BTG Global Advisory

INDUSTRY UPDATE

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Close to the wind?

BTG Global Advisory considers global and European political uncertainty, including international security. We look at Brexit in terms of profitability and international influence, notably on the Single European Sky. Meanwhile, low-cost carriers thrive, extending their services and fuelling price competition.

By many indicators, 2016 was a fairly strong year for Europe's airlines. But UK carriers were dealt an additional concern. The long shadow of Brexit hangs over the industry and analysts remain uncertain how far-reaching the effects will be.

Tempered Growth, Profitability

In December 2016, the International Air Transport Association (IATA) predicted "another strong year" for airline profits, estimating global profitability at $35.6bn for 2016, but projecting a dip to $29.8bn in 2017. A major factor in the year-over-year decrease is the cost of jet fuel, forecasted to rise from $52.1/barrel last year to $64.9/barrel this year; for airlines, the good news is fuel will represent 18.7% of costs in 2017, a significant reduction from 33.2% in 2013.

As for European airlines, IATA forecasts a $5.6bn profit for 2017, down from $7.5bn in 2016. Traffic is expected to increase 3.8% in 2016 and 4.0% in 2017, less than global increases of 5.9% and 5.1%, respectively. IATA's European assessment is somewhat harsh: "The region is subject to intense competition and hampered by high costs, onerous regulation, and high taxes."

European Airline Industry Net Profits (2010 – 2017)

	2010	2011	2012	2013	2014	2015	2016	2017
Net Profit	$1.9bn	$0.3bn	$0.4bn	$1.0bn	$1.0bn	$7.5bn	$7.5bn*	$5.6bn**

** Estimated ** Forecast*

Source: International Air Transport Association

Tourism in 2016 "remained robust" globally, according to the World Tourism Organization, with international tourist arrivals rising by 3.9% to 1.2 billion. Results for European regions were "rather mixed" and flat in Western Europe; overall, however, the continent received 620 million international arrivals, 12 million more than in 2015.

In the UK, the Association of British Travel Agents called 2016 "eventful and challenging", but noted visits abroad by UK citizens increased 7% over 2015, while spending rose by 10%. Although agents warn of "caution and uncertainty" for 2017, overseas holiday bookings already are tracking 11% over last year. The real concern is currency fluctuation due to Brexit.

Through Q3 2016, British inbound tourism was up only 1%, although inbound travel by air reached a record 27 million visits, nearly three times tunnel and sea modes. For 2017, VisitBritain forecasts 4.0% growth from 36.7 million to 38.1 million inbound visits. Visitor spend is expected to increase 8.1%, from £22.3bn to £24.2bn.

UK: Inbound Visits and Spend (Oct 2015 – Sep 2016)

Transportation Mode	Visits	Spend
Air	27,066,000	£18,953,000
Tunnel	4,573,000	£1,563,000
Sea	5,143,000	£1,638,000

Source: VisitBritain.org

Capacity Expands

In the summer of 2016, European airlines increased seat capacity by 8%, the largest such expansion in six years. Some growth occurred on routes to the Americas, but there also were increases by low-cost carriers (LCC). Overall, IATA estimates European capacity will grow by 4.3% in 2017, compared to 3.8% last year.

The intra-European market – which represents 86% of the total number of seats from Europe – saw the largest growth last summer with eight airline groups posting double-digit increases. But it's worth noting six were LCCs; the only non-LCCs to record such seat capacity growth were Turkish Airlines and Aegean/Olympic.

For Britons, the government provided some capacity relief in October 2016 by approving a third runway at Heathrow Airport, claiming it will generate £61bn. The British Air Transport Association called it "long overdue".

The Impact of Brexit

The June 2016 referendum supporting the UK's withdrawal from the EU will have myriad effects, with some directly impacting the airline industry.

Profitability

In the immediate aftermath of the vote, airline stocks dropped dramatically; shares in IAG – British Airways' parent – fell more than 30% within days. Even LCCs such as easyJet and Ryanair suffered financially (see below). But by the year's end traffic had increased for UK carriers.

IATA issued a detailed briefing on Brexit, predicting UK passenger traffic could drop 3%–5% by 2020. The devaluation of sterling immediately made outbound trips more expensive for UK citizens, with a 2:1 ratio in the UK's outbound trips (53.9 million visits) versus inbound trips (26.2 million visits).

Pricing

The *International Business Times* speculated the UK may need to develop a "traditional" bilateral treaty with the EU that "could make flying between the UK and Europe a lot more expensive". Much will depend on the relative value of the sterling to the euro.

Regulation

Experts warn of much negotiation on regulatory details prior to exiting; PricewaterhouseCoopers suggested the UK may need to renegotiate EU-level aviation agreements with the US and other countries. As for safety, analysts predict the UK will remain under the authority of the European Aviation Safety Agency (like other non-EU European nations).

Others suggest British regulators may "ease" consumer protection requirements. Ultimately, IATA noted Brexit presents a "trade-off" for UK airlines, between accessing the European Single Aviation Market and "policy freedom for the UK to set its own regulations".

Single European Sky

As for Single European Sky, AirTrafficManagement.net reported the UK "could now lose its place at the negotiating table in shaping future regulation". This was echoed by IATA, which warned of a "full divorce" on aviation, and the UK being excluded from the initiative "it has long promoted and championed".

Ancillary Revenues Soar

Airline ancillary revenue is projected to reach $67.4bn in 2016; this represents a 200% increase over six years, with baggage fees and onboard services representing nearly half the total. Although many LCCs are dubbed "ancillary revenue champs", Ryanair's total ancillary percentage dipped slightly from 26.1% in 2015 to 25.5% last year.

In June 2015, the Lufthansa Group shook the travel world by reducing its expenses through Distribution Cost Charges (DCCs), which manifested in a fee of €16 for flights booked on third-party sites. European travel agents called DCCs "another fare increase" that makes fare transparency and shopping "more difficult". But eventually technology firm Amadeus acknowledged that "DCC is a part of the distribution landscape".

Terrorism

Aviation again was a focal point for terrorism, as attacks rocked airports in Brussels and Istanbul in 2016. The March explosion at Brussels Airport halted air service and triggered heightened security at airports from Russia to the US. Three months later, the Ataturk Airport assault temporarily shut down Europe's third-busiest airport.

The industry – based on the sad reality of a "new normal" – responded rather quickly as Ataturk reopened within 24 hours. But BBC News has reported that terrorism put Turkish tourism "in crisis", with an expected drop in visitors of 40% for 2016.

IATA noted that "terrorist threats remain a real risk, even if confidence is starting to return after the tragic incidents in recent times".

The EC Aviation Strategy

The EC's Aviation Strategy – dubbed a "milestone initiative" – was published in "proposal phase" in December 2015. The ambitious goals include generating growth and fostering innovation.

The European Regions Airline Association said that the strategy would not "increase the long-term competitiveness of the industry", so ERA and other groups are crafting independent proposals. By 2017 the Aviation Strategy had not completed the "negotiation phase" let alone the "implementation phase".

Low-cost Carriers

Growth Continues

The LCC revolution remains in full swing, with leaders Ryanair and easyJet still filling seats at record levels. That said, in October 2016 Ryanair downwardly adjusted its full-year profit growth, from 12% to 7% (about £900m), due to the falling pound. easyJet announced an even bigger decline of 28% (about £490m).

An analysis of Europe's LCC market found "competition is heating up" and Norwegian Air could soon be in league with Ryanair and easyJet, as Norwegian's subsidiaries expand on both intra-European and long-haul routes. Last year Norwegian launched services from Manchester and Edinburgh.

In addition, Norwegian's momentum was aided by being named "World's Best Low-Cost Long-Haul Airline" by Skytrax in 2016. And in the category of "Best Low-Cost Airlines in Europe", Norwegian ranked first among ten, with easyJet second, Ryanair fifth, and Monarch tenth.

Skytrax: Best Low Cost Airlines in Europe (2016)

Rank	Airline	Based
1	Norwegian	Fornebu
2	easyJet	London/Luton Airport
3	Eurowings	Dusseldorf
4	NIKI	Vienna
5	Ryanair	Dublin/Dublin Airport
6	Vueling	Barcelona
7	Wizz Air	Budapest
8	airBaltic	Riga
9	Pegasus	Istanbul
10	Monarch	London/Luton Airport

Source: Skytrax

Norwegian Battles

Norwegian Air has long generated controversy for its multiple "flag of convenience" operating jurisdictions and employment practices. In 2015 Norwegian Air's UK subsidiary applied to operate from Gatwick Airport to the US, and the normal 60-day approval process dragged on for months.

The American opposition prompted Britain to intervene, as the Director General for Civil Aviation asked the US to approve Norwegian's application. The request didn't help, as the US dismissed the application in June, citing "significant issues", while critics claimed Washington played politics on behalf of American carriers. In December, the US granted authority for Norwegian's Irish subsidiary to launch service.

Meanwhile, Norwegian's presence over the Atlantic spurred responses. In December 2016, British Airways' parent IAG said it would initiate no-frills, long-haul flights from Barcelona to the US, which analysts called a direct response to Norwegian.

Taxation

Airlines Fight Air Passenger Duty

The UK's Air Passenger Duty both gave and took away in 2016. The APD was eliminated in March for children ages 12–16 in economy class (those under 12 were already exempted). But in April rates were increased again, though not on short-haul flights, which clearly benefitted LCCs. On flights longer than 2,000 miles, APD rose in economy class from £71 to £73, and in premium classes from £142 to £146.

However, in April 2017 rates will increase on short-haul flights yet again. On "destination bands" exceeding 2,000 miles the economy class APD will rise to £75 and the premium class APD will rise to £150 (except airports in Northern Ireland and Scotland).

Not surprisingly, European airlines remain strongly opposed to APD. In September, Airlines for Europe called APD "the highest aviation tax worldwide", noting passengers paid more than £31bn between 1994 and 2015, as the tax increased by 824%. A4E suggested abolishing APD would "boost British tourism and economy".

The Chancellor's Autumn Statement in November 2016 addressed APD and stated "the government does not intend to take specific measures now". The airline community expressed disappointment, with Airlines UK (formerly the British Air Transport Association) calling such inaction "untenable". Airlines UK also supported a move by Scottish Conservatives to repeal APD on long-haul flights in Scotland by 2018.

Tax Hikes

Other European tax initiatives include:

- In December 2015, the Norwegian Ministry of Finance approved a new air passenger tax of NOK 80 (£8.50) per departing passenger.
- In January 2016 a sudden 33%–38% increase in the Italian Council Tax was announced, from €6.50 to €9–€10. IATA predicted disaster: 755,000 fewer passengers and 2,300 lost jobs. The Italian government responded, rolling back the legislation, largely to prevent Ryanair from reducing Italian operations.
- In November 2016, a Swedish commission recommended a climate offset tax of between 80 Swedish crowns (£7) and 280–430 Swedish crowns (up to £39).

Once again, A4E called for aviation taxes to be abolished, asking that Member States "cherish the positive long-term impact on economic activity".

Labour Actions

Service disruptions throughout Europe in 2016 included 22 separate ATC strikes, costing the EU economy €12bn. Included were actions in France, Greece, Italy, Portugal, and Spain; A4E urged the EC to take action by implementing arbitration. Analysts noted such strikes have a disproportionate effect on intra-European LCCs.

But not all labour actions involve ATC. In April 2016 Lufthansa cancelled 900 flights due to action by service workers, and by the summer pilots had walked out at easyJet and SAS. There's little respite in sight; 2017 kicked off with a three-day British Airways strike.

Mitigating Emissions

The United Nations International Civil Aviation Organization issued a global market-based measure (GMBM) in October 2016 to control aviation's CO_2 emissions and reach a carbon-neutral goal. The GMBM focuses on technical/operational improvements and sustainable alternative fuels. Unlike earlier initiatives, ICAO's GMBM received broad support globally, with 66 Member States (representing 86.5% of international aviation activity) pledging voluntary participation, and the G7 Transport Ministers expressing "strong support".

European airlines remain concerned that the devil is in ICAO's details. A4E called the agreement "historic", but also urged the EC to develop a legislative proposal on the Emissions Trading System to ensure competitiveness while avoiding "adverse financial implications".

Meanwhile, Virgin Atlantic continues as a worldwide leader in reducing emissions: The carrier announced its CO_2 was down 28.1% since 2008. In announcing the use of low-carbon fuel from ethanol, Virgin Founder Richard Branson stated: "This is a real game-changer for aviation."

Consolidation Rumours

After British Airways' parent IAG acquired Aer Lingus in 2015, experts predicted more mergers. But although rumours flew, the marketplace was quieter last year.

In May 2016 FlightGlobal speculated about:

- Lufthansa expanding its subsidiary Eurowings
- Alitalia acquiring a stake in Air Malta (that deal was nullified in January 2017)
- Luton-based Monarch Airlines accepting takeover proposals

Without an acquisition, Monarch was nearly grounded in October when UK authorities almost revoked its operating licence due to insufficient funds. An "eleventh hour reprieve" of £165m from majority shareholder Greybull Capital offset financial woes caused primarily by the weak pound. Monarch is developing a new six-year business plan.

Boston Consulting Group anticipates further consolidation with "intense" competition, as full-service brands and LCCs are "the most likely acquirers" in Europe.

Germanwings Fallout

Worldwide, ICAO noted both airline accidents and fatalities fell globally in 2015. And despite terrorism threats, operationally 2016 was another very safe year for European airlines.

However, the 2015 intentional crash by the Germanwings Flight 9525 co-pilot is still debated by regulators and airlines. In the wake of six recommendations made by the European Aviation Safety Agency, ERA said it will lobby EASA for further expertise in implementation.

Outlook for 2017

The airline industry worldwide is growing faster than in Europe, though European growth and profitability still seem certain. Challenges include intensified competition that depletes profits, rising fuel costs, ongoing labour unrest, and terrorist threats. For UK aviation, all these issues are overlaid by an even more acute concern – Brexit. The EU withdrawal has heightened uncertainties for British carriers, and the falling pound is worrying travellers and airlines alike, even high-flying LCCs. Currency stabilisation remains the premier challenge for 2017.