Jetliner market braces for downturn

Just how bad is the commercial aviation business? It depends on who you are. If you are an airline, the odds are good that your business is being hit hard by slack demand and high fuel prices. By contrast, if you build jetliners, there are enough positive indicators to suggest that your business remains robust.

This is a notable disconnect between manufacturers and their market. And the two big jetliner primes are unquestionably concerned about the floor dropping out from under their rising production rates. But the fragmented nature of the air transport market sends multiple and at times conflicting signals.

Grim times

The airline industry is in rough shape. In August, the International Air Transport Association (IATA) reported that traffic growth hit a five-year low, a mere 3.8% in June. IATA also forecasts that losses at airlines could reach $6.1 billion this year, wiping out the $5.6-billion profit the industry made in 2007.

The problem is clear: a weak global economy and high fuel prices. This combination of high costs and stagnant demand was once known as stagflation, and although oil is currently falling back from its $147/barrel price to an almost tolerable level, there are few hopes for renewed strong economic growth in most of the world for the next year or two.

Slack demand is not caused by a slowing economy alone. Higher ticket prices—a necessity if airlines are to have any hope of keeping their heads above water—hurts demand, too.

Historically, the business- and first-class traffic has been the most resilient in the face of higher prices. But there are warning signs there, too. According to IATA, premium traffic (business or first class) fell 3.9% in March compared with March 2007. This was the steepest monthly decline in five years. Premium traffic also provides the overwhelming bulk of airline profits.

Capacity cuts are the only way for airlines to regain pricing power. There are three ways for the industry to cut capacity. First, they can simply reduce capacity by taking jets out of the system, a strategy pursued with a vengeance by U.S. and some European airlines. Second, mergers are a good way to cut capacity, but domestic and international regulations make these problematic.

The third way to cut capacity is to let carriers exit the business. More than 20 airlines have ceased flying this year, including Ohio-based Skybus, business-class carrier Silverjet, EuroManx, and the no-frills international Oasis Hong Kong Airlines. Others, most notably Frontier, have declared bankruptcy.

On top of the big economic concerns, previously minor issues are suddenly looming large. Politicians, particularly in Europe, are proposing onerous taxes and regulations on aviation. Emissions and other environmental concerns could play a role in constraining growth rates. There are even renewed political doubts about globalization. Whether it concerns market deregulation, global trade, or manufacturing supply chains, continued globalization is a key factor in maintaining industry health.

A fragmented market

The jetliner market is no longer a monolithic entity that follows a relatively consistent pattern of global shrinkage and growth. Rather, there are now five discrete segments, each one functioning with its own growth rate and vulnerabilities.

The one healthy segment is Mideast demand. Emirates is the healthiest international carrier in the world. Two other players—Etihad and Qatar—have emerged

Emirates is currently the healthiest international carrier.

Ryanair is planning to ground 20 aircraft this winter.

to follow in Emirates' footsteps. While they lack experience, they do enjoy virtually unlimited financial resources, many of them provided by governments.

Along with smaller regional players, these Mideast airlines now hold 15% of the world jet backlog by value. More important, they hold 25% of outstanding widebody orders by value.

The problem with this healthy segment is that it is effectively fratricidal. Most forecasts call for Mideast traffic growth to account for about 5% of global demand. The difference between this figure and the higher backlog figures is due to an ambitious effort to attract international traffic between non-Mideast markets. This means Mideast capacity growth is effectively taken from legacy carriers. It also means that Mideast jet orders will largely be filled at the expense of legacy jet orders.

The other airline market segments are European and Asian legacy international carriers, low-cost carriers (LCCs), U.S. legacy carriers, and emerging market carriers. Of these, the first group is by far the most exposed to the predations of the aggressive Mideast airlines. The global legacy carriers such as British Airways, Lufthansa, ANA, Qantas, and others are gradually ceding ground as Emirates, Etihad, and Qatar increase their global presence. This process is not a big problem as long as international traffic enjoys strong growth rates, but if a downturn is accompanied by a continued Mideast carrier push, the legacy carriers will suffer.

Unfortunately for the legacy carriers, they probably cannot do much about these aggressive new players. A trade complaint would likely have no effect. The only possible disruption to the new Mideast carriers' growth rates are radically cheaper oil prices and a war or terrorist event that destabilizes the region.

As for LCCs, they have some advantages and disadvantages relative to legacy domestic market players. They have the lowest cost structures, but they are also the most exposed to the most elastic traffic. As costs rise, they will certainly lose some of their market. Even the two most powerful LCCs have started to feel pain. In August Southwest Airlines announced its first monthly traffic drop since 2004. It also hinted that it might not add any capacity in 2009. Meanwhile, Ryanair says it will ground 20 aircraft this winter, equivalent to about 10% of its capacity.

Mideast carriers are responsible for 64% of the orders for the A350 XWB.

That leaves the U.S. legacy big carrier market. In June, these carriers announced plans to shrink their fleets by a combined total of over 250 planes, continuing a long string of capacity cut announcements. While they also need to replace hundreds of older, less efficient planes, it is safe to say they will not take more than a handful of new jets in the coming three or four years—certainly less than 10% of total world deliveries.

As for the two biggest emerging markets, China and India are showing serious signs of growth fatigue. Asian Pacific airline traffic growth has declined to an anemic 2.5% rate. The much-lauded Indian market has also been cut by over 50%, to about a 7% growth rate. In China, the end of fuel price controls will also hit airline finances, and therefore demand as well.

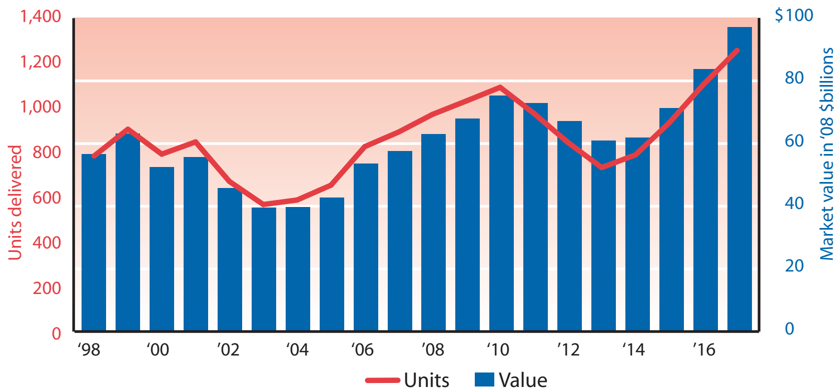
The other two emerging aviation markets, Brazil and Russia, are generally in good shape, thanks largely to the high resource prices that help drive economic growth in these countries. But they lack the same size and backlog numbers as the two bigger emerging markets.

While the cargo market is not large enough to rank among the big five air markets, it does affect total jet demand, particularly with residual values for used planes. Concerns about global trade, and whether it is vulnerable because of higher shipping and air freight costs, add a final layer of worry to a troubled jet market. According to IATA, world freight demand fell by 0.8% in June, the first market drop since May 2005.

These individual markets impact the two big jet manufacturers in very different ways. Airbus is generally more vulnerable. But the European company also has the best exposure to the fastest growth market.

This year's Farnborough Air Show confirmed a clear trend emerging over the past two years: The new aggressive Mid-

COMMERCIAL JETLINER HISTORY AND FORECAST



east carriers are definitely favoring Airbus. When the show ended, over 38% of Airbus's widebody backlog was held by Mideast carriers. These airlines also hold 40% of the A380 order book. Most astonishingly, 64% of the orders for Airbus's most important project—the A350 XWB—come from Mideast carriers.

As for Airbus's non-Mideast market presence, it is generally less impressive. It is heavily reliant on domestic market narrowbodies, which cater to the weakest traffic and the weakest players. Airbus has a strong LCC presence, for example, except with the two strongest LCCs, Southwest and Ryanair. It has a high level of exposure to the endangered emerging markets, with plans continuing for an A320 assembly line in China.

In North America, one of Airbus's biggest customers—United—is the weakest major carrier. Another, Northwest, is to be merged into pro-Boeing Delta. Only USAirways looks secure, but not particularly strong.

Boeing, by contrast, is far better exposed to international traffic, which is generally more resilient and profitable than domestic traffic. The strong-selling 777 and 787 will continue that trend for years to come. But again, Mideast demand will help sustain Airbus's widebodies against this strong Boeing product line.

Great numbers, for now

Despite the airline industry's rough shape, the two jetmakers continue to talk about boosting production rates. They also continue to complain that parts shortages and other supply chain difficulties have slowed efforts to increase those rates. Orders continue to be strong, with over 1,500 likely to be placed this year—a book-to-bill ratio of 1.5:1.

The Boeing 787 offers superior fuel efficiency and is hindered only by production problems.

Airbus and Boeing can take comfort most of all in their backlog—about 7,500 aircraft jets, split almost evenly between the two. Company officials admit that 25-30% of that backlog is at risk, but that still leaves at least 5,000 jets. Superficially, that is five years of production at current rates, but many orders cover deliveries after 2013. And there are few doubts that given lenient penalty terms, orders can be deferred at little cost to the airline.

Right now, there are four factors keeping production numbers high, and, for the next few years at least, rising. One is sheer inertia. This will definitely end if airline news remains bleak. But for now, planes in the pipeline are being built and delivered. The second factor is Mideast demand. Again, there is no guarantee that it will continue, but for the next few years it looks robust.

The third factor is the availability of financing. Airlines may be cutting capacity, but they are acutely conscious of the need to replace older jets with new fuel-efficient ones. While financing for aircraft is not quite as easy as it was a year ago, there are few problems lining up funding for new jets. Despite the capacity cuts, new production jets are retaining their value, and thanks to the Capetown Convention, they are easier to repossess in the event the customer goes bankrupt. Once again, new emerging Mideast lessors and finance providers will likely play a growing role in financing jet transactions.

Finally, there is the stimulant of new technology. The 787's superior fuel efficiency virtually guarantees a strong production ramp-up that is limited more by industrial constraints than demand concerns. A few years later, the A350 XWB should continue that effect, possibly followed by a 777 replacement or upgrade. If the C Series results in Airbus and Boeing introducing new or reengined narrowbodies, they will extend that stimulant process into the bottom half of the jetliner market.

Looking at these factors, and at the nature of the backlog, it is likely that jetmakers will continue to enjoy good times for the next two years. After that, it is quite likely that they will face tougher times. The nature of the downturn depends on oil and the global economy, two factors that Airbus and Boeing cannot affect.

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