Aviation Strategy

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IATA and OECD reveal the bad news

IN JUNE IATA published its biannual update of the airline industry economic performance. The economics team usually does this to coincide with the trade group's annual general meeting — but this year the AGM has been postponed to December in deference to the lack of airline connectivity in the coronavirus crisis (although it is still currently planned to be a physical rather than virtual meeting). The forecasts do not make for happy reading: IATA bluntly points out that 2020 will be the worst year in the history of the airline industry.

With most of the world's fleet grounded for a large part of the second and third quarters, the group is forecasting total passenger traffic demand to be down by 55% year-on-year (with a 20 percentage point drop in load factors to 62.7%), and passenger revenues to fall by 60% to $241bn. Cargo demand continues, but without the aircraft to fly it (50% of freight is carried in the belly-holds of passenger aircraft) and IATA is forecasting freight demand will be down by 17% year on year while, with the squeeze on capacity, freight yields could grow by 30% and total freight revenues could rise by nearly 10%.

With so many unescapable fixed and semi-fixed costs, it expects operating expenses for the industry as a whole to fall by 35% and the industry to register full year operating losses of an astounding $-98bn (a negative margin of 23%) and net losses of $-84.3bn (equivalent to each departing passenger being paid $37.50).

The numbers are huge but also reflect the fact that this will be the first truly global crisis to affect the industry with airlines in each of the regions worldwide equally hammered: IATA expects net losses of $20-25bn each in North America and Europe, $29bn in Asia; negative operating margins of over 20% in North America, Europe, the Middle East and Latin America and nearer 30% negative margins in Asia and Africa.

The organisation is muted on optimism for recovery. It is forecasting a rebound in 2021 and a 50% jump in passenger traffic: but an expectation of 3.4bn total passenger numbers for that year would be 25% less than the peak in 2019 and even represent a shortfall from the 3.5bn carried in 2015. Its forecast for industry revenues of $598bn would still be 28% below the peak in 2019 (and 7% below that achieved in 2011). In profit terms IATA is suggesting that 2021 will see further operating losses of $-25.2bn and net losses of $-15.8bn.

In context, the $100bn of losses IATA is forecasting for the next two years equates with half the total net profits generated by the industry since the second world war (actually since 2005 as the industry had modestly lost a net $2bn in the previous

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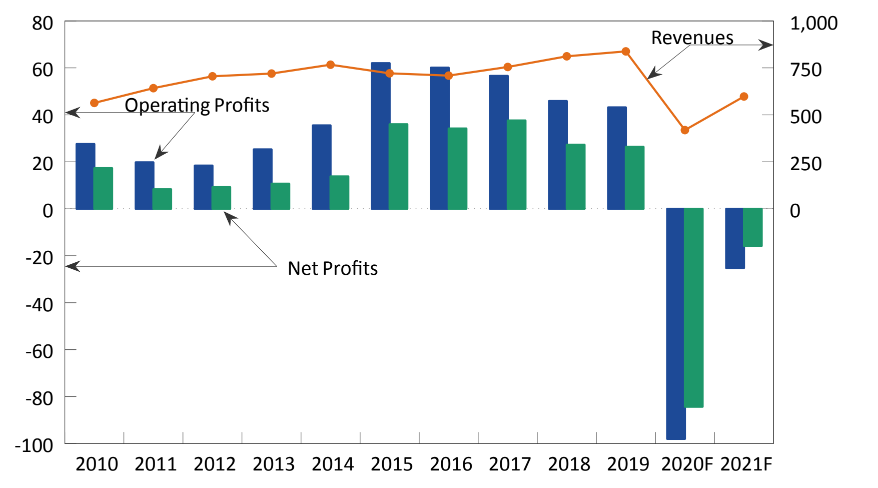
GLOBAL INDUSTRY PROFITS ($bn)



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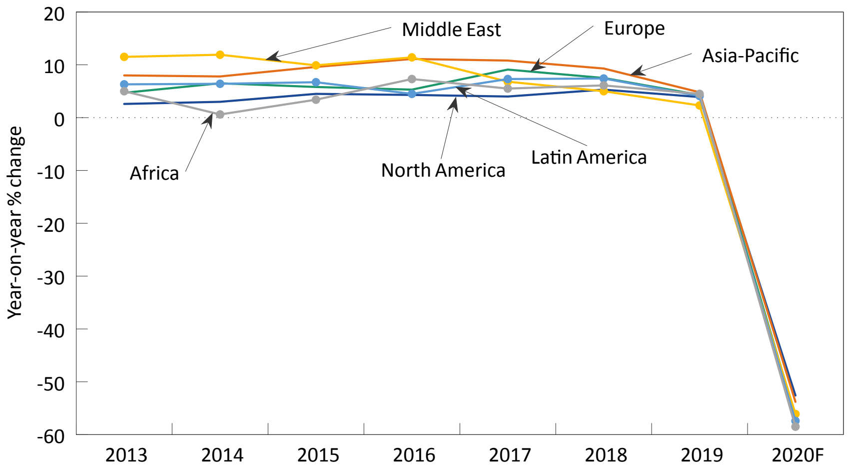
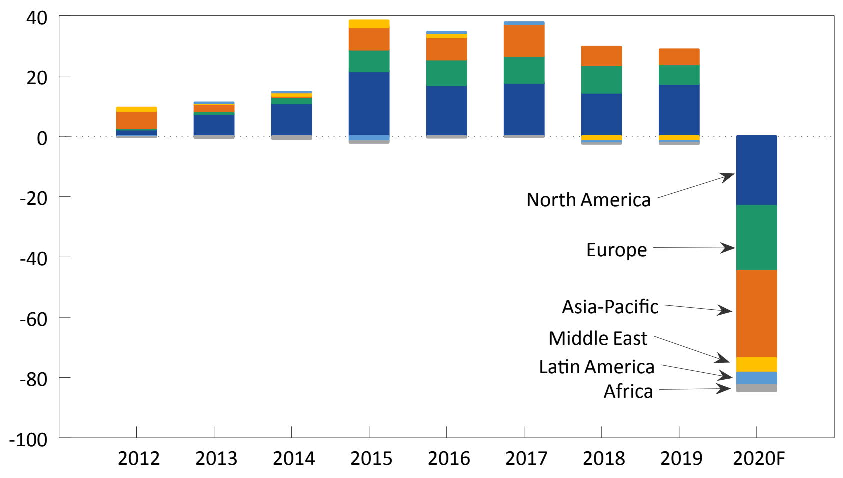
TRAFFIC GROWTH BY REGION



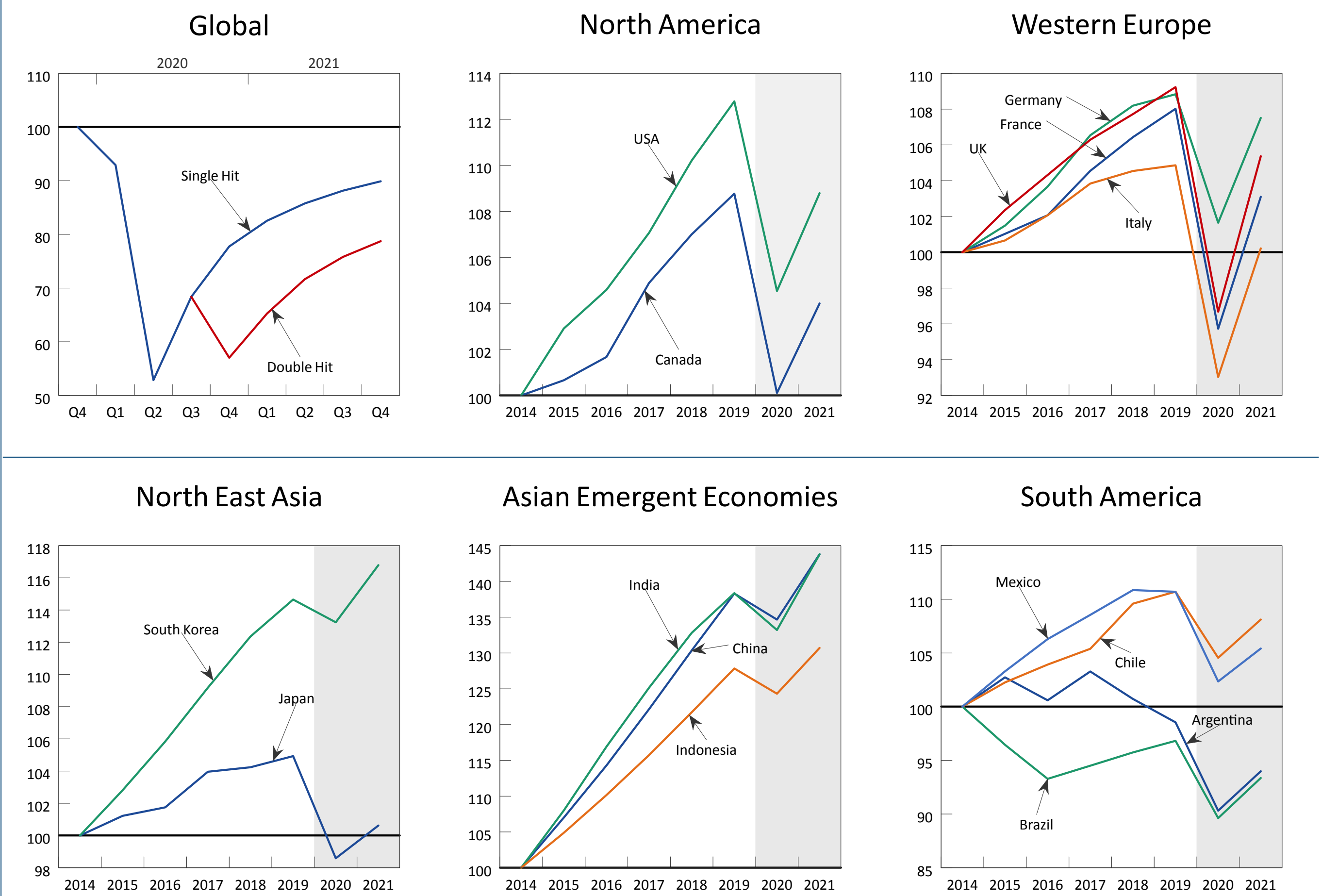
60 years); and as the IATA team points out in its report, the annual average $111bn in tax revenues generated by the industry and its customers; and an estimated $123bn (by mid-May) of government aid made available to the industry because of the Covid-19 crisis.

But the aid, while welcome and possibly allowing the industry to survive the crisis, is helping to add a significant debt burden (50% of the government aid comes in the form of debt and loan guarantees) which will delay recovery from the crisis. In an earlier study in May, IATA estimated that industry debt levels could rise by $120bn in 2020 to total $550bn. IATA's Director General and CEO, Alexandre de Juniac, was quoted as saying: "Government aid is helping to keep the industry afloat. The next challenge will be preventing airlines from sinking under the burden of debt that the aid is creating. It changes the financial picture of the industry completely. Paying off the debt... will mean that the crisis will last a lot longer than the time it takes for passenger demand to recover".

GLOBAL INDUSTRY NET PROFITS BY REGION ($bn)



GDP FORECASTS BY REGION



Source: OECD, IMF.
Notes. Global Real GDP seasonally adjusted, Q4 2019=100. Regional 2014=100.

Also in June, the OECD released its *Economic Outlook*, containing an assessment of how Covid-19 will affect GDP, to which the aviation industry contributes, and by which it is driven.

Globally, there are two basic scenarios: single-hit epidemic in which economic activity gradually creeps up so that by the end of 2021 the world is just 10% below the end-2019 GDP level; a double-hit scenario whereby the virus returns in a second wave which depresses the recovery path so that GDP at the end of 2021 is over 20% below end-2019 levels. The OECD is unwilling to hazard a view beyond 2021, which is understandable given the record errors made by all forecasters when predicting 2020 GDP.

The regional analyses reveal some interesting differences.

✈ US GDP grew strongly since 2014 but the 2020 fall is precipitous, so the 2021 recovery only gets the country back to 2017 levels.

✈ In Europe, Germany appears better off than the other three major economies, with a shallower recession and a return to 2018 levels in 2021. (Lufthansa is another story — see over.)

✈ A relatively minor impact from Covid-19 in South Korea which gets all the plaudits for its handling of the crisis. But Japan's long tern GDP growth has been so insipid that the crisis means that in 2021 Its GDP will be about the same as in 2014.

✈ A quick reversion to dynamic GDP growth is anticipated For China, the principal generator of aviation growth, as well as for India and Indonesia.

✈ By contrast, Covid-19 has just added to the longer term recession in Brazil, which in 2021 will be 7% below where it was in 2014 in GDP terms. With none of the South American economies performing well, it may not be a surprise that the first big casualty of the crisis has been LATAM.

Lufthansa state aid: How difficult can it be to give away €10bn?

Lufthansa Group entered the current crisis as well-prepared as could be expected from any airline. Its finances were in good shape, and the future had been looking rosy.

In 2019 revenues in 2019 had grown by 2.5% to a record €36.4bn. While profitability had been under pressure from increases in fuel prices and intense competition in Vienna, the group still managed to report an operating result of over €2bn and a margin of 5.5%. Within this, the network airlines — Lufthansa, Swiss and Austrian — achieved respectable margins of nearly 8%, while losses at the point-to-point Eurowings airline subsidiary had been cut by more than a quarter to a mere €-166m.

Indeed the restructuring measures the group had put in place for the short haul operation seemed to be starting to work. These measures included simplifying the plethora of AOCs into a single one in Germany; placing long haul "*touristik*" routes, and realigning Brussels Airlines into the Network Airlines division; modernising and harmonising the fleet; concentrating on simplicity, improving crew and aircraft productivity. All looked set to allow Eurowings, now Europe's third largest point-to-point airline (behind Ryanair and easyJet) to aim for break-even by 2021 and achieve long term margin goals of 6% a year.

At the 2019 capital markets day, CEO Carsten Spohr reiterated the group's prime corporate strategy message to be the #1 for *all* stakeholders, committed to drive sustainably higher returns: for customers ("there is no better way to fly"); for employees ("there is no better place to work"); and shareholders (margins and return on capital doubled since 2014, free cash flow to exceed €1bn a year in the medium term, and dividends of up to 40% of net income).

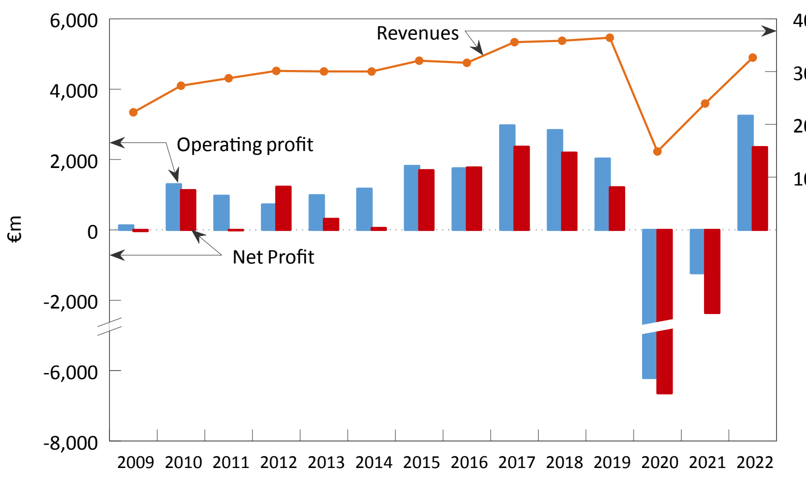
Coronavirus crisis shattered all rosy plans.

Lufthansa was one of the first airline groups to react decisively to the pandemic. On the announcement of its annual results at the beginning of March, having seen a dramatic plummeting of demand in a matter of a mere fortnight, it effectively grounded the majority of its fleet and cut flying capacity by 95%.

But Lufthansa, *despite* its natural conservative accounting tendencies, had one of the lowest levels of available liquidity of all the large European carriers as it entered the crisis with only €4.4bn of cash and equivalents (almost entirely funded by advance ticket sales). In grounding the fleet it could avoid variable costs (60% of the total) and has worked hard to try to slash its fixed costs as much as possible. Even with these efforts, as Carsten Spohr pointed out at the group's virtual AGM at the beginning of April, the group was burning through cash at the rate of €1m an hour (or €700-800m a month).

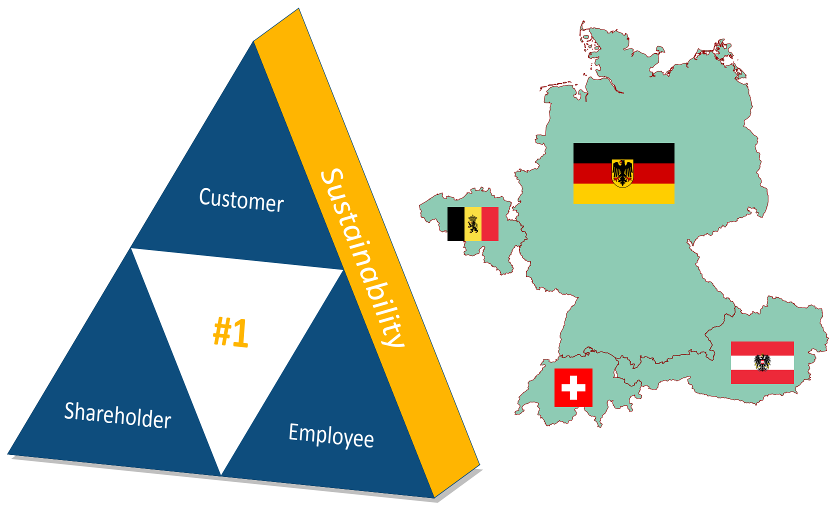
At the same time, *because* of its very conservative nature, it had one of the lowest level of leased aircraft in its fleets (115 planes out of a total fleet of 744), perhaps relying on the idea that, if necessary, it would be able to raise cash on its unencumbered assets. A low level of leased equipment has certainly reduced the level of monthly cash obligations, but the policy has not provided flexibility in a crisis. Various major carriers have been able to raise funds backed

LUFTHANSA GROUP FINANCIAL RESULTS (€m)



Source: Company reports, Bernstein estimates.

LUFTHANSA GROUP:
Sustainable balance of all stakeholders' interests?



by aircraft since the onset of the crisis (notably Qantas, Delta and recently British Airways), but Lufthansa seems to have found difficulty in achieving reasonable capital market transactions, averring on its Q1 results' call that the aircraft financing market was virtually dead.

With only a few months of liquidity remaining, time has been running out fast, and Lufthansa has had to go cap in hand to governments for help. Naturally, as the national flag carrier of Germany, it is far too big and important to the German economy to be allowed to fail merely because of a pandemic.

But it is also the owner of the national flag carriers of Switzerland, Austria and Belgium. And the very organisational structure has created a fraught background to negotiations with governments in the four countries in which the group owns airlines.

The second of the European major network carriers to the consolidation game, Lufthansa was able to learn from some of the mistakes of the Air France-KLM merger of 2004. But it didn't quite have the imagination to go beyond making its acquisitions of Swiss (2005-8), Austrian (2009) and then SN Brussels (2009-17) anything more than direct subsidiaries of the German airline. This has possibly created difficulties around the negotiating tables in trying to get State help.

Switzerland came to the fore with a CHF1.5bn package of loan facilities (with an 85% stake-backed guarantee up to CHF1.25bn) but seems to have been done with a condition of being secured on the shares of Swiss and its leisure subsidiary Edelweiss. The funds will be ring-fenced, requiring all cash flow to be used primarily to repay the liquidity assistance, and banning dividends or remittance to the group parent until repaid. The Swiss general council said that it did not envisage taking direct ownership in the airlines, "as the success of Swiss and Edelweiss is essentially linked to their significant integration into Lufthansa Group". (Interestingly, on the announcement the Swiss government stated that it would not provide support to easyJet — which has a Swiss AOC — on the grounds that its parent company had adequate resources).

Negotiations in Austria have taken longer. Lufthansa is reported to a have approached the government there for support of up to €800m for Austrian Airlines (AUA), but there appears to have been some reticence. The Austrian Chancellor Sebastian Kurz said "Lufthansa is and remains a German company, so there can be no state aid without something in return". Austria has stumped up €300m in loans (with a 90% state guarantee and no doubt secured on AUA's fleet) and €150m in grants, while Lufthansa will be adding €150m of its own cash. The deal includes a 10-year guarantee that Vienna Scwechat will grow in proportion to the group's other hubs. "For us the priority was saving Austrian jobs and in particular securing Vienna as a hub," said Kurz. "We have four strong hubs in a small space — we have Munich, we have Frankfurt, we have Zurich and we have Vienna. And since Lufthansa is a German company and the Zurich hub is extremely profitable, in Austria of course we are always slightly concerned about this Vienna hub." At least Carsten Spohr successfully negotiated away the original idea that Austria would require an equity stake.

On top of this the Austrian government is requiring Austrian Airlines to halve its carbon emissions by 2030 (which it was probably going to achieve anyway), will introduce a €30 tax on flights of up to 350km (which will affect only 9 out of over 200 routes from Vienna pre-crisis, and maybe none post) and impose a minimum ticket price of €40, plan-

LUFTHANSA GROUP TOP SHAREHOLDERS

	June 2020	Post bailout
German State (WSF)		20.0%
Heinz-Hermann Thiele	15.5%	12.4%
Amundi Asset Management	3.2%	2.6%
Lansdowne Partners	2.9%	2.3%
Lyxor Intl Asset Management	2.0%	1.6%
Norges Bank IM	1.9%	1.5%
DWS Investments	1.9%	1.5%
Vanguard	1.5%	1.2%
Deka Investment GmbH	1.4%	1.1%
BNP Paribas AM	1.2%	0.9%
Dimensional Fund Advisors	1.1%	0.9%
Top shareholders	**32.5%**	**46.0%**

ning to stipulate in law that an airline ticket cannot be sold "below cost to the airline".

Equally in Brussels Lufthansa is reported to have asked the Belgian government for support of up to €290m. But comments by Carsten Spohr at the AGM that Brussels Airlines would have to accelerate its "reboot" restructuring programme and could end up with an operation 25%-30% smaller do not seem to have gone down well. An article in the *Brussels Times* suggests that the Belgian Prime Minister Sophie Wilmès has made it clear she expects hard guarantees from Lufthansa on how the money, if any is forthcoming, will be used. Those include a commitment to invest in Brussels Airlines, to ring-fence the Belgian aid for the Belgian arm of the group, and to invest in the growth of Brussels Airport. Meanwhile there has been growing pressure from local environmental groups that Belgium should concentrate state aid on greener transport solutions, asserting that "air travel is often non-essential and reserved for a more affluent segment of the population".

But it is on Berlin that the Lufthansa team has been concentrating efforts. The coalition government recognised that Lufthansa had little other choice (and was hampered in its negotiations by the departure of its CFO on health grounds), but the individual political parties seemed to have difficulties in working out what they themselves wanted out of a deal. Spohr tried to resist suggestions that the German State should take an equity position in Lufthansa, but his threats to put the group into liquidation didn't quite work, and a €9bn bailout deal now appears to have been agreed.

Under the terms of the deal, the country's Wirtschaftsstabilisierungsfonds (the Economic Stabilisation Fund, or WSF) will take a 20% stake in new equity for €300m (at the nominal price of €2.65 a share) in one fell swoop making it the group's largest shareholder (see table above).

It will also provide up to €5.7bn in *stille Einlagen* (or "silent contributions" — an idiosyncratically German debt and equity hybrid instrument) in two parts. The first, for €4.7bn (*precisely* €4,693,955,673.60), can be drawn in tranches at the company's option up to the end of 2021. It is undated, can be terminated by the company in whole or in part on a quarterly basis, and carries a "profit participation" coupon of 4% for the first two years rising thereafter to 9.5% by 2027. It can be treated as equity and used to offset balance sheet deficits.

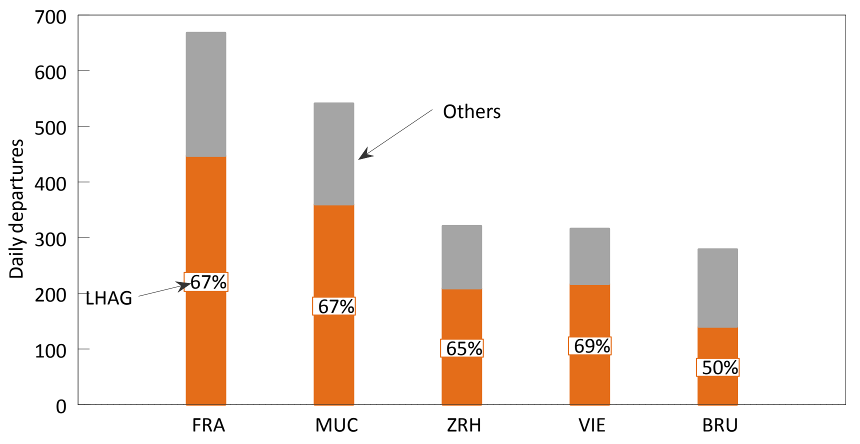
The second part, for €1bn, is to be treated as convertible debt and has a 6 year term at the same rate of interest as part I. It gives the WSF the right to an additional 5% equity stake (plus one share) in the case of a "takeover event" (which under German law could act as a blocking minority "golden share"); protection against dilution should Lufthansa issue equity without subscription rights; and "coupon protection" of 5% equity each in 2024 and 2026 should the accrued coupon on the silent contribution Part I not have been paid, subject to a maximum 30% total stake.

In addition Lufthansa will have access to a €3bn three-year credit facility organised by the state-owned KfW Bankengruppe.

The WSF undertakes to sell its shareholding in full at the market price by the end of 2023, as long as the stille Einlagen have been repaid in full and the sale price reflects a minimum 12% annual return.

It is hardly surprising that this bailout comes on the condition of two seats on Lufthansa's Supervisory Board, restrictions on dividends, share buybacks and management remuneration. In addition, Lufthansa has to commit not to make any acquisitions; not to cross-subsidise group companies; and not to prepay existing debt obligations. As a sop to political tensions, it is required to "make a strong effort to use the funds... in connection with the green and digital transformation including the EU target of climate neutrality

LUFTHANSA GROUP HUB DOMINANCE:
TOTAL DAILY SLOTS



by 2025" (which it was planning to do anyway) while it will continue its fleet modernisation programme to invest in 80 new aircraft between 2021-23 (cleverly avoiding any political pressure to favour Airbus) and "expand its strategic alliances for aviation fuels based on renewable energies". Other conditions include a ban on using the funds in tax havens and, somewhat surprisingly, for commercial advertising.

The agreement needed the approval of the Supervisory Board, an Extraordinary General Meeting of shareholders, and the EU Commission.

Objections sprouting from Brussels

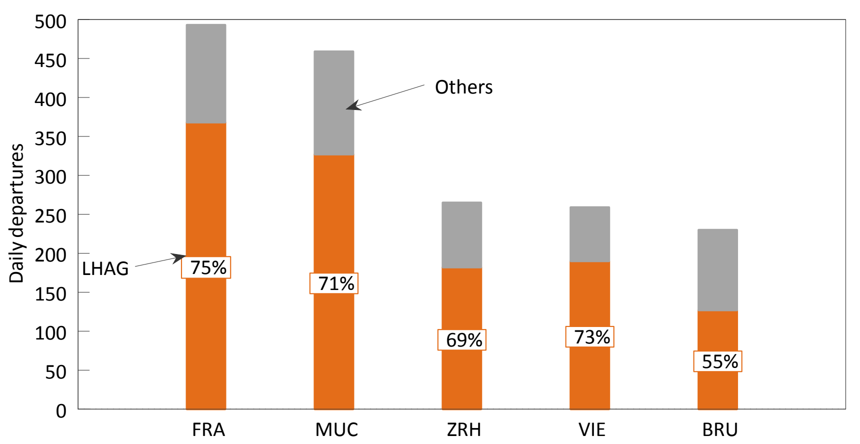
Brussels had relaxed certain aspects of its regulations against state aid in the wake of the crisis — and had worked at break-neck speed (for it) since the middle of March in approving the plethora of applications by member states for the circumvention of the rules: responding within 24 hours and even at weekends. As the *Economist* pointed out in a recent article, "Never have the rules been loosened to the extent they have been today... politicians are brokering aid packages to industry in a way no one in living memory has been allowed to do".

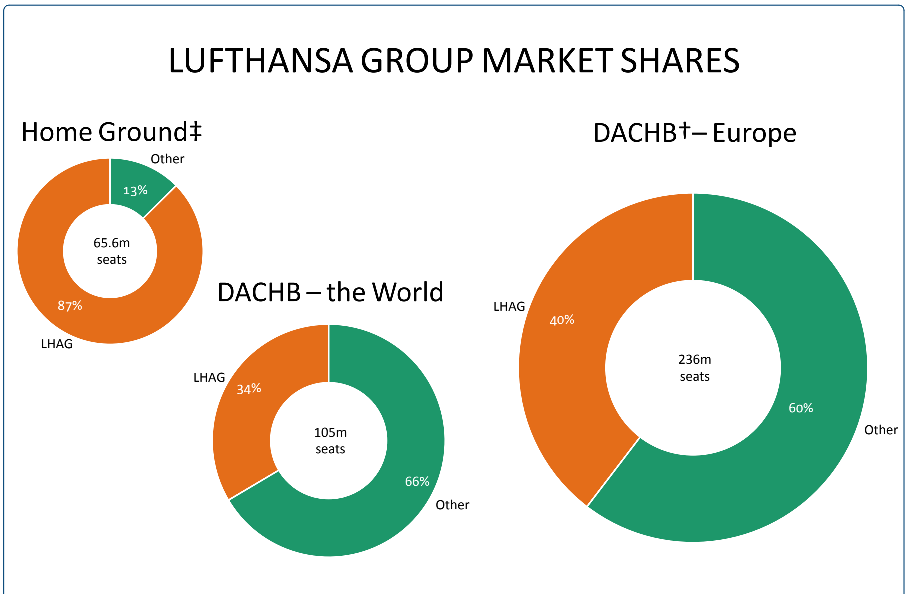
But Germany had gained approval for nearly 50% of the total €2tn state-aid approved so far, and was proposing to take a major equity stake in return for its support to Lufthansa.

The European Competition Commissioner, Margrethe Vestager emphasised that the EU would require penalties in order to allow the proposed state aid deal to go ahead because the provision of equity and the suggestion of the German state taking a major stake in the carrier would distort competition in a way that merely providing debt support would not. Rescue packages in which states injected large amounts of capital, she said, would be seen by investors as "a strengthening of the company", and thus make it easier for saved businesses to raise money. (This incidentally raises the idea that the EU Commission will disallow Italy's proposed renationalisation of Alitalia).

As remedies for perceived competitive distortion, the Commission required slot disposals at Frankfurt and Munich. These are Lufthansa's two German intercontinental hubs and are only constrained airports *because* of Lufthansa's dominating presence (Munich has some attraction for tourism, but Frankfurt has a relatively low level of point-to-point O&D demand). As the charts above show, Lufthansa controls 70-75% of European departures and two thirds of all departures at these two airports, and the group has a similar dominance at its other three hubs. Initial suggestions for a disposal of up to 80

LUFTHANSA GROUP HUB DOMINANCE:
EUROPEAN DAILY SLOTS





Notes: † Germany, Austria, Switzerland and Belgium; ‡ In and within DACHB

slots and around 10% of the portfolio were watered down to a paltry 12 slots (to be shared betwen three aircraft) at each airport. Only available to new entrants and by competitive tender — and importantly for operations to be based at the airports — the measure seems to be an empty face-saving gesture. Importantly it ignores the group structure and its dominant position within the tedescophone home markets where the Lufthansa Group has an 87% market share (see graph above).

Brinkmanship

Negotiations done, a (virtual) EGM was called for the 25 June to gain shareholder approval. But shareholder approval for the deal was not necessarily a foregone conclusion.

Industrialist Heinz-Hermann Thiele (and Germany's third richest individual) had built a 15.5% stake in Lufthansa's since the beginning of March to become the group's largest single shareholder, and had been critical of the need for the government to acquire any equity interest. According to the *Frankfurter Allgemeine Zeitung (FAZ)* he said "Lufthansa doesn't need the state as a shareholder to restructure itself", displaying a healthy distrust of political influence.

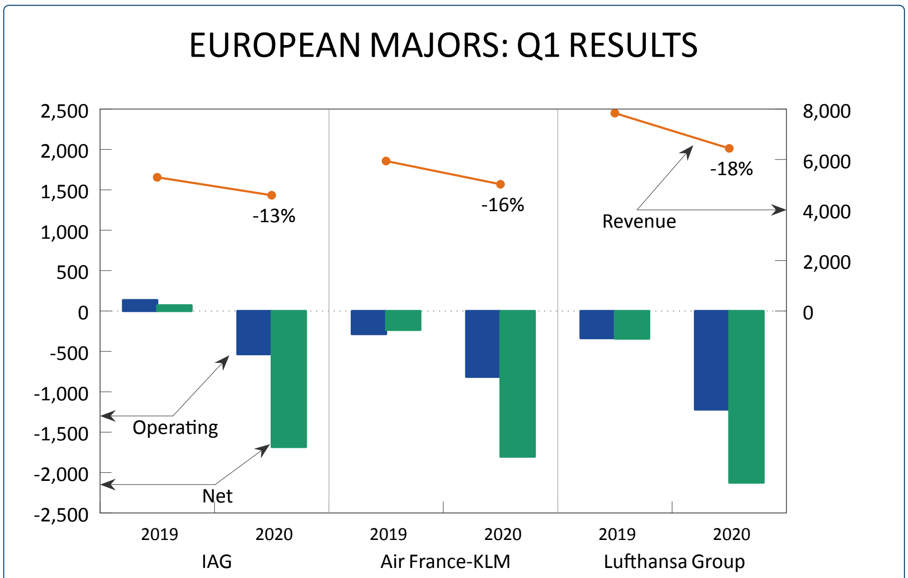
The threat that he may have voted against the proposal was enough for Lufthansa to pay staff wages for June a few days early while it still could.

In the end he voted in favour and the EGM granted the mandate for the capital issuance and the bailout deal. Looking ahead to Lufthansa's post-bailout future, Theile told the FAZ that he "will continue to exert influence".

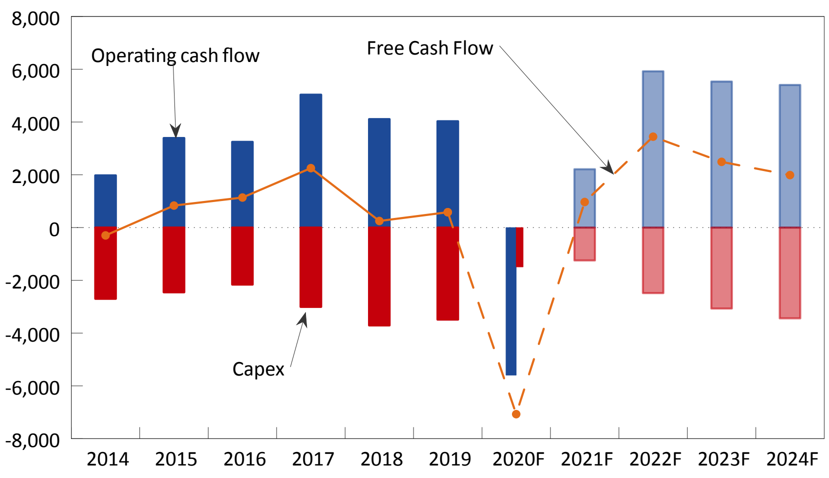
Dire financial results

Lufthansa had delayed the full announcement of its first quarter earnings pending government negotiations: had these failed, it might well have had to file for bankruptcy protection. It is hardly surprising that the results do not make good reading. With the fleet mostly grounded for half the quarter, total traffic was down by 24% in RPK terms (and 26% in passenger numbers), revenues fell by 18% and operating losses reached €-1.22bn (a negative margin of 19%) from €-336m (-4%) in the prior year period. Net losses for the period came in at €-2.124bn. The group had to write off €925m for inefficient fuel hedges. Having decided on the premature retirement of 49 aircraft from its fleet of 744 (six A380s, five 747-400s and 11 A320s from Lufthansa; three 767s, 13 Dash-8s at Austrian; and 11 leased aircraft at Brussels Airlines) it applied a charge of €266m against realisable values. In addition it took a charge of €157m against goodwill at Eurowings and catering arm LSG.

The one bright point that the



LUFTHANSA GROUP: CASH FLOW (€m)



Source: Company reports. Forecasts Bernstein

management could mention was an increase in margins in the logistics business: freight rates had been given a strong boost by the effective elimination of belly-hold capacity in passenger aircraft (which in normal times would provide half the total freight capacity).

In comparison with its European network carrier peers, Lufthansa produced the worst figures for the quarter (see chart on the preceding page). Air France-KLM reported results with revenues only down by 15% year-on-year, an operating loss of €-815m (15% of revenues), while a fuel hedge loss pushed it to a net loss of €-1.8bn for the quarter. IAG saw revenues decline by 13%, an operating loss of €-535m (13% of revenues and down from a profit of €135m in Q1 2019) while write-offs below the line resulted in a net loss of €-1.68bn.

But the comparison is irrelevant. All three of the large network carriers know that the financial news will get worse, and that their very existence relies on retention of sufficient liquidity to ride out the crisis. All three acknowledge that the airline industry is unlikely to return to the level of activity seen in 2019 until at least 2023, while the covid-coincident world-wide economic recession will particularly restrict a recovery in business and corporate travel on which they rely for the bulk of their business.

Never waste a good crisis

On the Q1 earnings call Carsten Spohr highlighted that Lufthansa was working on the basis that the group would have to be significantly smaller, but given the level of debt it was building (effectively raising 100% of what were its shareholders' funds), would need to use the crisis as a catalyst to transform itself into generating cash flow — and significantly higher levels of cash flow than it has been able to achieve in the past. In the last ten years the group has managed to average annual free cash flow generation of less than €1bn (see chart above), and under pre-crisis plans wasn't promising much more than

Supporting the flag-carrier

The Coronavirus epidemic represents an existential crisis for all the the major European carriers, but each of the European countries have provided support in their idiosyncratic ways.

Air France-KLM has also been given a €10bn life-line. It got a quick response from the French government when it appealed for help: a €4bn loan with a 90% state guarantee (solely for the use of the subsidiary Air France) and a €3bn convertible shareholder loan. The EU raised no objections, possibly because France had acted so quickly, but also because the French state still has a 14% stake in the group (with double voting rights thanks to the *loi Florange*) and so therefore it could be treated as a rational decision from a rational investor. Conditions attached are minimal (no dividends or bonuses) or aspirational ("Air France becomes the most environmentally friendly airline on the planet"). It has also been told to cut back on domestic flying (which it has been wanting to do) giving it a political green light to attack the restructuring of loss making short haul routes.

KLM separately asked the Dutch Government (which also has 14% of the group equity) for support. This has taken a little longer to negotiate highlighting perhaps a continuing level of distrust between the two nations: the Dutch pragmatically wanting to have oversight to ensure that the funds they provided did not get transferred up to the group. But the Hague came through with a five year package of €3.5bn.

IAG in contrast has only taken advantage of general help that was on offer: British Airways raising £300m through the UK's Coronavirus Corporate Credit Facility (CCF), Iberia and Vueling receiving five-year ring-fenced loans from the Spanish Government respectively for €750m and €260m. IAG entered the crisis in a lot better financial health than its main rivals, and no doubt realised that to ask for sector specific help from the Boris Johnson Government would be problematic. The British love to hate their national treasures, but IAG may not have expected the deep level of political opprobrium it is receiving for its attempts to use the crisis to restructure BA for the next normal.

LUFTHANSA GROUP FLEET

	Lufthansa	SWISS	Austrian	Brussels	Eurowings	LH Cargo	Total	Leased	*Avg Age*	Orders	Options
A330	15	16		15			46	11	*12.4*		
A340	37	9					46		*17.2*		
A350	16						16		*2.1*	30	10
A380	14						14		*8.6*		
747	32						32		*12.5*		
767			6				6		*24.3*		
777		12	6				18	2	*8.5*		
787										20	20
777-F						7	7		*4.7*	2	1
MD11F						10	10	-4	*21.4*		
Widebody	114	37	12	15		17	195		*12.6*	52	31
A220		29					29		*2.5*		30
A319	29		7	22	50		108	37	*15.5*		
A320	96	30	24	17	59		226	35	*11.4*	82	17
A321	68	9	6		5		88	2	*15.1*	43	
737					6		6	6	*12.4*		
Narrowbody	193	68	37	39	120		457	80	*12.5*	125	47
CRJ	35						35	35	*11.3*		
E190	9						9		*10.1*		
E195	17		17				34		*9.3*		
Dash8			14				14		*15.8*		
Regional	61		31				92	35	*6.8*		
Total	**368**	**105**	**80**	**54**	**120**	**17**	**744**	**115**	***12.3***	**177**	**78**

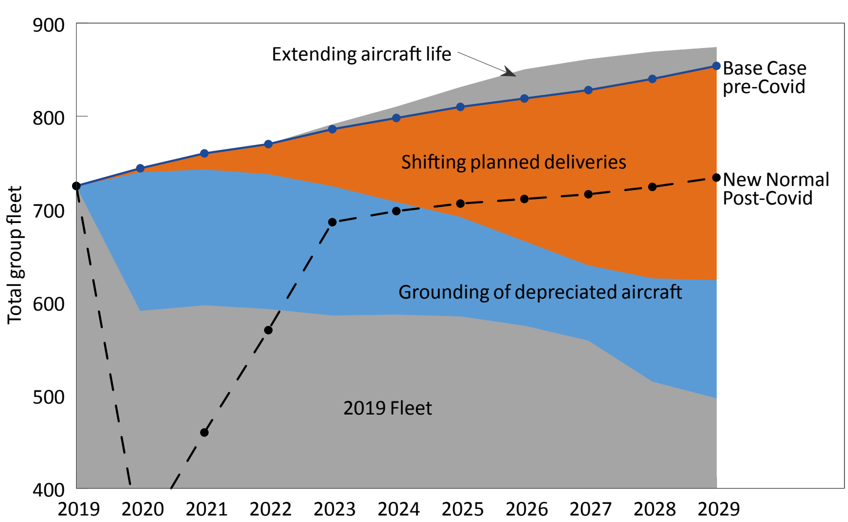
Source: Company reports.
Note: Lufthansa includes Air Dolomiti.

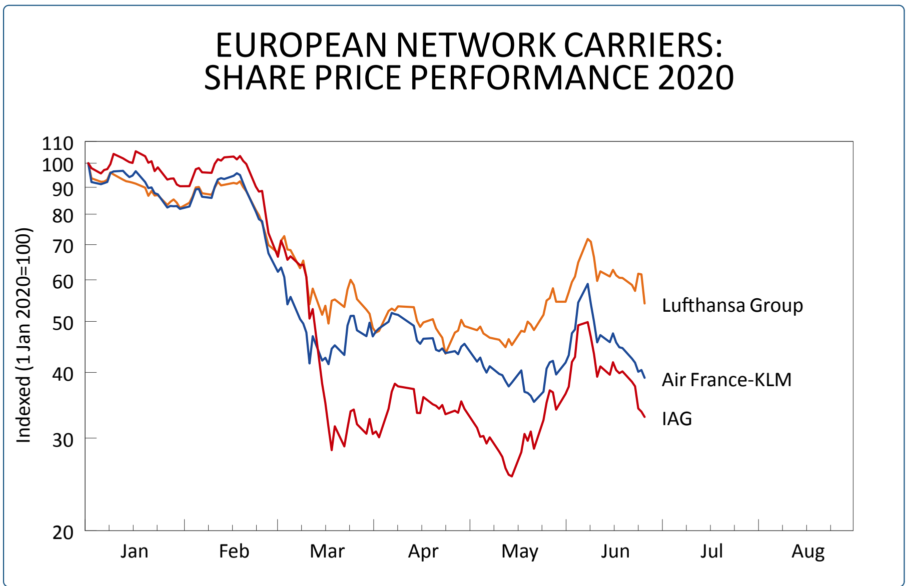
that. But to be in a position to pay back the government bailout it will need to generate over €3bn a year in fairly short order.

Any return to operations will be slow. In the short run, the group aims to rebuild production from 3% of the original plan in May towards 40% in September. In the longer run Spohr said that he expected the fleet to be 300 units smaller than pre-crisis plans in 2021; and to operate 200 fewer aircraft than expected in 2022 and 100 fewer from 2023 (see chart right).

The company has already permanently grounded 49 aircraft, and we should probably expect a significant number of the larger capacity and older equipment (A380s, A340s and 747-400s) to be mothballed prema-

LUFTHANSA FLEET FLEXIBILITY: THE VIEW IN 2019 ... and now





turely.

But the group is still likely to continue its fleet reequipment, having committed to acquiring 80 new aircraft over the next few years (all now to be leased) as part of the agreement for the bailout — at the beginning of the crisis it had orders outstanding for 30 A350s, 20 787s and 125 A320s (see table on the facing page).

It also needs a way permanently to reduce overheads and variable costs. This will mean redundancies; and the group will be hoping that it will finally be able to achieve long lasting adjustments to its legacy employment contracts, effectively hiding behind the pandemic crisis to affect change. Lufthansa had been busy trying to negotiate with its main unions to be able to present an agreement in principle by the time of the EGM. Publicly the group has stated that it will need to get rid of 22,000 full-time positions group wide (out of a total group complement of 140,000) and half of these in Germany. Lufthansa German Airlines will suffer the brunt of the cuts, but Eurowings — now envisaged to come out of the crisis with only 90 aircraft (down from 120) — and the operations at Austrian and Brussels, which had been financially challenged even in the good times, will also be targeted.

Will these measures be enough? It is likely that the group will need to sell some of the family jewels.

Lufthansa had already planned to dispose of the European arm of its catering operation LSG SkyChefs to Gategroup (a deal finally approved by the European competition authorities at the beginning of April) having admitted that it no longer sees catering as a core activity. It is likely to start hunting for possible buyers for the remainder of the operation.

Through Lufthansa Technik the group operates the world's largest independent MRO business. Although a third of the €6.9bn revenue comes from intra group sales, it prides itself on a customer base of over 850 airlines, lessors, OEMs and operators of private jets worldwide. It has tended to regard the MRO business as a core activity but may (perhaps grudgingly) consider a minority sale or IPO.

Similarly its Logistics operations, with revenues of €2.5bn, make it one of the largest European freight operators, and one of the few, through Lufthansa Cargo, to continue to operate a meaningful fleet of freighter aircraft.

Unlikely as it may appear, there may even be someone at some point in the future willing to acquire Brussels Airlines (which never fitted comfortably in the portfolio) — or the group could let it slip into liquidation — although Lufthansa would baulk at the idea of dismantling the tedescophone hegemonic grouping with Austrian and Swiss. Finally it also has a bundle of unencumbered aircraft.

However, these are all aviation assets, and prices at anything more than firesale valuations are difficult to foresee for some time to come.

Carsten Spohr holds on to the idea that it is right to pursue a policy to treat all stakeholders equally to provide the basis for a sustainable future. But, with government stakeholders on board, superseding customer, employee and shareholder, Lufthansa will be a considerably changed animal when it emerges from this existential crisis.

Wizz Air: Virus, what virus?

IN THE pool of despond that is European aviation Wizz Air projects a bright ray of optimism. Is it justified?

Wizz Air has been impacted just as much as other airlines. In May it operated just 7% of the 2019 equivalent capacity. It has furloughed about 1,000 employees, 19% of the total, and cut salaries by an average of 14%. Yet CEO József Váradi is convinced that once lockdowns are eased and restrictions on air travel removed, demand for Wizz seats will rebound. His plan is for Wizz to operate at 80% of the previous year's capacity in the second quarter of FY 2021 (July-September) and to get close to 100% by the end of the year.

There are particular characteristics of Wizz's demographics which support this outlook. Most of Wizz's key markets are in Central and Eastern European countries (CEE) where Covid-19 has been relatively mild but its core business also involves connecting these markets to the UK, the worst affected country in Europe. A high proportion of Wizz's clientele are young (the average age is 36) with a strong inclination to travel, and two thirds of demand is related to VFR which is probably more resilient than pure leisure. In some markets, notably the UK, potential demand may have been boosted by the savings built up during lockdown by normally high spending youth.

In contrast to just about every other airline Wizz Air has been expanding its planned network in recent months, taking advantage of airports desperate to sell unused capacity. It has reaffirmed its ambitious A321-based fleet plan which is designed to grow traffic at an average of 15% a year from 40m passengers in FY2020 (year to March 31) to around 110m in FY2027.

FY 2020 results issued in June were good, despite the impact of Covid on March numbers. Total revenues rose 11.2% to €2.76bn while EBIT before exceptional cost increased 12.6% to €402m. the exceptional item related a loss of €64m on discontinued fuel hedges. Net profit after tax was €281m, more than twice the 2019 result of €123m. As is the norm for LCCs, management is giving no guidance on the losses expected for the current year.

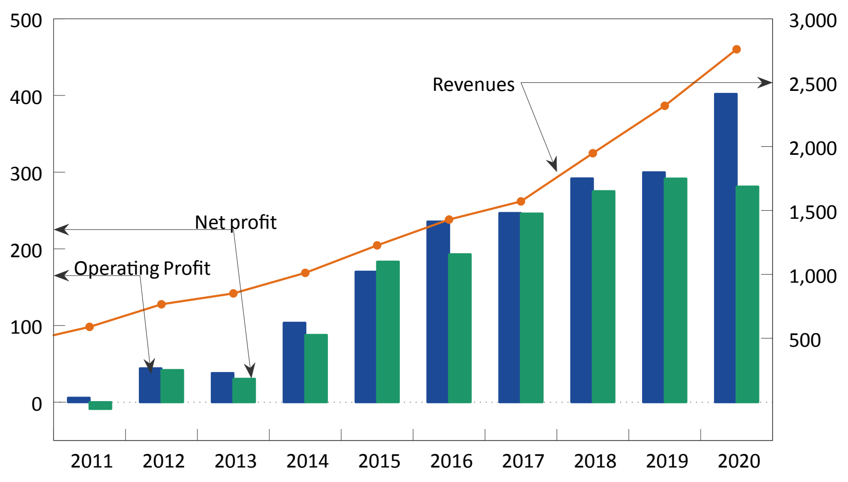
Underpinning the company's confidence is a healthy balance sheet, with a debt/equity ratio of 1.6/1, and more importantly, very good liquidity; as at the end of March Wizz Air had €1.5bn of cash, almost all unencumbered, and has since received £300m of low-interest loans from the UK government under CCFF, a scheme available to all solvent UK

WIZZ AIR GROUP BALANCE SHEET

	€ billions
Fleet and equipment	2.55
Receivables	0.19
Other Assets	0.10
Cash etc	*1.52*
Total Assets	**4.36**
Payables	0.47
Deferred Income	0.18
Derivatives	0.31
Provisions	0.12
Debt	2.04
Total Liabilitiles	**3.12**
Equity	**1.24**

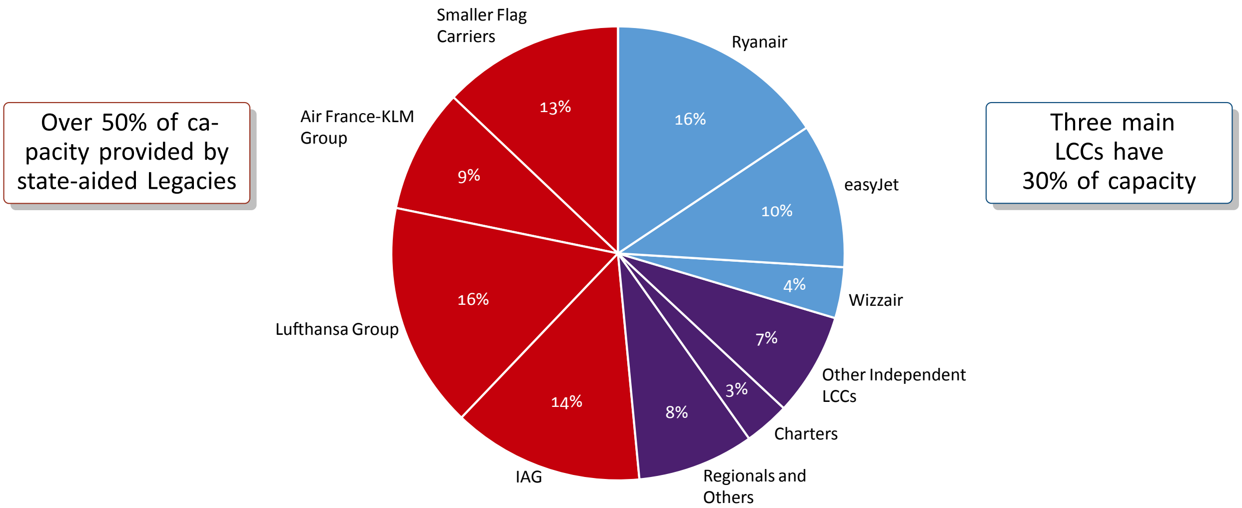
Note: Wizzair's fleet is entirely under operating lease, so most of the fleet value and related debt is calculated according to IFRS16.

WIZZ AIR: FINANCIAL RESULTS (€m)



Note: YE March

INTRA-EUROPEAN MARKET PRE-COVID



Note: Legacies include subsidiaries, Eurowings, Transavia, Vueling etc

companies. Even assuming a full grounding, the airline estimates that its monthly cashburn is only €70-90m which would allow it to survive a prolonged crisis of over one year.

Despite the fact that it was generating hardly any income, Wizz Air's capitalisation on the London Stock Exchange was €3.3bn in early June, the third most valuable airline in Europe, below IAG at €5.5bn and Ryanair at €12.4bn, but remarkably above easyJet at €3.0bn. Investors tend to put Wizz Air in the same category as Ryanair; in 2019, when such measurements were possible, Wizz and Ryanair had p/e ratios of 14 to 15, while the Legacies were rated in the 3-6 range.

High-level market basics

The pie chart below opposite is a reminder of the structure of the intra-European market in the pre-Covid era (based on scheduled capacity between countries in west and central Europe, ex-Russia, and in domestic markets). It is remarkable that the three network groups, the Legacies, accounted for nearly 40% of the market, and the three main low cost subsidiaries within these groups — Vueling, Eurowings and Transavia — contributed for just 10% of the market

Add in the smaller flag-carriers — Alitalia, SAS, TAP etc — and over 50% of intra-European capacity market is now facing a traumatic restructuring, partly dictated by the conditions of state aid, finally being forced into addressing the reality of the economics of feed to their global hubs, abandoning unprofitable routes and airport bases.

About 30% of the market is operated generally efficiently by the three well-capitalised and liquid LCCs — Ryanair, easyJet and Wizz Air — though each is differently positioned to deal with the post-Covid world.

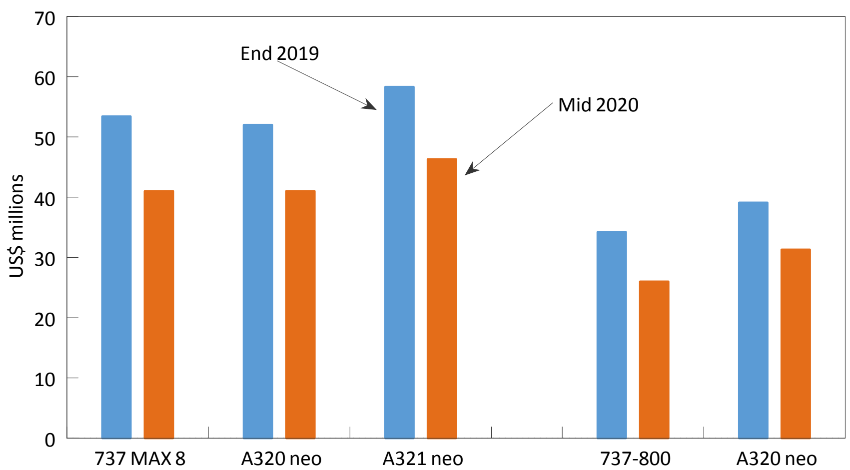
The remaining 20% of the intra-Europe market is again mostly populated by endangered carriers — regionals like Flybe which has folded, charters like TUI which are drastically downsizing or LCCs like Norwegian, perpetually on the brink of bankruptcy — though there are some dynamic airlines — for example, Volotea, which has found low cost niches overlooked by larger carriers, or Aegean, combining low cost with strong local branding.

In the post-Covid era there will undoubtedly be a re-setting of the intra-European industry, though there are a lot of opaque questions. How much demand will disappear altogether as a result of changed leisure and business travel patterns? Can demand be re-stimulated through low fares or will anti-viral regulations permanently raise costs? How radical will the Legacies' restructurings be? Will Air France and Lufthansa in particular use this crisis to cull their loss-making short-haul networks? Or will governmental largesse, to use Michael O'Leary's terminology, be used to offer below-cost fares?

Overall though, all the opportunities seem to be with the LCCs while most of the threats are with the Legacies.

Wizz Air's strategy is to seize the opportunities; more precisely, to be opportunistic with its western expansion while being dependent on regulatory change for eastern expansion. In the middle of the Covid crisis Wizz

ESTIMATED AIRCRAFT MARKET VALUES



Source: AVAC

Air has announced a stream of new bases: Milan Malpensa (five aircraft); Larnaca (two); Tirana (three); Lviv in the Ukraine (one); Dortmund (three); Saint Petersburg (one); Bacău in Romania (two); plus expansion at Belgrade (three). a doubling to six aircraft at its new Abu Dhabi venture and plans for a Gatwick base. (However, it should be noted that aircraft have been moved from other Wizz airports to these new bases). József Váradi commented: "We continue take advantage of market opportunities and re-stimulate demand for low-cost travel. This expansion further contributes to the vital recovery of the economy in our markets and we remain focused on best servicing them, while protecting the health of our customers and employees".

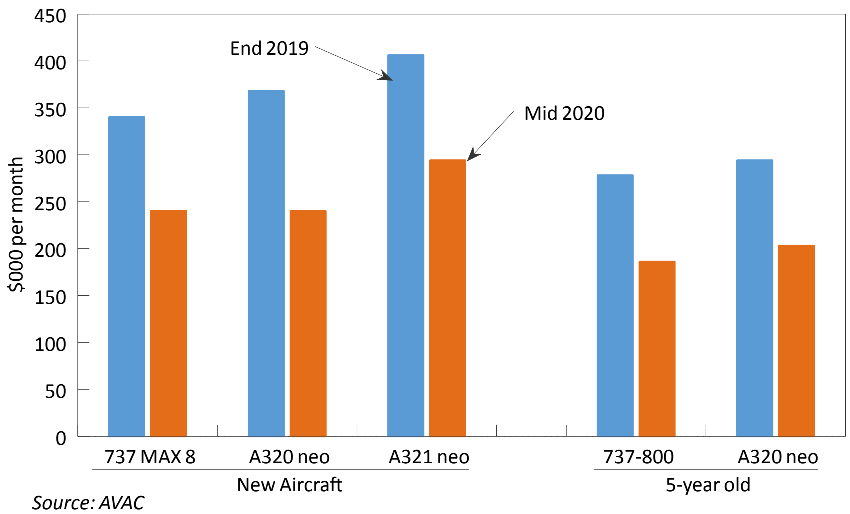
Airports are, to varying extents, desperate for new business as both aeronautical and commercial revenue have evaporated while costs are mostly fixed. Even London Gatwick now faces a pile of spare slots depending on whether BA's withdrawal is permanent and whether Virgin Atlantic and Norwegian find financial support. It is significant that it is Wizz rather than the other two LCCs that has made the first move here, with plans for a four-aircraft base in the winter, possibly rising to 10 next year. Wizz has been allocated an additional 196 weekly slots, to add to its existing slot total of 56, though it is not clear what proportion of the new slots are historic.

In the post-September 11 crisis, the secondary and tertiary airports looked to the new entrant LCCs for rescue; in the Covid crisis almost all airports need the LCCs to begin to restore traffic volumes. Yet Wizz is the only real player at present.

easyJet is being cautious, reverting to its low fleet growth plan (see *Aviation Strategy*, December 2019) and planning to return to only about 40% of pre-Covid capacity by September and starting to focus on a major cost reduction effort. If Sir Stelios had managed to persuade other shareholders, easyJet would be retrenching like a Legacy carrier, having cancelled its A320 neo orders.

Ryanair is aiming at restoring 60-70% of capacity by August and in the meantime seems to be concentrating on renegotiating its existing airport contracts, with the threat of intensifying its churn tactic whereby underperforming airports, or those that do not agree to Ryanair's cost and performance terms, are dropped or aircraft are shifted to more profitable or compliant bases.

ESTIMATED OPERATING LEASE RATES



Source: AVAC

Wizz vs Ryanair

Ryanair's post-Covid expansion prospects are still clouded by the 737 MAX. Its plans require the delivery

WIZZ AIR ROUTE MAP

of 200 units over the next five years, 150 of which are for growth rather than replacement, and It expects recertification to be completed by this summer and delivery of some of the backlog to take place soon after, but nothing is certain. Its fall-back strategy of gaining experience as an A320 operator at Lauda Air, then negotiating a major order with Airbus now seems to have been abandoned, with Lauda Air being downgraded to a wet-lease operator.

Meanwhile, Wizz Air intends to continue to take delivery of nine A321s, six neos and three ceos, through this financial year. The expected operating improvements of the A321 neo compared to the A320 include: 239 against 186 seats, 16% lower fuel burn per block hour and 50% reduction in noise pollution. In total 268 A320 neo family units are on firm order, including 20 XLRs. As the table below shows a net increase of 174 to 295 units is planned between now and FY2027.

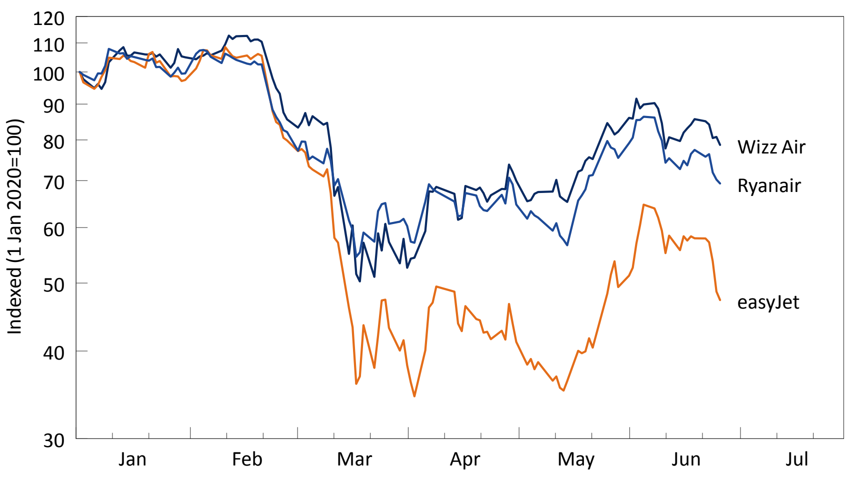
Both airlines will have to grapple with the repercussions of the Covid crisis on new aircraft prices and lease rates. According to AVAC (see………) new *market* prices for MAXes and neos have collapsed by at least 20% and operating lease rates are down by around 30%.

Ryanair is negotiating fiercely and successfully for compensation and discounts from Boeing. It has massive leverage because, as well as being is a key customer, it is legally entitled to cancel deliveries and

WIZZAIR FLEET PLAN (as at June 2020)

ye March	2020	2021	2022	2023	2024	2025	2026	2027
A320	72	68	56	40	32	17	13	5
A320 neo		7	13	13	14	32	46	65
A321	41	41	41	41	41	37	25	15
A321 neo	8	15	40	76	113	137	168	190
A321 XLR					6	12	18	20
TOTAL	**121**	**131**	**150**	**170**	**206**	**235**	**270**	**295**
SEATS (000s)	**24.3**	**26.6**	**31.5**	**37.2**	**46.2**	**53.1**	**61.1**	**66.6**
Change		**9%**	**19%**	**18%**	**24%**	**15%**	**15%**	**9%**

EUROPEAN LCC SHARE PRICE PERFORMANCE 2020



recover all its deposits and PDPs as delays in fixing the aircraft design have exceeded one year. On the other hand, there is no alterative supplier in the foreseeable future.

Wizz is a key customer for Airbus but probably cannot negotiate any significant change in the pricing on its A321 contracts. The market price analysis, necessarily tentative at present, implies that Wizz now stands to receive less cash from the sale/leaseback transactions it uses to finance its deliveries. But there will probably still be a cushion between the discounted unit price negotiated by its founding shareholder, Indigo Partners, with Airbus. On the other hand, the lease rate on its new deliveries should fall.

Ryanair and Wizz bases overlap everywhere in the CEE. Wizz's own analysis puts itself at 40% of the LCC CEE market, Ryanair at 32%, easyJet at 6% and others (Norwegian, Pegasus, Flydubai, Blue Air, etc) at 22%. Significantly, Wizz places itself as the number one LCC operator in nine of the 14 CEE countries it serves. Wizz's share of the total CEE market is estimated at 18%, with Ryanair number two at 14% and LOT with 6% in third.

In terms of cost and efficiency there is almost nothing between the two LCCs. Wizz has a longer average stage length, 1635 km, than Ryanair, 1250 km, and achieves total revenue of €69 per passenger against €57 white its operating cost per passenger is €61 against €50, a 21% difference in both cases. Net profit margin at Wizz in FY2020 was 10.2%, pretty close to Ryanair's 11.8%.

The point is that Ryanair has potentially a serious competitor on cost and efficiency in Wizz, and one whose expansion path is more certain because of the A321. It could be added that Wizz is a more attractive brand than Ryanair.

Finally, Wizz Air's joint venture with the Abu Dhabi Developmental Holding Company (ADDH), is not only going ahead this summer but also the number of based aircraft has been doubled from three to six. Wizz envisages a growth in this fleet to 50 aircraft within ten years. The logic is a market of five billion within an 8-hour radius of Abu Dhabi and counter-seasonality, UAE travel tending to peak in the winter season. The reality is another unknown element added into the maelstrom of Middle Eastern aviation market (see next article).

How will Covid damage the Super-connectors?

COVID-19 tends to target those with underlying problems so the over-expanded connecting networks of Emirates, Etihad and Qatar are particularly susceptible to the coronavirus.

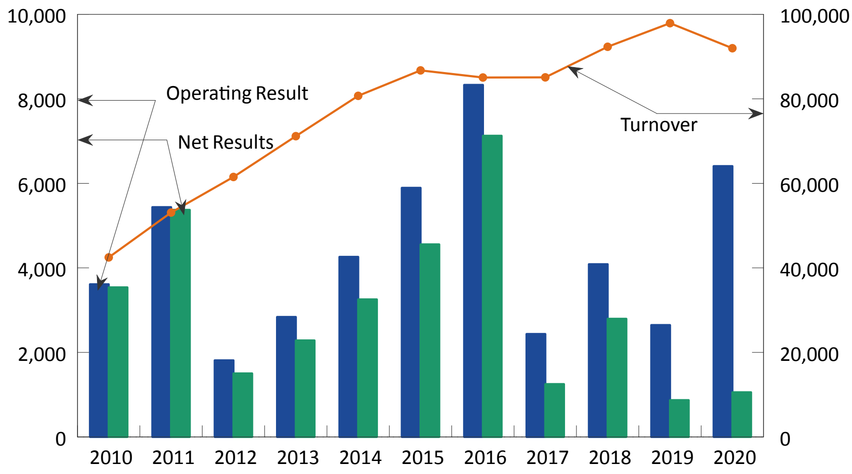
The Middle East Super-connectors essentially link 100 different countries by funnelling traffic flows through their terminals at Dubai, Abu Dhabi and Doha, a logistically superb system but potentially a super-spreader for disease. The operators are faced with the challenge of carrying 200-plus nationalities on each long-haul flight and complying with the relevant national health and safety regulations of each of the nationalities.

When business re-starts, the implication is that some traffic, especially premium traffic, will divert where possible to point-to-point competitors, notably the European and Asian traditional flag carriers. China was the originator of Covid-19 but it also dealt ruthlessly with the outbreak and is now in a position to resume international service. Chinese carriers are targeting not only direct traffic from China to Europe but also building up their own regional hub networks. Then there is THY, the fourth super-connector; Turkey claims to have been only mildly impacted by Covid-19, and business there seems to be moving swiftly back to normal.

It is ironic that Covid-19 has brought an end to US complaints about the Middle Eastern carriers state aid as US carriers have received their own support funds from the Trump Administration. When the Middle East to US market is re-opened one of the priorities for Emirates will be to establish some form of partnership with a US carrier.

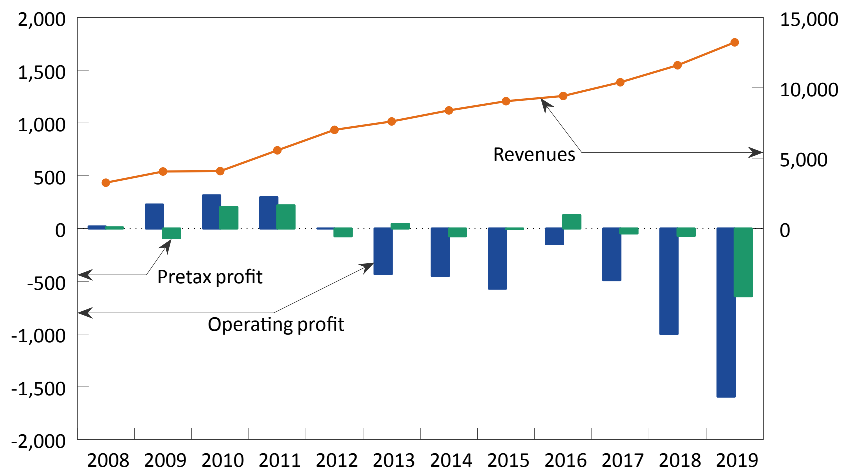
Sir Tim Clark, president of Emirates, has guessed that it will take until 2023 for his airline to return to 2019 traffic levels, but is confident that Emirates can re-capture premium business travellers. But that assumes that an effective vaccine

EMIRATES: FINANCIAL DATA (AEDm)

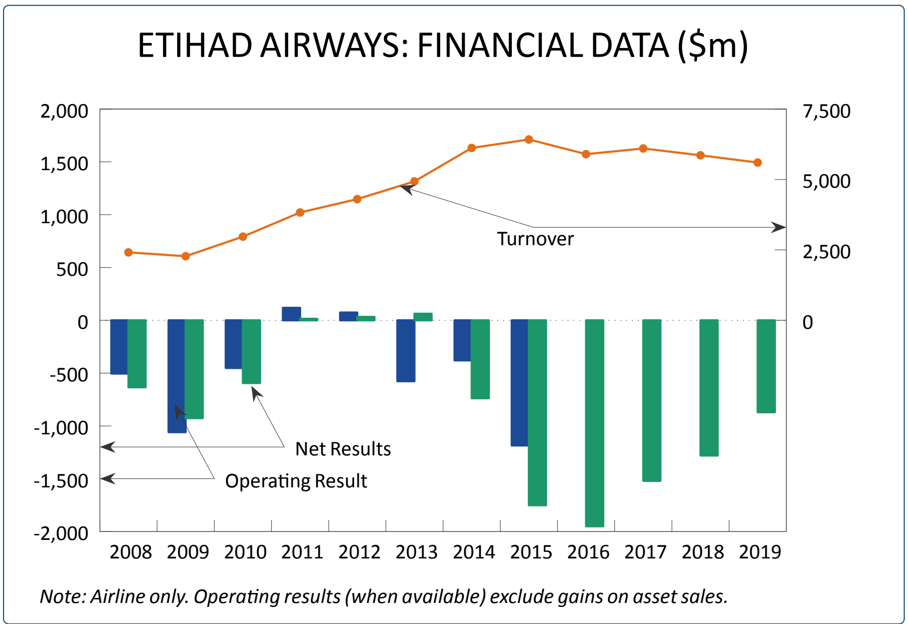


Note: financial years to end March

QATAR AIRWAYS: FINANCIAL DATA ($m)



Note; FY ending March. Excludes profits on asset sales. FY2008-2014 Qatar Airways QCSC; FY2015 on Qatar Airways Group.



is available globally, which is a big uncertainty. Qatar maintained a relatively high degree of operations throughout the lockdown, but Akbar Al Bakar, the CEO, has indicated that perhaps 25% of his fleet, mainly elderly A330s and A320s, will not fly again. All three airlines have implemented drastic redundancy programmes and are intensely attempting to negotiate deferrals and cancellations with the manufacturers, at the same time as making some optimistic noises about service resumptions.

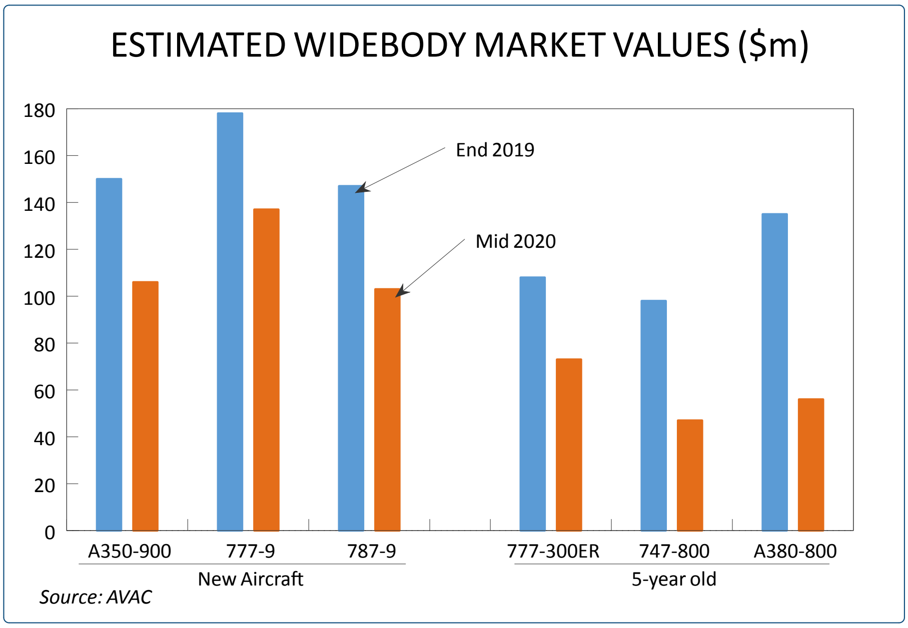
The Middle East super-connector system was under pressure long before Covid-19. Emirates was a dynamic, innovative airline producing 10%-plus net profit margins in the 1990s, but the emergence of state-funded competition in the form of Qatar and then Etihad caused structural over-capacity in the order of 10%, according to our estimates. Even with "normal" demand growth of 4-5% pa, this surplus was set to increase as a result of planned net deliveries. This over-capacity squeezed out profitability at Emirates while the other two super-connectors relied on their governments to fund massive negative cash flows.

The three graphs on the previous page and above update the results for the latest financial year. Emirates produced a marginal net profit in FY2020 equating to a margin of 1.1%. Both Qatar and Etihad were yet again severely loss making, pre-tax net loss margins of -17.6% and -15.5% respectively, and their financial reporting has again been opaque, more press releases than audited accounts.

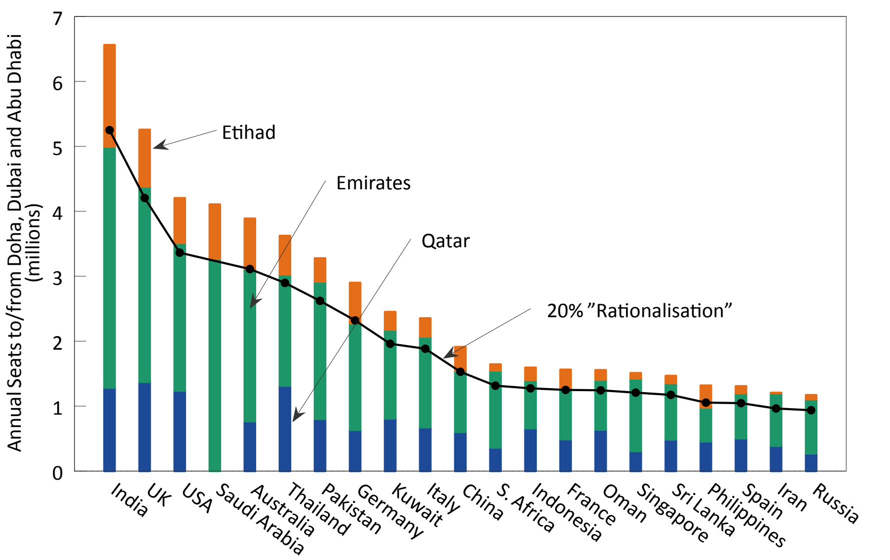
At the same time as the super-connectors are attempting to rebuild their networks, the Middle East is facing a economic crisis because of the collapse in the oil price; as at the end of June the spot crude oil price was around $40/barrel. According to the IMF, the fiscal break-even price — the minimum price of crude required to cover government spending — was $70/bbl In the UAE and $84 in Saudi Arabia, the key economic driver for the region.

There must be serious doubts about whether even Abu Dhabi can afford to continue funding at levels needed to support Etihad. Construction and other investment projects are being reined in in UAE and Qatar, which will have a very negative impact on direct traffic to the super-connector hubs. Whether tourism to Dubai can be resurrected post-Covid is yet another unknown.

Etihad's policy of dubious investments has now totally collapsed as Jet Airways, India's number two international carrier, which was 49% owned by Etihad, went bankrupt last year and Virgin Australia (in which it had a 21% stake — see *Aviation Strat-*



PRE-COVID SUPER-CONNECTOR CAPACITY BY COUNTRY



egy, Dec 2019) threw itself into voluntary insolvency in April because of the virus. Qatar's investment in Air Italy imploded in February with the bankruptcy of that carrier, followed by the failure in May of LATAM, in which it had a 10% stake. Still, Qatar will provide DiP financing to LATAM and has said that it is willing to up its 10% stake in Cathay Pacific and 25% stake in IAG.

The super-connectors also have to worry about the value of their fixed assets and order books. According to AVAC, the Covid-19 effect on widebody values and lease rates has been even more severe than on narrowbodies. AVAC estimates that new 787s and A350s are now valued at 30% below 2019 levels. (these are *market* prices, not "fair values"). A380s now have no substantial operator apart from Emirates, and the theoretical value of an A380-800 has been marked down by a remarkable 60%. All this is going to cause a major headache for the super-connectors' financiers.

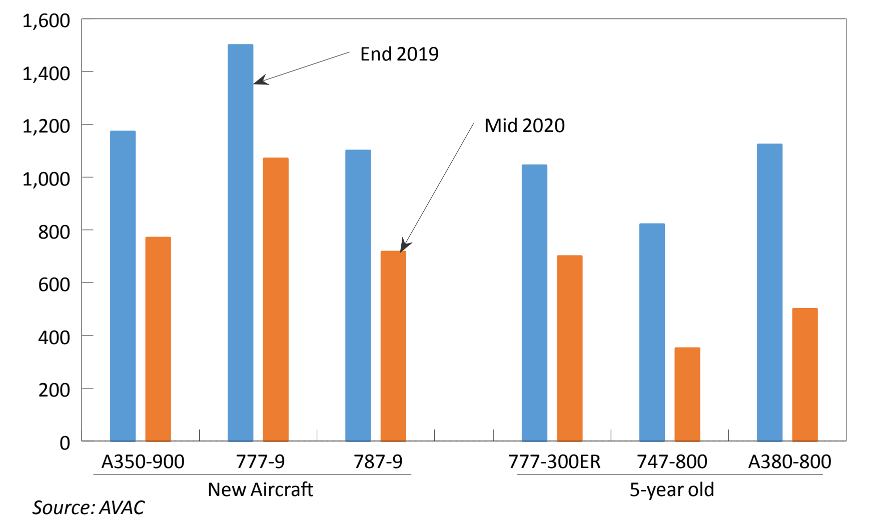
In the past we have emphasised the logic for a consolidation of the super-connector system, in particular a rationalisation of the overlap between Emirates and Etihad (estimated at 73% of their joint network) and in the current circumstances such consolidation has surely become inevitable.

The graph left shows the top 20 countries served by the three super-connectors in terms of seat capacity allocated in the pre-Covid era. In the medium term, this capacity will have to be curtailed — our tentative suggestion is by 20%. At 20% the capacity eliminated would be equal to almost all of that previously provided by Etihad.

The rationalisation has to take place between Emirates and Etihad; Qatar Airways will continue to fly almost regardless of its economics, supported by the vast financial resources of the country which remains politically ostracised by Saudi Arabia and other Gulf states.

A final complication for the super-connectors is the incursion of LCCs into some of their markets using long range narrow bodies. Both flydubai and Air Arabia have ambitious expansion plans from their bases at Dubai and Sharjah while Wizz, as described in the previous article, is starting off its joint venture with ADDH in Abu Dhabi with plans to move to a fleet of 50 or maybe 100 A321s within ten years. Air Arabia has a similar joint venture planned with Etihad from the same airport. The key market for the LCCs is the Indian subcontinent which accounted for about 25% of the super-connectors' pre-Covid passenger flows.

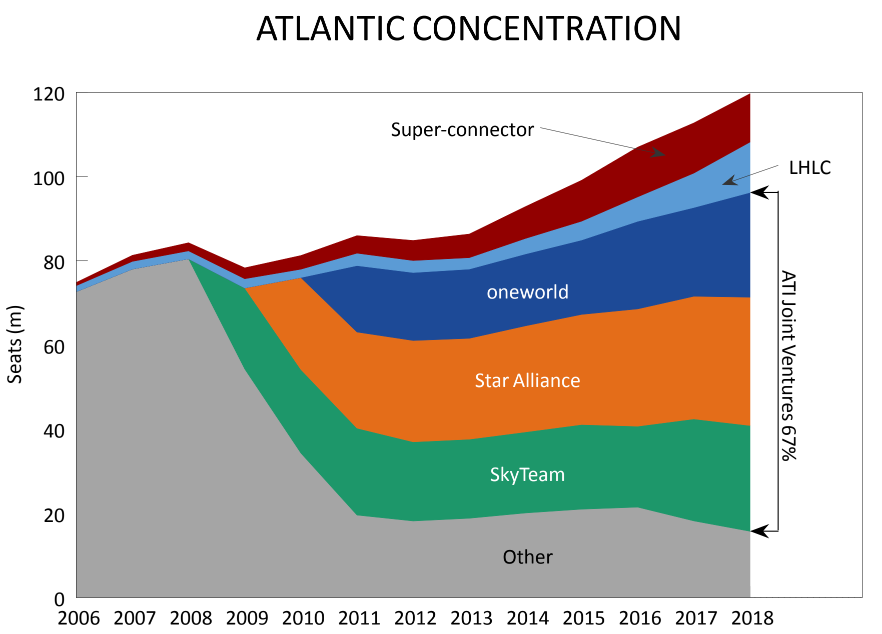
ESTIMATED OPERATING LEASE RATES ($000/month)



Source: AVAC

Immunity from competition law: BA/AA OK?

How times change. Airline alliances, especially where immunity from competition law was involved, were once the subject of intense review and debate. Competition authorities almost competed among themselves to highlight the potential for anti-competitive behaviour and to devise painful remedies (painful for the applicants at least). Now it seems that such applications hardly raise an eyebrow and are regularly approved almost routinely.



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

The experience of the alliance between British Airways and American Airlines, now expanded to include other carriers, is a good example of this development, and it is worth going back to its beginning to see the full impact. When first proposed in the mid-1990s, the BA/AA alliance quickly received strong support from both the UK and US Governments. On the US side this reflected the fact that anti-trust approval would be accompanied by UK acceptance of an open skies bilateral agreement, and in particular by increased access for US airlines to Heathrow.

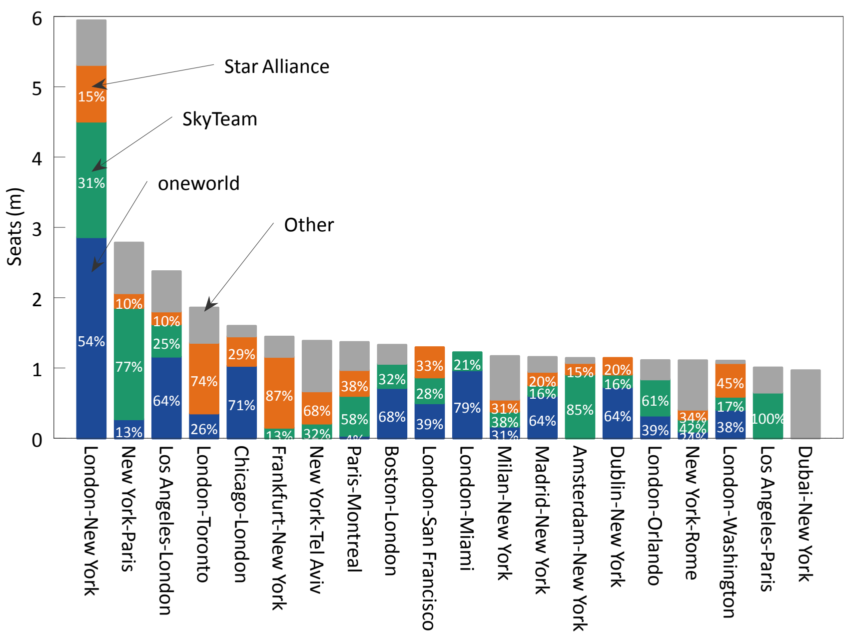
For many years, the UK (and of course BA) had resisted reform of the Bermuda 2 agreement in the absence of concessions by the US to open up its domestic market to foreign competition. The benefits to be gained from a trans-Atlantic alliance with American clearly persuaded BA that allowing more access to its Heathrow fortress hub was a price worth paying. Like most national flag carriers at the time, BA had a very close relationship with its government (and especially the Transport Department — again how times have changed!) and it was far from a surprise that the UK indicated its support for this U-turn.

Everything was set, therefore, for a quick approval of the alliance, accompanied by the death of Bermuda 2. As was the norm at the time, it wasn't thought necessary to consider in any real detail the competition implications, nor the interests of other airlines, let alone consumers. Except that Sir Richard Branson had other ideas. Realising that a BA/AA North Atlantic alliance would be a major threat to Virgin Atlantic's prospects, he launched a well-financed campaign aimed at two separate audiences in Europe and the US: the general public and politicians on the one hand, and the competition authorities in London, Brussels and Washington DC on the other.

The publicity campaign, which included the famous "BA/AA No Way" slogan on the side of every Virgin aircraft, together with full-page, often amusing advertisements in national newspapers and even a blimp flying over Washington, attracted considerable attention. But the real battle was fought before the competition authorities, and their decisions were to prove decisive and disruptive for BA/AA's plans.

Initially BA in particular paid very little attention to the UK Office of Fair Trading and effectively ignored the European Commission. The result was a disaster, with demands from the competition authorities for the divestiture of a large number of Heathrow slots in order to miti-

TOP ATLANTIC CITY-PAIRS



Source: Schedules data 2018

gate the perceived anti-competitive nature of the alliance. BA and AA walked away. They returned later to try again, taking the European Commission more seriously this time, only for the US Department of Transportation this time to take the initiative and demand the divestiture of numerous Heathrow slots. BA and AA walked away again.

It was only in 2010, following the signing of the EU/US trans-Atlantic open skies agreement (and therefore the replacement of Bermuda 2) and some 13 years after the original application, that approval was finally given at the third time of asking. This time the price for approval, particularly the divestiture of Heathrow slots for additional services on six routes from London, was acceptable to BA and AA. The alliance was later expanded, with its anti-trust immunity, to include the trans-Atlantic services of Iberia, Aer Lingus and Finnair, now known as the Atlantic Joint Business Agreement (AJBA).

BA/AA may have been the first international airline alliance to be subject to serious review by competition authorities, but it certainly was not the last. Such reviews have now become routine, following an established methodology. Usually they identify areas of concern from a competition point of view which the authorities then try to mitigate with a number of penalties, especially slot divestiture where congested airports are involved.

Unfortunately, such action has had only limited success in attracting new competition, possibly with the exception of Heathrow. With the slot-restricted airports invariably dominated by airlines with significant market power, it is often difficult for new entrants to establish themselves, even with the help of remedies imposed by the competition authorities.

In a joint paper issued in 2010, for example, the European Commission and the US DOT agreed "that one of the main challenges in the airline industry is to design a remedy that can effectively address the identified negative effects of the parties' cooperation while giving consideration to the principle of proportionality,"

In at least one case, the European Commission even went so far as to make it a condition of approval of a joint venture that the applicants obtain an effective competitor on a route, an initiative which has not been noticeably more successful and one that hardly suggests that there is a lengthy queue of new entrants eager to take on the dominant players.

After the original application, the EU Commission took control of the BA/AA cases in Europe and was responsible for the eventual approval in 2010, when clearance was also obtained from the US DOT. It is worth listing the demands made by the Commission in 2010:

- ✈ BA/AA agreed to make slots available to allow non-stop entrants to operate or increase services on the London to Dallas/Fort Worth, Boston, Chicago, Miami and New York and Madrid to Miami routes. (Slot divestures were also required in 2013 in relation to the London — Philadelphia route, which facilitated the entry of Delta. Under the terms of this commitment, after three years Delta was able to withdraw from the route and use the slots for another service to the US. AA is currently challenging the legality of the Commission's original decision in this case).
- ✈ They agreed to allow third party airlines to offer a return trip comprising a non-stop trans-Atlantic service provided by the third party airline and a non-stop service in the other direction by the AJBA partners.
- ✈ They agreed to allow third party airlines to conclude a bilateral Special Prorate Agreement with the AJBA

partners on favourable commercial terms.

✈ They agreed to provide access to their frequent flyer programmes, when requested, to non-stop airlines that have commenced or increased services on the identified city pairs. However, this only applies to carriers that do not have a comparable FFP and do not participate in any of the parties' FFPs.

The European approval of the alliance was granted for ten years and is due to expire this year. It is not surprising, therefore, that a review was launched in late 2018. What was unusual, however, was that the European Commission stood back and let the UK's Competition and Markets Authority take the lead. Clearly a decision was taken that with the end of the Brexit transition period fast approaching, when the Commission will no longer have responsibility for competition policy in the UK, and with five of the six routes previously identified as being of concern involving London, the CMA was the appropriate body to act.

Interestingly, of the seven city-pairs where BA and AA services overlap, the CMA quickly decided to ignore London to Los Angeles and New York, noting that there were at least three independent competitors to BA/AA on these routes, including new entry since the 2010 Commitments were accepted. Presumably this is a reference to Norwegian's operations, although it remains to be seen how significant a competitor Norwegian proves to be in the post-COVID world. The CMA also decided that there were sufficient competitive constraints from United and, again, Norwegian for the non-premium market on the London — Chicago route.

Probably the most significant change in the positions adopted by the competition authorities and the alliance applicants can be seen in the fact that, rather than resist concessions, the AJBA soon offered a series of commitments to address competition concerns, which the CMA readily accepted. The only changes in the identification of so-called 'routes of concern' were the dropping of London — New York and the non-premium segment of London — Chicago. Given the speed of agreement, it is perhaps understandable that at the time, IAG's Chief Executive Willie Walsh commented that this process was not at the top of his agenda. What a change from the decade after the first BA/AA application.

Noting that "the AJBA has as its object and effect the prevention, restriction or distortion of competition", the CMA acknowledged that there are significant barriers to entry and expansion of flights on the routes of concern. According to the CMA, the AJBA provides for the ongoing exchange of commercially sensitive information in relation to pricing, capacity, schedules and marketing. "The CMA's current view is that the Commitments Parties have not demonstrated that the claimed benefits are sufficient to outweigh the CMA's current competition concerns."

Hence the slot divestitures (with applicant carriers having the choice of Heathrow or Gatwick) and a roll-over of the other commitments. This package differs only marginally from the commitments made ten years ago, although overall they probably represent some easing of the price, despite the wider coverage of the AJBA with the addition of more carriers. The CMA has also reserved the right, because of the exceptional circumstances created by the COVID-19 pandemic, to review the joint venture between two and five years after the commitments come into effect.

Comments from the competition authorities in both Brussels and Washington not long ago appeared to suggest that airline alliances might find it more difficult to obtain approval for anti-trust immunity. Unless the UK CMA is at odds with their Commission and DOT colleagues, which is unlikely given the co-operation and consultation that exists between these bodies, the interim decision on the AJBA would seem to suggest otherwise, which will be good news for alliances. However, the post-COVID world could produce a very different competitive environment and force the regulators to again adopt a more critical approach.

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