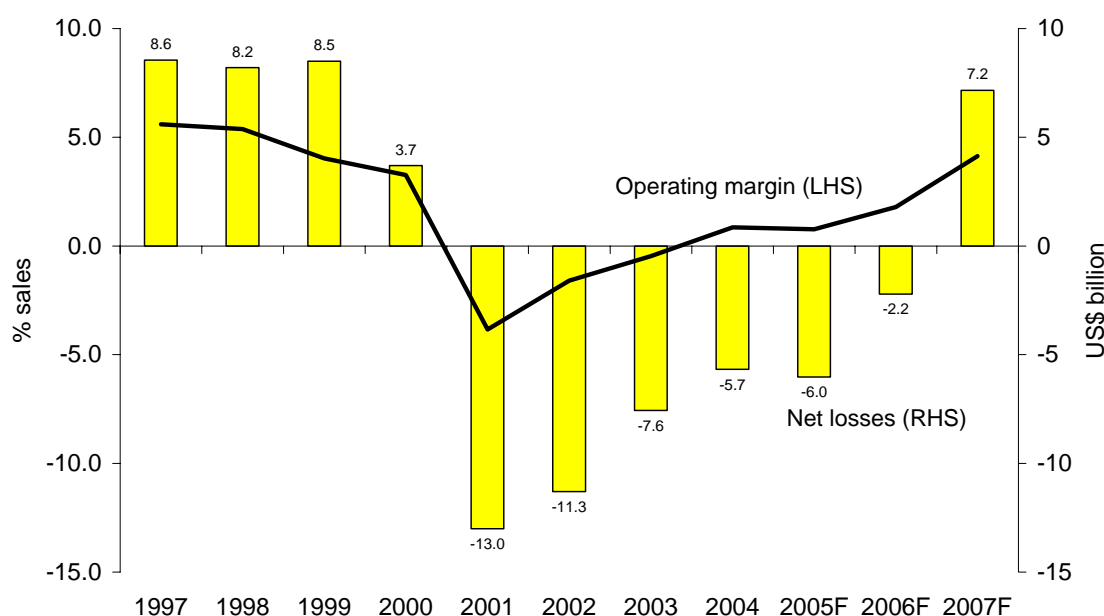


# NEW FINANCIAL FORECAST

March 2006

## BOOST FROM STRONGER ECONOMIC GROWTH

- IATA's latest forecast of industry financial performance shows significantly **reduced losses of \$2.2 billion in 2006 and increased profits of \$7.2 billion in 2007**, largely as a result of stronger economic growth prospects in Europe and Asia. Stronger economic growth will keep oil prices higher for longer, and these are now expected to average \$57 a barrel this year, but the beneficial impact on revenues more than offset higher fuel costs.



- Operating margins are forecast to reach 4% in 2007, which is not far from late-1990s performance. However, this implies a return on invested capital of just 3% which is far below the 7-8% necessary to pay investors what they would expect from investments in other industries of similar risk. The industry still cannot cover its cost of capital. The **imperative to cut costs** and enhance premium-revenue streams will remain.

## SIGNIFICANT CHANGES SHAPING THE FORECAST

- Economic growth** was stronger than expected at the end of 2005 and early this year, particularly in Europe and Asia but also in the US. Growth forecasts for 2006 have been raised which has boosted passenger and freight traffic volumes;
- Stronger growth coupled with capacity reductions in US markets has **increased pricing power**. In other regions pricing power remains weak, as deregulation opens new markets to competition and aircraft orders add to capacity. As a result N. America benefits from the largest improvement in financial performance;

- Stronger economic growth will also keep **oil prices** from falling significantly. The market consensus has increased from a forecast average \$53 a barrel in 2006 to \$57. With a \$15 refinery margin on top that implies a barrel of jet fuel will cost an average \$72 a barrel this year, higher than last year's \$71;
- ICAO have **revised** up net losses in 2004 from \$4.2 billion to \$5.7 billion. Our forecast for 2005 of net losses totalling \$6 billion is close to current estimates – excluding United Airline's fourth quarter reorganisation expenses. As a result cumulated **net losses for the industry over 2001-2005 now total \$43.6 billion**.

## CAUSING IMPROVED FINANCIAL PERFORMANCE

- As a result we have reduced our forecast for **global commercial airlines system-wide** net losses from \$4.3 billion to \$2.2 billion this year. In 2007 we expect a return to net profits of \$7.2 billion, up from our November forecast of \$6.2 billion;
- The largest improvement is forecast to benefit **N. American airlines**. This is partly due to cost reductions made possible by Chapter 11 bankruptcy arrangements. More significantly it is due to capacity reductions which, as well as cutting costs, are increasing pricing power and operating profitability.
- In **other markets** pricing power is under pressure from increasing market deregulation and competition plus the additional capacity coming on stream from last year's record aircraft orders. Providing some offset to this yield dilution will be a boost to premium traffic growth, from stronger economic growth and business confidence, which will benefit those network airlines with extensive long-haul exposure;
- **Asia-Pacific airlines** continue to generate the largest absolute profits in the industry, and are forecast to continue to do so, benefiting from strong regional growth and the cost advantages that come from low labour costs and long average route lengths. The oil shock has also reinforced the position of airlines with the strongest competitive advantage and balance sheets. We expect this divergent performance to continue this year and next;
- This performance divergence has also been apparent in **Europe** where the industry has been able to improve its profitability over the past year, largely due to fuel hedging of 70-80% among major airlines and in spite of sluggish European economic growth. This year airlines will be paying more for their fuel as existing hedging programmes mature but resurgent economic growth in the region should boost profits in 2007;
- Airlines in the fast growing regions of the **Middle East** and **Latin America** are small relative to the more developed regions, but we are forecasting that their profitability will double over the next two years.

Industry net profits, US\$ billion	2004	2005	2006	2007
<b>Global</b>	<b>-5.7</b>	<b>-6</b>	<b>-2.2</b>	<b>7.2</b>
<b>Regions</b>				
North America	-10	-10.8	-5.4	1.1
Europe	1.1	1.8	1.4	2.1
Asia-Pacific	3.4	2.9	2	3.1
Middle East	0.2	0.3	0.2	0.5
Latin America	0.1	0.2	0.2	0.4
Africa	-0.4	-0.4	-0.6	0.0
<b>Markets</b>				
Domestic (US only)	-9.4	-10	-5.5	0.9
International (IATA members only)	2.9	2.7	2.1	5.1
Other	0.8	1.3	1.2	1.2

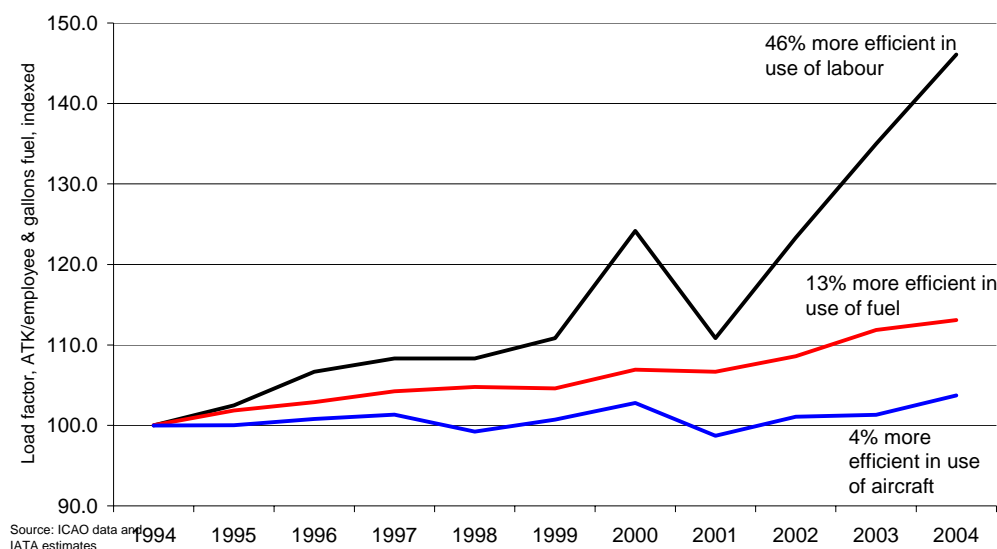
Source: ICAO data to 2004. IATA forecasts 2005-2007.

- **International markets** continue to be more profitable than the highly competitive and contestable domestic markets in the US and the EU. In spite of increasing capacity on some of these markets from US and Middle Eastern airlines we forecast strong growth to enable a doubling of net profits in the next two years.

## KEY FINANCIAL PERFORMANCE INDICATORS

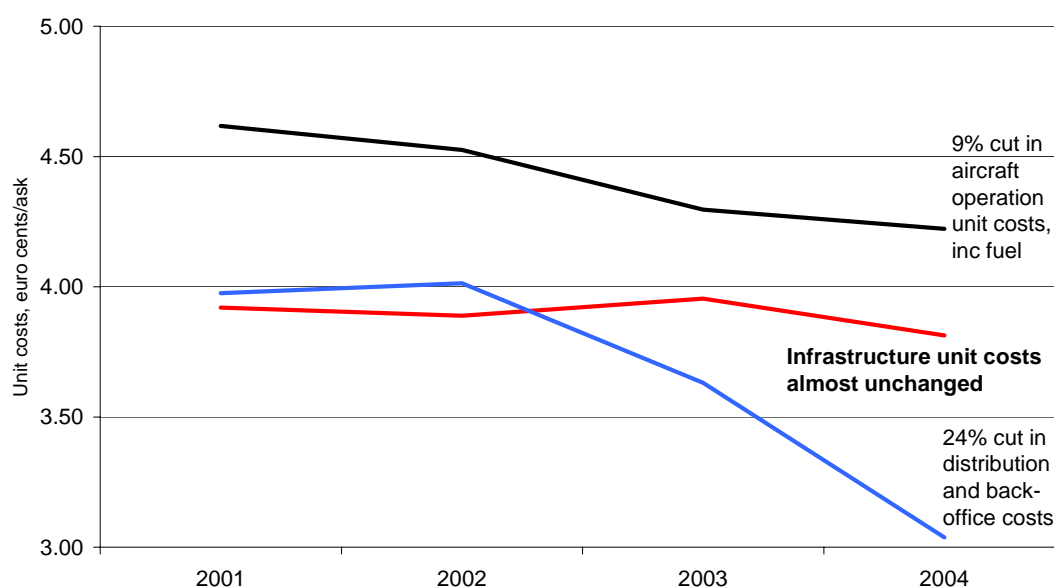
- There has been a substantial **improvement in efficiency** in the global commercial airline industry which has put financial performance closer to break-even and profitability. This can be seen with airlines three largest cost categories. Compared to a decade ago airlines are 46% more efficient in their use of labour, 13% more efficient in their use of fuel and 4% more efficient in their use of aircraft;

### Productivity for global commercial airlines



- This is reflected in **unit cost performance**, despite inflation in salaries and in the price of other key inputs not least fuel. Excluding fuel, unit costs for the industry globally fell 7% over the past ten years in US dollar terms. If the impact of a falling US dollar is excluded then we estimate non-fuel unit costs have been cut by 9% since 2001;

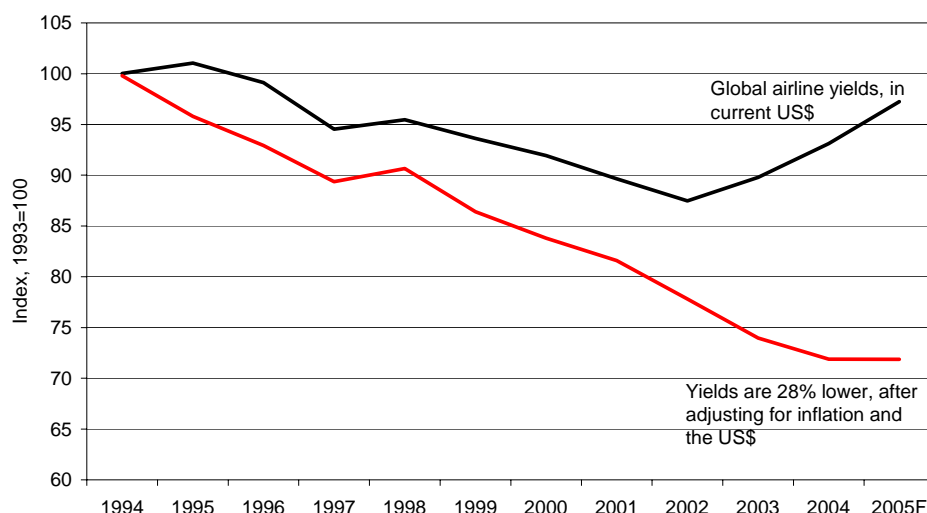
### Unit cost performance for European network majors, short-haul



- The chart above shows European network majors have managed to cut the unit cost of flight operations by 9% in the past 3 years, despite the 63% rise in the price of fuel of that period. Distribution and back office

unit costs have been slashed by a quarter, due to technologies such as e-ticketing and on-line booking. The one major area where costs are not falling is the **cost of using airports** and other infrastructure. In the absence of effective economic regulation, the lack of competition in these sheltered supplier markets means there is still insufficient pressure for efficiency improvements;

### Yield performance for global commercial airlines, passenger and cargo



- Although pricing power and **yields** have improved, particularly in US markets where capacity has been cut, the apparent improvement globally is largely a distortion from a weaker US dollar. Adjusting for inflation it can be seen that airlines still face declining real yields. The **imperative to cut costs remains**.

System-wide global commercial aviation	2000	2001	2002	2003	2004	2005f	2006f	2007f
<b>REVENUES, \$ billion</b>	329	308	306	322	379	420	449	477
Passenger	256	239	238	249	294	329	354	376
Cargo	40	39	38	40	47	52	56	60
Traffic volumes								
Passenger growth, %	9.6	-2.9	0.1	1.5	14.0	7.6	6.5	6.3
Airline expectations (IATA survey), %						6.6	5.7	5.4
Passenger numbers, millions	1672	1640	1639	1657	1887	2030	2162	2298
Cargo growth, %	9.2	-6.3	6.1	4.3	11.9	3.0	7.0	6.8
Airline expectations (IATA survey), %						6.8	6.3	6.6
Freight tonnes, millions	30.4	28.8	31.4	34.5	38.6	39.8	42.5	45.4
World economic growth, %	4.7	1.6	1.7	2.6	4.0	3.5	3.6	3.4
Yield growth, %	-1.8	-2.5	-2.4	2.7	3.7	4.4	0.4	-0.2
Yield growth, inflation/ex rate adjusted %	-3.0	-2.6	-4.6	-4.9	-2.8	0.0	-2.4	-3.3
<b>EXPENSES, \$ billion</b>	318	319	311	323	376	416	441	458
Fuel	46	43	40	44	61	92	105	105
% of expenses	14	13	13	14	16	22	24	23
Crude oil price, Brent, \$/b	28.8	24.7	25.1	28.8	38.3	54.5	57.0	52.0
Non-Fuel	272	276	271	279	314	324	336	353
cents per atk (non-fuel unit cost)	37.9	38.5	37.8	38.2	38.8	38.0	37.0	36.3
% change	-2.9	1.7	-1.7	1.1	1.5	-2.0	-2.6	-2.0
% change, adjusted for ex rate	-0.9	4.4	-2.4	-4.3	-2.3	-3.2	-3.1	-3.2
Break-even weight load factor, %	61.5	63.9	62.9	63.3	63.7	64.0	63.5	61.5
Weight load factor achieved, %	61.9	59.4	60.8	61.0	62.4	63.0	63.0	62.7
<b>OPERATING PROFIT, \$ billion</b>	10.7	-11.8	-4.9	-1.5	3.3	3.2	8.1	19.7
% margin	3.3	-3.8	-1.6	-0.5	0.9	0.8	1.8	4.1
<b>NET PROFIT, \$ billion</b>	3.7	-13.0	-11.3	-7.6	-5.7	-6.0	-2.2	7.2
% margin	1.1	-4.2	-3.7	-2.3	-1.5	-1.4	-0.5	1.5

- By 2007 the industry is forecast to fly **2.3 billion passengers** and **45 million tonnes of freight** annually.

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