



Rex Features

CAPACITY CAUTION

Seabury Group's Gert-Jan Jansen and Ryan Keyrouse ask whether future demand growth and industry trends justify airlines splashing out on new freighter aircraft

A scan of recent news begs the question if the air cargo industry has forgotten that capacity discipline was a key reason why cargo profits soared in 2010. A buying frenzy seems to have taken hold of airlines around the globe: Hong Kong Airlines bought six Boeing 777Fs, and is rumoured to be negotiating for Boeing 747-8Fs; Lufthansa is about to buy five 777Fs; FedEx Express ordered another 15 777Fs; Turkish Airlines placed firm orders for three A330-200Fs; Qantas is rumoured to be adding 747-8Fs or 777Fs, AirBridge adds freighters, Thai will convert two 747-400s. And the list goes on.

This may appear reasonable, given the air cargo industry has in many ways seen a remarkable recovery. Demand was up 21% in 2010, average load factors reached an all-time high of 57%, yields improved 10-20% and carriers who publish annual reports, such as Cargolux, showed a return to profitability after years of losses.

The cargo industry, however, has a reputation of confidently ordering freighter aircraft at a peak, then scrambling to utilise them profitably once they arrive and the need for capacity is less buoyant. Predictably, the recent announcements come at a time when growth has normalised and capacity is again outpacing demand growth. In the first two months of 2011 demand grew 5.5% – while 9.5% capacity was added. Additionally, despite the excitement around the 2010 recovery, there are other long-term industry trends not shifting in carriers' favour.

Has the industry failed to recognise these industry trends and become over exuberant in placing freighter orders? Or is the commitment to further capacity justified and have some airlines discovered how to outperform others?

MARKET PRESSURE

Recent orders show air cargo operators are bullish on the future. While 2010 saw demand growth return, some could argue much of this recovery was due to government stimulus packages and inventory replenishment. Either way, industry growth rates have declined and are projected to remain below historical averages. More positively, one can say the cargo business will continue to be a growth business. The global air freight market has proven resilient through continued crises and is projected to grow, albeit at a slower pace (see graph opposite). While growth is anticipated,

the fear is rampant capacity growth occurring carelessly in an industry still faced with uncomfortable long-term trends:

- Volatile markets and weakening growth projections: airlines are experiencing difficulty planning their networks and fleets, with continued volatility and uncertainty in market growth projections. Much of this is due to the lack of a recent “normal year” to ground comparisons, stemming from an increased number of economic and non-economic crises.
- Long-term decline of net yields: recent yield improvements were largely due to capacity discipline after the crisis. However, with capacity reintroduced net yields have levelled off and are now back on the decline. Historically, net yields have deteriorated and no evidence suggests a reversal of this trend.
- Gradual slowing of supply chains: sustained increases to oil prices and recent ocean capacity oversupply are putting downward pressure on shipping rates and will make the ocean as an alternative to air freight an increasingly viable option.
- Additional environmental and security reg-

ulations: screening cargo adds considerable cost and transit time, and environmental concerns will increase transportation costs once carbon emission trading is in effect.

■ Evolving business models of key players: forwarders and airlines are consolidating, joint ventures and new types of agreements between industry stakeholders are being established and the traditional roles of the industry are blurring. These evolving business models represent both a threat and an opportunity.

With market recovery uncertain and long-term fundamentals against the industry, it behoves airlines to be diligent with the lever most in their control: capacity.

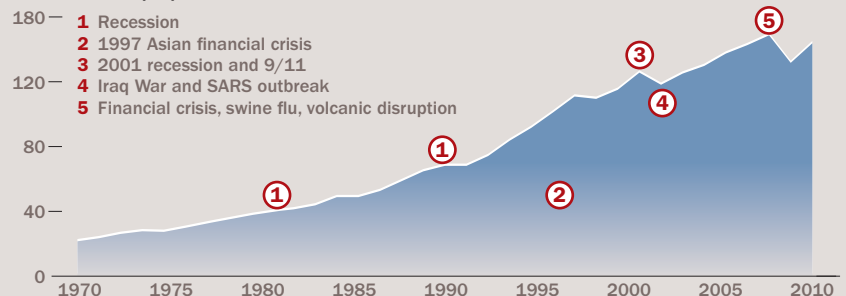
CAPACITY GROWTH

For the sector's long-term sustainability, capacity should balance with demand growth. With the air freight market forecast to grow 25% over the next five years (5% compound annual growth rate), this implies capacity growth should, at a maximum, match this rate – if not grow less quickly to fill current oversupply.

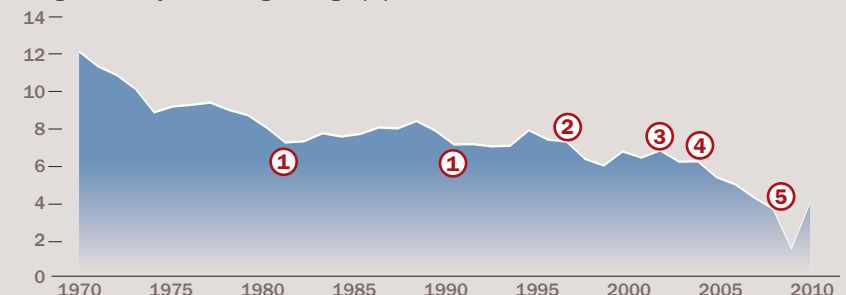
While most think of capacity increases com-

AIR FREIGHT LONG-TERM TRENDS: STILL GROWING, IF MORE SLOWLY

FTK volumes (bn)



FTK growth 10-year moving average (%)



SOURCE: ICAO, IATA, Seabury analysis

ing from new production freighters, capacity increases come from other sources, including passenger-to-freighter conversions, increased passenger aircraft belly space and return-to-service aircraft. This gross figure nets down by age and economical retirements.

Manufacturers – for the first time in history – simultaneously introduced three new freighter types to the market, and have significant backlogs for the A330-200F, Boeing 777F and Boeing 747-8F. An unprecedented spike in production freighter deliveries is coming in the next few years, and this hasn't prevented new orders. Demand for conversions is still weak, but recently activity seems to be picking up as well. New feedstock, especially for the 747-400, is hard to come by. Last, increases in fuel prices may accelerate retirements, as older aircraft are unable to fly profitably and are replaced with more fuel-efficient (and much larger) new production freighters.

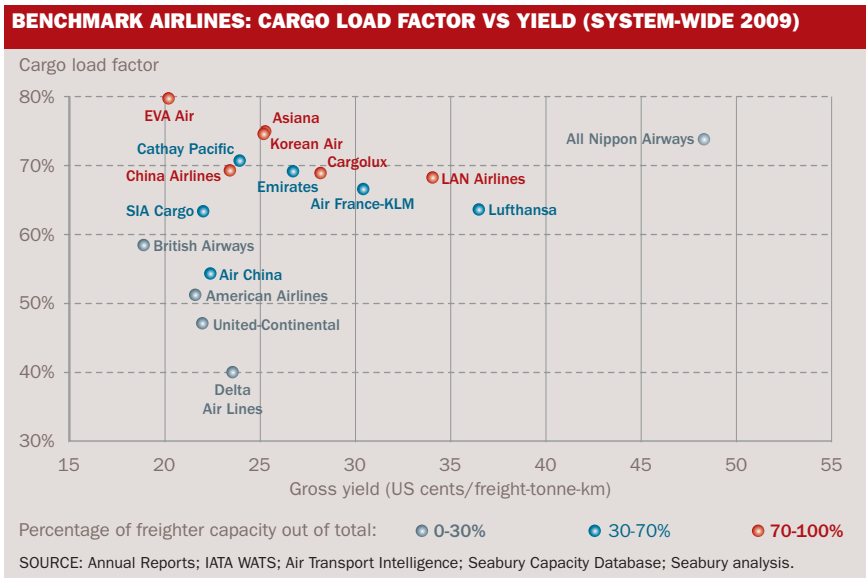
While freighter capacity introductions are alarming in themselves, this coming alongside increasingly cargo-friendly passenger aircraft is cause for further concern. The average cargo capacity per seat increased 20% in the past decade, implying if no more passenger seats were added freight capacity would grow 20% through passenger fleet renewal. Additionally, recent passenger aircraft have been designed to increase range with cargo on board, enabling carriers to serve more distant markets with increased belly cargo.

The impact of increased belly capacity does more than potentially oversupply markets. Without the burden of aircraft operating costs associated with freighters, belly cargo's high contribution margin presents a problem for yields. With an average contribution margin of 65% for belly cargo, carriers can cut yields to gain market share and fill their increasingly large belly holds. Expensive freighter operations lack this flexibility, and could be heavily impacted on routes experiencing increased widebody passenger flights.

If the recent gold rush for additional air cargo capacity continues – which may appear likely – there should be growing concerns regarding supply and demand imbalances.

AIRLINE CHOICE

Airlines will experience declining load factors, or decreased utilisation to match demand. With the high cost of ownership from new freighters requiring high utilisation, airlines will find it increasingly difficult to



remove capacity quickly. Parking aircraft will be expensive for airlines to absorb, and combined with declining yields this has a severely negative impact on profitability.

Airlines have a choice. Though the air cargo industry will remain under pressure, worsened by a continued oversupply of capacity, airlines today have the opportunity to position themselves in a variety of ways to outperform their competitors. A high-level comparison of load factors and yields reveals remarkable differences amongst carriers (see chart). While some differences can be explained by the region, aircraft type or methodology used by airlines for determining capacity, it is clear airlines can view the cargo opportunity as a by-product of the passenger business, or a core business.

Data highlights airlines which have invested in cargo and achieve a relative high share of revenue from cargo reap increased load factors and yields. Also, airlines for which cargo revenue makes up less than 10% of the total lost most ground in 2009, due to a great yield decline – and an average 3-4 point load factor decrease. Conversely, cargo-focused carriers experienced load factor improvements during the downturn, while seeing yields decrease at a slower rate.

This correlation does not suggest airlines should grow freighter operations and simply chase increased revenues from cargo, as this approach does not necessarily lead to increased profitability. However, it does

highlight that airlines who have committed to developing their cargo divisions have been better able to mitigate the impact of downturns, while adding to the bottom line.

DEFINED STRATEGY

Cargo-focused carriers have varying approaches to this cargo opportunity. While some chose to build extensive freighter networks, others opted to operate profitable cargo operations without freighters. Some airlines chose to be the lowest absolute cost, others to differentiate their belly products, to cherry-pick the most profitable cargo. Each approach merits consideration, but airlines should avoid following a strategy that fundamentally does not suit the airline's goal.

Capacity growth is potentially planting the seeds for tomorrow's air cargo crisis and much of it will be self-inflicted within the industry. While a hard stop on new production freighters or conversions is not our suggestion, more diligence and realistic network and fleet planning will contribute to a profitable industry in the long term. Simply adding capacity and then scrambling to deploy it leads to disappointment and profitability erosion. ■



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