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Flybe continues search for profitable role

EUROPE'S leading regional carrier, Flybe, is attempting to find a clear strategy in a small but complex market, and to achieve at least a break-even financial result.

Flybe's latest financials (to end March 2018) showed another loss, the norm for the past eight years. Total revenue increased by 6% to £752.6 and the headline pre-tax loss was more than halved from £19.9m to £8.1. Unfortunately, this loss reduction was only on paper. Operating losses grew from £2.4m to £13.5m. Changes in non-cash items, mainly the valuation of dollar loans into sterling and a provision for Embraer 195 leases, were positive relative to the previous year, hence the apparent net loss improvement.

Almost 90% of Flybe's revenues come from its regional operations using Q400s, Embraer 175s and 195s, the rest from a rolling wetlease contract with SAS for its ATR72s, its maintenance subsidiary FAS and airport agreements that support some developing routes.

Flybe has been cutting back capacity, but only slightly in 2017/18 — to 12.6m from 12.7m seats — though this year could see a reduction of up to 7%. Passenger volume grew by 7.7% to 9.5m passengers, which meant that Flybe achieved its target of a substantial improvement in load factor — from 69.6% to 75.6%.

With a slight improvement in passenger yield, unit revenues per seat rose by 9% to £58.7, but still not enough to cover operating unit costs of £59.7.

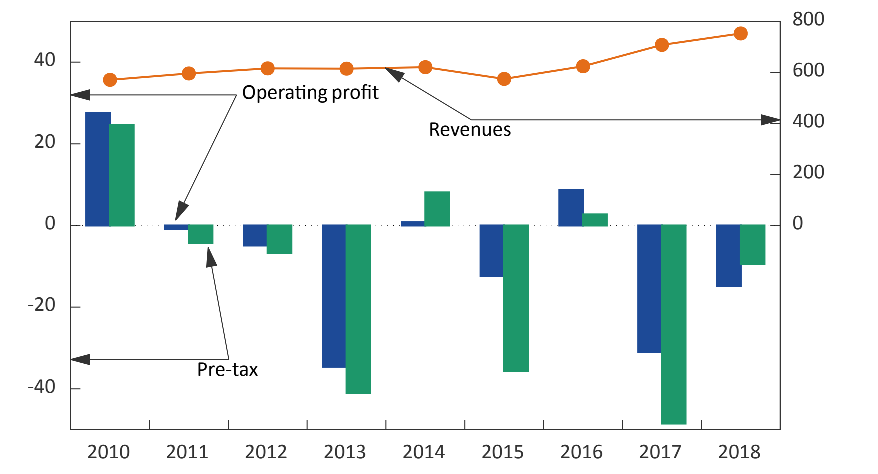
The revenue/cost equation is proving very tricky for Flybe, and indeed all regional airlines. On the unit revenue side there is a limit to which regionals can push up load factors largely because it is difficult to stimulate traffic on their routes; finding particular routes that command high business travel yield is possible, but building a network on this basis has proved impossible. For intra-UK flights Flybe is obliged to add £26 in government tax (APD) at least to its round-trip prices.

On the cost side, there are various realities which frustrate regional airline from replicating LCC metrics. The complexity of the network relative to the passenger volume is core. Turboprops and regional jets cannot match A320-type aircraft operating costs. Without volume growth it is difficult to strike deals with airports, and the pricing structure of larger airports, Heathrow especially, discriminates against smaller aircraft. Even crew costs can be a problem because of heavy personnel churn as pilots want to advance to narrowbodies at mainline carriers.

The balance sheet as at March 2018 showed £244.1m of long-term liabilities and £93.0m of sharehold-

This issue includes

FLYBE FINANCIAL RESULTS (£m)



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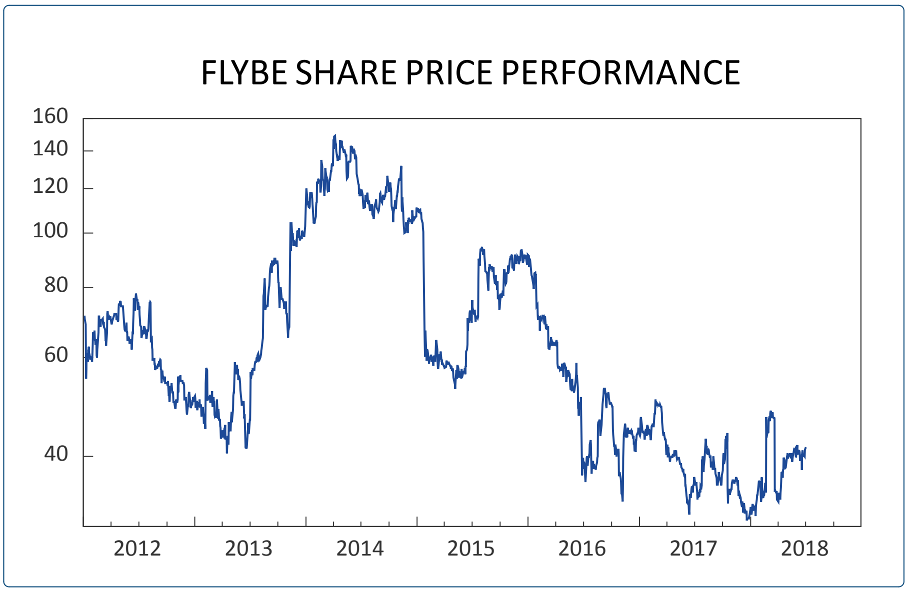


ers funds, which is almost exactly Flybe's stockmarket value, suggesting that investors are not anticipating a growth into profitability.

As with many companies, Flybe's current positioning is the result of the conflicts of history. Here is a brief resumé.

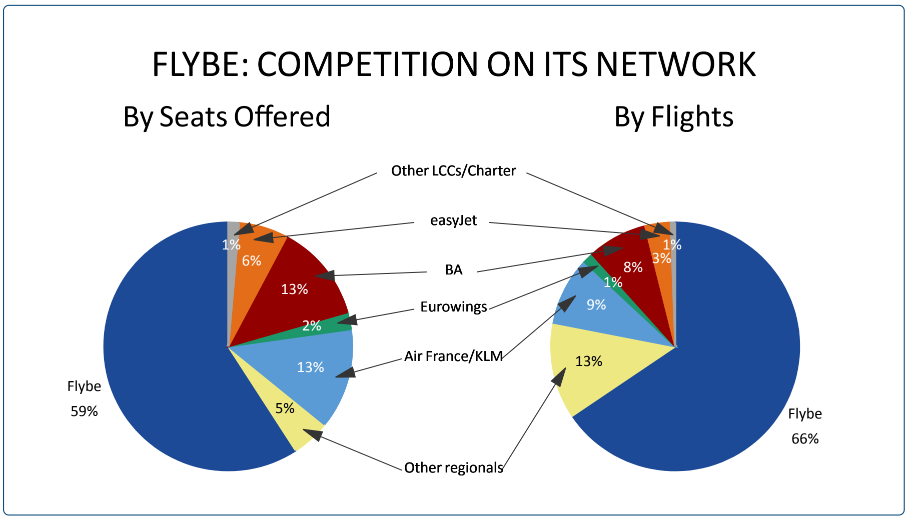
Flybe started operations in 1979 as Jersey European Airways based in the Channel Islands, flying inter-island routes and to the UK mainland. It was acquired in 1983 by multi-millionaire Jack Walker and re-based to Exeter, eventually renamed as British European. After a series of losses in the downturn at the beginning of the noughties it reinvented itself again as Flybe, attempting to combine elements of the short haul legacy business model with LCC practices.

In 2007 it acquired BA's regional operation, BA Connect, for a negative price. BA effectively paid £130m to Flybe and took a 15% equity stake in the airline, now reduced to zero, to ensure the disposal of its loss making UK regional services.

In 2010, Flybe floated on the London Stock Exchange, valuing the company at £215m and raising £60m but shares sank rapidly after numerous profits warning. CEO Jim French departed in 2013 with some controversy regarding his pay package. Former easyJet COO Saad Hammad was brought in to implement a radical management culling and route restructuring plan, with some operational success but still no profits. He did however oversee the raising of a further £150m in equity.

By late 2016 Hammad was on his way out, again with a generous package. Christine Ourmières-Widener, ex-CityJet, the Air France owned regional carrier based at Dublin, which had faced a plethora of issues, and is now solely a wet lessor, was appointed as the new CEO of Flybe.

Under the new regime Flybe emphasises its role as a connecting airline for its 11 codeshare and interlining partners, which are Air France, BA, Cathay Pacific, Virgin Atlantic, Alitalia, SIA, Emirates, Etihad, Air India, Finnair and Aer Lingus. According to the airline's Chairman, Simon Laffin: "In the UK, Flybe is the pre-eminent regional connector. We have developed our interlines and codeshares better to tap into long-haul airline hub connectivity".



on Flybe's network by Flybe itself and by other carriers. Flybe does have a dominant position, with a 59% seat share and 66% flight share, but perhaps not as much has might be expected for a carrier that aims to control a range of thin or niche routes. Other regionals account for some 5% but more than half of this is operated by Eastern Airways, with whom Flybe signed a franchise agreement last year, and most of the rest is flown by Loganair, the Scottish regional, whose franchise agreement with Flybe was terminated last year.

The Euro-majors, or their regional subsidiaries, offer the main competition, on 28% of the network. As noted these are codeshare partners but there is no prospect of their outsourcing these operations to Flybe.

Interestingly, Flybe has succeeded in mostly avoiding direct competition with LCCs on its network. Only easyJet has a sizeable presence. However, the regional dilemma remains: if a regional succeeds in developing a thin route, it will inevitably attract a voracious LCC onto that route.

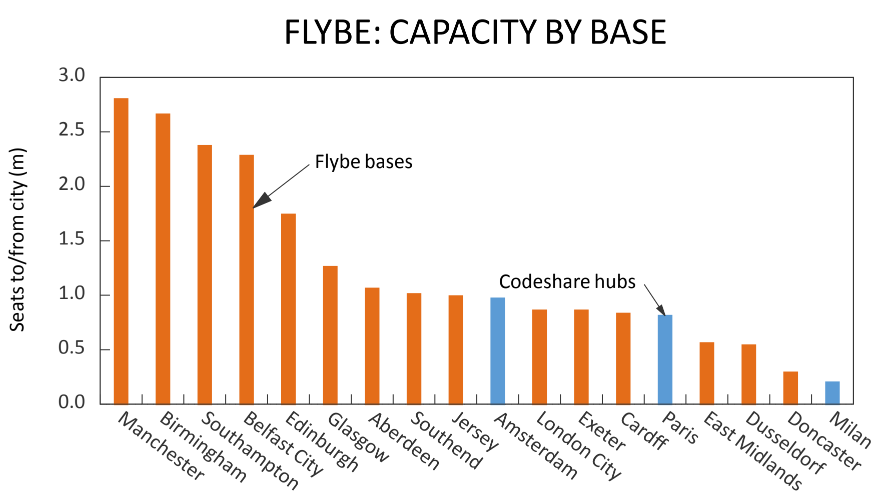
Management at the airline

Slightly surprisingly this strategy is not elaborated upon in the company's presentations, and it is difficult to ascertain just how much connecting traffic Flybe generates. As the graph below illustrates, Flybe's network is built on its bases at UK regional airports, and its "hubs" at Manchester and Birmingham, though in total it serves 80 points, 31 in the UK and 49 in continental Europe. Some 72% of its total capacity is deployed to/from the UK bases (plus Dusseldorf). There are undoubtedly connecting possibilities at its main UK bases from, say, an Emirates flight to Manchester and onward on a smaller UK city, but this is very much a niche operation rather than a core strategy.

According to our analysis only about 8% of Flybe's seat capacity is allocated to routes to/from major European hubs — Amsterdam and Paris CDG — where it could connect to massive long-haul networks. But then Flybe comes into direct competition on routes between the UK and these continental hubs with the regional subsidiaries of its code share partners, KLM Cityhopper and Air France's Hop!,

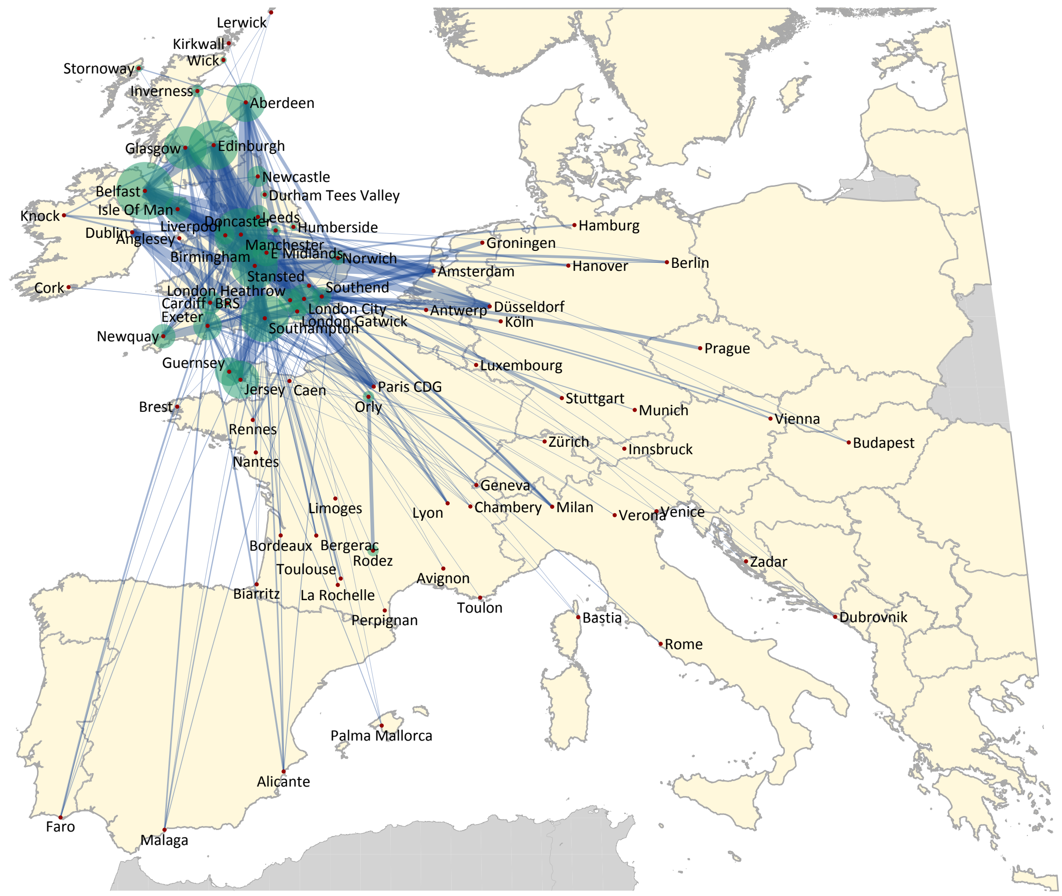
Flybe made the decision last year to take up some ex-bmi slots to launch services to Heathrow from Edinburgh and Aberdeen with the intention of feeding its seven codeshare partners that operate to the global hub. But on the Scotland-LHR routes it has to compete directly against codeshare partner BA on price, frequency and flight speed. In a recent presentation at the Heathrow Connectivity conference, Flybe stated that it wanted to grow at Heathrow, then added with a capitalised BUT, that it needed to obtain favourable slots, reduced airport charges and reform of APD.

The two pie charts above give an indication of Flybe's competition; they show seats and flights operated



Notes: Based on estimated 2018 schedules Capacity is seats offered to/from each base (ie Manchester includes MAN to/from AMS and Amsterdam includes AMS to/from MAN) Other airlines operating on FlyBe routes only

FLYBE ROUTE NETWORK



strongly hint at future consolidation in the regional airline sector, but it is difficult to see how this will be accomplished. Earlier this year Stobart Air, operator of Southend airport and franchisee for both Flybe and Aer Lingus, offered to buy out Flybe but its undisclosed bid was rejected as being too low.

bmi Regional has a similar model to Flybe operating mostly smaller Embraers, 135s and 145s, and there is little network overlap. For the latest financial year available, to March 2017, its parent company, AIL, made a loss of £3.2m on revenues of £182.1m. Could there be some elusive synergies there?

The Euro-majors have been retreating from the regional sector so they are not candidates. Nor, as far as we can ascertain, are the myriad small turboprop operators throughout continental Europe.

Perhaps there is no grand strategy possible for Flybe. Its future depends on concentrating on protecting its core routes and bases and tackling costs, which is what Christine Christine Ourmières is attempting through her Sustainable Business Improvement Plan (SBIP). This covers what one might expect — sales and marketing drives, cost improvement, operational and organisation excellence, new technology, employee engagement and customer satisfaction. The devil is in the implementation details.

At the core of the plan is a rationalisation of the fleet following "extensive studies" of the route and aircraft operating economics. From a peak fleet of 85 units in 2017 the aim is to reduce to 70 units by early 2021, with all the 9 Embraer 195s, on which Flybe has made an onerous lease provision, are to be returned to the lessor. This leaves the Q400s as the core aircraft in the fleet (55 units at present), despite concerns about reliability. These will be complemented by Embraer 175s (11 at present with scheduled deliveries for four more) which can operate longer routes and are interchangeable with the Q400.

In short, Flybe is aiming to shrink to break-even.

Ethiopian Airlines: taking the wildebeest by the horn

ETHIOPIAN Airlines is the largest, most profitable and commercially oriented airline in sub-Saharan Africa. It set out on a mission to offset a decline in the African carriers' share of traffic to and from the continent and has set up a successful full service network hub operation in Addis Ababa, in the Horn of Africa. Can it successfully compete against the airlines of the former colonial powers and the insurgence of the Superconnectors?

The national flag carrier of Ethiopia was established in 1945 (with help of TWA). From the start it has operated on a commercial basis — even during the Marxist-Communist era of the Derg regime in Ethiopia of the 1980s — and has consistently been one of the more profitable carriers in sub-Saharan Africa.

But land-locked Ethiopia is one of the poorest nations in the world, with an average $872 per capita GDP ($2,160 in PPP), while being the second largest nation in Africa with a population of 104m (behind Nigeria at 180m). It has one of the fastest growing economies in the world (albeit from a low base) with an average real GDP growth of 10% in the past eight years; and the IMF forecasts an average real growth of 8%pa over the next five years.

At the same time its national flag carrier has built the largest flight training school, aircraft maintenance operation, cargo facility, and inflight catering operation in sub-Saharan Africa; it now operates to 21 domestic destinations, 62 regionally, 35 intercontinentally and carries over 9m passengers a year.

Its revenues have grown from $1bn in 2008 to $2.7bn in 2017 (FY ending June). Capacity in terms of ASK and traffic in terms of the number of passengers has grown by an average annual 15% over the period. And yet it has remained profitable throughout the period (see chart below) achieving peak operating margins of 14% and pretax margins of 11% in the year ended June 2016.

As a Government-owned operation it is not necessarily required to make public its full annual accounts, but has tended to do so. There may be a question of disquiet that the full accounts for the year to end June 2017 are still not available, although in a press release it stated that it achieved net profits of $233m in that financial year.

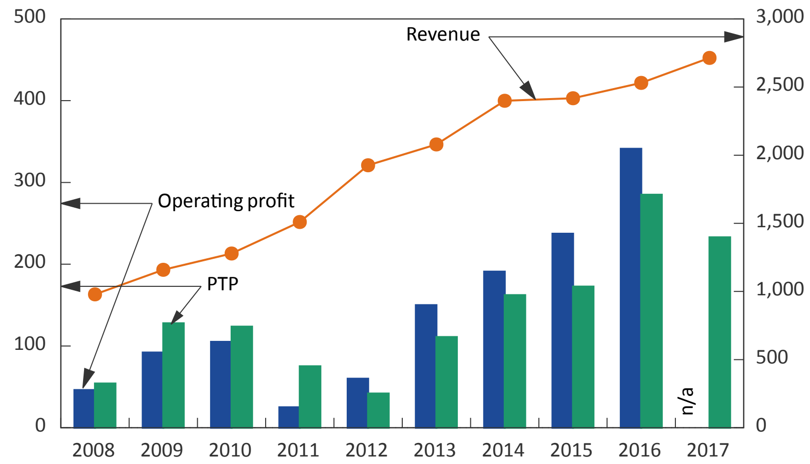
This is in stark contrast to the next two largest operators in the region — South African Airways and Kenya Airways.

SAA lost R13bn (US$1bn) in the five years to end March 2017 at the operating level with static capacity and demand growth over the period.

Kenyan managed to lose /=72.5bn ($700m) over the same period with a similar low rate of growth in capacity and demand: and it went through a debt-for-equity swap at the end of last year to attempt to remain solvent.

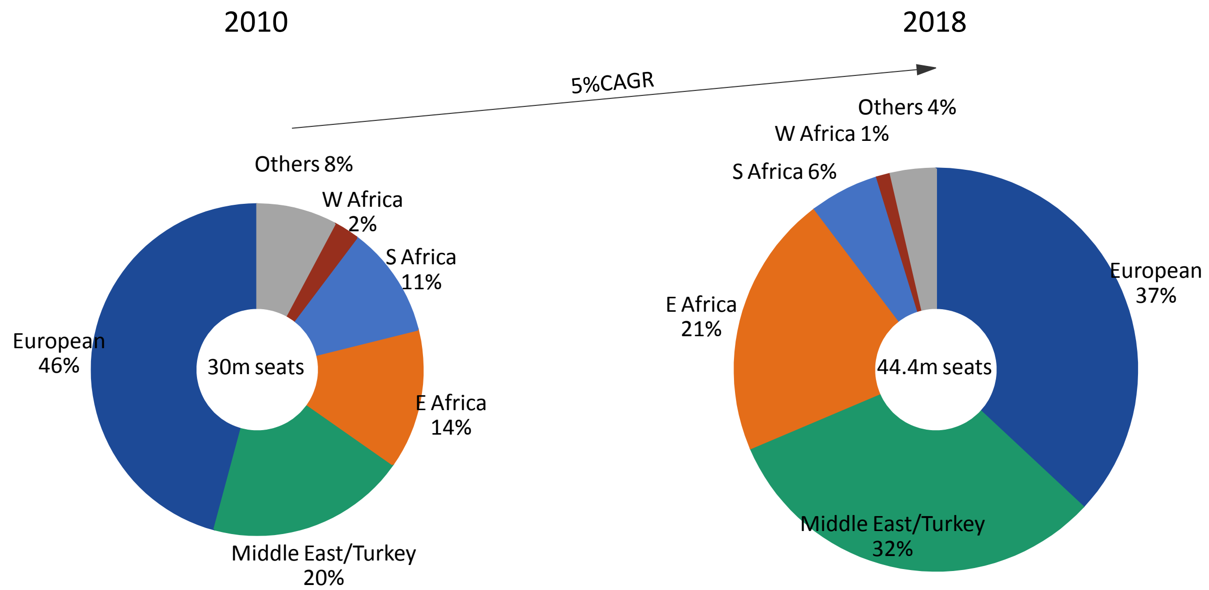
One of the main reasons behind Ethiopian's success, maintains the company's long-standing CEO Tewolde GebreMariam, is a concentration on efficiency and tight cost control. Employees do not get paid unless they electronically clock in and out each day; the airline does not give free flights to civil servants or politicians; the back-office is paper-free. These are not necessarily usual practices in Africa.

ETHIOPIAN AIRLINES FINANCIAL RESULTS (US$m)



Source: Company reports
Note: Financial year ending June

SUB-SAHARAN INTERCONTINENTAL SEAT CAPACITY BY NATIONALITY OF OPERATOR



It also helps to have relatively low employment costs (for all except the flight crew). While maintaining a full-service two class operation (the premium class, with full lie-flat seats on long haul, imaginatively branded "Cloud-Nine"), Ethiopian seems to have a substantial unit cost advantage against its main competitors (see chart below).

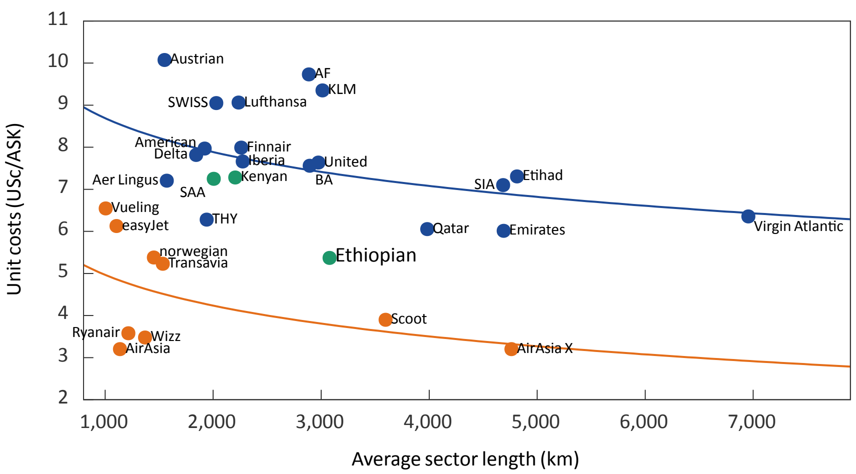
Ethiopian has grand plans. Under its "Vision 2025" strategic plan it has stated that it aims to build its business to increase its fleet by 50% from the current 100 units to 150 by 2025 and increase revenues to $10bn a year. "The centre of confidence for us in Vision 2025", explains Gebre-Mariam, "was the trade lane between China, Africa and Brazil... which is the fastest-growing trade lane in the world."

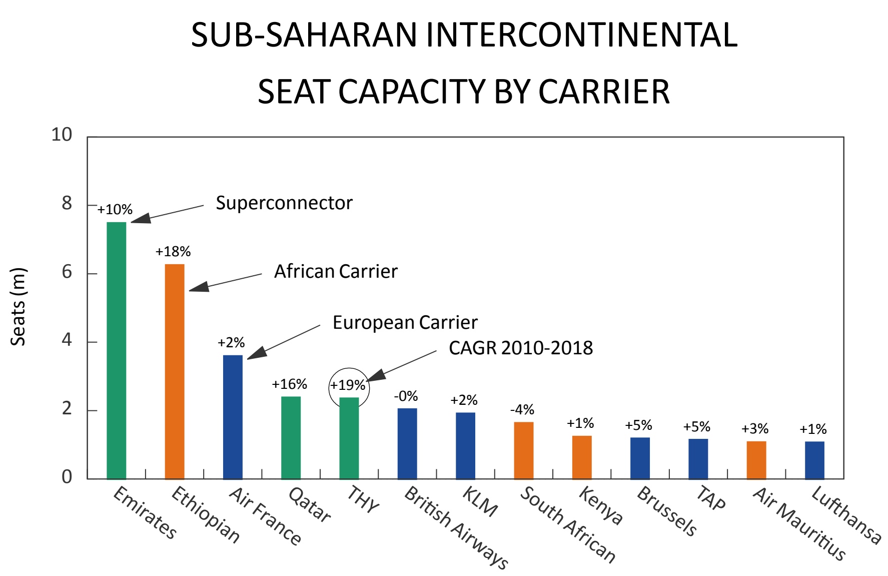
It is not just relying on its hub in Addis Adaba. Ethiopian took a 40% stake in and a management contract to run Togo-based ASKY Airlines in West Africa — a multinational replacement for the defunct Air Afrique — operating four 737s and four Dash 8s. It has a 49% stake

ETHIOPIAN AIRLINES: FLEET PROFILE

	In Service	On Order
737-700	8	
737-800	16	
737 MAX8		30
767-300	6	
777-200	6	
777-300	4	
787-8	19	
787-9	2	6
A350-900	7	17
Q400	20	13
777F	6	4
757-200F	2	
737-800F		2
Total	**96**	**72**

UNIT COSTS AND STAGE LENGTHS





Source: schedules data. Excludes France-La Reunion (technically domestic).
Note: top 13 carriers account for 75%of seat capacity.

in Lilongwe-based Malawi Airlines (operating one 737 and one Dash 8). It recently signed an agreement with the Zambian government to take a 45% stake in a re-launch of a national flag carrier Zambia Airways and develop Lusaka as another regional hub. It is planning to start a new airline in Mozambique, initially for domestic services.

It appears to want to create a multi-hub system in the sub-continent through associate investments and management contracts, and Tewolde GebreMariam says that he has also been in discussion with Chad (an MoU signed earlier this year), Djibouti, Equatorial Guinea and Guinea. Bluntly, GebreMariam points out: "Going forward, it will be difficult for us to compete with only one hub in Addis Ababa."

It has not been particularly successful in reversing the decline in the presence of African airlines in Intercontinental access to sub-Saharan Africa, but has least stabilised the decline through its own growth: airlines based in the region in 2018 seem set to provide the same 28% proportion of intercontinental capacity as they did in 2010 (see chart on the facing page).

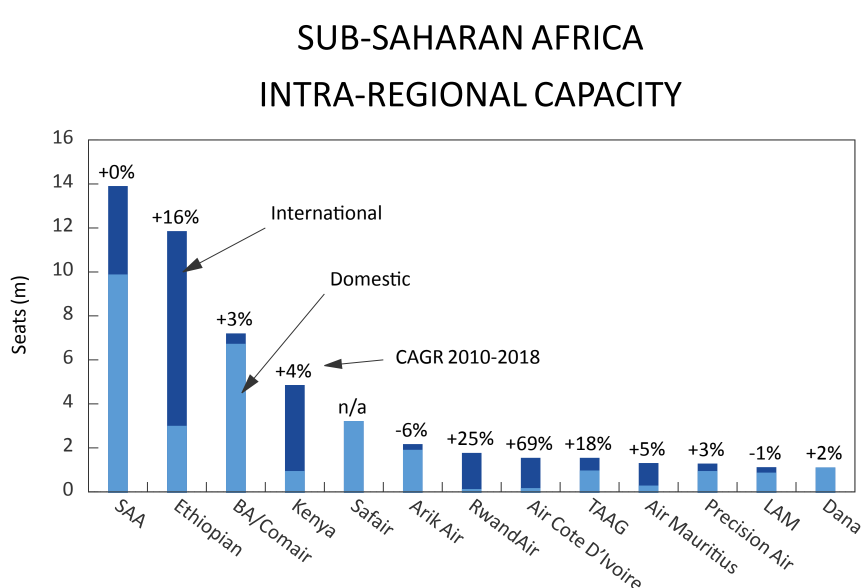
However, in the past decade there has been substantial growth of services into the region from the Super-connectors in the Middle East and Turkey (primarily Emirates and THY). Since 2010 the Superconnectors' share of capacity has grown from 20% to 32% — reflecting a compound annual growth of 12% — mostly at the expense of airlines of the former Colonial powers. The European network carriers have seen their share of capacity fall from 46% to 37% over this period (excluding the domestic services between France and its Indian Ocean dominions) — an annual average growth of 2%.

SAATM

The African air transport market only accounts for 2% of the world's air traffic but has huge potential.

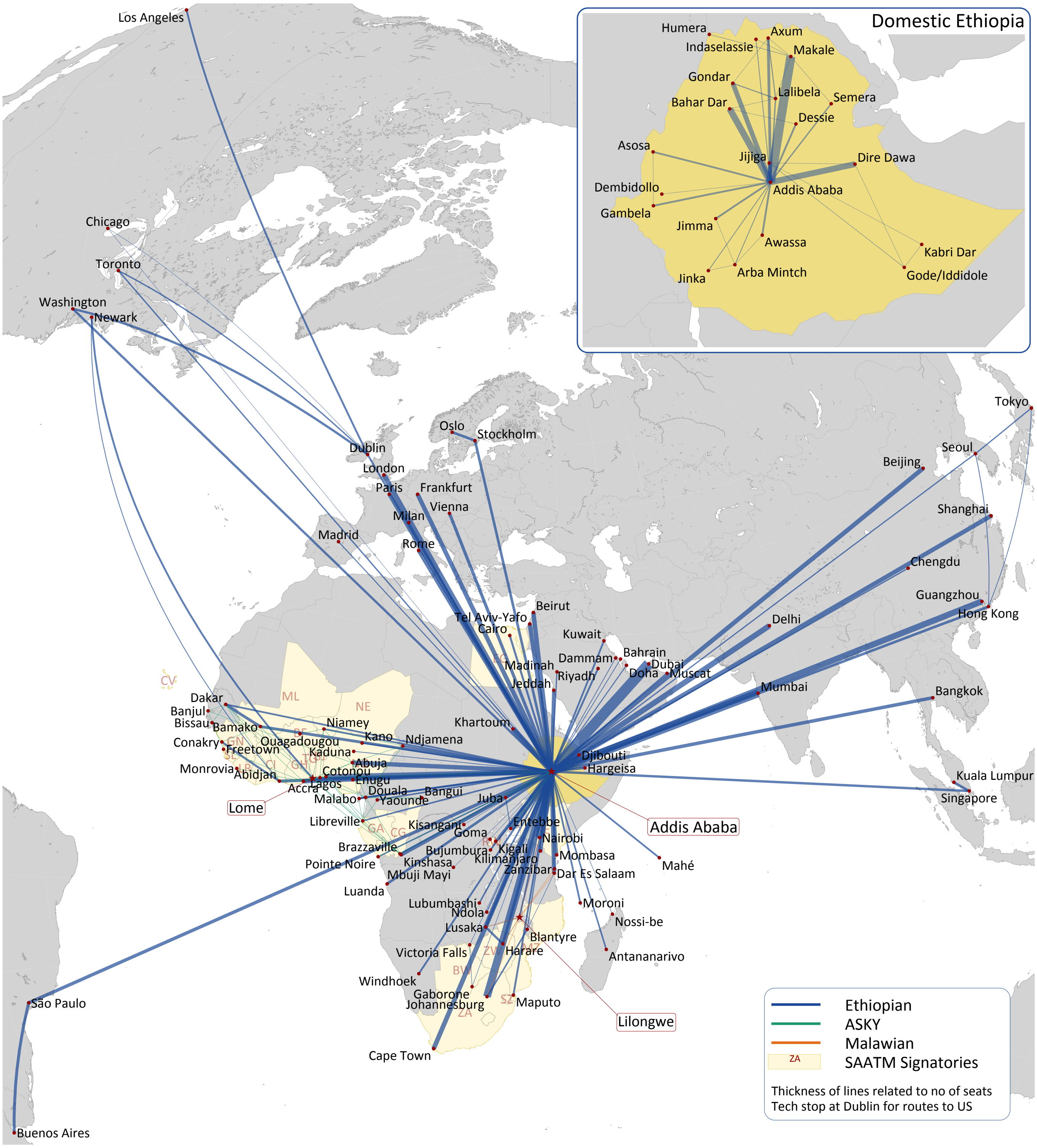
The continent has a population of over 1.2bn people, some fast growing economies, huge mineral wealth, dramatic levels of inward investment (particularly from China), and poor ground transport infrastructure. And yet it has some of the most restrictive cross-border aviation bilateral agreements, highest costs of aviation fuel, taxes and airport fees in the world.

In January this year, after first being promulgated 30 years ago,



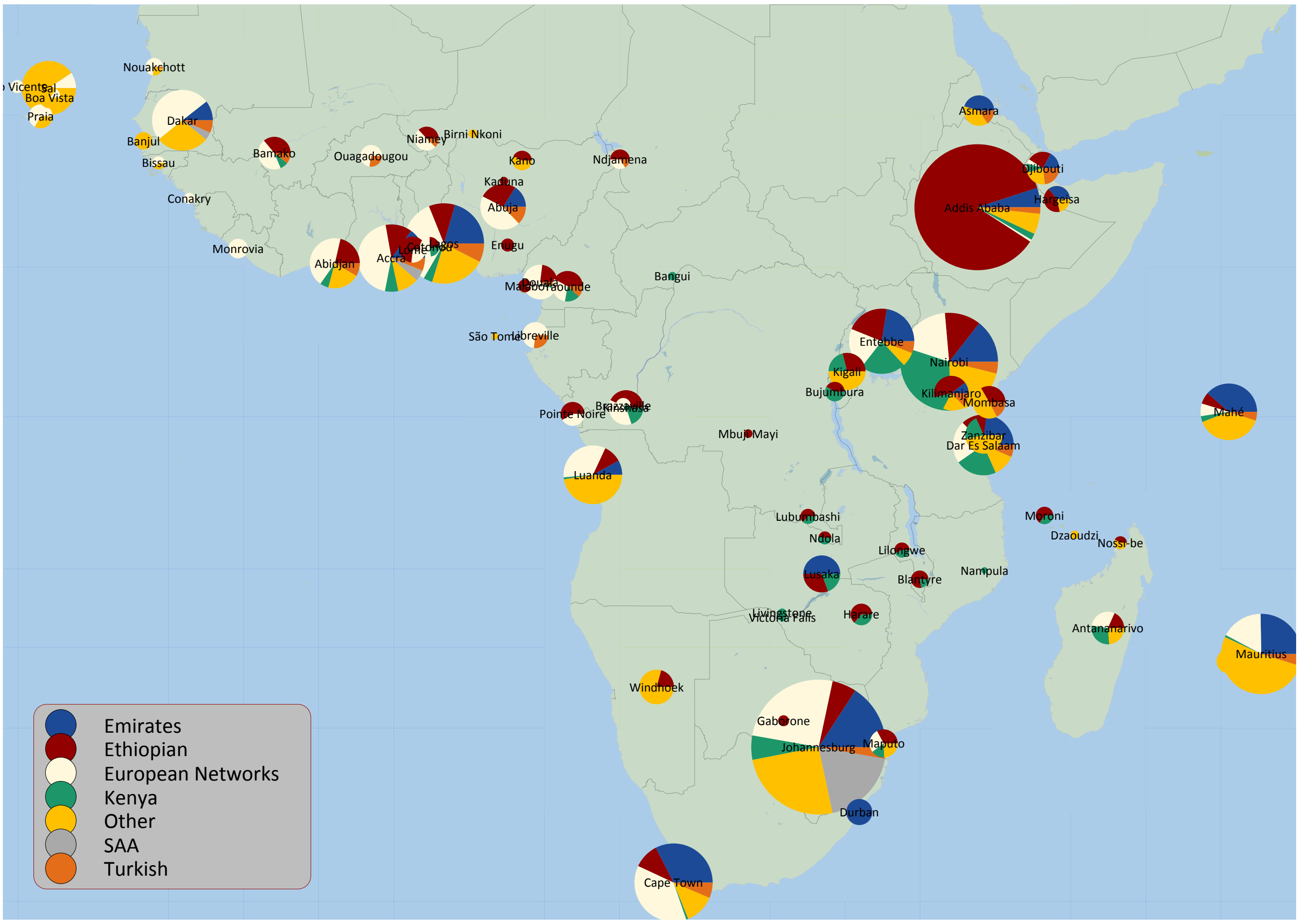
Source: schedules data. Notes: Top 13 carriers account for 80%of capacity. Ethiopian includes ASKY; SAA includes Mango. Includes domestic operations.

ETHIOPIAN: ROUTE NETWORK



Notes: Equidistant map projection centred on Addis Adaba (great circle routes appear as straight lines)
Thickness of lines directly related to number of seats.

SUB-SAHARAN INTERCONTINENTAL HUB CAPACITY



Source: schedules data. Notes: number of seats by operator. a) Ethiopian and Kenya: intra-regional services to their respective hubs in Addis Ad-aba and Nairobi, inter-continental services from those hubs b) Emirates, THY and Euro Network carriers (IAG, AF-KL, LHAG, TAP): intercontinental services to their hubs outside the region.

the 1998 Yamoussoukro declaration was formally adopted by the African Union to implement the Single African Air Transport Market (SAATM). Twenty-three of the 55 AU nations signed up to the deal. IATA remarked that "the SAATM has the potential for remarkable transformation that will build prosperity while connecting the African continent".

Hitherto, there have been very limited air traffic flows within Africa, except domestically. South Africa accounts for half of the 40m domestic seats in sub-Saharan Africa with Cape Town–Jo'burg the densest route (itself the 26th busiest city-pair in the world) followed by Durban–Jo'burg; domestic operations in the next biggest markets of Nigeria (Abuja–Lagos the third largest route in the area), Kenya, Ethiopia and Tanzania account for another third. Domestic routes have grown by an annual average 2% a year since 2010.

The SAATM provides the potential for liberalisation of fares, schedules and access within the region. No doubt in time this will generate growth; but to get that growth passengers need a reason to travel, and there seem little in the way of natural traffic flows within the region. There are only a handful of route pairs that currently support more than a modest level of capacity or frequency: the largest routes (having more than 0.5m seats a year) being Jo'burg-Harare; Nairobi to Entebbe, Addis Adaba and Jo'burg; Jo'burg-Windhoek; and Harare-Lusaka.

Sub-Saharan cross-border capacity has grown from 21m to 29m seats since 2010 — an annual average growth of 4%. Half of this growth has been generated by Ethiopian itself in opening and expanding services into its hub in Addis Adaba.

(The one recent attempt to establish an intra-regional LCC seems to be on the brink of failing. Fastjet (see *Aviation Strategy*, Sept 2014) is currently going through an emergency $10m capital raising exercise to give it enough cash to last through the rest of the year — in its last financial year to end Dec 2017 it lost $25m at the operating level on revenues of only $45m, although that was better than the prior year operating loss of $66m on revenues of $69m.)

Inter-continental battle ground

And yet the largest existing traffic flows are intercontinental — some 45m return seats in 2018 up from 30m in 2010 — and have been growing at 5% a year. Historically these routes primarily served connections to former colonial powers in Europe, and for onward services through the main hubs there: and for the European carriers, these routes have tended to be highly profitable, partly because of the poor local competition.

A decade ago the densest routes included London to Johannesburg, Lagos, Nairobi and Capetown, and Lisbon to Luanda. But in the past ten years there has been a shift in focus towards the East; and as the Super-connectors have grown they have specifically been able to target China's growing interest in Africa.

Emirates is the largest operator on intercontinental services out of Africa (see chart on page 7), and Dubai now features in seven of the top ten routes. It (and short haul sister company flydubai) operate to 23 destinations in the region from Dubai (up from 14 in 2010), and is probably Ethiopian's biggest competitor.

The other Middle East superconnectors have also increased presence with Qatar serving 14 destinations (up from 4 in 2010) and Etihad present in 6. However, Etihad is currently reviewing its whole operations and Qatar, prohibited from Saudi airspace, cannot operate competitively.

Of more concern may be the expansion of THY, currently serving 30 destinations in the region from İstanbul (up from 7 eight years ago). The amount of capacity it has put into the individual markets is relatively small, using narrowbody equipment, but it has expanded its footprint strongly.

However, Ethiopian has a strong advantage. It serves 49 destinations in the region outside Ethiopia (up from 40 in 2010) and can access relatively short haul and low density routes to feed its hub in Addis Adaba.

Capacity constraints

But Ethiopian's base at Addis Adaba's Bole International Airport has become constrained by the company's high growth. A new terminal facility is due to open shortly to boost annual capacity to 22mppa.

The government meanwhile has plans to build a new hub airport — 4 runways and ultimate capacity of over 80mppa at a cost of c$2.5bn. It is expected that a site will be chosen before the end of this year. Among the criteria for the choice are that it should be close to the city but at a lower altitude — at an elevation of 2,300m above sea-level the current airport is classified as "hot and high" which significantly constrains Ethiopian's operation of long haul routes (the US routes it operates direct have tech refuelling stops in Dublin, see map on page 8).

Opening doors

Ethiopia has not been known as the most open of countries. But in April this year a youthful 41-year old Abiy Ahmed Ali was elected Chairman of the country's ruling coalition, the Ethiopian Peoples' Revolutionary Democratic Front (EPRD), and thereby appointed as the country's Prime Minister.

Quite quickly he has embarked on a series of much-needed reforms. He has signalled the end to the long running border dispute with Eritrea since the end of hostilities in the Ethiopian-Eritrean war in 2000. In June the government announced a plan to pursue the large-scale privatisation of state-owned enterprises and open certain sectors to competition — including telecoms and aviation. Well, privatisation may be too big a word — the state will retain a majority interest — but it will be open to selling a minority stake in Ethiopian Airlines to local or foreign investors. While being an ideological shift in the EPRD's long held views of state-control it could be viewed as a pragmatic way to boost much-needed foreign reserves. It has even been suggested that the country will open a local stock exchange.

Ethiopian Airlines aims to be the pan-African passenger and cargo network that connects the continent. It has grown to its current position profitably. As GebreMariam has said: "Growth in the industry is often unprofitable, but being government-owned, we have no other way of raising money — we can't go to the stock exchange — so we have to make sure it *is* profitable." The challenge will be to continue to do so and efficiently manage the development of its multi-hub network of associate airlines.

Aeroflot and podeba: Putinesque

THOUGH oil prices have risen and the Russian economy has escaped from recession, Aeroflot's profitability plunged during 2017. But while the country's flag carrier is hamstrung by majority state ownership and influence, it is a statist corporate strategy that is Aeroflot's biggest challenge.

In calendar 2017, under IFRS standards, the Aeroflot group's revenue rose by 7.4% to ₽532.9n (US$9.1bn), thanks to a 15.4% rise in passengers carried, to 50.1m. However, group operating profit fell 26.1% to ₽40.4bn ($693m) and the net profit was down a substantial 40.6% year-on-year to ₽23.1bn ($395m) — see charts below.

The downward profit trend is continuing into this year. In the first quarter of 2018, revenue rose 8.5% to ₽112bn ($2bn), with passengers carried up 6.8% to 11m. However, EBITDA plunged from a ₽1,136m loss in Q1 2017 to a ₽7,732m ($138m) loss in the first quarter of 2018 — close to a sevenfold rise in losses, which Aeroflot claims is due to "the seasonality pattern of the Russian aviation market coupled with macroeconomic factors".

That is a surprising statement given macro trends are starting to improve for Russia. After the value of the Rouble fell by around 60% in two years, from a rate of 33 Roubles to the US Dollar at the start of 2014 to 84 Roubles exactly two years later, it has improved significantly since then, and today stands at around 62 Roubles to the Dollar.

The Rouble's recovery is linked with an improvement to Russia's economy. The country's rate of GDP growth started falling in 2012 before the economy shrank in both 2015 and 2016 — with the causes lying almost entirely at the feet of the Putin government, whose imperialistic ambitions in the Ukraine/Crimea (and challenges to the West in general) have been met by US and EU sanctions that have helped — along with Putin's domestic policies — drive the Russian economy into the ground.

But 2017 was a year of recovery for the economy — inflation has fallen significantly recently and GDP grew by around 1.5%, which though modest is a considerable improvement compared with the last few years. The World Bank expects Russia's economy to grow at around 1.7% this year and 1.8% in 2019.

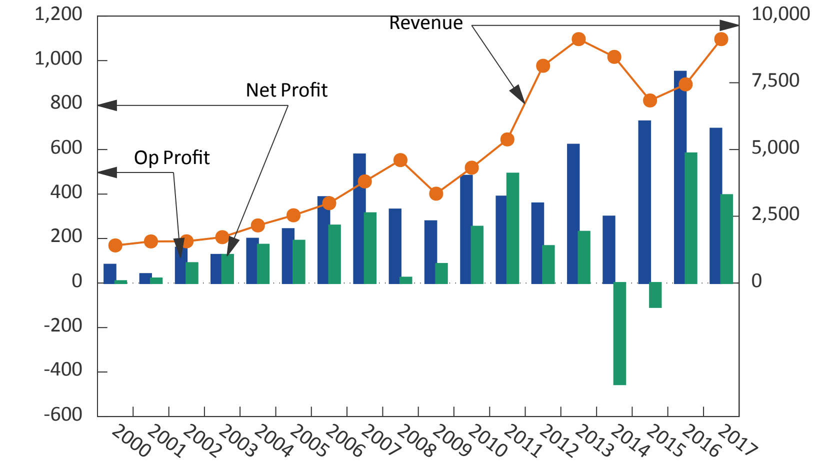
Structural weakness

However — and it's a big however — there are still severe structural weaknesses in Russia's economy, not least of which is the high correlation with oil prices. Prices for crude oil plunged from $108 a barrel in September 2013 to less than $30 in February 2016, and it's no coincidence that Russia's escape from recession has coincided with an improvement in oil prices since then.

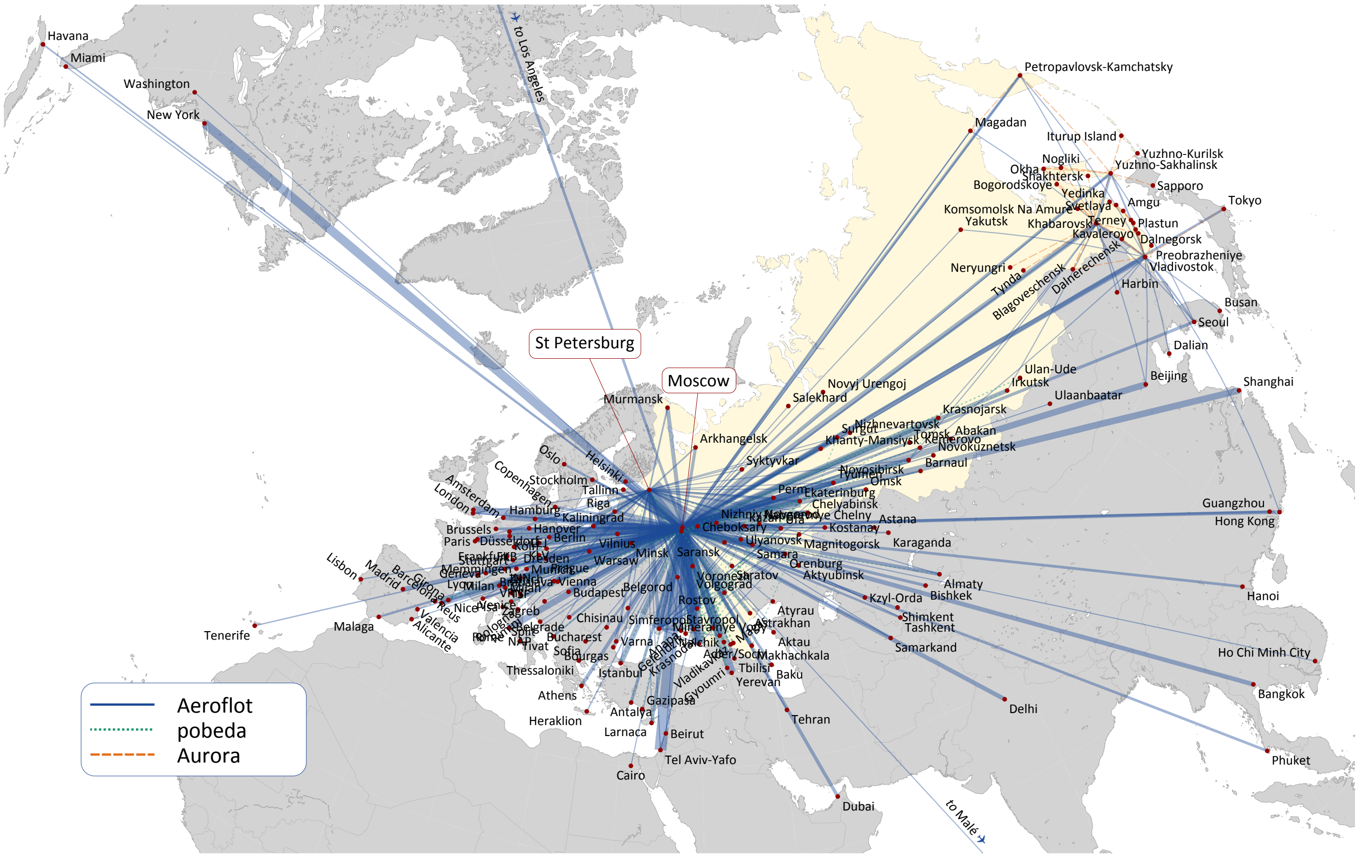
Hydrocarbons account for an estimated 30% of Russia's GDP and somewhere between 40% and 50% of the federal budget. Russia is now trying to reduce its dependency on these volatile revenues, and earlier this year introduced a new regulation whereby once the price of oil goes above $40 a barrel, all revenue over that level will be allocated to a "National Welfare Fund" (ie allocated for long-term investment), rather than being used for regular government spending, as has usually been the case.

Perhaps more crucial than oil prices, international sanctions have

AEROFLOT: FINANCIAL RESULTS (US$m)



AEROFLOT ROUTE NETWORK



made it very difficult for the Russian government, banks and companies to raise funds outside of the country, and the result has been significantly reduced investment. Until the first quarter of 2017, Russia went 11 consecutive quarters where investment growth fell (as measured by percentage change on gross fixed capital formation). Those sanctions have therefore forced Russian companies and banks to wean themselves off what had been cheap foreign debt, and domestic economists hope that Russia retains that discipline when sanctions are lifted.

Yet, if anything, Putin is becoming more belligerent towards the West, and despite president Trump's wishes to bring Russia back "in from the cold" (including an unsuccessful plea in June this year to allow Russia to rejoin the G7 nations, to make it a G8 again), sanctions on Russia remain obstinately in place. Also in June, Jens Stoltenberg — Secretary-General of NATO — said that continuing sanctions deters Russia from invading other countries.

In short, the Russian state will remain a virtual international pariah until either Putin reverses his aggressive stance internationally, or — perhaps more feasibly — he is replaced by a moderate president at some time in the future. That won't be soon though, as he was re-elected easily in March (while hardly bothering to campaign overtly) and is undoubtedly popular domestically.

Against this challenging background, Aeroflot has to operate as the nation's flag carrier.

Aeroflot post-Transaero

Aeroflot's dip in profitability during 2017 comes despite being boosted considerably in the last two years by the demise of Transaero Airlines, formerly the second largest airline in Russia (see *Aviation Strategy,* April 2017), when in effect Aeroflot has been able to cherry-pick the best of Transaero's international routes. They are now served by the group's multi-brand strategy, with the mainline Aeroflot operating alongside regional/charter airline Rossiya, regional carrier Aurora and LCC podeba.

podeba (which means 'victory' in Russian) has garnered a lot of attention since its launch in December 2014, but the LCC saw passengers carried rise just 6.9% in 2017, to 4.6m. Of those, 3.7m were carried on domestic routes, which was actually 3.7% down year-on-year — a remarkable achievement in a year when the overall Russian domestic market grew by 11%.

Based at Moscow Vnukovo, podeba operates 18 737-800NGs, with six more due for delivery this year and a target of 45 aircraft in operation by 2022. They fly on 62 routes (38 of which are unique within the wider Aeroflot group), and the focus now is clearly on international routes, where passengers carried rose 84.8% last year, to 0.9m.

The LCC, however, has to be seen within the context of the Aeroflot group — it accounted for just 9.1% of total group passengers carried in 2017 — and this percentage was actually down on 2016, when it accounted for 9.9% of all group passengers carried.

Strategic confusion

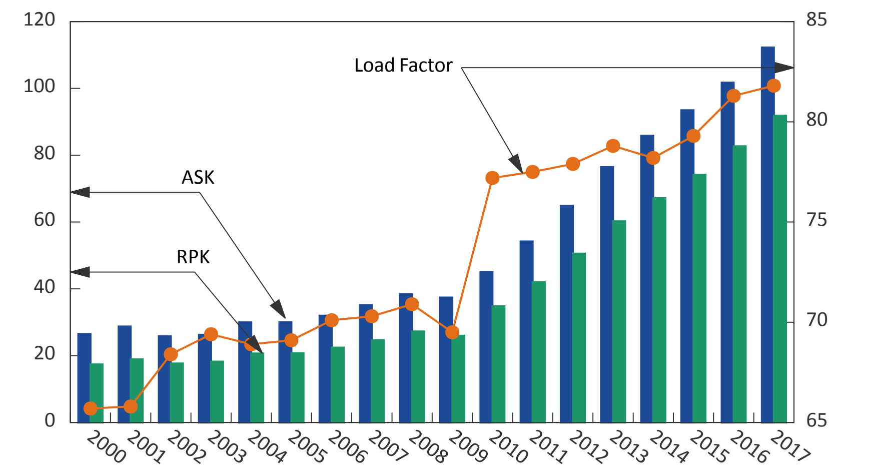
Is this a rejection of the LCC model in the Russian market, or just poor management of podeba by Aeroflot within the wider group portfolio? Aeroflot suggests "limitations in fleet" are to blame, but responsibility for that lies squarely with Aeroflot's management. A net profit of ₽2.8bn ($48m) in 2017 was 24.4% down on 2016, and — worryingly — in the first quarter of 2018 (which is traditionally the weakest quarter in the Russian market), podeba made an EBITDA loss of ₽882m ($16m), 28.8% worse year-on-year, and a net loss of ₽736m (a 55.1% higher loss than Q1 2017).

Whatever the reason for podeba's struggling performance. the powerhouse of the group is increasingly the mainline Aeroflot, which saw passengers carried rise 13.3% in 2017, to 32.8m. Based at Moscow Sheremetyevo, somewhat obstinately the mainline continues to develop Moscow as a transit point for passenger flows between the Asia/Pacific region and Europe/North America — which is a tough ask given Russia's reputation currently.

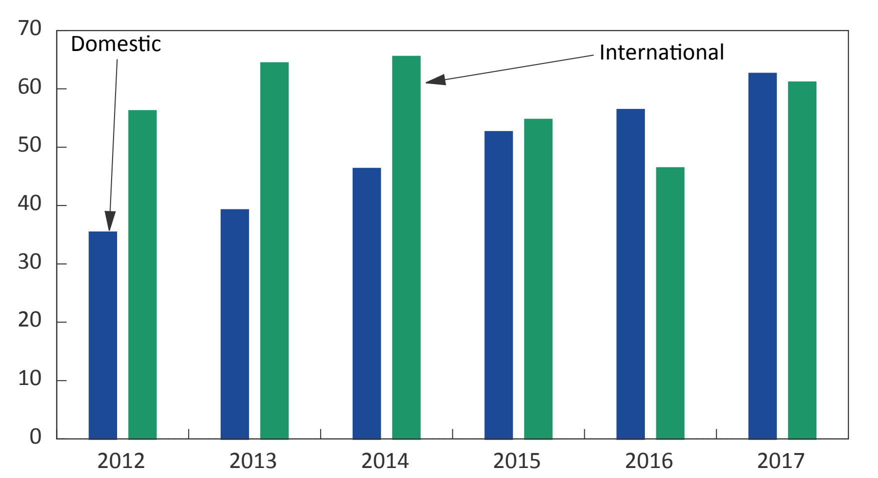
Aeroflot's total international to international transit passengers rose from 3.7m in 2016 to 4.4m in 2017, thanks to increasing frequencies on international routes, but as a proportion of all international passengers carried by Aeroflot that has actually fallen year-on-year, from 20.2% in 2016 to 19.5% in 2017.

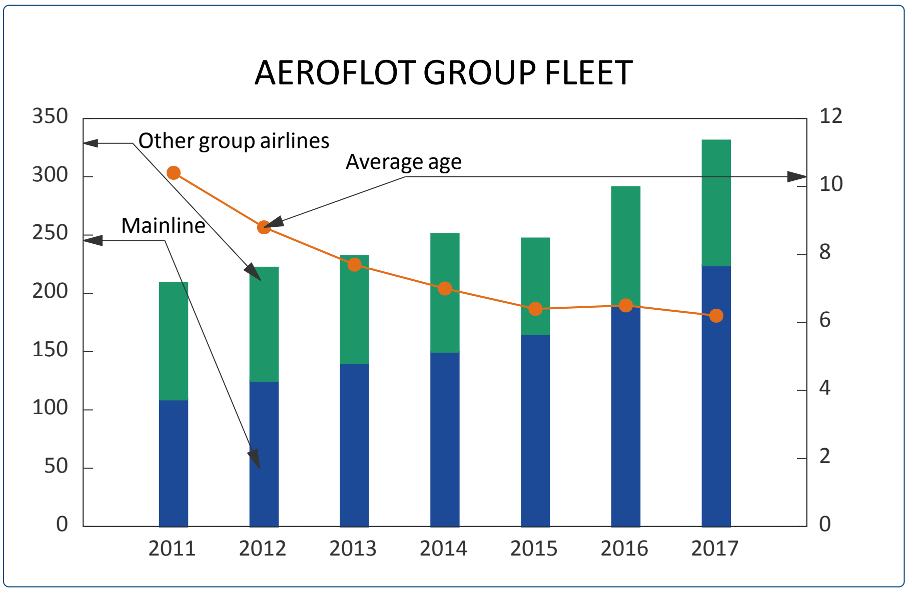
We have commented on Aeroflot's strategic goals for 2025 previously (see *Aviation Strategy*, April 2017), and suffice to say that many are already in tatters, with transit passengers a case in point. The airline has an explicit goal for 32% of total group passengers carried to be transit passengers by 2025, but the proportion is going down, not up.

AEROFLOT MAINLINE TRAFFIC



PASSENGERS CARRIED IN RUSSIAN MARKET BY SEGMENT





In any case, the transit goal seems in direct contradiction for the plans to develop podeba's point-to-point network — or then again, this might explain why the LCC's traffic growth was so poor last year. Interestingly — and in complete contrast to its stated strategy — at the conference call with analysts to discuss 2017 results, Giorgio Callegari (Aeroflot groups' deputy CEO for strategy and alliances) said that "transfer traffic is an important and interesting opportunity — but not the focus of our efforts. The percentage of International–International traffic still remains a very, very minor part of our total number of passengers". Intriguingly, Callegari, who is internationally respected, resigned in March, and Aeroflot is reportedly a shortlist of replacement candidates that are "all foreign", according to Vitaly Savelyev, Aeroflot CEO.

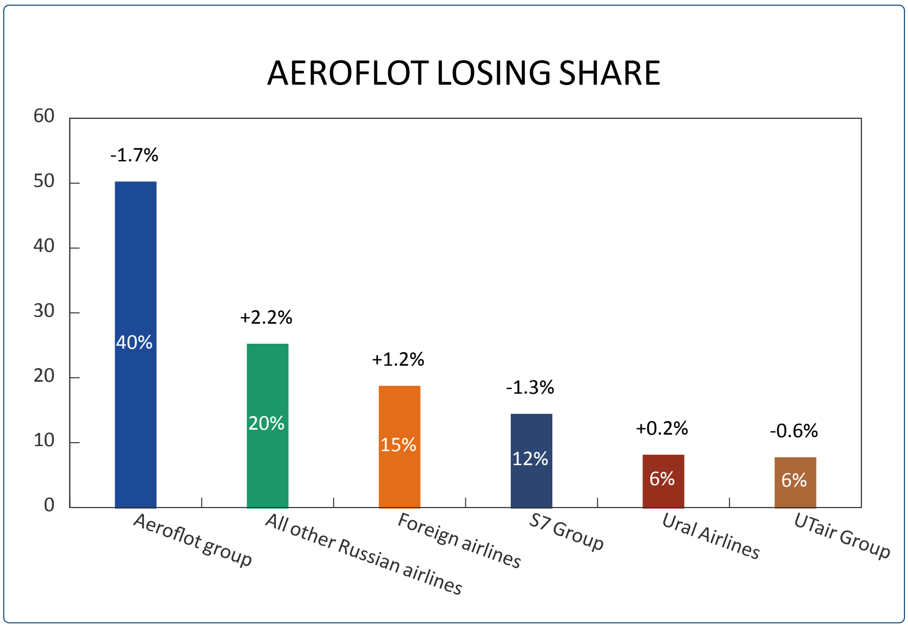
In terms of fleet, the group continues to expand, and it now comprises 336 aircraft, 45 more than at the end of 2016 (see chart below). Modernisation of assorted fleet types is advancing steadily, although the group still has 10 different major types, with subsidiaries operating DHC-8s and DHC-6s; thankfully, the last of the An-148s and An-24s have left the group fleet, which now operates to 169 destinations in 52 countries.

On outstanding order for the group are 131 aircraft, comprising 14 A350-900s, six 777-300ERs, 18 787-8s, four 787-9s, 22 737-800s, eight SSJ-100s and 50 MC-21s (the first of which is due in the first quarter of 2020). Much of this is "front-loaded", with 41 aircraft due for delivery over Q2-Q4 this year, and the overall group fleet is set to rise to 409 aircraft by the end of 2022.

Immense challenges

What is fundamentally worrying for Aeroflot is that it is losing market share in both the domestic and international markets (see charts on the current page). In 2016, in terms of passengers carried, the group had a 44.6% share of the domestic market and a 39.4% share of the international market to-from Russia, but in 2017 this fell to 44.1% and 36.9% respectively.

The international market performance is the most disappointing. While international passengers carried by the Aeroflot group actually rose by 23.3% in 2017 (to 22.6m), that was substantially less than the overall increase in the international market in 2017, of 31.7%. That market rise (helped by the appreciation of the Rouble) came after two years of sharp stagnation as the Russian economy tanked, sanctions bit and international executives sharply reduced their travel to the country. Indeed, international passengers carried to/from Russia fell from



65.5m in 2014 to just 46.4m in 2016, and despite the recovery last year the international market was still some 3.3m passengers lower in 2017 than it was back in 2013.

The international market is critical to Aeroflot since international revenue accounts for almost 60% of total scheduled passenger revenue, and both yield and unit revenue are higher on international flights than domestic ones. Yet on any measure Aeroflot's international performance last year was poor.

In 2017 international revenue per RPK fell a hefty 7.7% year on year, from ₽4.11 in 2016 to ₽3.79 last year (by contrast domestic yield fell 1.1% year-on-year), while international revenue per ASK fell 5.6% year-on-year, from ₽3.25 to ₽3.06 (domestic unit revenue fell 1.6%). International yield has improved in the first quarter of 2018, but that has to continue through the whole of this year.

With yield and unit revenue falling in 2017, Aeroflot needed unit costs to fall similarly, but that just didn't happen. Excluding fuel, CASK fell from ₽2.40 in 2016 to ₽2.35 in 2017, but most of that gain was wiped out by the rise in fuel costs, so that overall unit cost fell by just ₽0.01 over the year, to ₽3.13 in 2017. And the continuing rise in fuel costs plus increasing lease costs led to a 7.7% rise in unit costs in the first quarter of 2018, to ₽3.37 (compared with ₽3.13 in Q1 2017).

Perhaps the only good news on the horizon for Aeroflot is the current World Cup, which is undoubtedly boosting traffic, both internationally and domestically, this summer (and in which Russia is doing unexpectedly well). But it will be a short-term boost only — the tournament lasts for a few weeks, and very few of the international fans that will use Aeroflot group flights will ever repeat the experience in the future.

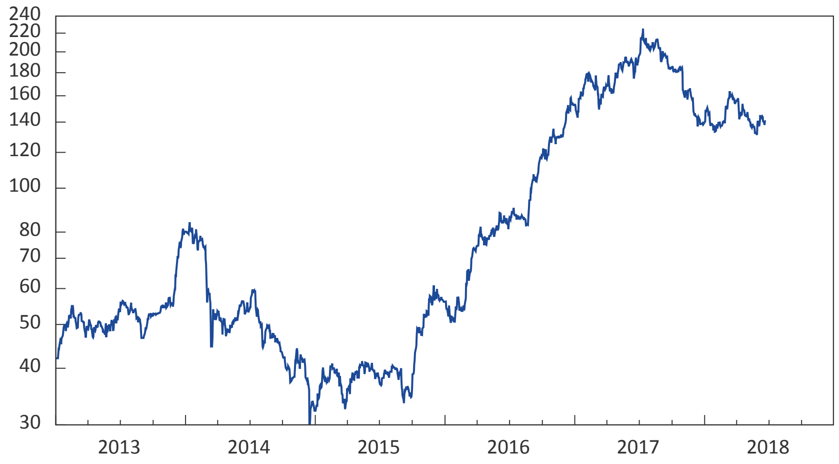
Other than being the flag carrier in a country ruled by an effective dictator, the last major challenge is that Aeroflot continues to be state-owned, with holding agency Rosimushchestvo having a 51.2% stake. State control over Aeroflot's strategy is absolute; the geopolitical interests of the Russian state are the prime driver of all major decisions made by all state-controlled entities in Russia, and this will not change until the flag carrier is fully privatised — and there are no serious signs that this will happen under Putin's watch.

Naturally the airline's management is keeping to the party line, with Savelyev saying: "I don't currently see any reason to part with a company, even for some large amount of money, that fulfils really big social functions for the country. If there was a different owner, it's not a fact that we would offer flat rates and cheap tickets for the World Cup football championships".

AEROFLOT GROUP FLEET

	In service					
	Aeroflot	**Rossiya**	**Aurora**	**Pobeda**	**Group Total**	***On order***
A319		26	10		**36**	
A320	76	5			**81**	*10*
A321	38				**38**	*5*
A330	22				**22**	
A350						*14*
737-800	38	16		18	**72**	*26*
747-400		9			**9**	
777-2/300	16	6			**22**	*6*
787-8/9						*22*
SJ100	42				**42**	*13*
DHC-8/-6			14		**14**	
MC-21						*40*
Total	**232**	**62**	**24**	**18**	**336**	*136*

AEROFLOT SHARE PRICE PERFORMANCE (₽)



Mexico's airlines: Trump and now AMLO

THE PAST couple of years have been challenging for Mexican aviation, with the US-Mexico open skies regime coming into force, competition intensifying in the domestic market, and Trump effects hitting the Mexican peso, business sentiment and travel demand. The July 1 presidential election and the ongoing North American Free Trade Agreement (NAFTA) renegotiations pose further economic uncertainty. How are Mexico's main airlines — Aeroméxico, Volaris, Interjet and VivaAerobus — dealing with it all?

Mexico is heavily dependent on its northern neighbour, with 80% of its exports going to the US. The airline sector is heavily exposed to the Mexico-US air travel market — about 30m passengers in 2017, or two-thirds of the total international travel to and from Mexico.

So President Trump's protectionist trade policies and anti-immigration rhetoric, including his campaign promises to build a wall on the US-Mexico border and terminate NAFTA, were devastating blows to Mexico's economy. Business confidence declined, investment plans were put on hold and the Mexican peso plummeted.

The peso's depreciation played havoc with Mexican carriers' financial results. The airlines have up to 60% of their costs denominated in US dollars (fuel, aircraft rentals, etc), so they saw terrible cost headwinds and foreign exchange losses. After being consistently profitable, the four largest carriers all plunged into losses in the first quarter of 2017.

After the initial shock, though, it looked like things were going to get better. Trump softened his policies or found his proposals blocked or delayed in Washington. He conceded that NAFTA could be renegotiated and that there would be no mass deportations of Mexicans. Funding the border wall was a non-starter in Washington. By June 2017, the peso had recovered to its pre-election level, and there was optimism that Mexico's airlines could see a quick recovery in profit margins.

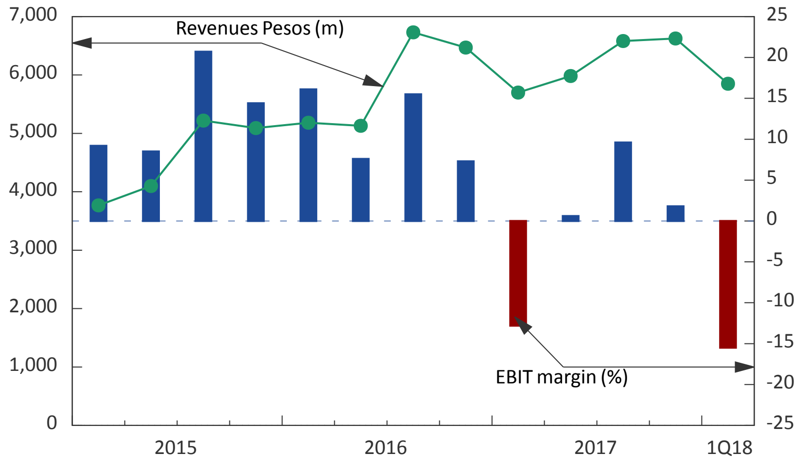
But in the past two months Trump's rhetoric and actions have taken a turn for the worse. Although his primary target is China, the EU, Canada and Mexico have all been hit by new tariffs on their steel and aluminium exports to the US. All have retaliated; in early June, Mexico announced 15-25% tariffs on $3bn of US products.

Second, in mid-June Trump's inhumane policy of splitting up undocumented immigrant families at the southern border blew up into a full-blown crisis. Reportedly at least 2,300 children (mainly from Central America but also from Mexico's most violent areas) have been separated from their parents since mid-April, while the parents are being prosecuted for crossing the border illegally.

On June 20 Trump bowed to intense pressure and signed an order ending the separation of children, but it is not clear whether the damage can be undone. Trump then revived the claim that Mexico will pay for the border wall (to which President Enrique Peña Nieto responded on twitter that Mexico will "never pay for a wall. Not now, not ever").

Unsurprisingly, the Mexican peso has again lost value: since mid-April it has fallen from 18 pesos to the dollar to the 20-21 level. The weakness also reflects the mid-June increase in

VOLARIS' QUARTERLY REVENUES AND EBIT MARGINS



Source: Company reports

the US benchmark interest rate; Mexico's central bank limited the damage by raising its own key interest rate. With more US Fed tightening on the cards, analysts expect the peso to remain under pressure.

Mexico's central bank cited two big unknowns: NAFTA renegotiations and the July 1 elections. The airlines, too, noted in their latest earnings calls that those two factors made it hard to predict customer behaviour.

The NAFTA talks, which began in August 2017, could now take longer, and the risk of the talks failing is higher. Many in the financial community now assume that there will not be a NAFTA deal this year but that a positive outcome is still likely. Fitch said in early June that it believed that the outcome of the NAFTA talks would "not seriously affect Mexico's trade access to the US". In the meantime, though, Mexican companies can be expected to continue to delay investments, and hence probably also travel decisions.

The uncertainty around the upcoming presidential election is not about who will win but what the likely winner will do. The candidate with an overwhelming lead in the polls (90% odds of winning), Andrés Manuel López Obrador (known by his initials AMLO), is a left-leaning populist with some controversial ideas but who is mostly an unknown quantity.

According to *Forbes*, AMLO, like Trump, is not a fan of NAFTA. With two populists clashing, US-Mexico tensions could worsen. The economic implications of AMLO's victory are not at all clear: on the one hand, he could turn out to be a moderate and his increased social spending could boost growth in the near term; on the other hand, his plans to reverse Peña Nieto's key reforms, such as the opening of the oil and gas industries to the private sector, would adversely affect investment in the longer-term.

In its June 23 issue, *The Economist* called AMLO "Mexico's answer to Donald Trump", noting that he has a "folksy air of incorruptibility that enchants many Mexicans". The article continued: "But the nationalist populism he offers is unlike anything Mexico has seen since the early 1980s. When AMLO promises a 'radical revolution', some worry that he will be as good as his word."

AMLO's victory could have specific ramifications for airlines: he does not approve of the New Mexico City Airport project. But there is hope because he appears to be softening his stance (discussed more in the last section).

Yet despite all the politics, Mexico's economy has remained relatively healthy. The IMF expects Mexico's real GDP to expand by 2.3% in 2018 and by 3% in 2019, following 2% growth in both 2016 and 2017.

Financial losses and new strategies

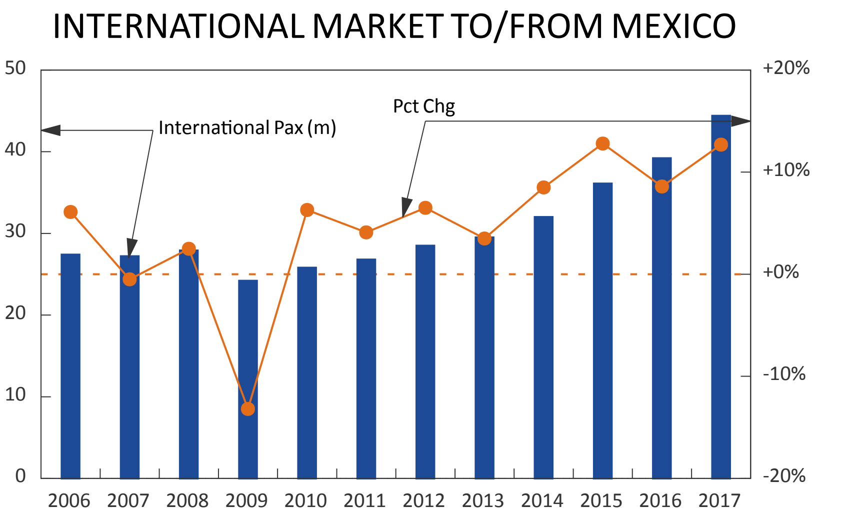
Mexico's challenges and intensified competition in key markets have taken their toll on airline profits: An industry that was doing well right through the end of 2016 is now reporting weak results and even heavy losses for the seasonally weakest quarters.

Volaris has been hit the hardest. In the latest period (Q1 2018), the leading ULCC incurred alarmingly high operating and net losses of 906m pesos and 1,118m pesos, respectively (negative margins of 15.5% and 19.1%). The operating loss was blamed on higher fuel prices and lower base fares. Domestic fares fell by as much as 17%.

Those losses followed a weak 2017, in which Volaris achieved a mere breakeven operating result (after double-digit margins in previous years) and a net loss of 595m pesos (2.4% of revenues).

The latest results would have been truly dismal had Volaris not seen continued strong growth in ancillary revenues (non-ticket revenues rose 17.4% to account for 34% of total revenues) and good cost controls (ex-fuel CASM fell by 9%).

VivaAerobus, the other ULCC in



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

Mexico, incurred operating and net losses of 192m pesos and 37m pesos, respectively (9.6% and 1.8% of revenues) in Q1 2018 — both steeper than in the year-earlier period.

However, the airline also grew at a breakneck pace with very promising results. Despite 37% ASK growth, VivaAerobus achieved a 87.4% load factor, 8.8% higher unit revenues and a 12.7% higher average fare. The secrets: aggressive fleet renewal, strong ancillary revenue growth and (evidently) improved yield management.

VivaAerobus has rectified its biggest initial mistake, which was to operate old aircraft. In 2013 it opted to replace its used 737-300s with new A320neos/ceos, placed a $5.1bn aircraft order and completed the fleet transition in November 2016. As of March 31, the airline operated 23 A320ceos and two A320neos. The aim is to have a 55-strong A320 fleet by 2022, of which at least 70% will be neos.

The carrier's ancillary revenues surged by 53.2% in Q1 (or by 18.7% on a per-passenger basis), to account for 46% of total revenue — an indication of a very successful implementation of the fare-unbundling strategy.

Interjet, the up-market LCC, reported operating and net losses of 567.1m pesos and 593.5m pesos, respectively (10.7% and 11.2% of revenues) for Q1 2018, which were similar to the year-earlier losses.

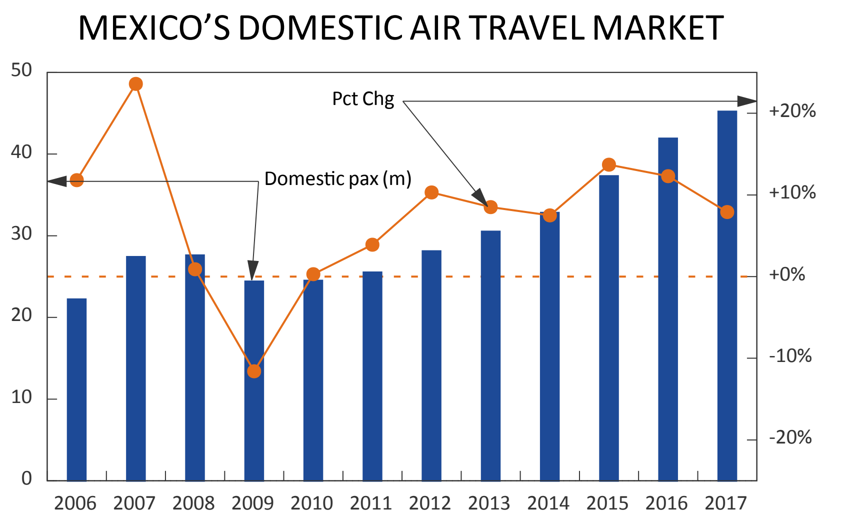
Interjet's annual results have deteriorated steadily in the past two years. Last year's operating margin was 1%, down from 7.3% in 2015. And 2017's net loss was 236m pesos, contrasting with net profits of 412m pesos and 277m pesos in 2015 and 2016.

Aeroméxico has not fared quite so badly because it benefits from a diversified global network. The carrier achieved a tiny 24m peso operating profit in Q1 (a breakeven effectively), enabling it to claim a 32nd consecutive positive EBIT result. Net loss was 722m pesos, reflecting a large foreign exchange loss.

The sharp deterioration in Aeroméxico's EBIT reflected weaker international demand, yields and load factors. The airline has focused on the international segment (ASMs up 25.5% in Q1) and reduced domestic exposure (ASMs down 5.2% in Q1).

The two ULCCs, Volaris and VivaAerobus, are both benefiting from successful ancillary revenue strategies, especially in the cross-border market where checked bag fees are allowed. Those fees are helping to compensate for the base fare declines as the markets have become more competitive.

The other positive development



Source: SCT/DGAC

LARGEST OPERATORS IN THE INTERNATIONAL MARKET TO/FROM MEXICO (APRIL 2018)

	Int'l sched. pax (000)	% chg yoy
Aeromexico	635.8	+4.0%
American	417.5	-9.7%
United	405.5	-5.2%
Delta	337.3	+8.2%
Interjet	295.2	+41.2%
Volaris	227.7	-14.1%
Southwest	202.7	+8.5%
Alaska	171.3	+11.5%
WestJet	130.5	-1.5%
Top 9 airlines	**2,823.5**	**+2.5%**
Total market	**4,000.1**	**+2.4%**

Source: SCT/DGAC

is diversification in terms of markets. The best example so far is Volaris' venture into Costa Rica. Volaris created a new AOC, which replicates its business model, and obtained a new foreign air carrier permit in the US. The unit launched US operations in March, currently serving Los Angeles, JFK and Washington Dulles from Costa Rica, with some of the flights stopping in San Salvador and others in Guatemala City.

The other potentially promising area is alliances with foreign carriers. Volaris has again stolen the show by signing a codeshare deal with the US ULCC Frontier in January (sales will begin in Q3). The airlines claim that it is the first-ever codeshare agreement between two ULCCs.

Interjet was the first Mexican LCC to embrace codesharing (currently with American, Iberia and LATAM) and is now reportedly seeking cooperation with Hainan and a deeper JV with American. But the latter could take years to materialise.

Aeroméxico has been implementing its immunised JV with Delta since May 2017, which probably helped it weather some of the capacity pressures on US-Mexico routes. However, Bradesco analysts suggested in April that macroeconomic headwinds may delay Aeroméxico's plan to extract the full US$200m annual synergies from the JV within five years.

Of the three LCCs, despite its steep Q1 losses, Volaris is clearly the best-positioned to return to solid profitability when the dust settles (the ULCC model, lowest costs, robust ancillary revenue strategy, the Costa Rica unit, strong balance sheet, etc).

VivaAerobus may have a bright future — if it can consolidate its new strategies, manage growth and build a better position in the Mexico-US market. As of April, it still had only a 1.6% share of Mexican carriers' international traffic.

Interjet is currently the weakest of the three, not just because of the recent issues with the Superjet SSJ100 engines. The balance sheet looks weak, with current liabilities exceeding current assets as of March 31 (14,166m/5,567m pesos). Cash reserves were only 5.7% of last year's revenues. Rapid growth does not help, and nor does having to compete in a domestic market dominated by ULCCs.

Demand strength, yield pressures

Air travel demand has remained strong in most markets. Domestic passenger numbers in Mexico rose by 7.9% in both 2017 and January-April 2018 — lower than 2016's 12.3% growth, but April actually witnessed a 10% surge. The domestic market has doubled since 2006, from 22.2m

MEXICO-US PASSENGER TRAFFIC AND NUMBER OF FLIGHTS

	Passengers		Flights	
	('000s)	% chg	('000s)	% chg
2010	17,836		197.0	
2011	18,219	2.1	201.7	2.4
2012	19,088	4.8	210.1	4.2
2013	20,737	8.6	219.2	4.3
2014	22,508	8.5	227.3	3.7
2015	25,232	12.1	248.8	9.5
2016	27,391	8.6	256.6	3.1
2017	29,873	9.1	270.6	5.5
Jan-Apr 2017	**10,395**		**95.2**	
Jan-Apr 2018	**10,846**	**4.3**	**99.2**	**4.3**

Source: SCT/DGAC

to 45.2m passengers — entirely attributable to the growth of LCCs.

Domestic demand has remained strong because of healthy GDP growth and because a weaker peso has prompted more Mexicans to vacation at home. But the sharp decline in domestic fares and yields, especially in Q1, and the comments made by some airline executives indicate that significant capacity addition and fare wars played a part in stimulating demand.

Some analysts have expressed concern about what they see as unsustainably low domestic fares. Brazilian airlines saw a similar situation in late 2015 and early 2016, albeit for different reasons; they reduced capacity drastically and fast, and stopped burning cash. Why can't Mexican airlines do that?

Aeroméxico and Interjet have done that. Aeroméxico Group reduced domestic capacity by 1% in 2017 and by 5.2% in Q1 2018, with promising results: in the first quarter, its average fare recovered by 12% and its load factor rose by seven points.

But the problem is that, unlike Brazil where there are no ULCCs, in Mexico ULCCs account for 45% of domestic passengers (April data). Being the lowest-cost producers by a wide margin, airlines like Volaris feel justified in continuing to add capacity domestically. They stimulate the market and continue to switch passengers from bus to air. They also know that they will be the eventual winners.

Volaris grew domestic capacity by 10% in 2017, 12% in Q1 2018, 11% in April and 14% in May. The leadership stated recently that they had no intention to reduce capacity in the domestic market. "We're convinced that volume-generation remains the most important driver of the top line and a healthy corresponding increase in our ancillary business." Volaris especially wants to maintain capacity leadership in the "core markets of the Mexico Pacific corridor", as well as Cancun.

But the international market is a different matter. There Mexican airlines compete against at least 10 US carriers, including ULCCs, LCCs and the legacies. The latter enjoy feed from their huge domestic networks and can now match ULCCs' fares with their Basic Economy product. In recent months, Volaris has followed United's and Aeroméxico's example and cut capacity in the US-Mexico market; its total international ASMs declined by 4.1% in April and by 5.5% in May.

Mexico's international market, which at 44.4m passengers in 2017 is similar in size to the domestic market, remains extremely imbalanced. Almost two-thirds of international passengers travel to or from the US. Mexican carriers account for only 29.5% of Mexico's international passengers, while US carriers have a

MEXICAN AIRLINES' DOMESTIC MARKET SHARES

	% of total domestic passengers			
	Apr 2018	**Apr 2017**	**2012**	**2009**
Aeroméxico Group	28.2	28.8	37.7	32.3
Volaris	27.9	27.8	20.5	12.8
Interjet	21.5	21.1	23.9	12.7
VivaAerobus	17.4	16.7	12.5	5.8
Mexicana				27.2
Others	5.0	5.7	5.3	9.2
Total	**100.0**	**100.0**	**100.0**	**100.0**
Top 3 LCCs	**66.8**	**65.6**	**56.9**	**31.4**

Source: SCT/DGAC

MEXICAN AIRLINES' INTERNATIONAL MARKET SHARES

	% of Mexican airlines' total international passengers			
	April 2018	**April 2017**	**2012**	**2009**
Aeroméxico Group	53.9	56.0	67.0	31.1
Interjet	25.1	19.2	9.0	
Volaris	19.3	24.3	21.9	2.9
VivaAerobus	1.6	0.3	2.2	0.4
Mexicana				65.4
Others	0.1	0.2		0.2
Total	**100.0**	**100.0**	**100.0**	**100.0**
Top 3 LCCs	**46.0**	**43.8**	**33.1**	**3.3**

Source: SCT/DGAC

47.2% share.

The Mexico-US market has seen a substantial increase in flights and frequencies under the open skies regime, which became effective in August 2016. However, airlines from both countries had already benefited from a liberalised regime in the secondary markets, which had led to an influx of new flights and operators. That explains why Mexico-US passenger numbers surged by 12.1% in 2015 and growth then moderated to 8.6% in 2016 and 9.1% in 2017.

But the Trump effects and other negatives have meant that demand could not keep up with the capacity addition, resulting in lower load factors, weaker yields and financial losses in the Mexico-US market. So this year is seeing a correction. The first quarter saw an estimated 6.2% reduction in available seats. April saw a 0.5% reduction in passenger numbers.

The cutbacks, which are also in response to the recent surge in fuel prices, were initiated by US carriers such as United and Alaska, but Aeroméxico and Volaris followed quickly. Volaris has retrenched in large markets such as New York and Los Angeles in favour of refocusing on its traditional strengths — VFR and niche markets between Mexico and the US, which have been "tremendously successful".

New MEX under threat?

But the biggest problem Mexico's airlines face is lack of slots at Mexico City's Benito Juárez International Airport, which now handles 47m passengers annually — almost 50% over its design capacity of 32m — and cannot be expanded. The airlines have done a remarkable job in squeezing more growth there, but the strategy of relying on aggressive upgauging has its limits.

In September 2014 President Enrique Peña Nieto announced plans to build a new six-runway airport for Mexico City to replace Juárez. Construction began in 2015. The airport, officially referred to as NAICM (Nuevo Aeropuerto Internacional de la Ciudad de México), is being built on government-owned land just three miles away. It will be able to handle 125m passengers a year. The initial three-runway airport, with capacity to handle 68m passengers, is scheduled to open in October 2020.

But AMLO has slammed the US$13bn project as corrupt, too expensive and unnecessary. After initially threatening to cancel it outright, he has relaxed his stance somewhat in recent months. He is now talking about reviewing the project and conducting a "public consultation" or referendum in September. He is reportedly looking at three options: continuing it as a public-private partnership (as it is now); making it a private-sector concession; and scrapping it and instead building two new runways at the existing Santa Lucia air force base.

According to *Bloomberg*, 70% of the $13bn estimated cost of the new airport is already being financed by private investors. The project is managed by state-owned airport operator GACM, which has a 50-year concession on NAICM and is also the parent company of Juárez. At least $6bn has already been raised through private debt securities, which draw from passenger charges at the current and future airport. In January, the international passenger arrival fee at Juárez was raised by 25% to a relatively hefty $51 to help finance a $2bn bond for the construction of the airport.

The consensus is that the new airport will move forward. First, it is badly needed. IATA warned in April that without it there could be 20m fewer annual passengers, $20bn less in GDP contributions and 200,000 fewer aviation-related jobs in Mexico in 2035.

Second, it is probably too late to cancel the project. More than 75% of the contracts have been awarded and construction is at an advanced stage, with the three runways expected to be completed by the end of 2018.

Third, there are no viable alternative sites. MITRE, a US-government sponsored not-for-profit organisation, recently analysed seven locations and concluded that the current site is the best option. Developing Santa Lucia would not solve the long-term capacity needs.

Apparently AMLO's preferred option would be to immediately auction the NAICM project to the private sector, but the consensus opinion (GACM, IATA, analysts, etc) is that an auction would make more sense after the airport has been completed.

By Heini Nuutinen

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