Aviation Strategy

Issue no. 209
September 2015

airberlin: four basic scenarios

REMARKABLY few airlines in Europe since the introduction of liberalisation have successfully transferred from the charter sector to mainstream scheduled operations. airberlin is one such that has tried — evolving into a strange hybrid. Normal independent airlines with airberlin's financials would be faced with bankruptcy. But airberlin, with its Etihad ownership, is a peculiar case.

airberlin started life as a Berlin-based charter carrier in the late seventies and launched into scheduled services following European liberalisation (for its early development see *Aviation Strategy* March 2004). It came to the markets through an IPO in 2006, describing itself as a low cost hybrid carrier; and then went on an acquisition spree.

In short order it acquired dba (Munich-based domestic carrier originally developed by British Airways as its foray into European deregulation), which provided it with a ready-made domestic network and a plethora of corporate accounts with which it thought would allow it to compete effectively against Lufthansa; Belair, a Swiss-based charter carrier; Vienna-based Niki; TuiFly's scheduled operations; and Düsseldorf-based LTU to provide access to long haul leisure scheduled and charter routes. It also tried to acquire former Lufthansa charter carrier Condor — but this fell by the wayside in the wake of rising fuel prices and cartel office opposition.

The strategy at the time was described as one to cement an effective benign duopoly in the German speaking countries alongside Lufthansa to provide a barrier against the insurgence of the growth of LCCs (primarily Ryanair and easyJet). Lufthansa would concentrate on operations through its hubs at Frankfurt and Munich; airberlin would be allowed to develop hub services through Berlin and Düsseldorf.

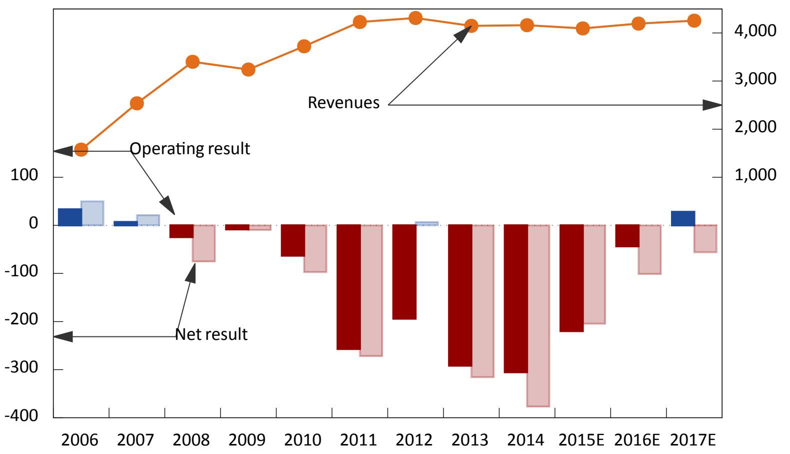
The LTU acquisition could not have been executed at a worse time. 2008 saw fuel prices rise to over $140/bbl and the financial crisis had a disastrous impact on air traffic demand as well as the local economy. Since then airberlin has been struggling to find a strategy. It last recorded a profit before tax in 2006; since then it has lost a total of €1.8bn.

This issue includes

Arabian rescue

In 2011 Etihad pumped in €73m and increased an existing small stake to 29% of the equity. Since then it has ef-

AIRBERLIN FINANCIAL RESULTS (€M)



Source: Company reports, Aviation Strategy analysis, HSBC forecasts.

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)

AIRBERLIN GROUP FLEET

	2010	2011	2012	2013	2014	6/2015
A319	19	11	8	8	9	9
A320	46	46	43	39	44	50
A321	11	14	16	16	17	22
A330	13	14	14	14	14	14
737-700	27	26	21	11	9	8
737-800	38	42	36	35	34	27
Q400	10	10	10	10	16	17
E190	5	7	7	7	6	
Saab						2
Total	**169**	**170**	**155**	**140**	**149**	**149**

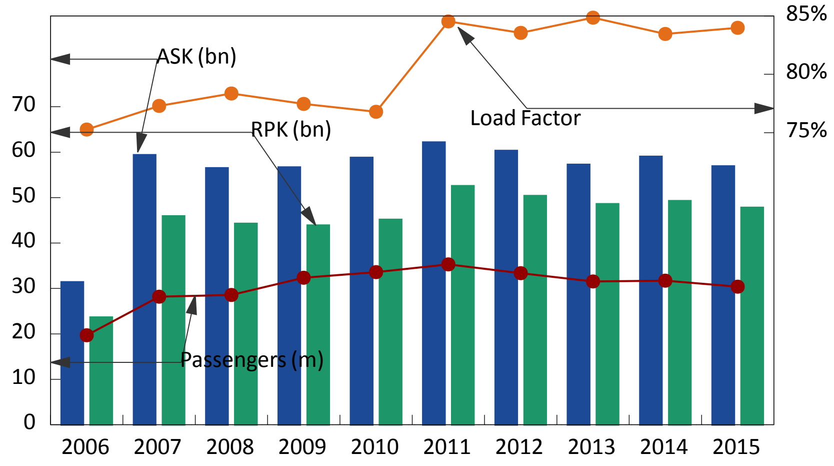
fectively been bankrolling the airline — with an additional €300m perpetual convertible, a €250m rolling debt facility and buying 70% of the frequent flier programme *topbonus* for €200m.

In September this year Etihad used its newly granted A-rating from Fitch to raise $500m on the international debt markets (since increased to $700m by popular demand) for Etihad Airways Partners IBV — the vehicle through which it (possibly) owns its stakes in airlines and other non-consolidated assets. (Fitch in its rating summary carefully avoided controversy by stating that the rating was entirely independent of the Sovereign rating of Abu Dhabi). Of the sum raised 20% each is earmarked for airberlin, Alitalia and Etihad Airport Services, 16% for Jet Airways and the remainder for Air Serbia and Air Seychelles.

Restructuring Plans

For airberlin this additional loan injection should allow it to cope with bond repayments due before the end of the year, but is unlikely to do anything to improve its dire financial position. Since the 2008 financial crisis

AIRBERLIN GROUP TRAFFIC



Source: Company reports. Note: 2015 extrapolated from first half results.

AIRBERLIN SHARE PRICE

the company has introduced a series of cost reduction and restructuring programmes — none of which have been particularly effective.

The number of passengers carried peaked in 2011 at 35.3m; the 2014 numbers were 10% below this at 31.7m. Over the same period it has pushed up the length of haul (in part by adding connections to Abu Dhabi) and ASKs and RPKs last year were respectively only 5% and 6% below the peak. Revenues likewise have stagnated at just above €4bn a year — on which since 2011 it has achieved an average negative operating margin of 6%.

At the end of December 2014 net assets on the balance sheet stood at a negative €(416)m. By June this year this had declined further to €(575)m. If we deduct intangibles (mainly airport slots) the net asset position would sit at just under €(1)bn. At the end of June net debt stood at €727m — which increases to €5.2bn when taking into account capitalisation of lease rentals. At the same time the gross cash position stood at 6% of annual revenues. Clearly this is not sustainable.

AIRBERLIN FINANCIAL POSITION

€m	June 2015	Dec 2014
Equity and reserves	619	523
Retained earnings	(1,508)	(1,248)
Equity due to Etihad	313	309
less Intangible assets	(409)	(409)
Net Assets	(985)	(824)
LT Debt	(700)	(730)
ST Debt	(286)	(333)
Cash	259	402
Capitalised Leases	(4,524)	(4,384)
Net Debt	(5,251)	(5,046)
Cash % revenues	6.3%	9.7%

Source: Company reports

At the beginning of 2015, the company appointed its fourth CEO in as many years — Stephan Pichler (formerly Lufthansa, Thomas Cook, Virgin Blue and Fiji Airlines) — who has introduced yet another restructuring programme. He stated: *"Our company strategy is clear: we are a European multi-hub airline with four major advantages over our competitors: we produce with lower unit costs than other network carriers, a lead we want to further extend by consistent revenue management; we have a strong touristic sales organization; we have an expandable position in strong catchment areas and we can count on our employees and their loyalty and excitement."*

The focus of the "new" programme appears to be in three phases:

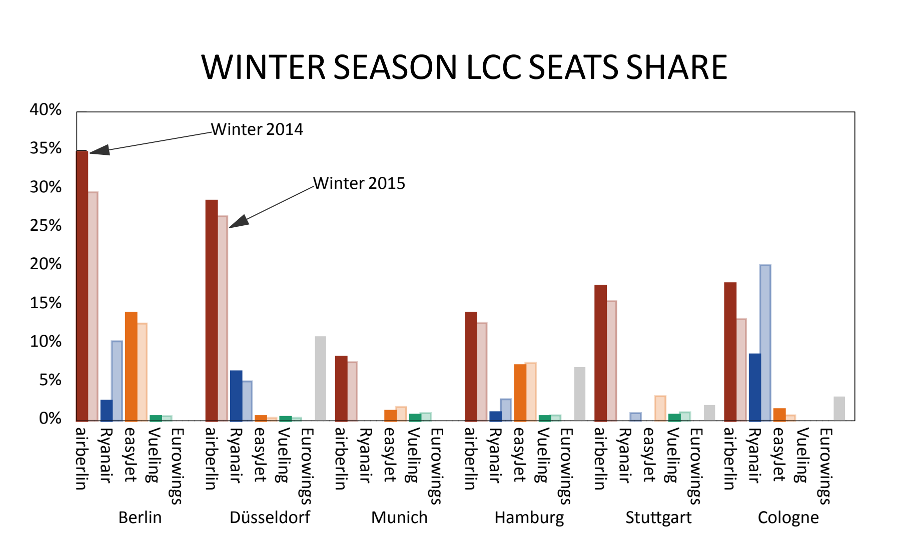
- ✈ **Management and leadership** (by Sept 2015). KPIs and incentives for senior management; realignment of the corporate structure; review of network strategy, scheduling and revenue management; staff engagement.
- ✈ **Market segmentation and capacity adjustments** (by March 2016). Cut winter capacity by 5%; new revenue management strategy to improve yields; withdrawal from non-strategic markets and build market shares in its hubs and on strategic target markets; focus on core business.
- ✈ **Profitability and growth** (from Apr 2016). Developing multi-hub strategy and new long haul routes; "platform growth" strategy, outsource non-core activities; improve

IT infrastructure as a basis for future growth.

Not entirely convincing. But Pichler appears to be aiming for profitability by the spring of 2016. *"We can't wait for 2017 to be profitable,"* he is quoted as saying. "*We need to follow a clear corporate strategy. We can't wait for the new airport to open in Berlin. We have multiple hubs now in Düsseldorf, Stuttgart and Vienna. They're in strong catchment areas. Within 120 minutes drive of Düsseldorf Airport there are 37 million people, unfortunately we are only getting 34% market share there. We need to grow that... We will focus on point to point... Some 65 percent of our revenue comes from touristic sales. We have long standing relationships with more than 100 tour operators. We need to establish a fair distribution of risk and opportunity.*"

Unfortunately for airberlin the market conditions in Germany are changing. Lufthansa has moved its point-to-point non-hub services to its (slightly lower cost) Germanwings putting pressure on airberlin in direct competition (but at the same time increasing the acceptance of low cost airline operations to the conservative German consumer); while its plans to build its new (even lower cost) Eurowings will squeeze it even more.

Other LCCs are also taking advantage. Ryanair has announced a significant increase in operations in Germany — with its new "friendly" face it is looking to build from the current 4.5% market share (less than half the share it has throughout Europe) and this month re-entered the German domestic market with 30 weekly frequencies on the Köln/Bonn-Berlin route. While O'Leary is quoted as saying that *"the legacy carriers' model in Europe is over"*, it is likely that Lufthansa will aggressively respond to protect its back garden. As Lufthansa CEO Carsten Spohr says *"Lufthansa won't be squeezed out of its home market"*. Although Lufthansa may not actually want airberlin to fail, if anything the "cosy duopoly" that it and airberlin may have enjoyed no longer exists.



Possible scenarios

✈ **Turnaround.**

It is conceivable that airberlin is successful in its plans to restore profitability. It seemingly has a long way to go, and restructuring its balance sheet will take a great deal of effort. Ignoring yield developments, a 20% reduction in non-fuel unit costs might allow it to break even at the operating level; a 30% reduction give it a net return (and perhaps make it competitive with the new Eurowings). A 50% reduction may give it a chance of competing with Ryanair. Given the competitive pressures developing it may be able to do very little on the revenue side.

✈ **Status quo.**

It could be that Etihad — seemingly without the pressures of public shareholders — may be willing to continue to support the finances of a loss-making operation to fulfil its ambition of catching up with its Gulf rivals in access to worldwide markets. Lufthansa may even be happy to retain a weak but supported competitor to help it against the Ryanair onslaught — in much the same way that it and SAS supported bmi for many years.

✈ **Porchi volanti.**

Etihad pushes its two larger European associate airlines — Alitalia and airberlin — into merger. Although the overlap is small, and the two are developing code share routes linking their respective networks, it is difficult to conceive of any convincing corporate strategy.

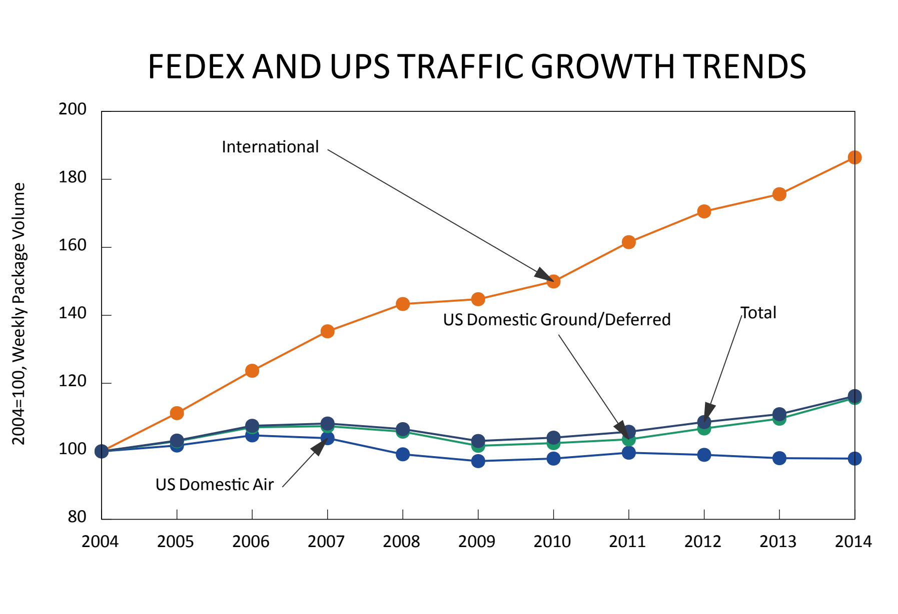
✈ **Exit.**

Having put so much money and effort into its minority investment in an airline over which it can have no official control, Etihad may find it difficult to stomach, but could walk away.

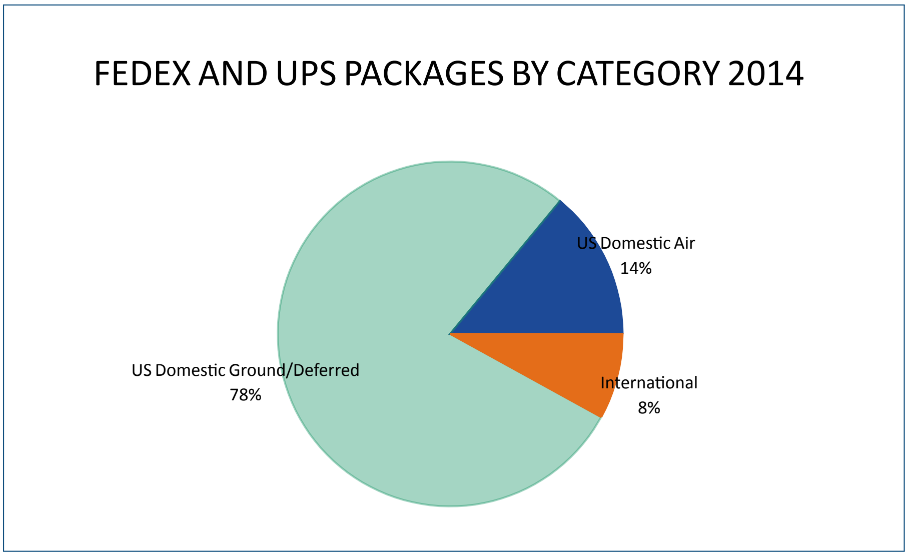
airberlin may be in ill health, and in a position redolent of many smaller legacy flag carriers. However, it is still a favoured airline for sun-seeking German tourists to head for holidays in Spain and the Balearics, no matter how much Etihad pays them to get there.

Integrators: Response to IoT surprises

THE INTEGRATORS — FedEx, UPS and DHL — account for about 50% of the global cargo fleet, but their *air* traffic growth has been slow or non-existent in recent years and they currently have no plans to expand the size of their fleets although they will still need to acquire aircraft for replacement (for example, FedEx recently ordered 50+50 767Fs but its overall fleet plan for the next eight years shows a slight decline in aircraft capacity). Volume growth has predominantly come from the ground segment of their businesses. Yet 10 years ago the integrators were confident about 10%-plus pa traffic growth, and FedEx and UPS both placed major orders (subsequently cancelled) for the freighter version of the A380.



Internet communication and, specifically, video-conferencing was supposed to pose a serious threat to Business travel; in the event there has been little discernible impact on passenger demand, or at least the effect has been dwarfed by cyclical factors. By contrast, 10-15 years ago the integrators were hugely optimistic about IT developments; FedEx at one point branded itself the "Official airline of the Internet". It was more than plausible — transactions would be increasingly be conducted online and, for example, Amazon, the new electronic bookstore might carve out a small niche for itself in the publishing market, while FedEx was perfectly positioned to provide rapid physical transport for goods ordered through websites.



A number of IT trends have impacted the Integrators' air business, developments which now seem obvious but were not evident ten years ago.

- ✈ Delivery method: CDs were once dispatched, now music is universally downloaded; books shipped from publishers have to a large extent been replaced by downloads to Kindles
- ✈ Miniaturisation: One old Desk Top Computer equals 200+ Tablets, 500+ I-phones
- ✈ Documents — legal, governmental, business — are now universally transported by email, worries about "electronic signatures" long forgotten

✈ Software updates and replacements are now always provided by downloads not by physical discs in polystyrene-insulated boxes

There have also been structural changes:

✈ Falling production costs for IT products and for industrial components have increasigly tended to shift the mode from of transport for these goods from air to surface.

✈ Just in Time (JiT) inventory control became a largely defunct concept with improvement in IT and process control.

✈ The **Internet of Things (IoT)** has replaced JiT as the dominant strategy. It is admittedly difficult to pin down exactly what this means in its totality, but it applies, in the transport sector, to the integration of communications, control, and information processing across various production systems, primarily through computers communicating among themselves. In practice, an algorithm is designed to monitor inventory levels, demand patterns, alternative supply sources, and then predict where a product should be located in order to get it to the purchaser in the minimum time. The decision to move a product from a warehouse to a distribution centre is made before the purchasing decision is made. Amazon call this "anticipatory shipping".

The strategies being implemented by Internet giants — Amazon and Google — to control distribution networks themselves further undermine the airfreight business. Amazon is decentralising its warehouse network away from its Seattle base, building new facilities in, initially, San Francisco, New York, Boston and Chicago and ultimately targeting the top 50 urban markets. Wall-Mart is doing something similar. The additional cost of the new facilities will, Amazon expects, be outweighed by savings generated by cutting FedEx and UPS out of the distribution chain and using its own, franchised local delivery companies under the Amazon brand. Fulfilment costs, which are mostly transport-related, have now risen to 15% of Amazon's revenues, up from 11% in 2009. Amazon's ultimate aim for Amazon is to guarantee one day, or even one hour, delivery to customers — as close to physical shopping as possible. Google is moving inexorably into this market with a slightly different concept — here the customer orders online and a local courier company, branded Google Express, picks up the good from the shop and delivers it to the customer's home.

Both the internet giant companies, plus the other established and emergent internet distributors are, in effect applying IoT strategies which tend to circumvent the air express operations of the Integrators.

Maritime perspective

Rapid delivery no longer necessarily means air delivery. IT developments have enabled rapid delivery using lower cost maritime, alternatives.

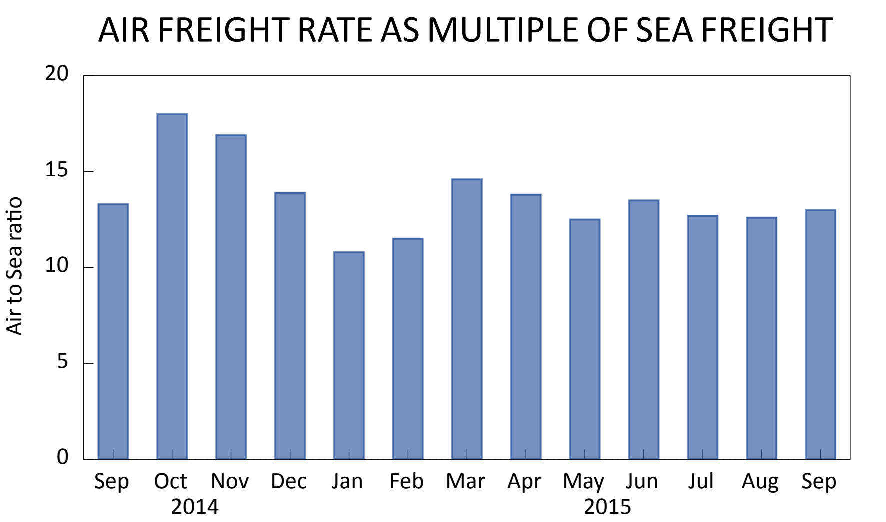
Total containers shipped have grown significantly more strongly than air cargo in recent years: by 7.2% in 2011, 2.9% in 2012, 4.9% in 2013, 6.1% in 2014, with projected growth for 2015 of 6.7%, according to Clarksons, a leading shipbroker.

From a maritime perspective the key characteristics of this industry are:

✈ JiT, whereby air transport appeared to be required to transport urgently needed components, has been supplanted by much more efficient supply chain management and peak demand planning, meaning that even time-sensitive goods can be cost-effectively delivered by containership.

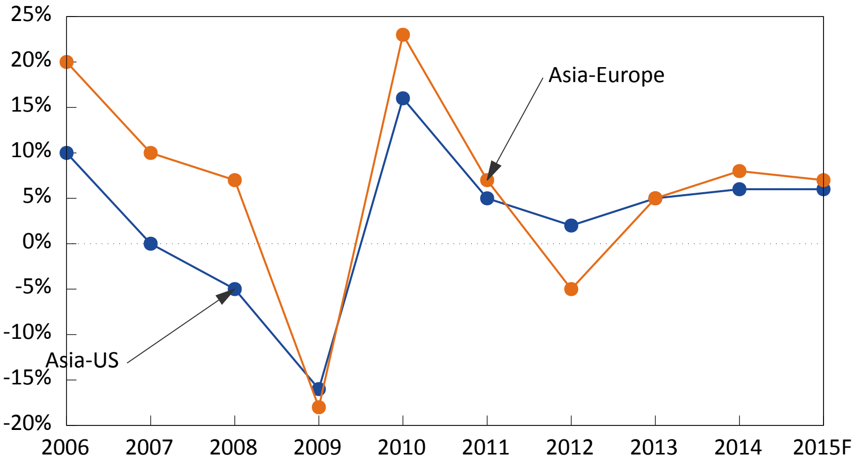
✈ Containerships operating on a regular circular schedule can be regarded as floating warehouses delivering a continuous stream of goods.

✈ Even launches of new high-tech products, IPads for example, are not primarily transported by air from their manufacturing base in China or



Source: HP Drewry. East-West Container Index compared to East-West Airfreight index both expressed in $ per kilo carried

MARITIME CONTAINER TRAFFIC: GROWTH RATES



Source: Clarksons

Korea but are shipped and trucked to distribution centres near to the main demand areas prior to launch.

✈ With containers usually being transferred rapidly, using advanced crane technology from ship to ground (truck or railway) at ports, the freight rate in effect includes a warehousing element during the voyage, whereas airfreight is logistically more complicated and expensive with actual warehousing needed at airports at both ends of the flight.

✈ When comparing air and freight modes, the important factor may not be whether an aircraft can deliver goods within 24 hours against a ten day voyage for a containership but the "conveyor belt" concept — maritime transport can often deliver the same goods every 24 hours.

✈ Maritime container rates have exhibited volatility: peaks resulted from the late 1990s global upturn and the China import boom; troughs were caused by the collapse of dotcom in the early 2000s and the global recession in 2009. However, the global average freight rate per container is more or less the same today as it was 20 years ago.

✈ More importantly, the difference between air and maritime freight rates is very wide. According to a regular survey by HP Drewry, shipping consultant, the ratio of air freight per kilo to maritime containerised freight per kilo is currently about 13:1 on the key Europe-Asia route.

Aeroflot and Transaero merge amid turmoil in Russia

A DEPRESSED Russian economy exacerbated by sanctions over Russia's meddling in the Ukraine has resulted in troubled times for the Russian aviation market — and has given the government a rationale/excuse to merge Aeroflot and Transaero. But are Russia's two largest airlines a good fit?

There's little doubt that the Russian economy is in deep trouble — according to the IMF, the economy is expected to contract by a substantial 3.4% in 2015 — and that's not all due to macro-economic factors such as the falling price of oil (with Russia the world's second largest oil exporter, selling 3m barrels a day).

It was inevitable that Russia's interference in the Ukraine/Crimea would attract reaction, and the EU, US, Japan and others started imposing sanctions against Russian individuals and entities in 2014. The US and EU sanctions targeted financial services and the energy sectors, among others, and the result has been immense pressure on the Russian economy. The IMF observes: "It is very difficult to disentangle the impact of sanctions from the fall in oil prices, but our estimates suggest that sanctions might have initially reduced real GDP by 1 to 1½ percent; prolonged sanctions may compound already declining productivity growth."

The Rouble has been in freefall for the last 18 months: a US Dollar bought 33 Roubles at the start of 2014, but 68 Roubles in September 2015. The Russian government has raised interest rates in order to stem the fall in the Rouble, but this has just accelerated economic downturn.

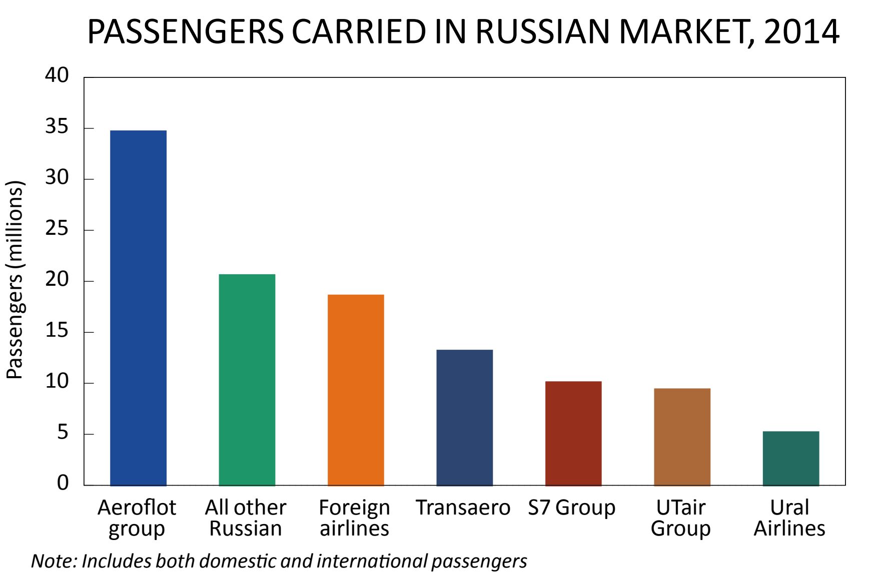
The result is a perfect storm of trouble for Russia's airlines, and one that the two leading carriers — Aeroflot and Transaero — have not been able to avoid. A government-mandated merger between the two was announced in early September, with Aeroflot stating: "Following a comprehensive discussion, and taking into account the social tensions surrounding the passenger air transport market and the extremely difficult financial position of Transaero... the board decided that it was necessary to involve Aeroflot Group in the restructuring of Transaero."

The majority acquisition of Transaero by Aeroflot is due to be completed by the end of September, after which "operational management" of Transaero will be transferred to Aeroflot.

Market position: Aeroflot

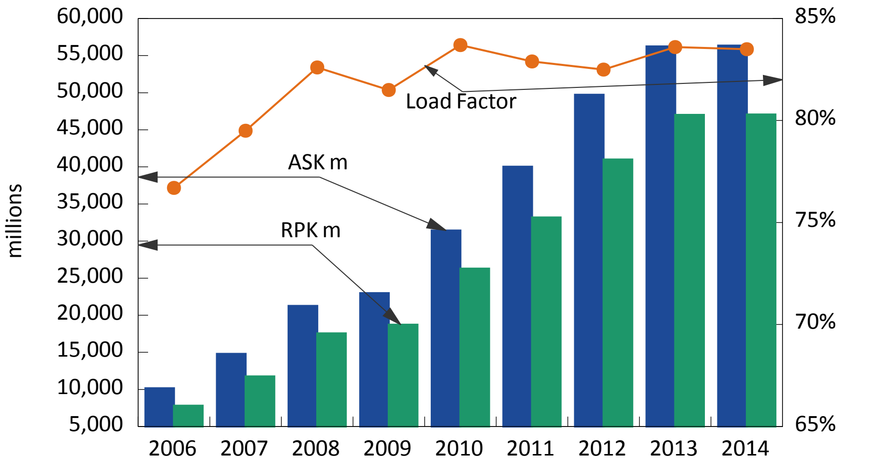
Still burdened by majority state ownership (state agency Rosimushchestvo owns 51.17%) and with major strategic decisions such as merging with other Russian airlines taken out of its hands (see *Aviation Strategy*, August 2013), Aeroflot has been struggling to transform itself into a modern, profitable airline for many years.

Altogether, the Aeroflot group operates to 140 destinations in more than 50 countries, and in 2014 it carried 34.7m passengers, of which 23.6m were flown by the mainline Aeroflot. That gave the group a 38.1% share of the domestic market and a 26.1% share of the international market to-from Russia last year. That compares well with the respective market shares of 20.6% domestically and 18.9% internationally it had back in 2009, though while the domestic



Note: Includes both domestic and international passengers

TRANSAERO TRAFFIC STATISTICS



share has been rising constantly over the last few years (thanks to government-mandated domestic consolidation and a significant decline in long-haul domestic rail passengers, as train fares have risen, from 119.6m passengers in 2009 to 102.8m in 2014), the international share is down from a peak of 28.5% in 2012.

Internationally, Europe is by far the most important market for the group, accounting for 26.8% of all scheduled revenue in 2014, followed by Asia, with a 14% share. Unsurprisingly the group's routes to the CIS saw passengers carried fall by 15.2% last year, thanks to the turmoil in Ukraine, and its share of total group scheduled revenue fell from 8.2% in 2013 in 6.3% in 2014.

Overall, in 2014 the Aeroflot group had a 31% share of the total Russian market (domestic and international combined), and had a significant lead over its closest competitor, Transaero.

Market position: Transaero

Also based in Moscow, Transaero Airlines became the first privately-owned carrier in Russia after the demise of the Soviet Union when it was launched in 1991 by Alexander Pleshakov and Grigory Gurtovoy. Pleshakov is still chairman of the airline today, and — until the takeover by Aeroflot is completed — he and his wife were the main shareholders, between them owning 36.6% of the equity.

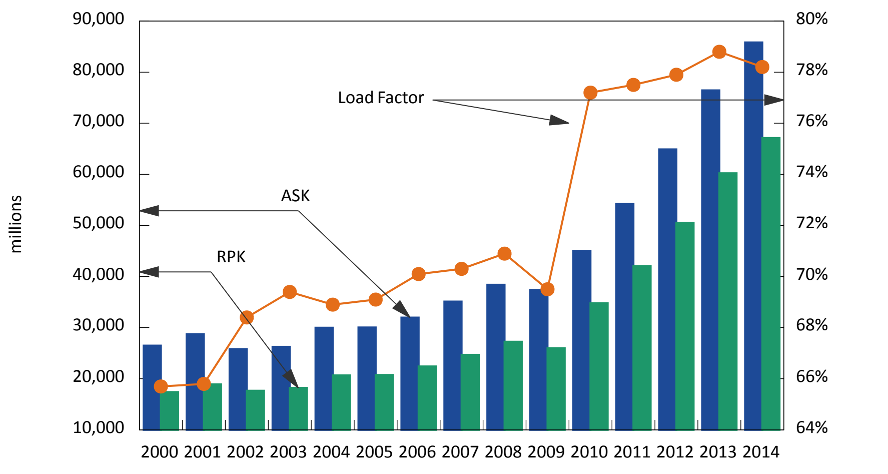
From 2006 to 2013 Transaero grew more than fivefold, and was firmly established as the main challenger to Aeroflot — in 2014 it had a 11.8% market share in terms of passengers carried in the Russian domestic and international market combined. The problem for Transaero is that this share was significantly behind Aeroflot and didn't give it enough scale to become financially sound — or to challenge the political status quo.

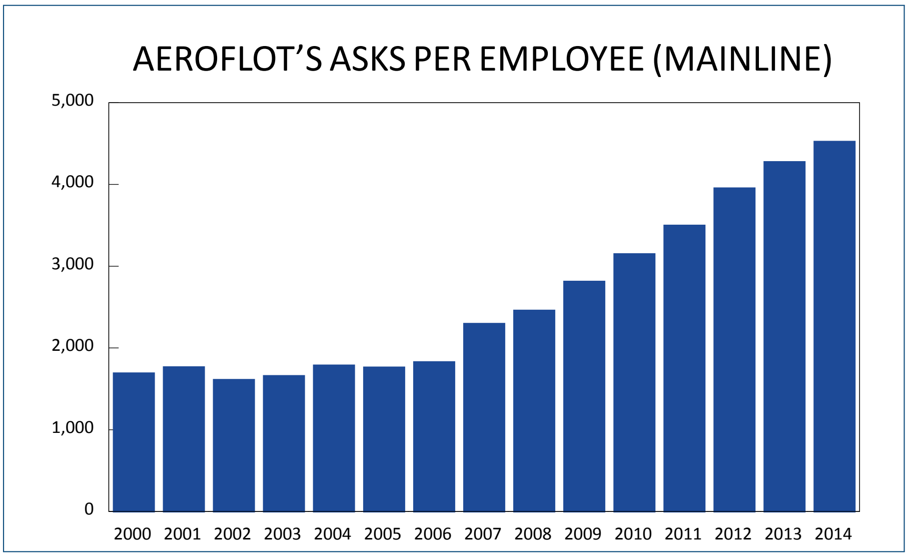
Last year Transaero's ASKs crept up by just 0.2% — while Aeroflot's rose by 12.3%. Transaero argued that this was a more sensible strategy in a tough Russian market (for example its passenger load factor was 83.5% last year, compared with 78.2% at Aeroflot) — but this still hasn't translated into profitability.

Financial woes: Aeroflot

In 2014, under IFRS standards, Aeroflot saw revenue rise 9.9% to RUB319.8bn (US$8.3bn), but EBITDA fell a hefty 22.0% to RUB24.8bn and a net profit of RUB7.3bn in 2013 turned unto a net loss of RUB17.1bn ($444m) in 2014. Despite increased traffic and revenue, at a net level there was a significant loss thanks to the slide of the Rouble as well as a raft of one-off items, ranging from bad debt, early return of leased aircraft and provision for unexpected repairs and maintenance. And the group's

AEROFLOT MAINLINE TRAFFIC STATISTICS





cost per ASK increased by 7.1% year-on-year to RUB2.66 (US¢6.9) in 2014 thanks largely to the negative effects from the Rouble's weakening and some one-off costs.

While yield rose on Aeroflot's international routes in 2014 — up from 3.05 RUBper RPK in 2013 to RUB3.07 in 2014 — on domestic routes it fell, from 3.07 year-on-year to 2.98 RUBin 2014 — the latter due to "aggressive pricing strategies of domestic competitors", according to Aeroflot.

In the first-half of 2015, under IFRS, Aeroflot saw revenue rise 25.8% year-on-year to RUB176.5bn ($3.1bn), but while an operating loss of RUB1.4bn in the first six months of 2014 turned into an operating profit of RUB5.9bn in H1 2015, a RUB1.9bn net loss in H1 2014 almost doubled, becoming a RUB3.5bn ($61m) net loss in January-June 2015.

At the end of 2014 the mainline Aeroflot employed just under 19,000 (which rose 6.1% compared with 2013), with 12,578 employed elsewhere in the group (up 7.0% year-on-year), to give a total of 32,439 employees at the group — and as the charts on this page show, its productivity in terms of ASKs per employee lags behind Transaero.

What is particularly worrying about the Aeroflot group is its debt position — net debt more than doubled in just 12 months, from RUB67.7bn as at the end of 2013 to RUB146.8bn ($3.8bn) at end 2014. The group says this is "due to revaluation of finance lease obligations", but it's clear that this level of debt is unsustainable, and has to be brought down significantly.

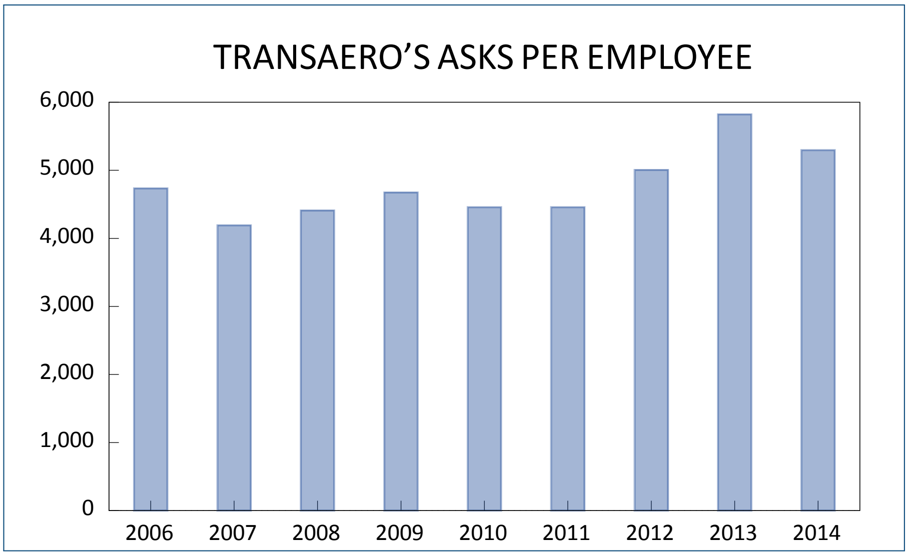
Financial woes: Transaero

In 2014 Transaero carried 13.2m passengers, 5.6% up year-on-year, with 9.3m of them carried on international routes. Under Russian Accounting Standards (RAS) it reported revenues of RUB117.3bn ($3bn) up by 6.9% over the previous year; an operating loss of RUB0.3bn and a net loss of RUB19.3bn ($0.5bn). At the same time it restated the prior year figures with little explanation. What had originally been reported as an operating profit of RUB5.6bn and a net profit of RUB1bn for 2013 now were shown as an operating loss of RUB12.4bn and a net loss of RUB16.4bn for that year. The accounts were also qualified.

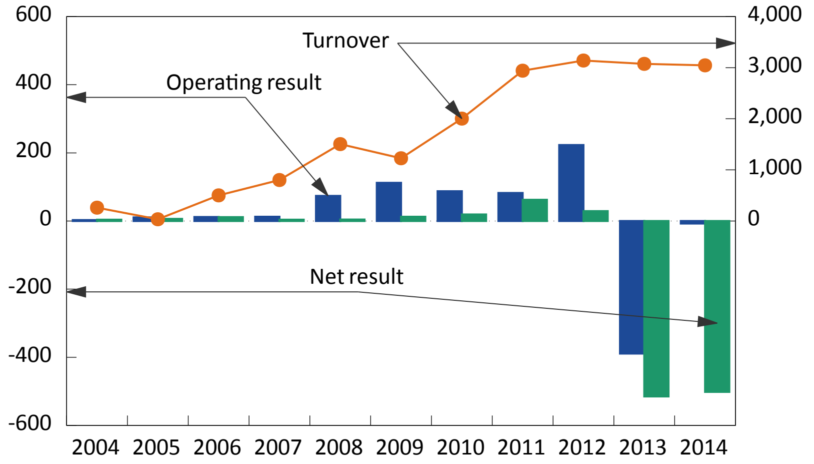
That financial performance worsened in the first half of 2015, Even though Transaero carried 5.8m passengers — 0.4% up on the first half of 2014 — with a load factor of 82.5% (the same as in H1 2014) and revenue (again under RAS) rising 3% to RUB50.4bn ($873m), the airline posted an operating loss of RUB12.9bn, compared with a restated loss of RUB5.1bn in the same six month period of 2014.

Most worryingly, Transaero's short-term debt stood at RUB45.8bn ($794m) at the end of June 2015 (a rise of 26% in just six months), with total debt totalling RUB67.5bn at the same date (up 3% in six months).

At the end of 2014, the Russian



TRANSAERO FINANCIAL RESULTS ($M)



government agreed to underwrite a three year loan from VTB bank (which is 61% government-owned) of up to RUB9bn (US$234m) — enabling Transaero to repay a RUB2.5bn bond in March — but the poor results for the first-half of 2015 forced an urgent need to further restructure the airline's burgeoning debt. The airline's creditors — led by Sberbank — agreed a short-term covenant holiday until the start of October so that new financing could be agreed, and (prior to the Aeroflot deal) the airline was reportedly negotiating with a consortium of Russian banks for seven-year syndicated loan of up to Rub 29.5bn, potentially with further state guarantees.

Aeroflot goes multi-brand

Against those results and financial pressures, the two airlines have been pursuing their different strategies. Aeroflot group's latest plan — for 2016-2020 — includes two main themes: cost control/efficiency gains (particularly in fuel and maintenance costs, plus continued improvement in labour productivity); and development of a multiple brand approach to the market.

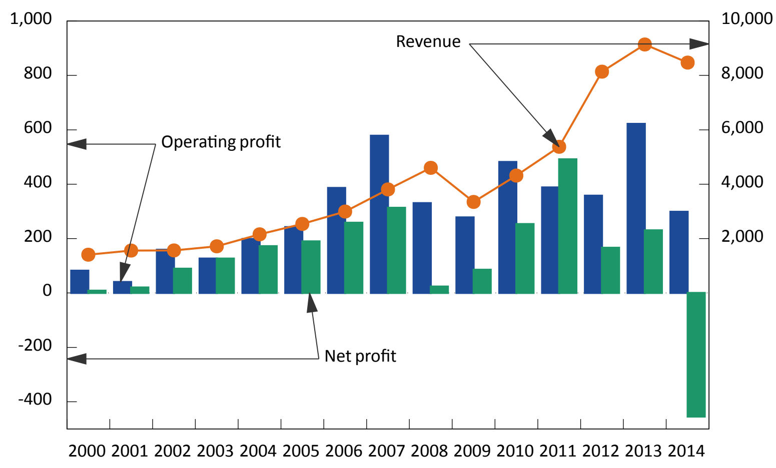
The latter is designed to enable the Aeroflot group to win passengers "in every market segment, from premium to low-budget", and most pertinently this means further development of its latest attempt at a LCC.

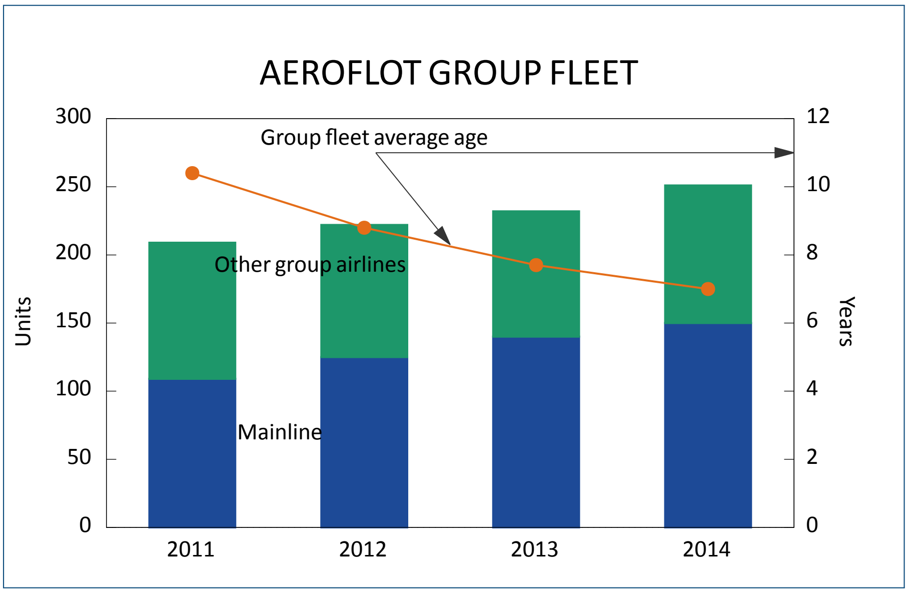
The engine of the group remains the flag carrier, Sheremetyevo-based Aeroflot, which accounted for 68% of total passengers carried at the group last year. The unglamorous workhorses of the group are the regional airlines, which provide feed into Aeroflot's international routes — Pulkova (Saint Petersburg)-based Rossiya (5.2m passengers; 14.9% of the group total); Rostov-based Donavia (1.7m; 5.0%); and Vladivostok-based Aurora (1.1m; 3.0%). The group also operates a charter carrier Orenair, based in Orenburg (3.0m passengers in 2014, representing 8.7% of the group total), but whose "strategic positioning is currently under review" according to the group.

The group portfolio is completed by LCC Pobeda (0.1m; 0.3%). A previous attempt at an LCC — Dobrolet — was launched in June 2014 but suspended after just 55 days of operation, in August, after the airline was placed on a list of sanctioned companies by the EU; its initial route was to Simferopol, which the EU said made it complicit in Russia's attempt to annex the Crimea region. So in September last year the Aeroflot group launched another LCC, called Pobeda (which means 'victory' in Russian), with flights starting in December.

Pobeda currently operates 12 leased 737-800s (transferred over from the group) out of Vnukovo airport In Moscow on 15 domestic routes, utilising a standard LCC busi-

AEROFLOT GROUP FINANCIAL RESULTS ($M)





ness model with paid-for food and drink, fees for carry-on luggage (generating 10-15% of total revenues) and the majority of sales coming from direct or online channels. Fares are around 20-40% lower than typical fares on services operated by competitors on those same routes, Aeroflot claims, but by operating out of Vnukovo, the group says that this "reduces cannibalisation risks".

In July the group said it would transfer up to further 13 737-800s to Pobeda on "long-term lease" after the summer season was over, as part of its plan to operate 40 aircraft by 2018, when it is targeting around 10m passengers on up to 50 routes, both domestically and internationally .

A diversified portfolio is seen as a necessity strategically for Aeroflot in a challenged Russian economy, and it will be interesting to see what kind of market penetration Pobeda wins; if successful it will no doubt encourage other LCCs in the Russian market — subject to government permission.

The group is also pushing the concept of Moscow as an alternative transit point (to the Gulf super-connectors based in the Middle East) on passenger flows between Asia and Europe/North America. It says flights between Asia and Europe connecting at Moscow are always shorter than via connecting at Dubai; for example it claims a Paris-Tokyo route is three hours shorter, or that Milan-Beijing is 2.5 hours shorter when connecting via Moscow. Whether passengers will prefer to change aircraft at Moscow rather than Dubai is dubious, but Aeroflot says that its policy of increasing frequencies on key international routes is resulting in a steady increase in transit passengers at Sheremetyevo; international to international transit passengers accounted for 11.8% of Aeroflot's total passengers at the Moscow airport in 2014, compared with 10.6% in 2012.

The total Aeroflot group fleet now stands at 251 aircraft, an increase of 42 over the last three years as the airline has modernised and expanded its fleet in an attempt to build, as Aeroflot calls it, "a "young western-built fleet easily transferable from one route to another".

The average age has come down from 10.4 years to 7.0 years over the same period (see chart above), and the mainline Aeroflot fleet of 150 aircraft has an ever lower average age, of 4.1 years. But there still remains much to do in terms of fleet overhaul, in particularly at the other group airlines, where — for example — there are still nine DHCs and six An 148s in operation.

The group has reportedly put up for sale 21 A321s and a single A320, and in terms of its order book, Aeroflot did have 22 787s on order (placed back in September 2007), with initial deliveries slated for 2018, but the entire deal was cancelled in the summer, and there is much speculation that other outstanding orders will also be cancelled.

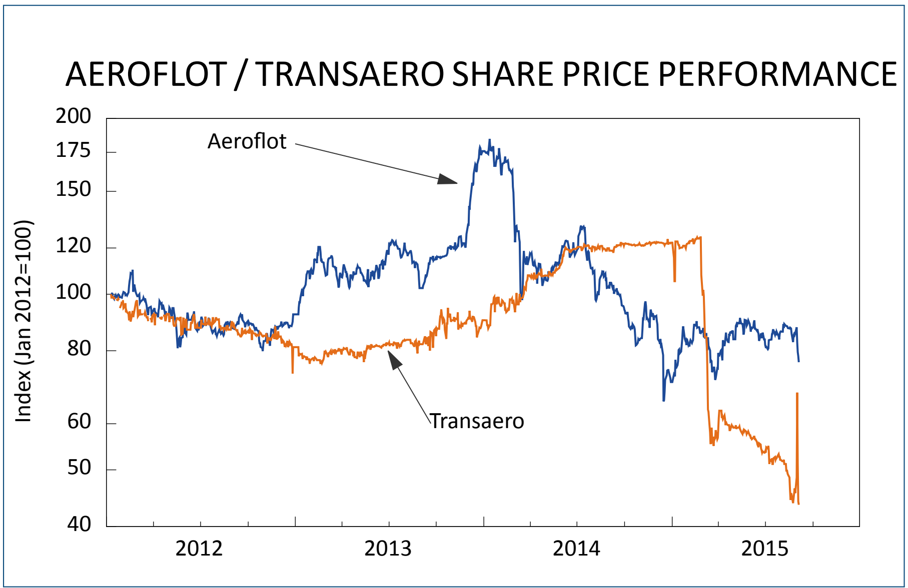
Currently Aeroflot has three 777s, 22 787s, 14 A350-900s and eight A350-800s on order. The latter are due for delivery from 2018, but though has been speculation that this may be scrapped, Aeroflot says that there are discussion with Airbus on the "mix" of the order only.

Transaero fleet adjusting

Prior to the Aeroflot takeover — and on the assumption that a successful refinancing was possible — Transaero Airlines was planning to intensify its pre-existing major cost cutting and efficiency programme, which was only initiated in November 2014.

The major focus had been on resizing/adjusting the fleet. Transaero currently operates 106 aircraft, of which 52 are widebodies, making it the largest operator of widebody aircraft fleet in Russia and eastern Europe — though many of those widebodies are placed onto medium-haul routes that just don't justify those kinds of capacities.

This year two A321s and a 737-800 have joined the fleet, and through the rest of 2015 two further leased A321s will join. Though these will be direct replacements for widebodies, a post-integrated Transaero



is likely to shed widebodies much faster.

Currently four A380s, 12 A320neos, four 747-8s and six Sukhoi Superjet 100s are on firm order direct from manufacturers. The first two A380s were due to be delivered this year, but thes have now been rescheduled — though there is no public confirmation as to when they will now arrive.

Even prior to the merger with Aeroflot it was highly likely that, given Transaero's finances and its excess widebody capacity, the A380s and 747-8s would be cancelled at some point. The direction of travel in terms of orders is clear — last year Transaero cancelled an order for 787s, and it has yet to firm up an MoU for 20 A330s placed at Farnborough in 2014.

Elsewhere, one of its subsidiaries — Shannon-based maintenance provider Transaero Engineering Ireland — entered bankruptcy protection in January this year as a result of its parent's financial problems. Formerly operating as Air Atlanta Aero Engineering, the Boeing maintenance specialist company was bought by Transaero in 2012 and employed around 230.

Given the imperative to cut costs, planned route expansion was limited at Transaero. In its summer 2015 schedule Transaero operated more than 200 routes domestically and to Europe, Asia, the Americas and Africa, with 65 of those operated out of Moscow Vnukovo, around 50 from Moscow Domodedovo airport and 23 from St Petersburg. Altogether there were 60 domestic routes, and while they provided feed into international routes they won relatively little revenue; domestic routes accounted for 18% of Transaero's revenue in 2014, compared with 82% for international services. On the international sector, this summer new routes were launched from Moscow to Malta and Prague, and from St Petersburg to Shanghai.

So far Transaero has not gone down the LCC route. It did launch a "low cost service" called Discount class in January 2014, but while the product is offered on selected domestic and international routes (with 1.8m passengers booking the class through 2014), it can't be described as a LCC operation.

In May Transaero also rebranded itself with a new logo, livery and colour scheme, but it's unlikely that this, combined with a refinancing underwritten by the Russian government and renewed cost-cutting, would have be enough to save Transaero. Olga Pleshakova, the CEO of Transaero had urged the Russian government to offer more support to its airlines in general, such as by reducing VAT on domestic flights — which she said would save the airline RUB2bn ($37m) a year — but regardless the prospects for Transaero's continued survival as a standalone airline had declined markedly as 2015 progressed.

Time for downsizing

Once Aeroflot and Transaero are merged, there will rationalisation of routes, fleet, outstanding orders and staff — the only question is just how much of that will occur, and how fast.

Inevitably Transaero — and most likely its domestic network — will bear the brunt of any adjustments. Aeroflot group's goals of carrying 70m passengers a year and becoming a top five European and top 20 global airline by revenue and passengers carried by 2025 still remain, but Russia's economic decline means that this year (and maybe the two or three years) is a time for consolidation and cost-cutting, not expansion.

Aeroflot's plans for Transaero will become clearer in the next few months, and while it's probable that Transaero name will remain for the short-term as part of Aeroflot's multi-brand strategy, the brand will eventually disappear.

Mexico's LCCs: Domestic discipline and US expansion

AFTER a challenging first-half 2014 characterised by overcapacity and price wars, the past 12 months have seen an improvement in airline industry conditions in Mexico. Capacity discipline has taken hold in the domestic market, leading to a stronger revenue environment.

Much of the improvement was a result of a decision by Volaris — the main instigator of the earlier fare wars — to drastically slow growth in the domestic market. Volaris had seen three consecutive quarters of operating and net losses, but after opting to focus on yield domestically and channelling growth efforts to international markets, it quickly returned to healthy profitability.

Mexico's LCCs have also benefited from a relatively robust economy, by Latin America's current standards at least. Mexico's GDP growth, which had dipped to 1.4% in 2013 after 4%-level growth in 2011 and 2012, recovered to 2.1% in 2014 and is projected to be 2.5% in 2015 and 3% in 2016. In contrast, Brazil is in a recession and IMF expects the Latin America region as a whole to record only 0.5% GDP growth in 2015.

Mexico was unfortunate in that oil prices fell sharply just as the government abolished the state-owned oil company's production monopoly and hoped to attract foreign investors into the sector. But, importantly, consumer demand has not weakened.

Because of the strength of travel demand and the stimulation provided by the LCCs' low fares, Mexico's domestic market has continued to grow at a healthy pace. Passenger numbers rose by 13% in the first seven months of 2015. By comparison, 2014, 2013 and 2012 saw 7%, 8.5% and 10.3% growth, respectively, but before that there was stagnation in 2010-2011 and an 11.6% contraction in 2009.

The six years up to and including 2011 were tumultuous on the Mexican aviation scene. First, the emergence of three vibrant LCCs (Interjet in December 2005, Volaris in March 2006 and VivaAerobus in November 2006) led to overcapacity in the domestic market. Much of that excess capacity was removed when Mexicana, formerly the country's second-largest carrier, filed for bankruptcy and ceased operations in August 2010. The late 2000s also saw seven other smaller airlines fail.

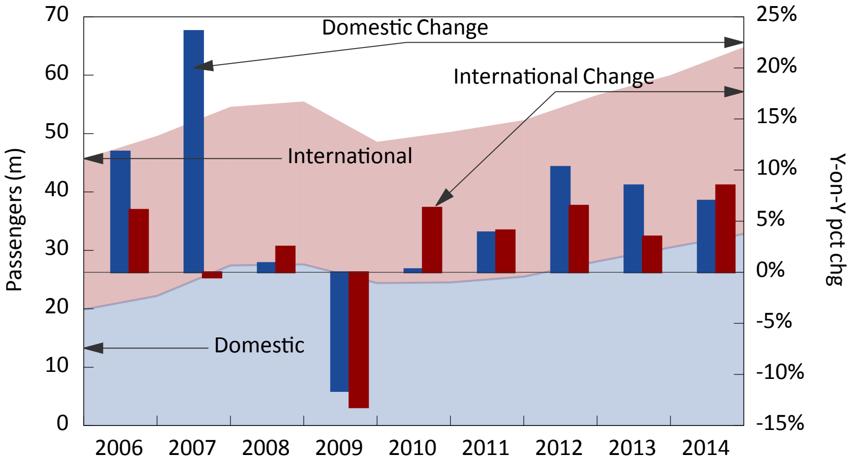
Mexicana's demise gave the new-entrant LCCs unique growth opportunities. By 2012 the three top LCCs had captured a 57% share of Mexico's domestic passengers and a third of Mexican carriers' international passengers. The latest DGAC statistics show that those shares were 63% and 41% in July 2015.

While Aeromexico and its regional unit Aeromexico Connect also initially captured significant chunks of Mexicana's domestic market share, since 2012 Grupo Aeromexico has ceded all of those gains to the LCCs. Its domestic passenger share (31.1% in July) is now back to the level it was in 2009.

Since the top three LCCs have focused on international expansion this year, their combined international share has surged by 5.8 percentage points in the past year (July over July) — all captured from Aeromexico.

While Volaris has been the clear winner in the market share battles in

MEXICO'S AIR TRAVEL MARKETS



*Note: * Mexican and non-Mexican carriers*
Source: SCT/DGAC

MEXICAN AIRLINES MARKET SHARES (%)

	Domestic			International		
	July 2015	2012	2009	July 2015	2012	2009
Aeromexico Group	31.1	37.7	32.3	59.1	67.0	31.1
Volaris	26.3	20.5	12.8	25.5	21.9	2.9
Interjet	23.8	23.9	12.7	13.0	9.0	
VivaAerobus	12.9	12.5	5.8	2.3	2.2	0.4
Mexicana			27.2			65.4
Others	5.9	5.3	9.2	0.1		0.2
Total	100%	100%	100%	100%	100%	100%
Top 3 LCCs	*63.0*	*56.9*	*31.4*	*40.8*	*33.1*	*3.3*

Source: SCT/DGAC

recent years, Interjet has caught up somewhat in the past 12 months as it has accelerated international growth.

VivaAerobus has been the least successful of the three, both financially and in the marketplace. The carrier has managed to build only 13% and 2.3% domestic and international market shares, respectively. In the past 12 months it has actually lost 0.3 points in domestic market share. And the international share is set to fall back below 1% now that VivaAerobus is suspending the US routes it added last winter.

Analysts blame VivaAerobus' troubles mainly on its old fleet (average age 17.5 years), which has led to quality issues, delays and customer complaints. After nine years, VivaAerobus still only operates 18 aircraft.

However, VivaAerobus expects to complete a transition from 737-300s to an all-new A320 fleet by early 2016. That and some strategy refinements (discussed in the section below) could revitalise the carrier and lead to a growth spurt at some point.

In the first seven months of 2015, the three top Mexican LCCs' combined international passenger numbers surged by 27%, as the airlines tapped mostly US growth opportunities. That helped boost growth in the total international market to and from Mexico to 10.8%, up from 8.5% growth in 2014.

US expansion has helped Mexican carriers deal with the past year's currency headwinds. The Mexican peso has declined against the US dollar by 23% over the past 12 months, which has increased Mexican carriers' dollar-denominated costs, such as fuel, maintenance and lease expenses. The US services bring in dollar revenues, providing a natural currency hedge.

Of the three LCCs, Volaris is the best positioned on the currency front, as about 30% of its total revenues are dollar-denominated. It has the most extensive US operations and on a typical Mexico-US route sells half of its tickets in the US.

But Mexico's LCCs face the challenge of funding the $13bn-plus of new aircraft orders they have placed since 2010. While Volaris went public successfully in September 2013, Interjet and VivaAerobus are now seeing their IPO plans again delayed, this time because of stock market volatility caused by concerns about China and other emerging economies. Not surprisingly, aircraft lessors have been very active in Mexico this year.

Another challenge for the LCCs is serious congestion and lack of slots at Mexico City's Benito Juarez International Airport, which has been operating at capacity for years.

In September 2014 Mexican president Enrique Pena Nieto announced plans to build a new $9.2bn, six-runway airport for Mexico City, to replace Juarez. Construction began in September. The airport, which is being built next to Juarez on government-owned land, will be able to handle almost 120m passengers a year, quadrupling Juarez's capacity. The initial three-runway airport, with capacity to handle 50m passengers, is scheduled to open in October 2020.

So in the long term Mexico's airlines will have the capacity they need to grow their operations out of the nation's capital and most important

MEXICAN LCC FLEETS

	Interjet		VivaAerobus		Volaris	
	In service	Orders	In service	Orders	In service	Orders
A320	39		8	10	55	10
A320neo		40		40		30
737-300			12			
Sukhoi Superjet	16	14				
Total	55	54	20	50	55	40

business and leisure traffic hub.

In the meantime, though, the airlines are scrambling to find alternative strategies. While Toluca Airport is taking much of the overspill, the LCCs are also developing new focus cities (VivaAerobus at Tijuana), temporarily operating more nonstop flights from secondary cities that bypass Mexico City (Interjet at Monterrey) and operating larger aircraft at Juarez (Volaris' upgauge to A321).

Mexico City's future mega-airport will also accommodate significant growth by foreign carriers. That and the liberalised US-Mexico ASA, which is expected to take effect in January 2016, and the eventual US-Mexico open skies regime will mean intensified competition for Mexico's LCCs on their US and Latin America routes.

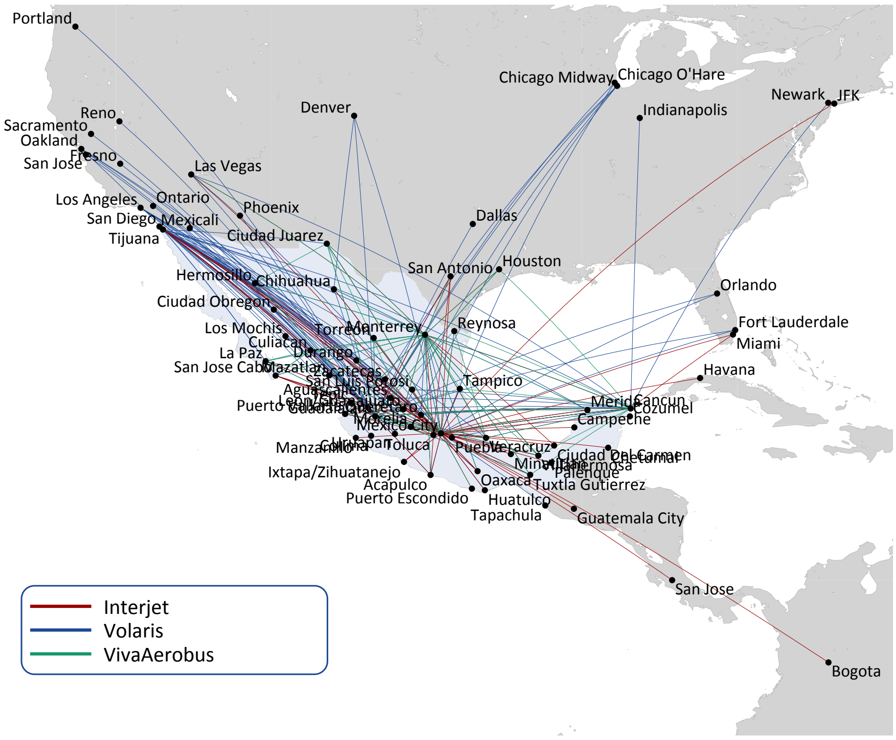
But the LCCs will also benefit from new growth opportunities. They will gain better access to key markets that currently have restrictions, such as Houston, New York and Los Angeles, and they will have increased opportunities for interline or commercial alliances.

It is not clear how much interest there will be in alliances. While Interjet, a JetBlue-style operator, has already embraced the concept, forging interline or codeshare deals with Iberia, BA, American and LAN, the ULCCs will have a harder time finding benefits in such deals.

Volaris briefly had a feeder-type deal with Southwest a couple of years ago, which it says did not make economic sense. The management remains open to partnering with US airlines, but another potential problem is that the current reservations system does not have interlining or codeshare capabilities. Volaris believes that its VFR traffic and secondary city focus will shield it from competition at least in the initial years under the new ASA.

In the following pages *Aviation Strategy* takes a look at each of the three leading LCCs in turn.

MEXICO'S LCC ROUTE NETWORKS



Volaris: Focus on profitable growth

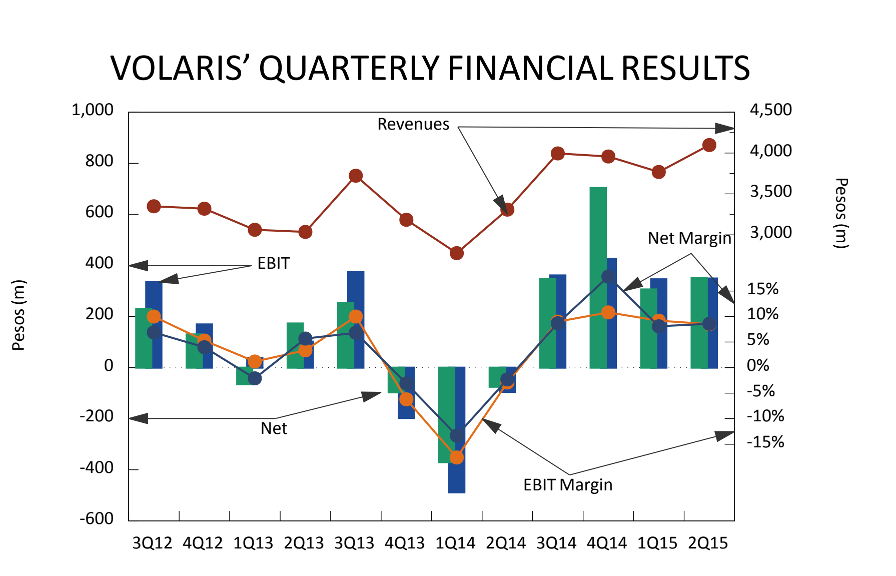
Volaris completed a well-timed $350m IPO in September 2013, just before industry conditions in Mexico deteriorated (though the airline itself largely contributed to the domestic overcapacity).

After three quarters of losses and a sharp decline in its share price (and indignities such as being hit by a shareholder class-action lawsuit related to the IPO), Volaris took remedial action and returned to profitability in Q3 2014. It has achieved 9-11% operating margins in each of the past four quarters, and the share price has soared this year.

Volaris has seen benefits from multiple factors: lower fuel prices, strong non-ticket revenue growth, good cost controls, a more rational domestic pricing environment and network diversification. Unit costs are benefiting from a project that increases the seating density on the A320s from 174 to 179 and from the arrival of more 220-seat A321s.

The current 55-strong fleet has an average age of 4.3 years and consists of 35 A320s, 18 A319s and two A321s. The 144-seat A319s are being phased out by 2019. The first two of three A321s from Air Lease Corporation arrived in May. Volaris will also receive at least five A321s from ILFC in 2016 and is reportedly keen to acquire additional A321s.

Volaris placed a $4.4bn order for



44 A320neos/A321neos from Airbus in 2012. In 2014 it signed a contract with a lessor for an additional 10 A320neos and six A321neos for delivery in 2016-2018.

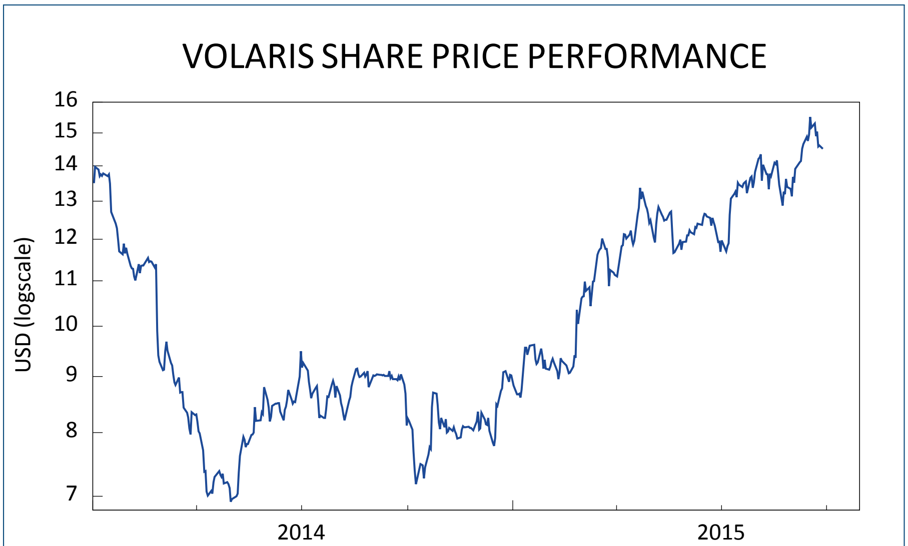
Post-IPO, Volaris has not yet started tapping the public markets to fund fleet expansion. It has used pre-delivery payment credit facilities, sale-leasebacks and operating leases.

Volaris is a classic ULCC, with point-to-point operations that target VFR, leisure and cost-conscious business travellers. It currently operates around 140 routes, serving 38 cities in Mexico and 23 internationally.

Much of this year's growth has focused on the Mexico-US market, where Volaris has added numerous new routes, including Guadalajara-New York in July. The heady pace of US expansion continues. Volaris' Mexico-US seat capacity is projected to surge by 32% in 2015.

Volaris has also made its first forays into Central America in recent months, adding service to Guatemala and Costa Rica from both Guadalajara and Cancun.

While Volaris sees further opportunities in Central America and also plans to venture to South America at some point, its main focus continues to be on North America. Earlier this year CEO Enrique Beltranena said that Volaris was currently serving only 40% of its planned US/Canada destinations.



Interjet: Doing well as an upmarket LCC

Interjet has sought to differentiate itself as a more upmarket, JetBlue-style LCC, one that provides "quality service at an affordable price". It offers a 34-inch seat pitch, free snacks and two free checked bags. The privately held, Toluca-based carrier was reportedly profitable in the second quarter of 2015.

Interjet was the largest beneficiary of Mexicana's shutdown domestically and now operates an extensive 38-point network in Mexico. But it only went international in July 2011 and currently operates to Guatemala, Havana, Costa Rica, Bogota and five US cities.

Interestingly, Interjet is currently making a push into Cuba. Having served Havana from Mexico City and Cancun for some years, the carrier is adding two new routes, Monterrey-Havana and Mexico City-Varadero, in October. The management has even talked of setting up a hub in Cuba in the longer term, when the US sanctions are lifted.

Otherwise, since launching service to Houston in October 2014, Interjet has boosted flights in international markets such as Miami, New York, Bogota and Guatemala. It has signed codeshare deals with American and LAN. It has launched a partnership with US tour operator Vacation Express to operate weekly charter flights from many US cities to resort destinations in Mexico.

CEO Jose Luis Garcia said in a recent interview with Flightglobal that Interjet could add 4-5 new US destinations, including Los Angeles, under the liberalised ASA. Interjet is also interested in South American points such as Lima and Quito, as well as more cities in Colombia.

Interjet's current 55-strong fleet consists of 39 A320s and 16 Superjet SSJ100s. The carrier became the SSJ100's first operator in the Americas in September 2013. The 93-seat SSJ100s are deployed on medium-density domestic routes and on some US routes.

Interjet's current firm orders include 40 A320neos, with deliveries from 2018, and 14 SSJ100s, with 2015-2016 deliveries. The latter include the last four aircraft from the original order and 10 new orders placed in February 2015.

Interjet has been seeking to go public for at least 4-5 years. In 2011 it had to pull a planned $300m IPO when market conditions deteriorated.

The company was known to be targeting a listing on the Mexican stock exchange this autumn; now, its chairman Miguel Aleman Velasco was reported saying at a September conference that "2016 would probably be the year".

In late July there were reports that Interjet was planning to raise 5bn pesos ($300m) through securities-denominated investment certificates known as CBFI (Certificados Bursatiles Fiduciarios Inmobiliarios) on the Mexican stock exchange, with an initial tranche amounting to $30-42m.

VivaAerobus: New fleet, new strategies

The smallest of the three, VivaAerobus calls itself Mexico's ULCC and a "pioneer in Mexico of the bus-to-air model". The airline is a joint venture between IAMSA, Mexico's leading bus operator, and Ryanair family investment vehicle Irelandia.

The Monterrey-based carrier has grown at a slower pace than its peers and has made many strategy changes. On the network front, there have been two unsuccessful major forays into the US.

The latest of the US forays was last winter. After hitherto serving only one destination north of the border (Houston), VivaAerobus added three cities (Las Vegas, San Antonio and Dallas). By July it operated seven US routes in total from Monterrey, Cancun and Guadalajara.

But VivaAerobus appears to have suspended, or is suspending in September-October, all of those routes except for Houston-Monterrey. The main reason is believed to be competition from US carriers. In the Dallas markets VivaAerobus clashed head-to-head with American and American Eagle.

VivaAerobus has now shifted its focus back to the domestic market, where it currently operates about 50 routes centred on four hubs or focus cities — Monterrey, Cancun, Guadalajara and Mexico City.

In early September VivaAerobus announced plans to develop Tijuana as a new focus city, beginning with service from Mexico City and Guadalajara in November/December and with more routes following in 2016.

VivaAerobus needed new markets for the aircraft that are pulled from US routes. But the Tijuana move may make sense. It is Mexico's fifth largest city and dominated by Aeromexico, which accounts for 60% of its traffic. It is an overpriced market that could be stimulated by ULCC-type fares. VivaAerobus plans to undercut Aeromexico by 28-30% on the Mexico City-Tijuana route.

Tijuana will also soon benefit from the Cross Border Xpress project — an airport terminal being built in San Diego that will have a 160-metre access bridge connecting it to Tijuana Airport. Passengers will be able to check in on the US side and fly out of Tijuana Airport. Scheduled to open in December, the project effectively expands the airport's catchment area to many parts of southern California.

VivaAerobus' leadership has acknowledged on many occasions that the airline has not had the expected results and that its interpretation and execution of the ULCC business model have left much to be desired.

By far the biggest mistake was to operate old aircraft. In a strategy shift in October 2013, VivaAerobus opted to replace its used 737-300s with new A320s. It placed a $5.1bn order for 52 A320s, consisting of 40 A320neos and 12 A320ceos, plus 40 neo options.

VivaAerobus began taking A320s from lessors in March 2014 and received its first aircraft from Airbus in May 2015. By mid-July the A320 fleet totalled eight and the 737-300 fleet had whittled down from the original 19 to 12. The 737s will have gone by March 2016.

The A320s, which have 22% more seats than the 737-300s, offer significant cost and efficiency benefits and a big improvement in cabin comfort. VivaAerobus is counting on the A320s to widen the cost-per-seat advantage that it already claims to possess relative to its peers.

With only 19 of the 52-aircraft

order being for replacement (the neo deliveries will continue through 2021), there will be plenty of aircraft available for growth. However, VivaAerobus' ability to grow will depend on it getting its act together also on other fronts.

As part of its latest makeover, VivaAerobus plans to operate more daily frequencies in its markets, ensure that it always offers the lowest fares, increase ancillary revenues and improve its product and customer service.

On its website, VivaAerobus informs its customers that, after 12 months of listening to them, it is starting a "new journey". The long list of product refinements includes assigned seating, a new bundled fare type called VivaSmart, more flexibility to make changes, more booking options and a 72-hour customer service guarantee.

VivaAerobus actually filed for an IPO in Mexico in January 2014, hoping to raise up to 2.8m pesos ($168m) on the back of a profitable 2013, before volatile market conditions scuppered those plans. But the airline's latest challenges have probably delayed a new IPO filing into the more distant future.

Separately, it has been reported that VivaLatinamerica, the Panama-based holding company set up by Irelandia in late 2014, is on track to launch a Viva-brand airline in Costa Rica in 2016. It is also working to coordinate some of VivaAerobus' and VivaColombia's activities, which may materially help those carriers. Given the huge success of Ryanair and other ULCCs elsewhere, it would be strange if the Viva brand did not succeed in Latin America.

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