Aviation Strategy

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2019: Cyclical and Regulatory turning points

TEN YEARS on from the collapse of Lehman Brothers and the consequent Global Financial Crisis, and it seems that there is no end in sight to a prolonged upturn. The IMF in its October World Economic Outlook forecasts global GDP growth continuing at around 3.6%-3.7%. IATA in its biannual airline forecast update, published in December, suggests that 2019 will see another year of above trend growth in the industry and yet another year of healthy profitability.

But both hint that there may be an increasing possibility of surprises on the downside. The IMF particularly remarks that expansion has become less balanced between regions and may have peaked in some major economies — and particularly the US. It points to growth rates falling over the next two years as the Trump inspired fiscal stimuli unwind and his trade war with China begins to bite.

For the advanced economies overall it forecasts GDP growth slowing from an expected 2.4% in 2018 towards 1.5% by 2022; emerging markets and developing economies as a whole continuing to grow at around 4.75% (with China's growth slowing gradually from 6.9% in 2017 towards 5.75%).

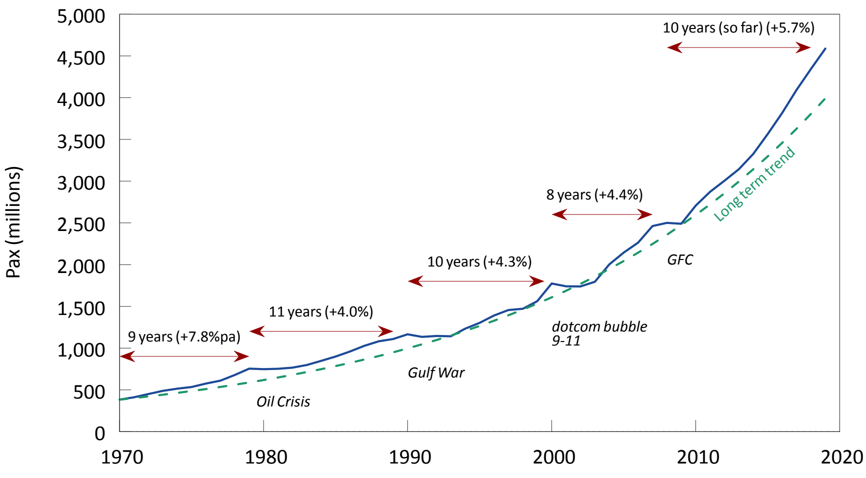
IATA, while recognising help from recent oil price falls, points to unit cost and unit revenue increases in the past 18 months removing some of the "price stimulus" from demand generation. Disturbingly perhaps it is forecasting a modest acceleration in the rate of increase in non-fuel unit costs.

It suggests that 2018 will have ended with an annual growth of 6% in the number of passengers and 6.5% in terms of passenger kilometres (slighly down on the respective 7.2% and 8% rates seen in 2017) while forecasting that 2019 will see a further slow down towards the long term trend with increases of 5.5% in the number of passengers and 6% in terms of RPK.

On airline profits however it is forecasting operating profits and net profits for 2018 and 2019 not too far different from those for 2017 (see chart on the following page) albeit reflecting operating margins of 6.8%, down from the peak of 8.6% in 2016. If so, then this decade will have proven to have been the longest period of continuous net profitability in the industry since the mid 1960s. Indeed in the ten years to 2019 the industry should have made a total net profit of $235bn compared with total net losses of $13bn in the preceding 63 years.

As IATA pointed out in a presentation at this year's GAD World Conference in Hamburg in November, each of the past four cycles have averaged ten years from peak to peak (see chart left). Over that period, the total number of airline passengers has grown

AIRLINE PASSENGERS AND PEAK-TO-PEAK CYCLES



Source: ICAO, IATA

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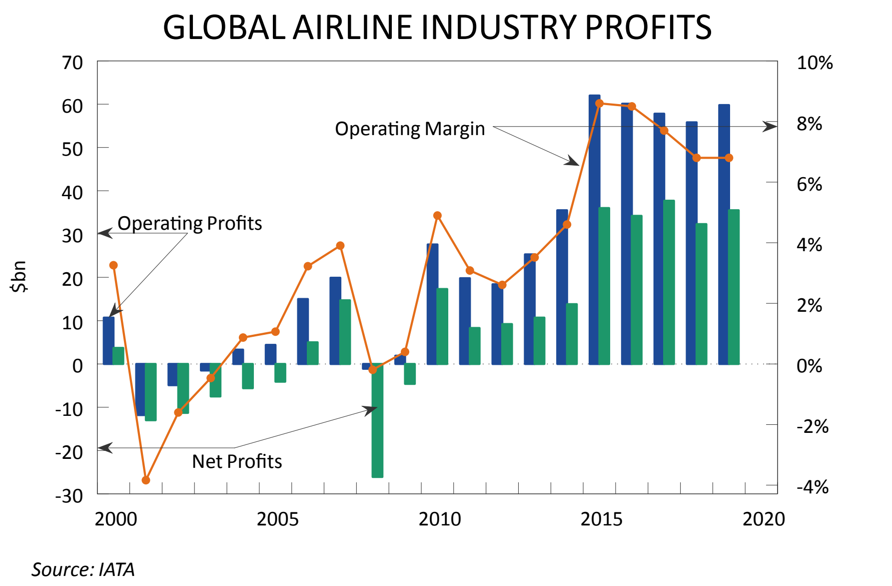
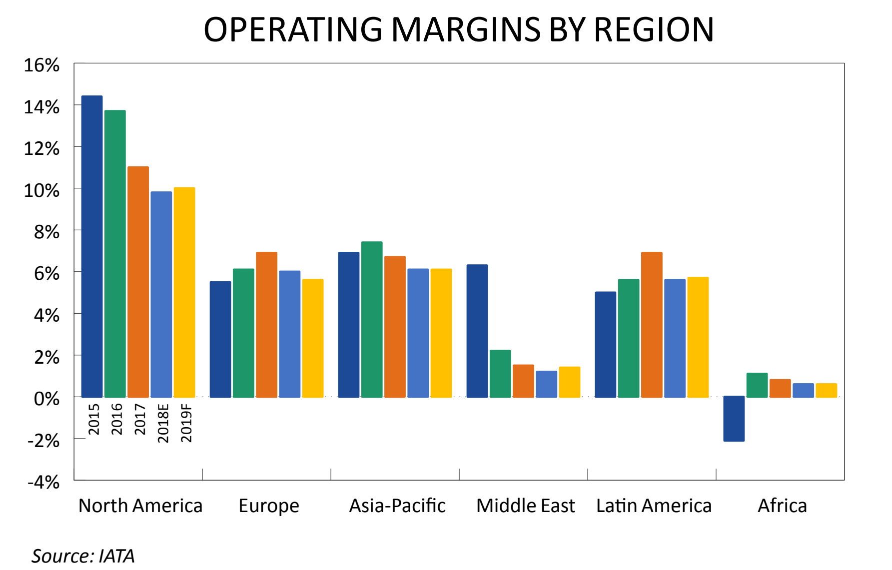


Source: IATA

nearly twelve-fold from 380m in 1970 to a possible 4.5bn in 2019, a compound average annual rate of 5%. The average length of haul has grown by an average 1% a year, and RPK by 6%.

Intriguingly since the peak of the last cycle in 2008 there has been an increase in the growth rates of passenger numbers (but a slowing in the growth of average length of haul), and in each of the past four years growth in demand has remained well above trend. This can mean one of two things: either there are 500m passengers a year who will stay at home come the next downturn, or the industry trends are changing.

And the downturn will no doubt come even though it is difficult at the moment to see the catalyst. The stock markets seem to be anticipating that it will come sooner rather than later: it is almost as if the “teenage scribblers” believe that not having seen



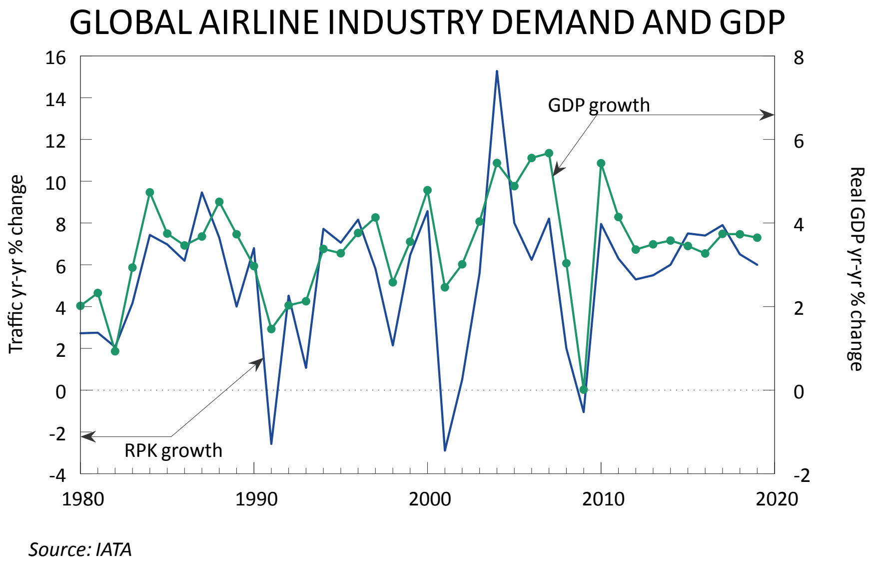
Source: IATA

a recession for ten years, one must be due soon. The US S&P 500 index ended 2018 6.25% down on the year and 15% down from its peak — its worst year in a decade; London's FTSE 100 ended 12% down on the year and 15% down from its peak; Japan's Nikkei and Hong Kong's Hang Seng indexes each down by 14%; and China's CSI 300 index down by a massive 25%.

Furthermore the US Government bond yield curve, while not quite in reversal, has flattened considerably in the past year suggesting increasing concerns over the trajectory of the US economy and the trumpery of disagreements between the executive and bodies political and fiscal.

The danger may be that the world is being beguiled into thinking that because historically it is time to have a recession, there will be one. This expectation process is integral to Keynesian economic cycle theory.

However, the peak of each of the past four cycles in the airline industry have been signalled by some luminary of the industry stating the "this time it is different". None has yet been brave enough to state the same sentiment.

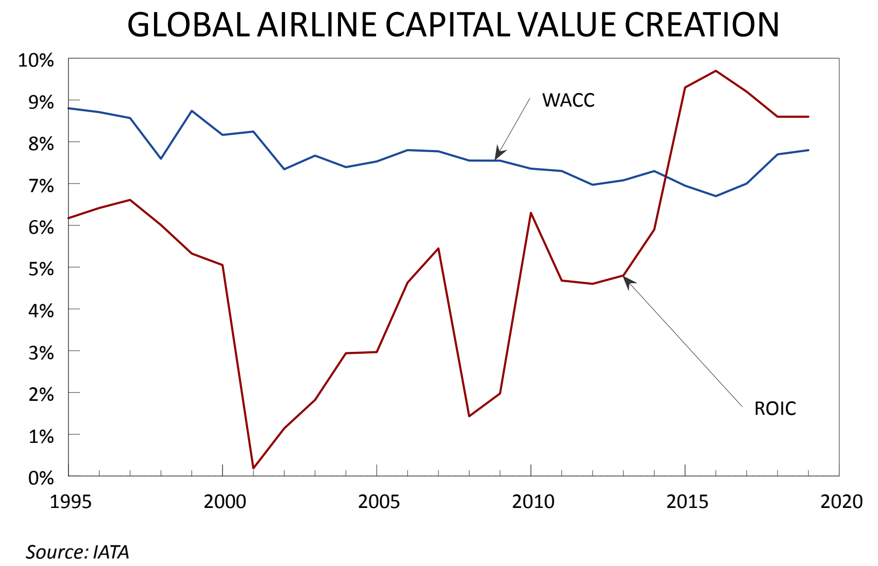


Brexit

There are foreseeable risks, and one of those is quite what happens when (*if?*) the UK leaves the European Union at the end of March 2019. We have written extensively in the past year in *Aviation Strategy* (see the April and September issues) on possible outcomes but with less than three months to go before the deadline we still have no idea what will really happen.

The UK is an important part of the airline industry. It ranks as the third largest country in the world by air passengers (to, within and from) after the US and China, and despite constraints at Heathrow and Gatwick, London is *the* gateway to Europe. And yet the divorce from Continental Europe has the potential substantially to disrupt its economy (severely impacting oubound demand) and create significant doubts over the ability of its major airlines to continue to provide service.

A report from the influential National Institute for Economic and Social Research (NIESR) in November estimated that the Government's current proposed exit deal would reduce the UK's economic performance by 4% by 2030 compared with remaining within the trading bloc, and that an orderly divorce without a deal would have a 5.5% negative impact. The Bank of England presented an assessment that falling out of the EU in a disorderly fashion would plunge the UK into a deep recession possibly pushing GDP down by over 10%. The main question is whether the UK leaves with or without a deal.



The EU has stated that air transport services, in the absence of any deal, will be confirmed as basic third and fourth freedom rights, but that it will enforce ownership and control rules. And it will be the requirement that UK airlines will have to be majority owned by UK nationals, and EU airlines majority owned by EU (ex UK) nationals that could be a stumbling block.

The UK meanwhile has negotiated new open skies agreements with the US and Canada (and a handful of other *really* important countries such as Albania, Georgia, Iceland, Israel, Kosovo, Montenegro, Morocco and Switzerland) effectively to maintain the *status quo*. The US agreement includes the usual ownership and control rules, but provides for a grandfathering of current operators' rights as long as majority shareholders are nationals of countries with liberal air service agreements and have "high labour standards in respect to air transport".

This is particularly important for Delta which, when Richard Branson finally sells a stake to Air France-KLM, will have effective control of Virgin Atlantic. But the DoT waived the opportunity to block Norwegian's North Atlantic operations from Gatwick.

But there are also unsolved ownership issues relating to British Airways (and its Spanish registered parent IAG), easyJet and the UK's third largest airline, Irish registered Ryanair.

In December the UK Department of Transport published a consultation document "Aviation 2050: The future of UK aviation". Its proposals include full liberalisation of air traffic rights, fostering multilateral open skies agreements, full interchange of equipment and to move to a definition of a UK airline as one that has its principal place of business in the UK.

This was an airline designation model originally proposed by ICAO as a clause for inclusion in air service agreements nearly 20 years ago, but only so far adopted by Chile (and the Andean Pact signatories), Costa Rica, El Salvador and (for domestic services) Australia and New Zealand.

A key question may be how likely the UK will be able to be able to introduce these proposals and foster their introduction on a multilateral basis. This, pragmatically, will depend in part on the way in which the EU responds to its treatment of BA, the UK's flag carrier, and it and its parent company's status.

These proposals could well form the model for a new aviation world, and may even create the opportunity for global consolidation in the industry. If so it will be ironic that it will be as a result of Brexit.

Interesting times!

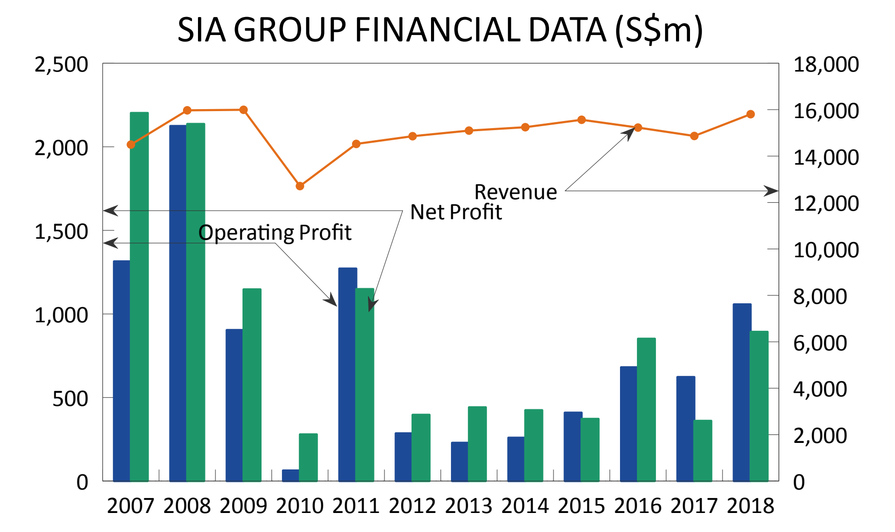
SIA: Its continuing struggle with declining yield

SIGNIFICANT decline in operating and net profit at the SIA Group during the first half of 2018/19 was partly the result of one-offs and rising fuel prices — but also due to ever-falling yield. Is Singapore Airlines caught between maintaining its traditional prioritisation of premium products and building up a substantial LCC business?

In the first half of SIA's 2018/19 financial year (the six months ending 30 September 2018), the Group saw revenue rise by 2.5% year-on-year to S$7.9bn (US$5.9bn), based on an 5.8% increase in mainline passengers carried, to 10.2m. Mainline capacity growth of 2.6% in the first-half of the year was surpassed by a 6.0% rise in RPKs, leading to 2.7 percentage point rise in passenger load factor, to 83.6%.

However, operating profit during the six-month period fell by a hefty 44.1% to S$426.0m (US$317.8m), with net profit totalling S$214.7m (US$160.2m), compared with S$649.7m in April-September 2017.

While it should be noted that comparisons with previous financial years are affected by the SIA Group being required by the Singapore stock exchange to adopt IFRS accounting standards from April 2018 — which resulted in a restatement of 2017/18 results and a reduction in book values for aircraft — the huge fall in profitability was due mainly to rising fuel costs. Despite hedging this was up by S$379.4m/US$283.1m (+20.4%) over the half-year compared with H1 2017/18 — although other cost categories rose faster than revenue growth year-on-year, including aircraft maintenance (+5.6%) and advertising (+7.2%). And at the net level the Group took a S$175m (US$135m) one-off loss from changes to its KrisFlyer FFP (S$115m) and compensation for changes in aircraft delivery slots (S$60m).



Source: Company reports. FYE March

To complete the bad news, the Group recognised an increase in share of losses totalling S$97m from associated companies during the half-year — mostly due to Virgin Australia (in which the SIA Group still owns 20%).

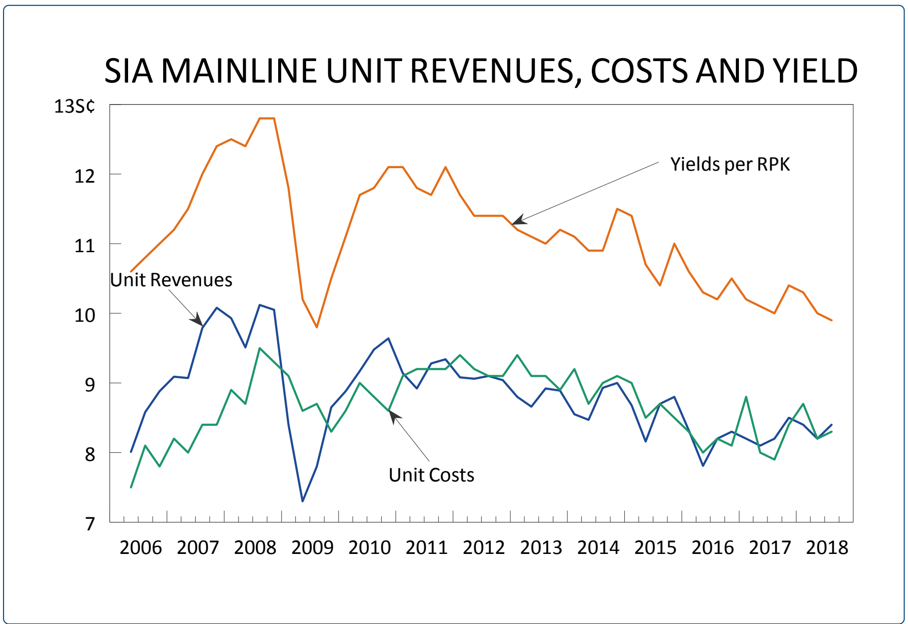
Almost all of the Group's operating profit in H1 came from the mainline (S$418m/US$312m), although this was down 39.3% year-on-year. SIA Engineering contributed a S$22m operating profit but both SilkAir and Scoot racked up operating losses of S$3m and S$10m respectively, compared with net profits of S$22m and S$5m in April to September of 2017.

Yield and cost trends

While profitable, the mainline is facing tremendous challenges, summed up by the continuing decline in yield, which — as the chart on the following page shows — has been falling more or less continuously for a decade as competition from other network carriers (particularly the Super-connectors) and the LCCs has increased.

In response, the Group has unleashed wave upon wave of transformation actions (aka cost cutting) that have slowly but steadily reduced mainline unit costs. The problem is that unit revenue continues to fall too, and the gap between the two is razor thin.

In a challenge faced by many other legacy carriers, SIA is in effect "scraping the barrel" in terms of finding substantial cost savings



over and above what it has already implemented. One area still be to be exploited fully is the fleet.

SIA mainline operates to 64 destinations in 31 countries out of its hub at Singapore Changi, and its fleet totals 111, comprising 19 A330s, 21 A350-900s, 19 A380s, 13 777-200s, 32 77-300s and seven 787-10s. The fleet has been overhauled over the last few years and has an average age of seven years, but further change is coming given the outstanding firm order book of 99 aircraft (see table on page 8). This includes 39 A350-900s, 20 777-9s (with deliveries starting in 2021), and 40 787-10s.

The new aircraft will replace the older A330s and 777s (for example, the 777-200s have an average age of almost 16 years) as well as fuelling growth; overall mainline capacity will grow at around 5% in the full 2018/19 financial year (ending 31 March 2019).

During the July-September 2018 period the mainline received the last of its A380 orders as well as two of seven A350-900ULRs on firm order. SIA was the launch customer for the model, and the airline started the world's longest non-stop route, between Singapore and Newark, in October 2018, followed by a non-stop Singapore-Los Angeles route in November 2018. The aircraft can operate for up to 9,700nm — or more than 20 hours non-stop.

The mainline continues to expand long-haul in general; in September 2019 it plans to launch a Singapore-Seattle service using A350-900s that will be its fourth non-stop route to the US market.

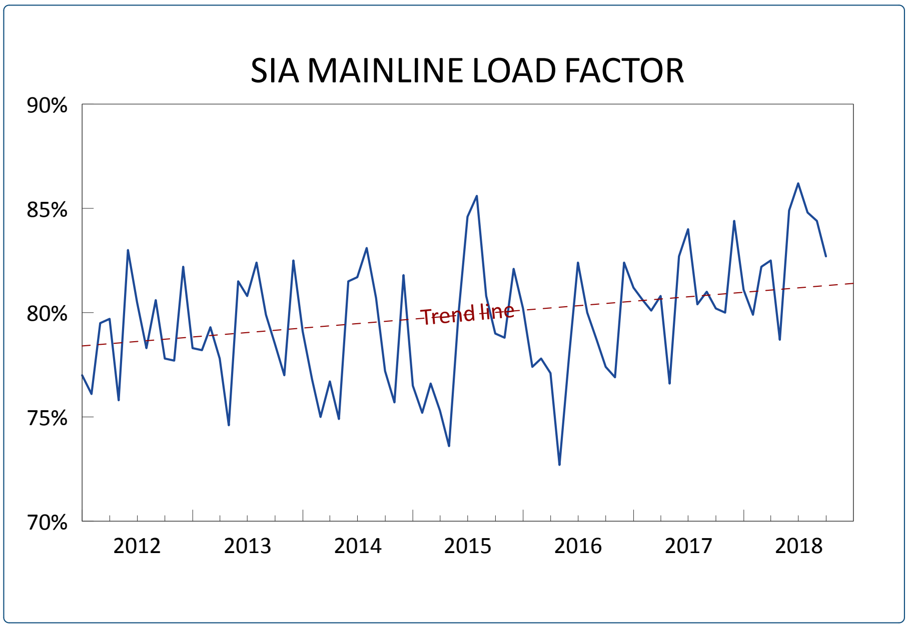
By the end of the current financial year the mainline will receive another 11 new aircraft (seven A350-900ULRs, three A350-900s and a 787-10), and after disposing of three ageing A330 and 777 aircraft will see its fleet increase to 119.

The SIA Group's cargo business operates seven 747-400 freighters (less than it used to have and indicative of the tough cargo market in general) that serve 19 cities in 13 countries.

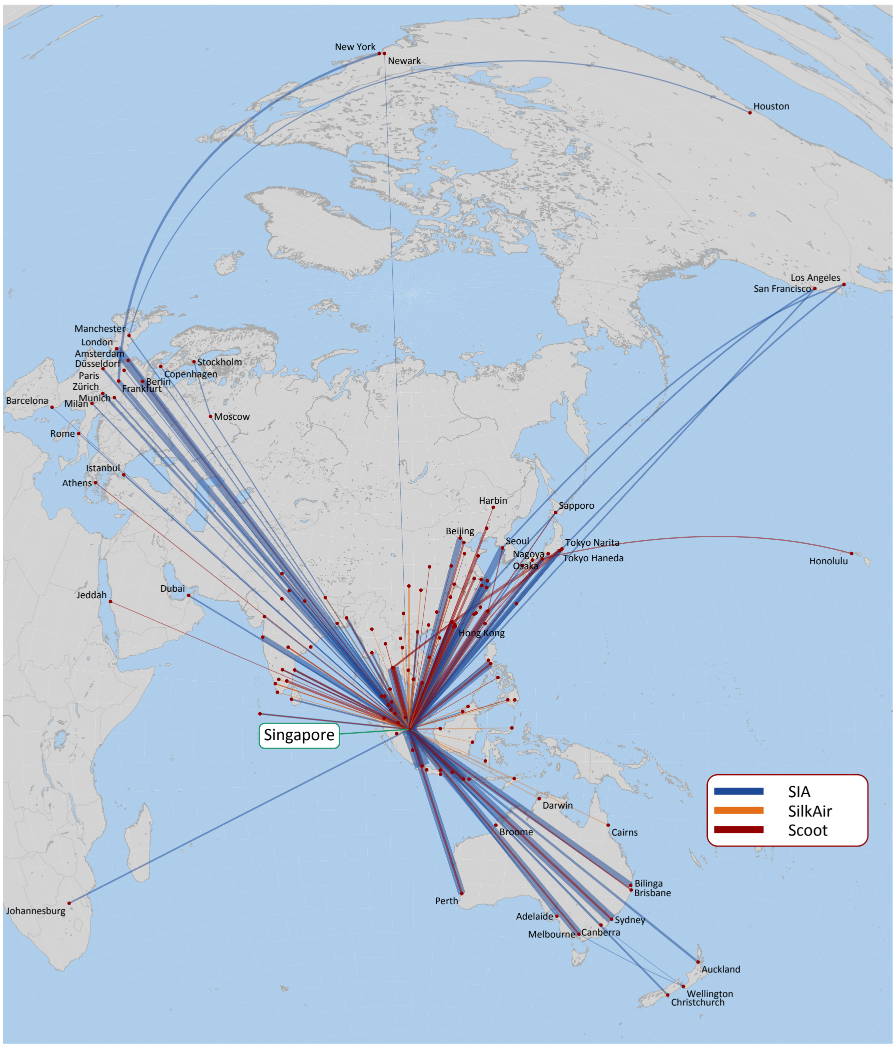
Premium fixation

The group's continuing and long-held strategy is prioritising premium traffic. For example, SIA's latest A380s have 471 seats in four classes — six "suites", 78 in business class, 44 premium economy and 343 economy seats. The suites each have a full-flat bed and leather chair, and the first two suites in each aircraft can convert into a double bed.

But is this continued focus on premium really viable in the long-term? Despite enhancing its traditional first-class and business products and services through revamped cabins and lounges, overall yield continues to de-



SINGAPORE AIRLINES LONG HAUL ROUTE NETWORK



Notes: Equidistant map projection based on Singapore (great circle routes appear as straight lines). Thickness of lines directly related to number of seats operated.

cline. The downward trend in unit revenues has, however, been somewhat mitigated by a gradually improving load factor (see chart on the facing page).

While there is an argument that if the Group didn't continue to invest in premium then its yield decline would be even steeper, the wider point is that management may be too focused on premium, failing to capture the fast-growing price-sensitive Asian traffic volumes. Despite the growth of Scoot, the share of the SIA Group (including Scoot) of the total Asia/Pacific market has hardly changed over the last year — 10.9% of the total passengers carried by the 36 airlines reporting to AAPA.

SilkAir merger

The merger of short/medium-haul airline SilkAir into the mainline SIA was announced in May this year although the implementation timetable appears long. SilkAir will first undergo a S$100m upgrade of its cabin products that will include new lie-flat seats in business class and the installation of seat-back in-flight entertainment systems in both business and economy classes.

According to the Group this will "ensure closer product and service consistency across the SIA Group's full-service network" before SilkAir is merged with the mainline (after which the SilkAir brand will disappear). But the cabin upgrades won't start until 2020 "due to lead times required by seat suppliers", and the merger will only take place once an unspecified sufficient number of SilkAir aircraft have had cabin upgrades.

Based at Singapore Changi, SilkAir currently operates a two-class service to almost 50 regional destinations in 16 countries, comprising 10 destinations in Indonesia, nine in China, eight in India, three each in Malaysia and Thailand, two each in Australia, Cambodia, Myanmar, the Philippines, Vietnam and Laos, plus Hiroshima, Malé, Kathmandu and Colombo.

It operates a 32-strong fleet that includes two A319s, eight A320s, 17 737-800s and five 737 Max-8s, with an average age of four and a half years. Planned ASK growth is around 4% in 2018/19. On order are 32 737-MAXs, although these may be transferred to Scoot, while the A320 family aircraft are gradually being replaced.

The airline is struggling; in the April-September 2018 period yield was 10.6S¢/RPK, compared with 11.4S¢ in H1 2017/18. Units costs of 8.4S¢ were 0.1S¢ higher than a year ago, while unit revenue of 8.1S¢ was 0.3S¢ down, leading to a significant increase in break-even passenger load factor, from 72.8% a year ago to 79.2% in H1 2018/19 — and significantly above its achieved

SIA GROUP FLEET DEVELOPMENT

							2019				
	at end March	2014	2015	2016	2017	2018	in	out	@ye	On order	Options
Singapore Airlines	777-200	16	13	11	11	8		-1	7		
	777-200ER	13	12	10	10	8		-5	3		
	777-300	7	7	6	5	5			5		
	777-300ER	22	25	27	27	27			27		
	A380-800	19	19	19	19	17	3	-1	19		
	A330-300	26	29	28	23	21		-4	17		
	A350-900			1	11	21	3		24	36	
	A350-900ULR						7		7		
	787-10						8		8	40	6
	777-9									20	6
	SIA Total	**103**	**105**	**102**	**106**	**107**	**21**	**-11**	**117**	**96**	**12**
Cargo	747-400F	9	8	9	7	7			7		
	SIA Cargo	**9**	**8**	**9**	**7**	**7**			**7**		
SilkAir	A319	6	5	4	3	3		-1	2		
	A320	16	13	11	10	9		-1	8		
	737-800	2	9	14	17	17			17		
	737 MAX-8					3	3		6	31	14
	SilkAir total	**24**	**27**	**29**	**30**	**32**	**3**	**-2**	**33**	**31**	**14**
Scoot	787-8		2	4	6	10			10		
	787-9			6	6	6	2		8	2	
	777-200	6	4								
	A319			2	2	2			2		
	A320		24	21	21	22	8	-4	26		
	A320neo						2		2	37	11
	Scoot total	**6**	**30**	**33**	**35**	**40**	**12**	**-4**	**48**	**39**	**11**
	Group Total	**133**	**162**	**164**	**171**	**179**	**36**	**-17**	**198**	**166**	**37**

load factor for the half-year, which was 75.8%.

Could the SIA Group have made the wrong strategic decision here — might it have been better to merge SilkAir with LCC Scoot, with the benefits that the LCC model will bring to overall unit costs and traffic growth?

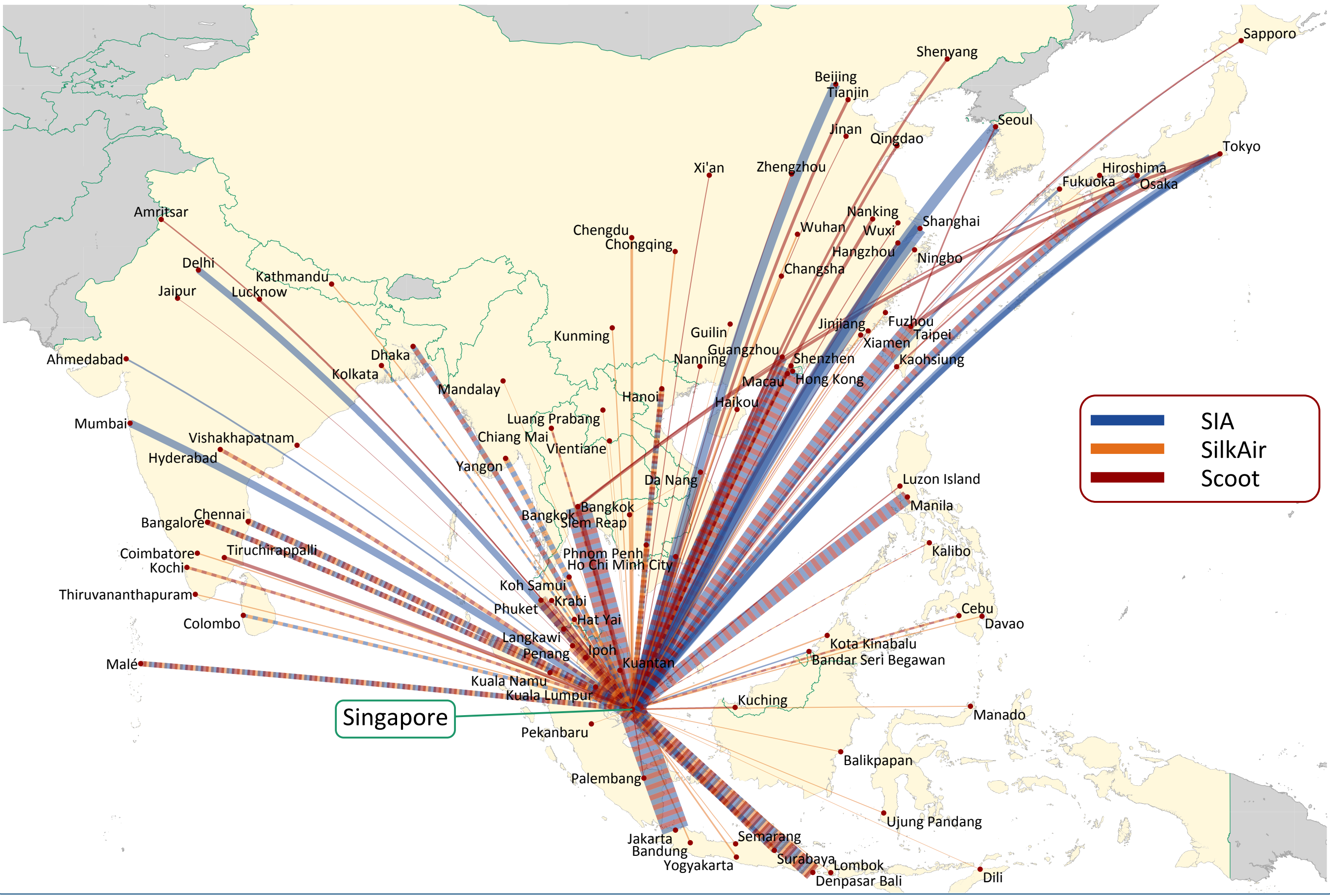
Scoot potential

LCC Scoot was launched in 2012 and operates medium- and long-haul routes from its base at Changi to 65 destinations in China (18 destinations), India (seven), Malaysia (six), Thailand (six), Indonesia (five), Australia (four), Philippines (four), Japan (three), Taiwan (two), Vietnam (two) plus Dhaka, Athens, Berlin, Hong Kong, Macau, Malé, Jeddah and Seoul. Berlin — its second European destination — was launched in last June.

Scoot has 44 aircraft — two A319s, 24 A320s, 10 787-8s and eight 787-9s, and on order are 38 A320neos, two 787-8s and two 787-9s. The first of 39 A320neos on order was received in October this year, and through to 31 March 2019 Scoot will receive six more A320s (two new ones and four currently sub-leased to IndiGo), with overall capacity growth for 2018/19 being 16% year-on-year.

Scoot has already taken over some services from the SIA mainline (such as to Jeddah), enabling routes that were marginally profitable under mainline operation to (presumably) become more profitable when operated by an LCC. More group transfers will occur between April 2019 and mid-2020 (the Group announced a list of such changes in late November), though in terms of Scoot and SilkAir's respective route networks, there is relatively little overlap. Out of Changi the two airlines double-up only on 14 destinations, with India having the greatest overlap (both airlines serve

SIA GROUP REGIONAL NETWORK



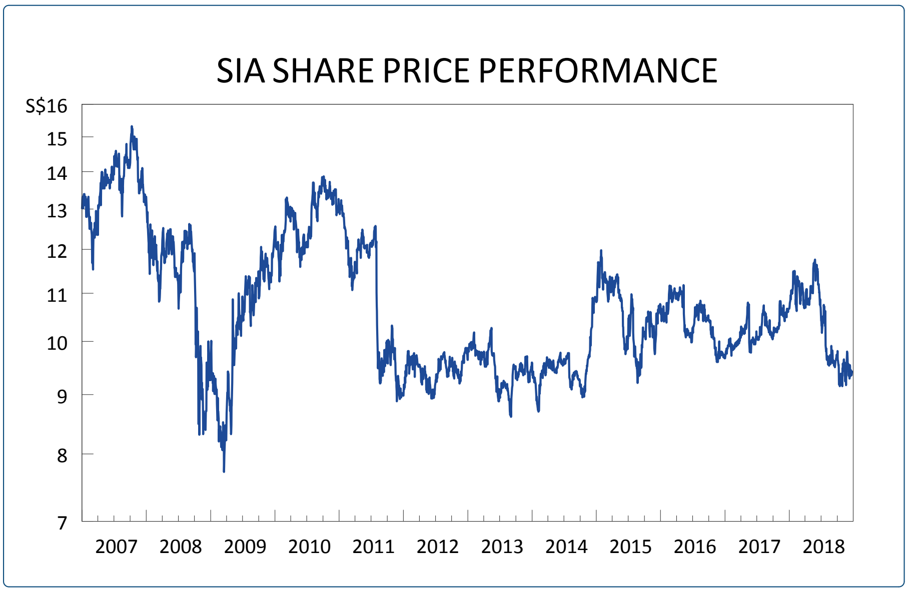
Bangalore, Chennai, Hyderabad and Kochi). Partly, though, this is the result of many routes already having been transferred from SilkAir to Scoot (such as between Changi and Hangzhou, Kuching, Kalibo, Langkawi and Palembang), though SilkAir has also taken over a route to Yangon from Scoot (in October 2017).

But even Scoot is struggling to break-even at the moment — in the first-half of 2018/19 revenue rose by S$139m, thanks to a 13.5% rise in passengers carried, to 5.2m. But unit costs rose above unit revenue by 0.3S¢, and with a break-even load factor of 91.1% the airline didn't come close to posting a profit (passenger load factor for the six months came in at 86.4%).

Scoot absorbed SIA Group subsidiary Tiger Airways in July 2017; the LCC was based in Changi and previously operated 25 A319s and A320s to almost 40 destinations in Asia), with a single class. But with the integration of Tiger now complete, Scoot is looking to further growth — and this includes long-haul. Routes to Athens and Honolulu were launched in 2017, and a four-times-a week service between Changi and Berlin started in June 2018; this operates alongside routes to Düsseldorf, Frankfurt and Munich that are flown by SIA. The long-haul routes use 787s that Scoot operates in a two-class configuration — economy and ScootBiz — with the latter product having 21 seats on the 787-8 and 35 seats on the 787-9.

Scoot also owns 49% of Thailand-based LCC NokScoot, which is a joint venture with Nok Air (it owns 51%), the LCC offshoot of Thai Airways International. Based at Don Mueang international airport in Bangkok, it operates five 777-200ERs to nine destinations in China, Taiwan and Japan in a two-class configuration — "ScootBiz" and economy — and will add five 737-800s to its fleet by the end of calendar 2019.

The SIA Group also owns 49% of Vistara, a full-service Indian joint venture with Tata Sons (which owns 51%), part of the Tata Group — the giant Indian conglomerate. Based at Delhi's Indira Gandhi airport, Vistara operates 22 A320s to 22 domestic



destinations in a two-class configuration. It aims to add 50 A320 family aircraft and six 787-9s to its fleet as it gears up for international operations for which it has applied to the Indian regulatory body for approval.

Within Asia, SIA Group's strategy is to dominate certain markets — the SIA Group is the largest foreign airline in terms of destinations served in Australasia, while it also has a major presence in the Chinese (29 destinations served) and Indian markets.

Group CEO Goh Choon Phong points out that, according to IATA projections, by 2025 "India will be the third largest travel market in the world, and China will also overtake the US to be the number one. We are so close to these two markets and obviously believe that those are the markets that we absolutely must have a strong presence in".

Strategic choices

Yet despite this logic, the Group appears to be sticking with prioritising the preservation of premium traffic at the mainline, with expansion of the LCC model a second priority. The opportunity to start incorporating LCC practices first into SilkAir and then even into the mainline appears to be disregarded; instead only a few routes are being transferred to Scoot, but quite sluggishly. It was not a binary choice — LCC practices could have been adopted by SilkAir while keeping two classes (as Scoot does on long-haul).

Looking to the rest of the 2018/19 financial year, SIA says that "headwinds continue to persist in the form of cost pressures from significantly elevated fuel prices, as well as keen competition in key operating markets". Despite this, the Group stubbornly remains loyal to its strategy of prioritising premium business, though the market's view on this is clear — as can be seen in the graph above SIA's share price is about a third lower than it was in 2007, and a weak rally in early 2018 has petered out, with the price now hovering around historically low levels.

To some extent, the SIA Group is insulated from the full effects of fluctuations in its share price as Temasek Holdings — the Singaporean state holding company — owns 55.5% of equity. But if the mainline's premium business starts sliding, then its shareholders may demand that the Group's overall strategy be revisited.

Alaska Air: Harvesting the benefits of the Virgin America merger

Alaska Air Group has seen its profits dip sharply in the two years since the closing of its $4bn acquisition of Virgin America in December 2016. But with 90% of the integration completed, the Seattle-based carrier is now ready to start harvesting the benefits. At its November 27 investor day, the management outlined plans to return to 13-15% pretax margins in the next couple of years. Is such a goal achievable?

Before the merger Alaska was one of the most financially successful airlines in the US. It was an industry leader on many fronts, be it cost reduction, profit margins, debt reduction, managing to ROIC or returning capital to shareholders.

Impressive cost reduction and deleveraging programmes, launched in the late 2000s, had given Alaska LCC-level unit costs and early investment grade credit ratings. It earned spectacular 24% pretax margins in both 2015 and 2016.

Alaska had a great brand, outstanding customer service and a strong culture. It was also a technological innovator; among other things, it was the first airline to sell tickets online and the first to have airport kiosks.

So why do a merger and screw that up? The main reason, according to the management, was that Alaska needed a bigger platform to remain competitive and to keep growing.

A series of mergers had given the four largest US carriers much more market power; by 2016 they accounted for 84% of domestic revenues. Although Alaska still had growth opportunities in its Pacific Northwest franchise, the management "could see our runway shortening" after years of rapid growth.

After two decades of ASM growth averaging 7.7% annually, and 10.6% growth in both 2015 and 2016, Alaska had gained very high 65% "customer relevance" in the Pacific Northwest (a measure of nonstop service). But it had only 19% relevance in California — a state that has more than three times the population of Alaska, Washington and Oregon combined. It was tough to grow organically in California because of airport infrastructure constraints.

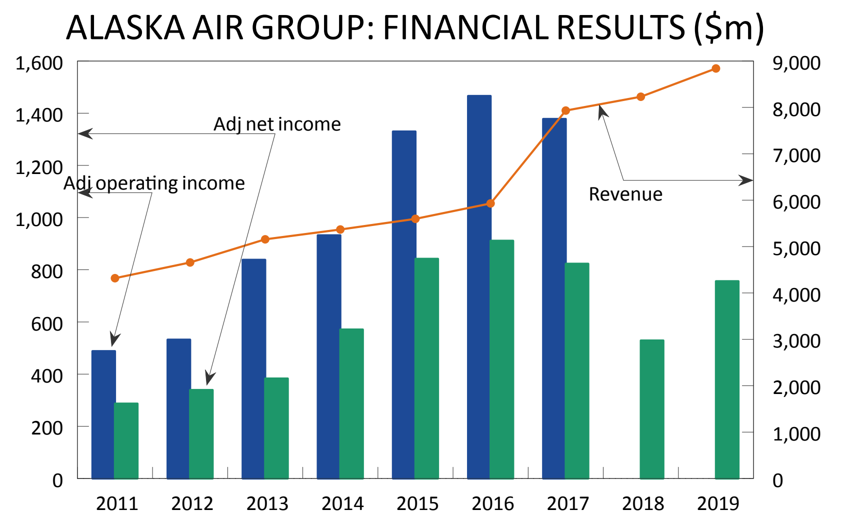
The Virgin America acquisition represented an opportunity to get a solid foothold in California and to grow on the West Coast as well as nationally (because the deal also brought more access to slot-constrained airports on the East Coast).

Alaska paid a big premium for what it considered "scarce real estate", so it was in a hurry to take advantage of the combined network. It launched as many as 44 new markets in 2017, which was in addition to the 38 acquired with Virgin America.

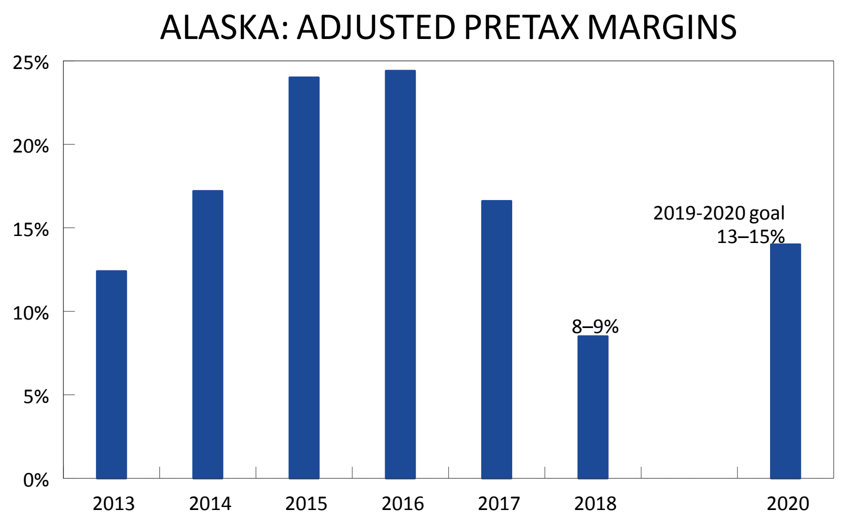
One particularly interesting development has been the increase in cooperation with international airlines and what Alaska executives describe as a "real mind shift" in the way they view global partners (see below).

The addition of Virgin America boosted Alaska's ASM growth to 40.6% in 2017; on a combined basis, ASMs were up by 7.1%. This year has seen 5.3% capacity growth.

Merger integration has gone flawlessly and at record pace — not really surprising given the manage-



*Source: Alaska Air Group reports * Analysts' consensus estimates (December 4, 2018). Virgin America's results included since December 14, 2016.*



Source: Alaska Air Group and analyst reports

ment's track record and the ability to benefit from the experience of past mergers. The messiest parts of integration are now behind the airline.

Alaska has done a decent job in blending the two very different brands and products. As evidence, it has continued to win "best US airline" type awards. One such award in Q3 from *Conde Nast Traveller* was especially meaningful because Virgin America had won it 10 years in a row; now Alaska has extended it to 11 years.

Despite there being very little left of Virgin America (which was all about the in-flight product, while Alaska is all about service and FFP), there has been no mass defection from Virgin America loyalists.

One likely reason is Alaska's loyalty programme, which is claimed to be the most generous in the industry. Since the merger Alaska's Mileage Plan revenues have grown by 38%, from $720m to $1bn annually.

But Alaska's profits have taken a hit in the past two years. Its adjusted pretax profit fell from the 24%-level in 2015-2016 to 16.6% in 2017 and to around 8.5-9% in 2018.

The current consensus estimates see Alaska earning a 6.4% adjusted net margin this year and 8.6% in 2019, down from the 15%-level 2-3 years ago.

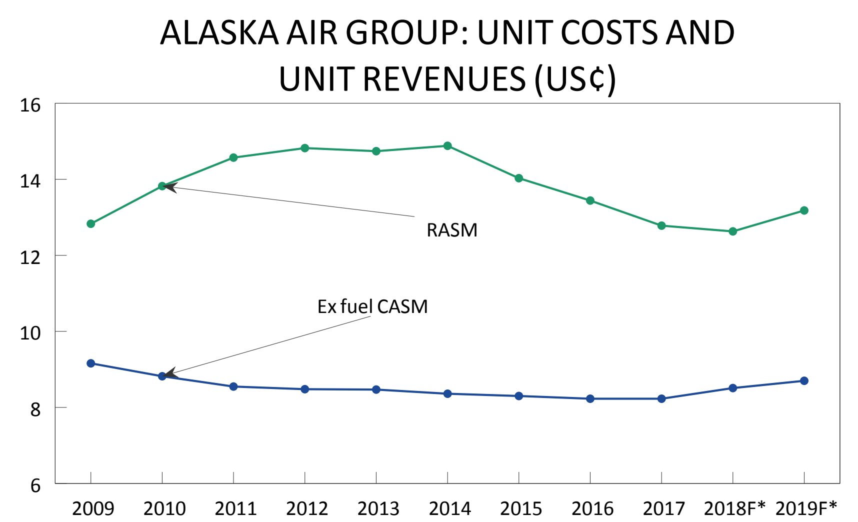
The management blames the margin deterioration on higher fuel prices, new labour agreements, increased competitive capacity growth, and Alaska's own post-merger growth spurt.

In the past two years Alaska has signed market-rate JCBAs with 93% of its unionised workforce. Much of the labour cost hike was attributed to being behind the curve, but bringing Virgin's workers to Alaska's higher pay rates must have also been a factor.

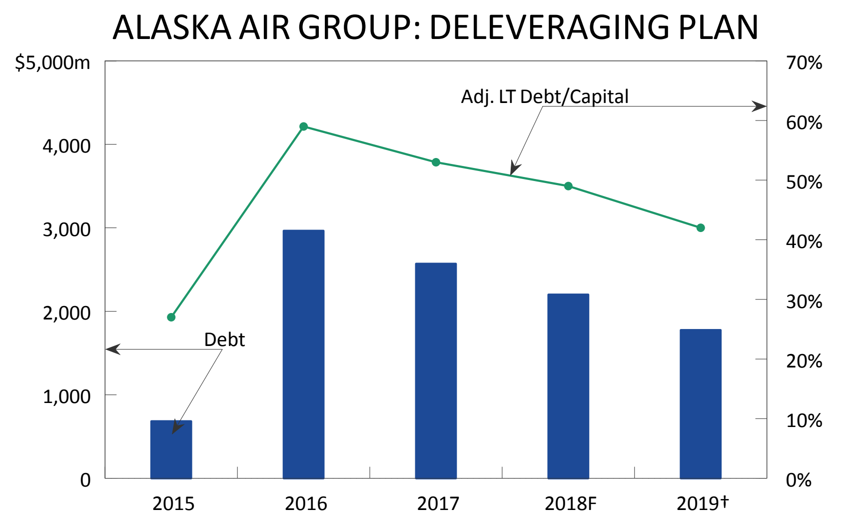
In the past three years the US West Coast has become a hotbed of competition. Many airlines focused their growth there because the economy was stronger, and then the Alaska-Virgin America merger triggered competitive responses. Alaska's RASM has declined every year since 2014.

In the past two years Alaska has had as much as 10% of its total capacity "under development", which tends to have a negative impact on profitability.

At the investor day, the key message was that the focus would now shift from integration to improving financial performance. CEO Brad Tilden stated: "We believe we passed through an inflection point in the last few months and we're now moving to harvest time and realising the benefits of the merger".



*Source: Alaska Air Group and JP Morgan reports Notes: * CASM projections by Alaska management (mid-points of ranges); RASM forecasts by JP Morgan (November 28 report)*



Note: †2019 targets are mid-points of ranges (41-43% and $1,700-1,800m). Debt = long term balance sheet debt including current portion.
Source: Alaska Air Group

Tilden also announced a goal of returning to 13-15% pretax margins in the medium term. It was not presented as a formal target but, rather, a "mind set" — a level of pretax profit the management believes Alaska is capable of, and should be, earning.

Some analysts are sceptical that Alaska can return to industry-leading margins anytime soon, given the competitive scene on the West Coast (which could intensify further if fuel prices remain at the current lower levels).

But most analysts have responded positively because Alaska's management is very highly regarded, because near-term RASM trends are positive, and because a credible "road map" for margin improvement was presented at the investor day.

Alaska projects significant multi-year "margin drivers" in four categories (see table on page 15): remaining merger synergies ($235m), new revenue initiatives ($240m-plus), operational efficiencies ($75m-plus) and support-function efficiencies ($85m-plus).

As much as $130m of the additional merger synergies and $200m of the extra revenues from new initiatives are expected to be realised in 2019, so higher profitability next year seems virtually guaranteed.

Alaska is also benefiting from an improved industry revenue environment, as domestic fares have continued to inch up even as fuel prices have declined. Alaska's RASM growth has turned positive in the current quarter and analysts tentatively project a 4%-plus increase in 2019.

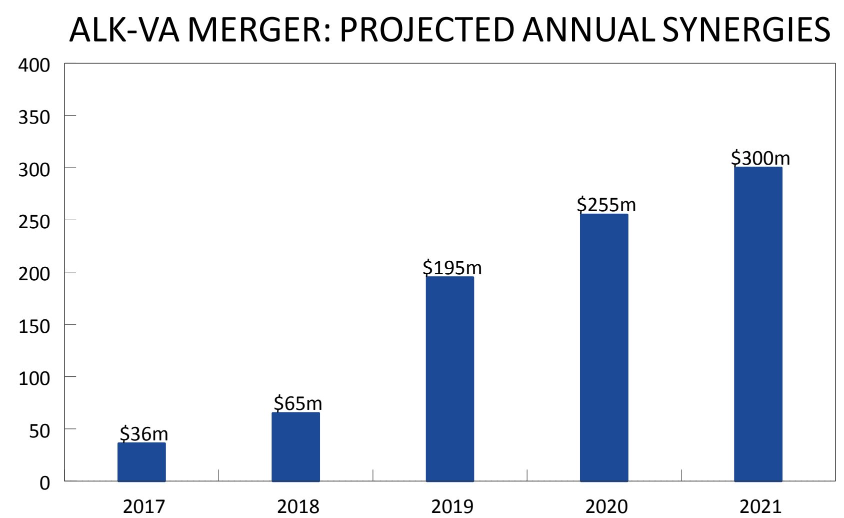
The RASM outlook is benefiting from Alaska's decision (earlier this year) to slow ASM growth to only 2% in 2019, followed by 4% growth in 2020. But the slower growth will put pressure on unit costs. Once the profit margins have recovered, Alaska plans to return to 4-6% annual capacity growth.

Merger integration progress

2018 has seen much progress with the merger integration: systems operation control (SOC) in January, single passenger control services (PSS) in April, joint collective bargaining agreements or transition deals with the last three unions (flight attendants, dispatchers and maintenance workers) in April-November and an integrated seniority list for the pilots in August.

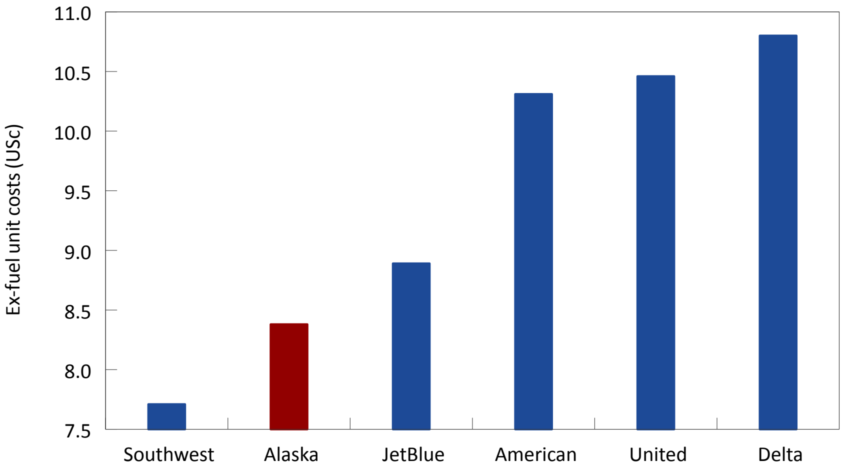
The single PSS was a critical milestone in that it allowed Alaska to start unlocking many of the revenue synergies. It meant the retirement of the Virgin America brand (April 25).

It was a feat to secure all of the labour deals and integrated seniority lists (ISL) in less than two years.



Source: Alaska Air Group

ALASKA'S UNIT COST ADVANTAGE



Source: Alaska Air Group.
Notes: Stage length adjusted non-fuel CASM 12 months ended June 2018. US West Coast-originating flights to North American destinations.

In other US airline mergers achieving ISLs took 3-6 years.

Alaska has begun mixing and matching aircraft and expects to fully deploy cross-fleeting by March. Cabin attendants, who have undergone cross-training to work on two aircraft types, are due to begin working as one team in February.

The process of converting Virgin America's Airbus fleet to the Alaska configuration is expected to be completed by the end of 2019. It entails adding more premium seats, eliminating some economy seats and reducing the premium seat pitch; the net effect is to increase the total number of seats. The move will facilitate Alaska's generous complimentary upgrades policy for elite FFP members, increase revenues and lower unit costs. Alaska estimates the revenue benefits at $40m.

The Alaska-Virgin America combination is expected to generate $300m in annual net synergies when fully integrated — $240m revenue benefits and $60m cost synergies. Only $65m of the $300m total synergies have been realised so far.

ALASKA'S TRACK RECORD OF FINANCIAL OUTPERFORMANCE

2010-2018	Airlines*	High Quality Industrials†	Alaska Air Group
Pretax margin	10.4%	13.0%	15.1%
Free cash flow margin	2.1%	7.7%	7.8%
ROIC	13.6%	14.8%	16.7%
Adj. net debt/EBITDAR	1.8x	1.6x	0.9x
P/E multiple	13.9x	18.6x	10.7x

Source: Alaska Air Group/Wells Fargo Securities
*Notes: *Airlines: Delta, American, United, Southwest, JetBlue, Spirit, Allegiant, Air Canada and WestJet. †HQIs: UPS, Fedex, 3M, Caterpillar, Boeing, J B Hunt, United Technologies, Ryder, Union Pacific, Kansas City Southern, Norfolk Southern, Canadian National and Canadian Pacific.*

Much of the future effort will focus on culture, which is critical for an airline that emphasises engagement and attributes much of its success to a "small company feel". There are no real issues, but the management feels that the integration has put a "tremendous amount of strain" on the culture.

Among other measures, Alaska is spending $15m to put all of its 23,000 employees through interactive one-day workshops with the leadership over the winter. Called *Flight Path*, the events take place in a huge rented warehouse. The workers attend in mixed groups of 600 to discuss topics such as shared values, working together as a team, history, plans, vision, etc. They can ask questions and air their concerns, and there is a "great social afterwards".

Alaska is tackling culture so aggressively that it is hard to imagine there not being a successful outcome. Importantly, Alaska also pays well and is recognised as a good employer (as Virgin America was).

New revenue and cost initiatives

Alaska was behind its peers in product segmentation and ancillary fees, so it was easy to find revenue initiatives.

First, Alaska has just launched its version of basic economy, Saver Fare. The move is projected to generate $100m in additional annual revenue.

Second, Alaska has increased its previously relatively low bag fees to bring them in line with those in the marketplace — a $50m revenue opportunity.

Third, new ancillary revenue initiatives (dynamic pricing, upgraded food and beverage menus, exit row sales, etc) represent another $50m revenue opportunity.

Fourth, Alaska targets a further $40m in revenues from corporate

ALASKA AIR GROUP: FLEET AND CAPEX PLAN

	Number of aircraft at year-end:				
	2016	**2017**	**2018**	**2019**	**2020**
Mainline aircraft	218	221	233	242	249
Regional aircraft	67	83	95	93	92
Total aircraft	**285**	**304**	**328**	**335**	**341**
Total capex*	**$678m**	**$1bn**	**$1bn**	**$750m**	**$750m**

*Source: Alaska Air Group (November 27 presentation) * Aircraft and non-aircraft capex*

contracts or deals with travel management companies.

Those four items add up to a significant $240m in revenues from new initiatives, most of which is expected to be realised in 2019.

On the cost side, Alaska has identified $160m of multi-year savings from higher productivity, schedule optimisation, self-service technology, reduced overheads, improved purchasing power, and selling and distribution. Most of those are either merger synergies or represent a reversal of temporary inefficiencies created by the merger.

However, most of the cost savings will only be realised from 2020 onwards. 2019 will see a continued "training bubble", most of the Airbus retrofits, unusually high growth on the regional side (which has double the mainline costs) and $25m investments in the product and culture. Regional capacity will surge in 2019 because of the peaking of E175 deliveries to Horizon.

Nevertheless, Alaska expects to limit the increase in non-fuel CASM to only 2-2.5% in 2019, which would be impressive in light of the mere 2% capacity growth.

Low costs are critical to Alaska's business model. Alaska believes that it has a roughly 20% cost advantage over the legacy carriers on a stage length-adjusted basis (largely unchanged in the past two years) and that it has narrowed its gap to Southwest to mere 0.67 cents (see chart on the preceding page).

ALASKA'S ROADMAP TO HIGHER MARGINS

Category	Multi-year opportunity	2019 target	Details
Remaining merger synergies	$235m	$130m	Cross-fleeting, loyalty growth, Airbus retrofits, global partners
Revenue initiatives	$240m+	$200m	Saver Fare, higher bag fees, other ancillary initiatives,corporate sales
Operational efficiencies	$75m+	[illegible]25%	Productivity, schedule optimisation, guest self-service
Support function efficiencies	$85m+	[illegible]55%	Constraining overhead, vendor management, selling & distribution

Source: Alaska Air Group

Network and alliance moves

After two years of growth to "connect the dots" and some restructuring of the network inherited from Virgin America (notably, VA's Dallas Love Field-East Coast and Mexico services have gone), Alaska feels that it now has the right network in place.

Alaska claims that the West Coast network is now the industry's strongest. In the past two years, its West Coast-originating nonstop markets have increased from 233 to 283, daily flights from 756 to 931, seat share from 20% to 24% and customer relevance from 33% to 48% (the runner-up Southwest has 41% relevance).

In California, Alaska has considerably strengthened its position: its daily departures have increased by 71% (to 330-plus) and its customer relevance has more than doubled to 40%. But the 12% seat share reflects the fact that California is an important market for everybody.

California presents a sizeable opportunity for Alaska to grow its loyalty and credit card programmes, because only 6.5% of its customers there currently have its credit card, compared to 44% in the Pacific Northwest.

The combination has a decent New York franchise, with 30 daily departures split equally between New York JFK and Newark. Earlier this year Alaska leased its LaGuardia and Washington Reagan slots to another airline until 2028, as it cannot currently use them for transcon service because of perimeter rules (generally limiting flights to less than 1,500 and 1,250 miles respectively).

Alaska is fortunate to have a very strong position in the West Coast-Hawaii market, with mostly nonstop operations from eight West Coast gateways to four islands. That and

ALASKA AIR GROUP: FLEET AND AIRCRAFT COMMITMENTS

	Operating fleet	Firm orders	Lease commitments	Delivery schedule/ comments
737-700F	3			
737-700	11			
737-800	61			
737-900	12			
737-900ER	73	6		
737 MAX 9		32		From June 2019
A319	10			
A320	53			
A321neo	8		2	2019
A320neo		30		2022-2024/cancelable
Total mainline	**231**	**68**	**2**	
Q400s	41			Operated by Horizon
E175s	16	17		4Q18-2021/Horizon
E175s	32		3	2021 / SkyWest
Total regional	**89**	**17**	**3**	
TOTAL FLEET	**320**	**85**	**5**	

Source: Alaska Air Group 10Q

a differentiated product will help it weather the competitive effects of Southwest's entry next year.

Alaska has maintained its 55% seat share in Seattle, its primary hub, despite an influx of competitor service. Seattle is now very congested, but there are solutions in sight. First, Horizon is able to launch E175 service in Q1 2019 from nearby Paine Field, which is getting a $40m passenger terminal. Second, expansion projects at Seattle, including a new 20-gate terminal, are due to be completed in 2021-2022.

Lack of infrastructure is a serious problem at all of the key West Coast airports, but Alaska executives said that, with some $48bn of expansion projects under way or planned, they felt reasonably good about the longer-term prospects.

However, there will be fierce competition for any new facilities that open up at the key California hubs. United recently announced its largest ever international network expansion from San Francisco. Southwest, among others, is keen to grow from Los Angeles.

The investor day message was that there would be no major changes to the Alaska network in 2019 or 2020; rather, the focus would be on optimising the schedule and getting the right aircraft in the right markets.

The best example of the latter is allocating the larger 737-900ERs to the highest-density transcon markets to replace the smaller A320s, which are better deployed in north-south flying. There will also be much aircraft reshuffling resulting from the E175 deliveries.

In later years Alaska will boost frequencies and add some new destinations. The management does not see much international expansion, although the 737 MAX 9s would open up some opportunities (32 on firm order, deliveries from June 2019). The key message was that Alaska would mostly rely on partners internationally.

The expanded LAX and SFO presence led to a "huge increase in interest" from global partners to work more with Alaska. In the past six months, four of Alaska's 15 airline partners have started or announced international service to Seattle, after previously receiving feed from Alaska only in California. Mileage Plan member accruals on global partners have nearly tripled over the past three years.

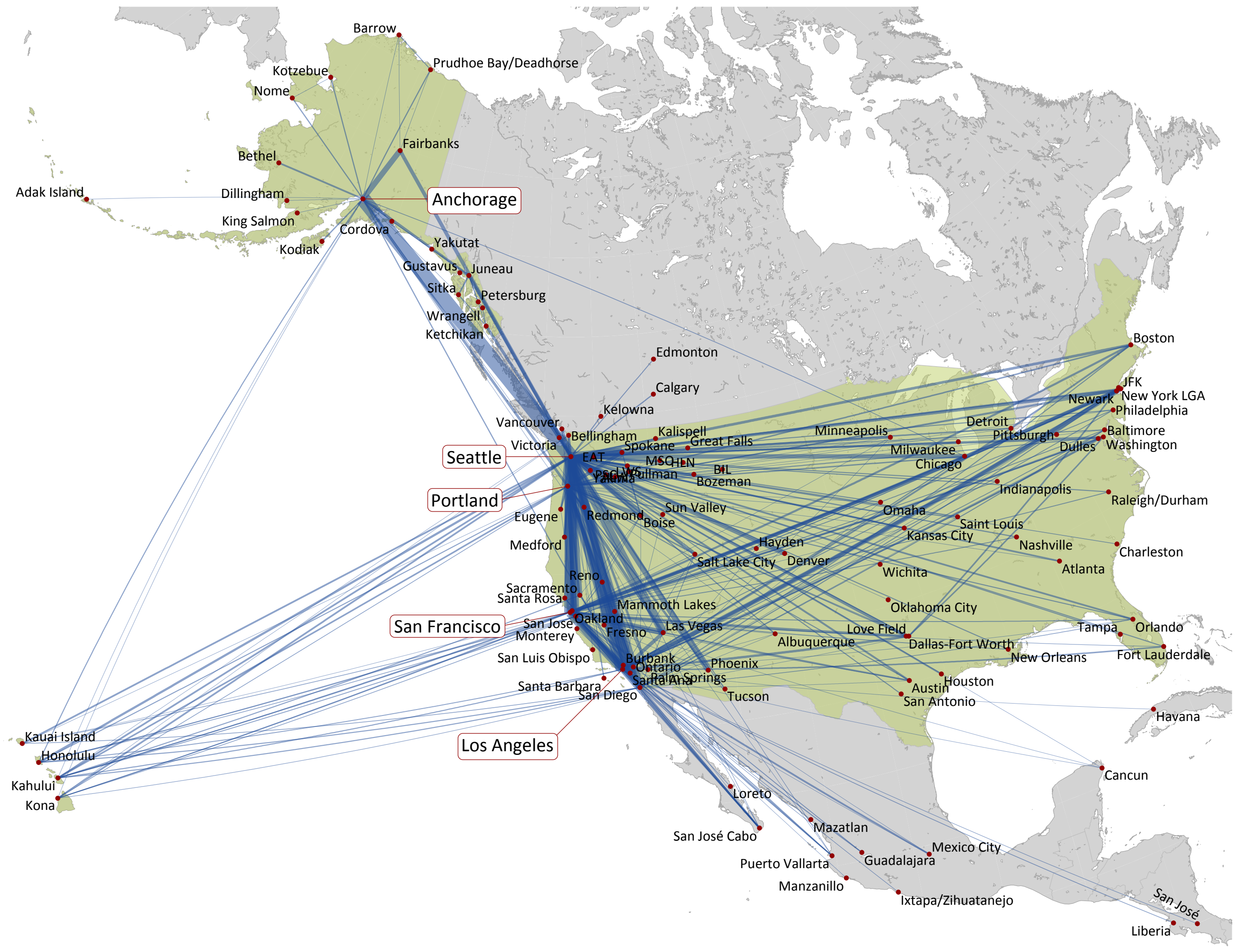
The investor day presentation included an interesting table showing that "Alaska Global Partners" now has a higher share of all long-haul international seats out of Seattle than SkyTeam (39% and 38%, respectively), and with more destinations. Similarly, Alaska's partners now have a higher combined share of international seats from the entire West Coast than the average of SkyTeam, Star and oneworld (29% and 26%, respectively).

The partnerships are at most one-way codeshares (like JetBlue's), with Alaska displaying the partner's code but not vice versa. But they enable Alaska to offer its loyalty programme members a global network of over 900 destinations for earning and redeeming miles. It is all about retaining loyalty members and growing the lucrative programme. In that respect Alaska has an advantage over Southwest, which does not have global partners.

So Alaska is keen to deepen the cooperation and make it more seamless. Among other things, it will start selling its international partners' fares on its website next year.

Alaska executives also mentioned that they were considering oneworld connect membership — a lower-cost category created this year for smaller carriers that has so far attracted Fiji Airways. The benefits are more

ALASKA AIR ROUTE MAP



extensive with member airlines that become "oneworld sponsors". Eight of Alaska's 15 partners belong to oneworld (including American, BA, JAL, Qantas, Cathay and LATAM).

Fleet decision

Alaska had no choice but to become a mixed fleet operator for many years, because the vast majority of Virgin's Airbus aircraft are leased and it would have been "extraordinarily expensive" to terminate the leases early. In any case, Alaska needed the lift and having two mainline types offered useful flexibility for developing the post-merger network.

But a dual 737/A320 fleet makes little sense for a low-cost carrier in the long run, so Alaska is widely expected to go back to an all-Boeing fleet if it can do that without excessive added training costs or harming growth.

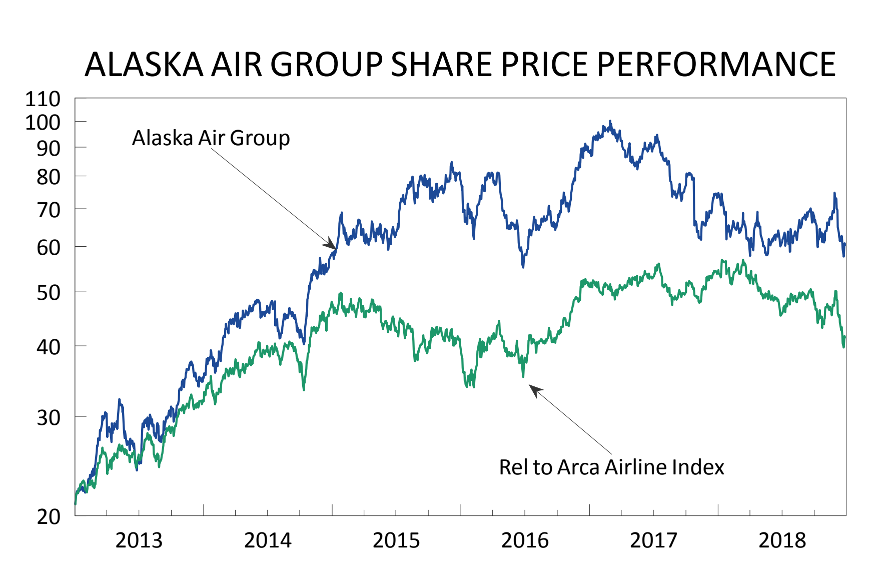
The topic was not discussed much at the November investor day, but the management did say that they expected to make the long-term fleet decision in 2019.

The fleet dis-synergies have been greater than originally anticipated. Alaska now estimates the added cost of a dual fleet to be "in the $40m range" annually, compared to $20-25m previously.

All but 10 of the 63 A319/A320s that Alaska acquired in the merger are leased. The vast majority of those leases expire in 2023-2025. Since the merger, Alaska has received the first eight of 10 A321neos that Virgin committed to leasing from GECAS, with the final two arriving in 2019.

Alaska also inherited an order for 30 A320neos from Airbus for 2020-2022 delivery that can be cancelled for just $15m.

Some in the financial community have speculated that Alaska will



return the A319s and A320s as they come off lease but will keep the A321neos. The latter are ideally suited to the Hawaii market (and the current GECAS leases run through 2030 anyway).

Re-deleveraging success

One thing seems certain: Alaska will be successful in repairing its balance sheet after borrowing $2bn to finance the Virgin acquisition.

Before the merger Alaska was under-leveraged, having reduced its debt-to-capital ratio from 81% in 2008 to 27% in 2015. The Virgin financing caused the ratio to soar to 59%. The management announced plans to "re-deleverage" and set a target of 45% by 2020.

As of September 30, Alaska had paid off $800m of the Virgin-related debt and reduced the debt-to-capital ratio to 49%. It now expects a 41-43% ratio next year, thus achieving its target a year ahead of schedule.

With fleet growth moderating in the next two years, Alaska expects its total annual capex to decline from the past two years' $1bn to the $750m-level in 2019-2020. Assuming profit growth, free cash flow should improve significantly.

Alaska is committed to "balanced capital allocation favouring conservatism". The priorities are to fund growth, make scheduled debt repayments and pay dividends. The remaining operating cash flow will be available for either share buybacks or further debt reduction.

Filling the Virgin America gap

After the merger many people felt that the disappearance of the much-loved Virgin America product had created an opening for an edgy new entrant to shake things up in the increasingly consolidated US domestic market. Virgin Group's founder Richard Branson, too, frequently hinted that he might launch a new Virgin brand airline in the US.

Two years on, new mainstream entry looks difficult. First, the gap may have been effectively filled by Alaska and other airlines. Second, industry consolidation and other structural changes have created a very tight market.

On transcontinental routes, JetBlue has filled much of the gap with its highly acclaimed Mint premium product offering, which it has expanded aggressively since the Alaska-Virgin America merger was announced.

The most price sensitive customers in the US now either fly on ULCCs or buy the basic economy fares offered by the legacies and Alaska; JetBlue and Hawaiian will introduce their versions in 2019. Those fares have really taken off and spread nationwide only in the last two years.

Better product segmentation has enabled the legacies to focus more sharply on improving their domestic premium offerings, raising the bar at the top end of the market.

But there is always room for an edgy niche operator. The only substantial new airline currently on the drawing board, JetBlue/Azul founder David Neeleman's planned US start-up, arguably belongs to that category because it will focus mainly on point-to-point operations between secondary cities.

After long angling a return to the US with a new airline venture, Neeleman got his opportunity because of the availability of the A220 (formerly CSeries). The outstanding economics and passenger appeal of that aircraft type may facilitate a new type of profitable upmarket LCC business model.

By Heini Nuutinen
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Freighter Values and Lease Rates — October 2018

THE FOLLOWING tables reflect the current values (not "fair market") and lease rates for cargo aircraft. Figures are provided by The Aircraft Value Analysis Company (see below for contact details).

The values and rates reflect AVAC's opinion of the worth of the aircraft in the present market. In assessing current values, AVAC bases its calculations on many factors such as number of type in service, number on order and backlog, projected life span, build standard, specification etc. Lease rates are calculated independently of values and are all market based.

FREIGHTER VALUES (US$m)

	New	5 years old	10 years old	20 years old
A300-600RF			21.6	11.3
A330-200F	79.1	69.9	47.3	
737-300QC				5.8
737-400SF				8.3
737-800CF	na			
747-400F			34.3	20.2
747-400ERF			38.5	
747-8F	166.7	136.4	97.9	
757-200PF				12.2
767-300F	46.6	41.1	31.9	16.5
777-200F	143.7	117.5	76.7	
MD-11F				5.2

FREIGHTER LEASE RATES (US$000)

	New	5 years old	10 years old	20 years old
A300-600RF			194	145
A330F	682	563	458	
737-300QC				81
737-400SF				107
747-400F			437	293
747-400ERF			502	
747-8F	1499	1243	940	
757-200PF				119
767-300F	373	351	308	211
777-200F	1175	1015	775	
MD-11F				89

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