
Aviation Strategy

Issue no. 246

May 2019

# Can FS make Alitalia run on time?

TWO YEARS ago Alitalia ran out of cash and was put into short-term emergency administration, getting a government loan of €900m to be repaid within six months. The idea was to allow the administrators the time to find a buyer for the flag-carrier. The period of special administration has been extended several times and now is due to expire at the end of June. Meanwhile this month, various unions staged an industry-wide 24-hour strike causing an irritating level of flight cancellations. Ostensibly this was to protest at the lack of progress in securing a future for Alitalia; it could also have been because this is Italy and it was May.

Various potential bidders have come and gone — including easyJet and Lufthansa — while Air France-KLM, with its own problems and having already been badly burnt, refused to take part. Those still in the frame appear to be Delta and Ferrovie dello Stato (FS, the Italian state-owned operator of railways and motorways). The excuse for the further extension of the loan to the end of June was to allow FS to "develop a credible business plan". You would have thought that the two years since having been told to invest might have been sufficient for a rail operator to learn about the aviation business, and work out how to justify an investment of a few billion euros.

The Italian Government appears to have run out of plausible choices to push through a restructuring of the flag-carrier, without incurring the wrath of Brussels for providing (illegal) state aid without a rational business investment case. The state-owned Poste Italiane (the Italian postal service) was forced into investing in the last Alitalia restructuring in 2013 (designed to prepare it for the Etihad investment in 2014), along with Italian banks Banco Intesa Sanpaolo and UniCredit. All of these will have lost their equity investments. Poste Italiane refused to countenance the idea of further investment.

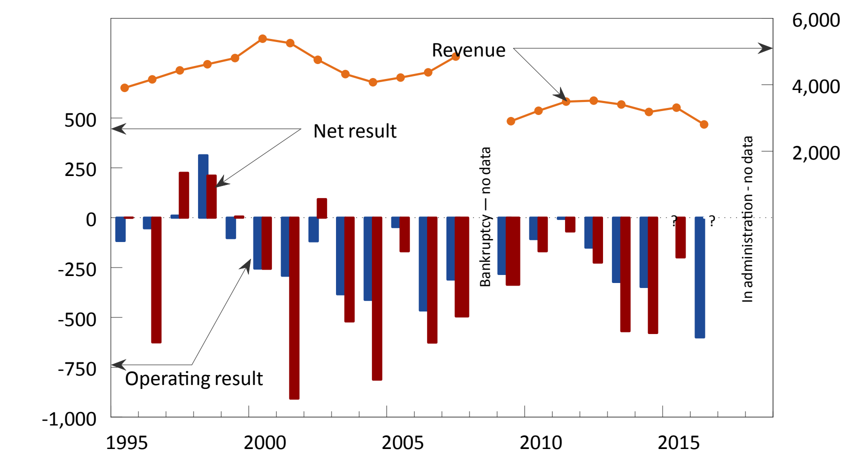
On the face of it FS might be a good choice as a major shareholder. It appears to be a profitable and commercially oriented business. Its accounts show revenues of €12bn in 2018, up by 30% from the prior year levels because of acquisitions; operating profits of €714m and net profits of €559m. It has €48.4bn in net invested capital and equity of €41.8bn. It has investment grade credit ratings of BBB from both Fitch and S&P.

But it is a government-owned entity and its all important credit rating is linked to that of the Italian State.

## This issue includes



ALITALIA: FINANCIAL RESULTS (€m)




*Source: Company Reports.*

Aviation Strategy

## 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.

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ISSN 2041-4021 (Online)



FS runs the Italian railway system — the operation of Trenitalia along with the network infrastructure and stations — on a long term virtual monopoly (although, unusually, there is a smaller private competitor, NTV, on the high-speed rail network, owned by Global Infrastucture Partners). It also owns ANAS (in charge of the construction and maintenance of Italian autostrade and state highways) along with Italian bus operator Busitalia, the c2c rail franchise in the UK, Thello in France (operating night trains between Paris and Venice) and Dutch bus operator Qbuzz.

FS mentions in its accounts that one of its corporate objectives is to develop the rail networks in Italy to encourage a modal shift to rail away from air transport for short-haul journeys. The development of the "Frecciarossa" high speed line between Turin and Naples via Milan, with top speeds of 300km is a major achievement (the journey time between Rome and Milan is just under three hours and that from Naples to Milan around four hours). Further expansion is planned.

It has had an effect. The Italian domestic air market as a whole has been virtually static over the last decade (while that between Rome and Milan has halved). Alitalia remains the largest player with 41% of the seat capacity on offer (see table below); but it has shrunk its offering by an annual average of 3% in the last five years and its share fallen from 50% (although Ryanair has grown by an annual average 7.7% and pushed its share of domestic capacity to 33% from 23% in 2013).

An article in *Il Sole 24 Ore* in March suggested that FS had reached an agreement with Delta. FS would take a maximum 30% stake in the

### ALITALIA FLEET

| | in service | owned | Average Age |
|---|---|---|---|
| 777 | 12 | 4 | 15.6 |
| A330 | 14 | | 10.0 |
| A319 | 22 | 12 | 12.1 |
| A320 | 38 | 10 | 12.4 |
| A321 | 11 | 1 | 21.7 |
| ERJ170 | 15 | | 7.0 |
| ERJ190 | 5 | | 7.5 |
| **Total** | **117** | **27** | **12.4** |

### ITALY: DOMESTIC CAPACITY

| | 2013 | | | 2018 | | | |
|---|---|---|---|---|---|---|---|
| | | Seats(m) | Share | | Seats(m) | Share | CAGR |
| 1 | Alitalia | 18.59 | 49% | Alitalia | 16.00 | 41% | -3.0% |
| 2 | Ryanair | 8.73 | 23% | Ryanair | 12.63 | 33% | 7.7% |
| 3 | Meridiana | 4.52 | 12% | easyJet | 3.61 | 9% | -0.2% |
| 4 | easyJet | 3.65 | 10% | Air Italy | 2.09 | 5% | -14.9% |
| 5 | Volotea | 0.89 | 2% | Volotea | 2.06 | 5% | 18.2% |
| 6 | Blue Panorama | 0.82 | 2% | Blue Air | 1.16 | 3% | |
| 7 | Darwin Airlines | 0.53 | 1% | Vueling | 0.72 | 2% | 101.6% |
| 8 | Air Italy | 0.17 | 0% | Blue Panorama | 0.33 | 1% | -16.6% |
| 9 | New Livingston | 0.03 | 0% | Neos | 0.16 | 0% | |
| 10 | Vueling | 0.02 | 0% | Alidaunia | 0.03 | 0% | |
| | Others (10) | 0.04 | 0% | Others (11) | 0.06 | 0% | 6.9% |
| | **Total Domestic** | **37.99** | | | **38.84** | | **0.4%** |

## ITALY: SHORT HAUL INTERNATIONAL CAPACITY

| | 2013 | | | 2018 | | | |
|---|---|---|---|---|---|---|---|
| Rank | Airline | Seats(m) | Share | Airline | Seats(m) | Share | CAGR |
| 1 | Ryanair | 20.6 | 21% | Ryanair | 31.1 | 24% | 8.7% |
| 2 | Lufthansa Group* | 13.3 | 14% | easyJet | 17.2 | 13% | 8.7% |
| 3 | easyJet | 11.4 | 12% | Lufthansa Group* | 16.4 | 12% | 4.3% |
| 4 | Alitalia | 9.8 | 10% | IAG† | 14.1 | 11% | 11.3% |
| 5 | IAG† | 8.3 | 9% | Alitalia | 9.6 | 7% | -0.4% |
| 6 | Air France-KLM‡ | 6.8 | 7% | Air France-KLM‡ | 7.4 | 6% | 1.7% |
| 7 | Wizz Air | 3.0 | 3% | Wizz Air | 5.8 | 4% | 13.8% |
| 8 | Air Berlin | 2.9 | 3% | THY | 2.3 | 2% | 4.5% |
| 9 | THY | 1.8 | 2% | Aeroflot | 2.0 | 1% | 14.6% |
| 10 | TAP | 1.1 | 1% | Blue Panorama | 1.8 | 1% | 50.0% |
| | Others (88) | 17.6 | 18% | Others (96) | 23.7 | 18% | 6.2% |
| | **Total short haul Intl** | **96.5** | | | **131.3** | | **6.3%** |

*Notes: Total scheduled seats on flights of under 4,000km to or from Italian airports. * Lufthansa Group includes Lufthansa, SWISS, Austrian, Brussels, Eurowings, Air Dolomiti and Germanwings. † IAG includes BA, Iberia, Aer Lingus and Vueling. ‡ Air France-KLM includes Air France, KLM, HOP!, Transavia and Transavia France.*

new Alitalia (it doesn't want to endanger its credit rating or its ability to fund infrastructure spending, its *raison d'être*), with Delta taking an initial 10% stake that could rise to 49% over four years were the new Alitalia to be profitable, and the Italian Government suggesting it would take a direct stake of 15% so long as the business plan, *at least on paper,* appears able to succeed.

Delta's interest fits in with its strategy of taking minority stakes in overseas carriers to help cement and intensify joint venture operations. Since 2010 it has acquired stakes in Aeromexico, GOL, China Eastern, Air France-KLM and Virgin Atlantic (see *Aviation Strategy* Jan/Feb 2016 and Jan/Feb 2017). Its interest in Alitalia would be to bring it fully back into the SkyTeam antirust-immunised joint venture on the Atlantic. It might even be able to exercise effective control and provide strong commercial experience, though it would be limited under European law to a maximum 49% equity stake.

This FS business plan envisages eliminating loss-making short haul feeder flights by creating inter-modal connections with the high speed rail network — hardly a recipe for success or one that addresses Alitalia's fundamental problems. (It doesn't particularly help that Italy's high speed trains — designed to provide fast city-centre to city-centre transport — do not stop at the airports.) But FS still has to find other investors for the remaining 45% of the equity.

However in establishing a new company to create the newest Alitalia what would the investors really be acquiring? The fleet is mostly leased, and the few aircraft it does own are more than 20 years old. But It has 67% of the slots at the heavily constrained Milan Linate and a handful remaining at London Heathrow.

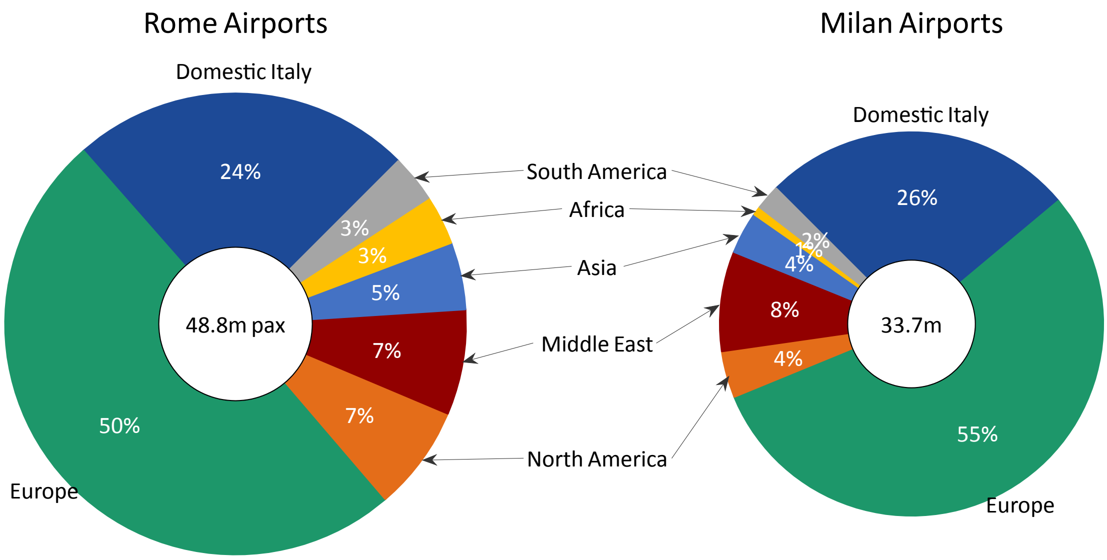
Meanwhile that six-month Government loan of €900m in May 2017

## ITALY: LONG HAUL CAPACITY

| | 2013 | | | 2018 | | | |
|---|---|---|---|---|---|---|---|
| Rank | Airline | Seats | Share | Airline | Seats | Share | CAGR |
| 1 | Alitalia | 2.61 | 25% | Alitalia | 3.04 | 18% | 3.0% |
| 2 | Emirates | 1.74 | 17% | Emirates | 2.73 | 16% | 9.4% |
| 3 | Delta | 0.76 | 7% | Qatar | 1.35 | 8% | 13.3% |
| 4 | Qatar | 0.72 | 7% | American | 1.16 | 7% | 8.9% |
| 5 | Air China | 0.40 | 4% | Delta | 0.96 | 6% | 4.9% |
| 6 | US Airways | 0.40 | 4% | Air China | 0.59 | 3% | 7.7% |
| 7 | United | 0.39 | 4% | Etihad | 0.57 | 3% | 25.4% |
| 8 | Cathay Pacific | 0.39 | 4% | United | 0.55 | 3% | 7.2% |
| 9 | American | 0.36 | 3% | Neos | 0.53 | 3% | |
| 10 | Thai Airways | 0.26 | 3% | Air Canada | 0.53 | 3% | 29.1% |
| | Others (23) | 2.38 | 23% | Others (25) | 4.80 | 46% | 15.1% |
| | **Total long haul** | **10.41** | | | **16.79** | | **10.0%** |

*Notes: Total seats to and from Italy on routes over 4,000km. * Growth rate compared with combined AA and US capaity in 2013*

PASSENGERS BY DESTINATION 2018




*Note: Rome Airports - Fiumicino and Ciampino; Milan Airports - Malpensa and Linate.*

to keep Alitalia afloat until a buyer is found is subject to an EU investigation for illegal state aid. The loan is now due to be repaid at the end of June, while the EU investigation will probably not rule until a sale is completed. *Caveat emptor*.

## Brand decay

Alitalia has allowed its "natural" position as the national flag-carrier of Italy erode so much that it has probably destroyed what was once a national brand. Alitalia's share of seats in the Italian short/medium haul market has fallen from 31% in 2010 to 15% in the 2018 schedules. The largest carrier in this market is now Ryanair with a 26% share of the total departing seats. Excluding domestic operations, Alitalia's share of international short haul capacity has fallen to 7%. In the last five years it has shrunk capacity while the market has grown by an average annual 6.3% (see table on the previous page).

Long-haul markets have been equally affected. On the 2008 restructuring Alitalia moved its long-haul hub back to Rome from Milan Malpensa. It is still the largest player, but Its share of long-haul seats has fallen to 18% of the total, closely followed by Emirates on 16% and Qatar on 8% — each of which have increased their offerings into the market by an average annual 9% and 13% respectively in the past five years. Capacity on long haul has increased by an average 10% a year in this period, but Alitalia's growth has been a mere 3% a year.

## A divided country

Italy is really at least two disparate countries within one. The North, and particularly the Po valley, is the wealthy industrial area: a continuation of the "blue banana" distribution of European population density that runs from London through Paris, the Rhine valley to Turin. The South — the *Mezzogiorno* — is a relatively impoverished area with regional annual per capita incomes less than half that of the North. The industrial North is centred perhaps in Milan, the mercantile centre; the political centre is in Rome on the northern borders of the *Mezzogiorno*. There is strong air traffic demand domestically between Rome and Milan and Rome and Naples, weakened by the introduction of high speed rail. There is strong demand from the *Mezzogiorno* to the North, ideal for for low cost airline competition against road and bus transport. However, there is also strong demand from the Po valley on longer haul routes, and this (without having to go through Milan) is easily diverted to other European hubs for long haul connections (notably Frankfurt, London, Paris, Amsterdam, Zürich and Munich), or with the building of services from the superconnectors to the East via the Gulf or Istanbul.

Italy is not suited to operating traditional transfer hubs in Europe. Rome is too far south to access convenient connections on the Atlantic or to the Far East except perhaps from within Italy, while Milan Malpensa is stymied by the attractiveness of Milan Linate for high yield point-to-point demand.

In Alitalia's last suggestion of a restructuring plan in 2016, the then CEO, Cramer Ball, highlighted the structural realities: 75% of Alitalia's total traffic was carried on short haul operations; 50% of all its traffic transfers; and transfer traffic makes up 85% of long haul traffic. Management at the time claimed that long haul operations were profitable.

### Clear Asset Sale?

The Italian Government appears to have taken over the sale of a failed national asset as if it were still majority shareholder. It appears to want to preserve the notion that it is essential for a nation to have a flag carrier, although the real reason probably has more to do with long-standing vested interests. Notable in the process of European consolidation have been the failures of such flag carriers as Sabena, Swissair, Malèv, Cyprus and Olympic. In each case the respective Governments walked away: Sabena and Swissair ended up through their successor companies, Brussels and SWISS, to be owned outright by the Lufthansa Group; Malèv and Cyprus were allowed to dissolve, but other airlines moved in to provide air services on a more efficient, commercial and profitable basis.

Perhaps Italy should be taking a lesson from the experience of Greece in its "privatisation" of Olympic in 2008. In that case the Greek Government put the core assets up for sale — essentially the brand and airport slots at Heathrow — bribed the staff through generous redundancy packages, assumed the problem of disposing of unwanted ancient owned aircraft and dissolving leases, to allow the new owner to start with a clean slate.

The new owner, Marfin, sold the "new" Olympic two years later to Aegean. And Aegean is a highly cost efficient operation that has since made a great success in the Greek market (see *Aviation Strategy*, April 2018). Italy doesn't have the equivalent of Aegean, but perhaps the closest is Air Italy.

### Air Italy

At the beginning of 2018 Qatar Airways took an effective 49% stake in Meridiana, Italy's second largest scheduled airline based in Olbia on Sardinia. The airline rebranded itself as Air Italy, moved the base of operations in Milan to Malpensa from Linate with the aim of establishing a feeder hub. It has ambitious plans significantly to grow its fleet from the 11 it had at the date of the announcement (three 767s and eight 737NG) to 50 units by 2022. It has since replaced the 767s with A330s leased from Qatar (with Qatar's high quality in-flight spec) and taken three 737MAXs out of a commitment of 20.

Air Italy currently operates to 26 destinations and has plans to build its network to 50 in the next three years. It seems to be pursuing an interesting long haul strategy of seasonal services from Milan: eg while it does have year round operations to New York and Miami, it has only summer operations on the Atlantic to Los Angeles, San Francisco and Toronto switching to winter operations to Mombasa, Maldives and Zanzibar.

The original plan was to become an all-Boeing operator, leasing 787-8s from Qatar as that carrier took deliveries of its new 787-9s, and bulding its leased 737MAX fleet. Given the delay in deliveries of the 787 programme, and with the problems with the MAX, it could move to an all Airbus fleet. Qatar has a policy of operating a very young fleet, and while the Gulf goes through its current difficult operating environment, it is still taking deliveries on its substantial orderbook. But Qatar has been ostracised by its neighbours and has been leasing out excess capacity. It currently has 27 A330s and 40 A320 family aircraft which it could gradually lease out to its Italian associate.

AIR ITALY FLEET

| | In service | On order |
|---|---|---|
| A330 | 5 | |
| 737MAX | 3† | 1 |
| 737NG | 5 | |
| **Total** | **13** | **1** |

*Note: † Currently grounded*

It may take Air Italy a long time to become a credible alternative flag carrier. But the move has not escaped the notice of the US "Partnership for Open and Fair Skies", backed by the three major US carriers (including Delta, purported to be interested in investing in Alitalia) in its continuing campaign against "unfair" competition by the Gulf Carriers. It claims "the only reason a failing airline like Air Italy can continue to launch new routes without consumer demand is because of Qatari government dollars designed to fuel unchecked growth", and that Qatar Airways is using Air Italy to "violate" the Open Skies agreement between the US and the State of Qatar.

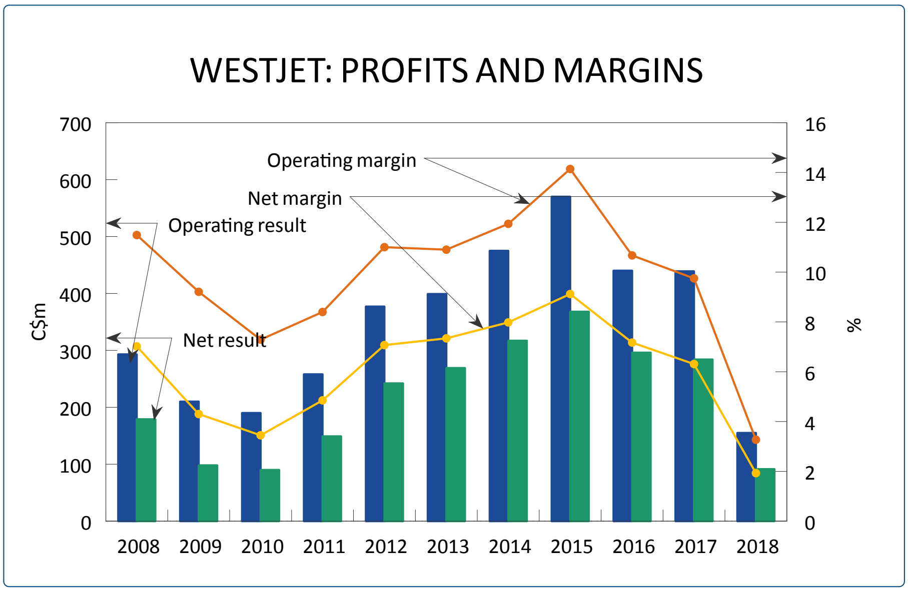
The claim has been roundly refuted by Qatar and Air Italy as being without foundation, while JetBlue, FedEx and Atlas Air have also rallied against "this disinformation campaign" emphasising the "illogicality" of Delta's position.

# Onex and WestJet: Local and global fall-out

In May Onex, a private equity fund, made a successful bid for WestJet, offering C$3.5bn (US$2.6bn), or C$31 per share, roughly 67% above the C$2.1bn that the Toronto stockmarket had been valuing the airline at for the past year. This is a development that will not only shake up the Canadian market but could have wider repercussions for international competition.

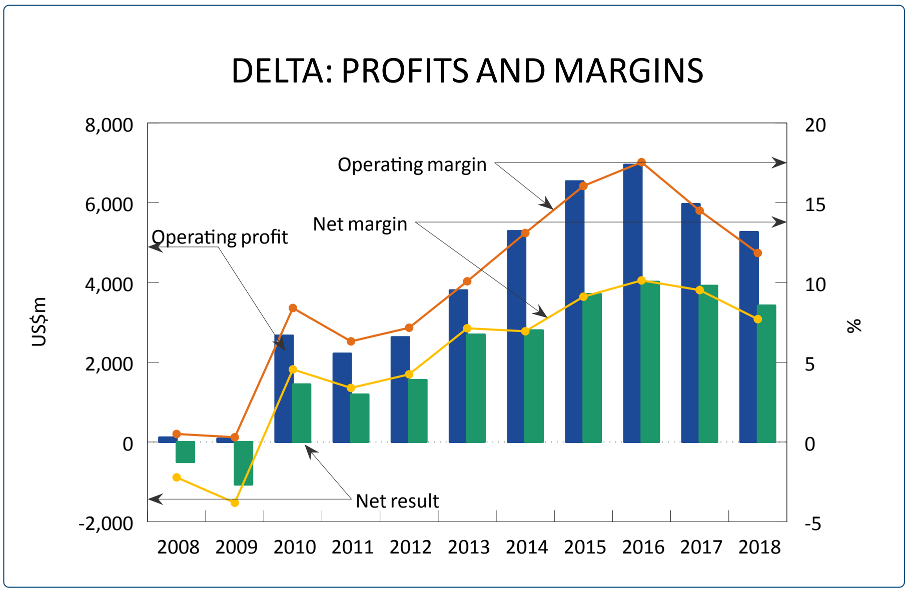
The transaction will not be completed until the end of this year, and needs to go through regulatory assessment, but it is difficult to see how any substantial objection could be made, given the Onex's all-cash price and WestJet management's fulsome welcome. Clive Beddoe, WestJet's founder and chairman commented: "I am particularly pleased that WestJet will remain headquartered in Calgary and will continue to build on the success that our 14,000 WestJetters have created. Onex's aerospace experience, history of positive employee relations and long-term orientation makes it an ideal partner."

Why was Onex willing to pay such a premium for WestJet? The price of C$3.5bn represents an historic p/e ratio of 38, which means that Onex is anticipating a radical turnaround in profitability under its ownership, and that there is a firm base for this turnaround, which is supported by the fact that the price is just 50% above the airline's book value. (The deal has also been attributed a total value of C$5bn which includes the WestJet debt assumed by Onex.) To achieve such a turnaround, Onex will have to accelerate WestJet's current strategy.




WestJet has been going through a fundamental transition (see *Aviation Strategy*, September 2018), moving from a pure LCC operating mainly 737NGs to a full-service network carrier, expanding internationally with 787s and 737MAXs, increasing its connecting operations, upgrading its premium classes and spinning off a ULCC subsidiary, Swoop.

However, the transition process has eroded WestJet's profitability. The airline's 2018 financial results showed an increase in total revenue of 4.9% to C$4.73bn, but operating profit slumped from C$432m



to C$155m, while the net result, C$92m, represented a mere 1.9% margin. This is a very poor result in comparison to both leading LCCs and network carriers globally.

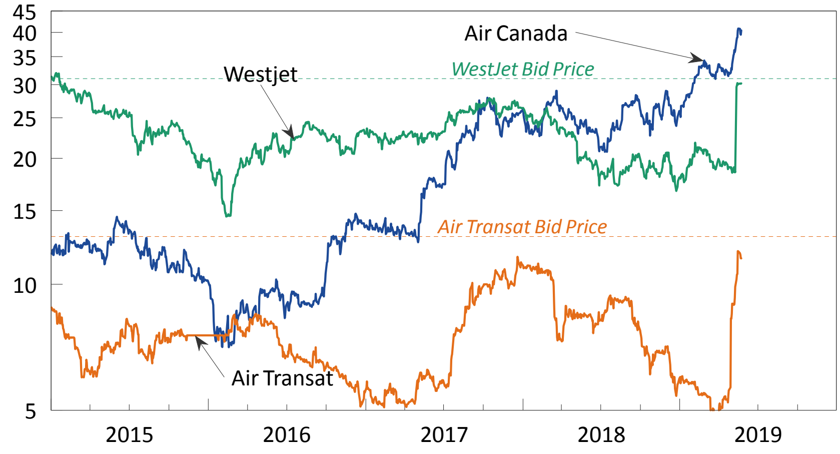
WestJet seems to have lost its commercial élan in the Canadian market. Until relatively recently, WestJet was seen as the dynamic upstart from Calgary, and WestJet executives had an almost evangelical belief in their company, while Air Canada was embedded in the Toronto-Ottawa-Montréal triangle, painfully emerging from bankruptcy, trying to shake off its state-supported legacy, and trying to absorb its former rival Canadian.

But the unit cost gap between WestJet and Air Canada has almost disappeared, as WestJet added costs by adding complexity while Air Canada partly re-invented itself through the "global champion" strategy implemented by CEO Calin Rovinescu. In 2018 Air Canada produced C$677m in net profits, 3.8% margin — significantly underperforming US and European network carriers but appreciably better than WestJet (*Aviation Strategy*, March 2019).

The Onex purchase removes WestJet from the tyranny of quarterly reporting and responding to the shorter term concerns of the stockmarket over, notably, the grounding of WestJet's fleet of 13 737MAXs, 10% of its system capacity. On the other hand, the view that Onex's takeover will allow smooth implementation of a long-term plan, supported by Onex's deep pockets, is a little benign.

Private equity companies make their profits from exiting — selling or refloating purchased companies, having turned their operations around, usually through cost cutting.

SHARE PRICE PERFORMANCE (C$)




Onex's targeted return on investment is 20% pa over a 5-8 year period. To to achieve this it is likely that Onex will load up WestJet with debt, which immediately defrays its own cost of acquisition, and leverages the return on equity, if the company improves its financial performance (the opposite effect if the financial situation deteriorates).

WestJet's balance sheet is already quite highly leveraged; at the end of 2018 it had C$4.6bn of total liabilities, including C$1.44bn in long term debt, against C$2.3bn of shareholders equity, a ratio of 2/1. Standard & Poor's, has responded to the Onex purchase by putting WestJet's debt rating, currently BBB-, on credit watch.

The Onex deal has been driven by Gerry Schwartz, CEO of the $31bn fund. Back in 1999 he launched a bid for Air Canada, with the intention of merging the flag-carrier with Canadian, and creating a globally-competitive airline. That bid looked very likely to succeed until Air Canada brought in a lawyer — Calin Rovinescu — who at almost the last minute blocked the takeover on technical grounds.

So there is a bit of personal history, and that adds to the competitive threat faced by Air Canada from a resurgent WestJet. There is no doubt that WestJet under Onex will be expansionist within the framework of alliance; the question is what type of expansion.

One approach would be for the new WestJet to invade more of Air Canada's markets in the east of the country with the ultimate aim of a takeover or merger, the logic being that Canada's air transport market — 90m domestic passengers, 29m cross-border and 33m other international — cannot support two global network carriers (Air Canada/ Canadian replayed), especially with the emergence of a new wave of ULCC types, Flair Airlines and others.

The other, more likely, approach, would be to expand and compete within the context of global alliances. WestJet currently is not a member of a global alliance, though it has in the past flirted with oneworld, but that could change as its relationship with Delta, and in the future SkyTeam, develops.

In November last year WestJet and Delta applied to the US DoT for antitrust immunity for their cross-border joint venture. This will allow the two carriers to fully coordinate services, jointly set fares and share profits on routes between 30 Canadian and US cities. Although Air Canada continues to be the major player on cross-border routes, it does not yet have an immunised agreement with its Star partner United.

One can envisage an extension of the immunised agreement to the Atlantic with WestJet becoming part of the SkyTeam JV as a junior partner to Delta and Air France. Conceivably, it could develop a similar role within the alliance to that of Aer Lingus within oneworld — lower cost than the Legacies, concentrating on leisure traffic but also offering a good business product.

Across the Pacific, WestJet at a later point could slot into the immunised SkyTeam JV with Delta and Korean Air. WestJet's strong market position on the Canadian west coast, which has such strong social and economic links to China, is a key asset.

Speculating with regard to Onex's exit strategy, might Delta be a candidate for investing in WestJet, as it has previously done with Virgin Atlantic and Aeroméxico? The Canada Trans-

## AIR TRANSAT, CONDOR, THOMAS COOK AIRLINES: TOP TEN LONG-HAUL ROUTES 2018

| | Route | | | Seats ('000s) | Market share | Main competitor | share |
|---|---|---|---|---|---|---|---|
| | | | **Air Transat** | | | | |
| 1 | Montréal | to | Paris | 344.0 | 25% | Air France | 41% |
| 2 | Toronto | | London | 260.8 | 14% | Air Canada | 54% |
| 3 | –"– | | Manchester | 110.1 | 72% | Air Canada | 28% |
| 4 | –"– | | Glasgow | 104.5 | 80% | Air Canada | 20% |
| 5 | Vancouver | | London | 100.7 | 12% | Air Canada | 44% |
| 6 | Toronto | | Rome | 91.6 | 25% | Air Canada | 53% |
| 7 | Montréal | | Rome | 84.3 | 41% | Air Canada | 59% |
| 8 | Toronto | | Paris | 82.9 | 13% | Air Canada | 42% |
| 9 | –"– | | Lisbon | 79.1 | 26% | TAP | 41% |
| 10 | Montréal | | Lisbon | 78.4 | 71% | Air Canada | 29% |
| | | | **Condor** | | | | |
| 1 | Frankfurt | to | Cancun | 137.4 | 77% | Lufthansa | 23% |
| 2 | –"– | | Punta Cana | 132.4 | 100% | | |
| 3 | –"– | | Seattle | 97.9 | 28% | Lufthansa | 69% |
| 4 | –"– | | Mauritius | 90.4 | 69% | Lufthansa | 31% |
| 5 | –"– | | Havana | 86.3 | 100% | | |
| 6 | –"– | | Las Vegas | 78.8 | 100% | | |
| 7 | –"– | | Santo Domingo | 73.6 | 100% | | |
| 8 | –"– | | Montego Bay | 69.7 | 100% | | |
| 9 | –"– | | Varadero | 67.4 | 100% | | |
| 10 | –"– | | Vancouver | 52.6 | 13% | Lufthansa | 64% |
| | | | **Thomas Cook Airlines** | | | | |
| 1 | Manchester | to | Orlando | 181.5 | 29% | Virgin Atlantic | 63% |
| 2 | –"– | | New York | 175.9 | 33% | Virgin Atlantic | 43% |
| 3 | –"– | | Cancun | 131.2 | 43% | TUI | 57% |
| 4 | –"– | | Hurghada | 129.7 | 76% | TUI | 24% |
| 5 | –"– | | Las Vegas | 103.8 | 65% | Virgin Atlantic | 35% |
| 6 | Birmingham | | Hurghada | 69.3 | 67% | TUI | 33% |
| 7 | London | | Orlando | 60.3 | 5% | Virgin Atlantic | 46% |
| 8 | London | | Cancun | 57.8 | 13% | TUI | 48% |
| 9 | Manchester | | Holguin | 55.9 | 100% | | |
| 10 | –"– | | Punta Cana | 54.1 | 45% | TUI | 55% |

portation Act 2018 increased the percentage of foreign ownership allowed in Canadian airlines from 25% to 49%.

Back to the present, Air Canada has responded to Onex by moving for the Montréal-based tour operator Transat, parent of Air Transat, offering C$540m for the C$3bn turnover company which just about broke even in 2018. But Air Transit is a substantial player on Canadian long-haul routes — its own figures indicate that a merger would increase Air Canada's market share on Canada-Europe routes from 43% to 63%.

**What does all this imply for the LHLCC sector on the Atlantic?**

Despite its global network ambitions, WestJet has continued to promote its low cost credentials on Canada to the UK and France routes, and it was a founder member along with Norwegian of Worldwide by easyJet, the low cost short/long-haul connecting operation based at Gatwick. If the carrier moves down the global alliance route, its competitive strategy will be tempered by Delta and Air France.

The traditional LHLCCs — the carriers from an inclusive tour background which operate long-haul as well as short-haul — are disappearing or being recaptured by Legacy carriers. Monarch has gone. Air Transat will probably become an Air Canada subsidiary. Thomas Cook is dismantling itself in an attempt to survive, with the Condor brand probably being re-taken by Lufthansa while Virgin Atlantic is reported to be thinking of Thomas Cook Airlines.

The table on the facing page reveals how significant these long-haul charter/scheduled carriers are, or have been, in certain long-haul markets:

- ✈ Air Transat from Canada to all European cities, particularly secondary ones like Manchester and Glasgow, in direct competition with Air Canada.
- ✈ Condor dominant from Frankfurt to mostly Caribbean leisure destinations but also in direct competition with Lufthansa on four important city pairs.
- ✈ Thomas Cook Airlines, very important out of Manchester in particular, to US and Mexican leisure cities, competing directly against Virgin Atlantic and TUI.

With WOW and Primera bankrupted, financially stressed but resilient Norwegian is the only independent LHLCC left. Inevitably, there are rumours of new bids either from a Legacy carrier (but not IAG again) or an equity fund. No short-haul LCC is interested at this point.

# Aviation Strategy

# FedEx: Shipping the Goods

In the late 90s FedEx briefly branded itself as the "Official Airline of the Internet". It seemed plausible — transactions would be increasingly be conducted online. Amazon, the then new electronic bookstore, might carve out a small niche for itself in the publishing market. Google was just a search-engine. FedEx was perfectly positioned to provide rapid physical transport for goods ordered through websites.

It hasn't quite worked out like that. FedEx is still the world's largest air express operator, with a current fleet of 396 jets and 284 turboprops, but its traffic volumes have been stagnant or in decline for some time — even accounting for its 2016 acquisition of European TNT Express. Its relationship with the internet and e-commerce has been complicated.

FedEx reported an adjusted operating profit of $4.9bn on revenues of $65.5bn in its last financial year (to May 2018), a respectable overall 8.7% margin. In the nine months to end February 2019 it increased revenues by 8% to $51.9bn and adjusted operating profits by 7% to $3.50bn up from $3.29bn in the prior year period — giving a 1.7 point increase in margins for the period.

The Groups has a strategic aim to generate an operating margin of 10%, increase earnings per share by 10%-15% a year, improve cashflows, increase RoiC and increase returns to shareholders.

But FedEx's strategy is not based on rapid traffic growth but on cutting costs, rationalisation and yield increases.

At the operating level FedEx breaks down its performance by segment. It is perhaps surprising to note how modest the profitability of the air operation, FedEx Express, is compared to that of the boring Ground segment. Even the traditional Freight segment produces a higher margin. In the first three quarters of FY 2019 (to end May) FedEx's margin improved to 6.8%, with Express at 4.9%, Ground 12.0% and Freight 7.5%.

However, FedEx Express operating profits have been under pressure from the effects of integrating TNT Express which FedEx acquired in 2016 for €4.4bn — its largest acquisition to date in its 45 year history. Also the 2018 results were effected by the NotPotya cyberattack on TNT — apparently part of a nation-state supported ransomeware attack on Ukraine. The group estimated it cost them $400m in disruption and lost business.

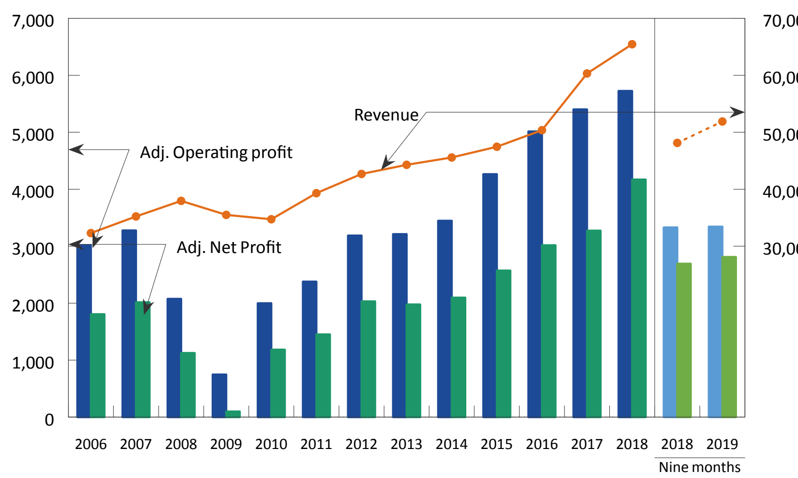
The integration of TNT within the FedEx Express segment is a complex and costly affair: it spans over 200 coutries and territories worldwide,

## FedEx: Group Results

| Year end 31 May | FY 2018 | | Q1-Q3 FY 2019 | |
|---|---|---|---|---|
| | $bn | %ch | $bn | %ch |
| **Revenues** | | | | |
| FedEx Express | 36.2 | 7% | 27.8 | 5% |
| FedEx Ground | 18.4 | 11% | 15.2 | 12% |
| FedEx Freight | 6.8 | 12% | 5.6 | 14% |
| FedEx Services | 1.7 | 2% | 1.2 | 3% |
| Other | 2.4 | 5% | 2.0 | 10% |
| **Total** | **65.5** | **9%** | **51.9** | **8%** |
| **Operating profit** | | | | |
| FedEx Express | 2.1 | -12% | 1.4 | 10% |
| FedEx Ground | 2.5 | 13% | 1.8 | 7% |
| FedEx Freight | 0.5 | 32% | 0.4 | 31% |
| Other* | -0.9 | 99% | -0.5 | 38% |
| **Total** | **4.3** | **-6%** | **3.2** | **7%** |
| **Operating margin** | | | | |
| FedEx Express | 5.8% | -1.2pt | 4.9% | +0.2pt |
| FedEx Ground | 13.7% | +0.2pt | 12.0% | -0.6pt |
| FedEx Freight | 7.2% | +1.1pt | 7.5% | +1.0pt |
| Group adj | 8.7% | -0.3pt | 6.8% | +1.7pt |

*Source: Company reports. Note: *Corporate, other and eliminations*

FEDEX CORP FINANCIAL DATA ($m)



## FEDEX EXPRESS FLEET PLAN

| | Type | Gross payload ('000lbs) | FY end May 2016 | 2017 | 2018 | 2019 | To Be Delivered/(Retired) in FY 2020 | 2021 | 2022 | 2023 | 2024 | 2024 Fleet |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Trunk Jet Aircraft | 757 | 63.0 | 119 | 119 | 119 | 119 | | | | | | 119 |
| | 767F | 127.1 | 32 | 46 | 57 | 73 | 17 | 18 | 12 | 6 | | 126 |
| | DC10-10 | 137.5 | 30 | 26 | 25 | 18 | (11) | (7) | | | | |
| | DC10-30 | 175.9 | 13 | 13 | 13 | 13 | | (7) | (6) | | | |
| | MD11 | 192.6 | 56 | 57 | 57 | 57 | *[2]†* | *[1]†* | | *[2]†* | *[3]†* | 57 |
| | 777F | 233.3 | 27 | 30 | 34 | 38 | 5 | 2 | 3 | 4 | 1 | 53 |
| | 747-400 | 261.4 | 2 | 2 | 2 | | | | | | | |
| | A300-600 | 106.6 | 68 | 68 | 68 | 68 | *[7]†* | *[10]†* | *[1]†* | *[2]†* | *[7]†* | 68 |
| | A310-300 | 83.2 | 10 | 10 | 10 | 10 | | | | | | 10 |
| | **Subtotal** | | **357** | **371** | **385** | **396** | **11** | **6** | **9** | **10** | **1** | **433** |
| Feeder Aircraft | Cessna 208B | 2.8 | 239 | 239 | 239 | 238 | | | | | | 238 |
| | Cessna 4083 | 6.0 | | | | | | 12 | 12 | 12 | 14 | 50 |
| | ATR-72 | 18.0 | 21 | 21 | 21 | 21 | | | | | | 21 |
| | ATR-72 600F4 | 17.6 | | | | | | 5 | 6 | 6 | 6 | 23 |
| | ATR-42 | 12.1 | 26 | 26 | 25 | 25 | | | | | | 25 |
| | **Subtotal** | | **286** | **286** | **285** | **284** | | **17** | **18** | **18** | **20** | **357** |
| | **Fleet Total** | | **643** | **657** | **670** | **680** | **11** | **23** | **27** | **28** | **21** | **790** |

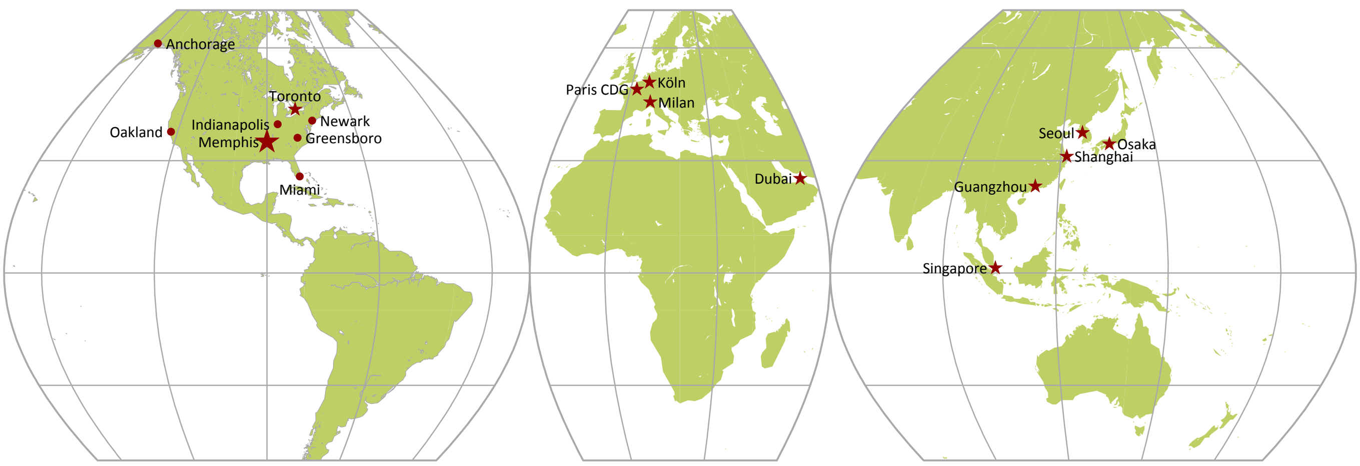
*Note: † Scheduled lease expiry, fate of aircraft to be determined at end of lease and not included in totals*

and involves combining pickup-and-delivery services at the local level. Integration expenses amounted to some $380m in 2018 up from $175m in the year before and is expected to come in at around $435m for the year to end May 2019.

The TNT acquisition increased the exposure to Europe which now accounts for a "significant percentage" of the combined FedEx/TNT international revenue, workforce and facilities. In February it was proud to announce that it started to integrate the FedEx intra-European shipments into the TNT Express European road network which would provide European customers with at least one business day of transit time improvement on 40% of traffic lanes.

Given the complexities of different employment regulations in individual countries — requiring, for example, employee and works' coun-

## FEDEX EXPRESS HUBS



cil consultations — the group suggests that although the majority of the integration programme will be substantially complete by the end of FY 2020, further work will continue into the following year and that the whole programme will have cost around $1.5bn.

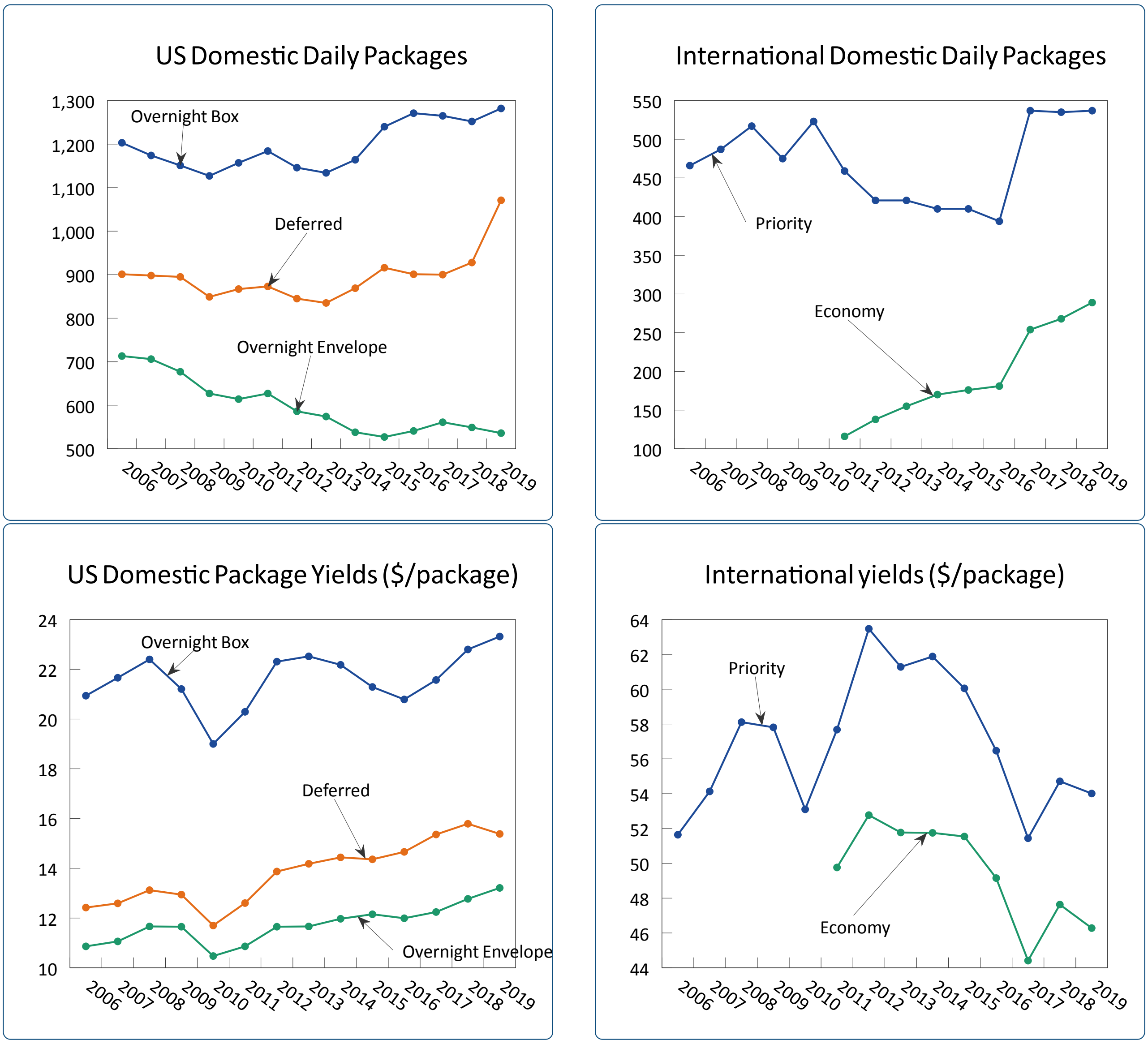
But the group expects the combination with TNT Express to generate significant synergies and is targeting an operating profit for the segment in the year to May 2020 some $1.2bn-$1.5bn higher than the $2.1bn achieved in 2017.

That expectation is based on "moderate economic growth and stability in global trade".

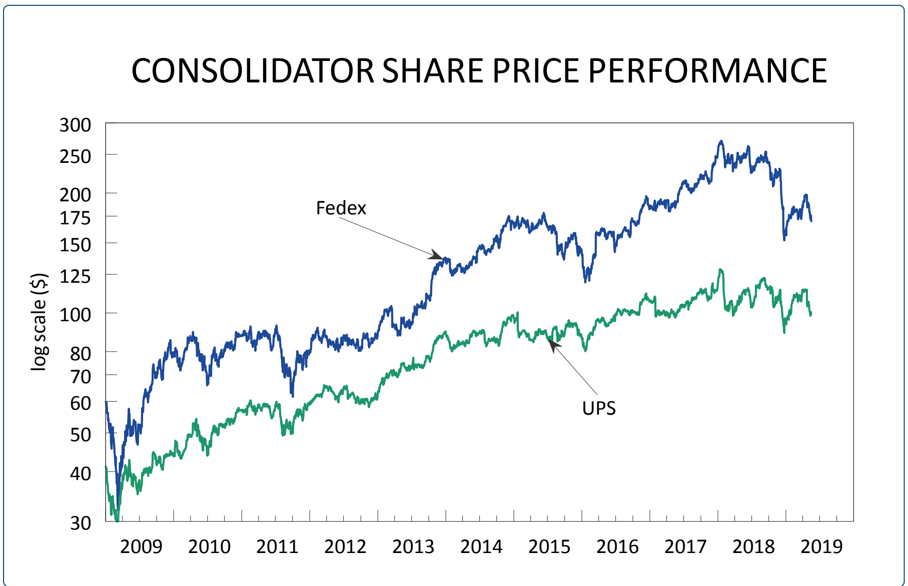
## Fleet renewal

The company is part way through a major fleet renewal programme. It is in the process of retiring its 40-year old DC10 fleet and has outstanding orders to acquire 50 new build 767-300Fs and 15 777Fs (see table on the previous page) which are expected to provide respectively a 30% improvement in trip cost and 18% improvement in fuel efficiency compared with the MD11. The current fleet plan envisages the jet fleet to grow by 37 units by the end of May 2024 — a modest seven units a year with most of the deliveries designed for replacement of older aircraft —

FEDEX EXPRESS OPERATING STATISTICS




*Source: Company reports. Note FY end May 31*




but the company retains significant flexibility given the timing of lease expirations scheduled on the MD11 and A300 fleets. To serve smaller markets more effectively FedEx has ordered 30 new ATR 72-600F with customised large cargo doors and 50 newly designed Cessna SkyCourier C-408 twin turboprops which have nealry twice the volume of the company's current single-engine Cessnas.

## Competing forces

E-commerce has developed in ways that have not necessarily benefited FedEx and the other integrators. Most obviously the volume of documents and contracts that formerly was air-expressed has greatly diminished with email. Just-in-Time inventory control is not as dominant as previously, partly because hardware has become much more reliable and much less expensive, reducing the cost of inventory held by retailers. Software is now universally downloaded over the internet rather than dispatched as discs in a polystyrene-filled package.

A worrying development for the integrators is a change in distribution strategy by the big e-commerce retailers in order to reduce their own shipping costs. Fulfilment costs, which are mostly transport-related, have risen to 15.5% of Amazon's revenues, up from 11% in 2009. Amazon has been decentralising its warehouse network away from its Seattle base, building new facilities in, initially, San Francisco, New York, Boston and Chicago and ultimately targeting the top 50 urban markets. The additional cost of the new facilities will, Amazon expects, be outweighed by savings generated by cutting FedEx and UPS out of the distribution chain and using its own, franchised local delivery companies under the Amazon brand.

It also started up its own freight airline Amazon Air, with a main hub based in Hebron, Kentucky at Cincinnati/North Kentucky Intl airport. Starting with 20 767Fs in 2016 it currently operates 33 and has plans to increase the fleet to 50 aircraft by 2020.

The ultimate aim for Amazon is to guarantee one day, or even one hour, delivery to customers — as close to physical shopping as possible. Google is moving inexorably into this market with a slightly different concept — here the customer orders online and a local courier company, branded Google Express, picks up the good from the shop and delivers it to the customer's home.

The e-commerce giants are not, however, guaranteed success. FedEx and UPS aver that logistics is a complicated business in which they have decades of experience. Their customers are not going to leave them for the new e-commerce upstarts. The bricks-and-mortar retailers are not going to give without a fight either. FedEx has strategic links with Walgreens and Walmart with convenient pickup and drop off locations. FedEx is placing 500 new FedEx office locations in Walmart stores nationwide. Walmart too announced this year that it plans to offer next day guaranteed delivery direct from its warehouses — no doubt using bioth FedEx and UPS.

Then, there is a further technological break-through on the near horizon — commercial drones delivering air cargo (after all, wars are now been fought using drones). Amazon's Prime Air, using an octopus-looking unmanned aircraft, is according to Amazon, ready for service from a technological point of view. It will have a payload of 5lbs and a range of 10 miles. It was successfully tested in Cambridge (England), and only requires FAA approval. In the UK BALPA, the pilots union, has been lobbying for strict regulation of drones on safety grounds (the need for which has been highlighted by the two day closure of London Gatwick in December because of a rogue drone operator), but it expects drones "the same size as small passenger aircraft" to be operating commercially within ten years.

# Seaplanes: Maldivian model, Mediterranean potential

SEAPLANE operation is one of the most esoteric segments of the airline industry. Seaplanes have a romantic image but they can also be serious commercial propositions, notably in the Indian Ocean and on the North American west coast. Is there also potential in the Mediterranean?

A useful database on seaplanes, manufacturers and operators has been compiled by researchers at Munich Technical University for the EU, entitled FUSETRA (Future Seaplane Traffic). Their survey identified 136 seaplanes — propeller driven aircraft with floats as opposed to flying boats — in commercial service in 2018. The most popular type was the twin-engine 19-seat DHC-6 Twin Otter, accounting for 38% of the total, followed by the DHC-3 Otter and the DHC-2 Beaver, single-engine with 11 and 6 seats respectively, accounting for 20% and 26% of the fleet. The other significant manufacturer was Cessna whose planes, ranging from the 3-seat capacity Cessna 172 to the 9-seat Cessna 208 Caravan, made up 23% of the fleet.

The main seaplane airlines are shown in the table below. Harbour Air, and its two smaller competitors Kenmore and Tofino Air, all operate in the archipelago off the border of the USA and Canada, with their networks centred on the Vancouver seaport.

Harbour Air Seaplanes, a private company 75% owned by its Canadian founders and 25% by the Chinese manufacturing company Zongshen, carries about 400,000 passengers per year on a combination of scheduled and charter flights, using a fleet of DHC-2s and DHC-3s. Mail and freight is as important for Harbour Air as passengers — remote communities rely on this service, and volumes are been boosted by Amazon-type shopping.

### Trans Maldivian Airways

Trans Maldivian (TMA) is the global leader in the seaplane universe.

TMA evolved from a helicopter operation, Hummingbird Island Aviation, established by Danish entrepreneurs, transitioning to seaplanes in 1999 and merging with another seaplane operator Maldivian Air Transport in 2013 when they were bought by a private equity fund managed by Blackstone. The founders and majority shareholders — Lars Erik Nielsen, Lars Petré and Hussain Afeef — retained director positions and a minority holding in the new TMA. It was a private transaction but the investment was reported to be in the order of US$120-150m.

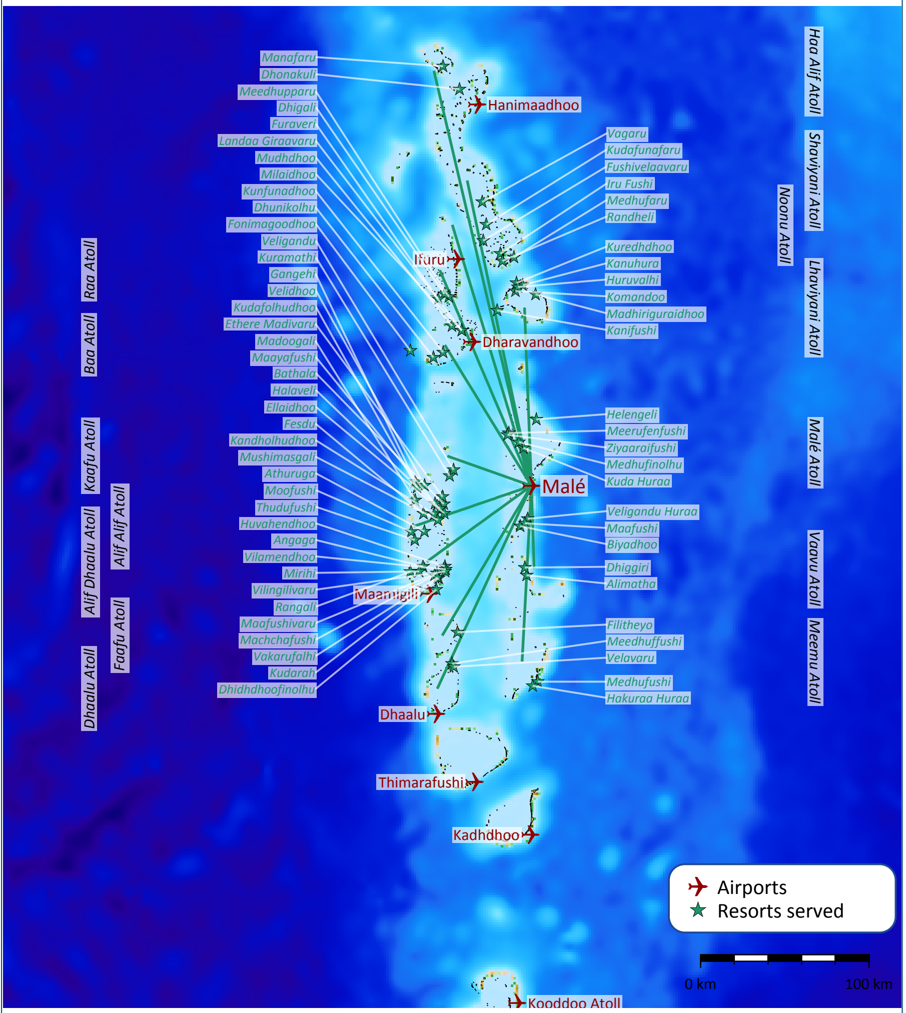
For Blackstone this was not an excuse to send stressed financiers to recover in a tropical paradise but a hard-nosed deal which produced one of its best returns in Asia. In December 2017 Bain Capital led a consortium that acquired TMA for an estimated US$600m, of which half was raised from a loan secured on TMA's assets, giving Blackstone an estimated RoI of 47% pa over four years. Apart from Bain which took an 80% stake the other significant partner in the purchasing was a Chinese tour operator, Shenzen Tempus; the Chinese now constitute the largest national group, 25% of the total, in Maldivian tourism.

The Maldives is a perfect market for seaplanes — an archipelago of 1,200 island and islets in the middle of the Indian Ocean close to the equa-

MAIN COMMERCIAL SEAPLANE OPERATORS

| | Cessna 185 Skywagon (3 pax) | Cessna 208 Caravan (9 pax) | DHC-2 Beaver (5-6 pax) | DHC-3 Otter (10-11 pax) | DHC-6 Twin Otter (19 pax) | TOTAL |
|---|---|---|---|---|---|---|
| Trans Maldivian Airways | | | | | 52 | 52 |
| Harbour Air (Western Canada) | 1 | | 14 | 18 | 6 | 39 |
| Kenmore Air (NW USA) | 2 | | 10 | 6 | | 18 |
| Tofino Air (Western Canada) | 3 | | 4 | 1 | | 8 |
| Air Whitsunday (Australia) | | 3 | 3 | | | 6 |

TRANS MALDIVIAN AIRLINES ROUTES




tor where sea conditions are generally placid inside the protected lagoons. There is very little land available for buildings, let alone runways, and global warming is raising sea levels.

TMA operates a fleet of 52 DHC-6s configured for a maximum of 15 passengers to allow for generous vacation baggage loads. The core business is the transfer of tourists from the seaplane terminal at Malé airport to 70 resorts in the archipelago. Each island has just one resort, and the connections are normally sold *en bloc* to the resorts as part of the tour packages. TMA also offers island hopping, short trips for sightseeing and fishing, VIP charters, walk-up tickets for independent travel plus medivac services.

TMA has its own dedicated terminal at Malé Airport, with four "runways". The airport itself has two runways and is served, among others, by European network and charter carriers, the three Middle East superconnectors and three major Chinese airlines.

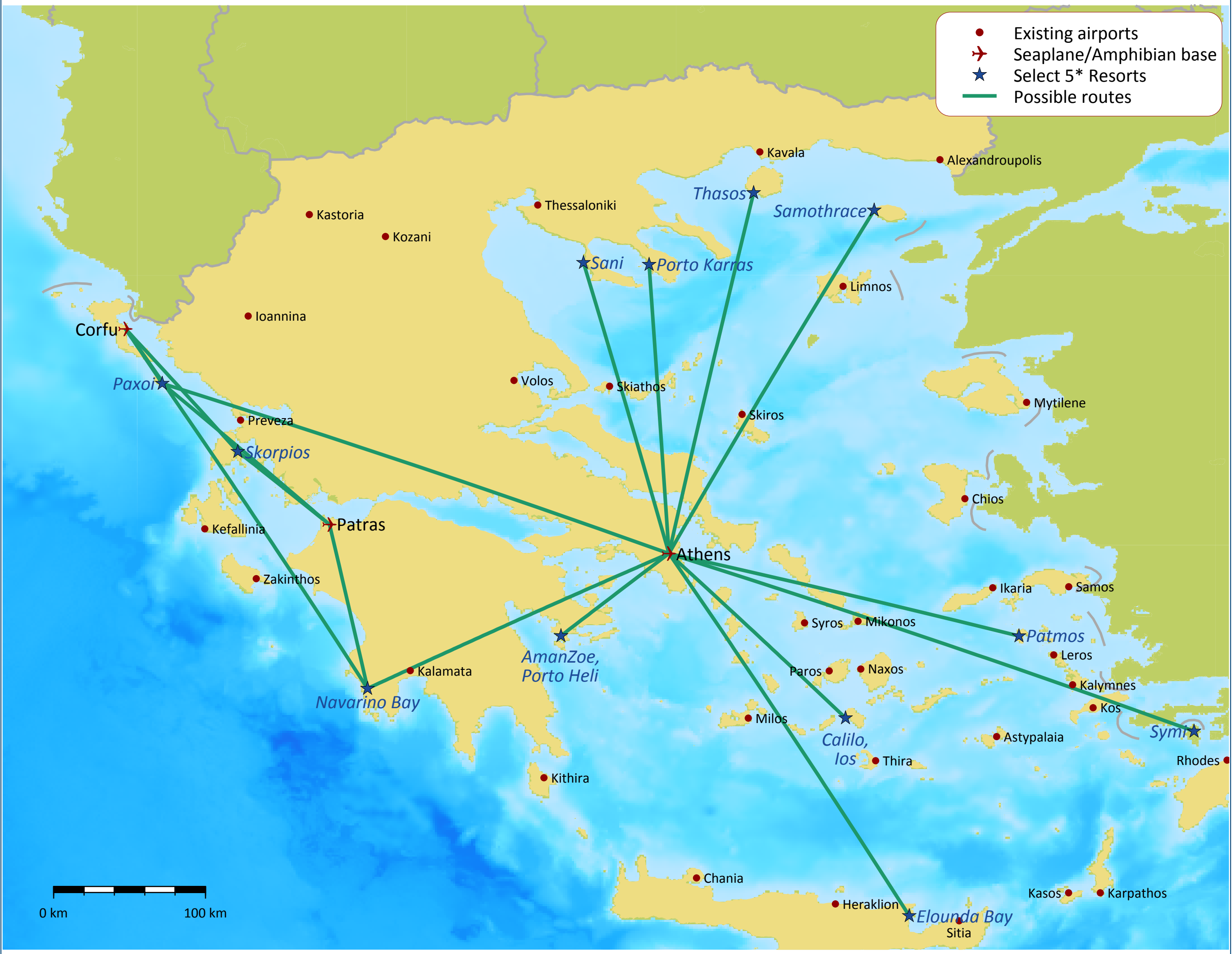
As a private company TMA does not publish financial data but it can be assumed that it is profitable, maybe very profitable. TMA is the sole airline operating to most of the islands within the Maldives, and the majority of its customers are wealthy — spending $500 to $5,000 per night on their Maldivian vacation.

According to TMA, it carried 960,000 passengers last year and operated 120,000 flights. It runs an efficient operation with 900 employees in total. It has fewer than two flying crews per aircraft; the DHC-6 is flown by two pilots, one of whom also acts as a cabin attendant, refuelling operator, baggage handler and security screener when needed. Landing charges are negligible as the planes park at jetties or pontoons — a DHC-6 requires about 400 metres of water for a take-off or landing — while the 23 lounges that TMA runs are self-funding through sales of drink and food. Maintenance is a major cost because of the saltwater environment — on a per hour basis comparable with that for a narrowbody jet.

Tourist arrivals to the Maldives have grown steadily and hit 1.5m in 2018. This is getting close to the maximum given the current number of hotels. The Maldives are a year-round destination but the peak season is December to March while the low season, because of the monsoon, runs from May to October.

The islands have been affected by social unrest and volatile political decision-making in recent years, an example of which was the privatisation of Malé Airport. In 2010 the Indian construction conglomerate GMR won a 25-year concession to expand and run the airport. In 2012 a new administration voided the contract, after complaints about delays, and renationalised the airport, having given GMR seven days notice. The airport has been renamed Velana, the family name of the Maldivian president.

GREEK SEAPLANE POTENTIAL



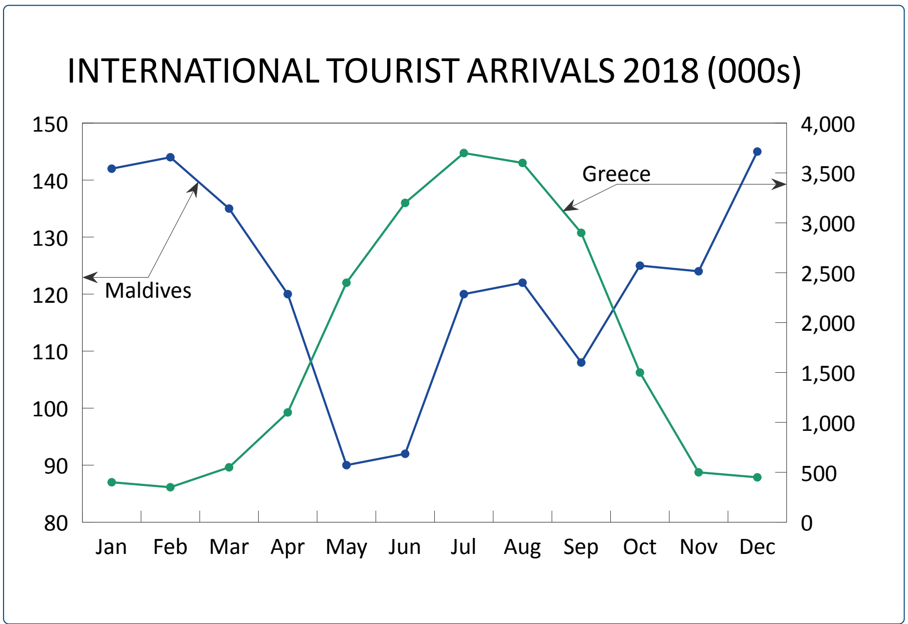

## Greek potential

According to the *Lonely Planet* website, “Seaplanes are the buzzword for the 2019 tourist season in Greece”. Not yet is the reality, though there are some plans on paper: two companies, Hellenic Seaplanes and Water Airports have been involved in the arduous process of licensing water airports — the latter includes major Greek construction group Aktor in its shareholding. Aktor has just been awarded the long term concession of Alimos Marina (the largest in the Athens area) and envisions adding a seaplane terminal.

Greece, like the Maldives, has an archipelagic geography, but there are important differences. The two maps on the previous page and above are to the same scale. The Maldives are clearly much more compact, while Greece has the eleventh longest coastline in the world and is the largest country in Europe (as measured in land and sea mass, from Corfu in the west to Rhodes in the east, from Macedonia in the north to Crete in the south).

There is a total of more than 160 inhabited islands, of which only 26 are served by an airport. From those relying exclusively on ferry service at least 30 are home to between 1,000 and 15,000 permanent residents — a population number that for the majority grows exponentially in the summer as Greece hosted 33 million visitors in 2018. About half of the 30 most populous non-airport islands project between 100,000 and 500,000 tourist ferry arrivals each in 2019.

Such traffic levels indicate viability for a limited seaplane scheduled




network; however, such a network may well prove sustainable only in the peak season (June to September). For year-round service some government subsidy would be needed. Many of these remote islands qualify for Public Service Obligation (PSO) status.

There is currently no commercial seaplane service in Greece. Between 2004 and 2008 Air Sea Lines operated two DHC-6s mostly in the Ionian Sea, carrying 170,000 passengers on over 14,000 flights during that period, but went out of business having failed to establish operations in the Aegean Sea.

But could a Greek seaplane operation replicate at least some of TMA's success?

The opportunity exists for a DHC-6 scheduled and/or charter operation to some high-quality resorts. Of a total of 500 five-star hotels, a significant number are geared towards high end vacationers who value ease of access and have the volume to support 2-3 weekly rotations to/from Athens — much like the TMA model. Examples include resorts (and resort clusters) like Costa Navarino in Peloponnesus, Porto Karras in Khalkidhiki, Calilo on Ios island, plus resorts in Elounda Bay in Crete, and in the Porto Heli area.

There is also a sub-market from the cruise business. In the summer an estimated 5,000,000 passengers typically visit four or five different islands in a week with a shore time of 6-12 hours on each island. Scenic tours by seaplane to view sites like Mount Athos, Meteora and Caldera in Santorini would appeal to some of the cruise passenger. (Cruise lines offer seaplane sightseeing when calling on Vancouver Harbour.)

Then there are vacationers, both Greek and foreign, who would just appreciate the speed of transit from Athens to their favourite island without mixing on overcrowded ferries with the *hoi polloi* (ie the crowds). This is not a market for the super-rich, who own or charter helicopters and yachts, but for the reasonably well-off, probably slightly elderly, customer.

## Obstacles

Unfortunately, a web of bureaucracy between the several authorities involved (HCAA, Hellenic Coast Guard, Police, Customs, etc) is obstructing seaplane development. The licence for a water airport can only be issued to a public sector entity (typically the local Port or the Municipality) whereas a Water Airport Operator's Licence can be granted to a private company. This differentiation is proving a deterrent for investing in the necessary infrastructure.

Key to developing an Aegean network would be an Athens Metropolitan water airport. There are a number of suitable locations but Greek regulatory processes are always an interesting challenge.

Current regulations dictate that all flights either depart or arrive at a licensed water airport to allow for a thorough security check on the one end of the flight at least. But at present there are only three licensed water airports — in Corfu, Patras and Paxoi, all in the Ionian Sea. This makes achieving any scale in network and charter routes a major challenge.

Whereas the Ionian sea in the west is relatively placid, the same cannot always be said about the much larger Aegean (where the prime seaplane destinations are). The strong summer northerly wind, known as the Meltemi, routinely reaches 5-6bF in force, which might eliminate many destinations with strong commercial potential simply because there is no suitable place to land under the prevailing sea conditions.

Finally, there is the issue of operating in a highly seasonal market. But, as mentioned above, the Greek and Maldivian markets are to some extent counter-seasonal; could there be the possibility of cross-leasing seaplanes?

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