

European airlines outlook 2019: Flight paths diverge as smaller carriers face credit squeeze



Scope Ratings maintains its negative credit outlook for Europe's airlines sector.

Volatile fuel prices, intense competition and slowing passenger growth are piling pressure on the credit quality particularly of smaller, less diversified carriers. The gap in the creditworthiness of larger airline operators and smaller carriers is set to widen further, with more consolidation in the sector on its way after a series of mergers and airline defaults in 2018.

Scope has identified the following trends working for and against the business-risk and financial-risk profiles of European airlines in 2019:

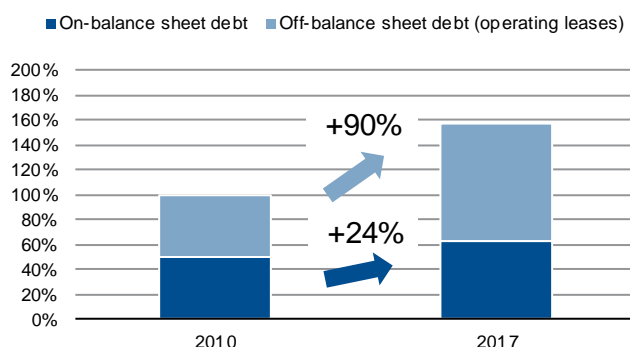
↑	Continued passenger growth, however, at a slower pace than in previous years
↑	Further sector consolidation, from the perspective of the remaining airlines
↑	Limited further price cuts (ex fuel costs) even for budget airlines
↓	Deteriorating supply demand balance (RSK vs ASK) and route saturation
↓	Burden of rising jet fuel prices and other costs to the detriment of profitability
↓	Continuous geopolitical and other external shocks, such as: i) trade tensions ii) Trump tax breaks iii) upcoming discussions about CO2 trading scheme

Survival of the fittest: Diversified carriers better placed than niche airlines

Conservatively financed, diversified airlines such as Lufthansa (rated BBB-/Positive at Scope) and other larger European groups are likely to cope with the turbulence ahead, benefiting from their scale and diversification, in terms of brands, bases, and routes. It will be another difficult year for the smaller, more leveraged airlines which lack such economies of scale.

Airlines will try to pass on increased costs—e.g. fuel, personnel, airport charges—to customers, but higher levels of debt (on-balance sheet and off-balance sheet as displayed in figure 1) accumulated in recent years will become an existential issue for some less diversified airlines as slowing growth also squeezes profit margins. The marginalisation of smaller airlines and more consolidation appears inevitable, the latest example being UK-based regional airline Flybe which has put itself for sale. Eventually, a less fragmented market in Europe along with a reduction of overcapacity would be positive for the sector.

Figure 1: Rising debt in recent years could turn out to be problematic (debt profile of an average European airline) – Financial debt and NPV of operating leases 2010 = 100%



Source: Scope peer group of 20 European carriers

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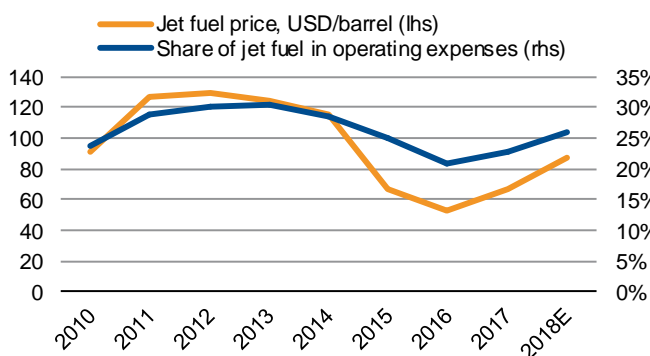
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Full pass-through of rising costs to customers comes with difficulties and delay

Cost control remains central challenge for airline sector

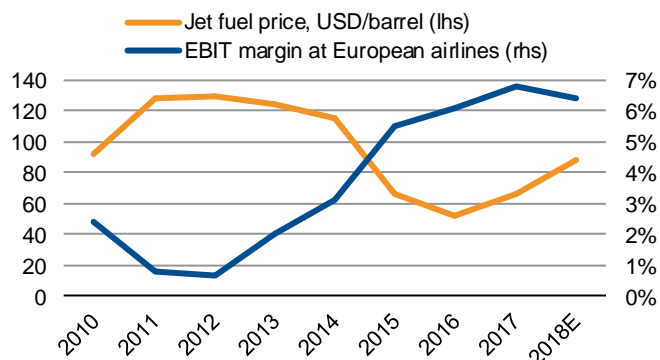
A rising cost base remains one of the most critical issues for most airlines. While carriers try to pass on rising jet fuel prices, higher wages and other forms of inflation to customers, this usually involves some delay and the risk that, to stay commercially competitive, only a portion can be recouped through higher fares. Smaller carriers are inevitably more vulnerable given the capacity of larger airlines to absorb rising costs by keeping ticket prices low in the hopes of securing greater market share. Growing ancillary income—from charging more for luggage, priority boarding, seat allocation and other services—is becoming more difficult given competition in the sector. Consequently, Scope expects further margin pressure for most European airlines in 2019.

Figure 2: Fuel costs as share of total expenses; jet fuel prices



Source: Scope peer group of 20 European carriers

Figure 3: Correlation of jet fuel prices with EBIT margins



Source: IATA, Scope

Negative correlation between profitability and jet fuel prices

Fuel costs constitute between 15-35% of an airline's overall cost base (see Figure 2 with the example of European airlines) and as such remain the most critical single cost component for the industry. IATA's data on jet fuel prices and average profitability in the airlines industry underpin the negative correlation between fuel prices and profit margins (see Figure 3). With jet fuel prices of USD 85/barrel in November representing an increase of around 15% on average prices for the year to date, kerosene costs will again test the average airline's cost controls and profitability. Scope expects fuel prices to stay at the currently high level of between USD 75-90/barrel, but show increasing volatility as a result of geopolitical tensions. Coupled with adverse market conditions like labour tensions and fluctuations of local currencies against the USD, the negative effect on the average European airline's profitability and cash flow is set to challenge the viability of small and/or highly leveraged airlines, as was indeed the case in 2018.

Passenger growth expected to slow down

Capacity ramp up of recent years expected to strike back

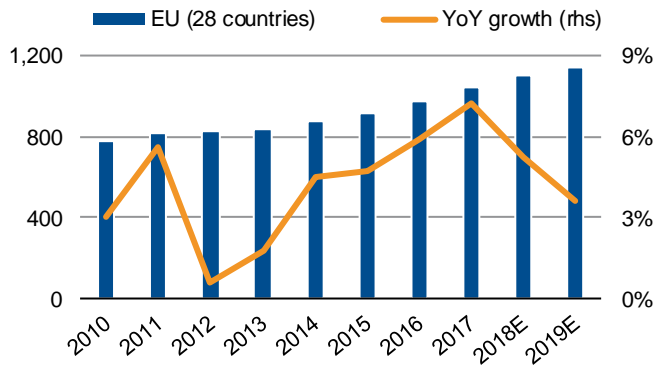
Scope expects growth in European air travel to slow further in 2019. Higher air fares as airlines try to pass on least some of their increased costs will likely put a brake on further increases in passenger traffic in Europe's increasingly saturated market. Tensions concerning international trade (see figure 4) might also hold back growth in traffic.

Expansion cycles don't last forever

European airlines have ramped up capacity in recent years, finding it easy to fill extra seats amid strong demand related to the robust economic recovery in Europe and the rest of the world. Airline load factors rose and margins spiked. However, as is typical of the airline sector when the economic cycle turns, carriers face having too much capacity (ASK), now growing faster, as airlines bring new planes into service, than growth in average unit revenues (RPK) (see figure 5). Reduced RPK growth below ASK growth implies a bumpy ride ahead for European carriers. Consolidation so far has only helped on the margin. Surviving larger carriers have quickly taken on the capacity of defunct

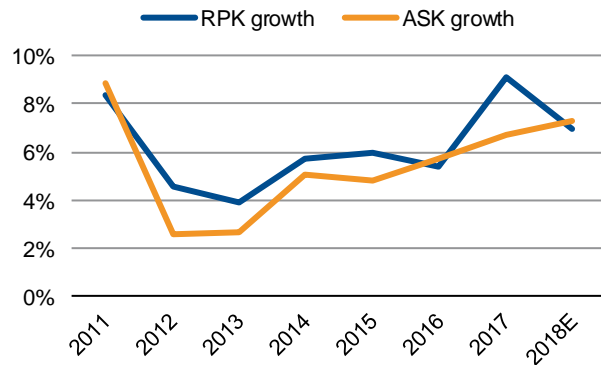
carriers, leaving little net change. One example would be the breakup of Air Berlin whose routes were largely taken on by Lufthansa and easyJet.

Figure 4: Passenger traffic at EU airports (in m) and passenger growth rate



Source: ACI Europe, Scope

Figure 5: ASK (capacity) growth exceeding RPK (demand) growth again in Europe



Source: IATA, Scope

IATA itself forecasts a downturn in the next 2-3 years, citing weaker business confidence, tariff wars and increasing protectionism, and mounting fiscal constraints for many governments given public debt remains elevated. Ryanair, Norwegian, Wizz Air—among Europe’s more aggressive and fastest growing airlines of recent years—have all lowered their growth forecasts to take into account the less rosy economic outlook.

Ramped-up debt levels turn out to be a problem

From Scope’s credit perspective, the increased risks of a looming demand-supply imbalance and lower utilisation rates will be dangerous considering how much extra debt – particularly through operating leases – airlines have taken on over the past few years for fleet expansion (see figure 1) with the highest debt expansions seen at carriers such as Icelandair, Norwegian, Virgin Atlantic, Jet2 and vueling.

Trade tensions and reduced globalisation may hit volatile airlines industry

Geopolitical risks and other external shocks

Scope assumes that geopolitical and other potential external shocks could cause greater disruption for European airlines than in previous years. The risk of rising global trade tensions also hitting European markets directly and indirectly through slower growth in trade and cargo volumes and reduced need for business travel could severely impact airline traffic in Europe and abroad. European passenger volumes currently account for around a quarter of the global total.

Stronger competition on Transatlantic routes

Such disruption might prove particularly severe on specific routes such as the transatlantic market where Scope expects rising competition from US carriers, emboldened by tax cuts (see also Scope’s research: [Trump tax reform to spur competition on transatlantic routes](#)). All three leading US carriers Delta, United and American Airlines have announced expanded eastbound routes in their route schedules for 2019, promising more competition for European incumbents with a significant exposure to transatlantic routes such as Virgin Atlantic, British Airways or AF-KLM. Smaller carriers such as Norwegian and WOW Air recently announced cancellations of several transatlantic routes.

Potential disruptions to cargo in the mid term

Another disruptive element for the established airlines’ cargo business has popped up with the emergence of Amazon Air as possibly serious new long-term competitor. While Amazon.com’s new air-cargo unit is operating only in the US so far, using 40 carriers through leasing capacity from other carriers, it could be imagined that business will also shift to Europe in the medium term, depending on slot availability particularly at night times. European airlines and established cargo ventures such as Fedex, DHL, UPS are

Discussions around CO2 emissions of airlines

likely to face more competition. Again, this is more of a threat to the smaller airlines for which carrying cargo is an important source of extra revenue.

Tougher environmental regulation is another potential headwind for the industry in Europe, with growing talk for the airline sector to take part more fully in the EU Emissions Trading Scheme. Expanding the geographic scope of the ETS to flights into and out of the European Economic Area (currently only within the EEA) or further restricting the scope of CO2 emission allowances are possibilities as Europe seeks to toughen up environmental regulations across much of industry. While rising costs for CO2 emissions will surely be passed on to passengers by the airlines, it would aggravate the wider cost pressures the industry faces.

Consolidation through acquisition of slots and assets

Marginalisation of smaller airlines seems inevitable

Sector consolidation will continue in 2019, considering the mix of negative sector fundamentals. From our perspective, two things remain crucial for airlines seeking to operate sustainably in the highly competitive and volatile industry:

- i) size and geographic reach, leading to economies of scale and diversification, or
- ii) the coverage of a niche where an airline retains pricing pressure.

Primera Air, VLM, Small Planet Airlines' German and Polish units, Azur Airlines, SkyWork and Cobalt are all small airlines which went into administration in 2018. Icelandair has breached covenants. Their experience shows smaller, less diversified airlines with a lack of economies of scale can quickly face financial difficulty if costs rise steeply, plane deliveries are delayed or flight delays at congested airports lead to reimbursements for passengers.

Consolidation helping to bolster industry's health in the longer term

More mergers seem likely. Flybe has put itself on the market for a takeover or merger. In early 2018, Air Nostrum and CityJet (see Scope's comment [Air Nostrum-CityJet merger plan shows European airlines are buckling up for a bumpier ride](#)) took the initiative to strike a deal before encountering financing difficulties. Icelandair has agreed recently to take over WOW Air. Scope believes that sector consolidation will remain largely passive, with defunct airlines giving space to the remaining airlines which can then collect slots and aircrafts at a better pricing. The five leading European airline groups Lufthansa Group, Ryanair, easyjet and IAG and AF-KLM will likely be the interested parties with regards to collecting these assets, thereby strengthening their reach and credit profiles. Wizz Air might also play an active role in expanding towards Western Europe from Central and Eastern Europe. While unfortunate for the stakeholders of the defunct airlines, such industry consolidation could eventually help bolster the industry's economic health in the longer term.



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