Profitability and the air transport value chain – current market conditions and observations

Institute of Transport and Logistics studies
The University of Sydney Business School

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Observations on the air transport sector and some questions that they pose

- The commercial aviation industry has grown at a multiple of global growth rates and has been critical in linking the global economy.

- The commercial industry has been transitioning from a government controlled sector to a privately controlled sector – with some notable exceptions.

- The commercial aviation industry has been able to largely pay its creditors and debt providers – with again some notable exceptions – however providers of the capital have not received their returns.

- Airlines point out at that everyone else in the air transport value chain makes money apart from them – and this needs to change. They are correct however it is not all everyone else's fault.

- The emergence of a largely profitable lower cost sector has demonstrated there is another way – however being a lower cost airline has not guaranteed profitability or survival.

- How will the next stage of growth of the industry be funded? IATA says $4-5 trillion over the next 20 years. What are some of the challenges?
Aviation industry returns – usually enough for creditors and providers of debt – but not always

- The industry as a whole does not pay its way.

Return on invested capital in airlines and their WACC

Source: McKinsey & Company for IATA
# Aviation industry returns – many headwins buffet the industry

## Macro economic trends impacting airlines

<table>
<thead>
<tr>
<th>Fuel</th>
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<tr>
<td><strong>Fuel costs over $200 billion - 5 x 2003 levels</strong></td>
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<td>&quot;accounting for 33% of operating expenses at $110.0/barrel Brent of oil. &quot;</td>
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<td>Source: IATA press release June 2012</td>
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<th>Foreign exchange</th>
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<tr>
<td><strong>Volatility with little ability to manage directly</strong></td>
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<th>Europe</th>
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<td><strong>Slow recovery – significant restructuring going on</strong></td>
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<tr>
<td>&quot;These are positive results for the quarter with an operating profit of €245 million based on total revenue up 3.4 per cent and costs down 2 per cent. Fuel costs were down 3.9 per cent. &quot;</td>
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<td>Willie Walsh, IAG chief executive 30 June 2013 Quarterly report</td>
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<th>Competition</th>
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<td><strong>Impediments to consolidation</strong></td>
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<tr>
<td>&quot;the merger, which would result in the creation of the worlds largest airline, would substantially lessen competition for commercial air travel in local markets throughout the United States and result in passengers paying higher airfares&quot;</td>
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<td>Source: US Department of Justice</td>
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<th>Profitability/ Cashflow</th>
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<td><strong>Thin margins</strong></td>
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<td>&quot;We now expect the industry to generate net post-tax profits of $12.7 billion. The direction of change is positive but that’s still a very thin 1.8% margin on revenues of over $700 billion. &quot;</td>
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<td>Source: IATA press release June 2013</td>
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Aviation industry returns – Balance sheets of airlines have been hit hard

Global Financial Crisis $ million

- Delta: 7,296
- United: 2,625
- AMR Corp (American Airlines): 1,128
- US Airways: 640
- China Eastern: 426
- Ryan Air: 385
- China Southern Airlines: 269
- Scandinavia Airlines: 244
- Qantas: 152
- Thai Airways: 145

- $7,296 million — Delta primarily for goodwill ($6,939 million) triggered by significant decline in market capitalisation and high fuel prices at the time.
- $2,625 million — United primarily for goodwill ($2,277 million), triggered by high fuel prices, analyst downgrade of stock, credit rating downgrade and announcement to remove 100 aircraft from fleet.

- $190 million — Alaskan Air retire MD80 fleet
- $183 million — British Airways fleet asset impaired and discontinued operations
- $148 million — China Eastern impairment of fleet assets to market value
- $158 million — Ryan Air impair holdings of Aer Lingus
- $147 million — All Nippon impair fleet assets
- $135 million — JAL impair fleet
- $291 million — United impair intangibles and fleet assets
- $205 million — Scandinavian Airlines impair fleet
- $182 million — Delta impair fleet assets (50 seater aircraft)
- $121 million — Lufthansa impair aircraft assets
- $725 million — AMR Corp impair fleet assets (MD-80s B757s and B767s)
- $371 million — Air China impair fleet assets
- $319 million — Scandinavian Airlines impair fleet assets and holding in Spainair

2011/2012 — Euro Zone crisis (other announcements)
- $740 million Euro — Air France KLM announce major restructuring and derivative losses.


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What has impacted financial performance over recent years?

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- **Asset utilisation** – better management by airlines and technology improvements
- **Productivity of non-fuel inputs** – again good management
- **Fuel efficiency** – mainly technology driven
- **Lower cost market emergence** – has lifted the game and changed mindsets of management

**-**

- **Market structures** – heavy regulation
- **Low marginal cost of flying a passenger** – capacity fly’s longer even when airlines are in trouble
- **Supply chain structure** – eg airports and air navigation monopolistic
- **Airlines are working capital positive** – whilst a positive, can lead to airlines chasing marginal capacity
### Market structure – continued focus on alliance and joint ventures shaping networks

#### Least alliance cooperation

**Limited cooperating on specific routes**
- Interlining
- Frequent flyer programs
- Airline lounge access

#### Expanded cooperating to develop joint network

**Code sharing**
- Direct coordination on prices, routes, scheduling and facilities

#### Merger-like integration

**Antitrust immunity agreements**
- Revenue, cost and benefit sharing joint venture
- "Metal neutral" joint ventures

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<tr>
<th>Alliance</th>
<th>Principal US airline</th>
<th>Transatlantic joint venture partners</th>
<th>Transpacific joint venture partners</th>
<th>Other airline members</th>
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<td>Americas</td>
<td>Europe and Africa</td>
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<td>Avianca(a)</td>
<td>Continental Airlines</td>
<td>LOT Polish Airlines</td>
<td>Adria Airways</td>
<td>Air China</td>
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<td>COPA Airlines(b)</td>
<td>Aegean Airlines</td>
<td>SAS</td>
<td>Aegean Airlines</td>
<td>Air India</td>
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<td>TACA(b)</td>
<td>Croatia Airlines</td>
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<td>Blue 1</td>
<td>Air New Zealand</td>
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<td>TAM Airlines</td>
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<td>TAROM Romanian Air Transport</td>
<td>Garuda Indonesia(a)</td>
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<td>Korean Air</td>
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<td>Middle East Airlines(a)</td>
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<td>Cathay Pacific Airways</td>
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<td>S7 Airlines</td>
<td>Royal Jordanian Airlines</td>
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How does the industry grow

- Propensity for air travel appears linked to GDP ... However not on a linear basis
- As China, India and areas of ASPAC transition through income levels, trips dramatically increase

Source: Airbus, "Global Market Forecast 2011-2030"
Lower cost sector emergence

- Legacy carrier cost bases were 50% higher than legacy carriers 8 years ago
- This cost base gap is narrowing over time
- The lower cost sector has also turned now to ancillary revenues for its margin advantage
- Continual innovation, strong management and clean sheet approach have been critical to their success
Lower cost sector emergence (continued)

- KPMG analysis demonstrates the shrinking of the cost gap between lower cost and legacy carriers
- Management focus and learning are key drivers of this change

![Chart 3: Cost per ASK bridge between legacy and low cost carriers by category in 2011 (excluding impairment charges)](chart1)

![Chart 4: Reduction in the composition of cost disadvantage to legacy carriers over low cost carriers between 2006 and 2012 by cost category](chart2)
Lower cost sector emergence (continued)

- Prima facie whilst the lower cost sector is performing better, returns are still not where they should be

**ROIC and WACC by region and business model, 2004-2011**
Some observations on the current market

- The US market finally has shown that market forces may work, three major consolidations have occurred or are planned:
  - Delta and Northwest
  - United and Continental
  - US Airways and American (in progress)

- This however has not been received well by all and now the US Department of Justice (USDOJ) have stated “the merger, which would result in the creation of the world’s largest airline, would substantially lessen competition for commercial air travel in local markets throughout the United States and result in passengers paying higher airfares”

- Given every major US legacy carrier has had a chapter II visit – has the US consumer been paying a sustainable fare? US airlines returns for the last 5 years have been between 1.2% - 5.7% each year
Observations on the current market

- Australian market place is interesting – whilst prima facie we are back to two groups – we have six airlines domestically battling it out

- Qantas
- Virgin
- Jetstar
- Tiger
- Qantas Link
- Virgin Australia Regional Airlines
Some observations on the current market

Some upcoming accounting changes

- An accountant cannot talk without noting a few upcoming financial change that will impact airlines
  - More lease may come on balance sheet with new standard changes being debated. Over $100 billion in new balance sheet debt
  - Changes to the rules in how airlines can account for currency and fuel hedges – generally a positive for airlines

Final thoughts on the financing challenge …

- More reliance now on the asset being the security versus the airline
- More reliance on the export credit agencies to assist manufacturers in selling aircraft
- Diversification of funding base as demand changes – eg more aircraft into Gulf hub and Chinese carriers
- Whilst returns remain well below WACC, funding will always be a fundamental issue