

THY: Superconnecting and geopolitical risk

THE CENTRE of European aviation gravity has been moving eastwards to Istanbul where THY Turkish Airlines has a clear mission — to establish itself as a leading global superconnector, deploying a unique narrowbody-focused connecting strategy, bypassing Europe's major flag carriers in the process (see *Aviation Strategy*, March 2014). Although economic conditions remain resilient, with 4.5% real GDP growth expected for this year, the country and the airline are being directly impacted by what THY describes as “geopolitical risks and security concerns”.

THY's first quarter results were poor, the worst quarterly performance since the airline embarked on its dynamic expansion ten years ago. Foreign arrivals in Turkey have been in decline since the middle of 2015, with THY noting extensive group cancellations from Europe, Russia, Japan and China. Nevertheless, continuing capacity expansion and strong growth in connecting passengers pushed traffic numbers up by 10% and ASKs by 19% between the first quarter of 2016 and the same period in 2015. Load factor fell to 74.0% from 76.9%. RASK slumped by 16.6% (11.7% if the effect of the depreciating Lira is excluded). CASK disturbingly went in the opposite direction — the reported unit cost did fall by 8.1% but, if currency effects and fuel decrease impact are factored in, CASK would have risen by 8.3%.

In summary, total revenue fell by 1% to \$2.19bn and the net operating result was a loss of \$280m compared to a loss of just \$35m in Q1 2015. Net income was a loss of \$421m against a profit of \$153m in 2015. THY appears to regard this quarter as an outlier rather than reflecting a fundamental

change in its fortunes, pointing out that, as well as the tourism disruption impact, maintenance costs were exceptionally high in the early part of 2016.

This year THY might benefit from a side-effect of the Middle East wars. An agreement between the EU and Turkey, which hadn't been finalised by late May, would extend visa-free travel, for up to one year, for all Turkish citizens to, from and within the Schengen area, in return for Turkey stemming the flow of refugees across its borders. The EU is also asking for

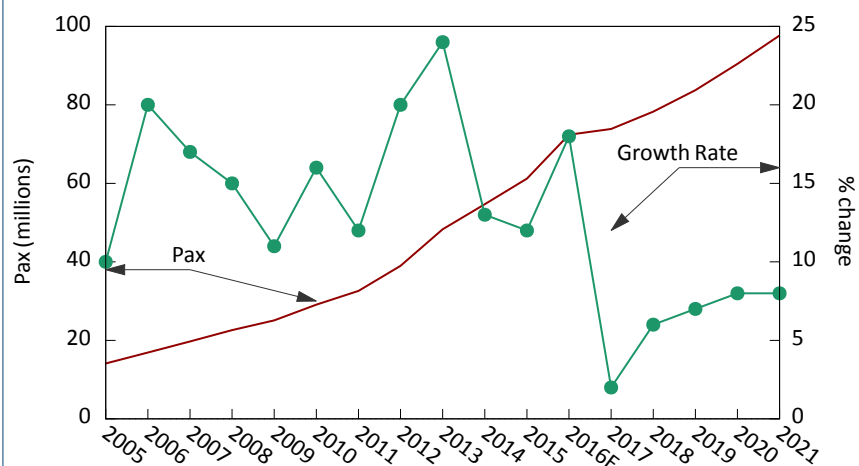
a series of reforms to civil rights in Turkey to reverse what it sees as a move towards authoritarianism under President Erdogan, and it is this issue which is holding up the conclusion of the travel agreement.

There is no chance in the foreseeable future that Turkey, although it is an official candidate for member-

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THY: HISTORIC AND PROJECTED GROWTH



Aviation Strategy

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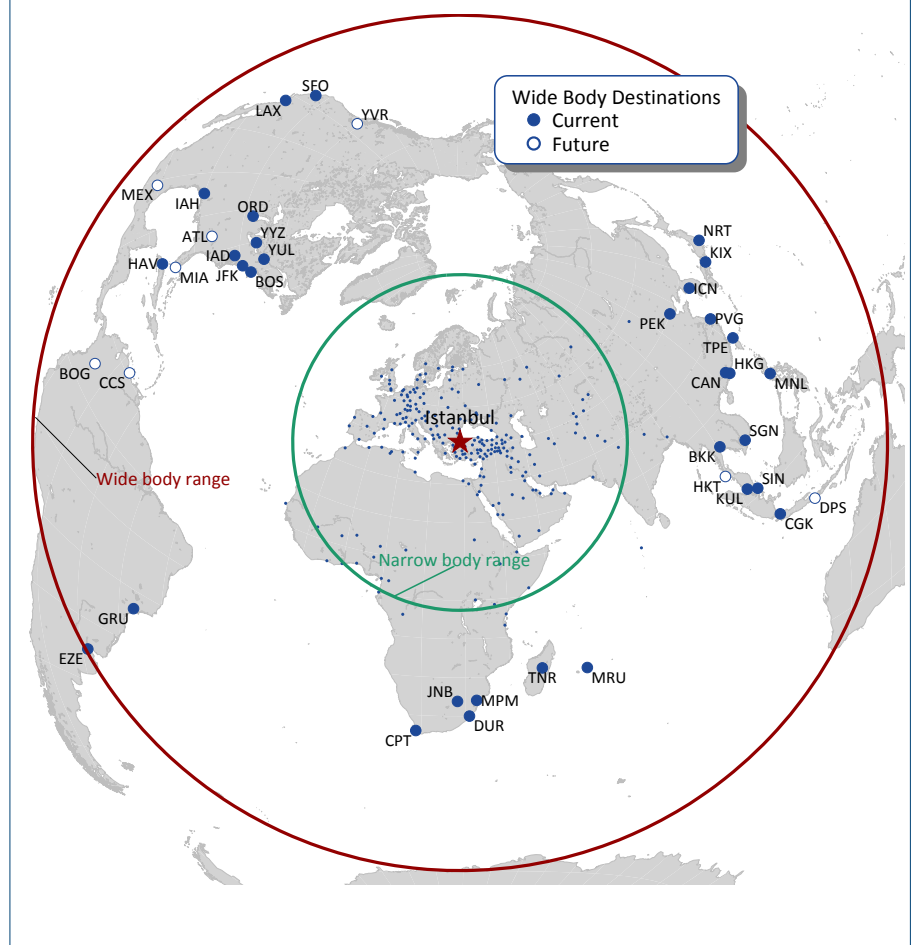
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THY: ISTANBUL'S NATURAL ADVANTAGE



ship, will become an EU state, but the EU proposed last December that, as part of an overall convergence programme, Turkey and the EU should move rapidly to a “wide ranging aviation agreement”, ie open skies. Turkey is, after the US, the most important aviation market for the EU, with about 40m passengers a year.

The proposed agreement would replace the current system of horizontal EU bilaterals, which permit EU carriers to fly to/from any EU state to Turkey, but which excludes EU carriers from the substantial Turkish domestic market (54m passengers). The combination of the new visa regime and open skies would boost THY's core business, but the potential ex-

pansion of European LCCs into the Turkish market also poses a threat to THY. Perhaps the greater threat would be Pegasus Airlines (see *Aviation Strategy*, November 2015) — the LCC explains its recent high but unprofitable expansion partly as a strategy to establish greater market presence before the likes of Ryanair and easyJet arrive on a large scale.

2016 will see THY increase its seat capacity by a net 16%, with the delivery of 11 widebodies, A330-300s and 777-300ERs, and 30 narrowbodies, 737-800s and A321s. The airline projects an increase of 18% in passengers to 72.4m this year.

Revenues for the year are predicted by THY to grow by 16% to

THY FLEET PLAN

	year end	2015	2016	2017	2018	2019	2020	2021	2022
Widebodies	A330-200	20	20	18	18	16	13	13	8
	A330-300	26	31	31	31	31	31	31	31
	A340	4	4	4	4	4	4	4	4
	777-300ER	23	32	35	35	34	32	32	32
	Total	73	87	88	88	85	80	80	75
Narrowbodies	737-900ER	15	15	15	15	15	15	15	15
	737-9MAX					5	10	10	10
	737-800	92	112	110	99	96	88	86	82
	737-700	4	1	1	1	1			
	737-8MAX				20	30	55	65	65
	A321 neo				14	39	61	86	92
	A319	14	14	11	9	8	6	6	6
	A320	29	29	22	19	12	12	12	12
	A321	56	66	68	68	68	66	64	64
	E195	6	3						
	Total	216	240	227	245	274	313	344	346
Cargo	A330F	6	8	9	9	9	9	9	9
	Wet Lease	4	4						
	Total	10	12	9	9	9	9	9	9
TOTAL		299	339	324	342	368	402	433	430

\$12.2bn. which seems a little optimistic given the recent downward trend in unit revenues. Concerned also by unit cost trends, the Istanbul-based airline analyst at HSBC is forecasting an 8% rise in 2016 revenues to \$11.36bn, a fall in operating profit of 8% to \$95m and a 30% reduction in net profit to \$745m.

THY is continuing to expand beyond its unique narrowbody connecting market (see map on the facing page) into its widebody market which from its Istanbul hub covers most of the planet. The Americas is the main focus, with new routes starting or planned to Vancouver, Atlanta, Mexico City, Havana, Bogota and Caracas. The risk is more direct competition with the three Middle East superconnectors.

On the other hand, THY is a growing threat to the European network carriers, especially Lufthansa, siphon-

ing off intercontinental connecting traffic to its lower cost hub operation and also attacking local feed traffic to the Euro-hubs by its innovative 737 connecting strategy, bringing intercontinental service to myriad secondary city pairs.

Even with a planned sharp reduction in growth post-2016 THY is on target to meet two psychologically significant targets — surpassing Lufthansa Passenger Airline in terms of traffic in 2019 and reaching 100m passengers by around 2021.

This, however, depends on the new Istanbul airport opening in early 2018, as currently scheduled. Initially the airport, yet to be named, will have three runways and a terminal capacity of 90m passengers. By 2028 capacity will have been extended to 150m passengers. The government has announced that commercial operations will be run down and closed at Atatürk

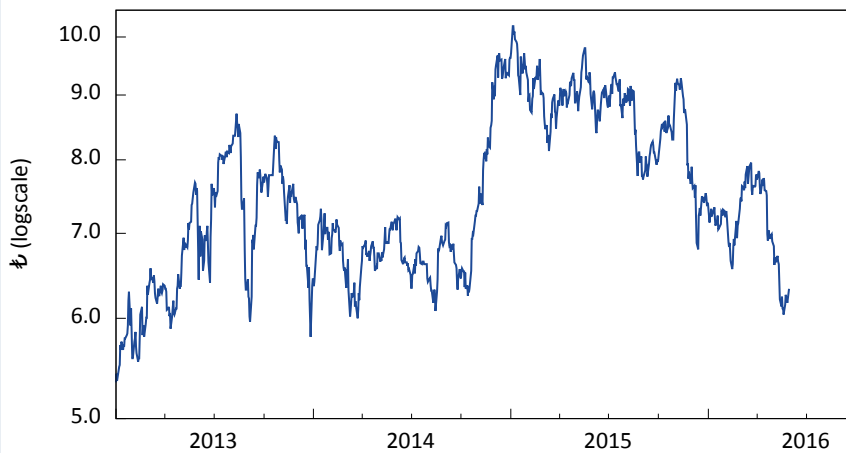
airport, although the timing is unclear.

THY's fleet plan (see table on the current page) reveals a marked change in growth strategy. For the five years from 2016 THY's seat capacity growth will be around 5% pa in contrast to 15% pa for the ten years to 2016. The airline officially is not planning for any increase in its widebody fleet. This makes THY an enticing target for both Boeing and Airbus but, based on past ordering policy, THY, if or rather when it decides on long-haul expansion, is likely to select both 787s and A350s. There is regular speculation about THY opting for new or second-hand A380s, but it is very difficult to see how this type could fit into its network.

The narrowbody fleet is planned to grow by a net 20-30 units a year after 2017, with 737MAXs and A321neos systematically replacing

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THY SHARE PRICE PERFORMANCE



the conventional types in THY's fleet. Again this is fairly modest growth by historic standards.

THY, although growing at roughly twice the rate of the Euro-majors, is entering a period of relative consolidation. It is focusing on a number of KPIs with the aim of at least maintaining its current cost advantage — with a slightly lower average stage

length, THY estimates its unit costs to be about 30% below those of the Euro-majors and 10% below the average of the superconnectors but at a much shorter stage length.

✈ With fixed costs representing 29% of total costs, increasing aircraft utilisation by 10%, roughly the efficiency gain it achieved during

2010-15, will reduce CASK by 3%.

✈ There is significant potential for pushing up load factors. On short haul, THY's load factor in 2015 was 83.5%, up from 76.7% in 2010, but still some points below the LCC standard. On long haul the load factor was 77.1%, again below the levels being attained by European and US network carriers.

✈ RASK is about 8.1 US¢ at present compared to 11¢ for the Euro-majors; THY sees the potential of increasing its unit revenue to 9¢. Winning more business class passengers — currently only about 4% of the total — is the challenge.

Finally, there is the perennial question of a deep alliance with Lufthansa, the last attempt at which ended a bit acrimoniously in 2013. THY may feel that it doesn't need Lufthansa on purely commercial rationale but there is now a wider geopolitical consideration.

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Air Traffic Control: Chances of Reform?

AIRLINES, airports and air traffic control companies were once overwhelmingly owned and centrally controlled by governments. Airlines (and increasingly airports) have long since moved on, with the majority now in private ownership, having experienced both deregulation, substantial cost cutting and efficiency improvements. For air traffic management, on the other hand, while there have been technological advances, the changes in ownership structures and the increase in competitive pressures have been far more modest. Is this about to change? Don't hold your breath.

Before considering the global trends behind this statement, it is important to differentiate between the two sub-sectors of the ATM industry: towers and en-route. Often, though not always, they are provided by the same company, and they differ in particular in that there does seem to be at least some movement towards more competition in tower services. In the UK, for example, the market is deregulated and while most airports employ NATS, some use an alternative supplier or provide their own ATM. The second largest tower contract in the UK, that for Gatwick Airport, was recently transferred from NATS to DFS of Germany.

Similarly, faced with extremely high salary levels and inefficiencies, together with the country's general economic situation, Spain contracted out the provision of tower services at several of its secondary airports. Ten of the contracts were awarded to a consortium of NATS and the Spanish com-

pany Ferrovial. The UK outsourcing company Serco won the remaining three contracts. In Germany the Austrian ANSP Austro Control handles air traffic services at several smaller airports. Even in the United States the FAA has outsourced a significant number of smaller tower operations, apparently with little if any opposition from other stakeholders. (This contrasts markedly with the reaction of some to reform of the FAA's en-route services).

This trend for more contracting out, and therefore increased competition, in the provision of tower services is likely to continue, probably aided by the development of "virtual" towers at smaller, more remote airports.

En-route ATM, however, is quite a different matter. A very small number of countries have brought in external expertise to run their air traffic control, often those faced with rapid

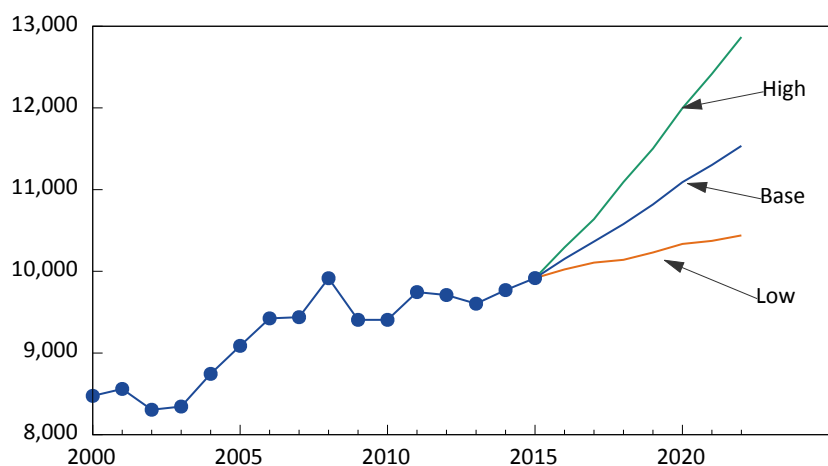
This is the first of a two-part examination of air traffic control reform around the world.

Part 2 will feature in the next issue of Aviation Strategy.

increases in demand and very limited local ATC expertise, such as the Gulf States. But overwhelmingly governments guard the sovereignty of their airspace ferociously, with the result that the vast majority of countries, no matter how small, retain control over ATM provision. It is certainly true that the separation of ATM companies from direct ministerial control is now common, but the companies involved still tend to be State enterprises.

The monopoly positions and public sector employment practices (including pensions) of ATM companies make achieving efficiencies

EUROPE: IFR FLIGHT FORECAST



Source: Eurocontrol STATFOR Feb 2016

and meeting customer needs all the more challenging. Cost pass-through practices reduce the pressure to reform and often mean ATC prices increase significantly when air services demand is weakest, such as in 2001/02 and 2008/09, just when the profitability of their airline customers is under particular pressure. It is not difficult to see why relations between airlines and ATC companies are often strained, even without the controller strikes that have become all too common in Europe.

NATS

Two countries in particular have broken out of this rigid model, the UK (NATS) and Canada (Nav Canada). Their objectives were similar, but the solutions they came up with differed in several important respects. In the UK, the Labour party strongly opposed privatisation of NATS in any form when in opposition. ("Our skies are not for sale".) However, when elected to form a government in 1997, Labour quickly proceeded to sell off 51% of the company by

means of a so-called Public Private Partnership (PPP) initiative. It chose a complex governance structure with the objective of at least reducing the opposition to the sale from various interests, not least the unions and the left wing of the Labour Party, while at the same time maximising the financial proceeds for the Treasury.

5% of NATS' shares were given to the staff at no charge, with 46% made available to the private sector. However, this 46% brought with it the role of "Strategic Partner", effectively giving the minority shareholder control of the company, subject only to certain powers reserved for the State. Three serious bidders were in the running, Serco, Lockheed Martin and a consortium of seven UK airlines known as The Airline Group. It was The Airline Group, politically the least contentious bidder, which emerged as the winner.

The fact that seven airlines put aside their intense competitive instincts to co-operate in this way is indicative of how critical air traffic control is for their operations. Considerable attention is often paid to ATC charges, which are certainly a significant cost item for airlines, but in fact the avoidance of delays and reduction in flight times which flows from an efficient ATC system is far more important for most carriers. At the time of the privatisation, NATS, like almost all ATC companies, had a poor reputation for meeting customers' needs, with airlines experiencing major delays to their flights on a regular basis and investment projects failing to be delivered on time and budget.

This and the feeling that the other bidders were less likely to address the company's fundamental problems in a way that would satisfy airlines' needs, led to the creation of The Airline Group and eventually to

the successful bid. It was a reflection of the group's priorities, and of the expectation that the investment would not produce early profits, that the bid was promoted as "not for commercial return", subsequently often misquoted as "not for profit", which was not the objective. Profits would (hopefully) come, but the main challenge was to turn NATS into an efficient ATC provider meeting its customers' requirements. To this end, several airline employees were seconded for a period to the ANSP.

The Airline Group bid, which was higher than its two competitors, involved a highly geared investment. It may well have worked, with NATS' borrowing being reduced gradually as the effects of the new investment programme worked through, except for one event — 9/11. The dramatic reduction in traffic, especially across the Atlantic, put considerable pressure on NATS' finances shortly after the completion of the PPP in 2001. It proved necessary to refinance the company. The Government provided additional finance and a new investor was introduced, the airport operator BAA (now Heathrow Airport Ltd) with a 4% stake. The Airline Group's shareholding was reduced from 46% to 42%, but its Strategic Partnership role, and accompanying governance powers, were largely unaffected.

So, apart from the initial financial problems, which arguably could not have been foreseen, has the privatisation been a success? The answer is almost certainly a yes. Despite claims to the contrary at the time, safety has not been impaired; indeed it has improved. Flight delays have been reduced substantially and project delivery standards raised to those common in the private sector. Industrial relations have been good and financial performance excellent.

NATS FINANCIAL RESULTS

Year ending March (£m)	2015	2014
NATS Airspace	716	720
NATS Airports	177	170
NATS Engineering	17	13
Other	13	14
Total Revenues	922	918
Salaries	404	419
Depreciation	110	108
Other	156	151
Costs	670	677
Operating profit	253	240
Net finance costs	28	28
Fair value adjustments	2	18
Pretax profit	227	230
Tax	45	38
Net profit	181	193

The main negative aspect is probably the fact that NATS remains, largely as a result of high employment costs, one of the most expensive ATC companies in Europe, despite quinquennial price reviews by the Civil Aviation Authority. More recent regulatory intervention by the European Commission, however, is likely to increase the pressure to reduce costs.

Although the seven airlines which formed The Airline Group were initially focussed primarily on improving the service provided by NATS rather than financial returns, after a few years their investment in fact proved to be quite profitable, probably more so than running airlines. However, reorganisation among the group, such as bmi's shares being acquired by Lufthansa and ownership changes and mergers with respect to Thomas Cook and Tui, eventually led to four of the founding carriers (Tui, Thomas Cook, Lufthansa and Virgin Atlantic) deciding to sell most of their shares to

USS, a pension fund. This left British Airways, easyJet and the Monarch Airlines Pension Fund (which had acquired the airline's stake in The Airline Group some time previously), together with the four selling carriers which retained small stakes, owning 51% of the company. The Airline Group's 42% ownership of NATS and its Strategic Partnership role remained unaffected.

In 2015, the Government announced its intention to sell its 49% shareholding in NATS, but it remains to be seen whether this will in fact prove to be feasible. A previous attempt to sell down the stake got nowhere. The complexity of the governance procedures introduced at the time of the initial PPP have created difficulties which, while not insurmountable, are certainly a challenge.

Nav Canada

NATS was not the first ATC company to be privatised. That honour goes to Nav Canada, established as a private company in May 1995, and formally taking responsibility for the provision of ATC services on 31 October 1996. It controls an enormous airspace stretching from the Pacific West coast of Canada to the East coast of Newfoundland and on to the centre of the North Atlantic. It describes itself as representing "a unique consensus among the company's four founding groups: commercial air carriers, the Government of Canada, business and general aviation, and our employees, represented by their unions." A Board of 15 Directors, all Canadian citizens, consists of four elected by the airlines, one elected by the Canadian Business Aviation Association, three appointed by the Government, two representing the unions and four independent Directors elected by

the other 10 members, plus a Chief Executive Officer appointed by the Board.

This governance structure of the Board is important because it is designed to minimise the opportunity for any one stakeholder group to exert excessive influence. In addition, Board members are not permitted to be active employees of airlines, unions or government. There is, however, a 20-member Advisory Committee of aviation professionals which analyses and reviews issues facing the company and makes recommendations to the Board. It is perhaps an indication of the stakeholder consensus approach adopted from the beginning in establishing the governance principles for Nav Canada that its first Chief Executive, John Crichton, who went on to serve for 20 years, came from the Air Transport Association of Canada.

Clearly Nav Canada is not a normal commercial company. It was established by an Act of Parliament as a "non-share capital corporation", financed by means of publicly-traded debt, currently amounting to some C\$2bn (US\$1.5bn/£1bn). The Canadian Government initially received C\$1.5bn as compensation for the assets transferred to the new company. By law Nav Canada is not allowed to set its service charges "at a level exceeding what is required to meet the cost of providing civil air navigation services." The previous ticket tax approach to funding was replaced by charges levied directly on the users of ATC services, with airline rates depending on the weight of aircraft and distance travelled as is the case in most countries and general aviation operators paying a fixed annual fee.

The reasons for establishing Nav Canada were similar in a number of ways to those behind the UK Gov-

NAV CANADA FINANCIAL RESULTS

Year ending August (C\$m)	2015	2014
Enroute	679	641
Terminal	476	464
Daily/annual/quarterly	78	75
North Atlantic	47	46
Other	52	46
Total revenues	1,332	1,272
Salaries	858	817
Depreciation	136	137
Other	238	226
Costs	1,232	1,180
Operating profit	100	92
Net finance costs	102	104
Rate stabilisation	2	12
Pretax profit	-	-
Tax	-	-
Net profit	-	-

ernment's decision to privatise NATS. It had a good safety record and respected operational staff. But its infrastructure was in desperate need of modernisation and flight delays and costs were seen as far too high. Government investment restrictions and wage freezes were affecting the company's ability to reform and move forward. There was also concern about having the service provider and regulator as part of the same organisation, contrary to the trend found in many other countries.

Airlines were particularly vocal in their demands that something had to be done. As the current Nav Canada Chief Executive, Neil Wilson, has said: "We had general dissatisfaction from everybody. We had a safe system, but it was not a system that was delivering all that it could." The option eventually chosen by the Canadian Government was certainly radical, and presumably not without its risks. In the event it has proved to be a great success.

John Crichton has cited six critical achievements which have contributed to that success:

- ✈ Safety, especially halving the loss of separation rate.
- ✈ World-leading technology, reflecting a C\$2bn investment in modernisation.
- ✈ People, with a constructive and productive labour relations climate.
- ✈ Fiscal strength, in particular maintaining an AA credit rating
- ✈ Focus on customer service, mainly as a result of reduced delays and lower charges.
- ✈ Space-based ADS-B, a new joint venture with Iridium Communications, ENAV, the Irish ANSP and Navair to be introduced into service in 2018, designed to maintain Nav Canada's leading technical position.

As we will see later, this success has often been compared with the FAA's record in the United States. Writing in *Forbes.com* in February of this year, Dan Reed highlighted the differences, and didn't mince his words: "By removing the air traffic control function from the clutches of government budget restraints and politically-driven appropriators, Nav Canada has been able to rapidly upgrade its technologies and practices and to implement those with considerable success. Meanwhile, the FAA has become the laughing-stock of the global air transportation management world for its chronic false starts, delays, missed deadlines, and misunderstandings of what's actually needed or possible in terms of air traffic control modernisation." Another journalist, Scott McCartney, writing in the *Wall Street Journal*, has described flying over the US-Canada border as like time travel for pilots. "Going north to south, you leave a modern air traffic control system run by a company and enter one run by the government struggling to catch up."

Rest of the World

When the UK Government partly privatised NATS in 2001, many involved expected the new company to act as a model for other countries, just as the UK's early privatisation of other State industries had been followed, to a greater or lesser extent, by many other governments. This has not, however, proved to be the case. The only exception, and even this is far from certain, is the proposed sale of ENAV in Italy. Similarly, while Nav Canada has attracted considerable interest in the US, so far there has been no duplication. There are a number of explanations for this lack of action. Pressure to

"do something" is certainly building up throughout the world, but the obstacles to progress should not be underestimated.

This is particularly the case in the Far East, for example. Depending on how Asia/Pacific is defined, there are over 40 ANSPs in the region, almost all nationally based. Khaw Boon Wan, Singapore Infrastructure and Transport Minister, has commented that the potential of the ASEAN Single Aviation Market, which came into effect early in 2015, is being stifled by poor co-ordination between air navigation service providers in South East Asia. "We need our airspace to be better integrated so air traffic can be more efficiently managed and safety enhanced." He went on to call for "one market, one seamless airspace" among ASEAN countries. "Governments are the key players in airspace integration."

Therein lies the problem, of course. As Tom Ballantyne has commented, if there is one issue that more than anything unites airlines, ANSPs and airports in Asia/Pacific it is the belief that the region's governments are not moving fast enough to address the damage the increasingly crowded skies is doing to their businesses. But the fact remains that integration and consolidation, to be effective, to save costs and to improve efficiency, almost inevitably mean closing ATC centres. Not surprisingly governments shy away from announcing that high skilled, well paid jobs are to be abolished and the work handled by employees of foreign ANSPs, especially since there are likely to be few actual cost savings for the governments themselves apart from probably modest initial sale proceeds. This is despite the fact that there are very real economic benefits from ATC reform for the

countries involved which have been repeatedly identified.

In the Middle East, for example, airspace is similarly highly fragmented, made worse by the impact of regional conflicts which result in traffic disruption from airspace closure. According to a report produced by Oxford Economics and commissioned by the UK's NATS, if nothing is done the Gulf Co-Operation Council States (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) together with Iraq and Iran will lose some \$16bn in economic benefits by 2025 as a result of increased delays to passengers and airlines.

Speaking last October at the IATA Middle East Aviation Day conference in Abu Dhabi, IATA's Director General and Chief Executive Tony Tyler noted: "The enormous success that aviation has enjoyed in much of the region has created challenges that will require co-operation and visionary planning to overcome. In some ways the region is in danger of becoming a victim of its own success... The challenge is to increase the overall efficiency of the ATM system of the region through improved airspace design and organisation... The need for action is urgent and strong political will is required." *Co-operation, visionary planning and strong political will* have, unfortunately, all been notable by their absence so far in the ATM field, especially among governments.

Europe is just as complicated, with a highly fragmented, expensive and politically dominated airspace. The Internal Aviation Market may have existed for several decades, but there is very little sign of consolidation among European ANSPs. A study recently published by IATA highlights what is at stake. European ATM modernisation/reform would,

it is claimed, result in the creation of one million additional jobs and boost the European economy by some \$245bn by 2035. Currently average flights in Europe are nearly 50 kms longer than they need be and delays average some ten minutes per flight.

Single European Skies

To address this problem Europe has an ambitious technical/organisational solution, the Single European Skies initiative, including the Single European Sky ATM Research project, or SESAR, with the objective of delivering a threefold increase in capacity, improved safety by a factor of ten, reduced environmental impact of 10% per flight and 50% lower costs. Unfortunately, as Tony Tyler has pointed out, these goals are not being achieved. "Despite a strong

European Commission vision and push for SES, national interests have prevailed." The ambitious SESAR technical initiative is running way behind schedule and over budget and faces major challenges. As Michiel van Dorst, KLM's EVP Flight Operations and Deputy COO, has said: "There has been a lot of talking and not much action. We have become a bit cynical and disappointed about the progress of SES."

The introduction of Functional Airspace Blocks, or FABS, is a start towards consolidation, but a very tentative one with limited objectives. Nine have been proposed, but only two (UK-Ireland and Denmark-Sweden) have been implemented (see map on this page). In fact some believe FABS may even be a step backwards in certain respects. For example, Mark Deacon of Monarch

SINGLE EUROPEAN SKIES: PROPOSED FABS



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Airlines and a long-serving representative of the International Air Carrier Association on ATC matters has argued that they have “actually increased fragmentation of the network by protecting States and ANSPs within another line of defence. For those of us longing for a Single European Sky, the FAB empires appear to be the biggest blocker of all.”

Jan Klas and Lubos Hinovsky of Air Navigation Services of the Czech Republic similarly question the value of FABs, noting that there is no doubt that their current development cannot meet the high expectations of both airspace users and the European institutions, although they argue that it would be a mistake to abandon the concept altogether. They go on to comment: “Unfortunately there is a hopeless lack of shared vision in the European air traffic management industry... [The] consequences are a poorly communicated political vision; inconsistent stakeholder requirements; contradictory regulations; inefficient and inaccurate business planning across the ATM industry; outcomes opposite to expectations of the airline users; and a rigid environment preventing better use of state of the art technology.” Presumably apart from that, everything else is rosy!

The industrial relations problems experienced by several ATC providers in Europe illustrate the scale of the underlying issues. The one-day strike by French controllers in late-May was the *sixth* in five months, the *47th* in seven years. (More strikes are already in the pipeline, so by the time you read this these numbers will almost certainly have been exceeded.) And this is not just a French problem. Similar strikes have occurred recently in Greece, Italy, Belgium and Iceland. It is perhaps hardly surprising that a

growing number of airlines, led by the new lobbying group Airlines for Europe, are calling for such strikes to be banned, or at least for ways to be found to mitigate their effects, such as allowing other ANSPs to take over strikebound airspace. The financial impact on airlines from grounded aircraft and longer flying times is considerable, now exacerbated by the need to compensate passengers for delays under EU Regulation 261. All European ANSPs are protected from being sued by airlines or passengers for delays caused by strikes.

Perhaps the nadir of European ATM industrial relations came with the strike by Belgian controllers in April, shortly after the Brussels Airport terrorist attack. For once putting diplomatic language to one side, and reflecting the anger increasingly felt by ANSPs’ customers, IATA called the action “a kick in the teeth for all the airlines and airport staff who have worked so hard to reconnect Brussels to the world after the appalling terrorist attack just three weeks ago. It is the height of irresponsibility ... If we cannot count on simple human decency from such highly-compensated professionals then it’s time for governments to find ways to guarantee the availability of air traffic control services.”

The job of an air traffic controller is certainly challenging, requiring a high level of technical competence and several years of training. However, as IATA points out, controllers are almost invariably highly compensated and it is difficult to believe their working conditions are such as to justify the level of disruption seen recently in Europe. The underlying problems are more likely to be structural, and therefore unfortunately all the more difficult to solve given their political dimension.

Some among the European ATM leaders do have a vision of a reformed future. Klaus-Dieter Scheurle, CEO and Chairman of DFS, the German ANSP, and former State Secretary at the German Federal Ministry of Transport, Building and Urban Development, recently wrote, for example: “My vision is that, within the regulatory framework, the air navigation services sector will be consolidated and free-market conditions will determine success ANSPs will co-operate and at the same time offer and purchase services from each other as required. Only a few of the privatised enterprises will be able to provide the complete value chain of air navigation services. National borders will no longer determine the route network or service provision throughout Europe.” That may be Herr Scheurle’s vision, but unfortunately so far there is precious little sign of it being implemented.

Dr Barry Humphreys
Aviation consultant.

Dr Humphreys was a Director of Virgin Atlantic Airways, served two terms as Chairman of the British Air Transport Association, the trade body for UK airlines, and spent several years as a Director of NATS.

Cebu Pacific: Hitting growth constraints at Manila

PHILIPPINE LCC Cebu Pacific Air saw profits rise fourfold in 2015, but its ambitions for growth on both short- and long-haul are facing a major problem — lack of capacity at Manila's Ninoy Aquino airport.

Cebu Pacific Air was established as a legal entity back in 1988, but didn't launch operations until 1996, a year after it was bought by JG Summit Holdings, a giant Filipino conglomerate that has interests in everything from banks and hotels to property and utilities. Its founder was John Gokongwei — of Filipino-Chinese extract and one of the wealthiest entrepreneurs in Asia — and today his only son Lance is president and CEO of Cebu.

Based at Ninoy Aquino airport in Manila, Cebu was a pioneer of the standard LCC business model in Asia, though today it has multiple aircraft models and an FFP called GetGo. It was launched initially as a domestic-only carrier before expanding onto international routes from 2001, and now operates almost 100 routes to 64 destinations, of which 34 are domestic, 24 are short-haul and six long-haul. They are flown by Cebu's 57-strong fleet that comprises seven A319s, 36 A320s, six A330s and eight ATR 72-500s — which have an average age of less than five years.

In 2015 Cebu recorded an 8.7% rise in revenue to ₱56.5bn (US\$1.2bn), based on an 8.9% increase in passengers carried to 18.4m. Passenger revenue was up 6.2% to ₱42.7bn (\$938m), with ancillary revenue rising 19.6% to

₱10.4bn (\$228m) and cargo revenue up 10% to ₱3.5bn (\$76m). In 2015 EBIT more than doubled, to ₱9.7bn (\$213m), while net profit increased by 414% compared with 2014, to ₱4.4bn (\$96m).

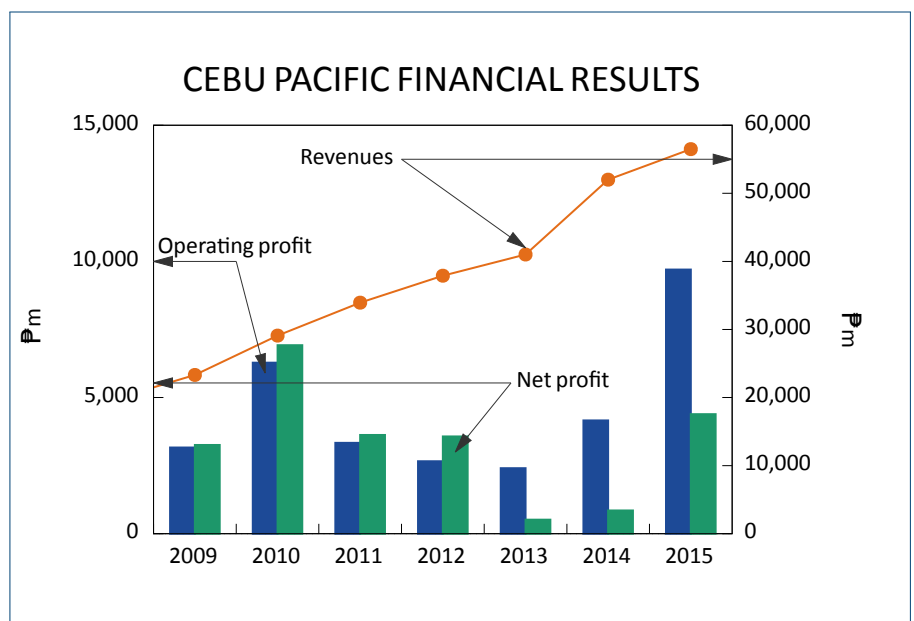
Larger aircraft

On order are two A320neos, 30 A321neos and 16 ATR 72-600s, all of which will arrive by 2022. The six-hour flying radius of the 240-seat A321neo will allow Cebu to operate to new markets in Australia and the Indian subcontinent, although they will also replace older Airbus models. All the A319s will be sold by 2018; in May Cebu announced a deal for the sale of four of the type to Las Vegas-based Allegiant Air in 2017 and 2018. Seven A320s will also leave by 2019 as their leases expire.

All Cebu's ATR 72-500s (operated under the Cebgo brand) will depart by 2018, being replaced by the arriving

16 ATR 72-600s from the third quarter of 2016 that were ordered in June 2015 (along with options for another 10 aircraft) in a deal worth about US\$200m for the firm orders at actual prices. The 72-600s will be equipped with high-density Armonia cabins — with 78 so-called "slim-line" seats and wider overhead bins — and will be used to expand Cebu's network regionally and for increased inter-island services in the Philippines.

Cebu's fleet only grew by three aircraft in 2015 (to 55 at the end of the calendar year), and future expansion will continue to be gradual, with the fleet expected to reach 69 by 2018, when it will comprise 36 A320s, 15 A321s, six A330s and 12 ATR 72s. As can be seen in the chart on the next page, in terms of ASKs Cebu has grown gradually over the last 24 months, maintaining a focus on improving its load factor, which has climbed impressively over the pe-



CEBU PACIFIC FLEET PLAN

	In service	Orders	at year end		
			2016	2017	2018
A319	7		4	3	
A320	36	(2)	36	38	36
A321neo		(30)		3	15
A330	6		6	6	6
ATR72	8	(16)	10	11	12
Total	57	(48)	56	61	69

riod and is now close to its medium-term target of 85%.

That strategy is partly of its own choosing, but partly because it has little alternative given capacity constraints at Ninoy Aquino. Ninoy is located centrally in the Metro Manila conglomeration (population around 12m), with the alternative, lower cost airport being Clark International, which is 70km from the centre. Owned by the state, Ninoy Aquino's throughput was 36.7m passengers in 2015, of which 19.5m were domestic. The airport's growth rate has been substantial — it has more than doubled passenger numbers since 2006 (when it had a throughput of 17.7m).

Cebu operates out of Terminal 3, which opened partially in 2008 (after several years of delay) and then launched fully in August 2014, with a capacity of 13m passengers a year. Cebu was the first carrier to move into the facility, but many others have joined since, including PAL subsidiaries Air Philippines and PAL Express, as well as Delta, SIA, Cathay Pacific and KLM.

The government has plans for a fifth terminal at the airport, to be built next to Terminal 3 and to which Cebu and the other LCCs at T3 will move across to, leaving T3 exclusively

for full-service carriers operating internationally. But the terminal is currently in the design stage, and inevitably it will be many years before it becomes operational. But overall the airport is almost at full capacity and expansion is desperately needed as passengers are forecast to grow to 51.4m a year by 2037.

The situation is complicated by the fact that the construction of a second airport in Manila — no further than 20km from the city's business centre — is also a possibility. Earlier this year the Philippine transport ministry said the location of a second airport would be unveiled soon, with a

target for it to become operational in the next 10 to 15 years, initially with two runways but then expanding to four.

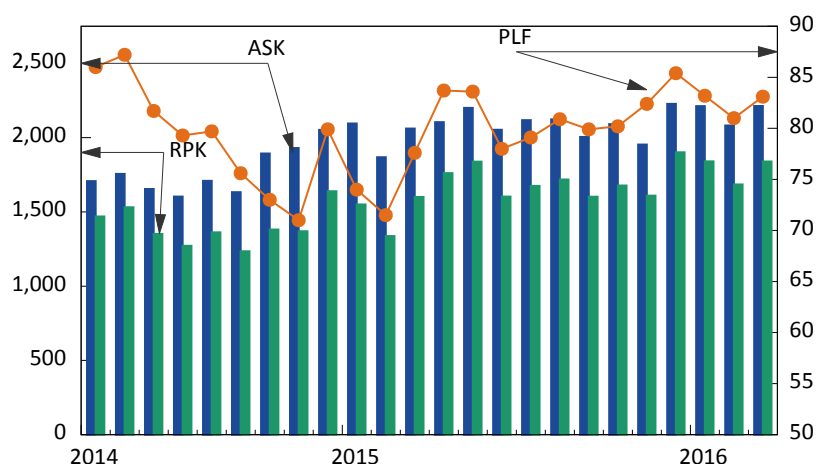
The new airport is likely to be funded by the government, with the commercial sector awarded contracts for its operation and maintenance. The government is also pondering the question as to whether this will exist separately to Ninoy, or whether it will become the sole airport for Manila, with Ninoy eventually closing down.

While Cebu waits for the government to announce its plans, all it can do is grow marginally at Ninoy by increasing the average size of its aircraft and squeezing more capacity onto existing routes (hence the switch from ATR72-500s to -600s and from A320ceos to A321neos), and build up routes connecting key Asian destinations with secondary airports in the Philippines.

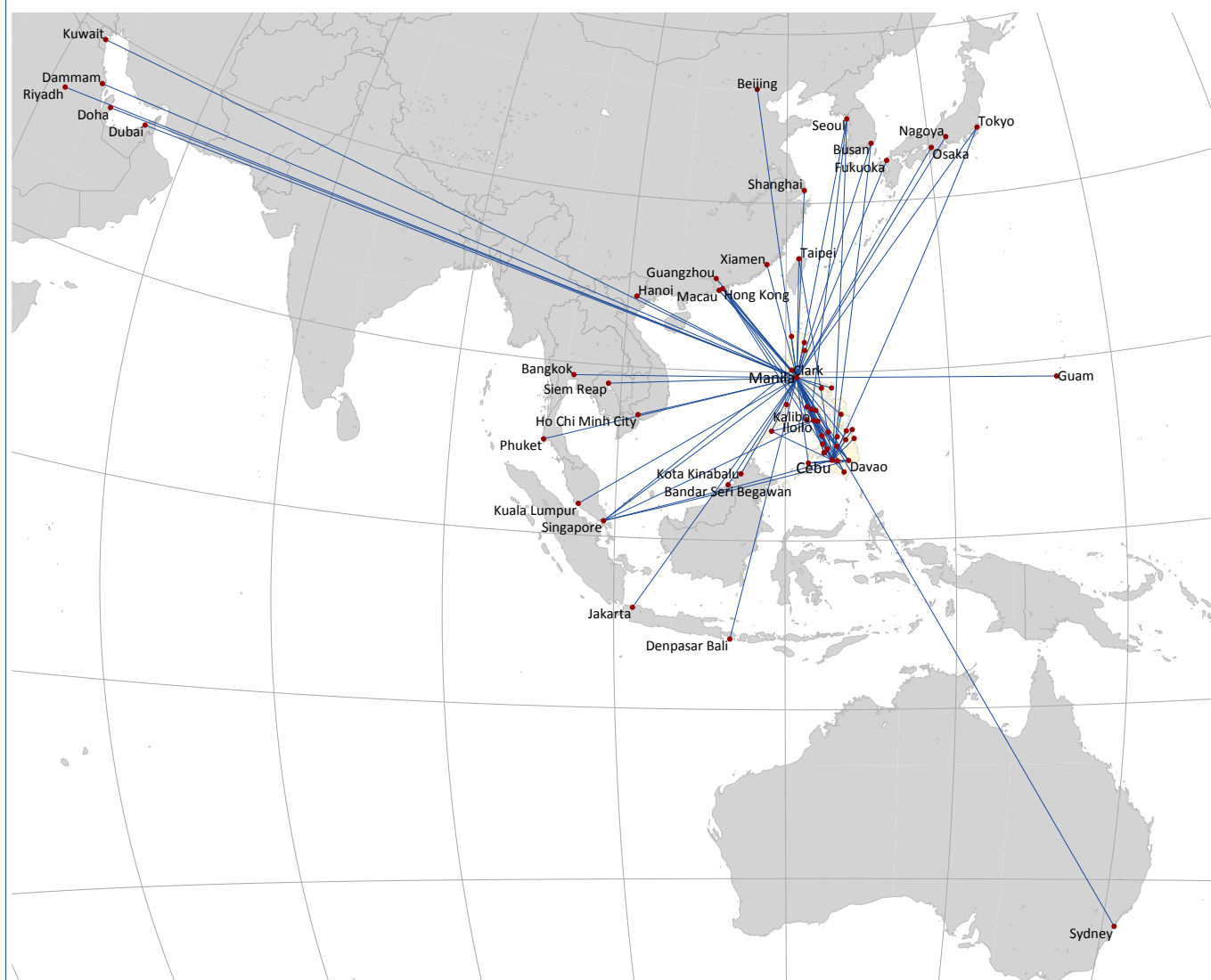
Segment strength

According to Cebu's own estimates, it achieved a 60% share of the domestic Philippines market in 2015, compared with 29% for the PAL Group

CEBU IS SLOWLY IMPROVING LOAD FACTOR



CEBU PACIFIC ROUTE NETWORK



and 11% for Air Asia; that was Cebu's highest-ever market share. The domestic network is based on six hubs — Manila, Cebu, Clark, Kalibo, Iloilo and Davao.

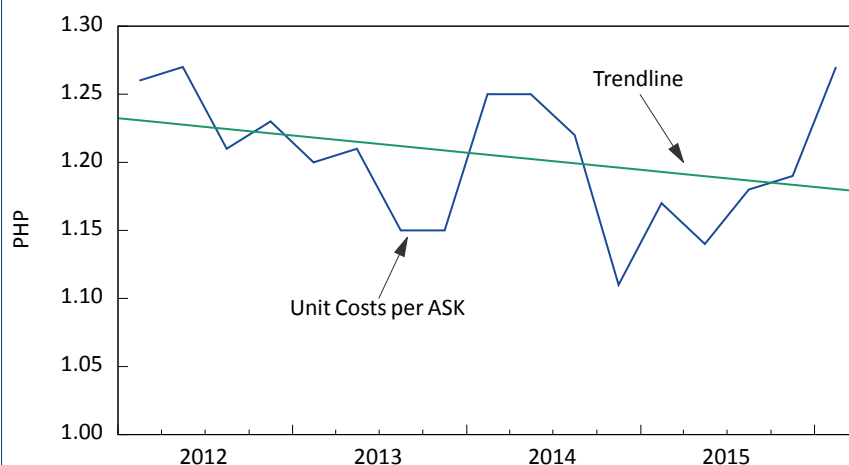
On short- and medium-haul, the three most important markets for Cebu are to Hong Kong, Singapore and China, where its share of seat capacity on routes to/from the Philippines in the first quarter of 2016 was 30%, 33% and 20% respectively, according to CAPA data.

Other destinations include South Korea and Japan, and in December 2015 three new routes (all using A320s) were added — Manila to Fukuoka (Cebu's fourth destination in Japan after Osaka, Tokyo Narita and Nagoya); Cebu to Taipei; and Davao to Singapore. And in March this year Cebu launched a service between Manila and Guam (where 30% of the population are Filipino), with four A320 flights a week, so becoming the first LCC to operate on the route.

Cebu would also like to launch further flights to other US territories after the FAA granted the airline a Category 1 safety rating in 2014.

Long-haul operations are based on the 400-seat (all economy) A330, the first of which was leased in 2013. Today Cebu operates to Sydney, Kuwait, Dubai, Riyadh and Doha, with the airline taking respective seat capacity shares on those routes of 39%, 76%, 31%, 19% and 15% in the first quarter of 2016.

CEBU'S UNIT COSTS EX-FUEL TRENDING DOWN



Clearly Cebu faces more competition on some routes than others, but where it faces well-entrenched incumbents it appears to be establishing a bridgehead. For example, it has seen passengers carried on its Manila-Sydney route increase 58% from 2014 to 2015; it has now become the largest carrier operating on the route, with seat share rising from 14.2% to almost 40% in 12 months against the incumbents of Qantas and PAL (and with Qantas taking seats out of the route).

Cebu's long-haul strategy is almost entirely based on the VFR and business markets between the Philippines and countries with significant Filipino communities. The Philippines itself has a young population of 104m in total (35% of which are under the age of 15 years), but a significant international diaspora and some 2.3m (or around 4% of the population of working age) employed overseas and remitting funds home (see chart on this page).

In July Cebu will add a third weekly A330 service between Manila and Doha, where it's the only Philippine carrier serving the two cities

non-stop. Qatar has the third-largest Filipino population in the Middle East after Saudi Arabia and the UAE.

Though the airline has analysed the potential of A350-900 XWB, large orders are not imminent. If added, new capacity is likely to come from one or two extra A330s.

The future

In the first quarter of 2016 Cebu reported a 13.4% rise in revenue to ₱16.1bn (\$341m), with operating profit rising 49% to ₱4.2bn (\$89m)

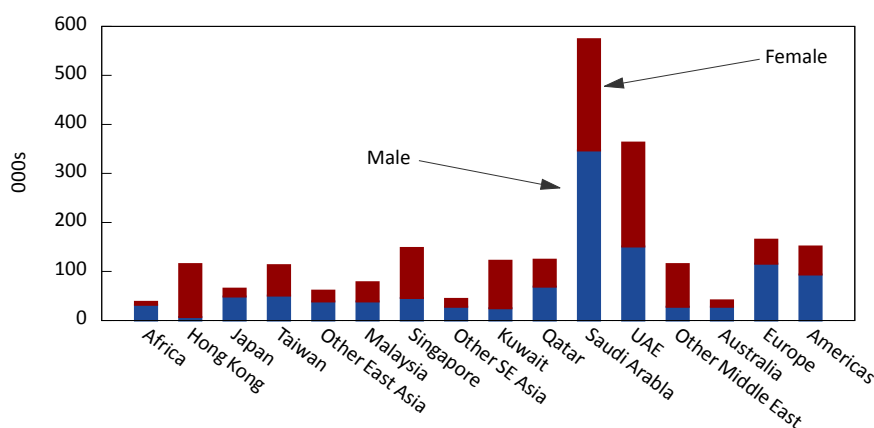
and net profit up 81.4% to ₱4.0bn (\$85m).

Given the constraints at Ninoy, growth will come largely from routes to/from secondary cities, though larger aircraft over the next few years will provide some capacity growth out of Manila. Cebu executives can do nothing about the airport situation in the capital, but it must be a source of frustration to them that they can't fully exploit the significant growth in the Philippine economy over the last few years, where annual GDP growth has averaged more than 6% since 2010. Cebu hopes that economic growth in the Philippines as a whole will translate into demand for air travel to/from secondary cities, which it can more easily exploit.

The airport capacity constraint will also limit the benefits to Cebu of the open skies agreement of the Association of Southeast Asian Nations (ASEAN), which took effect across the region in December 2015. Frustratingly the Philippines was the only one of the 10 members of ASEAN that had not ratified the open skies agreement at that date.

Though the Civil Aeronautics Board wanted to ratify the agree-

2.32m FILIPINO MIGRANT WORKERS



Source: Philippine Statistics Authority 2014 Survey on Overseas Filipinos

CEBU PACIFIC SHARE PRICE PERFORMANCE



out the possibility of launching subsidiaries elsewhere in Asia, and is instead concentrating on building up routes to secondary cities in the Philippines, increasing average capacity out of Ninoy through new aircraft, and keeping a lid on costs. The LCC gives relatively few details on the cost breakdown between short- and long-haul, but as can be seen in the chart on the preceding page, unit cost excluding fuel had been trending downwards for some time — although it has started to rise again in the last 12 months.

Altogether Cebu is targeting more than 20m passengers carried this year, thanks largely to expansion of domestic and regional routes out of Filipino airports other than Ninoy, and in the first three months of 2016 Cebu saw 13% rise in passengers carried year-on-year, to 4.8m.

Cebu came to the markets through an IPO on the Manila stock exchange in October 2010, when it floated 30.4% of equity. After a substantial decline though to the beginning of 2014, the share price has steadily recovered since (see chart on this page). Shareholders (and JG Summit still controls a majority of the shares) will probably remain patient given the current profitability, but are as frustrated as Cebu is that growth opportunities are being missed.

ment that allows designated airlines to operate unlimited flights between Asean capital airports, the government — under the leadership of President Aquino — was reluctant, partly due to pressure from flag carrier PAL. It agreed initially only to open up secondary airports to ASEAN carriers, including Clark, Cebu and Davao, but in February the agreement was finally ratified by President Aquino. As a result, Cebu expects to add more services to key cities in ASEAN, though initially only from secondary Filipino airports.

Cebu expects to see some growth thanks to a strategic partnership signed with Tiger Airways last year, which extended the existing interline agreement between the two through

closer coordination on schedules, sales and other areas.

The deal also included the re-naming of Tigerair Philippines as Cebu. Tigerair Philippines was previously known as SEAir until 2013, but Cebu initially bought a 40% stake in the turboprop operator and then full control in 2014 as Tiger sold its stake as part of its strategy to exit from loss-making subsidiaries.

In May Cebu also announced the launch of an Asian LCC association called “the Value Alliance” (the other members are Jeju Air, Nok Air, NokScoot, Scoot, Tigerair Singapore, Tigerair Australia and Vanilla Air), which will essentially offer interline benefits to passengers.

For the moment Cebu has ruled

Aviation Strategy

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WestJet: Pioneering a new model in transatlantic flying

WESTJET, Canada's JetBlue-style LCC, has embarked on a significant new phase of its international expansion: nonstop flights to London from six Canadian cities with its own 767-300ERs. How exactly does WestJet plan to make money in the competitive transatlantic market where it does not have much of a cost advantage?

The Calgary-based carrier launched its first widebody transatlantic flights at the beginning of May and plans to operate as many as 56 weekly flights to and from London Gatwick this summer. Toronto and St. John's have daily service, while Vancouver, Edmonton, Calgary and Winnipeg have 1-6 flights a week. Calgary and Toronto will be operated year-round, the others seasonally. The St. John's-London route uses 737NGs; the others are flown with 767-600ERs.

With introductory one-way fares as low as £177 (C\$238) and C\$20 add-on fares available to/from other points in Canada, there must be many happy people in Canada and the UK who will now be visiting their friends and relatives across the Atlantic this summer.

At Gatwick, WestJet's passengers can connect to flights operated by codeshare partners BA and Emirates, as well as various LCCs' services, so perhaps the new transatlantic services will also be a viable option for travel between Canada and continental Europe and further afield.

Transatlantic expansion is just the latest of many new strategies WestJet

has adopted in the past three years. Most notably, the carrier has moved aggressively to capture business traffic in Canada, launched regional subsidiary WestJet Encore and entered the Canada-Hawaii market (initially with wetleased 757-200s).

The London move may seem aggressive, but in reality it is more like an evolutionary development for a carrier that is financially very successful and tends to grow its network cautiously and at a measured pace.

WestJet has been testing the transatlantic market since June 2014, when it launched its own daily scheduled seasonal Toronto-Dublin services with 737s, operated via St. John's (Newfoundland), a stop mandated by ETOPS rules. Those flights were successful, so they were resumed in May 2015, when WestJet also launched its second transatlantic route, Toronto-Halifax-Glasgow.

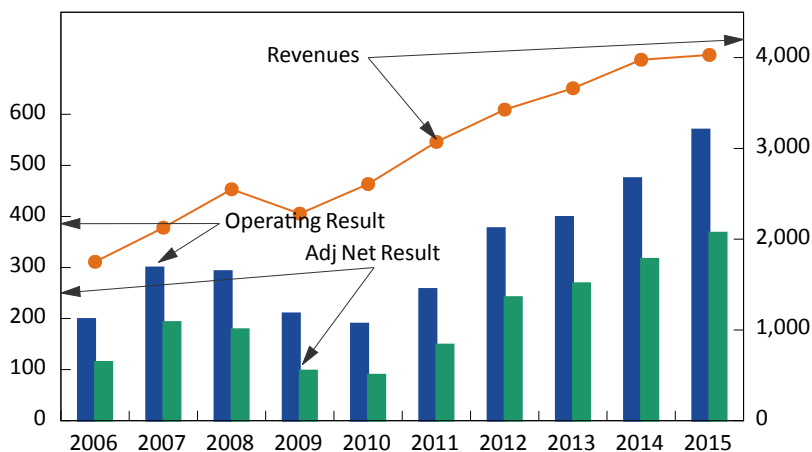
Likewise, WestJet minimised risk

by entering its first long-haul over-water market, Alberta-Hawaii, with wetleased 757-200s. The 767-300ERs now on the transatlantic were first tested on the Hawaii routes, beginning in January 2016.

The four 767-300ERs in the fleet are ex-Qantas aircraft acquired from Boeing in a July 2014 agreement (delivered between August 2015 and April 2016). WestJet is moving very slowly with further fleet plans, taking its time to acquire more used aircraft and pick the 767's longer-term replacement.

Despite its low-key approach, WestJet is probably a good candidate for network growth and diversification. It has an impeccable profit record, a strong balance sheet and ample cash reserves. It has consistently met its ROIC target. It enjoys a relatively low cost of capital, having in early 2014 become only the second airline in North America to be rated

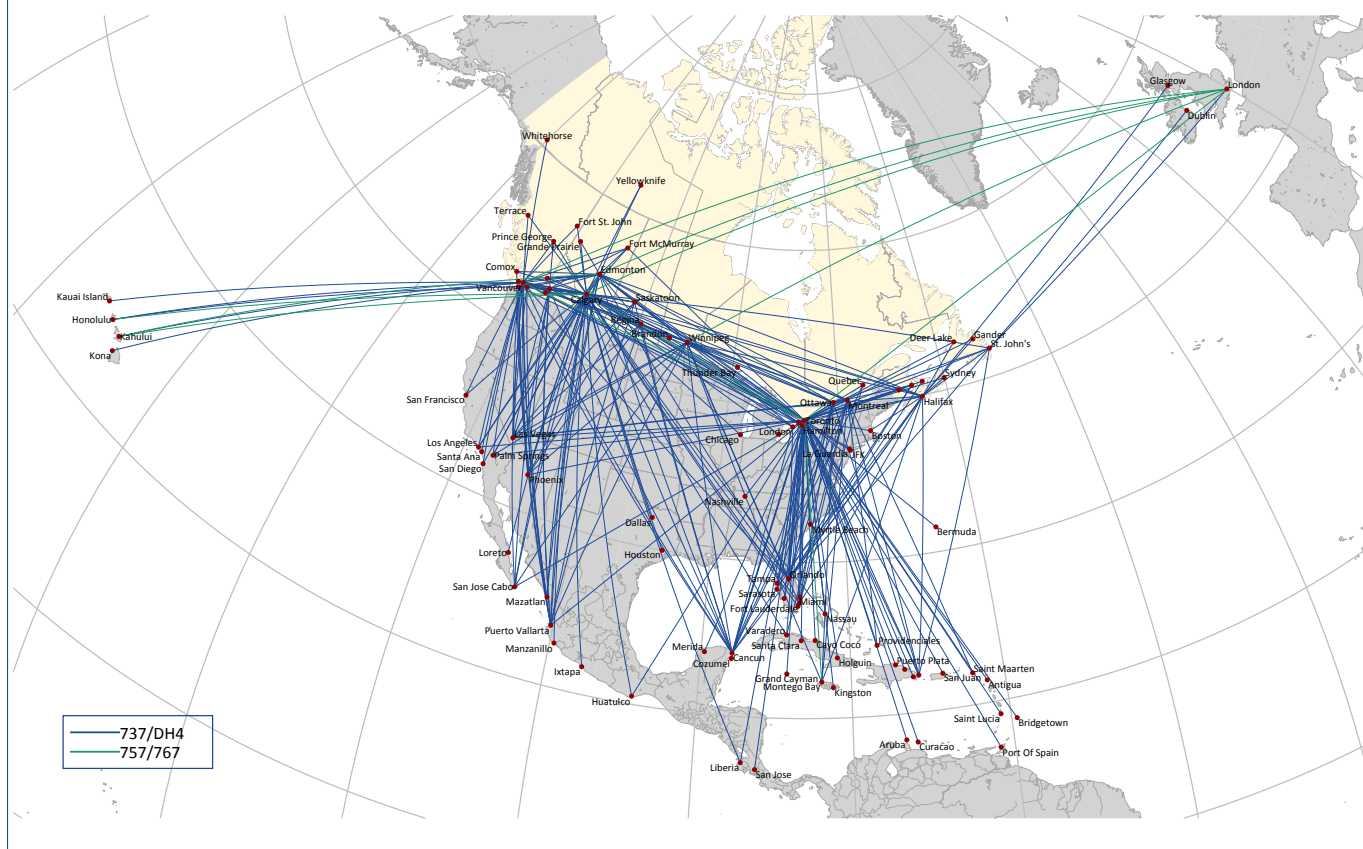
WESTJET'S FINANCIAL RESULTS (C\$m)



Source: Company Reports

Aviation Strategy

WESTJET ROUTE NETWORK



investment grade (after Southwest; Alaska became the third in June 2014 and Delta the fourth in February 2016).

WestJet has a unique people-focused culture, an award-winning product and a strong brand. It benefits from a non-union workforce (a rarity for North American airlines). It has high productivity and efficiency levels and great cost controls.

And WestJet needs new growth areas. It does not have the opportunities that US LCCs enjoy in being able to tap the huge US market for domestic and near-international expansion. It has already captured 40% of the Canadian domestic market and entered the key transborder business markets. It is already a major player in the Canadian winter sun market to Florida/Mexico/the

Caribbean and has staked out a position in the Canada-Hawaii market.

Many of WestJet's traditional markets have seen adverse macro-economic trends over the past year or so. Canada's GDP grew by only 1.2% in 2015 amid a slowdown in the energy sector. WestJet is heavily exposed to the economic weakness in Alberta and the Prairie provinces.

The Canadian dollar's plunge against the US dollar has led to a sharp decline in southbound Canadian travel. While Canada is now a bargain for travellers from other countries, those coming from the US tend to fly on US airlines. In the Canada-Europe market, WestJet arguably has a better chance as a price discounter to capture Europe-originating leisure traffic.

While WestJet seems well po-

sitioned to make the transatlantic operations a success, the venture also poses many risks. First, it is a new area of overlap with Air Canada. Competitive clashes between the two have escalated significantly in the past three years. As WestJet set up a regional subsidiary, Air Canada added regional turboprop operations. As Air Canada launched its low-cost unit Rouge for international leisure markets (2013), WestJet began its seasonal transatlantic forays. As WestJet began tapping the business segment, Air Canada implemented successful cost cutting; the result of that has been a narrowing of the cost gap between the two airlines.

Second, on the transatlantic WestJet is exposed to competition from a multitude of airlines.

It is the sole operator only on the Winnipeg-Gatwick route. In many of the other markets, it competes head-on with Air Transat, another Canadian low-cost operator.

Third, like other LCCs, WestJet has less of a cost advantage on long-haul routes. Much of its near-term cost advantage in the Gatwick markets arises from the low ownership costs associated with the used 767s. What will happen when the time comes to replace those aircraft?

Fourth, adding a third aircraft type and a new international region increases the complexity (and hence the cost) of operations. But the larger aircraft and longer stage lengths will obviously have beneficial impact on unit costs.

Fifth, even though WestJet believes that the transatlantic operations will be immediately accretive to earnings, the combination of higher costs and super-low fares is likely to mean lower profit margins on those routes. The likely impact is to keep WestJet's system operating margins well below those of US carriers.

Sixth, the new risks, negative unit revenue effects and reduced operating margins will keep many investors and analysts unhappy. Some have questioned whether WestJet has got its capital deployment priorities right.

The new transatlantic model

WestJet's transatlantic business model has two unusual components: deployment of used 767s and imposition of ancillary fees such as a \$25 checked-in bag fee.

While bag fees are now charged by nearly all airlines within North America (Southwest may be the only holdout), they are not common on the Atlantic. WestJet makes the reasonable-sounding assumption that since it is entering the markets

with significantly lower basic fares than incumbent operators such as Air Canada, travellers will happily pay a \$25 bag fee. And, of course, there are plenty of exceptions; for example, the fee can be avoided if one books with a WestJet credit card or through WestJet Vacations.

WestJet will also collect additional revenues from its premium class. The 767s feature a "Plus" cabin with 24 premium seats and a main cabin with 238 regular seats. The premium cabin has seats in a 2-2-2 configuration (the middle seat is blocked on the 737s) and offers hot meals and other amenities. The Plus product also offers priority boarding and security screening and flight change flexibility.

When revamping the Plus product last year, the airline also launched "WestJet Connect", a new in-flight entertainment system featuring wireless internet connectivity and 450-plus films/TV programmes. As of May 2, all four 767s and 44 737NGs had been equipped with the system.

While low fares (at least compared to Air Canada's) will be the key to getting the traffic on the London routes, ancillary revenues could meaningfully improve the viability of those operations.

WestJet also expects to be operating at very high load factors, similar to those seen on the Dublin and Glasgow routes.

But WestJet also enjoys network, scale and other benefits that will help it on the transatlantic. The key factors include strong VFR demand in the Canada-UK market, feed from WestJet's sizeable Canadian route network, cooperation with BA, potential connections with other LCCs at Gatwick, and WestJet's exceptionally strong brand (more on these factors below).

WestJet executives said at the carrier's quarterly earnings call on May 3 that they had seen a strong market response to the new transatlantic services, with advance bookings running ahead of expectations. Feed from the network was "as planned", while Sterling's strength against the Canadian dollar had helped boost UK-originating bookings. The executives said that they still expected the London routes to be accretive to earnings this year.

The Atlantic is a tough market for LCCs, but WestJet has a reasonable shot at making it a success for the following reasons (in no particular order of importance):

➔ Strong historical and ethnic connections

WestJet executives described London as "the crown jewel of international travel to and from Canada". There are strong historical and ethnic connections between the two countries and therefore significant VFR traffic and steady demand. US LCCs' experience in the Caribbean/Latin America has shown that VFR traffic makes a huge difference to the viability of low-cost air services.

➔ Scale and network benefits

In its 20 years of operations, WestJet has built enough scale and critical mass in North America to successfully venture into long-haul markets. With its traditional 737 operations and now also smaller-market penetration with Encore, it has a strong domestic network that will feed the transatlantic services. It promises "convenient connections from cities across Canada in both directions". It is in a much stronger position than point-to-point competitors without networks.

There could even be some feed from the US. WestJet has seen a "nice flow"

WESTJET'S FLEET PLAN

	Fleet	Future deliveries							Fleet
	31 Mar 2016	Q2-Q4 2016	2017	2018	2019-20	2021-23	2024-27	Total	2027
737-600	13								13
737-700†	59								59
737-800	43	3	2					5	48
737 MAX 7‡					6	4	15	25	25
737 MAX 8‡			4	7	12	11	6	40	40
767-300ER	3	1◇						1	4
Q400§	27	7	2					9	36
Maximum fleet↑	145	11	8	7	18	15	21	80	225
Lease expiries		-3	-6	-9	-12	-14		-44	-44
Minimum fleet↓	145	8	2	-2	6	1	21	36	181

Notes: † One leased 737-700 was returned on April 1. ‡ There are options to purchase ten 737 MAX aircraft for 2020-2021 delivery. The MAX 7 and MAX 8 orders can be substituted for one another or for the MAX 9. ◇ The fourth 767-600ER was delivered on April 12. § There are options to purchase nine Q400s for 2017-2018 delivery. ↑ all leases renewed. ↓ all leases allowed to expire.

Source: WestJet

of US point of origin traffic on the Dublin and Glasgow services. But the flow could be less to London because there is a lot of nonstop service in the London-US market.

✈️ Dublin and Glasgow experience

WestJet has gained useful experience and learned much about the transatlantic market with the 737 operations to Dublin and Glasgow. It has proved that the markets can be significantly stimulated by low fares. It has seen extremely high load factors and “decent margins” on those routes.

✈️ BA, Emirates and other partnerships

Even though WestJet operates to Gatwick, where BA has a lesser presence, it could benefit significantly from feed from BA's services and the FFP partnership.

Earlier this year WestJet added Emirates as its 15th codeshare partner and the first partner with whom it will exchange Middle East and South Asia subcontinent traffic via Gatwick.

More such deals could be on the cards, because “enhancing alliance partnerships” is one of WestJet's key

focus areas in 2016.

✈️ Strong brand

WestJet is a high-quality LCC in the JetBlue/Southwest mould and benefits from an exceptionally strong brand. *Canadian Business* magazine has ranked it in the top three among 25 leading Canadian brands for four consecutive years. It enjoys much customer loyalty.

Fleet considerations

WestJet has not yet indicated which long-haul destinations could follow London. A year ago, when launching Glasgow, it tantalisingly said that it would become a “truly global carrier in the years to come”.

Widebody fleet plans are also up in the air. WestJet has been in talks with Boeing and Airbus for quite some time on a next-generation widebody that could replace the 767s from 2019 or 2020. But the management has also said that they would consider good used aircraft, such as A330s or 777s, and leasing aircraft. And they continue to look for additional 767s for growth in the interim period.

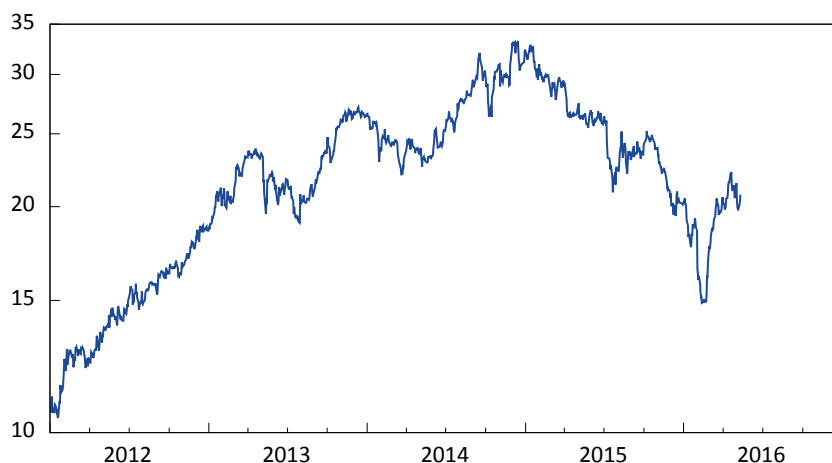
The 767-300ER programme experienced delays in getting ETOPS certification, apparently largely because three different international governing bodies were involved (Australian, US and Canadian). As a result, WestJet had to delay the type's deployment in the Hawaii market (began in January).

But the 767 has also had reliability issues, as a result of which WestJet has contracted one aircraft from its former wetlease provider Omni Air International as a “hot spare” for the transatlantic, as it did for the delayed start of the 767 Hawaii operation.

The ex-Qantas 767s are 22 years old. The first aircraft has now achieved the same reliability level as the 737 fleet, and WestJet said that it knows from talking with its codeshare partner Delta, which has the world's largest 767 fleet, that the type operates very reliably (though it must be noted that Delta's success with older aircraft is partly due to its maintenance expertise and capabilities).

But relying on old aircraft is nothing new at WestJet either. The man-

WESTJET SHARE PRICE PERFORMANCE



agement has described the 767s as a “low-cost way of getting that line of business going, not dissimilar from how WestJet started 20 years ago with 30-year-old 737-200s”.

Financial strength

WestJet has been profitable through its 20-year history, except for a small operating loss in 2004. It has had double-digit annual operating margins since 2012, and last year’s margin was a record 14.1%. It earned a pre-tax ROIC of 12.8% in the 12 months to March 31, which was within its long-term targeted range of 13-16%.

However, after being the most profitable airline in North America in the mid-to-late 2000s, in recent years WestJet has fallen significantly behind its US peers both in terms of operating margin and ROIC.

There are several reasons. First, both WestJet’s capacity and industry capacity in Canada have grown at a faster rate, leading to a weak domestic pricing environment. WestJet’s ASMs rose by 6.7% in 2014, 5.2% in 2015 and 7% in Q1 2016.

Second, Canada has been in an economic slump in the past 18 months or so, mainly because of the

fall in oil prices (Canada is a net oil exporter). As a result, domestic fares in Canada are at their lowest in six years. In the latest quarter, WestJet’s RASM declined by 11%.

Third, in the past couple of years the Canadian dollar has weakened significantly against the US dollar, mirroring the fall in oil prices (though this year has seen a slight rebound in both). It has increased WestJet’s dollar-denominated costs, such as leasing, maintenance and interest expenses.

WestJet has taken remedial action, including schedule adjustments in the Alberta market, deferral of three 737 deliveries, return of some leased aircraft (for the first time in its history) and a slight reduction in this year’s planned ASM growth to 7-9% (of which about six points will be expansion with 767s).

In addition to the growth in wide-body operations, longer-term strategies to help keep unit costs in check include the substantial 737 MAX orders (see fleet table on the previous page) and potentially increasing seating density following the installation of new slimline seats on the 737s.

In addition to growing widebody

operations, which has a negative impact on unit revenues, WestJet also continues to develop the regional Encore operation, which has the opposite effect of improving RASM. Encore now accounts for 5.5% of WestJet’s system ASMs and utilises 27 Q400s, with nine more scheduled for delivery in 2016-2017. The unit recently added its first transborder destination (Boston).

In the first quarter, WestJet’s network was nicely balanced, with domestic operations accounting for 41% and international (including transborder) 59% of system ASMs.

The consistent earnings have enabled WestJet to maintain a healthy balance sheet. Cash amounted to C\$1.4bn in March, representing 35% of trailing 12-month revenues. Adjusted debt-to-equity ratio was 1.38. But continued fleet spending has meant negative free cash flow, which is not likely to change anytime soon.

In early May, WestJet secured investment grade corporate credit ratings (Baa2) from a second rating agency, Moody’s, which mentioned the carrier’s “low leverage, strong liquidity, good margins and a long record of operating success”. In March S&P confirmed the BBB- rating and stable outlook that it originally assigned in 2014. Those actions probably speak louder than words about WestJet’s prospects in new long haul markets. There are not many other investment grade rated airlines on the transatlantic.

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