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## AIRLINES EXPERIENCE TURBULENT TIMES

Fasten your seatbelts ladies and gentleman, we are entering an area of turbulence.

Arguably no other industry has faced as much instability in the past decade as the aviation industry. After years of restructuring, mergers, opening up of new markets, the entry and growth of low cost carriers, the impact of events such as 9/11 and SARS, and now with an oversupply of aircraft entering the market and fuel costs spiralling beyond levels anyone could reasonably expect, the airline industry is once again at the crossroads.

In this article, we explore the issues that have shaped the airline industry in recent years and how airlines are battling to deal with a range of potentially terminal issues.



### Industry evolution – a foundation for failure?

Following deregulation of the airline industry in many parts of the world in the late 1970s and early 1980s, legacy airlines operating hub and spoke style networks saw that the only way to counter an increase in competition was to look for economies of scale, and the only way to achieve this was to expand networks, merge with other airlines, or form alliances. This kept legacy airlines in a holding pattern for some time, albeit there was still volatility in profitability caused by worldwide economic swings.

Fast forward in time to the 1990s and we saw the entry of low cost carriers (“LCCs”). With a point to point network and a flexible labour force, LCCs were able to achieve not only significantly higher utilisation rates for their aircraft, but also higher labour productivity (interestingly enough, not necessarily obtained from using a de-unionised workforce or paying lower salaries).

By 2000 the two stories started to conceptually merge, although financial indices suggested otherwise. Legacy airlines weathered a further restructuring phase and looked once again to slash overheads, in particular labour costs, believing this was the panacea to their problems. However, baggage from their less efficient networks still resulted in significantly lower aircraft utilisation rates and profitability per available seat mile than their LCC counterparts. Worse still, legacy airlines were also losing significant market share to the LCCs.

Legacy airlines may well have evolved to achieve significant efficiency gains, but remain unable to reach the efficiency levels of LCCs. Today, they are now being further squeezed by the inability to adequately counter increasing jet fuel prices by raising ticket prices given the large footprint of LCCs.

LCCs are not flying smoothly either. Largely reliant on passengers of a lower socio economic standing or leisure passengers, and who are both price sensitive, they look set to suffer pain not only from increasing jet fuel

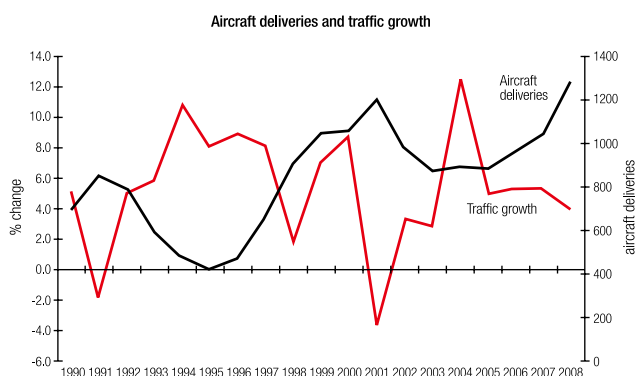
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prices, but the inevitable evaporation of demand as the impact of a deteriorating world market continues.

## Over supply – the industry is its own worst enemy

Ever focussed on an increasing growth in demand, and with airlines not wanting to be left behind, the industry has recently worked itself into a lather by ordering more and more new aircraft.

We are now unsurprisingly seeing that aircraft deliveries are out of synch with traffic growth (see chart below). Whilst this is not a new phenomenon, it does create significant challenges and adds another dimension to the current fuel crisis.



Source: IATA The outlook for the global airline industry in 2008

The continuing delay in delivery dates for the Airbus A380 and the first Boeing 787 is on one hand providing some respite for certain market players, enabling them to delay huge capital expenditures at a particularly difficult time. However, as these two aircraft represent only a fraction of new deliveries coming to the market (approximately 5% and 17% respectively) it will not curtail the spending problem for long. On the other hand however, the newer aircraft may also be the longer term solution to the fuel crisis and so the current delays could be causing equally as much harm as good.

Legacy airlines and LCCs alike that have purchased or will be receiving new aircraft in the immediate future face a double edged sword. It is an easier decision to cut routes which will allow the grounding of some

of the fully paid and less efficient aircraft in the fleet (which we are already seeing), but when new aircraft have been purchased and lease costs mount, airlines will need to ensure these costs are met by passengers in seats. For this reason, we are unlikely to see a commensurate increase in ticket prices (to oil price – and notwithstanding those pesky fuel surcharges that passengers abhor) and are more likely to see a consumption of shareholder equity (albeit at lower rates than if the aircraft were grounded). We are also likely to see a glut of aircraft on the second hand market which can present a serious issue for financiers.

## On the smell of an oily rag – escalating fuel costs

Profit volatility is not a new occurrence for the airline industry, particularly over the last 15 years which have shown equally as many profitable years as unprofitable. However, with fuel costs now making up approximately 30% to 40% of a typical airline's total operating costs (now exceeding the amount spent on labour for many airlines), it is clear that management of fuel costs has become essential.

The International Air Traffic Association which represents more than 240 airlines across the world paints a bleak picture, recently adjusting forecasts for industry profits down by USD6.8 billion from its March 2008 estimate to an overall loss position of USD2.3 billion by year end (utilising an average oil price of USD107 per barrel). Obviously if fuel prices are sustained at current levels, these estimates might well need further adjustment.

The situation for individual airlines is at marked extremes, and everything in between. For those with enough foresight (or perhaps fortuity), they have secured a short term reprieve by hedging their fuel bills. These airlines look forward to taking market share from others whilst competitors grapple with absorbing costs and looking for efficiencies.

The figures are quite dramatic, making it apparent how easy it is for both legacy airlines and LCCs to be faced with the same concerning outlook, regardless of how

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efficient aircraft utilisation rates are, or how low labour and other operating costs are per available seat mile.

For instance, Southwest Airlines, a LCC operating in the United States (and which was the largest airline in the world by passenger numbers as at 31 December 2007) has locked in 65% of its 2008 fuel bill at USD49 per barrel, and 50% of its 2009 fuel bill at USD51 per barrel. Legacy airlines such as Qantas and British Airways (BA) are a mixed bag. Qantas pays around USD72 per barrel for its needs, but will be significantly exposed after 1 July with those contracts coming to an end. BA is also marking time with its fuel needs at around USD86 per barrel until March 2009.

So what about the LCCs? In short, many LCCs simply don't have the weight to hedge their fuel bill properly, and so ride the oil price wave which, at these heights, simply means they are left to either hold their breath and hope they can weather the storm, find even more efficiencies, look for other ways to charge passengers more, or simply be pushed to oblivion.

Our experience in dealing with distressed airlines and realisation of surplus aircraft has shown the difficulties faced in ensuring value is maximised. There are a myriad of issues to be properly managed to avoid a nose-dive in value.

### Quick fixes in stormy skies

Facing a rough ride, airlines must look for ways to recapture lost money, and fast. It is quite clear that ticket prices need to increase at some stage. Even Easyjet and Ryanair which are the two dominant LCCs operating in Europe have problems, admitting ticket prices need to rise.

Virgin Blue is a relatively new LCC entrant to the Australian market and has been flagged by analysts as cannibalising equity at rapid rates at current fuel price levels. One analyst has warned that Virgin Blue would need to raise ticket prices by 10% to neutralise the effect of increases in jet fuel, a report that Virgin Blue strongly rejected before announcing higher prices shortly afterwards.

### Airline Obituary List 2008 (So Far...)

| Airline                   | Country       | Date        |
|---------------------------|---------------|-------------|
| Alpi Eagles               | Italy         | 1 January   |
| Aero Airlines             | Estonia       | 6 January   |
| BritishJET                | Malta         | 8 January   |
| Coast Air                 | Norway        | 23 January  |
| City Star Airlines        | Scotland      | 30 January  |
| Bosto-Maine Airways       | United States | 29 February |
| Big Sky Airlines          | United States | 8 March     |
| Girjet                    | Spain         | 13 March    |
| Adamair                   | Indonesia     | 18 March    |
| African Safari Airways    | Kenya         | 25 March    |
| Freedom Air               | New Zealand   | 30 March    |
| Airclass Airways          | Spain         | 30 March    |
| Aloha Airways             | United States | 31 March    |
| ATA Airlines              | United States | 2 April     |
| Skybus Airlines           | United States | 4 April     |
| FlyNordic                 | Sweden        | 5 April     |
| Skyway Airlines           | United States | 5 April     |
| Swazi Express Airways     | Swaziland     | 7 April     |
| Oasis Hong Kong Airlines  | Hong Kong     | 9 April     |
| Ocean Airlines            | Italy         | 25 April    |
| Eos Airlines              | United States | 27 April    |
| Nationwide Airlines       | South Africa  | 29 April    |
| Mihin Lanka               | Sri Lanka     | 3 May       |
| Angkor Airways            | Cambodia      | 8 May       |
| EuroManx                  | Isle of Man   | 8 May       |
| Far Eastern Air Transport | Taiwan        | 13 May      |
| Silverjet                 | Britain       | 30 May      |
| Champion Air              | United States | 31 May      |
| Manicharters              | Mexico        | 10 June     |
| Aero Condor               | Peru          | 11 June     |

Note:

- Up to 27 June 2008

- Excludes mergers

Many airlines have also been adding a fuel surcharge for some time, offsetting at least part of the increase in costs to the consumer in an indirect way of avoiding the untouchable front end ticket price. But an increase in the overall ticket price at a level of 10% for instance, will almost certainly carry with it a significant reduction



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in demand. Given more difficult global economic conditions at present, a passenger (especially from a lower socio economic position) may rethink booking that flight for a family holiday, especially those who rely on the LCCs to make the sums work.

Whilst loathed by all travellers, LCCs do find that they can get away with a certain degree of add-on charges for services such as check-in baggage, ticketing fees, credit card fees etc. We are now seeing many LCCs start applying these charges if they didn't before, and for those that already did, increasing them.

Legacy airlines on the other hand find they are less able to include add on charges and look to rely more on reputation, frequent flyer programs and airside lounges to retain and entice passengers at a higher ticket price. Legacy airlines are also looking at other ways to attract passengers, now competing in areas which were fairly standard across the industry e.g. in-flight entertainment (Emirates), more comfortable seating for economy class (Cathay Pacific) and premium economy (Qantas and Air New Zealand) to name just a few. The problem with these services is that they tend to require newer aircraft and significant capital outlays.

## The Wash-up

The rise in oil prices and heavy capital outlays required to be a leader in the airline industry has highlighted the turbulent nature of the industry. Whereas there was substantial growth in routes and passenger volumes either side of 9/11 and (at least in Asia) SARS, the sheer volume of airline collapses over the past 12 months is again shaking up the industry. Whilst the strong and well managed will of course survive, critical decisions regarding route operations, capital outlays and managing fuel prices will ensure that a number of airlines have a bumpy landing ahead of them.



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