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European majors: Degrees of rationality

IN THE depths of the downturn following the global financial crisis, each of the three top network carrier groups in Europe promoted strategies to return to a sustainable level of profitability by 2015. Things don't always go as planned; and it is only IAG that has come anywhere close, generating a return on invested capital of over 13% and operating margins of 11%. Lufthansa and Air France-KLM have stopped talking about any targets for creating returns to shareholders.

All three have recently published their third quarter and nine month's results (with IAG capping theirs with the group's annual investor day), which each show broadly similar trends. Yields and unit revenues have been under pressure — as to be expected, when fuel prices fall, airlines pass on part or all of the savings to the passenger. There does however appear to have been market weakness on the Atlantic and to Asia which has added to pricing pressure.

For the three months to September — the main summer season — each registered a decline in revenues, fall in operating profits and a boost to net income. To be fair, the underlying performance at IAG was somewhat better but marred by losses on translation of British Airway's results into Euros following the collapse in Sterling after the UK's referendum result.

The mainline network airlines in each group maintained "capacity discipline"; although in IAG's case, Iberia, having gone through successful restructuring in the last few years has resumed growth with capacity up by over 5% in the nine months. BA increased capacity by 3% and Aer Lingus (acquired in August last year) expanded strongly on the Atlantic, growing by 9%.

The three groups have all been pushing growth into their respective "low cost" brands. Lufthansa's Eurowings increased capacity by 25% year on year in the nine months and for the period accounted for 9% of the group's total capacity (in ASK terms) and 17% of passenger numbers. Air France-KLM's Transavia grew by 13% and now accounts for 15% of the group's total passenger numbers and 9% of capacity. Vueling — the only one of the three an independent player — had operational difficulties but still grew by 11%. It now accounts for 22% of IAG's passenger numbers and 11% of seat capacity.

In these earnings presentations sometimes what is interesting is what is omitted. In this season's results IAG, for the first time since the merger between BA and Iberia, neglected to detail the respective revenues and op-

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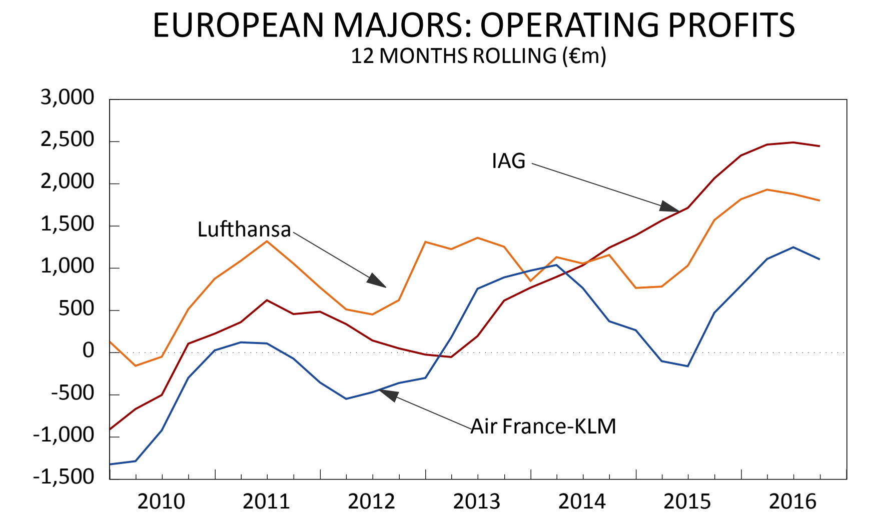

Note: Rolling twelve months. Source: company reports. IAG - underlying operating profit. Air France-KLM - operating result. LHAG - "Adjusted" EBIT.

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erating profits by "brand". There was also a notable absence of reference by any of the three to the Atlantic metal neutral joint ventures. We can only assume that there is some embarrassment associated with this collective omission.

Air France-KLM

Air France-KLM meanwhile took the opportunity to announce a new strategic programme. Having failed in its "Transform 2020" and "Perform 2020" plans to persuade employees that it really needed to transform and perform, and following a change of senior management, new CEO Jean-Marc Janaillac has introduced a new plan entitled "Trust Together". On the face of it, it appears to be an internal message to try and mend badly-eroded relations between the Air France management and the French unions, as well as between Air France and KLM.

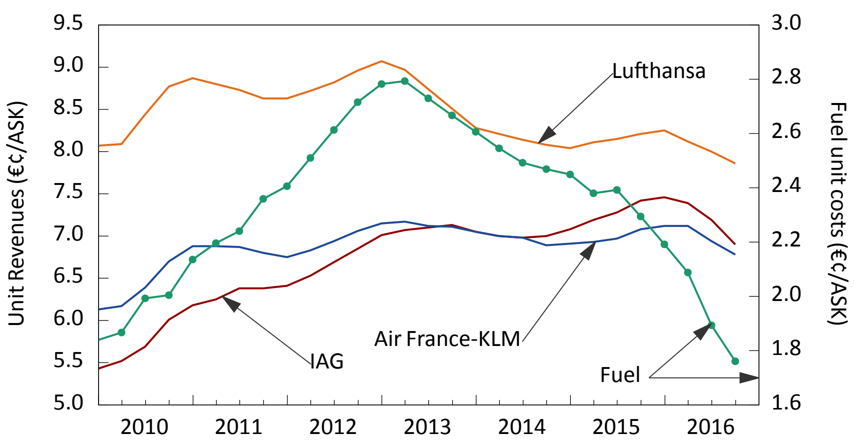
Alongside this the group announced plans for what was described as a new long haul low cost airline based at CDG: up to ten aircraft by 2020 with volunteer crew from the Air France corpus. It would in fact be a full service airline probably operating the full Air France brand, so could not possibly be described as low cost, and smacks to us as an attempt to introduce 'B' scale wages in the company's primary hub to force through employee productivity. This is sort of what British Airways managed to do at its London Gatwick operations a decade ago: the difference being that Gatwick is not BA's main hub, with flights on predominantly point-to-point low-yield ″leisure″ routes.

The company states that this venture will allow it to fly long- and medium-haul routes that are currently uneconomic or subject to intense competition and give junior pilots the chance to fly long-haul. Even if the unions do agree to the idea, it is not clear what would happen at the ten aircraft limit. It does nothing to create significant productivity improvements in the Air France mainline operations — or indeed change how they manage pilot seniority lists. The plan seems doomed to fail.

At the same time Air France has decided to rein back on expanding Transavia into a pan-European brand (which idea, for some reason, the

EUROPEAN MAJORS: UNIT REVENUES AND FUEL

12 MONTHS ROLLING



EUROPEAN MAJORS: Q3 2016 RESULTS

	IAG			Lufthansa Group			Air France-KLM		
	2016	2015	%chg	2016	2015	%chg	2016	2015	%chg
Revenues(€m)	6,486	6,756	(4.0)%	8,828	8,939	(1.2)%	6,938	7,306	(5.0)%
Operating profits(€m)	1,205	1,250	(3.6)%	1,148	1,225	(6.3)%	737	880	(16.3)%
Net profits(€m)	930	848	9.7 %	1,422	794	79.1 %	544	481	13.1 %
Operating margin	18.6%	18.5%	+0.1pt	13.0%	13.7%	(0.7)pt	10.6%	12.0%	(1.4)pt
Pax ('000s)	30,849	27,564	11.9 %	32,694	32,098	1.9 %	26,553	25,897	2.5 %
ASK (m)	83,441	76,138	9.6 %	81,044	77,905	4.0 %	84,426	83,172	1.5 %
RPK (m)	71,431	65,272	9.4 %	68,397	66,973	2.1 %	74,237	73,953	0.4 %
Load factor	85.6%	85.7%	(0.1)pt	84.4%	86.0%	(1.6)pt	87.9%	88.9%	(1.0)pt
Passenger unit revenues (€¢/ASK)	7.0	8.1	(13.6)%	8.0	8.6	(7.0)%	6.8	7.3	(7.5)%
Unit costs (€¢/ASK)	6.3	7.2	(12.4)%	6.8	8.1	(16.0)%	5.9	6.3	(6.3)%

French pilots never liked), and plans to revert the low cost subsidiary to a defensive position in Amsterdam and France. Transavia France, however, by pilot agreement, is limited in the number of aircraft it can operate. No doubt the attempt to force its way into Lufthansa's second base in Munich has been an unmitigated disaster (although the LCC subsidiary did improve operating results in the third quarter by around 20% to €100m, giving it €17m for the nine month period up by an underlying €38m from the prior year levels). Meanwhile, it will once again rebrand the French domestic point-to-point services (no doubt still heavily loss-making) from a mixture of Air France and HOP! to HOP! Air France.

Lufthansa Group

Lufthansa's move to develop Eurowings as a low- cost point-to-point alternative to the mainline network operations and catapult it into the position of the third largest pan-European LCC has been given a boost by the possible wet-lease deal from the moribund Air Berlin (see *Aviation Strategy,* October 2016). It describes the

EUROPEAN MAJORS: 9 MONTHS 2016 RESULTS

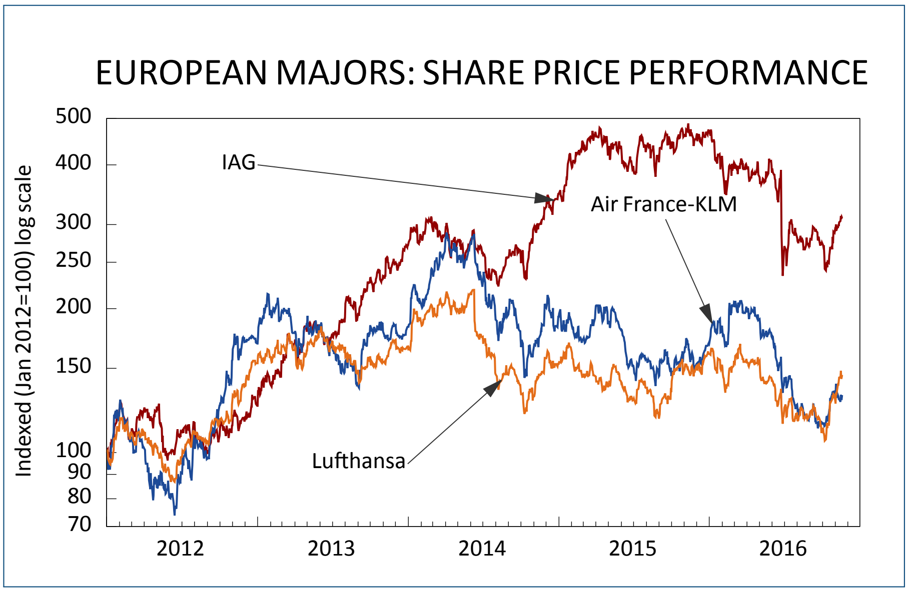
	IAG			Lufthansa Group			Air France-KLM		
	2016	2015	%chg	2016	2015	%chg	2016	2015	%chg
Revenues(€m)	17,272	17,119	0.9 %	23,870	24,304	(1.8)%	18,758	19,447	(3.5)%
Operating profits(€m)	1,915	1,805	6.1 %	1,677	1,693	(0.9)%	955	643	48.5 %
Net profits(€m)	1,484	1,180	25.8 %	1,851	1,748	5.9 %	430	-158	nm
Operating margin	11.1%	10.5%		7.0%	7.0%		5.1%	3.3%	
ROIC	13.0%	13.6%		9.9%	9.7%		6.5%	5.8%	
Pax ('000s)	77,525	66,202	17.1 %	83,946	83,022	1.1 %	70,834	68,498	3.4 %
ASK (m)	226,356	203,381	11.3 %	219,130	210,478	4.1 %	230,011	227,103	1.3 %
RPK (m)	185,726	166,147	11.8 %	173,864	170,831	1.8 %	197,797	195,159	1.4 %
Load factor	82.1%	81.7%	0.4 %	79.3%	81.2%	(1.8)%	86.0%	85.9%	0.1 %
Passenger unit revenues (€¢/ASK)	6.8	7.5	(9.8)%	7.7	8.3	(7.2)%	6.6	7.0	(4.9)%
Unit costs (€¢/ASK)	6.8	7.5	(10.0)%	7.7	8.8	(12.5)%	6.1	6.6	(7.4)%
LCC Growth	**Vueling**			**Eurowings**			**Transavia**		
Pax ('000s)	17,400e	15,800e	10.1%	13,962	12,892	8.30%	10,439	8,638	20.8%
ASK (m)	26,569	23,979	10.8%	18,863	15,163	24.40%	20,116	17,840	12.8%
RPK (m)	22,148	19,511	13.5%	15,084	12,077	24.90%	18,041	16,164	11.6%
Load factor	83.4%	81.4%	2.0%	80.0%	79.6%	0.32%	89.7%	90.6%	-0.92%

Eurowings business model as being ″sustainably successful through [a] unique market position″.

It aims to be the largest point-to-point European operator in its home markets (Germany, Austria, Switzerland and Belgium) and hold the top or second position in all relevant German airports. It currently operates around 90 aircraft in seven bases (Hamburg, Berlin, Hanover, Düsseldorf, Köln/Bonn, Stuttgart and Vienna). And following the Air Berlin and SN Brussels deals it expects to operate 160 aircraft in eleven bases — with the addition of Brussels, Munich, Salzburg, Palma di Majorca and Brussels. (For some strange reason it plans to include SN Brussels — it will take full control early next year — within the Eurowings umbrella).

While keeping growth at the group's network carriers below market rates (for the nine month period capacity in ASK terms at Lufthansa, SWISS and Austrian grew by 2.5% year on year, while passenger demand in RPK terms was on a par with prior year levels), Eurowings has been expanding strongly — and particularly on long haul — with ASKs and RPKs up by 25% in the nine months (but passenger numbers up by only 8% and revenues by 7%). Revenues for the point-to-point carrier for the period approached €1.6bn, not far short of that achieved by Austrian, but it registered an adjusted operating loss of €35m apparently down nearly €100m on the same period last year.

Lufthansa avers that it will get Eurowings' operating unit costs down to 5.8€¢ by 2020 from 8.0¢ last year. This is still a long way above the figures for European market leader Ryanair (which has just launched a broadside at Lufthansa by starting operations at the Frankfurt home base



while pushing expansion into the German market). Meanwhile industrial relations continue to ebb: strikes at Lufthansa and Germanwings by the pilots, and by the cabin attendants at Eurowings.

IAG

IAG was particularly hit in the quarter by the fall in the value of Sterling against the Euro. The operating margins at British Airways were on a par with the prior year third quarter at 18.6% but the collapse in the pound resulted in a net €140m lower operating profit on translation. The effects of exchange rate movements at British Airways overall is somewhat complicated: around 40% of revenues are each in Sterling and US Dollars, with only 10% in Euros.

Given its strength at its base at Heathrow — which is still the premier long haul gateway to Europe — it has the ability to sell into higher value currency markets and ″switch on″ transfer traffic through its hub, away from UK originating sales (which might be expected to weaken in light of lower growth and lower value of the pound).

The highlight was the performance at Aer Lingus, achieving an operating margin for the quarter of nearly 30%, up nearly seven points on the prior year level. It even achieved a near 21% return on invested capital. Aer Lingus has been expanding strongly, particularly on the Atlantic. Here the group has an opportunity to develop Dublin as a new ″low cost″ gateway, with a distinct advantage of having US immigration preclearance facilities. In one sense it provides the extra runway capacity lacking at Heathrow. The challenge will now be to bring Aer Lingus into the immunised joint venture with American on the Atlantic.

At the group's Capital Markets day, the management contended that nothing had really changed since last year (see *Aviation Strategy*, November 2015). The group has slightly reduced its long term growth plans by 1 point to 3%, cut capital expenditure to an average €1.7bn over the next four years, and reduced its target of average EBITDAR to €5.3bn from €5.6bn. It maintains its plans to target 15% ROIC, operating margins of 12%-15% and earnings growth of over 12% a year.

US airline stocks: Not Trumped but Buffetted

President Trump's election came as a bit of shock, but the US airline industry — in contrast to the British reaction post-Brexit when European airline shares slumped both absolutely and relatively — has responded with equanimity.

In fact as the graph below illustrates, the market dismissed any uncertainty that the radical presidential choice has caused; all the major US airline stocks moved up following the election result, continuing the general trend for strong growth over the past five years.

Aviation policy did not figure prominently, if at all, in Trump's unconventional campaign, but it is possible to make a positive case (purely from the US industry's perspective). First, if the election promises are followed, there will be a massive increase in government spending on infrastructure at the same time as corporate and personal taxes are slashed, which — if (a rather big if) all the economic and fiscal multipliers align correctly, and investors, including presumably the Chinese, are willing to buy US infrastructure bonds — could mean that GDP growth will be substantially boosted, doubled according to Trump's claim. Second, US foreign policy is now protectionist, again interpreting from the campaign rhetoric. This presumably means that US carriers will be more protected from "unfair" competition from the Middle East superconnectors and pesky new entrants like Norwegian.

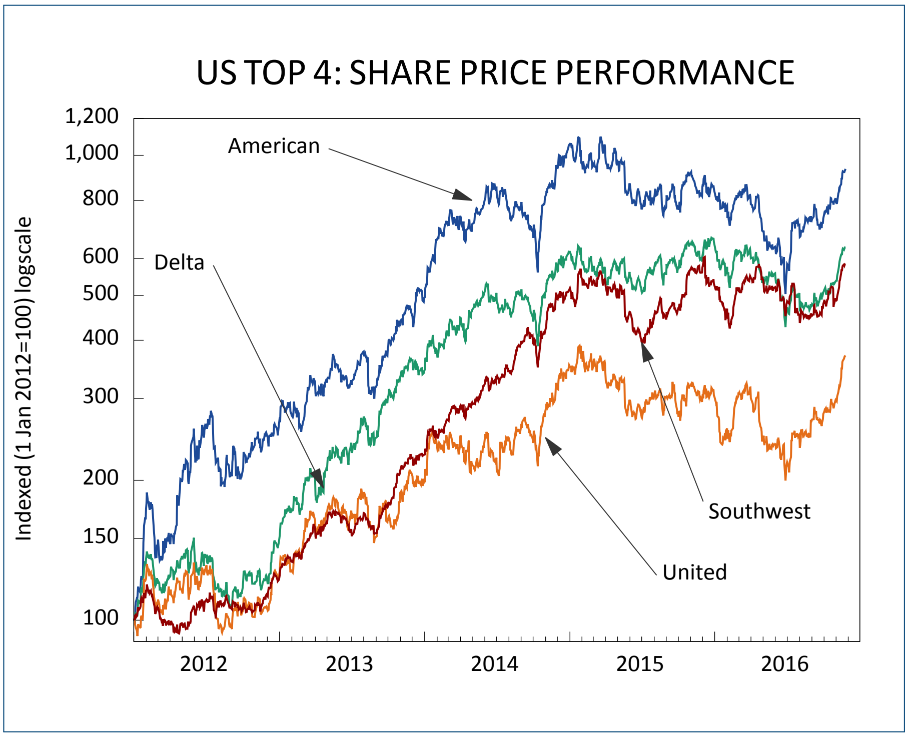
More fundamentally, there appears to have been a fundamental shift in the investment community's attitude to the main US airlines, which has been brought into prominence by a decision by Berkshire Hathaway (BH), the Omaha based investment fund/insurance company/industrial conglomerate headed by Warren Buffett, whose very investment moves are obsessively monitored in the hope of replicating his consistent financial success.

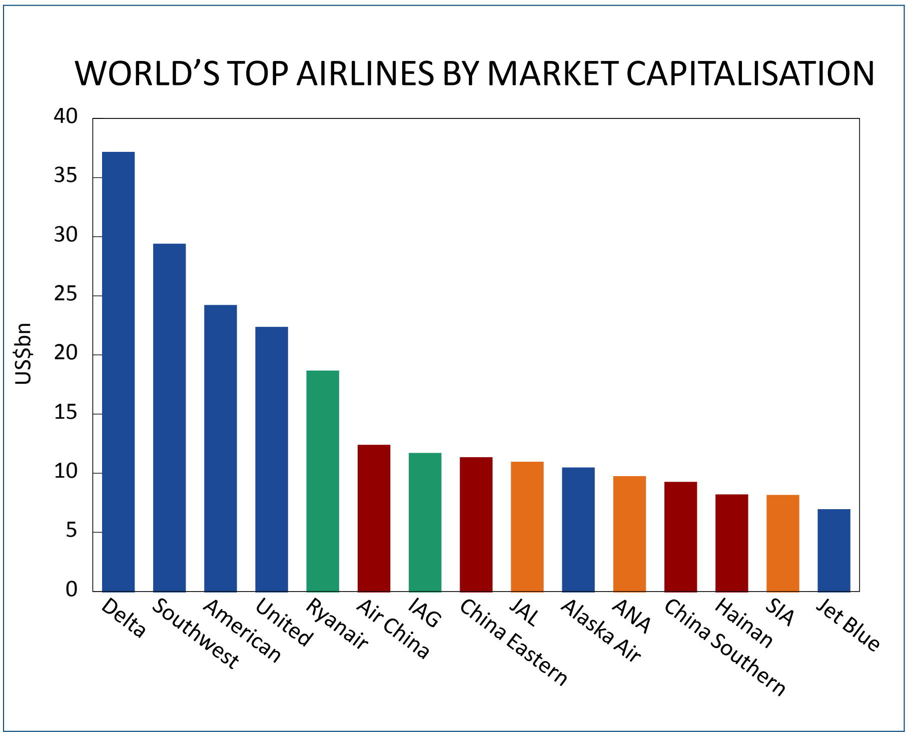
In its recently filed Form 13F, BH revealed an investment of $0.8bn in American, $0.25bn each in Delta and United, plus, a little later, a further purchase of an estimated $0.25bn in Southwest — about $1.55bn in total, which is about 1% of the BH's share portfolio.

This is interesting because Warren Buffett was perceived to be vehemently anti, when it came to airline stocks, following a painful investment in USAirways in the early 90s. Commenting in Berkshire Hathaway's always entertaining annual report, Buffet said at the time: "As for the future performance of the airline industry, your guess is as good as mine. Actually, given my record with USAirways, your guess will be better than mine."

He also joked to a group of business school students, "I now have an 800 number I call every time I think about buying a stock in an airline. I say, 'I'm Warren and I am an airaholic."'

But that is not the full story. BH held on to USAirways convertible preferred stock which became very valuable when CEO Steven Wolf started to deliver financial success at the car-





rier in the late 90s, and the share price soared. By the end of the decade Buffett was able to write that his airline investment record was no longer "unblemished by success" and that the "USAirways shares will produce a decent profit — that is if my cost for Maalox is excluded." [for non-US readers, Maalox is an over-the-counter indigestion medicine].

BH has also been the sole owner of NetJets for the past 20 years, a decision made by Buffett because his own experience of the fractional ownership operation was so good.

Now US airline stocks have been accepted into the BH portfolio, it is worth asking the question: why is BH deemed so important? Under the charismatic but self-deprecatory Warren Buffet, BH has achieved a stock market valuation of $390bn, and generated a roughly 20% annual average increase in value since the 1960s (when he joined BH, it was primarily a declining textile company). The core business is insurance which provides the "float", premiums paid up front, for investment either directly in wholly owned companies or into major stakes in publicly quoted companies, mostly American but a few European. It's a low cost method of obtaining investment funds.

BH's aim, or rather raison d'être, is to achieve long-term value growth in its shares substantially above that of the S&P500 (otherwise, as Buffett points out, investors would be better off with a low cost tracker fund). These are some of the, deceptively simple, principles that BH applies:

✈ BH does not play industry cycles (which is what investors have mostly done with airline stocks) but always invests with the aim of holding for the very long-term, although recessions are regarded as increasing buying possibilities.

✈ Share purchases are made using the same criteria as BH uses when buying companies — strong franchises, consistent long-term growth prospects, quality management that are dedicated to the company (BH never imposes its own managers).

✈ BH likes strong brands; its portfolio includes Coca-Cola, Amex, Wells Fargo, Phillips, Wall Mart, etc.

✈ BH's aim is to buy the right company at the right price, but even if it buys the right company at a wrong price that should ultimately sort itself out because of its long-term holding strategy; however, it should never buy the wrong company at what appears to be a bargain price.

✈ BH finds comfort in industries where there isn't or doesn't appear to be a threat from disruptive new technology — commercial aviation mostly fits this criterion.

✈ Conversely, BH does not generally invest in new technology, leaving that to those who understand such things; notably BH refused the temptation to invest in dotcoms during the early 2000s boom, was criticised for underforming the stockmarket but was quickly vindicated when the bubble burst.

The obvious change that has brought the US airlines into BH's universe is the massive consolidation that has taken. As the result of AA/US, UA/CO and DL/NW the four biggest US airlines (Southwest being the fourth) now control 76% of the total US industry (measured in RPMs) compared to 55% ten years ago. As a result, the big four are producing the sort of results that appeal to BH: in 2015, $122bn of revenues, $23.3bn of operating profits (23% margin) and combined net profit of $21.7bn (18%).

Significantly, it appears as if this performance is sustainable in the long run, though the business cycle has not gone away and there are always external events, because the industry is being very moderate in increasing capacity, concentrating on unit revenue improvements and not entering into destructive market share wars. What is rather less clear is whether the financial gains will eventually leak back to labour, and whether one or more of the smaller low cost carriers might be able or willing to aggressively take on the big four, and challenge the status quo.

Ownership consolidation by cross-holding funds

While the US operational consolidation is obvious, there has been another development which might be of equal or even greater importance — a remarkable degree of ownership consolidation, identified in an analysis in the *Harvard Business Review* (HBR, November 2016). The table, below, compiled from data in the HBR report, shows that seven huge investment funds, of which BH is the latest and smallest, have each accumulated cross-holdings in all four of the US largest airlines.

Their joint shareholdings range from $7.3bn in United, $7.4bn in Delta, $10.4bn in American to $11.1bn in Southwest — $36.1bn in total or about 32% of the current market capitalisation of the four airlines. This gives the crossholding funds substantial control over the core US industry, and actual control is probably greater still as the HBR estimates the percentage of voting shares held by the seven funds to be well over 40%.

From a shareholder's perspective, this is generally very good news; not only does it demonstrate great confidence in the sector, it also acts as a block to excessive competition or destructive fares wars.

The funds are not backing one airline but all four, so an aggressive expansion might be successful and enhance that airline's value but it would damage the others — a zero sum game for the funds.

The funds can exercise control passively, just through the weight of their shareholdings, or more actively, through for example, signalling to Wall Street analysts, whose coverage of US airline stocks appears at times to be obsessed with projecting ASM and RPM trends, and issuing calls for "capacity discipline" when the former exceeds the latter.

From a passenger perspective, the industry and ownership consolidation is perhaps not such good news. It implies a collusive industry characterised by strengthening unit revenues, which means rising fares, uncomfortably high load factors and restricted service on thin routes. Wealthier business travellers might then be tempted to try out NetJets' fractional ownership product — clever man, that Warren Buffett.

INVESTMENT FUNDS OWNERSHIP OF MAJOR US AIRLINES

$bn	American	Delta	United	Southwest	Total 4 Airlines
PRIMECAP	1.61	0.96	1.44	3.48	7.49
Vanguard	1.52	2.25	1.71	1.84	7.32
BlackRock	1.37	1.84	1.60	1.83	6.63
T. Rowe Price	3.79	0.05	0.79	0.32	4.94
Fidelity	0.45	0.78	0.72	2.29	4.24
State Street	0.85	1.26	0.80	1.06	3.97
Berkshire Hathaway	0.80	0.25	0.24	0.25	1.54
TOTAL 7 FULL CROSS-INVESTORS	**10.39**	**7.38**	**7.30**	**11.07**	**36.14**
% of Market Cap	***43%***	***20%***	***31%***	***38%***	***32%***
OTHER MAJOR INVESTMENT FUNDS (EST)	**1.57**	**4.70**	**3.74**	**1.85**	**11.86**
% of Market Cap	*7%*	*13%*	*16%*	*6%*	*10%*
ALL OTHER SHAREHOLDERS	**12.14**	**24.62**	**12.71**	**16.48**	**65.95**
% of Market Cap	*50%*	*67%*	*54%*	*56%*	*58%*
MARKET CAP (End Nov 2016)	**24.10**	**36.70**	**23.75**	**29.40**	**113.95**
% of Market Cap	*100%*	*100%*	*100%*	*100%*	*100%*

Source: Harvard Business Review, S&P, Aviation Strategy

South Korean LCCs: Challenging relationships

The LCC market has grown rapidly in South Korea over the last few years, and today no fewer than six low cost airlines compete against the legacy carriers of Korean Air and Asiana Airlines (although three of these LCCs are controlled by those two airlines).

With a population of 51.5m located in the centre of East Asia, South Korea was essentially a monopoly for Korean Air until the late 1980s, when Asiana Airlines was launched, and it wasn't until 2006 that the first LCC appeared.

Since then, however, LCC services have expanded significantly — for example, on South Korea to Japan routes (which is the most important country pair in Asia by passengers carried, excluding routes to/from China), South Korean LCCs have expanded their share from nothing in 2008 to approximately 24% by 2015. That's still behind the market share of Korean Air (c35%), but close to Asiana (c26%) and well ahead of the combined share of Japanese airlines (which is just 14%).

According to the South Korean ministry of land, infrastructure and transport (KADA), the country's LCCs accounted for a 15% share of the international market as at the end of September 2016 — compared with 11% as of September 2015 — and KADA forecasts that the LCC's market share will rise to 30% over the next five years.

South Korean LCCs can be split into two types: Air Busan, Air Seoul and Jin Air, which are backed by South Korean's two legacy carriers; and three independent LCCs — Eastar Jet, Jeju Air and T'way Airlines — which are more exposed, both strategically and financially.

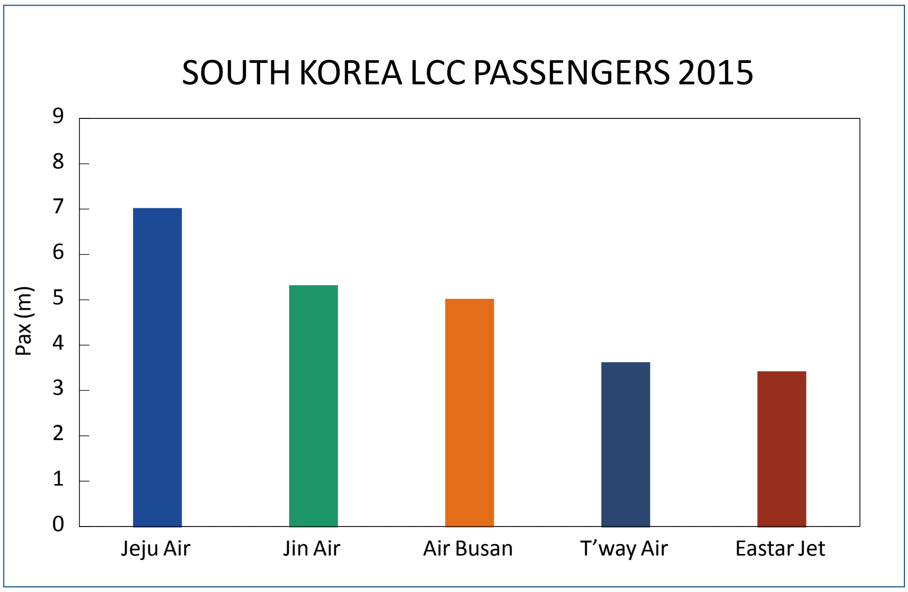
That's significant in a market where short- and medium-haul routes (particularly to Japan and China) are close to saturation; in 2015 alone the five LCCs (the sixth began operations in 2016) launched routes to 40 new international destinations. As a result, some of South Korea's LCCs are now looking at long-haul routes — though that will necessitate the abandoning of the typical single aircraft LCC model.

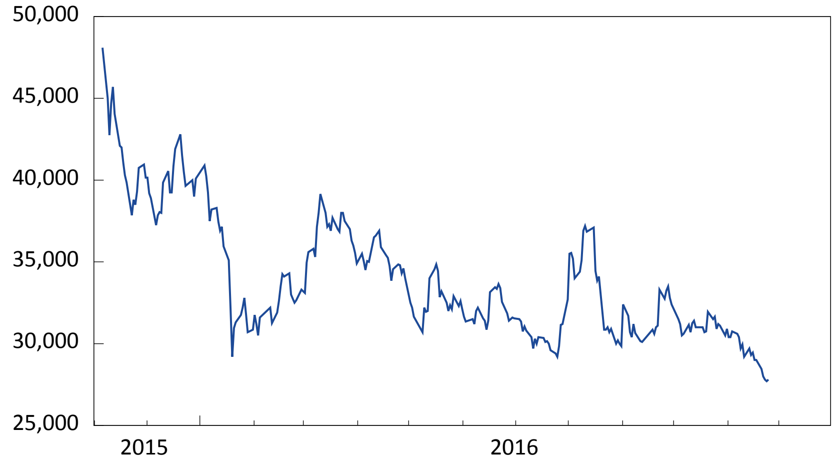
Jeju Air

Jeju Air became the first LCC in South Korea after launching in 2006 out of Jeju City on Jeju, an island off the southern coast of South Korea. Just under 82% of its equity is owned by the Aekyung Group — a South Korean chaebol (or conglomerate)— with the Jeju regional government owning 5%.

From hubs at Jeju and Incheon, Jeju Air operates a network of six domestic destinations and 25 internationally, with its most important markets being China (eight destinations, with Sanya on Hainan Island added in November this year) and Japan (six), followed by two in Thailand, Vietnam and the Philippines, with one each in Taiwan, Cambodia, the Northern Mariana Islands, Guam and Malaysia.

The airline carried 7m passengers in 2015 and currently uses a fleet of 25 737-800s, almost all of which are leased and which have an average age of more than 11 years. The airline plans to increase its fleet to 26 by the end of 2016, with another four to five aircraft being added each year until it reaches the 40 aircraft mark by the end of 2019. Four leased aircraft will join the fleet in 2017, although it is believed to be planning the placement of an order for 737-800s direct from Boeing sometime over the next year or two.





Jeju Air became one of the eight founding members of the Value Alliance — an alliance for Asia/Pacific-based LCCs — in May this year. Set up as a rival to U-FLY, the Value Alliance also includes Tigerair, Scoot and Nok, and enables passengers to book flights on any other partner's routes through the websites of each member.

Jeju Air is considering long-haul routes, with Ken Choi — its president and chief executive — saying that it is also looking at the potential for joint ventures: "Bangkok is a very good market and Thailand is relatively flexible in allowing the establishment of a new carrier."

Jeju Air is the only LCC to be quoted — it listed on the Korean Stock Exchange in November 2015, and was the first South Korean airline to list since Asiana Airlines in 1999. On debut Jeju Air immediately rose from its IPO price of ₩30,000 to more than ₩48,000, but ever since it has been on a gradual but steady downwards path (see chart above), with the price standing at under ₩30,000 as at the middle of November. The listing was made only after Jeju Air was unable to close a deal for an investment by Singapore Airlines, with negotiations apparently carrying on for five months before collapsing.

In the first-half of 2016 Jeju Air recorded revenue of ₩335.3bn (US$284m) — 17% higher than January-June 2015 — although operating profit fell 47% year-on-year to ₩16.2bn (US$14m), thanks partly to higher maintenance costs on its ageing aircraft.

Air Busan

Based at Gimhae International airport in the Gyeongsang province in the south-east of the country, Busan International Airlines was established in 2007 before changing its name to Air Busan the following year, when it began operations. Air Busan operates a fleet of 10 A321-100s and six A320-200s, all of which are leased and which have an average age of 13 years. It carried around 5m passengers in 2015.

Asiana Airlines owns 46% of the LCC, with the city of Busan and as many as 13 local companies holding the remainder of the equity. Air Busan operates to four domestic destinations and 17 abroad, with six in China, four in Japan, two in Taiwan and one each in Guam, the Philippines, Cambodia, Vietnam and Mongolia. A seventh Chinese destination will be added in December this year with the commencement of a service between Seoul and Sanya on Hainan island.

Although not majority-owned by Asiana Airlines, Air Busan has taken over some routes that were previously operated by the legacy carrier, though there tends to be an overlap of operation before Asiana withdraws from a route that Air Busan has entered.

Jin Air

Jin Air was founded by Korean Air in 2008 as a domestic LCC to compete against the country's high-speed rail service, called KTX, and which was launched in 2004.

Jin Air added its first international routes in 2009 and has concentrated on expanding its international network ever since. Today it operates to five domestic destinations and 21 internationally, comprising five in China, four in Japan, two in the Philippines, Thailand and Vietnam, and one each in Guam, Laos, Malaysia, the Northern Mariana Islands, Taiwan and the US (Honolulu). In December two new routes are launching, from Seoul to Cairns and to Kitakyushu in southern Japan.

Jin Air operates these routes from two hubs — Gimpo International (located 17km west of Seoul) and Incheon International (located 47km west of the capital). Incheon is now the largest airport in South Korea and opened in 2001 to partly replace Gimpo, which now largely serves domestic routes and secondary airports in China, Japan and Taiwan.

Jin Air carried 5.3m passengers in 2015 (almost 50% up on 2014), of which 2.0m were domestic and 3.3m international. Its fleet comprises 18 737-800s and four 777-200ERs — the latter being used on longer routes; Jin Air was the first South Korean LCC to launch a long-haul route — between Incheon to Honolulu — in December 2015. The majority of the fleet is leased, and the average age is just over 11 years.

The LCC is formally owned by the Hanjin Group, a South Korean chaebol that also took control of Korean Air in 1969. Interestingly, where Jin Air has launched a service on a route that Korean Air already has an established operation, more often than not Korean Air has tended not to cease its service or even reduce its capacity significantly (in contrast to the strategy of Asiana Airlines and Air Busan).

In 2015 Jin Air earned revenue of ₩461bn (US$400m) — 76% higher than 2014 — and posted a ₩29.7bn operating profit, 73% up compared with 2014.

Eastar Jet

Owned by the Korea Investment Corporation (KIC) — the sovereign wealth fund of South Korea — Eastar Jet launched operations in 2009 and is based in Seoul, with hubs at Gimpo and Incheon airports. It operates between five domestic destinations and 17 internationally, including five in China, four in Japan, two in each of Thailand and Taiwan, and the rest in Vietnam, Taiwan, Malaysia and Cambodia.

Eastar Jet has been codesharing with another LCC — T'way Airlines — on the Seoul-Taipei route since 2013, but in July this year it joined the U-FLY alliance of LCCs, which largely comprises airlines owned by China's HNA Group but which has been looking for new, independent members (with Eastar Jet being the first of these).

Eastar Jet carried 3.4m passengers in 2015 and operates a fleet of 17 leased aircraft, comprising 14 737-800s and three 737-700s, which combined have an average age of more than 12 years. It plans to add another two aircraft to its fleet by the end of 2017.

T'way Airlines

T'way Airlines is based at Gimpo International in Seoul and was launched in 2010 by the South Korean private equity company Shinbo Investment Corporation (which owns a 95% share) after it acquired the AOC of an effectively defunct regional airline called Hansung Airlines. Under an LCC model, T'way Airlines began operations with a couple of 737-800s on domestic routes.

Today it operates 15 737-800s to six domestic and 22 international destinations, including eight in China, seven in Japan, two in Vietnam, two in Taiwan and one each in Guam, Laos and Thailand. This December the LCC will launch two new routes — between Daegu in the east of South Korea and Cebu in the Philippines, and between Seoul and Saipan in the Northern Mariana Islands,

The fleet is entirely leased and has an average age of 10 years. T'way Airlines carried 3.6m passengers in 2015.

Air Seoul

Asiana Airlines launched an LCC subsidiary in July this year, called Air Seoul. Based at Incheon airport, Air Seoul currently has just three leased aircraft — A321-200s — with an average age of four years. They operate from Incheon to 10 international destinations, seven of which are in Japan and one each in Cambodia, China (Macau) and Malaysia. Two more aircraft will be added to the fleet by the end of 2017.

Asiana's second LCC has been in the planning stage for at least two years, with the rationale being that Asiana needed a low cost operation at one of its main hubs in Seoul in order to better challenge Korean Air and the other LCCs based there (and an LCC that was 100% owned by its parent — unlike Air Busan).

In its most important market, Japan, Air Seoul largely operates to secondary airports, which Asiana has previously struggled to break-even on given its legacy airline cost structure.

However Air Seoul's launch was delayed partly due to concern by Air Busan's other shareholders (as Asiana only holds a minority stake), but more significantly by concerns from South Korean regulators following the 2013 crash of an Asiana aircraft at San Francisco airport, resulting in three deaths, and another (non-fatal) incident at Hiroshima airport in April 2015. Eventually however, Air Seoul received an AOC, allowing operations to start this year.

Unlike Air Busan, the 100% controlled Air Seoul is taking over completely some of Asiana's existing routes, though how many of Asiana's routes to more than 90 destinations will eventually move over to its LCC offshoot remains to be seen.

There are also plans to launch a seventh LCC in South Korea, provisionally to be called **Nambu Air**. It will be based at Busan airport and reportedly is to be funded 10% by the local Gyeongsang government and the rest from five local companies, who between them will provide start-up capital of around US$87m. No other details are available as yet, other than that there is a tentative launch date of December 2017.

American: Creating returns for stakeholders

American Airlines Group (AAG), the world's largest airline by traffic, has accomplished some impressive feats in the three years since the closing of the AMR-US Airways merger and AMR's exit from Chapter 11 in December 2013.

First, it took the new American less than a year to close the profit gap with Delta and United; for a brief period, American even reported higher operating margins than its peers (albeit because of its lack of fuel hedges and profit sharing).

Second, American has passed the tough merger integration hurdles on schedule and largely without a hitch. After combining the two FFPs in early 2015, in July-October last year American moved to a single reservations system. It was a smooth and successful cutover, contrasting with the highly disruptive event that United Continental experienced in 2012 (apparently the trick was to do it over 90 days, rather than on a single day).

Last month (October 1), American completed flawlessly the key flight operating system (FOS) integration — an extremely complicated undertaking that has led to operational disruptions at other airlines. Being able to freely schedule pilots and aircraft across the combined network is crucial for unlocking the full potential of the merger.

Third, American has already reached new joint agreements with all of its work groups, bringing everyone on new pay scales — a process that has often dragged on in other mergers. Having the deals done will boost morale. It also means that large cost increases are now behind American while many of its peers will continue to face significant labour cost pressures in 2017.

The early labour deals were possible because American's management recognised that, in light of the history of contentious labour relations at both AMR and US Airways, the only way to clinch joint contracts would be to build trust and restore pay rates.

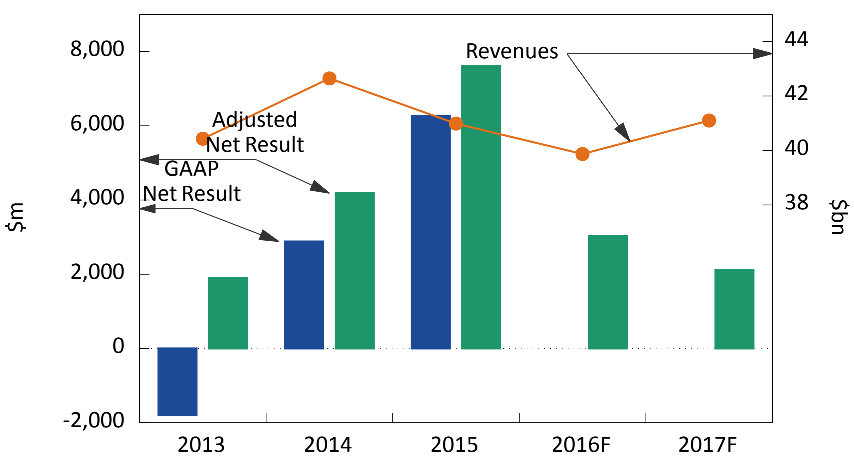
In March 2016, in a major policy reversal, American's leadership also unilaterally instituted a profit-sharing programme, retrospective to January 2016, which will pay employees 5% of the company's pretax profit before special items, starting in early 2017. It brought the carrier in line with Delta, United and Southwest, though American's unions had not asked for it.

The management has also made some extraordinary special gestures. In 2015 CEO Doug Parker gave up his salary, opting instead to be paid only in stock. And earlier this year he gave up his contract (and associated benefits and protections) and switched to working on the same "at will" basis as the airline's employees. "Nothing about having a contract felt like a shared commitment to working together", Parker wrote in a letter to employees.

All of those moves were aimed at mending labour relations and achieving a good employee culture, which is critical for a service-oriented company, especially a global carrier seeking to capture premium traffic (something many airlines still don't realise).

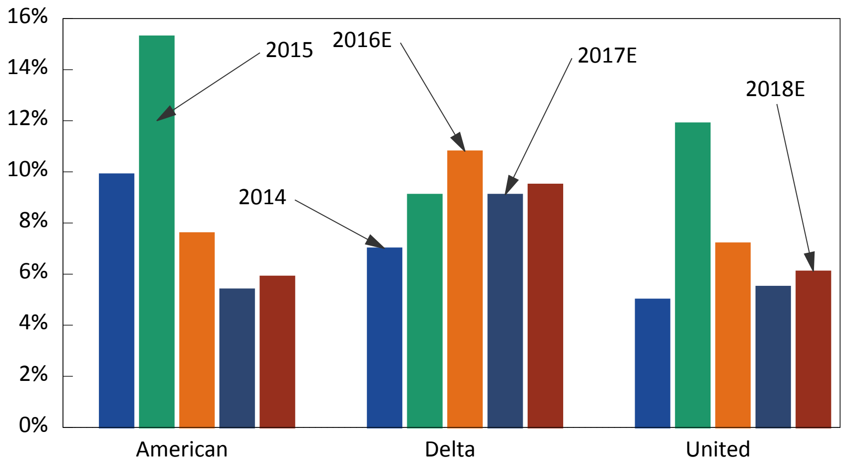
As another accomplishment, American has dealt effectively with the LCC/ULCC threat in its key domestic markets. In 2015 American was disproportionately affected by

AMERICAN AIRLINES GROUP: FINANCIAL RESULTS



Notes: 2013 revenues are AMR and US Airways combined revenues. 2013 financial results are AMR full-year results plus US Airways results for 22 days in December 2013. 2016E and 2017E are analysts' consensus estimates as of November 21.

TOP 3 US CARRIERS' ADJUSTED NET MARGIN TRENDS



Source: Data from JP Morgan's October 31 report on US airlines.

incursions into its DFW hub by Spirit and other low-cost operators. It began to match the LCCs on fares. The strategy seems to have worked; American recently noted that LCC competition had eased off, while yields had also benefited from the ending of Southwest's initial growth spurt at Dallas Love field.

In July American stunned the world with the announcement of new credit card agreements with its AAdvantage partners (Citi, Barclaycard US and Mastercard) that are expected to boost its pretax income by a staggering $1.55bn in the next 2.5 years ($200m in the second half of 2016, $550m in 2017 and $800m in 2018).

Until those deals American was disadvantaged in that many of its competitors (including United and Southwest) had secured lucrative new credit card agreements in recent years. But American made up for the delay by clinching deals not just with one but with two credit card providers (apparently an industry-first). CEO Doug Parker attributed that and the magnitude of the benefit to the combined network being a "powerful draw" for both business partners and customers.

The new American was unusually quick to start returning capital to shareholders after bankruptcy. The airline introduced a $1bn share buyback programme and brought back dividends in July 2014 — just seven months after exiting Chapter 11. As of September 30, American had returned more than $9bn to shareholders in the form of share repurchases and dividends.

American is, of course, noted for its aggressive fleet renewal and significant investment in new aircraft and the product, as it strives to restore itself as "the greatest airline in the world". Its gross capex ($5.6bn in 2016 and $5bn in 2017, though declining to $4bn in 2018 as a result of A350 order deferrals last summer) is massive compared to Delta's and United's, but as a result American has a younger and more efficient fleet than its peers. On the product front, American has become the first US airline to offer premium economy seating internationally — a new class that the carrier will roll out over the next 18-24 months.

On the negative side, the early labour deals have caused American's costs to soar and profit margins to dip below those of Delta and United. In the third quarter, American's adjusted operating margin, while an extremely healthy 16.3%, lagged Delta's by 2.5 points and United's by half a point. Its adjusted pretax margin of 14% lagged Delta's by 4.2 points and United's by 1.7 points.

And the downside of the aggressive use of cash to repurchase stock is that American has had to take on significant additional debt to fund aircraft purchases. The strategy contrasts with Delta's and United's focus on debt reduction; those two airlines also have more modest new aircraft order books and acquire used aircraft more frequently.

American's management feels that increasing leverage is justified, among other things, because of the current availability of extremely low interest rates (3% or less) for long-term aircraft financings. Also, American protects itself by maintaining a strong liquidity position.

But in recent months analysts have begun to comment more on American's debt levels. Many have suggested that while gearing may not matter in the current environment where revenue trends are improving, were the environment to deteriorate, or RASM trends turn positive (expected by mid-2017), investors would pay more attention to leverage and American's shares could suffer.

The question many are asking is: Will American start deleveraging its balance sheet in 2017 or 2018, when its fleet renewal programme nears completion? Will it at least start providing financial and balance sheet targets (like Delta does) for profit margins, earnings growth, leverage ratios and suchlike?

AMERICAN: ROUTE NETWORK

That said, there are many reasons to be excited about American's prospects. While most US airlines' (including American's) earnings are likely to decline modestly in 2016 and 2017, American would seem to have especially promising cost cutting and revenue-boosting opportunities, which could boost its profit growth from 2018.

Outperforming in RASM

The easing of LCC competition in the Dallas markets, the ending of Southwest's initial growth spurt at Dallas Love Field, the recovery in Latin America, and the incremental revenue from the new credit card deal have already led to American outperforming the industry in unit revenues.

In the third quarter, American's RASM fell by only 2.2% — a much lesser decline than at competitors. American could now be the first US carrier to return to positive RASM growth next year. In an October 31 report, JP Morgan analysts predicted that American will see the highest RASM growth among the US carriers in 2017 (around 2.1%).

Domestically, American will soon benefit from its version of Basic Economy — a product technically trademarked by Delta but now also being introduced by United and American during the first half of 2017. It is basically an unbundled, ULCC-type product. United announced details of its Basic Economy in mid-November. American will follow suit in January, when it plans to start rolling out its new product. American has described it as a ˝game changer˝ that will allow it to "meet competitors' prices without the same amount of dilution".

JP Morgan analysts see Basic Economy essentially as a "corporate fare increase", because most corporate contracts prevent employees from booking those fares given the onerous restrictions. The analysts wrote: "Apart from bag fees, we consider Basic Economy to be one of the industry's most creative revenue concepts of the past decade".

Internationally, American will see a gradual revenue benefit from the rollout of its Premium Economy cabin, which came out in October on the 787-9s and will be added to the existing 777/A330 long-haul fleet by June 2018. It is American's version of the type of cabin already offered by a number of Asian and European airlines, and Delta will be joining the fray in 2017. American expects to initially monetise it through its existing "main cabin extra" product until it gets to critical mass. The main impact will be in 2018.

American is benefiting from a robust RASM/yield recovery on US-Latin America routes, to which it has the highest exposure among the US carriers. Latin America was the first region to turn positive with 1.8% PRASM growth in Q3, driven by a 25% improvement in Brazil unit revenues as capacity in that market was rationalised and the Brazilian currency strengthened.

While American sees continued strength in Mexico, it could reap benefits from Latin American recovery for at least a couple of years, as economic growth resumes and accelerates in key markets such as Brazil.

Unfortunately, it looks like the Atlantic has taken over from Latin America as the entity to experience a prolonged slump. Continued capacity growth — especially from LCCs and the MENA carriers, collapse of the British pound and lingering

AAG's MAINLINE FLEET

	No. of aircraft at end:	
	Sep-16	Dec 2016E
A319	125	125
A320	51	51
A321	193	199
A330-200	15	15
A330-300	9	9
737-800	279	284
757	52	51
767-300	35	31
777-200	47	47
777-300	20	20
787-8	17	17
787-9	1	4
E190	20	20
MD-80	58	57
Total	**922**	**930**

effects from recent terrorist attacks contributed to an 11.2% decline in American's Atlantic PRASM in Q3. Many see tough conditions continuing through 2017 and 2018, and American is reducing its Atlantic capacity by 6% this winter, with the cuts focusing on markets where it has partners. With about 15% of its consolidated capacity on the Atlantic, American is less exposed to that region than United and Delta (both 21%), though when immunised partners are included the three have broadly similar exposure.

The other problematic entity is the Pacific, where much of American's growth has focused this year. In the third quarter, American's PRASM in that region fell by 10.5% as its capacity surged by 28.7%.

Like its peers, American continues to take a disciplined approach to overall capacity growth, which will help in the quest to restore positive unit revenue trends. It currently expects system capacity to increase by only 1% in 2017, compared to this year's 1.5% growth. Next year domestic capacity is likely to be flat and international up by 3.5%, driven by the annualised impact of this year's Pacific expansion.

Cost saving opportunities

American was fortunate to secure two key labour deals early in the integration process. New five-year joint collective bargaining agreements with pilots and flight attendants became effective in January 2015. Other groups followed, and American now has agreements in place with all of its contract employees.

Costs have soared as a result of the wage increases. American projects that its mainline ex-fuel CASM will increase by 8-10% in the current quarter, of which six points will be driven by labour agreements. The new deals signed this year will add about two points to next year's core ex-fuel CASM growth, which would otherwise have been just 2%.

But the good news is that because the key deals were signed early and because the rest of the industry has seen, or is about to see, much labour cost escalation, American now has a relative labour cost advantage over Delta, United and Southwest.

Two years ago, American's pilot deal provided industry-leading base pay but left total compensation below Delta's. Now, under the latest agreement being finalised, Delta's pilot pay will soar even higher. Thanks to a snap-back provision, United's pilots will see pay automatically increase to that of the highest-paid pilots in the industry. And Southwest is awaiting ratification of tentative agreements with all three major labour groups that grant hefty pay increases.

In addition to the favourable impact of the normalisation of labour expenses, American can achieve more cost savings in 2018 and beyond as a result of eliminating duplicate tasks, processes and excess headcount in certain areas, made possible by the recent FOS integration. Much of the work in 2017 will focus on achieving such cost efficiencies. The workforce reduction will be achieved through voluntary means such as attrition and early retirements.

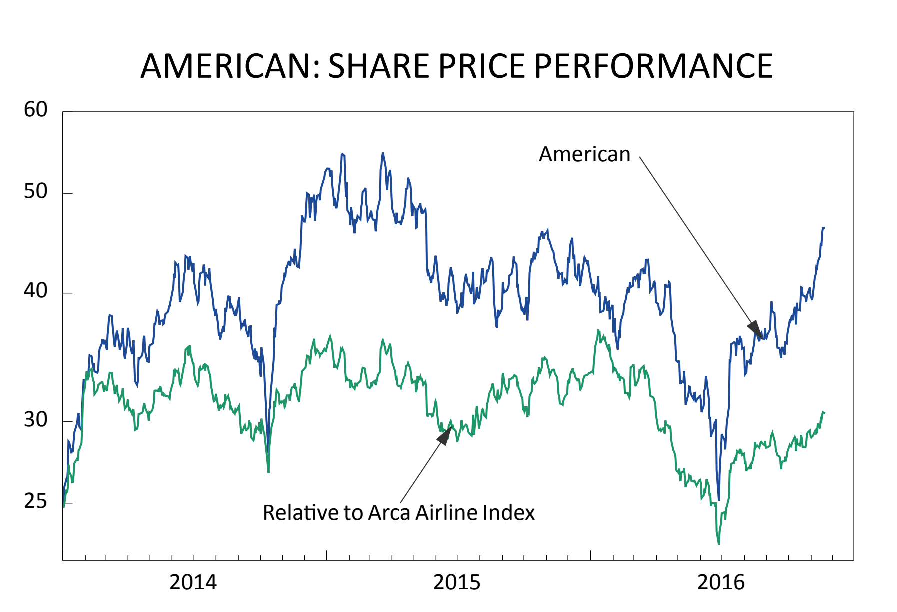
Network and fleet plans

American's network expansion this year has focused essentially on growing its Los Angeles hub, continuing to add new service to Asia-Pacific and in-

AAG'S MAINLINE AND REGIONAL AIRCRAFT FIRM ORDER BOOK

	At end of Sep 2016	Delivery schedule
A320 family	26	2016-2017
A320neo	100	From 2019†
A350 XWB	22	From 2018
737-800	25	2016-2017
737 MAX	100	From 2017
787 family	24	2016-2018
ERJ175	18	2016-2017
Total	**315**	

Note: † Originally from 2017 (deferred in June 2015).



troducing scheduled service to Cuba.

Since the merger, American has more than doubled its Asia-Pacific destinations. This year's new services have connected Los Angeles with Hong Kong, Tokyo Haneda and Auckland. Following a hot contest with Delta (because US airlines are coming up against the limits of the US-China bilateral), in early November American secured tentative approval to operate Los Angeles-Beijing.

The Asia routes are a natural fit for the 787, which American began taking delivery of in 2015. By year-end American will have received half of the 42 787s it has ordered — seventeen 787-8s and four 787-9s. Its first 787-9 entered international service on the DFW-Madrid and DFW-São Paulo routes in early November.

American began its first scheduled flights to Cuba in September, with service initially to two secondary cities from Miami, and Havana flights are due to follow at the end of November. Having long served Havana with charters, American is determined to be the leading US carrier to Cuba. However, there are still many restrictions in place that make it hard to sell in Cuba; most of the US carriers' sales are in the US. Making those routes profitable will clearly be a struggle. "We're in it for the long haul", CEO Doug Parker stated recently.

American will essentially complete its narrowbody fleet renewal in 2017 with the last A320, 737-800 and ERJ175 deliveries. There will then be a brief pause (of sorts) before the start of the deliveries of the latest-generation aircraft mostly in 2018 or 2019 (the 737 MAX, the A320neo and the A350XWB). At the end of this year, the MD-80 fleet is projected to stand at 57, down from 96 a year ago and 132 in early 2015.

Shift of focus to deleveraging?

At the end of September, American's total debt and capital leases stood at a $23.6bn, which included current maturities of $1.8bn. However, the top executives continue to insist that they are comfortable with that level for several reasons.

First, American maintains a strong liquidity position, which amounted to $9.2bn in September or about 23% of this year's revenues. That figure is well in excess of the $6.5bn minimum the company seeks to maintain.

Second, as American's fleet renewal will be substantially complete in 2017, and assuming that healthy cash flow generation continues, debt ratios will probably start improving from 2018. Some analysts have noted that even as debt increased in recent years, American's EBITDAR generation was so strong that the leverage metrics remained unchanged.

Third, with liquidity protections in place and the debt levels passing appropriate stress tests against recession, American's executives feel that it would not be right or in shareholders' best interest to pass up opportunities to lock in long-term aircraft finance at today's rock-bottom rates. New aircraft are long-lived assets and good investments. "The right thing is to take debt rather than use cash to pay for aircraft", the executives noted recently.

Fourth, American feels that the new fleet will give it a significant competitive advantage, both in terms of lower costs and a better product. The new fleet offers "an absolute customer advantage", and American is well ahead of other US airlines in terms of modernising its fleet.

However, under pressure from analysts, American's executives have indicated in recent months that they are considering providing long-term guidance and financial targets, which would help the investment community monitor trends and performance.

By Heini Nuutinen
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Jet values and lease rates

THE FOLLOWING tables reflect the current values (not "fair market") and lease rates for narrowbody and widebody jets as at the end of October 2016. Figures are provided by The Aircraft Value Analysis Company (see following page for contact details) and are not based exclusively on recent market transactions but more generally reflect AVAC's opinion of the worth of the aircraft. In assessing current values, AVAC bases its calculations on many factors such as number of type in service, number on order and backlog, projected life span, build standard, specification etc.

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

JET VALUES ($m)

			Years old					Years old		
		New	5	10	20		New	5	10	20
Regional	CRJ 900NG	25.9	20.2			Emb 175✴	28.3			
	CRJ 1000	28.0	21.6			Emb195	33.2	23.8	15.4	
	CRJ300-ER	35.1								
	MRJ90	33.6				S100-95	23.0	16.6		
Narrowbody	A318		15.8	9.0		717-200			7.8	
	A319†	36.6	25.1			737-300‡				2.3
	A320-200§			19.3	9.5	737-400‡				2.8
	A320NEO	47.6				737-500‡				1.8
	A321-200†☆	50.9	35.3			737-600‡			9.3	4.0
	A321NEO	56.9				737-700†✈		24.6	17.0	
						737-800†✈		32.6	23.4	
						737 MAX 7	40.6			
						737 MAX 8	53.5			
						737 MAX 9	54.2			
						757-300†				7.6
Widebody	A300B4-600†				4.8	747-400				12.2
	A310-300§				2.9	747-8I	152.9	112.2		
	A330-300✴§	102.8	83.6			767-300ER‡✈			25.1	14.4
	A340-300 ER				9.6	777-200ER		54.1	39.8	11.1
	A350-900	142.8				777-300ER	157.6	122.8	87.9	
	A350-1000	168.0				787-800	119	82.9		
	A380-800‡	215.7	155.0			787-900	139.9			
	A380-800†	226.1				787-1000	159.1			

Source: AVAC.
Notes: As at end-October 2016, lease rates assessed separately from values
†=HGW, ‡=LGW, §=IGW, ✈=Winglets, ☆=Sharklets, ✴=Enhanced

JET LEASE RATES ($'000s per month)

			Years old					Years old		
		New	5	10	20		New	5	10	20
Regional	CRJ 900NG	191	172			Emb 175✳	233			
	CRJ 1000	226	194			Emb195	257	214	169	
	CRJ300-ER	284								
	MRJ90	273				S100-95	148	137		
Narrowbody	A318		118	86		717-200			107	
	A319†	295	214			737-300‡				66
	A320-200§			200	134	737-400‡				59
	A320NEO	379				737-500‡				38
	A321-200†☆	415	315			737-600‡			96	155
	A321NEO	455				737-700†✈		184	164	
						737-800†✈		270	227	
						737 MAX 7	346			
						737 MAX 8	431			
						737 MAX 9	468			
Widebody						757-300†				97
	A300B4-600†				81	747-400			156	143
	A310-300§				70	747-8I	1,212	1,028		
	A330-300✳§	843	740	322	174	767-300ER‡✈			269	211
	A340-300 ER				161	777-200ER		578	474	204
	A350-900	1,121				777-300ER	1,544	1,229	1,051	
	A350-1000	1,629				787-800	922	697		
	A380-800‡	1,727	1,304			787-900	1,173			
	A380-800†	1,830				787-1000	1,332			

Source: AVAC.
Notes: As at end-October 2016, lease rates assessed separately from values
†=HGW, ‡=LGW, §=IGW, ✈=Winglets, ☆=Sharklets, ✳=Enhanced

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