Issue no. 217
June 2016

Rule Britannia?
Dis-United Kingdom.

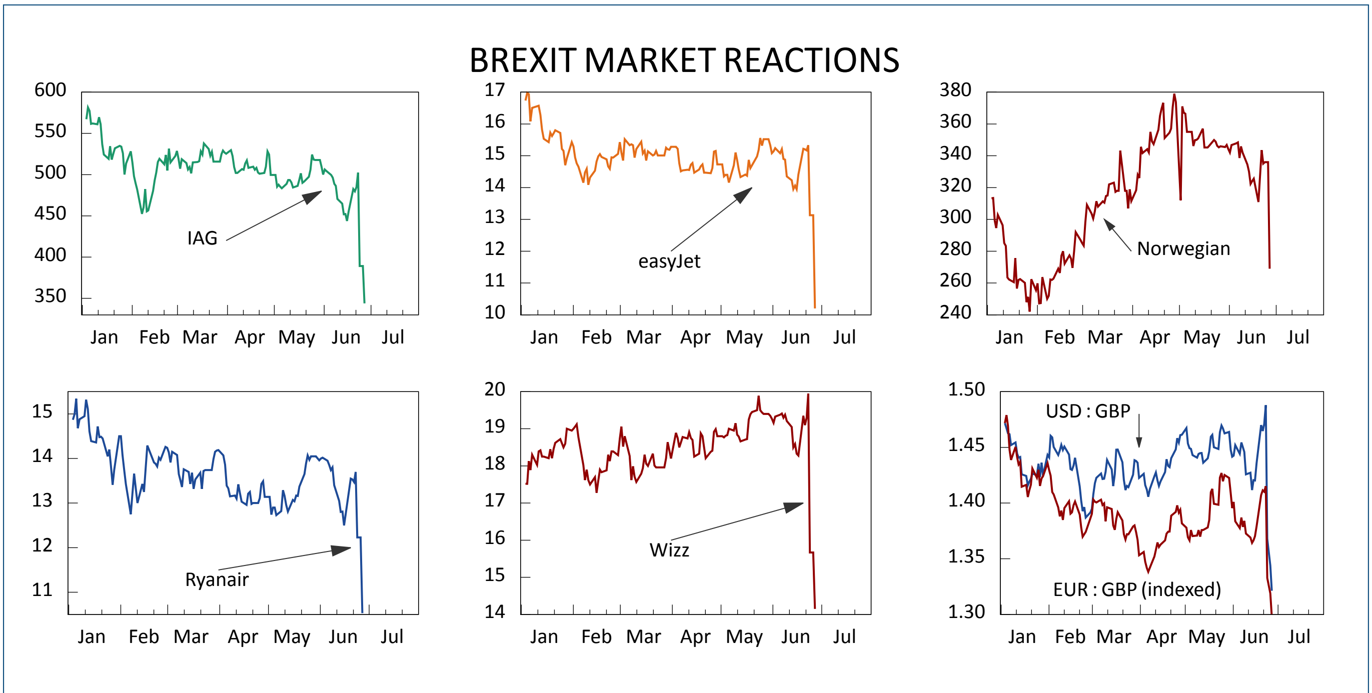
DIVORCES are painful, stressful and rarely easy. The UK's decision to leave the European Union (by a 52/48 margin) has come as a shock to the political elite, the EU, and the fragile world economy, not least because this is the first referendum (the fourth in the country's history) where the voters have opted for change.

In the UK there will be a change of government. Prime Minister Cameron, having made as one commentator put it the worst political decision since the 1956 Suez crisis in holding the referendum, signalled his intention to hand over the reins by the autumn; and the leadership of the ruling Conservative Party is likely to take it a lurch further to the right of the political spectrum. Although it has a narrow majority in Parliament (and despite the new five year parliament rule) there could well be pressure for a general election in 2017. In anticipation of this perhaps the opposition Labour party elected members are in the process of forcing their leader Jeremy Corbyn to fall on his sword.

The process for a member state to leave the EU seems to have been included in the Lisbon Treaty almost as an afterthought. The UK will have to invoke "Article 50" formally indicating its desire to leave and at that point will be given two years to negotiate the terms of the divorce settlement.

Cameron has stated that he will leave it to the next Prime Minister to start the formal process. This might give the UK a bit of time to decide what it actually wants: balancing the economic need of retaining access to the single market with the political expediency of trying to "keep foreigners out". It could join the EEA (which encompasses the EU members along

This issue includes



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with Norway, Iceland and Liechtenstein), but this would mean accepting all the principles of EU membership except for fishing and agriculture — and without any involvement in decision making. It could just join the EFTA and like Switzerland negotiate a plethora of bilateral agreements with its former partners. It might find its own solution.

The EU itself is likely to take a tough line in the negotiations. Apart from anything else the main member states will be terrified of other nationalist movements being encouraged to push for separation, in the fear that this could lead to the break-up of the EU itself.

Perhaps the best hope of limiting the economic damage from the Brexit vote would be to delay enacting Article 50 for as long as possible — the earliest a new British PM could make the formal move would be October or even November. This delay would help clarify the economic fallout from Brexit and allow a focus on the real issues facing both the UK and the rest of the EU (by their own astounding admission the Leave campaign does not have a post-Brexit plan in place).

This period, hopefully, would, allow the pragmatists to take control, and it is just possible that the UK might end up trading access to the single market for free movement of EU citizens — probably the best outcome for the European economies and European aviation. Politically though such an outcome is highly problematic or ironic — the UK would be in the same economic position as it is today, the perceived issue of immigration would be unchanged, it would still be paying into the EU budget and it will have lost all it legislative powers in Europe.

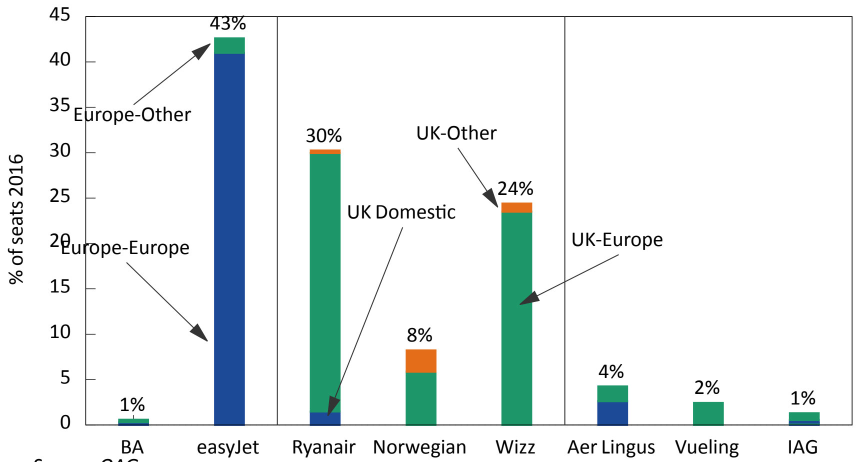
The impact on the UK economy will be relatively high in the short run. HM Treasury's own assessment was that the economy would be some 3.6%-6% lower by 2018 than it would otherwise have been: the main reasons for this coming from the very uncertainty of the exit procedure, the lower value of the pound, and higher imported inflation. The markets certainly seem to have believed this by marking Sterling down by 12% immediately, and with forecasts suggesting it will force an overall 20-25% devaluation.

The impact on aviation could also be severe. The UK is one of the strongest markets for originating air traffic — and London has some of the strongest pure O&D air travel markets in the world. The lower value of Sterling combined with a lower GDP growth rate will have a negative impact on demand growth. Conversely the weakness of the currency could have a positive effect on in-bound air travel demand, but as this runs at about half the level of outbound traffic is unlikely to make up for the shortfall from what would otherwise have been.

More important perhaps is the uncertainty of the regulatory regime. There is a possibility, however unlikely, that the UK is excluded from the European Single Aviation Area. This could mean that UK majority-owned and operated airlines be excluded from internal EEA routes and routes from the EEA to non-EAA countries, while non-UK owned and operated airlines would equally be prohibited from routes with the UK or from the UK to countries other than their home.

The pragmatic expectation would be that the UK would look to negotiate membership of the European Common Aviation Area (ECAA), although this will probably be well

CAPACITY AT RISK FROM REGULATORY CHANGE



Source: OAG

down on the list of priorities for the next Government. ECAA membership obliges the UK to conform to the "air transport *acquis communitaire*", ie all the continuously evolving EU aviation laws and regulation. But now the UK will have very limited influence on these regulations.

There could be significant risks to the operating rights of easyJet, Ryanair, Wizz, Norwegian and to a lesser extent IAG.

easyJet has grown strongly throughout Europe. Some 40% of the seats it operates this year will be on flights that do not touch the UK. It may be able to find a solution of creating an "EU owned" subsidiary AOC (it currently has a Swiss AOC for easyJet Switzerland, but this could also come in question), but this would add an unwanted element of complexity.

(This structure is reminiscent of the LCC pioneer, Air Europe, which in the 1980s had to set up subsidiaries in several other countries in order to create a European network: one of the many factors that led to that airline's failure.)

Ryanair is an EU airline but has its largest European base outside its home country at London Stansted and operates a significant level of outbound as well as domestic operations, accounting for some 30% of its seat capacity this year, (though it now plans to shift all future expansion to outside the UK), while its original core Irish-UK flights (some of the most profitable in its network) would not be affected.

If Ryanair wanted to, it might try to establish a UK AOC under "UK ownership". Michael O'Leary lobbied furiously for a remain vote, one of his deepest concerns being a domino effect with other counties following the UK out of the EU.

Norwegian has been building presence at London Gatwick, and specifically has been targeting long haul routes to the US. It has a UK AOC, and although it might try to move it to "UK ownership" its operating license on the Atlantic (already having been under severe pressure) will be in doubt and could severely dent its long haul plans.

Wizz, Europe's second largest ULCC, is based in Hungary but has built up a significant business from Central and Eastern Europe. According to the schedules some 28% of its seat capacity this year is on routes that touch the UK (but less than 4% on routes between Hungary and the UK). It is likely to be harder hit by the UK's apparent xenophobia.

IAG ironically should have less at risk on the European scene. While IAG is registered in Madrid, BA remains officially UK majority owned under the structure of the 2011 merger with Iberia. It may have to replace some UK based routes currently operated by Aer Lingus and Vueling, but could move its minor OpenSkies airline operations out of Paris to another of its subsidiaries. However, in the unlikely event that the UK is booted out of the European-US open skies agreement, its North Atlantic JV with American would have to be dismantled.

IATA's SUMMARY OF UK's POST BREXIT OPTIONS

	Access to Single Aviation Market	EU Horizontal Agreements	Influence on EU Policy	Policy Freedom
Continued EU membership	Full access	Full validity	High	Very limited
ECAA membership	Full access	Would probably remain valid	Very limited	Limited
UK-EU horizontal	Access	May need to be renegotiated	None	Potentially limited
No formal agreement	Would need to be negotiated	Would need to be negotiated	None	High

Source: IATA

Air Traffic Control: Chances of reform in the United States

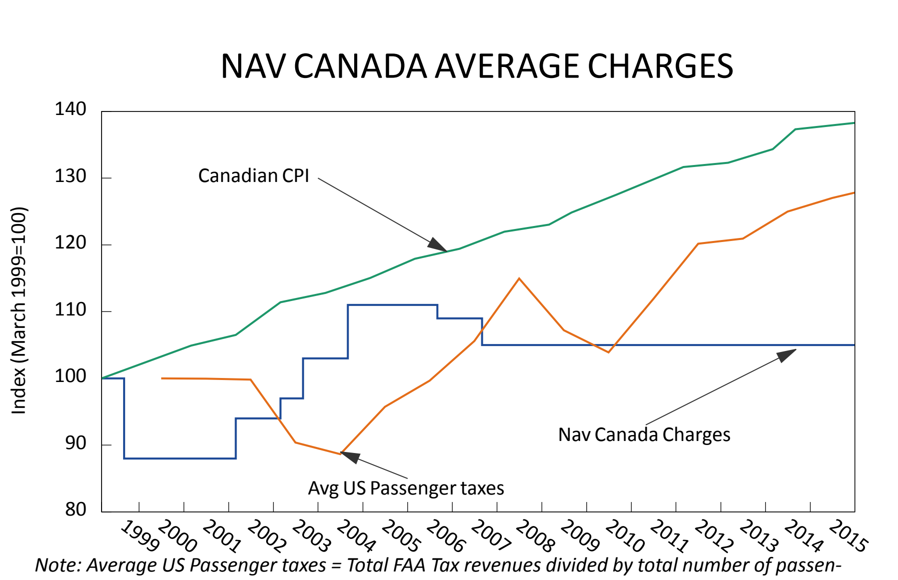
THE MOST intense and arguably most important debate about the future structure of ATM is to be found in the United States, which is perhaps somewhat ironic given that the US, with its single ANSP covering such a large geographical area, is often held up as a model for other regions, not least Europe. (European ANSPs have some 25% more staff to handle half the level of traffic at lower costs than the US does.) In fact, an intense argument is taking place which has become highly political and even set airlines against airlines. The Federal Aviation Administration regulates and provides all ATC services, with the exception of some towers. It is a government body, part of the Department of Transportation, and has therefore over the years been subject to the vagaries of government finance. The result is that the FAA has a substantial investment backlog, despite its ambitious NextGen (New Generation Air Transport System) programme, the equivalent of Europe's Single European Skies/SESAR.

One issue can be isolated quite easily. It seems incredible to many that the FAA should be both the provider of ATC services and their safety regulator. Such an approach would never be accepted for airlines and has long since been abandoned by many other countries. Clear separation of roles is surely the answer. Some 60 countries have done precisely that over the past two decades, in accordance with ICAO recommendations. But that still leaves the question of what form of organisation should actually provide ATC services within the US, assuming that the regulatory functions remain with a government-owned FAA. That is where the debate gets complicated, and heated.

Numerous models have been considered, including full privatisation, partial privatisation as in the UK, the Canadian stakeholder run example and a version of the government-owned status quo. One might expect, given what is at stake for their operations, that the airlines would have united around a single solution, but that is far from the case. Delta in particular has lobbied strongly against *any* form of privatisation, even leaving the main airline trade body, Airlines for America, to be better able to argue its case. (It is interesting that Delta has also taken the lead, very publicly, in opposing the expansion of the Gulf carriers.)

This is the second of a two-part examination of air traffic control reform around the world. Part 1 featured in the previous issue of Aviation Strategy.

Ed Bastian, Delta's CEO, maintained recently that collaboration, not privatisation, was the way to improve airspace efficiency, but gave a hint, albeit well hidden, of what is really driving the company's position: "The fact is the current air traffic control system, run by the Federal Aviation Administration, is the same for every airline operating within it. What sets Delta apart is that we have invested in our people, our operation and our technology to enable us to outperform our competitors within the system where we all operate … Where the efficiency of our nation's airspace is concerned, Delta's operational performance is proof that today's model is far from broken.



Note: Average US Passenger taxes = Total FAA Tax revenues divided by total number of passengers. Source: Nav Canada, FAA

While I agree that more needs to be done, privatising the Air Traffic Organisation isn't the answer."

It certainly seems to be the case that Delta sees benefit for itself from, if not maintaining the status quo, at least substantially slowing down the speed of reform. One commentator has noted that Delta has the oldest fleet among US major airlines (over 17 years on average, compared with just 11.5 for American and 13.6 for United), largely a reflection of the aircraft inherited from Northwest following their merger. It might, therefore, be expected to face the largest additional costs from equipping its aircraft with new technology. It also has less congested hubs than most of its competitors, reducing the potential benefits of NextGen modernisation. Thus, it seems that structural and technical change in relation to ATC reform may have become closely, and probably unhelpfully, connected.

Most other US airlines and their trade body have come out strongly in favour of ATC reform as soon as possible, primarily in order to free the FAA from what they see as the shackles of political interference and government funding restrictions and thereby enable it to invest more easily in NextGen. Bob Poole of the free market Reason Foundation, a frequent commentator on this subject, noted in evidence before Congress in February that the airlines have been supported by a number of former DOT Secretaries, several former FAA Administrators and all three former COOs of the air traffic organisation. All have argued in favour of some form of "corporatisation", with the main focus being on something close to the Canadian model.

Several studies have compared the US and Canadian ANSPs, and almost invariably the conclusion has been that the Canadian approach is far superior in terms of efficiency and customer satisfaction. To quote Bob Poole again, over its 20 years of operating the Canadian ATC system, Nav Canada's fees have gone down by more than 30% in real terms. It has not had a rate increase for some eight years, and recently announced a reduction. Productivity measures by CANSO, the ANSP global trade body, show Nav Canada's cost per IFR flight hour to be lower than the FAA's, despite operating a considerably smaller system. (There are significant economies of density in ATC provision, although equally parts of the US system are more congested, which raises unit costs.) As Bob Poole notes: "There is pretty solid evidence that Nav Canada is delivering ATC services very cost-effectively to its aviation customers."

New proposals

In February this year, legislation was introduced in the House of Representatives to, inter alia, separate the provision of ATC services from the FAA and create a new independent, not-for-profit corporation governed by a board of industry stakeholders and government officials, in other words something very similar to the Canadian model. However, a similar Bill introduced in the Senate the following month contained no such provision. At present the FAA, including ATC services, is financed by means of a ticket tax. Inherent in most reform proposals, including that tabled in the House of Representatives, is a move towards user fees as found in the vast majority of other countries. Needless to say, the airlines are keen to ensure that the introduction of fees paid directly by themselves is accompanied by an appropriate reduction in passenger taxes.

The legislation tabled in the House of Representatives proposed an 11-member Board of Directors for the new non-profit organisation, consisting of -

- ✈ 2 Directors appointed by the Secretary of Transportation
- ✈ 4 Directors appointed by the primary airline trade body
- ✈ 2 Directors appointed by the GA representative body
- ✈ 1 Director appointed by the air traffic controllers organisation, and
- ✈ 1 Director appointed by the largest airline pilots body.

Interestingly, no role seems to have been seen for airports, nor for passenger and freight representatives, unless the DOT appointments are meant to do this. However, all Board members would be expected to owe a fiduciary duty to the company, rather than to the body appointing them.

In addition, this being America with its powerful general aviation lobby, the GA community soon got involved. At present GA has a free ride with respect to ATC charges. The draft House legislation proposed that this should largely continue, with exemptions from fees for piston and turbine non-commercial aircraft. However, GA representatives remained concerned that a Nav Canada corporate model would be dominated by airline interests, to the longer-term detriment of GA operators. To be fair, concern about airline dominance was shared by some other stakeholders as well.

The aviation legislation introduced into Congress in February/March was primarily aimed at re-authorising FAA financing beyond the end of March. There was never likely, therefore, to be sufficient time to address the complexities of ATC reform, a development which, in magnitude, one commentator has compared to airline deregulation in 1978. As *Aviation Week* noted, while FAA reform might be long overdue, it is important to "get the details right." "Probably no measure would win unanimous agreement among all stakeholders. But Congress needs to slow things down if it is to bring as many on board as possible. The risk in not doing so is that opponents could kill the proposal." Equally, however, this subject has been around for a long time, with no shortage of debate.

As a generalisation, ATC employee representatives around the world have tended to oppose moves away from government ownership. In the US, however, NATCA, the controllers' union, has endorsed the principles behind the recent draft House of Representatives legislation. Whether this mainly reflects frustration at frequent government intervention and investment restrictions or a belief that remuneration for its members would be more attractive in a corporatised body, is not wholly clear. (To be fair, NATCA's President, Paul Rinaldi, has been very complimentary about Nav Canada, describing it as "an excellent model." The FAA, on the other hand, while certainly at last phasing out World War II technology, was replacing it, he noted, only with "1990s technology — because it takes that long.") Ironically, however, NATCA's support for reform has generated opposition from certain conservatives to the whole concept of corporatisation, in the apparent belief that it would result in a union-run organisation.

Congress split

Congress itself is split on what to do about air traffic control, to a large extent along party lines, with the Republicans in favour of reform, apart from those fearing increased union power, and Democrats against it, despite the unions' support. On the whole, Republicans are usually likely to favour smaller government, but the Democrats did support airline deregulation in 1978, which was actually promoted by the Carter Administration. Similarly, subsequent Democratic Administrations, including that of Bill Clinton, have argued in favour of ATC reform. Clearly the political situation at present is confusing and complex, with ample room for disagreement.

The influential Government Accounting Office, a research body which reports to Congress, is undertaking a substantial study of ATC reform. It issued its "Preliminary Observations" in February, having consulted over 30 parties (including this author) and its final report is expected shortly. It would be surprising if the GAO did not join others in favouring a Nav Canada-type model, probably with some adjustments designed to satisfy specific US stakeholder interests.

The Democrats seem to have got themselves into an awkward position, possibly because they are confusing corporatisation and privatisation, which are not necessarily the same thing at all. It is worth quoting in this respect the views of Dorothy Robyn, who served in the Clinton White House as an infrastructure/aviation expert and is still an influential commentator. As reported by Bob Poole of the Reason Foundation (hardly a natural supporter of Democratic policies), she notes: "Democrats should not treat this as a principled fight over 'privatisation'. Controllers support the Shuster bill because they like Canada's user co-operative approach to air traffic management, which rewards productivity and involves controllers intimately in the technology modernisation process. Aircraft operators and consumers also benefit. Had Nav Canada existed in 1995, I suspect it … would have been the prototype for the Clinton Administration's proposal. With the problems that prompted that proposal having only gotten worse over the last 20 years, an idea that made sense then should be even more compelling now."

Leaning towards the Canadian model

Thus the argument in the US seems to be leaning towards ATC reform, and towards a Nav Canada model rather than the partial or full privatisation favoured in the UK. On the other hand, this is hardly a new subject. It has been around for many years and there is clearly ample opportunity for further delay. Ronald Reagan, in frustration, once sacked most of the US air traffic controllers then on strike and introduced legislation banning further industrial action. Perhaps it needs a similar brave (foolhardy?) move to break the FAA reform deadlock. Anyone know what Donald Trump's views are on this subject?

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.

TUI looks to long-haul to help stem AIT decline

Following the merger of TUI AG and TUI Travel in December 2014, the "new" TUI Group is attempting to become a globally-scaled, integrated vertical business in the all-inclusive tour (AIT) market. But can that business model — and the company's ambition to expand long-haul flights — compensate for the underlying structural decline of the AIT market?

Aviation Strategy has been following the UK AIT market for many years, and the gradual decline that began in the early 2000s shows no sign of reversal. As can be seen in the chart on this page, total charter passengers out of the UK yet fell again last year — for the 14th year in a row — and the 2015 total of 16.4m is less than half the 2001 figure of 34.5m charter passengers.

In terms of the split of scheduled versus non-scheduled capacity offered by UK airlines (see chart on the next page), non-scheduled ASKs also dropped again last year, to 13.6% — its lowest ever proportion — and is substantially down on the 32% that non-scheduled ASKs represented in 2001, or the 37% of 1989.

As is well recognised now (though that wasn't the case as recently as three or four years ago), the decline in the AIT market is structural and permanent, with the power of the internet allowing leisure travellers to research, construct and book their own holiday packages of accommodation and flights from multiple suppliers online very easily. The concept of prospective holidaymakers being trapped on the other side of a desk while travel agents tell them what is and isn't available has been rendered anachronistic, and the number of high street travel agencies has declined relentlessly year after year.

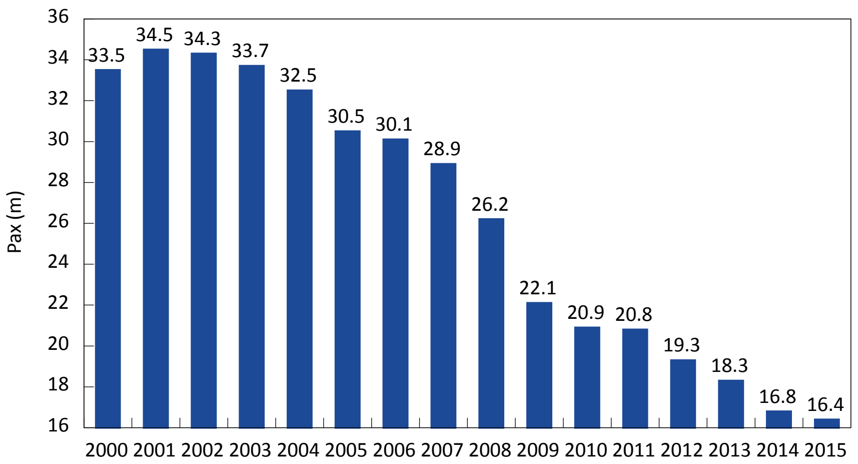
The last remaining giants of the European AIT industry — TUI and the Thomas Cook Group — belatedly reacted to these changing fundamentals by overhauling their business models and managing the decline of the lower margin, mass holiday package while building up revenue from (more profitable) differentiated holiday experiences and services.

The TUI merger

For the first of these giants, though, part of its reaction to the changing market was a plan by TUI AG (the Hannover-based travel and shipping conglomerate) and UK-based TUI Travel to merge and become the world's largest integrated tour operator/tourism business. However, this ambition had met with a mixed response from analysts, with scepticism based partly on the seemingly never-ending history and rumours of the on-off merger, which started not long after TUI Travel came into existence in 2007 following the merger of TUI AG's travel assets with UK-based tour operator First Choice (see *Aviation Strategy,* July/August 2014).

The more legitimate concern was based on the potential financial benefits of the merger, and whether it made sense strategically. From TUI's point of view, the strategic rationale was that the UK business was a good fit in terms of vertical integration, while the merger of TUI AG and TUI Travel is expected to deliver annual cost savings of €50m by the end of 2016/17 — although TUI is incurring €35m of one-off integration costs in order to achieve those savings.

THE STEADY DECLINE OF UK CHARTER PASSENGERS



Source: UK CAA

In fact in financial year 2014/15 (which included nine months post-merger) TUI posted its best-ever 12-month period of underlying EBITA (€1bn, based on €19bn of revenue), and the second year (FY15/16) has started reasonably well. In the first half of its 2015/16 financial year — the six month period ending 31st March 2016 — the TUI Group saw revenue rise 2.7% year-on-year to €6.8bn, and at the EBITA level it reported a loss of €288.3m, compared with a €368.5m loss a year earlier (tour operators typically rack up losses in the first six months of their financial year, where they have more costs than revenue). Its "underlying" results (which exclude one-offs and other items, and which adjust for timings of key travel dates such as Easter) for H1 2015/16 showed an EBITA loss of €236.9m, compared with a €283.1m loss a year earlier. At the underlying level the net loss was €293m in H1 2015/16, compared with a net loss of €323m in April to September 2014.

Looking at the critical summer holiday season for 2016 (as can be seen in the table on the facing page), as of early May TUI Group had achieved a 1% increase in the average selling price (ASP) of all its mainstream holidays, and with a 1% increase in bookings the two factors combined to produce a 2% rise in revenue. The situation, however, varies significantly between source markets. In the large UK market TUI has not pushed through price increases, and customer numbers have risen by an impressive 7%. However, in the Nordics, an average 6% increase in the selling price has seen customers fall by a hefty 9%, leading to an overall fall in revenue of 4% out of the Nordics.

TUI — like all tour operators — is vulnerable to external shocks that can effectively switch off demand for popular destinations almost instantaneously, and at the moment the company is coping with reduced demand for Belgium, North Africa and Turkey. If Turkey's figures were excluded, for example, TUI's 2016 summer bookings would be 8% up year-on-year, rather than 1%.

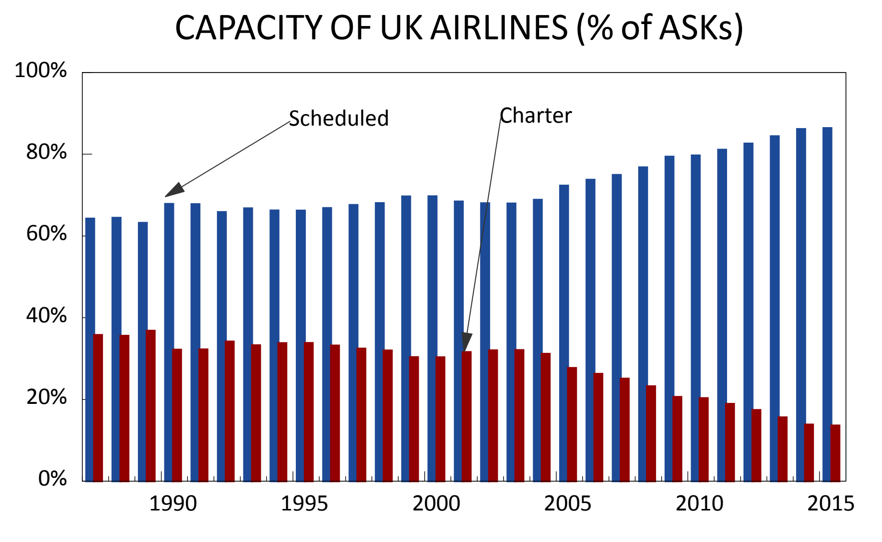
TUI's strategy

The TUI Group's goal is to become a "content centric, vertically integrated tourism business" — and in financial terms it aims to deliver at least a 10% CAGR in underlying EBITA in the current financial year (2015/16, ending 30th September 2016) and the following two years, to 2017/18.

To achieve the latter, TUI is being ruthless in its drive to become vertically integrated and achieve economies of scale globally. For example, in April this year TUI announced a deal to sell its Hotelbeds subsidiary (a marketplace selling rooms to travel agencies and airlines) by September for €1.2bn to Cinven and the Canada Pension Plan Investment Board, the proceeds of which will be used to strengthen its balance sheet and "invest in future growth opportunities". That first purpose is crucial, as TUI Group still has long-term debt of €2.3bn, as at the end of March 2016.

And, interestingly, the TUI Group now says that after carrying out a strategic review it will break up and dispose of its so-called Specialist Group. A move into specialist holidays had been part of TUI's core strategy previously and was seen as a big growth engine as it attempted to diversify away from lower margin product, but clearly management now believes that not all specialist products offer those high margins. Perhaps more importantly, according to Fritz Joussen — TUI Group chief executive — the 50 individual businesses that make up the Specialist unit "don't use our brand; they don't use our IT; they are not in our hotels; they are not in our cruise ships; they don't use our aviation. There is no synergy and we therefore have decided we want to be disciplined — we want to be vertically integrated and content-centric".

Therefore some specialist busi-



Source: UK CAA

TUI GROUP FLEET

	Thomson Airways	TUIfly	Jetairfly	TUI Airlines Netherlands	TUIfly Nordic	Total
A320			2			**2**
737-400			1			**1**
737-700		5	5			**10**
737-800	33	35	14	7	5	**94**
737 MAX	(60)					**(60)**
757-200	14					**14**
767-300ER	4		2	1	1	**8**
787-8	9		1	3		**13**
787-9	(3)					**(3)**
ERJ-190			3			**3**
Total	**60 (63)**	**40**	**28**	**11**	**6**	**145 (63)**

Note: Orders in brackets

nesses (such as Crystal Ski and Thomson Lakes & Mountains) are being transferred into the UK source market core product, but all the other more esoteric specialist businesses (such as educational trips for schools and high-end tailor-made holiday products) will be sold in one transaction. The emphasis is now firmly on making the "core" holiday product — from where the majority of revenues are generated — more differentiated and value-added for customers.

The key to achieving this goal is the assembly of "exclusive content" — whether holiday packages, hotels or cruises — and a vital way to deliver that is a concerted push into more long-haul product, which typically is higher margin and makes revenues more resilient by diversifying risk of market downturns (such as has been occurring in Mediterranean destinations this summer through fear of ISIS attacks).

Indeed TUI's long-haul bookings rose by 9% in the winter 2015/16 season, and as at May long-haul bookings for the summer 2016 season were up 10% year-on-year, with destinations in the Caribbean and the Asia-Pacific region proving to be particularly popular with European source markets (and specifically from the UK source market, for long-haul holidays to Mexico and the Dominican Republic).

Long-haul expansion

That strategy is flowing into TUI's group's fleet plans. Currently the company operates 145 aircraft in five airlines (see table on the current page), and they fly approximately 13m passengers a year to more than 180 destinations around the world.

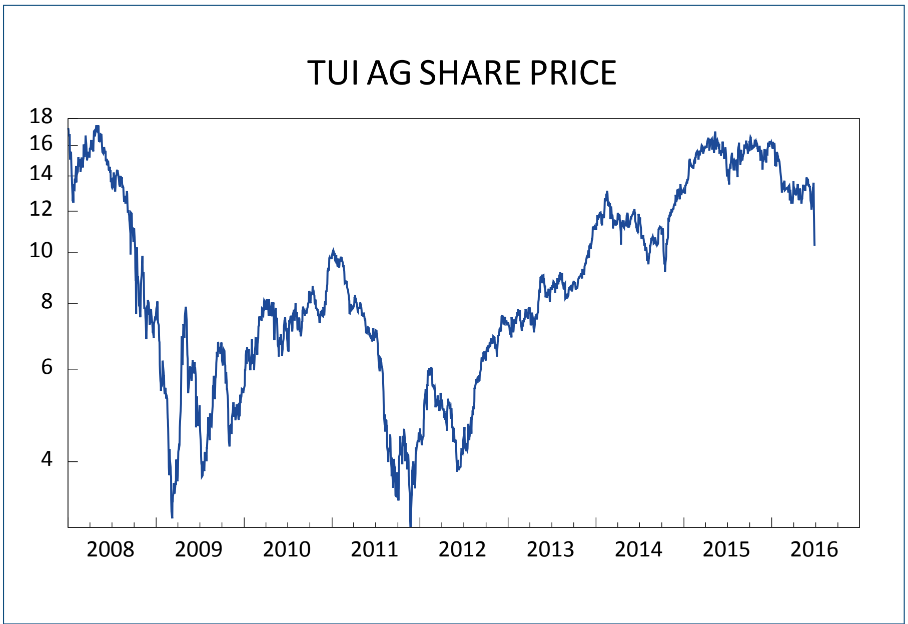
The TUI Group currently has 63 aircraft on firm order, comprising three 787-9s (one each arriving in FYs 15/16, 16/17 and 17/18) and 60 737MAXs (with 40 MAX-8s and 20 MAX-9 models), which are being delivered through to 2021. TUI Group ordered one 787-9 in May 2015, and then swapped two undelivered orders for 787-8s for two 787-9s. The Group also has options for a further 21 737MAXs and a single 787-9.

Currently the TUI Group carries 1m long-haul passengers a year on its packages, and the group wants to increase this to more than 1.5m within the next five years. The 787s are core to this long-haul ambition, and among key destinations for new

TUI SUMMER 2016 BOOKINGS

	Change on summer 2015		
Mainstream holidays	Average selling price	Customers	Revenue
UK	0%	7%	7%
Nordics	6%	-9%	-4%
Germany	1%	-3%	-2%
Benelux	-1%	0%	-1%
Total	**1%**	**1%**	**2%**

Note: As at early May, compared with figures at the same date a year earlier.



charter routes as the fleet builds from the current 13 to 17 (including one option, which the Group is likely to exercise) will be the Caribbean, the Indian Ocean and Thailand.

In terms of the individual airlines, Luton-based Thomson Airways operates a fleet of 60 to almost 100 destinations, and is the group owner of the firm orders for three 787-9s and 60 737s MAXs. Its current fleet of nine 787s will be the core of TUI's long-haul business going forward, and it currently operates to multiple destinations in Africa, the Americas and Asia. Its 14 757s will be phased out by 2021

Based at Hannover airport is TUIfly, which operates 40 737s to around 40 destinations, while Jetairfly (based in Brussels) has 28 aircraft; TUI Airlines Netherlands (Schiphol) has 11; and TUIfly Nordic (Stockholm) has six.

One further airline is Corsair International, which is based at Orly airport and which operates two A330-200s, two A330-300s and three 747-400s. It operates both scheduled and charter services to a handful of destinations in the Africa and the Americas, but is loss-making and as the TUI Group has been trying (unsuccessfully) to sell the carrier for a while, it is no longer regarded as being part of the core TUI airline fleet.

But even after discounting Corsair, the five constituent airlines still contain 10 different aircraft models. Although the dominant model is the 737-800, which accounts for almost two-thirds the total fleet, this variety has long been the norm for TUI (whatever its corporate structure), and it's a valid criticism to say that over the years management has been far too slow in rationalising and standardising the fleet.

Rebranding and rationalisation

When the merger was completed TUI stated that the different airlines would be rebranded under one single and global TUI airline brand, although Fritz Joussen — TUI Group joint chief executive at the time, alongside Peter Long (Joussen becoming sole chief executive in February 2016) — said that it would be a careful process as they did not want to "destroy local brand equity".

That process will therefore take many years to complete (some reports say up to 10 years!), and is starting with continental European airlines first, before the Thomson brand gives way to the TUI brand in a second phase. So far only Schiphol-based ArkeFly has been rebranded (in October 2015), and it is now known as TUI Airlines Netherlands. According to Joussen the rebranded Dutch airline has since "won seven percentage points in market share". Jetairfly is scheduled to be the next airline to be rebranded.

TUI also has a "One Aviation" programme in which its airlines align and combine their engineering and maintenance, ground operations, supplier management and procurement; this effort is targeting €50m of annual savings by 2018/19.

There has been speculation that these rebranding and savings programmes are the first step towards a much greater rationalisation of TUI's aviation assets in face of fierce competition from LCCs (which make self-assembly for prospective holidaymakers easy and cheap), with some unconfirmed reports that TUI's long-term plan is to use Thomson Airways as the base for the combined airline. Potentially this could lead to significant reduction in jobs at the Tuifly operation in Hanover (where 2,000 people are based) — though this will inevitably face fierce opposition from German unions if it does occur.

The anglo-german strategy will come under review following the Brexit vote.

Air Canada: Quest to become a "global champion"

AIR CANADA and its lower-cost unit Rouge are in the midst of an aggressive international expansion drive. In the past month or so, Air Canada has launched three new intercontinental routes — Toronto-Seoul, Vancouver-Brisbane and Montreal-Lyon — while Rouge has entered seven new seasonal transatlantic markets (Gatwick, Glasgow, Prague, Budapest, Warsaw, Dublin and Casablanca). Since early May Air Canada has also launched 11 new US transborder routes, including four new US destinations.

Furthermore the strategy of trying to capture sixth freedom traffic between the US and Asia/Europe via Toronto and other Canadian hubs has gone into overdrive.

At a time when capacity restraint is the name of the game among global carriers, Air Canada is unashamedly going after market share. The management admitted it in the latest quarterly earnings call. One of the executives noted that Air Canada had ceded a lot of market share to foreign carriers in the past and now intended to recapture it.

Air Canada feels justified in stepping up growth because it has staged an impressive financial recovery since 2009 and has continued to meet or exceed its financial targets. The company insists that "sustained profitability" remains its key long-term goal.

Thanks to a combination of reduced costs, best-in-class premium offering and the "right transit programmes in place at key airports", AC feels that it is well positioned to attract transit traffic. It enjoys network, scale and other benefits that position it well for such a strategy (more on that below).

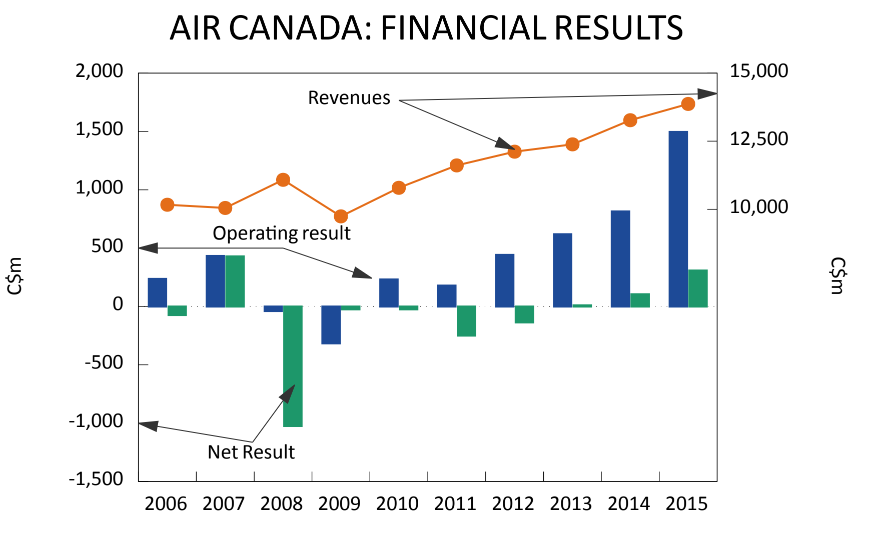
But the financial benefits are somewhat questionable, especially at a time when the global economy is slowing and fuel prices are on the uptick. Also, although Air Canada is now profitable, its operating margins (10.8% in 2015 and 4.6% in Q1 2016) continue significantly to lag those of its North American peers.

There are three obvious reasons for the margin gap: Canada's economic slump, a weak domestic pricing environment and the sharp weakening of the Canadian dollar against the US dollar in the past couple of years (though this year has seen a slight rebound). But Air Canada has also benefited from lower fuel prices. In the March quarter, its fuel bill contracted by 25%; yet, because of increases in all other cost categories and a weak revenue environment (systemwide RASM fell 5%), operating profit declined by 23% and adjusted net profit by 30%.

It is not the wisest strategy to embark on what Air Canada describes as its "most intensive period of international expansion" in the current environment. Then again, if one takes a long-term view, the potential payout may justify it.

Amazing transformation

Few global carriers have received as much help as Air Canada in terms of bailouts, restructurings (in and out of bankruptcy), labour concessions and pension relief in order to get their houses in order. After completing an 18-month bankruptcy reorganisation in 2004, Air Canada continued to be



Note: The results are on a Canadian GAAP basis up to and including 2009; 2010-2015 results are on an IFRS basis. Source: Company reports plagued by high costs and financial losses. When the global recession hit in 2009, AC almost ran out of cash but managed to pull itself out of that crisis thanks to labour and supplier concessions and some creative financings. But Air Canada's subsequent (post-2009) transformation has been nothing short of miraculous.

Calin Rovinescu, who took over as Air Canada's CEO in April 2009, reminisced in a recent speech how he originally came up with the idea of "global champion" as a topic for a September 2010 speech. He noted that as Canada had just lost many prominent businesses, and given Air Canada's dismal history, some in the audience thought he was delusional while others wondered what he was smoking.

Rovinescu asked: "Why couldn't Air Canada, a then 75-year-old company, be capable of really thinking big?" He believed that the key tactics would be to take some risk, play to strengths and be nimble.

The subsequent "global champion" strategy had four core components: cost reductions and revenue initiatives; pursuing profitable international growth opportunities; enhancing product/service differentials; and fostering cultural change.

Air Canada has made great progress on all of those fronts. There was an initial programme targeting C$530m of cost reductions and revenue enhancements in 2009-2011, but progress has been particularly swift since 2012 when more initiatives were adopted — boosting aircraft utilisation, ordering more efficient aircraft, setting up a lower-cost airline subsidiary and revising the contract with regional carrier Jazz.

The two most important moves have been, first, the introduction of the 787. There were 16 in the fleet in March, with 21 more to come by the end of 2019 (see fleet table above). The type offers significant efficiency improvements over the 767-300ER and has opened up new opportunities for profitable growth.

AIR CANADA FLEET PLAN TO 2017

		Year end	
	March 2016	**2016**	**2017**
Mainline			
787-8†	8	8	8
787-9†	8	13	22
777-300ER	17	19	19
777-200LR	6	6	6
767-300ER	17	15	10
A330-300	8	8	8
737 MAX‡			2
A321	15	15	15
A320	42	42	42
A319	18	18	18
E190	28	25	25
Total mainlineϕ	**167**	**169**	**175**
Air Canada rouge			
767-300ER	17	19	25
A321	4	5	5
A319	20	20	20
Total rouge§	**41**	**44**	**50**
Total mainline & rouge	**208**	**213**	**225**
Air Canada Express¶			
E175	20	20	
CRJ-100/200	27	27	
CRJ-705	16	16	
Dash 8-100	24	19	na
Dash 8-300	26	26	
Dash 8-Q400	36	47	
Beech 1900	17	17	
Total Air Canada Express	**166**	**172**	

Notes: † Air Canada has ordered a total of 37 787s for delivery by year-end 2019. ‡ Air Canada has firm orders for 61 737 MAXs for 2017-2021 delivery; the associated narrowbody retirements have not yet been determined. § Rouge can operate a maximum of 50 aircraft under a 2014 pilot deal. ϕ Air Canada has signed an LoI to acquire up to 75 Bombardier CSeries aircraft for mainline operations for delivery from 2019. ¶ Jazz, Sky Regional and other airlines under capacity purchase agreements with Air Canada.
Source: Air Canada

Second, Air Canada set up Rouge in 2012. The unit first flew in July 2013 and has grown rapidly to 41 aircraft, operating 99 routes to 70 destinations. It has been deployed mainly to the Caribbean and European leisure destinations but also to Africa (Casablanca), South America (Lima), Asia (Osaka) and selected leisure-oriented routes in Canada and to the US. Some of the routes have been transferred from Air Canada but many have been new.

Rouge was a risky endeavour, given the potential fallout for Air Canada's premium brand and conventional offerings and the dismal history of low-cost units operated by legacy carriers. But the venture has exceeded management expectations. It has enabled Air Canada to maintain or expand its existing leisure routes and enter new markets, and it has contributed to profitability.

Air Canada has said that Rouge offers 25% lower CASM compared to the mainline fleet. The cost savings arise from higher seat density, lower wage rates, more flexible work rules and reduced overhead costs. Also important is the coordinated approach that leverages the strengths of Air Canada, Rouge and Air Canada Vacations.

The problem now is that Rouge is nearing it maximum permitted size. Under a 2014 agreement with Air Canada's mainline pilots, the unit is allowed to operate up to 50 aircraft (25 767s and 25 narrowbody aircraft).

Another profit-enhancing project is refurbishing the mainline 777-200/300ER and A330-300 fleets with new interiors and adding a premium economy cabin. The move will improve the economics and provide a product consistent with the 787's. The 777 conversions were due to be completed this quarter, with the A330s following in the next 6-9 months. Air Canada expects to recoup the C$300m cost within three years.

Narrowbody fleet renewal from 2018 will also help reduce costs. Air Canada has an order in place for 61 737 MAXs, which will arrive from late 2017 through 2021, plus 48 options. The type will replace the mainline A320-family fleet, resulting in an estimated 10% CASM saving.

The airline is also targeting some narrowbody cost savings in the interim period. It is leasing some additional A321s and A320s so that 20 E190s can exit the fleet, and it is retaining five 767s that had previously been slated for retirement this year. Added together, those two moves will drive a 10% CASM reduction.

Continued cost reductions are critical because Air Canada's yields and unit revenues will remain under pressure for the foreseeable future because of the increasing average stage length, expansion in leisure markets and a higher percentage of connecting traffic.

Air Canada has reduced its unit costs by 9.3% since 2014 and is apparently on track to meet its target of a 21% reduction in CASM between 2012 and 2018 (excluding the impact of foreign exchange and fuel prices).

Key revenue initiatives include a new passenger revenue management system, which is expected to boost profits by C$100m annually when fully implemented. And there remain opportunities to develop ancillary revenues.

As CEO Calin Rovinescu boasted to shareholders at the company's AGM in May, Air Canada has staged quite a transformation since 2009. Its operating revenues have risen by 40% in the six-year period, from C$9.7bn in 2009 to C$13.9bn in 2015, which is impressive for a legacy carrier. EBITDAR margin has improved from 7% to 18.3%, exceeding the target of 15-18%. Adjusted net income has risen from a loss of C$671m to a profit of C$1.2bn.

In the same period, leverage ratio declined from 8.3x to 2.5x (the target is 2.2x by 2018). And Air Canada now has a pension solvency surplus of C$1.3bn, compared to a deficit of C$2.7bn in 2009.

ROIC was 17.4% in the 12 months to March 31, exceeding the 13-16% target for 2016-2018. Unrestricted liquidity was C$3.2bn (23% of last year's revenues).

But perhaps the most amazing achievement is the turnaround in labour relations. Achieving a good culture is one of the toughest challenges for airlines; yet, it is critical for the success of a service-oriented company. Air Canada has historically had difficult labour dealings and a culture that was "rule-bound and process-driven". But, according to Rovinescu, it now has an "engaged" workforce and a "culture of entrepreneurship and performance orientation".

Air Canada has been named one of Canada's top-100 employers for three years in a row. It was also recently named one of the best places to work in Canada in "Glassdoor's 2016 Employees' Choice Awards", which are based on a vote by employees. Who would have thought that possible six years ago?

Importantly, Air Canada now has 10-year agreements in place with most of its unions; the key deals with pilots, flight attendants and mechanics were signed in 2015.

It is not entirely clear how such major shifts in labour relations were accomplished, though back in 2010-2011 the management seemed pretty determined to instigate change (see *Aviation Strategy*, June 2011). Other factors that may have helped: stabilisation of pension plans, resumption of growth and the new career opportunities associated with the global expansion.

The long-term labour deals give Air Canada unprecedented labour stability, and the happy and engaged workforce positions it well for

AIR CANADA ROUTE MAP

Note: equidistant map projection based on Toronto.

retaining premium traffic.

Becoming a "global champion"

Since 2009 Air Canada has launched nonstop service to more than 30 new destinations around the world. US transborder and long-haul international operations now account for almost two-thirds of its passenger revenues (65% in 2015). That percentage will continue to increase as about 90% of this year's capacity growth will be international.

One major benefit has been to diversify risk — especially helpful in the past couple of years as Canada's economic growth has slowed, the currency has weakened and the domestic pricing environment has deteriorated.

Air Canada's international growth has focused on two specific strategies: competing effectively in the leisure market to and from Canada (which has been accomplished with Rouge) and tapping sixth freedom traffic via Air Canada's international gateways, especially Toronto and Vancouver but also Montreal and Calgary.

Tapping sixth freedom traffic to and from the US makes much sense because the Canadian domestic market is limited in size and already quite mature. The US market is 10-12 times larger.

Air Canada estimates that at present it has 1% of the international connecting traffic to and from the US carried by non-US airlines. The management makes the point that just increasing that share to 1.5% would translate into 1.68m extra passengers per year or around C$605m incremental revenue.

The sixth freedom strategy is successful and has further potential because Air Canada enjoys the following benefits (in no particular order of importance):

✈ Geographically well-positioned hubs, with efficient transfer processes

Toronto Pearson, Air Canada's main hub for global traffic, is well located near the centre of North America and in close proximity to the densely populated major markets in the US. The city also has significant local traffic.

There is strong competition for global traffic from rival hubs in New York and Chicago, but Air Canada and the airport authority have worked closely to create a fast and efficient connection process that compares very favourably with the US hubs. For example, the elapsed travel times via Toronto for someone going from Philadelphia to Asia would be "very competitive, if not the fastest". An added benefit is that Air Canada and its Star partners operate from the same terminal in Toronto.

Vancouver, in turn, is a natural gateway to Asia Pacific, offering some of the shortest elapsed travel times to that region from North America. Air Canada is growing it into a premier Pacific gateway. And Montreal is being "invigorated" as a "francophone hub" — a gateway to French international markets. An example is the recently added five-per-week Montreal-Lyon service, utilising 767-300ERs.

To illustrate the strengths of Air Canada's four hubs, at year-end 2015 the hubs offered the following total daily departures: Toronto 349, Vancouver 148, Montreal 144 and Calgary 110.

✈ US-Canada open skies ASA

Canadian airlines benefit from a full US-Canada open skies regime. The transborder services were initially liberalised in 1995, and the ASA was further relaxed in 2007 to allow sixth freedom via Canada.

✈ Extensive traffic rights and slot holdings

Canada has extensive traffic rights around the world that in the past were largely unused as Air Canada struggled financially. So now, unlike US airlines in many cases, Air Canada does not have to wait for ASAs to be liberalised; the opportunities are there to be cherry-picked.

Also, Air Canada claims that it benefits from extensive holdings of slots at favourable times at busy airports, including Beijing, Shanghai, Hong Kong, Tokyo Narita, Tokyo Haneda, Paris, Frankfurt, London Heathrow, London Gatwick, New York LaGuardia and Washington Reagan.

✈ Canada's multi-ethnic population

Canada is a common destination for immigrants from around the world and has large communities of different ethnic groups. There are strong historical ties especially with the UK and France. All of that means significant VFR traffic and steady demand.

✈ Scale and network benefits

Air Canada has a strong route franchise and leading market shares in the Canadian domestic, US-Canada transborder and long-haul international markets. In 2015 Air Canada and its units accounted for about 55% of domestic ASMs (compared to WestJet's 37%), 41% of total ASMs (including US carriers) in the US-Canada market (compared to WestJet's 20%) and 37% of total ASMs (including foreign carriers) in the Canadian long-haul international markets (compared to WestJet's 4%).

Air Canada offered as many as 53 US destinations from Canada at year-end 2015 — and that list will grow this year. The mainline, Express and Rouge operations are coordinated to maximise connections. Such scale, dominance and critical mass in North America adds up to impressive connectivity.

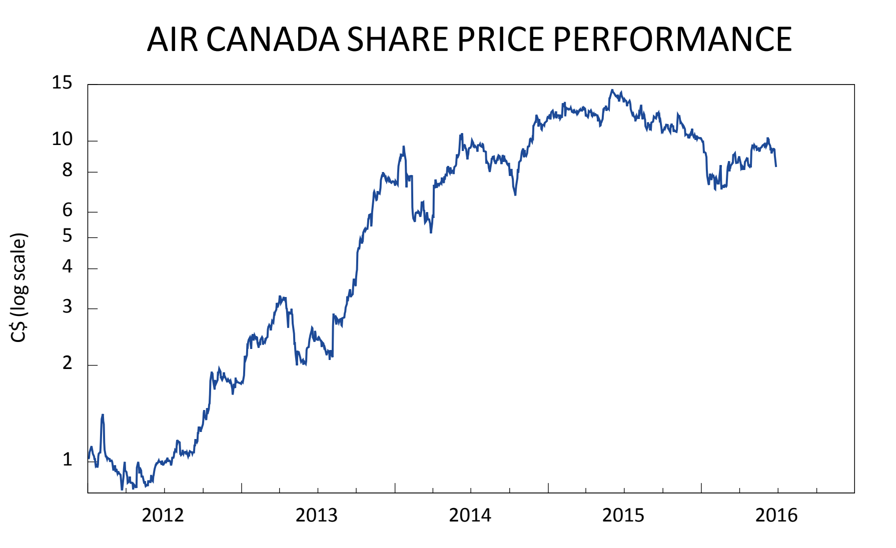
✈ Star and transatlantic JV benefits

Air Canada is a founding member of Star and benefits greatly from belonging to what is arguably the strongest of the three global alliances. Other benefits include a revenue-sharing transatlantic JV with United and Lufthansa and codesharing with United in North America.

✈ Superior product and well-known global brand

Air Canada stands out for its industry-leading product offering and service quality. That has been the case historically and the airline continues to maintain the differential; one recent example is the introduction of a "next-generation cabin" in international business class. Air Canada is the only North American airline to offer a true premium economy cabin, and it is the only international airline in North America to be rated four-star by Skytrax.

All of that, in combination with the iconic global brand, bodes well for



profitable international growth and for attracting connecting traffic.

✈ New traffic management tools

Air Canada has new tools at its disposal that enable it to pursue international growth opportunities more profitably. In particular, its new O&D management system enables it to "better optimise traffic flows we select to carry, be it point-of-sale in Canada, US or international".

✈ Solid fleet plans

Air Canada has the fleet plans in place to facilitate robust international expansion. Its C$9bn capital investment programme (mostly on new-generation aircraft) will ensure both sufficient aircraft numbers and one of the youngest fleets in the industry.

In addition to the continuing 787 deliveries and the substantial 737 MAX orders, Air Canada is expected to in the near future firm up an earlier letter of intent for up to 75 Bombardier CS300s (45 firm and 30 options, with some CS100 substitution rights). The first 25 of those aircraft will replace the mainline fleet of E190s; the rest are for growth.

All in all, Air Canada seems uniquely well positioned to grow internationally and attract sixth freedom traffic. But it is less certain that the strategy will help it attain the goal of "sustained, long-term profitability".

It is a low-yield growth strategy that will require continuous relentless cost reductions. Those in turn depend on rapid fleet renewal and mean heavy capital spending at a time when profitability is not yet that strong and when margins may have peaked. But there is flexibility in the fleet plan (via lease expirations, for example) to slow growth if necessary.

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