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US Legacies: Mergers not the answer

New York-based hedge fund Pardus Capital Management is urging Delta to seek a merger with another carrier, preferably United, "given the rapid rise in fuel prices and the increased risk to the business as a standalone entity". But mergers would do nothing to help US airline finances in 2008. If anything, starting the merger process now would only divert management effort from the real challenge: how to cope with the potential double whammy of $100-a-barrel oil and a slowing economy in 2008.

Pardus' proposal to Delta's management, made public on November 14 after discreet talks with the airlines went nowhere, is only the latest in a string of investor attempts to spur airlines into taking concrete action to create shareholder value. American has faced pressure from FL Group, one of its largest shareholders, to spin off its FFP and other non-core assets.

At Goldman Sachs' recent Global Industrials conference in New York, investors, who normally ask a broad spectrum of intelligent questions, had a one-track mind. They really badgered airline CFOs about creating shareholder value. How much profit is your MRO business making? Why haven't you said anything about asset spin-offs in the past three weeks? And so on.

In its letter, Pardus expressed concerns that "fuel costs and other macroeconomic factors could once again drive US airlines towards financial insolvency". However, there is little chance of that happening in the short-to-medium term, and hedge funds do not usually think long-term. Rather, Pardus' real motive was to breathe life into airline stocks that would otherwise languish because there is nothing positive on the horizon. The hedge fund holds 2-5% stakes in Delta and UAL.

Just putting the idea forward led to an immediate surge in major airline share prices (helped by initial speculation that Delta and United were already in negotiations, which the airlines firmly denied). Delta's and UAL's shares were up by more than 10% at the peak on November 14, despite a $3-per-barrel increase in WTI oil prices that day, though since then prices have eased off. Merrill Lynch analyst Michael Linenberg suggested on November 15 that major airline stocks could rise by 20-30% in the coming months "as M&A headlines and chatter intensifies".

But the involvement of Gordon Bethune, Continental's highly respected former CEO, as an advisor to Pardus gave the proposal instant credibility. Bethune had been hired some months ago to analyse different airline combinations, and on November 16 he helped Pardus pitch the Delta/United proposal to other major shareholders (at a meeting reportedly hosted by Merrill Lynch).

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Pardus proposed a stock-for-stock merger in which Delta shares would be issued to UAL holders and Delta's management team would be in charge. The combined company could achieve net synergies of $585m and a share price of $53 by 2012; the latter would be 70% higher than Delta's current share price. The hedge fund recommends the Delta/UAL combination because it was found to offer much greater synergies than Delta/Northwest or Delta/Continental.

Delta and United were quick to declare that they were not negotiating, though both indicated that they were open to mergers. Delta said that with oil over $90 a barrel, analysis of its strategic options "takes on a heightened importance as we factor those prices into our long-term planning process" and that it had established a special board committee to review its options.

The large US carriers are all broadly in favour of consolidation, with United, US Airways, Delta and Northwest being the most vocal proponents of the idea. However, the airlines will not be pushed into transactions that do not make total sense, are not consensual or are too risky. They have learned lessons from past mergers or merger attempts, including US Airways' failed hostile bid for Delta in early 2007.

"We cannot do anything that's hostile", noted UAL's CFO Jake Brace at the GS conference. Brace also did not accept the argument that a trigger such as fuel prices was needed to prompt mergers. "The event for us prompting the action is that there is a lot of shareholder value created."

One thing holding off airline consolidation is that most of the legacy airlines have labour contracts in place until at least the end of 2009. A merger transaction would give unions an easy opportunity to reopen contracts. While labour has always been one of the biggest obstacles to successful mergers, it would certainly seem to be the case now, as workers at many airlines are extremely unhappy about concessions granted in bankruptcy, generous stock awards collected by managements, etc.

There is some pressure to get the merger process started right now, to give the DOJ of the Bush administration the 8-12 months it needs to complete its reviews; if the Democrats take over in January 2009 (as seems likely), regulatory approval could be near-impossible. However, a Delta/United deal (the second- and third-largest US airlines by revenue) would probably be unpalatable for any administration.

Some analysts have suggested that smaller transactions might be the way to go. For example, a couple of months ago JP Morgan's Jamie Baker mentioned a Delta/Alaska combination as a "less ambitious and lower-risk" alternative to a Delta/Northwest marriage.

Fuel prices and fare rises

But airline managements will have their hands more than full in the coming months as they figure out how to respond to oil price and economic challenges. WTI oil prices have risen by about 40% since August, hovered in the $90-95 per-barrel range in the first half of November and are widely expected to hit the $100-mark (at least briefly) in the coming months. Although air travel demand has been strong since the second quarter and US airlines have not yet seen any fall-off in demand, economic trends are not very encouraging, with slowdown widely expected in 2008. In past cycles, a slowing economy often helped lower fuel prices, but that is not expected to be the case next year, so the airlines may face both sluggish demand and higher fuel prices.

The best solution to $100-a-barrel oil is simple in theory but very hard to implement in the fiercely competitive US domestic market: raise fares. So far so good: there have been six industry-wide fare increases since Labour Day, with American leading a record-setting $20 roundtrip fare hike on November 1. The efforts have been successful because LCCs have often joined in. However, the fare hikes have only partially compensated for the higher fuel prices.

The biggest fear now is that demand will soften either in response to the fare hikes or worries about the economy. It is hard to predict what will happen, but airlines are trying to spread the message that domestic air fares are still below where they were in

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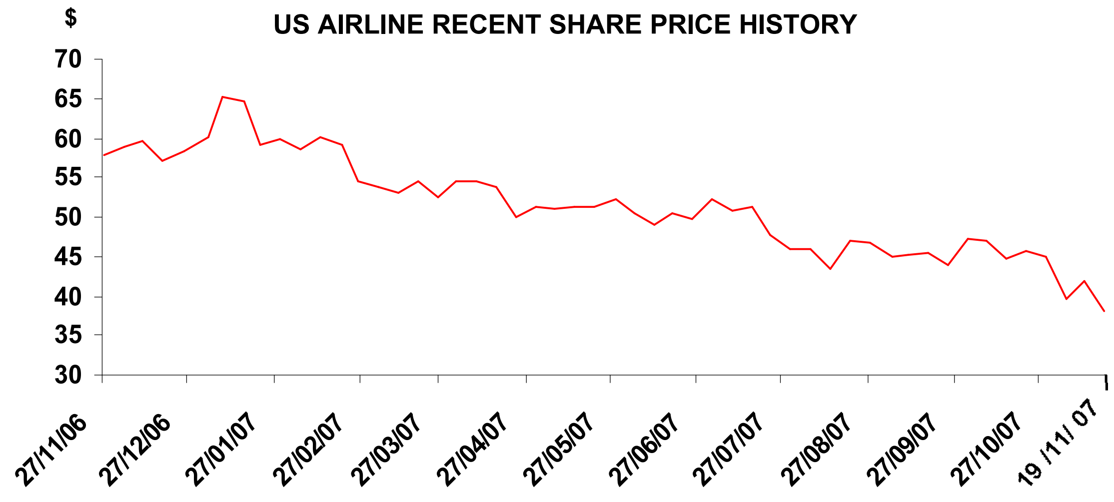


Note: AMEX Airline Index (XAL) includes: AirTran, Alaska, AMR, Continental, Delta, Frontier, JetBlue, US Airways, Southwest, Mesa, Northwest, SkyWest, UAL and ExpressJet.

2000.

As many airline executives have pointed out in recent weeks, either the industry passes on the higher fuel prices to consumers or there will have to be a drastic domestic capacity reduction.

Potential capacity cuts

The good news is that many of the legacies have significant flexibility in their domestic fleets. According to Jake Brace, United has some 100 unencumbered aircraft that could be grounded if necessary (including 50 737s), plus another 13 narrowbody aircraft and one 757 coming off lease in 2008. Northwest has 103 unencumbered DC9s that could be grounded (see separate briefing). American has at least 75 and Delta 60 aircraft that could potentially be grounded even though they are not unencumbered.

JP Morgan's Baker has identified more than 450 legacy aircraft, representing 17% of the total fleet, that are either unencumbered, coming off lease or otherwise suitable for grounding. There are labour impediments, but Baker believes that domestic industry capacity could shrink by 3% in 2008 "without breaking a sweat".

Currently, industry capacity (including LCCs and regional airlines) is still expected to grow by 2.5% next year, but Baker believes that the reality will be something significantly lower.

Mergers are often suggested as a good way to shed capacity - US Airways CEO Doug Parker made that point at GS. But who needs mergers if there is fleet flexibility and willingness to voluntarily pull down capacity?

The bad news for the rest of the world is that the US legacies' anticipated domestic contraction in 2008 will make them keener than ever to expand in international markets, where fuel surcharges are the norm and fares usually at healthy levels. United indicated that there is still potential to shift aircraft from domestic to international routes.

Despite the alarming outlook, US legacy carriers have been so successful in cutting costs in recent years that they are still expected to make an aggregate profit in 2008. Jamie Baker's latest (November 13), below-consensus forecast is an industry EBIT of $3.6bn next year, down from an earlier forecast of $7bn but similar to the 2006 profit. The new forecast is based on $92 oil and assumes a 2.5% mainline capacity reduction and sharply higher fares. Baker said that he took a "deliberately bearish view" but noted that JP Morgan's house view was that oil prices would fall to average $68-a-barrel in 2008 - a scenario that would make next year highly profitable for US carriers.

By Heini Nuutinen

Northwest: Out of Chapter 11 and into profitability

Northwest is currently one of the most profitable US airlines, thanks to its hugely successful Chapter 11 restructuring. Having attained a competitive cost structure, repaired its balance sheet and kept in place a $6bn re-fleeting programme, the Minneapolis-based carrier is well positioned to make the most of its unique assets, which include a large Pacific network and a hub at Tokyo Narita. But can an airline with chronic labour problems and poor morale really succeed in the long term?

Northwest accomplished essentially everything it set out to do in Chapter 11: cutting annual operating costs by $2.4bn, slashing debt and lease obligations by $4.2bn, solving the pension problem and right-sizing the fleet. The airline shrunk by 10% in terms of ASMs and optimised its network by eliminating less profitable routes, strengthening key hubs and adding new international service.

As a result, Northwest has the lowest unit costs among the US legacies and is achieving industry-leading profit margins. It has just reported a healthy $405m pretax profit before special items for the third quarter. The 12% pretax margin was the second-highest in the industry (after Alaska's 14%).

Significantly, Northwest was able to keep in place its aggressive long-haul fleet renewal programme: all of its A330 and 787 orders were reaffirmed in bankruptcy. Given that the 787 is now sold out until at least 2012, Northwest, the type's North American launch customer, is fortunate to hold delivery positions for 18 firm orders and 50 options from early 2009. The A330 and 787 fleets will give Northwest an important competitive advantage.

But Northwest's turnaround and promising prospects are not reflected in its share price, which has fallen by 32% since the new shares began trading following the Chapter 11 exit at the end of May - among the sharpest declines in the industry.

The stock has declined, first, because Northwest emerged from Chapter 11 at a difficult time. First there were fears of weakening domestic demand, oil prices then surged and now there is talk of a possible economic slowdown in 2008 (of which airlines have seen no sign so far).

Second, in June and July Northwest suffered a rise in flight delays and cancellations due to absenteeism among pilots. This caused negative publicity just as the airline needed to rebuild its image after bankruptcy. The problems were solved by August, but Northwest had to trim its domestic flight schedule, boost pilot hiring and renegotiate contract issues and work rules with its pilots.

Third, like Delta's stock, Northwest's shares have been volatile due to selling by creditors who received equity for their unsecured claims. That process is still under way, though at least Northwest does not have the uncertainty of the PBGC (the government) holding a sizable equity stake (as is the case with Delta).

The magic combination of low share price and promising prospects has obviously presented a buying opportunity, prompting investors to take a look. At least ten analysts have reinstated coverage of Northwest in recent months; of those, seven currently recommend the stock as a "strong buy" or "buy".

In addition to the attractive valuation, analysts have mentioned Northwest's lower cost structure, good RASM momentum, sector-leading profit margins, deleveraged balance sheet, profitable re-fleeting, long-term labour agreements and experienced management. The airline's special attributes include a strong franchise, with dominant positions at Minneapolis and Detroit hubs, a large Pacific network, 376 weekly slots at Tokyo-Narita, fifth freedom rights from Japan to Asia, great alliances, a sizable cargo business and less than typical exposure to LCCs.

But Northwest has an Achilles heel: an unhappy workforce - a potentially serious flaw in a service oriented industry like airlines. The key question regarding Northwest's otherwise promising future is: To what extent will labour ruin it?

While financing the orderbook is not believed to be a problem, major fleet renewal in a downturn poses risk. Even in the best scenario, Northwest will have little free cashflow in the next few years. What impact will the fleet renewal have on its balance sheet?

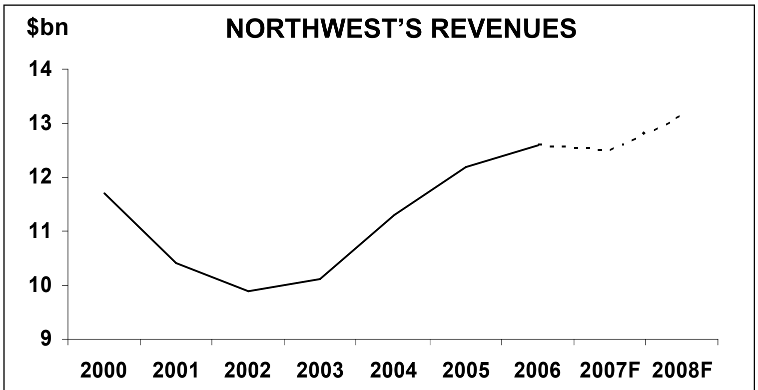
A major point of interest is what Northwest could eventually do in Asia. Will it, as it has recently hinted, use its Tokyo slots and traffic rights to build service to secondary cities in China?

The Chapter 11 reorganisation

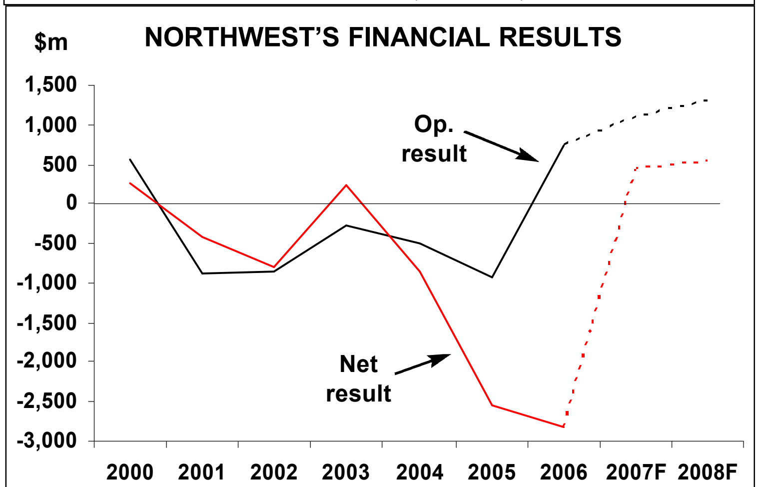
Northwest filed for Chapter 11 on September 14, 2005, the same day as Delta. Lack of liquidity was the trigger: the airline realised that it would end the year with only about $950m in cash. Its labour costs were out of control. Despite extensive cost cutting, Northwest had lost $4bn since 2000 and had $12bn in debt.

It was a swift reorganisation, lasting only 20 months - a month longer than Delta's. Northwest converted its $1.2bn DIP credit facility into a Chapter 11 exit financing, which is secured on its Pacific route rights, and also raised $750m in a new equity rights offering. The new stock was listed on the NYSE under the symbol "NWA".

Based on the total of 277m new common shares (when all the distributions are completed) and the initial trading price of just over $25 a share, Northwest was valued at about $7bn when it emerged from Chapter 11. Most of the shares went to unsecured creditors, who recouped 66-83% of their claims in stock - an extremely generous payout by recent airline bankruptcy standards. Unsecured creditors were also invited to subscribe to the rights offering; only about 10% did so. Of course, secured creditors were paid in full. As is



Note: 2007 and 2008 are consensus forecasts (November 9)



Note: 2007 and 2008 are consensus forecasts (November 9)

typical in airline Chapter 11 cases, former shareholders were left with nothing as the old stock was cancelled.

Another group that was treated well was Northwest's management. The top 400 executives and managers will receive 4.9% of the new equity over four years, worth $340m at the initial valuation. CEO Doug Steenland's share is around $30m, with four SVPs receiving more than $10m each. The awards are in the form of restricted stock and stock options and will only have value if the business plan targets are achieved and the stock price appreciates. The stated aim was to reverse a high attrition rate and retain high-quality management.

Northwest granted its workers $1.25bn in unsecured claims in exchange for concessions. This would have given labour a 14% ownership stake based on the initial valuation, but the unions chose to sell their stakes and distribute the cash proceeds, totalling $960m, to members. In addition, Northwest put in place a profit-sharing plan that is projected to pay out $500m over five years.

Thanks to the provisions of the Pension Protection Act of August 2006, Northwest (like Delta) avoided the trauma of pension plan terminations. Keeping the defined benefit pension plans avoided the loss of some $2.1bn of retirement benefits at Northwest. However, the old plans were frozen in respect of future benefit accruals and new cheaper defined contribution plans were put in place for most labour groups.

Despite those positives, overall it was a rough deal for the workers. The unsecured claim and profit sharing payouts will nowhere near make up for the workers' sacrifices. Northwest's employees had granted $1.4bn worth of annual concessions. Pilots had taken 40% pay cuts. The airline had used court permission to void a contract with its flight attendants and impose new conditions. Flight attendant pay at Northwest now tops at just $35,400 a year, down from $44,200 before Chapter 11.

Consequently, Northwest's Chapter 11 process was characterised by labour strife, particularly in the final months when the workers knew of the healthy 2006 profit and the executive stock award plans. In the final weeks there was even a strike threat hanging over the airline. The flight attendants ratified their concessionary contract with the narrowest of margins (50.9%) and only two days before the Chapter 11 exit.

It will also be remembered as the airline Chapter 11 case where holders of the old equity fought back. In late 2006 several hedge funds had built up large positions in Northwest's old equity on speculation that US Airways' hostile bid for Delta would lead to a merger wave in the industry. When that fizzled out and airline stocks plummeted, the hedge funds fought unsuccessfully to recover their investments, among other things, by opposing the Chapter 11 plan and pressing Northwest to consider a merger.

The hedge funds succeeded in getting an examiner appointed to look into whether Northwest had made reasonable efforts to explore value-boosting merger possibilities. The conclusion was that Northwest had acted appropriately, except that it had not assigned proper value to its "golden share" in Continental, which gives it veto powers over any Continental merger. The examiner noted that Northwest was under no obligation to market itself to another airline. The hedge funds eventually settled with Northwest, agreeing to drop their objections to the Chapter 11 plan in return for Northwest paying up to $5m of their legal bills.

As of late October, Northwest had about $1.1bn in remaining disputed unsecured claims to be resolved, to bring the total allowed unsecured claims to $8-8.4bn.

Northwest's new 12-member board of directors looks exceptionally strong. Roy Bostock, a principal of private investment firm Sealedge Investments and a Northwest board member since 2005, took over as chairman from 67-year-old Gary Wilson (who led the leveraged buyout of Northwest in 1989). The board gained five new members, including former US transportation secretary Rodney Slater, former Northwest CFO Mickey Foret and former AMR CFO Mike Durham.

The highly respected top management that oversaw the restructuring stayed on. The team is led by CEO Doug Steenland, 55, a lawyer who joined Northwest in 1991, became president and a board member in 2001 and was named CEO in 2004.

Profits and CASM: from laggard to leader

Like its legacy peers, Northwest returned to profitability in 2006 after five years of heavy losses. Last year the airline earned a modest $301m pretax profit before reorganisation items, accounting for 2.3% of revenues and broadly in line with industry results. But this year Northwest's profit performance has been truly impressive, far exceeding that of its peers.

Northwest earned a $778m pretax profit

in the first nine months of 2007; the 8.2% pretax margin was the best among the network carriers. The September quarter's 12% pretax margin (typically Northwest's strongest quarter) was well above the 4-9% margins achieved by the other legacy carriers and higher than Southwest's 10%.

The third-quarter $405m pretax profit was Northwest's highest quarterly profit in ten years and the third highest in its history. Operating margin was 13.6% - an amazing achievement in the current fuel cost environment.

The results are obviously testament to the success of the Chapter 11 restructuring. However, S&P's Philip Baggaley made the point recently that Northwest did not have as many problems to fix as Delta. Its non-labour costs were in relatively good shape and its revenue generation was not below-par.

Since filing for bankruptcy, Northwest has reduced its annual costs by $2.2bn and is on track to achieve a further $200m in savings. The $2.4bn total includes $1.4bn in labour cost savings and $400m in fleet ownership cost savings. The remainder came from savings in interest expenses ($150m), pension costs ($100m) and non-labour costs ($350m).

The $2.2bn savings to be achieved by year-end 2007 represent about a 15% reduction in ex-fuel unit costs over two years, from 8.48 cents per ASM in 2005 to around 7.22 cents in 2007 (the latter is a late-October forecast by Merrill Lynch).

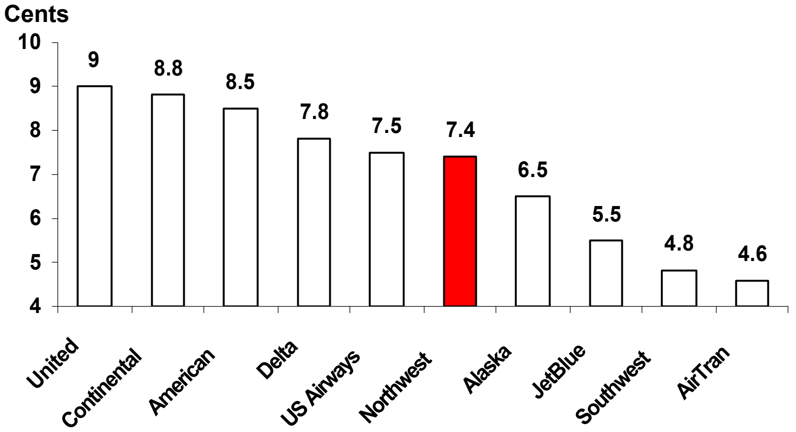
The result is the most competitive cost structure among the network carriers. Northwest calculated that its second-quarter ex-fuel seat-weight/stage-length adjusted CASM of 7.4 cents was right at the bottom of the legacy carrier range, below United's 9, Continental's 8.8, American's 8.5 and Delta's 7.8 cents. It was even below US Airways' 7.5-cent CASM - a carrier that is essentially a "hybrid" legacy/LCC. The differential between Northwest and the top three LCCs was 2-3 cents.

The reason Northwest's ex-fuel CASM has dipped below US Airways' is its impressive labour cost reduction; in terms of non-labour CASM, US Airways was 12% below Northwest - a differential that Northwest attributes to its larger international network and premium revenue-related costs.

Northwest has transformed its labour cost structure from the highest to the lowest among the network carriers. Its second-quarter seat-weight/stage-length adjusted labour CASM of 2.5 cents was a whopping 34% below American's 3.8 cents, 17% below US Airways' 3 cents and 7% below Delta's 2.7 cents (see chart, below).

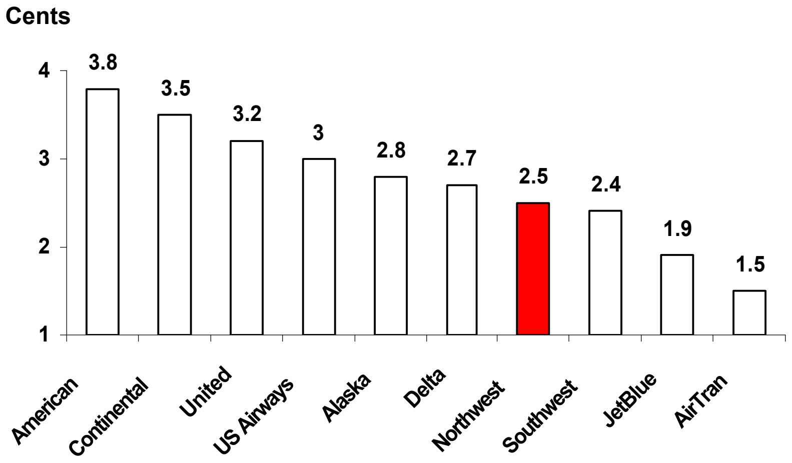
The most exciting thing about Northwest is that it is likely to increase its cost advantage in the coming years. This is because of its aggressive fleet renewal, long-term labour contracts, growing use of low-cost

US CARRIERS' 2Q07 ADJUSTED EX-FUEL CASM

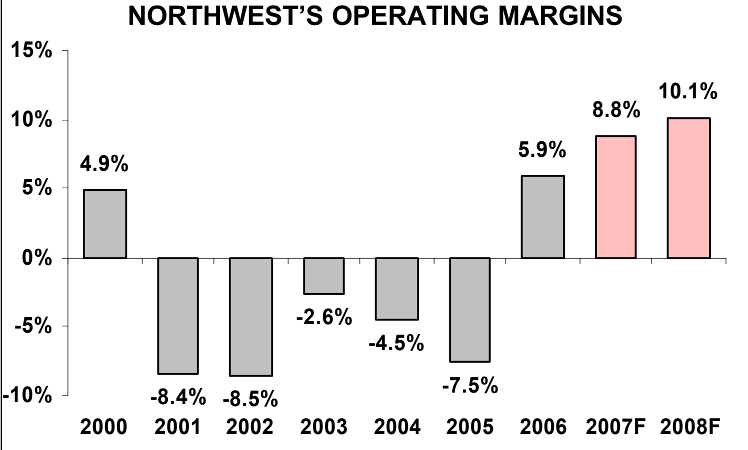


Note: Second-quarter 2007 total CASM excluding fuel, profit-sharing and unusual items, seat-weight and stage-length adjusted to Northwest. ***Source***: *Northwest*

US CARRIERS' 2Q07 ADJUSTED LABOUR CASM



Note: Second-quarter 2007 labour CASM, seat-weight and stage-length adjusted to Northwest. *Source: Northwest*



Note: 2007 and 2008 are consensus forecasts (November 9)

regional subsidiaries, potential cost savings in combining wholly-owned regional units and the restructuring of the cargo business.

Northwest does not have any labour contracts become amendable until the end of 2011, in theory giving it the longest labour respite among the major carriers. However, if American's pilots succeed in getting hefty pay increases next year, the other legacy pilot unions may demand to reopen their contracts before amendable dates, especially if the industry remains profitable. ALPA has officially adopted the position that the concessions negotiated by several carriers in bankruptcy must be rolled back.

Furthermore, the recent adjustment to the Northwest pilot contract and possible new actions by an unhappy workforce may significantly dilute the cost savings. In the summer, to restore operational reliability, Northwest had to grant its pilots new performance bonuses, reinstate premium pay of 50% for pilots flying more than 50 hours a month and boost new pilot hiring. The pilot sickouts happening so soon after the Chapter 11 exit does not bode well for the future.

On the revenue side, Northwest has been a solid RASM performer because of its strong network and hubs, dominant position in key markets and lesser LCC exposure. The network, fleet and product improvements instigated as part of the restructuring led to a healthy 12% unit revenue improvement last year. Northwest had the industry's fourth highest seat-weight/stage-length adjusted RASM in 2006 (10.8 cents), similar to American's but some 6% below United's and Continental's.

Because of the recent restructuring, Northwest (like Delta) is expected to continue to enjoy slightly stronger RASM trends than competitors in 2008. The process will be helped by customer service enhancements, a $50m investment in product improvements this year and a major new frontline employee training initiative launched this autumn.

The five-year business plan that Northwest prepared in Chapter 11, which predicted continued strong profitability through 2010, was always considered more realistic than Delta's plan, because Northwest's plan relied mainly on cost cuts that were already in place rather than forecast revenue gains. However, with oil prices exceeding $90 a barrel, the plan forecasts (which assumed $65 oil) are no longer realistic.

That said, because of its cost advantage and better CASM and RASM outlook, Northwest is likely to outperform its peers profitability-wise in the next couple of years. It will earn excellent profits if economic fundamentals remain strong; it is also among the best positioned carriers to face a downturn or continued high fuel prices.

Currently, in the absence of any evidence of slowing demand, and assuming that oil prices moderate somewhat in 2008, Northwest is heading for strong profits in 2007 and 2008. The consensus forecast (as of November 9) is a net profit of $2.01 per share, or about $440m, this year, followed by $2.06, or about $540m (on a higher share count), in 2008. Operating profits are projected to rise from last year's $740m to around $1.1bn this year and $1.3bn in 2008 (5.9%, 8.8% and 10.1% margins, respectively, see chart above).

After reducing this year's planned capacity growth twice in recent months, Northwest expects its total ASMs to inch up by just 0-1% in 2007 (domestic down 2-3%, international up 4-5%). Despite that, ex-fuel CASM is still expected to decline by 2-3% this year, in line with the business plan forecast.

Northwest has not yet released its capacity plan for 2008. Like its peers, it does not have meaningful fuel hedges in place for 2008. However, Northwest does have significant fleet flexibility to respond to changing industry conditions.

Deleveraged balance sheet

Northwest was able to reduce its debt and lease obligations by $4.2bn in Chapter 11, from $13.5bn to $9.3bn (net debt and leases were more than halved from $12bn to $5.8bn). This involved eliminating $1.7bn of unsecured debt, cutting lease obligations by $2bn and reducing aircraft debt by some $500m. In addition, Northwest refinanced $2.25bn in secured bank and aircraft debt (achieving significant interest cost savings) and raised $750m in equity through a rights offering.

As a result, Northwest has one of the strongest balance sheets in the industry. At the end of June, its lease-adjusted-net-debt/EBITDAR ratio of 3 times ("net" meaning after the deduction of cash reserves) and its lease-adjusted-net-debt/capitalisation ratio of 49% were very similar to Delta's ratios (2.9 times and 48%), which were the lowest in the industry excluding Southwest. Using the more common measure, Northwest's lease-adjusted-total-debt/capitalisation ratio of 61.6% was also among the lowest in the industry.

The balance sheet improvements have earned Northwest the highest credit ratings among the network carriers. Back in May, S&P issued Northwest a B+ corporate rating and Moody's a B1 rating, both with "stable" outlooks.

While in Chapter 11, Northwest successfully restructured its pension liabilities, which totalled $3.1bn pre-bankruptcy. By freezing its defined-benefit plans, replacing them with defined-contribution plans and taking advantage of the new rules that permit an 8.85% discount rate and amortisation of the pension liability over 17 years, Northwest has reduced its annual cash contributions to a very manageable $80-100m.

Northwest had an ample $3.1bn in unrestricted cash, or about 25% of last year's revenues, at the end of September. The airline also had $739m in restricted cash, including $213m related to a pending investment in Midwest Airlines. Year-end unrestricted cash reserves are expected to amount to $2.8-2.9bn.

However, Northwest will not be able to sustain its leading financial ratios because of its aircraft spending commitments. In comparison, American and United have very modest capex requirements and are also currently focused on paying down debt. From next year onwards, Northwest will probably find itself in the middle or bottom half of the Legacies' net-debt/EBITDAR league.

Northwest anticipates $4.1bn in aircraft capital expenditures in 2007-2010, or about $1bn per year, plus $200-250m in non-aircraft capex annually. Debt maturities are running at $400-600m annually in the next four years. The airline believes that all of that is manageable; management noted that the aircraft spending will actually be below the $1.5bn annual average aircraft capex seen in 2001-2005.

Previously aircraft capex was expected to peak sharply in 2008 ($1.9bn), but the 787 delivery delays have reduced next year's aircraft spending by $700m to $1.2bn. The $700m spending will presumably now be incurred in 2009, which previously had only $467m of planned aircraft capex. Incidentally, according to the management, Northwest is not entitled to penalty payments from Boeing for the delivery delays.

All of the new aircraft on order carry manufacturer backstop financing, but obtaining more attractive permanent funding should not be a problem, given Northwest's improved balance sheet. Last month the airline demonstrated its ability to tap the public capital markets by raising $454m through EETCs to fund 27 Embraer 175LRs for its regional subsidiaries, despite the more difficult credit market since the summer.

In the event of continued $90-per-barrel oil, a severe demand downturn or a worsened revenue environment, Northwest could always ground or accelerate the retirement of its unencumbered DC9s. Although Northwest will reap great economic benefits from new aircraft, if absolutely necessary, it should also be able to easily defer new aircraft deliveries or sell those slots to third parties.

Profitable re-fleeting

Northwest made many beneficial fleet moves in Chapter 11: restructuring 330 leases to market rates, rejecting 71 aircraft (including nine DC9s), accelerating the retirement of uneconomical aircraft (DC-10s, 747-200s and Avro RJ-85s), reaffirming A330 and 787 purchase agreements and placing new orders for 72 76-seat regional jets.

Although Northwest still operates 103 DC9s, it has made great progress in shedding its other older types. In 2001 the fleet still included 40 DC-10s and 21 747-200 passenger aircraft; the last 15 DC-10s were retired during Chapter 11 and the last two 747-200s went last summer.

Having missed the US legacy sector's last fleet replacement phase, Northwest is now in the middle of a $6bn renewal effort. The programme has added 32 A330s and will involve the acquisition of 72 Bombardier and Embraer regional jets and 18 787s. Northwest calculates that these aircraft purchases have a collective forecast return on investment in excess of 15%.

Northwest has now taken all of the firm A330 deliveries, following the arrival of the 32nd aircraft in October. The type has replaced DC-10s on European routes (with the help of ten 757s on the thinner routes) and DC-10s and 747-200s on the Pacific (with the help of some 747-400s). Northwest now boasts the world's largest A330 fleet and the youngest transatlantic fleet in the industry.

The 787 Dreamliner will be Northwest's pride and joy, the backbone of its international fleet. CEO Doug Steenland said recently that when placing the original launch order in June 2005, the airline worked with Boeing to forge a purchase agreement that could anticipate and survive a Chapter 11 filing. The deal - 18 firm orders and 50 options, at favourable launch customer prices - was reaffirmed in October 2006.

The 787 will be used to further optimise Northwest's Pacific network and develop new markets, including nonstop service to China. The 787-8 (the standard 200 seat version) would make it from Detroit to cities such as Mumbai, Delhi and Shanghai; the 787-4 (403 seats) would make it to all of Europe, Beijing, Seoul and Tokyo; the 787-9 (241 seats) would also make it to Johannesburg, Taipei and Hong Kong. The 787 will also provide opportunities to rationalise 747-400 service, improving pretax margins by as much as 15 points in some markets.

Production problems at Boeing have delayed Northwest's first 787 deliveries from August 2008 to the first quarter of 2009. The airline said that it was disappointed but that it could adapt; for example, it might launch its planned Detroit-Shanghai route with 747-400s. Northwest noted that it would have the 787 well

NORTHWEST'S FLEET

	No. of aircraft	Firm orders
A319	57	5
A320	73	2
A330-200	11	
A330-300	20	1
787-8		18
757-200	55	
757-300	16	
747-400	16	
747F	13	
DC9	103	
Total mainline	**364**	**26**
CRJ200	141	
Saab 340	49	
CRJ900	7	29
E175	3	32
Total regional*	**200**	**61**
TOTAL FLEET	**564**	**87**

Notes: Fleet as of Sept. 30. * Operated by Northwest Airlink carriers
Source: *Northwest*

ahead of the Pacific's 2009 peak summer season and that later 787 deliveries might not be delayed as much.

Northwest is the only US major that operates dedicated 747 freighters. Although the 13-strong fleet is old, the airline does not anticipate any fleet changes or additions in the coming years.

The A330 and 787 orders illustrate that, like many of its peers, Northwest currently focuses on growing internationally. Its international fleet will expand from 43 aircraft in 2005 to 73 by 2010.

The Bombardier and Embraer RJs ordered in October 2006 - 36 CRJ900s and 36 E175s, delivering between June 2007 and December 2008 - are the key component of Northwest's domestic rightsizing effort. The 76-seat aircraft, to be operated by subsidiaries Compass and Mesaba, will complement and replace 50-seat CRJ200 and 100-seat DC9 flying at Northwest's hubs. The aircraft are optimally sized, have first class cabins and offer range flexibility to serve a variety of markets. Northwest expects the RJs to offer a significant 16-point pretax profit margin advantage in markets where they replace DC9s.

Northwest split the order seemingly because it wanted to both build on its long-term relationship with Bombardier and benefit from the E175's superior 1,700-mile range (compared to the CRJ900's 1,400 miles and the DC9's 1,000 miles).

The RJ strategy is possible because Northwest's mainline pilots agreed to relax their scope clause to allow up to 90 76-seat RJs at regional partners. The deal did not go as far as had been hoped (and does not compare favourably with other legacy carrier scope clauses), but it was a good start.

Northwest's next major fleet decision will be the DC9 replacement. Around two thirds of the 103 DC9s are 35 years old. The DC9 fleet will still be sizable at the conclusion of the 76-seat RJ deliveries at the end of 2008. In any case, Northwest will need a 100-seater, which it will fly at the mainline. But while there have been discussions with Bombardier and Embraer on 100-seaters, the decision may not come anytime soon - among other reasons, because it may be beneficial to wait for new-technology aircraft. JP Morgan analyst Jamie Baker suggested in a recent research note that the future order could be for the Bombardier C-series aircraft and worth close to $3bn.

Network strategy and plans

Northwest's basic aim is to make the most of its unique network assets, which have enabled it to develop a powerful market position domestically and on US-Asia routes. The airline has a strong domestic franchise, with the number one position and 24% revenue share in Heartland (the Upper Midwest region), thanks to its strong hubs in Detroit, Minneapolis/St. Paul and Memphis. Northwest is also the largest US carrier on the Pacific, with a hub at Tokyo-Narita and valuable beyond-Tokyo fifth freedom rights.

However, in the short-to-medium term at least, Northwest is not the same spectacular international growth story that Delta is; its international growth is likely to be in single digits. The aggressive fleet plans are essentially for replacement and long-term growth.

Northwest differs from its legacy peers in two significant respects. First, it has embraced international alliances to a much greater degree, as evidenced by its old-established partnership with KLM, membership of SkyTeam and plans to develop a four-way transatlantic JV with KLM, Delta and Air France. This has helped compensate for shortcomings in its route network; for example, the Northwest/KLM combination generates $3.5bn in annual revenues, making it the fourth largest (and highly profitable) transatlantic carrier.

Second, Northwest operates 747 freighters and earns 8% of its revenues from cargo - unusual in the US context but, of course, totally in line with what global carriers elsewhere are doing.

Northwest's network restructuring in the past two years has featured a domestic to international shift, though nowhere near as sharp as Delta's. Between 3Q05 and 3Q07, mainline domestic passenger revenues remained unchanged, while Pacific and Atlantic revenues rose by 8.7% and 13.5%, respectively (to account for 24% and 16% of total mainline passenger revenues; the remaining 60% is domestic).

Domestic plans: The focus will be on a mainline-to-regional shift with the help of the 76-seat RJs. Regional growth is expected to be in the mid-teens. Having restructured its regional partnerships, Northwest is looking to develop synergies between its wholly owned subsidiaries. In the past year, Northwest has acquired its partner Mesaba and launched a new wholly-owned unit Compass. Mesaba will operate the new CRJ900s and Compass the E175s. The third regional partner, 12%-owned Pinnacle, will continue to operate 50-seat CRJ200s for Northwest.

Northwest is in the process of purchasing a $213.3m, 47% passive stake in Midwest Air Group as part of TPG Capital's $451m acquisition of the Milwaukee-based carrier; the transaction is expected to close by year-end. The two airlines have codeshared for some time and are now expanding that and exploring other forms of cooperation. Midwest will help solidify Northwest's Heartland position; however, the main benefit is to prevent low-cost carrier AirTran, which was previously aggressively bidding for Midwest, from gaining a foothold in the region. Since TPG will want to exit in due course, Northwest may end up as the majority owner of Midwest.

Atlantic: Northwest has continued to grow on the Atlantic as part of its alliance with KLM, which has been in place since 1991. This past summer saw the addition of new daily nonstop 757 Detroit-Düsseldorf and Hartford-Amsterdam flights. In spring 2008 Northwest will introduce Minneapolis-Paris and Portland-Amsterdam routes, while KLM will add an Amsterdam-Dallas service.

In a solid response to the US-Europe open skies treaty, in June Northwest and fellow SkyTeam members Air France, Alitalia, CSA Czech Airlines, Delta and KLM applied to the DOT for antitrust immunity for transatlantic routes. Currently, Delta has antitrust immunity with AirFrance, Alitalia and CSA, while Northwest has it with KLM. Included in the application is a four-way joint venture agreement between Northwest, KLM, Delta and Air France that would facilitate deeper KLM/NWA-style commercial integration. In mid-October the DOT made its first move: setting a timeline for consideration of the application. One Wall Street analyst suggested recently that the airlines have a "fair shot" at receiving the immunity.

Pacific: Northwest has one of the world's largest Pacific route networks. The operations focus on Tokyo Narita, as Northwest has unlimited fifth freedom rights from Japan to the rest of Asia. While United also has fifth freedom rights out of Japan, Northwest has 50% more slots at Narita - a total of 376 permanent weekly slots, the most for any non-Japanese carrier. Northwest uses those slots and rights to link nine US gateways and 12 Asian destinations via Tokyo. In addition, Northwest flies nonstop from Detroit to Osaka and Nagoya and uses its fifth freedom rights to serve points such as Guam and Honolulu from those cities.

But competition is growing on the Pacific, particularly in the lucrative US-China market. Those routes have become a focus for most of the large US carriers as the ASA is being progressively expanded. Under the latest US-China deal signed in July, flights between the two countries will be increased from the current ten per day to 23 by 2012. The US side will get two additional daily flights in 2008, four more in 2009, three more in 2010 and two more in 2011.

Competition for those rights has been fierce. So far, the DOT has awarded the two new 2008 flights to Delta and United, while American, Continental, Northwest and US Airways have been tentatively selected for the 2009 additions. Northwest plans to launch Detroit-Shanghai in March 2009 - its first nonstop service to China. Northwest has also sought Detroit-Beijing authority, which it may get in later years.

Northwest remains well positioned to

maintain its leadership position on the Pacific for two reasons. First, it will have the perfect long-range aircraft for Pacific nonstop operations. In addition to Japan, the airline expects to utilise the 787 on new routes to China, Korea, etc.

Second, Northwest may in the future take advantage of its Tokyo slots, fifth freedom rights and special provisions in the US-China ASA to launch service from Tokyo to secondary cities in China, using smaller aircraft such as the 757s. A large number of cities in China have no slot or frequency limitations under the US-China bilateral, because the Chinese government wants to encourage flights to underserved airports. Cities such as Chengdu, Changchun and Dalian are not large enough to justify nonstop service from the US, but they still have sizable populations (3-6m, plus many times more in their potential catchment areas), and Northwest could aggregate traffic in Japan coming from all of its US gateways. In the third-quarter conference call, Northwest's management described the secondary Chinese points as a "very interesting economic opportunity for us".

Cargo: Northwest's cargo business, which generates $900m in annual revenue, with 80% coming from US-Asia services operated through hubs at Anchorage and Tokyo, has underperformed the rest of the network in recent years. There have been reliability, product quality and profitability issues. Northwest is now trying to fix those problems; the measures including relocating maintenance facilities, changing the top management, improving revenue management and eliminating some marginal flying.

Opportunities for value creation?

The management indicated in the third-quarter call on October 29 that Northwest sees industry consolidation as inevitable and offering significant opportunities for value creation. Noting that the company is committed to maximising shareholder value, CEO Doug Steenland stated: "This commitment, together with Northwest's non-replicable strategic and network assets, our competitive cost structure, our strong earnings and our very strong balance sheet will make Northwest a key participant in any future industry developments".

But Steenland also stressed the need to take into account the many "execution risks" in mergers, including the "requirement to negotiate labour agreements, which would likely lead to cost increases", when deciding whether a deal was in the best interests of Northwest's constituents. It would be a shame if Northwest lost its hard-won cost advantage through M&A.

The key point is that Northwest is well positioned for any industry scenario - independent survival or consolidation.

Calyon Securities analyst Ray Neidl suggested in mid-September that Northwest had positioned itself for possible consolidation as either a buyer or seller, though its strong balance sheet and unique network assets made it an attractive acquisition target.

While Northwest would be a good fit with a number of airlines, Delta remains a favourite, based on potential network synergies, an existing commercial alliance (established in 2002 and also including Continental) and links at the leadership level (since Northwest's former CEO Richard Anderson took over at Delta in September). Another favourite is longtime partner Continental. Merrill Lynch analyst Mike Linenberg suggested in an early-October research note that the "golden share" Northwest holds in Continental represents "tremendous strategic value" in the event of industry consolidation.

Separately, like many of its peers, Northwest is currently analysing the potential of spinning off various assets, including its WorldPerks FFP. In 2003 Northwest sold most of its regional unit Pinnacle in a $272m IPO; it now retains only a 12% stake in the carrier. The two wholly-owned regional units, Mesaba and Compass, are obvious future spin-off candidates.

By Heini Nuutinen

Air Berlin: Expanding into a global hybrid?

Although Air Berlin began back in 1978 as charter airline, it wasn't until it launched scheduled flights into major European cities in 2002 that expansion really began. In May 2006 Air Berlin underwent a troublesome IPO (see *Aviation Strategy*, May 2006), but the float provided the impetus for a series of major acquisitions that is turning the airline into a global hybrid rather than the third European LCC that it recently appeared to be.

The first move was for dba, which was bought in August 2006 for €120m to secure a domestic network and feed that complemented Air Berlin's existing network of international routes to medium-haul holiday destinations and European cities. The deal also secured crucial slots at Munich and Düsseldorf airports and enabled Air Berlin to use dba aircraft on Air Berlin's leisure routes in the summer, and larger Air Berlin aircraft on busier domestic dba routes. Although the dba name was phased out in April this year, synergies from integrating the dba fleet are expected to top €30m in 2007, according to Air Berlin.

Boosted by the dba deal, 2006 was the most successful year ever for Air Berlin. After three years of losses (see chart, opposite), last year Air Berlin achieved an operating profit of €64.1m - its highest-ever, based on a 29.6% rise in turnover, to €1.6bn. Net profit reached €50m in 2006, compared with a €116m net loss in 2005. In 2006 passengers carried on Air Berlin rose 12.5% to 15.2m, which when added to the 4.5m carried by dba (up 12.8% compared with 2005) made a total of 19.7m passengers carried by the Air Berlin group last year (12.6% up on 2005), with a load factor of 75.3% - (see chart, opposite.)

LTU integration

In March this year the airline's next move was to buy charter carrier LTU from its investment firm owners for €140m, including the assumption of up to €200m of debt. LTU had revenue of €1.1bn in 2006, employs 2,900 and operates a fleet of 14 A320s and A321s on medium-haul and 12 A330s on long-haul.

Crucially, the deal signified a major change in strategy. Joachim Hunold, CEO of Air Berlin, has described the airline as a "hybrid carrier", targeting business travellers and leisure passengers as well. However, since 2003 there has been a steady change in emphasis away from leisure to the business traveller, and as can be seen in the chart, page 16, the proportion of revenue that comes from bulk sales to tour operators (i.e. charter flights) has fallen from 56% in 2003 to 37% in the first-half of 2007. More than 500 German companies have corporate deals with Air Berlin, and currently around 60% of domestic passengers and 55% of (non-German) European passengers are business travellers. Air Berlin wants to increase this further, and the vulnerability that the airline has in still being exposed to a large amount of business from lower margin and more fluctuating demand from leisure passengers was shown when Air Berlin released its results for the first-half of 2007.

In the first half of the year Air Berlin saw a 7.1% rise in revenue to €921m (on a proforma basis compared with 1H 2006 - i.e. including dba results), with passengers carried rising 11.7% to 10.1m. Disappointingly however, on a per passenger basis ancillary revenue only rose in the first-half of 2007 thanks to so-called "technical assistance" to other airlines; so far Air Berlin has not emulated the aggressiveness of Ryanair in driving up ancillary revenues. ASKs grew by 8.9% in January-June 2007 but RPKs grew by 10%, leading to a 0.7 percentage point rise in load factor, to 74.2%. However, operating losses increased to €37.3m (-€32.8m in H1 2006) and the net loss rose to €29.3m, compared with a net loss of €16.7m in the first-half of 2006. Air Berlin blamed the figures on yield pressure and delayed permission (not given until August) by the Bundeskartellamt - the

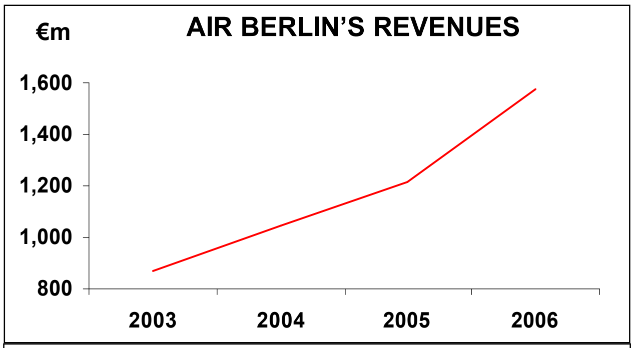
German competition regulator - for the LTU deal. The latter knocked operating profits by €30m according to Air Berlin, and during the half-year the airline suffered from expensive short-term contracts for wet-leased aircraft to make up for the unexpected shortage in capacity. Air Berlin also said that good German weather stopped leisure passengers from travelling and led to fierce competition from German and foreign airlines. Recently released third-quarter revenue figures came in at €858m, (although it is difficult to find a comparator due to Air Berlin's merger activity) and net profits jumped by 57% to €61m.

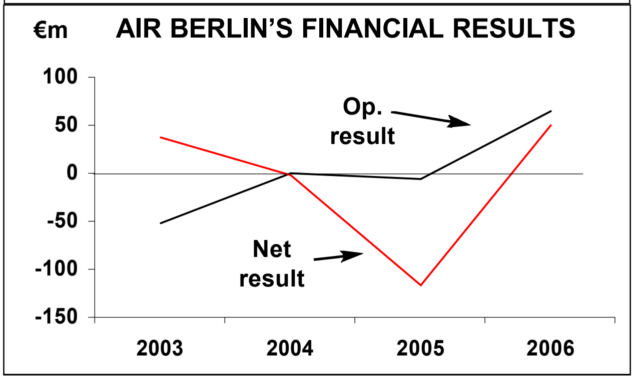
This exposure to the leisure sector was a key motivation for the LTU deal, because although LTU is primarily a leisure-focused airline (just under two-thirds of its revenue comes from tour operators), it has a significant number of long-haul routes, and it is these routes - and their slots at key airports - that are the core of the change in Air Berlin's strategy: to build up a network of long-haul business routes that can be fed by the existing European services.

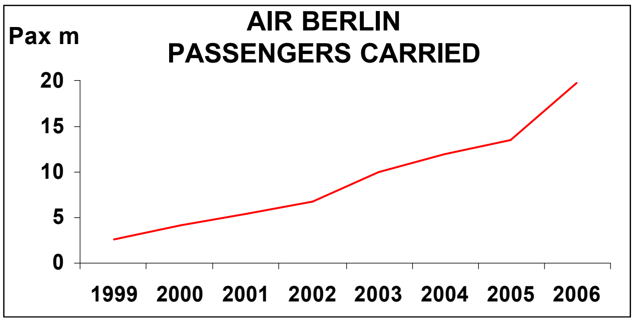
As LTU is primarily a leisure airline, this means a complete overhaul of the carrier's network and product as its operations are merged into the Air Berlin group. In Europe, there will be rationalisation of overlapping services and a cull of unprofitable routes: LTU adds 15 new destinations to Air Berlin in the continent (most of which are in the eastern Mediterranean), but LTU and Air Berlin overlap on 42 European routes, many of which are from Germany down to Palma de Mallorca.

LTU's European operation makes a loss as a whole, with around 55% of routes making a marginal or negative contribution, and Air Berlin says the main areas of concern are routes down to Spain, Portugal and certain "city destinations". Already earmarked to be closed in the upcoming winter timetable are LTU's routes from Düsseldorf to Madrid, Lisbon, Athens and Thessalonica, as well as domestic LTU services. Revealingly, while Air Berlin's European network is profitable, Air Berlin also admits that 30% of its own routes have marginal or negative contribution, with the latter due to being either new routes or to strong competition. Air Berlin has decided to terminate its Stansted hub and beyond services to Birmingham, Glasgow, Belfast and Manchester from the winter 2007/08 timetable. Air Berlin launched its first domestic UK service in 2005 but says they became "commercially difficult" following the increase in UK air passenger duty earlier in 2007. Stansted will remain an important point-to-point destination however, and a Stansted-Munich service launches this month.

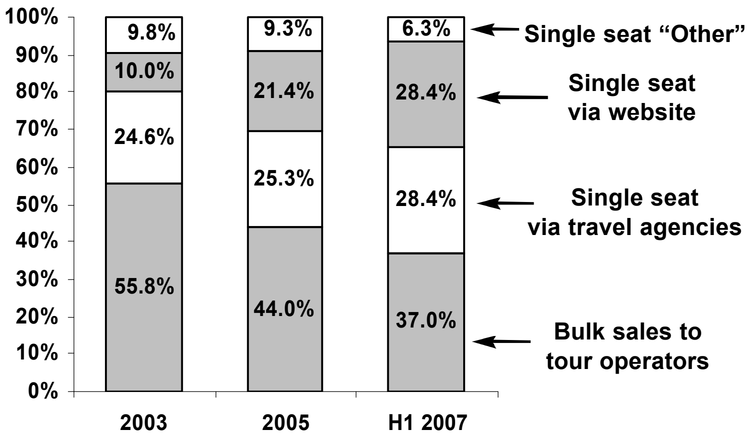
On long-haul, LTU currently serves 16 destinations in the Americas, six in Africa and four in the Asia/Pacific region out of Düsseldorf, Berlin and Munich. All these routes are now undergoing a review by Air Berlin management, but Air Berlin is closing LTU routes to Las Vegas, Toronto and Colombo, while all LTU routes out of Frankfurt







AIR BERLIN'S REVENUE BY DISTRIBUTION CHANNELS



are being transferred to Düsseldorf and Munich. For the rest, while Air Berlin says these routes are "currently dominated" by tour operators, and it will seek to increase seat-only sales, it's clear that there is a major distinction between what Air Berlin considers "leisure" and "business" routes. The former includes existing LTU routes to central America and the Caribbean, Africa, Indian Ocean and Thailand, while the latter will include existing LTU routes to New York, Los Angeles, Miami and Fort Myers (although it must be said that the inclusion of Fort Myers and Miami as business routes is puzzling), while new "business routes" to Beijing and Shanghai will be launched using LTU's A330s from the summer of 2008.

Started this October, the key initiative taking place on this route classification (in what Air Berlin calls a "quick win") is an overhaul of LTU's business class product. On the leisure routes, business class will be replaced by a "Relax Class", with an improved seat pitch and 24 seats per cabin instead of the current 18, while on the business routes a "Premium Business Class" is being introduced, with fully-reclinable seats and an increase in capacity from 18 to 30 seats per aircraft.

While Air Berlin is unlikely to wind down its long-haul charter business in the short-term, given that - as Hunold says - there is to be a "greater focus placed on business travel", the future of the leisure routes in the long-term is clear, and looking forward to 2008 compared with 2007 (see chart, opposite), "charter passengers" is the only market segment that Air Berlin expects to decline.

A further indication of the change in emphasis is Air Berlin's dropping of the LTU brand on everything other than the leisure route flights to the Caribbean, Africa and the Asia/Pacific region, as according to Hunold, "it makes sense" to operate all of the group's business services under the same brand. He admits that Air Berlin considered the total abolition of the LTU name, but this is likely to be no more than a temporary reprieve, lasting until the long-haul leisure routes have been wound down to a certain size - i.e. to those routes that can be supported by direct seat-only sales, rather than have to rely on declining charter business.

Air Berlin also owns 49% of Swiss-based Belair, a subsidiary of tour operator Hotelplan, which operates two 757s and a single 767 leased from ILFC on charter routes, mainly from Switzerland to the Mediterranean. Hotelplan bought the airline from Swissair (where - confusingly - it was called Balair) in 2001, but again, after Air Berlin announced the deal to buy Belair in March this year, it didn't get clearance from the regulatory authorities until August. Where Belair fits into the new strategy of a greater emphasis on business passengers is unclear.

The rationale for the long-term culling of the leisure network - and the underlying reason why LTU was bought - is slots, and in particular the slots that LTU has at Düsseldorf airport, its main operational base. Until recently, Air Berlin's strategy had been to have geographical coverage across the whole of Germany, with services from both primary and secondary airports, and today the airline operates out of 15 German airports to (pre-LTU) 87 business and leisure destinations in Europe and North Africa. But at the same time as Air Berlin has been slowly switching its emphasis from leisure to business travellers, it has also been building up hub operations at two airports - Berlin and Düsseldorf.

Air Berlin also operates two smaller "leisure hubs", one of which is at Palma de Mallorca, which was established back in 1997 and which offers connecting service from Air Berlin and Niki (which Air Berlin has owned

24% of since January 2004) to Iberian destinations, and through which 6m Air Berlin passengers are expected to travel in 2007. Air Berlin has a 27% share of passengers carried at Palma, and this should increase now that Terminal C at Palma has increased its capacity to 54 gates through a €50m investment by the airport operator, almost all of which are dedicated to Air Berlin flights. With services to 18 Iberian destinations, Air Berlin has a 7% market share of the entire Spanish market - although that is sure to come under pressure over the next few years given the increasingly cut-throat competition between Vueling, Spanair, Iberia and the foreign LCCs. Since 2006 Air Berlin has also built up a small hub operation at Zurich airport, connecting services from German and Austrian airports to flights into the Canary Islands.

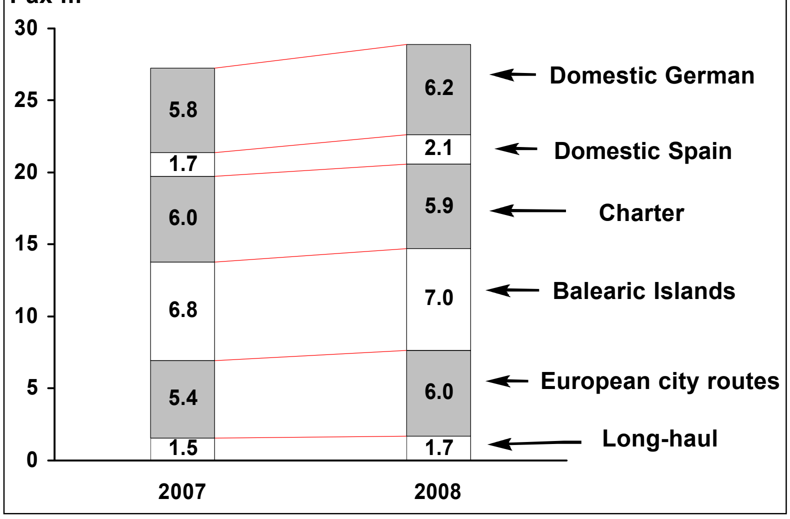
Düsseldorf - the key

Düsseldorf is where the airline is "betting its future on", as one analyst puts it. Air Berlin believes the airport has tremendous potential for growth - Düsseldorf airport expects to handle 17m passengers in 2007 and is investing €150m in developing its infrastructure so that it becomes a major hub. As the table (see page 18) shows, Düsseldorf is the most underdeveloped of the major German airports in terms of its traffic-to-catchment area ratio, but Hunold says that until now Air Berlin has not been able to grow at Düsseldorf "owing to the limitation of departure slots".

The LTU deal solves that problem. As of the summer 2007 schedule, Air Berlin fed around 400 flights a week into Düsseldorf, with capacity of around 54,000 seats. The LTU deal adds around 40,000 weekly seats at Düsseldorf, and combined (and even before Air Berlin's planned flight expansion out of Düsseldorf) this beats the 75,000 weekly seats at Düsseldorf offered by Lufthansa, as well as the 10,000 of BA.

Key to LTU's integration at Düsseldorf is ensuring good connections between Air Berlin's European feed and the LTU "business routes". The latter will be built up to a seven-day-a-week service by the summer of 2008 and will connect into a two-wave pattern that Air Berlin will operate at Düsseldorf.

AIR BERLIN PASSENGER GROWTH FORECAST



Eastbound, flights from Europe will arrive between 5pm and 6pm, connecting with services to Bangkok, Beijing and Shanghai that depart up to 7pm; while westbound, incoming European connections will cluster around 11am and feed into flights to Fort Myers, Los Angeles, New York, Miami and Vancouver that depart around 1pm.

Air Berlin is also bolstering partnerships at its long-haul destinations. In September, for example, the airline signed a partnership with Hainan Airlines, which will connect Air Berlin passengers arriving at Beijing from Düsseldorf next summer with around 50 domestic Chinese destinations. As part of the co-operation, Hainan will launch a service between Beijing and Berlin that will connect in with Air Berlin's domestic and European network.

The potential problem, however, with Air Berlin's Düsseldorf strategy is Lufthansa. It already has a major presence at Düsseldorf and has identified the airport as being the most likely point for a competitor to create a threat to its main hubs at Munich and Frankfurt (see *Aviation Strategy*, October 2007). There's little doubt that Lufthansa will try to build up a long-haul network out of Düsseldorf, but thanks to the LTU deal Air Berlin has - for now at least - a healthy lead over its rival.

Air Berlin needs to avoid a damaging long-haul fare war with Lufthansa out of Düsseldorf, although Air Berlin is relaunching

GERMAN CATCHMENT AREAS

	Population within 100km	Pax. carried at main airport(s) in 2006
Düsseldorf	18.0m	16.6m
Frankfurt	9.7m	52.8m
Stuttgart	9.5m	10.1m
Berlin	6.1m	17.9m
Hamburg	6.1m	11.6m
Munich	6.1m	30.8m

Source*: Air Berlin*

the LTU business routes with some targeted fare cuts, such as a one-way flight from Düsseldorf to New York from €129 from November this year, with an extra €40 for any connecting flight originating within Germany.

Already the danger signs of yield erosion on Air Berlin's European routes are clear to see. The most worrying aspect about the January-June 2007 results was the yield and unit revenue trend. Unit revenue fell 5.4% year-on-year in the second quarter and 1.7% overall in the first-half of 2007, while yield fell by 4.9% in 1Q and 2.6% in 1H. The real fear is that cut-throat competition on European business routes is here to stay, and Lufthansa has also experienced sharply falling yields within Europe - as have virtually all other European airlines.

The Condor acquisition

Therefore if Air Berlin is betting its future on securing high margins on long-haul out of Düsseldorf (which will more than compensate for low margin - but vital - European business feed), then it needs to dominate Düsseldorf. That's partly why Air Berlin has moved for Condor, yet another charter carrier, but one that has offers 10,000 seats a week at Düsseldorf that will be added to the Air Berlin/LTU total when it becomes part of the group. The Condor deal was signalled back in March when Air Berlin said it was ending its codeshare with Hapagfly (launched in November 2004 and part of the TUI group, and which has since become TUIfly after merging with low-fare carrier Hapag-Lloyd Express) at the end of the winter 2006/07 season, in favour of a partnership with Condor.

In September Air Berlin announced a deal to buy Condor from Thomas Cook, which is the travel division of German retailer Arcandor, previously known as KarstadtQuelle (Arcandor bought the 50% of Thomas Cook that it didn't own from Lufthansa in January this year). Air Berlin's shares plus cash deal for Condor will have to be ratified by the German regulator, and as Condor and LTU are the two largest charter airlines in Germany it's not inconceivable that the Bundeskartellamt may block the deal, or impose some kind of conditions.

However, barring any intervention by the regulator, Air Berlin plans to acquire the 75.1% of Condor that Thomas Cook currently owns in February 2009. At that date Thomas Cook will also acquire the remaining 24.9% of Condor that now belongs to Lufthansa, but for which Thomas Cook has a call option to purchase for €77m from February 2009. Thomas Cook will then sell that stake to Air Berlin in February 2010. In return, Thomas Cook will acquire at least €500m in cash and shares in Air Berlin, made up of shares worth between €380m-€475m (depending on the share price in February 2009) and representing between 20% and 29.99% of Air Berlin, plus cash of approximately €120m, which represents the cash assets of Condor.

Thomas Cook's rationale for the deal is that it doesn't need to own aircraft assets, particularly when 60% of Condor's revenues don't come from Thomas Cook (with 24% of overall revenue coming from third-party tour operators and 36% from direct seat-only sales). Thomas Cook will not be able to sell its stake in Air Berlin until February 2011, although both Air Berlin and Thomas Cook say they will remain long-term strategic partners following the deal, and Thomas Cook will appoint one executive and two non-executive directors onto the Air Berlin board. But Thomas Cook merged with UK tour operator MyTravel in June this year and is the second largest operator in Europe after TUI, and whether Air Berlin will want Thomas Cook to remain a shareholder in the long-term is open to some doubt, given that Air Berlin's current strategy is to give greater emphasis to the business market and less to leisure revenue.

The deal was also dependent on Lufthansa not exercising pre-emption rights to buy the whole of Condor once a formal offer came in from another party. While Lufthansa was tempted to stop the Air Berlin/Thomas Cook tie-up, the cost of acquiring the whole of Condor and the fact that it would not fit in with Lufthansa's strategy proved to be decisive, and Lufthansa says it will not exercise its pre-emption rights. On the other hand, if Lufthansa agrees, it could allow Thomas Cook to buy out its 24.9% stake in Condor earlier than February 2009, thus allowing the entire deal to go through quicker than the timetable suggested above. But Lufthansa is unlikely to agree to this, as it knows full well that Air Berlin will use Condor's assets to build up competition to the flag carrier's long-haul network.

Assuming the regulator does not object, Air Berlin will acquire Condor's fleet of 35 aircraft (as well as two other aircraft owned by Thomas Cook) that currently operate to 80 leisure destinations, split almost evenly between European (largely in the Mediterranean) and long-haul (mostly Caribbean North American and Indian Ocean) destinations. Condor has 2,300 employees and carried 7.8m passengers in 2006, with revenue of €1.2bn. Condor itself operates nine 767-300s and 13 757-300s, while subsidiary Condor Berlin has 13 A320s. While Condor operates from many German cities (including Düsseldorf), the carrier's main hub is Frankfurt, with Munich a secondary hub, and while there is no way that Air Berlin will be able to build up an operation comparable to that of Lufthansa at Munich and Frankfurt, (and indeed Air Berlin is transferring LTU routes away from Frankfurt in the short-term) the routes it will offer at these airports post completion of the Condor deal will be a key part of building up scale for Air Berlin and its business customers - even if Düsseldorf will remain the key long-haul hub for the Air Berlin group in the long-term.

Positive synergies

Air Berlin forecasts that the eventual merger of Condor into Air Berlin's operations will generate "positive synergies" of at least €70m a year by 2010, an estimate that will hopefully prove to be more accurate than the initial forecasts given for LTU. Air Berlin had expected significant benefits from integrating LTU this year, but in an update given to analysts in September Air Berlin said the delay in Bundeskartellamt approval meant that synergies will be "below original expectations" of €35m in 2007 and between €70m and €100m in 2008. Air Berlin now forecasts synergies of €20m in 2007 and up to €70m in 2008, although from this has to be subtracted integration costs of around €20m in 2007 (which means that there will be no overall effect on operating profit this year) and €15m in 2008.

The synergistic benefits from the acquisitions are important to Air Berlin as it needs to keep cutting costs on a unit basis in order to mitigate the fall in yields it is experiencing. While it is gaining some economies of scale as it grows (for example through the renegotiation of better terms with airports and other suppliers), unit costs are not coming down fast enough to negate the drop in unit revenue: unit costs came down 1.4% in the first-half of 2007, compared with the 1.7% fall in unit revenue.

Hence, once cartel office approval came through for the LTU deal, Air Berlin announced it was merging the engineering departments of dba, LTU and Air Berlin under the name "Air Berlin Technik", which will employ a total of 1,100 staff. That merger was done via agreement with unions, which is an interesting development since Air Berlin - like Ryanair - has traditionally had an adversarial attitude to collective representation and it had previously refused to negotiate with unions. This attitude has had to shift after the acquisition of dba and LTU, both of which have strong union representation. Indeed a first-ever collective agreement with 800 pilots (represented by Vereinigung Cockpit (VC), the German pilots' union) and 1,440 cabin crew (represented by the Ver.di union) at Air Berlin was agreed by management in August and September, including 2%-3% pay rises over the period to the end of 2008. Air Berlin also promised to open talks on setting up its first ever works council. This agreement excluded staff at LTU and dba, but after a "warning strike" by the former and the threat of more substantial industrial action, a deal was signed with LTU pilots represented by VC the same month, and this was quickly followed by an agreement with 130 dba pilots (again represented by VC), bringing their pay and conditions in line with those elsewhere at Air Berlin.

Despite this softer line, Air Berlin may be heading into potential union problems once Condor is acquired, since Condor's pilots have mostly been seconded from Lufthansa, and have pay and conditions that are substantially better than those enjoyed by Air Berlin pilots. How many Condor pilots will transfer over to Air Berlin at the end of the decade is unknown at the moment, but those that do go will be fiercely resistant to any erosion in the terms of their existing collective agreements.

Speculative future

Air Berlin's future depends not on cost-cutting but in being successful in its strategy of serving business passengers on both short- and long-haul. None of the other European LCCs have expanded into long-haul and Air Berlin's managers will have to deal not only with the complexity of two types of operations, but also with the intricacies of integrating the new acquisitions as well as the challenge of managing down the tour operating/leisure business over the foreseeable future.

Operationally, that is a lot to do. Air Berlin currently serves just under 90 destinations out of Germany, with routes to Gothenburg, Stockholm, Kavala, Zakynthos, St. Petersburg, Naples, Olbia and Palermo added in the first half of 2007, but even before the extra capacity from LTU and Condor comes on board, Air Berlin will have to find enough routes and markets for the substantial amount of aircraft it has on order. Air Berlin and LTU currently have a fleet of 115 aircraft (see table, opposite), and even without the extra aircraft from Condor that will join in 2009, Air Berlin has a substantial 149 aircraft on order. In November 2006 Air Berlin ordered 60 737-800s for delivery from the end of 2007 to 2014, and in the same month 25 737-700s were also ordered. Although they will partly replace the fleet of F100s acquired from dba, after Air Berlin announced the 737 order its shares plunged by more than 10% in two hours, reflecting unease in the market as to where the new aircraft would be placed profitably in a European market where Ryanair and easyJet are scouring Europe in search of new routes for their growing fleets. Just under 30 A320s are also on order, and Air Berlin is also reported to have ordered 10 Q400s for its affiliate airline Germania Express, although this is as yet unconfirmed.

For long-haul, in July this year Air Berlin ordered 25 787s for delivery in 2013-2017, and placed options for 10 aircraft and purchase right for another 15. The list price is $4bn, although a very substantial discount was obtained on this. Financially, Air Berlin is relatively strong. Long-term debt rose to €763m at the end of June 2007, compared with €518m at the end of 2006, but cash and cash equivalents stood at €364m at the end of the first-half of 2007 compared with €316m at the end of 2006, thanks to an issue of convertible bonds and new equity in March, and better cash flow from operations.

Some analysts believe that Air Berlin - which had 4,580 employees as at the end of June this year - has embarked on an aggressive acquisition strategy partly because there has been increasing speculation that Air Berlin itself might be the target of a bid by a larger airline. Takeover speculation was fuelled by Deutsche Bank's building of 16.4% stake in Air Berlin by September this year (from 10.1% in May), although the bank insists that this is a financial play, and not a strategic investment held on behalf of itself or a third-party.

Among potential bidders that have been mentioned is Air France/KLM (denied by the French/Dutch group), with one analyst saying that Air France/KLM would benefit not only by getting access to the German market in a direct attack on Lufthansa, but this move would also protect its home markets from Air Berlin's planned expansion at Düsseldorf, which would attract feed from the Dutch market. But there would be little overlap between the business models of Air France/KLM and Air Berlin, and - perhaps more importantly - a triple Paris, Amsterdam and Düsseldorf hub model may be too unwieldy and dispersed to work. Another candidate that has been mentioned in the press is Ryanair, a potential tie-up that looks a very long-shot, but one - if it ever happened - that would strike fear among the legacy carriers in Europe.

Away from the speculation however, there's little doubt that Air Berlin faces major challenges in managing its capacity growth and the planned mergers over the next few years. Air Berlin says that the LTU deal makes the Air Berlin group the fourth-largest in Europe in terms of ASKs, ahead of easyJet and BA and behind only Ryanair, Air France/KLM and Lufthansa, but although Air Berlin aims to carry 22m passengers in 2007 - and traditionally has much stronger results in the second half of the year rather than the first six months - the poor January-June 2007 results have forced the airline to withdraw its previous forecast of a 5% operating margin for full 2007.

Instead, Air Berlin "only" expects full 2007 operating profit to beat the €64m figure recorded in 2006, while 2007 net profit is also expected to be better than that of 2006. More worryingly, Air Berlin had previously forecast an improvement in overall yield during the whole of 2007 of up to 2%, but this will be very difficult to achieve now, given the fall in yield in the first-half of 2007 and the "tough winter" forecast by Ulf Huettmeyer, CFO of Air Berlin.

Unease about Air Berlin's future has been filtering into its share price. It has fallen from just above €20 in May this year down to €12 as at mid-October, due largely to worries about oil prices and the robustness of demand, although Hunold believes the company is undervalued at its current market capitalisation of around €800m. Currently 65% of Air Berlin's equity is on free float, with the rest held by a number of original founders, management and investors, including Hunold with 3.2% and Johannes Zurnieden (Air Berlin's chairman) with 1.5%.

AIR BERLIN GROUP FLEET

		Fleet	Orders (options)
Air Berlin			
	F100	14	
	737-300	1	
	737-500	1	
	737-700	7	25
	737-800	40	61
	787-8		25 (10)
	A319	8	11
	A320	18	27 (40)
LTU			
	A320	10	
	A321	4	
	A330	12	
Total		**115**	**149 (50)**

With Air Berlin continuing to increase capacity substantially - partly to secure market share and partly to avoid losing slots at key capacity-constrained airports - yield will remain under pressure for some time, and so will the share price. Indeed the nightmare scenario for Air Berlin may be that, thanks to the acquisition of Condor and the threat this presents to Lufthansa at Frankfurt, as one analysts puts it, the "cosy duopolistic " relationship that Air Berlin and Lufthansa held in the German market may vanish, and that the flag carrier's "gloves may come off". So whether management likes it or not, until the new emphasis on short- and long-haul business passengers translates into more robust financials, the speculation about Air Berlin being a potential takeover target will only grow.

Jet values and lease rates

The following tables reflect the current values (not "fair market") and lease rates for narrowbody and widebody jets. The figures are provided by the The Aircraft Value Analysis Company (contact details opposite) and are not based exclusively on recent market transactions but more reflect AVAC's opinion of the worth of the aircraft. These figures are not solely based on market averages. In assessing current values AVAC bases its calculations on many factors such as number of type in service, number on order and backlog, projected life span, build standard, specification etc. The lease rental rates are calculated independently of values and are all market based.

NARROWBODY VALUES (US$m)

	NEW	5 years old	10 years old	20 years old
A318	28.9			
A319 (IGW)	39.9	32.5	25.1	
A320-200 (IGW)	47.8	38.3	38.8	
A321-200 (LGW)	52.7	42.0	31.3	

	NEW	5 years old	10 years old	20 years old
717-200		13.0		
737-300 (LGW)			10.6	6.0
737-400 (LGW)			11.4	6.7
737-500 (LGW)			9.4	
737-600		22.3		
737-700 (LGW)	40.6	33.5	26.4	
737-800 (LGW)	50.7	41.3		
737-900ER	54.6			
757-200		26.7	21.5	11.0
757-200ER		29.0	22.4	12.1
757-300		35.2		
MD-82			5.5	3.5
MD-83			6.3	4.3
MD-88			6.6	3.9
MD-90			7.9	

WIDEBODY VALUES (US$m)

	NEW	5 years old	10 years old	20 years old
A300B4-600				5.8
A300B4-600R (HGW)			25.7	10.4
A310-300 (IGW)			17.4	6.4
A330-200E	99.5	83.2		
A330-300 (IGW)		72.4	52.7	
A340-200			41.3	
A340-300 (LGW)		72.3	54.9	
A340-300ER		82.9	62.1	
A340-500 (IGW)		87.2		
A340-600 IGW)		93.2		
A380-800	185.8			

	NEW	5 years old	10 years old	20 years old
747-200B				3.4
747-400		93.8	72.0	
767-200				6.3
767-300			27.8	10.9
767-300ER (LGW)		50.3	39.7	20.5
767-400		54.6		
777-200		69.4	52.8	
777-200ER	129.3	106.7	84.0	
777-300		97.6	72.1	
787-800	100.9			
MD-11P			39.0	

Note: As assessed at end-October 2007
Source: AVAC

NARROWBODY LEASE RATES (US$000's per month)

	NEW	5 years old	10 years old	20 years old		NEW	5 years old	10 years old	20 years old
A318	252				**717-200**		169		
A319 (IGW)	366	312	270		**737-300 (LGW)**			154	112
A320-200 (IGW)	380	347	293		**737-400 (LGW)**			152	124
A321-200 (LGW)	448	382	331		**737-500 (LGW)**			134	
					737-600		189		
					737-700 (LGW)	368	315	272	
					737-800 (LGW)	410	357		
					737-900ER	455			
					757-200		232	225	178
					757-200ER		264	244	174
					757-300		290		
					MD-82			112	84
					MD-83			115	86
					MD-88			118	81
					MD-90			114	

WIDEBODY LEASE RATES (US$000's per month)

	NEW	5 years old	10 years old	20 years old		NEW	5 years old	10 years old	20 years old
					747-200B				163
A300B4-600				134	**747-400**		788	675	
A300B4-600R (HGW)			254	154	**767-200**				123
A310-300 (IGW)			221	140	**767-300**			263	186
A330-200E	876	759			**767-300ER (LGW)**		474	434	373
A330-300 (IGW)		701	566		**767-400**		514		
A340-200			544		**777-200**		600	526	
A340-300 (LGW)		780	638		**777-200ER**	1,069	934	828	
A340-300ER		821	663		**777-300**		904	749	
A340-500 (IGW)		882			**787-800**	800			
A340-600 (IGW)		904							
A380-800	1,504				**MD-11P**			397	

Note: As assessed at end-October 2007
Source: *AVAC*

		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 emp.
Alaska	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
	Oct-Dec 06	790	808	-18	-12	-2.3%	-1.5%	9,261	6,828	73.7%	4,107	9,485
	Year 2006	**3,334**	**3,422**	**-87**	**-53**	**-2.6%**	**-1.6%**	**43,306**	**33,012**	**76.2%**	**24,025**	**12,933**
	Jan-Mar 07	759	778	-18	-10	-2.4%	-1.3%	10,652	7,552	71.0%	5,471	13,236
	Apr-Jun 07	904	827	78	46	8.6%	5.1%	10,448	8,196	78.5%	5,329	9,748
	Jul-Sep 07	995	852	143	86	14.4%	8.6%	10,225	8,154	79.7%	4,878	9,753
American	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
	Oct-Dec 06	5,397	5,212	185	17	3.4%	0.3%	67,813	53,430	78.8%	23,606	85,200
	Year 2006	**22,563**	**21,503**	**1,060**	**231**	**4.7%**	**1.0%**	**280,052**	**224,423**	**80.1%**	**98,139**	**86,600**
	Jan-Mar 07	5,427	5,179	248	81	4.6%	1.5%	72,362	56,063	77.5%	23,299	85,100
	Apr-Jun 07	5,879	5,412	467	317	7.9%	5.4%	68,632	57,402	83.6%	25,301	85,500
	Jul-Sep 07	5,946	5,627	319	175	5.4%	2.9%	69,636	58,401	83.9%	25,448	85,800
Continental	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
	Oct-Dec 06	3,157	3,137	20	-26	0.6%	-0.8%	43,903	35,036	79.8%	16,603	
	Year 2006	**13,128**	**12,660**	**468**	**343**	**3.6%**	**2.6%**	**178,500**	**144,060**	**80.7%**	**67,119**	**44,000**
	Jan-Mar 07	3,179	3,115	64	22	2.0%	0.7%	43,853	34,519	78.7%	16,176	
	Apr-Jun 07	3,710	3,447	263	228	7.1%	6.1%	47,622	39,626	83.2%	18,120	45,000
	Jul-Sep 07	3,820	3,540	280	241	7.3%	6.3%	48,836	40,912	83.8%	17,901	
Delta	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
	Year 2006	**17,171**	**17,113**	**58**	**-6,203**	**0.3%**	**-36.1%**	**238,168**	**186,892**	**78.5%**	**106,649**	**51,300**
	Jan-Mar 07	4,144	3,989	155	-130	3.7%	-3.1%	56,774	43,794	77.1%	25,325	52,260
	Apr-Jun 07***	5,003	4,513	490	1,592	nm	nm	61,358	50,818	82.8%	28,305	55,542
	Jul-Sep 07	5,227	4,774	453	220	8.7%	4.2%	65,889	54,774	83.1%	28,987	55,022
Northwest	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
	Oct-Dec 06	2,980	2,886	94	-267	3.2%	-9.0%	37,386	30,564	81.8%	16,600	30,484
	Year 2006	**12,568**	**11,828**	**740**	**-2,835**	**5.9%**	**-22.6%**	**149,575**	**125,596**	**84.0%**	**67,600**	**30,484**
	Jan-Mar 07	2,873	2,672	201	-292	7.0%	-10.2%	36,845	29,964	81.3%	15,600	30,008
	Apr-Jun 07**	3,181	2,824	357	2,149	nm	nm	38,070	32,495	85.9%	17,400	29,589
	Jul-Sep 07	3,378	2,919	459	244	13.6%	7.2%	38,445	33,222	86.4%	17,300	29,579
Southwest	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
	Oct-Dec 06	2,276	2,102	174	57	7.6%	2.5%	38,486	27,036	70.2%	21,057	32,664
	Year 2006	**9,086**	**8,152**	**934**	**499**	**10.3%**	**5.5%**	**149,123**	**108,936**	**73.1%**	**96,277**	**32,664**
	Jan-Mar 07	2,198	2,114	84	93	3.8%	4.2%	38,105	25,924	68.0%	19,960	33,195
	Apr-Jun 07	2,583	2,255	328	278	12.7%	10.8%	40,204	30,606	76.1%	23,442	33,261
	Jul-Sep 07	2,588	2,337	251	162	9.7%	6.3%	41,385	31,680	76.5%	23,533	33,787
United	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	
	Oct-Dec 06	4,586	4,563	23	-61	0.5%	-1.3%	63,226	50,324	79.6%	16,704	51,700
	Year 2006	**19,340**	**18,893**	**447**	**22,876**	**2.3%**	**118.3%**	**255,613**	**208,769**	**81.7%**	**69,325**	**53,000**
	Jan-Mar 07	4,373	4,465	-92	-152	-2.1%	-3.5%	61,900	49,415	79.8%	16,350	51,500
	Apr-Jun 07	5,213	4,676	537	274	10.3%	5.3%	64,451	55,049	85.4%	18,190	51,400
	Jul-Sep 07	5,527	4,871	656	334	11.9%	6.0%	65,547	55,089	84.0%	17,804	51,800
US Airways Group												
	Year 2006	**11,557**	**10,999**	**558**	**304**	**4.8%**	**2.6%**	**123,889**	**97,667**	**78.8%**	**57,345**	**32,459**
	Jan-Mar 07	2,732	2,616	116	66	4.2%	2.4%	35,411	27,039	76.4%	19,935	36,000
	Apr-Jun 07	3,155	2,866	289	263	9.2%	8.3%	37,144	30,631	82.5%	22,232	35,485
	Jul-Sep 07	3,036	2,834	202	177	6.7%	5.8%	31,653	26,385	83.4%	14,965	34,321
JetBlue	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
	Oct-Dec 06	633	569	64	17	10.1%	2.7%	11,712	9,331	79.7%	4,932	9,265
	Year 2006	**2,363**	**2,236**	**127**	**-1**	**5.4%**	**0.0%**	**46,016**	**37,522**	**81.6%**	**18,565**	**9,265**
	Jan-Mar 07	608	621	-13	-22	-2.1%	-3.6%	11,861	9,562	80.6%	5,091	9,260
	Apr-Jun 07	730	657	73	21	10.0%	2.9%	12,981	10,840	83.5%	5,587	9,421
	Jul-Sep 07	765	686	79	23	10.3%	3.0%	13,446	11,020	82.0%	5,528	9,301

Notes: ** = April to May Predecessor Company, June Successor Company; ***= April Predecessor Company, May to June Successor Company - During Q2, Delta and United were emerging from Chapter 11

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

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
Air France/	Apr-Jun 05	6,257	5,982	275	135	4.4%	2.2%	57,936	46,041	79.5%	17,948	101,886
KLM Group	Jul-Sep 05	6,790	6,154	636	864	9.4%	12.7%	60,472	50,961	84.2%	18,705	
YE 31/03	Oct-Dec 05	6,430	6,205	225	91	3.5%	1.4%	58,266	46,644	80.0%	17,120	102,291
	Year 2005/06	**25,901**	**24,771**	**1,136**	**1108**	**4.4%**	**4.3%**	**234,669**	**189,253**	**80.6%**	**70,020**	**102,422**
	Apr-Jun 06	7,282	6,766	516	306	7.1%	4.2%	60,839	49,596	81.5%	19,049	
	Jul-Sep 06	7,779	7,058	721	475	9.3%	6.1%	63,616	53,611	84.2%	19,600	
	Oct-Dec 06	7,593	7,260	333	302	4.4%	4.0%	60,999	48,663	79.8%	17,829	
	Year 2006/07	**30,773**	**29,129**	**1,644**	**1183**	**5.3%**	**3.8%**	**245,066**	**199,510**	**81.4%**	**73,484**	**103,050**
	Apr-Jun 07	8,011	7,486	724	566	9.0%	7.1%	63,376	51,567	81.4%	19,325	103,978
BA	Jan-Mar 06	3,692	3,530	162	144	4.4%	3.9%	36,657	26,780	73.1%	8,160	45,171
YE 31/03	**Year 2005/06**	**14,585**	**13,352**	**1,233**	**829**	**8.5%**	**5.7%**	**144,194**	**109,713**	**76.1%**	**35,634**	**47,012**
	Apr-Jun 06	4,208	3,825	383	280	9.1%	6.7%	38,222	29,909	78.3%	9,569	45,100
	Jul-Sep 06	4,331	4,080	251	315	5.8%	7.3%	38,727	30,872	79.7%	9,935	45,058
	Oct-Dec 06	4,051	3,798	253	210	6.2%	5.2%	36,563	27,073	74.0%	7,878	42,197
	Jan-Mar 07	3,792	3,731	61	-140	1.6%	-3.7%	36,405	26,003	71.4%	7,269	42,073
	Year 2006/07	**16,149**	**15,004**	**1,145**	**578**	**7.1%**	**3.6%**	**148,321**	**112,851**	**76.1%**	**33,068**	**43,501**
	Apr-Jun 07	4,395	3,868	527	539	12.0%	12.3%	37,514	28,836	76.9%	8,648	
	Jul-Sep 07	4,729		611	458	12.9%	9.7%	38,191	30,500	79.9%	9,206	42,024
Iberia	**Year 2005**	**5,894**	**5,426**	**468**	**490**	**7.9%**	**8.3%**	**63,628**	**49,060**	**77.1%**	**27,675**	**24,160**
YE 31/12	Jan-Mar 06	1,457	1,536	-79	-54	-5.4%	-3.7%	15,689	11,876	75.7%	6,300	23,772
	Apr-Jun 06	1,816	1,753	63	44	3.5%	2.4%	16,809	13,420	79.8%	7,461	24,109
	Jul-Sep 06	1,825	1,700	125	96	6.8%	5.3%	16,846	14,065	83.5%	7,354	22,721
	Oct-Dec 06	1,811	1,750	61	-12	3.4%	-0.7%	16,458	13,132	79.8%	6,682	
	Year 2006	**6,545**	**6,391**	**154**	**72**	**2.4%**	**1.1%**	**65,802**	**52,493**	**79.8%**	**27,799**	**23,901**
	Jan-Mar 07	1,745	1,734	16	16	0.9%	0.9%	16,104	12,798	79.5%	6,318	22,661
	Apr-Jun 07	1,829	1,752	75	83	4.1%	4.5%	16,458	13,307	80.9%	6,863	22,324
	Jul-Sep 07	2,080	1,882	198	211	9.5%	10.1%	17,119	14,653	85.6%	7,216	22,803
Lufthansa	**Year 2005**	**22,371**	**21,656**	**715**	**561**	**3.2%**	**2.5%**	**144,182**	**108,185**	**75.0%**	**51,260**	**90,811**
YE 31/12	Jan-Mar 06	5,369	5,460	-91	-118	-1.7%	-2.2%	33,494	24,044	71.8%	11,442	
	Apr-Jun 06	6,529	6,203	326	142	5.0%	2.2%	37,797	28,603	75.7%	14,106	
	Jul-Sep 06	6,765	6,188	577	461	8.5%	6.8%	39,225	30,627	78.1%	14,781	
	Year 2006	**24,979**	**23,913**	**1,066**	**1,014**	**4.3%**	**4.1%**	**146,720**	**110,330**	**75.2%**	**53,432**	**93,541**
	Jan-Mar 07	6,258	6,184	74	593	1.2%	9.5%	35,028	26,109	74.5%	12,329	95,696
	Apr-Jun 07	7,267	6,506	761	663	10.5%	9.1%	39,573	30,544	77.2%	14,629	97,067
	Jul-Sep 07 *	8,960	8,004	956	843	10.7%	9.4%	48,662	39,112	80.4%	18,836	
SAS	**Year 2005**	**4,877**	**4,796**	**81**	**-6**	**1.7%**	**-0.1%**	**38,454**	**26,487**	**68.9%**	**23,799**	**32,363**
YE 31/12	Jan-Mar 06	1,078	1,064	-150	-137	-13.9%	-12.7%	12,275	8,179	66.6%	8,532	31,528
	Apr-Jun 06	2,439	2,319	120	75	4.9%	3.1%	14,005	10,325	74.0%	10,325	32,622
	Jul-Sep 06	2,476	2,318	158	83	6.4%	3.4%	14,086	10,745	76.3%	10,141	32,772
	Oct-Dec 06	2,215	2,121	94	679	4.2%	30.7%	13,405	9,162	68.4%	9,611	25,534
	Year 2006	**5,270**	**5,010**	**260**	**169**	**4.9%**	**3.2%**	**36,971**	**27,506**	**74.4%**	**25,100**	**31,965**
	Jan-Mar 07	1,978	2,025	-47	-7	-2.4%	-0.4%	12,844	8,543	66.5%	9,088	26,136
	Apr-Jun 07	2,383	2,247	136	89	5.7%	3.7%	15,091	10,915	72.3%	11,045	26,916
	Jul-Sep 07	2,612	2,518	94	109	3.6%	4.2%	15,352	11,890	77.4%	11,031	27,447
Ryanair	Jul-Sep 05	652	409	244	208	37.4%	31.9%				9,500	2,987
YE 31/03	Oct-Dec 05	439	381	58	44	13.2%	10.0%			83.0%	8,600	2,963
	Year 2005/06	**2,096**	**1,639**	**457**	**380**	**21.8%**	**18.1%**	**39,070**	**30,302**	**83.0%**	**34,768**	**3,063**
	Apr-Jun 06	711	539	172	146	24.2%	20.5%				10,700	
	Jul-Sep 06	864	553	313	268	36.2%	31.0%				11,481	3,881
	Oct-Dec 06	651	575	76	63	11.7%	9.7%			82.0%	10,300	4,209
	Year 2006/07	**2,887**	**2,278**	**609**	**518**	**21.1%**	**17.9%**	**48,924**	**40,118**	**82.0%**	**42,500**	
	Apr-Jun 07	934	722	212	187	22.7%	20.0%			82.0%	12,600	
easyJet	Oct-Mar 05	1,039	1,116	-77	-41	-7.4%	-3.9%	14,526	12,150	83.8%	13,500	
YE 30/09	**Year 2004/05**	**2,478**	**2,356**	**122**	**109**	**4.9%**	**4.4%**	**32,141**	**27,448**	**85.2%**	**29,600**	**4,152**
	Oct-Mar 06	1,095	1,177	-82	-50	-7.5%	-4.6%	16,672	13,642	81.8%	14,900	
	Year 2005/06	**2,917**	**2,705**	**212**	**170**	**7.3%**	**5.8%**	**37,088**	**31,621**	**84.8%**	**33,000**	**4,859**
	Oct-Mar 07	1,411	1,333	-47	-25	-3.3%	-1.8%	19,108	15,790	81.2%	16,400	

Note: * Lufthansa Group including SWISS

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

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
ANA												
YE 31/03	**Year 2003/04**	**11,529**	**11,204**	**325**	**234**	**2.8%**	**2.0%**	**87,772**	**55,807**	**63.6%**	**44,800**	**28,870**
	Year 2004/05	**12,024**	**11,301**	**723**	**251**	**6.0%**	**2.1%**	**85,838**	**55,807**	**65.0%**	**48,860**	**29,098**
	Year 2005/06	**12,040**	**11,259**	**781**	**235**	**6.5%**	**2.0%**	**86,933**	**58,949**	**67.8%**	**49,920**	**30,322**
	Year 2006/07	**12,763**	**11,973**	**790**	**280**	**6.2%**	**2.2%**	**85,728**	**58,456**	**68.2%**	**49,500**	**32,460**
Cathay Pacific	**Year 2004**	**5,024**	**4,350**	**674**	**581**	**13.4%**	**11.6%**	**74,062**	**57,283**	**77.3%**	**13,664**	**15,054**
YE 31/12	Jan-Jun 05	3,074	2,799	275	225	8.9%	7.3%	39,535	30,877	78.1%	7,333	15,400
	Year 2005	**6,548**	**6,015**	**533**	**424**	**8.1%**	**6.5%**	**82,766**	**65,110**	**78.7%**	**15,440**	**15,447**
	Jan-Jun 06	3,473	3,201	272	225	7.8%	6.5%	43,814	34,657	79.1%	8,144	
	Year 2006	**7,824**	**7,274**	**550**	**526**	**7.0%**	**6.7%**	**89,117**	**71,171**	**79.9%**	**16,730**	
	Jan-Jun 07	4,440	4,031	409	341	9.2%	7.7%	49,836	38,938	79.6%	8,474	19,207
JAL												
YE 31/03	**Year 2003/04**	**18,398**	**19,042**	**-644**	**-844**	**-3.5%**	**-4.6%**	**145,900**	**93,847**	**64.3%**	**58,241**	**21,197**
	Year 2004/05	**19,905**	**19,381**	**524**	**281**	**2.6%**	**1.4%**	**151,902**	**102,354**	**67.4%**	**59,448**	**53,962**
	Year 2005/06	**19,346**	**19,582**	**-236**	**-416**	**-1.2%**	**-2.2%**	**148,591**	**100,345**	**67.5%**	**58,040**	**53,010**
Korean Air												
YE 31/12	**Year 2003**	**5,172**	**4,911**	**261**	**-202**	**5.0%**	**-3.9%**	**59,074**	**40,507**	**68.6%**	**21,811**	**15,352**
	Year 2004	**6,332**	**5,994**	**338**	**414**	**5.3%**	**6.5%**	**64,533**	**45,879**	**71.1%**	**21,280**	**14,994**
	Year 2005	**7,439**	**7,016**	**423**	**198**	**5.7%**	**2.7%**	**66,658**	**49,046**	**71.4%**	**21,710**	**17,573**
	Year 2006	**8,498**	**7,975**	**523**	**363**	**6.2%**	**4.3%**	**71,895**	**52,178**	**72.6%**	**22,140**	**16,623**
Malaysian												
YE 31/03	**Year 2003/04**	**3,061**	**3,012**	**49**	**86**	**1.6%**	**2.8%**	**55,692**	**37,659**	**67.6%**	**15,375**	**20,789**
	Year 2004/05	**3,141**	**3,555**	**-414**	**-421**	**-13.2%**	**-13.4%**	**64,115**	**44,226**	**69.0%**	**17,536**	**22,513**
	Year 2005/06	**3,602**	**3,685**	**-83**	**-37**	**-2.3%**	**-1.0%**	**65,099**	**46,122**	**70.8%**	**17,910**	**20,324**
Qantas	**Year 2003/04**	**7,838**	**7,079**	**759**	**448**	**9.7%**	**5.7%**	**104,200**	**81,276**	**78.0%**	**30,076**	**33,862**
YE 30/06	Jul-Dec 04	5,017	4,493	524	358	10.4%	7.1%	57,402	43,907	76.5%	16,548	35,310
	Year 2004/05	**9,524**	**8,679**	**845**	**575**	**8.9%**	**6.0%**	**114,003**	**86,986**	**76.3%**	**32,660**	**35,520**
	Jul-Dec 05	4,999	4,626	373	258	7.5%	5.2%	59,074	45,794	77.5%	17,260	35,158
	Year 2005/06	**10,186**	**8,711**	**1,475**	**542**	**14.5%**	**5.3%**	**118,070**	**90,899**	**77.0%**	**34,080**	**34,832**
	Jul-Dec 06	6,099	5,588	511	283	8.4%	4.6%	61,272	49,160	80.2%	18,538	33,725
	Year 2006/07	**11,975**	**11,106**	**869**	**568**	**7.3%**	**4.7%**	**112,119**	**97,622**	**80.0%**	**36,450**	**34,267**
Singapore												
YE 31/03	**Year 2003/04**	**5,732**	**5,332**	**400**	**525**	**7.0%**	**9.2%**	**88,253**	**64,685**	**73.3%**	**13,278**	**14,010**
	Year 2004/05	**7,276**	**6,455**	**821**	**841**	**11.3%**	**11.6%**	**104,662**	**77,594**	**74.1%**	**15,944**	**13,572**
	Year 2005/06	**6,201**	**5,809**	**392**	**449**	**6.3%**	**7.2%**	**109,484**	**82,742**	**75.6%**	**17,000**	**13,729**
	Year 2006/07	**9,555**	**8,688**	**866**	**1,403**	**9.1%**	**14.7%**	**112,544**	**89,149**	**79.2%**	**18,346**	**13,847**
Air China												
YE 31/03	**Year 2004**	**4,050**	**3,508**	**542**	**288**	**13.4%**	**7.1%**	**64,894**	**46,644**	**71.9%**	**24,500**	**29,133**
	Year 2005	**4,681**	**4,232**	**449**	**294**	**9.6%**	**6.3%**	**70,670**	**52,453**	**74.2%**	**27,690**	**18,447**
	Year 2006	**5,647**	**5,331**	**316**	**338**	**5.6%**	**6.0%**	**79,383**	**60,276**	**75.9%**	**31,490**	**18,872**
China Southern												
YE 31/03	**Year 2004**	**2,897**	**2,787**	**110**	**19**	**3.8%**	**0.7%**	**53,769**	**37,196**	**69.2%**	**28,210**	**18,221**
	Year 2005	**4,682**	**4,842**	**-160**	**-226**	**-3.4%**	**-4.8%**	**88,361**	**61,923**	**70.1%**	**44,120**	**34,417**
	Year 2006	**5,808**	**5,769**	**39**	**26**	**0.7%**	**0.4%**	**97,044**	**69,575**	**71.7%**	**49,200**	**45,000**
China Eastern												
YE 31/03	**Year 2004**	**2,584**	**2,524**	**60**	**39**	**2.3%**	**1.5%**	**41,599**	**27,581**	**66.3%**	**17,710**	**20,817**
	Year 2005	**3,356**	**3,372**	**-16**	**-57**	**-0.5%**	**-1.7%**	**52,428**	**36,381**	**69.4%**	**24,290**	**29,746**
	Year 2006	**3,825**	**4,201**	**-376**	**-416**	**-9.8%**	**-10.9%**	**70,428**	**50,243**	**71.3%**	**35,020**	**35,000**
Air Asia												
YE 30/06	**Year 2005**	**152**	**122**	**30**	**25**	**19.7%**	**16.4%**	**6,525**	**4,881**	**74.8%**	**4,410**	**2,016**
	Year 2006	**230**	**173**	**57**	**34**	**24.8%**	**14.8%**	**8,646**	**6,702**	**77.5%**	**5,720**	**2,224**

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

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 %
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
2006	329.9	226.6	68.7	230.5	188.0	81.5	182.7	147.5	80.7	588.2	478.4	81.3	874.6	677.3	77.4
Sep-07	30.4	22.7	74.7	22.2	18.0	81.3	15.3	13.1	85.7	52.4	43.6	83.1	79.0	63.6	80.5
Ann. change	4.3%	5.3%	0.7	5.5%	4.3%	-1.0	-0.1%	1.5%	1.3	3.9%	4.1%	0.2	4.6%	4.9%	0.2
Jan-Sep 07	261.6	183.2	70.0	184.1	150.2	81.6	137.7	114.0	82.8	457.9	377.1	82.4	687.2	540.0	78.6
Ann. change	5.0%	5.6%	0.4	6.4%	7.3%	-0.8	0.8%	3.5%	2.1	3.8%	4.6%	0.6	4.7%	5.4%	0.6

Source: AEA

NINE LARGEST US PASSENGER AIRLINES' 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 %
2005 Q1	227.9	170.0	74.6	38.2	29.4	77.0	26.5	21.6	81.5	26.9	19.9	73.9	91.6	70.9	77.4
Q2	237.5	188.8	79.5	45.6	39.1	85.6	27.6	23.2	84.1	25.4	17.9	70.6	98.6	80.2	81.3
Q3	239.1	192.4	80.4	49.5	42.2	85.3	28.9	24.2	83.7	25.0	18.8	75.2	103.4	85.2	82.4
Q4	225.1	172.2	76.4	41.9	33.2	79.2	27.4	22.3	81.4	24.2	17.2	71.1	93.5	72.7	77.8
2005	**929.6**	**723.4**	**77.8**	**175.2**	**143.9**	**82.1**	**110.4**	**91.3**	**82.7**	**101.5**	**73.8**	**72.7**	**387.1**	**309.0**	**79.8**
2006 Q1	219.2	169.3	77.2	39.6	29.7	75.0	26.1	21.7	83.2	28.2	21.1	74.8	93.9	72.5	77.2
Q2	228.1	188.3	82.6	49.7	42.1	84.7	28.2	23.9	84.7	26.3	20.4	77.6	104.2	86.4	82.9
Q3	232.2	187.9	80.9	54.0	45.3	83.9	28.7	24.4	85.0	26.3	20.4	77.6	109.0	90.1	82.7
Q4	223.2	174.3	78.1	46.0	36.1	78.5	27.8	22.8	81.9	25.8	19.2	74.2	99.6	78.1	78.4
2006	**902.7**	**719.7**	**79.7**	**189.2**	**153.2**	**81.0**	**110.8**	**92.8**	**83.7**	**106.6**	**81.1**	**75.7**	**406.7**	**327.1**	**80.4**

Note: Legacy airlines are American, Continental, Delta, Northwest, United and USAirways. Statistics also include Alaska, America West and Southwest.

JET ORDERS

	Date	Buyer	Order	Delivery	Other information/engines
Boeing	05 Nov	LAN A/L	26 x 787-8/9, 2 x 777F		
	08 Nov	Cathay Pacific	10 x 787-800F, 777-300ER		
	11 Nov	Emirates	12 x 777-300ER		
		Qatar A/W	30 x 787, 5 x 777F		
	12 Nov	LCAL	6 x 787-800		
		Royal Jordanian	2 x 787		
	13 Nov	transavia.com	7 x 737-800		
Airbus	26 Oct	ILFC	4 x A350XWB		addition to existing order
	11 Nov	Emirates	50 x A350XWB-900, 20 x A350XWB-1000, 11 x A380		
	12 Nov	Saudia A/L	22 x A320		MoU
		Air Arabia	34 x A320		plus 15 options
		DAE Capital	70 x A320, 30 x A350XWB		MoU
	13 Nov	Yemenia	10 x A350XWB		
		Oman Air	3 x A330-300, 2 x A330-200		
		Airblue	8 x A320		
	14 Nov	Nile Air	9 x A321		MoU
Embraer	15 Nov	NAS Air	5 x E190		
		Virgin Nigeria	7 x E170, 3 x E190		
Bombardier	14 Nov	Adria A/W	2 x CRJ900, 1 x CRJ1000		

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

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