Issue No: 110

Aviation Strategy

December 2006

Finance learns patience

The availability of both debt and equity finance, and financiers' voracious appetite for aviation-related businesses, is making for some very interesting speculation. M&A rumours abound, with some proponents evidently oblivious to the consolidation analysis ("Myth and reality") published in the previous issue of *Aviation Strategy*.

Various combinations of the US Legacy carriers have been proposed, though the only definite proposal so far is US Airways' bid for Delta, which is being strongly opposed by Delta's management and is unlikely to progress further unless the Chapter 11 creditors' committee at the airline persuades the Bankruptcy Court that a US-DL airline is a better bet that than Delta's stand-alone plan, which does look to contain some very optimistic forecasts.

In Europe the Italian government is becoming increasingly desperate in its attempts to find an airline owner for its flag-carrier. But Air France/KLM is subject to the discipline of the equity market, which generally hates the idea of putting money into Alitalia. With Alitalia a non-starter, Iberia has been linked not only with BA but also with Air France and with Lufthansa - though the network synergy arguments are totally unconvincing. For tactical reasons - the best rationale for M&A - consolidation is likely in the German charter and LCC sector; Air Berlin (incorporating dba) now has 60 737-800s to add to its 50 A320 orderbook, and probably has to buy into new markets.

The biggest financial takeover - possibly since Al Checchi's LBO of Northwest Airlines in 1989 - is in Australia where a Private Equity consortium, APA which includes Texas Pacific Group and Macquarie Bank, have had their Aus$11bn offer for Qantas accepted by the airline's Board. The Aus$11bn (US$8.7bn) purchase price, 60% above the stockmarket capitalisation of Qantas pre-bid, consists of approximately Aus$3.6bn in equity and Aus$7.5bn in debt.

"Patient capital" is the term being used by the APA investors, which means probably that they are taking a longer term view of the airline's value to that of the stockmarket, which is driven by short-term factors. The debt leverage is wonderful for the equity investors if their strategy succeeds (and in the short term, in cashflow terms, the additional interest payment from the new debt are probably equalised by not having to pay corporate taxes or dividends), but painful if the strategy fails and/or market competition intensifies. The key question, however, is how the APA consortium will add value to Qantas, given that no significant changes will apparently be made to the current strategy or to the top management.

Some ideas include:

- Negotiating better lease and purchase prices from the manufacturers (currently 70 A380s, 787s 737s and A330s) - probably marginal gains;
- Negotiating better airport charges - raises major competitive issues given Macquarie's' ownership of Sydney Airport;
- Driving down labour costs - Australia's stroppy unions make this difficult;
- Exploiting the Jetstar operation, using Texas Pacific's LCC experience with Ryanair and also Continental - again the downside is Australian labour opposition and also VirginBlue, which is set to start competing on the transpacific;
- Lobbying the Australian Government to open up Qantas to greater than 49% Australian ownership, and hence increase its value, which is feasible but which would also imply more international liberalisation and intensified competition from Emirates and others.

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What happens to traffic growth if emissions are capped?

Aviation Strategy
is published 10 times a year
by **Aviation Economics**

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ISSN 1463-9254

Air transport accounts for about 2-3% of total carbon dioxide emissions caused by human activities and was responsible for about 4-6% of all global warming effects. This difference in shares is because a 'radiative forcing impact' factor (see note 1, see page four) of between 1.9 and 3.5 has to be applied to airline emissions because much of it is deposited at high altitude.

A key issue facing the industry is that increases in airline traffic of 5-6% per year - the consensus forecast - are not likely to be offset by expected improvements in fuel (and therefore carbon) efficiency. These average out at about 1-2% per year and result from improvements in airframe, systems and engine technology, higher load factors and better operating techniques.

The problem is that by 2050, if other industries cut their emissions significantly, air transport could be one of the biggest contributors (around 15%) to climate change. Emissions from international flights were excluded from the Kyoto Protocol, which was signed in 1997 and came into force in 2004 (domestic flights were included), (see note 2). However, if other sectors such as power generation, manufacturing, agriculture, households and road users are going to be forced to go through a painful and expensive process of 'decarbonising' then, if air transport is permitted to increase its emissions, it is going to attract hostile criticism.

Results of modelling the fuel efficiency of the world jet fleet

In order to examine possible trends in the emissions at a global level from the growth of air transport to 2025, a model was developed by Andy Hofton, an independent consultant to investigate the effects of various growth assumptions. The starting point was the world fleet of 17,330 jet aircraft - passenger aircraft and freighters -- recorded at the end of 2005 (see note 3). An underlying assumption was made that the growth rates and retirement rates would be steady (e.g. business cycle effects were ignored). It was initially assumed that the average age of the world fleet was 12 years and that aircraft were retired at age 24. This approximates to an average annual retirement rate of 2% of the total fleet. Retirees were considered to be the most fuel inefficient members of the fleet.

It was also assumed initially that the basic fuel efficiency of aircraft types being acquired, both to replace older types and to add capacity for growth, had the best available fuel efficiencies. This corresponded to an improvement of 1% per year due to aircraft efficiency alone (this is close to the rate that new aircraft have historically achieved). This means that new deliveries would be 24% more efficient than those individuals being retired and 12% more fuel efficient than the fleet average. The assumption in the model was that the only changes to the efficiency of the fleet were due to the progressive introduction of new aircraft.

The results of this analysis are shown in the tables below and cover two time periods 2005-2015 and 2005-2025. They cover three possible growth scenarios, corresponding to average annual growth rates of 3%, 5% and 7%. A growth rate of 5% is 'most likely' if no constraints are placed on expansion. A 3% growth rate would correspond to a pessimistic scenario and 7% to an optimistic scenario.

Table 1: Baseline Case -- results based on an assumption that new aircraft being delivered for replacement and growth have a fuel efficiency that corresponds to a 1% improvement per year over earlier designs

This 'baseline case' (see table, opposite) highlights the outcome under a 'most likely' scenario of traffic increasing by 5% per year, and aerospace technology producing its his-

TABLE 1 - BASELINE CASE	Annual traffic growth (%)	2005-2015 Change in traffic (%)	2005-2015 Change in emissions (%)	2005-2025 Change in traffic (%)	2005-2025 Change in emissions (%)
Scenario 1	3%	+34%	+24%	+81%	+54%
Scenario 2	5%	+63%	+47%	+165%	+117%
Scenario 3	7%	+97%	+75%	+287%	+206%

toric rate of improvement in fuel efficiency - about 1% per year. *By 2015, traffic will have grown by 63% and emissions 47%. By 2025, traffic will have grown by 165% and emissions by 117%.*

Using the model, it is possible to explore another issue: what growth factor could be accommodated if a cap on emissions was imposed? This was investigated using the above assumptions - the key assumption being that the only improvements available were from new aerospace technologies and not from higher load factors, better aircraft utilisation or modifications to in-service aircraft. Under the 'baseline case' of Table 1, improvements due to aerospace technology of 1% alone would only allow traffic growth of 0.6% per year.

The basic evaluation was repeated using a much more optimistic assumption. This was that aerospace technology improved more rapidly and that new aircraft being delivered returned an improvement in fuel efficiency equivalent to 2% per year.

Table 2: More optimistic case -- results based on an assumption that new aircraft being delivered for replacement and growth have a fuel efficiency that corresponds to a 2% improvement per year over earlier designs

The above case might correspond to a situation under which the introduction of new aircraft technologies for new deliveries are accelerated as a result of the incentive of high fuel prices. It does not assume that the retirement of older aircraft is brought forward. In the Table 2 case, emissions grow at very approximately half the rate of traffic, but will still have risen by 85% by 2025 if traffic grows at a 'most likely' rate of 5% per year.

The question: 'what growth factor could be accommodated with no change in emissions?' was again evaluated. Under the case shown in Table 2, improvements due to aerospace technology of 2% alone would only allow traffic growth of 1.1% per year.

In order to examine the upper limits of improvements available from new aerospace technology, the case of a 3% annual gain was evaluated and the results are shown in Table 3 below.

Table 3: Very optimistic case -- results based on an assumption that new aircraft being delivered for replacement and growth have a fuel efficiency that corresponds to a 3% improvement per year over earlier designs

This case (see table on page four) reduces the increase in emissions to 58% at the end of the period (2025) under the most likely scenario.

The question: 'what growth factor could be accommodated with no change in emissions?' results in an answer of 1.5% per year.

In reality, deliveries over the next several years will be of types now in production. Deliveries of the 787 will begin in 2008, but will only become significant after that. A380 deliveries will not begin in volume until after 2010, the A350 will not arrive for several

TABLE 2 - MORE OPTIMISTIC CASE	Annual traffic growth (%)	2005-2015 Change in traffic (%)	2005-2015 Change in emissions (%)	2005-2025 Change in traffic (%)	2005-2025 Change in emissions (%)
Scenario 1	3%	+34%	+17%	+81%	+36.9%
Scenario 2	5%	+63%	+36%	+165%	+85%
Scenario 3	7%	+97%	+58%	+287%	+151%

TABLE 3 - VERY OPTIMISTIC CASE

	Annual traffic growth (%)	2005-2015 Change in traffic (%)	2005-2015 Change in emissions (%)	2005-2025 Change in traffic (%)	2005-2025 Change in emissions (%)
Scenario 1	3%	+34%	+10%	+81%	+22%
Scenario 2	5%	+63%	+26%	+165%	+58%
Scenario 3	7%	+97%	+43%	+287%	+104%

more years. Any new A320/737 replacement is not likely to influence deliveries before 2014. In the next case (Table 4 below), it is assumed that 'super fuel-efficient types' demonstrating a 2% per year improvement over the types they replace become the norm for deliveries from 2013.

Table 4: Rapid aerospace development case -- results based on an assumption that up to 2012 new aircraft being delivered have a fuel efficiency that corresponds to a 1% improvement per year over earlier designs. From and including 2013 the rate of improvement is 2%.

TABLE 4 - RAPID AEROSPACE DEVELOPMENT CASE

	Annual traffic growth (%)	2005-2015 Change in traffic (%)	2005-2015 Change in emissions (%)	2005-2025 Change in traffic (%)	2005-2025 Change in emissions (%)
Scenario 1	3%	+34%	+22%	+81%	+43%
Scenario 2	5%	+63%	+44%	+165%	+96%
Scenario 3	7%	+97%	+70%	+287%	+169%

As would be expected, the beneficial effect is later in the time period. Under the most likely growth scenario of 5% per year, traffic has again risen by 165% by 2025, but emissions have grown by 96%. This case might correspond to a more rapid pace of aerospace developments, possibly following a shortage of fuel, or the availability of government incentives to the aerospace industry.

A final case was evaluated. This combined the more rapid introduction of aerospace developments plus an accelerated rate of retirement of older aircraft - from 2% per year to 4% per year from 2010. The results are shown in the table below.

Table 5: Rapid aerospace development case - as for Table 4, but with accelerated rate of retirement from 2010. Even under this case, with the rate of traffic growth of 5% per year, emissions will have grown by 39% by 2015 and 77% by 2025.

The tables confirm that emissions from airlines raise a number of important issues - deliveries of new fuel-efficient aircraft would not alleviate the pain of a cap on emissions. Growth rates would have to be slashed to 1-2% per year. An early casualty could be ambitions for 5% growth set out for the UK in the 2003 'Future of Aviation' White Paper. They cannot be reconciled with the Government's objectives of reducing overall carbon emissions by 60% by 2050.

TABLE 5 - RAPID AEROSPACE DEVELOPMENT CASE (2)

	Annual traffic growth (%)	2005-2015 Change in traffic (%)	2005-2015 Change in emissions (%)	2005-2025 Change in traffic (%)	2005-2025 Change in emissions (%)
Scenario 1	3%	+34%	+18%	+81%	+28%
Scenario 2	5%	+63%	+39%	+165%	+77%
Scenario 3	7%	+97%	+64%	+287%	+143%

Notes: 1 = There is much debate about the magnitude of this RFI factor, with some research suggesting that a value of about 2.0 is realistic.
2 = The protocol commits 38 industrialised countries to reduce their CO2 levels to 5.2% below their 1990 levels by 2012.
3 = From Boeing 'Current Market Outlook 2006.' For simplicity, the contributions from turboprops are ignored - not only do they generate only small contributions to total hours and total traffic, but they are also very fuel efficient.

TAM: Positioning of Brazilian hybrid LCC

TAM, Brazil's largest airline, has a lot going for it: a low cost structure, high service quality, strong brand, profit margins that are among the highest in the industry and excellent growth opportunities. The Sao Paulo-based carrier is well-positioned to benefit from strong demand growth in Brazil and to take advantage of Varig's shrinkage in long haul international markets. Since its US IPO in March 2006 (which followed a listing in Brazil in June 2005), TAM has increased its market capitalisation by 35% and, in the words of a NYSE executive, become a "model for strong corporate governance and transparency".

But TAM still has some work to do to reduce the cost, profit and debt leverage gap with Gol and to persuade the international investment community that its business model is equally strong. Its shares have continued to trade at a discount to Gol and North American LCCs.

In recent months both TAM's and Gol's share prices have suffered due to investor concerns about the impact of Brazil's ATC slowdown, Varig's resurgence and potential excess capacity in the domestic market in 2007. When will be ATC issues be resolved? Could Varig stage a comeback now that it has been re-certified, and how much damage will it inflict on yields?

These issues were discussed at "TAM Day", the airline's annual investor day held in New York on December 8. TAM's CFO Libano Barroso and other senior executives outlined the airline's growth plans and explained the key aspects of the business model, and a top official from ANAC (the new national aviation authority) helped shed light on the ATC and Varig situations.

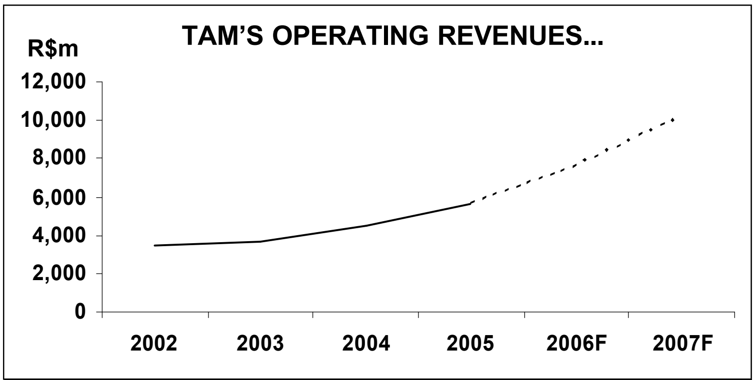
The executives wanted to get across essentially two things. First, they argued that the market is overreacting to the ATC situation and that concerns about excess capacity in 2007 are unwarranted. The ATC slowdown is apparently having only minimal financial impact and, being a top priority for the Brazilian government, is likely to be resolved in the very short term. Excess capacity, in turn, is unlikely in a rational market where the main players (TAM and Gol) are both public companies needing to grow earnings.

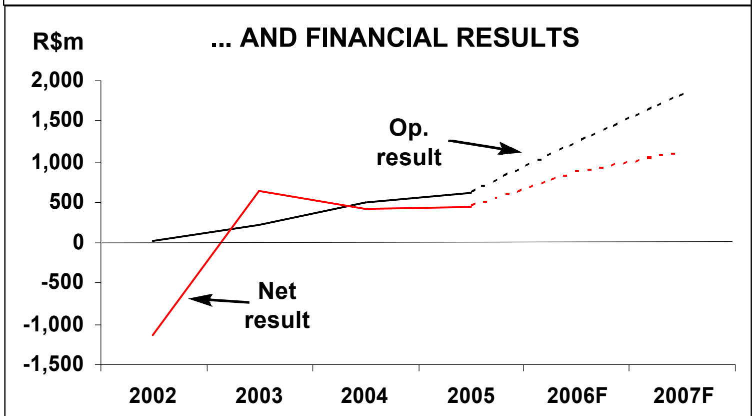
Second, TAM's management argued that the company is undervalued, which it blamed on being lumped into the "legacy" or "non-LCC" category. People like to categorise things to compare, or TAM's business model may not be that well understood. The executives argued that, domestically, TAM is effectively an LCC, and that international growth, by reducing currency mismatch, will make the company less risky than the typical LCC.

The most riveting part of TAM Day was hearing about the extraordinary long haul growth opportunities. Because of Varig's shrinkage, Brazilian carriers' share of international traffic to and from Brazil has fallen from 46% in 2005 to around 28% this year. In major markets such as the US, Spain, Portugal, Germany, Italy and Mexico, at least half of the weekly frequencies permitted by ASAs for the Brazilian side remain unallocated, and only 42% of the allocated frequencies in those six markets are currently operated.

Although the "New Varig" has just received certification from ANAC, it is initially authorised to operate only 13 aircraft - ten 737-300s and three widebodies (two MD-11s and one 767), serving nine cities in Brazil and four internationally (Frankfurt, Buenos Aires, Caracas and Bogota). Another four domestic cities will be added in the near term, but after that Varig will need to find more aircraft and convince ANAC that it is financially and technically capable of expanding operations. One potential problem is that, under the slot rules, Varig has only 30 days (from December 14) to take up its domestic slots and 180 days to start using its international slots; after those periods any unused slots will be "up for grabs" by other Brazilian carriers.

With Varig's growth effectively limited and





Note: Forecasts by Merrill Lynch (November 2); R$ = Brazilian Reals (US$1 = R$2.15)

Gol concentrating on Latin American expansion (with its all-737 fleet), TAM should be able to pick and choose which long-haul markets to serve first.

Great turnaround story

Calyon Securities analyst Ray Neidl, when initiating coverage of TAM in late 2005, observed that TAM was "the first to admit that it had to rapidly reform or perish, as have other Brazilian carriers in recent years". Its story is a nice contrast to VASP and Transbrasil's demise and Varig's bankruptcy and shrinkage.

Founded in 1986, with scheduled operations by predecessors going back to 1976, in the last decade TAM was a low-cost operator (Fokker 100s) with a well-recognised brand and reputation for warm and friendly, up-market service. Founder Rolim Amaro, who died in a helicopter crash in 2001, was always at the airport shaking hands and welcoming passengers to the carrier's "red carpet" service.

In the late 1990s TAM attracted fresh capital from private equity funds, which enabled it to acquire a larger fleet, including A320s. However, costs got out of control and the airline also found itself "squeezed" between Varig, the dominant carrier, and Gol, a high-profile new entrant that had a different value proposition (stripped-down service and low costs).

Consequently, in late 2002 TAM re-evaluated its strategy and adopted a three-pronged approach: maintaining a service differential but focusing on what the customer really wants, lowering its cost structure and offering competitive prices.

The result has been an impressive turnaround, while the company has also grown rapidly. TAM has doubled its passenger numbers in four years, from 13.8m in 2002 to an estimated 25.3m in 2006, while reducing its fleet from 102 to 96 aircraft. The growth has been accomplished by flying more efficiently: average daily aircraft utilisation has increased from 9.4 to 12.5 hours and the average load factor from 55% to 75% in the four-year period.

In its efforts to offer attractive prices and compete with Gol in the domestic market, TAM has traded yield for higher load factors and unit revenues. Its scheduled domestic RASK (revenue per ASK) increased from 13.8 Real cents in 2002 to 20.8 Real cents in January-September 2006. In the same period, domestic CASK declined from 20.4 Real cents to 18.2 Real cents.

Profitability was restored in 2003. The past couple of years have seen strong revenue and earnings growth, thanks to capacity expansion, resumption of robust GDP growth in Brazil and continued cost cutting. TAM achieved an 11% operating margin in both 2004 and 2005, and this year's will be around 16%. In 2005 it earned a net profit of R$427m (US$199m) on revenues of R$5.6bn (US$2.6bn).

TAM's profits are now comparable to those earned by the world's best LCCs. The management's comparisons show that it ranked third, after Ryanair and Gol (and well ahead of Southwest, Virgin Blue, WestJet and JetBlue), in the global LCC profit margin league in the 12 months ended September

30. Its operating margin of 16% compared with Ryanair's 23.9% and Gol's 21.1%, while its net margin of 11.9% compared with Ryanair's 19.9% and Gol's 17.1%.

But TAM compares less favourably with the LCC sector in terms of debt leverage. Its long-term liabilities rose to R$3.9bn (US$1.8bn) at the end of September 2006, following a R$500m public offering of six-year debentures to finance fleet expansion (an important event since it was the first such offering by an airline in Brazil and because it gave TAM credit ratings by Fitch and S&P - global "BB"). TAM's lease-adjusted total debt-to-capital ratio, at 84%, is much higher than Gol's 56%.

Nevertheless, TAM has made much progress in strengthening its balance sheet. For example, the current ratio (current assets over current liabilities) was 1.87 at the end of September, compared to 0.80 at the end of 2003. Cash position on September 30 was R$2,234 (US$1bn) - a superb 40% of 2005 revenues.

A new type of LCC

TAM and Gol have very different backgrounds and business models. While Gol is a new entrant and a brilliant adaptation of the Southwest-style LCC model, TAM is an older-established, larger airline that offers higher service quality. But the domestic yield and cost differentials between the two airlines are surprisingly small - currently 10-15% at most - reflecting the special characteristics of the Brazilian market and environment.

First, unlike in the US and Europe, there are no real labour or airport cost differentials between airlines in Brazil, and Internet penetration is still low. Consequently, on the cost front, airlines differentiate themselves on the basis of commercial costs, aircraft utilisation, management compensation and suchlike.

Second, Brazil's aviation market is relatively undeveloped, with huge growth potential particularly for leisure travel, if low fares are made available. No sizable airline can afford not to provide for that segment.

Third, with 68% of air travel in Brazil being currently for business purpose (TAM's is even higher at 75%), the airline cannot afford to ignore that segment either.

Fourth, Varig's shrinkage has given TAM a special opportunity to attract high-yield traffic. Because of its more up-market product offering, it is believed to be pulling more ex-Varig passengers than Gol.

Going for a "dual" low-cost/service differentiation model has therefore been the obvious choice for TAM, just as it has made sense to operate both short haul and intercontinental service. However, the model should not be confused with the legacy strategy of catering for every segment; rather, like US Airways, TAM could be described as a new type of LCC or a "hybrid" LCC.

The management made the point that while strategies have changed, TAM's mission statement has remained unaltered for the past 30 years. First, the airline wants to be differentiated through "espirito de servir" (spirit of service). Second, it strives to achieve "unchallenged domestic leadership". Third, it aims to be the "most competitive, solid and profitable airline in Latin America".

The key attributes of TAM's business model and strategy include the following:

A growth airline: Like LCCs, TAM is a growth airline. Following 16.6% and 33.5% ASK growth in 2004 and 2005, respectively, this year's growth is expected to be around 30% and next year's close to 40%, when the airline plans to grow its international ASKs by 60-70% and domestic ASKs by 30%.

Since mid-2003 TAM has captured most of the market share that Varig has lost and the bulk of VASP's, which had 8.8% of the domestic market when it ceased operations in September 2004. TAM has had the market share lead domestically since 2003 and internationally since July 2006, and it now accounts for more than half of Brazilian carriers' total RPKs in both markets. In November TAM had 51.7% of the domestic market (followed by Gol 35.3%, Varig 5.1%, BRA 3.2% and others 4.8%) and 61.2% of the international market (Varig had 17.1%, Gol 13.2% and others 8.4%). The 61.2% international share was up by 40 percentage points year-over-year.

TAM is likely to retain or even grow these shares. It still has only 20% of Brazil's total air traffic (including foreign carriers). The regulatory environment is unfriendly to start-ups. The policy is to allocate new domestic route opportunities on the basis of existing market share, while after Varig TAM is currently the only carrier with the widebody aircraft and infrastructure for long-haul expansion.

TAM has the largest domestic network among Brazilian carriers. It offers more non-stop city links, more frequencies and more daytime flights than Gol, amounting to a better schedule for the business traveller.

Also, TAM holds 40% of the slots at Brazil's top 10 airports, which account for 70% of all passenger traffic - an important barrier to entry for newcomers and an impediment to the growth of other competitors.

TAM is well positioned to benefit from Brazil's booming aviation market. Since only 2% of the population has flown, there is huge growth potential. This was one of the key selling points of TAM's US IPO, with many investors wanting to participate simply because Brazil's aviation market is so promising.

Low cost structure: TAM claims to have reduced its total unit cost (CASK) gap with Gol from 32% in 2002 to 15% this year. The airline also claims that its stage length-adjusted (and maintenance cost-adjusted) domestic CASK gap with Gol is only 10-12%. The goal is to reduce the 10-12% gap to 5% by December 2007.

In a separate presentation in early December, Gol calculated the current stage length-adjusted CASK gap with TAM at 21% (down from 28% previously, according to TAM). Gol also expects to reduce its CASK by 7% in 2007 due to commission cuts. TAM is confident of achieving the aggressive 5% CASK gap target because the "roadmap is already laid out". The savings will come from three areas: fleet and network, distribution costs and overheads.

The plan is to increase average daily aircraft utilisation to over 13 hours in 2007. TAM is also adding six extra seats to its A320s and A319s. On the distribution cost front, the aim is to increase direct sales from the current 17% to 25% in 2007 through web site improvement, fare bundles, call-centre outsourcing and developing new payment methods. The airline is bringing in-house airport check-in and other services and negotiating reductions in travel agent commissions. To reduce overheads, TAM is outsourcing non-core activities (such as IT), reassessing service standards, reducing management hierarchy, automating more processes and renegotiating contracts with suppliers.

Many of those are the sort of measures and cost cuts that have already been implemented by airlines in the US and Europe. In other words, it would seem that TAM has lots of low-hanging fruit to pick - something that bodes well for the success of the cost cutting programme.

Among the most interesting measures, TAM is working on ways to access the new (low-yield) client segment that may not have credit cards. For example, passengers will soon be able to buy a ticket through TAM's web site and pay for it at their local lottery store. Also, TAM is working with banks to provide special credit lines that its customers can use to pay for tickets within 48-72 hours of making a reservation via the web site.

Retaining a yield premium? On domestic routes, TAM has moved from full on-board meal service to lighter fare and paying more attention to what it believes is more important to customers: punctuality, regularity, frequencies, FFP, competitive pricing and suchlike. However, it still strives to provide a better on-board product and service than competitors. This has meant retaining VIP lounges, the policy of pilots and cabin attendants greeting passengers at the gate, and comforts such as 31-inch seat pitch and wider middle seats. It continues to be the only airline to offer video and audio entertainment on domestic flights. Internationally, TAM is following the regional trend of going nearly all-business class over the next year (retaining just four first class seats per aircraft).

Since it now caters for the whole customer spectrum in the domestic market, TAM recently launched a new simplified five-tier fare structure. The model is similar to the one used by carriers such as Air Canada. The fare types are priced according to the built-in benefits in terms of flexibility, refundability, lounge access, etc. Some of the lowest fares are competitive with bus fares.

In the domestic market, TAM aims to maintain a 10-15% yield premium over Gol, while achieving similar load factors as it stimulates demand with competitive fares. The yield premium over Gol used to be more than 30%.

While there is some uncertainty about TAM's ability to retain the yield premium in the long-term, if TAM reduces the CASK gap with Gol to 5% and if it also has other LCC characteristics, such as a strong corporate culture and highly motivated workforce - which appears to be the case - there is no reason why it could not simply make adjustments to the model.

Focus on international growth

TAM operates throughout Brazil, serving 48 destinations plus another 27 through alliances with regional carriers. International services cover eight destinations in Latin America - Buenos Aires and Santiago, as well as smaller cities served through Paraguay-based subsidiary TAM Mercosur - and four business routes to the US and Europe (Miami, New York, Paris and London). In addition, TAM has codeshares with American, Air France-KLM, Taca and others.

Domestic growth plans for 2007 include adding at least three new destinations, strengthening Sao Paulo's and Rio de Janeiro's international gateways (Guarulhos and Galeao) for the domestic market, adding frequencies in the main domestic markets out of Brasilia, Congonhas and Confins, and introducing some hub-bypass flights in the north.

The strategy is to expand selectively in high-density, business-oriented international markets. The daily London service, which was introduced in late October, is doing well with load factors exceeding 70%. A second daily flight has just been added to New York (mid-December), just six months after entering the market. A third daily flight to Paris will follow in January, and Milan will be added as a new city on March 30. TAM expects to announce another new long haul destination or an additional frequency for 2007. The airline will also continue strengthening Latin American international service, starting with a second daily flight to Santiago in January.

All of these new flights are through expansion of bilateral agreements, as opposed to replacing Varig's service. TAM must be intensely evaluating potential opportunities that might arise from Varig losing key slots in 2007, but not all of Varig's routes were that attractive. Frankfurt was mentioned as a desirable destination, but its is still served by Varig and TAM would need an alliance at that end, for example with Lufthansa. Portugal is not high on TAM's list of priorities, despite the cultural links, because it is a highly seasonal and primarily charter market.

TAM is currently only interested in airline-to-airline agreements on specific routes, rather than joining a global alliance, because Brazil is a final destination rather than a connecting point. However, the policy is kept under constant review.

Fleet plans

TAM's operational fleet will consist of 96 aircraft at year-end - 10 A330s, 64 A319/320s and 22 Fokker 100s. The fleet is expected to grow to 132 aircraft by year-end 2010 through the addition of four 777-300ERs, six A330s and 48 A319/320s. The Fokker 100s will have been retired by early 2008.

In June TAM very interestingly decided to replace the 100-seat Fokker 100s with the much larger 144-seat A319s and 174-seat A320s, after long considering the A318 and the E190. The decision was based on strong domestic demand growth and an increase in traffic density, and it will help maintain low unit costs.

Another interesting fleet decision took place in late October, when TAM announced a firm order for four 777-300ERs for mid-2008 delivery (plus four purchase rights) and signed an 18-month lease with Boeing Capital for three MD-11s. The ex-Varig aircraft will be delivered between year-end and March/April and will be operated until the 777s are delivered.

TAM needed a new aircraft type quickly in order to grab new long haul growth opportu-

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

Type	2006	2007	2008	2009	2010
A330***	10	12	14	16	16
A319/320	64	88	103	106	112
777-300ER*	0	0	4	4	4
MD-11**	0	3	0	0	0
Fokker 100	22	6	0	0	0
Total	**96**	**109**	**121**	**126**	**132**

Notes: * = plus four purchase rights; ** = Ex-Varig, on 18-month operating leases from Boeing Capital; *** = Due to be replaced by the A350 from 2012, but the A350 order status is uncertain until TAM completes negotiations with Airbus.

nities. After also evaluating the A340-600, the airline opted for the 777-300ER based on its lower cost per seat, higher technological lifespan and larger size. TAM wanted two long-haul types for flexibility, and the 370-seat 777 created a better mix with the 220-seat A330 already in the fleet. In addition, the MD-11 lease deal was priced very attractively: the lease cost offsets the type's fuel inefficiency, resulting in the same cost per seat as with the 777-300ERs. It was a "win-win" situation for both sides (Boeing gaining a new customer). TAM has secured in-principle agreement with Ex-Im Bank for a credit line to finance the 777s.

From 2008 TAM will operate a single-type Airbus fleet in the domestic and Latin American markets, while in long haul markets it will have a dual Boeing/Airbus fleet of 777-300ERs and A330s (after the MD-11s have been returned). The A330s are due to be replaced by the A350 from 2012, but the status of that order is currently uncertain as TAM is in negotiations with Airbus about the delivery delays.

There is some flexibility in the fleet plan to slow capacity growth if necessary. TAM could accelerate the phase-out of the Fokker 100s, and it could postpone taking five used A319/320s that it is currently negotiating.

Financial outlook

By Heini Nuutinen

The consensus in the financial community is that Brazil's ATC delays are a very short-term issue, likely to be solved in the first quarter and not affecting the airlines' ability to grow. However, analysts have slightly reduced TAM's and Gol's earnings estimates for the current (fourth) quarter and have suggested that share prices could remain under pressure until the market sees concrete solutions to the ATC issues.

Views differ on the extent that overcapacity will be a problem in 2007. TAM is confident that traffic will keep up with the supply, thanks to projected 3.5% GDP growth and demand stimulation through pricing. The airline currently predicts 10-12% RPK growth for the domestic market, an industry load factor of 68% (down from this year's 73%) and flat yields. TAM believes that its own load factor will be 70% and that its yield will be flat in 2007. The mid-December Wall Street consensus forecast was that TAM's revenues will grow by 21% in 2007, following 46% growth in 2006, and that its earnings per ADS will more than double to US$2.75 this year, followed by 6.5% growth to US$2.93 in 2007.

The financial community remains confident about TAM's long term prospects. Merrill Lynch analyst Mike Linenberg suggested recently that further market share gains, especially on the international front, could result in the valuation gap with Gol narrowing further. The rating agencies also indicated recently that growth in US dollar revenues is likely to lead to a credit ratings upgrade. Currently 50% of TAM's costs and 20% of its revenues are in US dollars, and the airline aims to increase the revenue percentage to 35%.

Interestingly, TAM's CFO indicated that the company is studying a possible future spin-off of its "Fidelidade" FFP, as well as its MRO at a later stage. TAM was the first airline in Brazil to introduce a loyalty programme (1993), and it is now the country's leading FFP with over 3m members and revenues of R$60m in the third quarter of 2006. The company is studying with banks how to extract more value from the FFP, and one possibility is following the ACE/Aeroplan example (except that Brazil does not have income trust funds). In the first place, TAM aims to double the FFP members through an agreement with a bank.

Iberia: strong on long-haul, vulnerable in Europe

Iberia has almost completed the first 12 months of its latest three-year "Director Plan", but do its cost-cutting measures go deep enough? And will network restructuring give Spain's flag carrier a defendable niche position?

Though the Iberia group includes handling and maintenance operations, the vast majority of revenue is provided by the transport operations - i.e. passenger airlines and cargo. But as can be seen in the table below the transport business only produced a 1.5% operating margin in 2005 (no profit breakdown by business areas is available in the 2006 quarterly reports). While the Iberia group almost doubled net profits in 2005, to €396m, this was due largely to the sale of stakes in Amadeus and Savia (which between them brought in €663m).

Iberia calls these programmes its "Director Plans", and after the third Director Plan of 2003-05, another one was drawn up for the 2006-08 period. It was unveiled in October 2005 and includes no less than 10 strategic targets and 230 specific measures to be achieved by the end of 2008. Most tangibly these include a ROE of 10%, an EBITDAR margin of 16%, a reduction in unit costs (excluding fuel) of between 8% and 10% in nominal terms, and an improvement to Iberia's bottom line of up to €600m by 2008.

To achieve these aims, this latest three-year plan has four so-called "pillars" - network restructuring (which aims to improve the bottom line by €126m a year), revenue improvement (€163m), better productivity (€142m) and cost-cutting (€159m, of which €68m comes from staff costs and €91m from other costs). The Director Plan covers the entire Iberia group, but 70% of the improvements are targeted at airline operations, and as of mid-December this year (almost one-third of the way through the three-year plan), there's enough evidence to see whether the plan is being achieved.

Network restructuring

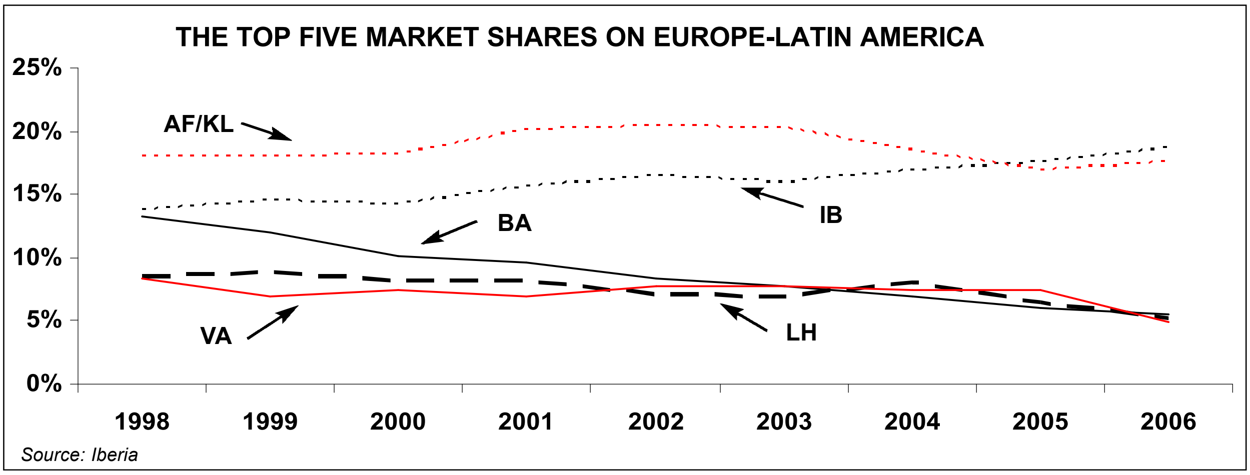
Essentially Iberia has decided to expand significantly in the one area where it has higher margins and defendable market share - i.e. long-haul, and specifically Spain-Latin America routes - while maintaining European routes and cutting back on loss-making domestic routes (other than key feed routes into the intercontinental network).

Iberia has steadily been adding routes to Latin America and now offers 118 flights a week on the sector, compared with 51 in 1996. As a result, over the last eight years Iberia has increased its share of the market (in terms of ASKs) from 13.7% to 18.7%, and this year has overtaken the combined Air France/KLM (which it has trailed ever since the airlines merged in 2003) as the market leader on routes between the two regions - see chart, opposite. Iberia has been helped by a "strategic retreat" from Lufthansa on Europe-South America routes, as well as by the crisis at Varig, which has seen its capacity to Europe cut by at least 80% over the last year. Iberia has also benefited from BA's willingness to hold back on route development into Latin America in favour of Iberia (BA's capacity to Latin America remained flat in the summer of 2006 compared with 2005).

On the other hand, TAP is starting to make a major push into Latin American routes, while - more worryingly - Air Madrid had been increasing capacity at Barajas. It offered 12 routes to Latin America, providing direct competition to Iberia for business travellers who wanted a cheaper alternative to the flag carrier - but in mid-December Air Madrid suddenly ceased operations, with Spain's CAA immediately revoking its air operator certificate, citing increasing delays and worries over maintenance. Nevertheless, Iberia currently operates to 17 destinations in Latin America,and boosted by product improvements (see below)

IBERIA GROUP RESULTS 2005

	Revenue share	Operating profit share	Operating margin
Passengers & Cargo	89.3%	55.4%	1.5%
Airports and Handling	6.6%	21.3%	7.7%
Maintenance	3.4%	21.3%	14.7%
All other	0.7%	2.0%	6.4%



Iberia is targeting a market share of 20%-25% on Europe-Latin America within two years.

Outside Latin America, the main long-haul routes are to Chicago, Miami and New York JFK, with a handful of routes to sub-Saharan Africa. Another 20 US cities are available via a code-share with American, but Iberia is believed to be analysing the launch of routes from Madrid to Boston, San Francisco Los Angeles and Washington.

Overall, Iberia says its unit revenue on long-haul routes increased by 17.3% in the nine months to end of September 2006 (higher than even Iberia expected), although this has to be compared to the general fuel surcharge-related increase in unit revenue on long-haul routes out of Europe, estimated to be in the region of 10%-12% in the first three quarters of 2006. Nevertheless, this is still a very good performance by Iberia, and long-haul accounted for 40% of Iberia's earnings in the first nine months of 2006, compared with 35% in the same period of 2005.

Iberia is under much more pressure in domestic and European markets, due primarily to fierce competition from LCCs at Madrid and Barcelona. Iberia currently has around 22% of the domestic market, but itself forecasts that by 2011 almost 60% of domestic traffic will be carried on LCCs. Vueling opened a base at Barajas in November and raised flights on the Madrid-Barcelona route to five a day (compared with 60 a day from Iberia). The airline has a fleet of 14 A320s and carried out a successful IPO in early December, raising €100m from selling 42.6% of equity. Vueling expects revenue to almost double in 2007, reaching €427m compared with a forecast €238 in 2006, and to achieve this it will need to win a much lager domestic share. Meanwhile, although not an LCC, Spanair - a subsidiary of SAS - is turning Barcelona into a hub operation as it seeks to increase its share of the Spanish market from 5% to more than 25% over the next four years. Spanair operates a fleet of 64 aircraft and sees Barcelona as its "main source of expansion", with a target of 5.5m passengers a year out of El Prat airport through a doubling of domestic destinations served to 40, as well as more international routes.

Iberia also faces increasing competition from high speed trains in Spain, and at least €40bn is being spent on improved rail links in 2006 and 2007 that will see all regional cities linked on the AVE high speed network. High speed trains could take as much as 70% of traffic on some domestic city pairs.

Iberia no longer has an interest in domestic market share as a strategy. Fernando Conte - Iberia's CEO and chairman - says that: "We don't want routes that are losing money systematically." The airline is therefore staging a managed retreat from selected routes in the domestic market, while at the same time shoring up its European networks, which provides vital feed/onward flights for passengers on long-haul services (see below).

Key to Iberia's revised strategy on both short- and medium-haul is Clickair (briefly known as Catair in its planning phase), a new low cost subsidiary. Iberia's own calculations estimate a 60% difference in its costs and those of LCCs, and in 2005 Iberia briefly contemplated buying an LCC or even forming a partnership with Vueling. Instead, the Iberia group decided on the more "controllable" option of building its own LCC.

Clickair hopes

Clickair is based at El Prat airport in Barcelona and operates five leased A320-200s (all of which have come off lease from Iberia) from Barcelona to Geneva, Lisbon, Seville and Zurich, from Valencia to Paris Orly and Rome Fiumicino, and from Seville to Paris Orly. It launched flights on October 1st (in its first month of operation recording a 70.8% load factor) and all aircraft offer a single-class, although flights also carry Iberia's code, thereby allowing travel agents to book seats for business clients (with tickets booked that way more expensive than those booked direct).

Clickair's CEO is Alex Cruz, who previously worked for American Airlines and for the airline department at Accenture Consulting. But even before the airline first got off the ground, SEPLA, the pilots' union, carried out a strike in July at protest at the LCC's impending launch, which it believes threatens the jobs of its members.

That unease is understandable. Clickair aims to have a fleet of 30 A320s by 2008 (crewed by 300 pilots and 600 cabin crew), operating 70 routes to 55 destinations and carrying 10m passengers a year, thus making it the third or fourth largest LCC in Europe. The airline is expanding by around one aircraft a month and will have 20 A320s by the end of 2007, when it expects to record revenue of at least €250m. It aims to break into profit in 2008, with a revenue target of €560m and a net profit of €37m (giving a net margin of 6.6%).

From January to March next year 12 more routes are being rolled out, including Barcelona to Malaga, Munich, Porto, Prague, Berlin, Frankfurt, Amsterdam, Dublin and Basel; from Valencia to London Heathrow and Milan Malpensa; and from Seville to London Heathrow. This will bring the total network to 20 routes, with a target of 4.5m passengers carried in 2007, up from 0.3m passengers in 2006.

Clickair will serve a mix of new routes and services previously operated by Iberia, and it is the relative emphasis between the two parts of this strategy that most concerns unions. Clickair has already taken over Iberia's routes from Seville to Barcelona (Iberia withdrew from the Barcelona-Seville route the day before Clickair started) and Paris, and in 2007 will take over further routes, potentially to include Seville to London Heathrow and Bilbao, and Valencia to London Heathrow. Just how cheaply Clickair can operate into Heathrow remains to be seen, but the point is that it can operate the route more cost effectively than Iberia can - and that is the whole point of Clickair for Iberia.

Barcelona is the initial focus for Clickair, as LCCs already account for approximately 50% of capacity to/from Catalonia - easyJet operates to Barcelona, Ryanair uses Girona and Zaragosa; Air Berlin operates to Reus; while Vueling has also increased routes out of Barcelona (it is now the third largest airline at the airport). These airlines have dented Iberia's profitability on routes to/from Barcelona significantly, so the introduction of Clickair will have little impact on revenue while reducing the costs of operating routes (as they are transferred from Iberia mainline). Unsurprisingly, Iberia's plans to cut mainline capacity out of Barcelona has caused controversy locally, although the flag carrier argues that with Clickair and extra flights from franchise affiliate Air Nostrum, total flights out of Barcelona on a group basis will rise by 50% by 2008.

Clickair insists that taking over Iberia routes is only a means to "jump-start" its operations, and that it will concentrate on routes of up to four hours flying time that are currently underserved out of Spain. For example, it has plans to operate longer routes into eastern Europe (with Moscow one possibility), although inevitably this will reduce the number of daily flights per aircraft.

Whatever the route strategy, Clickair appears a serious attempt by Iberia to set up a lower cost airline. Iberia has a 20% stake in Clickair, with 20% being held by each of Quercus Equity, Nefinsa (which owns 98% of Air Nostrum), tour operator Iberostar and construction firm ACS Group. Between them they have invested initially around €50m, although it is believed that Iberia is contributing around half of that, in return for which it will secure 80% of future financial returns (despite only having 20% in equity). According to Iberia it limited its voting share to 20% because if it took more "the unions can then ask for more rights", which would undermine the low cost basis of the airline. According to one of its shareholders, Quercus Equity, the long-term plan for Clickair is to IPO in between four and six years from now.

With Clickair now up and running, Iberia can increase the pace of its retreat from domestic routes, with selected routes transferred to Clickair and Air Nostrum, the latter of which is based in Valencia and operates a fleet of 61 aircraft to more than 50 destinations in Spain and internationally. The pace of Iberia's retreat can be seen at Seville airport, where Iberia's share of passenger traffic has fallen from 40% to 21% over the 12 months to November 2006 - with Clickair rising to 19% after just two months of operation.

Its not necessarily the case that passengers will move across to Clickair or Air Nostrum automatically. Rafael Aragones, managing director of Spanair, says that as flights out of Seville have passed from Iberia to Clickair, Spanair has seen an increase in passengers, with a 30% rise in passengers carried on Seville-Barcelona in the last two months. Spanair believes it will oust Iberia as the top domestic airline by the end of the decade, partly because it will keep expanding as Iberia contracts and partly because it believes the domestic market will grow 75% by 2020 thanks to falling domestic air fares.

Over the period 2006-08, Iberia plans to cut domestic capacity by 15.7%, though according to the Director Plan most of the domestic cuts will occur in 2007 and 2008, with the priority in 2006 being long-haul expansion. According to one Iberia source this restructuring order makes domestic reductions "easier" for unions to accept, and the domestic retreat is also more palatable now that Clickair is up and running.

Over that same three year period, medium-haul will increase by 1.8% and long-haul ASKs will go up by 12.4%, giving an overall capacity increase over the three years of 3.4%. But while the rationale for long-haul expansion and short-haul retreat is sound, Iberia's strategy for the medium-haul network (i.e. Spain-Europe) is more problematical.

In the total Spain-Europe market (which includes the large charter segment), the share of the Iberia group (Iberia plus Air Nostrum) has fallen "only" from 10.3% in 2003 to 9.8% in Q1-Q3 2006, with LCC share going from 20.4% to 32.3% over the same period, though at the expense mainly of charter airlines. That's because the main non-Spanish LCCs - Ryanair, easyJet and Air Berlin - have concentrated largely on leisure routes into Spain. However, this strategy is changing as the LCCs rae also targetting business passengers, and in the face of more direct competition from LCCs then surely Iberia cannot expect to maintain its market share on Spain-Europe? Even Air Nostrum has problems competing against the LCCs, and very demonstrably pulled its London-Gatwick to Asturias service in 2005 after easyJet announced it would serve the route.

The increasing threat from the LCCs is probably the rationale behind a medium-haul retrenchment at Madrid Barajas, and it's obvious that the Clickair "experiment" at Barcelona is not just about domestic routes but international routes too, with Clickair likely to expand from Barcelona and Seville into other regional cities. Indeed within its overall medium-haul increase of just 1.8%, over 2006-08, Iberia says it will increase Madrid-Europe capacity by more than 30% over the period, which directly implies that European routes out of other Spanish airport are going to be cut substantially and/or transferred to Clickair, while Iberia concentrates on building up the Madrid hub.

But is this feasible, given that in the Madrid-Europe market, Iberia group's share has fallen already from 43.3% in 2004 to 41.1% in Q1-Q3 2006, with LCC share rising from 8.8% to 11.2% over the same period? Ryanair is opening a hub at Barajas in November, (with 14 routes expected to carry 1m passengers a year) and easyJet following suit in February 2007 (with 16 routes and 1m+ passengers a year targeted). Vueling also has a base at Barajas and increased routes this year from four to 11 (including services to Amsterdam Schiphol, Lisbon and Milan Malpensa), with long-term plans for another 30 routes out of Madrid.

The key factor for Iberia is holding onto feed and onward connections for its long-haul network out of Barajas. At Barajas, 30% of Iberia's passengers are travelling point-to-point (which is most at risk form the LCCs) but 60% are connecting passengers to/from higher margin, long-haul flights. However, Iberia has had a major boost in holding on to these connecting passengers thanks to the new €6bn fourth terminal that opened at Barajas in February,. The 38-gate main terminal can handle up to 20m passengers a year, while an accompanying 26-gate satellite terminal is being used for long-haul flights and can handle another 15m passengers. Although other airlines are allowed to use the new terminal, Iberia and its oneworld partners will operate around 90% of the capacity at the new facilities. While the development frees up slots elsewhere at the airport, the new terminal makes it very easy for Iberia's European and domestic passengers to transfer onto the flag carrier's long-haul flights. Iberia's transition to Barajas cost the group an estimated €60m but will boost profit by an estimated €20m a year, according to Fernando Conte - although that may well be a substantial underestimate if a calculation for "saved" long-haul revenue is included.

In terms of the fleet, this network restructuring will be accompanied by a scaling back of both aircraft types and numbers. Iberia currently operates 153 aircraft (see table, above) , which have an average age of just over eight years, but the fleet still remains a mish-mash of different types.

Under the 2006-2008 plan the fleet will be cut from 152 as at end 2005 to 132 aircraft over the period (a 13% cut), with the short-and long-haul fleet shrinking from 122 to 101 and the long-haul fleet rising from 30 to 31. However Iberia adds that its fleet plans are flexible and that it has the ability to increase the fleet to 162 aircraft by the end of 2008 if market conditions improve. Just 24 aircraft are on outstanding order, and the last major order placed was back in the summer of 2005, when Iberia ordered 10 A318s, seven A319s, 10 A320s and three A321s. They began arriving in mid-2006 and are replacing MD-87/88s, 757s and the oldest of the A320s. On long-haul, the last 747 went in 2004, but in short- and medium-haul there is still a mix of Boeing and Airbus models, and the last Boeing aircraft will probably not leave the fleet until 2008 at the earliest - though once that happens, medium- and short-haul costs per seat will fall by around 7.3%, Iberia estimates.

Revenue improvement and productivity

On revenue improvement the key priority is improving the proportion of business travellers, particularly on routes to Latin America. A €100m investment in upgrading the business class product on long-haul aircraft began in May 2005 and was completed this spring, and this included flat seats, in-flight personal communications systems (with e-mail and instant messaging) and video-on-demand. Iberia says the long-haul business upgrade has contributed to a significant improvement in the amount of business passengers carried and that a Director Plan target of increasing Iberia's share of business class traffic to Latin America by 2.5% has already been achieved. However, though Iberia’s business class is currently on a par with Lufthansa and Air France, it still trails behind the product offered by British Airways, the standard the airline is aiming for.

IBERIA’S FLEET

	Fleet	Orders	Options
A319-100	11	13	
A320-200	56	10	73
A321-200	18	1	
A340-300	15		
A340-600	14		7
757-200	7		
MD-87	19		
MD-88	13		
Total	153	24	80

On short- and medium-haul, further differentiation between economy and business products is being attempted through a €50m investment in upgrading cabins across Iberia's short- and medium-haul fleet, which includes a new business class seat. Iberia is also increasing the number of seats per aircraft - the airline estimates it can increase revenue by €20m a year by increasing configuration on A319s from 132 to 141 seats, on A320s from 162 to 171, and on A321s from 194 to 200 seats, all at a one-off cost of some €33m. Finally, Iberia is working on a new revenue management system, although this will not be introduced until the end of 2007 at the earliest.

On productivity, via shorter turnaround time and better punctuality the aim is to increase hours flown per aircraft from 8.5 hours to 8.7 hours a day on short-haul and medium-haul over 2006-2008, while long-haul will rise from 13.8 hours to 14 hours. Employee productivity has improved steadily over the last six years, although the number of employees at September this year was little more than 1,000 fewer than in 2000. This will improve significantly however - by up to 20% - given the cuts in the workforce that Iberia is currently implementing

Cost-cutting

The 2006-2008 plan calls for a cut of 2,164 jobs from the 24,300 employed as at the end of 2005, thereby reducing the workforce to less than 22,200 by the end of 2008. This 9% cut will fall entirely on flight crew (867 positions) and ground staff (1,298), and although 833 of these positions were to go in 2006, almost 1,300 had gone by the end of October after more people than expected took up the redundancy terms. The staff cuts will save €122m in 2008, although the airline will pay around €280m for the cost of the redundancies.

Also €68m is to be saved by freezing salaries and from changing the basis by which they are calculated from fixed to variable (linked to performance targets) and through imposing new conditions for new hires. Obviously this needs agreement from unions, but so far only one category of staff has signed up to this - in February 18,500 ground staff represented by three unions agreed a two-year pay deal with Iberia that includes a pay freeze but is softened by the award of a €18m bonus payment to the workforce.

Iberia also wanted new collective deals signed with pilots and flight attendants by the end of the first quarter of 2006, but the timetable has been eased back time and time again after negotiations with unions failed to achieve agreements - and now no deals are expected until the beginning of 2007 at the earliest. Although Iberia is also dangling bonus payments to the unions concerned in exchange for pay freezes, neither group of workers appears particularly disposed to management. Negotiations with pilots have been going on for more than a year and a half on both a wage freeze and improvements in productivity (e.g. by reducing stopover time and increasing flying times), but as mentioned earlier SEPLA members carried out a strike in July in protest at Clickair (and prior to this action SEPLA proposed to reduce the pay of pilots operating Iberia flights out of Barcelona to "7% lower" than easyJet's pilot costs - although this was rejected by Iberia).

As for flight attendants, in the summer Iberia only narrowly avoided a strike by cabin crew unions STAVLA and TCP, again in protest at the launch of Clickair. Since then both the cabin crew and pilots unions have since come to "an understanding" with Iberia on the new LCC, which union sources say amount to explicit job guarantees and which were witnessed by representatives of the Spanish government, but this will make little impact on whether/when unions will sign new agreements on pay. In June flight attendants also carried out a 24 hour strike at protest at Iberia's decision to expand a wet lease deal with Gestair to from two to 10 757s. Union officials are worried that Iberia will make increasing use of wet leases over the next few years as it seeks to increase it fleet flexibility. Iberia previously had a major wet lease contract with Air Europe, but this capacity was quickly eliminated after September 11. Currently Iberia wet leases a handful of aircraft with Air Atlanta, and with Gestair Iberia passes on to it (and then leases back) aircraft whose leases have expired with the flag carrier. A union official say its members are not opposed to wet leasing as a principle - but only as long as it does not lead to more redundancies.

In July Iberia also suffered from a wildcat strike carried out by more than 1,000 Iberia ground handlers (represented by the UGT and CCOO unions) at Barcelona airport, carried out in protest at the awarding of AENA (the Spanish airport operator) handling contract to a different company after public auction, part of a move to liberalise ground handling at state-owned airports. The loss of this contract cuts Iberia's third party handling revenue by 25%, and Iberia called the decision "unfair". (However, under Spanish labour laws the new holders of the contract have to re-employ the staff employed by the previous contract holder.)

Elsewhere in the cost-cutting "pillar", €22m is to be saved from reduced commercial costs, €18m from reduced lease costs and €15m from lower cargo costs. Iberia has also been cutting back travel agents commission since 2004, but has not been able to eliminate them completely - after a meeting with travel agent associations in October, Iberia put off reducing the current 1% level from 2007 to January 2008, with the rate falling to 0.4% in 2007.

Iberia is also lagging behind its European rivals in terms of internet sales, although Iberia web site sales have risen from 9.1% in 2004 to an estimated 19.5% in 2006.

Is it doing enough?

Iberia says it will have completed around 70% of the measures outlined in the 2006-2008 plan by the end of 2006, and while this is obviously good news, the question has to be asked: has the airline set itself challenging enough targets?

The cost-cutting pillar of the Plan is its weakest part. On staff numbers, for example, by 2008 the workforce will be 13% lower than in 2000, which compares poorly with a 30% cut in the workforce at BA in the 2000-2006 period. And in terms of productivity, Iberia is also behind its major rivals; for example, it has 30% fewer ASK per employee than Lufthansa. In many other areas - distribution costs, fleet mix etc - Iberia simply lags behind the best practice of the leading European majors, and while Iberia is improving all the time, so are its rivals.

Still, the senior management team at the airline today is much improved, and the benefits of the network restructuring will "hit home" over the next few years. Previous CEO Angel Mullor resigned at the end of May after three year's in the position, and he was replaced as CEO by chairman Fernando Conte. At the same time the group revamped its senior management team and reduced the number of directors in order to improve the decision-making process.

In the January-September period revenue rose 11.4% to €4.1bn and operating profit fell 32.7% to €73.5m, with net profit down 83.5% to €66.3m. Unsurprisingly Iberia has been hard hit by rising fuel costs, up 43% in Q1-Q3 2006 compared to the same period in 2005, although fuel surcharges were eased back in October from €65 to €63 on long-haul flights and from €23 to €21 on European (although domestic surcharge stayed the same, at €10).Iberia has hedged around 50% of its fuel needs for 2007 at $61 per barrel, and with fuel prices continuing to fall management is much less concerned about this than it was previously.

Iberia's finances are also improving: cash and cash equivalents stood at €876m at as the end of September 2006 (compared with €821m as at the end of 2005), while long-term debt totalled €1.9bn at end of Q3 2006 (€2.1bn at end of 2005).

For the whole of 2006 a net profit for €140m is expected by the airline, and although Iberia regards 2006 as a "transition year", the implementation of the Director Plan has helped Iberia's share price rise from €2.27 at the end of 2005 by more than 15% over the course of 2006 (though it briefly fell to a low of €1.86 in July after the industrial disputes), with many analysts now bullish on the stock. After the third quarter results Merrill Lynch upgraded its target price for Iberia shares from €2.40 to €2.70, citing a background of lower fuel costs and good prospects for unit revenue growth, and indeed as at early December the share price broke through the €2.70 level.

The increased confidence in Iberia is also leading to rumours of acquisitions for the group. Over the summer Conte said that the group has €2bn to invest in Latin American acquisitions, though it had no specific targets at that time. In 2005 Iberia was interested in the privatisation of Aeromexico and Mexicana, though Iberia dropped out of the bidding race in October, while in the same year Iberia was also touted as a buyer of Varig's 49% stake in Uruguayan airline Pluna - though again nothing came of this. Closer to home, Iberia firmly denies all interest in buying a stake in TAP when it is privatised in the next year or so, although sources suggest it will look closely at the opportunity when it does arrive.

Iberia may be a merger target, with British Airways long-touted as a prospective buyer (and Air France/KLM recently touted as an alternate). BA increased its share of Iberia to 9% in November after buying the 1% stake previously held by American Airlines for €19m - in order to keep two seats on the Iberia group board after American indicated it wanted to sell its stake.

But the reality is that - at present - a merger between the two airlines is not logical. Iberia and BA currently share cost and profits on flights between London, Madrid and Barcelona, but BA would gain relatively little for a large investment now, and at a time when it has other problems to overcome. From Iberia's point of view, a merger with BA (as opposed to a less-acceptable "acquisition") might make strategic sense in that it would secure the Spanish flag carrier's future, but in the short-term its finances are improving and it will want to complete the medium-term network restructuring before deciding if a merger makes sense (or put another way, before being able to obtain the best "price" for its shareholders in any equity tie-up).

IBERIA'S SHAREHOLDERS

El Corte Ingles	2.90%
Logistica	6.49%
Banco Bilbao	7.07%
Caja Madrid	9.68%
BA	10.00%
Free float	63.86%
Total	**100%**

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
Alaska	Apr-Jun 05	756	747	9	17	1.2%	2.2%	8,920	6,947	77.9%	4,232	9,144
	Jul-Sep 05	689	609	80	82	11.6%	11.9%	9,369	7,399	79.0%	4,632	8,961
	Year 2005	**2,975**	**2,983**	**-8**	**-6**	**-0.3%**	**-0.2%**	**35,875**	**27,221**	**75.9%**	**16,759**	**9,065**
	Jan-Mar 06	735	861	126	-80	17.1%	-10.9%	8,914	6,566	73.7%	3,905	8,988
	Apr-Jun 06	710	639	71	49	10.0%	6.9%	9,389	7,440	79.2%	4,443	9,347
	Jul-Sep 06	760	789	-29	-20	-3.8%	-2.6%	9,895	7,842	79.3%	4,710	9,467
American	Apr-Jun 05	5,309	5,080	229	58	4.3%	1.1%	72,447	57,605	79.5%		88,500
	Jul-Sep 05	5,485	5,446	39	-153	0.7%	-2.8%	73,405	59,584	81.2%		88,500
	Year 2005	**20,657**	**21,008**	**-351**	**-892**	**-1.7%**	**-4.3%**	**283,417**	**222,685**	**78.6%**	**98,040**	**87,200**
	Jan-Mar 06	5,344	5,229	115	-92	2.2%	-1.7%	68,801	53,131	77.2%	23,642	86,600
	Apr-Jun 06	5,975	5,499	476	291	8.0%	4.9%	71,774	59,314	82.6%	25,879	86,500
	Jul-Sep 06	5,830	5,610	220	1	3.8%	0.0%	71,641	58,526	81.7%	24,977	86,400
America West	Apr-Jun 05	833	803	30	14	3.6%	1.7%	12,480	10,277	82.3%	5,752	12,200
	Jul-Sep 05	846	904	-58	-71	-6.9%	-8.4%	12,673	10,192	80.4%	5,802	12,179
	Year 2005	**3,254**	**3,374**	**-120**	**-195**	**-3.7%**	**-6.0%**	**49,088**	**39,042**	**79.5%**	**22,130**	**12,100**
	Jan-Mar 06	859	776	83	58	9.7%	6.8%	13,463	10,472	77.8%	6,730	12,828
	Apr-Jun 06	981	920	61	68	6.2%	6.9%	14,144	11,589	81.9%	7,377	12,766
	Jul-Sep 06	922	1,028	-106	-100	-11.5%	-10.8%	12,177	9,722	79.8%	5,463	12,365
Continental	Apr-Jun 05	2,857	2,738	119	100	4.2%	3.5%	36,138	29,041	80.4%	11,465	
	Jul-Sep 05	3,001	2,892	109	61	3.6%	2.0%	37,450	31,185	81.7%	11,642	
	Year 2005	**11,208**	**11,247**	**-39**	**-68**	**-0.3%**	**-0.6%**	**163,537**	**129,064**	**78.9%**	**61,015**	**42,200**
	Jan-Mar 06	2,947	2,936	11	-66	0.4%	-2.2%	37,070	28,996	78.2%	11,486	42,600
	Apr-Jun 06	3,507	3,263	244	198	7.0%	5.6%	45,477	37,605	82.7%	17,596	43,450
	Jul-Sep 06	3,518	3,326	192	237	5.5%	6.7%	47,091	38,691	82.2%	17,328	41,500
Delta	Apr-Jun 05	4,185	4,314	-120	-382	-2.9%	-9.1%	65,136	50,957	78.2%	31,582	65,300
	Jul-Sep 05	4,216	4,456	-240	-1,130	-5.7%	-26.8%	66,054	52,323	79.2%	30,870	58,000
	Year 2005	**16,191**	**18,192**	**-2,001**	**-3,818**	**-12.4%**	**-23.6%**	**252,327**	**193,042**	**76.5%**	**118,853**	
	Jan-Mar 06	3,719	4,204	-485	-2,069	-13.0%	-55.6%	55,685	42,460	76.3%	25,531	53,735
	Apr-Jun 06	4,655	4,286	369	-2,205	7.9%	-47.4%	60,699	48,364	79.7%	27,221	51,700
	Jul-Sep 06	4,659	4,491	168	52	3.6%	1.1%	63,797	51,150	80.2%	27,556	51,000
Northwest	Apr-Jun 05	3,195	3,375	-180	-217	-5.6%	-6.8%	38,256	32,218	84.2%	15,145	38,348
	Jul-Sep 05	3,378	3,545	-167	-469	-4.9%	-13.9%	38,881	32,889	84.6%	14,984	33,755
	Year 2005	**12,286**	**13,205**	**-919**	**-2,533**	**-7.5%**	**-20.6%**	**147,694**	**122,017**	**82.6%**	**56,470**	**32,460**
	Jan-Mar 06	2,890	2,905	-15	-1,104	-0.5%	-38.2%	35,757	29,432	82.3%	15,700	31,318
	Apr-Jun 06	3,291	2,996	295	-285	9.0%	-8.7%	37,743	32,593	86.4%	14,300	31,267
	Jul-Sep 06	3,407	3,041	366	-1,179	10.7%	-34.6%	38,741	33,024	85.2%	17,600	32,760
Southwest	Apr-Jun 05	1,944	1,667	277	159	14.2%	8.2%	34,341	24,912	72.5%	20,098	31,366
	Jul-Sep 05	1,989	1,716	273	227	13.7%	11.4%	35,170	26,336	74.9%	20,638	31,382
	Year 2005	**7,584**	**6,764**	**820**	**548**	**10.8%**	**7.2%**	**137,069**	**96,917**	**70.7%**	**77,693**	**31,729**
	Jan-Mar 06	2,019	1,921	98	61	4.9%	3.0%	35,532	24,591	69.2%	19,199	31,396
	Apr-Jun 06	2,449	2,047	402	333	16.4%	13.6%	36,827	28,716	78.0%	21,999	31,734
	Jul-Sep 06	2,342	2,081	261	48	11.1%	2.0%	38,276	28,592	74.7%	21,559	32,144
United	Apr-Jun 05	4,423	4,375	48	-1,430	1.1%	-32.3%	56,538	47,156	83.4%	17,150	55,600
	Jul-Sep 05	4,655	4,490	165	-1,172	3.5%	-25.2%	58,123	48,771	83.9%	17,448	54,600
	Year 2005	**17,379**	**17,598**	**-219**	**-21,176**	**-1.3%**	**-121.8%**	**225,785**	**183,898**	**81.4%**	**67,000**	
	Jan-Mar 06***	4,465	4,636	-171	22,628	-3.8%	506.8%	61,511	48,739	79.2%	16,267	53,600
	Apr-Jun 06	5,113	4,853	260	119	5.1%	2.3%	64,499	54,541	84.6%	18,228	53,500
	Jul-Sep 06	5,176	4,841	335	190	6.5%	3.7%	66,377	55,165	83.1%	18,099	
US Airways	Apr-Jun 05	1,945	1,904	41	-62	2.1%	-3.2%	26,547	20,165	76.0%	15,826	21,396
	Jul-Sep 05	926	997	-71	-87	-7.7%	-9.4%	21,281	16,503	77.5%	10,109	
	Year 2005**	**7,212**	**7,425**	**-213**	**160**	**-3.0%**	**2.2%**	**82,908**	**62,594**	**75.5%**	**39,977**	**21,486**
	Jan-Mar 06	2,648	2,523	125	65	4.7%	2.5%	17,748	13,350	75.2%	13,591	19,255
	Apr-Jun 06	3,191	2,849	342	305	10.7%	9.6%	19,396	15,944	82.2%	9,626	19,222
	Jul-Sep 06	2,968	2,952	16	-78	0.5%	-2.6%	20,255	15,943	78.7%	8,962	19,180
JetBlue	Apr-Jun 05	430	390	39	12	9.1%	2.8%	9,408	8,247	87.7%	3,695	7,284
	Jul-Sep 05	453	439	14	3	3.1%	0.7%	10,190	8,825	86.6%	3,782	7,452
	Year 2005	**1,701**	**1,653**	**48**	**-20**	**2.8%**	**-1.2%**	**38,145**	**32,508**	**85.2%**	**14,729**	**8,326**
	Jan-Mar 06	490	515	-25	-32	-5.1%	-6.5%	10,584	8,909	84.2%	4,335	9,039
	Apr-Jun 06	612	565	47	14	7.7%	2.3%	11,590	9,533	82.2%	4,525	9,377
	Jul-Sep 06	628	587	41	-0.5	6.5%	-0.1%	12,129	9,756	80.4%	4,773	9,223

** = Predecessor company, 9 months to 30/09/05; Successor company, 3 months to 31/12/05

*** = Including reorganisation items - net loss of $311m without

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

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
Oct-06	28.9	20.3	70.3	20.2	16.0	79.2	15.8	13.1	82.9	50.7	41.1	81.1	75.7	58.7	77.5
Ann. change	4.4%	5.9%	1.0	2.3%	0.8%	-1.2	7.0%	7.4%	0.3	4.3%	4.0%	-0.2	5.0%	5.0%	0.0
Jan-Oct 06	277.3	193.2	69.7	195.7	161.0	82.1	152.2	123.3	81.0	491.8	401.6	81.7	732.3	571.0	78.0
Ann. Change	3.1%	5.7%	1.7	1.8%	0.6%	-1.0	9.4%	10.6%	0.9	4.6%	4.8%	0.2	4.3%	5.2%	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
Nov 06	78.9	62.2	78.9	14.0	11.0	78.3	9.5	7.7	81.6	8.4	6.3	75.4	31.9	25.1	78.5
Ann change	-0.8%	1.4%	1.7	8.4%	6.4%	-1.4	1.0%	3.3%	1.8	3.5%	12.7%	6.2	4.8%	7.0%	1.6
Jan-Nov 06	897.1	718.2	80.1	174.8	141.6	81.0	108.3	90.1	83.2	97.6	74.1	75.9	380.7	305.8	80.3
Ann change	-2.7%	-0.3%	1.9	8.5%	6.8%	-1.3	1.2%	2.4%	0.9	2.3%	6.6%	3.1	4.7%	5.4%	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	26 Oct	CIT	5 x 787-800	2012 onwards	
	07 Nov	Fedex Express	15 x 777F	2009 onwards	
	14 Nov	Aeromexico	2 x 787-800	2011	
			10 x 737-800	2010 onwards	
	28 Nov	Air Berlin	60 x 737-800	4Q 2007 onwards	
	05 Dec	Arkia Airlines	2 x 787-900		
	05 Dec	Privatair	1 x 787-800		
	06 Dec	Lufthansa	20 x 747-800	2010 onwards	plus 20 purchase options
Airbus	13 Nov	ALAFCO	6 x A320		
	14 Nov	easyJet	52 x A319		plus 75 options
	16 Nov	TAM	12 x A319, 16 x A320		
			3 x A321, 6 x A330		plus 12 options

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

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