

# Aviation Strategy

Issue No: 10

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## Futuristic BA/AA

Now that the European Commission has made a (sort-of) final decision on 267 slot give-ups and other concessions, the BA/AA alliance can now go ahead - although more delays are inevitable as competitors react to the EC decision and the US DoT considers the alliance. The tortuous investigation has distracted attention from the strategy that lies behind the alliance, but this will now come to the fore as the two airlines have to prove the benefits of the venture as opposed to expounding the benefits of seamless travel, etc.

The first thing to note is that BA is much more exposed to the downside of the alliance (more competition in a newly deregulated market) than AA. Atlantic operations accounted for 54% of BA's operating profit in 1997 but only 15% of AA's. And it is difficult to see how this profit total will be boosted in the short term by the alliance: BA and AA are operating at close to 80% load factors across the Atlantic and any joint attempt to push up yield would surely provoke a regulatory response.

But, unlike the Star alliance, which is a wide-ranging and slightly bureaucratic operation, BA/AA gives the impression that it could evolve into a focussed transnational entity, perhaps eventually culminating in a full-blown merger (after all, a clause in the Continental/Northwest agreement indicates that this alliance will end up as one airline). Whether BA's artistic tailfins will be used to project the internationalist message is another issue.

In the meantime though, strategic lessons might be learnt from the just-announced joint venture between BT and AT&T in the telecoms sector. Their aim is to combine all the cross-border assets of the two companies in a joint venture while the core companies retain their own regional power bases.

One could envisage the Atlantic eventually becoming a BA/AA joint venture - with presumably BA having the majority stake - in which the two airlines would pool their aircraft, sales offices, etc. The other six regional operations clearly fall into the core competencies of one or other of the airlines. The power of BA/AA would then lie in the alliance's ability to route passengers between the various regions in its network, and in locking in passengers to its joint loyalty scheme. But, as corporations get larger, so service quality tends to get stressed, and management's ability to react to consumer demands becomes blunted.

So far there has been little if any evidence for economies of scale in alliances, but such is the potential scale of BA/AA, a 1% reduction in their joint operating costs would equate to a bottom line benefit of about \$300m a year.

### GEOGRAPHIC BREAKDOWN OF BA/AA PROFITS

\$m	Revenue		Op. profit		Revenue Op. profit	
	AA	BA	AA	BA	Combined	Combined
<b>US domestic</b>	10,613	-	862	-	10,613	862
<b>Intra-Europe</b>	-	5,207	-	10	5,207	10
<b>Atlantic</b>	1,979	4,978	219	590	6,957	809
<b>Pacific</b>	332	-	58	-	332	58
<b>US-Latin America</b>	2,670	-	309	-	2,670	309
<b>Europe-Asia/Pacific</b>	-	2,004	-	237	2,004	237
<b>Africa/Middle East</b>	-	1,811	-	254	1,811	254
<b>Total</b>	<b>15,594</b>	<b>14,000</b>	<b>1,447</b>	<b>1,090</b>	<b>29,594</b>	<b>2,537</b>

Notes: BA results are pre-exceptional charge. American year = calendar year. BA year = year to March 31. Figures may not add up to totals due to rounding.

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## Analysis

### Market outlook: a mass of conflicting images

The aviation industry presents a mass of conflicting images at present - economic disaster in Asia, boom in America and Europe; record profits for airlines, distress for Boeing; new aircraft in storage but orders still pouring in; an imminent widebody surplus but unfulfilled demand for narrowbodies. Here *Aviation Strategy* unravels the trends.

#### The economic background

Perhaps surprisingly, there is a positive side to the Asian crisis. The OECD Economic Outlook, published in June, argues that the immediate effect of the weakening in exports to Asia has been to reduce the danger of over-heating in the US and European economies. Hence strong economic growth may be sustainable for longer than previously expected.

Economic activity in the OECD region is projected to expand at about 2.5% p.a. in 1998 and 1999, which is only slightly below the level forecast last year. In addition, the economies of Germany and France, which had been lagging behind those of the US and the UK, are now showing strong signs of a significant cyclical upturn.

The big uncertainty, however, is Japan, where sluggish economic fundamentals plus a very fragile financial system have been aggravated by the Asian crisis. Japan remains mired in recession, with a real GDP decline expected this year, but the recently announced package of fiscal and deregulatory packages could, if effectively imple-

mented, stabilise the situation and allow a return to moderate growth next year.

#### How much has the aviation market balance changed?

Unfortunately, it seems that the global aviation industry, despite the optimistic outlook for Western economies, is likely to take a sizeable hit from the Asian crisis. That is the implication of the latest forecast from ESG, published in July\*.

As ESG represents the industry-standard in supply/demand forecasts, it is useful to appreciate the basic methodology. To summarise: the actual or projected number of RPMs is converted into aircraft by factoring in the average global load factor to get to ASMs, which are then divided by optimal average utilisation, speed per hour and average seating in order to give an estimated demand (cargo jets are also added in). This demand figure can then be subtracted from the actual or projected supply of aircraft in the worldwide commercial aviation fleet, the fleet projections taking account of future deliveries and retirements. The difference between demand and supply is the surplus that can manifest itself in jets parked in the desert or in underutilised and/or underoccupied aircraft flying around.

This graph below illustrates the significant rise in the surplus as projected now and

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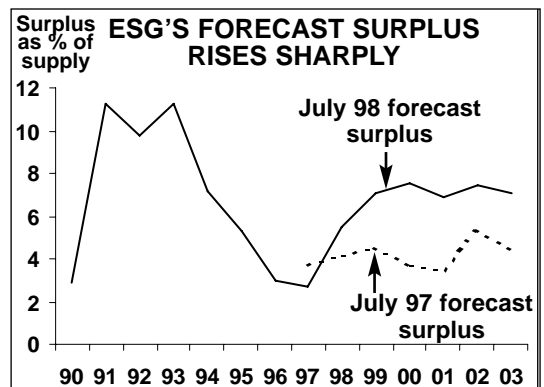
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#### REAL GDP FORECASTS

% growth p.a.	1997	1998	1999
US	3.8	2.7	2.1
Japan	0.9	-0.3	1.3
Germany	1.2	2.1	2.7
France	2.4	2.9	2.8
UK	3.3	1.7	1.8
OECD	3.1	2.4	2.5

Source: OECD Economic Outlook, June 1998.



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that forecast a year ago when there seemed to be little to worry about in Asia. According to the new analysis the surplus can be expected to rise to around 7% next year and to stay there until 2002 when ESG assumes that there will be a market cyclical downturn in the West.

This surplus is just shy of the 8% mark that ESG regards as being very serious - in the early 1990s the surplus was over 11% - but in absolute terms the number of surplus aircraft, over 1,000, is very close to that of the last, dire recession.

The graph on the right summarises where the changes in forecast aircraft demand occur. As expected most of the decline takes place in Asia while the US is down slightly and Europe up noticeably. Curiously though, demand from the rest of the world also rises significantly compared to last year. There is no obvious reason for this.

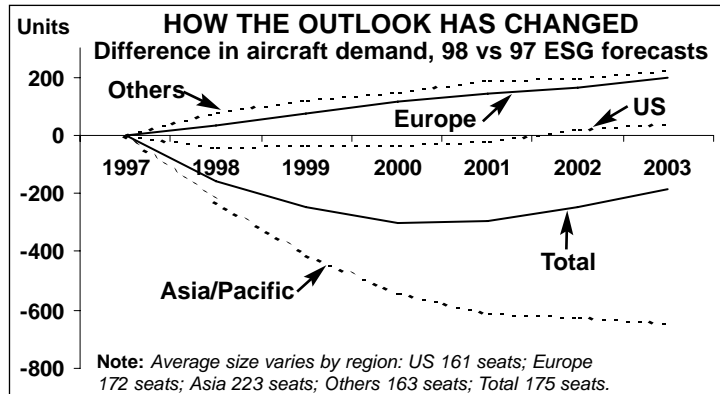
No aircraft forecast is complete without a reflection on aircraft retiral rates - or more specifically as to why actual scrapping rates are so much lower than anticipated (both ESG and Boeing have been 100% out on their deletion numbers in the last five years).

For the surplus to stay at around 7% and not drift up to 10-11%, some 1,000 aircraft will have to be retired between now and the end of 2000. This number, which is incorporated in the ESG forecast, is roughly twice the rate experienced during 1992-97. It appears not unreasonable given that non-operation rules for Chapter 2 jets will be in force from 2000 in Europe and 2003 in North America, but this legislation primarily impacts narrowbodies while the surplus this time seems to be emerging in the widebody sector.

### What's happening to the Asian surplus?

There is more than enough evidence now to match ESG's theoretical slump in Asian aircraft demand to actual developments in the region. Examples include the following.

- Most dramatically, PAL is officially shrinking its fleet from 55 to 14 jets (though the realistic rationalised total is more likely to be 25)



and is negotiating with Boeing to cancel the four 747-400s it is due to take delivery of, and with Airbus on the return of the eight A340s it is operating.

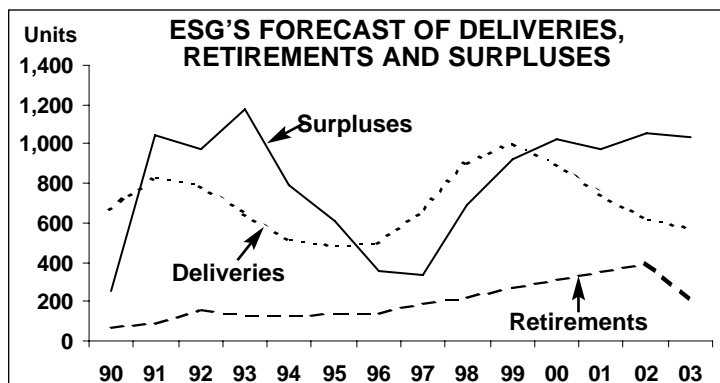
- Thai has managed to take all 16 planned 1998 deliveries, but on operating lease rather than outright purchase, and has sold eight aircraft so far with a further nine sales planned.

- Garuda is negotiating with Boeing and Airbus for the cancellation of leases on six MD-11s and six A330s.

- MAS has deferred nine deliveries of 747-400s and 777s, due in 1999 to 2003; 11 737s and one A330 have been leased out or returned early to the lessors, plus a further 10 747s and DC-10s are to be sold.

- Cathay intends to take delivery of 13 firm orders this year and next, but is attempting to sell or lease out five 747-200s; the other two -200s are likely to go as well while its six -300s could also be phased out.

- Qantas has postponed planned A340/777 purchases for at least two years, is selling four A300s and is buying three second-hand 747-400s.



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- Korean is negotiating to defer as many as possible of a total of 11 747s, 777s and A330s due for delivery next year.
- Even SIA has announced a quite extensive deferral programme - eight 747-400/777/A340s due to be delivered this year and next will not now be taken until 2000-2001.

There have also been important capacity redeployments. For example, SIA has increased capacity on non-Asia routes by 9-16%, including fifth freedoms to New York over Frankfurt and Amsterdam, while cutting Indonesian services in particular. Qantas has suspended all South Korean flights and cut back on Japan while adding services to the US and using 747s domestically. MAS has also suspended some Asian services and introduced a three-times a week flight to New York over Dubai.

So not only is the Asian surplus being transferred to other markets through aircraft sales but also the Asia/Pacific carriers are, wherever possible, deploying their own capacity from intra-Asia to the Pacific and the Atlantic.

And at Seattle the number of aircraft in storage is moving slowly but inexorably upwards because Asian airlines have been unable to accept deliveries: 19 aircraft, including five 747s, were being stored by Boeing at the end of the second quarter, compared with eight a year ago.

### Why are orders still coming through?

Orders are not just still coming through, airlines are ordering at a (slightly) higher rate than last year. As the tables on pages 5-6 show, there were 638 firm orders in the first half of this year compared with 1,246 for the whole of 1997.

Some of the biggest orders have come from European flag-carriers - Air France, Iberia, Sabena - which had previously been prevented by the terms of their state aid injections from placing orders, but there have also been substantial investments from the leading US majors - Delta, United, Continental and American. Three of these airlines have long-term agreements to order Boeing equipment, which are intended to

insulate fleet planning from the vagaries of the order/delivery/traffic cycles, and these orders (plus upcoming orders like American's for DC-10 replacements) are elements of the long-term contracts. South America, where market conditions are very buoyant, accounted for a large proportion of Airbus's orders.

However, one cannot but wonder about some of the orders. Is this really the correct time in the cycle for small start-ups like AB Airlines to be committing to new jets for the first time? How can technically bankrupt Korean justify an order for 22 new generation 737s (unless it has reached an accord with Boeing on the 11 747s and 777s it has on order)?

So far there have been no cancellations or deferrals from non-Asian carriers, with one small exception which may be significant. British Airways has switched three 747-400 orders to 777s and cancelled outright a further -400. Chris Avery, aviation analyst at Paribas (whose production forecast appears on page 21), reads a great deal into this, recalling that BA was the first major airline to appreciate that the industry was falling into recession in the early 1990s and the first to negotiate with Boeing on changing production slots.

Yet at the same time British Airways is on the point of placing a 30-100 order for either 737s or A320s. It is ruthlessly playing the two manufacturers off against each other by demanding "financial flexibility" in their proposals. What this means is that BA is expecting to take the aircraft on favourable lease terms which will probably include "power by the hour" provisions, in effect, forcing the winning manufacturer into taking on part of the risk of operating the aircraft from the airline.

BA's strategy again illustrates the disparity that is emerging between the potentially oversupplied widebody market and the relatively balanced 150-seater market.

### What are the manufacturers doing?

Airbus has dismissed the Asian crisis as a minor blip; Boeing, much more exposed to the Asian market, argues that the crisis is at least self-contained and will result in only a produc-

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tion loss of 150 units over five years. Both are gearing up production rates in the short term.

Airbus has shifted A320 family production up from 18 to 22 a month to avoid a complete log-jam of slots. Boeing, trying to overcome the huge setback it received when it was forced to install over-wing emergency exits on the new generation 737s in to order to receive certification, is attempting to push up production from 14 to 21 a month, a process which the Boeing chairman, Phil Condit, describes as entailing "significant performance risks". Boeing has also increased the production of the 747 to five units a month from four and the 777 to seven from five, a move which, again according to Condit, means "performance and schedule risks". "Schedule" in this case presumably means airlines not being able to take delivery of completed models.

The problem for Boeing is that it has so far failed to make anything like a reasonable return during the upswing and peak of the ordering cycle; its share price fell 14% in one day following the announcement that second

quarter 1998 net profit was \$258m, 45% down on the same period in 1997. Its strategy of extreme outsourcing, taking over MDC and matching Airbus on price and terms has backfired badly.

Now it has little choice but to keep pumping out planes while making some probably futile gestures on (irrelevant) sticker prices and price escalation clauses. However, it does recognise the fundamental uncertainties of the widebody sector, and has stated that it is planning to cut back 747 production in 1999.

### What are the implications of a widebody recession?

A global airline recession isn't inevitable - the surplus identified by ESG might be mitigated by a slowdown in manufacturers' output, scrapping might accelerate and the underlying economic strength in the West might provide a secondary boost to traffic. But if there is going to be a recession, it will primarily be a widebody recession.

<b>FIRST HALF 1998 FIRM JET ORDERS</b>			
	<b>Airbus</b>	<b>Boeing</b>	<b>Others</b>
<b>European airlines</b>			
AB Airlines		May 27 6 737-700s	
Adria Airways			Feb 24 1 CRJ-200LR
Aer Lingus	Feb 4 1 A330		
Air Berlin		Mar 3 2 737-800s May 20 2 737-800s	
Air France	Jun 23 15 A319s, 3 A321s		
Air Littoral			Feb 24 5 CRJ-100s
Air Nostrum			Mar 10 5 CRJ-200ERs
Bavaria		May 4 5 717-200s May 20 2 737-700s	
Brit Air			Feb 12 1 CRJ-100 May 8 6 CRJ-100s, 2 CRJ-700s
Condor		May 31 1 757-300	
CSA		Mar 1 2 737-400s, 1 737-500	
Edelweiss Air	Mar 31 3 A320s		
European Regional AL			Jan 27 2 ERJ-145s
Iberia	Jun 19 31 A320s, 19 A321s		
KLM		Apr 7 4 737-800s	
Lauda-air		Mar 1 1 767-300ER	
Lufthansa	Apr 20 10 A340s Jun 24 1 A340		
Lufthansa CityLine		Jun 30 3 MD11-Fs	
Maersk Air			Mar 20 3 CRJ-100s Mar 2 2 CRJ-200LRs Jun 1 1 CRJ-200LR
Nouvelair	Apr 24 1 A320		
Park Express			Mar 23 5 RJ100s
Ryanair		Mar 9 25 737-800s	
Sabena	Mar 12 26 A319s, 5 A320s 3 A321s, 2 A330-200s		
Swissair	Mar 12 9 A340-600s		
Turk Hava Yollari	Apr 23 2 A340-300s		
Tyrolean AW			Feb 9 2 CRJ-200B LRs
Tyrolean JS			Feb 4 2 328JETS
Undisclosed		Feb 7 1 747-400	
<b>European total</b>			

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In the last recession oversupply was concentrated in the narrowbody sector, which resulted in a collapse in second-hand values, which in turn allowed start-ups into the market, so intensifying competition and further damaging the incumbents. In a wide-body recession the dynamics will be somewhat different, as there is not the same scope for new entrants onto long-haul routes because of the remaining bilateral barriers and because of the much higher capital cost of large jets. Major carriers might even be able to benefit from lower rental charges.

On the other hand, the transatlantic market is the main source of profits for the likes of BA, Lufthansa and KLM, and a substantial increase in capacity - at the same time as slots are being given and open skies are being universally implemented - is a serious concern. US carriers are picking up bargain 777s with the intention of expanding on the Atlantic. And Virgin Atlantic has bought five 747-200s from Air New Zealand at about \$26m each (Boeing's sticker price for a -400 is \$166-185m) and has leased, with purchase options, another two -200s from Cathay.

\*Forecast of the commercial jet transport market, 1998-2020, The Airline Monitor, July 1998

FIRST HALF 1998 FIRM JET ORDERS			
	Airbus	Boeing	Others
<b>North American airlines</b>			
Air Canada	Apr 7 2 A340-500s, 3 A340-600s		Jun 23 4 CRJ-200LRs
Air Wisconsin		May 19 1 737-400, 5 737-700s	
Alaska AL		May 15 25 737-800s	
American AL		Apr 3 8 777-200s	
Atlantic Coast AL			Mar 5 5 CRJ-200ERs
Business Express			Feb 26 20 ERJ-135s
Continental		Mar 18 15 737-900s	
Delta AL		Mar 27 2 777-200s	
		May 19 4 757-200s, 1 737-800 1 767-300ER	
Federal Express		Apr 22 3 MD11-Fs	
Midway AL			Apr 8 3 CRJ-200ERs
Southwest AL		Jan 22 59 737-700s	
TWA		Apr 21 24 MD 80-83s	
United	Feb 27 20 A320s, 10 A319s	Apr 14 16 777-200s, 1 747-400 6 767-300ERs	
USAF		Jan 30 1 747-400F	
US Navy		Jun 10 1 737-700	
<b>North American total</b>			<b>240</b>
<b>Asian airlines</b>			
Air Lanka	Mar 30 6 A330-200s	Jun 29 5 737-700s, 5 737-800s	
CASC		Feb 25 4 737-800s, 4 747-400s	
China Airlines		May 28 1 747-400	
EVA Air		Jun 9 11 737-800s, 11 737-900s	
Korean Air			
Singapore Aircraft LE	Feb 10 2 A320s		
<b>Asian total</b>			<b>49</b>
<b>Others</b>			
Boullioun Aviation Services		Jun 2 1 737-300 Jun 30 1 737-300	
Egyptair	Jan 26 2 A340-600Rs	Apr 1 3 737-800s, 2 737-700s, 1 747-400	
EI AI		Jan 9 2 737-300s	
GECAS	Mar 3 3 A321s, 6 A320s, 1 A319	Jun 30 1 737-300	
LanChile	Mar 19 11 A319s, 9 A320s	Jun 5 1 737-500	
Sunrock Aircraft			
TACA Group	Mar 19 21A319s, 11 A320s		
TAM	Mar 19 25 A319s, 13 A320s		
Undisclosed	Feb 4 4 A320s Apr 27 2 A330s Apr 29 1 A320, 2 A321s May 6 2 A319s	Mar ? 1 MD11	
<b>Others total</b>			<b>126</b>
<b>OVERALL TOTAL</b>	<b>287</b>	<b>282</b>	<b>638</b>

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### The new, improved ARIA

The most challenging of the flag-carrier turn-arounds is probably that taking place at ARIA, which is attempting to find a strategy that will allow it to compete effectively with Western carriers on international routes to/from the Russian Federation.

ARIA has evolved from the two departments of the old centrally-planned Aeroflot that were responsible for international flights. It is still the main designated carrier for international services, operating to 53 foreign destinations plus 11 FSU (Former Soviet Union) points. The remaining political routes to Central America and Africa are due to be dropped.

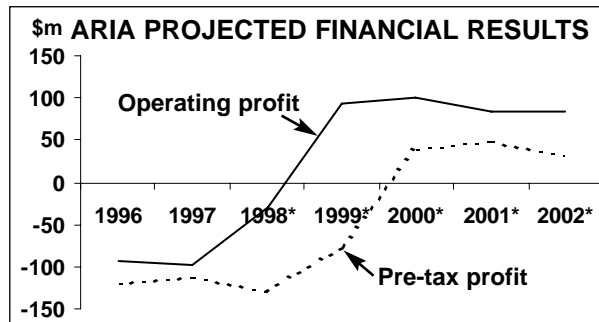
ARIA still sports the famous Aeroflot logo (as, confusingly, do most of the other "Babyflots"), but there is a major contrast between the current airline and what used to be the world's largest carrier. ARIA is now a modest-sized airline comparable to a minor Western European flag-carrier: its 1997 revenues are estimated at US\$1.2bn.

ARIA's fleet comprises about 110 jets, 97 of which are Soviet-built. But it achieves such poor utilisation with its Soviet-types - three to four hours a day on average - that it could conceivably operate its network with about 55 units.

Indeed, investment in Western types is central to ARIA's strategy. Two 777s have just been taken on a seven-year lease from ILFC, while 10 737-400s are scheduled to displace more than 20 TU-134s, TU-154s and IL-62s from international routes.

However, delivery of the 737s has been delayed because of a side-effect of the economic and political crisis in Russia. When the first two 737s arrived, Russian customs imposed a punitive import tax on them despite an agreement with the government that the aircraft, financed by Exim Bank and Chase Manhattan, would be exempted.

Apparently, the necessary decree for tax exemption had been passed in the Duma, but had not been signed off by the relevant ministers because President Yeltsin dismissed the whole Russian government in May this year. However, the CEO of ARIA, Valery Okulov, who is Yeltsin's son-in-law, raised hell and the tax problem has now been solved. A further six deliveries will take place in the near future.



Taking on the Western equipment exposes the airline to a serious exchange rate risk at a time when the ruble is under continuous pressure, with some speculators anticipating an Asian-style collapse in the currency. Yet the airline has little choice but to accept an additional \$40m per year in operating lease costs if it is to have a chance of achieving the yield increases envisaged in its business plan. Over the next five years ARIA expects its dollar yield to increase by about 2% p.a. - while traffic will increase by 8% p.a. - resulting in a net profit for the first time in the year 2000.

As ARIA's yields are roughly half those of the AEA average, some improvement should be achievable. But first of all, for yield management to work ARIA will have to get its load factors, currently in the low 60s, up into the 70s.

ARIA's aim is to recapture Russian passengers from Western airlines through improved service etc. Hopefully, this will then also attract Western passengers. It is using training programmes from Aer Lingus and SAS and intends to improve its schedule - for example, increasing frequencies on key routes (on Frankfurt-Moscow, Lufthansa offers 26 weekly services against ARIA's seven). Ensuring that standard (Western) aircraft are on key routes, as opposed to a mix of Western and Soviet types, should be a big help.

ARIA's business plan makes the right commercial noises, and the recovery path replicates the profit projections of most troubled European flag-carriers (see graph, above). The most nebulous yet also the most important aspect of ARIA's business plan is the improvement in service quality and the successful projecting of a new improved image to Russian and Western markets.

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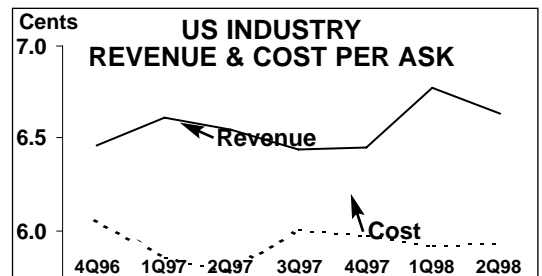
### US industry records its best-ever quarter

**B**oom times continue for the US industry following a record second quarter of the year, with eight out of the nine main airlines reporting an increase in operating profit compared with the same quarter in 1997.

The exception was Northwest, which was particularly hit by the Asian downturn and the dispute with its unions (now tentatively resolved).

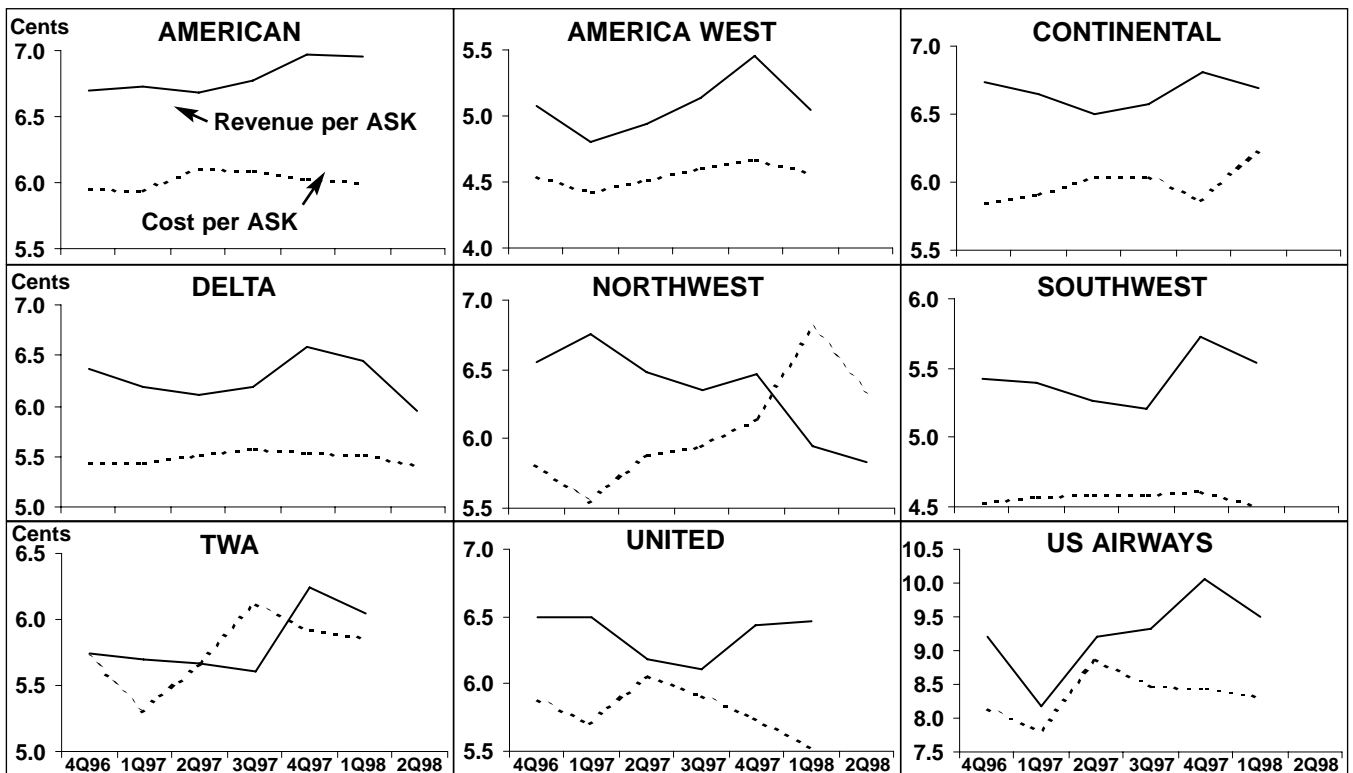
In fact six airlines - American, America West, Delta, Continental, Southwest and US Airways - reported the best quarterly net income figures in their history and a seventh (United) reported its best-ever second quarter. Not surprisingly the result was the industry's best-ever quarter, with combined operating profit for the nine airlines in April-June 1998 totalling \$2,777m, compared with \$2,402 in 2Q 1997. Combined net profit was \$1,652m in 2Q 1998, compared with \$1,418m a year earlier. Revenue rose 4.5% in the quarter.

Overall ASK growth was 1.9% in the quarter, and with industry RPK up 4.4%, load factor rose 1.8 points in 2Q98 to 73.9%.



The gap between industry revenue and cost per ASK opened up in the second quarter (see chart, above), as it did at all individual airlines apart from Northwest (see below).

The quarter encouraged three airlines to announce further stock repurchasing. Delta will buy back another \$750m of stock over the next 18 months, American is repurchasing an extra \$500m, and Southwest another \$25m. Airlines clearly believe that better-than-expected cash flows can be utilised best by handing them directly back to shareholders, rather than using them for suitable investment opportunities.





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## Briefing

### Europe's charter airlines await fall-out of industry consolidation

Europe's charter airlines have long been misunderstood (and unappreciated) by many observers. US-based analysts predicted their demise with the advent of European deregulation because they drew false analogies with their supplemental carriers. Others forecast that charters would switch to scheduled mode, bringing no frills/low fares into the European market. Neither development has happened. In this briefing *Aviation Strategy* takes a close look at European charter airlines and an industry that, nonetheless, has undergone fundamental change over the last few years.

Although deregulation has broken down artificial barriers (such as regulations preventing charters from selling direct to the public, or stopping scheduled airlines gaining access to charter markets), the distinction between charter and scheduled operations remains. The evidence is clear - there have been relatively few examples of charter airlines becoming successful scheduled players, or of scheduled airlines entering charter markets.

The main movers from charter to scheduled are shown in the table below. A distinction should be made between charter airlines that operate scheduled flights on traditional charter routes - such as many German carriers - and those charter airlines that have entered truly scheduled markets. That latter category - the true cross-marketers - consists mainly of Lauda-air, Virgin Express (ex-EuroBelgian), Spanair and Air Europa.

This indicates that charter airlines have - by and large - remained specialists in serving the markets and routes they know best. Many charters that have tried to enter the scheduled business in a big way - such as Britannia Airways in the 1980s - decided sooner or later that their long-term future lay in charter operations only.

And in the opposite direction - from scheduled to charter - there has been even less movement. Indeed many national airlines have sold their charter subsidiary - SAS and Scanair, Air France and Air Charter, and British Airways and Caledonian, to name but a few.

But why is this? Essentially, there are four reasons for why the charter and scheduled sectors remain distinct despite European deregulation:

- Differences between the charter and scheduled product;
- European tourism flows;
- Differences in charter and scheduled fleets; and
- The importance of vertical integration in the tourism industry.

### Product differences and tourism flows

Charter and scheduled products do not seem to be converging at all - or at least so far no supplier has been willing to bring them closer together. Despite some investment in new equipment, by and large the charter product consists of good soft spec (cabin crew service etc) disguising poor hard spec (seat pitch, food quality etc). Apart from seat-only sales, holidaymakers do not know how much their flights cost - all they want is the lowest holiday price possible. And there is even some indication that in the German market - where traditionally the charter product has been more upmarket and pricier than the rock-bottom UK market - there is now a tendency towards the traditional cheap and cheerful UK-style charter.

Given this, and other factors such as fixed stays, round-trips and single sectors, the charter airline has to operate within a very different set of

	December 1992		December 1997	
	Routes	Flights	Routes	Flights
<b>Domestic</b>				
<b>Air Europa</b>	0	0	57	1,663
<b>Spanair</b>	0	0	22	1,129
<b>Lauda-air</b>	0	0	1	5
<b>International</b>				
<b>Air Europa</b>	0	0	5	86
<b>Spanair</b>	0	0	1	4
<b>Monarch</b>	4	30	6	69
<b>Virgin Express</b>	0	0	7	797
<b>LTU</b>	0	0	64	479
<b>Aero Lloyd</b>	0	0	32	157
<b>Hapag-Lloyd</b>	0	0	70	661
<b>Condor</b>	2	8	65	458
<b>Transavia</b>	7	160	13	246
<b>Lauda-air</b>	2	39	14	517

Source: UK CAA.

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parameters than that of a scheduled carrier. And this makes it very difficult for one airline to change from one type of product to another with ease.

Similarly, the north-south Europe summer holiday flow remains the bedrock of the charter industry. The chart below shows how the charter industry has penetrated the deepest (in terms of what percentage of the population takes a charter flight) in countries in the north of Europe - UK, Germany, Scandinavia, the Netherlands and Belgium. Elsewhere - with the exception of Spain - charter penetration is almost negligible. Simple geography, therefore, and the desire of north Europeans to spend summer holidays by the Mediterranean still remains a strong barrier to charter operations being successful anywhere other than from northern Europe.

### Heterogenous fleets

Given the differences in product compared with the scheduled market, an airline serving the charter market generally needs a different type of aircraft to a scheduled carrier. The combined fleet of Europe's main specialist charter airlines (see table, right) has an average size of more than 200 seats, and many aircraft are larger than those used traditionally on scheduled routes. And in airports such as London Gatwick, even bigger aircraft may be the only answer to slot constraints.

Where the charter market is smaller - intra-Spain for example - smaller charter aircraft can be used more easily for scheduled services. But in the two largest markets, outbound from

Germany and the UK (which together account for almost two-thirds of all charter passengers in Europe), economies of scale are best exploited by using relatively large aircraft.

### Integration and consolidation

The main barrier to charter and scheduled airlines moving seamlessly between the two markets is the trend to vertical integration and consolidation within the European travel industry.

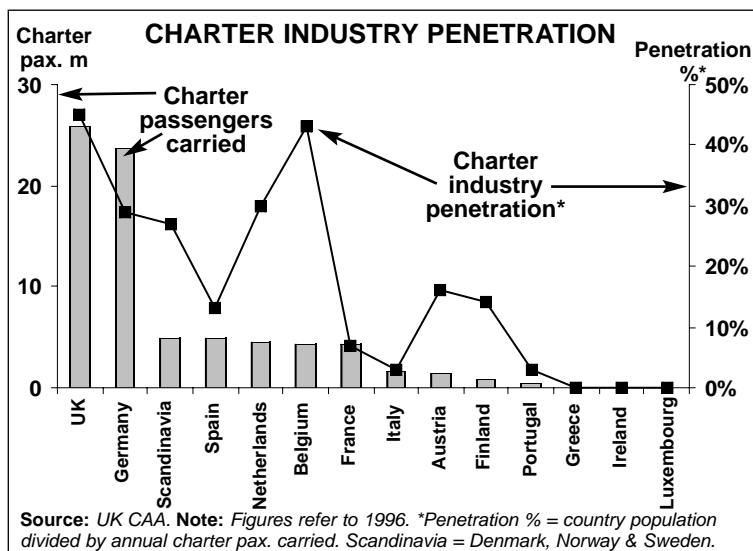
Vertical integration is now an accepted practice in the UK travel industry, following a 1997 investigation by the Monopolies and Mergers Commission (MMC) into complaints by smaller operators and agents that the large groups were squeezing them out. In a landmark decision the MMC ruled that the large integrated travel groups in the UK were "broadly competitive".

This led to a further round of consolidation in 1998, which has led to the emergence of four main travel groups - the so-called "Big Four". In June First Choice bought Unijet - the UK's fifth-largest operator, with 10% of the UK market - for \$180m. Unijet's charter airline, Leisure International, will be merged into First Choice's Air 2000 to form the UK's second largest charter carrier behind Britannia. (Unijet was 34% owned by KLM.) At the same time First Choice also bought Hayes & Jarvis, a specialist long-haul operator, for \$39m - long-haul is the fastest-growing segment of the UK package holiday market. Also in June 1998, Thomas Cook - owned by Westdeutsche Landesbank (WestLB) - bought Flying Colours for an estimated \$106m. Flying Colours has 4% of the UK package holiday market (through products such as Club 18-30) and in this case Thomas Cook's charter subsidiary, Airworld, will merge into Flying Colours' fleet.

The UK's Big Four - Thomson (which was floated in London in May at \$3.1bn), First Choice, Airtours (which failed in its bid to buy Unijet) and Thomas Cook - now control 80% of the UK's \$62bn a year package holiday market. And that market is growing at an estimated 8% per year.

The major travel groupings in the UK (and Germany) are shown on page 12. Only First Choice/Air 2000 does not have a travel agency chain, although some analysts predict a link-up with the AT Mays chain, owned by Carlson.

The same vertical integration and consolidation process is also occurring in the other major



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European charter market - Germany. Its travel industry has traditionally been comprised of an almost impenetrable maze of cross-shareholdings, but over the last 12 months two major and distinct travel groupings have emerged - dubbed the Yellow and Red alliances after their respective logos.

The Yellow alliance is based around C&N Touristic, a 50:50 joint venture formed by the 1997 merger of Condor - Lufthansa's charter subsidiary - and NUR Touristic, the tour operator owned by German retailer Karstadt. C&N has sold travel agency Euro Lloyd (owned 49% by Lufthansa and 51% by Karstadt) to Kuoni, but still has substantial travel agency presence via NUR. The full structure of the Yellow alliance is set to be unveiled in October.

The Red alliance is centred around German conglomerate Preussag, which in 1997 bought the travel group Hapag-Lloyd for \$1.5bn in order to link it to TUI (Germany's largest tour operator). However, the German Cartel Office insisted that it would only give its approval for this deal if WestLB - which owns 30% of Preussag - sold its 34% stake in airline/tour operator LTU (see page 13).

### The charter mantra

For charter airlines, the implication of this vertical integration and consolidation in national markets is clear - they need to be part of a major travel grouping in order to guarantee access to the tour operator contracts they rely on. The future for

the remaining independent charters looks increasingly difficult, because relying on supplying marginal capacity to the large travel groups in the UK and Germany is fraught with danger. For example, Wolfgang Beeser - the chairman of NUR Touristic - says that the proportion of seat capacity it buys from Condor will rise from the current 40% to around 60% through the dropping of non-Yellow alliance charter airlines.

Elsewhere, UK tour operator Inspirations - which owns Caledonian and accounts for 4% of the package holiday market - may be too small to survive long-term against its bigger rivals. Last year Inspirations was bought by the US-based Carlson Group, although in June Carlson served a writ against former Inspirations directors, accusing them of misrepresentation relating to the sale.

The necessity for a link-up with a large travel group is a point that European scheduled airlines with charter subsidiaries have realised only comparatively recently. Unless they can ally the charter offshoot with a major tour operator - as Lufthansa has done with Condor - for the reasons already explained they face no alternative but to sell the charter subsidiary.

When British Airways sold Caledonian in 1995 it stated that it made the move because successful charter operations needed to be vertically integrated with a successful tour operator. KLM too is selling its 34% stake in Unijet/Leisure International (although it still owns Dutch charter airline Martinair), Air France and SAS have

<b>FLEET OF MAJOR EUROPEAN CHARTER SPECIALISTS</b>										
	Condor	Britannia Airways	Hapag-Lloyd	LTU	Aero Lloyd	Airtours Int.	Monarch Airlines	Germania	Air 2000	TOTAL
737-300								9		9
737-400			11							11
737-500			5							5
737-700							6(6)			6(6)
737-800			3(13)							3(13)
757-200	18	19(2)		10		4	6		9(1)	66(3)
757-300	(12)									(12)
767-200		6								6
767-300	9	5		5		3				22
DC-10-30	3						1			4
MD-11				4						4
MD-80					10					10
A300-600							4			4
A310-200			4							4
A310-300			4							4
A320-200	3(3)				6(2)	10	5		4	28(5)
A321-200					2(1)	1	1(2)			4(3)
A330-200						(2)	(2)			(4)
A330-300				6						6
<b>TOTAL</b>	<b>33(15)</b>	<b>30(2)</b>	<b>27(13)</b>	<b>25</b>	<b>18(3)</b>	<b>18(2)</b>	<b>17(4)</b>	<b>15(6)</b>	<b>13(1)</b>	<b>196(46)</b>

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offloaded their charter subsidiaries, while Iberia is deciding whether to turn its loss-making charter airline, Viva Air, into a low-cost scheduled carrier.

### Pan-European consolidation

But over and above vertical integration and consolidation within countries, charter airlines also face the consequences of increasing consolidation across countries. The German Cartel Office's ruling on WestLB and LTU marks the limit of domestic consolidation, and with most of the small players now snapped up in the UK, any consolidation between the Big Four would tip a merged group past the crucial 25% market share mark, which is the key determinant of whether the MMC would intervene. And that is why the Big Four, as well as the two German groups, are now looking to expand overseas.

Although the German groups have a head start in foreign expansion, the UK companies are catching up fast - and their prime target is Germany itself, particularly now that the complex cross-shareholdings are being broken down. The German charter market differs slightly from the UK in that German package holidaymakers have traditionally preferred a higher quality, higher

priced product. There are also regulations that forbid fare discounting outside a specified period.

But these norms were challenged in 1997 by Thomson, which set up a charter airline subsidiary - Britannia Airways Germany - in partnership with local tour operator FTi Touristic. According to some estimates, Britannia's German operation offers tour operators fares that are up to 30% lower than German charter airlines' prices. Thomson is also looking for opportunities in the Benelux markets, and in 1997 bought Scandinavian tour operator Fritidsresor and its charter airline Blue Scandinavia (renamed Britannia AB) for \$425m.

Airtours was not far behind Thomson. In May 1998 Airtours bought 29% of German tour operator Frosche Touristik for \$28m (and has an option to acquire the rest of the privately-owned company in 2002). Frosche has 5% of the German package holiday market, and also has more than 100 franchised travel agents.

However, Thomson and Airtours' forays into Germany so far are small beer compared with the main prize on offer - LTU. As both a tour operator and an airline LTU is a key player in the German travel industry, and beyond. For example LTU has won a major contract to fly for Swiss operator ITV

### MAIN TRAVEL GROUPINGS IN UK AND GERMANY

HOLDING COMPANY	TOUR OPERATOR /TRAVEL GROUP	AIRLINE	TRAVEL AGENT	OTHER EUROPEAN INTERESTS
21% share of UK package holiday market				
Thomson Corp. (Canada)	Thomson	Britannia Airways	Lunn Poly	Swedish tour operator Fritidsresor Also interest in Ireland & Germany
15% share of UK package holiday market				
Carnival Cruise Lines (US)	Airtours 30%	Airtours International	Going Places	Scandinavia: SL Group/Premiair 29% of German operator Frosche Touristik. Also in France, Benelux (Sun International/Air Belgium) & Italy
15% share of UK package holiday market				
First Choice Holidays	First Choice	Air 2000 (& Leisure Int.)		
9% share of UK package holiday market				
Westdeutsche Landesbank	Thomas Cook Group/Sunworld	Flying Colours (& Airworld)	Thomas Cook	
28% share of German package holiday market				
Preussag	TUI	Hapag-Lloyd	Hapag Lloyd	Hotels interests in Greece and Spain. Tour ops. in Benelux; 50% of JetAir
20% share of German package holiday market				
Lufthansa Karsdadt	C&N Touristic/ NUR Touristic	Condor	NUR Touristik	Tour ops. in Austria, Belgium, France, the Netherlands, Hungary & Poland

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(itself a 1997 merger of three Swiss companies), after ITV was gazumped by Swiss rivals Kuoni and Hotelplan, which chartered the entire summer 1998 capacity of Balair/CTA and TEA Switzerland.

Yet the German Cartel Office's ruling means that a German buyer with large existing travel interests is out of the question for LTU, so this theoretically provides an ideal opportunity for Airtours or Thomson to grab a major share of the German market in one go.

WestLB, though, has other ideas. It may have ruled out any acquisition by UK buyers by transferring its LTU stake to an insurance company and setting it a three year deadline to find a suitable permanent buyer. This delay is likely to encourage German buyers with few existing travel interests to come forward and put together a high enough price to outbid any UK competition. A so-called "Third Force" in Germany's travel industry would be the result - but WestLB would far prefer that to Airtours or Thomson acquiring LTU.

The main competitor to Airtours and Thomson in German may come from the Swiss. Kuoni has bought the travel agency Euro Lloyd from C&N and is believed to be looking for further German acquisitions, while the SAirGroup is reported to be interested in LTU.

Outside Germany, Airtours and Thomson have pretty well sewn up Europe's third-largest charter market - Scandinavia. Although Airtours' SLG has recently faced difficulties due to overcapacity in the local market, together Airtours and Thomson account for two-thirds of package tour sales in Scandinavia.

## Two options for charters

The chief determinant of the charter industry into the next decade will be pan-European tour operator and travel group consolidation - not charter airline consolidation. But as tour operators consolidate across Europe, their respective charter airlines will consolidate too.

It will be interesting to see just how far UK travel companies penetrate the German market, and whether their associated lower-cost charter airlines can win large chunks of the outbound market. Whichever company - British or otherwise - acquires LTU will have a real opportunity to challenge the Red and Yellow alliances.

For independent charter airlines though, the future holds one of two options - to give up inde-

pendence and merge/align with one of the major travel groups/tour operators; or to battle it out with the remaining independents for the marginal charter capacity needed by the big group.

On the first option, time may be running out to find suitable benevolent parents. The large groups have charter subsidiaries of their own and are mostly interested in acquiring tour operators first and charter capacity second. Guaranteed demand for the holiday product is the scarce resource that travel groups most urgently seek - not charter capacity.

The second option - remaining independent - is fraught with danger. If a charter airline is too reliant on contracts with independent tour operators, there is always the possibility that the operator may get taken over by one of the large groups, which will then install its own in-house charter carrier.

This happens to even the larger charter airlines. For example Thomson won a three year contract to supply charter capacity via Britannia to the German tour operator Frosche. But since that deal Airtours has taken a stake in Frosche, and so when the contract ends Airtours International is likely to step in and replace Britannia. At least in this case Britannia is linked to a travel giant of its own, and the Frosche contract is only a small proportion of its overall business.

The remaining independent tour operators may just decide to set up their own charter airlines anyway. Spanish group Viajes Iberia, for example, replaced Airworld (which it sold along with operator Sunworld to Thomas Cook in 1996) with a new charter airline of its own - Iberworld.

The independent charter airlines, therefore, may prefer to supply the marginal capacity needed by the large travel groups (on extended contracts, if possible), rather than the bulk of the capacity needed by a small, independent (and vulnerable) tour operator. But competition will be tough, and only the non-aligned charter airlines with rock-bottom costs (and perhaps smaller-capacity aircraft) will survive. And in times of recession it is the independents that face the most danger - Dan-Air is the perfect example of this.

However, large travel groups *will* always need marginal capacity at peak periods, so there will always be a niche for small, independent charter airlines. But the days of the medium-to-large sized independent charter airline are firmly over.

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### Alaska Airlines comes in from the cold

Alaska Airlines, the smallest of the US major carriers, has returned to good profitability thanks to its ability to reduce drastically unit costs while maintaining excellent service quality. Its sister company Horizon, the nation's sixth largest regional carrier, is now, in turn, staging a turnaround. Record profits, a vastly improved balance sheet, a \$425m new aircraft order and good expansion opportunities in a stabilised West coast competitive environment make the prospects for Alaska Air Group (AAG) look particularly promising.

This is in total contrast to the situation three or four years ago, when Alaska Airlines looked very much like a loser when it was suddenly caught in the fierce market share battles between Southwest and United's Shuttle. Alaska's unit costs, at almost 10 cents per ASM in 1993, were among the highest in the industry. It was a full-service carrier, charging high fares and focusing on business traffic. Apart from some limited damage inflicted by low-cost carriers like MarkAir (now defunct) in the early 1990s, Alaska had hitherto faced only gentle competition from the other majors.

The carrier seemed largely unprepared when Southwest and United's Shuttle saturated the bulk of its markets with extremely low fares. The impact was to slash Alaska's yield by 14.2% in 1994 and by another 5% in 1995, which the company called one of the roughest years in its 64-year history. Although AAG had managed to return to profitability in 1994 (after two years of net losses totalling \$116m), its net profit fell in 1995 and remained at a very marginal 1-2% of revenues up to and including 1996.

However, the latest financial results indicate that Alaska managed to turn the potentially disas-

trous developments to its advantage. This was largely accomplished through a rapid and extremely successful cost-cutting programme, which appears to have had minimal negative impact on service quality, though lower fuel prices and a stabilised competitive environment have also helped.

AAG posted a \$15.1m net profit for the fourth quarter of 1997 - usually a loss-making period - and a record \$72.4m profit for 1997, which was nearly double the previous year's \$38m. In the first quarter of 1998, traditionally Alaska's toughest, the company earned a \$13.1m net profit, compared with a \$5.7m loss a year earlier. In mid-July, analysts were expecting a net profit of around \$30m-\$35m for the quarter ended June 30.

#### Impressive turnaround

Alaska's cost-cutting programme, which was instigated in 1993, included extensive fleet rationalisation and restructuring. The carrier cancelled some aircraft orders and began to reduce its fleet to just two types, which included the disposal of its 727s. It also renegotiated aircraft leases and refinanced debt.

Some marginal one-stop routes were terminated, often in favour of operating those sectors non-stop. Alaska also laid off around 600 mostly white-collar workers and cut the number of flight attendants manning aircraft. When threatened by fleet cuts and furloughs, its pilots agreed to a 5% pay cut and reduced pay rates for additional flying.

The combined effect of the cost cuts, which amounted to about 10% or \$110m per year, and continued capacity growth was to slash Alaska's unit costs by 22% in just two years, to 7.71 cents per ASM in 1995. This was probably the closest that it could get to Southwest's levels, given the higher costs involved in having significant operations in the state of Alaska.

Since then the airline's unit costs have risen (8.51 cents in 1997), in large part due to growth but also because of inevitable wage increases. Flight attendants (AFA) secured higher pay in 1994, dispatchers (TWU) in 1996 and pilots

#### ALASKA FLEET PLANS

	Current fleet	Orders (options)	Delivery/retirement schedule
737-200C	8	0	
737-400	30	8	5 in 1998, 3 in 1999
737-700	0	8 (14)	5 in 1999, 3 in 2000
737-900	0	10 (10)	5 in 2001, 5 in 2002
MD-80-82	9	0	To be replaced by 737s
MD-80-83	33	0	To be replaced by 737s
<b>TOTAL</b>	<b>80</b>	<b>26(24)</b>	

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(ALPA) late last year. However, the long-term deals offered increased productivity, as well as staffing and scheduling flexibility. While talks continue with the mechanics (IAM) and the AFA contract becomes amendable next March, Alaska is in the enviable position of not having to start negotiating with pilots until the beginning of 2003.

The earlier cost cuts were painful enough to lead to the departure of Alaska's former CEO Raymond Vecci. The board fired him, citing differences in management style, in early 1995, even though by then recovery was underway. With hindsight, Vecci has been given the bulk of the credit for the turnaround.

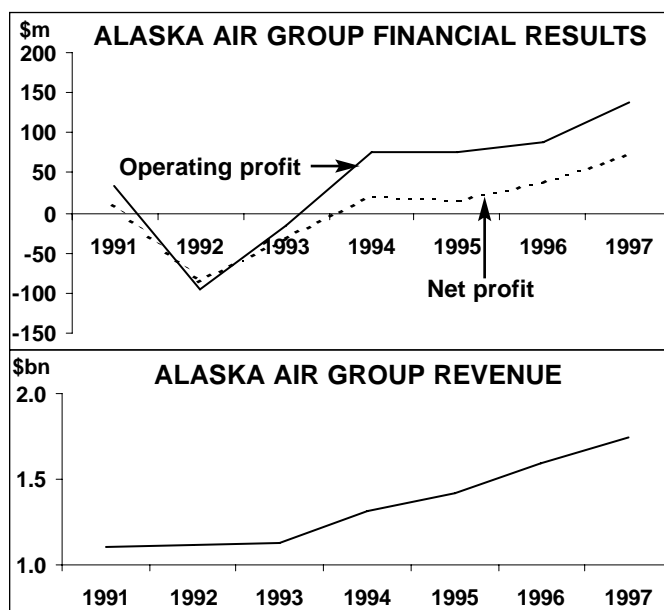
Even when the main emphasis was on cost-cutting, Alaska had the foresight to invest extensively in labour-saving technology. It was early to provide electronic ticketing, which offers major savings in distribution costs, and claims to have been the first US carrier to sell tickets on the Internet.

But the most impressive aspect of Alaska's deep cost-cutting was that it appears to have had little adverse impact on its traditionally excellent service quality. The airline has continued to receive prestigious awards from travel organisations and perform well in the DoT's service quality rankings.

By continuing to pay exceptional attention to detail, both in the air and on the ground, Alaska has retained much of the high-yield business travel segment. Although some of the extra luxuries that it was previously famous for have had to go, product differentiation appears greater now that the main competitors are Southwest and the Shuttle rather than the large majors. But by lowering its fares to match those of the low-cost competitors, Alaska is obviously now also carrying more leisure traffic.

The stabilisation of the West coast competitive situation over the past 18 months has provided much relief. This began when the Shuttle conceded defeat to Southwest, pulled out of many competitive markets and focused on feeding United at its San Francisco and Los Angeles hubs. The two carriers now co-exist relatively peacefully, while Southwest itself is focusing its main efforts on the East coast.

Alaska attributed much of the 1997 financial improvement to the "absence of silly fares" that it had in 1996. Its unit revenues rose by 7.8% and yield by 7.1% last year, and the positive trends have continued. Over the past 18 months,



Alaska's revenue growth (over 9% annually) has been the highest among the majors, even exceeding Continental's (which is in the middle of a major growth phase).

While the policies initiated by Vecci were continued by his successor, John F. Kelly, there has also been a new emphasis on growth in existing markets. Alaska's capacity rose by 7.3% in 1996, 3.6% in 1997 and 7.4% in the first six months of this year. Much of this has been achieved with the same fleet, as the more flexible union contracts have made it possible to improve aircraft utilisation (from just over eight hours per day in 1993 to 11.4 last year).

Since traffic growth has exceeded capacity addition, Alaska's load factors have also improved. The average passenger load factor rose from the low-60s typical up to and including 1995 to 66% in 1996 and 67.3% last year.

The efforts of Horizon, Alaska's regional subsidiary, to adjust to increased competition in its markets are also finally beginning to pay dividends. After merely breaking even in 1996, the regional carrier reported a \$6.3m pre-tax profit on \$303.6m revenues for 1997, and also a small profit for the March quarter.

The turnaround was attributed to lower fuel prices, reduced costs associated with a simplified fleet and a longer average stage length. The fleet simplification has meant the retirement of the Dornier 328s, Metros and F28-1000s, and eventually also the Dash 8-100s, to narrow the fleet down to just two types. After operating a compli-

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cated route network from four different hubs, the carrier is now focusing on more long-haul flying out of a single Seattle hub.

As a result, after years of unit costs persistently exceeding 20 cents per ASM (the highest among the US regional carriers), Horizon's unit costs fell by a substantial 12.5% in the first quarter. Further cost reductions are anticipated as the streamlining of the fleet takes full effect.

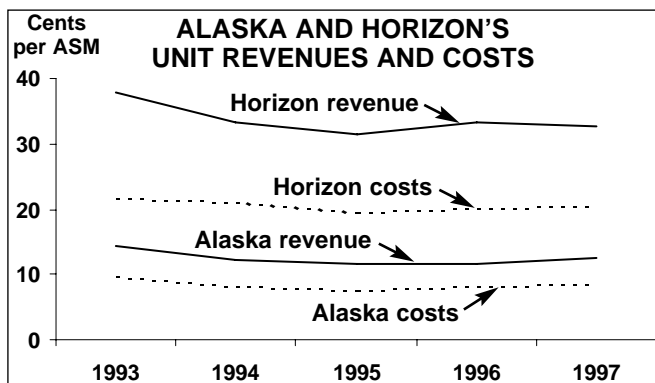
The bottom line improvements at AAG have been accompanied by a substantial strengthening of the balance sheet. Long-term debt and capital lease obligations have fallen from \$590m at the end of 1994 to \$335m at the end of March 1998, while in the same period shareholders' equity rose from \$191m to \$553m. The balance sheet and leverage ratios improved further in the June quarter as the company completed the redemption of \$126m of debentures due in 2005. The Group had \$251m in cash on March 31, up from \$102m at the end of 1996.

In recent months Alaska has been one of only two US major carriers to see their corporate ratings upgraded by credit rating companies (the other one was US Airways). S&P recently revised AAG's rating from BB- to BB+, citing "improved financial profile due to higher earnings as well as a reduction in balance sheet debt".

The improvements have also meant a steady rise in AAG's share price, from \$20-\$25 in the second half of 1996 to about \$40 at the beginning of 1998, and a further rally to almost \$60 by mid-July.

## Fleet plans

Alaska currently operates a fleet of 80 aircraft: 42 MD-80s, 30 737-400s and eight 737-200s (Feb 26). It is in the process of eliminating the MD-80 fleet, in order to achieve the substantial commonality benefits offered by an all-737 fleet.



The carrier's improved cost structure and the more stable West coast competitive environment have positioned it well for growth, while the reduction of debt has eased the financing of major new aircraft acquisitions. The past two years have seen several new Boeing aircraft orders, for a flexible mix of 737 variants to fit short, intermediate and long-haul markets.

The process began in September 1996 when Alaska ordered 12 140-seat 737-400s and took 12 options, valued at about \$540m. The deliveries of that batch began about a year ago, replacing the older MD-80s on a one-for-one basis.

In November 1997 Alaska became the launch customer for the 737-900 when it announced a firm order for 15 aircraft (two -400s delivered this year, three 122-seat -700s due in 1999 and 10 -900s due in 2001-2002) plus 10 options, valued at over \$1bn. The carrier said that the 174-seat 737-900 was a perfect fit for its high-volume, long-haul markets.

In May the carrier placed a \$425m order for six 737s, including five 700-series and one 400-series, plus options for four "next generation" 737s, for delivery in 1999-2001.

This latest order brought to 50 the number of 737s currently on order and option. Five more -400s are due for delivery this year, followed by eight -400/700s in 1999 and up to eight -700s in 2000. If all the options are taken, Alaska's fleet will expand from the present 80 to 130 in six years' time.

For some years already, Alaska's fleet has been the youngest among the majors, currently averaging 7.6 years of age. The fleet also became the quietest in December, when Alaska completed the hushkitting of its remaining 737-200s - the first US major to achieve an all-Stage 3 fleet.

The aim at Horizon is to eliminate the currently 21-strong Dash 8-100 fleet in favour of the Dash 8-200s. There are now 17 of the 200-series in the fleet, with further deliveries due in a steady stream through 2004. The F28-4000s (17) have already replaced the earlier F28-1000 fleet.

## Route expansion strategy

Alaska operates a north-south network along the West coast, stretching from the Russian Far East to Mexico. Together with Horizon, it currently serves 76 cities in Alaska, Mexico, Canada, Russia and seven Western states.



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Over the past few years, much effort has gone to strengthening the key strategic routes, namely those that link Seattle with the Bay area and Los Angeles, with substantial frequency additions. As a result, Alaska has not only retained but improved its number one position in most of those markets. Its share of Alaska-West coast passengers has risen from 56% in 1994 to 75% at present, while the Pacific Northwest to Northern California market recorded a similar increase.

The airline appears to have lost only a couple of percentage points in market share on Pacific Northwest to Southern California routes (about 40% at present), where competition has been the fiercest.

In 1996 Alaska began serving Vancouver in Canada from San Diego, and last year, thanks to the full implementation of the open skies agreement, expanded service there from several West coast cities. The idea is to tap the Canadian leisure market destined to winter sun. At the same time, the carrier has boosted winter services to Mexico. A fifth Mexican destination, La Paz, will be added in October with flights from Seattle via Los Angeles.

Alaska has also continued to boost its services to the Russian Far East, which began in 1991 and now cover five destinations. While otherwise much of the recent focus for new expansion has been in the south, the state of Alaska remains an important market, accounting for about a quarter of the carrier's total traffic.

Having found a good niche, Alaska has no plans to divert away from the north-south flying pattern and venture further east to more competitive pastures. The new aircraft will be used to boost service in existing markets and introduce more non-stops between cities already served.

### Position vis-à-vis alliances

Alaska's long term strategic position in a future domestic marketplace possibly dominated by a few mega-alliances appears reasonably secure because of its longstanding co-operation with Northwest. The association dates back to 1989, when Horizon began codesharing with Northwest, and Alaska followed in the early 1990s.

The link-up is a natural one because of Northwest's extensive Asian operations. After codesharing on numerous domestic and Mexico routes, about a year ago Alaska and Northwest expanded their co-operation to Alaska's flights in the Russian Far East. The carriers offer convenient connecting flights, through fares and check-in processes and reciprocal FFPs.

As an indication of things to come, in early June Alaska and Northwest's longstanding partner KLM signed a marketing alliance, which also includes Horizon, to offer reciprocal FFPs and to codeshare on selected flights. Alaska will carry KLM's code on certain flights connecting with Northwest-operated KLM flights at Seattle and with KLM-operated service at Los Angeles, San Francisco and Vancouver (the latter subject to government approval). The deal also envisages co-ordination of schedules and connections, as well as linked computer check-in and reservations systems.

Alaska was also one of the four US airline signatories in the recently-forged marketing and codeshare agreement with Air China. Deals like that may pave the way for codeshare opportunities with Continental and America West.

### Prospects

Alaska Air Group's 1997 net profit margin of 4.2%, though similar to America West's, still lagged behind those of the large majors by a few percentage points. Consequently, its main challenge now is to improve profit margins, while coping with the additional demands posed by growth.

The further improvements could come from higher load factors, yields and aircraft utilisation, as well as the commonality benefits and scale economies offered by the eventual all-737 fleet. However, keeping unit costs under control poses a major challenge after years of heavy cost-cutting.

The traffic and load factor statistics for the second quarter indicate a continuation of positive trends. Most analysts view the company's earnings prospects as excellent and still rate its shares as a buy, though some now feel that the stock is becoming overvalued. The current First Call consensus forecast is a net profit of \$4.63 per share for 1998 (up from \$3.53 last year) and \$4.74 for 1999.

*By Heini Nuutinen*

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## Management

### How widespread is managerial incompetence?

When airlines turn in poor results or go bankrupt, just how much is management to blame? In this article *Aviation Strategy* examines whether airlines should look a bit closer to home for the real reason for poor performance.

In general, the relationship between weak management and corporate performance is clear - poor management almost always results in weak company performance, but poor corporate performance does not necessarily mean the company has poor managers; there may be industry-specific or macro-economic reasons instead.

But although this relationship is obvious, few companies in any industry are willing to admit that current management is responsible for current woes. It usually takes a shareholder - often fund managers with large investments - to force managerial changes.

Aviation is no exception to this phenomena. In Europe and Asia in particular, management change usually occurs only after a sustained period of poor performance - and when chief executives go there is little (public) reflection on what effect their decisions have had.

#### The US experience

In North America, poor managerial performers last for less time than in other areas of the world, due to shareholder pressure, but even here the impact of poor management on airlines is rarely discussed. However, the issue may now be getting some attention following the release of a study by the Aviation Institute at George Washington University\* into why new entrant airlines fail.

The study almost entirely dismisses predation as a factor in start-up failure. Instead the report's author, Darryl Jenkins, Director of the Aviation Institute, cites poor management as the main cause of corporate failure.

According to the report, its survey of Chapter 11 and Chapter 7 filings since 1979 found that the following reasons are most regularly given by airlines for their failure:

- 1) Operational plans
- 2) Excessive debt
- 3) Escalating costs
- 4) Inadequate traffic
- 5) Economic downturns
- 6) Inability to obtain adequate financing
- 7) Lack of management expertise

The report claims that the common link between most of these is management. It appears that airlines that fail seem to have an amazing ability to hire poor management. The report found that of all the airlines that failed in the 1990s, 97% employed senior executives who had been involved in a previous Chapter 11; 75% had executives who were involved in two previous Chapter 11s; more than 50% had executives with experience of three filings; and 15% had executives who were involved in four or more previous filings. In *Aviation Strategy's* opinion these facts are somewhat misleading because what the report does not do is give comparable figures for managements at airlines that do not fail - but nonetheless the figures do raise the question of just what calibre of executives do failed airlines actually employ?

#### The bad management effect

And what are the precise characteristics of poor management? According to the report, the most telling contribution of weak management is a "basic inability to plan a route network". Evidence for this comes from a tendency at airlines that fail for them to enter and exit markets with enormous frequency. Over the last five years, the average length of time a start-up remains on a city pair before it retreats from the market is six months. And predatory pricing is *not* to blame for market exit, the report claims. If routes

# Aviation Strategy

## Management

where predatory pricing has been alleged are taken out of the survey, the average time spent by start-ups in routes before they retreat is the same. With or without predatory pricing, there is no statistical difference in how long start-ups stay in markets.

The report also states that very few airlines that file for bankruptcy cite predatory pricing as a cause of their failure (although surely that in itself does not mean that predation does not exist?).

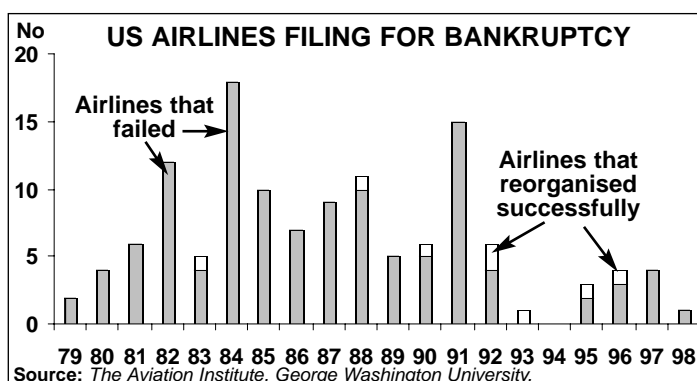
The study also looks at the most successful new entrant - Southwest - and compares it with the failures (although, again, this can be criticised since Southwest existed long before US deregulation and, critically, enjoyed regulatory protection during its early growth at Dallas Love Field).

In particular, the report highlights Southwest's tendency to offer high frequency in the markets it enters. This contrasts with most start-ups, which usually offer low frequency, resulting - it is claimed - in low average aircraft utilisation rates, high unit costs, low marginal revenue and high marketing and station costs. It seems it is much better to offer high frequency service in a relatively small number of new markets each year (as Southwest does) than offer low frequency and rapid market growth.

However, what the report doesn't go on to do is examine just *why* managements adopt a low frequency/high growth strategy? Is it by choice or do start-ups have no other option? Often start-ups have no choice but to aim for rapid growth - if you are tiny to begin with, any growth is rapid. And other airlines do try their best to make it impossible for start-ups to launch with higher frequencies.

Nevertheless, Jenkins says: "The problem with growth is managing it. It takes up every available cent, causes costs to go up rapidly and results in confusion for management, who often get reports back too late to really know what is going on."

As growth gets unmanageable, a chain of events is set in motion - break-even load factors rise (to the high 60s to high 70s), leading to poor revenue management and pricing. But it would be wrong to condemn growth as a strategy for start-ups - surely it is more



accurate to say that it is the execution of growth is the real problem.

### Lessons of a flawed study

Although Jenkins' study consists more of assertions than detailed analysis, it does serve to bring the issue of poor management to the fore, and it has brought forward a barrage of counter-arguments by critics. Most loud are those observers who have traditionally blamed predatory behaviour by established competitors for the demise of start-ups, and not poor management. They emphasise the concerns about the study that *Aviation Strategy* has pointed out, but disingenuously ignore the point that poor management is a key factor in start-up failure.

The reality lies between the two extremes. Yes, predation is a major cause of start-up failure (although this depends on how you define predation), but poor managerial decisions do have a greater impact on success or failure than many realise. Often the two factors overlap - start-up managements often choose markets where predation by an established competitor is inevitable, even if it is illegal.

Poor management and the reasons behind it are certainly something that the industry needs to consider further. Perhaps there is one factor that many observers overlook. Unlike other industries, aviation is regarded as sexy, and that often attracts not just pure entrepreneurs but also former industry employees (from pilots to financiers) who want to stay in the industry and believe that they can do better than others. Perhaps that is the real cause of poor airline management.

\*An examination of why new entrant airlines fail, by Darryl Jenkins, The Aviation Institute, George Washington University

# Aviation Strategy

## Macro-trends

### EUROPEAN SCHEDULED TRAFFIC

	Intra-Europe			North Atlantic			Europe-Far East			Total long-haul			Total international		
	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 %
1991	114.8	65.2	56.8	120.9	84.3	69.7	80.0	53.1	66.4	267.6	182.0	68.0	397.8	257.9	64.7
1992	129.6	73.5	56.7	134.5	95.0	70.6	89.4	61.6	68.9	296.8	207.1	69.8	445.8	293.4	65.8
1993	137.8	79.8	57.9	145.1	102.0	70.3	96.3	68.1	70.7	319.1	223.7	70.1	479.7	318.0	66.3
1994	144.7	87.7	60.6	150.3	108.8	72.4	102.8	76.1	74.0	334.0	243.6	72.9	503.7	346.7	68.8
1995	154.8	94.9	61.3	154.1	117.6	76.3	111.1	81.1	73.0	362.6	269.5	74.3	532.8	373.7	70.1
1996	165.1	100.8	61.1	163.9	126.4	77.1	121.1	88.8	73.3	391.9	292.8	74.7	583.5	410.9	70.4
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
May 98	15.8	10.4	65.6	17.1	13.4	78.8	11.5	7.9	68.6	38.8	28.5	73.6	57.2	40.5	70.7
Ann. chng	6.6%	9.0%	1.4	10.1%	7.4%	-2.0	5.4%	5.0%	-0.3	9.2%	9.0%	-0.2	8.8%	8.9%	0.1
Jan-May 98	74.5	45.7	61.3	73.7	54.4	73.9	56.0	40.6	72.5	179.5	132.5	73.9	266.3	185.9	69.8
Ann. chng	7.5%	10.3%	1.5	9.7%	8.0%	-1.2	7.6%	5.8%	-1.3	9.5%	8.3%	-0.9	9.0%	8.5%	-0.3

Source: AEA.

### US MAJORS' SCHEDULED TRAFFIC

	Domestic			North Atlantic			Pacific			Latin America			Total international		
	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 %
1990	863.1	523.2	60.6	121.3	84.2	69.4	106.7	75.8	71.0	42.2	26.6	63.0	270.2	186.5	69.0
1991	835.1	512.7	61.4	108.0	75.2	69.6	117.0	78.5	67.1	44.3	27.4	61.8	269.2	181.0	67.2
1992	857.8	536.9	62.6	134.4	92.4	68.7	123.1	85.0	69.0	48.0	27.4	57.0	305.4	204.7	67.0
1993	867.7	538.5	62.1	140.3	97.0	69.2	112.5	79.7	70.8	55.8	32.5	58.2	308.7	209.2	67.8
1994	886.9	575.6	64.9	136.1	99.5	73.0	107.3	78.2	72.9	56.8	35.2	62.0	300.3	212.9	70.9
1995	900.4	591.4	65.7	130.4	98.5	75.6	114.3	83.7	73.2	62.1	39.1	63.0	306.7	221.3	72.1
1996	925.7	634.4	68.5	132.6	101.9	76.8	118.0	89.2	75.6	66.1	42.3	64.0	316.7	233.3	73.7
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
May 98	80.2	57.8	72.1										30.0	22.3	74.4
Ann. chng	0.4%	3.9%	2.4										7.9%	6.7%	-0.8
Jan-May 98	393.2	271.4	69.0										140.6	100.3	71.3
Ann. chng	0.8%	2.0%	0.8%										7.0%	4.8%	-1.5%

Note: US Majors = American, Alaska, Am. West, Continental, Delta, NWA, Southwest, TWA, United, USAir. Source: Airlines, ESG.

### ICAO WORLD TRAFFIC AND ESG FORECAST

	Domestic			International			Total			Domestic growth rate		International growth rate		Total growth rate	
	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK %	RPK %	ASK %	RPK %	ASK %	RPK %
1991	1,267	800	63.2	1,487	998	67.1	2,754	1,798	65.3	-0.3	0.6	-2.6	-6.1	-1.6	-3.2
1992	1,300	840	64.6	1,711	1,149	67.2	3,011	1,989	66.1	2.7	5.0	15.0	15.2	9.4	10.7
1993	1,347	856	63.6	1,790	1,209	67.5	3,137	2,065	65.8	3.6	1.9	4.6	5.2	4.2	3.8
1994	1,403	924	65.8	1,930	1,326	68.7	3,333	2,250	67.5	4.2	7.9	7.8	9.7	6.3	9.0
1995	1,477	980	66.3	2,044	1,424	69.7	3,521	2,404	68.3	5.3	6.1	5.9	7.4	5.6	6.9
1996	1,526	1,046	68.6	2,163	1,537	71.1	3,689	2,583	70.0	3.3	6.7	5.8	7.9	4.8	7.4
1997	1,617	1,102	68.2	2,387	1,704	71.4	4,004	2,807	70.1	4.6	5.5	7.6	9.1	6.4	7.7
*1998	1,624	1,122	69.1	2,470	1,751	70.9	4,094	2,873	70.2	0.4	1.8	3.5	2.7	2.3	2.4
*1999	1,675	1,155	69.0	2,586	1,833	70.9	4,261	2,988	70.1	3.2	3.0	4.7	4.7	4.1	4.0
*2000	1,738	1,194	68.7	2,729	1,930	70.7	4,467	3,124	69.9	3.7	3.3	5.5	5.3	4.8	4.5
*2001	1,791	1,218	68.0	2,857	2,004	70.1	4,648	3,222	69.3	3.1	2.0	4.7	3.8	4.0	3.1
*2002	1,806	1,210	67.0	2,916	2,015	69.1	4,722	3,225	68.3	0.8	-0.7	2.1	0.6	1.6	0.1
*2003	1,857	1,273	68.5	3,066	2,165	70.6	4,923	3,437	69.8	2.9	5.2	5.1	7.4	4.3	6.6

Note: \* = Forecast; ICAO traffic includes charters. Source: Airline Monitor, July 1998.

### DEMAND TRENDS (1990=100)

	Real GDP					Real exports					Real imports				
	US	UK	Germany	France	Japan	US	UK	Germany	France	Japan	US	UK	Germany	France	Japan
1991	99	98	101	101	104	106	99	112	104	105	99	95	113	103	97
1992	102	98	102	102	105	113	103	112	109	110	107	101	115	104	96
1993	105	100	100	101	105	117	107	106	109	112	117	104	108	101	96
1994	109	103	103	104	106	126	117	115	115	117	131	110	117	107	104
1995	111	106	105	106	107	137	126	122	123	123	141	115	124	113	119
1996	114	108	107	107	111	152	135	128	128	126	155	124	127	116	132
1997	118	112	110	109	112	172	146	142	142	138	177	135	136	123	132
*1998	121	113	113	113	112	180	154	155	154	145	200	148	146	133	130
*1999	124	115	116	116	113	189	160	166	163	155	219	156	156	141	133

Note: \* = Forecast; Real = inflation adjusted. Source: OECD Economic Outlook, June 1998.

# Aviation Strategy

## Macro-trends

### COST INDICES (1990=100)

	Europe						US					
	Unit revenue	Unit op. cost	Unit lab. cost	Efficiency	Av. lab. cost	Unit fuel cost	Unit revenue	Unit op. cost	Unit lab. cost	Efficiency	Av. lab. cost	Unit fuel cost
1990	100	100	100	100	100	100	100	100	100	100	100	100
1991	106	109	103	105	108	88	100	102	102	101	103	84
1992	99	103	96	119	114	80	98	100	101	107	108	75
1993	100	100	90	133	118	82	101	98	99	116	115	67
1994	100	98	87	142	123	71	98	94	101	124	125	62
1995	99	97	86	151	128	67	99	93	98	129	127	61
1996	100	101	88	155	135	80	102	94	98	129	126	72
*1997	110	107	85	161	136	84	107	96	102	124	126	71

**Note:** \* = Provisional. European indices = weighted average of BA, Lufthansa and KLM. US indices = American, United and Southwest. Unit revenue = airline revenue per ATK. Unit operating cost = cost per ATK. Unit labour cost = salary, social charges and pension costs per ATK. Efficiency = ATKs per employee. Average labour cost = salary, social costs and pension costs per employee. Unit fuel cost = fuel expenditure and taxes per ATK.

### FINANCIAL TRENDS (1990=100)

	Inflation (1990=100)					Exchange rates (against US\$)						LIBOR 6 month Euro-\$	
	US	UK	Germany	France	Japan	UK	Germ.	France	Switz.	ECU	Japan		
1990	100	100	100	100	100	1990	0.563	1.616	5.446	1.389	0.788	144.8	8.27%
1991	104	106	104	103	103	1991	0.567	1.659	5.641	1.434	0.809	134.5	5.91%
1992	107	107	109	106	105	1992	0.570	1.562	5.294	1.406	0.773	126.7	3.84%
1993	111	109	114	108	106	1993	0.666	1.653	5.662	1.477	0.854	111.2	3.36%
1994	113	109	117	110	107	1994	0.653	1.623	5.552	1.367	0.843	102.2	5.06%
1995	117	112	119	112	107	1995	0.634	1.433	4.991	1.182	0.765	94.1	6.12%
1996	120	114	121	113	107	1996	0.641	1.505	5.116	1.236	0.788	108.8	4.48%
1997	122	117	123	114	108	1997	0.611	1.734	5.836	1.451	0.884	121.1	5.85%
*1998	123	119	125	116	109	Jul 1998	0.604	1.782	5.974	1.497	0.902	142.2	5.75%**
*1999	126	122	127	117	109								

**Note:** \* = Forecast. **Source:** OECD Economic Outlook, June 1998. \*\* = \$ LIBOR BBA London interbank fixing six month rate.

### PARIBAS JET OUTPUT FORECAST\*

	1992	1993	1994	1995	1996	1997	1998E	1999E	2000E	2001E	2002E	2003E	
<b>AIRBUS</b>													
A300/310		46	44	25	19	16	8	15	11	10	10	8	8
A319/320/321		111	71	64	56	72	127	175	207	231	240	240	210
A330/340		0	23	34	49	38	47	45	65	65	60	58	55
Airbus total		157	138	123	124	126	182	235	283	306	310	306	273
<b>BOEING</b>													
737		218	152	121	89	76	135	285	272	260	240	240	210
747		61	56	40	25	26	39	54	45	38	34	34	34
757		99	71	69	43	42	46	54	56	48	44	44	40
767		63	51	40	36	42	41	45	45	45	45	40	40
777					13	32	59	62	68	62	55	50	45
MD-80/90		84	42	22	32	36	42	40	30	0	0	0	0
717/MD-95									12	40	40	45	55
MD-11			42	36	17	18	15	12	8	4	0	0	0
Boeing total		567	408	309	256	269	374	550	536	497	458	453	424
BAe 146/RJ		18	18	26	22	26	21	23	25	25	22	22	20
F-70/F-100		54	53	32	41	17	7	0	0	0	0	0	0
<b>TOTAL</b>		<b>796</b>	<b>617</b>	<b>490</b>	<b>443</b>	<b>438</b>	<b>584</b>	<b>808</b>	<b>844</b>	<b>828</b>	<b>790</b>	<b>781</b>	<b>717</b>

**Note:** \*Jets > 70 passengers. **Source:** Paribas European Equity Research.

### JET AND TURBOPROP ORDERS

	Date	Buyer	Order	Price	Delivery	Other information/engines
ATR	Jul 27	Arkia	3 ATR 72-500s	\$50m	4Q98-1Q99	
Airbus	Jul 2	US Airways	7 A330-300s		2H99+	+ 7 options for A330 family aircraft
	Jul 1	Air France	16 A319s, 4 A321s		2Q99-1Q02	CFM56-5 engs. + 20 options A320 family
BAe	Jul 24	CityFlyer Express	2 RJ100s	\$100m (inc. opts)	2Q99	+ 2 options
Boeing	Jul 28	EasyJet	15 737-700s			+ 15 options
	Jul 16	Air Algeria	7 737-800s, 3 737-600s		00-02	
	Jun 29	CASC	10 737 family			
Bombardier	Jul 7	SAS Commuter	2 Dash 8-400s	\$45m	2H99-3Q00	
Embraer	-	-	-	-	-	-
Fairchild Dornier	Jul 8	Midwest Express Holdings	5 328JETs		2Q99+	+10 options. For Skyway Airlines

**Note:** Prices in US\$. Only firm orders from identifiable airlines/lessors are included. MoUs/Lols are excluded. **Source:** Manufacturers.





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