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BAA in play

Shareholders in BAA have enjoyed a 30% increase in stock value since Ferrovial, the Spanish infrastructure company, announced a possible bid for the airport group in February. Although Ferrovial has not yet assembled its bidding consortium, and reports of a rival consortium centred on Macquarie Bank remain unconfirmed, the fact that BAA is being seriously considered as a takeover target is remarkable.

Since its privatisation in 1987 BAA has been a heavily regulated entity, with the regulator, the Civil Aviation Authority (CAA), controlling the aeronautical charges that can be levied and the rates of return that the BAA can generate. According to a detailed analysis of BAA by Dresdner Kleinwort Wasserstein (DrKW) the Regulated Asset Base (RAB) accounts for about at least 76% or £11.12bn of BAA's enterprise value.

Essentially the CAA reviews on a five-yearly, or quinquennial, basis the BAA's planned capital expenditure at the three London airports, its operating expenditure and its forecast income from commercial activities (this is the single till approach whereby income from concessionaires in effect subsidises aeronautical charges, unlike the dual till approach at most major European airport which excludes commercial revenue from pricing regulation). Based partly on the capex planned the CAA agrees weighted average cost of capital (WACC) that the BAA can apply - currently it is 7.75% pre-tax in real terms - and the resultant net income is then used as a basis for setting the maximum aeronautical fees that BAA can charge.

For the current quinquennium, 2003-08, BAA set charges per passenger at Heathrow at £6.48 with annual increases equivalent to inflation (RPI) plus 6.5% permitted. At Gatwick the regulated charges were £4.32 per passenger with increases limited to RPI, and at Stansted £4.89 also limited to RPI.

It is difficult to see how a new owner could escape in any significant way the constraints of the regulatory regime, and the CAA has issued a statement emphasising the importance of its role as the regulator (see box on page two). In the next quinquennium (2009-2014), following the completion of Terminal 5 at Heathrow, there are two major projects planned: the first phase of capacity expansion at Stansted, including a new runway, costing an estimated £3.5bn and the redevelopment of Terminals 1 and 2 at Heathrow, creating a new terminal with a similar design to Terminal 5, costing £1.5-2.0bn. These projects are probably non-negotiable.

Normally an airport purchaser would attempt to extract value from the investment by trimming operating costs or enhancing retail activity. But under the BAA regime, the regulator would be likely to channel the benefits from such activities into capping aeronautical charges.

A takeover of BAA would inevitably leave the group with a much more highly leveraged financial structure. But the CAA does not take gearing levels into account when calculating WACC. So this probably closes off another avenue for a new owner to extract value.

DrKW Equity research report, "BAA - potentially undervalued" of 2nd March 2006. Contact: andrew.f.evans@drkw.com

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The Civil Aviation Authority's role

Under the Airports Act of 1986, the CAA is responsible for setting price controls every five years, specifically airport charges for Heathrow, Gatwick and Stansted. This is done under a system of single till regulation, meaning both aviation and non-aviation revenues are regulated. The CAA operates and sets these price controls under four key objectives:

- To further the reasonable interests of users of airports within the UK
- To promote the efficient, economic and profitable operation of such airports
- To encourage investment in new facilities at airports in time to satisfy anticipated demands by the users of such airports
- To impose the minimum restrictions that are consistent with the performance by the CAA of its regulatory functions

CAA's statement regarding takeover

The CAA issued a statement regarding the possible takeover of BAA by Ferrovial. It acted as a reminder that BAA is a regulated entity and that certain approaches to extracting value from BAA are unpalatable. It made three broad points:

- BAA is in the early stages of the regulatory review and a potential bidder needs to consider this.
- The CAA will not regulate to accommodate certain financing arrangements, such as significant increases in debt. Furthermore, the financing arrangements would need to take into account the significant capex that the company needs to undertake and therefore the maintenance of credit quality to ensure cost-effective financing.
- BAA's regulatory review also passes through the Competition Commission. Any behaviour deemed to be against the public interest could be a cause for action.

There is the possibility of refinancing or selling the other assets in the BAA group, which include four UK airports (Glasgow, Edinburgh, Aberdeen and Southampton), 75% of Budapest Airport, bought last year, plus smaller stakes in Italian, US and Australian airports. These are valued by DrKW in total at £4.3bn or 24% of the group's enterprise value, using multiples from recent transactions (see table below) in the case of the UK regional airports and purchase price in the case of Budapest. But even with these airports there is a form of regulation, albeit with a lighter touch - for example, the CAA reviews and approves the fees charged at the UK airports.

Regardless of whether a firm bid materialises, the interest shown in BAA and Heathrow in particular has possible political repercussions. DrKW observes that 20 years of UK utility regulation have turned Heathrow into one of the cheapest major airports in Europe, leaving it undervalued in normal economic terms, and there is now an opportunity to correct that anomaly by a one-time rebasing of the aeronautical charges. The airlines will not be happy, but DrKW argues that this would have the effect of better rationing finite capacity, reducing congestion, planning and environmental pressures as well as the capex requirement. And it would also have the effect of rendering BAA virtually bid-proof.

RECENT AIRPORT TRANSACTION MULTIPLES

Date	Airport/Target	Acquirer	Transaction value ($m)	Stake (%)	Sales (x)	EBITDA (x)	EBIT (x)	EBITDA margin (%)
12/05	Budapest	BAA	1,773	75	12.8	29.9	40.7	43
10/05	Copenhagen	Macquarie Airports	1,795	60	7.6	13.4	20.4	56
12/04	TBI	Abertis/AENA	1,234	100	3.8	15.3		25
11/04	Brussels	Macquarie Airports	1,431	70	6.1	14.7		41
11/03	Florence	Acquisizione Prima	119	29	4.3	14.3	59.5	30
11/03	Sydney	Macquarie Airports	84	5	15.5	20.7	32.5	75
05/03	Belfast City	Grupo Ferrovial	57	100	3.5	17.6	37.5	20
08/02	Hamburg	Hochtief/Aer Rianta	715	49	4	10.7	15.2	38
07/02	Aeroporti di Roma	Malsa	2,595	45	5	14.4	29.8	35
06/02	Sydney	Southern Cross Consortium	3,583	100	13.8	19.3	28.0	72
04/02	Malta Int'l	Malta Medi	215	40	5.7	14.6	23.9	39
12/01	Birmingham Int'l	Macquarie Airports	605	24	5	12.1	17.3	41
03/01	Perth	BAA/Australian Infrastructure Fund	507	16	14	21.7	32.8	65
02/01	East Midland and Bournemouth Int'l	Manchester Airport	349	100	5.9	13.8	18.2	43

Source: Company data, Dresdner Kleinwort Wasserstein

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TAM: investors hope for new Brazilian success

TAM, Brazil's largest domestic airline, raised almost US$700m through a global share/ADS offering on March 10, which also gave the company a listing on the New York Stock Exchange (NYSE). The management has reiterated plans to expand the modest international network to key cities such as Lima, Caracas and London in 2006. Does TAM have a viable long-term strategy?

The airline has traded on the Bovespa (Sao Paulo stock exchange) since its June 2005 IPO, which raised R$547m (US$257m) from the sale of 30.4m preferred shares to local and international investors. The stock has performed well, rising from the IPO price of R$18 to almost R$50 in mid-February, when the global offering was announced.

On March 10, TAM and some of its shareholders sold 35.6 million preferred shares, including 11.7m preferred shares in Brazil and 23.9m preferred shares in the form of American Depositary Shares (ADSs) in the US and other-countries. The price was R$42 per preferred share and US$19.43 per ADS, based on the previous day's closing price on the Bovespa. The offer price was lower than originally expected, reflecting a 15% decline of the Bovespa share price since the offering was announced. TAM began trading on the NYSE on March 10, becoming the fourth Latin American airline to do so (after LAN, Gol and Copa).

Unfortunately, the bulk of the shares (30.6 million) were part of a secondary offering by TAM's shareholders, including investment funds and members of the founding Amaro family. The airline itself raised only US$94m in net proceeds from 5m shares, though it will raise an additional US$100m if underwriters exercise fully their over-allotment option of 5.3m shares.

But, importantly, TAM established a foothold in the much larger US capital markets, which it can tap for further funds in the future. While Credit Suisse Securities and Pactual Capital Corporation were the joint bookrunners on the global offering, TAM began the relationship- building by also bringing in Merrill Lynch, Citigroup, JP Morgan and UBS.

Nevertheless, the proceeds, which will be used for fleet renewal and expansion and general corporate purposes, come in handy for an airline that is highly leveraged, has all of its fleet on operating leases and has significant aircraft order commitments.

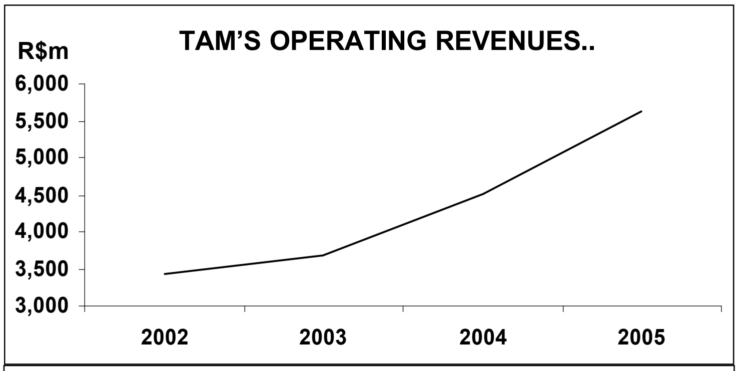
The share/ADS offering has increased TAM's free float from 21% to about 45%. The Amaro family's stake declined from 59% to 55%, while the five investment funds that previously held 20% got out entirely.

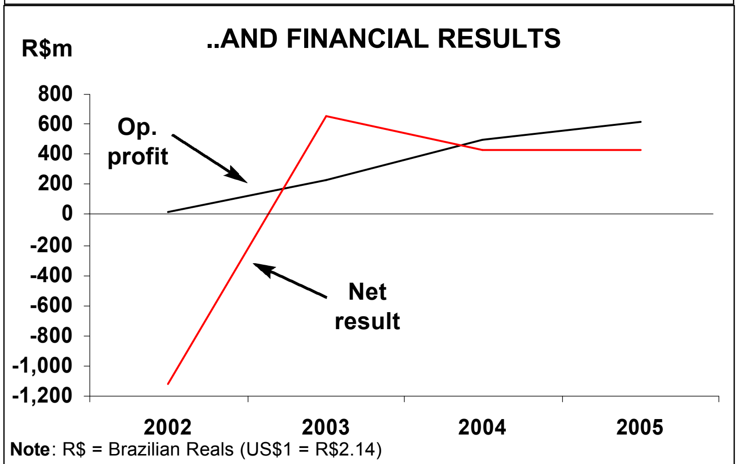
However, the Amaro family remains firmly in control through its ownership of 99.97% of TAM's common shares, which carry voting rights. The company's eight-member board includes three family members: the wife, daughter and son of founder Rolim Amaro, who died in a helicopter crash in 2001. Mrs. Noemy Almeida Oliveira Amaro is chairman. The CEO since January 2005 has been Marco Antonio Bologna, who was previously the company's investor relations officer and before that held executive positions in major financial institutions.

The holders of preferred shares or ADSs have no general voting rights but have the right to receive dividends equal to holders of common shares. Brazilian corporate law requires a company to distribute at least 25% of its annual adjusted non-consolidated income to shareholders. Although TAM previously escaped that requirement (because it was able to set profits against prior losses), the company has approved the distribution of R$29.4m (US$13.7m) in dividends based on 2005 earnings.

That said, international investors are mainly hoping that TAM might in some degree repeat Gol's success story. Gol has more than tripled its share price since its NYSE debut in 2004 and is now achieving 30%-plus operating margins.

Gol and TAM are completely different entities. While Gol is a new entrant and a brilliant adaptation of the Southwest-style LCC model, TAM is an older-established, full-service airline and a great turnaround story. TAM is also more than twice the size of Gol in terms of 2005 ASKs.





Note: R$ = Brazilian Reals (US$1 = R$2.14)

Calyon Securities analyst Ray Neidl, when initiating coverage of TAM late last year, observed that TAM was "the first to admit that it had to rapidly reform or perish, as have other Brazilian carriers in recent years". Its story is a nice contrast to VASP and Transbrasil's demise and Varig's bankruptcy and shrinkage.

Founded in 1986, with scheduled operations by predecessors going back to 1976, TAM attracted fresh capital from private equity funds in the late 1990s and spent several years restructuring its fleet and operations. The result was a modern cost-competitive airline with a growing fleet of A320s and A330s. Profitability was restored in 2003.

In the past seven years, TAM has grown at a much faster rate domestically than its competitors. Since mid-2003 it has captured most of the market share that Varig has lost and the bulk of VASP's, which had 8.8% of the domestic market when it ceased operations in September 2004. TAM's domestic market share surged by 7.7 points in 2005. In December, it accounted for 46.1% of domestic RPKs, compared to Gol's 29.8% and Varig's 21.7%.

Varig's struggles have also meant new long-haul international expansion opportunities for TAM. Last year the airline increased its international market share by 4.4 points to 18.9%, partly a result of the addition of new routes to Miami, Paris and New York.

The past two years have seen strong revenue and profit growth, thanks to the market share gains, resumption of robust GDP growth in Brazil and continued cost cutting. TAM achieved a 10.9% operating margin in both 2004 and 2005. Last year it earned a net profit of R$427m (US$200m) on revenues of R$5.6bn (US$2.6bn). Capacity rose by 33% and the load factor by 4.6 points to 70.6%.

TAM continues to benefit from cost savings and efficiency improvements resulting from restructuring. Last year its ex-fuel unit costs declined by 16.4%, helped by an increase in average daily aircraft utilisation from 8.98 to 11.36 hours. Including fuel, unit costs fell by 7.4% to 18.63 centavos (8.7 US cents) per ASK.

Like other Brazilian carriers, TAM has been able to increase its fares to compensate for higher fuel prices. The airline believes that over 50% of any increase in fuel costs may be passed on to customers in fares - a contrast to the US situation. The biggest negative in last year's results was that TAM's domestic and international yields fell by 10.8% and 16.1%, respectively. The airline admitted that it sacrificed some yield for market share improvement.

TAM intends to continue to focus on the business segment, which accounts for around 80% of its traffic domestically, while also operating leisure-oriented and cargo services (to maximise aircraft utilisation). This may not sound dramatically different from other airlines' strategies, because 70% of all domestic trips in Brazil are for business purposes. However, TAM's business model specifies "service levels superior to competitors and charging higher fares".

The airline rightly pointed out in the offering prospectus that one of its key risks is that there is a significant demand shift in favour of low-fare operations. In other words, there is some uncertainty about the long-term viability of TAM's full-service, higher-fare business model.

Then again, if TAM has a competitive cost structure and other LCC characteristics, such as a strong corporate culture and highly motivated workforce - which appears to be the case - there is no reason why it could not simply make adjustments to the model.

TAM believes that it can hold onto business traffic because it offers "value-added service at competitive prices", meaning a larger network of destinations, more direct flights, more frequencies and more convenient schedules than Varig and Gol. It has a strong brand and "espirito de servir" (spirit of service). It was the first airline in Brazil to introduce an FFP (1993) and, among other things, the only airline to offer video and audio entertainment on domestic flights.

Curiously, TAM listed "liquidity and solvency" as one of its competitive strengths, which is not really the case even though the balance sheet has improved steadily in recent years. For example, the current ratio (current assets over current liabilities) rose to 1.57 at year-end 2005 from 0.80 two years earlier. Cash position improved from R$297m at year-end 2004 to R$996m (US$465m) at year-end 2005 - the latter represented an adequate 17.6% of annual revenues. Total debt is not excessive at R$641m (US$300m), but lease-adjusted debt-to-capital ratio before the share offering remained high at 89%.

It seems likely that international investors - quite justifiably - overlooked some of those weaknesses because Brazil's aviation market is so promising. The market is relatively undeveloped with huge growth potential. According to the prospectus, Brazil had only 32.2m domestic enplanements out of a population of 182m in 2004, compared to 587.5m domestic enplanements in the US out of a population of 293m in 2003. The Sao Paulo-Rio de Janeiro shuttle is one of the busiest shuttle routes in the world. Furthermore, regulatory policies in Brazil continue to protect the airline industry's financial performance; the rules limit route entry, addition of capacity or frequencies, acquisition of new aircraft and the entry of new carriers.

The market is so large and undeveloped that there are probably plenty of good growth and profit opportunities for three efficient and well-managed major airlines - TAM, Gol and Varig, if the latter gets its act together.

International growth plans

TAM operates throughout Brazil, serving the largest number of domestic destinations (46), plus another 27 through regional alliances with other airlines. International services cover eight destinations in Latin America - Buenos Aires and Santiago, as well as smaller cities served through Paraguay-based subsidiary TAM Mercosur - and three business routes to the US and France (Miami, New York and Paris). In addition, TAM has codeshares with American, Air France-KLM and others.

TAM'S FLEET PLAN
(operational fleet at year-end)

Type	2005	2006	2007	2008	2009
A330*	7	8	8	8	8
A319/320	49	59	62	66	70
Fokker 100**	20	18	18	18	18
Total	**76**	**85**	**88**	**92**	**96**

Notes: * = To be replaced by the A320 from 2012,
** = replacement decision pending (A318 or E190)
Source: *Global Offering Prospectus (February 2006)*

The strategy is to expand selectively in international markets. According to the prospectus, TAM plans to begin daily flights to Lima (Peru) in a codeshare with Taca on March 18. The airline also recently obtained authorisation to serve Caracas (Venezuela), which is likely to begin in mid-2006. After that the focus will be on London, which TAM hopes to begin serving before year-end with seven weekly flights (subject to government approvals).

TAM's all-leased operational fleet consisted of 76 aircraft at year-end (see table, above) - seven A330-200s, 36 A320-200s, 13 A319-100s and 20 Fokker 100s. In addition, eight aircraft (three A330s and five Fokker 100s) were on short-term subleases to other airlines. With an average age of 7.5 years, the fleet is the youngest in Brazil. There are firm orders for 29 A320s, plus 20 options, for delivery over the next five years. In December TAM also firmed up an order for ten A350s, plus five options, to replace its current A330s from 2012.

The airline is still evaluating the A318 and the E190 for Fokker 100 replacement; the decision has been delayed several times and could come at any time. In 2003-2004 TAM converted ten Fokker 100 finance leases into operating leases and negotiated the return of 19 aircraft - the final two of that batch will go this year, leaving the Fokker 100 fleet at 18 aircraft.

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Copa: creating that Latin American buzz

Panama's Copa (Compania Panamena de Aviacion) made its debut on the New York Stock Exchange (NYSE) in mid-December, following decisions by its 49%-owner Continental and Panamanian shareholders to monetise part of their stakes via a public offering. The IPO, which made Copa the third Latin American airline (after LAN and Gol) to trade in the US, generated considerable investor interest and was priced above expectations. The stock surged in the subsequent weeks, valuing Copa virtually on a par with the world's most successful LCCs.

Since early January the share price has fallen to a more realistic level as several Wall Street analysts called the company overvalued in their initiation reports. Notably, UBS launched coverage of Copa on January 6 with a "reduce" recommendation (before upgrading the stock to "neutral" two weeks later).

JP Morgan, Morgan Stanley and Merrill Lynch - three of the five underwriters on the IPO - initiated coverage of Copa on January 24, followed by Calyon Securities on March 3. Analysts have been somewhat divided on how Copa should be valued and what its longer-term prospects are. Merrill and Calyon, which have "buy"/"add" recommendations on the stock, have stressed the airline's numerous positive attributes and the fact that it is now trading at discounts to Latin American airlines and North American LCCs. (Merrill calculated those discounts at 20% and 40% respectively, on a 2006 P/E basis, or 5% and 10% on an Enterprise Value/EBITDAR basis.)

But JP Morgan, Morgan Stanley and UBS, which have "neutral" ratings on the stock, have expressed more concern about potential risks. JP Morgan also pointed out that when an adjustment is made for the airline's unusually low tax rate, on an Enterprise Value/EBITDAR basis Copa trades "directly alongside proven heavyweights Gol, Southwest and Ryanair". Because of its unique circumstances, unusual business model and relatively low profile before the IPO, Copa is probably less well understood in international investor circles than other Latin American carriers were when they went public. It has been helpful to hear Copa's top executives tackle directly some of the issues at recent investor conferences. CFO Victor Vial gave a presentation at Raymond James' growth airlines conference in New York in January, while CEO Pedro Heilbron spoke at JP Morgan's aviation conference in late February.

In the first place, Copa created buzz because the Latin American airline sector is hot. Large untapped markets with huge growth potential within the region, the progress made by key economies, success stories like LAN and Gol, and the rising LCC phenomenon in the largest countries have all helped catch the attention of international investors.

Panama is a very small country, but its strategic location, special international status and strong and stable dollar-based economy have enabled Copa to develop its home base into the "Hub of the Americas". Some investors may have seen it as a safe way to participate in the rapidly growing Latin American airline industry.

Although Copa is not an LCC (it is 100% hub-and-spoke), it shares many characteristics with LCCs, including a track record of profitable growth, some of the industry's highest operating margins, competitive labour costs, a strong management team and good labour relations.

The airline has been profitable for five years, increasing its net earnings from US$14.8m in 2001 to an estimated US$77m in 2005. Operating margins improved from 8.6% in 2001 to 20.6% in 2004 - a level where it remained in 2005, which was among the best in the airline industry.

Like most LCCs, Copa is a growth airline. Between 2000 and third-quarter 2005, its ASMs increased by 74%. The airline plans to double its fleet to 50 aircraft by the end of 2009. And interestingly, like JetBlue, it has just introduced to service the Embraer E190 as its second fleet type.

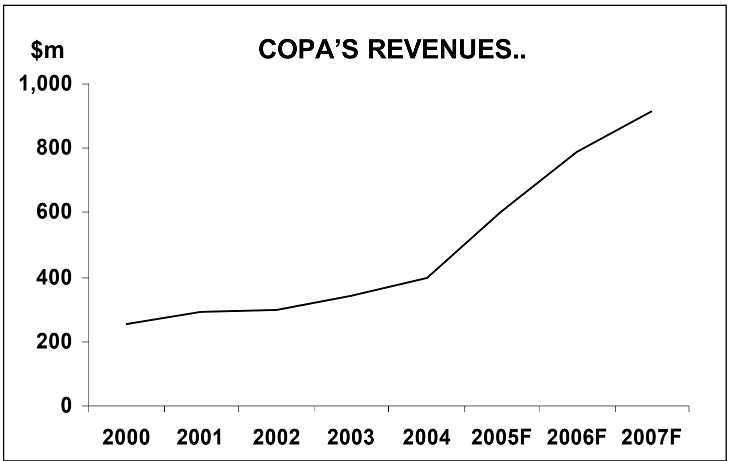
Copa also benefits from a strategic alliance with Continental - one of the healthiest legacy carriers. The unusually comprehensive pact is regarded as one of the most successful airline alliances in the Americas. Immediately before the IPO, the deal was extended by ten years until 2015.

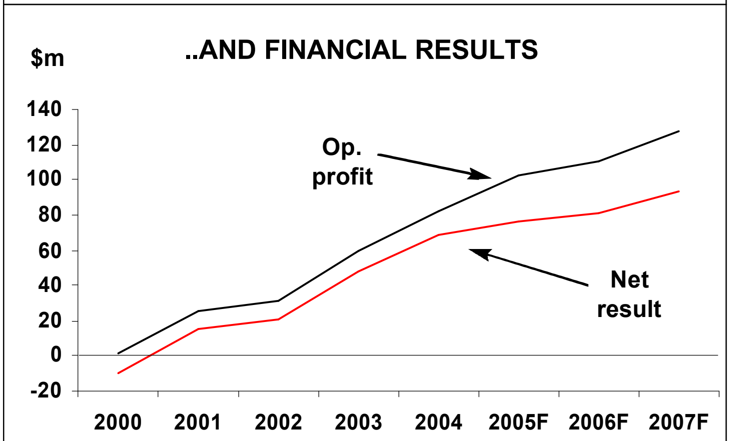
However, analysts have mentioned several potential problems related to growth. First, there is the challenge of managing rapid growth while also integrating a new aircraft type to the fleet.

Second, there is the challenge of successfully integrating AeroRepublica, the Colombian carrier that Copa purchased for US$23.4m in April 2005. AeroRepublica potentially offers an excellent growth opportunity, but Copa will have to replace the smaller carrier's old fleet and turn it around financially, while fending off growing competition.

Third, there are concerns that the lack of a good home market and excessive reliance on connecting traffic leaves Copa particularly vulnerable to competition from other network carriers like Taca, Avianca and LAN, as well as future LCCs.

US experience has shown that an airline is skating on very thin ice if it does not have a solid local market that it can dominate - that relying on connecting traffic means not just lower yields but an uncertain future. But is the situation in Panama different?





Note: Merrill Lynch forecasts

Copa's background

Copa's background and growth path have been unusual. Established in 1947 as a joint venture between Pan Am and local Panamanian investors, the airline led a very quiet existence until new owners and management arrived in the late 1980s. The Motta Group - a major economic force in Panama with interests in banking, insurance and telecommunications - acquired a majority stake in Copa in 1986, which led to a growth phase in the 1990s.

A new management team, led by the current CEO, took over in 1988. The US-educated, bicultural and highly regarded leadership initiated and guided the airline through several important strategies.

First and most significantly, the new management saw an opportunity to develop connecting traffic via Panama's Tocumen Airport, and Copa began a hub operation there in 1992. The hub has grown to become the airline's most valuable asset, now offering connections between 800-plus city pairs.

Second, in 1998 Copa's management secured another unique growth opportunity by forging the alliance with Continental, which also involved the Houston-based carrier acquiring a 49% stake in Copa. Since Panama signed an open skies ASA with the US in 1997, the alliance enjoys antitrust immunity in the US, which has enabled the airlines to conduct joint pricing, scheduling and revenue management, in addition to co-branding, codesharing and FFP cooperation.

However, the alliance goes much deeper, in that it also includes cooperation on information technology, coordination of maintenance programmes and joint purchasing of insurance, aircraft, spare parts etc. Copa believes that it has been able to achieve economies of scale that would be difficult to achieve for an airline of its size; for example, its insurance costs have probably halved. In addition, Copa has benefited from a transfer of know-how from Continental.

Third, in 1999 the management initiated a vital part of Copa's transformation into a successful modern airline: complete fleet renewal. The process, which was completed last year, replaced the carrier's 737-200 fleet with brand new 737-700/800s and E190s.

The December IPO

This very interesting decade of so in Copa's history culminated with the opportunity to go public in December simply because Continental needed cash. The Houston-based airline and the Panamanian 51%-owner CIASA (Corporation de Inversiones Aereas), which is controlled by members of the Motta, Heilbron and Arias families, each sold about 9m Class A common shares in the IPO (including over-allotments) at US$20 a share.

The sellers each collected about US$172m in total proceeds, which for Continental represented a nice gain on the US$53m it paid for the 49% stake in 1998. Furthermore, Continental has collected an estimated US$70m in profits from Copa in the past two years, plus US$10m in dividends.

The IPO reduced Continental's ownership in Copa to 27%, which gives it the right to designate two of the 11 directors. CIASA, which now has a 29% stake, remains in control through its ownership of 100% of the Class B shares, which carry voting rights, and the right to designate six directors (the remaining three directors are independent, pursuant to NYSE rules). CIASA also has the right of first offer for any shares that Continental may propose to sell in the future.

There were suggestions that Continental may have considered this to be a good time to exit Copa, given the future risks associated with growth and competition in the Central American markets. But that is unlikely; Continental simply needed cash to meet its pension obligations - it immediately contributed US$50m of the IPO proceeds to its pension plans. The airline said that it wanted to keep its promises to employees, even in these difficult times.

JP Morgan analyst Jamie Baker described Continental's remaining 27% Copa stake as its "last and final liquidity raising option, should fundamentals deteriorate". Continental's lock-up period expires in June.

While Copa received no proceeds from the IPO, it established a foothold in the US capital markets, which it can tap in the future for growth funds.

The Panama hub advantage

Back in the early 1990s, Copa's management saw an opportunity to develop connecting traffic from multiple points in the Americas via Panama because of the unique advantages offered by the country and its main airport. First of all, the Panama hub is geographically well located, allowing 737-700s to fly nonstop to practically anywhere in the Americas. The airport benefits from a sea-level location - the two key competing airports in the region are at hot and high locations - and favourable weather, which has given Copa excellent on-time performance and completion factors.

Because of its manageable size and Panama's policies accommodating transfer passengers, the airport offers easy transfers and short connecting times.

Tocumen has two parallel runways (something that is not common in Latin America), is not gate-constrained and has ample room to grow. The US$70m first phase of an expansion project launched in 2004, due to be completed this April, has added eight new gates with jet bridges, to bring the total gates to 22, along with extra parking positions and improved facilities. The second phase of the expansion could add another five gates.

According to Copa executives, Tocumen Airport is also in the lowest third in terms of costs in Latin America and probably in the world. The geographic reach provided by

Panama's location has allowed Copa to develop a nicely diversified revenue base. In 2004 its revenues were generated as follows: Panama 16%, rest of Central America 15%, the Caribbean 13%, Colombia 10%, rest of South America 29% and North America 17%.

Copa also benefits from having its home base in an attractive business environment. Panama's stable, dollar-based economy has meant low inflation, and GDP growth has been strong in recent years. Copa faces less currency risks than many other Latin American carriers, and the low tax environment has meant only a 10% basic tax rate.

Copa benefits from Panama's role as a major financial, trade, shipping and international business centre, arising from the existence of the Panama Canal. The country is home to many regional offices of multinational corporations and international institutions. As a result, it generates international business traffic way beyond the size of the population (3m, the majority living in Panama City).

A planned US$6bn-plus Panama Canal expansion project, which will go to a referendum this year, would further benefit Panama's economy and Copa. And the country is a growing tourist destination, following in Costa Rica's footsteps. The past couple of years have seen an accelerating construction boom, fuelled by tourism and retirees from the US, Canada and Spain buying second and third homes in Panama.

Through its "Hub of the Americas", Copa currently operates about 80 daily flights to 30 destinations in 20 countries. Another 120 destinations are served via codeshares mainly with Continental and to a lesser extent with Mexicana, Gol and Gulfstream International Airlines. Copa flies to cities as far north as New York and Los Angeles and as far south as Sao Paulo and Buenos Aires. Substantially all of its flights either depart or arrive in Panama. Transit passengers account for an estimated 80% of total traffic.

Copa does not currently provide a domestic service. Travel within Panama is mostly by ground transport, as distances are short, though there are two local airlines - Turismo Aereo and Aeroperlas - operating turboprops of less than 30 seats. Those airlines operate to a domestic terminal in Panama City that is a 30-minute drive from Tocumen.

The business model

Copa is a hub-and-spoke carrier, catering primarily for high-fare business passengers in connecting markets that typically lack non-stop competition, but it also has a reasonably competitive cost structure arising from a labour cost advantage.

Business passengers account for around half of Copa's traffic, which means higher yields, better ability to pass along fuel costs and less seasonal variation.

Copa has a strong brand and a reputation for quality service, based on an award-winning in-flight service and operational metrics that are among the best in the world. Significantly, the airline appears to have succeeded in creating a Southwest/Gol-style employee culture "based on teamwork and focused on continuous improvement". The highly motivated workforce benefits from the best training practices, performance-based profit sharing etc.

The relationship with Continental has further enhanced the brand. Copa's "Clase Ejecutiva" is virtually identical to Continental's executive class, except that it has "a Latin flavour". Aircraft liveries and aircraft interiors are also similar, while Copa benefits from access to Continental's OnePass FFP and airport lounge programmes.

According to the IPO prospectus, Copa's fare structure is "designed to balance load factors and yields in a way that maximises profits" and the aim is also to "maximise total revenues while remaining generally competitive". This is very US legacy-style.

Copa participates in all the major GDSs, including Sabre, Amadeus, Galileo and Worldspan. In 2004 about 75% of its sales were through travel agents or other carriers. The airline operates 78 ticket offices, plus 17 co-branded with Continental.

The goal is obviously to boost Internet sales. Copa began accepting ticket purchases through its web site in January 2003, reducing the cost of each booking to 25% of a travel agency booking, but in 2004 still only 0.8% of the airline's total sales were through the site.

Copa is in the middle of the pack in terms of unit costs. Its CASM, at 8.7 cents per ASM in 2004 or 9.1 cents in the first nine months of 2005 (7 cents and 6.5 cents excluding fuel), was similar to WestJet's - lower than the unit costs of the US legacy carriers but higher than most LCCs'.

The cost structure is excellent for a hub-and-spoke carrier that operates in a relatively healthy revenue environment. Copa attributes it to its young fleet, efficient operations (including high aircraft utilisation resulting from high average stage length) and Panama's low labour costs.

However, JP Morgan's Jamie Baker argued in his initiation report that Copa's cost advantage is almost entirely driven by what he called the greatest labour cost advantage he had ever witnessed at an airline. In Baker's estimates, Copa's unit labour costs are nearly 30% below those of JetBlue, the US labour cost leader.

That differential reflects lower wages and salaries in Latin America. According to Merrill Lynch analyst Michael Linenberg, a Copa pilot earns about US$35,000 in annual salary, compared to the average pilot salary of well above US$100,000 in the US. However, Heilbron indicated recently that the labour cost advantage over other Latin American carriers arises from better productivity, because "we pay better than most countries in Latin America".

Copa benefits from excellent labour relations and does not foresee labour cost pressures. However, some analysts feel that because 59% of the workforce is unionised and because contracts are currently amendable with the flight attendants and mechanics, with the pilots following in 2008, the situation warrants monitoring.

Copa's total CASM has been on a declining trend since 2000 and the airline continues to seek cost reductions. There is scope to reduce distribution costs through increased web and direct sales, as well as improving efficiency through technology and automated processes. Challenges include re-fleeting and modernising AeroRepublica to give it the right cost structure. The growth of Copa's E190 fleet will have some negative impact on CASM, but that will probably be offset by the impact of significant ASM growth.

Copa's business model works well because the airline operates in a relatively stable competitive environment. The main competitors are Taca and its partner American, and to a lesser extent Colombia's Avianca and Chile's LAN. However, competition in the region can be expected to progressively intensify.

First, there are the network carriers in neighbouring countries that are keen to strengthen their own hubs. Copa noted in the IPO prospectus that Taca had recently made aggressive fare-cutting moves, to which it had been forced to respond. However, Avianca may pose a bigger longer-term threat, now that it has emerged from bankruptcy with the help of new owners who want to aggressively grow the airline and the Bogota hub.

Second, there will be the LCCs keen to offer low-fare point-to-point services that bypass the network carriers' hubs. The theory, based on what has happened in the US, is that Copa will be particularly vulnerable to such competition because of its small home market and reliance on connecting traffic.

However, Copa's leadership believes that the airline's focus on the thinner intra-Latin America markets, rather than trunk routes, will keep it from much contact with LCCs, which typically prefer high-demand routes. In other words, not many of Copa's markets are large enough for hub bypass service.

On about 600 of the 800 city-pairs, Copa transports fewer than 10 passengers a day. The airline consolidates traffic from numerous points via the hub to achieve a satisfactory load factor to every destination city.

The Sao Paulo-Managua (Nicaragua) market provides an example of how Panama's location and market size come together to make the business model work. The passenger has three choices: flying via Miami (elapsed time 12 hours 45 minutes), via Lima and San Jose (over 15 hours) or via Panama (less than 10 hours; straight line, no immigration or customs). Of the four daily passengers in that market, three choose Copa. A similar thing happens in 600-plus markets daily.

Consequently, Copa considers its business model "defensible", one that is hard to duplicate. Nevertheless, the airline must brace itself for having some traffic siphoned off by LCCs in its largest and most lucrative markets in the future.

Growth plans

After retiring its last two 737-200s in 2005, Copa's 24-strong fleet at year-end included 18 737-700s, four 737-800s and two E190s. There were firm orders for seven 737NGs (700/800s) and 10 E190s, plus options for 18 E190s and purchase rights for ten 737NGs.

The current plan is to double the fleet to 50 aircraft - 30 737NGs and 20 E190s - by the end of 2009. This would mean 19% average annual capacity growth, which would be not dissimilar to the growth seen in recent years. There would still be 19 options at the end of 2009, adding flexibility to the fleet plan.

Those figures exclude AeroRepublica, which operated 11 MD-80s and two DC-9s at year-end. The fleet had an average age of 22.4 years at the end of September. Copa's executives said in late February that they were in the final stages of analysing the re-fleeting of the Colombian carrier. The company indicated earlier that additional aircraft orders for AeroRepublica were likely.

Copa chose the E190, which it will operate with 94 seats, essentially for the same reasons as JetBlue - because its small size and highly efficient operating characteristics made it the ideal aircraft to open new mid-sized markets that could not be served profitably with 150-seaters and to add frequencies on existing routes.

The overall growth strategy is simple: to continue to strengthen the Panama hub with increased frequencies and new destinations. Copa believes that it has significant growth potential because a large number of cities in Latin America do not have connectivity within the region - they may have domestic service and nonstop flights to the US but not adequate intra-regional links. In late February Copa announced the addition of three such cities - Manaus (Brazil), Santiago de los Caballeros (Dominican Republic) and Port of Spain (Trinidad) from June/July, to be served with E190s.

The airline expects to de-peak the hub, to add two new flight banks to the present two (morning and everning), as it grows over the next few years. That will help improve asset utilisation.

COPA'S FLEET PLAN
(number of aircraft at year-end)

	2004	2005	2006	2007	2008	2009
737-200	2	0	0	0	0	0
737-700	17	18	20	20	20	20
737-800*	3	4	4	6	8	10
E190	0	2	6	11	15	20
Total	**22**	**24**	**30**	**37**	**43**	**50**

Notes:* = Copa may substitute 737-700s for post-2006 deliveries, table excludes AeroRepublica, which operated 11 MD-80s and two DC-9s at year-end and whose fleet plan has not yet been determined.

Copa executives consider AeroRepublica as a "very interesting growth opportunity", providing access to Latin America's third largest country that has a population of 45m and a relatively undeveloped aviation market. Panama was part of Colombia until 1903 and the two countries have strong links. Copa already serves six cities in Colombia. AeroRepublica is Colombia's second-largest carrier, with a domestic network of 11 cities and a market share of 30%.

In the first place, AeroRepublica will provide feed to Panama - a process that began in December with services from Cartagena and Medellin. The airline has also added frequencies within Colombia and will introduce Cali as a new domestic destination later this year.

AeroRepublica represents a demanding project for Copa, requiring capital spending and management time. While recognising the acquisition's longer-term strategic value, some analysts believe that the carrier will represent a drag on Copa's profit margins for several years. However, Copa can afford it. The company is set to continue to post strong earnings, though operating margins are expected to decline to the 14-15% level this year and in 2007. The balance sheet is healthy, with cash of US$129m (24% of annualised revenues), total assets of US$846m and total debt of US$430m at the end of September 2005. The lease-adjusted debt/capitalisation ratio was 73% - lower than JetBlue's and AirTran's. Contractual obligations on aircraft purchases, operating leases and debt amount to a manageable US$200-300m annually over the next three years.

By Heini Nuutinen
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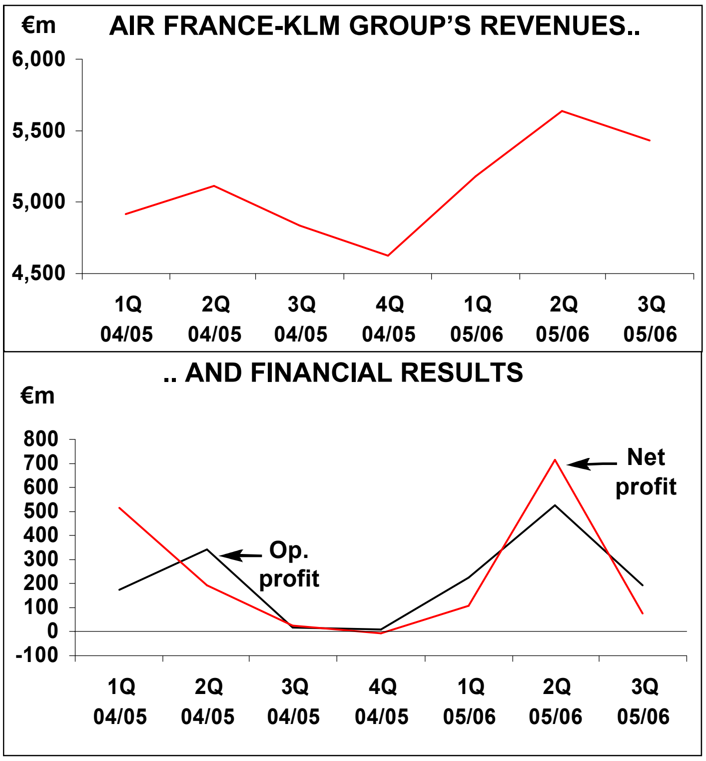
Air France-KLM: building the twin hub strategy

Following the merger of Air France and KLM in May 2004, the France-KLM group is today the largest airline in the world, with 100,000 employees and a fleet of more than 500 aircraft that operates to 234 domestic and international destinations. Can the group's strategy of two separate brands, two largely separate managements and workforces, and twin hubs at CDG and Schiphol be successful in the long-term?

The financial results since Air France and KLM came together have been encouraging (see graphs, below). In its first year of merged operations (the financial year to end of March 2005), Air France-KLM recorded an operating profit of €489m (compared with €405m in 2003/04 on a comparable basis) and net profits of €351m (compared with €292m in the previous financial year), based on a 7% increase in revenue to €19.1bn and a 5.7% rise in passengers carried, to 64m.

And in first three-quarters of the 2005/06 financial year (April-December 2005), Air France-KLM saw operating profit shoot up 77% to €940m compared with the same period in 2004/05, thanks largely to a rise in passengers and cargo carried. In April-December 2005 passengers carried rose by 5.8%, with a 5.8% rise in a capacity outstripped by an 8.8% rise in RPKs, leading to a 2.2% rise in load factor to 81.3%. In the same nine-month period cargo traffic rose by 2.7% and cargo turnover by 11.4% to €2.2bn - Air France is the second largest cargo operator in Europe, after Lufthansa.



Air France-KLM's turnover for the nine-month period increased 9.4% to €14.9bn, and net income rose 23.9% to €731m. However, fuel costs rose 27% in the third quarter (to €1bn), resulting in an operating cost increase of 8.9% in the same period (excluding fuel, operating costs rose by just 5.3%), although the impact of fuel price rises was offset somewhat by hedging and fuel surcharges, which increased again in September 2005, by another €6 for long-haul flights, €2 for medium-haul and €1 for domestic. Nevertheless, Air France-KLM's improved performance was seen as slightly disappointing by some analysts, who had expected an even stronger set of results. One analyst said he had expected a better result as the 2005/06 year was likely to be a "cyclical peak" for the European aviation industry.

That viewpoint is a little harsh, and although January-March is traditionally Air France-KLM's weakest quarter, for the full financial year to end of March 2006 Air France-KLM expects to report an operating income of more than €900m. This implies an operating loss for the January-March 2006 period - whereas Air France-KLM reported an operating profit of €9m in January-March 2005 - but overall, an operating profit of close to €1bn for the full year is still impressive

Air France-KLM has been particularly effective in hedging its fuel costs. As at mid-February, Air-France-KLM had hedged 84% of its fuel needs for the current financial year (2005/06) at $39 per barrel, and at the same date had hedged 62% of its fuel needs for 2006/07 at a price of approximately $47 per barrel, and 34% of its needs for 2007/08 at $50 per barrel. That is better than BA is doing, as at the same date the British flag carrier had hedged 81% of 2005/06 at $45 and 50% of 2006/07 at $55, and even better than Ryanair, which had hedged 90% of 2005/06 needs at $49. But, as group chairman and CEO Jean-Cyril Spinetta admits, "at the end of the day - probably in 2008 - we'll be paying the market price for our fuel as the effect of our hedging policy decreases over time … The only solution is to reduce our costs."

Cost cutting

Since the merger, the group has adopted a variety of cost-cutting measures, including joint purchasing, the integration of country operations, rationalisation of maintenance, the adoption of a joint FFP (Flying Blue), combined corporate sales and joint IT systems (although this latter project will take up to five years to complete).

This cost cutting appears to be going well, and since 2004 Air France-KLM has steadily raised its estimate of synergies from the merger. The latest forecast is for cumulative synergies of €610m by the end of the 2008/09 financial year, up 22% from the original estimate. This breaks down into €180m from revenue management, €98m from commercial synergies, €97m from network savings, €76m from maintenance, €73m from IT, €50m from cargo and €36m from all other synergies.

These synergies come on top of continuing cost cutting programmes at both airlines. KLM saved €520m in costs during the 2004/05 financial year, mainly through cutting 4,500 jobs, using more efficient aircraft and through the elimination of commission for travel agents. At Air France, the so-called "Performance" cost-cutting plan ended in March 2004, having achieved savings of €300m per year. In its place is the "Major Competitiveness 2007" programme, which aims to cut another €800m in costs a year by the 2006/07 financial year. Measures here include outsourcing the airline's entire lost baggage handling service (partly in order to save costs and partly to mitigate the risk of the EU's tougher compensation regulations) and the increased outsourcing of ground handling (for example, 11 airports were outsourced last year to Swissport, which the airline says will give it "tangible cost savings").

As part of this ongoing effort, last January Air France unveiled a new three-year plan for its 35,000 ground staff, in which geographical and functional mobility of staff is encouraged in the light of the increasing use of self check-in terminals and online check-in. In 2005, 250 ground staff retrained to become flight attendants, and in the future half of all flight attendants will be hired from existing ground staff. Following the presentation of the plan, CGT - the giant French trade union - said it suspected that Air France was planning to trim between 3,000 and 5,000 positions from the current workforce of 71,600 by not replacing staff retirements from now until 2008.

In February Air France denied the claim, saying that the workforce would remain "stable" at its current level until the end of the 2008/09 financial year, and that in any case productivity per employee had risen by 21% in the four years to end of September 2005. Nevertheless, unions are worried about the spread of e-ticketing and Air-France KLM's target of eliminating paper tickets by 2007. Currently 70% of domestic passengers and 54% of international passengers "opt" for e-tickets, but the group will accelerate the take-up by imposing a €15 surcharge for each paper ticket issued, to be introduced some time this year.

Despite this, relations between unions and management appear reasonably good, even though union members at Air France joined the general strikes in France last year to protest at the government's economic policies (and which are continuing with another day of action in March). The relationship will be bolstered by a €500 bonus Air France is expected to give to each of its employees for the 2005/06 financial year. Unions protested vehemently last year after the airline only awarded staff a bonus of €45 for 2004/05 while at the same time giving senior management substantial increases in salary.

Management has learnt a lesson from that, although the bonus is likely to cause trouble elsewhere in the group as it applies only to Air France workers, and not to those employed by KLM. In February Air France-KLM also announced it was setting up a pan-European works council, or "employee representatives committee" with a rather unwieldy membership of 37, drawn from across Europe and with each member appointed or elected for four-year terms.

Overall, although the merger of Air France and KLM is giving synergies and the two airlines are continuing to cut costs, essentially the group's core strategy going forward is centred around growth and the winning of market share from competitors, particularly European ones. Spinetta says: "In the past, many mergers have failed because they have concentrated too much on cost-cutting and downsizing and not enough on growing market share and revenues. Right from the beginning, we decided on an offensive rather than defensive strategy - although some industry analysts were disappointed when we decided not to cut back on capacity and staff. But giving up slots and reducing capacity at airports with restricted capacity following a merger would be a great strategic mistake."

Fleet

The base for this growth strategy is the group's massive fleet. Air France currently operates 253 aircraft (see table, opposite) with 35 aircraft on firm order - 11 A320 family aircraft, 10 A380s and 14 777s. The A320 family aircraft are replacing Air France's fleet of 737-500s, while the long-haul fleet will be boosted by nine 777-300ERs and 10 A380s, although the latter's introduction is being delayed for a year, with the first flight now scheduled for April 2008.

"Half the blame" for the A380 delay is due to Airbus, says Air France-KLM, and the other half belong to the Franco-Dutch group itself, as although aircraft will be ready for delivery from October 2007, this is a traditionally a period of low demand for the Air France, and instead it preferred to receive the first aircraft in time for the summer 2008 season, when they will be used initially on routes to China and Japan.

For cargo Air France operates a fleet of seven 747-200Fs and five 747-400ERFs. The 747-200Fs are being phased out and will be replaced partly by five 777-200LRFs that will be delivered from autumn 2008 onwards and partly by three 747-400SFs that are being converted from passenger aircraft from 2007 onwards.

KLM operates 104 aircraft and has 14 aircraft on order. All but one of the orders are for long-haul models, with five outstanding A330-200s due to arrive by March 2007 as part replacement for KLM's fleet of 767-300ERs.

Air France-KLM also has more than 170 aircraft in four subsidiary airlines - the largest regional aircraft network in Europe - and the group is expected to place a large order for up to 100 replacement aircraft within the next few years. At this stage the only potential rival to an Embraer 170/190 order appears to be the proposed Russian Regional Jet and the Bombardier CSeries. Air France's Régional subsidiary - which serves 45 destinations with a fleet of 66 aircraft, the majority of them being Embraer - is also receiving six 100-seat Embraer 190LRs from the first quarter of 2007.

Twin hub focus

Ever since starting its development of CDG as a hub in 1996 (which the airline admits was five years too late), Air France has concentrated primarily on improving frequency on connecting routes into the hub (the average number of weekly frequencies per route is up 82% in 2005 compared with 1996) over rises in capacity (seat capacity is up by 46% over the same period). Now however, Air France believes that its density of connections into CDG is sufficiently developed, and so over the next few years it will concentrate on boosting capacity on the existing medium-haul feeder routes.

CDG is set up with six waves of arrivals and departures a day, and in 2004/05 Air France had around 18,000 weekly connections (both ways) at CDG , defined by Air France as less than a two-hour gap between an arriving medium-haul and departing short-haul flight. This compares with 6,700 weekly connections for KLM at Schiphol, 12,000 for Lufthansa at Frankfurt and 6,600 for BA at Heathrow. For CDG, that translates into approximately 24,000-25,000 passengers arriving at the airport each day on one Air France flight and departing on another one. In 2004/05, this represented 52.9% of all Air France passengers each day at CDG - although, interestingly, this number has been flat for three years, not improving since a fall from the 58% figure that Air France recorded in 2001/02. Air France says the step fall in 2002/03 (to 52.7%) was due to Iraq, SARS, a depressed economic environment and air traffic controller strikes, but it offers no explanation for why the airline has not regained this level over the last three years.

Air France believes that percentage will be improved by infrastructure developments at CDG, which is one of the few hubs in Europe that has room for expansion. Feed comes into CDG from regional subsidiaries Brit Air, Régional and Irish carrier CityJet (which between them connect to more than 20 European destinations), and Air France has recently agreed to rent its own regional terminal (to be named 2G) at CDG for a 19-year period from 2008. The deal with Aeroports de Paris (ADP) will cost Air France-KLM an upfront fee of €89m, and the move comes despite criticism from Air France over the government's decision to approve ADP's proposed increase in fees at CDG by 5% a year until 2010. The group believes that exclusive access to a terminal that will be able to handle 20 regional aircraft at any one time (equating to 3m passengers a year) will help it develop much better feed for its long-haul flights. Air France-KLM had contemplated buying a minority stake in ADP (as Lufthansa did with Fraport), but has now decided that directly funding the terminal it needs would be a better use of its money. This policy may extend to an Air France investment in new satellite S3, which is due to open in 2007 in order to handle A380 operations.

Feed also comes into CDG via the TGV high speed rail network (via a station at CDG) and a strong regional train network through SNCF. On the other hand, the Eurostar train service has eaten into what was previously a lucrative Paris-London market. Eurostar now has a 71% share of passengers on the route, compared with 10%-12% for both Air France and British Airways, and apparently Air France only continues London-Paris flights in order to pick up connecting business passengers that resolutely refuse to take the delay-prone Eurostar. Altogether, connecting passengers account for more than a third of all Air France's passengers coming from the UK.

For Air France, dominating CDG is key to its strategy. Connecting passengers represent 56% of all passengers on Air France's long-haul flights to North America, rising to 63% for routes to Asia, and those connecting passengers come not just from France, but from all over Europe. An analysis of Air France's connecting passengers at CDG shows that only 24% live in France - 40% are from other European countries, 24% from North and South America, 7% from Asia and 5% from Africa/the Middle East. And 31% of connecting passengers are classified as senior managers (defined as director level of a company), which is why Air France believe its medium-haul mainline feed must keep a business class product.

Following the merger, initial route and service restructuring between Air France and KLM took place through 2004 and 2005, but the "final" overhaul and co-ordination of the two airlines' timetables will take effect this summer. In particular, flight arrivals and departures from the "non-country" airline partner are being adjusted to optimise connection times with long-haul flights out of CDG and Schiphol. However, the twin hub strategy is

AIR FRANCE-KLM GROUP FLEET

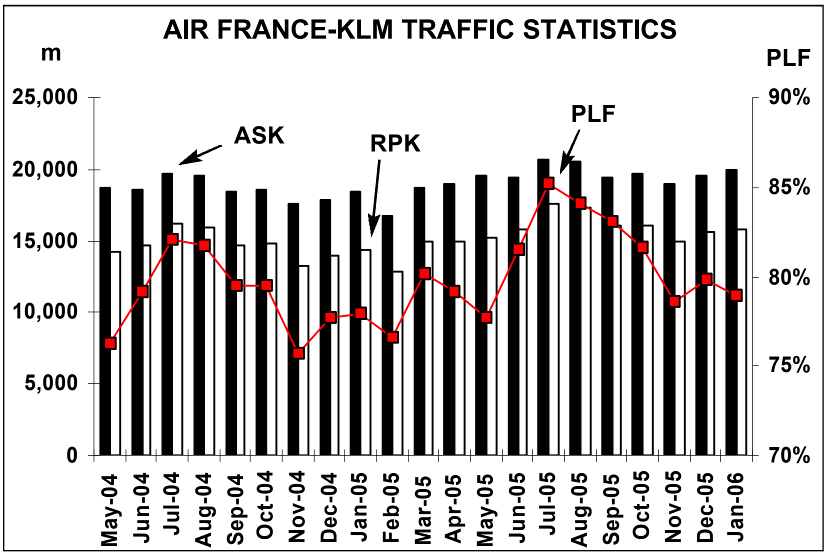
	Fleet	Orders
Air France		
A318	11	7
A319	44	2
A320	67	
A321	13	2
A330	16	
A340	20	
A380		10
737-500	13	
747-200B	3	
747-200F	7	
747-300C	2	
747-400	10	
747-400C	6	
747-400ERF	5	
777-200ER	25	
777-200LRF		5
777-300ER	11	9
Total	**253**	**35**
KLM		
A330	3	5
737-300	14	
737-400	13	
737-800	15	1
737-900	5	
747-400	5	
747-400C	17	
747-400ERF	3	1
767-300ER	9	
777-200ER	10	7
MD-11	10	
Total	**104**	**14**
GROUP TOTAL	**357**	**49**

Note: Excludes regional subsidiaries not about each hub specialising in routes to certain parts of the world, with the group eliminating overlapping routes to the same destinations. Instead, Spinetta insists each hub is being built up on its own merits, maximising incoming feed from both Air France and KLM. What the group will not do is "develop one at the expense of the other", says Air France-KLM - which reflects the political realities behind Europe's first merger of flag-carriers.

Air France-KLM argues that the long-haul networks of the airline are complementary, and indeed - as of the summer 2005 season - of 111 long-haul destinations offered by Air France and KLM, just 32 were served by both airlines, with the figure for medium-haul being 45 out of 126. Inevitably there will be some rationalisation of the network (long-haul destinations with moderate demand will only be served by one of the group's two airlines) but, as Air France puts it, there will be no "sawing off branches". Instead the group is encouraging "fluidity" between the networks via combinable fares that allowing outbound flights on one carrier and inbound on the other.

The group is building feed from France and elsewhere into Schiphol - for example, wholly owned Air France subsidiary Régional launched a Strasbourg-Schiphol route in October 2005. As a result, in 2005 Air France-KLM passengers carried through Schiphol rose 5.4% to 27.4m, representing 62% of all passengers at Schiphol last year. That proportion is increasing, as Air France-KLM passenger growth at Schiphol is rising faster than Schiphol overall passenger growth (3.8% in 2005). KLM hopes to repeat the trend through a 5% increase in capacity this summer, mostly via extra frequencies on existing routes, although some routes are being dropped, such as Amsterdam-Tbilisi. This summer KLM is also realigning its economy product to that of Air France's, including the introduction of in-flight wine and beer.

According to Air France-KLM, the double hub strategy, with feed coming in from more than 150 European destinations, will result in additional revenue of around €60m in 2005/06, and this figure is expected to rise to almost €100m in 2008/09.



Long-haul

The other side of Air France-KLM's twin hub strategy is the building of an even stronger long-haul network out of CDG and Schiphol to the Americas, Asia, Africa and the Middle East, to which Air France and KLM currently serve 112 destinations. In the winter of 2005/06 capacity grew by 6.4% at Air France-KLM, focused mostly on routes to Latin America (up by 25%) and Asia (up by 13%), and this summer group capacity is rising by 5.6% compared with a year ago. The summer increase is coming largely through increased frequencies and the use of aircraft with greater capacity, with a 6% rise coming on long-haul routes (with Asia up 11%, Africa 11% and the Middle East 20%). In comparison, medium-haul capacity is rising this summer by 6.3% (with new routes to Yerevan, Leipzig and Katowice), while domestic capacity will grow by just 1%.

Spinetta says that the group's annual revenue growth target is 5%-6% for the next five years, based on capacity increases of 4%-5% per annum, but with long-haul the focus of growth, with 5% growth in capacity each year until the end of the decade, compared with 2%-3% p.a. at medium-haul. Up to 2010 particularly strong annual growth rates are planned for Latin America and the Middle East (both 8%) and Asia excluding Japan (7%). Most of this increase will come from higher capacity aircraft such as the 777-300 and the

A380, which will replace long-haul aircraft that are currently experiencing load factors approaching the mid-80s. The introduction of larger aircraft and the "efficiency of our connecting hubs" will also cut units costs on long-haul by 3.5% by 2010, the group estimates.

Among the specific long-haul markets targeted is China, to which the group currently operates just four routes, with a Schiphol-Chengdu route being added by KLM in May. Air France and China Southern (which is joining SkyTeam later this year) currently codeshare between CDG and Guangzhou and the two airlines are keen to extend their relationship, perhaps even to a joint venture based on cost and revenue sharing between the two countries. Air France-KLM would also like to operate a route direct between Schiphol and Taipei (without having to stop at Bangkok, as KLM does at present) but to do that it needs to overflow China, and the group will apply for permission soon.

Another area targeted for growth is India, and Air France plans to increase capacity there by 20%-25% a year for the next three years. Air France currently operates 29 flights a week (a tripling of capacity in less than two years), to New Delhi, Mumbai, Chennai, Hyderabad and Bangalore but will increase frequency, add new routes and increase codesharing. The Bangalore route was launched in November 2005 but already has a load factor of more than 90%. Much of the demand for Air France's flights from India is for connecting traffic onto other European destinations, Africa and North America. If passenger growth is maintained Air France will analyse operating A380s into Delhi or Bombay from 2010.

Elsewhere on long-haul, in December 2005 Air France agreed a joint hub deal with TAM to allow Air France passengers onward connections throughout the continent from Sao Paolo and Rio de Janeiro, while in October 2005 KLM started an all business class service between Schiphol and Houston in partnership with Swiss-based PrivatAir (which provides similar services for Lufthansa), taking advantage of increasing demand for business class by oil company executives.

In terms of product, this winter season Air France has axed first class on all long-haul aircraft others than 777s, with the premium product remaining only on routes to selected Asian and North American destinations such as Tokyo, Singapore and Hong King. All A330, A340 and 747 aircraft will instead now have economy and the new business class launched last year, which includes a telephone and flat bed, and which with development and fitting will cost Air France around €300m

This product improvement is vital for Air France-KLM as senior Air France managers are becoming increasingly concerned at proposed long-haul capacity increases from competitors, particularly from Emirates. Air France estimates that if it was able to benefit from the same fees and charges in Paris that Emirates does at Dubai, it would improve its operating income by more than €800m, but the key fear is that the planned long-haul capacity increases from Emirates will depress fares and yield for everyone on routes from Europe to Asia. Air France is also beginning to realise that long haul markets may be as price sensitive as short-haul - when Air France reduced its return fares on one route to North America route by just €14, it immediately gained 10% in market share.

LCC challenge

While Air France-KLM is concerned at potential competition in long-haul, the group appears much less worried about the threat from LCCs. That appears dangerous given the steady steps that both easyJet and Ryanair have made into the French market. easyJet is already the second largest airline in France, carrying some 5m passengers a year out of Paris and in total offering 39 routes from Paris CDG (nine routes, with Lisbon starting on March 1st), Paris Orly (10, with Rome Ciampino being added in April), Nice (13), Grenoble (three), Toulouse (two), Lyon (one), and Marseilles (one, with Liverpool launching in April).

Ryanair has 47 routes out of France, from Paris Beauvais (nine routes), Carcassonne (five), Nantes (four), Nimes (four), Limoges (three), Bergerac (three), Biarritz (two), Marseille Provence (two), La Rochelle (two), Dinard (two), Montpellier (two), and one route from each of Brest, Tours, Poitiers, Rodez, Perpignan, Toulon, St. Etienne, Grenoble and Pau.

Both easyJet and Ryanair are believed to be talking with Lyon-Saint Exupéry airport about setting up an operational base there centred on a new, dedicated LCC terminal with capacity of between 1.2m-1.8m passengers each year. This would be a major challenge to Air France-KLM as Lyon is its second most important French hub, out of which it carries 3.2m passengers each year. The airport's owner, the Lyon chamber of commerce, is apparently offering to convert a charter departure building into a "basic" terminal for LCCs with fees per passenger of around €1.50, compared with €7.95 levied to Air France-KLM passengers at the existing terminal. easyJet currently operates 17 flights week out of Lyon to Stansted, but it carries 2.1m passengers a year out of nearby Nice airport, and would look to build up a similar level of business out of Lyon if it agreed a suitable deal.

Naturally Air France is complaining bitterly about the proposed terminal, and has filed a legal case not only against Lyon's low-cost terminal but also against similar plans at both Geneva and Marseilles airports. In October 2005 Spinetta said that LCCs were obtaining airport facilities at much lower price than Air France-KLM even though "runways and control towers" were paid for by other airlines (such as Air France).

This is nothing more than a normal competitive reaction by Air France-KLM, but the group's only other response to the LCCs appears to be ongoing cost cutting and a (somewhat reluctant) dropping of fares where necessary. For example, in November and December 2005 Air France offered 4m seats for flights in 2006 at promotional fares up to 72% lower than normal (domestic routes were available from €89 return and Europe flights from €139 return).

When pressed on the point, the response from Air France-KLM's management is that as long as the group keeps building its long-haul business, the impact of the LCCs will be minimal. Air France considers that LCCs have a totally different business model, and its calculations show that 65% of the difference in unit costs are due to two factors: denser seat configurations and better aircraft utilisation. In these areas - according to Air France - a "typical LCC" is 15% and 24% cheaper respectively (in terms of unit cost) than Air France. But Air France believes these differences are "acceptable", as its lower aircraft utilisation is inevitable due to the peaks of CDG, while lower seat density per aircraft is a result of business seats that are essential for securing feed into long-haul flights out of CDG. In other areas - particularly distribution (only 9% of ticket sales to the French market come via the Air France website, for example) - Air France is working hard to reduce its costs down to an LCC's level, but as a whole Air France believes it would be a mistake strategically to be drawn into a bitter product, cost and fare battle with LCCs on point-to-point markets.

Instead, Air France prefers to concentrate on its hub strategy. Spinetta quotes a figure from a 2005 study by the Boston Consulting Group that on long-haul flights out of Europe, connecting passengers accounted for 70m out of a total of 125m passengers in 2003, and that in 2013 connecting passengers will account for 115m out of 215m passengers. Although the proportion of connecting passengers falls over this period (from 56% to 53%), Air France-KLM is basing its strategy on the fact that in absolute terms there will always be a huge market for connecting passengers, and that in CDG and (to a lesser extent) Schiphol, Air France-KLM has key assets in securing this connecting business.

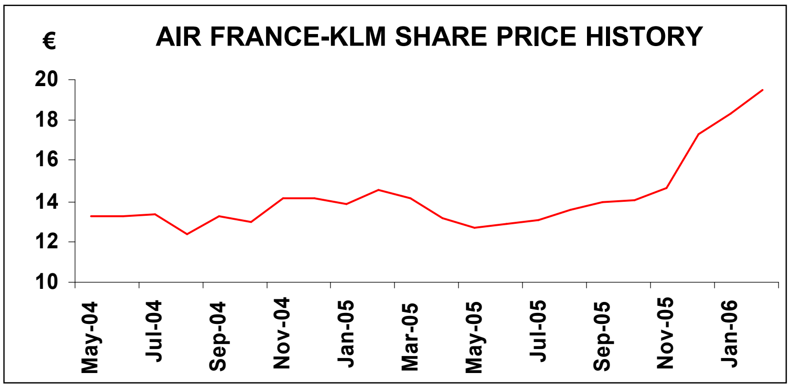
The future

For the moment, Air-France-KLM's strategy seems to be working. On release of March-December 2005 results (in mid-February), Air France-KLM's share price rose to more than €20 - its highest level since the group was formed in May 2004 (see graph, opposite). Results for the financial year to end of March are released in May, and barring the unexpected, the group will reveal a record profit margin. Importantly, Air France-KLM's cash position stood at a relatively healthy €4.3bn as at the end of 2005, compared with €3.1bn a year earlier, with €817m of the increase in cash coming from the sale of 23.4% of global distribution system Amadeus. More importantly, net debt fell by €1.1bn in the first nine months of 2005/06, to stand at €4.5bn as at 31 December 2005.

That's not to say everything is going according to plan. In January, after continuing opposition from the US Justice Department, Air France-KLM, Delta and Northwest admitted defeat in their exhaustive efforts (which were initiated back in 2001) to secure antitrust immunity from the US for their SkyTeam alliance. Air France-KLM now claims that the existing bilateral agreements between Air France and Delta, and between KLM and Northwest, will continue irrespective of antitrust immunity, and that codesharing and other permissible links between the airlines will produce around 70% of the benefits they would have gained if antitrust immunity had been secured. But there's no doubt that the failure to win immunity is a setback for Air France-KLM, and the inability to harmonise both fares and timetables across the SkyTeam members (particularly between Delta and Northwest) will cut many millions of euros from revenues at the respective airlines.

In any case, Delta and Northwest both went into Chapter 11 bankruptcy protection in September 2005 and while Air-France KLM says this does not impact upon the Franco-Dutch group, at the very least the moves signify that Air France-KLM's SkyTeam partners are in no position to grow and become major players in the global aviation industry - let alone within the SkyTeam alliance - even though Delta, for example, wants to focus on the transatlantic market. A Northwest-Delta merger may be the best result for Air France-KLM in the long term.

With transatlantic moves blocked, speculation will inevitably grow on potential equity deals this side of the Atlantic, or even further afield. Thanks to historical strategic and political reasons, Air France currently has an eclectic portfolio that includes, among others, stakes in Air Caledonie (2%), Air Madagascar (3%), Air Mauritius (3%), All Africa Airways (51%), Air Tahiti (7.5%), Austrian Airlines (1.5%),



Cameroon Airlines (3.5%), CCM Airlines (12%), Royal Air Maroc (3%) and Tunisair (5.5%).

At the start of the year the press speculated on a possible bid by Air France for Alitalia, after it invested €20m to maintain the 2% stake in the Italian flag carrier that it has held since 2002 (see *Aviation Strategy*, January/February 2006). Air France denied the bid rumours, and it makes little sense for Air France to get entangled with the mess of Alitalia. Among the other airlines Air France has been linked with in terms of an equity stake are THY (the airline is supposedly in negotiations to buy 51% from the Turkish state), and Garuda - both of which have been dismissed by Air France-KLM.

Air France-KLM will probably steer clear of risky investments and instead concentrate on a declared strategy that is clear, consistent and which - for the moment at least - appears to be working. Analysts are prepared to give group management the benefit of the doubt over its assessment of the threat from LCCs, but nevertheless Air France-KLM must continue to drive down costs where possible. Excluding currency fluctuations, Air France has kept its cost per ASK in the Euro-cent 6.5 to 7 range for the last seven or eight years, and unit cost would be lower by at least 10% over that period if oil costs are stripped out. While this is not as good as the LCCs it's a fair performance, although there is no room for complacency in the drive to cut costs.

The main uncertainty in the short-term may be a change in top management. Spinetta is contracted until 2010, but French sources suggest he may step down before then for "personal reasons".

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
Alaska	Apr-Jun 04	699	719	-20	-2	-2.9%	-0.3%	9,068	6,605	72.8%	4,116	10,255
	Jul-Sep 04	702	626	76	41	10.8%	5.8%	9,675	7,356	76.0%	4,589	10,201
	Oct-Dec 04	656	714	-58	-45	-8.8%	-6.9%	8,774	6,399	72.9%	3,998	9,433
	Year 2004	**2,724**	**2,804**	**-80**	**-15**	**-2.9%**	**-0.6%**	**35,849**	**26,121**	**72.9%**	**16,295**	**9,968**
	Jan-Mar 05	643	723	-81	-80	-12.6%	-12.4%	8,642	6,271	72.6%	3,851	9,219
	Apr-Jun 05	756	747	9	17	1.2%	2.2%	8,920	6,947	77.9%	4,232	9,144
	Jul-Sep 05	689	609	80	82	11.6%	11.9%	9,369	7,399	79.0%	4,632	8,961
American	Oct-Dec 04	4,541	4,896	-355	-387	-7.8%	-8.5%	69,049	51,325	74.3%		90,700
	Year 2004	**18,645**	**18,789**	**-144**	**-761**	**-0.8%**	**-4.1%**	**280,042**	**209,473**	**74.8%**		**90,700**
	Jan-Mar 05	4,750	4,727	23	-162	0.5%	-3.4%	68,965	52,024	75.4%		88,500
	Apr-Jun 05	5,309	5,080	229	58	4.3%	1.1%	72,447	57,605	79.5%		88,500
	Jul-Sep 05	5,485	5,446	39	-153	0.7%	-2.8%	73,405	59,584	81.2%		88,500
	Oct-Dec 05	5,168	5,552	-384	-604	-7.4%	-11.7%	68,599	53,471	77.9%		87,200
America West	Oct-Dec 04	579	602	-24	-50	-4.1%	-8.6%	12,236	9,471	77.4%	5,336	11,845
	Year 2004	**2,339**	**2,357**	**-18**	**-90**	**-0.8%**	**-3.8%**	**48,525**	**37,550**	**77.4%**	**21,132**	**11,904**
	Jan-Mar 05	723	673	50	34	6.9%	4.7%	11,749	9,126	77.7%	5,172	11,869
	Apr-Jun 05	833	803	30	14	3.6%	1.7%	12,480	10,277	82.3%	5,752	12,200
	Jul-Sep 05	846	904	-58	-71	-6.9%	-8.4%	12,673	10,192	80.4%	5,802	12,179
Continental	Oct-Dec 04	2,397	2,558	-161	-206	-6.7%	-8.6%	37,962	29,350	77.3%	14,253	
	Year 2004	**9,744**	**9,973**	**-229**	**-363**	**-2.4%**	**-3.7%**	**95,082**	**73,151**	**76.9%**	**56,482**	**38,255**
	Jan-Mar 05	2,505	2,676	-171	-184	-6.8%	-7.3%	37,955	29,148	76.8%	14,122	
	Apr-Jun 05	2,857	2,738	119	100	4.2%	3.5%	36,138	29,041	80.4%	11,465	
	Jul-Sep 05	3,001	2,892	109	61	3.6%	2.0%	37,450	31,185	81.7%	11,642	
	Oct-Dec 05	2,845	2,939	-94	-43	-3.3%	-1.5%	36,410	28,449	78.1%	15,447	
Delta	Jul-Sep 04	3,871	4,294	-423	-646	-10.9%	-16.7%	63,031	48,952	77.7%	28,247	69,700
	Oct-Dec 04	3,641	5,897	-2,256	-2,206	-62.0%	-60.6%	61,384	45,237	73.7%	27,794	69,150
	Year 2004	**15,002**	**18,310**	**-3,308**	**-5,198**	**-22.1%**	**-34.6%**	**244,097**	**182,351**	**74.7%**	**110,000**	**69,150**
	Jan-Mar 05	3,647	4,604	-957	-1,071	-26.2%	-29.4%	60,955	45,344	74.4%	29,230	66,500
	Apr-Jun 05	4,185	4,314	-120	-382	-2.9%	-9.1%	65,136	50,957	78.2%	31,582	65,300
	Jul-Sep 05	4,216	4,456	-240	-1,130	-5.7%	-26.8%	66,054	52,323	79.2%	30,870	58,000
Northwest	Jul-Sep 04	3,052	2,973	79	-38	2.6%	-1.2%	38,324	31,774	82.9%	14,800	38,178
	Oct-Dec 04	2,753	3,177	-424	-412	-15.4%	-15.0%	36,964	29,107	78.7%	13,775	
	Year 2004	**11,279**	**11,784**	**-505**	**-848**	**-4.5%**	**-7.5%**	**147,055**	**117,981**	**80.2%**	**55,374**	**39,342**
	Jan-Mar 05	2,798	3,090	-292	-450	-10.4%	-16.1%	36,636	29,238	79.8%	13,502	39,105
	Apr-Jun 05	3,195	3,375	-180	-217	-5.6%	-6.8%	38,256	32,218	84.2%	15,145	38,348
	Jul-Sep 05	3,378	3,545	-167	-469	-4.9%	-13.9%	38,881	32,889	84.6%	14,984	33,755
Southwest	Jul-Sep 04	1,674	1,483	191	119	11.4%	7.1%	31,359	22,794	72.7%	18,334	30,657
	Oct-Dec 04	1,655	1,535	120	56	7.3%	3.4%	32,540	21,140	65.0%	17,709	31,011
	Year 2004	**6,530**	**5,976**	**554**	**313**	**8.5%**	**4.8%**	**123,693**	**85,966**	**69.5%**	**70,903**	**31,011**
	Jan-Mar 05	1,663	1,557	106	76	6.4%	4.6%	32,559	21,304	65.4%	17,474	30,974
	Apr-Jun 05	1,944	1,667	277	159	14.2%	8.2%	34,341	24,912	72.5%	20,098	31,366
	Jul-Sep 05	1,989	1,716	273	227	13.7%	11.4%	35,170	26,336	74.9%	20,638	31,382
	Oct-Dec 05	1,987	1,824	163	86	8.2%	4.3%	35,000	24,364	69.6%	19,485	31,729
United	Jul-Sep 04	4,305	4,385	-80	-274	-1.9%	-6.4%	61,403	50,439	82.1%	19,360	59,000
	Oct-Dec 04	3,988	4,481	-493	-664	-12.4%	-16.6%	58,033	44,824	77.2%	17,143	57,500
	Year 2004	**16,391**	**17,168**	**-777**	**-1,644**	**-4.7%**	**-10.0%**	**233,929**	**185,388**	**79.2%**	**70,914**	**58,900**
	Jan-Mar 05	**3,915**	4,165	-250	-1,070	-6.4%	-27.3%	55,133	43,103	78.2%	15,667	56,300
	Apr-Jun 05	4,423	4,375	48	-1,430	1.1%	-32.3%	56,538	47,156	83.4%	17,150	55,600
	Jul-Sep 05	4,655	4,490	165	-1,172	3.5%	-25.2%	58,123	48,771	83.9%	17,448	54,600
	Oct-Dec 05	4,386	4,568	-182	-17	-4.1%	-0.4%	55,991	44,869	80.1%	16,498	53,200
US Airways	Jul-Sep 04	1,799	1,976	-177	-232	-9.8%	-12.9%	25,462	19,382	76.1%	14,274	26,835
	Oct-Dec 04	1,660	1,802	-142	-236	-8.6%	-14.2%	24,514	17,622	71.9%	14,097	24,628
	Year 2004	**7,117**	**7,495**	**-378**	**-611**	**-5.3%**	**-8.6%**	**98,735**	**72,559**	**73.5%**	**55,954**	**24,628**
	Jan-Mar 05	1,628	1,829	-201	-191	-12.3%	-11.7%	24,976	17,779	71.2%	14,068	23,696
	Apr-Jun 05	1,945	1,904	41	-62	2.1%	-3.2%	26,547	20,165	76.0%	15,826	21,396
	Jul-Sep 05	926	997	-71	-87	-7.7%	-9.4%	21,281	16,503	77.5%	10,109	
JetBlue	Jul-Sep 04	323	300	23	8	7.1%	2.5%	7,950	6,753	84.9%	3,033	6,127
	Oct-Dec 04	334	322	12	2	3.6%	0.6%	8,200	6,802	82.9%	3,179	6,413
	Year 2004	**1,266**	**1,153**	**113**	**47**	**8.9%**	**3.7%**	**30,434**	**25,315**	**83.2%**	**11,783**	**6,413**
	Jan-Mar 05	374	349	26	7	7.0%	1.9%	8,318	7,136	85.8%	3,400	6,797
	Apr-Jun 05	430	390	39	12	9.1%	2.8%	9,408	8,247	87.7%	3,695	7,284
	Jul-Sep 05	453	439	14	3	3.1%	0.7%	10,190	8,825	86.6%	3,782	7,452
	Oct-Dec 05	446	478	-32	-42	-7.2%	-9.4%	10,229	8,229	81.1%	3,851	8,326

Note: Annual figures may not add up to sum of interim results due to adjustments and consolidation. 1 ASM = 1.6093 ASK. All US airline Financial Year Ends are 31/12.

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
Air France/												
KLM Group	Apr-Jun 04	5,394	5,205	189	115	3.5%	2.1%	48,944	38,025	77.7%		
YE 31/03	Jul-Sep 04	6,328	5,964	364	248	5.8%	3.9%	57,668	46,767	81.1%		
	Oct-Dec 04	6,628	5,745	883	83	13.3%	1.3%	54,144	42,042	77.6%	15,934	
	Year 2004/05	**24,641**	**21,744**	**641**	**453**	**2.6%**	**1.8%**	**214,606**	**168,998**	**78.7%**	**64,075**	**102,077**
	Apr-Jun 05	6,257	5,982	275	135	4.4%	2.2%	57,936	46,041	79.5%	17,948	101,886
	Jul-Sep 05	6,790	6,154	636	864	9.4%	12.7%	60,472	50,961	84.2%	18,705	
	Oct-Dec 05	6,430	6,205	225	91	3.5%	1.4%	58,266	46,644	80.0%	17,120	102,291
BA	Jan-Mar 04	3,386	3,327	164	22	4.8%	0.6%	35,232	24,932	70.8%	8,142	46,551
YE 31/03	**Year 2003/04**	**13,806**	**13,067**	**739**	**237**	**5.4%**	**1.7%**	**141,273**	**103,092**	**73.0%**	**36,103**	**49,072**
	Apr-Jun 04	3,479	3,208	271	127	7.8%	3.7%	36,150	27,083	74.9%	9,288	46,280
	Jul-Sep 04	3,645	3,213	432	221	11.9%	6.1%	36,639	28,749	78.5%	9,822	46,179
	Oct-Dec 04	3,801	3,589	212	94	5.6%	2.5%	35,723	25,999	72.8%	8,428	45,888
	Jan-Mar 05	3,549	3,474	96	17	2.7%	0.5%	35,677	26,062	73.0%	8,178	45,914
	Year 2004/05	**14,681**	**13,666**	**1,015**	**472**	**6.9%**	**3.2%**	**144,189**	**107,892**	**74.8%**	**35,717**	**46,065**
	Apr-Jun 05	3,716	3,398	318	162	8.6%	4.4%	36,706	27,768	75.6%	9,177	46,079
	Jul-Sep 05	3,887	3,427	460	301	11.8%	7.7%	37,452	29,812	79.6%	9,767	46,144
	Oct-Dec 05	3,664	3,362	301	212	8.2%	5.8%	37,119	27,499	74.1%	8,530	45,624
Iberia	Jan-Mar 04	1,325	1,356	-32	-1	-2.4%	-0.1%	14,563	10,721	73.6%	6,136	
YE 31/12	Apr-Jun 04	1,461	1,371	90	95	6.2%	6.5%	14,743	11,106	75.3%	6,913	
	Jul-Sep 04	1,593	1,452	141	110	8.9%	6.9%	16,053	12,699	79.1%	7,314	25,839
	Oct-Dec 04	1,660	1,605	55	74	3.3%	4.5%	15,700	11,398	72.6%	6,329	24,783
	Year 2004	**5,895**	**5,663**	**232**	**230**	**3.9%**	**3.9%**	**61,058**	**45,924**	**75.2%**	**26,692**	**24,993**
	Jan-Mar 05	1,531	1,571	-40	-21	-2.6%	-1.4%	15,261	11,421	74.8%	6,181	24,044
	Apr-Jun 05	1,466	1,392	74	54	5.0%	3.7%	15,843	11,939	75.4%	7,242	24,435
	Jul-Sep 05	1,439	1,368	71	53	4.9%	3.7%	16,659	13,619	81.8%	7,656	25,069
	Oct-Dec 05	1,451	1,504	-53	-7	-3.7%	-0.5%	15,864	12,082	76.2%	6,596	23,845
Lufthansa												
YE 31/12	**Year 2003**	**20,037**	**20,222**	**-185**	**-1,236**	**-0.9%**	**-6.2%**	**124,000**	**90,700**	**73.1%**	**45,440**	**94,798**
	Jan-Mar 04	4,742	4,883	-141	76	-3.0%	1.6%	31,787	23,030	72.5%	11,414	93,479
	Apr-Jun 04	5,269	5,045	224	-28	4.3%	-0.5%	36,440	26,959	74.0%	13,336	
	Jul-Sep 04	5,511	5,164	347	154	6.3%	2.8%	38,115	28,883	75.8%	14,053	92,718
	Year 2004	**25,655**	**24,285**	**1370**	**551**	**5.3%**	**2.1%**	**140,648**	**104,064**	**74.0%**	**50,300**	**90,763**
	Jan-Mar 05	5,041	5,079	-38	-150	-0.8%	-3.0%	32,477	23,793	73.3%	11,190	89,939
	Apr-Jun 05	5,487	5,138	349	140	6.4%	2.6%	37,700	28,178	74.7%	13,583	90,373
	Jul-Sep 05	5,798	5,411	387	501	6.7%	8.6%	38,967	30,466	78.2%	14,203	91,433
SAS												
YE 31/12	Jan-Mar 04	1,652	1,823	-171	-184	-10.4%	-11.1%	11,852	7,031	59.3%	7,238	
	Apr-Jun 04	2,007	1,979	27	13	1.3%	0.6%	13,456	8,960	66.6%	8,879	
	Jul-Sep 04	2,099	1,860	239	9	11.4%	0.4%	13,557	9,198	67.8%	8,591	
	Oct-Dec 04	2,271	2,293	-22	-96	-1.0%	-4.2%	12,667	7,649	60.4%	7,645	32,600
	Year 2004	**8,830**	**8,967**	**-137**	**-283**	**-1.6%**	**-3.2%**	**43,077**	**28,576**	**64.0%**	**32,354**	**32,481**
	Jan-Mar 05	1,842	1,990	-148	-137	-8.0%	-7.4%	12,465	7,342	58.9%	7,299	31,797
	Apr-Jun 05	2,046	1,925	121	64	5.9%	3.1%	13,810	9,259	67.0%	9,357	32,285
	Jul-Sep 05	2,140	2,036	104	68	4.9%	3.2%	13,599	9,838	72.3%	9,325	
	Oct-Dec 05	2,050	1,966	84	25	4.1%	1.2%	12,880	8,646	67.1%	8,945	
	Year 2005	**7,789**	**7,717**	**173**	**32**	**2.2%**	**0.4%**	**38,454**	**26,487**	**68.9%**	**23,799**	**32,363**
Ryanair												
YE 31/03	**Year 2002/03**	**910**	**625**	**285**	**259**	**31.3%**	**28.5%**	**14,072**		**84.0%**	**15,740**	**1,900**
	Year 2003/04	**1,308**	**978**	**330**	**252**	**25.2%**	**19.3%**	**22,524**		**81.0%**	**23,133**	**2,300**
	Apr-Jun 04	366	288	78	64	21.3%	17.5%			83.0%	6,600	2,444
	Jul-Sep 04	516	305	211	181	40.9%	35.1%			90.0%	7,400	2,531
	Oct-Dec 04	402	335	68	47	16.9%	11.7%			84.0%	6,900	2,671
	Year 2004/05	**1,727**	**1,301**	**426**	**345**	**24.7%**	**20.0%**	**28,665**		**84.0%**	**27,593**	
	Apr-Jun 05	488	392	96	84	19.7%	17.2%			83.4%	8,500	2,764
	Jul-Sep 05	652	409	244	208	37.4%	31.9%				9,500	2,987
	Oct-Dec 05	439	381	58	44	13.2%	10.0%			83.0%	8,600	2,963
easyJet												
YE 30/09	**Year 2001/02**	**864**	**656**	**111**	**77**	**12.8%**	**8.9%**	**10,769**	**9,218**	**84.8%**	**11,350**	**3,100**
	Oct-Mar 03	602	676	-74	-76	-12.3%	-12.6%	9,594	7,938	82.2%	9,347	
	Year 2002/03	**1,553**	**1,472**	**81**	**54**	**5.2%**	**3.5%**	**21,024**	**17,735**	**84.1%**	**20,300**	**3,372**
	Oct-Mar 04	803	861	-58	-36	-7.2%	-4.5%	10,991	9,175	83.3%	10,800	
	Year 2003/04	**1,963**	**1,871**	**92**	**74**	**4.7%**	**3.8%**	**25,448**	**21,566**	**84.5%**	**24,300**	**3,727**
	Oct-Mar 05	1,039	1,116	-77	-41	-7.4%	-3.9%	14,526	12,150	83.8%	13,500	
	Year 2004/05	**2,364**	**2,278**	**86**	**76**	**3.6%**	**3.2%**	**32,141**	**27,448**	**85.2%**	**29,600**	**4,152**

Note: Annual figures may not add up to sum of interim results due to adjustments and consolidation.

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
ANA												
YE 31/03	**Year 2001/02**	**9,714**	**9,529**	**185**	**-76**	**1.9%**	**-0.8%**	**87,908**	**57,904**	**64.7%**	**49,306**	**29095**
	Year 2002/03	**10,116**	**10,137**	**-22**	**-235**	**-0.2%**	**-2.3%**	**88,539**	**59,107**	**66.7%**	**50,916**	**28,907**
	Year 2003/04	**11,529**	**11,204**	**325**	**234**	**2.8%**	**2.0%**	**87,772**	**55,807**	**63.6%**	**44,800**	**28,870**
	Year 2004/05	**12,024**	**11,301**	**723**	**251**	**6.0%**	**2.1%**	**85,838**	**55,807**	**65.0%**		**29,098**
Cathay Pacific												
YE 31/12	**Year 2002**	**4,243**	**3,634**	**609**	**513**	**14.4%**	**12.1%**	**63,050**		**77.8%**		**14,600**
	Jan-Jun 03	1,575	1,672	-97	-159	-6.2%	-10.1%	26,831		64.4%	4,019	14,800
	Year 2003	**3,810**	**3,523**	**287**	**168**	**7.5%**	**4.4%**	**59,280**	**42,774**	**72.2%**	**12,322**	**14,673**
	Jan-Jun 04	2,331	2,046	285	233	12.2%	10.0%	35,250		76.1%	6,404	
	Year 2004	**5,024**	**4,350**	**674**	**581**	**13.4%**	**11.6%**	**74,062**	**57,283**	**77.3%**	**13,664**	**15,054**
	Jan-Jun 05	3,074	2,799	275	225	8.9%	7.3%	39,535		78.1%	7,333	15,400
JAL												
YE 31/03	**Year 2001/02**	**9,607**	**9,741**	**-135**	**-286**	**-1.4%**	**-3.0%**				**37,183**	
	Year 2002/03	**17,387**	**17,298**	**88**	**97**	**0.5%**	**0.6%**	**145,944**	**99,190**	**68.0%**	**56,022**	
	Year 2003/04	**18,398**	**19,042**	**-644**	**-844**	**-3.5%**	**-4.6%**	**145,900**	**93,847**	**64.3%**	**58,241**	
	Year 2004/05	**19,905**	**19,381**	**524**	**281**	**2.6%**	**1.4%**		**102,354**	**67.4%**	**59,448**	
Korean Air												
YE 31/12	**Year 2001**	**4,309**	**4,468**	**-159**	**-448**	**-3.7%**	**-10.4%**	**55,802**	**38,452**	**68.9%**	**21,638**	**15,127**
	Year 2002	**5,047**	**4,679**	**368**	**366**	**7.3%**	**7.3%**	**58,310**	**41,818**	**71.7%**	**22,160**	**15,309**
	Year 2003	**5,172**	**4,911**	**261**	**-202**	**5.0%**	**-3.9%**	**59,074**	**40,507**	**68.6%**	**21,811**	**15,352**
	Year 2004	**6,332**	**5,994**	**338**	**414**	**5.3%**	**6.5%**	**64,533**	**45,879**	**71.1%**	**21,280**	**14,994**
Malaysian												
YE 31/03	**Year 2001/02**	**2,228**	**2,518**	**-204**	**-220**	**-9.2%**	**-9.9%**	**52,595**	**34,709**	**66.0%**	**15,734**	**21,438**
	Year 2002/03	**2,350**	**2,343**	**7**	**89**	**0.3%**	**3.8%**	**54,266**	**37,653**	**69.4%**		**21,916**
	Year 2003/04	**2,308**	**2,258**	**50**	**121**	**2.2%**	**5.2%**	**55,692**	**37,659**	**67.6%**	**15,375**	**20,789**
Qantas												
YE 30/06	**Year 2001/02**	**6,133**	**5,785**	**348**	**232**	**5.7%**	**3.8%**	**95,944**	**75,134**	**78.3%**	**27,128**	**33,044**
	Jul-Dec 02	3,429	3,126	303	200	8.8%	5.8%	50,948	40,743	80.0%	15,161	34,770
	Year 2002/03	**7,588**	**7,217**	**335**	**231**	**4.4%**	**3.0%**	**99,509**	**77,225**	**77.6%**	**28,884**	**34,872**
	Jul-Dec 03	4,348	3,898	450	269	10.3%	6.2%	50,685	40,419	79.7%	15,107	33,552
	Year 2003/04	**7,838**	**7,079**	**759**	**448**	**9.7%**	**5.7%**	**104,200**	**81,276**	**78.0%**	**30,076**	**33,862**
	Jul-Dec 04	5,017	4,493	524	358	10.4%	7.1%	57,402	43,907	76.5%	16,548	35,310
	Year 2004/05	**9,524**	**8,679**	**845**	**575**	**8.9%**	**6.0%**	**114,003**	**86,986**	**76.3%**	**32,660**	
Singapore												
YE 31/03	**Year 2001/02**	**5,399**	**4,837**	**562**	**395**	**10.4%**	**7.3%**	**94,559**	**69,995**	**74.0%**	**14,765**	**29,422**
	Year 2002/03	**5,936**	**5,531**	**405**	**601**	**6.8%**	**10.1%**	**99,566**	**74,183**	**74.5%**	**15,326**	**30,243**
	Year 2003/04	**5,732**	**5,332**	**400**	**525**	**7.0%**	**9.2%**	**88,253**	**64,685**	**73.3%**	**13,278**	**29,734**

Note: Annual figures may not add up to sum of interim results due to adjustments and consolidation. 1 ASM = 1.6093 ASK

AIRCRAFT AVAILABLE FOR SALE OR LEASE - MONTH END

	Old narrowbodies	Old widebodies	Total old	New narrowbodies	New widebodies	Total new	Total
Dec-1999	243	134	377	101	53	154	531
Dec-2000	302	172	474	160	42	202	676
Dec-2001	368	188	556	291	101	392	948
Dec-2002	366	144	510	273	102	375	885
Dec-2003	275	117	392	274	131	405	797
Dec-2004	185	56	241	194	48	242	483
Dec-2005	145	51	196	258	45	303	499

AIRCRAFT SOLD OR LEASED

	Old narrowbodies	Old widebodies	Total old	New narrowbodies	New widebodies	Total new	Total
1999	582	230	812	989	170	1,159	1,971
2000	475	205	680	895	223	1,118	1,798
2001	286	142	428	1,055	198	1,253	1,681
2002	439	213	652	1,205	246	1,451	2,103
2003	408	94	502	1,119	212	1,331	1,833
2004	321	177	498	1,815	325	2,140	2,638
Dec-2005	27	13	40	172	42	214	254

Source: *BACK* **Notes:** *As at end year; Old narrowbodies = 707, DC8, DC9, 727,737-100/200, F28, BAC 1-11, Caravelle; Old widebodies = L1011, DC10, 747-100/200, A300B4; New narrow-bodies = 737-300+, 757. A320 types, BAe 146, F100, RJ; New widebodies = 747-300+, 767, 777. A600, A310, A330, A340.*

EUROPEAN SCHEDULED TRAFFIC

	Intra-Europe			North Atlantic			Europe-Far East			Total long-haul			Total Int'l		
	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %
1997	174.8	110.9	63.4	176.5	138.2	78.3	130.4	96.9	74.3	419.0	320.5	76.5	621.9	450.2	72.4
1998	188.3	120.3	63.9	194.2	149.7	77.1	135.4	100.6	74.3	453.6	344.2	75.9	673.2	484.8	72
1999	200.0	124.9	62.5	218.9	166.5	76.1	134.5	103.1	76.7	492.3	371.0	75.4	727.2	519.5	71.4
2000	208.2	132.8	63.8	229.9	179.4	78.1	137.8	108.0	78.3	508.9	396.5	77.9	755.0	555.2	73.5
2001	212.9	133.4	62.7	217.6	161.3	74.1	131.7	100.9	76.6	492.2	372.6	75.7	743.3	530.5	71.4
2002	197.2	129.3	65.6	181.0	144.4	79.8	129.1	104.4	80.9	447.8	355.1	79.3	679.2	507.7	74.7
2003	210.7	136.7	64.9	215.0	171.3	79.7	131.7	101.2	76.8	497.2	390.8	78.6	742.6	551.3	74.2
2004	220.6	144.2	65.4	224.0	182.9	81.6	153.6	119.9	78.0	535.2	428.7	80.1	795.7	600.7	75.5
2005	309.3	207.7	67.2	225.9	186.6	82.6	168.6	134.4	79.7	562.6	456.4	81.1	830.8	639.3	76.9
Jan-06	24.1	14.1	58.8	16.9	12.9	76.0	15.1	12.0	80.0	47.3	37.8	79.9	68.3	50.5	73.9
Ann. change	1.0%	4.0%	1.7	-0.4%	-1.2%	-0.6	11.9%	15.0%	2.1	4.9%	5.4%	0.3	3.8%	5.2%	0.9

Source: AEA

US MAJORS' SCHEDULED TRAFFIC

	Domestic			North Atlantic			Pacific			Latin America			Total Int'l		
	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %
1997	953.3	663.7	69.6	138.1	108.9	78.9	122.0	91.2	74.7	71.3	46.4	65.1	331.2	246.5	74.4
1998	960.8	678.8	70.7	150.5	117.8	78.3	112.7	82.5	73.2	83.5	52.4	62.8	346.7	252.7	72.9
1999	1,007.3	707.5	70.2	164.2	128.2	78.1	113.2	84.7	74.8	81.3	54.3	66.8	358.7	267.2	74.5
2000	1,033.5	740.1	71.6	178.9	141.4	79.0	127.7	97.7	76.5	83.0	57.6	69.4	380.9	289.9	76.1
2001	1,025.4	712.2	69.5	173.7	128.8	74.2	120.1	88.0	73.3	83.4	56.9	68.2	377.2	273.7	72.6
2002	990.0	701.6	70.9	159.0	125.7	67.2	103.0	83.0	80.5	84.1	56.8	67.5	346.1	265.5	76.7
2003	963.1	706.6	73.4	148.3	117.6	79.3	94.8	74.0	80.5	84.2	59.3	70.5	327.2	251.0	76.7
2004	1,014.5	763.6	75.3	164.2	134.4	81.8	105.1	87.6	83.4	96.4	68.0	70.5	365.6	289.8	79.3
2005	1,004.4	783.7	78.0	174.6	143.3	82.1	116.8	96.0	82.2	105.0	76.6	72.9	396.4	315.9	79.7
Jan 06	80.1	59.0	73.7	13.3	9.7	73.5	9.7	8.0	82.5	9.8	7.3	75.0	32.8	25.1	76.6
Ann change	-2.1%	1.5%	2.6	2.1%	0.4%	-1.2	1.5%	2.5%	0.8	2.9%	3.7%	0.6	2.2%	2.0%	-0.1

Note: US Majors = Aloha, Alaska, American, Am. West, American Transair, Continental, Cont. Micronesia, Delta, Hawaiian JetBlue, MidWest Express, Northwest,Southwest, United and US Airways **Source**: ATA

JET ORDERS

	Date	Buyer	Order	Delivery	Other information/engines
Boeing	13 Feb	Air China	10 x 737-800	4Q07 - 4Q08	
	21 Feb	SpiceJet	5 x 737-900ER 5 x 737-800	2007 - 09	converted options, plus additional 10 options
	06 Mar	Gol	2 x 737-800	2012	
	07 Mar	Kenya Air	6 x 787-800	2010 - 11	plus 4 options
	09 Mar	Pegasus	6 x 737	2008 onwards	
	10 Mar	Cargolux	2 x 747-400F	2007 - 08	
Airbus	25 Jan	Air Europa	10 x A350-800	2010 - 12	
	13 Feb	Hamburg Int'l	14 x A319		plus 6 options
	20 Feb	Indian Airlines	20 x A319 4 x A320 19 A321		CFM56-5
Embraer					
Bombardier	02 Feb	J-Air (JAL)	1 x CRJ900		

Note: Only firm orders from identifiable airlines/lessors are included. *Source: Manufacturers*

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