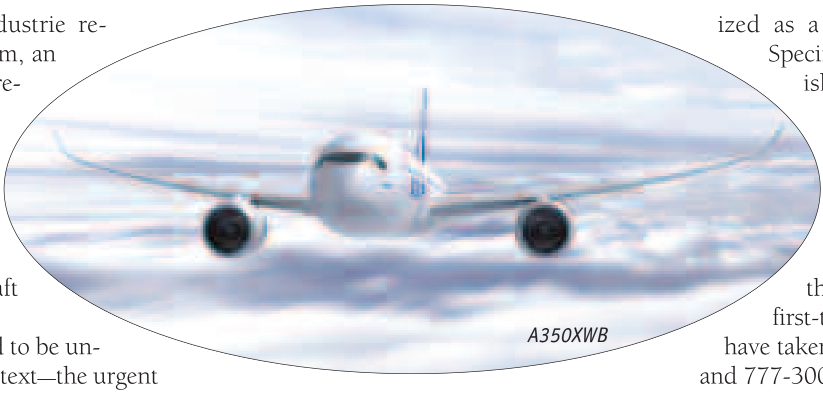
Airbus reinvents to reinvest

In February, Airbus Industrie revealed its Power8 program, an effort to reduce costs by restructuring the company and changing the way it builds airplanes. It also announced continued and unprecedented production increases for its most successful aircraft programs.



A350XWB

These measures need to be understood in a broader context—the urgent and essential need to sustain high levels of new product development to bring the A350 XWB to market. But the magnitude and timing of this requirement leave little room for error.

The requirement

The A350 XWB (extra-wide body) is the sixth incarnation of Airbus' efforts to reinvent its middle market product line. This 250/400-seat market segment, primarily driven by rapidly increasing international traffic, has been growing at a very strong pace. It now comprises over 45% of the jetliner market in terms of delivery value. We project it to grow to 50% of the market by the end of the decade.

While Airbus holds a strong position in this market with the A330, that 250/300-seat product is quickly being overtaken by Boeing's new 787 Dreamliner. Airbus' other midmarket product, the A340 series, has been plagued by higher operating costs relative to its competitor, the 777, and has suffered on the market.

Boeing 787

Development of the A350 cannot proceed at a leisurely pace. Demand for aircraft in this class has been extremely strong over the past five years, as evidenced by 500 up-front 787 orders and a record 777 backlog. In fact, there have been 1,500 orders for aircraft in this class since the A380 was launched in 2001. By contrast, after February's UPS cancellation, the A380 order book totals just 156 aircraft.

On the positive side, the first firm A350 XWB order was signed by Finnair in March, covering 11 planes. But the only other likely imminent customers are either secondary carriers or politically captive markets like Aeroflot. Worse, since the A350 became the more ambitious A350 XWB, several original A350 customers have either ordered 777s and 787s or announced plans to revisit their decision.

Much of the remainder of this middle market, at least for the next six to nine years, could commit to an aircraft in the next 18 months. There are several important upcoming airline competitions that could determine whether the A350 XWB has a place in the blue-chip carrier market, or if it will continue to be marginalized as a less competitive machine. Specifically, Air France/KLM, British Airways, Emirates, Lufthansa, and USAirways all have considerable requirements for aircraft in the 250/400-seat class.

If all of these carriers decide in favor of Boeing, they will join most of the other first-tier carriers in the world that have taken sizable positions in the 787 and 777-300ER. Airbus will be stuck in a permanent second place, and inferior pricing for its widebody products will hamper its efforts to generate additional new models.

Therefore, it is essential for Airbus to fund a credible A350 development roadmap, to assure potential customers that their aircraft will arrive as planned and on schedule. This credible roadmap is also needed to attract investors for Airbus' parent, EADS.

The investment challenge

Reinventing Airbus' entire midmarket product line will create unprecedented investment challenges. The likely $10-billion A350 XWB development bill would not be difficult under normal circumstances, but manufacturers typically make such investments once or twice a decade. Airbus, by contrast, is still in the midst of spending about $18 billion bringing its 550-seat A380 to market. This bill could even grow due to the program's cost overruns, delays, and the need to make penalty payments to customers waiting for aircraft.

Since the A380's launch, Airbus independent research and development (IR&D) spending has averaged over 8% of sales, which is extremely high for a commercial aerospace firm. This represents a major surge that is difficult to sustain. Yet to introduce the A350 XWB by 2013, this 8-9% level of IR&D expendi-

ture needs to continue, particularly since Airbus must also start work on a new narrowbody successor to its strong-selling A320 family. Even if this new narrowbody jet does not arrive until 2015, that means some development work must be funded starting around 2010.

By contrast, Boeing's new product development spending has not exceeded 6% of sales for more than 10 years. It has ramped up in the past two years to meet 787 and 747-8 development needs, but given a rising (and highly lucrative) widebody revenue base, the company is very well positioned for future product development. It can easily meet existing product development needs, and develop a 737 narrowbody successor, with an average IR&D level of less than 5% of sales.

In fact, if the company can maintain that 5% level, it will be able to introduce a major 777 upgrade, or an all-new 777 replacement using composite structures, just after the A350 XWB arrives.

The challenge of sustaining high levels of new product investment is the biggest issue confronting Airbus. It dwarfs the lesser (but significant) challenge of coping with an expensive euro and a weak dollar. After all, if currency concerns were overwhelmingly important, the A320 and A330 would not be selling in record numbers.

Funding the A350 is difficult enough, but there are serious structural changes under way at EADS. Several private sector stakeholders are withdrawing equity, most notably DaimlerChrysler. Injecting government cash to replace the private sector equity could create political headaches. To attract private equity, the company could be forced to continue to pay dividends.

In fact, DaimlerChrysler is demanding continued dividend payments, and still owns 15% of EADS (and controls 22.5% of the shares' voting rights). This money would be diverted from new product development initiatives.

In short, these EADS structural changes will likely make Airbus behave more like a publicly held company—like Boeing. And as the U.S. company's new jetliner funding history shows, companies in this business are lucky to sustain an IR&D level of 5% of sales.

Original plans called for Airbus' new product spending to ramp down after first A380 deliveries, in early 2006. This would have allowed Airbus to focus on satisfying shareholders while maintaining a 50+% market share position with a new product line. Yet thanks to the A380's marginal commercial relevance, the 777's victory over the A340, and Boeing's renewed commitment to the market in the form of the 787, Airbus has no choice but to press ahead and generate the cash any way it can.

Problems with the solution

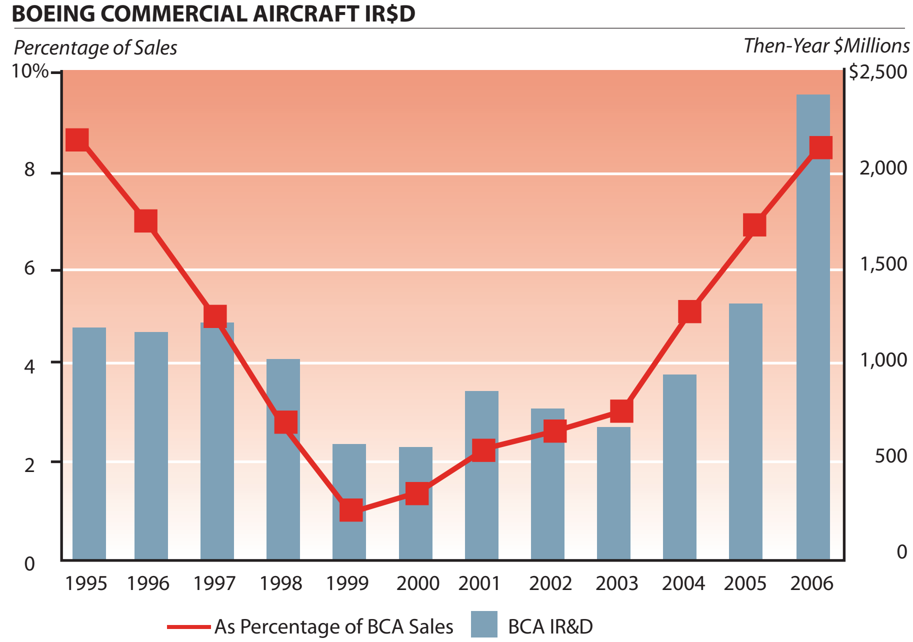
Airbus' most obvious method of funding the A350 is to increase production of its existing models. The A320 narrowbody family production rate, already headed to 38 aircraft per month, may go on to 40 per month. In March Airbus chief commercial officer, John Leahy, announced that the A330/340 widebody rate, already scheduled to rise to nine per month, would possibly be raised to 10.

But even though the A330 has been a notable success, it will shortly be eclipsed by the 787. The newly launched A330-200F freighter will help for a time, but it is unlikely that A330 numbers can be sustained beyond 2009. Meanwhile, the A340 backlog is dwindling. Airbus' order book states it at 60 aircraft, but this includes some highly dubious orders, such as 18 A340-600s for Emirates. That airline announced in 2006 that it canceled this order, and that it had never actually placed firm orders for all 18 aircraft.

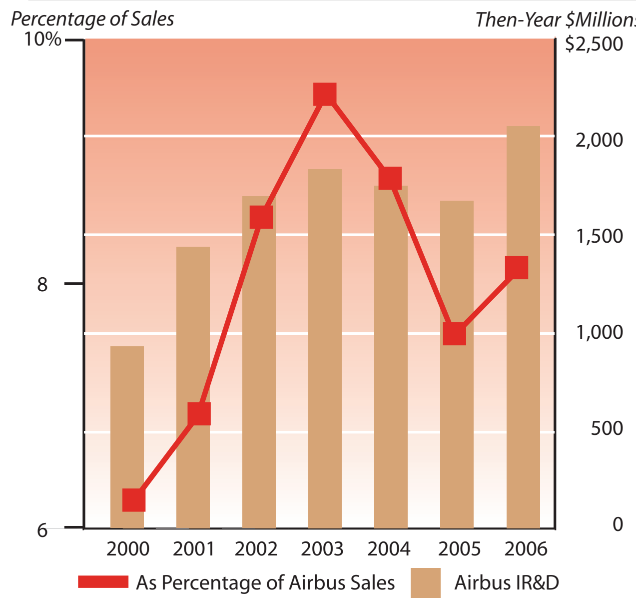
Although A319/320/321 sales are strong, they are unlikely to justify more than two or three years of production at the new peak rate. Single-aisle plane deliveries have already reached 50% of the jet transport market by value of deliveries, the first time that has happened since the advent of the twin-aisle era. Since international traffic is growing in importance to carriers, the balance will likely shift back in favor of larger, longer ranged jets by the end of the decade.

The A320 family backlog stands at 2,000 planes, but this too includes some soft orders, such as 65 aircraft for Skybus, a highly uncertain new startup carrier based in Ohio. In fact, about 20% of the

BOEING COMMERCIAL AIRCRAFT IR$D

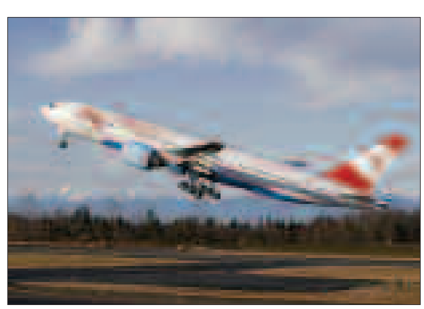


AIRBUS IR&D



A320 family order book can be regarded as highly speculative.

Clearly, production ramp-up plans can only provide a minority part of the resources Airbus needs to develop the A350. Power8 is a more important initiative, with a longer potential life span than the announced production increases. Its goal is to attain €2.1 billion in annual cost savings, generating €5 billion in cash by 2010.



Boeing 777

If this ambitious objective is successful, that means Airbus would be more thaf halfway toward paying the A350 XWB development bill. Power8 calls for job reductions, workshare reallocation between member countries, and possible plant divestitures.

The very need to lay off up to 10,000 workers in the midst of a tremendous boom jetliner market and unprecedented production rate increases illustrates the huge funding challenge for Airbus and the A350 XWB. It is a paradox that could result in the most immediate problem with Power8: the likelihood of industrial action. Already Airbus workers have announced strikes, slowdowns, and protests. Left unresolved, these union grievances could disrupt Airbus' lofty new aircraft production goals.

The clear objective of Power8 is for Airbus to copy Boeing, and become a systems integrator. That would mean outsourcing as much structural work as possible to partners and vendors. This can be accomplished by spinning off Airbus factories, or by transferring work from Airbus factories to outside companies such as GKN, Spirit AeroSystems, or Vought Aircraft.

But this goal produces an even bigger problem with Power8: disagreements between the member countries. France has an equity stake in EADS, and expects returns, in the form of jobs and technology. Germany is acting to protect its industrial investment, too. Both countries have announced possible further equity investments, as a defensive measure.

Even the U.K., which has no government stake in Airbus and no national corporate stake either, has threatened to hold up defense contracts to EADS if significant Airbus work is withdrawn from U.K. factories. But since BAE Systems divested its 20% stake in Airbus last year, those defense contracts represent the U.K.'s last line of defense against Airbus work and jobs reductions.

Assuming Airbus can overcome these considerable labor and political difficulties, Power8 will do its part to create the A350 XWB. Whether it arrives on time in 2013 or a year later, this plane is the key to maintaining Airbus as a manufacturer of jetliners in all major market segments.

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