Liquidnet
Market Structure

What does Flygskam mean for Capital Markets?

January 2020

Liquidnet

Growing environmental concerns are impacting consumer behaviour and companies are rapidly having to sit up and take notice. A year ago, a no-fly movement seemed a radical idea, yet during 2019 "Flygskam" or "flight-shame" gained significant traction, creating new challenges not only for airlines, but also manufacturers and supporting industries. Sectors falling in and out of investor favour is nothing new—so why should the industry pay attention now?

Although active managers often have a long-term investment horizon, the need to meet growing demand for Environmental, Social, and Governance (ESG) investment strategies is now impacting how companies are evaluated and the data required to do so. Managing downside risk is no longer a question of monitoring financial statements and earnings calls, but staying abreast of new developments that can impact companies future earnings in the move to a carbon neutral economy. Mark Carney, the governor of the Bank of England, recently warned the financial sector was not moving fast enough to address climate change concerns and companies' assets risked becoming worthless without swift action[1]. The Bank of England also launched a stress test to analyse the companies and sectors that would be the most impacted by climate change with the first results to be expected in the first half of 2021[2].

New regulatory initiatives are quickly emerging in Europe both at national and at a European-wide level to ensure investments that claim green credentials deliver what is marketed to end investors. Firms subject to MiFID II, UCITS directive, AIFMD, the European Union Venture Capital Funds regulation (EuVECA), and the European social entrepreneurship funds regulation (EuSEF) will be required to incorporate and disclose ESG factors and risks as part of their investment process from 2021[3]. The disclosure regulation published in the Official Journal of the European Union requires firms to provide information on the degree of environmental sustainability of investments, as well as how they integrate ESG risk into their decision-making and advisory processes (to read more on ESG regulations, click here).

Impact on future business models

Airline companies that fail to address environmental issues risk joining the ranks of other "sin stocks" such as cigarette manufacturers, fossil fuels, or plastic producers. As ESG investments move sustainability mainstream, asset managers are increasingly focusing on the long-term viability of company business models. Whether as a result of public behaviour or future policy from governments needing to lower carbon emissions, airlines will likely have to re-think how they operate to maintain their licenses to fly in Europe, as well as survive as a viable, commercial entity.

The challenge for the sector is that if aviation was a country it would be in the top 10 of the world's largest carbon polluters[4]. The democratisation of air travel with lower fares led to an explosion in commercial flights. The sector's footprint is estimated to be approximatively 70% higher in 2020 than it was in 2005, with a rise in greenhouse gas emissions representing around 3% of all EU emissions and more than 2% of the world. Consumer concerns are starting to bite; a survey conducted in May 2019 by UBS with 6,000 people in France, Germany, UK, and US showed that 21% of travellers had reduced the number of flights over the last 12 months[5].

"In the future, I expect the aviation industry's license for growth to be linked directly to perceptions of sustainability"

Violeta Bulc, European Commissioner for Transport

This reduction looks set to continue. The French government currently plans a tax levy of EUR €1.5 for domestic and European economy-class tickets to EUR €18 on international business-class flights[6]. Germany is set to double its taxes on flights originating from the country and Switzerland is considering similar types of tax measures. As a result, some airlines are already taking actions to curb their environmental impact and make their business models more sustainable in the long-term.

1, 2: https://www.ft.com/content/f67833ba-2ad7-11ea-bc77-65e4aa615551
3: https://data.consilium.europa.eu/doc/document/PE-87-2019-INIT/en/pdf
4: https://www.politico.eu/article/the-popular-revolt-against-flying-climate-european-airlines-carbon-emissions/
5: https://www.bbc.co.uk/news/business-49890057
6: https://www.telegraph.co.uk/news/2019/07/09/france-slap-eco-tax-flights-france-fund-greener-transport/

So what does this mean for Capital Markets?

There is already an argument that flight shaming has affected, to some extent, the performance of airline stocks. Return on equity (ROE) in the airline sector has been on the decline since 2017, accelerating in 2019 *(see Appendix, Exhibit 2)*. In parallel with the decline on ROE, shorting interests rose progressively over the last year as markets speculated on the decline in European airlines stocks *(see Appendix, Exhibit 3)*.

Consumer concerns regarding climate change is also impacting investment processes overall. The UN Principles for Responsible Investment (PRI) invites investors to sign and publicly endorse an expectations statement regarding airlines and aerospace companies managing climate-related risks and their transition to a low-carbon economy[7], which only reinforces the need for carbon-friendly industries to take notice of ESG and the impact on the investment process.

The issue for capital markets is that this change in consumer sentiment will affect a far broader group of sectors than just airlines, requiring a wholesale change in how companies are evaluated, and shareholder interests are protected. The speed at which climate change is having a direct impact on consumers' behaviours alongside government targets to meet UN Sustainable Development Goals, and the subsequent impact on company balance sheets will require asset managers to adjust their investment strategies accordingly. The ban on single-use-plastic is another example of the changing global phenomenon. Recently, India's government proposed to ban single-use plastic to tackle the country's pollution crisis. Although the initiative is currently targeting voluntary reductions due to the recent economic slowdown affecting the job market, future draconian measures to curb plastic waste are likely, given the country uses approximately 14 million tons of plastic on an annual basis[8].

Rethinking value

Growing environmental concerns on carbon-friendly sectors will likely impact traditional pricing of risk; holding inventory in a name that is deemed non-sustainable in the long-term will only increase the cost of capital as the risk profile deteriorates. The bond market is also likely to become increasingly affected as carbon friendly sectors struggle in their capacity to raise debt. In addition to this, the PR collateral damage of holding a fossil fuel company in a portfolio will continue to challenge an asset managers notion of how to assess value. This will require PMs to rethink the data they consume, the manner and the consistency in which they consume it so that they continually reassess holdings on what may cause a negative impact in the future rather than the traditional buy and hold investment strategy of the past.

Performance is only delivered once the investment strategy has been executed. A strong partnership between fund managers and buy-side trading desks will be required to provide alpha and preserve performance from the investment decision to the execution of the strategy. Some asset managers are already looking at alternative solutions to enhance execution processes by investing in trading platforms that will match flow as well as capture execution data, quotes, and additional information around the trade. This will necessitate buy-side trading desks increasing their use of technology backed by historical and predictive data to establish where liquidity is pooling in an instrument or when an issue was last traded as well as the execution strategy required.

Business models that are deemed non-viable in a carbon-neutral environment will likely face continued regulatory, legal, and reputational challenges. As the backlash from consumers, investors, and stakeholders intensifies, the risk of stranded assets will become an increasing concern, making the ability and the timing of entering and exiting an investment strategy even more critical. Companies that are seen as a safe blue-chip bet today may just become the risky illiquid investment of tomorrow. That will impact what is traded, how and where, faster than many anticipate.

7: https://collaborate.unpri.org/system/files/2019-11/pri_investor_expectations_statement_on_climate_change_for_airlines_and_aerospace_companies_final.pdf
8: https://uk.reuters.com/article/us-india-pollution-plastic/india-shelves-plan-on-countrywide-ban-on-single-use-plastic-products-idUKKBN1WG43W

Appendix: European airline stocks behaviour

Stocks analysed include: Finnair, Lufthansa, SAS, Ryanair, Air France, EasyJet, IAG, Wizz Air

Valuation estimates

Exhibit 1

Valuation estimates: Negative six-months analysts' forecasts confirm the downward pressure on European airlines.

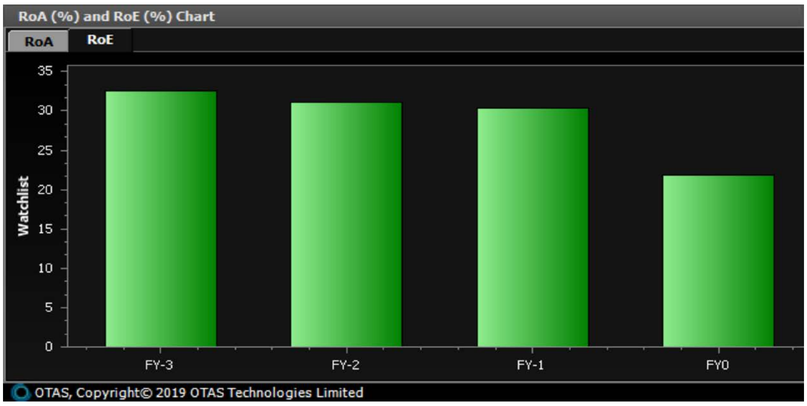
			EPS 12M Forward (% Change)				Price Target				
Ticker	Name	P/E	5 Days	1 Month	3 Months	6 Months ▲	Median	No. of Estimates	Up	Down	Discount (%)
FIA1S FH	Finnair	14.19	-4.38	-7.12	-5.02	-32.65	6.50	5	1	0	10.54
LHA GY	Deutsche Lufthansa (XE...	4.87	0.00	-1.72	-8.42	-27.91	15.50	24	1	2	-0.39
SAS SS	SAS	6.32	0.00	3.95	-1.14	-27.27	13.25	2	1	0	-11.62
RYA LN	Ryanair Holdings (London...	14.42	0.26	0.76	-5.40	-20.58	9.25	4	0	0	-28.43
RYA ID	Ryanair Holdings	14.11	0.14	1.46	-2.54	-18.50	10.30	21	0	1	-15.78
AF FP	Air France-Koninklijke L...	7.02	1.96	-3.29	-2.04	-11.94	11.00	19	2	2	1.95
EZJ LN	EasyJet	12.81	-0.03	0.10	-0.42	-11.83	1,100.00	23	4	1	-9.23
IAG LN	International Consolidat...	5.37	-0.41	-3.42	-2.43	-7.76	659.38	14	1	4	21.17
IAG SM	International Consolidat...	5.21	-0.76	-3.07	-1.35	-4.56	7.80	13	0	3	22.62
WIZZ LN	Wizz Air Holdings	14.51	0.00	0.97	0.21	-1.91	3,705.69	15	1	0	-2.73

Source: OTAS data

ROE analysis

Exhibit 2

ROE (percentage) chart: FY0 represents year 2019, therefore FY-1, FY-2, and FY-3 represent years 2018, 2017, and 2016 respectively based on historical data.



Short interest

Exhibit 3

Short Interest Median: Progressive increase in shorting interest over the last two years as markets speculate on the continued decline in European airlines stocks.

About the authors

Rebecca Healey
Global Head of Market Structure + Strategy
rhealey@liquidnet.com
+44 20 7614 1607

Rebecca is considered to be one of Europe's leading industry voices on market structure, regulatory reform, and financial services technology. She has authored a plethora of qualitative research reports and commentary covering the impact of market regulation on all asset classes, changing market structure and developments in dark pools, HFT, and surveillance. She joined Liquidnet in July 2016 to use her 20 years' experience to collaborate and deliver research and insights for both the European equities and fixed income markets. Rebecca is also Co-Chair of the FIX Trading Community's EMEA Regulatory Subcommittee, dedicated to addressing real business and regulatory issues impacting multi-asset trading in global markets. She has held prior roles at TABB Group, Incisus Partners, the British Embassy in Bahrain, Credit Suisse, Goldman Sachs International, and Bankers Trust International.

Charlotte Decuyper
EMEA Market Structure + Strategy
cdecuyper@liquidnet.com
+44 20 7614 1701

Charlotte joined Liquidnet in May 2017 to work with Rebecca Healey on EMEA market structure and deliver research and insights about the European financial markets. Charlotte joined from Reed Exhibitions where she was a mergers and acquisitions analyst. Prior to Reed Exhibitions, Charlotte held a role at The Boston Company Asset Management in Boston.

Lara Jacobs
EMEA Market Structure + Strategy
ljacobs@liquidnet.com
+44 20 7614 1687

Lara recently joined the EMEA Market Structure and Strategy team. Prior to this, she studied at the University of Manchester where she obtained her Bachelor of Arts in geography with first class honours.