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Air France-KLM: où allons-nous?

WE ENCOUNTERED the realisation of two implausible thoughts last year — the British vote to leave the EU and the US election of President Trump. Last month we met another: the outstanding success of the election of Emmanuel Macron as Président of the République Française (with 66% of the popular vote — the highest since Charles De Gaulle in 1959) and the subsequent overwhelming majority of his newly-founded centrist party *La République en Marche!* in the National Assembly, to the virtual annihilation of the established political parties. The new president promises a "new broom" to revitalise the French economy. This could have a dramatic impact on the French corporate sector — even on Air France-KLM.

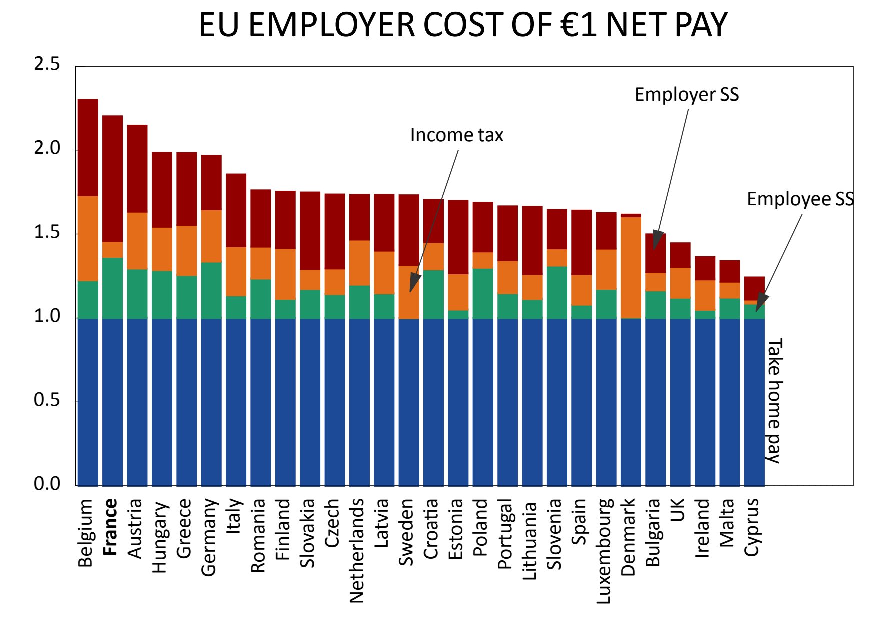
This issue includes

France, despite being the world's sixth largest economy lags in the competitive stakes. According to the World Economic Forum's Global Competitive Index the country comes in a poor 21st place in the world rankings — compared with for example the Netherlands (at no 4), Germany (no 5) and the UK (no 6). Among the elements of core pillars of the survey's criteria it gets marked down especially by lack of labour market efficiency (placed at no 51 in the world, behind Germany at no 22, Netherlands at 14 and the UK at no 5).

Historically France has had rigorous and inflexible labour and employment laws. These generally favour the employee (which is not always *that* bad an idea) but have created an inflexibility perhaps incompatible with 21st century reality as we go through the fourth industrial revolution.

Within Europe the country has one of the highest employer costs — second only to Belgium: according to the annual tax-burden analysis of typical EU workers from the Belgian-based Institut Économique Molinari, in 2015 a French company would have had to pay a total of €2.20 to provide an employee with €1 of take home pay (see chart). This is not the whole story — and excludes the impact of VAT rates, widely varying average incomes and benefits.

In 2016 the French Government under the Hollande presidency tried to introduce a modest increase in flexibility for employers: a relaxation of the 35-hour week to make it an average rather than an absolute limit (and a trigger for overtime



Source: Institut Économique Molinari

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payments); greater freedom to reduce pay; easing of conditions on dismissing workers; more leeway for employers to negotiate holidays and special leave. The proposals led to a series of violent demonstrations and significant opposition in the National Assembly. In the end the law was introduced by decree.

It looks as if Emmanuel Macron wants to go further. His main challenges appear to be to tackle the 10% unemployment rate (nearly 25% for the under-25s), bloated public spending (56% of GDP in France compared with 44% in Germany and 39% in the UK), and generate economic growth.

In the next five years he apparently aims to make budget savings of €60bn so that France sticks to the EU's government deficit limit of 3% of GDP (which it has not achieved since the global financial crisis). He has stated that he wants to cut the civil service employment by 120,000 by natural wastage — or by just over 2% (5.3m people, 21% of the active population, are employed by the state). France's retirement age will remain at 62, but sweeping reforms are planned to the generous state pension schemes, to bring them into line with private schemes. Corporation taxes could be cut from 33% to 25%.

He and his executive will no doubt encounter significant opposition from the militant French unions and the left-wing parties. But with a strong majority in the lower house — and a significant number of political *ingénus* as deputies with backgrounds in the real world — he just may be able to swing it in creating an economic revolution as important to the future invigoration of the French economy as had been the Thatcher reforms in the UK in the 1980s. This is not to say that it would create an Anglo-Saxon economic model, but rather give the opportunity to create the reforms to generate a more liberal economy and maybe even abandon the traditional sclerotic French *dirigisme*.

Meanwhile Macron has also started to try to reinvigorate the Franco-German axis of control within the EU. Germany's Chancellor Merkel is also due to face an election in the autumn, and although seemingly favourite to win a fourth term in power, is sensitive to anti-establishment political views. In May the two agreed to pursue a "common road map" for Europe, neither discounting the possibility of treaty change. It may be unlikely that Macron will win over the Germans to his view of greater fiscal integration in the Euro-area, but his enthusiasm could lead to some form of restructuring and reform of the EU itself. The question may be whether such reform develops into greater protectionism or a significant liberal structural reform.

This would all be somewhat ironic in the light of the British decision to leave the EU, partly for lack of reform; and the UK no longer has any influence in EU decision making.

Macron however is no revolutionary, but a well-entrenched member of the political élite establishment. He is an *énarque* — a graduate of the École Nationale d'Administration (ENA) set up in the aftermath of the second world war to "democritise" the appointment of French civil servants on a meritocratic basis. It only produces 80-90 graduates a year (this compares with the thousands that graduate each year from the Ivy League Universities in the US or Oxbridge/Russell Universities in the UK) but many go on to control politics and business in France.

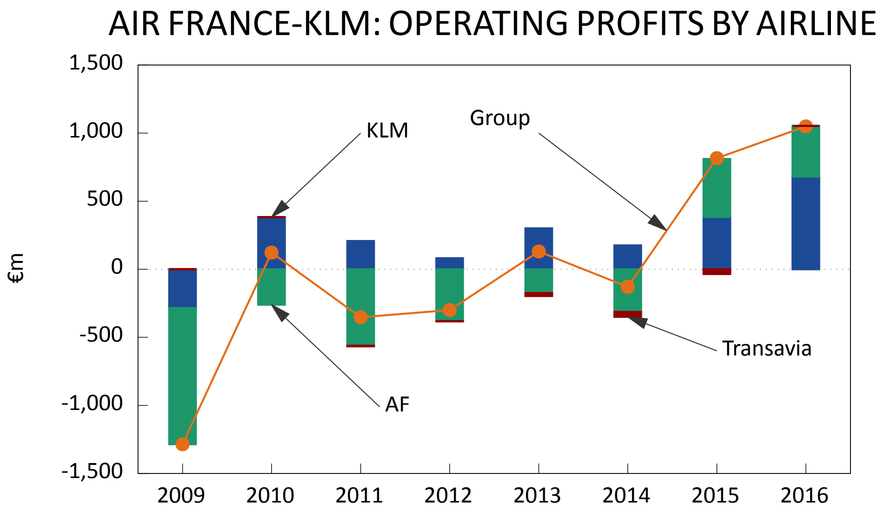
Air France — reflecting the *malaise*

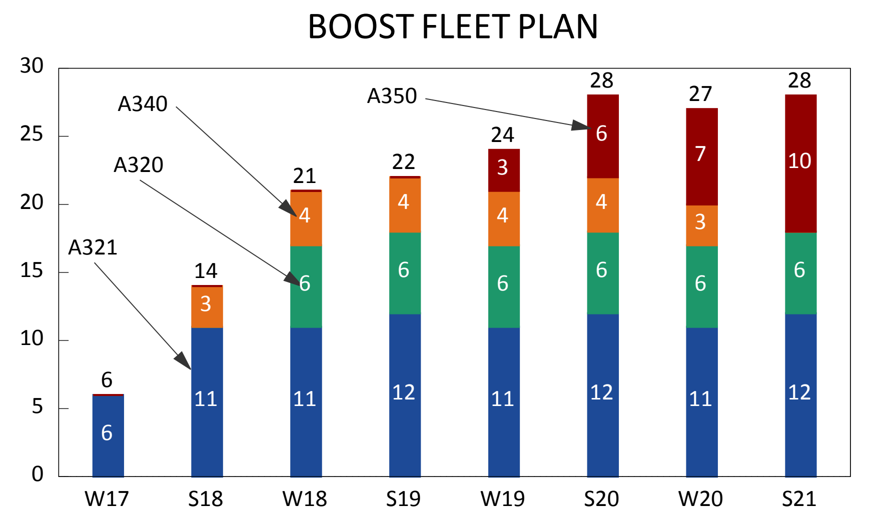
Jean-Marc Janaillac, Chairman and CEO of Air France-KLM, like Macron, is also an *énarque* (interestingly a graduate of 1980 and a contemporary of French political luminaries such as François Hollande, Dominique de Villepin, and Ségolène Royal among others). So also was his predecessor Alexandre de Juniac, who decamped to run IATA; and so too *his* predecessor Jean-Cyril Spinetta who ran Air Inter from 1980 and Air France from 1997. (It is almost as if graduation from ENA is a required qualification for the job.)

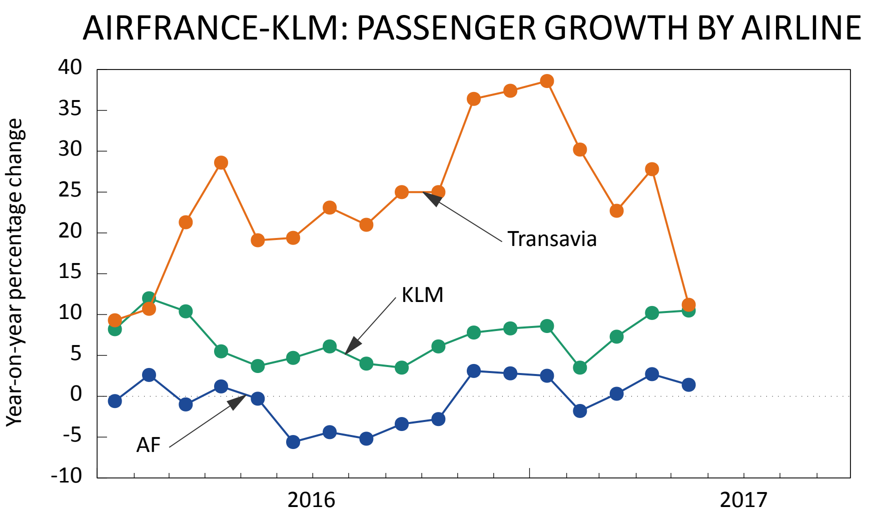
Air France has had severe labour issues going back decades that it has found almost impossible to address. Through the group's various restructuring programmes in the past ten years ("Transform 2015", "Perform 2020" and now "Trust Together") it has attempted to pursuade its unions that there is a need to improve productivity. This has failed and resulted in damaging strike actions by flight and cabin crew.

Three years ago the company took the idea of expanding Transavia France into a pan-European low cost operation. The pilots didn't like the idea of seeing a sister company expand where pilots were paid less or worked harder. The company did open a base at Munich (albeit using Transavia's Dutch operation) — which actually seems to have been doing quite well. But this will close in the autumn and the plan now appears to retrench to operating Transavia out of the respective local markets in the Netherlands and France.

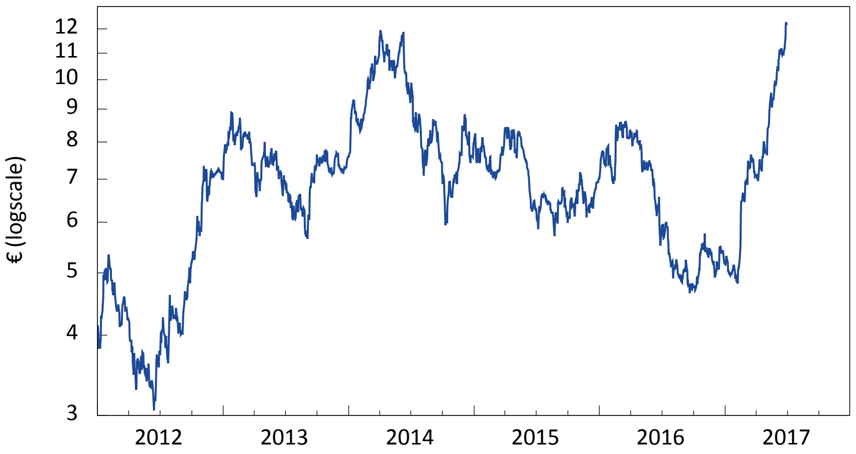
Not but what Transavia has been expanding very strongly (see chart on this page) and Air France has grad-







AIR FRANCE-KLM SHARE PRICE PERFORMANCE



ually been transferring slots at the heavily constrained Orly airport from mainline operations to Transavia. On the whole Transavia appears to have a competitive low cost base: it just hasn't yet been that profitable, although it broke even at the operating level in 2016.

The latest idea is to create a lower cost network airline based at CDG, nominated the "Boost" project (although if it gets of the ground — planned for winter 2017 — it will probably have a more chic brand name). Described as an "ambitious" business plan to develop profitable growth. The company aims to run on unit costs targetted to be 15%-18% below those of Air France itself (from which it would wet-lease the equipment) and have an effective "B"-scale wage agreement for the cabin crew. It is expected to focus on ultra-competitive long haul routes (and operate short haul feed) and account for 10% of Air France's total activity by 2020.

In contrast British Airways managed to pursuade its unions to leave the regulated era more than a decade ago and accept more flexible working conditions (even though it is having a few problems at the moment). Iberia, under IAG leadership, successfully went through a restructuring after the 2008 financial crisis significantly to improve employee productivity. It looks as if Lufthansa's measures in the last few years in pushing through a move to develop a lower cost Eurowings operation is generating the employee efficiency *it* needs.

KLM itself has successfully implemented new collective labour agreements and seen productivity rise by around 5% in the last eighteen months. As CEO Pieter Elbers put it at the group's investor day in May, "KLM has become increasingly competitive" to allow it to grow profitably. Indeed it has seen passenger numbers increase by 10% in the past two years (to 30m in 2016) and has managed to turn around its short haul services into generating profits.

Air France meanwhile has stagnated in the last decade (pursuing what is referred to as "capacity discipline"). In 2016 it (along with HOP!) carried just under 50m passengers, roughly the same as in 2006.

Air France-KLM is still highly geared. The group ended 2016 with a net asset value of €1.3bn almost exactly matched by goodwill and intangibles. Despite the first quarter loss this improved to €1.8bn at the end of March 2017. Against this it has reasonable levels of cash liquidity and has net debt of €3.3bn — but including capitalised operating leases (which will soon be a standard requirement) provides an adjusted debt position of €11bn against very little equity.

While the share price has performed strongly this year amid benign fundamentals, this gearing leaves the group extremely vulnerable to any downturn.

AIR FRANCE-KLM: BALANCE SHEET GEARING

€m	Mar 2008	Dec 2016	Mar 2017
Equity	10,536	1,284	1,762
less Intangibles	(852)	(1,284)	(1,320)
Adjusted equity	9,684	0	442
Gross debt	6,914	7,978	7,834
Net cash	(3,873)	(4,323)	(4,456)
Net debt	3,041	3,655	3,378
Capitalised leases	4,277	7,511	7,651
Adjusted debt	7,318	11,166	11,029
Adj Debt/equity	0.7x	8.7x	6.3x
Adj Debt/adj equity	0.8x	∞	25.0x

AirAsia Group: Consolidation should lead to transparency

AFTER almost going into the red in 2014 during what AirAsia called a "perfect storm" of aviation incidents, geopolitical unrest and natural disasters, the region's leading LCC recovered strongly in 2015 and 2016. But first quarter 2017 results revealed operating profits down by a quarter and a net profit decline of a third. Is the AirAsia Group heading for another troubled year in 2017?

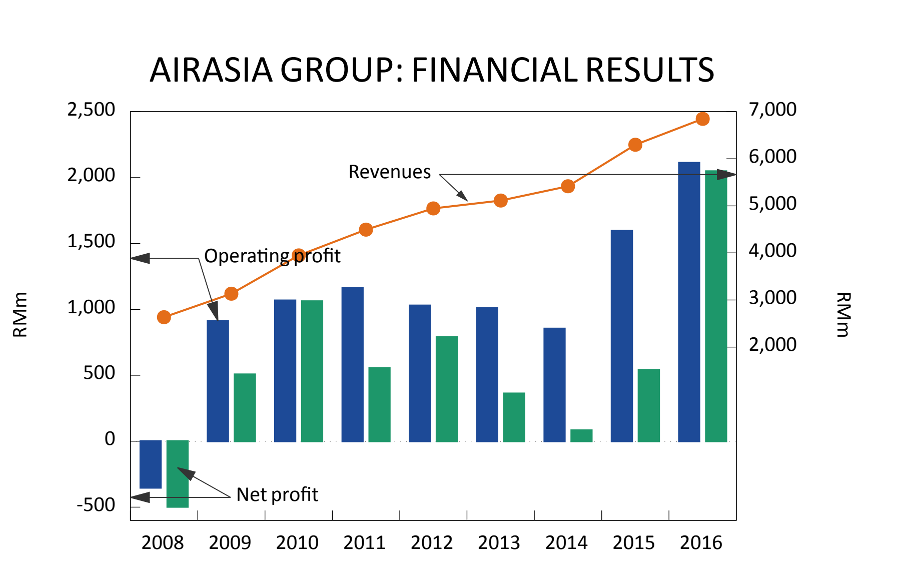
AirAsia is the undoubted pioneer of the LCC business model in the Asian region, and today the group and its associate carriers have a major presence in six countries (excluding the long-haul affiliates AirAsia X, Thai AirAsia X and Indonesia AirAsia X, which are not covered in this article).

It is the largest carrier in terms of seats operated in Malaysia and Thailand — the second and third largest markets in the ASEAN region (see table on page 7) — supplanting the local legacy flag carriers with a capacity share respectively of 25% and 20%, and is the third largest operator in the Philippines with a 10% share of the market.

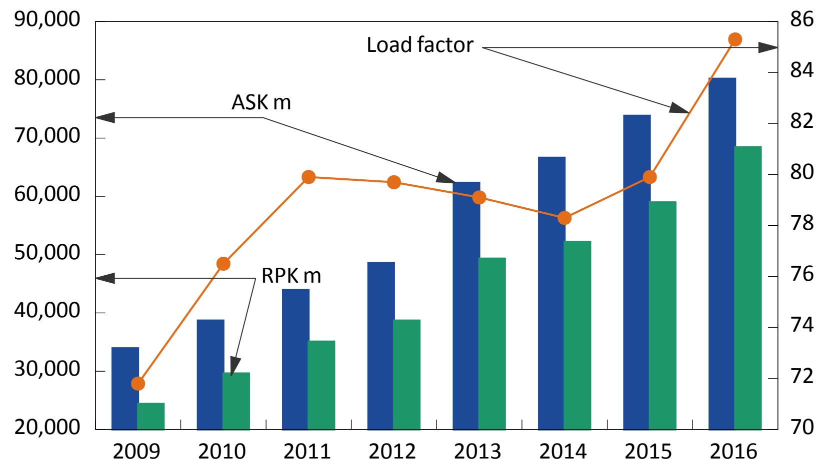
The nub of its problems as it expands in the region is that, while ASEAN has gradually moved towards a region-wide open skies regime, the countries have not reached any agreement on a common regulation for airline ownership and control. Consequently AirAsia's moves into countries outside its home base of Malaysia has by necessity required majority local shareholding investors and has led to a necessariy complicated group ownership structure and an opaqueness in financial reporting (see chart on page 7).

Intriguingly AirAsia has renegotiated some of its shareholder agreements to specify that it does have actual management control over its associates. As a result it has been able to consolidate the results of the Philippines and Indonesian operations and hopes to be be able to do the same for the Thai operations.

This should go some way towards improving transparency in the accounts. There have been some suggestions that the group may float AirAsia Investment Ltd (AAIL) — the vehicle through which it holds the investments in the associate airlines



AIRASIA GROUP: TRAFFIC STATISTICS



— and possibly in a good jurisdiction such as Hong Kong. In the short term it may be more practicable to expect local IPOs (see below).

Following the nightmare year of 2014, in which net profit dropped 77% year-on-year to RM82.8m (US$25.3m) — see *Aviation Strategy*, June 2015 — the AirAsia group made a significant recovery in 2015, posting a net profit of RM541m (US$139m), and followed this up with a substantial net profit of RM2,047m ($495m) in 2016.

However, in the first quarter of 2017, despite a 7.7% rise in group revenue to RM2.2bn (US$0.5bn) operating profit fell 24.3%%, to RM391m ($88m), and net profit decreased by 33.4%, to RM584m ($131m). While passengers carried rose by 6% in the quarter year-on-year (to 9.2m) and load factor increased by 4% (to 89%), unit revenue growth of 3% was swamped by a hefty 14% rise in cost per ASK.

The problem for AirAsia is that there wasn't just one cause of the fall in unit margins, with the airline citing higher fuel prices, staff costs and user charges. The average fuel price for the group was US$67 per barrel in January to March 2017, compared with US$56 per barrel in Q1 2016, while staff costs increased 27% year-on-year due to higher pilots' pay. And user charges rose 17% year-on-year thanks to lower incentive payments from airports.

That is of concern given that an intense focus on costs is clearly at the heart of the group's overall strategy, which have three key pillars and which are all based around themes of "digitalisation" and cost discipline. They are:

✈ **Passenger revenue**: AirAsia claims to be the world's lowest-cost airline (in terms of CASK), and through new associate joint ventures intends to gradually expand its footprint through the Asia region, with a planned 8-10% growth of capacity annually.

✈ **Ancillary revenue**: AirAsia aims to strengthen what it calls its "ancillary income machine", through initiatives such as enabling wi-fi of its entire fleet by the end of 2017; developing "Big duty free" (i.e. inflight delivery of purchases made online); "connection fees" for baggage transfers etc

✈ **Releasing special dividends** for shareholders, via the continuing sales of non-core business. It has announced plans for an IPO of its AACE flight crew training centres. Final bids were due in at the end of May for the sale of its leasing business, Asia Aviation Capital — which we understand has some 50 A320s on its books, all but two leased to the AirAsia group carriers — expected to raise a little over $1bn.

Group airlines

The AirAsia group fleet and the associate airlines in Thailand, India and Japan (but excluding the three long-haul affiliates) totals 180 aircraft, all of which are A320s (see table on the current page). Within the group struc-

AIRASIA FLEET

	A320ceo		A320neo		A321neo
	In service	On order	In service	On order	On order
AirAsia	73	*3*	4	*297*	*100*
AirAsia (India)	10				
AirAsia Japan	2				
Indonesia AirAsia	17				
Indonesia AirAsia Extra	5				
Philippines AirAsia	16				
Thai AirAsia	50		4		
Total	173	*3*	8	*297*	*100*

AIRASIA MARKET POSITION IN ASEAN AND INDIA

	Market size	AirAsia					
Country	(m seats)	Rank	Seats	Share	#1	#2	#3
India	215.9	7	6.2	2.9%	Indigo (27%)	Jet Airways (15%)	Air India (12%)
Indonesia	175.6	4	9.3	5.3%	Lion Air (43%)	Garuda (29%)	Sriwijaya (6%)
Thailand	140.5	2	24.9	17.7%	Thai Airways (18%)		Lion Air (8%)
Malaysia	95.8	1	34.7	36.2%		Malaysia Airlines (23%)	Lion Air (12%)
Singapore	79.6	3	4.9	6.1%	SIA (50%)	Jetstar (7%)	
Vietnam	70.6	4	1.8	2.6%	Vietnam Airlines (39%)	VietJet (23%)	Jetstar (11%)
Philippines	64.5	3	5.9	9.1%	Cebu (33%)	PAL (29%)	
Myanmar	12.2	3	0.9	7.5%	Air KBZ (10%)	Myanmar National Airlines (8%)	
Cambodia	10.6	2	1.3	12.2%	Cambodia Angkor Air (12%)		Vietnam Airlines (11%)
Laos	3.7	3	0.4	10.5%	Lao Airlines (41%)	Vietnam Airlines (12%)	
Brunei	2.2	2	0.3	11.7%	Royal Brunei (77%)		SIA (5%)

ture there are 81 of the model at the Malaysian operation, 17 in Indonesia and 16 in the Philippines. The affiliates add another 54 aircraft in Thailand, 10 in India and two in Japan.

On outstanding order are three A320-200s, 297 A320 neos and 100 A321neos. The A321neos were ordered in July 2016, for delivery from 2019 onwards, and are will be used by AirAsia to provide extra capacity at slot-constrained Asian airports. Of the huge outstanding order book for A320s, 29 aircraft will be delivered through to the end of 2017.

The key strategy for the airlines, as AirAsia Group CEO Tony Fernandes puts it, is: "regional consolidation and streamlining group operations across the board". The group accounts now consolidate the Malaysia, Indonesia and Philippine units (with Thai AirAsia expected to join in the second quarter of 2017), and Fernandes adds that "we are taking a major step to being recognised as one airline, not many — AirAsia as OneAirAsia, sharing a single cost structure and bringing immense benefits in terms of economies of scale".

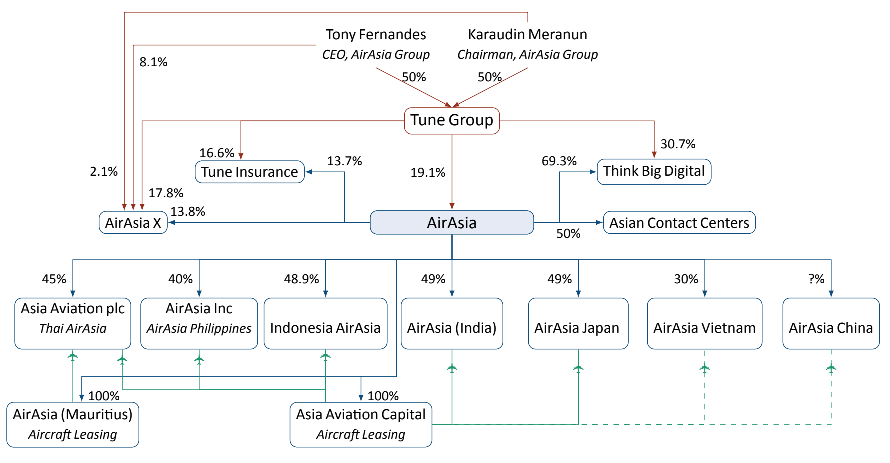
✈Malaysia

Based at Kuala Lumpur, the Malaysian airline is still the most important part of the group — operating to more than 70 destinations from five hubs — though its percentage of total passengers carried on the group's short- and medium-haul airlines has been falling steadily as other operations have built up (see chart on page 5) — from 63% in 2009 to less than 47% in 2016.

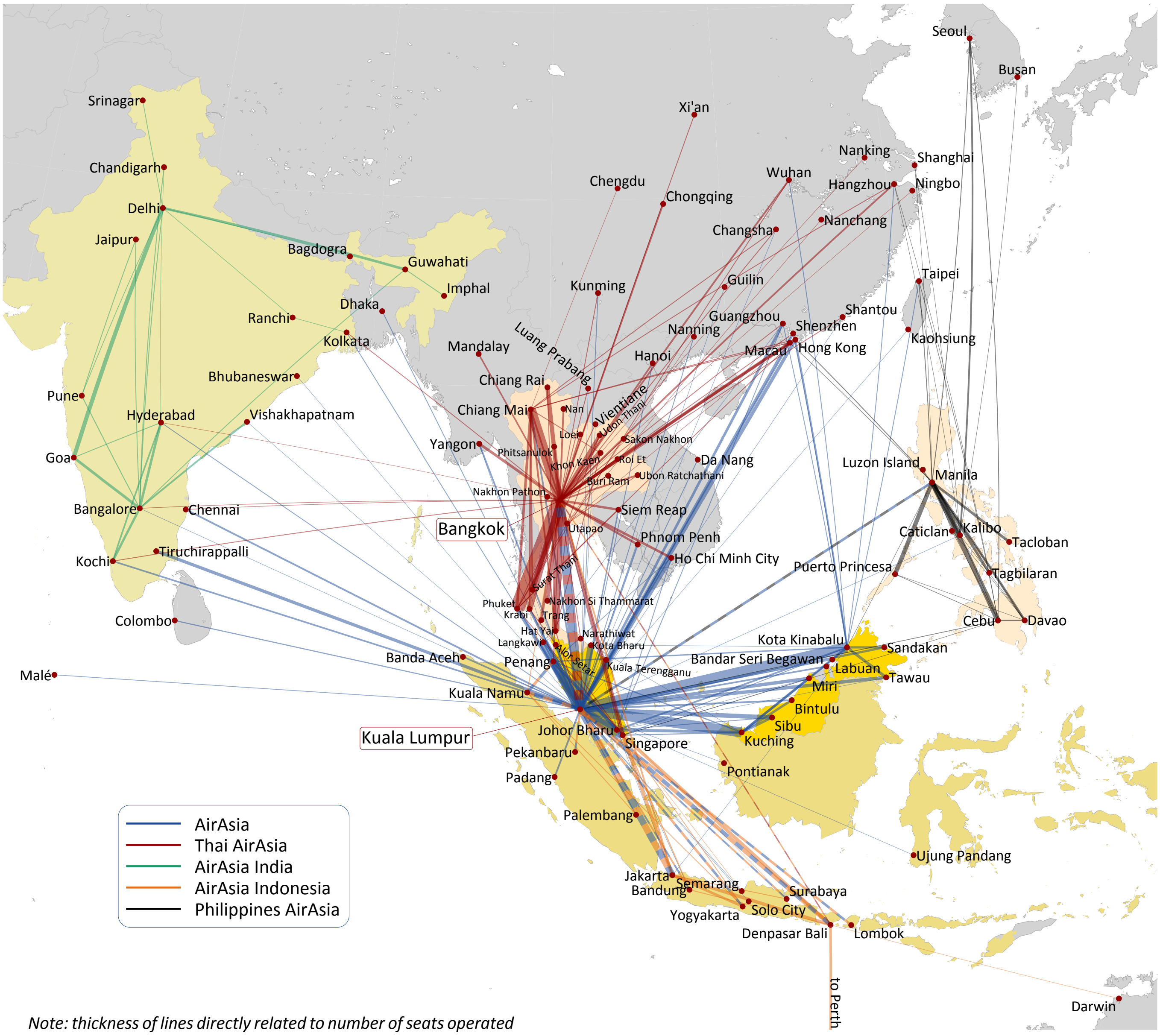
But revenue pressure is growing in Malaysia. Average fares at Malaysia AirAsia had fallen for five years in a row, from RM177 (US$54.9) in 2010 to RM157 in 2015, before improving to RM167m in 2016. However, the average fare fell yet again in the first few months of 2017 year-on-year, from RM175 in Q1 2016 to RM171 (US$38.5) in Q1 2017 — and this wasn't compensated for by a RM1 increase in ancillary income per passenger over the 12-month period, to RM50 (US$11.2) in Q1 2017.

Worryingly, the same trend is seen in the (positive) gap between unit revenue and cost at the Malaysian airline. It fell from 4.48 sen (1.46US¢) in 2011 to 0.67 sen (0.2US¢) in 2014, before rising to 3.09 in 2016 — but in the first quarter of

AIRASIA ORGANOGRAM



AIRASIA: ROUTE MAP



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

2017 the gap shrank to 1.3 sen, which was less than half the 2.45 sen gap achieved in Q1 2017.

✈Indonesia

In Indonesia, the AirAsia airline operates to 16 domestic and international destinations out of three main hubs (Jakarta, Surabaya and Medan), though the group gave no detail of financial performance in the first quarter of 2017.

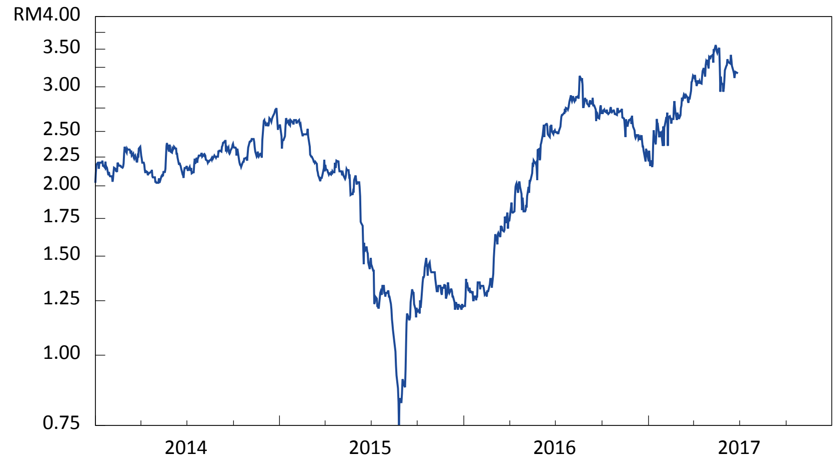
✈Philippines

Operating out of Manila to 16 destinations, AirAsia Philippines reported operating profit of ₱400m (US$8m) in Q1 2017 — its best quarter yet. Passengers carried increased by 19% year-on-year and revenue rose by 41%. The airline aims to double its fleet over the next three years, and this will be funded by a planned IPO sometime in the second half of 2017, which will aim to raise around US$200m.

Associates

The group's share of profits at associates declined 58% in the first quarter of 2017 year-on-year, to RM34m (US$7m), and it's these associate carriers that are consistently proving to be the biggest challenge for the group — partly because ownership of these

AIRASIA: SHARE PRICE PERFORMANCE



carriers is shared with local investors, partly because of their need for cash.

✈Thailand

The group owns 45% of Thai AirAsia (itself 51% owned by Bangkok listed Asia Aviation), which is based in Bangkok and serves just under 50 destinations domestically and through the Asia region. It reported a 2% increase in revenue for Q1 2017 — to ฿9.2bn (US$262m) — although operating profit fell 44% to ฿1.2bn ($34m) and net profit was 43% down at ฿1bn ($28m). The fall in profits was attributed to weakness in the China-Thailand travel market, which saw average fares plunge 9% year-on-year, with ancillary revenue also falling by 4%. It did not help that Thailand increased passenger departure taxes. Altogether, unit revenue fell by 5% in Q1 2017 (compared with Q1 2016), while unit costs rose by 8%.

✈India

The Indian associate saw revenue up 47% year-on-year in Q1 2017, to ₹2.8 hundred crore (US$42m), but AirAsia India posted an increased operating loss of ₹53.9 crore ($8m) — 15% up year-on-year — and a net loss of ₹40.5 crore (compared with a ₹46.9 crore loss in Q1 2016). Again, average fares fell, this time by 7% year on-year, with ancillary revenue per passenger falling even faster, at 17%.

Based at Bengaluru airport, in the south of the country, all AirAsia India's flights are domestic (linking 15 airports), though its intention is to start international services sometime in 2018 now that the restrictive 5/20 regulations have been eased. The AirAsia group has a 49% stake in AirAsia India, with 40% held by Tata Sons and 10% by Arun Bhatia's Telestra Tradeplace.

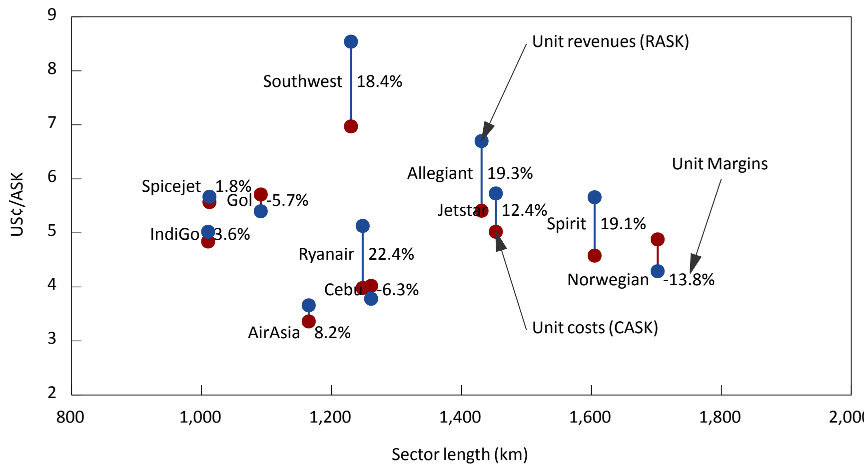
✈Japan

The latest associate is AirAsia Japan, in which the group has a 49% stake and rest being held by an eclectic mix of local investors, comprising private equity company Octave Japan (19%), online retailer Rakuten (18%), aircraft lessor Noevir Holdings (9%) and sportswear firm Alpen (5%). The airline was established in 2016 after a previous venture into the Japanese market in partnership with All Nippon Airways in 2012/13 failed. The Japanese carrier plans to operate from Nagoya from June, initially with a fleet of two A320s, and prior to launch racked up a net loss of RM39.7m (US$9m) in the first quarter of 2017.

China ambitions

In May AirAsia filed an application with the relevant authorities to launch an LCC in China, to be based at Zhengzhou (a city in the east of the country and almost equidistant between Beijing and Shanghai). China is clearly is the biggest aviation market in Asia, but LCC penetration

LCC UNIT MARGINS



Source: AirAsia presentation

is very low, accounting for between 6-8% of total domestic passengers.

However, AirAsia faces many hurdles before it can launch operations (which ideally it would like to do by the spring of 2018). The Big Three (Air China, China Eastern and China Southern) will fight hard against the entry of Asia's most successful LCC into their home market, using their government and lobbying contacts to deny the licence or at worst (from their point of view) to limit the scope of slots and routes that AirAsia might use.

AirAsia will not be intimidated by such opposition, and cites reforms made in the country in 2014 that encourage low cost operations in the country, such as abolishing minimum fare rules and cutting airport fees in many secondary cities. The Chinese government is certainly keen to develop routes into secondary airports as it is investing substantial amounts of capex into its aviation infrastructure outside of the main cities.

The AirAsia group airlines currently operate around 15 routes into mainland China, and its Chinese offshoot would operate in partnership with the provincial Henan government and China Everbright Group, a state-owned financial services conglomerate.

An AirAsia associate airline in Vietnam is also due to launch in early 2018, with AirAsia owning 30% and local investor Gumin (based in Hanoi) having a 70% stake. The carrier will operate routes domestically and internationally out of three bases — Ho Chi Minh, Hanoi and Da Nang. However, AirAsia is late to this market as the country already has two LCCs — VietJet Air (which operates a fleet of 40 A320s and A321s) and Jetstar Pacific Airlines (with a fleet of 14 A320s).

Another potential AirAsia operation is reportedly planned for Cambodia, according to local sources. AirAsia currently operates daily services between Kuala Lumpur and Phnom Penh and Siem Reap, and is adding a route from the Malaysian capital to Sihanoukville from August.

A wobbly 2017

The AirAsia group is not exactly weak financially — as at the end of March 2017, deposit, cash and bank balances totalled RM2,552m (US$574m), 47% higher than 12 months previously and partly thanks to a share issue that raised RM1bn ($226m). Total debt for the group stood at RM10.3bn (US$2.3bn) — some RM331m ($74m) less than a year previously.

Nevertheless, following the fall in profitability in the first quarter, analysts will look closely at April-June results when they are released sometime in August.

A key indicator as to how AirAsia will fare through the rest of 2017 will be given by how successful the group has been in driving further cost savings among its airlines. A further annual cost reduction of $45m (called the "Power of One" programme) is being targeted through tightening of operating expenses at all group airlines (ranging from annual cost savings of $2m in Japan to $14m in Malaysia), plus an annual group procurement saving of $14m — so the group is clearly indicating that it can recover quickly from the bumpy first quarter by yet another tranche of cost cutting.

Asia's aviation drama in numbers

RECENT and forecast traffic growth in the Asian region is normalised at 5%-plus, more than twice the market growth rate for Europe and North America. But the Asian market is diverse and fragmented with contrasting trends in different countries, as this overview of capacity trends illustrates.

The analysis is based on crunching schedule data for the period 2010-2016, then identifying trends by various carrier groups (there is always a grey area in classifying airlines, but we tend to be quite restrictive in defining LCCs, excluding hybrid type carriers which may claim low cost status). Five countries are included — Malaysia, Indonesia, Philippines, India and Japan — covering the main economies in the three key sub-regions — SE Asia, South Asia and NE Asia.

ECONOMIC INDICATORS

	GDP/Capita (US$ 2016)	Real GDP Growth (2016 est)	Population (millions 2016)	Total Seats (Dom& Int) (millions 2016)
Malaysia	9,545	4.30%	32	90
Indonesia	3,635	5.00%	258	172
Philippines	2,991	6.40%	104	59
India	1,718	7.60%	1,309	195
Japan	37,800	0.50%	127	260

Source: IMF

The overall picture is condensed into the table below: a 7.2% average annual growth rate, 7.4% for the domestic markets and 6.8% for the international markets. The market share of the flag-carriers (excluding low cost subsidiaries) has fallen sharply — from 46% of the total in 2010 to 32% in 2016 — and their capacity in absolute terms has stagnated (to be precise it has risen at just under 1% pa). Growth has been generated mostly by the new wave of LCCs but also by low cost subsidiaries, the Middle East superconnectors and Chinese carriers — in total 11% average growth for 2010-16.

As in Europe, it is clear that the Asian flag-carriers, no matter how uncommercial, are not going to be allowed by their governments to exit the market. At present cross-border mergers seem totally unfeasible, so managed decline is probably the best outcome for the flag-carriers.

The extent to which the traffic growth comes as a direct consequence of economic growth or from price stimulation or as a result of diversion from other modes is almost impossible to discern exactly. However, the three factors tend to reinforce each other. For instance, Japan's stagnant economy growth is matched by timid experimentation with LCCs, and traffic growth, domestically at least, has been very depressed. India, at the other extreme, has experienced buoyant GDP growth, albeit from a very low base, with new air travel demand further boosted by capturing passengers

MARKETS AND FLAG CARRIERS

	Total market 2016 Seats (m)	Annual Growth 2010-16	Flag carrier(s) Share 2016	Change from 2010 (% pts)
Domestic				
Malaysia	32.1	5.9%	34%	-13
Indonesia	132.1	14.5%	21%	-2
Phillipines	29.6	5.8%	31%	-12
India	126.1	10.5%	15%	-6
Japan	153.8	2.0%	78%	-12
Total domestic	**473.7**	**7.4%**	**39%**	**-16**
International				
Malaysia	57.6	6.3%	19%	-9
Indonesia	39.6	7.8%	15%	0
Phillipines	29.5	8.2%	27%	-22
India	69.4	6.3%	17%	-13
Japan	106.1	6.8%	21%	-3
Total international	**302.2**	**6.8%**	**19%**	**-13**
TOTAL	**775.9**	**7.2%**	**32%**	**-14**

Note: Flags = MAS, Garuda, PAL, Air India/Indian AL, JAL & ANA. Does not include low cost subsidiaries.

from the huge, slow railway network. This has proved to be an enticing combination for the multiple LCC new entrants after liberalisation of the air transport system, and domestic growth has surged (though individual airline profitability is another matter).

Populations and GDP per capita are useful markers for defining markets, and for highlighting the huge variations between countries, but are of limited use when trying to understand the dynamics of the rapidly growing and structurally changing aviation scene. Detailed demographic analysis — specifically the volume of citizens gravitating to the "flying middle class" tranche, or dropping out of it through old age in Japan's case — might provide a stronger guide to future trends.

Malaysia

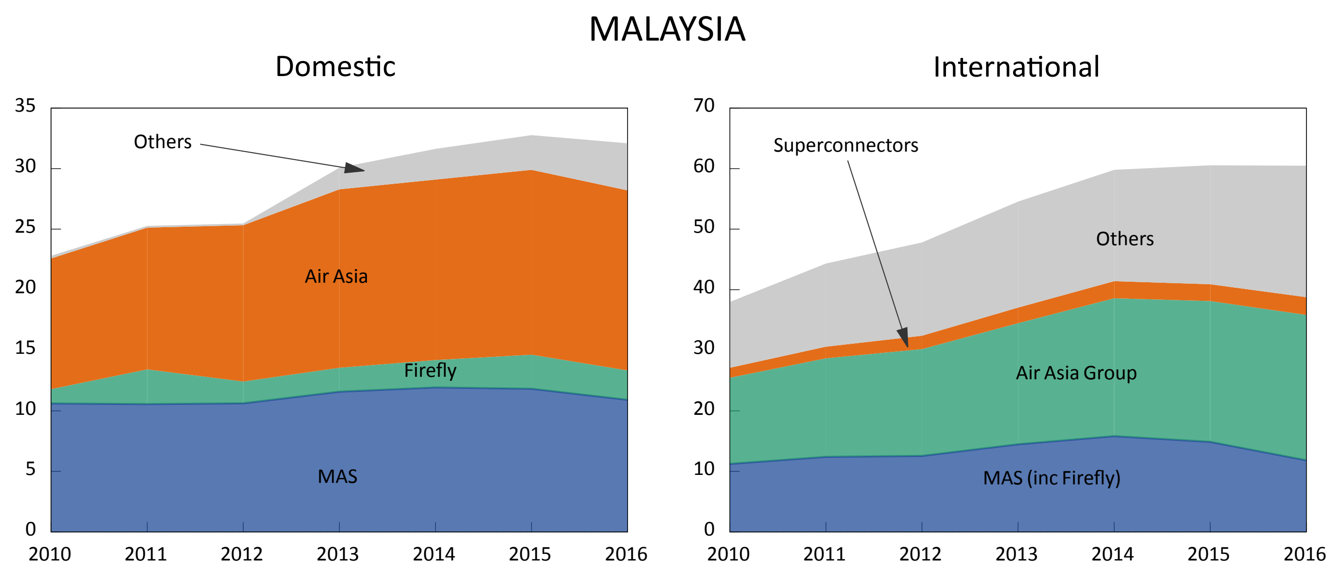
In population terms Malaysia is small (32m) relative to other Asian countries, which explains the necessity of AirAsia's multi-country, multi-airline strategy. Domestically, the region's first genuine LCC, modelled on Ryanair, has grown at just 5.5% during 2010-16, partly the result of the "perfect storm" that hit its expansion in 2014. It is, however, the largest airline domestically with a 46% share. MAS, has not added any net capacity over this period and has seen its share dip to 34%, but its low cost subsidiary, Firefly, has filled some of the gap, accounting for about 8% of the market in 2016. Malindo, a Malaysian-Indonesian joint venture, is Lion Air's response to Air Asia's expansion in the Indonesian domestic market; rapid growth has taken this LCC to around 12% of the domestic Malaysian market. In total, the domestic market grew at 5.9% pa during 2010-16.

Internationally, MAS's capacity was roughly the same in 2016 as it was in 2010, which is not a bad outcome given the two tragic accidents it suffered and its fundamental financial weakness. Its share has dropped to just 19% of the total market. The AirAsia airlines, including AirAsia X and the Indonesian, Thai and Philippine associates, have grown strongly, at 9% pa, taking the group's share to 42% in 2016. The Middle East superconnectors have expanded solidly at about 10% pa, as has SIA's full service subsidiary, Silkair. In total, the international market grew at 7.2% pa during 2010-16.

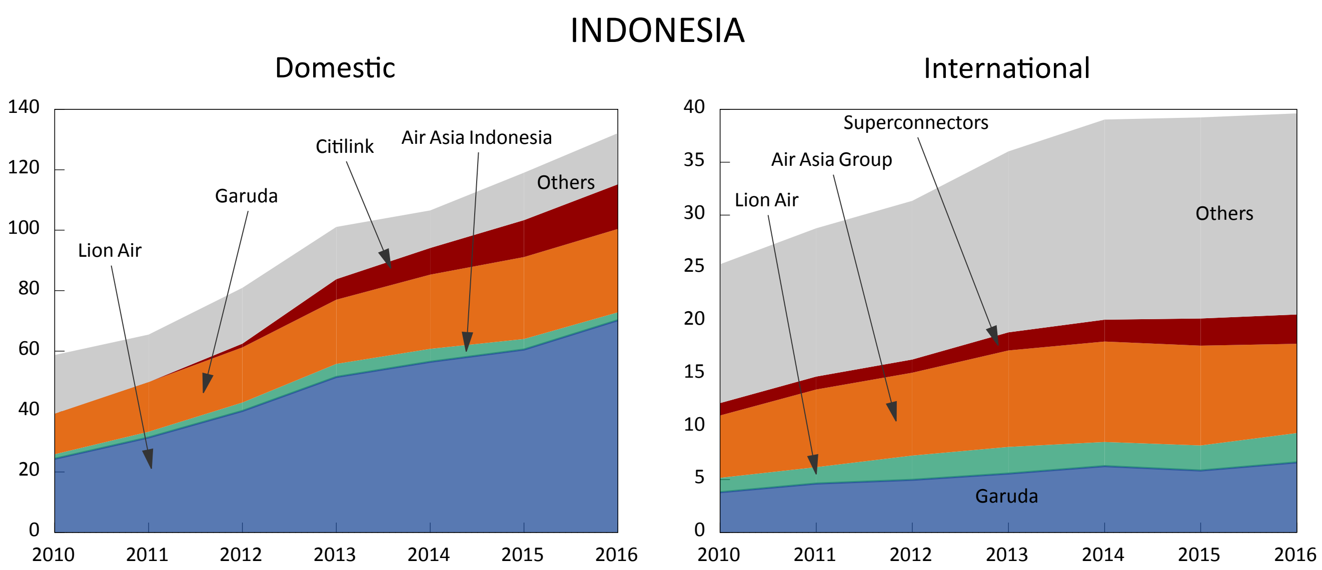
Indonesia

Indonesia is the "I" in MINT, the group of countries also comprising Mexico, Nigeria and Turkey which were identified by Goldman Sachs as representing the newest wave of global economic growth. Politics have dented that prognostication somewhat, but Indonesia, with consistent GDP growth of at least 5% pa, a huge population on the archipelago (258m), and a well-established tourism industry in Bali, should have strong air traffic growth. It does: seat capacity in the domestic market grew by a remarkable 14.5% pa during 2010-16.

Lion Air, record orderer of A320s, has driven the domestic market, expanding at an impressive 19% pa to



Note: Scheduled one-way seats 2016 in millions

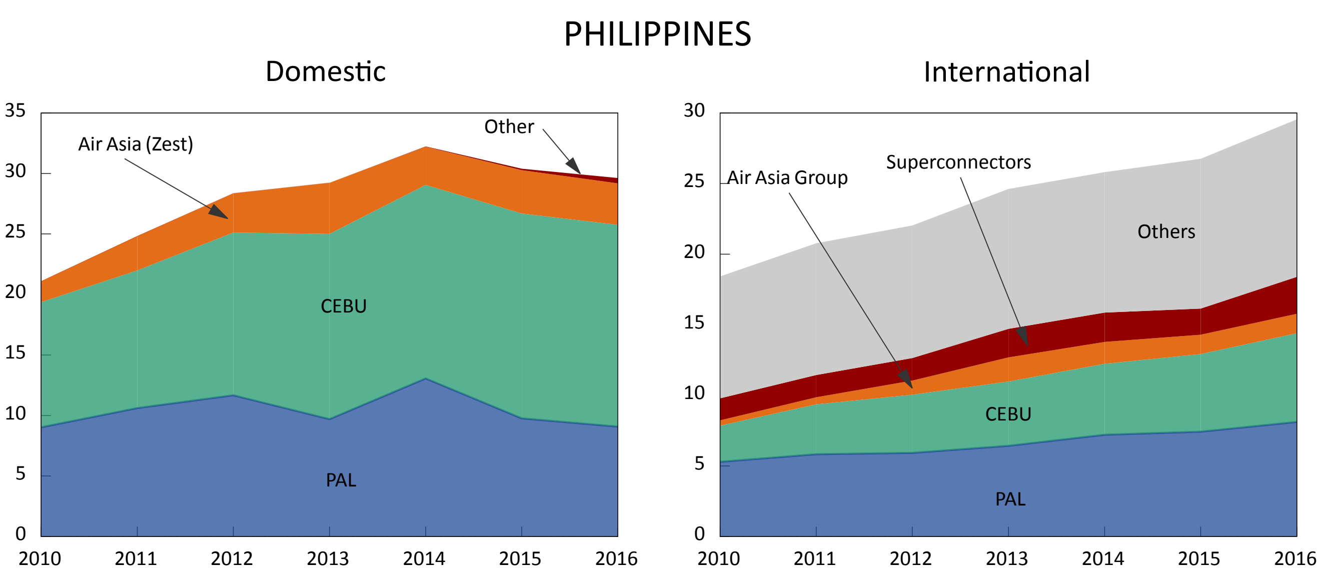


Note: Scheduled one-way seats 2016 in millions

achieve a capacity market share of 53% (Lion Air includes its owned affiliates, Batik and Wings). AirAsia Indonesia has also grown, about 9% pa, but its market share is very modest — just 4%.

Remarkably the flag carrier Garuda has grown at 13% pa domestically during this period. Add in its low cost subsidiary, Citilink, which was spun off in 2012, and the group's market share was 32% in 2016, up from 23% in 2010. The period 2010-16 coincided with Grauda's five-year turnaround plan — codenamed "Quantum Leap" — which has seen a doubling in the fleet and an aggressive attempt to recapture business lost in the previous ten years. In capacity terms the growth is impressive but there is little evidence that it has translated into profitability.

Internationally, The Indonesian market grew at 7.5% pa overall during 2010-16. Garuda resumed a significant number of routes previously suspended (partly because of safety



Note: Scheduled one-way seats 2016 in millions

issues) and grew capacity at 7.4% pa to maintain its market share at a modest 15%. Lion Air's and the Air Asia Group's positions in the international market are the reverse of the domestic situation: shares of 6% and 24% respectively, though they exhibit similar growth rates of 8-10%. The biggest movers have been the superconnectors, growing at 14% pa to establish a 7% market presence.

Philippines

The Philippines is another hugely populous country (104m) but one of the poorest in SE Asia. GDP growth has been around the 6% pa mark, but this has only translated into a similar, 5.8% pa, domestic growth rate over the 2010-16 period.

PAL is a large part of the reason for this sluggishness. The loss-making flag-carrier's growth rate has been precisely 0% domestically since 2010. Its market share is down to 31% in 2016 from 43% in 2010, yet political support from the government remains strong. CEBU is clearly the dominant force in the domestic market — growing at 8% pa to achieve a market share in 2016 of 56% (including affiliates). AirAsia, operating under the local brand Zest, has also established a sizeable market position — a 12% share in 2016.

Internationally, PAL has been growing steadily — at 7.4% pa — but not quite matching the overall market rate of 8.2%, though it still has the leading position with 27% of seats offered. CEBU has been very aggressive — 16.1% pa growth and a capacity share of 21% in 2016. The AirAsia Group has expanded rapidly but from a small base and its share has just reached 5%.

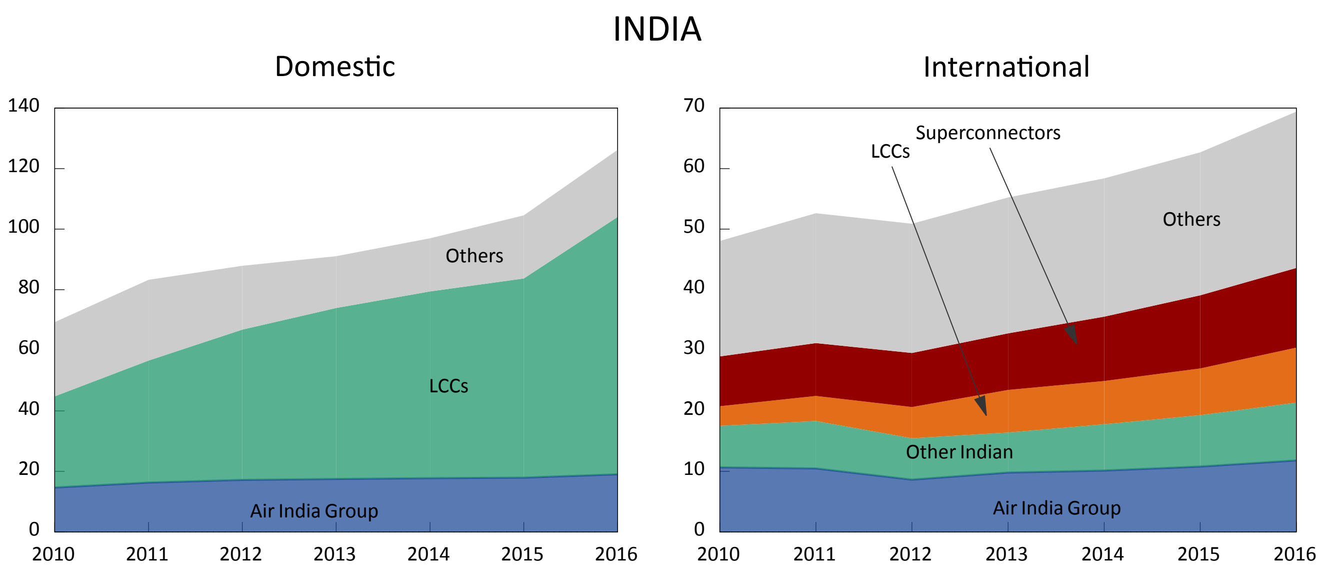
With strong migrant labour flows the Middle East superconnectors have been expanding in the Philippine market by about 9% pa and have a 9% capacity share. This sector is softening as economic and social problems increase in the Middle East.

India

The regional superpower, exhibiting dynamic economic growth, is now demonstrating powerful aviation growth after decades of suffocating regulation and protection for the national airlines. Domestically, the 2010-16 capacity growth rate averaged 10.5% during 2010-16.

The wave of new LCCs — Indigo, Spicejet, Go, JetLite, Air Asia India, and Vistara — have driven this expansion. In total they grew an 18.9% pa during 2010-16 and now account for 67% of the internal market, though only Indigo as yet has demonstrated an attractive RoI. Given the emergence of, in local terms, an affluent middle class, somewhere between 100 and 200m in a total population of 1.3bn, the vibrancy of the Indian IT industry, the attraction of its tourist destinations, and the evident superiority of air transport over railways and roads, there is no reason why this type of growth cannot be sustained.

Meanwhile, the once dominant Air India/Indian Airlines has seen its share of the domestic market fall from 22% in 2010 to 15% in 2016 (this includes Air India Express/ Alliance Air). Surprisingly, the Indian government now seems to be proposing to



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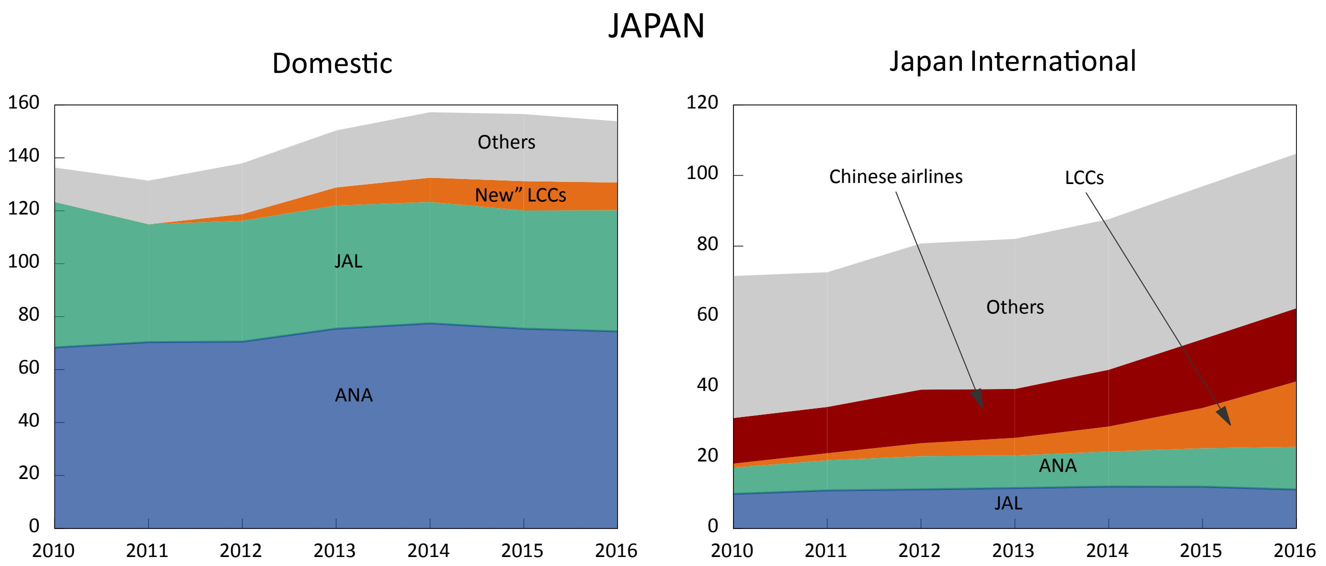


Note: Scheduled one-way seats 2016 in millions

privatise of the national carrier. There are some high profile names in the "others" group — Jet Airways, part of the Etihad empire, has just about maintained its share of the domestic markets, while Kingfisher has soared and crashed.

The international market remains constrained by bilaterals and has grown in capacity terms by "only" 6.3% during 2010-16. Yet the LCCs are expanding aggressively here as well — all LCCs, Indian and others, notably Air Arabia, flyDubai and Air Asia, have in total grown by 18.7% pa, taking their capacity share to 13% in 2016. This compares with 17% for Air India and 14% for other Indian airlines, mostly Jet. India is the key market for the Middle East superconnectors whose annual capacity growth of 8% has won them a 19% share of seats to/from India.

Japan

Japan contrasts with the rest of Asia — very affluent in terms of GDP/capita, but economically stagnant for over ten years, a declining population, and continuing market control by the two national carriers — JAL and ANA.

In the domestic market ANA has grown at 1.4% pa and JAL has fallen by 3.0% pa during 2010-16, yet the two carriers still command 78% of capacity, which is down from 90% in 2010. The new LCCs have achieved a modest 7% of the market, and they are in effect controlled by the two majors — Peach and Vanilla by ANA, while Jetstar Japan is joint venture between JAL and Qantas. Even the other domestic airlines — Air Do, Skymark and Fuji Dream, for example are tied into the majors through co-operation agreements. It is difficult to see how the domestic market can be revitalised, and the regional airport privatisation plan accomplished, with this status quo. The total domestic market grew by just 2% pa during 2010-16. Things have to change in this huge market of 154m seats, but change will be managed in a uniquely Japanese manner.

The international market is somewhat different — a 6.8% pa capacity growth 2010-16. Much of the growth has been driven by Chinese carriers, at 8% pa, which now have a 20% share in the Japanese international sector, compared to 21% for JAL and ANA combined. The future of air travel to/from Japan increasingly depends on Chinese tourism, and that is not a comfortable prospect for many Japanese politicians.

LCCs have come from nowhere to take 17% of the international market in 2016. These LCCs include the ANA/JAL subsidiaries, Chinese carriers Spring and Okay, the AirAsia Group, Scoot, SIA's subsidiary, and the South Korean airlines, Air Busan, Eastar and Jeju.

Mexico's LCCs: The Trump effect

THE PAST 10 months have been eventful on the Mexican aviation scene, with the US-Mexico open skies regime coming into force, Delta and Aeroméxico launching their immunised joint venture, President Trump's pronouncements hitting the Mexican peso, business sentiment and travel demand. How are the leading LCCs – Volaris, Interjet and VivaAerobus – dealing with all this?

Trump's protectionist trade policies and anti-immigration rhetoric, including his campaign promises to build a wall on the US-Mexico border and terminate the North American Free Trade Agreement (NAFTA), seemed like devastating blows to Mexico's economy. Business confidence declined, investment plans were put on hold and the Mexican peso plummeted.

The peso, already volatile, fell by 14% against the US dollar in the week after the election and by a further 6% by mid-January, to bottom out at around 22 pesos to the dollar.

Fortunately, though, Trump has had to soften his policies or has found his proposals blocked or delayed in Washington. In April he conceded that NAFTA can be renegotiated and that the talks will be sensible and gradual. There will be no mass deportations of Mexicans. Scant progress has been made on controversial proposals such as funding the border wall or imposing a 20% tax on imports.

As the economic threats on Mexico have diminished, the peso has gradually strengthened. By June 20 it was back to its pre-election level of 18 to the dollar. The peso is still weak by historical standards; three years ago it was at the 13 peso level (see chart below).

The peso's depreciation against the US dollar (about 13% year-on-year in Q1) played havoc with Mexican carriers' first-quarter financial results. The airlines have up to 60% of their costs denominated in US dollars (fuel, aircraft rentals, etc), so they have seen terrible cost headwinds and foreign exchange losses. The four largest carriers all reported losses for the period.

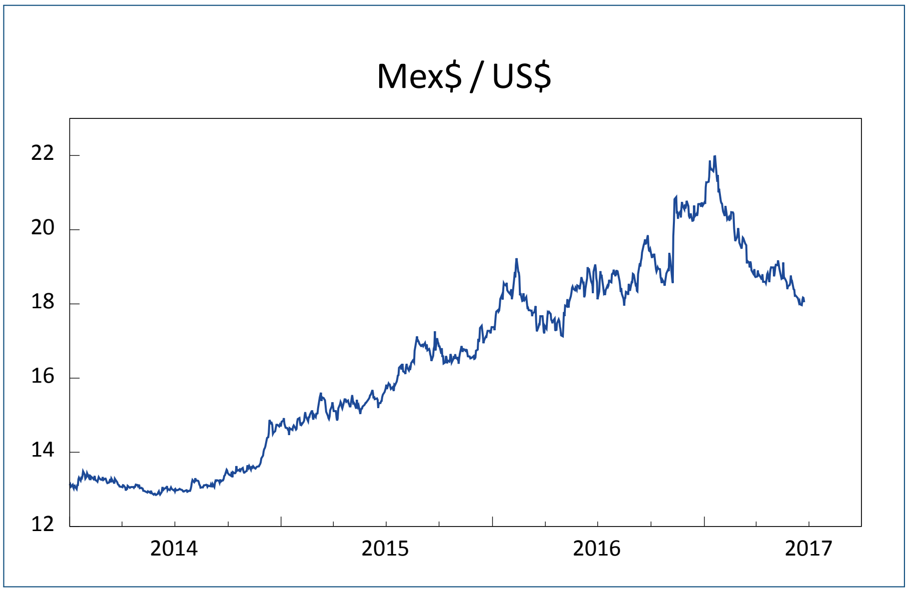
Aeroméxico did not fare too badly, limiting its adjusted operating loss to 2% of revenues, as its highly diversified international operation helped mitigate the weakness in US-Mexico operations. Net loss was 258m pesos, contrasting with a profit of 161m pesos a year earlier. That net loss included a foreign exchange gain of 312m pesos, as Aeroméxico uses the US dollar as its functional currency.

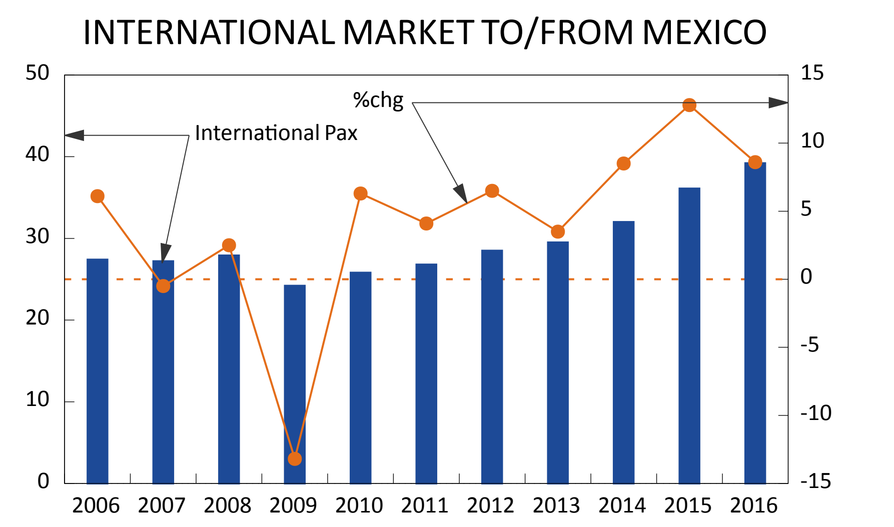
Volaris reported steep operating and net losses of 722m and 1,361m pesos (negative margins of 13.7% and 24.1%) — its first quarterly losses since 2014 (see chart). Unit costs surged by 26.6%. The losses came despite the fact that Volaris earns about a third of its revenues in US dollars – a result of extensive Mexico-US operations and a high volume of US-originating VFR traffic.

Interjet reported operating and net losses of 477.7m pesos and 595.6m pesos (10.8% and 13.5% of revenues). A year earlier it earned operating and net profits of 271m pesos and 203.9m pesos (7% and 5.3% of revenues).

The good news is that Mexico's airlines could see profit margins recover quickly now that the peso has bounced back (as long as the Trump rhetoric does not take a turn for the worse).

The LCCs are being helped by growth in ancillary revenues. Since March they have been permitted to charge a first checked bag fee for





*Note: * Mexican and non-Mexican carriers*
Source: SCT/DGAC

travel to/from the US and Puerto Rico. Based on the experience of US airlines, those fees could provide a lucrative revenue stream.

Analysts are especially bullish on Volaris, because it deploys a true Ryanair-style ULCC model, is seeing strong non-ticket revenue growth (28% in Q1) and has good opportunities to pursue additional US dollar revenues with its new unit in Costa Rica (more on that in the section below).

Mexico's airlines continue to benefit from a relatively robust economy. Mexico's GDP expanded by 2.3%, 2.7% and 2.0% in 2014, 2015 and 2016; and the OECD now projects growth to remain at around 2% in 2017 and 2018.

In its June review, the OECD noted that exports were strengthening (helped by the peso's weakness) and that, as the Trump fears faded, "investment plans that were put on hold due to recent heightened uncertainty and turbulence are expected to resume as confidence is gradually restored". However, the OECD warned of substantial risks to the outlook, including the possibility of NAFTA renegotiations or other protectionist measures.

Travel demand strength

Despite Trump, Mexico's domestic and international air travel markets have continued to grow at a healthy pace.

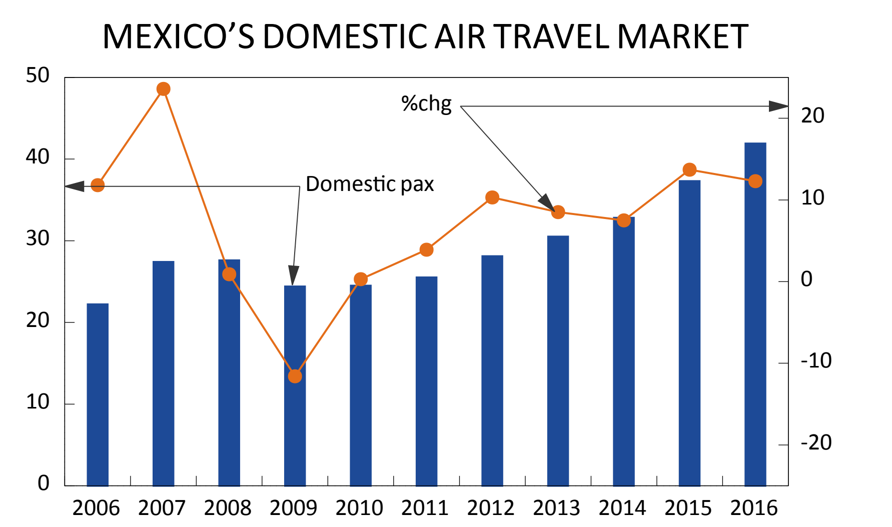
Domestic passenger numbers have continued the double-digit growth seen in the past two years: up 12% in the first four months of 2017, with April witnessing a 16.1% surge.

Growth in international passengers to and from Mexico has accelerated this year: up 15.7% in the first four months of 2017, compared to 8.6% and 12.6% increases in full-year 2016 and 2015. In April international passenger numbers surged by 22.3%.

Those trends are easy to explain. Domestic demand has remained strong because healthy GDP growth has continued and because many Mexicans have chosen to vacation at home, as a weaker peso has made the US a more expensive destination for them.

The surge in international travel has reflected the substantial increase in new flights and frequencies (and lower fares) under the Mexico-US open skies agreement. The US market accounts for 63% of the total international travel to/from Mexico, and passenger numbers on the US-Mexico routes rose by 20% in April.

Airlines have reported that, mainly because of the exchange rate developments, northbound travel from Mexico to the US has been weak but southbound leisure and VFR



Source: SCT/DGAC

Source: SCT/DGAC

travel have remained strong.

Including projected 2017 traffic, Mexico's domestic market will have doubled in just seven years. Domestic passengers have increased from 24.5m in 2010 to 41.9m in 2016. That growth has largely been a result of the stimulation provided by LCCs' low fares and the "bus switching initiatives" of operators such as Volaris and VivaAerobus.

But the airlines believe that the domestic market has significant further growth potential. Volaris has said that is hopes to convert to air the estimated 70m people that take bus journeys of longer than five hours each year.

The top-three LCCs have increased their combined domestic market share from 31.4% in 2009 to 65.6% in April 2017. That is an unusually high LCC penetration compared to other countries or regions.

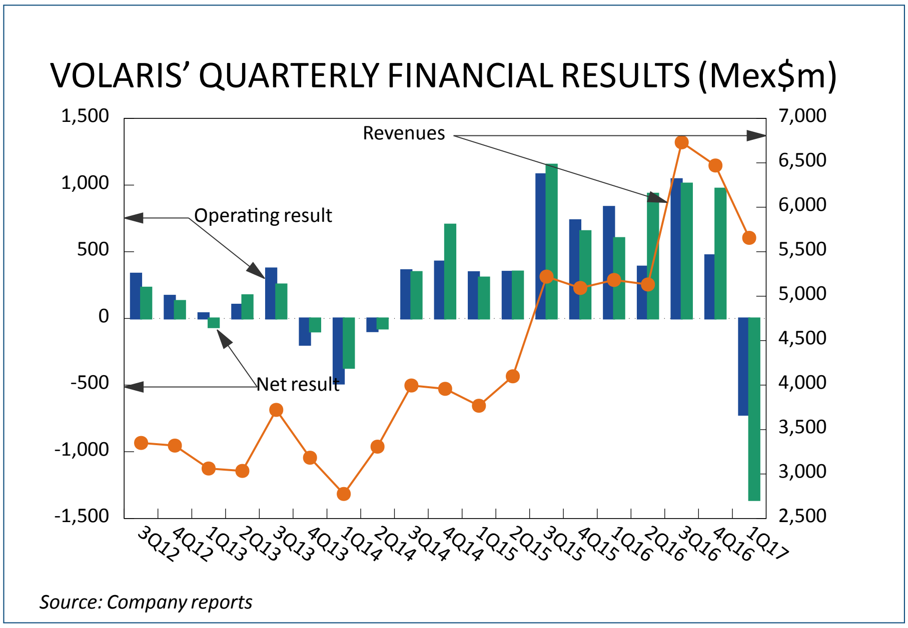
The LCCs have captured all of the 27% domestic market share held in 2009 by Mexicana, which filed for bankruptcy and ceased operations in 2010. The LCCs have also captured a little bit of domestic market share from Grupo Aeroméxico (Aeroméxico and its regional unit Aeroméxico Connect), which had 28.8% of the domestic market in April, down from 32.3% in 2009. It will be interesting to see if Aeroméxico can recapture any of that share with the help of Delta.

In April, Grupo Aeroméxico's domestic passengers rose by only 1%, compared to 9.6% growth for Interjet, 18% for Volaris and 57.5% for VivaAerobus. The latter has been aggressively building its domestic market position with the help of a new Airbus fleet and new strategies.

The LCCs have made equally impressive inroads into Mexico's international air travel market, which at 39.2m passengers in 2016 is similar in size to the domestic market. The top-three LCCs have increased their share of the international passengers carried by Mexican airlines from 3.3% in 2009 to 43.8% in April 2017. However, Volaris and Interjet account for virtually all of it, with VivaAerobus' share being currently only 0.3%. Regional carrier Aeromar has a 0.2% share and Grupo Aeroméxico accounts for the remaining 56%.

The total international market to and from Mexico remains extremely imbalanced by nationality, with Mexican carriers accounting for only 27.9% of passengers and foreign operators (mostly US airlines) having the lion's share of 72.1%.

The situation is improving gradually as Aeroméxico, Volaris and Interjet continue to grow at a heady rate internationally; the latest (April) data show a 2.7 percentage point year-on-year improvement in the Mexican



Source: Company reports

carriers' share.

In April Grupo Aeroméxico saw its international passengers surge by 30.3% as it continued long-haul expansion, which in the past year has focused on Europe. Interjet's international traffic grew by 56% and Volaris' by 34%, but VivaAerobus saw a 15.2 decline.

US-Mexico Open skies

A long-awaited open skies-style regime became effective in August 2016, replacing the highly restrictive bilateral air service agreement (ASA) that dated back to 1960. It opened up all US-Mexico city pairs for unlimited flights by any number of airlines. The previous ASA had limited the number of airlines to just two or three from each side on 30 or so key routes, which had prevented many airlines from entering the largest markets.

However, airlines from both countries had already benefited from a liberalised regime in the secondary markets, which had led to an influx of new flights and new operators. Under that regime, for example, Southwest was able to enter Mexico and add several routes, while Volaris grew significantly to the US as its strategy focused on secondary markets anyway.

The new regime is not totally open skies in that slot constraints at Mexico City Airport and New York JFK continue to require government approvals and limit access to some of the most attractive US-Mexico markets.

The open skies ASA facilitated Delta's additional investment in Aeroméxico and an immunised joint venture agreement (JVA) for the two airlines in the US-Mexico market. Delta completed its tender offer for an additional 32% of Aeroméxico in March, as a result of which it owns 36% of the equity (which along with options for a further 13% would give it 49%). The airlines formally launched their JVA in early May.

Getting the JVA approved was a long and contentious process because of Aeroméxico's extensive slot holdings at Mexico City. The eventual remedy was a divestiture of 24 daily slot pairs at Mexico City and four at JFK for US-Mexico service by LCCs. 14 of the Mexico City slots and two JFK slots were allocated for the current summer season and the other half will be made available if needed next summer.

As things turned out, only five airlines submitted proposals and got more or less what they wanted. Alaska, JetBlue, Southwest, Volaris and VivaAerobus received Mexico City slots, while Interjet, Volaris and VivaAerobus received JFK slots. Interjet did not receive any Mexico City slots because it is already the second largest carrier by a wide margin at the airport.

So Mexico's LCCs got some decent growth opportunities as a result of the Delta-Aeroméxico divestitures that will earn them more dollar revenues to offset the new cost pressures. All three LCCs can now serve New York JFK from Mexico City; and Volaris also from Cancun. VivaAerobus can enter Mexico City-Las Vegas and Volaris can introduce new or additional service from Mexico City also to San Antonio, Los Angeles, Denver, Dulles, San Jose, Ontario, Chicago and Oakland. Some of those services will be launched in 2018.

But Mexico's LCCs will also see increased competition from US carriers. They will face Alaska for the first time in Mexico City; tougher competition from JetBlue now that it has decent slots there (rather than pre-6am slots) and will operate more flights from its Fort Lauderdale, Orlando and Los Angeles focus cities; and substantially more competition from Southwest (from Houston Hobby, Fort Lauderdale and Los Angeles).

The largest US airlines have been busy entering popular US-Mexico leisure or VFR markets that no longer have limits on the number of operators. Routes such as Los Angeles-Cancun and Los Angeles-Los Cabos now have five US airlines.

But the main competitive threat to the LCCs may come from Delta-Aeroméxico, which will dominate the US-Mexico market with a 23% passenger share. The combination will be twice as large as American, the number two in that market.

Delta and Aeroméxico plan to grow under the JVA. They will dominate Mexico City airport, and because of the feed from Delta's domestic network, Aeroméxico will be able to develop new gateways for transborder traffic such as Monterrey and Guadalajara. Delta has said that it will provide Mexico service through Atlanta, Detroit, Los Angeles, Minneapolis-St. Paul, New York, Salt Lake City and Seattle.

In the JVA's first expansion phase, Aeroméxico will launch five new transborder routes this autumn, including Seattle and Portland to Mexico City using 737-800 services.

The many frequency additions under the JVA will include a third daily flight on the JFK-Cancun route operated by Delta, marking it as an early clash point with Volaris, which is likely to enter that market in 2018. Volaris is likely to do well in competitive markets with its ULCC business model (as it already does on the Mexico City-JFK route), but then again Delta has a new weapon at its disposal — the "basic economy" offering.

The Delta-Aeroméxico JVA is a first of its kind globally in that it applies to short-haul, high-frequency operations (rather than an intercontinental market). For that reason alone regulators will be keeping a close eye on its effects. The US DOT has made it clear that even though the ATI has been granted for five years, it reserves the right to re-examine it earlier if necessary.

But the combination poses potentially the biggest threat to the LCCs in Mexico's domestic market. Delta is in effect acquiring Aeroméxico. The key attraction, in addition to Aeroméxico's Mexico City slot holdings, was the huge marketplace of 127m people right next to the US that is "still relatively underdeveloped".

It is indicative that Delta has adopted a very hands-on approach with Aeroméxico. In addition to having board representation, one of its VPs (Mike Medeiros) became Aeroméxico's COO in January. There should be a lot of know-how, best practices and advice passed to Aeroméxico.

Back in January Mexico's Senate quietly passed legislation increasing the foreign investment limit in the country's airlines to 49%, to facilitate the Delta's additional investment in Aeroméxico. It would not be surprising (though obviously depending on political developments) if Mexico abolished the limit altogether at some point, following the example of Brazil. That would allow Delta to establish a true "airline of the Americas" with Aeroméxico and GOL.

The Mexican government sees the new policies as potentially levelling the playing field between US and Mexican airlines. In a 2014 letter, the Mexican negotiators wrote that ATI could enable Mexico's carriers to "be competitive given the natural asymmetry between [the two sides]". And the government has made the point that the new freedoms will be equally available to the smaller carriers.

But it is not clear if the LCCs can benefit from foreign investment or immunised alliances. While Interjet, a JetBlue-style operator, has embraced alliances (and in late 2016 reportedly even explored selling a stake to American or United), Volaris has not forged any alliances since finding a few years ago that cooperation with Southwest did not make economic sense. VivaAerobus lost its foreign investor and Viva brand partners last year when Irelandia sold its stake in the airline to its Mexican co-owners. However, Mexican regional carrier Aeromar late last year sold a 49% stake to Brazil's Synergy Group (which owns a majority stake in Avianca-TACA).

Perhaps there will be more interest from foreign carriers in alliances with Mexico's LCCs when access to Mexico City improves. The first phase of the planned new $13bn, six-runway airport, which will replace the current Benito Juarez International Airport, is apparently on schedule to open in 2020. It will initially have three runways and capacity to handle 50m passengers a year. Eventually the airport will be able to handle 120m passengers, quadrupling Juarez's capacity.

In the following pages *Aviation Strategy* takes a look at each of the leading LCCs in turn.

Volaris

Mexico City-based Volaris, founded in March 2006 with the help of an investment from Indigo Partners, completed a $350m IPO in September 2013, which gave it listings in Mexico and New York (NYSE). Volaris is a classic Ryanair-style ULCC that has grown extremely rapidly and has been consistently profitable since mid-2014 except for the latest quarter.

Volaris operates point-to-point services that target VFR, leisure and cost-conscious business travellers. It operates from five bases in Mexico (Cancun, Guadalajara, Mexico City, Monterrey and Tijuana), serving typically high-volume markets.

In recent years Volaris has focused on growing its international network, largely to the US where it now serves 23 cities (the most among the Mexican LCCs). Its network also covers 40 cities in Mexico and five destinations in Central America (Puerto Rico, Costa Rica, Nicaragua, Guatemala and El Salvador).

In an unusual move in November 2016, Volaris launched a Costa Rica-based unit that essentially seeks to replicate its ULCC model in Central America, offering low base fares and point-to-point service. The venture currently operates four daily segments and three routes from San José (Costa Rica), serving Guatemala, El Salvador and Nicaragua. The next stage will see Volaris Costa Rica flying to Mexico and the US (subject to government approval). It could potentially later also fly to South America. The plan is for the unit to operate 18-20 aircraft by 2020.

The Costa Rica unit represents an opportunity for Volaris to increase its dollar-denominated revenues (33% in 2016), as all of Central America is priced in US dollars. It is a move to diversify away from Mexico, should macroeconomic conditions there deteriorate, and to also reduce dependence on the US-Mexico market. The main disadvantage is greater exposure to formidable competitors such as Copa, which incidentally has launched its own low-cost unit (Wingo) for Central America.

Volaris sees further growth opportunities. According to its latest annual report, it has identified 135 suitable international routes (of 200+ miles) and around 110 potential routes within Mexico that it could serve.

As of March 31, Volaris operated 68 aircraft, consisting of 43 A320s, 14 A319s, 10 A321s and one A320neo. It has firm orders for 39 more A320neos and six A321neos, all scheduled for delivery over the next four years. The entire fleet is on operating leases.

Volaris is one of the best positioned carriers in Latin America. First, it is in promising growth markets with the right kind of business model. Second, it is among the world's lowest-cost airlines, with CASM-ex of just 4.4 US cents in 2016. Third, it is well positioned to grow ancillary revenues, with many new products in the pipeline. Fourth, it has good opportunities to diversify risk and grow dollar revenues.

Interjet

Toluca-based Interjet is a more upmarket, JetBlue-style LCC that offers a "unique brand of lower fares with free checked bags using our priority fare, more legroom and great service".

Interjet only went international in 2011 but has ventured into interesting markets, including Cuba and South America. Domestically it is about the same size as Volaris. The network now covers around 53 destinations in seven countries, including 36 cities in Mexico, nine in the US, one in Canada (Montréal, from July), three in Cuba, two in South America (Bogotà and Lima) and two in Central America (Guatemala and Costa Rica).

Since early 2016 Interjet has been undertaking significant US expansion, entering typically much more competitive markets than Volaris. It benefits from significant slot holdings at Mexico City (almost a quarter of the airport's total), which in combination with its more conventional product offering positions it to attract business traffic. It was indicative that in mid-June Interjet, citing robust business travel demand, added a fourth daily flight on its Mexico City-JFK route.

Interjet is the only one of the Mexican LCCs that has embraced codeshare relationships. Last year it added LATAM to the roster that also includes Iberia and American.

As of May 18, Interjet operated 73 aircraft, including 45 A320s, three A320neos, three A321s and 22 Superjet SSJ100s. Current firm orders include 37 A320neos (deliveries from 2018), 10 A321neos, three A321ceos, one A320ceo and eight SSJ100s.

Interjet has been keen to step up growth, to keep up with Volaris and take advantage of the US opportunities, but it has found it hard to raise funds. It has been seeking to go public for at least 6-7 years and last year unsuccessfully explored selling an equity stake to a US airline.

In May Interjet found a solution: leasing 10 additional A320s from Aviation Capital Group, the first of which will be delivered in July.

VivaAerobus

Monterrey-based VivaAerobus is the smallest and the least financially successful of the top-three LCCs. It has made many strategy changes over the years. There have been two unsuccessful major forays into the US, the latest of which was in 2014-2015.

One of the biggest earlier mistakes was to operate old aircraft. In a strategy shift in October 2013, VivaAerobus opted to replace its used 737-300s with new A320s and placed a $5.1bn order for 40 A320neos and 12 A320ceos, plus 40 neo options. It began taking those aircraft in March 2014 (initially from lessors) and completed the fleet transition in November 2016.

The airline currently operates a 22-strong all-Airbus fleet consisting of 20 A320s and two A320neos. The 38 A320neos on firm order have deliveries stretching through 2020.

Since the fleet transition VivaAerobus has focused on domestic growth; in the past two years it has actually been the fastest growing carrier in Mexico's domestic market. Its network now covers around 33 points and system capacity is protected to grow by 22% in 2017.

While operating primarily domestic services, VivaAerobus is now cautiously venturing back into the US market to take advantage of opportunities offered by the open skies agreement. It will launch the Mexico City-Las Vegas route in December, entering a competitive market where Interjet and Aeroméxico already provide service.

Originally founded as a joint venture between Grupo IAMSA, Mexico's leading bus operator, and Irelandia, VivaAerobus became wholly owned by IAMSA in December 2016. Irelandia sold its 49% stake in the carrier for $250m as part of a strategy to focus on South America.

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