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Airbus: Pitfalls of economic nationalism

The first question about the escalating crisis that has engulfed Airbus is: will it get worse before it gets better? The second is: will it ever get better?

The reason the second question even arises is that the delays at the A380 coincide with financial stress caused by the strength of the Euro against the US dollar and a growing problem in product development. Not only is Boeing outselling it overall this year, it is cleaning up in the long-haul market, with its 777s and new 787. Airbus has been so pre-occupied with the A380 that it has fumbled the response to the 787, which was designed originally to replace the 767, but is now promising so much that it is shaping the whole long-haul medium-large aircraft market. Even though there are growing murmurs of technical problems with the new aircraft, Boeing chief executive James McNerney reassured investors at the end of October that it would be on time.

Airbus also has to consider spending on the next generation of single-aisle aircraft, the area where it really made its mark with a superior competitor (in terms of attractive cabin) to the 737. With its stronger financial position and experience of lightweight composites developed for the 787, Boeing could be better placed to develop a new 737 single-aisle, while Airbus' problems delay its upgrade of the A320 family. (In a recovery step at the end of October, Airbus announced its first assembly factory in China, along with a big order for 150 A320s and a letter of intent for the 20 of the upcoming A350XWB, assuming it is formally launched.)

Meanwhile, the A380 bad news just keeps dribbling out. The problem with the A380 was not the fault of Airbus's distributed manufacturing system per se. After all, Boeing is successfully imitating it with its global risk-sharing development and production of the 787 in Japan and Italy, as well as Kansas and Seattle. Boeing has the great advantage that it was easily able to sell off its fuselage factory in Wichita to a private equity firm which promptly slashed the workforce, the pay rates and the cost to Boeing of obtaining fuselages. Yet the hints of problems with the new Boeing include difficulties bringing the supply chain up to speed with meeting weight targets.

The basic manufacturing problem for Airbus was just that the A380, with widely varying cabin configurations to attract launch customers, was complex from the start. Also, the reality of work-sharing to garner political support needed for government launch aid from four countries meant some fuselage assembly was allocated to Hamburg. So this site was making its debut on more complex wide-body assembly with a notoriously difficult product, insofar as final wiring was concerned. It is a cardinal rule of complex manufacturing such as in automobiles or aircraft that you do not

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start a new factory and a new workforce with a new product and new technology. It transpired that Hamburg was not up to speed with the new 3D software to tell its engineers how and where the complex wiring looms could thread through the new aircraft.

The fact that many wires were of lightweight, but bulkier, aluminium compounded this deficiency. When the German rear fuselages reached Toulouse they could not, as supposed, be snapped together with the French sub-sections from factories in Normandy and the Vendee. The practical problems on the shopfloor were not dealt with swiftly enough by Toulouse engineers, allegedly because of a "Not my problem" mentality that created a gulf between designer engineers and shopfloor, aggravated by the fact that the problem originated with the Germans.

French hierarchical management culture may have led to the problem being concealed: to generalise, French and German middle managers hate passing bad news up the line of command, whereas Americans live with this unpleasant but necessary aspect of industrial life. A good example of this was Boeing in 1997/98, when its factories collapsed into chaos. It was trying to ramp up output with a new production system that was to track more efficiently bought-in components. It did not work. Half-finished planes littered the hangars in Seattle. But within four months the boss of Boeing Commercial Airplanes Group was fired, and a new manager quickly brought the problem under control.

Credibility?

October opened with the first remotely credible assessment of the impact of the delays to the A380 programme caused by the wiring difficulties in the Hamburg factory. Broadly, Airbus said that the whole production programme was going to run two years late: instead of nine aircraft produced next year, only one will leave Toulouse, two years late. It will take until 2010 before Airbus hits its planned production rate of 25 aircraft a year. The financial hit between now and then is US$6bn of cash-flow, including compensation claims and delayed payments. Some of that will obviously be recovered later.

Ominously that announcement was lacking in details about how Airbus was going to cope with its other underlying problem: the 30% fall in the dollar (its revenues) against the Euro (which accounts for most of its costs). The reason for the vagueness on the Eurozone cost-cutting was soon clear, when Christian Streiff, the outsider brought in from French building materials group Saint-Gobain, resigned only days after his update on the crisis. Although he had talked bravely about a new cost-cutting plan called Power8 to lop €1bn off annual costs and measures to cut overheads by 30%, there were no details about where the axe would fall in France, Germany, Spain or the UK. Instead details were being withheld for further discussions and would not be clarified until January. As he made abundantly clear in press interviews,

Streiff left because he was not going to be allowed the freedom to do what he thought best at Airbus. He would have to pilot his plans through the board of the parent company, EADS. The parent company is now more than ever hands-on in Toulouse since BAe sold its one-fifth stake to its erstwhile partner for barely $2bn, half what it was supposed to be worth only a few months ago before the delays began to get worse.

Louis Gallois, the French co-chief executive of EADS, stepped in as chief executive of Airbus, with Fabrice Bregier due to come over from EADS's Eurocopter as chief operating officer and obvious successor. Gallois is a smooth operator, a typical grande ecole French top civil servant who knows how to navigate the murky waters of French industrial politics. Although Bregier is one of the "Lagardere boys" now being blamed for the fall of Airbus, he has earned respect for his work at Eurocopter. But, ominously, the news of Bregier's appointment had to be delayed until a heavyweight German could be found to balance this increase in French control in Toulouse.

In late October the A380 crisis spread wider when EADS told investors in Hamburg what the damage would do to the economics of the A380 programme. Instead of breaking even at 250 planes, it would now take sales of

420 before the non-recurring costs had been recovered. Airbus reiterated its view that there was a market for 1,500 planes of more than 450-seat capacity. It expected to get half that with the A380. Meanwhile, Boeing has revised upwards its forecast of sales for planes of 400-plus seats to 900, which it hopes to address with its new 747-800-the latest version of the venerable jumbo.

In the event, Boeing has not needed to do that. Although the 777, launched in 1994 (on time, a rarity), undoubtedly ran over budget on development costs, it has outperformed the A340 on its own merits. Now the problem that Airbus has, for the first time, in responding to Boeing's 787 is that it risks cannabilising sales of its own medium-haul twin engine A330 with some versions of the A350. Meanwhile, the profitability of the A380, always problematic, is made more difficult by the delays to its entry into service. Expect few, if any new orders, until it finally shows its paces in service in 2008.

The next big decision for Airbus's parent EADS is whether or not to approve the industrial launch of the extra widebody A350-the belated contender to challenge the 787, the most successful new widebodied aircraft ever, with some 400 orders already. It is inconceivable that EADS would not approve this project, because that would hand Boeing a monopoly in the biggest part of the widebody market. But finance is going to be tight in Toulouse as it works its way slowly out of the A380 mess. It will need to tap both bond markets and governments to get the new plane off the ground.

While all this is going on a pall of uncertainty still hangs over ownership of EADS. Both DaimlerChrysler and Lagardere have sold tranches of shares worth 7.5% of the equity. That leaves the French government with 15% (plus 2.5% bought by a government-owned bank, CDC), DaimlerChrysler with 22.5%, Lagardere 7.5%, the Spanish state holding firm SEPI with about 5%, and the rest free floating, some of it (around 5%) in the hands of a Russian state bank. Lagardere has made clear it wants to sell out completely, while DaimlerChrysler wants to reduce its stake further to 15%.

The German government has been trying to round up private sector investors to take the car company's place, but with little success. The talk now is of the German government reluctantly keeping parity with the French shareholders with the help of state-owned banks and German lander (regional governments). EADS/Airbus looks set for creeping nationalisation, a trend that seems inevitable given the economic nationalism that seems to be dictating decisions about where it builds its aircraft.

A380: THE PLANNED DELIVERY SCHEDULE

	Firm Orders	Options	2007	2008	2009	2010	2011	2012	2013	2014	2015
Emirates	**45**	**10**	3	6	9	14	7	6	0	0	0
Lufthansa	**15**	**0**	0	2	4	3	1	1	1	2	1
Qantas	**12**	**10**	3	3	6	0	0	0	0	0	0
Air France	**10**	**4**	0	2	3	4	1	0	0	0	0
FedEx	**10**	**10**	0	0	3	3	3	1	0	0	0
SIA	**10**	**15**	3	6	0	0	0	0	0	0	0
UPS	**10**	**10**	0	0	2	3	3	2	0	0	0
ILFC	**8**	**10**	0	1	3	4	1	0	0	0	0
Malaysian	**6**	**0**	0	0	0	2	2	2	0	0	0
Thai AW	**6**	**0**	0	2	2	2	0	0	0	0	0
Virgin Atlantic	**6**	**6**	0	0	2	3	1	0	0	0	0
China Southern	**5**	**0**	0	2	2	1	0	0	0	0	0
Kingfisher	**5**	**0**	0	0	0	2	3	0	0	0	0
KAL	**5**	**3**	0	1	2	1	1	0	0	0	0
Etihad	**4**	**0**	0	2	2	0	0	0	0	0	0
Qatar AW	**2**	**2**	0	0	0	2	0	0	0	0	0
Total	**159**	**80**	**9**	**27**	**40**	**44**	**23**	**12**	**1**	**2**	**1**

Note: Information correct as at September 2006, before the latest announcement of delays

Air Canada IPO: Unlocking the value in ACE Holdings

In the coming weeks, if market conditions remain favourable, investors will get a rare opportunity to participate in the IPO of a major global airline. ACE Aviation Holdings has initiated the process of spinning off a minority stake in its wholly-owned subsidiary Air Canada. While certainly a less risky proposition than the LCCs floated in Europe and Asia earlier this year, is Air Canada - just two years out of bankruptcy - a sound long-term investment?

According to the preliminary prospectus filed with the Canadian regulatory authorities on October 16, Air Canada will sell C$200m of Class A and B voting shares in the IPO. This will be followed by a secondary offering of Air Canada shares by ACE, the size of which is yet to be determined.

The shares will be sold only in Canada - like ACE, Air Canada hopes to trade on the Toronto Stock Exchange (TSX). However, non-Canadians will be able to participate by acquiring the so-called "variable" voting shares (Class A), which carry the same voting rights as Class B shares until foreign ownership exceeds 25%.

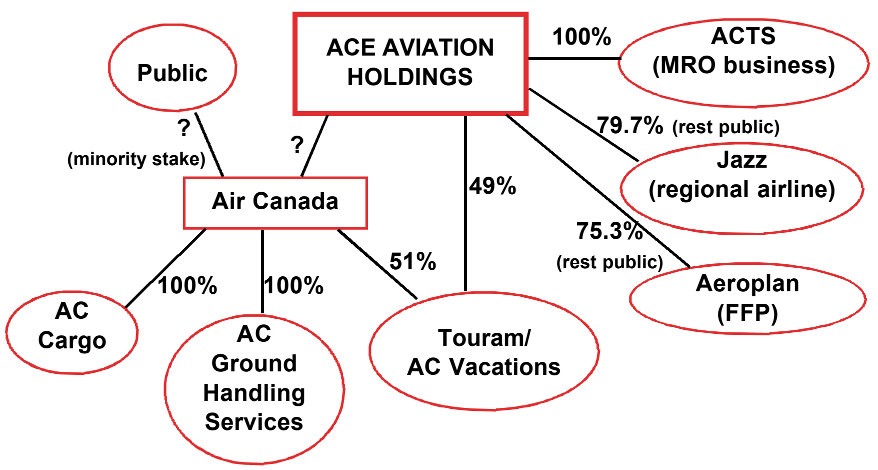
The spin-off comprises ACE's "transportation services" business segment, which accounted for 76% of ACE's revenues in the second quarter. In addition to Air Canada, the segment includes Air Canada Ground Handling Services, Air Canada Cargo and Air Canada Vacations. Under the post-IPO organisational structure, the ground handling, cargo and vacations businesses will report to Air Canada - the first two will be 100% owned by Air Canada, while Vacations will be a 51%/49% Air Canada/ACE joint venture. ACE will, of course, retain control of Air Canada through a majority interest. And Air Canada will continue to benefit from close business relationships - though there will be no ownership links - with the other three ACE business segments: Aeroplan (FFP), Jazz (regional carrier) and Air Canada Technical Services (ACTS, a full-service MRO organisation).

Why the spin-off?

Air Canada's planned IPO is a key part of ACE's strategy of maximising shareholder value by "unbundling" parts of its franchise to unlock the value of subsidiaries. The offering follows minority IPOs of Aeroplan (June 2005) and Jazz (February 2006), both of which were sold as income trusts and have delivered strong financial results. ACE currently holds 75.3% and 79.7% stakes in Aeroplan and Jazz, respectively.

The value-maximisation strategy was adopted following the reorganisation of Air Canada's corporate structure immediately before the company emerged from an 18-month bankruptcy restructuring in October

AIR CANADA'S POST - IPO ORGANISATIONAL STRUCTURE



2004. Air Canada and its business units became stand-alone entities or limited partnerships under a newly created holding company, ACE, which then set about to strengthen the units and further develop synergies between them. It is quite an innovative strategy - the Aeroplan IPO was the first-ever monetisation of an airline FFP.

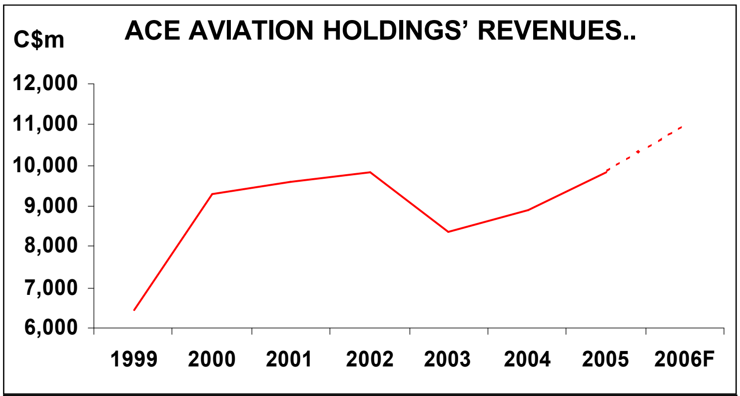
The C$200m or so funds that Air Canada hopes to raise through the IPO will also come in handy, given the airline's significant fleet renewal programme.

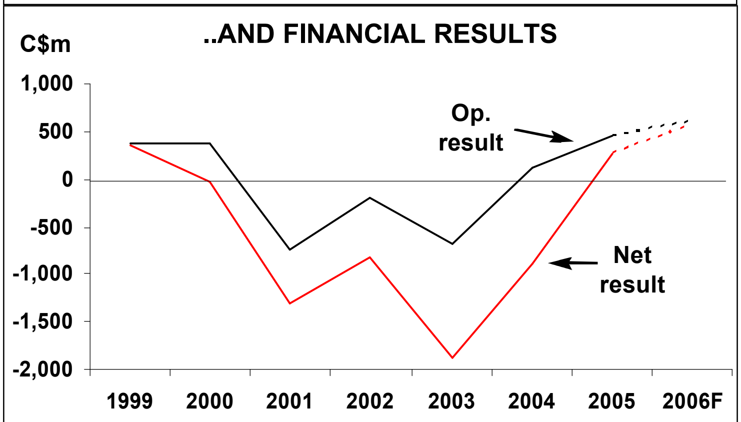
The IPO is possible because ACE has staged an impressive financial turnaround in the past two years. After three and a half years of operating losses totalling C$1.73bn, the company returned to profitability in the third quarter of 2004 and posted a modest C$117m operating profit for that year. This was followed by impressive C$452m and C$258m operating and net profits in 2005, achieved despite a C$592m higher fuel bill. In the current year ACE is heading for an operating profit approaching C$600m.

Air Canada returned to profitability earlier than the US network carriers, thanks to the steep cost cuts in bankruptcy, an improved domestic revenue environment after rival Jetsgo ceased operations in March 2005 and many innovative business strategies. That said, ACE's profit margins now lag behind those being achieved south of the border - its 2Q06 operating margin was 6.7% and the full-year margin is likely to be lower.

Nevertheless, the IPO seems well timed. When it was announced, ACE's share price had surged by 25% in the previous three months, from around C$29 to C$36, reflecting the recent decline in fuel prices and a further easing of competitive pressures when CanJet, a privately held Halifax-based airline, halted scheduled service in early September. Four days after the IPO filing, on October 20, the stock closed at C$38.24, nearing its 52-week high of C$40.

Many analysts who follow ACE have noted that the market is not giving full credit for Air Canada. Merrill Lynch's Michael Linenberg said in an October 17 research note that his sum-of-the-parts analysis suggested that the market ascribes no equity value for the airline in ACE's share price.





Note: Forecasts by Merrill Lynch

Merrill Lynch "conservatively" arrived at a value for Air Canada of C$15 per ACE share by applying a 10% discount to US network carriers on a 2007 EV/EBITDAR basis.

Air Canada's strengths

In the preliminary IPO prospectus, Air Canada lists as its strengths its position as the largest airline in various market areas, its innovative revenue model, strong RASM performance, strong financial position, premier FFP, strong brand recognition, and proven results oriented management team. The following are probably the most important factors:

• Dominant market position

Air Canada's greatest strength is its dominant market position. It is not only the largest domestic operator, with a 60% ASM share (January-September 2006), but it also has 38% of the Canada-US transborder market and 45% of the long-haul international market. These figures represent more than twice the scheduled capacity of the second largest competitor in each segment.

Air Canada controls regional feed with its affiliate Jazz, which operates substantially all of its RJ and turboprop capacity on Air Canada's behalf and is Canada's second largest airline. In addition to serving thinner regional markets, Jazz also provides off-peak service in higher-density markets throughout Canada and to some US destinations.

Air Canada is the world's 14th largest airline in terms of 2005 ASMs and has a strong global network. It has virtual monopoly of Canada's international traffic rights and is likely to remain the country's dominant long-haul international carrier for many years to come. In addition, Air Canada is a founding member of the Star Alliance, which extends its network coverage to over 840 destinations in 152 countries.

A balanced route structure also helps minimise risk. In the first half of 2006, Air Canada generated 41%, 20% and 39% of its revenue from domestic, transborder and long-haul international services, respectively.

• Innovative revenue model

One of the key earlier concerns was that Air Canada might not be able to retain a large-enough unit revenue (RASM) premium over LCCs, given its higher cost levels. But so far at least revenue performance has exceeded expectations, which the company attributes to an innovative revenue model that enables it to compete effectively with LCCs (on pricing) and with leading international full service carriers (on products and services). The model "establishes a clear link between price and value" and enables Air Canada to provide for customers who value different aspects of its products and services.

The "branded fare strategy" was introduced domestically in May 2003 and expanded to certain US destinations in February 2004. In October 2005 Air Canada introduced a similar, simplified fare structure on some transatlantic routes, and the plan now is to take it to other international routes over the next two years.

The strategy offers five simple fare types (ranging from Tango, the lowest, to Executive Class, the highest), priced according to the built-in benefits in terms of flexibility, refundability, level of FFP mileage accumulation, lounge access, etc. But Air Canada goes a step further by also offering à la carte options to enhance each of the branded fares. Currently a Tango customer is able to buy seat assignment for a fee and obtain discounts by electing not to check luggage or waiving the right to make changes to the ticket. This autumn, Air Canada is adding à la carte options on all its branded fares, including the ability to pay for a meal and to access airport lounges.

It is the a la carte options that make Air Canada's model substantially different from the approach pursued by other network carriers, which traditionally limit customer choice in an effort to optimise revenue. But the customisation concept has been very successful in other industries, such as cars and computers. It is evidently paying dividends at Air Canada, helping attract and retain customers and boosting revenues. For example, nearly 20% of Tango customers elect to purchase seat assignment, which has improved the base yield of the product.

Air Canada's management believes that the new revenue model has contributed to higher load factors, yields, RASM and cost efficiency. The airline has achieved record or near-record monthly load factors for more than two years. The passenger load factor rose from 73.1% in 2003 to 79.5% in 2005. Quarterly domestic RASM has risen steadily, from about 15 cents in 1Q04 to over 18 cents in 2Q06.

• Premier FFP and strong brand

Because Air Canada does not have to share the domestic market with other large carriers, it has been able to build Aeroplan into a uniquely strong FFP. According to a recent business travel study, 91% of frequent Canadian business travellers (six or more trips per year) are Aeroplan members. The strategic relationship with Aeroplan provides a long-term stable revenue source for Air

Canada.

Because of the breadth of the network, old-established and dominant market position, reputation for reliable operations and the creative new product strategies, Air Canada's brand is one of the most recognised in Canada and widely recognised in North America and internationally. The brand will be further enhanced through fleet renewal and refurbishment of aircraft interiors.

• **Strong financial position**
The 2003-2004 bankruptcy restructuring process reduced Air Canada's debt and capital lease obligations from C$12bn to C$5bn and gave the company a relatively healthy cash position of C$1.9bn. In April 2005 ACE raised over C$1bn in new liquidity through concurrent equity and convertible note offerings and by obtaining a new C$300m credit facility. This reduced the debt and lease obligations to C$4bn and improved cash reserves to C$2.1bn. Since then ACE has raised further funds from the partial sales of Aeroplan and Jazz, as well as from the sale of stock held in the merged US Airways-AWA - the latter raised more than US$200m, producing a nice profit on the original US$75m investment.

According to the preliminary prospectus, Air Canada expects to have more than C$2bn in cash after the IPO - an ample 22%-plus of last year's revenues - plus access to a restated and expanded $400m senior secured revolving credit facility. Pro-forma accounts for the Air Canada Group (including Jazz, which will not be part of the post-IPO Air Canada), for June 30 and adjusted for the IPO, show cash of C$2.7bn and debt and capital lease obligations of C$3.9bn.

However, future funding needs are substantial, now that Air Canada is entering a period of accelerated fleet renewal, expansion and refurbishing. Projected capital expenditures over the next two years alone (through the end of 2008) amount to C$4.4bn, plus minimum lease payments in that period add up to C$1.1bn. Pension funding obligations are running at around C$470-500m annually in the next five years.

Air Canada's stated aim is to try to lower the cost of capital. It is not surprising that the underwriter line-up for the IPO includes at least ten financial institutions - five of them are being rewarded for providing credit facilities; the rest is pure relationship building as clearly they are not all needed to sell the offering.

Cost and labour issues

Air Canada evidently exceeded the targets of its 2003 cost-cutting programme, which aimed to reduce annual operating expenses by C$2bn or 20% between 2002 and the end of 2006. Labour cost savings have amounted to C$1bn (mainly through productivity improvements), aircraft rents were reduced by C$600m while in bankruptcy, and other sources have contributed at least C$500m in savings. Air Canada's ex-fuel CASM declined from 14.5 cents in 2002 to 12.2 cents in 2005.

But that was not enough to take Air Canada anywhere near LCCs' cost levels; the CASM gap with WestJet, the main low-cost competitor, is at least 3 US cents - more than the differential between most US legacy carriers and LCCs.

However, success on the revenue side has lessened the imperative to get costs closer to LCC levels. Air Canada now describes itself as simply "lower-cost" or "loyalty" carrier. Because of its dominant market position, strong FFP, virtual monopoly of Canada's international traffic rights and innovative revenue model, Air Canada should - more than legacy carriers generally - be able to retain a large enough high-yield traffic component to justify a higher cost structure.

Like the US carriers, Air Canada now sees cost cutting as a continuous process to remain competitive. The fleet modernisation programme will help further reduce unit costs. In addition, Air Canada is trying to reduce internal costs by streamlining business processes. The airline also aims to lower distribution and processing costs through improved web-enabled technology - a new system for passenger reservation and airport customer service will be deployed from late 2007 or early 2008. Another goal is to reduce transaction and marketing costs with single-purchase and multiple-use products such as flight passes; recent weeks have seen two new offerings: "London Pass" (six prepaid one-way trips between anywhere in Canada and Heathrow) and "Unlimited Pass" (unlimited travel anywhere within North America, offered in several versions).

This year's mid-term wage revisions, permitted by the concessionary collective bargaining agreements which were negotiated in 2003-2004 and which expire in 2009, have created new labour cost pressures. On the positive side, however, productivity is not a re-opener, and the parties originally agreed on two issues important at a unionised carrier: use of binding arbitration, if necessary, and no industrial action through 2009. Except in the case of pilots, who may also revisit certain pension issues, only wage revisions are permitted.

As of early October, Air Canada had settled the mid-term wage revisions with three of its five main unions (IAM, IBT and CAW) and several smaller groups. This year's wage rates were raised by 1-1.6%, to be followed by typically 1.6-1.75% annual increases in 2007 and 2008. These are not insignificant increases, and the raises for the two most critical unions - pilots and flight attendants - are yet to be settled (the pilots are in arbitration and the flight attendants in mediation).

Separately, Air Canada expects to complete an earlier programme of reducing its non-unionised workforce by 20% by the end of this year. That programme was introduced in part to help offset the 2005/2006 hike in fuel prices.

In light of the history of labour problems, special efforts are being made to improve communication with employees. New initiatives include senior executive roadshows, an online dialogue with Air Canada president/CEO Montie Brewer, an employee suggestion programme, employee surveys, new knowledge sharing and team building opportunities and new grievance procedures.

Growth plans

Air Canada's post-bankruptcy North American strategy is to offer a high-frequency schedule on key routes, while maintaining competitive frequencies in other markets and adding new non-stop routes. Since October 2004 the airline has increased frequencies on 80 routes and added 17 new domestic and nine new transborder point-to-point routes.

The strategy has meant increased reliance on small aircraft. Two years ago ACE placed firm orders for 15 ERJ-175s and 45 ERJ-190s, plus 60 options for the ERJ-190, all to be operated by Air Canada at pilot costs that are believed to be only slightly higher than JetBlue's. The ERJ-175s were delivered by January 2006, and by the end of September Air Canada had also received 15 ERJ-190s, with the remaining 30 due to arrive by March 2008. The Embraer aircraft are both for growth and replacement of some older A319s and A320s. By the end of 2008, 70-90 seaters will account for 39% of Air Canada's planned narrowbody fleet of 155 aircraft.

The new North America strategy has also meant a greater role for Jazz. The post-bankruptcy RJ orders also included 15 CRJ-705s and 15 CRJ-200s for the regional airline, all of which were delivered by the end of 2005. At the end of September Jazz operated 73 CRJs and 60 turboprop aircraft on behalf of Air Canada.

The new RJs have created many new transborder route opportunities, such as linking Toronto, Montreal, Halifax and Ottawa with new points in Florida and Texas, and East Canada hubs with points in California and Arizona. For its 2006-2007 winter schedule, Air Canada is significantly increasing its flights from Canada to leisure destinations in Florida, California and Las Vegas, meaning a 13% increase in seats.

But the main focus of Air Canada's post-bankruptcy strategy has been on international markets outside North America. The past 2-3 years have seen significant Latin American and Caribbean expansion, partly because of the opportunity offered by the US "no transit without a visa" policy, which has made transiting via Canada an increasingly attractive option. Recent route additions have included Montreal-Havana, Toronto-Santo Domingo and Montreal-Mexico City. This winter Air Canada is planning to add 25 more weekly flights to Mexico and also additional service to the Caribbean.

The other post-bankruptcy strategy has been to look for niche markets not served by other international carriers. New route additions in that category included Toronto-Delhi (via Zurich) and Vancouver-Sydney last year.

Air Canada continues to strengthen its transatlantic network, often by introducing service to existing European destinations from new Canadian points. This autumn it is adding Edmonton-Heathrow flights with 767-300ERs, and Montreal-Rome 767-200ER service will follow in June 2007.

Otherwise, the focus is on building non-stop service to Asia particularly from Toronto, even though Vancouver remains the main Asian gateway. In recent years Air Canada has added Toronto-Hong Kong, Toronto-Beijing and Toronto-Seoul services. The biggest near-term growth opportunity is China, following a more liberal new ASA signed last year.

Air Canada will begin renewing its wide-body fleet in March 2007 when it starts receiving the 777s. This is not significantly behind the original schedule (first three aircraft in 2006) that the airline had before it temporarily cancelled the order in June 2005 after its pilots rejected a tentative agreement on costs and other issues (the order was reinstated in November 2005). The airline has 19 777s on firm order, plus 18 options. The firm orders include six 777-200LRs and 11 777-300ERs - all scheduled for delivery by the end of 2008 - and two 777-200 freighters due in 2009. The 14 787s on firm order are scheduled for delivery in 2010-2011, plus there are 46 options.

Those two types will eventually replace all of Air Canada's 12 A340s, as well as most of its 12 767-200/200ERs. The overall size of the widebody fleet (65 at year-end) will remain largely unchanged until the 787s arrive, after which the plan is to increase the operating fleet to 74.

In addition to acquiring new aircraft, Air Canada commenced a major refurbishment of its existing aircraft in April 2006, which is expected to be completed by mid-2008. All existing aircraft except the A340-300s will get new seats, personal in-flight entertainment systems and in-seat power outlets. International executive class cabins will also get flat-bed seats.

Further spin-offs?

In August, when disclosing its second-quarter results and intention to spin off Air Canada, ACE also announced that it expected to commence the process of "monetising" ACTS in late 2006 and that it was pursuing opportunities that realise the value of its remaining investment in Aeroplan and Jazz.

After Air Canada's IPO, ACTS would be ACE's only remaining wholly owned business unit. It was originally expected to be the next in the IPO line after Aeroplan, but its spin-off was delayed as it struggled with some unprofitable contracts. But a new management team and restructuring have helped - ACTS reported a modest operating profit for the second quarter. In September it also amended a problematic US$300m maintenance contract with Delta, further enhancing its prospects. However, ACTS's monetisation is currently expected to be an outright sale rather than an IPO. ACE CEO Robert Milton indicated in August that several private equity firms had expressed interest.

It was previously believed that ACE's likely goal was to be an aviation holding company with majority stakes in a number of thriving businesses. But the August announcements raised the prospect that the holding company structure could eventually disappear. Milton said that the board had actually come to the conclusion that it does not need to own any of the component companies - which can have just as beneficial relationships with each other through operating contracts as through cross-ownership - though it was not at all certain that ACE would follow that strategy.

By Heini Nuutinen

American and Continental: Leading the Legacy rebound

While the US LCC sector struggled in the third quarter, with JetBlue and AirTran recording losses and Southwest only flat earnings, American and Continental saw their profits soar. Significantly, these two airlines - the only ones of the "big six" US network carriers to have avoided Chapter 11 in the post-September 11 environment (AMR has never been in bankruptcy) - have stepped up their balance sheet repair efforts, which have already resulted in credit rating upgrades. But why is Continental continuing to grow at a heady pace when American is cutting capacity in 2007?

American's parent AMR Corp. reported a $114m net profit before a $99m non-cash charge (related to fuel hedges) for the third quarter, contrasting with a $95m loss a year earlier. Revenues rose by 6.6% to $5.8bn. Operating income was $284m, representing a 4.9% margin, up from 1.8%. This was the first time in six years that AMR achieved net profits in two consecutive quarters.

Continental, in turn, saw its net profit before special items more than double from $61m to $146m, as revenues surged by 17.2% to $3.5bn. Including a $92m gain from the sale of its stock in Copa, net income quadrupled to $237m. Operating income was $192m or 5.5% of revenues - a margin similar to AMR's - compared to $109m or 3.7% of revenues in the year-earlier period.

American's and Continental's operating margins in the third quarter, though obviously in a different category from Southwest's 11.1% (which was down by 2.3 points), were slightly better than the 4.4% operating margin achieved by US Airways - this year's star performer among the network carriers.

The results were impressive in light of the fact that the airlines still paid 15-18% higher average fuel prices in the third quarter than a year earlier. Also, the profits were achieved despite the negative impact of the tighter security procedures and restrictions on carry-on baggage put in place in the wake of the August 10 London terrorist threats.

The new security regulations made the latter half of the third quarter challenging for all airlines. However, contrary to the initial expectation that transatlantic operators would be the worst affected, in the US domestic operators suffered the most. This was probably because the new rules were the biggest hassle for short-haul passengers, who tend to carry on their luggage.

American and Continental tentatively estimated the 3Q revenue impact of the security rules at $50m and $25-30m, respectively, though both said that it was hard to separate it from other possible factors contributing to a softening of revenue trends. In any case, the impact was only temporary as the new security measures were relaxed in late September.

In all other respects, the airlines enjoyed a uniquely strong industry environment in the third quarter. Demand trends were robust, domestic fares were at healthy levels and industry capacity was under control.

American's mainline unit revenues (RASM) still grew by 7.7% and yield by 7%, while Continental's RASM was up by 6.8% and yield by 5.5%. The fact that the transatlantic was Continental's weakest RASM area (a mere 1.4% increase) probably had more to do with the airline's 15% capacity addition in that region than the August 10 factor. Mainline load factors were at record levels - Continental's was 82.7% and American's 81.7%.

Cost controls have remained excellent. American's ex-fuel CASM only inched up by 1%, while Continental's declined by 0.8% in the third quarter. Including fuel, American's CASM rose by 3.8% and Continental's by 5.9%. There had been some concerns that demand might be slowing in response to a possible weakening of the economy, but neither airline has detected any such trends. Most of the US airlines have reported strong advance bookings, which bodes well for the fourth quarter. However, RASM growth is decelerating and is likely to continue at single-digit rates, if only because year-over-year comparisons are becoming more difficult.

Of course, airlines are currently benefiting from lower fuel prices. AMR's management has reduced its second-half 2006 fuel cost projection by $528m from the previous estimate made in mid-July. However, fuel prices remain at historically high levels and continue to be volatile. AMR's current forecast assumes that its average per-gallon price will decline from $2.16 in 3Q to $1.85 in 4Q but that the price will average at the higher $2.10 level in 2007.

Add to that the fact that American and Continental are potentially disadvantaged on the cost front for not having had the Chapter 11 opportunity to slash labour and aircraft ownership costs, and it is hardly surprising that both airlines continue to emphasise cost cutting and now see it as an ongoing process.

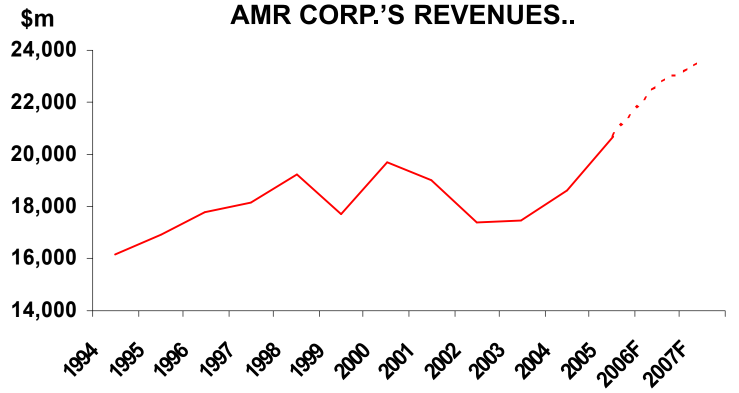
American is on track to achieve $700m in cost cuts in 2006, on top of the $4bn achieved in the previous three years (including labour concessions in 2003 when the company came close to filing for Chapter 11). Continental said recently that it does not have a specific overall financial target for further cost cuts following the $1.6bn in cost saving and revenue generating initiatives achieved since 2002 (including $500m in wage and benefit reductions).

Both airlines currently focus on simplifying processes, improving efficiency and productivity, reducing distribution costs and improving fuel conservation. Continental is using a method it describes as a "metric-based target initiative", which involves identifying and setting targets for key operational metrics to drive productivity. For example, the target could be to improve fuel burn per ASM. Continental is also in the process of installing winglets for its 737 and 757 fleets.

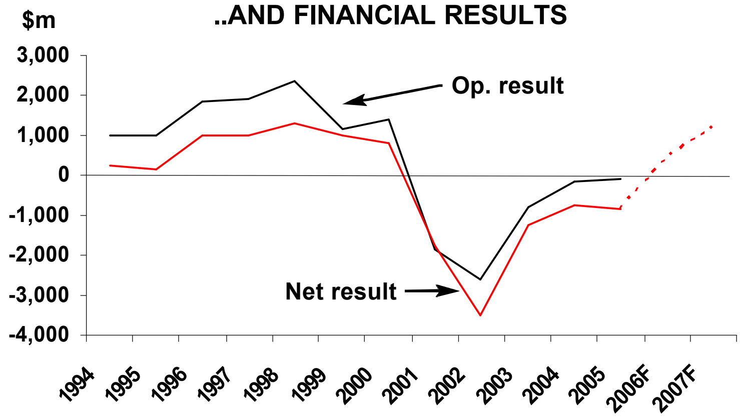
Continental benefits from the youngest fleet among the large network carriers. With an average age of 8.8 years in the second quarter, compared to American's 13.4 years and Northwest's 17.1 years, the fleet, according to Continental's calculations, is about 10% more efficient than American's and Northwest's in terms of fuel burn per ASM. That 10% difference amounts to a significant competitive advantage in the current fuel environment.

On the ancillary revenue side, both airlines proudly reported that they have secured five-

AMR CORP.'S REVENUES..

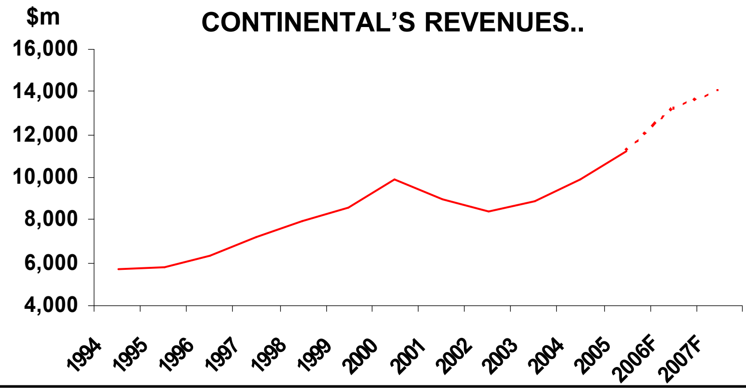


..AND FINANCIAL RESULTS

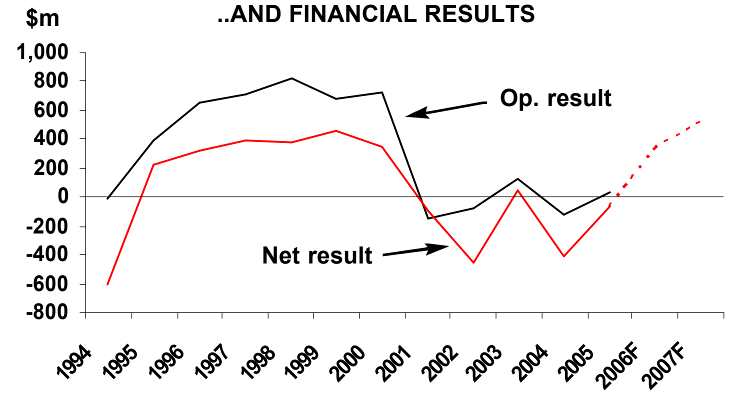


Note: Op. result excludes special charges and gains. Forecast is analysts' consensus.

CONTINENTAL'S REVENUES..



..AND FINANCIAL RESULTS



Note: Op. result excludes special charges and gains. Forecast is analysts' consensus.

year mail contracts with the US Postal Service. American's contract is potentially worth $500m in revenue, while Continental's is valued at $258m.

Balance sheets repair efforts

Both airlines have been very successful in recent cash raising efforts. Continental raised $203m from a public equity offering in October 2005, and AMR followed suit with a $400m public offering in May 2006. Continental has also raised $328m in total from the sale of its stock in Copa, first in December 2005 as part of Copa's IPO and in a follow-on offering in July 2006.

The cash raising and improved operating results - and in American's case also a pull-back in growth-related capital spending - have given both airlines exceptionally strong liquidity positions. AMR ended the third quarter with total cash of $5.5bn, up from $4.3bn at year-end 2005. The unrestricted cash balance was $5bn, or 24.2% of 2005 revenues. Continental had $2.5bn in unrestricted cash on September 30, accounting for 22.3% of 2005 revenues and up from $1.9bn at the end of last year.

The improvement is particularly important for Continental, because its historically below-norm cash reserves - typically around $1.5bn in the past five years, which actually was the company's target - made it the most likely candidate to succumb to an event-specific liquidity crisis.

In addition to raising cash, Continental has reduced its 2007 debt obligations from $937m to $556m by paying off about $100m of debt early and completing two refinancings this past summer. The first of those refinanced a $292m debt facility, lowering the interest rate and extending the maturity date from December 2007 to June 2013. The other deal lowered the interest rate on a $350m loan due in 2011, resulting in total savings of $30m.

AMR began reducing its leverage by repurchasing $128m of debt in the first nine months of 2006. This was in addition to making $1.1bn of scheduled debt payments. However, the move provided no relief for 2007, when debt and capital lease obligations add up to around $2bn.

The recently passed pension bill has enhanced both airlines' ability to fund their pension obligations. American expects to contribute $360m (a greatly reduced amount) and Continental $200m to pension plans in 2007.

The improvements are being recognised by the rating agencies - something that will help reduce future borrowing costs. On October 20, the day after American and Continental released their third-quarter results, Fitch raised both airlines' corporate credit ratings from "CCC" to "B-minus" (still speculative grade) and debt ratings from "CC" to "CCC". Also, S&P revised Continental's outlook from "negative" to "stable", which may not seem much but is a step in the right direction. Both agencies cited improved earnings, cash flow and liquidity.

But the airlines are keenly aware that they have a long way to go in mending their balance sheets. According to Calyon Securities, AMR's and Continental's debt and capital lease obligations amounted to $20.3bn and $11.9bn, respectively, at the end of June. The lease-adjusted debt-to-capital ratios were 103% and 95%. By comparison, United's debt and lease obligations and the debt-to-capital ratio were a more reasonable $14.8bn and 88%.

Contrasting growth philosophies

While both American and Continental focus on international expansion, they provide a fascinating contrast in terms of growth philosophies. American continues to exercise extreme restraint about capacity addition; its latest plan, disclosed in the 3Q call, anticipates its overall capacity shrinking by 1% in 2007.

Even though American is planning some international expansion - notably Dallas-Beijing from March 2007, if it is lucky enough to be selected for the one new US-China route allowed by the ASA next year (United, Continental and Northwest have also applied) - the leadership stressed that any flights to be added must be profitable on a year-round basis. American's CEO Gerard Arpey has also repeatedly said that the airline will not be able to grow until it reduces its $20bn debt.

Because of American's size, its continued capacity discipline is obviously great news for the industry. Several analysts noted after the call that industry prospects for 2007 suddenly looked much better.

By contrast, Continental - the only one of the "big six" that has expanded in size significantly since 2001 - intends to grow its mainline capacity by 5% in 2007. This is at the lower end of the 5-7% annual growth range envisaged by the carrier's long-term plan, mainly because Continental is a little aircraft-constrained, with only two 777s scheduled for delivery next year.

While the focus is heavily on international expansion, unlike the other legacies, Continental is also growing domestically. This year's mainline domestic growth is expected to be 5.1% and international 13.5%, for total mainline growth of 8.8%. However, the airline will substantially scale back RJ operations in the first half of 2007.

Continental justifies the domestic growth by a need to provide feed to the rapidly expanding international network, which already accounts for 48% of its flights. As its executives explained at Continental's recent investor day, the airline aims for "balanced" growth and "does not want to become a carrier that is too international, like TWA or Pan Am".

A key aim is to take advantage of the powerful Newark hub, which caters for the huge and wealthy New York market and therefore has strong O&D traffic. Newark is Continental's key strength - a unique asset not unlike Heathrow is to BA.

Continental also feels comfortable growing at the 5-7% rate because it has a flexible fleet plan, making it possible to accelerate or slow growth to suit market conditions. In the "maximum fleet" scenario (see table, right), the airline could expand its fleet from 368 aircraft in 2007 to 461 in 2011 by taking all current orders and options and not retiring aircraft. At the other extreme, the "minimum fleet" scenario would mean no growth at all, as the airline would only take firm orders, let leases expire and retire the 737-300s (its oldest aircraft), as well as some of its 737-500s and 767s. It would not mean parking any aircraft in the desert.

The airline also feels justified at growing because of its relative size (smaller than American, United and Delta) and the promising growth opportunities around the world. In the past year, it has added India and China to its route map - both huge developing markets.

During the investor day, Continental's executives stressed that the company believes that "there is an opportunity for a significant amount of long haul international growth to be added". Somewhat ominously (from non-US airlines' point of view), the executives said that the airline is ready to up capacity growth to take advantage of the A380 delays.

While Continental's profit margins could well be higher if it grew at a lesser rate, good growth opportunities are so rare that they are worth pursuing.

By Heini Nuutinen

CONTINENTAL'S FLEET

	Fleet	Orders	Delivery schedule
787	0	20	Three in 09;Rest in 2010+
777-200ER	18	2	2007
767-400ER	16	0	
767-200ER	10	0	
757-300	17	0	
757-200	41	0	
737-900	12	3	2008-2009
737-800	99	22	Six in 2H06; Rest in 08-09
737-700	36	41	2008-2009
737-500	63	0	
737-300	48	0	
Total mainline	**360**	**88**	
ExpressJet			
ERJ-145XR	104	0	
ERJ-145	140	0	
ERJ-135	30	0	
Total RJs*	**274**	**0**	

Note: *69 of the ExpressJet RJs will be withdrawn beginning in Dec. 06. Those aircraft will be partially replaced by 44 RJs to be operated by Chautauqua Airlines on behalf of Continental from 2007. Fleet as at 30 June 2006

CONTINENTAL'S FLEXIBLE FLEET PLAN

	Max. fleet size	Min. fleet size
YE2006	366	366
YE2007	368	368
YE2008	398	371
YE2009	431	370
YE2010	448	366
Year2011	461	365

Notes: Maximum fleet size=Take all orders and options, keep all existing aircraft.
Minimum fleet size=Take firm orders but not options, let leases expire, retire all 737-300s and some 737-500s and 767-200ERs.

Russian airline roundup

Russian president Vladimir Putin has repeated that Russia's newly formed Unified Aircraft Corporation (UAC) is objectively interested in building closer production ties with EADS through cross-ownership. The government, a 75% stakeholder, has pledged to invest over $13bn in UAC, to help re-establish Russia's position as a major aviation player.

Russian state-controlled Vneshtorgbank last month revealed it had acquired a 5% holding in EADS through its stock market activity, Putin commented "I personally believe that Russia could in time increase its stake up to 10%, maybe more." Such a move would balance a 10% shareholding owned by EADS in one of UAC's constituent firms - NPO Irkut (aircraft manufacturer and Su-37 fighter producer). An enlarged shareholding can only go ahead with the backing of EADS' shareholders and following the conclusion of an appropriate co-production agreement.

There was a cool European response to these latest Russian moves, personified by Bavarian state premier Edmund Stoiber's comments spoken after meeting Putin: "I asked him to understand that in some strategic industries there are limits to taking reciprocal stakes."

Aeroflot Russian Airlines

Russia's national airline saw traffic rising from 6.6m passengers in 2004 to 6.7m in 2005. Total 2005 revenue of $2.5bn for Aeroflot was an increase from 2004's $2.2bn. Net results for 2005 and 2004 were $190m and $172m respectively. The airline is targeting a 6.7% increase in passenger traffic and a 12.2% rise in revenue for 2006.

In April 2006, Aeroflot Russian Airlines formally became the tenth member of the SkyTeam alliance, taking two years from the MoU signing for Aeroflot to meet the necessary criteria to join. The third terminal at Sheremetyevo Airport is expected to be completed by the end of 2007. Aeroflot has a 30% share in the Terminal venture, Vneshtorgbank 25% and other part-owners include the airport itself and Russian finance group Sberbank RF.

Aeroflot is now expressing a strong inter-

ACTIVE RUSSIAN FLEETS

	Aeroflot	S7	Pulkovo	Kras Air	UT Air	Transaero	Domo-dedovo	Russian Sky	Volga Dnepr
737-3/4/5/700		11	5	5		7			
747-200B						3			
767-200ER				3		3			
767-300ER	10					4			
DC10-40	4								
A310		8							
A319/320/321	18 (12)	6							
IL-62							4		
IL-76 TD				2				4	6
IL-86	7	9	7	4					
IL-96-300	6 (6)						5		
Tu-134	13		10		31				
Tu-154B			6	2	4				
Tu-154M	26	23	18	11	10		5	1	
Tu-204		1 (4)		3					
Tu 214				1					
An-24					17				
An-26					1				
An-124-100									10
Yak 40					10				5
Yak 42				2					
TOTAL	**84 (18)**	**58 (4)**	**46**	**33**	**73**	**17**	**14**	**5**	**21**

Note: Active fleets and orders only, aircraft in storage are excluded
Source: ACAS, as at end September 2006

est in the Russian Far East. Air transport is of crucial importance is the Far Eastern regions but local carriers lack the resources to develop their fleets and services. Last year, Aeroflot was angling to acquire a controlling interest in the 100% state-owned airline Dalavia, based at Khabarovsk Airport. This summer, Aeroflot's original interest has expanded into details of a concept to create an airline group, tentatively named Aeroflot-East. Aeroflot's plan envisages a merger of state controlled operators Vladivostok Avia and Dalavia, at least 70% of this entity would be transferred to Aeroflot, which would ensure that it continued to provide intra-regional services.

Aeroflot has postponed taking a decision about the choice of a Western model for its long-haul fleet. Whatever the choices, delivery will be scheduled for 2010 onwards. However, it is going ahead with its medium-haul fleet renewal plan. The airline has announced that it will pull nine Il-86s from service (to be sold or leased out), and has taken delivery of the first of seven A321s that were ordered a year ago.

CEO: Mr. Valery Okulov
Address: Leningradsky Avenue 37, Bldg 9. Moscow 125167, Russia
Tel/ Fax: 095 752 9001, 095 155 6647

Russian Sky

In August 2005 Russian Sky Airlines, formerly East Line, the airline division of East Line Group and part of Moscow Domodedovo Airport's operating company, was 100% acquired by businessman Rashid Mursekaev. Mursekaev was linked to financial firm Centr-Capital, a group which has ties with other Russian airlines, such as VIM-Avia.

Passenger numbers fell by more than 70% over the first half of 2006 to fewer than 66,000. In developments last month, it was reported that Russian Sky is to abandon its scheduled passenger operations to focus instead entirely on developing its freight transport activity. All of its passenger flight operations have been transferred to VIM-Avia, a Moscow-based, Russian charter airline that is increasing its scheduled passenger operations.

Director General: Mr. Vyacheslav Khabarov
Address: Domodedovo Airport, Moscow Zone 142015, Russia
Tel/ Fax: (495) 795 3838, (495) 795 3855

S7 Airlines (formerly Sibir)

S7 Airlines operates scheduled passenger and cargo flights from its bases at Moscow (Vnukovo airport) and Novosibirsk (Tolmachevo airport), to more than one hundred destinations within Russia and the CIS. S7 has eight routes outside of this area.

In June 2004, Russia's authorities ordered that 25% of Sibir (branded as S7 since 2005) be put on the list of the state-owned assets to be privatised in 2005. This was the fourth consecutive attempt by the Government in the past few years to sell the shareholding and unsuccessful once again.

S7 Airlines now operates 11 737s, eight A310s and six A319s, a fleet of 25 foreign-built aircraft as well as nine Il-86s and 23 Tu154s. Further fleet renewal plans envision acquiring 10 A319s and up to five 737-500s.

The carrier hopes to raise traffic by 19% and transport in excess of 5 million passengers in 2006. It carried 4.2m passengers in 2005 and 3.7m in 2004. The expansion plans are expensive - S7 suffered a net loss for a second consecutive year in 2005 following increased spending on expansion plans. Overall losses totaled $40m on revenues of $694m in 2005, up nearly a third on the previous year. S7 points out that this loss comes at the same time as its "inordinate capital outlays on business development".

CEO: Vladislav F. Filiov
Address: Tolmachevo Airport, Novosibirsk 633115, Russia
Tel/ Fax: 3832 227 572, 3832 599 064

Pulkovo Airlines

In 2005, Pulkovo Airlines carried 2.8m passengers and earns 70% of its revenues on services to Western Europe. Pulkovo and merger partner Rossiya were due to begin operating as a single entity this October. Under articles of incorporation endorsed by the Government, the integrated state-owned company inherits legal rights from Pulkovo Airlines and maintains Rossiya's brand name. The new entity is scheduled to begin operating on 29 October from St Petersburg Pulkovo and Moscow Vnukovo airports.

The combined airline will embark on replacing ageing Tu-154s in its fleets with A320s and 737s. "The plan is to lease another five Western models on the medium-range side," says acting general manager Gennady Boldyrev. Additionally, Boldyrev says the carrier will shortly sign a deal with GECAS to take seven-year operational leases on up to ten Embraer 170s.

Pulkovo was under investigation after one of its Tu-154s crashed in Ukraine in August, killing all 170 people aboard. The airline has just escaped censure from the EC for its safety record. The EC will monitor the implementation of corrective actions promised by Pulkovo.

Acting Director: Mr. Alexander Golovin
Address: 18/4 Pilotov Street, St Petersburg 196210, Russia
Tel/ Fax: 812 122 9422, 812 104 3302

KrasAir

In October 2004, KrasAir and Domodedovo set up a joint management company, the beginnings of the AirUnion alliance. Since then Samara, Omskavia and Sibaviatrans have also joined the alliance. Moscow-based Domodedovo is a specialist in long-haul flights to Russia's Far East and Asia using a 17-strong fleet of Il-62 and Il-96s. KrasAir provides scheduled services from its home airport Krasnoyarsk throughout the country and charter flights abroad. Revenues for Kras rose from $293m in 2004 to $356m in 2005; passenger numbers have fallen slightly over the same two years from 1.9m to 1.8m passengers

KrasAir has signed an agreement for 30 Russian Regional Jets (manufactured by Sukhoi and recently rebranded as “SuperJet”). Kras has committed itself to taking 15 SuperJets in a 95-seat configuration. At the same time, KrasAir is continuing to work with the lessor Ilyushin Finance Company and the Antonov Design Bureau on finalising a contract for 12 An-148 regional twinjets plus six options that was signed last year.

General Director: Boris M. Abramovich
Address: Emelianovo Town, Krasnoyarsk, Krasnoyarsk Region 663020, Russia
Tel: 3912 555 999, 3912 244 895

Domodedovo Airlines

Kras Air owns 49.6% of Domodedovo and while the companies retain separate legal entities, they are planning to integrate networks and services. In 2005, Domodedovo recorded revenues of around $212m and a $9.5m net loss.

Director General: Mr. Sergei Yanovoy
Address: Domodedovo Airport, Moscow 142045, Russia
Tel/Fax: 095 323 8991, 095 952 8651

UTAir Aviation

Providing passenger and cargo services mainly in the oil and gas regions, UTAir Aviation is also the largest helicopter operator in Russia. UTAir carried 1.9m passengers in 2005 up around 29% from 2004. UTAir's financial results for the first six months of 2006 reported a revenue increase of almost 44% to about $242.5m compared to $169m in the first half of 2005. Profit from the airline's core operations was $8.4m compared to $1.4m a year ago. In the first half of 2006, the airline carried 1m passengers, 35% more than the same period of 2005.

UTAir is one of only two Russian airlines traded on Russian stock exchanges, (Aeroflot being the other).

General Director: Mr Andrei Martyrosov

Address: Airport of Khanty - Mansiysk, Tyumen Region, West Siberia 628012
Tel/ Fax: 34671 94557, 34671 94588

Transaero

Based at Moscow's Domodedovo airport, with a second operational base at St Petersburg's Pulkovo airport recently opened. Transaero has been buoyed by a 16.5% increase in passenger numbers to 1.6m from 2004 to 2005, a cargo traffic increase of 30% and a bright business outlook. 2005's operational results were the best in Transaero's 15-year history. Net profits rose 50% to almost $6.6m on revenues of $347m, an improvement of 32%. Transaero aims to boost profits in each of the following three years and meet a $42m target on revenue of about $900m in 2008.

The airline recently signed a MoU with Airbus for the purchase of eight A330-200s, and is negotiating an order for 10 A320s. Deliveries are scheduled to begin in 2009. Transaero says the MoU confirms the airline's commitment to the development of long-haul services from Moscow and St Petersburg to domestic cities, as well as destinations in Africa, the Americas and Asia.

Key shareholders in Transaero are tightening their grip on the company in preparation for an IPO. Alexander and Olga Pleshakov, the company chairman and general manager respectively, have initiated a plan to buy an additonal 32% of company shares. The Pleshakov couple already collectively own almost 41% of Transaero. Pleshakov's mother Tatyana Anodina, who heads the CIS airworthiness authority ARMAK, holds a 3.25% interest. Earlier this year, a specially-created subsidiary Transaero-Finance purchased a 5.8% stake from an offshore firm registered on the Virgin Islands.

The Pleshakov family intends to gain a majority shareholding ahead of launching a planned IPO for Transaero. The carrier will seek to list on one of the Russian and, possibly, on a foreign stock exchange next year. Russian analysts expect its market value to double to $600 million following the listing while Pleshakov is looking at raising $100 million by offering up to 20% of its stock to the public in 2008.

Director General: Mrs. Olga Pleshakova
Address: 3/4, 2nd Smolensky Pereulok, Moscow 121099, Russia
Tel/ Fax: 095 937 8478, 095 937 8463

Volga-Dnepr Airlines

The Russian outsize freight operator is forging a marketing partnership with Antonov Airlines. To be known as Ruslan International - after the name associated with the An-124 freighter, used by both carriers - the venture will jointly market the capabilities of the two sides' fleets. Volga-Dnepr saw cargo revenues rise from $168m in 2004 to £340m in 2005.

Ruslan International will also allow the airlines to benefit from a joint spares pool, shared loading equipment, and to combine forces to drive forward a planned restart of An-124 production. Volga-Dnepr and Antonov Airlines between them operate some 17 An-124s. Ownership and shareholding of Ruslan International has yet to be finalised. But it will build on the two sides' Ruslan Salis partnership which last year agreed to provide strategic airlift to NATO using An-124s. Antonov declines to disclose the Ruslan Salis deal value but market experts in Moscow estimate it at up to $650m.

Chairman: Mr. Alexei I. Isaikin
Address: 14 Karbysheva Str., Ulyanovsk 432072, Russia
Tel Fax: 842 2 59 0059, 842 2 20 26 75

		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 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	**Year 2003**	**3,810**	**3,523**	**287**	**168**	**7.5%**	**4.4%**	**59,280**	**42,774**	**72.2%**	**12,322**	**14,673**
YE 31/12	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
	Year 2005	**6,548**	**6,015**	**533**	**424**	**8.1%**	**6.5%**	**82,766**	**65,110**	**78.7%**	**15,440**	**15,447**
JAL												
YE 31/03	**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 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**
	Year 2005	**7,439**	**7,016**	**423**	**198**	**5.7%**	**2.7%**	**66,658**	**49,046**	**71.4%**	**21,710**	
Malaysian												
YE 31/03	**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**
	Year 2004/05	**2,882**	**2,798**	**84**	**86**	**2.9%**	**3.0%**	**64,115**	**44,226**	**69.0%**	**17,536**	**22,513**
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**	
	Jul-Dec 05	4,999	4,626	373	258	7.5%	5.2%	59,074	45,794	77.5%	17,260	35,158
Singapore												
YE 31/03	**Year 2003/04**	**5,732**	**5,332**	**400**	**525**	**7.0%**	**9.2%**	**88,253**	**64,685**	**73.3%**	**13,278**	**14,010**
	Year 2004/05	**7,276**	**6,455**	**821**	**841**	**11.3%**	**11.6%**	**104,662**	**77,594**	**74.1%**	**15,944**	**13,572**
	Year 2005/06	**6,201**	**5,809**	**392**	**449**	**6.3%**	**7.2%**	**109,484**	**82,742**	**75.6%**	**17,000**	**13729**

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-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
Apr-06	200	62	262	237	45	282	544

AIRCRAFT SOLD OR LEASED

	Old narrowbodies	Old widebodies	Total old	New narrowbodies	New widebodies	Total new	Total
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
2005	321	114	435	1,653	346	1,999	2,434
Apr-06	18	7	25	151	29	180	205

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 %
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
Aug-06	28.8	21.3	73.9	21.9	18.2	83.1	15.8	13.1	82.7	52.4	43.7	83.5	78.1	63.1	80.8
Ann. change	3.0%	5.3%	1.6	3.5%	-0.2%	-3.1	9.0%	8.8%	-0.2	4.5%	3.1%	-1.1	4.9%	4.3%	-0.5
Jan-Aug 06	213.9	147.9	69.1	154.5	127.4	82.4	121.1	97.3	80.3	390.8	318.8	81.6	579.3	450.3	77.7
Ann. Change	2.9%	5.6%	1.8	1.3%	0.5%	-0.7	9.8%	11.3%	1.1	4.5%	5.0%	0.4	4.6%	5.5%	0.7

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 %
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
Sept 06	78.6	58.7	74.7	17.4	14.3	81.9	9.9	7.9	80.0	7.4	5.1	68.8	34.8	32.1	78.5
Ann change	-1.2%	-1.5%	-0.2	8.4%	6.5%	-1.5	0.9%	1.0%	0.1	0.4%	4.7%	2.8	4.4%	4.5%	0.0
Jan-Sept 06	736.5	592.1	80.4	143.6	117.3	81.7	88.7	74.1	83.6	81.5	62.3	76.4	313.8	253.7	80.9
Ann change	-3.2%	-0.8%	1.9	8.3%	6.6%	-1.3	1.0%	2.2%	0.9	2.1%	6.0%	2.8	4.5%	5.1%	0.5

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	29 Sept	Ryanair	32 x 737-800	2008 onwards	converted options
	1 Oct	EgyptAir	6 x 737-800		converted options
	3 Oct	Travel Service	2 x 737-900ER	4Q 2009	plus 2 purchase rights
	9 Oct	Emirates	10 x 747-8F	2010 onwards	
	11 Oct	SIA	20 x 787-9	2011-13	
	17 Oct	Guggenheim	4 x 747-8F	2009 onwards	plus 2 options
Airbus	26 Oct	CASGC	150 x A320 family		
Embraer	5 Oct	Northwest Airlines	36 x E175	2Q 2007 onwards	plus 36 options
Bombardier	5 Oct	Northwest Airlines	36 x CRJ900		plus 96 options

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

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