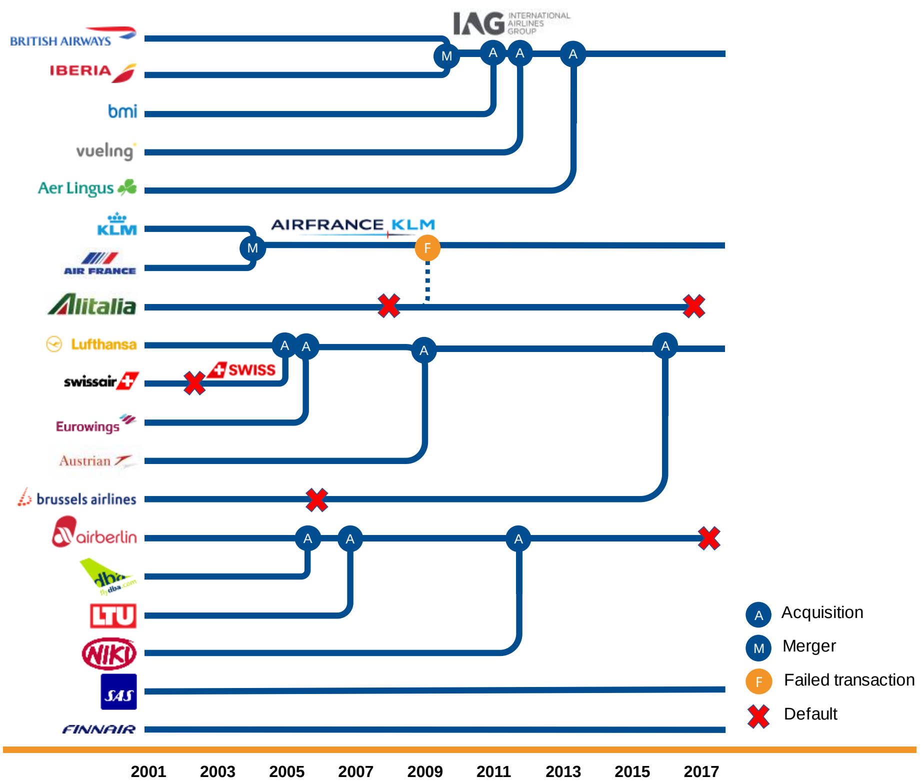
European Airlines
Growing Need for Consolidation?

Recently, a combination of ever-rising demand and favourable jet fuel costs has lifted load factors and profitability for most European airlines. Despite these buoyant conditions, the European market has been shaken up by the insolvencies of Alitalia, Air Berlin and Monarch Airlines this year. The question arises whether the still-fragmented European industry will enter a new round of consolidation undergoing a process similar to the US market. Scope believes that the sector is not being forced into accelerated consolidation. However, major industry challenges will create a pressing need for consolidation in the medium to long term in order to structurally improve the industry's profitability and credit metrics. For the time being, consolidation will likely remain a function of acquiring assets and slots of troubled airlines or collaborations.

Consolidation credited to structurally improve profitability and credit quality

The European airline market remains comparatively fragmented although consolidation tendencies can be observed in the European market (see Scope's simplified overview of major consolidation events). Still the top five airline groups Lufthansa, IAG, Air France-KLM, Ryanair and easyjet only cover around 45% of European air traffic, compared to around 80% market coverage by the top five carriers in the US. The long, painful consolidation process which the US market has undergone, including many defaults, can ultimately be credited with the structural transformation of US airline industry profitability, leading to average EBITDAR and EBITDA margins of around 30% and 20% respectively, compared to 19% and 10% for European airlines. In Scope's view, the pressure to consolidate further could increase once the overcapacities hit the market and the LCCs find that they can only achieve further growth and market shares by slashing average air fares at the cost of short-term profitability.

Figure 1: Overview of consolidation activities of major legacy carriers



Includes M&A activities of controlling stakes and only deals with airlines with a fleet size of over 30 carriers; smaller M&A deals of European LCCs are shown in Figure 4 on page 3.

Source: Scope presentation

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Persisting challenges for European airlines

Recent insolvencies associated with persisting sector challenges

Favourable market statistics for most European carriers in terms of load factors and profitability, should not obscure the fact that industry challenges, particularly for legacy airlines, remain severe. In some markets, price-aggressive LCCs have already taken pole position ahead of national flagship carriers (see Figure 2). From Scope's perspective, the recent insolvencies of Air Berlin, Alitalia, as well as the most recent grounding of Monarch Airlines, have again hinted at structural weaknesses in the sector. Moreover, the dogfight over Air Berlin assets (with initial bids from Lufthansa/Eurowings, IAG, easyjet, Condor/Niki and industry outsiders) demonstrates the quest for acquiring market share. Over the past few years, supportive jet fuel prices and high load factors have disguised persisting sector challenges and the necessity for structural cost adjustments. The following major challenges remain from Scope's perspective:

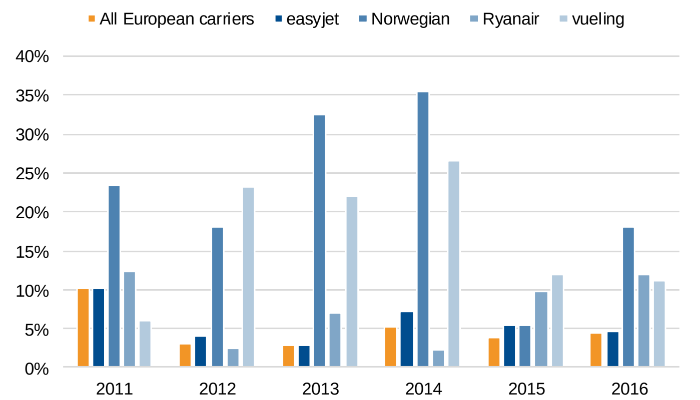
- Steadily increasing capacities (i.e. see available seat kilometre development of major European LCCs in Figure 3) but which could lead to severe overcapacities that cannot be shifted to emerging markets as in past recessions.
- Greater debt financing including a massive hike in operating leases along with a capacity ramp-up.
- Headroom for major LCCs to cut air fares further in order to boost market shares at the cost of profitability.
- Growing overlap within the route network not only between LCCs and legacy carriers but also among LCCs.
- Consumers' high price sensitivity for short-haul flights, taking precedence over comfort and reputation.
- Increased pressure on long-haul routes given LCCs indirect move towards long-haul through collaborations (i.e. Ryanair-Air Europa and easyjet-Norwegian).
- Greater political headwinds for European airlines due to ambitious EU CO_2 emissions targets.

Figure 2: Top three carriers in major European markets

Country	PAXm total	No 1	No 2	No 3
UK	130	easy jet	Ryanair	British Airways
Germany	122	Lufthansa	Air Berlin	Ryanair
Spain	117	Ryanair	vueling	Iberia
Italy	90	Ryanair	Alitalia	easyjet
France	77	AF-KLM	easyjet	Ryanair
Greece	27	Aegean	Ryanair	easyjet
Portugal	23	TAP	Ryanair	easyjet
Poland	18	Ryanair	LOT	Wizzair
Ireland	17	Ryanair	Aer Lingus	BA
Belgium	17	Ryanair	Brussels	Jetairfly

Source: Ryanair, Scope

Figure 3: Available seat kilometre development of selected European LCCs (yoy growth)



Source: company reports, IATA, Scope

Challenges call for true consolidation in the longer term

Such challenges are likely to shake up the market if macro conditions deteriorate and the sector is hit by overcapacities. Any such scenario would force the industry to push for true consolidation. Scope believes that pressure for more sector consolidation could increase in the long term given the stronger market saturation and increasing overcapacities resulting from the highly ambitious expansion plans of Europe's LCCs. As a consequence, some of

Europe's small and medium-sized legacy carriers, as well as niche LCCs, which are too small to compete effectively in the long-haul markets against the big players, and too expensive to compete effectively in the short-haul markets against the large LCCs, may be ruined unless they can find protection inside a larger group.

Greater obstacles to European sector consolidation than in the US

Greater obstacles to European airline consolidation than in the US market

From Scope's perspective, sector consolidation among European airlines is impeded considerably by major obstacles with which US airlines did not have to contend. European carriers face three major restrictions:

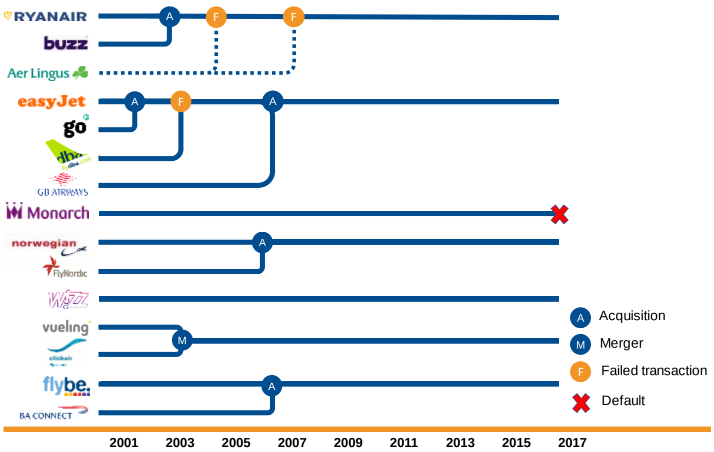
1. Governmental and legal barriers in terms of government stakes in certain carriers and European Commission approval.
2. Trade unions may strongly oppose planned transactions, especially if airlines want to rationalise and optimise their operations.
3. Tightening restrictions on foreign capital as non-European airlines can hardly take part in the consolidation game given regulatory restrictions (EU Regulation No. 1008/2008 states that, in order to obtain and retain an operating license, an EU air carrier must be majority-owned and effectively controlled by EU nationals).

Such obstacles have primarily led to failed M&A as in the cases of the unsuccessful dba takeover bid by easyjet in 2002, the abandoned merger of Air France-KLM and Alitalia in 2008 or the repeated failure of Ryanair to acquire Aer Lingus in 2005 and 2007.

LCCs have not pushed much for consolidation, although they could afford to do so

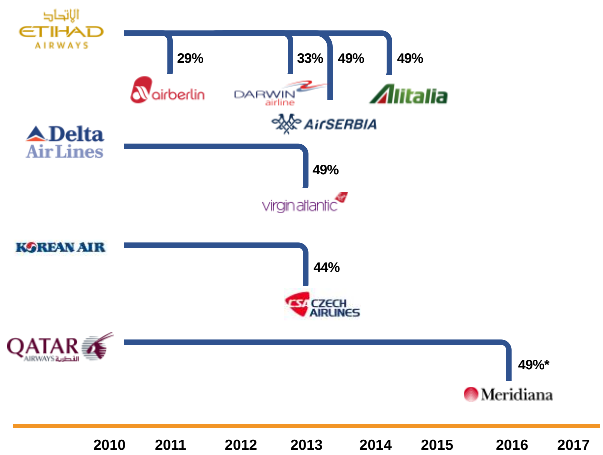
Europe's larger legacy carriers have dominated the consolidation activities in Europe's airline landscape (see Scope's overview in Figure 1). In contrast, Scope notes that LCCs have not yet participated much in this process, particularly not in the 2010s, preferring to push available seat kilometre capacity organically. As illustrated in Scope's consolidation overview for major European LCCs in Figure 4, LCCs have so far only arranged smaller transactions. From Scope's perspective, this is surprising, as LCCs could afford to play a more active part in consolidation. Ryanair and easyjet in particular are deemed to have the financial strength to do so, with large piles of cash and a lease-adjusted leverage of less than 2x. As long as the pressure to undertake active consolidation remains low, LCCs are relying on collaborations with other airlines to satisfactorily utilise capacity, or the expansion of route networks to gain traction, as in the most recent collaborations between Ryanair and Air Europa or easyjet and Norwegian.

Figure 4: Consolidation activities of European LCCs



Source: Scope presentation

Figure 5: Non-European airlines participating in sector consolidation



* Deal thrown off by Gulf crisis

Source: Scope presentation

Credit quality outlook

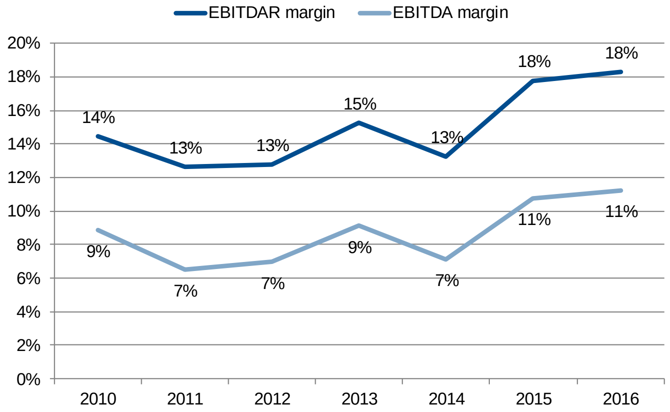
Comprehensive peer data from 22 European airlines

In addition to rating Lufthansa (BBB-/Stable), Scope also rates some other European and non-European airlines on a private basis as counterparties for structured finance, project finance or AIF transactions.

Average industry leverage should have reached the floor

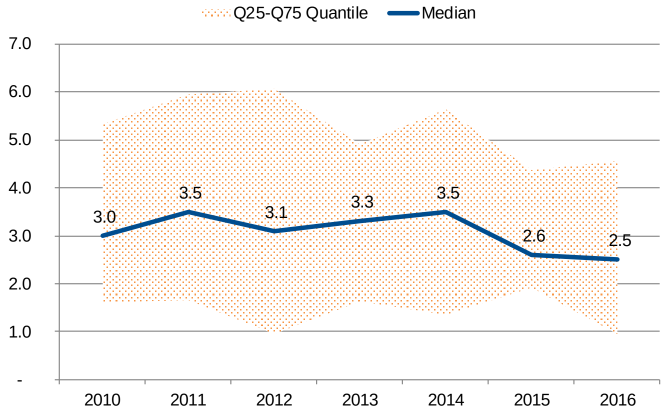
Contrary to the picture which has been painted by the three airline defaults in 2017, the financial status quo of European airlines is comparatively strong. Scope highlights the significant improvement in average profitability measures and key credit metrics for 22 European[1] airlines in Scope's industry database. The average leverage – measured as Scope adjusted debt/EBITDAR – has moved in the direction of 2.5x. However, Scope emphasises the fact that the industry's improved leverage is not the result of active deleveraging but rather of scaling effects and a peaking margins with an average EBITDAR margin of almost 20% in 2016. In general, European airlines have hiked debt levels (on-balance and off-balance), taking advantage of the low-interest rate environment and the growing popularity of operating aircraft leases (as displayed by the growing gap between the EBITDAR and EBITDA margin).

Figure 6: Median margin profile of European airlines (n=22)



Source: Companies' annual reports, Scope

Figure 7: Median leverage[2] of European airlines (n=22)



Source: Companies' annual reports, Scope

Current comparatively rosy credit picture not sustainable due to no structural improvements

Scope does, however, question whether such improvements point to a structural improvement of the average credit quality of European airlines. In light of the high industry-inherent risks relating to the sector's strong cyclicality and comparatively low barriers to capacity expansion or new market entrants, the rosy picture painted by the average credit metrics does not represent an 'all-clear' for the larger carriers. Cost advantages from low jet fuel prices and fleet optimisation are quickly passed on to customers in the form of lower air fares, and do not, therefore, stabilise airlines in the long-run. In the event of a new industry downturn or a more aggressive European LCC pricing strategy, key credit metrics are likely to once more experience rapid deterioration. Scope sees little chance of a structural increase in industry profits as long as true consolidation among the players does not occur.

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1 Includes data of some airlines within a group on a standalone basis, i.e. Iberia, British Airways, Aer Lingus, KLM.

2 Leverage includes NPV of minimum lease payments for operating leases and pension adjustments.

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