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# Alitalia: Decline and fall

Once again Alitalia has run out of cash. Not even a decade has passed since the 2008 bankruptcy and the merger with AirOne. Only a couple of years have gone by since the rescue by Etihad and a €1.75bn recapitalisation — with a target to create sustainable profitability by 2017. The latest restructuring plan — designed as usual to bring the carrier to breakeven in two years — gained the negotiated approval of the unions, but failed a vote from the employees. The airline has thrown up its hands, once again filed for special administration (ie bankruptcy protection) and been granted a €600m government loan to cover it over the next six months as the administrators prepare it for sale. Will Italy let it fail this time?

Alitalia, in all its various guises, has been inherently unprofitable for decades. As the graph below shows, it last made an operating profit in 1998 and a net profit (accidentally) in 2003. In the last twenty years (excluding the unknown 2008) it has lost a total of €4bn at the operating level and €6bn at the net — average negative margins of 4% and 7% respectively. In 2016 it carried 22.6m passengers, some 7% fewer than the 24.5m it carried in 2007. It has a fleet of 117 aircraft (see table on the following page) — 25 widebody A330s and 777s, 72 narrowbody A320s and 20 Embraer 175/190s — and flies to 94 destinations (26 domestic, 56 short haul international and 12 long haul).

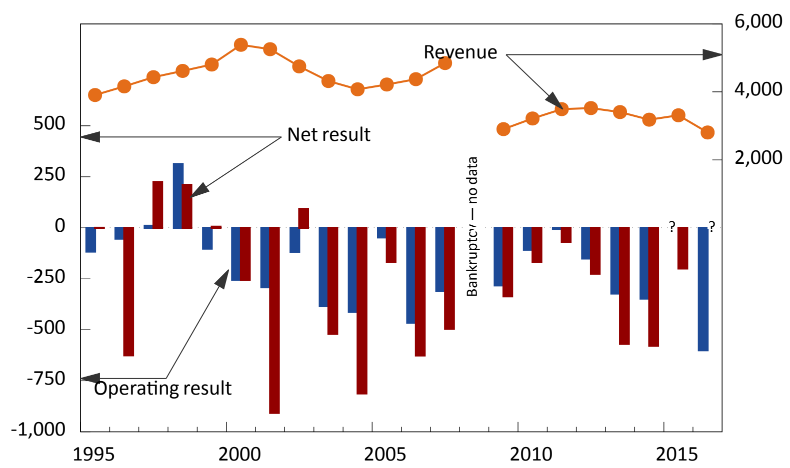
The restructuring plan approved by the company's board in March (but rejected by the employees) was drawn up on the traditional idea of shrinking, reducing costs and increasing revenues. By 2019 it aimed to reduce annual costs by €1bn, increase revenues by 30% (and thereby gain profitability). It would have seen a significant downsizing of the short haul fleet by twenty units, and moved the short haul product offering closer to the low cost competition: buy-on-board, higher density seating, higher utilisation, ancillary revenues, low one-way fares. At the same time it would expand its long haul operations "to better serve and regain market share in the Italian market".

These plans would have required another significant level of redundancies from its existing workforce of 12,500. This may be the reason why the company involved the Government in its negotiating stance — the current Alitalia is a fully privately-owned airline. But then, the Italian Government has always interfered: from the political horse-trading over the role of the Milan airports that

## This issue includes



ALITALIA: FINANCIAL RESULTS (€m)




*Source: Company Reports.*

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helped break up the Alitalia-KLM virtual merger of the late 1990s; to PM Berlusconi's insistence on keeping the airline in Italian hands that killed off the potential Air France-KLM acquisition of the company in 2008 and the forcing of his friends to acquire the "good bits" out of bankruptcy; to the decision by the state-owned postal services to invest €75m in the company in 2013.

With the rejection of the plan by the employees, the three main shareholders (Etihad, Intesa Sanpaolo and UniCredit) ditched their support for a €2bn recapitalisation package almost in frustration saying it was now impossible. As Carlo Messina, CEO of Intesa Sanpaolo said "there isn't a plan 'B'".

Etihad's CEO James Hogan was patently frustrated: "We deeply regret the Alitalia staff vote outcome, which means that all parties will lose: Alitalia's employees, its customers and its shareholders, and ultimately also Italy, for which Alitalia is an ambassador all over the world." His shareholders in Abu Dhabi must have been deeply embarrassed, not only by the failure of the investment in Alitalia but also by the deepening losses at airBerlin, both highlighting the failure of Etihad's "hunter strategy". He has been replaced in his position at Etihad even while they look for another permanent CEO.

At least Rome appears to have

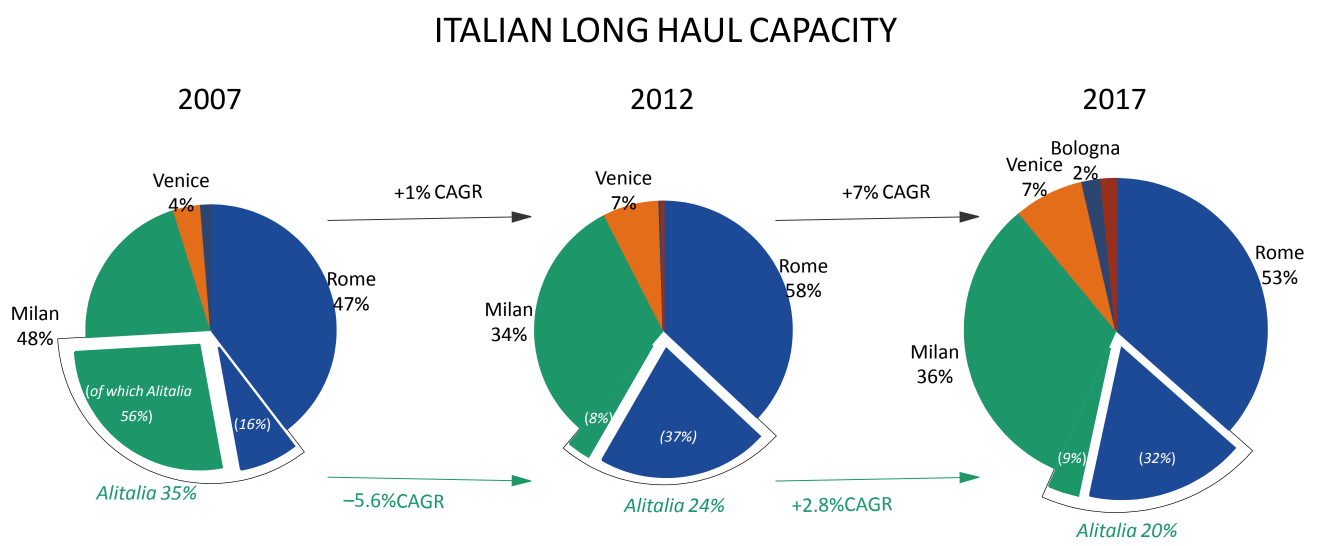
### ALITALIA FLEET

| | Aircraft in service | | |
|---|---|---|---|
| | Owned | Leased | Total |
| A330 | | 14† | 14 |
| 777 | 6 | 5 | 11 |
| A319 | 12 | 10 | 22 |
| A320 | 12 | 26 | 38 |
| A321 | 5 | 7 | 12 |
| E175 | 2 | 13 | 15 |
| E190 | 2 | 3 | 5 |
| **Total** | **39** | **78** | **117** |

*Notes: †including two A330s leased from Jet Airways*

### LESSOR EXPOSURE TO ALITALIA

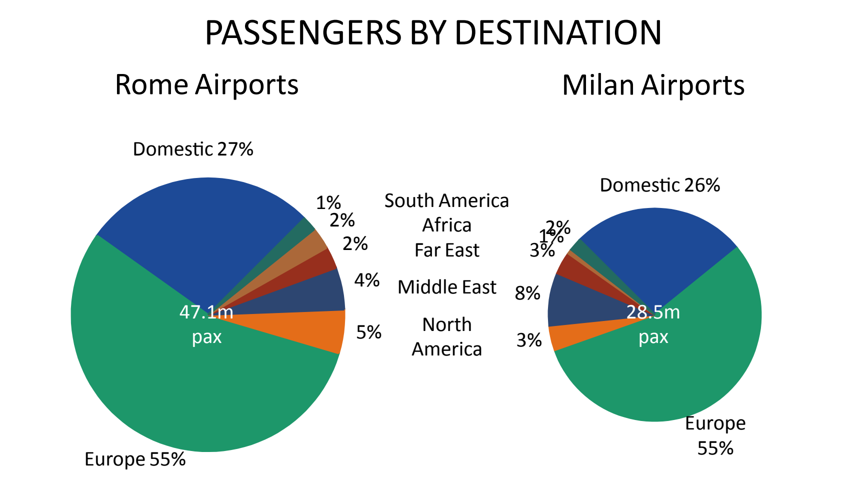
| | Aircraft type | | | | |
|---|---|---|---|---|---|
| Lessor | 777 | A330 | A320 | E175/E190 | Total |
| Castlelake | | 1 | 16 | | 17 |
| Nordic Aviation Capital | | | | 11 | 11 |
| AerCap | 1 | | 6 | | 7 |
| Avolon | | | 2 | 4 | 6 |
| AWAS | | | 6 | | 6 |
| Air Lease Corporation | | 4 | | 1 | 5 |
| GECAS | 4 | | | | 4 |
| ICBC | | | 4 | | 4 |
| ALM | | | 3 | | 3 |
| CDB | | | 3 | | 3 |
| Deucalion | | 2 | | | 2 |
| Intrepid Aviation | | 2 | | | 2 |
| ORIX | | | 2 | | 2 |
| Aergo | | 1 | | | 1 |
| Aircraft Purchase Fleet | | 1 | | | 1 |
| Apollo Aviation | | 1 | | | 1 |
| Total | 5 | 12 | 42 | 16 | 78 |




*Source: schedules data. Note: Annual number of seats departing Italian airports on routes over 4,000km. Milan=Milan Malpensa, Rome=Rome Fiumicino. Area of pie directly related to number of seats.*

ruled out renationalisation. The government-appointed commissioners have invited expressions of interest from individual companies (or consortia) by June 5th to buy the whole company, restructure it, or acquire assets and contracts.

Apparently at the end of February the company had debts and liabilities of €5.3bn against assets of €0.9bn. Without detailed accounts it is difficult to guess how much of those assets may be real. The company sold all its Heathrow slots to Etihad in the 2014 restructuring, and its other route rights and landing slots are unlikely to have realisable cash value. The FFP *Mille Miglia* might have had some value — but Alitalia sold 75% of this to Etihad. The fleet is mostly leased. As far as we can find out we believe that Alitalia owns only 39 aircraft out of its 117 strong fleet — six 777s, 30 A320s and 4 regional jets.




*Source: Aeroporti di Roma (Fiumicino and Ciampino), SEA Group (Società Esercizi Aeroportuali, Linate and Malpensa)*

The likelihood of a serious bidder for the business seems slim: Lufthansa and Air France-KLM, both of whom a decade ago had been interested, have much more pressing matters on their agendas. The Italian state railway Ferrovie dello Stato denied rumours that it would come to the rescue. There may be some airline somewhere in the world with more cash than sense; but a non-European bidder would need to find a consortium partner (preferably Italian) to take 51% of the equity.

### The world has moved on

In the past ten years Alitalia has allowed its "natural" position as the national flag-carrier of Italy erode so much that it has possibly totally destroyed what may have once been a national brand. Alitalia's share of seats in the Italian short/medium haul market has fallen from 31% in 2010 to 21% in the 2017 schedules. The largest carrier in this market is now Ryanair with a 28% share of the total departing seats (having grown by a compound 8.4% a year over the period). The third and fourth largest

### ITALIAN LONG HAUL CAPACITY

| | 2010 | | 2017 | | |
|---|---|---|---|---|---|
| | | Seat share | | Seat share | CAGR |
| 1 | Alitalia | 25% | Alitalia | 20% | 2.8% |
| 2 | Emirates | 12% | Emirates | 19% | 13.9% |
| 3 | Delta | 10% | Qatar | 7% | 12.2% |
| 4 | Qatar | 5% | American | 7% | 4.2% |
| 5 | US Airways | 4% | Delta | 7% | -0.5% |
| 6 | American | 4% | Etihad | 4% | nm |
| 7 | Meridiana | 3% | United | 4% | nm |
| 8 | Air China | 3% | Air China | 4% | 7.1% |
| 9 | Cathay | 3% | Meridiana | 3% | nm |
| 10 | SIA | 3% | Air Canada | 3% | nm |
| | Others (31) | 29% | Others (19) | 23% | 2.1% |
| | Total | 100% | | 100% | 5.7% |

*Note: Seats on routes over 4,000km*

are easyJet and Vueling respectively. Capacity in the market itself is virtually the same size as it was seven years ago.

Long haul markets have been equally affected. On the 2008 restructuring Alitalia moved its long haul hub back to Rome from Milan Malpensa. Its share of long haul seats has fallen to 20% of the total, closely followed by Emirates on 19% and Qatar on 7% — each of which have increased their offerings into the market by an average annual 14% and 12% respectively since 2010. Capacity on long haul has increased by an average 5.7% a year in the period, but Alitalia's growth has been a mere 2.8% a year.

But then this may all be part of the difficulties presented by the Italian market itself. Perhaps it is just not conducive to the idea of a single country flag carrier.

Italy is really at least two disparate countries within one. The north, and particularly the Po valley, is the wealthy industrial area: a continuation of the "blue banana" distribution of European population density that runs from London through Paris, the Rhine valley to Turin. The south — the *Mezzogiorno* — is a relatively impoverished area with regional annual per capita incomes less than half that of the North. The industrial north is centered perhaps in Milan; the political centre is in Rome on the northern borders of the *Mezzogiorno*. There is strong air traffic demand domestically between Rome and Milan and Rome and Naples, weakened by the introduction of high speed rail. There is strong demand from the *Mezzogiorno* to the north, ideal for for low cost airline competition against road and bus transport. However, there is also strong demand from the Po valley on longer haul routes, and this (without having to go through Milan) is easily diverted to other European hubs for long haul connections (notably Frankfurt, London, Paris, Amsterdam, Zürich and Munich), or with the building of services from the superconnectors to the East via the Gulf or Istanbul.

At the same time Italy is, like the other mediterranean countries, at the bottom of a tourism well. Inbound tourist traffic is intent on reaching the leisure destinations, well away from the industrial or political centres: highly seasonal and price oriented.

Geographically also any attempts at operating a traditional transfer hub puts an Italian carrier at a disadvantage. Rome is too far south to access convenient connections on the Atlantic or to the Far East except perhaps from within Italy, while Milan,

### ITALIAN SHORT HAUL CAPACITY

| | 2010 | | 2017 | | |
|---|---|---|---|---|---|
| | | Seat share | | Seat share | CAGR |
| 1 | Alitalia | 31% | Ryanair | 28% | 8.4% |
| 2 | Ryanair | 16% | Alitalia | 21% | -5.2% |
| 3 | Meridiana | 8% | easyJet | 11% | 5.4% |
| 4 | easyJet | 8% | Vueling | 4% | nm |
| 5 | Lufthansa | 5% | Lufthansa | 3% | -7.0% |
| 6 | Wind Jet | 4% | Wizz Air | 3% | nm |
| 7 | Air France | 2% | Meridiana | 3% | -14.8% |
| 8 | Blue Panorama | 2% | Volotea | 2% | nm |
| 9 | British Airways | 2% | British Airways | 2% | 3.2% |
| 10 | Air Berlin | 2% | Blue Air | 2% | nm |
| | Others (125) | 19% | Others (101) | 22% | 2.1% |
| | Total | 100% | Total | 100% | 0.4% |

*Note: Seats on routes under 4,000km*

ALITALIA: SHAREHOLDING STRUCTURE

| | Investment in Alitalia – Società Aerea Italiana | Owned by | |
|---|---|---|---|
| Etihad Investment Holding Company LLC | 49.0% | Etihad Airways PJSC | 100% |
| Compagnia Aerea Italiana SpA | 51.0% | UniCredit | 33.2% |
| | | Banca Intesa Sanpaolo | 31.1% |
| | | Banca Popolare di Sondrio | 13.5% |
| | | Atlantia† | 6.3% |
| | | Banca Monte Paschi di Siena | 3.4% |
| | | Poste Italiane | 3.0% |
| | | Immsi | 2.6% |
| | | Pirelli | 1.4% |
| | | Macca | 1.4% |
| | | Air France-KLM | 1.1% |
| | | Others (17) | 2.9% |

*Source: Alitalia annual report 2014. Shareholding as at end January 2015. † owner of Aeroporti di Roma*

albeit important within the Po valley, is subject to intense competition. But any operator is under pressure to develop a long haul network encompassing both centres.

CEO Cramer Ball highlighted the problems in the company's suggestion of a restructuring plan. 75% of Alitalia's total traffic is currently carried on short haul operations. 50% of all its traffic transfers; and transfer traffic makes up 85% of long haul traffic. He claimed that the long haul operations were profitable. This seems unlikely (although the Atlantic operations do still form part of the ATI Joint Venture with Air France-KLM and Delta).

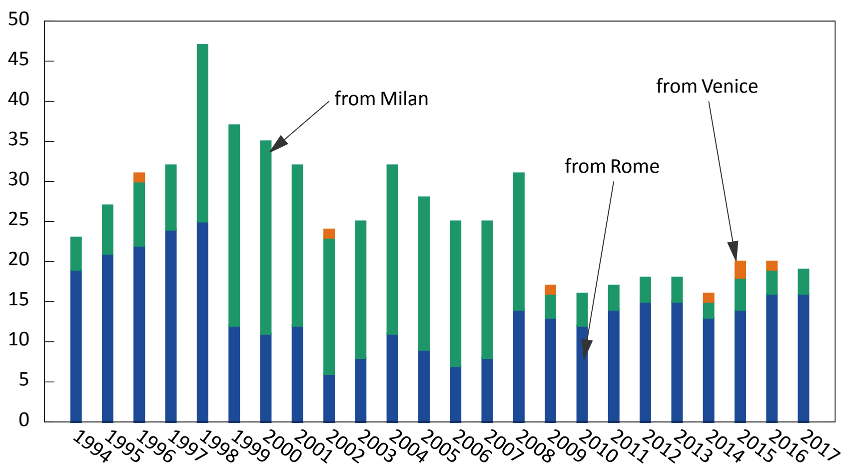
## Hatching the phoenix

If Alitalia were to survive this bankruptcy it would of necessity be smaller yet again. It may have lost a battle to continue to be able to operate short haul services profitably. Should a new Alitalia perhaps concentrate on long haul services and invite the likes of Ryanair, easyJet or Vueling to provide the short haul services and feed that it will need into Rome, Milan (and maybe Venice) to achieve the political expediency of providing an Italian flag carrier? There may be a business model that encompasses lower capacity long haul equipment such as the 787 or A350 and concentrates on underlying O&D demand. Such a model may not involve taking on the legacy baggage.

Meanwhile, in the six months it has to the end of the government bridging loan, it is likely that the market will vote with its feet and Alitalia's finances will continue to deteriorate in administration.

The European airline industry has been eagerly pursuing consolidation since deregulation twenty years ago. Etihad's development of its "Hunter Strategy" and its investments in Alitalia and airBerlin created a new force that seemed to put a halt to the process. This strategy is now in tatters. Consolidation can take place through acquisition or attrition (and it is always remarkable how long an airline can last while losing money). Only a handful of flag-carriers have gone to the wall — Swissair, Sabena, Olympic, Malèv, Cyprus. Some no doubt are

ALITALIA: LONG HAUL DESTINATIONS



hoping that Alitalia is the next.

### Clean asset sale?

One of the options being pursued is the sale of Alitalia's assets. This could be the best option for the Italian government, which appears to acting as Alitalia's owner, if it could use this mechanism to get rid of Alitalia's liabilities, including its management and union culture, while preserving the airline's flag-carrier status and core network.

The Greek government attempted a clean asset sale in 2009 in order to finally privatise Olympic. But what does it imply for Alitalia in reality? And how could it be accomplished in practice?

First, there are minimal or no fixed assets — the fleet is leased, property is leased or mortgaged, IT systems probably have no transfer value.

Slots at congested airports are valuable, but Alitalia's readily monetisable slots — those at Heathrow — have been sold to and are currently leased back from Etihad.

Is there brand equity? For a failed airline, we would suggest zilch. Pan Am's brand used to be the second most recognised in the world (after Coca-Cola) but, after the airline's demise, the brand (logo and name) was traded a couple of times, valued at tens of thousands of dollars; Alitalia's name and brand would at most raise thousands.

To what extent is the network transferable to a new entity? The short haul has in effect been taken over by LCCs. But long haul, still largely under bilateral ASAs, could have value for an investor. The analysis above has shown a marked expansion of Rome and Milan long haul services, providing an attractive smaller scale alternative to the global hubs at Frankfurt, CDG and Heathrow, but there is no visibility on how profitable or unprofitable the network is.

This franchise is salable. But the purchaser will not want to inherit Alitalia's cost structure and inefficiency (this might be an opportunity to apply the evolving Long Haul Low Cost model). In Olympic's case investors were invited to bid for the core assets (brand and key routes) but had the option on whether to take on personnel, supply contracts and aircraft. The successful bidder declined to offer contracts to Olympic's staff; instead it recruited directly on new terms and conditions, didn't touch the contracts, and decided on its own new fleet.

The Greek government then had to bear the expense of unwinding the aircraft leases, failing to sell surplus aircraft, terminating contracts and providing massive compensation for the redundant Olympic staff, especially the powerful and influential pilots. Could the Italians do something similar, or will the government choose the cheaper, simpler but politically sensitive route of bankruptcy and liquidation of Alitalia?

# Aegean: Genuine niche carrier

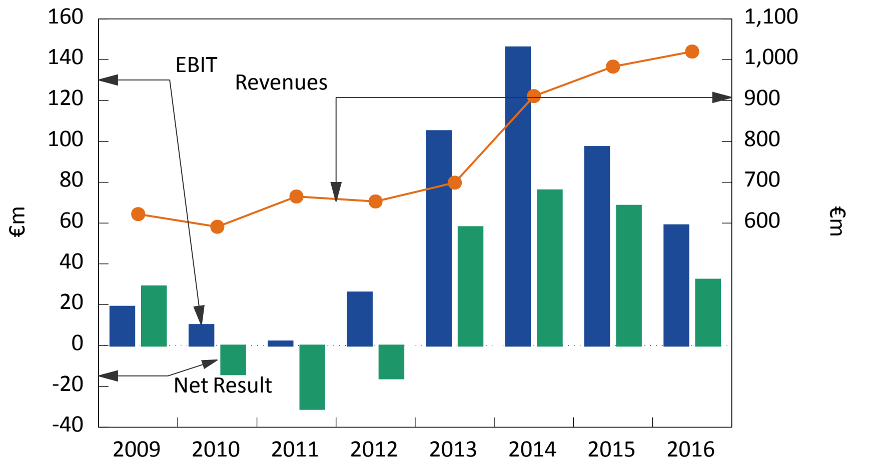
AEGEAN Airlines is facing greater competition from Ryanair, profit margins have slipped, but it is maintaining its status as Europe's most successful niche airline.

Based at Athens, Aegean has found a rare niche where the hybrid airline model works. The airline has a fleet of 47 A320 Family aircraft plus 9 Q400s, two ATR42s and two Dash 100s (essential for the tiny PSO airports), carrying 12.5m passengers last year. The A320s are operated with a business class section at an overall load factor of 77%, comparable to network carriers rather than LCCs which are now averaging loads in the low 90s. Onboard service, with free food and drink in both cabins, is now superior to that offered by BA on intra-European flights.

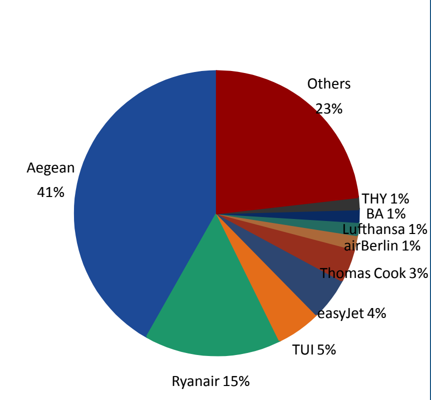
Aegean manages to control unit costs at LCC-type levels — its 4.8€¢ per ASK ex-fuel is almost exactly the same as easyJet's — but 40% above Ryanair's ULCC levels. However, Ryanair's unit costs at Athens at are likely to be significantly higher than its system average as Athens International Airport (AIA) levies some of the highest airport charges in Europe, comparable to Heathrow's, although discounts on new routes and services have, however, been implemented following the 2013 sale by Hochtief of its 40% share to PSP, a Canadian pension fund. AIA and the Greek government (the state owns 55% of the airport) have rejected Ryanair's offer of delivering 10m passengers and/or providing zero cost seats on some island routes if fees were to be drastically cut.

In 2016 Aegean's revenues increased by 3.9% over 2015 to €1.02bn, but EBIT fell to €58.8m from €97.2m, and at the net level profits more than halved to €32.2m from €68.4m. The net profit margin was therefore just 3% compared to the 9% achieved in 2014 when Aegean

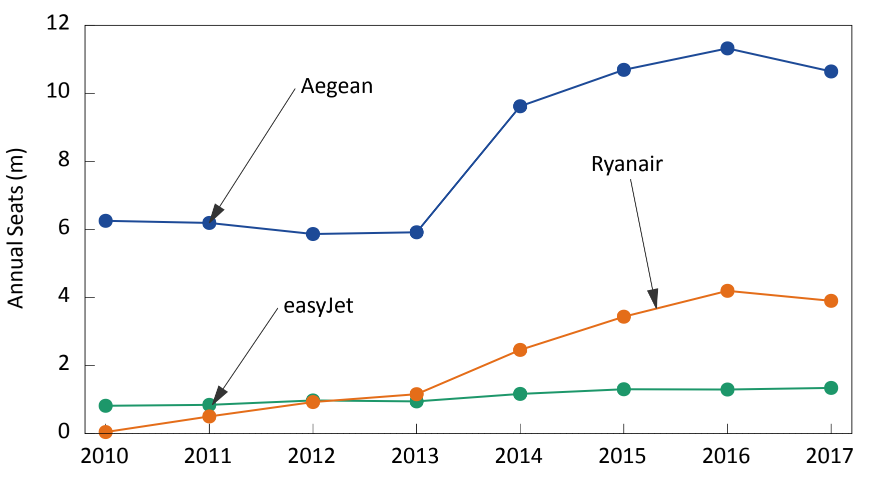
AEGEAN GROUP FINANCIAL RESULTS




MARKET SHARES
AT ATHENS 2016




AEGEAN AND LCC RIVALS AT ATHENS



AEGEAN GROUP FLEET

| | Aircraft type | In service |
|---|---|---|
| Aegean | A320 | 38 |
| | A321 | 8 |
| | A319 | 1 |
| | **Total** | **47** |
| Olympic | Q400 | 9 |
| | D100 | 4 |
| | ATR 42 | 2 |
| | **Total** | **15** |

could claim to be the second most profitable European airline, after Ryanair.

CASK fell by 5.6% to 5.05€¢ from 5.35€¢ but this was almost entirely due to the decline in fuel prices. RASK unfortunately fell by 7.8% to 6.31€¢ from 6.83€¢ . Apart from the Ryanair factor — the ULCC now accounts from 16% of seat capacity at Athens having entered the market in 2013 — Aegean itself has been expanding rapidly, taking delivery of the final seven A320ceos it had on order during the past two years and growing system ASKs by a total of 34%.

AEGEAN BALANCE SHEET

| | 2016 (€m) |
|---|---|
| Fixed assets | 100.8 |
| Goodwill and Intangibles | 86.8 |
| Others | 38.4 |
| Non-current assets | 226.0 |
| Receivables and Prepayments | 130.7 |
| Cash | 248.5 |
| Others | 45.6 |
| Current assets | 424.8 |
| **TOTAL ASSETS** | **650.8** |
| Unflown revenue | 100.9 |
| Payables | 98.0 |
| Others | 120.5 |
| Current liabilities | 319.4 |
| Finance leases | 35.8 |
| Others | 51.3 |
| Long term liabilities | 87.1 |
| **TOTAL LIABILITIES** | **406.5** |
| Share capital | 119.2 |
| Retained profit | 95.0 |
| Others | 30.1 |
| **EQUITY** | **244.3** |

By contrast, capacity growth is expected to be minimal this year and next, 1-2% pa, affording the airline the opportunity to push up unit revenues. Management are guiding that 2017 yields are stabilising, and that RASK trends will exceed any CASK growth. HSBC analysts anticipate an improvement in net profit to €45m in 2017.

The balance sheet is strong with long term debt being just 35% of shareholders' equity, reflecting largely Aegean's fleet policy of concentrating on operating leases (AerCap and AWAS being the main lessors). Liquidity is also strong with cash and equivalents standing at €249m at the end of last year.

## Greek context

Aegean Airlines' origins were as a tiny turboprop operator in the 1980s flying advertising banners to entertain sunbathers on Greek beaches, then moving into scheduled and charter services in 1999, and growing steadily through the 2000s. Its prime shareholder is the Vassilakis family, and 34% of the equity is listed on the Athens stock exchange.

Until 2009 it was obliged to coexist with Olympic, the larger but grossly inefficient state-owned flag-carrier, which lurched from one financial crisis to another, surviving only because of state aid. When in 2009 the government finally came up with a formula for privatising Olympic, in effect selling off the core assets — brand and airport slots — Aegean was the strong favourite to take over the flag carrier's operations. But the Aegean Board assumed that their company was the only candidate and did not make a formal bid, which was a mistake as the government found an alternative investor — Marfin Investment Group — and Aegean found itself in competition with a new, albeit downsized, Olympic.

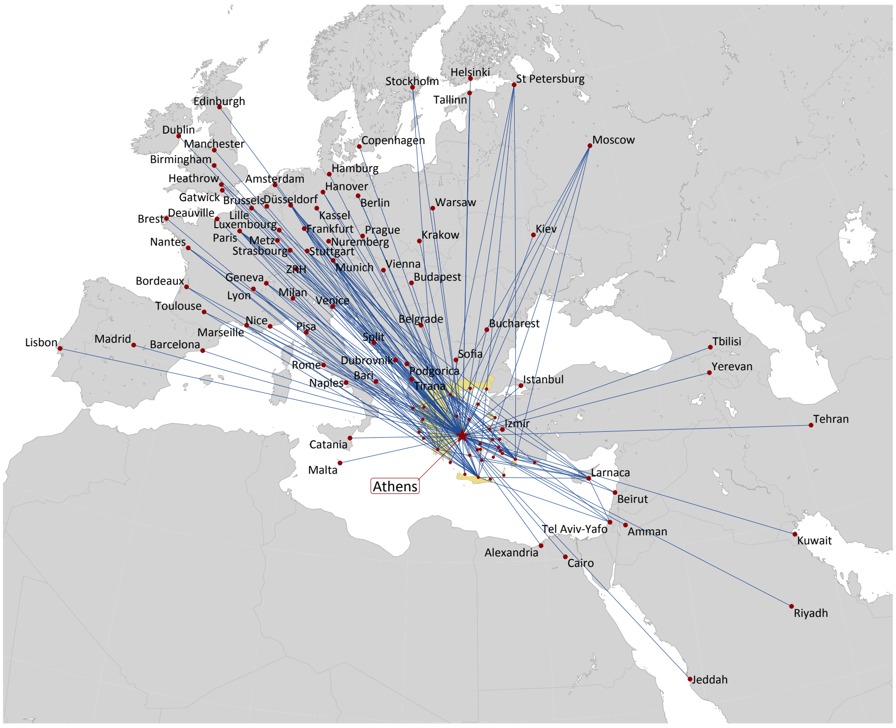
However, it rapidly became clear that the Athens market would not support two similar scheduled carriers, and Aegean was by far the stronger. After protracted negotiations with the European Commission, Aegean took over Olympic in 2013 and consolidated operations over the next two years. The former flag carrier, originally set up by Aristotle Onassis, has in effect disappeared, though the Olympic brand is still used for turboprop operations in the island market.

Aegean has managed to produce profits during a period of perpetual crisis for the Greek economy. In 2008 Greek GDP peaked at $355bn; last year GDP was measured at $195bn. Currently Greece is seeking yet another loan tranche from the IMF, having yet again failed to match the conditions set for the previous loan. The country remains in a debt spiral for which the only realistic solution is a write-off.

Yet alongside the austerity and depression in Athens there are encouraging signs of new commercial dynamism as youngish executives made redundant from the private and public sectors have set up their own enterprises. Tourism is booming — arrivals were up almost 10% in 2016 — as Greece has benefitted from the collapse of the Turkish and Egyptian markets.

Moreover, Aegean is to a large extent protected by the pattern of international sales. According to an

## AEGEAN: NETWORK MAP




## AEGEAN: DOMESTIC NETWORK


*Note: thickness of lines directly related to number of seats operated.*

analysis by HSBC 70-80% of international tickets sales are made in other continental European countries, particularly Germany, while 20-30% are sold in Greece. The determinant of Aegean's traffic demand is therefore GDP or disposable income in northern Europe. The UK market is slightly a different with a 50/50 split, reflecting the greater business component in this market. As for the Cyprus market, where Aegean has established a base at Larnaca, a majority of ticket sales, about 60%, are estimated to be transacted in Greece.

The large majority of Aegean's costs are in euros or dollars and would remain in them if Greece exits the Eurozone, a scenario which is looking less likely now than it did a couple of years ago. As a rough estimate, 30% of its international ticket sales and most of its domestic sales would have to be in New Drachmae, a currency which inevitably would depreciate rapidly. Joining the Eurozone, using very dodgy national accounts, was a mistake for Greece and the EU, but leaving the Eurozone now would be catastrophic for enterprises like Aegean which are essential to the country's fragile economic recovery.

Although Ryanair's rapid penetration of the Greek market is a serious threat, Aegean's competitive profile is more complicated that a simple battle between a higher cost incumbent and very low cost new entrant. As the table on the next page indicates, Aegean competes head to head with Ryanair on the dense domestic routes, where Ryanair has undoubtedly a cost advantage, and is able to adjust capacity to match widely fluctuating seasonal demand much more effectively that Aegean, though the Greek carrier does command genuine brand loyalty.

Interestingly, Ryanair is retreating

slightly from the Greek market this year. It has cut frequencies by half on the key route from Athens to Thessaloniki, Greece's second city and financial centre, because of ongoing delays to extending the runway there.

On most of the other European routes, Aegean competes against full service flag-carriers where it has a distinct advantage in terms of both unit costs and service quality. These are airport pairs which are unlikely to be targets for Ryanair. The main non-flag-carrier competition comes from Air Berlin, which should not be a problem for Aegean.

## Dilemma

The dilemma facing a niche airline like Aegean is whether expand into new risky markets or stick strictly to its home base and risk its market being eroded by low cost newcomers. For Aegean this strategic issue is becoming more critical as it currently has no aircraft on order and its fleet contains a number of, by European LCC standards, elderly units: ten of its A320s are ten or more years old, and management noted a worrying escalation in maintenance costs in its Q1 2017 report.

What is clear is that the Aegean Board is rigorously focused on RoI and shareholder value, as evidenced by the share price performance. The Aegean CEO, Dimitris Georgiannis, has a strong reputation for efficiency (his background was in engineering in Germany).

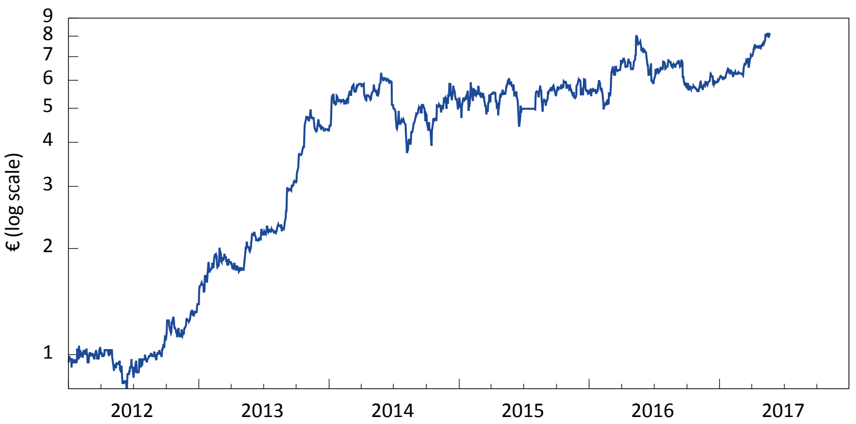
As such, the speculative proposals for Aegean's development can probably be dismissed. These include moving into long-haul: there is a perceived gap in the US-Greece market for year-round as opposed to seasonal service, but it is one that could be better served by Emirates, if the US authorities permit. Besides, as a Star alliance member Aegean has an important role feeding Lufthansa at Frankfurt and Munich. There is also the possibility of taking over Air Serbia's operation, if Etihad pulls out, but Aegean is, rightly, very wary of the Balkan market.

An intriguing prospect for Aegean is the further development of its hubbing operation at Athens. Until relatively recently Aegean concentrated on being a point-to-point airline but its transfer traffic has more than quadrupled over the past six years to 3.2m passengers in 2016, about 26% of the total. In its annual presentation, management highlighted the multiple connecting possibilities through Athens. The airport is well suited to transfer traffic and is operating well below capacity, so it is feasible that Aegean could evolve into a significant hub operator, providing a niche alternative to THY's mega-hub at Istanbul.

MARKET SHARES ON AEGEAN'S TOP 20 ROUTES

| Route | | Aegean | FSCs | Ryanair | Others | Total |
|---|---|---|---|---|---|---|
| Athens | Thessaloniki | 55% | | 44% | 1% | 100% |
| " | Heraklion | 92% | | | 8% | 100% |
| " | Santorini | 65% | | 26% | 9% | 100% |
| " | Rhodes | 64% | | 36% | | 100% |
| " | Larnaca | 69% | | | 31% | 100% |
| " | Mikonos | 77% | | 17% | 6% | 100% |
| " | London (LHR) | 44% | 56% | | | 100% |
| " | Paris (CDG) | 49% | 51% | | | 100% |
| " | Istanbul | 38% | 62% | | | 100% |
| Thessaloniki | Munich | 84% | | | 16% | 100% |
| Athens | Rome | 35% | 54% | 1% | 10% | 100% |
| " | Milan | 67% | | | 33% | 100% |
| " | Brussels | 82% | 13% | | 5% | 100% |
| " | Bucharest | 48% | 24% | 28% | | 100% |
| " | Tel Aviv | 54% | 46% | | | 100% |
| Thessaloniki | Larnaca | 53% | | | 47% | 100% |
| Athens | Frankfurt | 28% | 72% | | | 100% |
| Thessaloniki | Frankfurt | 100% | | | | 100% |
| " | Düsseldorf | 49% | | | 51% | 100% |
| Athens | Madrid | 52% | 47% | | 1% | 100% |
| " | Sofia | 59% | 21% | 20% | | 100% |

AEGEAN: SHARE PRICE PERFORMANCE



# Battle hots up for India's international market

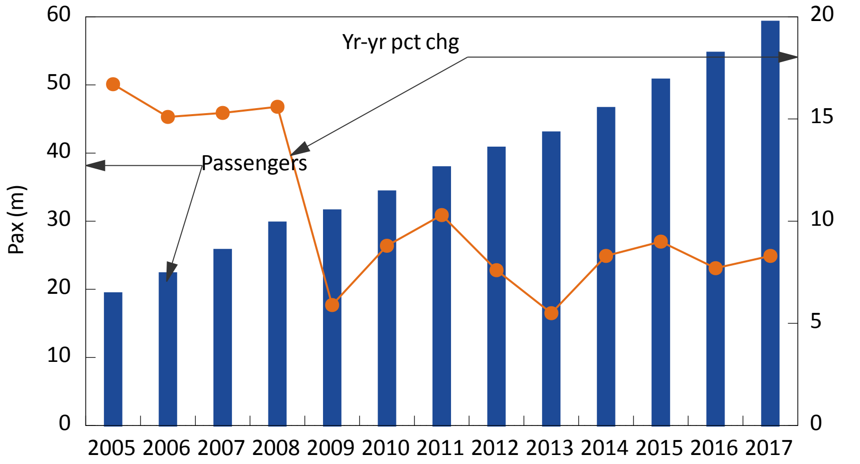
THE INTERNATIONAL market to/from India has tripled over the last 12 years, and is forecast to continue growing significantly for some years to come. How are India's airlines faring in the battle for this lucrative market?

As can be seen in the graph below, the international passenger market to/from India has grown significantly in recent years, more than trebling from 2004/05 to 2016/17 at an average annual growth rate of 9.7% over that 12-year period.

International travel is being driven by India's GDP growth and higher disposable incomes among the country's fast growing urban population, which numbered more than 419m people out of a total population of 1,282m in 2015. That urban percentage in India is less than 33%, compared with a figure of 40% in Africa, 56% in China, 74% in Europe and 82% in North America — so there is still lots of scope for growth in the urban proportion. Even so, in 2015 India had an incredible 58 cities with a population of more than 1m (compared with 56 in the whole of Africa and just 38 in Europe).

The manufacturers consider India to be a key area of passenger traffic growth over the next two decades; in its Current Market Outlook for 2016–2035, Boeing says that India and China are "the main engines of growth" for the Asia region, whose share of world GDP is projected to rise from 31% in 2016 to 39% by 2035. Airbus's Global Market Forecast for 2016-2035 forecasts that the Indian subcontinent-Middle East will be the sixth largest international traffic segment globally in 2035, with its traffic in 2035 increasing by 3.4 times compared with its RPK level of 2015. In fact, according to Airbus's forecasts the Indian sub-continent (ISC) will account for four of the 20 fastest growing traffic flows over the next 20 years, with ISC-China RPKs multiplying by 4.9 times its 2015 total by 2035, followed by ISC-Asia emerging countries (4.1x); ISC-Japan (3.7x) and ISC-Asia advanced countries (3.7x). Incidentally, another top 20 place is taken by the Indian domestic market, whose traffic is forecast to rise by 5.6 times over the 2015-2035 period.

INTERNATIONAL MARKET TO/FROM INDIA



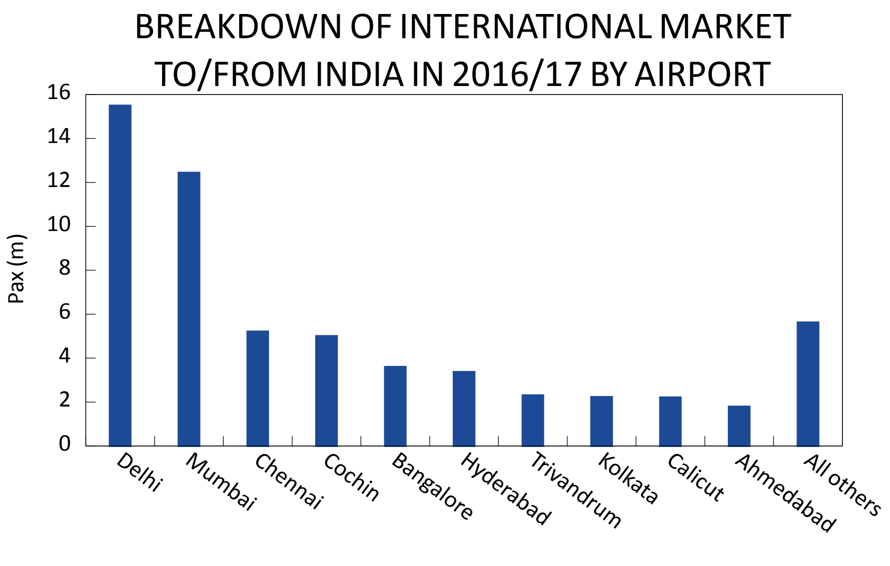

*Source: AAI. Note: Year ends March 31st.*

## Government laggards

Unfortunately, the Indian government has been sluggish in liberalising aviation regulations and funding infrastructure in order to meet this growing demand. It began to liberalise the aviation industry in 2004 (see *Aviation Strategy,* December 2003 and June 2007), leading to the emergence of a number of LCCs (see *Aviation Strategy,* May 2014), but it wasn't until June 2016 that the Indian ministry of civil aviation (MoCA) finally unveiled a much-called for new and comprehensive aviation policy.

That includes (among other measures) a planned increase in the number of commercial airports in the country from 77 to 127 by 2019, and — most crucially — a modification of the 5/20 rule. This had previously mandated a minimum five years of domestic operations and a fleet size of at least 20 aircraft before an Indian airline could launch international operations, and had been heavily criticised as a barrier to international traffic expansion for India.

The new policy eases the restric-




Source: AAI. Note: Year ends March 31st.

tions and enables airlines to commence international routes as long as they deploy 20 aircraft or 20% of total capacity (whichever is higher) for domestic operations.

This will now enable India's airlines to compete better in the international market — between them, India's five international airlines accounted for just 37.7% of international passengers to/from India in the latest available quarterly statistics (for October-December 2016) — see chart on the current page — as provided by the Indian Directorate General of Civil Aviation.

The Air India group (the mainline plus Air India Express) is the market leader, accounting for 16.3% of the international market in that period. Jet Airways is a close second with 14.6%, with two other Indian carriers accounting for 3.7% (IndiGo) and 3.1% (SpiceJet).

The challenge — clearly — is from the three main Gulf competitors, who racked up an 18.5% share of international passengers carried in calendar Q4 2016. Add in Air Arabia, Oman Air and Saudia, and the proportion taken by Gulf carriers rises to 27.4%. The largest international market to/from India is clearly the Gulf states, where significant amounts of Indians work (often in poor working conditions) and who commute home reasonably regularly. Indian airlines also get substantial traffic through passengers connecting via Gulf states to other destinations. However, struggling Gulf economies recently have led to — as Amit Agarwal, CFO and acting CEO of Jet Airways puts it — the "shelving or deferral of projects, which no longer need increased manpower; that is why we have seen a dip in demand for traffic in the Gulf market".

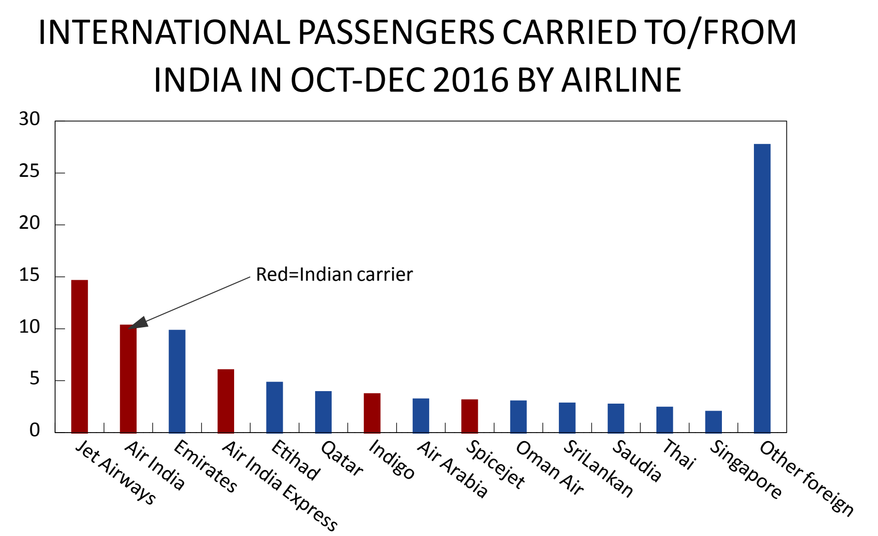
Despite that, in anticipation of better economic times and in an effort to win market share most Indian airlines (and many of their international rivals) continue to pile capacity onto Gulf routes, and thanks to this excess capacity demand must be stimulated through major fare wars — which is resulting in yields falling significantly.

The major long-haul players in India are:

**✈ Air India**

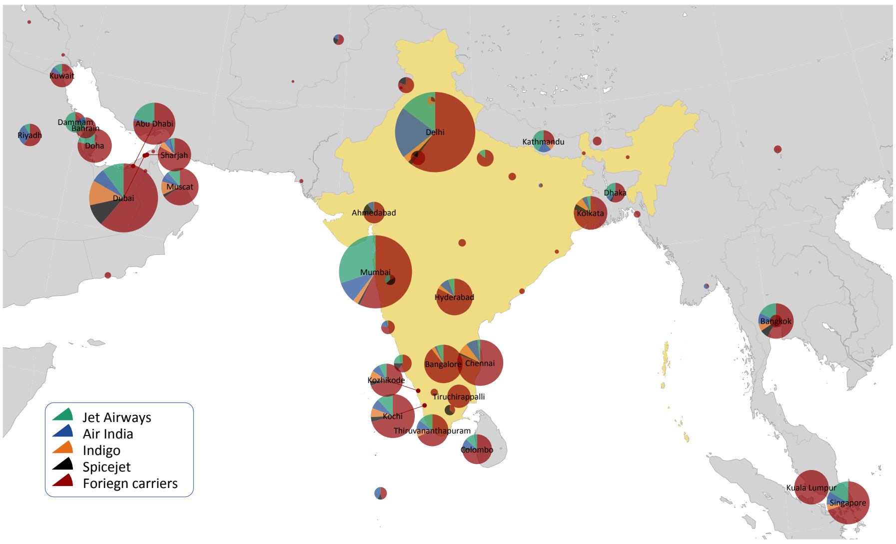
The big beast of international travel is still Air India, which (frustratingly for its rivals) is still in effect being bailed out by the Indian state despite making substantial losses at the net level.

Air India's main hubs are at Delhi and Mumbai, which gives it a major advantage given that of the total 59.3m international passengers carried to/from India in 2016/17, more




Source: DGCA.

TOP INDIAN INTERNATIONAL SERVICES




*Note: area of pies directly related to volume of annual seats scheduled.*

than 47% of them flew through just two airports — Delhi and Mumbai (see chart on the facing page and map above). Another 43% flew to/from eight other airports, meaning that the international market is highly concentrated.

The flag carrier currently offers services to 38 international destinations in 26 countries, based on a fleet of five 747-400s, 15 777s (12 300ERs and three 200LRs) and 23 787-8s. Currently on order are three 777-300ERs and four 787-8s — the former are due for delivery in early 2018 and the latter will arrive by the end of this year. The international network is dispersed and without focus, and covers the US (four destinations), Saudi Arabia (three), the UAE (three), UK (two) Australia (two), Japan (two), Italy (two), Bahrain, Dhaka, Paris CDG, Vienna, Kabul, Frankfurt, Hong Kong, Tel Aviv (launched this May), Shanghai, Kuwait, Yangon (Myanmar), Kathmandu, Malé (Maldives), Muscat, Moscow, Singapore, Seoul, Madrid, Colombo and Bangkok.

The destinations in the US are Chicago, New York JFK, Newark and San Francisco, and a fifth route — between Delhi and Washington Dulles — will commence in July, using 777-200LRs on the almost 16-hour non-stop service. Air India did have a fleet of eight 777-200LRs (with a range of 17,370 km) that were to be at the heart of a significant ultra long-haul network, but those ambitions were scaled back rapidly, and five aircraft were sold to Etihad Airways a few years ago.

In addition, Air India has an LCC — Cochin-based Air India Express — that was launched in 2005 to operate to destinations within a four-hour flying time from the country. It has a fleet of 23 737-800s and operates to 15 international destinations, of which all but three (Singapore, Kuala Lumpur and Dhaka) are in the Middle East, including an operational base at Dubai. However, previous ambitious plans to expand its international routes significantly — i.e. beyond the Middle East to destinations such as Russia and Iran — have, so far, come to nothing.

While the Air India group has (for the moment) a market-leading share of the international passengers to/from India, rivals argue bitterly that this is largely based on state support and the dominant slot positions it has at the two most important international airports in India.

### ✈ Jet Airways

The main competitor to Air India internationally is Jet Airways, which was founded (and is still chaired today) in 1993 by Naresh Goyal, one of the richest men in India (though Etihad Airways bought a 24% stake in Jet Airways for around $380m in 2013). Today it operates to 51 domestic and 22 international destinations, comprising three in the UAE, three in Saudi Arabia, plus Bahrain, Dhaka, Toronto, Paris CDG, Hong Kong, Kuwait, Nepal, Amsterdam, Muscat, Doha, Singapore, Colombo, Bangkok and London Heathrow.

Its main hub is Mumbai, where last year it moved its operations to the new Terminal 2, enabling better connections between its domestic and international networks. The airline's fleet includes five A330s-200s, four A330-300s, four 737-900Ers and 10 777-300ERs, and on outstanding firm order are 75 737 MAX 8s and 10 787-9s, the former of which will be delivered from mid-2018, and the latter of which start arriving from the last quarter of 2017.

In March last year Jet Airways switched its European hub from Brussels to Amsterdam Schiphol, at which it codeshares with KLM on its network across Europe. Jet also codeshares with Delta and KLM to points across North America, and while it isn't a member of any global alliance it is expected to join SkyTeam at some point.

International routes accounted for 53% of total revenue in the October-December 2016 period for Jet Airways, but although international ASKs grew by 13.4% in those months, revenue increased by just 2.5% as international RASK fell by 11.2% in the quarter year-on-year — due primarily to the slowdown of the Gulf economies on the back of lower oil prices since 2015. However, Jet is bullish about its position relative to others, and Amit Agarwal say that "despite this slowdown we have grown our market share to the Gulf, shifting share from our competition".

**✈ IndiGo**

The LCC launched in 2006 by Rahul Batia, owner of Indian conglomerate InterGlobe Enterprises, and Rakesh Gangwal, a former CEO of US Airways, is now the largest Indian airline by passengers carried. However, it focuses on domestic routes, with just seven of its 46 destinations being international — Kathmandu, Muscat, Singapore, Bangkok, Dubai, Sharjah and — from May this year — Doha. That new destination operates from both Delhi and Mumbai, and IndiGo wants to add further Doha routes from Calicut, Cochin, Trivandrum and Chennai as it (along with everyone else) targets the Indian working population in the Gulf.

However, the Gurgaon-based airline (with its main base at Delhi) has 20 A321neos on order (converted in September last year from an order for 250 A320neos made back in August 2015), for delivery from this year. Although Aditya Ghosh, president and executive director of IndiGo, says that the LCC has no plans to launch a long-haul offshoot — insisting that the bigger opportunity is the Indian domestic market and short-haul international destinations — he points out that the 240-seat A321neo could certainly operate to "the further ends of the Middle East or south-east Asia".

This tentative medium-haul strategy would be made redundant overnight if long-held rumours of Qatar Airways buying a major stake ever come to fruition. Qatar didn't participate in Indigo's IPO in November 2015, with Akbar Al Baker, Qatar group chief executive, whining that it couldn't invest in the IPO thanks to "government regulations" and lack of time for Qatar's sovereign fund to participate — adding that that "Qatar is unfairly treated by Indian authorities" in general.

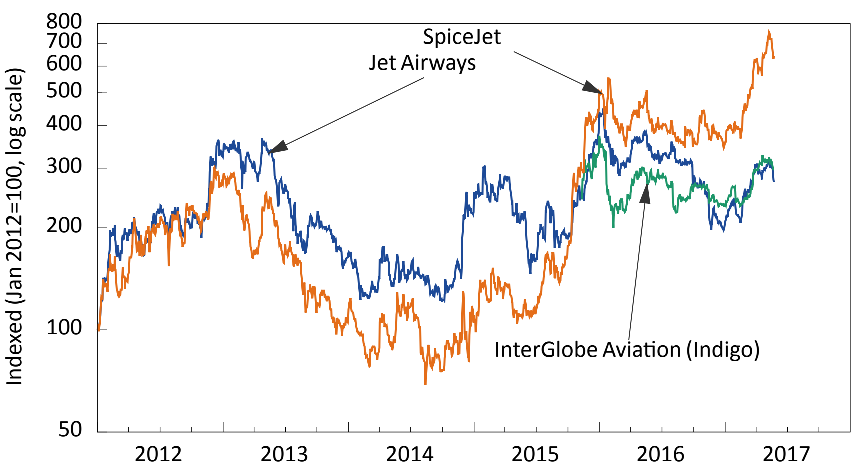
**✈ SpiceJet**

SpiceJet — the second-largest LCC in India — is based at Chennai airport and operates to just a handful of international destinations (seven out of a total of 45): Kabul, Dhaka, Male (Maldives), Muscat, Colombo, Bangkok and Dubai. A daily Kolkata-Dhaka route was launched in March this year, but the airline says it will "aggressively look" at more international routes following its firm order in January for an additional 100 737-MAXs (for delivery over 2018-2024), which brought its total order for the model to 142. SpiceJet is also talking with Boeing over the so-called 10X, the potential stretched version of the Max, which would seat up to 230 passengers and be available around 2020 or later.

**✈ GoAir**

Mumbai-based LCC GoAir operates only to domestic destinations though had always complained about the India's 5/20 regulations, lobbying hard to get them altered and saying that it was very keen to launch international operations. Since these regulations were changed last year there has been no sign that GoAir will fulfil that promise, though potentially it may have run into problems securing traffic rights for the markets it might be targeting out of Mumbai and Delhi. These are likely to be in the Gulf region and neighbouring south-east Asia countries, though with so much international competition out of Mumbai and Delhi the LCC might be better off prioritising international services from second-tier Indian airports.

SHARE PRICE PERFORMANCE



# WestJet: Will the ULCC-within-an-LCC model work?

IN RECENT weeks WestJet has announced two significant strategic moves: setting up its own ultra-low cost carrier (ULCC) for the domestic market and selecting the 787-9 as the future widebody type for global expansion.

The 787 order (10 firm plus 10 options), announced on May 2, was not much of a surprise as WestJet had been in talks with Boeing and Airbus since at least 2015. The 787 has become an aircraft of choice for many LCCs venturing into long-haul markets.

Perhaps the most interesting question regarding the fleet is whether or not WestJet will keep its 767s after the 787s arrive and operate a dual-type long-haul fleet for the foreseeable future.

But the ULCC plans, first announced on April 20 and subsequently discussed at length at WestJet's first-quarter earnings call on May 2, have left many scratching their heads. Why would an established LCC want to set up a ULCC?

The economics of a "ULCC-within-an-LCC" seem questionable. To start with, would it not add too much complexity to a business model that thrives on simplicity?

The North American financial community has not been impressed, especially since the ULCC plans come at a time when WestJet is also focusing on long-haul expansion. In mid-May, most analysts who follow WestJet had a neutral recommendation on the stock.

The headline of a May 2 note from Cowen and Company summed up well the general investor sentiment: "Too much going on to get comfortable". The Cowen analysts wrote that they could see issues with the ULCC cannibalising yields of the mainline operation. They also cautioned about possible growing pains with the 787's introduction and expansion into new markets such as China (a potential destination mentioned by WestJet's management).

WestJet suffered a setback on May 15 when it was announced that its pilots had voted to join ALPA. It was not a surprise; there had been several unionisation attempts over the years, and pilots at all of the US LCCs are now unionised. But the move certainly added uncertainty especially for the ULCC project.

Analysts from Canaccord Genuity pointed out that the unionisation meant that WestJet would have less operational flexibility with the ULCC and widebody expansion. Analysts from AltaCorp Capital noted that it would affect WestJet's ability to drive down costs at the ULCC.

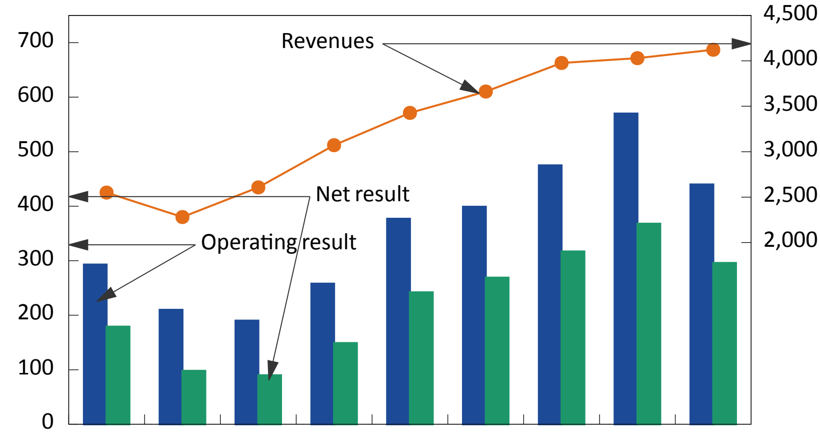
That same day, Moody's revised WestJet's outlook to "negative", citing in part execution risk with the ULCC and the long-haul expansion plans. The rating agency also noted a reduced ability to deleverage the balance sheet.

WestJet is currently not achieving its ROIC targets (more on that in the last section below) and its profit margins could well be pressured when it implements the new projects. However, despite those concerns, WestJet would seem to be a good candidate for further diversification and growth.

First, WestJet has an impeccable profit record, a strong balance sheet, ample cash reserves and investment-grade credit ratings. It can easily fund growth.

Second, WestJet has an award-

WESTJET: FINANCIAL RESULTS (C$m)



winning product, a strong brand and a formidable domestic market position (about 40% of traffic). In its 21 years of operations, it has built enough scale and critical mass in North America to successfully venture into more long-haul markets and experiment with new business models. It is in a much stronger position than the typical point-to-point LCCs in other countries.

Third, WestJet has a history (albeit a short one) of successful diversification. After spending its initial 15-16 years focused on being a high-quality LCC, in the past four years it has moved aggressively to capture business traffic in Canada, launched regional subsidiary WestJet Encore and entered the Canada-Hawaii and transatlantic operations. Those moves involved the introduction of two new aircraft types to supplement the 737 fleet: the Q400 and the 767-300ER.

Fourth, WestJet has proved that it can be successful in the competitive transatlantic market where it does not have much of a cost advantage. In a bold move a year ago, it launched nonstop flights to London Gatwick from six Canadian cities with ex-Qantas 767-300ERs (see *Aviation Strategy*, May 2016).

Fifth, as it demonstrated with the extremely cautious entry into long-haul overwater markets, WestJet likes to plan things well and grow its network at a measured pace. It tested the transatlantic market with seasonal one-stop Toronto-Dublin 737 flights, the Canada-Hawaii market with wetleased 757-200s and the transatlantic 767-300ER operation by first deploying the aircraft on the Canada-Hawaii routes.

Sixth, WestJet needs new growth areas. It does not have the opportunities that US LCCs enjoy in being able to tap the huge US market for domestic and near-international expansion. It is already a major player in Canada, in the key transborder markets and in the Canadian winter sun market to Florida/Mexico/the Caribbean.

Furthermore, many of WestJet's traditional markets out of Alberta and the Prairie provinces have seen adverse macroeconomic trends in recent years because of the slump in the energy sector. With the relative weakness of the Canadian dollar also depressing outbound international leisure travel, it makes sense for WestJet to expand in markets that can generate leisure travel to Canada, such as Europe and Asia (travellers coming from the US tend to fly on US airlines).

Finally, there is a defensive element to WestJet's ULCC plans. Despite being a tough market for new airline entrants, Canada has suddenly become a hotbed of ULCC start-up activity. At least two companies with solid credentials — Canada Jetlines and Enerjet — are gearing up to launch domestic services with fares 30-40% below those of Air Canada's and WestJet's.

The new hopefuls will benefit from an increase in the foreign ownership limit in Canadian airlines from 25% to 49%, first announced in November 2016 and confirmed by the Canadian government earlier this month. Some reports have suggested that the new rules could become effective by the end of this year.

As a result, for example, Enerjet is in talks with US private equity firm Indigo Partners about the latter providing funding and helping it to "fast-track" its development into a ULCC. Indigo has a strong track record in building successful ULCCs; it is also the owner of Frontier Airlines and Chilean start-up JetSmart, and it previously owned or held large minority stakes in Spirit, Tiger Airways, Wizz Air and Volaris.

Previously ULCC ventures in Canada faced an uphill battle to raise sufficient start-up funds. Now, with prominent global investors involved and government policy strongly in favour of competition and more low-fare options for consumers, ULCCs potentially pose a real threat to WestJet. If it does not respond, WestJet could lose significant domestic market share.

## WestJet's ULCC plans

Under the plans announced in April, WestJet is setting up a separately branded ULCC that will target the most price-sensitive traveller. The intent is to move rapidly, with operations starting in late 2017 or early 2018 with an initial fleet of ten "high-density" 737-800s.

The yet-to-be-named ULCC will be flown by WestJet pilots and led by WestJet EVP Bob Cummings, but it does not look like it will have a separate full management team.

With respect to the brand and the expectations in the market, the aim is to keep it entirely separate from WestJet, while relying on the latter for expertise, assets and support services.

The new airline will have a Ryanair-style product and pricing, offering fully unbundled, rock-bottom base fares and charging extra fees for everything. It will provide a "pro-competitive, cheap and cheerful flying experience from a company with a proven track record".

Cost savings will mainly come from a higher seating density on the 737-800s. WestJet plans to increase the seat count from 174 to 189, which it claims will by itself reduce ex-fuel CASM by over 10%.

WESTJET'S FLEET PLAN

| | Fleet | Future deliveries | | | | | | | Fleet |
|---|---|---|---|---|---|---|---|---|---|
| | 31 Mar 2017 | Q2-Q4 2017 | 2018 | 2019 | 2020 | 2021-22 | 2023-27 | Total | 2027 |
| **737-600** | **13** | | | | | | | | **13** |
| **737-700** | **56** | | | | | | | | **56** |
| **737-800** | **46** | 2 | | | | | | 2 | **48** |
| **737 MAX 7‡** | | | | 2 | 1 | 1 | 16 | 20 | **20** |
| **737 MAX 8‡** | | 4 | 4 | | 2 | 3 | 10 | 23 | **23** |
| **737 MAX 9‡** | | | 3 | 4 | | | | 7 | **7** |
| **767-300ERW** | **4** | | | | | | | | **4** |
| **787-9†** | | | | 3 | 3 | 4 | | 10 | **10** |
| **Q400** | **36** | 7 | 2 | | | | | 9 | **45** |
| **Maximum fleet↑** | **155** | 13 | 9 | 9 | 6 | 8 | 26 | 71 | **226** |
| **Lease expiries** | | -1 | -9 | -8 | -5 | -15 | -3 | -41 | **-41** |
| **Minimum fleet↓** | **155** | 12 | | 1 | 1 | -7 | 23 | 30 | **185** |

*Notes: ‡ There are options to purchase another 25 MAX aircraft for 2020-2027 delivery. The MAX 7 and MAX 8 orders can be substituted for one another or for the MAX 9. † Options for another ten 787s in 2021-2024.*
*Source: WestJet*

Offering a no-frills product will also save money. CEO Gregg Saretsky noted that there are "a lot of frills sitting on WestJet", including an Economy Plus cabin, Wi-Fi, free in-flight entertainment, free snacks and beverages and free carry-on bags. The ULCC will charge extra for any frills.

Using WestJet pilots will limit the potential to obtain cost savings. The new unit will not be able to get its costs down to the levels at the ULCCs that are starting from scratch. In the Q1 call many analysts said that they struggled to see the worth of creating a new airline around mainly changes to seat configuration and the way fares are presented.

But WestJet executives insisted that the planned airline would have "significantly lower costs on every line of that business". CEO Saretsky said that its CASM would "approach something closer to 6-6.5 cents from the 10 cents that we're operating today".

Another challenge will be to avoid cannibalising WestJet's own yields. According to the management, that would be accomplished for the most part by not competing head-to-head in the same markets. WestJet knows the Canadian market and all the network flows well. Its analyses and segment evaluations suggested that there is room in the Canadian domestic and southbound leisure markets for both brands and that the ULCC would be accretive to the group's earnings.

The executives indicated that they had studied the Ryanair-style ULCC business model around the world and expected it to be just as lucrative in Canada. After analysing the market and also considering the competitive landscape, the project "made complete sense to us".

In the first place, the ULCC will defend WestJet's market position against new ULCC entrants in Canada. But WestJet also sees it as a growth opportunity as ULCC-type fares can stimulate a lot of traffic. The executives noted that in the US ULCCs account for about 4-5% of system capacity and suggested that a there may be a similar opportunity in Canada.

WestJet also hopes that the ULCC will capture what it calls "cross-border leakage". Apparently some 5.5m Canadians annually cross the border to US airports such as Bellingham and Buffalo to catch flights operated by US ULCCs.

But the ULCC is not going to make much impact with just ten aircraft. WestJet executives said that it was hard to estimate how large it could grow. Canada is a small market, but stimulation from low fares can lead to dramatic growth. On balance, however, WestJet expects the ULCC to remain a small airline, serving a small segment of the market.

The one thing that could scupper the ULCC plans is any change in the stance of the newly unionised pilots. WestJet had already obtained some kind of preliminary approval from its old pilot association, but that will now have to be revisited with ALPA. The executives remain optimistic, given the 21-year history of working collaboratively with the pilots and the growth and career advancement opportunities offered by the ULCC. The latter will include first officers becoming captains and WestJet Encore pilots moving from Q400s to jets (and actually securing pay rises).

The ULCC will not lead to incremental aircraft orders in the foreseeable future. The initial ten 737-800s will all be aircraft that WestJet had previously planned to return to lessors over the next couple of years as the 737 MAXs arrive. WestJet is now in discussions with lessors about keeping those aircraft.

WestJet expects to receive its first 737 MAX 8 in the third quarter and have four of those aircraft in revenue service by the year-end. Another seven MAXs are scheduled for delivery in 2018.

**787 plans**

The management described the 787-9 order in early May as heralding an "exciting new chapter in WestJet's history". It will "diversify the network, de-risk dependence on the Alberta and Canadian point of sales and provide a great new plank of revenue growth".

The 10 firm orders are scheduled for delivery in 2019-2021 and the 10 options are available in 2020-2024. WestJet has selected GE's GEnx-1B engines for the type.The order was possible after WestJet's pilots formally endorsed the airline's long-haul expansion plans in December (though it is hard to see why they would not have approved of such growth).

WestJet's widebody fleet currently consists of four 767-300ERs, which this past winter operated to London Gatwick (from Toronto and Calgary), to Hawaii (from Edmonton and Calgary) and on select transcontinental routes in Canada (including Toronto-Calgary).

The transatlantic operations have been successful, even though WestJet does not have much of a cost advantage on such routes (only through the low ownership costs associated with the used 767s) and the London markets are mature and highly competitive. WestJet has seen very strong demand on the Gatwick routes as it has stimulated traffic with its unique blend of low fares and great service. The initial reliability issues with the 767s were resolved quickly.

WestJet hopes to repeat that success in new long-haul markets with the 787. Two years ago when it launched Glasgow as its first transatlantic destination, it stated that it would become a truly global carrier in the years to come.

The airline notes that the 787's 14,000+ kilometre range will enable it to serve Asia, South America and more destinations in Europe. China was mentioned as a likely good opportunity for the 787s. The Canada-China bilateral is "fairly expansive", though WestJet is not yet a designated carrier.

WestJet will benefit from Canada's great collection of traffic rights around the world, which Air Canada too only began seriously taking advantage of fairly recently. WestJet will have to apply for designation under many open skies ASAs, though no problems are anticipated on that front.

The initial 787s may be deployed to Gatwick, because the type is more suitable to that market than the 767 and could help boost ROIC right from the start.

Interestingly, WestJet expects to operate the 787 in three classes. In addition to the premium economy and economy cabins offered on the 767s, the 787s will also have an "appropriately-sized business class cabin with a few more frills that will disrupt how people think about business travel". Those frills are likely to include lie-flat seats. The management calls it "classic WestJet" or similar to the "value player" approach that has been so successful within North America and that has been tested on the 767s.

The three classes, offerings such as lie-flat seats and higher ownership costs of new aircraft would mean more questionable economics in the 787 operations, but WestJet insists that it will still have a cost advantage over primary competitors.

As with the ULCC, the long-haul cost advantage would largely come from higher seating density. The premium classes could be small. WestJet says that it would also have a "feed advantage" (the substantial domestic network, including Encore) and that it would be relying on sixth freedom traffic flows. A well-developed loyalty programme and airline partnerships around the world will also help.

One of the executives stated in the Q1 call: "We are in a good position at this particular point to go into the widebody market in a bigger way and capitalise on our franchise in Canada and our growing capabilities all the way around."

That said, WestJet also feels that it will be important to keep the size of the widebody fleet modest enough so that the aircraft can be moved around seasonal markets and utilised all year round.

WestJet expects to make the decision on whether or not to keep the 767s as the 787s start to arrive. The airline originally saw them as having a five-year useful life, so the aircraft will be fully depreciated and could leave or stay.

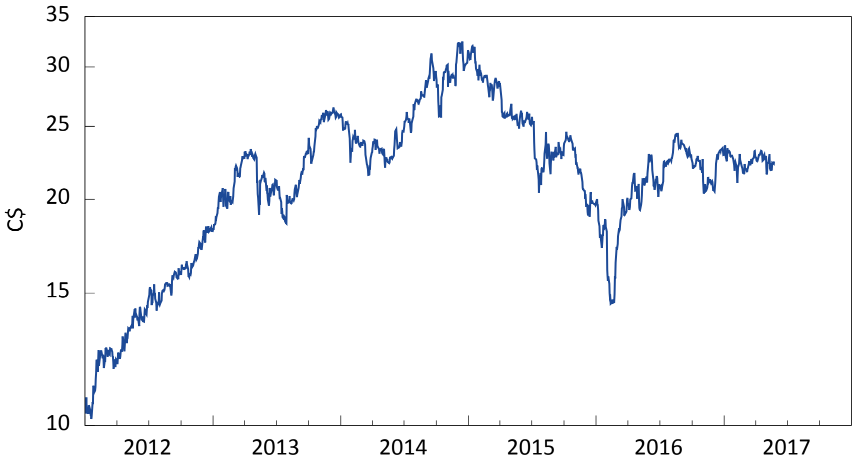
## Financial considerations

While WestJet's operating margins have remained remarkably steady over the years (see chart below), its ROIC declined to 10% in the 12 months ended March 31, which was below the targeted 13-16%. The management is committed to getting ROIC back to the targeted range by improving earnings.

On the revenue side, there are efforts to attract more business traffic and corporate contracts by improving or expanding product offerings. On the cost side, there are two separate seat reconfiguration programmes — one adding several rows of seats to the ten 737-800s destined for the planned ULCC and another adding one row of seats to WestJet's other 105 737-800s.

There has understandably been some concern from analysts that WestJet has so many projects going on that it could further negatively impact ROIC. WestJet has sought to reassure them that it has minimised execution risk by "decoupling" the biggest projects from each other. The ULCC is a 2017-2018 project and the 787 is a 2019 initiative.

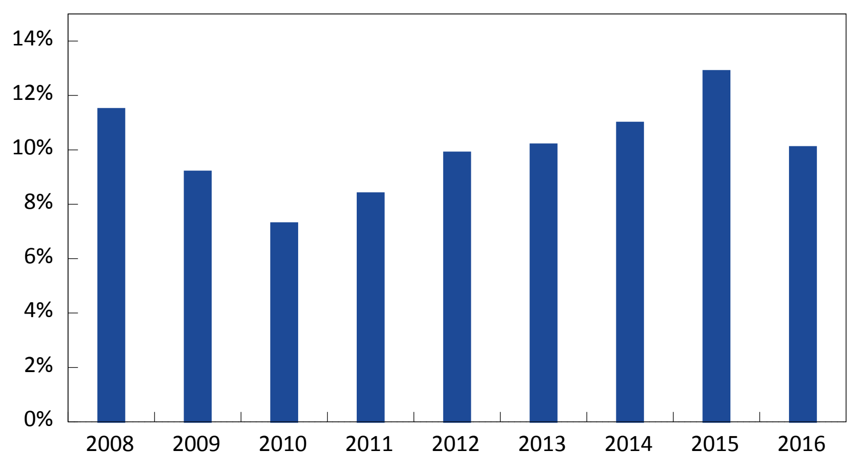
WESTJET: SHARE PRICE PERFORMANCE




While the balance sheet and liquidity remain strong, WestJet has taken action to conserve capital. As part of the 787 deal with Boeing, the airline converted 15 firm orders for the 737 MAX that were due in 2019-2021 to options available in 2022-2024. This will help keep the net debt-to-equity ratio below 2.5.

In the longer term, WestJet believes that it can maximise ROIC by having three distinct products that will address what it considers are the three segments of the airline business in Canada: ULCC, "value player" (classic WestJet) and "luxury segment" (the future product on the 787). This is similar to Delta's thinking: becoming the aviation equivalent of Amazon by catering for every kind of travel need.

WESTJET'S STEADY OPERATING MARGINS

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