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Price war for European airlines – Fasten your seatbelts

07 July 2022

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EXECUTIVE SUMMARY

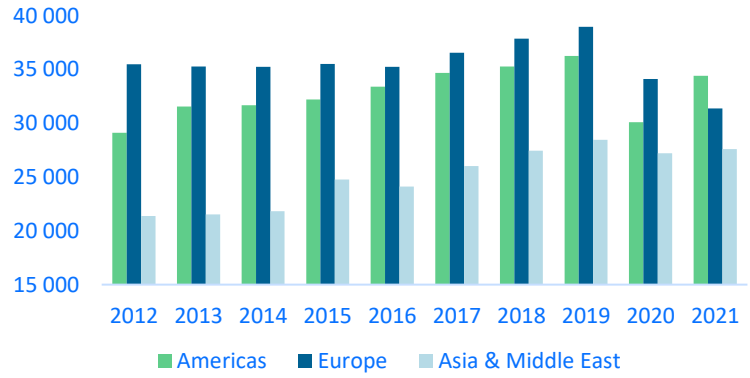
- Cancelled flights could become the new normal in Europe as airlines strive to protect margins amid surging jet fuel prices (+89% YTD). With wages accounting for 25% of revenue (vs. the global average of 19%), European airlines have little incentive to address staff shortages in the short term.
- As a result, airfares are taking off in Europe: After years of declines, we expect prices to increase by +21% in 2022. While this will boost revenue by +102% y/y in 2022, it will not be enough to prevent a third consecutive year of net losses (-USD9.7bn). European airlines won't reach breakeven until 2023.
- In the long term, the green transition represents an even bigger disruption for airlines in Europe given the increasing competition from rail operators, which produce 85% less CO_2 than planes and are state-owned (i.e. financially backed when investing). Renewing an old-generation fleet in a context of increasing rates and downgraded ratings will be pricey for a sector whose debt grew 1.4x in 2020. New regulations on the use of Sustainable Aviation Fuel (2.5x more expensive) will also further damage margins: the 38%/62% blend of SAF/kerosene mandatory by 2045 will increase fueling costs by +57%.

Cancelled flights could become the new normal in Europe as airlines strive to protect margins amid surging jet fuel prices.

With wages accounting for 25% of revenue (vs. the global average of 19%), European airlines have little incentive to address staff shortages in the short term. In 2020, lockdowns and border closures forced airlines around the world to take drastic cost-saving measures, including suspending dividends, reducing capex to the bare minimum, shifting to a more rational management of working capital and, the most criticized, furloughing personnel. While jet fuel has always been the biggest cost for airlines globally (around 25% of total revenues), its variable nature allowed for consumption to be reduced in proportion to the reduction in sales. In contrast, wages for staff, the second most significant cost for airlines, are fixed, equivalent to 19% of pre-pandemic revenues.

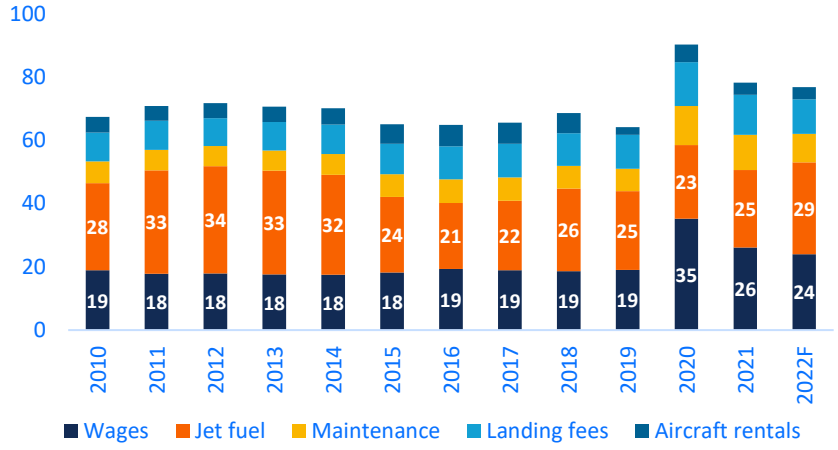
The wage bill is higher for European airlines (25% of revenues in FY2019 vs 19% for jet fuel), not only because of their larger-than-average workforce size but also because minimum salaries in Europe are relatively higher. This explains why European airlines had the lowest EBITDA margin in 2020 (-44% on average, vs -20% for the Americas and -10% for Asia & Middle East), and why they further reduced their staff by -8% y/y in 2021, even as peers in North and South America increased their staff by +14% y/y on average.

Figure 1: Airlines[1] average number of employees by geography



Sources: Bloomberg, Allianz Research.

Figure 2: Operating expenses as a % of revenue (global)



Sources: Bloomberg, Allianz Research.

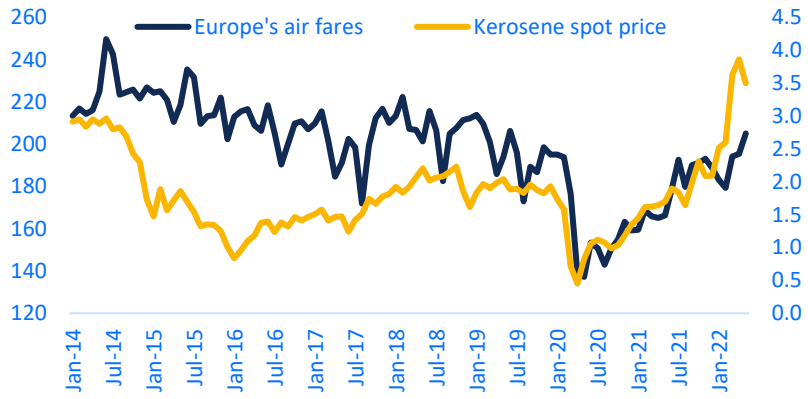
Now, staff shortages combined with strikes by current employees, demanding higher salaries and better working conditions, have resulted in many airlines cancelling flights. This in turn has pushed up prices (average air passenger fares for Europe moved from USD193 in February 2022 to USD215 in May). In the short term, the scarcity of flights can actually benefit airlines since they can raise revenue by increasing fares, rather than volume. By doing this, companies can absorb the negative effects of surging jet fuel prices (which have increased +89% YTD) and delay the additional expense of hiring more workers.

As a result, airfares will take off in Europe: After years of declines, we expect prices to increase by +21% in 2022.

With the arrival of low-cost airlines in Europe, elevated competition forced traditional airlines to cut prices: From May 2014, when kerosene prices began to drop, to May 2020, airfares fell -39%. However, this trend has reversed in 2022: As of May, YTD fares have increased by +12%. We expect the surge in ticket prices to hit +21% y/y by the end of 2022 and peak only in Q1 2023.

[1] *A sample of 55 airlines was used for this exercise: 13 from Europe, 15 from North America and Latin America and 27 from Asia and the Middle East.*

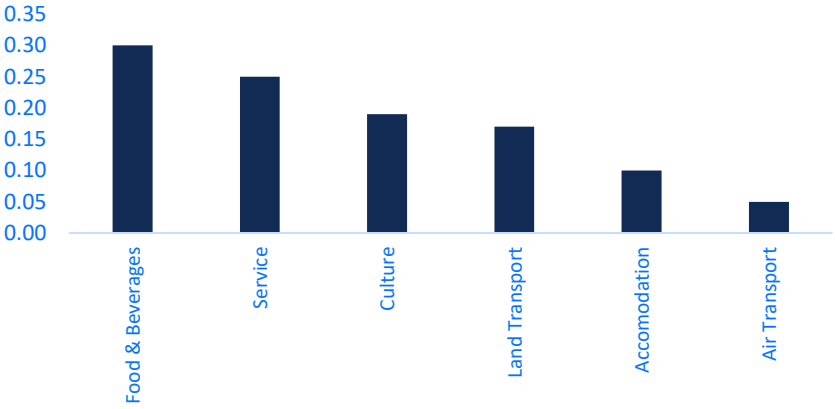
Figure 3: Air passenger fares (USD, left) vs jet fuel price (USD/gal, right)



Sources: Refinitiv Eikon Datastream, Allianz Research.

Despite higher prices, we expect demand to remain strong as the third and fourth quarters of the year are traditionally peak travel periods (with the summer season in the northern hemisphere and the end-of-year festivities). In 2019, the global load factor[2] was 90% on average and 85% for Europe. Today, it is at 77% and 71%, respectively, showing clear signs of recovery. In addition, following the pandemic lockdowns, consumers appear more willing to travel, preferring to shorten the length of their trips or to stay in less expensive accommodation to compensate for higher transportation costs, suggesting that traveling is no longer considered as discretionary as it used to be. As a result, we expect European airlines' revenue to increase by +102% y/y on average in 2022. In 2023, we expect an increase of +23% y/y in 2023, which will take revenue back to the levels observed in 2019 (in value terms), reaching breakeven.

Figure 4: Eurozone services spending sensitivity. Services production % y/y change in response to 1pp change in real incomes (estimated on 2007-2019 data)



Sources: Oxford Economics, Allianz Research.

However, higher airfares will not be enough to prevent a third consecutive year of net losses. After -USD137.7bn in 2020 (net margin of -36.0%) and -USD42.1bn in 2021 (net margin of -8.3%), the International Air Transport Association expects net losses of -USD9.7bn in 2022 (net margin of -1.2%).

[2] *Load factor is a metric used in the airline industry to measure the capacity utilisation. It is the ratio between the revenue passenger kilometre (RPK) and the available seat kilometre (ASK).*

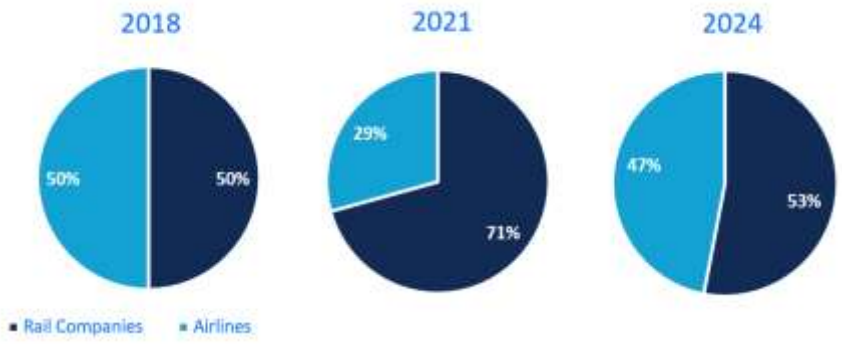
In the long term, Europe's green transition presents an even bigger disruption.

In a world that seeks to go greener, the momentum for European airlines will fade in the medium term as they will have to face an even bigger disruptor: rail operators. Europe's relatively small size and the free mobility between countries make rail transportation a viable alternative to flights. With a total length of 200,161km (of which 58% is electrified), the EU has one of the longest rail networks of the world and the highest network density (length/surface).

Before the pandemic, European airlines and railway companies each held 50% of the market in terms of revenue, with each posting around EUR118,000mn per year. However, this split changed over 2020-2021 as airlines lost market share to rail companies (30% airlines, 70% rail companies). For low-cost airlines, around 38% of the revenue comes from the long-haul business, which suffered the most during the pandemic. In contrast, rail companies have almost no business outside Europe. As a result, they already exceeded their 2019 revenue levels.

While taking a train is still more expensive on certain routes (Paris-London round trip: EUR194 by train vs EUR101 by plane; Munich-Milan round trip: EUR176 by train vs EUR 129 by plane), rail companies are set to become more competitive as governments accelerate the transition to high-speed railways. In this context, even as airlines could return to their pre-pandemic market share amid the revival of long-haul services, we believe the rail companies will continue to see robust business, and could even maintain market share above 50%.

Figure 5: Market share by revenue (Europe)



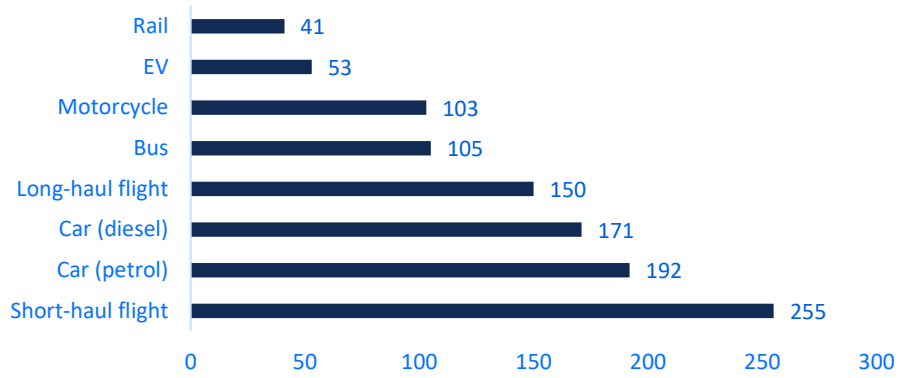
Sources: Refinitiv Eikon, Allianz Research.

Three factors will contribute to the increased use of trains in the coming years:

1) While rail companies operate as a monopoly in most European countries, the EU decided to liberalize the commercial long-distance rail market from 2021 in order to encourage competition and innovation, as well as improve the services. In parallel, the European Commission has been working on a Trans-European Transport Network (railways and roads), aiming to connect 424 cities and imposing a minimum speed of 160km/h. The network is planned to be fully completed by 2040.
2) The vast majority of rail operators are state-owned, meaning they are financially backed by governments. This provides access to cheaper financing facilities as these companies benefit from a sovereign rating. For comparison, barely 28% of European airlines are investment grade. Having access to credit is crucial when it comes to new projects, network expansion plans or the renovation of rolling stock. Because of this, airlines are in a disadvantageous position and will find it harder to finance their green transition.
3) Consumer awareness about carbon footprints has been increasing, contributing to new environmental movements such as "flight shaming". This sets the stage for an uptick in

the use of less-polluting transportation. After all, the carbon footprint of a round trip flight between Paris and Amsterdam (862km is 96kg of CO_2; taking a train would emit only 13kg (i.e. 86% less).

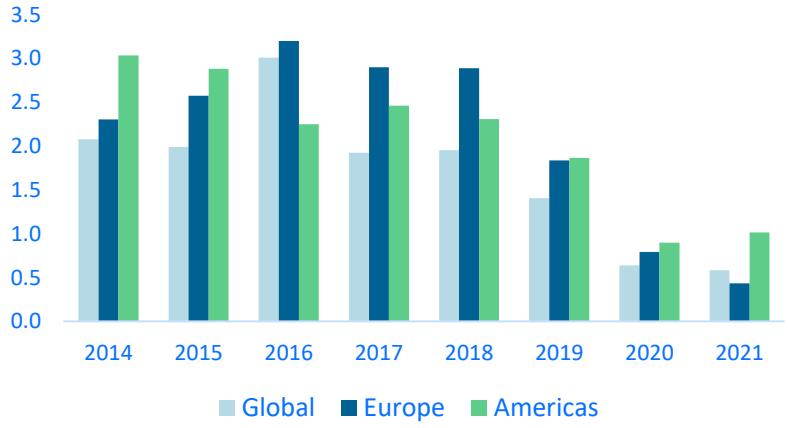
Figure 6: Carbon footprint of travel (grams of CO_2/passenger kilometer)



Sources: UK Department for Business, Energy & Industrial Strategy, Allianz Research.

For airlines, the only way to avoid losing market share and to compete with eco-friendly rail companies is to also go green, but this strategy requires a lot of investment. When looking at the capex to depreciation ratio of airlines, we find that Europe is precisely the region that needs to invest the most in new aircraft. Yet, Figure 6 shows that since 2019, European airlines have not been putting efforts into renewing their long-term assets.

Figure 7: Airlines' capex to depreciation ratios



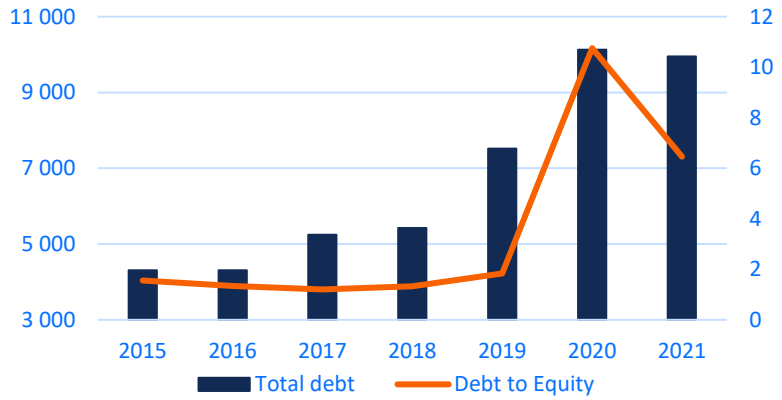
Sources: Bloomberg, Allianz Research.

New zero-emission aircraft models are in the making, but designing and building a brand-new model from scratch is a process that can take many years. In the meantime, aircraft manufacturers need to upgrade existing models, adapting the engines and making them more fuel-efficient. However, these upgraded models are also more expensive, with prices running between USD105mn-150mn for a commercial aircraft with capacity of 110-200 passengers (short/medium-haul) and USD275mn-440mn for aircraft with capacity of 400-550 passengers (long-haul).

Can airlines afford an increase in capex? Before the pandemic, European airlines were recording around USD2 050mn of cash from operations on average. This figure went negative

in 2020 (-USD1 770mn) and reached breakeven in 2021. This suggests that airlines are not even able to organically invest their own funds in new fleets in the short term, which forces them to seek external financing. While this is feasible, financing today is much more expensive than a few years ago when airlines used to be better rated (covenants for non-IG companies used to be very tough due to their poor credit risk profile) and interest rates were lower. In addition to this, most of the companies in the sector have reached never-before-seen levels of indebtedness[3]. This debt will have to be repaid in the coming years to return to pre-pandemic leverage ratios. As long as airlines continue without deleveraging and failing to generate enough OCF[4], they will not be able to carry out new investment projects.

Figure 8: European airlines' average debt (USD mn, left) and leverage ratio (right)



Sources: Bloomberg, Allianz Research.

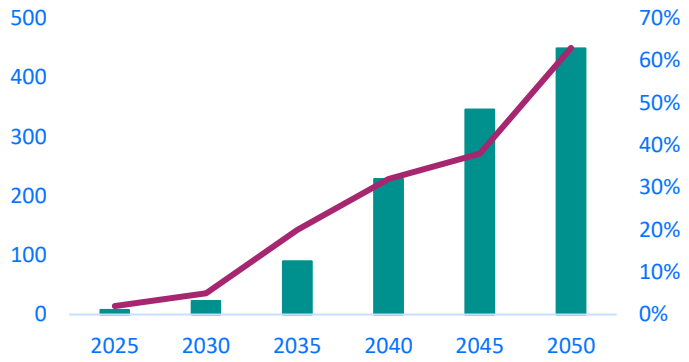
Transitioning toward less-polluting aircraft also mean shifting away from traditional jet fuel. In 2020, the EC agreed on a set of initiatives called the "European Green Deal", seeking to reduce greenhouse gas emissions by at least 55% by 2030, and to make the EU climate neutral in 2050. Since transport represents around 25% of the EU greenhouse gas emissions, airlines operating in and from the EU will be subject to a new tax on aviation fuel and be required to use more Sustainable Aviation Fuel (SAF), made from sources such as sewage sludge, agricultural and wood residues, used cooking oils or waste. SAF reduces CO_2 emissions by up to 80%. This mandate starts in 2025, the year by which total airline fuel consumption must contain at least 2% of SAF, and the requirement will continue increasing thereafter.

Today's aircraft engines allow airlines to safety operate passenger flights on a 50/50 blend of SAF and standard fuel. Yet, SAF represents today only 1% of total jet fuel consumption within the EU because their lower-scale production makes them 2.5x more expensive than conventional jet fuel. As a result, the green deal's mandate poses a strong threat to airline margins, especially in the case of low-cost carriers. By 2025, the effects of this transition will not be that harmful but we estimate that using a blend of 20% SAF and 80% kerosene by 2035 will increase fuel costs by +30%. A 38%/62% blend (required by 2045) will raise costs by +57%. Thus, to incentive the use of this fuel and accelerate the energy transition of airlines, governments need to promote the mass production of SAF and make it more accessible.

[3] *New accounting rules on leases (IFRS-16) were introduced in 2019. Under these standards, leases have to be recognized in the balance sheet in the form of a Right-of-use asset and offset with a Lease liability, which "artificially" enlarges the level of debt of lessees (airlines).*

[4] *Operating cash flow: the amount of cash generated by a company's business operations. It should be positive and large enough so that a company can maintain and grow its operations organically (without external financing).*

Figure 9: Expected SAF required for Net Zero 2050 (billion liters: left, min % requirement: right)



Sources: IATA, Allianz Research.

To develop a sustainable transportation industry, Europe will require government ecological-linked subsidies and public policies that guarantee the continuity of the market in the coming years (rail vs planes). But above all, airlines will need to transform their cost structures. In the medium term, digitalization and artificial intelligence may be the way for allowing staffing to be reduced in airports and streamline processes. By 2035, this will potentially compensate for increasing e-fueling consumption. However, the transition will also require additional injections of capital to make it feasible.

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