

Pegasus: A Winged Wonder

PEGASUS claims to have transformed Turkish aviation. In the process it has established itself as Europe's third ULCC and reported the highest level of profitability in Europe.

The specific elements of Pegasus's low-cost model are:

- A fleet of mostly A320-family aircraft, with growth plans of totally focused on the A321neo.

- CASK was €€3.36 (€€2.13 ex-fuel) this year on an average stage length of 1,574km, compatible with Wizz.

- Total traffic is expected to be around 33m passengers this year, about half of Wizz's total and just 18% of Ryanair's.

- Its main hub is at Istanbul Sabiha Gökçen, and it is a genuine hub airport: unusually for a LCC, 25% of its traffic is connecting, half of this international-domestic and half international-international.

- Other bases are at Adana, Ankara, Antalya and Izmir in Turkey, plus Ercan in Northern Cyprus.

- The network consists of 95 international destinations and 36 domestic.

- The sales message concentrates on low fares, in much the same way as Ryanair. There are no frills apart from a FFP ("BolBol" — abundantly, in English). All of Pegasus's aircraft have a one-class configuration.

- The airline is 57% owned by ESAS, a private Turkish investment conglomerate, which is believed to have assets of at least €30bn; in this respect it is similar to IndiGo and its Interglobe parent.

Pegasus's CEO is Güliz Öztürk, one of the few female chief executives in the airline business (seven of the top

100 according to FlightGlobal) but currently one of the most high profile, a regular speaker at conferences and recipient of industry awards. She has been in aviation since 1999, firstly at THY, then joining Pegasus in 2005 when Aer Lingus sold its 49% stake to ESAS Holding, the private conglomerate owned by the (late) entrepreneur Şevket Sabancı and his family. In 2022 she replaced Mehmet Nane who moved to vice-chairmanship of the carrier.

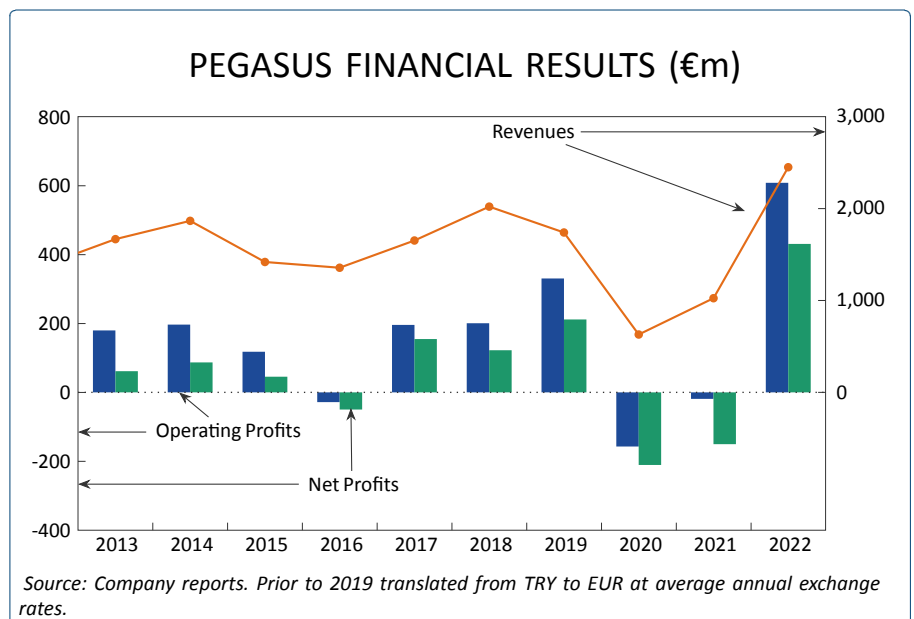
Under Öztürk's leadership the airline has emphasised its diversity and sustainability credentials. It has met its initial target for 25% female board membership and is working to improve its current 30% female participation in its workforce — the "Harmony" project. It has committed to

This issue includes	
	Page
Pegasus: A Winged Wonder	1
United Rejects Commoditisation and Embraces Differentiation	7
Norwegian Reborn: Another Chance	12

Net Zero and has received accolades for sustainability financing initiatives and carbon emission disclosure. And all this on top of a globally leading financial performance.

Finances, inflation and depreciation

Pegasus's 2022 results were truly remarkable. It reported a net profit of €430.8m on revenues of €2.44bn, a margin of 17.8%; for comparison Ryanair's net margin was 12.0%. This



Aviation Strategy

Aviation Strategy

ISSN 2041-4021 (Online)

This newsletter is published up to ten times a year by Aviation Strategy Limited. Jan/Feb and Jul/Aug usually appear as combined issues, some others may also. 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.

Publisher:

Keith McMullan
James Halstead

Editorial Team

Keith McMullan
kgm@aviationstrategy.aero

James Halstead
jch@aviationstrategy.aero

Subscriptions:

info@aviationstrategy.aero

Copyright:

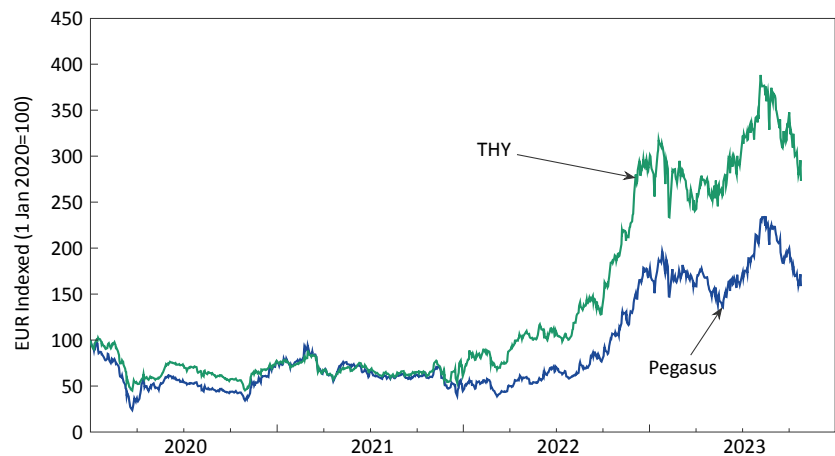
©2023. All rights reserved

Aviation Strategy Ltd
Registered No: 8511732 (England)
Registered Office:
6 Langside Avenue
London SW15 5QT
VAT No: GB 162 7100 38
ISSN 2041-4021 (Online)

The opinions expressed in this publication do not necessarily reflect the opinions of the editors, publisher or contributors. Every effort is made to ensure that the information contained in this publication is accurate, but no legal responsibility is accepted for any errors or omissions. The contents of this publication, either in whole or in part, may not be copied, stored or reproduced in any format, printed or electronic form, without the written consent of the publisher.

Typeset in Calibri and Rockwell using X_{La}T_EX

SHARE PRICE PERFORMANCE (EUR)



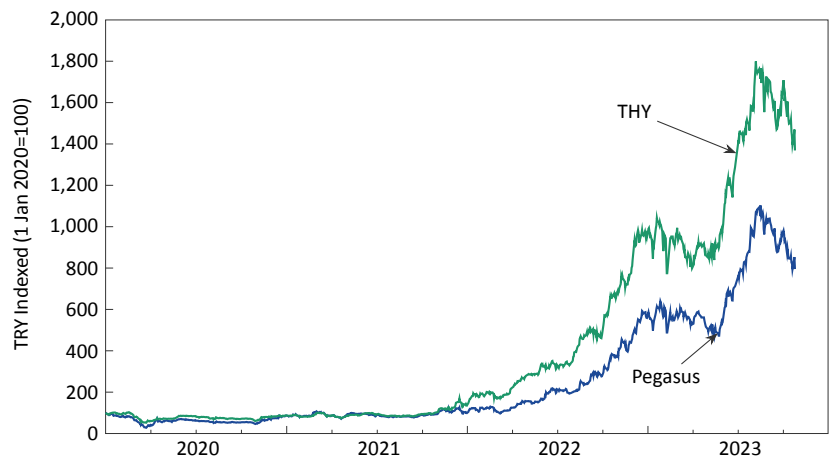
was twice the profit level of pre-pandemic 2019, and at the EBITDA level it achieved a 34% margin, which Pegasus claimed to be the best globally.

Pegasus attributed its success to the rapid recovery in traffic to Turkey (inbound tourism doubled in 2022 from 2021 to 45m visitors, back to the same level as in 2019), a very strong revenue environment and capacity shortages. In fact, unit revenue, measured in terms of total revenue per passenger averaged €90.90 in 2022, 61% up on 2019's

€56.60. Other European LCCs also experienced a post-pandemic surge in yields but not on anything like the same scale — Ryanair, for instance, saw a 14% increase in unit revenue.

Expressed in Lira per passenger, Pegasus's unit revenue increase was even more more spectacular — 342% between 2019 and 2022. This hints at a problem for all companies that operate in Turkey's extremely high inflation (over 80% in 2022) and rapid currency depreciation environment: distortion of accounts. Pegasus explains that its "functional"

SHARE PRICE PERFORMANCE (TRY)



Aviation Strategy

PEGASUS FINANCIALS (€ Millions)

FY (Jan-Dec)	2019	2020	2021	2022	Jan-Jun		@end June	2023
					2022	2023		
Revenues	1,739.5	629.9	1,024.6	2,449.4	774.1	1,099.7	Fleet/other fixed assets	3,819.6
Net result	211.6	(753.2)	(150.2)	430.8	(100.8)	68.5	Current Assets	470.1
							Cash and equivalents	907.7
Operating Cashflow	552.8	49.4	392.1	906.2	385.3	338.2	Total Assets	5,197.4
Capex and Investments	(88.4)	(42.8)	(291.7)	(332.3)	(83.7)	(84.6)		
Free Cashflow	464.4	6.6	100.4	573.9	301.6	253.6	LT debt/lease liabilities	(2,946.0)
Increase/(Decrease) in Debt	(291.5)	(170.0)	83.2	(523.5)	(245.7)	(216.7)	Current liabilities	(1,298.7)
Currency Translation Effect	2.0	(65.9)	(108.7)	3.9	23.8	(1.3)	Total Liabilities	4,244.7
Total Change in Cash	174.9	(229.3)	74.9	54.3	79.7	35.6	Shareholders' Equity	952.7

currency is the Euro because the Euro represents a significant proportion of its revenues and costs, and budgeting is carried out in Euros. However, the Lira is the “representational” currency under the legal framework. Translation between the Lira and the Euro and to/from the US Dollar and other currencies is made under various rules determined by the Central Bank, which we do not have the space to cover in this article (and even if we did have the space it’s very doubtful that we could explain them adequately).

Overall though, Pegasus emphasises the fact that the Lira has become less important in its operating cost structure. This change reflects Pegasus’s focus on growing its international services while allowing its domestic market share to slip.

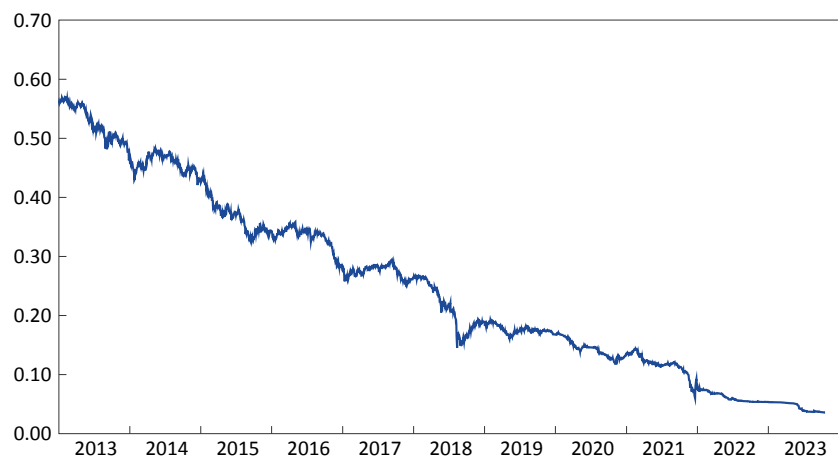
In 2019, 71% of its revenues were in Euros or US Dollars (Pegasus attempts to peg its fares to the Dollar) and 26% in Lira; by 2023 the proportion had changed to 80% and 17% (3% others). Similarly, cash operating costs were 70% Dollar or Euro and 27% Lira in 2019; this year the split is 78% and 25%.

Turkey in recent years has been

afflicted by a monetary crisis that threatened to derail the entire economy, undermining the progress made over the past 20 years. Under President Erdoğan real GDP growth had been strong, averaging about 5.5% pa, with the growth largely built on an infrastructure building boom fuelled by massive credit expansion. The most prominent project is the new Istanbul airport, İGA, which, with planned capacity for 150m passengers by 2027 and with eight runways, will be Europe’s, and maybe the world’s, biggest airport.

But when that economic expansion started to produce excessive price inflation Erdoğan overruled his central bankers, insisting on a policy of low interest rates plus various populist measures like boosting public sector salaries. The result was consumer price inflation almost becoming hyper, hitting annual rates of 80%-plus. Consequently, the Lira depreciated by 70% against the Dollar over the past three years while foreign capital fled the country. The depreciation might have been steeper had Erdoğan not im-

USD / TRY



plemented major, and sometimes covert, support for the Lira, as well as relying on new regulations designed to penalise companies for holding foreign currencies.

However, faced with a very serious balance of payments crisis, it appears that in September Erdoğan signalled a change in policy. Under a new head of the central bank, Hafize Erkan, incidentally also female, has started the process of rationalising Turkey's monetary policy, implementing an increase in base interest rates from 8.5% to 30%. Whether she can maintain the new programme, which aims to reduce inflation to 8.5% by 2026, is of course uncertain.

This was the difficult politico-economic background for Pegasus as it managed to report record profitability and maximise its foreign currency holdings. The Borsa İstanbul appears to have appreciated Pegasus's recent financial performance, though not quite as much as that of THY, which itself reported record net profits of US\$2.7bn, a 14.7% margin, in 2022. At the end of October, the stock exchange was valuing Pegasus at the equivalent of €2.4bn, which compares to Wizz's €2.1bn market cap on the UK stockmarket.

Meanwhile, the depreciation of the Lira continues to benefit the tourism sector by reducing the cost of Turkish holidays relative to the rest of the Mediterranean, resulting in a 20% rise in foreign visitors in the first half of 2023. Pegasus recorded a similar, 21%, increase in passengers while unit revenue slipped back to €77 per passenger. The airline describes the market as "normalizing" after the 2022 surge, allowing it to reinstall its "habitual strategic focus", which means concentrating on international rather than domestic growth; pushing up the load factor,

which increased from 79.6% in the first half of 2022 to 82.7% this year, still low by European LCC standards; and driving ancillary revenues, up by 34% to €26.2 per passenger this year.

The balance sheet as at mid-year looks fairly solid, with shareholders' equity of €953m against long-term debt of €2.95bn, almost all of which is in Euros or Dollars. Cash and equivalents stood at €908m, of which only 12% was in Lira.

Fleet planning and projected growth

Pegasus's fleet planning is based on a long-term commitment to the A320 family. The original order was placed in 2012 and amended on several occasions, the last time in August this year when 36 A321 NEOs were added. Pegasus is the launch customer for the CFM-Leap engine, so it has avoided the problems associated with P&W's GTF engines.

The fleet currently comprises 101 aircraft with 239-seat 78 A321neos on firm order. The schedule is for 16 neos to be delivered on average each year up to 2029, with the 737-800s and early A320 eos exiting. The

PEGASUS FLEET

	In Service	On Order
737-800	16	
A320ceo	8	
A320neo	46	
A321neo	31	78
Total	101	78

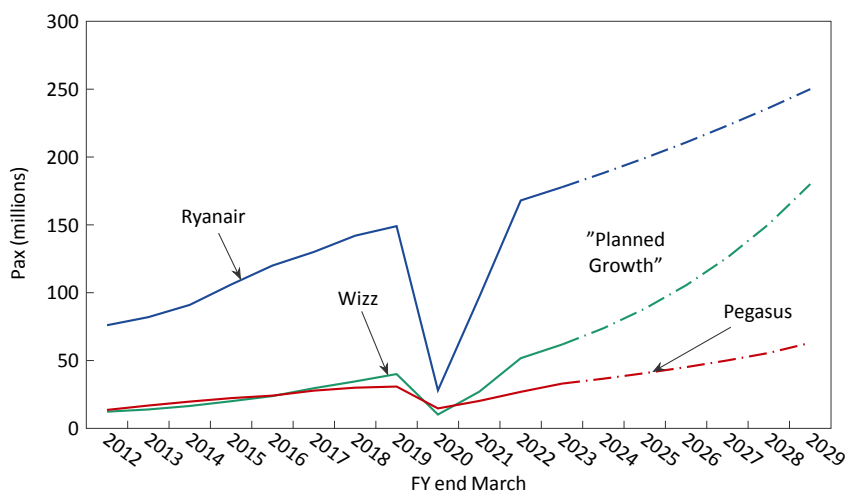
official target is for a fleet of 151 A320/21neos by 2029, with an average seat capacity for the whole fleet of 223 against 191 in 2021.

Although this equates to a seat capacity CAGR of about 11.5%, it is a relatively modest plan given the relatively low traffic base, and will probably be upsized. Öztürk has referred to 170 units by the end of the decade which would imply a 2029 traffic volume of around 65m passengers.

Still, a comparison (see chart below) with Ryanair and, in particular, Wizz, shows Pegasus lagging well behind in terms of projected traffic volume.

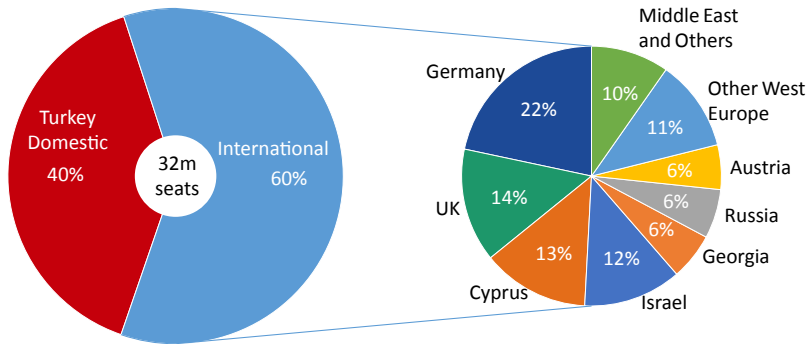
Moreover, THY is expected to announce a mega-order, apparently delayed because of the various issues

ULCC GROWTH PLANS



Aviation Strategy

PEGASUS CAPACITY DEPLOYMENT
(32m Seats, 2022)



to 88 from 70 currently.

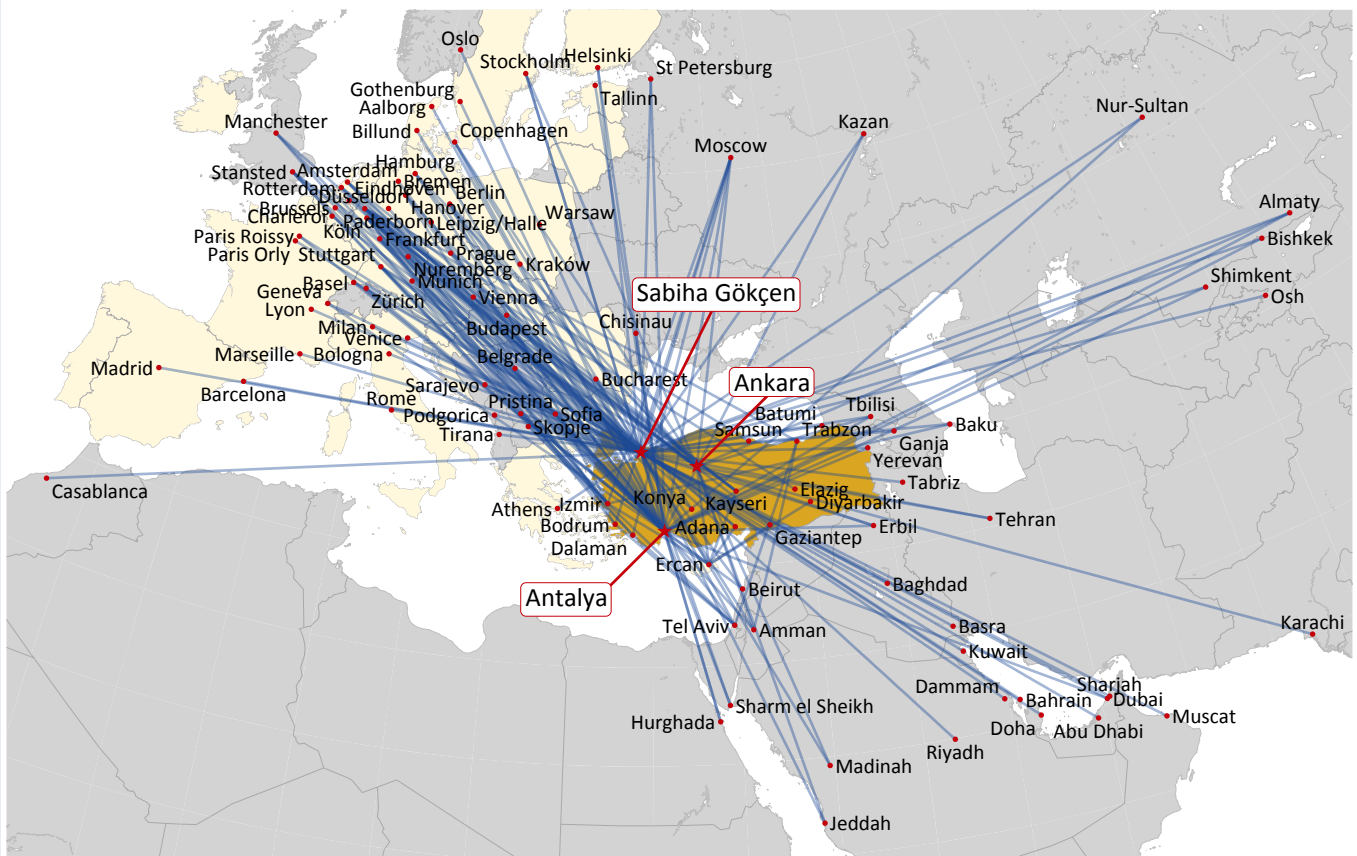
Pegasus has almost no direct competition with the European ULCCs — Ryanair and Wizz — though it does to a limited extent with easyJet. Its main international competitors are the charter carriers, notably Sun Express, based at Antalya, Sabiha Gökçen and Adana, which is jointly owned by THY and Lufthansa, operating a fleet of 66 aircraft, mostly 737-800s and MAXs. The other important charter competitor is Corendon, also based at Antalya, operating a fleet of 737-800s and MAXs mostly to/from Germany.

with new engines, for up to 600 aircraft — 400 narrowbodies and 200 widebodies. THY, through its lower cost unit, Anadolujet, is Pegasus's single biggest competitor directly at

Sabiha Gökçen, and indirectly at IGA, its global hub. THY plans to spin off Anadolujet as an independent LCC in 2024, having boosted its fleet of A320 family and 737-800s and MAXs

The chart left is a snapshot of estimated seat deployment in 2022 — roughly two-thirds international, one-third domestic. The largest single international market is Germany,

PEGASUS INTERNATIONAL ROUTE MAP



Aviation Strategy

22%, unsurprising considering the huge Turkish diaspora in that country plus the predilection of Germans for vacationing on the Turkish Riviera or in the TurkAegean, as these resorts are now marketed, while Turkey itself is being progressively renamed Türkiye. Other Western European tourist-generating countries, the UK and Austria in particular, accounted for another 31% of Pegasus's capacity. These traffic flows have proved to be very resilient but they have been affected by, for example, the attempted coup in Turkey in 2016 and the earthquake that hit Turkey and Syria this year.

Other significant markets include Israel, both for tourist flows and connecting traffic to Western Europe, but air connections between the two countries have been suspended following the Hamas massacre and Israel's military response in Gaza. Turkey offers a transit possibility for Russians, and this has been a significant source of business for Pegasus.

Some 10% of Pegasus' capacity is allocated to the Middle East and Central Asia, the most important markets

being Egypt, the UAE, Iran, Azerbaijan and Kyrgyzstan. According to recent interviews with Öztürk, Pegasus plans to build up markets to the east of Turkey, partly to develop connecting flows from Europe, partly to exploit cultural and economic links in Central Asia, but in this the airline is restricted by traditional Air Service Agreements.

A solution might lie in establishing subsidiary or associate companies with separate AOCs in the Asian countries and in Eastern Europe. Poland, the Czech Republic and Romania have been suggested, which could provide Pegasus with the opportunity of operating intra-Europe (and competing directly against Ryanair and Wizz).

Pegasus has some experience in this field. In 2012 Pegasus bought 49% of Air Manas, an airline based in Bishkek, Kyrgyzstan, that operated 737-800s on a network between two domestic Kyrgyzstan cities and nine international destinations in India, Russia, Turkey and China. Unfortunately, Air Manas did not survive the pandemic and ceased operations in May 2022.

Much of the strength of Pegasus'

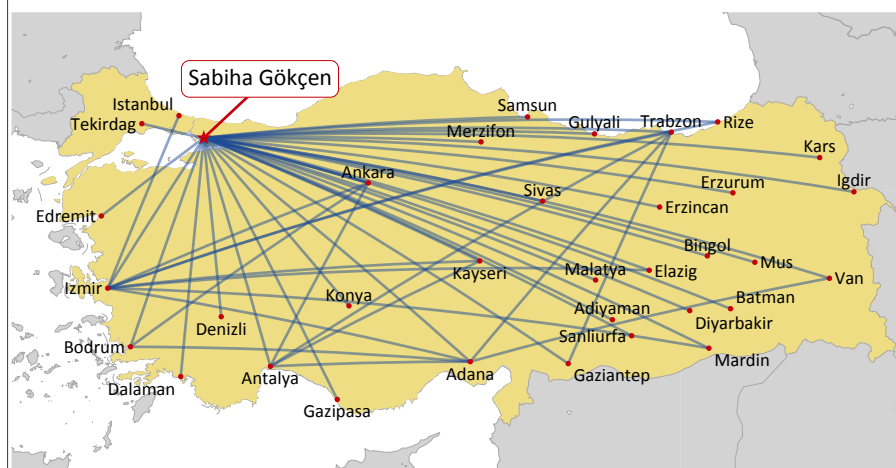
network derives from its hub at Sabiha Gökçen (named after Turkey's first female fighter pilot — there is a theme here.) It is located 35km southeast of central İstanbul on the city's Asian side and is operated by Malaysian Airports. This year throughput will be around the 35m mark, equally split between international and domestic passengers, which is right at the capacity limit. In November, a second runway was completed which in theory will double capacity, but the one terminal at the airport is close to its capacity limit. A new terminal is in the planning stage but will not open until late 2025 at the earliest.

Pegasus's position as the dominant force at Sabiha Gökçen has been reinforced as since 2019 as THY has focused on İGA, having moved its entire passenger operations from the old İstanbul Atatürk, leaving Sabiha Gökçen as a pure LCC/Charter airport, albeit with an important connecting role. Pegasus should be able to deal with the threat from the new Anadolujet as LCC spin-offs from full-service carriers are rarely effective. The charging structure at Sabiha Gökçen also favours Pegasus, in comparison to İGA which has some of the highest airport charges in Europe.

Pegasus also has the option of developing international services from its other bases. For example, in 2023 it has started up flights from Ankara to Moscow, Warsaw and Kraków, and from Antalya to St. Petersburg and Symkent (Kazakhstan).

Overall, the key strategic question for Pegasus is how it might expand beyond the Turkish market without jeopardising its powerful niche position.

PEGASUS DOMESTIC ROUTE NETWORK



United Rejects Commoditisation and Embraces Differentiation

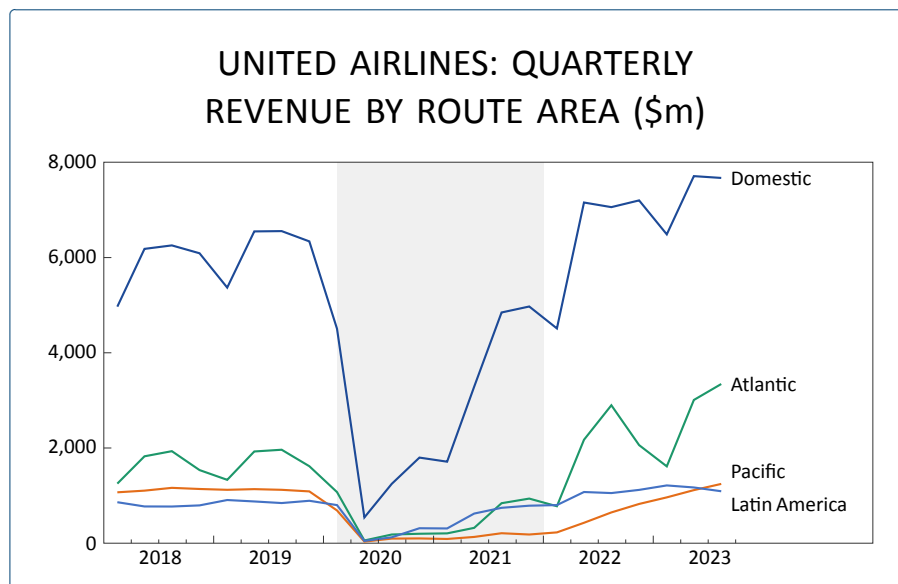
UNITED Airlines is the third largest airline in the USA behind Delta and American, but it has the highest exposure to international and long haul markets: pre-pandemic its two Legacy rivals generated 28-30% of their turnover from their international operations, while United produced 40% of its revenues internationally.

In 2022, the force of pent-up air travel demand in the recovery from the pandemic led to strong domestic and short haul international traffic. In the current year that has switched strongly to demand for international services playing nicely into United's portfolio of routes.

Record Q3 Results

In its third quarter results for the three months ending September 2023, United proudly announced a record level of group quarterly revenues at \$14.5bn, 12.5% up year on year and 27% higher than that achieved in the same pre-pandemic period of 2019. Domestic revenues were up by 9% year on year on the back of an 11% growth in seat mile capacity — an underlying unit revenue decline of 2% was relatively benign in comparison with the rest of the industry for the period. Without going into details, the company stated that the domestic system “remains solidly profitable”.

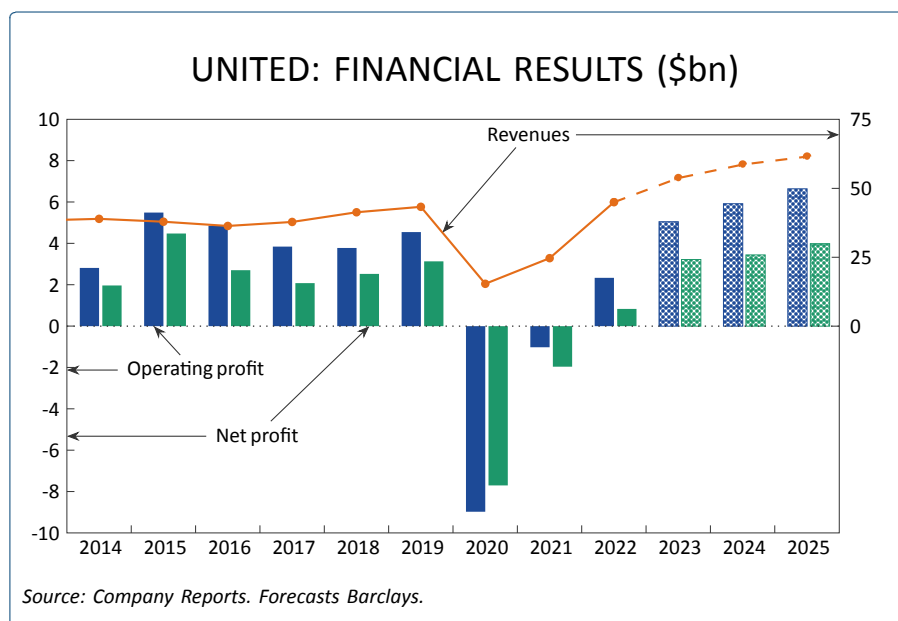
The stellar performance was on international services. United had pushed a lot of capacity on the Atlantic this year, adding 12% in the number of available seat miles compared with Q2 2022 and increasing



its share of the market from 10% in 2019. In total United's capacity and traffic on the Atlantic was 34% higher than in the same period in 2019. (To be fair, its joint venture partner Lufthansa has had difficulties returning capacity to the long haul markets, and there

appears to be little overall difference in the JV's combined share of around 21%). Revenues on the Atlantic in the quarter were 15% higher than in the prior year period and an astounding 70% higher than in the third quarter of 2019.

United is also the US market



UNITED AIRLINES: FINANCIAL DATA (\$bn)

	2019	2020	2021	2022	2023†	@ end	Sep 2023	Dec 2019
Revenues	43.26	15.36	24.63	44.96	52.49	Fleet and other fixed assets	51.24	44.42
Net result	3.01	(7.07)	(1.96)	0.74	3.48	Current Assets	4.83	3.25
						Cash and equivalents†	17.09	4.94
Operating cashflow	6.91	(4.13)	2.07	6.07	8.98	Total Assets	73.15	52.61
Capex and investments	(4.66)	(1.72)	(2.00)	(4.68)	(7.66)	Long term debt and leases	(30.50)	(18.31)
Free cash flow	2.25	(5.85)	0.07	1.39	1.32	Other liabilities	(9.05)	(7.83)
Net change in debt	0.37	11.21	5.86	(3.35)	(2.65)	Current liabilities	(24.76)	(14.94)
Equity raised (bought back)	(1.65)	1.75	0.53			Total Liabilities	(64.30)	(41.08)
Change in cash†	0.97	7.11	6.46	(1.96)	(1.33)	Shareholders' funds	8.85	11.53

Notes: † includes short term investments, ‡ trailing 12 months to Sept 2023

leader on the Pacific with a near 16% share — up a couple of points from four years ago. Countries in the Asia/Pacific region were much slower in reopening borders after the crisis. Japan was able to relax controls in the last quarter of 2021, but China only really started allowing cross-border traffic from the beginning of 2022. United's Q2 capacity and demand to the region increased by 86% year on year — although absolute levels remained 24% below those in Q3 2019. Those passengers who are flying are willing to pay for the privilege: revenues nearly doubled to a point where they were 7% higher than pre-pandemic levels.

Again without giving details, the Company stated that "profits were at record highs in both the Atlantic and Pacific regions".

On a consolidated basis, passenger numbers and demand in passenger miles were up by 14%, load factors down by 1 percentage point and passenger unit revenues fell by 1%. Unit costs fell by 3.6%, helped by lower fuel prices although ex-fuel unit costs rose by 2.6% possibly reflecting restaffing and new collective agreements. Adjusted operating profits came in at \$1.8bn, 20% higher

than the year before and reflecting a 12% operating margin.

For much of the 2010s United's total revenues stagnated — hovering at \$37-40bn before picking up slightly in 2019. Admittedly inflation was low, the industry was consolidating, which enabled the Legacy carriers to enjoy the first period of really strong profitability since deregulation.

The trailing twelve month results indicate a new level of profitability. Revenues for the year to end September topped \$52bn — a third higher than the average for the last decade. Forecasts suggest revenues could top \$61bn by 2025. Adjusted net profits come in at \$3.5bn, 16% higher than those achieved in 2019.

Product differentiation the key?

Speaking on the results' call, CEO Scott Kirby was adamant. He appears firmly of the opinion that the (US) airline industry is not just a mere commodity and that the ULCC mantra that the lowest cost provider will win is fallacious; that the industry will recover its "natural" 1% revenue proportion of GDP; that the industry cost structure changes (which United helped foster) — with all major players boosting pilot wages by 40% in the

face of severe pilot shortages — will change the structure of the domestic industry. There will be a shakeout in 2024, the ULCCs will disappear, and all will be rosy.

This may be overly optimistic rhetoric. But United says it has done a good job in "product differentiation". It claims it as built a "winning strategy around giving customers choice when it comes to the level of service they want". It introduced premium economy services in 2019 (taking nearly thirty years to catch on to EVA Air's 1991 innovation) and has found that revenues have outpaced capacity growth since its introduction. The company noted that in the third quarter revenue from premium products was up 20% year-over-year and accounts for more than half of all passenger revenue.

They have a "Basic Economy" product, introduced in 2017 (five years after Delta initiated one) and designed to offer the equivalent to the offerings from the ULCCs: a no-frills fare, with one small personal item to fit under the seat in front; carry-on luggage to store in overhead bins is charged a fee (unless the passenger is a MileagePlus member with Premier status, holds the right type

Aviation Strategy

of MileagePlus credit card or is flying internationally); checked in luggage for a fee (unless flying internationally on the Pacific).

This product they say “has also provided another popular option for customers and has been a great competitive offering with revenue... up 50% year-over-year”. CEO Scott Kirby noted that “Basic Economy” now accounts for 12% of domestic passengers.

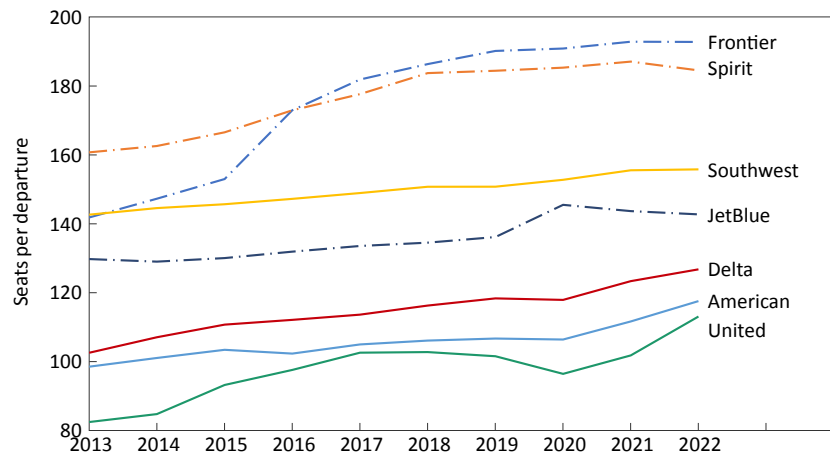
United Next

In June 2021 United placed the largest aircraft order in its history — for 200 737MAX and 70 A321neos. It followed by announcing its latest transformation plan entitled “United Next”. The tenets of the plan are to increase aircraft gauge to reduce the marginal unit cost of capacity introduction; concentrate on denser aircraft and higher frequencies on existing markets rather than increase scope of the network by entering new domestic markets; drive feed to its international services where it feels it has superior margins.

United historically has had the lowest aircraft seat density in the domestic market as the chart above shows. In 2019 it averaged 104 seats per aircraft departure on domestic routes, behind its major legacy competitors and well behind the 175 seat average for the ULCCs.

A major reason is its use of small regional jets: which accounted for a third of all domestic departures. These aircraft are not suitable for the product differentiation it needs to ensure what Kirby calls the “de-commoditization” of the product. So in hand with the delivery of new narrowbodies, the plan envisaged disposal of 200 regional jets (of the 580 it had in 2019) leading to a 30% increase in aircraft gauge, a 75% growth

DOMESTIC GAUGE



in “premium” seats per departure, by 2026.
an 8% reduction in unit-costs ex-fuel (and a target 14% operating margin)

United continued its aircraft order spree with an order in December

UNITED AIRLINES FLEET

		In Service	Parked	Total	Δ v 2019	Avg age	Orders
Widebodies	777-300ER	22		22	↑2	5.8	
	777-200ER	52	3	55		23.6	
	777-200	19		19		26.3	
	787-10	21		21	↑10	3.3	
	787-9	37	1	38	↑13	6.1	150
	A350						45
	787-8	12		12		10.3	
	767-400ER	15	1	16		22.1	
	767-300ER	34	3	37	↓1	27.6	
	Widebodies	212	8	220	↑24	16.9	195
Narrowbodies	757-300	20	1	21		21.1	
	757-200	36	4	40	↓13	26.7	
	737 MAX 10						
	737 MAX 9	72	2	74	↑74	2.2	
	737 MAX 8	63		63	↑63	2.1	
	737-900ER	124	12	136		10.8	
	737-900	12		12		22.0	
	737-800	128	13	141		19.6	
	737-700	36	4	40	↓1	24.5	
	A321neo						130
	A321XLR						50
	A320-200	90	9	99	↑2	24.9	
	A319-100	75	6	81	↑1	21.9	
	Narrowbodies	656	51	707	↑126	16.3	556
	Total mainline	868	59	927	↑150	16.4	751
Regional	E175	183		183	↑13		
	E170	35		35	↓3		
	ERJ145	63		63	↓112		
	CRJ700	20		20	↓27		
	CRJ550	36		36	↑18		
	CRJ200	133		133			
	Regional	470		470	↓111		
	Total fleet	1,338	59	1,397	↑39		

Aviation Strategy

2022 for 100 787s (plus 100 options) — Boeing's single largest 787 order — and added another 100 737MAXs to its order position. And then in October this year the company ordered another 110 aircraft — 50 787s and 60 A321neos for delivery 2028-31 — while adding another 50 787 options and 40 A321s for the end of the decade.

(In June 2021 United had also announced plans to acquire 15 Boom Overture supersonic aircraft with 35 options for delivery from 2029 — see *Aviation Strategy*, June 2021. That particular aircraft type doesn't yet ap-

pear in the books.)

Unusually, United has a much larger mainline fleet now than it did in 2019 (see table on the previous page): taking delivery of 25 wide-bodies and 140 narrowbodies in the intervening period. The regional fleet on the other hand is down by a net 111 units.

A further element of the United Next plan is to concentrate on international growth. Scott Kelly clearly sees United as the USA's flag-carrier, and wants to capitalise on the superior margins he sees in international flying. On the results call, he sug-

gested that there may be a pause in 2024 in the rate of expansion on the Atlantic, implicitly suggesting the focus next year will be on restoring the Pacific.

Growth to 2026 according to the plans will be a modest 4-6%, primarily driven by increase in aircraft size. But somewhat enigmatically he said that the airline would "pivot to global growth in 2025-30".

The United Next plan has raised some concerns over the group's financial position: debt has doubled since 2019, and capital expenditure is running high — with c\$8bn in the cur-

UNITED AIRLINES: INTERNATIONAL ROUTE MAP



Notes: Azimuthal equidistant map projection centred on Chicago O'Hare.

Airspace over Russia and Ukraine (marked in red) currently unusable: those great circle routes shown traversing it subject to diversion.

rent year. But the company appears confident that by 2026 its net debt will be back below pre-pandemic levels and that its net debt to EBITDAR could be under 2.5x — almost approaching investment grade.

MileagePlus

Modestly, Scott Kirby considers that United's loyalty program, MileagePlus, is "the most attractive program in the world for customers, and therefore generates significantly directly earned EBIT, significant loyalty, but also significant opportunity to do even more with it in the future".

In June 2020, in desperation for cash, United established a highly innovative financing structure to raise \$6.8bn secured by the cash flows of its frequent flyer programme (FFP) — see *Aviation Strategy*, Jul/Aug 2020. None of the US carriers explicitly detail the earnings power of the FFPs in their regulatory filings (Qantas has for many years, and IAG has just started to do so). United in its presentation at the time highlighted that MileagePlus was consistently profitable and was responsible for generating a quarter

of the group's EBITDA.

This quarter's results statement made little mention save that: "The third quarter showed a continued multi-year new MileagePlus member trend, setting a record for third quarter enrolments and nearly doubling the number of new members versus the third quarter just five years ago. Spending across the US card portfolio year-to-date is up double-digits over the first three quarters of 2022 and this third quarter saw more miles redeemed across the program than any third quarter in history for award travel."

Kirby did however mention that we should expect to hear a lot more details from United on this front, "starting at an investor day in early 2024".

However, there is currently a little piece of proposed legislation before in the US Senate, "The Credit Card Competition Act of 2023", which might undermine the validity of credit card loyalty schemes such as MileagePlus. Put forward by Senators Dick Durbin (D) and Roger Marshall (R) it aims to introduce

greater competition in credit card payment processing and reduce the underlying cost to merchants for accepting payments. The proponents point out that the Visa-Mastercard duopoly controls 80% of US credit card network market — more than 576m cards — and that in 2022 they and the issuing banks charged merchants a total \$93bn in fees. This they argue inflates costs to the consumer by up to 3% (the US has some of the highest card interchange fees in the world, and unlike the EU has not introduced a fee cap).

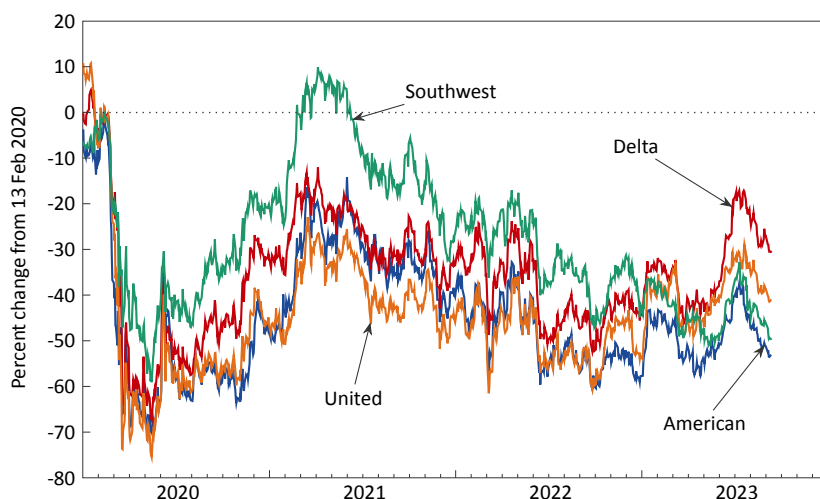
The proposal is to force large card issuers to enable at least two credit card networks to be used on their credit cards instead of just one, and at least one of those networks must be a network other than the Visa or Mastercard. Then the merchant would get to choose which of those networks to use to process a transaction.

They tried once in 2022, and again mid-2023, but failed to get the bill attached to the National Defense Authorization Act; they have apparently been promised a vote on the bill before the end of the year.

The Act has been nicknamed "Durbin 2.0", because Sen. Durbin introduced an amendment to the Frank-Dodd Act in 2010 that did the same thing for debit cards: that, opponents say, killed off debit card loyalty programmes, and free checking-accounts, for a net disbenefit to consumers.

If passed it might destroy the current US business model of FFPs: the high interchange and credit card fees are in part used to buy the miles and other goodies that FFP members enjoy as their rewards.

US BIG 4 SHARE PRICE PERFORMANCE THROUGH THE PANDEMIC (AND BEYOND)



Norwegian Reborn: Another Chance

NORWEGIAN Air Shuttle was severely financially challenged even before the onset of the Covid-19 pandemic. The crisis pushed it into bankruptcy in late 2020 which allowed it to completely restructure its fleet, network and balance sheet, and redesign its operating model and strategy. It has emerged as a leaner and simpler airline. In a recent research report, Barclays' veteran analyst, Andrew Lobbenberg, highlighted the attractive position posed by its reincarnation.

The old Norwegian: downed by high growth, long haul and complexity

Norwegian Air Shuttle (NAS) was originally founded as a regional airline in 1993, in part acting as a feeder to Braathens SAFE. Following SAS's acquisition of Braathens in 2001, it reinvented itself as a low cost airline in direct competition with the incumbent Scandinavian flag-carrier and expanded strongly (helped by its 2007 acquisition of Finnair's Swedish LCC FlyNordic) to end the noughties as Europe's third largest LCC behind Ryanair and easyJet, with a fleet of 57 737s.

In the following decade it embarked on a period of aggressive growth. In 2012 it announced the hitherto largest single aircraft order from a European airline: 22 737-800, 100 737-MAX8s (plus 100 options) and 100 A320neos (with another 50 options) — its first foray into the Airbus camp.

It also threw itself into long haul

expansion, launching a long haul low cost service with a fleet of 787 Dreamliners.

At its peak in 2018, Norwegian operated a total fleet of 164 aircraft: 114 737NGs, 18 737MAX8s and 32 787s. Half of the fleet was leased.

Its growth ambitions were far too aggressive. Having made hefty market share gains in its home markets against legacy incumbent SAS, it had to find places to put the monthly deliveries of new aircraft. It pushed narrowbody aircraft into European markets beyond its natural Nordic base (where its brand was well regarded).

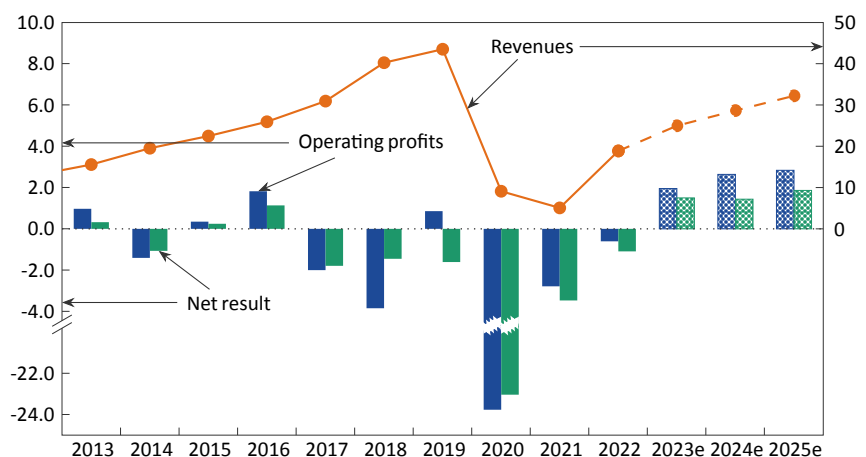
It established an operating base at London Gatwick, competing against the established (and lower cost) low cost UK airlines on the traditional sun, sea and sand routes to the Mediterranean; it opened a domestic Argentine airline, and set up an operation in the Caribbean making use of the freedoms in the

US-EU Open Skies agreement to fly from Martinique and Guadeloupe to the US — by a strange quirk of colonial history, both islands are *départements* of France and therefore in the EU.

At the 2018 peak, Norwegian's long haul operations featured routes from the Nordic capitals (as well as Bergen), London, Paris, Rome, Madrid and Barcelona to some fifteen destinations in the USA as well as Bangkok, Singapore, Dubai, Rio and Buenos Aires. It had built up a meaningful 6% share of the seats on the Atlantic — and briefly became the largest non-US airline serving New York. The airline was also a pioneer in using new generation narrowbody aircraft on the Atlantic, flying to small airports like Hartford CT, Providence RI and New York Stewart.

The management pushed the operating model further away from the KISS principle, creating an excessively

NORWEGIAN FINANCIAL RESULTS (Nkr bn)



Source: company reports, forecasts Barclays

NORWEGIAN AIR SHUTTLE FINANCIAL DATA (Nkr bn)

bn kr	2018	2019	2020	2021	2022	@ end	Jun 2023	Dec 2019
Revenues	40.27	43.52	9.10	5.07	18.87	Fleet and other fixed assets	16.45	70.73
Net result	(1.45)	(1.61)	(23.04)	1.87	1.01	Current Assets	4.52	11.51
						Cash and equivalents	9.35	3.10
Operating cashflow	0.46	3.04	(1.39)	0.14	2.43	Total Assets	30.32	85.34
Capex and investments	(8.56)	8.33	2.66	0.22	(0.80)	Debt and lease liabilities	(11.18)	(52.22)
Free cash flow	(8.10)	11.37	1.27	0.36	1.62	Other liabilities	(2.86)	(4.97)
Net change in debt	6.03	(10.81)	(0.07)	(0.46)	(1.11)	Current liabilities	(12.57)	(24.03)
Other financial flows	(1.50)	(3.35)	(1.96)	(0.74)	(0.45)	Total Liabilities	(26.61)	(81.22)
Equity raised	1.46	3.96	0.33	5.86				
Change in cash	(2.12)	1.17	(0.43)	5.03	0.06	Shareholders' funds	3.71	4.13

Note: US\$1=Nkr11

complex business (for an LCC). It held multiple AOCs — in Norway, Sweden, Ireland, the UK and Argentina — (and even a Bangkok crew base) partially initially designed as an attempt to mitigate the high cost of employment under Norwegian regulations (and in the UK's case to access route rights otherwise denied following Brexit).

But this reduced its flexibility to switch aircraft and crew between the separate operations with a negative impact on productivity. Its innovative employment strategies also engendered regulatory, competitor and union opposition when it attempted to expand operations into the US.

Until Norwegian started on this aggressive growth strategy the airline had been reasonably profitable: in the decade up to 2013 it had generated kr2.3bn in operating profits representing a 15% margin. But in the following five years to end 2019 it lost kr4.2bn at the operating level and kr4.5bn after tax while revenues more than doubled to kr43.5bn.

Norwegian's incursion on the Atlantic, and especially from its base in Gatwick, even led IAG (aka British Airways) to consider acquiring it. IAG built up a near 5% stake in the

company in 2018, but its offers of a takeover were rebuffed.

The airline had tried to change its growth strategy from the end of 2018 in order to return to sustainable profits and at the beginning of 2019 announced some restructuring efforts to help it to do so.

But then it was hit by the grounding of its 737MAX fleet in March 2019 following the Ethiopian and Lion Air crashes; it also suffered from reliability issues of the Rolls Royce engines on the 787s.

In July 2019, CEO Bjørn Kjos — the luminary behind Norwegian's development and growth — bowed out of the group he had fostered.

The group had tried to shore up its liquidity — during 2018-19 it raised a total of kr5.4bn in new equity. But it ended 2019 with only kr3bn in cash — less than one month's normal operating cash burn — and kr52bn in debt and lease liabilities: totally unprepared for the crisis of the Covid-19 pandemic.

Bankruptcy and Restructuring

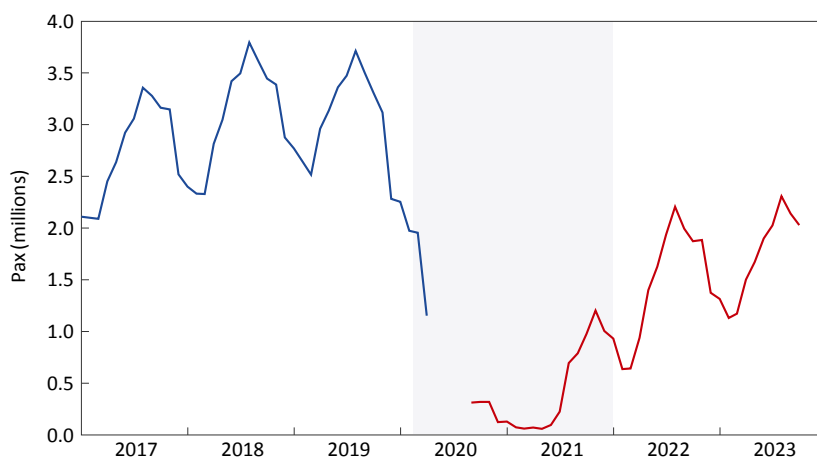
When the pandemic hit, Norwegian furloughed 7,650 positions (80% of its staff), cancelled crew agreements

covering 4,700 pilots and cabin staff, and parked all but seven of its aircraft — only 200 employees remained in operations. It slashed its monthly operating cash burn from kr3bn to around kr200m (excluding finance costs).

It was granted kr3bn state guaranteed loans, under condition of putting its finances in order. To do so, in May 2020, it reached agreement with lessors and bond holders owed a collective kr38bn (this included a kr3.3bn bond secured against its then valueless slots at Gatwick, but excluded kr22bn liabilities on its owned aircraft) for a debt for equity swap. The net impact of this along with a small public equity offering was to increase book equity by kr15bn, dilute existing shareholders by 95%, and boost cash to kr4bn. The company nevertheless reported a kr5.4bn loss for the first half of 2020 (and went on to register a kr24bn loss for the full year).

In November, with no further state aid forthcoming from Oslo, the group filed for bankruptcy protection, examinership and reconstruction in Ireland and Norway. It emerged some six months later with net debt

NORWEGIAN: MONTHLY PASSENGER TRAFFIC



of kr500m, kr6bn new equity, a much smaller fleet of 51 737s, the entire outstanding order book cancelled, and ownership costs on its remaining aircraft reduced by an average 35%.

New Norwegian — Back to KISS

Norwegian's new business plan is a return to its origins in the noughties: a short haul low-cost airline concentrating on short- to medium-haul point-to-point, fast turnaround, high utilisation services within the Nordic countries and from there to sun, sea and sand destinations in the Mediterranean and Canaries, and city-break destinations across Europe.

The complexities of multiple AOCs have been abandoned — it retains two: one in Norway (in EFTA, but non-EU), one in Sweden (in the EU). with the fleet split between them. The tortuous outsourced methods of employing flight and cabin crew under the old business plan — originally designed to reduce the need to employ staff under onerous Norwegian and Swedish rules — have been brought back in-house (as has maintenance) and most of the staff are on Scandinavian contracts; although the company retains three

bases in Spain (Alicante, Málaga and Barcelona) sharing a handful of aircraft to take advantage of lower labour costs of Spanish-domiciled crews. In 2024 it plans to open new bases in Palma de Mallorca and Riga.

One of the strengths of the original business model was the very home country: Norway is a very dynamic air travel market. The absolute population of around 5.5m may be low in relative terms, but there is a very high standard of living (income of \$78,000 GDP per capita in purchasing power parity terms), the terrain is difficult and distances between population centres great. This creates a high propensity to travel by air: over five trips per head of population. Two of the trunk routes (Oslo to Bergen and Oslo to Trondheim, covering distances of 325km and 365km respec-

tively) were the busiest routes in Europe in 2022.

Since emerging from examiner-ship (the Irish version of administration) in 2021, the airline has rebuilt its fleet to a strength of 82 737s (including 17 MAX8s), and has negotiated a new order for 50 737MAXs for delivery from 2025. Given that the order was negotiated in the depths of the downturn, Norwegian probably got a very good price. The company is planning modest growth to 90 aircraft by 2024 and 110 by the end of the decade.

Strong Nordic market position

The new Norwegian is the market leader in Norway (see charts on the facing page) with 32% of the capacity within, into and out of the country in 2022, well ahead of SAS's 27%, and regional player Widerøe's 13%. The position has since improved: Flyr, founded in June 2021 in an attempt to take advantage of Norwegian's difficulties, didn't last the course and filed for bankruptcy in January 2023.

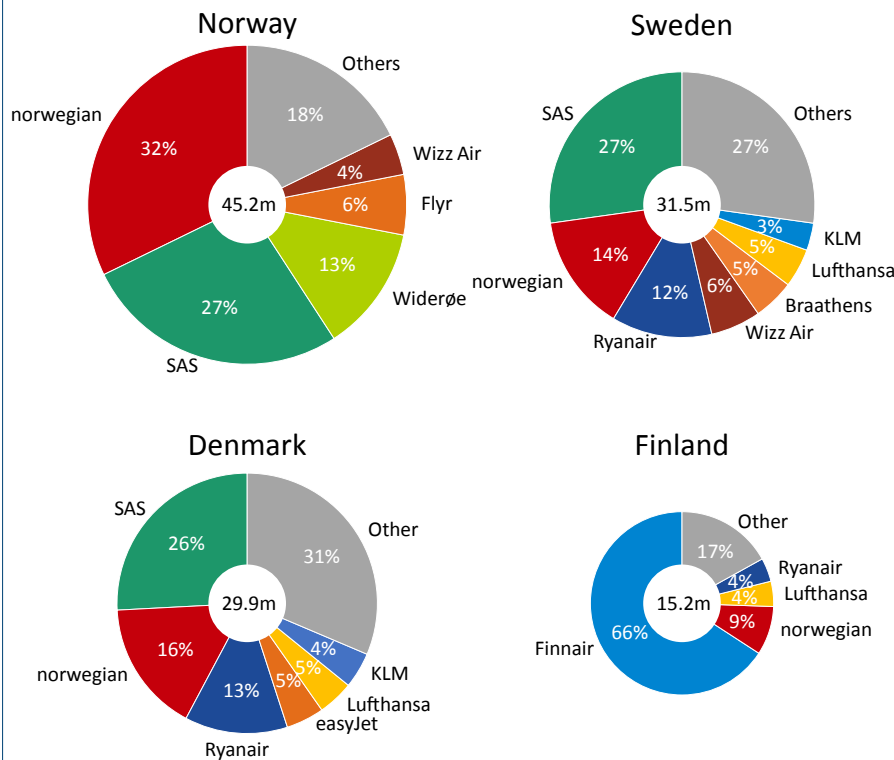
In Sweden (twice the population and two thirds the number of seats) and in Denmark (5.8m population and two thirds the number of seats) it trails SAS's 26-27% market share in second place with 14% and 16% — but still ahead of Europe's largest airline Ryanair.

Fortunately for Norwegian its main Nordic competitors are particularly challenged. Its main rival, SAS,

NORWEGIAN FLEET

	In service	Parked	Total	Δ v 2019	Avg Age	On Order
787				↓37		
737-800	67	1	68	↓34	10.0	
737MAX	17		17	↓1	1.8	50
	84	1	85	↓72	8.4	50

NORDIC INTRA-EUROPEAN MARKET SHARES 2022 (Seats)



tively small operation but with a 9% share is second behind Finnair. The Helsinki-based flag-carrier is particularly challenged by geopolitics. Its pre-pandemic strategy was to operate a hub in Helsinki connecting traffic flows from Western Europe to North East Asia and China — providing the most direct routes and shortest flights. But the closure of Russian airspace has removed any advantage it had, and it is being forced to shrink back.

Consolidating Norway

In July Norwegian announced an agreed takeover of domestic competitor Widerøe for kr1.1bn. Based in Bodø, and originally founded in 1934, Widerøe is Europe's largest regional airline.

It has a fleet of 45 Dash-8s — ranging in size from the 39-seat 1/200s (optimal for steep approach and short runways), 50-seat 300, to the 78-seat 400 — and three 110-seat Embraer 190s for longer domestic and select international routes from secondary airports. In 2022 it generated revenues of kr5.7bn carrying 3.3m passengers and recorded an operating profit of kr80m. It appears that it has been consistently profitable, with operating profits in 14 of the past 15 years (it suffered a small operating loss of kr57m, -1.4% of revenues, in 2020) and average margins of 4.5% over that period.

filed for bankruptcy in July 2022 in the US and is currently in the process of securing the equity to emerge from protection by the year end. It has struck a deal with a consortium led by Castlelake, the aircraft lessor and investor, to provide US\$1.2bn in new equity, convertible debt and DIP refinancing: as members of the consortium the Danish State will have 26%, and Air France-KLM 20% of the new equity. SAS is focusing restructuring on reducing the size of its fleet, renegotiating employment contracts and aircraft leases. For SAS, the airline economic environment is far tighter now than it was when Norwegian went through its restruc-

turing mid-pandemic: shortage of staff is adding wage pressures, and global shortage of aircraft, exacerbated by P&W engine problems, is pushing up lease rates. Both make it a challenging time for negotiations.

In Finland, Norwegian has a rela-

WIDERØE FLEET

	In service	Parked	Total	Δ v 2019	avg age
DHC-8-100	20	3	23	↑1	29.1
DHC-8-200	3		3		27.4
DHC-8-300	3		3	↓4	24.9
DHC-8-400	13	3	16	↑6	14.9
E190-E2	3		3		5.5
	42	6	48	↑3	22.5

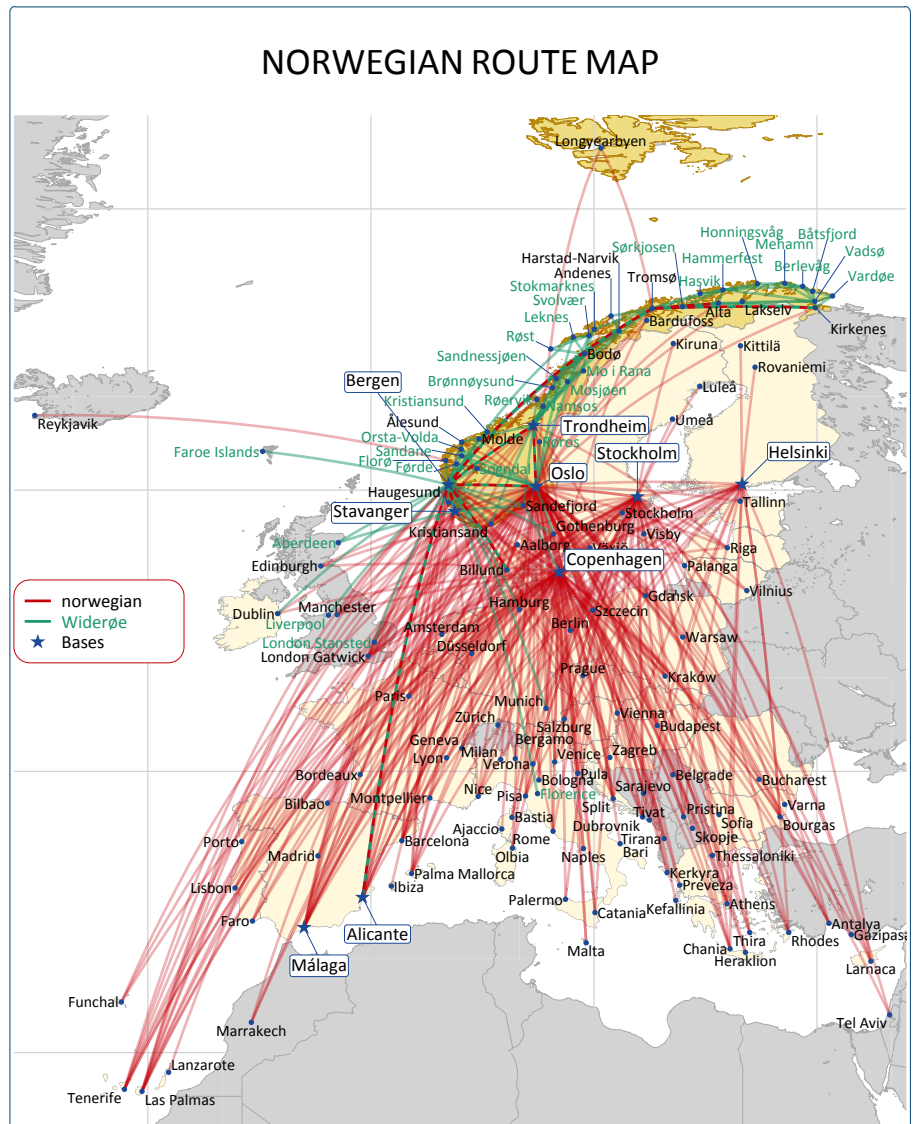
Aviation Strategy

The route network is largely complementary; Norwegian and Widerøe overlap on only 13 routes. Half of Widerøe's flights, accounting for a third of its passengers, are on government-subsidised public service obligation (PSO) routes — largely covering tiny markets, and some with harsh and complex flight conditions, in north and northwest Norway. Its core business is a selection of commercial regional scheduled and charter services within the country — in total it has a 20% domestic market share.

The regional carrier also has a ground-handling operation — the largest in Norway — located at 40 airports, serving 100 airline customers that in 2022 handled 14.5m pax and 330,000 flights.

Intriguingly, Widerøe set up what it calls an “air mobility business incubator”, Widerøe Zero, to look at electric aircraft — for which many of its routes should be suitable. It signed an MoU with Embraer's Eve at the COP26 meeting in Glasgow, “to develop a new concept of operation where passengers will experience the future of electric transportation and a new model of sustainable mobility, connecting people living in a sparsely populated region and challenging geography”.

The plan for the acquisition is to keep the brands and operations separate. This appears sensible as the two airlines have completely different operating models, although Norwegian suggests that there will be opportunities for synergies. Among other things the management note that Widerøe's operations have much lower seasonal variation; it has good business traffic; that there is the potential for “seamlessly connecting” regional Norway to feed onto Norwegian's international flights from Oslo (76 destinations),



Bergen (20) or Trondheim (10). The deal is subject to regulatory approval: and the regulator has asked for more time to consider the implications.

For the full year 2022 NAS reported an operating profit of kr1.5bn — but as more than kr2bn of this related to exceptional writebacks, it still suffered an underlying loss of kr604m. So far in 2023 the group reported underlying Q1 operating losses of kr886m little changed on the prior year, but Q2 saw profits of kr676m reversing losses in the same period of 2022. For the third, peak quarter, NAS reported a record quarterly revenue in its 21 year

history, and the second highest level of profits (after Q3 2019) with an EBIT of kr2.2bn, more than double the prior year and showing a 25% margin. The company is guiding to a full year operating profit of up to kr2bn, which would allow it to publish its first annual profit since 2016.

It is possible that the newly rejuvenated Norwegian this time has a viable business model.

Aviation Strategy

The Principals and Associates of Aviation Strategy apply a problem-solving, creative and pragmatic approach to commercial aviation projects.

Our expertise is in strategic and financial consulting in Europe, the Americas, Asia, Africa and the Middle East, covering:

- ✈ Start-up business plans
- ✈ Due diligence
- ✈ Antitrust investigations
- ✈ Credit analysis
- ✈ IPO prospectuses
- ✈ Turnaround strategies
- ✈ Privatisation projects
- ✈ Merger/takeover proposals
- ✈ Corporate strategy reviews
- ✈ Antitrust investigations
- ✈ State aid applications
- ✈ Asset valuations
- ✈ Competitor analyses
- ✈ Market analyses
- ✈ Traffic/revenue forecasts

For further information please contact:

James Halstead or Keith McMullan

Aviation Strategy Ltd

e-mail: info@aviationstrategy.aero

Subscription Form

Enter my Aviation Strategy subscription for: 1 year (up to 10 issues – usually Jan/Feb and Jul/Aug are usually combined, other months may also be)

- ✈ UK: £475
- ✈ EU: €610 (+VAT where applicable)
- ✈ USA and Rest of world: US\$780

starting with the _____ issue.

- ☐ I enclose a Sterling or Euro cheque made payable to Aviation Strategy Ltd
- ☐ Please invoice me
- ☐ I wish to pay by credit card or PayPal.
- ☐ I am sending a direct bank transfer of the the relevant sum net of all charges to Aviation Strategy's bank account:
Metro Bank Ltd, 1 Southampton Row, London WC1B 5HA
IBAN: GB04 MYMB 2305 8013 1203 74
Sort code: 23-05-80 Account no: 13120374
Swift: MYMBGB2L

Delivery Address

Name _____
Position _____
Company _____
e-mail _____
Telephone _____
VAT No _____

Invoice Address

Name _____
Position _____
Company _____
Address _____

Country _____
Postcode _____

DATA PROTECTION ACT

The information you provide will be held on our database and may be used to keep you informed of our products and services or for selected third party mailings

PLEASE RETURN THIS FORM TO:

Aviation Strategy Ltd, 6 Langside Avenue
London SW15 5QT, UK
e-mail: info@aviationstrategy.aero
VAT Registration No: GB 162 7100 38