Uncertainties lurk in jetliner market

In May, Airbus CEO Noel Forgeard announced that anticipated jetliner production for this year would be slightly more than 300 aircraft, up from the previous estimate of just under 300. More impressively, the company also said that narrow-body production would rise by about 20% in 2005, with further increases possible that year. The A318/319/320/321 narrow-body family typically represents 75% of total Airbus output.

That Airbus forecast followed an April Boeing announcement that it was seeing upward pressure on aircraft production rates. Although Boeing's 2004 jetliner output will only slightly exceed last year's production—285 planes, up from 281—the company raised its 2005 forecast to at least 300, from an earlier prediction of 285. It also hinted that further rate increases were likely.

These optimistic production rate announcements reflect a belief that the low point of the jetliner business cycle has passed—that the world's air travel troubles are over. In fact, a comparison with the last cyclical low point—1995—indicates that this down cycle has not been all that harsh. Last year's 586 deliveries, worth $35.5 billion, represent a much better low point than 1995's 379 deliveries, worth $25.5 billion (both these values are in 2004 dollars).

Yet an examination of the world airline business indicates that further industry changes are possible. This injects a strong element of uncertainty into any jetliner market outlook.

Delta, United, and US Airways are all currently facing serious financial woes.

Airlines: Change, or collapse?

It is difficult to find the jetliner manufacturer's level of optimism reflected in the airline industry today. While Europe's and Asia's markets continue to grow, their fleets are relatively young, and demand for aircraft has been somewhat stable over the past few years. The huge North American market, with its aging fleets, is still the best hope for jetliner deliveries growth. U.S. carriers still operate 41% of the world's jetliners.

Yet the situation is grim for all but a few North American players. The six biggest U.S. carriers lost $7.4 billion in 2002 and $5.3 billion in 2003. Traffic numbers have increased over the past 12 months, but this has been at the expense of yields. U.S. industry revenues rose 10% in the first quarter of this year, yet losses still came to $1.6 billion.

Rising fuel prices have obliterated any remaining hopes for an airlines profit recovery this year. Financial weakness has prevented carriers from hedging more than a small percentage of their fuel needs. Other than Southwest, no U.S. major has locked in more than 50% of its fuel requirements for this year.

The industry's woes are currently concentrated in a handful of serious problem carriers. US Airways is struggling to avoid a second, and probably fatal, move into Chapter 11 bankruptcy. United has had little success in arranging financing to exit Chapter 11, which could necessitate drastic downsizing, or other harsh changes. Delta, long regarded as the healthiest and most fiscally conservative hub-and-spoke major carrier, has begun openly speaking of entering Chapter 11. And abroad, Air Canada, Alitalia, and Swiss International face extremely uncertain futures, with talk of major restructuring or outright liquidation.

What will become of these six carriers? It remains very difficult to kill an airline. Chapter 11 is a powerful protective maneuver, particularly when accompanied by government aid. Despite the industry carnage, the only outright casualty has been Belgium's Sabena. Swissair went bankrupt, only to be reinvented as equally troubled Swiss International. The Air France/KLM merger, consummated earlier this year, so far looks more like a financial arrangement than an operational move designed to reduce capacity.

And in the U.S., despite an economy that increasingly revolves around concentration and critical mass, only one legacy hub-and-spoke carrier—TWA—has exited the market in over 12 years. In short, the airline industry still has barriers to exiting

The demand for new aircraft is coming primarily from new, low-cost carriers such as JetBlue and easyJet.

that are much higher than its barriers to entry.

That the industry has seen relatively little restructuring so far in this crisis should not imply optimism. It could mean that the worst lies ahead. Recent efforts by U.S. carriers to obtain relief from the government have gone nowhere. In June, Congress rejected United's request for a loan guarantee to assist in the carrier's restructuring. In the aftermath of the September 11 terrorist attack of 2001, the U.S. government has provided about $10 billion in cash relief to the airlines. Shutting off this source of cash could prove a strong catalyst for change.

Jetliner deliveries in 2003 to the big legacy airlines were predictably light. Last year, deliveries to the above six troubled carriers, which again can be regarded as the industry's biggest problem companies, came to 19 (17 from Airbus, two from Boeing). Delta, living up to its conservative image, did not take a single jetliner.

The two manufacturers are acutely conscious of the changed landscape in the airline industry, and have learned to live in the new environment. The decline in deliveries to the majors has been accompanied by strong demand from the fast-growth low-cost airlines. Deliveries to veteran low-cost Southwest, and to the six big new low-cost carriers—Air Tran, easyJet, Frontier, JetBlue, Ryanair, and WestJet—came to 78 planes in 2003 (28 from Airbus, 50 from Boeing). These carriers have also provided the majority of new orders over the past two years.

Meanwhile, a look at the fleets of the six most troubled carriers listed above reveals large numbers of relatively new planes. Delta has 71 737NGs. The other five carriers have over 420 Airbus narrowbodies, including over 120 A319/320s at United alone. Focusing on the newer equipment shows this is primarily a narrowbody problem, although the carriers have numerous older widebodies. And dozens of late-model A330s and A340s could produce some temporary problems for Airbus.

Looking at the jetliner market over the past few years, used aircraft availability has not been a problem, although this could change. Since the industry's troubles began in 2001, there has been a relatively consistent number of used aircraft in storage—about 2,000-2,500 jetliners. Yet as of June, only about 150 have been types that are in production, with only a few hundred more economically useful models. The majority of stored planes are over 20 years old and will likely be scrapped. And values of new equipment have remained relatively stable, with mostly earlier models suffering precipitous price drops.

Meanwhile, for airlines fortunate enough to need aircraft, new planes are the option of choice. As just mentioned, the fast-growth low-cost carriers are indeed taking new planes. In contrast to earlier startup carrier efforts, the last five years have not seen such companies opting for used aircraft. Even the last-generation startup ValuJet, which operated old DC-9s, has successfully reinvented itself as Air Tran, with dozens of new 717s and 737NGs.

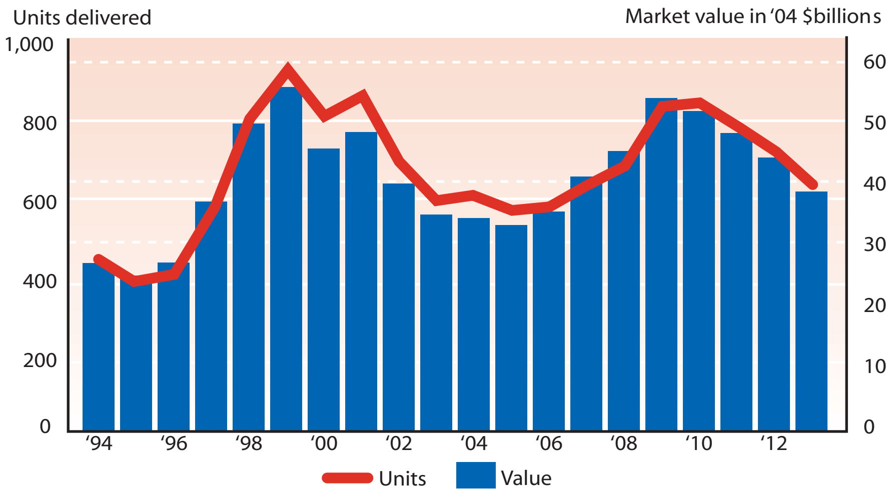
There are many reasons these companies prefer new aircraft, but only three primary reasons. First, later model narrowbodies are simply more capable. Economically efficient 150-seat planes with transcontinental range are a feature of the current generation. Second, the concept of a single-type fleet has become a mantra among low-cost carriers, with lower training, logistical, and operational cost and complexity. Large block purchases of new aircraft are the best way to attain that single-type fleet goal.

And finally, new airlines have found it relatively easy to obtain financing from manufacturers, banks, or lessors. After all, the new low-cost carrier business model is clearly successful, and even if financing new carriers means hurting other legacy carrier customers, it is a better outcome for manufacturers or lessors than losing market share to a competing manufacturer or lessor.

Despite this rosy situation, there is an obvious problem. What happens to aircraft values and demand for new aircraft if large numbers of new-generation planes do come on the market? If large numbers of the 600+ relatively new aircraft at the six troubled airlines are made available, an airline's decision to acquire new or used planes might shift in favor of used planes. It's one thing for a carrier to choose between new A320s or 737NGs and a mixed fleet of older 727s or DC-9s, or even MD-

Reinvented AirTran has dozens of new 717s in its fleet.

COMMERCIAL JETLINERS: HISTORY AND FORECAST NEARING THE LOW POINT



80s or 757s. But what if the choice were between new A320s or 737NGs, and used A320s or 737NGs with the same capabilities at significantly reduced prices?

Also, airline industry failures could have a chilling effect on finance for carriers that still wanted new aircraft. One reason that carriers—even financially troubled ones—have been able to obtain financing for new planes is that financiers like the historically high level of government support for airlines. This support effectively serves as an asset value guarantee, ensuring that very few carriers actually fail, and keeping aircraft values from drastically falling. But if financiers see this de facto government guarantee diminish, they may change the terms offered to airlines seeking to pay for new equipment.

Therefore, the outcome of airline industry restructuring plays a major role in determining new jetliner demand in the coming few years. There have been a lot of successful start-ups, and no failures, resulting in serious overcapacity. If the past three years of government intervention and bankruptcy maneuverings have protected carriers from the worst part of a perfect storm, that would be welcome news. But it is just as likely that these steps have merely forestalled the inevitable restructuring, which will now take its toll on jetliner purchase decisions.

Looking ahead

For our forecast, Teal Group has no choice but to assume a continuation of business as usual, with more relatively painless airline industry restructuring and no major drops in aircraft values. However, we still believe the low point of the market is yet to come, with a slight drop in 2005 and no sustained recovery until 2007. In all, our 10-year forecast calls for 6,792 large jetliners (100 seats and above)—all Airbuses and Boeing planes, excluding Bombardier and Embraer—worth $432.6 billion (in 2004 dollars).

Yet the next few years are unlikely to look like our forecast, which offers an unlikely middle-of-the-road scenario. The reality is likely to follow one of two courses: no major industry changes, in which case the manufacturers' estimates will be accurate and Teal Group's numbers will be low, or a significant change in airline fortunes and aircraft values, in which case both the manufacturers' and current Teal Group forecast numbers could prove somewhat high.

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Correction: Several photos and captions are misplaced in the article "Life after Comanche" in the June issue (page 10). The lower photo on page 10 is an early Apache rather than the Comanche that was meant to be placed there; the lower photo on page 11 is also an Apache, not an A/MH-6, which can be found on page 12. The Web version, found at http://www.aiaa.org/aerospace, is correct.

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