Investment Funds and Airline Ownership

In March this year, Margrethe Vestager, the powerful Danish EU Commissioner for Competition, gave a speech in Brussels which attracted only modest press coverage but which could have wide-ranging implications for the future ownership structure of airlines. The speech focused on the growing concentration of company ownership, and in particular cross-ownership by investment funds, something which has generated increased attention in North America and Europe. What was particularly interesting, however, was the fact that Ms Vestager specifically mentioned the airline industry in this respect.

As she noted: "In the US, they collect much more complete information than in Europe about exactly who owns which shares. So we can see examples of industries — **like the airline business** — where some investment funds own shares in all the big companies in the industry. And when investors have an interest in several companies in the same market, they might be better off if those companies don't compete too hard. If they ease off on trying to outdo each other, so no one wins big — but no one loses big either. And of course, that can mean that consumers lose out." [Emphasis added]

She went on to say that the European Commission is seeking to establish whether the potential problem already identified in the US exists as well in Europe. "We also need to understand what effect it really has — because even if some investors would benefit from less fierce competition, you can't just assume that they have the power to make that happen."

It seems, therefore, that the Commission is at an early stage in its investigation and there can't be any certainty that something will actually come of it. But it would be foolish to ignore the concerns identified by Ms Vestager. As the US tech giants have discovered to their cost, the Commission (like the Department of Justice in the US) has substantial powers if it concludes that companies are restricting competition and acting against the consumer interest, powers that can prove extremely costly to guilty parties.

The core issue is that today diversified mutual funds and other institutional investors hold an increasing proportion of companies' shares. Much depends, of course, on how you define such funds. Some have estimated that their joint ownership might be as high as 80% of US stocks; others put the figure as low as 62% in 2015, but even this represented an increase from some 37% in 1980. Thus, it is not surprising that competition authorities have started to question whether opportunities for anti-competitive behaviour are being created, although it is less obvious why the airline industry has been picked on in particular. The answer may lie on Ms Vestager's reference to the quality and quantity of data available for the industry.

Good quality, publicly available data tend to attract the interest of academics for their research, and it is academics who seem to have been especially active in highlighting the potential problems created by joint institutional ownership of airlines. One study in particular is worth considering: 'Anti-Competitive Effects of Common Ownership' by José Azar, Martin C. Schmalz and Isabel Tecu, published in March 2017 in the Journal of Finance (Volume 73/4).

This is a lengthy and very detailed economic analysis which comes to a clear conclusion in relation to the US airline industry: "We find a robust correlation between with-route changes in common ownership concentration and route-level changes in ticket prices… We conclude that a hidden social cost — reduced product market competition — accompanies the private benefits of diversification and good governance."

Cutting through the jargon, this

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INSTITUTIONAL US AIRLINE SHAREHOLDINGS, 2016 Q4

	American	Delta	Southwest	United
Berkshire Hathaway	7.75%	8.25%	7.02%	9.20%
Blackrock	5.82%	6.84%	5.96%	7.11%
Vanguard	6.02%	6.31%	6.21%	6.88%
State Street GA	3.71%	4.28%	3.76%	3.45%
J P Morgan AM		3.79%	1.31%	3.35%
Lansdowne Partners		3.60%		
PRIMECAP	8.97%	2.85%	11.78%	6.27%
AllianceBerstein		1.67%		
Fidelity	3.30%	1.54%	5.53%	
PAR Capital Mgt		1.52%	-	5.18%
T.Rowe Price	13.99%		1.26%	2.25%
BNY Mellon AM			1.22%	
Egerton Capital (UK)			1.10%	
Putnam	1.18%			
Morgan Stanley	1.17%			
Northern Trust G I	1.02%			
Altimeter Capital Mgt				3.26%
AQR Capital Mgt				2.15%
Total	**52.93%**	**40.65%**	**45.15%**	**49.10%**

Source: José Azar, Matin C. Schmalz & Isabel Tecu: 'Anti-Competitive Effects of Common Ownership.' Journal of Finance, 73/4.

means that the authors claim to have found evidence that common ownership of airline shares, ie large funds having significant stakes in several carriers, has led to higher fares. The accompanying table above shows data for the top ten investors in four of the nine airlines studied in the Fourth Quarter of 2016. Note that American Airlines' top seven shareholders, who jointly control 49% of the company's shares, are also among the top ten investors in Southwest Airlines. Similarly, each of Southwest's largest six shareholders is among the top ten investors in American and Delta and five of them are among the top ten holders of United/Continental stock. (See also *Aviation Strategy*, November 2016). This pattern is repeated to a greater or lesser extent for all nine airlines included in the study.

(In the table on the next page we show updated ownership data for the top four US carriers from recent filings — which if anything show further concentration. For contrast in the table on the facing page we show the limited data available for the top five carriers in Europe).

The usual way of measuring industrial concentration for competition analysis is the so-called Herfindahl-Hirschman Index (HHI), which involves squaring the market share of each firm competing in a market and then summing the results. An HHI of 0 indicates perfect competition, one of 10,000 shows a total monopoly. Azar, Schmalz and Tecu produce a modified index (MHHI) to reflect the extent to which competitors are also commonly owned by the same investors.

The results show "levels of market concentration that far exceed those indicated by the conventional measure of [such] concentration [ie, HHI]. Common ownership concentration for the average route is more than ten times larger than what

INSTITUTIONAL US AIRLINE SHAREHOLDINGS, 2018 Q2

Shareholder	American	Delta	UAL	Southwest	Exposure ($m)
PRIMECAP	11.3%	4.0%	13.1%	12.1%	9,713
Berkshire Hathaway	9.8%	7.6%	10.0%	8.2%	9,003
Vanguard	6.0%	6.1%	7.5%	6.3%	6,595
T. Rowe Price	13.0%	2.8%	3.0%	1.4%	4,761
BlackRock	4.3%	3.9%	4.5%	4.2%	4,313
SSgA FM	3.2%	3.4%	3.3%	3.3%	3,439
Fidelity	4.3%		2.2%	4.2%	2,480
PAR Capital		1.9%	5.6%		1,785
Lansdowne Partners		3.7%			1,270
JPMorgan		2.6%			888
Altimeter Capital			4.2%		850
Newport Trust		2.0%			708
Harris Associates	2.8%				615
Egerton Capital			1.8%		475
Diamond Hill				2.0%	407
Boston Partners			1.5%		393
Columbia MIS			1.4%		382
Geode Capital	1.1%				230
Invesco	1.0%				216
Total	**56.9%**	**37.9%**	**58.0%**	**41.6%**	**48,520**

Source: SEC, NASDAQ, Factset latest filings.

would be presumed 'to be likely to enhance market power' in the case of a traditional merger, according to the US Antitrust Agencies' Horizontal Merger Guidelines." The results of the authors' calculations suggest that US airline ticket prices are 3 to 7% higher because of common ownership, certainly sufficient to attract the interest of the competition authorities.

As the authors recognise, even if common ownership causes higher prices, that does not necessarily mean that mutual funds actively and consciously pursue anti-competitive practices. But there may be other ways that such investors can influence company behaviour. Competitive pressures may be reduced, for example, by just "doing nothing", such as by not actively encouraging certain market behaviour which in other circumstances shareholders might be expected to pursue. Similarly, the authors suggest that some common owners "(i) use ***voice*** to make understood their preferred product market strategies, that they can (ii) structure ***incentives***, ie pay, of commonly owned firms' top managers in ways that reward less aggressive competition, and that they can (iii) use the power of their ***vote*** to silence dissenting undiversified shareholders that push for more competition."

Needless to say, this being economics, not everyone agrees with the Azar, Schmalz and Tecu analysis, far from it. A particularly strong counter-argument has been published by Patrick Dennis, Kristopher Gerardi and Carola Schenone. ("Common Ownership Does Not Have Anti-Competitive Effects in the Airline Industry", published online on 5 March 2018.) They certainly do not disagree on the importance of this subject, pointing out that the risk of funds increasing prices has resonated with both academics and policymakers and put significant pressure on anti-trust authorities to open formal investigations.

They go on to note that the US

INSTITUTIONAL EUROPEAN AIRLINE SHAREHOLDINGS, 2018 Q2

Shareholder	Air France-KLM	IAG	Lufthansa	Ryanair	easyJet	Exposure (€m)
Capital	5.3%	12.7%		17.0%		4,822
Fidelity		0.9%		5.5%		995
Invesco		1.6%			10.0%	935
HSBC				4.8%		755
Baillie Gifford				4.8%		750
Lansdowne Partners		1.9%	3.6%			685
BlackRock		0.6%	3.3%		2.6%	629
Total	**5.3%**	**17.7%**	**6.9%**	**32.1%**	**12.6%**	**9,570**

Note: Intitutional Investors holding at least 3% of the equity in one or more of the European major airlines. Lufthansa Group data sourced from 2017 Annual Report.
Source: Financial Times, Factset, Company reports.

Congress has even been urged to introduce new legislation withdrawing tax advantages for retirement funds investing in any mutual fund that owns a significant number of shares in multiple firms in the same industry and limiting investors' "holdings of an industry to a small stake (no more than 1% of the total size of the industry) or [to …] the shares of only a single 'effective firm' per industry." Others in the US have argued that instead what is required is the enforcement of current legislation, notably the Clayton Act which, it is claimed, already bans the acquisition of stocks that result in a common set of investors owning significant shares in corporations that are horizontal competitors.

Action along these lines would, of course, inevitably have severe consequences for the airline industry and its investors. But any such action would only be necessary if the conclusions about anti-competitive behaviour are correct, and Dennis, Gerardi and Schenone argue strongly that this is not the case. They conclude, on the basis of their own detailed study, that the Azar, Schmalz and Tecu analysis is in fact far from robust and probably misleading. Again the arguments are complex and technical, but the authors (and at least one other study has pointed in the same direction) come to the clear conclusion that the "results indicate the spurious nature of the Azar, Schmalz and Tecu findings, and should be seriously considered by both legal scholars and policymakers who are currently contemplating regulations aimed at decreasing the extent of institutional ownership in product markets."

It is evident that this debate will continue for some time, and given its complexity and technical nature, it is unlikely to attract much public attention, at least until definitive conclusions are reached. As the recent speech by Commissioner Vestager indicated, policymakers in both Europe and the US are now closely involved. It may be that the most likely outcome is that at the end of the day no regulatory action will be taken, but nevertheless the risk of *any* action, no matter how tentative, is not something that should be ignored. The impact on the airline industry could be substantial.

There is another aspect to this debate which may also be worth highlighting. Airlines suffer from archaic rules governing the nationality of who can own and control them. Attempts over many years to reform these rules, notably the negotiations between the EU and US to create a fully liberal Trans-Atlantic Aviation Area, have got nowhere. Indeed, if anything it may be the forces of protectionism that are in the ascendancy, as illustrated for example by campaigns to restrict the expansion of the Gulf carriers. IATA appears to have retreated from its reform initiative, and the exit of the UK from the European Union increases the risk that the latter will adopt a less liberal external aviation policy. It looks as though the airline ownership and control rules are here to stay for the foreseeable future.

Yet the debate about common ownership in the industry outlined above highlights one important factor. It is clear that investment funds of various kinds are becoming ever more prominent in the list of shareholders of most publicly-quoted carriers. Many of these funds are enormous, with divers and often secret investors. It can be difficult to determine with any precision who the ultimate shareholders are, and therefore it must be equally difficult to determine the real nationality of airline stakeholders. Many regard the airline ownership and control rules as being harmful to the industry's economic well-being. It seems that in fact they may be even less fit for purpose than was thought.

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After an early career with the UK CAA, he became Director of External Affairs and Route Development at Virgin Atlantic Airways for many years. Since retirement he has, inter alia, chaired the trade body for UK airlines and been a Non-Executive Director of NATS, the UK air traffic control provider.

Ryanair: The model evolves

RELUCTANT unionisation, high profile strikes, a steady drip of adverse news items: is the Ryanair model under terminal threat? Certainly not, is the answer from this review of the fundamentals of the airline's financial and operational performance. However, in this financial year (to March 2019) the company will probably see a drop in profitability from the 20%-plus norm, and it may prove very difficult be recover such margins.

Over the past five years Ryanair has averaged 10% passenger growth, largely through stimulating traffic in new markets. It has pushed average load factors up to 95%, a level that would have been regarded as inconceivable a few years ago. The strategy has been based on yield neutrality — adjust price to generate the required traffic to fill the aircraft. Consequently, yield has fallen every year — from €48.20 per passenger in 2013 to €39.10 in 2018.

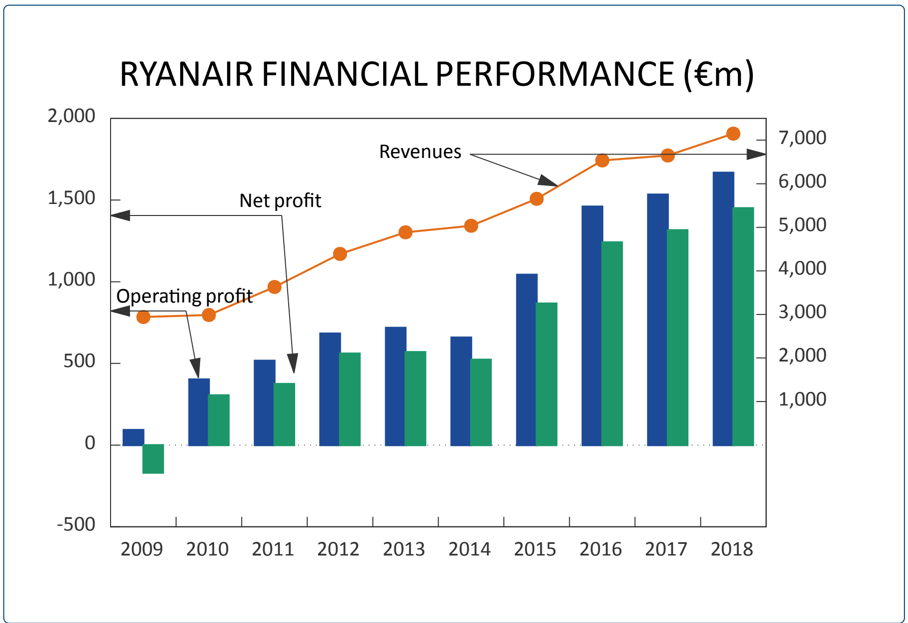
The proposition by Ryanair that it would somehow be acceptable for prices to slide towards zero as revenue would be generated from other sources now seems implausible. Ancillary revenue per passenger did grow by 4% to €15.50 in FY2018 but this is roughly the same level as in 2014. Substantially increasing ancillaries on a pure short-haul network is challenging, and has been tasked to RyanairRooms (competing with Booking.com, and other online agencies, through cutting out their 10% commissions — but customers only receive this benefit in credit for future air travel) and RyanairLabs (clever new apps and other techie stuff).

Nor is traffic growth a given. Ryanair's target is 200m passengers by 2024, and it has always hit its targets in the past, but saturation must be reached at some point — in our analyses of Wizz and Aegean (*Aviation Strategy*, March and April 2018) we noted how these two very different airlines had succeeded in slowing or blocking Ryanair's expansion in their key markets.

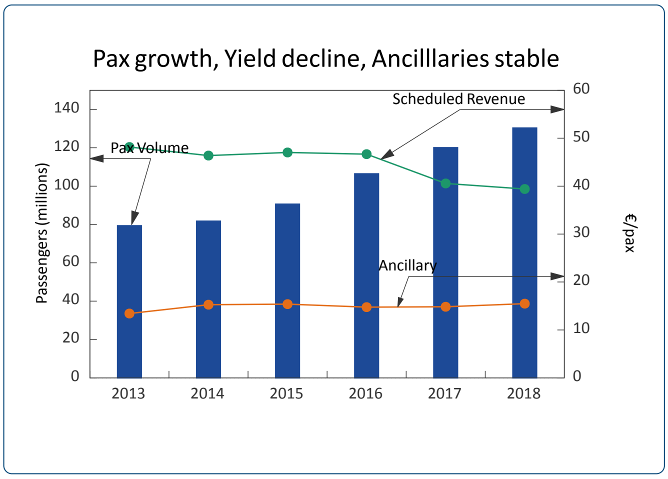
The exit of Monarch and AirBerlin has not done much to improve supply/demand balance as the capacity from these two carriers was rapidly backfilled by other low cost and network airlines. Ryanair darkly hints that the real market adjustment will come from Norwegian — whose "uncommercial" expansion it blames for at least exacerbating the pilot shortage, adding to its embarrassment when its crew rostering system imploded last September.

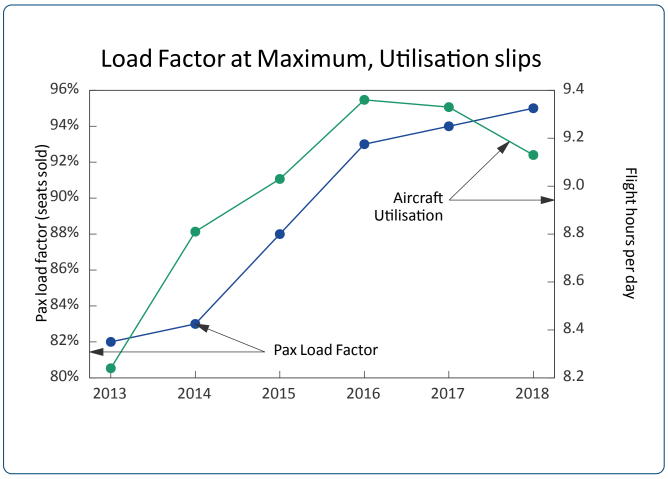
Turning to the labour situation, agreements with plots unions in the UK, Italy and now Ireland have been signed though tricky negotiations are ongoing in Spain and Germany. Ryanair has made some major concessions in its newly unionised world: 20% salary increases for pilots, making Ryanair rates better than its benchmarked rivals (Jet2 and Norwegian) according to its own assessment; rebasing of 900 pilots to preferred cities; and a new sponsorship programme for trainees.

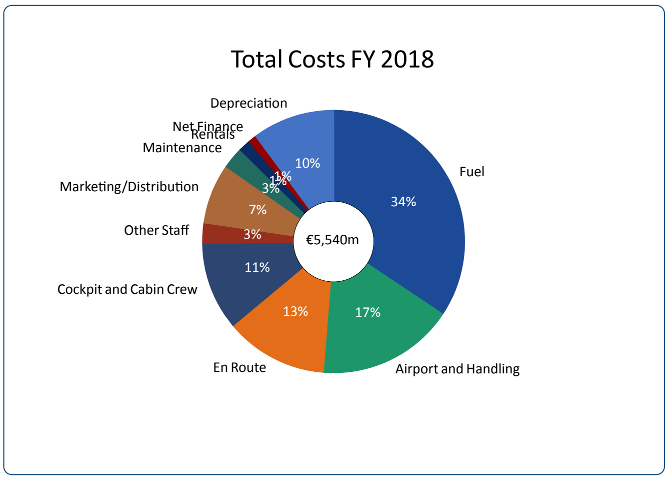
This, along with new cabin crew agreements, will inevitably push costs up and reduce productivity (on the measure of cockpit crews per aircraft, Ryanair's ratio has edged up from 4.3 to 5.6 over the period 2013-18). For perspective, as the pie chart on the next page shows, Ryanair's staff costs in FY2018 still only accounted for 14% of its total

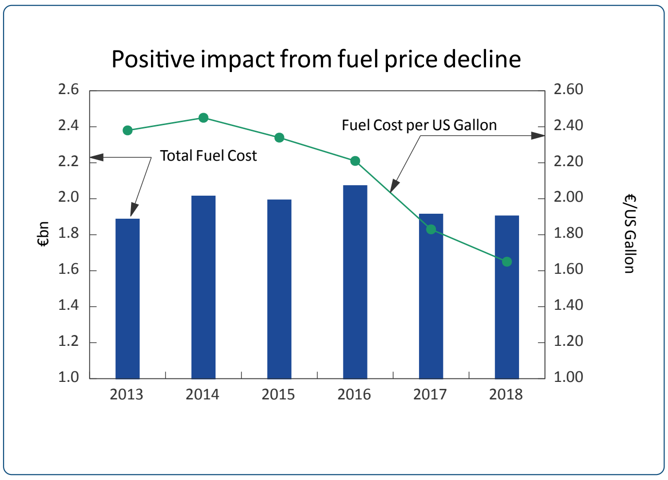


RYANAIR DEVELOPMENTS









Source: Company reports. Notes: FY to end March. Cockpit and Cabin crew costs estimated.

costs, and we estimate that cockpit and cabin costs amounted to 11%. Ryanair management state that the total impact on non-fuel unit costs in FY2019 will be an increase of 6% (in contrast to an average 1% annual decline during 2013-18) but contend that this will be mainly a one-off cost adjustment.

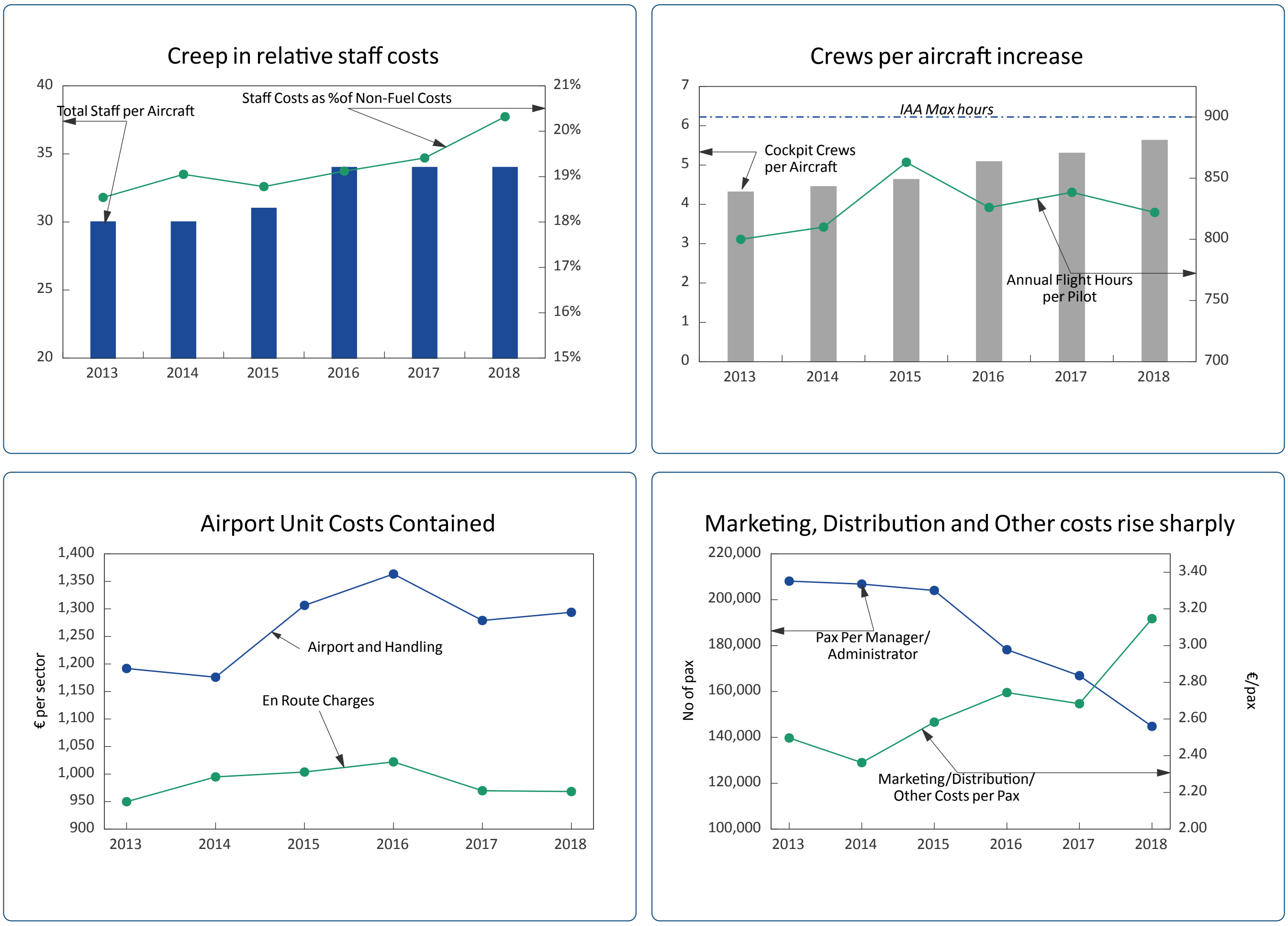
In negotiating with its unions Ryanair says that it will take strikes if its fundamental model is threatened and it still has the option, though probably to a lesser extent than before, of churning aircraft among its 86 bases. Whether unionisation will cause a continuous cost escalation will basically depend on the supply/demand balance in the pilot market, which at present is very tight, driven by the expansion of the Chinese carriers and in Europe, as Ryanair complains, by the existence of airlines which really should not be in the market.

Which is why Ryanair almost seems to welcome the escalation in fuel prices as a catalyst for removing financially weak but aggressively expanding competitors (ie Norwegian), despite the fact that higher fuel prices will add about €430m to its costs in FY2019, even taking into account a 90% hedging programme.

Fuel accounts for 34% of Ryanair's cost base and, as the chart on the facing page suggests, without the softening in prices from FY2014 to FY2018, Ryanair could not have been able to achieve 20% profit margins.

The first of the 197-seat 737 MAX-8s will arrive next spring, a type described, unoriginally, by Ryanair as a "game changer" because of a promised 16% reduction in unit fuel costs. Ryanair has succeeded in building in a critical capital cost advantage through its bulk orders from Boeing, the first in the year after 9/11 when the manufacturers were truly desperate. Presumably,

RYANAIR DEVELOPMENTS



Source: Company reports. Note: FY to end March

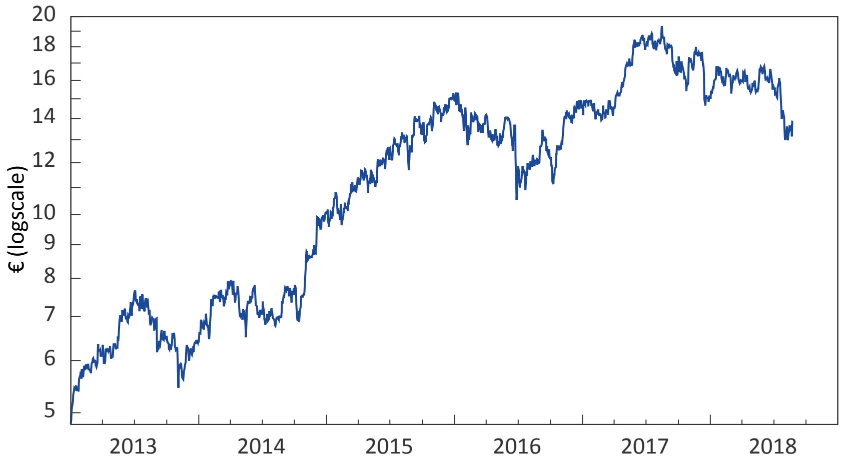
Ryanair will have achieved a very deep discount on the MAX's list price of $117m (50%?) and will, as before, absorb most of the capex through its very strong free cashflow. Its ownership costs were 12% of total costs in FY 2018, and only 2% in cash costs (rentals and net finance charges as opposed to depreciation).

Ryanair has now increased its ownership of Vienna-based LaudaMotion to 75%. The rationale for the investment is partly to obtain the Austrian AOC and gain access to restricted airport slots in Germany, but primarily it seems that it is to boost Ryanair's Airbus credentials. By operating A320s for the first time — and mooting a plan for rapid growth to 50 units — Ryanair's idea is to create real competition between the

RYANAIR CURRENT FLEET PLAN

				Planned		
	Current 2018	**On order**	**On Option**	**Additions**	**Disposals**	**Fleet 2024**
737-800	443	15		15	-83	375
737MAX 8		135	75	210		210
Total	**443**	**150**	**75**	**225**	**-83**	**585**

RYANAIR SHARE PRICE PERFORMANCE



manufacturers for its future business.

Unfortunately, LaudaMotion's operating losses for this year have already been revised up from €100m to €150m — the Austrians had no fuel hedging in place — before Ryanair's restructuring of the airline has begun and before BA's new short haul low cost airline, Level, also starts building its network out of Vienna. Surely Ryanair hasn't repeated the mistake it made with its only other purchase of an airline, Buzz way back in 2003, a decision made in rapid response to easyJet's takeover of Go (which in retrospect was also a mistake).

Airport charges and ground handling costs accounted for 17% of Ryanair's costs in FY 2018. Its airport model — trading guaranteed traffic growth for discounted per passenger costs — has been put under pressure as it has encountered EU legal challenges to alleged subsidisation at regional airports and as it has moved more and more into primary airports. However, since FY2016 it has contained its per sector airport costs, largely because of the growth deal it struck with MAG, the owners of its largest base at London Stansted.

But it is very difficult to see where the next deal of this magnitude could come from — unless it seriously expands into long-haul from one its main bases.

Ryanair has completed an agreement with Aer Lingus to connect passengers at Dublin which should become operational before the end of this year when IT systems are harmonised. Additional revenue to Ryanair will come from fees paid by Aer Lingus for the passengers it feeds to the IAG carrier. With 95% load factors Ryanair will be displacing its own point to point passengers, presumably the lowest yielding ones, when it starts connecting to Aer Lingus, rather than generating new traffic.

As an indication of changing times, the cost item which is clearly expanding at Ryanair is Marketing. Distribution and Other. One might have expected Ryanair to claim that this was due to its "Always Getting Better" initiatives, but it doesn't: it puts the blame on "Right to Care", the EU 261 regulation, mandating compensation to passengers for flight delays.

Still, Ryanair is evolving: Michael O'Leary himself says he can envisage a future IAG-type structure for the company with regionally-focused airlines (LaudaMotion, Ryanair Sun, the Polish charter, etc) plus the RyanairLabs experiments, just maybe a long-haul operation.

The airline's image is intimately bound up with O'Leary's carefully cultivated persona, and there has been no indication of CEO succession planning. Yet at some point in the not too distant fortune Michael O'Leary might be tempted to use his fortune to indulge full time his horse racing obsession. Nauseatingly however, he has already made a second fortune through his ownership of Classic-winning horses.

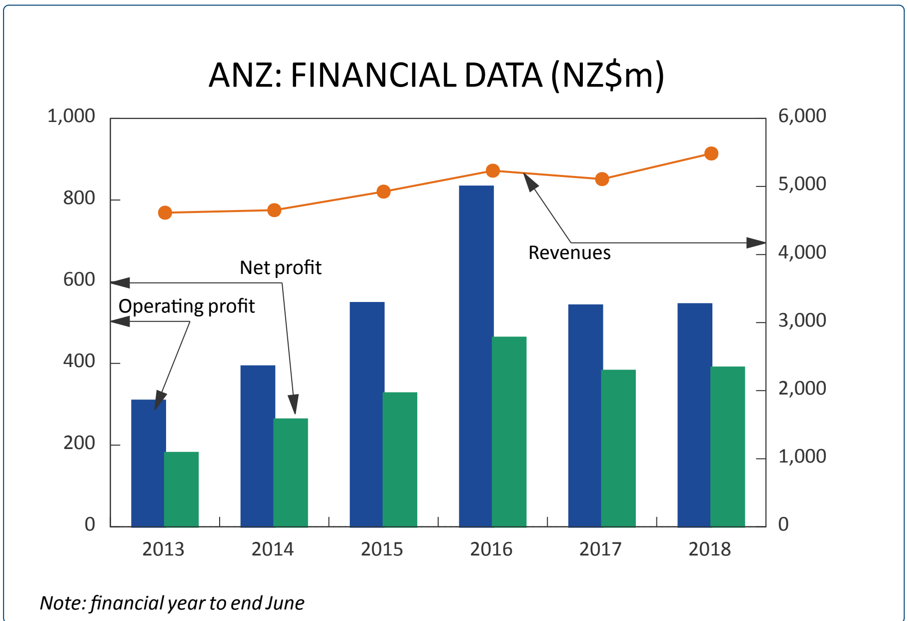
Air New Zealand looks across the Tasman

After being rescued by the government at the start of the millennium, Air New Zealand has been consistently profitable ever since — and is now prioritising the trans-Tasman market as it builds up traffic flows onto its long-haul routes to the Americas.

Air New Zealand dates back to 1940 and a carrier called Tasman Empire Airways, but today the New Zealand flag carrier operates to 20 domestic and 30 overseas destinations in 19 countries out of its main hub in Auckland, with secondary bases at Christchurch and Wellington.

ANZ has posted 16 consecutive years of profit at the net level, and in the 2017/18 financial year (the 12 months ending June 2018), ANZ reported a 7.4% rise in operating revenue, to NZ$5,485m (€3.3bn), based on a 6.4% increase in passengers carried, to 17.0m. RPKs rose 5.3% in the year, ahead of a 5.0% rise in capacity, leading to a 0.2. percentage increase in the passenger load factor, to 82.8% (see chart on the next page). EBIT was up 2.5% year-on-year to NZ$540m (€324m), and net profit increased 2.1%, to NZ$390m (€234m).

Air New Zealand operates a fleet of 57 aircraft, comprising 30 A320s-200s, nine 777-200s, seven 777-300s and 11 787-9s. The aircraft have an average age of less than eight years, with the eldest model being the 777-200s, which are more than 12 years old on average. On firm order is a single 787-9, and 13 A320neo family aircraft.



Domestic grip

Though New Zealand only has a population of 4.5m, as can be seen in the chart on the following page, intra-New Zealand routes are ANZ's most important market and domestic revenue underpins the entire airline. ANZ has an approximate 80% market share of the domestic market, and the only other competitor is Australia's LCC Jetstar Airways (owned by Qantas), which operates between five New Zealand destinations.

ANZ's domestic fleet comprises 17 A320s, all delivered between 2011 and 2016, and they operate on the main routes (where the longest sector is two hours) in a single-class configuration. Smaller routes are served by two ANZ subsidiaries — Air Nelson, which operates 23 DHC-8 Dash 8s, and Mount Cook Airline, which has 27 ATR-72s.

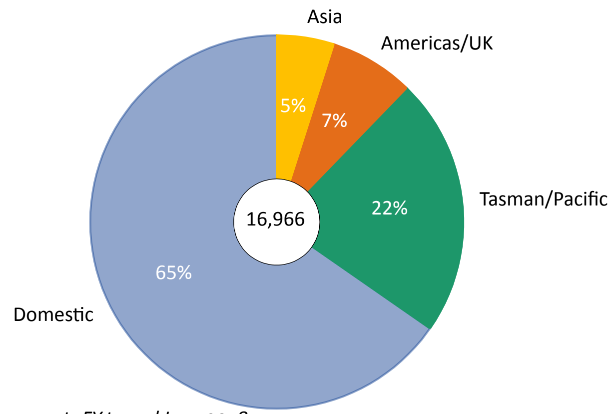
ANZ's domestic grip is helped by an FFP with 2.9m members (giving it an incredible 60% penetration of New Zealand households) and what ANZ calls "a significant market share of government air travel" thanks to a deal signed five years ago. ANZ also benefitted from a 10.2% rise in inbound visitors and tourists to New Zealand in 2017 and a 3.8% increase in 2018 (to 3.7m people). That number is forecast to rise to 5m by 2024, and ANZ points out that international visitors to New Zealand take — on average — two domestic flights during their visit to the country.

Some of the new A321neos will be used domestically, providing ANZ with a 25% increase in seats on trunk routes such as Auckland-Wellington, where it currently operates A320s up to 20 times a day and where it's difficult to add more flights to the schedule.

Tasman battle

With the domestic market in effect sewn up by ANZ, it's focus is turn-

ANZ PAX CARRIED BY REGION (000s)



Source; Company reports FY to end June 2018

ing more to the Tasman market — the Tasman is the sea between New Zealand and Australia, with the shortest distance between the two countries being more than 1,700 km. It's a huge market; in terms of VFR, every year 1.6m Kiwis travel across the Tasman and 1.5m Australians go to New Zealand, and on top of that is a large corporate market.

ANZ currently operates between four New Zealand and eight Australian destinations, and the airline is making a major move in the market by ending an alliance with Virgin Australia that dated back to 2011, but which will cease on October 27th this this year, two years after ANZ sold its 20% stake to Chinese Nanshan Group (owner of Qingdao Airlines).

The very next day ANZ will add capacity onto existing routes of Auckland-Sydney, Christchurch-Melbourne and Christchurch-Brisbane, while from December ANZ will start routes between Queenstown and Brisbane, and Wellington and Brisbane.

Behind the Virgin decision has been a conscious effort by ANZ to build its sales presence on the ground in Australia; previously the airline had reduced its offices in Australia to just one, but now sales offices have been opened across the country. In addition, ANZ's regulatory approval for the alliance was expiring, so it had to decide whether to renew for another three years. Another factor was the withdrawal of Emirates from all Tasman routes this year other than a daily Christchurch-Sydney-Dubai A380 service.

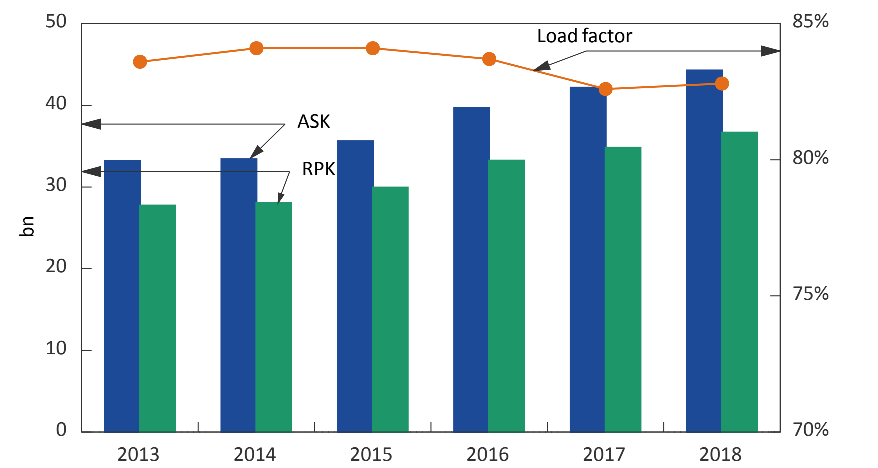
But perhaps the deciding factor is the need to maximise traffic flows from Australia onto ANZ's long-haul routes to North and South America (see below). ANZ wants to put widebody aircraft onto the crucial Adelaide-Auckland route, which ANZ admits doesn't make sense from an alliance point of view in terms of scheduling, capacity and prices, and "is in conflict with what a domestic carrier in Australia is trying to do, which is also trying to build its own services to America".

Nick Judd — chief strategy, networks and alliance officer — says he "feels very confident that we will retain the majority share of the sales that we have in that alliance, as our share of sales in that alliance far outweighed the ASK share that we had".

Also, on October 28th ANZ starts codesharing with Qantas on respective domestic routes in New Zealand and Australia. ANZ believes codesharing with Qantas will give it a "much stronger customer proposition into Australia than what we've had with Virgin".

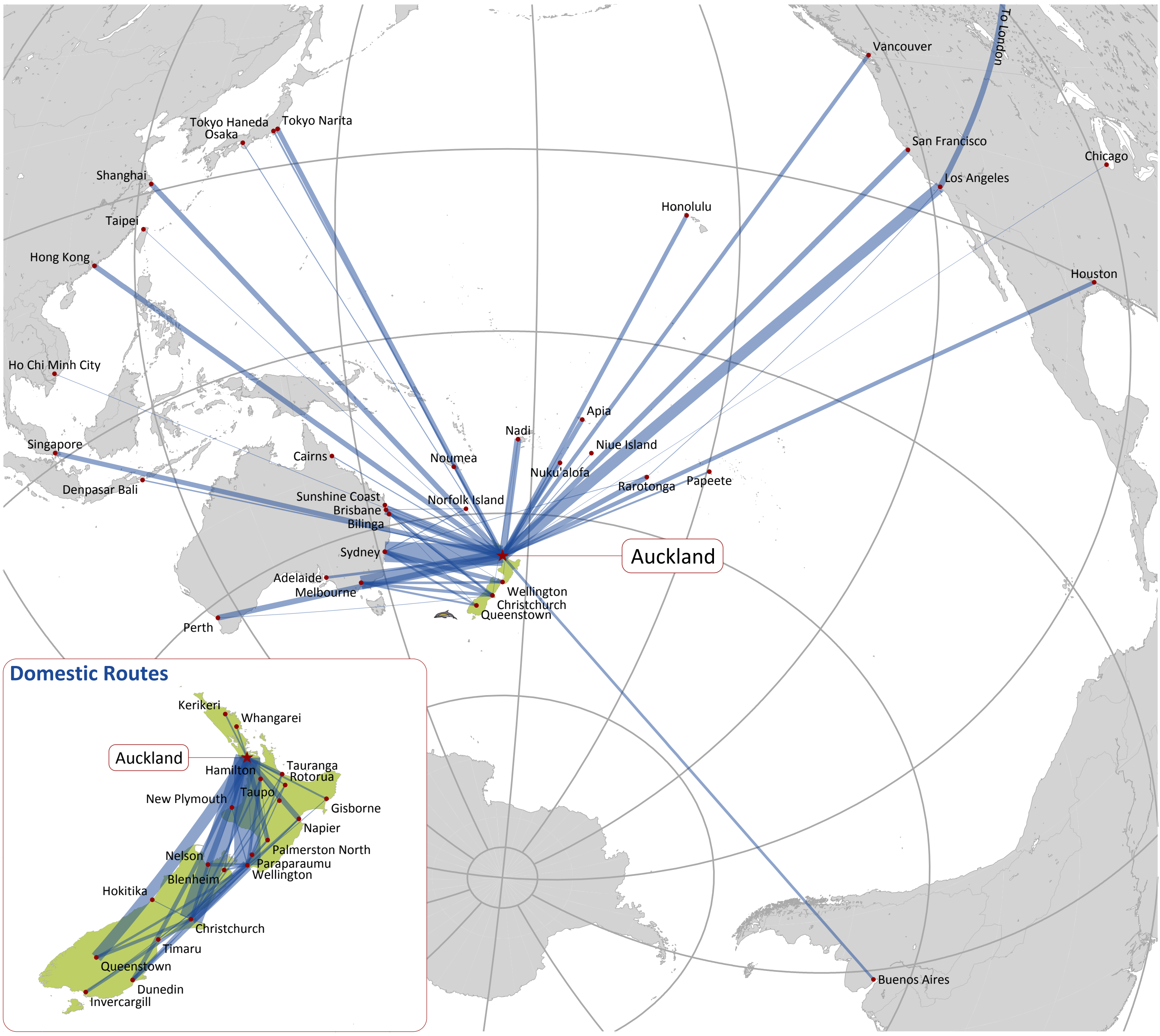
Some of the soon-to-arrive A321neos will go on busier Tasman routes, such as from Auckland to Melbourne and Sydney, while the A320neos will go onto smaller markets, such as from Wellington and Christchurch to Australia. Widebod-

ANZ: TRAFFIC STATISTICS



Note: FY to end June

AIR NEW ZEALAND ROUTE NETWORK



Note: Main map equidistant projection based on Auckland (great circle routes appear as straight lines). Thickness of lines directly related to annual number of seats. Source: schedules data.

ies are being added on some Tasman routes, such as Auckland to Adelaide.

Long-haul

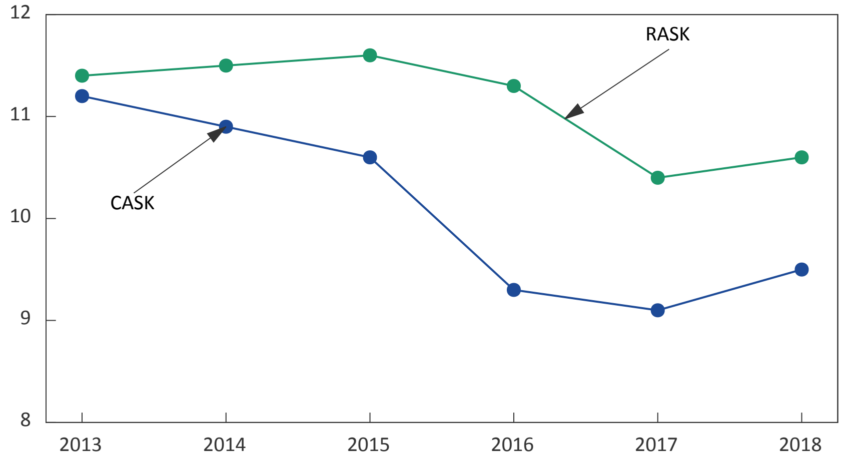
On long-haul (which ANZ defines as sectors of more than six hours), ANZ operates the Boeing widebodies.

Its long-haul strategy is no longer centred on routes to Europe, which ANZ now admits other airlines can serve better than ANZ can, but rather on the fact that New Zealand is three hours closer to North and South America than the eastern seaboard of Australia — which means ANZ can operate to the mid-west and east coasts of the US in a way that Australia routes struggle to serve.

ANZ's emphasis on the Tasman market for medium-haul is crucial here, as between 20% to 30% of all passengers on ANZ's long-haul flights are Australian. Most of these come via ANZ's hub at Auckland, where routes radiate out to Vancouver, San Francisco, Los Angeles, Houston and Buenos Aires.

Around 45% of Australians connecting in Auckland travel on to Buenos Aires and approximately 20%

ANZ: UNIT REVENUES AND COSTS (NZ¢/ASK)



Note: FY to end June.

travel on to Houston. Altogether 40% of all traffic on ANZ's route to Buenos Aires service originates from Australia (with 40% being South Americans and the rest Kiwis). Judd says that: “The market is growing much quicker than from New Zealand to South America and, being quite frank, we would not have been able to increase our capacity to South America or probably even land that route successfully without having that Australia feeder traffic”.

An Auckland to Chicago route will start in November 2018, which NZ hopes will stimulate new demand to/from the US east coast, and ANZ aims to open further routes to the mid-west and east coast USA, and also to the east coast of South America (with Rio de Janeiro and São Paulo of particular interest).

The key to long-haul for ANZ is the right mix of travellers — ie premium leisure and business, and not just the cheapest economy seats. ANZ points out that it previously lost tens of millions of dollars operating routes to China with aircraft that were always full, but which had the wrong mix pf passenger. Or as Christopher Luxon — ANZ CEO — says, “we want to turn New Zealand into Switzerland, not Bali or Cancun”.

An Auckland to Taipei route will also be launched in November with five services a week targeting the VFR and holiday markets.

Interestingly Luxon says they now have “ruthless visibility” over route performance and are quick to change routes when they are not performing. He says: “our routes have work like an SKU in a fast-moving consumer goods business — they have to stand up on their own right, rather than saying, well we lose money here because we make money there”.

That's why over the last eight years ANZ has withdrawn from what it calls “thin, narrow” long-haul routes (ie loss-making ones) — such as Christchurch-Osaka, and since 2014 has been building up an alliance strategy, in order to “shore up some routes that were marginal, such as Auckland-Hong Kong and built better flow-through traffic and connecting traffic through those”, according to Judd. Routes that had previously been cut have been bought back through alliances — eg Singapore, which ANZ exited in 2006 and which it re-entered in 2015 in partnership with Singapore Airlines. ANZ has been a member of Star since 1999, and a third daily service will be added on Auckland-Singapore from November, with ANZ operating the route in April to October and its partner flying it the rest of the year.

As for its key Auckland hub, although there are relatively few spare slots in the key 4pm-9pm time when long-haul flights depart, overall Auckland is not a particularly capacity-constrained airport. Nevertheless, there are plans to add a northern runway by 2028.

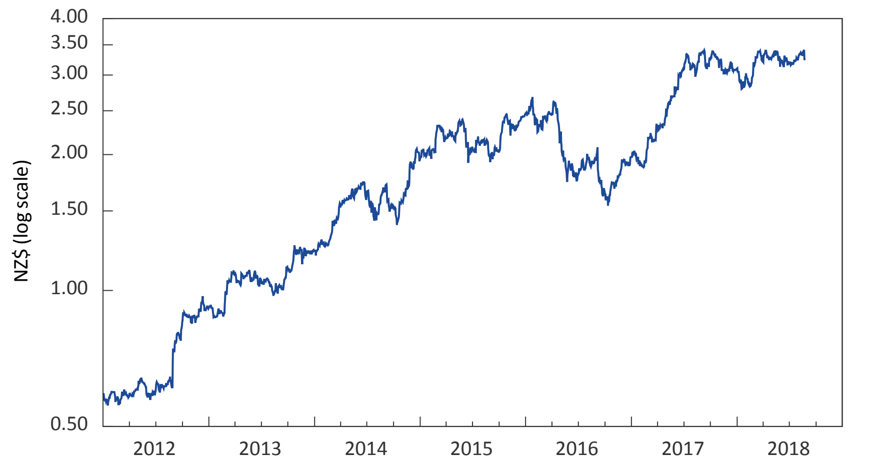
In terms of the fleet, ANZ plans to replace its 777-200s between the

ANZ: FLEET PLAN

	2018	2019	2020	2021	2022
777-300ER	7	7	7	7	7
777-200ER	8	8	8	8	8
787-9	11	13	14	14	14
A320	30	25	19	19	16
A320/321 neo		10	15	15	18
ATR72	27	28	29	29	29
Q300	23	23	23	23	23
Total	**106**	**114**	**115**	**115**	**115**

Source: Company reports.
Note FY to end June

AIR NEW ZEALAND SHARE PRICE PERFORMANCE



2023 and 2025 financial years, with models currently under consideration being the 777X, 787 and A350 families. This order will be awarded around end of FY 2018/19, while in the longer term (5+ years from now), the 777-300s will also be replaced.

The road ahead

In the CEO's words, ANZ "has been through a turnaround situation, been through a realignment phase and is now in in a 'sustaining success' stage". Overall capacity growth has eased back over the last two years, falling from 11.5% in 15/16 to 6.3% in 16/17 and 5% in 17/18, and ANZ says that for the next 3-5 years its ASKs will grow in the range of 5% to 7%, though as it looks forward to FY19 Judd says "we do have a higher end growth rate at the top of that range and the reason for that is that we've come out of the Virgin Australia alliance".

ANZ doesn't appear to be hampered by the fact that the New Zealand state still owns a 52% stake (though it has no direct board representation), a result of the government having to step in and rescue the airline in 2001 despite the carrier being privatised in 1989. The rest is owned by institutional (45%) and retail investors (3%), with the company dual-listed on the New Zealand and Australian stock exchanges.

Management appears to have tight control on costs, although in the short-term it is worried about increasing fuel prices. As at June this year ANZ had hedged around 80% of its needs for the first half of the 2019 financial year — which it says is close to the maxim level of hedging that it normally pursues ie it will always buys a minimum of 20% of fuel needs at spot prices.

Unit costs had fallen since for the four years up to and including FY2016/17, but they rose slightly in FY17/18 (see chart on the preceding page), and the gap between unit revenue and costs is starting to narrow.

The airline employs more than 11,000 staff, all but 6% of which are based in New Zealand, and in May this year ANZ entered into nine-year collective employment framework deals with two unions that represent most of its pilots, which ANZ calls a "strategic partnership with the unions that provides long-term stability in terms of industrial relations and labour costs".

The biggest external threat comes from competitors, although Luxon says that competition is becoming "more rational" (partly due to rising fuel prices) and that on the key Tasman market "we've seen the withdrawal of Middle Eastern carriers," while on Pacific routes "we saw American carriers move to seasonal services to New Zealand. Even out of China we started to see our competition rationalise, and particularly into second tier cities."

JetBlue: A220 key to targeting superior margins

JetBlue Airways recently placed a major order for A220s, previously known as the Bombardier CSeries, as efforts move to higher gear to keep costs in check and attain long-term goals such as superior margins to its peers. When will New York's hometown airline go for the A321LR and Europe?

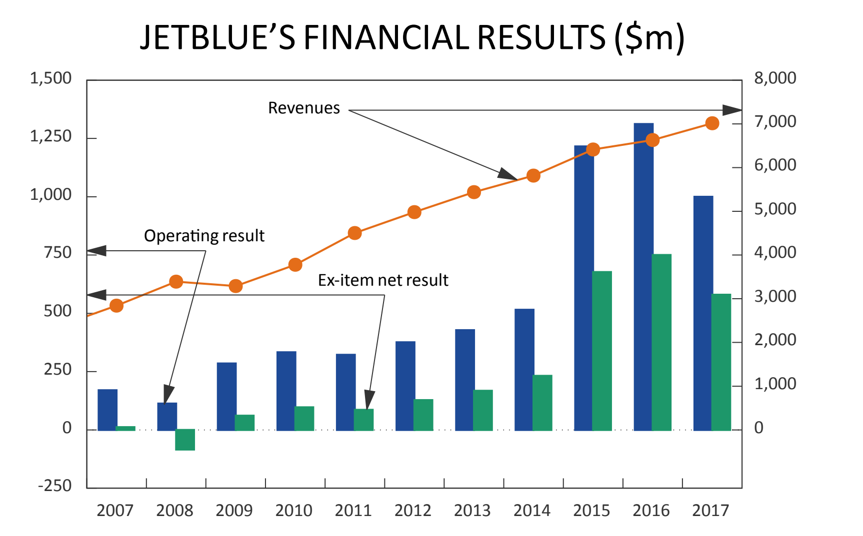
Now in its 19th year, JetBlue has always been a revenue story. First, its everyday low fares, high-quality product offerings and service-oriented culture have enabled it to attract price premiums and considerable customer loyalty.

Second, JetBlue has been at the forefront of the US airline industry's fare unbundling and cabin segmentation efforts, creating new revenue streams with offerings such as *Even More Space* seats, *Fare Options* and *Mint* premium product.

Third, JetBlue benefits from strong focus cities. To supplement its New York home base, JetBlue spotted opportunities from legacy carriers' withdrawal and developed five additional focus cities: LA/Long Beach, Boston, Orlando, Fort Lauderdale FLL and San Juan. In particular, the decision to invest heavily in and significantly grow the Boston operation is paying off handsomely.

Fourth, JetBlue is better able to maximise revenues because of the flexibility offered by its "hybrid" business model, which can cater to a wide range of customers. As an extreme example, JetBlue goes after business traffic in Boston, while remaining "primarily a leisure player" in New York.

Those strategies have enabled JetBlue to outperform its peers in unit revenues and close the historical profit margin gap. In 2017 its 13% pretax margin slightly exceeded the 12.8% average margin achieved by its "peer set" (the top five US carriers plus Spirit). In Q1 2018 it had a one-point lead over the peer set average.



Source: Company reports

JetBlue's improved financial performance has also reflected top executive changes. A sweeping management reorganisation in 2014, Robin Hayes' appointment as CEO in early 2015 and Steve Priest's promotion to CFO in early 2017 all represented a shift towards a greater focus on margins and ROIC.

But JetBlue has not bowed to pressure from the financial community to reduce its growth rate. It has continued to expand in Boston and Fort Lauderdale, because the management feels that strengthening relevance in the key focus cities is in shareholders' best long-term interest. Since 2010 its system ASM growth has been in the 7-9% range in most years, far exceeding US industry average.

JetBlue's continued growth can also be seen as an attempt to maintain relevancy in an increasingly consolidated market. JetBlue was outbid for Virgin America in early 2016, and the Alaska-VA merger subsequently knocked it down from fifth to sixth position in the US airline size ranks. And JetBlue's chances of playing a role in any further US airline industry consolidation seem slim.

In the months that followed the ALK-VA announcement, JetBlue outlined plans to expand Mint to more transcon markets, ordered 30 more A321s with an option to convert to A321LRs, and began to talk about potential transatlantic service.

JetBlue's balance sheet has been strong for a couple of years now, following successful deleveraging. In June total liquidity (including undrawn facilities) was 21.2% of LTM revenues and the adjusted debt-to-capital ratio was 31.3%. The strategy is to maintain investment grade financial metrics, have a leverage ratio of 30-40% and make opportunistic share repurchases.

But the downside of the growth and the fleet and focus city investments is that JetBlue continues to underperform the industry in terms of ROIC.

Also, despite all the growth, JetBlue has never managed to reduce its ex-fuel unit costs. It faces significant labour cost pressures but has not yet achieved any concrete results from the 2017-2020 "structural cost program" announced in December 2016.

For those reasons there is little excitement about JetBlue's stock. The NYSE-listed shares have underperformed the Arca Airline Index in the past three years and are almost perpetually rated "market perform".

All that was needed to cause a panic reaction in July was a modest setback in the margin recovery process and some cautious cost and revenue commentary. JetBlue reported an adjusted pretax margin of 8.2% for Q2 that was well below the peer set's 12.4% margin, partly due to problems associated with a switchover to a new platform for ancillary activities. The market's reaction was brutal: the share price plummeted by around 13% over two days (July 23-25) and has since recovered only partially.

What does a US airline do in this sort of situation? Hold an investor day, of course. JetBlue is planning one for October, at which it will discuss in detail the "many building blocks" that will help it attain its long-term goal of superior margins to its peers.

As another sign that the implementation of the strategic initiatives has moved into higher gear, in May JetBlue separated the roles of CEO and president/COO. Joanna Geraghty took over the management of day-to-day operations, freeing CEO Robin Hayes to devote his time to the long-term strategy and goals.

JetBlue has also announced some quick measures to try to boost profit margins, including slightly reducing its ASM growth rate in Q4, scaling down its Long Beach intra-west operations and moving some of that capacity to the transcon market.

Cost containment imperative

JetBlue needs to prove that it can deliver on its cost reduction targets. The 2017-2020 programme aims to achieve $250-300m of annual savings by 2020. The airline is also committed to maintaining ex-fuel CASM growth at 0-1% on a CAGR basis in 2018-2020.

But on July 27 JetBlue's pilots ratified their first contract, which became effective on August 1. It was welcome news because it removed a major uncertainty hanging over the airline since the pilots unionised in 2014, but the "market competitive pay rates, per diems and 401k provisions" are estimated to add $110-130m incremental costs in year one alone. The deal included a $50m ratification bonus.

JetBlue immediately increased its Q3 2018 ex-fuel CASM guidance from 1-3% to 3-5%. It now expects unit costs to increase by 0.5-2% in 2018, instead of being flat. But JetBlue merely reaffirmed the 2017-2020 cost projections, implying that it will somehow "catch up" with the plan in 2019 or 2020.

Labour cost pressures look set to continue also because JetBlue's flight attendants unionised in April and will soon be negotiating their first contract (though that will probably not impact the current cost cutting plan).

The three-year cost cutting plan does not include the impact of the E190/A220 fleet transition, which adds accelerated depreciation and transition costs through the mid-2020s. Those costs are estimated to be a 25bps headwind to the 0-1% plan projection.

JetBlue expects to achieve the structural cost savings in four areas: tech ops ($100-125m); corporate ($75-90m); airports ($55-65m); and distribution ($20m).

The best opportunities are with maintenance costs — an area where JetBlue has significantly underperformed. It has now invested in new technology and is negotiating new long-term "best-in-class" type maintenance contracts. At least two such agreements have already been signed (one for the heavy maintenance of the A320s and another for the maintenance of neo engines). There is currently an RFP out for the V2500 engine heavy maintenance.

In addition to renegotiating contracts with partners and suppliers, JetBlue recently completed a support centre organisational review that will lead to a streamlining of operations and an unspecified number of head office job cuts. The job cuts are culturally quite significant because they are rare (and possibly the first) at JetBlue.

The airport cost savings rely heavily on introducing more self-service technology to improve labour efficiency and the customer experience. The distribution cost savings, mostly completed, have come from renegotiation of contracts, termination of relationships with many third-party channels and encouraging direct

JETBLUE'S FLEET AND FIRM ORDERBOOK

	At 11 July 2018		
	Operating Fleet	Firm Orders	Delivery Schedule
A320-200	130		
A321-200	57	6	2H 2018
A321neo†		85	2019-2024
E190	60		
A220-300‡		60	2020-2025
Total	**247**	**151**	

Notes: † option to substitute some of the A321neo orders with the A321LR. ‡ plus 60 options (from 2025), some of which can be converted to the smaller A220-100.
Source: Company reports

bookings.

JetBlue's unit costs will continue to benefit from upgauging the A320 fleet with larger A321s, and in 2019-2020 from the seat densification/cabin restyling project on the A320s. This will add 15, or 10%, extra seats, and the A320 fleet will be fitted with a cabin similar to the A321's acclaimed cabin.

The A220 decision

JetBlue has benefited from operating a second, smaller aircraft type. The E190, introduced in 2005, has been critical for developing the Boston focus city, especially in shorter-haul business markets that require higher frequencies. But the E190 fleet faced higher maintenance costs and other investments to fly to a 25-year useful life.

So in April 2017 JetBlue initiated a 100-seat review that examined three options: keeping the existing E190 fleet; making changes to the Airbus fleet (presumably evaluating the A319); or moving to a new platform (the E195-E2 or the CSeries/A220).

The decision came in early July: JetBlue would transition from the E190 to the newly renamed A220. It placed an order for 60 A220-300s, with deliveries from 2020, plus 60 options (from 2025). There is flexibility to convert some of the options to the smaller A220-100. The aircraft will be powered by Pratt & Whitney engines and assembled in Mobile, Alabama.

The order was the first since Airbus completed its acquisition of a controlling stake in the CSeries programme from Bombardier on July 1, so JetBlue undoubtedly got a good deal. Moody's estimated on July 13 that JetBlue may pay only $1.4-1.7bn for the 60 A220-300s, compared to their list price of $5.4bn.

JetBlue cited three main factors behind the A220's selection: margin, flexibility (two versions) and a "fantastic range and network fit". It had been a difficult decision, because the E195-E2 was "incredibly close from an economics standpoint".

The Bombardier/Airbus union was described as a "secondary factor", though it was useful in that it allowed JetBlue to reshape its existing Airbus orderbook. As part of the A220 deal, the airline converted orders for 21 A320neos into A321neos and adjusted the delivery schedule.

The 60 A220 firm orders will replace JetBlue's 60 E190s between 2020 and 2025. The airline looks to sell the 30 owned E190s and will realise a $319m impairment charge in 2018. There will also be $90-110m of one-time costs this year associated with the return of the 30 leased E190s.

The A220 appears to be an outstanding aircraft in terms of operating economics, offering a higher seat count (130-160, compared to the E190's 100), 40% lower fuel burn and 29% lower DOC per seat. The spacious cabins present a "real opportunity to redefine the interiors and continue to deliver the best product".

JetBlue describes the E190-to-A220 transition as an "economic

JETBLUE'S REVISED ORDER BOOK

	Pre-11 July 2018				Post-11 July		
Delivery Year	*E190*	*A320neo*	*A321†*	*Total*	A220	A321†	Total
2018			*6*	*6*		6	6
2019			*13*	*13*		13	13
2020	*10*	*6*	*7*	*23*	5	15	20
2021	*7*	*16*	*4*	*27*	4	16	20
2022	*7*	*3*	*17*	*27*	8	15	23
2023			*14*	*14*	19	14	33
2024			*5*	*5*	22	12	34
2025					2		2
Total	***24***	***25***	***66***	***115***	**60**	**91**	**151**

Note: †2018 deliveries all ceos; from 2019 all neos.
Source: JetBlue

game changer". According to its pro forma analysis based on full transition benefits in 2025, if JetBlue currently operated 60 A220s instead of 60 E190s, its 2018 system CASM would be 5.3% lower, EPS $0.65 higher and pretax margin and ROIC both about three points higher.

The A220 will add flexibility to JetBlue's network strategy. While primarily targeted at the existing E190 markets — around a quarter of which would be better flown with larger-capacity aircraft today — the A220 is also likely to be deployed on the transcon.

The type's range (up to 3,300nm) comfortably covers all of North America, as well as northern parts of South America and even Ireland/UK from Boston. But JetBlue is not looking to deploy the A220 on the transatlantic.

Nor will JetBlue deploy the type in long-haul secondary point-to-point markets. Pointing out that JetBlue is a focus-city based airline, its executives stressed: "We are not looking to do Frontier Airlines, do point-to-point flying. That's not our strategy."

In that regard JetBlue's strategy differs from the one envisaged by its founder/ex-CEO David Neeleman's planned US start-up, which signed an MoU for 60 A220-300s a week after JetBlue's order, for delivery from 2021. Neeleman's venture plans to focus mainly on point-to-point operations between secondary cities.

JetBlue is likely to purchase the A220s, funding them with debt and cash. The near-term capex impact of the A220 order and the A320neo-to-A321neo swap is modest, increasing annual spending only by about $100m, to total $1-1.2bn in 2018 and an average of $1.2bn annually in 2017-2020.

The A321LR and Europe?

JetBlue spent much time at its December 2016 investor day discussing the A321LR and its potential deployment to European destinations such as London, Paris and Dublin. The airline has flexibility to convert some of its A321 orders to the long-range version, but it has to give Airbus two years' notice.

But that investor day enthusiasm soon fizzled out. JetBlue put Europe on hold, as it felt more pressure to improve margins and the domestic market offered more profitable growth opportunities.

JetBlue executives stated in July that any US-Europe routes would need to show equally strong returns to domestic A321 routes. The bar is high because the two domestic A321 versions ("all-core" and Mint) represent the highest-margin fleet types in the system.

However, route-specific returns are not the only criteria; there are also network considerations. JetBlue executives say that some of the European destinations are the biggest cities that the airline does not serve from Boston and New York. "We don't have a Europe strategy, we have a Boston/New York strategy", noted one JetBlue executive recently. "So any decision to go to Europe is really tied to our current focus city strategy."

Europe will come — it is just not clear when. JetBlue executives said in July that they continued to analyse it and talk to Airbus, having just ordered another batch of undesignated A321neos. Should all of them be all-core and Mint, as previously, or could some of them be LR?

JetBlue may also have to decide between LR and XLR. The A321LR is due to enter service this year and has much commonality with JetBlue's standard A321s, but it lacks the range to serve all of Western Europe. Airbus is now considering offering an even longer-range version, dubbed the A321XLR, but it may have less commonality with JetBlue's A321s.

Focus city strengthening

JetBlue continues to target "mid-to-high single digit" annual ASM growth. This year's growth will be 6.5-7.5%. The airline justifies the continued brisk growth on the basis that it is highly focused and accretive to earnings.

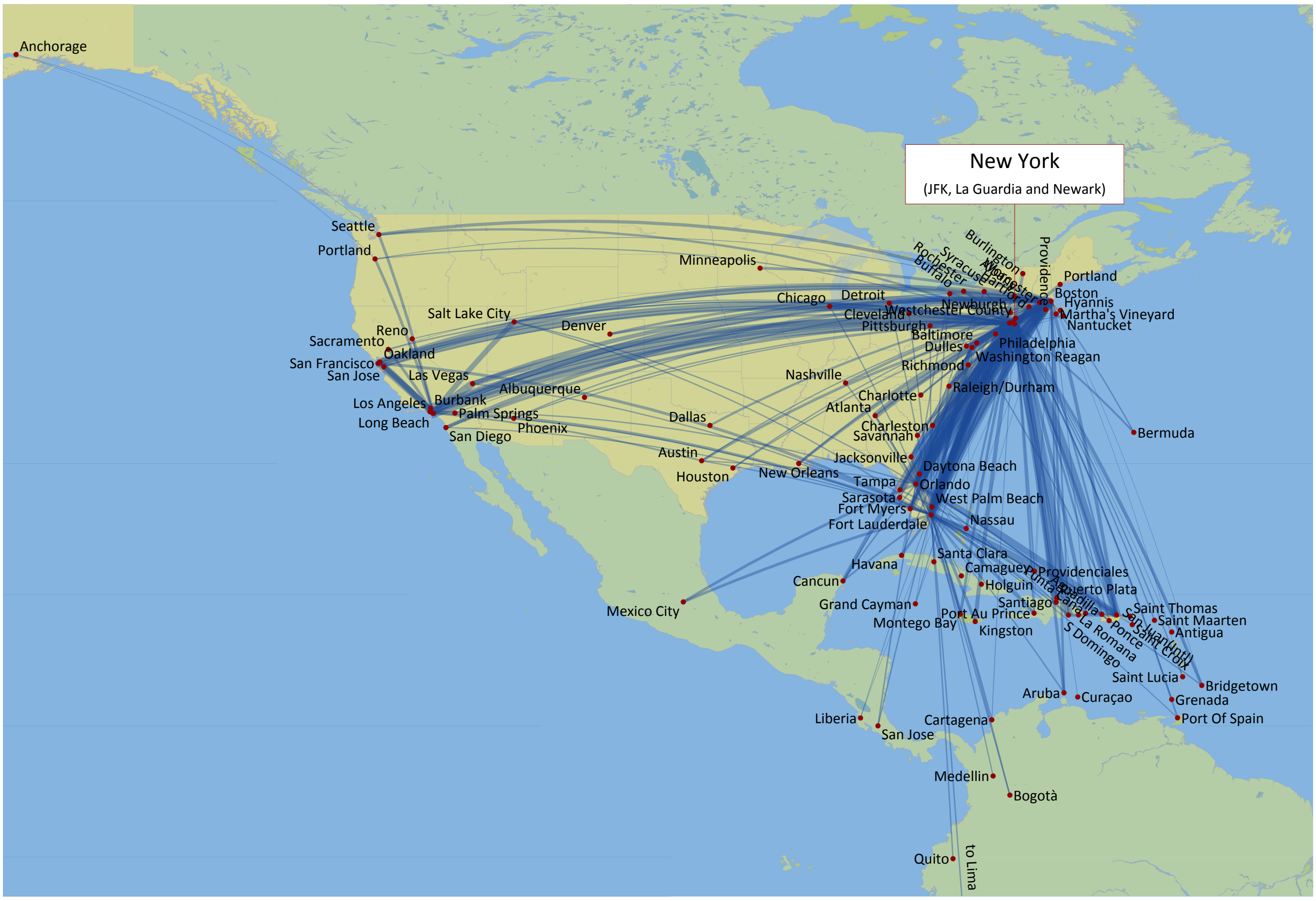
In the past couple of years virtually all the growth has been in Boston and FLL, where JetBlue feels it is relatively underrepresented with 30% and 25% market shares, respectively. Both focus cities have seen RASM strength. JetBlue is in the process of building Boston towards its goal of 200 daily flights and FLL to 140 daily flights. The main risks are Delta's aggressive expansion in Boston and several LCCs' growth in Florida.

The New York market remains "exceptionally strong" and continues to see growth via upgauging with all-core A321s (as do Boston and FLL).

The Latin America/Caribbean region, which accounts for nearly 30% of JetBlue's capacity, has been a huge success story for the airline. But it is also prone to natural disasters. JetBlue was hit hard by last year's devastating hurricane season. Puerto Rico took almost a year to recover to pre-hurricane capacity levels. But there continue to be opportunities: JetBlue is adding a new Boston-Havana route this autumn, consolidating its position as the leading US airline to Cuba.

The Latin America network will receive a major boost in October when JetBlue adds service to Mexico City from both JFK and Boston. The

JETBLUE ROUTE NETWORK



new routes will complement the airline's existing MEX service from FLL and Orlando.

JetBlue is contracting at Long Beach because of the tough yield environment in the west, its relatively weak position in the intra-west market and because its request for customs/immigration facilities to allow international service at Long Beach was turned down.

Instead, JetBlue will continue building its margin-accretive transcon flying, which is performing well in both Mint and non-Mint markets (something the airline attributes to its "leading onboard experience" and "fewer competitive choices" since the ALK-VA merger). September will see two new transcon routes: JFK-Ontario (LA Basin) and Boston-Burbank.

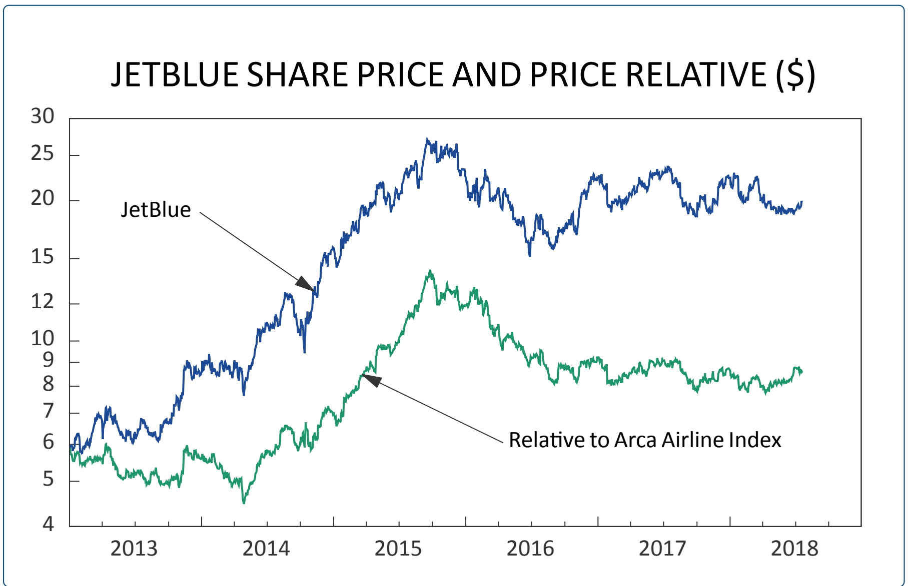
New revenue strategies

JetBlue has delivered on the revenue strategies it originally laid out at the 2014 investor day, which has resulted in strong RASM performance.

Mint was recently named "best business class in North America" by TripAdvisor. It offers the key luxuries to match the legacies' first class products (including lie-flat seats) but in a lower-cost way that meets the needs of a "modern traveller".

One JetBlue executive said recently that he thought the pricing strategy was the key to Mint's success. "We still have a fare in the mid-three digits at the bottom end. We think we can play all elements of the price spectrum." He continued: "JetBlue has a strong core of high-end leisure customers and they can more easily access our everyday low pricing strategy than the legacies' traditional way of pricing — higher fares or upgrades". Mint has a 100% paid load factor; there are no free upgrades.

Originally meant to help JetBlue in only a couple of key business markets such as JFK-LA and JFK-SFO, Mint was such a hit that it was quickly expanded to Boston and some Caribbean markets, followed by Fort Lauderdale, Las Vegas, San Diego, Palm Springs and Seattle. This



autumn will see the first Mint routes to Latin America: JFK-Costa Rica and Boston-St. Lucia.

The 34 or so Mint A321s in the fleet now fly roughly 20% of JetBlue's ASMs. After the two new Latin America routes, Mint will be available on 23 routes linking 15 cities. Many of the Mint routes consistently outperform JetBlue's system RASM and are among its most profitable markets.

The Fare Options platform, launched in 2015, has also continued to exceed expectations, driving an estimated $300m in incremental revenues in 2017. Customers can select a fare based on what they value (checked bags, reduced change fees, etc.) — an alternative approach to static fees. JetBlue has made multiple refinements to the bundling and pricing, which has helped drive "extraordinary growth" in ancillary revenue per passenger (now around $30).

This year JetBlue has turned its attention to non-air ancillary revenues. It has formed a new subsidiary, JetBlue Travel Products, to take over its vacations, car rentals and other travel-related activities and expand them in a "capital-light" way. The airline talked about "laying the foundation for the next level of ancillary earnings growth".

Travel Products is based at FLL, "right at the centre of the travel and tourism industry". JetBlue's leadership also wanted to separate the unit geographically from the New York headquarters to give it a little extra independence. "Just as our venture capital arm JetBlue Technology Ventures has found success by being based in Silicon Valley, Fort Lauderdale will be the perfect location to grow JetBlue Travel Products."

JetBlue has a history of being a technological innovator. An early example was LiveTV, which the airline developed over a decade and in 2014 sold to Thales for $400m proceeds. More recently, among other things, JetBlue has pioneered the use of biometrics and facial recognition technology in the boarding process.

JetBlue Technology Ventures was formed in 2016 to "incubate, invest in and partner with early stage startups at the intersection of technology and travel". In just two years the unit has assembled an impressive portfolio of startups, of which at least two are already helping JetBlue: *Gladly* (a multi-channel customer service tool) and *ClimaCell* (provides more accurate local weather forecasts).

This year JetBlue began a first-of-its-kind codeshare partnership with JetSuiteX, which operates short-haul public charter flights, sold by the seat, between private terminals at major West Coast destinations with 30-seat E135s. The idea is to offer the speed and comfort of private jet travel at affordable prices. JetBlue places its code on JetSuiteX flights, but not vice versa, and the two airlines' flights do not connect.

Launched in April 2016, JetSuiteX is a sister company of JetSuite, one of the largest private jet operators in the US. In October 2016 JetBlue acquired a minority equity stake in the company and gained a board seat. In April 2018 JetBlue increased its stake and Qatar Airways also became a minority investor. The purpose was to fund JetSuiteX's growth; an order for 100 12-seat hybrid-to-electric aircraft from Zunum Aero (another JetBlue-backed venture) followed, for delivery from 2022.

Though currently very small, JetSuiteX offers JetBlue customers new options on the West Coast and fits in well with JetBlue's efforts to build higher margins into the west. CEO Robin Hayes is enthusiastic: "A great product with a competitive fare — we think it's a market with a lot of growth potential, and we clearly want to be part of that."

By Heini Nuutinen

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