

# Commodity Risk Management Industry Trends Airlines

02/2012



**MERIT**

Commodity Management

# Airline Industry

## Current Topics

### Problems

- > Uncertain economic outlook dampens **expectations for 2012**
- > **Monetary divergences** lead to additional risk factors besides jet fuel cost
- > Ticket and jet fuel prices are quite **ambivalent**
- > Banks increasingly withdraw from financing aircrafts – **stressed financial situation**

### Markets

- > Oil und oil derivatives **gain momentum** at the beginning of the year 2012
- > EU embargo und Iran crisis **increase pressure** on kerosene price development
- > Future prices reflect the **uncertainty** in a mid-term contango and a long-term backwardation
- > EURO to USD tends weakly
- > **CDS spreads** – finance costs for airlines are found at historic high levels

## Current and future prices\*

### Current energy markets

|          |           |     |
|----------|-----------|-----|
| Jet fuel | 1,055 USD | (↓) |
| LGO      | 991 USD   | (↓) |
| WTI      | 99 USD    | (↑) |

### Future prices energy (3M)

|          |           |     |
|----------|-----------|-----|
| Jet fuel | 1,058 USD | (↑) |
| LGO      | 989 USD   | (↓) |
| WTI      | 100 USD   | (↑) |

### Future prices energy (1Y)

|          |           |     |
|----------|-----------|-----|
| Jet fuel | 1,054 USD | (↓) |
| LGO      | 975 USD   | (↓) |
| WTI      | 103 USD   | (↑) |

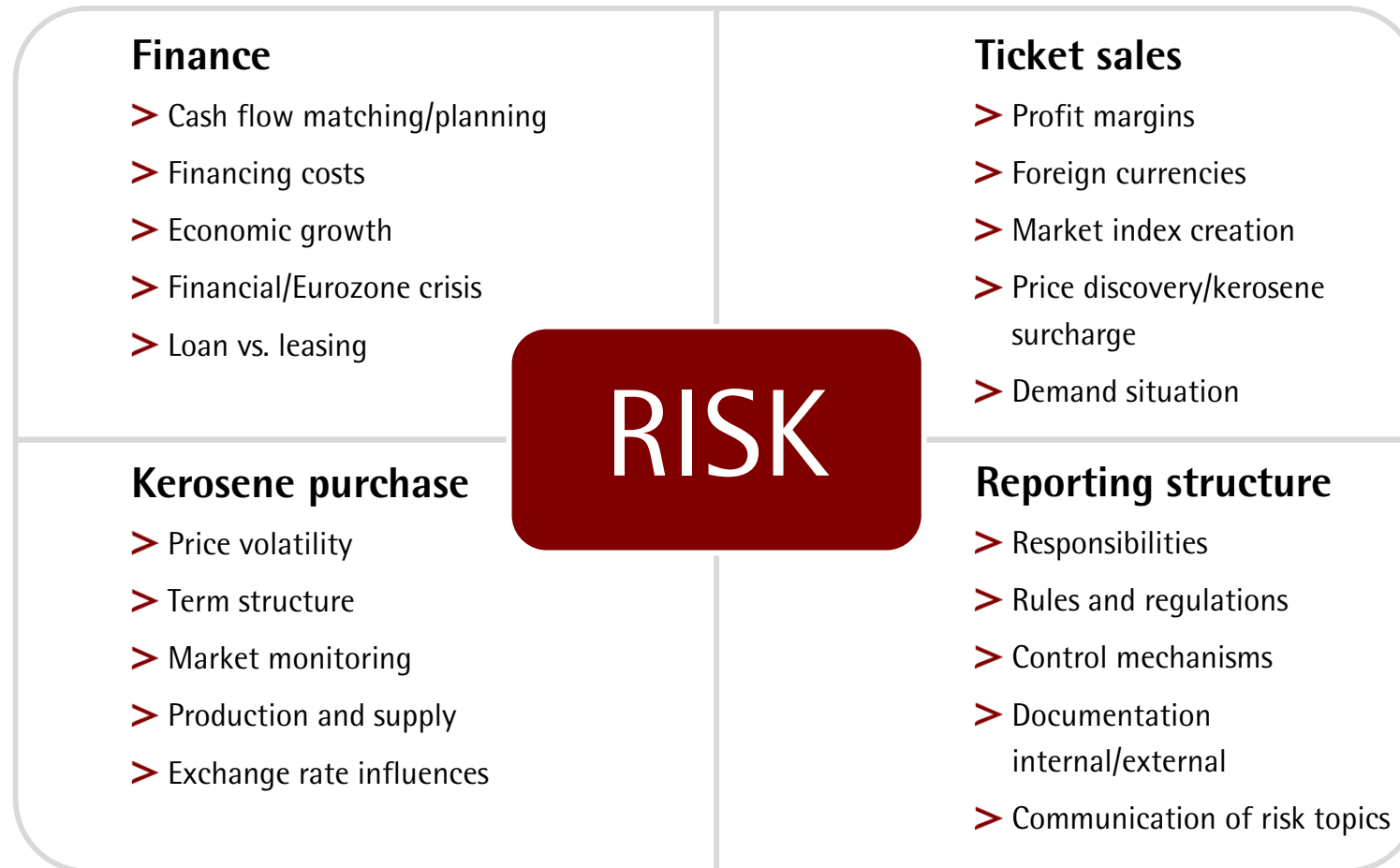
### Current currency markets

|         |         |     |
|---------|---------|-----|
| EUR/USD | 1.327   | (↑) |
| EUR/JPY | 102.220 | (↑) |
| EUR/GBP | 0.839   | (↑) |

\* Price indication as of 08.02.2012

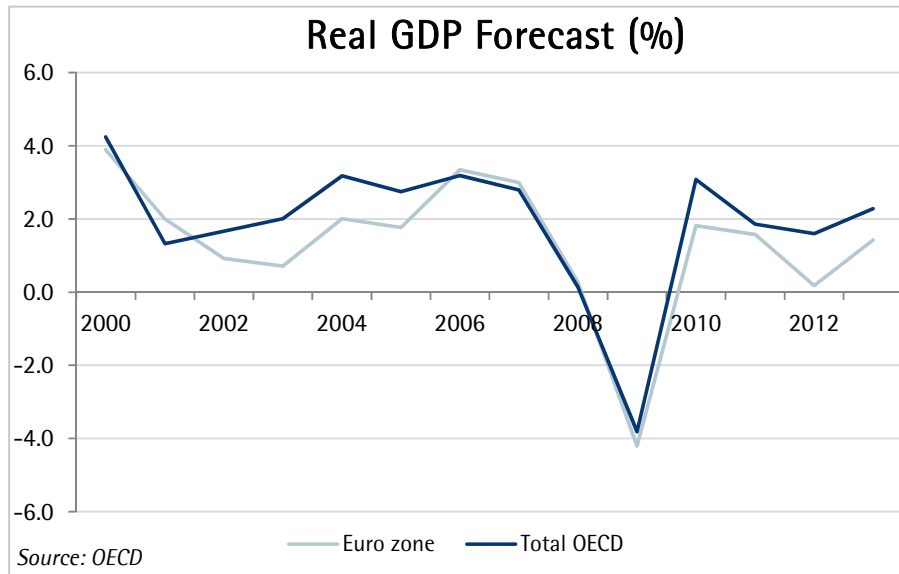
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## Company risk factors



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## General Market Environment



## Economic Outlook 2012

- > **Economic growth** in OECD countries is predicted with 1.6% (euro zone 0.2%) for 2012
- > Sentiment in the EU finance sector remains negative, however **positive signals** hail from real economy (IFO index 12 2011: 100.9)
- > After a notable growth in 2011 European airlines depend on the **consequences** of the euro zone crisis
- > **Ticket prices** and cargo rates remain under pressure – competitive advantage is subject to cost factors

## MERIT Basic Consulting

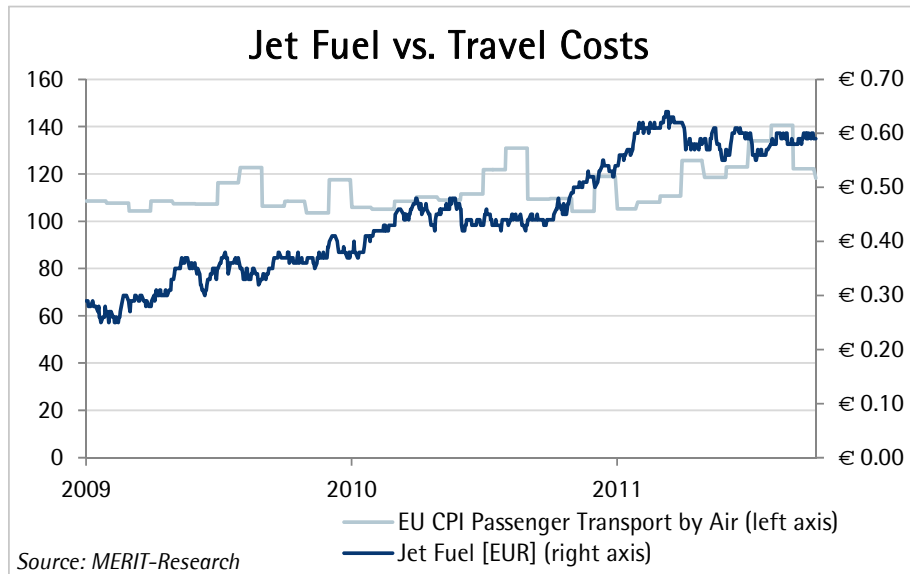
- > Identification, analysis and quantification of all **relevant risk factors** (energy, currency, finance, cash flow)
- > Segmentation of the risk areas in a **risk profile** according to Value-at-Risk
- > **Sensitivity analysis** respective market and profit development
- > Definition of a **risk strategy** to reduce risk and to hedge margins
- > **Reporting** of long-, medium and short-term industry trends

## Goal Setting

- > Comprehensive quantification of the company's **risk exposure** (or pre-defined parts of it)
- > Active usage of **price windows** and term structures to improve operating results
- > **Competitive advantage** resulting from prompt and active risk management
- > Combined **risk is lower** than the gross exposure of the individual risk factors

# Airline Industry

## Active Cost and Revenue Management



## Ticket and Jet Fuel Price Development

- > While the jet fuel price has heavily increased over the last few years, **air travel costs** have remained at their level and even start to decline
- > Macroeconomic **uncertainty** and the current Euro weakness worry airline companies
- > Jet fuel currently **quotes** at USD 1.055 and EUR 794 respectively
- > Since the beginning of the year jet fuel in USD rose by 7.1%, jet fuel in EUR only by 4.6%; almost 2.5% of the price change was determined by the **EUR/USD exchange rate**

\* In cooperation with business partners of the MERIT-Group

## MERIT Exposure Management

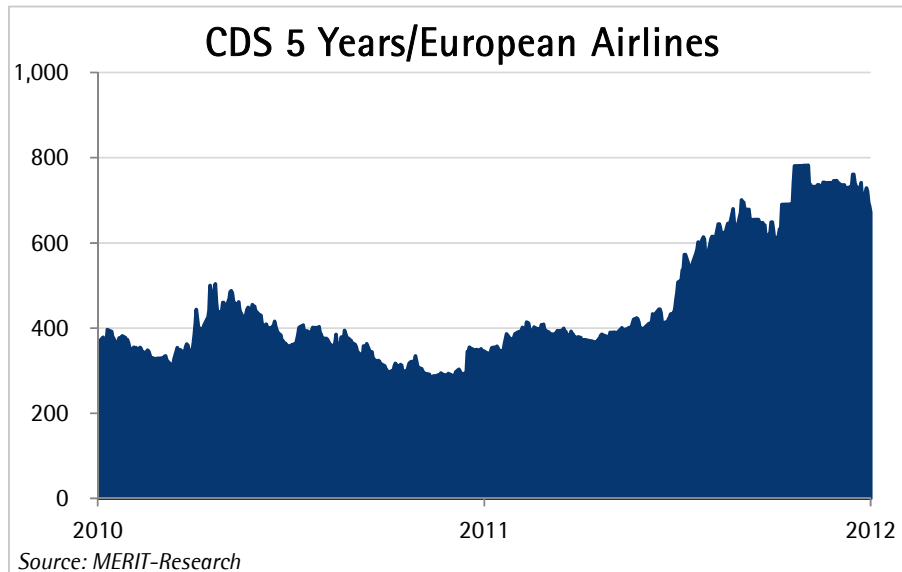
- > External **support** to operative risk management either as a signaling function, as management of a risk specific market area or the entire company risk exposure
- > Active management of the **risk exposure** considering predefined risk parameters (hedge ratio)
- > Base reporting (**position book**) comprises all risk positions of the company and serves as a prompt and central controlling/ engineering tool
- > Dedicated **MERIT-Key Account Manager**

## Goal Setting

- > **Complete handling** of clearing and settlement\* - no additional research required
- > Benefits from **MERIT-Expertise** in the core areas of energy and financial management
- > Gradual **reduction** of company risk and associated risk costs
- > Autonomous adherence to predefined **risk boundaries** (hedge ratio) to sustain stable margins

# Airline Industry

## How to Solve Financial Problems



## Withdrawal of banks

- > Basel III, debt crisis and a difficult **refinancing** situation prevent banks from being a money source for airline companies
- > Even **leasing companies** and aircraft manufacturers may be affected in 2012
- > Costs for financing have notably **increased** since mid of last year
- > **Interest and currency management** are to be integrated in a holistic risk strategy

## MERIT Interest & Currency Management

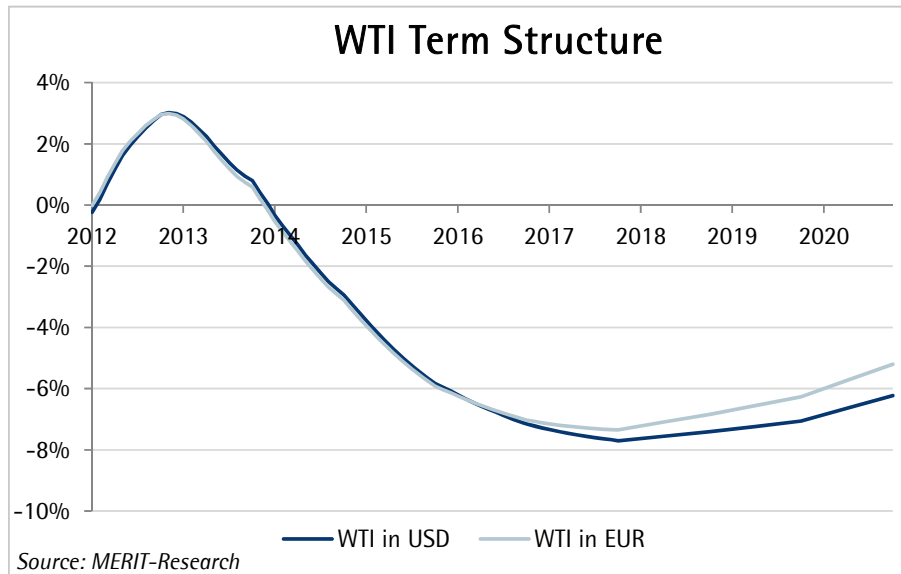
- > Accurate and prompt steering of interest rate and foreign currency risk in order to reduce **earnings volatility**
- > Long-term **minimization** of interest charges as well as costs resulting from fluctuating interest expenses and exchange rates
- > **Liquidity planning** taking account of different subsidiaries and currency markets
- > Systemic financial management to **grant sufficient liquidity**

## Goal Setting

- > **Planning certainty** in profit and budget calculation
- > Protection from changing **interest clauses** independent of the credit rating
- > **Comprehensive** risk management of interest rates, foreign currencies and commodities
- > Taking account of different **procurement and sales markets**
- > **Drastically reduced** overall financing costs

# Airline Industry

## Strategic Jet Fuel Procurement



## Future Markets Crude Oil and Euro

- > Currently we notice a **mid-term contango situation** on the crude oil market – however over the long-run future prices trade at a discount
- > Future markets **change daily**
- > Continuous **market observations** and tactical optimized market transactions are a must-have
- > Not only the hedge ratio but also **current and future flight schedules** have to be adapted in an active and timely manner

## MERIT Overlay Management

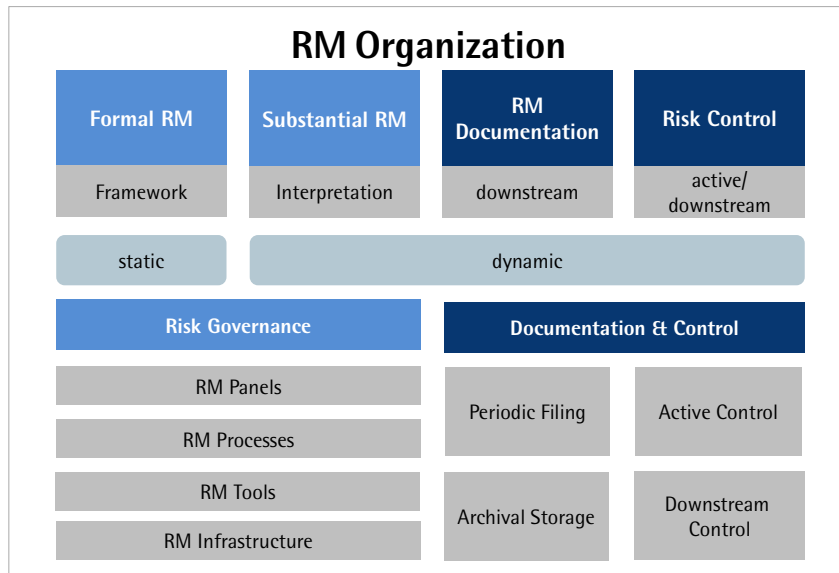
- > Hedging while **simultaneously** maintaining current jet fuel supply agreements
- > Analysis of **price discovery** in purchase and sales (particularly flight planning) – definition of a hedging strategy taking account of costs/benefits relations
- > Identification of **most adequate** contracts, transactions and counterparties for underlying commodities (WTI vs. LGO vs. kerosene)
- > A physical supplier serves as **intermediate** to create alternative pricing models and/or disengage from physical limits of pre-suppliers

## Goal Setting

- > Independence of suppliers' **price fixing terms** and ticket sales
- > Implementation of a **hedge overlay** for jet fuel procurement
- > Adjustment of the hedging strategy to **tailor-made needs** of the airline company
- > **Catalogue of instruments** for physical, off-market and exchange-based products

# Airline Industry

## Active Risk Management with Clear Lines



## Responsibilities of Top Level Management

- > Risk-adequate **reporting** to financial investors (equity or debts) requires sophisticated evaluation models
- > Legal requirements of **Corporate Governance Codes** have augmented in recent years
- > A state-of-the-art risk management with internal and external **transparency** proves its advantages today

## MERIT Risk Management Organization

- > Analysis of the **company-wide** risk management organization (current state)
- > Adjustment and integration of **feedback and control mechanisms** (processes)
- > Active and **rule-compliant risk governance** supported by clearly defined processes, allocated powers to act and risk panels
- > Development of a **framework** for the company risk management organization (handbook)

## Goal Setting

- > **Integration** of risk management in the company organization
- > Risk management **handbook** to enable clear regulations
- > Fulfillment of the legal **general framework** for risk control and documentation
- > Hedge accounting according to IAS39 and communication with **external auditors**



# MERIT-Group

## Company Profile

Since its foundation in 1988, MERIT has been specialized in all major areas of financial derivatives and commodities. Its core business includes alternative investments, fund and portfolio management, brokerage services, risk management, consulting and commodity trading. As a pioneer in derivatives and commodities in the CEE market, MERIT is dedicated to serving institutional investor needs.

The core expertise in the commodities business ranges from trading physical metals and energy through purchasing/sales optimization programs to hedging of price risks. The consulting arm specializes in risk management and consulting for finance- and commodity-dependent companies. Here we offer risk consulting, exposure management and full service risk management.



# MERIT-Group

## Industry Expertise

The MERIT-Group draws on long-term practice in jet fuel management and risk analysis of European airline companies. Our consulting team applies fundamental industry know-how combined with project-related experience and distinctive expertise in financial markets.

Joint ventures with renowned companies such as the London FTSE-Group, the Dubai Financial Services Authority or the Financial Times Publishing Group manifest MERIT-Group's activities in commodities on an international level. Our long-term expertise constitutes a crucial resource for instance in implementing the first fully physically-based raw material indices or offering alternative price indices to our clients.



### Metal

- Automobile
- Manufacturing
- Plant engineering
- Scrap trading
- Metal processing



### Agriculture

- Food production
- Beverage production
- Animal feed
- Tobacco industry
- Mills



### Energy

- Aviation
- Transport & logistics
- Utility companies
- Power production
- Heavy industry



### Other

- Timber & Paper
- Pharmaceutical
- Construction
- Plastics industry
- Rubber sector

# MERIT-Group

## Our Unique-Selling-Position

**Commodity specialist:** Since its foundation MERIT has been dealing with commodities and draws on an unique expertise in continental Europe respective both financial areas – value-oriented financial investment and risk-averse commodity management.

**Long-term industry experience:** In the German-speaking regions MERIT is a pioneer in the topics risk hedging, contract standardization and business model optimization. Moreover, we serve our clients on all relevant commodity and financial markets.

**Independence:** THE MERIT-Group is an owner-managed and independent business with legal seat in Austria and therefore a neutral link between classic consulting agencies and product-oriented banks or other financial institutes.

**Aggregation of theory and practice:** We begin at that point where others already finish. MERIT-Group combines industry consulting, strategy development, brokerage, hedging transactions and physical trading all under one roof. Thus, it represents an unbeatable competence center.

**Confidence:** Confidence, independence and transparency are the fundamentals of all our projects. We aim for a long-term partnership with satisfied clients and we want our services to be successfully and sustainably implemented.



**One-stop principle:** Our clients may draw on MERIT-Group's extensive competence and experience. We even take over the complete handling of a company's risk management if requested. Hence, our client saves costs for implementing sumptuous risk management processes.

# Contact

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