Aviation Strategy
Issue no. 256
September 2020

IAG: mostly grounded but shareholders mostly supportive

WHEN WILLIE Walsh announced, at the beginning of January, that he intended to retire from his post as Chief Executive at International Consolidated Airlines Group, he must have thought that he would have been doing so at the peak of a long and successful career.

He had started as a cadet pilot at Aer Lingus aged 17, took over the reigns as CEO of the Irish flag carrier in 2001 and moved to take on the same role at British Airways in 2005. IAG, formed in 2011 from the merger of British Airways and Iberia, had grown under his leadership organically and by acquisition (of Vueling, Aer Lingus, British Midland and Monarch slots) to become the most profitable of the three top European legacy airline groups, albeit third behind Lufthansa and Air France-KLM in terms of total revenues.

In each of the three years leading up to the end of 2019, the group had achieved underlying operating margins of around 13% and returns on invested capital of 15%-17% — above the targets the group had set itself at the time of the merger.

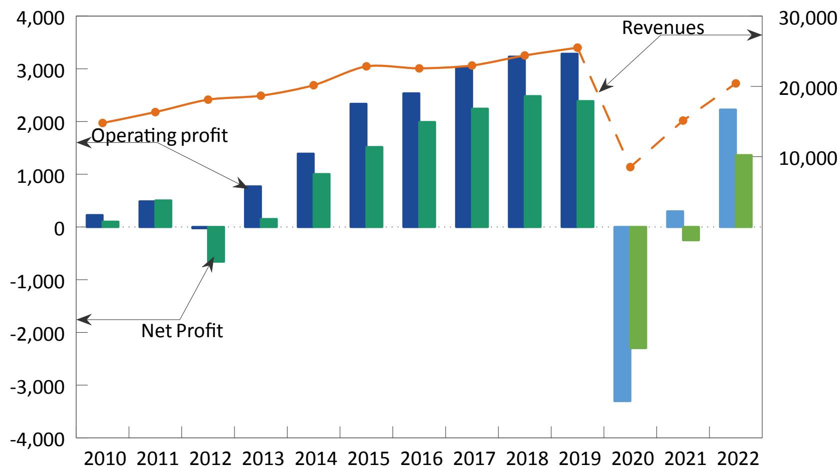
But then, just a matter of weeks after he made his announcement came the crisis of the global Covid-19 pandemic, a virtual grounding of air travel worldwide and a desperate hunt for cash and liquidity.

Here IAG was in better shape than many. It had built a strong balance sheet, and although it had returned funds to shareholders in the good years, it had done so prudently and had not been beguiled into borrowing money merely to fund investment banks' fondness for share buybacks. Over the five years to end 2019, IAG had returned over €4bn to shareholders providing them with compound annual average total returns of 8%. It ended 2019 with cash liquidity of €8.6bn (34% of 2019 annual revenues), net debt to EBITDA of 1.25 (compared with an internal target ceiling of 1.8x) and investment grade ratings from Moody's and Standard and Poors.

IAG had built a lot of flexibility into its fleet structure. At the end of 2019 the 600 strong fleet had an average age of 11.5 years; and, over the the next three years to 2022, 131 of the 200 long haul aircraft and 63 of the 398 short haul aircraft would approach the end of their useful lives. At the same time another 200 leased air-

This issue includes

IAG FINANCIAL DATA (€m)



Source: Company reports; forecasts HSBC

Aviation Strategy

ISSN 2041-4021 (Online)

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

Publisher:

Keith McMullan
James Halstead

Editorial Team

Keith McMullan
kgm@aviationstrategy.aero

James Halstead
jch@aviationstrategy.aero

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

Subscriptions:

info@aviationstrategy.aero

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

Typeset in Calibri and Rockwell using XƎLATEX

IAG FLEET PROFILE

	Dec 2019	changes	Jun 2020	*[of which Parked]*	Avg Age	Orders	Options
A318	1		1*	*[1]*			
A319	57	(5)	52	*[23]*	17.4		
A320	254	(4)	250	*[80]*	10.5	27	76
A321	66	4	70	*[26]*	9.8	43	14
A330-200	24	(3)	21	*[18]*	6.0		
A330-300	16	2	18	*[4]*	7.0		
A340-600	15	(11)	4*				
A350	9	6	15	*[1]*	1.1	28	52
A380	12		12	*[12]*	6.4		
747-400	32	(32)					
777-200	46	(3)	43	*[16]*	20.6		
777-300	12		12	*[2]*	8.0	4	
777-9						18	24
787-8	12		12	*[2]*	5.3		
787-9	18		18	*[2]*	4.3		
787-10						10	
E170	6	(4)	2		10.8		
E190	18		18	*[13]*	9.7		
Group total	**598**	**(50)**	**548**	***[200]***	**10.7**	**130**	**166**

*Notes: * since disposed. Excludes LOI with Boeing for 200 737MAX for delivery from 2023.*

craft would have their leases coming up for renewal over that period; at the end of 2019 the group had planned only to renew the leases on 75 of these.

When the crisis hit fully in March and countries round the world effectively closed their borders, the group reacted decisively. It grounded 70% of its fleet, cut passenger capacity by 95% and implemented emergency measures to reduce cash spending — including cancelling the shareholder final dividend announced for 2019 — and delayed Walsh's retirement to September.

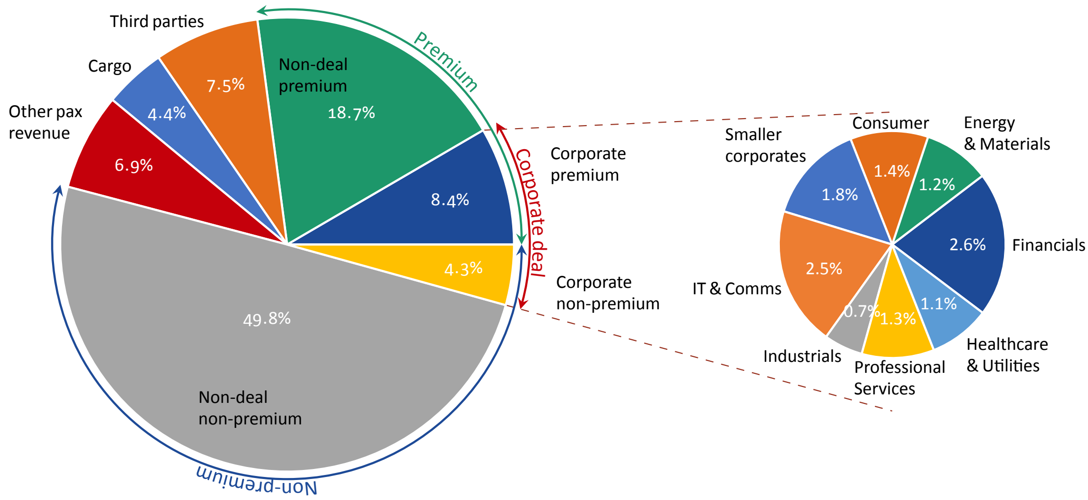
It took advantage of the wage support schemes where it could. It used the UK's Coronavirus Job Retention Scheme (CJRS) to furlough 22,000 staff (over half the workforce) at British Airways, Spain's Expediente de Regulación Temporal de Empleo (ERTE) for 18,000 employees at Iberia and Vueling, and Ireland's Temporary Wage Subsidy Scheme (TWSS) for 4,000 at Aer Lingus. In total affecting over 80% of the group's head count this brought in a modest €270m in the first half of the year.

IAG shied away from strong sector-specific government support although it did qualify for and took advantage of the UK's Covid Corporate Financing Facility (CCFF) with British Airways issuing the maximum permitted £300m commercial paper to HM Treasury and the Bank of England. In Spain, Iberia and Vueling entered into syndicated financing agreements respectively for €750m and €260m guaranteed by the Instituto de Crédito Oficial (ICO).

Willie Walsh over the years has been strongly opposed to state aid for airlines. On a recent webinar hosted by Eurocontrol, he pointed out that he was adamantly against governments' bailing out *failed* airlines (citing Alitalia in particular), but that support for well-managed carriers, such as Lufthansa, "who had entered this challenging position through no fault of their own" was fair. At the same time he noted that the major part of the current round of state support was in debt which had to be repaid, and that extrication from the support will be difficult.

As for all airlines round the world,

IAG REVENUES BY SOURCE (2019)



IAG's financial performance in 2020 has been dire. In the first six months to end June, passenger numbers were down by 64% from prior year levels; capacity in ASK down by 56% (and 90% in the second quarter); revenues fell by a similar percentage to €5.3bn; and it recorded an underlying operating loss of €1.9bn reversing a €1.1bn profit for the same period in 2019.

There was one bright point: cargo revenue was actually up 11% for the half year, and over 30% up in the second quarter — its best ever for cargo.

But when faced with an existential crisis these numbers are almost irrelevant and all focus has been on stemming the cash outflow and ensuring sufficient liquidity to last through the crisis. And it must have been depressing to have to state in the half year results that "a material uncertainty existed that may have cast doubt on the group's ability to continue as a going concern".

The group ended the half year with cash liquidity of €8.1bn, slightly down on that at the start of the year — but this was before the receipt of cash from a €380m sale and leaseback of five aircraft and £750m presale of frequent flyer points to American Express. But debt stood at 4.2x EBITDA (on an annual trailing basis) — reflecting the increase in debt and collapse of earnings. In September it concluded an emergency three for two rights issue to raise €2.7bn (fully supported by its 25% shareholder Qatar Airways, who itself has just received a $2bn injection from its owner).

IAG BALANCE SHEET ITEMS

€m	Dec 2019	Jun 2020	Proforma post rights
Equity	6,829	785	3,535
Cash	6,683	6,016	9,976
Bank loans	1,954	4,014	4,014
Asset financed liabilities	1,254	1,874	1,874
Lease liabilities∗	11,046	10,591	11,421
Total debt	14,254	16,479	17,309
Net debt/Equity	1.1x	13.3x	2.0x
Net debt/EBITDA	1.4x	4.2x	2.8x

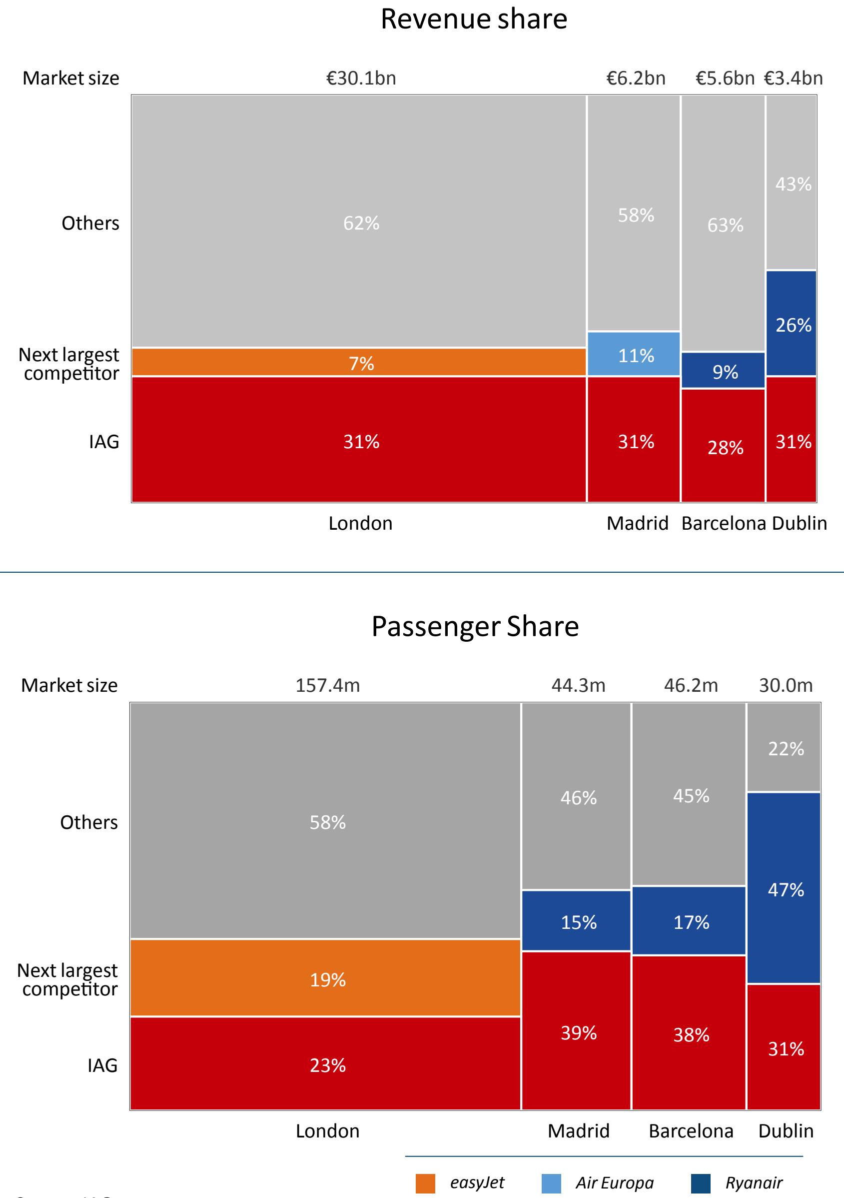
Source: company reports, Aviation Strategy analysis.
Notes: † includes €3.3bn intangible assets; ∗ of which c€4-5bn relating to operating leases

Future size and shape

Where will IAG go from here? In his talk with Eurocontrol Willie Walsh forcefully said that the industry is "*never* going to get back to the way it was". And the measures he oversaw since March, to be continued by his successor Luis Gallego, point to a significantly smaller group.

Along with temporarily grounding a large part of the fleet in the second quarter, the group accelerated the retirement of older, less fuel-efficient aircraft. British Airways retired its entire fleet of 32 ancient

IAG IN ITS HOME MARKETS (2019)



Source: IAG

747s, and Iberia its 15 A340s, and there were a further 20 narrow body aircraft that could be retired early without significant waste of useful operating life. There were 20 aircraft on plan to be returned to lessors at the end of their leases in the current year — and a further 42 and 54 whose leases expire respectively in 2021 and 2022 and which it could choose to return (it has probably negotiated the deferral of monthly lease payments).

It has also renegotiated planned deliveries of its aircraft on order from manufacturers, reducing the delivery of new aircraft by 68 units (from 143 to 75) between 2020 and 2022. 38 aircraft are now scheduled for delivery in 2020, 15 in 2021 and 22 units in 2022. This will help reduce group capex by more than half over the next two years (to €1.9bn and €2.4bn from €4.3bn and €5.7bn respectively).

All the airlines in the group are implementing restructuring plans to reduce staffing levels and improve wage productivity. At British Airways it expects that up to 13,000 staff could be made redundant and that most of the company's 38,000 UK based employees could be affected by the restructuring. Over 8,000 had already left the business by the end of August, and BA had concluded agreements with its pilots, engineers and Heathrow customer service staff. Negotiations with the cabin crew have been a little more difficult.

Aer Lingus has announced plans to make 500 jobs redundant (more than 10% of its workforce).

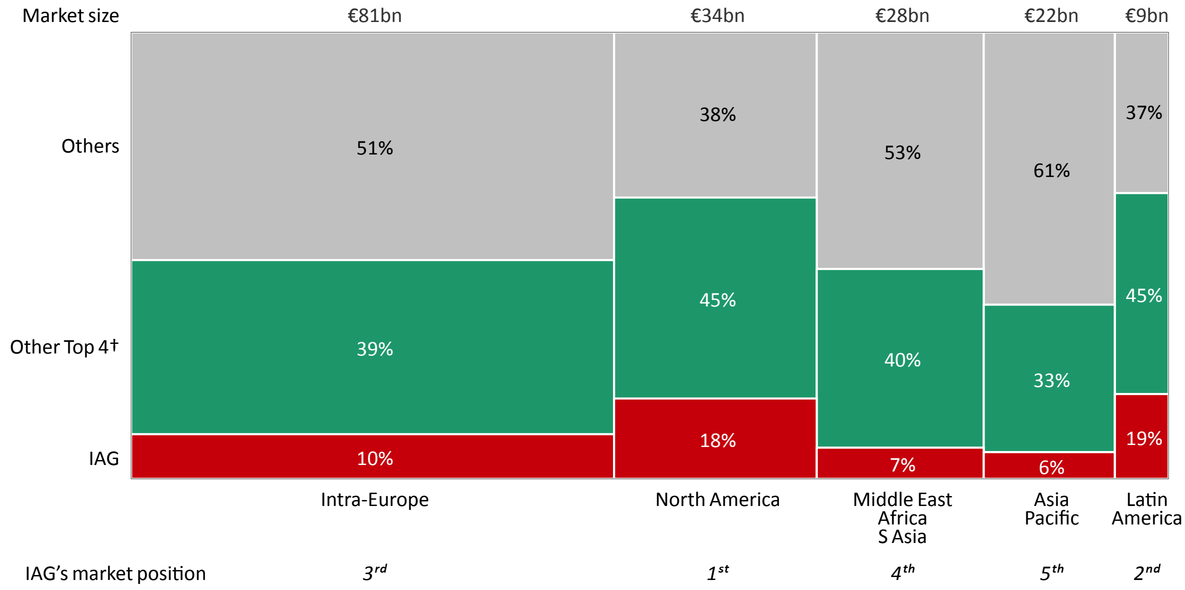
In Spain, things are a little more complex (Iberia went through a massive job reduction programme eight years ago), and the ERTE job support programmes require positions to be maintained for the duration of the crisis. But the group states that both of the Spanish airlines "have held regular meetings with the main labour representatives to inform them of the ongoing situation and the plans that the companies are developing to adapt their cost base to the new post-COVID capacity and demand environment".

Meanwhile Level has closed its Vienna based AOC, and OpenSkies (which operated Level's services out of Paris Orly) is trying to work its way through the French employment laws to close its operations there.

Unique strengths

IAG has a unique corporate model in the airline industry. When it was formed in 2011 it could learn from the mistakes that British Airways and Iberia identified in the structures created by the merger of Air France and KLM in 2004, and acquisitions

TOP 5 EUROPEAN CARRIERS' SHARE OF MARKET TO/FROM EUROPE BY REVENUE (2019)



Source: IAG.
Notes: † Lufthansa Group, Air France-KLM, Ryanair and easyJet

by Lufthansa (of Swiss and Austrian) in subsequent years to form the Lufthansa Group.

It is based on an independent corporate parent company which owns a portfolio of branded airlines and a common integrated platform to service its operations. The parent company makes decision about capital allocations to its airlines based on strict return criteria and exerts influence across the group to maximise returns.

The parent company is also responsible for setting the long-term vision for the Group. Its independence from the operating companies it sees as allowing it "objective, flexible and rapid decision-making" and enabling it to "implement a cohesive long-term vision for the Group".

Each of the IAG airlines is a standalone profit centre, with an independent credit identity and its own management team and board of directors. As a result, each airline retains its own brand and individual cultural identity, focusing on meeting the needs of its target customers and differentiating itself from its competitors.

British Airways is a premium network carrier based in the largest aviation market in Europe — the UK — where the group had a 31% share of estimated revenues and 23% of the passengers, some way ahead of its nearest competitor easyJet (see chart on the facing page). It relies London's strength as a true O&D market — in normal times London would feature in ten of the world's top 12 long haul origin and destination markets.

Because of this it may be less reliant on hub transfer traffic than some of its competitors — although the hub network has been an important part of its strategy.

It has a leading position on the North Atlantic, but its antitrust immunised joint venture (including Iberia, Aer Lingus and and Finnair) is with American — the weakest of the top three US carriers. As a premium carrier it is dependent on corporate and premium travel — and we estimate to a much larger extent than that suggested by the figures for the group in the chart on page 3, (premium: 27% of revenues; corporate deals: 13%). Both these segments are possibly going to take a long time to recover. But one saving grace is that the prospect for Heathrow's third runway will now be even further away.

Iberia as a network carrier has a strong position on the South Atlantic — the group had an estimated 19% of the revenues on routes between Europe and South America and Caribbean, slightly behind Air France-KLM. At the end of 2019 it had agreed to acquire Air Europa from Globalia

(Spain's largest tourism group) which being its next largest competitor in Madrid would consolidate its position at Barajas airport and give it the leading position to Latin America. It is still saying that it expects to complete the acquisition towards the end of 2020, although the eventual deal will no doubt be well below the originally agreed €1bn cash.

Iberia has a reasonable domestic market — a segment that is likely to recover from the crisis sooner — although this has been under pressure from the development of the high speed train network. It also depends on connecting flight in Madrid, (but to a lesser extent than British Airways on premium traffic) to make sense of its long haul routes, but there is a substantial level of VFR and cultural traffic between Spain and the hispanophonic countries of South America, which could also be at the forefront of a recovery in demand.

The acquisition of **Air Europa** still (probably) makes long-term strategic sense. It was the largest independent airline in Spain mainly flying domestic and intercontinental routes in the Spain-Latin America market where IAG's ambitions had been thwarted when LATAM (currently in Chapter 11 protection) switched allegiance from oneworld to Delta (and SkyTeam) in 2019, and provided a strengthened position particularly in Brazil. Strategically the acquisition mirrors the acquisitions by British Airways of British Caledonian, Dan Air and bmi that allowed it consistently to build market share in London. At the time of the announcement, IAG had described Air Europa's brand positioning as that of a "value" brand between full service and low cost.

Aer Lingus has 31% of the revenues and passengers at its home base in Dublin, although it is in second place behind Ryanair in the numbers of passengers carried. With a smaller, but noticeable presence on routes into North America, it had in recent years developed Dublin increasingly as a transfer hub, and in particular attracting what IAG refers to those looking for "frugal fun". However, it also initiated plans to use the A321neoXLR — it recently took delivery of the first of a planned fleet of eight due by the beginning of 2021 to replace former leased 757s (and it has another six on order). These are designed to allow it efficiently to access smaller markets in the US and target the hundreds of millions of US nationals who identify as Irish-American.

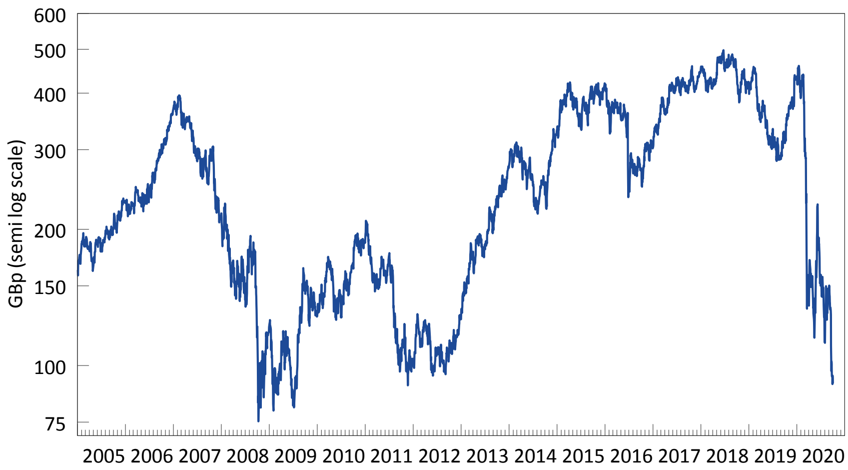
Vueling is Europe's third largest LCC operator. Based in Barcelona (as the de facto flag carrier of Catalonia) it had a leading position with 38% of the passenger throughput and 28% of the revenues, well ahead of its next largest competitor Ryanair. It also operates secondary bases in Rome and Paris Orly, and 14 airports in Spain. It is mostly a point-to-point operator (but has tried to market Barcelona as a transfer hub) with a single aircraft type adhering to the LCC "KISS" principle.

Level is the newest airline in the portfolio. Established as a long haul low cost operation with a fleet of three A330s to counter what may have been seen as the threat from Norwegian, it then expanded into short haul operations in the competitive Vienna market using aircraft from Vueling. These have now closed and it has retrenched in the crisis to operations from Barcelona. Immaterial in a group context, it is a possible future platform for a new normal in long haul flying. It could equally be closed.

Walsh's legacy

Willie Walsh has now retired and handed over the reins to Luis Gallego. He has left him with a high quality company but one stuck in the worst crisis the industry has ever seen. However, IAG is (relatively) well capitalised and has the support of shareholders. It is one of the few unfettered by Government aid. And it comes with an established core concept of allocating capital among constituent airlines purely on the basis of expected returns.

IAG SHARE PRICE PERFORMANCE



Note: British Airways prior to 2011

Accidental nationalisation of the North Atlantic

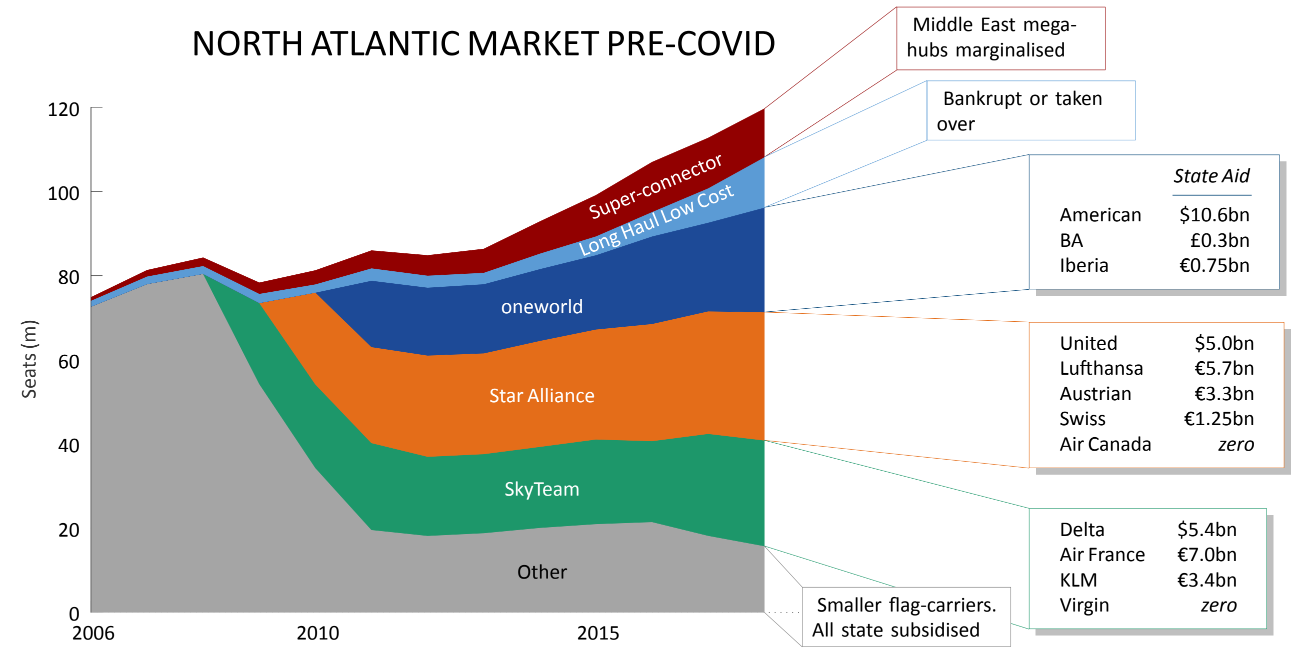
The North Atlantic was the largest and most mature long-haul air transport market in the world, until March 2020. Since then it has in effect been shut down, operating at around 20% of 2019 capacity, which could profoundly alter the competitive landscape and regulatory framework.

The re-opening date is simply unknown, but it is now clear that a V-shaped recovery pattern is highly unlikely. The CEOs of various airlines have been pushing back on the year when 2019 traffic volumes will be recaptured: 2023 or 2024 appears to be the consensus at the moment. And even if traffic does get back to the 2019 level by 2023/24, it will be 15-20% below that expected and planned for in the pre-Covid world.

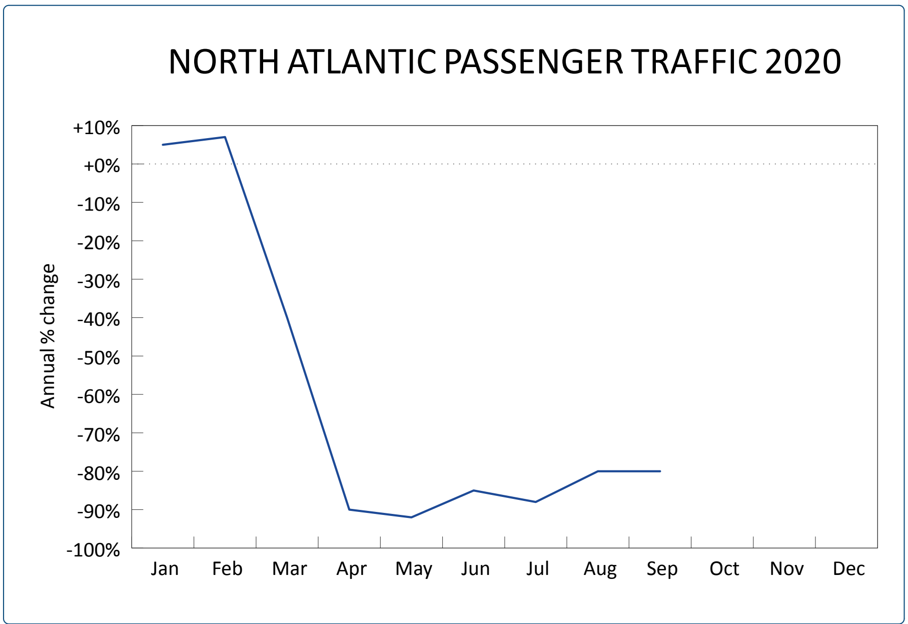
Post-Covid, when an effective vaccine is available or when travellers have adjusted to the risks of the disease, the transatlantic airline industry could resemble the pre-deregulation world — dominated by a few large airlines, owned or controlled by their governments, subsidised by their states, with limited real competition.

This outlook is partly the culmination of a trend that long predates Covid-19 (see, for example *Aviation Strategy*, November 2018). From 2009, the North Atlantic market has become increasingly consolidated and divided up among three multinational groups: the antitrust immunised joint ventures of Air-France-KLM with Delta (having taken over Northwest); the Lufthansa Group with United (having taken over Continental) plus Air Canada; British Airways, Iberia and Aer Lingus with American (having taken over USAirways). On the North Atlantic these groups, under the alliance brands of SkyTeam, Star and oneworld, became virtually merged entities, with the US and European partners making joint decisions on fares, schedules and capacity, sharing revenues and costs on a "metal-neutral" basis so that in theory there was no difference as to whose aircraft were operated, and producing their own consolidated (and confidential) financial accounts for the sector.

By the end of 2018 the three airline combinations had gained control of roughly 68% of the capacity on services between North America and Europe/Middle East (see chart), and their hub-to-hub routes across the Atlantic were in many cases completely



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



monopolised. What once might have been seen as illegal collusion was protected through the antitrust immunity provisions of the joint ventures.

All of the network carriers appeared commercially robust in 2019, but that robustness proved to be an illusion once Covid-19 struck. Collectively the six network carriers have absorbed some $45bn in state aid in grants and loans, and another round of state funding of a similar amount is likely over the next 12 months, as Air France and Lufthansa have strongly hinted at the need for more funding, plus aid under the US CARES Act will probably be extended in October. For comparison, the combined stockmarket value of the six carriers as at the end of September 2020 was $44bn.

The consolidation process on the Atlantic was predicated on an open skies regulatory regime — which would allow, hopefully, new entrants onto the North Atlantic, injecting competition into the market. Covid-19 has largely finished off that competition.

Long-haul low cost capacity, in various forms, had peaked at about 12% of the North Atlantic total. But Norwegian's operating model was being severely stressed before Covid-19, and survival prospects for the carrier, despite its own dose of state aid, look dim unless it too is nationalised. In which case it will join the myriad small European flag-carriers now fully supported by their states — Alitalia, SAS, TAP, etc. — which in the pre-Covid era had about 13% of the capacity on the Atlantic. The innovative Icelandic low cost hub operation has collapsed and the charter-type carriers like Thomas Cook either went out of business even before Covid-19 or have been left in limbo (Air Transat which was due to be merged into Air Canada).

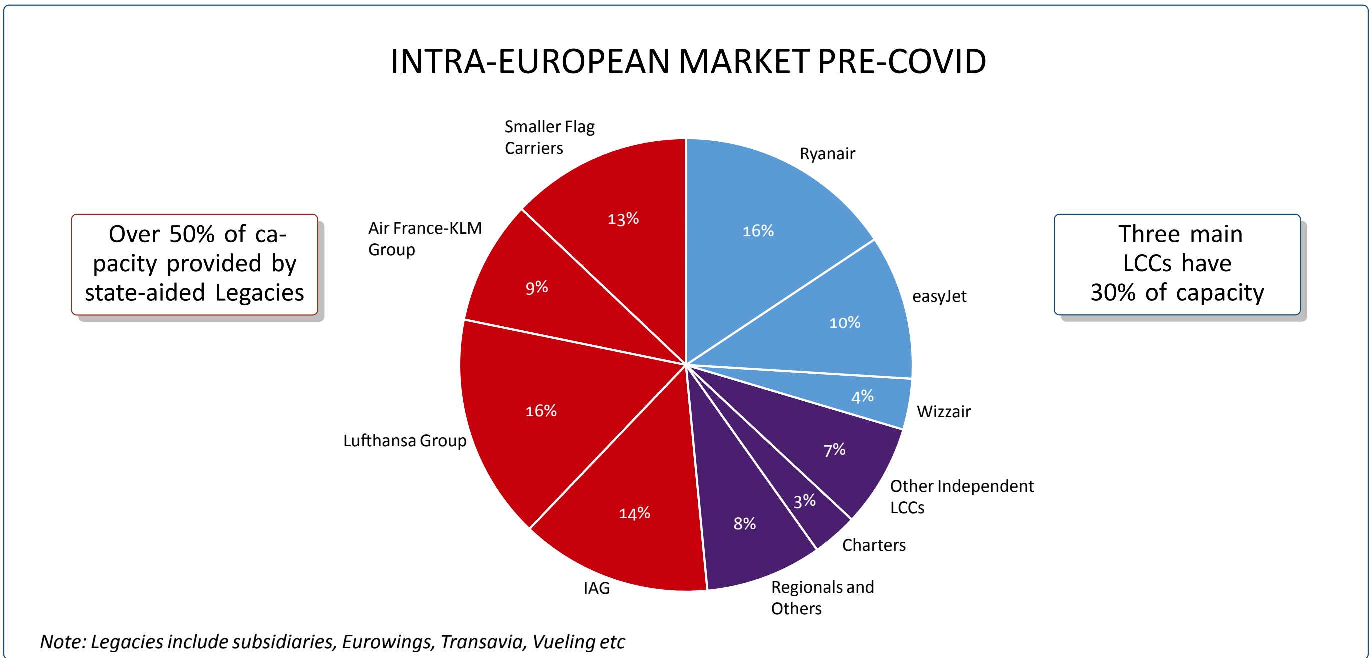
It is somewhat ironic that the super-connectors — Emirates, Etihad and Qatar Airways — provoked such outrage in the US over state subsidies when they started to become a threat on the Atlantic, with about 9% of capacity. Their Middle East passenger hubs have been devastated by the pandemic, and recovery will be painfully slow. Funnelling huge volumes of passengers to/from 200-plus countries through a few terminals no longer appears to be an attractive prospect.

So after decades of extricating themselves from their national carriers, governments now find themselves as significant shareholders — 20% at Lufthansa, 28% at Air France/KLM — again supporting their major airlines. Under the CARES Act, which allocated some $50bn to US passenger airlines, the government will have the right to participate in "the gains of the eligible business or its security holders through the use of such instruments as warrants, stock options, common or preferred stock, or other appropriate equity instruments" — in other words, partial nationalisation. On the Atlantic, this means that effective government ownership and control of capacity may well be close to total when the industry emerges from Covid-19.

Governments' new role

What role will governments play in this new world? Some of the conditions off the state aid reflect social aims — in Europe, the acceleration of carbon emission targets and the shifting short-haul passengers from air to rail while in the US the priority is the protection of jobs through no-furlough conditions — but the governments' stated aim is to facilitate rapid turnaround strategies so their subsidised airlines can repay their loans or convert them into commercial debt. The terms of the loans incentivise this, for example Lufthansa's interest rate on some of its state loans escalates from 4% pa to 9.5% pa in 2027. The Dutch government demanded a detailed recovery plan from KLM, which has now been delivered, as a condition of its state aid.

However, the challenges of restoring long-haul services to anything like pre-Covid operations are



such that governments may find themselves enmeshed for the long term, in which case It is not difficult to envisage long-haul international airlines once again assuming the role of national champions or chosen instruments. Aeropolitics necessarily reflect global trends in politics, and the political and economic *zeitgeist* has changed profoundly over the past five years — from a consensual belief in the benefits of globalisation and free competition to diverse nationalistic agendas, protecting and promoting narrower interests.

Alliance conflicts of interest

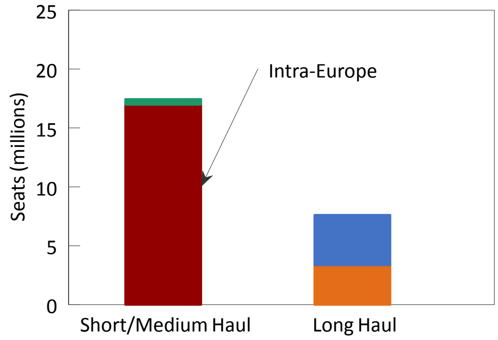
One issue that may well arise concerns conflicts of interests within alliances. The North Atlantic joint ventures may not be as solid as they appeared to be in the pre-Covid era; just as military alliances re-align under the threat of war, so do commercial alliances under the stress of a lengthy recession or depression.

In the oneworld joint venture the two main participants have been diametrically opposed in their attitude to state aid; whereas American, has taken the maximum available, $10.6bn to date, IAG has minimised its exposure to what it sees as potential state interference, BA taking just £300m under a general industry support scheme, while Iberia and Vueling have received €1bn in total of Spanish state funding. IAG is the strongest of the European carriers in terms of liquidity, having raised €2.7bn through a rights issue (though nearly €700m of that came from Qatar Airways, which has been hugely subsidised by its state). American is the weakest of the Big Four US carriers and is regarded as being the most likely candidate for Chapter 11. IAG had the strongest position on the North Atlantic in terms of overall capacity, twice that of Air France, and was dominant in the point-to-point markets (essentially London-New York) and in the premium travel market. American has been relatively weak in the northeast US but in July signed a strategic alliance with JetBlue, with JetBlue providing a domestic feed operation to American's transatlantic flights. It will be intriguing to see how this tripartite arrangement plays out when JetBlue starts up its own transatlantic A321 LR service, still scheduled for 2021.

In the Star joint venture the Lufthansa Group has been Europe's most avid recipient of state aid — over €10bn — while United has focused on raising funds through monetising its FFP for $6.8bn, and has received just $5.0bn from the US government. Lufthansa's problem is that it has a low proportion of transatlantic and other long-haul point-to-point traffic at its Frankfurt hub and has relied on its hubbing expertise to collect feed traffic. Downsizing a hub operation, as Lufthansa is planning, is a complex exercise as culling seemingly unprofitable short-haul routes may damage the viability of certain long-haul routes. Rationalising the hub network by consolidating long-haul traffic flows at Frankfurt and downgrading Vienna or Zurich is fraught with political problems. The state aid that the Lufthansa Group has received has come from Austria, Switzerland and Belgium as well as Germany, and those countries

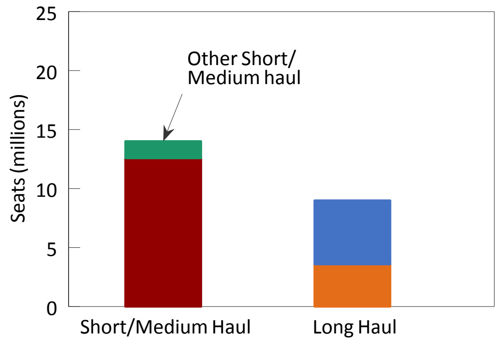
EUROPEAN HUB SYSTEMS PRE-COVID

KLM at Amsterdam



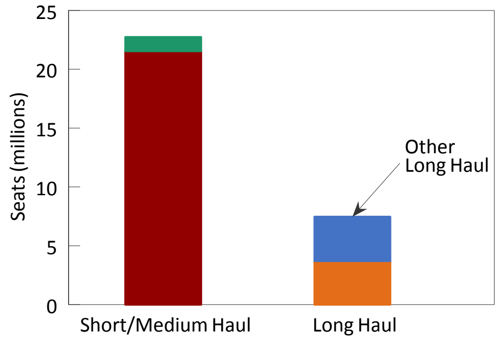
KLM as % of Hub Total 63%
Ratio of Short/Medium to Long Haul Seats 2.3

Air France at Paris CDG



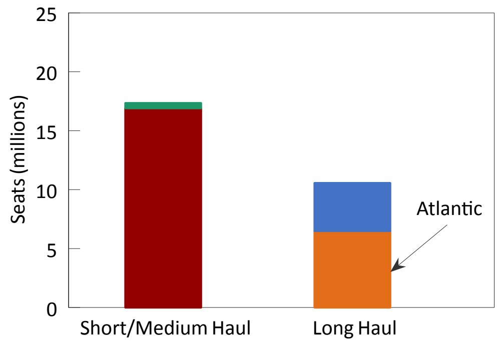
Air France as % of Hub Total 54%
Ratio of Short/Medium to Long Haul Seats 1.6

Lufthansa at Frankfurt



Lufthansa as % of Hub Total 67%
Ratio of Short/Medium to Long Haul Seats 3.0

IAG at London Heathrow



IAG as % of Hub Total 55%
Ratio of Short/Medium to Long Haul Seats 1.6

Note: Seat capacity estimated from Schedules. Includes mainline, subsidiary and US partner airlines

These charts summarise seat capacity offered at the four major European hubs by the incumbent network carriers (plus their subsidiaries and their US partners) in the pre-Covid market (2018 in this case).

Lufthansa's Frankfurt operation was the largest in terms of total seats, IAG's Heathrow hub in terms of long-haul seats. Perhaps surprisingly, KLM at Amsterdam was marginally larger in terms of total seats than Air France at CDG (Air France having other major bases at Orly, Lyons, etc).

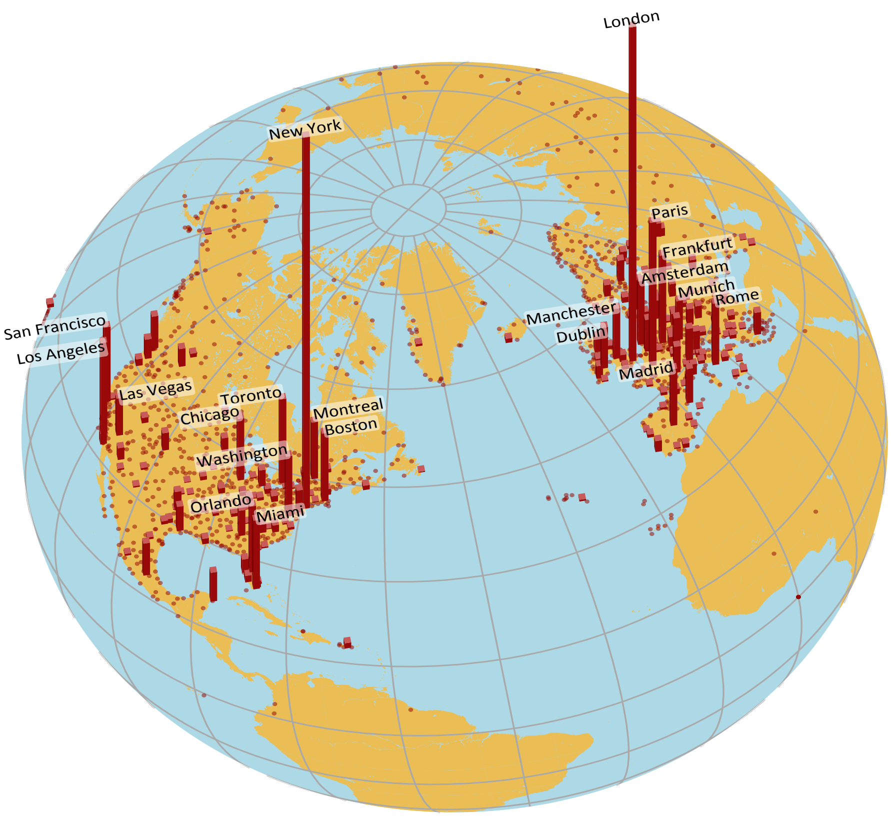
The ratio of short/medium-haul seats to long-haul seats is partly a reflection of the proportion of local to connecting passengers in the traffic mix. Frankfurt and Amsterdam are not strong O&D markets in themselves, and their long-haul networks rely on intense scheduling of connecting flights from domestic and intra-European points; hence the ratios were 3.0:1 and 2.3:1 respectively. IAG at Heathrow, by contrast, enjoys a very strong O&D market as, to lesser extent, does Air France at CDG; in both cases the ratio was 1.6:1.

The corollary is that KLM at Amsterdam and Lufthansa at Frankfurt have a greater share of total (all airlines) capacity at their hubs — 63% and 67% respectively — while London and Paris attract more competition both on short- and long-haul, and so control 55% and 54% of capacity respectively.

Long-haul capacity is split roughly equally between North Atlantic and Other long-haul (mostly Asia) at Frankfurt while more of the capacity at Amsterdam and CDG is directed to other destinations. Air France's Paris network strongly reflects the importance of francophone Africa.

In some ways, there are two transatlantic markets — the continental market and the UK market. Capacity provided by IAG, ie BA and AA, on the North Atlantic was equivalent to that of Air France and Lufthansa combined at their two hubs.

NORTH ATLANTIC O&D DEMAND (PRE-COVID)



understandably want to protect air transport connectivity at their capitals, as do the various *Länder* within Germany.

In the SkyTeam joint venture Air France/KLM has received €10.4bn in state aid, two thirds from France and one third from the Netherlands, while Delta (which incidentally owns 9% of Air France/KLM) has taken $5.4bn in US government funding. The problem is that the pandemic has exacerbated existing tensions between Air France and KLM. Put crudely the Dutch resent the fact they have been the profit generator within the group while Air France is perceived to have made too many concessions to its unions. Despite assurances from the two governments that all is well between the two airlines, investors will have to be persuaded that the Air France/KLM Group is operating as a coherent entity before providing the funds necessary to replace the state loans (some of which rise to Eurolibor plus 7.75% in year six).

Indeed, relations between Air France and Delta seem to be closer than those between Air France and KLM. Paris represents the second most important O&D point after London. Air France's new management might be considering whether, if the short-haul network can be rationalised, a downsized transatlantic operation, with a higher proportion of local traffic, emulating IAG's Heathrow model, might be the way forward. Where this would leave KLM's Amsterdam hub operation is unclear.

Collapse of premium business

The North Atlantic market has been heavily reliant on of premium travel for its profitability, but that sector has collapsed. At some point business travel will recover to pre-Covid levels but it is not going to be soon. The use of semi-efficient video technology — Zoom, etc. — is now universal; embattled corporations will continue to cut travel budgets; corporations have realised that they can use reduced business travel to meet their carbon reduction obligations; and super-elite passengers are much more likely to choose private jets.

This is particularly bad news for the transatlantic joint-ventures where premium passengers have accounted for 30-40% of their revenues. In the post-Covid world a 787 configured with 60 First/Business seats out of a total of 214 will still probably make sense on the key London-New York route, but on the thinner routes and hub-bypassing routes, smaller gauge equipment may well be the optimal solution — one that is being proposed by JetBlue with the launch of its A321 service featuring its MINT premium product.

It is not just premium volumes that have collapsed, premium class fares are down 70% year on year compared to a decline of around 30% for economy class, according to IATA. Pre-Covid the ratio of premium to economy fares was about 5:1 as a global average, higher on the main transatlantic routes. That type of ratio will not be achieved in the foreseeable future because to fill premium cabins premium fares will have to be moderated. Premium leisure is being promoted by some carriers, but this looks to be little more than a palliative strategy.

In short, for the revenue part of

the profitability equation — average RASM to get close to balancing the cost part — average CASM — economy class fares will have to be raised. In turn, a rise in economy fares would threaten to choke off a substantial recovery in traffic volumes.

Fragility of feed networks

Unlike US domestic hubs, European hubs are designed to feed traffic from short-haul to intercontinental long-haul. This exposes their short-haul operations to direct and indirect competition from the LCCs. Hubs with low proportions of local long-haul traffic, like Frankfurt or Amsterdam, are more vulnerable than those, like Heathrow and to a lesser extent Paris, that have strong local long-haul traffic demand.

It is perhaps surprising that in the intra-European market pre-Covid, ie 12 months ago, the big three network carriers (including their subsidiaries) accounted for nearly 40% of seat capacity. Add in the smaller flag-carriers — Alitalia, SAS, TAP etc — and over 50% of intra-European capacity market is state subsidised and facing a fundamental restructuring, partly dictated by the conditions of state aid. The network carriers are being forced into addressing the reality of the economics of feed to their global hubs, abandoning unprofitable routes and airport bases. Non-hub flying is being rationalised nearly out of existence in some cases.

About 30% of the intra-European market is operated 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. Wizz Air has made it clear that it intends to expand strongly when it is allowed to (*Aviation Strategy*, May 2020). Ryanair is on the point of making a classic recession-priced mega-order for 100-plus MAXes. They are going to encroach further onto the routes that the network carriers rely on for feed.

Streamlining of short-haul operations at Air France was overdue pre-Covid, and actions like phasing out the domestic subsidiary Hop! and moving to an A220 fleet should be beneficial for the airline's finances, Lufthansa has perennially tried to defend unprofitable non-hub short haul services as a marketing defence for its hub feed. Pre-Covid it had been in the process of trying to develop Eurowings as a low-cost point-to-point solution, but has since cut back its plans.

Reducing short-haul services into hubs could undermine the viability of some long-haul services, and these in turn may have to culled. If yields are depressed further on short-haul as the result of increased presence of LCCs, the only option may be to increase fares on the long-haul services — reinforcing the premium travel reduction effect described above.

For the moment the network carriers are able to retain their precious slots at their main hubs, as the European authorities have suspended the 80/20 use-or-lose rule, but there is no guarantee that this waiver will be renewed for summer 2021. If not, excess capacity at these hubs may be seized by new entrants, probably LCCs, intensifying the competitive pressures on the network carriers and the joint ventures.

Network speculation

✈ Nothing is clear in the post-Covid world, other than the fact that the key, previously highly lucrative, North Atlantic market faces a major medium-term disruption.

✈ Governments, having been obliged to subsidise their network carriers, are going to find it more difficult to extricate themselves as quickly as is officially expected. By accident long-haul carriers may again become national instruments.

✈ In Europe there will be a stark division between (mostly) unsubsidised IAG and the state-funded Air France and Lufthansa groups.

✈ The continental European hubs will have to be further rationalised and costs further reduced to protect streamlined feed operations to competitive attacks from the LCCs.

✈ National interests and commercial pressures will increase tensions within the alliance joint ventures. To speculate wildly: if the continental European hubs are downsized permanently, would either of the other two relatively strong US partners consider attempting to displace the weaker American at Heathrow?

✈ Structural changes in premium travel will probably push up economy fares which will slow the recovery in overall traffic volumes. Relying on premium class passengers to "cross-subsidise" discounted fares in the economy cabins will no longer be a viable tactic.

✈ New opportunities will open up the North Atlantic for carriers with lower costs and the right equipment — JetBlue is well positioned — but as yet none of the European LCCs looks remotely willing to take advantage of a classic combination of depressed resource costs (aircraft, flying personnel, slots) and greatly weakened incumbents.

UPS and FedEx: Delivering profits from Covid

IN NORMAL times, air cargo is a relatively small part of the overall aviation business. But these are not normal times.

Over the past fifteen years air cargo accounted for an average 12% of global commercial air transport revenues and 15% of the total tonnage carried (on the assumption of being able to squeeze nearly 11 passengers and their bags into a tonne).

The average length of haul is significantly higher for freight, more than twice the average 1,900km in the passenger business, and in revenue tonne kilometre terms air cargo in 2019 accounted for around 25% of total RTK performed, down from a peak of over 30% in 2003.

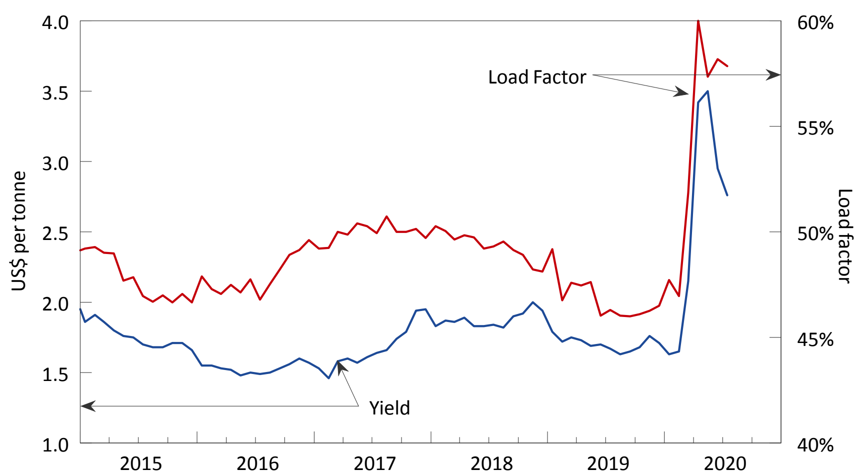
Roughly half of air cargo demand is carried on dedicated freighter aircraft (and up to 80% on some trade lanes), the rest in the the belly-holds of passenger aircraft. There is always a need for dedicated freighters as some items of cargo that need to go by air are too dangerous or too large to be carried on passenger aircraft.

It is a commodity business with a large number of players, many of whom treat cargo as a generator of marginal "ancillary" revenues, and a relatively small number of savvy customers. There is a significant imbalance in the flow of goods, with some trade lanes effectively monodirectional and with high seasonality. Load factors appear relatively low at below 50% compared with passenger load factors in the 80s, but this reflects unusable space in passenger aircraft and a complicated relationship between weight, size and shape of cargo transported: dedicated freighters operate happily with load factors in the mid 60s.

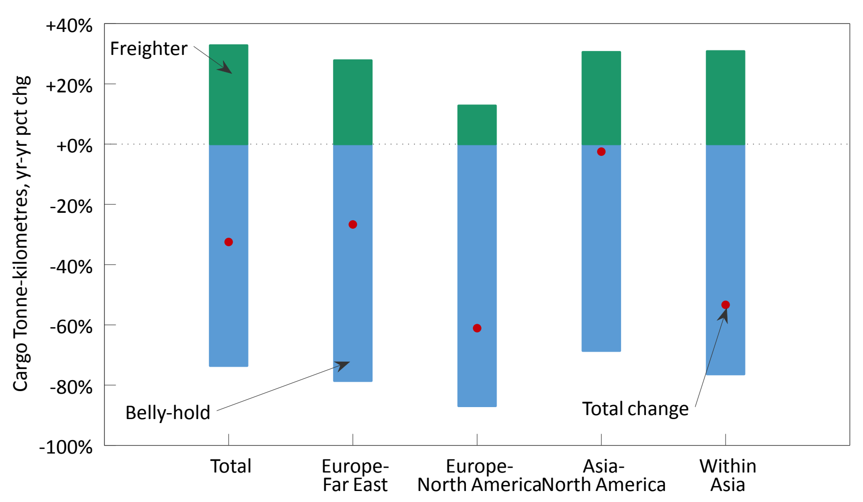
About 20% of total air cargo demand in RTK terms is carried by parcel integrators (FedEx, UPS and DHL) who between them account for half the world's dedicated freighter fleet.

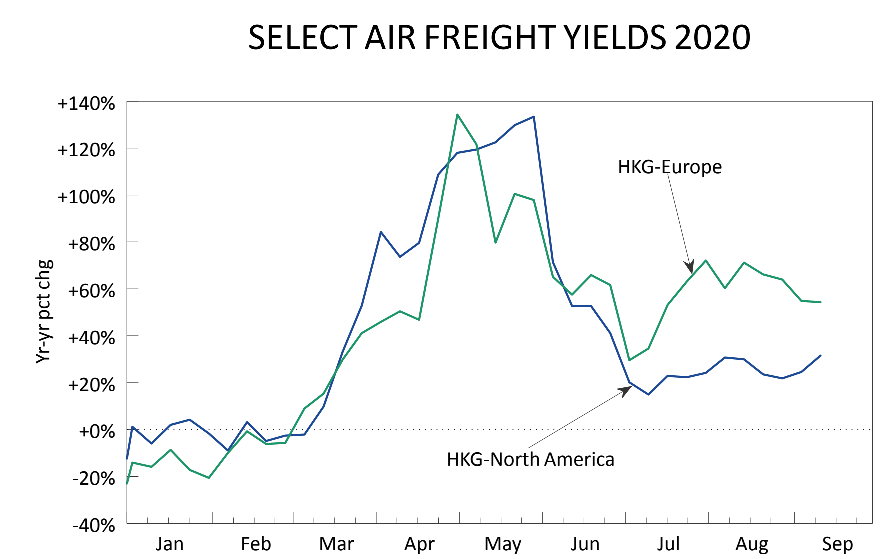
The effective grounding of the world's long haul passenger services since the outbreak of the Covid-19 pandemic has removed half of the available capacity and put a significant squeeze on supply. As the chart

AIR CARGO YIELDS AND LOAD FACTORS



AIR CARGO CAPACITY MAY-JULY 2020





on the preceding page shows, in the three months to end July, total cargo capacity fell by over 30% year on year: a 30% increase in the use of all freight aircraft was unable to offset a near 80% reduction in belly-hold capacity.

The demand is still there, but is constrained by the capacity shortage, and as a result, load factors have climbed while prices have doubled. In July industry data shows that total available air cargo capacity fell by 31% from prior year levels, but demand (in RTK) fell by only 13.5% producing load factors upda by 11.5 points to 56.4%. The chart above courtesy of IATA shows cargo yields between Hong Kong and Europe running at levels some 60% above year-ago levels. IATA's June forecast for the industry suggests that total cargo traffic could fall by 17% in 2020 but that cargo yields would rise by 30% and total cargo revenues could grow by 8% to $111bn — 30% of total industry revenues.

Airlines have been reported as operating cargo only services on passenger aircraft by stuffing boxes on seats and into overhead bins, and even taking out seats from their widebody passenger aircraft to chase the only source of international revenue.

According to a recent article in the *Wall Street Journal*, Delta has been flying an average of 50 cargo-only flights a week using belly-space in its passenger aircraft, while Emirates (which has a large fleet of its own freighters) has ripped out the economy seats from ten of its passenger jets since June.

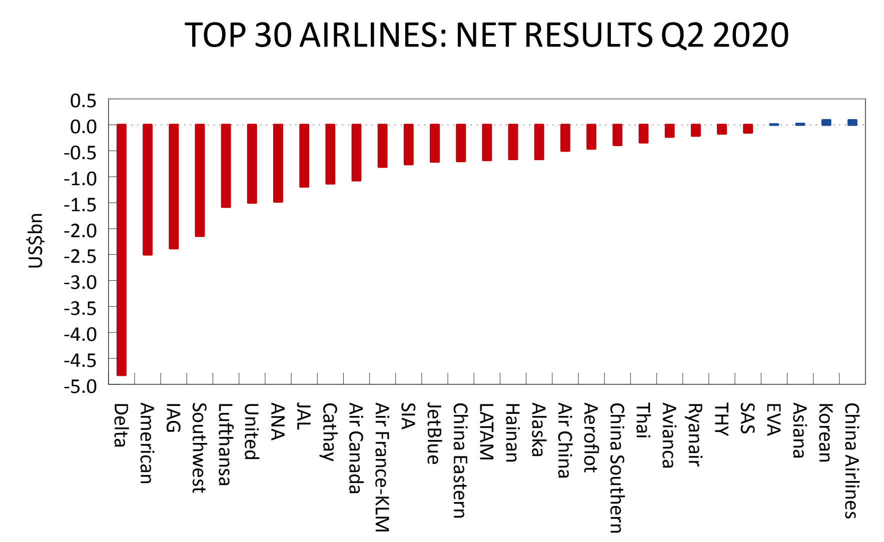
Tim Clark, Emirates' CEO, was quoted as having said: "The airline industry is still bleeding cash by the billions each month. We are taking baby steps on the path to recovery."

At the same time the *WSJ* points out that in the second quarter of 2020 only four of the top thirty passenger airlines worldwide recorded a profit: Korean ($90m), Asiana ($19m), EVA ($6m) and China Airlines ($92m) — entirely because of cargo.

Integrators performing

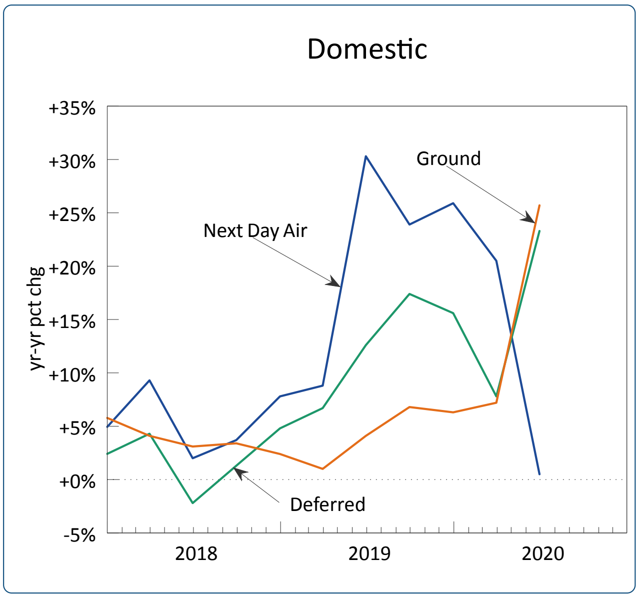
This structural undercapacity in the cargo market is providing a strong boost to the performance of the parcel integrators.

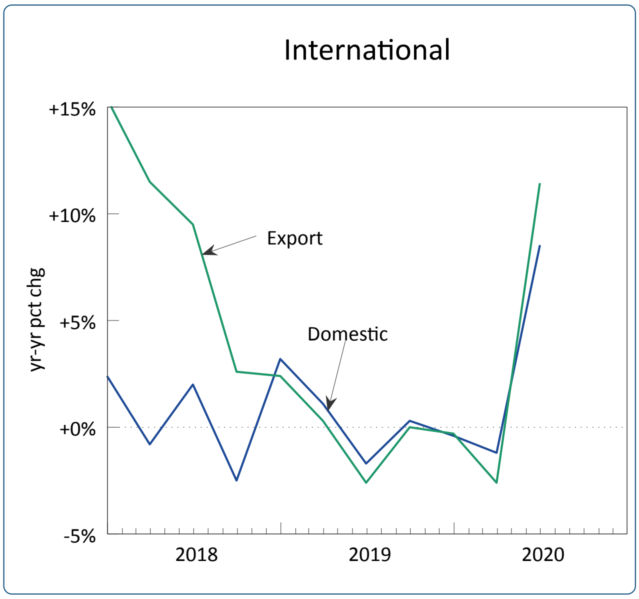
The UPS share price, which had wallowed between $90 and $110 for much of the last five years (see chart on page 17) has risen by over 60% since the beginning of the year; FedEx which had been trading around $160 for much of 2019, suffered an immediate 50% slump in the wake of the onset of the pandemic, but has since nearly tripled to over $240 approaching its all-time high seen at the beginning of 2018. Both presented stronger than expected performance in their latest quarter results and some large swings in operational data.



Source: WSJ

UPS DAILY PACKAGE VOLUMES





UPS

For the three months to end June, UPS reported revenues up by 13%, operating profits up by 7% to $2.3bn and adjusted net income of $1.8bn, some 9% higher than the prior year levels.

Through the deepening crisis it witnessed a fundamental shift in business focus towards the consumer. On domestic US operations there was an overall 23% surge in daily volumes of deliveries — primarily "ground" and "deferred" products while next day air products having been a strong area of growth in the previous eighteen months were flat year on year. But within these figures business-to-business (B2B) deliveries fell by an average 22%, while business to consumer operations (B2C) experienced a massive 65% growth year-on-year. Overall in the quarter B2C deliveries accounted for 69% of volumes.

A large element of this surge relates to the growth of e-commerce through the pandemic lockdown, and the closure of physical stores. By some estimates, online-retail sales in the US may show overall growth this year of over 50%, pushing e-commerce to account for 15% of total retail sales in 2020 up from 10-11% in 2019.

Total domestic revenues grew by 17%, but average package prices fell by 4% because of lower fuel prices and the shift to B2C, and operating profits fell slightly partly because of additional costs for dealing with coronavirus measures.

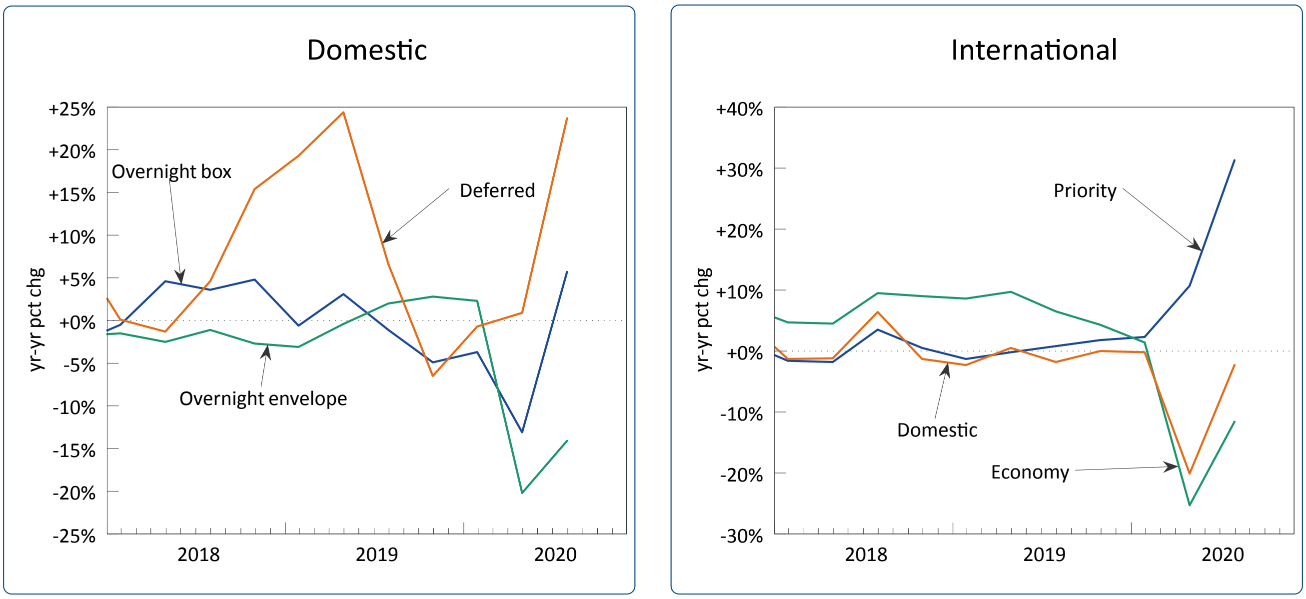
On international operations total volume in the quarter was up by 10% with export volume growing a little faster. This growth was particularly strong in Asia with volumes in May up by over 60% from prior year levels: outbound volume was up by 47% in the quarter and the company states it added some 335 additional flights above normal schedules. It also notes that the B2C trend was also very strong with a near doubling in volumes led by cross-border activity in Europe. International operating profits jumped by 26% with a near 4 point expansion in operating

UPS FLEET

	Operating fleet	*(Parked)*	Avg Age	On order
757-200	75	*(4)*	27.1	
767-300	72	*(2)*	15.5	8
A300-600	52	*(3)*	17.7	
MD-11	39	*(6)*	26.3	3
747-400F/BCF	13	*(1)*	18.8	
747-8F	16		1.8	12
Total	**267**	***(16)***		**23**

Note: excludes 294 leased and chartered aircraft

FEDEX EXPRESS DAILY PACKAGE VOLUMES



margins (to 22.7%).

FedEx

FedEx equally had a strong quarter. For the three months to end August total revenues also grew by 13% — to $19.3bn — but operating profits jumped by 63% to $1.6bn with a 24bp increase in margins to 8.3%. Net income in the quarter increased at a similar rate to $1.3bn.

A major element of the improved results was a strong performance in the FedEx Express package services — and particularly domestic US residential B2C e-commerce activities. While overnight envelope volumes continued to decline with average daily volumes down by 14%, there was a 6% uptick in volumes of overnight boxes and a strong 24% growth in "deferred" packages". International services meanwhile experienced a modest recovery from depths of the May quarter in "economy" and "domestic" packages (international domestic being services within countries outside the US) but average daily volumes for these were still down respectively by 12% and 2%. However, there was an acceleration in demand for international priority services with a 31% jump in average daily volumes up from an 11% growth in the previous quarter. FedEx Express generated an 8% increase in revenues to $9.6bn and a 150% jump in operating profits to $710m for the quarter.

FEDEX AIRCRAFT FLEET

	Operating fleet	*(Parked)*	Avg Age	Net deliveries to 2025
757	119	*(4)*	28.8	
767F	86	*(1)*	3.3	46
DC10-10/30	25		40.2	-25
MD11	57	*(5)*	26.8	
777F	43		6.6	12
A300-600	68	*(1)*	24.9	
Trunk fleet	398	*(11)*	20.7	33
Turboprops	281			73
Total	**679**			**106**

At FedEx Ground, where the group has been investing strongly in recent years, there was also a strong acceleration in growth. Average daily package volumes were up by 30% after having risen by 10% and 25% in the previous two quarters. Yields also improved and total revenues in the division were up by 26% year on year to $7.0bn. Margins however were under pressure, partly because of additional costs related to Covid-19 protection (which came to around $100m on a group wide basis for the quarter) and operating profits grew by a mere 30% to $834m.

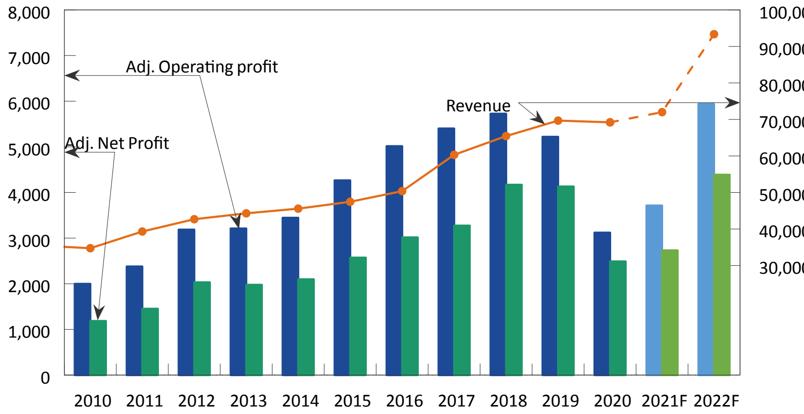
In the more B2B oriented FedEx Freight division, volumes were depressed with average daily shipments down by 8% and revenues by 4% to $1.8bn. Operating profits nevertheless jumped by 41% to $274m.

On the earnings call management highlighted that 96% of the growth in volumes in the current year were entirely due to e-commerce, and tried not to focus too much on how much the group is benefiting from the crisis. They emphasised that, particularly in Ground services, the growth that they had been planning on a five year time frame had been achieved in a matter of five months. In addition where internally they had been planning on seeing a domestic US market with daily package volumes of 100m a day by 2026, their forecasts suggested that this milestone would now be achieved three years earlier in 2023.

Fred Smith, founder, Chairman and CEO, modestly pointed out that "our earnings growth underscores the importance of our business initiatives and investments over the last several years, and, in many ways, the world has accelerated to meet our strategies".

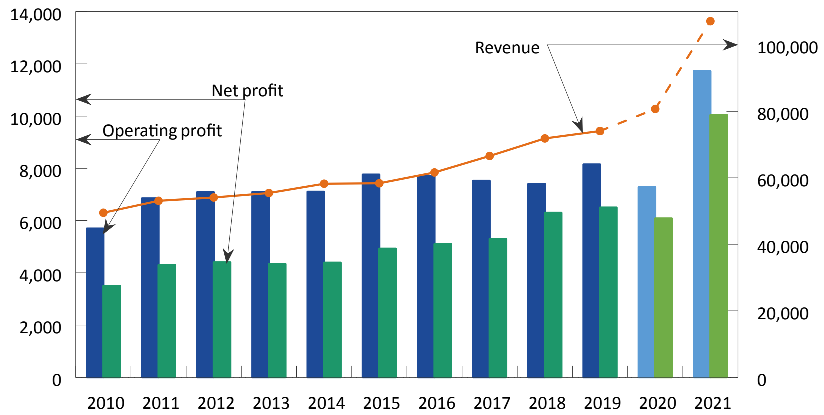
Are these trends permanent? The Covid crisis has probably accelerated changes in entrenched consumer behaviour, and e-commerce deliveries will take an elevated proportion of consumer spending world-wide. The structure of excess of demand over available capacity for global air cargo will not return to equilibrium until long haul passenger demand recovers. At the moment such a prospect seems several years away.

FEDEX CORP FINANCIAL DATA ($m)



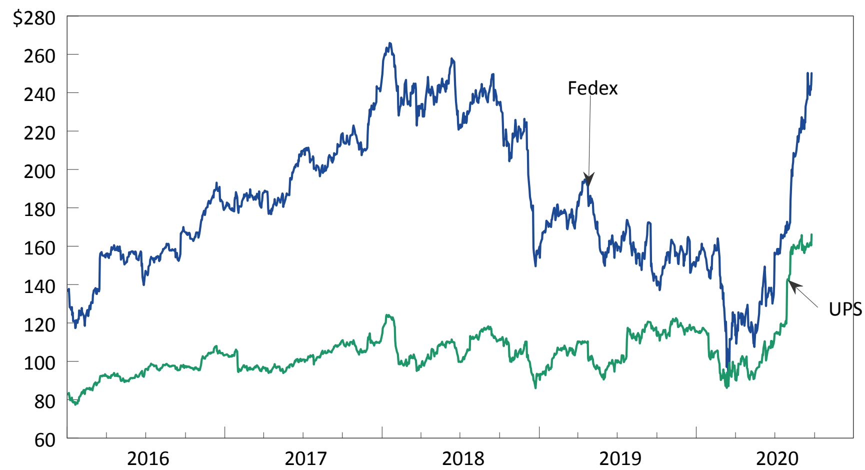
Source; Company reports; forecasts Bernstein. Note: FY end May

UPS FINANCIAL DATA ($m)



Source: Company reports; forecasts Bernstein

PARCEL INTEGRATORS SHARE PRICE PERFORMANCE



UK CIGA Act; Lessors and Financiers take note

The far-reaching Corporate Insolvency and Governance Act 2020 (CIGA) came into force in the UK on 26 June 2020, with the aim of providing "breathing space" to businesses affected by the Covid-19 pandemic. The act is radical, containing significant *debtor-friendly* reforms to UK insolvency law.

The CIGA doesn't exist in isolation, however:aircraft finance professionals should consider it alongside the regulations (the UK Regulations) by which the Cape Town Convention and Aircraft Protocol (together, the Convention), were, on 1 November 2015, implemented into law in the UK.

The Convention is based on encouraging the efficient financing and leasing of aircraft, and seeks to achieve this, in part, through registering an "international interest" to secure priority against subsequently registered interests, unregistered interests, and creditors in the debtor's insolvency.

Another way the Convention incentivises efficient financing and leasing is by including — for the benefit of creditors — a range of default and insolvency-related remedies in respect of companies facing financial trouble, as well as the ability for creditors to obtain "speedy relief" in such a situation.Under the UK Regulations, the creditor-preferred "Alternative A" US Chapter 11-style insolvency regime was imported into domestic law so that, as in the US, the debtor must return the aircraft, or cure the breach, within a 60-day window called a "waiting period". Failing this, the creditor may exercise all its available remedies.

There are three key areas where the CIGA reforms UK insolvency law; each such reform can be seen to interact with the UK Regulations.

A moratorium on creditor action

Firstly, under the CIGA, any company incorporated in England and Wales (or overseas provided it has a "sufficient connection" with the UK) may request a moratorium on creditor action where the company is unable to pay its debts, if having this moratorium would result in the rescue of the company as a going concern. This ability is not however available to companies already subject to formal insolvency proceedings, or to a moratorium, company voluntary arrangement (CVA) or administration in the prior 12 months.

The moratorium will initially last 20 business days (subject to extension). It will instigate a payment holiday in respect of rent (and any other amounts) due before the moratorium begins, but (importantly) does *not* extend to rent due, and amounts for goods and services supplied, during the moratorium itself — these sums *must* continue to be paid.

In addition, the moratorium will prevent creditors enforcing security and repossessing assets in the affected company's possession under the likes of leases and conditional sale agreements (except where the High Court authorises otherwise).

It will also enable the relevant company (with permission of the court) to dispose of assets (including those subject to leases or that are secured) in the ordinary course of business as if it were the owner (subject to creditor safeguards) if this would support the rescue of the company.

But, crucially for lessors and lenders, this is where the UK Regulations come to the fore. *No* such restrictions on creditors repossessing assets or claiming rent will apply where the creditor has a registered "international interest" at the International Registry over the relevant aircraft — at least, beyond from the 60-day "waiting period" mentioned previously (the window creditors must wait to elapse prior to seeking to enforce security or repossess assets).

Contractual Termination Invalidated

While a "relevant insolvency procedure" (such as a moratorium, administration, CVA or liquidation) is ongoing, the creditor will not be able to terminate certain supply contracts (including (likely) an operating lease, but excluding a finance lease) or the supply itself, or do "any other thing" (such as amending the terms of such contract).

Critically, the CIGA confirms that restrictions on terminating or amending a contract while the debtor is in the middle of an insolvency period will *not* affect the provisions of the UK Regulations. So, again, where the creditor has a registered "international interest" at the International Registry over the relevant aircraft, the UK Regulations prevail. Creditors can, if the debtor defaults, turn to remedies laid out in the UK Regulations (such as exercising "self-help" or seeking a court order) in order to repossess an aircraft.

Where the Convention does not apply, creditors should consider if they can avail themselves of any relevant exemptions (for example, banks will not be subject to the rule). Alternatively, creditors can still terminate contracts based on any event of default that occurs prior to the insolvency, or if the debtor does not pay any monies owed during any moratorium. Alternatively, the debtor may itself agree to contractual termination, or termination can be ordered by a court.

Proposing a Restructuring Plan

A company facing "financial difficulties" that affect or may affect its ability to carry on business as a going concern can propose a Restructuring Plan — a compromise or arrangement with its creditors and/or members. Virgin Atlantic Airways recently became the first entity to take advantage of this, with the UK High Court approving the Plan on 2 September 2020.

75% of creditors or members votes (based on value) must approve the proposal, which must then be sanctioned by the court. This may be done even in the face of dissenting creditors (dubbed the "cram-down" ability) if the court is satisfied that, amongst other things, no member of a dissenting class would be worse off than if the alternative to the Plan was followed (likely, liquidation).

But would a dissenting creditor that benefits from the protections afforded under the Convention be bound by any such Restructuring Plan created under the CIGA? Well, the answer broadly turns on whether a Restructuring Plan can be considered to constitute an "insolvency proceeding" for the purpose of the definition of "insolvency-related-event" in the UK Regulations.

The world's largest regional aircraft lessor, Nordic Aviation Capital, recently argued in the Irish High Court it *could not*. Although this distinct point was not determined, several commentators share this view. However, contradicting this, an annotation to the Official Commentary on the Cape Town Convention implies that a Restructuring Plan *would* constitute an "insolvency proceeding" — so messages for lessors and financiers are still mixed.

If this argument in the Official Commentary is correct, Cape Town creditors need not accept a "cram-down" and will be able to utilise their Convention remedies after the 60-day "waiting period". Clarification here — either via the courts or statutory instrument — would be welcome.

By Chris Knight,
Counsel at Pillsbury
Winthrop Shaw
Pittman LLP

Aviation Strategy

The Principals and Associates of Aviation Strategy apply a problem-solving, creative and pragmatic approach to commercial aviation projects.
Our expertise is in strategic and financial consulting in Europe, the Americas, Asia, Africa and the Middle East, covering:

- Start-up business plans
- Due diligence
- Antitrust investigations
- Credit analysis
- IPO prospectuses
- Turnaround strategies
- Privatisation projects
- Merger/takeover proposals
- Corporate strategy reviews
- Antitrust investigations
- State aid applications
- Asset valuations
- Competitor analyses
- Market analyses
- Traffic/revenue forecasts

For further information please contact:

James Halstead or **Keith McMullan**

Aviation Strategy Ltd

e-mail: info@aviationstrategy.aero

Subscription Form

Enter my Aviation Strategy subscription for: 1 year (10 issues – Jan/Feb and Jul/Aug are combined)

- UK: £475
- EU: €610 (+VAT where applicable)
- USA and Rest of world: US$780

starting with the ________________ issue.

❑ I enclose a Sterling or Euro cheque made payable to Aviation Strategy Ltd

❑ Please invoice me

❑ I wish to pay by credit card or PayPal.

❑ I am sending a direct bank transfer of the the relevant sum net of all charges to Aviation Strategy's bank account:
Metro Bank Ltd, 1 Southampton Row, London WC1B 5HA
IBAN: GB04 MYMB 2305 8013 1203 74
Sort code: 23-05-80 Account no: 13120374
Swift: MYMBGB2L

Delivery Address

Name ____________________
Position ____________________
Company ____________________
e-mail ____________________
Telephone ____________________
VAT No ____________________

Invoice Address

Name ____________________
Position ____________________
Company ____________________
Address ____________________
____
____
Country ____________________
Postcode ____________________

DATA PROTECTION ACT

The information you provide wil be held on our database and may be used to keep you informed of our products and services or for selected third party mailings

PLEASE RETURN THIS FORM TO:

Aviation Strategy Ltd, Davina House, 137-149 Goswell Road
London EC1V 7ET, UK
e-mail:info@aviationstrategy.aero
Tel: +44(0)207-490-4453
VAT Registration No: GB 162 7100 38