Aviation Strategy

Issue no. 243

Jan/Feb 2019

Smith to Forge New Air France-KLM

AIR FRANCE-KLM was the pioneer of the consolidation game in Europe. In the first four years after the 2004 merger between Air France and KLM it made significant progress in showing its rivals how to benefit from a merger of national flag branded airlines. But since the peak of the last cycle and the global financial crisis, the group has lagged its rivals, brought down by excessively weak financial performance at Air France. The group now has a new CEO — remarkably an aviation professional, non-French and non-Establishment — given the task of returning the group to its former glory. Can he do it?

This issue includes

2018 was a bit of a troubled year for Air France-KLM. Revenues on a like-for-like basis were up by 2.5% year-on-year to €26.5bn on the back of a 2.4% increase in capacity and 1.5% growth in currency-adjusted unit revenues. Total passenger numbers increased by a modest 1.1% to 101.4m. Costs were impacted by a 10% increase in fuel costs to grow by 5% and operating profits fell by 30% to €1.3bn down from a restated €1.9bn (the Group adopted IFRS16 at the beginning of the year — see *Aviation Strategy*, April 2016 "No accounting for leases").

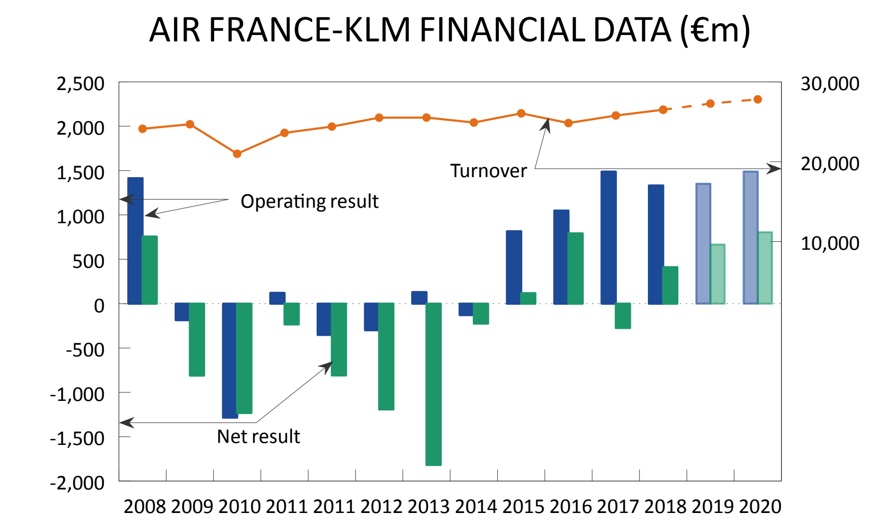
The results were severely impacted by a series of strikes at Air France through the year (which the management estimate cost something around €360m) and not helped by the (now usual) disruption of French ATC industrial action. At the results meeting the management also stated that it expected that the *gilets jaunes* civil unrest in France towards the end of the year cost it an additional €15m.

The previous ten years had also been troubled. Over that time the group achieved an average operating margin of 0.5% and lost a total €5.7bn at the net level. Still, KLM has been reasonably successful: it has registered operating profits since 2010 and achieved operating margins of 10% in each of the last two years. The problem has been at the larger Air France.

A new CEO, a change of culture?

In the first quarter of 2018 the former Chairman and CEO, Jean-Marc Janaillac, fell on his sword. He had tried to bypass the union leadership and appeal to the workforce directly to support the management proposals for renegotiated wage contracts. His brave attempt failed (see *Aviation Strategy* May 2018) and he resigned in May.

The Group board took its time to find a replacement but, remarkably, in August appointed British-born Ben



Note: IFRS 16 adopted 2018. Prior year figures have not been adjusted.

Aviation Strategy

ISSN 2041-4021 (Online)

This newsletter is published ten times a year by Aviation Strategy Limited Jan/Feb and Jul/Aug usually appear as combined issues. Our editorial policy is to analyse and cover contemporary aviation issues and airline strategies in a clear, original and objective manner. Aviation Strategy does not shy away from critical analysis, and takes a global perspective — with balanced coverage of the European, American and Asian markets.

Publisher:

Keith McMullan
James Halstead

Editorial Team

Keith McMullan
kgm@aviationstrategy.aero

James Halstead
jch@aviationstrategy.aero

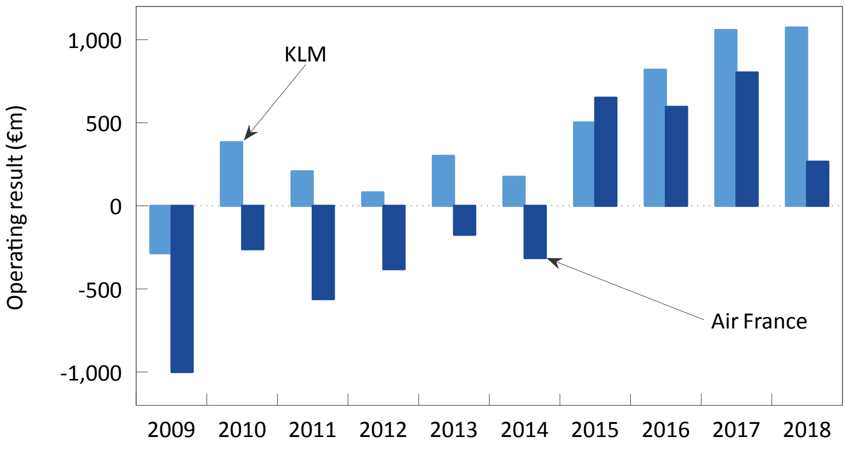
Tel: +44(0)207-490-4453

Subscriptions:

info@aviationstrategy.aero

Aviation Strategy Ltd
Registered No: 8511732 (England)
Registered Office:
137-149 Goswell Rd
London EC1V 7ET
VAT No: GB 162 7100 38
ISSN 2041-4021 (Online)

AIR FRANCE-KLM: NETWORK CARRIERS' PERFORMANCE



Smith, an industry professional with 20 years experience at Air Canada. Remarkable because he knows something about the airline industry, is not French and did not go to the Ecole Nationale d'Administration — and therefore is divorced from the French political establishment.

He has been tasked with three main priorities by the Group board of directors with the (modest) ambition to regain a sustainable position for Air France-KLM as the leading airline group in Europe: Re-establish meaningful social dialogue within Air France; Simplify and strengthen Group governance to support the Group's ambition; Develop a "go forward" strategy.

Social dialogue (tackling the unions)

The first task hasn't taken him long — but then one of his main achievements at Air Canada was the success of renegotiating contracts with *their* unions — but is surprising given the history of industrial conflict at Air France.

In October the group announced that Air France had signed collective agreements with most of the unions representing 75% of the workforce. In February the company, just before announcing its annual results for 2018, finally was able to announce it had reached a similar deal with the main pilots' union, the SNPL.

We don't know all the details, and the agreements almost certainly do not go as far as those reached by peers Lufthansa, British Airways or Iberia with their respective unions, but at least it is a starting point for future dialogue.

Importantly, while the agreements include backdated wage increases negotiated for the next few years, they appear to remove extreme restrictions on service flexibility, equality of treatment of Air France versus KLM operations and a revision of base wage scales for cabin crew which will create significantly greater flexibility for Air France in its operations. The company suggests the effects will be neutral on results through improved productivity.

Ben Smith stated that these negotiations had all been done under an umbrella of trust, respect and confidentiality.

One of the more sceptical analysts at the results meeting suggested

AIR FRANCE-KLM GROUP FLEET

	Air France	Joon	KLM	Martinair	Transavia	Air France HOP	KLM CityHopper	Group Total	Avg. Age	On order
A318	18							**18**	13.8	
A319	33							**33**	17.7	
A320	35	8						**43**	9.5	
A321	15	5						**20**	16.3	
737			49		77			**126**	9.8	
Total narrowbody	**101**	**13**	**49**		**77**			**240**	**11.7**	
A330	15		13					**28**	13.3	
A340	1	4						**5**	20.7	
A350										22
A380	10							**10**	8.1	
747			11					**11**	23.5	
777	68		29					**97**	12.5	
787	7		13					**20**	1.9	25
Total widebody	**101**	**4**	**66**					**171**	**12.1**	**47**
CRJ-1000						14		**14**	7.6	
CRJ-700						10		**10**	14.5	
E145						13		**13**	18.6	
E170						15	17	**32**	6.4	
E175										15
E190						11	32	**43**	8.0	
ATR 42/72						13		**13**	13.5	
Total regional						**76**	**49**	**125**	**9.7**	**15**
747-400F			3	1				**4**	19.0	
777-200F	2							**2**	10.3	
Total Cargo	**2**		**3**	**1**				**6**	**16.1**	
Group Total	**204**	**17**	**118**	**1**	**77**	**76**	**49**	**542**	**11.4**	**62**

to Ben Smith that “we have heard this before from your predecessor... what is different this time?”. The response that came was: “there were no press leaks”. So maybe for the first time Air France really has found the person to tame the unions.

Corporate governance

Regarding the second task, the Group had already separated the roles of Chairman and Group CEO after the departure of Janaillac. In February just before the release of the annual results, the Group announced that it would set up a new Group CEO committee — chaired by Ben Smith and composed of Pieter Elbers, CEO of KLM, Anne Rigail (new CEO of Air France) and Frédéric Gagey (CFO Air France-KLM) — to determine the strategic direction for all Group airlines and business units. The key goals as he sees it is to simplify and accelerate decision processes, and to maximise overall value for the Group and all its entities.

This at least is a start, but the Group governance still may fall short of the structures established at Lufthansa and IAG.

Ironically, given Smith’s comments about his negotiations with the Air France unions, in the weeks leading up to this announcement there were a series of press comments suggesting that the well-regarded Pieter Elbers would not have his position as CEO of KLM reconfirmed when his four year tenure expires in April. Apparently 25,000 of KLM’s 35,000 staff signed a petition of support for their CEO, and there were suggestions of strike action should he leave.

Even the Dutch Finance Minister, Wopke Hoekstra, voiced support for Elbers, and “had words” with his French counterpart Bruno le Maire (the Dutch Government still has a non-economic equity interest in the flag carrier for ownership and control reasons). If anything this highlights the continuing cultural differences between the two airlines.

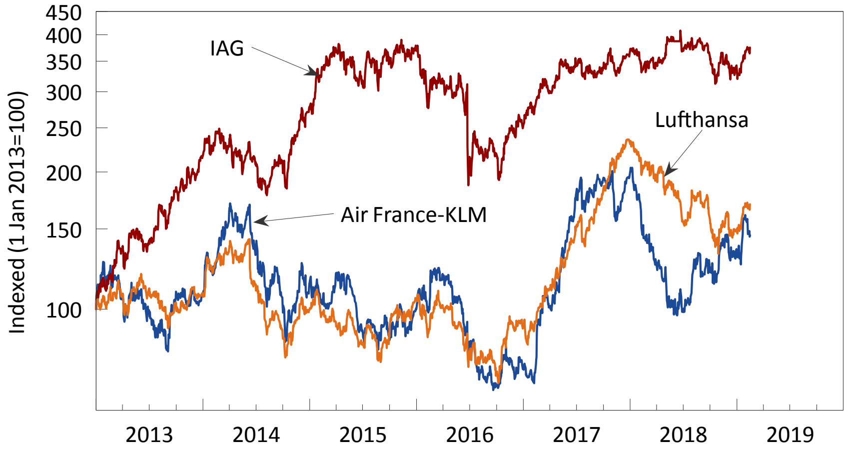
A “go forward” strategy

The third task may be more problematical.

Ben Smith outlined a handful of first initiatives: improving and simplifying Air France-KLM’s brand portfolio and product offer; simplifying and optimising the fleet; and, thirdly, “boosting our competitiveness”.

He has started on the simplification of the brand portfolio. As a first unsurprising move the Group is to scrap its ill-conceived Joon brand and reincorporate its operations within Air France. It only started operations in December 2017 at the Roissy CDG

EUROPEAN MAJORS SHARE PRICE PERFORMANCE



hub, and had built up to operate 17 A320/321s and four A340s to a handful of destinations. Apart from anything else the new cabin crew collective agreements allow Air France to achieve the cost savings originally envisaged at Joon through other means.

Secondly, it has removed the exclamation mark from its regional domestic subsidiary and added the main French brand to form Air France HOP. It operates a bewilderingly large number of aircraft types (see table on the preceding page) but at least has plans to phase out the ATRs in 2020. Not to say that it really makes sense continuing to operate this loss-making regional player under intense competition from the expanding TGV network, but maybe it is a start to winding it down.

That decision will be part of the conundrum of continuing to operate European point-to-point services that don't touch the main Air France hubs at Roissy CDG and Orly. The company in the past has insisted that these operations are essential to retain brand loyalty for corporate accounts, while not quite accepting that if they cannot be run profitably they may have no place in the network.

Air France regards itself as a premium airline, but has never really been at the forefront of inflight product development. It *has* started including the latest full lie-flat business class seats on new aircraft deliveries, but many of the older aircraft retain the uncompetitive 80 degree recline specification. Smith stated that the company is accelerating the retrofit of its fleet to the latest cabin standards — with the first A330 getting its makeover and a plan to retrofit the A380s in 2020. In contrast, KLM completed a full retrofit of its fleet last year.

Meanwhile, it will retain the mixture of subfleet configurations with "right-sized cabins and more efficient aircraft interior configurations to serve each market segment with appropriate gauge and product". The company also stated that it will, in some unspecified way, "simplify and strengthen the group's offer through network optimisation".

The fleet meanwhile, particularly at Air France, has been through a period in the last decade of relative underinvestment: and the group as a whole has no orders in place for its ageing A319s and A321s and only has orders in place for 26% of its long haul seat capacity.

The management also expressed the wish to simplify and optimise its fleet. In the short term the group is accelerating the expansion at Transavia with four new 737s planned for delivery in 2019, and will take delivery of six 787s and three A350s in the current year. It had already announced that it will hand back five of its A380s on the expiry of their leases (the other five in the fleet are owned), while the last remaining four A340s will be phased out in 2020 and KLM's 747s in 2021. It said that it would launch a tender offer for replacement of the medium haul fleet in the current year.

Boosting competitiveness

In his presentation at the results conference, Ben Smith pointed out that this strategy of upgrading and simplifying the product offer and optimising the fleet is all aimed to reinforce the group's competitiveness. He also expressed further aims to achieve Air France profitability and increase its margin to industry standards; improve operational robustness, reducing fleet constraints and adding spare aircraft at Air France; control infrastructure costs, improve the relationship with Aéroports de Paris and Schiphol; and in Europe, continue to campaign for the implementation of conditions for a level playing field. This all sounds good, but may be no more than an expression of hopeful wishes.

The prime ambition the Board has thrown to the new CEO is to regain a sustainable position for Air France-KLM as the leading airline group in Europe. But if the Board were truly thinking commercially, would the target not be to match IAG's share price performance.

Alliances: What the Competition Authorities are really looking at

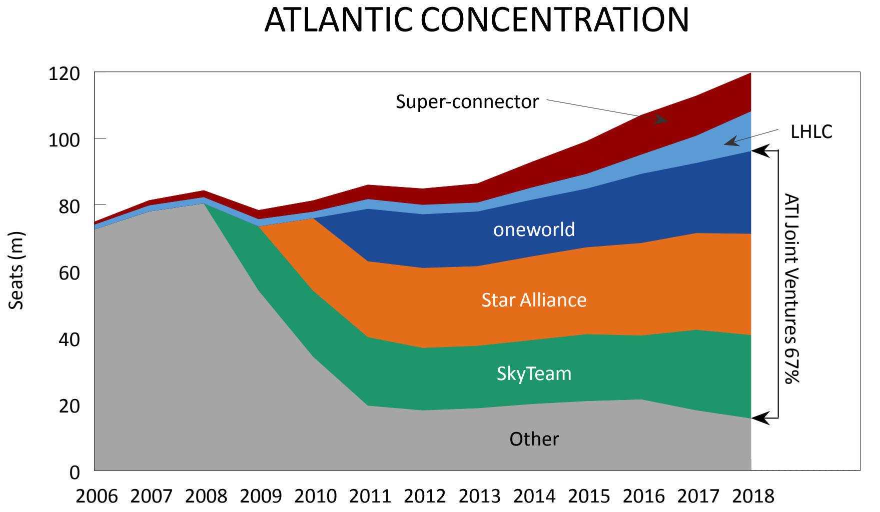
FOR SOME time now the approval of airline joint ventures by competition authorities throughout the world has become almost routine. Such joint ventures allow airlines to co-ordinate (some may prefer 'collude in') their operations on specified routes, including pricing, scheduling and capacity. In most jurisdictions collusion between companies is *prima facie* illegal, so any airline joint venture is almost invariably closely examined by the appropriate competition authorities.

They will consider whether any restriction on competition is against the overall interests of consumers, and if it is, they will seek ways to minimise such problems. This usually involves ensuring free market access for competitors, for example via an open skies bilateral agreement. If market access is still limited, perhaps because of slot shortages at capacity constrained airports, the authorities will often insist on the applicant carriers making slots available to potential competitors. There may also be other requirements before approval is granted, such as access to frequent flyer programmes or special prorate arrangements, designed to enable new entrant airlines to compete effectively against dominant players in the market.

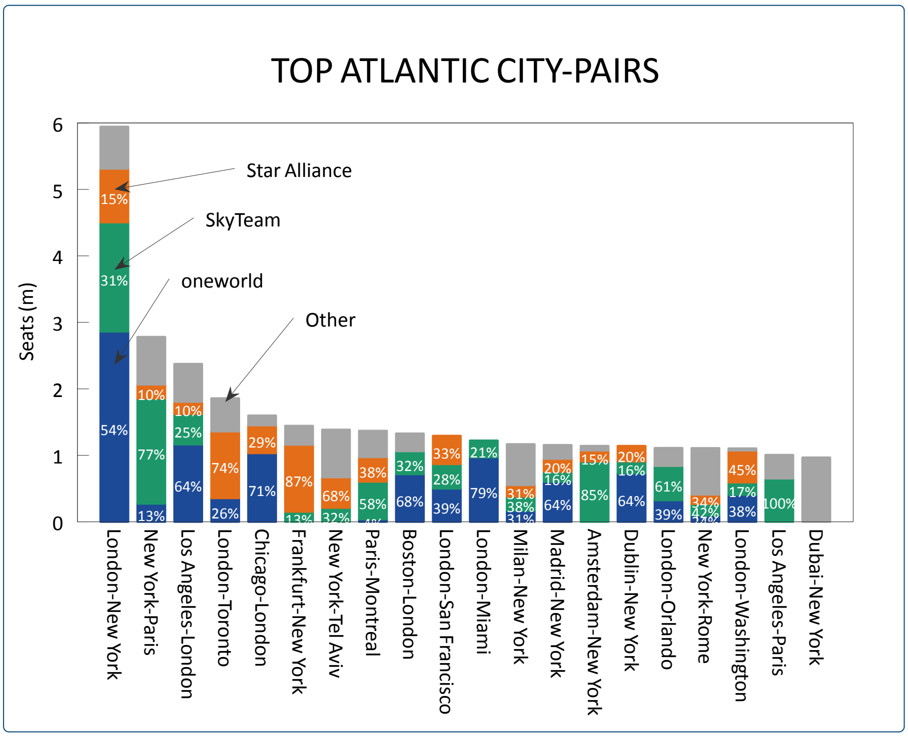
This approach has not been without its challenges, and some would argue that an alternative policy is needed. In particular, the dominance of the joint venture partners on the routes identified as presenting competition problems has often meant that new entrant carriers have struggled to survive, or have even been put off from entering the market in the first place. In at least one case the European Commission insisted that the applicant airlines actually found a competitor on a key route before approval could be given to their joint venture. Clearly this is far from a perfect solution and there are signs that the Commission is considering an alternative approach, although it is too early to judge whether this will be possible legally or any more successful.

Nevertheless, the process outlined above remains the way in which airline joint ventures obtain approval for what otherwise would be illegal activity. It is a well-trodden path with which airlines and their advisers are familiar. But it was far from always so. In particular, the original application by British Airways and American Airlines for anti-trust immunity for their trans-Atlantic alliance ran into serious problems, despite initial support from the UK and US Governments. Fierce opposition from Virgin Atlantic and others (remember 'No Way BA/AA!') and a number of miscalculations by the applicants resulted in demands for slot concessions at Heathrow which BA/AA could not accept.

A later application again ran into problems and again ended with the competition authorities demanding that a large number of Heathrow slots should be surrendered to competitors. It was only in 2009, some 13 years after the original application, and after the signing of the EU/US trans-Atlantic open skies agreement, that approval was finally given at a price acceptable to the applicants. The European Commission found that six routes were of concern from a competition perspective: London to Dallas/Fort Worth, Boston, Miami, Chicago and New York and Madrid



Note: Super-connectors include Emirates, Qatar, Etihad and THY.



to Miami. The US authorities went along with this conclusion.

It is worthwhile listing the slot concessions made by BA and American, as recent press reports have not been accurate. Initially Delta received two pairs of Heathrow daily slots from BA and one pair from AA, which it used for twice daily Boston and daily Miami services from summer 2011. Neither route proved to be as successful as Delta had hoped and the following year it handed back the Miami and one of the Boston pairs. For summer 2013, it took another pair of slots from BA to be used for a service to Atlanta and for summer 2015, it got a pair from AA (under a separate approval for the merger between American and US Air) for a route between Heathrow and Philadelphia.

Interestingly, after three years the Philadelphia slots revert fully to Delta, available to be used on any route, whereas the slots received under the BA/AA approval are time-limited and tied to individual routes. Despite its fierce fight against the BA/AA alliance, Virgin Atlantic initially didn't apply for any slots. However, it did receive one daily pair from AA for use on the Heathrow-Miami route from summer 2015. This was obtained when BA and AA sought to extend their joint venture to include Iberia and Finnair, with the alliance now called the Atlantic Joint Business Agreement (AJBA).

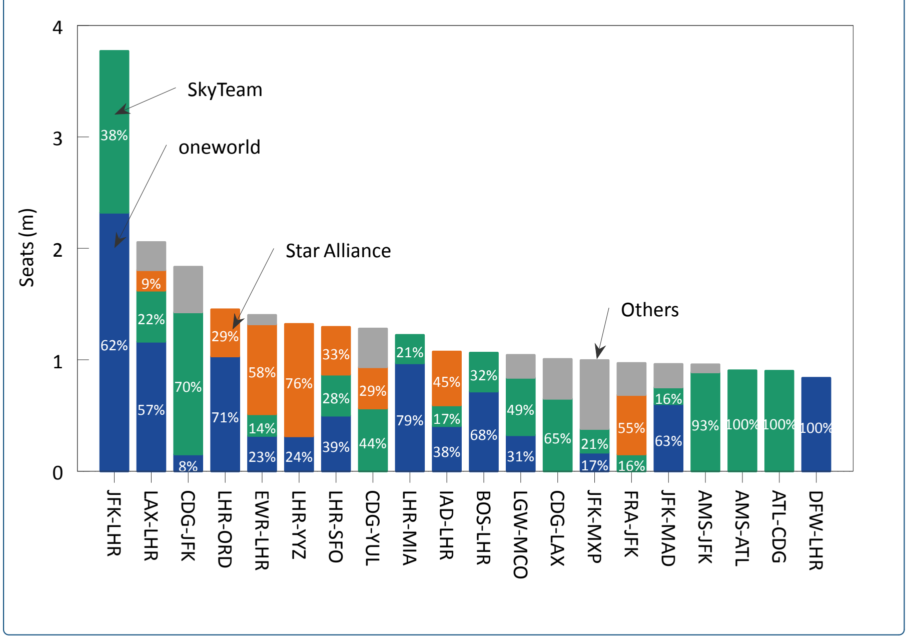
Norwegian obtained slots for one day per week for use on a Gatwick-Boston service in summer 2016. (Under the remedy settlements, airlines were required to do their best to get slots from the pool, so it is probably a reasonable assumption that Norwegian were able to obtain suitable slots for all or most of the other days in order to mount a competitive service. Note also that these slots were for Gatwick, while the competition problems identified related to Heathrow routes. This appears to be the first time that a city-pair rather than an airport-pair approach was adopted, which could be significant for future alliance anti-trust applications.) For summer 2018, Norwegian separately obtained slots for two services per week between Gatwick and Boston. It seems that the ten-year approval period will run out in 2020, despite more recent amendments to the AJBA joint venture. The free slots will then have to be handed back to BA and AA, unless further remedies are applied by the competition authorities.

The announcement in October 2018 that the UK Competition and Markets Authority (CMA) planned to carry out an investigation into the AJBA generated extensive coverage in the press. There were specific reasons for this, including the mooted take-over of Norwegian by IAG (IAG has now abandoned this project and is disposing of its small shareholding in Norwegian) and the implications of Brexit (more on this below). However, it is equally the case that the CMA review could be regarded as routine, with the previous ten-year approval period coming to an end, and in the absence of significant market or other changes the joint venture could reasonably be expected to be approved, probably with a continuation of the current slot concessions.

Anything significant changed?

The key question, therefore, is whether anything significant has changed since the 2009 decision which might result in a different conclusion by the competition authorities, whether in London, Brussels or Washington. The answer is that there may indeed be cause for concern on the part of the applicants. The chances of a simple rubber stamp certainly seem unlikely.

Let's first of all consider the three issues which attracted most attention at the time of the CMA announcement. Firstly, there is no reason to assume that the authorities



TOP ATLANTIC ROUTE PAIRS

will be any less concerned about competition on North Atlantic routes. The market is still dominated by the three major airline alliances and airport congestion is no less of a problem. In particular, despite government commitment to a third runway, additional capacity at Heathrow is several years away and far from certain to be built. At the same time, Gatwick (and even Stansted at peak periods) is filling up fast. Admittedly Virgin Atlantic is now closely tied to Delta and other Skyteam members, with its own application for anti-trust immunity recently approved by Brussels, and is unlikely therefore to object to an AJBA application anything like as rigorously as before. But ironically, that could be a double-edged sword.

Secondly, the suggestion that by intervening so early in the process the CMA was sending some form of signal to IAG about a possible take-over of Norwegian seems unlikely. ("The competition regulator appears to have warned the owner of British Airways against attempting a takeover of Norwegian by launching an investigation into the conglomerate's power in the transatlantic market," as *The Times* put it.) This is not the way competition authorities work.

The fact is that IAG did not control Norwegian and its then 4.6% shareholding was very unlikely to have raised any competition concerns. However, this does not mean that were IAG to have made a formal bid, there would not have been a referral to the CMA. Such a combination would clearly have significant implications for competition across the Atlantic and possibly elsewhere as well, with Norwegian already, for example, carrying more passengers between Europe and New York than BA does.

Thirdly, as ever Brexit looms in the background and almost certainly here lies the explanation for the timing of the CMA's intervention. As the Authority said itself: "To prepare for the time when the European Commission may no longer have responsibility for competition in the UK, the CMA has decided to review afresh the competitive impact of the agreement in anticipation of the expiry of the [slot divestiture] commitments." In the absence of a Brexit withdrawal agreement, EU competition law will no longer apply in the UK from as early as the end of March. If there is a deal, the UK will continue to be subject to EU law until the end of 2020, so even then any implementation of new commitments by the applicant carriers would require UK involvement.

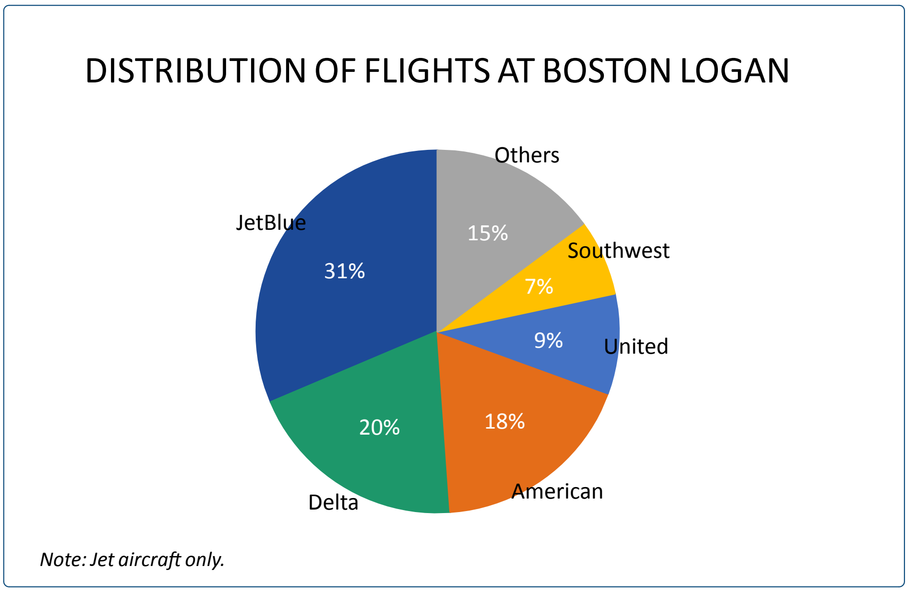
The European Commission may decide to carry out its own investigation in addition to the CMA's given the broader European coverage of the alliance application. Indeed, it would be surprising if it did not do so, although there is likely to be a degree of co-operation between Brussels and London, even in a post-Brexit world. The US authorities are similarly likely to intervene. (Adding to the uncertainty, of course, is the lack of clarity about the Trump Administration's attitude to competition policy generally, which not surprisingly seems to be following a more ad hoc approach rather than the established policies of its predecessors.) The important point from the perspective of the outcome of any CMA review, however, is that Brexit will not make any real difference. The UK has committed to continue to pursue competition policies effectively identical to the EU's, at least in the immediate future.

Competition authorities, whether in the UK, EU or US, will inevitably apply the appropriate law. But the officials involved are only human and it should not come as a surprise that they are likely to investigate an application with more rigour if they are under external pressure to do so. (An element of competition between the various bodies does no harm either.) This was illustrated by Sir Richard Branson's fight over many years to prevent approval of the BA/AA alliance, a success which surprised most observers (including, it has to be said, many in Virgin). With the apparent support of the UK Government and the desire of the US to replace the hated Bermuda 2 bilateral air services agreement with an open skies deal (a requirement for US airline anti-trust immunity), few expected any serious obstacles in the way of approval for the joint venture.

The high-profile campaign launched by Branson and backed by significant resources ensured that approval was delayed for some 13 years, and when it did come it still had a relatively high price (albeit lower than the previous two tentative approvals) in the form of slot divestitures. Despite complaints from consumer groups, there has not been another campaign on a similar scale against an airline joint venture since Virgin's, at least until now. If such a campaign were to emerge, it could have serious consequences for all trans-Atlantic alliances. It appears that this is now a distinct possibility. The new player threatening to disturb the status quo is US (relatively) low cost carrier Jetblue, which like Virgin Atlantic in earlier years, has resisted any temptation to join one on the three main alliances, preferring to co-operate via code shares with a large number of foreign airlines serving the US.

The JetBlue case

Two factors in particular seem to be influencing Jetblue's new involvement in competition cases. First, it has announced an interest in operating trans-Atlantic services in its own right, probably primarily from Boston, with new narrow-bodied Airbus 321LR aircraft when they become available. However, it appears to have concluded that in order to do so profitably, access to the principal European gateways is required, which means in particular getting hold of slots at Paris Charles de Gaulle and especially Heathrow. These are expensive, if they can be obtained at all, unless the competition authorities can be persuaded to force the dominant carriers at these airports to hand some over to new entrants for free.



Note: Jet aircraft only.

At the same time, JetBlue's position in the Boston market has come under increased competitive pressure from Delta. JetBlue accounts for 31% of jet aircraft departures from Boston Logan Airport, far more than any other carrier. American has about 18% and Delta just under 20% of flights, but critically Delta's presence at the airport is growing rapidly. Boston is one of two markets identified by Delta outside of its core hubs for significant additional investment. The city has been described as JetBlue's star performer, with the highest margin among the airline's main focus cities.

The impact of Delta's expansion at Boston is already being felt and the situation is likely to get worse during 2019, with the legacy carrier launching a number of new domestic routes, mostly to cities already served by JetBlue. In addition, it is expanding its international services from the city, both in its own right and in co-operation with joint venture partners. According to CAPA, as JetBlue works towards its immediate goal of 200 daily Boston departures, increasing the number of gates controlled from 24 to 30, Delta and its partners will operate 152 departures in 2019.

JetBlue is certainly well established in the Boston market, having served the airport now for some 15 years, and is well regarded, especially among business travellers with its Mint premium product. On the Atlantic, assuming it maintains its current aircraft configuration, it will offer significantly more leg room in Economy than the legacy carriers and a business product superior to Norwegian's. But Delta has the advantage of its sheer overall size and international experience and network, important factors with corporate customers in particular.

Boston is not the only city where Delta has proved to be a problem for JetBlue. The low-cost carrier has struggled to establish itself at Atlanta, where Delta is the dominant airline by a wide margin. According to JetBlue's Chief Executive Robin Hayes, JetBlue has been forced to operate its ten daily flights "over gates spread over two different concourses.... One airline has control or rights to 147 of the airport's gates. That's more than 75% — while JetBlue is not able to lease a single gate. Literally not one."

This is the background to JetBlue's objection in November to the application to the US Department of Transportation by Delta, Virgin Atlantic and Air France for anti-trust immunity for their trans-Atlantic joint venture. The objection follows a successful intervention in a similar application by Delta and Aeroméxico in 2016. Hayes commented that JetBlue was "delighted" when approval was limited to just five years, with slot divestitures required at Mexico City Airport. JetBlue was a beneficiary of these slots. Speaking at the Wings Club lunch in New York, Hayes remarked that "the Mexico City decision is a great template to follow when airlines seek to link up and it's something we urge governments around the globe to consider more aggressively."

JetBlue has argued that the Delta/Virgin/Air France joint venture will "restrict competition on both sides of the Atlantic" and has encouraged the DOT to carry out a comprehensive analysis of the slot allocation implications. It says that combining Delta, Virgin Atlantic and Air France into a "massive single entity, with all of their slots collectively pooled" would "further restrict JetBlue's ability to meaningfully serve the United Kingdom and European Union markets." There is a certain irony in these arguments being employed against Delta and especially Virgin Atlantic, both of whom made a very similar case against the BA/AA alliance.

So far JetBlue's attention has been focused primarily on the activities of Delta and its partners, but it is unlikely that the opportunities created by other anti-trust immunity applications, such as that by the Atlantic Joint Business Agreement, will have escaped its notice. Applications involving a UK airline in particular will raise the prospect of free slots at Heathrow, and perhaps gain other marketing benefits as well. As Hayes has commented: "We have to offer competitive schedules at airports like Heathrow when people will want to fly. We continue to work on that."

It seems likely, therefore, that airline joint venture applications can expect to be challenged more than they may have been in the recent past. No doubt the proponents and objectors will argue their different cases about the consumer benefits of these alliances, but one conclusion is clear: the lawyers will be busy.

Barry Humphreys

(Dr Barry Humphreys is an aviation consultant. As Director of External Affairs and Route Development at Virgin Atlantic between 1995 and 2009, he led the airline's campaign against the BA/AA alliance.)

Nordic noir aviation: Wow, Icelandair and Norwegian

ICELANDAIR was one of the most important factors in Iceland's remarkable recovery from the financial crisis, in which its banking sector played a disproportionately large and dangerously speculative role. Icelandair developed a 24-hour hub operation at Keflavik Airport (KEF), introducing a new competitive element to the oligopolised Atlantic market. The national carrier enjoyed a period of rapid growth and good profitability during 2014-16.

But in 2015 Wow appeared on the hubbing scene, operating new A320/321s with a pure LCC product concept and with an almost identical connecting strategy to Icelandair (its waves typically scheduled an hour after Icelandair's), owned and headed by the dynamic, triathlon-running, telecom entrepreneur Skúli Mogensen. Wow presented itself as no-frills and trendy, targeting European and American Millennials, and "providing lower prices than anyone else flying across the Atlantic". Icelandair, flying 757s and 767s, is more traditional, offering some frills and better seats, appealing to a wide demographic, particularly older, richer vacationers, with moderately priced tickets.

Traffic flows over KEF are very seasonal with a pronounced summer peak, and it is clear that the airport and ATC are struggling to cope with the two hub systems. For example, Icelandair's ontime performance fluctuates around the 80% during the low season but in the high season it collapses — in July and August last year it was 55% and 64%, in June a remarkable 39%. Icelandair estimates that IRROPS (irregular operations) cost $45m in 2018, or 80% of its total operating loss.

Conventional aviation wisdom states that two near-identical hub systems, in KEF's case funnelling traffic between Europe and America, cannot work at the same airport for logistical and economic reasons (one exception might be United and American at Chicago, but O'Hare is a domestic mega-airport). Icelanders, it must be said, appear to delight in challenging conventional wisdom — the country, population 334,000, accumulated nearly $200bn in foreign debt during its financing boom in the mid-2000s, but that ended in a spectacular bust and a bailout from the IMF.

According to its own analysis, 78% of Wow's capacity overlaps with Icelandair's. Back in 2017 (August edition), we posed the question: Can Icelandair live with Wow?

Wow's financials were opaque then, but it seemed that it must have a substantial cost advantage over Icelandair, which would normally prove decisive. In fact, Wow's operating unit cost (CASK), as revealed in the bond prospectus issued last summer, was about US¢4.3, less than half of Icelandair's US¢8.8. But low operating costs were not enough; Wow's unit revenue, including ancillaries, (RASK) was about US¢4.6, against US¢9.3 at Icelandair.

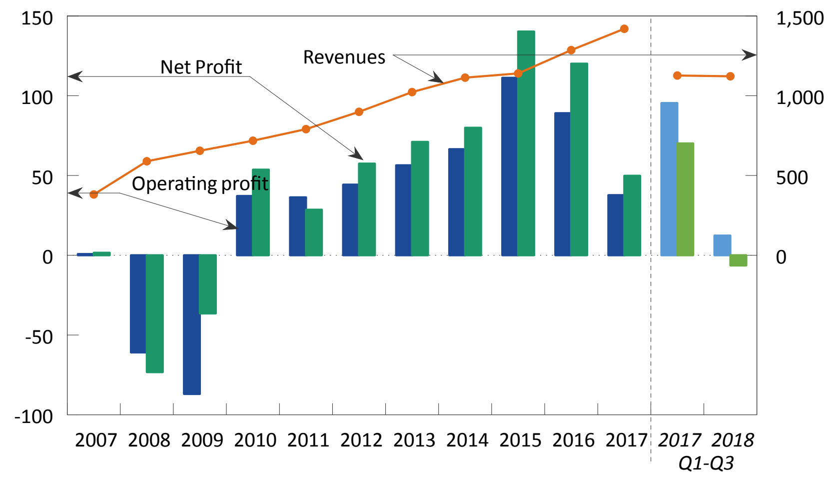
While Wow grew exponentially, Icelandair also continued to grow albeit at a more modest rate. Both

ICELANDIC TRAFFIC FLOWS
(Pax millions from/to and via KEF)

	2015	2016	2017	2018	Change 2018/2015
Icelandair					
From	0.4	0.4	0.5	0.5	38%
To	1.0	1.2	1.5	1.5	55%
Via	1.2	1.5	2.1	2.1	69%
Total	2.6	3.1	4.0	4.1	59%
Wow Air					
From	0.2	0.4	0.5	0.5	131%
To	0.4	0.7	1.0	1.1	172%
Via	0.1	0.6	1.3	1.7	1,649%
Total	0.7	1.7	2.8	3.3	371%
Total Icelandic					
From	0.6	0.8	1.0	1.0	69%
To	1.4	1.9	2.5	2.6	89%
Via	1.3	2.1	3.4	3.9	186%
Total	3.3	4.8	6.8	7.4	125%

Note: Wow 2018 partly estimated

ICELANDAIR FINANCIAL RESULTS (US$m)



carriers suffered the financial consequences of over-expansion, turning Icelandair from a profitable to a loss-making company and pushing Wow to the edge of bankruptcy.

The table on the preceding page summarises the traffic trends by segment. The two carriers' combined passenger volumes more than doubled from 2015 to 2018 to 7.4m pax. Their combined connecting traffic (the "Via" segment) almost trebled to 3.9m pax. For comparison, Norwegian the low-cost long-haul pioneer, with its 787 point-to-point operation, carried an estimated 4.6m pax on the Atlantic in 2018. Aer Lingus, the lowest cost Legacy, carried around 2.6m.

The Wow factor

Icelandair's unaudited financials for the year 2018 show the Wow factor. Although revenues increased by 7% to $1.5bn, a loss of $57m were recorded at EBIT level (a profit of $50m in 2017). The pre-tax loss was $68m compared to a profit of $38m the previous year.

It has been protected by a reasonably solid balance sheet. Shareholders' equity at the end of 2018 was $471m against total liabilities of $992m. Cash was a comfortable $300m (thanks to aircraft refinancing, see below).

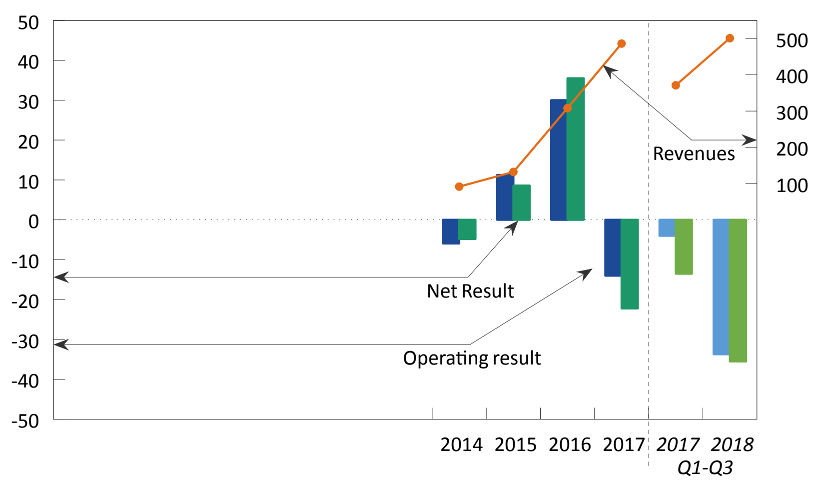
Wow's financials for the first nine months of 2018 were much worse. Total revenue grew by 35% to $501m, but a marginal operating profit in 2017 turned into a loss of $19m. From the data presented in the bond prospectus it looks as if Wow will have accumulated $50m loss at the EBIT level for 2015 through 2018. At the net level, Wow's loss for the nine months was $34m against a $13m loss the previous year,

Its balance sheet is very weak: at the end of September shareholders' equity of $27m against total liabilities of $393m. Cash was $41m, rescued from practically zero by a bond issued in September 2018.

Wow raised €60m through this bond issue, which officially was supposed to help prepare the airline for an IPO in 2020. But the interest rate attached to the 3-year bonds — in effect 9% pa, plus options to convert to shares — indicated investors' increasing concerns about the carrier, concerns which were underestimated.

That funding proved to be inadequate, and Wow, under pressure from lessors and other creditors, was obliged to seek a merger with, or rather a takeover by, Icelandair. In early November Icelandair came to agreement to buy out Wow at a price equivalent to 2-6% of Icelandair's stock value (currently $330m in total, having fallen over 50% over the past 12 months). The transaction, however, was contingent on various conditions relating to the satisfactory completion of due diligence. These

WOW AIR FINANCIAL RESULTS (US$m)



ICELANDAIR ROUTE MAP

conditions, for unclear reasons, were not met, though the suspicion was that the due diligence uncovered further financial problems, and Icelandair abandoned its offer at the end of November.

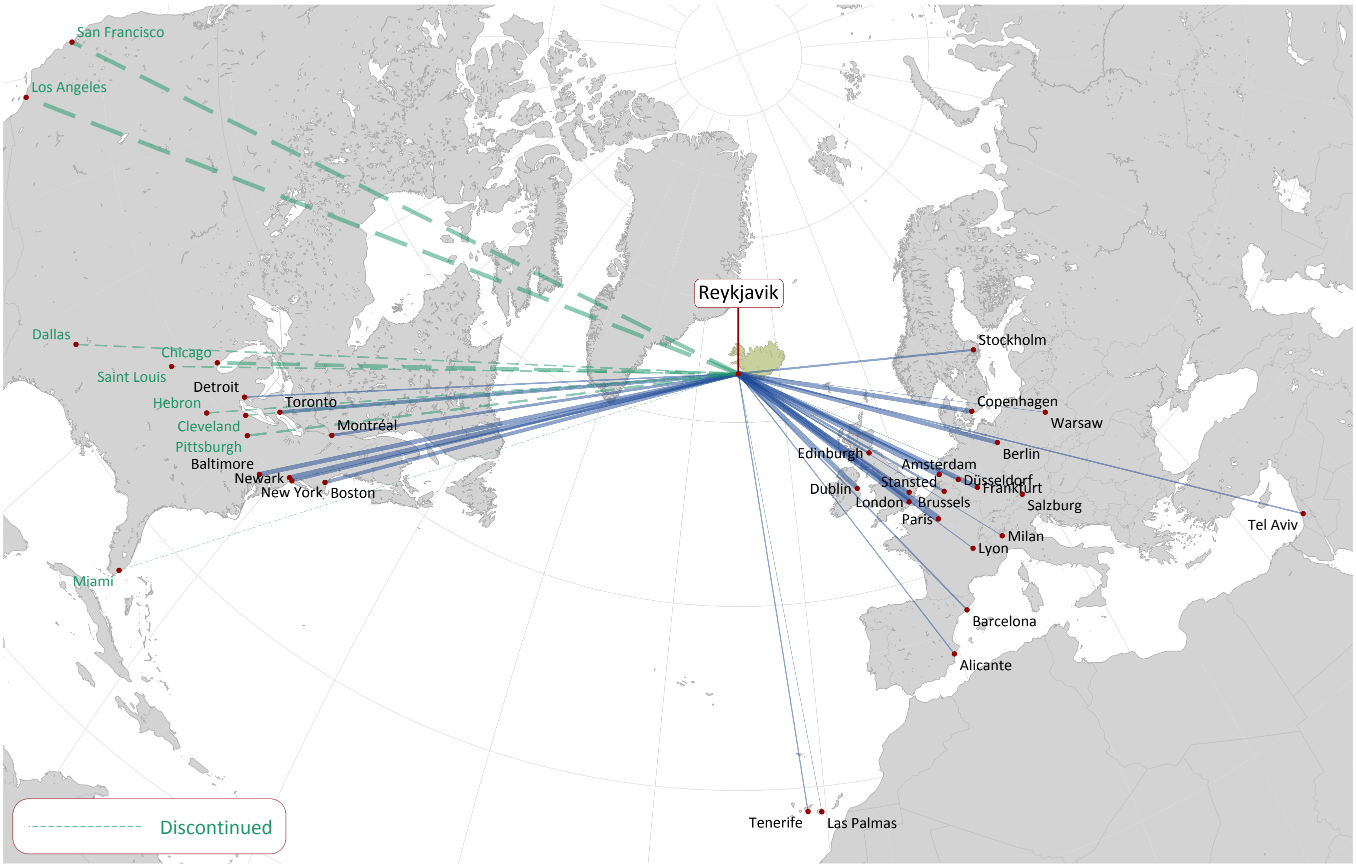
Almost immediately Indigo Partners — the private equity airline specialist company headed by Bill Franke (see *Aviation Strategy*, February 2018) — stepped in with an offer to invest in Wow and turn it around. However, the offer is provisional, and the sums involved are yet to be determined. Wow itself states:

"Should the investment be completed as planned, the actual investment amount will depend on the capital needs of the business through the turn-around of Wow. Indigo Partners intends to ... adequately capitalize Wow through the turn-around as they have done before with other successful aviation investments they have made. Indigo Partners has repeatedly demonstrated that they are long-term and patient investors, for example with their investments in Wizz (14 years), Volaris (8 years) and Frontier Airlines (5 years).

"When concluded, the investment will primarily be in the form of a convertible loan with a 10-year maturity, whereby annual interest will be, at Indigo Partners' election, payable in kind or in cash on an annual basis. The principal and all accrued interest will be payable at the loan's maturity. The initial shareholding of Indigo Partners will be 49%."

Indigo's rationale for investing in Wow is not as clear as at its other airlines — Wizz Air, Frontier, Volaris (Mexico and Costa Rica) and new Chilean start-up JetSMART — which

WOW AIR ROUTE MAP



are short-haul, point to-point ULCCs, modelled to differing degrees on Ryanair.

Wow presents a new set of challenges. It would be Indigo's first venture into low-cost long-haul and its first into a designed connecting hub operation, which because of its complexity and peakiness is more labour-intensive than a typical LCC. For example, by mid-2018 Wow's workforce had soared to 1,400 (from 290 in 2015) — 70 personnel per aircraft whereas a Ryanair-type target ratio would be in the low 30s.

More fundamentally, to succeed and expand Wow would have to be able to win in another battle against Icelandair, to become the dominant or sole hubbing airline in Iceland.

However, Wow's stated strategy is now the opposite of expansion: in December it announced a fleet restructuring whereby it will almost halve its fleet from 20 units to 11, all A321s, with the three A330s and the other A320 Family aircraft being returned to lessors. Staff numbers are being cut by 40% to around 1,000.

By contrast, Icelandair has confirmed that it will take six new 737 MAXs scheduled for delivery this year and another five in 2020. It aims again to increase capacity (ASKs) by 10% this year, mostly through increasing schedules to/from Europe while leaving American capacity at current levels, the idea being to rectify an imbalance in seats offered to/from the two continents. The precise target for 2019 passengers is 4.66m, 13% up on 2018. Icelandair has actually used the fleet expansion to improve its liquidity: funds raised from financing the new aircraft significantly exceeded its own funds expended on PDPs, leaving the airline with a surplus of $160m, which explains why the airline's cash balance improved to $300m at the end of 2018 from $221m a year previously.

The final form of Indigo's investment in Wow, if indeed it materialises, is expected fairly soon, at which point Indigo's plans for Wow may be unveiled. Interestingly, there is an Indigo connection that predates the current proposed investment. Ben Baldanza, from 2005 to 2016 CEO of Spirit Airlines, the Florida-headquartered ULCC, and probably the most successful investment by Indigo, is also on the Board of Wow.

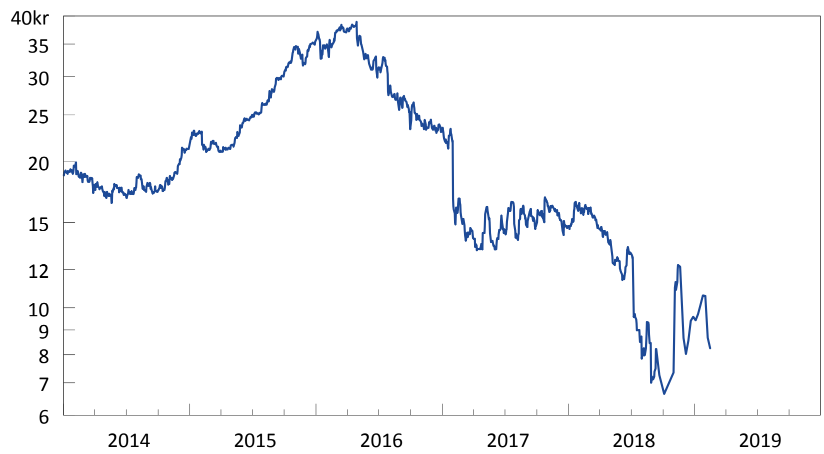
Could some form of A320 fleet sharing plan between Wow and other Indigo carriers, which would help solve Wow's seasonality issues, be an option?

And Norwegian

Continuing the Scandi-noir aviation theme, Norwegian's 40% capacity growth in 2018 resulted in a pre-tax loss of $300m on revenues of $4.8bn. Its balance sheet is precarious: shareholders' equity of $200m against total liabilities of $8.3bn. Then there are 190 aircraft on firm order with a theoretical capex totalling over $10bn.

Following the termination of IAG's interest in acquiring the carrier and the disposal of its 4% stake, the short-term solution for Norwegian is a discounted rights issue designed to raise about $350m. The rights issue is underwritten by John Fredriksen, a shipping magnate who was Norway's richest man until he decided to become a Cypriot national.

ICELANDAIR SHARE PRICE PERFORMANCE



However, it is probable that the funds will be insufficient to see Norwegian through this year, unless the market turns in its favour. Depending on whether Wow continues in its downsized form or goes out of business 0.6m to 1.5m pax (these figures are adjusted for Icelandair's planned growth) will be taken out of the low cost transatlantic market. With Norwegian carrying about 4.6m pax across the Atlantic this development might be key to whether Norwegian survives. It would take some pressure off Norwegian's unit revenues, maybe giving it the chance to restructure its network and fleet, and raise further funds through the sale of its leasing operation to a Chinese investor.

Avianca: United in Synergy

RECENT months have seen notable developments involving Synergy Group's Avianca brand airlines that have drawn global attention, may aid Latin American airline recovery in 2019 and could even lead to structural change in the sector.

First, on November 30, United Airlines, Colombia's Avianca and Panama's Copa announced a three-way joint business agreement (JBA) on US-Latin America routes (excluding Brazil), for which they plan to seek antitrust immunity. The three airlines were already Star and codeshare partners.

Second, in conjunction with the JBA, United agreed to provide a $456m term loan to Brazil's Synergy Group, the controlling shareholder (through Panama-based Synergy Aerospace Corp) of Avianca's parent Avianca Holdings (AVH).

Third, on December 11, Avianca Brasil filed for the Brazilian equivalent of Chapter 11 bankruptcy (known as "Judicial Recovery") in response to lessors seeking to repossess 30% of its fleet. Avianca Brasil is Brazil's fourth largest airline, 100% owned by Synergy Group and not part of Avianca Holdings.

Fourth, on December 13, Brazil's outgoing president Michel Temer signed a temporary decree allowing 100% foreign ownership and control in Brazil's airlines (which Congress must approve within 180 days). The move came after almost a decade of attempts to lift the previous 20% limit.

So what are the implications for Avianca, Avianca Brasil and the Latin American aviation scene?

Colombia's Avianca secured the strategic partner it had long sought and now looks certain to be a long-term survivor and perhaps even an A-list player — especially if it can reach agreement with Airbus and lessors to restructure its order book.

United will get its first immunised JBA on US-Latin America routes. The deal will balance the line-up that already includes American-LATAM and Delta-Aeroméxico. It should help facilitate better capacity management in the region.

However, obtaining regulatory approvals for the JBA from 20 countries is likely to take at least 18-24 months.

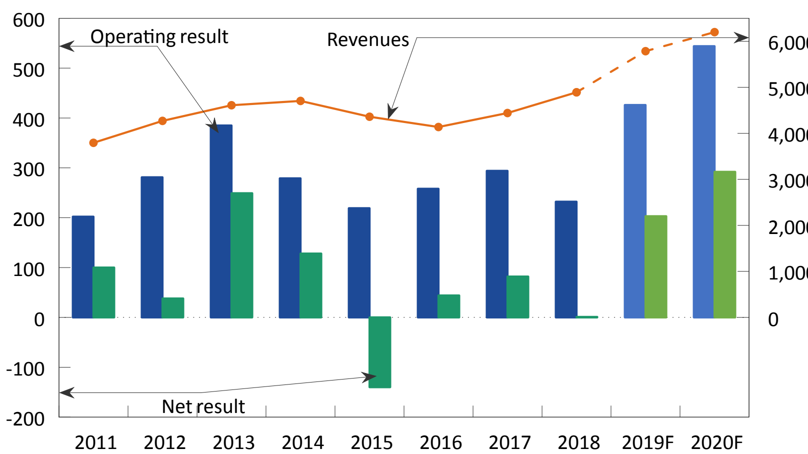
Avianca will not receive any funds at this stage, because Synergy will use the United loan to pay off earlier borrowings from New York-based hedge fund Elliott Management, for which it had pledged its Avianca stake as collateral.

But the United loan is also secured by Synergy's stake in Avianca, and Synergy has the option to pay part of the loan back in AVH stock, which raises the interesting prospect of United ending up with a stake in or even control of Avianca. It would not be a bad outcome for United in light of Latin America's enormous long-term potential. Some would also see it as a positive for Avianca, because it would lead to better corporate governance.

The JBA signatories will have to decide how to include Brazil in the partnership. Will Azul and Avianca Brasil be drawn in? Or will United seek a separate immunised JV with Azul for the US-Brazil routes?

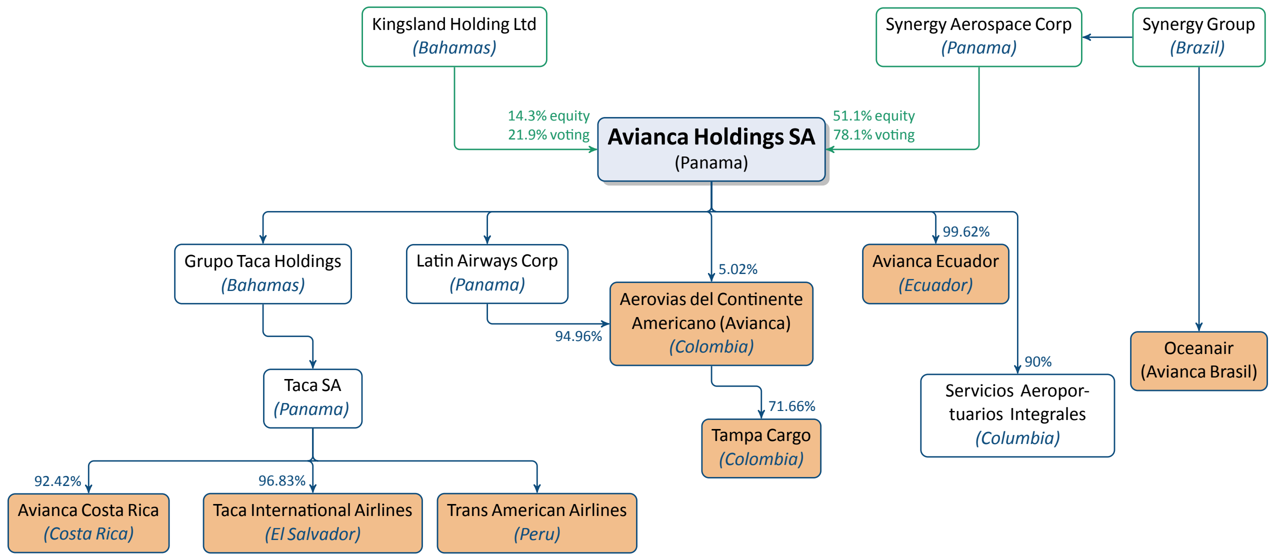
Having already downsized and returned some aircraft, Avianca Brasil is now focused on preventing further repossessions, securing new funds and getting a reorganisation plan approved by creditors at a meeting scheduled for early April. Beyond survival, the key questions are: How

AVIANCA HOLDINGS FINANCIAL RESULTS (US$m)



Note: Forecasts by Bradesco BBI (Dec 3, 2018)
Source: Avianca Holdings annual reports

AVIANCA HOLDINGS STRUCTURE (2018)



** Principal subsidiaries; excludes regional airlines and numerous other small subsidiaries.*
Source: Avianca Holdings 2017 annual report filing (May 2018).

much will Avianca Brasil downsize in bankruptcy and who will benefit the most? Will Azul or United acquire a restructured Avianca Brasil and merge it with Azul, thus consolidating Brazil's airline sector from four to three main players?

At this stage it seems unlikely that another foreign airline buyer for Avianca Brasil would emerge, despite ownership in Brazil's carriers being wide open to outsiders. One thing seems certain: it is only a matter of time before Delta and United increase their stakes in GOL and Azul, respectively (currently 9% and 8%).

The JBA and United loan

Avianca officially began to look for a strategic partner in mid-2016 and received three offers. But Synergy did not want to give up control, which ruled out two of the bids (from Delta and Copa).

The subsequent negotiations with United for the JBA/loan were a difficult and long-drawn out affair. There was a lawsuit from Avianca's minority shareholders seeking to block a deal with United as "egregiously one-sided" (settled in late 2017). Synergy's attempts to integrate Avianca Brasil into Avianca Holdings, as well as its search for a cash injection into Avianca Brasil at the same time as negotiating a loan for Avianca, evidently also complicated things.

The two airlines are legally separate, but Avianca licences its brand to the São Paulo-based carrier (whose official name is Oceanair). The two Efromovich brothers who own Synergy, Germán and José, act as chairmen of Avianca Holdings and Avianca Brasil, respectively.

Although Synergy has a controlling stake in Avianca Holdings (51% of total shares and 78% of voting rights) and minority investor Kingsland Holdings (the Kriete family, former owners of TACA) has 14% (with 22% of the votes), the latter has veto powers over strategic decisions (and has used them to block decisions such as bringing Avianca Brasil into AVH).

The terms of the $456m loan from United to Synergy and the details of the separate agreement between United and Kingsland are worth noting because they outline multiple paths for United to potentially become a part or full owner of AVH.

The loan bears interest at 3% annually and is payable in five annual instalments from 2021 to 2025. Synergy may pay up to 25% of any instalment in AVH shares. United also has an option to acquire up to 77.4m AVH shares from Synergy, and it will get a board seat if the stake reaches 5%. The loan is secured by the 516m common shares Synergy holds in AVH.

The agreement with Kingsland ensures the minority shareholder's cooperation and the availability of Kingsland's 144.8m shares in AVH in certain circumstances. In return, United granted Kingsland the right to put its AVH shares to United at market

AVIANCA HOLDINGS AIRLINE PORTFOLIO

Unit	Alternative or former name	Details	Country	Ownership Interest	Stake held via
Main airlines					
Avianca	Aerovias del Continente Americano	National airline (est. 1919)	Colombia	99.98%	
Avianca El Salvador	TACA International Airlines	National airline (est. 1931)	El Salvador	96.84%	TACA
Avianca Costa Rica	LACSA	National airline (est. 1945)	Costa Rica	92.40%	TACA
Avianca Ecuador	Aerogal	Est. 1986; Acquired 2008	Ecuador	99.62%	
Avianca Peru	Trans American Airlines/TACA Peru	Est. 1999	Peru	100%	TACA
Avianca Cargo	Tampa Cargo SAS	Est. 1973; Acquired 2008	Colombia	100%	Avianca
Small regional or cargo operators					
Avianca Guatemala	Aviateca	Est. 1929/ATRs	Guatemala		TACA
Avianca Honduras	Islena	Est. 1981/ATRs	Honduras	100%	TACA
Avianca Nicaragua	La Costena	Est. 1999/ATRs	Nicaragua	68%	TACA
SANSA		Est. 1978/Cessna Caravans	Costa Rica	100%	TACA
AeroUnion		Cargo/Est. 1998/A300F/767F	Mexico	92.72%	Tampa Cargo
Regional Express Americas		Planned for 2019/ATRs	Colombia	100%	
Brand licenced to but no ownership interest:					
Avianca Brasil	Oceanair	Brazil's 4th largest airline	Brazil	0%*	
Avianca Argentina	Macair Jet	Regional/ATR72s	Argentina	0%*	

*Note: * 100% owned by Brazil's Synergy Group, majority owner of Avianca Holdings. Source: Avianca Holdings filings and other sources*

price on the fifth anniversary of the agreement. Also, United guaranteed Synergy's obligation to pay Kingsland if AVH's ADR price is less than $12 on the fifth anniversary, ensuring that Kingsland would see an annual return of at least 18%.

In *Aviation Strategy*'s back-of-the-envelope calculations, assuming that Avianca pays back 25% of the loan in shares, United exercises its stock options and Kingsland exercises the $12/ADR put option, United could end up with 33% of the equity and 50% of the voting rights in Avianca Holdings (depending on share price performance to 2025) for around $450m, which compares with a possible current market capitalisation of $585m.

The JBA, which United hailed as the "next chapter in US-Latin America air travel", will cover 275-plus destinations and some 12,000 city pairs.

According to *Flightglobal*, Avianca, Copa and United had a combined 26% share of the total US-Latin America capacity in 2018, compared to American-LATAM's 32% and Delta-Aeromexico's 17%. However, United and Delta have not yet sought immunised JVs with their Brazilian partners.

Avianca, Copa and United said that they were "exploring the possibility" of adding Brazil to the JBA. Azul is the leading candidate, with United owning 8% and the two codesharing extensively. But United will have to decide if an immunised United/Azul JV would be more effective in countering a future Delta/GOL JV in the important US-Brazil market.

Avianca: new action plan

Since it will not receive any of the UAL loan proceeds, Colombia's Avianca will have to find other ways to strengthen its balance sheet. However, there is no urgency as AVH's financial position is quite stable, thanks to consistent profits and a strong market position.

Founded in 1919, Avianca is the oldest airline in the Americas. Its past includes a brief Chapter 11 visit in 2003-2004, when it lost its original NYSE listing. Synergy bought it out of bankruptcy in 2004 and turned it around quickly, revamping its customer service, renewing its fleet and expanding its network.

Having also acquired Colombian carrier Tampa Cargo and Ecuador's Aerogal, in 2010 Synergy merged Avianca with El Salvador's Grupo TACA — an early pioneer of the multi-country, multi-airline strategy in Latin America. The merger created a holding company for 11 airlines from nine countries.

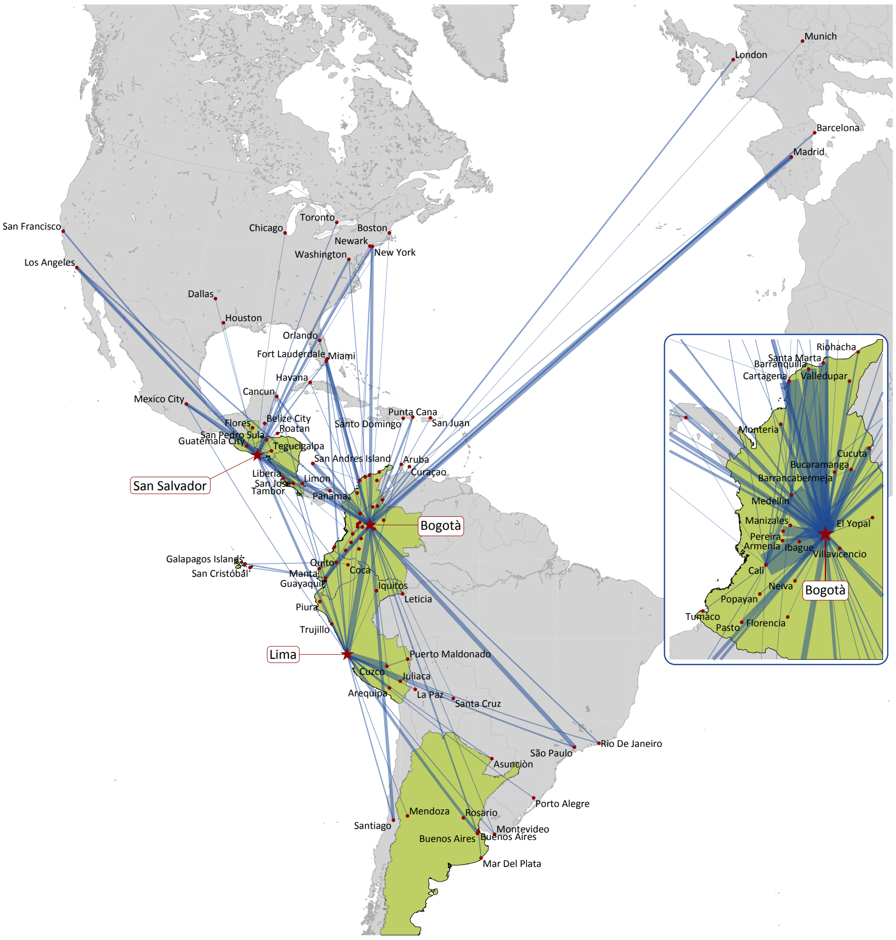
At that point Avianca had five solidly profitable years under its belt, with operating margins in the 7-13% range. It went public in Colombia in 2011 and relisted its stock on the NYSE in 2013. It joined the Star alliance in 2012.

In 2013, as the last major step in successful merger integration, the combine moved to a single brand. Nine of the 11 airlines that are currently consolidated under the holding company use "Avianca" as their commercial name, while maintaining their separate legal and labour structures (see table on the preceding page). Two other airlines that are owned directly by Synergy, Avianca Brasil and Avianca Argentina, use the name through brand licence agreements.

Avianca Holdings has grown its capacity at a brisk 6-10% annual rate in the past seven years (2017 was the exception when growth slowed to 2.7%), consolidating its position as the second largest airline group in Latin America. The network is diversified, with domestic operations in five countries (Colombia, Ecuador, Costa Rica, Nicaragua and Peru) and international operations throughout the Americas and the Caribbean, as well as to four destinations in Europe. There are three strategically located hubs (Bogotá, Lima and San Salvador) and focus city operations in Costa Rica, Quito and Guayaquil.

The group has a strong position in certain key Latin American markets, including a 54% domestic market share in Colombia and 64% of the international traffic between the five "home markets". In longer-haul international markets (where foreign carriers tend to dominate), AVH has respectable 26-33% traffic shares.

AVIANCA ROUTE NETWORK



Note: equidistant map projection based on Bogotá, great circle routes appear as straight lines. Thickness of lines directly related to annual number of seats.

Still, Avianca Holdings is less than half of LATAM's size, with around $4.9bn revenues in 2018 compared to LATAM's $10.4bn. Four of the nine airlines are very small regional operators with mainly turboprop fleets.

Avianca has built a strong brand associated with a superior customer service. It has been recognised as "best airline in South America" on both long-haul and short-haul flights by Skytrax and others. At the same time Avianca also has a competitive cost structure, but its labour relations are difficult, as was illustrated by an illegal seven-week pilot strike in 2017 that dented that year's operating profits by $126m.

Avianca's cost structure benefits from having one of the youngest passenger fleets in Latin America, with an average age of 6.9 years at the end of 2017. The passenger fleet has been streamlined on the A320/A320neo-family, the A330 and the 787. Around 72% of the total fleet is owned, with the remainder being on operating leases. The firm order book is substantial: 124 A320neo-family aircraft scheduled for delivery in 2019-2025 and three 787-9s in 2019.

Since the merger with TACA Avianca's profits have been relatively low but stable, with operating margins in the 5% to 8.4% range and net margins typically 1-3%. The operating margins have lagged those of other Latin American carriers mainly because of intense LCC/ULCC competition in Avianca's key markets.

In the Colombian domestic market, Avianca competes with VivaColombia, Copa's Wingo, LATAM's lower-cost unit and others. The Central America region has become a hotbed of LCC competition; notably, Mexican ULCC Volaris expects to have an El Salvador-based unit operational this summer, after launching Volaris

AVIANCA HOLDINGS TOTAL FLEET (DEC 2018)

	Owned/Finance Lease	Operating lease	Total Fleet
A318	10		**10**
A319	23	4	**27**
A320	35	26	**61**
A320neo	3	4	**7**
A321	7	6	**13**
A321neo		2	**2**
A330	3	7	**10**
A330F	6		**6**
A300F-B4F	5		**5**
787-8	8	5	**13**
ATR42	2		**2**
ATR72	15		**15**
767F	2		**2**
Cessna Grand Caravan	13		**13**
E190	10		**10**
Total fleet	**142**	**54**	**196***

Source: Avianca Holdings quarterly report 22 Feb 2018.
Note: The filings for Q4 2018 listed the following orders: 124 A320neo family aircraft (del. 2019-2025) and three 787-9s (del. In 2019), plus nine 787-9 options.
** Includes 6 aircraft leased out, of which 4 to Avianca Brasil (two A319s, one A330F, one A330) and two E190s to Aeroliteral SA.*

Costa Rica in 2016. US-Colombia has been a huge growth market for US LCCs in the past decade.

Avianca's net results are weighed down by heavy interest expenses. As of December 2018, Avianca had long-term debt and capital leases of $3.4bn and total liabilities of $6.1bn. Total assets were $7.1bn and book equity $978m. Its adjusted net debt/EBITDAR ratio was 6.2x. Cash reserves amounted to only $389m (8% of last year's revenues).

Most of Avianca's debt is aircraft-related and the interest rate on the long-term financings averaged only 3.48% at the end of 2017. But, as Fitch noted last year, upcoming debt maturities are relatively high for the airline's liquidity position and projected free cash flow generation. As of September 2018, Avianca had $2.1bn or 52% of its total long-term bank debt and bonds coming due within three years. The 12-month period from October 2019 looks especially challenging with $1bn of scheduled maturities (mostly in 2020).

Last spring both S&P and Fitch affirmed Avianca's 'B' credit ratings, saying that they expected Avianca to cover its capex and debt maturities from cash flow, debt refinancing and some incremental borrowing. However, Fitch flagged two areas of concern: liquidity position and a growth strategy requiring "material spending on aircraft deliveries over the next few years".

Avianca placed a $10bn order with Airbus for 100 A320neo-family aircraft in 2015. The following year it deferred $1.4bn of 2016-2019 deliveries. As a result, its A320neo deliveries will rise sharply in 2020, to about 20 each year. Its total aircraft commitments will surge from $290m in 2018 to $972m in 2019 and $2.1bn in 2020.

The airline has been talking with Airbus and lessors to significantly slow the introduction of new aircraft. The company said in its FY2018 results call that it had an agreement in principle with some suppliers, and that there would be a "material reduction" in commitments. A significant order book restructuring would enable Avianca to accelerate deleveraging.

Under its "transformation" plan, Avianca has changed its focus from growth to profitability; it is guiding only 0-2% ASK growth in 2019 compared to last year's 8.7%. It plans to cull the fleet from 190 at the end of 2018 to 150-165 in 2020 including the disposal of its 10 E190s this year. The six key pillars of the plan are to adjust aircraft commitments, improve operational efficiency, divest stakes in most non-core business units, optimise the network, strengthen capital structure and re-prioritise capex-intensive projects.

The decision to focus on three core units (airline business, cargo and loyalty) and shed marginal activities represented a U-turn from the earlier strategy of diversification. A streamlined group structure, together with segment reporting (to begin in the current quarter), could make it easier for Avianca to attract investors.

Notably, the JBA and closer relationship with United have already led to significant corporate governance improvement at Avianca. In the Q4 call, the airline unveiled reforms to the structure of its board, aimed at ensuring "impartial decision-making" and "balanced involvement and input" from all shareholders. The reforms include a new "board executive committee", more independent directors and United sitting in meetings as an observer.

Avianca's market position should benefit from being part an immunised JV and having United as a strategic partner. CEO Hernán Rincón said recently that Avianca was seeking a similar alliance with Lufthansa. Avianca is keen to expand in Europe with its growing fleet of 787s; it launched the Bogotá-Munich route in November and is now considering adding Zürich, Rome and Paris to its network.

Who will rescue Avianca Brasil?

Avianca Brasil's December 2018 bankruptcy was in some ways surprising. The airline has been successful in the marketplace, offering a blend of full service, generous seat pitch and low fares. It has consistently achieved load factors 3-4 points above the industry average. Its extensive slot holdings at key airports made it possible to build a network focusing on potentially lucrative trunk routes. It has been Star's sole representative in Brazil since joining the alliance in 2015.

But reckless growth through Brazil's recession, a prolonged weak domestic revenue environment and a chronically weak balance sheet meant that Avianca Brasil could not withstand 2018's severe fuel and currency headwinds.

Avianca Brasil's strategic position was weak as industry consolidation in Brazil had left it in a more distant fourth place in the domestic market. So it began to grow extremely rapidly; its ASK growth averaged 37% annually in 2010-2014.

The big mistake Avianca Brasil made was to continue heady growth through Brazil's deep three-year recession. In 2016, when industry capacity in Brazil contracted by 6% (and even Azul slashed capacity), Avianca Brasil grew its domestic ASKs by 14.1%. Its growth continued at the 13-15% level until mid-2018.

In July 2016, as most Latin American airlines were deferring aircraft deliveries, Synergy placed a $6.6bn order with Airbus for 62 A320neo family aircraft for Avianca Brasil.

In 2017 Avianca Brasil went international, launching services to Chile, Colombia and the US.

As a result, Avianca Brasil did increase its market shares. Its domestic RPK share rose from 2.4% in 2010 to a respectable 14.4% in April 2018, though this was still four points behind Azul's market share. Internationally, Avianca Brasil accounted for 8% of Brazilian carriers' RPKs in November 2018, which was not so far off Azul's and GOL's shares of around 12% each.

But the economics of its business model are questionable. While Avianca Brasil's unit costs are higher than GOL's (more upmarket product, smaller size, mostly leased fleet), in recent years its unit revenues have been lower than GOL's.

Avianca Brasil's filings with ANAC have indicated many years of weak results (losses or marginal profits) and then heavy losses last year. The net results, like those of other Brazilian carriers, have fluctuated depending on currency movements. The airline had a net loss of R$71.4m in 2016, a net profit of R$41.6m in 2017 and a net loss of R$176m in H1 2018.

Last year's second quarter (the latest quarter available for Avianca Brasil) was tough for all Brazilian carriers because of the triple whammy of higher fuel prices, a weak real and a lengthy truck drivers' strike. But Azul and GOL still achieved small operating profits, whereas Avianca Brasil had a negative -28% operating margin (R$259m EBIT loss on revenues of R$938m).

Avianca Brasil was vulnerable because its balance sheet was in very poor shape. It had unrestricted cash of only R$38m ($10.2m), adjusted net debt of R$5.1bn ($1.4bn) and net debt/EBITDAR of around 11x in June 2018.

Last summer it finally began reining in growth and said that it was seeking to reduce its fleet by eight aircraft. In early December Avianca Brasil returned four aircraft to lessors. The Chapter 11 filing came when three lessors sought to repossess an additional 14 aircraft. Avianca Brasil reportedly owed lessors more than $100m and suppliers another $125m.

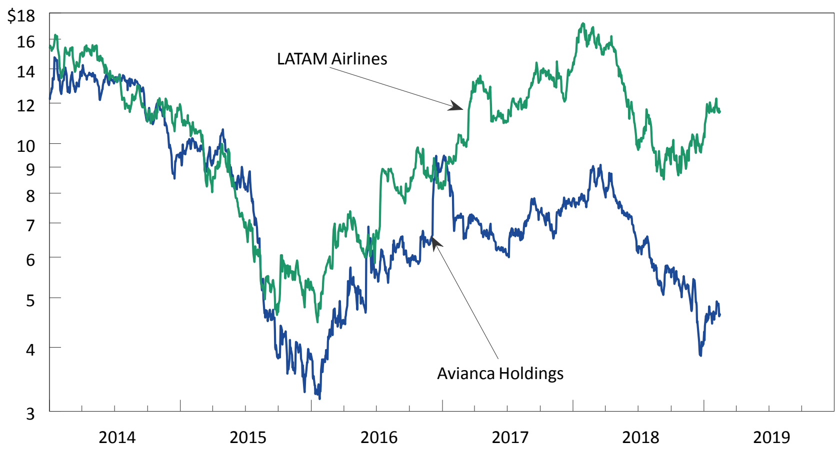
The initial 14 December bankruptcy court hearing in São Paulo suspended aircraft reposses-

AVIANCA BRASIL'S PRE-BANKRUPTCY LEASED FLEET

Lessor	A318	A319	A320	A320neo	A330-200	Total
Airbus Asset Management	9					**9**
Aircastle			10		1	**11**
Aviation Capital Group		1	8			**9**
Avolon					1	**1**
BOC Aviation				2		**2**
CDB Aviation Lease Finance					1	**1**
GECAS			1	10		**11**
Infinity Aviation Capital			1			**1**
Jackson Square Aviation		1				**1**
MCAP/MC Aviation Partners			4			**4**
Total aircraft	**9**	**2**	**24**	**12**	**3**	**50**

Source: Flightglobal (December 10, 2018)

AVIANCA AND LATAM ADR PRICE PERFORMANCE



sions for 30 days and other lawsuits for 180 days. Avianca Brasil was ordered to present a "judicial recovery plan" by mid-February.

Since the 30-day stay on repossessions expired in mid-January, Avianca Brasil has been fighting to keep the 20 or so A320s it leases from Aircastle and GECAS. And on 1 February the bankruptcy judge ruled that it could continue operating the aircraft until mid-April.

In many such instances lessors would have helped an airline, but Avianca Brasil had a poor track record. It had already been sued once for missed lease payments (by Avolon in 2016). One of its two main lessors, Aircastle, is heavily exposed with Avianca Brasil being its largest customer.

Avianca Brasil secured more time in part because it agreed to return eight aircraft, including four A330s. It is ending nearly all international service at the end of March (retaining only Bogotá) and is reducing its workforce by 600 or 11%, with more expected to go on unpaid leave.

Importantly, Avianca Brasil has found external backers. According to an early-February court filing, three hedge funds controlled by Elliott Management have agreed to provide $75m in capital in the form of convertible debt. And Aircastle confirmed in mid-February that the airline had resumed lease and maintenance reserve payments on 1st February, as stipulated by earlier court orders.

Avianca Brasil has filed a judicial recovery plan, which calls for the transfer of its aircraft and slots to a new company ("Life Air") that would be sold to pay off the debts. The new entity would have revenues of R$4bn, EBITDAR of R$925m and net earnings of R$96m in year one. The Elliott loan would convert to a 49% equity stake, and creditors and lessors would be able to take part in the capitalisation.

Avianca Brasil also has new leadership in place. Jorge Vianna, one of OceanAir's founders, has taken over as president from Frederico Pedreira.

However, ANAC obtained an injunction that allows it to deregister any leased aircraft operated by Avianca Brasil if a lessor requests it. The move was in response to criticism that Brazil was not complying with the provisions of the Cape Town Convention — something that lessors have warned could lead to higher lease rates for all Brazilian airlines. Avianca Brasil has appealed to the Superior Tribunal de Justiça, and as yet, no lessor had submitted a deregistration request. Aircastle and GECAS, though, have continued to try to repossess aircraft through the bankruptcy court: a hearing about 23 aircraft is scheduled for 11th March.

Bradesco analysts have predicted in recent reports that Avianca Brasil will have to shrink further in order to emerge from bankruptcy, because even if the judicial recovery plan is approved by creditors in April, it could take up to six months to conclude the financial transactions.

Azul would be the obvious candidate to make a bid for Avianca Brasil; it is growing and the two airlines have less than 10% network overlap. Their combined domestic market share of 31% (November 2018) would create a strong third carrier for Brazil.

According to *Flightglobal*, Azul has expressed interest in some or all of Avianca Brasil's A320neos. Azul operated 20 of that type at year-end and in January it added two A320neos that were previously leased to Avianca Brasil by BOC Aviation.

One thing seems certain: Brazil's airline industry will benefit. All possible scenarios — be they Avianca Brasil's contraction, disappearance or absorption into Azul — will lead to a capacity reduction in the domestic market, giving airlines more pricing power. GOL, with its 80% network overlap with Avianca Brasil, could benefit the most.

By Heini Nuutinen

Boeing and Airbus Orders 2018

BOEING managed to beat its arch rival Airbus in the order race in 2018. The total number of Boeing aircraft ordered in the year came in at 1,090 against Airbus's 831. Even after cancellations and changes in the order book net orders for the Seattle based manufacturer came in at 893 units against Toulouse's 747 (Boeing adopted ASAC 602 in the year which removed some 70 aircraft from the recognised backlog).

Roughly 20% of each manufacturers' orders were from leasing companies, but there was a significant difference between the two in the distribution of orders by airline operators by region. 20% of the Boeing orders were for carriers in Asia/Pacific — the world's engine of growth — against 9% for Airbus. But this mostly reflects a massive order from India's troubled Jet Airways for 150 737s.

20% of Airbus's orders each were raised by carriers in Europe and North America against 10% and 13% respectively for Boeing. But then Airbus's or-

BOEING ORDERS 2018

	Customer	737	747	767	777	787	Total
Asia/Pacific	ANA				2		2
	Jeju	40					40
	Jet Airways	150					150
	Qantas					6	6
	Vistara					6	6
	Total	**190**			**2**	**12**	**204**
Europe	Lufthansa				2		2
	Ryanair	25					25
	SkyUp	6					6
	SWISS				2		2
	TAROM	5					5
	TUI Travel	2					2
	THY				3	25	28
	Utair	30					30
	Total	**68**			**7**	**25**	**100**
MEAF	Air Peace	10					10
	Qatar				5		5
	Total	**10**			**5**		**15**
CIS	Turkmenistan	3					3
	Uzbekistan					1	1
	Total CIS	**3**				**1**	**4**
N America	American					25	25
	DHL				10		10
	FedEx			11	12		23
	Hawaiian					10	10
	Southwest	40					40
	United					13	13
	UPS		14	9			23
	Total	**40**	**14**	**20**	**22**	**48**	**144**
	GOL	15					15
	Total S America	**15**					**15**
Lessors	ALC	38				3	41
	Aviation Capital	23					23
	BOC Aviation	11			3	9	23
	Boeing Capital	75			2	30	107
	Goshawk	20					20
	Jackson Square	30					30
	Novus				4		4
	Total	**197**			**9**	**42**	**248**
	Unidentified Customers	297	4		14	8	323
	Government/Private	17		20			37
	Gross Orders	**837**	**18**	**40**	**59**	**136**	**1,090**
	Cancelled/Changes	(162)			(8)	(27)	(197)
	Net Orders	**675**	**18**	**40**	**51**	**109**	**893**

AIRBUS ORDERS 2018

	Customer	A220	A320	A330	A350	A380	Total
Asia/Pacific	ANZ		2				2
	Druk Air		1				1
	Sichuan				10		10
	Vietjet		52				52
	Vistara		13				13
	Total		**68**		**10**		**78**
Europe	Aegean		30				30
	easyJet		17				17
	IAG			2			2
	Lufthansa		32				32
	SAS		35	1			36
	SWISS		10				10
	THY				25		25
	Total		**124**	**3**	**25**		**152**
MEAF	Emirates					20	20
	Kuwait			8			8
	Salam Air		1				1
	SaudiGulf		10				10
	Total		**11**	**8**		**20**	**39**
N America	Allegiant		1				1
	Delta	15		10			25
	JetBlue	60					60
	Moxy	60					60
	Spirit		5				5
	Total	**135**	**6**	**10**			**151**
	Viva Aerobus		25				25
	Total S America		**25**				**25**
Lessor	Avolon		100				100
	BOC Aviation		3				3
	CALC		15				15
	Goshawk		20				20
	Macquarie		20				20
	Total		**158**	**4**			**158**
	Undisclosed		184	12	27		223
	Government/Private		1	4			5
	Gross orders	**135**	**577**	**37**	**62**	**20**	**831**
	Cancelled		(36)	(10)	(22)	(16)	(84)
	Net Orders	**135**	**541**	**27**	**40**	**4**	**747**

BOEING DELIVERIES 2018

	737	767	777	787	747	Total	
Asia/Pacific	159		13	54		**226**	***28%***
Europe	108		5	22		**139**	***17%***
MEAF	19		20	14		**53**	***7%***
Russia CIS	1		1	2		**4**	
N America	124	17	7	18	6	**172**	***21%***
S America	16			2		**18**	***2%***
Lessors	132			31		**163**	***20%***
Other*	21†	10		2		**32**	***4%***
Total	**580**	**27**	**46**	**145**	**6**	**806**	***100%***

*Note: *Other=Government, Private and Unidentified. †Inc 1xBBJ.*

AIRBUS DELIVERIES 2018

	A220	A320	A330	A350	A380	Total	
Asia/Pacific	4	193	32	43	3	**275**	***34%***
Europe	10	104	8	9		**131**	***16%***
MEAF	2	6		18	9	**35**	***4%***
Russia/CIS							
N America	4	80		5		**89**	***11%***
S America		17		4		**21**	***3%***
Lessors		225	4	14		**243**	***30%***
Other*		1	5				***1%***
Total	**20**	**626**	**49**	**93**	**12**	**800**	***100%***

der position was boosted significantly by its acquisition of the Bombardier C-Series programme: Moxy (Neeleman's potential new US operator), JetBlue and Delta ordered 135 of the (rebranded) A220.

However it should be noted that 30% of the orders were to customers either undisclosed or unidentified.

As usual the narrowbody workhorses — the 737 and A320 — topped the list, accounting for three quarters of all the orders in the year.

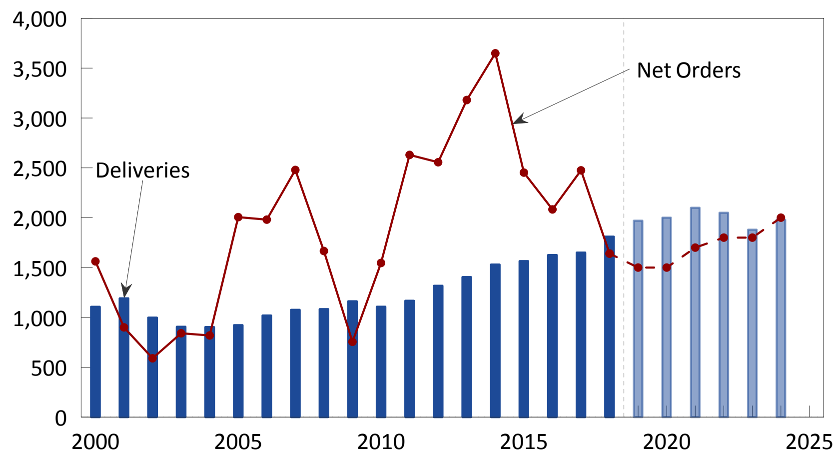
Among the widebodies Boeing continues to make headway with the freighter versions of the 767 and 747, while its flagship 787 Dreamliner seems to be consolidating its position as the long-haul passenger type of choice with 136 new orders in the year. Meanwhile the 777, perhaps the natural replacement for aging 747s as well as older versions of the type, performed modestly well with 59 new orders.

In contrast Airbus experienced a relatively poor year for its widebody offering. A new order for 20 A380s from Emirates was virtually wiped out by 16 cancellations in the year. That order was put in doubt as Emirates re-evaluated its long term fleet strategy in the wake of continued intense capacity competition among the Super-Connectors. Airbus was put under futher pressure following Qantas' decision in January to cancel its 8 outstanding orders and stick with the fleet of 12 it has. At its annual results in February Airbus announced that it would stop A380 production in 2021.

Nevertheless Airbus did achieve net orders for 40 A350s and 27 A330s, the latter increasingly seen perhaps as a short haul replacement for and freighter alternative to the 767.

Deliveries in 2018 were similar for each manufacturer with 806 units for Boeing (up from 763 in 2017) and 800 aircraft (against 718 in the previous year) for Airbus — the latter including 20 A220s following its acquisition of the C-Series programme from Bombardier in the second half of the year.

JET AIRCRAFT ORDERS AND DELIVERIES



Source: ESG Airline Monitor

ORDER BACKLOG DEC 2018

Boeing		Airbus	
		476	A220
737	4,763	6,056	A320
767	111	295	A330
777	431		
787	622	659	A350
747	24	87	A380
Total	**5,951**	**7,573**	

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