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## Airlines Risk Seat Glut by Growing Fleets as Traffic Teeters

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By *Steve Rothwell*

(Updates with Air Berlin, Delta earnings starting in seventh paragraph, comment from BAA finance chief in 21st.)

Oct. 26 (Bloomberg) -- Airlines are storing up trouble by swelling fleets with new planes and bringing older jets out of mothballs at the fastest pace since the world emerged from the last recession, just as traffic starts to collapse.

Carriers reinstated a net 39 stored planes in August, the most in at least two years, while the 137 jets added or recalled ranked second highest, the latest data from Ascend shows. Air France-KLM Group and Deutsche Lufthansa AG may be among those most exposed after Europe added seats at twice the pace of Asia and three times that of North America in the first eight months.

Airlines returned to profit last year by slashing routes and frequencies and raising fares on remaining flights. A glut of seats may prompt a reversal in prices, deepening a 40 percent slump in industry profit forecast next year by the International Air Transport Association trade group, which says passenger travel is poised to follow an accelerating drop in cargo demand.

"When airlines make capacity decisions they focus on how good it might be, when the real question is how bad," said independent airline analyst Chris Tarry. "This business is about revenue and once that starts to slow you come under immediate pressure. This is a time for caution, not valor."

### Lower Targets

Europe's top airlines have already cut earnings targets, with Paris-based Air France-KLM, the biggest, saying July 27 that it aims to break even in 2011 after posting a year-earlier operating profit of 28 million euros (\$40 million).

Germany's Lufthansa, the No. 2, said Sept. 20 it would miss a goal of beating 2010's 876 million-euro operating profit while achieving a total at the upper end of a "three-digit million- euro range." The carrier will later today post a third-quarter figure of 646 million euros, based on five analyst estimates.

Local rival Air Berlin Plc, Europe's third-biggest discount airline, said today quarterly profit minus interest and tax fell 44 percent to 96.8 million euros, 30 percent short of estimates.

The Bloomberg EMEA Airlines Index has dropped 33 percent in 2011, with Air France down 59 percent and Lufthansa 38 percent.

Last year's economic rebound from the global slump boosted traffic 8.2 percent, allowing airlines to turn a record \$15.8 billion profit even as they boosted capacity 4.4 percent.

### Weakening Picture

With a slowdown in global GDP growth confirmed on Sept. 20 by the International Monetary Fund, which slashed its full-year forecast, traffic gained only 6.1 percent in the first eight months and was outpaced by capacity expansion of 6.5 percent, according to IATA. That cut August seat-occupancy levels or load factors to 78.2 percent, down 1.3 percentage points from July.

GDP will expand only 1.6 percent in richer nations this year, the IMF reckons, while Roubini Global Economics LLC said this week there's a 50 percent risk that the U.S., U.K. and euro region will slip into recession over the next 12 months.

"Falls in business and consumer confidence, the unresolved financial situation in the euro zone and the stagnation or worse in world trade are all likely to weaken air travel and air freight further," IATA said Oct 3. CEO Tony Tyler said the next day in an interview that its forecasts for net income to drop by more than half to \$6.9 billion this year before sliding to \$4.9 billion in 2012 are subject to a "downside" risk.

While passenger demand grew 4.5 percent in August, cargo traffic fell 3.8 percent that month, continuing a negative trajectory that began in May, and freight trends are almost always replicated by the travel market, according to IATA.

### Late Braking

Airlines are reluctant to cut capacity too soon for fear of losing market share, said Neil Glynn at Credit Suisse Group.

"Capacity cuts don't usually happen in real time," the London-based analyst said. "If you're an airline you don't want to cut too early if there's just one week of slow bookings, so generally you do have to give it a bit of time."

All regions except Latin America have added seats faster than traffic has grown this year, according to IATA figures, with European airlines lifting capacity most at 10.3 percent through August, compared with increases of 4.8 percent in the Asia/Pacific and 3.6 percent in North America.

Carriers have belatedly put the brake on, with Lufthansa slowing winter expansion first from 12 percent versus a year earlier to 6 percent and finally to 4 percent on Sept. 21.

Delta Hit

Air France-KLM said Sept. 29 it would add only 3.4 percent more seats after paring long-haul growth by almost half to 2.6 percent. It and Delta Air Lines Inc. will scrap 9 percent of capacity in a trans-Atlantic venture following a 16 percent first-quarter jump. Delta yesterday posted third-quarter profit excluding items equal to 91 cents a share fell, short of the 94 cents predicted by analysts, sending the stock down 5.2 percent.

International Consolidated Airlines Group SA, formed via the January merger of British Airways and Iberia of Spain, still predicts "significant growth in operating profit" versus a pro forma 6 million euros in 2010, and CEO Willy Walsh said Oct. 18 in Toulouse, France, that he's not worried about seating levels, airlines having shown "good capacity management and discipline."

Still, IAG said Oct. 5 that premium sales are becoming "softer," and the carrier is cutting back on an increase in so-called "flexible capacity" in the final three months of this year, reducing the overall increase by one-quarter to 6 percent.

#### Planning Horizon

BAA Ltd., owner of Europe's No. 1 airport, London Heathrow, is "cautious about coming months" and the likely impact of macro-economic conditions on business travel, Chief Financial Officer Jose Leo said today, adding that "cautious doesn't mean taking a negative view, simply that we're coming out of a record summer."

Heathrow, like some other major hubs, has pent-up demand because of a lack of new operating slots, and is "particularly good at performing well in difficult times," Leo said in an interview. Scope for carriers to cut services at such crowded airports is also limited by a European Union "use it or lose it" rule obliging them to utilize 80 percent of slots or relinquish some, Tarry said, though that was suspended in the last slump.

Airlines will always struggle to match capacity with demand because of a mismatch between their six-month planning horizons and the speed at which demand can fluctuate, the analyst said.

Carriers are currently working on flying plans for summer 2012 before attending IATA's 129th slot conference in Singapore on Nov. 17 to agree timetables which will help determine future occupancy levels, fares and profitability, he said.

"The industry's decisions as to what levels of capacity it needed to put in this winter were taken months ago when people were a lot more optimistic," Tarry said. "But this is the real world and it's very difficult to predict."

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10

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Washington DC is losing the U.S. aviation industry. Douglas, Convair, Lockheed no longer building airliners. Only Boeing left. Indeed, smaller regional jets are built in Brazil, Canada and Europe - none in the U.S. The new NEX GEN air traffic control system will help but cannot achieve 100% efficiency unless five new international airports are built in the U.S. And on and on.

A reformed FAA should be removed from the USDOT (too busy with surface modes) and report to a new five-member National Aviation Board that will report direct to the White House with appropriate Congressional oversight.

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