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THY: Ten Years of Super-growth

THY WAS one of the first airlines to achieve a genuine postpandemic turn-around. Its strong upward trajectory continues as it aims to establish itself as the leading global superconnector.

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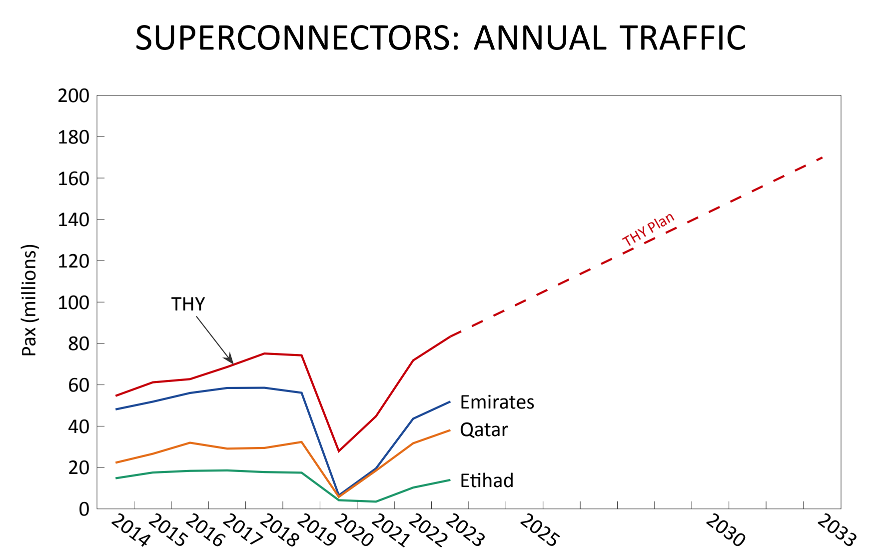
THY managed to produce a marginal net profit during the pandemic years of the 2021 and 2022, mainly by converting into a cargo carrier. It then surged ahead, with almost 200 jets added to the fleet during 2022 and 2023. Passengers carried increased by 16.1% from 71.8m in 2022 to 83.4m in 2023, capacity (ASKs) by 16.3% to 235bn. Total revenues reached $20.9bn in 2023 and net profits of $2.9bn were reported (ex-exceptionals), a remarkable 14% margin for a network carrier.

All this was achieved against a background of financial crisis in Türkiye as President Erdoğan's years of booming growth, fragilely based on grandiose infrastructure projects and populist spending, disintegrated into hyper-inflation. The inflation rate peaked at 85% at the end of 2022 and has since moderated to just 62%, Erdoğan having been forced to accept increases in interest rates to 50%. The Turkish Lira has depreciated sharply, by about 20% over the past year.

THY's operations protect it to a large extent from exchange rate volatility. Its revenue split is 55% US dollar or dollar-correlated, 33% Euro, 10% Turkish Lira, 2% other. Its cost split is: 55% dollar, 32% Lira, 10% Euro, 3% other. However, operating in a hyper-inflationary environment causes potential distortion of financial results and bizarre accounting complications.

The reporting currency for THY's IFRS accounts is the US dollar but its statutory tax accounts are denominated in Lira. This meant that, among other, things the original values of the THY fleet expressed in Lira were markedly undervalued, exposing THY to a major tax liability when the dollar values of the fleet were converted into Lira. However, when an inflation-related adjustment was applied this liability was reversed. This is why THY has reported profit for 2023 of $6.02bn, comprising a "real" profit of $2.9bn plus an exceptional income of $3.1bn relating to "Reversal of deferred tax liability due to inflation adjustment on the statutory tax accounts".

The table on the following page provides a snapshot of THY in the first half of 2024 compared to prepandemic 2019. Total revenues were up 75%, on the back of a 38% increase in capacity (ASKs), while operating costs were restricted to a 60% increase, turning an operating loss of $163m into a profit of $633m. In brief, the fi-



Notes: Figures for Emirates and Qatar for financial years ending March of the following year.

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2019 AND 2024 COMPARISON
(Jan-June periods)

US$ Millions	2019	2024	Change	%
Pax Revenue	4,971	8,421	3,450	69%
Cargo Revenue	799	1,635	836	105%
Other	179	374	195	109%
Total Revenue	**5,949**	**10,430**	**4,481**	**75%**
Fuel	1,836	3,123	1,287	70%
Personnel	1,041	2,117	1,076	103%
Aircraft Ownership	895	1,091	196	22%
Airports and Navigation	548	830	282	51%
Sales and Marketing	575	686	111	19%
Ground Handling	391	717	326	83%
Passenger Services	298	459	161	54%
Maintenance	384	517	133	35%
Others	174	257	83	48%
Total Operating Costs	6,142	9,797	3,655	60%
Operating Result	**(193)**	**633**	**826**	
Investment Income		768		
Net Finance Costs	(123)	(375)	(252)	
PBT	(316)	1,026	1,342	
Tax Refund	113	143	30	
Net Result	**(203)**	**1,169**	**1,372**	

nancial turnaround has been the result of a 27% improvement in unit revenue (RASK) compared to a 16% increase in unit costs (CASK).

Visionary plan

This year THY resumed the publication of its long-term plan, an exercise that was suspended during the pandemic. Its new vision for the period to 2033, which will be its hundredth year, is anything but modest.

✈ Increasing passenger volume by an average of over 7% pa from 83m in 2023 to 170m in 2033.

✈ Achieving revenues of over $50bn by 2033, compared to $21bn last year.

✈ Maintaining its current EBITDAR margin of 20-25% during 2023-2033.

✈ Expanding the fleet from 460 at end-2023 to over 800 aircraft by 2033.

✈ Growing the passenger network from 295 to 400 online destinations.

✈ Total employment (including subsidiaries) estimated at 150,000 by 2033, double the current total.

✈ Doubling the cargo volume, making Turkish Cargo one of the top three cargo carriers globally by 2033.

✈ Growing the low-cost subsidiary, Ajet, as a competitive force, with a fleet of 200 aircraft targeted for 2033, twice the current fleet.

✈ Improving customer experience and brand recognition through "a customised service across all service channels", as well as providing the best digital experience globally.

✈ Becoming a "Carbon Neutral" airline by 2050.

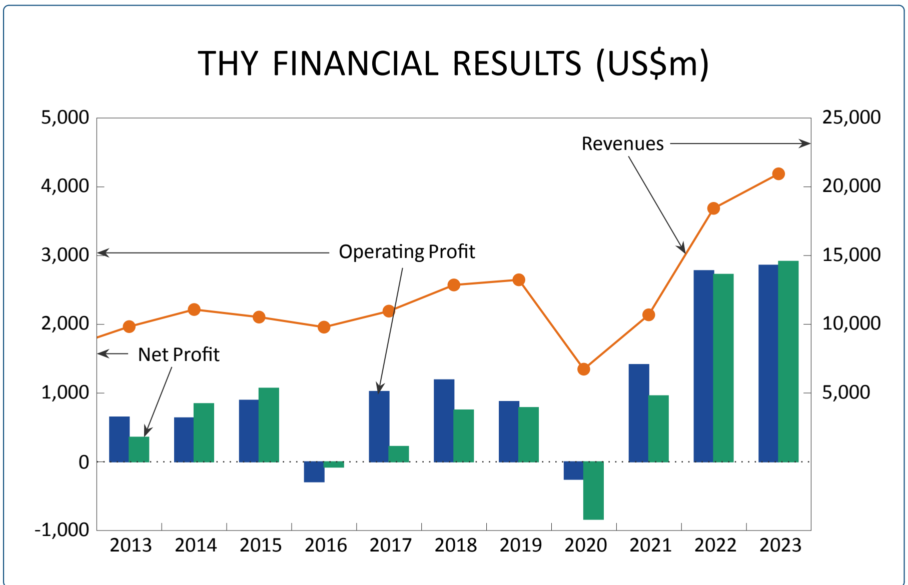
The foundation for this 10-year expansion is a mega-order for around 600 aircraft, split equally between

THY FINANCIALS: REVENUE, PROFIT, CASHFLOW AND BALANCE SHEET (US$ millions)

FY (Jan-Dec)	2018	2019	2020	2021	2022	2023
Revenues	12,855	13,229	6,734	10,686	18,426	20,942
Net result	753	788	(836)	959	2,725	6,021
Operating Cashflow	1,457	2,111	389	3,703	6,011	5,184
Capex	(1,242)	(1,068)	(1,153)	(769)	(994)	(1,186)
Other Income (Expenditure)	(1,161)	52	784	258	(684)	(4,522)
Free Cashflow	(946)	1,095	20	3,192	4,333	(524)
Increase (Decrease) in debt	691	(656)	(284)	(2,326)	(2,948)	(2,856)
Total Change in Cash	**(255)**	**439**	**(264)**	**866**	**1,385**	**(3,380)**

@ end Dec	2023
Fleet assets	6,075
Right of Use assets	16,928
Cash etc	*6,027*
Other assets	6,641
Total Assets	**35,671**
Long term debt	11,021
Short term debt	3,723
Other liabilities	5,369
Total Liabilities	**20,113**
Shareholders' Equity	**15,558**

Note: Net profit before inflation-accounting exceptional income of $3,043m



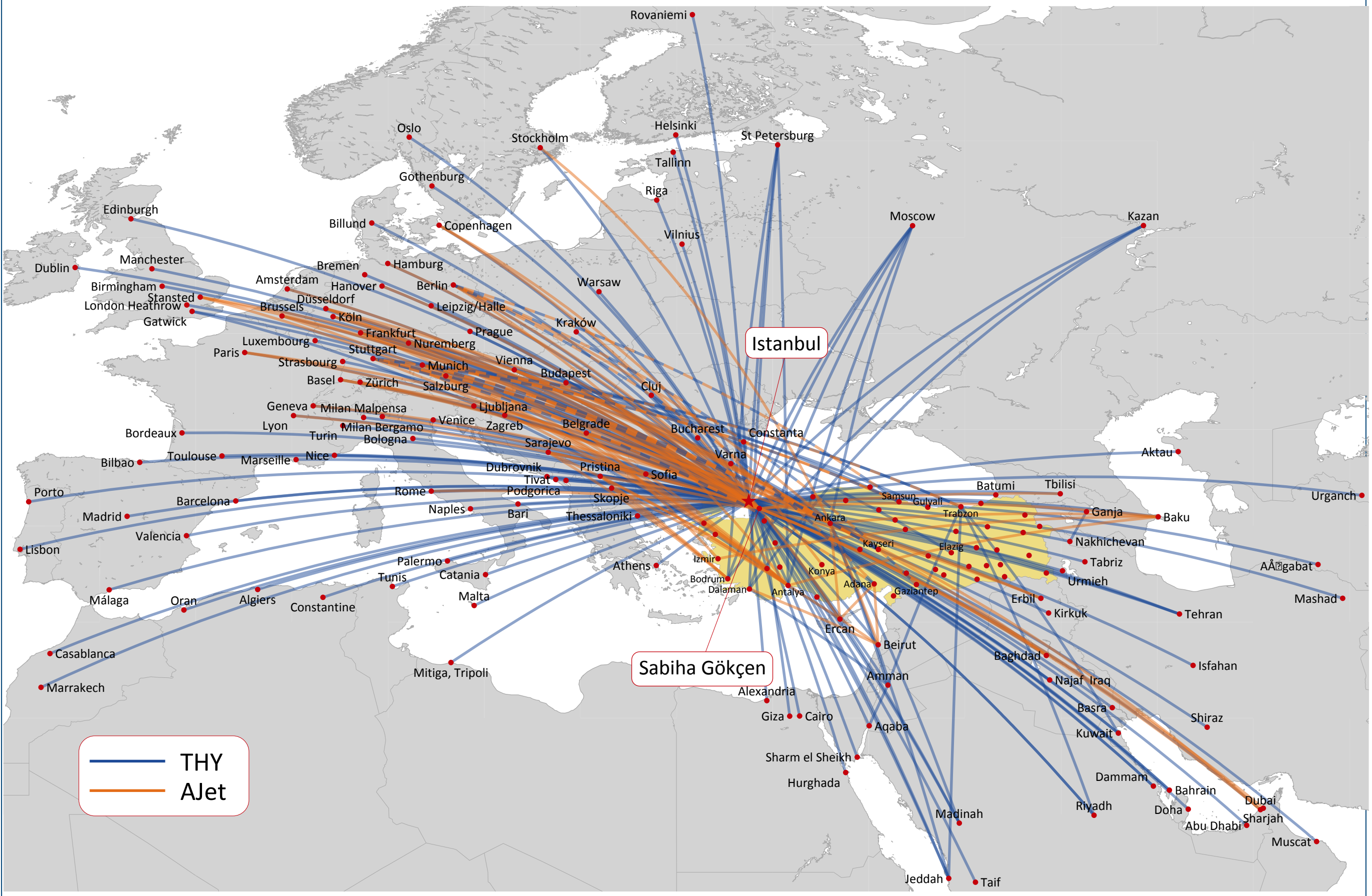
the two OEMs and equally in expenditure terms between narrowbodies and widebodies. THY made its intentions clear back in 2022 but there have been some issues that held up the transactions.

At the end of last year THY and Airbus confirmed an order for 150 A321 NEOs (plus options for a further 100), bringing the current backlog to 192 units. But this year the airline has faced engine reliability and availability problems with the PW1100G-JM that powers the A321 NEO, causing a disruption of delivery schedules. However, in July reached a compensation settlement with IAE.

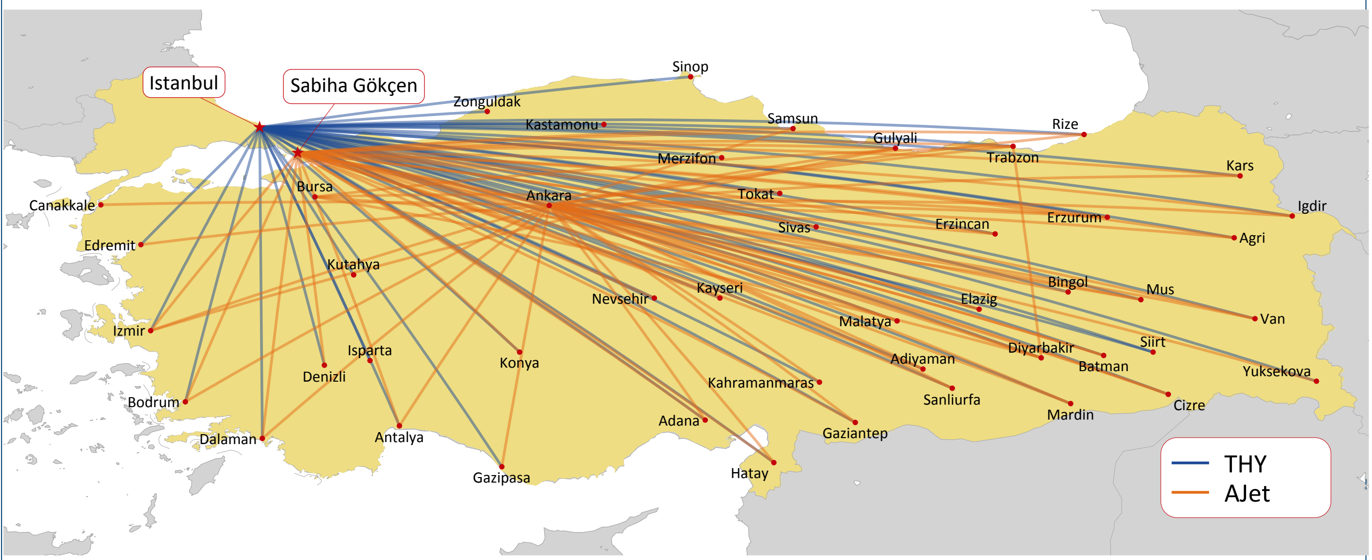
THY also ordered 70 A350s (50 A350-900s, 15 A350-1000s and 5 A350Fs), following on from two orders from the manufacturer for 14 A350-900s earlier in the year. Total A350 backlog is 87 units.

Negotiations, or rather renegotiations as an original order was cancelled in 2021, with Boeing on for 150 737 MAXs and 75 787s have been protracted, with the two parties unable to agree on the pricing for CFM's LEAP engines, the sole provider for the 737

THY SHORT HAUL ROUTES



THY DOMESTIC ROUTES



MAXs. Currently, THY's Boeing backlog consists of just 7 787-9s plus 4 777Fs.

Financing the mega-order

Even allowing for significant discounts the total order will be in the range of $30-35bn, implying an annual average capex from now to 2033, three times that of the average of the past ten years.

However, the balance sheet looks quite solid: $15.6bn of equity against $11.0bn on long-term debt, $6.0bn in cash and equivalents. And the airline is 49% owned by the Turkey Wealth Fund, the national investment vehicle, which facilitates access to bank funding and should keep down its cost of capital. This year Moody's upgraded THY credit rating by two notches to Ba3, which is the highest rating below investment grade, with a Positive outlook.

Scalability of operating model

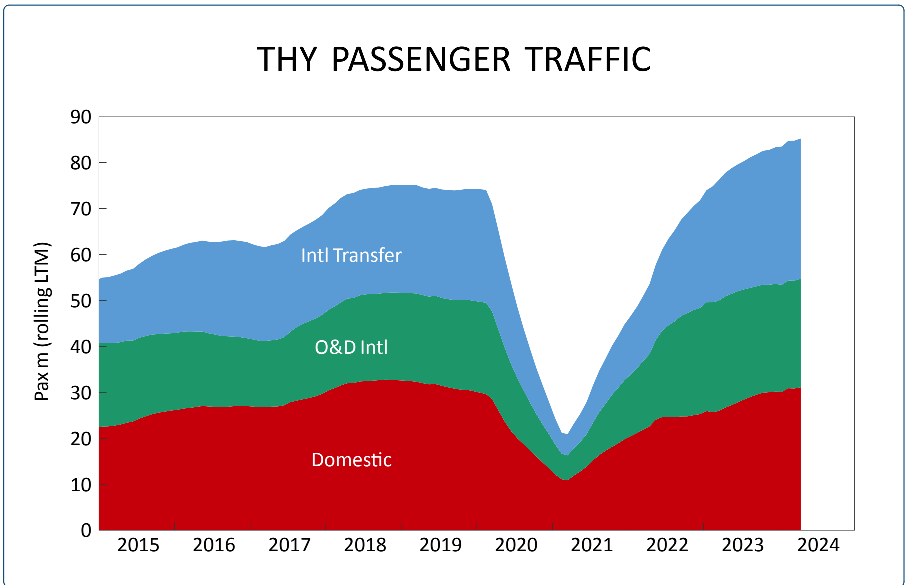
THY's growth strategy has been essentially to add more cities, add more aircraft so that traffic grew exponentially through the multiplication of city-pairs connected through the İstanbul hub. İstanbul's geography means that about 50% of the global air traffic market is within narrowbody range, and by using MAXs and A321s THY can open up thinner routes. With the build-up of its widebody fleet of A350s and 787s, THY's network has been extended to cover 90% of the global market.

The extrapolation effect is illustrated by THY's calculation that its 535 international destinations (including codeshare flights) can offer 52,000 connection options (defined as meaningful O&Ds with a detour factor from direct service of less than 1.4). Each new point introduced theoretically adds about 100 routes to the network.

Before the pandemic there were concerns that growth was not necessarily translating into profits; for instance, between 2016 and 2019 revenues grew by over 10% pa but net profit margins were in the zero to 6% range. But that appears to have changed post pandemic, with improved margins throughout the network. In its latest investor presentation, THY identified these future routes:

- ✈ **Americas:** Detroit, Denver, Orlando, Lima, Santiago, Rio de Janeiro;
- ✈ **Europe:** Bergen, Glasgow, Iasi, Katowice, Nantes, Newcastle, Timisoara, Bayburt, Yozgat;
- ✈ **Middle East:** Abha, Salalah;
- ✈ **Africa:** Aswan, Brazzaville, Hargeisa, Lome, Monrovia, Port Sudan, Windhoek;
- ✈ **Asia:** Sydney, Melbourne, Phnom Penh, Atyrau, Osaka.

This is certainly a diverse group, indicating the gaps still to be filled in the global network. One important role THY can play is connecting the emergent economic super-powers of China and India to both the developed and developing worlds.



The mega-hub

THY's greatest asset is its hub at İGA, located 50km north-west of Istanbul city centre on the European side of the Bosphorus, has a capacity of 90m passengers a year with a single terminal and two sets of parallel runways. Planned expansion will take it to 120m by 2025 and 150m passengers by 2027 with eight runways and a second terminal. It is clear that İGA will soon overtake Heathrow as Europe's biggest airport, and may well the world's, biggest airport. Moreover, user reaction to the new airport has been very favourable: for instance, it won the "Airport of the Year" at the "Air Transport Awards 2024" ceremony for the fourth time in five years.

The downside for THY is some of the highest airport charges in Europe as the pandemic discounts are unwound. The airport owners, a private Turkish consortium, having paid €22.1bn for the 25-year concession, have to recoup their investment.

Competitive reaction

The most important competitors for THY have been the three Middle East super-connectors (ME3), and as the graph on page 1 indicates, THY's expansion plans pose a further threat to Emirates, Qatar and Etihad. Before the pandemic approximately 62% of THY's international seat capacity operated to the same destinations as Emirates and 65% to the same destinations as Qatar.

One of THY's strategic advantages is that has a more diverse network structure and, importantly, a significant domestic market (as opposed to or not having any domestic market in the case of the ME3). In the first half of 2024, 37% of its passenger total was domestic and a further 5% domestic/international transfer. International to international transfer accounted for 38% and international direct for 21%. Its mix of narrowbody and widebody equipment gives it more flexibility in developing the network.

Currently, Emirates and Qatar appear to be consolidating rather than expanding aggressively, but this could change. There is also the unknown threat from the new Saudia.

Cargo superconnector

Cargo revenues increased to 16% of THY's total in the first half of this year compared to 13% a year ago. Building from its the cargo hub, SmartIST, one of the largest air cargo terminals in the world with capacity of 5m tonnes/year, THY has cargo operations to 366 destinations using 21 freighters as well as bellyhold. Its frequently stated ambition is the be one of the three biggest cargo carriers in the world, which implies that it would displace Emirates. In fact, THY claims to have already achieved the third position globally in terms of FTKs in the first half in this year.

The plan in 2021/22 was to spin Turkish Cargo (TC) off as a separate brand and to form a joint venture with a major player in the cargo sec-

THY LONG HAUL ROUTE NETWORK

tor. However, that joint venture has not yet materialised, one complicating factor being that FedEx has set up its own hub at İGA. Also THY's operations have been impacted by the postpandemic normalisation of the air cargo market: it is able to grow volume, but yields have fallen substantially, so eroding profitability in this segment.

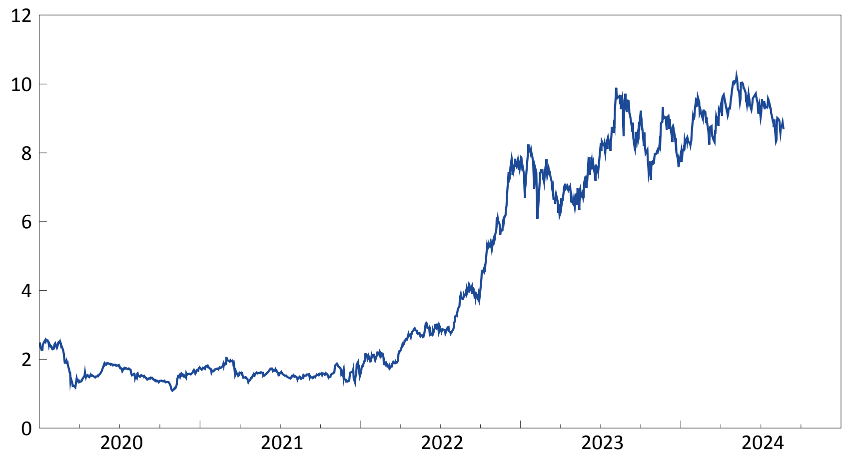
Ajet: LCC proposition

Ajet, rebranded from Anadolujet, is described as a "Growth Platform". It has been operating independently from THY since April this year. The intention appears to be to IPO the airline at some point, though financial details are sparse at present.

By mid-2024, 95 737-800s, MAXs and A320 Family aircraft were operating under the Ajet brand on 162 routes compared to just 30 in 2020. 2024 traffic volume is expected to be around 22m passengers.

Ajet is a classic LCC model: the aircraft are densely configured, 189 seats on the 737s, and the network is pure point-to-point, separate from the THY hub network. The focus is on price-sensitive passengers in Europe and the Middle East. The main bases are Sabiha Gökçen, the second İstanbul airport where it has a 23% international market share, and Ankara Esenboğa, both much less expensive airports than İGA.

THY SHARE PRICE PERFORMANCE (US$)



The risk with such LCC subsidiaries is conflicts of interest between management and unions at the mainline and subsidiary companies, plus the possibility of cannibalisation of mainline traffic and undermining of THY's hub economics, although the two markets appear distinct.

Ajet also has the classic LCC-subsidiary role of trying to protect the parent from aggressive competition, in this case from Pegasus, also based at Sabiha Gökçen (see *Aviation Strategy*, September 2023).

Lufthansa buys into Italy

LUFTHANSA has finally been given the green light to acquire a major stake in Italia Trasporte Aereo (ITA), the latest phoenix-like reincarnation from the ashes of the failed Alitalia.

For a modest €325m injection of new capital into the airline (matched by €250m new equity from the Italian government), Lufthansa will get a 41% stake, two of the five seats on the board, and the right to appoint ITA's CEO. ITA will be under joint operational control of Lufthansa and the Italian Ministero dell'Economia e delle Finanze (MEF), and the deal is structured in such a way that Lufthansa will not need to consolidate ITA in its accounts. There is a clause giving Lufthansa the right for a full takeover with call options between 2025 and 2033, and the Italian government put options, subject to undisclosed conditions.

Alitalia was the fourth largest European airline when it last made an operating profit in 1998. Since then it has all been downhill: bankruptcy in 2008 (from which it emerged two-thirds its former size); further restructuring in 2014 with a €560m investment from Etihad as part of its Hunter Strategy (see *Aviation Strategy*, April 2015). Alitalia finally ran out of cash in 2017 (before the COVID pandemic made it fashionable), and its troubled 49% shareholder Etihad walked away.

The Italian government provided a €900m short term loan and the airline was put into special administration with the hope of finding a buyer. Several suitors appeared, including the state-owned railway Ferrovie dello Stato (see *Aviation Strategy*, May 2019) and Delta (which, having splurged $1.9bn on a 20% stake in LATAM in 2019 — what timing! — baulked at paying more than €100m for 10% of Alitalia's equity). After the pandemic hit, hope was abandoned, and renationalisation became the only option.

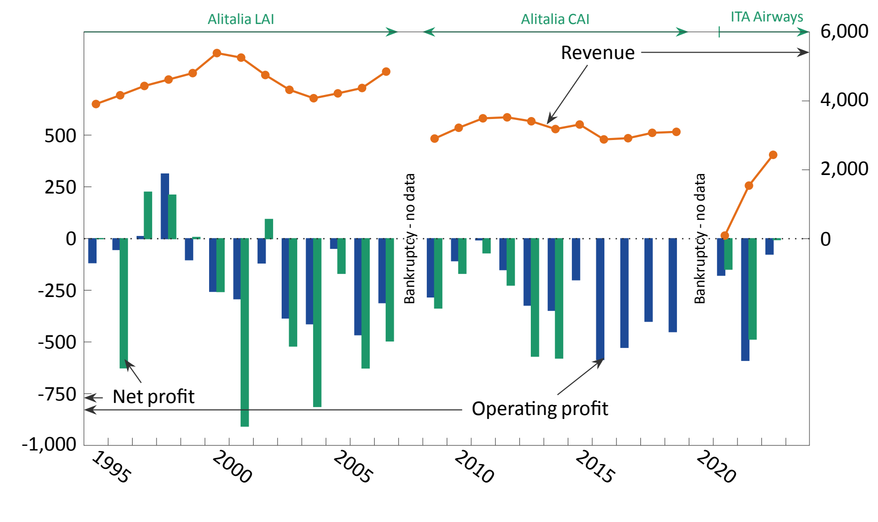
A new state-owned company, Italia Trasporte Aereo (ITA), with €3bn of funding was formed at the end of 2020 to acquire the "good" parts of Alitalia — the brand, the frequent flyer programme MilleMiglia, and the slots at Milan Linate. The new airline was launched in October 2021 — a much slimmed-down version of its predecessor. Alitalia in 2019 had had over 100 aircraft, carried 23m passengers and employed 10,000 staff, and probably generated turnover of around €3.1bn.

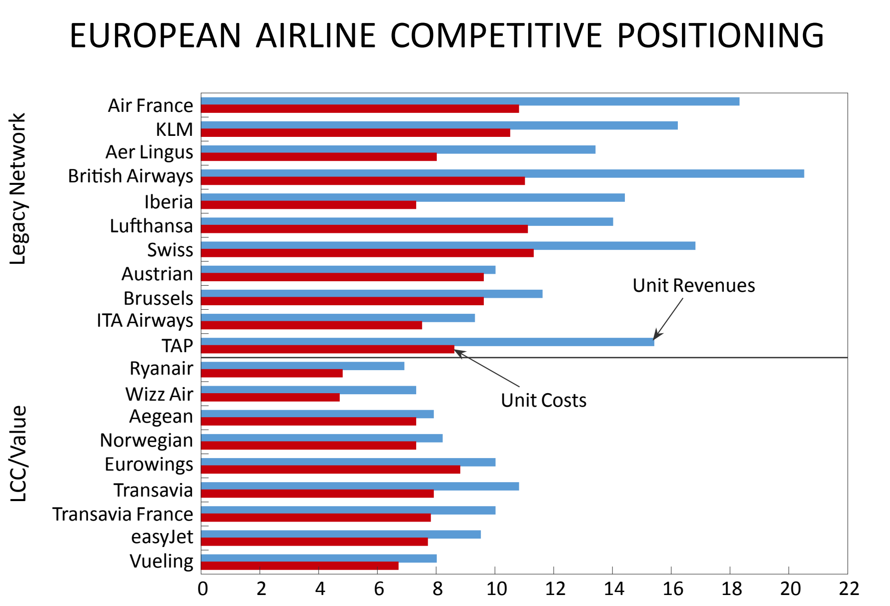
ITA in 2022 had 66 aircraft, around 3,900 employees on its payroll (the flight and cabin crew contracts had been completely renegotiated, and it had no legacy pension obligations from the former Alitalia), carried 10m pax and revenues reached €1.5bn.

It currently operates 99 aircraft, and in 2023, its second full year, carried 15m pax with a turnover of €2.4bn. With an homogenous leased Airbus fleet, fully outsourced maintenance and ground handling, and a "reset of the IT and supplier landscape", Lufthansa describes ITA as having been "fully restructured and set up as a structurally competitive airline".

The graph on the facing page may justify that statement. The data is taken from Skailark's Airline Economics data analytics, and shows ITA as having the lowest stage length adjusted unit cost of any airline in the Lufthansa Group (although unit revenues are another matter).

ITALY'S FLAG CARRIER: FINANCIAL RESULTS (€m)





Source: Skailark.

Note: stage length adjusted revenues and costs per ASK, twelve months to June 2024.

Remedies

Lufthansa made its original bid early in 2023. The intervening 18 months seem to have involved significant horsetrading between Lufthansa and DG Comp in Brussels (and no doubt the Italian Government), to allay the Competition Authority's concerns of market concentration. At one point Brussels is reported to have suggested that ITA should not be allowed to join the metal neutral immunised joint venture between Lufthansa Group, United and Air Canada — a demand that would have scuppered the deal.

The agreed solution required a divestment of a sixth of the joint slot portfolio at Milan Linate — leaving Lufthansa/ITA with only 50% of the slots down from 60%.

DG Comp voiced concern over the potential reduction of competition on routes from Italian airports particularly to points in Central and Eastern Europe where it saw significant overlap between Lufthansa Group airlines and ITA (bizarrely Brussels doesn't seem to regard Ryanair or Wizz as viable competitors).

It therefore required the new combination to ensure a new competitor on ten direct short haul routes (accounting for 3% of ITA's capacity) — and, oddly, give the new competitor access to ITA's domestic feed.

On long haul, Lufthansa and ITA are to facilitate new direct or indirect competition on three routes from Rome to Washington, San Francisco and Toronto for three years. This accounts for about 7% of ITA's intercontinental capacity. In the (somewhat likely) event that no new direct competitors are forthcoming, the remedy can be delivered by creating a new indirect routing through a competitor hub with no more than a three-hour connect in Europe or a four-hour connect in the US.

This also is a bit bizarre. Lufthansa said that this remedy could be met by ITA operating a new short-haul service to a competitor hub — eg London (if it could get the slots), Paris, Madrid, Dublin or Lisbon — with the right timing, thus creating an interline routing with BA, Air France, Iberia, Aer Lingus or TAP.

Rationale for ITA

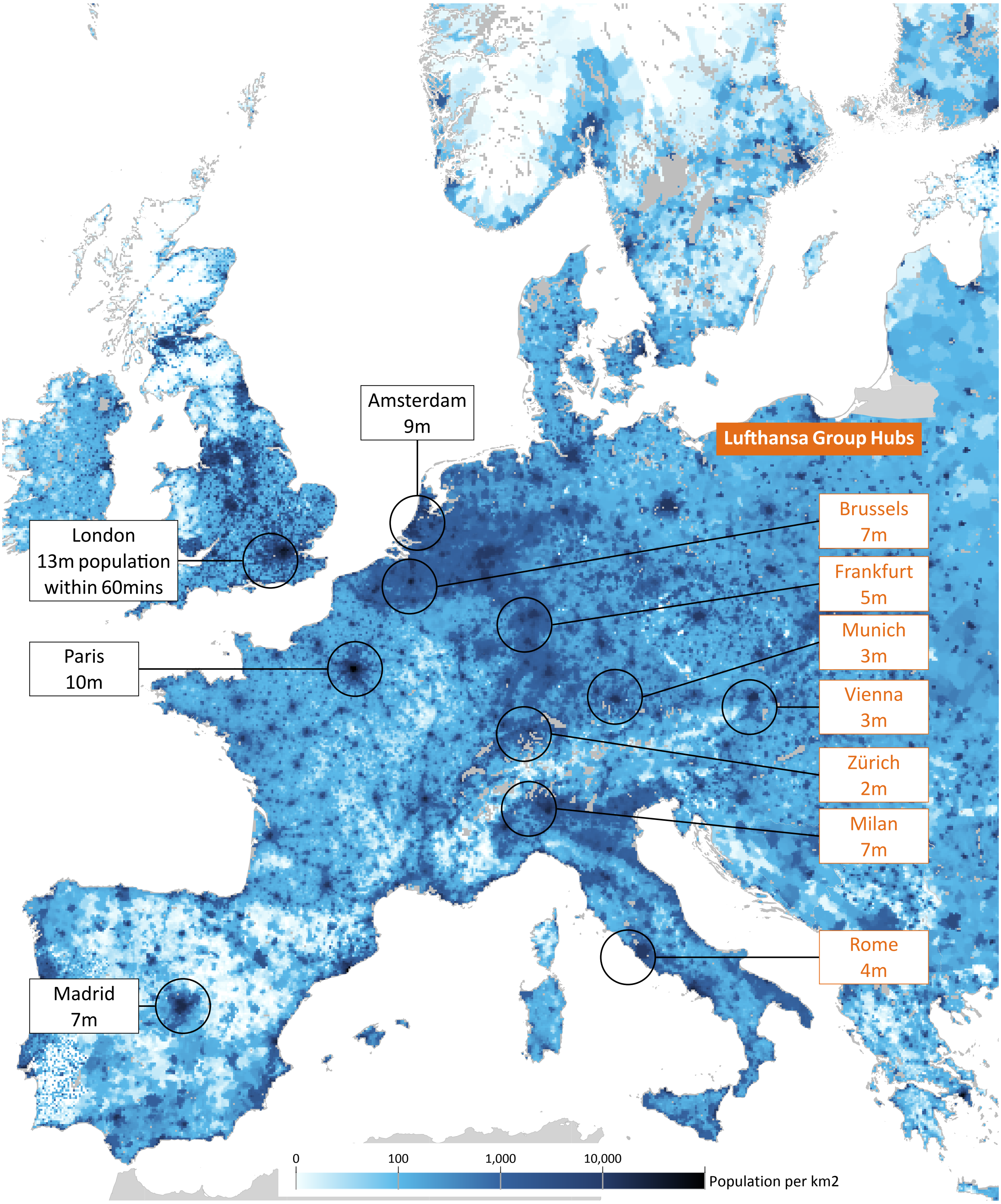
Why does Lufthansa want to buy a small national flag-carrier? Historically, Lufthansa has justified its acquisition policy on concentrating on its tedescophone "natural" area: Germany, Austria, and parts of Switzerland and Belgium speak variations of German. But then, so does a small part of northern Italy.

But Italy is also the third largest economy in the EU (post Brexit), the third largest airline market in Europe (post Brexit) and Lufthansa regards it as the fifth largest market for the Group (after its four "home" markets and the USA). Lufthansa notes that Milan is the second largest destination for local passenger traffic in the EU, and Rome the sixth.

Lufthansa contends that there is an attractive proposition to grow a profitable long haul business out of Rome Fiumicino, and that it is well positioned "to take advantage of Italy's importance as top private travel destination" (for which read in-bound tourist traffic) and that there is "potential to increase the feed of passengers into the Group's existing long-haul network including JV partners".

There are expectations of synergies. Lufthansa will be able to plug ITA into its multi-airline structure — subsuming non customer-facing activities (finance, revenue management, network planning, IT, fleet management, procurement) into existing Lufthansa Group functions. There is the strong possibility of good benefits from linking ITA Airways into services from Lufthansa Technik and Lufthansa Cargo. Taken perhaps by the idea that its acquisition target is based in a country with some of

EUROPE POPULATION DISTRIBUTION AND AIRPORT HUB CATCHMENT



the best food in the world, Lufthansa describes the amalgamation process as “One kitchen, many restaurants”.

The acquisition will add Rome Fiumicino and Milan Linate to Lufthansa’s agglomeration of restricted hubs. It currently controls Frankfurt, Munich, Zürich, Vienna and Brussels. Each of the group’s hubs, despite being some of the largest airports in Europe, have relatively small local catchment areas, some have relatively low true O&D traffic and are reliant on feeder transfer networks.

In the map on the preceding page we show the population density distribution within Europe, the top four Western Europe airports, Lufthansa’s seven hubs and their respective catchment populations. The mass of European population runs in a blue crescent from London through the Ruhrgebiet to Milan and the Po Valley.

Milan has a catchment population of 7m people within an hour of access to the airport. But ITA’s involvement there for historical and political reasons is exclusively in the downtown Linate airport (annual passenger throughput of 9.5m) which is limited to short haul intra-European flights. At the beginning of 2024 ITA withdrew its last remaining Milan-based long haul flight — to JFK — from the larger Milan Malpensa (29mppa in 2019): it lacked a feeder network.

ALITALIA / ITA AIRWAYS FLEET

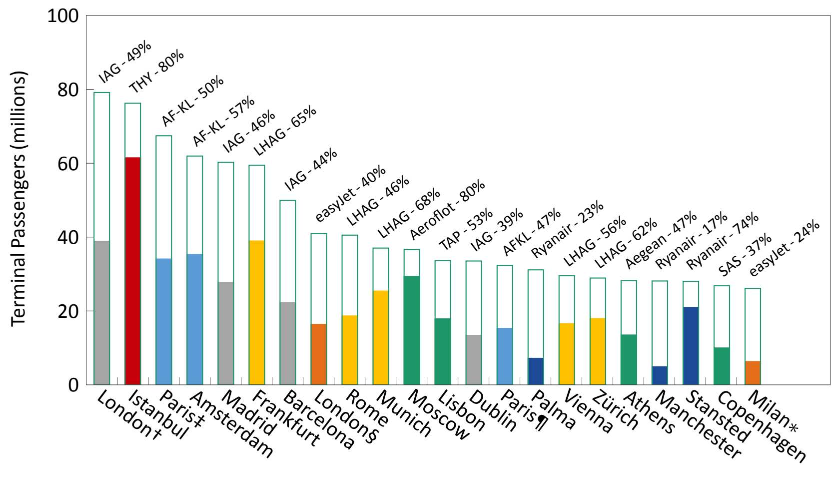
	Alitalia		ITA Airways	
	2019	avg age	2024	avg age
777	12	16.0		
A350			6	4.8
A330	14	10.5	18	5.5
A319	22	12.6	10	15.9
A320	38	12.9	43	9.5
A321	10	22.0	6	0.6
A220			16	1
E175	15	7.4		
E190	5	7.9		
Total	116	12.7	99	7.2

Rome has a catchment population of 4m, and Fiumicino is ITA’s choice of long haul network hub but there are geographical disadvantages. The key long haul market to and from Italy is the US, and there is good inbound demand from select points in Asia. But these are highly seasonal and Rome is too far south and east effectively to feed traffic from populous intra-European destinations on to these routes; there are limited opportunities to garner feed from European destinations to its east on to North Atlantic services.

South Atlantic is more promising. Argentina and Brazil have significant Italian diasporas that provide meaningful long haul markets for ITA, the routes to Argentina particularly benefitting from weak competition. Even so, Spain and Portugal are better placed to act as hubs between Europe and Latin America.

Lufthansa’s suggestion that it could develop routes through Rome into Africa is probably more wishful thinking than a likely prospect: Italy was late to the game in its colonial ambitions (colonial legacy being a large reason for the strength of long-haul demand to African destinations for British Airways, Air France and Brussels Airlines), and its establishment of colonies in Ethiopia, Somalia, Eritrea and Libya as part of the Italian Empire is best forgotten.

THE LARGEST EUROPEAN AIRPORTS (2023)



Notes: Largest base carrier with percentage of pre-pandemic seats (AZ included in LHAG). †Heathrow, ‡Roissy Charles de Gaulle, §Gatwick,¶Orly, ∗Malpensa.

Network Analysis

The chart below shows the competitive analysis of ITA Airways' network. The data (again) comes from Skailark's airline economics dataset showing the airline's relative market share on individual city-pairs plotted against its costs of operating those routes as a proportion of the costs of its competitors on those routes. We've excluded the handful of monopoly routes.

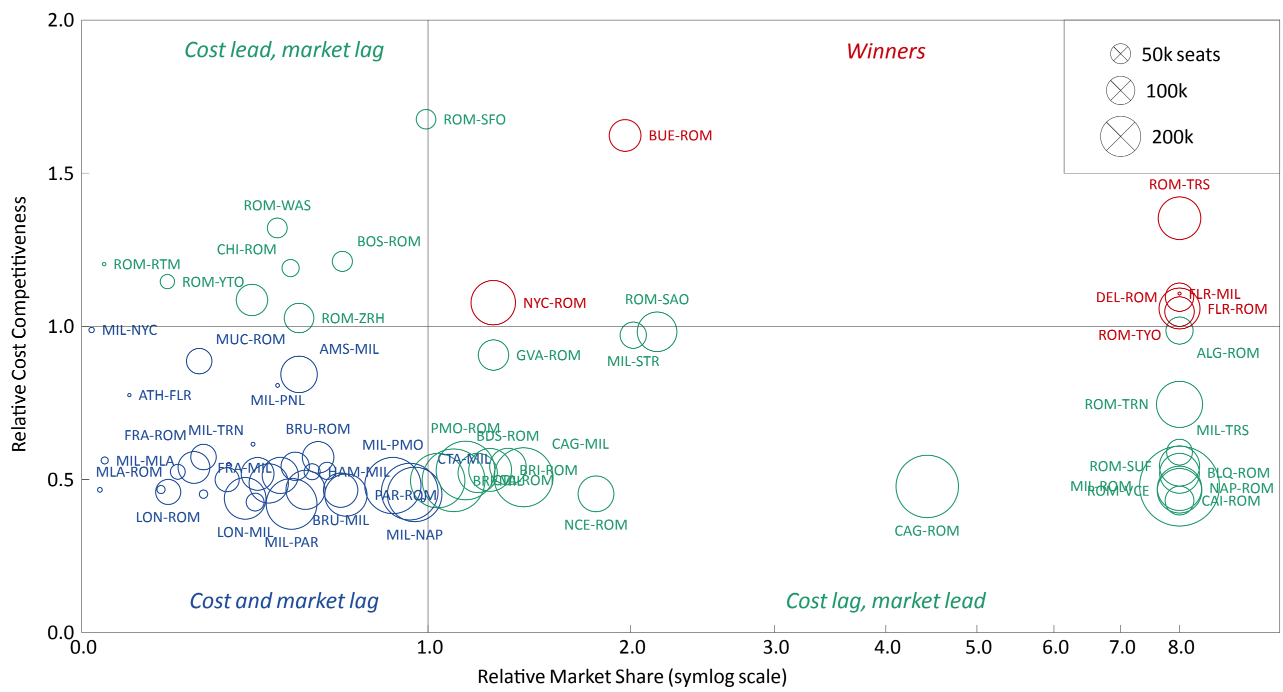
There are very few clear winners — where ITA has a leading market share and costs lower than the competition. These include routes from Rome to Buenos Aires, New York, Tokyo and Delhi. Its service to São Paulo almost makes it. Surprisingly a handful of domestic routes also appear: Rome to Trieste, Firenze and Milan to Firenze. (With a relative market share of 8 these are near monopolies.)

Those routes where ITA has a reasonable cost advantage, but market share weakness, are primarily on other North American routes: Rome to San Francisco, Washington, Chicago, Toronto and Boston.

There are a sizeable number of city-pair routes where it has market share advantage but a cost disadvantage, but nearly 50% of the city-pair routes it operates with competition it lags in both cost and market position. And despite its restructured cost base, on average its costs are twice those of its competitors.

This is not surprising. ITA Airways does not control its domestic or short haul international markets. Taking advantage of Alitalia's weakness and ITA's remodelling, Ryanair, easyJet, Wizz and Vueling have all muscled in. Ryanair has a commanding market position with over 40% of the domestic capacity (nearly twice the size of ITA Airways). Ryanair is also the largest operator on international routes with nearly 30% of the seats: here, ITA Airways trails in fourth place behind easyJet and Wizz.

ITA AIRWAYS: NETWORK ANALYSIS 2024



Source: Skailark

China Re-emerges, Western Airlines Retreat

By mid-year the Chinese aviation markets had finally reopened, their recovery lagging the rest of the world. While domestic passenger traffic was about 10% above 2019, international passengers on Chinese airlines were still were about 30% below. Meanwhile, Western airlines have been reducing or eliminating their Chinese services, which have proved to be unsustainably loss-making.

There is a sharp contrast between the current performance and official long-term optimism about China. Boeing's 2024 market outlook projects Chinese traffic growth at 6.2% pa up to 2043 compared to 4.4% for the rest of the world, giving a global average growth of 4.7% pa. This means that Boeing (and Airbus) are relying on Chinese markets to generate about 25% of the incremental traffic growth over the next 20 years.

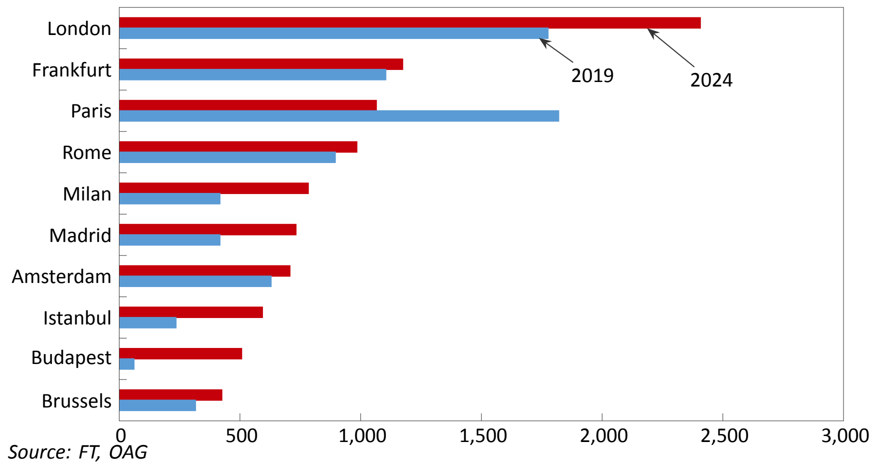
Conversely, economic performance indicators are stronger in the short-term and weaker in the long-term. In July the IMF revised up its 2024 GDP estimate for China from 4.6% to 5.0%, but it envisages a long-term decline in the growth rate, due to declining productivity gains and, importantly, the impact of a rapidly ageing population, largely the result of the "One Child" policy; a 3.3% growth rate is forecast for 2029.

Political and economic isolation

As of July this year, US sanctions had been applied to over 1,400 Chinese entities including giant semiconductor producers like SMIC and YMTC, ICT conglomerates like Huawei and Tikvision, and aviation manufacturers like Changhe Aircraft Industries and Jiangxi Hongdu Aircraft. The sanctions have impacted aviation both through the collapse in Chinese trade and tourism and through direct restrictions on direct airline capacity between the two countries.

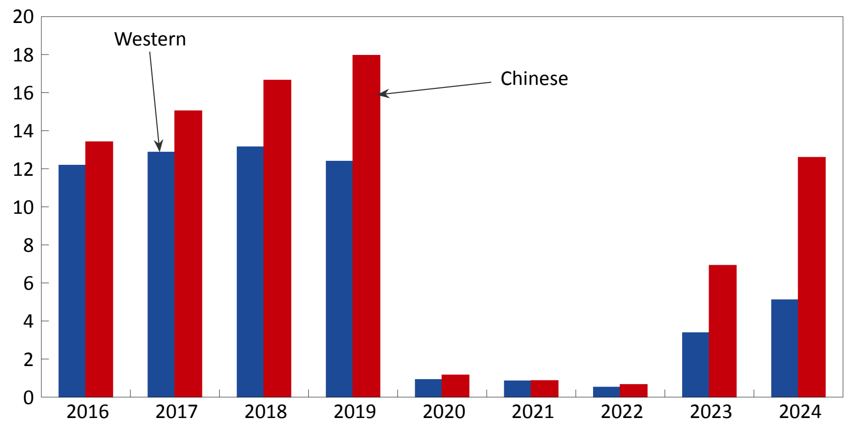
US-China seat capacity at the beginning of this year was at about 10% of the prepandemic level. However, the US government has since agreed to increase the number of direct flights between the US and China from 35 to 50 per week, compared to 325 prepandemic. United, Delta and American argued against this mod-

CHINA TO EUROPEAN HUBS (Summer 2024 flights)



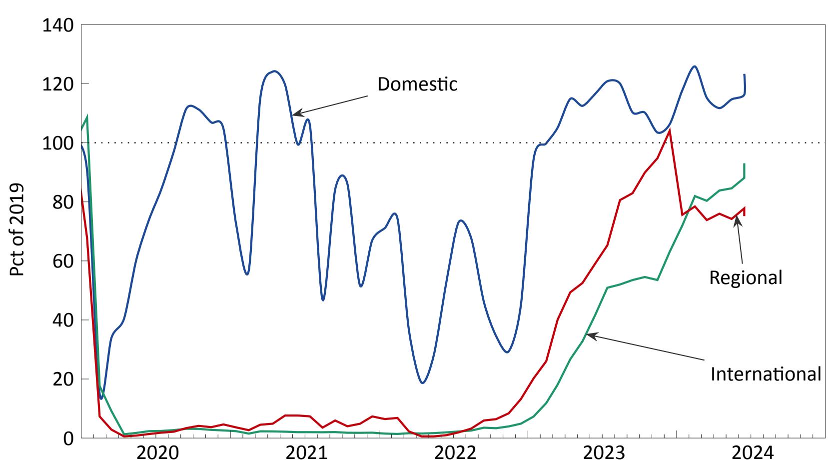
Source: FT, OAG

CHINA TO N. AMERICA AND EUROPE BY CHINESE/WESTERN CARRIER ('000s flights S2024)



Source: FT, OAG

CHINA: MONTHLY PASSENGER TRAFFIC v 2019



Source: CAAC. Note: Regional=Hong Kong, Macau, Taiwan.

est increase and continue to lobby through A4A. Their message was encapsulated in a letter to the Secretary of State and the Transportation Secretary: "If the growth of the Chinese aviation market is allowed to continue unchecked and without concern for equality of access in the market, flights will continue to be relinquished to Chinese carriers at the expense of US workers and businesses."

At present it seems unlikely that the sanctions policy will be eased under either a Harris or a Trump administration, indeed they may well be escalated if there is an incident between the PRC and the ROC (Taiwan). In the unlikely event that sanctions are eased, the difficult question for the US airline industry is whether "equality of access" is a genuine market requirement or protectionism as a response to the fundamental problem of competitiveness.

Australian airlines abandon China

Another indication of the depth of the problems Western carriers were having in the China market came in June this year when Qantas closed its Sydney-Shanghai route, in effect pulling out completely from the PRC. This route had been resumed in 2023 and was meant to go daily in March 2024. The reasons given were weak demand, strained diplomatic relations and the decision by the regulator, AACC, to terminate Qantas's codeshare agreement with China Eastern.

Qantas has never been able to realise the apparent potential of the emergent Chinese market. Its Sydney-Beijing service was being downsized before the pandemic and was closed in 2020. Attempts by the lower-cost subsidiary Jetstar to establish regular services also failed.

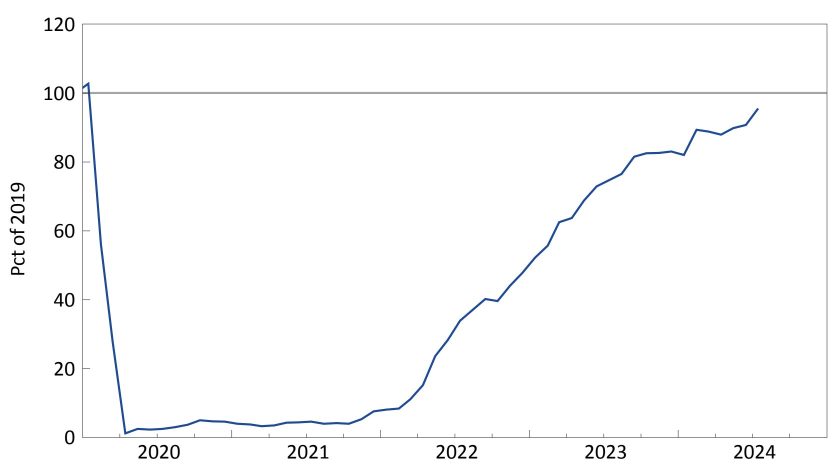
There are now no Australian carriers flying to China while the Big 3 Chinese carriers, as well as other Chinese airlines, offer over 100 flights per week to Australia during July-September, which is the low season.

The market is predominantly Chinese-origin and price-sensitive — tourists, students and VFR — and so has been dominated by the Chinese airlines. Qantas's strategy relied on winning high-yielding business travellers, but it appears that the market simply was not there.

European airlines and the Russia Airspace problem

For European carriers, closure of Russia's airspace following the invasion of Ukraine has been blamed for the withdrawal of Chinese services. The airspace above Russia was closed to Western airlines in 2022, forcing airlines to take a longer, more southerly route. On London-Beijing this increased the flying time by 2hrs 45 min or about 25% for BA, while Chinese airlines continued to fly the

AAPA: INTERNATIONAL PASSENGER TRAFFIC v 2019



shorter trans-Siberia route.

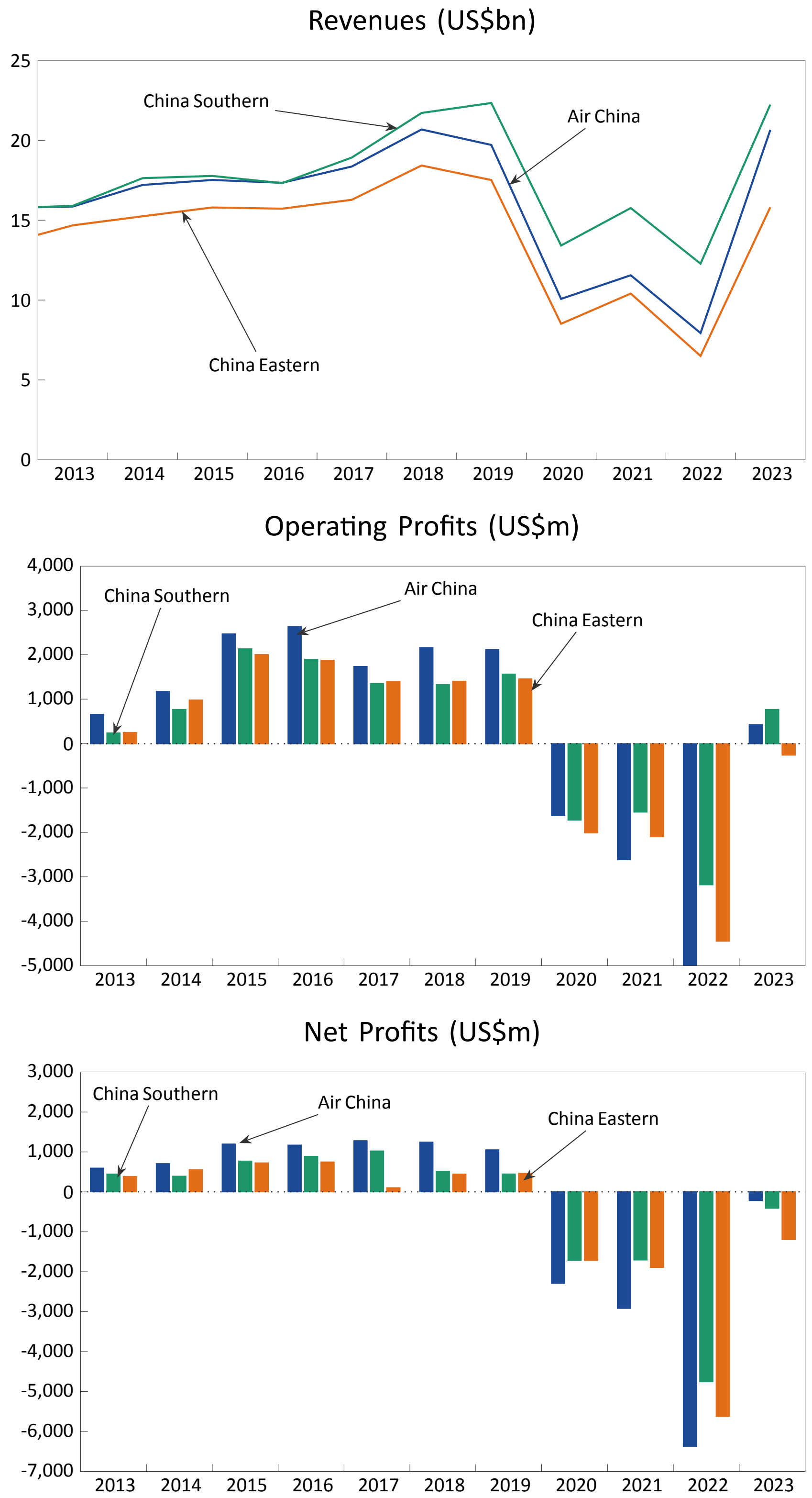
European airline representatives claim that they are at a 30% cost disadvantage compared to the Chinese, but the route diversion would only account for about a third of this gap.

BA has announced the closure of its London-Beijing service from October, following on from Virgin Atlantic's cessation of London-Shanghai. Air China and China Southern and China Eastern have responded by increasing capacity to the extent that the overall London-China market has grown by about 40%, comparing this summer to 2019.

Overall, Chinese carriers are estimated to have pushed up European capacity by 16% compared to 2019. Total capacity is up at all the European hubs with the exception of Paris where total Paris-China capacity is down about 30% compared to 2019, the result of the liberal bilateral between the two countries being suspended, which has partially locked Chinese carriers out of what was their favoured European gateway. Air France is insisting on a "balanced" return to prepandemic frequencies, and there have also been calls for some form of tax to close the cost difference between Air France and the Big 3 Chinese carriers.

The European Commission has signalled its intention to investigate possible anti-competitive actions on the part of the Chinese, specifically whether they are using the routeing advantage to dump capacity, which they cannot use to the US, into the European market, depressing fares and establishing a dominant market position. However, there appears to be a regulatory issue in that aero-relations are governed not by an EU-China bilateral but by a series of bilaterals between individual European countries and China. The Commission

CHINESE BIG THREE: FINANCIAL RESULTS



Source: Company reports.

CHINESE BIG THREE FLEETS

	Air China			China Southern			China Eastern		
	In service†	△ v 2019	On order	In service	△ v 2019	On order	In service	△ v 2019	On order
A320	348 *(42)*	+58	50	362 *(11)*	+45	96	373 *(1)*	+45	99
A330	55 *(1)*	-10		28 *(1)*	-19		56 *(1)*	–	
A350	30	+20		20	+14		20	+13	6
A380		–			-5			–	
737	396 *(1)*	-9	55∗	380 *(5)*	-21	32	276	-26	
747	13 *(2)*	+3			-2			–	
757		-5			–			–	
777	39 *(3)*	+11	2	32 *(1)*	+5		34	+14	
787	14 *(1)*	–	12∗	40	+3		10	–	
ARJ21	27 *(2)*	+27	11∗	32 *(1)*	+32		23	+23	
C919		–	100		–	105	6	+6	100
ERJ		–			-20		2	+2	
Total	**922 *(52)***	**+95**	**230**	**894 *(19)***	**+32**	**233**	**800 *(2)***	**+75**	**205**

Notes: † figures in brackets=aircraft parked; ∗planned deliveries 2024-26. USD/CNY 7.2 (6.93 2023)

could attempt to coordinate a unified response from the member states.

Culture and cost

European carriers have tended to regard connections to routes to Beijing and other major Chinese cities as prestige routes. In 2023 BA stated that the Beijing route was "one of its most important" when it relaunched flights after the pandemic. The idea is that the European network airlines had to be positioned to take advantage of the potential as the Chinese economy surged, possibly returning to the same global importance as it enjoyed in the sixteenth century when it was estimated to account for between a quarter and a third of the global economy. But now they may have to accept the same commercial logic as the Australians.

The Europe-China market is based on outbound Chinese tourism, with limited business demand, especially following the deterioration in diplomatic and trade relations, so it is very price-sensitive and quite seasonal, not the type of market where high-cost European network carriers can compete effectively. Moreover, long-haul international travel is a new experience for the large majority of Chinese so there are high cultural barriers to selling in this market. Familiarity is a strong marketing tool.

Earlier this year DragonTrail, a special market research firm, surveyed a sample of 1,015 experienced Chinese travellers. Some of the findings were:

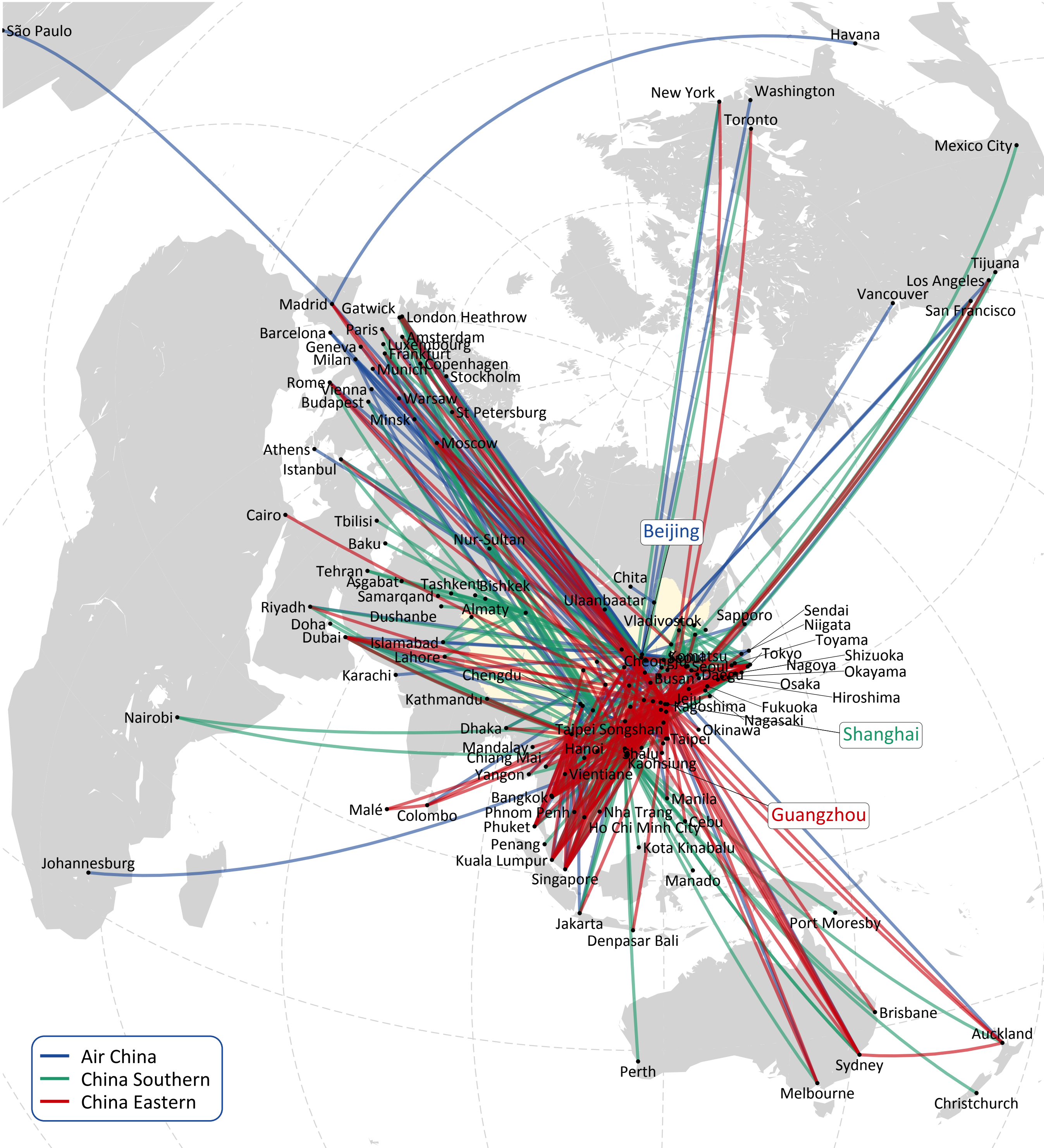
- ✈ Asia, unsurprisingly, is the main holiday destination, chosen by 60% of respondents, but 27% replied that they intended to visit Europe in contrast to just 3% for North America.
- ✈ When asked which travel type was preferred, there was an almost equal split between group and independent travel (though "independent" wasn't precisely defined).
- ✈ "Value for money" or "products with the best price" dominated answers to questions on choosing travel products.
- ✈ When booking outbound travel 60% of the responses referred to domestic booking platforms like Ctrip and Qunar; 38% via travel agencies on Chinese social media like WeChat and Xiaohongsu; 27% directly through airlines; 23% through traditional travel agencies; 37% others; and 17% international booking platforms like booking.com (multiple responses so the total sums to more than 100%).

Overall, there was a huge preference for local airlines. As the Chinese travel market matures, travellers may become more receptive to choosing foreign airlines in the same way as the Americans, Europeans and, to a lesser extent, the Japanese have done. But the Chinese carriers have an entrenched position not just because of cultural barriers but also because of their relatively low costs.

The Global South potential

The map on the next page which shows the combined international network of the Big 3 (as at August 2024) indicates the concentration of capacity in Southeast Asia and the importance of Europe compared to the US, as well as revealing the

CHINESE BIG THREE: INTERNATIONAL NETWORK



Note: Azimuthal equidistant map projection centred on Beijing limitations of their operations. There are few operations into Africa, India and South America.

Sanctions have accelerated the key trend in China's economic development. Economic growth had been driven by rapid expansion in domestic manufacturing and surging local consumer demand, but investment in foreign countries is increasingly important. And that investment — for example, in electric car manufacturing, lithium battery production, mining, smartphones and consumer goods — is concentrated in the Global South, which is Africa, South America and the developing Asian countries.

According to *The Economist*, foreign revenues from the Global South for stockmarket-listed Chinese companies quadrupled between 2016 and 2023 to nearly $800bn, while revenues from the developed world by increased by 90% to $780bn.

The top five countries for greenfield foreign direct investment by Chinese companies in 2023 were Saudi Arabia, Malaysia, Vietnam, Egypt and Morocco. The Global South is also emerging as the major consumer sector for Chinese products.

So the airlines that will benefit most from Chinese economic power are those that connect Chinese airline networks into the Global South.

The super-connectors, especially Emirates which has fully restored capacity to China, are very well positioned. They are also the most likely to capture Chinese travellers to Europe who are looking for an alternative to Chinese carriers.

The new Saudia sees China as its most important market.

Ethiopian Airlines' new hub airport at Addis Adaba offers pan-African connections, and has Chinese signage throughout.

There would appear to major potential for Indigo to develop Chinese links, politics allowing.

In Central and South America, connecting networks have not yet been developed, though Copa has an agreement alliance with Air China to connect traffic at Panama (Air China has yet to reinstate its Panama route first introduced in 2018).

Chinese Big 3 Recent Results

When we last reviewed the Chinese Big 3 (see *Aviation Strategy*, Dec 2022) the PRC was in the process of abandoning its zero-Covid policy, and it looked as if Air China, China Southern and China Eastern could make a swift return to their historic growth.

After three disastrous years during the pandemic — combined losses at the operating level of $24bn (a negative -25% margin on revenues) and $29bn at the net — 2023 allowed for some recovery in traffic.

The number of domestic passengers carried by the Big 3 jumped by 150% year-on-year to 353m — some 7% higher than in the whole of 2019. (The three airlines in 2023 accounted for 60% of the total domestic passenger numbers, up from 56% in 2019.) Regional passenger numbers (on flights to Hong Kong, Macau and Taiwan) increased over nine-fold to 7.2m, but were still less than two-thirds of the prepademic traffic on those routes. International passenger numbers at 22m were 14 times the prior year levels, but still only 40% of the numbers achieved in 2019.

Total combined revenues in that year of $59bn were only 1.5% short of the turnover in 2019; and Air China and China Southern reported a small operating profit — at a margin of 2% and 3.4% respectively. The full year net losses for the three of $1.9bn (in large part due to weaker performance at China Eastern) was a vast improvement on the near $17bn net loss reported for 2022.

In the first half of 2024, the traffic recovery has continued apace (see table on the facing page): Domestic passenger numbers up by another 18% year-on-year, regional by 78%, and international up by 283%. Regional traffic in the period had recovered to 80% of pre-pandemic levels, international to 86%. And all this growth came with a useful recovery in load factors of around 8.5 percentage points to over 80%.

Although revenues were 25% higher than the year before, financial results continue to disappoint. China Southern managed to produce a 5% operating margin, and China Eastern eliminated the losses it reported in the same period of 2023. But Air China's operating loss worsened to RMB1.1bn ($-156m). All three published net losses for the six month period.

None of the three pay much attention to shareholder communication — maybe it's a cultural thing, but given their ownership structure, maybe they don't think they need to. (For the complexities of the ownership structure of aviation in China see *Aviation Strategy*, Jul/Aug 2019).

In the official results release, or

even in a brief accompanying presentation, it might be a nice idea to explain how and why the airline group produced the results it did.

China Southern gets the prize for its first half Management Discussion and Analysis that includes the comment "We deeply carried out flight punctuality improvement actions... and reduced the number of passengers affected by unpunctual flights by 1.717 million year-on-year".

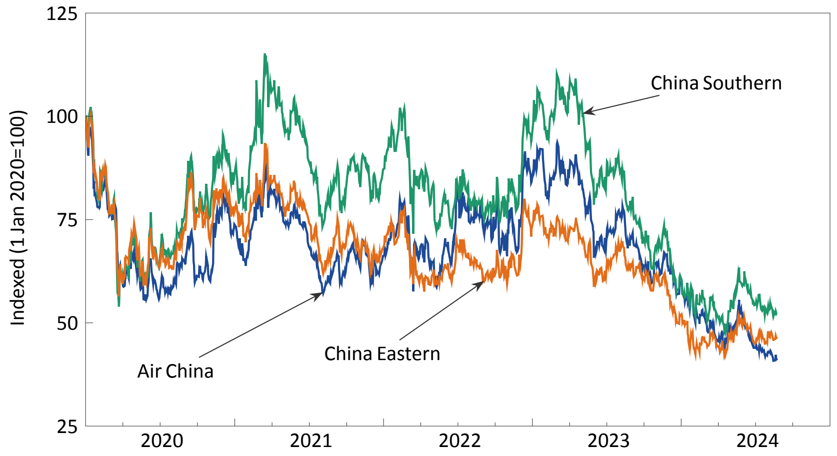
China Eastern in its results release at least stated "affected by the factors such as intensified competition in the domestic passenger transportation market, the lack of recovery of capacity in some international markets, competition from high-speed rail, and high oil price fluctuations, the operating pressure on airlines remained huge".

Air China was a bit more informative: "there was no significant reduction in the number of operating entities in the market, hence the Company still faced relatively huge industry competition pressure... as the international market has not yet fully recovered, widebody aircraft were used in the domestic market, which intensified the imbalance between supply and demand. In respect of the international market, the newly resumed and increased routes of domestic airlines were mainly concentrated in destinations such as Europe, Central Asia and the Middle East, resulting in an intense competition in certain regions."

So: too exuberant a reintroduction of capacity, yields fall (by 12%), load factors are up but unit revenues decline.

If only we understood Mandarin.

CHINA BIG THREE: SHARE PRICE PERFORMANCE



BIG 3 RESULTS FIRST HALF 2024

Jan-Jun	Air China 2024	Air China 2023	Air China Δ	China Southern 2024	China Southern 2023	China Southern Δ	China Eastern 2024	China Eastern 2023	China Eastern Δ
Financial results (RMBbn)									
Revenue	82.8	63.7	↑30%	84.8	71.8	↑18%	67.4	52.1	↑29%
Operating result	(1.1)	(0.9)	↓20%	4.5	1.4	↑215%	0.0	(2.6)	↑102%
Net result	(3.5)	(4.0)	↑12%	(0.4)	(2.5)	↑84%	(3.1)	(6.6)	↑53%
Pax (m)									
Domestic	65.2	52.6	↑24%	70.4	61.6	↑14%	58.1	49.4	↑18%
Regional	2.3	1.2	↑83%	1.0	0.6	↑50%	1.8	0.9	↑90%
International	7.5	1.7	↑333%	8.0	2.8	↑189%	7.8	1.6	↑390%
Total	75.0	55.5	↑35%	79.4	65.0	↑22%	67.7	51.9	↑30%
Load Factor	79.3%	70.5%	↑9%	83.1%	75.8%	↑7%	81.2%	71.8%	↑9%
Passenger yields∗	0.54	0.61	↓12%	0.49	0.56	↓13%	0.53	0.60	↓13%
Unit revenues†	0.43	0.43	↓1%	0.41	0.42	↓3%	0.44	0.45	↓2%
Avg fare	1,104	1,147	↓4%	1,067	1,105	↓3%	995	1,004	↓1%

Notes: ∗ RMB/RPK; † RMB/ASK; US$1=RMB7.20 (6.93, 2023)

From the archives: How the world has changed

IDLY SEARCHING the internet for news of an old friend and colleague, I was surprised to find, near the top of the results, reference to an article published in *Aviation Strategy*. What serendipity!

The subject of the search was Dr Julius Maldutis — *the* airline guru on Wall Street through the 1980s and 1990s. The article found came from issue number 6, published April 1998.

Entitled "The dawn of a Golden Age", the article commented on Julius's then controversial and optimistically contrarian view that the airline industry was entering a period of sustained and profitable growth.

The reasons cited included an intake of new CEOs intent on profits, not market share; a prolonged period of aircraft supply shortage as manufacturers struggle to keep up with rising demand (nothing's changed much); the new-fangled internet removing the need for printed tickets, agent intermediaries and commissions, and providing the ability to build load factors from the high 60s.

He was right in many ways, but cannot be blamed for not foreseeing the bursting of the dot-com bubble, the attacks on the Twin Towers in 2001, nor the Global Financial Crisis in 2008. It took another 20 years before the (now consolidated) US airline industry would generate healthy profitability.

The article contained a table of the top ten airlines ranked by number of aircraft in each of North America, Europe and Asia (but only the top five — the region not then deemed important), noting that over the previous 10 years "there has been significant change in the world's largest airlines by region (although interestingly the top three has stayed the same in all three regions)", and "what is certain is that when the table... is updated in 10 or 20 years' time, some current household airline names — those who cannot gain new competitive advantages — will not be on it".

It's been a bit more than 20 years, but we happily updated that table on the next page. And, indeed, what were household airline names in 1998 have disappeared from the lists.

✈ North America

In North America, the ranking of top three has not changed — American, United, and Delta. Fascinatingly the total fleet sizes of the latter two are close to the sum of the fleets that they and the airlines they subsumed in the intervening quarter century had had in 1998. Delta has ten more aircraft than it and Northwest had back then; United 31 more than it and Continental.

American in contrast has 195 more units in its fleet, 14% higher than the sum of the fleets of American, America West, TWA and USAir in 1998: equivalent to a net annual delivery of 7.5 aircraft over the period since then.

And those airlines involved as targets of the consolidating mergers — Northwest, Continental, TWA, USAir and America West — have seen their brand names disappear.

Five of the top ten in 2024 are LCCs of various flavours, with only Southwest (now the fourth largest carrier in the region) represented in the table in 1998, its fleet having grown three-fold over the intervening years (representing net average deliveries of nearly two 737s a month). Alaska Airlines meanwhile has outgrown the niche it occupied, to become the sixth-largest player with a fleet more than 2.5 times larger.

✈ Europe

In Europe, there have been two outright failures from the top ten of 1998 — Swissair and Alitalia — their successor flag-carriers brought (or about to be brought) under the Lufthansa Group umbrella (along with Austrian and Sabena's successor Brussels Airlines — both too small to register in the top ten back then).

The other household names that disappeared from the list (BA, Iberia, Air France and KLM) merged into groups that retain those brands as operating subsidiaries.

The three resulting legacy groups — Lufthansa Group, IAG and Air France-KLM have doubled their overall fleets over the period.

But five of the top ten are low cost carriers, a sector that hardly existed 25 years ago.

Ryanair (now the third largest fleet in the region) and easyJet (the sixth) were children of the early noughties. In 1998 they respectively operated 20 and 10 aircraft: their fleets have grown 30-fold in the period. Of the new entrants, Wizz has the same number of aircraft now as Lufthansa had 26 years ago, and Norwegian about the same as Nordic rival SAS — whose own fleet is now slightly smaller.

✈ Asia and the Middle East

Asia provides the greatest contrast. For whatever reason, the table published in Issue #6 only listed the top five Asian carriers — the two main Japanese carriers, JAL and ANA; Korean, Malaysian, and Singapore. It is as if neither China nor India existed.

But in 1998 the Chinese carriers were still in process of being formed from the bowels of state monopoly CAAC. The Big 3 have increased their total aircraft numbers by nearly 15 times — equivalent to each receiving average net deliveries of three aircraft a month over the period. The fourth largest, Hainan Airlines, was also a mere start-up all those years ago.

ANA, a stalwart of previous rankings, has been relegated to tenth place. And Singapore Airlines, the once world-leading brand, is now below the radar. There was no concept of the superconnector Emirates in 1988, nor of LCCs like Air Asia or Lion Air.

THE WORLD'S LARGEST AIRLINES BY FLEET SIZE, 1988, 1998... AND 2024

Region		1988 FLEET			1998 FLEET			2024 FLEET	
North America	1)	American	481	1)	American	649	1)	American	1,554
	2)	United	410	2)	United	601	2)	United	969
	3)	Delta	389	3)	Delta	567	3)	Delta	990
	4)	Continental	364	4)	Northwest	413	4)	Southwest	816
	5)	Northwest	307	5)	US Air	394	5)	JetBlue	286
	6)	Eastern	262	6)	Continental	337	6)	Alaska	221
	7)	US Air	231	7)	Southwest	259	7)	Spirit	201
	8)	TWA	212	8)	TWA	211	8)	Air Canada	197
	9)	Piedmont	201	9)	Air Canada	155	9)	Westjet	133
	10)	Pan Am	134	10)	America West	105	10)	Frontier	132
			2,991			**3,691**			**5,499**
Europe	1)	British Airways	167	1)	British Airways	270	1)	Lufthansa Group	834
	2)	Lufthansa	130	2)	Lufthansa	225	2)	IAG	664
	3)	Air France	114	3)	Air France	213	3)	Ryanair	599
	4)	SAS	85	4)	Alitalia	140	4)	Air France-KLM	562
	5)	Iberia	83	5)	SAS	138	5)	THY	356
	6)	Alitalia	65	6)	Iberia	114	6)	easyJet	347
	7)	Swissair	59	7)	KLM	88	7)	Wizz	222
	8)	KLM	46	8)	THY	65	8)	TUI	136
	9)	Air Inter	42	9)	Swissair	63	9)	Norwegian	135
	10)	Dan Air	36	10)	Finnair	55	10)	SAS	134
			827			**1,371**			**3,989**
Asia (and Middle East)	1)	JAL	91	1)	JAL	138	1)	Air China	924
	2)	ANA	85	2)	ANA	136	2)	China Southern	899
	3)	Korean Air	49	3)	Korean Air	119	3)	China Eastern	803
	4)	JAS	44	4)	Malaysia AL	98	4)	Hainan	629
	5)	Air China	40	5)	Singapore AL	84	5)	Indigo	388
							6)	Lion Air	370
							7)	Air India	298
							8)	Emirates	259
							9)	Air Asia	248
							10)	ANA	241
			309			**575**			**5,059**

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