Issue no. 205
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Etihad's European strategy and the new Realpolitik

This issue includes

ETIHAD in the past few years has pursued a strategy that has been likened to the "Hunter Strategy" of the former SAir Group (the airline formerly known as Swissair) in the late 1990s. It has acquired minority stakes in moribund airlines which without this investment would normally have been expected to fail. Commentators have tried to explain the moves as an attempt to form a fourth global alliance, to generate operational synergies directing feed to its Abu Dhabi hub; or as providing Etihad (the smallest and youngest of the Superconnectors) with a method of competing efficiently with its close cousin Emirates (now the largest carrier worldwide ranked by international RPK). These interpretations may be partly correct; it is becoming clearer that Etihad is cleverly positioning itself in the emerging Realpolitik of the global aviation industry.

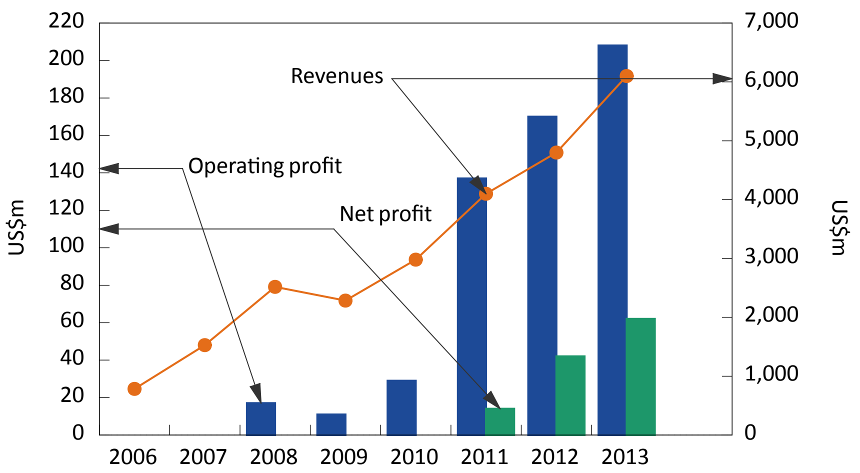
Firstly, a review of Etihad's investments; in 2011 Etihad acquired an equity stake of 29% in airberlin — Germany's second largest scheduled airline — for which it paid €75m. It subsequently acquired a 70% stake in airberlin's frequent flyer programme (topbonus) for €175m, subscribed to a €300m perpetual 8% convertible bond and provided a medium term loan facility of €225m. airberlin currently has a market capitalisation of €140m.

The perpetual convertible is an interesting vehicle that has been used by others (such as Wizz Air — see *Aviation Strategy* March 2015) to get round ownership rules. For accounting purposes it goes on the balance sheet as "equity" but voting rights legally do not accrue until shares are vested on conversion. Potentially, were this loan ever converted, Etihad would have an equity stake of over 70% in airberlin.

At the end of 2014 Etihad finalised its investment of a 49% equity stake in a new Alitalia — Società Aerea Italiana to take over the good bits from the dying Alitalia — Compagnia Aerea Italiana (which in turn had acquired the good bits of the bankrupt Alitalia — Linee Aeree Italiane in 2008). For the equity stake it paid €387.5m. In addition it bought five slot pairs at Heathrow from Alitalia for a reputed €60m to lease back to the Italian operating company and took a 75% stake in Alitalia's FFP *MilleMiglia* for €112m.

More minor investments in Europe have involved the acquisition of a 49% stake in Air Serbia (with a five-year management contract) and a 33% stake in Swiss regional airline Darwin (subsequently rebranded as Etihad Regional).

Etihad Financial Results



Note: From various sources.

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Meanwhile Etihad has also acquired a 24% equity stake in Indian carrier Jet Airways for $379m (with the sweetener of $70m for the acquisition of three slot pairs at Heathrow leased back and a majority of the Jet Airways FFP for another $150m). In addition it has been gradually increasing its stake in Virgin Australia — now with 24% equity involvement it is vying with Singapore Airlines and Air New Zealand for effective “control” of the Australian contender to Qantas. In addition it has a 40% equity investment and a five year management contract in Air Seychelles and built a 3% equity stake in Aer Lingus.

Alliance unlike any other

The Etihad alliance is unlike any of the other Global Alliances. Etihad, while on the face of it a minority investor in its partners, is a majority provider of capital, and effectively in control. It has main board representation and has parachuted senior management into the companies in which it has invested. Apparently there are senior management meetings every couple of months to discuss strategy; although so far there does not seem to have been a great progress in creating real synergistic benefits.

There has been some rationalisation — to align all operators on a common distribution platform, coordinate IT, purchasing power. There have been swaps of aircraft between operators (A320s from Alitalia to airberlin; 777s from Jet Airways to Etihad), and steps to combine the frequent flyer programmes into a single entity. Apparently one of the main targets from James Hogan, CEO of Etihad driving the strategy, is to align quality control particularly for in-flight cabin service (although it is difficult to imagine that the draconian control over the non-unionised Etihad ex-pat cabin crew could be accepted in Berlin or Rome).

There may be some network synergies. Both airberlin and Alitalia are developing routes to and through Abu Dhabi. airberlin had successfully applied for and operated code-share flights with Etihad from the Luftfahrt-Bundesamt (LBA) but was dealt a blow from the regulator last Winter when in a sudden U-turn its code-share application for the season was denied. Darwin, rebranded as Etihad Regional, may be able to provide some modest feed onto Etihad’s network. Code-share agreements between Alitalia and airberlin however are probably of very limited use. Etihad has claimed that the marginal additional revenue achieved from the airberlin link has already repaid the original investment.

CEO James Hogan, an astute manager, avers that the investments are done on a distinctly commercial basis. Unlike Swissair 20 years ago, it is not hunting out of desperation. There is a possibility that its highly experienced management team will be able to turn round airberlin and Alitalia. In the meantime it is effectively guaranteeing some 15,000 jobs directly (and a multiple of that indirectly) in a politically highly sensitive sector and starting to make itself as important a player in European airline operations as the Superconnectors collectively have done with their massive aircraft orders to the aircraft manufacturers in Seattle and Toulouse.

The investment strategy by Etihad could therefore be regarded as aeropolitical, a defence against the regulatory backlash that Etihad and the other two Superconnectors are facing in Europe where the Commission is in the process of investigating the question of effective control of European airlines by non-EU nationals. While looking at Etihad's involvement in airberlin and Alitalia, it is also considering Korean Airlines' investment in Czech Airlines and Delta's 49% stake in Virgin Atlantic. In the US there has been an intensification of the high-profile lobbying of the Administration to take action to curtail the Superconnectors.

Etihad vs the US protectionists

At a conference on this subject, organised by CAPA at the end of April, Etihad's Legal Director, Jim Callaghan, found himself the sole Superconnector representative ranged against silver-tongued attorneys from Delta and American, this time allied with Lee Moak, ex-president of ALPA and now fronting "Americans for Fair Skies", a body which claims that that it support Open Skies but thinks that the consequences of the US-UAE and US-Qatar Open Skies agreements are outrageous.

The Fair Skies message is robustly populist. Its website proclaims: "What US policy makers did not envision, however, is that emirs and sheiks and their authoritarian governments would use this as an opportunity to manipulate the understandings and agreements established under Open Skies to undertake a sustained effort to steal our passengers and threaten the entire viability of our airline industry and the tens of thousands of Americans it employs".

By contrast, the rhetoric from the US carriers was fairly restrained — they said that they weren't attacking Etihad or Emirates or Qatar Airways themselves but contended that their complaints were to be seen within the context of a trade dispute between the US and the Middle East countries. This seems to be a lawyerly distinction — basically they argued that government subsidies were behind the rapid expansion of the Superconnectors across the Atlantic, forcing *them* to contract, and to nearly abandon important markets like India; this was unfair competition and that the US government should put a hold on new services from the Superconnectors, specifically capping capacity into the US at January 2015 levels, until the subsidy issues were resolved. According to Delta, this will be when "the US stems the flow of subsidised capacity to the US".

This view horrified the representative of the US travel and tourism industry who saw the recent gains in inbound tourism being undermined by protectionist actions — what about Orlando, its hotels, restaurants and DisneyWorld, which are to be connected to the Emirates network with a new daily service starting in September?

It also revealed a profound split between the US passenger airlines and the cargo business. FedEx pointed out that it and UPS combined employed three times the number of people as the big three US carriers, and it operated a very successful cargo network at its Dubai hub hugely outcarrying the Superconnectors in terms of freight tonnage and the US passengers airlines in terms of flights. The US passenger airlines' trade dispute was potentially a serious threat to FedEx, and it was not at all impressed by American saying that cargo could be excluded from the complaint. The US position would then be presented as: cargo excluded as the US has a competitive advantage, passenger traffic only to be considered as the US has a competitive disadvantage.

The FedEx attorney also introduced a wider concept to the aeropolitical argument. Trade agreements for the cargo integrators are not just about the allocation of flying rights between two countries; they encompass, as is normal in most industries, "equal national treatment". Basically this allows FedEx or UPS or DHL to operate distribution centres and fleets of trucks in foreign countries beyond the entry airport. The passenger airline equivalent would be cabotage, a concept that causes an apoplectic reaction in US major carriers, their unions and most politicians.

Back to Jim Callaghan of Etihad: he managed to draw a parallel between the attack from the US Majors and the abuse Ryanair, his previous airline, was subjected to by the European incumbents. Equating Etihad with Ryanair might be a stretch, but he did allude to what we consider to be a real issue. The US majors with their European partners have oligopolised the North Atlantic, maybe they have monopolised it, as the market has clearly been divided up into Star, SkyTeam and oneworld zones of control. In this context the encroachment of the Superconnectors in this super-profitable sector appears intolerable, even though their current North American capacity share is only about 2%.

The US majors the have some difficult questions to answer (which they completely failed to in the conference). If the Superconnectors were forced to freeze or reduce their capacity to the US, would the US airlines be willing or able to fill the gaps? What prices would they charge? As Callaghan pointed out, the relevant unfair competition clause in the US-UAE and other bilaterals refers to predatory pricing, and no case has been made for that. In effect, the Delta and American were reduced to whingeing that they couldn't compete with the Superconnectors in India, potentially the second most important growth market after China.

How much subsidy then?

Nevertheless, Etihad had to address a tricky question: how much does the Emirate of Abu Dhabi subsidise its airline? Research commissioned by the US carriers suggested $14bn out of a total of $40bn for the three Gulf carriers. Callaghan's response was in essence that; the balance sheet amounts that had been categorised as subsidy was the totality of Abu Dhabi's equity investment in the carrier.

This is where things get complicated. Is Etihad's situation analogous to the European flag carriers in the 1970s and 1980s whose governments poured in subsidies for political reasons or, to put it more positively, to enable commercial turn-around plans? Or is a rational investment in a national carrier by an oil rich state planning for a diversified future?

For perspective, the population of the UAE is about 9m (only 1.4m are Emirati citizens), less than 3% that of the US. In such tiny states it is impossible to know where the political world end and where the commercial sector begins (indeed in difficult to distinguish in much larger companies), However, it could reasonably be argued that what Abu Dhabi, Dubai and Qatar have done is invest in a sector where they have a comparative advantage, which is the economic basis for the benefits of free trade (see Adam Smith, David Ricardo, etc). And that comparative advantage comes from the geographical position of the hubs, the 24 hour operations, the new aircraft, the tax regime and the non-unionisation of the workforce. In the present global market, the Superconnector model is the most efficient for inter-continental traffic, and the old but persistent idea of fair bilateral competition simply does not apply.

Ambiguous Europeans

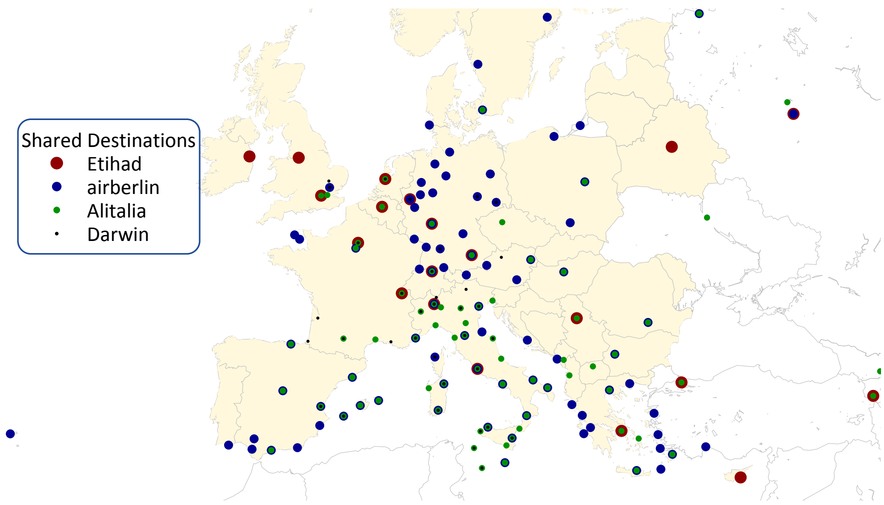
The American Airlines attorney was asked about its **one**world partner IAG which clearly strongly opposes the US carriers' complaint. "Disagreement among close friends", was the muted reply. However, the fact that BA is saying that Superconnector competition is a "good thing" is very significant. IAG, of course, is now 10% owned by Qatar Airways and the Qatar state investment fund has a sizeable 20% stake in Heathrow Airport.

European airlines do not have a unified aeropolitical response to the Superconnectors in general or Etihad in particular, and cannot form a united front with the US Majors. Alitalia and airberlin has followed BA and Iberia in exiting the Association of European Airlines (AEA) which appeared to be supporting the US carriers' compliant. The AEA's aeropolitical power has now been emasculated.

Lufthansa is in a dilemma. It has complained at length about Emirates (which has limited access into Germany itself but can bypass Frankfurt) and the undermining of its network by THY (with no such restrictions) into the hinterland behind its hubs. However, it probably prefers to have airberlin as a weak competitor in a "comfortable duopoly" rather than see it fail and see Ryanair or easyJet expand further in the domestic market.

Even Air France/KLM may be becoming a little ambiguous, as its poor financial performance and weakened balance sheet may soon require support from an investor with a deep pocket. As Michael O'Leary has rudely suggested, Air France's ultimate strategy should be to de-merge KLM and seek a Middle East airline partner willing to take a substantial equity stake.

Etihad Equity Alliance European Destinations



TAP Portugal up for sale again

DESPITE reporting a large net loss in 2014, TAP Portugal has again been put up for sale by the Portuguese government. As it celebrates its 70th anniversary, will Portugal's flag carrier find a new owner this time around?

The Portuguese state — which has always owed 100% of TAP — previously tried to privatise the airline in 2011 (see *Aviation Strategy*, June 2011), but without success. After receiving 12 offers of interest, the only firm bid the state received was from Polish/Brazilian businessman German Efromovich, whose Brazil-based Synergy Group owns a majority of Avianca Holdings (which controls the Avianca group of airlines). But this was turned this down after the government criticised the bidder's apparent inability to provide adequate financial guarantees. Sources indicate that Efromovich offered €35m in cash for the airline, plus a €316m injection into the balance sheet as well as the assumption of the airline's €1.1bn debt.

The latest plan to offload the airline was announced in November 2014, with the state aiming to sell 66% of its stake, with 61% going to investors and 5% reserved for TAP's 7,500 employees (at a discount to the final sale price). The state says it may also sell its remaining 34% in the future, at no earlier than 24 months after the sale of the first tranche, though of course that's dependent on getting the first away successfully — which will be no easy task.

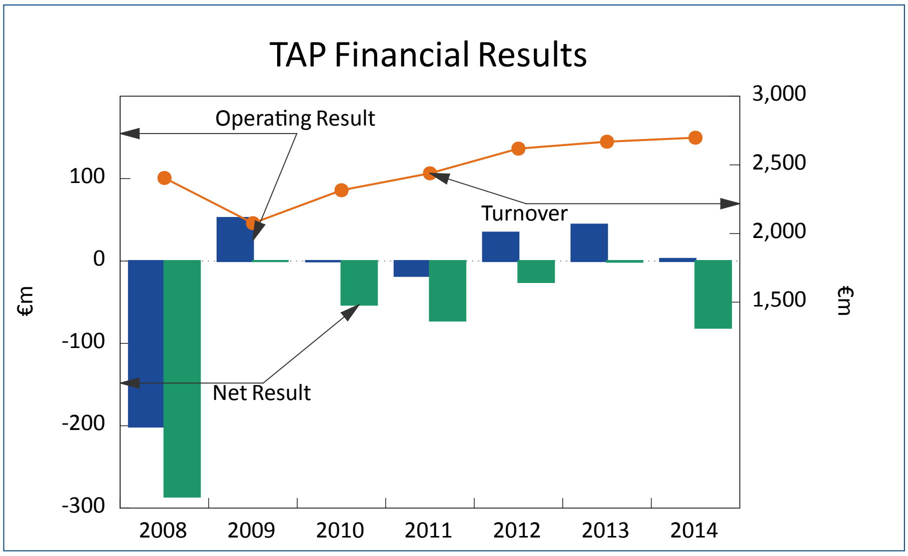
Conditions for a sale are, if anything, worse for TAP this year than they were back in 2011. After posting a €20.1m net loss in 2012, in 2013 TAP posted a 1.9% increase in revenue to €2.7bn, with operating profit up 8.1% to €44.1m and the net loss coming down to €1m. In 2014, however, while revenue rose 1.1% to €2.7bn, the operating profit plunged 94.3% to just €2.6m, with the net loss increasing 93 fold to €80.1m.

TAP blamed the results on various causes — the World Cup in Brazil in June and July (when the airline said that no-one wanted to leave the country, preferring to stay at home and watch the tournament instead), the late arrival of new aircraft, 22 days of strikes through the year and "operational issues" which, combined, took €108m off the bottom line. The strikes alone cost more than €25m, the airline claims, and one of the key problems facing any acquirer is management's relationship with its workforce, which is poor.

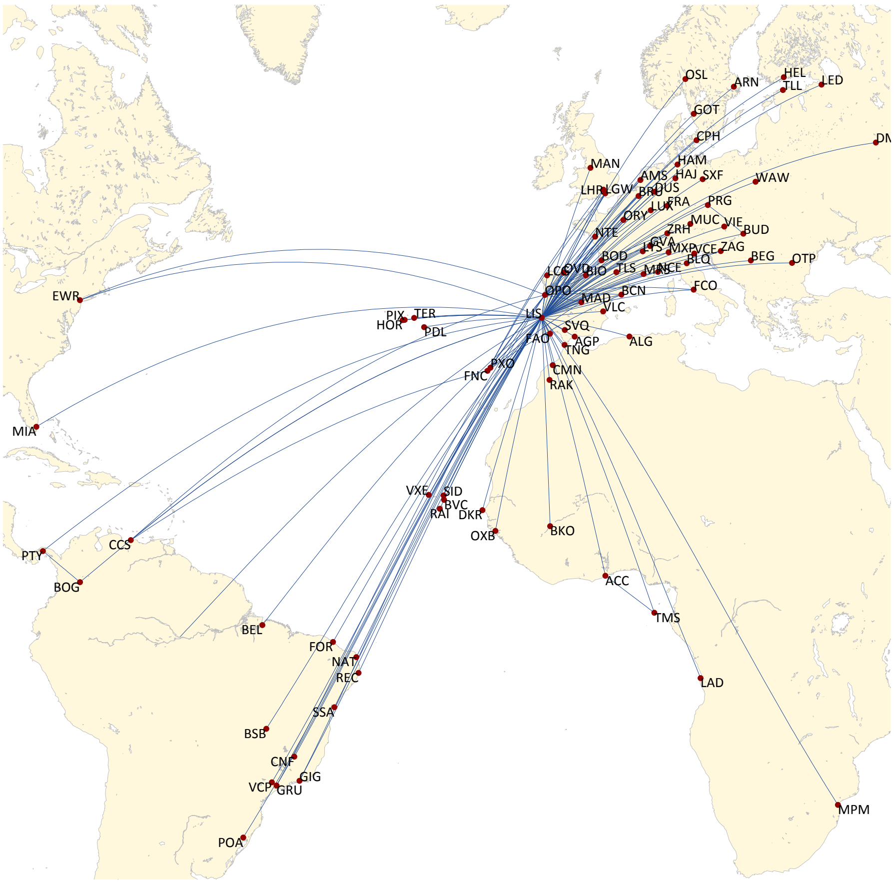
TAP's unions are vehemently opposed to the sale of the government's stake, which they argue will only lead to redundancies and cuts in pay and conditions. But after a coalition of 12 unions representing the workforce threatened to strike for four days over the Christmas holiday period as a protest against the sale, the government backtracked and said it would impose a strict condition upon any acquirer whereby they couldn't make any mass lay-offs once they acquired TAP.

30 months moratorium

According to the terms of that agreement signed between the government and TAP's unions in January, there will be a 30-month moratorium on collective redundancies or for as long as the state remains a shareholder. Another agreed pre-condition of a sale (there are nine major ones in all) is the full implementation of all existing collective bargaining agreements between unions and TAP, as well as maintaining TAP's status as the



TAP Route Network



Portuguese flag carrier, preserving the company headquarters and main hub in Lisbon, as well as "effective management" remaining in Portugal. Those conditions will be a major stumbling block for investors, who are likely to want to make cost savings and at least trim the existing TAP workforce, but they are not insurmountable; if the price were right, an acquirer would wait the 30 months before making the necessary cost rationalisation.

TAP states that it has already cut €250m from its cost base over the last three years, and the airline is in the last two years of a 2012-2016 strategic plan that has three goals — network growth, unit cost improvement and unit revenue increase.

That is a fairly generic set of objectives, and any purchaser would look very closely at the underlying cost structure of TAP, and particularly at the network structure and strategy. The Portuguese domestic market is small by any European standard (around 70% of TAP's revenue is generated outside of Portugal) so in effect the airline's strategy depends on interconnecting passengers at the Lisbon hub from Africa and Brazil to and from Europe.

TAP carried 11.4m passengers in 2014, 6.6% higher than in 2013, with a 30:70 split between long- and short/medium-haul passengers. TAP currently operates to 84 destinations in 35 countries, across Europe, Africa, North America and South America, with the largest route network being in Europe, with nine cities served in Portugal and 44 in the rest of Europe, within which Spain is the most important market, with eight destinations, followed by France, with seven, and Germany (six).

In 2014 Europe accounted for the largest proportion of TAP's turnover — at 38.4% — but the South Atlantic market was close behind, providing 34.4% of revenues (of which the vast majority comes from the Brazilian market) and certainly a much higher proportion of overall profit

Faced with extensive LCC competition, most of TAP's European routes are loss-making, but a reasonable European network is necessary in order to attract feed into/onto its long-haul routes, which are the profit-drivers of the airline. But this brings TAP into competition with the much bigger and efficient (and higher yielding because of a higher proportion of business traffic) hubs operated by IAG, AF-KLM and Lufthansa. The Superconnectors' hubs in the Gulf are also filtering off connecting traffic from what were strong Africa-Lisbon routes.

On long-haul TAP serves 15 African destinations (including former Portuguese colonies) plus three in central and North America (Panama City, Miami and Newark), and 13 in South America. 11 of the latter market are to Brazil, which with 84 flights a week clearly is the key market for TAP. The airline's traffic flows between Portugal and Brazil depend on the business market both ways, the VFR market from Brazil to Europe, and holiday traffic to Brazil.

From its Lisbon hub to Brazil, TAP enjoys a monoply on every route as Latam, which absorbed the failed flag-carrier Varig, has not replaced Varig's services. Latam is concentrating its Atlantic operations on the north European hubs, but it will surely add Lisbon to its network in the medium term.

TAP, remarkably, says it has ambitions to fly to Asian markets (which it has served in the past) as well as the Americas and Africa, but is constrained by its fleet. The fleet totals 61 aircraft. comprising 21 A319s, 19 A320s, three A321s, 14 A330s and four A340s. In addition, its regional subsidiary, PGA (Portugalia Airlines), operates eight Embraer 145s, six Fokker 100s and two ATR 42-600s on domestic and international routes from its base at Lisbon and a secondary hub at Porto.

The only aircraft on order for TAP are 12 A350-900s, which will start arriving in 2017 and all be delivered by 2020, to replace A330s and A340s and to underpin growth on long-haul. The A340s will be the first to leave the fleet, followed by the older A330s (although most of the A330s are newer models), but it's only once the A350s arrive that the airline can expand its long-haul operations.

TAP's A320s (a type TAP is happy with) have an average age of 14 years and a replacement fleet also needs to be ordered for these, but TAP simply doesn't have the finances necessary for a new order, and clearly the decision will not be made this side of a new investor coming in.

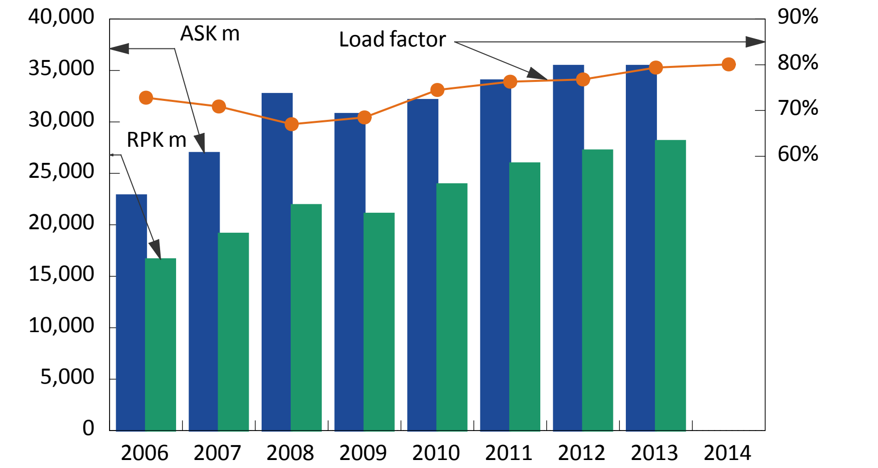
Deep pockets needed

But rationalising a European network and examining the cost base will not be the only challenges that a new owner will face. TAP also has debts of around €1bn ($1.3bn), and of course the airline can no longer be propped up by a state injection of capital. The government is clear as to what its priority is, with Sergio Monteiro, Portuguese transport minister, saying that "the state does not intend to obtain financial gains from this privatisation; rather it wants to guarantee that TAP is adequately capitalised˝.

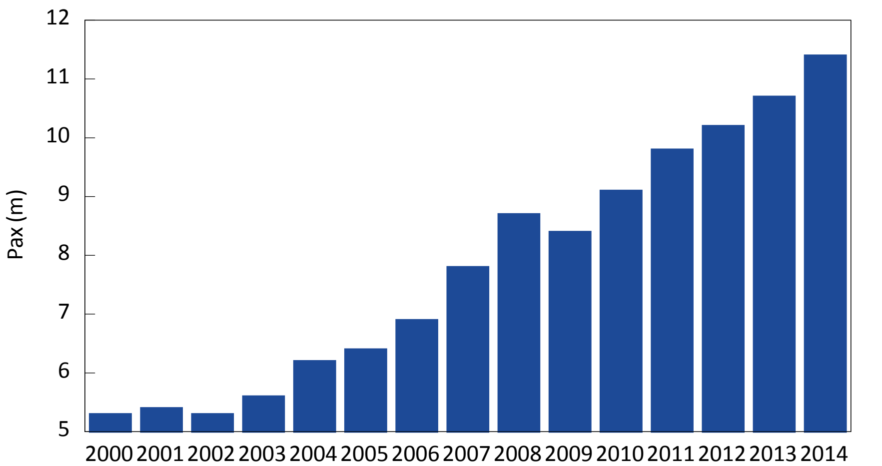
Originally TAP's privatisation was just one part of a mandated sale of state assets that was imposed on Portugal as a condition of a massive EU, European Central Bank and IMF bailout signed in May 2011, when those institutions provided €78bn of financial assistance over a three year period ending May 2014 in order to help the country out of its economic troubles. Conditions included a series of tax increases and cost-cutting programme in order to reduce Portugal's budget deficit, the latter including privatisation of national assets — and TAP Portugal was at the top of that list.

Over the last four years more than €9.4bn has been raised from sales of stakes in energy companies, banks and other state entities — substantially more than the €5.5bn target given to the Portuguese government for the sale of assets. However the government still wants to sell off TAP, as it wants to offload the airline's debt and find someone able to fund the airline going forward. Or, as Fernando Pinto, CEO of TAP Portugal, puts it

TAP Traffic Statistics



TAP Passengers Carried



— getting rid of majority government ownership will give the airline "more liberties".

Government sources indicate that this time around the state is looking for a minimum of €300m in cash and investment in the airline (on top of the assumption of debt commitments) — which is some €50m less than Efromovich offered in 2012.

There is no official timetable for the latest privatisation attempt, though the government says it ideally wants to select a preferred investor by the end of the first half of 2015, with an unofficial deadline of May 15th for binding bids from interested parties.

Monteiro says that the government "is more optimistic now and we face this process with redoubled confidence that it will be successful — though we will only know when we receive the formal proposals″. But complicating the process is substantial opposition to the move, not just from unions but from a significant part of Portuguese society as a whole. The upcoming general election in Portugal (being held in September and October) puts the sale even more at the forefront of the news pages, and the centre-right government's is facing intense opposition from the main opposition, the Socialist Party (PS) which opposes the plan to privatise TAP.

PS argues that a sale is no longer needed for bailout reasons, and that TAP is "one of the pillars of national sovereignty" as it connects Portugal with its interests in South America and Africa, with PS instead suggesting that the state should IPO a minority part of TAP while retaining a majority stake in the flag carrier. To add to the mix a number of Portuguese celebrities have recorded video messages attacking the government's sales, and the Pilots' Union has now announced another strike protesting against the privatisation, to run from May 1st to May 10th (and which will severely affect TAP's operation even after a "minimum services" provision that will be set by an arbitration tribunal and which the union will have to adhere to).

The usual suspects?

Against this background, who will step forward and make a concrete offer? The usual potential buyers have been mentioned in the Portuguese press — the Gulf super-connectors (though of course investors from outside the European Union couldn't acquire a majority stake), IAG, Lufthansa, Spanish group Globalia (which owns Air Europa), US/Brazilian entrepreneur David Neeleman (who founded JetBlue in the US and Azul in Brazil) and German Efromovich (yet again), as well as a number of Portuguese entrepreneurs that include Miguel Pais do Amaral, who reportedly may bid jointly with Frank Lorenzo, former chairman of Continental Airlines.

If it has a choice (and that's a very big if), the government will choose an airline investor who has the very deepest pockets — but there are not too many of those candidates around.

A bid from International Airlines Group might make some strategic sense, as a combination of the Lisbon and Madrid hubs would provide IAG a with a dominant grip on traffic flows between South America and Europe — although that's something that regulators would be concerned about. It might be more logical for IAG to wait and see if an independent investor can start to turn TAP around, then make a move.

Etihad's deep pockets would make a deal relatively easy to finance and the Abu Dhabi carrier already operates a codeshare with TAP across the South Atlantic and there might be aeropolitical advantages.

Lufthansa might be tempted. TAP joined the Star alliance in 2005 and has codeshare deals with many Star members, while TAP's Lisbon gateway into South America could be developed into an alternative to **one**world's Madrid hub.

Reports from Portugal, however, suggest that TAP's management would prefer not to be acquired by a large rival of the size of BA, Lufthansa or Qatar, as it would then be subservient to the managerial experience of the larger and more efficient acquirer. But that's the key point of the deal — to bring in better, more ruthless management that can do away with many of TAP's inefficiencies, and make the tough decisions over routes, fleet and workforce that a state-owned TAP has avoided for far too long.

TAP Fleet

	In Service	Orders	Total
A319	21		21
A320	19		19
A321	3		3
A330	14		14
A340	4		4
A350		12	15
100	6		6
ERJ-145	8		8
Total	**75**	**12**	**90**

Future of the A380

IT IS TEN YEARS since the first flight of the A380. So far it has won only 317 orders, less than a third of the 1,200 Airbus originally projected for its first 20 years. So what can Airbus do to revive sales: should it invest in a re-engined version for better fuel economy, or try to squeeze out better numbers by less ambitious performance improvement packages? The aircraft is certified to carry 853 passengers, but the standard version now is being offered with 544 seats, and most operators put in only 525 seats, preferring to market the comfort of superior roomy, quiet cabins, especially in economy. Seats are being sacrificed for cocktail bars, just like in early 747s.

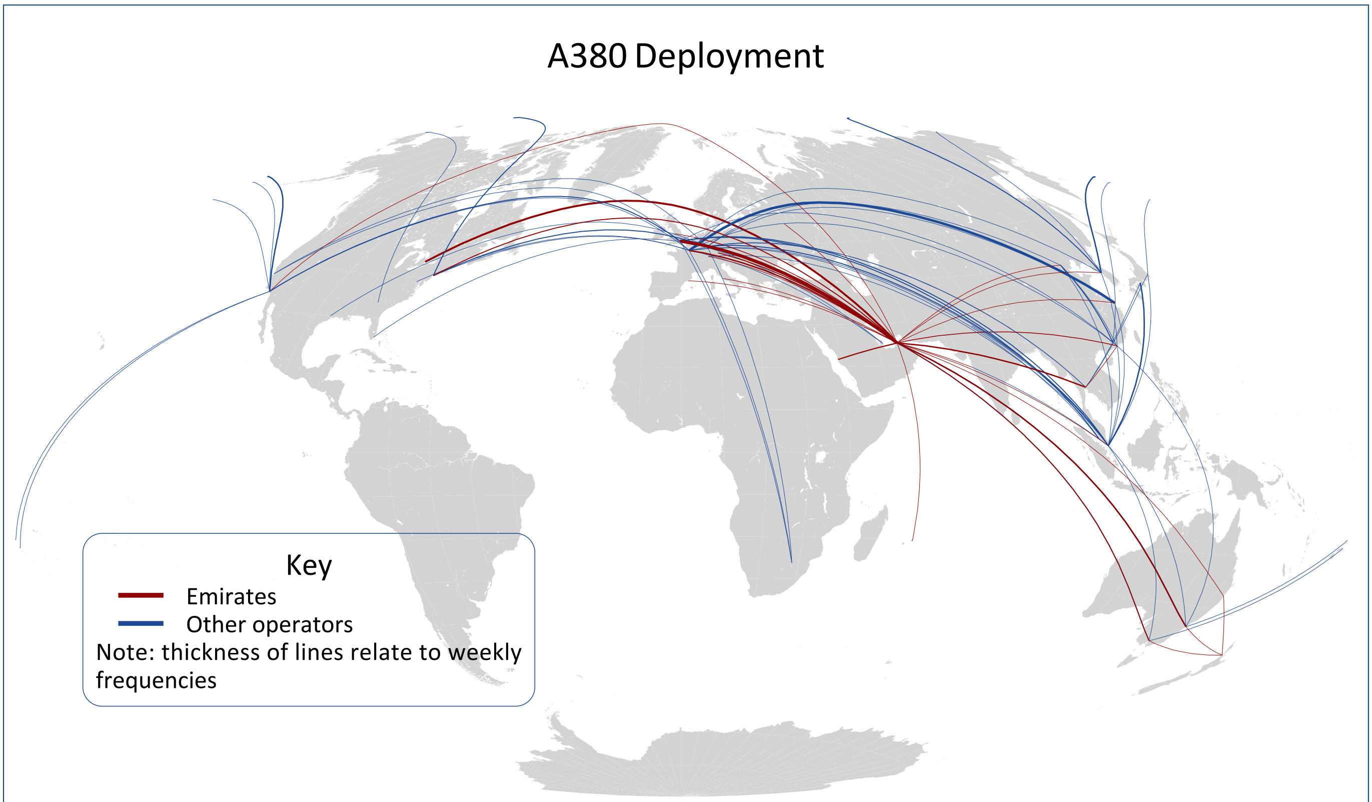
There is no doubt the aircraft is generally popular with its passengers, but no new airline order has appeared for two years. Last year the only order came from Amedeo, a leasing company, whose sole lessee is Emirates. In December 2014 an Airbus executive's careless remark to journalists gave the (false) impression the manufacturer was contemplating stopping production in a few years. But now there are signs of life, reviving hope for the aircraft's prospects.

The most significant is the campaign by Emirates, by far the biggest buyer and operator, to persuade Airbus and Rolls-Royce to come out with a re-engined and upgraded version in a few years. Emirates CEO Tim Clark suggests he would buy up to 200 extra A380s, were it to get updated engines.

Numbers are being crunched in Toulouse and Derby to justify spending an additional $2 billion on developing a plane whose sales have stalled. It will take cool nerves and a long view to justify the investment. But the decision, announced in April, by Emirates to put Rolls-Royce engines for the first time on its latest order batch of A380s could be interpreted as a step towards an A380 neo.(Orders for 30 announced at the Paris air show, another 30 later at the Dubai air show?).

But there are also strong voices both in Airbus and Rolls-Royce which say that there is no business case unless other airlines commit to a new version.

Tim Clark criticises other carriers for not making the best use of the A380. Emirates builds up traffic on a



A380 Order Book May 2015

	Orders	Delivered	Backlog
Air Austral	2		2
Air France	12	10	2
Amedeo	20		20
Asiana	6	2	4
BA	12	9	3
China Southern	5	5	
Emirates	140	59	81
Etihad	10	1	9
Korean	10	10	
Lufthansa	14	13	1
MAS	6	6	
Qantas	20	12	8
Qatar	10	4	6
SIA	24	19	5
Thai	6	6	
Transaero	4		4
Virgin Atlantic	6		6
Undisclosed	10		10
Total	**317**	**156**	**161**

Source: Airbus

route enabling the airline to move up from serving it with A330s and 777s to the A380. Higher density versions serve destinations in India. Across the board Emirates says its A380 load factors are more than 75-80%.

The map below traces the current pattern of A380 schedules. Unsurprisingly, the Middle East hubs, essentially Dubai at present, dominate the picture accounting for 48% of total A380 departures. The other concentrations are around the Euro-hubs, especially Heathrow, and SIA's Changi hub. They account for 18% and 15% of departures respectively.

The Middle East market depends on uncongested airports and 24 hour operations, enabling a huge number of connecting flows to be channeled through the hubs. The European market depends on congested airports, with traffic being consolidated in to ever-larger aircraft. However, there are limits: to fill A380s, except on certain routes and timings, requires feeder flights which do not alleviate congestion at the airport, and the demand for frequency on high volume but business-orientated routes means the use of smaller gauge aircraft.

North American airlines continue to focus on 777 and now 787 types equipment for their long-haul routes, and the chances of Airbus making a break-through into this market are remote.

Airbus still argues for demand for 1,500 super-widebodies over the next 20 years, convinced that airport congestion will eventually haul up sales, assuming that, as the manufacturers' forecasts contend, air traffic continues to double every 15 years. A recent analysis by the United Nations suggests by 2030 about 9% of the world's population will be living in 41 "mega cities" of more than 10m inhabitants. That is double the share in 36 such cities at the turn of the century. By definition these cities will be the richest spots on earth, generating demand for long-haul air travel connecting them, while their geographic sprawl will limit airport expansion. The argument is that demand for scarce take-off and landing slots will eventually force airlines to buy A380 types.

But, as Airbus chief executive Fabrice Bregier ruefully remarked recently, the A380 may have been launched ten years too early. Although the A380 has sold only a handful in China, which is set to be the world's largest aviation market by about 2030, the ultimate fate of the A380 could lie in Chinese hands.

Airport Valuations

NOTABLY there are relatively few airport operators worldwide with shares open to public investment; and those that are seem to attract valuations well below levels achievable in private and trade transactions. The European airport groups in the chart top right currently trade on forward EV/EBITDA ratios of around 11 times compared with recent trade and private transactions of other airports at the 15-18x level.

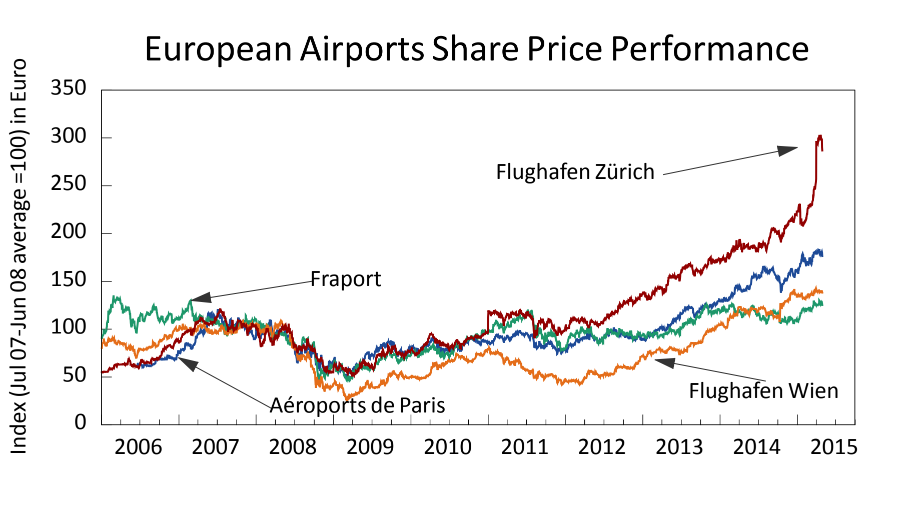
Following the 2008 financial crisis Fraport took three years to before its share price recovered to pre-peak levels — and in the meantime was spending vast amounts on a new runway. It has only recently returned to generating free cash flow but will be shortly embarking on a €3bn new terminal and with profits flat, the shares have flatlined.

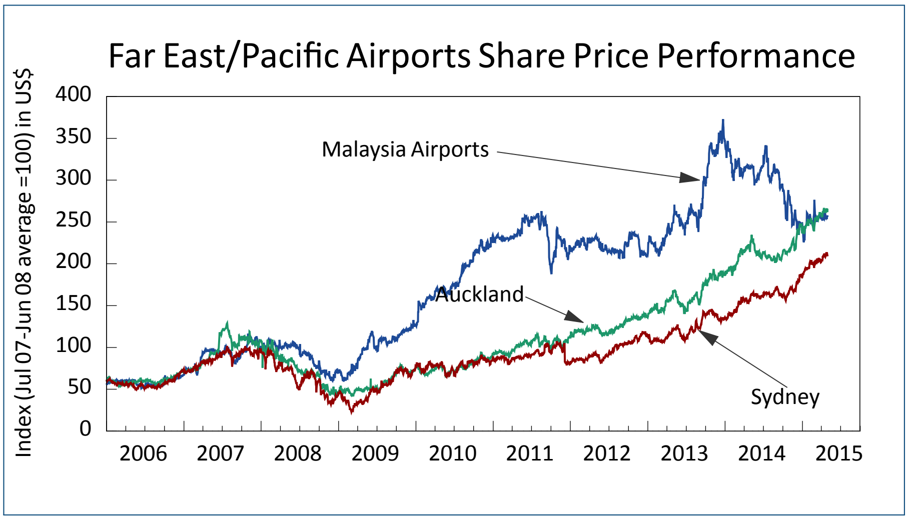
Vienna was hit harder in the downturn partly because of concerns over the survival of its base carrier Austrian; but with an acceptance that it may not need to build a third runway before 2022 and with Austrian's recovery under Lufthansa management the shares have been performing strongly.

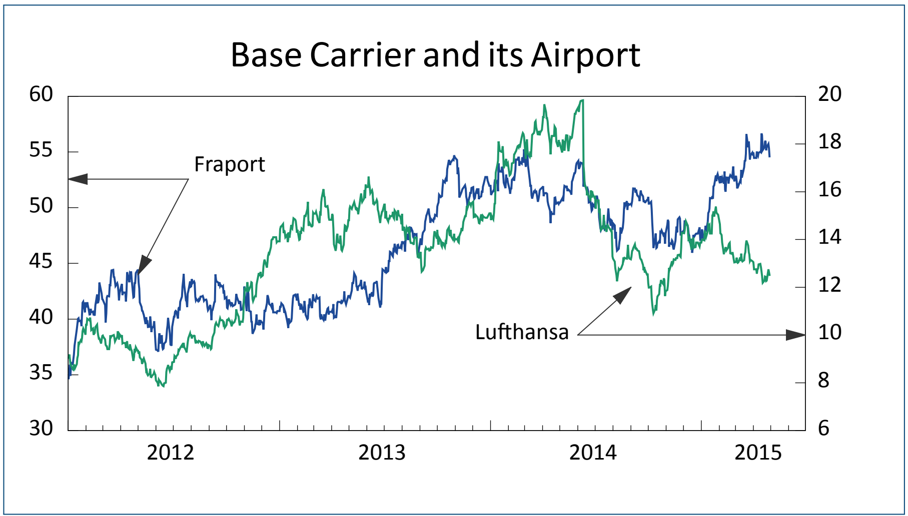
The strongest performer has been Zürich — again with a Lufthansa-backed base carrier of Swiss — helped of course by the recent strength in the Swiss Franc.

In the Far East, it is notable that Malaysian Airports has been particularly hard hit by the combined catastrophes of its two base airlines in Kuala Lumpur — MAS and AirAsia.

For investor reactions to the relative value of investments in aviation we show the chart bottom right: an airport can be attractive when an airline is not and *vice versa*.







Allegiant: Stepping up growth in an ever-expanding niche

ALLEGIANT Air, a Las Vegas-based ultra-low cost carrier, has achieved fame for its unusual but highly profitable strategy of operating cheap fuel-guzzling MD-80s in low-frequency service between small cities and popular leisure destinations and deploying Ryanair-style revenue strategies.

Now Allegiant is in the news for two additional reasons this spring: becoming the first sizable airline in memory to earn a 33% operating margin (in the first quarter), and getting perilously close to becoming the first US airline since 2010 to be hit by a pilot strike.

Adding to the intrigue, Allegiant is stepping up growth significantly this year, in what some sceptics had argued was a limited niche. The airline plans to grow its ASMs by 16-20% in Q2 and by 21-25% in Q3, following only 6.1% growth in Q1. In full-year 2015, ASMs are projected to increase by 15-18%, after 10.1% growth in 2014.

Some of those plans, however, could be scuppered by a pilot strike. Allegiant obtained a temporary restraining order that averted a strike over the Easter holiday. On April 22 the management stated that they were confident of securing, within a week or two, a preliminary injunction ruling that would bar the pilots from staging a strike, sick-out, slowdown or any other actions. However, in some press interviews the pilots painted a very different picture of the situation.

There are obviously two imperatives: the need to avert a strike and the need to properly resolve the issues with the pilots' union for the longer term. If the latter is not accomplished, Allegiant's growth plan could still be jeopardised.

Allegiant Travel Company, the airline's parent, has been profitable for 12 consecutive years. It achieved double-digit operating margins through the challenging industry years in the late 2000s. In 2014 it had the US airline industry's second-highest operating margin (17.6%, just below Spirit's 19.2%). In the fourth quarter, Allegiant took the lead with a 20.8% margin.

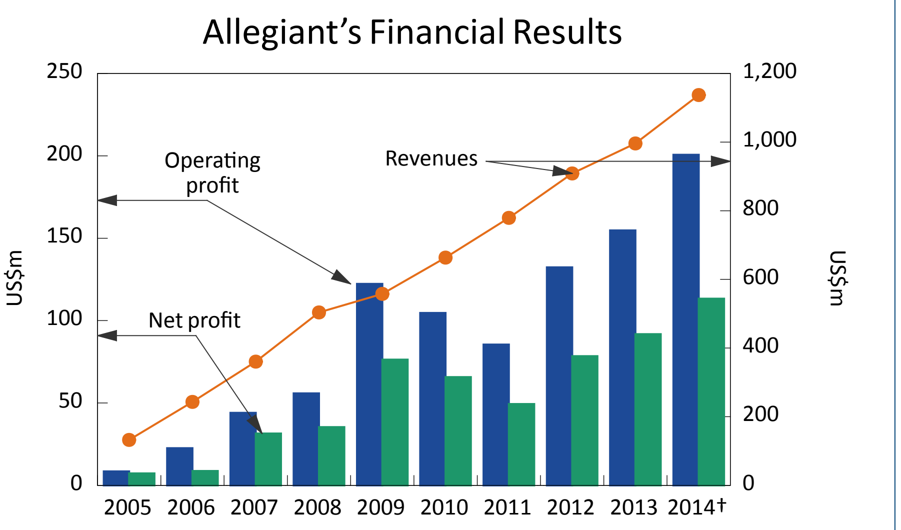
In this year's first quarter, Allegiant was in a category of its own with a stunning 32.8% operating margin. Its operating profit almost doubled to $108m, net income surged by 90% to $65m and revenues rose by 9% to $329m.

Because of its lack of fuel hedges, limited profit sharing and leisure traffic focus, Allegiant is one of the biggest beneficiaries of the decline in fuel prices. In the first quarter, its average fuel cost per gallon declined by 40% and its total CASM fell by 15% to 8.73 cents.

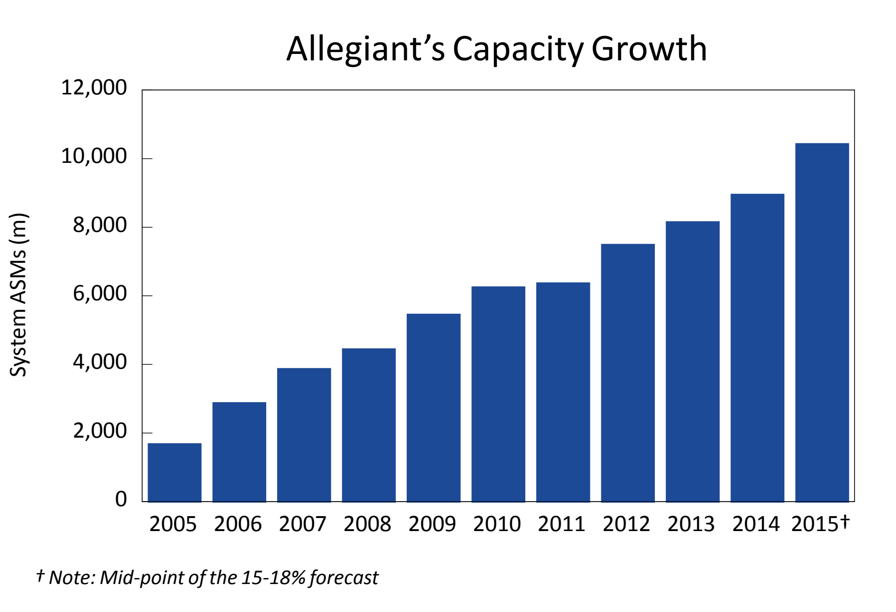
Allegiant is also benefiting from strong ancillary revenue growth, which has helped offset weakness in its yield and average ticket revenues. In the first quarter, ancillary revenue per passenger reached a record $52. Total revenue per passenger fell by 2.9% to $142.

Allegiant is able to step up growth, in the first place, because lower fuel prices have improved the economics of operating its old fleet. The carrier has also resolved the pilot availability and training issues that plagued it last year. And there are plenty of good used aircraft available, enabling Allegiant to pick up A320s for just $10m each.

Importantly, Allegiant has enhanced its growth prospects by



† Note: Adjusted for a $43.3m writedown of the 757 fleet.



making some major changes to its business model since the late 2000s. When *Aviation Strategy* last took an in-depth look at the company in the Jan/Feb 2007 issue, investors were concerned about two things that could limit Allegiant's growth. First, there was the question of how long the airline could rely on an aircraft type that was no longer in production (the MD-80). Second, there were fears that Allegiant was beginning to reach the limits of its small-cities-to-Las Vegas/Florida niche.

Allegiant has successfully resolved both those issues. It has diversified its fleet from MD-80s to three types (also 757-200s and A319s/A320s). It has diversified its network to include the East Coast, medium-sized origin cities and many new leisure destinations, including Hawaii. (The 757/Hawaii plans were covered in the July/August 2010 issue of *Aviation Strategy*.)

Allegiant's background

Founded in 1997, the airline initially operated charters and a small network of high-frequency services focusing on the business traveller in the West using DC-9s. The strategy was unsuccessful and the company filed for Chapter 11 in December 2000. After two-years' restructuring, Allegiant emerged from bankruptcy in March 2002 with a new strategy.

The company's two largest original investors — CEO Maurice Gallagher and Robert Priddy — were the founders and top executives at ValuJet, the hugely successful early 1990s LCC that was grounded following its DC-9 crash in 1996. (That said, the executives were not directly blamed, and Priddy oversaw ValuJet's successful transformation into AirTran and remained CEO for many years.)

As part of Allegiant's reorganisation, Gallagher's debt was restructured and he injected additional capital, becoming the majority owner, with a stake of about 80%. He took over as CEO in August 2003.

In subsequent years, Allegiant sold equity to four of its senior officers and brought in additional investors through private placements. A holding company structure was introduced in April 2006. Allegiant went public in December 2006, which reduced Gallagher's ownership stake to around 23%.

Gallagher remains Allegiant's largest single shareholder, with a 21% stake at year-end 2014. Such a holding by a CEO is unusual for a major carrier; Allegiant is the tenth largest US airline, with $1.1bn revenues in 2014. But it aligns the management's interests well with those of other shareholders, keeping the financial community happy. Analysts often comment on how "shareholder-friendly" Allegiant's management is.

Allegiant has been a steady buyer of its stock. As of March 31, it had returned around $514m to shareholders through share repurchases since 2007. After many years of paying special cash dividends, in January Allegiant's board approved the payment of a regular quarterly dividend of $0.25 per share, which started in March.

Allegiant has a healthy balance sheet. At the end of March, unrestricted cash was $438m (38.5% of last year's revenues), total debt $617m and stockholders' equity $302m. Return on capital employed in the 12 months ended March 31 was 21.3%.

But debt has crept up in recent years, with the result that Allegiant's credit metrics, which used to be similar to Southwest's, are now measurably worse. For example, Allegiant's year-end 2014 debt/adjusted EBITDAR ratio was 2.3 times, compared to Southwest's 1.5 times.

The debt has increased mainly because of higher aircraft capex, which was $279m in 2014 and is expected to be around $260m this year. Allegiant stresses that it only raises debt "opportunistically", when it can secure attractive terms.

Target markets

Allegiant targets price-sensitive leisure travellers in underserved cities that otherwise have few options to travel to what the company calls "world class leisure destinations". There are a large number of "origin cities" throughout mainland US (81 as of February 2) and a relatively small number of "destination cities" (15 currently).

The markets targeted by Allegiant are typically too small for nonstop service by legacies or traditional LCCs, or they are so low-yield that they are not a priority for other carriers. While some of the markets might be suitable for RJs, Allegiant's CASM is significantly lower and its larger aircraft offer a comfortable alternative to travellers. Consequently, Allegiant has competition on only 24, or 11%, of its 229 routes (as of February).

Since the late 2000s, there have been three notable network developments. First, the number of destination cities has increased significantly. In 2007 there were only three: Las Vegas, Orlando and Tampa/St. Petersburg. Now the list also includes places such as Honolulu, Phoenix, Los Angeles, San Francisco, Palm Springs and New Orleans, as well as additional Florida destinations.

Second, Allegiant has expanded its network to include medium-sized origin cities, seizing opportunities that arose from the US legacy consolidation. Allegiant noted in a recent presentation that between 2007 and 2014, medium-sized hubs in the US saw a 20.9% reduction in total domestic seats, compared to 15.3% and 3.3% reductions for "small" and "large" hubs, respectively.

This new strategy has brought Allegiant to larger origin cities such as Indianapolis, Pittsburgh and Cincinnati. The latter has apparently been the carrier's "fastest-ever growing city".

Third, Allegiant has made a major — and evidently very successful — push for the East Coast. Most of last year's growth was in the East, which now accounts for more than 50% of the airline's system ASMs.

All of those changes meant not just revenue opportunities but risk diversification. Allegiant is now more protected from regional variations in the economy, airport issues or competitors' actions.

The East Coast continues to be the focus of Allegiant's expansion in 2015, seeing almost 20% ASM growth, while the Las Vegas markets will see flat capacity. Growth will kick off in May, when Allegiant adds five new cities and 22 new routes. Based on the published schedule, total routes will increase from 233 at year-end 2014 to 271 by November. There will be another batch of city and route announcements in the autumn.

So Allegiant's niche is showing no sign of reaching its limits. It is evidently a very large niche. In the longer term, the management envisages annual ASM growth in the "mid-teens", based on a net addition of around seven aircraft per year.

Flexible, low cost model

But Allegiant's "small cities, big destinations" niche is only possible because of a unique fleet and operating strategy. Profitable operation of 150-seat or larger aircraft in relatively small markets calls for very limited frequencies. Depending on the period (peak or off-peak), 60-80% of Allegiant's routes have only two weekly frequencies.

This gives the airline very low average daily aircraft utilisation — just 5.3 hours in 2014, compared to 11-13 hours typical for LCCs. But Allegiant compensates for that by buying or leasing used aircraft at extremely low prices. Its earlier MD-80 acquisition and introduction costs averaged less than $6m per aircraft — up to 80% below what other LCCs paid for new 150-seaters.

The low aircraft ownership costs give Allegiant exceptional flexibility to fly when demand dictates. The airline can tailor flight frequencies to the needs of the market on a daily and seasonal basis. It can more easily enter or exit markets.

Despite the low utilisation and higher maintenance costs associated with the old fleet, Allegiant is one of the lowest-cost producers in the US, with ex-fuel CASM of 6.61 cents in 2014. This is because it employs many aspects of the LCC model.

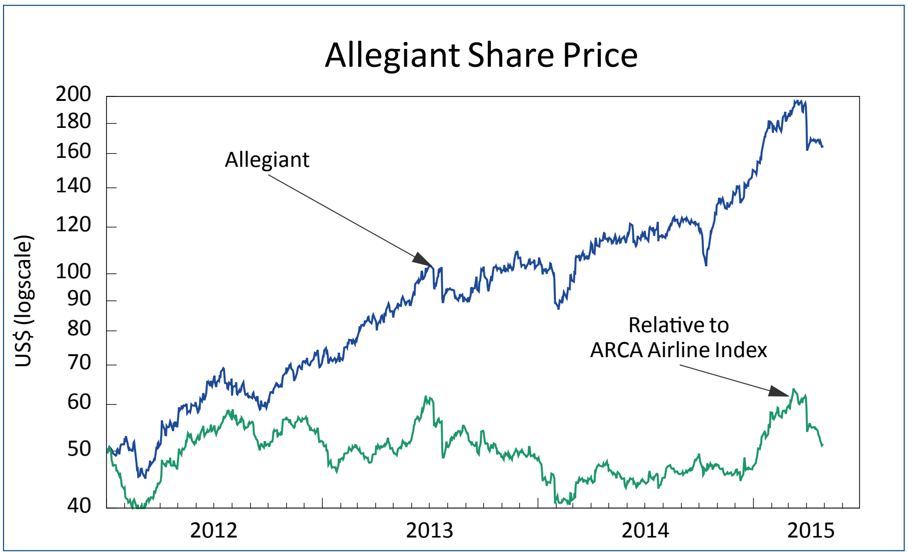
In addition to the low aircraft ownership costs, Allegiant's low cost structure stems from a highly productive workforce, a simple product, a cost-driven schedule, low distribution costs and the use of cheaper small airports.

The cost-driven schedule is an interesting concept. The airline designs its flight schedule so that most aircraft return to the crew bases at night, thereby reducing maintenance and flight crew overnight costs and providing a "quality of life" benefit to employees.

Evolving fleet strategy

After operating only MD-80s, in March 2010 Allegiant signed an agreement to acquire six used 757-200s for the purpose of serving Hawaii. The airline obtained ETOPS certification for the 215-seat aircraft, which were all delivered by the end of 2011.

In mid-2012 Allegiant began



acquiring A320-family aircraft for growth. The first transaction was for nine leased 156-seat A319s from GECAS, for delivery from mid-2013. The management noted that A319 asset values had declined significantly to "mirror the environment we saw when we first began buying MD-80s".

Later that year Allegiant announced the purchase of nine 177-seat A320s, which averaged 12 years in age and had been operated by Iberia. The deal was described as a "tremendous opportunity to purchase a sizeable fleet of sister-ships with CFM powered engines at very attractive price".

Since then Allegiant has grown its A320-family fleet and commitments in a series of opportunistic transactions. Most of the aircraft have been purchased with cash, but the airline has often subsequently raised debt secured on the A319/A320s.

In June 2014 there was a series of transactions that included the purchase of 14 additional A319/A320s, conversion of future operating lease obligations to forward purchases, a $300m public debt offering and an interesting sale-leaseback type deal.

The latter involved Allegiant buying 12 A319s that were already subleased to a European carrier, keeping that arrangement until the leases expire in 2018 and then using the aircraft for growth. In the short term it is collecting $30m annually in lease revenues. However, Allegiant does not intend to become a leasing company; the rationale is that sale-leasebacks can "provide aircraft commonality and greater fleet plan certainty than spot market transactions".

In recent months Allegiant has been extremely active in the used A319/A320 market. Since the beginning of this year, it has committed to 15 additional aircraft, including an April 22 purchase of three A320s that were repossessed from Hamburg Airways. The 15 aircraft will be delivered from late 2015 through 2017.

At the end of March, Allegiant's 73-strong operating fleet consisted of 53 MD-88/82/83s, six 757-200s, five A319s and nine A320s. The MD-80s' age range is 19-29 years and the 757s' 21-23 years.

Allegiant does not anticipate much, if any, reduction in its MD-80 fleet over the next two years — unless good A320 acquisition opportunities arise. The MD-80's maintenance costs have been stable and the aircraft are nowhere near their FAA-approved cycle or flight hour limits.

However, Allegiant took a $43.2m write-down on the value of its 757 fleet in December. Residual values were reduced from $6m to $3m, based on what the company believed was a permanent decline in the used 757 market. Allegiant is now projecting its 757 fleet to decline from six to four units by year-end 2016.

Allegiant remains on the look-out for high-quality used A319/A320s that fit its specifications. Because of that, it does not have exact fleet projections. Current plans suggest that it could operate 44-46 A320-family aircraft by 2018, accounting for around 45% of its total fleet of perhaps 99-103 aircraft.

The Airbus aircraft can fly longer routes and make marginal flying profitable. They also achieve higher average daily utilisation (7.9 hours in 2014) than the non-Airbus fleet (4.9 hours).

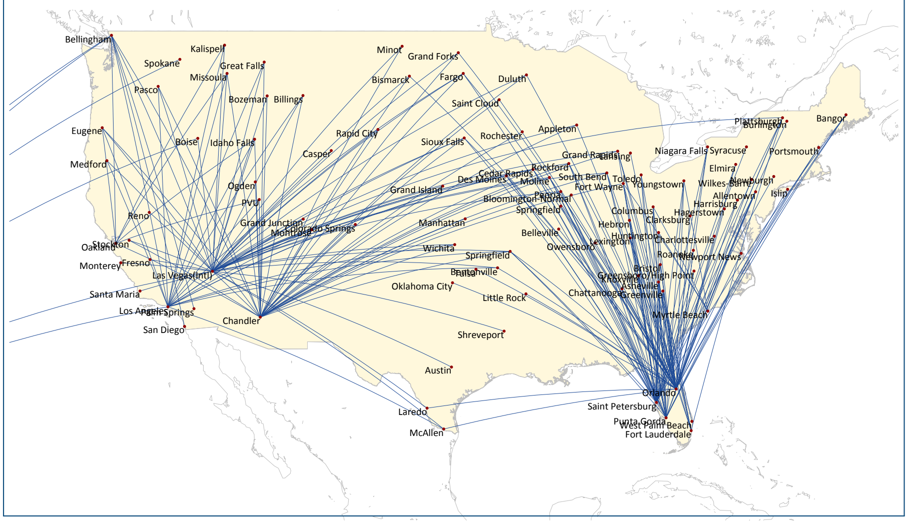
Allegiant Fleet Profile

Aircraft Type	In service
757	6
A319	5
A320	9
MD-80	53
Total	73

Expedia with wings

Another key piece in the puzzle that makes Allegiant successful is that it is more than an airline: it is in the business of selling travel. Some years ago the management described it as "Expedia with wings". It has the ability to

Allegiant Route Network



access and sell inventory for hotels, cars and other third-parties at wholesale rates, sell it combined with an air seat and manage the margins as it sees fit.

Allegiant owns and manages its own air reservation system, which makes it easier to fine-tune product offerings. The company believes that the control of its automation systems has allowed it to be an industry innovator with travel services and products.

Last year Allegiant derived 36% of its revenues from non-ticket sources — a little less than Spirit's 41%. But Allegiant has an unusually diversified non-ticket revenue structure. Its activities also include fixed-fee flying and aircraft leasing.

There are many ancillary revenue initiatives in the works that should sustain growth in non-ticket revenues. At its investor day the airline talked about fare buckets, seat assignments, prepaid bag pricing, a charge for check-in and "TripFlex" pricing. Growth areas include convenience fees and priority boarding fees.

Labour risks

Allegiant's pilots unionised in August 2012, electing to be represented by the Teamsters (IBT). Two years of negotiations produced no contract (which is not unusual for airlines), but the two sides have not talked since October or November. It is not all about pay. IBT claimed that Allegiant's management unilaterally changed existing work rules in violation of the Railway Labor Act, especially when they implemented a new flight duty crew scheduling system in January 2014. IBT filed a lawsuit in federal district court, which last summer ordered Allegiant to restore the work rules. Allegiant has not complied because it is appealing against the court ruling.

In January 2015 IBT asked the National Mediation Board to proffer arbitration with respect to the contract talks, to which the management objected. The pilots then voted overwhelmingly in favour of a strike. The NMB has ordered the two sides back to the negotiating table.

The management has spent a lot of time in the courts trying to prevent strike action. Moreover, in a unilateral move, in late April the management also granted the pilots a 5-7% rise in their hourly rate, citing Allegiant's strong operating margin performance in the past 12 months. But IBT could see such an offer as another attempt to circumvent the normal contract negotiating process. The management appears not to have budged at all on the crew scheduling issue.

Because of the labour situation, Allegiant is under heightened surveillance by the FAA, which will not approve additional growth plans for the carrier at least as long as a strike threat remains.

When the strike threat first surfaced at the end of March, Allegiant's share price plummeted by 17% over three days, and the price has remained at the new low level. But many analysts still rate Allegiant as a "buy", based on a belief that the management will avoid a strike. In that case Allegiant may well see the industry's best operating margin expansion in 2015. There will be a huge fuel windfall. Non-fuel CASM is expected to fall by 4-7% because of the acceleration of ASM growth. And demand for Allegiant's low-cost leisure product remains strong.

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