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Brexit update: Evidence for Walsh and O'Leary views

HAVE YOU heard the one about the two Irishmen, each a Chief Executive of a major airline, but both apparently with very different views on the likely impact of Brexit on aviation? Michael O'Leary, CEO of Ryanair, predicts that we are all doomed. "I think Brexit is going to be one of the great economic suicide notes in history. I think it is a shambles — the UK will suffer hugely, Europe will suffer ... and it will be bad for our industry."

On the other hand, Willie Walsh, Chief Executive of IAG (which he is quick to point out, in the context of Brexit, is a European holding company and not actually an airline), takes a far more sanguine approach. "I'm a firm believer that this will get resolved," he told the A4E Aviation Summit in March.

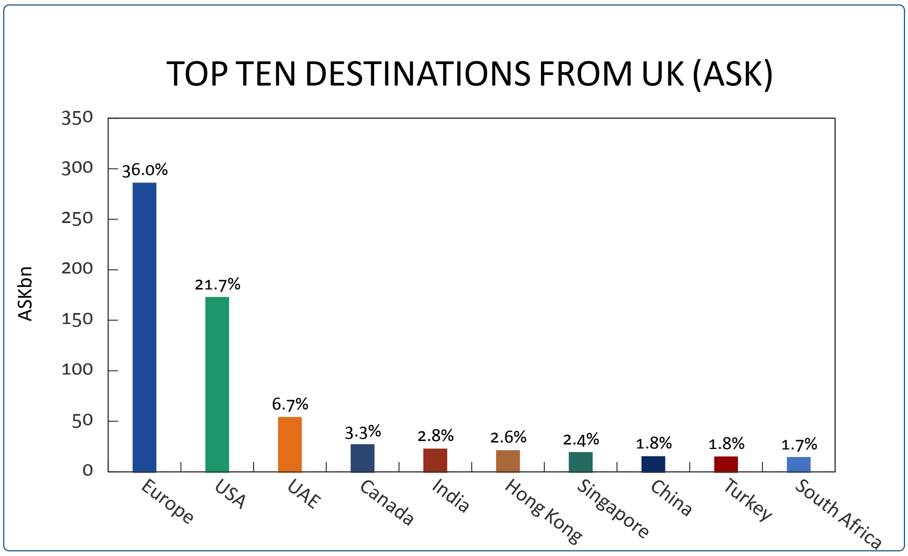
In reality, and in private, O'Leary and Walsh may well share similar views on the likely impact of Brexit on the industry and what needs to be done. Certainly, both Ryanair and IAG should have at least some concerns about their own ownership structures in the event of a failure to agree a liberal (soft) post-Brexit regulatory regime. Clearly, however, they have decided to adopt very different approaches to influencing the political debate.

A similar split can be seen in the political debate itself, to the limited extent that it has been made public. The UK Government appears to share Willie Walsh's view that there is no need to panic; it will be all right on the night. Chris Grayling, UK Secretary of State for Transport, for example, told the Airlines UK Annual Dinner in January: "We want the best possible access to European aviation markets. We believe it is in the EU's interests to seek a liberal arrangement for aviation ... I am confident that we will get what we need."

At the same time, Henrik Hololei, the European Commission's Director General for Mobility and Transport, has painted a far more pessimistic picture. Attending the A4E Aviation Summit in Brussels along with O'Leary and Walsh, he was quoted as rejecting the possibility of an aviation sectoral negotiation ("everything must await the progress of the wider framework of the negotiations between the blocs"). He suggested that Grayling's approach was far too optimistic ("wishful thinking") and "not really substantiated by facts at this stage."

Perhaps the most accurate comment came from Brian Pearce, Chief Economist at IATA, when he said shortly after the referendum: "Bluntly, we are in uncharted waters." At the time IATA had followed most economic commentators in forecasting a substantial and early negative impact on UK GDP and therefore on air traffic to/from the country. This didn't happen, at least

This issue includes



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in the way envisaged. But there was an economic impact, notably the significant fall in the value of sterling which affected air transport. Craig Kreeger, Chief Executive of Virgin Atlantic Airways, recently claimed that this was a factor in Virgin's poor financial performance in 2017.

It is now evident that while there is likely to be a negative economic impact as a result of the Brexit vote, both on the economy in general and the aviation industry in particular, it will not be as great nor as immediate as was first envisaged. Inevitably much will depend on what type of Brexit is eventually negotiated, and in all probability, as is so often the case when dealing with the EU, that will not be totally clear until the last moment. We could yet experience again the infamous EU *stopped clock*. Nevertheless, in general expectations of a softer Brexit have certainly increased as the negotiators inch forward, and this is as true of aviation as it is of the wider negotiations.

The positives and negatives

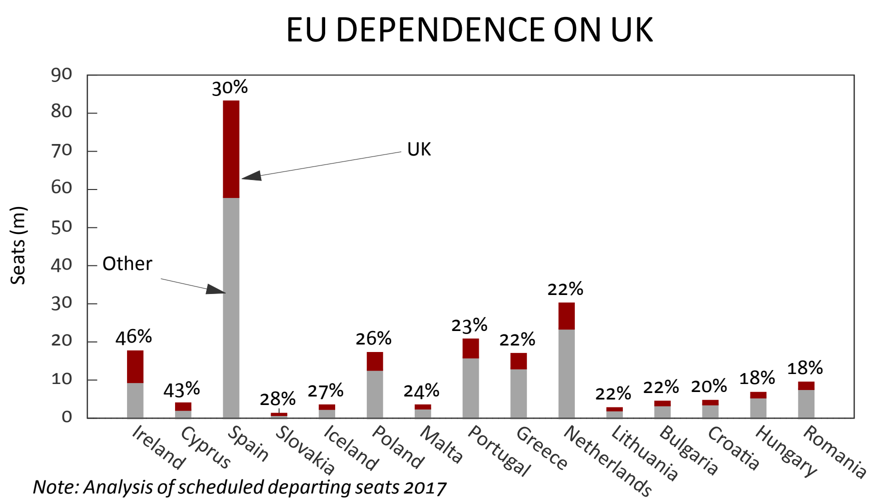
There is a dearth of hard facts in the public domain about how much progress, if any, has been made in the various negotiating streams leading to a post-Brexit aviation world. But it is not true to say that we know nothing about what is taking place, and much of what we do know gives reason for some optimism. However, before considering what has been achieved, and always bearing in mind the negotiators' tenet that *nothing is agreed until everything is agreed*, it might be helpful to list some of the more positive factors which have slowly emerged.

✈ The UK is the world's third-largest origin/destination aviation market, and by some margin the largest in Europe. It is certainly not a market that the rest of Europe can ignore, nor would want to. In 2016, some 153 million passenger journeys were made between the UK and the EU/27. Of the more than 370 international destinations that had at least a weekly service from a UK airport, over half were in the EU.

✈ The creation of the internal aviation market (to which, ironically, the UK contributed so much) has been one of the EU's greatest successes, an iconic popular achievement producing clear benefits for both consumers and industry. The exclusion of the UK from even a part of this market would have a significant negative effect, felt throughout Europe.

✈ Among the most difficult issues to be addressed in the Brexit aviation negotiations are the rules applicable to the ownership and control of airlines. But this is as much an EU/27 problem as it is a UK one. Airlines such as Ryanair and Wizz will, as things stand at present, struggle to maintain their status as Community carriers, while if IAG's ownership structure is challenged, one might reasonably expect the UK to raise similar questions about the nationalities of various Lufthansa subsidiaries in Belgium, Austria and Switzerland. A common problem often results in a common solution.

✈ Many EU/27 countries and those situated outside the EU with whom the Community has signed liberal aviation agreements are highly dependent on UK tourist traffic. They are unlikely to want to see this market put at risk. In 2016, UK tourists spent over £25 billion in the EU as a result of 53 million visits. (EU citizens spent less than £10 billion in the UK during 25 million visits.) It may be relevant in this context that it was Spain which



Note: Analysis of scheduled departing seats 2017

reportedly insisted on there being a specific mention of aviation in the recently signed Transition Agreement.

✈ Similarly, some EU Member States attract substantial numbers of UK transit passengers, notably the Netherlands where KLM serves more UK destinations than any other major airline.

✈ The Transition Period, not dissimilar to the 'comity and reciprocity' arrangements occasionally applied to aviation bilateral disputes, will extend the time available for negotiations by some 20 months. This provides airlines with more certainty and negotiators with more time to address the complicated issues remaining.

✈ There are tentative signs (see below) that the Gibraltar issue might not be such a serious problem after all.

These are all positive factors which should help to achieve a favourable outcome to the Brexit aviation negotiations. However, there are also negative elements which can't be ignored. Commission officials are never slow, for example, to remind everyone that the UK cannot be seen to gain from leaving the EU, for fear that others might be tempted to follow. This highlights one of the more disappointing aspects of the way in which the UK has conducted the negotiations so far, namely its failure to argue persuasively that a liberal post-Brexit aviation agreement would be mutually beneficial to both sides.

Instead, such an outcome has repeatedly been presented as very much a British objective, a win for the UK rather than a draw for both sides. If left unchallenged, this will inevitably risk reducing the negotiating flexibility available to the EU, or require the UK to make politically difficult concessions in other sectors (fishing rights?) to get an acceptable aviation deal. It is noticeable that despite the widespread support among most stakeholders for maintaining the *status quo* in air transport, there has been no co-ordinated lobbying campaign of the kind we have seen in the industry in the past. Nor have the voices of consumer groups been heard seeking to protect what liberalisation has achieved. This is both surprising and disappointing.

There is also a minority of aviation stakeholders, with Air France/KLM and Lufthansa to the fore, who seem to see commercial advantage in a more restrictive European aviation regulatory regime in the future. For them, anything that limits the ability of UK airlines to compete in Europe can probably only be beneficial. At the A4E Aviation Summit in March the position of Air France/KLM seemed to be softening slightly, possibly a reflection not only of the importance of the UK market for KLM's transit traffic, but also a recognition that the holding company's investment in Virgin Atlantic could run into problems in the absence of liberal airline ownership and control rules. However, there was no sign that Lufthansa was changing its hardline approach, and even Air France's position is by no means certain.

The Gibraltar problem

It is worth looking at the Gibraltar problem in more detail. While most attention has been devoted to the border between the Republic of Ireland and Northern Ireland, for aviation Gibraltar threatened to be more significant. Spain, like Ireland, has been given a veto on the final Brexit deal in order to put pressure on the UK to come up with a solution to a disagreement that stretches all the way back to 1713. For some years Spain has held up important EU aviation legislation on consumer rights and Single European Skies, insisting that such rules should not apply to Gibraltar.

The key aspect of the dispute with respect to aviation seems to revolve around access to the airport, which borders to the north on La Línea de La Concepción in Spain. An original deal providing for joint use was reached in 1987, but was blocked by Gibraltar. Another agreement in 2006 allowed for tripartite negotiations between the UK, Spain and Gibraltar. However, these do not seem to have made much progress. Now, in the light of the Brexit decision (which of course was strongly opposed by the vast majority of Gibraltarians), there are again reasons for some optimism. In particular, according to CAPA, the Gibraltar Government has indicated a willingness to accept the joint management of the airport, with access in both Gibraltar and Spain.

At the end of the day, the outcome of the Brexit negotiations will be determined by the self-interest of the States involved, and this is as true of the aviation talks as it is of the broader negotiations. Since self-interest tends to vary from country to country, predicting the final outcome is never easy, but on balance, and with all the usual caveats, it is beginning to look more rather than less likely that Willie Walsh's public statements will prove to be more accurate than those of Michael O'Leary. This seems to be a reasonable conclusion from what has emerged so far from the government exchanges which have taken place and the public comments made.

EASA

First, let's consider the critical issue of safety regulation. There is a widespread consensus among aviation stakeholders that the UK should continue to play as large a role as possible in the European Aviation Safety Agency (EASA). The problem is that EASA is an EU agency subject to the jurisdiction of the European Court of Justice, initially a solid red line for the UK. In addition, while it is possible to be an associate member of EASA, only full members, restricted to EU Member States, have a vote on key decisions. Again this was seen by many as a major barrier to the UK's continued participation.

Both of these problems are more presentational than real with respect to EASA. (See, for example, *Aviation Strategy*, September 2016.) The European Court of Justice (ECJ) has never been involved in EASA affairs and there is no obvious reason why it should in the future. Similarly, formal votes are rare. EASA is a technical organisation which seeks to reach consensus decisions. It should also not be forgotten that in terms of finance and manpower, the UK is the largest current contributor to the organisation. Other members will be aware of the implications of the UK cutting all ties to EASA.

It looks as though common sense has prevailed, at least as far as the UK Government is concerned. In Theresa May's Brexit speech on 2 March, she emphasised that the UK intended "to explore with the EU the terms on which [it] could remain part of agencies such as … the European Aviation Safety Agency" even if this would "mean abiding by the rules of those agencies and making an appropriate financial contribution." In other words, the UK is looking for the type of associate membership which several other non-EU countries already enjoy. This is a major about-turn for the UK, and especially for arch-Brexiteer Chris Grayling, who previously had resisted any role for the ECJ once the UK had left the EU.

To say that most aviation stakeholders were delighted by this outcome is an understatement. There is still much to be done, of course, not least the acceptance of such a proposal by the EU/27 and the Commission. But realistically the likelihood of the UK remaining a key participant in EASA activities, and subject to its regulations, has increased substantially. It is difficult to see a UK application for associate membership, accompanied by a large cheque, being rejected when so many other non-EU countries have been welcomed.

Market access: the non-EU bilaterals

Market access is more complicated, involving a series of separate negotiations and numerous partners. Through its current EU membership, the UK has access to 44 countries, including the 27 other EU Member States. In passenger number terms, these agreements cover the bulk of international traffic to/from the UK. In other words, the UK has to re-negotiate 17 ASAs plus a new arrangement with the EU/27. The UK's other 111 bilaterals are essentially unaffected by Brexit.

A key negotiation will be that between the UK and the US, covering the largest trans-Atlantic market. Before the EU/US agreement was signed, aviation relations between the UK and US were at times, to put it mildly, very strained. Coincidentally, a history of the Bermuda II saga has just been published — 'The Life and Death of a Treaty' by Handley Stevens. As Jeff Shane (the US Undersecretary of Transportation for Policy, US DOT, from 2003 to 2008) aptly says in the Foreword: "Allies standing shoulder-to-shoulder in respect of just about everything else, they have more often been eyeball-to-eyeball when it comes to the commercial flights that connects their two territories."

No doubt some may have dreamt of a return to 'the good old days', with access to Heathrow limited to just two US airlines, but that was never going to happen. Some early press reports suggested that the UK would have to accept a quite limited, and one-sided, agreement, little more than the model US Open Skies deal. Such reports, however, have proved to be wide of the mark. Instead it seems that good progress has been made.

Reports indicate that an agreement is very close, possibly with just one substantive issue left to be addressed, involving the ownership of Norwegian UK (probably not a surprise given that company's past history, let alone its possible future ownership). By the time this article is published, even that problem may well have been settled. As Willie Walsh said in March: "There will be an agreement between the UK and the USA. That will be a comprehensive open skies agreement. Anybody who doesn't believe that is living in cloud cuckoo land."

The other trans-Atlantic bilateral agreement that the UK needs to negotiate post-Brexit is with Canada. However, that is very unlikely to be a problem. After all, the Canadian Prime Minister has recently stated publicly that he wants an early broad trade agreement with the UK going beyond the Canada/EU arrangement, and expects to get one. The UK had a liberal ASA with Canada, meeting both countries' aviation needs, long before the EU became involved.

The other countries with which the UK needs to negotiate new ASAs are those around the periphery of Europe, such as the Balkan and North Africa States. It is not clear how much progress has been made here. The sheer number of countries involved certainly presents an administrative challenge. However, the Transition Agreement, if signed, will allow an extra two years for the work to be undertaken. Given the size of the UK market and the fact that many of these countries rely heavily on tourism from Britain, it seems unlikely that they will not readily agree to a continuation of the liberal regulatory environment they have been enjoying with the whole of the EU. There is every reason to be optimistic that mutually beneficial arrangements can be agreed.

Market access : the EU internal market

If serious negotiations on future access to the EU internal aviation market have started, they are being kept under wraps. The October 2017 issue of *Aviation Strategy* outlined various possible scenarios for a future EU/UK regulatory regime, based on an analysis carried out by Andrew Lobbenberg, an analyst at HSBC. Most of the options identified have serious shortcomings which would significantly reduce the benefits of the current internal market, or would be political non-starters.

It seems the most likely, and productive, way forward would be a new, fully liberal EU/UK agreement which went a long way towards maintaining the status quo in terms of market access. The fact that a model of such an agreement already exists, one moreover that has previously been supported by all EU Member States and most European aviation stakeholders, can surely only help. This is the negotiating mandate originally given to the Commission when it opened talks on a trans-Atlantic deal (not, of course, the more restricted deal eventually signed.)

It is difficult to judge at this stage the chances of achieving such an objective. As already explained, there is certainly opposition from some of the European legacy carriers, not helped by the failure on the part of other stakeholders to lobby effectively in favour of a liberal agreement. Similarly, it is unfortunate that the UK Government has been less than convincing in presenting a fully liberal aviation model as a win/win for both sides. But at the end of the day one has to hope that common sense will prevail and neither the EU nor the UK stands idly by as the much cherished baby is thrown out with the bathwater.

Thus, overall while much uncertainty still remains, there is also some reason for optimism. The Transition Period gives everyone more time to address the considerable problems associated with withdrawal from the internal aviation market; continued UK participation in EASA seems far more achievable than it did only a short time ago; and the new bilateral air services agreements which the UK has to sign to replace EU arrangements, notably that with the US, appear to be making progress. The major concern, if only because of the lack of transparency of what is happening, surrounds intra-EU market access, but even there at least there has been no obvious back-tracking, and some reason for hope. What might make a real difference is a strong public push from those keen to maintain the benefits of European liberalisation, including consumer groups.

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Aegean: Conservative success amid Greece's financial crisis

Athens-based Aegean Airlines continues to prove that success is possible for an airline defined neither as an LCC nor a FSC.

At the end of March Aegean announced an order, cautiously described as a Memorandum of Understanding (MoU), for up to 42 units of the A320neo family, after a close-run competition against the 737MAX. The firm element of the order is for 30 units, of which at least 10 will be A321neos, the rest A320neos unless Aegean chooses to convert them to A321s.

The order of valued at $5bn at list prices (so maybe around $3bn after discounts). The engine selection — either P&W's 1100G or CFM's LEAP — will be made in June, but either is expected to deliver 15% fuel saving compared to the standard A320 plus increased range of 600-1500km. There should also be major MRO saving on maintenance costs which have been escalating alarmingly — by 30% in 2017 — for its relatively elderly fleet (a quarter of its A320s are over 10 years old).

Aegean's previous order for new equipment was back in 2005 when it committed to the A320. Since then it has IPOed on the Athens stock exchange, acquired the former flag-carrier Olympic Air and managed to prosper through the worst financial and economic crisis to hit a European country in the post-WW2 era.

Greek GDP in 2017 was still 28% below pre-crisis levels but there have been signs of recovery in economic activity, government finances have improved enough to allow the end of EU-imposed austerity controls by this summer, and tourism is buoyant (arrivals up from 18m in 2013 to 27m last year).

Moreover, Greek official statistics rarely reflect a completely accurate picture — they grossly overestimated the strength of the economy when Greece joined the eurozone and now underestimate the scale of new investment in the Athens area.

Aegean itself lists some of the key projects: the Chinese company Cosco's plans for a transshipment hub; the luxury developments along the Athens Riviera, Niarchos Foundation's various civic building projects; new five-star hotels; and the €7-10bn regeneration of the prime real estate formerly occupied by the old airport, Hellinikon; Fraport's investment in the regional airports.

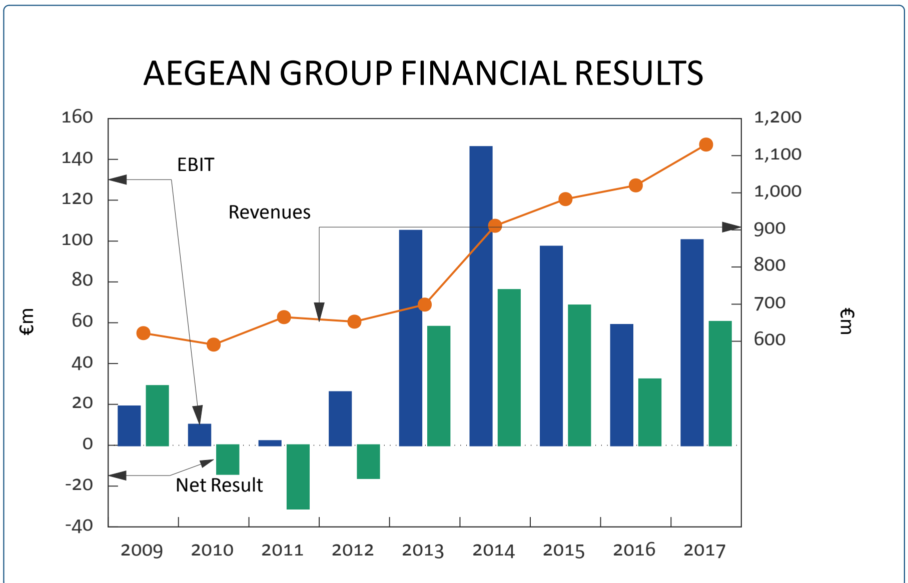
2017 results

In 2017 Aegean's revenues increased by 11% over 2016 to €1.13bn, while EBIT improved from €58.8m to €100.4m, and at the net level profits nearly doubled to €60.4m from €32.2m. The EBIT margin was therefore 8.9%, not quite in the Ryanair class but comparable to easyJet.

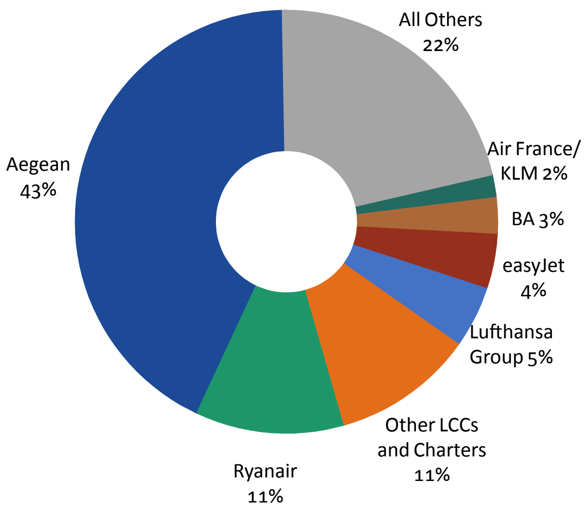
The balance sheet is strong with long term liabilities at €87.1m being just 13% of total assets, partly reflecting Aegean's fleet policy of concentrating on operating leases. Liquidity is also strong with unrestricted cash and equivalents standing at €286m at the end of last year.

Passenger volume was up 6% in 2017 to 13.2m, mostly due to growth in international routes, which, combined with modest capacity growth of just 2%, pushed up average load factor to 83.2% from 77.4%. As a result, Aegean was able to reverse a five-year decline in unit revenue — in 2017, with yields more or less constant, RASK increased 9% to €¢6.9.

Its average fare — around €85 — is well above that of its LCC rivals, but



CAPACITY SHARES IN TOTAL GREEK MARKET 2017



Note: Analysis of scheduled international and domestic seats

generally below Legacy carrier pricing. Aegean makes a genuine effort with service quality. Its A320s are operated internationally with a business class section, and onboard service, with free food and drink in both cabins, is now clearly superior to that offered by BA on intra-European flights.

CEO Dimitrios Gerogiannis, in a recent presentation in London emphasised how, for instance, cabin staff record any complaint or issue from a passenger on their iPads, and that passenger is then automatically contacted by a customer-relations person as soon as is possible. It sounds impressive, in sharp contrast to the LCC or Legacy experience.

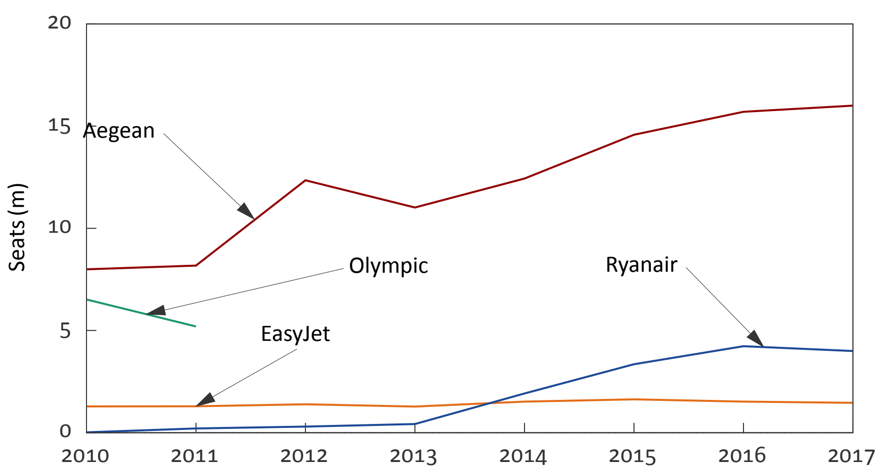
Aegean manages to control unit costs at easyJet-type levels but 30-40% above ULCC levels— in 2017 it reported CASK of 4.1€¢ ex-fuel, 6.3€¢ total, with a 905km average stage length. Labour and overhead costs are competitive, largely as a result of Greece's financial and economic crisis, but Athens International Airport (AIA) levies some of the highest airport charges in Europe, comparable to Heathrow's.

Aegean's position between the LCCs and the FSCs illustrated by the graph on the following page which summarises capacity shares on its main routes. Aegean competes head to head with Ryanair on the dense domestic routes, where Ryanair should have a cost advantage, and is more flexible in adjusting capacity to match widely fluctuating seasonal demand. On most of the other, longer European routes, Aegean competes mostly against flag-carriers where it has a distinct advantage in terms of both unit costs and service quality.

The main non-flag-carrier competition has come from Air Berlin, which has now mostly been taken over by Lufthansa. As Aegean is a Star Alliance member and provides intercontinental feed at Frankfurt, this development is probably advantageous for Aegean.

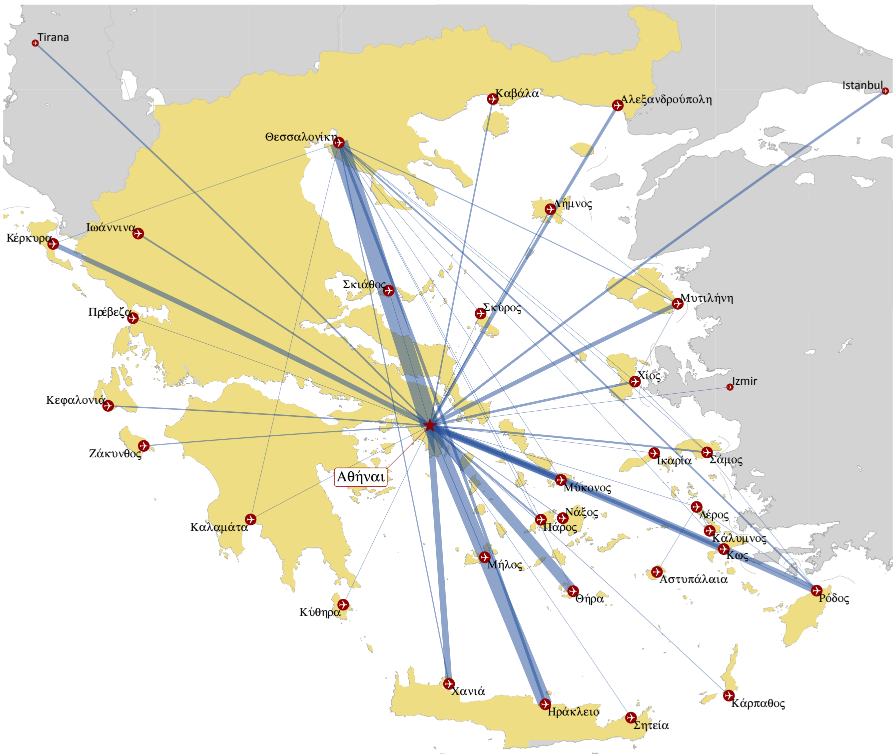
Ryanair is the second largest competitor by seats offered in the Greek market but it has not expanded as rapidly as expected (or feared). As the chart below illustrates, Aegean had grown steadily, by about 7% pa in ASK terms, since the 2013 retrenchment, following its absorption of Olympic Air. Ryanair entered the market in 2013, surged ahead then levelled off — interestingly, the same pattern as in many of the CEE markets it entered in competition with Wizz (see *Aviation Strategy*, April 2018). easyJet, long established at Athens, has stagnated over the past four years.

AEGEAN AND THE LCC COMPETITION



Note : Olympic amalgamated into Aegean in 2012

AEGEAN DOMESTIC NETWORK



Ryanair has been unable to persuade Greek airports to comply with its operating strategy. AIA, jointly owned by a Canadian pension fund and the Greek state, rejected Ryanair's offer of delivering 10m passengers and/or providing zero cost seats on some island routes if fees were to be drastically cut. In April this year, Fraport which owns a 40-year concession to operate 14 regional airports and is committed to investing €230m by 2020, increased it landing charges by about 30%. This was from a very low base and resulted in a new landing fee equivalent to just over €1 per passenger, but other charges and taxes bring the total up to €14 per departing passenger. Aegean considers this level to be internationally competitive; Ryanair, used to regional airport charges of half than sum, does not.

Ryanair's response was to announce the closure of its base at Chania in Crete, cutting its domestic capacity by about a third and transferring two 737-800s to Germany. However, it is maintaining its domestic Athens network on thick routes to Thessaloniki, Rhodes, Mykonos and Santorini.

Ryanair also stated that it still wanted to discuss a development plan with the airport operators that would enable it to add aircraft back into the market and operate year-round as opposed to seasonal service. And Wizz Air, with currently minimal presence in Greece, is reported to be considering expanding in this market.

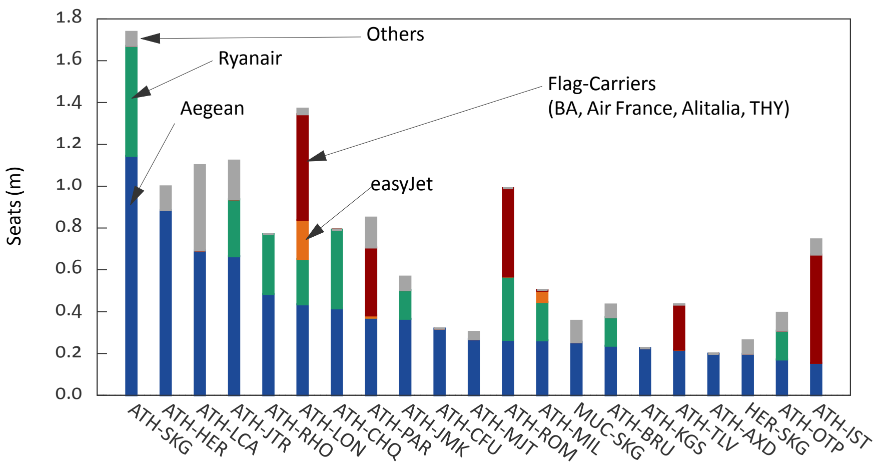
Objectives

Dimitrios Gerogiannis is rather disdainful of grand strategies and long term projections. In a presentation this March, Aegean's stated objectives for 2018-2023 were simply summarised as:

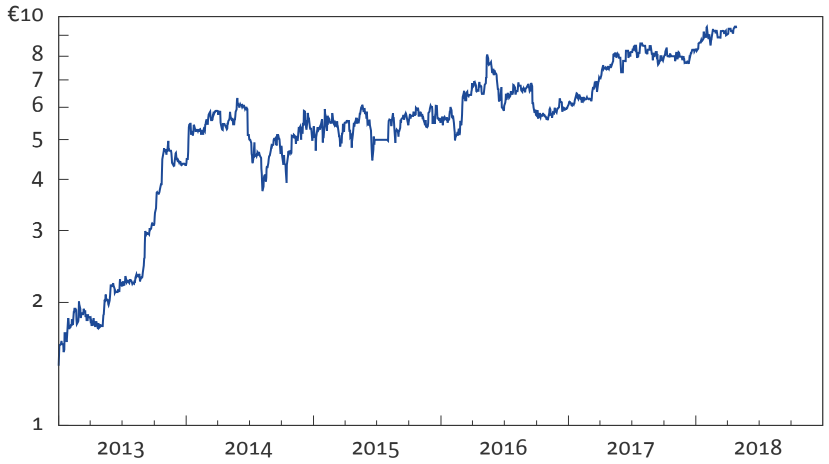
✈ Grow passenger volume from 13m to 15m-plus. (This seems overly modest; based on the fleet plan, 18m passengers should be targeted.)

✈ Increase the fleet from the current 61 (49 A320 family plus Olympic Air's 10 ATR42s, 8 Q400s and two Dash 100s) to 75 in total. The turboprop fleet, operated under the Olympic brand, will be rationalised to one type.

AEGEAN'S TOP ROUTES



AEGEAN SHARE PRICE



✈ Retain existing aircraft bases at seven (hubs at Athens, Thessaloniki, Larnaca in Cyprus plus focus cities of Rhodes, Heraklion, Chania and Kalamata).

✈ Increase international points served from 145 to 175, while domestic destinations remain at 30.

✈ Concentrate operations on Athens, where the airline can capture business travel and avoid the extreme seasonality of the Greek island market, and develop connecting flows there.

Aegean puts increasing emphasis on its role as a connecting airline. Since 2008 the number of connecting passengers at Athens has risen five-fold to 3.5m, 32% of total throughput. It identifies numerous connecting possibilities and has built a wave structure at Athens — no less than eight daily waves, though three of these are "rolling".

AIA certainly has the facilities to deal with an expanded transfer hub, but the reality is that that Aegean's international points to the east and south are sparse, and, given its conservative nature, the airline is unlikely to invest in these higher-risk regions. Nevertheless, Aegean will develop its hubbing operations, perhaps evolving into a niche alternative to THY's global hub at Istanbul, which for perspective is approaching 40m connecting passengers.

AEGEAN EUROPEAN NETWORK

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The Pacific's terrific, but is it all that it's cracked up to be?

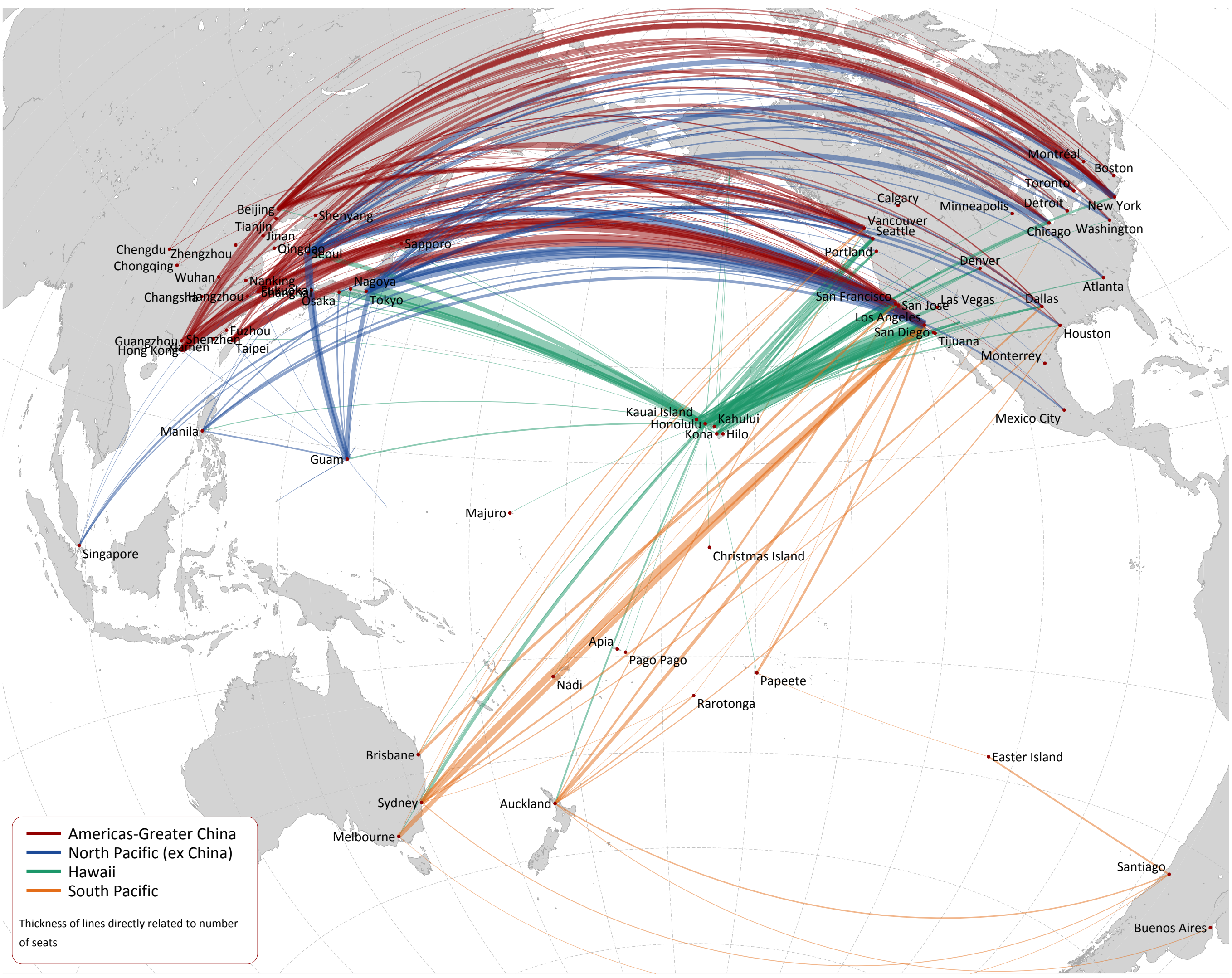
According to Irving Berlin the Atlantic's not romantic and the Pacific not terrific. In aviation terms he may have been wrong about the latter.

In the following charts and tables we present an analysis of the Pacific market.

The Pacific is a huge area — the ocean accounting for 45% of the planet's water — ringed by extreme volatility in geological and political terms. It encompasses huge distances: the average stage length for flights between Asia and the Americas is over 10,000km. It includes some of the longest routes in the world: SIA plans to reintroduce a direct flight between Singapore and New York towards the end of the year using its new A350-900ULR aircraft — an amazing 19 hour flight and 15,300km — which will top the current world record of 17 hours between Auckland and Doha.

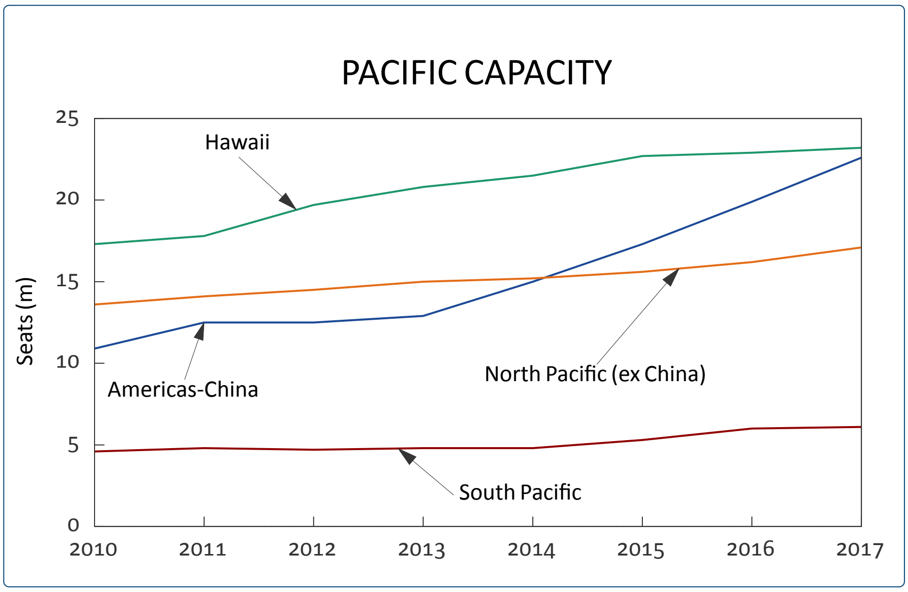
Total traffic on the Pacific measured in RPK terms is around half

TRANS-PACIFIC ROUTES



that on the Atlantic — the largest and most mature long haul market. Because of the distances involved this inflates its importance: the total number of seats and passengers is around a quarter of that carried on the Atlantic. In itself long haul is a small part of the market, accounting for around 15% of the total numbers of passengers and seats. As a result the Pacific has tended to be a relatively modest part of the global industry — at least until recently. What has changed is that Chinese traffic, and Chinese airlines, have been pushing growth on to the region at an amazing rate.

The Pacific route structure can be divided into four broad areas, each displaying different characteristics: Americas to Asia ex China; Americas to Greater China (including Hong Kong and Taiwan); Hawaii — the ultimate tourist paradise; and the South Pacific.



Hawaii

For the purpose of this analysis we have cheated a bit and included all the data for the domestic US services to its Pacific haven: they account for over 80% of total seat capacity to the island group. Hawaiian has very successfully defended its niche position and has 25% of the market (up from 19% in 2010), closely followed by United, Delta, American and Alaska/Virgin America — see chart on the following page.

One of the perhaps surprising results of the analysis is that the largest city pair by far on the Pacific in terms of the number of seats is Honolulu to Tokyo (having grown by an annual average 3.5% since 2010 and overtaken Honolulu to Los Angeles in 2017).

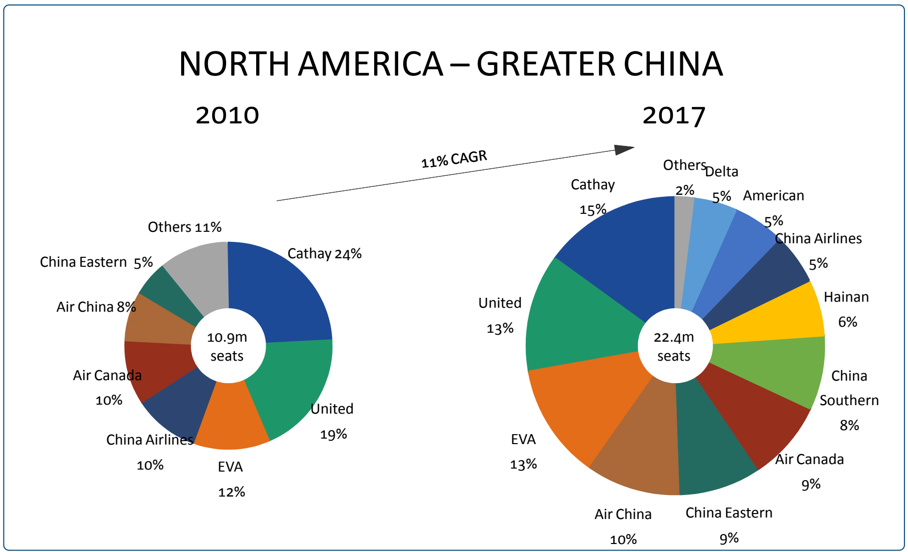
This incidentally is the second largest international city-pair route out of the USA behind London-New York, albeit with 2.6m annual seats less than half the size of the latter. Indeed it is a favoured destination from North Asia: JAL, ANA, Korean and Asiana enjoy a near 10% share of the total Hawaiian market, which has grown by an average annual 4% since 2010.

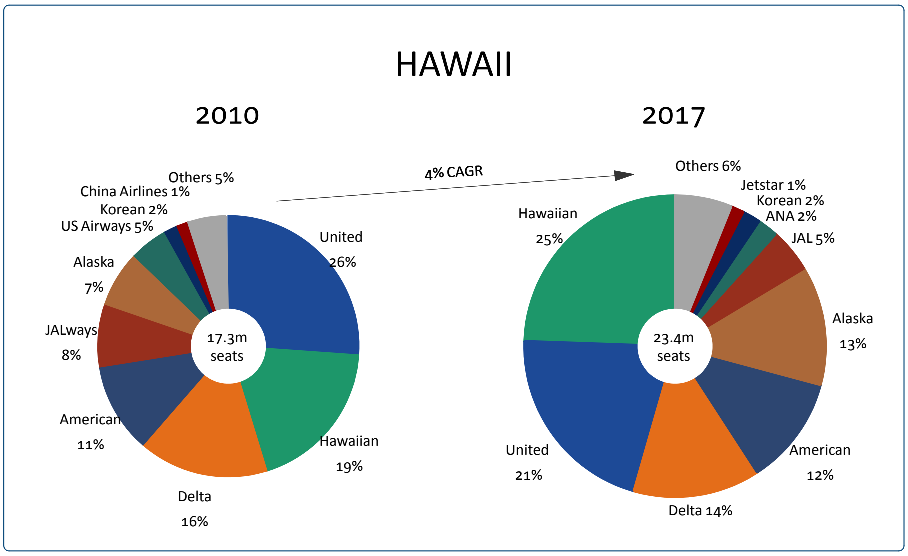
ANA meanwhile recently announced that it plans to configure its three A380s on order — all destined for the Honolulu route, with the first delivery scheduled for 2019 — with 520 seats in four classes, more than twice the capacity of the 787s it currently operates on the route (according to the schedules the highest current density for the A380 is 517 seats operated by Qatar).

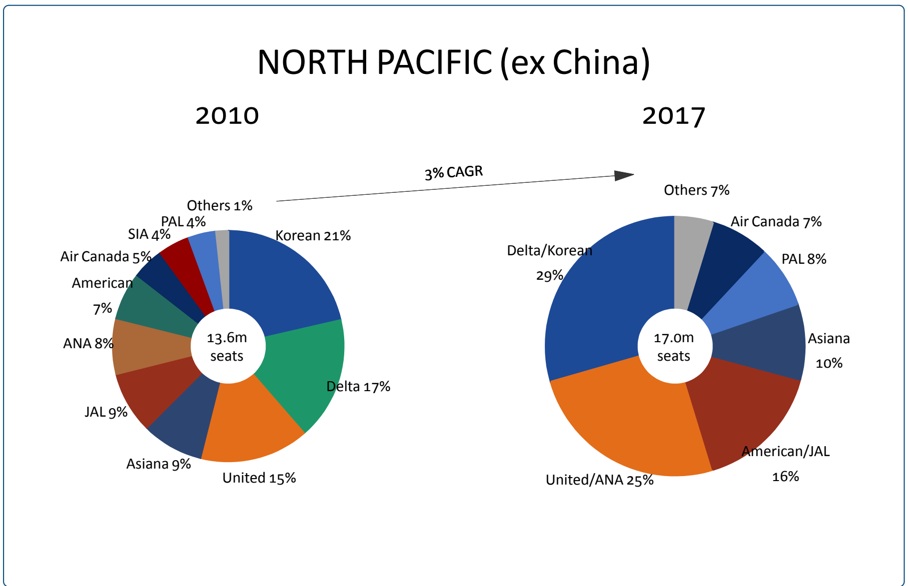
North Pacific

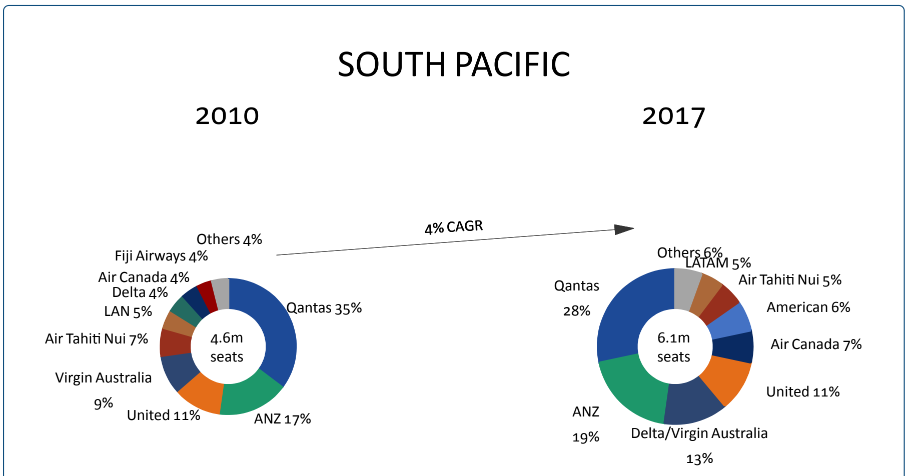
We have defined this route area as from North and Central America to North and South East Asia excluding greater China (including Hong Kong and Taiwan). Total growth in this segment has been lacklustre, with average annual increases in capacity since 2010 of 3%.

The market has consolidated to a certain extent: American and JAL, and United and ANA established metal-neutral anti-trust immunised









Note: analysis of scheduled seats 2017

joint ventures in 2011; Delta and Korean are due to cement a similar agreement in 2018 — see chart on the current page.

Following this the three will have an effective 70% of the market — slightly below the share of the Atlantic enjoyed by the three main joint ventures in that market but important nevertheless.

Within the segment it is noticeable that some of the prime traditional routes to Japan have been static or in decline (see table on the facing page), Korean routes have grown modestly, while Philippines Airlines and Air Canada have grown substantially faster than the market at an average 15% and 10% respectively.

South Pacific

The South Pacific is the smallest cousin in this group of route networks. It encompasses routes between North America and the Australasia and there to South America and involves around 6m seats a year — it has grown at an average compound rate of 4%. It is not surprising that it is relatively small: the population of Australia and New Zealand is around 29m. The largest route in the segment is Los Angeles to Sydney; and the population of the greater Los Angeles metropolitan area is estimated at 14m.

Capacity on the route area has grown at an annual average 4% in the past seven years. 60% of the capacity is covered by Qantas, Air New Zealand and Delta/Virgin Australia — who gained approval for an immunised joint venture in 2011, renewed for ten years in 2016. Qantas and American have been trying to do the same, and after rejection in 2016 reapplied for approval from the DoT in February 2018. If successful the

AMERICAS-GREATER CHINA: TOP 20 ROUTES 2017

Rank		City Pair		Seats ('000s)	CAGR
1	(1)	Los Angeles	Taipei	1,220	+0.7%
2	(6)	San Francisco	Taipei	1,092	+8.5%
3	(2)	Hong Kong	San Francisco	1,020	+0.1%
4	(3)	Hong Kong	New York	997	+3.9%
5	(18)	Los Angeles	Shanghai	983	+22.6%
6	(5)	Hong Kong	Los Angeles	954	+5.8%
7	(4)	Hong Kong	Vancouver	931	+3.8%
8	(8)	Beijing	New York	757	+8.0%
9	(20)	Beijing	Los Angeles	642	+18.2%
10	(17)	San Francisco	Shanghai	636	+14.8%
11	(10)	New York	Shanghai	627	+7.2%
12	(12)	Beijing	Vancouver	613	+8.0%
13	(7)	Hong Kong	Toronto	605	+0.5%
14	(14)	Taipei	Vancouver	577	+9.4%
15	(30)	New York	Taipei	572	+36.2%
16	(9)	Beijing	San Francisco	551	+3.9%
17	(19)	Beijing	Toronto	503	+12.7%
18	(11)	Chicago	Shanghai	493	+4.0%
19	(22)	Shanghai	Toronto	491	+16.3%
20	(15)	Shanghai	Vancouver	474	+6.5%

AMERICAS-ASIA (ex China): TOP 20 ROUTES 2017

Rank		City Pair		Seats ('000s)	CAGR
1	(1)	Los Angeles	Tokyo	1,585	-0.16%
2	(2)	Los Angeles	Seoul	1,543	4.58%
3	(6)	New York	Seoul	916	3.28%
4	(5)	Chicago	Tokyo	899	0.82%
5	(3)	New York	Tokyo	860	-3.45%
6	(7)	San Francisco	Seoul	845	2.83%
7	(4)	San Francisco	Tokyo	825	-2.28%
8	(13)	Dallas	Tokyo	538	6.00%
9	(8)	Tokyo	Vancouver	527	2.01%
10	(15)	Seattle	Seoul	515	7.68%
11	(27)	Los Angeles	Manila	476	15.97%
12	(14)	Seoul	Vancouver	436	4.95%
13	(20)	Tokyo	Toronto	395	7.51%
14	(24)	Houston	Tokyo	388	9.41%
15	(9)	Tokyo	Washington	379	-1.61%
16	(11)	San Francisco	Singapore	369	-0.82%
17	(25)	Manila	Vancouver	364	+9.5%
18	(23)	Seoul	Toronto	360	7.32%
19	(12)	Chicago	Seoul	359	-0.45%
20	(18)	Atlanta	Seoul	337	2.81%

Qantas JV will almost regain the 35% share of the business it had in 2010.

Americas-Greater China

This is the terrific element of the Pacific. Within this area we have included routes to Taiwan and Hong Kong — more traditionally treated as North Pacific or SE Asian destinations — which catches the declining element of Hong Kong as a gateway to China and the relatively strong growth exhibited by Taipei.

Here the growth has been extraordinary. Capacity on the routes have doubled since 2010, a compound *average* annual growth of 11%, and the market has fragmented. Back then Cathay, United/Continental, EVA, China Airlines and Air Canada held 75% of the seat capacity on the segment. Since then the mainland Chinese carriers have emphasised a push into the market. In 2017, Air China, China Eastern, China Southern and Hainan (including their subsidiaries) accounted for 33% of the capacity up from 15% seven years ago.

In 2010, there were only three main entry points into China Pacific (Hong Kong, Beijing and Shanghai) serving routes to 10 main points in the Americas (San Francisco, Vancouver, Los Angeles, Chicago, Toronto, New York, Detroit, Seattle and Washington) — although there was also a four times a week service by China Southern from its hub in Guangzhou to Los Angeles.

Since then, the capacity on the established routes has grown at a phenomenal rate: up by a compound annual average of 14% out of Beijing and Shanghai (and 40%pa out of Guangzhou); 14% out of New York, 10% Los Angeles, 9% Vancouver and Toronto, 20% Seattle.

Moreover, the number of points served has proliferated. By 2017 there were services from another 14 points in China (albeit operating only one or two flights a week) — Changsha, Chengdu, Chongqing, Fuzhou, Hangzhou, Jinan, Nanjing, Qingdao, Shenyang, Shenzhen, Wuhan, Xi'an, Xiamen and Zhengzhou. These are all megalopolises representing a combined population of 225m people. There were an additional seven points in the Americas (Dallas, Boston, Houston, Montréal, San Jose, Las Vegas and Calgary) representing a combined metropolitan population of 28m, although two of those destinations are major hubs.

This exciting development of air services is likely to continue. A large part of this growth is still likely to come from the expansion of the Chinese carriers as they develop services from airports behind China's congested hubs. It is hardly surprising that the North American players have been trying to establish relationships with their Chinese counterparts: Delta with its 3.6% equity stake in China Eastern; American with a 2.7% stake in China Southern; Air Canada announced it is in talks to form a "joint venture" with Air China on the Canadian market.

With the current incumbent in the White House and increasingly protectionist rhetoric, a full open skies agreement seems a long way off.

Gol: Now a Delta/Ryanair hybrid?

Gol Linhas Aéreas Inteligentes, Latin America's largest LCC, has seen a strong financial recovery in recent quarters as Brazil's economic growth has gathered pace. With operating margins already in the low-double digits, the São Paulo-based airline is outperforming its larger peers in the region.

Gol is doing so well in large part because between mid-2015 and early 2017 it implemented what may have been one of the strongest and fastest restructurings by an airline outside of bankruptcy.

Among other things, Gol raised new equity from key shareholders, renegotiated supplier contracts, slashed capacity, restructured its network, downsized its fleet, negotiated concessions from lessors, deferred aircraft deliveries, and reduced and deferred debt obligations.

All of that gave Gol a much stronger balance sheet and reinforced its position as the lowest-cost airline in Brazil and South America.

However, while restructuring, Gol also aggressively sought to capture more premium traffic. Those efforts have been so successful that in 2016 Gol took the lead in Brazil in terms of revenues earned from corporate travellers (ABRACORP data). Its share of corporate revenues is about 30%.

Gol's success in the premium segment is not totally surprising. In Brazil, the bulk of air travel has always been for business purposes, and Gol is the largest carrier domestically, with 35% of RPKs. Gol has gained business traffic share also because of LATAM Brasil's sharp contraction since 2012.

But Gol's business model has clearly changed. Intriguingly, Gol seems to have achieved the impossible: being both a true LCC (with ULCC-level costs) and a full-service airline with a product that appeals to business travellers.

In November 2016, following Gol's investor day, Bradesco analysts wrote a note titled "More Delta and more Ryanair". They commented that an efficient revenue management system allows Gol to serve both leisure and corporate customers. Delta's influence is clearly visible here. But how does Gol really pull it off?

Gol's next big focus will be international expansion, facilitated by the start of its 737 MAX 8 deliveries this summer. International ASK growth could be as high as 30-40% in 2019.

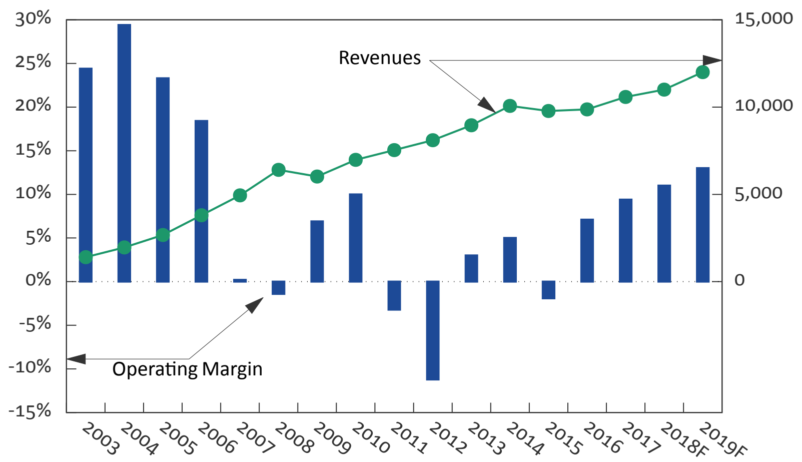
There are also interesting new developments with strategic partners. A new joint hub with Air France-KLM is in the works in Fortaleza. An immunised JV will soon be in the works with Delta.

Accelerating financial recovery

Gol was hit hard by Brazil's economic troubles, because its operations are primarily domestic (still 85.5% of its revenues in 2017). The airline incurred net losses for five consecutive years (2011-2015). However, only 2012 saw a heavy operating loss, because Gol was quick to contract in size and also benefited from industry capacity discipline from 2012 onwards.

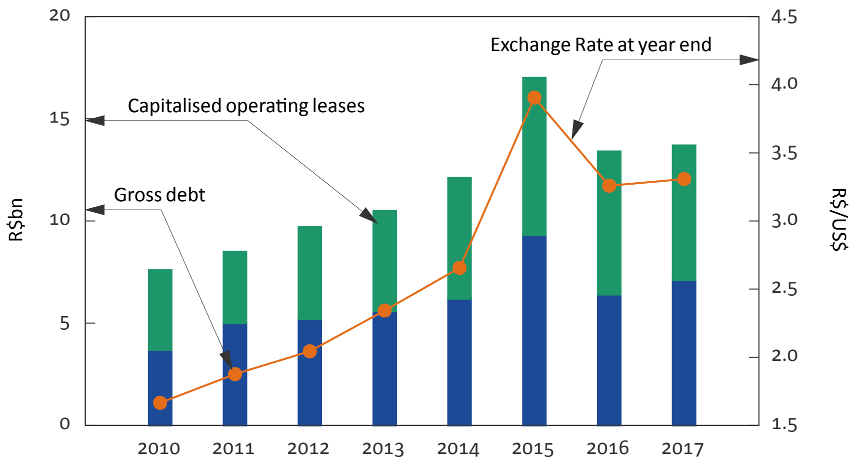
In 2014 Brazil slid into its worst recession in decades and the economy contracted by 3.8% in 2015 and 3.6% in 2016. But Gol had only a marginal operating loss in 2015 and turned a

GOL'S REVENUES AND OPERATING MARGINS (R$m)



Note: Gol's forecasts (March 7)
Source: Company reports

GOL'S DEBT, LEASES COSTS AND THE BRAZILIAN REAL



Source: Company report. Note operating leases capitalised at 7x.

corner financially in 2016, achieving a 7.1% operating margin and its first annual net profit since 2010. The early turnaround was mainly a result of the restructuring, which saw Gol slash its operating fleet from 144 to 121 and ASKs by 6.9% in 2016.

Gol consolidated the recovery in 2017, achieving a 9.4% operating margin, though net income declined due to unfavourable foreign exchange effects. The fleet restructuring was officially completed in April 2017 with the final leased aircraft returns.

The latest quarterly results illustrate the accelerating recovery momentum. In Q4 2017 Gol's revenues rose by 12%, operating profit doubled and the operating margin surged by 5.6 points to 13% — the highest Q4 operating margin since 2011.

According to Gol's April 5 guidance, in the first quarter of 2018, PRASK rose by 10.5-11% and the operating margin was as high as 15-15.5% (the results will be released on May 9).

Gol forecasts its full-year operating margin to increase to 11% in 2018 and 13% in 2019. The airline is resuming modest growth this year, with ASKs increasing by 1-3%, followed by 5-10% growth in 2019. But nearly all of the growth will be international: up 7-10% in 2018 and 30-40% in 2019. Domestically, Gol will remain disciplined with only 0-3% ASK growth this year and 1-3% in 2019.

This year's main themes are, first, continued economic and demand recovery. Brazil emerged from recession in June 2017. The IMF currently forecasts Brazil's GDP growth to accelerate from last year's 1% to 2.3% in 2018 and 2.5% in 2019. Inflation has returned to historic lows: just 3% in 2017, with 3.8-4.2% projected in 2018-2019.

Brazil is seeing a gradual return of business travellers. The corporate segment contracted sharply in 2015-2016 but started to pick up in the second half of 2017, helped by a combination of GDP growth, low inflation and low interest rates. The recovery is set to accelerate in 2018.

The past two quarters have also seen a strong rebound of international travel out of Brazil, especially to the US and Europe — also likely to continue in 2018. A new US-Brazil open skies regime could provide a major boost (in late April the deal still needed President Michel Temer's signature).

Importantly, capacity discipline is set to continue in the Brazilian airline industry. That and the demand recovery should ensure continuation of healthy revenue trends.

Gol's profits will also benefit from higher ancillary revenues. Like its Brazilian peers, Gol was able to introduce first checked bag fees domestically in June 2017. Earlier this year it added fees for seat assignments. Both of those are optional items for passengers in the two lowest fare categories (*Promo* and *Light*) but included in the airfare in the higher fare categories (*Max* and *Plus*).

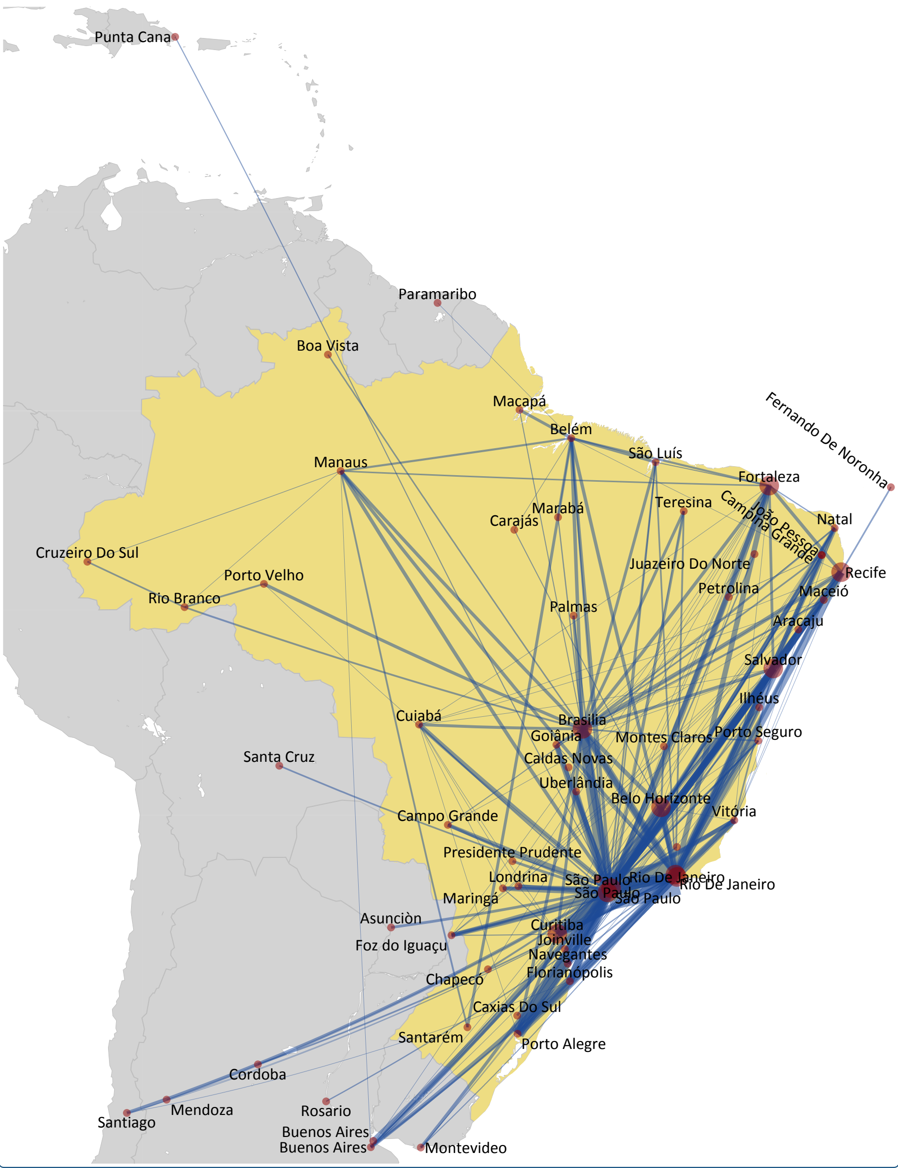
With its Gollog cargo and logistics subsidiary (R$300m revenues in 2017), Gol is also well positioned for the continued recovery in the cargo segment. "Cargo and other" revenues (cargo, FFP, ancillary fees) grew by 16.2% in 2017.

Finally, Gol's costs are under control. Its ex-fuel CASK declined by 4.6% in Q4 (though it partly reflected normalisation of maintenance costs after earlier spending associated with aircraft returns).

But there are challenges and risks. S&P and Moody's both recently downgraded Brazil's credit ratings in part because of lack of progress in legislating reforms. Upcoming presidential and congressional elections in October 2018 create political uncertainty.

Gol executives said last month that they had kept the 2018 capacity plans fairly conservative because of the elections.

GOL ROUTE MAP



Balance sheet deleveraging

Gol was never a near-term bankruptcy candidate, but in mid-2015 it faced ballooning debt, increasing cash burn and a deteriorating economy. All three main rating agencies had warned of a cash crunch in 12-18 months as debt payments were coming due and demand and yields in Brazil continued to deteriorate.

Gol's US dollar-denominated debt had ballooned because the Brazilian real almost halved in value relative to the dollar in the three years to December 2015 (from 2.04 to 3.9). During 2015 alone the real weakened by 47%, which had devastating impact on Gol's balance sheet: debt soared from R$6.2bn to R$9.3bn and lease-adjusted debt from R$12.1bn to R$17bn. The airline's short-term liabilities also increased dramatically during 2015.

So Gol embarked on a comprehensive financial restructuring (for details, see the October 2016 issue of *Aviation Strategy*). The result: an effective deleveraging that also eliminated any liquidity risk in 2016-2017, giving Gol breathing space while its earnings recover. But Gol remains relatively highly leveraged by industry standards, so continued debt reduction remains a priority.

The deleveraging process was greatly helped by the reversal of the R$/US$ trend at the end of 2015. The real strengthened by 16.5% during 2016 (from 3.9 to 3.3) and has since then stabilised in the 3-3.5 range.

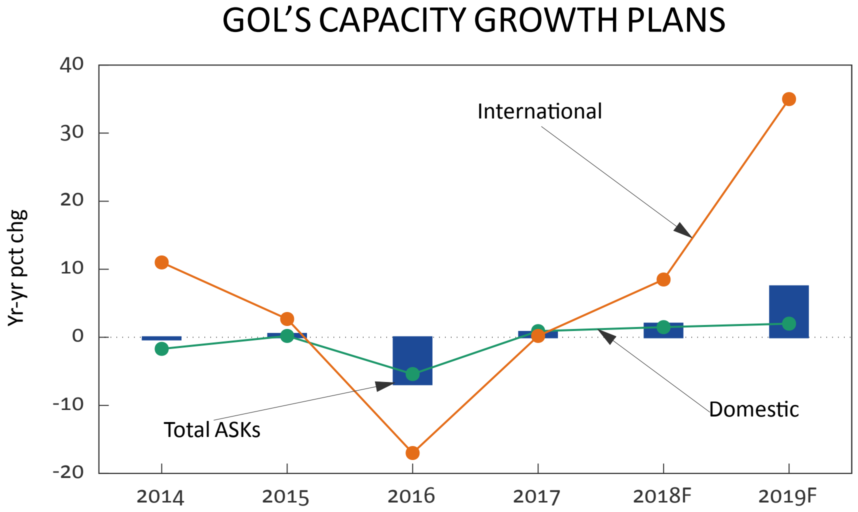
In the two years to December 2017, Gol's total debt fell by 24% to R$7.1bn ($2.1bn) and lease-adjusted debt by 21% to R$13.7bn ($4bn). Adjusted gross debt/EBITDAR declined from 12.7x in 2015 to 5.4x in 2017; the ratio is expected to reach 5x in 2018-2019.

The past two years' refinancings have driven down Gol's cost of debt, reducing interest payments. Gol's dollar-denominated debt amortisation schedule also looks manageable, with R$354m ($104m) of maturities in 2018, R$68m ($20m) in 2019, R$1bn ($294m) in 2020, R$108m ($32m) in 2021 and R$3bn ($882m) thereafter (as of January 31).

Gol plans to fully pay down its local currency debt when it comes due. The next maturity (R$400m) is in October 2018, with the remaining R$625m maturing in 2019.

Gol's cash position has fluctuated but is currently very healthy. At the end of 2017, total liquidity amounted to R$3.2bn or 30.1% of annual revenues.

The improvements have been recognised by the three main credit rating agencies, all of which upgraded Gol's ratings in 2017 (some did it twice). S&P raised Gol's ratings



Notes: Gol's forecasts. Mid-points of ranges. Source: Company reports

by two notches to B-, Fitch by two notches to B, and Moody's by four notches to B2.

As a result, Gol now enjoys more financial flexibility. It can access the international debt capital markets at attractive terms to refinance more debt.

The two-part US$650m bond offering that Gol completed in December-January was a good example. The senior notes, which have a 7% coupon and mature in 2025, partly refinanced 8.9-9.5% notes that were due in 2020 and 2022.

Gol now generates free cash flow (FCF), but the amount may decline in 2018-2019 as the airline starts growing its fleet and expanding internationally. Any excess cash in the near term is likely to be used mainly to pay down debt. The management said recently that dividends would only be considered when the annual operating margin exceeded 15%. However, regulatory filings in April indicated that Gol was planning some modest share repurchases.

Gol has 120 737 MAX 8s on order, with deliveries beginning in July 2018 (six this year). The type will replace the 737-700s and 737-800s and provide for growth through 2028. This year Gol's operating fleet is projected to increase by six units to 121; after that the fleet will grow by 3-5 units annually (see table).

Some of the MAX 8s will come directly from Boeing and some will be on operating leases. In 2018-2019 at least, it will be all operating leases. Gol has already done some sale-leaseback deals with GECAS and AWAS.

New international focus

Gol's network restructuring in 2016 involved the following: culling lots of unprofitable routes (including its US services); adding more long-haul flights out of São Paulo's Congonhas to Brazil's north and northeast; reducing short-haul leisure operations; adding more business-oriented routes at Congonhas; and working with partners Delta and Air France-KLM to strengthen presence at Rio de Janeiro's Santos Dumont and Galeao airports.

The Brazil-Florida services, which Gol had operated via the Dominican Republic because the 737-800s needed a fuel stop, were terminated in early 2016 after Brazil-originating demand had fallen sharply due to recession.

In 2017 Gol focused on keeping its dominant position in Rio; improving connectivity in Galeao, Guarulhos and Brasilia; developing new markets in the north and northeast; and adding new international services within South America and to the Caribbean.

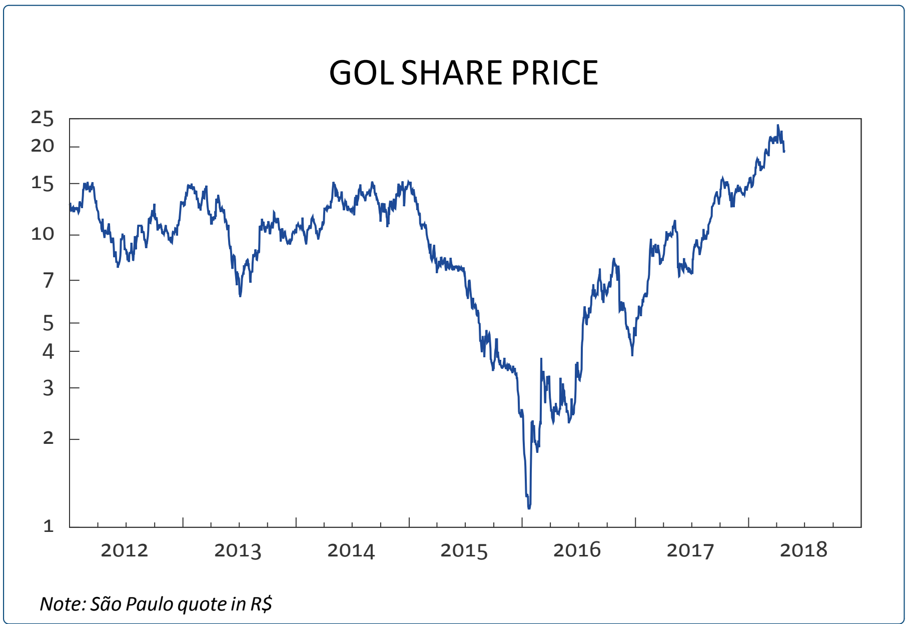
The focus has now shifted to international expansion, which will kick off in November 2018 with Gol's return to the US market — this time on a nonstop basis. Gol will serve Miami and Orlando from Brasilia and Fortaleza — gateways that make sense geographically and offer good connectivity with the rest of Gol's network.

The new Florida flights are possible because of the MAX 8's 15% longer range (6,500km), which will also enable Gol to serve new markets

GOL'S FLEET PLAN

	Number of aircraft at year-end:					
	2017	**2018**	**2019**	**2020**	**2021**	**2022**
737-700	24	25	22	21	16	16
737-800	91	91	89	86	83	78
737 MAX 8		5	13	21	34	43
Total	**115**	**121**	**124**	**128**	**133**	**137**

Source: Gol (March 7)



in Central America, southern Mexico and the west coast of South America. Gol has identified more than 16 potential new destinations. The management expects international revenues to grow to around 20% of total revenues (currently 13%).

US expansion will help diversify Gol's revenue sources and give it a natural exchange rate hedge (through an increase in dollar revenues). The flights will of course benefit from feed from Delta's vast US network.

This year will also see further development of the Gol-Delta partnership. The airlines have had an exclusive codeshare relationship in the Brazil-US market since 2011, when Delta acquired a 3% stake in Gol (now 9.5%). Delta played a pivotal role in Gol's restructuring (equity injections, loan guarantees, taking over leases, etc.) and product revamping.

Taking that relationship to the next level will be just a formality: When the Brazil-US open skies regime comes into force, Gol and Delta are likely to quickly seek approval for an immunised JV.

Gol does not plan to operate flights to Europe, but it is fortunate in having an enthusiastic partner in Air France-KLM that is keen to grow Europe-Brazil services and engage in creative collaboration. In 2014 Air France-KLM invested US$100m in a 2% equity stake in Gol, which also created a (mostly) exclusive codeshare relationship in the Brazil-Europe market (TAP is also listed as a codeshare partner).

In a major collaborative venture, Gol and Air France-KLM are launching a new joint hub in Fortaleza in Brazil's northeast on May 3. The hub will initially have five flights a week from Europe, with KLM operating three from Amsterdam and Air France's Joon two from Paris. Gol is boosting its flights at Fortaleza by 35%; it already is the largest carrier there with 40% of the traffic.

The concept is brilliant because of Fortaleza's geographical position. All flights to Europe from Brazil go over Fortaleza, so travellers from many parts of the country can save considerable time by rerouting via that airport, also avoiding the congested main hubs in the south. There is an opportunity to generate significant new demand. Gol also sees Fortaleza serving as a connecting hub for traffic between Europe and Florida, the Caribbean and all major cities in South and Central America.

The management confirmed again recently that Gol is not interested in joining SkyTeam; it remains committed to the "open architecture" type alliance strategy in markets other than the US and Europe. It currently has around 12 codeshare partners.

Unique competitive strengths

Gol seems uniquely well positioned for the future for four reasons: being the lowest-cost LCC; having a strong business-oriented network and product offering; having extensive slot holdings at key airports in Brazil; and having two very successful strategic partnerships with staying power.

Gol has retained its position as South America's lowest-cost airline. According to a recent company presentation, its 2017 ex-fuel CASK was 4.41US¢, which was 18.3% below LATAM Brasil's and 9% below US ULCC Spirit's (on a stage-length adjusted basis). In the Americas, only Mexican ULCC Volaris had lower unit costs than Gol.

The cost advantage arises from a standardised single type fleet, which enables Gol to obtain lower crew costs, higher utilisation and better spare parts management. Gol has one of the lowest fixed cost structures among LCCs globally.

Gol's unit costs will benefit from a seat densification project, which increases the seat count on the 737-800s from 177 to 186 and is due to be completed by July. Otherwise Gol will rely heavily on its fleet modernisation and the larger size of the MAX 8s to mitigate cost pressures in the future.

Improving offerings to the business segment has been a multi-year process involving heavy investment in products and services. The airline has introduced *Gol+ Conforto* seats with more legroom, domestic premium lounges in São Paulo and Rio (the only airline to offer that) and onboard Wi-Fi in Brazil (the first airline to offer that). Gol has the industry's best on-time record (though Azul makes the same claim, citing OAG data). And Gol has an attractive loyalty programme, Smiles, which is Brazil's largest FFP with 13m members.

Having bolstered its presence at key Brazilian cities, boosted frequencies in the main business markets and improved schedules all around, Gol believes that it offers the "best network for business travellers".

So having the best network, the right combination of products and the most reliable operation puts Gol in a strong position to continue to attract corporate traffic — the segment that collapsed during the recession and is now recovering at the fastest rate.

Gol has vast slot holdings at Brazil's key airports for historical reasons: it was founded in 2001 and it pioneered the development of leisure travel in Brazil, stimulating demand with low fares. Domestic passengers in Brazil have roughly tripled since 2003. Later, Gol strengthened its slot holdings through two acquisitions — Varig in 2007 and Webjet in 2011.

Gol is the number one or number two carrier at the 12 key airports that represent 75% of Brazil's traffic — a formidable market position. It has a 41% share of the total traffic in São Paulo (CGH and GRU), 50% in Rio (SDU and GIG) and 35% in Brasilia. Those are all slot-constrained airports.

The Delta and Air France-KLM partnerships represent another great strength. The relationships are probably permanent (or as permanent as an airline marriage can be) because Gol offers something special to the global carriers: long term access to the huge Brazilian market.

Whether the equity stakes are raised or not is probably irrelevant — Gol has a strong support network. Incidentally, the Brazilian Constantino family still holds a 61% stake (with only 28% being publicly held; Gol is listed in both New York and Sao Paulo), but that helped Gol during its restructuring in that it provided stability and the founders also contributed additional funds.

The Brazilian market has high barriers to LCC entry, but competition is set to intensify with the implementation of the US-Brazil open skies ASA. Gol has three strong competitors at home that are making the exact same moves as Gol: capturing business traffic, building new hubs in the northeast, growing in the US market, seeking immunised JVs with foreign partners and possibly getting more equity injections from those partners (when foreign ownership restrictions are abolished).

Brazil is a huge underpenetrated market with significant long-term growth potential, so there may be enough traffic for everyone. Gol is well positioned to capture the growth, but because of the competitive scene, its annual operating margins may never get back to the high-double digits of the earlier years.

By Heini Nuutinen