Jetliners face a spotty market recovery

Judging by the two aircraft manufacturers' ambitious production plans, the world jetliner market is in the midst of a sustained up cycle. Despite the well-known financial troubles of the U.S. major legacy airlines, both Airbus and Boeing sound confident that the broader global market is in healthy shape, and in need of additional new-build aircraft.

But while there are some promising indicators of an air travel market recovery, the reality is that the industry is in extremely uneven shape. There are also strong indications of market volatility that call into question plans for long- and even medium-term production rate increases.

Big numbers; big problems

The manufacturers are somewhat tentative about their rate increase plans. Airbus has spoken of ramping up to 450 deliveries in the next two years, and is currently saying that it expects 2006 deliveries to be 15% over 2005. In May, Boeing announced ambitious plans for an increase in 737 rates to 31 planes per month, a 25% jump. It is also talking about a 777 rate increase, possibly to a record-setting 10 per month.

These optimistic moves come at a time of well-publicized financial horrors in the airline industry. Although traffic numbers and load factors have improved and orders have risen, the market is dependent more on profitability than on travelers. This profitability is demonstrably absent from the equation. After years of heavy losses, the world's airline industry looks set to lose $5 billion to $6 billion in 2005. These problems are largely centered on the U.S., where airlines have managed to lose $34 million on average each day through May.

It is important to note that the U.S. legacy airlines are not just ailing—they are also quite brittle. They have sold off many of their assets, particularly aircraft, to raise cash, and are increasingly becoming "virtual airlines." Some have even sold their fuel hedging rights (contracts to buy fuel at a preestablished price), a somewhat shortsighted move.

Basically, they have done everything they can to raise cash to keep their heads above water. And because they have less to offer as collateral for loans or as something for an equity investor to sell if the airline collapses, the terms airlines get for their capital are worsening.

ATA's bankruptcy filing shows the vulnerability of even low-cost carriers to a brutal market.

Because the carriers have little else to sell, this brittleness implies vulnerability, the prospect of a sudden collapse by one or more of them due to changing industry conditions. Continued high oil prices alone are a major cause of concern, particularly if they go any higher. And higher interest rates, due to ongoing U.S. budget and trade deficits, would make debt servicing and the cost of capital considerably more expensive.

If a broader economic downturn hurts traffic numbers and/or yields, that too might cause airline failures. There is a growing realization that the air travel market, from the standpoint of passenger demand and willingness to pay, might have peaked.

It is also worth noting that the U.S. legacy carriers have received about $10 billion in government aid since the September 11, 2001, terrorist attacks. But while lenient bankruptcy regulations are effectively a form of state aid, direct government capital injections are no longer a prospect.

Manufacturers are quick to point to the large numbers of planes absorbed by the U.S. low-cost carrier industry. But this market is small, by U.S. historical standards. Last year, Boeing delivered just 75 planes to U.S. operators, primarily Southwest and Continental; Airbus delivered 57, primarily to JetBlue, Frontier, America West, and Northwest.

Also, much of the manufacturer backlog is held by weak legacy carriers. According to *The Airline Monitor*, an industry trade publication, the 10 U.S. airlines that lost money in 2004 hold orders for

328 aircraft, of which 46 were scheduled for 2005 delivery. These numbers are comparable to the three U.S. carriers that earned a profit in 2004 (Southwest, Jet-Blue, AirTran). These profitable carriers hold orders for 348 jets, with 67 scheduled for 2005. And, ATA's October 2004 Chapter 11 bankruptcy filing shows that even low-cost carriers are vulnerable to a brutal market.

If there are multiple failures, there is also the real chance that, for the first time, new-generation jetliners will be dumped on the market. These planes will be irresistible, because of their low cost and youth, also cutting into the manufacturers' ambitious production plans.

Planes dumped on the market will also join the 1,500 aircraft that remain parked. Although only a few hundred of these are current-generation designs, at least 300-400 can be regarded as competitive and likely to reenter service. Any new additions to the available stock of used planes could actually create a "tipping point" effect, lowering prices to the level where numerous carriers change their minds and decide that used planes are a good alternative to continued new acquisition.

JetBlue is one of just three U.S. carriers that earned a profit in 2004.

High hopes abroad

Manufacturers are quick to point out that international carriers outside the U.S., primarily in Europe and Asia, are in considerably better health than their U.S. legacy counterparts. Whether this will be sufficient to justify the anticipated rate increases is another matter.

First, there is much truth to the view that non-U.S. carriers are healthier; even legacy flag carriers in Europe are in respectable shape. For example, British Airways, Europe's third largest airline, managed to post a profit in the fourth quarter of 2004, despite high fuel prices. And although Lufthansa, Europe's second biggest carrier, lost money last quarter due to higher fuel prices and low-cost competition, the extent of the loss, €116 million, was paltry by U.S. standards.

British Airways posted a profit in the fourth quarter of 2004, despite high fuel costs.

Most other non-U.S. carriers are either posting modest profits or nonthreatening losses. Air Canada, which emerged from bankruptcy in September, says it is on track to earn a strong profit in 2005. Air Canada's $3.5 billion (Canadian) market capitalization exceeds the four largest U.S. carriers combined. Most other non-U.S. carriers are either posting modest profits or nonthreatening losses.

There are important reasons for this. For one, Europe has seen a greater level of industry restructuring. Since 2001, there have been no major mergers in the U.S. airline business, and no major carriers have exited the industry. In fact, since 1992, just one legacy hub-and-spoke carrier, TWA, has left the business. As of this writing, US Airways and America West have announced plans for a merger, but this action depends heavily on external financing. This is a very different situation from a relatively healthy carrier, such as Lufthansa, absorbing smaller carriers.

By contrast, European carriers have seen considerable progress, and there are fewer barriers to market exit. Olympic Airways, Sabena, and Swissair have gone out of business. Lufthansa has absorbed Swiss, the reborn Swissair, and it may also absorb Polish flag carrier Lot. Air France and KLM have merged, and there is general agreement that more European mergers are on the horizon.

In addition, non-U.S. carriers have successfully emphasized international routes. European and Asian carriers are increasingly resigned to surrendering low-margin short-range routes to the low-cost carriers. In Asia, legacy flag carriers have even aided in the creation of these new discount players. In their place, they have focused on long-haul higher profit routes where they have more pricing power and the customer is more willing to pay for a premium level of service. This is a particularly key discriminator with Air Canada, which enjoys a higher percentage of long-haul routes compared with its U.S. industry counterparts.

Non-U.S. carriers also have never had a "pension overhang." While several U.S. carriers have succeeded in offloading their pension responsibilities, most notably US Airways and United, the remaining legacy carriers remain saddled with retirement payment obligations. Unless they enter Chapter 11 bankruptcy and then obtain court approval to nullify these retirement plans, they represent an ongoing financial drag. European and many other international carrier employees have

Lufthansa has purchased Swiss and may also buy the Polish flag carrier, Lot.

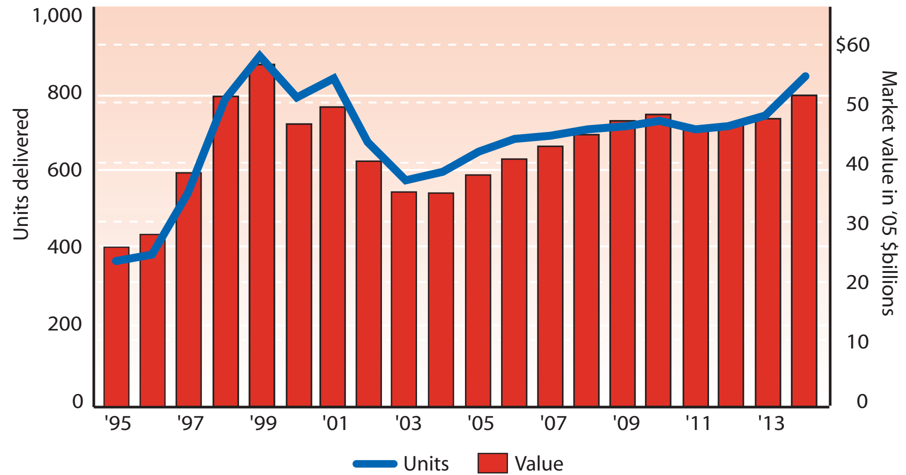
their retirement costs, and often their health care costs, covered by their resident governments.

Finally, since non-U.S. carriers are mostly newcomers to the private sector (and some Asian carriers remain in government hands) they have had fewer years to acquire crippling levels of debt.

However, there is no disguising the fact that the U.S. market is crucial to any sustained industry recovery. Of the 2,600 planes on backlog, approximately 1,800 are single-aisle models, primarily for domestic and medium-range markets. North American carriers hold 48% of the existing single-aisle backlog.

And just because non-U.S. carriers have their heads above water now does not mean they will keep them there. A few more quarters of mild unprofitability, or of greater unprofitability, might just convince Lufthansa or SAS to play it safe and defer aircraft deliveries.

COMMERCIAL JETLINERS HISTORY AND FORECAST



Strong downside

Aircraft values provide the most eloquent comment about the market's volatility. Availability of new equipment has gone down and lease rates for this equipment have gone up. This certainly implies a current need for capacity in certain parts of the world. Yet values of aircraft, even of modern types currently in production, have stayed relatively flat, suggesting an uncertain and volatile market, one unwilling to make long-term commitments to adding capacity.

This volatility could be exacerbated by greatly reduced jetliner assembly times. Both Airbus and Boeing have made great strides in cutting the number of days needed to build a jetliner. The old methods required many months to create a jet. New techniques, including greater outsourcing, moving production lines, and lean manufacturing methods, have reduced these times drastically (see "Leaning on lean solutions," June, page 32). After 1999, Boeing reinvented the way it builds aircraft, and can now assemble a 737 in just 11 days. This emphasis on efficiency has largely been repeated down the subcontractor supply chain.

These reduced times, accompanied by greater customer power to defer or even cancel orders, suggest that downturns could happen more abruptly than in the past.

It is also important to remember that the two manufacturers have motives of their own for wanting to deliver planes (and bring in revenue) now, even if it comes at the expense of future years. Both need cash for ambitious new jetliner development programs (Boeing for its 787 and perhaps 747 Advanced; Airbus for its A380 and A350). Boeing has always had to worry about satisfying investors; as EADS looks set to float additional shares in the next two years, Airbus will also need to start impressing the investment community. Airbus must also think about the weak dollar, and much of its currency hedge expires in the next year or two.

Air Canada emerged from bankruptcy in September and expects to earn a strong profit in 2005.

Teal Group's current 10-year (2005-2014) jetliner forecast (Airbus and Boeing only) calls for 7,279 aircraft worth $462.4 billion (in 2005 dollars). Our forecast for the next two years—the market's rate of growth—is more conservative than the manufacturers', for the reasons we just discussed: overcapacity at the U.S. majors and the strong risk of troubled carriers being forced to sell aircraft.

Yet in another sense, our numbers are optimistic, too. If the manufacturers do ramp up production to meet current short-term needs (real or illusory), then the next two years will see numbers well above our forecast. But then there is a strong chance that they would need to ramp down again, well below our numbers, after this need was satisfied.

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