



## Aerospace and Defense Industry Market Update: Europe

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For additional information on our Investment Banking Group, please contact:

**Michael McManus**

Managing Director, Investment Banking Group  
(310) 246-3702  
mmcmanus@imperialcapital.com

**Robert Wagner**

Managing Director, Investment Banking Group  
(310) 246-3624  
rwagner@imperialcapital.com

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## Executive Summary and Outlook

As uncertainty remains with regard to the European Sovereign Debt Crisis, we believe the implications for commercial aerospace OEMs and aftermarket suppliers remain unclear. We believe a negative outcome in Europe would likely adversely affect aftermarket suppliers more than the commercial aerospace OEMs as we would expect increased discipline in managing inventories by operators, similar to what happened during the Great Recession. As the second largest air travel market worldwide, Europe remains an important region for aerospace market participants and an additional slowdown in Europe could put pressure on an already fragile global economic recovery.

The International Air Transport Association's (IATA) December 2011 financial forecast provides global air traffic demand and capacity estimates depending on the outcome in Europe. According to IATA, global air traffic in 2012 could decline 1.3% year-over-year without a resolution to the European banking crisis with global capacity remaining flat year-over-year. Specific to Europe, without a resolution to the banking crisis, IATA estimates air traffic could decline 3.7% year-over-year, a combination of a slowdown in both air passenger and air cargo traffic. Capacity is expected to remain roughly flat year-over-year at 0.1% as a result of an already disciplined approach taken by operators during a fragile recovery. During the back half of 2011, a number of European airlines announced their intentions to trim capacity. In October 2011, Lufthansa announced its 2012 capacity would be increased by 3% instead of the originally planned 9%. Other European airlines announcing slower capacity growth include Air Berlin and Air France. In January 2012, Air France announced further reductions on capacity, lowering capacity growth to 5% between 2012 and 2014 and deferring deliveries of some narrowbody and widebody aircraft, citing higher fuel prices and slower growth air traffic as the cause. In the U.S., American Airlines and Delta announced capacity reductions for 2012 of 2-3%.

**Figure 1: Worldwide Air Traffic and Capacity Growth, 2009–2012E**

	Traffic (TKP)			2012F	
	2009	2010	2011F	Resolution	No Resolution
<b>Global</b>	<b>-4.3%</b>	<b>10.4%</b>	<b>4.2%</b>	<b>2.9%</b>	<b>-1.3%</b>
North America	-6.3%	9.9%	2.0%	2.2%	-1.0%
Europe	-7.7%	5.0%	7.5%	2.5%	-3.7%
Asia/Pacific	-2.2%	12.6%	2.1%	2.0%	-0.2%
Middle East	9.5%	20.0%	7.9%	5.7%	4.5%
Latin America	0.0%	14.5%	10.6%	8.5%	2.3%
Africa	-5.4%	15.0%	0.8%	3.5%	2.3%

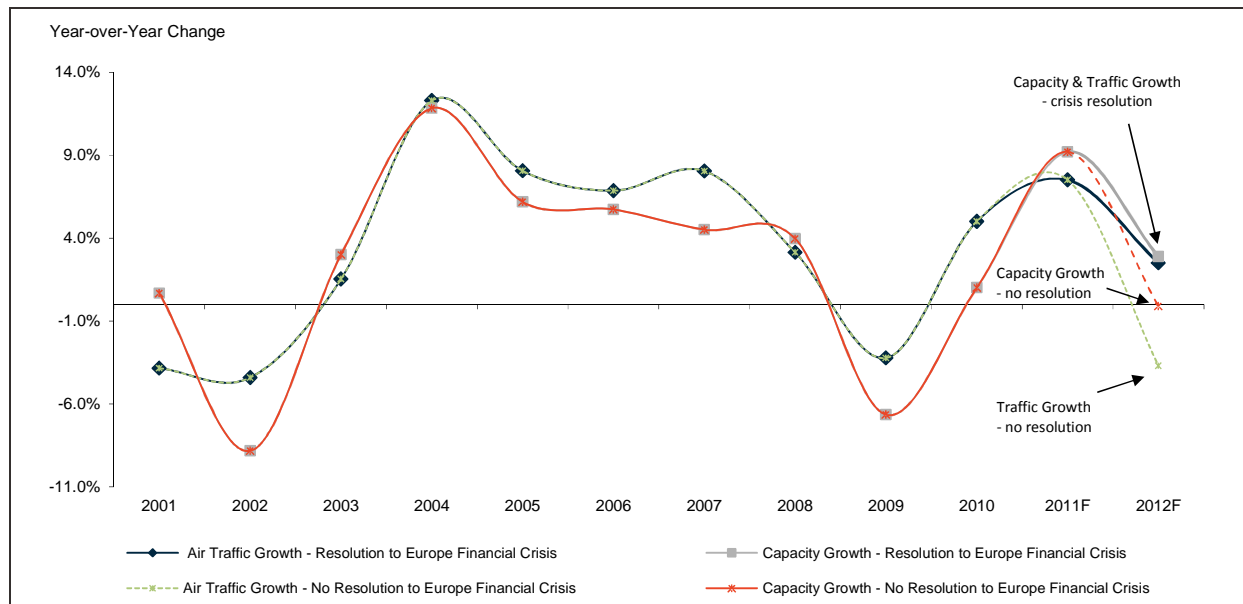
  

	Capacity (ATK)			2012F	
	2009	2010	2011F	Resolution	No Resolution
<b>Global</b>	<b>-3.5%</b>	<b>5.2%</b>	<b>6.0%</b>	<b>3.1%</b>	<b>0.0%</b>
North America	-5.6%	3.9%	3.4%	2.0%	-0.5%
Europe	-5.4%	1.5%	9.2%	2.9%	-0.1%
Asia/Pacific	-4.8%	5.8%	4.6%	2.9%	0.1%
Middle East	11.1%	15.8%	10.8%	5.8%	4.8%
Latin America	1.4%	9.6%	8.0%	8.3%	3.3%
Africa	-1.5%	9.5%	2.9%	3.7%	0.7%

Sources: IATA and Imperial Capital, LLC.

Headwinds to a steady global economic recovery are increasing as a resolution to the European banking crisis appears elusive. Global air cargo traffic, a leading economic indicator, began to decline in June 2011 while growth in air passenger traffic began to slow in the same month. We expect European air traffic to be the most affected by lack of a resolution to the European banking crisis. Nevertheless, we believe commercial aircraft backlogs will remain relatively unaffected in the near term even with a slowing recovery or a potential decline. In our view, the aftermarket suppliers could be the most affected as airlines could return to their strategy during the Great Recession where they reduced capacity by destocking inventory and delaying required maintenance, repair, and overhaul work. Should global air traffic begin to decline, this could be a likely outcome as airlines would need to reduce capacity to maintain load factors near current levels.

**Figure 2: European Air Traffic and Capacity Growth, 2001–2012E**



Sources: IATA and Imperial Capital, LLC.

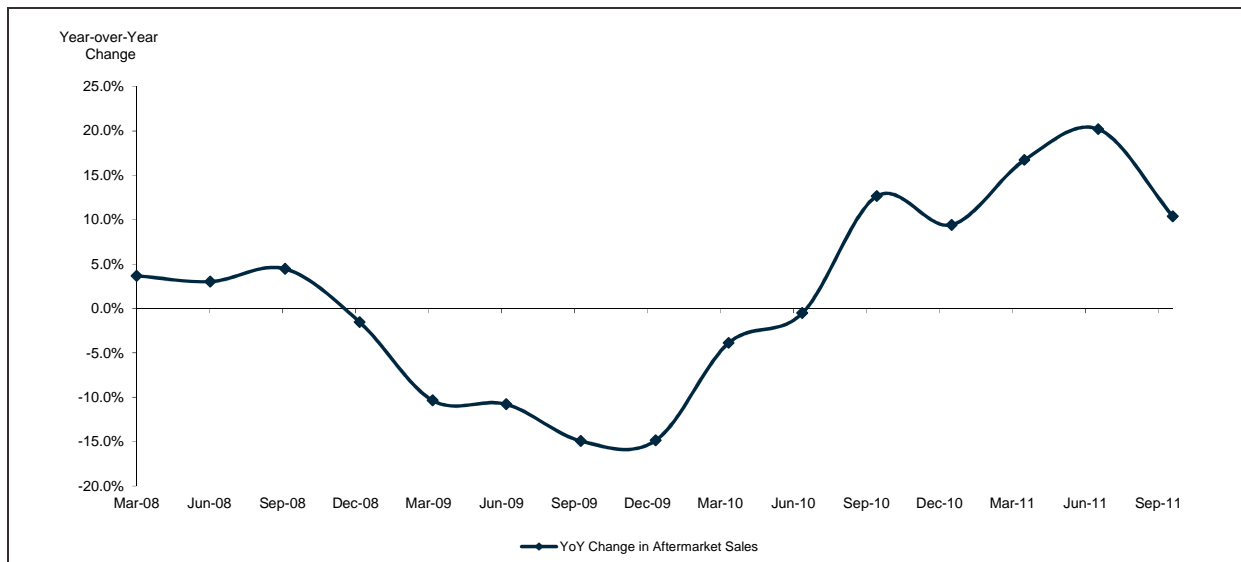


## Aftermarket Outlook and Commentary

### ■ Slowing aftermarket sales growth could be signs of potential headwinds to come.

Commercial aftermarket sales growth slowed during the third quarter of 2011 to 12% year-over-year from 20% during the second quarter of 2011. Between the third quarter of 2010 and the second quarter of 2011, aftermarket sales grew sequentially each quarter. The significant year-over-year growth since the third quarter of 2010 reflected inventory restocking at airlines, in our view. During the Great Recession, airlines were driven to large reductions of inventories in order to preserve cash. Slowing air cargo and passenger traffic lead us to believe growth in aftermarket sales could continue to decline through the beginning of 2012. We believe inventories at airlines are now more consistent with aircraft utilization rates. We look to near-term aftermarket sales volumes to grow consistent with air traffic, and therefore, we think there could be a possible decline in aftermarket sales without some near-term resolution to the problems in Europe and continued slowing air traffic demand.

**Figure 3: Commercial Aftermarket Sales Growth, 1Q08–3Q11<sup>(1)</sup>**



(1) Includes Goodrich, Rockwell Collins, United Technologies, Honeywell and TransDigm.  
Sources: IATA and Imperial Capital, LLC.

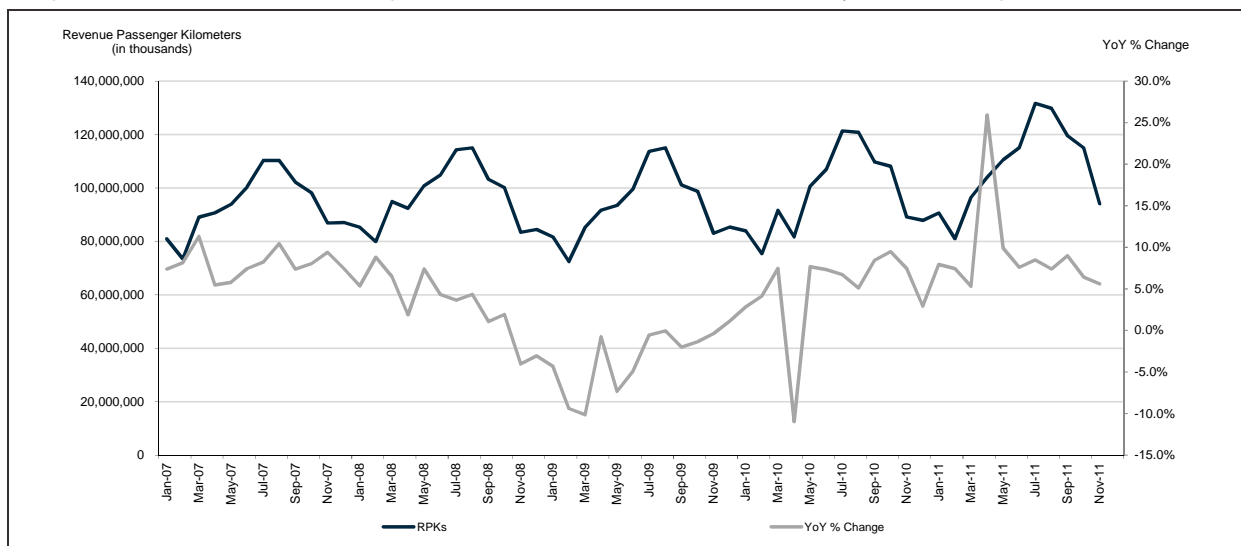
## Air Traffic and Capacity Trends

### Air Passenger and Cargo Traffic

- **European air passenger traffic continues year-over-year growth despite potential economic headwinds.**

Despite the euro-zone banking crisis, passenger air traffic in Europe as measured by revenue passenger kilometers (RPKs), continued to increase year-over-year through November 2011, growing 5.6%, although the growth rate is noticeable lower than the 9.0% in September and 6.4% in October. Year-to-date through the end of November, European passenger air traffic increased 9.2% year-over-year. The continued year-over-year growth in RPKs increase can be attributed to business travel as well as increased long-haul travel, in our view. We believe it is possible to see a 2012 slowdown in European air passenger traffic even with a resolution to the banking crisis. We think the timing of a resolution remains unclear, which could be negative for European air traffic, particularly in the near term. Should there be a resolution sooner than expected, we still believe air traffic demand could suffer since we think some form of cut in austerity measures will likely be a part of the plan, which could curtail European leisure travel. Additionally, in our view, the decline in demand could be exacerbated with a potential slowdown of economic growth in Asia leading to lower demand for Far-East long-haul travel from Europe.

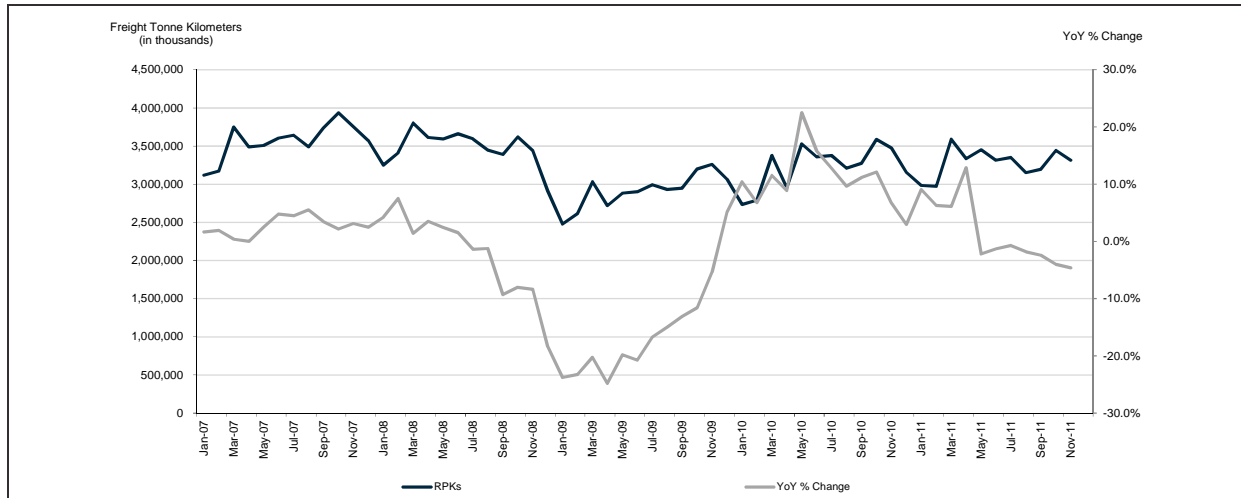
**Figure 4: European Air Passenger Traffic (RPKs) and Growth, January 2007 through November 2011**



Sources: IATA and Imperial Capital, LLC.

- **European air cargo traffic has steadily declined from May to November 2011 with little near-term relief in sight.**

In contrast to air passenger traffic, air cargo traffic in Europe has steadily declined year-over-year beginning in May 2011. Freight tonne kilometers (FTKs) declined 2.2% in May following in high-single digit growth during the first quarter of 2011. In November of last year, FTKs declined 4.6%, the largest decline year-to-date. Part of the decline can be attributed to shippers choosing slower and cheaper methods of transport compared to 2010 when there was a rapid restocking of inventories as an economic recovery began to take shape. As of the end of November 2011, FTKs were down 7.7% from a high in March of that year, and we think continued economic uncertainty will likely cause a continued decline in European FTKs.

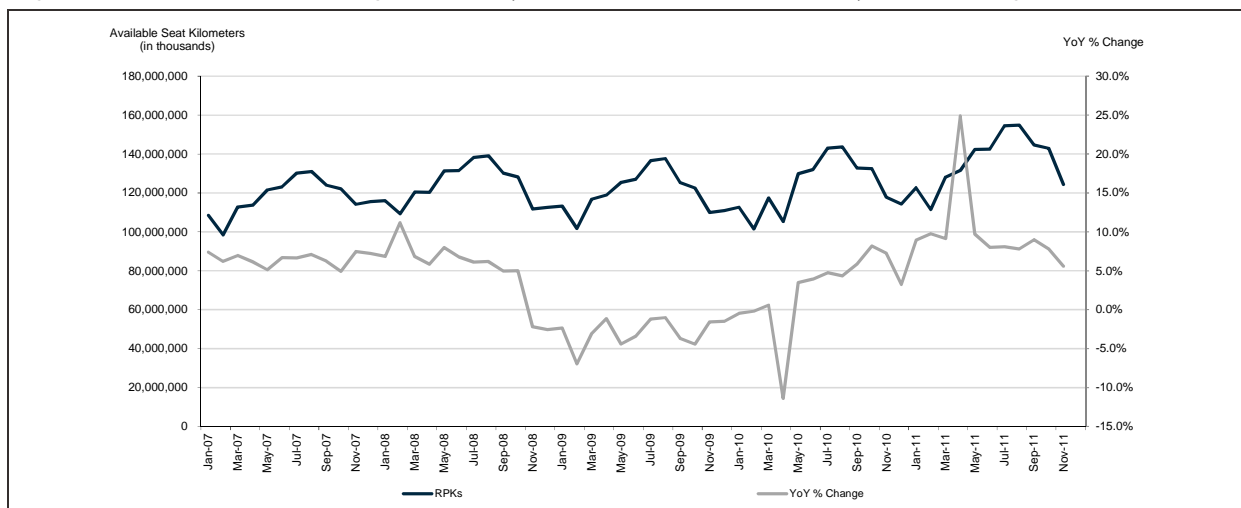
**Figure 5: European Air Freight Traffic (FTKs) and Growth, January 2007 through November 2011**

Sources: IATA and Imperial Capital, LLC.

## Air Passenger/Freight Capacity and Load Factors

### ■ Air passenger capacity growth begins to slow, but load factors remain strong.

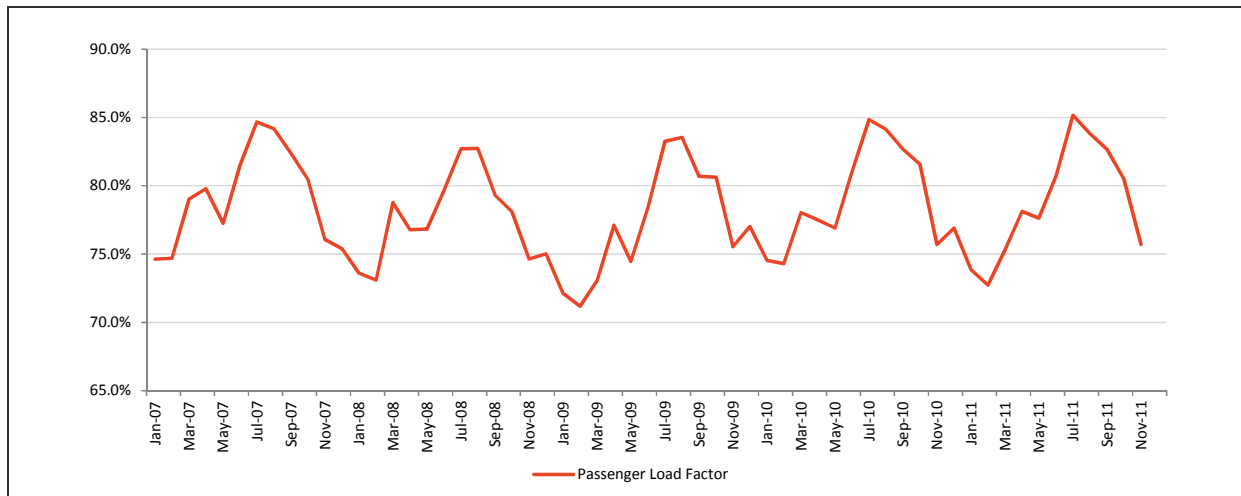
European airlines have added capacity throughout 2011, increasing available seat kilometers (ASKs) by 9.6% through the end of November, slight above the 9.1% year-over-year growth in RPKs. Beginning in October 2011, ASK growth began to slow, growing 7.8% compared to 9.0% in September. November 2011 saw ASK growth of 5.6% year-over-year. Passenger load factors year-to-date through November 2011 totaled 79.1% compared to 79.6% in the same period during 2010. Capacity discipline remains a focus for European airlines as illustrated by recent announcements to curtail capacity growth. We believe additional capacity restraint could come with continued limited visibility on a resolution to the European banking crisis. We think capacity discipline would more likely come in a form similar to that during the Great Recession when airlines chose to defer maintenance work on in-service aircraft and reduce inventories while parking more aircraft. Such a response, in our view, would have negative implications for companies with significant aftermarket parts businesses.

**Figure 6: European Air Passenger Capacity (ASKs) and Growth, January 2007 through November 2011**

Sources: IATA and Imperial Capital, LLC.



**Figure 7: European Passenger Load Factors, January 2007 through November 2011**

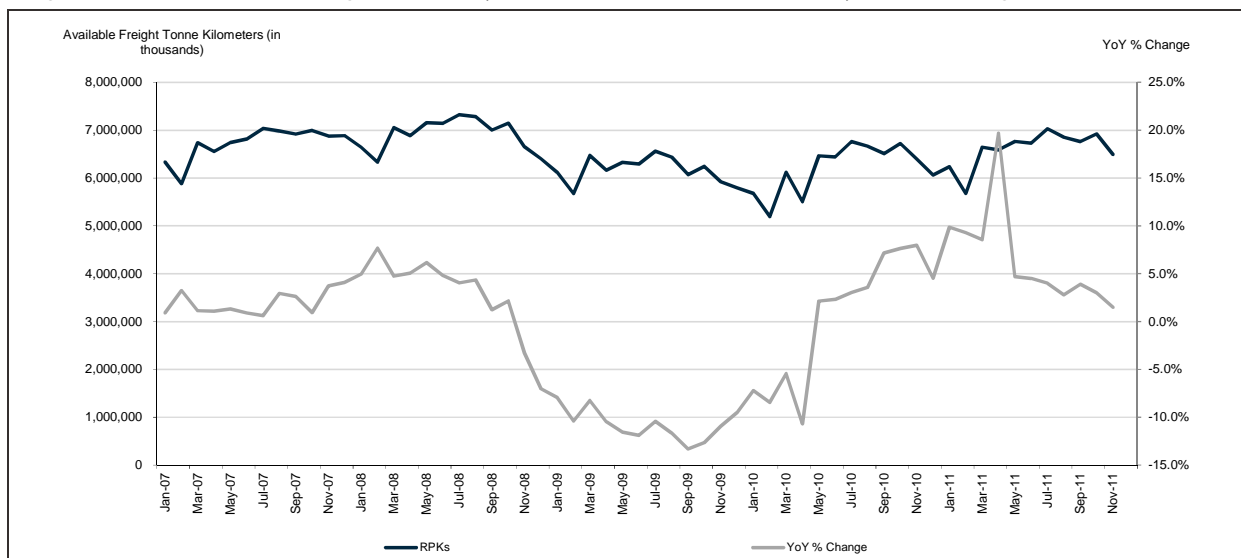


Sources: IATA and Imperial Capital, LLC.

■ **Air cargo capacity growth continues to slow leading to lower load factors.**

Beginning in May 2011, growth in air cargo capacity as measured by available freight tonne kilometers (AFTKs) started to slow with AFTKs growing only 1.5% in November 2011 compared to 8.0% in November 2010. Year-to-date through November, AFTKs have grown 6.2% year-over-year compared to only 1.2% growth in FTKs. As a result, air cargo load factors through November have declined 4.7% to 49.6% compared to 52.1% during the same period in 2010. We attribute a portion of the decline to slowing global demand and a shift in methods for the transport of goods versus added capacity which is partially a result of new widebody aircraft deliveries, according to IATA.

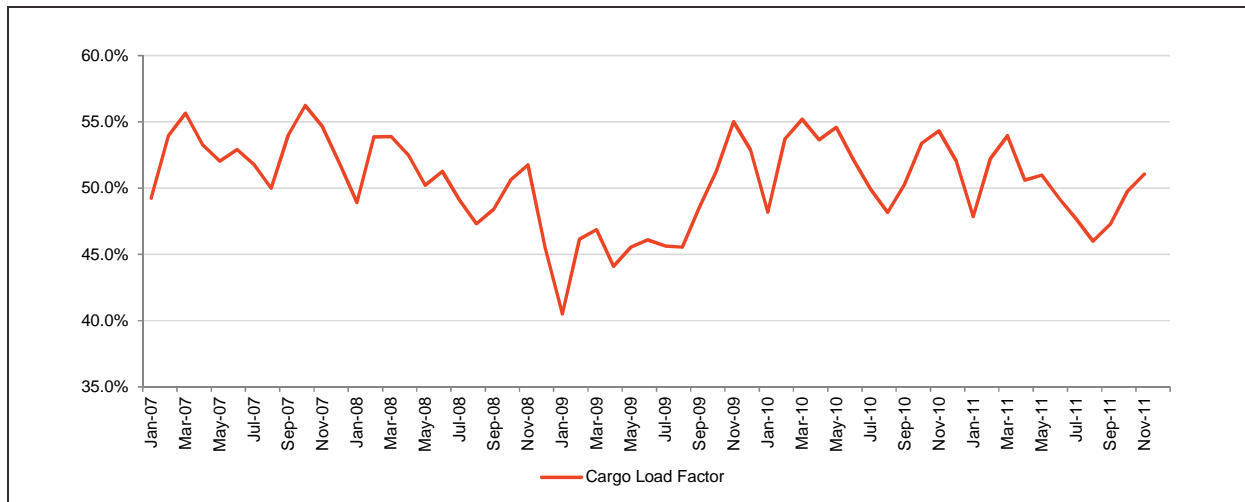
**Figure 8: European Air Freight Capacity (AFTKs) and Growth, January 2007 through November 2011**



Sources: IATA and Imperial Capital, LLC.



**Figure 9: European Cargo Load Factors, January 2007 through November 2011**



Sources: IATA and Imperial Capital, LLC.



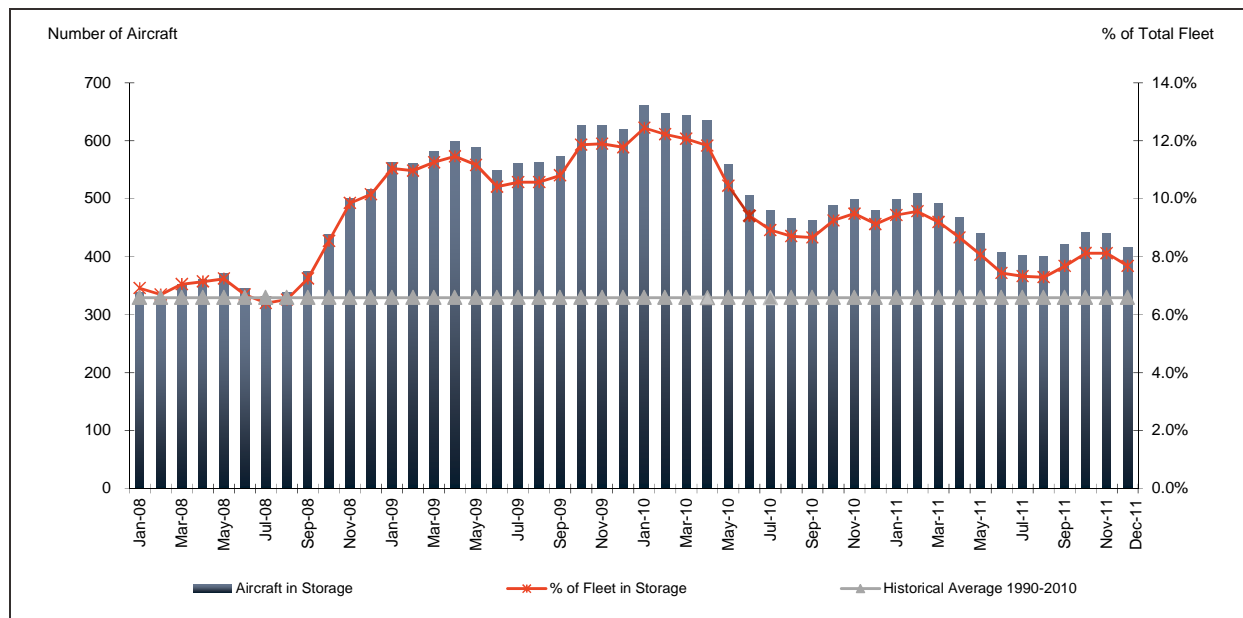
# Fleet and Backlog

## Aircraft in Storage

- Aircraft in storage remains above the 20-year average for the region.

Although capacity has been increasing steadily during 2011, we believe European airlines are maintaining capacity discipline as illustrated by the continued above average amount of aircraft that remain in storage. As of 12/31/11, approximately 7.7% of the European jet aircraft fleet remains in storage compared to a historical average of 6.6% between 1990-2010. Although we believe the number of aircraft in storage could include a meaningful amount of older, less fuel efficient aircraft that will likely remain in storage for a while; nevertheless, we believe younger, more fuel efficient aircraft now in storage could remain there until airlines have clear signs of a real recovery in passenger air travel. We estimate approximately 23% of jets operated by European based operators that are in storage are younger<sup>1</sup> aircraft, equating to approximately 2% of the European fleet.

**Figure 10: Monthly Aircraft in Storage and as a Percent of European Fleet, January 2008 through December 2011**



Sources: Ascend and Imperial Capital, LLC.

<sup>1</sup> Includes the following models: 737-300 to 900, 757, MD-80/90, A320 family, Canadair Regional Jet and Embraer Regional Jets, 747-300/400, 767, 777, A300-600, A330, A340, A380.

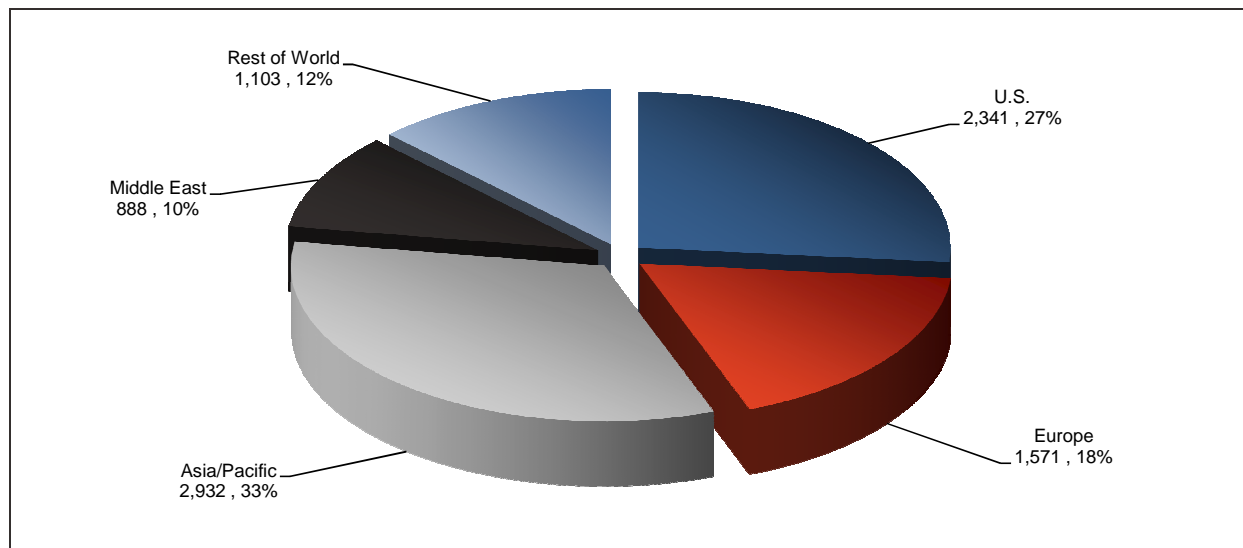


## Commercial Aircraft Backlog

### ■ Near-term backlog headwinds remain at bay, despite uncertainty in Europe.

We think a continued slowdown in Europe could cause a global economic slowdown; however, we believe it would likely have a minimal near-term effect on global aircraft orders. We estimate emerging markets, including the Middle East, Asia/Pacific Region, Africa, and Latin America, account for nearly 56% of the global commercial aircraft backlog. In comparison, European operators account for approximately 18% of the global backlog or approximately 1,600 aircraft. Looking to 2012, approximately 24% of Europe's commercial aircraft backlog is expected to be delivered during the year; of these, approximately 82% or 304 aircraft are narrowbody planes. We think there is limited risk of delivery cancellations in the near term based on the recent announcement that Air France firmed up its order for 25 787s, but believe if cancellations were to occur, they would likely be directed towards the European narrowbody fleet as those aircraft are widely used by Western Europe's low cost carriers which largely target leisure travelers. We believe long-haul routes would fare slightly better than shorter routes, and therefore believe the backlog of widebody aircraft could be less impacted.

**Figure 11: Global Commercial Aircraft Backlog by Region, as of December 31, 2011**



Sources: Ascend and Imperial Capital, LLC.

## Important Disclosures

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Imperial Capital Locations

**Los Angeles**

2000 Avenue of the Stars  
Los Angeles, CA 90067  
Office: (310) 246-3700

**New York**

277 Park Avenue  
New York, NY 10172  
Office: (212) 351-9700

**San Francisco**

55 2nd Street  
San Francisco, CA 94105  
Office: (415) 615-4000

**Minneapolis**

60 South Sixth Street  
Minneapolis, MN 55402  
Office: (612) 692-6900

**Boston**

101 Arch Street  
Boston, MA 02110  
Office: (617) 478-7600

**Chicago**

200 South Wacker Drive  
Chicago, IL 60606  
Office: (312) 674-4713

**London**

Imperial Capital (International) LLP  
Berkeley Square House Suite 299  
Berkeley Square  
London W1J 6BD  
Office: +44 0 207 887 1319

