Aviation Strategy
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IAG: Superior returns but unappreciated

ANNUAL results for 2018 from IAG showed another excellent year. Each of its operating airline improved in key performance indicators. At the Group level it exceeded its long term targets for margins and returns on invested capital. It achieved investment grade rating from the credit agencies. And it has increased its final dividend payout for the year and announced a special dividend. But the share price is 25% below its peak in June 2018. Are the market's perception of clouds on the horizon real?

For the full year 2018, IAG generated a 7% increase in revenues to €24.4bn, an underlying operating profit of €3.23bn up by 9.5% year-on-year, and reported net profits of €2.9bn up by 45%. This resulted from an increase in capacity of 6%, demand of 7% and a growth in unit revenues of 0.1%. Fuel costs were up by 14% overall, but on a like-for-like basis unit costs fell by 1.9% over the year. The group is proud to note that ex-fuel unit costs have fallen by 11% in total since the formation of the group in 2011, and it is targeting a further 5% reduction by 2023.

The best performer in the group's portfolio of airlines in absolute terms was British Airways, with a near 6% growth in revenues (in Sterling) to £13bn and a 12% growth in operating profits to £1.95bn giving it a margin of 15% and a return on invested capital of 17.3%. Capacity only grew by 3.5% but it achieved a unit revenue increase of 3% while underlying ex-fuel unit costs fell by 2%.

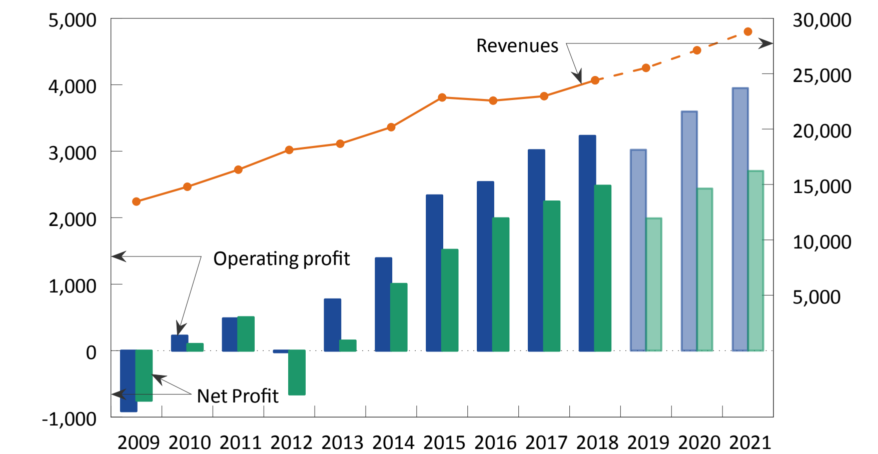
Aer Lingus continued a strong performance. It also generated an operating profit margin of 15% while revenues increased by 9%, capacity by 10%, unit revenues fell but unit costs fell at a faster rate of 5% as it increased its exposure to longer haul flying. It managed to increase its RoIC to an astounding 27%.

The Spanish carriers also improved even if the absolute levels were naturally lower. Iberia increased capacity by 7% and demand by 9%. Unit revenues fell slightly, but unit costs ex-fuel fell faster (by 2%). Operating profits improved by €61m to €437m giving it an improved margin of 8.4% and an RoIC of 13.2%.

Vueling, despite significant disruption from ATC constraints and delays, had a reasonable year. Capacity was up by 9% and demand grew by 10%. Total revenues were up by 12.7% but while costs grew by 13.5%

This issue includes

IAG: FINANCIAL DATA (€m)



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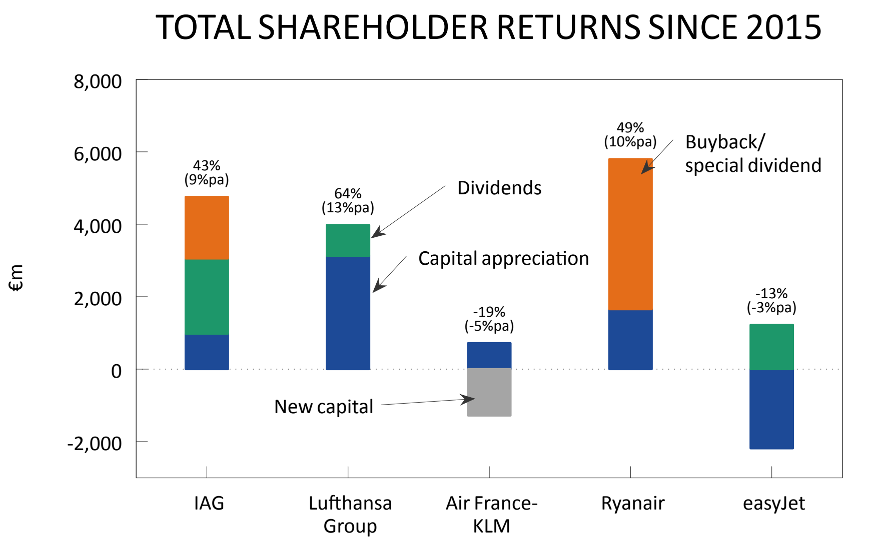
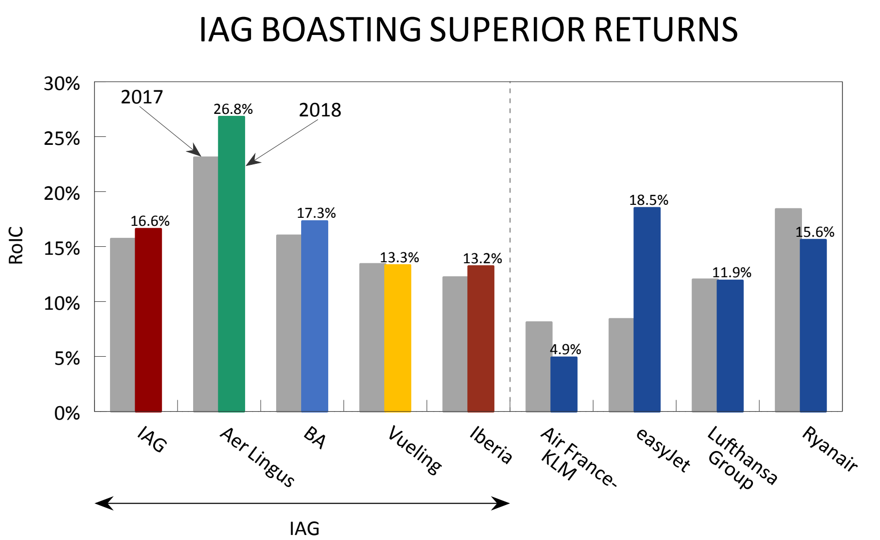


Notes: Capital appreciation=increase in market capitalisation (in Euros) since beginning of 2015

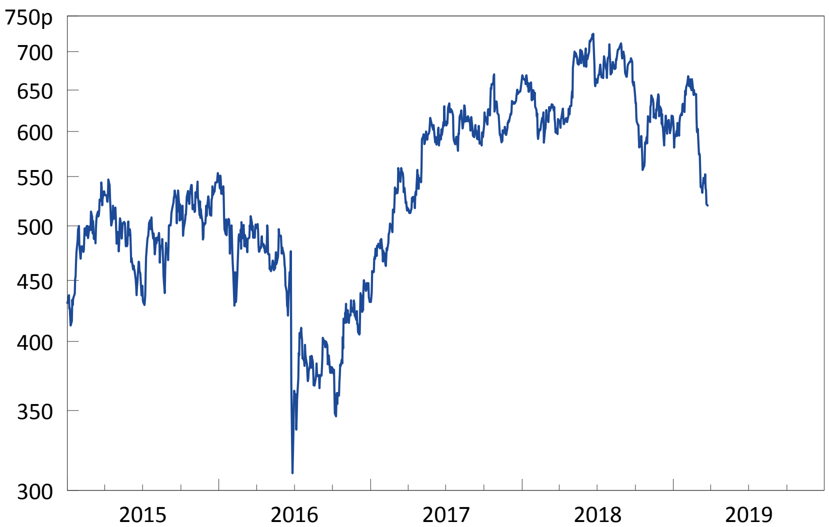
year on year it achieved a modest improvement in operating profits to €200m and achieved a 13.3% return on invested capital.

The group announced a proposal to increase the final dividend to 16.5€¢ a share (making a total for the year of 31€¢) and to offer a special dividend of 35€¢ a share (at a cost of €700m). The management was keen to point out that it has provided shareholders with cash returns of €2.7bn since it resumed dividend payments in 2015, through a mixture of ordinary dividends, share buybacks and special dividends, and will pay out another €1bn in 2019.

In the chart above we show *Aviation Strategy's* approximation of the returns provided by the top five European airline groups since the beginning of 2015. Admittedly, we have taken an arbitrary date from which to measure the share price perfor-



IAG SHARE PRICE PERFORMANCE



mance, and the whole sector has fallen some 30% from peak share price values in the middle of last year. But from this picture it appears that IAG management may be justified in assuming that it has been able to provide superior returns to shareholders.

However, since the publication of the results the shares have continued to fall.

Coincident with the results the group announced it had firmed an order for 18 777-9X aircraft (plus 24 options) for delivery to British Airways between 2022 and 2025 to replace its remaining 747s and some of the older 777-200s. This should have come as no surprise: BA has a fairly chunky fleet renewal programme and the order was flagged as possible in the company's capital market's day presentations last November (see *Aviation Strategy, "IAG: Creating value"*, November 2018).

There was also some confusion on the results call: the company guided that it expected operating profits for 2019 to be broadly in line with the results for 2018 but that capex would increase. It had to send out an emergency email to analysts to correct statements management made suggesting free cash flow would improve. Intriguingly Lufthansa underwent a similiar confusion over free cash flow on *its* results conference — is this all to do with professional confusion over the introduction of IFRS16? (See *Aviation Strategy*, *"No accounting for leases"*, April 2016.)

Brexit B******s

The reason for underperformance may have something to do with stock-market fundamentals. In late February IAG announced that it was restricting voting access to non-EU shareholders (always a part of its constitution) to the current 47.5% (note that Qatar Airways has a 20% stake). In light of this announcement MSCI stated it would remove IAG from its global indices, and as a result global tracker funds using them would be discouraged from investment in one of the top five global airline groups.

Secondly, while IAG publicly maintains a sanguine approach to the Brexit process, a large portion of its shareholder base is in the UK. Were Britain to leave the EU, these shareholders would no longer be qualified investors to be owners of an EU airline. And the question is the interpretation of the ownership and control regulation of an airline.

When the group was established in 2011, it put in place trusts for Iberia and British Airways so that it could prove to bilateral partners that ultimate equity ownership for those carriers lay in nationals of the designating country, in the unlikely event that bilateral partners would take the *option* to oppose access.

However, the European Commission has incorporated European ownership and control into law as a legal *requirement* for the operation of air services within the EU and EEA. Not that Brussels necessarily understands what this really means (Wizz Air is ultimately owned and controlled by US-based Indigo Partners, but not necessarily directly through issued equity; Qatar holds only 49% of the equity in Air Italy, but sure as dammit has control).

This antidiluvian approach is stupid. The UK in its recent strategy white paper suggested that it would move to the ICAO model (proposed 15 years ago, and only adopted by a handful of countries) to designate any airline for international services that had its principal place of business in the UK.

This is a typically pragmatic British solution. IAG's risk is that blind adherence to rules from Brussels could destroy the viability of a successful and profitable airline group.

737 MAX grounding perspective

A TOTAL of 346 people died in two 737 MAX crashes — Lion Air on October 29, 2018 and Ethiopian Airlines on March 10, crashes with disturbing similarities that have led to a global grounding of the new type.

There appears to be a consensus among technical experts that three inter-related factors — one hardware, one software and one human — contributed to the crashes.

In brief, tentative evidence suggests that in both accidents false readings indicating the danger of a stall from an angle-of-attack (AOA) sensor caused the new Manoeuvring Characteristics Augmentation System (MCAS) to push the aircraft's nose down to regain speed. Unfortunately, the pilots seem to have failed to recognise that the MCAS was driving the nose-down trim and tried to rectify the problem manually pulling back on the yoke. This resulted in the aircraft pitching up temporarily then pitching down again as the MCAS cut back in — a terrible series of oscillations that culminated in the crashes.

The MCAS was installed in MAXs to smooth out differences in handling characteristics, and hence minimise transition training, between 737NGs and 737MAXs. The 737MAX is powered by more powerful LEAP1 engines than the CFM56s installed on 737NGs, and these engines have a tendency to push the nose of the aircraft up; the MCAS was designed to adjust the horizontal stabiliser to compensate.

Tragically, it appears that the problem could have been resolved by the cockpit crews switching off the MCAS and/or de-powering inputs to the stabiliser, but the crash crews were apparently unaware of the MCAS functionality. And this is where Boeing has faced intense criticism, because the MCAS changes were not directly communicated to airlines and not included in critical checklists. The counter-argument is that the cockpit crews should have been able to resolve the "runaway stabiliser" situation, regardless of the new MCAS.

Following the grounding Boeing has swiftly come up with a solution, which could be rolled out to airlines within one to two months. This involves new alerts on AOA sensor readings; software re-writes to ensure a much more gradual MCAS response to stall situations

PARKED 737 MAXs

Airlines	Units
Southwest	34
Air Canada	24
American	24
China Southern	24
Air China	15
Norwegian	15
flydubai	14
United	14
SpiceJet	13
WestJet	13
THY	12
Hainan Airlines	11
Shanghai Airlines	11
Lion Air	10
Xiamen Airlines	10
TUI	10
Jet Airways	8
GOL	7
Shandong Airlines	7
Smartwings	7
Aeroméxico	6
COPA	6
Icelandair	6
SilkAir	6
Others (31 airlines)	77
Total	**384**

737 MAX FIRM BACKLOG

Airline/Lessor	Units
Southwest	249
flydubai	237
VietJet Air	200
Lion Air	187
Air Lease Corp	154
GECAS	151
Ryanair	135
GOL Linhas Aereas	129
SpiceJet	129
Jet Airways	125
United	123
Aviation Capital Group	98
AerCap	95
Norwegian	92
SMBC Aviation Capital	89
BOC Aviation	80
China Development Bank	77
American	76
Avolon	75
Boeing Capital Corporation	75
THY	63
TUI	58
COPA	55
Aeromexico	54
CALC	50
Garuda	49
WestJet	43
ALAFCO	40
Jeju Air	40
Virgin Australia	40
Others (35 companies)	626
Unidentified	942
Total	**4636**

and prevention of multiple MCAS engagements. Specific MCAS training will be given to crews.

It is then up to the various civil aviation authorities with grounded MAXs to approve the fixes and to recertify the 737MAX for commercial operations. The FAA will take the lead, but that organisation has come under political and legal scrutiny for allegedly outsourcing too much its technical approval and certification process to Boeing. A DoT committee has been set up to investigate.

Costs

The cost of the MAX grounding is impossible to estimate accurately, and claims are confusing, but the following are the main considerations.

✈Crash costs:

The costs of writing off two new aircraft — $100m or so, plus, more importantly, compensation for the victims, at least $500m, for the brutal reason that many of the dead in the Ethiopian crash were Western professionals. This cost will ultimately be borne by the insurers.

✈Direct lost profits:

This refers to the cash operating surpluses suffered by the airlines. Profitability will of course vary greatly among the 50-plus operators affected by the grounding, though the claims will logically be towards the top end of the profitability spectrum and should reflect the difference between operating a fuel-efficient new type against a less efficient replacement. This gets complicated as the replacement types may have lower capital costs.

✈Rescheduling costs:

These are the costs associated with cancelling or consolidating flights, re-allocating other aircraft, parking MAXs and changing planned maintenance to liberate capacity. These can be substantial but, for most of the affected airlines, 737MAXs as yet make up relatively small proportions of their total capacity; for example, for Southwest, the largest operator, MAXs account for only about 4% of total seat capacity.

The situation is rather different for airlines like Norwegian which is suffering significant disruption to its schedules; if the MAX grounding is presented as a factor in pushing Norwegian over the edge (see *Aviation Strategy*, Jan/Feb 2019) might there be a case of a legal action? Who bears this cost depends on Boeing customer contracts but again we suspect insurers will pick up a significant portion of the bill.

TUI, which (including associate airlines) operates 15 737MAXs, has been explicit in its cost estimate — €200m for the four months between grounding and mid-July when it expects the MAX to be able to re-enter service. Working this number through, we estimate that that TUI is claiming losses of around $9,000/flight hour on its MAX fleet, which compares to operating costs per hour somewhere in the $5,000 region.

✈Delivery delays:

For the airlines this is again a rescheduling cost while for Boeing it is probably a cash-flow impact from delays in PDPs and final delivery payments.

✈Reputational damage:

In the short/medium term this cost, for manufacturer and airlines, appears very high, but it tends to dissipate quite quickly. There have always been serious problems associated with the introduction of new types: back in the 60s there was a series of 727 crashes attributed to pilots not being prepared for the slower landing speed of this type through to the grounding of 787 two years ago because of lithium battery and engine problems. (September 11 was the ultimate example of over-reaction to a tragedy — a leading US airport consultancy forecast a permanent 25% reduction of passenger traffic globally, which was *so* wrong). Once an aircraft issue is fixed, and seen to be fixed, the travelling public's memory tends to fade quickly. Airlines recognise that the 737MAX situation is serious but temporary, and in a vote of confidence Lufthansa has indicated that it is considering a 100-unit 737MAX order.

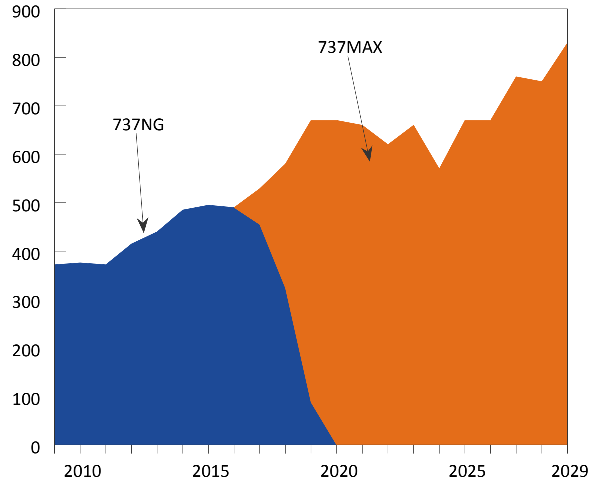
As it stands, the financial cost to Boeing, after insurance, does not seem too substantial, at least in relation to its 2018 operating cashflow of $15.3bn. Cowen Washington Research Group estimate $2bn which seems as good a guess as any. However, one unknown is whether the 737MAX grounding might get embroiled in Sino-US trade disputes, Boeing's Chinese business (note that many of the 942 "Unidentified" 737MAX orders in the table on the preceding page are probably for Chinese entities) being played against Huawei's US ambitions and US legal actions against the Chinese conglomerate (whose revenues incidentally have now touched $100bn, exactly the same as Boeing).

Perspective

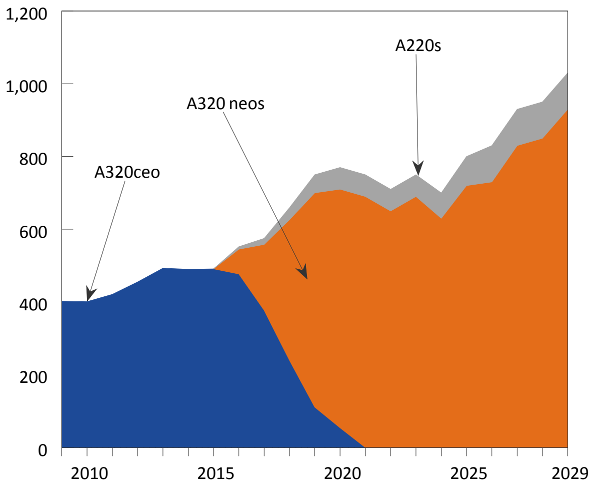
Finally, for perspective, the following charts, compiled from the Airline Monitor's 2019 forecast, highlight the inevitable delivery pattern of MAXs and NEOs, both types with long, successful and safe pedigrees. The impact of the 737 MAX grounding will not be perceptible in the long term.

NARROWBODY DELIVERIES

Boeing



Airbus



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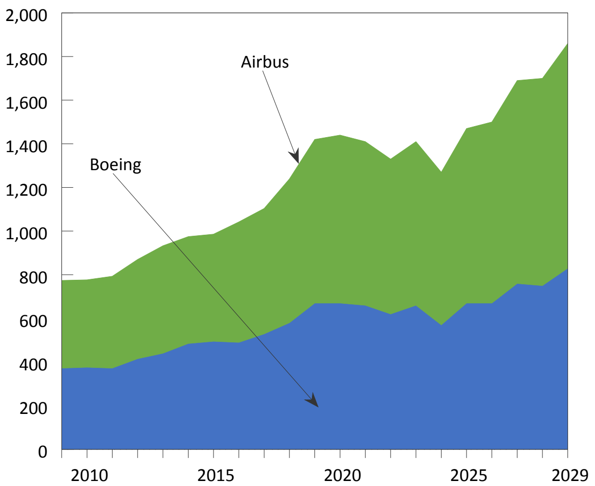
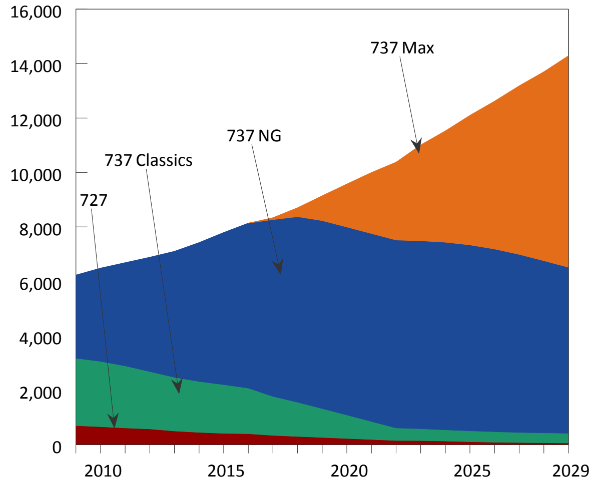
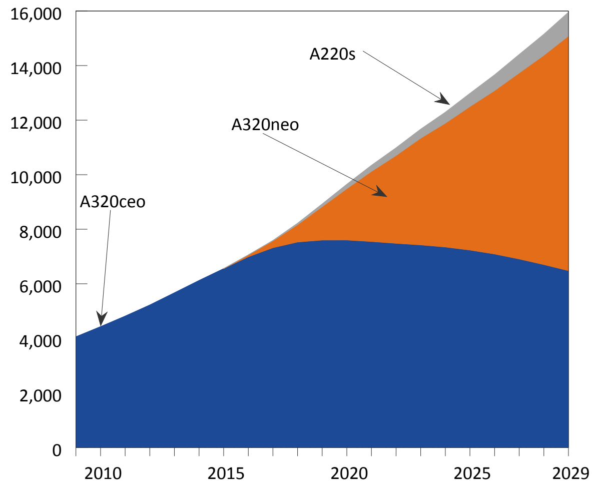


NARROWBODY FLEET

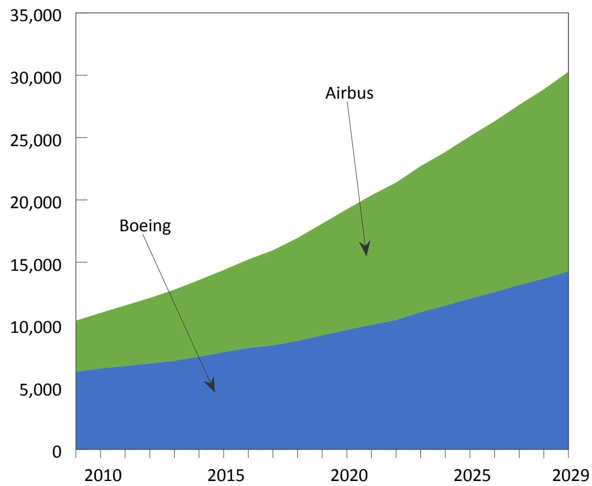
Boeing



Airbus



Total



Source: Airline Monitor, Feb 2019. Note: Fleet projections take account of retirements; No new types assumed

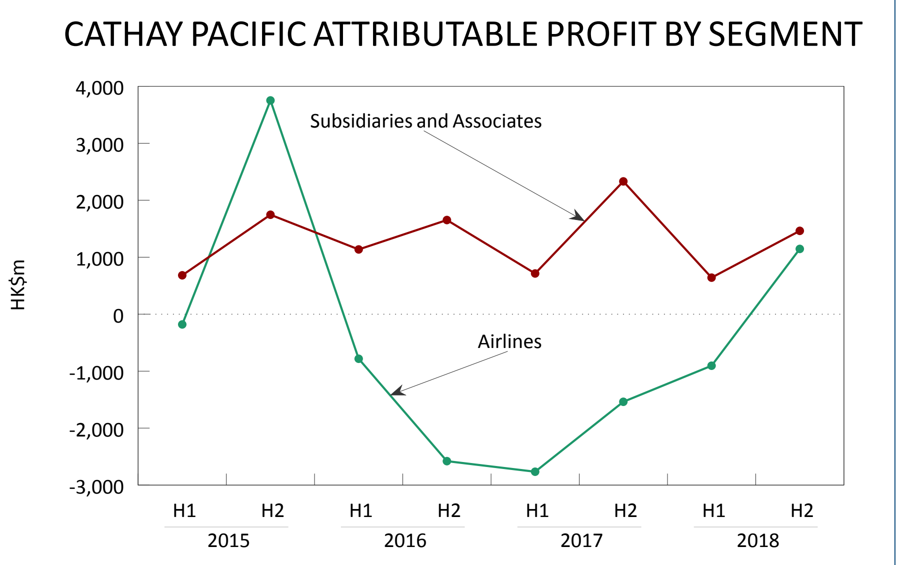
Cathay Pacific: King Hong
Turning the corner?

PROFIT warnings are not unusual. What is rare is for a company to notify the markets that its annual results will be substantially higher than market expectations. And this is what Cathay Pacific did in February this year suggesting that annual profits would approach HK$2.3bn, twice as high as market expectations. Indeed when it published its results in March net attributable profits came in at HK$2.3bn (US$218m) for 2018 up from a loss published a year ago of HK$(1.2)bn.

But Cathay Pacific has had a tough time since the GFC. It last made a decent profit in 2010 — an operating margin of 12% on revenues of HK$89bn (see chart below). Since then, it has achieved an average operating margin of a paltry 2.7%, while revenue has grown by an annual average of only 2% a year. The results for 2018 show operating margins of 3% and net margins of 2%. And this is one of the few well-run airline groups based at the heart of the region displaying some of the highest rates of air traffic growth and potential in the world.

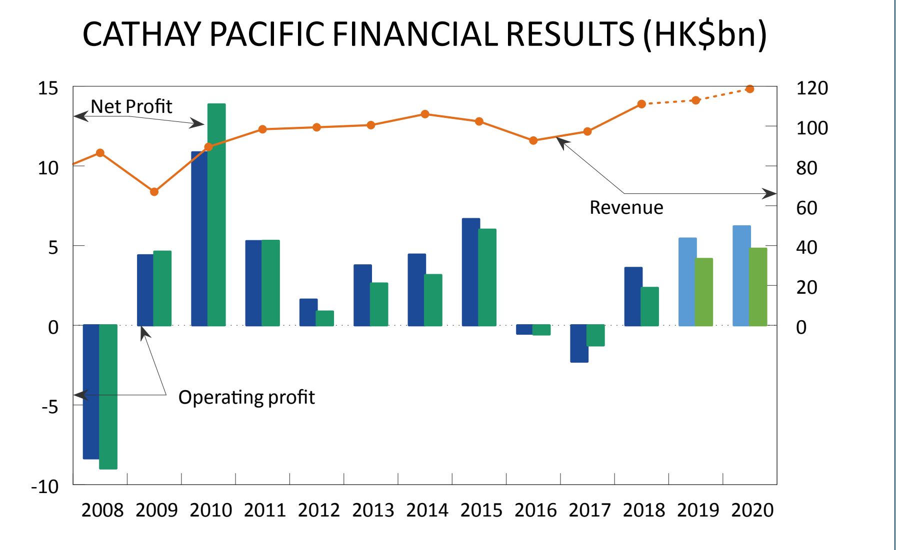
These ratios fall far short of a sustainable level of profitability to provide a return to shareholders — and the Swire Group (as major shareholders behind Cathay Pacific) has shown in the past a ruthless attention to returns, albeit within its long term goals as its position as the foremost *hong* in Hong Kong.

Swires own 45% of Cathay (through seperately quoted Swire Pacific) and Air China a further 30%.



Qatar Airways also has a 10% stake. Cathay itself has an 18% stake in Air China and 40% share of the Chinese flag-carrier's freight subsidiary Air China Cargo.

Part of the reason behind this poor performance has been significant losses at the airline subsidiaries — Cathay Pacific and the short haul operation Cathay Dragon. In the two-and-a-half years from the beginning of 2016 the group's airlines lost a total of HK$8.6bn (US$1bn). Over the same period its subsidiaries and asso-



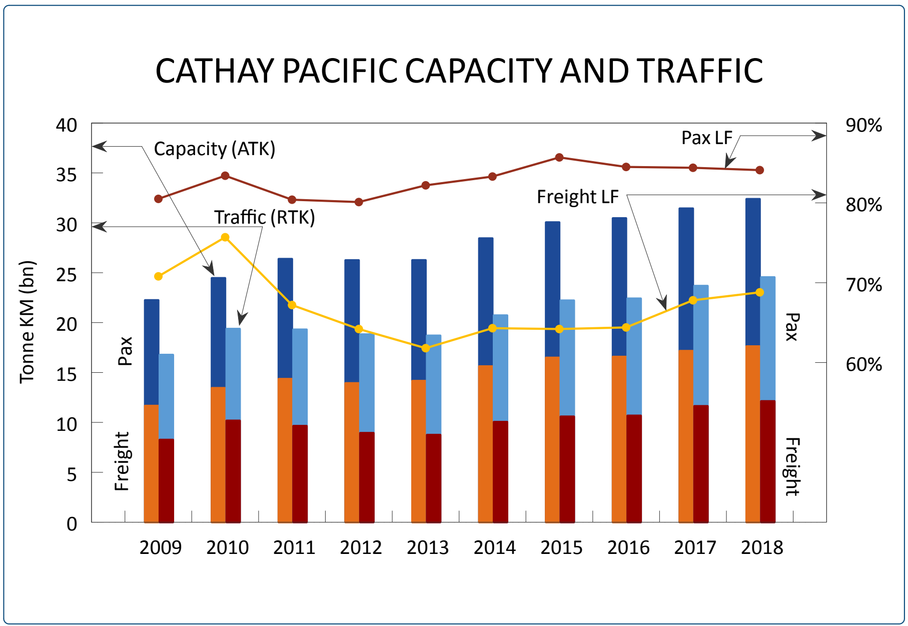
ciate company investments (primarily reflecting its stakes in Air China and Air China Cargo) generated profits of HK$6.5bn. And then in the second half of 2018 the airlines finally generated a profit (see graph on the previous page).

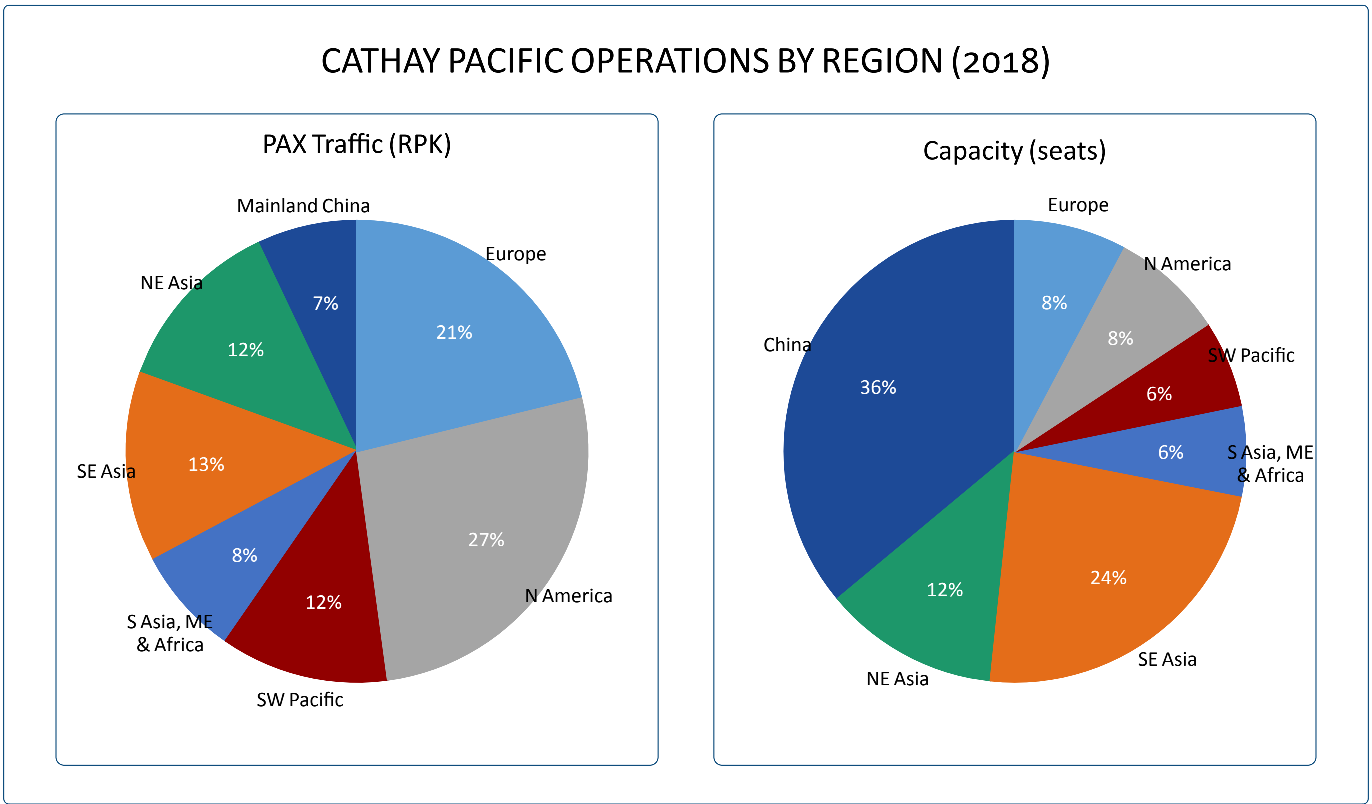
For the whole year 2018 Cathay Pacific generated revenues of HK$111bn up by 15% (finally exceeding the previous peak in revenues in 2014), operating profits of HK$3.5bn compared with a loss of HK$2.28bn in the prior year and net attributable profits of HK$2.3bn (HK$1.3bn).

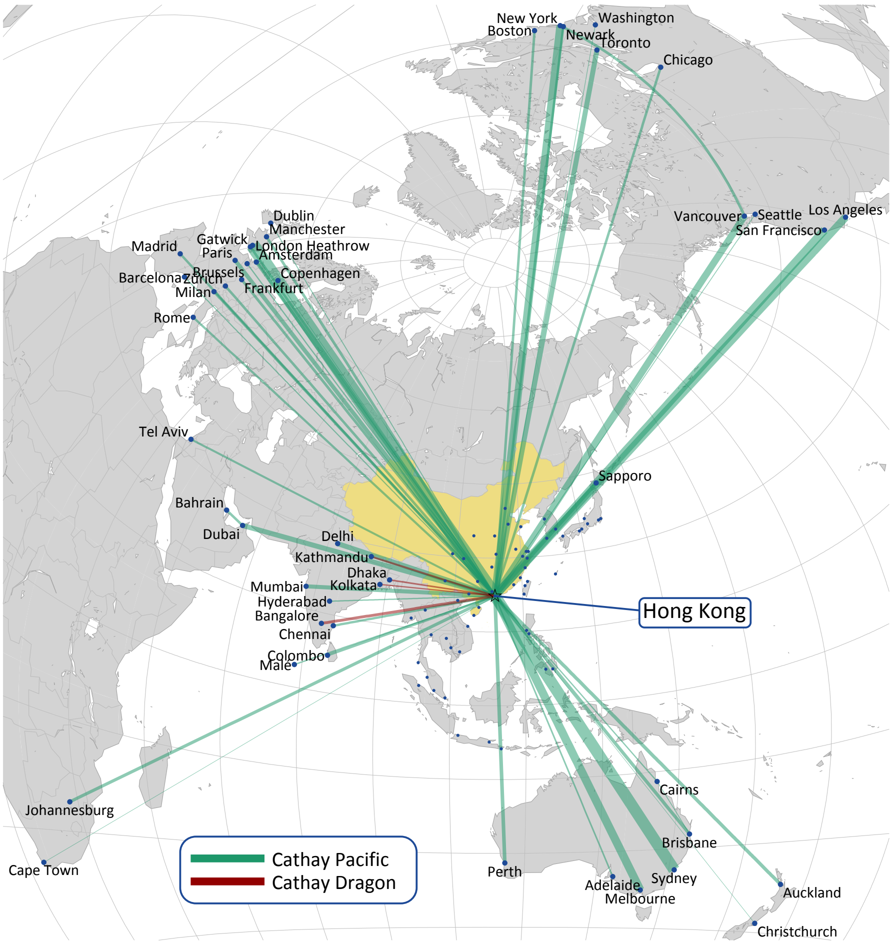
This was on the back of a 3.5% increase in passenger capacity (in ASK) and a 2.6% increase in cargo capacity; a 3.1% growth in passenger demand (in RPK) and a relatively strong 4.2% improvement in freight demand.

Yields and unit revenues were strong. For the passenger services this translated into a 6.6% increase on a like-for-like basis (management notes that it had refocused yield management towards individual and away from group travel while emphasising strong premium demand on services to Europe and North America) — the adoption of new accounting standard HKFRS15 meanwhile distorts historic comparisons. Cargo unit revenues jumped by 17%: the company highlights increased demand for premium and temperature controlled services, and the success of implementing higher fuel surcharges.

Underlying non-fuel unit costs excluding fuel grew by 1.9% year on year and while the group unwinds out-of-







Note: azimuthal equidistant map projection based on Hong Kong (great circle routes appear as straight lines). Thickness of lines directly related to annual number of seats.

the-money fuel hedges unit costs including fuel increased by 4.8%.

Two years ago the company embarked on a major restructuring programme to return it to a sustainable level of profitability. A large part of this has involved redesigning internal processes, head office organisation and cultural customer-facing reinforcement.

When faced with unacceptable results airlines tend to choose one of two basic courses: trim operations to slim down to profitability; or grow operations to reduce unit costs and hope that unit revenues stay static or improve.

In 2018, Cathay started implementing a new expansion strategy after years of modest growth. It opened ten new destinations — Nanning, Jinan, Brussels, Copenhagen, Dublin, Washington DC, Davao City, Medan, Cape Town and Tokushima — and increased frequencies on popular routes. This year it has introduced services to Seattle and Komatsu. (It meanwhile killed services to Düsseldorf and Kota Kinabulu).

As a result, overall seat capacity (in ASK) grew by a modest 3.5% in 2018, but services on European routes increased by 11% and these routes now account for 21% of total traffic (see graph on the facing page). Despite this capacity growth, strong premium demand meant that yields on European services were up by 7% on a like-for-like basis while load factors only dipped by 1.3 points to 86.2%.

This increase in services suggest that 2019 will see a surge in growth with capacity set to increase by 6-7% year-on-year. The company guides that this will be heavily weighted to long haul operations (10-12% growth in capacity to Europe, North America and Africa, 5% to North Asia; while regional Chinese, SE and South Asian routes are likely to grow by no more than 2-3%).

In common other Asian network carriers — notably Korean and EVA — Cathay is heavily into freight operations: 50% of its total output is in cargo (see chart on the preceding page). It also has a major cargo joint venture with associate Air China. While cargo operations performed relatively well last year, the company notes that there had been a softening of load factors towards the end of the year: and the current trade war between the US and China is unlikely to help. At the end of 2018 it also acquired the 40% minority it did not own in Air Hong Kong (which operates almost exclusively for DHL) while signing a 15-year agreement to provide wet-lease services to DHL.

Cathay has made significant progress in aligning its fleet and reducing subfleet complexity. The long-haul passenger services are now based on fleets of 33 A330s, 30 A350s (with 16 on order) and 66 777s — the last 747 left the fleet in 2016 and A340 in 2017. It has plumped for the 777X for long term renewal and has 21 of the 777-9X on order to be delivered from 2021. The short haul fleet at Cathay Dragon revolves round the A320 (with 23 in operation and 32 -neos on order) and 25 A330s.

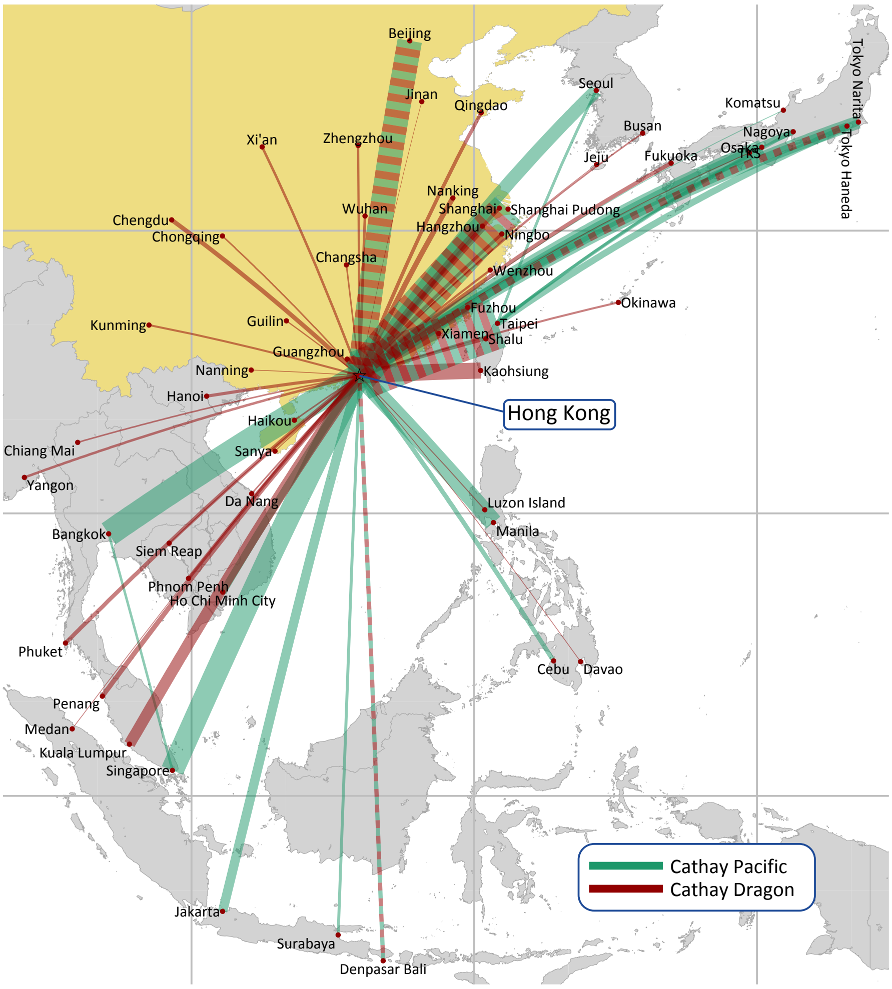
Management refers in the results announcement to 2018 having produced "solid results despite intense competition". And yet on the face of it Cathay should be in a very strong position. It is the de facto flag carrier for Hong Kong; has strong natural point-to-point O&D demand; positioned strategically in the Greater Bay Area (the megalopolis of the Pearl River Delta with a population of 69 million people); controls nearly half of the slots at HKIA; and, having a reciprocated share swap with Air China, clearly seen to be in favour with the state controlled capitalism in the PRC.

But the airport is running at design capacity and there are significant constraints on airspace infrastructure. Cathay's record of on-time performance has been deteriorating: ten years ago it achieved a punctuality rate of 86% of flights departing within 15 minutes of scheduled time; by 2017 this had fallen to 71%.

Construction of a third runway as part of the airport's Master Plan 2030 started in 2016. Expensive and complicated — it will involve the reclamation of 650 hectares of land with a cost estimate of HK$140bn — it is not scheduled to open until 2024.

Competition has been intense, and most of all from mainland China. Cathay may have half the capacity between Hong Kong and mainland destinations, but it has lost out as Chinese aviation has grown. The route between Hong Kong and Taipei used to be the densest air route in the world and a strong one for Cathay as it could provide one of the few ways for connecting the PRC with Taiwan. As the PRC has increasingly opened cross-straits access, this advantage has diminished.

CATHAY PACIFIC REGIONAL ROUTE NETWORK



Note: cylindrical equidistant Plate Carrée map projection. Thickness of lines directly related to annual number of seats.

Secondly, the mainland carriers — the Big Three, HNA and their affiliates — have been encouraged to open international routes from cities behind their main hubs in Beijing, Shanghai, Guangzhou and Hainan. In the last ten years international services have grown exponentially: the number of international route pairs out of mainland China has doubled and the number of seats grown by 2.5 times, annual average growth of 10% and 12% respectively.

Cathay has been particularly successful in fending of incroachment by low cost carriers. Jetstar had been trying to set up an affiliate in the region and, rebuffed, gave up the attempt in 2015. Local competition, however, is provided by HNA Group subsidiaries Hong Kong Airlines and LCC Hong Kong Express. These carriers have 10% and 6% respectively of the slots at Chek Lap Kok — the next largest carriers are China Airlines (of Taiwan) and China Eastern each with 3%.

Then at the end of March Cathay announced that it had agreed to acquire Hong Kong Express from the debt-laden HNA Group for HK$4.9bn

CATHAY PACIFIC GROUP FLEET

		In service	On Order			
		Dec 2018	2019‡	2020	≥2021	Total
Cathay Pacific	777-200	4				
	777-300	14	3			3
	777-300ER	52				
	777-9X				21	21
	A330	33				
	A350-900	22	2	4		6
	A350-1000	8	4	3	5	12
	Total CX	**133**	**9**	**7**	**26**	**42**
Cathay Dragon	A320	15				
	A321	8				
	A321neo			9	23	32
	A330	25				
	Total KA	**48**		**9**	**23**	**32**
Cargo fleet	747-400BCF	1				
	747-400ERF	6				
	747-8F	14				
	A300-600F†	10				
	Total Cargo	**31**				
	Group Fleet	**212**	**9**	**16**	**49**	**74**

Source: Company reports.
Notes: † Operated by Air Hong Kong; ‡ two A350s were delivered in Feb and Mar 2019; three used A330-300 to be delivered 2019.

(US$630m). The LCC has a fleet of 24 A320 family aircraft with eight on order. It operates a handful of routes to South Korea, Japan, Thailand, Taiwan and Vietnam, but lost HK$141m in 2018. Cathay stated that It intends to continue to operate HKE as a standalone low-cost airline.

The group expects to get clearance from the competition authorities and complete the transaction by the end of the year.

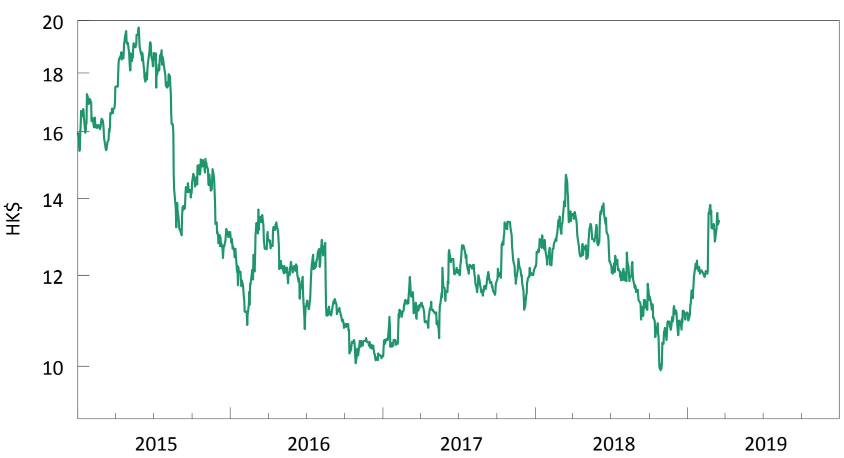
The management states that their long term strategy is:

- ✈ Relentless focus on customer experience, whilst creating a "through train" of transformative capability to enable continuous productivity and efficiency improvement. (Whatever that really means).
- ✈ ASK growth of 3-4% per annum through to the opening of the 3rd runway in 2024. Growing the network and HK Hub in destinations, frequencies and capacity.
- ✈ Continued fleet investment in both regional (A321neo's) and long haul (A350s and 777-9X).
- ✈ Build Hong Kong's position as a gateway airport for the Greater Bay Area (GBA), making HKIA accessible to GBA through improved multi modal connectivity and seamless access.
- ✈ Increase the Group's presence and penetration in the GBA.
- ✈ Position the Group to take advantage of capacity increases that arise on the opening of the 3rd runway in 2024.

One would hope that underlying this vision will be a return to a real level of profitability. To do this Cathay needs to return operating margins on the order of the 10% it used to achieve before the global financial crisis. This means tripling the results it achieved last year.

In the 2017 annual report chairman John Slosar stated that "Cathay remains committed to Hong Kong and its people, as it has been for the last 70 years". As those operating in the Chinese sphere of influence recognise, commitment has a long horizon.

CATHAY PACIFIC SHARE PRICE PERFORMANCE



Thomas Cook and TUI: Big Two tour operators evolve under pressure

THOMAS Cook and TUI — the last surviving AIT giants in Europe — both posted poor first quarter results for their latest financial years. On top of the relentless decline in the traditional all-inclusive tour market, they now face headwinds from Brexit uncertainty — and with both facing mounting debt piles, at least one of them is contemplating a virtual fire sale of its aviation assets.

Aviation Strategy has been tracking the AIT (Air Inclusive Tour) market out of the UK for many years, and the decline of the traditional package holiday market (the combination of holiday accommodation resort hotel and charter flight) that started in the early 2000s continues apace.

As can be seen in the chart below, total charter passengers out of the UK from UK-registered airlines fell again fell last year — for the 17th consecutive year — and the 2018 total of 11.3m is less than a third of the peak 34.5m charter passengers carried in 2001. In terms of the split of scheduled versus non-scheduled capacity offered by UK-registered airlines operating out of the UK (see chart on the next page), non-scheduled ASKs fell again in 2018, to 9% — another new low — and compares with the peak 37% that non-scheduled ASKs represented in 1989.

The traditional package holiday is being replaced substantially by consumers who research, assemble and book their own "holiday packages" of accommodation, flights, care hire (etc) from multiple suppliers online. The majority of seats booked on scheduled flights to leisure destinations in the summer are undoubtedly replacements for former AIT bookings. These are mostly self-assembled holidays that have a flight element, but the charter seat has been replaced by a scheduled flight (and more often than not that flight is with an LCC — though it shouldn't be forgotten that the LCCs themselves offer package holidays).

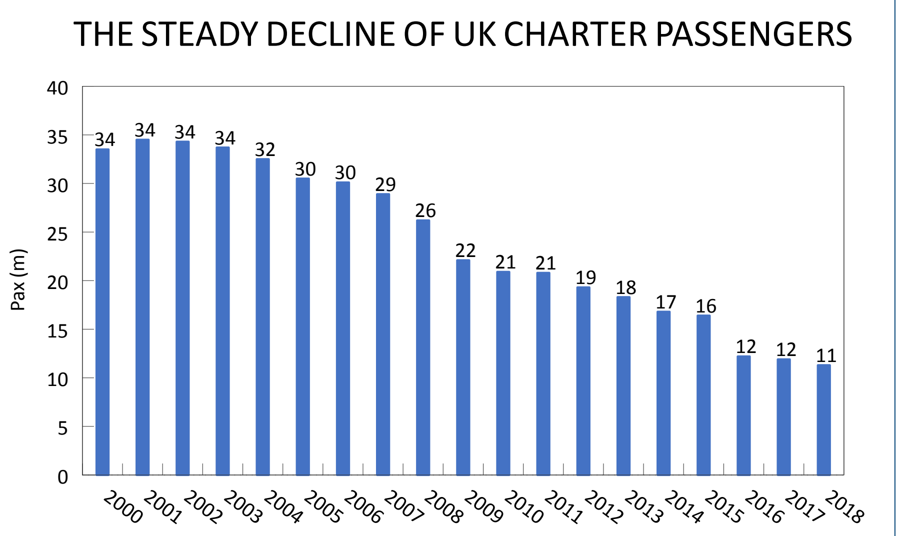
Brexit B******s

Then there is the mess caused by Brexit, which for the travel industry is made even worse by scare stories in the press such as a front-page story by the UK-based Sunday Times in December 2018 that declared: "Don't go on holiday after March 29".

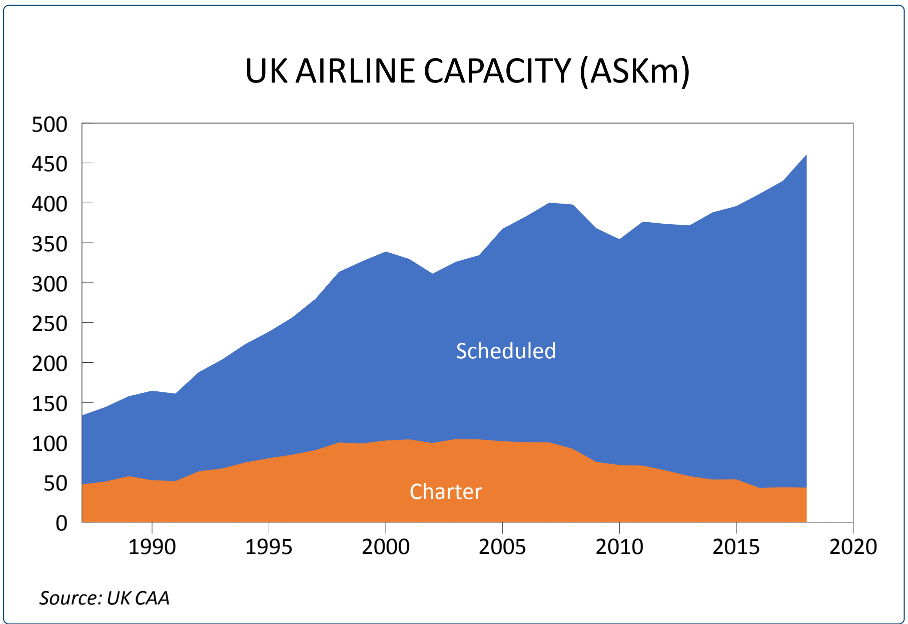
Last year the UK government warned that in the event of a no-deal, travellers should have at least six months left on passports from the date of arrival into the EU (compared with 90 days previously), though frustratingly for those renewing passports it quietly changed the rules so that unexpired portions of existing passports would no longer be added on to the period of a new passport.

Much more helpfully, in early February this year the European Council said it was liaising with the European Parliament to pass legislation that will allow UK citizens visa-free travel for up to 180 days to any of the 26 countries in the Schengen area, as long as the UK reciprocates (which the UK government has already promised). This move will sit alongside (though not replace) existing European Commission plans to make UK visitors to the EU from 2021 pay €7 for the "European Travel Information and Authorisation Scheme" (ETIAS), which will last for three years and mirrors the ESTA scheme that many visitors to the US have to participate in.

At the end of January, market re-



Source: UK CAA



search company Gfk said that summer 2019 bookings out of the UK had fallen sharply in the latter part of the month, thanks to the ongoing Brexit process and a slew of scare stories on travel in the British press.

Remarkably, however, despite that late-January dip, going into February holiday bookings out of the UK for the summer of 2019 were an impressive 4% up year-on-year, with revenue up 1% compared with bookings for summer 2018 of late January 2018. Indeed, Gfk says family bookings for summer 2019 were a significant 7% up year-on year, while all-inclusive bookings were up 10% compared with the same point 12 months ago.

That could be seen as a rejection by the majority of holidaymakers to Brexit uncertainty and those worrying news stories, but the softening in late January is a worry, and clearly much will much depend on whether a Brexit solution of some sort is passed by the UK's parliament by the new deadline of 12th April (and this hadn't occurred by the time *Aviation Strategy* went to press).

Another caveat comes from a closer look at just where UK holidaymakers are booking this year — Gfk reports that as at the end of January it's non-EU destinations that are seeing the biggest increase in summer 2019 bookings, with holidays booked to North Africa up two-thirds year-on-year, and to Turkey up by almost 50%. Data for holiday bookings out of other EU markets is harder to come by, though German-based TUI Group says demand out of Germany so far this FY is broadly in line with next year.

Thomas Cook woes

Thomas Cook, one of the two European AIT giants, is essentially still suffering from poor management of the past, and specifically a much later realisation (than its key rival, the TUI Group) that the AIT was going through structural changes. The company is now furiously trying to change its strategy in a very similar way to TUI, through differentiating its products and trying to improve margins, but it looks like a case of too little action, too late.

In its 2017/18 financial year (ending September 30th 2018), Thomas Cook saw revenue rise 6.4% to £9.6bn, but underlying EBIT fell 23.3% to £250m and a pre-tax profit of £43m in 2016/17 turned into a £53m loss in 2017/18. Management partly blamed a prolonged heatwave in Europe that restricted the ability to achieve good margins in crucial late holiday bookings for summer 2018, as well as poor airline performance, higher hotel costs in Spain and "complexity and scale" of the group's transformation plans.

The woes have continued into this year. In the first quarter of its 2018/19 financial year (ending December 31st), Thomas Cook's revenue rose by 0.1% on a like-for-like basis compared with Q1 2017/18, to £1,656m. However, an underlying operating loss rose by £14m year-on-year, to a £60m loss.

Brexit fears (or at least an ailing Sterling against the Euro) may have had an effect via weaker demand for winter holidays to Spain, whereas demand for winter holidays in Turkey and North African destinations grew. But overall holiday margins were lower in the quarter, which Thomas Cook says is "a continuation of the highly competitive market conditions in the UK at the end of the summer season".

The performance of the group's tour operations out of the UK and Northern Europe was "weak", though partially compensated for by a good performance in demand out of continental Europe. The group airlines performed well, according to the group, even though they delivered an underlying loss comparative with Q1 2017/18. Added to this was a £4m hit from "currency translation movements" during the quarter.

Will things get better in the crucial summer season? Peter Fankhauser, chief executive of

Thomas Cook is downbeat, stating that "bookings for Summer 2019 reflect some consumer uncertainty, particularly in the UK", and the group has been adjusting capacity downwards.

In its latest trading update, released in early February, Thomas Cook said that its summer 2019 programme was 30% sold, which was "slightly ahead" of the same point as of 2018.

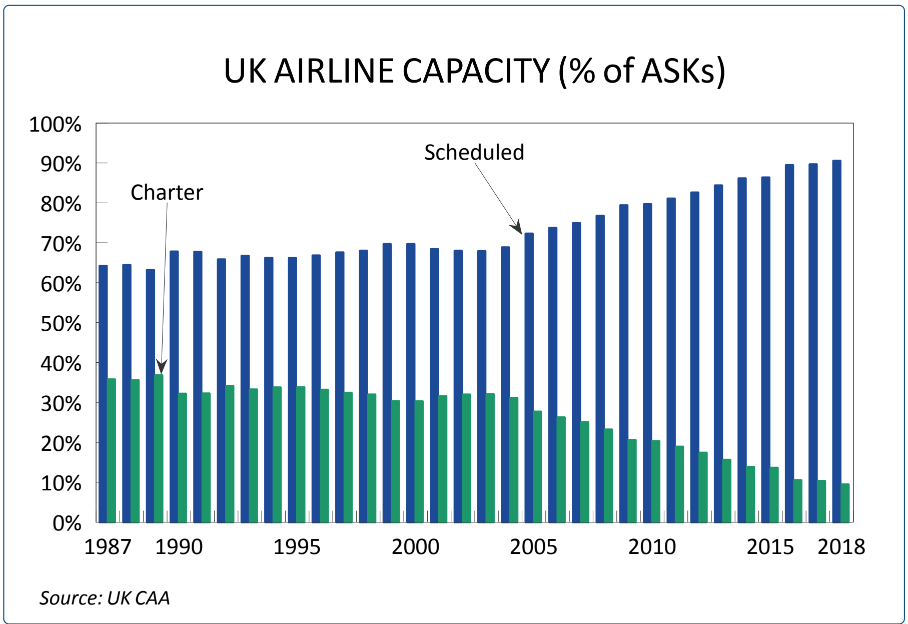
Significantly though, the group gave far less detail than normal on its 2019 summer bookings, and instead only revealed that tour operator bookings were down 12% year on-year, which is "consistent with the capacity reductions we have made across our markets to closely manage our risk capacity

throughout the year". However, average prices on sold bookings was up in all key segments, and 4% higher overall.

In terms of airline bookings, they were "below last year", thanks to reduced capacity in short- and medium-haul destinations through less wet-leased capacity. This was partially offset by growth in bookings to long-haul destinations, and average selling prices were up 6% year-on-year.

Critically, net debt for the group as at the end of 2018 was a hefty £1.6n — a worrying increase on the £1.3bn net debt level as of one year previously, and this is ringing alarm bells among analysts, particularly given the group's abysmal share price performance. Last November a second profit warning in three months saw shares collapse by 30% in a single day, and overall the share price has fallen by around 75% since late 2014.

While there is still some growth story — 20 new hotels are being opened this summer and a strategic alliance with Expedia is being expanded — the clear narrative for the group is to try and reduce its debt mountain.



Alongside its Q1 results, the group announced a strategic review of the company's airlines that Fankhauser says will "consider all options to enhance value to shareholders and intensify our strategic focus" — which analysts are interpreting as signalling the sale of the airline assets in an attempt to pay down debt and give the beleaguered group some breathing space.

It's a complete strategic about-turn for the group, with Fankhauser now saying the business "doesn't need to own an airline outright to be a successful holiday company".

The group currently operates a fleet of 110 aircraft, in five different models and operated by four group carriers. The largest airline is Condor, based at Frankfurt and which operates nine A320s, nine A321s, three A330s, 14 757s and 16 767s. Those 51 aircraft have an average age of more than 18 years. Thomas Cook Airlines is based in Manchester and has a 41-strong fleet (with an average age of 11 years) comprising 30 A321s, 10 A330s and a 757.

Based in Copenhagen is Thomas Cook Airlines Scandinavia, with eight A321s and five A330s (and an average age of 12 years). A Brussels-based Thomas Cook Airlines Belgium ceased operations in October 2017, with three of its A320s transferring to other Thomas Cook carriers, while two other A320s were sold to Lufthansa-owned Brussels Airlines.

However, in October 2017 the group established another carrier — Thomas Cook Airlines Balearics. Based in Palma de Mallorca, the airline operates five A320s (including three that previously operated with Thomas Cook Airlines Belgium), with an average age of 17 years.

The group doesn't have any aircraft on firm order, and overall the fleet is pretty old. While management is reportedly valuing its aircraft at more than £1bn, this may be a case of wishful/muddled thinking, as the entire group's market cap is currently below £500m, and the global market for elderly aircraft is not exactly strong at the moment. At the very least any potential buyers will know that — if not quite a fire sale — then the Thomas Cook group will be very eager to get whatever cash it can for its assets.

TUI wobble

The German-based TUI Group was the first of the Big Two to react to the changes in the underlying AIT market, and has been long been pursuing its strategy of moving to more-defendable, higher margin segments with "exclusive content" — whether holiday packages, hotels or cruises.

CEO Friedrich Joussen has a vision of TUI becoming the "Amazon of Travel" — as do quite a few other aviation and travel companies — developing into a digital one-stop shop for holiday/airline bookings, destination experiences, holiday review portal etc.

In the 2017/18 financial year (ending September 30th 2018), the group posted a 5.3% increase in revenue to €19.5bn, but operating profit was down 0.9% to €1,982m and net profit (at continuing operations) was down 14.3% to €780m. The downward trend is continuing. In the first quarter of the 2018/19 financial year (the three months ending December 31st), group revenue rose 4.4% year-on-year to €3.7bn but EBITA fell from a €56.9m loss in Q1 2017/2018 to a €105.6m loss in October-December 2018. At a net level, losses worsened from €69.3m in Q1 2017/18 to €111.9m in Q1 2018/19.

TUI admitted that it had a weak performance in its core "Markets & Airlines" business (the AIT and airline part of the group) in the quarter, where the "seasonal loss increased significantly". The group gave a long list of reasons for this, including the knock-on impact of the summer 2018 heatwave (resulting in later bookings this year); overcapacities in Spain (especially in the Canaries) arising from a shift in demand to the eastern Mediterranean (particularly to Turkey); pressure on yield; continued sterling weakness; Brexit uncertainty and weaker results from the Nordic region year-on-year. And the disappointing Q1 result came after a net one-off benefit of €11m from special items, which included a €20m gain from the Niki bankruptcy impact and a €29m gain from a hedge taken out in the group's northern region.

Similar to Thomas Cook, TUI has been far less forthcoming with detail on prospects for the summer season as it usually does. It says is that there are "significant sector headwinds", and that "previously it was anticipated that these headwinds would impact negatively on our H1 (winter); however, we are seeing from current bookings an adverse impact on H2 (summer)".

As at early February, Market & Airlines bookings for winter 2018/19 were 1% down on the prior year, with the average selling price down 2% and a "lower margin performance" than the prior year. For summer 2019, 34% of the programme had been sold to date, with a flat average selling price and again a "lower margin performance than prior year". The group is explicit about the threat of downside scenario for Brexit — and particularly a hard Brexit — and says that "the main concern remains whether our aircraft will continue to have access to EU airspace".

The group insists its overall growth strategy is still intact, but it's clear where the problem lies. Its Holiday Experiences division (which includes hotels, cruises and other activities/excursions) delivered just 13.2% of revenue in Q1 of the 2017/18 financial year, but posted (positive) earnings of €111m. In contrast, the Market & Airlines business) was responsible for 82.6% of revenue in the quarter but delivered a massive loss of €178m (compared with a €141m loss in Q1 2017/18).

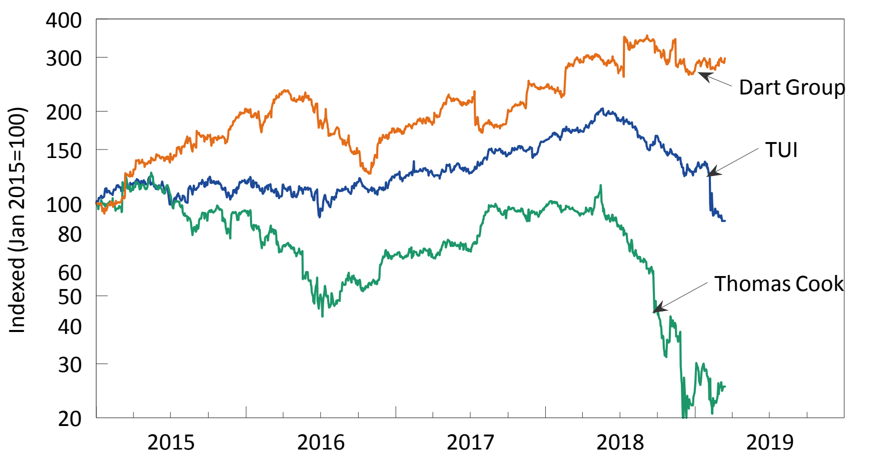
While the first half of the financial year is traditionally poor/loss-making for all tour operators, this pattern of contrasting performance between the businesses was also evident in the last full year (2017/18), when Holiday Experiences delivered 9.3% of revenue and 75% of earnings, while Markets & Airlines contributed 87% of revenue and 19% of earnings.

The group needs to turn Markets & Airlines around fast. It had already combined the airlines and regional AIT businesses to form a single division in order to drive efficiencies and cost savings, and it is also trying to sell more capacity direct to reduce distribution costs (in FY 2017/18 74% of bookings were made direct, and 48% online).

Interestingly, in a trading note issued in early February (before the quarterly result was released), the group said that it expected that continued headwinds may trigger market consolidation (such as the bankruptcy of Berlin-based Germania in February 2019), and that "TUI could be a beneficiary of this". That's a more passive approach than Thomas Cook; at this point in time TUI still seems attached to the concept of owning its own fleet — but will this last?

That TUI group fleet currently comprises 155 aircraft, flown by six airlines. The largest is Luton-based TUI Airways, with 36 737s, 13 757s, 12 787s and four 767s, followed by TUIfly, based at Hanover airport and which operates 34 737s and a single A321. TUI Airlines Belgium (based in Brussels) has 27 737s, two 787, a sin-

TOUR OPERATOR SHARE PRICE PERFORMANCE



gle 767 and four ERJ-190s; Schiphol's TUI Airlines Netherlands operates six 737, three 787s and a 767, while TUIfly Nordic (Stockholm) has four 737s. The only non-TUI branded airline is Orly-based Corsair International, which operates four A330s and three 747s. TUI has been trying to sell the loss-making carrier for years, and in March announced a deal to sell 53% to German turnaround specialist INTRO Aviation for an undisclosed amount, with TUI initially retaining a 27% stake and Corsair's Employee Benefit Trust keeping 20%. The TUI group also has 61 737MAXs on firm order.

Thanks to the strength of the Holiday Experiences division, the TUI group says underlying earnings will be "broadly stable" in full 2018/19 compared with FY 17/18. However, the pressing problem is the group's debt position; net debt has more than doubled in just 12 months, from €874m as at December 31st 2017 to €1,832m a year later (and due partly to finance leases for additional aircraft). If Thomas Cook sells its aircraft portfolio for anything approaching a decent price, then surely the TUI group might be tempted to follow?

The challenger — Jet2.com

After the big two AIT group airlines, with the demise of Monarch the largest independent UK airline operating in the AIT segment is Jet2.com.

Based at Leeds-Bradford airport, Jet2 dates back to 1983 and is owned by the Dart Group, a UK holding company that also owns a chilled food distributor.

In the first half of its 2018/19 financial year (the six months ending September 30th 2018), Jet2 recorded 4.4m flight-only passenger sectors and had 2.3m package holiday customers (up 24.4% and 27.6% year-on-year respectively). Overall, Jet2's revenue grew by 38% to £2.2bn in the half-year, with operating profit up 69% in April-September 2018 to £347.8m and net profit up 56.8% to £274.8m.

Jet2 operates 100 aircraft from its main base and eight other UK airports to more than 70 leisure and city destinations in Europe. It also operates major bases al Alicante and Mallorca airports.

The last of an order for 34 737-800s was delivered in January 2019, and this summer three new destinations will be added — Chania in Crete, Bourgas in Bulgaria and İzmir in Turkey. A total of 12m seats are available on summer 2019 season, which is a capacity increase of 15% compared with summer 2018.

In November Philip Meeson — the chairman of the Dart Group — said that he was "unclear how demand will develop in the medium term", thanks to "the overall uncertain UK economic outlook, particularly related to Brexit and how it may impact on consumer spending".

At the time he added that Jet2's strategy remained consistent — to grow both flight-only and package holiday products, though this was "on the assumption that the UK government secures a pragmatic and balanced Brexit agreement with the EU".

Air Canada: Target is to eliminate gap with US peers

AIR CANADA held a bullish investor day on February 28 that included much talk about network diversification, sixth freedom traffic, low-cost unit Rouge, fleet renewal, balance sheet strengthening and other successful strategies pursued in recent years.

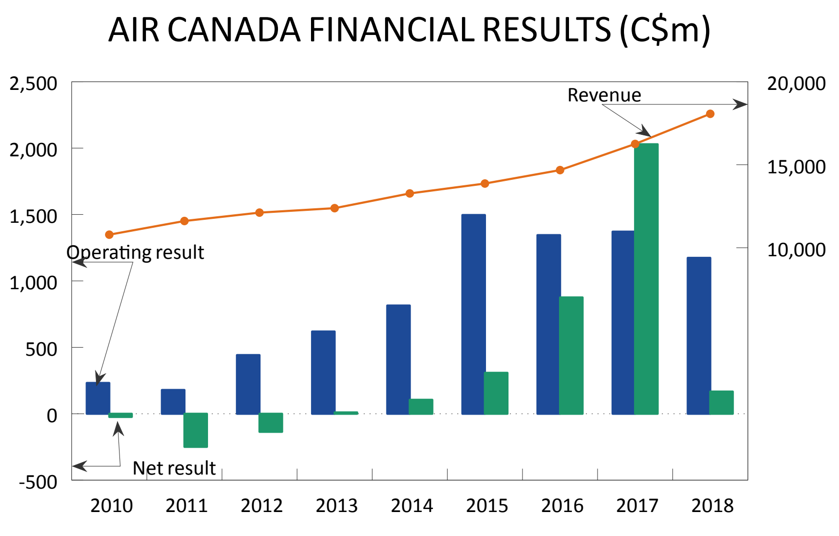
Senior executives announced lofty financial targets for the next three years and promised substantially lower capital spending and more aggressive share buybacks. They argued that continued deleveraging would make the business more resistant to economic downturns and, hopefully, result in investment-grade credit ratings.

Under the new plan, Air Canada targets an annual EBITDA margin of 19-22% and annual ROIC of 16-20% in 2019-2021. Aggregate FCF in the period would be C$4-4.5bn, including C$400-600m in 2019. The leverage ratio (net debt/EBITDAR) would be reduced from last year's 2.1x to 1.2x at the end of 2019.

Unfortunately, just two weeks later, Air Canada had to suspend the financial targets for 2019 in the wake of the Boeing 737 Max's worldwide grounding.

Air Canada is feeling much impact as it operated 24 Max 8s on March 13, accounting for 6.6% of its ASMs, and had expected to receive another six in March and April. Its narrowbody fleet transition relies heavily on the Max: there are 43 firm orders for delivery in 2019-2024.

The immediate operational impact has been manageable. Air Canada has backfilled nearly all of the grounded capacity through delaying aircraft retirements, extending leases and enlisting the help of Rouge and international partners. But it has had to temporarily suspend transatlantic services linking Halifax and St. John's with London Heathrow (passengers are rerouted through the Toronto and Montréal hubs).



Source: Company reports

The negative effects will worsen if the Max grounding extends into the peak travel season. Air Canada has acted more conservatively than its peers by removing the Max from its schedule until July. However, if the Max issues are resolved this year, Air Canada could get back on track to achieve the investor day projections from next year onwards. For now the airline is sticking to the 2020 and 2021 targets.

Air Canada has come a long way since 2009, when it almost ran out of cash and faced extinction after years of high costs and financial losses (despite many bailouts and restructurings). It managed to pull itself out of that crisis thanks to labour and supplier concessions and some creative financings.

The subsequent transformation has been nothing short of miraculous. Air Canada staged a strong financial turnaround in the first half of this decade, enabling it to achieve 10%-level annual operating margins for the first time in 2015 and 2016.

There was also a dramatic shift in labour relations. For reasons that are not entirely clear, Air Canada managed to transform itself from an airline with horrendously bad labour relations to one with a happy workforce and an "entrepreneurial, can-do culture". In 2015 it even secured 10-year agreements with its key unions.

By most standards, Air Canada has delivered on the "global champion" strategy introduced in 2010 by Calin Rovinescu soon after he became

CEO. Rovinescu's strategy had four core components: cost cuts and revenue initiatives; pursuing profitable international growth opportunities; enhancing product/service differentials; and fostering cultural change.

In the past five years, Air Canada's operating revenues have surged from C$12.4bn to C$18.1bn (US$ 13.4bn) in 2018 — a CAGR of 7.8%. In the same period its annual passenger numbers rose by 42% to 50.9m last year.

Progress with costs has been particularly swift since 2012 when more initiatives were adopted — boosting aircraft utilisation, ordering more efficient aircraft, launching Rouge and revising the contract with regional carrier Jazz. Since 2012 Air Canada has reduced its ex-fuel CASM by 9.8%, compared to an 8.9% increase seen by WestJet and a 16.9% increase for the average of the three largest US carriers (figures from Air Canada's recent presentation).

Air Canada claims that its ex-fuel CASM has fallen by 14% since 2012 if "normalised for the impact of the US$/C$ exchange rate on operating expenses" and that on that basis its unit costs are now similar to those of the largest US network carriers.

The cost differential with the main Canadian competitor, WestJet, is also diminishing, although that largely reflects WestJet's changing business model. Air Canada calculates that its 2018 ex-fuel CASM was only 4.6% higher than WestJet's.

In the past five years Air Canada has been on a major international expansion drive, having identified an opportunity to tap sixth freedom traffic. It has also continued to grow Rouge after its pilots relaxed their original 50-aircraft maximum limit for the unit.

The balance sheet has strengthened significantly. For example, adjusted net debt/EBITDAR has fallen from 8.3x in 2009 to the 2.1x-level in the past two years. And Air Canada now has a pension plan surplus of C$2.4bn, compared to a surplus of C$1.3bn in 2015 and a deficit of C$2.7bn in 2009.

Air Canada's share price has more than quadrupled in the past three years; yet, most analysts see room for further improvement and continue to recommend the stock as a buy or strong buy.

The negative is that Air Canada's profit margins continue to lag those of the US network carriers, and the company continues to be undervalued relative to its US peers. Its operating margin peaked at 10.8% in 2015, and since then has somewhat declined (9.2% in 2016, 8.4% in 2017 and 6.5% in 2018).

Air Canada's aim is to eliminate the gaps with its US rivals, and strategies disclosed at the investor day may help accomplish those goals.

Tapping sixth freedom traffic

Targetting sixth freedom traffic between the US and the rest of the world has been the cornerstone of Air Canada's growth strategy in the past five years. The strategy takes advantage of the carrier's many inherent advantages: Canada's geographical position, with proximity to the world's largest air travel market; the US-Canada open skies ASA; Air Canada's well-positioned hubs (Montreal, Toronto and Vancouver); and Air Canada's extensive traffic rights.

In many cases, Air Canada can offer the shortest route to and from the US. The strategy has been successful also because of the efficient transfer processes offered by the airports; not having to pick up bags is crucial for attracting international transit traffic. Another selling point has been Air Canada's superior product (compared to US airlines).

Air Canada's international transit traffic grew by 15% in 2018 (versus 2017) and has increased by 142% since 2013. Still, last year the carrier's share of long-haul international traffic to/from the US (US-Pacific and US-Atlantic) was still only 1.3%; the management made the point that increasing that share to 2% would translate into around C$675m incremental annual revenue.

The sixth freedom strategy has enabled Air Canada to expand its international network far beyond what Canada, with a population of 37m, could support. Since 2009 the airline has added 64 new destinations, of which 48 have been international.

US transborder and long-haul international operations now account for 71% Air Canada's passenger revenues, up from 62% in 2012. Such diversification away from the domestic market is critical as increased competition from ULCCs will very probably drive down domestic fares.

In recent years the fastest growth has been on the transatlantic, where in 2018 alone Air Canada and Rouge added 18 new routes. Management sees an opportunity to increase "highly profitable hub-to-hub flying" within the Atlantic JV, to better link the Canadian hubs with Brussels, Frankfurt, Munich, Vienna, Zürich and Geneva.

Airline partnerships feature prominently in Air Canada's global strategy. In addition to further strengthening what it calls its "A++" Atlantic JV with United, Lufthansa and others, Air Canada will be developing the Pacific JV it signed with Air China last year.

The future will also see Air Canada launch more counter-seasonal routes, deploy Rouge to

AIR CANADA ROUTE NETWORK

Notes: Equidistant map projection based on Toronto (great circles appear as straight lines); thicknesss of lines directly related to number of seats.

up-gauge more regional flights and leverage the Max and the A220 in North America.

The first of Air Canada's 45 A220-300s is scheduled to enter service in January 2020. The executives noted that the type's "unparalleled operating economics" will open many new possibilities, including routes such as Vancouver-Washington DC and Montreal-Seattle.

Plans for the 737 Max see it deployed just about everywhere: to Europe, Hawaii, transcon, Mexico and the Caribbean.

The benefits of Rouge

Air Canada's international growth has also focused on competing more effectively in the leisure market to and from Canada with the help of Rouge. The "airline-within-an-airline" concept faced much scepticism initially but has been successful. Since it first flew in July 2013, Rouge has carried 30m passengers, grown its fleet to 53 aircraft and expanded its network to 70 destinations on five continents. Its stage-length adjusted CASM is 29% lower than Air Canada's.

Management described Rouge as a "key strategic tool" that enables Air Canada to compete in leisure markets, swing capacity from the sun markets in the winter to the transatlantic in the summer, and effectively defend against ULCCs in Canada.

Particularly important is the coordinated approach that leverages the strengths of the mainline operation, Rouge, Air Canada Vacations and Air Canada Express. Notably, Rouge has helped facilitate strong growth for Air Canada Vacations, also helping it to offer domestic holiday packages.

Rouge's CASM and margins will benefit further from the growth of its current predominantly-A319 narrowbody fleet to include the larger A320s and A321s. The A320s are coming from the mainline fleet (see table on the following page). Rouge also operates 25 767-300ERs.

Fleet plans and capital allocation

Air Canada is nearing the end of its widebody fleet renewal programme, which has seen it build a 35-strong 787 fleet and steadily retire 767-300ERs. The last two 787s on firm order will arrive this year. There will also be four A330 deliveries in 2019, which will facilitate the retirement of the six remaining 767s in the mainline fleet, and one more A330 delivery in 2020.

The only other widebody spending anticipated at this point is the need to replace some of Rouge's 767-300ERs by the mid-2020s.

The focus has now shifted to the narrowbody fleet transition. The 43 737 Maxes on firm order (with de-

AIR CANADA FLEET PLAN TO 2020

	Year end	2018	2019	2020
Air Canada Mainline	787-8*	8	8	8
	787-9*	27	29	29
	777-300ER	19	19	19
	777-200LR	6	6	6
	767-300ER	6		
	A330-300	8	12	13
	737 Max 8†	18	36	50
	A321	15	15	15
	A320	42	29	16
	A319	16	16	16
	A220-300‡		1	15
	E190	19	14	
	Total Mainline	**184**	**185**	**187**
Air Canada Rouge	767-300ER	25	25	25
	A321	6	10	10
	A320		6	7
	A319	22	22	22
	Total Rouge	**53**	**63**	**64**
	Total Mainline & Rouge	**237**	**248**	**251**
Air Canada Express	E175	25	25	25
	CRJ-100/200	24	22	15
	CRJ-900	21	26	35
	Dash 8-100	15		
	Dash 8-300	25	23	19
	Dash 8-Q400	44	44	36
	Total Air Canada Express	**154**	**140**	**130**

Source: Air Canada.

*Notes: * Air Canada will receive its final two 787-9s in 2019. There are options for 13 and purchase rights for 10. † At year-end 2018 Air Canada had firm orders for 43 additional 737 Max aircraft for delivery in 2019-2024. ‡ There are firm orders for a total of 45 A220-300s for delivery in 2019-2022, plus 30 options.*

liveries currently suspended) are intended to replace the mainline A320-family fleet, resulting in an estimated 11% CASM saving.

Air Canada has 45 A220-300s on firm order for delivery to the end of 2022. The type offers a 12% CASM advantage over the E190, which it will replace (among other uses).

With the widebody renewal winding down, at the investor day Air Canada forecast its total annual capital expenditure to decline from C$2.9bn in 2019 to C$1.4bn in 2021. Non-aircraft capex (mostly investments in technology) would amount to around C$600-800m annually, meaning that fleet capex would fall from C$2.2bn in 2019 to only C$700m in 2021.

Some of those projections may well change as a result of the Max crisis, but one thing seems certain: Air Canada will have much more free cash flow at its disposal.

The plan is to continue to deleverage, buy most of this year's aircraft deliveries with cash and return more capital to shareholders.

In the first place, Air Canada intends to repurchase stock more aggressively when opportunities present, but dividends would also be considered.

Air Canada's balance sheet is in reasonable shape, with unrestricted liquidity of C$5.73bn (32% of annual revenues), shareholders' equity of C$4.0bn and adjusted net debt of C$5.86bn at the end of 2018. The airline expects to maintain a pension plan surplus in the next three years.

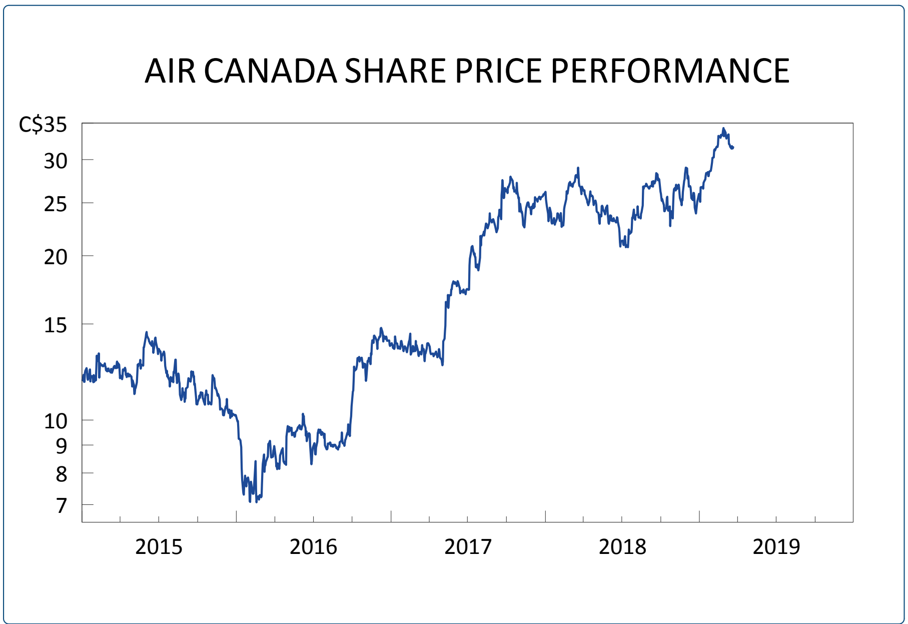
One of the themes at the investor day was that Air Canada is keen to obtain investment-grade credit ratings and that the management believes that the targeted 2019 leverage ratio of "no more than 1.2x" would support that.

Air Canada is certainly heading in the right direction: its credit ratings with S&P and Moody's have improved steadily since 2012. But the ratings are still two notches below investment grade, so analysts have suggested that getting there could take a year.

Closing the valuation gap?

Air Canada's earnings growth prospects are promising. Its growth rate is moderating. It can start consolidating the impressive global network it has built. There are good opportunities to grow ancillary revenues, expand Rouge and continue to build the cargo and vacations businesses. C$250m of new cost savings have been identified for 2019. An improved and expanded deal is in place with regional partner Jazz.

There are also two major value-enhancing initiatives in the pipeline. First, Air Canada plans to implement a new reservation system in late 2019 that is expected to generate C$100m-plus in annual benefits. Second, mid-



2020 will see the implementation of a new loyalty programme that has an NPV in excess of C$2.5bn.

But why would Air Canada launch a new loyalty programme after spending C$450m to buy its former loyalty business Aeroplan back from Aimia (a transaction that closed in January)? Apparently because having Aeroplan's expert team, customer data and partner relationships will "significantly accelerate and de-risk" the launch of the new programme.

One of the big themes at the investor day was that Air Canada has lowered its risk profile and become more resistant to economic downturns. It has a lower financial leverage, record liquidity levels, a US$2.6bn pool of unencumbered assets and flexibility in its fleet plan (via lease expirations and apparently "deferral rights on new aircraft yet to be delivered"). There are currently 55 unencumbered aircraft in the combined Air Canada/Rouge fleet, a figure that is projected to rise to 100 by 2021 (40% of the fleet).

The executives argued that Air Canada has "demonstrated that it can be sustainably profitable over the long-term". They have modelled a recession scenario similar to the 2008/2009 recession against its three-year business plan and concluded that the EBITDAR margin contraction would be "less than half of the 500 basis point decrease we experienced in 2009 for the year following the start of the recession". However, they also recognise that Air Canada may have to actually go through an economic downturn to convince all investors.

They believe that the earlier higher cost of regional lift and not having an in-house loyalty programme — both outcomes of the ACE restructuring 15 years ago — were the "two key inhibitors to reaching or exceeding the valuation multiples enjoyed by US airlines". Both of those issues have now been dealt with.

By Heini Nuutinen

Book Review: "Flying off Course" (5th edition)

PROFESSOR Rigas Doganis has produced the fifth edition of his classic book on airline economics. The theme of this book is that for individual airlines, financial success depends on matching supply and demand in a way which is both efficient and profitable. Entitled as usual "Flying off Course", it might well this time have been retitled "Flying on Course", reflecting the vastly greater commercial focus of the industry and consequent improvement in returns on capital, but publishers are reluctant to change an established brand.

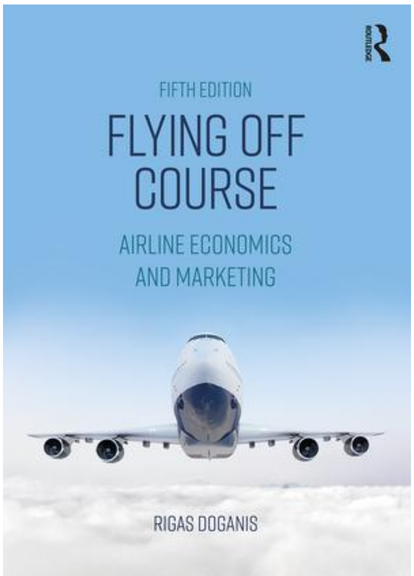
The book focuses initially on how different factors influence airline costs and the degree to which such factors can be controlled or influenced by management. It then covers the perennial details of regulation that pervades the industry. It provides a detailed coverage of the different airline business models with a clear explanation of the *modus operandi* of each, showing with examples that no matter whether low-cost or high-cost, legacy network or point-to-point, the key for success is to achieve unit revenues higher than unit costs.

The author examines a much neglected topic in the aviation literature — the charter sector. The short-haul charter airlines, integrated into inclusive tour companies, have been badly hit both by the growth of LCCs and by the changing travel patterns associated with the internet and the desire for more independent holidays. While the author shows that the charter model can produce lower seat-kilometre costs, he argues that its survival depends on offering passengers greater flexibility and choice than has been the case in the past.

The second half of the book focuses on airline marketing, that is the demand side of the equation, dealing with product planning and pricing and analysing the impact that LCCs have had on changing traditional airline pricing structures.

An extra section in this edition proposes strategies for success. Rigas suggests that there are priorities common to all airlines: vigilence on costs and improve revenue generation. He highlights that cost control must be seen by airline management as a long term necessity and not just a short term reaction to profit erosion or losses. One of the more intriguing subsections looks at the potential for the mid-sized and smaller network airlines. The author suggests that for some of these, collapse and closure, or sale to a larger network carrier seems to be the future. Some may only survive if supported by their Government; others if (such as TAP on routes to Brazil, or Finnair on routes through Helsinki to the Far East) they can find a niche.

The first edition of "*Flying off Course*", published in 1985, sits proudly still on the bookshelf. It was the one industry bible that taught the dynamic economic forces of this complex global industry and inspired a lifelong career of analysing the sector. The new edition is again well written and illustrated with real examples and case studies. Rigas Doganis has again succeeded in giving an insider's lucid view of the economics and marketing of the airline industry.



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