ASSESSING FACTORS CONTRIBUTING TO LOW PROFITABILITY MARGINS AT KENYA AIRWAYS BETWEEN THE YEAR 2009- 2012

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ABSTRACT

The objective of the study was to establish causes for the low corporate profitability margins at Kenya Airways. The objective was to understand if the management style had an impact on the Kenya Airways (KQs) performance; to investigate if the impact of other world economical forces had impact on the company profit levels, to evaluate the impact of the cost on profitability level and to examine whether the fuel hedging has an impact on profitability level. Due to the continued significant financial losses that had been incurred over time; the share equity value at the stock market declined consequently causing shareholders loose on their wealth, it led to further resulted to low pricing and devaluing of the KQ wealth capital accumulation and the losses resulted to retrenchment of workers/employees. Hence it is from this reasons that the research come up with problem of the statement for these study of the KQ. The study used the survey research design this was because not much studies had been carried out on Kenya airways. The study used desk research, secondary data evaluation and internet. The data was analyzed and presented through use of descriptive analysis, and content analysis. The findings of study concluded that there was positive relationship between the impact of Euro-zone crisis and fuel hedging to Kenya airways Profitability that led to losses. The study recommended the need to search for new untapped emerging markets in Asia that will cushion against the economic downtimes of the Eurozone crises, to adopt new type of air carrier that is cost and fuel efficient that would in turn save on fuel cost to avoid hedging and losses in profits and to broaden

strategic alliances with other airline industries in order to capture a larger market and enter into new markets.

Key Words: *corporate profitability, low profitability margins, Kenya Airways*

Introduction

In 2008 and 2009, United States (U.S.) passenger airlines reported aggregate net losses, before extraordinary income and charges, of $14 billion on revenues of $270 billion. About 76% of the losses were on domestic U.S. operations, which have been deregulated since the fall of 1978. Most international routes remain more heavily regulated and generally more lucrative for those carriers that are permitted to serve them. The very poor financial results in 2008-2009 again sparked discussions of why the airline industry has fared so badly since deregulation. Since 1979 through 2009, U.S. airlines lost $59 billion on domestic operations (Borenstein 2011). Borenstein & Rose (2008) addressed the volatility of airline profits, showing that fluctuations in demand and fuel prices along with fixed capital costs and sticky labor costs can explain the industry's earnings volatility. By 2000, Southwest was the fourth largest carrier in the US based on passengers flown and the largest based on departures (see previous section). Obviously, competition is a top concern for Southwest. With air travel becoming a commodity business, being competitive on price is the key to survival and success (McCartney, Michaels, and Rogers, 2002).

The airline industry went through tremendous turmoil in the early 2000's with four major bankruptcies and two mergers. In August 2002, US Airways filed for bankruptcy. A few months later, United Airlines followed suit. It stayed under Chapter 11 bankruptcy protection for more than three years, the largest and longest airline bankruptcy in history. In September 2005, Delta Airlines and Northwest Airlines went bankrupt on the same day (Barney, 1991). By then, four of the six legacy carriers were under bankruptcy reorganization. Only American and Continental Airways managed to escape bankruptcy, but all legacy carriers reported a large reduction in profits. On the supply side, a variety of changes have affected the industry's market structure and profitability. The most cited transition is the expansion of the low cost carriers (LCC), whose market share of domestic origin-destination passengers increased steadily over the past decade, from 22.6% in 1999 to 32.9% in 2006.8 As a result, the legacy carriers are forced to lower fares and offer competing service. Some legacy carriers have shifted their capacity to the more lucrative international markets, and reluctantly surrendered part of the domestic markets to the LCCs (Barney, 1991).

Kenya Airways traces its history back to 1946 with the formation of the East African Airways Corporation (EAA) and was incorporated in January 1977 as a company wholly owned by the Kenyan government. It was established as the national flag carrier of Kenya and acquired certain of the assets and staff of EAA. It operates scheduled services throughout Africa and to Europe and the Indian subcontinent (Kenya Airways, 2011).

It is commonly referred to as the Pride of Africa and was started in 1977 after the break of the East African Community. Kenya Airways, (2011) reveals that Kenya Airways is the leading operator on domestic routes. Kenya Airways operates sixty seven flights a week to four domestic destinations: Mombassa, Malindi, Kisumu, and Nairobi. Internationally, Kenya Airways operates scheduled passenger service and cargo services to twenty four international destinations with forty five flights a week. Kenya Airways serves seven destinations in Europe; eleven in sub-Saharan Africa; and six in North Africa, Asia, and the Middle East. Kenya Airways, as the national airline of Kenya, has rights under existing bi-lateral agreements to operate flights to a total of fifty eight countries (Kenya Airways, 2011).

Statement of the Problem

Kenya Airways share price has lost 17.5 per cent of its value in the last three months and more than half of its value in the last 12 months due to increased selling by investors, lower profits, and the publicity around its retrenchment plan. This has led to a Sh4.9 billion loss in shareholders' wealth on the counter between June and October 2012 as measured by market capitalisation which is the total number of shares multiplied by the share Price (Otini, 2012). The carrier, which is 26.73 percent owned by Air France-KLM and is one of Africa's largest, KQ's shares fell 12,7% at the Nairobi bourse to trade at ksh 19 compared with closing price of ksh23.50 (Miriri, 2009). The national flag carrier Kenya Airways reported full year earnings profit after tax loss of 7.864 billion versus a full year profit after tax of +1.66 billion, Full year revenues retreated -8.3755 per cent to 98.86 billion. In the main full year results were a 'known known' and had been telegraphed at the first half earnings release. In fact, the second half numbers marked a material improvement versus first half. The improvement was worth +1.8775 billion (Satchu, 2013).

The profit warning is despite the carrier announcing higher passenger numbers for the third quarter up to December, a 15.4 per cent increase to 956,742 passengers. Kenya Airways plans to double its fleet in the next five years to 68 jets and add 60 new routes over 10 years, a plan that will cost Sh300 billion financed through bank loans and internally generated funds (Gachiri, 2012). KQ's shareholder funds have fluctuated in the past, registering a 22.84% growth in 2008 and a 35.38% drop in 2009. In 2010, we expect a marginal 1.09 drop as the company pays the Kshs.462Million from its revenue reserve. Analysts reported that in 2007, KQ made a profit of Kshs. 4.098 billion; profit of Kshs.3.869 billion in 2008; a loss of Kshs. 4.083 in 2009; profit of Kshs. 2.035 billion in 2010; profit of Kshs. 3.538 billion 2011; and profit of Kshs. 1.66 billion as of 31st March 2012. The analysis showed an overall downward trend of KQ profits between 2007 and 2012 (GOK, 2012). The low pricing of KQ's share price fell by 21 per cent in the past year to the current price of Sh10, making it one the worst performing counters at the NSE over the period that saw firms record double-digit share appreciation Victor Juma (2013). As a result shareholders incurred losses on their wealth and also it led to devaluation of the KQ wealth capital accumulation.

General Objective

To investigate factors contributing to low profitability margins in Kenya Airways carrier.

Specific Objectives

The research is expected to accomplish the following objectives:

1. To examine the impact of Eurozone crisis on Kenya airways profitability marginal level.

2. To examine the effect of fuel hedging on Kenya Airways profits.

Materials and Methods

Descriptive survey research designs are used in exploratory studies to allow researchers to gather information and summarize, present and interpret data for the purpose of clarification (Orodho, 2003).The study was a desk survey, intended to analyze the available literature on the variables that explain the factors contributing to low profitability margins in Kenya airways. The appropriateness of this method to the study was the ability to review a wide variety of secondary literature that is relevant to the research topic. The study population is the complete set of individual cases or objects with some common characteristics to which the research wants to generate the results of the study (Mugenda & Mugenda, 2003). The study comprised Kenya Airways as an industry. Purposive sampling technique was used. This method enabled the researcher to select cases that had the desired information or the required characteristics that were useful in achieving the objectives of the study. The study made use of only secondary data which was extracted from various published sources as well as the internet. These included books, journals or periodicals, newspapers or magazines, and Kenya Airways websites. Content analysis method was used in view of the qualitative nature of much of the data collected. The method was quite appropriate in the analysis of the contents of documentary materials such as books, journals, newspapers, internet resources, and statistical reports.

Results

Euro Zone Crisis

Europe’s debt crisis had hit Kenya Airways operating environment and depressed demand for travel in key markets that account for nearly a third of the revenue for Kenya airways, as passenger numbers remain flat on euro crisis (Reuters 2012) Revenues dipped by Sh5.1 billion to Sh49.8 billion, and passenger traffic, which account for 90 per cent of the business dipped 10 per cent to Sh43.6 billion causing a net loss of Sh6.8 billion from a net profit of Sh2.0 billion in the first six months last year. Kenya Airways closed the first half of the year with a Sh2 billion exchange rate loss arising from a stronger shilling that stayed at an average of 84 units to the dollar compared to an average of 88 units to the dollar last year .The strength of the shilling is critical to the airline’s performance because a large portion of its revenue is dollar denominated, exposing it to losses during conversion. Kenya Airways reduced capacity on European routes

such as London, which account for about 30 per cent of its revenues. That action saw revenue passenger kilometre fall by three per cent, resulting in a 9.6 per cent drop in total revenue for the period to Sh 49.8 billion. Europe's share of Kenya Airways' passenger volumes dropped from 29 per cent to 22 per cent in the period under review (www.businessdailyafrica.com).

Exports from Kenya dropped on account of unfavourable weather patterns evidenced in the quarter and market capacity, while volumes from Europe shrunk reflecting the volatile economic conditions. The ongoing volatile economic conditions in the Euro-zone are continuing to affect Kenya Airways' (KQ) capacity to Europe that shrunk by 13.8 percent in the third quarter ended September. The National carrier observed capacity rationalization occasioned by the Euro-zone crisis and the suspension of the Rome flights were major factors leading to the decline of passenger uplift to Europe at 134,214 was a reduction on last year's level of 158,247 following the capacity reduction (Rubadiri 2012)

Fuel Hedging

This is a type of contract entered into between airlines and financiers, where the airlines agree to buy jet fuel and oils at a predetermined price for a specified future time period. In common language, it is a gamble against future prices. If KQ predicts that cost of fuel is going to increase in the future, it enters into a hedging contract to purchase fuel at the current price for months or years ahead of time. If prices double in a year, KQ would be able to purchase the fuel at the previous year's 'locked in' lower rate, resulting in savings. If the price falls below what the airline hedges to buy, it is bound to pay the higher rate than the market price, thereby losing money. In 2012, KQ lost Kshs 85 million in this gamble, and won a staggering Kshs 1.45 billion in 2011 (GOK 2012).

Given that the cost of fuel is unpredictable, it is prudent to hedge. However, as has been indicated by recent hedging risk exposure(s), it can be a costly undertaking. In 2009, KQ paid Kshs. 1.3bn as hedging cost. In 2010 and 2011, it was anticipated that the airline would pay about Kshs. 985m and Kshs. 1bn respectively in hedging cost. Also, unrealized losses on fuel derivatives (which were marked to market in 2009 leading to the significant LBT) could markedly reduce from 2010 as the price of fuel improves and as the company reviews its hedging policy, leading to a return to profitability in the medium term (Duncan Miriri 2009). Fuel Hedging: In compliance with fuel hedging accounting rule (IAS 39) that requires changes in fair value balances of outstanding derivatives to be passed through the income statement, KQ charged an unrealized hedge loss of Kshs 7.5bn through the FY2009 income statement. The unrealized hedge loss relates to future fuel consumption up to December 31 2010. Although the company is in the process of reviewing the hedging policy through a committee of the company's board, we reckon that the item will continue to affect the company's bottom-line in the medium-term (http://www.sterlingstocks.com).

Fuel price volatility and cost management are therefore expected to top the list of challenges for the airline this second half of the year. Fuel cost remains Kenya Airways' largest expenditure item, accounting for 39 per cent of total operating costs (http:// www.businessdailyafrica.com**).**

KQ had fixed its price under the hedge contracts at 100-120 dollars per barrel of fuel and later on the prices collapsed, accordingly, International Accounting Standards [IAS 39] required KQ to account for this as a loss (GOK 2012). This concurs with (British Airways, 2005) that made losses of USD 107 Million in 2002.

Discussion

Impact of Fuel Hedging on Kenya Airways

Hedging seems to be driven by economies of scale, reflecting the high fixed cost of establishing risk management programs Graham and Rogers (2002). Nance, Smith and Smithson (1993) and Geczy, Minton and Schrand (1997) found that hedging firms have greater growth opportunities, which is consistent with the argument that hedging helps mitigate the potential under-investment problem of firms. The shareholders maximization argues that firms hedge to reduce various costs involved with highly volatile cash flows. According to Mayers and Smith (1982), hedging helps to reduce the expected cost of financial distress, Smith and Stulz (1985) says that hedging may be motivated by tax incentives. When firms face a convex tax function, hedging should help to reduce expected taxes. Hedging can also increase the debt capacity therefore realizing greater tax advantages from greater leverages (Leland, 1997). Lastly hedging may also be used to relieve the problem of under- investment, when firms have many growth opportunities and external financing is more expensive internally generated funds. Froot, scharfstein and Stein (1993). The problem arises when investment opportunities are negatively correlated with cash flows.

Impact of Euro Zone Crisis on Kenya Airways

The Eurozone officially called the euro area, is both an economic and monetary union (EMU) of 17 European countries that have adopted the euro (€) as their common currency. The eurozone currently consists of the Netherlands, Austria, Malta, Belgium, Cyprus, Slovakia, Finland, France, Greece, Germany, Ireland, Estonia, Italy, Luxembourg, Portugal, Slovenia, and Spain. It is an ongoing crisis that has been affecting the countries of the Eurozone since late 2009. It is a combined sovereign debt crisis, a banking crisis and a growth and competitiveness crisis Jay C (2012).

The crisis made it difficult for some countries in the euro zone to repay their government debt without the assistance of third parties. Moreover, banks in the Eurozone are undercapitalized and have faced liquidity problems. Additionally, economic growth is slow in the whole of the Eurozone and is unequally distributed across the member states Jay C (2012). Higher passenger taxes and weak home-market economies have limited profitability in Europe, resulting in a downward profit forecast from $1.4 billion to $1 billion, despite the region's outstanding traffic growth Gregory Polek (2011).This poor economic performances have been attributed to the

significant losses in Kenya airways performance (Victor Juma 2013). According to IATA, the airline industry has seen profit turn into loss whenever global GDP growth falls below 2 percent. As recent global GDP forecasts suggest growth of just 2.1 percent, IATA's outlook for 2012 has turned still more pessimistic Gregory Polek (2011).

Key variables driving the downgrade include a downward projection in passenger demand from 4.6 percent to 4 percent, while cargo shows flat growth, compared with a previously forecast 4.2-percent expansion. Finally, the association sees a modest profit of just $100 million in Latin America, largely as a result of weakness in the Brazilian market, while African carriers lose $100 million due to weaker yields coupled with only modest load factor increases Gregory Polek (2011). Most airlines have taken heavy losses and to withstand the crisis had to use various different marketing policies of lower prices or promotions in order to diminish losses. The main European companies as Air France-KLM announced decrease of over 30 % of income because of the cheaper tickets but estimated an annual profit of over 15 %, British Airways adopted a new policy of "flights of survival" by which companies try to provide some incentives to loyal customers and keep them even if the company does not register profit Marius (2010).

Conclusions and Recommendations

The two independent variables from the study are thus evidential as factors that contribute to an airline profitability performance. From the above findings, hedging of fuel although it can be a good cushion on price swings however for the case of Kenya airways, it was a factor that contributed to the low profits margins hence it had a direct impact on the losses incurred.

The effect of economic hardships experienced from the European regions resulted to low uptake of tourism in general as a result there were fewer passengers who could travel to Kenyan thus the reduction in number of the tourists to use Kenya airways resulted to low revenues hence it is attributed that the Eurozone crises had a direct bearing as the cause of low profitability margins in Kenya airways.

The researcher recommended that on Eurozone crisis, there is need to search for new untapped emerging markets in Asia that will be able to form a hedge and cushion against the economic downtimes of the Eurozone crises in order to explore new ways of generating profits. On the issue of fuel hedging, due to large consumption of fuel by the Kenya Airways, there is need to adopt new type of air carrier that is cost efficient and uses battery or renewable and recycled energy that would in turn save on fuel cost to avoid hedging and losses in profits.

There is need to broaden strategic alliances with other airline industries in order to capture a larger market and enter into new markets in order for the Kenya airways to increase its presence and compete effectively in a global market.

As a service sector, the airline sector is seen as a sector which is open to changes, which has high flexibility of demand, dense uncertainty and competition (Taşgit, 2008).

There is need to study factors which affect and have a bearing on the profitability level of the Kenya airways industry such as the customer satisfaction and service quality, cost of operation, travel warnings from foreign governments, innovation and technological changes.

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