



## PILARSKI SAYS...

# Rashomon and the aviation bubble debate

Will the manufacturers and financiers ever agree on the state of the industry, asks Adam Pilarski, senior vice-president at Avitas.

The great Japanese film director Akira Kurosawa produced in 1950 the epic movie *Rashomon*. This movie portrays some events from the sometime self-serving points of view of all the actors in the drama, views that, despite portraying the same event, all show a very different version of reality.

The so-called *Rashomon Effect* can be detected in the current debate on the state of the industry as related to the existence (or not) of a bubble of over-ordering and excessive production levels. There is no debate about the facts, but how comfortable the industry should be with the situation is contentious.

The view through the eyes of manufacturers is best expressed by the words sung by the loveable characters in the *The Lego Movie* "everything is awesome". And why shouldn't it be? Buoyed by the historically low cost of capital, high but stable oil prices and a finally profitable airline industry, all the elements are there for record orders, production levels and backlogs. Airbus and Boeing are sold out for almost a decade and the orders keep on coming. Orders exceeding deliveries seems like an immutable reality. Hence, the only rational response is what the manufacturers are doing – increasing production levels.

There is a chance that oil prices will dramatically drop, that worldwide recession will occur or other calamities will materialize but rational businesses should not base their decision-making on unlikely (in their view) scare scenarios. Additionally, the perceived threat by other manufacturers to take a substantial part of their market is receding. Hence, everything looks excellent from their perspective, and all of us would copy the behaviour of the top two manufacturers if in their shoes.

So why is the general feeling of euphoria exhibited so justifiably by the manufacturers not shared by other players in the industry? How come financiers become melancholy when told by the manufacturers "this is as good as it can get"?

Obviously they do not see the reality through the eyes of manufacturers. Record production and backlog levels, though critical to manufacturers, are meaningless to financiers. A much more meaningful parameter for the latter is the value and lease rates of existing aircraft. These vary tremendously by

aircraft type, vintage, engine option and other variables. A calculation of the current market value (CMV) versus base values aggregated over all aircraft categories shows the reason for the financiers' lack of enthusiasm. Simply stated, we are not yet at a point where the aggregated aircraft CMVs exceed their base values – a point at which the financiers will start feeling content.

In fact, this particular business cycle is different from others when examined from the point of view of manufacturers versus financiers. Using US data, which is the only source readily available for monthly comparisons, the present expansion is quite weak. As of April, the expansion is in its 56th month. During that period the economy expanded by a mere 11.8% versus 15.7% during the comparable 56 months of the previous expansion and compared to a solid 30% growth during a comparable period in the cycle before that (1991-1995).

The weak performance in US air traffic has been even more pronounced. Traffic has been growing at 1.3% annually, which compares with much higher numbers during the past two cycles, when growth rates were 9.6% and 4.5%.

Surprisingly, though, the present weak expansion is accompanied by a significant increase in aircraft production numbers, whereas a decline occurred at similar phases of the past two cycles. That pattern of declining production rates during the early stages of a business cycle has been universally true since the beginning of the jet age. It occurred in all of the past six cycles and the only exception is the present one.

In terms of values, at the comparable time into the expansion (56 months) we are still faced with a deficit of CMVs versus base value aggregates. At the equivalent point in the past two cycles the financiers were happy with good lease rates. This may explain why, despite the high production rates, the financial community is not overly enthused by the current situation. The positive view from me is that, barring unforeseen circumstances, I predict about three more years of economic expansion, while at the same time expecting a rise of CMVs over base values.

So maybe we will get to a situation where financiers will join manufacturers in believing everything is excellent. ▲