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Airline profits cycle: Up, down or sideways?

The airline industry is a low margin business. We all know that. In the years from 1945 to the end of the twentieth century the global airline industry made total net profits of $36bn representing a margin of 0.8% to revenues. In the first decade of *this* century the industry generated net *losses* of $49bn — a third more than it had ever made. But in the last five years the industry produced net *profits* of nearly $59bn (a margin of 1.7%).

IATA, however, in its latest industry forecast is projecting that 2015 could see net profits of $29bn reflecting an operating margin of nearly 7% and a net margin of 4% — the latter last reached in 1978 and the former not touched since the introduction of the jet aircraft in the mid 1960s.

Since the introduction of the jet age the industry as a whole has generated operating margins fluctuating between a positive 6% and a negative 2% in exceptional years. For those who believe that historical performance is a basis for future development there may be a worry that the IATA forecast represents a suggestion of peak profitability in this cycle trending to a downturn from 2016. In previous cycles, however, there was always someone who would say that "this time it is different" just before the downturn appeared (a key signal that the cycle had indeed peaked). None has yet done so.

The IATA forecast is predicated on an acceleration in the rate of growth of capacity (to 6.5% up from 4% and 5% in the past two years) and demand (6.7% for passengers and 5.5% for cargo) but a 7% fall in yields, a 35% decline in fuel prices and a 3% decline in non-fuel unit costs. Integral to the forecast is an assumption that GDP growth will also accelerate to 2.9% this year up from 2.5% and 2.6% in 2013 and 2014.

Within this forecast there is a wide variation of performance by region of airline incorporation. North America is forecast to generate net profits of some $15.7bn (more than half the global total and more than double that achieved in 2013) representing a net profit margin of 7.5% of revenue and $18.12 per passenger.

Europe meanwhile is projected a net profit of $5.8bn — finally exceeding the peak of the last cycle in 2007 when it achieved $5.1bn — but only reflecting a margin of 2.8% and a profit per passenger of $6.30.

It is closely matched by Asia/Pacific airlines who are forecast to produce $5.1bn — the area's best performance since 2010 — at a margin of 2.5% and $4.25 per passenger.

Interestingly, for airlines in the Middle East IATA is projecting profits

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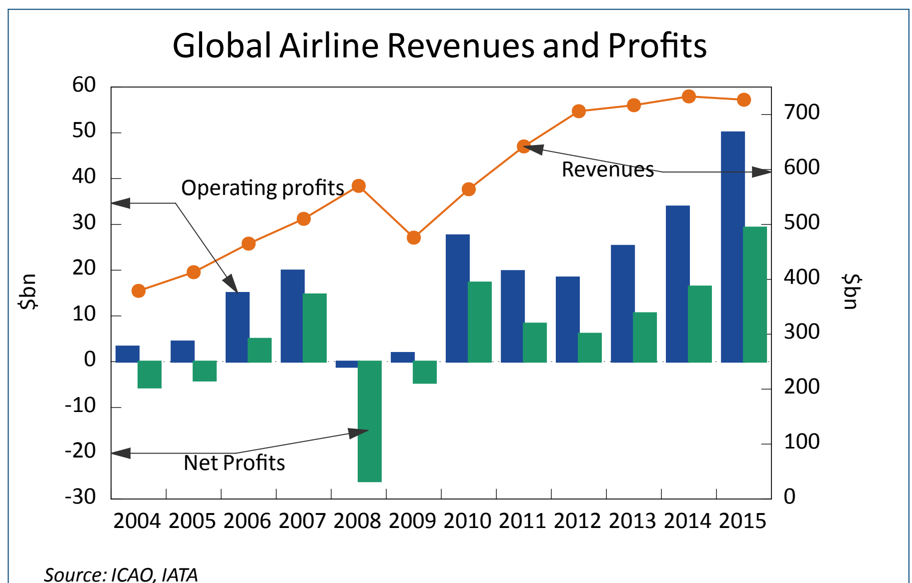

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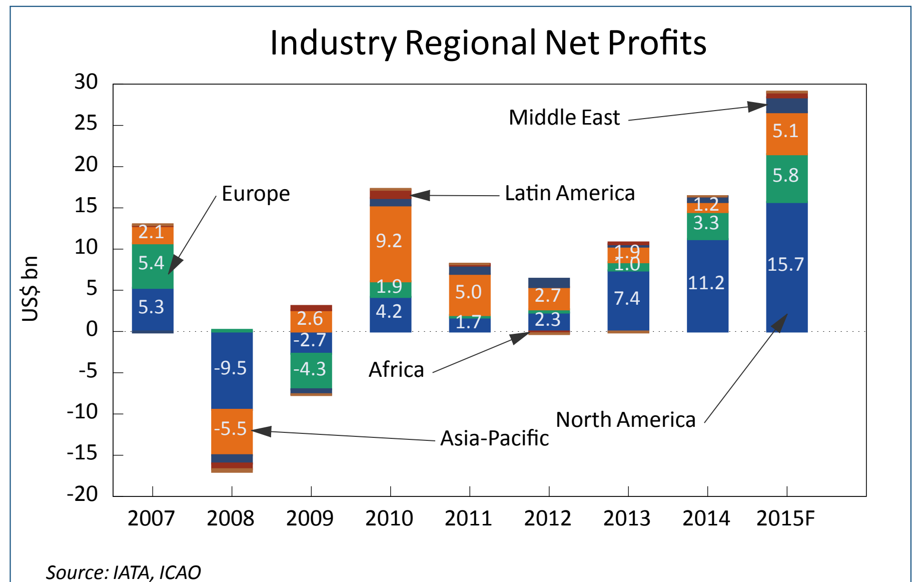


Source: IATA, ICAO

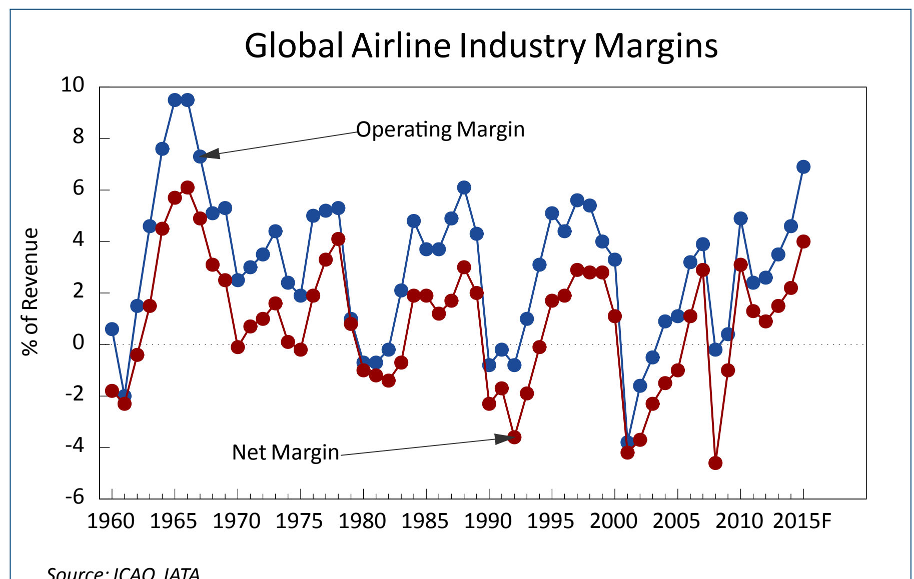
of $9.61 per passenger, $1.8bn in total and a 3% profit margin ("yields are low but unit costs are even lower") — which no doubt could add fuel to the legacy campaign against the Middle East superconnectors.

Is this time different? The problem when looking at a global aggregate is that it can sometimes blind one to the conscious appreciation of changes at the micro level.

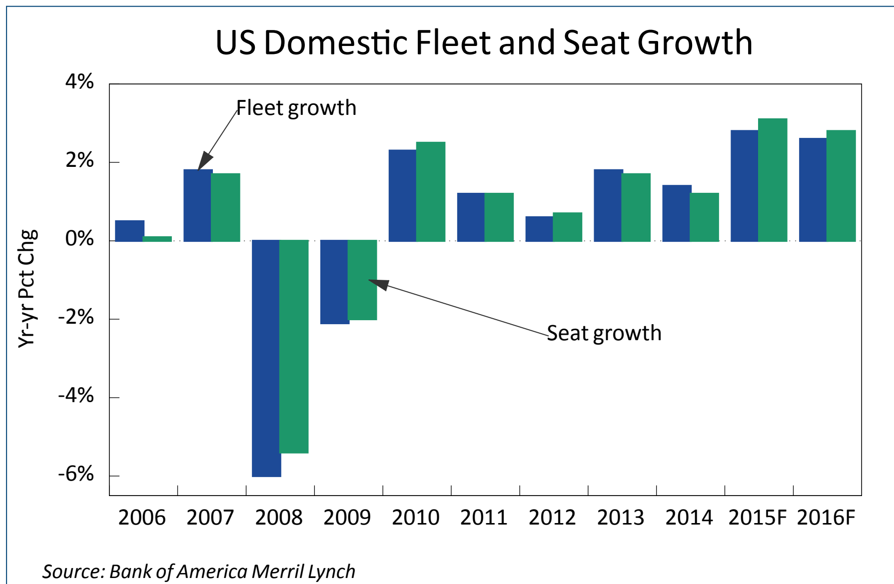
Some individual airlines will only start to benefit from the fuel price decline in 2016 as their relatively high fuel hedge positions unwind. There are of course many without fuel hedges in place.

One major consideration is that since the last cyclical peak there have been some substantial structural changes in the industry, not least of which is an increased shift from legacy to new (generally profitable) business models: the LCCs in Europe continue to grow profitably at the expense of flag carriers; the superconnectors (particularly Emirates and THY) are adding profitable services at high rates of growth.

Moreover, since the last down-



Source: ICAO, IATA



Source: Bank of America Merril Lynch

turn two of the largest aviation markets have effectively consolidated: the US domestic and the trans-Atlantic markets.

In the US domestic market, despite capacity increases at Southwest as it resumes a growth path (see *Aviation Strategy* November 2014) and growth at the relatively small ULCCs, there still seems to be no break to the capacity "discipline" in the US. As the chart above seems to show, the US domestic market seems set to increase total seat capacity (depending on assumptions of retirement of older equipment) at a modestly higher rate than aircraft units, implying that capacity will be introduced using increased aircraft utilisation and an upgrade in aircraft gauge both possibly leading to improvements in per aircraft cash flow and profitability.

At the same time the Delta-Virgin joint venture through Heathrow and the potential IAG acquisition of Aer Lingus (to be incorporated into the BA-AA transatlantic joint venture) further intensifies regulator-approved consolidation in that market.

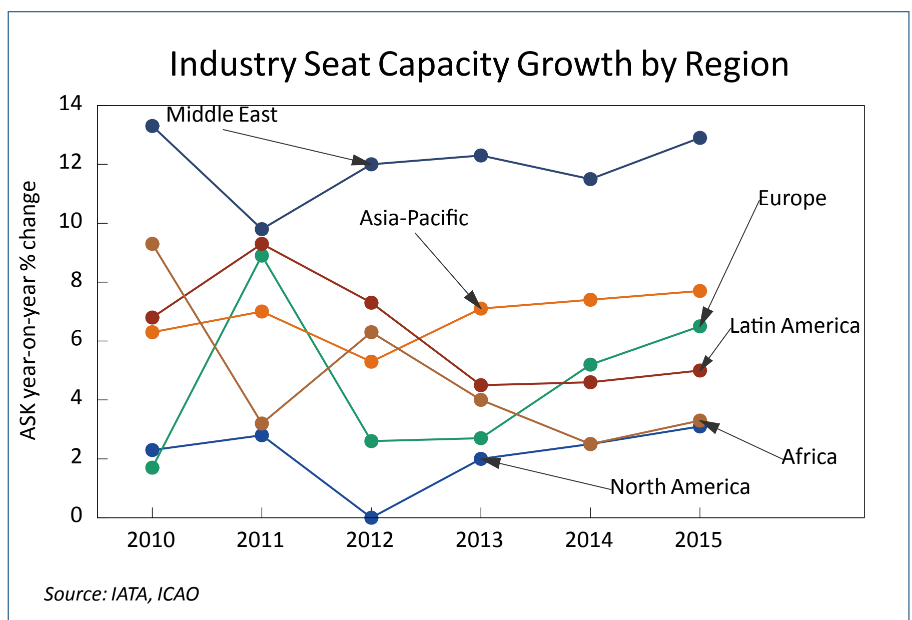
These however are the more mature market regions and in the lowest growth segments of the industry — and other regions still see rampant competition and in some measures continued market fragmentation.

Whereas the airline industry profit cycle can be said to be primarily driven by economic performance, the world's economies are still running below perceived long term growth rates and the developed economies continue to operate in an era of significantly negative interest rates — seemingly, seven years on from the global financial crisis still unable to stimulate real performance.

This all may suggest that we could be in an extended cycle with a plateau or further upturn in profitability in 2016.

IATA points out that its forecasts suggest that the industry as a whole will generate "for the first time" a positive return on equity above the weighted average cost of capital. This immediately raises the thought that we have reached the peak.

However, the assumption that the industry should achieve this target is a peculiarly equity market focussed idea. (And on a *global* view there may be few industries that do it on a long term consistent basis.) There are a handful of quoted airlines that achieve the target. There are a handful that strive to achieve it. There are some airline shareholders for whom other returns may be more important: tourism, employment, connectivity.



Source: IATA, ICAO

Ryanair: Steamrollering to €1bn net profits

UNLESS there is some external negative event it is probable that Ryanair will produce a net profit of over €1bn in FY2016 (official, cautious guidance is €940-970m) on revenues of €6.1bn.

The bottom line, literally, in Ryanair's Investor Presentations is "Forecasts subject to 'LF active/price passive' policy", which is at first sight fairly innocuous — the European LCCs have all subscribed to the notion that the important thing if to fill the aircraft to 80-90% with the average fare being the means to do so. But Ryanair is carrying this further: O'Leary contrasts this, Ryanair's core strategy, with the other LCCs' (mostly easyJet's) aim of maximising RoCE and making promises on RoI.

What does this mean in practice? Especially, as the share price chart (on the next page) shows, Ryanair is, according to the stockmarkets, the leader in providing investment returns over the past three years? And Ryanair's RoCE is around 20%, roughly the same as easyJet's; IAG and the Lufthansa Group are achieving 12% and 8.5% respectively; Air France/KLM is negative.

To illustrate what we think it means, and explain the distinction Ryanair is making: the chart on the right compares Ryanair's more-or-less fixed fleet plan — adding over 200 737-800s over the next seven years — with easyJet's flexible plan — maximum growth of just under 100 A320-types over roughly the same period, which is close to easyJet's Base Case plan (how it *expects* it will develop). But at minimum, if things go awry, it could reduce its fleet by 30 units to 200, still staying within the contracts agreed with Airbus.

So, easyJet will respond to a recession or downturn in trading conditions by slowing or reversing capacity growth, in the expectation of pushing up unit revenues or at least stabilising them. But Ryanair will continue to add capacity in a downturn, confident that its much lower cost structure will mean that it can schedule services profitably when its competition cannot, inevitably capturing more traffic from its rivals, stressing them financially, maybe forcing them out of business. For this strategy to work, Ryanair doesn't have to worry about unit revenues too much — "Load factor active/price passive". And, as O'Leary has pointed out, Ryanair does not have explicit RoCE targets for the investment community to become fixated on.

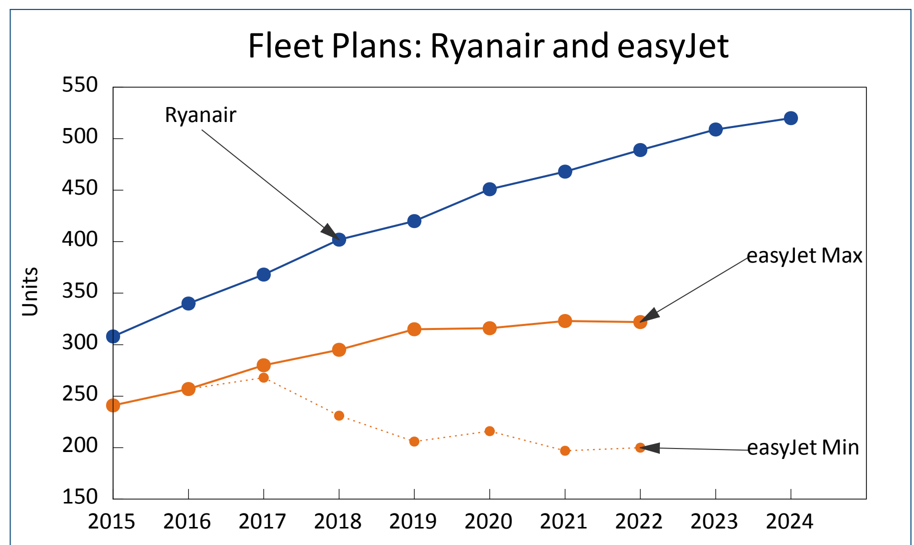
This is a classic economics game — place your bets.

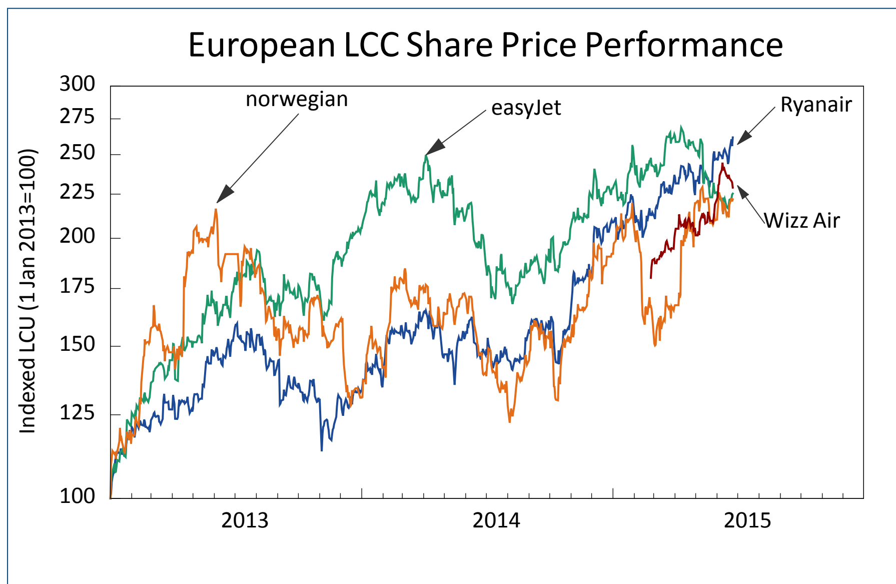
Cost differentials

How sustainable is Ryanair's cost advantage? In its latest investor presentation Ryanair puts its average seat cost at €29, 45% below easyJet, 53% below norwegian and 73% below airberlin.

The price differential with easyJet has not changed over the past year despite the implementation of "Always Getting Better". Perhaps this is not surprising as the elements of AGB — allocated seating, removal of extreme penalties, free extra bag, revamped website, etc — are mostly concerned with removing Ryanair's unnecessary aggressiveness rather than any fundamental strategic change — as O'Leary mused, "If I had known I could make more money by being nicer, I would have done it much earlier." (There are still quite a few unpersuaded customers out there, however.)

The main low cost dynamics still appear to be in place:





✈ Fleet: Ryanair's current delivery schedule comes from a 180-unit order of 737-800NGs, which are end of production line aircraft whose unit price was further depressed by Airbus's success with the early A320neo orders at the time, mid 2013, when Ryanair finally committed its order. Then, from 2019 Ryanair will start to take delivery from its order (100 firm plus 100 options) for the 737 MAX, with seating of 197 seats (against 189 for the current fleet) and a claimed, guaranteed probably, improvement in fuel efficiency of 18%.

✈ Airport charges: This represents the big difference between Ryanair and easyJet — €8 against €21 per seat — a gap which must diminish as Ryanair expands into more and more mainstream airports (the only ones excluded from its possibilities are Heathrow, Frankfurt Main and Paris CDG). Yet Ryanair still does innovative deals: at London Stansted, its second base, it drastically cut back capacity when the then owners, BAA, applied the regulatory maximum charges, and as a result total traffic at the airport collapsed by 25% between 2008 and 2011. With MAG (Manchester Airport Group) in charge following the mandated disposal of Stansted, all that traffic has been recovered and more, as Ryanair has expanded again, having signed a ten-year contract with MAG. We do not know what the price per passenger is for the additional traffic generated by Ryanair, but suspect well under £5/pax against about £6.5/pax according to the rack rate. All German airports, according to O'Leary, are interested in negotiating growth-related deals with Ryanair.

✈ Ryanair like easyJet (but unlike norwegian) has not benefitted from the fall in oil prices because it hedged at above the 2014/15 average price, and is 90% hedged at $92/bbl for the year to end March 2016. If fuel stays low Ryanair will benefit as the hedges unwind; if fuel prices soar it is protected.

Glossier easyJet

easyJet, by comparison, tends to concentrate more on its revenue side in its (much glossier) investor presentations, focusing on yield management and capacity disciple, both of which pushed up unit revenues by about £1.1 between the first half FY2014 and the same period in FY2015. However, adverse FX movement meant that the overall unit revenue scarcely changed — £54.9 against £54.8. Unit costs over the same period fell by £1.8 from £56.5 to £54.7/seat, but as the investor presentation makes clear, "management initiatives" as a whole accounted for almost none of the change, the decline coming mainly from a combination of fuel and FX effects. easyJet's financial year runs to September 30, for which net profits of about £420m on turnover of £4.8bn are anticipated).

easyjet's core strategy is its network. Within Europe it is the leading carrier in terms of number of market pairs operated between the 100 primary airports — 47 market pairs compared to BA's 38 and Ryanair's 22. It business orientation is illustrated by its route frequencies — 7 per week on average against 4 for Ryanair. It is the number one carrier at Gatwick, Edinburgh, Milan Malpensa and Geneva.

Ryanair responds by quantifying what happens when it enters a market. For example, it started Stansted-Edinburgh in January this year and by March was carrying 25,200 passengers, while easyJet's long-established operation saw volumes fall from 25,500 in October 2014 to 22,800 by March. On Stansted-Glasgow, Ryanair also started in January and had built up to 24,200 pax by March; meanwhile easyJet's traffic slumped from 24,000 in October to 13,700 in March.

So, according to Michael O'Leary, Ryanair will continue to become more and more dominant in the European market, because the cost gap between his airline and his rivals is so wide. They can claim that they do not compete directly with Ryanair because they have developed separate markets and/or products — primary cities (easyJet), eastern Europe

(Wizz), loyal home base (Vueling), long-haul (Norwegian) — but ultimately, O'Leary warns, they will have to face their nemesis.

De-fragmentation

The European short/medium haul industry is fragmented, consisting of:

- The five main LCCs, each with a different strategy
- The short haul networks of the three global carriers, (of which only one, IAG, is currently successful, while the other two, Lufthansa Group and Air France/KLM are struggling (see *Aviation Strategy*, May 2015)
- Lower cost subsidiaries of the Globals — eurowings, Transavia, HOP!
- The remaining independent or quasi-independent national carriers — SAS, LOT, TAP, SN Brussels, etc.
- A subset: Etihad-invested airlines — air berlin, Alitalia, Air Serbia, etc
- The residual charter industry (UK charter passengers volume, for instance, has fallen by more than 50% over the past ten years — see *Aviation Strategy*, March 2015)
- The niche carriers — Aegean (successful hybrid but exposed to Greek crisis), Flybe (low-cost regional, floundering) and Volotea (ultra-niches and ultra low-profile)

Although the different airline models can to a large extent co-exist, some shake-outs are inevitable. In the medium term this could happen:

- Intra LCC mergers: Wizz has achieved unit costs similar to Ryanair, has the leading position in east and central Europe, and might possibly be a target for either easyJet or Ryanair. Ryanair has had much greater management continuity than easyJet, and O'Leary has the painful memory of the Buzz acquisition 15 years ago, while easyJet executives may know about the benefits of buying Go but may be unaware of the full costs and disruptions of that take-over. In any case Wizz now has a price — £0.8bn — its market capitalisation following its recent listing on the London Stock Exchange. Five years ago O'Leary dismissed speculation on Ryanair's interest in Wizz by saying he valued the airline at five or six euros in total.
- LCC/National carrier mergers. The obvious combination would be Norwegian/SAS, a possible solution to the former's struggling long-haul growth plan and SAS's cost structure.
- Legacy spin-offs. According to O'Leary, the rationale behind the wrapping-up of its loss-making, non-hub European traffic in Eurowings is to distance the brand from Lufthansa, acknowledging that it will sooner or later be sold off or closed down. AF may be forced to do something similar with Transavia/HOP!
- Legacy/LCC link-ups. No-one has yet worked out how to mesh LCC point to point operations with the requirements of a global hub system, though Vueling has innovated. Vueling and easyJet would appear to be the obvious candidates for this short-haul outsourcing, with their experience in business-orientated traffic. Yet Ryanair could surprise, by coming up with the lowest cost solution.

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Perfect storm envelops the AirAsia Group

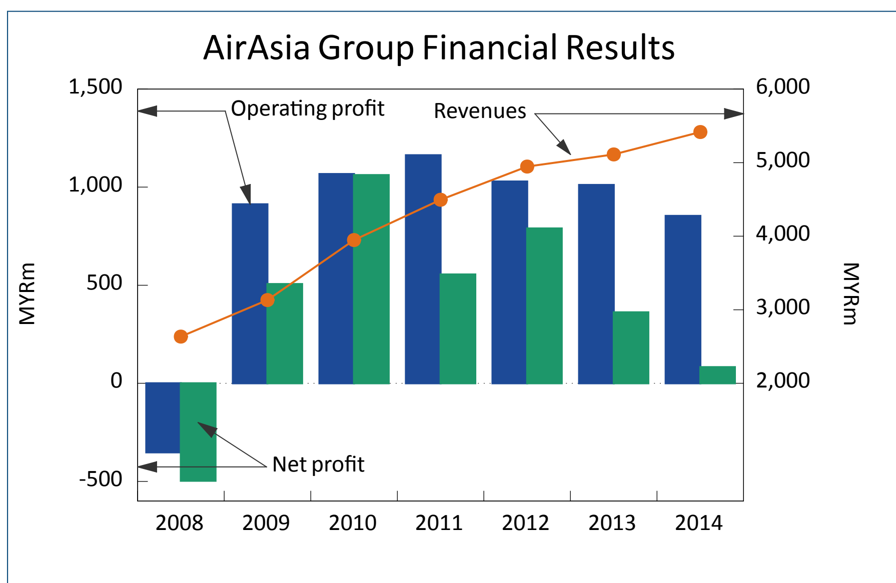
AirAsia says it faced a "perfect storm" of aviation incidents, geopolitical unrest and natural disasters in 2014, which led to a sharp drop in net profits. Can the LCC recover in 2015?

Launched only in 2001, the AirAsia group pioneered the LCC business model in the Asian region (with LCCs now accounting for more than half all seats in southeast Asia, compared with less than 5% in 2003) and today operates to more than 100 destinations in 22 countries, with affiliate carriers in other countries complementing the original and largest airline in the group, based in Malaysia.

Despite constant growth and substantial profits over the last 14 years, the AirAsia group had faced a tricky time recently, with Tony Fernandes — AirAsia founder and group CEO — saying: "2014 was indeed a tough year for the group. We faced so many challenges from the move to klia2, the high fuel price, irrational competition, weakening regional currencies, the political situation in Thailand and devastating aviation tragedies". The pressure can be seen in the AirAsia share price, which has steadily declined from just under RM4 as of mid-2011 to around RM2.2 as of early June this year.

The Malaysian operation is the most important part of the group — still accounting for almost half of all passengers carried on the group's short- and medium-haul airlines in 2014 (see chart, next page) — but it has been battling against immense pressure on yield and fares thanks to fierce competition that will only get worse once Flymojo — a start-up airline owned by the Malaysian state — launches operations out of Senai airport with 20 Bombardier CS100s in October 2015.

Average fares at Malaysia AirAsia have fallen for five years in a row, from 177 ringgit (US$54.9) in 2010 to RM165 ($50.5) in 2014. However, according to AirAsia "starting from 3Q14 we have seen the curve bottomed in and moved back to the positive side in 4Q14. This trend is continuing into 2015". But while revenue per ASK rose in 2014 compared to 2013 — 15.66 sen (4.79US¢) versus 15.30 sen — the gap between unit revenue and cost continues to shrink, falling from 4.48 sen in 2011 to 2.47 sen in 2014. That is the result of a rise in unit costs, from 11.83 sen in 2010 to 13.19 sen in 2014. And even when fuel costs are taken away, the cost story is not great, with cost per ASK rising from 5.93 sen in 2013 to 6.67 sen in 2014.



That cost pressure has numerous roots. On the one hand are essentially one-off factors, such as the move to the new Kuala Lumpur International Airport low cost terminal (known as klia2) in May last year, which AirAsia says "required intensive operational restructuring", but many more are structural, either external — such as a 9% rise in landing fees imposed by Malaysian airports and higher dollar denominated route charges — or internal, such as a larger workforce as the airline expands. As can be seen in the chart, next page, the rise in employees in Malaysia over 2013 to 2014 has not been accompanied by a larger relative increase in ASKs, and as a result productivity (in terms of ASKs per employee) has remained flat over the last two years, which may be a symptom of underlying problems.

As a result, while for calendar 2014 the Malaysian airline reported a 5.9% rise in revenue, to RM5.4bn ($1.7bn), operating profit fell 7% to

RM853.6m ($261.1m) and net profit dropped 77% to RM82.8m ($25.3m).

While it's still a profitable company, the fall in net profits in full 2014 in particular is worrying, and that has led to a number of strategic and tactical changes at the AirAsia group.

Changes

Perhaps the most important change is a re-balancing of growth against profitability, with a significant move away from the former towards the latter.

The AirAsia group fleet (excluding AirAsia X) totals 186 aircraft, all of which are A320-200s. There are 82 of the model at the Malaysian operation, 43 in Thailand, 29 in Indonesia, 28 in the Philippines and four in India. However, on outstanding order are 10 A320-200s and 304 A320 neos, with the latter entering into service from the end of 2016.

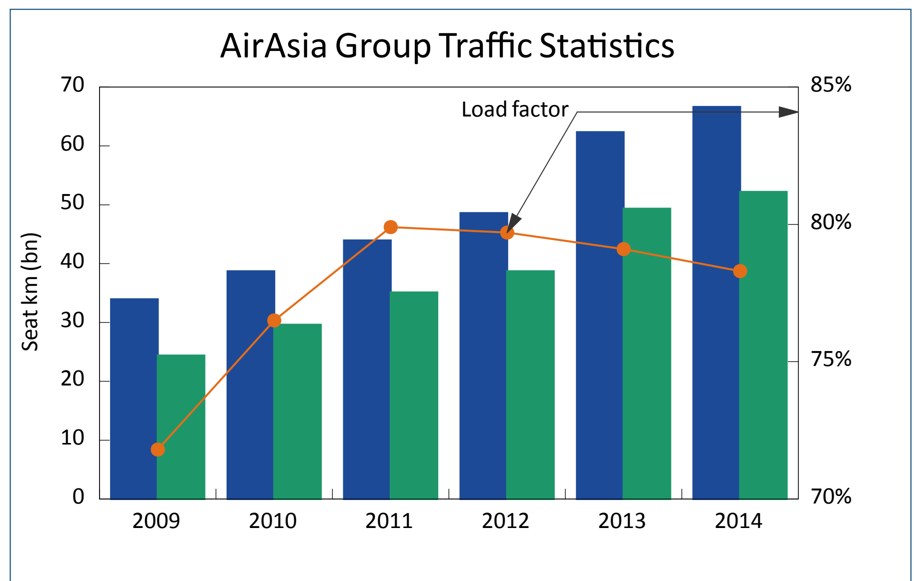
Yet the group added just 18 net aircraft last year, which was the first sign of an attempt to bring — as AirAsia puts it — more "discipline" to capacity management. That effort is accelerating through 2015, with a focus on sweating existing capacity even more. That means the group will expand the overall fleet by just five net aircraft this year (going to Thailand, India and the Japan), after it deferred delivery of some A320-200s to later dates.

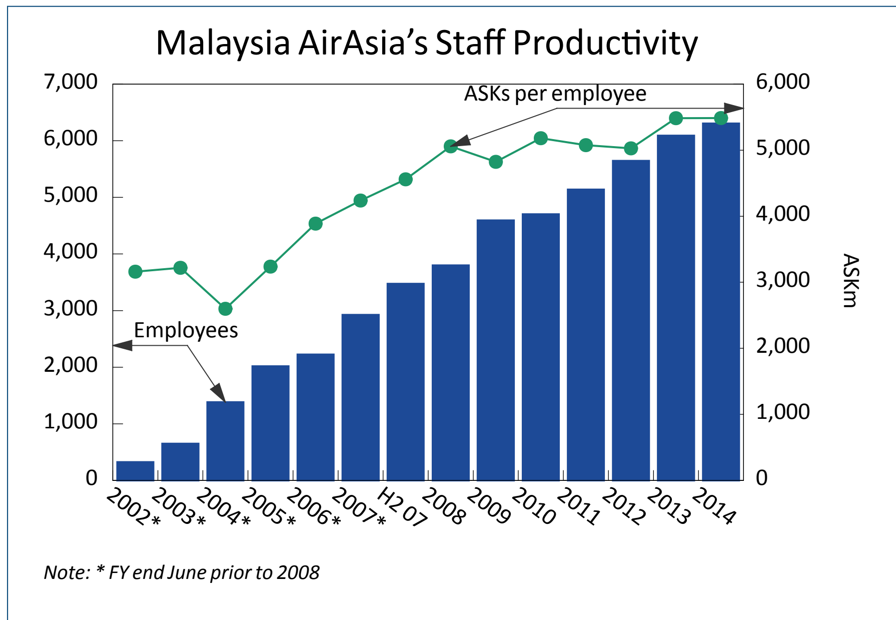
This is just one part of a wider effort to improve the group's cash position — as at the end of December 2014, deposit, cash and bank balances totalled RM1,338m ($409.3m), just RM8m ($2.5m) higher than 12 months previously, and more than 40% lower than the cash balance at the end of 2012.

Just under 80% of the fleet is owned outright, so older aircraft are now being sold and leased-back, while AirAsia is also selling other aircraft and some slots as well. In a further effort to boost the cash pile, in February this year the group reduced its stake in AirAsia Expedia, an online travel site joint venture started in 2011, from 50% to 25%, raking in US$86.3m by selling a 25% share to partner Expedia. These two businesses are just part of a growing portfolio of group "private equity investments" in adjacent businesses (many of them joint ventures), such as Big (a loyalty programme, with AirAsia's stake valued at $120m according to AirAsia); Tune Money (valued at RM25m); Asian Aviation Centre of Excellence (airline simulators; RM250m); and a leasing company (which leases aircraft to AirAsia affiliates; $400m to $500m).

Surprisingly, given the focus on cash generation, the group has opened itself up to criticism by going ahead with the construction of a new 57,000m^2 corporate headquarters in Kuala Lumpur, to be completed in the summer of 2016.

Elsewhere, in the face of pressure on fares a continuing push will be made in the field of ancillary income.





The group has finally achieved its long-held target of RM50 ancillary income per passenger, and that's been helped by the sale of duty free goods on selected international flights from August last year, which has added RM2.66 ancillary revenue per passenger, plus paid-for wi-fi on flights from October. The average revenue was be boosted further by the launch of credit card payments on board in February this year, and a new duty-free website (to enable pre-flight ordering) in March.

Affiliate focus

A greater challenge for the group comes from its affiliates, all of which also faced a challenging 2014. An analyst note published by HSBC in June this year says that: "AirAsia's associate ventures are turning out to be more problematic than we initially anticipated. With the exception of Thai AirAsia, all the other airline ventures are loss-making and are being increasingly funded by the parent. Consequently, loans to associates doubled in 2014 (more than 50% overdue) and equalled half of AirAsia's equity value, the highest level in history."

The group focus is now on turnaround plans for the Indonesia and the Philippines operations (in which it owns 49% and 40% respectively), as the group would like to launch IPOs for them sooner rather than later. Fernandes says he wants to raise up to $600m from selling 20-30% stakes in those Indonesia and Philippine associates, each of which he says are worth up to $1bn.

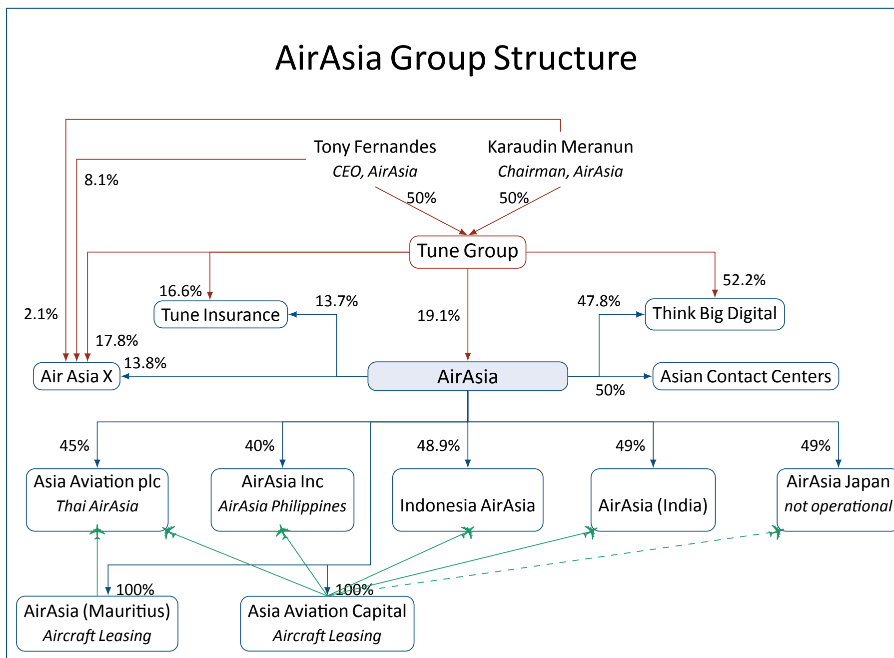
Facing, as AirAsia puts it, "irrational competition", AirAsia Indonesia saw its operating loss almost quintuple to IDR 562.6bn ($56.3m) in 2014 and the net loss more than doubled, to IDR 856.3bn ($85.6m), although revenues were up 9% to IDR 6.34 trillion ($634m). However, he group believes the affiliate is on the "right track", as it has been rationalising its route network, closing loss-making sectors and increasing frequencies to popular destinations. As a result load factors and fares improved through 2014, and that's evidenced by the turning of an operating loss of IDR 369bn ($36.9m) in 4Q 2013 turning into an IDR 23.4bn ($2.3m) operating profit in September to December 2014.

Unfortunately the airline was then hit by the crash of Indonesia AirAsia's flight QZ8501 in late December 2014 — although, after a subsequent dip, demand appears to have returned to normal levels through 2015. Indonesia AirAsia operates more than 30 routes (of which 21 are international) out of five hubs — Jakarta, Bandung, Bali, Surabaya and Medan, and the carrier will be helped by the launch of Indonesia AirAsia X at the end of 2014 (see page 10), between which it's hoped that there will be substantial feed.

The Philippines AirAsia operation recorded a net loss of RM19.3m ($5.7m), in the fourth quarter of 2014. The Clark airport-based Philippine operation is a 2013 consolidation of the existing Philippines AirAsia and Zest Airways, and today operates on 16 domestic and international routes to 14 destinations. The group says a turnaround is well under way in the Philippines associate, with a move into the black forecast in the second quarter of 2015 following a major cost-cutting exercise and a network refocus onto leisure destinations.

Also of concern for the group is the Thai affiliate, which despite an 8% rise in revenue in 2014 to THB25.4bn ($780m), saw operating profit fall 87% to ฿300.7m ($9.2m) and net profit fall 82% to ฿344.6m ($10.6m) due to the unrest in that country. Thai AirAsia is aiming to increase load factor this year, but the political situation in the country is still tense, and until martial law is lifted the tourism market will stay suppressed.

Elsewhere, AirAsia India was launched in June last year and today operates to six domestic destinations out of Bengaluru airport, which is in



the south of the country. The AirAsia group has a 49% stake in the airline, with 30% held by Tata Sons and 21% by Telestra Tradeplace. For the 2014 financial year it recorded a net loss of RM54.7m ($16.7m).

AirAsia India has four/five aircraft and the group believes that it will become profitable from the sixth aircraft onwards, which will arrive later this year as it focusses is on secondary domestic markets and routes that are currently poorly served. However the Indian affiliate can only operate domestic routes of the foreseeable future thanks to India's "5/20 rule", whereby a domestic airline has to wait five years and have a fleet of 20 aircraft being it is allowed to operate on international routes.

Fernandes says that "airlines have been inefficient in India but I don't think we should be punished for two or three carriers making losses." Those are the very same private airlines that objected to AirAsia's entry into the Indian market.

Relief may be at hand given that the Indian government is proposing replacing the 5/20 rule with a so-called credit-based system, whereby an airline gains Domestic Flying Credits (DFCs) dependent on distances flown domestically, with extra points for routes to remote destinations. Once it receives sufficient credits, domestic airlines will be allowed to operate internationally.

But while accepting the proposed system is better than the existing 5/20 rule, Fernandes says this new system is even more complicated than the Duckworth-Lewis maths formula used for run chases in rain-affected cricket matches, and AirAsia has calculated it would need to operate 16 aircraft for 12 months to accumulate sufficient DFCs. Given its "pragmatic" plan for India it will realistically take the airline between two and three years to accumulate the points, with a fleet of 20 aircraft needed at the end of that period. However it's believed the government may allow airlines to buy DFCs "at a market-driven rate".

Looking further ahead, Japan is the next target for the group. A previous venture into the market in partnership with All Nippon Airways in 2012-13 ended in failure, but the group intends to try again in 2016, this time in alliance with online retailer Rakuten.

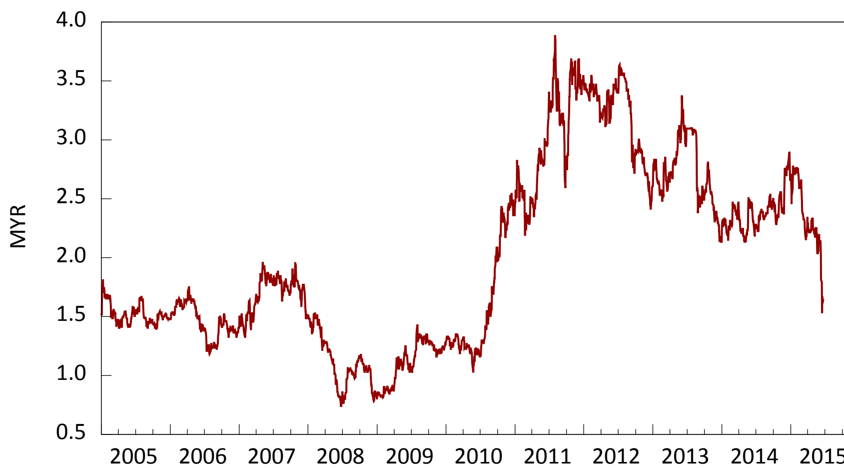
AirAsia X

The group also faces challenges at AirAsia X, the long-haul airline owned 14% by the AirAsia group (with a larger percentage controlled by Tony Fernandes). In 2014 despite passengers carried rising 33.8% to 4.2m and revenue increasing 27.3% to RM2.94bn ($899m), it reported an operating loss of RM212.2m ($64.9m) — compared with an operating profit of RM31.4m in 2013 — and its net loss increases almost six-fold, to RM519.3m ($158.9m). That was much greater than expected by analysts, many of whom then posted sell notes on the company's shares. AirAsia X was listed on the Kuala Lumpur stock exchange in July 2013 at a share price of RM1.25, and this has steadily declined ever since, going under RM0.3 at early June 2015.

RHB Research noted that "2014 yields took a beating on its aggressive capacity expansion (33% up year-on-year) amidst intensifying competition". That expansion saw seven new aircraft arrive last year, bringing its fleet up to 23 A330s and A340s, which operate out of Kuala Lumpur to 18 destinations in Asia, plus Jeddah in Saudi Arabia. On order are 77 aircraft, comprising 12 A330-300s, 55 A330-900s and 10 A350-900s.

However the group says that in order to fill the new capacity "huge efforts of marketing as well as reduced promotional fares had to be offered — all of which carried a cost". Load factor fell only fractionally, to 82% in 2014, but average fares and yield both came down.

As a result of its 2014 troubles



new senior management was put in place at AirAsia X at the start of 2015, and they immediately conducted a strategic review, the outcome of which is a renewed focus on three areas — higher yield, cost savings (through reducing the workforce and renegotiating supplier contracts, all aimed at achieving a 5-7% improvement in unit costs ex-fuel in 2015) and a closer relationship with the group in order to get better efficiencies, and presumably greater feed.

Nevertheless, expansion will still continue for AirAsia X; the airline wants to launch a route to Honolulu in November — its first US flight — and to resume flights to Europe next year for the first time since 2012, when it cancelled unprofitable A340 services to London and Paris. London is likely to be the first route in 2016, though this time operated with A330-900s, for which it placed an order for 55 aircraft in December 2014.

More important, though, is the launch of AirAsia X affiliates throughout Asia, which the group hopes will enable passengers to transfer between the local Asian affiliates and the long-haul affiliate and giving a significant revenue boost to the group.

Thai AirAsia X started in June 2014 and today operates to Seoul, Osaka and Tokyo Narita with three A330-300s, while Indonesia AirAsia X uses two A330s and was launched in January this year with a route from Bali to Taipei, before adding a route to Melbourne in March 2015. Interestingly the group says that as the two offshoots grow then the main AirAsiaX will be "able to release more of its excess capacity onto its associates, thus help in its capacity rationalisation". That's a clear statement that the current fleet (plus outstanding orders) at AirAsia X is simply too large.

However, some analysts are not optimistic. Tan Kee Hoong from AllianceDBS is worried that AirAsia X's Thai and Indonesian associates will be drag down profits, and if that occurs then the AirAsia's troubles of 2014 may well be repeated in 2015.

A crucial year

2015, therefore, is a crucial 12 months for the AirAsia group. In the first three months of this year revenue fell by 0.4% year-on-year at the core Malaysian operation, to RM1.3bn, but operating profit was up 20% to RM273m and net profit increased 6.9% to RM149m. That's just one quarter though, and the share price has continued to fall through the year, which indicates that investors are not yet convinced that AirAsia has responded sufficiently to the challenges that it faces.

That scepticism is shared by some analysts, with HSBC stating that "AirAsia's recent attempts to push back capex, sell stakes in adjacency businesses, sell old aircraft and generate cash flow from sale & leaseback of aircraft should be helpful, these are unlikely to make a material difference to its stretched financial positioning". AirAsia's debt "has risen to unprecedented levels", says HSBC, and unless substantial progress is made through 2015 in its refocussed strategy, it appears that the group may need a significant rights issue to bolster its equity position.

This view is emphasised by a recent research report from Hong Kong based independent GMT which aggressively accused AirAsia of manipulating its links with its associates artificially to boost the group's earnings. The publication of the report has led to a further 20% decline in the share price and renewed efforts by CEO Fernandes to calm investor fears.

AirAsia has been remarkably successful in broadcasting the LCC model in SE Asia, despite the problems of ownership and control in a region yet to embrace full "open skies" or a common aviation area. However, it has yet to prove that the "associate" model under a brand umbrella will really work.

American: Amazing turnaround, tough integration hurdles to come

American Airlines Group (AAG), the world's largest airline by traffic, has staged a surprisingly strong financial recovery since the closing of the AMR-US Airways merger and AMR's exit from Chapter 11 in December 2013. The new American has not only closed the profit gap but is reporting operating margins that are vastly superior to Delta's and United's margins (albeit because of AAG's lack of fuel hedges and profit sharing).

There is excitement about American's prospects for a number of reasons. The group has a competitive cost structure. The stronger combined network is attracting more corporate contracts and higher volumes of business traffic. And the synergies from the merger are likely to build up rapidly from 2016. Analysts expect AAG to achieve the highest profit margin gains among the top three US carriers in the next several years.

The fact that American's shares (AAL) were admitted to the S&P 500 Index in March, becoming only the third airline to receive the honour (after Southwest and Delta), was testimony to how far American has already come.

But American still has the toughest hurdle in merger integration ahead of it: a move to a single reservations system. Will it be a smooth and successful cutover, like Delta-Northwest's, or more like the highly disruptive event that United-Continental experienced? UAL's switchover in 2012 resulted in months of widespread flight delays and cancellations, business customer defections and an adverse profit impact.

Another challenge American faces this year is that it is heavily exposed to LCC growth hotspots: Southwest's long-haul expansion out of Dallas Love Field and Spirit's entry and rapid growth in many of American's markets. American is therefore seeing greater PRASM pressures domestically than its peers.

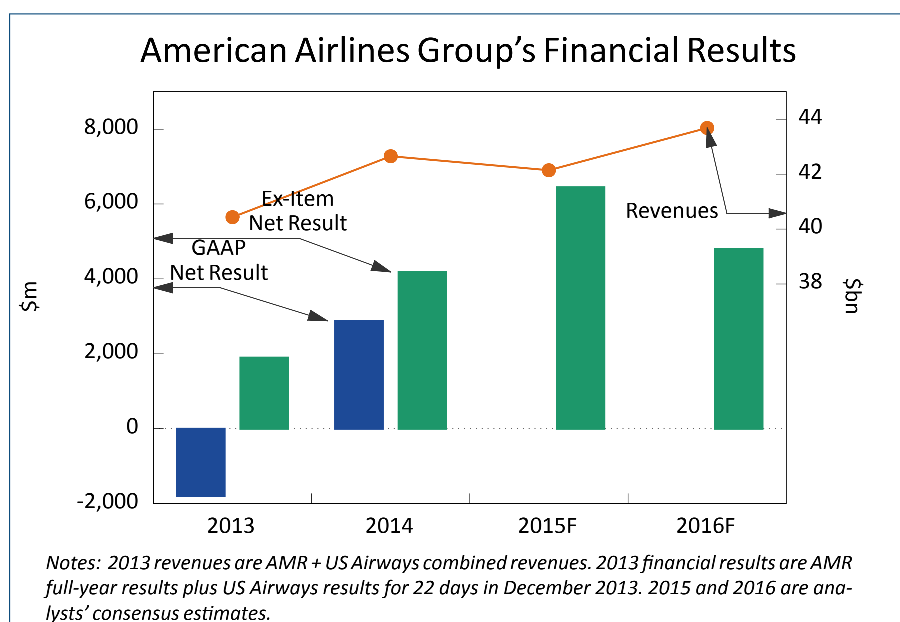
In recent months many US airline stocks have been punished by sudden concerns by investors that the domestic industry capacity discipline is faltering, which analysts have argued is not the case. Because American has been on the frontline of the battles with LCCs, its stock has taken a mighty beating. As of June 23, AAL's share price had fallen by 20% since the beginning of the year.

As a result, American has taken some action to appease investors and to ensure continuation of capacity discipline. It has modestly scaled back capacity growth plans and delayed some aircraft orders. Of course, since American continues to be highly profitable and has promising prospects (if it can avoid the merger integration pitfalls), most analysts continue to recommend the stock as a "buy".

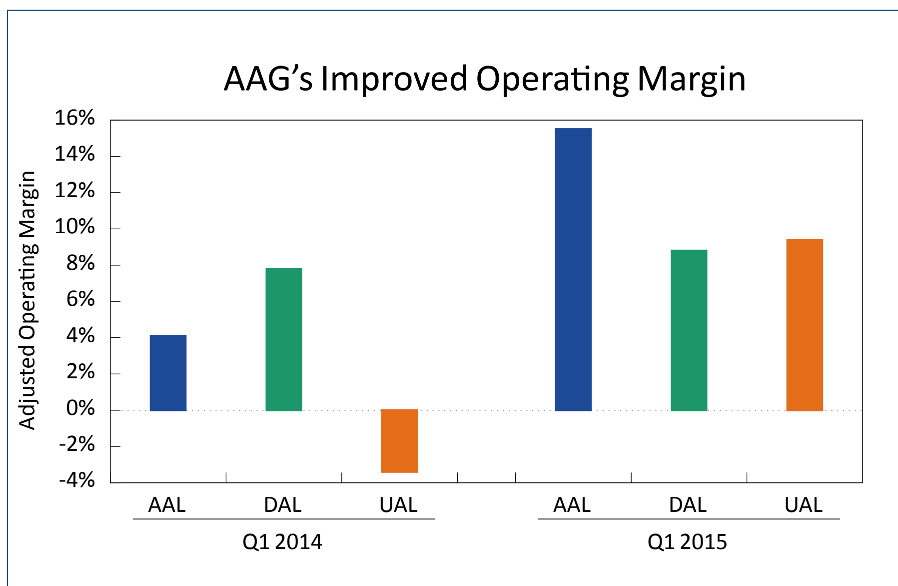
Another thing that the financial community will be watching for is how American allocates the significant free cash flow that it will be generating. Currently its priorities are to complete merger integration, renew the fleet, pay down expensive debt and invest in the product, but American is also already returning capital to shareholders in the form of share buybacks and dividends.

Turnaround story

AMR incurred adjusted net losses totalling $11.2bn in 2001-2012. US Airways lost $1.3bn in 2008-2009



Notes: 2013 revenues are AMR + US Airways combined revenues. 2013 financial results are AMR full-year results plus US Airways results for 22 days in December 2013. 2015 and 2016 are analysts' consensus estimates.



but was otherwise profitable since 2006 (following the September 2005 closing of the US Airways-America West merger, which pulled US Airways from Chapter 11 and created an AWA-managed nationwide carrier). But the AMR-US Airways combine began earning healthy profits even before the closing of the merger. The initial results were diluted by huge extraordinary charges related to the merger and restructuring, but excluding such items each quarter saw progressively stronger profits.

While AAG reported a GAAP net loss of $1.8bn for 2013, on an ex-item basis it had a $1.9bn net profit (mainly AMR results; US Airways only included for 22 days). In 2014, the first year of fully consolidated results, AAG had a GAAP net profit of $2.9bn and an ex-item net profit $4.2bn. The latter accounted for 9.8% of revenues.

The table right summarises the 2014 operating results by region. While Latin America was pushed into losses by the adverse economic conditions there, the Pacific recovered from previous losses and posted a good profit. The Atlantic, where American operates under the antitrust immunised agreement with BA, was outstanding: a profit margin of 22%.

The latest quarterly results illustrate how American is now outperforming its network peers. In the three months ended March 31, AAG achieved a 15.5% operating margin, compared to Delta's 8.8% and UAL's 9.4%. A year earlier, AAG's operating margin was only 4.1% — behind Delta's 7.8% but better than UAL's negative 3.4% margin.

It must be noted, though, that the AAG-Delta margin differential in Q1 was entirely due to differences in employee profit sharing and fuel hedging. American has neither, while Delta reported $1.1bn of "settled hedge losses" and $136m in profit sharing payments for that period.

According to JP Morgan analysts, the absence of profit sharing "remains contractually sustainable until the decade's end" at American. In contrast, Delta has a generous profit sharing programme that paid out $1.1bn to employees for 2014 (16% of their pay). The other two of the top four US carriers, UAL and Southwest, also have profit sharing programmes.

As regards fuel hedges, AAG's mostly ex-US Airways top management shed all of AMR's fuel hedging positions soon after the merger, to bring the carrier in line with US Airways' no-hedging policy. AAG could reap $4bn of fuel cost savings in 2015, though those will be partly offset by higher non-fuel costs.

American is seeing greater non-fuel cost inflation than its peers in 2015 and 2016 because of the new joint labour contracts. The pilot and flight attendant deals that are already in place are expected to lift non-fuel CASM by 3-5% in 2015. But some of that will be offset by continued fleet renewal and aircraft upgauging.

Interestingly, American may not have a pilot cost disadvantage much longer. Delta's recently concluded pilot deal is believed to raise pay rates by around 8% to restore parity with American's.

This year American is seeing revenue pressures in both international and domestic markets. Internation-

2014 Regional Operating Results ($m)

	Revenues	Op Result	Margin
Domestic	23,060	3,158	13.7%
Atlantic	5,984	1,341	22.4%
Latin America	4,578	(485)	-10.6%
Pacific	1,709	251	14.7%
Total	35,331	4,265	12.1%

Source: Form 41/Airline Monitor

AAG's Mainline Fleet

	No. of aircraft at end	
	Mar 2015	Dec 2015E
A319	122	125
A320	57	55
A321	148	174
A330-200	15	15
A330-300	9	9
737-800	250	264
757	97	68
767-300	57	51
777-200	47	47
777-300	17	18
787-8	2	13
E190	20	20
MD-80	132	96
Total	973	955

ally, there are headwinds related to FX, fuel surcharges and Venezuela. As the dominant US carrier serving Latin America, American is also severely affected by the currency devaluations and economic problems in that region, including a significant weakening of demand and PRASM on the Brazil routes.

Domestically, there are the new competitive challenges from Southwest and Spirit, as well as tough year-on-year PRASM comparisons through mid-2015.

Since the full expiry of the Wright Amendment in October 2014, Southwest has been aggressively adding long-haul flights out of Dallas Love Field, its home base. Its daily departures from Love Field have increased from 118 last year to around 180 this August. The super-low introductory fares on a large number of new routes have created enormous pricing pressure for American at its nearby DFW hub, which accounts for more than 10% of AAG's revenues.

American has also blamed some of its PRASM weakness on increased competition from Spirit. It is not entirely clear why American feels the need to match Spirit's fares, because it cannot really be interested in the type of traffic that a ULCC attracts. In any case, that fare-matching has to be on a very limited scale, so the PRASM impact cannot be significant.

The good news is that US domestic demand remains healthy, the year-on-year PRASM comparisons will ease after Q2, another round of capacity growth reductions by the top three carriers is expected later this summer, and the worst of the Love Field effects should dissipate by 2016.

American has taken several actions in recent months to trim capacity growth plans. In April it reduced this year's planned ASM growth from 2-3% to 2% (the growth will be through increased stage length and upgauging). Subsequently, it delayed five 787 deliveries from 2016 to 2017-2018. American is known to be considering further growth rate reductions for the upcoming winter season.

In mid-June American deferred deliveries of 35 A320neos from 2017-2018 to 2021-2023 — a move that will improve flexibility to control capacity levels in those years. Like its peers, American appears interested in holding onto older aircraft longer now that fuel prices are at a lower level.

The fuel price windfall will mean American reporting an operating margin in the high-teens for 2015. The airline's own estimate as of May 11 was 17-19%.

Integration milestones

2015 is a critical year for American in terms of merger integration. Two key milestones have already been achieved: combining the two FFPs (late March) and obtaining a single operating certificate from the FAA (early April). Integration has so far gone smoothly and on schedule.

Next will be the historically most challenging step: the reservations system cutover. American has had the advantage of being able to learn from the other carriers' mistakes; also, many members of its current management completed a similar integration at US Airways-America West.

American's plan includes several refinements. First, the reservations switchover will be done over a 90-day period (and separately from the merging of FFPs), contrasting with United's decision to do everything

AAG's Mainline and Regional Aircraft Firm Order Book

	At end of March 2015	Delivery Schedule
A320 family	74	2015-2017
A320neo	100	*From* 2019†
A350 XWB	22	2017-2019
737 family	54	2015-2017
737 MAX	100	*From* 2017
777-300ER	3	2015-2016
787 family	40	2015-2018
CRJ900	29	2015-2016
ERJ175	58	2015-2017
Total	480	

Note: † originally 2017 deferred June 2015.

(FFP, reservations) on a single day. Second, US Airways will be moved to the much larger AMR's Sabre platform (contrasting with the strategy at United-Continental). Third, American is emphasising staff training, which it sees as a larger obstacle than the IT integration.

So American intends to begin combining the reservations systems in July and to complete the process in October, after which all bookings will be through American's website and the US Airways brand will cease to exist. There could still be problems but those would be on a more limited scale.

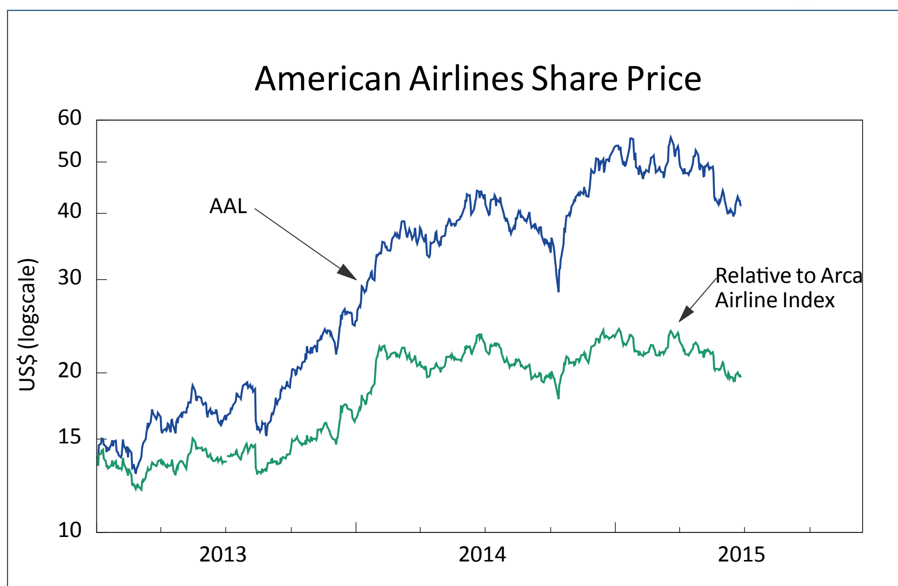
American was fortunate to secure the key labour deals early in the integration process. New five-year joint collective bargaining agreements with pilots and flight attendants became effective in January. This was possible because American's management recognised that, in light of the history of contentious labour relations at both AMR and US Airways, the only way to clinch joint contracts would be to build trust and restore pay rates.

The management made some special gestures. For example, they agreed to restore the $81m of pay rises that the flight attendants lost when they narrowly voted down an initial contract proposal in November and faced a less favourable deal imposed by arbitrators. That gesture may have paved the way for a good working relationship. The flight attendants now have the highest hourly rates among network peers.

The deal with the pilots (immediate 23% pay rise and 3% annually in 2015-2019) provided industry-leading base pay but left total compensation below Delta's. The pilots had sought profit sharing but the management had refused.

Some of the pilot contract issues (including work rules) still need to be addressed. The often tricky issue of seniority list integration will be settled by arbitration; there are hearings scheduled in June-October and the deadline is December 9. American also still needs to reach joint contracts with other groups representing 50,000-plus employees.

While full behind-the-scenes integration, including that of flight operating systems, will take another couple of years, having a single reservations system will unlock a lot of opportunities, especially on the revenue side. One example is full codesharing. American can also start investing in its product and systems — something that has been on hold since December 2013. For example, American would have liked to make changes to its FFP and further unbundle its product — enhancements that competitors have made — but none of that is feasible until systems integration is completed. So American will have many additional revenue tailwinds in 2016 and 2017, and the original $1bn annual synergy target seems likely to be exceeded.



Capital deployment plans

Being the latest carrier to complete Chapter 11 restructuring and a merger, American's spending priorities are different from Delta's and United's. At the company's annual shareholder meeting in early June, CEO Doug Parker confirmed the two most important priorities: buying new aircraft and paying down high-interest debt.

Despite the Chapter 11, AAG carries a relatively high debt load. Because of continued significant aircraft deliveries, its total debt has increased in the past 18 months. That contrasts with Delta's, and to a lesser extent UAL's, efforts to reduce debt in recent years.

Although American is not expected to start reducing its total debt soon, it is reducing debt that carries high interest rates. It has paid off some $3bn of such debt since December 2013, from cash reserves or through refinancings, taking advantage of low interest rates. American has also completed several EETCs to lock in low-cost, long-term financing for large numbers of new aircraft deliveries.

American is in the middle of a massive re-fleeting effort that will see deliveries of 60-75 mainline aircraft annually over the next several years. According to a late April filing, in 2015 AAG is taking 75 mainline aircraft — seven A319s, 35 A321s, 18 737-800s, two 777-300ERs and 13 787-8s — and retiring 103 aircraft (nine A320s, 38 757s, six 767-200s, seven 767-300s and 43 MD-80s).

Fitch Ratings noted in a late-2014 report that AAG's total capital spending would be about $5.5bn annually for the next several years, compared to UAL's $3bn and Delta's $2-3bn (all similarly sized airlines). But Fitch, like the rest of the financial community, accepts that AAG's re-fleeting efforts are necessary; after all, in March the fleet still included 132 MD-80s, which have an average age of over 22 years. The upgrade from MD-80s to 737NGs and A320s will also see CASM benefits through a higher seat count.

On the widebody front, American has firm orders for 42 787s (plus 58 purchase rights) and has just deployed the type internationally, initially to Beijing and Buenos Aires. The airline will be taking both 787-8s and 787-9s. It still has three firm orders for the 777-300ER, which will bring that fleet to 20 units by the end of 2016. Deliveries of the 22 A350 XWBs will begin in 2017.

But American's cash flow generation has been so strong that it was also able to start returning capital to shareholders just seven months after exiting Chapter 11. The company introduced a $1bn share buyback programme and brought back dividends in July 2014. The buybacks were completed a year ahead of schedule, so in January AAG put in place a new $2bn programme that it hopes to complete by the end of 2016.

By Heini Nuutinen

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