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Aer Lingus: Pricing the Shamrock

This issue includes

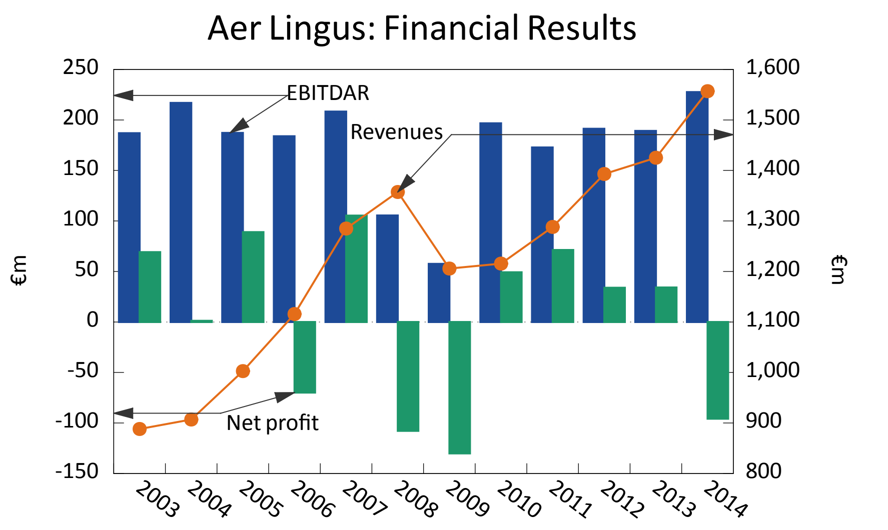
AER Lingus’ independence has been in question since it was privatised in 2006 through an IPO on the Irish stock exchange (at €2.20 a share). Within weeks of the initial flotation local competitor Ryanair had launched a bid at €2.80 a share, and eventually built up a stake of 29% in the Irish flag carrier. The takeover attempts by Ryanair have consistently been politically rebuffed at local, EU (and, strangely, UK) levels. Etihad meanwhile built a modest investment and tried to interest Aer Lingus in its peculiar alliance strategy. In December IAG weighed in with a bid to acquire the company finally persuading the board to recommend an offer of €2.55 a share (including a €¢5 per share dividend) valuing the company at €1.3bn.

The issue is politically sensitive. When the airline was privatised eight years ago the government retained a 25% stake but insisted that it had a veto on any sale or transfer of slots at Heathrow. From a strategic point of view the Irish government wants to ensure that there are sufficient connections from Dublin, Shannon and Cork into London’s hub airport to guarantee long haul connections from Ireland to the rest of the world through Europe’s prime gateway.

The Heathrow slots are probably the most valuable of all Aer Lingus’s assets. Following BA’s acquisition of BMI in 2012, EI is the third largest operator by movements at London Heathrow after BA and Virgin Atlantic. The valuation of slots at Heathrow is a particularly arcane subject — *Aviation Strategy* has been involved in a number of projects in the past few years to validate valuations of slots at the airport. From our analysis it seems likely that the EI slot portfolio at that airport could be worth a conservative minimum of £250m or a quarter of the value that IAG is offering for the company. (This assessment is based on ten good year round daily slot pairs that may attract values of up to £20m apiece — but the company also has a series of seasonal, overnight and oddly-timed slots whose value individually could be much lower).

Once IAG achieved the nod of agreement from the Aer Lingus board it has tried to assuage the political fears. IAG’s CEO Willie Walsh (himself a former CEO of Aer Lingus) spoke before the Oireachtas (the two houses of parliament) promising that IAG would guarantee:

✈ The Aer Lingus slots at Heathrow would not be sold even to other IAG airlines;



Note: 2014 net profit includes net exceptional costs of €180m relating to pension deficit settlement. Source: Company reports.

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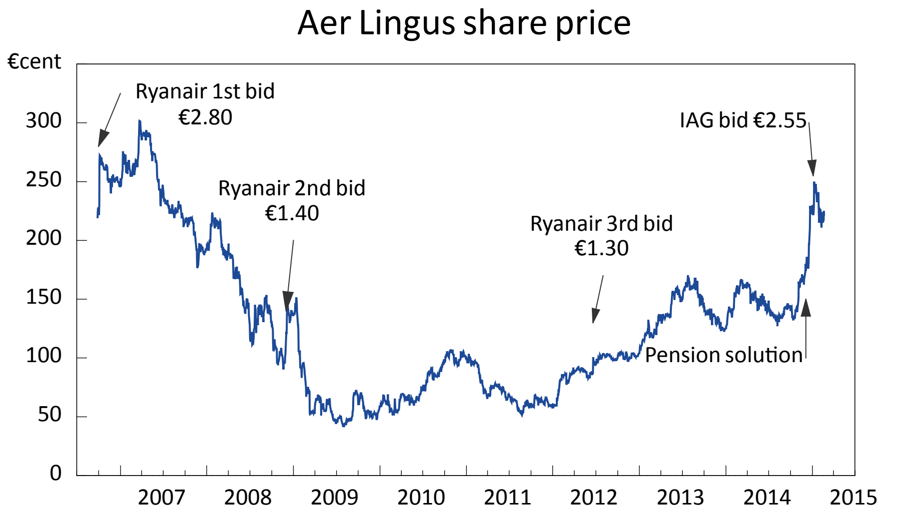


- Aer Lingus' name, head office location or place of incorporation in the Republic of Ireland, cannot be changed; and,
- The Aer Lingus Heathrow Slots would be operated on Irish routes for at least five years and, within that general commitment, three daily slots would be operated on London Heathrow — Shannon and four daily slots would be operated on London Heathrow — Cork.

Essentially, IAG's plans are based on retaining the Irish nationality, the Aer Lingus brand, and international connectivity for the island state.

What's the attraction for IAG?

First, given that Heathrow is so heavily constrained it may be argued that Aer Lingus provides (through access to the relatively unconstrained Dublin airport) the third runway that IAG's British Airways unit will eventually need for expansion. (Even were the Davies Commission to recommend that Heathrow gets a new runway, it would not come into operation before 2025). Dublin (and Shannon) certainly have a competitive advantage in being the only airports in Europe to provide US immigration preclearance. The thought may be that with the benefit of BA's corporate accounts it will be able to divert traffic from the UK regions westward through Ireland on US routes. There could also be marginal group benefits from multi-hub routing through adding a third (fourth, if Barcelona is included) hub to the IAG airline network.

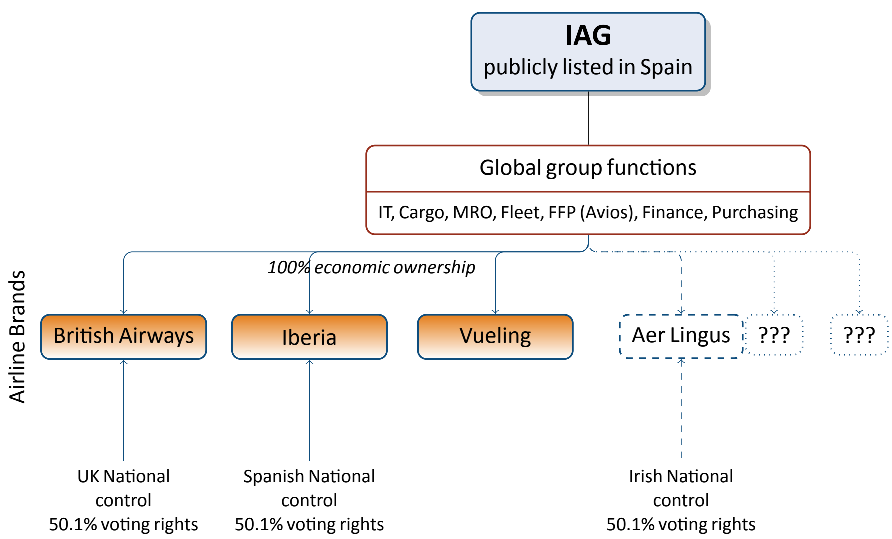
Secondly, it would bring Aer Lingus within the immunised metal-neutral North Atlantic joint venture IAG runs with BA, American and Iberia (and Finnair). Although Aer Lingus is a relatively small player on the route, it is one of the last meaningful European independents with 1.8% of the seats on offer over the pond. It would also presumably promote the idea that Aer Lingus rejoins the **one**world alliance.

Atlantic Seat Share 2014

Alliance/Group	Share
Star Alliance	32.1%
oneworld	31.5%
SkyTeam	19.3%
Virgin Atlantic	7.6%
Aer Lingus	1.8%
Other (13)	7.7%

Note: Europe-North America weekly seats August 2014

IAG Corporate Structure



Note: national control companies required to safeguard bilateral route rights

Thirdly, it would acquire an airline with a good and profitable brand. Although EI has not been exceptionally profitable it has been able to hold sway against the Rottweiller competition from Ryanair, reinvent itself as a quasi-LCC, and (unlike the other European majors) make money on short haul operations.

Fourthly, because of the holding company structure IAG put in place at the time of the merger between BA and Iberia, it should be able to extract reasonable synergies. IT, Cargo, FFP could now be relatively easily subsumed into the group functions, along with increased supplier, fuel and aircraft purchasing power.

Importantly, as Willie Walsh emphasised to the Oireachtas, IAG has no real interest in the Aer Lingus Heathrow slots *per se*. BA has a sufficient number of the total slots at its main base to be able to manipulate its route structure to produce the return BA needs. Apart from anything else the connectivity that the Irish Government seeks through its flag carrier's access to Heathrow is highly beneficial to BA itself.

IAG Passenger Traffic

	Passengers (m)	RPK (bn)
BA	39.6	138.4
Iberia	10.6	42.7
Vueling	17.2	21.4
Aer Lingus	*11.1*	*16.1*

Note: Data for 2014 except passenger numbers for BA, IB and Vueling which relate to 2013

What benefit to Aer Lingus?

First of all, Aer Lingus would gain a resolution to the uncomfortable position of having Ryanair as an unwelcome and potentially disruptive 29% shareholder.

Secondly, the size, power, corporate and equity strength of Europe's third largest (but most profitable) airline group will allow a significant level of protection against the vagaries of the economic and air transport cycle.

In addition there is likely to be a redivision of the routes between London and Dublin (the strongest O&D route within Europe) which (competition authorities' concerns notwithstanding) should significantly improve returns on what we believe is one of Aer Lingus's most profitable routes.

Fourthly, the corporate power of the BA network, the Avios FFP currency, the North Atlantic joint venture, and maybe the **one**world connections, could provide significantly greater connectivity and more security in expanding the long haul network.

Competition authorities' reactions

The EU is likely to look (as always) at direct competition concerns. Its main focus is likely to be on forcing the combined entity to allow access to others on to the DUB-LHR route, with perhaps some forced disposal of slots to allow competitors to offer rival services. This in itself will raise interesting questions: which carrier realistically will be able to compete against BA/EI, unless it be Ryanair or easyJet. In which case this could prove to be the catalyst to allow the first real LCC into Heathrow.

On the other hand the UK competition authority is probably going to rub its hands in glee in having got rid of the thorny problem of trying to force Ryanair to sell its stake in Aer Lingus to below 5%.

Bouncing the ball in the other court

Meanwhile, the Irish Government appears to have repulsed the first salvo from IAG. It has stated that it needs more assurance on jobs and growth prospects before it would consider selling its 25% stake. In particular it seems to seek "firm commitments and details" on how Air

Lingus's transatlantic routes would be expanded and guarantees on connections between Ireland and Heathrow beyond the five years promised by IAG. As Paschal Donohue, the Irish Minister of Transport stated, "the information and commitments that have been provided to date do not at present provide a basis on which the government could give an irrevocable commitment to accept an offer to dispose of its shares, should one be made by IAG." He added that the government remained "open to considering any improved proposal from IAG".

This now leaves the ball in IAG's court. Willie Walsh has stated that he wants the backing of the Irish Government, and obviously would prefer to acquire full ownership; but that could just be part of the opening gambit. There may be little to stop IAG pursuing an offer for the Irish flag carrier acceptable to the other shareholders that leaves the Irish Government with a 25% minority holding, however uncomfortable that may be on control grounds. Interestingly, Stephen Kavanagh, appointed as Aer Lingus CEO in February, is close to Willie Walsh, not only being his preferred candidate for leadership of the Irish airline, but also a potential top executive at IAG.

The solution will be Irish.

Air Astana: Kazakhstan's remarkably successful airline

Air Astana is a relatively small (3.8m passengers in 2014) but remarkably successful airline based at Almaty and Astana, the two main cities of Kazakhstan, a country roughly the same size of Western Europe but with a population of only 16m.

The airline has little apparent Soviet heritage, being jointly owned by Samruk Kazyna , Kazakhstan's Sovereign Wealth Fund, with 51% and BAE Systems, the British defence company, with 49%, the side-result of a national radar project in 2000. (That project never materialised but the airline did, under Sir Richard Evans, the BAE Chairman, who seconded BAE executives to Almaty.) The country itself is a presidential republic, although President Nursultan Nazarbayev has been in power for the last twenty years and could be described as moderate authoritarian, strongly committed to economic liberalism but with firm political control. One of the fastest growing economies in the world throughout the 2000s, Kazakhstan remains largely dependent on oil, mining and agriculture, although the financial sector has also been expanded. The sovereign wealth fund currently holds over $100bn of assets.

Air Astana's culture is multinational reflecting the ethnic make-up of the country — a mixture of Kazakhs, Russians, Uzbeks and numerous other minorities. Top management is drawn from various European and Asian backgrounds, though the dominant influence is that of Cathay Pacific. Peter Foster, president and CEO since 2005, is ex-Cathay Pacific.

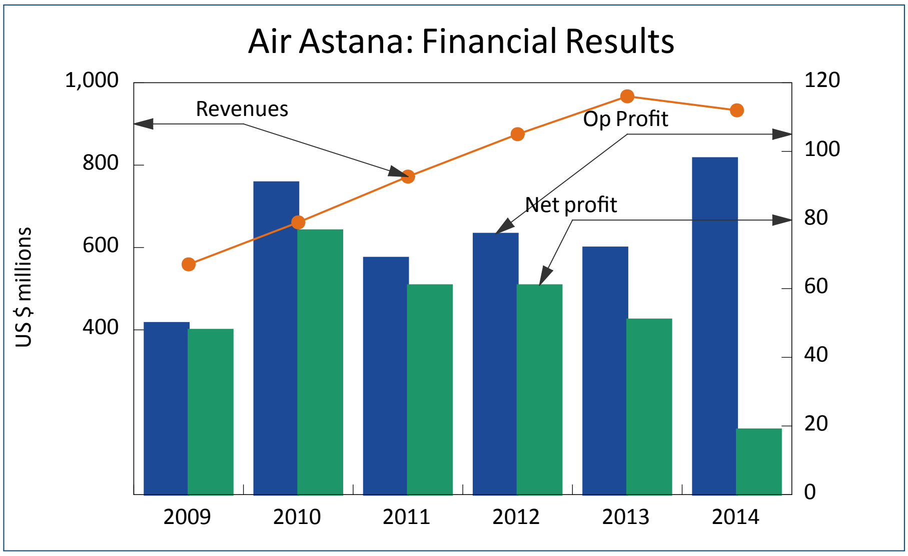
Peter Foster emphasises Kazakhstan's divergence from Russia. Whereas Russia is turning inwards and backwards to a command economy, Kazakhstan is continuing to implement a raft of liberal legislation relating to property and legal rights and to building up a skilled, enterprise-orientated administration — "there is no plan B". In contrast to Russia, Kazakhstan now has no visa requirement for visitors from the USA, UK, Germany, France, the UAE and five other major countries.

The company has a proactive approach to hiring local managers, usually selecting young, inexperienced but Western-educated types who can be inculcated with the Air Astana culture (a bit like the John Swire approach). The Kazakhstan government runs the "Bolashak" programme which sends students to foreign universities, mostly in the US and the UK, on government scholarships.

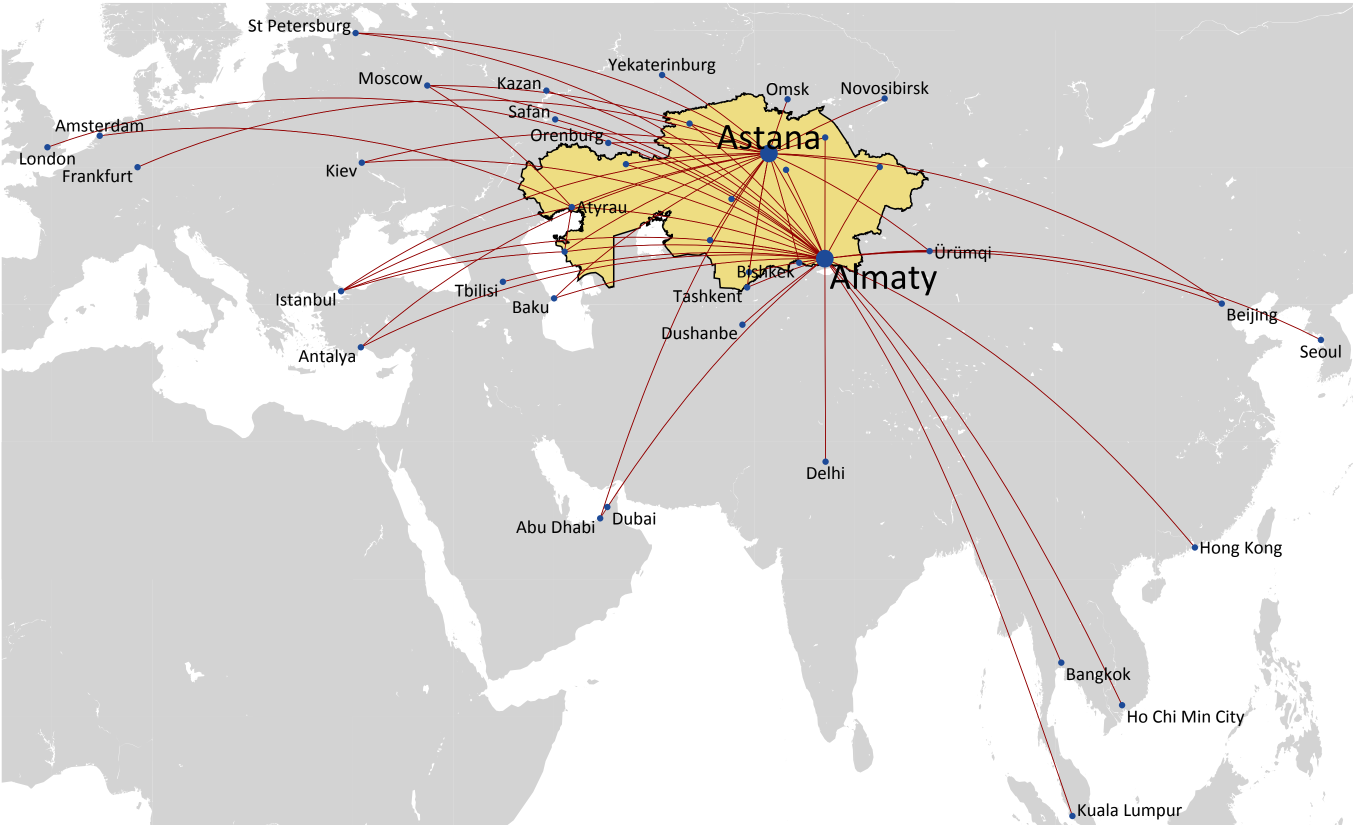
Air Astana Fleet

	In service	On Order
A320/321	13	
757-200	5	
767-300ER	3	
787		2
Embraer 190	9	
Total	**30**	**2**

Air Astana operates an all-Western fleet and has an excellent safety record, but has suffered from the inadequacies of the national aviation authority. In 2009 the Civil Aviation Committee failed an audit by ICAO, resulting in a ban on Kazakhstan airlines by the EU; Air Astana was exempted because of its record but was restricted from adding new capacity to Europe. This led to the ludicrous situation whereby Air Astana was unable to upgrade its service by scheduling its new 757s and 767s on European routes. In April 2014 this restriction was finally



Air Astana Route Network



removed, with the influence of Tony Tyler, IATA Secretary General and ex-CEO of Cathay Pacific perhaps being significant.

The Air Astana model is fairly unique, neither a network carrier nor having any of the characteristics associated with an LCC. It is a full service airline (on board service is very good, the opposite of the ex-Soviet archetype), with an award-wining Business class (four stars according to Skytrax). It is essentially point-to-point with very little connecting traffic at its hubs (though that strategy is being modified — see below). It flies to 60 destinations from its main hubs at Almaty and Astana and secondary Caspian Sea hub at Atyrau, a network which consists of long thin routes and very long thin routes — the average stage length is over 2,000km.

The fleet is designed to match aircraft capacity to low frequency demand on these routes. Hence with only 30 aircraft, it has four very different types — 767-300ERs, 757-200s, A320 Family (A319, A320 and A321) and Emb 190LRs. While average aircraft utilisation is high, especially considering the winter operating conditions, at around 12.5 hours/day, load factor is just 64%.

With its Central Asia hubs remote from competing systems and with weak competition from airlines in the surrounding countries and in the domestic market, Air Astana can focus on yield maximisation (though there is government regulation of domestic pricing). The average one-way fare was about $240 in 2014.

Domestic competition comes from the unfortunately named SCAT, which operates 737s and 767s but is excluded from Western European airspace, and Bek Air, an F100 operator and (intriguingly) a Sukhoi Superjet launch customer. The former national carrier, Air Kazakhstan, has been dormant for the past ten years but plans to re-awaken late this year, flying a fleet of Q400s. Air Astana envisages a feeder role for the new Air Kazakhstan.

The idea of a Central Asian or ex-Soviet open skies, rather than the current bilateral regime, does not appeal to Air Astana, the reason according to Peter Foster being that would mean more unfair subsidised competition. He is particularly annoyed by Russian overflight fees being used to subsidise Aeroflot.

Financial results

Air Astana has been consistently profitable since 2002, and 2014 was for Peter Foster "a superb year". Preliminary operating results for the year show a profit of $97.7m, an increase of 35% over 2013, the highest in the company's history, and representing a 10.5% margin on revenues of $932.9m. By contrast net profit fell by 62% to $19.3m.

A largely unexpected devaluation of the local currency, the tenge, by 19% in February 2014 had severe repercussions for the airline. US dollar debt was revalued by $49m, contributing to a decrease in net profit from $51.4m in 2013 to $19.3m in 2014. The tenge is pegged against the US dollar but the devaluation was provoked by the rouble's collapse against the dollar which in turn overvalued the tenge relative to the rouble, undermining Kazakhstan's competitiveness with its major trading partner. While the debt revaluation could be described as a paper transaction there is a serious underlying problem for the airline as the majority of its costs, notably fuel and finance lease charges, are dollar-related whereas most of its revenues are in the local currency.

In this respect the operating profit was a very impressive result, reflecting well on the flexibility of the company. The plan was to grow ASKs by 13% in 2014 but this was cut back to 3%, with three Russian routes suspended and Ukrainian services cut back. While unit revenues fell by 2%, unit costs were reduced by 8%. This was partly due to the introduction of two 767s with 6% lower unit operating costs than 757s, the scheduled renegotiation of three A320 leases and the contracts in place with Kasakh fuel refineries.

Some 70% of Air Astana's fuel is sourced locally at tenge-contracted prices. Last year the refineries took the hit when, following the depreciation against the dollar, the price of fuel shot up. This year, the collapse in the oil price should have a significant direct benefit for the airline although 50% of the foreign uplift (15% of the airline total) is hedged at $75-85/bbl (current price is around $55), and it is not clear how much the price of contracted local tenge-denominated supplies will fall in response to lower international dollar-priced oil.

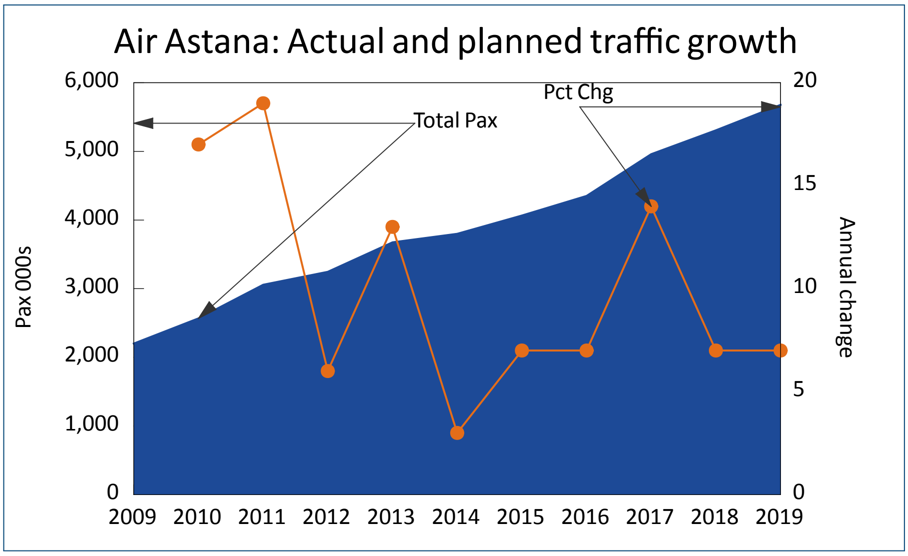
Moreover, Kazakhstan is to a large extent an oil economy, and the impact of the oil price collapse is threatening its short-term prospects. Late last year the EBRD (European Bank for Reconstruction and Development) downgraded its 2015 GDP forecast from 5% to 1.5%. Russia is lurching into a severe recession, with the oil price collapse being compounded by Western sanctions over Ukraine — GDP this year is likely to fall by more than 5%. Russia accounts for 25% of Air Astana's international traffic, but the hope is that the recession there will increase Air Astana's competitive and service advantage over Aeroflot and Transaero.

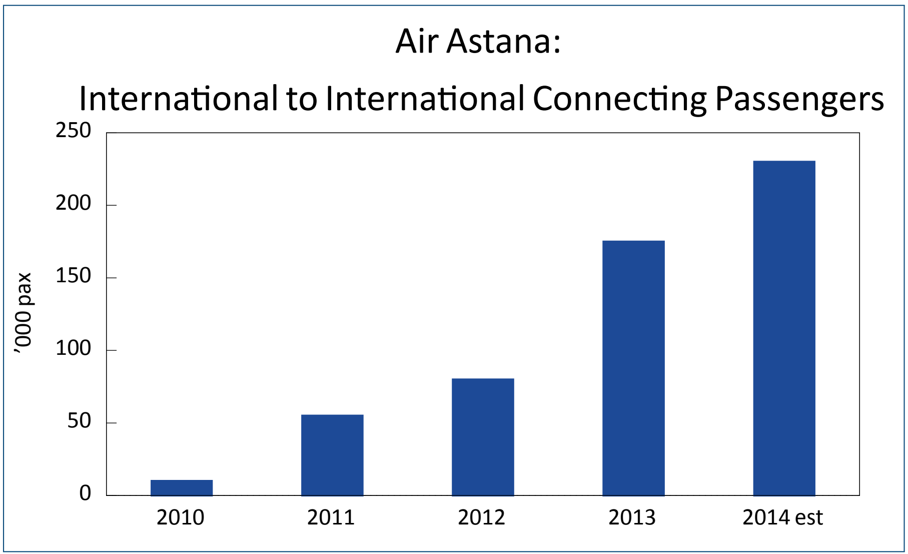
Another tenge devaluation is likely soon. On the futures markets the 6-month forward contract is currently trading at over 225 tenge per US dollar — almost 40 tenge above the official fluctuation corridor of 170 to 188 tenge per US dollar. Azerbaijan, another oil-based economy, has decided to abandon its currency peg to the dollar.

Growth plans and connecting strategy

Following the 2014 retrenchment the plan is to resume traffic growth at about 7% a year (see chart) with a surge in 2017 when Expo 2017 will be staged at Astana, attracting an expected 2-3m visitors. However, given the probability of a tenge devaluation and the difficult economic conditions 2015 may also prove to be a low growth year.

The major new destination planned for 2015 is Paris, with Tokyo slated for 2016, probably in a joint venture with ANA. Korea is a substantial growth market, and new services





will be added from Astana to Seoul in a joint venture with Asiana. The Kazakhstan-China bilateral is being renegotiated this year which should open up Shanghai and Chengdu in addition to the current service to Beijing.

While remaining essentially a point-to-point airline, Air Astana has been developing its transfer business. As the chart above shows international-to-international connections have been growing steadily and now account for 13% of the international total.

The idea is to add passengers without adding capacity — with a 64% load factor there should be plenty of scope — and also to avoid the complexity that comes with network operations. There are three connecting markets:

✈ Regional-regional. This is by far the most important market, connecting underserved neighbouring countries, and one in which Air Astana has a strong competitive position. Typical city-pairs: Bishkek-Dushanbe, Omsk-Tashkent, Moscow-Delhi.

✈ Regional-Intercontinental. Air Astana has the potential of leveraging its Astana hub on routes like Urumqi-Frankfurt. Urumqi is a new Chinese mega-city, located 1-2 hours flying time from Almaty and Astana, with a rapidly growing population, estimated at anywhere between four and six million (so about a third the population of Kazakhstan)

✈ Intercontinental to Intercontinental. For example, London-Bangkok: basically Air Astana doesn't even try to compete with the Super-Connectors, but "takes orders" if they happen.

Air Astana is also developing a stop-over product — connecting passengers buy a package which gives them a connecting flight and one or two-day vacation in Almaty or Astana. This is small scale — Cathay did the same thing at Hong Kong in the 1990s — but it is good marketing for the country.

Almaty vs Astana airports

Astana since 1998 has been the capital of Kazakhstan, fast-growing, population of 0.8m, with a Russian majority, the "Dubai of the Steppes"; Almaty used to be the capital, is larger, with a population of 1.1m, a Kazakh majority and a deep cultural heritage. The climate is less extreme in Almaty compared to Astana, one reason the Almatyans seem to resent the decision by President Nazarbayev, based on "32 objective criteria", to redesignate the capital.

Air Astana's relationship with Almaty airport, its primary base, has not been easy. The facilities are cramped and tired, and connecting there is difficult. Moreover, there are no plans by the airport owners to improve the situation unless forced to do so. That is a possibility as Almaty is shortlisted with Beijing for the 2022 Winter Olympics, and if Almaty wins it will be obliged to upgrade the airport.

As Peter Foster puts it, "the network will follow the airport facilities", and, as Astana airport, has announced plans to double capacity to 12m passengers a year, the growth is going to be concentrated at that airport.

Fleet plans and financing

Air Astana is due to finalise a \$800m refleeting plan this year, the financing of which may have become more problematic in the light of the currency weakness.

Two 787s are now scheduled for delivery in 2019 (originally three were expected to be delivered at an earlier date), and a decision will be made on an 11-unit order designed to replace the five 757s and four A321s in the current fleet (although the recently refurbished 757s could also have their service extended). The two candidates are the 737-900MAX and the A321neo (perhaps a launch order for the A321LR).

Air Astana will probably fund the PDPs from internal cashflow and seek ECA or ExIm finance for the aircraft deliveries. However, capex of \$800m might strain the airline's balance sheet; as at the end of 2013 shareholders' equity totalled \$308m while long term debt and finance leases were $383m. Net debt was $300m and cash amounted to $128m.

This raises the question of whether a capital increase might be needed; in fact it almost certainly will be needed given the scale of the investment plans. An IPO is possible but private equity would probably place a greater value on the company, especially because of the attraction of a close link with Samruk Kazyna. Air Astana also has a good dividend record paying out 25-35% of net profits to its two shareholders in recent years. BAE might well consider cashing in on its $8.5m initial investment if the company were to be valued at say ten times operating profit, or $1bn. Etihad has inevitably been mentioned as an investor, but this is very unlikely as it would entail Air Astana giving up its UAE service which because of oil industry links has major strategic importance.

Aviation Strategy

Japanese LCCs and the Abenomics third arrow

UNTIL relatively recently Japan was a LCC-free zone, dominated by JAL and ANA supported by secondary airlines like Skymark, Starflyer and Air Do, sometimes described as low cost but generally following a traditional airline model. And like the stagnant Japanese economy, domestic air transport hasn't grown since 2001 — 92m passengers then, the same number in 2013.

About five years ago the Japanese MILT (Ministry of Land, Infrastructure, Transport and Tourism) began to explore a new policy for Japan — the introduction of LCCs and the parallel privatisation of regional airports. This was a part of the third "arrow" of Prime Minister Shizi Abe's approach to ending Japan's lost decade; the first two arrows of Abenomics related to monetary stimulus and fiscal reform while the third arrow concerned deregulation, privatisation and restructuring.

In typical Japanese fashion the experience in other countries was studied closely. The UK provided a good example of how regional airports could be sold off from local government ownership and revitalised. It was also noted how the success of these sales depended on the growth strategies of dynamic aggressive LCCs, which didn't exist in Japan. (As Stelios Haji-Iannou has observed, Japan is the last great unexploited market for LCCs.)

The operating models of the most successful European, Asian and American LCCs were dissected with the aim of transplanting the most useful bits into the Japanese industry. It is of course rather difficult to transfer the entrepreneurial drive of LCC leaders, but this could, it was thought, be created through joint ventures with the likes of AirAsia and Jetstar.

Japanese LCCs were never intended to replace the incumbent carriers. Indeed, the LCC strategy had to accommodate the restructuring and turn-around of JAL whose bankruptcy necessitated a $4.6bn government bailout in 2011. Equally important was the situation of ANA, the dominant domestic operator and disadvantaged by the government rescue of JAL.

Consequently, the new LCCs launched in Japan have been closely associated with the country's legacy carriers, specifically with ANA's multi-brand policy. Consumer reports from Japan indicate that domestic passengers appreciate these new entrants and the significantly lower fares on offer. Major questions remain as to whether these LCCs will overcome the conflict issues that have arisen between subsidiaries and full-service parents everywhere else in the world. AirAsia's partnership with ANA has already failed, and Tony Fernandes intends to re-enter the Japanese domestic market this year, but with partners in the Japanese retail sector rather than a local airline. Once established, LCCs are not going to go away; but it may be that the current group of LCCs represent a transitory stage before the emergence of fully independent LCCs.

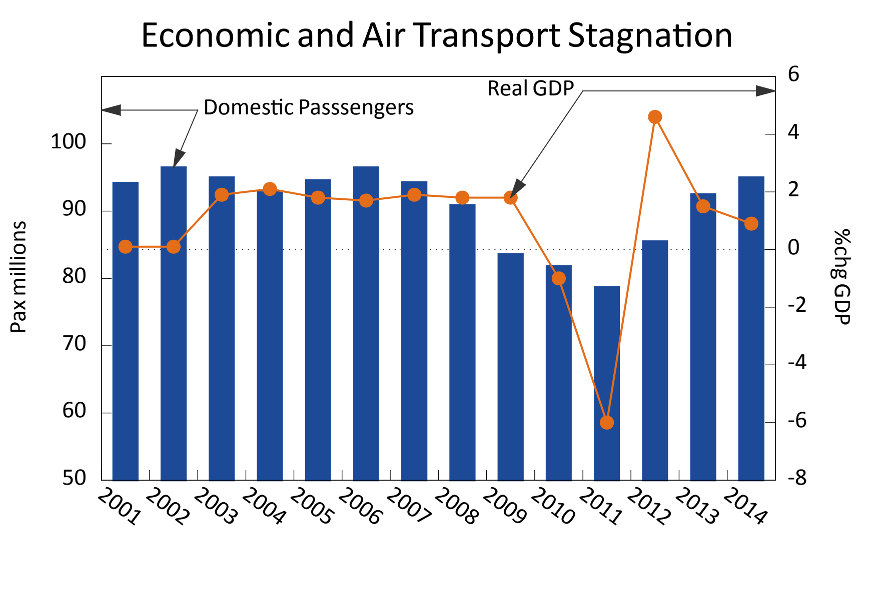
Peach Aviation

Japan's new wave of LCCs started with Peach Aviation, which is based at Kansai airport in Osaka. It was originally founded under the name A&F Avia-

Japan's LCC Fleet

	Peach Aviation	Jetstar Japan	Vanilla Air	Spring Japan	StarFlyer	Skymark Airlines	Air Do	Total
A320	14	20	9		9 (1)			**52 (1)**
737-500							6	**6**
737-700							4	**4**
737-800				3		28		**31**
767							3	**3**
A330-300						5		**5**
Total	**14**	**20**	**9**	**3**	**9 (1)**	**33**	**13**	**101 (1)**

Note: orders in brackets



tion in February 2011 as a joint venture between All Nippon Airways and Hong Kong-based private equity company First Eastern Investment Group. A month later The Innovation Network Corporation of Japan (INCJ) — a Tokyo-based a public-private partnership between the Japanese government and major corporations — also invested into the start-up, and the airline's equity is currently owned 38.7% by ANA, 33.3% by First Eastern and 28.0% by INCJ.

Peach began operations in March 2012 and today a workforce of 650 operate a fleet of 14 A320s out of Kansai and a secondary base at Naha airport on Okinawa (though it reportedly has plans to open a base at Tokyo Haneda too). The A320s have an average age of less than two years and are all leased from GECAS, Avolon and SMBC. They operate to 15 destinations, 10 of which are domestic and five international — Hong Kong, Seoul (Incheon), Busan, Taipei and Kaohsiung.

Four more leased A320s are planned, and they will allow gradual expansion of the network to two types of destinations — secondary airports within Japan, and to selected international cities. A new route between Okinawa and Hong Kong launches in late February this year, but beyond that there are no other confirmed new routes — although China, Thailand and Vietnam all on the wish list.

How fast Peach will grow depends partly on how the airline will solve the growing problem of a shortage of pilots — in the summer of 2014 Peach cancelled more than 15% of its total capacity (some 2,000 flights) due to a pilot shortage, with reports suggesting that some staff had been tempted over to rival LCCs with higher salaries.

Interestingly, part-owner ANA didn't transfer any of its pilots across to Peach temporarily in order to help it through that summer crisis, with a senior ANA executive saying: "Basically, they have to handle the problem on their own; we have to maintain the firewall between the two airlines' operations." That's consistent with ANA's claimed policy of minimal influence on Peach's strategy since it launched, though staff have been seconded, particularly in the early stages — although a more important factor may be that ANA is also facing a pilot shortage of its own (as do most other Japanese airlines).

In its last reported financial year (13/14, the 12 month period ending March 31st 2014), Peach saw operating revenue more than double to ¥30.6bn (€230m), based on 3m passengers carried and a load factor of 83.7%. This allowed the airline to break into profitability for the first time — at the operating level a loss of ¥1bn in 12/13 turned into a profit of ¥2bn (€15m) in 13/14, while a net loss of ¥1.2bn in 12/13 turned into a ¥1bn (€8m) net profit in 13/14.

Vanilla Air

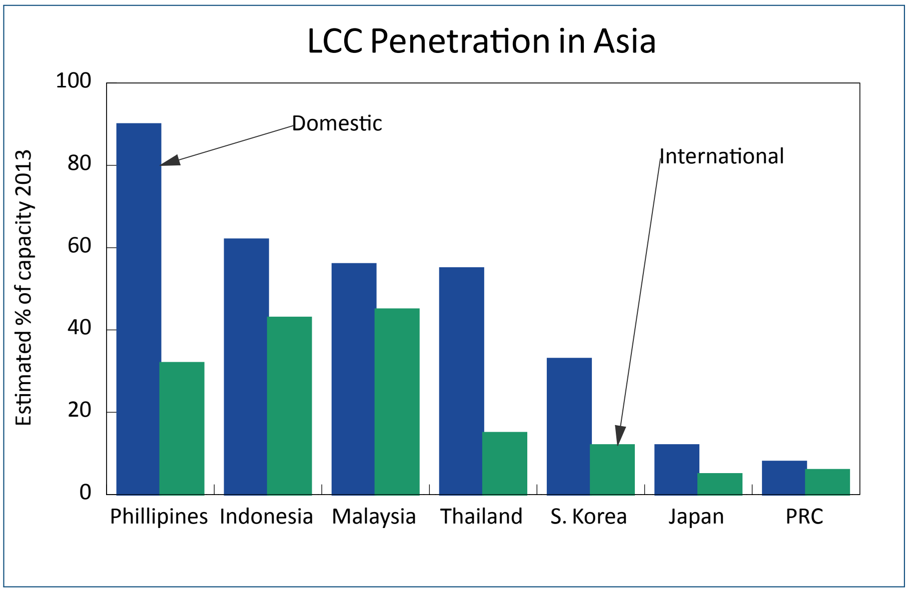
Based at Tokyo's Narita airport, Vanilla Air started life as AirAsia Japan, which was launched as a joint venture between the AirAsia group and ANA back in August 2011. However, AirAsia withdrew from the initiative in October 2013, selling its stake to ANA, after the carrier was reported to have the lowest load factors among the three new LCCs in Japan. Japanese sources indicate that among the several major issues the airline had at the time was an absence of a distribution deal with Japanese travel agents (which are a key part of the Japanese market) and a website that was not fully translated into Japanese (clearly a major inconvenience for domestic customers). AirAsia has since announced that a new AirAsia Japan will start service out of Chūbu Centrair airport (in central Japan) in the summer of 2015 as a joint venture with local partners that include Rakuten, a Japanese e-commerce company.

After ANA took full control of the old AirAsia Japan, the LCC was rebranded as Vanilla Air in November 2013, initially operating with two aircraft (after the original fleet was returned to AirAsia). Today the airline employs around 500 and has a fleet of nine A320s leased via ANA from AWAS/SMBC. They operate to three other domestic airports, but a key part of the strategy is to build up international routes, which currently include four destinations: Seoul, Hong Kong, Taipei and — since February this year — to Kaohsiung in Taiwan.

Until recently the plan was for the fleet to grow by a single aircraft by the end of FY15 (ending March 2016), but in an update to its strategy released at the end of January 2015 ANA stated that in order to ensure profitability in FY16 it would slow down the introduction of new aircraft. The Seoul route will be suspended from March, though Vanilla says services will start to Guam and Saipan at some time in the not-too-distant future. Indonesia is also believed to be a key target market for Vanilla.

In April this year Vanilla will move its Narita operations from Terminal 2 to the new LCC-dedicated Terminal 3, and ANA's strategy for the LCC is to rebuild the Vanilla business at Narita through "increased brand recognition, simplified reservation system, improved aircraft utilization efficiency, and reduced CASK" before an expansion" mainly with a focus on international".

But ANA also sees the "success of Vanilla routes in/out of Kansai as springboard from which we develop Okinawa as the second hub and strive to break into the Asian market". Crucially ANA says that as the Vanilla fleet has expanded it has become clear that "increasing yield is a priority assignment", though it insists that "it is important that the LCC be free to set fares and establish routes independently; it is not the case that we assume demand segregation between ANA and LCC".



In the first meaningful results period for Vanilla Air (the first three-quarters of FY14 — the nine months covering April to December 2014), the ANA Group revealed that LCC's load factor reached 76.9%, with 821,000 passengers carried in the period — although no financial information has been released.

Jetstar Japan

Jetstar Japan launched operations a few months after Peach, in July 2012 (with its launch brought forward from the end of the year because of Peach's market entry). Based at Narita airport in Tokyo and with a secondary base at Kansai airport in Osaka, Jetstar Japan is owned by JAL (with 47.1% share of equity in the airline) and Qantas (47.1%).

However, that division is significantly different from when the LCC was founded in 2011, at which time JAL and Qantas had a 33.3% share each, with 16.7% each held by founding partners Mitsubishi Corporation and Century Tokyo Leasing. But since then Jetstar Japan has struggled to break into profitability, and as a result two capital injections by JAL and Qantas (of ¥11bn repsectively in November 2013 and November 2014) has seen their equity percentage rise, with Mitsubishi and Century not participating and hence seeing their interest fall to 2.9% each — although each of the four companies keep their original percentages in terms of voting rights at the LCC, despite the adjustments to equity (or "economic rights", as they are called under the terms of the deal).

The latest capital injection came after the airline posted a third consecutive year of losses. In financial year 13/14 — the 12 months to June 30th 2014 — revenue more than doubled to ¥29.1bn, but despite that the net loss totalled ¥11.1bn, 26% worse than the net loss in the previous financial year.

Though the second largest airline in the Jetstar Group (after the Australian operation), the Jetstar brand has relatively little resonance in the Japanese market. But the biggest factor in the airline's poor performance so far has been poor decision making by management. For example, the launch of a hub at Osaka's Kansai airport was nothing short of a disaster for Jetstar Japan. Its opening was delayed five times before it finally came online in June last year, with the airline citing a lack of maintenance staff as the key reason for the delay. Unfortunately, during the delay as many as six A320s earmarked for Kansai were essentially left completely unused (they were parked at Narita), with a significant effect on the airline's bottom line.

Jetstar Japan currently operates 20 A320s (of which 11 are leased) on 18 routes between 11 domestic destinations, and the launch of international routes is seen as crucial in helping the LCC break into profitability. The first is a three times a week service between Osaka and Hong Kong starting in February. It's a route that JAL no longer serves, and the relationship with JAL is such that new routes are unlikely to be launched that would compete against an existing JAL service.

Delivery of outstanding A320s on order was paused in 2014 as the airline struggled to break even, but expansion restarted in October 2014 with two new A320s delivered by the end of the year.

Jetstar Japan has close ties with its parent airline, with codesharing and FFP links with JAL. The LCC also has a codeshare relationship with American Airlines, and in January this year a codesharing deal started with Qantas.

Spring Japan

Spring Airlines — China's first LCC that was founded back in 2004 — established a subsidiary in Japan in 2013, although it didn't launch its first flights until August 2014. Shanghai-based Spring Airlines owns 33% of the Japanese carrier, with the remainder split between various Japanese investors.

Spring Japan currently operates three 737-800s leased from GECAS and AWAS out of Narita airport to three domestic destinations — Hiroshima, Saga and Takamatsu — and has plans to add a fourth 737 this year.

That's a much smaller operation that Spring Airlines, which operates 48 A320s on 70 domestic and international routes. In January it launched a successful IPO on the Shanghai stock exchange that raised more than US$280m to fund international expansion, including an international base at Kansai. However, none of these funds have been allocated for investment in the Spring Japan itself.

StarFlyer

StarFlyer was launched by two former executives at Japan Air System and ANA as Kobe Airlines back in 2002, before being renamed as StarFlyer in May 2003. Based at Kitakyushu Airport in the south of the country, the airline also has bases at Haneda, Fukuoka, and Kansai airports, and currently operates nine A320s (with one A320 on outstanding order) with an average age of just over two years (of which seven are leased from GECAS and AWAS) to six domestic destinations, plus Seoul and Busan in South Korea.

With 600 staff StarFlyer is a so-called hybrid airline, operating to primary airports, having wider seats and enhanced in-flight services, while attempting to operate with low costs. The airline has extensive links to ANA, sharing its reservations system and codesharing and with ANA taking an 18% stake in December 2012, making it the single largest shareholder. StarFlyer undertook an IPO on the Tokyo stock exchange in December 2011, since when the share price has yoyoed significantly.

The rise of the new LCCs has impacted StarFlyer significantly. In late 2013 StarFlyer retrenched by trimming its workforce by 30, suspending a route to Busan and cutting its fleet from 11 to 9 aircraft.

This measures don't seem to have had much of an effect. In the 2013/14 financial year (ending March 31st 2014), StarFlyer posted a 31% rise in revenue to ¥33bn, but at the operating level a ¥481m operating profit in 2012/13 turned into a ¥3.4bn operating loss in 2013/14. Similarly, a ¥288m net profit in 2012/13 became a ¥3bn net loss a year later.

Air Do

Air Do started operations on the Tokyo-Sapporo route in 1998, but was forced into bankruptcy protection in 2001, when it was in effect rescued by a consortium in which ANA was a key investor. ANA is now a major shareholder in Air Do and operates various code-shares.

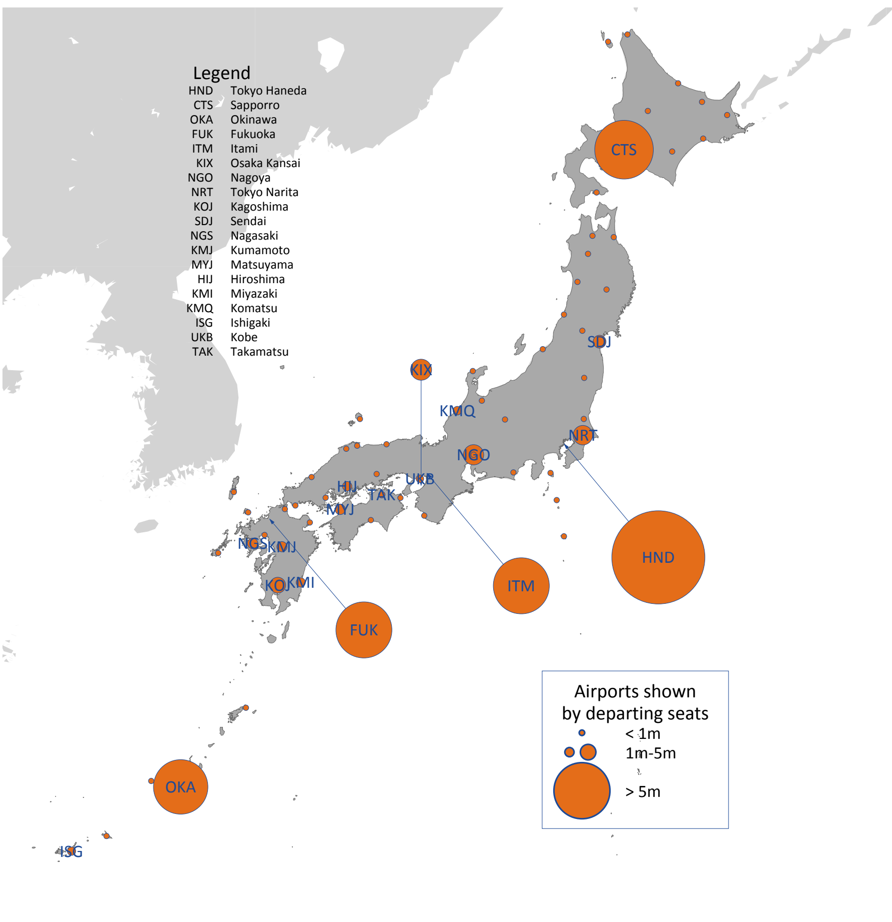
Air Do operates in a leisure dominated market, with its core business being seasonal routes from the Tokyo Haneda to its base at Sapporo in the northern Hokkaido region in Japan. Traffic volumes are high in the summer, allowing it to fill its three 767s to charter carrier levels. It fleet of ten 737s are deployed on thinner routes from Sapporo. The airline is reported to be marginally profitable.

Skymark Airlines

In late January Skymark became the first Japanese airline in more than five years to file for protection under Japan's bankruptcy laws.

Skymark was established by a number of private investors (including the HIS travel agency) back in 1998, although after years of financial troubles entrepreneur Shinichi Nishikubo invested into the airline, becoming the CEO and today holding the largest single stake, with a 30%

Domestic Seat Capacity at Japanese airports



share.

Through the 2000s the airline gradually disposed of a seven 767 aircraft, but in 2011 it ordered four A380s, which were to be used with a three-class service on trunk routes to Europe (London, Paris and Frankfurt) and the US (New York). The next year Skymark also agreed leases for seven A330-300s, for delivery in 2014 and 2015.

However, after the new LCCs entered the market in 2012 life became more challenging for Skymark, particularly as Vanilla Air and Jetstar Japan have bases at Narita, directly competing against Skymark's main base at Haneda. Much to Skymark's dismay, the A380 order was unilaterally terminated by Airbus in the summer of 2014, with the manufacturer expressing concerns over whether Skymark could finance the aircraft. The two parties have since been arguing over contractual terms and obligations, with Skymark saying that Airbus is demanding an "unreasonable cancellation fee", reportedly for as much as $700m. A330 deliveries had gone ahead though, with the first five aircraft arriving in 2014 and being used on domestic trunk routes from Narita to Sapporo and Fukuoka.

Skymark currently employs 2,200 and operates a fleet of 28 737-800s (all leased) and five A330-300s to 14 domestic destinations, with other operating bases at Kobe, Naha, Fukuoka and New Chitose airports. However, under relentless pressure from the new LCCs, in the first half of the 14/15 financial year (the six months ending September 30th 2014), Skymark saw revenue drop 0.7% to ¥45.2bn, with an operating profit of ¥2bn in H1 13/14 turning into a ¥4.4bn operating loss in H1 14/15.

Skymark said it would reduce its Narita network down to just three routes (Sapporo, Yonago and Okinawa), though a continued future without a link with one of the two legacy carriers looked unlikely. In January it filed for bankruptcy, with the airline citing the decline of the Yen the prime driver behind its decision, given its exposure to aircraft leases and fuel purchased abroad that are denominated in Dollars. But clearly a more significant reason was the risky decision by management to buy A380s in 2011, at a time when the Yen's strength versus the Dollar was high.

Skymark is reshuffling management and says it will no longer fly A330s, instead becoming a single-model operator, but this is too little too late, and whether Skymark will emerge from bankruptcy will depend entirely on whether the carrier will receive financial help from ANA. The only, but possibly significant, attraction for ANA is Skymark's Haneda slots, though these are all domestic slots rather than international which could be traded with US Star Alliance partner United. As always a Japanese solution may be available.

Spirit, and now Frontier: ULCC business model gains traction in the US

THE Ryanair-style ultra-low cost airline business model is at last gaining traction in the US, where up-market LCCs such as JetBlue and Virgin America, in addition to low-cost pioneer Southwest, have dominated the scene.

Spirit Airlines — hitherto the only true ULCC in the US — is growing at a heady rate. Having expanded its capacity by 15-22% annually and doubled its revenues since 2010, Spirit is now accelerating ASM growth to 30.4% in 2015.

Fort Lauderdale-based Spirit, which completed a modest $190m IPO in May 2011, is already the eighth largest US airline, with $1.9bn revenues in 2014. It has grown from its original Caribbean/Latin America and domestic north-south leisure niche to become a nationwide operator. It sees potential to expand into more than 500 new markets.

And now there is another ULCC in the works. Since buying Frontier Airlines from Republic Airways Holdings in October 2013, Indigo Partners, the US private equity firm, has been in the process of transforming the Denver-based LCC into a "leading nationwide ULCC".

It is early days yet. Frontier is still working to attain a ULCC-type cost structure, restructuring its network and trying to educate its customers about the merits of ULCC-style pricing.

But Frontier has two advantages. It is benefiting from the experience of Bill Franke, its current chairman and the managing partner of Indigo Partners, who has a strong record of building successful ULCCs. It can also benefit specifically from the lessons learned at Spirit, which was a struggling LCC when Franke initiated its transformation into a ULCC in 2006.

Franke sold his stake in Spirit and resigned as its chairman in the summer of 2013 after Indigo began exclusive talks about acquiring Frontier.

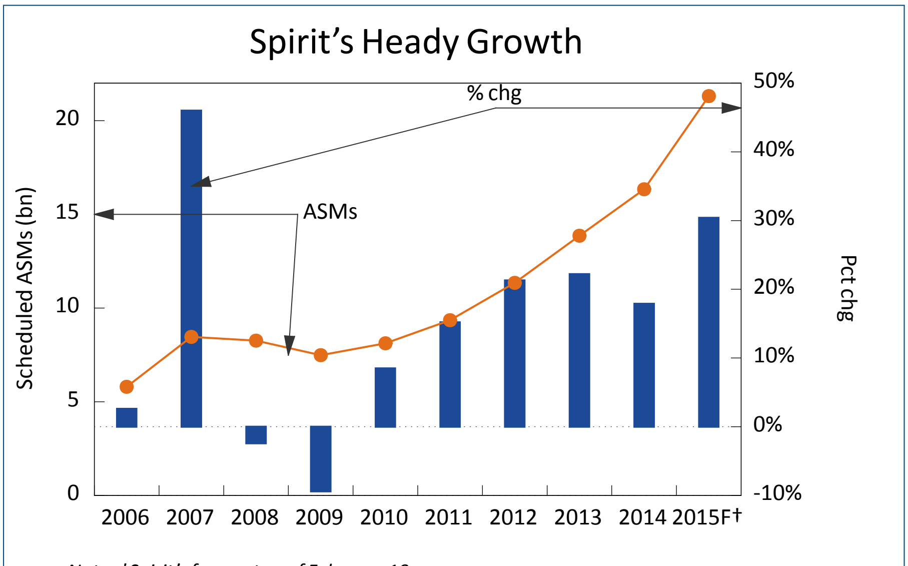
Indigo also previously held a stake in Singapore's Tigerair and it remains a lead investor in Hungary's Wizz Air and Mexico's Volaris.

Las Vegas-based Allegiant Air — the tenth largest US carrier and publicly listed since 2006 — is also a ULCC, but it is a true niche carrier and has an unusual business model. Allegiant operates from small cities to key leisure destinations such as Las Vegas, Orlando and Hawaii, utilising an old fleet that still included 53 MD-80s at year-end (along with used 757s, A320s and A319s). The old fleet gives it a uniquely flexible business model that allows it to fly when demand dictates. High fuel prices and other factors kept the airline's ASM growth below 10% in each of the past two years, but a combination of low fuel prices and Allegiant's lack of fuel hedging — factors that are likely to make its profits soar this year — may help revive Allegiant's growth model.

The ULCC business model is gaining traction in the US in part because it is proving to be a superior profit generator. Spirit and Allegiant were the two most profitable US airlines in 2014 in terms of operating margins — 19.2% and 17.6%, respectively.

The ULCC model has also proved to be highly recession-resistant. Both Spirit and Allegiant maintained relatively stable unit revenues and profitability through the tough industry years of 2008 and 2009.

Of course, the fundamental reason why the ULCC business model is gaining traction in the US is that it is being increasingly accepted by the US travelling public. The lawsuits, legisla-



Note: †Spirit's forecast as of February 10.

Spirit's fleet plan

	2014	2015	2016	2017	2018	2019	2020	2021
A319	29	29	26	22	17	16	9	5
A320	34	42	45	52	54	54	54	54
A320neo		1	5	5	11	14	27	45
A321	2	8	17	25	30	30	30	30
A321neo						10	10	10
Total	**65**	**80**	**93**	**104**	**112**	**124**	**130**	**144**

Note: Number of aircraft in service at year-end. Includes scheduled deliveries and retirements/lease expirations. Source: Spirit Airlines

tive threats and negative press coverage that were previously associated with it have dissipated.

In 2012 Spirit was still fending off federal lawsuits that alleged it misled passengers and dealing with vitriolic national press coverage. One *Forbes* article (ominously titled "Spirit Airlines: the day of reckoning is yet to come") slammed the airline for a lack of transparency in fares, for its plans to introduce a $100 checked/carry-on bag fee at the gate, and for an unfortunate incident in which it refused to refund a ticket to a "dying Vietnam veteran".

But, like Ryanair, which has mended its ways since being rated the worst brand in the UK for customer satisfaction in a 2013 survey (*Aviation Strategy*, January/February 2014), Spirit has cleaned up its act.

Spirit has made a big effort to educate consumers about ULCC-style pricing and has made its fares and fees transparent. Its "Bare Fares" and "Frill Control" are very clear concepts. It now allows customers to see all available options and their prices before buying a ticket. Interestingly, a recent survey by Spirit found that much of the customer anger it was dealing with was directed at airlines generally.

While Frontier can learn from Spirit's past mistakes, it will still have to educate its own flyers about the ULCC transition and find the pricing strategies best suited for its markets.

Spirit: Rare US growth story

Originally founded as a trucking company in Detroit in 1964, Spirit has been a scheduled airline since 1992. Initially it was a typical mainstream LCC, operating north-south low-fare services with DC-9s and MD-80s.

In 1999 Spirit moved its headquarters to Fort Lauderdale — a market it already knew well and where it had spotted an opportunity to build Latin America service. It became "South Florida's hometown airline".

Subsequently, Spirit made significant investments in its systems, technology, product and brand and essentially transformed itself into an up-market LCC, with a separate business class. It launched international operations to Mexico in 2003.

In 2004-2005 Spirit received a total of $225m in equity funding from Oaktree Capital and Goldman Sachs Credit Partners, which enabled it to order up to 95 A320-family aircraft and complete a transition to an all-Airbus fleet in 2006.

In 2004 Spirit formally positioned itself as an LCC with a focus on the Caribbean and began launching those routes after the A320 deliveries started in late 2004. Spirit also terminated many thinner domestic routes and began to add major markets. The current CEO, Ben Baldanza, arrived from US Airways in 2005.

So, while Spirit was incurring losses, many of the key components for future success were already in place when Indigo acquired a majority stake and control from Oaktree in July 2006. Oaktree wanted to bring in Indigo's significant airline expertise to accelerate Spirit's growth.

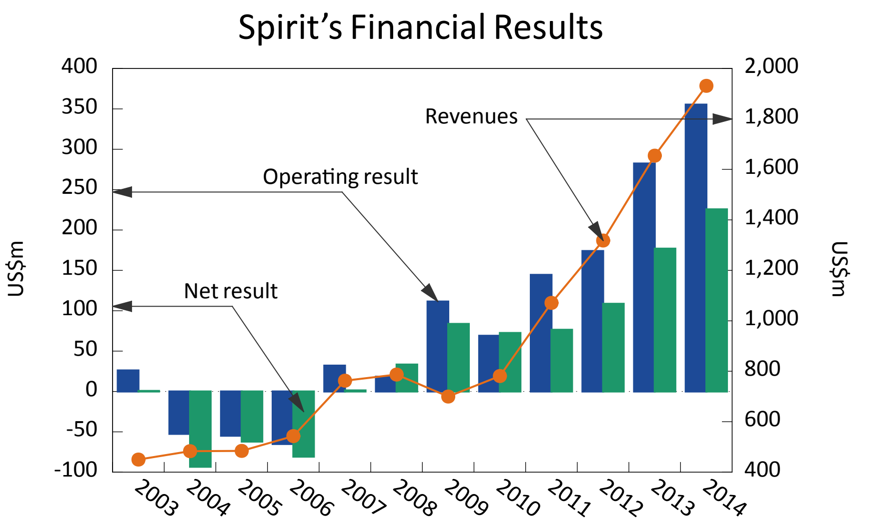
The new fleet, the network re-alignment and the switch to the ULCC business model had an immediate dramatic impact on Spirit's financial performance. After three years of operating and net losses totalling $172m and $236m, respectively, the airline turned modestly profitable in 2007.

Since then Spirit's profits have soared (see chart). In recent years, the annual operating margin has been in the mid-to-high teens. Pretax ROIC has exceeded 28% each year since 2011; in 2014 it was 30.1%.

The post-2006 financial recovery reflected success in reducing ex-fuel unit costs while maintaining relatively stable total unit revenues. Between 2006 and 2009, ex-fuel CASM fell by

Spirit's changed revenue structure

Average revenues per passenger flight segment	2006	2010	2014	Difference 2006/2014
Ticket revenue	$104.56	$77.39	$80.11	($24.45)
Non-ticket revenue	$4.80	$35.00	$55.03	$50.23
Total	$109.36	$112.39	$135.14	$25.78



Note: Operating results include minor special items in some years.

a stunning 21%, from 6.89 to 5.45 cents, while RASM was unchanged (9.37 and 9.35 cents). Importantly, since then Spirit has retained the low ex-fuel CASM (up slightly in the past five years, to 5.88 cents in 2014), while increasing its RASM by 26% over the period.

Spirit has one of the lowest cost structures in the Americas. According its recent presentation, on a stage length adjusted basis, Southwest, JetBlue and American had 9%, 28% and 50% higher CASM, respectively, than Spirit in the 12 months ended September 2014.

Like ULCCs typically, Spirit achieves its low cost structure through high aircraft utilisation, a single-type fleet, high-density seating, simple operations, no hub-and-spoke inefficiencies, high labour productivity, use of outsourced services and use of low-cost distribution methods.

Spirit has the highest average daily aircraft utilisation among US airlines — 12.7 hours (up from 9.1 hours in 2006). Its A320s have 178 seats, compared to Virgin America's 146.

While Spirit aims to hold ex-fuel CASM "flat to down slightly" in the long term, it is projecting a significant 6-8% reduction to 5.41-5.53 cents in 2015. The airline believes it can achieve that thanks to accelerated ASM growth (up 30.5% this year, compared to 17.9% in 2014), larger-aircraft efficiencies (all of this year's 15 deliveries will be A320s and A321s) and a shift from operating leases to debt funding. There will also be benefits from cost measures implemented in late 2014, including many renegotiated agreements and leases, a new aircraft heavy maintenance agreement with Lufthansa Technik in Puerto Rico, and a transfer to third-party catering.

So Spirit is set to further increase its cost advantage over other US carriers this year. The trend could continue beyond 2015, because Spirit is targeting 15-20% annual ASM growth in the longer term.

The low costs enable Spirit to offer very low base fares, which are combined with a range of optional services for additional fees. The low fares stimulate demand, and the resulting higher passenger volumes and load factors lead to increased sales of ancillary products and services. This, in turn, enables Spirit to reduce the base fares even further, stimulating additional demand.

Citing the DoT, Spirit says that its base fares are on average 40% lower than other airlines', and that even after paying extra for bags, seat assignments and snacks, its total price is still 35% lower.

Between 2006 and 2014, Spirit's non-ticket revenues grew from $23.8m to $786.6m, to account for 40.7% of its total revenues. This may be the highest ancillary revenue percentage in the world; according to Spirit's data for the 12 months ended June 2014, its 40.4% compared with Allegiant's 34.2% and Ryanair's 24.3%.

On a per-passenger-flight-segment basis, between 2006 and 2014, Spirit's non-ticket revenues increased from $4.80 to $55.03, which amply offset the decline in average ticket revenue from $104.56 to $80.11.

Spirit generates non-ticket revenues by charging for checked and carry-on baggage, passing through all distribution-related expenses, charging for premium seats and advance seat selection, enforcing ticketing and service change policies and selling subscriptions to its "$9 Fare Club". Spirit also derives revenues from proprietary services such as its co-branded credit card, sells third-party travel products (hotel, car rental, attractions) packaged with air travel, sells third-party travel insurance through its website and sells in-flight products and onboard advertising.

The management conceded recently that the non-ticket revenue line was maturing and that growth would be a little flatter from now on, though there are many enhancements and new products in the works. Future growth will come from three areas: "applying proven revenue management techniques to ancillary items" (such as peak pricing for bags); "capturing a larger portion of the total travel budget" (more hotels, new items such as show tickets and dive packages); and "more products" (credit cards in Colombia and Central America, advertising onboard aircraft, plane wraps).

Of course, there will also be a near-term drag on ticket unit revenues resulting from this year's heady ASM growth and increased price competition in off-peak periods (evidently because of the fuel price decline). Spirit estimates that its RASM will fall by 9-11% in the current quarter.

Spirit already has a diversified network covering 57 destinations. It is a major player in the Florida to the Caribbean/Latin America markets — one of its key strengths. After several years of expansion, it also has a nationwide domestic network covering 84% of the top 25 US metro areas.

The airline is interested in markets that are underserved and/or overpriced and operates mainly point-to-point services. Route selection is based on optimising operating margin and utilisation. The services are often low-frequency or seasonal. Spirit has "no emotional attachment to any particular route" and places "no value in market share".

Spirit continues to target both international and domestic growth, but the focus has now shifted to "connecting the dots". This year's plan is to add 35 new routes, but Cleveland (added in January) may or may not be the only new city. So far, Spirit has announced plans to boost service in Atlanta, Los Angeles, Las Vegas, Boston, Denver, Cleveland and Houston IAH. The Houston move is significant in that it will add many new Latin America routes, making IAH Spirit's second-largest base for international flights (after Fort Lauderdale), just as Southwest is preparing for its Latin America push out of Houston Hobby.

In recent presentations, Spirit executives noted that the airline accounts for only 1.6% of the total average weekly seats for sale in the US. By comparison, Ryanair accounts for 10.6% of the seats in Europe (a similar-sized market). Therefore, Spirit argues, there is significant untapped market potential for a ULCC in the US. Spirit has identified more than 500 markets in which it could grow while maintaining current levels of profitability.

The current fleet plan is to grow from 65 aircraft (at year-end 2014) to 144 at the end of 2021. In that period Spirit is currently scheduled to add 20 A320ceos, 45 A320neos, 28 A321ceos and ten A321neos, while reducing its A319 fleet from 29 to five.

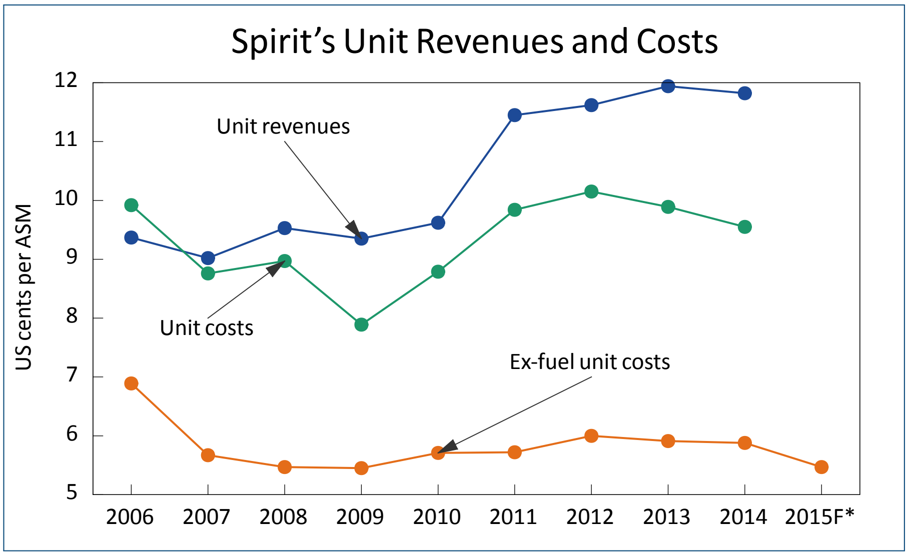
Spirit is at last leveraging its strong balance sheet by taking on debt to finance aircraft (the first such transaction was in 4Q14). Cash at year-end was $633m or 33% of annual revenues. The company has announced a $100m share buyback authorisation, but dividends will have to wait because Spirit is very much a growth company.

Spirit's share price has rocketed since it was listed in May 2011, vastly outperforming XAL. The industry-leading growth prospects have kept it as a "top pick" for many analysts.

Can Frontier make the transition?

All eyes are now on Frontier to see if it can emulate Spirit's ULCC success. Frontier, which began operations in 1994, has struggled financially through much of its existence. It filed for Chapter 11 in April 2008, from which it was rescued by Republic in 2009.

Frontier's historical struggles could largely be attributed to the decision to be a hub-and-spoke carrier at Denver International (DIA) — a relatively high-cost location and one of the most competitive markets in the US. DIA is a hub for United. Since Southwest's 2006 entry and subsequent extremely aggressive expansion there, Frontier has fallen from second to third position at its



home base. The fierce competition between Frontier, United and Southwest has made DIA's average fares among the lowest for the top 100 US airports.

Pre-Indigo, Republic had already implemented successful restructuring at Frontier, which enabled Frontier to close the unit cost gap with the mainstream LCCs. But much work remained to be done to turn the carrier into a ULCC.

One of Franke's early moves was to put together what could be described as a ULCC "dream team". CEO David Siegel is supported by a new president (Barry Biffle), who was previously CEO of VivaColombia and EVP at Spirit, and a new CFO (Jimmy Dempsey) who was previously Ryanair's treasurer.

Frontier is working to reduce its ex-fuel CASM from 7.5¢ at the time of the Indigo acquisition to the 6¢ level, which is typical for ULCCs. CEO Biffle reportedly predicted in January that the target would be reached by year-end 2015. Among other cost saving moves, Frontier is outsourcing 1,300 airport operations and reservations workers — about a third of its workforce.

Under the initial unbundling strategy adopted in April 2014 (which is evolving), Frontier lowered its fares by an average of 12% and introduced fees for baggage and seat selection. The carrier has said that even before the 12% reduction, its fares in Denver were 6% lower than Southwest's and 45% lower than United's. Frontier has introduced a "Discount Den" club and has continued its long-time FFP.

But there are some important differences between Spirit's and Frontier's brands. Bill Franke, who spoke at a Wings Club lunch in New York in late January, called Spirit a "tremendously successful investment for us" but mentioned three lessons that he had learned. First, Spirit did not communicate the ULCC transition well with customers — a mistake that Frontier wants to avoid. Frontier puts more emphasis on customer service (picture a nicer, more genteel carrier). Second, Franke felt it was important to also offer a convenient, fully bundled fare. Frontier offers such as fare, called Classic Plus. Its mantra is "low fares done right". Third, Franke felt there should be more focus on operational performance, such as punctuality, at LCCs in general.

Franke described Frontier's progress so far as "encouraging". In the first nine months of 2014, Frontier had revenues of $1.17bn, up 15.7%, and a net income of $103m, up from less than $10m in the same period in 2013.

Fleet plans are in place to support growth well into the future. The 80 A320neo orders placed by Republic in 2011 start to be delivered in 2016. In November 2014 Frontier ordered its first larger A321ceos (nine aircraft). So the fleet strategy takes a page from the Spirit playbook: moving to larger aircraft over time, which will help maintain the low cost structure. Frontier's current 55-strong fleet consists of 35 A319s and 20 A320s.

Frontier's two key challenges are, first, the point Franke made about successfully communicating the ULCC transition to its longtime flyers. In both 2014 and December, Frontier came worst in the DoT's customer complaint rankings (though it must be noted that Spirit has chosen not to report that data voluntarily).

Second, Frontier has to find the good markets. It does not have any obvious highly promising growth niches, such as Spirit's Caribbean out of FLL. While Frontier is committed to the Denver market, it is not a growth market. Even before Indigo's involvement, Frontier was reducing its dependence on Denver, which used to account for 90% of its operations. It began growing from relatively small underserved airports such as Trenton (NJ) and Wilmington (DE). But under Indigo the focus has shifted to bigger cities, and last year the withdrawal from small Denver markets intensified.

Only about 50% of Frontier's routes now touch Denver. It is uncertain how much lower that percentage will go. Perhaps it will also depend on rent and fee negotiations with the airport authority; Frontier's lease on its gates and terminal space at DIA is up in 2016.

So far Frontier has made two notable big-city moves: Chicago O'Hare and Atlanta. It is aggressively developing ORD as its second-largest base. Its planned April expansion from Atlanta will make Delta's main hub its third-largest base. The Atlanta expansion is possible because of Southwest's contraction there since its merger with AirTran, which freed gates. Apparently, fares are higher than average at Atlanta. Frontier is also growing at Cincinnati and Cleveland — cities that have seen sharp contractions by Delta and United, respectively — and in Miami and Philadelphia.

One potential problem is that the best growth opportunities will draw interest from multiple LCCs. Spirit and JetBlue, too, are growing at Cleveland, while Spirit continues to also target Chicago, Atlanta and Denver. No-one has hinted that this might happen, but it is really hard not to picture Spirit and Frontier merging at some point in the future.

By Heini Nuutinen
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Boeing and Airbus Orders 2014

Boeing Orders 2014

Customer	737 MAX	737 NG	747	767	777	787	BBJ	Total
Air New Zealand						2		2
All Nippon					26	14		40
Garuda Indonesia	50							50
Japan TransOcean Air		6						6
Nok Air	8	7						15
Okay Airways	6	4						10
Turkmenistan Airlines		3						3
Asia/Pacific Total	**64**	**20**			**26**	**16**		**126**
AirBridgeCargo			1					1
Belavia		3						3
Cargolux			1					1
Monarch	30							30
Ryanair	100	5						105
SunExpress	15	25						40
Turkish Airlines	15							15
Virgin Atlantic						1		1
Europe Total	**160**	**33**	**2**			**1**		**196**
COPA		2						2
Latin America Total		**2**						**2**
Air Algerie		10						10
Emirates					150			150
Ethiopian	20							20
Kuwait					10			10
Qatar					54			54
Middle East/Africa Total	**20**	**10**			**214**			**244**
Air Canada	61				2			63
Alaska Airlines		16						16
Eastern Air Lines		10						10
FedEx				4				4
Jetlines	5							5
United States Navy		16						16
North America Total	**66**	**42**		**4**	**2**			**114**
ALC	20	1			6			27
Avolon	5					6		11
BOC Aviation	50	32			2			84
CIT Leasing						10		10
GECAS		5			2			7
Intrepid Aviation					6			6
Jackson Square Aviation		3						3
MG Aviation						2		2
SMBC Aviation Capital	80							80
Leasing Companies Total	**155**	**41**			**16**	**18**		**230**
Business Jet / VIP Customer(s)	4	1			3	1	3	12
Unidentified Customer(s)	422	153			22	29		626
Total Gross Orders	**891**	**302**	**2**	**4**	**283**	**65**	**3**	**1,550**
Changes/Cancellations	(92)		(2)			(24)		(118)
Net Orders 2014	**1,101**			**4**	**283**	**41**	**3**	**1,432**

Airbus Orders 2014

Company	A320 ceo	A320 neo	A330	A350	A380	Total
Air China			4			**4**
Air New Zealand	1	13				**14**
AirAsia	(31)	31				
AirAsia X			55			**55**
ANA		30				**30**
China Eastern			7			**7**
China Southern			9			**9**
Hainan Airlines			8			**8**
Lion Air			3			**3**
Philippine Airlines		8				**8**
QANTAS	(21)	21				
Royal Brunei		7				**7**
Tibet Airlines	1					**1**
Tigerair	(9)	37				**28**
Transasia Airways			4			**4**
Vietjet Air	21	42				**63**
Asia/Pacific Total	**(38)**	**189**	**90**			**241**
Aegean Airlines	2					**2**
Aeroflot	22					**22**
British Airways		20				**20**
Easyjet	29					**29**
Finnair				8		**8**
Iberia			8	8		**16**
Lufthansa	10					**10**
Swiss		15				**15**
Turkish Airlines		8				**8**
Europe Total	**63**	**43**	**8**	**16**		**130**
LATAM	(16)	25				**9**
Latin America Total	**(16)**	**25**				**9**
Air Algerie			3			**3**
Air Mauritius				4		**4**
Kuwait		15		10		**25**
Libyan				2		**2**
Qatar	8					**8**
Saudi	4					**4**
Yemenia	(4)	4				
Middle East/Africa Total	**8**	**19**	**3**	**16**		**46**
American	78					**78**
Delta	15		25	25		**65**
Frontier	9					**9**
Hawaiian			6			**6**
Jetblue	(10)	10				
North America Total	**92**	**10**	**31**	**25**		**158**
AIG	13					**13**
ALC	1	60				**61**
Amedeo					20	**20**
Aviation Capital Group	2					**2**
Avolon			15			**15**
AWAS	1					**1**
Azul Finance		35				**35**
BOC Aviation	38	7				**45**
CALC	30	74				**104**
CIT	5		15			**20**
GECAS	6					**6**
Hong Kong Aviation Capital		70				**70**
ILFC		50				**50**
International Airfinance Corp			5			**5**
SMBC Aviation Capital	5	110				**115**
Synergy Aerospace	12					**12**
Z/C Aviation Ptns	8					**8**
Leasing Companies Total	**121**	**406**	**35**		**20**	**582**
MTAD			6			**6**
Private Customer	3		1			**4**
Undisclosed	180	349				**529**
Gross Orders	**504**	**1,041**	**174**	**57**	**20**	**1,796**
Cancellations	(194)	(30)	(20)	(89)	(7)	(340)
Net Orders	**310**	**1,011**	**154**	**(32)**	**13**	**1,456**

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