Scope Ratings

2020 European Airlines Outlook

The credit outlook for European airlines remains negative. Management, notably at indebted carriers, is under pressure to control operating costs, despite falling fuel prices, as growth in passenger, cargo traffic slows.

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Executive summary

The credit outlook for European airlines remains negative. Management, notably at more indebted carriers, is under pressure to control operating costs, despite falling fuel prices, as growth in passenger, cargo traffic slows.

Europe's leading carriers by market share – Air France-KLM SA, Deutsche Lufthansa AG, easyJet PLC, IAG PLC and Ryanair PLC – are relatively well placed to cope with the prospect of slowing passenger growth, downward pressure on ticket prices and volatile costs, even though these factors will squeeze profit margins.

Much of the rest of the industry is just breaking even or making losses. The precarious position of smaller carriers was evident last year, with the collapse – Germania, Aigle Azur, XL, WOW Air – or sale – Air Europa – of several companies.

The main trends for 2020 are as follows:

- Further industry consolidation looks inevitable in the fragmented European sector.
- Growth in passenger traffic and air freight will slow as the European economy loses steam and external shocks, from the coronavirus outbreak in China to trade disputes and continued conflict in North Africa and the Middle East, weigh on demand.
- Capacity growth will be moderate, helping to improve the supply-demand balance in the over-supplied European air-travel market.
- The timing of the return of Boeing's B737 MAX aircraft to commercial service will be important in determining the outlook for capacity growth and its impact on the European market.
- Operating costs that can't be easily passed on to customers will continue to put pressure on profit margins, though we expect to see relatively stable jet fuel prices.
- Regulatory risk is rising as pressure grows on governments to impose heavier environmental taxes on airlines.

Scope Corporate Ratings

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Key themes for 2020

Macroeconomic and geopolitical risk:

The aviation industry is sensitive to macroeconomic and political events beyond its control. Easing fiscal policy and loose monetary policy should underpin economic growth and demand for air travel in Europe this year. However, external shocks, from the coronavirus outbreak in China to trade disputes and continued conflict in North Africa and the Middle East, will weigh on demand.

Coronavirus risk

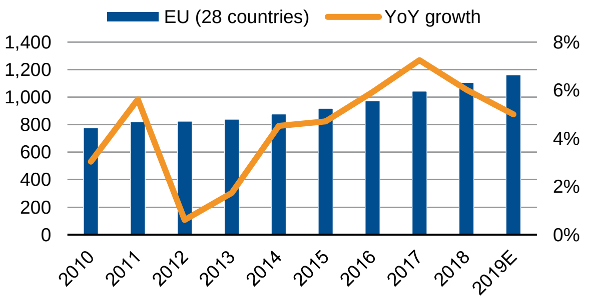
European airlines' exposure to the Chinese market is limited to a few carriers such as the Lufthansa Group (BBB/Stable), Air France-KLM and to a lesser extent British Airways and Finnair. These airlines have proved their resilience in face of short-lived international turbulence in the past. Much depends on how quickly and successfully the authorities in China and elsewhere can contain the outbreak. Only in the event of the authorities needing a prolonged period to contain the virus would European airlines have to rethink their long-haul routes and configuration of their operations in Asia.

Passenger demand versus supply

For 2020, capacity growth is expected to be moderate, helping to improve the supply-demand balance.

The slow rate of capacity growth in winter 2019/20 suggests that Europe's airlines are taking a cautious approach to managing capacity in an environment of slowing economic growth and global trade uncertainty. Combined with recent airline failures, we expect this to cap growth in the EU air-travel market.

Figure 1: Passenger traffic at EU airports (in m) and passenger growth rate

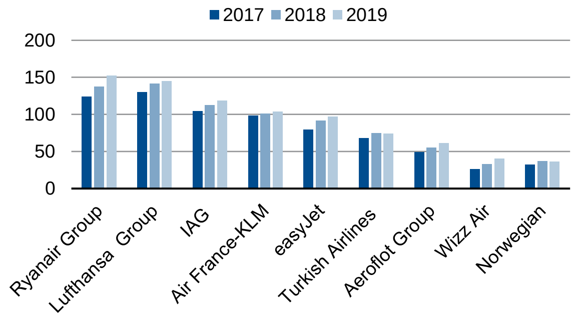


Source: Scope, Eurostat

Europe's biggest airlines reported more moderate growth in passenger traffic in 2019. Lufthansa's passenger growth decreased to 2% in 2019 from 8% in 2018.

Europe's airlines sector remains highly fragmented. The five increasingly dominant companies with more than 50% of the intra-European capacity leave little room to manoeuvre for their smaller competitors, numbering more than 100 airlines.

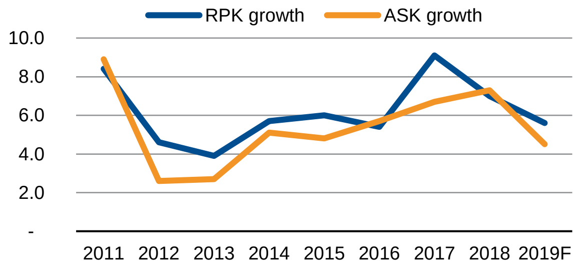
Figure 2: Top European airlines in terms of passenger volume (Pax m)



Source: Scope peer group of airlines

Until April 2019, airline capacity in terms of available seat kilometres (ASKs) was growing faster than traffic measured by revenue passenger kilometres (RPKs), whose growth rate was slowing. Overcapacity had led to intense competition and a price war over airfares. The situation changed with the grounding of Boeing's 737 MAX jetliner, which is still waiting for regulatory approval before it can resume commercial service. Subsequent delays in Boeing deliveries and the inability of Airbus to take advantage of its rival's problems, given its own huge order backlog, have reduced capacity growth since April 2019. Capacity growth, measured by ASKs, has moved more in line with demand.

Figure 3: ASK (capacity) growth versus RPK (traffic) growth in Europe (in %)



Source: Scope, IATA

How long this will continue is harder to judge. The B737MAX is expected to return to service in late 2020, but there is, as yet, no firm date.

In the short term, Boeing's troubles with the B737MAX have provided a silver lining to the clouds facing Europe's airline sector, as not all the capacity taken out of the market has been replaced. With the grounding of this model, airlines with stretched finances and/or perhaps over-ambitious backlogs have had an opportunity to reshape growth plans and reduce cash outlays, leaving them better prepared for a further slowdown in passenger traffic.

Conversely, excess capacity may build up again once Boeing's growing backlog of undelivered B737MX planes returns to the skies. Some airlines have also had to resort to using back-up planes, which they may find hard to get rid of at short notice – hence, the renewed pressure to lure passengers to their flights with cheap tickets. Airlines may face renewed downward pressure on airfares until the market adjusts to the absorption of the Boeing planes. This process is likely to extend beyond 2020 amid slowing overall demand for air travel.

Operating costs remain the major challenge

Airlines tend to pass on the increased costs to their customers through higher airfares. On long-haul routes, passengers often find 100% of any increase in fuel prices reflected in ticket prices. However, in a short-haul and medium-haul market as competitive as Europe's, it can be much harder for airlines to pass on fuel costs without losing market share as rivals can undercut them.

Fuel costs constitute between 15-35% of an airline's overall cost base. We see volatility in crude oil prices in 2020, but relatively little risk of sharp increases, with Brent crude to trade around USD 60/barrel (see Scope's Integrated oil & gas outlook 2020). Jet fuel prices will fluctuate around USD 70-75/barrel in 2020, providing some relief to the airlines from the high level of between USD 75-90/barrel in 2019.

Hedging jet fuel prices remains of strategic importance for European airlines – though it is not without its risks. Ryanair, Lufthansa, IAG and easyJet are hedging more than 50% of their fuel spending in 2020. Hedging can provide some protection against increases in oil price but declines in the price of oil may expose airlines to some risk of hedging losses. Hedging costs have contributed to financial difficulties at airlines such Germany's Air Berlin, which went out of business, and Flybe, the financially troubled regional UK airline.

Figure 4: Share of fuel hedged for some airlines

Sample of European airlines	Hedging percentage in 2019
Lufthansa Group	~77%
Air France-KLM	~59%
IAG	~80%
Ryanair	~90%
easyJet	~65%
Wizz Air	~82%

Source: Annual reports

Labour costs are becoming an important issue for airline management across the industry. A shortage of pilots worldwide is exposing European airlines to wage inflation among a critical proportion of their workforce. For example, Ryanair faced tough negotiations with its pilots last year. Experienced pilots in Europe are finding better-paid work in the Middle East and other regions. Most airlines operate multiple bases in more than one country, exposing them to a multiplicity of unions and different labour laws and thus making negotiations with employees complex. Industrial action was common in Europe in 2019, with strikes by flight attendants and pilots from several airlines including Lufthansa, British Airways, Air France and Ryanair.

Airlines are also facing the challenge of controlling infrastructure-related costs, notably airport charges.

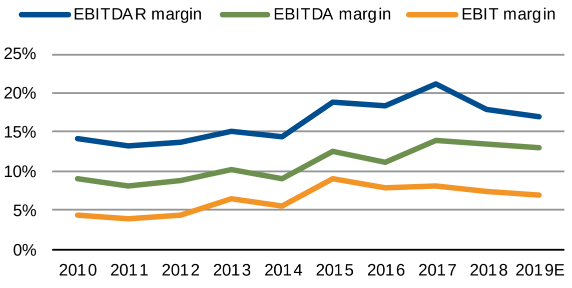
Pressure on margins will continue

Slowing revenue growth will weigh on the performance of European airlines in 2020, putting the onus on management to control operating costs carefully. Europe's larger, better-financed carriers are likely to find opportunities for growth.

We expect the sector's average EBITDA margin to fall in 2019 based on slowing passenger growth and volatile fuel costs.

For the year ahead, we expect that any decline in jet fuel prices might not be enough to offset increases in airlines' other operating costs.

Figure 5: Margins for European airlines



Source: Scope peer group of airlines

Financing conditions remain favourable for airlines as banks and leasing companies are open for aircraft financing. However, the sector's creditworthiness is precarious – the median credit rating is B – so creditors are reluctant to provide loans without security.

Airlines and sustainability

The aviation industry will be reliant on fossil fuels for the foreseeable future, making it vulnerable to environmental campaigners eager for the industry to do more do reduce CO_2 emissions. The 'flight shaming' phenomenon – which has spread from Scandinavia into other parts of Europe – has had some impact in reducing demand for short-haul travel. According to IATA, Swedish airports' passenger traffic declined by 4% in 2019, with domestic air travel 9% lower.

The airline industry has made a significant improvement in reducing carbon emissions, with airlines flying increasingly fuel-efficient planes. However, the sustained growth in demand for air travel will outpace further efficiency improvements.

The EU plans to open discussions on further ways to limit aviation emissions. Governments are considering additional aviation taxes to respond to environmentalists' concerns, but are mindful of the short- and medium-term, if not long-term, economic costs of restricting air passenger and cargo services.

Annex II: Related research

China: coronavirus outbreak's longer-term policy side-effects more important than direct GDP, published Jan 2020 available here

Steady consolidation of Europe’s fragmented airlines sector continues with IAG, Air Europa deal, published Nov 2019 available here

Europe’s big five take more than half of region’s air travel market as small airlines struggle, published Jan 2019 available here

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