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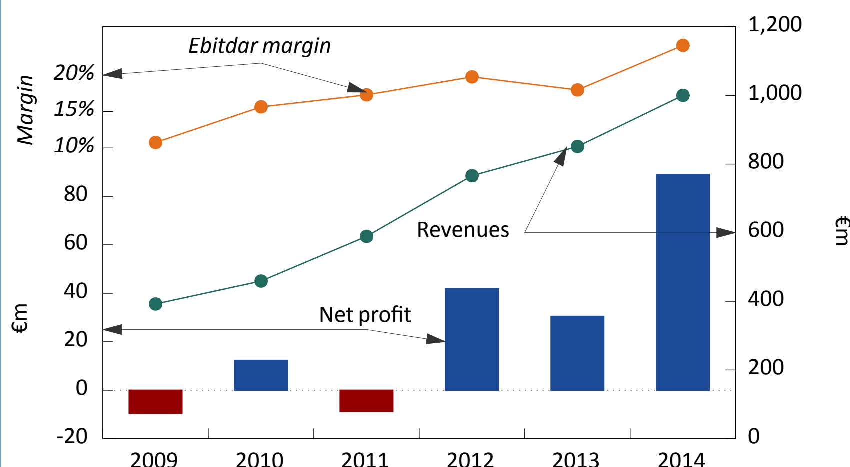
Gee Wizz

THE IPO of Wizzair has been long awaited, rumoured, and seemingly oft abandoned. The announcement at the end of May that the Hungarian-based ULCC was planning to list on the the London Stock Exchange therefore was not a total surprise. However, following a handful of somewhat disappointing new equity flotations in London, exacerbated by a profit warning from Lufthansa, Wizz has withdrawn its immediate plans for a public offering because of "current market volatility in the airline sector".

Wizzair is the fifth largest LCC in Europe with traffic in 2013 of some 13m passengers having grown at a compound annual rate of 10% in the past five years. Formed in 2003 by the former CEO of the (now defunct) Hungarian flag carrier Malév and based at Hungary's Budapest airport, it has pursued the strategy of developing a route network connecting the poorer Central and Eastern European nations with the richer mainstream EU markets. It has pursued the ultra-low-cost-carrier model, targeting demand from CEE markets deemed too weak for the likes of Ryanair and easyJet (which up to now have had more lucrative targets to pursue). It was given a significant boost from the demise of the Hungarian flag-carrier Malév in 2012.

Operating in a niche area it has been able to build a network of 18 bases in Central and Eastern Europe to secondary and tertiary airports in Western Europe and operates to 97 destinations in 35 countries with a fleet of 52 A320s (and 63 further on order). With a prime AOC in Hungary, it also has an operation in the Ukraine through Wizzair Ukraine (and formerly ran a subsidiary in Bulgaria before that country's accession into the EU).

Published financial and traffic data are sparse; it had been hoped that the IPO prospectus would provide some reasonable details of the operations. It is a member of the European Low Fare Airline Association through which it reports its passenger traffic trends on a half yearly basis. In 2010 it established a UK-based, Jersey registered plc holding company – presumably as a vehicle for a future planned IPO. From the accounts at this holding company it appears that revenues have grown from €390m in the year ended March 2009 to €850m for the year ended March 2013 – while press comments suggest revenues to the end of March 2014 touched €1bn. Profits up to the year ended March 2011 were marginal, but since then the group has started to achieve reasonable returns: according to



Note: YE March. Source: 2009-2013 Wizz Air Holdings; 2014 Reuters.

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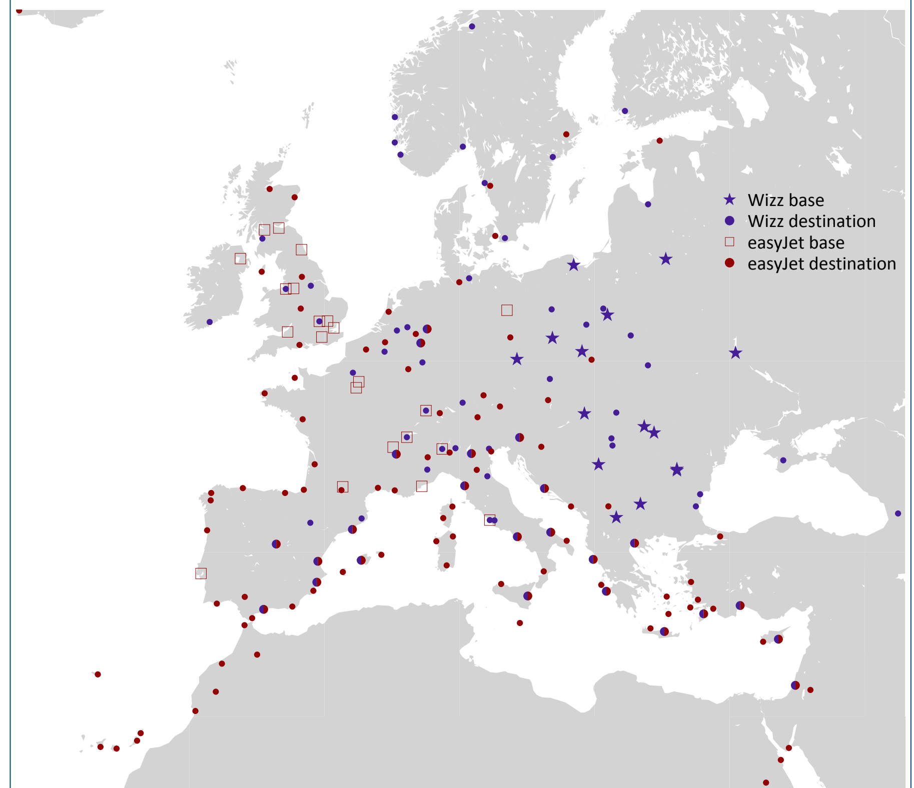


press reports the group achieved net profits of €89m in the year to end March 2014 reflecting a very respectable EBITDAR margin of 24%.

The group's major shareholder is Indigo Partners. Indigo is a US-based private equity business with a serial interest in developing low cost and ultra-low cost carriers round the world. Run by Bill Franke – former CEO of America West, and closely linked with other serial investors such as TPG's Bonderman (chairman at Ryanair) – Indigo has been involved in the start-up and development of Spirit, Mandala, Tiger, Avianova, and last year acquired Republic to develop as a ULCC (see *Aviation Strategy* October 2013). Not all of its investments can be categorised as successful but part of its strategy is to build up a wide portfolio in the expectation the some investments will do very well. Having supported Wizzair for the past ten years (as a US investor it can only officially have a minority stake in the European airline) Indigo is obviously looking for an exit.

What are the options? An IPO is out of the question in the short run now. Having missed the February-June equity issue window on the London Stock Exchange a post-summer break introduction after September may be possible; but given the tenor of the announcement to withdraw this would possibly require a significant improvement in market sentiment towards the airline sector. Could the group revitalise an idea of selling the operation to another airline in Europe?

It has been over ten years since the last flurry of LCC take-over in Europe – EasyJet/Go and Ryanair/Buzz – so the timing may be apposite again. Memories too may have faded – Ryanair's take-over of Buzz was followed by integration problems and caused the Irish carrier to issue a profits warning. Go caused a major dent in easyJet's profitability, and there is a sound argument that, had easyJet just waited another year, rather than paying investment group 3i £374m, Go would have run out of cash and gone out of business.

There are three main strategic rationales for M&A in the LCC sector:

- Rapid expansion into a new or under developed market (in Wizzair's case, east and central Europe);
- Removal of a competitor from the overall LCC market (or prevent another competitor taking over Wizzair);
- Cost savings and synergies, which make a good investment story and appeal to the regulators, but which usually prove elusive.

Ryanair?

In one sense Wizzair's operation is close to that of Ryanair. It operates relatively low frequencies to secondary and tertiary airports in order to reduce the cost of operation to enable it to offer the lowest fares possible. It also seems to have a unit cost of operation not far from Ryanair's ultra low cost base.

As the map on page 2 shows there is significant overlap between the Ryanair network and that of Wizzair – with two major bases in Warsaw and Budapest where they currently fly head-to-head. From Ryanair's point of view it may feel that it can progressively move into Wizzair's destinations without the any need to buy out the competition. Some years ago Micheal O'Leary in his pre-cuddly mode, derided the idea of buying Wizzair for any price.

In addition Ryanair is a 737 operator – although it might like to introduce competition for suppliers of aircraft. Its only interest may be piqued by the idea of another carrier acquiring Wizz.

easyJet

The second map on page 2 shows a fairly complementary network between easyJet and Wizzair. Although there is a difference in philosophy towards destination airport category, the two carriers both operate A320 family aircraft, with identical layout. While easyJet is dedicated to turning Europe orange, and is seemingly successfully pursuing a strategy of providing a business-friendly alternative to the legacy carrier intra-EU offering, it may just be intrigued to acquire a separate brand.

Legacy Interest

IAG is probably the most likely of the Euro-Majors to be interested. It has successfully integrated Vueling into the Group, and there is no overlap between Vueling and Wizzair (and usefully both operate A320s). It is probably the only one of the legacy carriers to have the imagination to think of acquiring a pan-European brand seemingly in competition with another of its subsidiaries. That is unless Lufthansa decides that Wizzair is a fast track to building up its own planned LCC subsidiary to operate alongside Germanwings and attack the Etihad-backed airberlin.

Airbus: Emirates poses tricky questions

The cancellation by Emirates of its $16 billion order (list prices) for the newest version of its A350 highlights a number of issues facing the manufacturer in the run-up to next month's Farnborough air show.

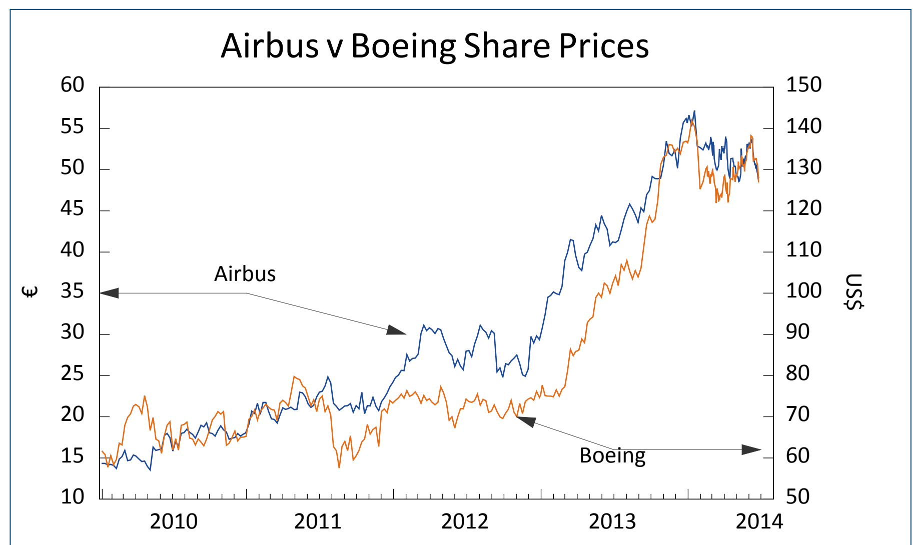
The first challenge is **what to do in the wake of the Emirates cancellation.** Even the ebullient chief salesman John Leahy had to admit at the opening of the group's innovation days in Toulouse in mid-June that the loss of the deal for 70 A350 XWB airliners was "commercially, not good news". It looks as though the super-connector might now proceed to firm up its order for at least 150 rival Boeing 777Xs. Not only would this be the biggest civil aircraft order ever, it would be a strong endorsement of the American company's two-pronged approach to the long-haul widebody market: the 787 family and a new 777 that can outfly the top end of Airbus's twin-engine models, with more range and seats.

In reality, it is not all that bleak for Airbus. First, the cancellation might be a blow to prestige, but no more than that; the A350 development is proceeding (so far) without the delays and dramas that befell Boeing's 787. Second, as Fabrice Brégier, the Airbus CEO, explained, the Emirates cancellation will have no financial effect since the delivery dates were for so far ahead that Airbus would have no problem filling the slots with other orders, most certainly at better prices than Emirates obtained as a launch customer. Third, it not entirely clear what is a firm cancellation any more than what is a firm order: it has subsequently been reported that Airbus may be given another chance to re-tender for the A350 order.

Airbus's basic challenge is how to **sharpen its competition in the wide-body market**. It is offering two versions of the A350 (the smallest of three seems to be in the process of being withdrawn, as customers opt for the larger two) against three versions of the 787s and two of the 777. This means Boeing seems to be offering a range tailored to a wider variety of airline needs. From here, the challenge breaks down into how to respond, segment by segment. Like Boeing, Airbus is on record in recent weeks of saying that there is no desire to launch further whole new programmes, each of which can cost upwards of $10bn. So Airbus's response must be to produce significant upgrades.

The most obvious opportunity is the A330, which could be fitted with new engines to compete with Boeing's 787s. Although a re-engined A330 could not compete on range it would be able to fly 90% of the missions the 787s will be used for. With competitive fuel economy thanks to the fitting of more modern Rolls-Royce (or, less likely, General Electric) engines and with competitive pricing thanks to development costs of the 1993 aircraft having long been written down, Airbus could hold on to market share. Talks have been going on with Rolls-Royce; and Airbus wants the engine maker to assume some of the cost of adapting the airframe for the newer engine. Unless it opts for an A330 neo, Airbus risks losing the 250-300 seat segment to Boeing's 787s. Although the A330 has been an outstanding Airbus success, orders have been drying up recently

The next challenge is the **A350 stretch**. A350-800 (276 seats) orders are regularly being switched to larger models, with the encouragement of the manufacturer. But Emirates has made no secret of its interest in a



twin-engined aircraft carrying more than the A350-1000's 369 passengers. Their view of the world is of stronger growth at slot-constrained airports, thus putting a premium on larger aircraft. Indeed, the surprise order last year for 40 more A380s looks almost like a swap of the super-widebody for the larger twin. But this only serves to point to Airbus's next challenge.

A **bigger, better A380** is now being sought by Emirates. Tim Clark, Emirates President, has for some years talked about the eventual need for a larger aircraft carrying up to 800 passengers in some configurations. Now he is calling for a re-engining of the plane to improve its cost per passenger kilometre in the light of what the biggest Boeing twin, the 777X will offer when it comes into use in five or so years. It is likely that Rolls-Royce would get an exclusive deal to supply new engines for both the A330neo and the A380neo, if they happen. This is a reinforcement of the way the civil widebody market is lining up as a transatlantic duopoly: Boeing/GE on one side and Airbus/Rolls-Royce on the other.

Below these strategic challenges, Airbus faces tactical decisions. For instance, one other option for prolonging the life of the A330 (about 1,000 in operation) is the development of a so-called regional variation aimed at the Chinese market. This has de-rated engines and a lower certified fuel capacity (with attendant reductions in maintenance and operating costs) to cram in up to 400 passengers in single class to fly two- to four-hour hops between Chinese cities. The larger capacity planes would counter limits to air-traffic control capacity. Airbus is already working with China to help them improve air-traffic control but may be forced into a deeper involvement (to add to its A320 final assembly line in Tianjin) to assemble or adapt A330s in China to secure the order which had been expected during the Chinese leaders' visit to France several months ago.

Airbus Backlog

Aircraft	Ordered	Delivered	In operation	Backlog	*Of which Emirates* In operation	*Of which Emirates* On order
A318	79	79	68			
A319	1,514	1,410	1,403	104		
A320	6,694	3,671	3,473	3,023		
A321	2,060	931	927	1,129		
A300	561	561	273			
A310	255	255	126			
A330-200	602	537	531	65	21	7
A330-200F	38	26	26	12		
A330-300	702	525	518	177		
A340-200/300	246	246	217		4	
A340-500/600	131	131	130		10	
A350-800	34			34		
A350-900	589			589		*50* ✈
A350-1000	189			189		*20* ✈
A380	324	132	132	192	48	92
Total	**14,018**	**8,504**	**7,824**	**5,514**	**83**	**169**

Source: Airbus. Note: ✈ Cancelled

Aviation Strategy

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Super-Connectors: The real threat

THE Euro-Majors are getting more and more upset by the incursion of the Super-Connectors – Emirates, Qatar, Etihad and THY – complaining loudly about unfair competition and instigating EC investigations. Here, we attempt a quantification of the threat.

In round numbers, the four Super-Connectors have a combined fleet of about 700 aircraft, with 900 jets on order plus a further 300 or so options (and then there also Letters of Intent).

In total the Super-Connectors have about $125bn of aircraft on firm order plus a further $45bn of options; for comparison, the combined commercial backlog for Airbus and Boeing is about $845bn, so a backlog share of at least 15%. (These figures are *not* list prices, which are normally quoted in press releases, but estimated from actual delivered or ordered prices, which imply a discount of 40-60%.) Emirates is almost certainly Airbus' most important customer accounting for 7.5% of the total backlog value, which largely reflects its A380 purchases.

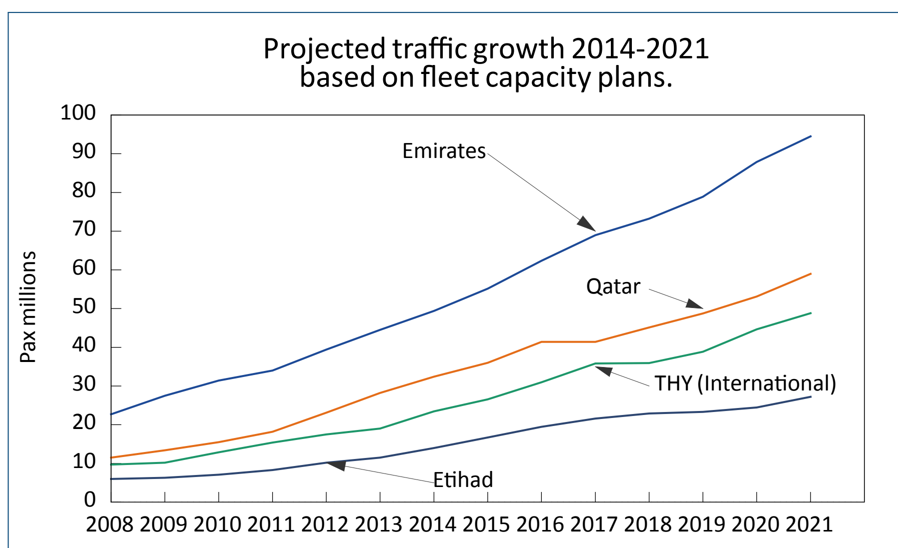
This puts an interesting perspective on protectionist responses to the Super-Connectors. If, for instance, Air France or Lufthansa were to block or restrain further expansion into France or the EU, what would be the repercussions for the French and European aerospace industries and their supply chains?

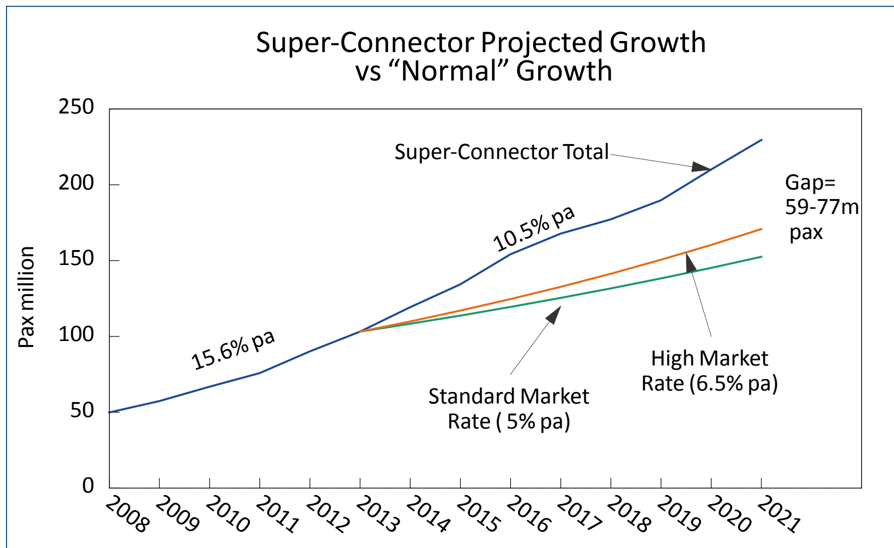
In the following analysis we have projected seat capacity forward using the carriers' aircraft annual delivery schedules and adjusting for replacement capacity (we assume conservatively that widebody aircraft will be retired at 12 years and narrowbodies at 15 years). No deliveries from new additional orders are allocated in the forecast period. We have also compared the forecast to the Super-Connectors' own growth plans where available. We then assume that load factors are constant and passenger volumes will grow at the same rates as seat capacity growth, and come up with these forecasts for 2021: Emirates at 95m passengers by 2021, THY at 60m international (close to 100m if domestic is included); Qatar and Etihad at 48m and 37m, respectively. For comparison, Lufthansa is around 80m today.

Now to address the implications of the Super-Connectors' supergrowth, particularly for the European carriers.

The graph below brings together the historic passenger growth of the four airlines and the combined passenger forecast (based on the methodology described above). From 2008 to 2013, a period which coincides with the longest post-1945 recession in the developed world, the Super-Connectors grew by 15.6% pa, from 50m to 100m passengers; from 2013 to 2021, their combined growth rate will probably be a little lower – 10.5% pa – but this will accumulate 230m passengers by 2021.

The next step is to compare this forecast to the volume of passengers associated with a "normal" growth rate; by "normal" we mean the market growth predicted by Boeing, Airbus and other forecasters, which falls in the range 5% pa (average) to 6.5% pa (high growth regions); this is the traffic that the Super-Connectors would plan for if they were growing at the same rate as the market. As the two curves diverge a gap of 59-77m passengers emerges by the year 2021. This is the, say, 68m enigma – the additional traffic that





somehow has to be generated by the Super-Connectors to fill their new aircraft.

Of course, the traffic forecasts could simply be wrong. The growth rates from Asia and Africa could be stronger than anticipated with the Super-Connectors stimulating traffic in a similar way to the LCC effect on short/medium haul markets. Or the Super-Connectors could have, like many airlines before them, over-expanded, in which case Middle Eastern consolidation will probably have to take place.

Impact on the Euro-Majors

The Euro-Majors fear increased market share capture. Currently, the Euro-Majors fly about 36m passengers between Europe and the Middle East/Asia/Africa , and they might expect to grow this total to say 45m by 2021 if they tracked market forecasts, but, given the Super-Connectors' capacity plans, they face the threat of very low growth, maybe retraction, in the world's fastest growing markets. This would be consistent with an analysis of historic trends. The following graph compares the European carriers' traffic performance on Middle East/ Asia and Africa routes against the Super-Connectors over ten years (remember that Etihad only started operations in 2003).

The message is that the Super-Connectors have captured or generated almost all the additional traffic in these fast-growing developmental markets while the European carriers have more or less stagnated.

One implication is that the Euro-Majors become essentially niche players in these markets, focusing on the major point-to-point routes where they may be able to achieve substantial yield premiums over connecting flows.

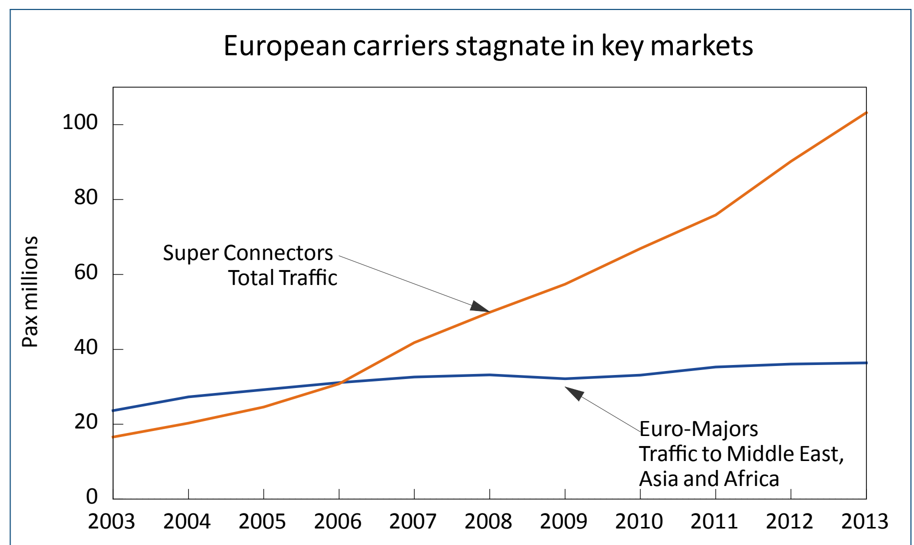
The Euro-Majors and their US partners have also to be concerned about the Super-Connectors allocating new capacity to the Atlantic, diverting non-European originating traffic and by-passing the Euro-hubs. The Super-Connectors could then emerge as a new competitive force on the Atlantic which the Euro-Majors had oligopolised through their immunised alliances with the US Majors. This is probably a much more worrying development for the Euro-Majors than long-haul start-ups like norwegian.

Finally, the Super-Connectors add to the Euro-Majors' problems in their short-haul sectors, which are generally very loss-making. Having seen their point-to-point traffic eviscerated by the LCCs, their connecting traffic is now also being eroded by the Super-Connectors.

IAG

IAG appears able to take a relatively sanguine view on the Super-Connectors as the threat is limited.

✈ Both hubs, Heathrow and Madrid, face west. Heathrow is, and is likely to remain, the prime gateway on the North Atlantic while Madrid is the main gateway on the South Atlantic.



✈ British Airways is the dominant player at *the* hub in Europe with the best International O&D traffic flows; it is much less reliant on connecting traffic than the other two Euro-Majors

✈ Capacity restraints at the airport mean that BA will be increasingly unable to provide short haul feed on to long haul services – especially from domestic regional points, reinforced by UK aviation policy and taxation. The regional feed services into LHR have for years been under competition from KLM through Amsterdam, so, for example, Emirates' operations to Newcastle probably impact KLM more than BA.

✈ Madrid is the main gateway on the South Atlantic with strong O&D traffic to Latin America and Iberia has no exposure to Asia and limited exposure to the Middle East or Africa.

✈ Among the Euro-Majors it has a relatively low exposure to the Far East – but where it is present it has a significant level of O&D point to point demand (such as Hong Kong or Singapore).

✈ How its passenger alliance with Qatar will develop is uncertain but the cargo joint-venture looks like a good strategic innovation.

✈ Nevertheless, IAG will be subject to possible diversion of traffic through the Super-connectors' hubs, particularly India-UK traffic and UK-Africa routes, which are highly capacity constrained on direct services. Traffic could be lost on India/Asia to Americas, Japan-Europe and Asia-Europe (particularly Spain connecting traffic). The Kangaroo route is in danger from continued attack (following Virgin Atlantic's recent withdrawal, BA is now the only European carrier serving Australia).

Air France-KLM

Air France-KLM has a high degree of connecting traffic and is under serious threat from the Super-Connectors. A tendency to retreat into protectionist bilateral-think just postpones rather than obviates this threat.

✈ Amsterdam is primarily a transfer hub with low levels of pure O&D demand, and KLM relies on successful short haul routes from regional (ie non-hub) European cities to feed its long-haul services.

✈ KLM is particularly exposed to incursion into European non-hub airports by the super-connectors on routes to the Far East, Middle East and Africa. Air France and KLM have a relatively high level of access into China which leaves them open to traffic diversion on routes to Europe, Africa and North and South America.

✈ AF-KLM has chosen to ally with Etihad but this alliance is with the smallest of the Super-Connectors and is greatly complicated by Etihad's investment spree in Europe.

Lufthansa Group

Lufthansa, probably correctly, feels itself to be under various attacks by the Super-Connectors.

✈ The three main Lufthansa Group airlines each have small local catchment areas at their main hubs and are reliant on transfer traffic. Within Germany the biggest problem is that the country is for historical reasons highly decentralised: Lufthansa may have its main hub in the financial centre in Frankfurt; but each of the federal states has a significant level of originating travel demand which generally will have to transfer somewhere to go long haul.

✈ Lufthansa has some regulatory protection in that the UAE bilateral currently restricts the number of German cities that can be served by Emirates and Etihad, but Qatar is building up its network to the east and, importantly, THY is saturating Germany, offering intercontinental connections from small cities.

✈ Having failed with THY, its only other alliance option is with Emirates, but this is out of Lufthansa's hands, dependent on Emirates changing its non-alliance policy.

✈ On all its long haul routes Lufthansa appears exposed to the growth of the Super-Connectors. On short haul, Etihad's support of airberlin is a double-edged sword (which may even be Damoclean): it may help to keep at bay further incursion from the LCCs (Ryanair, easyJet, norwegian, Vueling and Wizz) into Germany, but it is likely to exacerbate the pressure on yields and feeder traffic as airberlin chases cash.

✈ In addition, the Gulf carriers in particular are pursuing cargo traffic; and with limitations on night flights at Frankfurt, Lufthansa may find itself increasingly under pressure in one of its core operational segments.

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Cargolux and the Chinese connection

FOLLOWING the recent acquisition of a major stake in Cargolux by a Chinese company, a new dual-hub strategy appears to have caused division among the airline's senior management. What does the future hold for Europe's largest cargo-only carrier?

Cargolux was established in 1970 by flag carrier Luxair and a number of private companies, including Icelandic Airlines and the Salen Shipping Group. Since then, however, the airline has had an eventful history; both Lufthansa and SAir bought and then sold minority stakes, and in 2010 the airline was fined €80m by the European Commission for price-fixing (which the airline is still appealing against), with Ulrich Ogiermann – the CEO at the time – given a prison sentence.

In September 2011 Qatar Airways bought a 35% stake in Cargolux, making it the second largest shareholder at the time after Luxair, which owned 43.4%. Qatar was eager to make Cargolux one of the world's top cargo carriers by 2015, but just a year later Qatar announced it would sell its stake after differences with other shareholders over the carrier's strategy.

In 2012 Qatar's stake was sold to the Luxembourg state for $117.5m, before in turn being sold to China-based Henan Civil Aviation Development and Investment Co. (HNCA) in April 2014 in a deal worth $120m. Today the other shareholders are Luxair, with 35.1%; the Banque et Caisse d'Epargne de l'Etat (BCEE), 10.9%; the Société Nationale de Crédit et d'Investissement (SNCI), 10.7%; and the Luxembourg state (8.3% – a stake bought from Luxair in April 2014 in order to give the state an ongoing role in Cargolux).

At the same time as the HNCA deal was closed, Cargolux announced that shareholders had approved a $175m increase in its share capital in order to strengthen the balance sheet and provide funds for freighter orders and expansion of the route network. As well as the $120m it paid for the 35% stake, HNCA is providing $15m to Cargolux's "development fund" and up to $61.5m towards this capital increase. The balance sheet certainly needs strengthening – as at the end of 2013, Cargolux's non-current liabilities stood at $1.5bn, up considerably from the $1.2bn level of 12 months earlier.

Chinese intentions

State-owned HNCA was only established in 2011 and its remit is to "accelerate the growth of the Henan civil aviation industry", and to develop the Zhengzhou airport economic zone. Zhengzhou is the state capital of Henan province, which is located to the west of Shanghai.

The deal is resulting in major changes to Cargolux's strategy, with the airline now changing to a dual-hub operation at both Luxembourg and Zhengzhou. This change of strategy though is known to have faced opposition by several senior executives at Cargolux.

The alleged unpopularity of the impending deal and its implications for strategy directly led to the resignation of both Peter van de Pas, COO, and Robert van de Weg, the SVP for sales and marketing, earlier this year. Weg had been with the airline for 14 years, and both executives have now started new positions at AirBridgeCargo, Russia's largest scheduled cargo operator (with 12 747Fs) and owned by the Volga-Dnepr Group.

And Robert Song – briefly Cargolux's SVP, head of Asia Pacific – left the company a few weeks after "brokering" the deal with HNCA, with unconfirmed reports implying he clashed with senior executives at Cargolux. Song previously advised HNCA and only joined Cargolux in March.

The Volga-Dnepr Group – which van de Weg and van de Pas have joined – was one of the companies that had (unsuccessfully) bid to buy the state's 35% stake in Cargolux. Other rumoured bidders included Nippon Cargo Airlines and Silk Way Airways, but sources suggest that all other companies fell away early in the process, leaving HNCA as the only serious bid left. In addition the Luxembourg government may have been attracted by selling its stake to a company that would clearly improve trade ties between China and Luxembourg – rather than a trade buyer that made most strategic and commercial sense for Cargolux itself.

Based at Luxembourg's Findel airport, Cargolux currently operates a fleet of 20, comprising 11 747-400Fs and nine 747-8Fs. It was the launch

customer for the 747-8F back in 2005 and has ordered 14 of the model in total (the latest order for another aircraft – costing $358m at list prices – coming in February this year). The first aircraft arrived in October 2011 and five are still to be delivered. Two will be delivered in 2014 and all will arrive by 2017; they are gradually replacing all the ageing 747-400Fs in the fleet. The airline's fleet has grown steadily but slowly over the last few years, and this pace is not set to change anytime soon.

In 2013 Cargolux reported a 14.5% rise in revenue to US$1,989m, based on a 16.7% rise in tonnes sold to 0.8m. However, load factor fell 0.9 percentage points to 67.7% in 2013, and daily aircraft utilisation also decreased marginally, from 15:07 block hours in 2012 to 14.57 hours in 2013.

Cargo overcapacity

Nevertheless, Cargolux turned a S35.1m net loss in 2012 (following a $18.3m net loss in 2011) into a $8.4m net profit in 2013, with operating profits increasing from $8m to $59.5m, though the airline said that "the airfreight industry continued to operate in a difficult environment for the most part of 2013 – capacity growth still outstripped demand, which resulted in an industry-wide decline in yields and load factors".

Much of that capacity growth came from the Gulf Super-Connectors, who added considerable belly capacity as their passenger fleets grew (see *Aviation Strategy*, November and December 2013, and January/February 2014). Though other airlines took freighters out of service through the year this only partially compensated for the greater cargo capacity of the Big Three in the Gulf region.

Cargolux also competes against the so-called "integrators" – companies such as DHL, FedEx and UPS. Germany-based DHL, for example, has five aviation subsidiaries under DHL Aviation that operate more than 100 aircraft between them across the world, including 44 757-200Fs and 29 A300Fs. But even DHL is tiny compared with the might of Fedex, which operates 650 aircraft, of which 100 are Airbus models and 260 Boeing models.

Despite industry overcapacity Cargolux increased its own capacity through 2013, and "successfully increased volumes in order to maximize contribution to fixed costs". As well as extra capacity on existing routes, in 2013 Cargolux added 12 new destination all over the world – to Buenos Aires, Santiago de Chile, Dallas, Columbus, Tripoli, Bamako, Port Harcourt, Ouagadougou, Muscat, Munich, Vienna and Zaragoza – and the airline now operates to around 100 destinations globally.

According to IATA statistics on international scheduled FTKs, Cargolux's global market share grew to 3.5% in December 2013, making it the eighth largest airline in the air cargo airline rankings. Cargolux will keep growing this year, although to a lesser extent than in did in 2013; at the end of April, Dirk Reich – CEO and president of Cargolux – said: "We don't expect market conditions to improve significantly in 2014, but our priority is to expand our global network while focusing on efficiency and performance improvements."

Reich became CEO in March, replacing Richard Forson, who had been interim CEO (as well holding down his regular position, CFO) since August 2012. Reich was previously an EVP at Kuehne & Nagel International, a Swiss transportation and logistics company, and prior to that worked at Lufthansa.

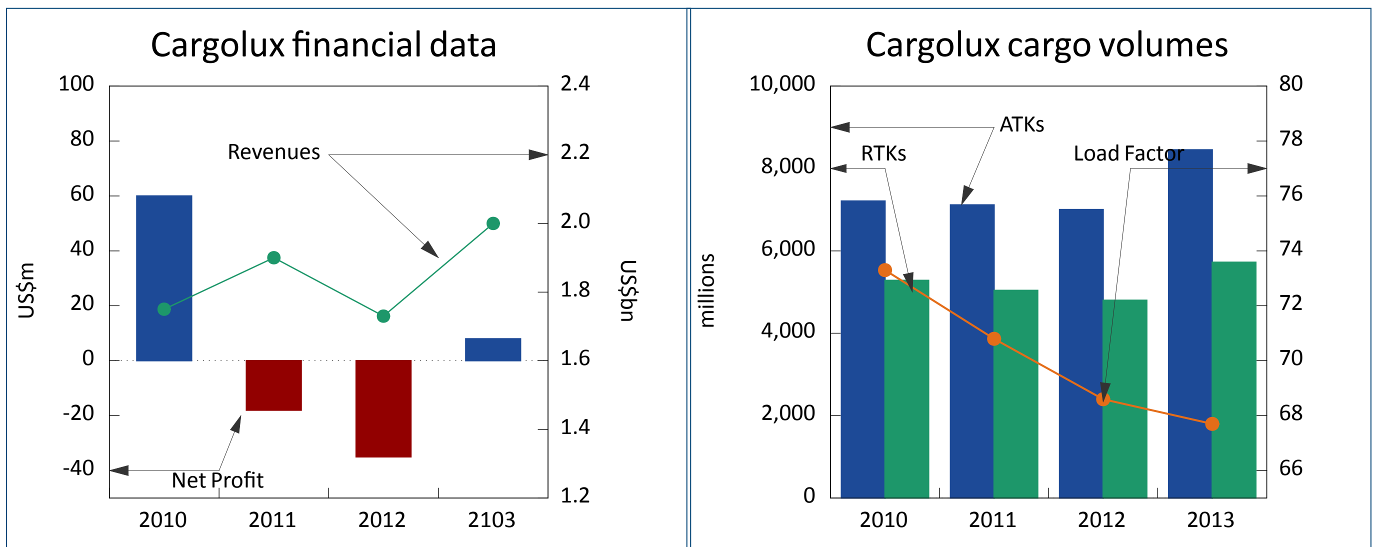
However, just where Cargolux's continued growth will come is now open to question following the investment by HNCA. Cargolux initiated a five-year business plan in February 2013, which was updated in early 2014 in preparation for the HNCA deal, and core to the new plan going forward is the adoption of a dual-hub strategy.

In practice this means that Cargolux will operate two times a week between Luxembourg (and via Baku, Azerbaijan) to Zhengzhou initially, rising to at least four times, although those initial operations hit regulatory clearance problems, and the launch of the route had to be pushed back from April to June.

HNCA has an initial target of 20,000 tonnes a year between Luxembourg and Zhengzhou, which is at the centre of a region known for the manufacture of technology and IT products that are exported into Europe. The longer term plan is for Cargolux to build up routes from Zhengzhou to other Asian cities, and even transpacific routes, although

Cargolux Fleet

	2010	2011	2012	2013	On Order
747-8F		2	6	9	4
747-400F	13	10	9	8	
747-400BCF		3	2	2	
747-400ERF				1	
Total	**13**	**15**	**17**	**20**	**4**



what the implications for Cargolux's existing network to China has yet to be revealed; the carrier currently operates a daily service to Shanghai and other flights to Beijing and Xiamen.

Apparently Cargolux has suspended a route between Luxembourg to Taipei and Singapore in order to free up capacity for the new Zhengzhou flights, and some reports say the plan is to base around six to eight of Cargolux's current fleet permanently in Zhengzhou – though this has been denied by one member of Cargolux's management.

What is known is that Cargolux is currently analysing the possibility of a joint venture airline based in China, and if the initial route to Zhengzhou is successful that joint venture will certainly be launched, though this is not likely until the first quarter of 2015 at the earliest.

It's something that Cargolux has done before, as in December 2008 it set up Cargolux Italia, a joint venture with Italian investors (and owned 40% by Cargolux). Based near Milan Malpensa airport, Cargolux Italia operates a single 747-400F on routes to Dubai, Hong Kong, Osaka, Almaty, São Paulo and Luxembourg. In 2013 the airline carried 93,106 tonnes of freight, 29.5% higher than in 2012, with revenue increasing by 16% year-on-year in 2013 to US$143m.

But the worry that some people have – both within and outside Cargolux – is that HNCA's long-term aims are incompatible with a sensible strategy for Cargolux. HNCA's rationale for the acquisition and the adoption of a dual hub strategy is clear – Zhengzhou was the fastest-growing cargo airport in China last year, with a 70% increase in tonnes passing through the airport thanks to being part of the government's cargo development plan – and the Cargolux stake will undoubtedly accelerate that growth.

Veto power

Controversially, it has been reported than HNCA – despite having just a 35% share – has been granted a veto over all decisions at Cargolux, effectively giving it control over the strategic direction of the carrier. This has caused concern among unions, who already have a long-running dispute with management over job guarantees and proposed replacement of existing work contracts – last year unions and the company clashed over these proposed staff cost savings, with many rounds of negotiations breaking down several times.

The two unions representing most of the airline's 1,600 employees are wary of the intentions of the Chinese shareholders and its vision for the strategic future of Cargolux, and the Luxembourg Chamber of Employees has also criticised the deal, saying that it will divert aircraft from profitable parts of the Cargolux network.

Unfortunately for both HNCA and Cargolux, in December 2013 the Chinese cargo company Navitrans launched a two times a week freighter flight between Zhengzhou and Liège, which is just 165km away from Luxembourg. 747-400Fs are operated on Navitrans' behalf by TNT Airways with the company saying it is targeting at least 20,000 tonnes a year on the route, carrying equipment such as smartphones into Europe – which us exactly the same market that Cargolux/HNCA is targeting for the Zhengzhou to Luxembourg route.

Nevertheless, Cargolux will press on with its new dual-hub strategy, and whether unions and some senior management like it or not, Cargolux's future is now closely tied to the desires and intentions of HNCA.

JetBlue: Making its unique LCC business model pay off at last?

After years of underperforming its peers in terms of profit margins and ROIC and seeing its share price languish, JetBlue Airways has suddenly become the hottest airline stock on Wall Street. The stock surged by more than 30% in May and has continued to inch up in June, contrasting with the declines seen by airlines generally because of concerns about energy prices. Why the change in the sentiment for New York's hometown airline? Could it be Mint, the attractive premium product JetBlue has just launched on the transcon? The sale of LiveTV? Is there now evidence to suggest that, having been a huge success in the marketplace, JetBlue can also be a financial success?

Until May, JetBlue was essentially out of favour on Wall Street. This was, first, because of its decision some years ago to focus on growth at the expense of profit margins, ROIC and free cash flow (FCF).

The decision to focus on growth was understandable, because JetBlue had some unique growth opportunities. In 2009 it was able to take advantage of a sharp contraction by American and other legacy carriers in Boston and quickly build itself into Boston Logan's largest airline. Thanks to another gift from American, JetBlue was also able to grow San Juan (Puerto Rico) into a sizeable focus city operation.

More recently, JetBlue has taken advantage of Fort Lauderdale's "very rich demographic" and enormous cost difference with Miami by making FLL a staging post for significant new expansion to the Caribbean, Central America and northern parts of South America.

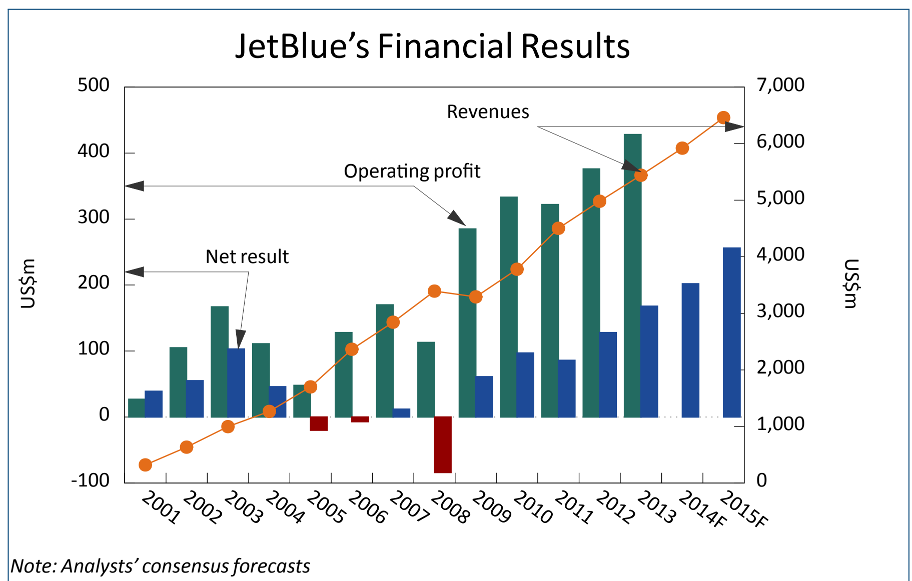
But the benefits have been slow to materialise. At the end of 2013 JetBlue's ROIC was still only 5.3%, up from 4.8% a year earlier. For the second year running, JetBlue fell short of its (very modest) goal of improving ROIC by one percentage point annually. Although JetBlue expects to make up for those shortfalls in 2014, to achieve a ROIC of 7%, that would still be well below the 10-15% that other large US carriers are now achieving. Although JetBlue has continued to report satisfactory operating margins (7.9% in 2013), it has lagged behind its peers in terms of net margins.

Analysts have been tough on JetBlue because the other large US carriers (legacies and Southwest alike) have all maintained tight capacity discipline since 2009 and are intensely focused on FCF, ROIC and returning capital to shareholders. The spring saw a steady string of announcements from Alaska, Southwest and Delta about expanded share buybacks, dividends and suchlike. Some analysts said that they felt that JetBlue's management was not interested in returning capital to shareholders.

Some people have blamed JetBlue's lacklustre financials on the unusual "hybrid" business model, which, among other things, has meant JetBlue becoming a business traffic-focused airline in Boston and "primarily a leisure player" in New York.

And JetBlue has been viewed negatively because in late April its pilots voted to unionise. The pilots elected by a margin of 74% to 26% to be represented by ALPA.

But the sharp fall in JetBlue's



Note: Analysts' consensus forecasts

share price after the unionisation announcement was a turning point. Many analysts upgraded their recommendations on the stock, which is now rated mostly a "buy".

In the first place, analysts realised that JetBlue's stock was undervalued relative to its peers, in terms of projected P/E ratios and other measures. One analyst noted that JetBlue was the only major US airline stock that had declined in January-April.

Second, there was a feeling that the market had overreacted to the pilots' decision to unionise. It had no material impact on the earnings outlook. JetBlue already faced a $145m hike in pilot costs in the next three years, after a January agreement to raise pilot pay. And, as Southwest and others have demonstrated, unionisation is not necessarily associated with weaker financial performance. JetBlue's labour relations remain good, and the airline is committed to paying "peer competitive" pilot salaries.

Senior management changes have taken place. The late April announcement of the departure of COO Rob Maruster and the assumption of his duties by president Robin Hayes have been interpreted as a shift in culture that will focus more on costs and margins. Maruster oversaw JetBlue's rapid expansion phase from 35 destinations to the current 85. Hayes is more financially oriented, having worked as JetBlue's chief commercial officer until his promotion to president in January.

The shift in culture could be even more pronounced if CEO Dave Barger leaves the company when his contract expires in February 2015. Barger himself has not yet disclosed what he wants to do. JetBlue's board is expected to start discussing the matter of post-February leadership in the autumn.

The long-awaited sale of LiveTV – the in-flight entertainment subsidiary that JetBlue spent a decade developing – to French aerospace company Thales was completed on June 10. It was solid good news to JetBlue: $400m proceeds, lower operating costs and capex, and maintaining full access to the product.

There has been excitement about Fly-Fi – the new-generation, superfast in-flight connectivity product that JetBlue is racing to install on its fleet this year. JetBlue believes that Fly-Fi will be a "key differentiator" in long-haul markets.

Mid-June saw the launch of Mint, JetBlue's spectacular new premium product for the transcon market, which one analyst estimates could bring in as much as $300m in annual incremental revenues.

And, thanks to efforts to tweak its successful "Even More" offerings and its TrueBlue FFP, JetBlue expects to grow its ancillary revenues by 10-15% in 2014.

Finally, JetBlue's gradually improving earnings and modest efforts to pay down debt have been acknowledged by the rating agencies. In May S&P affirmed the airline's 'B' credit rating and revised the outlook to positive, saying that it now expects JetBlue to maintain improved credit metrics through 2015, despite substantial capital spending.

Will Mint be successful?

Mint debuted on JetBlue's first "premium version" A321 on the New York-Los Angeles route on June 15. It will be available on all JFK-Los Angeles flights by August and on the JFK-San Francisco route from October 26.

The product features 16 lie-flat first-class seats, including four private suites; tapas-style dining (choice from five menus), an upgraded LiveTV experience (15-inch flat screens with 100-plus channels each of TV and satellite radio), among other extras. The seats are supposedly the widest and the flat-beds the longest in the US domestic market. No other US airline offers private suites in regular commercial service.

The Mint seats are available at a significantly lower fare than other airlines' premium services: $599 one-way. Passengers who book early can get the suites at the same price.

The product has attracted rave reviews. A *Time* magazine journalist wrote that the seats "feel more luxury car than commercial aircraft" and "can accommodate anyone up to NBA height", though the private suites are "not quite the Etihad or Emirates cabin". The meals are "top rate" with a "distinctly Big Apple focus". Overall, the review called it a "well thought out, distinctive product with a dash of whimsy that has been the airline's trademark".

Still, JetBlue faces stiff competition for the premium traveller in the transcon market, where flat-beds are now the norm, where the legacy carriers have all been upgrading their offerings, and where Virgin America has built a loyal following with its extraordinary product over many years.

The *Time* reviewer aptly concluded that it will depend on whether transcon business fliers will abandon their FF-mile accruing legacy carriers for JetBlue's lower ticket prices (the reviewer thought they very well might), "whether the numbers that do will justify the airline's investment", and "how the people in the back, once JetBlue's focus, will feel now that they're in effect second class flyers".

But Mint is only JetBlue's re-

sponse to the challenges in the transcon market; it does not represent a decision to become a two-class airline. The transcon between New York and LAX/SFO is a unique market. As CEO Barger noted, those two routes are among the few where passengers are actually willing to pay for premium, as opposed to being upgraded to it.

JetBlue introduced Mint because it has underperformed its peers in terms of PRASM on the transcon. Its average fare there has been only $247, compared to Virgin America's $320. Its most loyal customers have been telling it for years that, even though they fly JetBlue to Florida and the Caribbean, they have switched to other airlines on the transcon because JetBlue does not offer premium service or Wi-Fi.

To illustrate the limited scale of Mint, only 11 or so of JetBlue's A321s will be in the 159-seat "premium version" configuration by the end of March 2015. The rest of the A321 fleet will be in the 192-seat "core JetBlue experience" version that debuted in December 2013. JetBlue has ordered 88 A321s, of which five had been delivered as of March 31.

Cowen Securities analysts calculated that if JetBlue closes the PRASM gap with Virgin America on the transcon, it would mean $300m in annual incremental revenues. Barger has called that estimate "rather large". The financial benefits would be realised from 2015 onwards.

The Wi-Fi race

Having fast and reliable in-flight Wi-Fi will be central to both the Mint experience and the core JetBlue experience. JetBlue was the launch customer for Fly-Fi, the Ka-band satellite-supported solution developed by LiveTV and ViaSat. First introduced in December 2013, JetBlue expects to have installed the product on its entire Airbus fleet by year-end, with the E190s following in 2015.

JetBlue has received lots of positive customer feedback to Fly-Fi. On some long-haul flights 80% of passengers are connecting to it, sometimes more than 100 people simultaneously. But evidently also complaints about performance have continued, because JetBlue has extended the free beta test period by several months to the autumn, when it also expects to disclose plans to monetise Fly-Fi.

The key competitor is Virgin America, which five years ago pioneered Gogo in-flight Wi-Fi and remains the only airline to offer Wi-Fi on every domestic flight. To retain its lead, VA is in the process of equipping its fleet with Gogo's faster ATG-4 Wi-Fi service – a process that will be completed by the autumn.

Network and alliance plans

JetBlue continues to gradually moderate its ASM growth; currently a 4-6% increase is projected for 2014, down from last year's 6.9%. And the growth will be highly focused: up 17% to the Caribbean/Latin America, up 15% from Fort Lauderdale, and relatively flat elsewhere.

The newest focus of activity is Washington DCA, where JetBlue won 12 slot pairs thanks to the AMR-US Airways divestitures. It will essentially mean reallocation of aircraft from Washington Dulles long-haul flying to more attractive underserved, high-fare shorter-haul markets.

JetBlue expects FLL to be its fastest-growing focus city in 2014. After last year's rapid international expansion from there, which included Lima (Peru) and Medellin (Colombia), this year JetBlue is adding Cartagena (Colombia), among other destinations. The plan is to expand FLL to 100 daily departures by 2017 (about 60 at year-end 2014).

Growth in Boston has moderated somewhat in 2014, so JetBlue is seeing some maturation benefits there. But JetBlue is still committed to growing the Boston operation to 150 daily departures.

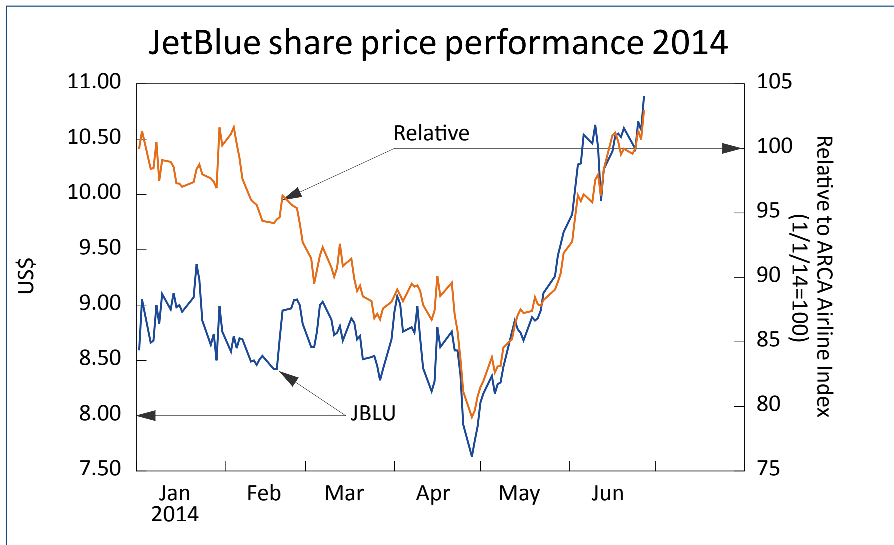
Almost a third of JetBlue's capacity is now in the Caribbean/Latin America markets (compared to 25% on the transcon). Expansion in that region is easy to justify, because those markets mature very quickly and are nicely profitable.

On the alliance front, JetBlue recently suffered the blow of American terminating their cooperation (because after the merger AAL no longer needed the East Coast feed). Otherwise, JetBlue has continued to sign up new interline partners (now 30+) and evolve some of those into codeshare relationships. JetBlue says that from now on the emphasis will be on deepening existing relationships, rather than signing up more partners.

Monetisation of LiveTV

The LiveTV story is a great example of how JetBlue has innovated in the airline business. JetBlue acquired the small Florida-based company in 2002 for $41m in cash and assumption of $40m of debt, which gave it a "really nicely priced" live satellite television feature, enabling it to differentiate its product. LiveTV has always been offered free-of-charge as part of the "JetBlue experience". The management describes it as "core to the brand".

In the mid-2000s JetBlue began



selling LiveTV products to other airlines. Initially it was careful not to give direct competitors access to the product, but that changed in 2008 when Continental signed a long-term contract for its 737s and 757s. The shift in strategy came when JetBlue's management realised that LiveTV no longer offered a distinct competitive advantage; rather, having a LiveTV-type product would soon be necessary just to keep up with competition.

LiveTV has not been a huge money-maker because of the late-2000s recession, the high cost of installing the systems and the weight of the equipment. But it still had a respectable $72m in sales in 2013. At year-end, it had been installed on 461 aircraft, with another 196 in firm orders through 2015. Customers include United, WestJet, Frontier, Alitalia and Azul. But some analysts believe that LiveTV's sales could really take off now that it is no longer owned by an airline.

The $400m proceeds represented five times the original investment. JetBlue executives have noted that it was hard to say what a good payback was, because LiveTV had brought such enormous benefits to the brand at low cost, though JetBlue also invested a lot in R&D for the unit (something it never fully disclosed).

The sale enables JetBlue to simplify its business and reduce operating costs and capex. JetBlue has not yet released revised figures for 2014, but analysts say it had earmarked $75m capex for LiveTV this year.

A crucial part of the decision to sell was that JetBlue managed to structure long-term agreements with LiveTV that "will preserve our access to both Ka and the TV and the satellite radio and developments to those items thereafter".

Shifting priorities?

When the sale of LiveTV was announced in February, some in the investment community thought that it might lead to capital returns to shareholders, such as a dividend or stock buyback. But it is clearly too early to talk about that at JetBlue.

Rather, the proceeds will be used to prepay $200-300m of debt in 2014 and to help fund aircraft deliveries. JetBlue is taking nine A321s this year, and total aircraft capex is estimated to be $600m. Because of the desire to reduce debt, the aim is to buy aircraft and other assets with cash.

JetBlue needs the A321s not just for profitable growth but to keep unit costs in check. However, the airline remains committed to keeping the level of invested capital relatively flat as it expands margins through profitable growth.

Interestingly, JetBlue is now at the point where its network growth calls for larger gauge aircraft. In a fleet restructuring move in October 2013, the airline deferred 24 E190 deliveries, converted 18 A320 positions to A321s and placed an incremental order for 15 A321s and 20 A321neos. At the end of March, JetBlue operated 195 aircraft – 130 A320s, 60 E190s and five A321s.

A combination of slightly slower ASM growth, maturing markets, new products, ancillary revenue initiatives and keeping costs in check should enable JetBlue to improve its operating margins and eventually start returning capital to shareholders.

But will it be soon enough to keep shareholders happy? It will be interesting to see what position, if any, the board will take in the autumn. Specifically, is it time for JetBlue to focus on investor returns over customer satisfaction and network growth?

By Heini Nuutinen
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