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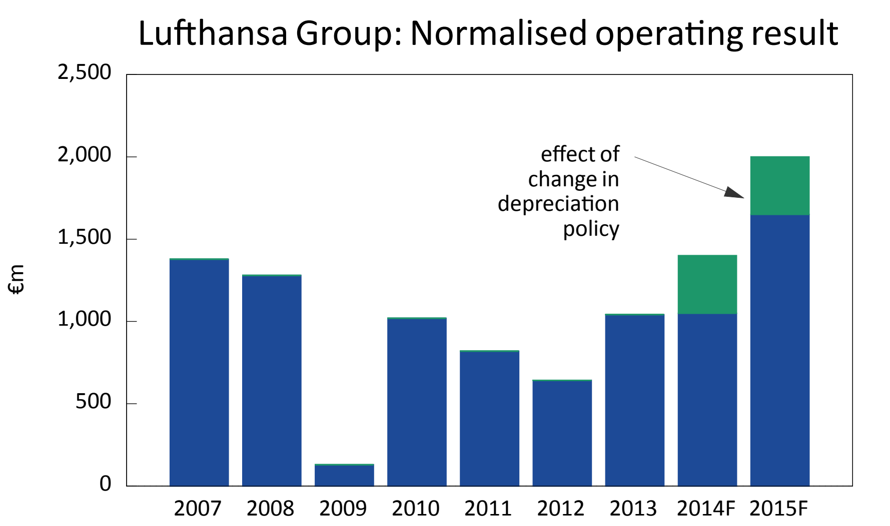
Lufthansa: new CEO, new strategy

CARSTEN Spohr, the new CEO of the Lufthansa Group, in July outlined his vision of the new strategic direction for the German aviation conglomerate under the title of "The Way Forward" to staff, investors and customers. With the exception of one or two troubling concepts the new view is not a lot different from the old. The aim is to be "the benchmark again" and therefore the "first choice for customers, employees, shareholders and partners".

The Lufthansa Group is the world's largest aviation group with leading positions in passenger transport in Europe, the global leader in the MRO ex OEM market, a strong global position in airline catering, and a leading role in air cargo and IT services to the airline industry.

However, it is facing strong headwinds. Low economic growth in Europe is hampering its ability to generate demand growth in its home markets. As a network carrier without a strong base of true O&D demand at its hubs (because of the decentralised nature of Federal Germany and the low populations of its subsidiaries' home countries in Switzerland and Austria) it is under attack from the Super-Connectors from the Middle East and Turkey. As the largest legacy carrier on intra-European routes it is being attacked by LCC new entrants.

Two years ago Lufthansa introduced its latest restructuring and cost cutting programme under the soubriquet of SCORE. Echoing plans, comments and targets from the other two major European network groups – Air France-KLM and IAG – the idea was to be able to produce a group-wide level of profitability in 2015 sufficient to exceed its cost of capital. However, shortly after Spohr took over the reins in April the group issued what amounted to a profits warning: it would not achieve its 2015 target of operating profits of €2.65bn. This is even after abandoning its traditionally conservative depreciation policy – from 2014 it will depreciate its aircraft assets over 20 years to a 5% residual value instead of over twelve years to 15%. This has the effect of inflating operating profits by €350m over the next two years.



Source: Company reports. 2014F and 2015F company guidance

Spohr recognises that restructuring and cost cutting programmes are perennial elements of running a mature legacy carrier. Long term yield decline is a major factor behind growth in the airline industry, so any carrier has to strive continuously to improve productivity to offset this. One of the traditional ways of doing this has been to increase capacity (lowering seat unit costs by spreading

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indirect operating costs over a larger number of seat kilometres). But this rarely works at a mature carrier.

Lufthansa itself has found this out in the last two years: it increased seat density on long haul aircraft which this year appears to have added downward pressure on yields on the Atlantic (LH increased its capacity on the route by 6% in the second quarter and 10% in July alone). This "overcapacity" is one of the reasons it cited for its profits warning – and was echoed by a similar complaint from Air France.

In his presentation Spohr outlined the Lufthansa Group's modest goal to be number one for market position, financial stability and fleet age in order to be the first choice for (and provide equal benefits to?) shareholders, staff and customers.

How they are going to achieve this goal is another matter. Spohr stated *"With SCORE we have equipped ourselves with an ability to change, which we now need to use to shape our future. We now aim to continuously devise and develop new ideas for increasing our productivity and safeguarding our competitive credentials"*.

Constant improvement in efficiency

The plan is to create a culture of permanent and continuous cost reduction programmes. One of the aims of the SCORE programme is to move the organisation towards process orientation, rather than function orientation, on the basis that optimisation of functions (sales, marketing, finance, operations) *per se* can be detrimental to the organisation as a whole. The group is aiming to flatten the levels of management hierarchy to help create faster decision making processes.

This, it is hoped, will lead to the establishment of a group-wide process for generating a constant stream of new ideas and actions. In the short run, more importantly, the company is slashing its original plans for airline capacity growth by half (ie, to around 2% a year) and immediately is looking to remove five short haul, three long haul passenger aircraft and two MD-11 freighters from the operational fleet this winter.

Customer orientation and quality focus

Spohr is targeting the prize of getting Lufthansa to become the first European 5-Star airline in the Skytrax rankings (at the moment there are only seven, all Asian or Middle Eastern: ANA, Asiana, Cathay, Hainan, MAS, Qatar and SIA). Currently it is the highest ranked of the western carriers in the Skytrax league tables at number 11. Given the size of its operations within Europe it might be argued that it difficult to improve its ranking: its 66m passengers flying short haul will have a greater influence on the perception of quality than the 16m passengers flying long haul.

Lufthansa is concentrating on upgrading its premium services. It is installing its new first class and business class products across the fleet and from this December will introduce a premium economy class (which can be the most profitable bit of real estate on the aircraft per square foot). It will be upgrading the catering in long haul business class, improving premium check-in at Frankfurt and Munich, and re-emphasising premium transfer and arrival services. In the longer run it will be establishing a group-wide "Quality Circle" (making it one of the CEO's prime focuses and concerns). It has plans to personalise products and services further "to pleasantly surprise" its customers

– with the aim of tripling revenues from ancillary services by 2020.

New concepts for growth

Lufthansa is intensifying its joint-venture partnerships with leading airlines in the major regions. It has the metal-neutral immunised joint venture on the Atlantic with United and Air Canada, and an established jv with ANA in Japan (with whom United also has an immunised jv). It recently signed an agreement with Air China – currently subject to regulatory approval. The company boasts that the jvs allow it to participate in growth outside its European home markets, exploit synergies and offer the customers *"an even better service and quality"* (however difficult that may be to believe – surely the real aim of a joint venture is to remove competition?).

As for the other divisions of the group, Spohr stated that he aimed to pursue the growth potential of the MRO business Lufthansa Technik and LSG Sky Chefs – presumably through further acquisitions in the Asian growth regions. In addition, Lufthansa aims to start exploiting the profitability of its Miles & More loyalty programme (which it claims to be Europe's largest) now spun off into a separate legal entity.

Low Cost Wings

These previous points are hardly a new strategic plan. However, the company also announced its aim to establish a new "low cost" point to point European and a new point-to-point "low frills" long-haul airline under a new "Wings" multi-platform brand.

The rationale behind this appears to be that the group has woken up to the fact that 75% of all intercontinental passenger demand and nearly 80% of short haul European traffic is conducted for "private" reasons – and that private (Lufthansa's terminology, aka leisure) travel grows faster than the business travel segment. It is also as much to do with trying to providing an effective competitive response to the super-connectors.

As part of the SCORE programme it had already started the transfer of all point-to-point non-hub short haul services to its "low-cost" germanwings subsidiary. This should be complete by the spring of 2015; and it now aims to increase the fleet to 60 A320s from the current 51. The Eurowings regional subsidiary will have its 23 90-seater CRJs replaced with an equal number of A320s from April next year, and will develop operations in Lufthansa Group's "home markets" – not only Germany, but also Austria, Switzerland and Belgium – with the first non-German base planned to be at Basel.

More contentiously the group stated that it is planning to establish a long-haul low frills airline under the Wings brand (possibly to be called Cont-Wings or Intercont-Wings). It has been in discussions with THY, possibly to use the LH-TK joint venture SunExpress (which has a German operation with its own AoC) as a seed for the start-up. The new airline is expected to start services at the end of 2015 initially with seven 767s or A330s flying from Düsseldorf, Köln or Munich. If it is successful it would re-equip and expand the fleet with more modern fuel-efficient aircraft.

Spohr tried to explain that this new brand would act as a complement to its existing multi-brand and multi-hub portfolio. It would only operate point-to-point services from the core German, Austrian, Swiss and Belgian markets. It would be an "independent" separate platform focusing on price-sensitive leisure travellers. As a result the "combination of hub-based and point-to-point products creates [an] omnidirectional service offer from all Lufthansa Group home markets".

Lufthansa appears to admit that the growth potential is its classic core European business is limited. Currently its network airlines generate 70% of group revenues; and in this area it will emphasise profitability over growth. It expects that by 2020 the service companies and the new point-to-point airlines will grow to account for 40% of group revenues, up from the current 30%.

The establishment of a long-haul low frills airline may appear to be a risky move, one that could cannibalise traffic from its own long haul operations. However, Lufthansa is the one major carrier in Europe most exposed to the incursion of the Super-connectors in the Gulf and Turkey (see *Aviation Strategy*, June 2014), and perhaps it may be able to make some additional returns by retaining otherwise spilled traffic.

The start-up of yet another European LCC (and Air France next month is expected to announce further expansion at its Transavia subsidiary as part of its own new strategic plan) to counter further expansion of Ryanair, easyJet, norwegian, Vueling and Wizz is starting to make that sector of the industry look increasingly crowded.

Ouigo: SNCF adapts LCC model to TGV

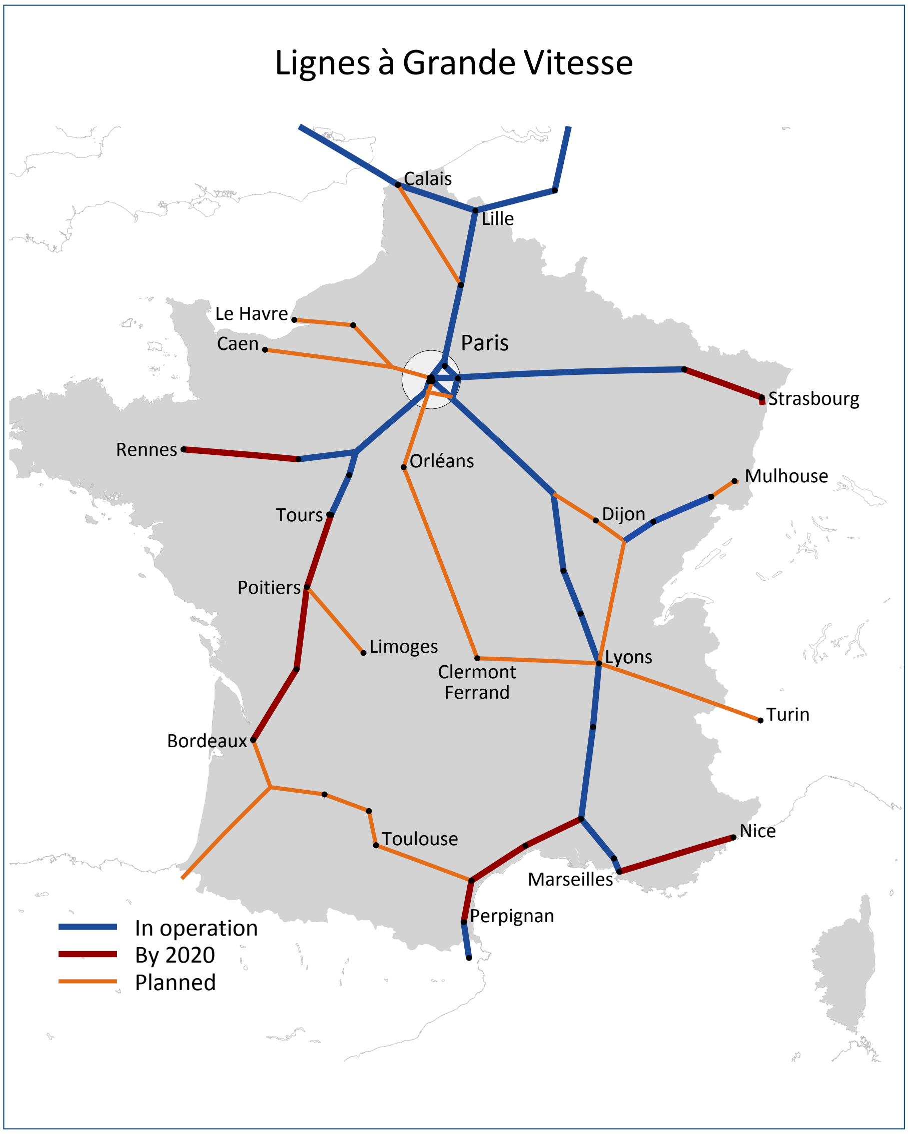
IMAGINE a new low-cost airline based in the outskirts of Paris with a fleet of 480 Airbus A380s adapted to carry up to 1,000 passengers. Fares for a third of seats on its short-haul flights would be as low as €25. Well, if you are in France or on its borders that is what is coming soon to a station near you.

French railways, SNCF (Société Nationale des Chemins de fer Français), have a problem with their hitherto successful high-speed trains, TGV (Train à Grande Vitesse). Revenues are falling and operating costs are rising. One answer is to turn them into low-cost high speed trains, modelled explicitly on easyJet or Ryanair. An initial service started last year to the south of France from a station on the eastern outskirts of Paris. Now SNCF is considering rolling out its Ouigo budget service across the whole high-speed network, leaving only 20% of the operations with a full service TGV.

This the same SNCF whose TGVs obliterated Air France's domestic network when it started running the first high-speed trains between Paris and Lyons in 1981, capturing nearly 90% of the traffic by the end of that decade. It is the same state rail monopoly whose sleek 200mph trains have been imitated all over the world — the very embodiment of French chic, style and *savoir-faire*.

But the fact is: TGV trains hide SNCF's embarrassment. Much of the French rail network is in serious trouble. In the past couple of years it has even started to have the sort of accidents that so tarnished the railway in the UK in the late 1990s and early 2000s. Starting with the Paris region, whole swathes of the rail network are crumbling. Ancient, dirty trains rumble along crumbling tracks with their speed limited to minimise further damage. France spends about as much as other European countries subsidising its railways. But, whereas in, for example, Switzerland, the money goes to keeping the whole network in excellent condition, in France half of it goes to keeping fares low, notably for suburban or regional services. SNCF is paid by regional transport authorities for providing train services judged to be socially and economically useful.

In addition, the state-owned Réseau Ferré de France which owns and operates the tracks uses high tolls on the TGV lines to help pay for



the upkeep of the rest of the network, and these are set to increase steeply. Track tolls, which have risen by a third since 2007, now account for 40% of the average TGV rail ticket. This, combined with falling passenger numbers in the past three years as the great recession has hit France hard, has damaged the finances of SNCF Voyages, the subsidiary that runs the TGV services.

The results for the first half of this year, published at the end of July, saw TGV revenues fall by 3%, continuing a trend of the past three years. Profits tumbled from €389m to €259m and the operating margin slipped again from 11.4% to 8.1%. As recently as 2011 the profit margin was over 14%. The operating margin will erode further as the impact of higher tolls filters through, to levels completely inadequate to service required capital investment and the existing debt burden of about €44billion.

This is the challenge facing Guillaume Pépy, chairman and chief executive of SNCF.

French government finances are in such dire straits as to rule out any possibility of greater state subsidy. Indeed, the government counts on receiving dividends from the railway. The French public would take to the streets to oppose any rise in fares to the level that their phlegmatic British neighbours tolerate so placidly.

One option is to cut back the TGV network, with its 180 origin-destination routes, to concentrate on its profitable core of some 40 routes. Scores of French towns would lose their direct TGV service to Paris. Instead passengers would have to take slow trains using a network of regional hubs, some connected to TGVs. The number of TGVs would be halved to around 240 and the latest LGV (Ligne à Grande Vitesse) — only one third built so far — would simply be abandoned. This option would go down badly with politicians so it is probably only being discussed to scare the powerful trade unions into accepting drastic changes. (There was a damaging ten-day strike earlier this year.)

The second option would be to go all out for growth, cutting fares across the board to raise passenger loads and increase train usage from barely six hours a day to around 15 — the same utilisation that LCCs aim for. The trouble with this policy is that, with parallel labour efficiency improvements, it would leave the TGV business with an annual loss of around €400m according to an internal study at SNCF.

The third option is the most likely to be adopted. This consists of changing working methods and timetables to get 15 hours a day out of each train, with a root-and-branch approach to improving labour productivity, cutting costs and implementing an LCC-type operating model.

The Ouigo trains are to have 20% more seats crammed into their double decks, with comfort levels reminiscent of Ryanair. There is no buffet car. Passengers have to buy tickets online and turn up 30 minutes before departure to facilitate boarding. There are no ticket offices or uniformed staff hanging around stations doing nothing, as only railway people do. Only hand baggage is allowed free; anything else is charged separately. The team of four onboard staff have to go through each carriage at the terminus to pick up the rubbish and tidy the seats, just like on a budget airline. Children travel for a low fare regardless of destination.

The vision for SNCF in 2020 is becoming clearer, though there is likely to be blood on the tracks before it is achieved. As for easyJet, France's second largest airline, and the other LCCs (and the network carriers) a new dynamic is entering short-haul competition.

Euro-charters: TUI become one

PLANS by TUI AG and TUI Travel to merge and become the world's largest integrated tour operator/tourism business have been met with a mixed response from the analyst community. Is scepticism justified, or would a successful merger help to slow down the underlying structural decline of the all-inclusive tour (AIT) market?

Aviation Strategy has been analysing the slow but steady decline of the AIT market since 2002 (see the March/April 2013 issue for our last article), and the underlying pattern remains absolutely clear. As can be seen in the chart below, UK charter passengers fell again in 2013 (for the 12th year in a row), by another 1m passengers, and the trend shows no sign of stopping. In terms of the split of scheduled versus non-scheduled capacity offered by UK airlines (see chart below), non-scheduled ASKs also dropped again last year — to 16%, its lowest ever proportion.

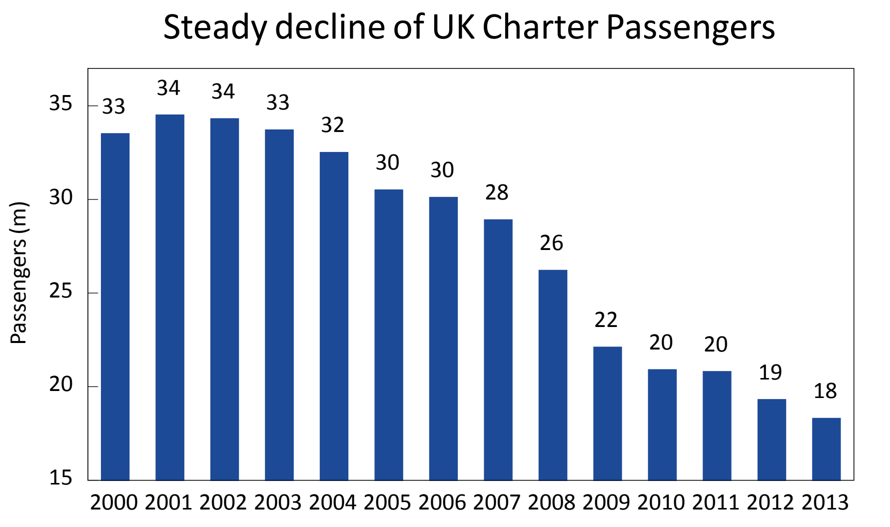
Structural woes

While economies in the main European outbound markets are improving (the UK's faster than others), the decline in the AIT market is structural, with the internet allowing travellers to put together their own "packages" of flights and hotels from LCCs and other providers. This process is now so easy that the concept of the high street travel agent seems an anachronism. While those travel agents still exist, the number of them in the UK and across Europe has declined relentlessly year after year.

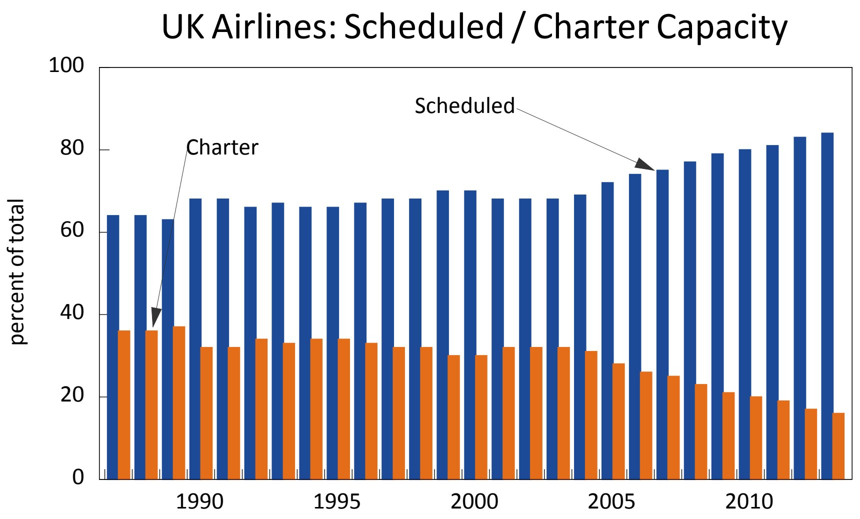
That structural change was refuted or ignored for years by the remaining giants of the European AIT industry — TUI Travel and the Thomas Cook Group — until both embarked on an urgent overhaul of their businesses, mainly by ditching lower margin packages in favour of more profitable specialist holidays and differentiated services.

Of those Big Two tour operators, the UK-based TUI Travel had been the faster to react to the changing AIT market, and in its last full financial year — the 12 month period ending 30th September 2013 — TUI Travel reported revenue of £15.1bn (4.1% up year-on-year), operating profit of £297m (1.7% down) and a profit before tax of £181m (compared with a £201m profit before tax in FY 11/12). In its "underlying" results (which exclude one-off and other items, and adjust for timings of key travel dates such as Easter) for the first three-quarters of FY 13/14 (covering the period October 2013 to June 2014), TUI Travel reported a drop in revenue of 2.9%, to £9.0bn, although the operating loss improved from £213m in Q1-3 12/13 to a £186m loss in Q1-3 13/14.

Analysing the key summer 2014 holiday season (as can be seen in the table on page 7), as of early August TUI Travel had achieved a 2% increase in the average selling price (ASP) of its mainstream holidays booked out of the UK, and though the number of holidays sold decreased, overall revenue rose by 1%. TUI Travel says that "there has been an increased level of capacity in the wider UK market this year, particularly around sales of commodity product". However TUI's efforts to offer more "unique" holidays within its UK mainstream offer (ie, distinct products such as *Splashworld* and *Sensatori*) "puts us in a strong position relative to our competitors", the company says. In addition, more and more UK mainstream



Source: UK CAA



Source: UK CAA

holidays are being sold online, now accounting for 51% of all summer holidays sold.

However, in France a 3% increase in ASP was met with a 13% reduction of holidays sold, leading to a 10% fall in revenue out of France — although it must be pointed out that TUI Travel significantly cut capacity offered out of the country in the 2014 summer season.

But the mainstream UK markets' importance overall to TUI Travel meant that total European mainstream ASP rose 1% in summer 2014, with holidays sold down 2% and revenue down by 1%. TUI's accommodation wholesale business had an impressive summer; while ASP remained flat the number of customers rose 15% and revenue was up by 16%, driven by increasing demand for accommodation in Latin America and Asia.

The merger plan

In June this year came the news that TUI Travel and TUI AG (the Hanover-based travel and shipping conglomerate) had agreed a merger in principle. The merger terms involve existing TUI Travel shareholders (other than TUI AG, which already owns 54.5% of TUI Travel) receiving 0.399 new TUI AG shares for each TUI Travel share that they own.

The merged company will be a "German domiciled group", though with a dual listing on the London and Frankfurt stock exchanges and with an anticipated market cap of around €7bn (which would make it a member of the FTSE100).

When the initial end of July deadline from the UK Takeover Panel to firm up the terms of a binding merger was not met, an extension to the 19th of September was agreed — though even after terms are finalised there will be several more hoops to go through before the deal is completed. Most analysts anticipate this to happen sometime in the spring of 2015 — although the "two TUIs" are hoping that it will close earlier, ideally sometime nearer the start of next year. Russian billionaire Alexei Mordashov is TUI AG's largest shareholder, with a 25% stake, and he supports the deal, and it's highly likely that enough shareholders of both companies will nod through a merger agreed by both boards in advance.

Once the deal closes, it will bring to an end an almost constant saga of "will they, won't they?" between the two companies, ever since TUI Travel came into existence in 2007 following the merger of TUI AG's travel assets with UK-based tour operator First Choice. TUI Travel and TUI AG first attempted a merger in 2008 and then again 18 months ago, but failed to agree terms the last time around due to their relative share prices at the time, with TUI AG's shares trading at approximately a 30% discount to net asset value.

At that time Peter Long, TUI Travel's chief executive, declared a merger would "never happen" — a

TUI Travel Summer 2014 Bookings

	Average selling price	Customers	Revenue
Mainstream holidays			
UK	2%	-1%	1%
Nordics	-1%	-4%	-4%
Germany	0%	-1%	-1%
France	3%	-13%	-10%
Other	1%	0%	0%
Total mainstream	**1%**	**-2%**	**-1%**
Accommodation wholesale	0%	15%	16%

Note: As at early August, compared with figures at the same date a year earlier.

TUI Travel Fleet

	Thomson Airways	TUIfly	Jetairfly	ArkeFly	TUIfly Nordic	Corsair International	"Unassigned"	Total
A330						4		**4**
737-700		5	5					**10**
737-800	33	25	14	5	6		(5)	**83 (5)**
737 MAX							(60)	**(60)**
747-400						3		**3**
757-200	15							**15**
767-300	5		1	4	2			**12**
787-8	6 (1)		1	1 (1)			(5)	**8 (7)**
ERJ-190			2					**2**
Total	**59 (1)**	**30**	**23**	**10 (1)**	**8**	**7**	**(70)**	**137 (72)**

Note: orders in brackets

position he restated publicly as late as this March. Since then, however, both companies' shares have risen significantly (see chart opposite), and evidently Long has changed his opinion. He's now slated to become joint chief executive of the merged company with Friedrich Joussen, who is currently CEO of TUI AG, until 2016. At that point Long would become chairman, with Joussen taking over as sole chief executive.

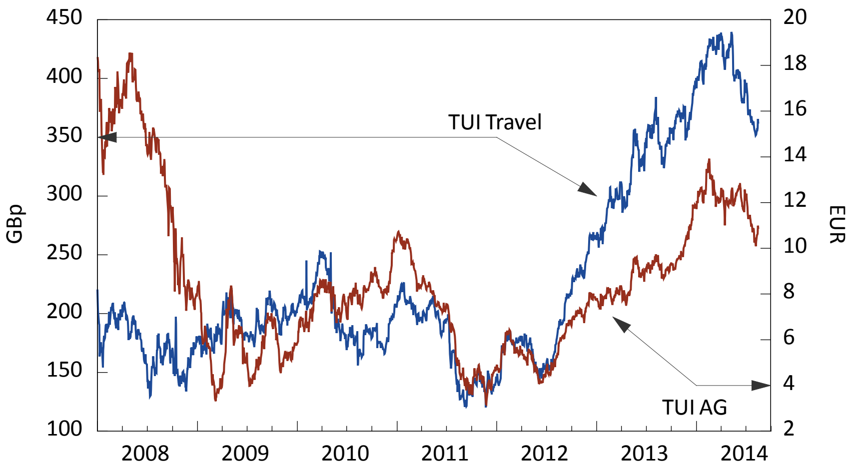
But while the merger will almost certainly now occur, there are mixed opinions from analysts as to whether the deal makes sense. Some analysts are sceptical of the actual synergistic benefits of a merger, while Morgan Stanley analyst Jamie Rollo says the merger is "strategically questionable" for TUI Travel as it will be merging with a weaker business. The absence of a "take-out" premium also makes the deal appear unappetising to some.

The initial figures from the two TUIs are that the move will enable at least €45m of cost savings at the merged entity each year, which would be fully realised in the third year after merger. Most of those savings will come from eliminating double functions in the current head offices. The two companies actually have four headquarters; two in Germany and two in UK, as one location in each country is a corporate headquarters and one is the head office of the local operating company. The merger will also release a one-off cash tax benefit, which would have amounted to around €35m if the two companies had been combined in FY 12/13, it is claimed.

However, there are likely to be one-off exceptional costs of approximately €45m to realise those synergies, TUI says, and the criticism from some analysts is that this level of cost savings is not significant.

As for the strategic rationale for the merger, from TUI Travel's point of view the main strategic benefit is access to TUI AG's hotel and cruise ship assets — the German company owns more than 230 hotels around the world, offering around 155,000 beds, as well as seven cruise ships. When announcing the proposed deal Joussen said that: "The fundamental belief we both have is that vertical integration drives value. It increases the potential for differentiated products on the tour operator side, and at the same time it decreases the risk of building new properties, of actually owning, or not always owning but operating new hotel and ship properties on the AG side, because we can manage occupancy through direct market access."

TUI and TUI AG share price performance



The two TUIs also emphasised that the combined group will become "a pure play leisure tourism business", so non-core businesses will be "run separately and maximised for value" — and they include:

- TUI Travel's accommodation wholesale and B2C businesses, which in FY 12/13 had a total transaction value of £2.1bn and brought in EBITDA of £40m;
- TUI Travel's "Specialist & Activity" travel businesses, which had revenue of £1.4bn and EBITDA of £41m in 12/13;
- TUI AG's 22% stake in the Hapag-Lloyd Container Shipping company (which will definitely be sold, the two TUIs claim).

As Jeffrey Harwood from Oriel Securities points out, there's a significant question as why the online and specialist businesses are being designated non-core because, "not so many years ago, the specialist businesses were seen as the big growth engine in the company". All TUI says on this that is "we are defining non-core as non-synergistic — we haven't said we're going to sell them".

Aviation assets

In the press and analyst briefings that the two TUIs gave on the proposed merger, little was said about the implications for the aviation assets of the merged TUI empire.

In terms of its fleet, the TUI Travel group contains a total of 137 aircraft, with 72 aircraft on order (see table above). With six separate airlines and brands, the fleet still contains eight different models, with the dominant model being the 737-800, which accounts for more than 60% of the total fleet.

Eight 787s have now been delivered to TUI Travel, six of which are operated by Thomson Airways and with one each at Jetairfly and Arke-Fly, and seven more are on order, although only two of these have been formally assigned to an airlines in the TUI Travel group.

Also on order (but again, as yet not yet allocated to any individual airline) are 65 737s. These include five 737-800s and 60 737 MAXs, with an order for the latter being placed by TUI Travel in July last year (and with an option to buy another 60 of the type). Delivery of the 60 firm 737 MAX orders will start in January of 2018 and the last aircraft will be delivered in March 2023. 40 of the aircraft will be 737 MAX-8 variants and 20 will be 737 MAX-9 models.

The merger of the two companies will have little direct impact on these airlines, though of course if the newly-formed company is more robust and performs better as a result, a stronger company is naturally a more stable home for those aviation assets. Set against that though is the fundamental and continuing decline of the AIT market — a trend that the merger of TUI Travel and TUI AG will do little if anything to stop.

Azul: Brazil's regional LCC goes intercontinental

AZUL Linhas Aereas Brasileiras, Brazil's third largest carrier, deploys an unusual but successful LCC business model: providing affordable, high-quality, JetBlue-style service in regional markets throughout Brazil with a fleet of E190/195s and ATR72s.

Now, in its sixth year of operation, the São Paulo-based airline has announced plans to diversify its strategy in a significant way: entering long-haul international markets with a fleet of A330s and A350s.

Azul has stated that it will acquire a long-haul fleet of six A330-200s and five A350-900s and that operating leases were in place with ILFC for three of the A330s and all of the A350s. With the initial A330s Azul will launch daily services from its Campinas hub to the US in December. The A350 deliveries from March 2017 will mark a new expansion phase that could see Azul add flights to Europe.

Entering the Brazil-US routes poses many risks for Azul. It is a competitive market ruled by much larger carriers and powerful alliances. Because of its regional/small city focus and strategy of avoiding too much overlap with Gol and TAM domestically, Azul has not been exposed to much competition. According to its May 2013 filings with the SEC, Azul was the only airline on 70% of its routes and the frequency-leader on another 10%. Azul is also a total newcomer for the international scene; it is jumping straight into intercontinental operations, without testing the intra-Latin America cross-border markets.

Still, the odds are in favour of Azul being successful in the long-haul markets for a number of reasons.

First, Azul will probably get the traffic, because it has sufficient scale and a huge domestic network to provide feed to the international services. The network is centred on a strategically located hub, with great facilities and room for growth.

Azul operates around 850 daily flights, which represent 30% of the total daily flight departures in Brazil. It serves some 100 destinations – roughly the same as Gol and TAM combined in the domestic market.

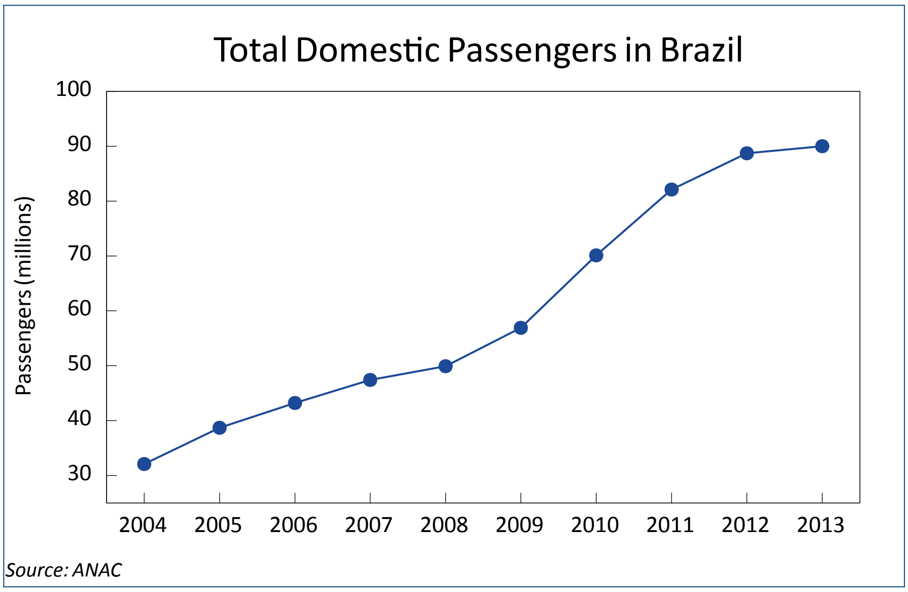
Azul's home base and main hub is at Viracopos Airport in the city of Campinas (1m population), just 50 minutes from downtown São Paulo. The airline operates a secondary hub at Belo Horizonte's Confins.

Azul operates from a brand new $1.5bn terminal at Viracopos, from which it currently offers 150-plus daily departures to 51 destinations. Although some of the cities served are small, Azul covers all of Brazil and offers high frequencies in many markets. Its customers have been asking for US services (which will be important also for the success of the carrier's FFP, TudoAzul).

Second, Azul will be successful internationally because it has built a strong brand. Its low fares, nonstop flights, superior offerings (leather seats, more legroom, free LiveTV at every seat) and its customer focus and fresh approach have gone down well in the domestic marketplace. Azul has been voted "best low-cost carrier in Latin America" four years in a row by Skytrax. An offering suitably modified for long-haul operations should position Azul well in the Brazil-US market.

Third, Azul will benefit from having a strong business traveller customer base. Reportedly 65% of its business is corporate travel.

Fourth, Azul will continue



Source: ANAC

Brazilian Airlines' Domestic Market Shares

	% of total domestic RPKs	
	June 2014	June 2013
TAM	37.5%	39.7%
Gol	35.1%	36.0%
Azul		*12.8%*
TRIP		*3.9%*
Azul+TRIP	17.7%	16.7%
Avianca Brazil	9.0%	6.9%
Others	0.7%	0.7%
TOTAL	**100%**	**100%**

Source: ANAC

growing its domestic market share especially because it is poised to become a major beneficiary of two upcoming government programmes: the planned redistribution of slots at São Paulo's Congonhas Airport and a R$1bn regional aviation subsidy programme.

Fifth, Azul's founder, CEO and majority-owner David Neeleman has a great track record of exploring market opportunities in the airline industry and executing innovative LCC strategies. He co-founded Morris Air in the 1980s (and sold it to Southwest in 1993), co-founded WestJet in 1996 and created JetBlue in 1998. Because of that track record, Azul was able to raise $200m of start-up capital from investment funds in the US and Brazil, making it one of the world's best-funded airline entrants when it began operations in December 2008.

The international plans

Azul received its first A330-200 in June and will begin testing the type on high-demand domestic routes out of Campinas from September 1. Having secured ANAC approval to operate initially 18 weekly frequencies in the Brazil-US market, Azul announced on August 12 that it will launch daily services to Fort Lauderdale on December 1, Orlando on December 15 and New York in mid-2015. Other future US gateways mentioned in the past include Los Angeles and Las Vegas.

FLL is a great choice, because the airport offers easy access to Miami – the top US destination for Brazilians, just 30 kilometres away – at, according to JetBlue, a quarter of the cost levels of American's MIA hub.

Azul will operate red-eyes to FLL and daytime flights to Orlando, thus giving US-bound customers convenient options. At FLL there would be connections to 60 other US cities on other airlines. At Campinas, in addition to flight connections on Azul all around Brazil, passengers can take advantage of free bus services operated by Azul to São Paulo and Congonhas Airport.

Azul's A330-200s will be reconfigured to "establish a new standard of comfort and innovation" featuring lie-flat business class, 34" pitch economy-plus (half of which will feature the ANZ-designed skycouch) and 31" economy. It plans two configurations: a high density 271 seat version (20C, 122W and 129Y), and a lower density 242 seats on two aircraft for longer routes (35C, 52W and 155Y).

In a recent interview with Bloomberg News, Neeleman recently indicated that Azul intends to price aggressively in the São Paulo-South Florida markets. The airline can be expected to undercut Gol, which operates one-stop services in those markets with 737-800s via Santo Domingo. Neeleman also said that he expected Azul's profitability on long-haul routes to outpace that of its domestic network.

At first glance, Azul seems well positioned to compete with Gol's one-stop flights and smaller aircraft. Gol has been in the market since December 2012 and now operates daily São Paulo-Orlando, Rio-Miami and São Paulo-Miami. But there is no guarantee that Gol will stick to the one-stop strategy.

Gol and TAM have strong alliances with US carriers that boost their traffic. Gol is in an exclusive codeshare relationship with Delta on the Brazil-US routes. TAM is now part of Latam, part of **one**world and in a codeshare relationship with American, the leading carrier on US-Brazil routes.

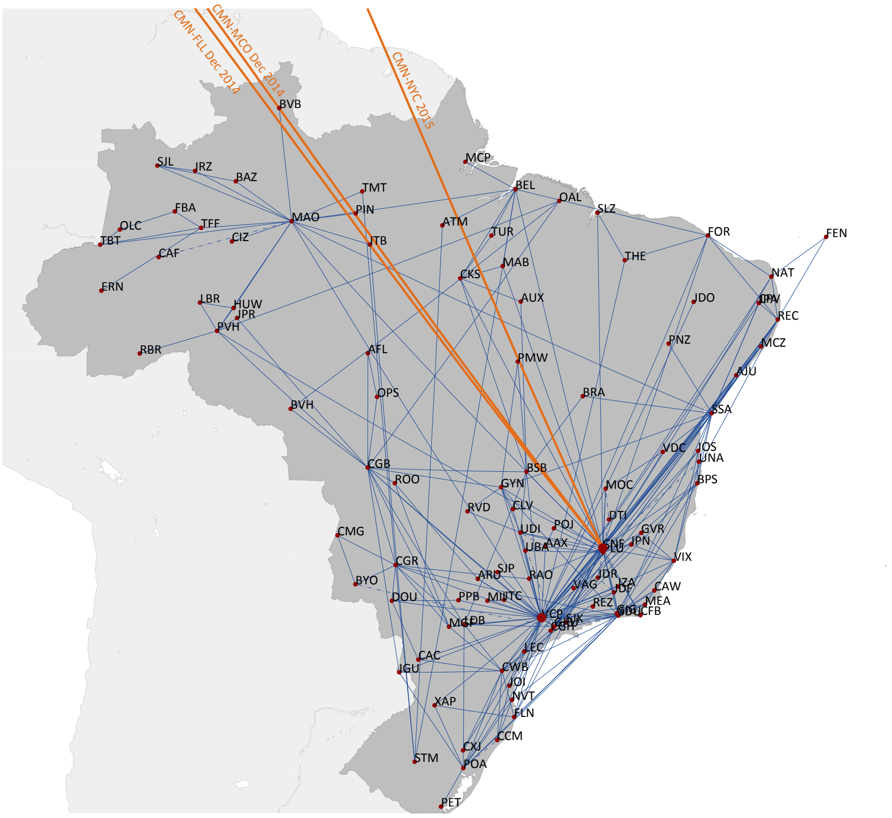
In a surprisingly aggressive response, American will be entering Azul's Campinas hub in December with flights from Miami and New York. The carrier announced it as part of its "winter schedule adjustments". To facilitate this move, American will reduce service to São Paulo's Guarulhos.

There are two interesting things to watch for: how Gol might respond (if at all); and whether Azul will forge an alliance with a US carrier.

Azul could link up with United (Brazil represents a hole in the Star Alliance's global network). But JetBlue would be the most obvious choice now that Azul's initial gateways are known. FLL and Orlando are both JetBlue focus cities. JetBlue is building Latin America service from FLL, but its current aircraft do not have the range to serve São Paulo. Azul could fill that gap. As a bonus, passengers would enjoy similar, very high-quality service and amenities on both carriers.

If and when Azul ventures to Europe, it would then need European feeder partners at its chosen gateways. This year Azul has begun such a relationship on the Brazilian side with Portugal's TAP. (Neeleman has repeatedly stressed that Azul is not in-

Azul Route Network



terested in bidding for TAP when it is eventually privatised.)

Azul's future is bound to include some international operations within Latin America, but in the short-to-medium term the management probably prefers to focus all of its efforts on making the US routes successful.

Azul has prepared for the international expansion phase also by strengthening its management team. In January Neeleman gave up the president's title so that he could devote more time to strategic issues (he remains CEO). The new president is Antonoaldo Neves (ex-McKinsey, ex-Infraero). In July Azul named JetBlue's chief revenue officer Trey Urbahn "chief strategy officer".

Well-positioned in Brazil

Azul has grown extremely rapidly, helped by the ample start-up funds, a $1.4bn Embraer order (with $1.6bn of options) in March 2008 and a large ATR72-600 order in 2010. By its third year (2011), Azul was achieving $1bn annual revenues. Subsequently, Azul boosted its size by acquiring regional carrier TRIP in May 2012; that deal was completed in May 2014 (when the TRIP brand also ceased to exist).

So, Azul has emerged rapidly as a true "third force" in Brazilian aviation, with a domestic RPK share of 17.7% in June. Azul operates in different domestic markets from Gol and TAM. It has brought affordable air travel to a population segment that was not being served by the two largest carriers.

Azul has proved wrong its initial sceptics who argued that it would not be possible to be a viable low-cost, low-fare carrier with RJs and large turboprops.

Azul stimulates demand by providing frequent and affordable air service to underserved markets. Because it operates smaller aircraft, it can serve cities the larger competitors cannot. These attributes have enabled it to attract both business and leisure traffic, build a formidable network and dominate the markets where it is present.

A leading network position and a good yield management system have enabled Azul to achieve significantly higher unit revenues than the other carriers. The PRASK premium, consistently high load factors, high efficiency and a competitive cost structure offset the poorer economics of smaller aircraft.

But Brazil may be an especially suitable market for this type of business model, because it has a large number of medium-sized cities scattered around the huge country that have much economic power, and hence travel demand, but cannot support regular operations with 150-seat aircraft. Many such regional markets had considerable pent-up demand. And demand has remained strong as many of those regions have continued to see double-digit growth even as Brazil's GDP growth has slowed.

Still, Azul is believed to have attained only marginal profitability. The company has not disclosed financial results for the past five quarters, but its earlier SEC filings provided the information up to and including 1Q13. Azul lost R$194m on an operating basis in its initial two years and then earned R$21.1m and R$8.6m operating profits in 2011 and 2012, respectively (just 1.5% and 0.3% of revenues). The results improved in 1Q13, when the operating margin jumped to 10.3% from 5.9% a year earlier (evidently a seasonally strong period for Azul), but TRIP's heavy losses dragged down the pro-forma consolidated results. Add to that merger integration expenses, continued ASK growth and record-high fuel prices in Brazil, and it is hard to believe that Azul's earnings could have improved significantly from the 2011-2012 level.

But there is more growth and profit potential for Azul in the Brazilian market. The airline will gain access to São Paulo's centrally-located Congonhas Airport in the coming months – something it has coveted for years, after having only one weekly (Saturday afternoon) slot at that airport.

The Brazilian government is looking to break TAM's and Gol's near-stranglehold of slots at Congonhas. The plan is to create some new slots and redistribute existing slots, based on a carrier's domestic market share and operational reliability. The process was expected to begin in late August, with a second phase following in March 2015.

The proposed new rules strongly favour Azul, which has estimated that it could receive 14-16 daily slots at Congonhas. Avianca Brazil would be a lesser beneficiary. Gol and TAM currently hold around 200 weekday slots each, and Avianca Brazil has 12. Avianca Brazil's CEO has been quite vocal in criticising the allocation method as unfair.

Neeleman has indicated that Azul is likely to use the Congonhas slots to strengthen services to smaller cities.

There will also be a regional aviation stimulus programme, under which the Brazilian government will pay subsidies totalling R$1bn ($440m) in 2015 to encourage airlines to develop regional services. The government wants to make air fares competitive with long-distance bus fares. The programme could subsidise up to 20% of Brazil's domestic routes. The broader aims of the subsidies and the massive infrastructure investment programme already under way at regional airports are to ensure that 95% of Brazilians live within 100 kilometres of an airport.

In August Brazil's airlines were still waiting for details of the programme, which also requires approval from Congress. TAM, Gol and Avianca Brazil are all considering entering the regional market, and for Gol at least it would mean acquiring a new aircraft type. But the extent to which those airlines will participate will depend, among other things, on there being a guarantee that the subsidies will continue beyond 2015, given all the political uncertainty in Brazil.

Azul needs such guarantees much less. The airline has said that the programme would provide subsidies in cities that it was already planning to serve, though the subsidies might accelerate its entry to some of those markets and help compensate for high fuel costs.

Azul is best-positioned to benefit from the regional programme, because it already has the right aircraft types and because it knows how to operate to small cities. Azul has said that it could add 6-8 new cities in the first year of the programme.

According to *Valor Economico*, Azul's president Nevos estimates that the subsidy would reduce Azul's regional fares by 10-25%. Around 25% of the subsidy collected by Azul would come from flights already operated; the rest would come from new destinations, increased frequencies and new direct connections. Nevos estimated that Azul would need 10-20 new E-jets and possibly 10 more ATRs.

Azul's domestic fleet currently consists of about 140 aircraft – 77 E190/195s, five E170s and 58 ATR72s. There are 11 E-jets on firm order. At Farnborough Azul signed an LoI with Embraer for up to 50 E195-E2s (30 firm and 20 purchase options). The E195-E2 is the largest of the updated E-jet family (Azul's will have 132 seats), and Azul will become the type's first operator in 2019. Of course, those aircraft will be too late for the regional stimulus plan.

IPO prospects

In May 2013 Azul filed plans to raise up to R$1.1bn ($484m) in offerings in the US and Brazil, but those plans had to be shelved last summer due to bad economic and market conditions. Brazil was seeing faltering GDP growth, rising inflation, currency volatility and a wave of anti-government protests.

This has been another difficult year in Brazil. The World Cup hassles, anaemic GDP growth (current projections for 2014 range between 0.7% and 2% growth), inflation at 6.5% and October's presidential election have meant that there has not been a single IPO in Brazil in 2014. Azul formally withdrew its IPO registration in July.

Because of the aircraft leasing deals, Azul has no urgent need to raise funds, but after six years it is under pressure from its investors (which include TPG with a 10% stake) to go public. Azul is reportedly looking to revisit the IPO plans in December or January. One potential benefit of this delay is that Azul may then be able to raise more funds, because it will be a larger and more diversified airline.

By Heini Nuutinen
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Heavy going for all-cargo airlines

The global recession that started in 2008 clearly depressed air cargo demand more than passenger demand, and high fuel prices have added to the industry's problems. But with most major economies around the world now recovering, it would be reasonable to assume that the air cargo market would turn up in parallel. However, that isn't proving to be the case, and more fundamental changes to the structure of the market appear to be taking place.

According to IATA the twin drivers of weak demand and increased belly capacity on passenger aircraft meant that air cargo industry's yield fell in 2013 for the third year in succession. Air cargo tonnage increased by less than 1.1m tons between 2010 and 2013 – but revenue decreased by 10.4%, to $67bn, over the same period.

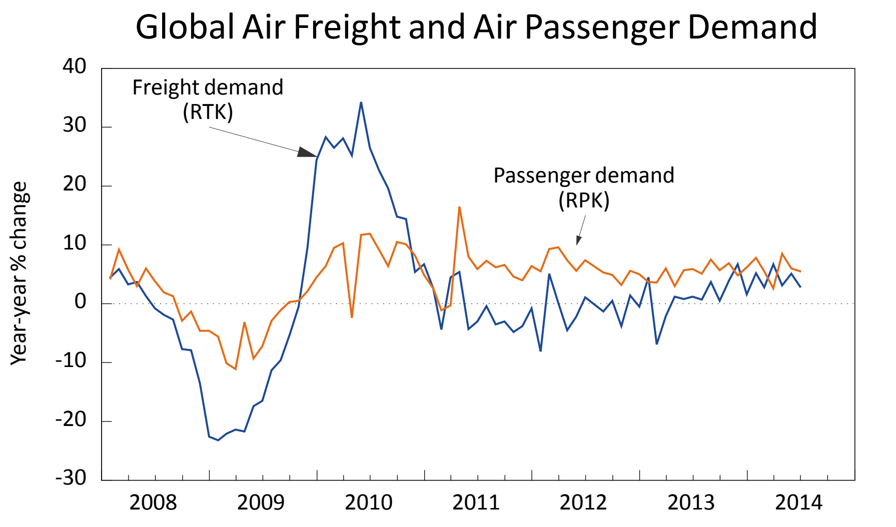
Tony Tyler, IATA's CEO and Director General, said that: "2013 was a tough year for cargo. While we saw some improvement in demand from the second half of the year, we can still expect that 2014 will be a challenging year. World trade continues to expand more rapidly than demand for air cargo. Trade itself is suffering from increasing protectionist measures by governments. And the relative good fortunes of passenger markets compared to cargo make it difficult for airlines to match capacity to demand."

Boeing's biennial World Air Cargo forecast was last published in 2012, but even then the manufacturer noted: "More worrisome is the slowing long-term growth trend. Since 2001, world air cargo traffic has only grown 3.7% per year. The global economic downturn, rising fuel prices, and improving surface transport mode options have dampened air cargo growth". However it added that "On the other hand, long-term projected economic and international trade growth, the continuing globalization of industry, increasing adoption of inventory-reduction strategies, and ongoing renewal of the world freighter fleet with more efficient capacity should help world air cargo traffic growth return to a rate closer to historic norms."

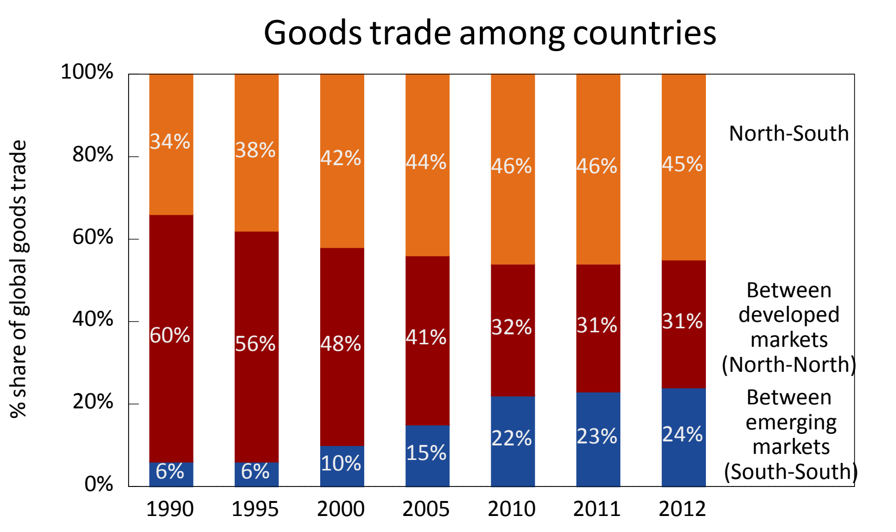
In that report Boeing observed that freight yields have declined at an average rate of 4.2% per year over the past 20 years, although it points out that "the most recent decade saw a slight yield increase of 0.9% per year, compared to the 9.0% average annual decline recorded in the preceding decade".

Airbus's latest Freight Forecast was published more recently, in October 2013, and stated: "There is no disguising the difficulties faced by freight carriers in recent years. On a worldwide basis, freight traffic growth has been impacted in the years following the global financial crisis that struck in 2008, and this has very clearly affected air freight. These recent difficulties, combined with pressure from other modes of transport have caused some to question whether there has been a longer-term shift away from air freight."

On the other hand, even with a relatively small volume share of the global cargo market (and even if it is shrinking), the value share of air cargo is substantial – estimated at around 30% of the value of all cargo transported. And though weak, overall cargo demand is still growing. Today 35% of goods produced



Source: IATA



Source: Comtrade/MGI

across the globe cross national borders (compared with 20% in 1990), according to a report by MGI, which adds that the flow of goods internationally has now recovered from the global recession and is higher than its pre-recession peak of 2007.

However, the MGI report adds that the direction of the trade in goods internationally is shifting, and that "emerging economies now account for 40% of goods flows, and 60% of those go to other emerging economies — so-called South-South trade". In fact South-South trade has quadrupled its share of the global goods trade since 1990 (see chart above), and that share is of a sharply growing overall market in global goods; the market was worth \$3.3 trillion in 1990, but increased to \$17.5 trillion in 2012.

This has major implications for airlines, and signals a need to develop freight routes into these emerging economies. But at the same time as a shift in *where* international trade is occurring, there is also a shift as to just *how* goods are being transported internationally, with air cargo starting to see the effects of a "mode shift" — a switch away from air to surface transport.

Modal shift to sea

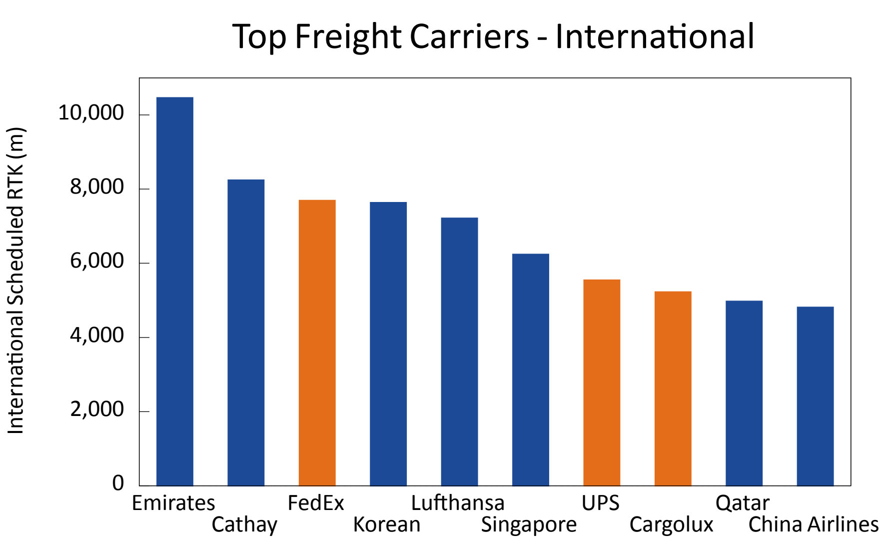
An analysis by Seabury presented at the IATA World Cargo Symposium held in March this year revealed that the "market share" of air has dropped from approximately 3% of total international containerized trade in 2000 to around 1.7% in 2013, with average annual growth in ocean trade over the 2000 to 2013 period of 7.4% significantly exceeding growth in air shipments over the same period, of 2.6%.

However, Seabury says the underlying cause of this loss of market share for air shipment was only partly due to the mode shift; there were two other factors.

First, there is a "commodity mix effect", with higher growth of products that are typically shipped by sea versus those that are shipped by air; an example of this is higher growth of 'raw material' commodities.

Second, there is also a "value effect", with higher growth of cheaper products, which typically require cheaper sea freight — such as higher demand for 'low-end T-shirts' manufactured in China and sold in western Europe by discount retailers.

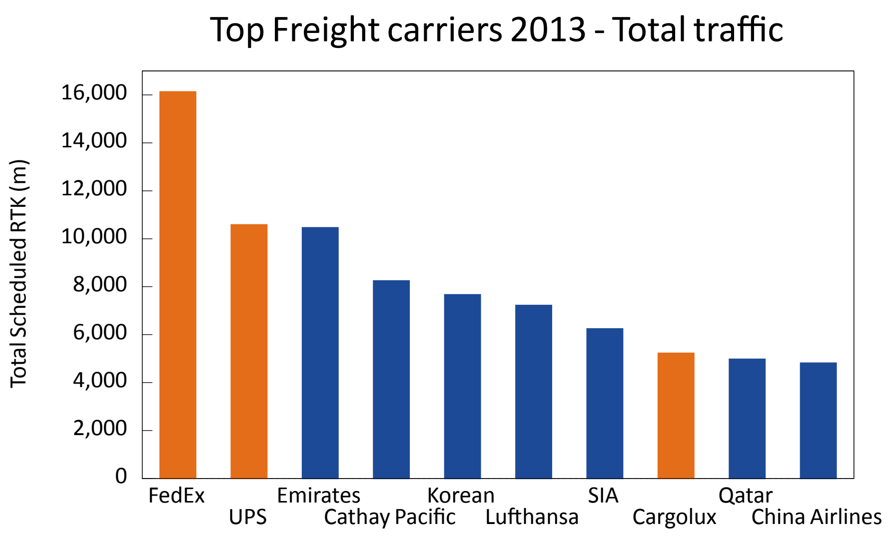
But even stripping out the effects of commodity mix and value, the modal shift is still significant, and it occurs across all product groups. The four biggest shifts from air to oceanic cargo (excluding commodity mix and value effects) over the 2000 to 2013 period have been in high technology goods, fashion goods, perishables and raw materials.



Source: IATA WATS

Fred Smith, CEO of FedEx, points out that a unique factor in the air cargo sector is the miniaturization of electronics which represents about half of all tonnage transported by air. He says: "Not only is there less weight being transported, but price reductions driven by technology have reduced the value-per-pound. New product introductions that require large main-deck freighters have slowed considerably as the market for electronic devices has been satiated."

This shift from air to ship cargo is more prevalent on certain routes, particularly intra-Asia, Transpacific (from Asia to the Americas) and from Asia to Europe. The link between all these markets is Asia, which clearly is growing in importance in world trade, and yet routes to, from and within the region are switching more and more cargo from air transport to ocean shipping.



Source: IATA WATS

The battle for air cargo

Given these structural challenges, what are the implications for air cargo carriers? As can be seen in the chart on page 15, the top two cargo airlines in 2013 (by total scheduled freight tonne km carried) were the two "integrators" — FedEx and UPS, which between them carried almost a third of all freight carried by the top 10 carriers.

Those statistics though are skewed by the fact that Fedex and UPS have huge businesses in the US, and if this is taken out (so as to consider international freight only), these integrators fall down the ranking (though they are still substantial international freight carriers — see chart above). But the leading international freight carrier is Emirates; and Cargolux is the only all-cargo airline in the top global freight carriers (see *Aviation Strategy*, June 2014 for a profile).

Many cargo analysts believe that the all-cargo airlines will not survive the challenge from Emirates and others, with one saying: "There is so much passenger belly hold capacity that freighter operators are having to compete on price, which is hurting their yields. Load factors at the moment are relatively good – sales are not a problem; it's price that is the issue."

Certainly more efficient, modern aircraft, such as the 777-8/9, 787 and A350 not only have belly capacity but are operated on origin and destination long-haul routes – often into Asia, which is a direct threat to all-cargo carriers.

While demand for air cargo is increasing (albeit slowly) year-on-year, it's not rising as fast as the growth in passenger aircraft capacity, thanks partly to huge order from the Gulf's super-connectors (see *Aviation Strategy,* November and December 2013, and February 2014). Between them, Emirates, Qatar and Etihad have 504 widebody aircraft on order, and of course these passenger aircraft will arrive with an equivalent uplift in belly capacity.

Looking at the current Airbus and Boeing order book, there are 2,648 widebody passenger aircraft on firm order, with one analyst estimating they will offer the same capacity as around 520 777Fs. That's substantially larger than the outstanding firm orders for 120 dedicated freighter aircraft from Airbus and Boeing.

Airbus forecasts that the dedicated freighter fleet will grow from 1,645 as at the beginning of 2013 to 2,905 by 2032, with more than 870 new-build freighters being required over the next two decades, plus another 1,859 passenger aircraft being converted into cargo carriers. For its part Boeing predicts that the freighter fleet will increase from 1,738 as of 2011 to 2,198 as at 2031, with 935 new production aircraft and 1,819 freighter aircraft converted from passenger models.

Chance to survive?

All this spells trouble for the pure all-cargo airlines. Some are responding by retiring or parking older freighters that are no longer fuel efficient, but others are taking a more drastic option. Evergreen International Airlines, for example, was an Oregon-based all-cargo specialist that was established back in 1975 and which operated a fleet of 24 747s until it ceased operations in December 2013, after the cargo market became tougher and the company found it difficult to service its large debts.

What else can the all-cargo carriers do to avoid demise? One answer may be to partner with passenger airlines, though the major global carriers will have little if no need to add what may be marginal freight capacity compared with their existing belly hold. Alliances with medium-sized passenger airlines are potentially more feasible, with all-cargo carriers adding dedicated onwards cargo capacity into key trading zones as extension of passenger routes.

Worryingly, surveys of freight forwarders identify price as the only sure way that air cargo can reverse its share of overall cargo carried, and that's the one area to which all-cargo carriers are most vulnerable, since freight is their only revenue stream. The massive passenger airlines, however, are more flexible in the rates they will take in order to fill their belly holds (though of course in public they say they maintain the highest possible freight rates).

In March this year Des Vertannes, IATA's global head of cargo, said that one way the air cargo industry could fight back against the encroachment of ocean transport is by reducing average end-to-end transit times significantly; the average end-to-end transit time for air shipments is between six to seven days, and according to historical data that transit time has stayed the same since the 1960s.

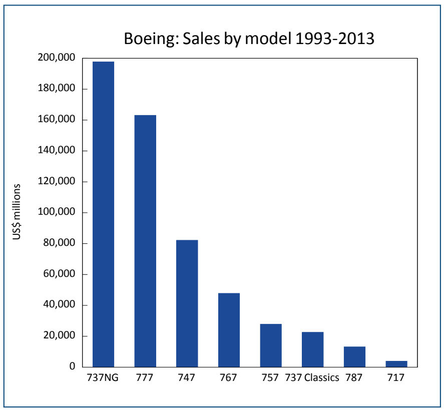
Faster transit "would really make a difference to our value proposition; faster delivery times, coupled with competitive quality benchmarking and more efficient processes, will enable air cargo to compete and win new business." He added that he was certain the industry could meet that goal by the end of the decade — but that's a relatively long timeframe for a sector under such pressure.

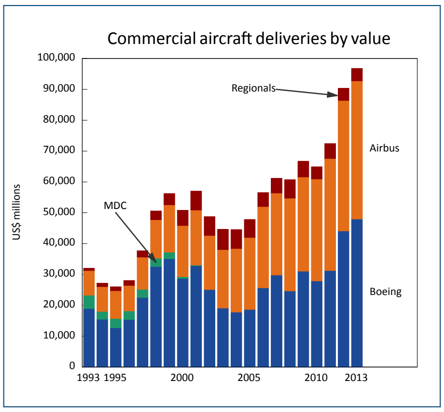
Manufacturing trends

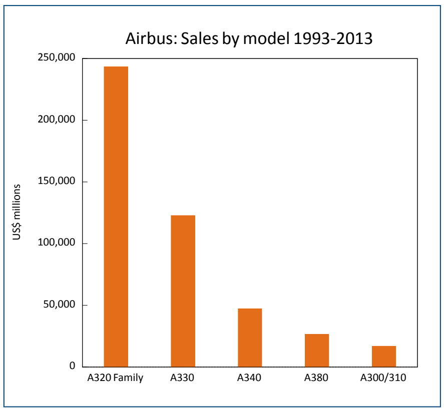
Ed Greenslet has produced an intriguing analysis of commercial aircraft manufacturing trends in his *Airline Monitor* by tracking total sales using estimates of actual prices realised for delivered aircraft (rather than list prices). Looking at the overall trends, two things stand out. First, the steady rise of Airbus to a more or less equal position with Boeing. Second, with \$97bn delivery value last year, the current peak dwarfs previous cyclical highs. 2014 and 2015 are likely to be higher still.

The analysis also reveals the dependence of the two manufacturers on their core products. For Boeing this has been the 737, accounting for 40% of sales over the past 20 years, and the 777, accounting for 29%. Now, of course, both these types are being replaced by the 737MAX and the somewhat problematic 787.

For Airbus the A320 Family (A318 through to the A321) has accounted for about 53% of its commercial revenue, which emphasises the importance of the A320neo project. The A330 is the other mainstay of the Airbus portfolio, with 27% of sales; again a neo version is planned, while the A350 program continues to suffer delays. The A380, despite its high profile, has only accounted for 6% of revenues so far.







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