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IATA Forecast: Conundrums

IATA ENTITLED, a little enigmatically, its half-year outlook, “Highly Resilient, Less Robust”. The resilience refers to the traffic recovery from the pandemic.

The recovery has been led by North America with traffic in that region expected to attain 2019 levels this year; this may now be on this pessimistic side with A4A estimating summer volumes to have reached record levels, A similar performance is expected for the Latin American and Caribbean region. Asia/Pacific has been the slowest to recover, the result of the rigorous international restrictions that were put in place. Europe will be very close to 2019 levels this year.

2024 is now the year of full recovery for all the six regions monitored by IATA. The global total is forecast to be 6% above 2019, increasing to 18% above in 2025.

There are lots of short-term risks: the slowness of China’s recovery and the fragility of some major economies in the new persistent inflation/high interest rate environment. There may also be, it has to be said, some new nasty variant of Covid lurking somewhere. This presumably is where there is lack of robustness of the industry.

IATA has decided that the long-term outlook for the industry is unchanged. The global traffic volume is predicted to grow by 3.4% pa, which will double passengers carried from 4 billion in 2019 to 8bn in 2040. IATA comments, “the uncertainty around climate change and the costs associated with the net zero transition raise major concerns around the outlook”.

Among climate change activists the forecast raises apoplexy.

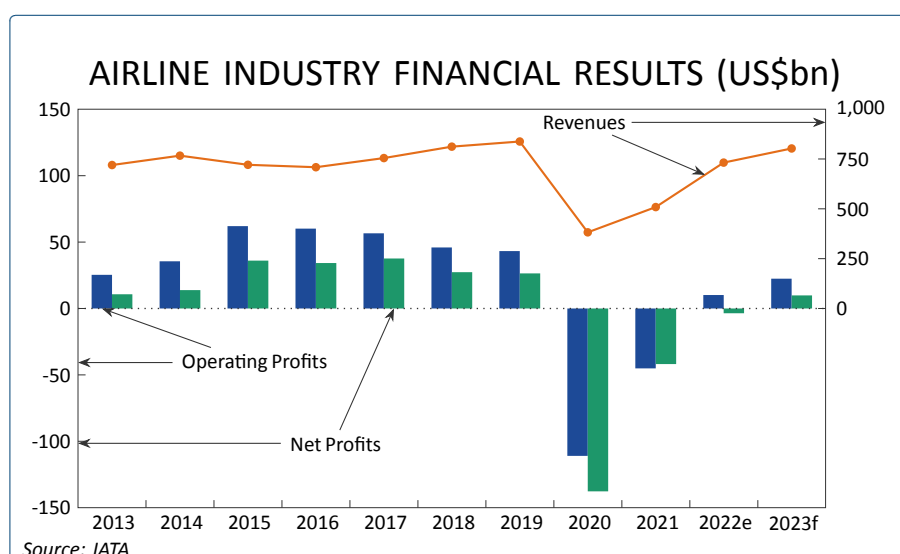
It is perhaps a little strange the high case offered by IATA refers to a “a quicker return to pre-coronavirus trends” and the low case to “macro-economic conditions inflicting lasting damage”. The most relevant scenario is surely one where traffic growth has to be severely suppressed in order to achieve net zero, given the deep problems with alternative solutions, for example, Sustainable Aviation Fuel (see *Aviation Strategy*, June 2023).

IATA expects the global industry to return to profitability next year, a remarkable outcome after the huge loss of nearly \$120bn in 2020 followed by \$42bn in 2021. 2022 is estimated as a loss of \$3.6bn, while 2024, according to IATA, will see a profit level of \$9.8bn.

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IATA has reproduced its regular chart comparing Weighted Average Cost of Capital (WACC) and Return on Invested Capital (ROIC), highlighting the negative gap that has re-emerged between the two financial ratios and commenting: “Historically the air transport industry has struggled to deliver the returns which equity investors expect for risking their capital”. This has been a theme, admonishing the industry for somehow “destroying capital”.



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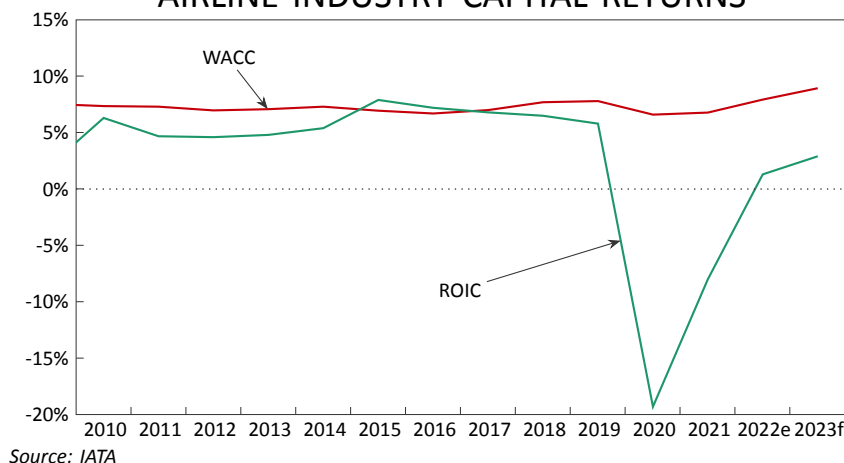
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AIRLINE INDUSTRY CAPITAL RETURNS



The WACC/ROIC comparison is very interesting though not just for the reason given by IATA. Investors invest in individual companies not industries, and at any point some companies are growing while other are declining. For instance, in the periods when new entrant LCCs undermined Legacy airlines, the gap between WACC and ROIC would probably have widened (because the cost of borrowing for incumbents would have increased as their profitability and balance sheets deteriorated while return on investment in the LCCs would not have been fully realised). So a positive structural development for the industry might not be indicated by a global WACC/ROIC comparison, the opposite in fact.

An inter-industry comparison would be fascinating but the reality

is that other industries generally do not have the comprehensive data that aviation has as a result of its regulated past. We suspect that on this measurement many (most?) industries “destroy capital”. Indeed, according to Schumpeter, “creative destruction”, disruptive new technology wrecking incumbents’ profitability, is the critical element in capitalism that drives progress.

It would be also interesting to try to work out whether a WACC/ROIC negative gap is related to increased negotiating power on behalf of labour (something IATA hints at) or changes on the production chain (manufacturers or lessors or airports improving their returns at the expense of airlines, a McKinsey thesis of some years ago).

LONG TERM OUTLOOK

	Recovery year	CAGR (2019 - 2040)	Additional passengers by 2040, millions
Africa	2024	3.4%	155.72
Asia Pacific	2024	4.6%	2,554.41
Europe	2024	2.1%	665.81
Middle East	2024	3.7%	276.03
North America	2023	2.2%	564.98
Latin America & Caribbean	2023	2.9%	313.47
World	2024	3.4%	3,940.80

Sources: IATA Sustainability and Economics, Tourism Economics

IndiGo: An LCC with no limits?

INDIGO is in an enviable situation. The leading Indian airline, operating in the world's fastest growing economy with a strong technological bent (highlighted by the recent lunar landing), IndiGo has an established LCC model, a dominant market share and inherent advantages over the local competition. It is Airbus's most valuable customer having just placed an order for 500 A320XLRs.

IndiGo's roots can be traced back to 2005 when the Indian regulators started to ease their grip on the domestic market and began to understand that protecting Air India was not in the best interests of the country. At that time Rahul Bhatia, head of the InterGlobe tourism, air transport and technology conglomerate, was part of a consortium aiming to launch India's first LCC, using the AOC of a grounded carrier (Royal Airways). The consortium (by the way, advised by members of *Aviation Strategy* who developed a detailed operational and financial plan) succeeded, establishing India's first LCC, SpiceJet, in 2005. But by then Rahul Bhatia had split away with a very similar plan for IndiGo which started up the following year.

IndiGo has been clearly more successful than SpiceJet, largely because Bhatia persuaded Rakesh Gangwal, who, among many other achievements, had been CEO of US Airways to join as CEO and major shareholder. Gangwal understood the Indian market and the LCC model, despite having worked mostly at Legacy carriers. Like Ryanair and easyJet in Europe, he laid the foundation for

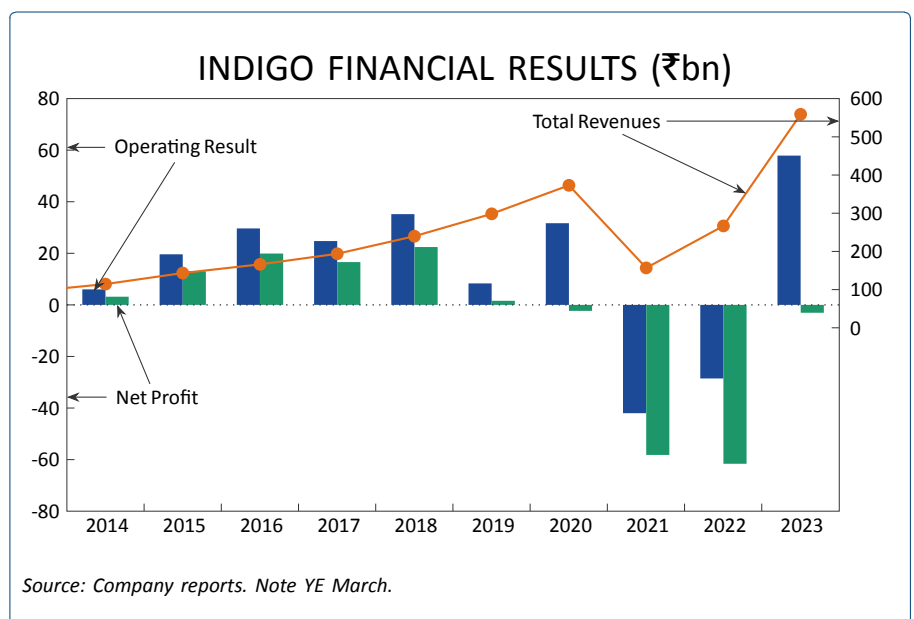
Indigo's growth with an early 100-unit mega-order for A320s. SpiceJet's initial top personnel choices were traditional and wrong, bringing in recycled Western executives, who didn't really understand the Indian market nor the LCC model; and over time its management, led by multi-sector entrepreneur Ajay Singh, has never seemed to focus totally on realising the potential of an LCC in the Indian market. SpiceJet entered the pandemic in a weak financial state and has not been able to reverse its decline — recently it has had to pay its lessors with equity in the airline.

Not that IndiGo's management has been without controversy. When the company launched an IPO in 2015 its balance sheet showed negative equity, largely because Bhatia and Gangwal had extracted about \$530m of dividends, for a modest initial investment in the start-up. Still, the IPO succeeded, and some years of strong

financial results followed.

But by 2018 serious tensions had developed between the two founders, and they ended up in the courts. The argument seems to have started with a divergence on growth strategy — Gangwal wanted to go for a major growth surge, increasing capacity by over 50% to take full advantage of the weakness of Air India and the other competitors. Bhatia was more circumspect (and correct in retrospect because of the pandemic) but he also reportedly wanted to expand into widebodies, a strategy that was anathema to Gangwal.

Then Gangwal, who owned 37% of the equity against Bhatia's 38%, tried to change certain articles in the company's constitution which he said favoured Bhatia, and, when blocked, complained about the airline's governance to, *inter alia*, the Finance Minister, citing IndiGo's various contracts with other InterGlobe



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companies owned by Bhatia. This painful clash between two ageing and extremely wealthy egos ended with Gangwal's exit at the end of 2021. Since then, Gangwal and his family have been unloading substantial amounts of IndiGo shares, a process which he has said he will continue for the next five years.

The model

IndiGo's LCC model has these elements:

- ➔ Essentially a point-to-point LCC operation, current serving 78 domestic points and 22 international destinations.
- ➔ Building in a capital cost advantage through a series of mega-orders from Airbus, the latest being for 500 A320/321s, financed using sale and leasebacks.
- ➔ Load factor is 89%, dispatch reliability is a remarkable 99.9% and on time performance is 89%.
- ➔ Average aircraft utilisation is around 11.5 hours per day for the A320-family fleet which has an average age of 3.6 years, so reducing maintenance costs.
- ➔ Like most other LCCs, it is increasing the average size of its fleet, shifting from 180-seat A320s to 222-seat A321s.

➔ No frills but consistent service, regularly awarded the "Best Low Cost Airline in India and Central Asia" title by Skytrax.

➔ The original target for IndiGo was to divert middle class passengers from the very slow railways to aeroplanes, and then to stimulate new markets. In FY 2024 (year to March 31) IndiGo expects to carry 100m passengers, roughly ten times the total domestic air traffic volume of 2005.

➔ Post-pandemic, 10-15% annual traffic growth is again feasible — IndiGo's new target is 200m passengers by 2030. IndiGo now aims to achieve this volume by increasing international traffic at a faster rate than domestic.

➔ The international network is concentrated on the Middle East but the introduction of XLRs will bring European cities into the network.

➔ It has an extensive list of code-share partners: THY, Qatar Airways, Qantas, KLM, American, Virgin Atlantic and Air France, but does not provide traditional passenger or baggage interlining facilities.

Financials

In the immediate pre-pandemic years IndiGo's financial results were

not impressive by LCC standards, or by any airline standards. In FY 2019 and 2020 it just about broke even at the net level, and then in FY 2022 and FY2013 accumulated ₹119.8bn (US\$1.44bn) of net losses. FY2023 was marginally loss-making although there was a marked recovery in operating cashflow.

As a consequence, and despite all its apparent competitive advantages, IndiGo's balance sheet as at March 2023 showed ₹62.5bn (\$750m) of negative equity — a startling contrast to, for example, Ryanair which has about \$6bn in shareholders' funds. However, the state of the balance sheet does not appear to be of concern to investors — the stockmarket valuation of the company is around ₹950bn (\$11.4bn) compared to \$19.7bn for Ryanair. (About one third of IndiGo's shares are in free float on the Delhi stock exchange, a proportion that will rise as Gangwal unloads his holdings.) And behind IndiGo is Bhatia's InterGlobe, a conglomerate that is privately controlled and releases little financial information, but which operates across 28 countries with a workforce of 55,000.

In 2022 Pieter Elbers was brought in from KLM to be the new CEO. Although KLM is the ultimate hub-and-

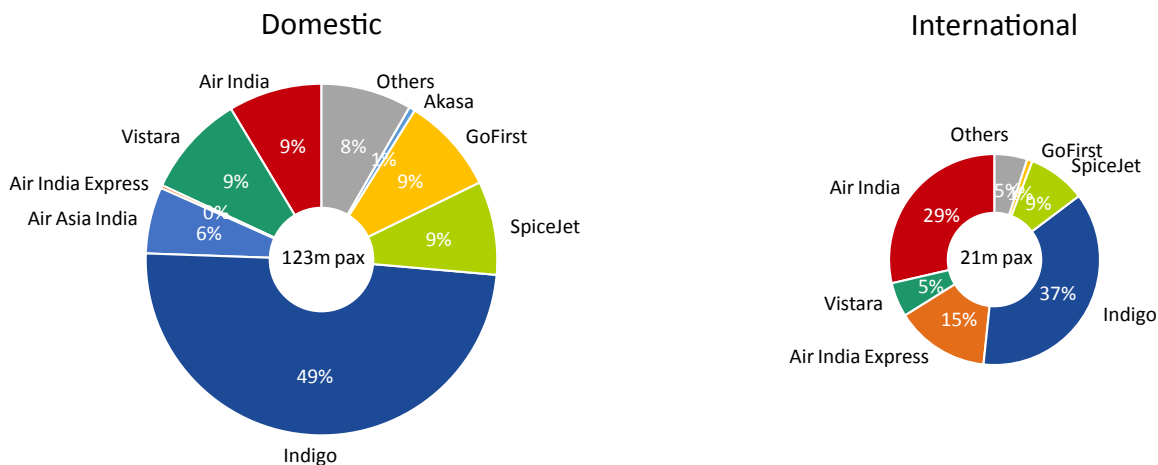
INDIGO (INTERGLOBE AVIATION) FINANCIALS (₹ Billions)

FY (end March 31)	2019	2020	2021	2022	2023	At end March	2023
Revenues	298.2	372.9	156.8	266.5	558.8	Fleet and other fixed assets	330.2
Net result	1.6	(2.3)	(58.1)	(61.7)	(3.0)	Current Assets	132.7
Operating Cashflow	31.6	69.7	(16.1)	20.9	127.3	Cash and equivalents	128.8
Capex and Investments	(25.4)	(45.7)	32.0	15.0	(40.6)	Total Assets	591.7
Free Cashflow	6.2	24.0	15.9	35.9	86.7	Long term debt and lease liabilities	415.7
Increase/(Decrease) in Debt	(5.9)	(24.1)	(17.7)	(30.8)	(84.3)	Current liabilities	238.5
						Total Liabilities	654.2
Total Change in Cash	0.3	(0.1)	(1.8)	5.1	2.4	Shareholders' Equity	(62.5)

Note: 1 Billion ₹ = US\$ 12 million

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INDIA MARKET 2022



pure speaking airline and IndiGo is a point-to-point LCC, Elbers is highly respected throughout the industry for his operational and strategic expertise. His timing was good as IndiGo has rebounded this year — the first quarter FY 2024 (April to June) saw an annual increase in revenue of 30% to ₹166.8bn (\$2bn) and a return to net profit, ₹30.9bn against a loss of ₹10.6bn for the same period last year.

At the Paris Air Show in June Elbers announced the largest ever aircraft order (by number of units) — 500 Airbus A320neo-family aircraft

(125 A320s and 375 A321s, including an unspecified but substantial number of XLRs) to be delivered in 2030-35. For the period up to 2030 IndiGo has outstanding orders totalling 466 units.

The value of the latest order is probably around \$25bn (estimated not list pricing), making IndiGo Airbus' most important customer. Over its lifetime IndiGo has ordered 1,330 A320 family aircraft; the next biggest airline client is Air Asia with 592.

Commenting on the order Elbers said, "it speaks to the potential of

Indian aviation ... one of the fastest-growing in the world." Certainly, the outlook for Indian air traffic is very positive, with India leading global GDP growth rates, 7.2% estimated for this year, but the detailed economic and political picture is more complex — see "India — A Golden Age?", *Aviation Strategy* March 2023.

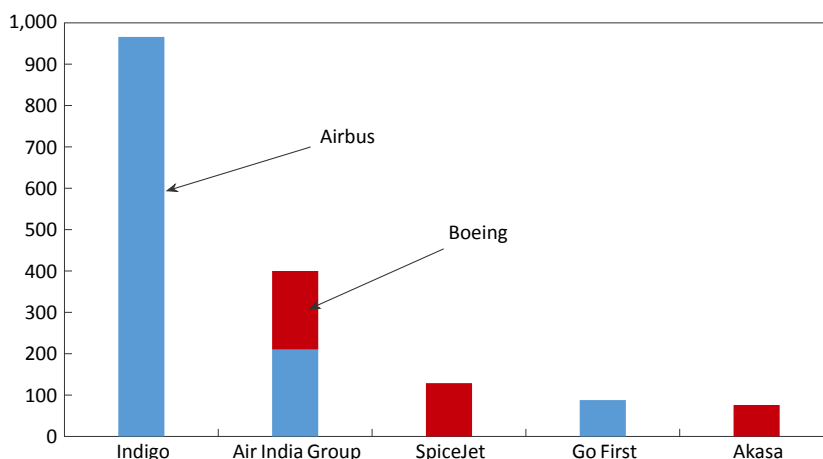
The competition

In 2022 IndiGo had just under half the domestic market in terms of passengers carried, and its share had risen to an estimated 56% by mid-2023. This is in part due to the weakness of some of the competition.

Go First and SpiceJet, which between them accounted for 18% of the domestic market in 2022, have both had to suspend operations. SpiceJet has struggled to raise additional funding after borrowing \$500m from the government's Emergency Credit Line Guarantee Scheme (ECLGS), and is currently operating a reduced schedule under "enhanced surveillance" from the DGCA.

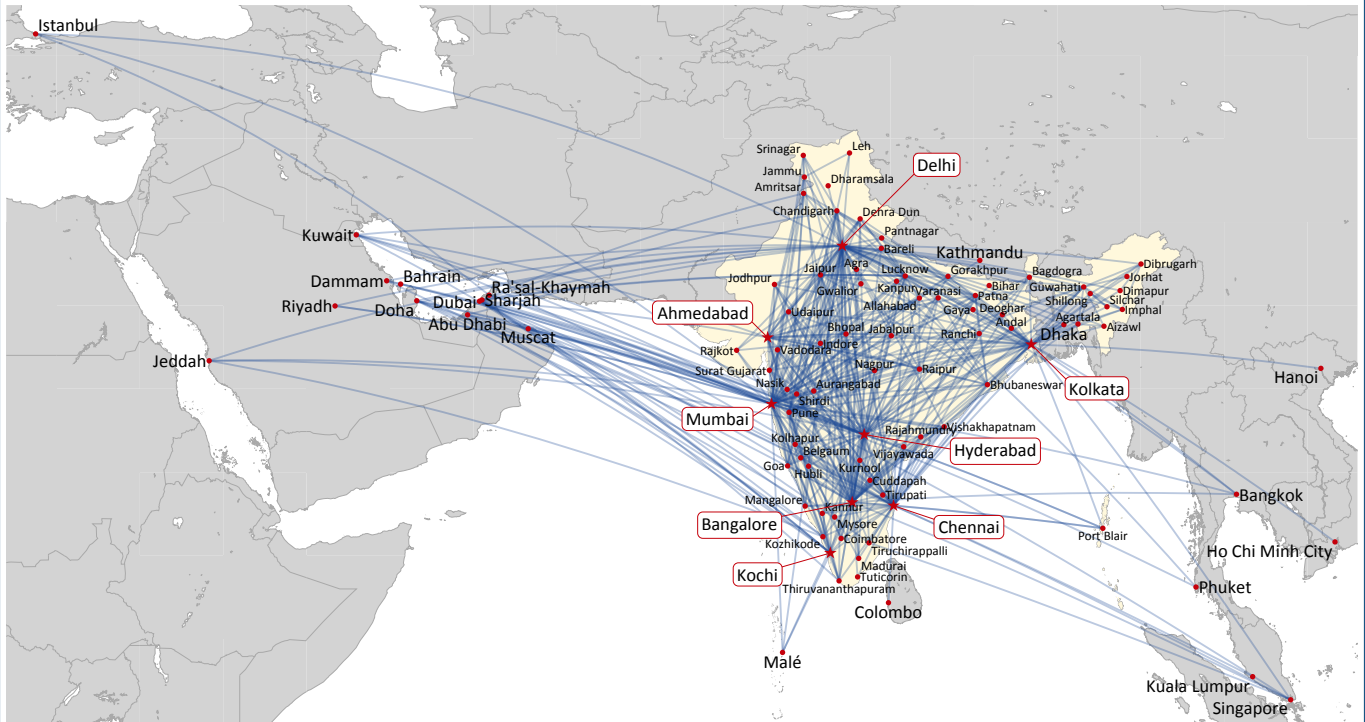
First Go declared voluntary liquidation in March blaming its situation on problems with its P&W engines. It is still not clear whether Go First

NARROWBODY ORDERS BY INDIAN AIRLINES



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INDIGO: ROUTE MAP



will cease operating or restructure (it is owned by the very wealthy Wadia Group), but its problems go beyond the P&W issue. The smallest of the first wave of LCCs, Go Air (as it was then) never found the scale of IndiGo nor achieved genuine LCC oper-

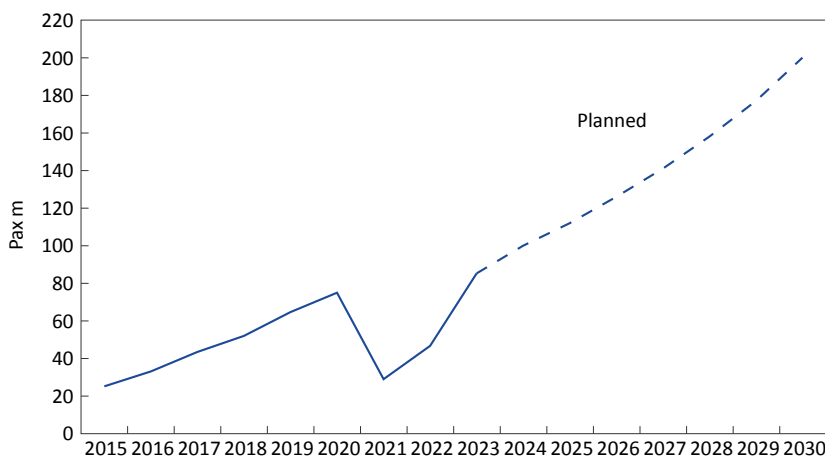
ational performance.

SpiceJet has orders for 129 737 MAXs and First Go 88 A320neos, aircraft theoretically scheduled for delivery before 2030. This puts another perspective on the 466 A320/21s IndiGo is expecting to

receive before that date, and makes its target of doubling its passenger volumes to 200m passengers by 2030 appear even more attainable. (Also, Jet Airways, which has not managed to restart despite being awarded an AOC in 2022, officially has an order backlog of 135 MAXs.)

There is of course the threat posed by the new Air India Group, now controlled by TATA and still the favoured instrument of the Indian government. It signalled its intentions with a 470-unit mega-order and is attempting to effect deep changes throughout its operations (see *Aviation Strategy*, March 2023 on page ??). However, the new entity is immersed in a complex dual merger between two loss-making, full-service carriers — Air India and Vistara — and between two fundamentally different low-cost airlines — Air India Express and Air Asia India. As

INDIGO: PASSENGER TRAFFIC



INDIGO FLEET

	In Service	On Order
A320 ceo	20	
A320 neo	166	300
A321 neo (inc XLRs)	87	666
A321F	2	
777 (damp leased)	2	
ATRs	39	
Total	316	966

Note: As at June 30 2022

well as merger implementation, TATA is faced with multi-type fleet planning, bilateral liberalisation, brand re-launch, LCC versus full-service network balance, and the need for severe cost reduction.

By comparison, IndiGo's challenges, although substantial, mostly relate to the overall Indian economy and the airframe and engine suppliers, and appear manageable. They include:

- ✈ Cost pressures on fuel, associated with the depreciation of the Rupee. Also, government-owned fuel suppliers dominate the market, and sales and excise taxes are applied in an unpredictable manner.
- ✈ IndiGo's fleet is financed through sale and leasebacks, and lease rates are being impacted by increased dollar interest rate rises as well as the Rupee depreciation.
- ✈ Dealing with Indian bureaucrats and regulators can still be very difficult, although deregulatory momentum is now entrenched.
- ✈ Capacity constraints and outdated infrastructure, though this is being rapidly addressed through various main airport investment projects, as well as the planned construction of 80 new regional airports.
- ✈ Problems with the PW1100G durability engines, leading to the

grounding at times up to 40 A320s.

✈ Linger uncertainty over the reliability of Airbus' production schedules, and whether 80-100 new aircraft a year will actually be delivered to IndiGo.

Cost advantage

The chart below, compiled by the DGCA, shows stage length-adjusted unit costs (2021/22) for the Indian airlines. IndiGo comes out at the equivalent of \$US4/ASK, which is above the Ryanair benchmark but is significantly below the main competition: about 50% below the mainline Air In-

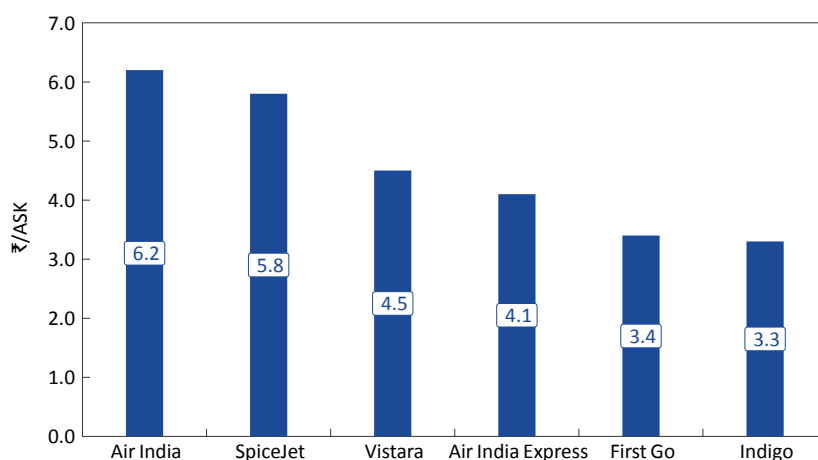
dia level and 25% below that of Air India's lower cost unit.

Could a genuine ULCC undercut IndiGo? This is the model that Akasa claims it is bringing to the Indian market. Akasa was founded by Rakesh Jhunjhunwala, a high-profile investor, and Vinay Dube, ex-CEO of Jet Airways, starting up in August 2022 at what was assessed as being the bottom of the aeromanufacturing market. It currently operates 20 737 MAXs and plans to expand rapidly with a further 55 units on order. But the background of the ex-Jet top management raises questions over whether a true ULCC can be developed. Moreover, Akasa has announced plans for international services which do not appear to fit in the ULCC model, at least at this stage of development.

Long-haul strategy

This year IndiGo will allocate about 30% of its capacity to international routes, up from 20% pre-pandemic. Operations to the Arabian Gulf are back to close to pre-pandemic levels and key services to Singapore and

COMPARISON OF ADJUSTED UNIT OPERATING COSTS

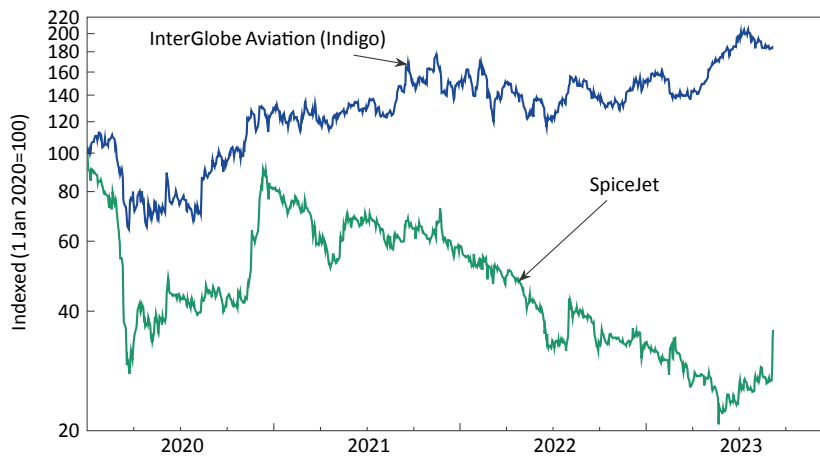


Source: DGCA

Note: 2022 basis, adjusted to 1,555km stage length

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SHARE PRICE PERFORMANCE



Hong Kong have been restored.

New underserved markets are being opened up like Mumbai-Nairobi and Mumbai-Jakarta, which should have strong expat demand, and from Delhi to central Asian points like Baku, Almaty, Tashkent and Tbilisi, perhaps reflecting India's growing politico-economic influence in that region.

For longer-hauls IndiGo relies on its codesharing partners, buying capacity on their flights and selling its own seats to the partner airline for domestic itineraries. The most important alliance agreement is with THY which codeshares with IndiGo on 33

European routes with flights from India connecting at its Istanbul hub. This summer the US was brought into the joint network, with THY offering connections from IndiGo flights onto New York, Boston, Chicago and Washington. To solve a temporary capacity problem IndiGo also entered into a 12-month damp-leasing agreement early this year for two of THY's 777-300s (the flying crew are from THY).

The next international expansion phase is linked to the A321neo XLR. IndiGo had scheduled deliveries for 70 XLRs before the Paris mega-order which will probably add another 100-150 units. In theory the XLR could

have sufficient range to cover all of Europe, including London and most of Asia north of Australia. Immediate plans are more modest, adding points like Athens and Rome plus Seoul in Korea.

The strategic question for IndiGo is: to what extent does the airline want to be a major a major long-haul player.

On the one hand, it would be loath to cede prestigious long-haul routes and premium traffic to Air India/Vistara.

On the other, long-haul brings it in into direct competition with the European and global long-haul, business travel-orientated specialists as well as the very efficient Middle East super-connectors. Would its alliance with THY survive a sustained move into long-haul? What are the risks to moving too far away from the proven short/medium-haul LCC model? Would the XLRs be suitable to operate all the new network, or would IndiGo have to, as rumoured, place orders for A350s or 787s?

Unfortunately, the only real precedent for an LCC moving into long-haul operation is Air Asia/Air Asia X, which is not too encouraging.

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Pearl of the Orient: A focus on The Philippines

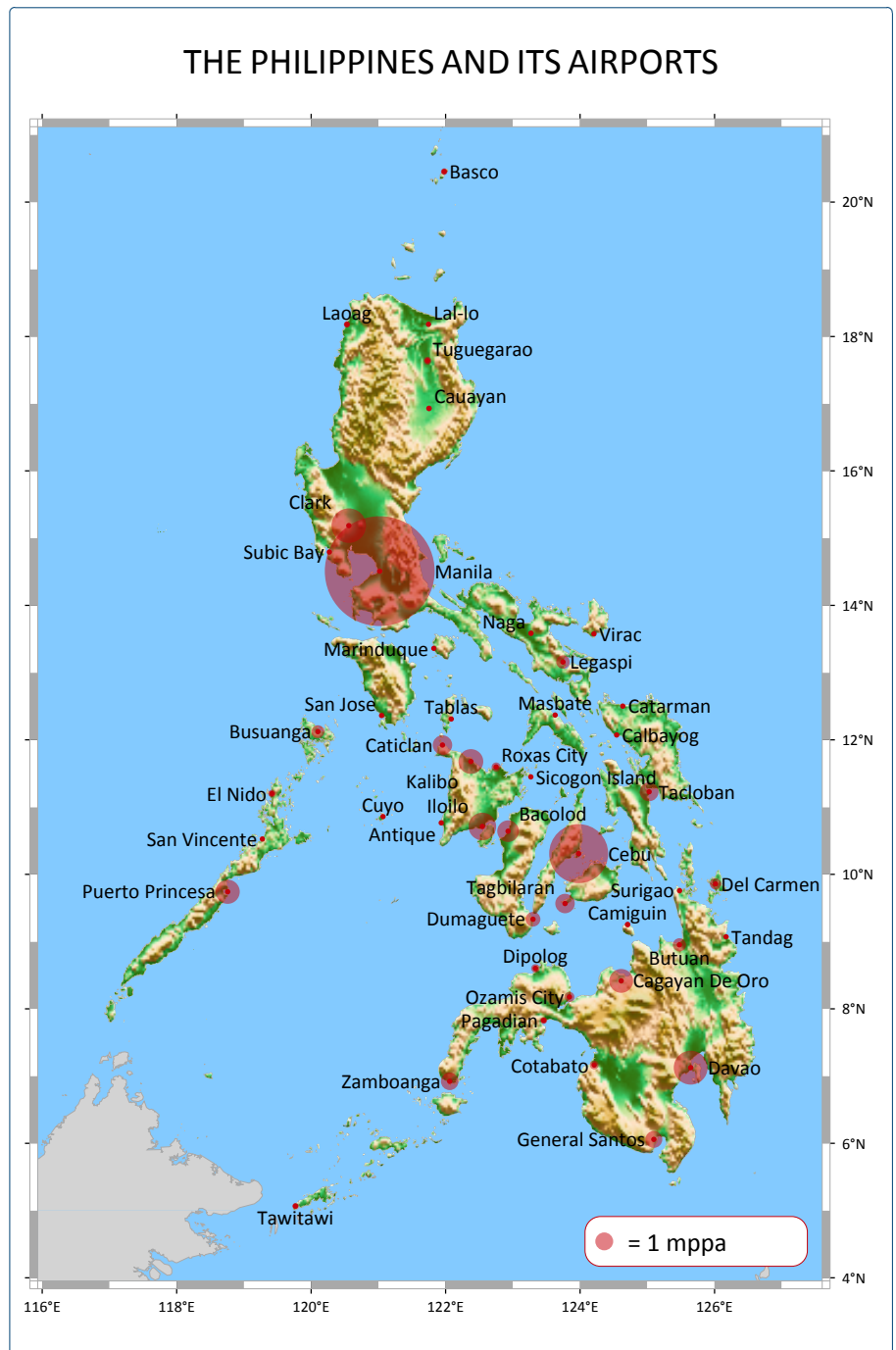
BETWEEN 117° and 127° East of Greenwich and 4°-21° North of the equator, lies the archipelagic state of The Philippines.

Stretching 1,850km north to south It comprises an estimated 7,641 islands, has a land area of 300,000km² and a coastline measuring over 36,000km (and hosts 24 active volcanoes).

It is the world's 12th largest country by population, with over 110m inhabitants — 54% of whom are urbanised: the area around the capital city Manila is the 5th most populous urban area in the world with nearly 25m residents. Manila itself is the most densely populated city in the world with over 40,000 residents per km².

The population is relatively young: 30% are under the age of 15 and only 6% over the age of 65. There is also a huge Filipino diaspora — estimated to amount to over 10m people, or nearly 10% of the population — that has spread to many countries round the world (the largest being the USA, Canada, Saudi Arabia, UAE and Japan). It is estimated that a fifth of these are designated Overseas Filipino Workers (OFW). In 2019 the Philippines' Bangko Sentral estimated the OFWs remitted over \$33bn "back home", having a material positive impact on c8% of GNP.

The predominant religion — unusual for the region — is Christianity: 90% of households claim affiliation (and 80% to Roman Catholicism) while only 5% adhere to Islam. The Philippines can lay claim to having the



third largest Roman Catholic population in the world behind Brazil and Mexico.

But the Philippines has not been

immune from religious discontent. In the southernmost island of Mindanao, the indigenous Moro (the word used by the colonial Spanish

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government to refer to Muslim people) have been waging a war of independence for most of the past 400 years. In recent decades there have been bouts of terrorist activity and armed conflict between the government and the insurgent Mindanao National Liberation Front (MNLF) and its break-off group the Mindanao Islamic Liberation Front (MILF). The latest settlement has been the 2019 creation of the Bangsamoro ("Moro Land") Autonomous Region in Muslim Mindanao (BARMM). The hope is that this settlement will provide lasting peace.

This newly industrialising country is one of the poorer nations in the world. Average GDP per capita is a mere \$3,900 in nominal, and \$11,420 in purchasing power parity terms (2022). But it is growing strongly: the economy averaged real GDP growth of 6.5% in the decade to 2019, and the IMF is forecasting growth of nearly 6.2% over the next five years. As far as air travel is concerned, The Philippines is on the steep part of the S-curve of its development (see chart right), and has the potential to see the propensity to travel by air double in the next five years.

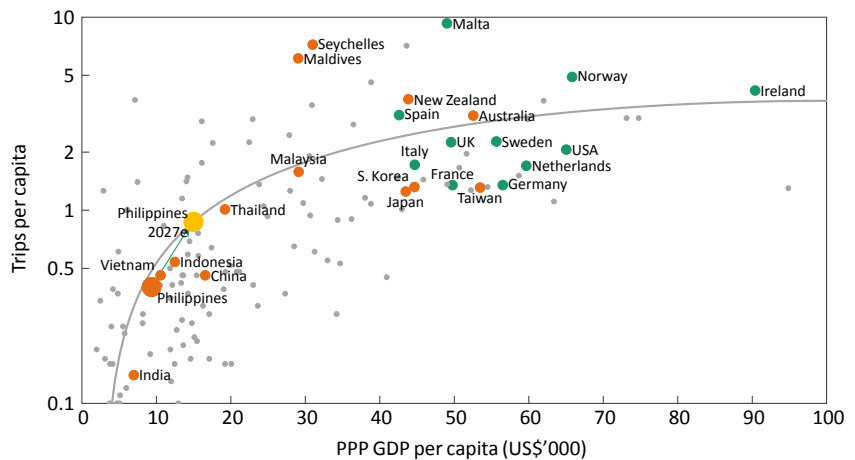
Burgeoning Tourist Destination

The country is an enticing tourist destination boasting tropical beaches, rainforests, diving, eco-tourism, heritage towns, golf courses and (important perhaps for the Chinese markets) casinos.

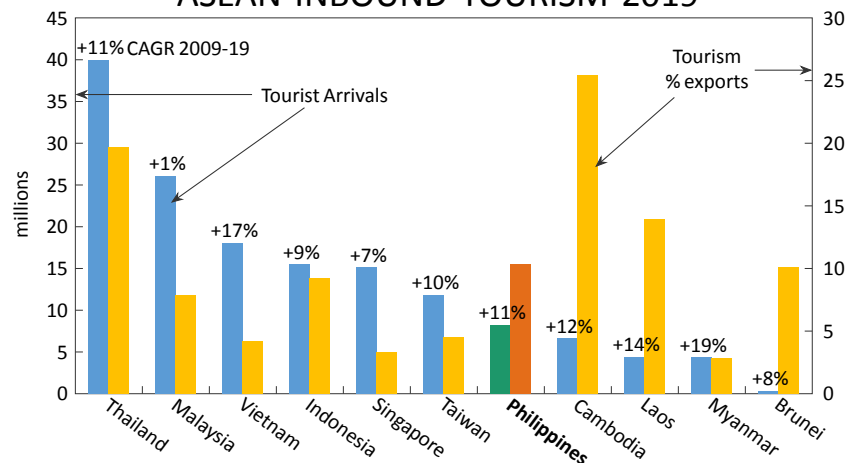
Pre-pandemic, tourism accounted for over 10% of exports and in the ten years leading up to 2019, the numbers of inbound tourist visitors had grown strongly from 3.0m to 8.3m, a compound average annual growth rate of 10.6%.

In absolute terms among ASEAN

PROPENSITY TO TRAVEL BY AIR 2019

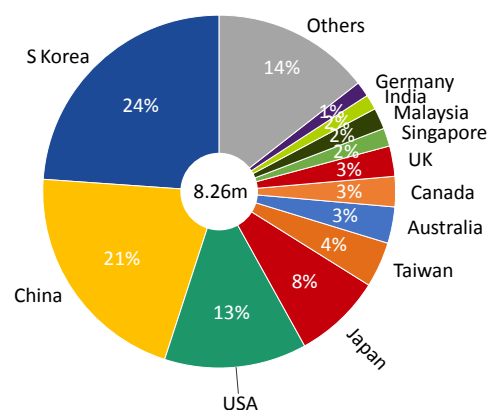


ASEAN INBOUND TOURISM 2019



Source: UN WTO

PHILIPPINES: VISITOR ARRIVALS 2019



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member nations this is relatively small: a quarter of the annual visitors to the region's favourite tourist destination, Thailand (see chart on the preceding page), a third of those to Malaysia, a half of the numbers visiting Indonesia. But the compound growth rate had been above the average of 8.4%pa for ASEAN as a whole.

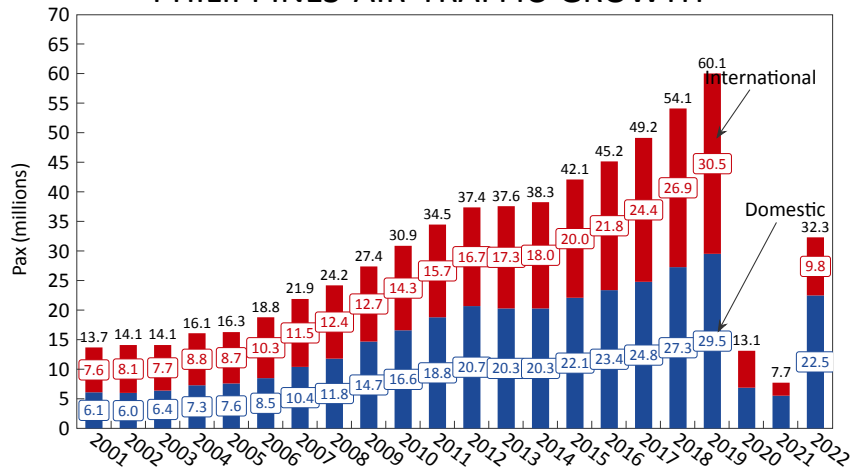
South Korea has been the largest source of inbound tourists for most of the last decade and in 2019 accounted for 24% of the total having increased at an annual average 12% since 2010. But, in common with other tourist destinations in the region, the highest rate of demand growth has come from China: in 2010 Chinese visitors accounted for 5%, grew at an average annual rate of 28%, and ended 2019 accounting for 21% of the total.

High growth in air traffic

Air traffic demand to, from and within the Philippines has been growing well above the world average. Between 2001 and 2019, the total number of passengers carried grew at an average annual rate of 8.6% to peak at 60.1m. Roughly half the demand is carried on domestic routes and has grown at a slightly higher rate of 9.1% over the period. International passenger traffic had grown by 8% a year, but in the five years leading up to the pandemic, that international growth rate had accelerated to approach 10%pa.

The country has a dense airport network with nearly fifty operational scheduled airports: 15 of these deal with over a million terminal passengers a year (and another five more than 200,000 mppa). But domestic traffic is heavily centralised with over 80% of seat supply on routes to or from the Greater Capital Region

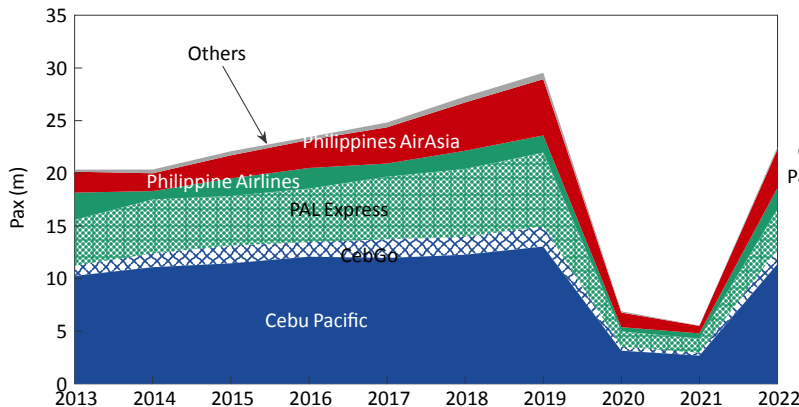
PHILIPPINES AIR TRAFFIC GROWTH



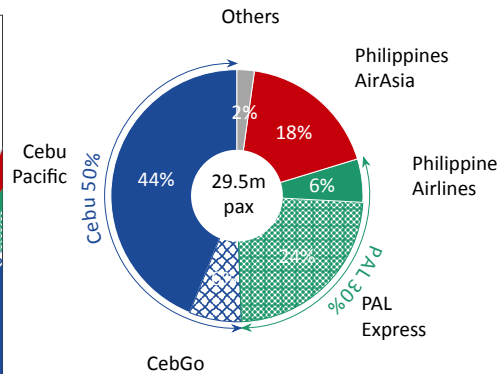
PHILIPPINES: DOMESTIC ROUTE MAP



PHILIPPINES: DOMESTIC AIR PASSENGERS BY CARRIER



2019 Market Shares



(GCR): the three densest routes being from Manila to and from Cebu, Davao and Iloilo, each (in normal times) serving more than 2m pax a year.

Domestic traffic, after the devastation of the pandemic in 2020 and 2021, recovered strongly in 2022 to end only 14% below 2019 levels. Indications suggest that there is almost a full recovery to pre-pandemic levels in the current year.

International traffic is heavily focused on Manila — the GCR airports account for 83% of international capacity. Nearly three quarters of traffic is on routes to other ASEAN countries; but the densest routes are to destinations in Korea, Hong Kong, Macau, Japan, China, Singapore, Taiwan and the UAE — all with more than 2m seats annually.

With draconian border restrictions during the pandemic, international demand tanked in 2020 and 2021. Borders slowly re-opened in 2022, and China only started abandoning its zero-Covid policy towards the end of the year — and only recently fully restored its list of approved destinations for outbound tours. Figures from AAPA suggest that passenger numbers on international

routes have been gradually recovering, but in July this year were still 20% below 2019 levels.

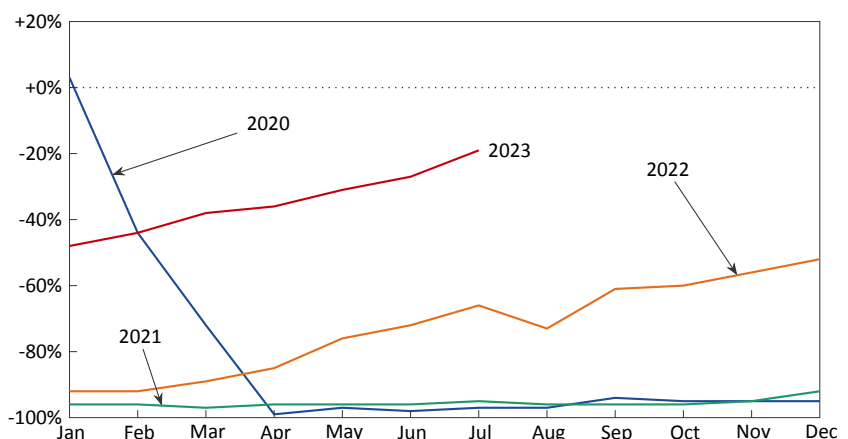
Capacity constraints in Manila

Manila's Ninoy Aquino International Airport (NAIA) is the country's largest, and accounts for three quarters of the nation's international arrivals. It has been operating well over its design terminal capacity (of 32mppa) for many years — in 2019 it had 48m terminal pax — and operates an estimated 10% above the designed capacity of its two runways and apron

structure. Within the GCR it is supplemented by the former US Air Force base at Clark International Airport (4m pax in 2019), some 90km north of metropolitan Manila, often used as a diversion when congestion gets too much.

The much-needed expansion and refurbishment of NAIA — to increase capacity to 65mppa — has been mired in controversy over the last six years. Various consortia have made unsolicited proposals under president Rodrigo Duterte's 2017 infrastructure development initia-

AAPA: INTERNATIONAL MONTHLY PASSENGERS v same month in 2019



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tive (entitled Build! Build! Build!). In July this year, current president Bongbong Marcos rejected the latest unsolicited proposal from a consortium of local conglomerates for a 25-year ₱267bn (US\$4.8bn) concession. The government will apparently now be inviting competing bids for a 15-year ₱170bn PPP BOT project.

In 2016 local billionaire Henry Sy came up with the idea of using facilities at Sangley Point, a single runway Air Force base some 9km due west of NAIA (but 28km by road), for low cost carriers and general aviation “while waiting for a new airport”. In 2019, then-president Rodrigo Duterte ordered the transfer of domestic and general aviation operations to Sangley Point — ignoring the lack of terminal, control tower, hangars, lighting and a need to asphalt the runway — and he officially inaugurated the new airport in February 2020. It doesn’t yet have any scheduled passenger service.

In 2017, the country’s San Miguel Corp put in an unsolicited bid to build the New Manila International Airport (NMIA) along with an adjacent airport city at Bacalan, some 35km north of Manila. Awarded the ₱735bn (US\$12bn) 50-year BOT concession in 2019, ground works were initiated in 2020 and construction started in 2022. The plans are for an initial two runways (with potential for six) and an ultimate capacity of 100mppa. It is expected to be operational in 2027.

Three Airline Oligopoly

The domestic industry is consolidated: three airlines provide substantially all of the capacity.

✈ Market leader with a 50% share is LCC Cebu Pacific (with its regional subsidiary Cebgo). On the 20% of services that avoid the GCR airports of NAIA and Clark, Cebu has an esti-

mated share closer to 60%.

✈ Flag carrier Philippine Airlines (and its “lower” cost subsidiary PAL Express, that had been designed to counter Cebu’s incursion) have 30% of the market.

✈ LCC Philippines AirAsia (previously known as Zest AirAsia), a subsidiary of Kuala Lumpur-based Capital A Group (the conglomerate formerly known as an airline called the AirAsia Group) trails with an 18% share.

In the following sections we briefly explore how they have survived the pandemic.

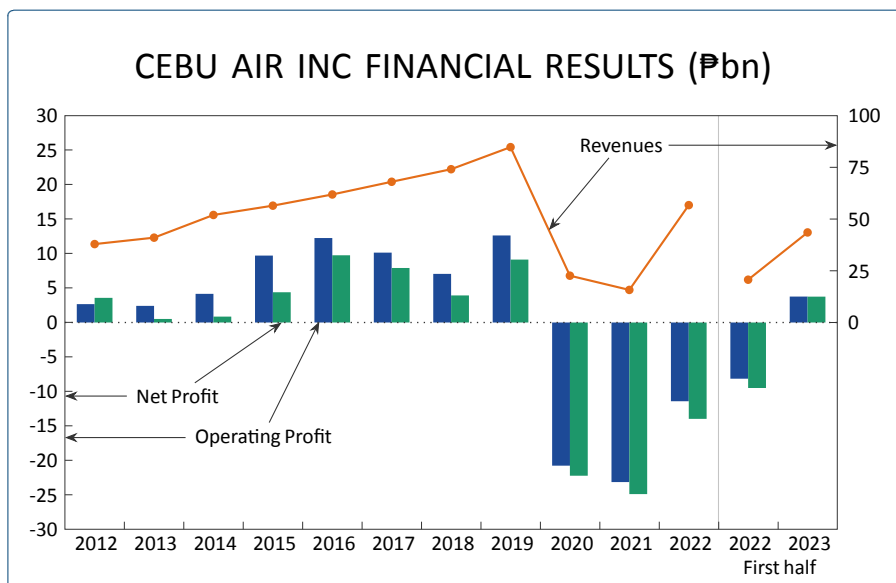
Cebu Pacific

Cebu Pacific Air was established as a legal entity back in 1988, but didn’t launch operations until 1996, a year after it was bought by JG Summit Holdings, a giant Filipino conglomerate that has interests in everything from banks and hotels to property and utilities. Its founder was John Gokongwei — of Filipino-Chinese extract and one of the wealthiest entrepreneurs in Asia — and today his only son Lance is president and CEO of Cebu.

Based at Manila’s NAIA, Cebu was a pioneer of the standard LCC business model in Asia, though today it has multiple aircraft models, an FFP called GetGo and a regional turboprop operator Cebgo. It was launched initially as a domestic-only carrier before expanding onto international routes from 2001, and has built up a domestic market share of 50% and one of 19% on international routes, which in turn account for 30% of its overall capacity. But it had been growing its international presence: in the decade up to 2019, its international capacity had grown at a compound rate of 12.5% a year.

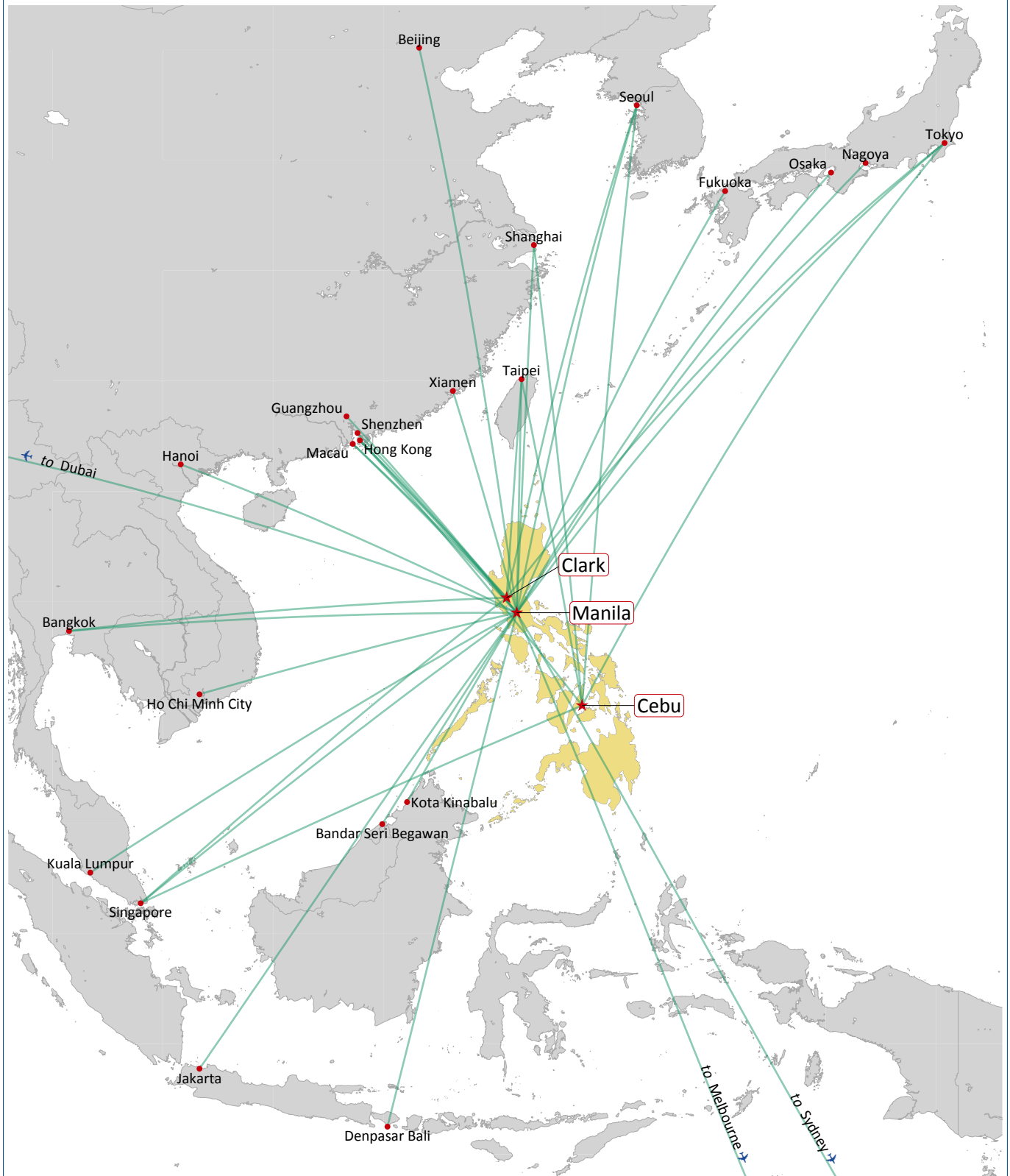
Cebu has been consistently profitable. Between 2012 and 2019 it achieved an average operating margin of 12% (peaking at 20% in 2016) and net margins have averaged 8% a year. Revenues over that period grew at an average of 8% a year.

Over the three years of the pandemic and its immediate aftermath, Cebu lost a total of ₱60bn (\$1.05bn), 50% more than the profits it had made in the previous seven years. It had entered the crisis with a strong balance sheet and a reasonable cash balance of ₱18bn (just over 20% of



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CEBU PACIFIC: INTERNATIONAL ROUTE MAP



annual revenues). By the end of 2020 this had fallen to ₱4bn and the group successfully raised ₱12.5bn (\$260m) through a rights issue.

In the first half of 2023, the group bounced back into profit: a modest ₱3.8bn operating profit representing a margin of 8% on total revenues only 3% below 2019 levels. This was sufficient to restore the equity position into positive territory. Total seat capacity in the period was still 9%, and the number of passengers 8%, below levels in 2019. Average fares were on a par with pre-pandemic levels but ancillary yields were 27% higher: ancillary revenues accounted for 26% of income in the period.

Despite this performance, Cebu has been hit with operational instability particularly in the second quarter. On-time performance plummeted to 58% in May and June, partly because of issues with the Pratt and Whitney engines on its A320neo fleet (the company mentions that engine maintenance currently takes around 220 days compared with a more normal 90 days, and that there is a resulting scarcity of slots in the workshops).

It has also this year been impacted by weather issues: longer and more frequent “lightning red alerts” where it has to stop all flight and ground operations. Each such event can last up to three hours and cause significant disruption; and it mentioned that there were 72 incidents recorded in the rainy season of the second quarter.

Cebu has a fleet of 76 aircraft (one unit more than in 2019) with an average age of only 5.9 years. Over the past three years it has taken delivery of 12 A320/321neos and five widebody A330s. It looks as if most have been done on sale and lease-back deals. It has outstanding orders for 41 aircraft.

CEBU PACIFIC: FLEET

	In Service	Parked	Total	Δ v 2019	Avg Age	Orders
ATR 72	15	2	17	↓4	7.2	
A320-200	17	4	25	↓5	9.9	
A320neo	9	5	10	↑6	2.1	10
A321-200	7		7	—	5.2	
A321neo	11		11	↑6	3.0	20
A330-300		1	1	↓7	6.4	
A330-900	5		5	↑5	2.0	11
Total	64	12	76	↑1	5.9	41

From 2024 it expects to take delivery of 43 new aircraft and dispose of 33 leaving it at the end of 2028 with a fleet of 88 aircraft: 16 widebodies, 56 narrowbodies — all new generation — and 16 turboprops.

PAL Holdings Inc

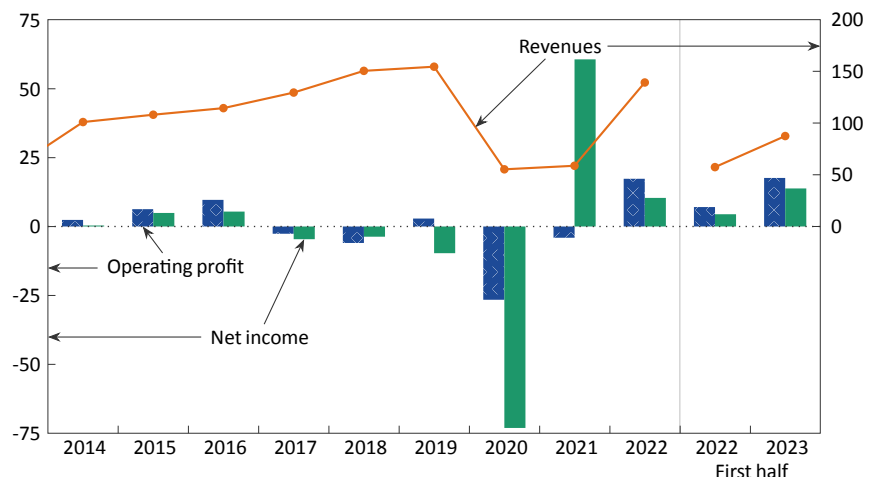
Philippine Airlines is one of the oldest airlines in Asia, having been established in 1941 as the de facto flag carrier for The Philippines. It fell into bankruptcy in the aftermath of the 1997 Asian financial crisis.

Lucio C. Tan, another billionaire sino-filipino tycoon and majority owner of local conglomerate LT

Group, used PAL Holdings Inc. to acquire the airline out of insolvency in 2006. For a brief spell he relinquished management control to San Miguel Corp and its magnate Ramon Ang, selling him a 49% stake in 2012 for \$500m. They obviously fell out and he bought it back two years later for \$1bn.

89-year old Tan remains Chairman and CEO, his wife Carmen Tan deputy Chairman, while his grandson Lucio C. Tan III is President, and son-in-law Stanley K. Ng Chief Operating Officer. His daughter, Sheila Pascual is also on the board. Needless to say, the underlying ownership structure is somewhat opaque: the shares are

PAL HOLDINGS FINANCIAL RESULTS (₱bn)



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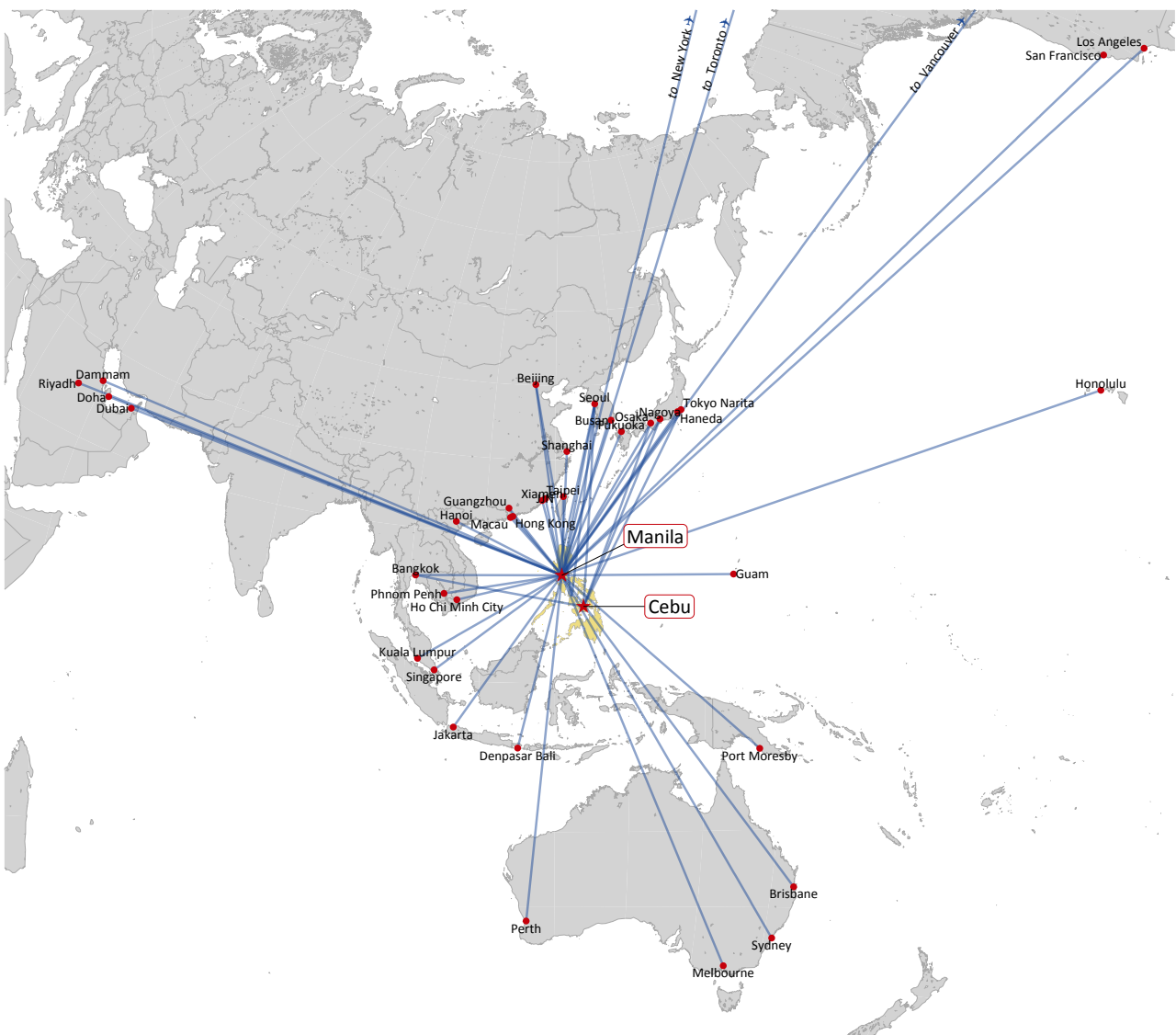
quoted on the Philippine Stock Exchange with a tiny free float. (The company doesn't need to bother with investor presentations.) In 2019, ANA Holdings (owner of All Nippon Airways) acquired, with remarkable timing, a 9.5% stake for \$95m.

Apart from the two years following San Miguel's exit, PAL Holdings has been notably unprofitable, having lost a total of ₱7.7bn in the six years to end 2019. Its peak operating profit was achieved in 2016 with ₱9.6bn, reflecting an 8% margin.

PHILIPPINE AIRLINES FLEET

	In Service	Parked	Total	Δ v 2019	Avg Age	On Order
A320ceo	13		13	—	14.0	
A321ceo	19	3	22	↓2	8.7	
A321neo	4	4	8	—	4.7	13
A330-300	8	2	9	↓6	9.5	
A350-900	2		2	↓4	4.8	
A350-1000				—		9
777-300ER	8	1	9	↓1	9.9	
Dash 8-400	10	1	11	—	6.9	
Total	64	11	75	↓13	9.1	22

PAL: INTERNATIONAL ROUTE MAP



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With a weak balance sheet — over \$3bn of debt supporting \$85m in net assets and cash of \$265m equating to less than 10% of revenues — PAL entered the pandemic unprepared.

Tan shored up Philippine Airlines' finances with a cash injection of \$295m in 2020, and then in late 2021 decided to go for a court approved capital restructuring. Astutely, he put Philippine Airlines (but not PAL Express) through Chapter 11 bankruptcy proceedings in the US courts, emerging (after only four months) at the beginning of 2022 with a \$2bn reduction in debt and a 20% reduction in the fleet size. The 13 A321s on order were rescheduled for delivery beyond 2026. The quid pro quo was an issue of 20% of the equity in Philippine Airlines to creditors and DIP funders; and a reduction in PAL Holding's stake in the airline to 79.5% (from 98.9%). Lucio Tan also injected some \$500m new equity into the holding company.

Because of the accounting behind the restructuring, PAL's published profitability measures for 2020 and 2021 are somewhat meaningless. In 2020 it posted a net loss of ₱73bn (\$1.3bn) only to recognise a gain on the condonation of debts in 2021 and post a net profit of ₱61bn (\$1.1bn).

PAL too has bounced back to profitability. It has a higher level of international service than competitor Cebu — in 2019 accounting for 47% of total capacity — so it has not quite reached the same level of recovery in traffic or capacity terms to pre-pandemic levels as its main competitor.

Surprisingly it was profitable in 2022, probably because of the restructuring. It published revenues of ₱139.2bn, only 10% below 2019 levels, but generated its highest ever op-

erating profit of ₱17.3bn — a margin of 15%. The first half results for 2023 are somewhat lacking in operational details, but revenues of ₱87.4bn were 7.6% higher than in the corresponding period of 2019, operating margins touched 20%, and net profits reached a record half-year ₱13.8bn, an extraordinary 15% margin (in 2019 they reported a loss).

This has given the group the confidence to confirm an order with Airbus for nine A350-1000s, in part to replace its aging 777-300s.

Philippines AirAsia

The country's third largest player is the result of plans by Malaysia-based LCC AirAsia Group to expand its brand footprint throughout ASEAN and the region. Formed in 2010 it merged with local carrier Zest Airways in a complicated series of share swaps and cross-holdings that gave AirAsia effective management control while ensuring that the arrangement did not fall foul of a law capping foreign ownership of utilities (which included airlines) at 40% (and allowed it to consolidate the results in its accounts).

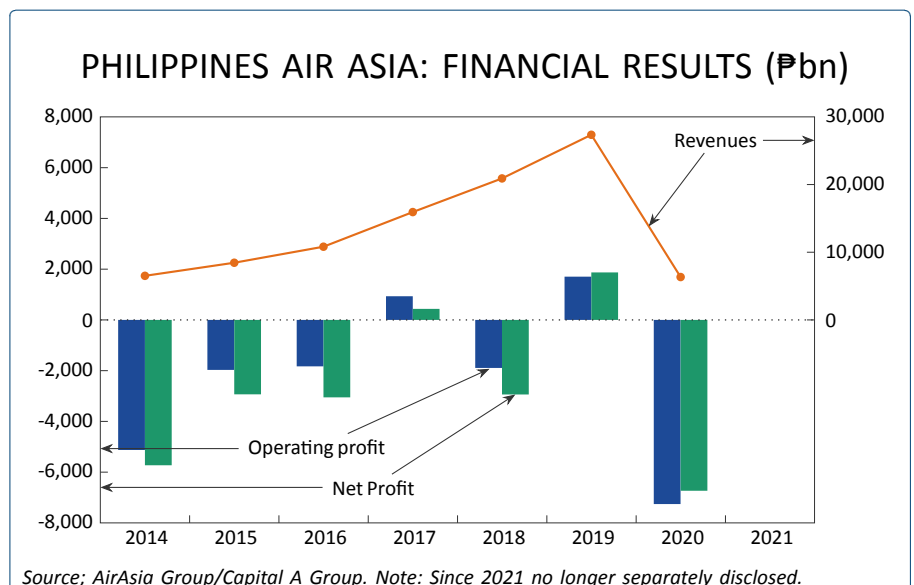
The deal also provided Philippines AirAsia with precious landing slots at NAIA.

Since inception it has grown strongly with an annual increase in capacity of nearly 20%. But it has not been particularly profitable: it achieved a modest operating profit margin of 6% in 2019, but had lost ₱10bn in the previous five years (and ₱14bn at the net level).

The parent company AirAsia Group raised MYR1.3bn (\$300m) new equity in 2021 to provide liquidity to survive the pandemic but ended the year with negative net assets of MYR6.4bn (\$1.4bn). Its problems were compounded in the crisis by having major stakes in subsidiaries in foreign jurisdictions where there was not a clear ability to transfer cash.

It was (and remains) under pressure from Bursa Malaysia to "regularise" its financial position with details of restructuring. After various extensions, it now has a deadline to comply of the beginning of October 2023.

But then the AirAsia Group changed its name to Capital A at the beginning of 2022 to highlight that it was no longer an unfashionable



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airline but a more trendy “super-app” and then a super-trendy unicorn (see *Aviation Strategy*, June 2022).

Capital A no longer provides details on the profit performance of its individual airlines. But in the Q2 results for 2023 the group seemed to show that Philippines AirAsia was currently operating at around 75% of 2019 levels. Early in 2022 Duterte removed the categorisation of airlines as “utilities” in law, and the ownership restrictions were voided earlier this year. As a result Capital A increased its effective stake in the airline to 100%.

The Capital A results show that the airline division’s revenues are only 5% below levels of 2019 on capacity as a whole still 26% down. It also points to very strong ancillary sales, with ancillary yields per passenger 37% higher than pre-Covid times. On an underlying basis however the group as a whole remains loss making. The negative equity on the balance sheet had increased to RM10.2bn (US\$2.2bn).

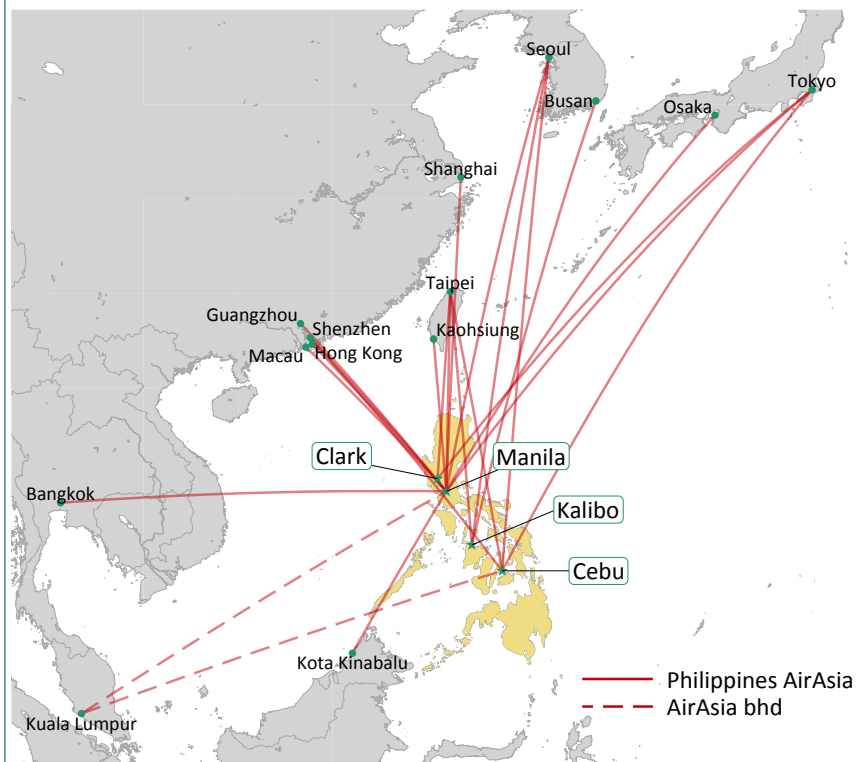
The airline has a fleet of 25 A320neos (12 currently parked) with an average age over 15 years, and none on order. But it could have access to the parent group’s outstanding order for 362 A320-family neos.

PHILIPPINES AIRASIA FLEET

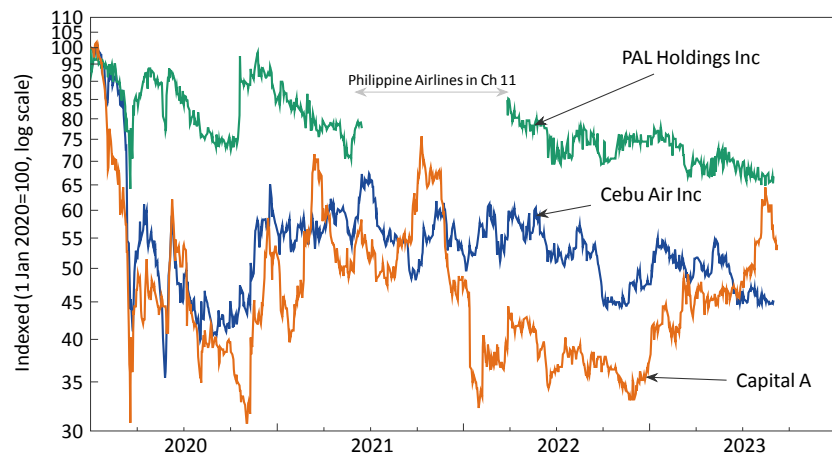
	In Service	Parked	Total	Δ v 2019	Avg Age	On Order
A320ceo	13	12	25	↑1	15.3	362‡

Note: ‡ Capital A / AirAsia Airlines total order

PHILIPPINES AIR ASIA: INTERNATIONAL ROUTE MAP



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