

easyJet fleet decisions: providing shareholder value?

This year's Paris Le Bourget air show as usual exhibited the normal flurry of announcements for aircraft orders. In total the manufacturers were able to announce firm orders for 696 aircraft with letters of intent for a further 383 orders along with options for a further 447.

Notwithstanding all the caveats about the validity of orders announced at air shows, in total the industry appears to have ordered a total of 2,191 aircraft so far this year; not far short of the 2,551 net orders achieved in 2012. The industry backlog now stands at nearly 11,900 units up by more than 1,250 from the end of 2012, and is equivalent to more than eight years of current production. This may add fuel to the idea that there is an order "bubble".

The two largest single orders at the show were from Ryanair and easyJet; the one for 175 737s, the other for 135 A320s. Both of these dominant European LCCs had each entered long term aircraft acquisition agreements respectively with Boeing and Airbus for very advantageous prices in the early noughties. Both deals were coming to an end and both carriers, while recently reducing the rate of capacity expansion, had been actively looking for new deals to provide for replacement and growth over the next decade.

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Changes at Aviation Strategy

Aviation Strategy has a new website – www.aviationstrategy.aero – and has undergone some changes. The newsletter is no longer part of Aviation Economics, which has been taken over by RDC Aviation (www.rdcaviation.com), but will continue to be produced by the same editorial team, 10 times a year.

A PDF will be distributed each month that it is published and all back issues are available to subscribers via the website. In addition, we will now post articles and comment on the website on a rolling basis, available only to subscribers. We welcome feedback and comment on the analyses.

Aviation Strategy also provides customised analysis and research reports on all topics relating to aviation, and if you have an issue or a company you would like us to cover, please contact us via the website or email at info@aviationstrategy.aero.

Details of Aviation Strategy's other services will be added to the website over the next months.

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Aviation Strategy

Aviation Strategy

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Our editorial policy is to analyse and cover contemporary aviation issues and airline strategies in a clear, original and objective manner. Aviation Strategy does not shy away from critical analysis, and takes a global perspective – with balanced coverage of the European, American and Asian markets.

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easyJet Fleet Plans

	2014	2015	2016	2017	2018	2019	2020	2021	2022
Fleet plan -- base case	226	231	241	256	261	264	269	276	276
A320	32%	36%	39%	42%	41%	41%	40%	39%	39%
A319	68%	64%	61%	57%	52%	44%	41%	33%	25%
A320neo	-	-	-	1%	7%	15%	19%	28%	36%
Average age of fleet	5.8	6.4	7.2	7.6	7.7	7.8	8.3	8.0	7.9
Seats flown growth	4.7%	4.6%	5.4%	4.8%	3.0%	3.0%	3.0%	2.8%	3.1%
Maximum fleet	226	237	247	262	279	300	301	306	298
Minimum fleet	226	215	217	223	185	167	177	162	165

There the similarity may end. Comment on Ryanair's orders will have to wait for another issue; in this article we concentrate on easyJet's position.

easyJet uniquely has Stelios Haji-Ioannou as a major shareholder who has publicly slated the company he founded for even *considering* the idea of buying new aircraft. The main focus of his arguments seem to be that it would be better for the airline to stop growing and allow margins to expand to over 10%, than to spend billions at list prices (forgetting the significant discounts) and destroy shareholder value (which is what the industry as a whole is perceived to do). His arguments may seem preposterous from the founder of and airline in an industry wedded to the idea of growth, but may have validity if the acquisition of further capacity could be seen to generate marginal revenue below marginal cost.

easyJet's original aircraft deal in 2002 with Airbus provided for up to 315 aircraft. The original contract was for 120 firm orders and 120 purchase rights at prices reputed to be at more than 50% discount to list prices. This was extended in 2006 to add a further 75 purchase rights. By

May this year 230 aircraft had been delivered with a further 15 deliveries due by 2014; while there are a further 70 options and purchase rights that could be exercised.

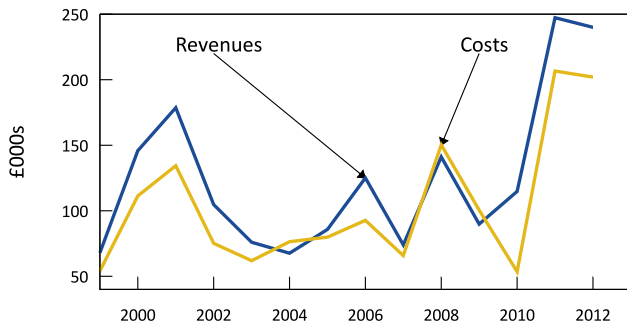
The new Airbus order

The new arrangement with Airbus signed this year (approved by shareholders despite Stelios's objections) allows for an interim "bridge" contract between 2015 and 2017 and a "new generation" contract from 2017 (when the A320neo should be available) to 2022. Under the "bridge" contract easyJet has ordered 35 A320 aircraft (with CFM engines) and has options and purchase rights for a further 35 (while retaining existing 35 options and purchase rights) – and may be seen as a pure extension to the 2002 arrangement.

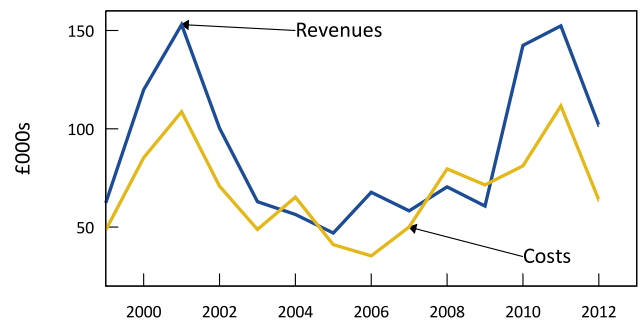
From 2017 the "new generation" contract encompasses firm orders for 100 A320neo up to 2022 and an additional 100 purchase rights (to be exercised by 2025). The company states it has agreed ceiling prices (which may come down) with both CFM for the LEAP, and Pratt & Whitney for the PurePower engines – and is obviously leaving the engine manufacturers to pitch

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easyJet: marginal growth per seat pa



easyJet: marginal growth (ex fuel) per seat pa



Definition: Marginal revenue and costs are calculated from the change in annual £ revenues (or costs) divided by the change in the average total number of seats in the fleet. Source: Company Reports

against each other for the contract.

With such hostility to growth plans from Haji-loannou, the company has gone out of its way to explain why and how it made the decision to go with Airbus. One of the more telling comments has been that it is getting the same level of discounts on the A320s in the period up to 2017, but even greater discounts to list prices for the A320neo after that (perhaps *just* making it the same effective acquisition price).

In one sense easyJet has had a cost disadvantage against Ryanair in the number of seats per aircraft. Ryanair had standardised on 180 seat 737-800s, but easyJet had a

mixture of 156 seat A319s and 180 seat A320s. As fuel prices jumped it became apparent to easyJet that the unit cost advantage of higher capacity aircraft outweighed the flexibility on thinner routes provided by the A319: the A320 with 15% more seats is 7-8% per seat cheaper to operate than the A319. The move to the A320neo, the company states, will add a further 4-5% saving in costs per seat – mostly provided by the fuel advantage of the new generation engines offset a little by a modest increase in ownership costs.

The company has reiterated the flexibility it has built in to its fleet plans. Its base case is for the fleet to grow to 276 units by September

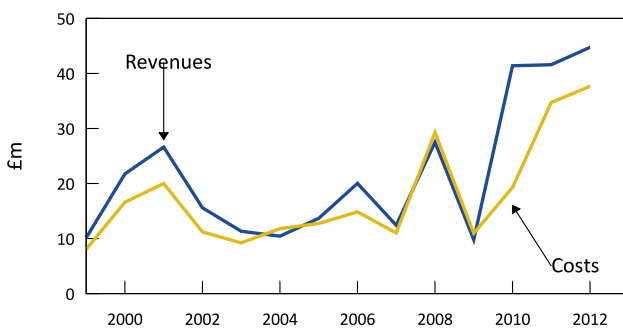
2022 (from 217 this year) – but has the possibility to allow the fleet to grow to nearer 300 (excluding the additional purchase rights) or slim to 165 units by the same year (on the scenario of cataclysmic disaster in 2014).

In the attempt to allay Stelios's objections the company has highlighted that the deal with Airbus fits in with all its financial targets.

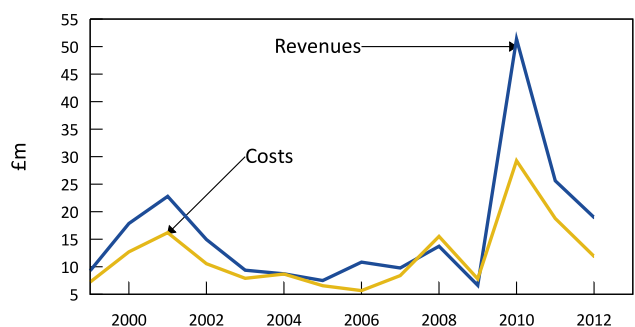
Is Stelios right?

We have analysed the public data from easyJet since 1999 to try to see if the idea that the company itself is starting to mature to a point where growth could be destructive to shareholder value – seemingly

easyJet: marginal growth per aircraft



easyJet: marginal growth (ex-fuel) per aircraft



Definition: Marginal revenue and costs are calculated from the absolute change in annual £ revenues (or costs) divided by the change in the average number of aircraft in the fleet. Source: Company Reports

Stelios's main thesis. We have looked at a series of measures presented in the charts on the previous page: the marginal revenue growth and marginal cost increase by average number of annual aircraft; the marginal revenue growth and marginal cost increase on the basis of the total number of seats on those aircraft – to take account of the varying fleet gauge. We have not considered actual traffic, and as we are looking at the total effect of

the number of aircraft we have not included actual flown operations. We have additionally done the same calculations excluding fuel costs from both revenues and costs.

The results of this analysis as shown in the charts on the previous page seem to show little to suggest that easyJet's addition of aircraft to its fleet has not normally been accretive to shareholder value.

Despite the vociferous complaints from Stelios, the stock

markets believe the easyJet story. Its share price, despite recent weakness, has more than doubled in the past year. The company has been elevated into the FTSE100 and is now the largest airline in the UK by market capitalisation. It boasts one of the highest returns on capital (along with Ryanair) in the European industry. And unlike most airlines worldwide it pays a dividend.

Aeroflot: state control still firm but privatisation in prospect

Ninety years old this year, Aeroflot is still controlled by the Russian state – a link that affects every major decision that the airline makes – but privatisation is again on the cards.

In 2012, under IFRS standards, the Aeroflot group posted a 51% rise in revenue to \$8.2bn, with the Aeroflot mainline carrying 17.7m passengers last year – 25% up on 2011 – and the group carrying 27.4m passengers, a 27% increase year-on-year. In its current summer schedule the Aeroflot mainline operates to 49 domestic and 75 foreign destinations, with the latter including 49 destinations in Europe, 12 in the Asia/Pacific region, eight in the US and six in the Middle East and Africa. In addition Aeroflot group airlines operate to 113 destinations.

However, in 2012 group operating profit fell 7.9% to \$358m and net profit was down a sub-

stantial 66% to \$166m (well below the consensus forecast of \$239m), due primarily to the burden of having to incorporate four loss-making domestic airlines – a decision that, of course, was imposed on Aeroflot by the Russian state.

That government-mandated deal in November 2011 dumped five airlines previously controlled by state-owned corporation Rostekhnologii into Aeroflot (in return Rostekhnologii received a 3.6% stake in Aeroflot) – Orenair, Rossiya Airlines, Sakhalinskiye Aviatrassy (SAT), Saravia and Vladivostok Air. Saravia has since been disposed of to private investors but Aeroflot has had to spend time and resources incorporating the others into its operations. Those four airlines contributed a massive \$203m net loss to the group in 2012.

Aeroflot has ambitious expansion plans. During 2012 the group

estimates it had a 32.5% share of the Russian domestic market (in terms of passengers carried) and a 41.3% share of the international market, and it aims to increase both shares through to 2018.

That will be achieved by a significant increase in the fleet, from 237 today to 282 in 2018, with passengers carried increasing from 27.4m in 2012 to 47.3m in 2018. Aeroflot's financial target is to increase IFRS net profit to \$362m by 2018 (compared with \$166m in 2012), according to Vitaly Savelyev, CEO of Aeroflot, speaking at the airline's AGM in June.

The challenge that Aeroflot faces in achieving this growth is being able to make 100% commercial decisions, free from government influence. The most obvious example of this is Aeroflot's fleet.

In 2012 the Aeroflot group added 18 new aircraft (12 European

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Aeroflot group fleet

Aeroflot group fleet	Fleet (Orders)						Total
	Aeroflot	Donavia	Rossiya Airlines	Orenair	Vladivostok Avia	SAT Airlines	
A319	15	4	12				31
A320	44 (11)				6		50 (11)
A321	21 (5)		8				29 (5)
A330	22				1		23
737		6	1	24		3	34
767	7		3				10
777	4 (12)			3			4 (12)
787	(2)						(2)
DHC 8						6	6
MD-11	3						3
An-12						1	1
An-24						4	4
An-148			6				6
Tu-154			5				5
Tu-204					6		6
Mi-8					3	1	4
Yak-40					2		2
IL-96-300	6						6
Sukhoi SuperJet 100	10 (20)						10 (20)
Total	132 (50)	10	35	27	18	15	237 (50)

and six Russian types), and today the fleet totals 237 aircraft. However, as can be seen in the table on the page opposite, the group is still lumbered with a variety of assorted Russian/Soviet-era types, and as fast as it gets rid of ancient aircraft it's burdened with more as further airlines are dumped into the group by the Russian government.

New Western aircraft are coming; for example Aeroflot ordered 16 777-300ERs in 2011 and has received four so far this year, which are being used on routes to Bangkok, Phuket, New York and Hong Kong as well as to long-haul domestic destinations. Five A321s are also being delivered this year, and older 737 models are gradually leaving the fleet.

Aeroflot has no option but to buy both Western and Russian

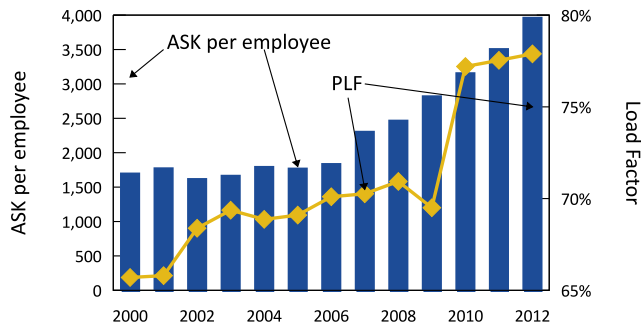
models. An order for 30 Sukhoi SuperJet 100s was placed back in 2005 and Aeroflot has received 10 of these so far – though thanks to manufacturing delays these have had to be so-called “Basic” versions, which the airline will sell these back to Sukhoi for approximately \$19m each as they are replaced by “Full” versions (with a longer operating range). The first such Full version was delivered in June, with six more due to be delivered in 2013 and three in 2014. Aeroflot executives can't speak openly on the issue, but it's highly unlikely the model would have been ordered given a free choice.

Another example of government interference is on the group's alliance policy. In July a Russian newspaper reported that Aeroflot wanted to leave the SkyTeam

alliance, of which it has been a member since 2006. Aeroflot is reportedly unhappy with the terms of its alliance agreement with Delta and would prefer to become a member of Star (which has long been looking for a member airline in Russia), although apparently the alliance (and decision to leave it) is primarily a “political matter” – i.e. a decision for the Russian government to make, and not Aeroflot executives.

Of course, Aeroflot also benefits tremendously from the Russian's state's influence. With a hub at Moscow's Sheremetyevo airport, Aeroflot needs that facility to keep up with its planned expansion by adding a third runway and new terminals. Aeroflot directly owns 9% of Sheremetyevo, and with the Russian state owning another

Productivity improving



83% the airport can be relied upon to expand exactly in line with Aeroflot's needs.

Until recently Aeroflot also benefited from the monopoly the Russian carrier had on 34 European routes, while the revenue it receives from overflight fees from foreign airlines operating over Siberian territory will be cut back significantly from January 2014. And last year the Russian government gave more than \$35m worth of subsidies to the airlines (60% up on 2011), which are paid to cover losses on routes to the more distant parts of Russia, such as to the Far East.

But another state intervention may be looming. There are rumours and newspaper reports swirling around in Russia that Aeroflot may take over one of its competitors – either Sibir, Transaero or UTair. The government is trying to sell its 25.5% stake in Sibir, but if no buyers can be founded at the mooted \$35m price then reports suggest the government may “encourage” Aeroflot to make a bid so that it can gain control of Sibir's routes into China as well as potentially using its fleet of A320s for its LCC plans. Aeroflot executives are believed to be concerned about the potential deal, with management not wanting

to consider another merger or acquisition in either the short- or medium-term while it tries to complete the consolidation of the airlines imposed on it in the last government-arranged deal.

Aeroflot would much prefer more profitable/strategic moves – an LCC is top of its wish list. Aeroflot is planning to launch an LCC in the “near future” according to its CEO, and is currently looking for key executives to run the operation. The airline will be based at either Sheremetyevo or Vnukovo airports in Moscow, initially with a fleet of eight A320 or 737s in its first year of operation, with eight aircraft being added annually after that.

However, before a LCC can be launched the Russian parliament will have to pass new legislation as currently a number of standard LCC practices are prohibited in Russia, such as non-returnable tickets, baggage fees and the ability to hire foreign pilots. The last restriction is particularly problematic as the LCC would need at least 40 pilots in its first year of operation. Aeroflot has found potential highly-qualified pilots from Ukraine and Kazakhstan who want to be based in Russia, but the current regulations forbid even CIS pilots from being hired.

Aeroflot has commissioned a

brand identity to be ready for the new LCC by September, with a strict stipulation that the name of the airline contains “from seven to nine characters”. The LCC would fly domestic and international routes of up to four hours duration (though two hours is likely to be the average). Once the regulations change it's expected that an LCC will be launched within six to 12 months.

Other urgent items on Aeroflot's agenda include an ongoing enquiry into alleged corruption by Aeroflot deputy CEO Andrei Kalmykov, who was suspended in June after being accused of giving favours to companies linked to his relatives. Aeroflot also expects to recover more than \$200m that was allegedly “removed” from the airline by entities controlled by late and controversial tycoon Boris Berezovsky in the 1990s.

Earlier this year a state audit report said that Aeroflot had “misspent” more than \$440m in a period between 2010 and the first nine months of 2012 in areas such as the purchase of services, buying and selling costly trademarks, and in loans and investment in its subsidiary Aeroflot Finance. These are charges that Aeroflot has denied, though interestingly in its response the airline said that with regards to investing in loss-making regional airlines that it had “a major social responsibility” as a flag carrier and that “it could not simply make mass redundancies without considering the social consequences for the regions and the nation as a whole”.

Currently the Russian government owns 51.2% of Aeroflot, with entities controlled by Russian

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businessman Alexander Lebedev owning 4% and Rostekhnologii 3.6%. Over the summer reports surfaced that Lebedev was negotiating a sale of his stake in Aeroflot, worth approximately \$78m. The controversial entrepreneur once had a 25% stake in the airline but he is now getting rid of his last holding as a protest against being charged with assault when he threw a punch at another businessman on a Russian television talk show.

More importantly, there are signs that government dominance of Aeroflot may be coming to an end. Though privatisation of the state's share in Aeroflot has been on the agenda since the late 1990s, the Russian government now says Aeroflot is now "ready for privatisation", and it says that it wants to reduce its majority share in the airline down to 25% plus one share by 2016 at the latest.

Intriguingly, in June CEO Savelyev said Aeroflot would only be ready for privatisation in 2016 or 2017. He argues that "Aeroflot is about 40% underpriced, so what is the point in selling?", and that a foreign investor might not be beneficial to Aeroflot as its service quality "is Europe's best", a debatable point. Aeroflot's decision to pay dividends at the level of at least

25% of its net profit in 2012 will undoubtedly support its share price. Savelyev also warned that the government shouldn't pressurise Aeroflot to cut fares, which would be difficult to do as well as pay dividends.

Results for the first half of 2013 will be released in September, and one analyst – SKRIN Analytics – says that the airline "could surprise investors with higher than consensus profits" thanks to two factors, the first of which is strong growth in the Russian air passenger market, with yields growing faster than the level given by management guidance. This will be due primarily to the recent closure of two regional airlines – Kuban Airlines and Red Wings – which together accounted for approximately 2% of Russian capacity last year.

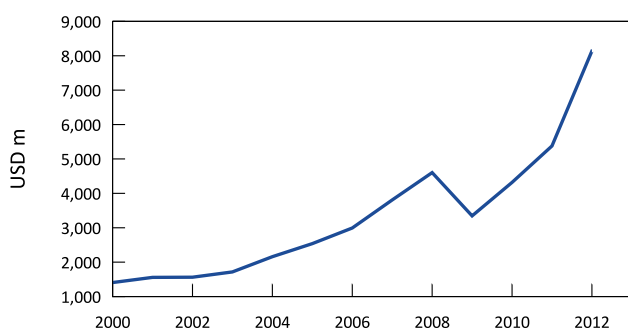
The second factor is a decrease in travel agent fees (in a country where travel agents account for approximately 70% of all air tickets sold). Earlier this year Aeroflot lowered agent commission from 7% for economy class tickets and 9% for business class to 4% for both, which will have a significant impact on revenue. Aeroflot wants to abolish agent fees completely by the end of the year.

Aeroflot is also focusing on

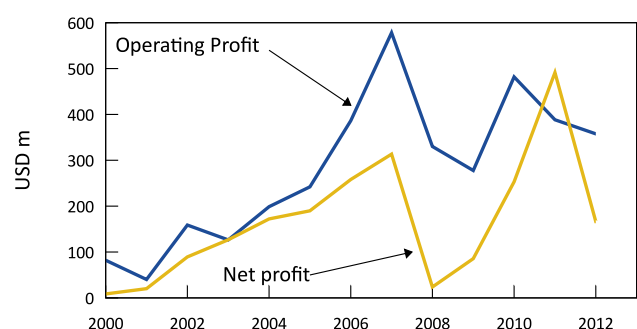
continued cost-cutting, and that includes staff (given that each government-driven deal brings an influx of poorly-motivated employees).

Improving profitability and share price may encourage the government to reduce its stake sooner rather than later, and a crucial first step regardless of Aeroflot's performance would be the sale of a relatively small stake in order to bring the government share to under 50%. Though largely symbolic (as no-one would doubt the ongoing controlling influence of the government), this would give real hope that the beginning of the end for state control had arrived. The key test for Aeroflot though will be when it is allowed to make commercial decisions (and not political ones) on purchasing Russian or foreign aircraft, or whether to keep operating loss-making regional routes or even subsidiaries. Even if the state's share went down to 25%, would Aeroflot's management really be free to make the decisions it wanted?

Aeroflot Revenues



Aeroflot Financial Results



Mexico's LCCs gear up for significant fundraising

Recent months have seen a spate of airline IPO filings around the world as, after years of global economic malaise and other challenges, LCCs in particular are spotting opportunities to tap the capital markets for growth funds and to provide exits for their initial backers. Although some of the planned IPOs (including Brazilian carrier Azul's) are currently on hold due to local economic or market volatility, or simply because it is August, come September-October-November time and it could get quite lively on the IPO front.

In Mexico, the country's third largest carrier Volaris registered for a global IPO of up to \$400m on June 6 – a long delayed move that will help the carrier fund the \$3.9bn A320/A320neo order it finalised in January 2012. That deal, too, was put on hold in late June because of a plunge in Mexican stocks, but it is expected to be revived in the autumn as soon as market conditions allow.

The owners of Mexico's second-largest carrier Interjet may also launch an IPO this autumn, having had to shelve earlier plans to go public in the spring of 2011. Interjet recently started taking deliveries of Sukhoi Superjet SSJ100s, continues to add A320s and has plans to triple its fleet to 111 aircraft by 2015.

VivaAerobus, the third sizable Mexican LCC, is reportedly nearing its long-awaited major fleet

	% of total domestic passengers			% of total international passengers		
	1H2013	2012	2009	1H2013	2012	2009
Aeromexico	35.3	37.7	32.3	63.9	67.0	31.1
Interjet	24.9	23.9	12.7	13.4	9.0	0.0
Volaris	22.6	20.5	12.8	21.5	21.9	2.9
VivaAerobus	12.8	12.5	5.8	1.1	2.2	0.4
Mexicana	0	0	27.2	0	0	65.4
Others	4.4	5.3	9.2	0.1	0	0.2
Total	100%	100%	100%	100%	100%	100%

Source: Volaris' preliminary IPO prospectus (DGAC data)

decision, which is likely to mean a large order for either Airbus or Boeing aircraft to replace 737-300s and provide for growth. Its owners will no doubt give an IPO serious consideration, even though they have spoken of adequate alternatives, such as debt or sale-leasebacks.

The timing could be right for multiple Mexican LCC IPOs. Airline industry conditions in Mexico have improved dramatically since Mexicana, formerly the country's second-largest carrier, filed for bankruptcy and ceased operations in August 2010. The shutdown of Mexicana and its low-cost and regional units Click and Link removed a large chunk of the overcapacity that had developed as a result of five years of intense start-up LCC activity. The seven other smaller-airline failures since 2007 (Azteca, Aladia, Aerocalifornia, Avolar, Alma, Aviacsa and Nova Air) have also helped create a more

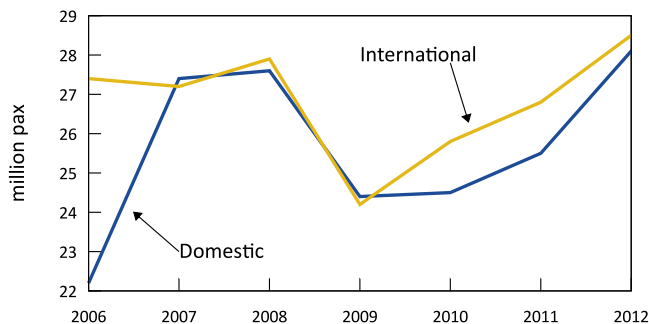
rational domestic pricing environment.

As a result, Aeromexico, the country's only surviving large airline, was able to stage a financial turnaround in 2010 and complete a \$330m IPO on the Mexican Stock Exchange in early 2011. The airline has continued to post strong financial results.

Mexicana's demise also gave the new-entrant LCCs unique growth opportunities, both domestically and internationally. Even though Interjet, Volaris and VivaAerobus only began operations in December 2005, March 2006 and November 2006, respectively, in first-half 2013 those three airlines already carried 60.3% of the country's domestic passengers and 36% of the Mexican carriers' total international passengers.

The domestic market has seen a healthy recovery in air travel demand since the 2009-2010 contraction, no doubt stimulated by

Mexico's Air Travel Market



the low fares. Domestic passenger numbers grew by 3.9% in 2011, 10.3% in 2012 and 6.8% in first-half 2013.

Air travel demand is also benefiting from the strength of the Mexican economy. After a 6% contraction in 2009, Mexico's GDP expanded by 5.3% in 2010 and by 3.9% in both 2011 and 2012. Although there was a marked slowdown in this year's second quarter and full-year growth is now expected to be a modest 2-3%, the Bank of Mexico expects GDP growth in 2014 to return to the 3-5% range projected for the next ten years.

Mexico is the second largest economy in Latin America (after Brazil). The expectation that it will outperform Brazil in the next couple of years should help boost global investor interest in Mexican equity offerings.

The country's population (around 112m) is estimated to grow by 1.4% annually. Like Brazil, Mexico is seeing a steady increase in the number of middle income households, which have already grown from 5.1m in 1992 to 15.8m in 2008.

There is also potential to attract traffic from long-distance buses (Mexico has limited passenger rail services). According to Volaris' IPO

filings, Mexico had 2.8bn bus passengers in 2012, of which 74.4m were "executive or luxury" passenger segments (long or short haul). As Volaris noted, only a small shift is needed

to dramatically increase the number of airline passengers.

Socio-economic trends all point to significant long-term growth in air travel. The Mexican aviation market remains underdeveloped. In 2011 total (domestic and international) trips per capita, adjusted for income, were only 0.46, compared to 1.71 in the US, 1.78 in Panama and 0.58 in Colombia.

Volaris said that it believed the substantial investments made in airport infrastructure in Mexico in the last decade will help sustain the growth in air travel. Mexico privatised most of its key airports years ago. Mexico City, though, has serious airport congestion and capacity issues that the government is trying to tackle in the near-term.

The one dark cloud on the horizon is Mexicana's potential comeback. Unbelievably, efforts to reorganise and revive the carrier and its units are still ongoing. As one government official aptly wondered recently: "Why was this not resolved three years ago?"

The answer is unusually determined labour groups (which have vowed to keep the 92-year-old company alive) and a continuing crop-up of potential investors (none of which pan out in the end).

Mexicana's fate is in the hands of the bankruptcy court, which is clearly struggling with the decision.

Volaris operates 15 ex-Mexicana routes, while Interjet holds temporary rights to some nine ex-Mexicana routes. The airlines seem resigned to the fact that they will lose those routes and the associated slots if Mexicana returns. But the broader industry implications could be even more serious: disruption of the capacity equilibrium, end of healthy industry conditions, emergence of a lower-cost competitor, etc.

If Mexicana's fate is not resolved by the time the IPOs are launched, the issues and the uncertainty are something that could give pause to some potential IPO investors.

Volaris: Ambitious growth plans

Volaris is planning a global IPO, consisting of Mexican and international offerings, and is looking to list its shares on the Mexican Stock Exchange and on the NYSE. According to the preliminary filings, the plan is to sell up to \$100m in ADRs and up to \$400m in total. The IPO would make Volaris the sixth Latin American publicly traded airline (after COPA, Gol, Latam, AviancaTaca and Aeromexico).

The proceeds will be used for debt repayment and general corporate purposes, including aircraft pre-delivery payments. Of course, the major benefit will be the ability to tap the large US capital markets (equity or debt) for aircraft funding needs in the future. The IPO will give a potential exit strategy for initial backers, which include

William Franke, founding partner of Indigo Partners and Tiger Airways.

Volaris calls itself a ULCC (ultra-low cost carrier) and claims to have the lowest CASM among Latin America's publicly traded airlines. It has high efficiency levels, achieving an 83% load factor, 12.4-hour average daily aircraft utilisation and 35-minute standard turnarounds in 2012. The A320s are operated in a single-class, high-density configuration (174 seats, compared to Interjet's 150).

The airline has been unbundling its fares since May 2012, offering low base fares and selling optional products and services for additional fees. The base fares are priced to stimulate the market and compete with long-distance bus fares. But Volaris also believes that it has developed a strong brand recognition, a loyal customer base and a strong company culture.

Volaris targets VFR, leisure and cost-conscious business travellers in Mexico and selected US-Mexico markets. After the addition of a batch of new services through November, the network will cover 31 cities in Mexico and 11 in the US.

Volaris mainly goes for markets that are large and either underserved or overpriced. It has a substantial market presence in the top five airports in Mexico (Cancun, Guadalajara, Mexico City, Monterrey and Tijuana). As of June 30, it had leading 50%-plus passenger shares on 46 of its 73 routes.

The US cities served are home to some of the largest Mexican communities in the country. The network focuses heavily on the US West Coast, though Chicago and Orlando are also served. Having only entered the US market in 2009,

in 2012 Volaris earned 24% of its passenger revenues from the US routes.

Key US routes such as Los Angeles, Las Vegas and Chicago are operated under temporary licences, which Volaris would have to cede back to Mexicana. But the overall growth potential seems promising. Volaris has identified around 180 potential routes within Mexico and 150 internationally that meet its basic criteria.

But Volaris' financial results have fluctuated. After a promising 7.5% operating margin in 2010, the airline plunged back to losses in 2011. Since then it has returned to modest profitability, achieving 3.2% and 2.3% operating margins in 2012 and first-half 2013, respectively. Last year Volaris had a \$29m operating profit and \$16m net profit on revenues of \$897m. Its ASMs grew by 16% and revenues by 32%. It has minimal debt because the current fleet is on operating leases.

Volaris operates a mix of A319s and A320s and projects its year-end fleet to be 44. The airline is receiving A320s from both Airbus and lessors while gradually returning A319s, with the aim of achieving an all-A320 fleet by 2020. Volaris is committed to a single fleet type and a "disciplined ramp-up" in young and efficient aircraft. It has firm orders for 49 A320s, including 30 A320neos, for delivery over the next eight years.

Interjet: Next on the IPO block?

Interjet's chairman Miguel Aleman stated in January that the company planned to raise as much as \$1bn in an IPO, realistically after September 2013, after backing

away from selling shares in 2011 when market conditions and investor demand deteriorated. But in June Aleman played down the need to issue equity this year or even in early 2014, indicating that Interjet would rather wait for truly robust market conditions in order to get a good price.

Such conditions may or may not materialise this autumn, but because of Interjet's aggressive growth plans, an IPO at some point in the short-to-medium term is likely.

In the meantime, Interjet has been taking on debt to fund aircraft. Most recently, in early August, the carrier issued 1bn Pesos (\$77m) of senior notes due in 2021 (at 6.97% interest rate), as the second issue in a \$387m-programme over five years. The first SSJ100 delivered this summer secured ECA financing.

Interjet has been the largest beneficiary of Mexicana's shutdown domestically and now serves about 25 cities in Mexico. But it only went international in July 2011 and currently serves only five US cities, though it also operates to Guatemala, Havana, Costa Rica and Bogotá and is now growing at a heady rate. The Toluca-based carrier expects to almost double in size in the next 18-20 months and to operate a 61-strong fleet by the end of 2014.

Interjet is more upmarket than Volaris. It currently operates 37 A320s and has 40 A320neos on order. This summer it received the first of 20 SSJ100s on firm order, becoming the first airline in the Americas to operate the type. It will deploy the 93-seat aircraft on medium-density domestic routes, while using A320s for international

destinations.

As a privately held airline, Interjet does not report its financial results, but the management has claimed that it achieves better results than Volaris. It also has aircraft on its balance sheet.

VivaAerobus: Major fleet decisions

VivaAerobus' top executives have indicated in recent months that they are close to a decision on the carrier's next aircraft type, which will also replace the 21-strong existing 737-300 fleet that has an average age of over 22 years. The management has talked of a potential multi-billion dollar aircraft

order before year-end.

There has also been some IPO talk. In late June Irish papers reported that the Ryan family, which owns VivaAerobus (via their Irelandia investment vehicle) as a joint venture with Mexican bus operator IAMSAs, had hired an investment bank to arrange a \$100m-plus IPO in Mexico. However, as yet no filings have been made and the management has continued to stress that adequate alternatives exist to an IPO.

The Monterrey-based carrier currently operates a network covering around 25 domestic and two US cities (Las Vegas and San Antonio). It earlier pulled out of

several US markets introduced in late 2011 and is focusing exclusively on the domestic market this year. However, VivaAerobus is looking at Central and South American markets from 2014 and is planning to expand rapidly in the next two years.

VivaAerobus has a Ryanair-style no-frills business model, is debt-free and has claimed four consecutive years of profits (2009-2012). It may not need to raise equity in the near term, but an IPO is certainly on the cards at some point.

By Heini Nuutinen
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AirAsia: the X factor

In July, after over a year of delay, AirAsia X completed a successful IPO, listed on the Bursa Malaysia, raising about RM988m (\$315m); roughly one-third each for capex, for repayment of bank borrowings and for general working capital.

Investors were persuaded that an airline with no record of real profitability, which had just effected a major change in route structure and with a not fully proven business model had genuine potential. AirAsia X's stated strategy is: to be the leading low-cost, long-haul airline, operating primarily in the Asia Pacific Region, with the lowest unit cost of any airline in the world (CASK of US\$3.74 and CASK ex-fuel

fuel of US\$1.90 for 2012), about 70% lower than full service airlines in the region, offering fares 30%-50% lower than full service carriers, in order to stimulate new market demand.

Of course, AirAsia is a very well-established brand and the leading LCC group in the Asia Pacific region, which made founder Tony Fernandes's and AirAsia X's CEO Azran Osman-Rani's task in promoting the long-haul carrier somewhat easier. Also about one third of the shares were sold as retail, rather than to institutions, and individual shareholders, if they hold on to the shares for specified periods, stand to benefit from free flights.

As the table overleaf shows, AirAsia X has struggled to break even at the operating level over the past three years. And without the benefit of exchange rate gains on borrowing and tax credits, the airline would have reported net losses in every year (the actual profit shown for 2012 was the equivalent of \$11m, 1.7% of revenues). The company had been adequately capitalised and as at the end of last year its net asset value was RM580m (\$186m)

Retrenchment

Over the past 18 months AirAsia X has withdrawn from high-profile routes to Europe (London

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and Paris), India (Mumbai and Delhi) and New Zealand (Christchurch), those regions with negative results showing clearly in the table below. The airline's rationale for closing these routes was as follows.

A340-300s were used on the London and Paris routes due to the extended range which could not be met by A330-300s. However, the 10-year old A340-300s were much less fuel efficient, and their economics were undermined by sharp increases in fuel prices at a time when the European market for leisure was depressed. Attempts to increase fares to reflect the higher operating cost demonstrated the high price elasticity of travel, with demand falling. London and Paris

were no longer viable, and the two A340s were leased out.

The Mumbai and Delhi routes, which had relatively low load factors, around 72%, came under additional pressure when the Malaysian government removed visa-on-arrival facilities in summer 2010. Then there were massive increases in airport taxes, fees and handling charges; for example, in May 2012, Delhi increased airport fees by 346%. The Indian routes were therefore terminated.

AirAsia India is in the tortuous process of setting up as a joint venture in the sub-continent, the latest start date being December 2013. AirAsia X states that it does not have immediate plans to re-

commence flights to India, but does foresee the potential of AirAsia India's feeder network, especially as under Indian regulations AirAsia India will have to operate for a minimum of five years domestically before being allowed to launch its own international services.

Christchurch in New Zealand was mainly a leisure destination for Malaysians, but traffic was badly impacted by the 2011 earthquake there.

Expansion

AirAsia X's route expansion strategy from Kuala Lumpur is now focused almost exclusively on the Asia/Pacific region (routes with a flying time of at minimum four hours). The airline states that it has secured the relevant traffic rights (currently unutilised) for new routes, in addition to the unlimited traffic rights under the open skies agreements between Malaysia and South Korea, China and Australia (Melbourne, Sydney, Perth and Brisbane have capacity restrictions but these have been substantially lifted following the revision of the ASA). A key development will be ASEAN Open Skies multilateral, expected in 2015, which should provide long-haul opportunities to and from Southeast Asia, as well as providing opportunities for additional feed. AirAsia X's principles for growth are as follows.

→ **Increase Frequencies on existing core routes.** Twelve of their current 14 routes are to major metropolitan cities, such as Sydney, Perth, Melbourne, Tokyo, Seoul, Beijing, Shanghai and Taipei. Each route, which currently has 80%-plus load factors, should support a double-daily service.

Air Axia X: Financial Results

	RM millions		
	2010	2011	2012
Passenger Revenues	994	1410	1283
Charter	9	4	69
Fuel surcharge	2	44	148
Cargo	55	96	79
Ancillaries	238	307	363
Others	-9	1	25
Total revenues	1,289	1,862	1,967
Employee Costs	125	158	180
Fuel	598	1018	925
Maintenace and User charges	229	306	381
Depreciation	101	104	107
Leases	74	146	152
Other	194	204	180
Total Op. costs	1,321	1,936	1,925
Operating profit (loss)	-32	-74	42
Other income	39	14	7
Net operating result	7	-60	49
Finance costs	53	46	55
Exchange rate loss (gain)	-144	25	-44
Pre-tax profit	98	-131	38
Taxes (deferred taxes)	-49	-35	4
Reported net result	147	-96	34

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AirAsia X Results by region

	RM millions			Margins	
	Revenues	EBITDAR	Pre-tax result	EBITDAR	Pre-tax result
North Asia	878	145	33	16.5%	3.8%
Australia	758	137	46	18.1%	6.1%
Middle East	127	56	36	44.1%	28.3%
West Asia	25	8	5	32.0%	20.0%
Europe	103	-35	-66	-34.0%	-64.1%
India	28	0	-4	0.0%	-14.3%
New Zealand	48	-4	-12	-8.3%	-25.0%
Total	1,967	307	38	15.6%	1.9%

→ **New routes in existing core markets.** In 2013 Australia is the focus, following the recent further liberalisation of the bilateral, with almost all of the carrier's additional capacity being allocated to this market. Adelaide, a new destination, was announced in late July. Other major cities to be targeted include Nagoya and Fukuoka in Japan, and Chongqing and Xian. The AirAsia brand is known in these cities: AirAsia Japan, the joint venture with ANA, served the Japanese cities, but this operation

has now shut down after recording substantial start-up losses; the Chinese cities are served by Thai AirAsia.

→ **Establish routes in new markets in the medium term.** AirAsia X's criteria are: market size (catchment and propensity to travel), strength and growth of traffic, diversity of market demand (for example, two-way travel and multiple travel segments) and the competitive environment.

→ **Build new hubs.** The idea is to take advantage of the various short-haul hubs and the network connectivity established by the AirAsia Group. Bangkok will be the first new long-haul hub, probably starting in 2014. Indonesia and the Philippines will likely follow. The criteria for establishing new hubs include the hub being located in a marketable destination, a strong catchment, an established short-haul operation and low start-up costs.

The X model

AirAsia X's model is simply to be the lowest cost operator in the long-haul market.

AirAsia X currently operates 13 A330-300s, with an average age of 3.5 years and a maximum capacity of 377 passengers (almost 30% above the average seat capacity for Asia full service A330 operators). On the new aircraft there is a 31 inch seat pitch, plus six premium Flatbed seats. Rapid fleet expansion is planned: 20 new A330-300s are scheduled for delivery during 2013-17 and 10 A350-900, with 425 seats, from 2018 onwards. Actual prices paid have, as normal, not been revealed but it is likely that AirAsia X, as part of the AirAsia Group which is one of Airbus' main clients, will have achieved serious discounts.

Aircraft utilisation is the highest among the top 10 Asia Pacific carriers – 16.2 hours per day in 2012, almost 50% higher than the average. This, however, is below AirAsia X's target of 17.0 hours per day because, as the airline states, it is not always able to secure slots suited to optimal aircraft planning. AirAsia X operates to congested airports such as Beijing, Shanghai and Haneda, while others such as Sydney and Gold Coast have curfew constraints. The strategy is to achieve a build a balanced portfolio of airports without slot constraints to offset congested airports and so achieve the target aircraft utilisation rate.

The full service model relies heavily on business travellers who are sensitive to convenient departure, arrival and connecting times, and so full-service airlines have to design their flying schedules to suit these requirements leading to significant aircraft idle time. AirAsia's X's priority, like that of short-haul LCCs, is fast turn-around

AsiaAsia X: Schedule from Kuala Lumpur (Summer 2013)

Destination	Start date	Weekly frequencies
Gold Coast	Nov 2007	5
Perth	Nov 2008	9
Melbourne	Nov 2008	7
Sydney	April 2012	7
Hangzhou	Feb 2008	7
Chengdu	Oct 2009	4
Beijing	June 2012	7
Shanghai	Feb 2013	6
Taipei	July 2009	11
Tokyo	Dec 2010	7
Osaka	Nov 2011	4
Seoul	Nov 2010	7
Kathmandu	July 2012	3
Jeddah	Feb 2013	3
Busan	July 2013	4

– 60 to 75 minutes. During the turnaround time, up to 750 passengers are disembarked and embarked, as well as cargo, compared to say 300 passengers and no cargo in 25-30 minutes for a European LCC. In 2012, the airline achieved an on-time departure rate of 85%, with weather and air traffic control congestion being the two main factors causing delays.

AirAsia X operates from its hub at the LCCT in Kuala Lumpur, about 70 kilometres from the city centre, where the long-haul network connects with an extensive LCC feeder market, with up to 1,400 weekly flights and 73 destinations. The airline was supposed to move to KLIA 2, a brand new terminal, with capacity for 45m passengers a year (against 15m at LCCT) in June 2013, but delays in finishing the construction work mean that the change-over date is now probably May 2014. Passenger charges at the LCCT are about 50% of those at the main KL terminal, but KLIA2, officially a “hybrid” rather than an LCC facility, will have higher charges, though probably still 25% below that of the main terminal.

Other elements of the AirAsia business model follow that of the short haul LCC AirAsia, which in turn was originally based on Ryanair.

AirAsia X’s most important innovation is the offer of low-cost connecting services: passengers can buy “Fly-thru” allowing them to avoid immigration at Kuala Lumpur and for their baggage to be delivered directly to the final connection. Connection times are a

minimum of 90 minutes up to six hours (aircraft scheduling for AirAsia X is still designed for high utilisation not connectivity).

Yield management is based on the same underlying principle as most short haul-haul LCCs: fares, usually 40%-plus below full service carriers’, increase as departure time approaches, with the aim being to maximise load factors. When the route matures then yields can be pushed up.

Fares are unbundled, with the result that ancillary revenue is very high – \$46 per passenger in 2012. Passengers can for example buy Hot Seats (seats with extra legroom), bid for an upgrade to a Premium FlatBed seat (if they remain empty four hours before departure) or pay to be in the “Quiet Zone” (no children). There are, of course, change fees, credit card charges, baggage fees (in blocks of 5kg), Food is also chargeable and is normally booked in advance (which minimises wastage and catering costs).

The marketing slogan, “Now Everyone Can Fly Xtra Long!” catchily summarises the AirAsia X product. Overall the AirAsia Group is very e-media savvy. The airasia.com website is a top travel-related website in Asia and one of the most active e-commerce platforms in Asia, with over 9 million unique visitors per month. It is also the airline leader in social media promotion, actively using Facebook, Twitter and Weibo.

Long-haul carriers are even more exposed to fuel price

escalation than short-haul LCC – fuel accounts for about 50% of AirAsia X’s total operating expenses. The size of the air Asia Group gives it a certain competitive edge in negotiating contracts, and 30-50% of requirements are hedged six months forward. In 2012 fuel surcharges, equivalent to 11% of base fares, were applied.

AirAsia X currently has about 1,400 employees (115 per aircraft compared to around 50 for a leading short-haul LCC), but employee costs are just 9% of the total. Malaysian cost of living is lower relative to other major cities in the Asia Pacific Region, and the workforce is nonunionised. Productivity is high; 12.5m ASKs per employee 2012, three times the average of Asian full service airlines.

Success characteristics

It is interesting that the Asian long-haul model has developed fairly rapidly whereas no European equivalent has got close to start-up. But AirAsia X has a number of characteristics that probably could not be replicated across the Atlantic. These include: the seating density, a varied route structure with multiple strong O&D markets, affording more opportunities to maximise aircraft utilisation, a large scale dedicated connecting base and access to low-cost labour. It’s a model which has also attracted the attention of the Asian full service carriers with SIA establishing its Scoot subsidiary and others such as Cathay Pacific and PAL developing similar plans.

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