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Norwegian: LHLCC finances stressed

This issue includes

NORWEGIAN has achieved a small but significant share of the transatlantic market, 3-4% in seat capacity terms, and is expanding rapidly, but it has not yet demonstrated the financial viability of its long haul low cost carrier (LHLCC) model.

Norwegian's positive news was that passenger volume was up 13% to 33.3m in 2017 while load factor remained roughly the same at 87.5%.

But its fourth quarter financials were disturbing.

Revenues in Q4 2017 were up 30% on the same period in 2016 to NOK7.84bn ($1.0bn), but operating losses of NOK1.03bn were recorded, in contrast to a positive EBIT of NOK335m in Q4 2016. The fourth quarter is normally the poorest performing period of the year, but the extent of the losses was unexpected, and as a consequence the full year results were negative, whereas most of the other European airlines have been reporting improved profitability. CEO Bjørn Kjos stated phlegmatically: "We are not at all satisfied with the 2017 results".

For the full year, revenues were up 19% at NOK30.94bn ($3.96bn), EBIT was a loss of NOK2.0bn, and the net loss was NOK299m. However, the net loss figure was only arrived at after a tax credit of NOK768m and NOK1.69bn proceeds from its sale of 3.6% of its previous 20% holding in Norwegian Finans bank (NOFI).

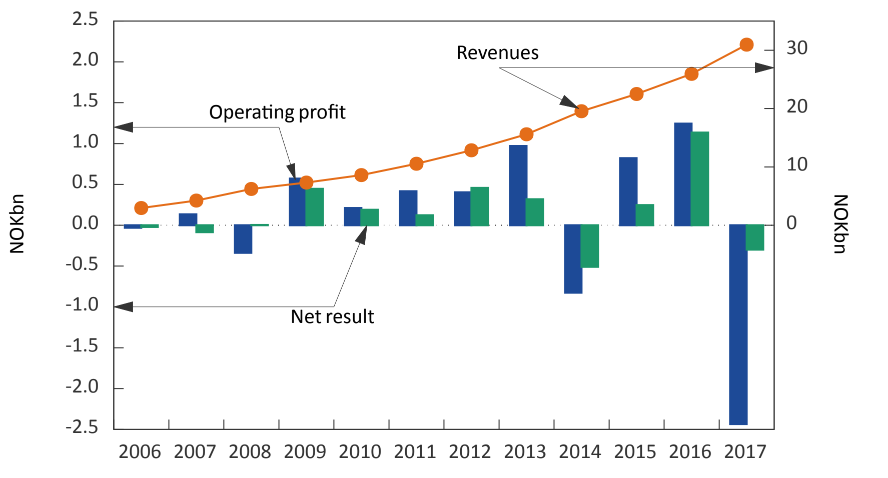
Management attribute the 2017 outcome to fuel and growing pains. Capacity, mostly on long-haul, was boosted by 25% last year, which, unsurprisingly, resulted in a 6% decrease in passenger unit revenue (per ASK). Improved ancillaries and other income brought the overall unit cost decrease down to 4.5%.

Despite the capacity expansion, and an increase in average sector length by 9% to 1,607km, no scale economies were achieved; on the contrary, operating unit costs rose by 8% in 2017, while ex-fuel unit costs were up by 6%.

Problematic cost areas included: Personnel unit costs rose by 7% (unadjusted for currency effects), the result of a labour force increase of 37% to 9,400 by year-end, which Norwegian explained as being partly attributable to the need to ramp up pilot crews to cope with peak demand. The related category of flight operation, covering training, crew expenses and insurance, increased by 12% on a unit cost basis. Unit maintenance costs were up by 16%, the result of changes in the fleet through the net addition of nine 787s and six 737MAXes, plus escalation of engine service charges.

Expansion is planned to continue apace this year — a further 40% increase in ASKs and the addition of another 11 787s and 14 737MAXes and -800s. In contrast to 2017 Norwegian anticipates a strong beneficial impact

NORWEGIAN FINANCIAL RESULTS



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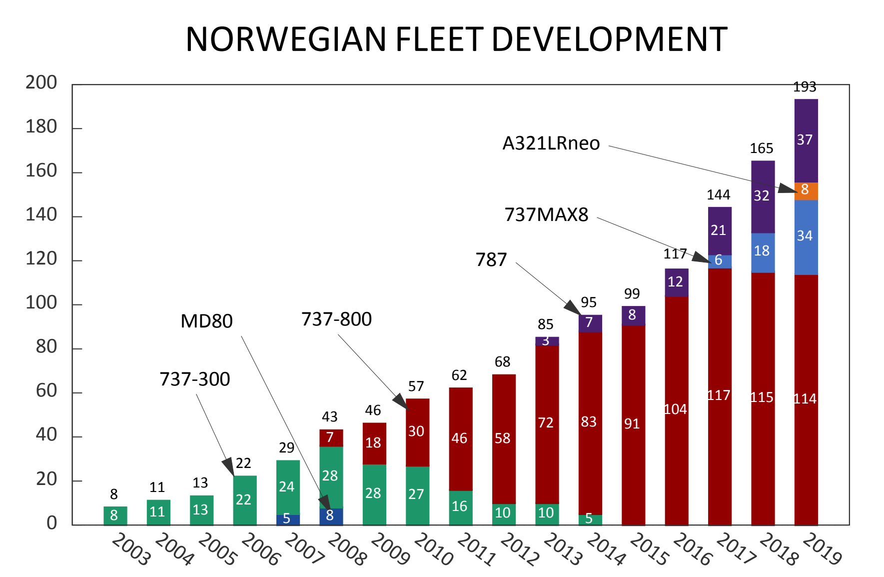


from scale — the company's headline guidance is for a 12% decrease in cash unit costs (ex-fuel and depreciation) and a 9% decrease ex-fuel. Apart from "scale" there is little visibility on how this turn-around will be achieved (we also had some difficulty in precisely reconciling Norwegian's own numbers with the predicted decreases).

No prediction on the revenue side has been made by management for 2018, though the implication is that the decline in unit revenues will be less than the decrease in unit costs, and the airline will return to profit. Equity market analysts are less confident: HSBC forecasts a loss of NOK225m at EBIT level and a loss of NOK767m at the net level, reflecting increased finance costs.

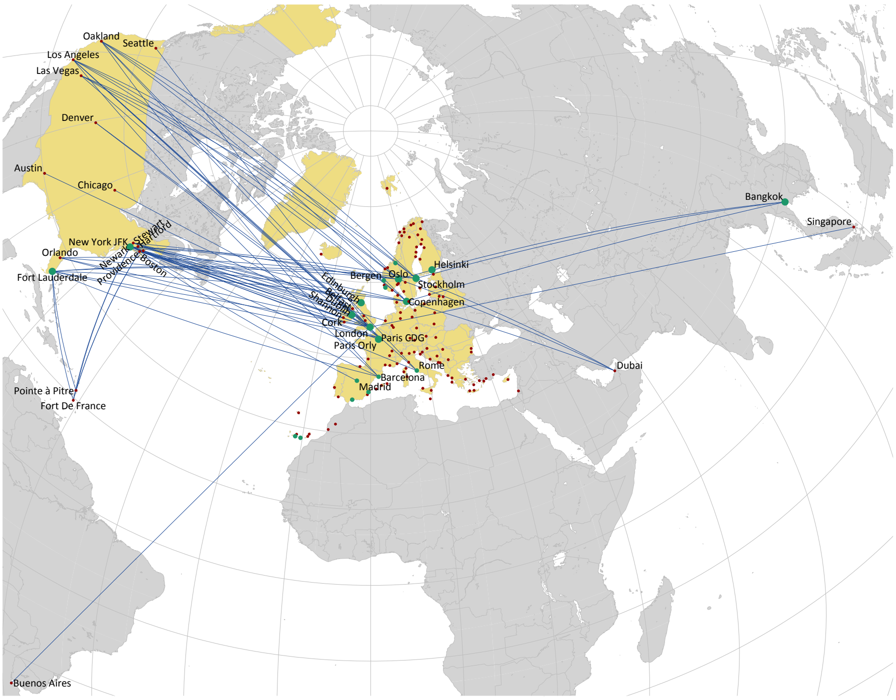
This will place further stress on Norwegian's balance sheet. At the end of last year total liabilities amounted to NOK41.6bn and shareholders funds only NOK4.1bn — a debt/equity ration of 9/1. Moreover, the narrow equity base could be halved if the Norwegian Financial Supervisory Authority (Finanstilsynet, or FT) rules on whether Norwegian's stake in NOFI should be treated as a financial investment, as it currently is, or as an associated company on an equity basis; in the latter case, the balance sheet value of NOFI would be reduced by NOK2bn.

Then there is the impact of IFRS 16 in January 2019, which will oblige airlines to treat operating leases and finance lease in the same manner, in the process bringing about NOK48bn of lease obligations onto Norwegian's balance sheet as debt (though the asset values of the aircraft will also be added to the balance sheet).

This capitalisation, despite a relatively good current cash position, looks incompatible with planned fleet expansion — gross capex commitment for this year and next is $4.5bn or NOK12.3bn — and unless profitability is turned around rapidly and significantly, it is unclear as to how Norwegian can continue in its current form. There have been suggestions by the company that Norwegian could be split into an aircraft leasing company and an airline operating company, which does not really address the fundamental issue: which is, Norwegian appears to need new equity.

The largest shareholder in Norwegian is HBK (the investment vehicle owned by Bjørn Kjos and others) with 27%: then Folketrygdfondet, the manager of the state pension fund, 6%; 18 Scandinavian investment funds and banks, 32% in total. Whether they would be willing or able to inject new funds is unknown. Also unknown is whether leading European LCCs would consider an acquisition: very probably not at present, for financial, strategic and aeropolitical reasons (Brexit *again*, the uncertain status of the UK-US bilateral). But Ryanair and easyJet are interested observers of Norwegian's situation.

NORWEGIAN LONG HAUL ROUTE NETWORK



Second generation LHLCCs?

Norwegian's operating model has many innovative features and has been based on detailed research into the market, but it might come to be regarded as the first generation LHLCC. The historical parallel would be the early 2000s in Europe when second generation LCCs, Ryanair and easyJet, improved the models developed by the likes of Air Europe. They eventually thoroughly disrupted the intra-European market and distressed the incumbent flag-carriers.

What elements might make a second generation LHLCC a true disrupter of the network carriers — ultimately taking 30-40% of the market, maintaining unit costs and fares below network carrier levels and achieving 20% profit margins? Here are some thoughts on the possible second generation.

✈ Network and bases

The map above shows Norwegian's now extensive Atlantic network with flights being operating from just about everywhere in Western Europe — Oslo, Copenhagen, Stockholm, Dublin, Amsterdam, Madrid, etc. The network, Norwegian suggests, is complete as three quarters of capacity expansion will be generated through ramping up schedules.

But what is missing is a large-scale symbiotic relationship with a major base airport, preferably in London. This has been, for example, a key element in Ryanair's strategy — negotiating discounted rates in return for guaranteed volume growth, most notably at its main base, London Stansted. It is conceivable that a typical Ryanair agreement applied to the Atlantic would result in passenger charges of less than 25% of those in force at Heathrow and less than 50% of those applicable at Gatwick. Stansted has an incentive to enter into a growth/discounted price contract as its capacity, soon to be 36m pax/year, substantially exceeds throughput of 26m; Gatwick, on the other hand, is at its limit and so has little incentive for such a contract.

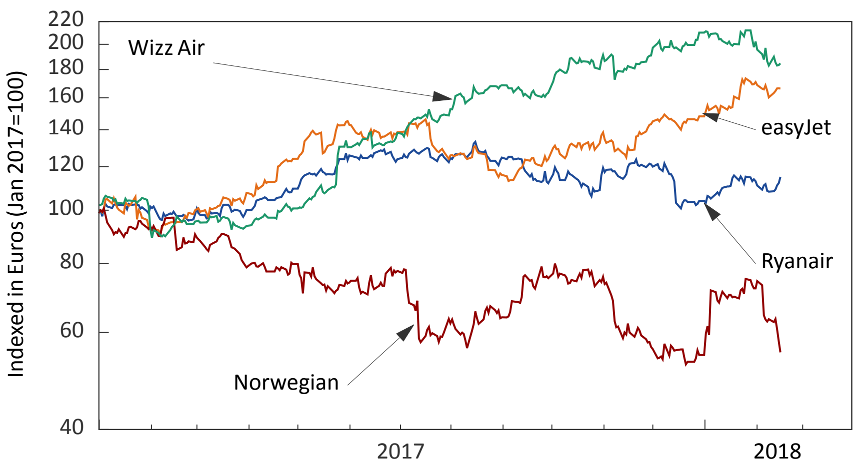
LHLCCs clearly cannot be pure point-to-point operators; they also need feed. Norwegian has been actively pursuing transfer traffic to feed its long-haul operations but this requires scale at the connecting bases, which it does not have. Also, it has not progressed much with interline agreements with other LCCs. The idea of a large scale intraline operation at Stansted connecting short- and long-haul traffic might give the Legacies palpitations.

✈ Product

Norwegian is increasing its Premium cabin on its new 787s. This is a recognition that that filling Premium as well as Economy cabins is vital for an LHLCC on the Atlantic. Without this income stream, it is impossible for the operation to achieve decent returns.

This is undoubtedly a challenge —

EUROPEAN LCCs: SHARE PRICE PERFORMANCE



no one as yet has achieved the right combination of Premium seats allocation, ratio of Premium to Economy fares and product — but business travel is price-sensitive, and there are important passenger segments that LHLCCs can appeal to by offering fares at say 25% of the published tariff of the Legacies. Business travellers from SMEs without access to the corporate rates (maybe half the published prices) negotiated by conglomerates and banks are a target for LHLCCs. Corporate travel departments will soon catch on to the potential cost savings.

It is almost a given that the legacies will respond to LHLCCs by matching seating density in Economy and by duplicating their short-haul Economy product on long haul — basically this means paying for food and drinks. Making onboard service a profit centre rather than cost has been an integral part of the LCC model, but when a Legacy adopts this policy, consumers' perception hardens, they understand than they are buying a commodity, and price becomes all-important for Economy travel.

SNAPSHOT

US$m	Norwegian	Ryanair
Revenues	3,957	8,673
EBIT	-255	2,113
EBIT Margin	*-6.4%*	*24.4%*
PBT	-136	1,808
Net Debt/ Total Assets	*95.0%*	*5.3%*
ROIC	*1.1%*	*26.0%*
Shareholders Funds (BS)	521	5,440
Stockmarket Value	660	23,200

Norwegian: FY to Dec 2017 Ryanair: FY to March 2018 (est). Ratios sourced from HSBC

✈ Labour costs and Overheads

This is the segment of the cost pie where LHLCCs should have an unbridgeable advantage over the Legacies.

Despite the fracas over unionisation at Ryanair, the LCC model, short or long, does not necessarily mean low cockpit pay but it does require efficiency. Cockpit crewing levels are necessarily higher on a long-haul operation — say, 7.5 crews per aircraft, compared to 4.5 for a short-haul LCC operation. The problem for the Legacies is that they have a multiple of these ratios.

Lean management really means lean at genuine LCCs. For example, Ryanair with a fleet of about 400 aircraft, employs just 112 managers and 485 administrators. Then there is the looming question of unfunded pension liabilities, a big problem at Legacies but not an issue at LCCs. Further major costs savings come from a clean IT set-up as opposed to adding onto Legacy systems and from inexpensive buildings.

The problem is sustaining this cost advantage over time, and Norwegian's 2017 results tend to show a vulnerability to cost escalation.

Total employees per aircraft is a crude but sometimes useful indicator. Ryanair provides the exacting LCC benchmark of about 30, for its all 737 fleet. For the Legacies the ratio of employees per aircraft is well over 100 for total operations, short and long-haul. Norwegian, which is still predominantly a short-haul operator, now has 65 per aircraft.

✈ Fleet costs

Norwegian will have achieved a good discount from list prices on its 787 and 737MAX orders, how much exactly is a guess — 35%?

What would be really disrupting would be an LHLCC obtaining 50-60% discounts from a manufacturer as the result of a severe recession, or managing to pick up a distressed 787 fleet sale. Ryanair and easyJet locked in an unmatchable and long-term cost advantage when they placed mega-orders for 737s and A319s in the wake of 9/11. Such a severe downturn is unpredictable, but if or when it does happen then the Legacies would again be left very exposed to low cost new entrants. Ryanair has specifically stated that it is only likely to enter long-haul when it can do an aircraft purchase deal at deeply discounted prices, bulk purchasing, including future contract prices, as it did so successfully in 2002.

Airline Incubation: The Serial Investors

AT THE end of December 2017 Airbus confirmed a series of orders that included the largest single order it had ever received for its narrowbody A320 family: a massive order for 430 aircraft to be delivered over the next eight years brokered by Indigo Partners.

The order is to be split between the Partnership's four current ULCC airline investments: Hungary based Wizz Air, Frontier (USA), Volaris (Mexico and Costa Rica) and new Chilean start-up JetSMART. The total value of the order at list prices was put at $50bn — but the discounts that Airbus would have been willing to settle at were probably extraordinarily deep.

This single order (along with other announced orders at the end of December) pushed the European manufacturer into the lead position in the annual OEM orders race, aiding the swan-song accolades for the departure of Airbus's retiring sales director John Leahy (see *Aviation Strategy* December 2017).

Adding these aircraft to their existing portfolios, the Indigo Partners' airlines have a total 659 aircraft on firm order against a current combined fleet of 238 units (see table below). This is equivalent to a combined 11% of Airbus's narrowbody backlog (excluding unidentified and non-commercial orders) and 5.5% of the world total narrowbody backlog. The next largest A320 customers are the Indian LCC Indigo (no relation) and AirAsia with 7% each. In contrast Boeing's largest exposure on the narrowbody fleet is to flydubai, Southwest and Lion Air with orders accounting each accounting for around 6% of *their* identified commercial 737 backlog.

Who are these guys?

Indigo Partners is one of a handful of related private equity companies involved in the serial development of LCCs and ULCCs round the world. It is headed by 80-year-old Bill Franke, who seems to have been hooked into the industry to rescue and turn round America West Airlines in the early 1990s. He ran America West as Chairman and Chief Executive from 1993-2001.

He founded Indigo Partners in 2002 in conjunction with private equity firm TPG's David Bonderman, who came to notice in the industry on the then Texas Pacific Group's acquisition of Continental Airlines in the early 1990s — at a time that Continental was regarded as a basket case.

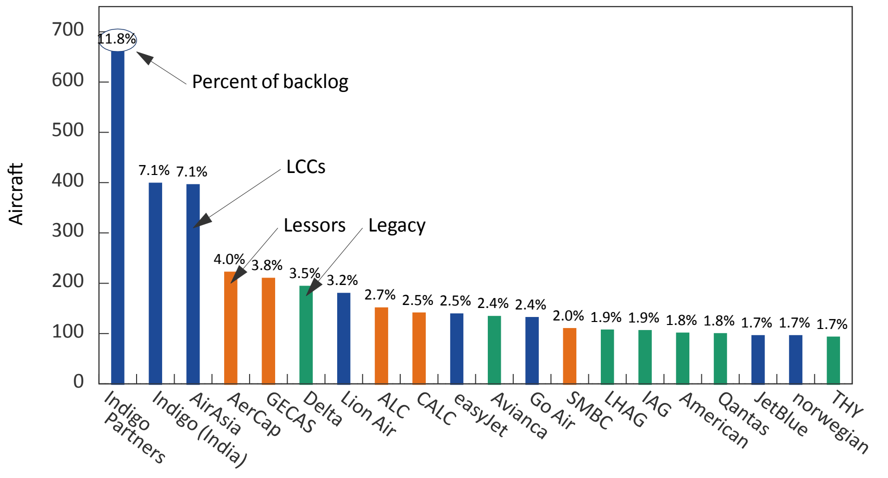
They were both involved in Ryanair — Bonderman has been Chairman since 1996, and Franke was a pre-IPO investor — helping to transform a regional turboprop operator and junior competitor to Ireland's flag-carrier Aer Lingus into an LCC and the largest intra-European carrier it is today.

Intriguingly connected to that common stable is Irelandia Investments, another airline incubator, founded by the Ryan family as an investment vehicle and run by Declan Ryan, scion of Tony Ryan's Guiness Peat Aviation heritage and one of the original founders and former CEO of Ryanair. (His brother Cathal,

INDIGO PARTNERS: COMBINED FLEET

	In Service					On Order				
	Wizz	Volaris	Frontier	JetSmart	Total	Wizz	Volaris	Frontier	JetSmart	Total
A319		12	18		**30**					
A320	64	41		5	**110**	8				**8**
A320neo		14	41		**55**	72	75	165	56	**368**
A321	24				**24**	17				**17**
A321neo			19		**19**	184	34	34	14	**266**
Total	**88**	**67**	**78**	**5**	**238**	**281**	**109**	**199**	**70**	**659**

AIRBUS A320 BACKLOG – TOP 20 CUSTOMERS



Source: Airbus January 2018. Notes: Indigo Partners includes Wizz, Volaris, Frontier and JetSmart; IAG includes BA, Iberia, Vueling; LHAG includes Lufthansa, Swiss, Austrian and Brussels.

co-founder and Ryanair pilot, tragically died young in 2007). Both Indigo and Irelandia were involved in the establishment of Tiger Airways in Singapore in 2003 (now fully owned by Singapore Airlines) and the defunct associate Indonesian carrier Mandala Airlines.

There have been suggestions that both Airbus and IAE are investors in Indigo or its funds. This may reflect some conspiracy theory thinking to help explain why they only buy A320s — not one of these groups' airlines have ordered any 737s from Boeing — but it is quite possible that there is some form of formal understanding that improves their purchasing power to ensure the lowest cost of equipment.

However, in a recent article in *TheStreet* Franke denies the imputation saying "I'm agnostic about airplanes: we look for the best deal. I am agnostic [on aircraft manufacturers]. I guarantee you I am."

All these companies are private, and there is very little financial information freely available. Indigo Partners is particularly secretive, and does not try to blow its own trumpet. Irelandia is somewhat different. On its website it has a counter disingenuously noting the total number of LCC passengers carried on the airlines in which it has invested (currently standing at over 1.15bn), and continues to boast its representation in those carriers where it has sold or now has minimal interest.

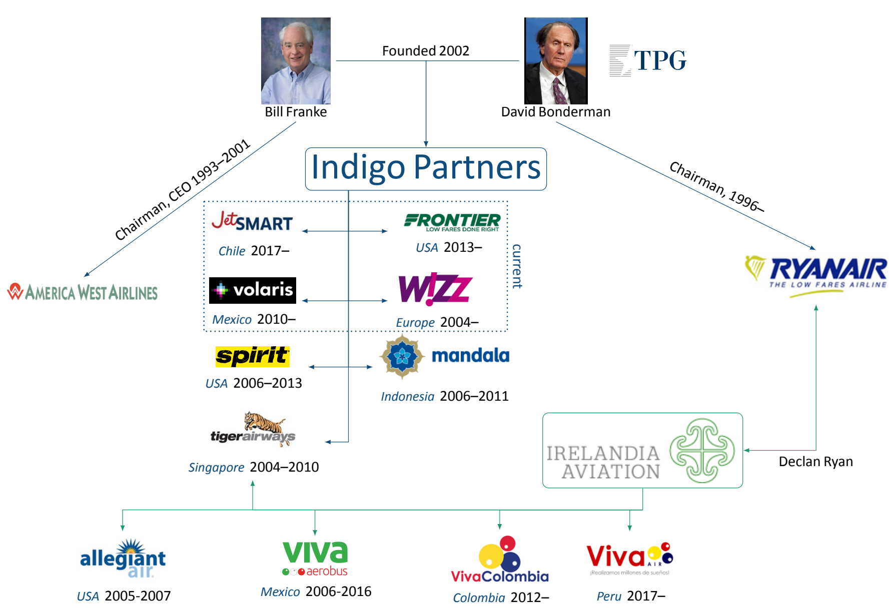
These serial investors have found a "cookie-cutter" business financing model. It is simple — adopting the KISS principles of the airline operating models in which they invest:

- ✈ take a major stake in a start-up or existing airline;
- ✈ have significant control of the airline through management and board representation;
- ✈ use existing contacts and expertise to acquire cheap aircraft (whether leased or bought);
- ✈ use their financial muscle to achieve low financing costs;
- ✈ concentrate on high aircraft utilisation, ultra-low cost operating model;
- ✈ aim for IPO and exit route.

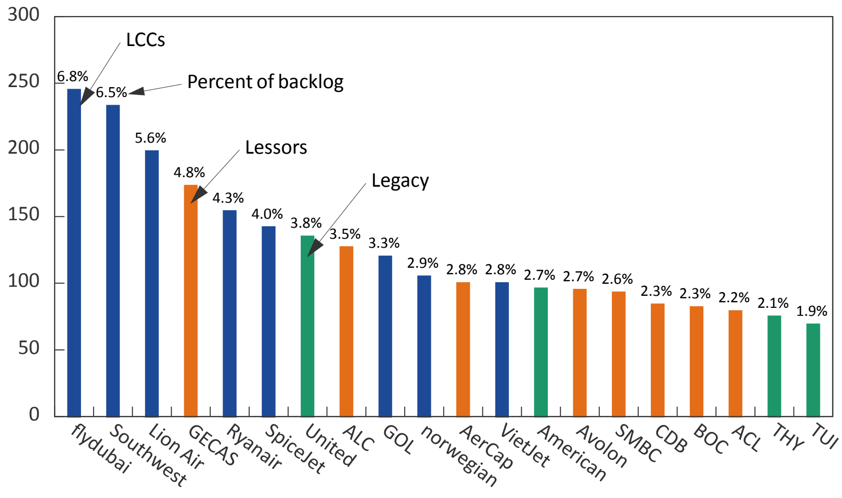
The core airline operating model imposed on the investment targets is patently based on that of Ryanair (itself developed from the Southwest model):

- ✈ single aircraft type;

ULCC INCUBATORS



BOEING 737 BACKLOG – TOP 20 CUSTOMERS



- ✈ point-to-point short-haul services, short turnaround, high aircraft utilisation;
- ✈ no hotac, locally employed crew, maximum crew utilisation;
- ✈ secondary airports (where available), avoidance of high airport costs;
- ✈ outsourced, or OEM guaranteed, maintenance while ensuring strong control over safety and quality;
- ✈ price unbundling, ancillary revenue emphasis;
- ✈ concentration on bottom-line profitability, low admin overheads.

In each case the model has had to be adapted to local market conditions in terms of marketing, advertising, positional imaging and education of the merits of the ultra-low cost model.

IRELANDIA: VIVA AIR FLEET

	A320	
	In Service	On Order
VivaColombia	12	50
Viva Air Perú	2	
	14	**50**

One of the first investments by both groups was in Asia. And it was joint: each took a 24% stake in startup Tiger Airways in Singapore. Despite this being the area of the aviation world with one of the highest growth rates, since then the two have effectively concentrated on the Americas. (Indigo established Wizz Air in Europe in 2004, but Irelandia is excluded from investing in companies in Europe that would compete with Ryanair).

In the US, Indigo Partners transformed Spirit Airlines into a ULCC from an initial investment in 2006, sold out in 2013 and acquired Frontier Airlines to do the same. Irelandia took an advantageous stake in Allegiant in 2005 and helped transform it also into a focussed LCC (see *Aviation Strategy* Jan/Feb 2015).

Irelandia helped develop Viva Aerobus as a startup in Mexico in conjunction with local partner bus company IAMSA in 2006. It sold out last year to concentrate on other South American markets (see below). Indigo Partners bought into Mexico-based Volaris in 2006 (and which had a successful IPO in 2013). See *Aviation Strategy* September 2014.

Indigo announced last year the establishment of Chilean-based startup JetSmart currently operating domestic services and a route from Santiago to Lima with five A320s. Irelandia founded Rionegro-based VivaColombia in 2012 in conjunction with IAMSA, its partner in VivaAerobus. Following Irelandia's withdrawal from the Mexican carrier early last year, it has taken control of VivaColombia and established a Lima-based startup Viva Perú in 2017.

Neither of the two have expressed interest in Africa.

Returns

Among other "case examples", Irelandia highlights its investment in Singaporean Tiger Airways. It and Indigo each took 24% of the start-up in conjunction with Singapore Airlines and Temasek in 2004 (with Bill Franke as Chairman and Declan Ryan on the board). It turned a profit in the third year of operation. By the time of the IPO in 2010 the carrier had grown to 17 aircraft, 35 routes and 3m passengers. The IPO valued the company at US$560m and Irelandia boasts that it made a 28x return on its investment.

No wonder they continue to expand the ULCC model; and in doing so increase their influence, and disruption, on the industry. Will they go long haul?

Is this part of a trend? These investment companies are helping to divorce the relationship between nationality of ownership and control of airlines and nationality of operation inherent in the bilateral system under ICAO. Perhaps in the same way that major US investment funds hold effective control through their stakes in the top carriers (see *Aviation Strategy* November 2016).

Can Saudia compete with the super-connectors?

The Saudi state is eying a medium-term IPO of Saudia once the flag carrier returns to profitability and somehow becomes a competitor to the three Gulf Super-connectors — but is this plan far too ambitious for an airline based in one of the most conservative regimes in the Middle East?

The Saudi Arabian flag carrier's history dates to 1945, with the donation of a Dakota to King Abdul Aziz from President Roosevelt. Fully owned by the Saudi state and known as Saudi Arabian Airlines or Saudia in different periods of its life, it is now called Saudia following the latest re-brand, carried out in 2012.

Saudia's main base is at King Abdulaziz International Airport in Jeddah, with secondary hubs in operation at King Khalid International Airport in Riyadh, King Fahd International Airport in Dammam and Prince Mohammad Bin Abdulaziz Airport in Medina.

The Saudia group employs around 17,000 and operates to 27 domestic and 70 international destinations, the latter comprising 12 in the Middle East, 15 in Africa, 15 across the Indian sub-continent, 10 in the Asia-Pacific region (China, Hong Kong, Indonesia, Malaysia, the Philippines and Singapore), 14 in Europe (Belgium, France, Germany, Italy, the Netherlands, Spain, Switzerland, Turkey and the UK), and four in the US and Canada.

Few financials are available for Saudia, though it is believed to be heavily loss-making. In November last year, Saleh bin Nasser al-Jasser — director-general of Saudia — said it made a profit in the third quarter of 2017 and expects to return to annual profitability in 2019, which is a year earlier than it previously expected.

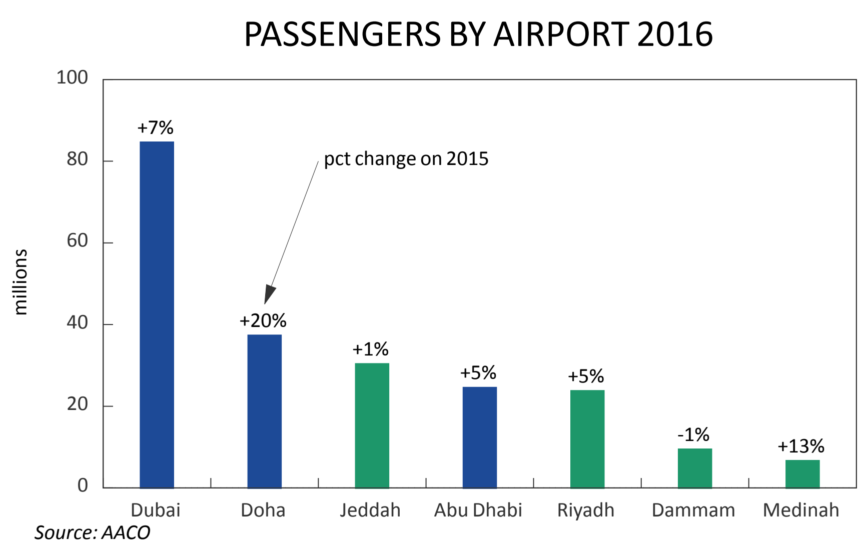
In 2016, Saudia capacity grew by 10.6%, to 80.3bn ASKs, considerably ahead of a 6.3% rise in RPKs, to 57.1bn. As a result, passenger load factor fell by 2.9 percentage points, to 71.1%. In 2017 passengers carried grew by 8% to 32.2m, carried on 119,000 domestic and 78,000 international flights.

Strategic goals

In 2015 the Saudia group launched a medium-term transformation strategy called the "SV2020 Strategic Plan", designed to make the carrier more efficient by selling off some businesses (such as medical services and flight training), transforming the fleet and refreshing its services and products.

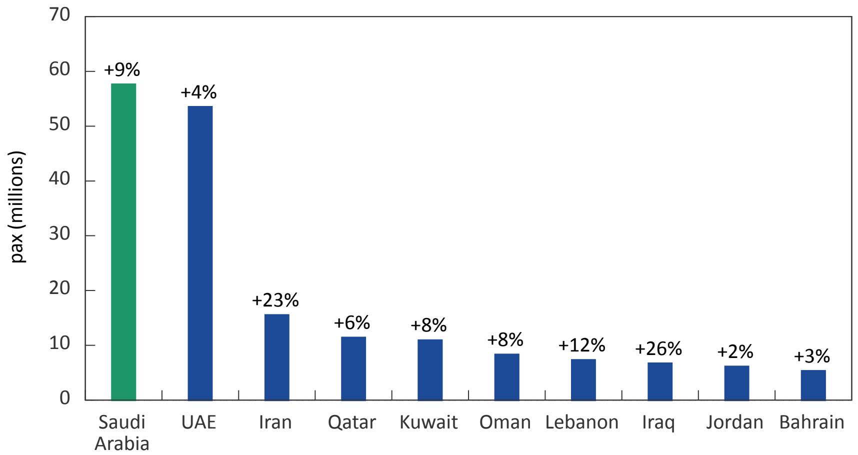
Among the targets is a mainline fleet of up to 200 aircraft by 2020. The group fleet currently totals 178, and the mainline comprises 159 aircraft, including 44 A320s, 15 A321s, six A330-200s, 32 A330-300s (the last of an order for 20 A330-300Rs placed in 2015 was received in December 2017), nine 777-200s (with an average age of 18 years), 35 777-300s (all delivered since 2012, with five arriving in 2017), seven 747-400s and 11 787-9s (which were all delivered in 2016-18).

28 new aircraft joined the fleet in 2016 and 32 in 2017, and this has fuelled expansion of the network. Last year Saudia launched five new international routes, including Riyadh-Manchester in June and a route to Mauritius in September, while a twice-daily route between Jeddah and Baghdad was launched in October — its first service to Iraq for 27 years, after services were stopped following Saddam Hussein's invasion of Kuwait. In the summer 2017 season (June to September) Saudia boosted capacity by 20% compared with 2016, and this year



Source: AACO

SCHEDULED PASSENGERS BY COUNTRY 2016



Source: AACO. Note international and domestic

more seasonal routes to Europe will be added.

Currently there are no outstanding firm orders — although Saudia may place a widebody order sometime this year, it is believed.

Saudia also operates a 11-strong dedicated cargo fleet, comprising seven 747 cargo variants and four 777Fs (with an average age of three years). Three more 747 cargo aircraft are currently in storage. The group also includes Saudia Albayraq, a specialist VIP business flight operator between Jeddah and Riyadh, which uses three leased A319s (with an average age of 17 years)

LCC move

As part of SV2020, in April 2016 Saudia announced the launch of flyadeal, an LCC based at Jeddah airport. According to Arab Air Carriers Organization (AACO) data, the LCC share of the total Arabian aviation market rose from 5% in 2006 to 22% in 2016, and the Saudi group was very late to look at the business model.

Nevertheless, flyadeal began operating in September 2017 and today flies between six domestic destinations with a fleet of five A320s. With a classic LCC operating model, flyadeal is targeted at leisure, business and Hajj/Umrah pilgrim travellers, and Saudia executives have stated that flyadeal is likely to place an order for 30 narrowbodies with Airbus or Boeing before the end of 2018, with the company making an internal decision by the second quarter of 2018.

However, flyadeal now faces plenty of competition from Saudi airlines. Saudia had a complete monopoly as the only airline based in the country until 2007, when two new airlines obtained government licenses.

The main domestic competitor to the Saudia group today is flynas, which launched in 2007 as Nas Air before changing its name to flynas in November 2013. It's owned by two Saudi conglomerates and its marketing tag is "The Kingdom's First Low-Cost Airline". With hubs at Jeddah and Riyadh, flynas operates to 17 destinations domestically and 17 internationally (in Egypt, Lebanon, Jordan, Turkey, Iraq, Kuwait, Sudan, Nigeria and the UAE), while a codeshare with Etihad (first signed in 2012) expands its network considerably.

It carried 6.3m passengers in 2016 (a 14% rise year-on-year) with a fleet of 26 A320s, two A319s and a single 767, which have an average age of 11 years. However, under

SAUDIA FLEET

		In service		On Order
	Aircraft	**Saudia**	**flyadeal**	
Passenger	747-400	7		
	777-200	12		
	777-300	35		
	787-8			1
	787-9	11		2
	A319	2		
	A320	41	5	19
	A321	15		
	A330-200	7		
	A330-300	32		
	Total	**162**	**5**	**22**
Freight	747-400F	9		
	747-8F	2		
	777-200F	4		
	Total	**15**		
	Total Fleet	**177**	**5**	**22**

the leadership of CEO Paul Byrne (appointed in November 2014) the airline is pursuing aggressive expansion, and in January 2017 flynas ordered 80 A320neos (plus options for another 40 aircraft) — at a list value of $8.6bn — for delivery over 2018 to 2026.

Another competitor is SaudiGulf Airlines, owned by a consortium of Saudi companies and launched in October 2016. It operates four A320s between its main base — Dammam — and three domestic destinations. SaudiGulf targeted 700,000 passengers carried in 2017 and has ambitious plans to increase its fleet to 30 aircraft within the next three years. Last year its chief executive said the airline would order up to 16 777s before the end of 2017 (for delivery from 2020 onwards), which would enable the airline to launch international routes to Asia, Europe and North America. However, those orders haven't yet materialised. SaudiGulf also has 16 Bombardier CS300s on order, though delivery has been delayed and there is the possibility that the entire order may be scrapped.

The other Saudi scheduled carrier is Nesma Airlines — based in Jeddah and which operates to 14 domestic destinations, and Cairo, with seven Airbus A320 family aircraft and three ATR 72-600s.

That growing domestic competition is a challenge to the Saudia group. As can be seen in the chart on the preceding page, Saudi Arabia leads the Middle East in terms of scheduled passengers, and this is due largely to its large domestic aviation market in a country that contains 830,000 square miles — substantially larger than any other Gulf nations. The country also benefits from the massive pilgrim market; last year Saudia carried 0.5m pilgrims between 100 destinations on the annual Hajj, on virtually all its scheduled routes plus several charter destinations. The Saudi government also has a plan to increase the number of travellers coming from abroad for the Umrah pilgrimage (in contrast to Hajj, one that that can be undertaken at any time of the year) from 6m in 2015 to 15m in 2020.

But as large as it is, the domestic market or even intra-Arabian pilgrim traffic isn't the main prize that Saudia is eyeing; what it really wants to do is become an airline that can truly compete with the three Gulf super-connectors.

Saudi politics

Saudia's long-term strategic ambitions are inextricably tied with those of the Saudi Arabian state.

With the second-largest reserves of oil in the world (after Venezuela), Saudi Arabia has the largest economy of any Arab country. However, GDP per capita has fallen steadily since the oil peak of the early 1980s, and today Saudi Arabia lags the UAE, Kuwait and Qatar in this measure.

That's partly because Saudi Arabia is the least diversified economy among the Gulf states and is still heavily dependent on the oil sector (it accounts for between 40%-50% of total GDP, depending on which data source you believe) — and hence is vulnerable to fluctuating oil prices. To make matters worse, Saudi Arabia's proven oil reserves have changed little since 1988, and some analysts believe the country is significantly exaggerating the reserves it has declared.

The economy slipped into recession in 2017 (thanks to low oil prices) and — perhaps more importantly — there is growing unease about the lack of political freedom in a country where most of the population are millennials. In addition, of the 33.3m who live in Saudia Arabia, 8.4m are non-nationals (the majority of which are poorly-paid migrant workers).

The Kingdom is renowned within the Gulf states as having relatively few political freedoms. It's an absolute monarchy, with no political parties or national elections, and in effect is ruled feudally by the Saud royal family, heavily influenced by the puritanical Wahhabi form of Islam.

The Arab Spring didn't touch Saudi Arabia, and any political reform since then (such as last year's decree to allow women to drive) has been marginal at best; for example, it remains one of the few countries in the world not to accept the UN's Universal Declaration of Human Rights. But pressure is slowly growing from the young, urban population for change, and the Sauds realise that economic improvements (and diversification) is one way to head off calls for political reform.

Against that background, it's no wonder that Saudi Arabia has unveiled many plans to diversify the economy over the years. The latest is "Vision 2030", launched in 2016 with several objectives that include "transforming our unique strategic location into a global hub connecting three continents — Asia, Europe and Africa".

A futile challenge?

This includes heavy investment in airport and aviation infrastructure, which will help Saudia realise its own ambitious of strong growth in its fleet and network combined. But growth is one thing; it is an entirely different challenge for Saudia to grow and effectively challenge the Gulf super-connectors.

The scale of the task is shown

by looking at airport data (which includes transit passengers) — see chart on page 8. The five hubs that Saudia operates are largely second-class citizens compared with the hubs of the Gulf super-connectors, with only Jeddah preventing a complete Top Three dominance of Doha, Dubai and Abu Dhabi. And, of course, Jeddah's passenger flows are boosted considerably by being the closest airport to Mecca (100km), with many of the annual Hajj pilgrims passing through a dedicated Hajj Terminal that can handle 80,000 passengers at the same time thanks to its 5m square feet size.

But Jeddah's passenger growth was a measly 0.7% in 2017, significantly less than its three super-connector hub rivals, and that's because the airport is operating at capacity. Huge effort and investment is being made to expand the airport — a first phase that started in 2006 was completed last year (taking capacity to 30m), and the second phase will increase this to 43m annually by 2025, before a final phase will see capacity rising to 80m a year in 2035.

Yet increased capacity does not mean increased connecting traffic. In reality, Jeddah is no better or worse geographically than the super-connector hubs, but Saudia has a long way to go before it can match the appeal of its rivals. The fleets and connection offered by Etihad, Emirates and Qatar far exceed anything offered by Saudia and its hub — and to attract large amounts of west-east and east-west traffic flow Saudia must improve its service standards significantly.

Though Saudia was given the "most improved airline of the year" award by Skytrax at the Paris air show last year, that's partly because Saudia starts from a very low base.

SAUDIA: ROUTE NETWORK

Of course, Saudia is frantically trying to improve its standards and appeal to non-Arabic travellers. It joined the SkyTeam alliance in May 2012 and improved its in-flight entertainment services in 2017 by adding a selection of "Western" movies in 2017 after agreeing a deal with Warner and Fox to supplement its traditional programming (largely religious and Arabian content) and widen the appeal to non-Middle Eastern passengers.

The largely unspoken problem with Saudia is that it still has a severe image problem in terms of being associated with one of the most conservative regimes in the Middle East. And Saudia didn't help its cause in August last year when it warned it would kick off its aircraft any passenger who didn't adhere to the country's strict dress code, which forbids women to expose arms or legs. Its statement also said that women who wear "too thin or too tight clothes" would also be deplaned "at any point".

With that kind of message going into the market, it will be very difficult for Saudia to become a true competitor to the Gulf super-connectors any time soon — and certainly not by 2020 or 2021, when the Saudi state is planning a joint IPO of Saudia and flyadeal as part of its goal of raising $300bn by selling government stakes in companies over the next few years.

US airlines: Optimism for 2018

2017 WAS the eighth consecutive year of healthy profitability for the US airline industry, with the nine largest carriers earning an aggregate operating profit of $21.6bn (13.1% of revenues). The combined net profit before special items was $12.2bn, 7.4% of revenues.

But it represented a second consecutive year of profit decline. Industry operating earnings fell by 17.2% from the year-earlier $26.1bn, mainly because of higher fuel prices, though expensive new labour contracts were also to blame.

The US airline industry became profitable in 2010, following a decade of steep losses, and in 2010-2016 recorded an aggregate net profit of $61.7bn (A4A data, see chart on page 14).

The reasons for the turnaround have been well documented: a decade of restructuring, many Chapter 11 visits, extensive consolidation, lack of new entrants, years of tight capacity discipline, new ancillary revenue streams and return-oriented management teams. Between late 2014 and mid-2017 US airlines also benefited from lower fuel prices.

US airlines are now regarded as having transformed into a viable, long-term business that can achieve financial metrics comparable to those of other high-quality S&P industrials. However, US investors still worry that the airlines could slip back into the bad old ways. Every time there is a mere hint of an airline stepping up capacity growth, a competitive skirmish developing or unit revenue growth not meeting expectations, airline share prices fall.

There were plenty of such scares in 2017, as a result of which US airline stocks vastly underperformed the S&P 500 Index. While the S&P rose by 20.5% in 2017, the NYSE Arca Airline Index was up by only 5.5%.

2018 has already seen major drama with US airline stocks. Initially many airlines benefited from up-beat RASM and earnings reports. Then on January 23 United dropped the bombshell: it would step up capacity growth to 4-6% in 2018 and probably maintain that rate in 2019 and 2020.

As a result, United's share price fell by 15.2% and other airline stocks by 7-11% in January 23-25. The following week airline stocks got caught up in the turbulence that hit the global markets, which led to further price declines.

Analysts and airline CEOs were quick to play down the impact of United's plans. Most feel that the move makes sense and is unlikely to provoke competitive responses. But investor sentiment has been dealt a blow, which analysts believe could linger on.

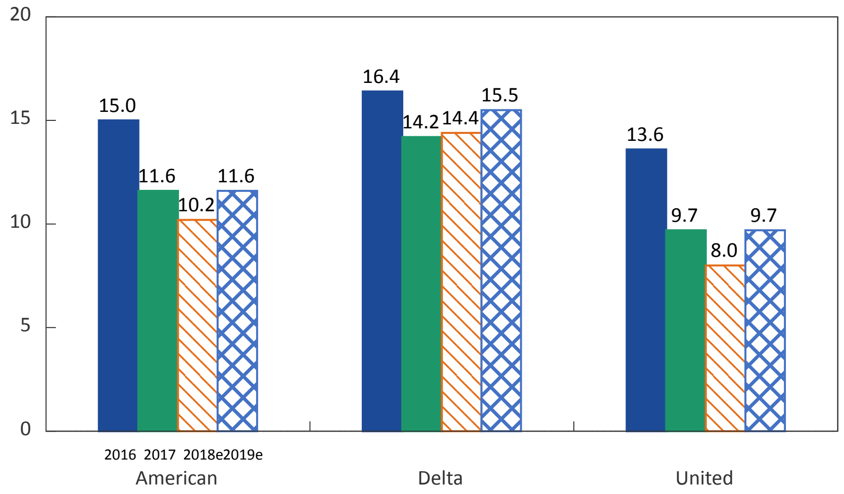
The biggest issue for US airlines in 2018 is likely to be higher fuel prices.

US AIRLINES' 2017 FINANCIAL RESULTS

	Operating revenue		Operating		Adjusted‡ net	
	$m	% chg	Result ($m)	Margin (%)	Result ($m)	Margin (%)
American	42,207	5.0	4,792	11.4	2,399	5.7
Delta	41,244	4.0	6,114	14.8	3,568	8.7
United	37,736	3.2	3,674	9.7	2,052	5.4
Southwest	21,171	3.7	3,455	16.3	2,107	10.0
Alaska	7,933	34.0†	1,378	17.4	823	10.4
JetBlue	7,015	5.8	1,000	14.3	580	8.3
Hawaiian	2,696	10.0	507	18.8	301	11.2
Spirit	2,648	14.0	402	15.2	231	8.7
Allegiant	1,504	10.3	263	17.5	156	10.4
Total	**164,154**	**5.6**	**21,585**	**13.1**	**12,217**	**7.4**

Notes: † Impact of the Virgin America acquisition, which closed on December 14, 2016. ‡ Excluding special items, tax credits, etc.
Source: Company reports

TOP THREE US AIRLINES'
OPERATING MARGIN PROJECTIONS



*Notes: * Excluding items. ** Forecasts by J.P. Morgan (January 30, 2018)*

After three years of WTI crude oil at $50-a-barrel or less, the past five months have seen the price rise to the low-to-mid 60s.

While higher fuel prices are likely to lead to higher airfares domestically (and fuel surcharges internationally), there will be time lags. Also, it may not be possible to fully offset the hike through ticket prices.

On the positive side, US airlines are benefiting from a promising macroeconomic outlook, robust demand for air travel in the US and internationally, improving RASM trends and labour costs being in check.

At this point, and assuming that crude oil prices will be in the $60-70/barrel range, analysts expect US airline pretax earnings to decline slightly in 2018, before bouncing back in 2019.

But tax windfalls resulting from the Tax Cuts and Jobs Act of December 2017 should significantly boost US airlines' net earnings and EPS growth in 2018. Who will benefit the most?

Labour holiday this year

Hefty labour cost increases, resulting from new labour contracts (or, in American's case, mid-contract pay increases), were the US airline industry's biggest cost headwind in 2017.

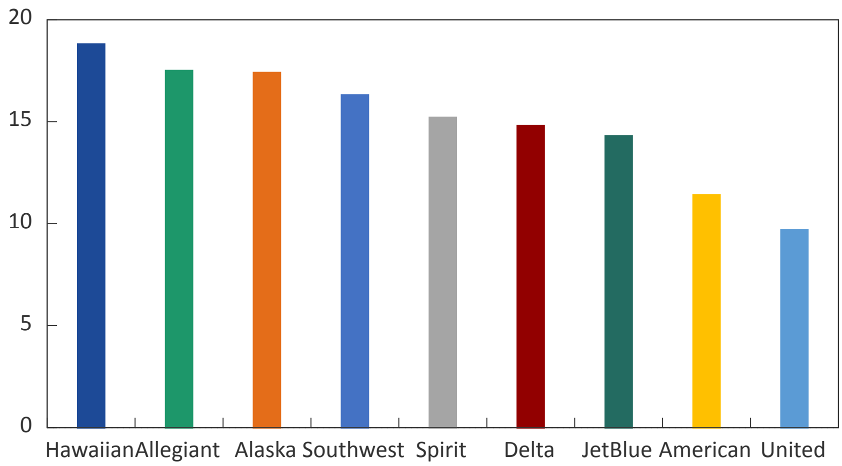
This year, labour cost increases should be more in line with the rate of inflation. The exceptions are two US low-cost carriers. Spirit, the largest ULCC, has secured a five-year tentative contract with its pilots that will include a 43% average pay increase, improved benefits and $75m in ratification bonuses, increasing Spirit's costs by $90m in year one.

JetBlue has been in negotiations with its pilots for a first contract for three years, following a vote to unionise in 2014. The union is seeking pay rates in line with those at other airlines. A deal seems likely in 2018, because the talks have been under federal mediation since last summer and the pilots have started picketing.

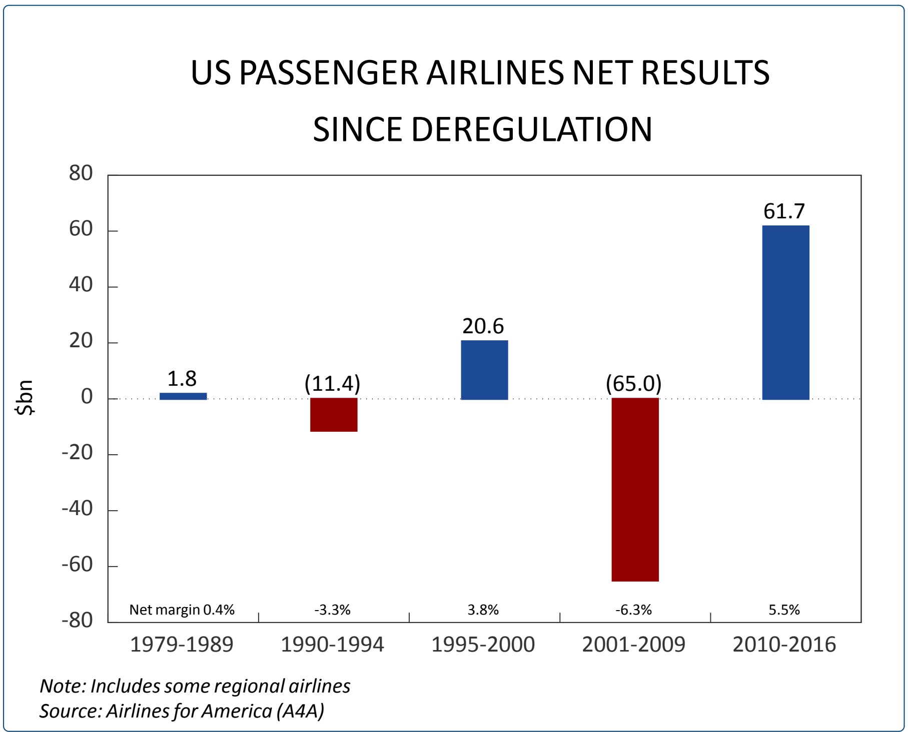
Fuel holiday over

The three-year slump in oil prices, which began when the WTI oil price fell from over $100 per barrel to the $50-level between August 2014 and January 2015 and included spikes to below $30, is over. Prices began rising in August 2017 and reached a high of $66-67 in mid-January, before re-

US AIRLINES' 2017 OPERATING MARGINS



Source: Company reports



treating to the low-60s in early February.

Fuel was already a headwind for US airlines in Q4. In 2017 the airlines saw their average unhedged fuel price per gallon increase by around 21-22%, from $1.40 to the $1.70 level. This year the average price is expected to exceed $2 per gallon — a level last seen in 2015.

American's CEO Doug Parker estimated in January that the carrier would face an additional $1.8bn fuel bill in 2018. United's executives put the figure at $1.6bn. Few of the US airlines hedge for fuel these days.

Internationally, the problem may again be solved by fuel surcharges, which have already started reappearing at least in the Pacific market. Domestically, the consensus is that higher fuel prices will lead to higher ticket prices. However, several airlines noted that there is always a time lag (of 2-4 months or more) in passing such cost increases to customers.

A consensus of sorts is emerging that airlines will be seriously concerned only if/when crude oil prices rise above $70 Brent/high-60s WTI and stay at such levels for a period of time.

US airlines have a pretty good record of managing a high fuel environment. They were profitable earlier this decade when oil prices were well over $100 a barrel. And if relatively high fuel prices persist, it could accelerate the processes of retiring older aircraft and making mid-life aircraft more efficient by adding more seats.

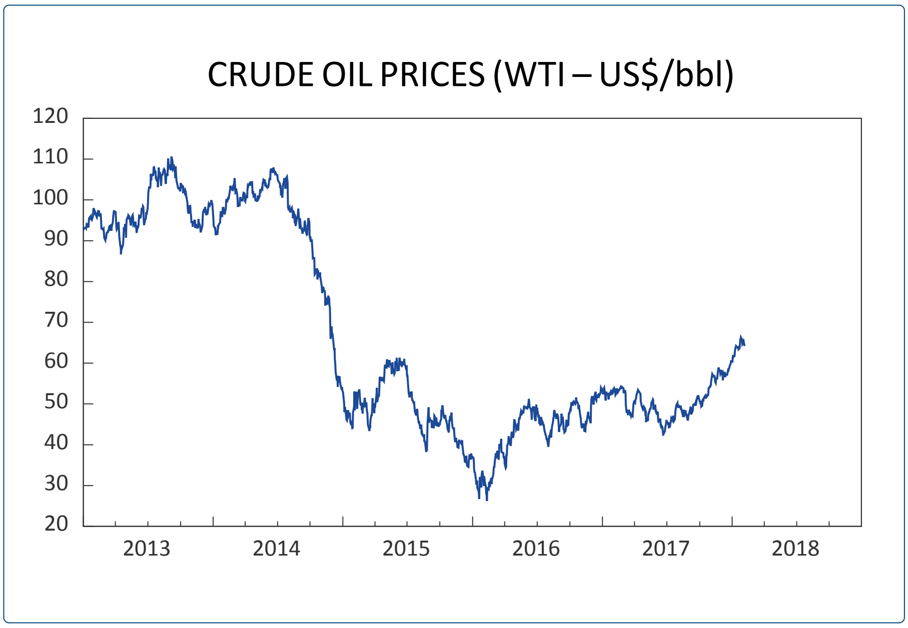
Demand and RASM strength

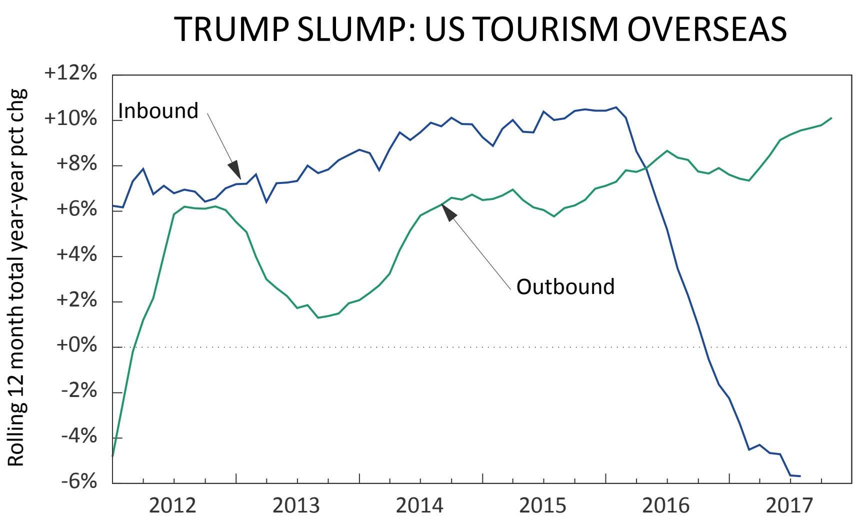
In Q4 calls all US airlines commented about the strength of demand — something that has helped accelerate unit revenue growth in recent months.

Importantly, the improvements have been broad-based, with both domestic and international markets, as well as all different revenue segments, recording healthy gains. Even cargo — long the laggard — is now producing stellar results.

Several airlines noted that the international environment had not been this strong in years despite what has been dubbed the "Trump slump" — in the first seven months of 2017, international visitors to the US fell by 4%. However, outbound travel (which the US Big Three airlines are well positioned to capture), is booming — especially to Europe — and has amply offset the inbound decline.

American has performed especially well because it is still reaping benefits from the December 2013





Source: National Travel and Tourism Office.
Inbound: foreign visitors to the US. Outbound: US citizens' trips. Excludes Canada and Mexico.

merger with US Airways and catching up on the product front. In Q4 the airline saw its PRASM increase by 5.4% — the sixth consecutive quarter of positive growth. Revenues from corporate contracts recorded the strongest growth in eight quarters.

Every regional entity in American's network saw positive unit revenue growth in Q4. PRASM rose by 5.7% in the domestic market, 7.7% on the Atlantic, 6.3% to Latin America and 1.2% on the Pacific.

The Atlantic result was the best American had seen since the merger and it was attributed mainly to "improved execution of LCC price matching together with strong premium cabin performance". The UK led the way with double-digit PRASM growth.

The somewhat alarming reference to "LCC price matching" probably just meant better yield management. The strong premium cabin performance reflected a new Premium Economy product on international flights — both American and Delta began rolling it out in 2017, with United following in 2018. The US airlines are merely catching up with their European and Asian partners, which already offered a comparable premium product.

In Q4 American's cargo revenues surged by 19.7% on both higher volume and higher yields, continuing a positive trend seen since mid-2016.

Delta executives described the overall demand environment as the "healthiest we've seen in years". System PRASM was up by 4.2% in Q4. All of the regions saw PRASM increases, with the Pacific turning positive for the first time in 4-5 years. Atlantic PRASM rose by 7.4% on strong business class bookings and a foreign exchange tailwind. Delta said that its Basic Economy offering, which is aimed at tackling LCC competition, is now available in more than half of its European markets. In 2017 cargo revenues grew for the first time in six years.

Like American, Delta is seeing strong corporate demand and expects the momentum to continue, helped by new product initiatives aimed at premium travellers. The weaker dollar means that Delta is positioned to benefit from a tailwind from foreign exchange in 2018.

Domestically, though, US airlines have repeatedly failed to get fare increases to stick. That and United's capacity hike announcement prompted JP Morgan analysts to reduce their industry PRASM growth forecast for 2018 from 2.5% to 2% in January. All of the six largest US airlines except Alaska are projected to see positive unit revenue growth in 2018.

Brighter economic prospects

US airlines are optimistic that buoyant economic conditions will help maintain strong air travel demand in 2018 and enable them to raise ticket prices without having to resort to capacity cuts.

GDP growth has picked up worldwide in recent months. In January the IMF raised its global growth forecasts for 2018 and 2019 by 0.2 points to 3.9%. That would be up from 3.7% growth in 2017 and 3.2% in 2016.

Importantly, the recovery is broad-based, with all world regions and both developed and emerging economies doing well. The IMF described it as "the broadest synchronised global growth upsurge since 2010".

The IMF also revised up its growth forecast for the US, in part to reflect the macroeconomic impact of the tax reform, which IMF estimates will boost US annual real GDP growth by 1.2 points by 2020. US GDP is now forecast to expand by 2.7% in 2018 and 2.5% in 2019 (up 0.4 and 0.6 points from earlier projections), following 2.3% growth in 2017 and 1.5% in 2016.

The corporate tax rate cuts and faster GDP growth should be positive for US business and corporate travel demand. The tax rate cuts may also mean that US consumers will have more money available for discretionary spending like air travel.

Capacity creep and hub bolstering

United is not alone in stepping up capacity growth; all of the top-nine US carriers currently expect to grow ASMs at a higher rate this year. JP Morgan estimated in a January 30 report that industry ASM growth would increase from 2.8% last year to 4.8% in 2018, before slightly moderating to 3.9% in 2019.

The higher rate is partly a result of the extensive flight cancellations in 3Q17 due to an unusually severe hurricane season in the Caribbean and Florida. For example, American expects 3% "actual" ASM growth but only 2.5% "schedule-over-schedule" ASM growth in 2018.

Also, all of the airlines have good reasons to add capacity. JetBlue is accelerating ASM growth from 4.5% in 2017 to 6.5%-8.5% in 2018 because it was hit hard in 3Q17 in the Caribbean and has good opportunities in its focus cities.

Southwest expects its ASM growth to accelerate from 3.6% in 2017 to "the low 5% range" in 2018, largely reflecting the retirement of its 737-300 Classics in September 2017 and recovery from last autumn's natural disasters.

Alaska is slightly boosting its system ASM growth from 7.1% in 2017 to 7.5% in 2018, because it still has good opportunities to "connect the dots" following its acquisition of Virgin America. However, Alaska made the financial community happy by announcing plans to slow capacity growth to 4% in both 2019 and 2020.

Hawaiian is stepping up its ASM growth from 3.4% in 2017 to 5-8% this year as it enters into the "last phase of a strategy mapped out over a decade ago".

The ULCCs are also growing at a faster pace this year: Spirit is projecting 23% ASM growth and Allegiant 11-15% growth, up from 16.1% and 10%, respectively, last year.

It all sounds very reasonable, but airline investors in the US are fixated about capacity growth outstripping GDP growth.

American and Delta both remain in line (with 3% and 2-3% ASM growth, respectively, in 2018), but United's growth will far exceed GDP growth in the next three years.

United held a special investor meeting in New York to discuss its new strategy. The aim is to strengthen essentially the three mid-continent domestic hubs (Chicago, Denver and Houston), which suffered when United shrank by 8% in the six years after merging with Continental. Although United has strong international gateways, the profit margins of its mid-continent hubs are 10 percentage points lower than those of American's and Delta's inland hubs.

The plan is to improve connectivity and regain relevance at the three hubs by broadly restructuring them and adding new services.

United sees hub strengthening as critical to driving higher profits and closing the operating margin gap with its peers.

At the January event, United's president Scott Kirby gave a master class on hub economics, reminding everyone why things like connectivity and hub dominance matter.

Equity analysts agree. In a January 23 note, Wolfe Research observed that hubs are key to US airline profitability and that it is critical that the carriers "truly dominate" their hubs.

JP Morgan analysts wrote on January 30 that they had "long identified United's paucity of hub dominance as a key contributor to sagging margins" and that the current plan to bolster hub connectivity comes "straight from the Best Practices handbook of Hub and Spoke Airlining, differing little from AAL and DAL efforts in recent years". The analysts said that they remained convinced that "American and Delta will not lash out" and upgraded United's stock from underweight to overweight.

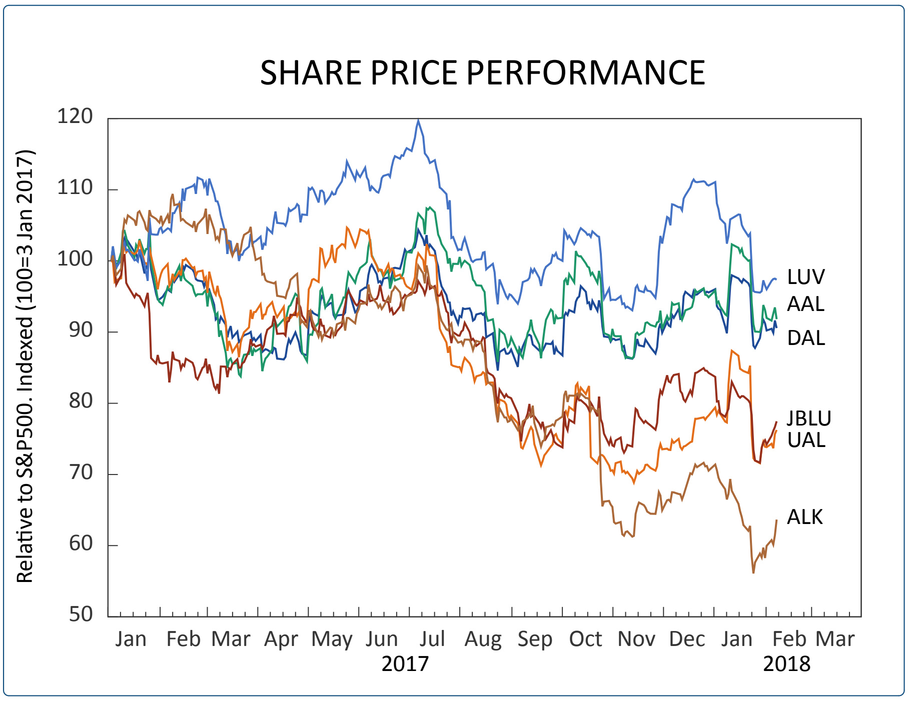
Bernstein analysts considered in a January 31 note that it was "hardly a return to the bad old days" and upgraded both United and American to outperform.

Commentary from other airline managements also helped. American's CEO Doug Parker stressed that investors needed to consider the type of growth in question. Growing out of a hub, where an airline has a "real strategic advantage" was the right kind of "smart, efficient" growth that does not result in yield decline or fare wars.

American, too, continues to strengthen its hubs. Its 2018 summer schedule will include 52 new nonstop domestic or international routes from its nine hubs. But all but five of the new routes will connect existing cities to new hubs — in other words, they are opportunities created by the merger.

Parker said that American would respond to competition where it made sense, but "it is always going to be around our core strategic assets" — meaning that American will continue to defend its hubs.

Even as there is agreement about hub-strengthening being the right move for United, there is scepticism about United's ability to close the margin gap. The management presented similar plans in late 2016 and the margin gap only widened last year. Many believe that there could



be another top-level shake-up at United this year.

Keeping ULCCs in check

The legacies' hub-strengthening is negative for ULCCs because the implication is that the Basic Economy product, which is directly aimed at ULCCs, will be available in more domestic markets.

In a recent report, Cowen analysts noted two major differences between the US and European markets. First, the US legacies "vigorously defend their hubs and match low fares regardless of whether or not those fares make sense". Second, "there aren't many second-tier airports in the US".

The latter helps explain why ULCCs like Spirit and Frontier took advantage of the legacies' earlier shrinkage and began venturing into legacy hubs as they sought new growth opportunities.

United executives noted that the airline had been losing connecting passengers to discount carriers, so the efforts to boost connectivity at hubs are also aimed at reversing those trends. United would also continue to have an "aggressive competitive posture vis-à-vis ULCCs". The following observation from Scott Kirby was indicative: "No-one chooses to fly on a ULCC if they can get the same price on United Airlines. Nobody".

None of that was new; rather, United's comments were merely a reminder that ULCCs will face an uphill battle to grow market share in the US. Although, if Southwest is included the LCC/ULCC share is already around 29%.

Another thing that may slow the progress of ULCCs in the US is higher costs. Spirit faces a significant hike in labour costs from the new pilot contract, which may make it less inclined to lower ticket prices.

Benefits from tax reform

Airlines are among the larger beneficiaries of the corporate tax reforms that were signed into law in the US in December, though the extent and timing of the benefit varies between individual carriers.

The airlines are benefiting from the reduction of the US corporate tax rate from 35% to 21% and a rule change allowing an immediate full expensing of capital investment (previously aircraft were depreciated over seven years for tax purposes).

Southwest is the clear winner, because it is a full US taxpayer and has significant ongoing fleet capex. The airline saw its 2017 income tax provision reduced by $1.4bn, which meant that it recorded a $237m tax benefit in 2017 and its net income surged to $3.5bn (16.5% of revenues). An estimated 23-23.5% tax rate in 2018 will also significantly boost Southwest's net earnings this year.

Alaska, JetBlue, Hawaiian and Spirit are also immediate beneficiaries. All of them recorded sizeable reductions in deferred tax liabilities in Q4 and will benefit from the lower tax rates in 2018.

The Big Three airlines are not yet cash taxpayers, because due to earlier heavy losses they are still using Net Operating Loss (NOL) carryforwards. But the NOLs will now last longer as the airlines can burn them at a lower taxable rate.

The Big Three will of course have lower tax bills when they become cash taxpayers in the future. That will not happen in 2018. Delta is expected to be the first to pay cash taxes in 2019/2020. Delta expects the benefit from the tax reform to be about $800m annually at its current earnings level.

According to Cowen analysts, American and United are not expected to pay cash taxes until after 2020. At year-end American still had $10.2bn of federal NOLs and $3.5bn of state NOLs.

Four of the airlines (American, Southwest, JetBlue and Alaska) followed the example of numerous S&P 500 companies and paid their employees a $1,000 cash bonus specifically related to the tax reform. Bonuses are tax-deductible and those booked in 2017 (and paid by March 2018) offered more in tax savings than if booked in 2018.

Otherwise, US airlines will use the tax savings to pay down debt, buy back stock, increase dividends and invest in the business. Delta also mentioned funding pension plans.

One question is whether US airlines will now order more new aircraft. So far only Southwest has done so, announcing in early January a "further investment in its Boeing fleet" specifically to take advantage of the tax reform legislation. The airline exercised 40 737 MAX 8 options for 2019-2020 delivery but deferred 23 737 MAX 7 firm orders.

The Big Three's fleet plans always included some new aircraft orders. Delta made its long-awaited narrowbody decision in the fourth quarter before the tax reform was passed, ordering 100 A321neos with deliveries from 2020.

American's hitherto industry-leading aircraft capex will decline from $4.1bn in 2017 to $1.9bn in 2018 now that the airline has completed its "accelerated fleet renewal programme". But 2019 and 2020 will see higher aircraft spending ($2.8bn and $2.5bn) and American continues to have significant non-aircraft investments ($1.8bn in both 2018 and 2019).

But it will be interesting to see how United will facilitate the planned three-year growth spurt. The management projects total capex to decline from $4.7bn in 2017 to $3.6bn-3.8bn in 2018 but 2019 and 2020 seeing higher spending. United will continue to add used aircraft. This year's capex will fund 24 new aircraft deliveries, opportunistic purchases of aircraft off-lease and continued investment in product, technology and infrastructure.

By Heini Nuutinen

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