Aviation Strategy

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Low cost subsidiaries – Repeating past errors?

THE EMERGENCE of long-haul low cost, in the initial form of Norwegian Air Shuttle operating across the Atlantic and into Asia, potentially poses a serious challenge to established European, US and Asian network carriers. Yet it is not at all clear that the incumbents see Norwegian — whose North Atlantic market share is less than 2% — and other new entrants, like WOW and Westjet — as really viable, as a major threat in the long term.

Barriers to entry remain high, notably the requirement for feed at high cost hub airports, the unit cost advantage achieved through high utilisation of widebody aircraft and the ability to offer heavily discounted Economy seats "cross-subsidised" by Premium traffic.

Nevertheless, there is a growing suspicion that the Legacies could be repeating the mistakes they made in the 90s and 00s — hugely underestimating the impact of a new low cost business model on their established business — when the expansion of Ryanair, easyJet, Wizz, etc in effect undermined their network models, forcing them into painful cost cutting and route rationalisation.

One of the unsuccessful strategies that is being re-enacted today is the establishment of lower cost subsidiaries, but this time for the long haul sector. The short haul versions in Europe were unprofitable and generally could not be made to work as part of the parent airline group: BA managed to sell off Go to 3i, the investment fund, and hence to easyJet, while KLM offloaded Buzz to Ryanair, purchases which were soon deeply regretted by the two LCCs.

In the US, Delta's experiment with Song and United's with Ted were eventually abandoned.

Vueling is admittedly a successful short haul LCC within IAG, though this is largely because of its distinct brand as the de facto flag-carrier of Catalonia. Aer Lingus could conceivably play a role as a lower cost long haul carrier within IAG, but it appears that it is being integrated (mostly) into the antitrust-immunised Atlantic JV, which means that its pricing and capacity has to be tightly coordinated with BA and American, with the three carriers operating as a virtually merged entity.

Instead IAG has opted to set up Level as a long haul low cost subsidiary based at Barcelona and initially operating two A330s. Lufthansa's low cost subsidiary Eurowings has six A330s for long haul operation, while Air France's Boost proposes A340s and later A350s based at Paris CDG.

A fundamental problem with low cost subsidiaries is strategic ambiguity: what exactly is their purpose?

Conflicting aims

Management at the parent company have to resolve a number of conflicting aims:

✈ The low cost subsidiary is a means of taking on unions with the aim of ultimately reducing costs at the mainline airline, through the introduction of A/B type wage scales. This is why pilot unions can be so vociferously opposed to low cost subsidiaries, with Air France unions for instance. demanding that Boost's pilots be on the same contracts as mainstream employees. The result, as all the Legacies know, is protracted strikes.

✈ The subsidiary is an attempt to block off expansion of pure LCC entrants or even put them out of business. This is never, of course, an explicit aim, and in today's litigious world it is a dangerous strategy.

✈ The subsidiary is designed as a niche market operator. This strategy

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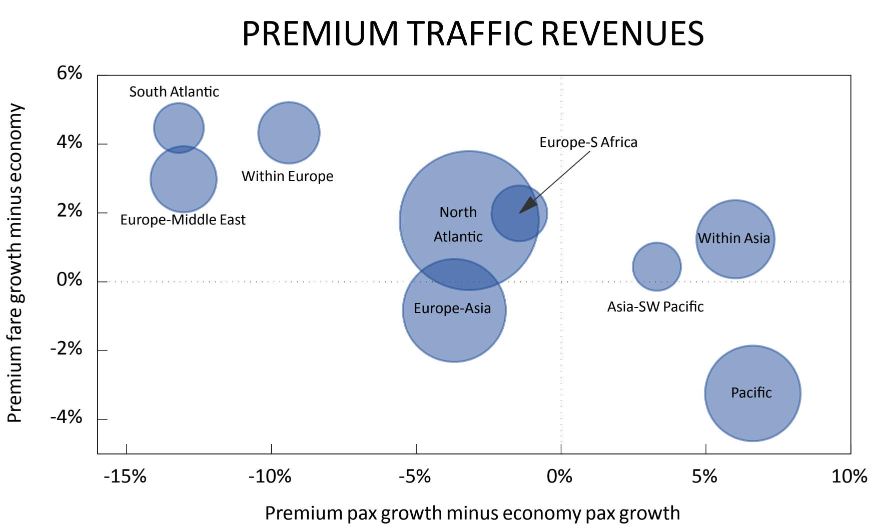
is meant to ensure that the subsidiary does not cannibalise the parent. The problem is finding suitable niches: pure leisure destinations are the usual choice, but then the subsidiary is operating in essence as a charter carrier, in a highly price sensitive market and one in which a Legacy airline has no real competitive advantage.

✈ Finally, there is the possibility of using a low cost subsidiary to transition the parent airline to a more efficient operation, through allowing the subsidiary and the parent to compete for routes; the closest to this radical strategy is Qantas/ Jetstar.

Meanwhile, BA appears to be coming up with a variation on the parent/subsidiary airline strategy — creating two different airlines on the same long haul aircraft. The proposition seems to be to duplicate its new short haul Economy product on long haul — most visibly this means paying for food and drinks (but not just airline food but *Marks & Spencer* airline food) and increasing seating density (from 2018 BA's Gatwick-based 777s will be reconfigured to 332 seats from 280, which will equalise, BA claims, the operating cost per Economy seat between itself and Norwegian's 787s). By contrast the Premium classes are being upgraded with more seating capacity, gourmet food, refurbished lounges, etc).

The outcome will be a sharper differentiation between long haul Economy and Premium, which is vitally important to BA and the other European Legacies (see IATA's bubble chart on this page). The problem is that the Legacy carrier ends up with an Economy product that to passengers is indistinguishable from that of a new entrant LCC, while total unit seat costs remain way above those of a pure LCC.

Then the Premium class is exposed: most attention so far has focused on long-haul LCCs winning Economy passengers but there is also growing competition for a segment of the Business market — those travellers from SMEs, for example, whose companies cannot negotiate corporate discounts with the network carriers.



Source: IATA. Note: the size of each bubble is proportional to eachroute's share of industry-wide premium revenues.

Aeroflot: State resumes control

ON THE face of it 2016 was a superb year for Aeroflot, with significant increases in revenue and profits. But it was also the year that Aeroflot reverted to being close to a state monopoly, with all that implies for corporate strategy

In calendar 2016, under IFRS standards, Aeroflot group saw revenue increase by 19.9% to ₽495.9bn (US$7.4bn), thanks to a combination of traffic growth (passengers carried rose 10.3% to 43.4m), efforts to increase yield and the continuing devaluation of the rouble. With further cost control efforts, Aeroflot's operating profit rose 43.4% to ₽63.3bn ($949m) and a net loss of ₽6.5bn in 2015 turned into a net profit of ₽38.8bn ($583m) in 2014.

The Aeroflot group's debt position has improved significantly in the last 12 months — total debt fell by 38.4% in 2016 to stand at ₽143.9bn ($2.2bn) at as December 31st 2016, while cash and short-term investments rose 3.2% to ₽37.8bn ($567m). However, this was due partly to the continuing devaluation of the rouble, the sale of nine aircraft and a revaluation of finance lease obligations; and net debt still stood at a not inconsiderable ₽106.1bn ($1.6bn) at the end of 2016.

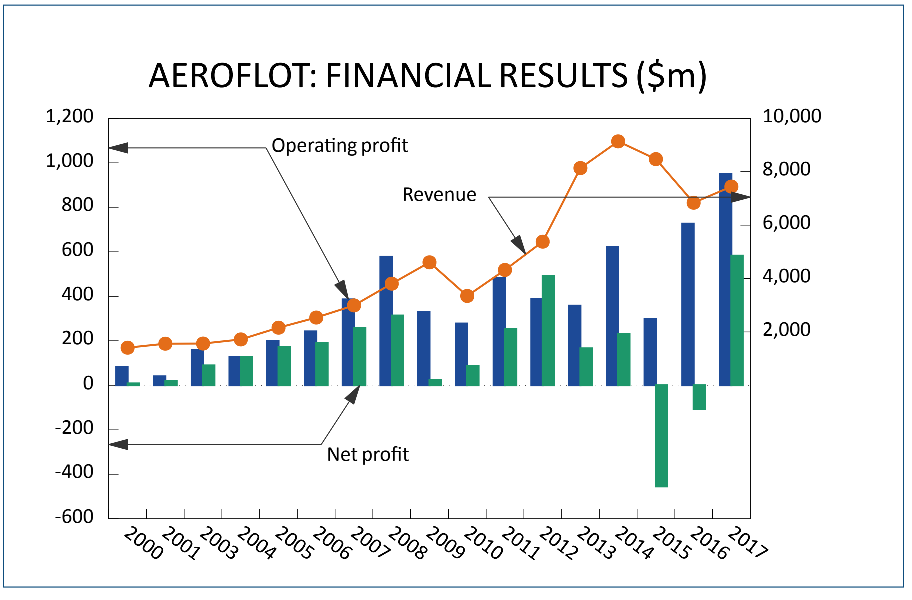
Transaero effect

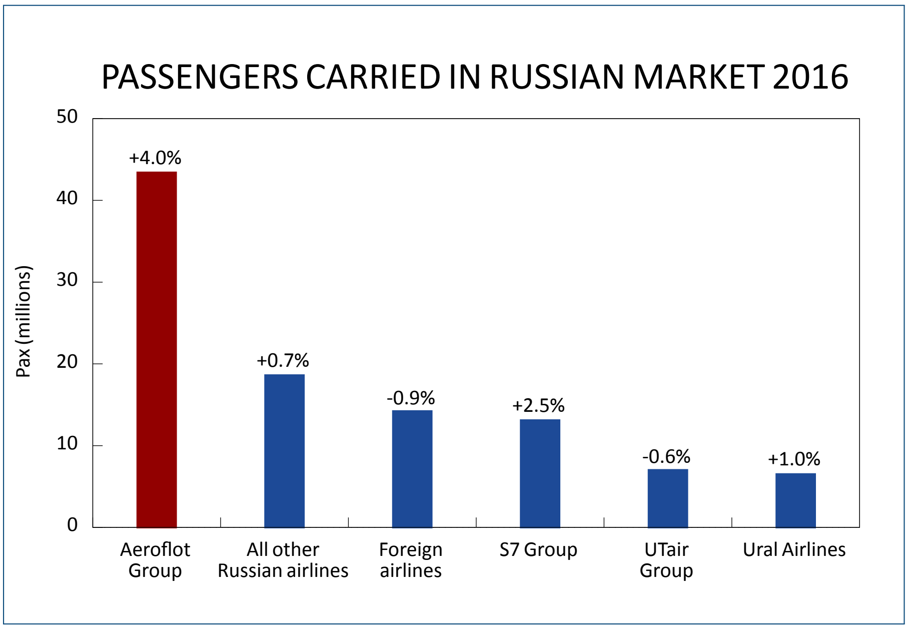
The airline's 2016 results were boosted by the demise of Transaero Airlines, the second largest airline in Russia. The government-mandated merger (see *Aviation Strategy*, September 2015) between Aeroflot and Moscow-based Transaero in 2015 failed to materialise, and Transaero ceased operation in late October of the same year, instantly taking out a carrier that accounted for around 11% of the total domestic and international market in Russia.

Aeroflot was obliged to step in anyway, financing the carrying of 1.8m passengers on "Transaero" flights through the rest of the year, while transferring another 0.2m passengers onto its own equipment and fully refunding all others that couldn't be accommodated on those flights. In total, support to Transaero passengers cost Aeroflot some ₽16.8bn (US$277m), and there have been other adverse impacts of the bailout, such as provisions for Aeroflot group loans to Transaero. In addition, the Aeroflot group hired more than 4,250 ex-Transaero employees and took over 30 aircraft from the former Transaero fleet, including 10 737s and six A321s that were on outstanding order at the time the carrier collapsed.

While that was the short term price to pay, the longer term result for Aeroflot is a lot better than if it had been forced to swallow the whole of Transaero, as the government wanted back in 2015. Instead, Aeroflot has been able to cherry-pick the best of the former Transaero routes; it has taken over (or plans to take over) 56 of the 141 international routes previously operated by Transaero — although of course the ability to take over Transaero slots at international airports is not as easy as it is in Russia, where the government rubber stamps anything Aeroflot wants. Indeed, rights for 13 Transaero routes were returned by Aeroflot to the Russian aviation authorities voluntarily, while seven destinations were not extended after one year of operation.

The Aeroflot group currently operates to more than 150 destinations in 51 countries. It follows





a confusing multi-brand strategy, largely as a result of the variety government-mandated domestic mergers and acquisitions it has had to swallow. The mainline Aeroflot is the country's flag carrier and operates a hub-and-spoke operation out of Moscow Sheremetyevo, which accounts for around two-thirds of all passengers carried by the group (29m passengers in 2016, 11% up year-on-year).

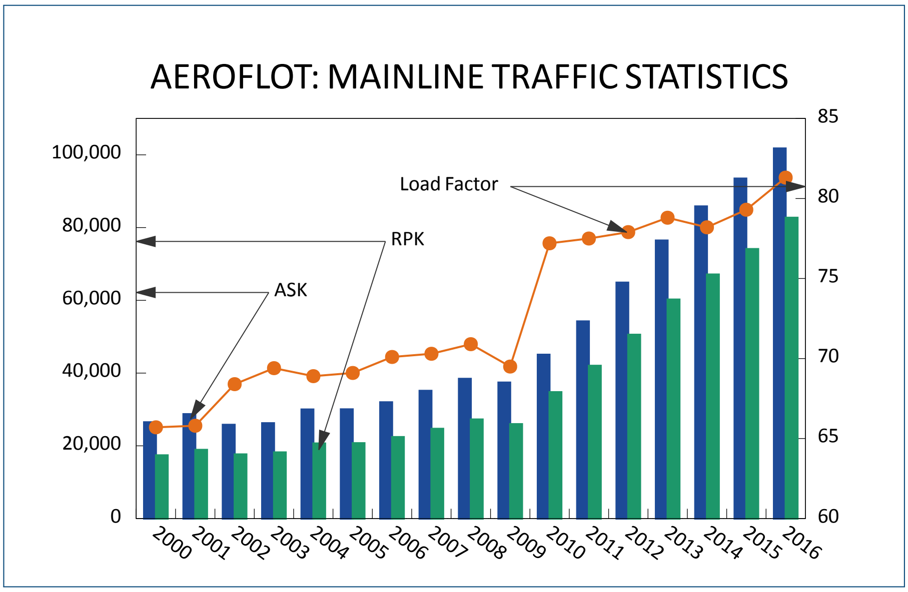
Somewhat obstinately, Aeroflot is still attempting to develop Moscow as a transit point for passenger flows between the Asia/Pacific region and Europe/North America, though — frankly — this is a tough sell to passengers, many of whom would prefer to transit anywhere other than Russia. Indeed international-international transit passengers for the group fell from 9.1% in 2015 to 8.5% in 2016, and at Sheremetyevo airport the proportion of Aeroflot traffic that was transit fell from 44.2% in 2015 to 42.1% in 2016 (with international-international transit traffic falling from 14.0% to 13.1%).

Next in the group portfolio is — in its own words — "middle-price" Rossiya, which is based in Pulkova (Saint Petersburg) and operates on domestic, regional flights and a handful of international routes out of Pulkova and Vnukovo airport in Moscow. Last year Rossiya absorbed the group's Donavia and Orenair airlines, and today it operates 67 aircraft, carrying 8.8m passengers in 2016 (2.8% down on 2015).

Not part of Rossiya (as yet) is Aurora, a regional airline in the far east of Russia that operates 23 aircraft domestically and to some international destinations out of the remote airports of Vladivostok, Khabarovsk and Yuzhno-Sakhalinsk. It carried 1.4m passengers last year, compared with 1.1m in 2015. Aeroflot owns 51% of Aurora, but it makes little sense not to incorporate it into the Rossiya operation; indeed there is a strong argument that Rossiya itself is a brand too many for the Aeroflot group, where operations, management and marketing would probably be much simpler were it to consist of solely the mainline Aeroflot brand and an LCC operation.

That LCC operation is Podeba (which means 'victory' in Russian), the group's latest attempt at the low cost segment and which operates 12 737-800s (all leased) out of Moscow Vnukovo on 36 routes — mostly domestic, although it does operate to eight international destinations. It carried 4.3m passengers in 2016, a 39% increase on the year before, and follows a standard LCC business model with paid-for meals, fees for carry-on luggage and tickets sold primarily through direct channels.

The total Aeroflot group fleet comprises 291 aircraft, 44 more than 12 months ago (see chart below),



as the airline continues to expand and modernise its fleet from the assorted rag-bag of types it used to have into a young, western-built fleet — the last six An-148s have now been phased out through a sublease. The total group fleet has an average age of 6.5 years — slightly higher than at the end of 2015 — but that is still impressive, and the mainline's average of 4.2 years is better than almost any other full-service rival.

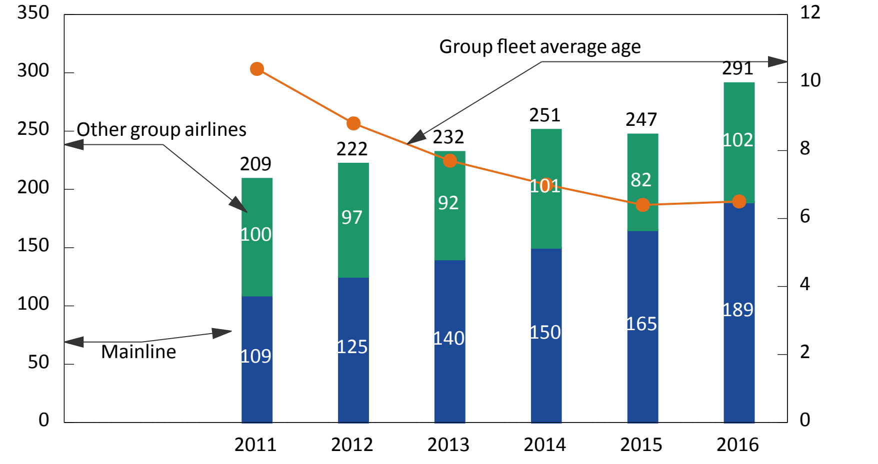
On outstanding order for the group are 35 aircraft, comprising 14 A350s and one 777. At the end of last year it cancelled 8 of its original order for 22 A350s, and transferred its order with Boeing for 22 787s to Avia Capital Service — the leasing subsidiary of state-owned conglomerate Rostec from which Aeroflot has a contract to lease 50 737NGs. Its medium term fleet plan (see table below) show it acquiring a net 68 new aircraft over the next two years including two 747-400s for long-haul, and 37 737s, 21 A320s and 13 A321s. In addition, Aeroflot has another 20 SSJ-100s due to be delivered this year and next (and yet another example of state interference).

State control

The state agency Rosimushchestvo owns 51.17% and Rostec, a state conglomerate, has a further 3.3%. There is a free float of about 41% of the shareholding, but the reality is that strategic decisions are made by the state, and this effectively means that Aeroflot has little — if any — chance of transforming itself into a truly modern airline that is flexible enough to instantly take advantage of new market opportunities as they crop up.

Not that there are many of these at the moment, as the Russian economy is still in deep trouble. GDP growth fell steadily from 2010 to 2014, plunging to a 3.7% GDP contraction in 2015 and followed by another 0.7% GDP shrinkage in 2016. There are many reasons for this deep recession but falling oil prices have been exacerbated by US and EU sanctions over Russia's illegal interference in the Ukraine/Crimea, carried out partly by President Putin to divert attention domestically from increasing economic woes. The most significant effect on Aeroflot (and all Russian airlines) is that the value of the Rouble fell by almost 60% in just two years, from a rate of 33 Roubles to the US Dollar at the start of 2014 to 84 Roubles exactly two years later. Of course that significantly increases costs incurred abroad in

AEROFLOT GROUP FLEET

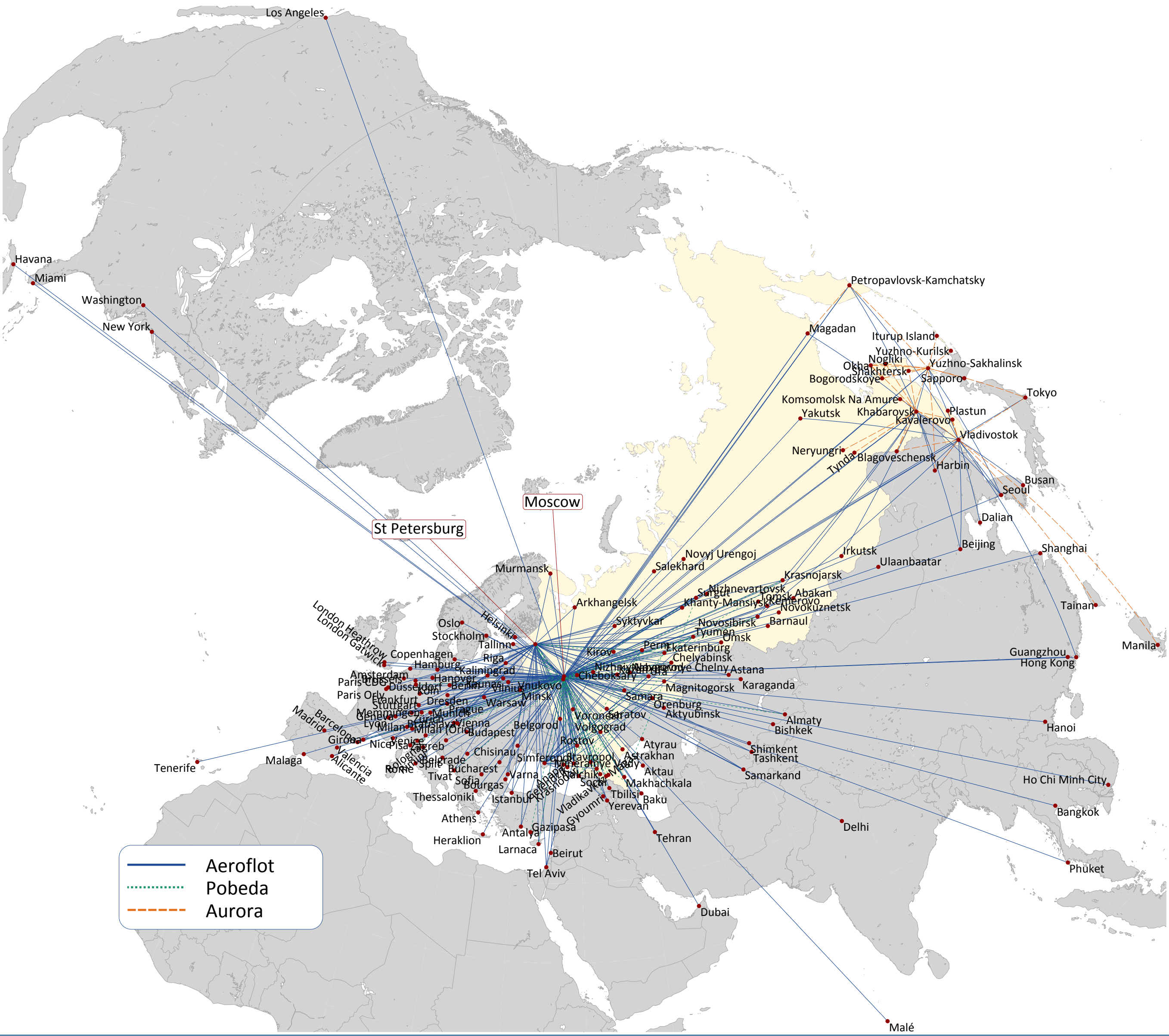


AEROFLOT GROUP FLEET PLAN

	2016			2017	2018	2019	2020
	Aeroflot	**Subsidiaries**	***Orders***				
A319		36		33	26	18	15
A320	70	5		79	80	69	59
A321	32			39	43	41	41
A330	22			22	22	19	15
A350			*(14)*		5	8	10
737-800	20	29		68	80	79	79
747-400		7		9	9	9	9
777-2/300	15	6	*(1)*	21	26	26	26
SJ100	30		*(20)*	42	50	50	50
An-148		6					
DHC-8		11		10	10	7	6
DHC-6		2		2	2	2	2
	189	102					
Total	**291**		***(35)***	**325**	**353**	**328**	**312**

Source: Company reports, Boeing, Airbus. Notes: plan in according with existing contracts. Excludes one An-24.

AEROFLOT: ROUTE MAP



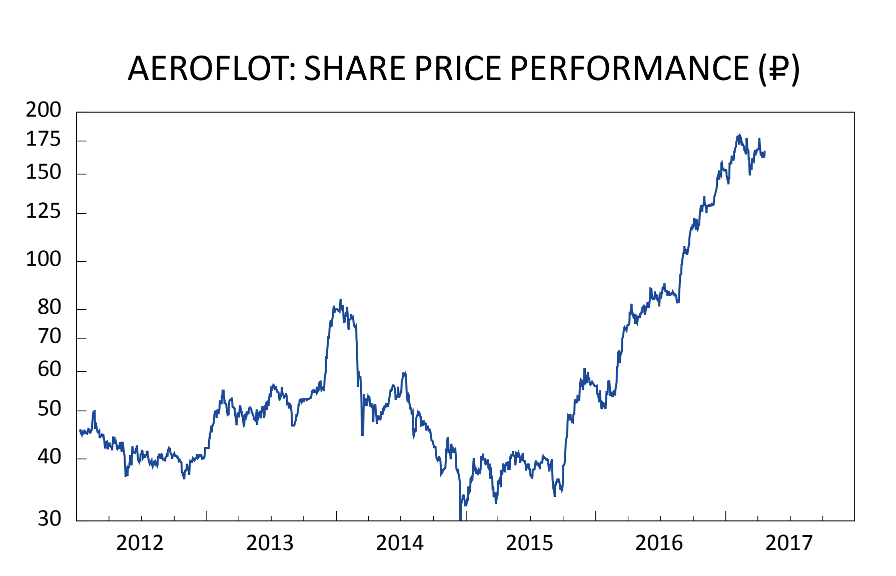
Rouble terms. The good news is that the currency has recovered partially since that huge devaluation, to approximately 59 Roubles to the Dollar as at mid-March 2017, and there is hope of returning to GDP growth this year — though Putin would be unwise to assume that a "Russian-friendly" President Trump will substantially reduce sanctions anytime soon, especially after events in Syria.

Long term goals

The Aeroflot group has four strategic goals for 2025, a date that is such a long way away (maybe on purpose) it is very difficult to pass considered judgment on how well the airline is doing in getting there.

✈ **To become a top five European and top 20 global airline in terms of passengers carried**, with more than 40m international passengers and 30m domestic passengers carried a year by 2025. The group carried 18.2m international and 25.2m domestic passengers in 2016, so from that it needs just an average annual growth of 2% domestically from now until 2025 — but for international it needs a CAGR of 9.2% for nine consecutive years, which could prove difficult to achieve.

Overall the group has 44.7% share of the domestic market and a 39.4%



share of the international market to-from Russia last year. That compares very well with the respective market shares of 20.6% domestically and 18.9% internationally it had back in 2009, and Aeroflot's domestic share has risen consistently over the last few years thanks to government-mandated domestic consolidation, development of the LCC market and a decline in "long-haul" domestic rail passengers as train fares have risen. However, yield is clearly higher on international routes (by around 20%), and the critical problem that Aeroflot faces is that the international market continues to shrink — which the airline says is due to "continuing pressure on consumer confidence" — another way of saying international travel has been hit hard by precarious domestic economy as well as international sanctions to punish Putin for his imperial ambitions in Ukraine. In fact the total number of international passengers to/from Russia has fallen from 65.5m in 2014 to 46.4m — a calamitous drop of almost 30%. This means it will be extremely difficult for Aeroflot to hit its 2025 international target unless either the market grows very fast (unlikely) or the Russian flag carrier can effectively double its market share (extremely unlikely).

✈ **To become a top five European and top 20 global airline in terms of revenue**. As of 2015 Aeroflot claims to be the seventh highest revenue airline in Europe and 23rd in the world, but most analysts would say this goal is irrelevant; what counts is profitability and cash generation — measures that are noticeably absent from Aeroflot's grand strategic vision.

✈ **Development of the hub-and-spoke model**, with an explicit goal by 2025 to have a 32% share of transit passengers among total group passengers carried. The problem is that, given very strong growth for LCC Podeba, the percentage of transit passengers in the group is actually falling, not rising — the proportion of transit passengers fell from 28.7% in 2015 to 27.5% in 2016. It would be madness for the group to restrict the growth of its LCC, and so the only way it will be able to increase its transit proportion to 32% by 2025 is to significantly increase transit passengers at the mainline at Moscow, which is a very tough ask indeed.

✈ **Increasing presence in various geographical and price segments.** This is a vague, general statement and is the only one of its four strategic goals without any specific KPI target.

Despite the negatives, Aeroflot's share price has quadrupled since 2015 giving it a market capitalisation of $3.5bn and a historic PER of 5x. Investors appear to have taken the view that the benefits of consolidation of the Russian airline industry outweigh political interference and international sanctions.

SIA: Reconciling Premium tradition with Budget growth

SINCE the financial crisis a decade ago Singapore Airlines has been stuck in a rut of low growth, weak financial results (while remaining profitable as a group) and a mire of external competitive forces — beset by the pincer development of the growth of SE Asian LCCs on short- and medium-haul, the seemingly inexorable growth of the super-connectors undermining its 6th freedom hub in Singapore. In the background has been the relatively weak local economic performance.

SIA has been trying to establish a multi-brand group of airlines offering products in the low cost sphere as a complement to its traditional full service high-quality offering, while it anticipates a resumption of growth in the parent company airline as its new generation ultra-long haul A350s and 787-10s are delivered.

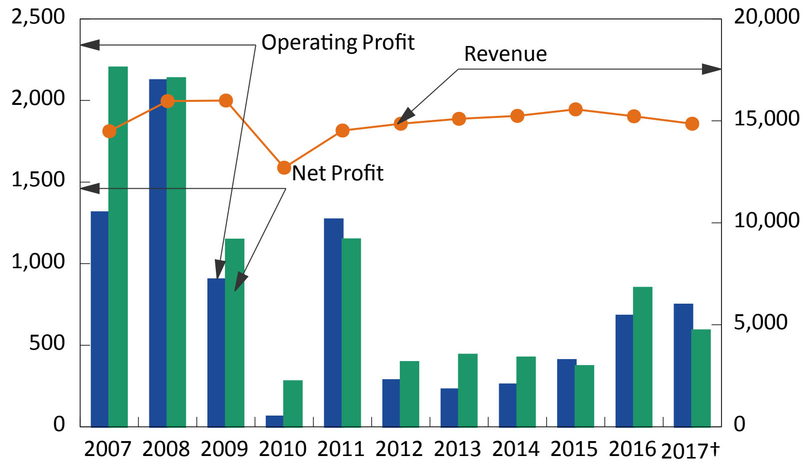
SIA's financial year runs to end March, and in the first three-quarters of 2016/17 (the nine months ending December 2016), the Group saw revenue fall by 3.2% year-on-year to S$11.1bn (US$8bn). However, operating profit during the period increased by 13% to S$595.2m (US$425m) as fuel costs fell by 23% to S$2.78bn, while net profits fell by 14% to S$499m. Operating profit improvements offset by losses from associates, losses on disposal of aircraft and a writedown of the Tigerair brand and trademark.

This was on the back of a 3.4% increase in the total number of passengers carried by group airlines, a 2% growth in demand in terms of revenue passenger kilometres and a 3% increase in capacity in ASKs. The load factor dipped by 1.5 points to 78.5%.

On a divisional breakdown, the parent company Singapore Airlines itself increased operating profits by 10% to S$427m up from S$387m in the prior year period; Silkair — its regional full service carrier — by 25% to S$74m; Tigerair and Scoot — the low cost brand offering — reversed minor operating losses to operating profits of S$20m and S$26m respectively; while SIA Engineering saw profits decline by a third to S$48m, but SIA Cargo registered a modest S$8m profit for the period — and this is following Cargo losses of S$458m in total over the previous five financial years.

At the end of December 2016 the Group had total debt of S$1.6bn, some S$245m higher than the debt figure at the end of the last financial year. On the other hand, cash and cash balances fell from S$4.6bn at end March 2016 to S$3.7bn at the end of the period. This compares with a total net asset value of S$13.8bn.

SIA GROUP FINANCIAL DATA (S$m)

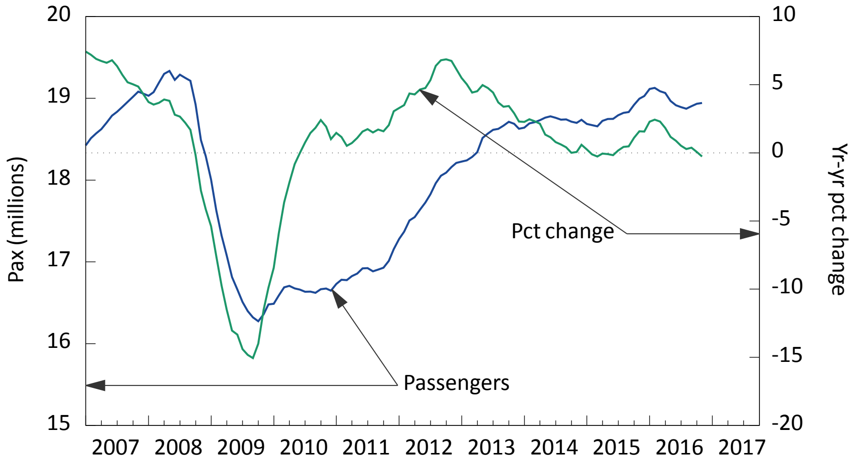


Note: Financial years ending March. † rolling twelve months to Dec 2016.

Parent company pressure

The parent company Singapore Airlines remains the critical driver of the group's performance, accounting for 85% of group revenues and profits. However, the airline is under significant pressure and has deliberately reined in growth plans in the past five years. As we show in the chart below, since the last cyclical peak in 2008 and the collapse in demand following the financial crisis, Singapore Airlines' passenger numbers have stagnated. In the past four years growth in passenger demand has been lacklustre — and on a twelve month rolling basis annualised carryings of 18.9m to the end of February 2017 were still somewhat below the peak 19.4m achieved in the twelve months ending August 2008.

SINGAPORE AIRLINES PASSENGER TRAFFIC

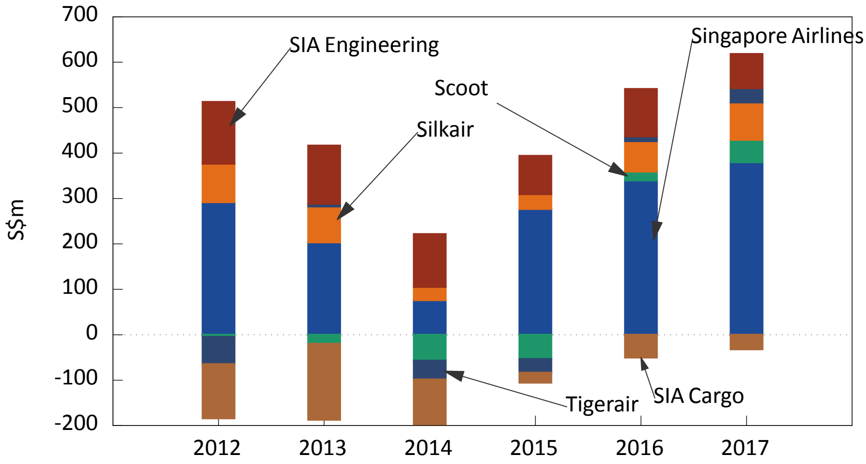


Source: Company reports. Notes: twelve month rolling total passengers carried parent airline only.

Further, up to the end of 2008, the Singapore economy had been motoring along with GDP growth averaging 7% a year. In the last ten years, under the "new normal" economic environment it has only managed a modest 4.5% growth a year — with the last two years generating a relatively insipid 2% growth reflecting the impact perhaps of the slower rate of growth in China. The latest IMF forecasts suggest that this lower rate of growth will continue.

In the nine-month period to the end of 2016 Singapore Airlines itself saw revenues fall by 6% year on year to S$8.4bn as fuel costs fell by a quarter (it effectively passed on all the fuel savings to the benefit of the passengers). It cut ASKs by 0.5% year-on-year, but with RPKs falling by 2.6%, the passenger load factor dipped by 1.6 percentage points to 78.4%. Yields in the period fell by 4.5% but unit revenues fell by 6.6% and unit costs dropped by 7%. The passenger breakeven load factor came down to 78.4% from 80.4%, matching that achieved. Disturbingly, ex-fuel unit costs increased by 3.7%.

SIA GROUP DIVISIONAL OPERATING PROFITS



Note: Year end March. Data for 2016/17 four quarters to end December 2016.

Conundrum

Singapore Airlines was one of the industry disruptors when it developed 6th freedom services through the Changi hub through the 70s and 80s — attracting the same type of opprobrium currently being directed at the Superconnectors in the Gulf. With a population of less than 6m, the island state could not naturally support an airline of SIA's size purely on O&D demand. SIA itself doesn't give the figures, but Changi Airport has indicated 30% of passengers are in transfer through the Singapore hub, and with SIA and Silkair holding 34% of the slots at the airport it is reasonable to assume that 60% of the airline's traffic is 6th freedom transfer.

It now itself is suffering from the competition on its mainstay Europe-Asia routes from the aggressive growth represented by the new competing models, as well as an attack on the Pacific from the development of Chinese international services.

The management is well aware of the changing fundamentals of the market, and recognises that these changes are structural and probably permanent. Taking the decision not to grow however puts pressure on unit costs that other expanding carriers avoid at the margin.

SIA has traditionally provided a quality product and, has been recently reducing the density of seating, adding premium economy to the new fleet acquisitions (and retrofitting existing aircraft in the

SIA GROUP FLEET

	SIA		SilkAir		Scoot/Tigerair		NokScoot	Vistara	
	In service	On order	In service	On order	In service	On order	In service	In Service	On Order
747F	9								
777-200/300	53						3		
787-8/9					12	(8)			
787-10		(30)							
A330	24								
A350	12	(55)							
A380	19	(5)							
737-800			17						
737MAX-8				(37)					
A319			3		2				
A320ceo			10		21			13	
A320neo						(39)			(7)
Total	**117**	**(90)**	**30**	**(37)**	**12**	**(8)**	**3**	13	(7)

Source: Company Reports

fleet), presumably to try to reduce the number of seats available for the deepest discount buckets in the revenue management system.

At the same time it has been trying to bolster access to markets at the other end of its long haul routes and has been developing a plethora of code share agreements — currently on some 10,000 frequencies up from 2,000 six years ago.

Last year it signed a Joint Venture agreement with fellow Star Alliance partner Lufthansa Group (including SWISS, Austrian, Brussels and Silkair) to coordinate on pricing and capacity — cleared by the Singapore authorities subject to certain conditions in December 2016 — covering routes between Germany, Austria, Switzerland and Belgium (the "LH Home Markets") and certain Asia/Asia Pacific countries (specifically Singapore, Indonesia, Malaysia and Australia — the "SQ Home Markets").

Things don't always go to plan, and Indonesia has rejected the JV agreement and blocked SIA's proposal to operate a fifth freedom service between Jakarta and Sydney.

SIA prides itself on operating a young fleet (currently 7.5 years). It has started taking delivery of A350s. It currently has 12 of the type with a further 55 on order. It also has orders for 30 787-10s due for delivery from 2018. These will be used to replace the aging 777s in the fleet (see table).

CEO Goh Choon Phong describes the new equipment as a "game-changer". The extended range and lower seat density allows it to schedule services on some very long haul routes that conveniently overfly intervening sixth freedom hubs — seven of the aircraft on order are for the ultra long range version and will be delivered from 2018. It recently initiated a direct Singapore-San Francisco service (see map) and anticipates being able to return to operating direct services from Singapore to New York and Los Angeles — (which it used to operate with the less optimal four-engined A340).

Other recent route openings meanwhile appear less than optimal: tagged routes via Manchester to Houston; via Moscow to Stockholm; via Canberra to Wellington. And tagged routes are rarely very profitable, but may be a precursor of future direct intentions.

Meanwhile there may be questions of the long term future of the company's A380 fleet. The first of these is approaching the end of its ten-year lease in the current year and SIA has stated that it does not intend to renew the lease. It has 19 A380s in operation and nominally has another five of the type on order. The airline currently operates the aircraft to 14 destinations with double daily flights to slot-constrained Heathrow and to Sydney aside from Aukland, Bombay, Paris, Frankfurt (tagged on to New York), Hong Kong, Kansai, Melbourne, Beijing, Shanghai, Sydney and Zürich.

The LCC future hope

In 2016 Singapore Airlines Group took full control of its associate short-medium haul low cost operator, Tigerair Singapore, with the aim of merging it fully with its long haul low cost operator Scoot. It has put them into a new holding subsidiary under the dynamic sobriquet of

SIA LONG HAUL ROUTE NETWORK

"Budget Aviation Holdings" with the idea of combining the two under a single AOC, single management and operational control. This is expected to take effect in the second half of 2017.

Scoot was launched in 2012 to operate medium- and long-haul routes from its base at Changi. It has fleet of 12 787s (with another 8 on order) and flies to 22 destinations. It has an average stage length of 3,600km (the longest routes being Singapore-Athens and Singapore-Gold Coast).

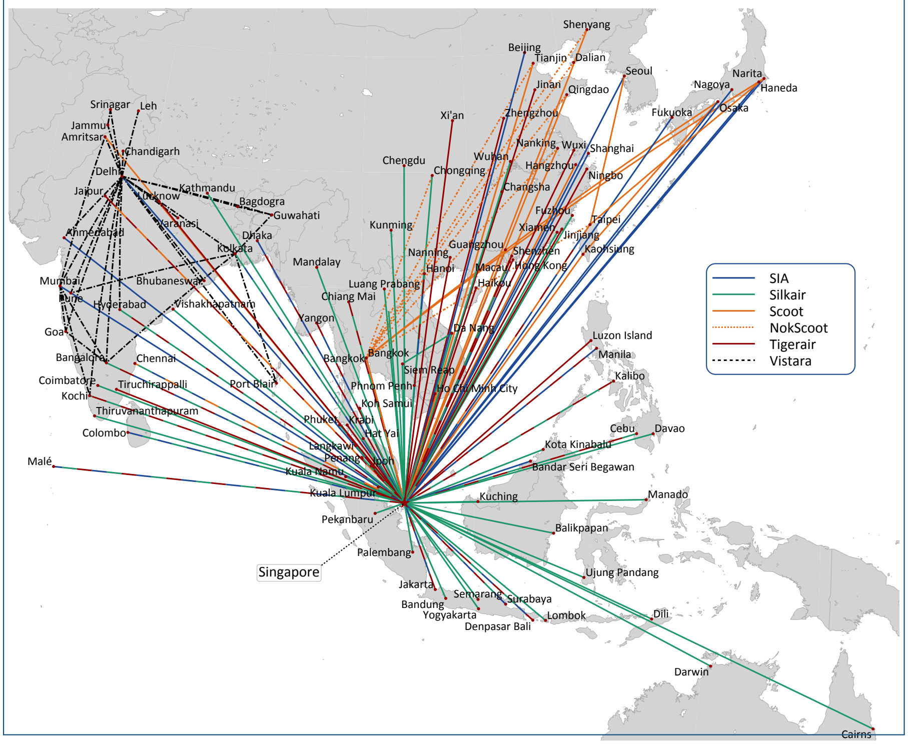
Scoot has been growing strongly. In the last twelve months it increased the number of passengers carried by 45% year on year and achieved a total number of passengers booked of 3.5m with an 81% load factor. It only started in 2012 but has become profitable relatively quickly — it registered a S$20m operating profit for the first time in the financial year ended March 2016. The published figures we have are sketchy, but it appears that it is operating on a unit cost base of around US¢3.5/ASK — not far from that achieved by AirAsia X albeit on a slightly shorter stage length — roughly half that of parent company SIA. And, as we mention above, it is now profitable.

One of the more interesting new routes starting this year is that to Athens (see map) — SIA itself used to operate the route with 777s until 2015 — seemingly a strange choice of a first destination in Europe. However, this does seem to signal the strategy to target a sixth freedom low cost operation through Changi, in this case perhaps focusing on low yielding VFR traffic of the Greek diaspora: Australia has one of the largest Greek communities in the world.

Tigerair operates 23 A319s and A320s out of Changi to almost 40 destinations in Asia (within a five-hour flying time), with a single class. It also has 39 A320neos on order. Its performance recently has been somewhat less than dynamic. In the past twelve months it carried 5.1m passengers with an average growth rate of 0.2%. After a couple of loss-making years it returned to profitability at the operating level in the financial year ended March 2016 and generated a modest S$20m profit in the nine months to Dec 2016. It encounters intense competition at its Changi base, not least from Jetstar Asia and AirAsia (which are after SIA, Silkair and Tigerair the fourth and fifth largest operators at the airport).

From SIA's point of view, the rationale for the full Tiger acquisition was to "harness full synergies to benefit the SIA Group and the Singapore hub", although it also argued that as an independent airline Tiger lacked the scale and network necessary to compete in the LCC market. By bringing the two under a single brand, the management is clearly signalling that a long haul low cost operation needs feed.

SIA REGIONAL ROUTE NETWORK



Multi-hub?

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

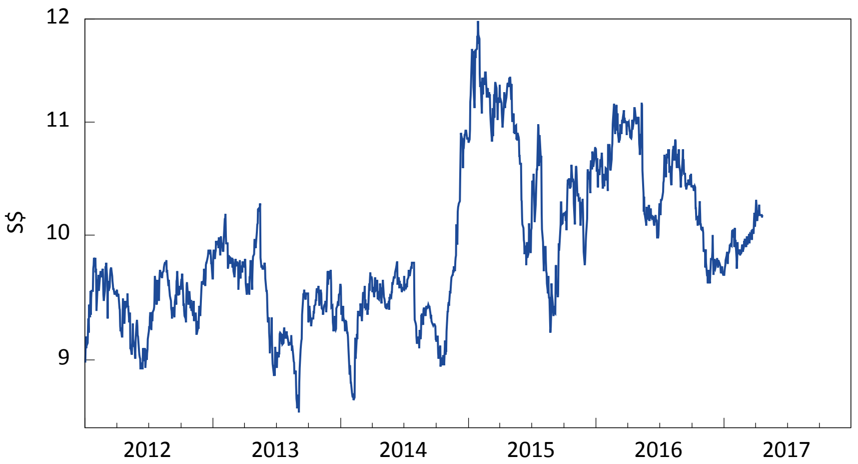
Based at Delhi's Indira Gandhi airport, Vistara operates 13 A320s domestically in a three-class configuration (with 8 business class, 24 premium economy seats — becoming the first airline to introduce the class domestically — and 126 in economy) to 20 domestic destinations (see map). The medium-term plan is to increase the fleet to 20 aircraft by 2018 with the seven A320neos it has on order due for delivery from late 2017.

The airline has been a success (it carried 2.5m passengers in 2016, its second year of operation, on a 76% load factor) even though it may not yet be profitable. The longer term strategy has been given a boost by the recent changes to the Indian state's so-called 5-20 rule, where new carriers had to operate domestically for five years and have a fleet of at least 20 aircraft before being allowed to fly internationally. The new 0/20 rule announced last June specifies that an indian airline has to have the lesser of 20 aircraft or 20% of its fleet dedicated to domestic indian routes.

We would expect that SIA will move quickly to expand Vistara further, enabling India to become a major source market for the SIA Group for passengers travelling west into the Middle East and Europe, and east into Asia.

The final airline in the group stable is NokScoot — a joint venture with Thai Air's Nok subsidiary. Based in Bangkok's older Dom Mueang airport it started operations in 2015 and flies 3 777s in a two-class configuration to six cities in China as well as Taipei — directly targeting inbound leisure travel. The SIA management appears to believe that this also fits in with a multi-hub strategy.

SIA GROUP SHARE PRICE PERFORMANCE



Alaska Air absorbs Virgin America's "great emotional energy"

Alaska Air Group's $4bn acquisition of Virgin America, which closed in mid-December, has been generally well-received by US analysts and investors. The combination has moved quickly to take advantage of new growth opportunities. The merger synergy target has been raised from $225m to $300m. Everyone agrees that the new Alaska will continue to report industry-leading 20%-plus pretax margins.

The merger combined two award-winning, low fare airlines into "West Coast's premier carrier" and the fifth largest US airline, which will benefit from the West Coast's strong economy and a focus on the growing "bleisure" segment.

The management team, led by CEO Brad Tilden, has an impressive track record. Alaska has been an industry leader on many financial fronts, be it cost reduction, profit margins, debt reduction, managing to ROIC or returning capital to shareholders.

In a recent report, JP Morgan analysts reiterated their "higher-than-usual confidence in Alaska's ability to profitably integrate". Two-thirds of the analysts who cover Alaska currently have a positive recommendation on the stock.

However, this merger also faces many potential challenges that have prompted some analysts to adopt a wait-and-see approach (and neutral ratings).

In addition to the usual integration risks associated with airline mergers (especially with systems and labour), the Alaska-Virgin America deal faces fleet dis-synergies, sizeable labour cost hikes, potential loss of premium market share, and risks associated with expansion in some of the nation's most competitive markets.

One of the toughest decisions was what to do with the two strong brands. Alaska announced on March 22 that it would eliminate the Virgin America name, probably in 2019. Will Virgin America's cult-like followers take their business to other airlines?

Another potential problem is that the combination is going down-market with the product offering. Will that result in a loss of premium market share on the transcon?

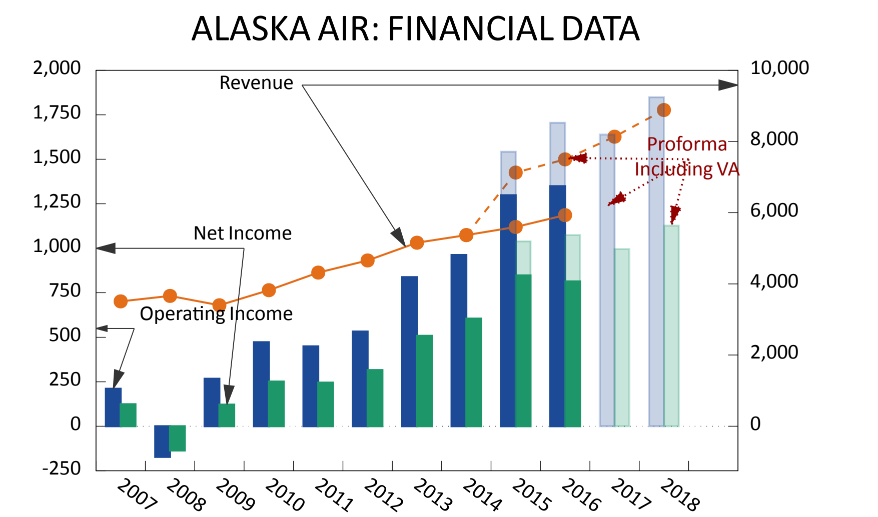
Investors are eagerly awaiting Alaska's big decision on whether or not to retain two fleet types in the longer term — expected by year-end 2017. What is the management's current thinking?

Another question in the minds of investors: Will Alaska be successful in re-deleveraging its balance sheet after borrowing $2bn to finance the acquisition?

Alaska held its first post-merger investor day on March 29, which gave the management an opportunity to tackle some of those issues and explain the strategy and plans in more detail. Highlights included a presentation on a thorough 10-month brand analysis.

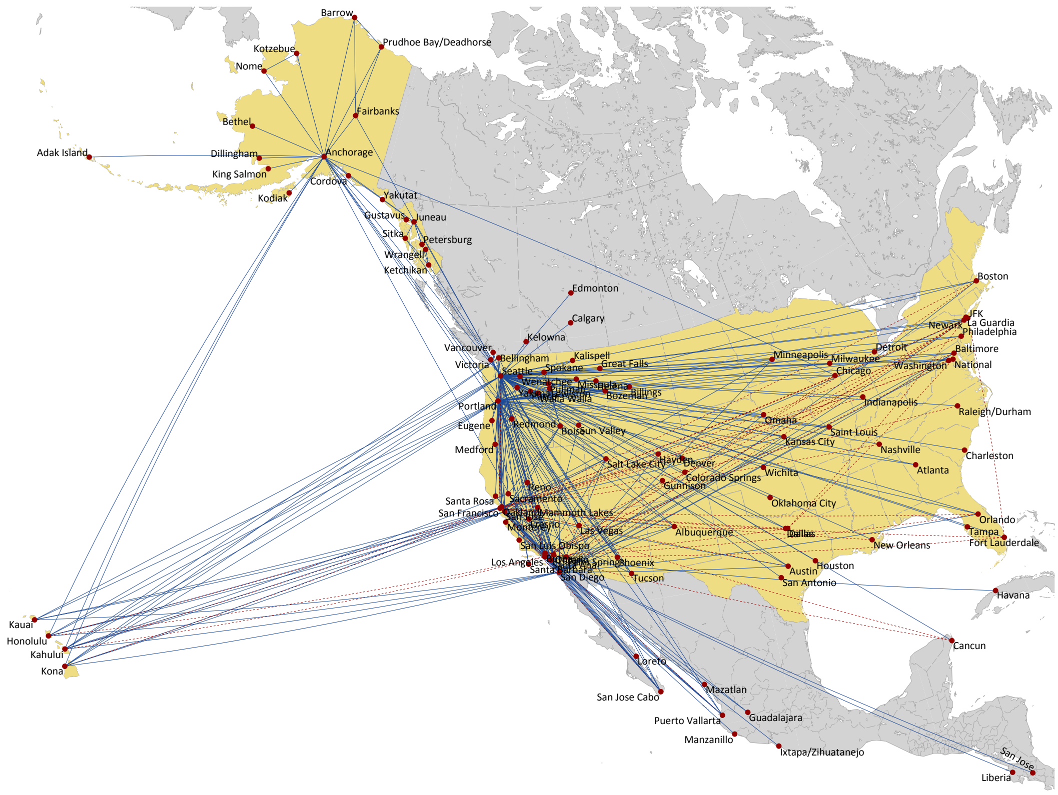
Bigger platform for growth

Alaska has grown at a relatively brisk 7.7% average annual rate since the mid-1990s. 2015 and 2016 both saw a 10.6% capacity growth. As a result, the network has broadened from the original north-south/West Coast/Alaska niche to include sizeable transcon, midcon and Hawaii



Note: The 2016 figures include Virgin America's results for the 18 days from December 14th to 31st. Sources: Alaska Air Group, J.P.Morgan North American Equity Research (March 30, 2017)

ALASKA AIR ROUTE NETWORK



operations; and destinations in Mexico, Canada, Costa Rica and Cuba (since January). But the network is still heavily focused on the states of Washington, Oregon and Alaska.

A couple of years ago, in the face of the consolidation of the US airline industry, Alaska's management became convinced that "scale is relevant" and that Alaska Air, too, should be bigger.

The Virgin America acquisition represented a unique opportunity to get a solid foothold in California, which has more than three times the population of Alaska, Washington and Oregon combined (39.1m, compared to 11.9m). California is also the nation's largest economy.

The deal gave Alaska an "enhanced platform for growth" so that it could become more relevant to customers on the West Coast and nationally. The deal also brought more access to slot-constrained airports on the East Coast.

Alaska paid a big premium for what it considered "scarce real estate" and a one-time opportunity. But it would have taken it a long time to achieve the same through organic growth because of airport infrastructure constraints alone. There was also a defensive element to the deal: JetBlue was also bidding for Virgin America (see *Aviation Strategy*, April 2016).

At the investor day, Alaska's management found a novel way of communicating the West Coast's economic dynamism: the "crane index", or the number of cranes that are currently up in each city. That number was roughly 2.5 times higher on the West Coast than on the East Coast, even though the latter has a much larger population.

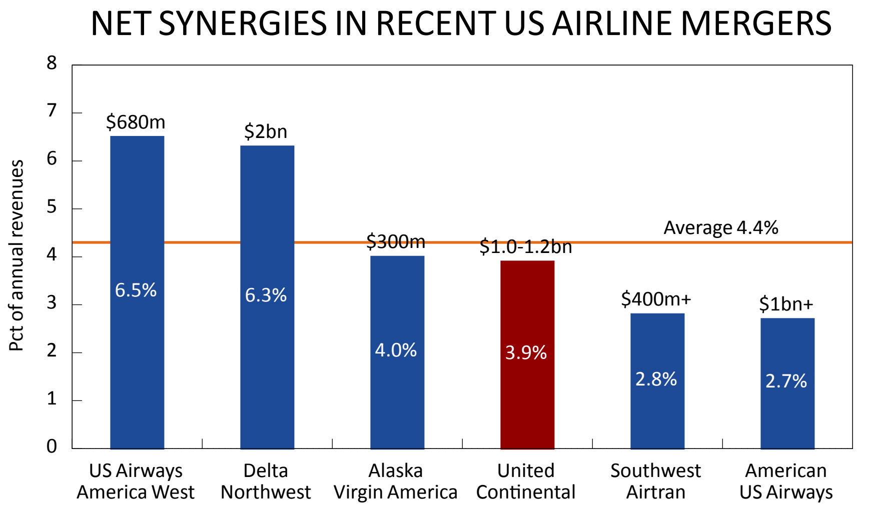
Alaska has moved quickly to take advantage of the new growth platform, launching reciprocal FFP accruals and codesharing just five days after the merger closed.

As of mid-April, in the four months since the merger closed, Alaska had announced an unprecedented 37 new routes from the West Coast that "connect the dots". The services will be operated on a codeshare basis until the airlines are able to combine their operations.

The routes announced so far include at least 13 new destinations from San Francisco, seven from San Diego, five from the LA Basin, three from San Jose, and two from Portland. Alaska has also announced a 40% increase in Dallas Love Field flying — an aggressive move that targets business traffic at Southwest's home base.

Such routes were not viable (or a priority) for Virgin America, but they now look attractive, first, because of the critical mass achieved when the networks are combined. Second, much of the new growth is to cities Alaska already serves, which helps reduce start-up and operating costs.

Another reason why some routes are now more viable is that there is more fleet flexibility. Virgin America lacked a regional aircraft type to take advantage of mid-sized markets.



Source: Alaska Air Group presentation (April 2017)

Now, for example, Alaska is bringing its regional partner SkyWest's E175s to Dallas Love Field this summer to replace Virgin's A320s on the La Guardia and Washington National routes. The A320s will be freed up for new transcontinental services.

Importantly, California presents a sizeable opportunity for Alaska to grow its loyalty and credit card programmes, which currently bring in $900m in cash flow annually.

Alaska operates an unusually generous FFP by industry standards. It also continues to make the programme more attractive, which contrasts with the trend of other US airlines reducing the basic value proposition to regular FFP members as they focus more on revenue at the top.

That helps explain why Alaska's FFP has attracted 3m members in the Pacific Northwest, or one in every four residents. But the airline also attributes the high participation to its 69% customer "relevance" in the region (meaning that 69% of the residents are able to take nonstop flights on Alaska Air to where they want to go in North America).

In California, Alaska currently has 2m loyalty programme members in a population of 39.1m. The strategy is to "build Pacific Northwest-like relevance to develop Pacific Northwest-like loyalty in the significantly larger California market".

Alaska says that the merger has already increased its customer relevance in California to 38% (120 nonstop markets). Its relevance in San Francisco has increased from 9% (Alaska only) to 70% (Alaska + Virgin, including the Q1 route announcements).

Synergies and dysergies

The combination is expected to generate $300m in annual net synergies when fully integrated — $240m revenue benefits and $60m cost synergies. One-time integration costs are estimated at $400m. The synergies are in line with other recent mergers in the US airline industry (see chart on the current page).

Because of the focus on debt funding, the transaction is likely to be accretive to earnings in year one (excluding integration costs). The synergies are expected to ramp up quickly, increasing from $26m in 2017 to $300m in 2021.

The integration timetable is robust: a single operating certificate in early 2018, joint labour deals by mid-2018, single passenger service system cutover in late 2018 and the remaining integration in 2019-2020.

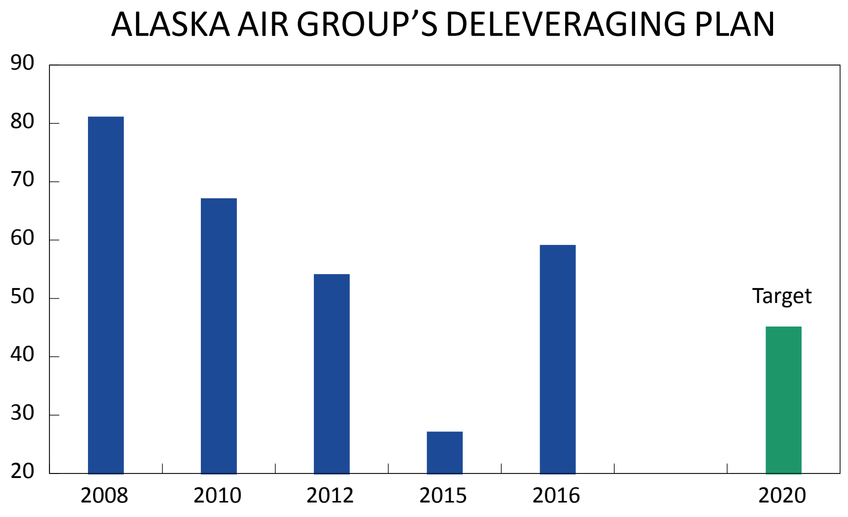
Alaska has identified revenue synergies from seven categories: network presence, network growth, fleet deployment, alliance portfolio, aircraft retrofits, cargo and loyalty.

The network synergies will come from two sources: an increase in the number of itinerary/connecting options for passengers created when the existing networks are combined, and from new routes and frequencies facilitated by the larger customer base.

The fleet synergies will come from the availability of two mainline aircraft types (at least for a few years) to better match capacity to demand in different markets. Essentially, Alaska plans to allocate the 178-seat 737-900ERs to the highest-density transcon markets and the smaller (146/149-seat) A320s to north-south flying.

Alaska says that the opportunity to boost revenues from alliances "increases exponentially" with the expanded Los Angeles and San Francisco presence. The two airlines have currently 15 international alliance partners.

The aircraft retrofit synergies will come from a reconfiguration of Virgin America's Airbus fleet, which entails adding more premium seats, eliminating some economy seats and reducing the premium seat pitch to 41 inches (Alaska's standard). The net effect is to increase the total number of seats. The move will facilitate Alaska's generous complimentary upgrades policy for FFP members, in-



Source: AAG presentation (March 2017)

crease revenues and lower unit costs. Alaska estimates the revenue benefits at $40m.

Loyalty and credit card programmes are the single largest component of the anticipated revenue synergies. Alaska did not give a figure, but the presentation slides suggested that it could be around 40% of the $240m total.

The $60m cost synergies will come from reduced overheads, improved purchasing power and higher efficiency/asset utilisation.

This merger will see labour cost dis-synergies as Virgin employees are brought to Alaska's higher pay scales and an A320 rate is incorporated into the Alaska pilot contract. However, pilot costs are on the rise for the industry generally, so not all of the cost escalation at Alaska will be merger-related.

On the positive side, Alaska Air, Virgin America and their ALPA-represented pilot groups have agreed to a timeline and binding arbitration, if necessary, to get to a new joint agreement by early 2018. After that there will be a defined process to agree on seniority list integration by mid-2018. The management expects to get the other labour deals in place in an expeditious fashion.

JP Morgan analysts in their latest report envision a worst-case total labour cost dysergy of $100m for the combined group.

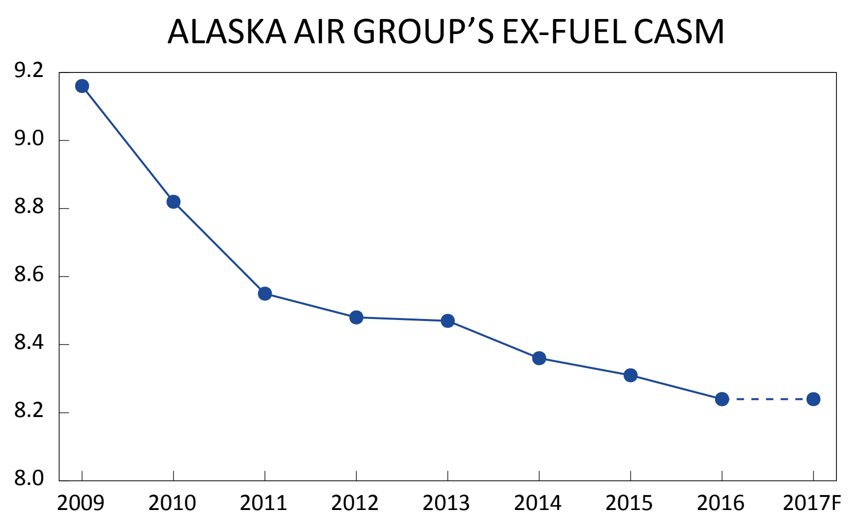
Alaska expects to benefit from the experience of past mergers at other airlines and in other industries. One of the key findings of its research is that if a merger does not work, or if the full synergy value is not extracted, it is typically because the cultures did not work together.

Consequently, and even though the cultures are not that different, Alaska has spent an "extraordinary amount of time" with people from both airlines (using surveys, focus groups, programmes and events) to "define what we want the new culture to look like" and to educate Virgin's workers about Alaska Air's history, values, etc.

Alaska is also determined to avoid the problems some past airline mergers experienced with the cutover to a single passenger reservations system. Being able to do a Sabre-to-Sabre migration will help. Otherwise, Alaska is following American's example of doing it gradually over a number of weeks or months, minimising data migration and using codeshares to bridge to the new Alaska.

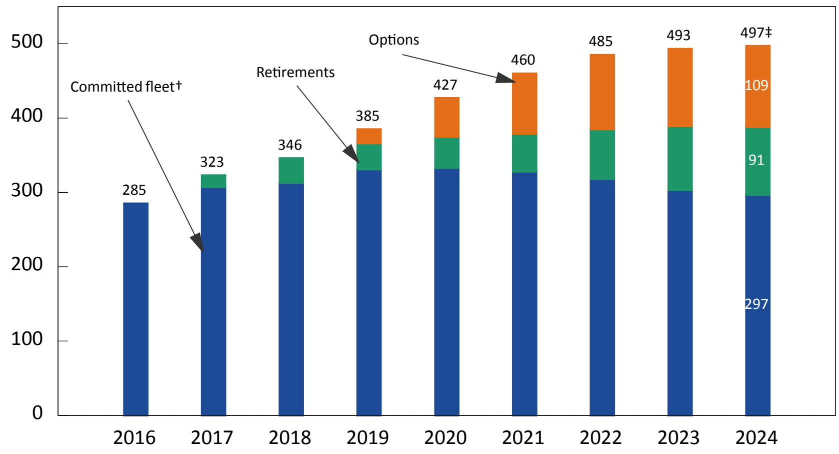
The brand decision

The decision to retire the Virgin America name was based on a comprehensive brand analysis that involved hiring an expert brand consulting firm, performing extensive qualitative research (focus groups) in



Source: AAG investor day presentation (March 2017)

ALASKA AIR GROUP'S CURRENT FLEXIBLE FLEET PLAN



Notes: † Committed aircraft, including existing firm deliveries. ‡ Fleet if all options exercised and no retirements or lease returns. Source: AAG presentation (March 2017)

California and Washington, conducting a national survey and completing a financial and operational analysis.

The challenge was that both Alaska and Virgin America have strong but very different brands. Alaska focuses more on the airport experience and has a highly acclaimed FFP, while Virgin focuses on the in-flight experience.

Either brand is a good fit for the "premium-product, low fare" segment (also known as "bleisure" or "leisure enthusiasts", Alaska's new term) that Alaska, Virgin America, JetBlue and Hawaiian all focus on. That segment makes up $25bn or a quarter of the $100bn US domestic air travel market.

Alaska's management had kept an open mind about using two brands because Virgin America has won a cult-like following in the California markets, especially among the Bay area business travellers. Seven out of its top-ten corporate customers are Silicon Valley-based tech companies. The Virgin brand is driving a big revenue premium at Virgin America.

The investor day presentation described Alaska as "service-oriented, authentic and professional" and Virgin America as "feel-good, hip, bold and modern" with "great emotional energy".

The management mentioned two factors that influenced their decision. First, Alaska appeals to a broader set of customers, while Virgin America has strong peaks at the top end but is less relevant for "value-oriented" travellers (the bottom category that ULCCs typically focus on). Second, preference for Alaska increases at a greater rate when flyers, especially Elite FFP members, become more familiar with the brand.

However, those differences would seem to have little to do with the brand. Virgin America gets fewer "value-oriented" travellers simply because it does not always need to offer the lowest fare types or discount heavily. And the "getting to know" impact is less because the Virgin brand is much better known globally and in the US than the Alaska brand.

The real reason why Alaska is dropping the Virgin America brand is that it believes that the two brands can be combined into a winner. Alaska plans to retain key elements of the Virgin brand such as mood lighting, music and enhanced in-flight entertainment. The management talked of building more "emotional energy" into the Alaska brand.

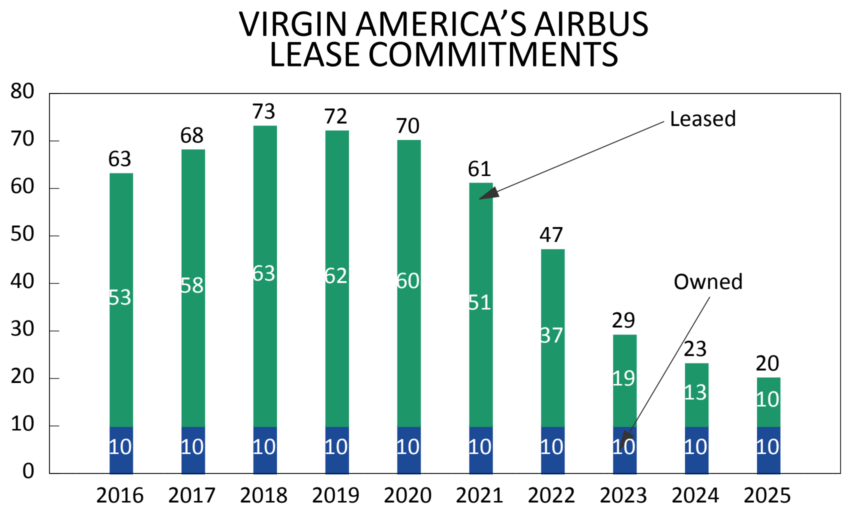
The new brand will be "warm and welcoming, with a modern, West Coast-inspired vibe". The planned enhancements, to be rolled out mostly in 2018-2019, include new seats and amenities, new uniforms, satellite WIFI, free movies and chat, more premium class seating and airport lounge expansion. Alaska's Mileage Plan will become the sole loyalty programme in 2018 and will offer the most generous complimentary upgrades in the industry.

This is obviously the most cost-effective solution. Maintaining two brands would be expensive, inefficient and potentially confusing to passengers.

The new brand could work, but the problem is that the combination is gravitating towards Alaska's more basic in-flight experience. First, Alaska will offer a lower premium seat pitch than competitors (41 inches in first class, which is a step-down from Virgin's 55-inches though in line with Alaska's recent upgrade from 35 inches). Second, Alaska has decided not to offer lie-flat seats, which are now the industry norm on the transcon.

The decision not to offer lie-flat seats reflected Alaska's determination to keep costs low. Instead, the airline will stick to the strategy that has worked well in the past, which includes easy upgrades to first class and a premium class that "fits the target market we're going after".

Many analysts disagree with the strategy of using the first class more



Source: AAG presentation (March 2017)

as free upgrades for highly valued FFP members, rather than monetising it like the rest of the industry does. But the management insists that the strategy works for the Alaska business model, where "getting a chance to upgrade is part of loyalty, and loyalty is part of successful growth".

It is not clear if the royalty payment that Virgin America pays to the Virgin Group (0.7% of annual revenues) had any impact on the brand decision. But now that Alaska is eliminating the Virgin America brand, it definitely does not want to continue paying the license fee until the contract expires in 2040.

Virgin Group founder Richard Branson is reportedly very unhappy about the brand decision and said at Virgin Atlantic's London-Seattle launch event in late March that Alaska would be required to pay royalties until 2040. However, Alaska has a different interpretation of the contract. When asked about it at the investor day, the executives said that there were "lots of ways out of the contract" and that in their opinion they would not need to keep paying for a brand they are not using.

Upcoming fleet decision

Alaska will be a mixed-fleet operator for many years to come because although the vast majority of Virgin's Airbus aircraft are leased, those leases will not start expiring until 2020. The lease commitments will then dwindle from 60 aircraft in 2020 to just 10 in 2025 (see chart on this page).

The management noted that it would be "extraordinarily expensive" to terminate the Airbus leases early. In any case, Alaska needs the lift and having two mainline types offers useful flexibility when developing the network to become more relevant in California.

The management estimated the current dysergy of operating two fleet types at just \$20-25m annually. They speculated that the "added leverage you'd get from having two different manufacturers" might even offset that dysergy (an interesting but not very convincing argument).

Cowen and Company analysts said in a recent research note that they continued to believe that Alaska would move to a 737 fleet and return the A320/A321s as they come off lease. But they also noted that the A321neos could be more interesting as they are attractive aircraft for the Hawaii and transcon markets.

According to regulatory filings, Virgin is due to take 10 A321neos from GECAS in 2017-2018. It also has an order for 30 A320neos from Airbus for 2020-2022 delivery that can be cancelled for just \$15m.

Alaska's management expects to decide by the end of this year whether to remain a mixed-fleet operator or go back to an all-Boeing fleet over time.

Financial considerations

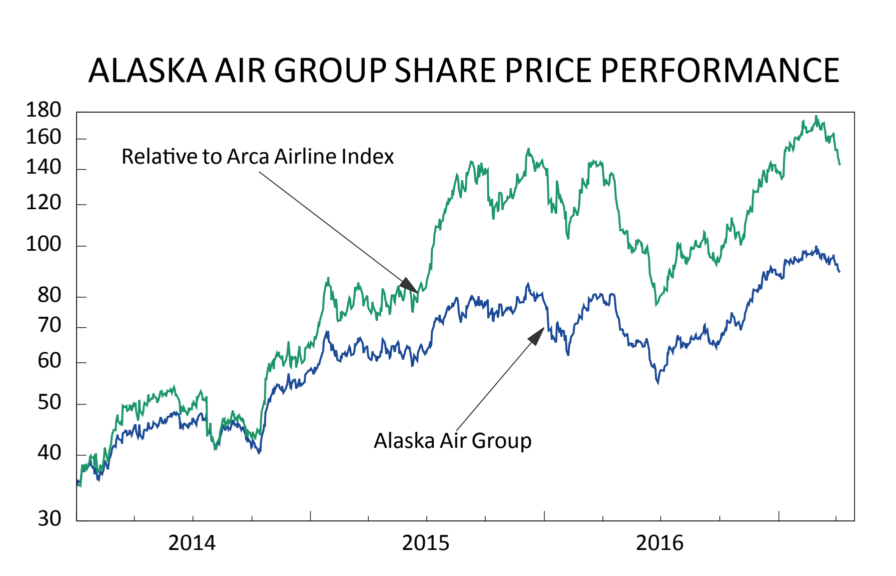
Alaska has been the industry's financial leader in many respects in the past decade and that is not expected to change post-merger. The only questions are whether the profit margin lead will narrow and whether Alaska will succeed in reducing the debt on its balance sheet.

According to the investor day presentation, last year Alaska had an eight-point lead over the legacy carrier group in terms of pretax margin (22%, compared to 14%) and a three-point lead over the US LCCs (19%). Alaska says that the \$300m run-rate merger synergies will make it a 25% pretax margin business.

Most US airlines' pretax margins are expected to temporarily decline by a couple of percentage points in 2017, but Alaska is still expected to remain in the lead.

The acquisition increased Alaska's capital base from \$4bn to \$7.4bn, as a result of which after-tax ROIC declined from 21.3% to around 15% (pro-forma 2016). But that is still almost double the weighted average cost of capital.

Low costs are critical to Alaska's business model and it has a strong



track record on that front: ex-fuel unit costs fell from 9.16¢ in 2009 to 8.24¢ in 2016. The management projects flat unit cost development for 2017 and hopes to continue a slight downward trend over time, though a new pilot contract may temporarily cause CASM to rise.

After slashing its debt-to-capital ratio from 81% in 2008 to 27% in 2015, Alaska saw the ratio soar to 59% in 2016 because it raised $1.8bn of debt to finance the Virgin acquisition (at very attractive rates thanks to its investment grade credit ratings).

A 59% leverage ratio puts Alaska squarely in the middle of the industry, but the management plans to "re-deleverage" and has set a target of 45% by 2020.

Alaska strives for "balanced capital allocation". Fleet growth and many non-aircraft investments will result in higher near-term capex ($1.2-$1.3bn in both 2017 and 2018), but Alaska is also committed to delivering free cash flow and continuing to increase the dividend. The management indicated that they would do some modest share buybacks this year but otherwise the priority in 2017-2020 is to implement integration, pay dividends and pay down debt.

Competitive concerns

Alaska has coexisted profitably with Delta in Seattle in recent years even as the legacy has aggressively built hub operations in that city. The management sees no reason why Alaska could not deploy the same strategies successfully in San Francisco and Los Angeles.

But investors fear that competition against United in San Francisco might be a different ballgame. United dominates San Francisco with a 47% domestic market share and is less ROIC-oriented than Delta.

JP Morgan analysts suggested that the outcome was actually likely to be "similarly benign" in San Francisco, because Virgin as a pricing agitator is taken out, because the new Alaska represents a significantly lesser threat to United, and because United's recently-reconstituted board and management offer hope.

But the analysts were less optimistic about Alaska's prospects on the transcon. Referring to the decisions to eschew lie-flat seats and reduce the first class seat pitch, they said that they were "surprised by the decision to go with an uncompetitive premium product in the lucrative transcon market". Then again, Virgin has only a 7% share of the premium seats on the New York to San Francisco/Los Angeles routes.

JPMorgan sees JetBlue as the biggest beneficiary of Alaska's decision to "all-but-abandon the premium transcon market". The analysts wrote: "If you liked the edginess of Virgin's offering, JetBlue's Mint is the next best thing out there". Since being outbid for Virgin a year ago, JetBlue has expanded the Mint premium product aggressively on the transcontinental routes.

A year ago Richard Branson said that he would consider launching a new Virgin brand airline in the US if Alaska chooses not to use the brand. There could now be an opening for an edgy new entrant to shake things up in the increasingly consolidated US domestic market.

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