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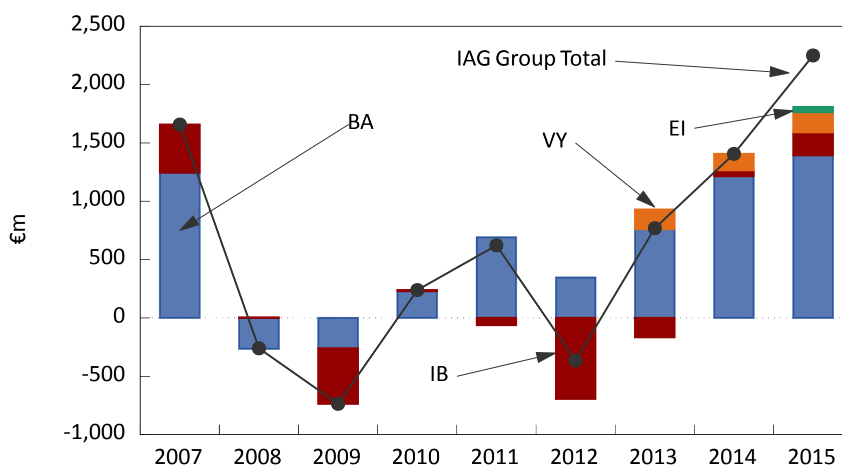
IAG: Delivering on its promises

FOUR YEARS ago each of the three major European networks carriers outlined strategic plans to restore profitability to levels that would provide returns to shareholders in excess of the cost of capital by 2015. In IAG's case this represented a target operating profit of €1.5bn. In the intervening period each has suffered significant industrial action from recalcitrant unions but should have benefited from the decline in fuel prices and the consolidation on the North Atlantic. Of the three only IAG looks to be able to produce results this year to achieve (indeed exceed) management plans of the time.

Indeed the group's optimism has been so great that on the publication of this year's nine months' results that it has announced its first dividend to shareholders and at its subsequent capital markets day a significant upgrade in long term financial targets.

For the nine-month period to end September 2015, IAG saw revenues rise by 13% to €17.1bn, operating profits before exceptional items jump by 60% to €1.8bn (including a €45m contribution from Aer Lingus, acquired mid August) and net profits up by 70% to €1.2bn. This was on the back of a 7% increase in total capacity, a 1 percentage point increase in load factor (to 81.7%) and a 6% increase in unit revenues.

Falling fuel prices helped a little but, with high levels of hedging at rates higher than current spot prices, not as much as the headline figures would suggest. Total fuel costs were 3% up on the prior year period (and down 3% in nominal unit cost terms).



Note: †2015 bars reflect nine months to end September; line the company's expected full year result. Aer Lingus included from 18/8/15.

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(The fuel hedges will unwind in time — with a potential benefit of €2bn at current prices and exchange rates over the next three years. However, the group is expecting that 80-85% of this saving will be passed on to customers through yield dilution.)

The weakness of the Euro however had an overall positive impact of nearly €80m at the operating level; underlying unit revenues excluding currency were down by 3.3% while unit costs on the same basis down by 3.1%.

Each of the airlines performed well (see chart left). British Airways' operating profits were up by over 45% to €1.4bn (significantly aided by the strength of sterling), Iberia's successful restructuring and resumption of growth generated operating profits of €196m up threefold from the prior year period, and the group's high growth stand-alone LCC Vueling increased its operating profits by 24% to €173m.

The group guided to a full year op-

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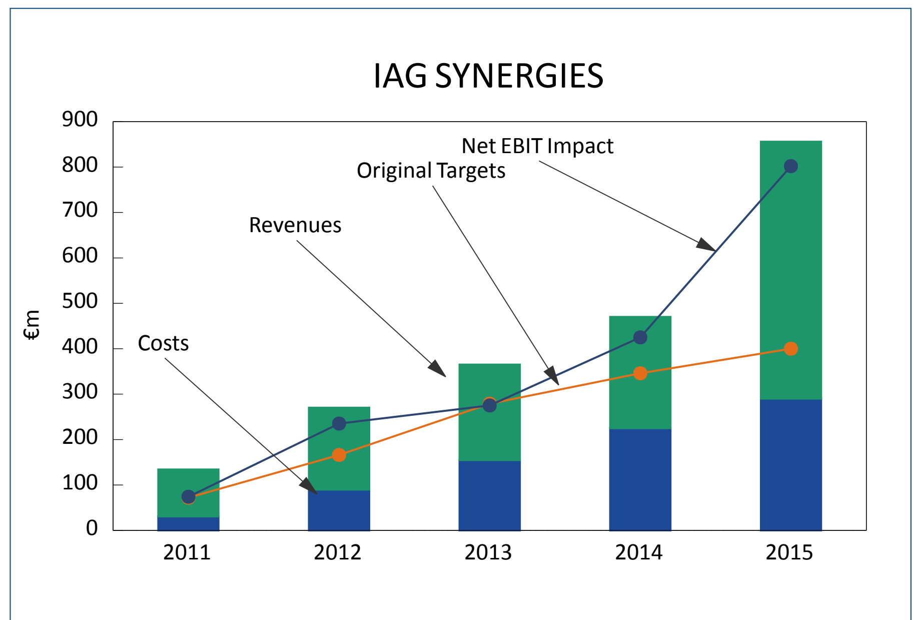


erating profit (excuding Aer Lingus) of around €2.25bn (up from €1.3bn before exceptional items in 2014) and announced an initial interim dividend of €0.10 per share with a policy of a full year payout of 25% of net earnings.

Synergy benefits

At the time of the merger between BA and Iberia in 2010 the group had forecast combined synergies of €400m, split 35:65 between revenues and costs, before implementation costs of €36m. For 2015 IAG is saying that it will have significantly exceeded the original merger synergies targets with an overall benefit of over €800m at the operating level — cost savings nearly 20% higher than planned at €290m but revenue benefits nearly four times original expectations at €566m.

The revenue synergies are equivalent to a compound annual growth in unit revenues of 0.8% over the past five years and the increased value came from:

- combined fare structure
- code shares, cross selling and ancillaries
- revenue management best practices
- sales force and distribution cost savings
- launch of *Avios* single group loyalty currency
- single integrated cargo network

At the same time the cost synergies equate to a compound annual reduction in unit costs of 0.5% with additional cost savings deriving from measures such as:

- fleet: common specification and volume
- establishment of a group wide Global Business Services platform
- joint MRO planning and shared inventory
- procurement: single group solution and volume
- IT standardisation
- outsourced back office transactional activity

In his presentation at the group's capital markets day CFO Enrique Dupuy illustrated these points on a chart entitled "Merger synergy program complete, target exceeded". However, it became apparent that the group believes that it can con-

IAG FLEET PLAN

Aircraft	Year End 2012	2013	2014	2015	2016	2020 Scenario	Post 2020 Orders	Options†	Notes
A330	33	29	31	9	18	21		7	*A330 replacing A340*
A340				23	18	11			
A350						24	10	52	*replacing 747 and A340*
A380		3	8	10	12	12		7	*replacing 747*
747	52	49	43	39	36	19			*retiring*
767	14	12	7	4					
777	52	54	58	58	58	58			
787		4	8	13	24	39	3	18	*replacing 747 and 767*
A318	2	2	2	2	2	2			LCY-JFK
Other‡				10	8	8			
Total long haul	153	153	157	168	176	194	13	84	
A320 family	187	227	266	287	298	359	12	143	*replacement and growth*
Other	40	39	35	27	28	25			
Total short haul	227	266	301	314	326	384	12	143	
Total fleet	380	419	458	482	502	578	25	227	

Note: Excludes Aer Lingus.
† Current further and rolling options. ‡ Possibly a reclassification of short-haul 767s

tinue to extract significant benefits from the programmes it has initiated well in excess of the synergies so far achieved.

Integrated Platform

The main reason for this optimism lies in the very structure that IAG established on the merger between BA and Iberia — one in which the operating airlines compete for group capital while maintaining their individual brand identities. Back office and brand-agnostic functions are put into a common group-wide organisation (which could also attract partners from outside the Group); all designed to be easily extensible as a "plug-and-play" framework, and scalable for any future acquisitions.

The result is what the group calls an "integrated platform". This encompasses IAG Cargo, the loyalty programme currency Avios, Group Business Services (IT, procurement and finance), MRO/Fleet planning and Digital services. So far the group has nearly completed the cargo integration, is half way through integrating the FFPs but has further to go in the development of the other elements.

Fleet harmonisation

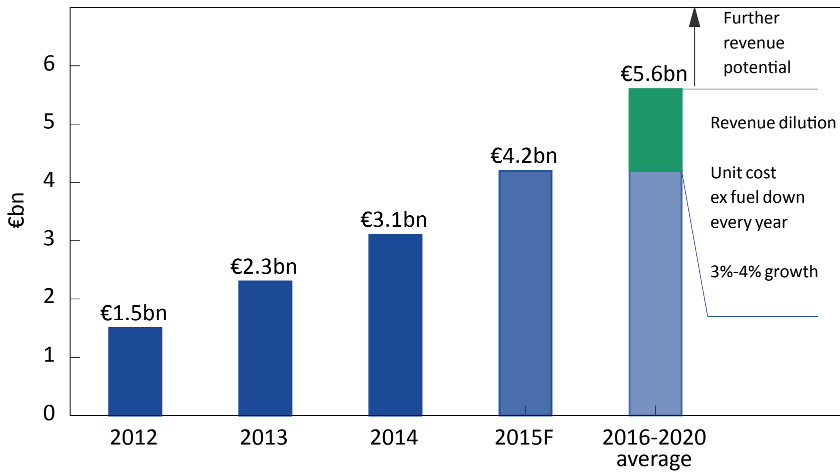
At last year's capital markets day (see *Aviation Strategy* November 2014) the group outlined the way it had moved to common specification for its A320 acquisitions (of which it has orders and options for over 250). The aim is to build a fleet over time of harmonised aircraft that can quickly and easily be redeployed to any of the group's operating airlines. In doing so the group has managed to reduce the aircraft weight by between 220kg and 470kg (depending on brand specification) by removing redundant items and moving to best-in-class (and lightest) seats. This will have a positive impact on operating fuel efficiency. In addition the group stated that it will be saving some €0.5-€1m per aircraft in acquisition cost through the proper specification of common avionics, cabin specific items, and better negotiating power with suppliers — even allowing for a small additional cost to retain a facility to allow for inter-brand flexibility.

By the end of this year the group

AER LINGUS FLEET

	2015	2016
A330-300	4	6
A330-200	4	4
B757†	3	4
Total Long Haul	11	14
A319	4	
A320	30	34
A321	3	3
ATR‡	11	11
Total	70	76

† Damp-leased in. ‡ Stobart Air under franchise.



will have 18 such A320s in the fleet; next year 30 and 109 by 2020 out of a total expected fleet then (ex Aer Lingus) of 359.

For the A330 deliveries the group has similarly designed a common specification and expects cost savings of about €1m per aircraft and weight savings of around a tonne. It is in the process of designing a common specification for the A350s, deliveries of which are due to start in 2018.

Global Business Services

The group's new Global Business Services subsidiary is its "back-office" platform covering common IT, procurement and finance functions. Planned shortly after the BA/IB merger in 2011 its gestation has been gradual: outsourcing transactional finance activities in 2013; establishing the scope for GBS in 2014; and in the current year establishing its head office in Krakow, Poland (with business processing outsourced to centres in such as Chennai), it has implemented common finance systems and taken on the responsibility for tax, treasury and decision support activities.

Cost savings achieved so far have been itemised as a head count reduction of some 550 at BA and 410 at Iberia, with supplier contract renegotiations (airports, engines, fuel, credit cards and marketing/advertising) providing savings running into the "hundreds of millions" of Euros.

The group is using this transformation to remove legacy inefficiencies. It estimates that it is less than half way through the process (and only a quarter of the way regarding IT integration). But after the process is complete it expects to have an efficient, single, centrally managed back office based in Krakow: simplified systems operating on a single platform for processes and information; smaller connected teams focussed on business partnering. It also expects this will lead to a near 30% reduction in back-office manpower costs.

Business change can be a slow process. The group avers that there is significantly more to come in total benefits beyond the synergies already achieved: transferring additional finance administration to Krakow; integrating Aer Lingus, Avios, Iberia Express and Vueling processes; IT integration.

Upgraded targets

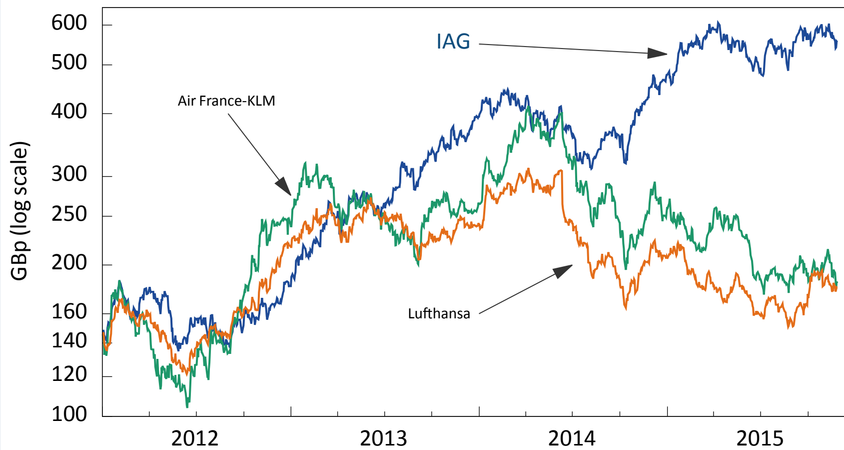
At the capital markets day the management announced a significant upgrade in long term planning goals. It is now targetting a real return on

IAG: OPERATING AIRLINE TARGETS 2016-2020

	British Airways		Iberia		Vueling		Aer Lingus	
	LTM†	2016-2020	LTM†	2016-2020	LTM†	2016-2020	LTM†	2016-2020
Operating margin‡	11.0%	12-15%	5.9%	8-14%	12.6%	12-15%	10.9%	10%+
RoIC	11.4%	〉15%	7.5%	15%	13.6%	15%	7.7%	15%
ASK growth pa	2.5%	2-3%	9.8%	7.0%	15.5%	10.0%	4.6%	7.7%
Fleet§	287	310	96	122	101	147	49	58

Notes: † Last twelve months. ‡ Lease adjusted. § At period end

IAG SHARE PRICE PERFORMANCE



Note: Air France-KLM and Lufthansa share prices converted to sterling and indexed to IAG share price at beginning of 2012.

invested capital of 15% (up from 12% previously), which translates to a group operating margin target of 12%-15%. It is still planning organic capacity growth of 3%-4% a year between 2016 and 2020. On the financial side it now expects to generate an annual average EBITDAR of €5.6bn up around 10% from its previous assumptions.

It has also reduced the estimate of ongoing capital expenditure. Partly because of the drop in fuel prices it has slightly adjusted its fleet plan — having decided to prefer the exercise of options on old generation aircraft rather than more expensive new generation equipment; extend the operating life of 777-200s and 747-400s; judiciously leasing in second hand short- and long-haul aircraft.

It expects savings from the fleet harmonisation, but is also increasing the proportion of leased aircraft to owned from the current 30:70 ratio towards 40:60. As a result it points to a maximum annual capital expenditure of €2.5bn despite the fleet re-equipment programme and is expecting to be able to generate equity free cash flow of some €1.5-€2bn a year (and return a lot of that to shareholders).

The *real* consolidation model?

BA had been criticised by the financial markets for being late in the European consolidation game — and as IAG's CEO Willie Walsh pointedly mentioned at the capital markets day, few in the the financial community believed that they could deliver the proposed synergies on the combination with Iberia that created IAG.

However, it may be sometimes best to let the first-movers in an industry development work away at *their* vision to discover a better way of doing things and learn from their mistakes. And IAG has shown that *its* integrated structure has allowed it to deliver on its promises and significantly outperform its main legacy competitors in Europe — Air France-KLM and Lufthansa.

Admittedly it has had the favourable tail winds of stronger economic performance in the UK and Spain (and Ireland), as well as the strength of sterling, that the other two have lacked. However, as the share price chart above shows the stock markets have credited the group for delivering.

There are dangers. The industry cycle currently appears favourable; and it is probable that while traveller confidence remains positive the group will retain benefits from the decline in fuel prices. The integration of Aer Lingus should go well; but the management ought not be complacent.

Attention may now move to the next possible acquisition target. Finnair (another **one**world partner carrier) has been mooted as such, which would give IAG a ″focus east″ hub on the periphery of Europe. The markets are giving credit to Willie Walsh that any future deal will only be done if it creates returns for shareholders.

Aviation Strategy

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Pegasus Airlines: Hybrid ULCC

Since becoming an LCC, Pegasus Airlines has experienced rapid growth in both passengers carried and profitability as the Turkish aviation market has boomed. Can the upward trend continue?

Pegasus Hava Taşımacılığı was launched as a charter airline through a joint venture between Aer Lingus and two Turkish companies — Silkar Yatırım ve Insaat Organizasyonu and Net Holding — back in 1990.

Pegasus grew slowly over the next few years before Aer Lingus and Net sold their stakes to İstanbul-based Yapı Kreditbank in 1994. The airline continued to develop, but in January 2005 it was acquired by Turkish entrepreneur Sevket Sabancı through the vehicle of his family's private equity holding company, called ESAS Holding.

This was the beginning of rapid transformation for Pegasus. The airline became Turkey's first LCC within a few months (with Ray Webster, former CEO of easyJet, being appointed to the board), and by the end of that same year it placed an order for 12 737-800s.

Perfect timing

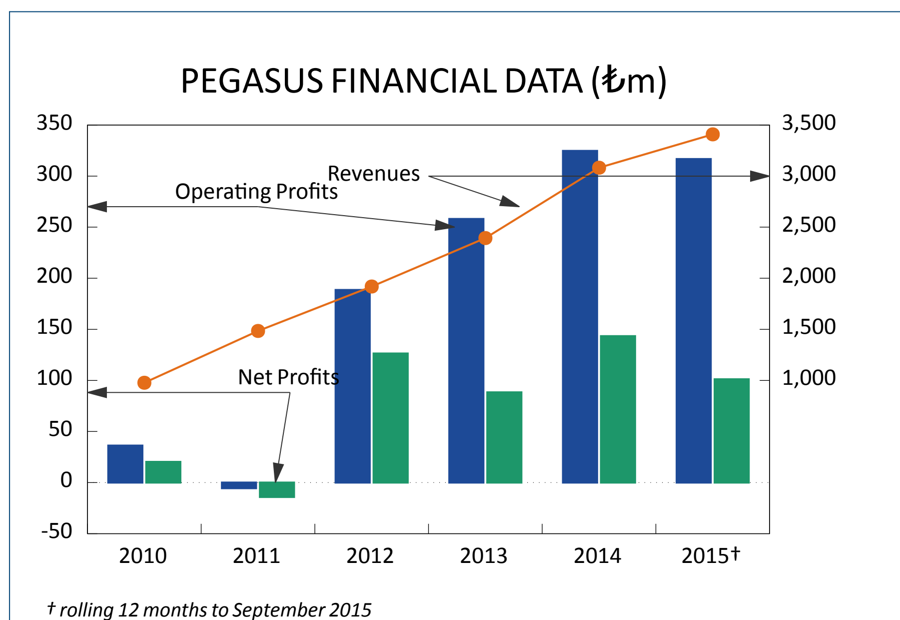
Pegasus's conversion into an LCC came at the perfect time, thanks to two key factors. First, the Turkish aviation market was liberalised through the 2000s, starting with the removal of domestic aviation tariffs in the early part of the decade. Second, at the same time, the Turkish economy underwent significant growth — Turkey's GDP (measured in current US$) grew by a CAGR of 10.5% between 2003 and 2013. With rapidly increasing disposable income and lower fares thanks to increased competition, the Turkish aviation market boomed. During the 2003-2013 period, combined domestic and international passengers grew at a CAGR of 13.1% (with the fastest growth coming from domestic passengers, with a 15.1% CAGR).

As a result of this growth, four domestic Turkish routes now feature in the list of the top ten highest density routes in Europe — from İstanbul to İzmir, Antalya, Ankara and Adana — with compound annual rates of growth of 16% in the past five years (see table on page 8).

With this favourable background, Pegasus made considerable inroads against what had been the dominant incumbent prior to the 2000s — Turkish Airlines (THY). As can be seen in the chart on page 10, Pegasus steadily increased its market share in the international market to/from Turkey — but it saw much faster growth in its share of the domestic Turkish market. That domestic share has grown from just 1% in 2005 — when it became an LCC — to 28% as of last year (out of a total domestic market of 43m passengers in 2014). In total Pegasus carried 19.7m passengers in 2014, 17.4% higher than in 2013.

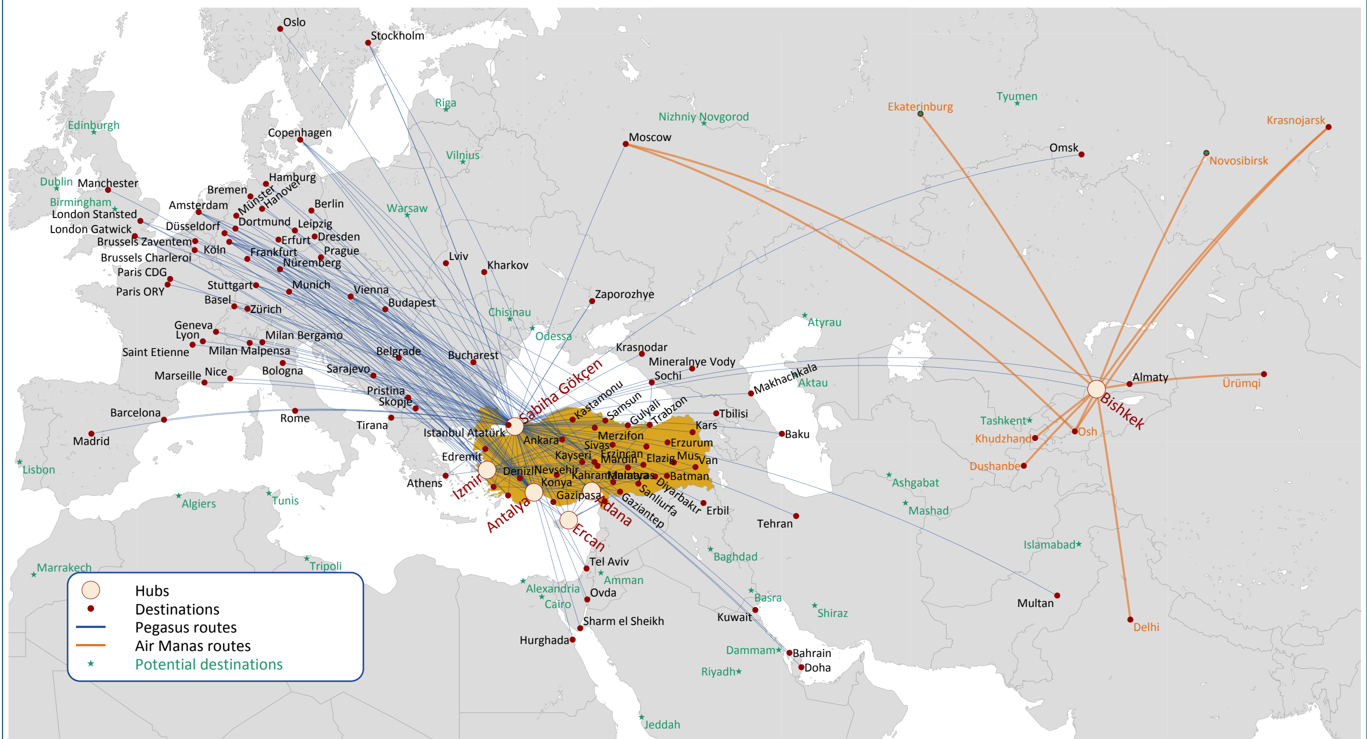
In fact its growth has been so rapid that in each of 2011, 2012 and 2013, Pegasus was fastest growing airline (in terms of capacity offered) of any major European carrier. Impressively, that didn't come at the expense of the bottom line — in 2014 Pegasus saw revenue rise 28.7% compared with 2013, to ₺3.1bn (€1.1bn), with operating profit of ₺324.7m (€112.3m) — 25.8% up on 2013 — and net profit of ₺143.3m (€49.6m) — 62.3% up year-on-year.

Today the airline (and its affiliates) operates to 31 domestic desti-

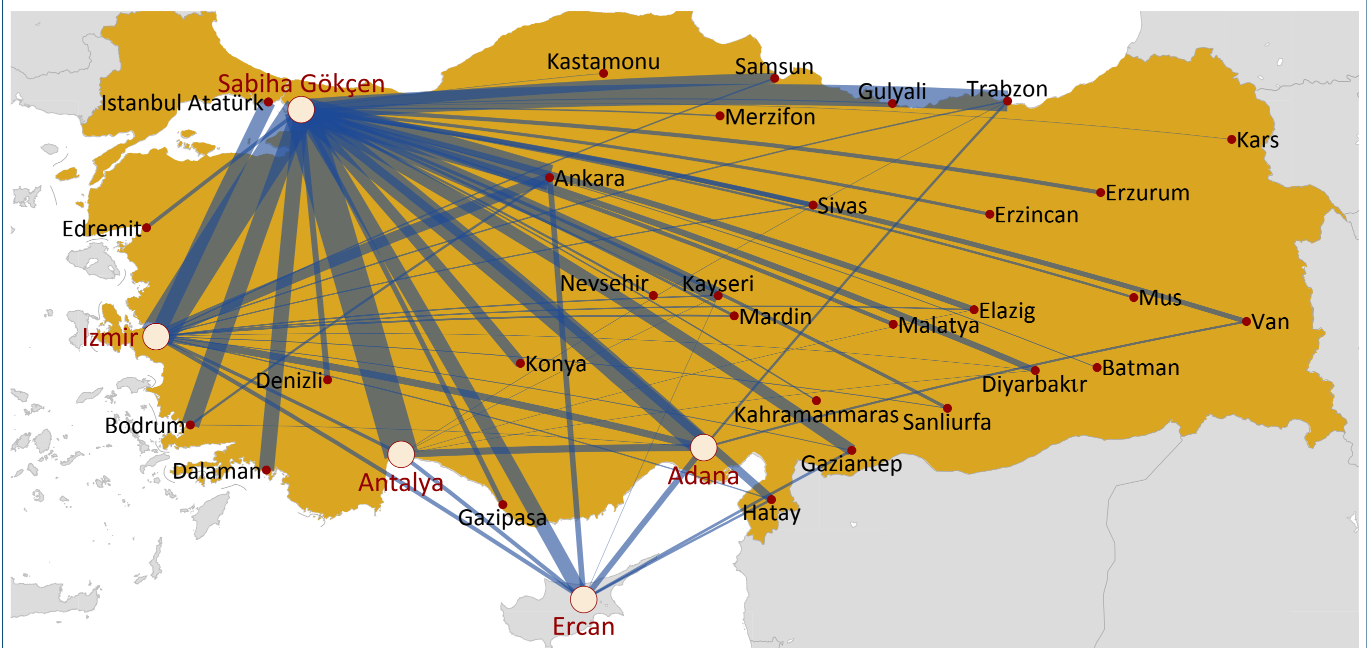


† rolling 12 months to September 2015

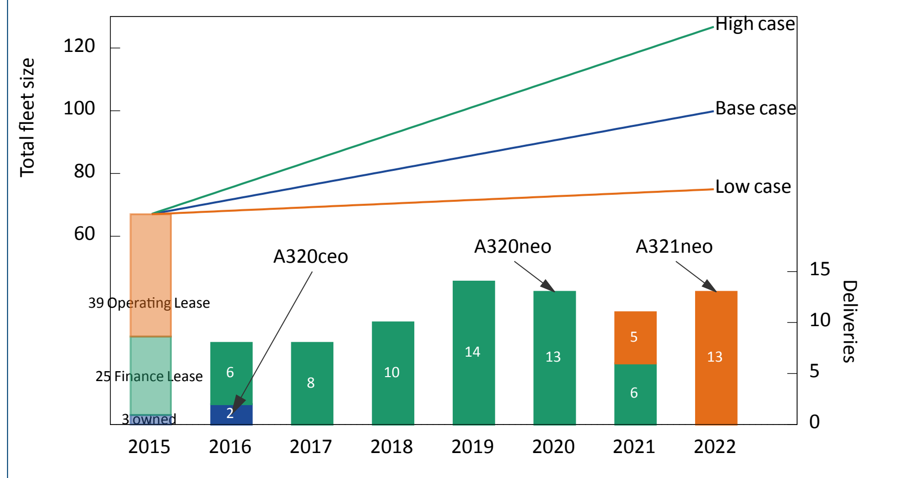
PEGASUS ROUTE MAP



PEGASUS DOMESTIC NETWORK



Note: Thickness of lines directly related to daily frequencies.



nations and 67 international airports across 36 countries, with a fleet of nine A320-200s, 56 737-800s and one 737-400 that have an average age of less than five and a half years. Of that total fleet, 30 aircraft are on operating leases.

On firm order are 57 A320neos and 18 A321neos, placed in December 2012 and which at the time — with a list value of $12bn — was the largest ever order for commercial aircraft by a Turkish carrier. Pegasus also has options for another 25 aircraft. The A320neos will start arriving in 2016 (seven will be delivered that year) and the order will be completed by 2021. The A321neos will be delivered later — five will arrive in 2021 and 13 in 2022. The options — if exercised — are for deliveries that will commence after 2022.

The company's strategy is to see its total fleet grow to 100 units by 2022 up from the current 67. With 39 aircraft on operating lease it has a significant level of flexibility and could given market conditions increase the fleet to 127 units by that year or constrain growth, as shown in the chart on this page.

Pegasus also owns 100% of İZair, an İzmir, Turkey-based airline that was founded by Turkish entrepreneurs as İzmir Hava Yolları in 2005 before ESAS Holding acquired a 20% stake in 2007 and Pegasus bought another 72.6% in 2010. It operates seven 737-800s (owned by Pegasus) between 11 domestic and 10 international destinations.

In June 2012 Pegasus also bought 49% of Air Manas, an airline based in Bishkek, Kyrgyzstan, that was launched as a charter airline by local investors in 2006 and which changed its name to Pegasus Asia and became an LCC after being acquired by the Turkish carrier. It operates four 737-400s and six 737-800s between two domestic Kyrgyzstan cities and nine international destinations in India, Russia, Turkey and China. However, in September this year the airline announced it was rebranding itself back to Air Manas, saying that it had "matured enough to grow and develop further on our own" — though the LCC model and ownership structure will remain the same.

PEGASUS FLEET

	Fleet	Orders
A320-200	9	
A320neo		57
A321neo		18
737-400	1	
737-800	56	
Total	66	75

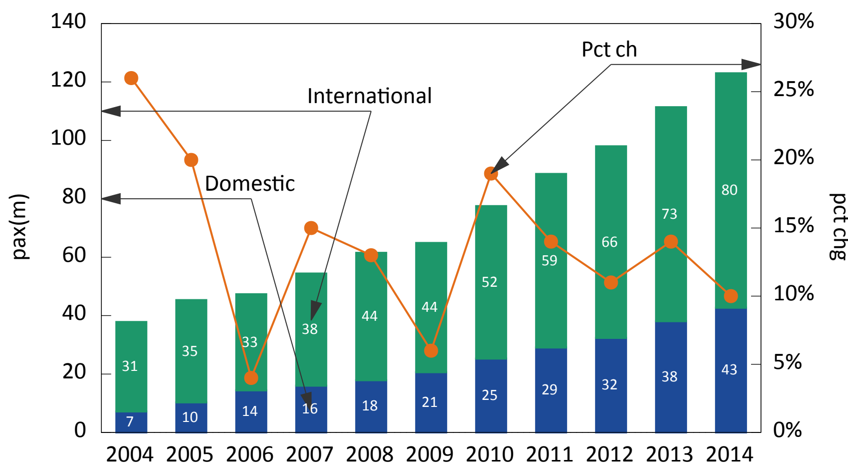
A "bespoke" LCC

Pegasus is based at Sabiha Gökçen International airport in İstanbul and its LCC business model includes a single class and paid-for frills — though in some other ways it's not an LCC at all. For example, it sells tickets via travel agents (a key part of the Turkish industry), and in 2011 it launched an FFP called Pegasus Plus.

Its key variation from the LCC model is its use of a hub-and-spoke network. That hub is İstanbul's Sabiha Gökçen International airport, at which it serves all the destinations on its route map directly. In contrast, Pegasus operates just a handful of routes from its other key Turkish bases of İzmir and Ankara, and it has no point-to-point routes that connect any cities outside of Turkey. But with İstanbul being so far to the east of Europe (where the majority of Pegasus's routes serve), the carrier has relatively few customers that use Sabiha Gökçen as a connecting airport, other than to/from domestic destinations and a handful of points to the east and north of Turkey.

İstanbul however is a large city with an estimated population of 14.5m (compared with Paris or London — the best aviation O&D cities in the EU — with 14m and 10m inhabitants in the greater metropolitan areas respectively) and has the potential to become an important O&D market in its own right.

Pegasus is only a point-to-point airline in the sense that one point is fixed — İstanbul. Indeed its manage-



Source: Devlet Hava Meydanları İşletmesi (DHMİ).
Note DHMİ double counts domestic passengers: numbers adjusted accordingly.

ment describes Pegasus as having a "bespoke LCC model".

In reality, as it's not a true pan-European point-to-point LCC, Pegasus does not compete against easyJet and Ryanair — easyJet doesn't operate to İstanbul, instead flying from the UK only to Turkish holiday destinations (with six routes from the UK to Bodrum, five to Dalaman, three to Antalya and one to İzmir). Ryanair doesn't operate to Turkey at all, although it has been considering the country as a destination for a number of years, reportedly considering Cyprus as a potential base of operation to Turkey (though this would potentially cause political problems with the Turkish government).

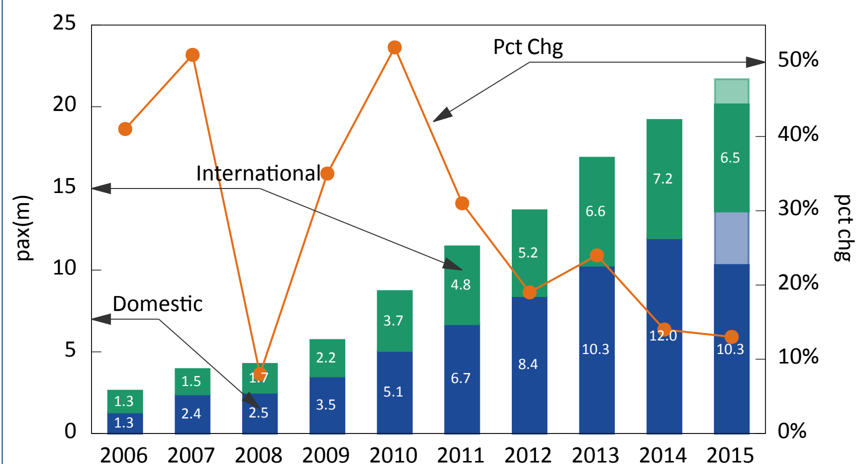
Instead, Pegasus is competing primarily against Turkish Airlines. The Turkish flag carrier operates most of its routes out of Atatürk airport in İstanbul, but at Sabiha Gökçen it also operates routes to 30 destinations, of which 24 are international. In addition THY's "low cost" feeder subsidiary AndoluJet also has a base at Sabiha Gökçen, from which it operates to 19 domestic destinations with a fleet of 737s and Embraer E-190/195s.

In terms of direct competition between THY/AndoluJet and Pegasus at Sabiha Gökçen, the airlines clash on 19 international and 17 domestic routes, and that explains the reason for the launch of Pegasus's FFP — to directly lure regular leisure and business passengers away from loyalty to the flag carrier.

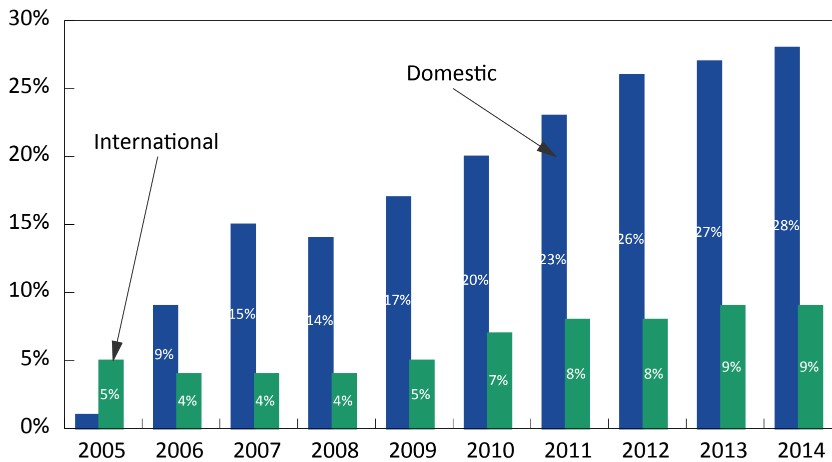
Currently Pegasus approximately has a two-thirds share of seat capacity at Sabiha Gökçen, with THY in second place with around 25%; the remainder is with an assortment of small LCCs and regional airlines.

Airport challenge

Opened in October 2009, Sabiha Gökçen International airport is located 35km southeast of central İstanbul (on the city's Asian side, which has much faster population growth than the European side) and which was built in order to relieve the pressure on Atatürk airport. Sabiha Gökçen airport has a single terminal that can handle up to 25m passengers a year, but it's already operating at close to that level; in 2014 it handled 15m domestic and 8.5m international passengers. By contrast Atatürk airport handled 18.8m domestic and 38.2m international passengers in 2014, though LCCs have little presence here as the airport is dominated by THY, which accounts for approximately 75% of all



Source: Company reports. 2015 numbers for 9 months to September. Pct chg and total bar height reflect companyfull year estimates.



its presence at Sabiha Gökçen in order to block growth by Pegasus.

Whatever happens in terms of airports, with passenger traffic within and to/from Turkey forecast to double over the next decade, Pegasus sees continued profitable expansion as its key goal over the next few years, and that long-term ambition is unlikely to be thwarted unless one or both of easyJet and Ryanair decide to launch a base out of İstanbul. This is unlikely to occur in the short-term; although the EU has a long term aim of developing closer ties with Turkey (and the country remains a candidate for accession to the EU), current air services are dealt with under a horizontal agreement alongside existing bilaterals; and both easyJet and Ryanair have more accessible markets to develop. But when — inevitably — it does happen then Pegasus will face a different kind of challenge altogether to the one it currently faces from THY.

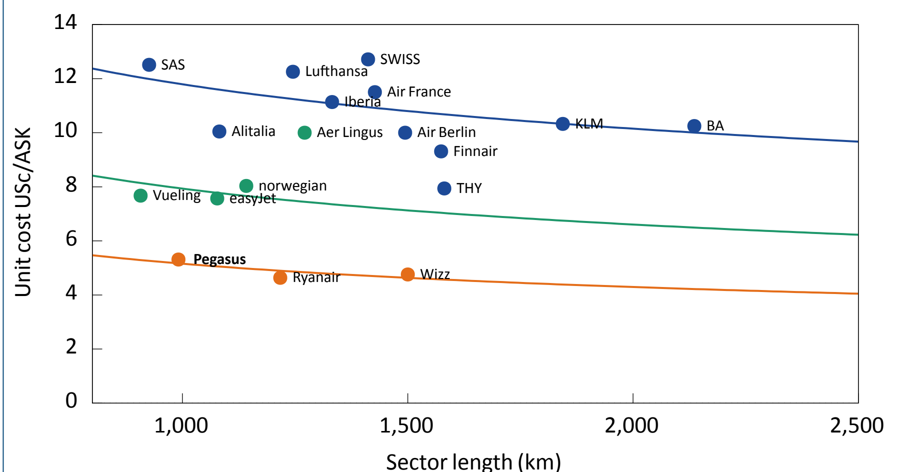
Immediate challenges

Regardless of whether/when the main European LCCs start competing, there are signs that things are already becoming tougher for Pegasus. Af-

international seat capacity.

The success of Sabiha Gökçen airport (largely driven — though not exclusively — by the growth of Pegasus) is presenting new challenges to the LCC. Sabiha Gökçen's capacity was not supposed to be reached until 2023, but it's likely to pass through that level in 2015, and Pegasus needs more capacity in order to cater for its expansion plans as its new A320 aircraft come on board. The airport is now owned fully by Malaysia Airport Holdings Bhd, and a plan for a second runway and a new satellite terminal is likely to be finalised sometime in 2017. In the meantime the Turkish ministry of transportation is assessing whether to reduce the separation between approaching aircraft from eight to six miles, and whether to build high-speed exit taxi ramps.

Pegasus would like Sabiha Gökçen to be developed much quicker than that, but that is unlikely given the plans for İstanbul New Airport, which began construction in May this year on the north-western (European) side of the city, some 35km as the crow flies from the city centre. With a capacity of 150m passengers a year it will become one of the largest airports in the world when it becomes fully operational by the end of 2028, although its first phase will handle 90mppa when it opens sometime in 2018. Atatürk airport is likely to be closed once İstanbul New Airport opens, and if THY moves all its operations from Atatürk and Sabiha Gökçen to the new facility (which its key shareholder, the Turkish government, is likely to want to happen), that will free up considerable space at Sabiha Gökçen, which in essence will become a specialist airport for LCCs. THY, however, may want to maintain



TOP 10 INTRA-EUROPEAN ROUTES 2015

City Pair	Annual Seats (m)		Rank			LCC Market Share		CAGR	
	2010	2015	2010		2015	2010	2015	Total	LCC
Izmir-Istanbul	3.05	6.66	10	↗	1	25%	34%	17%	25%
Dublin-London	4.80	5.81	2	→	2	39%	37%	4%	3%
Antalya-Istanbul	2.20	5.39	18	↗	3	16%	30%	20%	35%
Ankara-Istanbul	2.96	5.34	11	↗	4	13%	23%	12%	26%
Amsterdam-London	3.80	4.82	5	→	5	29%	34%	5%	8%
Edinburgh-London	3.83	4.68	4	↘	6	30%	39%	4%	10%
Paris-Toulouse	4.10	4.26	3	↘	7	17%	19%	1%	4%
London-Madrid	3.06	3.71	9	↗	8	37%	34%	4%	3%
Nice-Paris	3.77	3.52	6	↘	9	22%	26%	-1%	2%
Adana-Istanbul	1.33	3.31	36	↗	10	17%	33%	20%	36%

Source: OAG

ter a decade of significant growth, Turkey's GDP fell by 2.9% in 2014, and although the economy is doing better this year, of perhaps greater concern is continuing domestic political turbulence.

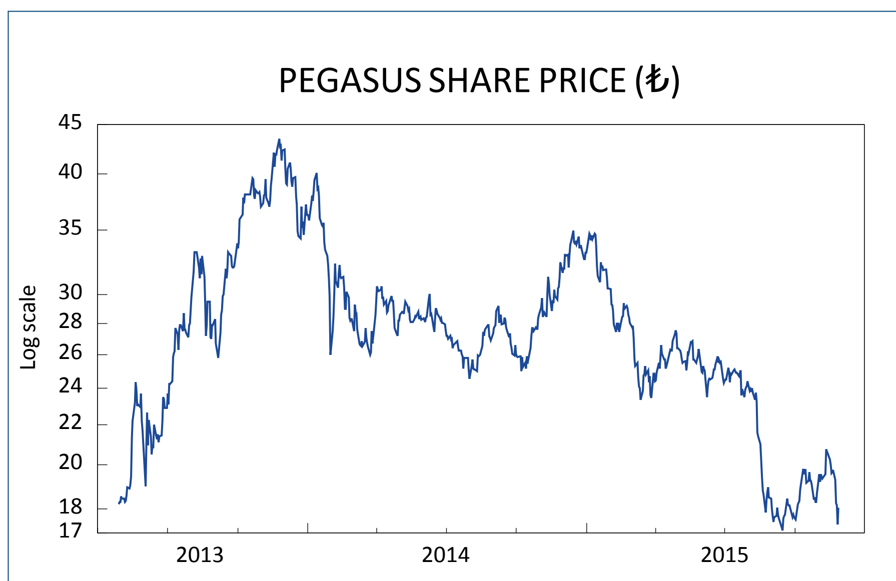
In the first nine months of 2015, Pegasus recorded revenue of ₺2.7bn (€805.2m), 13.6% higher than the same period of 2014, and based on a 12.1% rise in passengers carried, to 16.8m. However, operating profit fell to ₺280.3m (€82.5m), 8.1% down compared with Q1-Q3 2014, and the net profit fell even more — by 15.5% — to ₺197.9m (€58.2m) in January-September 2015.

That is still a great set of results by any standards and, importantly, as at the end of September this year net debt stood at just ₺228.3m (€67.2m), representing a significant 54.1% fall compared with 12 months earlier, thanks largely to a 58.5% rise in cash and cash equivalents over the 12 months to ₺1.4bn (€399.5m) as at September 30th 2015.

There are other challenges though. The Turkish Lira has fallen by 40% against the US Dollar in the past five years. As with many airlines Pegasus has a high level of US Dollar exposure (on equipment and fuel). Around 55% of total expenditure is in dollars (with 20% in Turkish Lira and 23% in Euros) while only 35% of revenues are dollar denominated (and 29% in lira and 22% in Euros). However, from July this year all international fares originating in Turkey have been priced in USD and the company stated that US dollar denomiated revenues increased by 16 percentage points in the three months ending September from the previous quarter.

Pegasus came to the İstanbul stock exchange through an IPO in April 2013, with 34.5% of the airline floated (with 62.9% staying under ownership of ESAS and 2.6% owned directly by the Sabancı family). Since then, however, the share price has not had a stellar performance — after an initial steep rise through 2013, the price has fallen since, and 2015 has seen the shares significantly underperform those of its main European LCC peer group — easyJet and Ryanair.

Turkey is rapidly developing as a new centre of European aviation activity. Pegasus is emerging as a new hybrid force.

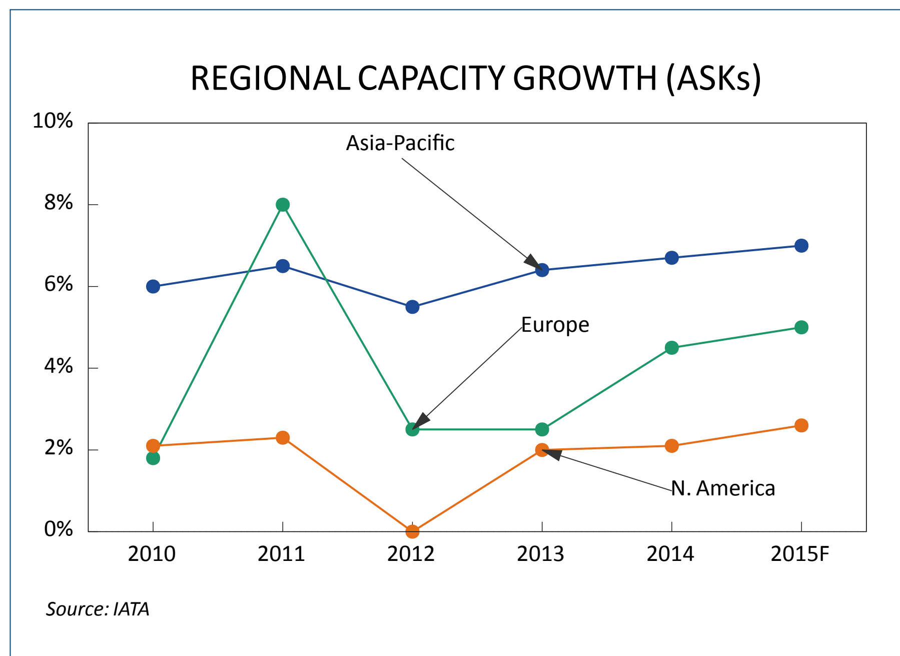


Asian growth/profitability dichotomy

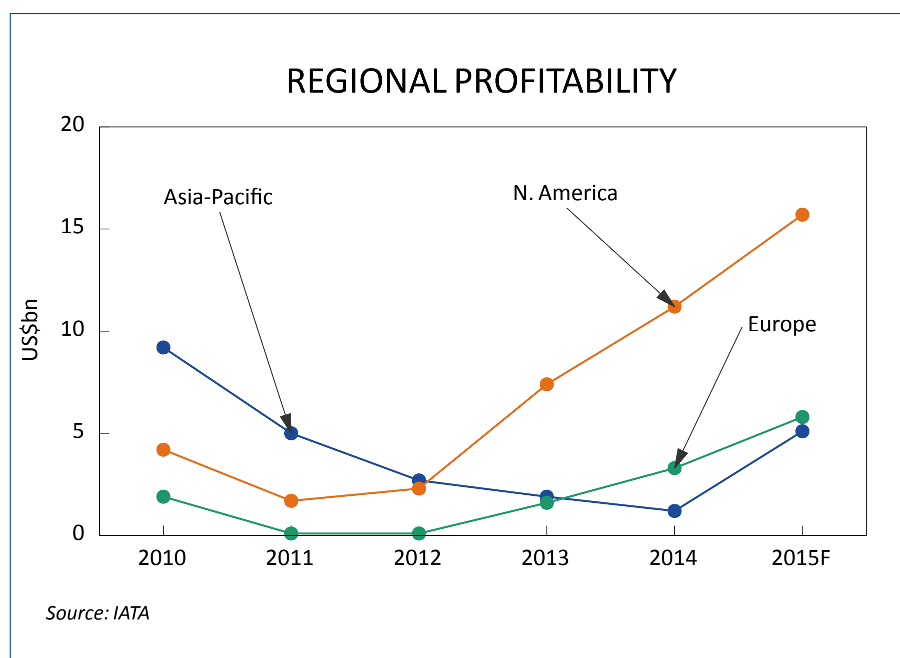
Asia-Pacific continues to be one of the fastest growing aviation regions of the world, with Airbus, for example, expecting the region's share of global traffic (RPKs) to increase from 29% today to 36% by 2034, by which time it will have eclipsed both Europe (21% in 2034 from 25% now) and North America (25% to 17%).

However, Asia Pacific carriers are facing a dichotomy. As Andrew Herdman, secretary general of AAPA (Association of Asia Pacific Airlines) highlighted at this month's AGM in Indonesia, while the region is outpacing Europe and North America in capacity and traffic growth, profitability has plunged from nearly $10bn in 2010 to around $1bn in 2014 (though a marked improvement is expected for 2015). By contrast in North America, where airlines overall practically ceased expanding, profitability has soared, from $4bn in 2010 to a forecast $16bn this year.

Asia-Pacific was the last of the major aviation blocs to deregulate — ASEAN open skies only came fully into force this year — so it is at a comparatively early stage of intense competition, characterised by over-capacity and the entry of LCCs, both independent and subsidiaries. It took the US three decades following deregulation to find the formula for producing investment grade RoI, the eventual result of domestic mergers and transatlantic virtual mergers. In the process, unfortunately, the US carriers have increasingly alienated the travelling public and now risk a pro-consumer regulatory reaction, while Asian carriers remain determined to maintain reasonably good service standards.



Stockmarkets have rewarded the US Big 3 by bidding up their share prices from the insipid levels of a few years ago to record valuations. In terms of both stockmarket capitalisation and enterprise value (stockmarket value plus long-term debt), Delta, American, United plus South-



WORLD'S TOP TEN AIR ROUTES 2014

	Pax m	No of scheduled airlines
Hong Kong–Taipei	5.1	5
Jakarta–Singapore	3.5	9
Hong Kong–Singapore	2.8	6
Hong Kong–Shanghai	2.7	5
Hong Kong–Seoul	2.5	11
Kuala Lumpur–Singapore	2.4	8
Bangkok–Hong Kong	2.4	8
Bangkok–Singapore	2.3	6
Hong-Kong–Beijing	2.0	5
Tokyo Narita–Taipei	2.0	10

Source: IATA WATS, OAG.

west now dominate the global valuation picture; their equity value is over twice that of the top five Chinese carriers combined — a reflection of how the markets reward stability over growth for network carriers.

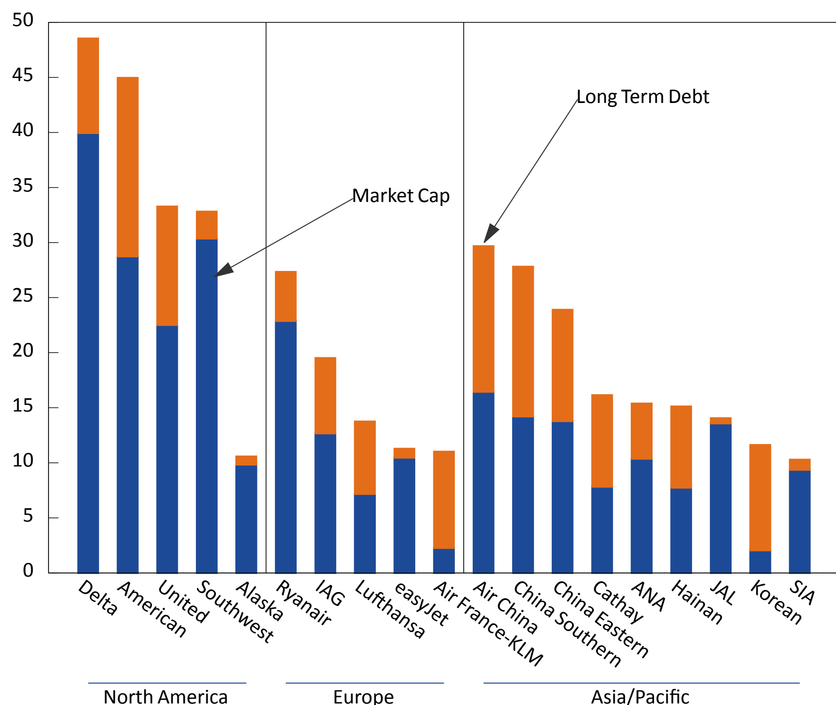
The table above illustrates firstly that the world's top ten airport pairs (on an O&D basis) are all in the Asia-Pacific region and, secondly, that there is a very high degree of competition, predominantly direct competition. Up to 11 jet airlines of different types — legacy, LCC, fifth freedom carrier — are operating on these routes while in the US or Europe two would be the norm, one in the case of most the transatlantic hub-to-hub services.

These market conditions represent such a degree of competition that some form of rationalisation would appear to be inevitable. Andrew Herdman talked of the major carriers streamlining long-haul operations and evolving multi-brand strategies while the LCCs would be more measured in their expansion and would experiment with codeshares, connectivity and customer service. Overall, he observed that there would appear to be a convergence between the LCC and network models.

As the political framework does not exist to enable European-style multinational mergers, regional alliances have to be of the more traditional codeshare variety. Nor is there scope for the fully integrated JVs of the transatlantic type between European and Asian carriers. Nevertheless SIA, for example, has entered into a revenue-sharing agreement with Lufthansa, in part a response to Emirates' successful alliance with Singapore-based JetStar Asia.

The Asian carriers have been much more effective than their US or European counterparts in establishing low cost subsidiaries. ANA's Vanilla and Peach appear to be expanding dynamically without — so far — generating friction with the parent airline. SIA is embarking on a major rationalisation — buying out the 44% it doesn't own in Tigerair in order to fully integrate its low cost operation with its longer-haul subsidiary Scoot.

AIRLINE ENTERPRISE VALUES BY REGION ($bn)



Market capitalisation as of 5 November 2015
Source: AAPA Estimates

Jet values and lease rates

THE FOLLOWING tables reflect the current values (not "fair market") and lease rates for narrowbody and widebody jets. Figures are provided by The Aircraft Value Analysis Company (see following page for contact details) and are not based exclusively on recent market transactions but more generally reflect AVAC's opinion of the worth of the aircraft.

In assessing current values, AVAC bases its calculations on many factors such as number of type in service, number on order and backlog, projected life span, build standard, specification etc.

Lease rates are calculated independently of values and are all market based.

JET VALUES ($m)

			Years old					Years old		
		New	**5**	**10**	**20**		**New**	**5**	**10**	**20**
RJ	CRJ 900	27.5	23.1			Emb 175	27.7	21.6	13.9	
	CRJ 1000	30.3	24.6			Emb 195	33.2	26.7	17.7	
	CRJ300-ER	36.7								
	MRJ90	26.8				S100-95	22.5	17.6		
Narrowbody	A318		19.3	11.8		717-200			7.8	
	A319†		19.9	17.0	7.6	737-300‡				2.3
	A320-200§		25.4	22.1	11.2	737-400‡				3.2
	A320NEO	48.0				737-500‡				2.1
	A321-200‡☆	50.4	41.0			737-600‡			10.1	4.7
	A321NEO	57.7				737-700‡✈		20.4	17.6	
						737-700†✈		21.8	19.0	
						737-800‡✈		27.8	24.0	
						737-800†✈		29.4	25.3	
						737-800✳	49.1	38.7		
						737 MAX 8	54.6			
						737 MAX 9	57.7			
						757-300†				8.9
Widebody	A300B4-600†				5.6	747-400			16.7	10.7
	A310-300§				2.9	747-800	160.8	130.7		
	A330-300§			28.9	13.2	767-300ER†✈		40.4	33.1	
	A340-300 ER			19.4	12.0	777-200ER		75.4	58.1	23.5
	A350-900	138.0				777-300ER	165.2	138.8	105.9	
	A350-1000	175.0				787-800	118.1	90.1		
	A380-800‡	213.7	169.4			787-900	135.3			
	A380-800†	224.1								

Source: AVAC.
Notes: As at end-October 2015, lease rates assessed separately from values
†=HGW, ‡=LGW, §=IGW, ✈=Winglets, ☆=Sharklets, ✳=Enhanced

JET LEASE RATES ($'000 per month)

			Years old					Years old		
		New	5	10	20		New	5	10	20
Regional	CRJ 900	207	185			Emb 175	223	189	144	
	CRJ 1000	239	210			Emb 195	271	234	187	
	CRJ300-ER	297								
	MRJ90	337				S100-95	152	146		
Narrowbody	A318		155	112		717-200			105	
	A319†		181	160	87	737-300‡				61
	A320-200§		235	222	143	737-400‡				66
	A320NEO	386				737-500‡				40
	A321-200‡☆	418	365			737-600‡			100	59
	A321NEO	478				737-700‡✈		184	164	
						737-700†✈		197	177	
						737-800‡✈		248	224	
						737-800†✈		262	236	
						737-800✳	365	310		
						737 MAX 8	438			
						737 MAX 9	463			
						757-300†				109
Widebody	A300B4-600†				89	747-400			197	143
	A310-300§				62	747-800	1,268	1,150		
	A330-300§			322	174	767-300ER†✈		344	337	
	A340-300 ER			279	186	777-200ER		726	612	359
	A350-900	1,129				777-300ER	1,567	1,334	1,051	
	A350-1000	1,651				787-800	889	734		
	A380-800‡	1,675	1,390			787-900	1,095			
	A380-800†	1,757								

Source: AVAC.
Notes: As at end-October 2015, lease rates assessed separately from values
†=HGW, ‡=LGW, §=IGW, ✈=Winglets, ☆=Sharklets, ✳=Enhanced

AIRCRAFT AND ASSET VALUATIONS

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