Aviation Strategy

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Atlantic Resurgence

THE TRANSATLANTIC market, aviation's largest and most mature long haul route, fell into hibernation during the pandemic. Statistics from the US DoT suggest that passenger numbers in 2020 were less than 20% of the total 83m carried in 2019; and in 2021 at 21.7m were still 75% below the pre-crisis level (and 30% below the numbers who flew on the route in 1990).

But for the period to April 2022 (the latest data available) passenger demand had recovered to 60% of 2019 levels, and airlines have increasingly responded to underlying pent-up demand by restoring capacity. The schedules suggest that seat capacity for the year as a whole will be 85% restored to pre-pandemic levels. (In this definition of the North Atlantic we look at services between North America — the USA, Canada and Bermuda — and Europe, Middle East and North Africa).

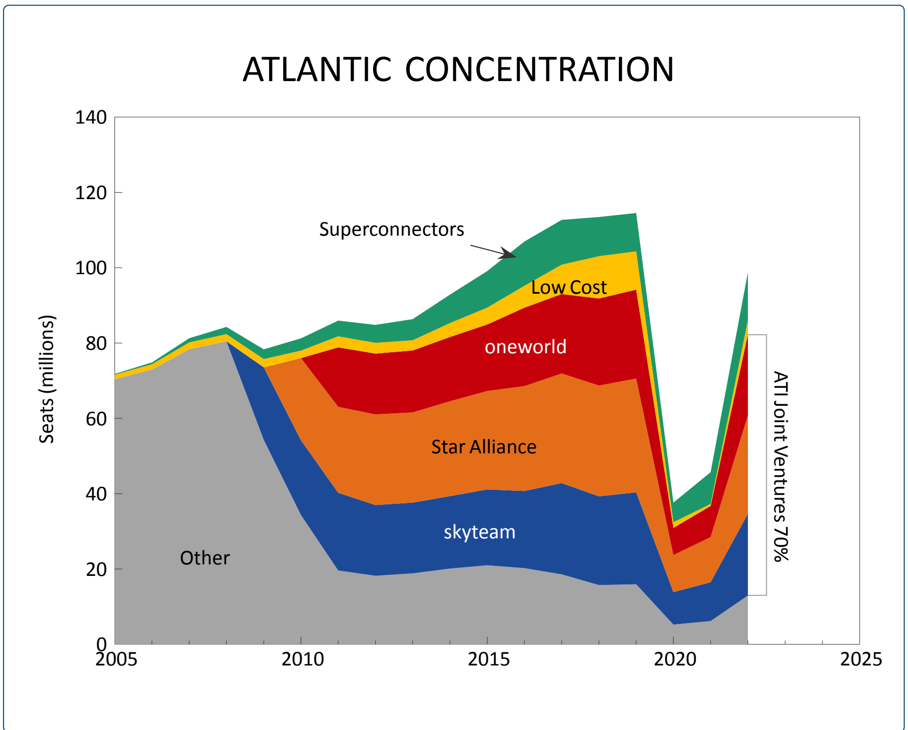
Supply on the route is highly concentrated, as the chart below shows, dominated by three virtual airlines — the anti-trust immune metal neutral joint ventures of the three global branded alliances.

- oneworld, incorporating American and the IAG long haul operations at British Airways, Iberia and Aer Lingus;
- Star Alliance led by United, Lufthansa Group (including Swiss, Austrian and Brussels Airlines) and Air Canada; and
- the SkyTeam alliance of Delta, Air France-KLM, Virgin Atlantic, (and possibly Alitalia's successor, ITA)

These three account for 70% of the current seat capacity on the route roughly equally shared. This share is two percentage points higher than in 2019.

Non-aligned carriers, mostly European Legacy carriers, provide 13% of the seats down a percentage point from three years ago.

The superconnectors (Emirates, Qatar, Etihad and THY) have increased their share of Atlantic capacity by four points to 13%, despite Etihad shrinking by 30% as it continues to rationalise. The four carriers' total capacity planned for this year is 25% higher than it was in 2019. The most notable increase (see graph on the next page) is from THY who has opened four new destinations (Dallas, Newark, Seattle and Vancouver) and Qatar with two new destinations of Seattle and San Francisco. Emirates also scheduled 4% more seats in 2022 than 2019 with new routes



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Publisher:

Keith McMullan
James Halstead

Editorial Team

Keith McMullan
kgm@aviationstrategy.aero

James Halstead
jch@aviationstrategy.aero

Subscriptions:

info@aviationstrategy.aero

Aviation Strategy Ltd
Registered No: 8511732 (England)
Registered Office:
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London SW15 5QT
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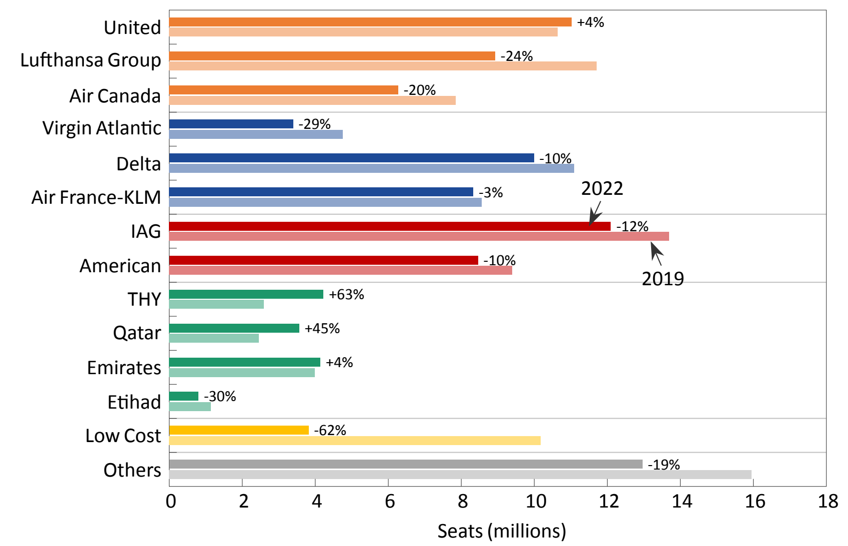
NORTH ATLANTIC CAPACITY 2022 v 2019



Source: schedules data

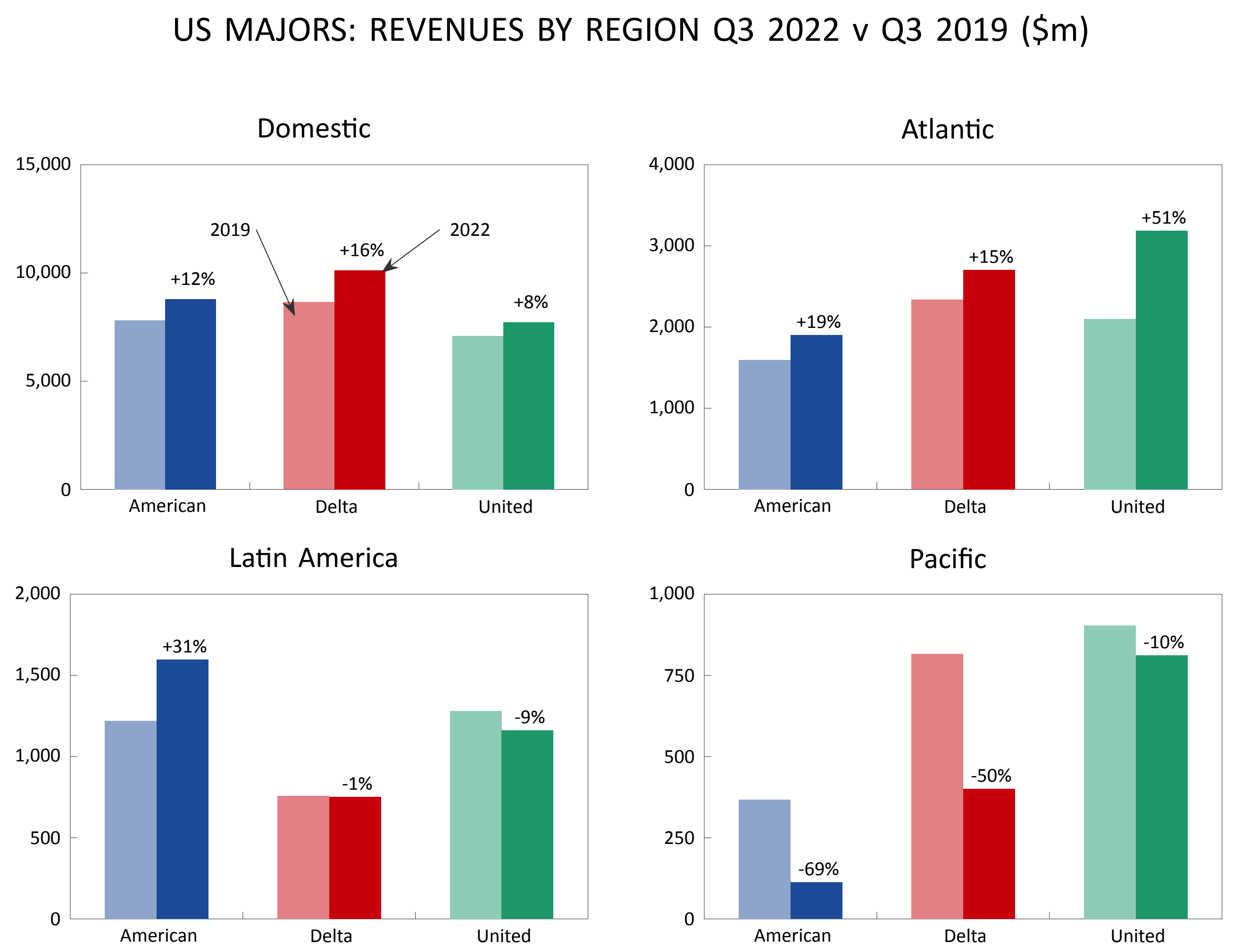
to Baltimore, Washington, Miami and San Francisco (but dropping Fort Lauderdale). Conveniently forgetting the very public arguments about "unfair competition" from the Gulf carriers of six years ago, American Airlines now has an extensive codeshare agreement with Qatar, and United with Emirates.

Low Cost tumbles

The big fall-out from the market over the pandemic has been among the low cost segment, which at its peak in 2018 accounted for 10% of the seats. In 2022 this share appears to be less than 4% with seat capacity down by 62% from 2019 levels. The main reason behind this decline was the failure of Norwegian's long haul low cost model — at its height Norwegian flew 7.5% of all passengers between the USA and Europe. Financially challenged before the crisis hit, the pandemic brought the airline to its knees and after six months of restructuring under bankruptcy protection it re-emerged in May 2021, having jettisoned its fleet of 37 787s, as a purely short haul LCC.

There is a replacement startup — Norse Atlantic. Backed by Norwegian Air Shuttle's former CEO Bjørn Kjos, and with an initial fleet of nine leased 787s (with plans for six more), Norse Atlantic started operations in June 2022 with flights from Oslo to New York JFK. It also decided to have a base in Berlin. Recognising that it needed to fly from London — the largest O&D market on the Atlantic — and complicated by Britain's withdrawal from the EU, it set up a UK AoC. In October the US DoT granted operating authority to Norse Atlantic UK (with none of the objections that Norwegian had faced over flags of convenience) waiving ownership and control restrictions on the basis that the new operation was "not inimical to US interests".

Another player in the low cost category that used to have a notable presence was Reykjavik based Wow Air. In 2018 it had a near 2% share of passengers between the US and



Note: Q3 operating revenues (American – passenger revenues). Source: company reports.

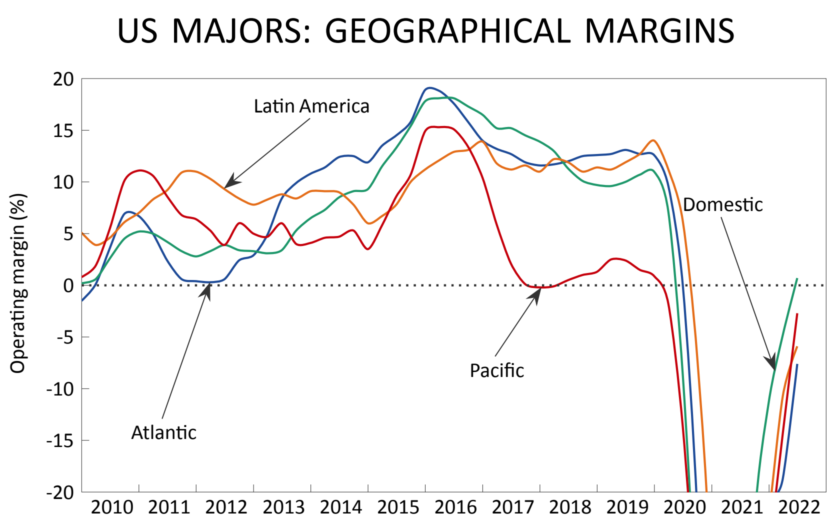
Europe operating a narrowbody hub and spoke network through Iceland. It failed abruptly in March 2019. It has re-emerged as Play, founded by former Wow Air executives Arnar Már Magnússon and Sveinn Ingi Steinþórsson, which started operations in June 2021. It seems to be pursuing the same network strategy, and started transatlantic connections in April this year.

A very interesting new player in this segment is JetBlue. It took advantage of the Covid-19 crisis to gain access to slots at Heathrow and Gatwick during 2021 and start its long awaited transatlantic services operating A321LRneos featuring its MINT premium product. It has the advantage of being based In New York, the prime US gateway on the Atlantic with a strong network of routes domestically in the North East of the country to be able to feed routes out of both its home city and Boston. It has the experience of successfully (and profitably) disrupting the erstwhile cosy transcontinental markets between west and east coast (while halving fares on the routes). It is operating with efficient, new, and relatively small aircraft. And it may be able to afford to treat the Atlantic as an experiment.

Demand outstrips supply

The US major airlines were all fairly optimistic as they reported their third quarter results. The Atlantic is an important market for them: in normal times it could provide 18-20% of their total route operating profits.

American boasted that it had achieved the highest ever level of quarterly revenues in its corporate history. On the Atlantic, its passenger revenues were 19% higher than it recorded in the same period in 2019. While not specifically referring to the Atlantic, it did highlight that on its long haul international operations



SourceL DoT Form 41. Note: rolling 12 month average

unit revenues were 25% higher than Q3 2019 with capacity down by 26%.

Delta also was proud of its record quarterly revenues, with overall capacity 83% restored to pre-pandemic levels. Overall international passenger revenues were 3% below 2019 levels, mainly because of performance on the Pacific (revenues down by half), but international unit revenue growth outpaced that on domestic routes for the first time since the pandemic.

On the Atlantic, passenger revenues were 12% up compared with Q3 2019 on capacity 11% lower. CEO Ed Bastian mentioned that the main strength of demand was to leisure destinations in Italy, Spain and Greece. The strength in demand can partially be attributed to the strength of the dollar (up on average by 10-15% against the Euro and Sterling) but, Intriguingly, Delta's Glen Hauenstein said that "foreign yields are more than offsetting the foreign exchange impact". What he possibly means is: such is a level of pent-up demand from Europe to the US that is overcoming the increased destination cost caused by currency movements.

Delta mentioned that from October it expected to be flying more on the Atlantic than it had three years ago, making it the first of their route areas to exceed 2019 capacity levels.

United in contrast had more than restored capacity on services to Europe, with a 14% increase in available seat miles in the quarter compared with 2019 and a 90% load factor. Unit revenues were also up by an astonishing 23% and total passenger revenues on the route 40% higher. Total Atlantic operating revenues were 50% higher.

On the other side of the pond the airlines tend not to report on a comparable geographic basis. In its quarterly results IAG specifically mentioned that long haul yields at British Airways, usually the strongest airline performer on the Atlantic but heavily dependent on premium traffic, were up by 24% in comparison with 2019 while North Atlantic capacity was only 13% down. And that was in spite of capacity limits imposed by London's Heathrow airport because of their staffing shortages.

Air France-KLM actually increased capacity on the North Atlantic — up by 4% against pre-pandemic levels — and achieved a 25% boost to average yields. They too had significant disruption and capacity constraints at Amsterdam's Schiphol airport.

Lufthansa Group, more dependent on transfer traffic through its main hubs in Frankfurt, Munich and Zürich still had capacity to the Americas 20% below 2019 levels but saw unit revenues up by 20%.

The increases in unit revenues are high, but even without the surge in oil prices this year, underlying unit cost comparisons with Q3 2019 are also high — for example United reported unit costs up 28% up on Q3 2019 and unit costs excluding fuel up 15%. There is some way to go before profitability can be restored.

The chart above shows the historic development of US Airlines' operating margins by geographical route area (on a rolling twelve-month basis).

This understates the recovery in fortunes: for Q2 2022, the latest data available from the DoT, domestic margins may have touched 10%, while it looks as if the Atlantic produced its first (albeit small) profit since 2019.

What shows is that it is not just capacity and traffic that is returning to "normal" on the Atlantic. Fares are higher and profitability has returned.

Korean Air: Rescued by Cargo, Rescuing Asiana

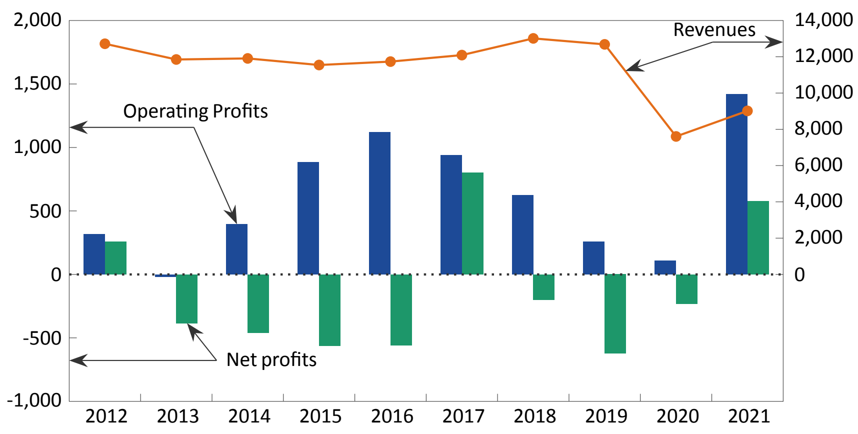
The COVID-19 pandemic has turned out to be an existential crisis for many airlines round the world. But for Korean Air, the flag-carrier of South Korea, it seems to have generated interesting opportunities.

Korean's revenues dipped by 40% in 2020, the first year of lock-downs and border closures, but it was able to report a small operating profit, and a reduction in net losses compared with the previous year. But in 2021, the second and full year of disruption, revenues grew (by 18%) and it achieved its highest ever level of operating profits of ₩1.4tn (US$1bn) reflecting a margin of nearly 16% on turnover of ₩9tn ($7.9bn).

This financially strong performance has continued into 2022. The company recently published its third quarter estimate of results showing (non-consolidated) revenues up by 65% to ₩3.7tn and, despite a 145% increase in fuel costs, a doubling of operating profits to ₩839bn (a 23% margin).

For the nine month period revenues topped ₩9.8tn, operating profits ₩2.4tn and net income came in at ₩1.4tn — a net margin of 14.5%.

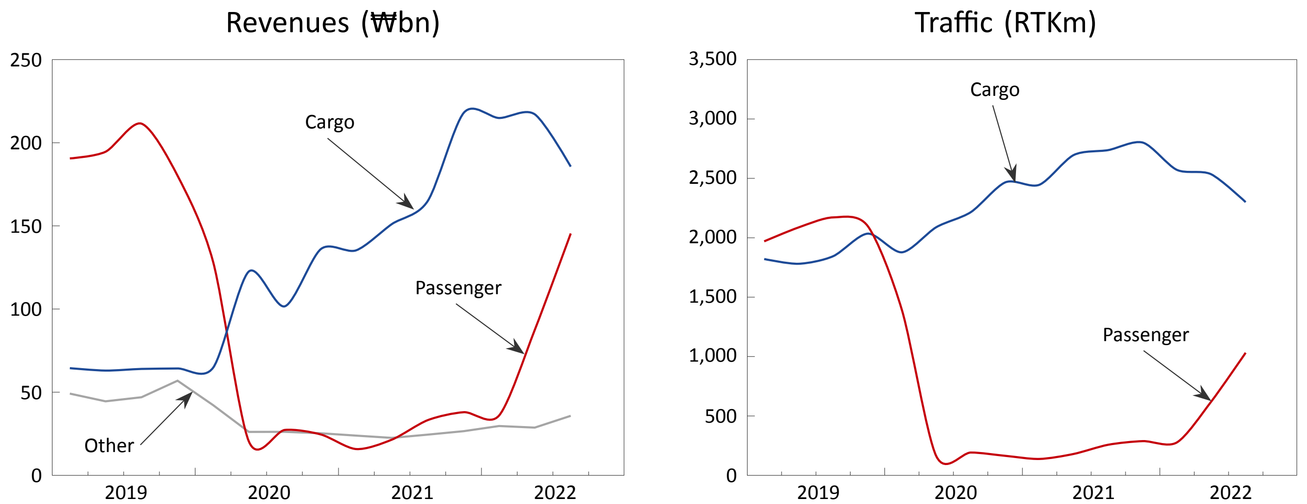
KOREAN AIR LINES FINANCIAL DATA (₩bn)



Cargo strength

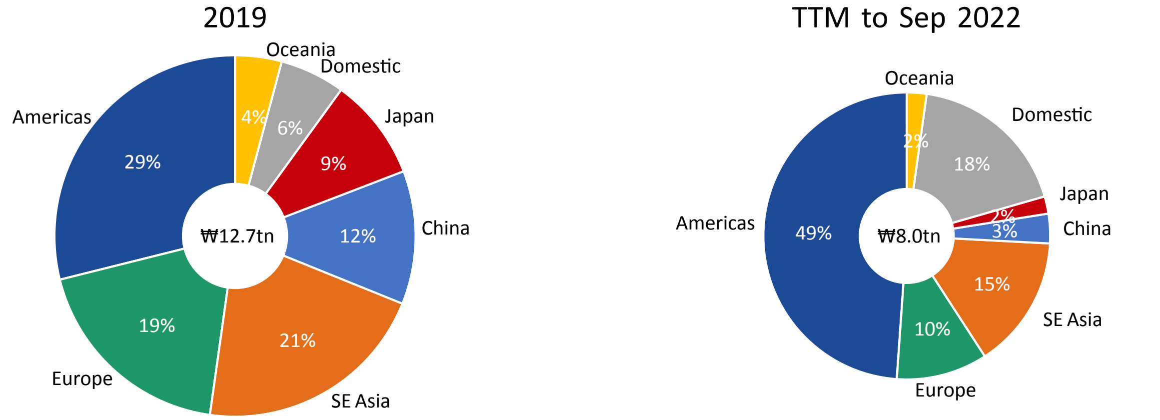
Korean has always had a strong position in air cargo: excluding the package consolidators, Fedex and UPS, it is the world's fourth largest cargo

KOREAN AIR: PERFORMANCE THROUGH THE PANDEMIC



Note: non-consolidated. Source: Company estimates

KOREAN AIR: PAX REVENUES BY ROUTE AREA



airline behind Qatar, Emirates and Cathay in terms of tonne kilometres flown.

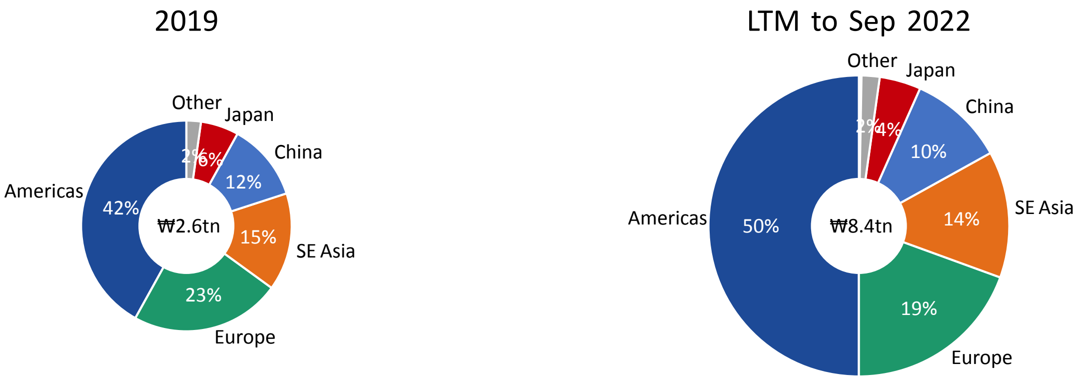
Pre-pandemic, freight operations accounted for roughly half of all tonne-kilometres performed, but only 20% of total revenues.

During most of 2020 and 2021, Korean was only able to achieve passenger volumes at 10% of 2019 levels. But it was able to take advantage of the supply chain problems and the shortage of air cargo capacity arising from the lack of long haul bellyhold capacity. And it even supplemented the use of its 23 strong dedicated freighter fleet with passenger 777s and A330s stripped to be able to accommodate cargo.

Cargo loads grew by 2.5% in 2020 and 17% in 2021, while cargo load factors increased from the "normal" 70% to a peak of 86% in the second quarter of 2021. Cargo yields jumped by 44% in 2020 and a further 16% in 2021, while cargo unit revenues surged by 62% and 21% in the same years. In 2021, Korean's cargo revenues were more than 2.5 times the level achieved in 2019, and accounted for 76% of total revenues.

However, Korean has seen freight demand soften in volume terms since the peak winter 2021 season (see graph on the previous page) and in the third quarter cargo tonne kilometres were 10% lower than prior year levels. Despite this, yields were strong (helped by a near 25% depreciation of the Korean won against the US dollar) and revenues were up by a further 12%. Yields were particularly strong on European routes — the second most important route area for Korean, accounting for a quarter of

KOREAN AIR: FREIGHT REVENUES BY ROUTE AREA



KOREAN AIR FINANCIAL DATA

Year ending Dec 31 (₩bn)	2019	2020	2021	Jan-Sep 2022†	at end	Dec '21†	Sep '22†
Revenues	12,683	7,611	9,017	9,806	Aircraft assets	13,315	12,516
Net result	(622)	(230)	579	1,426	Other fixed assets	6,505	7,940
Operating Cashflow	2,334	1,377	3,514		Cash	3,742	5,443
Net Capex	(1,162)	426	(270)		Other current assets	2,632	2,548
Other Investment flows	(2,013)	(5,976)	(73)				
Free Cashflow	(842)	(4,173)	3,171		Financial debt	(12,111)	(11,963)
Net inc (dec) in debt	336	3,784	(3,031)		Other liabilities	(7,104)	(8,104)
Share Issues	378	1,419	2,554				
Dividends, redemptions	(77)	(758)	(398)				
Total Change in Cash	**(205)**	**271**	**2,296**	**1,700**	**Equity**	**6,978**	**8,380**

Notes: † non-consolidated, company estimates.

freight traffic — and revenues there jumped by 37% year on year thanks to "supply restrictions".

Pent-up passenger demand

While freight volumes have weakened, Korean's passenger traffic has started to strengthen. As Asia's borders started to reopen from the second quarter of 2022, the airline has been able to restore passenger services: by the third quarter it was operating services only 50% below the same period in 2019. Load factors had also recovered to 80% in the six months to end September, compared with a mere 45% load factor in the preceding none months. Yields appear to be 45% higher (and unit revenues 40% higher) than in the corresponding periods in 2019.

The company highlights that it is seeing strong demand in long haul operations — particularly inbound visits from the Americas and Europe because of the weak won — and gradual recovery in mid- and short-haul routes as the Asian border restrictions have been relaxed. SE Asian routes are benefiting from pent-up outbound leisure demand and strong recovery in transit passengers from SE Asia through Seoul to the Americas. Business and leisure traffic on the important routes to Japan, which pre-pandemic accounted for 20% of Korean's international traffic, is bouncing back following the reintroduction of the visa waiver programme that had been suspended in March 2020.

In the last decade China had dominated air traffic growth within the Asian region. Korean had been a strong beneficiary and by 2019 Chinese traffic accounted for 20% of its international demand. It looks as if that segment will remain closed to all but essential travel for some time to come as long as the PRC maintains its zero-Covid policy.

Asiana take-over

At the beginning of 2021 Korean Air launched South Korea's largest ever rights issue: a ₩3.3tn ($3bn) offering, doubling the number of shares in issue.

This was not just to shore up liquidity — as had been its ₩1tn issue in July 2022, or other airline equity issuances elsewhere in the world at the time — but to provide the finances for a ₩1.8tn acquisition of a 68% stake in Asiana Airlines, South Korea's second largest airline.

Formed in 1988 by the Kumho Asiana chaebol specifically to upset Korean Air's then monopoly, Asiana Airlines (including its low cost subsidiaries Air Busan and Air Seoul) had grownby 2019to account for 34% of the domestic market and 23% of the international. This compares with Korean Air Group's market shares (including its LCC subsidiary Jin Air) of 33% and 30% respectively.

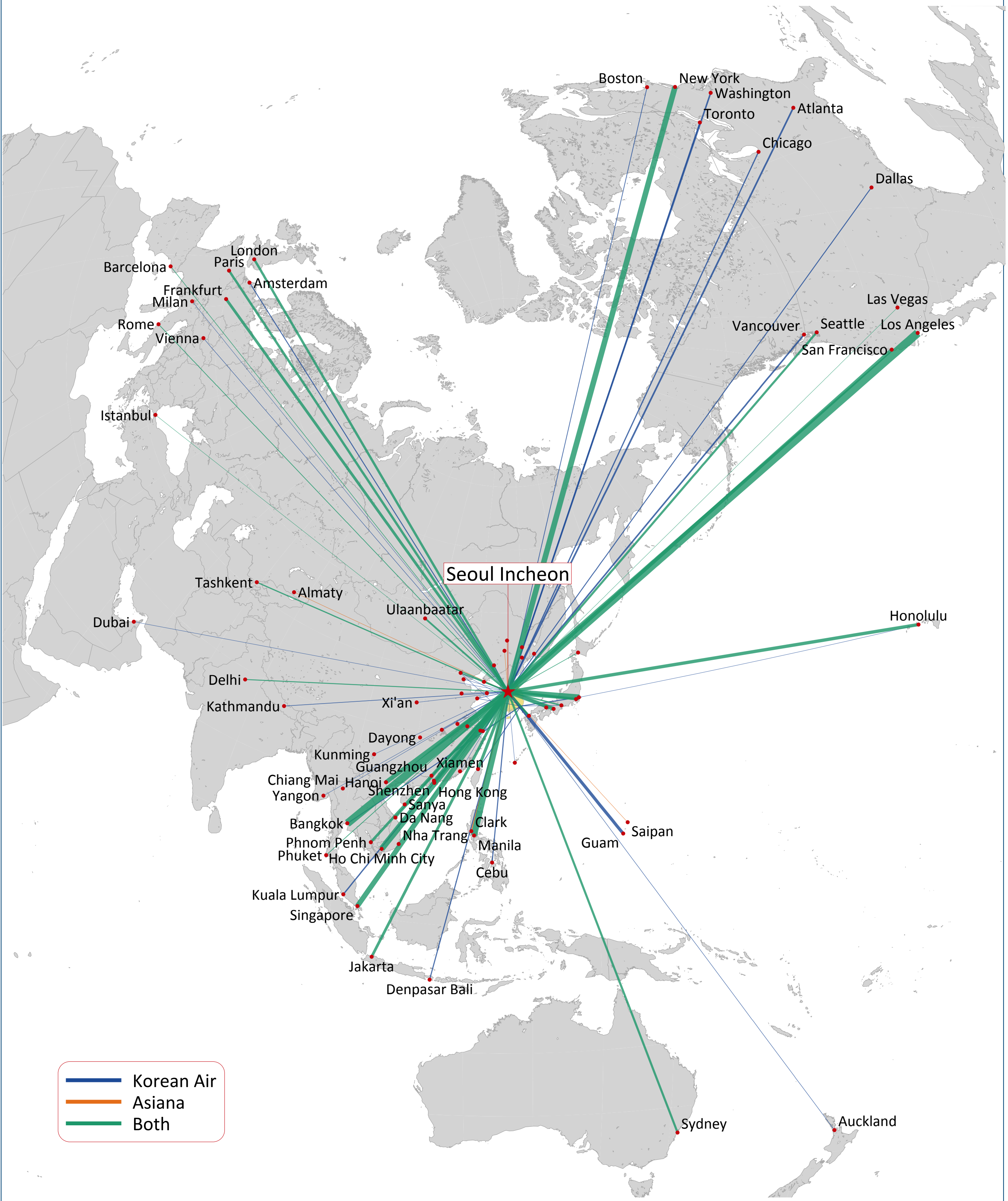
With a fleet if 80 aircraft, and revenues (in 2019) of ₩6.9tn Asiana is around half the size of its bigger rival. It has not been particularly profitable: in the five years before the pandemic struck it achieved an average operating margin of 0.5% and registered total net losses of ₩860bn.

There is significant overlap in operations. The two carriers competed directly on 68 routes — out of Korean's total 148 routes (pre-pandemic) and Asiana's 97.

There are significant differences. Asiana is a member of the Star Alliance; Korean, with immunised JVs with Delta and Air France, is a founding member of the SkyTeam alliance.

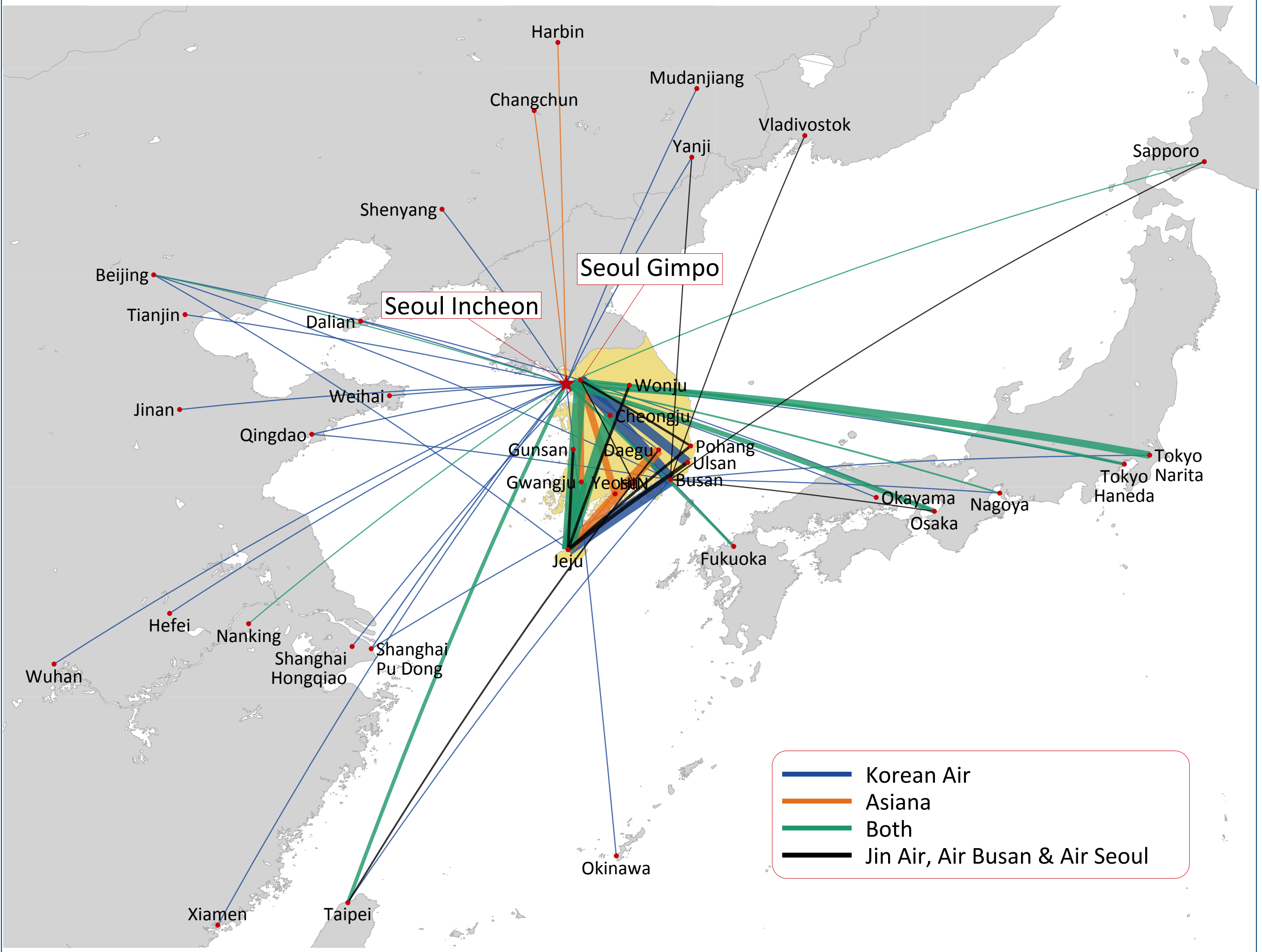
Integration of the two will be a challenging exercise. They both have

KOREAN AND ASIANA LONG-HAUL NETWORKS

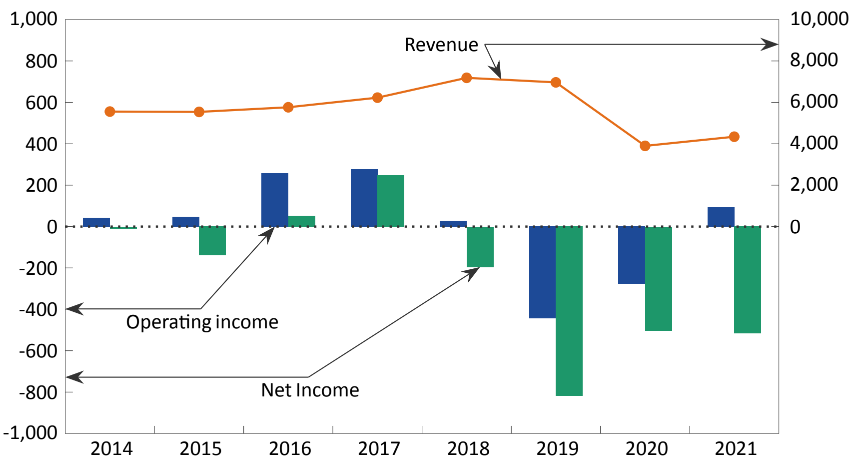


Notes: Equidistant map projection based on Seoul (great circle routes appear as straight lines. Thickness of lines relate to seat capacity

KOREAN AND ASIANA DOMESTIC AND SHORT-HAUL NETWORKS



ASIANA AIRLINES FINANCIAL DATA (₩bn)



A380s, A330s and 777s (see table below). But for its narrowbody fleet Asiana has gone for the Airbus A320 family while Korean is a Boeing 737 operator (although it does have 30 A321neos on order, the first of which is due for delivery this year). Korean plumped for the 747-8i and 787s (with 20 on order); Asiana the A350 (10 in service with another 17 on order). Korean's CEO, Walter Cho suggests, perhaps optimistically, that it will take two years to integrate the two full service carriers.

Then there is the question of the three LCC subsidiaries. Korean's Jin Air (which in June 2022 was transferred back to Korean Air from parent Hanjin KAL) is firmly in the Boeing camp with 22 737s (including one MAX-8) and four 777s; while Asiana's 42%-owned (and separately quoted) Air Busan and the 100% owned Air Seoul owe allegiance to Toulouse with 22 and six A320 family aircraft respectively. There are suggestions that the three may be subsumed under the single Jin Air brand. Cho accepts the difficulty: "if we merge together we will have four different aircraft with five different engines".

Asiana Airlines had already been put up for sale in mid 2019 as its parent Kumho Asiana encountered a liquidity crisis (before that became fashionable during the pandemic). An agreed sale to Hyundai was pulled, possibly under pressure from the Korean Development Bank, and in November 2020 Korean Air announced its intention to buy the group (with ₩800bn support from the KDB to its chaebol holding company Hanjin KAL in order to maintain its position as holding company).

At the time Korean Air stated: "the main reason behind the decision to acquire Asiana Airlines... is to stabilise the Korean aviation industry, which is suffering from the COVID-19 pandemic. Considering that Korean Air's financial status could also be endangered if the COVID-19 situation is prolonged, it is inevitable to restructure the domestic aviation market to enhance its competitiveness and minimize the injection of public funds."

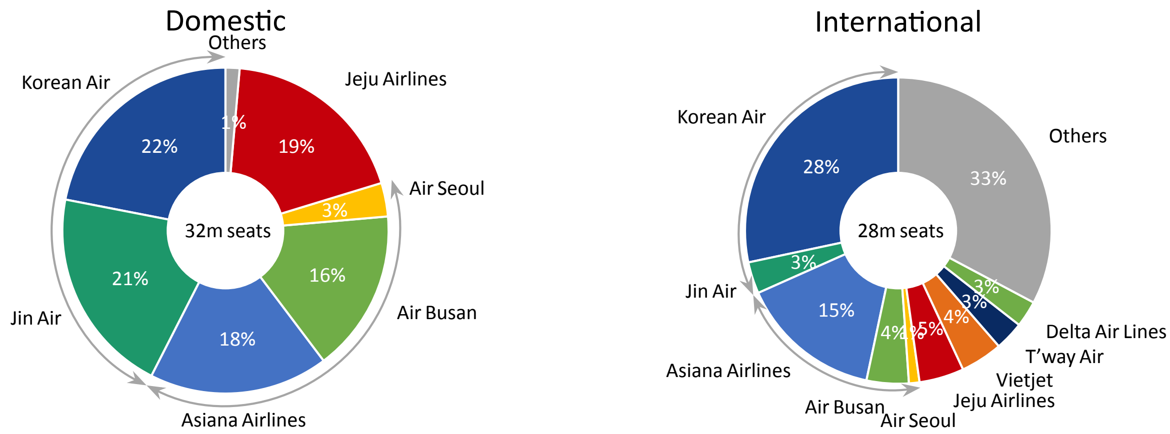
Obtaining approval from the various competition authorities has

FLEET PROFILES

	Korean Air Lines				Asiana			
	Current	*parked*	△ 2019	orders	Current	*parked*	△ 2019	orders
A380	10	*6*	–		6	*2*	–	
A330	30	*7*	+1		13	*1*	-2	
A350					10		–	17
747-400			-2		1		–	
747-8i	9	*2*	-1					
767					5		-1	
777	40	*10*	-4		9		–	
787-9	10		–	20				
737NG	18		-13					
737MAX-8	5		+5	24				
A320ceo					1		-6	
A321ceo					14		-4	
A321neo			–	30	5		+4	20
A220	10	*1*	–					
Passenger fleet	**132**	***26***	**-14**	**74**	**64**	***3***	**-9**	**37**
747F	4		–		10		-1	
747-8F	7		–					
767F					1		–	
777F	12		–					
A330F					2		+2	
A350F					3		+3	
Freighter fleet	**23**		**–**		**16**		**+4**	
Total fleet	**155**	***26***	**-14**		**80**	***3***	**-5**	

Notes: excludes low cost subsidiaries Jin Air (Korean Air), Air Busan, Air Seoul (Asiana)

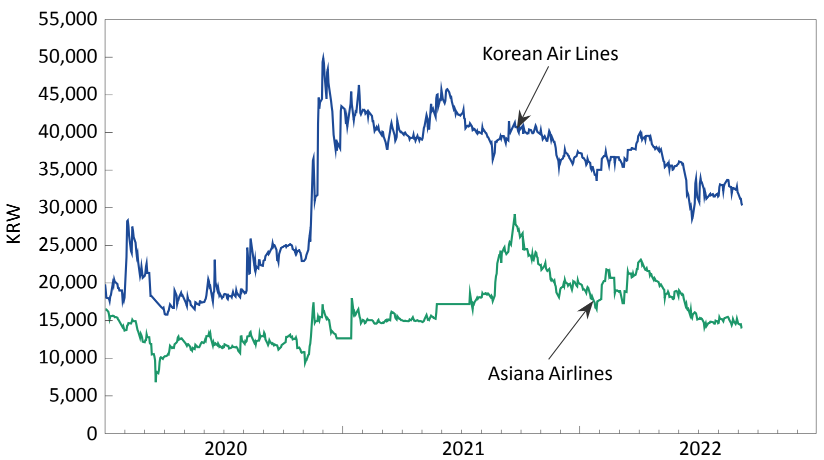
SOUTH KOREA – COMPETITIVE POSITIONS 2022



taken time. Even the home-based Korea Fair Trade Commission (KFTC) took more than a year, but in January 2022 approved the deal. It attached some conditions: to hand over slots and traffic rights for 26 international and 14 domestic routes in the next 10 years if a newly competing airline requests them; and, "until competing airlines seek slots and traffic rights, to limit fare increases, refrain from reducing supply and make sure that service quality does not deteriorate until new market entry". Strong stuff!

Outside Korea, the merger has been approved by Turkey, Vietnam, Taiwan and Australia, but the group is still waiting for approval from the more important US, UK and EU competition authorities. In the meantime the acquisition and integration is on hold. But the airline group is sitting on a useful $4bn of cash at a time when traffic is recovering, and in the knowledge that when the deal is finally approved it will be in a much stronger position.

SHARE PRICE PERFORMANCE



Wizz Air: Where now for its bold plan?

AT THE beginning of the pandemic we observed that Wizz Air had a bold plan: it would pursue growth aggressively, build its A321neo fleet rapidly and enter new markets where the incumbents were weak. It looked as if this could be a successful, that Wizz Air would emerge as a triumphant disruptor (see *Aviation Strategy*, May 2020), But when it published its Q1 results Fy2023 (April-June 2022), the picture had changed for the worse.

Wizz Air was directly exposed to the repercussions from Putin's invasion of Ukraine. Demand in central and Eastern Europe (CEE) Europe, Wizz Air's home market, fell sharply, pushing RASK down by about 10% compared to pre-pandemic operations. In 2021 Wizz Air management made a decision to go to a policy of no hedging on fuel and currency, because it had lost out on its previous hedging positions. This proved disastrous when fuel prices surged and the euro weakened against the dollar. CASK rose about 40% compared to pre-pandemic.

In hindsight, no hedging looks reckless, but it should be remembered that in the past airlines like Ryanair and Southwest have taken major hits as the result of oil prices declining and exposing fully hedged positions. Wizz Air resumed hedging this summer using collar and cap derivatives — $982-$1130, compared to IATA's estimate of the current spot price of $1140, but a concern is that Wizz Air has restarted fuel hedging at what may be the high point in the present oil price cycle.

The fall-out from the Ukrainian war and no hedging for Wizz Air was a net loss in Q1 (April-June) of €452m, 56% of revenues, albeit that €140m of this was a non-cash foreign exchange loss on capitalised leases. So it appeared that Wizz Air had gone from being a genuine ULCC threat to Ryanair to being another financially troubled airline.

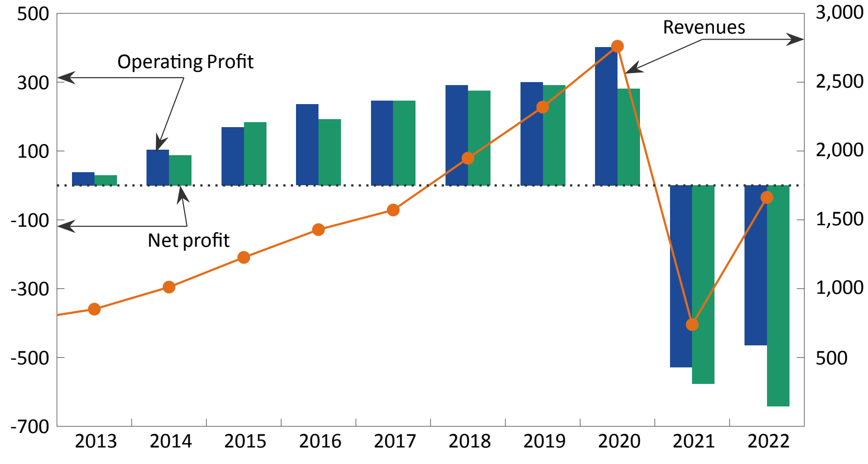
However, Wizz Air has a very experienced CEO in József Váradi and is now supported by Robert Carey who has the title of President and is in charge of the network, revenue, ancillaries, digital and marketing teams. Mr Carey joined the airline in June 2021, after three years as CCO at easyJet and before that was a partner at McKinsey's airline practice, where he no doubt gained experience of aggressive expansion strategies.

The carrier at least partly recovered the situation in the summer in that the reported loss for H1 was €384m, of which €285m was classified as unrealised forex losses. Passengers carried more than doubled to 26.5m compared to 2021, RASK was up 32% to €c4.48, partly reflecting increased fuel prices, and ex-fuel CASK was reduced by 5% to €c2.62.

Wizz Air divides the equity analysts, with target prices for its shares, which are quoted on the LSE and stood at around £20.9 at the end of October, ranging from £12.5 to £50.0. Or, in terms of market capitalisation, from today's value of £2.15bn (€2.4bn) the airline could potentially be worth anywhere between £1.3bn and £5.1bn.

The bearish view focuses on Wizz Air's balance sheet which at the end of September showed a negative net asset value of -€260m, a figure that is likely to have risen to around -€500m by the end of the current FY2023. With €4.7bn of long-term debt and lease liabilities on the balance sheet

WIZZ AIR: FINANCIAL RESULTS (€m)



Note: YE March

WIZZAIR HOLDINGS FINANCIALS (€ billions)

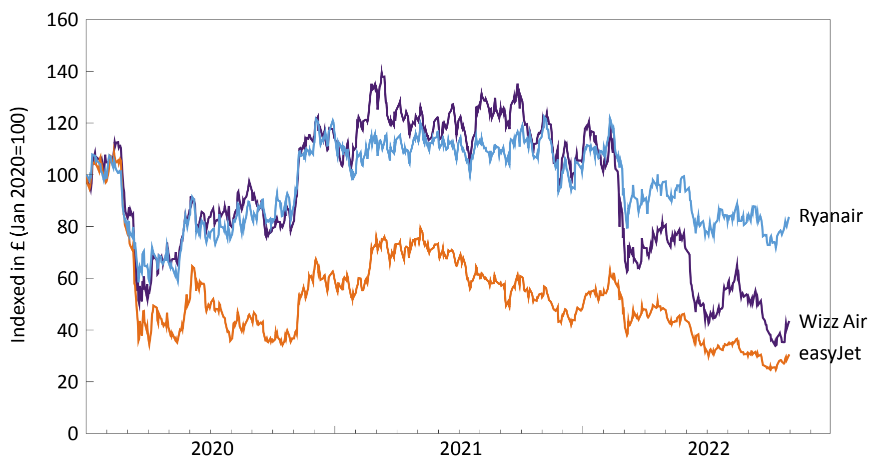
Year ending March 31	2019	2020	2021	2022	2023 H1
Revenues	2.32	2.76	0.74	1.66	1.18
Net result	0.13	0.28	(0.58)	(0.64)	(0.38)
Operating Cashflow	0.74	0.77	(0.22)	(0.07)	0.47
Capex & Acquisitions	(0.20)	(0.45)	(0.25)	0.34	(0.09)
Other Investment Income (Expenditure)	0.14	(0.23)	0.10	(0.28)	0.27
Free Cashflow	0.68	0.09	(0.37)	(0.01)	0.65
Net increase (decrease) in debt	(0.34)	(0.10)	0.62	(0.32)	(0.24)
Share Issues	–	–	–	–	–
Dividends & Share buy-backs	–	–	–	–	–
Total Change in Cash	0.34	(0.01)	0.25	(0.33)	0.41

at end	Sep-22
Fleet assets (inc lease rights)	4.47
Intangibles	0.08
Cash and short term deposits	*1.57*
Other current assets	0.36
Total Assets	**6.48**
Long term debt	4.58
Other long-term liabilities	0.10
Other current liabilities	2.06
Total Liabilities	**6.74**
Shareholders' Equity	**(0.26)**

plus a heavy fleet delivery schedule, investors have shown some concern over Wizz Air having to raise fresh capital through an equity rights issue or a bond placement at a high interest rate.

Wizz Air management at the H1 results presentation vigorously refuted the possibility of a rights issue: they could restore the balance sheet through post-pandemic profits. Moreover, liquidity was strong — €1.6bn in cash and near-cash at the end of September — and operating cashflow was positive — €470m in the first half of FY 2023 (see table above). The company is one of the few airlines to enjoy an investment grade credit rating, affirmed earlier this year by Fitch, which a rights issue might jeopardise. And it could use the delivery programme as a source of cash (presumably because the total PDPs, which are calculated on the list price of new aircraft, would be in surplus when the airline took delivery at the discounted unit price Indigo Partners had been able to negotiate).

LCC SHARE PRICE PERFORMANCE



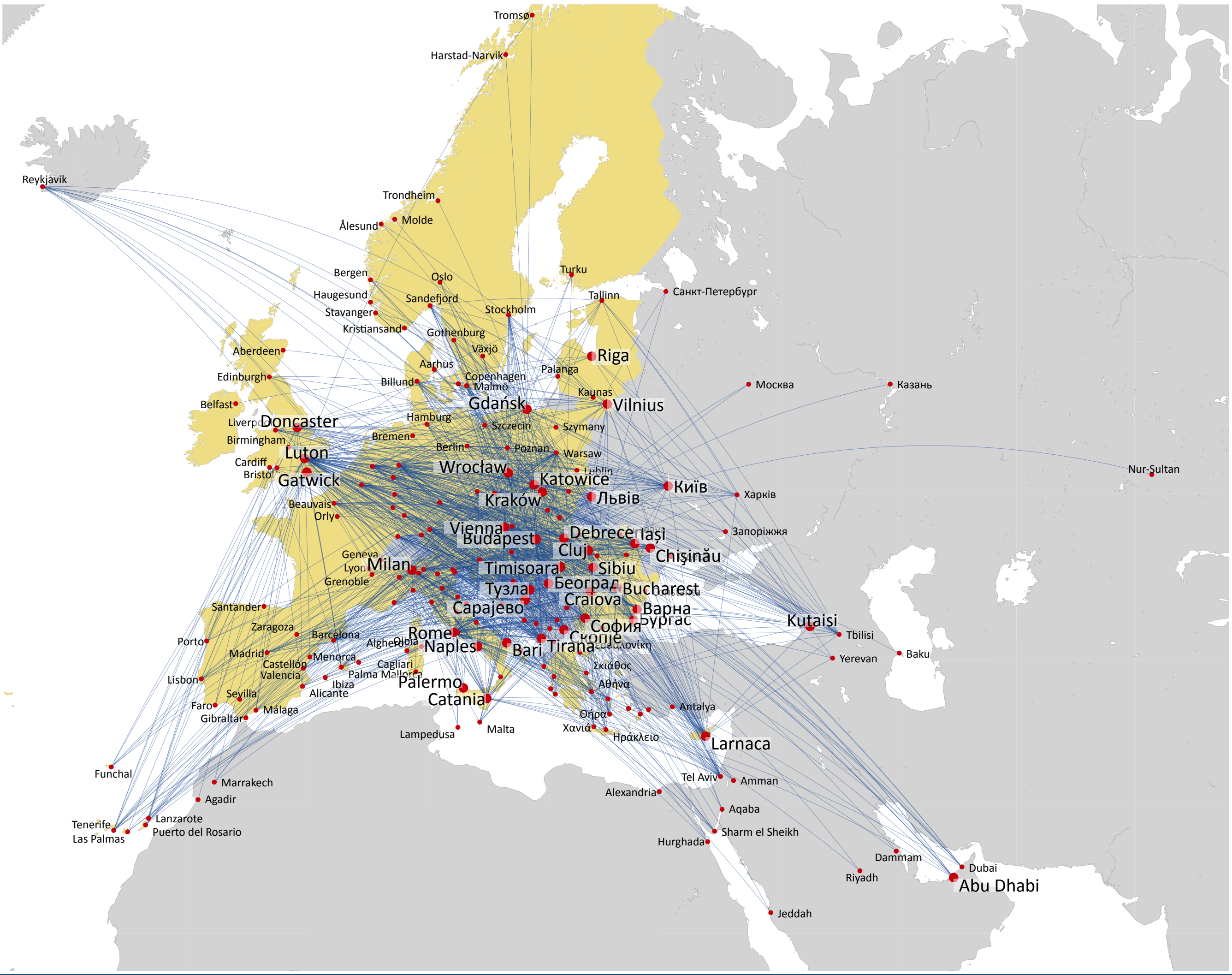
The virtuous growth story

Wizz Air is all about growth. Building on the mega-order placed by Indigo Partners in 2017, Wizz Air this year exercised options of 75 A321neos for delivery in 2028-29 as part of its plan to be a 500 aircraft company by 2030 (for comparison its fleet at the end of this year will be 173 A320 family air-craft while Ryanair currently operates 483 737s). Of the 304 firm orders 257 are A321 neos and 47 are for the XLR version.

With 239-seat A321neos re-placing 180-seat A320ceos seat capacity will triple between 2023 and 2030 with an expected increase in passengers from 2019's 40m to around 200m, which was Ryanair's pre-pandemic target for 2025.

Wizz Air contends that the stream of new neos will continuously im-prove its unit costs. through the A321 neo's fuel efficiency (16% better than the ceo) and through the increase in seats (59 more than the ceo). In terms of CASK Wizz Air currently estimates that it is a little below Ryanair; Ryanair measures compet-itiveness on ex-fuel operating costs per passenger and states that it is

WIZZAIR ROUTE MAP

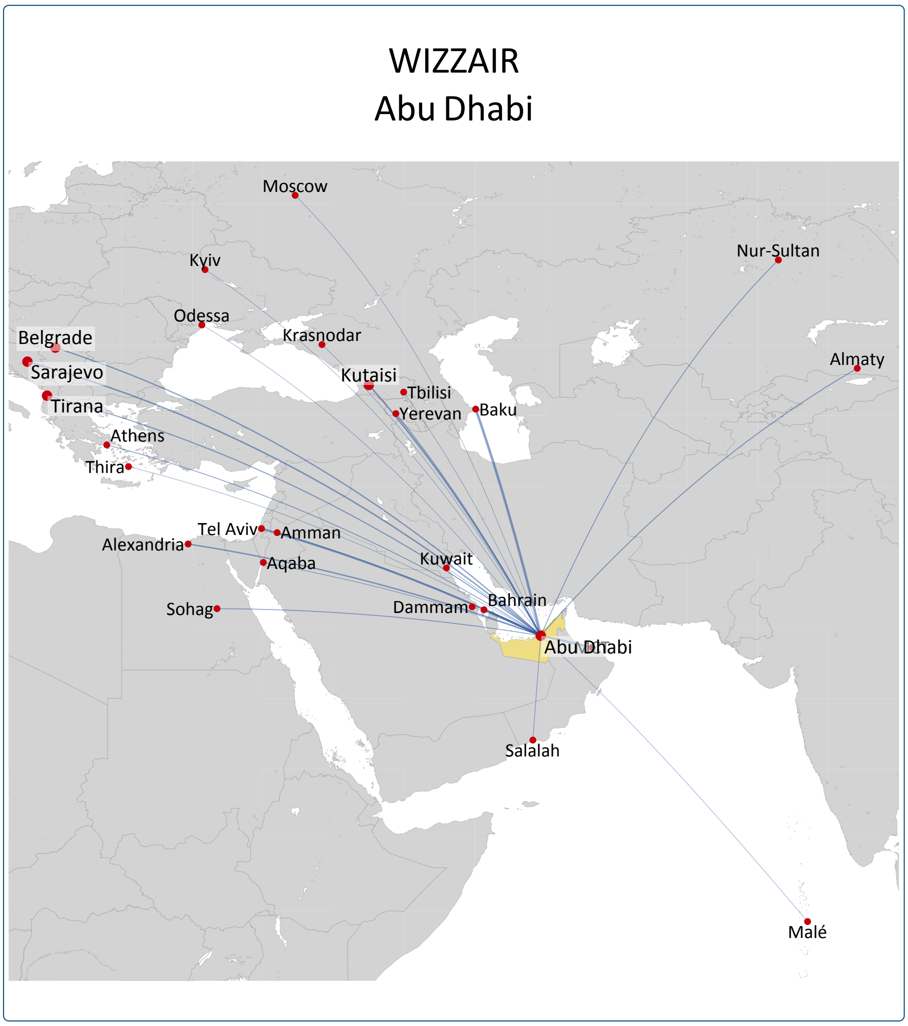


30% below Wizz Air. Such is Wizz Air's confidence in its growth that it has complained strongly about Airbus's delays in delivering nine scheduled aircraft this year; given the scale of its losses the reduced deliveries might have been regarded as a relief.

The success of the growth strategy depends on Wizz Air getting on a virtuous circle: increased capacity, increased cost competitiveness, increased penetration into and stimulation of new markets, exploiting the fact that it has a guaranteed stream of new capacity whereas its biggest rival, Ryanair, has a potential orderbook problem (*Aviation Strategy*, August 2022). However, there are two issues.

The first goes back to the negative equity: can Wizz Air implement such an ambitious strategy with an apparently weak balance sheet? The capitalisation issue goes beyond liquidity. In Western Europe Wizz Air will be increasingly competing against very well capitalised competitors in Ryanair and easyJet and the state-supported Legacies.

If or when things go wrong will it be able to find additional finance at competitive terms? Wizz Air's position is further complicated by the fact that its fleet is not owned, having been financed through sale and leasebacks, which have also generated working capital for the airline as the sale price from the lessor has generally been higher than the discounted purchase price from Airbus. Wizz Air is starting to rebalance its fleet financing through the use of instruments like JOLCOs (Japanese operating leases with a purchase option) but this is relatively small scale as yet.



The limits to opportunism

The second issue relates to Wizz Air's network expansion into new markets in Western Europe and the Middle East.

Wizz Air divides its fleet into two segments to implement its strategy of what it describes as "choiceful expansion" :

✈ The core fleet which is deployed in the established markets, mostly Central and Eastern Europe but also UK regional, which totalled 99 units at the end of October, just 4 aircraft more than in 2019.

✈ The expansion fleet which accounted for 50 units in October, 39 units up from 2019. Approximately 15 of these additional aircraft have been deployed (not necessarily based) in the Italian market, 12 in Albania and other Balkan countries, 6 in London Gatwick, 4 in the UAE and 2 in Cyprus.

Wizz Air saw the pandemic as an opportunity to expand opportunistically, picking up slots at London Gatwick, penetrating the Italian market as Alitalia retreated into ITA, and

Note FY end March

replacing defunct carriers like Blue Air in Romania, a 737NG operator which carried over 5m passengers in 2019.

This opportunistic approach, which meant entering new markets with uncertain demand and, in many cases, offering low frequencies, soon found its limits, causing the airline to close some of its new bases in Italy and the Balkans. In an insightful interview with *Simpleflying*, Wizz Air President Robert Carey admitted that it had entered the Italian domestic market with a "fairly typical Wizz-type philosophy … to spread across many different markets and see what would work [but] last winter, there was a pivot towards focusing on a meaningful domestic presence rather than covering as many markets as possible.

"If you've got Ryanair and easyJet flying three times a day, and we're operating four times a week, it just doesn't compute. And so we [reviewed] the whole network last winter and basically said, 'Look, we're going to really focus on the markets where recently which we think can work, let's get meaningful products'. So, a daily or multiple daily product in those markets. And we didn't have more planes to just throw into it."

Putting the blame on Airbus is understandable but not totally convincing. How exactly can it achieve the critical mass in markets dominated by Ryanair and easyJet? Low costs don't necessarily solve the problem, and Wizz Air seems already to have switched from a Ryanair-type yield-neutral management system to one that attempts to maximise revenue rather than load factor.

Arabian dreams

Longer term, the plan is to divide its ultimate 500-unit fleet as follows: 250 in its CEE home market, 125 in Western Europe and 125 in the Middle East.

At present only the equivalent of four or five aircraft are allocated to Wizz Air Abu Dhabi. Wizz Air's joint venture with the Abu Dhabi Developmental Holding Company (ADQ) was set up in 2020, and now flies to the Middle East (including Israel), Eastern Europe and Central Asia. The logic is a market of five billion within an 8-hour radius of Abu Dhabi and counter-seasonality — UAE travel tends to peak in the winter season. The potential is a fleet of 50-100 aircraft according to József Váradi. The reality is the politics of Middle Eastern aviation.

For example, this summer Wizz Air Abu Dhabi seemed to have found a golden route — Abu Dhabi-Moscow — one of the few gateways for Russians escaping Western embargos. Inevitably, there was an outcry in Europe and the service was cancelled, leaving Air Arabia Abu Dhabi — the joint venture between Air Arabia, the very effective Sharjah-based LCC, and Etihad — to take up the route with a daily service.

Now Wizz Air's great expectation is a similar joint venture in Saudi Arabia as part of that country's hugely ambitious Vision 2030 strategy (see box). Saudi Arabia looks promising but is full of pitfalls.

Overall, the growth strategy may well still work out but success may also depend on structural changes — ie, mergers and acquisitions — in the European industry.

SAUDI VISION 2030

At the World Travel Market, the tourism industry's biggest exhibition, held recently in London, the highest profile stand and the most expansive marketing was for a new holiday destination - Saudi Arabia. Perhaps a surprising choice for traditional vacationers.

However, this promotion is all part of Saudi Vision 2030, initiated by Saudi Arabia's de facto ruler, Crown Prince Mohammed bin Salman (MBS). It includes:

- ✈ The Saudi Air Connectivity Program (ACP), established in 2021 to support tourism growth in Saudi Arabia – target 100m tourists - by forming joint ventures with foreign airlines to enhance connectivity and develop destinations. Wizz Air is an early participant.
- ✈ A plan to rapidly build global hub infrastructure with the explicit aim ifor Saudi Arabia to transport 330m passengers, to/from more than 250 destinations, plus 4.5m tons of cargo, by 2030 - a $100bn-plus project — which would at least double Middle East connecting capacity.
- ✈ A new international airline operating alongside Saudi Arabian Airlines.
- ✈ Various related giga-projects: a $500bn investment in an all-new eco-city named Neom; a $10bn investment in an entertainment project called Qiddiyah; and a Red Sea project featuring 90 new islands.

Aviation Strategy will look at the Saudi aviation scene in the next issue.

What about IAG/easyJet?

IN THE previous issue we speculated about the rationale for a Ryanair/Wizz merger. Since then, absolutely nothing has developed on that front, but media attention has focused on IAG/easyJet. The source of the rumours was an interview with IAG's CEO Luis Gallego in the *Sunday Times* where he hinted at expanding the IAG airline portfolio and didn't deny interest in easyJet (or TAP for that matter).

There are a number of strategic and/or expedient reasons for taking IAG/easyJet seriously:

✈ The economic outlook for the UK is very uncertain. This year saw a welcome resurgence in demand post-pandemic, but this may not continue in 2023 and beyond, as inflation and interest rates soar, and the UK government seems determined to talk itself into a recession. In such circumstances a merger might be a good defensive move.

✈ Refinancing during the pandemic has left airlines with comparatively high levels of liquidity. As at mid-year IAG had €9.2bn in cash and €13.5bn in broader liquidity; easyJet had €3.0bn in cash.

✈ An easyJet merger might finally solve BA's perennial problem at Gatwick where it has consistently lost money.

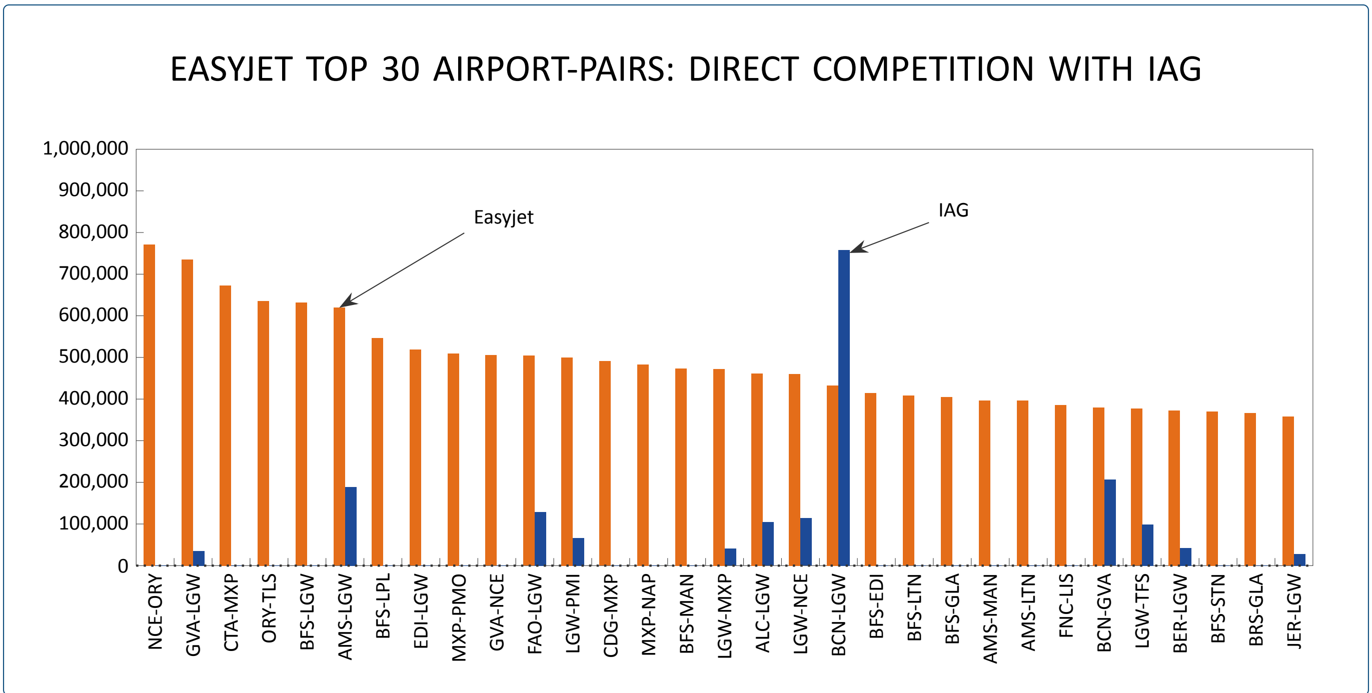
✈ easyJet could be used to restructure BA's intra-European feed network to Heathrow, leaving BA to concentrate on its profitable long-haul network.

✈ Stelios Haji Ioannou no longer has an active interest in the airline he founded, having reduced the shares he controls to 15%, though this is still a significant stake, but it is a reasonable guess that he is not happy about the 40% decline in easyJet's share price this year (compared to a 20% fall in IAG's value).

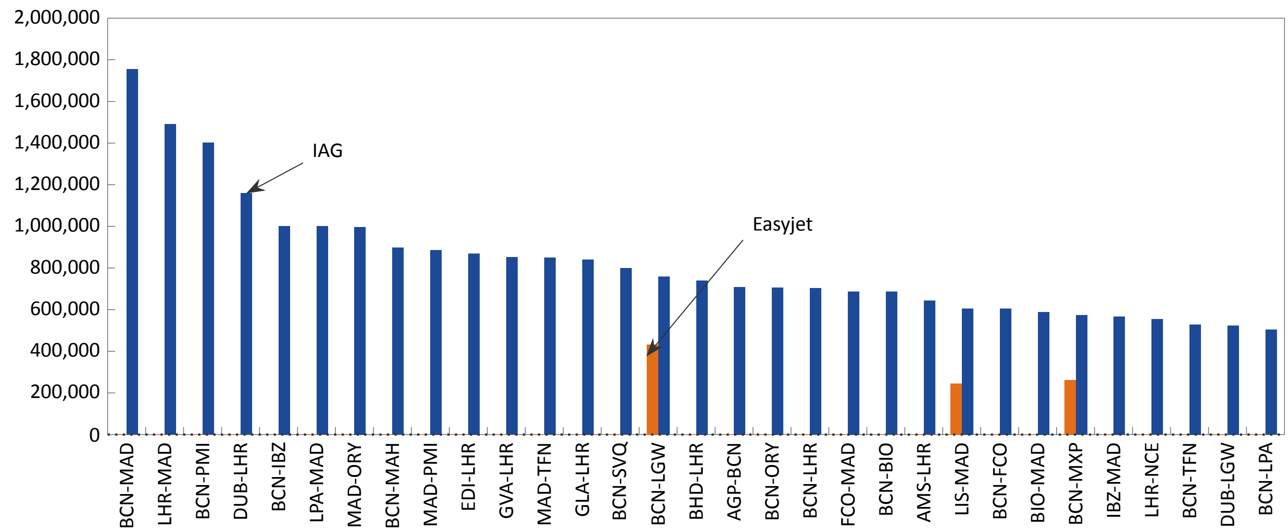
✈ The easyJet brand could in theory be smoothly incorporated into the IAG ownership structure alongside BA, Iberia, Aer Lingus and Vueling.

However, BA and easyJet are the UK's two biggest airlines, both with bases at Gatwick, so there would be major anticompetitive issues to address. (There is a precedent for BA taking over the second largest British carrier — BCal, way back in 1987.)

The solution might be found in these two charts. If it can be argued that competition primarily takes place on an airport-pair rather than a city-pair basis — that Heathrow is a distinct market from Gatwick or Luton — then it is possible to refute the anticompetitive claims.



IAG TOP 30 EUROPEAN AIRPORT PAIRS: COMPETITION WITH EASYJET



On an airport-pair comparison there is only an approximate 12% overlap in seat capacity between the two airlines. Looking at IAG's top 30 intra-European routes only three are in direct competition with easyJet, the most important by far being Barcelona-Gatwick where Vueling and easyJet collide. For easyJet, IAG airlines compete on 12 of its top 30 airport-pairs; Vueling is generally easyJet's major rival, though BA does directly compete on Amsterdam-Gatwick and Faro-Gatwick.

EASYJET BALANCE SHEET

£bn	Mar-22
Fleet assets (inc lease rights)	4.68
Intangibles	0.57
Cash and short term deposits	*3.5*
Other current assets	1.58
Total Assets	**10.33**
Long term debt	3.46
Other long-term liabilities	0.46
Other current liabilities	3.97
Total Liabilities	**7.89**
Shareholders' Equity	**2.44**

IAG BALANCE SHEET

€bn	Jun-22
PP&E	18.16
Intangibles	3.29
Other fixed assets	4.24
Cash and short term deposits	*9.19*
Other current assets	4.95
Total Assets	**39.83**
Long term debt	17.67
Other long-term liabilities	3.35
Current liabilities	17.02
Total Liabilities	**38.04**
Shareholders' Equity	**1.80**

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