Airlines
Trump Tax Reform to Spur Competition on Transatlantic Routes

The transatlantic market between North America and Europe is still the largest intercontinental market in the world with an annual passenger volume of about 60m a year. Dozens of US and European airlines fly non-stop across the Pond, with an increasing offering from low-cost/hybrid carriers such as Norwegian, Air Europa, LEVEL, Joon and Primera Air. Scope asks whether the Trump tax reforms which aim to reduce the effective tax rate for business generated in the US and to encourage investment through accelerated depreciation on purchases of new aircraft might be a game changer, favouring US-American airlines in the transatlantic market.

Trump tax reform

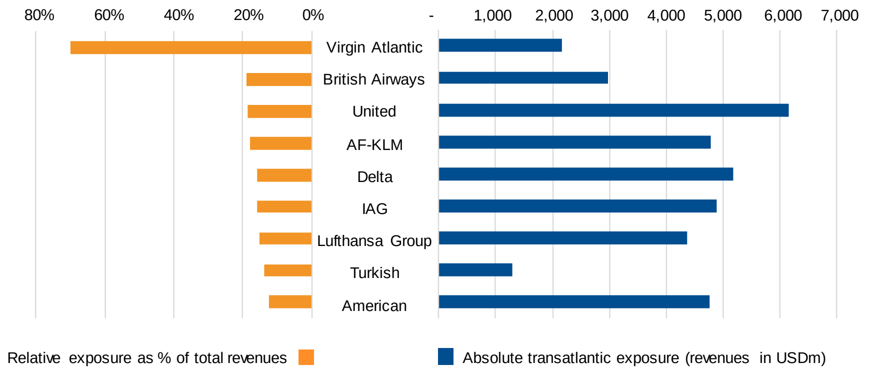
The tax reform, signed as the 'Tax Cuts and Jobs Act', which was passed by the Senate and Congress in Dec 2017, is likely to have a significant effect on airlines' earnings, particularly in the medium term:

- The corporate tax rate, which applies to earnings generated in the US, falls to a flat 21% rate from a maximum of 35% under the existing graduated rate structure. This is likely to boost US airlines net profits, unless management decides to reinvest the gains in reduced average fares, increasing salaries, or accelerated investment and depreciation or unless the gains are eaten up by rising jet fuel prices or unforeseen events.
- While the application of net operating loss (NOL) carryforwards will be capped at 80%, net operating loss carrybacks cannot be applied any longer.
- Companies can expense 100% of certain business property acquired and placed in service between September 27, 2017 and January 1, 2023 - and even a year in addition for some assets including certain aircraft - rather than having to depreciate it over several years.

Significant exposure to transatlantic routes

With about 60m passengers flying between the US and Europe the transatlantic air-travel business is lucrative for airlines on both sides of the Pond. The three US carriers generated revenues of more than USD 15bn from such routes in 2017. As displayed in figure 1, major European and US carriers have an exposure of around 15% to 20% to transatlantic air traffic (measured as a share of total revenues). The outlier is Virgin Atlantic Airways which primarily focuses on this market segment, thereby accounting for around 70% of total revenues.

Figure 1: Exposure of airlines to transatlantic services (2016)



Source: Company reports, Scope

Scope believes that the Trump tax reforms, if not reversed by the next administration, favour US airlines over European and Middle Eastern carriers in the competitive transatlantic market in the mid-term as a result of tax savings and a potential fleet expansion/rejuvenation.

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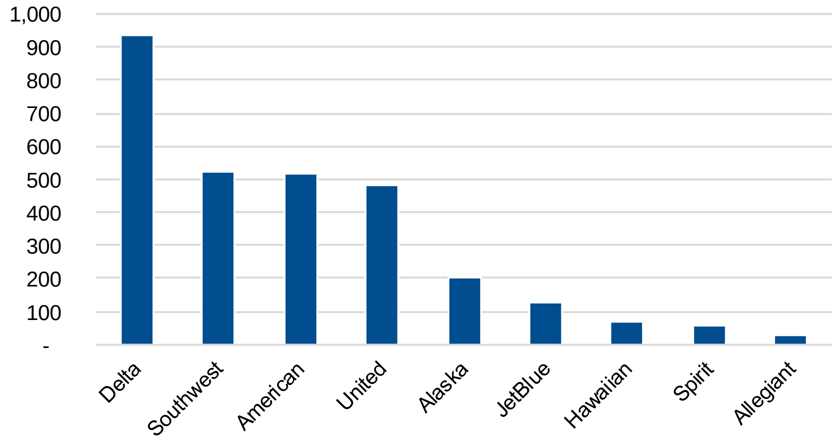
Modest short-term cash impact but significant longer-term benefit of corporate tax cut for the large US carriers

No immediate benefit from reduced corporate tax for large US carriers due to existing NOL carryforwards

US airlines, which display some of the highest effective tax rates among any sector in the US, may benefit from the reduction of the corporate tax rate. Scope calculates that for the larger airlines such tax savings could be between USD 500-1,000m per annum (see figure 2). However, this only applies in full when the companies no longer benefit from existing NOL carryforwards, which will be dissolved over a longer period. Scope notes that the larger US airlines (Delta, AA and United) currently do not pay federal corporates taxes as they still use their NOL carryforwards from the meagre years between 2008 – 2011 (which they will release over a longer time period given the lower effective tax rate and the eligibility of only 80% of carryforwards), while the smaller domestic carriers such as Alaska, Southwest and Spirit will immediately benefit from the lower tax rate.

Figure 2: Theoretical tax savings based on 2017 pre-tax results (in USDm)



Source: Companies, Scope calculations

Increased net profits, ceteris paribus, could be used in many ways

Given the US companies' strong focus on net income and P/E based multiples, US airlines however, will in the short to medium term (depending on the usage of deferred tax assets), benefit from the reduced tax rate as, ceteris paribus, the reduced tax expense increases net profit. Scope reckons that airlines might take different routes in using these tax savings:

- bonuses or higher salaries for employees as in the cases of Southwest and American Airlines;
- higher shareholder remuneration through increased dividend payments/share buybacks;
- deleveraging.

The positive impact on net profit and free operating cash flows will however, be deferred by some time if the airlines will rather boost their investment plans.

Cutting fares only in the mid-term

Scope believes that the likelihood of cutting average fares on domestic and transatlantic flights in the short term is rather limited as

- the large three carriers Delta, United and American first have to use their remaining NOL carryforwards before the reduced tax rate translates into reduced cash outflows and
- the smaller carriers, which immediately benefit tax savings, may not want to jeopardise their profitability for the sake of gaining market share in the oligopolistic domestic market.

However, Scope believes that in the medium to long-term these tax savings will translate into reduced fares, particularly on intercontinental routes, thereby stiffening the competition against European and Middle Eastern carriers on transatlantic routes.

Long-haul low-cost offer of European airlines also progressing

Scope notes that European low-cost carriers such as Air Europa, WOW or Norwegian are trying to gain market share by offering appealing fares. So are the low-cost ventures of the legacy carriers such as Joon (Air France), LEVEL (IAG) and Eurowings (Lufthansa) which are trying to develop long-haul routes.

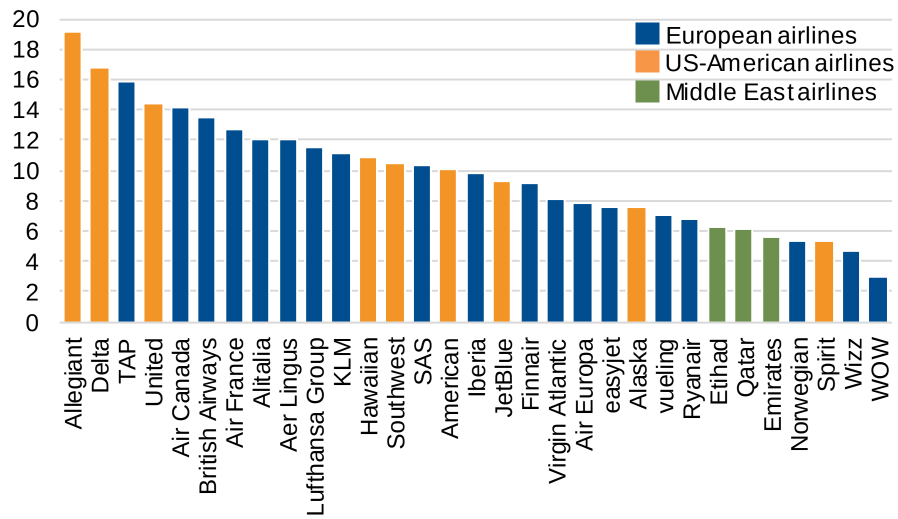
In any case, the US tax reform enables US carriers to better digest any other cost increases such as spikes in the cost of jet fuel compared with European or the Middle East competitors.

Stimulus for fleet renewal

US carriers have some of the oldest fleets in developed markets

As displayed in figure 3, US carriers, particularly those with transatlantic and other intercontinental route exposure, have some of the oldest fleets in developed markets. Moreover, they currently have some of the lowest order backlogs for new aircraft with Airbus, Boeing and Bombardier. Scope points out that company growth of US carriers has pretty much been focussed on market consolidation rather than on organic growth through capacity additions or new market developments given the high saturation of the North American market (see Scope study on consolidation 'European Airlines: Growing need for consolidation?').

Figure 3: Average fleet age of major airlines

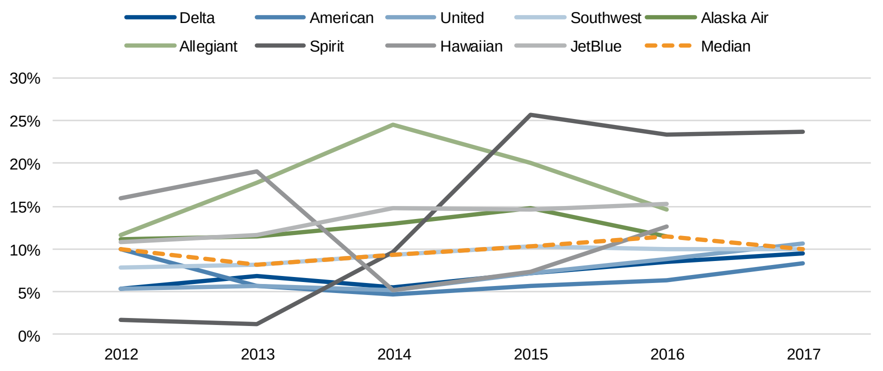


Source: airfleets.net, Scope

Scope believes that US carriers will increase their capex programmes, particularly for intercontinental traffic

This is underpinned by the comparatively modest investment ratios, particularly for the three legacy carriers, as measured in capex/revenues as displayed in figure 4. Scope expects that the US carriers will have a strong incentive to grow more organically through the investment in new capacity, such as A330, B787 or new B737-MAX and A321neo LR, even if it is only in the mid-term. Southwest and American Airlines have already announced a more bullish view on its order book and fleet expansion. While the waiting lists for new aircraft are long, the US carriers could be good candidates to take deferred aircraft deliveries in the short-term. Still, such fleet rejuvenation and/or expansion would allow the US carriers to stimulate increased passenger volumes and save money from more economical aircraft. That should improve the performance of the airlines' domestic and international activities.

Figure 4: Capex/Revenues US carriers



Source: Bloomberg, Scope

Fleet renewal ensures competitiveness

With competition for the US legacy carriers United, American and Delta and for their historic European competitors Virgin Atlantic, BA, Lufthansa and Air France-KLM stiffening from new entrants in the transatlantic market in the shape of European budget carriers (Norwegian, WOW and Air Europa/Ryanair) equipped with young, fuel-efficient fleets, such investment will be vital to ensure the US airlines' long-term competitiveness.

Conclusions on credit quality

Scope summarises its findings on the potential medium to long-term impact on the transatlantic business of European and US-American airlines in the following table. The short-term cash impact of the Trump tax changes on Delta, AA and United is limited given they are carrying forward losses from the industry's lean years after the Great Financial Crisis. Still, the fiscal reforms promise clearer skies for a notoriously turbulent part of the US economy.

Figure 5: Scope's view on US and European airlines' business risk and financial risk profiles

US airlines	European airlines
BRPs of US-airlines with significant exposure to transatlantic passenger and cargo traffic to be strengthened due to • potential to increase market share on Transatlantic routes • potentially high load factors as a result of more competitive fares • scaling effects to lead to sustained profitability measures **Potential fleet rejuvenation and capacity additions may lead to** • sustained profitability measures	**BRPs of European airlines to be weakened by** • market share losses as a result of unattractive passenger fares • shrinking load factors on Transatlantic routes • weakened profitability
General economic stimulus in the US may lead to • improved key credit metrics **FRP may be strengthened as a result of** • improved FFO-based credit metrics • deleveraging • improved financing conditions **FRP may be weakened temporarily as a result of** • pressure on Free Cash flow generation following boosted capex • more ambitious shareholder remuneration	**Potential weakening of capacity utilisation may lead to weakening key credit metrics**

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