Despite well-publicised high traffic growth rates, China's airlines are having to deal with high levels of competition, high fuel price and a revalued currency. It is only because of a consolidated and merger policy by the CAAC that China's main carriers have returned to profitability.

China's airlines face a challenging future

Airlines on both sides of the Pacific were experiencing ebb and flow in 2004. The US airline industry reported a total loss of $10 billion, indicating a continuous recession. On the other side of the Pacific, however, China's carriers generated a net profit of about $600 million, of which Air China's profit was about $450 million, China Eastern's $62 million and Hainan Airlines' $11 million.

Needless to say, the US airline industry's financial weakness was caused by the soaring fuel prices and declining yields driven down by low-cost carriers (LCCs). But after five years' combined losses of about $400 million, what has made the financial performance of China's airlines so resilient? Are there financial risks underlying their record profits?

Economy cycle and demand

The airline industry is influenced by economic cycles. China's airline industry is no exception to this, but this is masked somewhat by its considerable traffic growth rates over the past two decades.

In 2004, China's airlines' total revenue ton-miles increased by 35.2%, passenger volumes by 38.4%, and cargo and mail volumes by 26.3%. These growth rates outstripped China's GDP growth rate of 9.1 % in 2004, which has been the highest since 1994.

In 1998, when China's economy encountered unprecedented deflation as a result of the Asian Financial Crisis, and recorded a growth rate of only 7.0%, Chinese airlines correspondingly reported a combined financial loss of about $600 million. On the other hand, Chinese airlines have obtained loans from banks over the past decade to purchase aircraft and build infrastructure, which pushed the ratio of debts-to-assets to more than 90%. This high gearing ratio allowed these airlines to expand their businesses and so generate more profits in the economic upturn, with loans generating more revenue than the cost of interest. In a downturn, however, loans cause airlines to make financial losses, since profits are depressed despite the extra capitalisation from the loans and airlines still incur interest expenses.

In late 2003, China's economy recovered from a five-year deflation and the SARS crisis, and began a new cycle, which allowed airlines' to benefit from their gearing ratios again.

The success stories, however, vary between airlines. In terms of revenue source, China's airlines can be divided into two groups. The first relies mainly on the domestic market, and includes China Southern Airlines, Shanghai Airlines, Hainan Airlines and Sichuan Airlines. The other group, which includes Air China and China Eastern, has equal shares of the domestic and international market.

China Southern generates 82% of its revenue from the domestic market, and limited revenue from the international market, mainly because its main operation base, Guangzhou airport, is too close to Hong Kong.

Over the past three decades Hong Kong's home carrier, Cathay Pacific, has developed a strong route network covering Europe, North America and the Asia Pacific. As a consequence, its neighbour China Southern has had little chance to develop its international routes, particularly in Europe and North America.

Thanks to the traffic right protection from Hong Kong carriers, China Southern could dedicatedly develop its domestic route network, which is now the most extensive among the three major airlines. In 2004 China Southern's passenger yield on the domestic routes was RMB 0.58 (7 cents) per revenue-passenger-kilometre (RPK), 1.8% higher than in 2003. China Southern's domestic load factor increased from 65.3% in 2003 to 70.5% in 2004. The two increases translated into China Southern's dramatic revenue increase from RMB 17.4 billion ($2.1 billion) in 2003 to RMB 23.9 billion ($2.87 billion) in 2004.

In 2004, Air China's revenue generated from international passenger service accounted for 39.7% of total passenger revenues. Since 91% of this carrier's revenue was generated from passenger services, the international passenger revenues accounted for about 36% of the total revenue.

International passenger yields increased from RMB 0.47 (5.6 cents) per RPK in 2003 to RMB 0.51 (6.1 cents) per RPK in 2004. Passenger load factor increased from 64.8% in 2003 to 70.4% in 2004.

Consequently, international passenger revenues increased from RMB 6.66 billion ($800 million) in 2003 to RMB 10.83 billion ($1.3 billion) in 2004.

On the other hand, Air China's domestic passenger yield increased from RMB 0.57 (6.8 cents) per RPK in 2003 to RMB 0.60 (7.2 cents) per RPK in 2004. Domestic load factor increased from 67.4% in 2003 to 73.6% in 2004.

The two growths resulted in revenue increasing from RMB 11 billion ($1.3 billion) in 2003 to RMB 15.4 billion ($1.85 billion) in 2004.

China Eastern's operating revenue increased by 47.1% from RMB 13.4 billion ($1.61 billion) in 2003 to RMB 19.7 billion ($2.37 billion) in 2004. Most of this revenue, 77.6%, was generated by passenger services.

China Eastern's international passenger revenue, which accounted for 31.8% of total passenger revenue, increased by 60.7% from RMB 3.0 billion ($360 million) in 2003 to RMB 4.8 billion ($570 million) in 2004. Like

China's economy has entered a new economic cycle and recorded a GDP growth of 9.1% in 2004. China Southern consequently recorded a rise of 4.8% in passenger load factor and a marginal increase in yield.

China Southern and Air China, China Eastern reported an increase in load factor from 56.7% in 2003 to 62.4% in 2004. Overall yield, however, decreased from RMB 0.53 (6.3 cents) per RPK in 2003 to RMB 0.49 (5.9 cents) per RPK in 2004.

The decrease was due mainly to increased competition caused by the open skies policy implemented by Shanghai, China Eastern's home city. On the routes from mainland China to Hong Kong, which used to be China Eastern's golden routes, the situation was not encouraging either. Passenger yields dramatically declined from RMB 0.84 (10.1 cents) per RPK in 2003 to RMB 0.72 (8.6 cents) per RPK in 2004, although the load factor increased from 52.4% in 2003 to 62.6% in 2004.

Only the domestic market presented China Eastern with some encouraging signs. China Eastern's domestic passenger revenue, which accounted for 53.9% of this carrier's total passenger revenue, increased by 48.1% from RMB 5.5 billion ($660 million) to RMB 8.2 billion ($980 million). Passenger load factor increased from 64.8% in 2003 to 70.3% in 2004, and yield increased from RMB 0.54 (6.5 cents) per RPK in 2003 to RMB 0.57 (6.8 cents) per RPK in 2004.

Air China seems to have been the best positioned of the three major airlines. It has monopolised the north China market, and has yet to encounter any substantial threat in its home market. In the foreseeable future, an open skies policy will not be adopted by Beijing airport, which is Air China's main base, due to national security concerns. Nor will a strong rival like Cathay Pacific emerge beside it. Air China's operational performance will continue to grow, given the strong demand and rate of traffic growth. China Southern's operational performance will continue to be reasonable, due to its significant domestic market share.

Airline cartel

An economic upturn and strong demand are necessary for the airline industry's prosperity, but this is not all that is required. The consolidation and merger policy carried out from 2002 by the Civil Aviation Authority of China (CAAC), and the oligopoly created among the three major airlines, formed the main contribution to the Chinese airlines' profit performance of 2004.

Before 2002, there were nine airlines owned by the CAAC and several owned by local governments. These airlines often had price wars to earn more market share. Financed by the central or local government, these carriers did not have to take the financial outcome of a price war into account, with the result that price wars ruined the whole industry.

To stop irrational competition, the CAAC had to consolidate the nine airlines and encourage the three major airlines to merge with the regional carriers. The outcome of this policy was that every major Chinese airline merged with two smaller airlines, leaving only seven independent airlines in the market. With market concentration increasing, the three major carriers began to jointly control the fare price on trunk routes, such as Guangzhou-Beijing and Guangzhou-Shanghai. Domestic passenger yields consequently stopped declining and improved.

In 1999, when the price war was at its height, average domestic passenger yield was about 5 cents per available seat-mile. Although the then several airlines tried to stabilise the price by collaboration, their efforts could not result in a substantial outcome, since every player intentionally increased its market share by secretly lowering prices. Now with only two or three major airlines operating on key routes, it is easy for them to negotiate and comply with the price agreement. Yield has therefore increased by about 20% on some trunk routes.

Improved management

The improved management of China's airlines was another contributing factor to their record financial performance in 2004. With China's airlines consolidating and merging, ownership of the three major airlines was transferred from the CAAC to the State-Owned Asset Supervision and Management Commission (SASMC), an organisation responsible for supervising the national assets.

Substantially different from the CAAC, which used to be responsible for regulating the airline industry and supervising the state-owned airlines' assets at the same time, the SASMC has sufficient motivation to push the airlines to improve their financial performance. Under the mandate issued by the commission, the airlines' management must make their financial performance their first priority. The transferred focus has resulted in tight cost control and decreasing unit operating cost. More importantly, SASMC implements a policy that stringently links assessment of the airline's management with these companies' financial performance.

Executives that are unable to improve their companies' financial performance will be quickly removed. The airlines' managements therefore have to struggle to achieve the financial target set by SASMC. These efforts have generated a positive outcome. In 1999 when China Southern operated 110 aircraft, the value of the spare parts inventory was about $150 million. In 2005, when China Southern's fleet had increased to 221 aircraft, the value of the inventory had decreased to about $110 million.

China's airlines turned their fortunes around in 2004, after recovering from the SARS crisis and large losses in 2003. China's airlines recorded a net profit of $600 million in 2004, with Air China accounting for $450 million of this. Air China's main strength is its geographic position, which gives it a monopoly on the Beijing market.

Financial strength

The Chinese airlines have always been regarded as growth companies, whose shares are easy to sell on the stock market. Chinese airlines' long-term efforts have gone into collecting the necessary capital from domestic and international stockmarkets.

In December 2004, Air China issued its initial public offering (IPO) in Hong Kong and London, offering 31% of its enlarged share capital and collecting about $1.07 billion. Some of this capital was used to lower Air China's debt-to-asset ratio, and $580 million was used to finance its aircraft acquisition.

China Southern, which is listed on the Hong Kong stock exchange, won approval from shareholders in 2002 to sell 1 billion 'A' shares, equivalent to 22.86% of its enlarged issued share capital. In 2003 the share offering collected about $3 million, which substantially compensated for the great financial loss caused by SARS and enabled China Southern to maintain a healthy balance sheet.

The capital markets, however, are getting tired of the airlines' offerings and bonds. What Air China's share price achieved on the offering day was about 20 cents lower than China Southern's, even though Air China has a much larger scale of operation and several well-established subsidiaries, such as Dragonair and Air Macau.

This fading popularity is partly due to the fact that shareholders have never got any return from the publicly listed airlines. Even worse, the airlines' share price dropped significantly after the first day's trading, and has never returned to the purchase level.

The third, but fundamental, reason is that the majority of the shares are controlled by these airlines' parent companies, which represent the government to manage the assets. Even though they may be dissatisfied with a decision proposed by the major shareholder, other shareholders cannot obtain enough voting rights to change it. The structural flaw underlying the share compositions substantially damages the market's confidence in Chinese airlines.

The Chinese airline industry is expected to continue growing at an average annual growth rate of 8% to 2020. Yet behind this rosy future lies a mounting risk.

Fuel risk

China's airlines are forced by the regulations set in the planned economy era to purchase fuel from China Aviation Oil Company (CAO), a state-owned monopoly. Normally CAO charges China's airlines 20-40% more than the international fuel price.

As the international fuel price keeps rising, the price of fuel is becoming unbearable for China's airlines. In the first half of 2005, China's airlines (with the exception of Air China, Hainan Airlines, Shanghai Airlines and China Postal Airlines), recorded a combined financial loss of $40 million, due to the soaring fuel price.

If the fuel price increases by 1%, China Eastern's operating cost will increase by about $5 million. China Eastern's fuel cost increased from 32% of its operating cost in 2004 to 39% in the first half of 2005. The airlines are unhappy with the pricing policy, and are trying to persuade the central government to remove it. With pressure mounting, the central government may have to abandon the policy in the future.

The latest development is that the CAAC stipulated in July 2005 a new regulation allowing investors to establish new aviation fuel companies. Among all potential investors intending to enter the lucrative market, China Petroleum & Chemical Corporation, the biggest oil company in China, is expected to be the first company to enter the market if the central government lifts the regulation in October 2005.

The airlines, however, are facing a new dilemma as a result of deregulation. In the past when purchasing fuel was stagnantly regulated, the airlines making great financial losses blamed the monopolised fuel market, and asked for subsidies from the central government. With the market deregulated, the airlines will have to deal with the fuel risk by themselves. Because they are unable to develop the necessary ability to hedge the fuel price in a short time, the increasing fuel price will endanger these airlines' finances at the start of deregulation. But whether the airlines are able to meet the challenge addressed by the international market remains to be seen. "China's airlines are facing a systematic risk partly because of the fuel price," says Chi Zhou, chairman of Shanghai Airlines.

Aircraft financing risk

Over the next six years, China's airlines will have at least 258 factory-built aircraft delivered, 85% of which will be narrowbodies, such as the 737 and A320 family. These orders are valued at about $15 billion. With capital expenditure increased, these airlines' cash flow and liquidity are deteriorating. The past three years have seen China Eastern's liquidity ratio decreasing from 0.57 in 2002 to 0.43 in 2004, and its debt-to-asset ratio increasing from 78.34% in 2002 to 84.27% in 2004, due to massive aircraft purchases. The airlines' traditional approach to financing aircraft deliveries is to borrow from China's state-owned and foreign banks. With China's banks being commercialised and foreign banks' cautious attitude towards these airlines, China's airlines will have to borrow money from the banks at higher interest rates.

China Eastern's load factor increased by 5.7% in 2004, although yield decreased by 0.4 cents per RPK. China Eastern is also suffering some of the highest levels of competition in the Chinese market because of its Shanghai base.

In August China Eastern issued a one-year bond worth RMB 1 billion ($123 million), at an interest rate floating from 2% to 2.02%.

Another approach is to finance these deliveries by internal finance: cashflow generated from operations. This is workable when the economy is on the upturn and air traffic demand is soaring. But it is expected that China's economy will go into recession after 2008's Beijing Olympic Games. Will the peak of aircraft deliveries meet the downturn? A third concern is whether Chinese airlines are able to sustain costly factory-built aircraft with yields in decline.

Exchange rate risk

Airlines are always facing two external risks that they can hardly manage: fuel price risk and exchange rate risk. In the past decade Chinese airlines were not concerned about exchange rate risk because the Chinese government stuck to the policy of pegging its currency to the US Dollar at the rate of RMB 8.28 Yuan to one US Dollar.

Since Chinese airlines' revenue generated from the international routes is denoted in US Dollars, the policy substantially minimised the exchange rate risk, and provided the airlines with a stable business environment. With China's foreign trade increasing and trade surplus shooting up, and the US Dollar devaluing, pressure for the Chinese government to change its exchange rate regime and increase the RMB's value is mounting. On 21st July 2005, the Chinese authority revalued its currency upwards by 2.1% to RMB 8.11 Yuan to $1, and adopted a managed float to an undisclosed basket of currencies. In addition, the RMB will be allowed to trade within a daily band of 0.3% to the US Dollar around a rate set by the central bank, People's Bank of China. While most Chinese companies doing foreign business will lose out because the appreciation of RMB will weaken their competitive advantages in the international market, Chinese airlines will be the only beneficiaries. These adjustments in the short term would result in a reduction of their foreign debt by about 3%. Spurred by the adjustments, Air China's stock price increased by 10.1%, China Eastern's 11.48% and China Southern's 13.79%.

This small change is significant and should lead to further progress in improving China's monetary flexibility, and economic and financial structure. The flexibility, however, is a double-edged sword for these airlines. While the airlines might benefit from the rise in the RMB's value, they would have to bear a great financial loss if it were to fall. Furthermore, while the RMB's appreciation would reduce the airlines' debt, it would also undermine foreign tourists' desire to travel to China and weaken the airlines' competitiveness on international routes due to substantial increases in fares. Moreover, as the new exchange rate regime uses a basket of currencies, such as the Euro, Japanese Yen and UK Sterling, to manage the float, the airlines have to manage the exchange rate risk derived from every currency. A rise or fall of the RMB to the US Dollar will not necessarily affect an individual airline's total revenue like before. Chinese airlines are therefore entering a world of complexity and uncertainty.

Low-cost airlines

So far no LCCs have been established in China, but those based in south-east Asia are posing a substantial threat to China's airlines in the regional and international market.

Air Asia Thai, a subsidiary of Air Asia, began to fly from Bangkok to Xiamen from February 2005, with one-way fares priced at $25. These low fares immediately put Xiamen Airlines at a terrible disadvantage and forced it to lower its fares on this route. However, with Xiamen Airlines' unit cost being 50% higher than Air Asia's, Xiamen Airlines does not have the financial strength to compete with the latter for a sustained period.

History is likely to repeat itself with China Southern and Shenzhen Airlines. Their operational bases, Guangzhou and Shenzhen, are close to Hong Kong and Macau, where Air Asia and several other LCCs are going to start operations. The LCCs' operation in these areas will be a nightmare for Chinese airlines if the latter cannot significantly lower their unit costs. If LCCs obtain traffic rights to fly the Beijing-Shanghai route, the Chinese airlines' international market will shrink dramatically.

The threat in the domestic market is now being substantiated. Spring Airlines, a start-up airline based in Shanghai, aims to get its unit operating cost to 50% of the three majors' unit cost performance, by increasing aircraft utilisation and lowering aircraft financing charges.

Shanghai Airlines is also ambitious to transform United Airlines, its newly purchased subsidiary, into a low-cost airline. "We can achieve lower operating costs by lowering all costs concerned. The pilots, who are a constraint for new airlines, are not a problem for us because we inherited the pilots from the old United Airlines," says Zhou. "We also purchased Nanyan Airport, a former military airport, as United Airlines' future base. In this way, we can significantly reduce the operating cost." If Shanghai Airlines and Spring Airlines achieve this target successfully, the legacy airlines, especially those that heavily rely on the domestic market, will be forced to transform their operation. A crisis is looming. AC