

PILARSKI SAYS

Conflict between Airbus and Boeing threatens to burst bubble

The behaviour of the big two manufacturers could prove a problem for the market, writes Adam Pilarski, senior vice-president at Avitas.

A number of strange developments are happening relating to a potential bubble in aircraft production, especially in the narrowbody segment. Some data are beyond contestation. The number of aircraft ordered from Airbus and Boeing is very high compared to the current production levels. This results in historically record backlogs leading to unreasonably long times customers have to wait when ordering new equipment. Hence, the tremendous and real pressure on Airbus and Boeing to raise production levels, a pressure that resulted in announcements by both competitors to increase production levels significantly.

An alternative interpretation of the existing realities is the stipulation of an order bubble, which may lead to a production bubble. More analysts have been pursuing in that direction which, incidentally, does not imply a miserable long-term future for aviation.

That alternative view does imply special circumstances that contributed to the huge aircraft order surge. These include historically high oil prices and low cost of money, temporary involvement of governments in new aircraft financing and the emergence of new engine technology, together with redesigns of existing platforms, all spurring huge orders. Some of these special circumstances have changed, or are in the process of changing, casting doubt on the longevity of those record orders placed.

Some of the changes in the environment are of the traditional kind of increased uncertainties, which threaten a burst of the existing bubble. These include regional recessions, the potential of a full-blown downturn in world economic activity and various political conflicts threatening the viability of tourism and world airline traffic.

Additionally, there are two other aspects of the situation I want to comment on, both of which have a tremendous impact on the demand/supply balance in the industry. One is the recent Delta order of 75 CSeries aircraft from Bombardier and the other is the increasingly acrimonious competition in the narrowbody market between Airbus and Boeing, which can lead to tactical mistakes by either party.

The Bombardier CSeries is a good aircraft, which until recently had not been selling too well. When launched it was seen as a very viable competitor to the Airbus and Boeing narrowbody offerings. Many analysts believe that the Neo and Max versions were launched as a direct result of the CSeries, with the rationale of offering proven equipment with new engines to take away the main advantage the Bombardier product had over the

incumbents. The Neo and Max were very successful, selling thousands at reasonably low prices.

Bombardier insisted on relatively high prices for an unproven but excellent product. The world does not work like this. We can only assume that the Delta sale involved very substantial discounts, meaning that Bombardier will follow a different strategy from now on. Instead of providing a superb product at a premium price, the manufacturer will most likely try to sell a substantially larger number at lower prices and hope it will be able to deliver those sold aircraft at a reasonable cost. This new reality will impact Airbus and Boeing significantly.

Airbus and Boeing have a tendency to dismiss other manufacturers. This was evident when for years both pursued a policy of claiming half of the world market. Unfortunately for them, there are other producers in the world which also believe they are a part of the market. Fortunately for them, so far their so-called rivals' products, price and customer support do not match their lofty ambitions. The fact remains that when you look at Airbus and Boeing production assuming new rates, there does not seem to be room for other manufacturers. With Bombardier's success at Delta, future sales are fairly obvious and the net market remaining for the two existing major producers will shrink.

The whole concept of a bubble relies on some irrational behaviour. The duopolists need to be certain they will not lose a competition because of the inability to offer aircraft. Even if they do not believe the macro forecasts, they need to increase theoretical rates to remain in the competition. Not having aircraft to offer will surely lead to losses and may force them out of the market.

The problem is that both duopolists have a different vision of reality. Airbus's Neo has outsold the Max 4,515 to 3,090 as of the end of April. The difference is even more pronounced with the largest version of the aircraft, where the A321neo has outsold the 737 Max 9 by 1,114 to 294. Boeing believes this is a temporary phenomenon because of a head start Airbus had from December 2010 to August 2011. The head start though was of 788 units which since then has swollen to 1,425 units lending some credence to Airbus' claim of a superior product. Hence Airbus believes it has the right to increase its rate and Boeing does not. Boeing does not share that view.

Such a situation does not bode well for the future, because the irrational behaviour of the duopolists may lead to unnecessary production increases, a market share battle and an eventual burst of the bubble. ▲