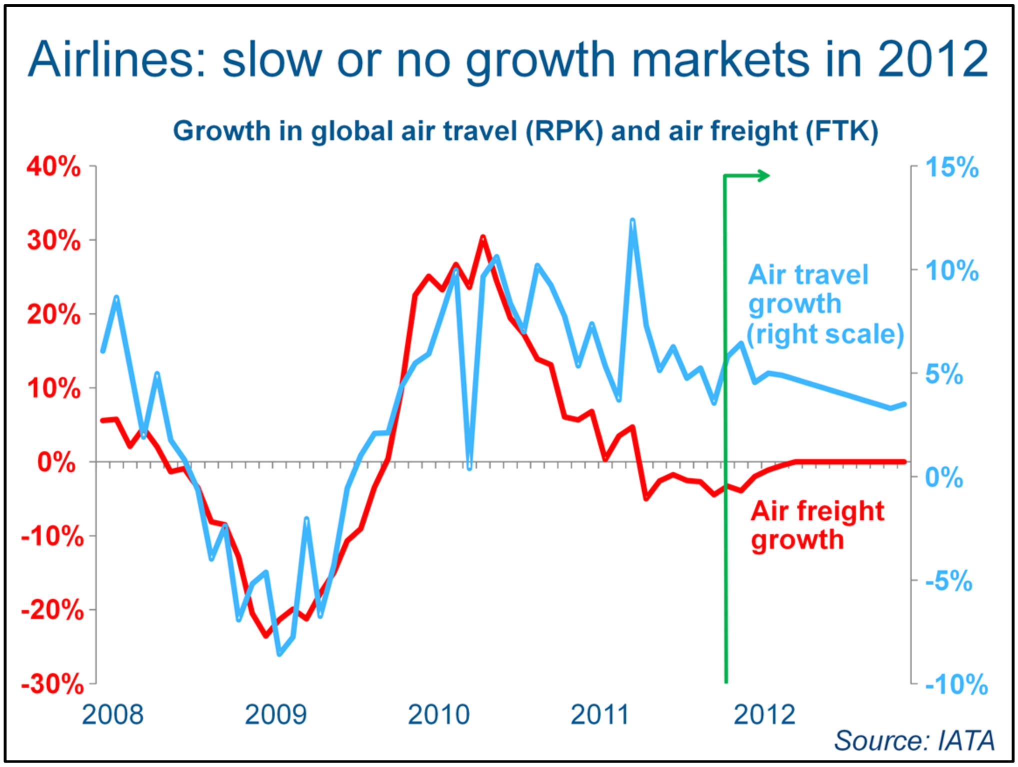
International trade is a key driver of air travel, particularly the business travel that makes up the majority of premium seat sales.
A negative signal is given by the virtual halt to growth in international trade. This is consistent with a further slowdown in the growth of premium passenger numbers – a key segment for network airline profitability.



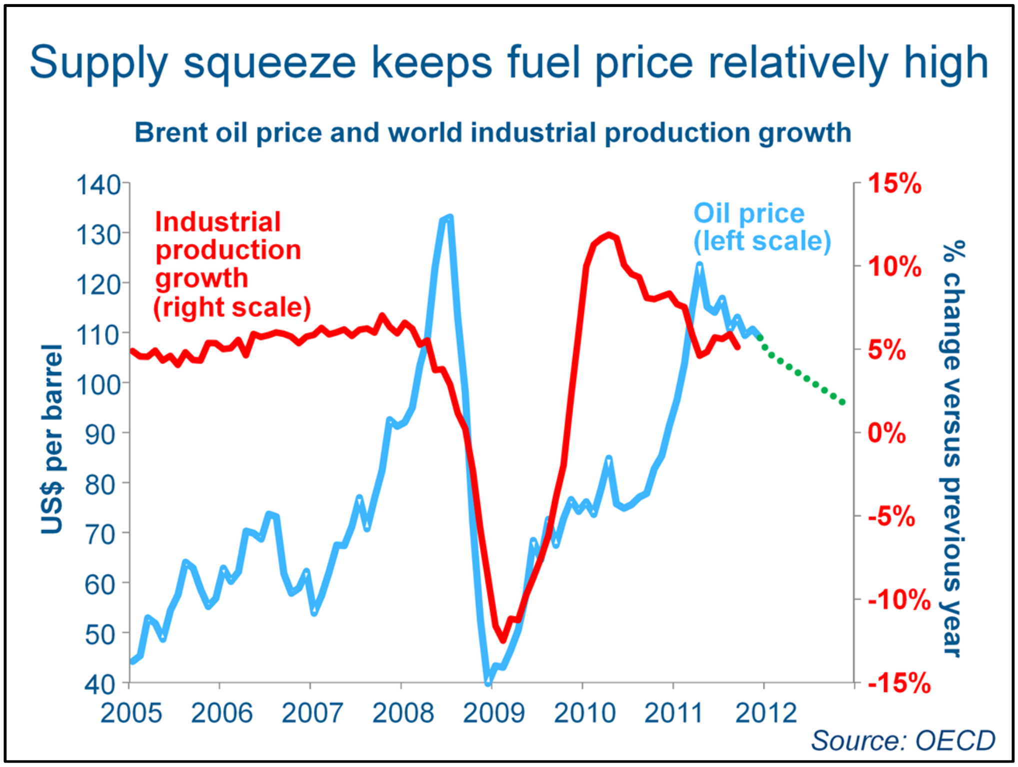
Another key driver of both premium travel and air freight is business confidence – measured here by the confidence of purchasing managers in manufacturing companies around the world.
This is a good leading indicators, as shown by the fit of the curves when confidence is advanced 2 months.
Falling business confidence is signalling a further decline in air freight in the months ahead.



Another important driver of economic growth at the moment are the austerity budgets of many government, particularly in Europe.
This chart shows changes in the non-interest government deficit as a % of GDP. In Europe governments are tightening fiscal policy by around 1.5% of GDP a year in both 2011 and 2012. This is taking a large chunk of GDP out of the European economy at a time when interest rates and debt are causing the private sector to cut spending. This is a key driver of the expected European recession in 2012.
Fiscal policy in the US is also starting to tighten but by a much smaller degree than in Europe, allowing a slightly better outlook for GDP.



The net impact of these economic factors will be to slow passenger market growth from an average of 6.1% to 4% and to keep air freight markets flat in 2012.



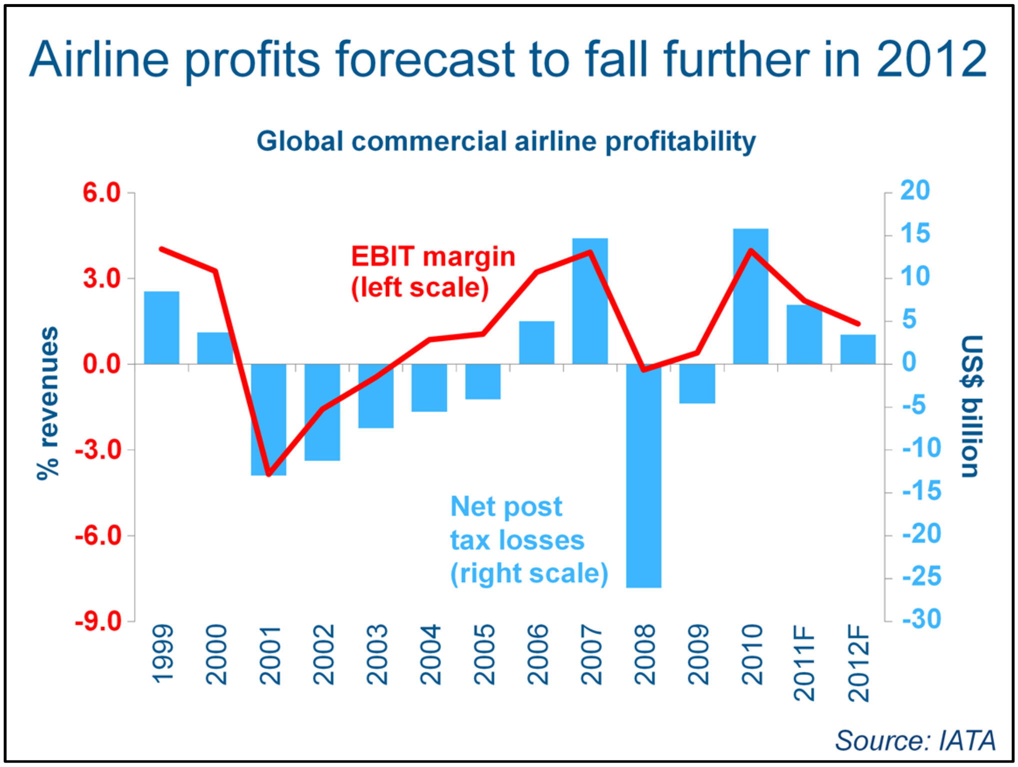
Oil and jet fuel prices have fallen from earlier peaks but remain much higher than had been expected, given the eurozone crisis and other economic issues.

One reason for the relatively high oil prices is that economic growth outside the OECD remains strong, sustaining a fairly high demand for oil.

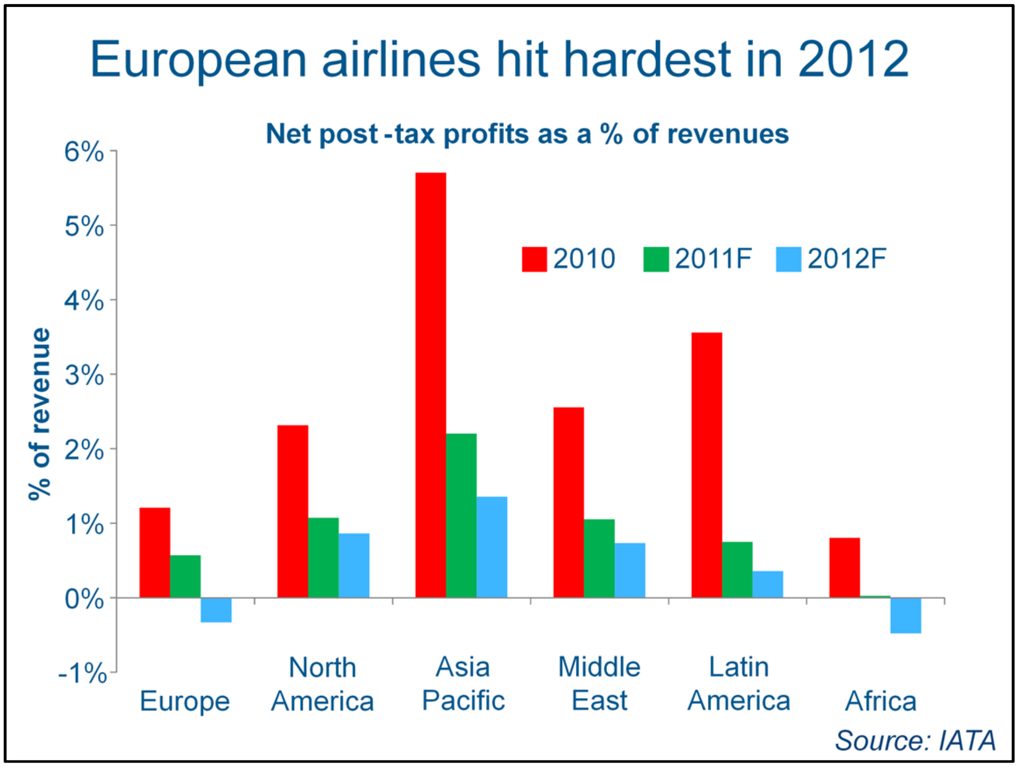
But there has also been a squeeze from the supply side too, with worldwide inventory cover having fallen by 9 days since mid 2009.

Most forecasts for oil prices in 2012 point to the supply squeeze preventing prices from falling far below $100 a barrel.

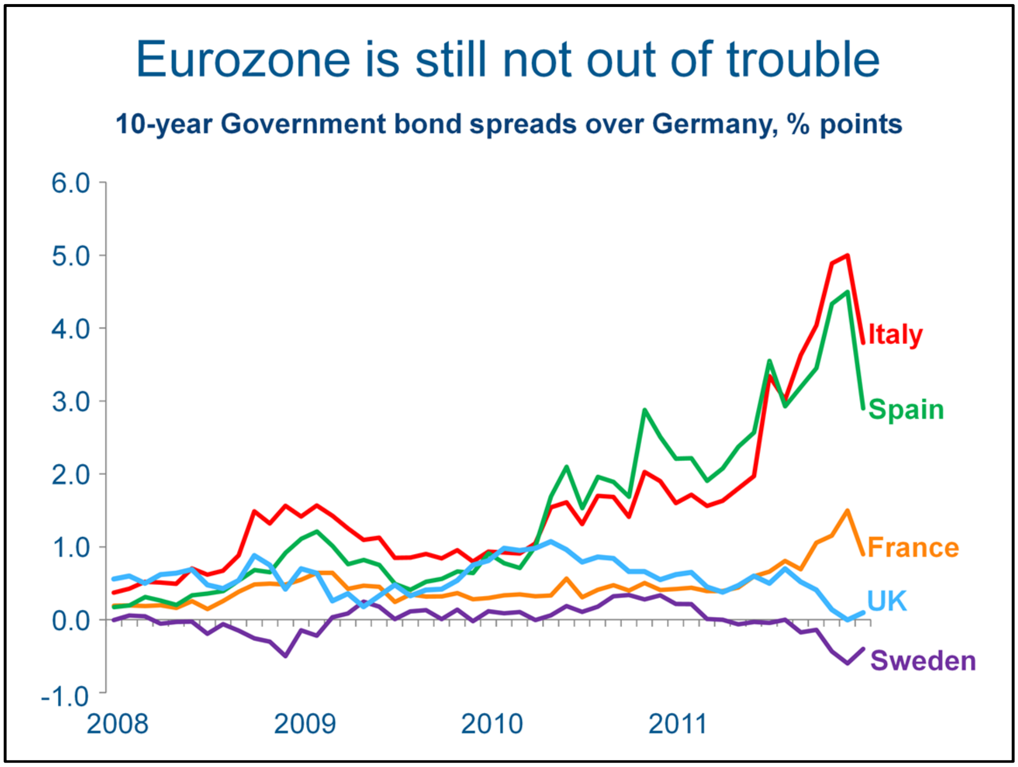
Clearly relatively high jet fuel costs and a weakening economy adds up to a squeeze on airline profitability.



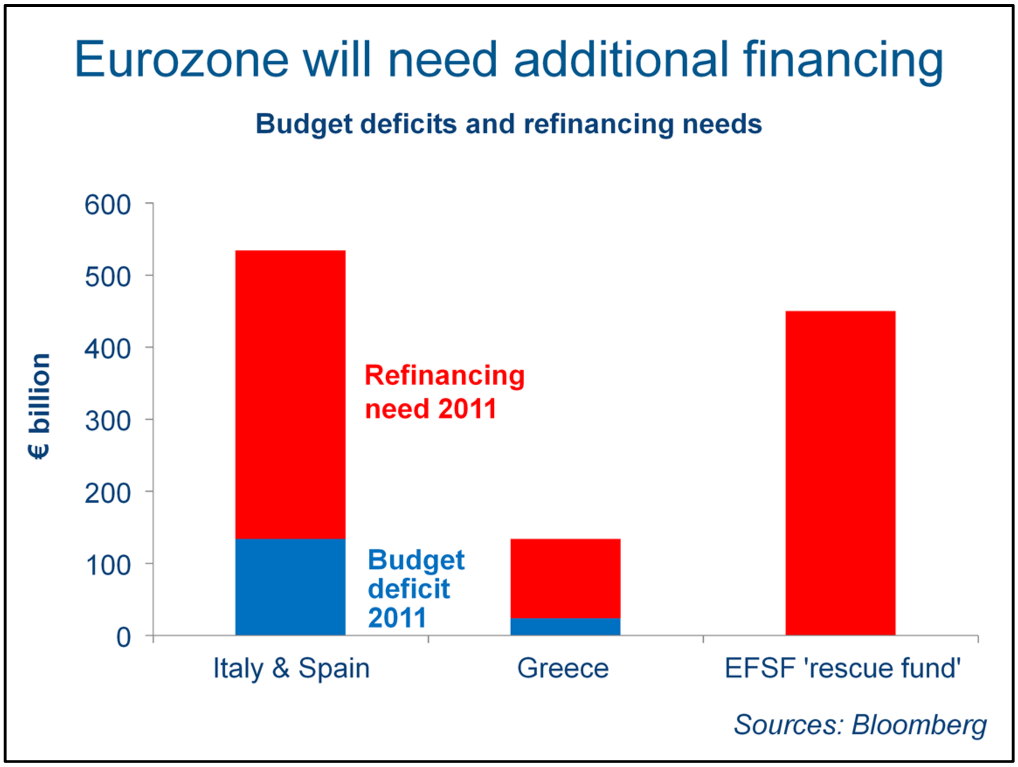
IATA's central forecast is that still high jet fuel prices and a weakening economy will lead to lower airline profits in 2012. We forecast a fall in net post tax profits from $6.9 billion in 2011 to $3.5 billion in 2012.



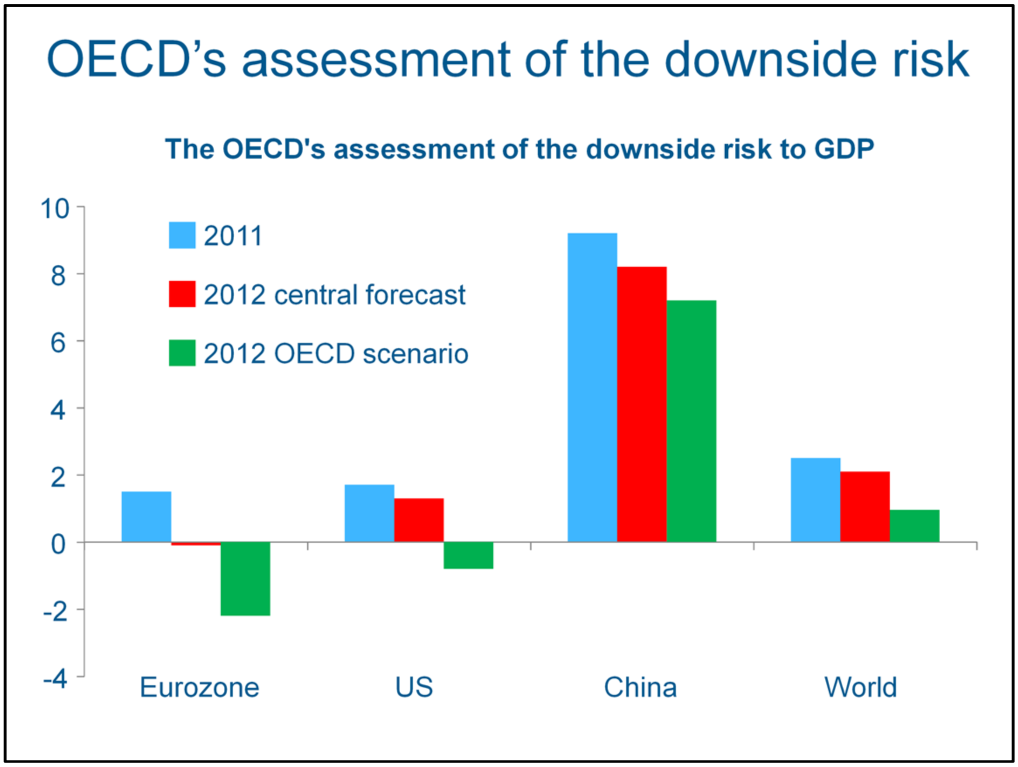
European airlines will be hit hardest, given the pressure from recession and rising passenger taxes.
US airlines have successfully cut capacity, keeping load factors and yields high. We expect this to continue in 2012, limiting the decline in their profits.
Asia-Pacific airlines have seen a sharp fall in profits because of the importance of cargo in the region. However, in some markets, such as the Chinese domestic market, airlines have managed to sharply increase both load factors and profitability.



Still wide bond market spreads show that financial markets are still not convinced that the euro-zone sovereign debt crisis is over.

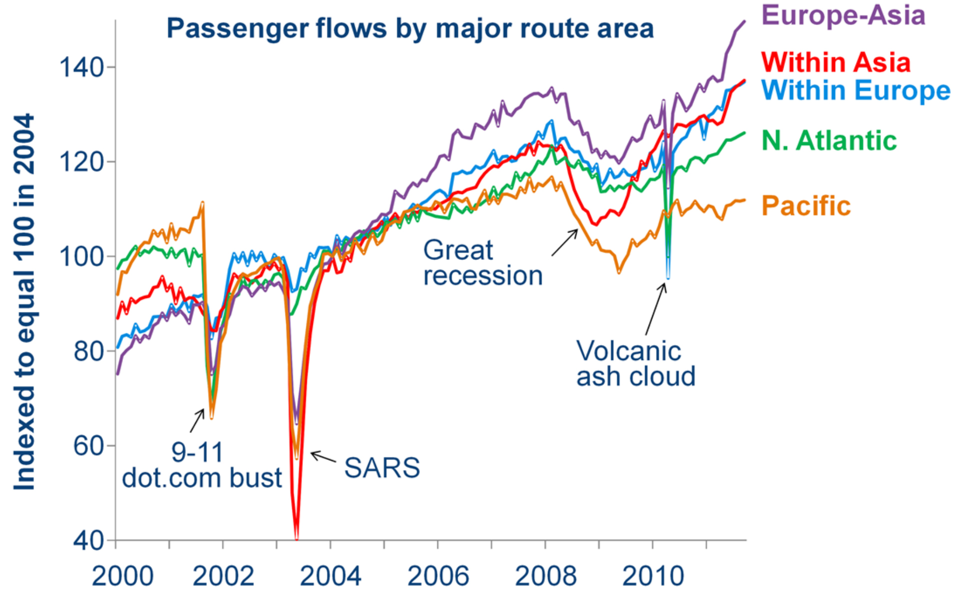


The European rescue fund (EFSF) is not big enough to finance Italy and Spain should they become unable to pay market rates.

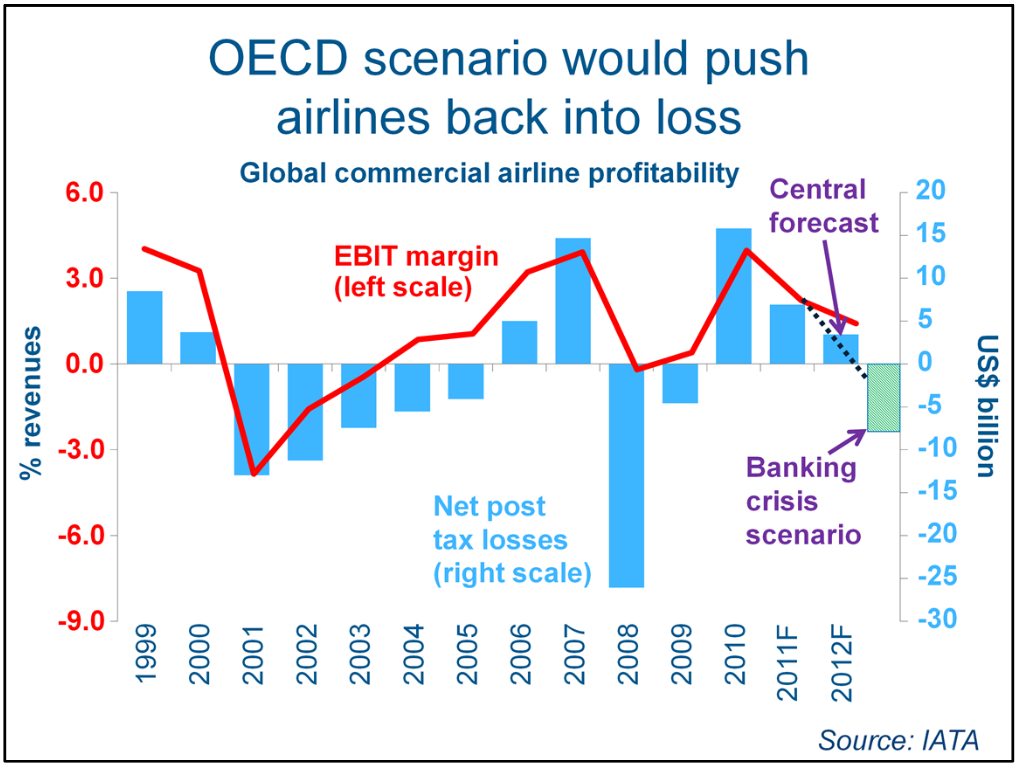


The OECD in their latest economic outlook assess a scenario where the eurozone crisis deteriorates into a banking crisis. They estimate this would send the EU into deep recession in 2012, cause a small US recession and pull growth down a little in China and other emerging economies.

Little chance of other markets escaping EU crisis



Travel markets rarely decouple in economic downturns. In the OECD scenario we would expect most travel and cargo markets to suffer.



If the eurozone crisis does deteriorate into a worst case banking crisis, and if the OECD are right about the economic damage, we estimate the airline industry could be sent back into loss, with net losses in excess of $8bn.

The outlook for air transport markets and the industry

Brian Pearce
Chief Economist

To represent, lead and serve the airline industry