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Oct/Nov 2021

## Cash is King but Debt Rules OK?

**T**HE COVID-19 pandemic has had a calamitous impact on airline operations and finances. With the closure of borders, mandated cessation of services, a collapse of demand, and an inability quickly enough to halt fixed cost cash burn, all airlines round the world were in desperate need of liquidity to stay alive. Cash was king. Some were lucky enough to get support from their governments. All have had to raise huge amounts of debt. Will the industry ever be able to return to the healthy pre-pandemic financial status?

Analysis from *Bloomberg* (see chart below) shows that the world's airlines have taken on an additional \$140bn liabilities in loans and bonds since the start of the pandemic giving a total of \$340bn, 70% higher than at the end of 2019. (These numbers seem a little on the low side for the industry as a whole and presumably only covers public figures in their databases.)

Interest rates may have remained low during this period but airline credit ratings have suffered and the cost of debt will have risen. Pre-pandemic, according to IATA, a third of the top 40 airlines in the world held investment-grade ratings, with only 20% marked as "highly speculative" or below. By August 2020, all but a small handful were rated sub-investment grade or worse.

### Top airlines doubled debt

For this analysis we have looked at the top four carriers in North America (American, Delta, United and Southwest), the top four in Europe (IAG, Air France-KLM, Lufthansa and Ryanair), and three top players in the South East Asia/Pacific region (Cathay, SIA and Qantas), as bellwethers for those in the industry that aim to provide returns to shareholders.

Between them these 11 airline groups have doubled their total on-balance sheet debt — from \$95bn to \$185bn — between January 2020 and end June 2021 (see chart on page 3).

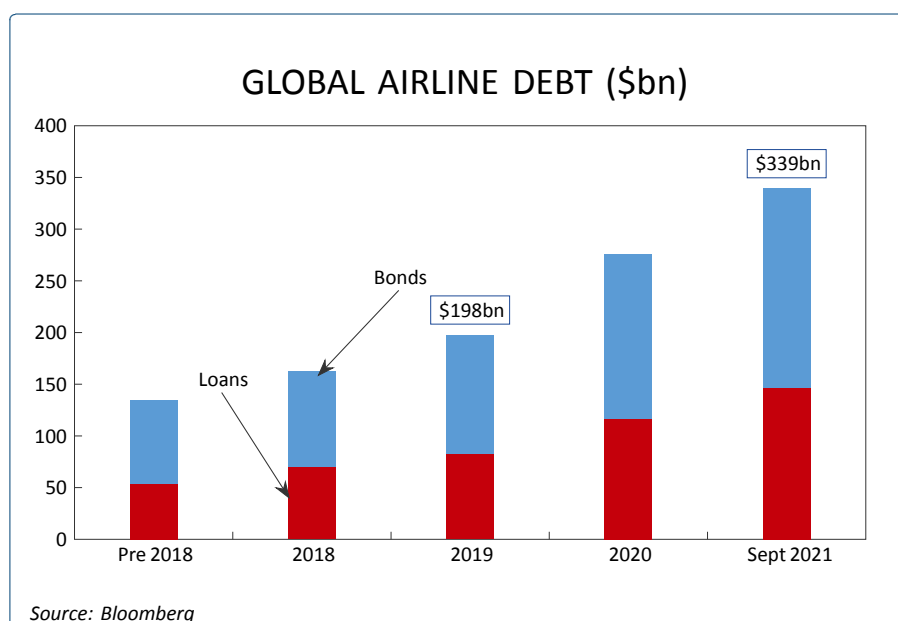
Some of the funds raised were at junk bond rates. In 2020 American issued \$2.5bn bonds at a rate of 12% (while LIBOR is only just above zero) — although it was able to raised a similar amount in 2021 at 4.2% backed by its frequent flier programme.

Some of the funds raised — particularly the government bailouts of Lufthansa Group and Air France-KLM — contained punitive rates of interest

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if not repaid within a certain period.

These figures exclude operating lease "debt". if anything this crisis has exposed the fallacy of IFRS16's requirement to capitalise operating leases as many airlines have been able to negotiate lease deferrals, renegotiate lease terms, including



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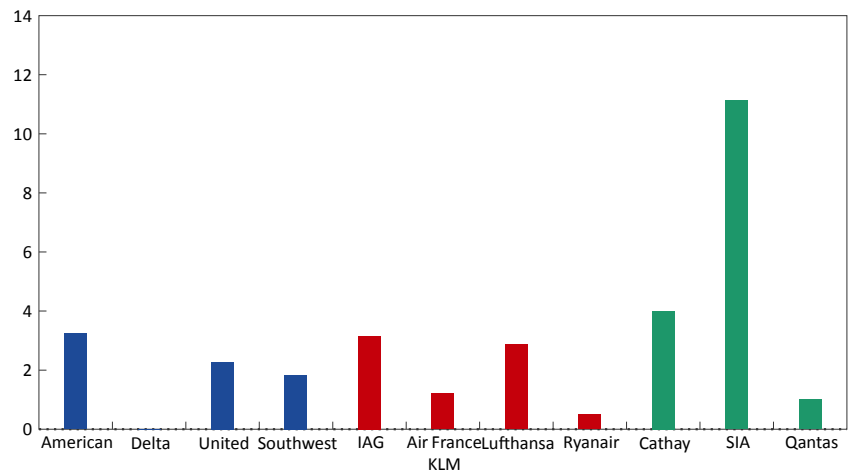
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## AIRLINES: EQUITY RAISED 2020-21 (\$bn)



power-by-the-hour, or just hand back aircraft. *In extremis*, the lessors have helped.

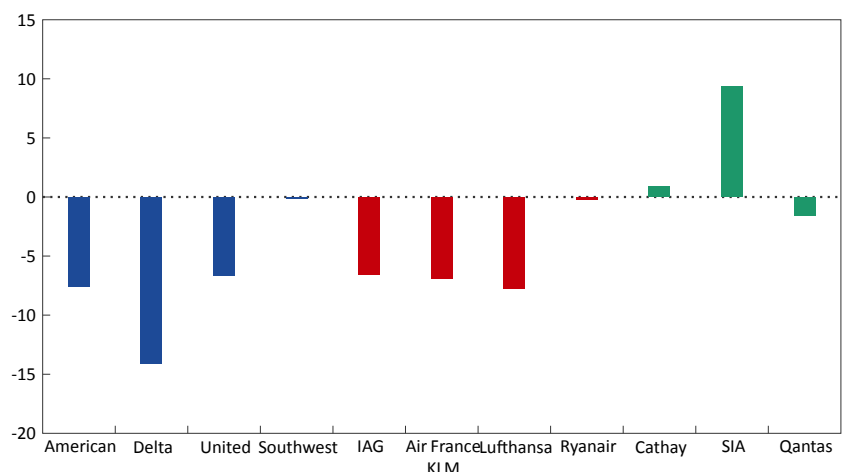
As a side point, over this period only three of these airlines have increased their operating lease “debt”. Delta, Southwest and, Singapore Airlines added liabilities of a total \$2bn (SIA accounting for half of the total). The other carriers in the group reduced their operating lease liabilities on the balance sheet by a combined \$3.5bn.

## Cash tripled

Over the same period this group of airlines saw cash balances rise by almost three-fold — by \$74bn from \$42bn to \$115bn (see chart on the facing page). Perhaps surprisingly, Southwest and Singapore Airlines have a net cash position (cash minus debt, excluding operating lease debt).

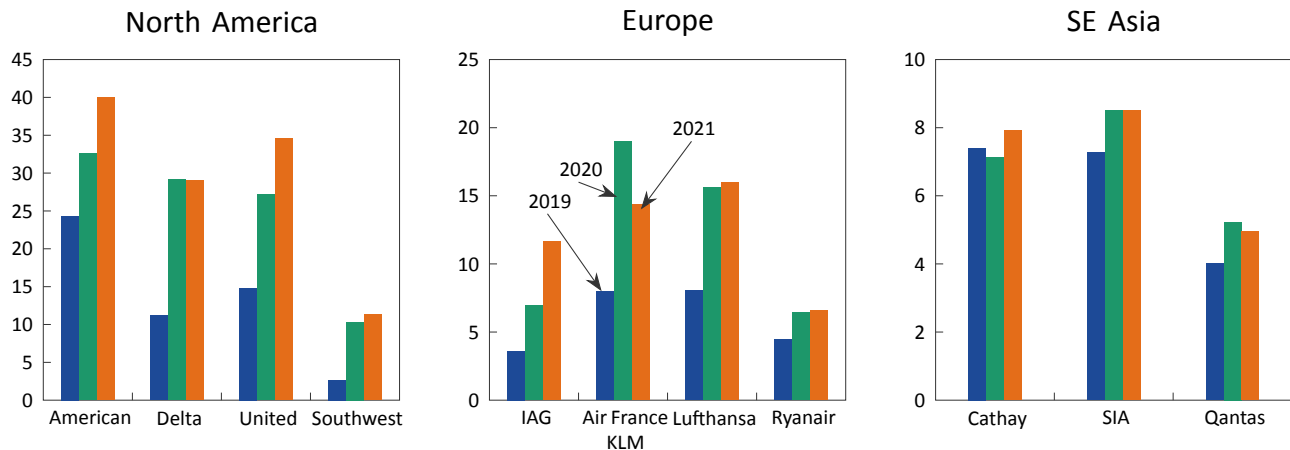
If demand recovery is slower than expected, this cash will be essential in

## AIRLINES: CHANGE IN NAV 2019-2021 (\$bn)



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## AIRLINE DEBT (\$bn)



Source: company reports. Note: Total debt excluding capitalised operating lease liabilities

covering monthly cash burn: if recovery is faster, it can be used to repay some of the mountain of debt.

### Equity raises

All (so far with the notable exception of Delta) have raised new equity on the markets averaging \$3bn each (see chart on the preceding page).

The real outlier is SIA whose two rights issues of \$11bn convertible quasi-equity was fully supported by government holding company Temasek. Cathay Pacific also received

above average support for its \$4bn rights issue from the government of Hong Kong.

Net asset values have been decimated (see chart on the facing page) by the extraordinary level of operating losses, write-offs of accelerated depreciation, restructuring charges and uneconomic hedge positions.

The six top legacy carriers in the list each saw their balance sheet net asset value fall by around \$7bn (and Delta by \$14bn, having had to write down its multitude of minority airline

investments) even after raising new equity.

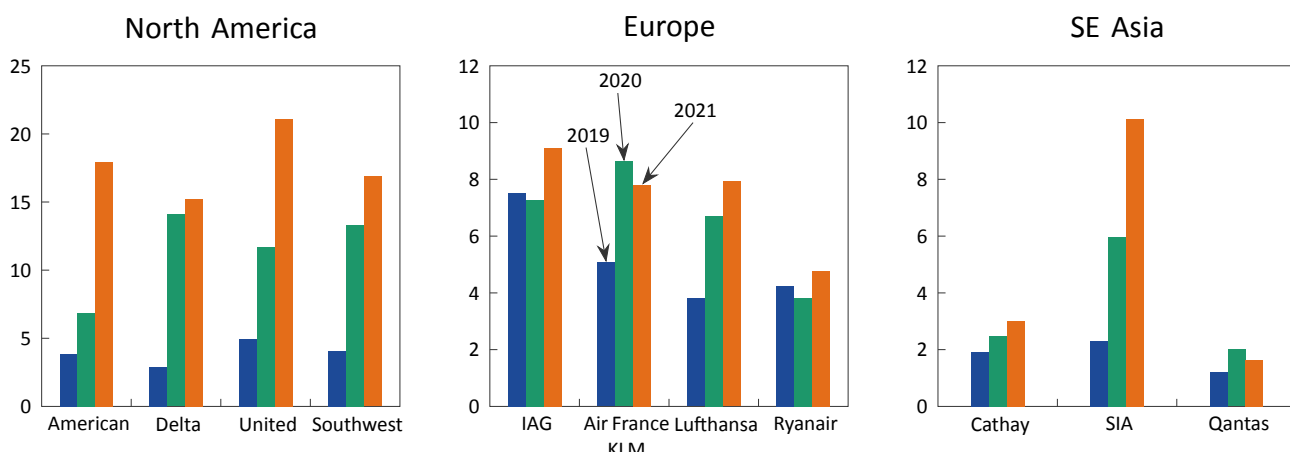
Both Air France-KLM and American bear balance sheets where the equity is severely negative. LCCs Southwest and Ryanair in contrast have been relatively unscathed.

### Recovery and required EBIT

The recovery in demand, particularly for cross-border and long haul traffic, is likely to take a long time.

The coronavirus pandemic is not yet over. New variants of the virus,

## AIRLINE CASH (\$bn)



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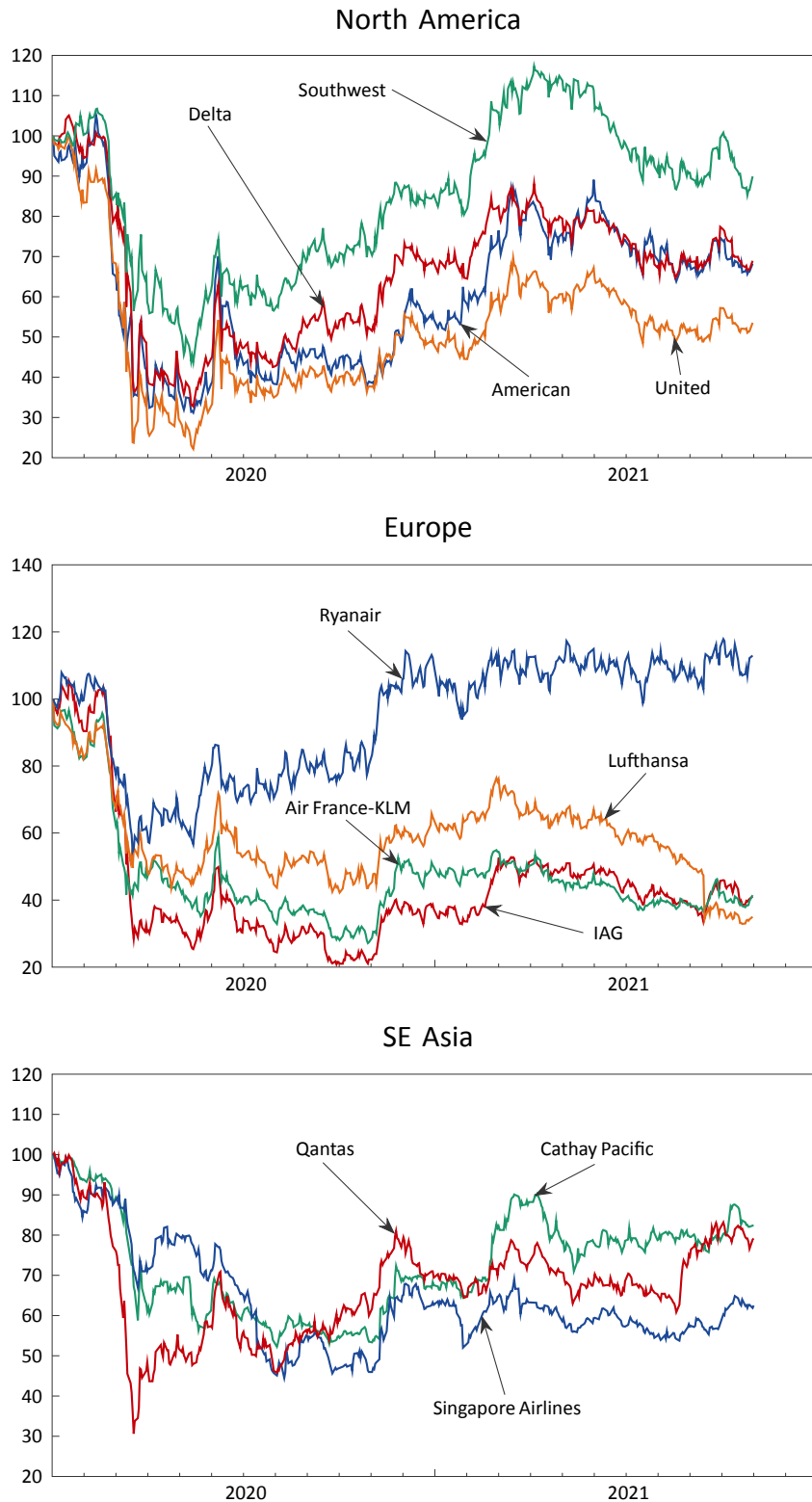
such as the recent omicron variant designated by the World Health Organisation (WHO) as “of concern”, spook nations into reintroducing or intensifying travel constraints extending the uncertainty of bookings; and, the number of potential new harmful mutations is not just limited to the remaining eight letters of the Greek alphabet.

Airlines may well be saddled with this high level of debt for years to come. And they will need to improve operational cashflow to pay for it. The annual cost of the increase in debt (interest and repayment) we estimate equates to 20-25% of the cash flow from operations achieved in 2019 — a modestly good year.

These airlines are all using the opportunity of this crisis to re-structure the cost base targeting a return to profitability. The traditional Legacy airline targets of 10-12% EBIT margins to allow a return to shareholders may not be enough in the post-pandemic reality: those targets should perhaps be pushed above 15%. This would mean a need for a strong improvement in unit revenues, difficult though it is to achieve in a commodity business such as aviation — more so for those who rely on premium traffic.

IATA's October financial forecasts for the industry suggest total net losses for commercial airlines to approach \$52bn in 2021 and another \$12bn loss in 2022. If these forecasts turn out to be accurate, the industry will have lost \$200bn over three years. This is only 90% of the profits it had generated in the 2010s following recovery from the global financial crisis. It is possible that these forecasts are optimistic.

## AIRLINE SHARE PRICE PERFORMANCE



## Air India's Karmic Re-birth within Tata Airlines

INDIA is emerging from the pandemic with a partly restructured airline industry, but it is an industry with its finances in a precarious state and with many competitive issues to be resolved.

To provide an Idea of how hard India has been hit by Covid 19: official statistics, however questionable, for the two Asian super-powers show India to have reported nearly 35m cases and around 500,000 recorded deaths while China, officially, experienced only 100,000 cases and 5,000 deaths.

The Indian government responded by placing draconian restrictions on international travel and restricting domestic flights, closing down the entire industry for two months in 2020. Domestic traffic is gradually recovering — latest monthly figures (September 2021) show traffic to be up 75% on 2020 though still down 40% on 2019. International is still very depressed with travel only permitted in certain bubbles; the India-Singapore bubble has just been established.

No industry-specific financial support has been provided by the government. Instead, it reverted to bureaucratic type, imposing capacity limits on the airlines, which have just been lifted.

It also imposed a complicated series of fares rules, setting minimum price caps in order to ensure fair competition and maximum price caps to protect consumers, applicable to advertised fares over a 30 day period. This period had now been reduced to 15 days and should be abolished alto-

gether by the end of the year.

The chart on page 6 summarises the impact on the main airlines in the domestic market. Passenger volumes in the first nine months of this year were half those of 2019, with Go Air and SpiceJet being particularly badly impacted while IndiGo and Vistara appear relatively resilient.

The ownership structure of the industry has changed radically. Following Tata's take-over in October of the national flag-carriers, the Tata group of diverse airlines — Air India, Air India Express (and Alliance, a small turboprop subsidiary), Air Asia India, and Vistara — has about in total 24% of the domestic market while IndiGo has reinforced its dominant position, with its share now estimated at 56%. The other two LCCs — SpiceJet and Go First (formerly Go Air) have 11% and 8% respectively. Other airlines, notably Jet Airways and Kingfisher, have largely disappeared, though new carriers — Akasa, an ULCC, and maybe

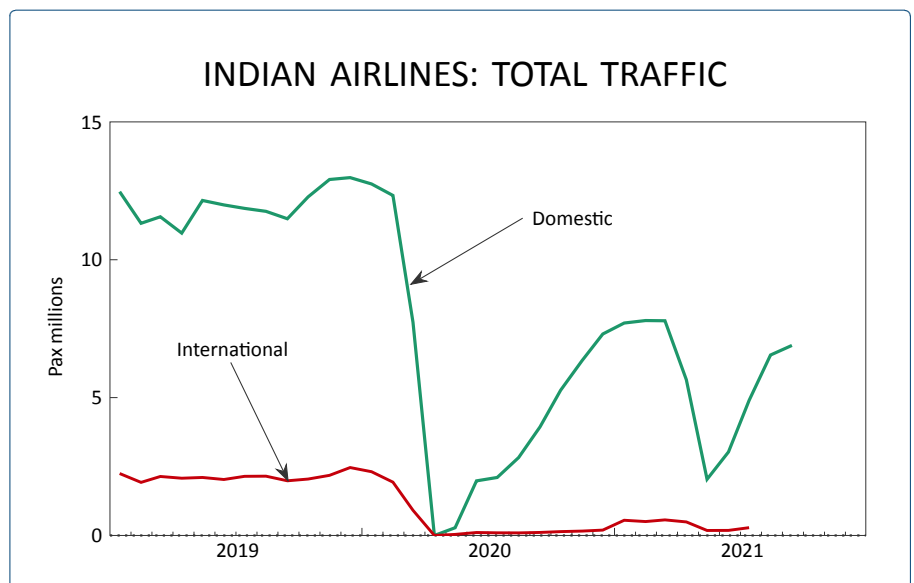
a resurrected Jet — plan to enter the market.

The pie charts might seem to indicate a neat consolidation of the Indian airline industry. The reality is messier.

### Tata reclaims Air India

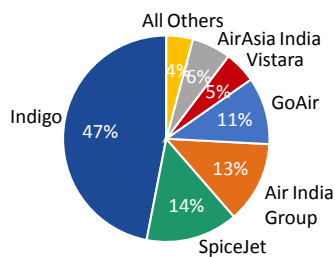
The painful process of privatising Air India — the first attempt was in 2010 — concluded in October when the Tata Group's bid for the flag-carrier was accepted ahead of SpiceJet's, though the transaction will not be formalised until January next year, which leaves a slight possibility that the deal could still unravel. This means that Air India will return to the conglomerate that founded the airline back in the 1930s and whose Executive Chairman was the legendary industrialist, J.R.D. Tata until 1978.

The details of the transaction are that the Tata bid totalled ₹180bn (\$2.4bn) for Air India and Air India Ex-

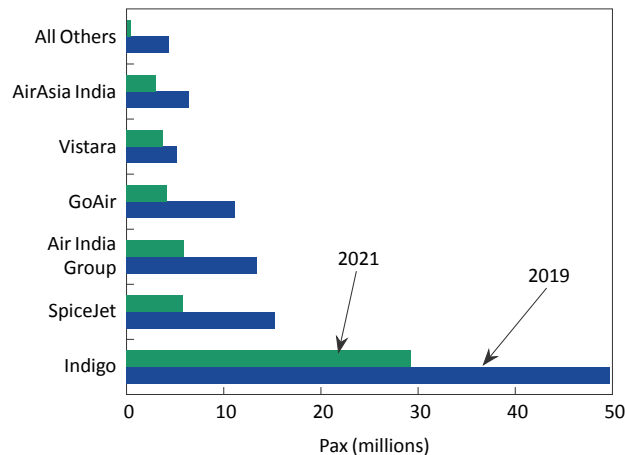


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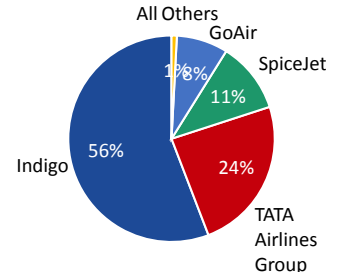
Domestic Market Shares 2019



2021 Domestic Pax Down 50% On 2019



Estimated Domestic Market Shares end 2021



Source: DGAC India

press plus 50% of the ground handling company jointly owned by Air India and Singapore Airport Terminal Services (SATS). ₹27bn of the purchase price is in cash, the remaining ₹150bn is the assumption of debt.

One of Air India's many problems has been its bloated and sometimes intransigent workforce, although the government has made some progress in recent years in rationalising it. Tata will be obliged to take on 9,500 permanent employees and retain them for one year before offering voluntary redundancies; it also has to assume pension and medical liabilities for current and previous employees.

So what exactly has Tata bought? (In theory, it could have got Air France-KLM for the same price).

Air India's financials pre-pandemic were distressed (and there are serious suspicions that its losses were understated). In the financial year to March 2020 Air India reported a net loss of ₹79.8bn (\$1.0bn) on revenues of ₹285.2bn; its balance sheet showed negative equity of ₹374.6bn (\$4.9bn).

The Air India fleet (not including Air India Express) comprises 125 units (of which 23 parked): 49 widebod-

ies, including ageing 747s and 777s, and 76 narrowbodies, including 40 A319/320ceo. It has zero aircraft on order. Assuming that the aim is to merge Air India into a full-service operator with Vistara (see below), a substantial capital expenditure programme looks necessary, considering that Vistara itself has only four 787s and 24 A320s on order.

There is of course the brand, which is always worth more in the minds of politicians than its real market value, and the domestic and international slots, only a few of which have a monetisable value. The attraction of Air India to Tata probably lies in its long-haul network.

Looking at the map on the next page there are two parts to Air India's international network — the dense medium-haul operation mainly to the Arabian Gulf and the long-haul network to the major cities of North America and Europe. The medium-haul operation is characterised by intense competition from the super-connectors and, increasingly, the A321neo/ 737MAX operations of the Indian LCCs — IndiGo, and SpiceJet — and the Arabian LCCs — Air Arabia, Flydubai, Jazeera, flyadeal, Wizz Abu

Dhabi, etc. The longer-haul operation, with good proportions of high yielding business traffic and scarce slots at congested hubs, could offer Tata prestige and profitability in the post-pandemic world.

Air India failed to find an effective response to the rise of the super-connectors which accounted for the large majority of the increase in international traffic to/from India in the 2010s.

Disturbingly the Comptroller and Auditor General (CAG) in a damning 2018 review of the national carrier's performance during 2012-16, when business conditions were relatively benign, revealed that nearly 70% of Air India's losses were in the international sector rather than in the liberalised domestic market. All international segments were loss-making, the worst being North America.

Traditionally restrictive ASAs between India, European countries and the US, designed to protect the flag-carrier, played into the superconnectors' hands enabling them to build up connecting traffic flows and channel them through their Middle Eastern hubs to Indian cities under comparatively liberal ASAs, signed before the

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## AIR INDIA: INTERNATIONAL ROUTE NETWORK



Note: Azimuthal equidistant map projection based on Delhi. Great circle routes appear as straight lines.

## FLEETS

|                      | Widebodies |           |           |           | Narrowbodies |           |           |            |            |           |           |            | Turboprops | TOTAL      |
|----------------------|------------|-----------|-----------|-----------|--------------|-----------|-----------|------------|------------|-----------|-----------|------------|------------|------------|
|                      | 747        | 777       | 787       | Total     | 737NG        | 737MAX    | A319      | A320ceo    | A320neo    | A321ceo   | A321neo   | Total      |            |            |
| Air India            | 4          | 18        | 27        | 49        |              |           | 20        | 9          | 27         | 20        |           | 76         |            | 125        |
| Air India Express    |            |           |           |           | 24           |           |           |            |            |           |           | 24         |            | 24         |
| AirAsia India        |            |           |           |           |              |           |           | 30         | 5          |           |           | 35         |            | 35         |
| Alliance Air         |            |           |           |           |              |           |           |            |            |           |           |            | 19         | 19         |
| Vistara              |            |           | 2         | 2         | 6            |           |           | 7          | 30         |           | 3         | 46         |            | 48         |
| IndiGo               |            |           |           |           |              |           |           | 80         | 128        |           | 43        | 251        | 31         | 282        |
| SpiceJet             |            |           |           |           | 51           | 13        |           |            |            |           |           | 64         | 32         | 96         |
| Go First             |            |           |           |           |              |           |           | 8          | 49         |           |           | 57         |            | 57         |
| <b>Total</b>         | <b>4</b>   | <b>18</b> | <b>29</b> | <b>51</b> | <b>81</b>    | <b>13</b> | <b>20</b> | <b>134</b> | <b>239</b> | <b>20</b> | <b>46</b> | <b>553</b> | <b>82</b>  | <b>686</b> |
| <b>TATA Airlines</b> | <b>4</b>   | <b>18</b> | <b>29</b> | <b>51</b> | <b>30</b>    |           | <b>20</b> | <b>46</b>  | <b>62</b>  | <b>20</b> | <b>3</b>  | <b>181</b> | <b>19</b>  | <b>251</b> |
| <b>Other LCCs</b>    |            |           |           |           | <b>51</b>    | <b>13</b> |           | <b>88</b>  | <b>177</b> |           | <b>43</b> | <b>372</b> | <b>63</b>  | <b>435</b> |

Notes: As at Oct 2021 Includes parked aircraft

likes of the UAE or Qatar had any aviation presence.

The pandemic may well have given a boost to long-haul point-to-point model relative to the connecting model, but to exploit the opportunity Tata faces some huge challenges.

Firstly, it has to radically change the corporate culture, ridding Air India of malign political, military and union influences. It may find that it has bought Air India in order to demolish it.

Then, it has to determine whether the Vistara model is the optimal replacement. In the process, Tata has probably got to build an IAG-type structure, accommodating a full-service airline (Vistara/Air

India) and an LCC operation (Air India Express/Air Asia India).

### Vistara: retro model

Vistara is a joint venture between Tata, with 51%, and SIA, with 49%, which started up in 2015, and is based at Delhi. The name is Sanskrit, apparently translating as “expansion without limits”.

Tata and SIA's discussions on a joint venture date back at least 20 years and involved both countries' prime ministers. Vistara emerged as a full-service airline, essentially replicating SIA's product, but on a mostly domestic network. Despite the fact that the average stage length domestically is just 970km, Vistara offers a three-class product on all its flights:

for example, the A321 is configured with 12 Business Class seats, 24 Premium Economy and 152 Economy. It promotes a quality brand, with fares to match, and emphasises its loyalty programme.

Its fleet size remains fairly modest, 48 units, mostly A320/21neos, with another 28 on order. Pre-pandemic the fleet plan was to reach 70 units by the end of 2023. International expansion was meant to be central to its strategy, but Covid restrictions have meant that its two 787-9s have been mostly limited to Singapore and, since last year, London. So far this year 97% of its passengers have been domestic.

Vistara seems like a throw-back to a previous travel era. Today no

## FIRM ORDERBOOK

|                      | Widebodies |     |          |          | Narrowbodies |            |      |         |            |          |            |            | Turboprops | TOTAL      |
|----------------------|------------|-----|----------|----------|--------------|------------|------|---------|------------|----------|------------|------------|------------|------------|
|                      | 747        | 777 | 787      | Total    | 737NG        | 737MAX     | A319 | A320ceo | A320neo    | A321ceo  | A321neo    | Total      |            |            |
| Vistara              |            |     | 4        | 4        |              |            |      |         | 21         | 3        |            | 24         |            | 28         |
| Indigo               |            |     |          |          |              |            |      |         | 204        |          | 355        | 559        | 19         | 578        |
| SpiceJet             |            |     |          |          |              | 155        |      |         |            |          |            | 155        |            | 155        |
| Go First             |            |     |          |          |              |            |      |         | 95         |          |            | 95         |            | 95         |
| <b>Total</b>         |            |     | <b>4</b> | <b>4</b> |              | <b>155</b> |      |         | <b>320</b> | <b>3</b> | <b>355</b> | <b>833</b> | <b>19</b>  | <b>856</b> |
| <b>TATA Airlines</b> |            |     | <b>4</b> | <b>4</b> |              |            |      |         | <b>21</b>  | <b>3</b> |            | <b>24</b>  |            | <b>28</b>  |
| <b>Other LCCs</b>    |            |     |          |          |              | <b>155</b> |      |         | <b>299</b> |          | <b>355</b> | <b>809</b> | <b>19</b>  | <b>828</b> |

Notes: As at Oct 2021

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European or American Legacy carrier would offer three cabins throughout its domestic or intra-regional networks. The pricing strategy also seems retro — Vistara promotes full fares far in advance of departure dates and discounts at the last minute, the opposite of a typical LCC booking profile. Its 2019 average load factor was 83% compared to, for example, 93% at SpiceJet; for the first nine months of 2021 it achieved 64% against SpiceJet's 75%.

Financial results for FY2021 (year to March) were very severely depressed by the pandemic — a reported net loss of ₹16bn (\$208m) or 73% on its revenues of ₹22bn. But even in the previous, year, mostly untouched by Covid, Vistara lost ₹18bn, 38% of its revenues. Indeed the airline has been consistently loss-making since inception, necessitating equity injections from its parents, despite which its debt/equity ratio

stood at 10:1 as at March 2020.

The pandemic frustrated Vistara's plan of replacing Jet Airways on international routes when Etihad's investment went bankrupt in 2019. Its full-service product would probably have worked on some of those routes, but persisting with it on short-haul seems odd.

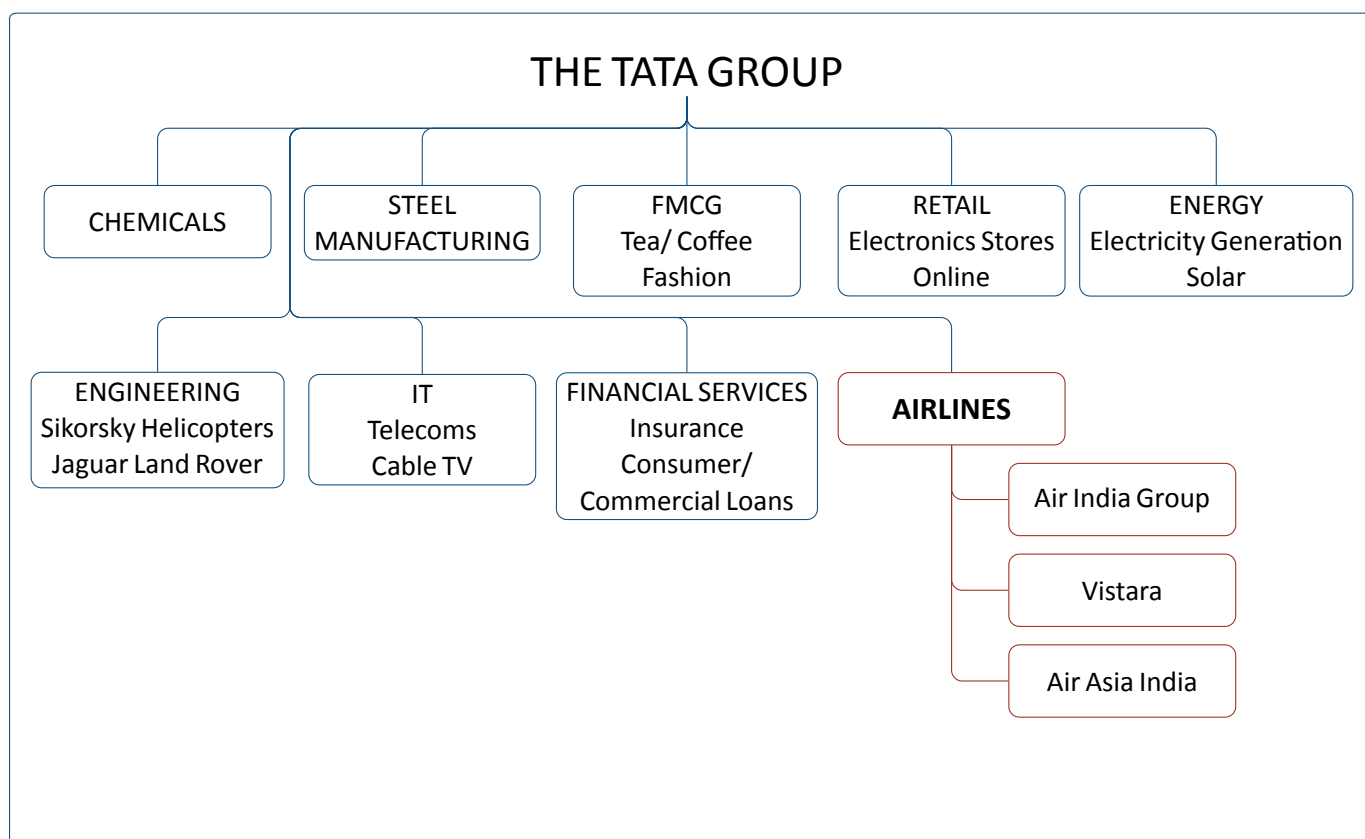
So, it is difficult to see how potential synergies can be achieved by Vistara and Air India as the two airlines stand at present. Both require fundamental structural reform. And the attitude of SIA towards the Vistara/Air India amalgam is uncertain; SIA has been profoundly impacted by the pandemic and may be forced to rationalise its investment portfolio

What of synergies within the Tata Group? The Tata group is a microcosm of India — huge, sprawling, dynastic, dynamic, bureaucratic and ungraspable. Founded in 1868, it encompasses industries as diverse as

steel making, motor manufacturing, IT, hotels and finance in India and globally (the organogram below is a highly simplified picture).

Although still largely controlled by family trusts, there are 29 stockmarket-quoted Tata companies with a combined equity market valuation of around \$250bn (about 30 times greater than IAG's, for comparison). Each unit operates independently but the new Vistara/Air India could conceivably benefit from synergies from the hotel business and IT; and the financial muscle that Tata could exercise in negotiations with OEMs would be formidable.

There is also the potential to direct Tata customers to Tata airlines. HSBC in a recent research note highlighted Tata's plan to launch a "super-app" which would enable customers throughout the empire to build up-air-mile points for use on Tata airlines. Further, such loyalty programmes are



# Aviation Strategy

eminently monetisable in the current market.

## Tata Low Cost

The take-over of the Air India Group has left Tata with two airlines — Air India Express and Air Asia India which it apparently intends to merge to form an LCC unit to operate beside the full service Vistara/Air India.

At first sight this seems to be logical link-up: in 2019 Air India Express and Air Asia India carried just 14m passengers between them, nowhere near the scale of the leading LCC IndiGo which carried 75m.

Because of the new joint ownership the integration process is projected to be smooth, according to Tata management who have brought in management consultants to manage the merger.

The problem is that the two Tata LCCs are niche operators with contrasting fortunes.

Air India Express is an almost purely international airline based

at Cochin in the state of Kerala. Remarkably for a state-owned company, it has found a specialist role — transporting Indian workers to/from Kerala and the Arabian Gulf — and was consistently profitable in the years immediately before the pandemic. Its FY2020 results showed a net profit of ₹4.1bn (\$53m) on revenues of ₹52.3bn. Its future depends on how quickly business in the Gulf recovers from the pandemic.

By contrast, Air Asia India was set up in 2013 as a joint venture between Tata (51%) and Air Asia (49%), the idea being to import the Malaysian LCC's expertise into the Indian domestic market, but the JV has been consistently loss-making. It recorded a net loss of ₹8bn (\$104m) in FY2020. For FY2021 (year to March), the airline is reported to have lost ₹15bn, somewhat more than its revenues of ₹14bn. Tata increased its stake in the airline to 84% in December 2020 and is in the process of buying out the remaining 16%. With its main

base at Bangalore, the global IT hub, Air Asia India has just not achieved the scale to compete with the much larger LCCs, IndiGo and SpiceJet.

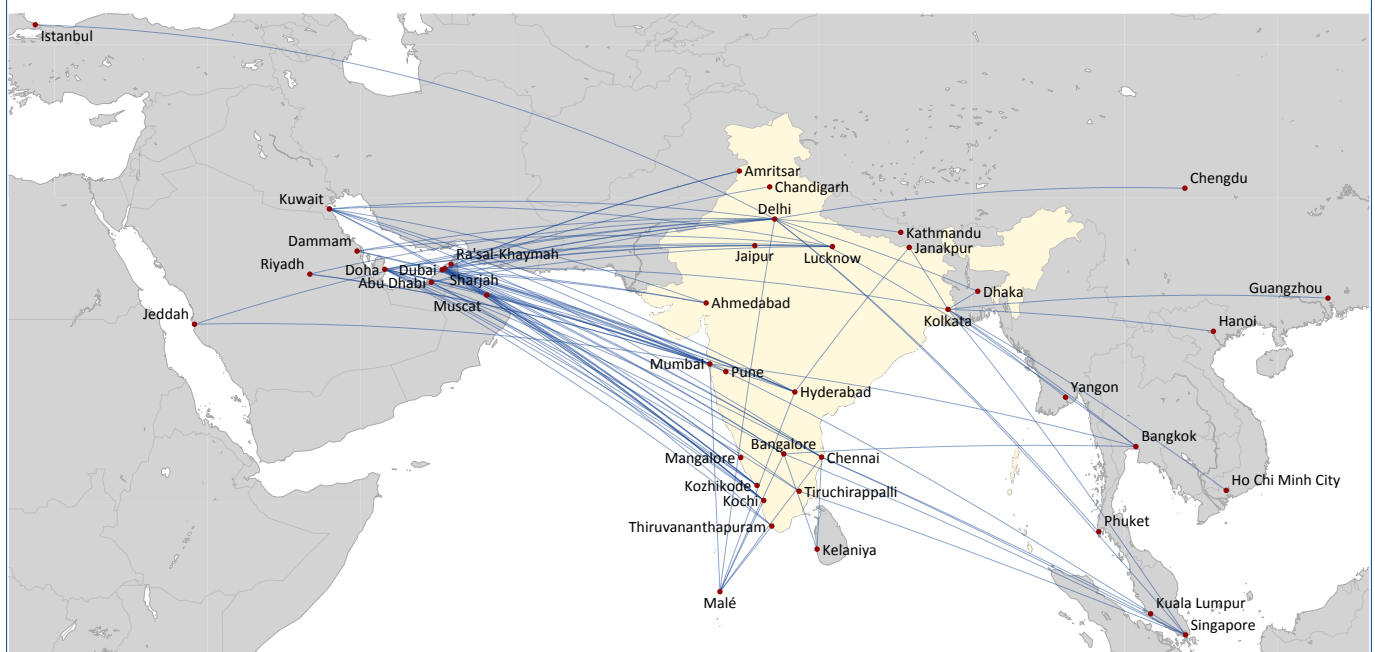
One of the issues facing Tata is that Air India Express is a 737-800 operator, with 24 units, while Air Asia India is a A320 operator, with 35 units. Neither carrier has aircraft on order, so, as with Vistara/Air India, if it is to achieve the scale needed for a domestic LCC, Tata will have to place an order for new equipment. The alternative might be to buy one of the other Indian LCCs.

## IndiGo: Purist LCC

IndiGo has firmly established itself as the sub-continent's dominant airline, but it too is being severely stressed by the Covid recession. The main concern is over whether it has over-expanded.

IndiGo was established in 2005 by Rahul Bhatia, head of the InterGlobe tourism, air transport and technology

## INDIGO: INTERNATIONAL ROUTE NETWORK



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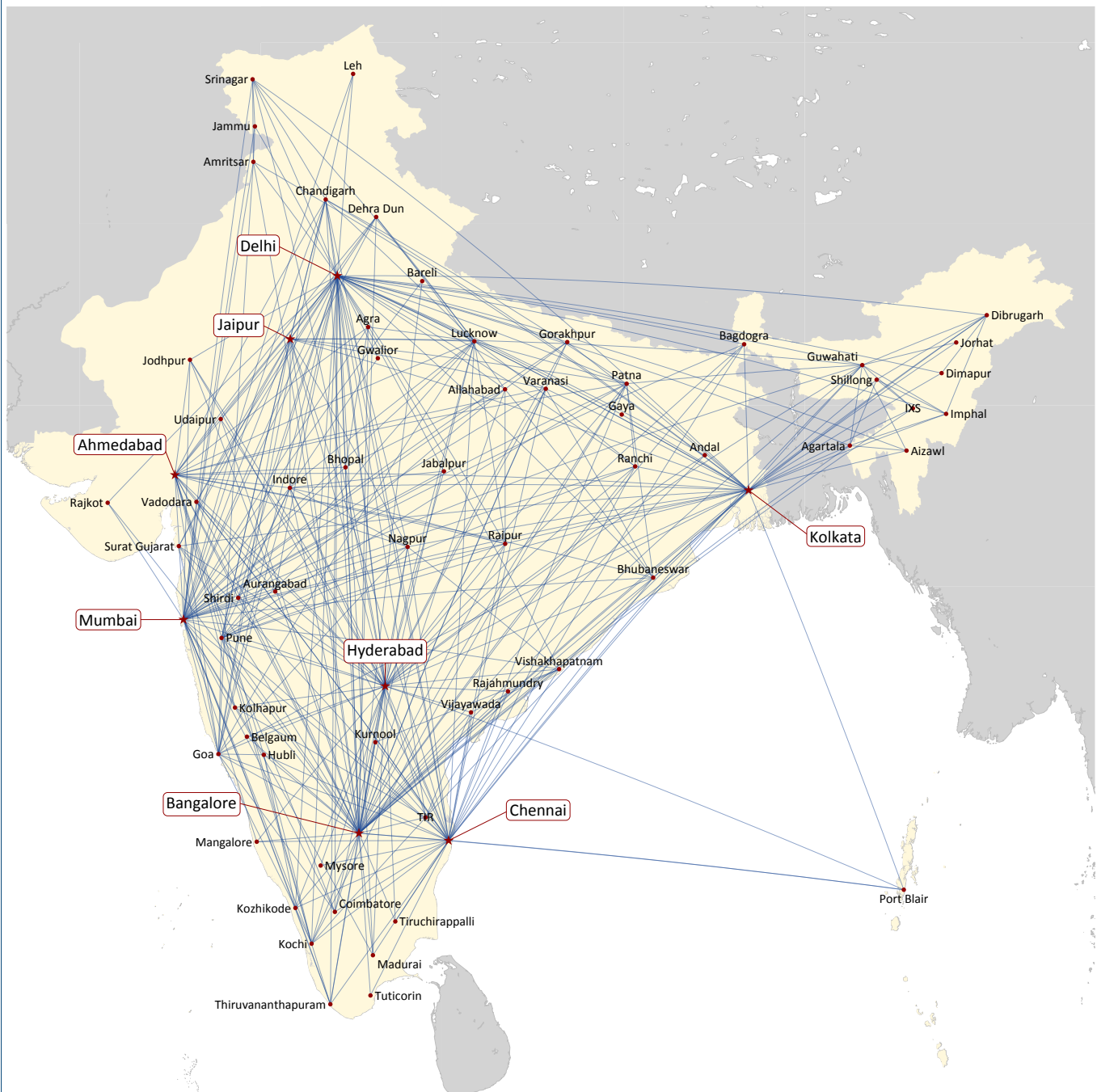
conglomerate, and Rakesh Gangwal, who, among other achievements, was CEO of USAirways. Both have shares of about 37% in the airline. Despite rapid growth over many years, consistent profitability and a generous dividend policy, these two

ageing, extremely rich gentlemen have fallen out and are engaged in a nasty court battle (which we frankly do not understand).

Traffic in 2019 was 75.0m, 91% in the domestic market, which put IndiGo in the top rang of global

LCCs, but the net result was just above breakeven. Losses escalated to ₹58.1bn (\$754m) in FY 2021, followed by ₹40.4bn in the April-September period of this year, pushing negative equity to Rp 44.6 on the balance sheet.

## INDIGO: DOMESTIC ROUTE NETWORK



## INDIGO FINANCIALS: REVENUE, PROFIT, CASHFLOW AND BALANCE SHEET (₹bn)

| FY (end March 31)     | 2019  | 2020  | 2021  | Apr-Sept 2021 | At End Sept                          | 2021         |
|-----------------------|-------|-------|-------|---------------|--------------------------------------|--------------|
| Revenues              | 298.2 | 372.9 | 156.8 | 41.7          | Fleet and other fixed assets         | 233.0        |
| Net result            | 1.6   | -2.3  | -58.1 | -40.4         | Current Assets                       | 116.1        |
| Operating Cashflow    | 31.6  | 69.7  | -16.1 | -9.2          | Cash and equivalents                 | 68.0         |
| Capex and Investments | -25.4 | -45.7 | 32.0  | 34.2          | <b>Total Assets</b>                  | <b>417.1</b> |
| Free Cashflow         | 6.2   | 24.0  | 15.9  | 25.0          | Long term debt and lease liabilities | 257.3        |
| Financing Activities  | -5.9  | -24.1 | -17.7 | -16.2         | Current liabilities                  | 204.4        |
| Total Cashflow        | 0.3   | -0.1  | -1.8  | 8.8           | <b>Total Liabilities</b>             | <b>461.7</b> |
|                       |       |       |       |               | <b>Shareholders' Equity</b>          | <b>-44.6</b> |

Note: ₹1bn = US\$13m

The CEO Ronojoy Dutta (appointed 2019, ex Air Canada and United) is unperturbed, pointing to the carrier's management of cash-flow and soundness of the business model. Indeed, IndiGo has adhered to a classic LCC model:

- ✈ Single A320 fleet with high utilisation and maximum seating in all variants;
- ✈ Point-to-point network but with tactical interlining alliances, the latest being with American;
- ✈ No frills, but consistent service and high on-time performance;
- ✈ Yield management through optimising the mix of demand-driven buckets on the assumption that the airline itself has no pricing power;
- ✈ Building in a capital cost advantage through mega-orders.

IndiGo is one of Airbus' most important customers; its orderbook stands at 559 A320/21neos, over twice the current fleet, and accounts for two thirds if the total Indian backlog.

IndiGo justifies the scale of its order book and scheduled deliveries by, firstly, emphasising its strategy of replacing CEOs with NEOs, so that by the end of 2022 it will be operating a exclusively NEO fleet. This implies

returning 80 A320 CEOs to lessors or putting them up for sale, which seems ambitious in today's fragile second-hand market.

Secondly, once borders are re-opened IndiGo is poised for rapid international expansion, the target being to have 40% of its capacity on international routes by 2025. IndiGo will focus solely on operations of a maximum of 6-7 hours, attacking in particular traffic that flows over the Middle East hubs by offering direct A321 flights. Tata, it will leave to the longer-haul full-service markets.

### SpiceJet and SpiceXpress

SpiceJet suffered the double-whammy of being a 737 MAX operator and having to ground its fleet in 2019 before the pandemic struck.

It reported substantial losses through FY2019-21, but the situation really deteriorated this year. In the April-September period it lost ₹12.9bn (\$168m), 46% of its ₹28bn turnover, which resulted in negative equity on its balance sheet ballooning to ₹38.6bn. Liquidity has become very problematic.

SpiceJet was the first of the low-cost new entrants back in 2004 but it

has never been tightly focused on the LCC model as IndiGo. The main shareholder and CEO through most of its history has been Ajay Singh, an entrepreneur in various businesses including television, sport and PR.

He has had to use all his PR skills in negotiating with SpiceJet's lessors where his airline has defaulted on payments, arguing that liquidity problems will be alleviated when compensation for the MAX grounding comes through from Boeing where it holds a firm backlog of 155 MAXes. Reports in November suggested that the compensation deal had been completed, just after the MAX was recertified in India. Curiously though, the compensation package from Boeing appears to include two 777-300ERs which SpiceJet intends to use on starting up a new long-haul operation, probably to the US.

The other element of SpiceJet's liquidity raising involves the spin-off of its logistical and cargo operation, SpiceXpress. SpiceJet grew its cargo business by a factor of six in FY2021 compared to the previous year, wet-leasing in capacity to supplement its fleet of five 737SFs. Cargo revenues in FY2021 were ₹11.2bn (\$146m) as against ₹40.5bn for passengers ser-

## SPICEJET FINANCIALS: REVENUE, PROFIT, CASHFLOW AND BALANCE SHEET (₹bn)

| FY (end March 31)     | 2019        | 2020        | 2021       | Apr-Sept 2021 |                                      | At End Sept | 2021         |
|-----------------------|-------------|-------------|------------|---------------|--------------------------------------|-------------|--------------|
| Revenues              | 92.6        | 132.1       | 61.2       | 28.0          | Fleet and other fixed assets         |             | 80.2         |
| Net result            | -3.2        | -9.3        | -10.0      | -12.9         | Current Assets                       |             | 28.8         |
| Operating Cashflow    | 4.6         | 18.2        | 3.8        | 0.2           | Cash and equivalents                 |             | 3.1          |
| Capex and Investments | -1.5        | -1.6        | 2.1        | 0.0           | <b>Total Assets</b>                  |             | <b>112.1</b> |
| Free Cashflow         | 3.1         | 16.6        | 5.9        | 0.2           | Long term debt and lease liabilities |             | 57.5         |
| Financing Activities  | -3.6        | -17.0       | -5.9       | -0.1          | Current liabilities                  |             | 93.2         |
| <b>Total Cashflow</b> | <b>-0.5</b> | <b>-0.4</b> | <b>0.0</b> | <b>0.1</b>    | <b>Total Liabilities</b>             |             | <b>150.7</b> |
|                       |             |             |            |               | <b>Shareholders' Equity</b>          |             | <b>-38.6</b> |

Note: ₹1bn = US\$13m

vices, but cargo produced a net profit of ₹1.3bn (\$17m) in contrast to the passenger loss of ₹11.4bn.

The idea is to transfer SpiceXpress to a new company that will be ring-fenced from SpiceJet's liabilities, and raise new funding from existing and new shareholders. The value proposed by SpiceJet for the new SpiceXpress entity is ₹25bn (\$325m). The problem is that lessors and other creditors are objecting to the transfer of certain assets to the new company.

### A wave of ULCCs?

The pandemic may have created another wave of new entrants — ULCCs.

Go Air announced its transition to the ULCC model by rebranding as Go First. It was the smallest of the 2005 wave of LCCs that entered the Indian market around 2005, but never found the scale of IndiGo or SpiceJet, and has generally struggled to break-even. It is, however, owned by the Wadia Group — smaller version of Tata, with equity of only about ₹540bn (\$7bn), but it was founded earlier, in 1736

Go First has not yet revealed its F2021 results but in FY2020 it reported a net loss of ₹12.8bn (\$166m) on revenues of ₹72bn. The balance

sheet showed negative equity of ₹15bn.

Now the plan is to restructure as a ULCC and raise funds of ₹36bn (\$470m) through an IPO, originally scheduled for the end of this year. Details are scarce on how Go First will effect the transition, given the barriers raised by Indian taxes on fuel and aircraft imports, and the lack of secondary airport infrastructure.

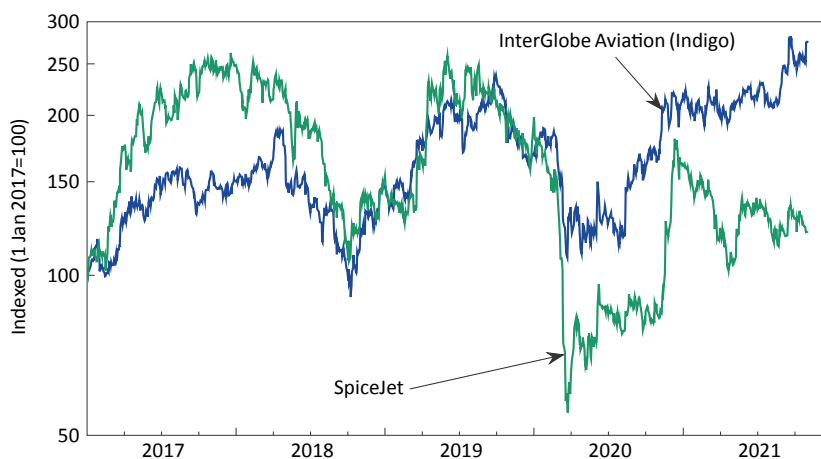
Akasa is a proposed ULCC start up founded by Rakesh Jhunjhunwala, an investor and stockmarket trader, reputed to be the Indian equivalent

of Warren Buffett. Entering at what he assesses as being the bottom of the market, he announced an order at the Dubai Air Show for 72 737MAXes, with deliveries starting early next year and operational start-up scheduled for the summer of 2022.

Indian aviation is never dull.



## INDIGO AND SPICEJET: SHARE PRICE PERFORMANCE



## Avianca

### A tale of intrigue

**A**VIANCA Holdings, South America's second largest airline group, immediately after celebrating its 100th year of continuous operation was one of the first to file for Chapter 11 protection in the US courts in the wake of the pandemic and forced closure of operations in May 2020.

It is also one of the first to have its restructuring plan approved by the court and seems set to emerge from Chapter 11 before the end of the year. The business plan it put forward suggests that it will be operating a dramatically different airline business model, and one that is portrayed as potentially profitable.

The events of the last few years leading up to the Covid-19 crisis were dramatic for Avianca and its shareholders. The story could provide the basis of a plot for such as a John Grisham novel featuring corporate intrigue and power play. Ideal for a long-haul flight from Bogotá.

#### The protagonists

➔ Germán Efromovich, a self-made billionaire — according to the *Financial Times* his first job was selling encyclopaedias door-to-door and later started and sold a quail farm; while working as a tutor at an adult school he taught a union leader named Luiz Inácio Lula da Silva, who later became president of Brazil (2003-2010). The Bolivian born son of Polish refugees had built, with his brother José, a Brazilian conglomerate — Synergy Group, registered in Panama — based on oil exploration but with fingers in

other pies including telecommunications and shipbuilding. The brothers apparently got into running airlines when a client repaid debts to the oil company with an aircraft in 1998. That grew into Oceanair which started scheduled Brazilian operations in 2002. In 2004 he buys Columbia's Avianca out of Chapter 11 for an initial \$64m. Oceanair later rebranded as Avianca Brasil (though never owned by Avianca).

➔ Patrician Roberto Kriete, born into El Salvador's elite, a billionaire and one of El Salvador's richest men. His father Ricardo Kriete had bought a controlling stake in the national airline TACA in 1961, and Roberto ran the airline successfully for many years even during the vicious civil war.

➔ United Airlines, one of the three major US network carriers, eager to build a strategic presence in South and Central America, fight off Delta

planning the same, both attacking American Airlines' preeminent position on the continent.

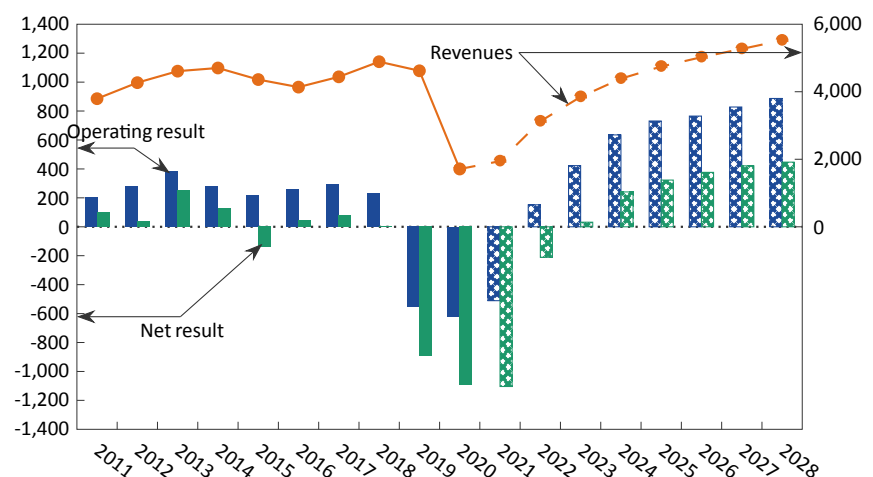
#### The plot

Avianca and Grupo TACA merge in 2010 to create a market-leading group of 11 airlines operating in nine countries in Central America and the Andean region of South America. The new holding company AviancaTACA (later renamed Avianca Holdings) was incorporated in Panama.

The relationship between the two billionaires initially appears amicable. Efromovich's Synergy Group ends up with two thirds of the enlarged group (held through Panama-registered subsidiary Synergy Aerospace) while Kriete's Kingsland Holdings (registered in the Bahamas) holds 33%.

A shareholders' agreement is signed to ensure Kriete's rights as a minority shareholder (including

#### AVIANCA FINANCIALS AND BUSINESS PLAN (US\$m)



Source: Avianca Holdings business plan. Note: 2019 includes \$600m extraordinary charges.

# Aviation Strategy

board representation, veto on specific board proposals, tag-along rights and buyout terms), and Roberto Kriete serves as the group's Chairman from 2010 to 2013.

The group lists non-voting preferred shares on the Bogotá exchange

in 2011 (Synergy and Kingsland retain all the voting rights through their holdings on Ordinary shares). The group returns to the New York Stock Exchange in 2013 in an IPO of ADSs representing preferred shares valuing the combine with a market capital-

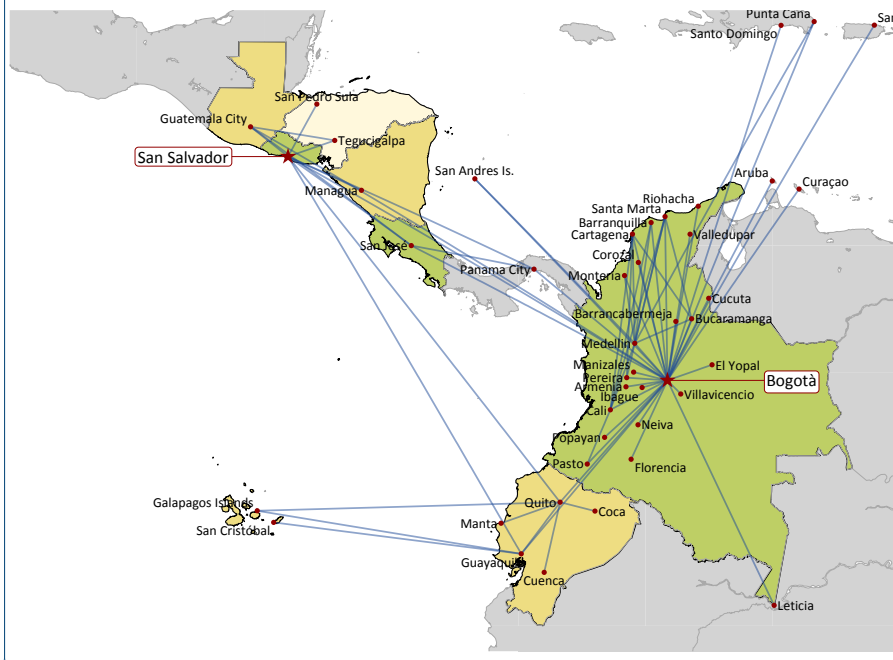
isation of \$2bn: during the process Kingsland sells a higher proportion of its holding ending up with 14% of the equity and 22% of the voting rights.

Over the subsequent years Avianca grows at a strong pace — increasing capacity at around 6-10% a

## AVIANCA ROUTE NETWORK



## AVIANCA: DOMESTIC AND SHORT-HAUL ROUTE MAP



year — and successfully consolidates the separate airlines under the single Avianca brand.

But revenues come under pressure (growing at an annual average of just 1% in the five years to 2018) from the incursion of LCC rivals into its home markets; and profitability is diminished (operating margins averaging 6% and net margins 1.4%). Roberto Kriete, it is reported, successfully vetoes the incorporation of Synergy's heavily loss-making Oceanair (operating as Avianca Brasil) and Avianca Argentina into the holding company.

Through this period Avianca significantly increases the size of its fleet, ending 2018 with nearly 196 aircraft up from 150 five years earlier. It seems that it had plans to continue to grow, with orders for 124 A320neos for delivery between 2019 and 2025 along with orders and options for 12 787s. It also builds up a high level of debt: it ended 2018 with long-term debt and capital

leases of \$3.4bn and total liabilities of \$6.1bn. Total assets were \$7.1bn and book equity \$978m. Its adjusted net debt/EBITDAR ratio stands at 6.2x. Cash reserves amount to only \$389m (8% of annual revenue). By the end of 2018 its stock market capitalisation falls to \$550m, a quarter of its IPO valuation. The board sees a financing crunch: over \$2bn of its total debt would mature within three years.

To understand the stresses on Avianca, we go back a few years to find that Synergy itself is stressed. In 2015 EISA, a Brazilian shipbuilding subsidiary of Synergy Group, goes bust with secured debts of \$295m owed to Elliott Management, a New York based hedge fund run by Paul Singer and one described by the *Financial Times* as ruthless. It appears that Synergy and Elliott have had a long-standing relationship over many years. It appears also that Synergy Group has pledged the majority of its shares in Avianca to Elliott Management as collateral.

In the same year, to raise much needed cash, Avianca sells 30% of its frequent flier programme, LifeMiles, to a private equity firm Advent International for \$340m.

In 2016 trouble brews at Avianca Brasil as Wells Fargo tries to sue for non-payment of leases.

In early 2017 Roberto Kriete's Kingsland Holdings files a lawsuit against Avianca Holdings, Germán and José Efromovitch, and United Airlines. The aim is to block a proposed strategic partnership between Avianca and United. Kingsland alleges that Efromovich secretly negotiated Avianca's proposed partnership with United for his own benefit (essentially as a bailout of Synergy) at the expense of Avianca and minority shareholders.

According to the complaint, the deal included a \$800m loan from United to Synergy, backed by Avianca and Oceanair shares. Half of this would be used to repay existing Synergy debt (including defaulted loans from Elliott) and \$130m would go to Oceanair, while Avianca itself would only receive about \$200m.

Kingsland also claims Avianca's liquidity problems had been caused by Efromovich's "misconduct", accuses Efromovich of channelling Avianca funds to his private companies through non arm's length related-party transactions, and alleges that Synergy used "Avianca's assets to shore up Efromovich's other financially-strapped business concerns". Kingsland claims that Avianca board meetings resembled a "corporate politburo rubber-stamping Efromovich's initiatives without advance notice, deliberation, independent judgement or hesitation".

Kingsland also claims that Synergy's pledge of Avianca shares to

back its loans violated the Kingsland-Avianca shareholders' agreement, as Synergy did not request Kingsland's approval, and third-party creditors were not permitted transferees of Avianca shares.

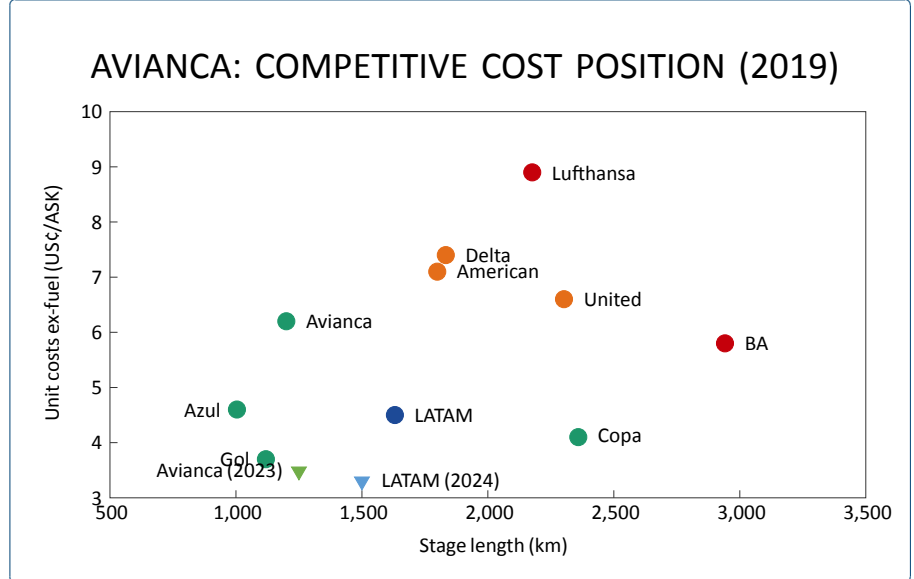
Maybe what really riles Kriete is that representatives from Elliott turned up at board meetings as special advisors, and may have been instrumental in negotiating with United without including him.

Avianca Holdings then files a retaliatory lawsuit against Kingsland and Roberto Kriete to stop Kingsland's "improper actions" aimed at blocking the pending alliance with United and "any further dissemination of the company's confidential information". Its defence of the United deal notes that while Delta and Copa were also interested in Avianca, their proposals required a change in control, which Synergy would not accept. It accuses Kingsland of trying to "take over the company" with other partners, and argues (somewhat bizarrely) that Kriete's Mexican airline Volaris (founded 2005) competes with Avianca in Central America.

## United again

Both sides stop calling each other names and withdraw their lawsuits. Negotiations restart with United, with Kriete this time on board. Avianca Brasil, possibly also supported by Elliott Management, struggles on but eventually goes to the wall at the end of 2018, thus removing it from the equation.

The deal with United is finally signed, setting up a tripartite joint venture (subject to regulatory approval) between United, Avianca and Copa. United's President, Scott Kirby, is quoted as saying that the agreement "represents the next chapter in US-Latin American air travel," adding



that United, Copa, and Avianca will provide "a better overall experience for business and leisure customers travelling across the Western Hemisphere".

United provides a loan to Synergy of \$456m, to allow it to pay off its defaulted loans to Elliott Management. Synergy transfers its entire Avianca shareholding to a new subsidiary, Delaware-incorporated BRW Aviation LLC, to act as collateral. The terms of the five-year loan are subject to several covenants benchmarked against Avianca Holdings' financial performance. United, in a separate agreement with Kingsland effectively also assumes the obligations of the Shareholders' Agreement between Synergy and Kingsland to satisfy Kriete's concerns as a minority shareholder.

Have the Efromoviches got away with it? But no! In April 2019, Synergy breaches at least one of the terms of the United loan: Avianca Holdings fails to comply with a collateral coverage ratio set down in the agreement. United takes control of the Avianca shareholding, handing the voting power to Kingsland to ensure ownership and control covenants at-

tached to debt and leases, ousts Germán and José Efromovich along with other Synergy appointees from the Board, and installs Roberto Kriete as Chairman.

"This is an important day. It is the right time to build a promising future for the company," Kriete tells Colombian *El Tiempo*. "Turning around the company will be a difficult challenge. My role is not to be the hero of this drama. My role is to assemble a world-class team who have the skills to lead the transformation of Avianca."

## Avianca 2021

Before Synergy's default, Avianca had already announced a restructuring transformation plan, named Avianca 2021, to change its focus from growth to profitability.

With a new management team in place, Kriete sets about intensifying the implementation: culling the fleet by 25%, renegotiating aircraft commitments, divesting non-core business units, and strengthening the capital structure.

The team negotiated successfully with debt providers to re-profile over \$5bn in debt (without needing to

involve the courts), improved the cash position through asset sales and sale and leasebacks, and even raised \$375m of new liquidity.

Financially 2019 was a very poor year: underlying operating profits of only \$44m (from \$4.6bn revenues) don't quite cover \$300m in interest costs. Restructuring charges of \$600m incorporating asset write downs, redundancy payments and professional fees, pushes the group into an annual reported loss of nearly \$900m, and virtually wipes out the net equity position on the balance sheet.

But, by February 2020, Avianca is tracking ahead of profitability and liquidity goals, giving hope that it would reach its 2021 targets. Roberto is back in control. Germán and José Efromovich will shortly be charged with bribery and money laundering.

A happy ending.

## New business plan

That sensational plot line did not exactly prepare Avianca for the Covid-19 pandemic.

Already having gone through a financial restructuring under its own steam, there was not much room for Avianca to cope with the enforced closure of operations. The entire fleet was grounded in March 2020 and borders did not start to reopen until September. (The total numbers of passengers carried fell to 7.9m for the whole of 2020 down from 30.5m the year before.) It had no other choice than to file for Chapter 11 protection.

It had some government support through the process — Columbia provided \$370m of the \$1.4bn debtor-in-possession (DIP) funding approved by the courts in late 2020. At the same time Kingsland and United maintained support through a second tranche of DIP funding convertible into equity on emergence from Chapter 11.

This was all refinanced (with the approval of the courts) in July 2021

with facilities of \$1.6bn, providing it with an extra \$200m in liquidity and sufficient for the courts to then approve the group's business plan to allow it to exit Chapter 11 protection before the end of the year.

The most important of its airlines subsidiaries have survived, but the group allowed the Peru operation to fail in 2020 and has now closed its domestic operations in the country.

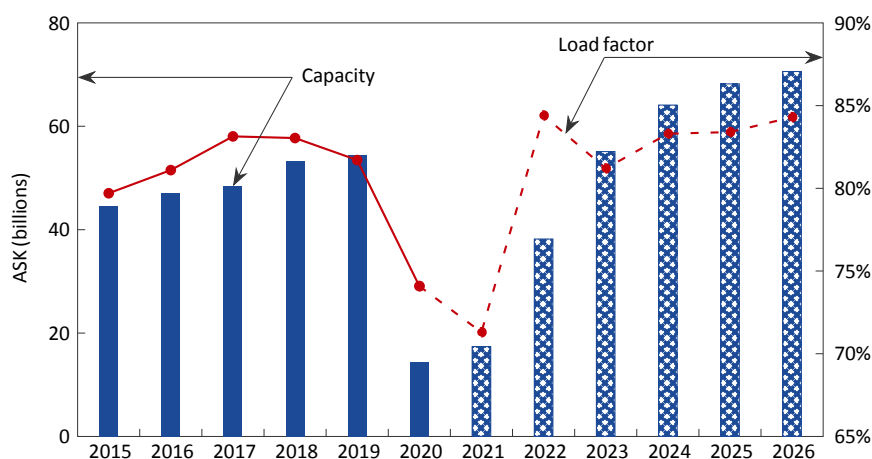
For the new business plan Avianca engaged management consultants Oliver Wyman to conduct a deep review of the strategic alternatives. The review suggested a further shift in the company's strategic direction to focus on an efficient cost structure and a network optimised for point-to-point leisure and VFR traffic — accepting that business travel and connecting international travel will take a very long time to recover.

The rationale behind the plan seems to be that the LCC business model has shown the value of flexibility and high ratios of variable- to fixed-costs: the company highlights that best-in-class LCCs have significantly outperformed legacy carriers through the crisis. It hopes that measures available under the Chapter 11 process will allow it to reduce its unit costs to, or even below, competitor LCC levels (see chart on the previous page).

The new business plan appears to be a traditional boilerplate for restructuring. It envisages that Avianca Holdings will remain a portfolio of aviation businesses. But at its core will be what the company describes as a highly-efficient narrowbody operation following all the prime elements of a low cost business model (with some exceptions) — simplicity, point-to-point, unbundled fares, ancillaries. It believes that it will retain superior



AVIANCA RECOVERY PLANS



## AVIANCA: PLANNED NETWORK STRUCTURE

|                      | 2019 | 2025 |
|----------------------|------|------|
| Destinations         | 79   | 85   |
| Routes               | 145  | 245  |
| Daily departures     | 662  | 698  |
| Routes per City      | 1.8  | 2.9  |
| Departures per Route | 4.6  | 2.8  |
| Departures per City  | 8.4  | 8.2  |

market positioning, and (somewhat questionably perhaps) provide a better product than LCC competitors to give it a revenue premium.

As part of this process it will be increasing seat density — it projects average seats per departure rising from 144 to 170 — and concentrate short haul flying entirely on the A320 family. It has renegotiated its outstanding order with Airbus, but the plan suggests that its short haul fleet will reach 133 units by 2026 up from 96 at the end of 2021.

It will also significantly restructure its network offering. As shown in the table above, by 2025 it is planning to increase the number of destinations offered modestly, the number of routes by 100 up from 145, increase the number of routes per city by a third and nearly halve the frequency of departures by route. This involves a higher proportion of non-hub point-to-point service. The average stage length is also expected to increase from 900km to 1,500km and aircraft utilisation to rise from 10 to 12 hours/day on the short haul fleet.

The long haul operations are planned to be streamlined to a single operating type, retaining the 787 and disposing of its remaining A330s (see fleet table right). The plans suggest a stable twelve widebodies in the fleet (half the number it had at the end of

2019) for the next six years, and that it will operate a limited service to Europe and Los Angeles that can stand on its own. But it will also treat long haul as a non-core “supplemental business unit”, presumably based on point-to-point services into Bogotá and San Salvador, with what it calls “accidental connectivity”.

It will also retain cargo operations (one of the two cash generative businesses it held in the last two years) as a separate entity, with a dedicated fleet of 11 aircraft. It is using this as collateral for its exit loans with a business value of \$870m and equity value after associated debt of \$660m.

The third stand-alone business operation will be the frequent flier programme LifeMiles. During bankruptcy it spent a modest \$5m to buy back in some of the stake it had sold in 2015 for \$340m — it now owns

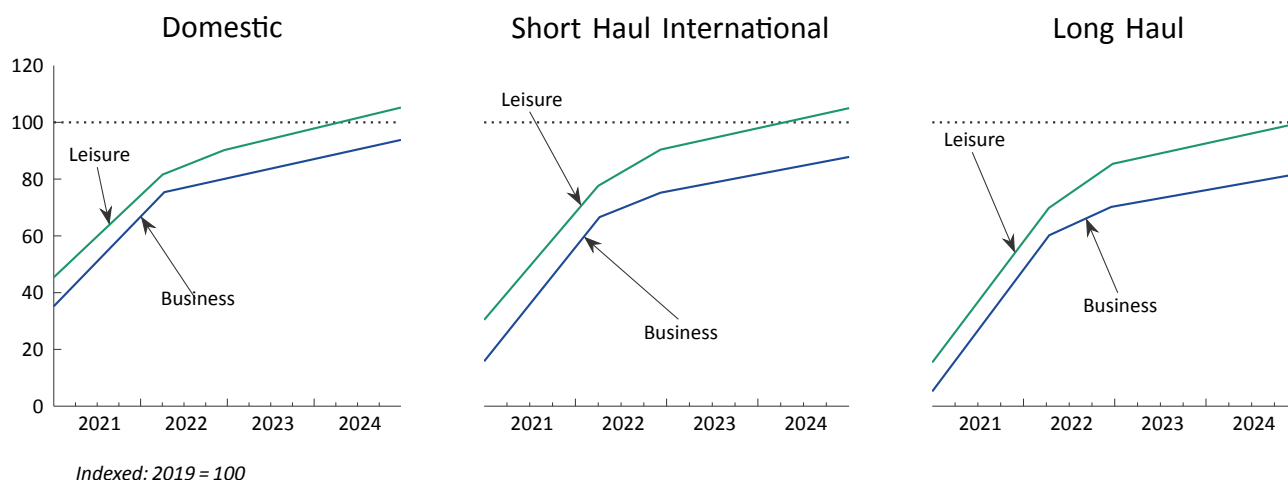
89.9% of the unit and has an option to acquire the remaining 10.1% for a similar amount. But this too has possibly been cash generative in the past two years. Perhaps Avianca has been influenced by United’s experience of raising funds from its monetisation of MileagePlus into thinking that an FFP really can be a separate business. It is using it as a source of collateral for the exit debt financing ascribing it a business value of \$2.2bn and an equity value of \$1.9bn. (For our views on FFPs see *Aviation Strategy* August 2020).

The Group has bravely set forth a business plan covering projections for the years up to 2028. It expects that it will have restored capacity to pre-pandemic levels by 2023 (see graph on the facing page) but does not expect traffic volumes fully to recover until 2024.

## AVIANCA FLEET PLAN

|            |                        | 2019       | Δ          | 2021       | ... | 2026       | 2027       | 2028       |
|------------|------------------------|------------|------------|------------|-----|------------|------------|------------|
| Narrowbody | A319                   | 27         | -5         | 22         |     | 10         | 10         | 10         |
|            | A320ceo                | 57         |            | 57         |     | 73         | 56         | 43         |
|            | A320neo                | 10         | +2         | 12         |     | 50         | 73         | 92         |
|            | A321                   | 13         | -8         | 5          |     |            |            |            |
|            | A321neo                | 2          | -2         |            |     |            |            |            |
|            |                        | 109        | -13        | 96         |     | 133        | 139        | 145        |
| Widebody   | A330                   | 10         | -3         | 7          |     |            |            |            |
|            | 787-8                  | 13         |            | 13         |     |            |            |            |
|            | 787-9                  | 1          |            | 1          |     |            |            |            |
|            |                        | 24         | -3         | 21         |     | 12         | 12         | 12         |
| Regional   | ATR72                  | 15         | -2         | 13         |     |            |            |            |
|            | E190                   | 10         | -10        |            |     |            |            |            |
|            |                        | 25         | -12        | 13         |     |            |            |            |
|            | <b>Passenger fleet</b> | <b>158</b> | <b>-28</b> | <b>130</b> |     | <b>145</b> | <b>151</b> | <b>157</b> |
| Freighter  | A330F                  | 6          |            | 6          |     |            |            |            |
|            | A300F                  | 5          | -2         | 3          |     |            |            |            |
|            | 767F                   | 2          |            | 2          |     |            |            |            |
|            | Cargo Fleet            | 13         | -2         | 11         |     | 11         | 11         | 11         |
|            | <b>Group Fleet</b>     | <b>171</b> | <b>-30</b> | <b>141</b> |     | <b>156</b> | <b>162</b> | <b>168</b> |

## PROJECTED RECOVERY BY MARKET



In general, leisure and VFR traffic is projected to recover more quickly than business traffic, with faster recovery assumed in domestic and short-haul international flying. The Company expects leisure demand to reach 2019 levels by early 2024 (see graph above), while business demand remains impaired versus 2019. It believes that the stronger and faster recovery in the leisure/VFR segment further supports the Company's business model shift to focus on low-fare point-to-point flying.

It is anticipating significantly lower yields through the recovery, not expecting to reach 2019 levels of revenue until 2025. But it, perhaps rather aggressively, is suggesting that operating profits will exceed the previous peak (\$294m in 2017) by 2023 with \$423m, and that the restructured network will be able to generate operating margins averaging 15% in the following five years. This will result in an ability to target investment grade ratings over the period with gearing forecast to fall from a ratio of 5.1x net debt to EBITDA at the end of 2022 to below 1.5x by 2028.

When Avianca emerges from Chapter 11, it is clear that existing shareholders will receive nothing. It is likely that Kingsland and United — both DIP tranche 'B' lenders — will emerge with some proportion of equity, but it will be intriguing to see who else appears on the register of new shareholders.

In a rather interesting twist, the Group proposed to the courts that its reincarnation would be as a company based in London and incorporated in England and Wales. We can only assume that this was a pre-requisite of some of the funders: the UK has a legal system that recognises Chapter 11 restructuring. And the UK is not a tax haven.



## AVIANCA HOLDINGS: BALANCE SHEET

|                      | US\$bn | Jun 2021 | Dec 2019 |
|----------------------|--------|----------|----------|
| P&E                  | 4.61   | 4.95     |          |
| Goodwill/intangibles | 0.48   | 0.51     |          |
| Other fixed assets   | 0.08   | 0.10     |          |
| Cash etc             | 1.05   | 0.40     |          |
| Stock                | 0.08   | 0.09     |          |
| Drs                  | 0.20   | 0.23     |          |
| Other                | 0.20   | 0.99     |          |
| Current Assets       | 1.53   | 1.71     |          |
| ST debt              | (5.66) | (0.87)   |          |
| Crs                  | (0.53) | (1.40)   |          |
| Advance tickets      | (0.42) | (0.34)   |          |
| Other                | (0.41) | (0.12)   |          |
| Current Liabilities  | (7.02) | (2.73)   |          |
| Net Current Assets   | (5.49) | (1.02)   |          |
| LT Debt              | (1.09) | (3.98)   |          |
| Crs                  | (0.02) | (0.01)   |          |
| Provisions etc       | (0.48) | (0.54)   |          |
| Net Assets           | (1.90) | 0.01     |          |
| Represented by:      |        |          |          |
| Share capital        | 0.83   | 0.83     |          |
| Retained earnings    | (2.68) | (0.54)   |          |
| Reserves et al       | (0.04) | (0.08)   |          |
| Shareholders' funds  | (1.88) | 0.21     |          |
| MI                   | (0.02) | (0.20)   |          |
| Net Equity           | (1.90) | 0.01     |          |
| Ratios:              |        |          |          |
| Net debt             | 5.69   | 4.46     |          |
| Net debt/Equity      | -300%  | 86,286%  |          |
| Net debt/EBITDA      | -50.6x | 7.0x     |          |

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