Into the Great Wide Open

2018 New Year Industry Review

Dick Forsberg, January, 2018

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Dick Forsberg has over 45 years' aviation industry experience, working in a variety of roles with airlines, operating lessors, arrangers and capital providers in the Disciplines Of Business Strategy, Industry Analysis and Forecasting, asset valuation, portfolio risk management and airline credit assessment.

As a founding executive and Head of Strategy at Avolon, his responsibilities include defining the trading cycle of the business, primary interface with the aircraft appraisal and valuation community, industry analysis and forecasting, driving thought leadership initiatives, setting portfolio risk management criteria and determining capital allocation targets.

Prior to Avolon, Dick was a founding executive at RBS (now SMBC) Aviation Capital and previously worked with IAMG, GECAS and GPA following a 20-year career in the UK airline industry. Dick has a Diploma in Business Studies and in Marketing from the UK Institute of Marketing is a member of the Royal Aeronautical Society and also a Board Director of ISTAT (The International Society of Transport Aircraft Trading).

Introduction

The start of another year provides an opportunity to reflect on the past 12 months and suggest some themes for consideration in the year ahead. Over the coming months, Avolon will be expanding further on topics likely to affect our industry with the objective of stimulating informed debate amongst our peers and colleagues.

Looking back over the fifty years since the Concorde was rolled-out, a good deal has changed, but the steady advance of technology means that new models and variants continue to see the light of day. 2017 saw the first deliveries of the 737-8MAX and the A321neo, although not the A350-1000, plus first flights for the A330neo, 787-10, A319neo, 737-MAX9, E195-E2 and C919. Boeing announced the 737-MAX10 and continues to evaluate the potential for a new middle-market aircraft for the mid-2020s.

Fifty years ago, global passenger traffic was passing the 300 million mark. In 2017, over 4 billion passengers travelled on 36.8 million flights connecting 20,000 city pairs. And despite a rocky few years, a third of global trade by value still moves by air.

Strong Fundamentals

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The industry heads into 2018 in rude health – according to IATA, global passenger traffic will have increased by 7.5% in 2017, a fraction faster than in 2016, with a still solid 6% increase forecast for this year. A 9% increase in freight traffic last year has underpinned the long-delayed recovery in the cargo market.

A billion passengers have been added to the global airline networks in the past five years. Much of this new volume is tourism driven. IATA reports an almost 6% rise in tourism expenditure in 2017 and expects this to top 9% this year. Clearly, with global GDP growth averaging little more than 3%, the growth multiple is still well above the long-run average, confirming that other factors now have a significant influence on passenger demand.

Ticket price will clearly be high on the list of influencers and is benefitting as the market continues to experience relatively low and stable fuel prices. The impact of fuel has moderated from being 35% of total airline operating costs coming out of the last downturn to less than 20%, although we should not lose sight of the fact that, whilst the price of a barrel of WTI oil has increased by a modest 6% since the start of the year, the high:low range was almost 35% and volatility here presents a challenge for non-hedged airlines when setting fares for future travel.

Two other factors are having an even greater influence on demand. This first of these is the sharply rising availability of affordable seats through the rapid growth of LCCs, especially in emerging domestic and regional markets, bringing air travel within reach of ever growing sections of the population. The second factor is these populations themselves and their demographics, where increasing economic wealth is expanding the so-called middle classes, many of them in the millennial age bracket and increasingly looking for “experiences” as they spend their discretionary income.

Strong Fundamentals

Continued

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The geographic characteristics of many of these emerging markets, such as China, India, Indonesia and the Philippines, further increase the attraction of air travel over surface transport, which is often slow, irregular and in many cases not much cheaper than an air fare.

We are finally seeing a meaningful recovery in the air freight market, with IATA reporting 10.6% year on year growth for 2017. This takes the overall traffic increase since the start of the global financial crisis to 26%, a 2.3% average growth rate which conceals absolute declines in four out of the past ten years. Nevertheless, the number of western jet freighters in storage has fallen by 15% over the past year and is 50% below the level seen five years ago.

Despite the steady rise in aircraft deliveries, capacity is still increasing more slowly than traffic and load factors continue to rise, with average passenger seat utilisation above 81% for the year and peaking at a remarkable 84.5% during the months of July and August.

All of these positive indicators have contributed to another stellar year of global airline profitability, with IATA estimating $34.5 billion of net profit, close to the levels of 2015 and 2016, and with a forecast step up to $38 billion in 2018. These levels represent an average net margin of 4.6% and a ROIC approaching 10%, however, this result must be caveated by the fact that almost half of the profit is still earned by North American carriers and that, apart from Europe, margins in other regions are below – in some cases well below – the average.

Industry Cycles

The question of the timing of the next cycle downturn remains a hot topic across the industry, along with a broader debate as to whether there is still a cycle to worry about. Avolon remains firmly convinced that the industry remains cyclical, despite the growing influence of non-GDP factors on growth rates.

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The current economic cycle has now lasted over eight years, two years more than the average of all post war recessions. However, time based representations of world growth cycles are an over-simplification for a complex system such as the global economy. Lower growth rates in this economic cycle imply that "economic slack" is being absorbed more slowly relative to previous cycles, suggesting that this cycle has some way to go, with remaining lifespan measured in years, not quarters.

From a lessor's perspective, the economic growth cycle does not have a significant bearing on aircraft leasing so long as lessors can continue to fund their capital commitments. Due to the long-term nature of lease contracts, which extend beyond the normal business cycle, lessors are insulated from periods of low growth. The past twelve months have underscored the availability of funding to the lessor community, with record number of new aircraft being financed through this channel.

The OEMs

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Preliminary figures for 2017 suggest that total commercial jet deliveries will be at or slightly above the 2016 total as the underlying upward trend in aircraft production rates was masked by GTF engine issues on the A320neo programme and by supply-chain problems on the A350. Improvements are expected for both in 2018, although a full return to normal may take most of the year. On the A320neo program, Pratt & Whitney have lost their first mover market share advantage and, although the LEAP engines have not had a flawless service entry, Pratt face a tough fight to move the market split back close to 50/50.

Unofficial data for orders placed during the year indicate an increase of around 10%, to approximately 2,300. Within the total, mainstream single aisle types netted 20% more orders, whilst widebody orders declined by 20%. Amongst the latter, the A380 programme looks increasingly under threat, with no orders in 2017 and a diminishing backlog that has already forced a production rate cut to less than 1 per month next year, with potential to go lower still.

The headline stories for 2018, however, will continue to feature the middle-market segment and the CSeries. The former may or may not result in a launch announcement from Boeing, but both OEMs will be exploring potential new or existing solutions to fill the gap in the market – whatever that is determined to be. The future of the Airbus-Bombardier alliance to re-boot the CSeries programme and save it from what is widely seen as sour American grapes will be determined during 2018 in a combination of regulatory and legal processes that began with International Trade Commission hearings in the week before Christmas. What would have been a prediction that Boeing and Embraer would also seek closer ties has been overtaken by a formal announcement of discussions, however it is unlikely that either Bombardier or Embraer will be totally subsumed by the larger OEMs.

With senior management changes at both Airbus and Boeing, the world is watching to see how the new teams position their businesses and product lines for future competitive advantage. Arguably, Airbus faces the greater challenge with more widespread changes at the top of the organisation and, specifically a new hand shaping sales strategy after almost a quarter of a century, with the choice of Eric Schultz to replace John Leahy suggesting that closer relationships could be forged with engine OEMs.

Financing Trends

Lessors are unlikely to face a liquidity shortage in 2018, although economic deployment of capital will remain challenging for some.

As the demand for delivery financing continues to rise, approaching $140 billion in 2018, liquidity remains plentiful, diversified and generally well-priced, all of which is supporting a number of emerging lessors on their path to reaching a critical mass.

Access to secured bank lending is still a mainstay of delivery financing, but alternative debt capital markets products are increasingly making their mark. ABS issuance exceeded $6.6bn in 2017, financing 331 aircraft and 56 engines in 12 transactions. The capital markets also closed more than $2bn in lessor private placements during the year, with new investors continuing to be attracted to the sector.

Lessors are unlikely to face a liquidity shortage in 2018, although economic deployment of capital will remain challenging for some. However, as interest rates continue their gradual rise, it will become increasingly difficult to sustain the sportier SLB terms that have been reported and that segment of the leasing market will, in time, revert to more measured activity. Expect also to see a further increase in the levels of assets under management for third party investors.

Fearless Forecast

Liquidity from private and fixed income investors will continue to increase, with Asian capital playing a growing role.

Looking out over the next 12 months, then, a number of predictions can be made with a reasonably high degree of confidence:

- Passenger traffic growth will continue to perform measurably above trend, led by emerging markets
- OEM deliveries will get back on track and continue to increase in number and value
- Lessors will remain the largest funding channel, although SLBs will remain largely the domain of emerging, or recently emerged, players
- Liquidity from private and fixed income investors will continue to increase, with Asian capital playing a growing role
- Further modest increases in interest rates will have little immediate impact on aircraft supply and demand

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