



This Time the Faltering Airline Sector Will Have an Impact on Aerospace Industry

MICHAEL J. DYMENT, MANAGING DIRECTOR, NEXA CAPITAL PARTNERS, LLC

International Air Transport Association Director General Giovanni Bisignani recently warned that rising fuel prices are setting the stage for a global airline crisis, a situation he described as unprecedented in aviation history. IATA forecasts a \$6.1 billion loss this year with crude prices at \$135/barrel. Several Wall Street investment banks see oil settling in at \$200-250/barrel. Analysts argue economic sustainability of the industry as a whole is unlikely without government intervention, even if oil adjusts to \$100/barrel.

Operators are in uncharted waters. Some would say the four horsemen of the apocalypse now circle the U.S. sector in the form of spiking oil prices, a weakening greenback, softening demand for air travel as the economy sputters, and zealous business and consumer resistance to fare hikes. While their balance sheets weaken, one must remember that this is a sector long remembered for stiffing investors. Wall Street remains largely closed to them.

JP Morgan says large U.S. airlines (excluding Southwest) collectively have some \$20 billion unrestricted cash. With fuel prices at \$120/barrel, this stash quickly dwindles to \$5 billion, or 15 days of working capital, with existing credit lines and revolvers tapped, by mid-2009. With so little cash, it will be hard to make payroll, keep up your aircraft leases, buy fuel and feed the credit card companies' risk aversion.

U.S. majors will work hard to survive. They will park inefficient aircraft, irritate customers with surcharges, price increases and nickel-diming strategies, lay off workers, consolidate to eliminate competition, outsource loss-producing routes to franchisees, sell non-core and even core assets, and seek lease-backs. With the majors' high fixed costs and the ability of low-cost carriers to undermine the majors' shifting strategies, the outlook is dismal. The LCCs have more pricing power, but less to fall back upon.

Amidst this perfect storm, there will be fallout. Airlines consume tens of billions of dollars of non-aircraft aerospace products and services each year. The maintenance, rehabilitation and overhaul sector is vital to keep fleets maintained. Airlines depend upon high value commercial aerospace products such as parts, ground service equipment, avionics, and the like.

The immediate impact is three fold: First, a drop in supply chain revenues will be driven in large part by forced reduction in airline capacity and therefore expenditures; second, tightening margins will be passed on to suppliers as air carriers seek further cost

relief wherever it can find, while suppliers will be required to absorb key non-oil commodity price inflation at the other end; and third, outright cancellation of capital expenditure programs for information technology systems, simulators, terminal equipment and similar programs, are expected as airlines scramble to preserve cash.

The longer term promises to cut a far deeper swath of misery for aerospace companies. We find ourselves looking into an abyss. The two major aircraft manufacturers' delivery forecasts depend heavily on undercapitalized LCC customers. While order books are bulging today, LCC fleet orders have slowed and deferrals or cancellations will continue to mount. As much as 25% of the order backlog could be vulnerable. Aircraft manufacturers have some cushion, and could adjust production volumes to minimize a sizeable financial fallout before the next business upswing. Again they are in uncharted waters.

Stemming airline losses and repairing balance sheets, prerequisites for new aircraft orders, will require nothing less than a sustained multi-year turnaround that may not begin for years. Despite their size the U.S. legacies amount to a disproportionately small percentage of the total orders. Rating agencies have recently placed U.S. carriers on credit watch with negative implications, making near-term aircraft deliveries doubtful as lessors assess their risks. Fuel prices where they are, many overseas airlines will see their creditworthiness downgraded in the months ahead. Analysts say a jump in global energy demand has created a permanent era of high prices, so the abyss seems immeasurably deep.

There are ways for airlines to turn the corner. New fuel efficient aircraft and the Next Gen air traffic control system-enabled flight procedures can lower fuel bills by 20-30%, yet these solutions require large capital outlays and massive upgrades to the ATC system. The FAA expects airlines to invest some US\$12-18 billion of their own money to equip for Automatic Dependence Surveillance-Broadcast (ADS-B), but that outlay is highly improbable at this point. Economic sustainability remains an elusive goal for the time being.

Published by Aviation Week and Space Technology
Magazine, August 2008