Europe's airlines brace for more consolidation Rising costs, competition, spare capacity make for turbulent mix

Europe's airline sector is in for a bumpy ride after several months without any major failures. Rising fuel prices, excess capacity and relentless low-cost and foreign competition are making it tough for all but the biggest carriers to survive.

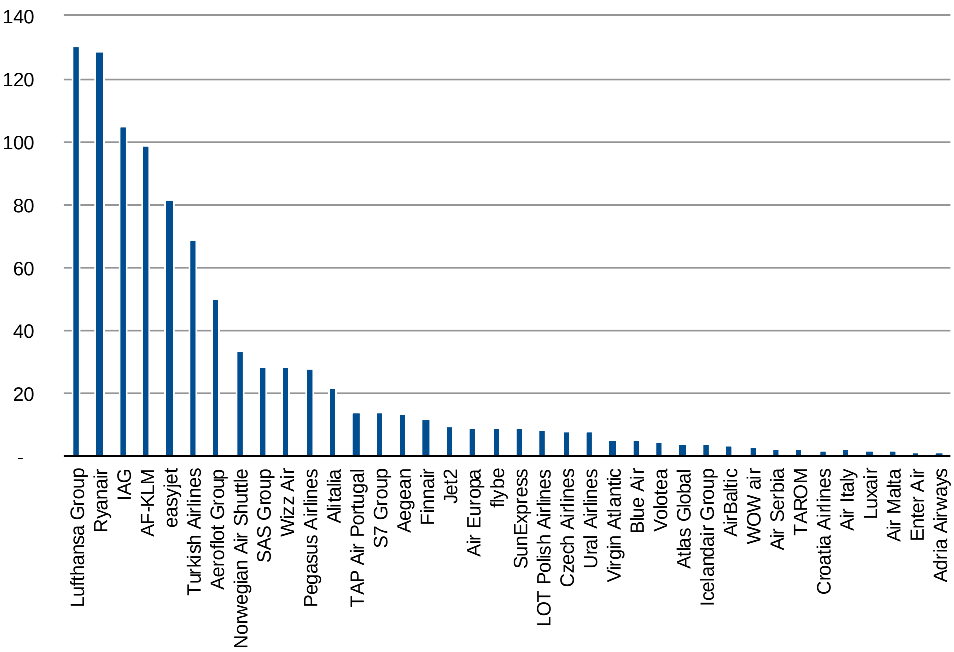
The aviation industry did benefit from a few years of low oil prices which gave a competitive advantage to healthy airlines and allowed some breathing space for weaker airlines to get their act together, says Scope Ratings.

Today, not only are fuel costs on the rise again, but there is no let-up in competition from low-cost carriers and non-European airlines, making it more difficult for smaller carriers to stay independent.

Mid-sized and smaller operators will have to seek the shelter of larger airline groups in the absence of another sharp drop in fuel prices, says Scope.

The upshot is that the consolidation of the European sector is entering a new phase even as barriers to entry for new players remain low and cheap funding is available for the launch of new airlines. Speculation is swirling around the future of Norwegian Air Shuttle, in which British Airways-parent IAG has taken a small stake amid possible interest from other carriers including Iceland's WOW air. IAG, Ryanair and Lufthansa have reiterated their willingness to be active consolidators of the European airline sector. Accor, the French hotels group, has also raised the possibility of investing in Air France, possibly mimicking the travel-and-tourism business model of Spain's Globalia, the UK's Thomas Cook Group and Germany's TUI. Ryanair has recently raised its stake in Austria's Air Niki-owner LaudaMotion.

Figure 1: Still fragmented European market with many fairly small supranational airlines (passenger volumes, 2017, in millions)



Source: companies, Scope

Analysts

Sebastian Zank, CFA
+49 30 27891 225
s.zank@scoperatings.com

Azza Chammem
+49 30 27891 240
a.chammem@scoperatings.com

Werner Stäblein
+49 69 6677389-12
w.staeblein@scoperatings.com

Media

André Fischer
+49 30 27891 147
an.fischer@scopegroup.com

Related Research

Trump Tax Reform to Spur Competition on Transatlantic Routes, Feb 2018

European Airlines - Growing Need for Consolidation?, Sep 2017

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

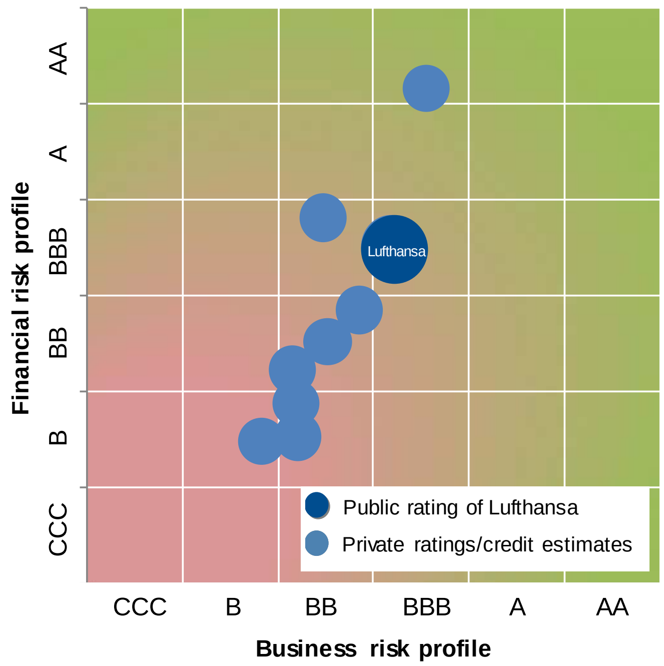
Bloomberg: SCOP

Clear correlation between size and credit quality for airlines

Larger airlines often display the better financial strength

Although Scope generally does not penalise the rating of corporates because of their size, Scope notes that for airlines there is a meaningful correlation between size and the credit quality of an airline (see Figure 2). This is intuitive as size goes hand in hand with economies of scale, market diversification and more robust financial risk profiles. Scope rates nine airlines (only Lufthansa – rated BBB-/Positive – is publicly rated; the remaining eight airlines are rated on a private basis, primarily as lessee counterparties in structured finance, project finance transactions or alternative investment funds rated by Scope).

Figure 2: Scope's airline coverage (standalone ratings*) show good positive correlation of an airline's rating and its size**



* not only European airlines

** indirectly reflected by the airlines' market position, diversification and profitability

Source: Scope

Some smaller airlines may seek shelter within a larger group

While there are many fairly small supranational airlines left in the European market flying less than 15m passengers a year, the question remains whether these will be able to survive or whether they have to seek shelter within a larger group.

Industry cycle has turned, on growing overcapacity and resurgent jet fuel prices

The most recent airline collapses in Europe took place last year, with the failure of Germany's Air Berlin and UK-based Monarch despite the benign industry conditions. Since then, some of the most important influences on the industry's health, namely jet fuel prices and the demand/supply balance, have shifted against the industry.

EBITDAR margins shrinking again

The European industry's profitability is on the decline as fuel prices are back at their highest level since 2014. Earnings before interest, taxes, depreciation, amortisation and rent will fall for third year in a row this year from a median 17.4% of revenue last year and a peak of 19.3% in 2015 (See Figure 5), according to Scope analysis.

Upward pressure on wages, evident in strikes over pay at Ryanair, Lufthansa and Air France, and airport fees are also squeezing margins.

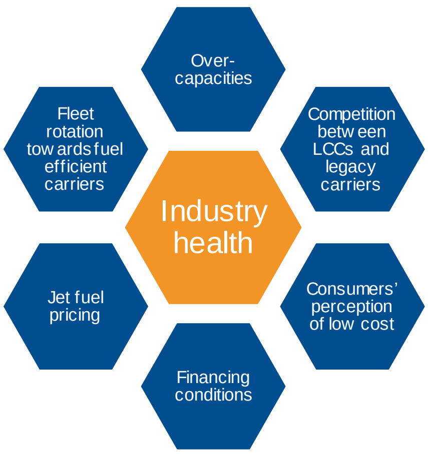
Capacity glut may become more evident for European airlines

Meanwhile, airlines are expanding their fleets faster than passenger demand is growth, exposing the industry's overcapacity. Airlines may not be able to quickly pass on higher costs to passengers through higher fares when competition is fierce and there is risk of a capacity glut. According to IATA, growth in airline capacity, measured by available seat kilometres, will overtake growth in unit revenues this year (see Figure 4).

Debt-finance expansion could backfire

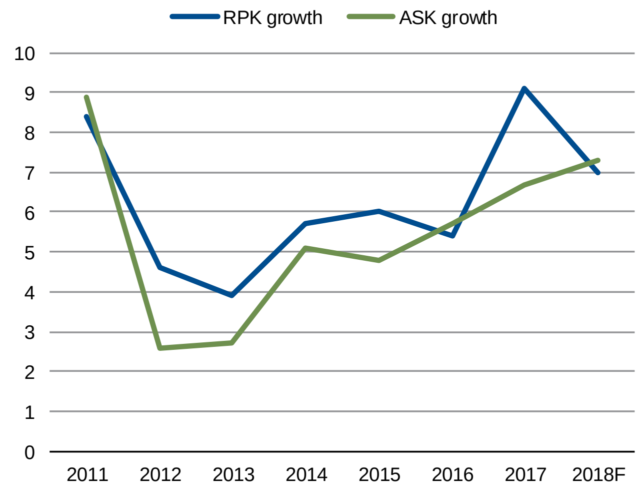
The industry imbalance will not only hit the short-haul market which has benefitted by strong macro fundamentals (tourism and business travel) and the ability of airlines to offer comparatively low fares, but also the long-haul routes (rising competition from European LCCs and non-European carriers). Overall, this might become an existential threat to some smaller airlines which executed debt-financed fleet expansion over the past few years such as Norwegian.

Figure 3: Scope's view on the most crucial challenges of airlines industry



Source: Scope illustration

Figure 4: ASK (capacity) growth exceeding RPK (supply) growth again in Europe (in %)



ASK = Available seat kilometres
RPK = Revenue passenger kilometres

Source: IATA, Scope

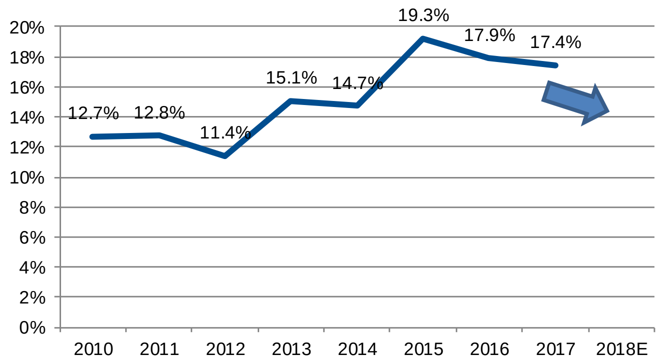
Shrinking profit margins expose the scale of the industry's leverage, need for fuel efficiency

Reduced profitability will also exposure operators whose indebtedness has increased during the recent benign trading conditions. Scope notes the increased usage of operating leases will become more visible with new accounting standards—the impact of IFRS 16 will be felt in 2019—when operating leases have to be taken on-balance sheet.

Rebounding jet fuel prices putting more pressure on less fuel efficient fleets

To cope better with the volatility in the oil prices, airlines have started to switch to more fuel efficient aircraft such as the MAX version of Boeing's 737 and the Neo version of Airbus's A320. However, not every airline can afford the re-engined jets, leaving the small or regional players flying at a cost disadvantage. As fuel typically makes up 20-35% of expenses, depending on the airline's size and its fare and hedging strategies, rising fuel prices can (see Figure 6) easily damage an airline's credit profile if it is unable to pass on such costs in the form of higher ticket prices.

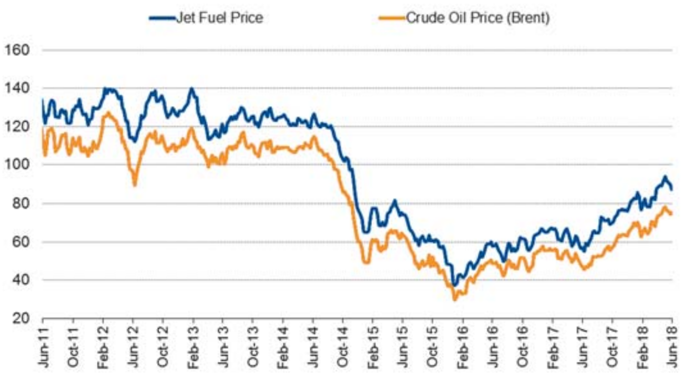
Figure 5: EBITDAR margin of European airlines on the way down again*



* excluding the data from defunct airlines

Source: Scope

Figure 6: Jet fuel prices reaching challenging levels again (in USD/barrel)



Source: IATA Jet Fuel Price Monitor based on data from Platts, Oanda

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris
33 rue La Fayette
F-75009 Paris

Phone +33 1 82 88 55 57

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com