
Aviation Strategy

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The Skies are Open

FINALLY, more than two years after putting in its application, Norwegian Air Shuttle has been granted tentative approval from the DoT for a US foreign carrier permit for its Irish subsidiary Norwegian Air International. Congratulations to CEO Bjørn Kjos for his perseverance. The whole process has been a bit of a farce: the objectors have been using an obscure side article in the EU-US open skies agreement (17*bis*) designed to uphold labour standards, and developed emotive arguments referring to "flags of convenience" and "flight to the bottom". All ironic considering that norwegian has two crew bases in the US (in New York and Fort Lauderdale) and that the sort of innovation that norwegian is developing is exactly what the open skies agreement was meant to be about.

This issue includes

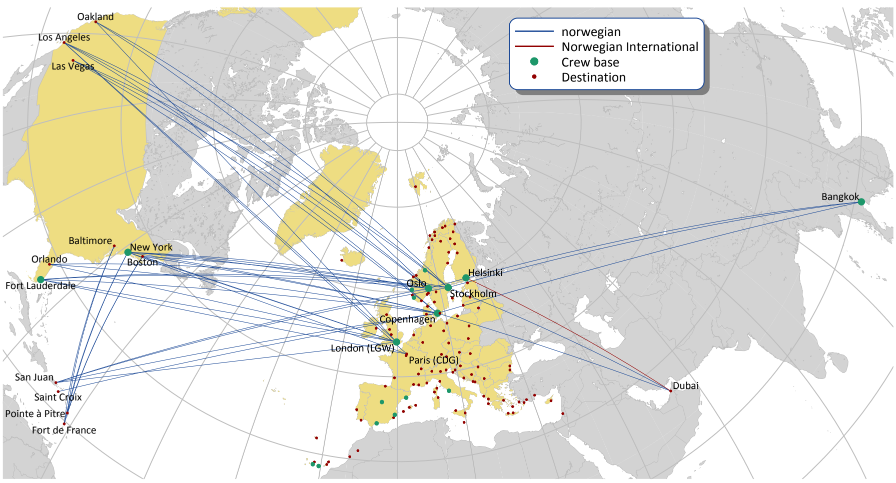
The tentative approval is subject to possible objections, but all other things being equal should be made "final" by mid May: the DoT in its announcement blatantly stated that after taking legal advice there was no reason to deny the application (but failed to say why it took so long to decide). This decision does not affect the application made by norwegian's UK subsidiary in December last year for a similar permit, but suggests that it will be granted.

Why is this so important for norwegian? It is based in Norway, part of the EEA but outside the EU. It gained full rights under the EU-US open skies agreement as a European airline in 2011 when Norway (and Iceland) were co-joined into the treaty and therefore is allowed to fly between any point in the EU (plus Norway and Iceland) to any point in the US. However, an airline with a Norwegian AoC is only able to access route rights between Scandinavia and other parts of the world depending on Scandinavian bilateral agreements, limiting available services effectively to departures from Oslo, Copenhagen and Stockholm (not the *largest* conurbations in Europe); and must adhere to the terms of the Norwegian AoC regarding local employment.

Up to now norwegian has been operating effectively with the Irish registered 787s wet-leased to it under a dispensation from the Norwegian authorities to allow it to employ non-Norwegian crew. It does operate one long haul route using the Norwegian International Irish AoC — between Helsinki and Dubai.

Despite the delay in the grant of a licence, norwegian has concentrated on pushing its capacity on the Atlantic — in the process developing innovative route structures such as between New York, Boston and Washington to the French Caribbean (which, bizarrely, *is* part of the EU).

NORWEGIAN: LONG-HAUL ROUTES



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Its only non-US long haul destinations are Bangkok (where it has a crew base) and Dubai.

Meanwhile, the company has upped its growth plans. In October last year it finalised an order for another 19 787s and ten options with the plan to operate 40 aircraft of the type by 2020. (Of course this order had nothing to do with the DoT's decision.) In its Q1 2016 results presentation norwegian highlighted its aim of growing by an average annual 20% in ASK terms over the next five years: 40% annually on long-, and 10% annually on short-haul.

With the grant of the permit to the Irish based carrier, (and the corollary that the UK based carrier will also gain a permit), it is likely that norwegian will start aggressively to develop routes available to it under the Irish and UK bilaterals to other parts of the world.

Feeding the growth

There are few good long haul O&D routes. Many airlines, to make sense out of running a long haul network, have to develop feed from short haul: the traditional legacy network model. norwegian already operates an intraline transit service — charging passengers an explicit £7 per person per leg (or £15 at Gatwick) for the benefit of seamless bag transfer and the insurance of being placed on the next available departure in case of cancellation or delay. This is a significant move away from the traditional low cost model adhering to the KISS principle as it adds complexity and cost but it is necessary.

A couple of airports have developed their own transit product to facilitate self-connect transfers. Both London Gatwick (with Gatwick Connect) and Milan Malpensa (through ViaMilano) charge the passenger an insurance to guarantee connections.

The low cost model is evolving. Ryanair's CEO Michael O'Leary has recently been promoting the idea that Ryanair could be better suited to providing short haul feed to the Network carriers in Europe than they themselves — and has reputedly been in negotiations with IAG and TAP. The sticking point appears to be over which airline assumes responsibility for missed connections, cancellations or delays.

Ryanair is also going to start trialling an intra-line transit product through Stansted and Barcelona this Summer. This is in spite of article 17 of the Ryanair T&Cs which bluntly states ˝We are a point-to-point airline˝ (with the unstated exhortation ˝so there!˝).

O'Leary recently announced that Ryanair and norwegian were close to an agreement for Ryanair to do just this for norwegian's services out of Gatwick and Copenhagen (and presumably any future long haul departure point). Ryanair's own services at these airports are relatively limited (resulting from slot transfers on Irish routes at Gatwick after the IAG acquisition of Aer Lingus, and suffering union labour issues in Denmark). With norwegian's long haul operations at Gatwick (and now Paris CDG), easyJet might appear on the face of it to be a better potential partner. However, Carolyn McCall, easyJet's CEO, is unconvinced that LCCs can provide feed to long haul "simply and easily and make money at the end of it".

Ryanair has made no secret of looking at the idea of moving into long haul — as long as the cost of the equipment were right. This may just be the way for the lowest cost producer in Europe to monitor the best way to enter the long haul low cost market.

Alaska Air and Virgin America: Regulatory, fleet and branding challenges

Alaska Air Group's planned $4bn acquisition of Virgin America, announced on April 4, would combine two award-winning niche airlines that have a similar focus and minimal network overlap into "West Coast's premier carrier". The combined airline would overtake JetBlue and become the fifth largest US airline. It would have the makings of a nationwide LCC that could compete more effectively with the four largest carriers (American, Delta, United and Southwest) that control 80% of the domestic market.

It would be the first airline merger in the US since the American-US Airways deal closed in December 2013 and the second combination involving low-fare carriers, following Southwest's acquisition of AirTran in May 2011.

But this deal faces many potential challenges, among them an inhospitable regulatory environment, fleet dis-synergies, labour cost hikes and tough decisions about branding.

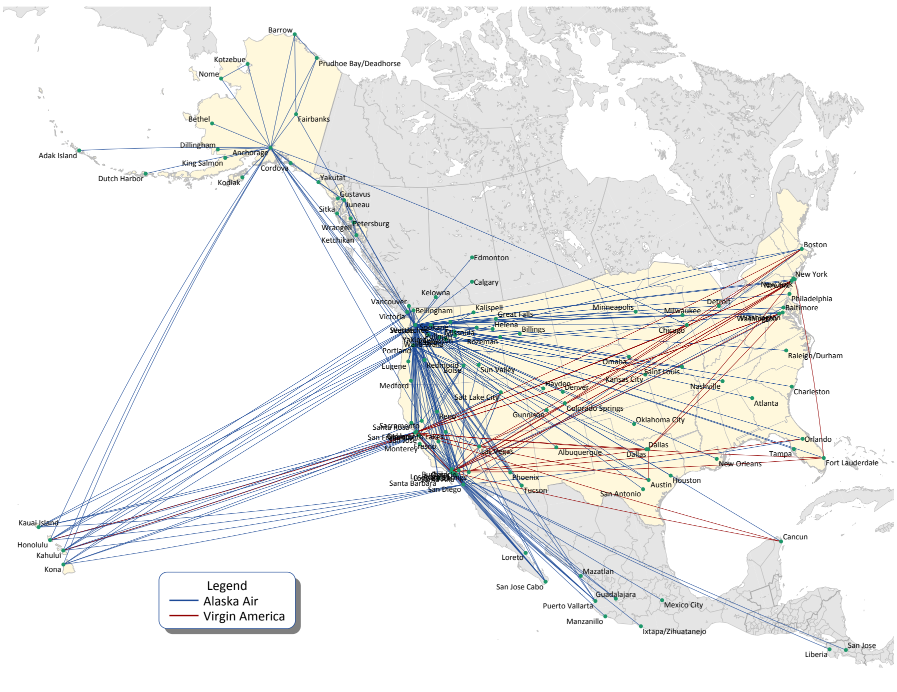
Alaska is paying a large premium for what it considers "scarce real estate" and a one-time opportunity to get a stronger foothold in California.

But Alaska will find itself in some of the nation's most competitive markets — where, incidentally, Virgin America is achieving a revenue premium over competitors thanks to its unique blend of friendly, hip upscale service and competitive fares.

Virgin America has been a huge hit in the marketplace and enjoys a cult-like following. If Alaska does not want the expense (and potential confusion) of maintaining a dual brand, would Virgin America's customers take their business elsewhere?

In contrast to many past airline mergers, this deal would be done from a position of strength. Both parties are earning healthy profits, have strong balance sheets and are in the growth mode. Is that a help or a hindrance?

COMBINED ROUTE NETWORKS



The proposed deal

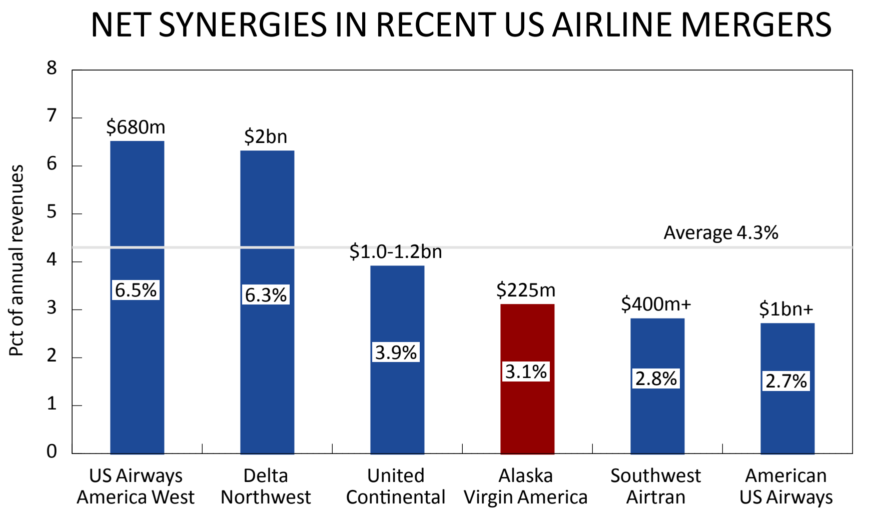
Alaska is acquiring Virgin America in an all-cash deal with an equity value of $2.6bn and an enterprise value of around $4bn. The latter includes VA's debt and capitalised operating leases, minus cash holdings.

The deal has been unanimously approved by the boards of both companies. Alaska hopes to secure Virgin America shareholder approval by June and regulatory approval in the second half of 2016, so that the transaction could close by the year-end.

Under the terms of the agreement, Alaska is paying Virgin America shareholders $57 per share, representing a 47% premium on the closing price the day before and an 86% premium on the price on March 22, the day before news leaked out that Virgin America was considering a sale.

The premium is so high because Alaska had to outbid JetBlue, though Alaska executives have described the price as "easily digestible", because there would be both immediate benefits and benefits "over the years and decades ahead".

Alaska expects to finance the



Source: Alaska Air Group presentation (April 2016)

transaction with a combination of cash ($600m) and new aircraft-backed debt ($2bn), and it plans to slow down share repurchases in 2016 and 2017 to help fund the deal.

With cash reserves of $1.6bn at the end of March, some 92 unencumbered aircraft and an investment-grade balance sheet, Alaska can easily afford the $2.6bn payment.

Alaska Air Group is 4-5 times the size of Virgin America in terms of annual revenues, passengers and daily departures. It is one of the most profitable US airlines, earning a 23% pre-tax margin in 2015, compared to Virgin America's 13%.

The two airlines have very different backgrounds. Alaska is 84 years old, though the Seattle-based group was formed in 1985 as a holding company for Alaska Airlines and regional carrier Horizon Air. San Francisco-based Virgin America was launched in August 2007 by the UK-based Virgin Group together with US investors.

But there are also many similarities. Both ALK and VA run strong operations, are known for low fares and outstanding customer service, have strong brands, are technological innovators, have strong cultures and are recognised as good employers.

The combine would have $7.1bn annual revenues (2015), around 290 aircraft (including regional types) and 114 destinations (excluding 22 overlapping cities). There would be five hubs: Seattle, San Francisco, Los Angeles, Anchorage and Portland.

The Alaska name, brand and Seattle headquarters are to be retained. However, in a nod to VA's loyal customers and corporate contracts in San Francisco and Silicon Valley, CEO Brad Tilden said that there would also be a "strong presence in San Francisco" and that Alaska would explore using the Virgin brand, which is driving a big revenue premium at Virgin America and is much better known globally.

The decision on whether or not to retain two fleet types (Alaska operates 737s, Virgin America A320-family aircraft) is not likely for a couple of years.

The merged carrier is expected to generate $225m in annual net synergies when fully integrated — $175m revenue benefits and $50m cost synergies. One-time integration costs are estimated at $300-350m.

Because of the focus on debt funding, the transaction is expected to be accretive to earnings in year one (excluding integration costs). The synergies are expected to ramp up quickly, increasing from 30% in 2017 to 100% in 2020.

Why this is happening

Virgin America did not put itself up for sale; Alaska approached it. Alaska executives said that they had first approached Virgin America's leadership in November 2015. Subsequently, early this year VA's CEO David Cush reportedly contacted JetBlue's CEO Robin Hayes about a possible combination. So, when Alaska submitted its bid in March, JetBlue had already become interested and it entered the bidding process.

The deal happened for two simple reasons: Alaska wanted Virgin America badly enough to pay a huge premium, and it was a great deal for Virgin America's investors.

It would provide a well-deserved exit for Cyrus Capital Partners and other Virgin America initial investors, which had to recapitalise the company several times in the seven-plus years before it was able to go public in November 2014.

The bailouts were necessary because Virgin America had a tough time getting started and becoming viable. Its setbacks included a two-year delay to its launch due to questions about its ownership and control structure, a new DOT enquiry in 2009 about its US citizenship status, and difficulties in obtaining gates and slots at desirable airports.

After a recapitalisation in January 2010, Virgin America got into trouble as the result of an over-ambitious growth spurt, which led to a restructuring of its Airbus orders and a no-growth strategy in late 2012. There was another financial restructuring in the spring of 2013, in which the shareholders wrote off $290m of debt in return for future stock purchasing rights and provided an additional $75m of debt.

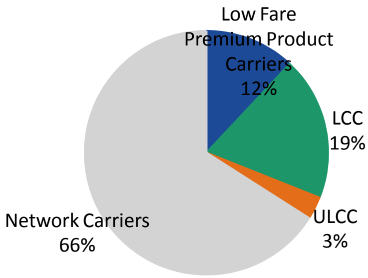
The backers recouped some of their investment in VA's successful IPO but, importantly, remained on board. After the IPO, Cyrus Capital Partners and the Virgin Group held 35% and 33% stakes, respectively, though as a non-US citizen the latter is limited to 25% of the voting rights.

In a blog post, Virgin Group's founder Richard Branson expressed "sadness" about the merger and noted that there was nothing he could do to stop it. The $500m-plus that his investment company will receive from the deal should compensate.

For the US-based investors, this could be the best time to exit Virgin America. The US airline industry may be at the peak of the cycle, and VA's own earnings are expected to fall this year. The current consensus estimate is a 21% decline in EPS in 2016.

While Virgin America is now reporting healthy profits, its RASM is under pressure due to price wars in markets such as Dallas. Many analysts are concerned about the limited network that is heavily exposed to competition from both network carriers and ULCCs (even though so far Virgin America has fared well in competitive markets).

US CARRIERS' NORTH AMERICAN REVENUE SHARES



Source: Company presentation

The main long term concern is about the extent of the growth opportunities for that type of business model, which Virgin America has described as "premium revenue generation with an LCC cost base".

Alaska sees the ALK-VA combine falling into the broader "bleisure" segment that also includes JetBlue and Hawaiian (low-fare airlines that focus on higher-end leisure and cost-conscious business travellers). That segment accounts for 12% of US carriers' North American revenues (see chart on this page). Alaska believes that it is a very promising and underserved segment of the market.

Alaska's main motive for the acquisition is the expanded West Coast and California presence that Virgin America offers, which would give it an "enhanced platform for growth". The deal would also give Alaska more access to slot-constrained airports on the East Coast.

Alaska's leadership noted that the company is in a strong position to take on new challenges, because it is performing well in all respects. "We're anxious to get more real estate to work with", Brad Tilden said.

Tilden also noted that the US industry had become more concentrated, which was good for investors but also suggested to an airline like Alaska that "scale is relevant".

And airport infrastructure constraints in the US now make it hard for airlines to grow organically. Tilden praised Virgin America for having done an "amazing job at building a network from slot-constrained airports from West to East".

There is undoubtedly also a defensive element to the deal. It would help protect against JetBlue's further inroads to the West, as well as more intense price matching by the legacies in the next economic downturn.

Although Virgin America is not much of a threat to Alaska (the network carriers' hub-building moves in Seattle have posed bigger competitive challenges in recent years), it must be noted that in 2009 Alaska was the leading voice in the campaign to try to get VA stripped of its US citizenship.

California opportunity

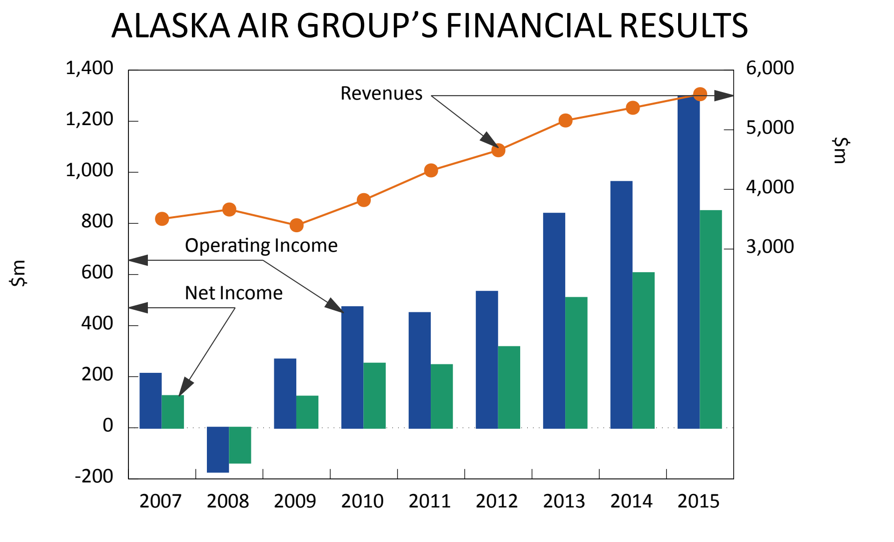
Given its size and financial success, it is a little surprising that Alaska is still a niche operator with a heavy focus on the Pacific Northwest and the state of Alaska. In 2015, about half of the group's capacity was along the US West Coast (36%) or to/from/within Alaska (15%).

But the network has gradually broadened to include a sizable transcon/midcon component (24%) and Hawaii operations (18%), both primarily from Seattle. Alaska also serves Mexico (6%), Canada (1%) and Costa Rica (since November 2015).

Alaska has grown at a relatively brisk 7.7% average annual rate since 1995. In the past five years, it added 26 new cities and 90 new markets. Last year's ASM growth was 10.6%.

The biggest driver behind the acquisition is the opportunity to get a solid foothold in California, which has more than three times the population of Alaska, Washington and Oregon combined (39.1m, compared to 11.9m) and 2.5 times the daily passengers.

In terms of seats offered, the ALK-VA combine would become the second largest carrier in SFO



Source: Company Reports

(compared to Alaska's current sixth position) and "relevant in a very fragmented market in LAX". Alaska would be present in SFO's ten largest markets, compared to one currently, while in LAX the number of top-ten markets served would increase from one to eight.

The ALK-VA combine would be the West Coast's largest carrier, with 22% of the total seats, compared to Southwest's 21%, United's 16%, Delta's 12%, American's 12%, Hawaiian's 7%, JetBlue's 2% and Spirit's 1%.

Alaska hopes that such critical mass would help make the future combined loyalty programme a big success. Virgin America has a significant loyalty base in California, and many of Alaska's current programme members are also based in that state.

Virgin America would bring to the union 23 valuable slots at JFK, as well as 12 slots at LGA and 15 at Newark. Today Alaska has only one daily red-eye to JFK and obtaining that slot pair "took at least five years".

Alaska believes that all of that would enable it to extend profitable growth well into the future, though it would probably stick to its long-established target rate of 4-8% annual ASM growth.

The combined network would offer more connections for international airline partners out of Seattle, San Francisco and Los Angeles. Between them, Alaska and Virgin America have an impressive array of global airline partners, and Alaska also has two-way codesharing with Delta and American.

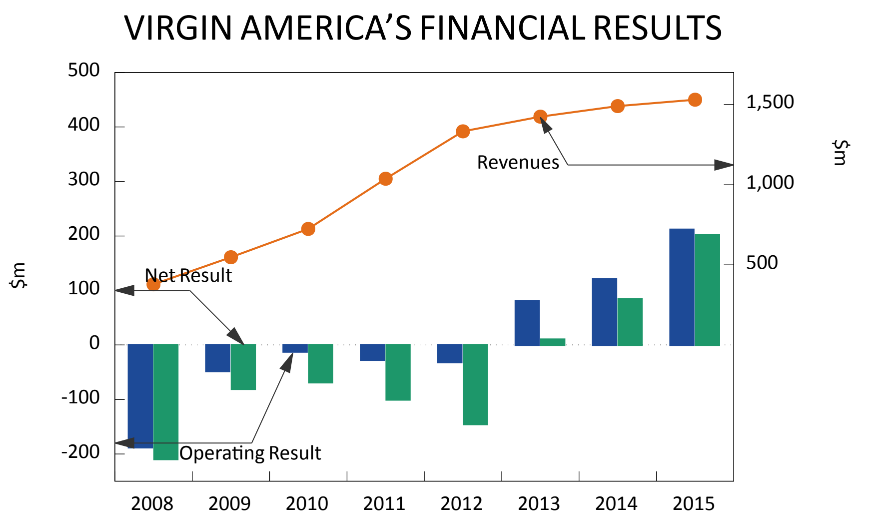
Financial strength

Alaska Air Group has now achieved double-digit operating margins for six years in a row. Last year it earned operating and net profits of $1.3bn and $848m, respectively, on revenues of $5.6bn. According to Alaska's presentation, its 24% 2015 pretax margin compared with the US LCC group's 18.8%, the legacies' 13.9% and the S&P Industrials' 13.1% margin.

After heavy losses up to and including 2012, Virgin America has now had three profitable years. In 2015 it earned adjusted operating and net profits of $212m and $202m, respectively, on revenues of $1.5bn. Pretax ROIC was a respectable 17.9%. The results have improved due to RASM outperformance, reduced lease and interest expenses post-IPO, and of course lower fuel prices.

Virgin America began growing again in the second half of 2015, as it resumed taking A320 deliveries. This year's ASM growth is projected to be around 15%, though about half of the new capacity will go to the Hawaii market that VA entered in November.

It makes sense for Virgin America to grow because it is still a young airline, but the brisk rate will make



Source: Company Reports

BALANCE SHEETS (end 2015)

	Alaska Air	Virgin America	*acquisition*
Net Current Assets	(143)	109	*(600)*
Fixed Assets	4,870	1,042	
Goodwill			*1,792*
Total Assets	4,727	1,151	*1,192*
Debt	571	259	*2,000*
Other liabilities	1,745	84	
Equity	2,411	808	*(808)*
Capital Employed	4,727	1,151	*1,192*
Off balance sheet debt†	840	1,758	

Source: Company reports. Note: † at 8x aircraft rentals

it hard to improve from the position at the bottom end of the US airlines' profit range.

Alaska has been the industry's financial leader in many respects. It was the first airline in the US to start managing to ROIC (25.2% in 2015). It began reducing leverage early and has slashed its debt-to-capital ratio from 81% in 2008 to 27% in 2015. It was the first US airline in the post-2001 era (other than Southwest) to secure an investment grade credit rating.

Alaska has also paid down its pensions and led the process of returning capital to shareholders. The $6.1bn of cash flow generated in 2010-2015 was used as follows: $3bn for fleet and other capital investments, $1.2bn for debt reduction, $1.4bn to reward shareholders via dividends and stock repurchases, and $500m for pension contributions.

So Alaska seems well-positioned for the Virgin America acquisition. The investment grade balance sheet will enable it to finance the $2bn debt component at very attractive rates. Alaska has not been in the market for aircraft financing since 2009 and apparently there is tremendous interest in financing the proposed transaction.

THE FLEETS

	Alaska Air Group		Virgin America	
	In service	On order	In service	On order
737 Classic	26			
737 NG	126	(29)		
737MAX		(37)		
A320			61	(2)
A320neo				(30)
Q400	52			
E175		(30)		
	204	**(99)**	**61**	**(32)**

Source: Ascend. Note: Virgin America also has a commitment to lease 10 A320neos from GECAS 2017-18.

The deal would weaken Alaska's balance sheet, though; it was indicative that Fitch and S&P immediately put Alaska's ratings on review for a possible downgrade. But Alaska believes that its debt-to-capital ratio would only rise to 58%, and it would aim to reduce it to 45% by 2020. Alaska also expects to resume share repurchases at the current level in 2018.

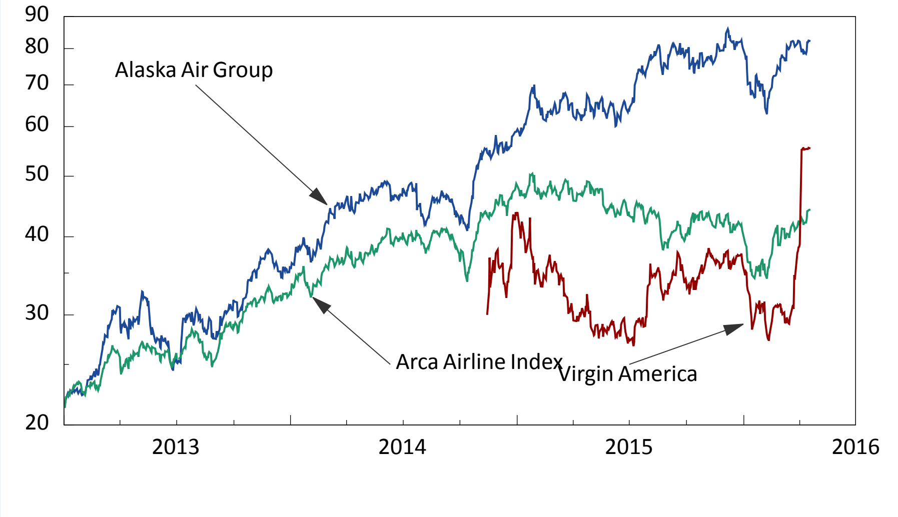
Synergies and dis-synergies

According to Alaska's presentation, the $225m net synergies, at 3.1% of combined revenues, are in line with prior mergers such as Southwest-AirTran but substantially lower than some of the biggest deals (see chart on page 4). The revenue synergies would come from network connectivity, "mixing and matching" aircraft and opportunities with the company-branded credit card.

However, at least one Wall Street analyst, JP Morgan's Jamie Baker, immediately said in a research note that he expected the synergies to be lower. Baker's "first pass" estimate on April 4 was $175m total synergies ($150m/$25m).

Baker cited an "inhospitable regulatory environment", which could lengthen the approval process. He noted that in consolidation labour costs usually escalate and that there were "no money-losing hubs to close or expensive airport real estate to consolidate". He noted that it was best to start from a basis of fleet commonality, "lest potential synergies end up being allocated to aircraft lessors and/or aircraft OEMs in pursuit of simplification".

Regulatory approval is clearly the big wild card. On the one hand, there is little network overlap and the intention is to grow. But the reality may prove different. The DOJ is known to



SHARE PRICE PERFORMANCE

be unhappy about the latest round of airline mergers, which have led to a high concentration in the industry.

A dual 737/A320 fleet is potentially a problem in a merger of two low-cost carriers. Either aircraft type would be perfectly suited for the combined network. But Alaska is a longtime Boeing customer, so if it opted for a single-type fleet, Boeing would probably win.

There is much flexibility around the Virgin America fleet, because substantially all of it is leased and the leases start expiring in 2020. Some 25 aircraft could be returned by 2022. VA is due to take 10 A321neos from GECAS in 2017-2018 but could probably get out of that commitment. And VA's order for 30 A320neos for 2020-2022 delivery apparently has a "favourable cancellation provision".

But Alaska said that it plans to get to know the A320 first. Interestingly, its regional unit has just opted for a second fleet type. On April 12 Horizon Air announced a $2.8bn order for up to 63 E175s, which will supplement its Q400 turboprop fleet (though the E175 and Q400 are for different types of markets).

Labour integration is normally a challenge in airline mergers. At this stage, all looks good. VA's workers would join another well-run company that takes good care of its employees. Alaska's key unions have publicly welcomed the deal — the growth opportunities probably made it an easy sell.

It always gets more complicated when the time comes to sort out the details. In this case, the two different fleets could cause problems. As Baker pointed out, there is no existing A320 rate in the Alaska pilot contract, and in the past 737 pilots have required incentives to cooperate. Baker envisions a gross labour dis-synergy of $100m inclusive of all work groups.

While the customers and loyalty members of both airlines would benefit from the broadened network, ALK and VA have different approaches to customer service, and their customer cultures are very different. Seven out of Virgin America's top-ten corporate customers are Silicon Valley-based tech companies.

Alaska focuses more on the airport experience and Virgin America on the on-board experience. One frequent flyer with both airlines interviewed by *The Wall Street Journal* described Alaska's FFP as "far superior" but said that there was no substitute for Virgin America's in-flight experience, which was "flying like a king".

Combining those approaches would be a certain winner, and Alaska has said that it would study the Virgin brand and customer experience. Alaska considers the royalty payment that VA pays to the Virgin Group (0.7% of annual revenues) "not huge in the grand scheme of things", so perhaps there is potential for a new licensing agreement to be negotiated.

In reality, though, maintaining two brands would be expensive and potentially confusing to passengers, so the combine will probably gravitate towards Alaska's more basic in-flight experience.

The key question is: how would Virgin America's passengers respond to the disappearance of the brand that they love? Would they take their business to other airlines in highly competitive markets such as the transcon?

In the meantime, JetBlue has moved fast to announce plans to expand its highly successful Mint premium product to more transcon markets, including Las Vegas, San Diego, Seattle and Ft. Lauderdale from early 2017. JetBlue said that it wanted to "capture opportunity to introduce new transcon competition for customers facing fewer options".

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No Accounting for Leases

BOTH THE IASB (International Accounting Standards Board) and the US-based FASB (Financial Accounting Standards Board) earlier this year announced new accounting standards to cover the reporting of leased assets. Both standards will come into effect by 2019 and may materially impact the presentation of accounts and financial decision-making by both airlines and lessors. The standards are similar but there are some fundamental differences.

The two standards boards have been working on a joint attempt to come up with a common standard for the last ten years. The main reason for the change has been concerns, specifically from the SEC, that the treatment of off-balance sheet items severely distorts the ordinary investor's view of the actual position of a company's state of affairs. Professional investors and analysts have for years adjusted the numbers from published accounts to judge risk and enable a reasonable comparison on a like-for-like basis, but the man in the street is deemed to need protection.

The IASB says that over 14,000 listed companies using IFRS or US GAAP (out of a total 30,000) disclose information about off-balance sheet leases in their annual reports and that the future payments showed totalled US$2,860bn. It has analysed a sample of 1,145 (3.8% of the total) companies (see table on this page) which reveals that they account for 80% or US$2,196bn. The airline industry is the lead sector for this form of financing with future undiscounted operating lease payments possibly accounting for 29% of on-balance sheet assets.

The current accounting standards (IAS 17) provide for a distinction between leased assets depending on the status of ultimate ownership at the end of the lease period. In general terms if ownership reverts to the operator at the end of the lease this becomes a finance (or capital) lease and should be capitalised with a corresponding debt liability reflecting future lease payments, whereas if ownership resides with and remains with the lessor at the end of the lease this becomes an "operating lease", remains off-balance sheet and the lease cost is expensed in operating costs as cash outflow.

OFF-BALANCE SHEET LEASE PAYMENTS BY SECTOR

			Future lease payments	
Sector	No of companies	Total Assets ($bn)	($bn)	(% of assets)
Airlines	50	527	152	29%
Retailers	204	2,020	572	28%
Travel/leisure	69	404	115	29%
Transport	51	586	91	16%
Telecoms	56	2,847	219	8%
Energy	99	5,193	400	8%
Media	48	1,020	72	7%
Distributors	26	582	31	5%
IT	58	1,911	70	4%
Healthcare	55	1,895	72	4%
Others	306	13,959	402	3%
Total	1,022	30,944	2,196	7%

Source: IASB.

BALANCE SHEET IMPACT OF IFRS 16 BY SECTOR

	Long Term Liabilities ($bn)			Gearing†		
Sector	Reported	IFRS 16	8x Rentals‡	Reported	IFRS 16	8x Rentals‡
Airlines	115	234	293	123%	251%	314%
Retailers	379	810	997	48%	103%	126%
Travel/leisure	135	219	239	118%	191%	209%
Transport	124	192	255	54%	84%	111%
Telecoms	809	981	1,090	79%	96%	106%
Energy	1,017	1,305	1,472	42%	54%	60%
Media	340	396	427	102%	119%	128%
Distributors	175	200	220	91%	104%	115%
IT	280	337	390	31%	37%	43%
Healthcare	437	492	522	58%	65%	69%
Others	2,629	2,936	3,159	64%	71%	76%
Total	6,441	8,103	9,064	59%	74%	82%

Source: IASB. † Long term liabilities to equity. ‡ Common market practice.

P&L IMPACT OF IFRS 16 BY SECTOR

	EBITDA ($bn)		EBIT margin	
Sector	Reported	IFRS16	Reported	IFRS16
Airlines	52	74	6.3%	7.7%
Retailers	270	348	6.0%	6.7%
Travel/leisure	50	63	11.8%	13.2%
Transport	71	88	10.0%	10.7%
Telecoms	399	434	13.2%	13.8%
Energy	688	745	8.1%	8.4%
Media	118	129	17.7%	18.3%
Distributors	29	35	3.7%	3.9%
IT	299	312	18.3%	18.5%
Healthcare	255	265	15.4%	15.6%
Others	1,163	1,229	10.6%	10.8%
Total	3,394	3,722	10.2%	10.6%

Source: IASB

The new rules from the IASB affecting IFRS accounts will do away with the distinction between finance and operating leases requiring all leased assets to be capitalised on the balance sheet (with the exception of leases with a duration of less than a year and leases involving low cost items such as personal computers).

In practice?

What does all this mean in practise? On the balance sheet a company will have to capitalise the net present value of future lease payments at a certain discount rate matched by a lease liability reflecting the value of the notional loan attached. This will boost total fixed assets and liabilities.

Through the income statement the company will depreciate the notional capitalised asset over the life of the lease, amortise the loan and record interest payments. This will reduce operating costs (which will no longer include lease rentals), increase EBITDA and EBIT, (with part of the cost of the lease allocated to depreciation) but should make little or no difference at the pre-tax level.

It will also increase gearing, reduce RoCE and interest coverage in the published figures (as both debt and capital employed are higher) but may increase RoE (as equity will be lower). Whether it has an effect at the net level will depend on local tax authorities' intelligence. On cash flow (which is the only thing that is really important) there will be no change — since this is all cosmetic — although individual reporting lines will become more incomprehensible and it may be more difficult to work out what is really happening.

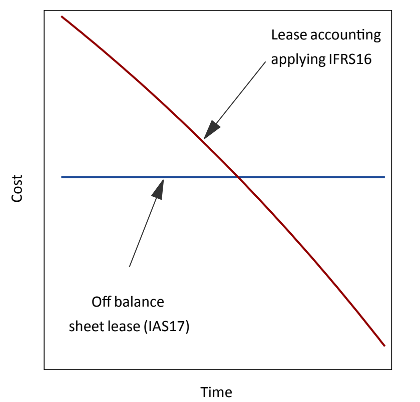
For an individual operating leased asset the new standards will mean that costs will be front-loaded in the profit and loss account (see chart on the current page). It is not certain how wet-leased aircraft will be treated, but if the lease term is for longer than twelve months, the asset element of the lease will probably have to be capitalised.

The standards require that the future lease payment stream be discounted but allows the company to choose the discount rate either as the implicit interest rate inherent in the lease term or the company's marginal rate of borrowing. This may cause some problems. In the airline industry it is unlikely that the lessor would divulge the information (somewhat commercially sensitive exposure of their funding and residual value assumptions), while a 25% increase in nominal ″debt″ (see table on the facing page) could have a material effect on the marginal rate.

Furthermore, for the first year of introduction, companies will be allowed to choose a transition method: either present all leases as if the standard had always been in effect (which will mean taking a hit to reported equity) or start as if from day one (which will increase future costs and reduce future earnings).

The US based FASB (affecting US GAAP reporting) has taken a slightly different view and has retained the definitions of finance and operating lease. All leased assets (excluding short term operating leases) must be capitalised. Operating leases are to be shown on the balance sheet as a ″right-of-use″ asset and a corresponding lease liability initially measured as the present value of future lease payments but recognise a single lease cost in the income statement calculated so that the cost of the lease is allocated over the lease term on a straight-line basis.

P&L IMPACT – SINGLE OPERATING LEASE



ACCOUNTING IMPACT OF IFRS 16 ON A SAMPLE AIRLINE

	IAS 17	IFRS 16	US GAAP
Balance sheet			
PP&E	27,886	27,886	27,886
Leased assets	**12,030**	**25,430**	**a) 12,030** **b) 14,923**
Other	9,114	8,952	8,952
Total fixed assets	49,030	62,268	63,791
Total current assets	21,152	21,152	21,152
Total assets	**70,182**	**83,420**	**84,943**
Borrowings	9,430	9,430	9,430
Lease liabilities	**10,516**	**25,277**	**a) 10,516** **b) 14,761**
Other liabilities	34,818	34,818	34,818
Total liabilities	54,764	69,525	69,525
Equity	15,418	13,895	15,418
Total liabilities and equity	70,182	83,420	84,943
Income statement			
Revenue and other income	67,272	67,272	67,272
Operating costs	(60,893)	**(58,340)**	(60,893)
EBITDA	6,379	**8,932**	6,379
Depreciation	(3,908)	**(5,674)**	(3,908)
Operating profit	2,471	3,258	2,471
Net finance costs	(865)	**(1,656)**	(865)
Profit before tax	1,606	1,602	1,606
Income tax	(285)	(285)	(285)
Profit for the year	1,321	1,317	1,321
Cash flow statement			
Operating activities	6,265	8,026	6,265
Investing activities	(5,190)	(5,190)	(5,190)
Financing activities	(851)	(2,612)	(851)
Total cash inflow	224	224	224
Ratios			
Debt/EBITDA	3.1	3.9	5.4
Interest Cover	7.4	5.4	7.4
ROCE	7.0%	6.7%	4.9%

Source: IASB. Note: a) Finance leases, b) operating leases.

One of the more intriguing aspects of the new standards is that a company will no longer be able to record a profit as the result of a sale and lease-back agreement if that deal is regarded as a refinancing of the asset. In the airline industry this historically has been a convenient method of taking advantage of the difference between agreed discounted purchases from the manufacturers and current market valuations of aircraft in order to boost equity — especially for weak carriers.

Aircraft lessors get off lightly under the new standards. All they will be required to do is provide more detailed information on their residual value risks of the leased assets under management. Good news for the aircraft appraisers!

What really changes? Under current IAS 17 rules most professional advisers and analysts adjust the published numbers anyway. The common practise is to capitalise operating lease rentals at 7-8x (or a capitalisation rate of 12-14%) to add a nominal amount to debt and enterprise value (which is *far* too complicated a concept for the standards boards) to allow for inter-company comparisons. No doubt the common practice will change: but perhaps over time the markets will foolishly come to expect that what is presented in a set of report and accounts really represents a true a fair view of the state of a company's affairs.

Even more intriguing is what the rule changes may mean for behaviour. When it makes no difference as to which method of asset finance you pursue for reporting basis, the company's board of directors will always favour the method that creates the best returns under which they are measured. Although the availability of cash and capital will always be the deciding factor.

The IASB assumes that most companies will have a balanced portfolio of leased assets. For the cyclical airline industry, however, aircraft portfolios can change and this could well be yet another accounting standard that will increase the volatility of reported earnings.

Accountancy is an art — but the standards boards for obvious reasons do not want to believe that it is anything other than a science. As the old joke goes, a good accountant when asked what is one plus one responds "the answer is two"; a clever accountant says "I *think* the answer is two"; but the brilliant accountant in return asks "*what number did you have in mind?*".

SIA's true position flattered by fuel prices

SIA Group's results for the first three-quarters of 2015/16 were good, but they were driven largely by a 12-year low in fuel prices. With increasing competition from LCCs and full-service Asian and Gulf carriers continuing to drive down yield at the mainline, can the Group build up the LCCs in its portfolio as quickly as it needs to?

SIA's financial year runs to end March, and in the first three-quarters of 2015/16 (the nine months ending December 2015), the Group saw revenue fall by 1.4% year-on-year to S$11.5bn (US$8.3bn). However, operating profit during the period increased by 66.3% to S$528.0m (US$382.5m), with profit before tax reaching S$729.2m (US$528.3m), compared with S$386.3m in April-December 2014.

The drop in revenue was due to reduced business in cargo, mail and engineering services, but this was more than compensated for by the fall in fuel prices, which lowered Group fuel costs by a hefty S$692m (US$501m) over the nine-month period.

The majority of Group operating profit in the first three-quarters of the year derived from the mainline (S$387m, which rose 43% compared with April-December 2014), followed by SIA Engineering (S$77m, up 26%), though SilkAir saw operating profit more than double, to S$59m. All the other airlines in the Group portfolio made operating losses — SIA Cargo (S$10m), Scoot (S$4m) and Tiger Airways (S$1m) — although all but Tiger improved their position year-on-year.

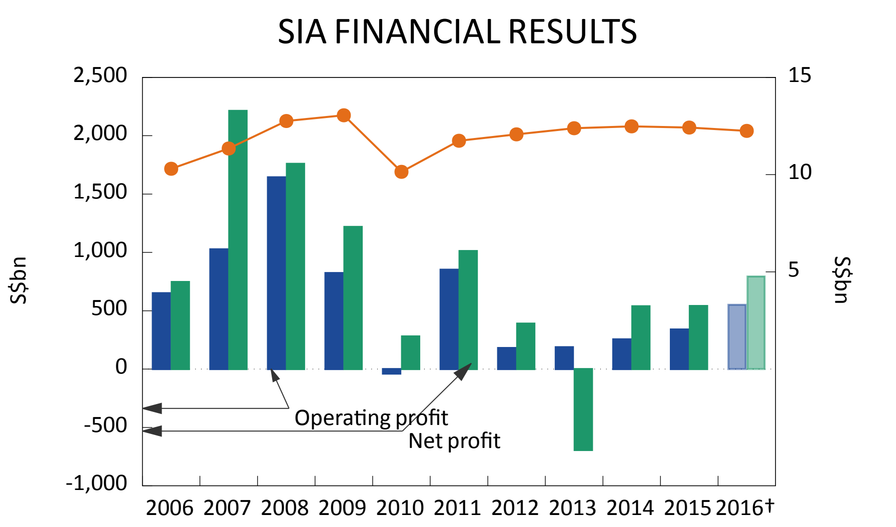
At the end of December 2015 the Group had total debt of S$1,376.4m (US$971.9m), some S$363m better than the debt figure at the end of the last financial year. On the other hand, cash and cash balances fell from S$5.3bn at end March 2015 to S$4.3bn (US$3bn) at the end of December 31.

Mainline pressure

The mainline remains the critical driver of Group performance, and as noted in our last analysis (see *Aviation Strategy*, April 2014), it is coming under increasing pressure from competitors that range from various flag-carriers (Cathay Pacific, BA, MAS etc), to the "Big Three" Gulf carriers flying east-west routes, and increasingly from Asian LCCs.

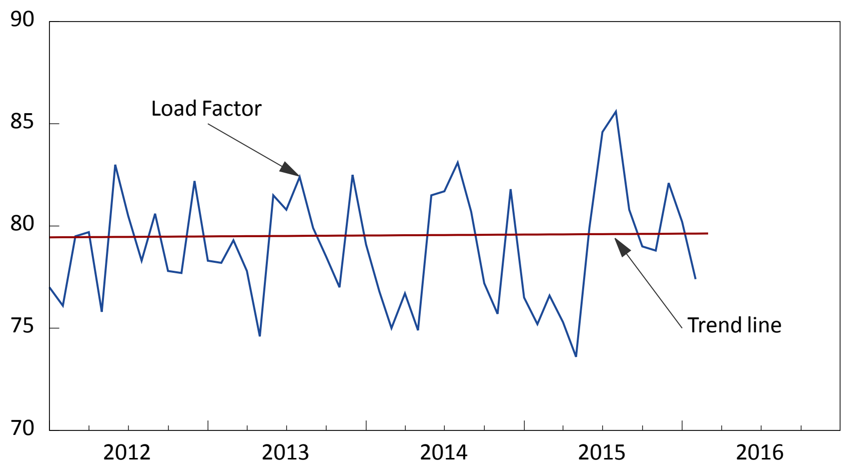
In the nine-month period to the end of 2015 the mainline reduced its ASKs by 1.7% year-on-year, and with RPKs falling by lower rate of 0.8%, the passenger load factor improved by 0.7 percentage points, to 80.0%. But as can be seen on the chart on the next page, the mainline load factor trend line has steadfastly remained flat (and under 80%) over the last four years and — critically — that unrelenting competitive pressure has resulted in mainline yield continuing to fall ever since 2010. Yield per RPK has fallen from S¢12.1 in October-December 2010 to S¢10.4 in July-September 2015, though it recovered to S¢11.0 in October-December 2015.

SIA is trying to stem the reduction in yield, and is attempting to shore up its traditional high-margin first-class and business passengers by enhancing those products/services through revamped cabins and lounges. The latest effort is the introduction of a new class — premium economy — that was launched in August last year, with US$80m being spent on introducing the product initially on 19



Note: FY end March. † Rolling twelve months to December

SIA MAINLINE LOAD FACTORS



A380s, 19 777-300ERs and the first 20 A350s. SIA's core strategy is clear: as expressed by Mak Swee Wah, EVP Commercial, it is to "hold on to our loads and our market share — and this has come at the expense of yield".

With yield falling away and without any substantial improvement in load factor, the result has been continuing erosion of unit revenue, and so much of SIA mainline's focus has been the continuing battle to cut unit costs. And that where SIA has struck lucky, thanks to the fall in fuel prices since late 2014 that has underpinned a significant cut in unit costs over the last few quarters.

Excluding the fuel effect, the situation is worrying. Even though mainline revenue fell by 5.5%, unit costs ex-fuel rose from S¢5.2 in October-December 2014 to S¢5.5 in the last three months of 2015, with costs increasing in multiple areas, from LPO — landing, parking and overflying — (up 1.6% year-on-year), to handling charges (+3.1%) to staff costs (+5.0%) to aircraft maintenance and overhaul costs (+10.8%). Part of the reason for increased costs in aircraft depreciation and lease rentals is the strengthening of the US dollar against the Singapore dollar, which has increased the S$ cost of those items.

Total unit costs at the SIA mainline fell below unit revenues in October-December 2015 for the first quarter since the same three-month period of 2011 — exactly four years ago (see chart on this page) — but it's likely that when fuel prices rise again then the mainline will plunge back into an operating loss.

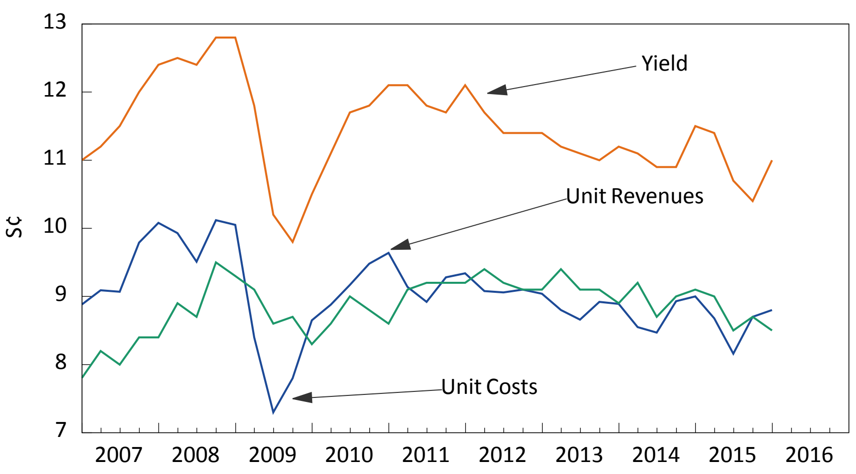
The Group is well aware of the changing fundamentals of the market, and that its traditional reliance on premium traffic as the bedrock of performance is now a liability rather than an asset. Or as Goh Choon Phong, SIA Group CEO, puts it: "To have a success formula that has enabled us to continue to be successful for more than 60 years — and to move from there to something else quite different requires quite a bit of mind-set change". He also talks about "the need for all of us to now move on and move into new models so that we can build the right foundation for the next 20 years".

The portfolio

The SIA mainline operates to more than 60 destinations globally out of its hub at Singapore with a fleet of 109, comprising 30 A330s, one A350-900, 19 A380s and 59 777s. The fleet is starting to age (it has an average age of more than seven years), and on order are 101 aircraft, including five A380s, 66 A350s, and 30 787-10 — with the last two models slated for replacement of the A330s and older 777s.

SIA is the launch customer for

SIA MAINLINE UNIT REVENUES, COSTS AND YIELD



SIA GROUP FLEET

	SIA		SilkAir		Scoot		NokScoot	Tigerair		Tigerair Taiwan
	In service	On order	In service	On order	In service	On order	In service	In service	On order	In service
747F	9									
777	59				2		3			
787		(30)			10	(10)				
A330	30									
A350	1	(66)								
A380	19	(5)								
737			14	(40)						
A319			4					2		
A320			11					22	(39)	8
Total	**118**	**(101)**	**29**	**(40)**	**12**	**(10)**	**3**	**24**	**(39)**	**8**

Source: Company Reports, Ascend

the 787-10 model, which arrive from 2018 or 2019 onwards, as well as for the A380-800, which will be delivered in 2018 and 2019.

The first A350-900 from an order for 67 of the model arrived in March this year and will be utilised on a new Amsterdam route from May with 253 seats in three classes — 42 in business, 24 in premium economy and 187 in economy. Seven of the A350s on order are the ultra-long-range variant (the -900ULR, for which SIA is the launch customer), which will arrive in 2018 and will be used to relaunch non-stop routes to New York and Los Angeles, as well as a third (as yet unnamed) US destination. The A350 could also be used on routes to Europe, where its smaller size (compared with the 777) could make more routes economically feasible.

The group's short-haul feeder airline is SilkAir, which operates a two-class service to more than 40 regional destinations with four A319s, 11 A320s and 14 737-800s (the latter configured with 12 business class and 150 economy seats). It has 37 737 MAXs and three 737-800s on order.

SIA Cargo, the Group's standalone cargo business, has eased back its fleet over the last few years in the face of tough market conditions, and today operates nine 747 freighters. SIA Cargo reduced its operating losses in the first three-quarters of the 2015/16 financial year, from S$17m to S$10m, but in the September-December 2015 period its profit fell from S$17m to S$2m thanks to a substantial overcapacity in the cargo market to/from and within Asia, which resulted in yield plunging 13.5% year-on-year.

Multiple LCCs

The SIA Group's main growth focus has been in the LCC business model, with separate airlines set up for short- and long-haul.

In the latter category is Scoot, which was launched in 2012 to operate medium- and long-haul routes from its base at Changi. Its fleet of 10 787s and two 777-200ERs fly to 17 destinations in China (six), Australia (four), Japan (two), Taiwan (two), plus Hong Kong, Seoul and Bangkok.

Another destination will be added in May with the launch of a service from Singapore to Jeddah, taking over a route currently operated by the mainline SIA with A330-300s. Scoot's first route in the Middle East will use larger capacity 787-8s, and the airline plans to gradually increase frequency from the three-times-a-week operated by SIA. The transfer of service from the mainline to Scoot may be a sign of things to come, with routes that are marginally profitable under mainline operation presumably becoming more profitable when operated by a LCC.

The first aircraft from an order for 20 787s (initially placed by the SIA Group, but now allocated to Scoot) arrived at the LCC in January 2015, and they are replacing an initial fleet of 777s borrowed from SIA. 10 aircraft have now been delivered, with six 787-8s and four 787-9s still to come.

In the nine months ending December 31st 2015 Scoot recorded a S$4m operating loss, although in the September-December quarter it posted its best quarterly operating result ever — an S$18m profit — thanks to "continued expansion and deployment of a more fuel-efficient 787 fleet". However, as with the mainline SIA operation, Scoot is coming under fierce competitive pressure, and yield plunged 6.7%

year-on-year in the quarter.

The main competitor on medium- and long-haul LCC routes is AirAsia X, which currently operates 20 A330-300s from its Kuala Lumpur base to 19 destinations across Asia and the Middle East within a four- to eight-hour flying time (see *Aviation Strategy*, February 2016). But AirAsia X will provide even more competition once it receives the 76 aircraft it has on outstanding order, comprising 66 A330-900neos and 10 A350-900s.

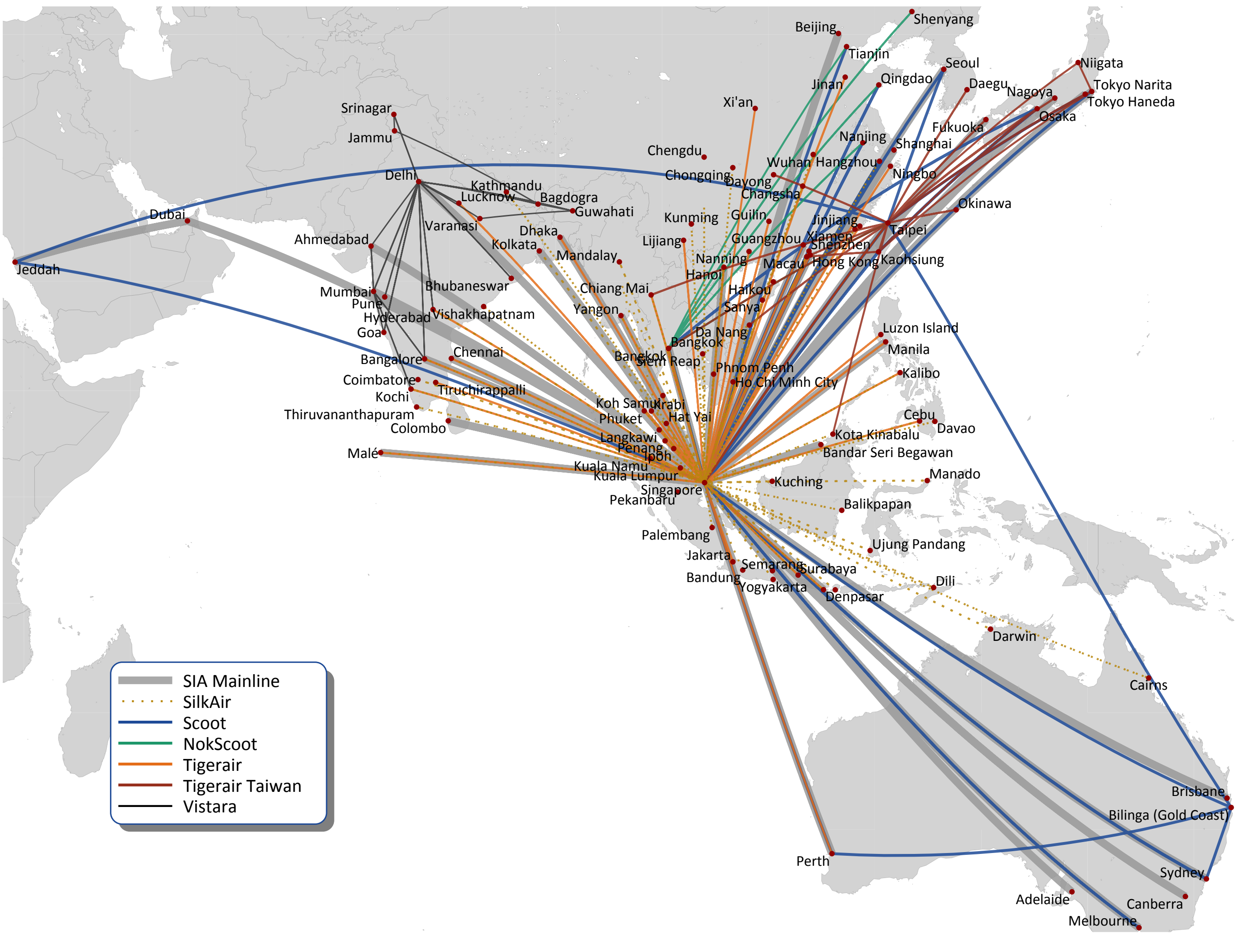
Despite (or because of) the growing competitive threat, Scoot is pushing into new territories — Thailand-based LCC NokScoot is a joint venture between Scoot (which owns 49%) and the LCC offshoot of Thai Airways International, Nok Air (51%). Based at Don Mueang international airport in Bangkok, it launched in May last year and operates three 777-200ERs on six medium- and long-haul routes to China, Taipei and Japan in a two-class configuration — "ScootBiz" and economy.

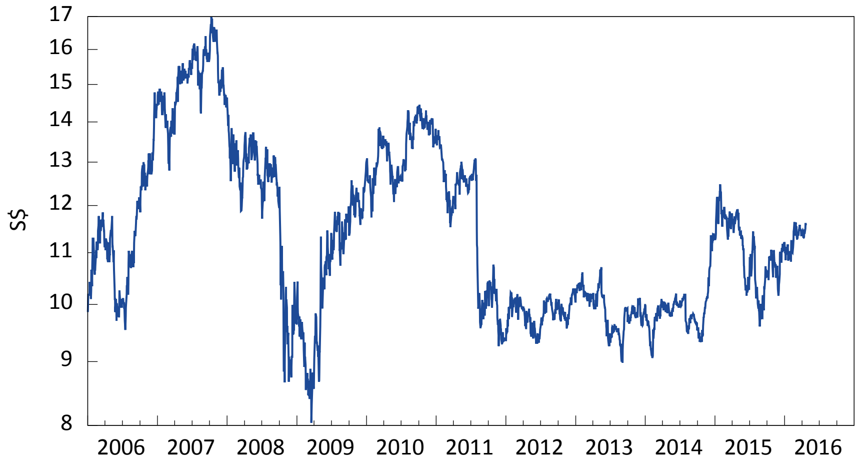
Scope for merger?

The SIA Group now owns more than 90% of LCC Tiger Airways Holdings (and which it plans to delist) after it made an initial offer for the shares it didn't own (44.2%) in November 2015 at S$0.41 per share (at a time when the market price was S$0.31), thereafter improving its offer to S$0.45 in January.

The main asset of the holding company is Tigerair, which operates 25 A319s and A320s out of Changi to almost 40 destinations in Asia (within a five-hour flying time), with a single class. It also has 39 A320neos on order. Tiger Airways Holdings also owns 10% of Tigerair Taiwan, with China Airlines owning 80% and Mandarin Airlines 10%. Based at Taoyuan

SIA GROUP ASIA/PACIFIC ROUTE NETWORKS





SIA SHARE PRICE PERFORMANCE

airport near Taipei, the airline was launched in September 2014 and operates eight A320s to 12 destinations in Asia.

From SIA's point of view, the rationale for the full Tiger acquisition is to "harness full synergies to benefit the SIA Group and the Singapore hub", although it also argued that as an independent airline Tiger lacked the scale and network necessary to compete in the LCC market.

With Tiger under full ownership, the obvious next step would be to merge the carrier with Scoot, and though SIA says that "at the moment these two companies will be operated in parallel", in the long-term such a move is inevitable. Not least because the SIA group portfolio is becoming unwieldy (for example all four of the mainline, SilkAir, Scoot and Tiger operate to some markets — such as China).

The SIA Group also has other airline investments; in January 2015 it launched Vistara, a full-service Indian joint venture (in which it owns 49%) with Tata Sons, part of the Tata Group — the giant Indian conglomerate. Though two previous attempts by SIA and Tata to start an airline in India had come to nothing, this effort appears to be more successful.

Based at Delhi's Indira Gandhi airport, Vistara operates nine A320s domestically in a two-class configuration (with 36 premium economy seats — becoming the first airline to introduce the class domestically — and 96 in economy) to 15 domestic destinations, including three that launched in April — Jammu, Srinigar and Cochin. Four more A320ceos will come in on lease this year, and the medium-term plan is to increase the fleet to 20 aircraft by 2018.

The airline has been a success (it carried 1m+ passengers in its first year of operation) but is hampered by the Indian state's so-called 5-20 rule, where new carriers have to operate domestically for five years and have a fleet of at least 20 aircraft before being allowed to fly internationally. Strenuous efforts continue at multiple aviation and political levels to overturn this regulation, and once it is the SIA Group will move quickly to expand Vistara, enabling India to become a major source market for the SIA Group for passengers travelling west into the Middle East and Europe, and east into Asia.

SIA Group also owns 23.1% of Virgin Australia, which operates 124 aircraft to 50 destinations domestically and within Asia with a two-class service. This March SIA and the other major shareholders (Air New Zealand, Etihad Airways and the Virgin Group) had to loan the airline a combined US$324m (on a 12-month term) in order to bolster its stretched balance sheet, and there is speculation from some analysts that SIA may be interested in acquiring ANZ's 25.9% stake, which the latter wants to sell.

LCC or bust?

As can be seen in the graph on the current page, SIA's share price has been sliding since late 2010, and a rally in the first-half of 2015 petered out by the summer although the price has recovered following good results for October-December 2015. However, to some extent the SIA Group can ignore short-term fluctuations in its share price given that Temasek Holdings — the Singaporean state holding company — owns 56.5% of equity.

Other shareholders, however, may be less patient, particularly if the mainline unit revenues/cost gap turn substantially negative when oil prices start to rise. At that point, much will depend on how well diversified the SIA Group is — and most particularly how much revenue and profit is being driven by the LCCs in the portfolio.

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