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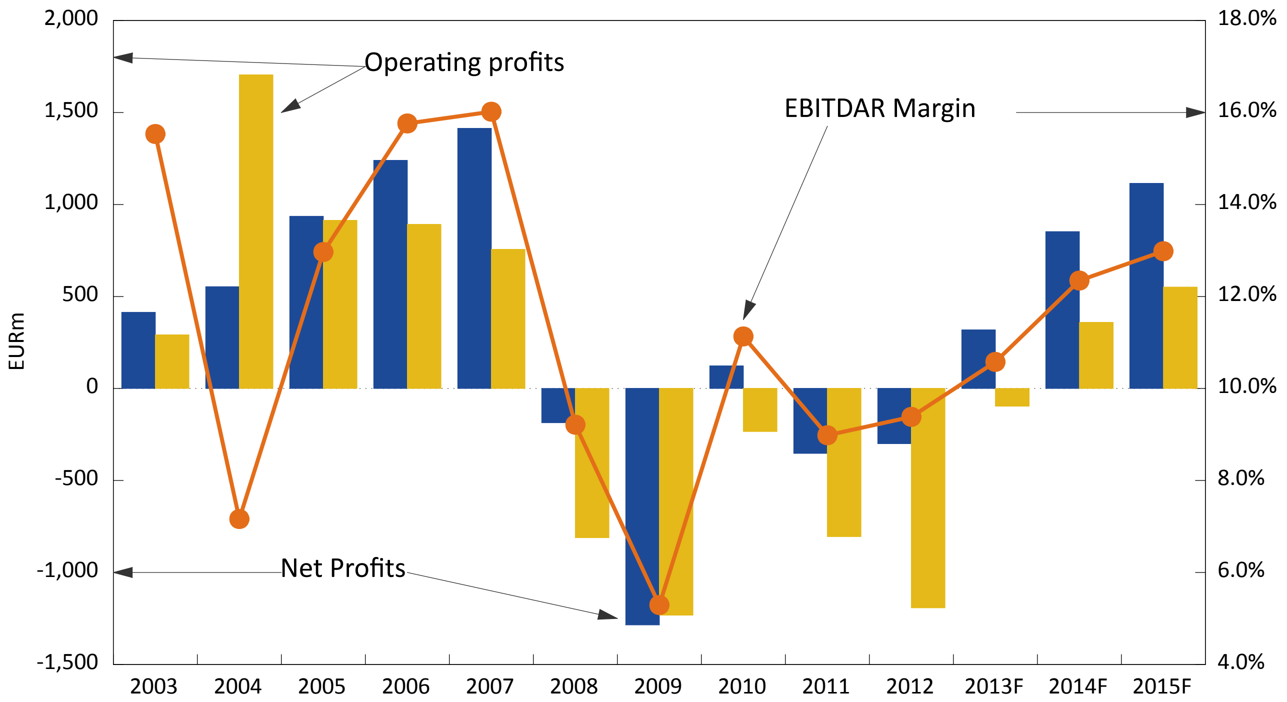
Air France-KLM – Transforming?

THE largest of the three European network carriers, Air France-KLM, is in the process of a restructuring exercise designed to return it to a reasonable level of profitability by 2015 (alright, so are the other two European majors). At the tail end of last year it revealed its strategic plan under the imaginative soubriquet of "Transformation 2015" with the aim of cutting debt by €2bn, manageable non-fuel unit costs by 15%; renegotiating all staff contracts, cutting staffing levels by 8% (9% at Air France and 6% at KLM), and importantly trying to return the short-medium haul operations to at least break even from losses of around €700m.

At the publication of the group's first half results in September, the group's new CEO Alexandre de Juniac affirmed that the plan was on track. At least, for the first time since 2008, the group was able to produce an operating profit in the June quarter (albeit a small €79m) up from a restated loss in the same period the year before of a similar amount – even after implementing the ludicrous IAS19 accounting policy on pensions. Revenues, however, only grew by 1% year on year, somewhat below the group's targets; the management admitted that the revenue environment, particularly in Europe, was weaker than it had expected at this stage of the plan. As a result the turnaround in the medium haul European network and in Cargo was taking far longer than hoped.

This issue includes

Air France-KLM Results



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Air France-KLM Fleet

	Aircraft Type	In service	Change	On Order	Options	In Storage
Mainline						
Air France	747	7	-1			
	777	62		3	10	
	A330	15			2	
	A340	13				
	A350			25		
	A380	9	+1	3	1	
	A320 Family	135	-9	4	16	1
KLM	747	22				
	777	23	+2	3	2	
	787			23		
	A330	16	+2		18	
	MD-11	5	-5			1
	737	45	+1	2	8	
Transavia	737	35	+1	2	3	
Transavia France	737	12	+3			
Cargo						
Air France	747F	3				
	777F	2				
Martinair	747F	4	-2			2
	MD-11F	6				
Regional						
Hop!	ATR 42/72	23				
	CRJ	39		1	2	1
	E170/190	25			9	
	ERJ	20	-5			1
KLM Cityhopper	E170/190	22		6	9	
	F100		-1			1
	F70	26				
Cityjet	RJ	19				2
Total		**588**	**-13**	**72**	**80**	**9**

Source: Ascend. Change compared with end June 2012

For the period of the restructuring, the group has abandoned its old idea of growing in line with the market. Passenger capacity grew by only 2.6% year on year in the quarter, mostly on long haul operations while traffic grew by 3.2% giving a half point increase in load factors to 83.2%. Cargo remains in the doldrums with a 6% drop in traffic against capacity down by 4% and cargo revenues down by a further 7% year on year. Unit revenues actually fell in the quarter by 1.9% year on year or 1.3% on a constant currency basis while unit costs fell by 5% year on year, helped by a 8% decline in the fuel price and a modest 0.6% fall in staffing costs.

The overall group net result rolled out at a modest loss of €163m down from losses of €897m in the second quarter 2012 while losses for the first half of the year totalled €793m compared with €1.3bn the year before. Definitely an improvement.

The original vision of the transformation plan saw 2012 as being the year for laying the foundations for the group's turnaround; implementing immediate cost reduction measures, imposing strict capacity discipline and reduced invest-

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ment, renegotiation of all collective labour agreements and the establishment of the structural operational changes.

2013 equally was meant to be the year for the roll out of the measures when the group could start to benefit from the cost reductions, the restructured short haul operations, a hoped for recovery in cargo and "initiatives to reconquer the customer base".

2014 is meant to be the year when the full impact would be felt allowing for a recovery to 6-8% operating margins by 2015.

It now seems that the group accepts that more needs be done. Firstly, medium term economic forecasts have fallen – although there is recovery visible in the US, and possibly the UK; Continental Europe remains stubbornly sluggish, and prospects for the BRICs have tended to be downgraded. Secondly, the weakness in Europe and France has not helped the plans to re-invent the short haul offering, while the weakness in the air freight business is hampering recovery there.

Staff cuts

By the end of June the group had reduced total employment levels by 5,600 FTE positions or 5.3% compared with June 2011 -through natural wastage, voluntary early retirement and redundancies. Last week Air France told its Central Works Council that it would need to find another 2,800 jobs to get rid of. The unions so far seem to have accepted this with equanimity, although there have been suggestions that it may prove difficult to achieve these cuts without compulsion. The target remains to reduce total staff costs by over €400m by the end of 2014.

Short haul reinvention

One of the dilemmas for a network carrier is how to justify unprofitable short haul feed to long haul operations, or unprofitable short haul operations that do not touch its hub and have to compete with low cost and ultra low cost operators. For Air France, admitting that it had lost some €700m on medium haul operations in 2011, while insisting, perversely, that non-hub European flying was vital for market presence, this was particularly pertinent.

For mainline operations the group has reduced its short haul AF A320 fleet by 16 units over the past year to 135, while KLM has "densified" its 737 fleet (ie, added more seats). At the beginning of this year Air France restructured its domestic regional feed (previously run under BritAir, Régional, and newly-consolidated Airlinair) into a single new "brand" called Hop! (obviously the exclamation mark was felt to be important, and the brand name may work for francophones). It excluded CityJet, which it put up for sale (but has seemingly yet to come to an agreement over the amount of cash it needs to pay any buyer to take it of its hands). It has not done much to the regional fleet, except to get rid of 5 ERJs, but has the aim of reducing ACMI costs by some 15%.

It had originally developed the idea of creating quasi "low cost" operations from regional French bases as add-ons to its domestic shuttle services to Orly and as a way to cut costs by relocating crews away from Paris to the provinces for local overnighting, and increasing utilisation – but, with limited real success (for which read significant failure?). It seems to have scaled back its expectations and operations.

Transavia France (originally a "leisure" brand to compete with LCCs) has been handed a few more aircraft, and it appears that the group is aiming to copy Lufthansa's strategy (of using germanwings for non-hub intra-Europe flying) by giving Transavia various routes from Orly. Meanwhile, on cargo operations the group continues to reduce its all-freight fleet (mostly from Martinair) to concentrate more on belly hold capacity

While it has all this on its plate, the group has been faced with the issue of whether to invest even more in Alitalia (it currently owns 25%, acquired on the "privatisation" of the bankrupt state owned carrier in 2008 – see *Aviation Strategy*, March 2008). The now privately-owned Italian carrier is once again in need of cash, and wants to call on shareholders by the end of the year. The Italian government now seems willing to allow Air France-KLM to take a majority stake – but this perennial loss-maker is the last thing the AF-KL board needs at the moment. The prospect of the full consolidation, even to protect the air-bridge from Italy into CDG and its southern flank from rivals Lufthansa and IAG, must gall.

Conclusions?

Turning round a legacy carrier is a difficult task – and Air France-KLM seems now to admit that it has a lot more to do to meet its 2015 targets. It has a lot of strengths: a prime base at Paris Roissy – the second major European O&D destination after London; the longest established cross-border merged group in the current era; a strong North Atlantic joint venture with Delta (being extended no doubt with the addition of Virgin Atlantic); superior links into the higher growth regions, particularly into China with its alliance links to four carriers through SkyTeam, joint ventures with both China Southern and China Eastern, and code-shares with Xiamen. It has even swallowed gallic pride to link up in a code share agreement with Etihad. It is doing its best to return to profitability. It may just be a bit further away than planned.

Alitalia – *con passione*

In July Alitalia's new CEO, Gabriele Del Torchio, outlined the Italian flag carrier's new four-year "Industrial Plan". It will focus on three principal businesses: Alitalia, Air One and Alitalia Loyalty (an effective spin-off of its frequent flyer programme). It also has a catchy new mission statement: "Proud to show the best of our country. With Passion."

Alitalia itself will focus domestic and international services at Rome Fiumicino. Beginning at the start of the winter IATA season this year it is realigning the operations at FCO to provide a much better wave system to try to improve the "hub". It aims to add an extra six aircraft to its long haul fleet in the next four years to expand intercontinental services, increase frequencies on existing routes, open new routes and concentrate on areas with "high Italian community presence". But having said it will concentrate on hub operations out of Rome, the company also states that it will be introducing long haul routes from Milan (to Shanghai, Abu Dhabi and Osaka), and from Venice (to Tokyo).

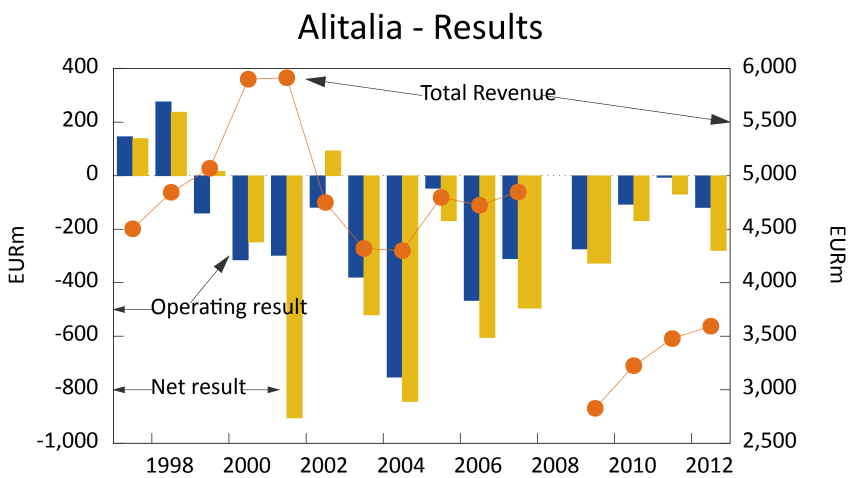
At Milan Linate it will be reducing services on the lucrative Milan-Rome route (it lost its monopoly when easyJet gained access last year) to make room to re-introduce services from Linate to other European destinations, while at Malpensa it will be adding services to medium haul non-European routes.

Air One is being rebranded to "bring it closer to Alitalia" and is being relegated to base operations from Catania, Palermo, Venice and Pisa. The group somehow hopes that this will increase the separation and differentiation between the brands and prevent overlap. Interestingly, the plan suggests an intention to increase international flying from Sicily, where they see "high demand", and from Northern Italy to recover market share lost to other European airports in recent years.

As for Alitalia Loyalty we can only quote verbatim from the company's release: "The main guidelines of the Plan relating to the operation of Alitalia Loyalty include: the push to increase the number of members of the MilleMiglia programme, the development of new ways to redeem miles on flights or other services, the creation of high value partnerships with leading financial and credit institutions, the entrance of the MilleMiglia programme in a coalition of many loyalty programs to increase the opportunities of earning and redeeming Alitalia miles, the development of new forms of communication and marketing towards MilleMiglia members." This probably speaks for itself.

The group at the same time stated that it aimed under this strategy to achieve a positive operating profit in the second half of 2013, annual break-even at the operating level in 2014, a "balanced budget" in 2015 and a profit by 2016. This is predicated on raising €300m in equity from its shareholders by December.

Does all this sound familiar? Between 1999 and 2007 the former majority-state-owned Alitalia lost over €3bn and entered 2008 in dire straits, running out of cash. It went bankrupt at the end of 2008, despite an offer from Air France-KLM, and with the help of the then new Berlusconi government which refused to allow majority foreign ownership of the flag carrier. The Italian government effectively wrote off the bad parts and the new Alitalia emerged as a combination with the former second largest Italian carrier Air One; and Air France-KLM holding 25%. The strategic plan was to concentrate on Rome Fiumicino as the group's intercontinental hub. Since 2009 Alitalia has lost €850m and is again running out of cash.



Note: no financial data for 2008

ANA's expanding business portfolio: Peach, Vanilla, Asian Wings, Pan Am, etc.

All Nippon Airways (ANA) has had a rough year, marred by the 787's long grounding, continued slowdown on China routes, yen depreciation and the associated surge in fuel costs, unexpectedly high losses at AirAsia Japan, and the June decision to dissolve the AirAsia JV. Those negatives led to a ¥5.6bn operating loss at ANA Holdings in the June quarter ($56m; $1.6% of revenues), when rival Japan Airlines (JAL) managed a ¥22bn operating profit ($222m; 7.5% of revenues).

Of course, this is just a blip in an otherwise impressively steady annual profit performance. ANA has posted an annual operating loss only once in the past decade (FY 2009) and achieved a 7% operating margin in each of the past two years, despite the devastating effects of the March 2011 earthquake and nuclear disaster in Fukushima. ANA continues to project a 6.8% operating margin for FY 2013.

While ANA's main focus is on the full-service carrier part of the business and growing its international operations – especially after new slots become available at the Tokyo airports in the summer of 2014 (Haneda) and summer 2015 (Narita) – the most interesting part of its strategy is the decision to diversify into "new growth segments". That means developing multiple airline brands and making strategic investments – in both aviation and non-aviation fields – especially in Asia.

The multi-brand strategy kicked off last year with the launch of the two Japan-based joint venture LCCs: Peach Aviation in March 2012 and AirAsia Japan in August 2012. When the relationship with AirAsia soured, ANA bought its partner's 49% stake for ¥2.45bn ($25m) in June and now plans to rebrand carrier as "Vanilla Air", with a new fleet and new strategies.

Recent months have seen the official kick-off of the "strategic investments" part of the diversification strategy. First, ANA established an investment firm in Singapore to oversee and accelerate those activities in Asia.

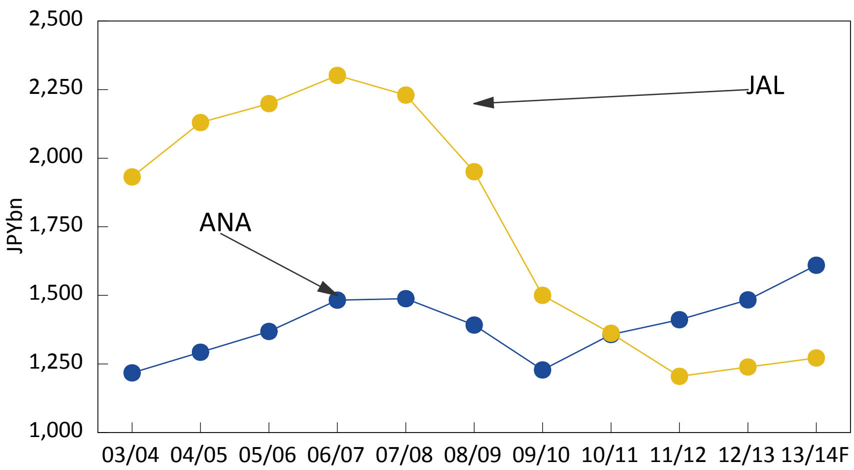
Second, as a major move into the global pilot training business, in July ANA announced a deal to acquire Miami-based Pan Am Holdings and its subsidiary Pan Am International Flight Academy for around ¥13.7bn or $138m (the transaction is expected to close by year-end). ANA plans to expand Pan Am into Asia and views it as a great business opportunity, given Asia's enormous air travel growth potential and hence likely significant demand for the development and training of airline pilots.

Third, in August ANA announced its first airline investment in Asia: a 49% stake, for ¥3bn ($30.3m), in Myanmar carrier Asian Wings. The Yangon-based airline operates only one A321 and three ATR72s on domestic routes but is keen to expand its Airbus fleet. After decades of military rule, Myanmar moved towards democracy in 2011 and is now seeing rapid growth in tourism and an inflow of investment. ANA, which resumed service to Yangon in late 2012 after a 12-year suspension, is now well-positioned to benefit from those trends.

ANA is also planning an MRO business at Okinawa (Naha). Having also developed a cargo hub and a JV logistics business there in recent years, ANA intends to promote more strategic business development that uses Okinawa as a base for expansion into Asia.

Further investments and acquisitions are likely as opportunities arise.

ANA's and JAL's Operating Revenues



ANA has the funds because it raised ¥182bn ($1.8bn) in a secondary share offering in July/August 2012. Also, in April 2013 ANA switched to a holding company structure to make it easier to manage the various airline brands and subsidiaries.

ANA's justification for the strategy is that the new revenue platforms will "increase the likelihood of achieving our medium-term goals" (among other things, a 10% operating margin and 10% ROE).

But it is a somewhat risky strategy, with uncertain profit prospects. Is it wise for an airline to get involved in everything? ANA already has some 57 consolidated subsidiaries and 19 affiliates, spanning passenger and cargo operations, catering, IT services, MRO and suchlike. Globally the trend for many years has been the opposite: shedding non-airline subsidiaries and refocusing on core activities.

Other intriguing questions: What exactly went wrong with AirAsia Japan? If AirAsia Japan did not work, can Vanilla succeed? And does it make sense to keep Peach and Vanilla separate?

Near-term challenges

The Japanese carriers saw the going get tougher in mid-2012, when Japan's GDP growth slowed, a strong yen began to hamper export growth, and Europe's recession and the global economic slowdown were accelerating.

Adding to the woes, Japan-China routes have been affected by China's slowing economic growth and, since September 2012, a flare-up of the longstanding territorial dispute between China and Japan over a tiny group of uninhabited islands known as Senkaku in Japan and Diaoyu in China. Anti-Japan sentiment, violent protests and a boycott of Japanese goods in China have led to a sharp reduction in travel demand between the two countries. China is a huge market that Japanese businesses depend on and one that ANA and JAL had been counting on for expansion.

The effects of the territorial spat have lasted much longer than expected. In April-June, ANA's total passengers on China routes were still more than 20% below year-earlier levels, though business travel demand had recovered.

Although Japan's domestic market is growing for the first time in decades because of all the new LCC activity, it has been at the expense of yields and profitability. ANA's June quarter domestic statistics were illustrative: RPKs up 2.4%, RASK down 5.6%, yield down 3.6% and revenues down 1.3%.

With Europe and Asia stagnating, North America was the only international region in ANA's network that saw traffic growth (in double-digits) in the June quarter. But ANA has seen strong business class demand on medium and long haul routes generally, reflecting route mix changes and the yen's depreciation.

The biggest blow this year has been the surge in fuel costs: up ¥15.7bn ($158m) for ANA in the June quarter, of which ¥9bn was attributed to the weakening of the yen.

As the 787's launch customer and largest operator, ANA was hit the hardest by the grounding, losing an estimated ¥12.5bn ($126m) in revenue between mid-January and the end of May. Of course, ANA will receive compensation from Boeing. Importantly, ANA was able to return to the original route plans and 787 deployment in the July-September peak travel period.

ANA has maintained its full-year forecast of a record ¥110bn ($1.1bn) operating profit, first, because Japan's economy appears to be on a gradual recovery path. Second, the yen's weakening is boosting exports, leading to stronger international business travel demand. Third, ANA expects to achieve another ¥25bn of cost savings this year, as part of its Y100bn ($1bn) four-year cost cutting programme initiated in FY 2011.

Plans for Peach and Vanilla

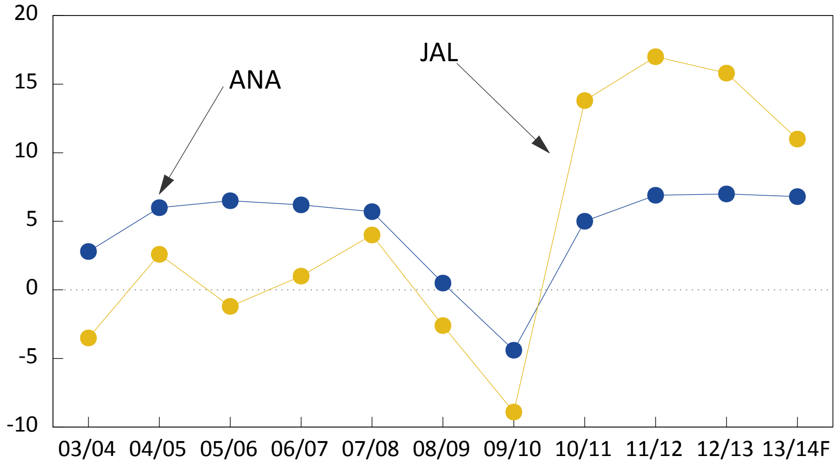
Peach Aviation – ANA's JV with Hong-Kong-based Far Eastern Investment Group and Innovation Network Corporation of Japan – has been much more successful than AirAsia Japan. ANA has a 38.7% stake in the well-funded Kansai (Osaka)-based venture.

In its initial 18 months, Peach has grown its fleet to 10 A320s and its network to eight domestic and four international points (Seoul, Hong Kong, Taipei and Busan). In October it will enter the Kansai-Narita market, where demand has been so strong that a third daily flight has already been announced from January. Peach has just begun building a second hub at Okinawa (Naha), initially linking it with Ishigaki and Taipei.

Peach has made a big effort to differentiate itself. It has a highly branded approach, friendly in-flight service and "cute and cool" aircraft design. It goes for aggressive US LCC-style fare sales, collaborative ventures with various companies and gimmicky marketing campaigns. Its slogan is 'Making the skies more fun and bringing Asia closer together'.

Importantly, Peach is striving to cater for Japanese tastes and preferences. For example, it sells tickets through convenience stores and includes menu items such as "first

ANA's and JAL's Operating Margins



authentic in-flight *"okonomiyaki"* (Japanese pancakes) for passengers to purchase on flights. It has achieved high on-time performance and flight completion rates – also important in the Japanese market.

Peach has benefited from being based at Kansai's T2, which became Japan's first airport terminal dedicated to LCCs when it opened in October 2012. T2 allows 24-hour operations.

As a result, Peach has seen faster than anticipated traffic growth, healthy load factors and relatively modest financial losses. In its first year ended March 31, Peach incurred a ¥900m ($9m) operating loss on revenues of ¥14.3bn ($144m). It is now expected to become profitable in the current fiscal year, which would be a year ahead of schedule.

In contrast, AirAsia Japan lost almost four times as much as Peach on an operating basis in the fiscal year ended March 31 (¥3.5bn or $35m), a period that included the first eight months' operations. In the June quarter, its domestic and international load factors averaged only 55.5% and 52.1%.

AirAsia Japan's growth was slow compared to the other LCCs. At its peak in July-August the airline operated only five A320s, compared to 13 at JAL's LCC venture Jetstar Japan (which launched operations only a month earlier). At its peak AirAsia Japan served five domestic and three overseas points (Seoul, Busan and Taipei).

AirAsia Japan will continue to operate under that brand until the end of October, when all of its A320s will have been returned to AirAsia. It seems likely that the LCC will briefly suspend operations, before being relaunched as Vanilla Air in December.

The JV was hampered by fundamental disagreements about AirAsia Japan's strategy. ANA was concerned about a revenue shortfall, which it blamed on the venture's online ticketing system and AirAsia's poor brand recognition in Japan. AirAsia has blamed the cost structure, misguided route choices and ANA's corporate culture.

Clearly, AirAsia Japan has not been able to achieve a low-enough cost structure. It feels the full brunt of the high costs associated with operating out of Narita – congestion, high landing fees, restricted operating hours, etc. Notably, Jetstar Japan has won some relief by establishing a secondary base at Kansai.

But it is also clear that the AirAsia brand and product offering have not worked in Japan. ANA executives have argued that not enough attention was given to adapting to the Japanese market.

One example is the booking method. AirAsia apparently insisted that the Japan-based airline offered only online ticketing (a key part of the AirAsia business model), but in Japan many people like to book and pay for air tickets through travel agents or convenience stores.

Therefore ANA plans to make Vanilla an LCC that is "tailored to Japan". Among other things, it will have a more user-friendly website, new non-internet sales channels and more promotions.

Vanilla will continue to be based at Narita, but it will focus more on international routes, especially to tourist destinations. This will help capture broader demand and better schedule flights around Narita's night curfew, thus improving aircraft utilisation and reducing unit costs. Vanilla will also operate from Nagoya (Chubu) Airport, which allows 24-hour operations. ANA expects to disclose more detail about the venture in late September.

The success of Peach and the experience gained in working with AirAsia have given ANA confidence that it can succeed with Vanilla. Though fleet plans have not yet been announced, ANA has said that it want to grow Vanilla's fleet much faster than what happened at AirAsia Japan.

Importantly, cost pressures for Narita-based low-cost carriers should ease when the planned terminal dedicated to LCCs opens there by March 2015.

ANA seems determined to make the dual-LCC strategy work. But it will always have the option to merge

Vanilla and Peach – something that was seriously considered but rejected at this stage.

LCCs have already helped revitalise Japan's aviation market. According to the MLIT, domestic passengers have grown in 2013 for the first time in six years. With many more airports planning special facilities for LCCs, and with the government adopting more favourable policies (reductions in domestic fuel taxes, easing of tourist visa requirements, etc.), LCCs look set to eventually become a major force in Japan.

In June the Japanese government introduced a new target of 30m foreign visitors by 2030 (the previous target of 10m will be achieved in 2013). With China's decline, the current focus is on Southeast Asia. The 2020 Olympics in Tokyo will provide an extra boost to tourism and the economy. All of that should ensure policies that help LCCs.

But it will mean intense competition. On its home turf, Vanilla faces Jetstar Japan, which has grown rapidly (though has delayed international entry) and is on track to become profitable.

Among foreign competition, China's Spring Airlines has established a 33%-owned Narita-based LCC unit that is due to start domestic flights with 737-800s in spring 2014. Spring Airlines Japan is the first domestic LCC with no Japanese airline shareholders.

Then there is AirAsia's possible solo return. As its CEO Tony Fernandez explained recently: "We have not given up on the dream of changing air travel in Japan and look forward to returning to the market". However, it may not be for some time, and Fernandez has said that the future carrier would not be based at Narita. In the meantime, AirAsia X has boosted its flights from Kuala Lumpur to Japan (Tokyo and Osaka) and reaffirmed its intention to serve additional cities in Japan within five years.

Big aircraft and Haneda decisions

ANA resumed commercial service with the 787 on June 1 and has now redeployed it on all four international routes operated before the grounding (Haneda-Frankfurt, Narita-San Jose, Haneda-Beijing and Narita-Seattle). Three more Asian routes have been upgraded to the 787 (Haneda-Taipei and Narita to Beijing and Shanghai), with Narita-Singapore following on October 1. Narita-Munich became a 787 operation on September 1. This was part of an expansion drive that also saw doubling of 777-300ER flights on the Narita-Chicago route.

At the end August ANA had received 21 of the 66 787s it has on firm order, of which 36 are 787-8s and 30 are 787-9s. The 787 gradually replaces ANA's 767s and 777-200s.

All eyes are now on two upcoming events of global significance that involve ANA. First, like JAL, ANA is nearing decision on the 777 replacement. It is expected to place an order for up to 30 aircraft, either the A350 or the 777X, by next spring.

The A350 would be a riskier choice as a new aircraft type, but it would be available earlier (from 2017). It remains to be seen if the 787's delivery delays and technical problems will play into ANA's decision. If ANA opts for the A350, it would be a major coup for Airbus, enabling it to break Boeing's near-monopoly in Japan (though ANA does operate A320s).

The other important event will be the Japanese government's October decision on how to allocate 20 new slots in 2014 at Haneda, the airport nearest to downtown Tokyo that business passengers prefer to use. It is likely to be the last major slot distribution at Haneda for years.

Normally new long-haul slots would be divided equally between JAL and ANA, but ANA has mounted an aggressive campaign to secure all 20 of those slots. ANA wants political intervention to rebalance the competitive landscape after the ¥350bn ($3.5bn) government bailout of JAL in 2010 and other favouritism shown to JAL to help it turn around financially.

This subject has been debated for years, but in the last year or so there has been a major shift in the political climate to favour ANA. There is now broad agreement in the ruling LDP circles that the JAL rescue went too far. ANA has seized on that support and the issue has become a mighty battleground.

The problem now is that Haneda has become vital also for JAL's and ANA's foreign airline partners and their global alliances, oneworld and Star. If ANA gets all 20 slots, Star would then have 50% of international flights at Haneda, compared to oneworld's 20% share. So, any attempt to right the wrongs between ANA and JAL could blow into an international conflict.

By Heini Nuutinen
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South African Airways: Eighth turnaround plan

Ever-changing senior management, inefficient operations, rising fuel prices, overcapacity in the South African market, the weak Rand and expected massive losses in 2012/13 are just some of the challenges facing the country's flag carrier.

A struggling SAA is significant for the continent as a whole. SAA remains the largest African airline, with history going back to 1934, accounting for a quarter of all intercontinental capacity offered by African carriers (though this falls to less than 10% once non-African airlines – which provide more than two-thirds of international traffic to/from Africa – are taken into account).

Given that size – and with strong forecast GDP growth across Africa over the next decade (and Boeing ,for example, forecasting African passenger traffic rising by 5.7% p.a. during 2013-32) combining with a continental land transport infrastructure that ranges from average to abysmal – SAA should be the exemplar African airline that other carriers aspire to match.

SAA is a 100% state-owned company reporting to the government's Department of Public Enterprise, with a dual mandate. As Cheryl Carolus, the airline's former chairwoman, put it last year: the SAA Group has not only to be a successful business but also "an enabler for policies and projects, which have been designed to transform the political and socio-economic landscape of our nation and continent".

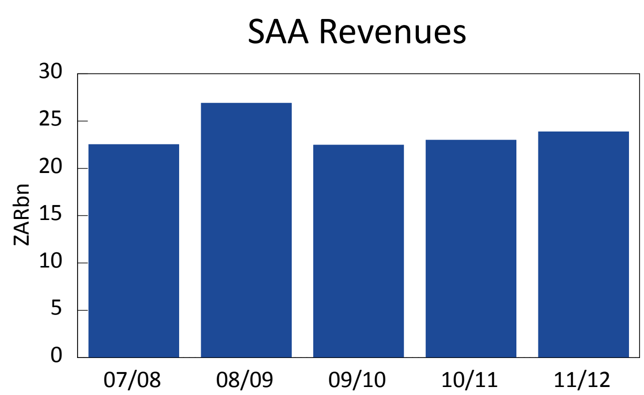
The inevitable result is that government-appointed management is caught between making purely commercial decisions and ones that fit in with (or at least don't offend) government policy. In years when the economy was strong and fuel prices low this contradiction wasn't too problematical, but the last five years has seen the airline's operational and financial position become steadily weaker, and the need for strong commercial management free of government interference is now essential.

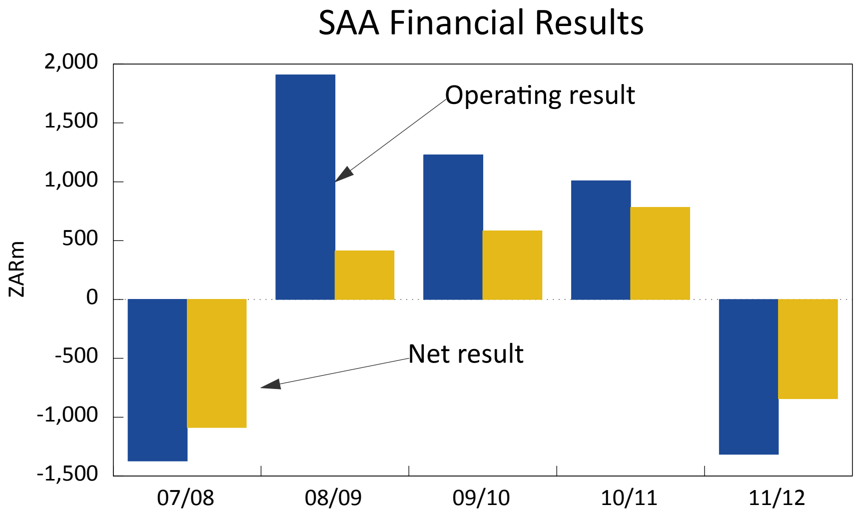
While 2010/11 results were boosted by the 2010 World Cup held in South Africa, once that effect faded away the global recession hit SAA hard. The SAA group only revealed its results for the 2011/12 financial year (ending March 31st) in October last year; while revenue rose 3.8% to R23.9bn ($2.7bn), at the operating level a profit of R1bn in 2010/11 turned into a R1.3bn ($147m) operating loss in 2011/12. The net result similarly went from a R782m profit in 2010/11 to a R843m ($94m) loss in 2011/12. The reasons are multiple – fuel costs rose by 36%, increasing to 33% of operating expenditure compared with 28% in the previous financial year; maintenance costs rose by 32% and "passenger revenue was below target for all sectors as expected demand did not materialise".

But it's more than just one bad year, with a steady decline in airline operations apparent over the last few years. From FY 2007/08 to FY 2011/12 load factor has declined from 76% to 72% (despite capacity falling by 6.2% over the period), yield has remained flat and unit labour costs have risen by 40%.

The financial situation is dire. While analysts estimate the South African government has invested more than $1bn into SAA over the past two decades in order to save the airline from bankruptcy, the group's cash flow became so bad in 2012 that in September that year it received an emergency R5bn ($560m) funding guarantee for the next 24 months from the government. This enabled SAA to continue operating as a going concern and borrow sums (against the government guarantee) to pay for fuel and avoid the real danger of the fleet being grounded. In May this year $167m of this facility was used but it's clearly only a short-term solution to problems, and the guarantee was given under the condition that the airline presented a sustainable turnaround plan.

The underlying problem for SAA





is that it's difficult to create a sustainable plan (let alone execute it) when there is a never-ending procession of senior executives. Chairwoman Cheryl Carolus and 14 board members resigned in September 2012, citing the fact that the airline's relationship with the South African government had become "untenable" after the ministry of public enterprises minister cancelled the airline's annual general meeting and postponed the release of its annual report.

After that, chief executive officer Siza Mzimela left suddenly in October 2012, to be replaced by acting chief executive Vuyisile Kona – who was then suspended by the airline in February 2013 over "certain allegations that have come to the attention of the board, in respect of which the board has a fiduciary duty to investigate," He was fired a month later and it was then the turn of Nico Bezuidenhout – the chief executive of SAA's LCC business unit, called Mango – to become acting CEO. He then faced media allegations – denied by SAA – that he "misrepresented" qualifications on his CV, and in April he was replaced by Monwabisi Kalawe on a five-year contract as (hopefully) a permanent CEO (with Bezuidenhout returning to manage Mango). Kalawe was previously the managing director for the South African operation of food services company Compass, although he has aviation experience as GM of Cape Town airport from 1998 to 2004.

In the midst of that managerial chaos, earlier this year the airline submitted a 20-year turnaround plan (catchily called the "Long Term Turnaround Strategy") to the government, though astonishingly this was the eighth turnaround plan put together by (different) management in the last decade.

That plan attempts to address many problems, perhaps the most urgent of which is the cost base. SAA has previously implemented cost-cutting measures but they simply have not been on a similar scale to those adopted at European or North American carriers.

The most obvious area for cost-cutting is labour; the group has more than 11,000 employees worldwide, but reducing costs here is very troublesome. For example, in August South African Airways Technical (SAAT), the maintenance subsidiary of the group, became embroiled in a dispute with the South African Transport and Allied Workers Union (SATAWU) over a number of issues, including the use of uncertified engineers on aircraft (a claim vehemently refuted by management). The main argument however is over pay: the union wants a 12% increase. In late August the airline agreed a one-year settlement with another union – the Aviation Union of Southern Africa (AUSA) – including one-off payments and an overdue increase from the previous year in a deal that airline says will increase its labour costs by 6.5% year-on-year.

That settlement wasn't acceptable to SATAWU, whose 750 members continued to take industrial action and which led to the airline breaking off from negotiations at the end of August. In September the dispute escalated as the airline took legal action against the union to stop "striking employees from acts of intimidation, assault and vandalising property", and followed this up with contempt of court proceedings after it claimed SATAWU had clearly ignored the earlier court action.

One area where SAA is making some progress is in bringing in fleet renewal. In July SAA received the first two A320s from an outstanding order for 20 of the type, which will replace the 13 737-800s currently in the fleet. 12 of these have been sold to and leased back from UK-based leasing company Pembroke, owned by Standard Chartered bank.

SAA is also looking to order between 25 and 35 widebody aircraft to replace ageing A340s (it retired its last 747-400s in 2010), with a choice likely to be made soon between 787s or A350s as the tender process draws to a conclusion. With new widebody aircraft unlikely to arrive for several years, SAA will is also looking for and will sign deals for the lease of interim aircraft, with former chief executive Nico Bezuidenhout saying that "it is imperative for us to get the Airbus A340-600s phased out as soon as possible".

Replacement aircraft – whether leased or owned – will be used to expand routes into east Asia in particular. SAA has 10 direct routes and 19 codeshares outside the continent, and with 26 routes into other African countries it accounted for an estimated 38% of international traffic to-from South Africa in the 2011/12 financial year.

Aviation across Africa is very much hub-based (Johannesburg, Nairobi, Lagos, Addis Ababa, Lagos etc), and while there is large potential for more point-to-point routes SAA has long wanted to establish hubs in east and west Africa (see *Aviation Strategy,* July/August 2004) to complement the airline's Johannesburg base, but the airline has never been able to realise its ambitions. Now South African Public Enterprise Minister Malusi Gigaba wants the airline to set up a joint venture airline in Ghana, which will allow more east-west routes – though where the cash to finance that will come from remains to be seen.

SAA also has ambitious plans to position Johannesburg as a hub for passengers travelling between South America and parts of Asia, although global ambitions more realistically lie with codeshare deals, of which SAA has signed a raft of over the last year. These include a codeshare with fellow Star member US Airways in December 2012; with Jet Airways in April 2013; with Etihad Airways in July; and with JetBlue Airways and Brazil's TAM Airlines in August.

At its Johannesburg hub SAA competes against more than 50 airlines, with more than 20 direct and indirect competitors on London routes alone. As a result pressure on fares is intense, with competition on domestic and regional routes being particularly fierce.

Comair (of which British Airways owns 18%) operates BA's domestic South African and regional flights as a franchisee; it concentrates on point-to-point services out of its Johannesburg hub with 17 737 aircraft. And Comair's LCC subsidiary Kulala.com – launched in 2001 – today operates 10 737s domestically.

LCCs have been trying to break into South Africa for some time now, but with a lack of cheap secondary airports and a low internet penetration it's not the easiest of markets for the business model. LCC 1time was launched in 2004, initially on a route between Cape Town and Johannesburg with two DC-9s and two MD-82s, with fares it claimed were up to two-thirds cheaper than SAA, and built the fleet up to 10 MD-80s operating domestically and internationally before filing for bankruptcy in late 2012. Velvet Sky, another LCC, started operations in March 2011 out of Durban and built up to four 737s before closing down less than year later.

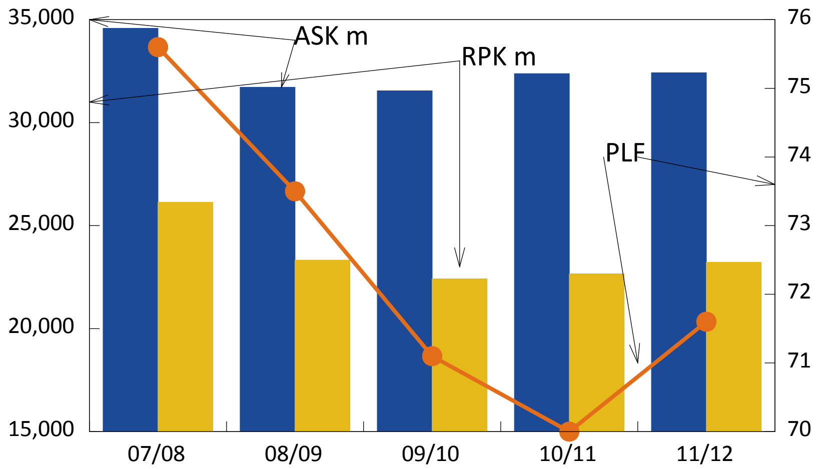
Another potentially more dangerous LCC challenger – Tanzania-based FastJet, backed by easyJet founder Stelios Haji-Ioannou – is keen to enter the South African market.

SAA's own LCC seems to be growing painfully slowly. Mango launched in 2006 and operates completely independently of SAA but still only has a fleet of nine aircraft, all borrowed from SAA and with an average age of more than 12 years. Based at Oliver Tambo airport in Johannesburg, Mango operates domestically to six destinations as well as

SAA Fleet

	In Service	Orders
Mainline		
A319	11	
A320	4	18
A321		10
A330-200	6	
A340-300	8	
A340-600	9	
737-800	13	
Cargo		
737-200	1	
737-300	2	1
737-400	1	
Mango		
737-300	1	
737-800	8	
Total	**64**	**29**

SAA Capacity, Traffic and Load Factors



to Zanzibar in Tanzania and while its results are not reported separately within the SAA group, the airline carried 1.6m passengers in 2011/12 (compared with 1.4m the year before) and is believed to have made a substantial loss in 2012/13.

SAA also partners with state-owned regional carrier South African Express (which has 22 Bombardier aircraft) as well as privately-owned SA Airlink (with 29 Avro RJ85s, Embraer ERJs and BAe Jetstream 41s), both of which provide a feed network into SAA's hubs across the country. SAA also moves approximately 60% of all air cargo in South Africa through SAA Cargo, and the SAA group also contains an aircraft maintenance, repair and overhaul unit (SAA Technical); in-flight catering (Air Chefs); and a travel agent chain (SA Travel Centre).

As to the future, any chance the latest turnaround plan has of succeeding depends on some continuity in management and continued financial support from the government. It's a "Catch 22" situation for SAA – without short- and probably medium-term financial backing from the government it has no chance of turning around and returning to profitability, but it's that very dependence on the government that is so damaging to the airline in the long-term.

Though rumours of privatisation have been doing the rounds for the last decade, the government is faced with pressure from voters and trade unionists not to nationalise for fear that new owners would drastically cut back the workforce, with one analyst believing privatisation is "unthinkable". But with results due out imminently for the 2012/13 financial year that are expected to be very poor, perhaps the unthinkable will have to become thinkable.

Fastjet:
The struggle to democratise African air travel

Africa would appear to have huge potential for the growth of LCCs. It also presents formidable obstacles and complexities. Fastjet is objectively a small airline, with a current annual passenger volume of less than one million passengers, but it has achieved a high profile, and its short history illustrates both aspects of the African market.

Flights under the fastjet brand started up in Tanzania in November 2012 using three A319s, operating from Dar es Salaam to Kilimanjaro, Mbeya and Mwanza. Fastjet plc is the holding company for fastjet itself (which was developed from the former Fly540 operation in Tanzania), plus other Fly540 operations in Kenya, Ghana and Angola.

Starting with the potential, Africa has a great economic future ahead (and always will have, according to the sceptics):

- More than one billion people, of whom maybe one third can now be described as "middle class"
- Rapid economic growth (GDP in the 5-6% pa range)
- Huge Oil, Gas and natural resources
- \$1.6 trillion consumer spend by 2020 (according to McKinsey)
- Infrastructure investment by governments and NGOs
- Restructuring of debt
- Hopefully, increasing political stability across the continent

Against this positive background, the aviation scene looks totally underdeveloped:

- Africa has 15% of the world population, 20% of the world land mass but less than 3% of world RPKs
- Propensity to fly: less than 0.1 seats per capita per annum in contrast to Europe's 2.0 seats per capita per annum
- 10.85 accidents per million flight hours, compared to a world average of 2.00
- Long history of failed operators and wasteful flag-carriers
- Poor reliability, with endemic cancellations and delays
- Liberalisation, as promised by the Yamoussoukro Agreement, is still far off, and travel between all 48 countries of sub-Saharan Africa remains controlled by Bilateral Air Service Agreements.

Fastjet's aim is to resolve this conundrum. Its mission statement is to implement the low-cost model across Africa, becoming the continent's first low-cost, pan-African airline. Management is packed with LCC expertise: CEO Ed Winter (Go and easyJet), CCO Richard Bodin (easyJet) and CFO Angus Saunders (British Mediterranean and Avianova, a Russian LCC which was forced out of business). Parallels could be been drawn with India where domestic air traffic shot up from 14m passengers a year in the mid 2000s to about 70m now, following the arrival of LCCs like Indigo and SpiceJet.

The fastjet plan at its launch last year was for rapid growth in its fleet to 10 aircraft this year and 25-30 by 2015, as it applied the LCC experience of, mostly, easyJet to the African continent. But the current fleet remains at three, and the organisational structure of fastjet has been questioned. The airline is headquartered at London Gatwick where the top management work. There have been rumours of relocation – but to Dubai, rather than an African city. How, critics ask, can fastjet adapt the LCC model to Africa if it isn't immersed in Africa?

However, fastjet can point to its marketing successes. At its most basic level this involves educating passengers about its "European" safety standards, demystifying the flying process (38% of its passengers have been first time flyers), through friendly videos, and establishing the brand.

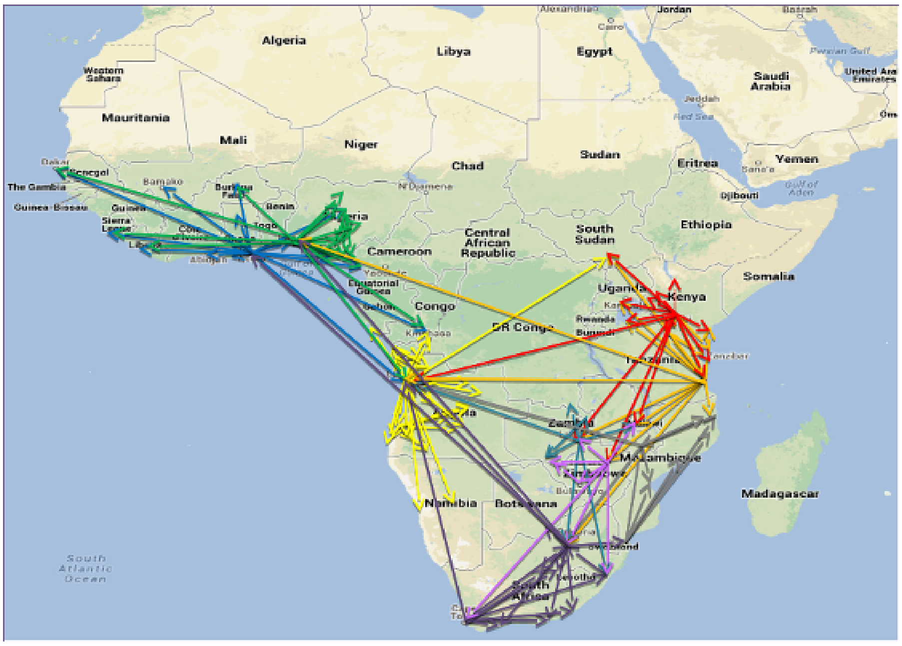
It has tackled the African airline phenomenon of "Go Show", whereby passengers don't turn up at the airport until the very last minute to purchase their tickets, suspecting, correctly, that their desired flight will be delayed or just not happen. Fastjet's on time performance from Dar es Salaam this year is put at 96% and cancellations at less than 0.1%, efficiency ratings unheard of in domestic African aviation. Consistent LCC pricing has also changed consumer behaviour; fastjet's one-way prices average \$70 (ex taxes) but are sold at around \$20 for early booking while last minute tickets go up to \$170. As in Europe, passengers quickly learn the LCC model. According to fastjet, its average advance booking/departure ratio has changed from 0.7 days when operations started at the end of 2012 to 15 days now.

Although internet usage is comparatively low in Africa, the website fastnet.com appears to be very well accepted in Tanzania, with over a million visits since its launch and a very respectable sale conversion rate of 8%. Mobile ownership is extraordinarily high in Africa (allegedly an average of two phones per capita) and has become a standard medium for making transactions and transferring money. About 25% of fastjet's sales are via mobiles, the airline having entered into a partnership with Tigo, the global, but South America and Africa focused, telecoms provider, earlier this year. Through facebook and other social media, fastjet claims to be the fifth most popular brand in Tanzania and the most "liked" airline in sub Saharan Africa.

Fastjet's logo is a fetching grey parrot, widespread throughout Africa, which is a very intelligent bird. It would undoubtedly applaud fastjet's operating and marketing successes but might squawk loudly at the financial results.

When fastjet was generating publicity and seeking funding last year the idea was that it could quickly become a pan-African LCC (see *Aviation Strategy*, December 2012) through acquiring the existing AOCs of Fly540, the aviation arm of the Africa-orientated conglomerate Lonrho (London-Rhodesian, if you go back far enough). A former software company, Rubicon, was used as a cash shell to absorb the aviation assets of 540 (two aircraft and the licences for Tanzania, Kenya, Angola and Ghana) as well as its liabilities. In the new company, fastjet plc, Lonrho became a 50% shareholder while Sir Stelios Haji-Ioannou, easyJet's founder and owner of the fastjet brand, added LCC credibility for investors, and received a very nice package – 5% of the share capital, a further 10% option, a royalty fee (5% of revenues) and €50,000 per month for consultancy services. As well as private investors, about 7% of fastjet's stock was floated on London's Alternative Investment Market (AIM); launched at 39p, the shares peaked at 48 early this year, since when the price has fallen precipitously to 6p in mid-September.

Fastjet – planned pan-African low cost brand



It is clear that African investment produced some nasty surprises for fastjet. Writing in the 2012 annual report, published in May, chairman David Lenigan wrote: "The Fly540 businesses acquired from Lonrho Plc have all seriously underperformed relative to expectations."

The seriousness of the underperformance is starkly illustrated by the following table taken from the annual report:

Fly 540 Results 2012 (US$m)

	Revenue	EBITDA
Tanzania	3.6	-13.8
Angola	13.1	-4.3
Ghana	4.2	-7.8
Central	0.2	-15.9
Total	**21.1**	**-41.8**

Also each country summary in the annual report referred to deep business problems and missing accounts. As a result the acquisition goodwill was adjusted down by $35m, and the auditors qualified the accounts.

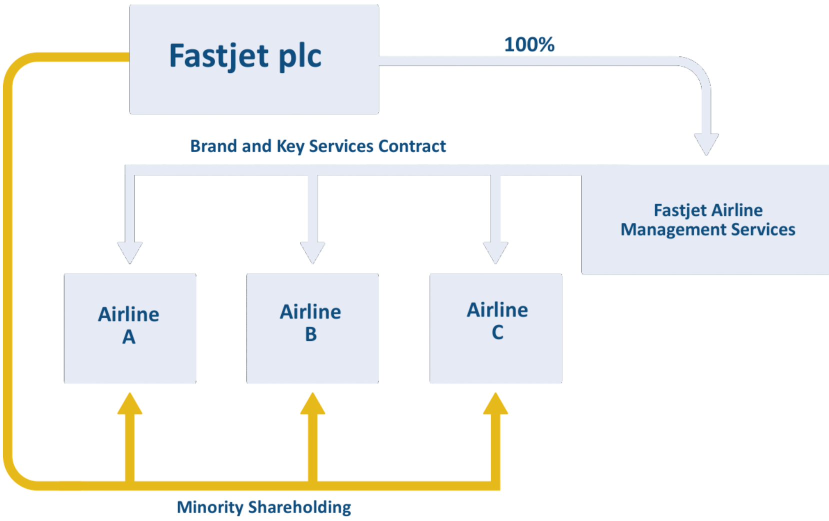
In June David Lenigas stepped down as Chairman, temporarily replaced by CEO Ed Winter. This followed the purchase of Lonrho plc by FS Africa for a reported UK£175m; FS Africa is an investment fund set up by Rainer-Marc Frey, founder of Swiss hedge-fund group Horizon21, and Thomas Schmidheiny, who is, among many other things, a former director of Swissair.

Revised pan-African strategy

So without the framework promised by the 540 network, fastjet has had to modify its approach to achieving the pan-African airline shown in the map above (which was presented at the Terrapinn Low Cost carrier Congress held at Heathrow in September). There are now three models for growing fastjet.

First, fastjet could set up a

Franchise Model



majority-owned carrier on the same lines as the Tanzanian operation in new countries – probably the preferred route but one likely to encounter bureaucratic and regulatory barriers.

Second, fastjet could take a minority shareholding in an airline and operate as a joint venture, with the partner providing local market expertise and compliance with ownership requirements. Air Asia has developed this model successfully, but Africa is more challenging.

Fastjet had advanced plans for a South African airline, 25% owned by fastjet and 75% by Blockbuster, a South African investment fund which was to have started this year. But this airline project has apparently been frozen as fastjet decided to concentrate on its first international services when it was awarded rights from Tanzania to South Africa, Zambia and Rwanda in June.

Flights to Johannesburg from Dar es Salaam were due to start on September 27th, posing a threat to SAA's monopoly on this route. But nothing in Africa is that simple and on the launch day the South African authorities demanded "further documentation" from fastjet, causing the launch to be postponed.

Fastjet has also been exploring ways into the potentially huge Nigerian market, and has signed a MoU with RED1, a start-up, which according to its website, is "an innovative passenger airline, strategically positioned to bring the low cost, low fare revolution to the Nigerian people and Africa's most dynamic region."

Thirdly, fastjet is offering franchise-type agreements whereby African airlines can in effect buy fastjet's LCC expertise, which is being packaged as Airline Management Service (AMS). The advantages of AMS, according to fastjet, are:

- Provides robust operational performance through group operational and safety systems and controls
- Maximises revenue by leveraging the brand
- Reduces risk for airline investors.
- Enables less experienced local airline management team to develop/operate a fastjet airline to the required international standards
- Provides the financial synergies of a large airline
- Creates efficiency through strategic guidance, business intelligence and management information from the whole group

Will Fastjet succeed?

The most obvious and painful lesson from fastjet's experience is that there is no rapid way of setting up a transnational LCC in the continent given the current regulatory and bureaucratic barriers, and that airline capitalisation is likely to considerably greater than expected. The positive lesson is that fastjet has introduced effective LCC operating standards to Tanzania, and eventually, as in most of the rest of the world, the LCC model will help to break down barriers and undermine entrenched interests across sub-Saharan Africa – democratising air travel. The timescale question remains unknowable.

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