



# OPINION: WHY AFTERMARKET DEMAND IS NOT TRACKING AIRLINE CAPACITY

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**The last month was brutal for iconic British suppliers Meggitt and Rolls-Royce. Both issued profit warnings, and their stock prices promptly declined 20%. And both blamed weak aftermarket demand as a key cause of disappointing earnings. They are not alone, as other OEMs also are experiencing flat aftermarket demand.**

According to Canaccord Genuity, air transport maintenance, repair and overhaul (MRO) demand will grow a paltry 1-2% in this year while global air transport capacity will increase a healthy 5-6%. Why the divergence? I believe several factors are to blame.

The first is well-documented: the rise of used and serviceable material (USM) as a result of surging retirements and sophisticated, well-capitalized suppliers. As highlighted in my September 2014 column, ICF estimates more than US\$3 billion in USM material is consumed per year, which is transforming the MRO market. Use of USM, once centered in the Americas and Europe, is spreading to Asia and the Middle East. Even Chinese operators are now leveraging it after completing their first in-country aircraft part-outs.

A second factor shaping aftermarket demand is evolving airline management objectives. A decade ago, many airlines were managed to maximize market share, which led to poor financial results. Today, an influential group of operators led by Delta Air Lines is focused on return on invested capital (ROIC) as a key measure. According to CEO Richard Anderson, "It's been about changing the mindset and the approach to the industry and really treating the airline industry like any other industrial business. For that reason, we target 15% ROIC just like other high-quality industrial transports."

This has had a profound impact on maintenance behavior. Delta has a group dedicated to parting-out older aircraft and "harvesting" parts to reduce maintenance costs. It is leveraging its internal technical capability to develop repairs, manage engine green time and modify MRO scopes to cut maintenance expenditures. The airline is upgauging its fleet; capacity today is roughly the same as it was during the 2008 merger with Northwest Airlines, but it is operating 14% fewer aircraft.

Delta purchases parts and repairs from OEMs as a last resort. The results are spectacular relative to peer airlines: In 2014, Delta achieved 20% ROIC, 13% operating margin and the highest on-time performance (by a large margin) among the U.S. majors. Its market capitalization is US\$38.5 billion.

A third factor underpinning soft aftermarket results is expanded penetration of integrated maintenance programs that combine asset pools with maintenance services - often for broad bundles of aircraft components. The upshot is that rather than purchasing spare components for maintenance bases and line stations, an operator enters into a pool agreement in which the supplier owns the inventory, and it shares the pool with other operators.

This is fundamentally more efficient than each operator engaging in its own provisioning, and deprives aerospace OEMs of a very lucrative element of their aftermarket businesses. Historically, uptake of these programs was limited to European charter operators and low-cost carriers, but it is now spreading like wildfire for new aircraft models such as the Boeing 787 and Airbus A350XWB and A320.

A final factor shaping aftermarket results, but admittedly harder to quantify, is the dramatic strengthening (20-30%) of the U.S. dollar in the last 15 months versus many key currencies, including the euro, Canadian dollar, Australian dollar and Brazilian real. Because most MRO and OEM service parts are priced in U.S. dollars, the net effect is to increase the cost of maintenance to operators at a time of soft economic growth. Not surprisingly, many of these operators are deferring maintenance and engaging in short-term cash conservation.

The good news in all of this is that aftermarket demand is cyclical and will eventually recover. Deferred maintenance needs to be completed sooner or later, and low fuel prices are beginning to slow the pace of aircraft retirements and part-outs. Aerospace suppliers, however, would be wise to tune in to the "Delta Effect" and the other factors currently impeding aftermarket growth.

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