

# BUSINESS AVIATION AND THE BLACK SWANS

As popularized by Nassim Nicholas Taleb a decade ago, the black swan metaphor describes rare and unpredicted events, which have disproportionately large systemic impact. Specifically, he had in mind the kinds of surprises, which disrupt the expected run of geopolitics and the macro-economy. Closely tied as it is to the performance and confidence in the global economy, business aviation is directly exposed to such black swans. And so far, 2016 appears to be the year of the black swan.

By Richard Koe

**A**t 2016's outset, the Economist Magazine ranked a 'hard landing' of the Chinese economy as the biggest risk to the global economy. With China's economic data showing the biggest slowdown in 25 years, the world's stock markets lost over a trillion dollars in January. Concerns that China's economy was heading for a crash saw the price of oil dip under \$30/barrel. Within a month the revenues of the world's wealthiest had been seriously recalibrated. As such, the first black swan of the year threatened to derail the meager recovery in global business aviation shipments in 2015. Confidence in the business aviation market fell back to levels last seen in 2012.

The increasing slowdown of economic growth in emerging markets had been a drain on the business aviation production line since 2014. Airframe manufacturers have been caught between two stools: mature markets in North America and Europe have had unusually weak economic recoveries, whilst promising business jet demand in China and Brazil,

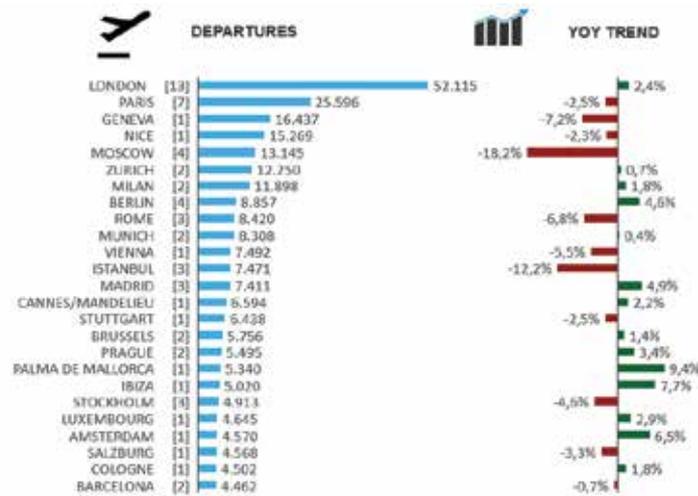
a mainstay of large jet sales between 2010 and 2012, has been falling well short of expectation. Fears that a slowdown would turn into a rout saw business jet billings fall 10% in the first Quarter of 2016.

## PUBLIC CONCERN

A very different black swan to emerge in the last few years has been the Islamic State, first as an insurgent regional power in failed Middle Eastern states, latterly as a terrorist virus spreading across North Africa and Europe. Following last year's attacks in Paris, this year has seen Brussels and Istanbul airports targeted, and most recently, Bastille Day celebrations in Nice. Not only are the attacks increasingly indiscriminate, but apparently implemented by 'lone wolf' individuals rather than conventional terrorist networks. This will significantly elevate public concern, and undoubtedly impact tourism, business aviation included.

Then in June came the next black swan of 2016, Brexit – the unanticipated UK referendum result to leave the European Union. Business aviation in Europe has a lot at stake in the decision and its repercussions. The regulatory and legal implications, in

Chart 1: Busiest cities for business aviation activity in Europe in 2015 (departures)



terms of the UK's access to the EU's traffic rights, import channels, aircraft operator certification and operator ownership – these are just some of the factors which might as a consequence require painful restructuring for the UK's business aviation industry. The extent of such changes will not be clearly apparent before several years of negotiation have taken place.

The broader economic impact of Brexit is expected to tip the UK into recession in the next 12 months. It may also presage the end of London's role as global financial center. At the very least it's expected that some of London financial services firms will relocate some resources to competing EU hubs such as Paris and Frankfurt. This could dilute London's concentration of wealthy individuals as well as its domination of European M&A and IPO activity. As shown in Chart 1, these developments would surely undermine London's role as Europe's foremost hub for business aviation activity.

The UK's EU exit will also probably stall the tepid economic recovery of the other 27 members of the EU. This is a blow as the Eurozone's growth cycle had been expected to pick up this year. Low energy costs and the ECB's sustained monetary stimulus had appeared to weather the global economy's wobbles in Q1, and economic performance was picking up in Germany, Spain, even Italy, and holding up in the UK. This relative recovery was reflected in business jet activity in the first 6 months of this year, with demand growing in these leading countries, offsetting the continued stagnation of peripheral markets such as Turkey and Russia.

## BOOST FOR ACTIVITY

What's driving the activity growth shown in Chart 2 is the relative gain in AOC/Charter flights, in contrast to the slide in Owner/Private flights. The contrasting trends of AOC and Private flights is indicative of a low-risk market; many owners have parked their aircraft for sale, and few new owners are coming into the market, whereas the ad-hoc charter market, requiring no-long term commitment, seems to have made a comeback. This may explain investors' enthusiasm for the online broker platforms targeting the spot market for charters. Fractional and block-hour programs have also done relatively well as their fleets have upgraded to newer aircraft.

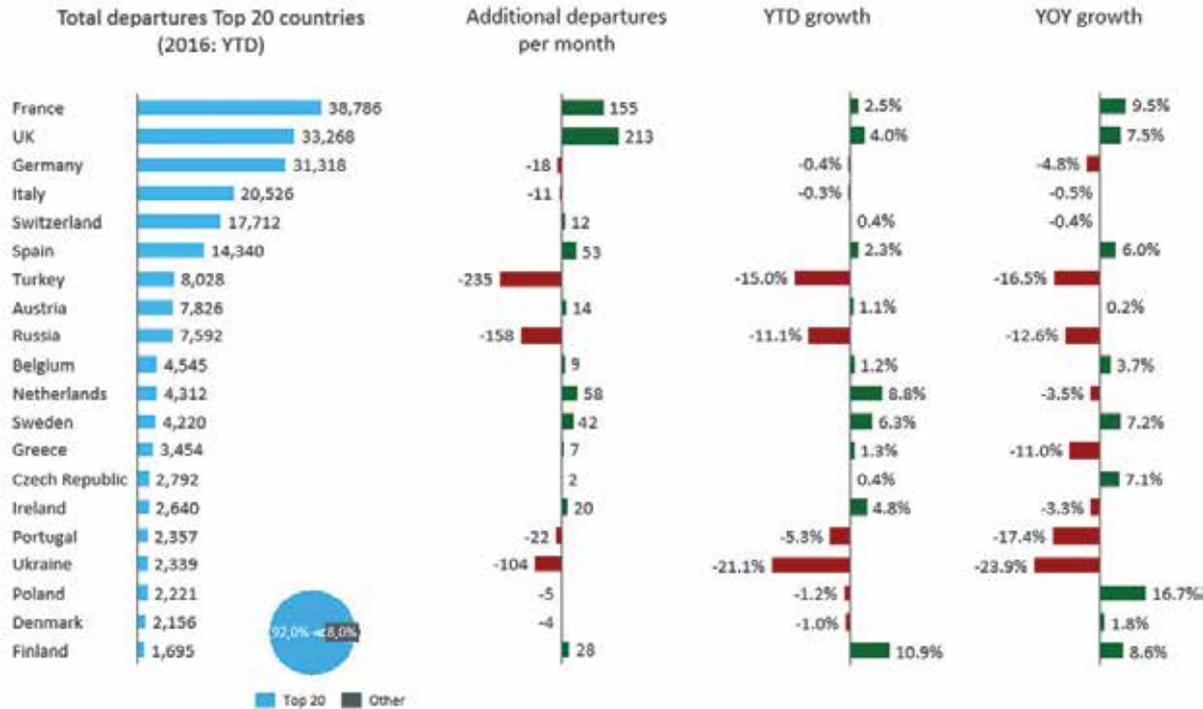
Undoubtedly one boost for European business aviation activity in 2016 has been the UEFA Football Championships. This is particularly evident in France, where business jet charter flights were up 17% year-on-year in June, and are 5% up at halfway 2016. Of the Football competition venues, Nice has seen the biggest spike in demand, with 19% growth in charter flights in June, and Small Jets flying 22% more through Q2 2016. Very Light Jets have been the preferred choice, with an impressive 20% YOY growth in charter flight hours for the Citation Mustang.

But operators will be worrying that the Brexit black swan takes the wind from these sails in the second half of the year. Brexit may prompt further exits from the EU and perhaps even its unwinding. Italy's referendum on parliamentary reform in October could be such a flashpoint. So too could next year's elections in France and Germany. The terrorist threat is not unconnected; each new atrocity strengthens the hands of populist parties which opposed immigration and implication are anti-EU. The rise of populist agenda is also by definition anti-elitist. Business aviation is hardly likely to prosper in this scenario.

## EXAGGERATED CONCERNS?

These concerns may be exaggerated. Indeed, there may be near-term opportunities from Brexit for precisely the kinds of customer that uses business aviation. For exporters, weaker sterling is likely to outweigh higher import costs (like fuel for aircraft operators) in boosting sales. Likewise, the cheaper UK currency should attract both foreign tourists and investors. Whilst some may postpone investments in light of uncertainty, others will recognize a window in which to strike a good deal. In the meantime, even a 'hard-Brexit' outcome is unlikely to dissuade the world's wealthiest from wanting to have a residence in London.

Chart 2: Business jet activity in Europe in H1 2016



The divergence of views on the potential outcomes of Brexit speaks to the underlying theme of our times which is most damaging to business aviation, uncertainty. All investment decisions need a certain amount of clarity on future market conditions to weigh up pros and cons. And as one of the recent succession of black swan events, it's a certainty that Brexit will compound the already hesitant and cautious outlook of business investment. When it comes to private jets this decision also has to account for the extra sensitivity of the industry's often toxic image.

## US PRESIDENTIAL ELECTIONS

Across the Atlantic, Brexit will focus attention on perhaps the biggest black swan of them all in 2016—the potential election of Donald Trump. After all, if a caricature of elitist politicians and uncontrollable immigration can be whipped up to overturn the UK's 40-year membership of the EU, a similar platform might be sufficient for Trump. At this stage a potential Trump administration has not been spelt out in any detail, but it's obvious it would damage America's diplomatic and trading relationships with global partners, challenging the globalizing trends which have been such an important driver of business aviation over the last two decades.

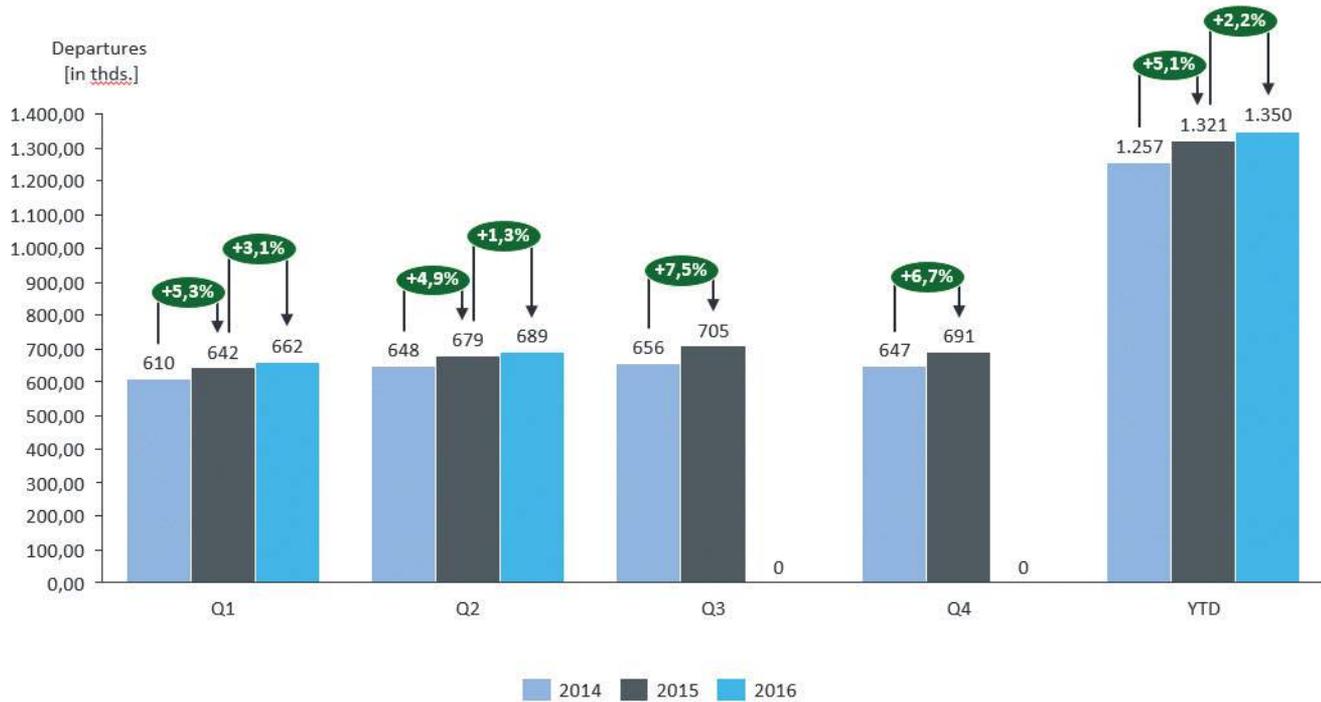
Amid these big geopolitical distractions, the business aviation industry's internal cycle should

be adapting to a new equilibrium. Unfortunately, this does not appear to be happening, as the stock of aircraft for sale continues to increase, and prices across almost all aircraft types continue to deflate. The North American business jet fleet is still eking out some growth in overall activity, as shown in Chart 3, but this is flattered by busy new aircraft, with up to a third of the older fleet idle, many parking in vain for a transaction. Average utilization per aircraft is still far below levels of activity before 2008 and aggregate flight activity levels are now plainly flagging.

## POLITICAL AND ECONOMIC DISTRACTIONS

Whilst it's abundantly clear that the market is over-supplied with aircraft, the business jet manufacturers appear to have ignored the warning signs the last few years, competing amongst each other to churn out a stream of new and ever more similar products. Clearly there was a misplaced assumption that demand for large aircraft from Brazil, Russia and China would grow indefinitely. But the OEMs also appear to have lost touch with their core markets in the US and Europe. As their deteriorating production backlog attests, there simply isn't enough customer appetite to soak up aircraft coming onto the market.

Chart 3: 2014-2016 Quarterly business aviation activity trends in North America



In an effort to move the market back towards equilibrium, the OEMs have now cut back on production and prices. This has amplified the ripple-effect of discounts in the pre-owned market, and should be prompting purchases in what is now a very attractive buyer's market. But until prices stabilize, the ever-swifter depreciation of business jets only makes would-be owners and their financiers more nervous. The only momentum left in the industry is the need for already well-established business jet owners to upgrade their existing fleet. And clearly even these decisions are being extended well beyond the historic replacement cycle.

Back in January, the consensus was that business aviation would get another flat year. Events - the black swans in the wider geopolitical context - have by now dashed even these modest expectations by introducing ever more pervasive levels of risk and uncertainty. Without these distractions, falling product prices and restrained production might have brought the industry into equilibrium. But for now political and economic distractions have taken center-stage on every CEO's agenda. Until these business aviation customers are unburdened of the constant concern of another black swan event around the corner, the industry will struggle to find any growth. ■



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