Issue no. 206
May 2015

IAG: Contrast with other European Majors

IAG is diverging further from its rivals, Air France-KLM and the Lufthansa Group. In 2014 the group produced an operating profit of €1.4bn and a net result of €1bn; for 2015 IAG is indicating an operating profit of €2bn. By contrast Air France-KLM lost €189m net while Lufthansa was just above break-even with a €55m profit.

IAG's stock price has soared over the past two years while those of the other two Euro-majors have flatlined. Although the smallest of the Euro-majors in terms of revenues, IAG is rated as being worth €16.1bn, Lufthansa at €5.9bn and AF-KLM at €2.7bn.

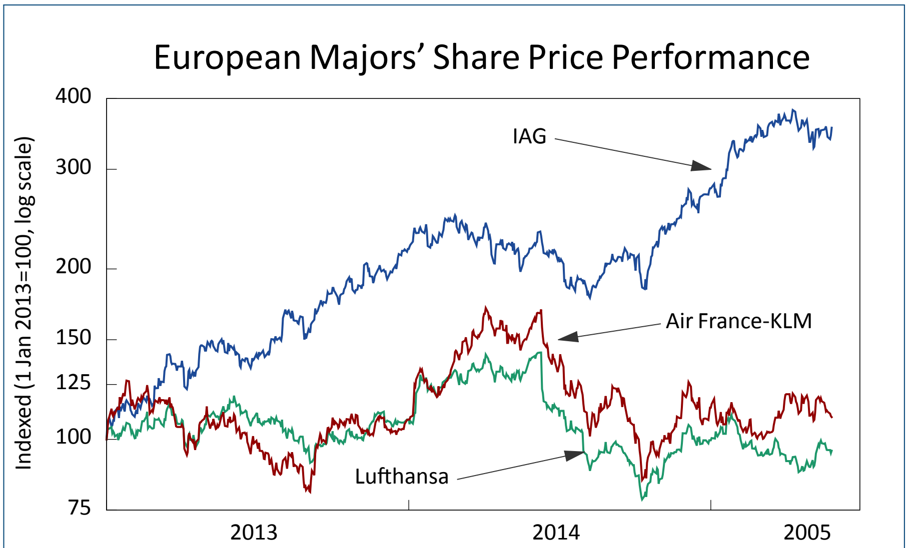
Economic fundamentals favour IAG. UK GDP growth was 2.6% last year and is expected to be 2.7% in 2015 according to the IMF. Spain is recovering: 1.4% growth last year, 2.5% this year. Germany is weaker, 1.6% for both years, while France is faltering, 0.4% in 2014, 1.2% in 2015.

Labour relations appear harmonious at BA at the moment and even the rationalisation processes at Iberia have proceeded as smoothly as could have been expected (which of course could change very quickly). By contrast Air France management have been bogged down in negotiations with its flying and maintenance staff, and Lufthansa have been beset with pilot strikes in opposition to pension changes. One of the problems that Air France has in particular is that inescapable non-progressive social charges are added to gross salaries in France, pushing up average labour costs by 25-30%. The comparative figure for the UK is about 5% (incidentally in the Netherlands it is zero).

In Vueling IAG has a dynamic low cost airline which is proving capable of competing with Ryanair in new markets, its Rome base for example, and which is actually the best performer in terms of operating profit and return on capital within the IAG group (see table, page 2). By contrast Lufthansa is faced with expansion by both EasyJet and Ryanair in its domestic market, expansion which will accelerate as airBerlin retrenches further. Lufthansa somehow has to restructure Germanwings into a lower cost Eurowings in order retain control over domestic feed which is iessential for its global hub system. Air France has had to abandon its project to develop Transavia into a Europe-wide low cost subsidiary in the face of union opposition.

This issue includes

For 2015 Vueling's capacity growth (ASKs) will be around 15.6% compared to 10.4% for Iberia and just 2.4% for BA. Indeed in its key market — the North Atlantic — BA is hardly growing at all, ASKs up by 0.5% in the first quarter, but unit revenues are very strong up by 5% despite the falling fuel prices (in all other segments IAG's unit revenues fell so the group-wide decline was 1%). The North Atlantic is where the



Aviation Strategy

ISSN 2041-4021 (Online)

This newsletter is published ten times a year by Aviation Strategy Limited Jan/Feb and Jul/Aug usually appear as combined issues. Our editorial policy is to analyse and cover contemporary aviation issues and airline strategies in a clear, original and objective manner. Aviation Strategy does not shy away from critical analysis, and takes a global perspective — with balanced coverage of the European, American and Asian markets.

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ISSN 2041-4021 (Online)

three Euro-Majors have established oligopolistic or quasi monopolistic markets, operating as virtually the same airlines as their three US partners. Willie Walsh is probably understating the situation when he describes the North Atlantic as “very healthy”.

Certainly, IAG does not share the other Euro-majors’ abhorrence of competition from the Gulf super-connectors, the opposite in fact, and not just because of its 10% ownership by Qatar Airways. The Heathrow hub is very different from those at Frankfurt and CDG. BA is nowhere near as reliant on connecting flows as the other Euro-majors and can exploit the congestion at Heathrow by using growth to replace connecting passengers with high-yielding direct passengers (ten of the top international O&D routes involve Heathrow). And if slots are required BA can usually obtain then through slot trading or adjusting its own schedules — Willie Walsh made this point to the Irish parliamentarians, defusing the argument that IAG’s interest in Aer Lingus was to get hold of its scarce Heathrow slots. In terms of domestic networks, BA again is in a different situation to Lufthansa or Air France. Emirates’ operations to UK regional cities like Manchester or Newcastle tend to divert traffic away from the European continental hubs rather than from London.

IAG’s principal long-haul expansion is now on the South Atlantic where Iberia, with a revamped product, has reinstated routes that where dropped or downgraded during the depths of the Spanish financial and economic crisis — Montevideo, Santo Domingo, Havana, Mexico City and Panama. Air Europa too has announced a substantial South American growth plan, but IAG is unconcerned with Willie Walsh claiming that Air France, which has admitted to serious losses on the South Atlantic, cannot compete against Iberia in this sector.

IAG Returns by Unit

	Capital allocation	RoIC	Op Margin
BA	71%	8.5%	7.9%
Iberia	20%	5.5%	4.8%
Vueling	9%	13.1%	12.1%
IAG	**100%**	**8.4%**	**7.8%**

Notes: capital allocation as at Q1 2015, RoIC and Op. Margin for last four quarters. Op. Margin adjusted for inflation

IAG appears to have positioned itself well to develop new intercontinental alliances. With Qatar BA has already outsourced its long-haul cargo operation, and a joint venture funnelling traffic into the Indian subcontinent, southeast Asia and China would appear attractive, though American, with its support for the US Fair Skies campaign (see page 8) is posing a diplomatic problem at present. LATAM (see page 15) promises to be a candidate for some form of integration into the IAG group at some point, particularly as its European services are relatively limited.

Meanwhile, the Aer Lingus purchase is close to completion. At the end of May the Irish parliament finally approved the sale of the government’s stake in return for some more guarantees on LHR slots, leaving Ryanair to divest its share (which it almost certainly will). The price for Aer Lingus is about €1.4bn but that includes €600m of net cash. This seems to be a very good deal for IAG which has in effect bought not just a profitable €1.7bn-revenue airline but also gained a new runway.

Cathay Pacific and Air China – an ideal merger?

CATHAY Pacific Airways and Air China hold significant minority stake in each other and speculation is growing over a full-blown merger between the two. Does a coming together of the flag carriers of Hong Kong and China make strategic sense?

Beijing-based Air China and Hong Kong-based Cathay Pacific already have very close ties — Air China has a 29.9% stake in Cathay Pacific and Cathay holds a 20.1% share of Air China, and the two airlines work closely with each other in everything from joint purchasing to maintenance.

On their own, each airline is a substantial operation. Air China is an immense carrier, with 25,270 employees at the mainline Air China and around 40,000 at the Air China group as a whole. Out of hubs at Beijing, Chengdu, and Shanghai they operate more than 330 routes to 159 destinations in 32 countries, of which 53 are international cities.

For calendar 2014 Air China reported a 7.9% increase in revenue to RMB 105.9bn (US $17.2bn), based on a 6.9% rise in passengers carried to 83m. Operating profit rose 76.4% to RMB 7.3bn and net profit increased 17% to RMB 3.8bn (US $618m) in 2014. That net profit came despite a net foreign exchange loss of RMB 360m (US $59m) in 2014, thanks to the depreciation of the yuan against the dollar. Air China — and other Chinese airlines — are vulnerable to a weaker yuan as most of their airline purchases are funded with dollar denominated debt, and they pay in dollars for leased aircraft and fuel purchased abroad.

Of the "Big Three" Chinese airlines (including China Southern and China Eastern — see Aviation Strategy, November 2014), Air China has consistently had the best results in recent years, and in large part that's due to the massive advantages that being China's flag carrier gives it. It has taken over in effect best of China's plethora of smaller airlines under the government-mandated aviation industry consolidation plan, and also benefits from a large amount of official government travel within and outside the country.

Air China's dominant position at Beijing airport was handed to it free of charge by the government. Though China Eastern's Shanghai and China Southern's Guangzhou are significant foreign gateways, they don't come close to Beijing's importance; as can be seen in the chart, page 4, Air China's international RPKs as a proportion of all RPKs were 30.8% in 2014 (compared with 27.5% at China Eastern and 21.4% at China Southern).

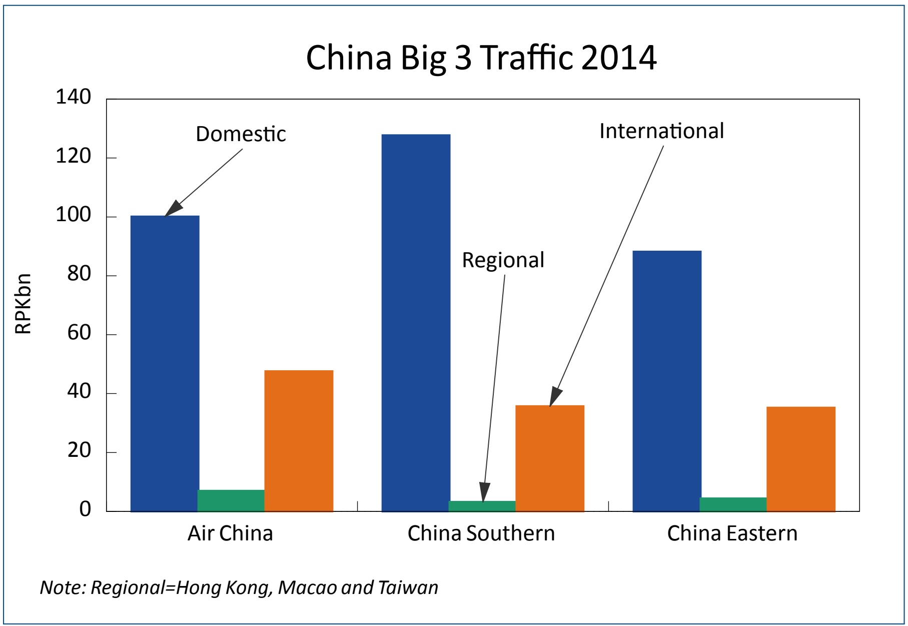
Cathay Pacific operates to approximately 200 passenger and cargo destinations in around 50 countries, and in total the group employs 32,900, of which 22,500 work for Cathay Pacific Airways; (and with 15,900 of those airline employees based in Hong Kong). The group is listed on the Hong Kong stock exchange, and currently 45% of its shares are owned by conglomerate Swire Pacific, with Air China owning 29.9% and CITIC Pacific 1.98%.

In calendar 2014 Cathay Pacific Airways saw revenue rise 5.5% to HK $105.99bn (US $13.7bn), of which passenger revenue accounted for HK $75.7bn (up 5.4%) and cargo HK $25.4bn (up 7.35). Operating profit

Cathay Pacific and Air China Fleets

	Cathay Pacific		Air China		Dragonair	Air China Cargo		Air Hong Kong
737			120	(6)				
747	24	(1)	8	(2)		3		3
757						4		
777	66	(25)	30			6	(2)	
787				(15)				
A300								10
A319			31					
A320			38		15			
A321			49	(3)	8			
A330	41	(2)	49	(4)	18			
A340	10							
A350		(48)		(10)				
Total	**141**	**(76)**	**325**	**(40)**	**41**	**13**	**(2)**	**13**

Note: Orders in brackets

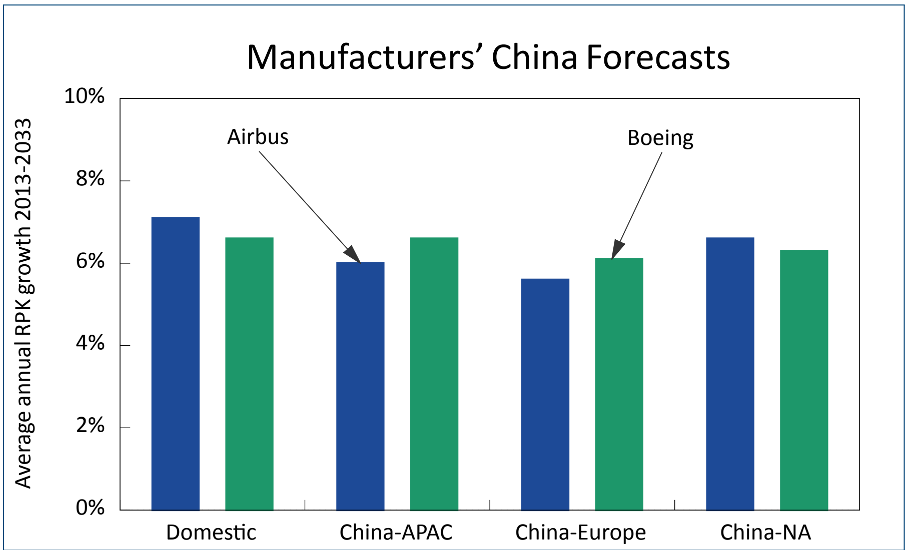


rose 18% to HK 4.4bn (US $572m) and net profit increased 18.8% to HK $3.45bn (US $444m).

In 2014 Cathay carried 31.6m passengers (a rise of 5.5% year-on-year), and a capacity increase of 5.9% (with new routes to Doha, Manchester and Newark as well as increased frequencies on existing routes) was met by a larger rise in traffic, leading to a 1.1 percentage point increase in load factor, to 83.3%.

John Slosar, Cathay Pacific chairman, says: "The overall improvement in our business in 2014 has continued in the first quarter of this year, and we are positive about the overall prospects for 2015. While we face growing competition in our passenger business, which makes it harder to maintain yield, overall demand remains strong and the outlook is positive."

Indeed Cathay saw a 1.8% fall in its passenger yield in 2014, to 67.3 Hong Kong cents (8.7 US cents). While LCCs have had a limited impact in the Chinese market so far, that's clearly not the case in Asia as a whole. But from Cathay's point of view, perhaps the greater threat comes from competition from the Gulf super carriers (even though Cathay has a codeshare deal with Qatar Airways).



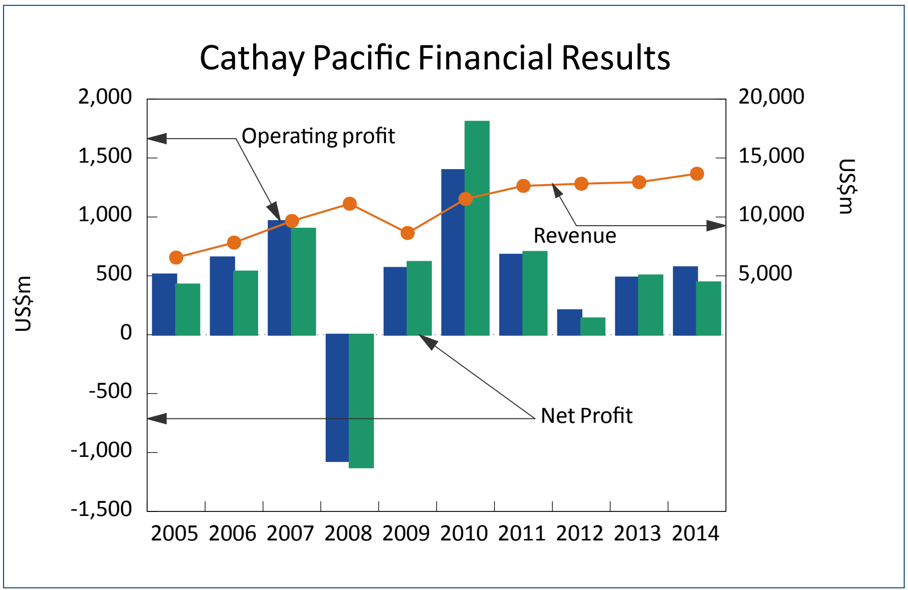
A super-merger

If the two airlines do merge, they will form an immense airline, whether measured in terms of aircraft, routes or employees.

The fleet compatibility appears good, with Cathay's long-haul fleet complementing Air China's mixed short and long-haul aircraft. The mainline Air China fleet totals 331, comprising 119 A320 family aircraft, 49 A330s, 124 737s, 30 777s and nine 747s. The order book is 199 aircraft — 61 A320 family aircraft, four A330s, 10 A350s, 87 737-800s, two 747s, 15 787s and 20 Comac C919s. Cathay's mainline fleet is smaller, at 122 aircraft, including 43 A330s, 10 A340s, two 747s and 67 777s. On order are 48 A350s and 24 777-9Xs.

The Cathay Pacific group also owns Hong Kong Dragon Airlines (100%) and AHK Air Hong Kong (60%). Hong Kong Dragon Airlines — which uses the brand name Dragonair — operates 41 A320 family and A330 aircraft on passenger and scheduled services to around 50 destinations throughout Asia, while Air Hong Kong is a joint venture with DHL Express, and offers cargo services to 12 Asian destinations with a fleet of 13 A300Fs and 747Fs.

Shanghai-based Air China Cargo is a joint venture between Air China and Cathay Pacific, (in which the former owns 51% and the latter 25%) that operates 14 freighters. However, the carrier had struggled over the last few years and the shareholders had to inject new funding in 2014, though the airline saw stronger levels of business last year, helped by lower fuel prices and increasing levels of inter-



annum, which far outstrips anything western economies are currently delivering.

According to Boeing, Chinese domestic passengers will grow at an AAGR of 6.6% over the 20 year period to 2033, while Airbus is even more bullish, forecasting that domestic Chinese passengers will grow by an average 7.1% per annum over the next 20 years (see chart, page 4) — and that "by 2033 the Chinese domestic market will be more than 60% larger in terms of passenger than today's largest market, the US".

Network benefits

Within China, Air China's current focus is on maintaining its dominant position at Beijing and building up its secondary hubs at Shanghai and Chengdu, while internationally the strategy is to grow routes to Europe and North America; this year Air China forecasts it will carry 88.5m passengers, an increase of 6.6% on 2014.

For Cathay, after concentrating on growing capacity and routes into North America over the last year or two, the focus for future growth is Europe; in 2016 A350-900s and then -1000s start arriving, which Cathay will

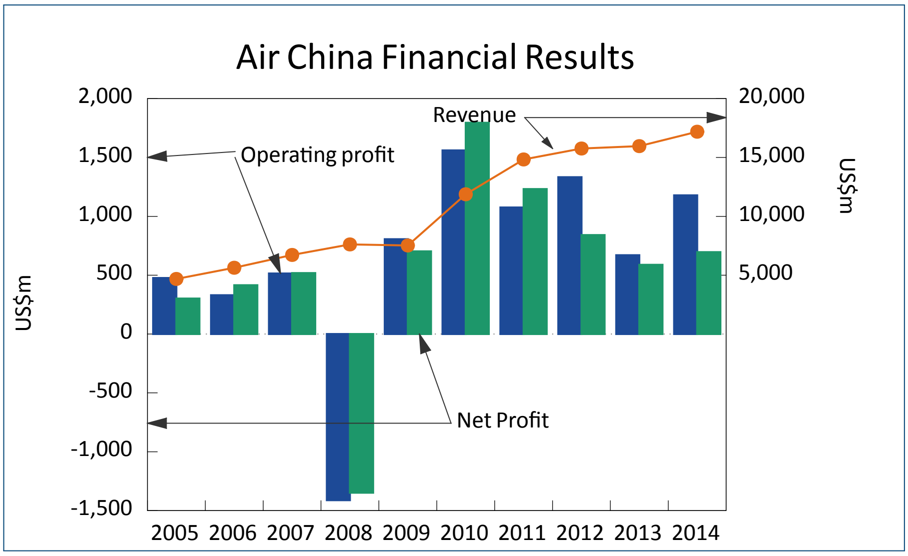
national trade, eventually managing to make a small profit for the full year after significant losses in 2013. The two airlines also have a ground handling joint venture to provide services at Shanghai's two international airports, Hongqiao and Pudong.

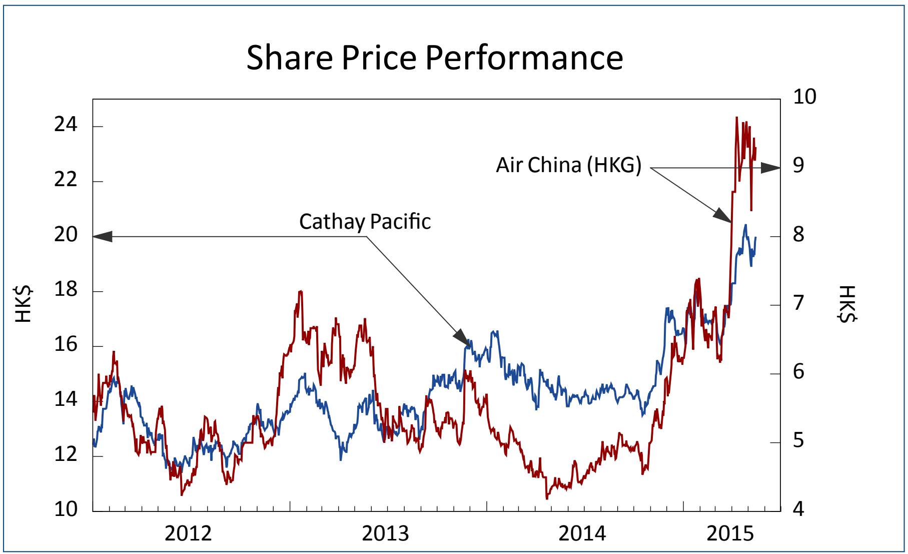
The problem in merging the fleets would come in scaling back the orders imposed on Air China by the Chinese government. For example, operationally Cathay Pacific would be highly unlikely to want Comac aircraft in a combined fleet, though the political reality may be that Cathay might have to swallow the order in order to keep on the right side of the powerful Chinese air ministry. Perhaps more of a concern are the 31 widebody aircraft on order at Air China, given the 72 widebodies that Cathay has already in its order book. Any rationalisation would again have to be agreed with the Chinese government, though of course the extent of scaling back of widebody orders will depend on the new strategy for a combined airline.

An obvious strategy

The strategic rationale for the merger is the untapped potential for Chinese passengers, both internally and on international routes; Cathay would dearly love Air China to feed passengers into its long-haul network.

China has a population of 1.3bn, but according to statistics from the Civil Aviation Administration of China for 2013 (the last full year figures it has released), Chinese airlines carried 360m passengers, which equates to 0.27 trips per person per year. That's a figure that will grow fast as China's economy keeps on expanding — although the Chinese economy has slowed in the last few years, it's still expanding at around 7-8% per





use "for secondary European points". In December 2014 Cathay launched a non-stop route between Hong Kong and Manchester, while this year routes to Zürich and Düsseldorf (September) are being added.

While Cathay and Air China expanded their codeshare in November last year, to two more internal Chinese routes, a merger would allow a substantial readjustment of schedules and networks, in order to provide greater feed into Cathay's long haul flights.

However, it's not all about Hong Kong. There is a capacity issue at Hong Kong airport, and Cathay was at the forefront of a campaign to build a third runway — which the Hong Kong Executive Council approved in March this year at an estimated cost of HK $141.5bn (US $18.2bn). But Ivan Chu, Cathay Pacific's chief executive, points out that the airport "will reach capacity well before a third runway could be built, which is of great concern when we are seeing increasing competition from other rapidly expanding hubs in the region."

A tie-up with Air China, therefore, would not only provide mainland Chinese feed into long-haul routes out of Hong Kong, but equally importantly in the short-and medium-term would give the merged entity space to expand international routes at Chinese airports, and in particular from Beijing.

The downsides

There are potential problems with a merger too — Cathay Pacific is a founder member of **one**world (which does not have a mainland Chinese member), while Air China is a member of Star. There would also be much haggling over the respective values of the airlines; Cathay's market cap as of mid-May was HK $78.5bn (US $10.1bn), while Air China's (it's listed on the Hong Kong, Shanghai and London stock exchanges) as of mid-May was HK $121.2bn (US $15.6bn). However, given the surprises that might be unveiled when Air China's books are opened to due diligence and/or a potential "discount" due to anticipated ongoing interference by the Chinese government, market caps may only be the starting point for negotiations regarding the relative values, rather than the definitive end point.

The respective workforces too may be wary of a merger, particularly if Cathay staff believe that over the long term unified pay and conditions may gravitate to mainland Chinese levels rather than that of an international company based in Hong Kong. Relations between unions and management at Cathay aren't great anyway; in December 2014 the Hong Kong Aircrew Officers' Association instructed its 2,000 pilot members at Cathay to work-to-rule after failure to agree a new three-year pay deal, and that action continued until this May, when a new deal was agreed between the two sides.

From the Air China side, there will be apprehension as to the improved practices that Cathay Pacific would inevitably bring to the Chinese flag carrier. Cathay has been making significant cost savings over the last years, with a focus on retirement of old aircraft. James Barrington, Cathay Pacific's director of corporate development, says that: "Pretty soon our fleet will be all 777s, all 748 freighters, and soon to be A350-900s and 1000s — all of which are new technology aircraft with a fuel burn per kilo somewhere between 10% and 20% of their forerunners of A340s and 747s. So that is an efficiency that's now built into the underlying cost of operating the aircraft."

Cathay also works hard to maximise utilisation — it claims to have "the third highest utilisation of 777-300ERs in the world; number three — at about 16 hours a day". Barrington adds: "If we operated our fleet only 12 hours a day, we'd need 13 more aircraft and have to spend another couple of billion US dollars. Fleet utilisation is a pretty major driver".

Cathay has also refreshed its cabin product across the entire fleet over the last few years, with new business class, premium economy, and economy classes accompanied by upgraded lounges across its international network — and upgrading Air China's product would be another area that Cathay might want to contribute to post a merger.

Overall, a merger between Air China and Cathay Pacific makes sound strategic sense — and despite the inevitable squabble the shareholders of the two companies will have over respective stakes in a merged entity, the market appears to agree. The Cathay share price (see chart, above) has risen substantially over the last seven months, from under HK$14 as at October 2014 to around HK$20 as at mid-May; similarly, over the same period Air China's shares have risen from under HK$5 to more than HK$9 today. While those share price increases must be due partly to the impressive results both airlines posted for 2014, it's also a reflection that both sets of shareholders see a prospective merger as being beneficial to their interests.

If (or when) a merger does occur, it will be interesting to see what Swire Pacific, the current 45% shareholder in Cathay, does post-merger. The Swire Group dates back to the 18th century, has long invested in the Chinese market and tends to be a long-term stakeholder in businesses. It is likely that Swire will back a deal in order to unlock long-term value, but if it starts selling shares at any point following a merger, that would be a major signal that things aren't going to plan.

The Gulf Carrier Row: Real Risk or Pantomime?

The attempt by the largest airlines in the US (and the world) to persuade the US government to create an "even playing field" with respect to competition from the Gulf carriers has attracted considerable attention, to put it mildly. The debate has quickly deteriorated into a virtual pantomime, *ya-boo* catcall politics made up of repeated claims and counter-claims but only limited actual illumination of the core arguments. It could be argued that in the real world none of it really matters much and might be expected to fizzle out eventually. In fact, it is far more serious than that. The row actually has significant implications and risks for the whole aviation industry which should be recognised and addressed.

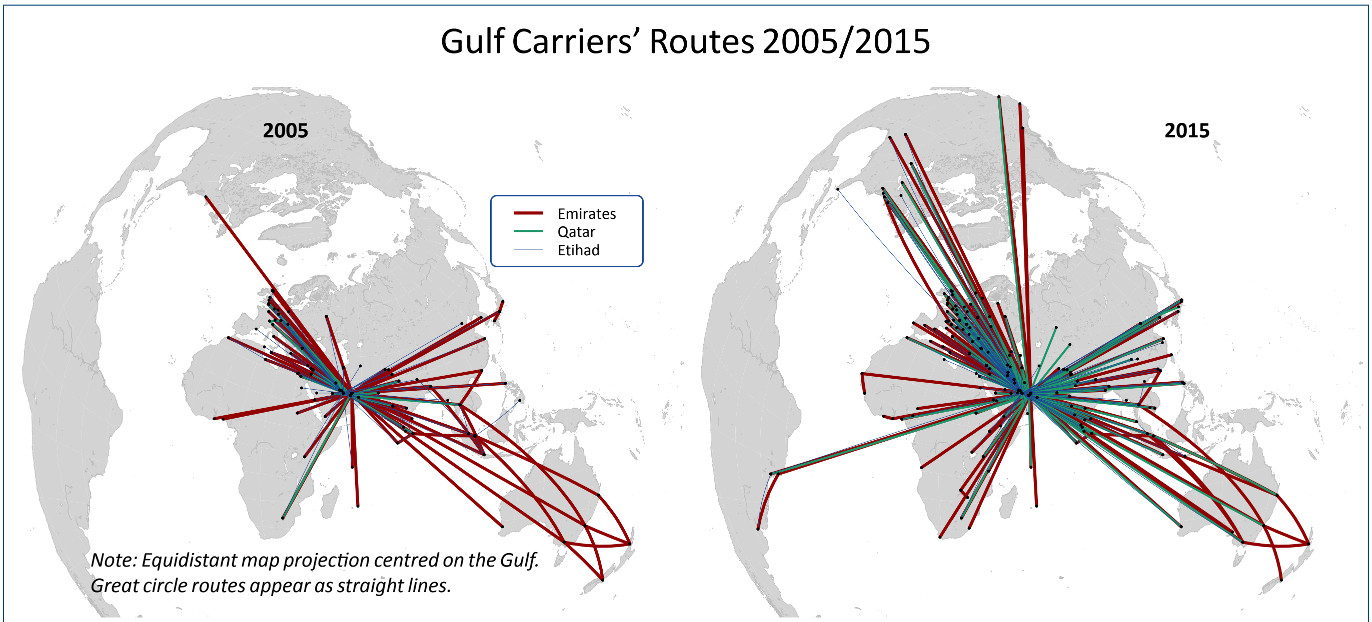
The arguments

The arguments presented by American, Delta and United have been widely reported. They repeat the case made by other legacy airlines, especially in Europe and Canada, for some time. Essentially they maintain that Emirates, Etihad and Qatar Airways are in receipt of massive state aid from their respective government owners which distorts the market to such an extent that other carriers are unable to compete. The lobbying group put together by the three US airlines — the Partnership for Open and Fair Skies — is clearly well resourced and has submitted a lengthy so-called White Paper to several US government departments.

The document is far from a rapidly put together case, a knee-jerk reaction to a recent problem. Forensic accountants and private investigators were initially hired by Delta some two years ago to examine the Gulf carriers' financial accounts and gather any other information which might appear incriminating. American and United joined later, together with unions representing the airlines' workforces.

According to their report, the accountants have discovered that the Gulf airlines have received some \$42bn in aid since 2004, of which Etihad got \$17bn and Qatar \$16bn. The *Wall Street Journal* claims to have seen many of the original 44 documents, uncovered in almost 30 jurisdictions. Of particular note was the fact that, according to the research, at times international auditors only endorsed two of the Gulf airlines (presumably Etihad and Qatar) as viable businesses (or "going concerns") on condition that further financial backing was provided by their shareholders. As the Partnership asserted: "State subsidies undermine free and fair competition, are in violation of Open Skies policy and threaten thousands of good American jobs."

Or as *The Economist* commented, paraphrasing dialogue from the film Casablanca, the US airlines are shocked — *shocked* — that gov-



ernment aid is being provided to the aviation industry. But the initial document was not the end of the matter by any means.

The Partnership followed up with another report, this one produced by the economic consulting company Compass Lexecon, which concluded that the Gulf carriers are diverting passengers from US airlines rather than stimulating new demand. "The Gulf carriers assert that their service stimulates new traffic in key US markets, bringing substantial numbers of new passengers to the United States. We find little — if any — evidence that this claim is true... Instead, they are using their subsidized capacity to grow their networks at the expense of US and other carriers."

The report goes on to warn that continued growth of Gulf carrier service to North America will prevent US airlines from serving more international routes, "which will harm passenger service to many small- and medium-sized communities".

The Chief Executives of the three US airlines didn't hold back when introducing the second report, highlighting what they perceive as the dangers involved. According to American's Doug Parker: "It's a lot bigger than just international flying. It puts the entire hub and spoke system at risk". United's Smisek noted that "we are under attack here from subsidized carriers who are basically taking our passengers — not through fair competition. When you're competing against arms of state and the treasury of oil-rich nations, that's a pretty tough row to hoe." Hardly the most diplomatic of language. Of particular note is the reference to "*our traffic*", surely a throw-back to the old protectionist days when sixth freedom operations were frowned upon.

Perhaps not surprisingly, the campaign has quickly attracted political support. In particular, at the end of April, 262 Members of Congress wrote to the Secretary of State and the Transportation Secretary supporting the US carriers' call for urgent consultations with the United Arab Emirates and Qatar about their "massive, market-distorting subsidies to their state-owned airlines... According to available research, each daily international round-trip frequency lost/foregone by US airlines because of subsidised Gulf carrier competition results in a net loss of over 800 US jobs."

However, American, Delta and United have not had the field to themselves. Other US carriers have been quick to distance themselves from the Partnership's campaign, especially the all-freight consolidators FedEx and UPS. Consumer groups have similarly argued that any move towards increased protectionism and away from open skies is not likely to be in the interests of the travelling public.

Several airports and JetBlue Airways have also not been slow to express their concern, while although less public in expressing its views, Boeing cannot be pleased with developments — after all the Middle East airlines account for at least 10% of its business.

CAPA has criticised the Partnership's submission for being short of subsistence in identifying any serious harm to US airlines from the expansion of the Gulf carriers, an important prerequisite when it comes to proving predation. The US airlines are, after all, currently enjoying one of their most profitable periods, earning a net return of almost $9 billion last year, equivalent to 45% of the global airline industry's total profits.

CAPA also noted that in the whole Partnership document there is only one reference to consumers, and that is merely a token quote. It concluded that "in many ways the White Paper is a throwback to aviation policies of 30 years ago." It is also relevant, argued CAPA, that on a distance adjusted basis, the post-Chapter 11 US full service airlines actually have lower costs on average than the Gulf carriers, raising the question as to why they are unable to compete.

A business travellers' lobby group even highlighted a study undertaken as long ago as 1999 by the Congressional Research Service which calculated that since 1918, the US Government had provided no less than $155bn in direct subsidies to build airports and air traffic control facilities.

The Gulf carriers may initially have been taken by surprise at the scale of the attack from American, Delta and United, but it did not take them long to respond.

In particular, Etihad financed a study by The Risk Advisory Group of the financial and other government benefits received by the three US airlines. The conclusion was that they had obtained aid amounting to over $71 billion in total, of which some $70 billion had been received since 2000. Most of these benefits came from bankruptcy restructuring under Chapter 11 ($35.5bn), followed by pension bailouts totalling $29bn.

Presenting the analysis, which he described as "conservative, quantifiable and credible", Etihad's General Counsel Jim Callaghan said: "We do not question the legitimacy of benefits provided to US carriers by the US Government and the bankruptcy courts. We simply wish to highlight the fact that US carriers have been benefiting and continue to benefit from a highly favourable legal regime, such as bankruptcy protection and pension guarantees, exemptions from certain taxes, and various other benefits. These benefits, which are generally only available to US carriers, have created a highly distorted market in which carriers such as Etihad have to compete." *15 All!* cried the tennis umpire.

Emirates, Etihad and Qatar are all relatively young airlines which have grown at a remarkably fast rate. Their aircraft orders from both Airbus and Boeing have been nothing short of breathtaking. Their business model is based totally on the hub concept, with limited point-to-point traffic, backed in each case by substantial national investment in airport infrastructure. The geographical position of the Gulf means that with modern aircraft there is virtually no inhabited place on earth which cannot be reached non-stop.

It is hardly surprising that the major US passenger carriers should be concerned. According to OAG, the three Gulf airlines currently (April 2015) have 170 flights per week to the US, including Emirates' fifth freedom service between Milan and New York, making the US their second largest market after the UK. Their total weekly seat capacity to the US at some 69,000 may represent just 7% of American, Delta and United's total international capacity, but it is of course growing rapidly. Even the current row hasn't stopped them, with several recent announcements by Emirates and Qatar in particular of additional flights to the US. At present Emirates and Qatar serve ten US destinations each and Etihad six.

But isn't this just *déjà vu* all over again? Some may recall that there was a time when KLM was a virtual pariah in the aviation industry for growing on the back of sixth freedom traffic; and then there was Singapore Airlines, which attracted substantial passenger flows between Europe and the Far East and Australasia over its hub. KLM and Singapore share several other characteristics with the Gulf carriers, including the strong backing of their governments, efficient, modern and ample airport infrastructure and small home markets. *Plus ça change plus c'est la même chose*, as the saying goes.

It is also the case that the US carriers are late coming to the party. Some European legacy airlines, especially Lufthansa and Air France-KLM, have been voicing their concern for over a decade. They have put pressure on their governments not to allow the Gulf carriers to add capacity to their home markets and have lobbied the European Commission to take action against alleged anti-competitive behaviour.

Similar arguments have been advanced by Air Canada, which strangely campaigned against Emirates' sixth freedom operations via Dubai while simultaneously launching Toronto and Vancouver as hubs for traffic to/from the US. The resultant Canada/UAE intergovernment argument even spilled over into non-aviation areas, with the UAE threatening to restrict Canada's access to military facilities in the Gulf.

As in the US, there has been an absence of unanimity among European airlines. The UK has had open skies bilateral agreements with Qatar and the UAE for many years and has shown no interest in backtracking. All three Gulf carriers have extensive networks to the UK regions and multiple daily flights to London. IAG has refused to join Lufthansa and Air France in demanding action by governments and the European Commission, with Chief Executive Willie Walsh saying that he has no issue with competing with Emirates etc, "none whatsoever."

IAG has even gone so far as to submit its own comments to the US State and Transportation Departments urging them to ignore the pleas of American, Delta and United. This reluctance to follow its fellow major legacy airlines pre-dates by some time Qatar Airways joining the **one**world alliance and investing in IAG.

We know the problem: What's the solution?

It is tempting to lump Emirates, Etihad and Qatar together, and they certainly share many characteristics, but it is also true that in certain respects Emirates is different from its two fellow Gulf airlines.

It has been established for longer, is significantly larger and perhaps most important of all for present purposes, does not receive overt financial support from its government owner. In May it announced that 2014/15 was the 27th consecutive year of profitability for the Emirates Group, with the airline recording a profit of \$1.2bn, up 40% on the previous year, despite adverse currency movements. Passenger traffic was up 11% at 49.3m, on a seat capacity increase of 9%. Interestingly, the Americas region accounted for only \$3.0bn in revenue, compared with \$6.9bn for Europe and \$6.7bn for East Asia and Australasia, but the Americas achieved by far the highest growth at plus 20%.

This is an impressive record for an airline established just 30 years ago in 1985 by Maurice Flanagan (who sadly died recently) with \$10m of government money (\$10m seemed "like a nice, safe sort of number" according to Flanagan) and instructions to "be good, look good, and make money." Many analysts have forensically examined Emirates' books over the years and not one of them has ever produced a smoking gun.

There may be room for argument about other forms of state support, but no-one has successfully shown that Dubai hands over regular wads of cash to keep Emirates going.

Etihad and Qatar are different. They still receive money from their government owners on a regular basis and would not exist, let alone continue their rapid expansion, without such financial support. But they are still young airlines.

They argue that it is not unreasonable for owners to provide additional investment in the early years of a company's existence. Is there any major legacy carrier, anywhere in the world, they ask, that has not received government financial help in the past? After all, one man's state aid is another's investment financing.

Even in Europe, the argument goes, state aid is allowed, as long as it is provided on commercial terms. The key issue is whether the shareholders of Etihad and Qatar can reasonably expect an eventual return on their investments.

The fact is that the allegations of state subsidies and unfair competition with respect to the Gulf carriers have been countered with arguments about government support for European and North American airlines. Which side you believe, if either, probably depends on where you start from.

The whole debate has quickly become unproductive and shows few signs of going anywhere. How are adjudicators supposed to weigh the provision of direct financial support against the elimination of all debt through a Chapter 11 process (once described by then British Airways' CEO, Rod Eddington, as "back door state aid")? It seems at times that the two sides in the debate are talking past rather than to each other.

American, Delta and United say that they are being completely reasonable. They are just asking for government to government consultations, as provided for under the open skies bilateral agreements.

But consultations are a means to an end, not a solution in themselves. The likelihood of governments being able to shed clarity on what is and is not state aid is remote. EU/US consultations on Norwegian International's application to operate trans-Atlantic services have failed to make progress, despite arguably involving less contentious issues.

Most bilateral air service agreements contain a "fair and equal opportunity to compete" clause, or a version of it. The vagueness of the phrase, with no accompanying definition, is deliberate because if the governments involved had been required to go any further, no ASA would ever have been signed.

Whether you call it clever drafting or obfuscation, the fact is that the clause now at the centre of a potential major diplomatic row between the US and Gulf countries was always recognised as a way of parking an insoluble problem.

If the US government representatives do meet their Qatari and UAE counterparts and fail to reach agreement, and it is difficult to see any other outcome, what next? The nuclear option would be for the US to give notice to terminate the two ASAs, but that hardly seems likely. Such a decision would certainly harm the interests of other US carriers such as Federal Express, and as in Canada, could well spill over into non-aviation areas, not something the State Department is likely to welcome in the current Middle East political climate.

(It is far from unknown for negotiations about ASAs to become entangled in other contentious issues. Some have drawn attention, for example, to the fact that in May, Qatar Airways secured additional traffic rights to France at the same time as the Government of Qatar agreed to purchase $7bn worth of French-built jet fighters. Only three months earlier the French Secretary of State for Transport had declared: "No more traffic rights will now be granted by France to the Gulf carriers.")

The ASAs themselves provide for arbitration by an independent body, usually ICAO-appointed, in the case of disagreements, but past experience suggests that such an approach is almost invariably very expensive and can take several years, with no guarantee of success.

So what do the US carriers want?

So far American, Delta and United have mounted a noisy and well-funded lobbying campaign to win the argument with the US authorities about unfair competition. We know they feel hard done by. What is less clear is what they really want. The debate has generated considerable heat, but there is little sign of a long-term strategy. It is far from obvious what outcome the three US airlines expect or want. Writing in *Forbes.com*, Dan Reed suggests five possible explanations for their action:

✈ Seeing how much traffic their European partners have lost to the Gulf carriers, the US airlines are fighting to prevent the same thing from happening to them now that the three Middle East airlines are aggressively expanding service to major US cities.

✈ US carriers are acting in defence

of their European alliance partners by opening up another front in the public relations and global legal battle against the rapidly expanding Gulf carriers.

✈ The leaders of American and United, which have less at stake strategically in the matter than Delta does, are allowing themselves to be led by the nose by Delta's CEO Richard Anderson, who was the first and is the loudest complainer among the Big 3's leaders.

✈ The Big 3 are using the Gulf carriers' modest market incursions to create a bogey man against which they can rail publicly as a way of distracting the public from the big — though still not remarkable on a net margin basis — profits the US airlines finally are earning.

✈ The fight against the Gulf carriers is a way to rally US airline labour groups to support a management that is seeking to protect US jobs, thereby making it difficult for labour to fight management for big raises and increases in benefits now that the airlines are making decent money.

It is possible to construct arguments in favour of each of these hypotheses, either separately or all together. They are plausible and yet not entirely satisfying as explanations for the behaviour of American, Delta and United, "because each theory relies on other people — judges, bureaucrats, politicians, and/or the travelling public — being extraordinarily gullible and easily persuaded to ignore significant counter arguments", as Reed comments.

The Partnership airlines may have convinced themselves that following the examples of Europe and Canada, the US government will be persuaded at least to slow down the Gulf carriers' expansion plans in the US market. This worked for Lufthansa, Air France-KLM and Air Canada, but critically they all had restricted bilateral agreements with the Gulf countries.

It is far easier for governments to sit on their hands and decline to move than it is to actually take action, especially when the only legal way of restricting air services in the absence of binding arbitration is to terminate an international agreement. Following on from the Norwegian International saga, the US would risk establishing a reputation as a very poor bilateral partner, with unpredictable ramifications for its other open skies agreements.

And where would it all end? It can hardly be argued that the Gulf carriers are the only airlines in receipt of state aid.

With the growth of Chinese airlines, also expanding rapidly into the US market, will *they* be next on the hit list? That would send shivers down the spine of any Secretary of State. Until now it has been the Chinese who have resisted pressure from the US for an open skies ASA.

Perhaps in future the boot will be on the other foot. According to OAG data, Chinese airlines operated 140% more seats to the US in an average April 2015 week than they did in an equivalent period in 2010, compared to an 80% increase in US airlines' capacity.

And what about Turkey? Once the new airport is built in Istanbul, many believe that Turkish Airlines will be just as much, if not more, of a threat to European and US airlines as the Gulf carriers have become. It already flies to more countries than any other airline in the world. Will a campaign be launched against Turkey, situated on Europe's border, a potential EU member and a strong NATO ally? A can of worms doesn't really do justice to what could emerge.

Thus, it is difficult not to conclude that while the lobbying campaign by the Partnership for Open and Fair Skies has certainly generated considerable heat, there is little evidence of a long-term strategy with a clear objective. American, Delta and United, with their European counterparts, have focused the world's attention on a problem without identifying a way out of it. Yet potentially there are serious implications for the whole aviation industry.

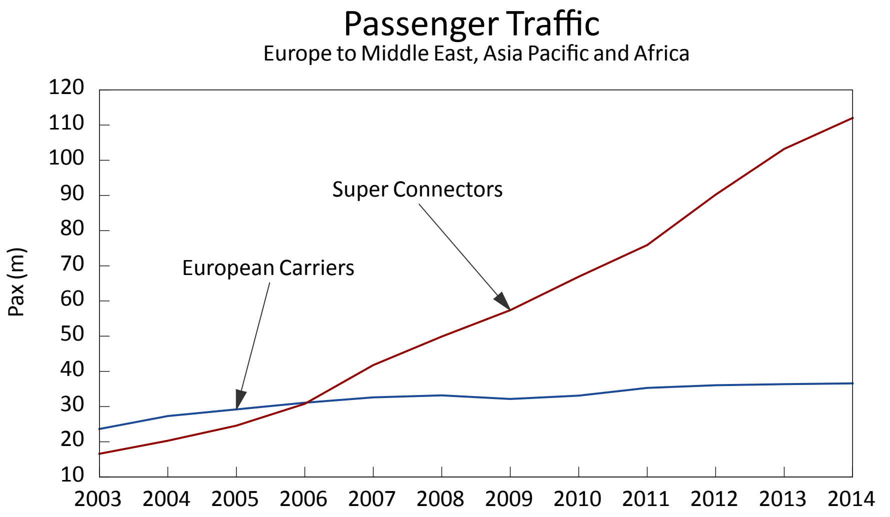
It is worrying that many of the acknowledged benefits of liberalisation of international air services may be put at risk by a less than well-thought out campaign.

The risks

The current argument between a group of European and North American legacy carriers on the one hand and three Gulf airlines on the other has certainly uncovered some fault lines in the structure of the aviation industry.

Alliance partners have found themselves on different sides of the debate, reinforcing the impression for many that the current three major alliances are highly unstable and may not have a long-term future, at least in their present form.

In both Europe and the US there is a clear lack of unanimity among airlines, not to mention other parts of the aviation industry and consumer groups. Nowhere is this fracturing more evident than in the virtual disintegration of the Association of European Airlines. The AEA's problems cannot all be blamed on the row over the Gulf carriers; it has been experiencing internal tensions for many years. But the decision of the IAG airlines to follow Virgin Atlantic in leav-



Source: AEA, Company Reports, Aviation Strategy. Note: Superconnectors include Emirates, Qatar Airways, Etihad and THY.

ing the organisation, then in turn followed by Alitalia and Air Berlin, has been a major blow.

It is almost a decade since Lufthansa and Air France-KLM began to complain about the aggressive expansion of the Gulf carriers into their home markets. Exactly the same arguments now advanced by their US counterparts were rolled out, albeit mostly behind closed doors and with far less supporting research.

The AEA was split, with British Airways and Virgin Atlantic resisting any protectionist moves. (Ironically, at the time Iberia, while not a major player in the debate, gave the impression of being more sympathetic to the Lufthansa/Air France-KLM case). Lufthansa and Air France-KLM made some progress with their own governments, succeeding in restricting the Gulf carriers' expansion plans at least for a time, but less so with the European Commission. The AEA itself was in a difficult position and unable to mount a united campaign on behalf of its members.

It is hardly unusual for representative organisations to have to deal with strongly held, disparate views among its members. They usually manage to cope, either by reaching compromises acceptable to most or simply saying that on certain issues there is no consensus and therefore the trade body cannot take a position. It is not obvious why this has not been possible in the AEA. Certainly there is intense commercial competition between members, but the fact is that on most aeropolitical issues they do manage to reach agreement.

Perhaps some view the problem of the Gulf carriers as just too important to ignore within the AEA, or perhaps some of the larger members simply feel that they are big enough to mount their own lobbying campaigns and therefore have less need for a body like the AEA. Whatever the reason, they may be making a major mistake.

The importance of ensuring that your views are known to and understood by the Brussels bureaucracy and political establishment should not be underestimated. Often the benefits come not from influencing the big debates, but from the myriad of smaller issues which daily plague airlines. Despite the progress made with liberalisation, aviation remains a highly political and regulated industry in which politicians and bureaucrats find it difficult not to meddle. Most observers would agree that a united industry is far more likely to achieve its objectives with governments and regulators than a divided one. It is too early to determine what the AEA's future might be, but it has clearly been weakened as a lobbying force.

IAG has announced that it will be joining one of the smaller Brussels-based airline trade bodies, the European Low Fares Airline Association (ELFAA), which somewhat disingenuously now describes itself as "the largest European airline group for passengers within Europe." (There are actually four airline representative bodies lobbying Brussels, each one originally based on different airline business models.) It remains to be seen whether Ryanair and easyJet, the two principal founder members of ELFAA, and the IAG airlines can work constructively together. Certainly Virgin Atlantic's early membership of the International Air Carrier Association, which mostly represents leisure airlines in Brussels, was not a wholly successful experience.

Before the Gulf carriers became such a focus of attention, it was the AEA which took the lead in first producing and then promoting a trans-Atlantic aviation agreement going well beyond the US open skies model.

Essentially the Trans-Atlantic Aviation Area, later renamed the Open Aviation Area, proposed to extend the EU internal aviation market across the Atlantic, covering some 60% of scheduled air services in the world. Had it been agreed, it would have set in motion a momentum for liberalisation which could have transformed global aviation, not least in opening up at last the possibility of cross-border airline mergers and consolidation, a (*the?*) key factor in achieving sustainable profitability for the industry, as US experience has shown.

It did not succeed because the US Government, under pressure from domestic interests, especially the unions, was unable to deliver on the liberalisation of the critical airline ownership and control rules.

The EU/US agreement eventually signed in two stages followed the US open skies model which already applied to most air services between the US and Europe, although it did of course bring the UK, and especially Heathrow, into the picture. The failure to achieve "true" open skies was a disappointment to many, but at the time most observers saw it as a setback rather than an end to progress. The liberalisation bandwagon would surely continue to role and eventually common sense, and wider economic interests, would prevail. The European Commission remained committed to reforming the arcane ownership and control rules.

That all seems a long time ago, although it isn't. The focus of attention now is on rolling back liberalisation, not taking it to the next level. The likes of Lufthansa and Air France-KLM in Europe and American, Delta, United and Air Canada in North America may concentrate on the need for a "fair and level playing field", whatever that might mean, but to many the reality of what they are seeking seems to be increased protection from the competitive threat presented by the Gulf carriers. Why else has all the attention been on the most successful airlines in recent years, at least in terms of traffic growth, and not on the many other carriers in places like China, India, etc clearly in receipt of substantial government *largesse*. The likelihood of opening up markets further is fast receding.

This is a very different regulatory and political environment to the one which existed only a relatively short while ago, and the implications are potentially very serious. The economic benefits of liberalisation are well documented; the economic disbenefits of increased protectionism are just as clear. As CAPA has remarked: "The issues raised go to the heart of US aviation policy post-Chapter 11… The [Partnership] paper puts the whole nature of open skies back on the table, with frightening potential for the negativity to ripple outwards, just as the positive movement did in the past."

Traditionally airlines were very close to their national authorities, even where they were not actually state owned. There was rarely any real difference between the policies advocated by individual carriers and those actually adopted by their governments. It was an industry "riddled with protectionism and patronage, bail-outs and handouts", in the florid words of *The Economist*.

This is still the case, of course, in some countries, but among the most significant changes in the industry over the past few decades have been the gradual move away from such close airline/government ties, the increased promotion of more competition and the more prominent role played by consumer interests. Some in the airline industry might look back to the old days with nostalgia, but most regard these developments as both inevitable and beneficial.

Yet the governments of Germany, France and the Netherlands, or at least their Transport Departments, were all quick to lend their public support to the campaign by their national airlines. They didn't seem to pay much regard to the interests of consumers, who give every indication of welcoming the increased competition provided by the Gulf carriers.

It is particularly surprising to see the Netherlands line up with France and Germany in this respect. After all, it was the Netherlands which once pursued precisely the same strategy as the UAE and Qatar in developing a successful hub airport at Amsterdam, and of course along with the UK, the Dutch were early proponents of liberalisation in Europe and open skies elsewhere. The AEA Trans-Atlantic Aviation Area model was even initially drafted by a former KLM employee. How times change.

Thus, on one level the campaign recently launched by the US Partnership for Open and Fair Skies might be viewed as little more than an irritant, perhaps a minor blip in the onward movement of the international airline industry from protected dinosaurs to global companies. However, this would be to ignore the very real dangers inherent in what has been released. A ripple on the pond could become a tsunami. The US carriers themselves may not have a clear or realistic picture of the outcome they want to achieve, but the risks to further liberalisation, the alliances and airline trade bodies are only all too evident.

by Barry Humphreys

Barry Humphreys is an aviation consultant. He was previously a Director of Virgin Atlantic Airways and Chairman of the British Air Transport Association.

LATAM: Successfully navigating South America's economic woes

After three years of losses, and despite surprisingly robust first-quarter 2015 results, LATAM Airlines Group is still some way from financial recovery. This is because the tough economic and airline industry conditions in South America — slowdown of GDP growth, currency woes, weakening demand and plummeting yields — have worsened further still in recent months.

LATAM was created when Chile's LAN completed its cross-border acquisition of Brazil's TAM in June 2012. The combine had by now hoped to show some benefits from the merger; instead, the very reason LAN wanted TAM — the huge Brazilian market — has, in the short term at least, turned into one of its biggest problems.

After four years of anaemic growth, Brazil is moving into recession this year. Its GDP is currently expected to contract by 1.2% in 2015, while inflation is set to rise to 8.3%. This spring the decline in corporate travel demand accelerated. The slump is affecting demand for international travel and the cargo business.

LATAM's yields have been hit hard by the significant depreciation of all the local currencies in South America this year. And the cargo market — one of LAN's traditional strengths — continues to be plagued by overcapacity.

Some of those negative effects were offset by two positives in the first quarter: the significant decline in crude oil prices and the favourable impact of the currency devaluations on costs in those currencies.

But an operating margin as high as 8.1% in the latest period was no mean feat — something that LATAM attributed to its ability to "successfully manage this difficult and complex environment".

LATAM accomplished that for two obvious reasons. First, it has a highly diversified and flexible business model. Most notably, it has domestic operations in seven different South American countries: Chile, Peru, Argentina, Colombia, Ecuador, Paraguay and Brazil.

Second, the ex-LAN management has long been regarded as the very best in the industry. It expertly guided LAN through many recessions in the past.

In recent quarters LATAM has benefitted from a number of unique strategies, including the following:

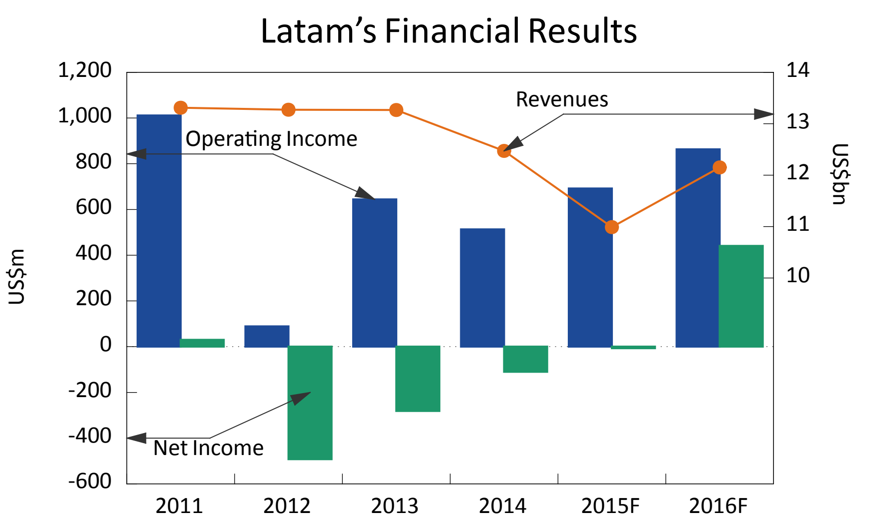
✈ Significantly shifting the point of sale mix within South America in response to demand weakness and yield pressures in international markets out of Brazil.

✈ Network and hub diversification in Brazil to take advantage of locations that enjoy relative economic strength (building Brasilia into a secondary hub, A319 expansion in regional markets, possibly developing new hub for the Northeast).

✈ Mitigating negative foreign exchange effects, among other things, by almost eliminating the exposure to the Brazilian real in TAM's balance sheet (reduced from $4bn in 2012 to around $600m at present).

✈ Successfully completing Latin America's first (and the largest non-US) EETC transaction of $1bn in a difficult economic climate, thus locking in low-cost long-term financing for 17 aircraft scheduled for delivery through March 2016.

Other (more conventional) strategies



Notes: 2011 and 2012 pro forma figures (LAN and TAM merged in June 2012). 2015 and 2016 are Bank of America Merrill Lynch forecasts (May 19, 2015) that LATAM is deploying to address the economic slowdown include:

Capacity discipline: Between 2012 and 2014, LATAM's ASKs declined by 1.5% and cargo ATKs by 5.6%. In 2015, the group expects to grow ASKs by 2-4%, while cargo ATKs will be somewhere between flat and down 2%.

Cost cutting: After some very successful cost cutting in 2013, last year LATAM announced new plans to reduce non-fuel operating costs by $650m over three years, which could reduce unit costs by 15%. The programme, which consists of a multitude of small initiatives, could add up to $200m savings in 2015.

Cargo fleet reductions: To manage the continued slump in the cargo market, LATAM has leased out three of its 11 767-300Fs to an operator outside the region for a three-year period. LATAM continues to look for opportunities to lease out more freighters in the current environment.

Complex environment

LAN was consistently profitable up to and including 2011 and had earned double-digit operating margins and solid net profits since the mid-2000s. But in 2012 the newly formed combine achieved only a 0.7% operating margin, which was followed by 4-5% margins in 2013 and 2014. Since the beginning of 2012 and including Q1 2015, LATAM has incurred net losses totalling $923m.

When the merger was completed, LATAM also lost its long-held investment-grade credit ratings, essentially because of TAM's high debt levels.

LATAM's share price performance has been dismal. After losing more than half of its stock market value between June 2012 and August 2013 (from $26-plus to $12), the New York-listed ADRs recovered briefly to $15-16, but in the past 12 months the price has declined steadily to the $8-9 level in late May 2015.

Mergers can wreak financial havoc in the short term, when one-time costs are incurred and revenue and cost synergies have not yet kicked in. In LATAM's case, the merger integration challenges were compounded by adverse developments in the marketplace that also began in 2012: rising costs, declining yields and weakening demand in key markets.

The adverse external effects felt by LATAM have intensified in the past three years, as economic growth has weakened throughout South America and, more recently, as local currencies have weakened against the US dollar.

The latter caused some wild fluctuations in costs and revenues in LATAM's first-quarter financials. The Brazilian real weakened by around 20%, the Chilean and Argentine currencies by 13-14% and the Colombian peso by over 20% during Q1. Domestic Brazil accounts for 32% of LATAM's total ASKs, while "SSC Domestic" (Spanish speaking countries) accounts for 17% and international the remaining 51% of ASKs. As a result, LATAM's operating revenues plummeted by 12.2% and RASK by 14.7% in the first quarter.

Most of the RASK decline was due to the local currency devaluations, though in Brazil there was also impact from weaker corporate demand. Domestic Brazil RASK was down by 19.6% in US dollar terms but only 5% down in Brazilian real terms.

But the revenue declines were more than offset by 16.3% and 17% reductions in total operating costs and CASK, respectively. The main contributor was obviously fuel (down 40%), but as the 9.6% decline in ex-fuel CASK indicated, LATAM also benefited from its cost-cutting programme and the favourable impact of local currency depreciations on the cost side. As much as 40% of LATAM's costs are in local currencies.

LATAM has maintained high passenger load factors in all of its network segments. In the first quarter, the system passenger load factor was 83.4%, up 0.7 points.

The result of the complex dynamics was a doubling of LATAM's operating income to $227m in Q1. But a $205m non-cash foreign exchange loss, resulting mainly from the Brazilian real's depreciation, led to LATAM reporting a $40m net loss for the period.

Brazil strategy

LATAM's performance in Brazil has actually been better than expected. Against the odds, it turned TAM's domestic operations profitable relatively quickly (in 2013) — a result of capacity reductions, cost-cutting and improved yield management and market segmentation. LATAM claims to have maintained its corporate market share in Brazil. And now LATAM has even managed to compensate for some of the Brazil demand decline by shifting the point of sale to stronger markets, such as Uruguay, Paraguay and the rest of the Southern Cone.

TAM's long-haul passenger operations out of Brazil were restructured and cut back quite drastically in 2013. Its 10 oldest A330s were grounded and replaced with LAN's 767s. TAM and American began codesharing in August 2013, and in March 2014 TAM joined oneworld — the global alliance selected by LATAM.

Last year LATAM began developing São Paulo's Guarulhos as TAM's

LATAM's Fleet Plan

	At year-end:		
	2014	2015	2016
Passenger aircraft			
Dash-8-200	7		
A319-100	52	49	46
A320-200	158	153	149
A320neo			2
A321-200	21	36	51
A330-200	13	7	
767-300	38	38	34
A340-300	3		
A350-900		1	7
777-300ER	10	10	10
787-8	10	10	10
787-9		7	13
Total	**312**	**311**	**322**
Cargo aircraft			
777-200F	4	4	4
767-300F	11	11	9
Total	**15**	**15**	**13**
Total Fleet	**327**	**326**	**335**

Note: The 767-300F numbers include two aircraft leased out in 2014 and one additional aircraft leased out from March 2015.

Source: LATAM

main hub for regional and long-haul traffic in South America. This was possible because more capacity became available at the airport, including a renovated Terminal 3. It has essentially meant improving itineraries to make them more attractive to connecting passengers.

LATAM has also been building Brasilia, the country's capital, into a secondary hub. Brasilia has a strong local market (third largest in Brazil) and the highest GDP per capita in South America. It is well located for capturing domestic traffic flows, has opened up some new international opportunities and has the infrastructure for further growth. TAM, which already has a 45% passenger share there, is expanding its Brasilia operations from 30 to at least 43 nonstop destinations this year, which will include three international points (Miami, Orlando and Buenos Aires).

In December LATAM announced plans to expand in regional markets in Brazil. Those operations, which utilise TAM's A319s and also involve codesharing with regional carrier Passaredo, focus on high GDP cities. Many of the regional economies in Brazil have continued to grow even as overall GDP has stagnated. The plan is to add 4-6 new regional destinations each year, starting in 2015.

The A319 regional expansion is independent of the Brazilian government's planned regional aviation development programme, which would pay subsidies to airlines to operate in specific regional markets (but which may be at risk because of the government's spending cuts). If that programme materialises, TAM will be adding regional jets to its fleet.

In a notable move, LATAM disclosed in April that it was exploring developing a new hub for the Northeast region of Brazil. The location — Natal, Fortaleza or Recife — will be decided by year-end and the hub could be operational from December 2016.

The main objective of the Northeast hub would be to expand LATAM's operations between Europe and South America. The move is seen as a response to TAP Portugal's upcoming privatisation and the high likelihood that TAP will end up in the hands of either Azul or the Synergy Group. TAP operates more Europe-South America flights than any other airline and serves a large number of cities in Brazil.

The move makes sense. It would tap into a potentially strong new market, improve connectivity for the northern part of Brazil, offer significantly shorter flights and connecting times to Europe, better utilise aircraft and improve productivity. LATAM has said that the new hub would be operated using the current fleet plan.

LATAM currently serves only five European cities (London, Paris, Frankfurt, Milan and Madrid), though Barcelona will be added as the sixth destination in October (from São Paulo).

Overall, LATAM is maintaining capacity discipline in the Brazilian domestic market, with plans to keep ASKs flat in 2015. The international passenger business and SSC Domestic offer some modest growth opportunities, resulting in 4-6% ASM growth in those segments this year.

Fleet renewal

LATAM continues to make progress with fleet renewal, which aims to reduce the number of types and replace older models with the latest-technology, more efficient aircraft. In the short haul fleet, two types were completely phased out in 2014: the Dash Q400 and the 737-700. LATAM is also slightly reducing its A319/A320 numbers in favour of taking more of the larger A321s.

As to the long-haul fleet, LATAM continues to phase out A330s and A340s. Having received 10 787-8s and its first two 787-9s in Q1, LATAM plans to build the 787-9 fleet to 13 units by the end of 2016. Later this year LATAM will be the first airline in the Americas to take delivery of the A350.

With cargo, LATAM's focus has shifted to almost exclusively filling bellyhold capacity, and the company foresees reducing its 15-strong freighter fleet by a couple of units by the end of 2016. But the management believes that LATAM will always need a certain number of freighters.

Balance sheet considerations and longer-term prospects

LATAM has had to give up hopes of an early return to investment grade. In April Fitch downgraded LATAM to "BB-", which is three notches below investment grade, while Moody's assigned the company a "Ba2" rating (two notches below investment grade).

Fitch cited LATAM's high gross adjusted leverage, which it estimated at 5x after taking into account a gradual debt reduction in 2015-2016. At year-end 2014 LATAM's total lease-adjusted debt was $12.4bn. LATAM faces substantial debt repayments in the next 18 months, which are expected to be mainly refinanced.

The rating agencies acknowledged that LATAM has adequate liquidity, with cash and available credit facilities adding up to about 15% of LTM revenues.

Last year LATAM reduced its planned 2016-2018 fleet capex by $1.8bn, but Fitch notes that it will still amount to $878m in 2015 and $1bn in 2016, keeping free cash flow "neutral to slightly negative".

The rating agencies, like the rest of the financial community, see LATAM gradually improving its operating results and FCF generation. But there is concern about Brazil's worsened macroeconomic outlook and FX trends, which will keep passenger yields declining in 2015.

LATAM is currently guiding for a 6-8% operating margin in 2015 (based on oil at $77 in 2H15). The consensus seems to be that, unless the situation in Brazil worsens significantly, the margin is trending to the 8%-level in 2015 or 2016, which would be a solid improvement on last year's 4.1%.

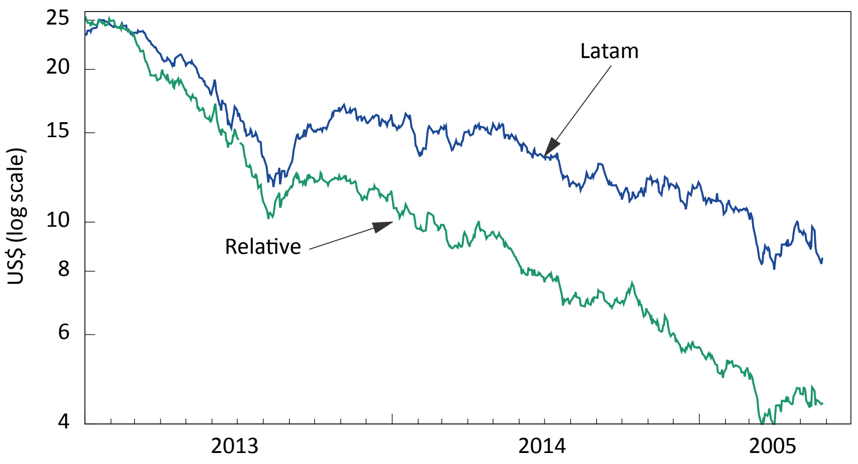
These tough times have not changed the thinking on the 2012 merger. It was a unique opportunity to create a dominant airline combine for a region that will one day again see robust economic and air travel demand growth.

But the many risks include potential setbacks with merger integration. One of the biggest risks will be the move to a single passenger reservations system — an event that has proved highly disruptive in some other airline mergers. Having just selected the Sabre technology, which LAN adopted in 2012, for the common platform, LATAM intends to move slowly and is looking at a 2017 switchover.

A full open skies US-Brazil regime should be implemented in early 2016 (though it is yet to be ratified by President Rousseff). By this stage one might have expected American and LATAM to be talking about enhancing their cooperation and even applying for antitrust immunity, but it seems that neither party is yet ready to do that because both are integrating after recent mergers. In any case, the initial impact of open skies may not be that great, because US carriers are cutting capacity on US-Brazil routes in response to Brazilian economic conditions.

LATAM's longer-term prospects remain excellent. When South America recovers from its economic doldrums, LATAM will reap significant benefits from its geographic diversity, strong regional market position (leading market shares both internationally in Latin America and in the Brazil, Chile and Peru domestic markets) and the enhanced network and other benefits resulting from the merger. LATAM clearly has the potential to return to the double-digit operating margins and the solid net profits it was earning before the merger.

Latam Share Price Performance



Note: Relative to ARCA Airline Index.

by Heini Nuutinen
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Sort code: 23-05-80 Account no: 13120374
Swift: MYMBGB2L

Delivery Address

Name ______________________
Position ______________________
Company ______________________
e-mail ______________________
Telephone ______________________
VAT No ______________________

Invoice Address

Name ______________________
Position ______________________
Company ______________________
Address ______________________
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Country ______________________
Postcode ______________________

DATA PROTECTION ACT

The information you provide wil be held on our database and may be used to keep you informed of ourpproducts and services or for selected third party mailings

PLEASE RETURN THIS FORM TO:

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