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Shocks and aftershocks

OF ALL THE INDUSTRY SECTORS it appears that the European airlines have been the hardest hit by the surprise result of the referendum vote by Britain to leave the European Union. The following charts show the share prices of the major European carriers, indexed (after translation into Euros where necessary) to the 23rd June. The prime reason for the negative reaction is the uncertainty generated by the result — for further edification see next article.

Both IAG (aka British Airways) and easyJet were marked down by 40% (10-15% of which was currency related); Ryanair (a major non-UK player in the UK market), and strongly growing Norwegian, by 20%; Wizz, because it is quoted on the London exchange and does good business providing links with Central and Eastern Europe, by 30%.

This reaction seems to us a bit of overkill, and the markets may have forgotten that the UK is still one of the strongest O&D aviation markets in the world. Meanwhile IAG is sitting on the best aviation real estate at Heathrow, which following the change of political power is unlikely to be granted the option to apply to build another runway.

Even the other two major European network carriers were affected. Lufthansa and Air France-KLM each dipped by 15%. Since the vote, Lufthansa has stabilised at around 10% below the level on the 22nd June while Air France-KLM has come under further pressure and its share price is some 50% below this year's peak in March.

The UK market index meanwhile has remained relatively steady (in Euro terms) while Sterling has dipped by 15%.

In the US markets there was a knee-jerk reaction, but most of the major players' share prices have rebounded. The best performer since the end of June being American — ironic considering that the uncer-

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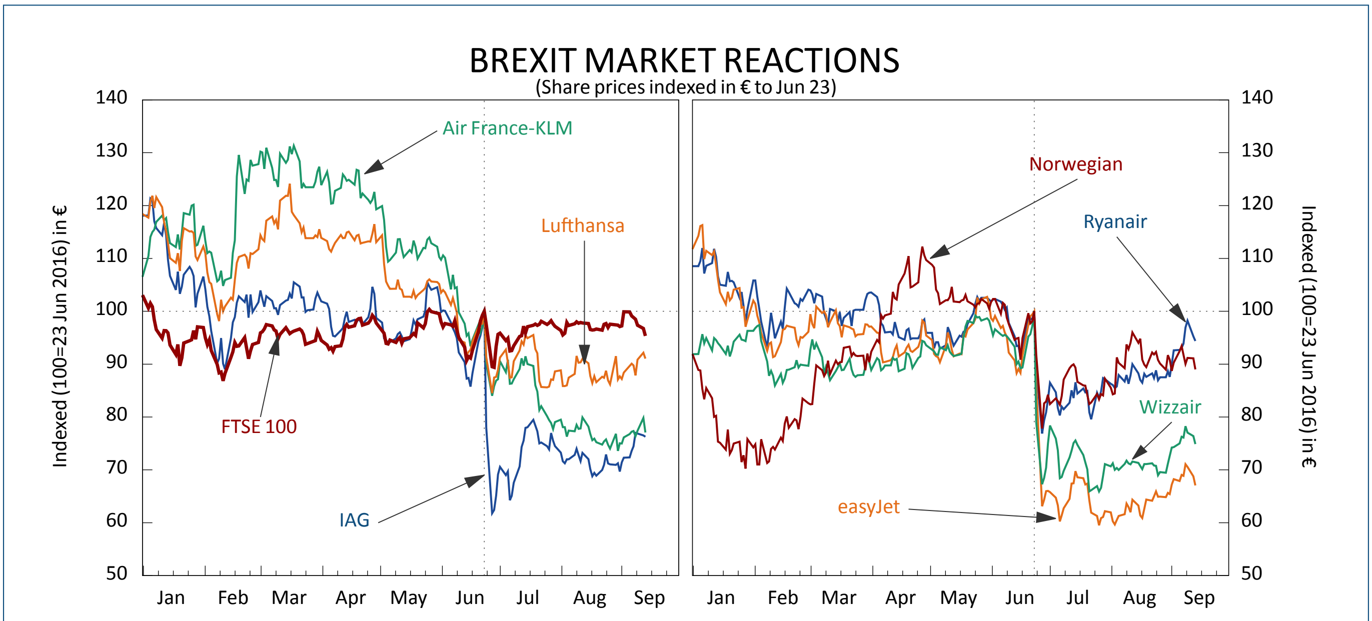

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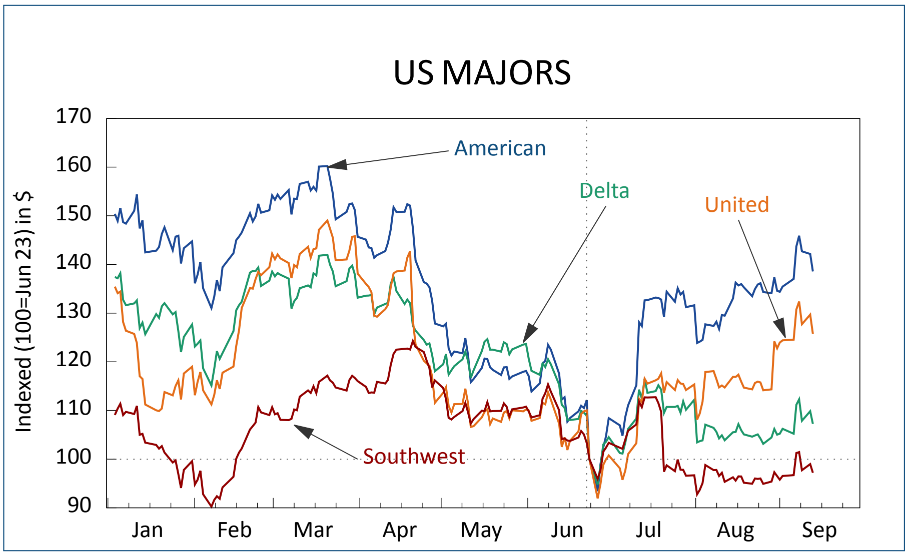
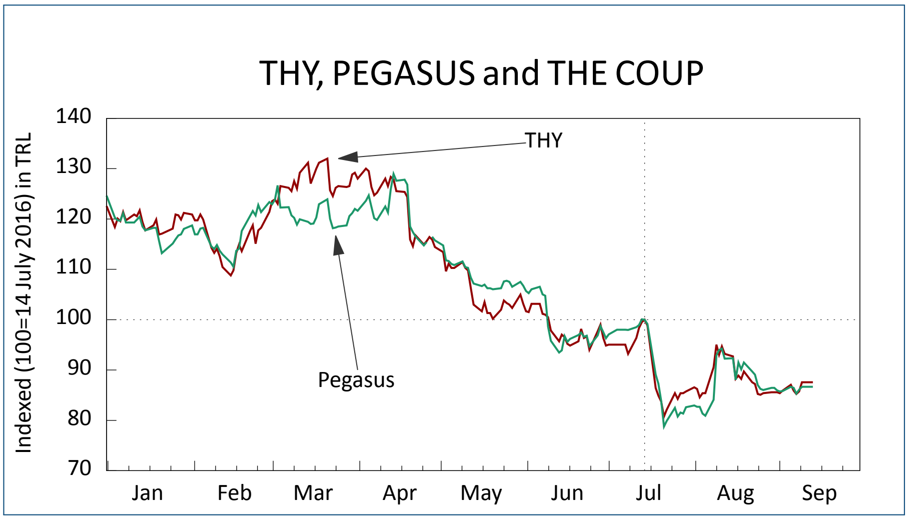


tainty surrounding Brexit could well undermine its trans-Atlantic joint venture with BA and Iberia. But then this is a recognition of the strength of the dollar following the vote and the parochial nature of the US stock markets.

Meanwhile, the failed Turkish coup in July sent its own shockwaves into the aviation sector. The share prices of both THY and Pegasus plummeted immediately then recovered, in effect reestablishing the downward trend seen since early this year when Turkey became embroiled in the Syria war, and tourism cratered.

In the first half of 2016 THY's revenues fell 3% to $4.63bn compared to 2015, and a net loss of $647m was recorded in contrast to a profit of $406m in 2015. Pegasus's revenues in the first six months of 2016 (its low season) totaled $514m, slightly up on 2015, but the pre-tax loss slumped to $102m compared to $9m in 2015.

In the short term, Turkish aviation ambitions in Europe (see *Aviation Strategy*, May 2016) have been thwarted by geopolitics. In the longer term, they might well recover — both airlines have strong operating models — but negotiating on access with an EU *sans* the UK, and now dominated by protectionist-leaning France and Germany, looks a bit problematic.



Brexit and Aviation : All Clear Now?

It is now almost three months since the citizens of the United Kingdom voted narrowly, but decisively, to leave the European Union. The shock to the aviation industry was at least as great as that to any other business sector. Overwhelmingly airlines, airports and manufacturers had urged a Remain vote. Not surprisingly the immediate reaction to the result was: *now what do we do?* It quickly became evident that the complexity of the subject was such that no-one really knew the answer to this question, or indeed could come close to knowing with any certainty.

Initial panic may have been replaced by the beginnings of serious planning, but the fact remains that the UK is still a long way from being able to identify its future relationship with Europe, and this is as true of aviation as of anything else. As the London *Sunday Times* commented, quoting numerous Whitehall sources, the Government has made little progress in drawing up a credible Brexit plan. The new Department for Exiting the European Union doesn't "yet even have a permanent home and lacks a phone number, e-mail addresses or IT systems". In terms of putting meat on the bones of the Referendum vote, "Brexit means Brexit" is just a meaningless slogan at present.

Despite this, however, it is at least possible to shed more light on the options available. The June issue of *Aviation Strategy*, published within days of the Brexit result, outlined the immediate reaction to the decision. It pointed out that Article 50 of the Lisbon Treaty, launching the two-year exit negotiations, would probably not be invoked until the autumn. In fact, the timetable will probably be pushed back even further, to early next year, or even to next September if some reports are to be believed. From one perspective this is good news: it gives more time to prepare what will certainly be the most complex set of negotiations the UK has ever undertaken. But it also means more uncertainty for everyone, which is definitely not what business wants. Too much delay would also risk the next General Election in 2020 being dominated by the Brexit debate, perhaps even turning into another referendum.

It is important to remember that no matter how critical aviation might seem to us, in the Brexit negotiations it will be just one of many key sectors which will have to be addressed in detail. At the end of the day there may well have to be trade-offs between sectors, which will not be easy for Ministers. Above all, and as explained further below, it will probably be impossible to determine the final outcome of the aviation package before other major macro decisions have been taken, for example on the overall policy on the free movement of labour.

The macro picture is further complicated by developments in the European political landscape over the next year or so. We have already had the appointment of a new Prime Minister in the UK, accompanied by a perhaps surprising change of direction on a number of policy issues. It remains to be seen how the Brexit negotiations will be handled by the triumvirate of leading (and personally ambitious and at times mutually antagonistic) anti-EU politicians appointed to lead them, under the no doubt firm hand and close supervision of Theresa May. At the same time, the principal opposition party, Labour, continues to tear itself apart, raising the possibility that by the time of the next General Election the populist anti-EU UKIP could significantly increase its presence in Parliament, assuming it doesn't itself implode by then. And to top it all off, lurking north of the English border is the pro-Europe Scottish National Party just waiting for the opportunity to declare Scotland independent and re-join the EU.

The political picture is no clearer on the Continent. Italy continues to face a financial as well as an ongoing political crisis, with the ever present threat of a banking collapse. Spain is unable to form a new coalition government, despite two elections, and another election seems a distinct possibility. (Spain, of course, is particularly significant in European aviation negotiations because of the ˝Gibraltar problem˝.)

As ever in the EU, however, it will be Germany and France which will be the key players when it comes to what kind of Brexit deal the UK can negotiate, and both countries face critical elections over the next year. Mrs Merkel may stand a reasonable chance of being re-elected, if she chooses to stand, but the signs are that her position will be significantly weakened. The prognosis for M. Hollande is even less rosy and defeat by the right looks likely. Even if this victory does not fall to the *Front National*, the anti-EU populist party, they will certainly have an impact on the the debate about the whole future of the EU and the UK's exit from it. There is also an election due in the Netherlands, again with a growing anti-EU party in contention, and of course, across the Atlantic, the US Presidential election will mean that any early attempt to negotiate a new UK/US aviation agreement will be difficult as the new Administration sorts itself out, which on past experience can take many months.

None of this is good news for anyone seeking clarity on the likely outcome of the Brexit negotiations. As the old joke goes about someone asking for travel directions, you really don't want to start from here. It is difficult to identify who the key decision-makers will be, and even more difficult to determine bottom lines. With Mr Junker and the European Commission at least notionally in charge of the negotiations from the European side, and the kind of rigid policy declarations which inevitably characterise elections, it is going to be a bumpy few months before, hopefully, calmer views emerge.

The Short-Term Impact

There is no doubt that business confidence, especially in the UK but also beyond, has taken a hit as a result of the UK decision to leave the EU. Inevitably economic forecasts differ, but overwhelmingly they point to a significant reduction in economic growth, despite some quite positive early indications. The assessment by the UK Treasury suggested that UK GDP will be some 3.6% to 6.0% lower by 2018 than it would otherwise have been. Admittedly this forecast was produced during the Referendum campaign and has been criticised by many supporters of Brexit for being too pessimistic; but even at its lowest level it implies a substantial negative impact. Business uncertainty in a post-Brexit world was a key factor in the assessment, and as we have seen, so far uncertainty remains the prevailing preoccupation.

Air transport demand is highly susceptible to GDP growth. A significant decrease in the performance of the UK economy, even if it falls short of actual recession, combined with the continuing poor record of the Euro zone, is not good news for the European aviation industry.

IATA's review of post-Brexit economic forecasts shows a likely reduction of 2.5% to 3.5% in UK GDP by 2020. This (when combined with the effect of a lower sterling exchange rate — see below) translates into a probable fall in UK passenger demand of some 3% to 5% over the same period, with a less certain but still likely weakness in freight demand.

The 1.0 to 1.5% reduction in the growth rate each year is a permanent downward shift in demand, not a temporary phenomenon to be reversed later. It comes at a time when the global airline industry has almost certainly passed its cyclical profit peak, following record high margins (for airlines) in 2015 and 2016. The direction is clearly downwards, meaning that the industry is less likely to be able to accommodate the Brexit effect painlessly.

The second immediate economic impact of the Brexit vote was the fall in the value of sterling against most other countries, and in particular against the dollar and Euro. Cheaper sterling can be good news for airlines in that it encourages tourism to the UK. However, for British citizens foreign holidays become more expensive, and for UK airlines those costs denominated in dollars, such as fuel and aircraft ownership, or Euros, such as European ATC charges, will increase.

Taken together, dollar and Euro costs account for a large proportion of total airline expenditure. The net impact on individual airlines will vary from company to company, but UK-based carriers, which tend to attract a disproportionate number of UK passengers, are likely to be worst affected.

There is growing evidence of individual airlines beginning to adjust to this new economic environment. Where they are able to do so, many are seeking to reduce their exposure to the UK and switch resources to other markets. Several, including IAG and easyJet, have issued profit warnings, although Brexit was far from the only contributory factor here. (For the latest reported quarter, IAG noted a negative currency impact of Euro148 million, primarily due to the weak pound.)

However, both IAG and easyJet have said that they did not expect the Referendum result to have a long-term impact on their businesses. Willie Walsh of IAG went so far as to say that "the fundamentals of the business have not changed. There is some short-term turbulence, but ultimately things will settle down." It remains to be seen whether this is just wishful thinking. There are certainly causes for concern.

The regulatory risk for individual airlines depends partly on their route networks. In the case of easyJet, for example, some 57% of its frequencies are either international UK or domestic UK, leaving 43% operating to, from or within other EU countries. In terms of ASKs, some 35% of its output is devoted to non-UK EU internal market services. The equivalent figure for bmi regional is 33%. Ryanair may be Irish-registered, but it serves 29 countries from the UK, only one less than easyJet. 35% of Ryanair's flights are to, from or within the UK. Wizz Air and Norwegian serve the UK from 14 and 13 countries respectively. Some 28% of Hungarian-based Wizz Air's seat capacity this year is on routes that touch the UK, but less than 4% on routes between Hungary and the UK. Three non-UK airlines, Aer Lingus, Ryanair and Germania, operate UK domestic services, but only to a limited extent; such services account for one percent of their total ASKs or less.

It is evident that the market access risks associated with Brexit are greatest for the short-haul low cost carriers. The legacy carriers almost invariably fly to the UK only from their home markets, so potentially might even gain from a curtailment of LCC competition.

Ryanair has already announced the allocation of 10 additional aircraft previously destined for the UK market to Germany, Poland and especially Italy. Overall the growth in Ryanair's UK flights next year will decline from 15% to 6%, representing about five million fewer seats to and from Britain than originally planned. Michael O'Leary has been quoted as saying that it is "highly unlikely" the airline will allocate new aircraft deliveries to the UK (out of 39 737-800s to be delivered during the 12 months to next March). "We will pivot our growth away from UK airports and focus more on growing at our European airports over the next two years."

Wizz Air has also halved planned capacity growth in the UK, from 30% to 15%, the equivalent of two A320s, pointing to the pound's devaluation as the main reason.

Long-haul services have similarly been affected, although probably to a lesser extent. Capacity reductions announced so far have been concentrated on UK-originating leisure routes, as one would expect.

Delta and its transatlantic partner Virgin Atlantic have announced a cut in UK-US capacity of 2-4%. Delta alone has forecast a $40 million reduction in its $350 million revenue earned in sterling as a result of the pound's devaluation. United will close its Newcastle-New York service, almost certainly a predominantly UK-originating route, from 6 September, and has agreed to continue to operate between Belfast and Newark only in return for a three-year £9 million subsidy from the Northern Ireland Government, having previously announced the route's closure from September.

On the other hand, American Airlines has said that the impact of Brexit may actually be positive in the short term. Its former President, Scott Kirby, just appointed to the same position at United, was quoted as saying that so far "it is hard to see any evidence it's a big problem." This optimistic view seems to be based mostly on "a lot more lawyers, bankers, consultants flying across the Atlantic trying to figure out what [Brexit] means," perhaps not the most sophisticated of analyses.

Market Access

There is at present an almost total lack of clarity about the likely outcome of the Brexit negotiations, both overall and in relation to aviation. All one can really do at this stage is to list the options available. However, the preferred outcome, expressed by almost everyone in the industry, is relatively easy to identify. The status quo would do nicely, thank you.

Despite periodic grumblings about Brussels bureaucracy and meddling, no Member State has had a greater impact on the EU aviation regulatory regime than the UK. It was the UK, along with the Dutch and Commission, later joined by the Irish, which were the driving force behind the liberalisation of air services in Europe and the creation of the aviation internal market; and the UK has similarly been a strong supporter of much subsequent legislation in areas such as consumer protection, safety regulation, ATC reform, assistance to passengers with reduced mobility — to name just some of the initiatives. Why would the UK industry, and Government, want to change fundamentally a regime which they have fought so hard to achieve, one which has also of course benefited consumers enormously?

Unfortunately, carrying on as before does not seem to be an option. There will have to be change of some sort. The question is: how much? There will almost certainly have to be agreement on certain macro issues, not least the movement of labour between the UK and the EU, before the details of an aviation package can be negotiated. The UK Government has identified three options for a future UK-EU relationship, and each of them has a broad parallel in air transport:

- ✈ Membership of the European Economic Area (EEA), the model followed by Norway. This would bring access to the single market, but so far has also meant acceptance of the free movement of labour. The aviation equivalent would be membership of the European Common Aviation Area (ECAA).
- ✈ A specific bilateral agreement between the UK and EU, as the Swiss

have. This would provide an opportunity to address specific concerns, but on past experience it would have most of the shortcomings of the EEA/ECAA approach.

✈ No special agreement, relying on WTO rules. For air transport this would probably mean falling back on the bilateral air services agreements which applied before the creation of the internal aviation market, if they are still legally valid, and negotiating new ASAs if they are not. However, this would only address the market access problem. There are many other challenges which would require additional negotiation.

At least superficially, the simplest approach might be for the UK to join the ECAA. This is now an enormous market, comprising 36 countries with a population of some half a billion. Furthermore, it is still growing, with the European Commission arguing that eventually it could encompass up to 55 states with a total population of almost one billion. Essentially it is a very large, liberalised air transport market covering the EU and numerous near-by countries, governed by an agreed set of regulations.

However, there are serious shortcomings from the UK's perspective. To join the EAA/ECAA, Norway, for example, has had to accept the free movement of labour, hardly something likely to appeal to those in the UK who voted for Brexit. In addition, the UK would have to accept all current and future aviation legislation (the so-called 'air transport *acquis communitaire*') without having any influence on it. Again, hardly consistent with the Brexit call to "take back control from Brussels". Finally, on past experience there would have to be some form of financial contribution by the UK to the EU budget, potentially a substantial contribution. That will appeal to the Brexiters!

The Swiss-EU agreement on air transport came into effect in 2002, one of seven sectors covered by the overall agreement. Switzerland is not a member of the ECAA, but its bilateral arrangement with the EU provides most of the same benefits. In return, however, it has had to agree to a number of conditions which, as noted above, will not appeal to UK negotiators, not least the free movement of labour. A 2014 Swiss referendum decision requiring restrictions to be placed on such free movement may well, if implemented, mean that Switzerland will be forced to abandon the air transport agreement with the EU. On the other hand, if the EU agrees to relax the labour movement requirement while allowing Switzerland to have continued membership of the ECAA, which some argue is a possibility (but most believe to be unlikely), this could be of interest to the UK.

It should not be forgotten as well that the UK will require the agreement of the remaining EU Member States. They will be under pressure from many of their own airlines and airports to minimise any market disruption and remove uncertainty as quickly as possible. Equally, however, they will have their own competitive agendas. Some governments, such as France and Germany, might be focused primarily on the macro issues determining the overall Brexit negotiations. But others, and perhaps especially Spain, may have particular aviation concerns. For the past couple of years Spain has held up a series of important aviation initiatives, especially in the areas of consumer protection and ATC reform, because of the ˝Gibraltar problem˝, essentially a disagreement between Spain and the UK on the extent to which EU aviation rules should apply to Gibraltar. The crown colony's economy will be very exposed post-Brexit (hence the highest pro-Remain vote of any UK region) and it seems unlikely that the UK Government would abandon its principled position now. At the same time, Spain may well dig in, especially given the current state of its domestic politics. A lengthy stand-off is not impossible.

Another option for the UK would be to negotiate bilaterals with those individual other countries currently covered by EU agreements. This would be a large job, but feasible over time. The UK negotiated a series of very liberal arrangements (at least in terms of third/fourth freedom and pricing rights) with several Western European states shortly before the creation of the internal aviation market. It is not clear whether these would automatically apply again post-Brexit in the absence of an alternative, but if they did, it would provide some reassurance to airlines. Given that the UK is the largest aviation market for most ECAA countries, they could well share an interest in maintaining as much of a competitive environment as possible. However, if new agreements have to be negotiated, there will be an argument over whether the European Commission has competency and therefore a monopoly of negotiating power for the core EU Member States.

The second largest air transport market for the UK after Europe is the US, governed by the EU-US Open Skies Agreement initially signed in 2007. Here there is less doubt about what would happen if the UK withdrew from the EU-US deal. Bermuda II is still a legal entity (it applies to air services between the US and a handful of British Dependent Territories) and would automatically govern UK-US air services again in the absence of anything else. (In fact, the EU-US agreement does not contemplate any individual European state withdrawing, but since technically it is still being applied provisionally, that should not create a problem.) Realistically, however, neither Government is likely to want to see a return to the old mercantilism of Bermuda II, despite the UK's initial lack of enthusiasm for the EU-US deal. The fact that the absence of an open skies regime would inevitably lead to the withdrawal of anti-trust immunity for their trans-Atlantic alliances would certainly mean that the major airlines would support an alternative approach. There is no obvious reason why both the UK and US would not choose to sign a new bilateral quickly based closely on current arrangements, once there is a working US Administration in place.

There is also an EU air services agreement with Canada. Here the previous UK-Canada bilateral agreement, which would presumably apply again if the UK withdrew from the EU deal, was very liberal in terms of third/fourth freedom rights and there is unlikely to be a problem in terms of market access for either side. Similar arrangements would have to be made for the non-EU members of the ECAA, but since for most of them the UK is such an important aviation market, not least for tourists, again it seems unlikely that significant problems would arise other than finding the time to negotiate so many the bilaterals. In the worst case scenario there are even precedents for carrying on without an ASA, at least for a while, on a so-called *comity and reciprocity* basis, as the US and France did for several years.

The European Commission has been negotiating aviation agreements for some time with Brazil, Australia and New Zealand. In addition, it was recently given mandates to approach Turkey, Qatar, the UAE and the ASEAN bloc. Post-Brexit the UK will clearly not be part of these negotiations. Where this matters most for global aviation is with respect to the Gulf area. In the face of strong pressure, in particular from France and Germany, to take action against 'unfair' competition from the Gulf airlines, the UK has been a consistent voice urging a less protectionist approach. The absence of this pro-competitive lobby will almost certainly alter the balance of the debate in Europe and could well lead to a far more protectionist EU international policy. (See *Aviation Strategy*, May 2015)

An additional issue is the fact that the UK, along with other EU Member States, has amended a large proportion of its global air services agreements to incorporate the concept of 'community carrier'. This means that in any UK bilateral agreement containing the clause, airlines from any member of the EAA have equal status in accessing the relevant traffic rights. Thus, French or German carriers, for example, will continue to be treated as UK airlines until every one of the relevant ASAs has been renegotiated, while UK carriers will cease to have similar treatment in EAA bilaterals from the moment Brexit takes effect. Fortunately the commercial importance of this problem is fairly small, given the relatively few airlines operating long-haul services from another EAA member state.

Thus, these are some of the market access complexities created by Brexit. There are no simple answers or obvious compromises. The whole debate will almost certainly be long and very difficult to conclude until the outcome of the negotiations on the macro issues becomes clearer. In other words, the immediate future will be characterised by more rather than less uncertainty, just what the aviation industry doesn't want.

Other Regulatory Issues

There is a whole series of non-market access issues, raising problems just as complicated, which will have to be addressed to implement Brexit. These are listed below.

✈Airline Ownership and Control

At present an airline must be majority owned and controlled by EU nationals to be treated as an EU carrier. If it meets these criteria, it is free to operate anywhere within the ECAA, including cabotage services within the borders of individual EU states. Post-Brexit, this will present a major challenge to several carriers, especially those registered in the UK. IAG has a complex governance structure (as does Air France/KLM and the Lufthansa Group) designed to ensure that BA can continue to be treated as a British airline, Iberia as Spanish, etc. Whether these structures will be sufficiently robust in the new environment remains to be seen, but there has been no serious challenge yet. However, the positions of airlines such as easyJet, bmi regional, Flybe, etc, all of which operate extensively on the Continent, are more problematical. (It is interesting that in easyJet's last Annual Report, Brexit is not even listed as one of the company's major risk factors, although "major shareholder and brand ownership relationship" is. Brexit is merely mentioned almost as an after-thought at the very end of a long list of lesser risks.)

There has been talk of easyJet applying for an AOC in another EU country. It already has a Swiss subsidiary, easyJet Switzerland SA, with its own AOC. (According to the company's latest Annual Report, easyJet UK has a 49% interest in the Swiss airline, with an option to acquire the remaining 51%.) As *Aviation Strategy* noted in June, the concept of establishing subsidiaries with their own AOCs to create a European network was pioneered by Air Europe in the 1980s, arguably one of the factors which led to its downfall. Nevertheless, such an approach could go some way towards solving the problem facing the likes of easyJet, but it would not address the key issue of ownership and control. Furthermore, to get an AOC from an EU Member State would require the airline to have its "principal place of business" in that Member State. This is defined as "the head office or registered office within which the principal financial functions and operational control, including continued airworthiness management … are exercised." This is considerably more than a brass plate job.

As of September 2015, the Hajji-Ioannou family so-called 'concert' party held almost 34% of easyJet's issued share capital, marginally less than the previous year. It is by no means obvious that an additional 16% of the shares are held by other EU nationals, given the company's quotation on the London Stock Exchange. According to one estimate, 54% of the airline's shares are UK held, presumably including the Hajji-Ioannou family holding (which could also be classiffied as Greek), and a further 20% are controlled by US interests. The final numbers will be close to the critical 50% level. There have been rumours of a joint £6.4bn ($8.4bn) take-over offer being prepared by Aercap and Stelios Hajji-Ioannou. Aercap is a major aircraft leasing and finance company with 1,202 aircraft valued at $43bn owned or under management. Why such a company would be interested in buying a low cost airline, especially in these challenging times, is unclear. However, if it did, it would again raise questions about ownership and control. Aercap may have its Head Office in Dublin, but it is quoted on the New York Stock Exchange and ultimately is almost certainly owned by US shareholders.

Ryanair, despite its extensive route network out of the UK, is registered in Ireland and will therefore remain an EU carrier post-Brexit. Or will it? It has already indicated that it might seek a UK AOC in order to continue to operate from there to the Continent. However, as of June 2016, according to its latest Annual Report, US shareholders held almost 42% of its shares. Many of the remainder will almost certainly be held by UK citizens. (One report has spoken of about 50% being UK-held.) It would clearly be a major challenge to achieve a majority EU ownership. On the other hand, there would be one piece of good news for Britain if Ryanair did decide to seek a UK AOC; it would earn additional revenue for the UK CAA. A move by several British airlines to the Continent, on the other hand, could put severe pressure on the regulator's finances.

Wizz Air is another non-UK airline which might fall foul of the EU's ownership and control rules post Brexit. It has recently stated that 'qualifying' nationals now account for just 51% of its shares. Wizz Air is having to consider the possibility of treating non-EU shareholdings as 'restricted shares', depriving the holders of certain rights, including the ability to vote at general meetings. The alternative is to force the disposal of shares held by non-EU citizens. In either event, there is bound to be a negative impact on the company's share price, and overall Brexit can only make matters worse.

At present the only UK airline flying long-haul services from the Continent is BA's Paris-based subsidiary, Openskies, apart from some limited operations by Thomson Airways. These services might not be possible post-Brexit, but presumably ownership of Openskies could relatively easily be transferred to Iberia and the Thomson operation could be taken over by another part of the Thomson group based in the EU. However, Norwegian operates long-haul routes from the UK, and could face problems in the future even with a UK AOC. The French-owned La Compagnie has just announced the termination of its London–New York service, ostensibly because of Brexit, but more likely a reflection of other factors.

There is one small oddity about the ownership and control of UK airlines under the EU internal market rules. When the original so-called Three Packages of liberalisation were negotiated two UK carriers could not meet the new strict ownership rules. (The UK CAA had applied a more relaxed approach, particularly to the ownership element.) Monarch was owned by Swiss interests and Thomson Airways by Canadians. These two carriers were, therefore, given a special status, as "honorary" EU citizens, so that they could be treated as EU airlines. Monarch is now fully UK owned, but the continued role of its special status is unclear. Could this unusual concept be a possible compromise for other airlines in the post-Brexit world?

✈Other EU Aviation Legislation

The EU has gradually expanded its regulatory influence far beyond the original internal market concept. Slot allocation, computer reservation systems, ground handling, consumer protection, the environment, safety, security, air traffic management — the list goes on and will grow further in the future. Most of these regulations are incorporated automatically into UK law and may therefore no longer apply post-Brexit. One obvious solution would be to introduce new UK legislation with identical rules, and carry on as before. Membership of the ECAA would avoid the need for this as it would come with automatic acceptance of all EU aviation legislation. However, this would presumably also involve subsequent adoption of any future new EU rules or amendments to the current ones without the UK having any influence over them. There is also the small matter of a financial contribution to the EU to help pay for the legislative work and enforcement. Some might argue that this is not what Brexit was supposed to achieve.

✈Aviation Policy

As already noted, the UK has had a significant influence on EU aviation policy from the beginning, and has tended to push that policy firmly in a liberal direction. On the whole it has been an ally of the Commission in this, but not of all other Member States. This influence will be missed, and the result could be a far more restrictive, even protectionist, EU aviation policy. Currently this is probably most visible in the debate over relations with the Gulf states, where France and Germany in particular have lobbied for restrictions to be placed on those Middle East airlines which they claim are in receipt of unfair state subsidies. The Commission now has a mandate to negotiate air services agreements with the UAE and Qatar, so this problem will have to be addressed soon.

The Commission published its regulatory vision for the future last December, entitled the *EU's Aviation Strategy*. It very much reflected the compromises needed to accommodate the different pressures the Commission is under. Inevitably perhaps the result has satisfied no-one. All six trade associations representing Europe's aircraft operators, for example, jointly described the document as lacking 'ambition'. The balance between liberalism and protectionism, which has recently been the centre of the EU regulatory debate and is seen in the Aviation Strategy policy paper, can only be destabilised by Brexit. As the Centre for Aviation Policy (CAPA) has noted: "...liberal ideals are under attack... Once the careful process unravels, the outliers can become revitalised. Vested interests re-emerge, and they are many and varied... Protectionism is a highly infectious disease."

✈Air Traffic Control

The creation of the Single European Sky, and in particular the huge SESAR technical initiative, is key to an efficient future European airspace. In the words of Violeta Bulc, EU Transport Commissioner: "Delivering on the SES2+ regulation in 2016 is vital. This is the single biggest issue to be resolved in making our EU aviation market more efficient and competitive." The UK, mainly via the partly privatised NATS, has been playing a key role in these developments, which so far has been largely financed (and promoted) by the European Commission. The amount of money involved is substantial. It is by no means clear whether, and if so how, the UK will be able to continue to participate in SESAR, yet without a UK involvement the whole initiative will be greatly diminished.

NATS itself appears relatively sanguine about the future. It has been quoted as saying that "we will still have to comply with the requirements of the current regulatory targets as part of the UK-Ireland Functional Airspace Block (FAB); we will continue to upgrade our technologies during the 2015-2019 regulatory period, which will enable us to deploy concepts developed through SESAR that will benefit our customers and passengers. Neither will change the need for airspace modernisation in the UK." Not many would shed tears if the UK-Ireland FAB was abandoned, at least in its current form, but the leading role played by NATS in the European ANSP alliance Borealis is a different matter. As ever, funding will probably be critical. It is relevant that Norway has been forced to contribute financially in order to become a SESAR member.

The regulation of ATC charges in Europe is now closely supervised by the Commission's Performance Review Committee (PRC). From one perspective the withdrawal of the UK from the EU won't matter as the CAA is the national regulatory body and continues formally to set charges. However, a reversion to the old, pre-PRC situation may not please airlines, who have been critical of the CAA's more benign approach to regulation in the past (admittedly there is now a new regime in place in the CAA) and have welcomed the more robust PRC approach. Finally, the Government's plan to sell off its remaining shares in NATS has surely been scuppered, at least for the time being. It would be impossible to launch a sale without considerably more clarity about the regulatory regime which will apply in the future.

✈Safety Regulation

Along with France, the UK was one of the two leading air safety regulators in Europe, particularly with respect to aircraft and engine certification. To a significant extent this reflected, of course, the large UK aviation manufacturing base. The establishment of the European Aviation Safety Agency (EASA) in 2002, building on the work of the Joint Aviation Authorities (JAA), was designed to harmonise safety, airworthiness and certification procedures across the internal market, and to some degree beyond. Based in Cologne, EASA has gradually extended its areas of competency and recruited a large staff, many transferred from national bodies. It has 32 members, the 28 EU states plus Iceland, Switzerland, Liechtenstein and Norway, and some partners such as Turkey. However, as EASA is an EU body, only the 28 Member States have a vote on the organisation's governing committee (not that votes are all that common) and other members have to make a financial contribution to the running costs.

The potential withdrawal of the UK from EASA would be "catastrophic" according to ADS, the trade body for British aerospace companies; it would take ten years, it is claimed, for the UK to re-create the certification infrastructure needed. Of course, a way has to be found for the UK to continue its EASA membership in some form, but the challenges should not be under-estimated. Even if the UK were to follow the precedent of Norway's membership, it is difficult to see how its current level of influence in the organisation could be maintained, and influence is often just as important as legal access.

✈Airports

Airports are arguably the aviation sector least affected by Brexit. They are subject to a number of EU regulations, but nowhere near as many as, say, the airlines are. Clearly they will feel any downturn in traffic in the short/medium term. Immigration and customs facilities will probably have to be redesigned, again, if EU and UK citizens are to be treated differently to control migration, which could be expensive. On the other hand, there is the possibility of the reintroduction of duty free for international short-haul flights, which is clearly a money-maker for airports.

There is also the question of whether Brexit will affect a decision on additional airport capacity in the South East of England, a debate which has been rumbling on now for almost 50 years. It would not be surprising if some were to argue that the likely short-term downturn in traffic is a good reason to put off a decision yet again. At the same time, however, the Government is likely to want to launch some infrastructure initiatives soon to help to counter any post-Brexit economic slowdown, and the new runway project has the advantage of mostly, though not wholly, being privately financed. Whether the current state of uncertainty about the economy will make it more difficult, or the lower interest rates less difficult, to finance a runway remains to be seen.

Conclusion

So basically it's all a bit of a mess. It is not too difficult to identify the post-Brexit outcome which most in the aviation industry would prefer, and we can list the options available to achieve such an outcome, but we are really no closer to saying with any certainty what the final outcome is likely to be. To be able to do so requires a clearer understanding of the parameters set for the overall UK-EU negotiating framework, and in particular what will happen about access to the common market and the principle of the free movement of EU citizens. Only then will it be possible to identify in any detail what will be achievable for aviation. It would hardly be surprising if the negotiations involved considerable horse trading across sectors, which in itself will create even more uncertainty. As CAPA has commented, "once the horse trading begins, there can be no certainty that other areas of trade and politics will not pollute any logic that applies in the aviation sector." We might hope for a rational outcome, but we shouldn't necessarily expect one.

by Dr Barry Humphreys

Aviation consultant, formerly Director of External Affairs and Route Development at Virgin Atlantic Airways, Non-Executive Chairman of the British Air Transport Association and Non-Executive Director of NATS.

Jet2.com: Solid northern English LCC

UK-based LCC Jet2.com and its sister tour operator Jet2Holidays posted significant rises in both revenue and profits in 2015/16 — but can the trend continue now that UK LCCs and tour operator airlines are pouring capacity into European destinations and away from North Africa?

Jet2.com was launched by a local entrepreneur back in the 1970s as Express Air Services, a Bournemouth-based airline that operated a variety of charter and cargo services to the Channel Islands with HPR-7 Herald turboprops.

In 1983 the carrier was bought by a former RAF pilot, Philip Meeson, and changed its name to Channel Express after winning contracts to deliver mail for the Royal Mail. In 2001 international passenger charter services began with 737s, and two years later the airline launched a low cost brand called Jet2, out of Leeds Bradford airport. The first route was to Amsterdam Schiphol, and the concept was so successful that further routes were quickly added, with operational bases opened at Manchester in 2004 and Newcastle, Blackpool and Edinburgh in 2005.

The airline rebranded entirely as Jet2 in 2006, at the same time relocating its main base from Bournemouth to Leeds Bradford. In 2007 Jet2Holidays — a sister tour operator — was launched, and the group grew steadily. Today Jet2.com operates a fleet of 63 aircraft on scheduled routes between 66 airports in the UK, 18 other European countries and the US, with seven operational bases in the UK plus one in Alicante.

The most important European market for Jet2.com is Spain, where it serves 14 destinations, followed by Greece (seven), France (six) and Italy (five). In this summer season Leeds Bradford operates to 46 destinations, with 11 aircraft based there, with its next most important base in terms of destinations being Manchester (42) followed by East Midlands (35), Edinburgh and Newcastle (29 each), Glasgow (26) and Belfast (14). An eighth UK base will open in March 2017 at Birmingham airport, with four 737-800s to be stationed there that will operate 57 weekly flights to 15 destinations in the summer of 2017, with daily flights to Alicante, Faro and Majorca.

In September, the airline announced its first excursion outside its northern heartland, with the establishment of a base, probably with four aircraft, at London Stansted, where it is clearly confident that it can exploit Ryanair's reduced post-Brexit expansion plans there.

Jet2.com also operates a winter and autumn route (with both package and seat-only sales) to New York Newark from East Midlands, Glasgow, Leeds Bradford, Manchester and Newcastle, using 757s.

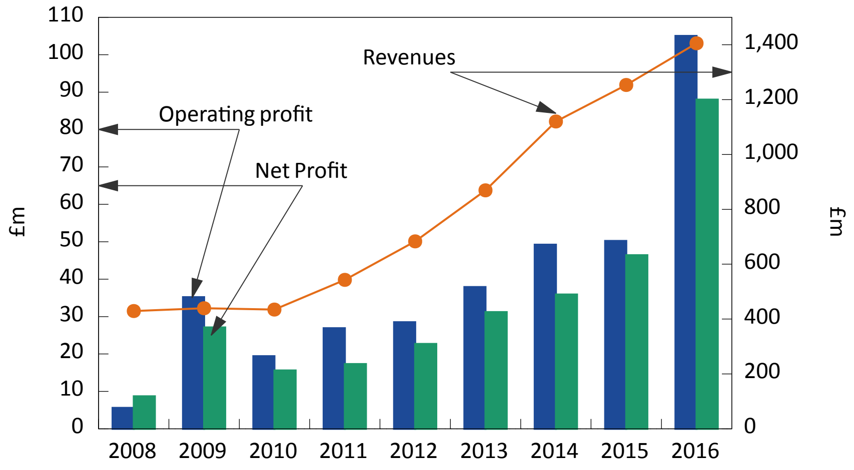
JET2.COM FLEET

	In service	Order
737-300	27	
737-800	23	28
757-200	12	
A321	1	
Total	63	28

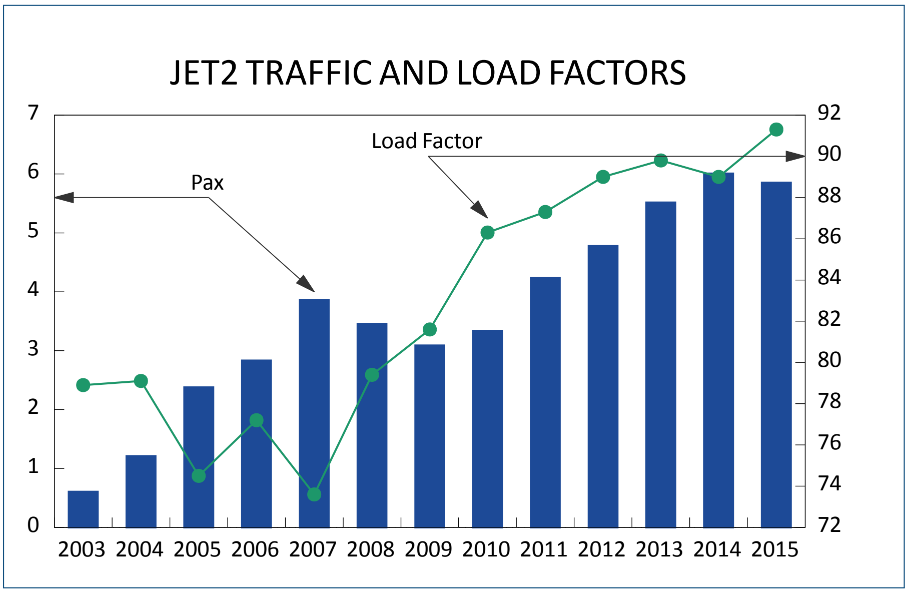
Fleet renewal

Jet2.com's fleet comprises 27 737-300s, 23 737-800s, 12 757-200s and a

DART GROUP FINANCIAL RESULTS



Note: FY ended March. Source: Company reports



single A321, of which approximately three-quarters are owned. However, the average fleet age is almost 22 years, and the older -300 models (which have an average age of more than 26 years) will be steadily replaced by outstanding orders for 30 737-800s. A firm order for 27 737-800s was placed in September 2015, which are being delivered over the period September 2016 to April 2018 and which are costing $2.6bn at list prices (though Dart will have secured a significant discount — 50%-plus?). This was the airline's first direct order from the manufacturer, after years of Boeing wooing Phillip Meeson who had preferred to put excess cash into his dividends rather than new aircraft; the second followed soon after when another three 737-800s were ordered in December 2015, with the same delivery schedule as the first deal.

Jet2.com is owned by holding company the Dart Group (whose chairman and chief executive is Philip Meeson), which also combines Jet2Holidays (now the UK's third largest ATOL tour operator) and Fowler Welch, a distributor of food throughout the UK, and with a total group workforce of more than 5,100. Incidentally, Meeson is perhaps the closest equivalent the UK has to Michael O'Leary; he once called striking French air traffic controllers "lazy frogs", and a few years ago police were called to an incident at Manchester airport after he reportedly "flew into a rage" at his own staff after becoming angry at the time they were taking to check-in a long line of passengers.

In its 2015/16 financial year — the 12-month period ending March 31st 2016 — the Dart Group recorded revenue of £1,405m, a 12.1% increase compared with the 2014/15 financial year. The group's underlying operating profit more than doubled year-on-year to £105m, with underlying profit before tax increasing by 82.2% to £104.2m.

Of the total group revenue, just £144m (representing 10.2%) came from Fowler Welch, with the rest coming from what Dart calls "Leisure Travel", which comprises Jet2.com and Jet2Holidays. Its £1.26bn revenue for the six-month period was up 14.5% compared with 2014/15.

The Dart Group provides no figures for operating profit by individual business unit (the airline and the tour operation), but it does say that Leisure Travel's underlying operating profit rose from £46.9m in 2014/15 to £99.6m in 2015/16 — accounting for almost 95% of total group profit.

Package holiday customers increased by 22% to 1.22m in 2015/16, representing 40% of customers flown overall; that's a significant rise year-on-year, as package holiday customers accounted for 33% of customers flown in 2014/15. Interestingly, Dart says its higher margin package holidays "continue to outperform the market", and that they will continue to provide an increasingly larger proportion of the passengers carried on Jet2.com.

Around half of Jet2Holidays' packages are sold online, with approximately 17% made though the company's call centre in Leeds (which employs 300 staff) and the rest through high street travel agents and other online outlets. Around 40% of the company's packages are sold on an all-inclusive basis, which Dart says "gives families certainty of price, and which have proven particularly successful in challenging economic times".

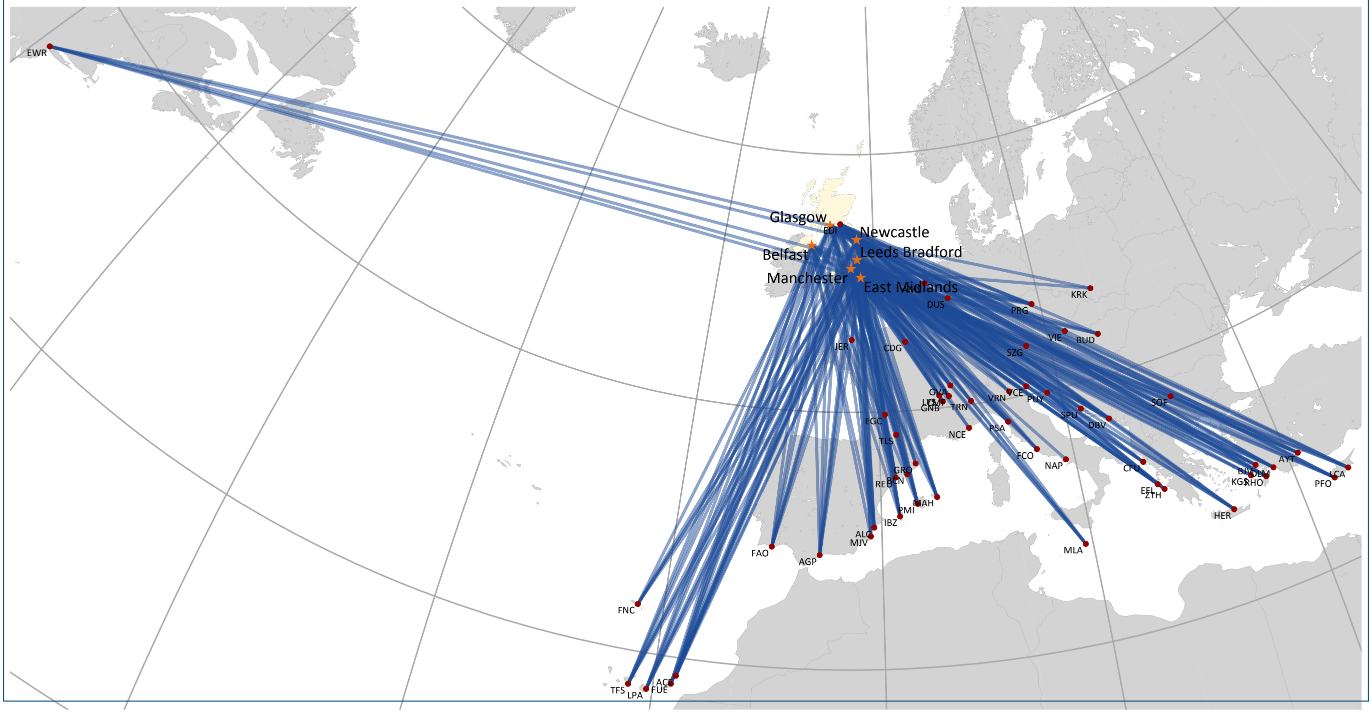
Seat-only drops

For Jet2.com, seat-only customers in 2015/16 totalled 3.63m, but that fell 10% compared to the 4.05m seat-only passengers flown in the 2014/15 financial year. 99% of Jet2.com's flight-only seats are booked on the Jet2.com website.

Overall, total airline passengers carried reached 6.07m in 2015/16 (comprising 2.44m Jet2Holiday passenger seats and the 3.63m seat-only passengers), which was just 0.3% higher than passengers carried in 2014/15.

This was a result of a policy that

JET2 ROUTE NETWORK



Dart describes as "careful seat capacity management" in the 2015/16 financial year, which resulted in record average load factor for the airline of 92.5% (compared with 91.2% a year earlier) and an increase in Jet2.com's average net ticket yield of 14%, to £91.11 per passenger in the six-month period.

Jet2.com follows a typical LCC strategy, and ancillary revenue per passenger grew 3.5% in 2015/16 to £31.98, thanks to a push on what Dart calls pre-departure customer contact, which has boosted advance sales of baggage, seat assignment, meals and other items.

Immediate prospects

Meeson describes Jet2.com as "the North's leading leisure airline", and as can be seen in the chart on the following page, Dart Group's share price (it is quoted on London's junior AIM market) rose more or less steadily from 2003 (the date that the Jet2.com brand was launched) all the way through to March of this year, since when the price has fallen back, the result of the Brexit vote depressing the valuation by 30% from the peak.

The Dart Group's finances are robust. Long-term debt is negligible, and cash and money market deposits rose by £109m in 2015/16 to £412m as at March 31st, although that includes advance deposits from Leisure Travel customers of £385.8m (compared with £318.7m a year earlier).

Looking ahead, in July Meeson said that "current financial year has started well in our Leisure Travel business — although we were disappointed at the result of the EU referendum".

The underlying challenge to Jet2.com is — inevitably — other LCCs, and increasing seat-only sales from tour operators' airlines. That challenge is seen clearly at its largest operational base in terms of seat capacity, Manchester, where — according to OAG data for this summer's schedules — Jet2.com has an 11% share of seats offered at the airport. That's just behind Ryanair (with 14% of seats offered this summer) but the same as Thomson Airways (11%) and just ahead of easyJet (10%) and Thomas Cook Airlines (10%), with Monarch Airlines not too far behind, on 7%. That's the very definition of a competitive market.

Jet2.com's largest destination market by far is Spain, which accounts for close to 60% of all seats offered during this summer season (with no other country reaching double digits). Demand to Spain has been very strong but the problem is that this year almost all tour operators (including the Big Two — TUI and Thomas Cook) have switched significant capacity from troubled markets in North Africa and the eastern Mediterranean to Spanish destinations. That trend is also being seen at

LCCs, though to a lesser extent that the tour operators.

Altogether, total seats out of the UK to Spain this summer is estimated to have grown by around 20%, and while demand from holidaymakers is growing too (again thanks to concerns about some east European and all North African destinations), some analysts believe the UK-Spain market is significantly oversupplied, which inevitably will depress yield for everyone, including Jet2.com.

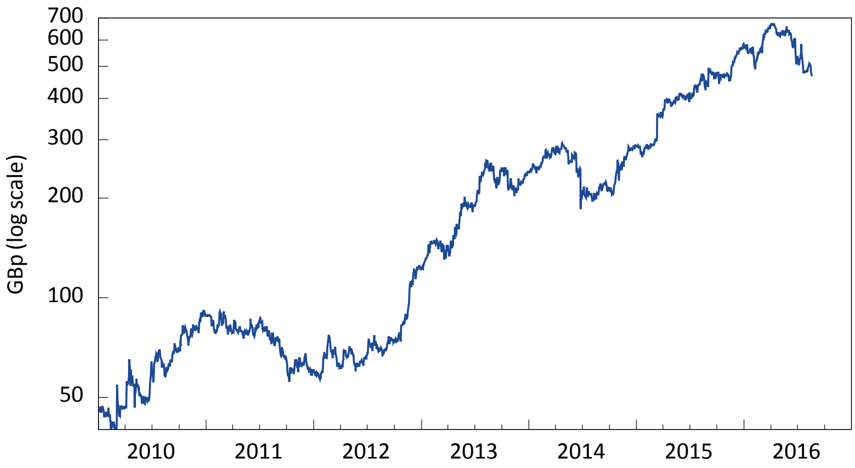
At Manchester, for example, Jet2.com operates to 14 Spanish destinations, while Ryanair has routes to 13 — of which seven are the same (Fuerteventura, Gran Canaria, Ibiza, Lanzarote, Malaga, Murcia and Tenerife). An even bigger challenge comes from Thomson Airways, which operates to 13 Spanish destinations out of Manchester, all but one of which are the same as Jet2.com's Spanish network.

Add in the other airlines operating out of Manchester, and the result is fierce competition for seat-only sales on all of Jet2.com's routes to its largest market from its most important operational base.

Against this competitive background, the first of 30 new 189-seat 737-800s start arriving this September. In the 18 months Jet2.com has been conservative in its growth; in the 2015/16 financial year it added just three new destinations — Antalya, Kefalonia and Malta — and only two destinations were added for the summer 2016 season — to Costa de Almeria, starting in April, and to Halkidiki in Greece, commencing in May.

It's unclear at the moment just how much extra capacity the new 30 737-800s will effectively provide; the Dart Group has previously said that they will "a sensational capacity increase at every base", but clearly they will replace the 27 737-300s in the fleet over time. In addition, the existing 27 737-800s in the Jet2.com fleet have an average age of more than 15 years themselves, and some of them may need to be replaced too.

DART GROUP SHARE PRICE PERFORMANCE



Cautious growth?

Meeson and the Dart Group have usually tended to err on the side of caution, and indeed it can be argued that this has been the basis of its success over the years (while many of its UK tour operator rivals have faltered) — and so it's unlikely that in the current climate that radical expansion is envisaged, However, the Dart Group always has the option to change gear and expand in the future, which will necessitate the placing of further new aircraft orders.

In the short- and medium-term, however, its focus is clear — to keep a tight control of seat capacity (which means limited net increases) so that load factors and yield remain high (see chart on page 12, which shows how load factor has risen steadily since 2007), with a major component of that being a gradual and continuing "switch" of seat capacity from seat-only sales to seats sold as part of holiday packages, which is a contrary to charter airline trends.

This should help Jet2.com mitigate against increasingly brutal fare wars in the UK seat-only sector thanks to growing competition from LCCs and tour operator airlines alike. And while it's too early to forecast what level Sterling will be at in 2017, it has taken a substantial hit this summer against the Euro thanks to the Brexit vote, and this will undoubtedly encourage some (or many?) UK holidaymakers to stay at home in 2016 and potentially 2017.

With terrorist attacks in mainland Europe adding to uncertainty, seat-only fares are only heading one way in the short- and probably medium-term, and Jet2.com is possibly right to try to switch capacity to its differentiated and therefore more defendable package holidays. Its, as yet, tentative expansion into southern England, with the new base at Stansted, is an indication of the owner's confidence in this particular LCC model.

Cathay Pacific: 2016 brings intense pressure

CATHAY Pacific Airways experienced a brutal six months in the first half of 2016, with profits plunging 82% year-on-year thanks to fierce competition, weak demand in some markets and hefty losses from poor fuel hedging. Will those trends continue for Cathay through the rest of this year?

Hong Kong-based Cathay Pacific Airways operates to more than 170 passenger and cargo destinations in 40+countries, with the airline employing 23,000 (of which 16,600 are based in Hong Kong), and the Group a total of 33,800 worldwide.

Cathay had an excellent 2015, with group profit up 91% to HK$6bn (US$774m), but there were warning signs in the second-half of the year with premium demand not as strong as expected on some long-haul routes and the air cargo market becoming weaker.

The first half of calendar 2016, however, was worse than many analysts expected. Group revenue of HK$45.7bn (US$5.9bn) was a worrying 9.3% down on the January-June 2015 period and, of that, passenger revenue totalled HK$33.4bn (US$4.3bn) — down 7.8% year-on-year.

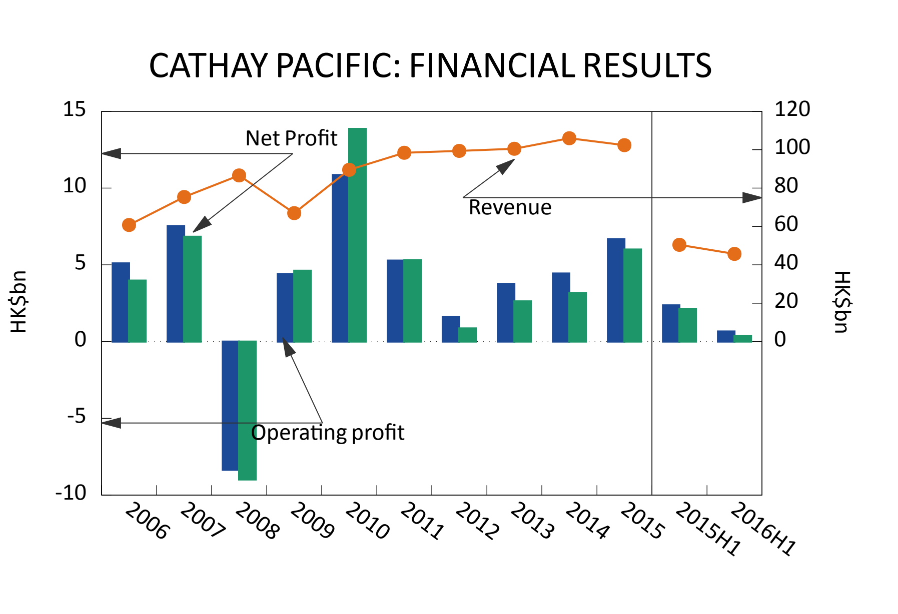
The group says that "the operating environment in the first half of 2016 was affected by economic fragility and intense competition. There was sustained pressure on revenues, reflecting suspension of fuel surcharges (from February), weak currencies in some markets, weak premium class demand, particularly on long-haul routes, and a higher proportion of passengers transiting through Hong Kong".

In the first half of 2016 Cathay (and subsidiary Dragonair) carried 17.3m passengers (a rise of 2.7% year-on-year). Capacity increased 4.2% in the six-month period, but traffic growth lagged behind at 2.6%, leading to a 1.4 percentage point decrease in load factor, to 84.5% — which threatens to halt what had a been a continuous improvement in annual load factor over the last three years (see chart on the following page).

In the first half of 2016 passenger yields fell by 10.1% to HK¢54.3, which according to Cathay reflected "the suspension of fuel surcharges, strong competition and adverse currency movements". Digging deeper into the numbers released by Cathay reveals that there was a significant reduction in premium corporate travel on all routes, but particularly on long-haul. Overall Cathay's revenue from long-haul declined compared with January-June 2015, despite a 4.7% increase in long-haul capacity.

Group attributable net profit fell a massive 82.1% year-on-year, from HK$1,972m (US$254m) in H1 2015 to HK$353m (US$45.4m) in January-June 2016. Fuel is the largest cost component for the group (accounting for 29.1% of operating costs in the first half of 2016). After hedging fuel fell by HK$3,360m (or 20.2%) in H1 2016 — though Cathay is still hampered by losses on its fuel hedging contracts, which cost the group some HK$663m in the period. Cathay also lifted its fuel surcharge in February, and this remains suspended to date.

Though productivity has continued to improve and non-fuel costs fell by 0.5% per ATK in the first half, the group has responded to weaker revenue by carrying out a review of all non-fuel expenditure.



Measures already taken include the freezing of new and replacement staff for all "non-operationally critical" functions, as well as cutbacks on non-essential discretionary expenditure.

Fleet renewal

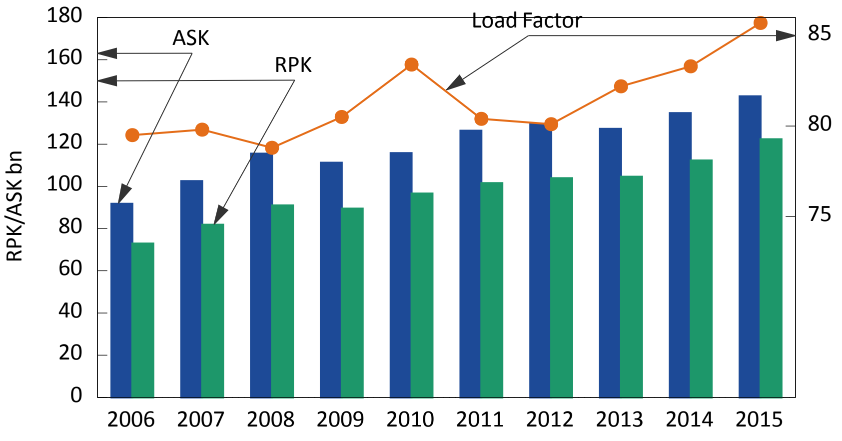
In terms of the fleet, Cathay operates 124 passenger aircraft, comprising 53 777-300ERs, 42 A330-300s, 12 777-300s, five 777-200s, five A340-300s, four A350-900s and three 747-400s. They have an average age of less than nine years. Fleet renewal is continuing — the last 747-400s will go by the end of October this year, while one A340-300 will be retired in the second-half of the 2016 and the remaining four in 2017.

On order are 65 aircraft — 26 A350-1000s, 18 A350-900s and 21 777-9Xs. The first of an order for 22 A350-900XWBs was delivered in May, and four have been delivered so far this year, and with eight more due by the end of 2016 and the rest in 2017. The A350-1000s will arrive between 2018 and 2020.

The first aircraft have been used initially on routes within the Asia/Pacific region (including from Hong Kong to Manila, Taipei, Bangkok

CATHAY PACIFIC AND DRAGONAIR

TRAFFIC DATA

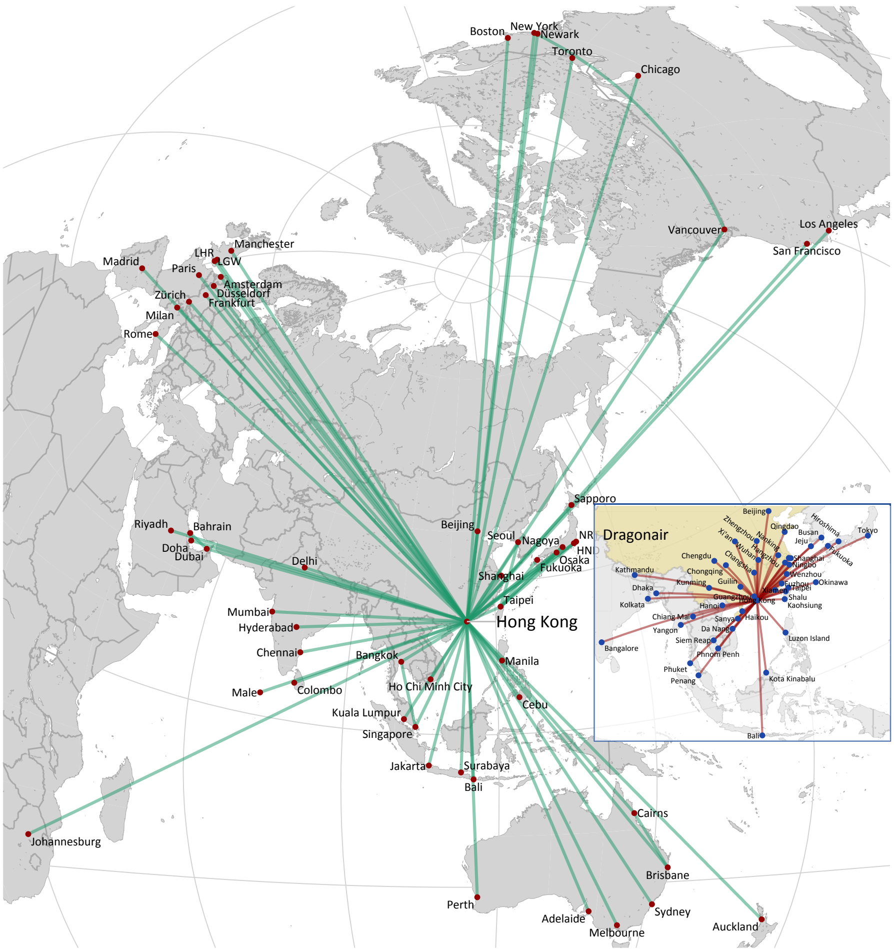


CATHAY PACIFIC FLEET

	Aircraft	Owned†	Operating lease	Total	2016	2017	2018	2019	2020	>2021
		as at 30 June			Deliveries					
Cathay Pacific	A330-300	36	6	42						
	A340-300	5		5	(1)	(4)				
	A350-900		1	1	10	11				
	A350-1000						6	10	10	
	747-400	3		3	(3)					
	777-200	5		5						
	777-300	12		12						
	777-300ER	30	11	53			3	2		
	777-9X									21
	Passenger aircraft	**103**	**18**	**121**	**6**	**7**	**9**	**12**	**10**	**21**
	747-400F	4		4						
	747-400BCF		1	1						
	747-400ERF	6		6						
	747-8F	13		13	1					
	Freighters	**23**	**1**	**24**	**1**					
Dragonair	A320-200	5	10	15						
	A321-200	2	6	8						
	A330-300	10	9	19						
		17	**25**	**42**						

† Includes finance leases

CATHAY PACIFIC NETWORK



Note: main map drawn using azimuthal equidistant projection centred on HKG. Great circle routes appear as straight lines.

and Singapore), before being deployed on long-haul routes to Europe from September, including London and Düsseldorf.

Significantly, Cathay is not installing any first-class cabins on the A350-900 and -1000s, and is instead fitting out the aircraft with a larger number of premium economy seats (with three classes in total — business, premium economy and economy).

First class is being retained on 777-300ERs to "trunk routes" out of Hong Kong (to destinations such as London, New York and Los Angeles), and will be introduced onto the new 777-9Xs, which will arrive from 2021. Cathay Pacific is already the largest operator of the 777 in Asia.

The group's cargo operation — 14 747-8Fs and 11 747-400Fs with a single 747-8F on order — has been hit hard by overcapacity and economic downturns in key markets globally. In the first half of 2016 Cathay's cargo revenue fell a substantial 17.2%, to HK$9.4bn (US$1.2bn), and cargo load factor at the group was just 62.2% (and that was 1.9 percentage points lower compared with the first six months of 2015).

The Cathay Pacific Group also owns Hong Kong Dragon Airlines (100%) and AHK Air Hong Kong (60%). Hong Kong Dragon Airlines previously operated under the brand name Dragonair to regional Asian destinations with a fleet of 19 A330s, 15 A320s and eight A321s. However, in January the Group announced that Dragonair was to be rebranded as Cathay Dragon (though they will remain separate airlines), and aircraft began to adopt the new Cathay Dragon livery in April. Air Hong Kong is a cargo joint venture with DHL Express, and operates 10 A300-600Fs and three 747Fs.

The poor half-year results — and a previous warning by the company of the impending financial downturn — were met by a raft of downgrades by Goldman Sachs and other analysts. For example, in June Singaporean bank UOB Kay Hian said that "China Southern has added capacity to international routes by 26% in the year to date, and more passengers may choose to fly with the airline out of Guangzhou as congestion at Hong Kong continues".

Hong Kong problems

Cathay continues to battle against overcrowding at its hub, Hong Kong International Airport. Though only opened at Chek Lap Kok island in 1998 (replacing Kai Tak airport), it has grown to serve 68.5m passengers and 406,000 air traffic movements (ATMs) in 2015 — perilously close to its maximum capacity of 420,000 ATMs.

Cathay had been urging the construction of a third runway and terminal for many years, and this was finally approved by the Hong Kong Executive Council in April this year (at an estimated cost of HK$141.5bn — or US$18.2bn). Once it is finished, the new runway will allow capacity expansion to more than 100m passengers and 607,000 ATMs by 2030, but despite construction starting in August it will not be completed until 2024 at the very earliest (assuming no delays), as it is a complex project requiring reclamation of 650 hectares of land north of the existing airport island. Meanwhile, full capacity at the existing facilities will be reached well before then, either this year or 2017 at the latest.

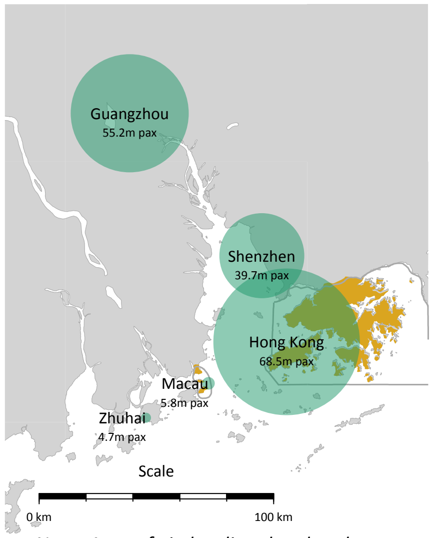
The sluggishness (in Asian terms) of the Hong Kong authorities to make a decision hasn't gone unnoticed by regional airport competitors, with most of them far advanced in expansion plans. Singapore Changi is building a fourth terminal to open in 2017 and a third runway (being converted from a military one) by 2020; Guangzhou Baiyun will build a second terminal (2018) and fourth runway (2020); and Shenzhen Bao'an will build a third runway by 2018 — and all of these developments will be completed well before the third runway is completed at Hong Kong, in 2024.

Increasing competition from Chinese airlines is a huge challenge to Cathay, particularly as many of them are piling on long-haul capacity, fuelled by new aircraft deliveries and by growth in international demand by the relatively affluent Chinese middle class. In particular capacity is being added onto routes into North America, which is having an adverse effect on premium yields for Cathay.

To make matters worse, many of the Chinese carriers are expanding international networks out of nearby airports in mainland China. For example, Shenzhen's Bao'an airport is located just 38km from Hong Kong airport and didn't have any scheduled, non-stop long-haul routes before 2016 — yet it now has three from three different airlines — to Sydney (operated by China Southern), Frankfurt (Air China) and Seattle (Xiamen Airlines), with at least three further new routes planned to open by the end of the year (including a service to Los Angeles).

The bigger threat comes from Guangzhou airport, some 135km from Hong Kong and which is the main hub for China Southern — with huge spokes of domestic flights drawing passengers onto its international flights.

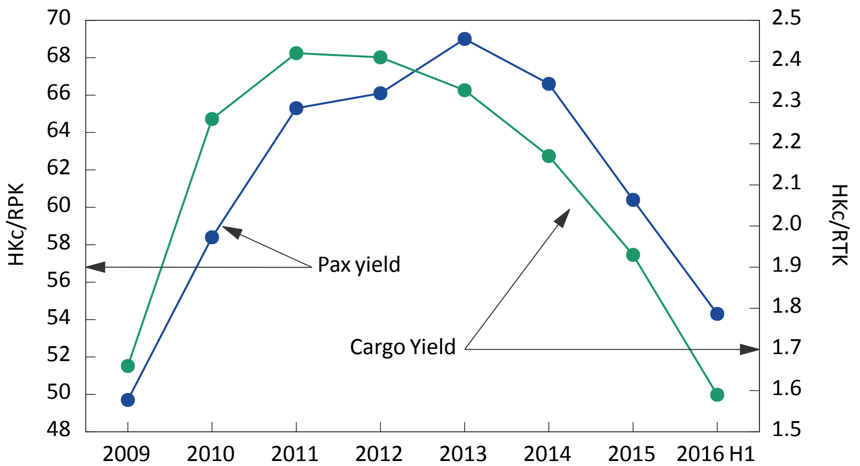
PEARL RIVER DELTA AIRPORTS



Note: Area of circles directly related to number of airport terminal passengers 2015. The Pearl River Delta is possibly the world's largest megalopolis with a population of 42m excluding Hong Kong (7m) and Macau (0.5m) over an area of 7,000km^2.

In the face of this competition and despite an agonising wait for extra capacity at Hong Kong, Cathay's strategy will continue to promote "Asia's premier aviation hub". However, even here the group is starting to face a growing challenge from the only LCC based at Hong Kong — HK Express, which was launched in 2004 by a local entrepreneur before HNA Group, the parent company of Hainan Airlines, bought a 45% stake in 2006. It evolved into an LCC in 2013, and today operates 14 A320s to more than 25 destinations throughout Asia — of which 14 are in direct competition with Cathay routes. HK Express also has 15 A320neos on order, and aims for a fleet of 30 aircraft by 2018.

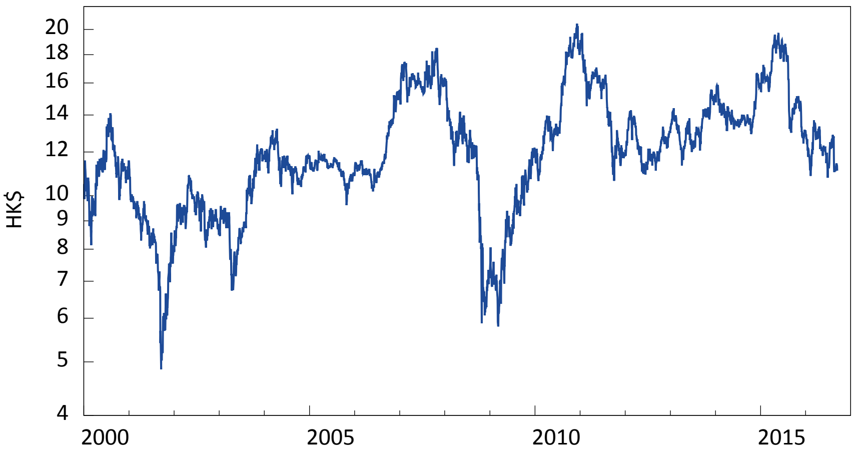
CATHAY PACIFIC: TRAFFIC YIELDS



2016 doldrums

Despite the good results in 2015, Cathay had already decided to scale

CATHAY PACIFIC SHARE PRICE



back capacity growth in 2016 early on in the year, although perhaps this was more luck than judgment thanks to a labour dispute that forced the airline to refine its plans.

The Hong Kong Aircrew Officers Association, which represents 2,100 of the 2,900 pilots employed by Cathay, took part in a work-to-rule earlier this year in an attempt to change work rosters that it claimed were unfair, and this reportedly led Cathay to put on hold the launch of new routes from Hong Kong to Manchester and Boston. They will now start up sometime in 2017. However, in June Cathay did launch a route to Madrid, and in September a route was launched to London Gatwick, using new A350-900XWBs that will operate four times each week.

The Cathay Pacific Group is listed on the Hong Kong stock exchange, and as can be seen in the chart on the current page though the group's share price has been volatile over the past few years, it has fallen substantially recently, from around HK$20 as at April 2015 to under HK$12 as at September this year.

The major shareholder remains the The Swire Group conglomerate, with a 45% share, while Air China has a 29.9% stake. Cathay itself still holds a 20% share of Air China, but the potential merger of the two airlines that was mooted just last year (see *Aviation Strategy*, May 2015) hasn't happened, even though this would have provided Cathay with substantial amounts of mainland Chinese feed into its long-haul routes out of Hong Kong. Nevertheless, Cathay says it still wants to develop its relationship with Air China.

Cathay's challenges will continue through 2016 and into 2017. In August John Slosar, chairman of Cathay Pacific, said that he expected the operating environment in the second half of the year to continue to be impacted by the same adverse factors as in the first half. He warned: "The overall business outlook therefore remains challenging — we expect passenger yield to remain under pressure".

GOL: Comprehensive restructuring but is it enough?

GOL Linhas Aéreas Intelligentes, Latin America's leading LCC, is nearing the completion of a comprehensive and intense restructuring, initiated in mid-2015 when the carrier faced ballooning debt, increasing cash burn and a deteriorating economy.

Brazil is mired in a deep recession for the second consecutive year; the IMF's current projection is that the country's GDP will decline by 3.3% in 2016, after last year's 3.8% contraction.

Over the past 12 months, Brazil has also seen unprecedented political turmoil, resulting from presidential impeachment proceedings and a widening corruption scandal involving the state-controlled oil company.

Despite weaker air travel demand, 2014 and 2015 saw continued domestic overcapacity, as growth by smaller competitors (mainly Azul and Avianca Brasil) offset a disciplined approach by the two largest carriers (GOL and TAM). That led to a weak pricing environment.

Business travel demand and yields have declined sharply. GOL reported that its corporate travel revenues fell from a historical average of around 70% of total travel to 58% in 2015.

GOL has been hit especially hard by the adverse trends because the bulk of its operations are domestic. Although the carrier has maintained healthy cash reserves and was never a near-term bankruptcy candidate, in February all three main rating agencies warned of a cash crunch in the next 12-18 months as debt payments were coming due and demand and yields in Brazil continued to deteriorate.

Consequently, GOL formulated a plan to "comprehensively address liquidity and capital structure concerns" and ensure that it emerges from the tough economic and airline industry conditions in Brazil "in the best competitive position".

In the past 12 months, the São Paulo-based carrier has implemented what may be one of the strongest and fastest restructurings by an airline outside of bankruptcy.

Among other things, GOL has raised new equity from key shareholders, completed an advance ticket sale to its loyalty programme, renegotiated supplier contracts, slashed capacity, restructured its network, downsized its fleet, negotiated concessions from lessors, deferred aircraft deliveries, and reduced and deferred debt obligations.

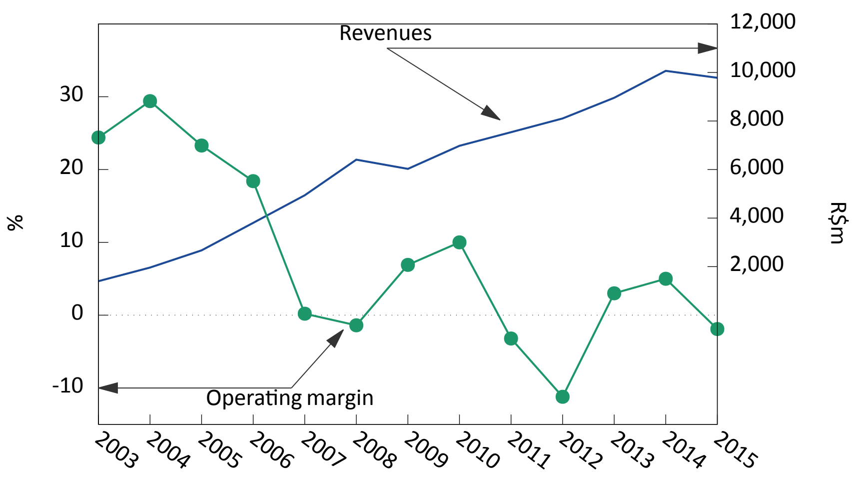
Most of it has gone according to plan, but earlier this summer GOL notably failed to persuade the majority of its US bondholders to agree to a US$780m debt restructuring.

However, the Brazilian currency's 20% appreciation against the US dollar this year has amply compensated for that setback. The real's surge has reduced GOL's dollar-denominated debt obligations far more than could have been accomplished with the debt exchange.

As a result of the currency swing, GOL has also reported net profits for the past two quarters. In the three months ended June 30, it had a net profit of R$309.5m, thanks to a massive R$778.8m foreign exchange gain resulting from the real's 9.8% appreciation between March 31 and June 30.

Although the operating result was negative in what is GOL's seasonally weakest quarter — a loss of R$149.6m or 7.2% of revenues —

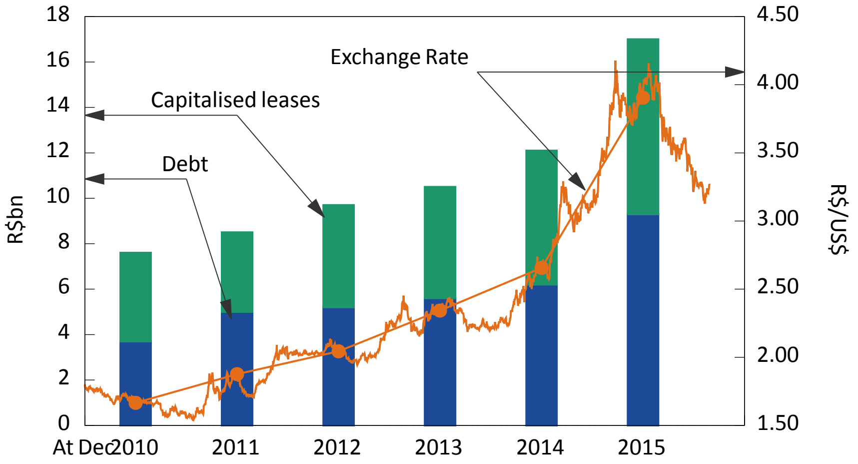
GOL's REVENUES AND OPERATING MARGINS



it represented a 5.1-point improvement from the year-earlier negative margin of 12.3%, amid signs that GOL's restructuring is beginning to pay dividends.

One of the key questions now being asked is: Given that Brazil's recession may have bottomed out and domestic industry capacity is falling sharply, is GOL is now out of the woods? Or will the recovery be so slow that GOL will have to continue to restructure?

Another interesting question: With the likely (though by no means certain) lifting of foreign ownership restrictions in Brazil's airlines in the next 6-9 months, will GOL be an early participant in the resulting M&A? In other words, will Delta fully acquire its Brazilian partner in 2017?



Source: Company reports and SEC filings

Comprehensive restructuring

GOL's 2015-2016 restructuring has involved most of the carrier's stakeholders — with the notable exception of labour, which in Brazil gets industry-wide annual pay increases tied to inflation (even in the worst recession in 30 years).

The management's key message throughout the restructuring has been that all of the components are vital and that "everyone must contribute". As CEO Paulo Kakinoff put it in May: "All pieces of this plan are critical, work together and should allow us to achieve our targets".

Many of the concessions granted were conditioned on other components of the plan being achieved. For example, the aircraft returns and order deferrals were conditioned on the US bondholders agreeing to the debt exchange offer. But when the latter flopped, it seems that GOL got the other concessions anyway — perhaps not surprising as the lessors and Boeing probably had little choice, and they have had a policy of being extremely flexible with Latin American airlines during the current economic downturn in the region.

The following is a summary of the key components of GOL's restructuring, some of which have already been completed and some are still in the process of being finalised:

✈US$150m equity infusion from key shareholders

GOL kicked off the restructuring in the summer of 2015 by raising US$100m from its controlling Brazilian shareholders and US$50m from its strategic partner Delta. The controlling shareholders' equity stake remained at 63%, while Delta's increased from 2.9% to 9.5%. (The US carrier acquired its original stake in 2011.)

✈US$300m term loan guaranteed by Delta

In August 2015 GOL secured a new US$300m five-year loan that has an effective average interest rate of 6.5%. The loan, arranged by Morgan Stanley, is guaranteed by Delta and is secured by GOL's shares in its publicly listed SMILES loyalty programme.

✈Other assistance from Delta

In March Delta agreed to reduce the collateral backing up the term loan, subject to the US dollar debt exchange being successful. But since the latter was taken up by only 22% of the bondholders, it is not known if any of the SMILES shares were freed up.

According to reports in late August, Delta participated in GOL's negotiations with its lessors and has agreed to buy eight aircraft that GOL currently leases from GECAS (four 737-700s and four 737-800s).

✈Supplier concessions/other cost cuts

During 2015 GOL's suppliers agreed to new contract terms, resulting in R$300m of annual cash savings to the airline.

GOL's cost cutting moves have also included overhead reductions, hiring freeze and the introduction of part-time employees.

✈Advance ticket sales to SMILES

In early 2016 GOL entered into an advance ticket sale agreement with SMILES totalling R$1bn through June 2017. The first tranche of R$376m was paid in February.

The airline said in early August that it had received a second tranche of R$600m and that an "outstanding balance of R$400m" would probably be paid in the fourth quarter. That suggested that the total amount to be received, which was linked to cash generated from the restructuring plan, will be higher than the originally envisaged R$1bn.

✈Revised delivery schedule with Boeing

In the first quarter GOL secured an agreement with Boeing to defer all further new aircraft deliveries until mid-2018 and have the associated pre-delivery deposits (PDPs) returned.

Before that agreement GOL had 15 additional 737-700/800 deliveries scheduled for 2016-2017; now the airline took only one of those aircraft in early 2016.

The return of the PDPs was expected to boost cash flow by R$555m, which was to be used to fund the US dollar debt exchange offers. But since only 22% of the bondholders took up the offer, it is not known if GOL received all of those funds.

GOL retains a substantial longer-term orderbook with Boeing consisting of 120 firm orders for fleet renewal through 2027.

In June GOL had a total fleet of 139 737-NGs (105 737-800s and 34 737-700s), of which 119 were in operation (nine were subleased to other airlines and 11 were in the process of being returned to lessors).

✈Changes to route network

To improve profitability, GOL has made major changes to its network this year. The main actions can be summarised as follows:

First, GOL has suspended a large number of routes and destinations, including its US services. The latter were no longer viable as Brazil-originating travel had fallen sharply due to recession and the currency's devaluation. GOL had operated one-stop São Paulo-Miami and Rio-Orlando flights via Santo Domingo (the Dominican Republic) because the 737-800s needed a fuel stop.

Second, GOL has added more long-haul flights out of São Paulo's Congonhas to the north and north-east regions of Brazil, while reducing short-haul leisure operations. Its average stage length has increased by 41% at Congonhas and by 14.2% systemwide. This will help reduce unit costs.

Third, GOL has made adjustments to routes and schedules aimed at providing better options for business travellers at Congonhas, a key hub for business travel in Brazil. Those moves will improve yield and compensate for the negative impact on RASK of the increased average stage length. GOL claims that it is now the leader in the number of cities served from Congonhas (33).

Fourth, GOL has worked with its strategic partners Delta and Air France-KLM to become "the most comprehensive network for both domestic and international passengers" at Rio de Janeiro's Santos Dumont and Galeao airports. The combine now apparently offers the most nonstop flights out of Rio and the best connections for domestic corporate passengers.

Fifth, GOL has added some international services out of Recife and other cities in Brazil's northeast. The new routes include Buenos Aires and Montevideo.

✈Deep capacity cuts

GOL has implemented the Brazilian industry's sharpest capacity cuts in the past 18 months. Since the beginning of 2015 its ASKs have fallen by 10.6%, which is 2.3 points more than TAM's and 5.1 points more than the industry average.

Despite that, though, GOL has maintained its leading market shares of domestic passengers and tickets issued to corporate customers. In the first half of 2016, it apparently also for the first time led in the sales volume to the corporate sector (travel association ABRACORP data).

This year GOL is slashing its total seats and flight departures by 15-18%. The ASK (capacity) reduction

GOL: AIRCRAFT FLEET PLAN

Aircraft @ 31 Dec	Seats	2013	2014	2015	2016	2017	2018	2019	2020
737-700	144	36	35	36					
737-800	177	17	9	5					
737-800SFP†	177	88	97	103					
Total		**141**	**141**	**144**	**122**	**125**	**128**	**131**	**130**

Source: Company reports. Note: † short-field performance.

will be less — around 5-8% — because of the increased average stage length.

✈US dollar debt exchange offers

Reducing US dollar-denominated debt was a priority in the financial restructuring because the real's weakening in 2012-2015 had caused that debt to soar. In early May GOL launched a voluntary private exchange offer for five classes of US dollar unsecured notes issued in international capital markets. The notes totalled US$780m and had maturities in 2018-2023. The bondholders were asked to swap them for new 8.75% secured notes due in 2022 and 2028 that had spare parts owned by GOL as collateral.

The offer represented a 20-50% premium over market prices, but the bondholders would have taken losses of up to 55% (70% originally). Most of them balked at the idea. Despite several extensions and a considerable sweetening of the terms, when the offer closed in early July the acceptance rate was only 22%, compared to GOL's original target of 95%. The resulting US$102m debt reduction represents only a US$9.3m saving in annual interest expenses.

The bondholders were unhappy about several issues, including an unequal treatment of US and Brazilian lenders (the latter were not asked to take haircuts) and that no equity was being offered. GOL also noted that the real's continued appreciation and a "drop in the Brazil risk perception" did not help.

✈Covenant waivers and maturity extensions with Brazilian banks

In recent months GOL has obtained two types of assistance from its local credit providers and bondholders — two major Brazilian banks that it has had long-term relationships with.

First, in June GOL secured waivers on debt covenants that it was about to violate. Second, since then it has also restructured R$1.05bn of locally issued debt. The amount of debt has not been reduced but the principal payments have been deferred from 2016-2017 to 2019, saving GOL R$225m in debt payments through 2018.

GOL was originally also seeking R$300m in new credit lines from the local banks but has not yet announced any such agreements.

✈Fleet reductions

GOL is in the process of "rightsizing" its fleet from 144 aircraft at year-end 2015 to 122 at the end of 2016 — a reduction of 22 units or 15.3%.

Some aircraft have been sold, but since almost three quarters of GOL's fleet has been leased, aircraft lessors are playing a key role in the restructuring. The airline has been in talks with all of its lessors this year about returning aircraft early, reducing monthly lease rates and deferring payments. It was looking to secure concessions from lessors worth R$220m in net present value savings.

As of early August, GOL had already returned seven of the 22 aircraft and was in the final stage of negotiations to return the other 15. Two of those will be sold and 13 are early lease terminations (with Delta apparently buying eight of those aircraft from GECAS). So GOL is on track to reach the 122-aircraft target by year-end.

The Real impact

Until recently, GOL's biggest problem was the sharp depreciation of the Brazilian currency. The real almost halved in value relative to the US dollar between year-end 2012 (2.04) and year-end 2015 (3.9). During 2015 alone the real weakened by 47%.

GOL has more than 50% of its costs denominated in US dollars (fuel, aircraft rentals, etc.) but earns revenues mainly in local currencies. So the airline saw terrible cost headwinds and foreign exchange losses. And it benefited only modestly from the decline in oil prices; while oil prices fell by 48% in 2015, GOL's fuel expenses dropped by only 14%.

The impact on the balance sheet was devastating: GOL's debt soared from R$6.2bn at year-end 2014 to R$9.3bn at the end of 2015. In the same period, the airline's adjusted gross debt (which includes operating leases capitalised at seven times annual costs) surged from R$12.1bn to R$17bn.

Most alarmingly, GOL's short-term liabilities increased dramatically during 2015. At the end of the year there was a R$3bn shortfall between current assets and current liabilities.

The key goals of the financial restructuring have been to reduce adjusted net debt, which amounted to R$14.7bn at year-end 2015, to below R$13bn and to avoid large debt repayments in the next two years.

But the R$/US$ trend reversed at the end of 2015. Reflecting renewed investor optimism, the real has been the world's best-performing currency this year. As of August 27, it had appreciated against the US dollar by 17.5% since January 1 (from 3.95 to 3.26), or by 21% since its lowest point on January 22 (4.15). Of course, this trend may not continue (given all the economic and political uncertainty).

GOL's balance sheet has benefited greatly from the real's strengthening. Pro forma for the conclusion of the US dollar debt exchange offer, GOL's total debt decreased by R$1.2bn during 2Q, and more than half of that (R$667m) was due to the exchange rate variation. The debt ex-

GOL: ROUTE NETWORK

change's contribution was a modest R$327m, and the remaining R$240m was the result of the shedding of aircraft-related debt.

GOL's adjusted gross debt/EBITDAR declined from 12.7x at year-end 2015 to 8.4x at the end of June. The airline projects the ratio to fall to 6-6.5x in the next 12-24 months, which would still be relatively high by industry standards.

GOL estimated in early August that when all of the initiatives in the restructuring plan were completed, the total adjusted debt reduction would be R$3.8bn. Of that, fleet restructuring would account for R$2bn and the real's appreciation R$1.3bn.

GOL saw its unrestricted cash shrink in the second quarter to R$1.4bn or 13.7% of lagging 12-month revenues. But total liquidity was healthy at R$2.1bn or 21.4% of revenues.

The management has indicated that they now expect GOL to be able to meet its obligations in 2016 and in 2017. But they have also said that GOL is looking to further reduce debt, given that it remains highly leveraged.

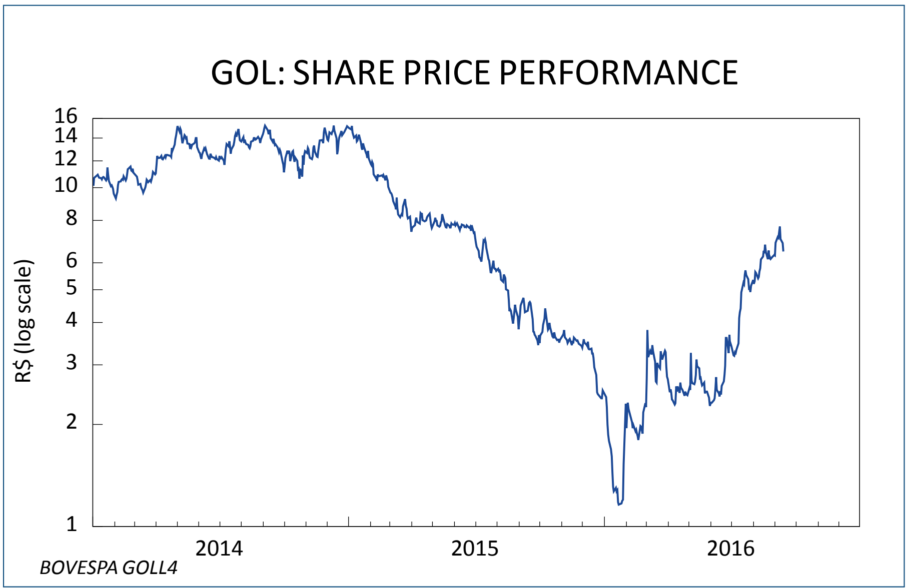
Economic and profit outlook

GOL's recovery prospects will obviously depend on the timing and speed of Brazil's economic recovery. There are some positive signs. The recession may have bottomed out and some data even point to a resumption of GDP growth before year-end. Inflation has been brought under control. The political situation has stabilised somewhat. The impeachment of suspended president Dilma Rousseff at the end of August should help further stabilise the situation and facilitate needed reforms.

One major positive is that, for the first time, 2016 will see airline industry capacity decline in Brazil. The domestic pricing environment has already improved. Based on the cuts announced by airlines so far, aggregate domestic capacity is expected to fall by 8-10% this year.

Then again, Brazil's economic recovery could be painfully slow, and there is uncertainty about how quickly political stability can be restored. And, with the smaller airlines keen to increase market share, and hence resume growth at the earliest opportunity, there is no guarantee that industry capacity discipline will continue in 2017.

But GOL reported promisingly in early August that it was already more or less breaking even on an operating basis. The yield-depressing effect of the Rio Olympics has not been systemic (unlike the World Cup's effect



two years ago). The second half of the year is typically stronger for the airline. GOL is tentatively projecting a positive 4-6% operating margin for 2016, which would represent a modest turnaround from last year's negative 1.9% margin. The forecast assumes the exchange rate averaging R$3.5-3.9 this year.

Analysts at Bradesco BBI have suggested in recent research notes that GOL's margin forecast may be conservative, because it assumes further macroeconomic deterioration and delays with the early return of aircraft. They believe that GOL can deliver 6% and have retained an "outperform" rating on the stock (which is listed in both São Paulo and New York).

The Bradesco analysts also noted that Brazil's Senate could vote in September to cap the VAT on jet fuel at 12% in Brazil — something that they estimate could boost GOL's annual EBIT margin by 160 basis points.

GOL also has more core cost cutting and profitability initiatives in progress or planned. One promising area is maintenance. The US FAA recently certified GOL to execute C-checks, which will reduce maintenance costs.

Bradesco also noted that air fares in Brazil continue to recover. Despite the recession, GOL recently raised its fares by 9% — the third consecutive quarter of fare increases. As GDP growth turns positive next year, Bradesco believes that fares could rise by 5% and GOL could achieve a 9.6% EBIT margin in 2017.

Will Delta acquire GOL?

GOL's late-July CFO change renewed speculation that the carrier's focus is now shifting to M&A. Richard Lark, who was GOL's CFO in the strong growth years of 2003-2008 and subsequently became a board director, has returned to the CFO's role, replacing Edmar Lopes, who oversaw the restructuring. Lark has an impressive résumé, with significant experience also on the equity side.

When asked on GOL's 2Q call about his focus in the next 6-12 months, Lark mentioned rebuilding, "final resolving of the capital structure and profitability" and "ultimately other issues that would help GOL competitively in the region".

Before those comments, the Bradesco analysts had already suggested that Lark's return meant that M&A would soon dominate the agenda. The analysts wrote on July 29: "We believe that installing someone with his investment banking experience suggests that GOL may seek to close a deal with Delta".

While the airlines have stated that no such talks have taken place, the likelihood that Delta will fully acquire GOL has increased also because Brazil is finally getting close to lifting foreign ownership restrictions in the country's airlines. Interim president Michel Temer wants to abolish the current 20% cap altogether. Although there has continued to be opposition among Senators, the government is reportedly determined to push the legislation through by the end of this year.

Delta could, of course, increase its stake in GOL to 20% under the current rules, but the motivation may be greater after the cap is abolished and there is a surge of interest in Brazil's airlines. It could be partly a defensive move by Delta. A delay undoubtedly suits Delta because it is committed to making a $750m investment in Aeromexico this year (currently expected in Q4).

Another thing that will help GOL in the future is an immunised joint venture with Delta, possible after Brazil ratifies the US-Brazil open skies ASA.

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