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Indian aviation erupts

After 60 years of suppression, the Indian aviation market has erupted.

In addition to the flag-carriers, Air India and Indian Airlines, there are now a further eight jet operators plus two low cost subsidiaries of the flag carriers, Air-India Express and Alliance Air. The independent airlines have about 177 jets on order and option (it is admittedly difficult to assess how firm some of these orders are), while the flag carriers are still waiting patiently for government approval for their 93-aircraft fleet renewal plans. Until a couple of years ago the number of commercial aircraft registered in India was about the same as it was in 1948.

A number of inter-related factors have caused the recent phenomenon. The Indian government now seems committed to deregulation: its new civil aviation policy will be published this summer, based on the liberal recommendations of an expert committee that completed a report in 2004.

This new policy will continue the liberalisation of international routes which have already seen the very effective entry of Jet Airways and Sahara. Investment restrictions will be relaxed to allow foreign airlines to buy up to 49% of Indian carriers. Domestically, the most important change should be the abolition of the traffic allocation

CURRENT AND PROPOSED INDIAN FLEETS

Airline	Type	Fleet	Orders/Options/ Others
Air Deccan	A320	5	34
Air Sahara	737	17	
Air India	A310	20	
	747	15	
	777	3	23***
	787		27***
Air-India Express	737	3	
Alliance Air	737	11	
Go Air	A320	11*	
Indian Airlines	A300	3	
	A320	46	43***
IndiGo	A320		100
Jet Airways	A340	3	
	737	36	2
Kingfisher Airlines	A319		4
	A320	2	12
	A380		5
Magic Airlines	A320	10**	
spiceJet	737	2	20
Totals		**187**	**270**

Notes: * = plans to operate 9-11 used A320s by October 2006
** = plans to operate 10 A320s by end of 2006
*** = pending government approval

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CONTENTS

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rules whereby an airline operating on a trunk route like Delhi-Mumbai, has then to allocate a certain percentage of its ASKs to thinner inter-state routes and a further percentage of regional points. Replacement of this regime by a European-style PSO subsidy system was recommended by the committee.

Traffic growth in any case hit a record level, 25%, in 2004, as the new entrants started to make their presence felt. The target market for the new entrants, which all profess to having an LCC model though there is a great deal of variation among them, is the Indian train market. 15m passengers a day use India's railways while 15m a year fly domestically (many of those connecting to international services). Specifically, the new airlines want to attract the AC2s - train passengers travelling in Air Conditioned Class 2 at fares comparable with those of an LCC.

The question now for the new entrants, and their venture capital backers, is who is going to survive the inevitable inter-airline wars, assuming that the Indian government will deem it necessary to continue protecting its flag-carriers.

Gol: Brazilian LCC's Mexican adventure

Brazil's hugely successful low-cost carrier Gol, which last month celebrated its first anniversary as a public company listed in New York and Sao Paulo, has announced plans to create a Mexican LCC. While the details are yet to be worked out, is the Gol model suitable for Mexico?

According to the July 5 announcement, Gol has signed an MoU on the LCC venture, which would begin operations in the second quarter of 2006, with Mexican group Inversiones y Tecnicas Aeroportuarias (ITA), businessman Fernando Chico Pardo and Copenhagen Airports (CPH). Pardo and CPH jointly own ITA, whose aviation investments include a 15% stake in Asur, which operates nine airports in southeastern Mexico. Gol is expected to take a large minority stake in the planned airline, which by law must be controlled by Mexican investors.

None of this is really surprising - everybody is looking at Mexico at present. This is largely because the long-delayed privatisation of the two largest airlines, Mexicana and Aeromexico, is finally becoming a reality. Cintra, the state airline holding company, launched the tender on July 6, inviting expressions of interest by July 26. Qualified investors will be able to bid for 51-100% stakes in the carriers.

The sale could potentially attract major foreign airlines bidding in consortia with Mexican investors, but so far only Iberia has publicly expressed an interest.

The fact that the two airlines, which together control more than 70% of the domestic market, will be sold separately - Aeromexico with regional carrier Aerolitoral and Mexicana with Click, its new LCC unit - has helped stir interest in the undeveloped LCC sector. There are at least two Mexican LCCs gearing for startup later this year or in early 2006 - Interjet and Vuela - and many more reportedly in the works.

Both Interjet and Vuela plan to operate domestic flights from Toluca, which is 40 miles west of Mexico City and could act as an alternate airport for the congested hub. They both seem to have solid backing and aggressive plans. Interjet will initially utilise seven leased A320s, offering 50% discounts on current fare levels. Last month its owner ABC Aerolineas placed a US$1.5bn order for 10 A320s, for delivery from 2007. Vuela, in turn, is backed by an investment fund controlled by Mexico's former finance minister Pedro Aspe, Connecticut-based Discovery Capital Management and some of TACA's investors. Like Gol in Brazil, the venture plans to offer low fares that could draw traffic from buses.

Click Mexicana began operations on July 1 on eight domestic routes from Mexico City, utilising Fokker 100s and offering 15-30% lower fares. The plan is to take over Mexicana's routes to Caribbean resorts and codeshare with international airlines.

Mexico is attractive to new LCC entrants because it is a relatively undeveloped aviation market with huge growth potential. The domestic market, with 30m annual passengers, is the second largest in Latin America after Brazil. Gol

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noted the many similarities: large underserved cities, extensive geographic distances and traditionally high fares.

However, the Mexican market poses some special challenges for LCCs, including high taxes and airport charges that add about $100 to the cost of an average domestic return ticket. Mexico-based analysts have also made the point that the country is not a natural market for the Brazilians.

That said, the Gol model has been such a huge success in Brazil that it is hard to imagine that it could not be successfully established in Mexico. The airline possesses something extremely valuable: a strong brand. It may not yet be as widely known globally as Southwest's and JetBlue's brands, but it must be well known throughout Latin America.

Above all else, the Gol brand is associated with safety and reliability - for that reason alone it would probably go down extremely well in Mexico, where LCCs do not have a good image.

Although Gol is essentially modelled after Southwest, it has cleverly adapted the model to suit the less developed Brazilian market. For example, Gol offers night flights at bus rates between major domestic cities. It operates multi-stop service in thinner leisure-oriented markets, while offering typical LCC-style point-to-point service in high-density competitive markets.

These strategies, which make Gol's network and operations look very different from the typical US or European LCC's, have enabled the airline to serve all segments of the population and achieve the highest narrowbody aircraft utilisation rate in the world (averaging 14.1 block hours daily). Many of the special strategies could clearly be applied or adapted for the Mexican market.

Phenomenal profits

Otherwise, Gol is well positioned to make strategic investments because its financial performance and balance sheet remain extremely strong. Operating margins have remained in the high-20s (29.4% and 30.1% in 2004 and 1Q05, respectively), while net margins have been 20% or higher. Although recent months have seen a tougher pricing environment in Brazil - mainly because of the ending of Varig-TAM codeshares in May - Gol still expects 27-29% operating margins in 2005. These are among the best margins in the airline industry worldwide.

Gol has benefited from a strong Brazilian economy in 2004/2005 and a continued rational industry environment. Tight government controls over capacity addition in the past few years have helped raise the industry load factor to around 65%. Since two thirds of Gol's passengers are business travellers, demand is fairly inelastic, and it has been possible to raise fares to compensate for fuel price increases. Gol's yield has increased at a compound annual rate of 19% since 2001.

The airline expects its unit costs to fall as it transitions to the larger 737-800 aircraft and starts buying (in addition to renting) aircraft from 2007. This could add two percentage points to the operating margin; however, Gol's leadership has stated that the aim is to maintain current margins and "re-invest" such cost savings in the business.

Following on from the June 2004 IPO, Gol completed a US$236m secondary offering in April, raising US$100m in net proceeds for the company (the rest was collected by shareholders cashing-in). This boosted Gol's cash position to US$388m - a healthy 46% of 2004 revenues. As of April, there was no long-term debt. The lease-adjusted debt-to-capital ratio was just under 50%, which is relatively low by airline standards.

Gol expects to double its current 36-strong fleet to 70 aircraft by year-end 2009. The fleet will then consist of 22 737-700s and 48 737-800s. This would mean average annual seat capacity growth of 24%. The firm 737-800 orders currently in place for 2006-2009 delivery represent a significant US$2.6bn capital spending commitment.

Going international

The Mexico LCC plans have emerged just as Gol is gearing up for its first major international growth phase within South America. After introducing its first international route, Sao Paulo-Buenos Aires, in December 2004, Gol is adding Santa Cruz (Bolivia), Montevideo (Uruguay) and Asuncion (Paraguay) in the second half of this year. At least seven other destinations - typically capital cities, such as Lima, Bogota and Caracas - will follow in the next couple of years.

To emphasise this new focus, Gol's CEO Constantino de Oliveira Junior said at a recent conference that the company wanted to be recognised by 2010 as "the airline that popularised high quality low-fare air transportation in South America".

Gol has another 15 or so new destinations it can roll out in Brazil, in addition to adding frequencies in existing markets. There is now evidence, for the first time, of what might be termed "Gol effect". At airports that Gol began serving in 2001, passenger volumes grew at a compound annual rate of 9.4-16.2% between 2000 and 2004, compared to 6.4% growth for the top 50 airports in Brazil.

The Brazilian domestic market offers great potential, given that only 7m of the 180m population have flown. Gol believes that lower fares can stimulate that 7m to grow to 20m.

But competition in the domestic market is intensifying, as Gol's success is inevitably attracting imitators. The first of these new LCC hopefuls, WebJet, took to the air on July 12 with the first of three leased 737-300s expected by year-end. The Rio-based carrier, which is backed by a venture capital fund managed by RealAssets Consultoria, aims to serve high-demand markets other than the most competitive shuttle routes. Another potential new LCC is BRA, which is in the process of converting from charter to scheduled.

At the same time, TAM has staged a strong recovery, tripling its profits in the first quarter. It captured most of defunct Vasp's market share, as well as some of Varig's share following recent cutbacks. In June TAM became the domestic leader, with a 42.5% market share, compared to Gol's 28.7% and Varig's 25.7%. TAM also recently launched an IPO in Sao Paulo with the aim of raising US$150m for fleet expansion.

It appears that Gol has not been able to capitalise on all recent opportunities because of a lack of aircraft. However, its market share is likely to grow as more 737-800s are delivered.

It is hard to envision new LCC entrants posing a threat to Gol, because they will not be able to access the key business markets in Brazil due to lack of airport slots and will therefore not be able to build strong integrated networks. Gol has 25% of the slots at the five main slot-restricted airports, which handle 45% of Brazil's domestic traffic. It has a highly integrated network, with 50% of its passengers making connections.

Some Brazil-based analysts have expressed concern that the Mexico LCC plans might divert Gol management's attention from important developments at home, namely Varig's "restructure or die" situation following its bankruptcy filing on June 17. However, it seems likely that Gol already has its growth plans lined up regardless of what happens to Varig.

Gol may have reached a new level of maturity because, first, it has started constructing its own aircraft maintenance centre and has even mentioned third-party work (with the Mexican LCC probably being an early client). Second, Gol has just joined the Amadeus travel booking system. Third, Gol is in talks with Air France, Delta and others about codesharing.

Differing LCC impacts on different routes

What happens when an LCC enters a new route is not always obvious. As part of a review of state of the sector (in which the consultants see growth as slowing as markets become saturated and the full-service carriers adapt competitively).

The classic LCC effect is shown in the London-Barcelona example, whereby the entry of easyJet created a new market through price stimulation leaving the incumbent carriers, BA and Iberia operating as codesharing partners, with more or less their existing volumes. This route has all the best stimulation characteristics - leisure demand both ways, an unexploited VFR market, a growing cost-sensitive business segment and relatively high incumbent fares. At Carcassone, Ryanair created a new and growing market from zero (partly comprising British second-home owners). In this case Carcassone proved to be an effective alternative to Toulouse airport.

Aarhus near Copenhagen is an example of a market that grew rapidly following Ryanair's entry but appears to have reached saturation point, where low price buckets fail to generate additional volumes.

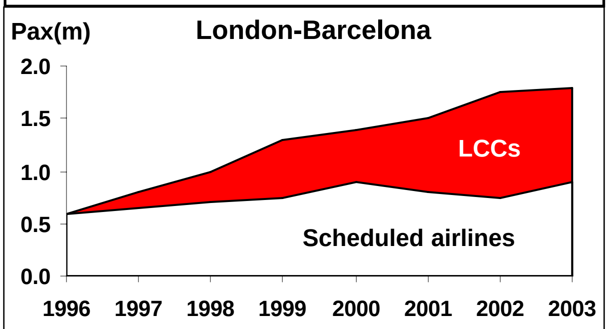
The LCCs, unlike the legacy carriers, do not sink costs into routes: if a route cannot reach the required level of profitability, it will be abandoned. And measuring route profitability is a much more precise exercise for the LCCs than for the legacies which have to take into account possible network effects, consider the impact of changing aircraft type, address entrenched union and management positions, etc.

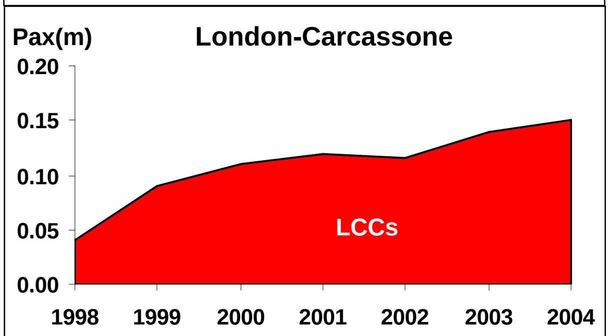
Despite its lucrative and controversial agreement with Charleroi Airport, Ryanair closed its London Stansted-Charleroi service in late 2004. Here, it appears, the distance of the airport from the city of Brussels combined with high-speed train competition into the centre of Brussels, rendered this low-cost service unviable. An LCC service from Stansted to Brussels Zaventem might be a different story, but that's unlikely unless a agreement could be reached on airport charges in Brussels.

Two examples of cannibalisation are shown. On London Stansted-Genoa, Ryanair has stimulated a new market and has also wiped out the incumbents, with Alitalia now having fully withdrawn from this route - a picture that is replicated on most of the UK-Italy city-pairs. On the route from London (Luton, Stansted and Gatwick) to Faro in Portugal, easyJet's expansion has mostly been at the expense of the charter carriers.

Charts taken from “Low-cost carriers at a crossroads”, a McKinsey and Company report by Dr. Lucio Pompeo, June 2005

DEMAND STIMULATION





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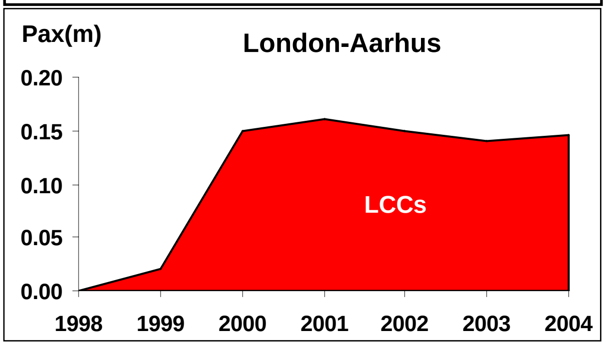

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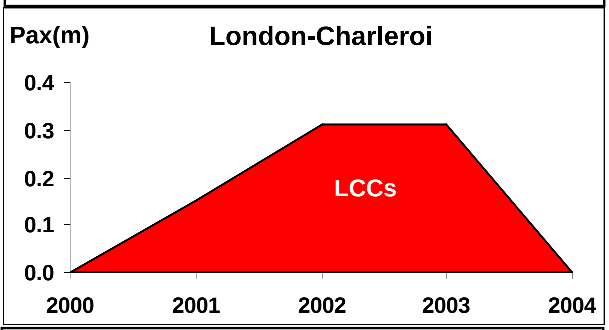

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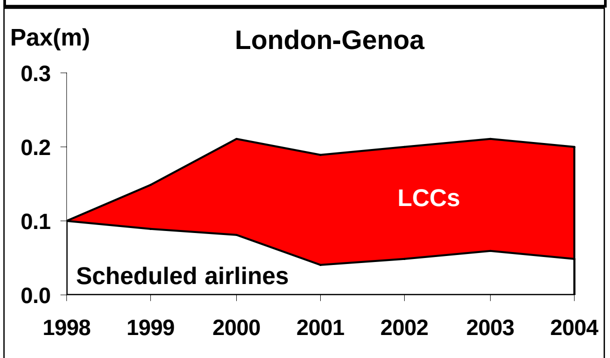
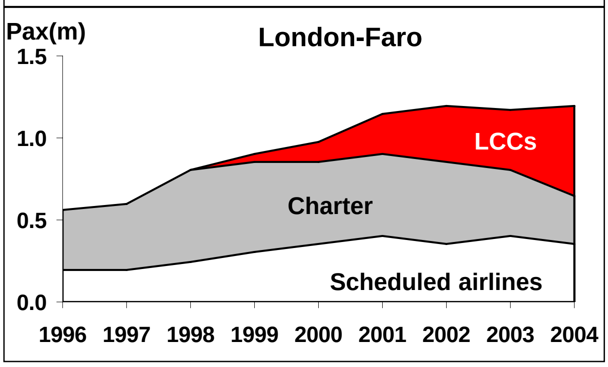




Air Canada: Resurgent and aggressive

When ACE Aviation Holdings, the parent of Air Canada, emerged from an 18-month bankruptcy restructuring in September 2004 with reduced costs and a greatly strengthened balance sheet, its near-term financial recovery prospects looked promising. However, the financial community was sharply divided on Air Canada's longer-term prospects - the key concerns were that its cost structure might not be competitive enough and that it might not be able to retain a large-enough unit revenue premium over LCCs (see *Aviation Strategy*, November 2004).

Nine months on, while the longer-term concerns are still there, Air Canada is in the middle of staging a remarkable financial recovery. Why is it able to go against the North American industry trend and turn profitable in this environment?

Air Canada has also made several aggressive or unusual moves in recent months - the sort of moves that one would not expect from a carrier that emerged from bankruptcy less than a year ago.

First, Air Canada has announced plans to make a US$75m equity investment in merged US Airways-America West. How can it possibly justify such a move?

Second, Air Canada has placed a spectacular US$15bn order for up to 96 Boeing 777s and 787s and, equally stunningly, cancelled it when its pilots failed to ratify a tentative agreement on rates and terms for flying the aircraft. Was the order really cancelled, and if so, what are the repercussions for strategy?

Third, in April ACE raised over C$1bn in new liquidity through concurrent equity and convertible note offerings and by obtaining a new C$300m credit facility.

Fourth, at the end of June, ACE spun off in an initial public offering (IPO) 12.5% of its Aeroplan FFP, collecting C$125m in net proceeds (or C$160m if the over-allotment option is exercised fully). This was the first-ever monetisation of an airline FFP.

Although some of the proceeds raised in April were used to refinance debt, the result has been improved cash reserves. If Air Canada continues to monetise its various business units, which seems likely, it may have the rather nice problem of deciding what to do with excess cash. It seemed so surreal when, at a time when other large North American carriers worry about liquidity, ACE chairman/CEO Robert Milton mentioned the possibility of dividends at Merrill Lynch's recent transportation conference.

Profitability on the horizon

After three and a half years of operating losses totaling C$1.73bn (US$1.41bn), ACE staged a turnaround in the third quarter of last year, posting a C$243m (US$199m) operating profit for the period. This was followed by a break-even result in the fourth quarter. For the full year, the company reported a modest C$117m (US$96m) operating profit (1.3% of revenues) and a reduced C$880m (US$721m) net loss, which was almost entirely made up of reorganisation charges.

ACE did well to achieve near break-even operating results in the first quarter of 2005 - the result actually improved by C$135m year-over-year, despite a C$77m higher fuel bill. Excluding hedging benefits, ACE was the only North American carrier to report improved results for the quarter.

With its cost cutting programme on track and an improving revenue picture, ACE is expected to start posting quarterly operating profits and achieve a net profit in 2005. Merrill Lynch analyst Mike Linenberg forecasts that ACE will earn operating and net profits of C$638m and C$323m, respectively, in 2005, followed by C$802m and C$462m in 2006. The operating margins (6.5% and 7.9%) would be similar to those achieved by the successful North American LCCs.

ACE's results are exceeding expectations essentially because progress on the revenue side (rather than on the non-fuel cost side) has been much better than anticipated.

The company's cost-cutting programme aims to reduce annual operating expenses by C$2bn, representing a 20% reduction from 2002's level of C$10bn, by the end of 2006. Of the C$2bn total savings, C$900m is slated to come from labour (mainly through productivity improvements), C$600m from aircraft rents (already achieved) and C$500m from other sources (see *Aviation Strategy*, November 2004).

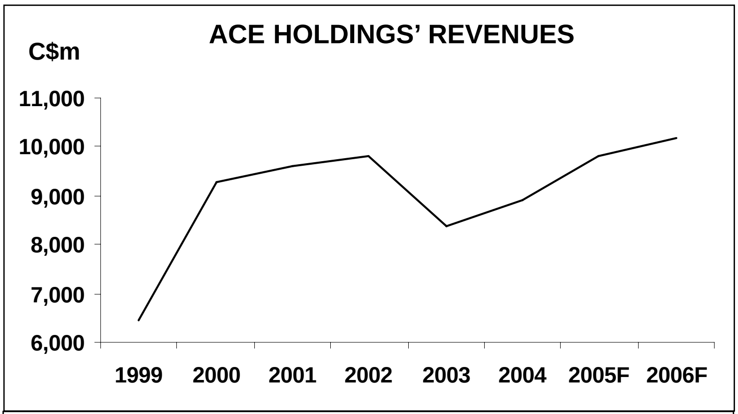
In the past couple of quarters, the cost savings have begun to show up more in ACE's unit cost (CASM) figures. Non-fuel CASM is now running about 20% below the levels two years earlier, which is quite impressive.

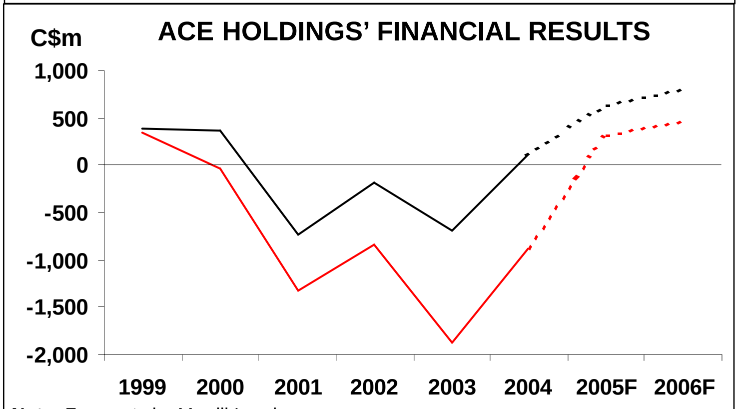
Nevertheless, the C$2bn overall annual cost reduction will not make Air Canada's cost structure competitive with LCCs. Last year, analysts estimated that the CASM gap with WestJet, the main low-cost competitor, was around 3 US cents - more than the differential between most of the US legacy carriers and LCCs.

Air Canada now openly admits that it is not getting close to LCCs' cost levels. Milton called the restructured airline simply "lower-cost", proclaiming that it has transformed itself from a "legacy" to a "loyalty carrier".

Air Canada has benefited enormously from the simplified domestic fare structure that it introduced in May 2003 and extended to its US network in February 2004. The fare structure "allows for better understanding of value" and makes it easier for customers to choose the fare that best suits their needs.

A key part of this strategy is the concept that Tango, the low-fare product, "will not be undersold". Air Canada matches all of its competitors' lowest fares. The strategy has helped the airline achieve its goals of regaining customer trust and building loyalty. Also, because Air Canada does not initi-





Note: Forecasts by Merrill Lynch

ate discounting (it merely matches fares), there have been instances of competitors adopting more sensible pricing.

As an indicator of the success of the new pricing strategy, Air Canada has built a significant domestic load factor premium over WestJet since early 2004. In recent months the premium has been as high as 6.5-7.5 points. (Air Canada obviously also enjoys a domestic RASM premium over WestJet and other LCCs, because it offers business class, FFP, etc.)

Otherwise, low-cost carrier Jetgo's departure (March 11) has significantly improved the domestic revenue environment. WestJet noted recently that fares in Canada have not been this stable for 20-25 years. Both WestJet and Air Canada have been able to cautiously increase their fares to offset the fuel price hikes.

Jetsgo had 7% and 5% domestic and trans-border market shares, respectively. Milton said at the ML conference that while Air Canada had expected to capture most of the transborder share, he was pleasantly surprised at how much of the domestic share it picked up too.

As a result of all that, Air Canada has been achieving record load factors for 16 consecutive months. In June it had 81.2% and 81.3% domestic and system passenger load factors, respectively.

The most striking thing about these trends is that Air Canada appears to be gaining at the expense of LCCs. The opposite is the case in the US and European markets, where LCCs as a group are gaining market share and the best of the carriers are also capturing higher-yield traffic from the legacy airlines.

The Canadian situation may have something to do with the fact that none of the LCCs there are particularly strong - WestJet, while an important player with a 27% domestic capacity share, is not of the Southwest/JetBlue calibre. However, above all, the situation reflects Air Canada's dominance in all market areas.

Air Canada is not only the dominant domestic operator, with a 55% ASM share, but it also has 40% of the transborder market and 45% of the long-haul international market. It controls regional feed with its subsidiary Jazz, which is Canada's second largest airline. Because it does not have to share the domestic market with other large carriers, it has been able to build Aeroplan into a uniquely strong FFP. Also, Air Canada has virtual monopoly of the country's international traffic rights.

Unlocking the value of business units

The bankruptcy restructuring slashed ACE's net debt and capitalised leases from C$12bn to C$5bn and gave the company cash reserves of C$1.9bn. The cash position was relatively healthy (21% of last year's revenues), but the debt was still on the high side. Furthermore, the liabilities included an expensive C$540m exit-financing facility provided by GE Capital.

Consequently, in March ACE sought to raise about C$600m through new share and debt offerings to refinance the GE facility. As things turned out, investor demand was so strong that the company was able to boost the offerings to C$792m (including over-allotments). In addition, ACE obtained a new C$300m two-year secured revolving credit facility for general corporate purposes.

After the transactions were completed in April, ACE had net debt and capital leases of C$4bn, cash of C$2.1bn (exceeding its target of C$2bn) and an unused credit line of C$300m. The refinancing of the GE facility cut annual interest costs by C$27m.

ACE then turned its attention to its business units, announcing plans for its first partial spinoff. At the end of June, it took Aeroplan public as an income trust, selling a 14.4% stake and listing it on the Toronto Stock Exchange. The sale raised gross proceeds of C$287.5m (including over-allotments). ACE collected about C$160m; the rest was retained by Aeroplan for a reserve for FFP mile redemptions and for capital expenditures. The IPO valued Aeroplan at C$2bn, which was above the earlier predictions of C$1.3-1.9bn.

Aeroplan was the first of what is expected to be many partial spinoffs. The consensus view is that Air Canada Technical Services (ACTS) is the next in line, followed by regional carrier Air Canada Jazz.

ACTS is a full-service MRO organisation and a "centre of excellence" for Airbus, Bombardier airframes and GE engines. It has 100-plus global customers (including JetBlue, United, Lufthansa and ILFC) and enough capacity to significantly grow third-party work without major capital investments. Earlier this year it secured a new five-year US$300m maintenance contract with Delta. But what really makes ACTS the hottest spinoff candidate is that it will pull in a large contract with US Airways-AWA as part of ACE's planned investment in the merged carrier.

This is all part of a strategy to enhance shareholder value, as well as obviously ensure that Air Canada can fund fleet renewal and expansion. ACE's likely goal is to be an aviation holding company with majority stakes in a number of thriving businesses.

Planned investment in UAIR/AWA

The planned US$75m investment in US Airways/AWA, announced on May 19, will give ACE an ownership stake of less than 7%. The investment will be made only if/when US Airways emerges from Chapter 11 (currently expected this autumn). Furthermore, Air Canada expects the investment to pay back fully in less than two years.

The investment is conditioned on commercial agreements in areas such as maintenance, ground handling and RJ flying, so it makes sense in the context of ACE's broader business strategy of growing its business units into stand-alone profitable companies.

The biggest beneficiary will be ACTS, which will pull in a new five-year maintenance contract worth C$1.5bn in revenues. As a result, ACTS will become one of the world's largest MRO companies, with C$1bn annual revenues by 2006. ACE also expects to benefit from maintenance and ground handling synergies to the tune of C$65m annually. It is also likely to gain access to better slots and gate selections at airports such as New York LaGuardia, Boston Logan and Phoenix.

There would appear to be promising revenue opportunities because the route networks are highly complementary. Air Canada sees such opportunities in key trans-border markets to southwestern US, Hawaii, Mexico and Florida. The deal could also strengthen its relatively weak presence along the North American West Coast. And Air Canada could pull significant volumes of traffic from the US Airways/AWA network to its international services out of Toronto and Vancouver.

ACE said initially that the US Airways deal would complement its existing relationship with United, which provides Air Canada with a strong east-west presence through Chicago and Denver. When asked about this at the ML conference, Milton was rather more specific: "There is absolutely no question: our primary US partner is United". Of course, Air Canada and United have incentive to help US Airways because all three are members of the Star alliance, which would lose out if US Airways failed. If the deal goes through, Star would benefit from the inclusion of AWA's network in western US.

North American RJ strategy

Air Canada aims to defend its domestic and trans-border market shares by offering a high-frequency "mass transit schedule" between key cities and deploying regional carrier Jazz to fill the network. That means extensive reliance on small aircraft. To facilitate that strategy, immediately after emerging from bankruptcy Air Canada placed orders for up to 180 new 70-90 seat jet aircraft, dividing the commitment equally between Bombardier and Embraer.

The orders were for three RJ types: the Bombardier CRJ-705, Embraer E170 and Embraer E190 (15, 15 and 45 firm orders, respectively). Jazz will operate all of ACE's Bombardier aircraft, while Air Canada will fly all of the Embraers.

This is a critical time for the RJ strategy because deliveries of each of the three types begin this year. Jazz started taking delivery of the 75-seat CRJ-705s in late May and will receive up to three per month by December, enabling it to boost its summer schedule across the country. Air Canada will receive its first E175s this month (July), while the E190 deliveries will begin in November.

The CRJ-705 is apparently getting "rave reviews" from customers, which is perhaps not surprising given that in many cases those aircraft are replacing Dash-8 turboprop service.

Air Canada's top executives have called each of the three aircraft types "a game-changer" both in terms of product offering and economics. That may be the case with the product offering - they will all be flown in two classes, with 34-37 inches of legroom, leather seats and (from this autumn) in-seat audio and TV systems. While only the E190 has the look and feel of a small jet, they are all clearly much more passenger-friendly than the 50-seat RJs.

However, while JetBlue has convinced the world that the E190, which it will start receiving in August, can more than match 150-seat economics (at the right pilot pay rates), it is hard to see how the 70-seaters could compete successfully against legacy carriers' 737s and A320s. If ACE's 70-seat strategy works, it may only be because of its market dominance and because Canada and US-Canada are not as competitive as the US domestic market.

All of the aircraft are well suited to ACE's plans to serve more long-haul thinner markets nonstop. The new aircraft are expected to create many new trans-border route opportunities, such as linking Toronto, Montreal, Halifax and Ottawa with new points in Florida and Texas, and East Canada hubs with points in California and Arizona.

Air Canada will fly the E190s under all-new pilot contracts. The management said last year that the aircraft would be introduced at totally competitive pay rates, which will be "within striking distance of JetBlue's".

Focus on international growth

But the main focus of Air Canada's post-bankruptcy strategy is on international markets outside North America. The airline ranks as the 13th largest international carrier in the world, operating a well-balanced global network as it enjoys unfettered access to parts of the world that US carriers cannot serve. Its Toronto and Vancouver gateways are well positioned to serve US to Europe and Asia traffic. It has a wealth of unused international route rights, because it was earlier sidetracked by the 1999 acquisition of Canadian and then delayed by the post-September 11 crisis and its own bankruptcy.

Furthermore, Air Canada's international services are highly profitable, because fares in those markets have remained high and because the international unit cost cuts have been the sharpest. ACE's top executives claim that Air Canada's international CASM is now among the lowest in the world, with the possible exception of the mainline China carriers.

Last year saw much Latin American expansion, partly because of the significant opportunity offered by the US "no transit without a visa" policy, which has made transiting via Canada an increasingly attractive option.

The other initial strategy was to look for niche markets not served by other international carriers. New route additions in that category included Toronto-Delhi and Vancouver-Sydney last year.

Otherwise, the focus is on building nonstop service to Asia particularly from Toronto, even though Vancouver remains the main Asian gateway. Last year Air Canada introduced Toronto-Hong Kong A340 service, and this summer it has added Toronto-Beijing and Toronto-Seoul. The airline now operates 13 daily flights from Canada to eight Asian cities.

The biggest immediate growth opportunity is China, following a more liberal new ASA signed in April. Air Canada's plans call for a Toronto-Shanghai nonstop service next summer, increase to daily flights on Toronto-Beijing by 2006, Vancouver-Guangzhou from summer 2007 and new freighter services to China from 2007.

Late last year the thinking at Air Canada was that it would be possible to find used 767-300s, A330s and A340s to accommodate international growth in the coming years, and the airline subsequently found six widebody aircraft to add to the fleet this summer. Now, after the Boeing order debacle, Air Canada has at least temporarily returned to the strategy of acquiring used aircraft.

The widebody renewal plan that Air Canada presented to the world with great fanfare in late April - and which it still may return to - included up to 36 777s and up to 60 787s. Those two types would have eventually replaced the entire long-haul fleet, including the A330s and A340s. They seemed uniquely well suited to Air Canada's route structure and plans, in that they offered different seating capacities (to suit different sized markets or seasonal demand fluctuations), yet the same speed and range. The order was for 18 777s (plus 18 purchase rights) in a yet-to-be-determined mix of 300ERs, 200LRs and freighters, and for 14 787s (plus 46 options and purchase rights). Deliveries of the 777 were set to begin in 2006 (first three aircraft) and the 787s from 2010.

Air Canada canceled the order on June 18 after its pilots rejected a tentative agreement on costs and other issues that had been reached with union leaders on June 8. The order had been conditional on the pilot deal, so there was no penalty. The airline would have had to pay a nonrefundable US$200m deposit to Boeing on June 19 to keep the order.

The cancellation is not material to Air Canada's business plan over the next few years - the critical components were the 787s slated for delivery from 2010 to replace the 767 fleet. The airline merely stated that "in time we will re-address this requirement", though Air Canada president/CEO Montie Brewer also expressed hope that it would be possible to bring new aircraft into the fleet.

The pilot vote apparently reflected an unrelated longstanding dispute over seniority that stemmed from the merger with Canadian. It therefore seems odd that the management simply accepted the vote - allowing a pilot protest to dictate fleet strategy in such a major way - or that Boeing would not have given more time to resolve the problem.

Consequently, many people believe that Air Canada hopes to revive the Boeing order and that negotiations are continuing behind the scenes. Air Canada might lose the earliest 787 delivery positions - Boeing said recently that the type, which has so far attracted orders from 17 other carriers (including Continental and Northwest in the US) and will be available from 2008, is "essentially sold out through 2010".

Also, it is not certain that Air Canada could keep the extra-special price that it negotiated with Boeing when competition with Airbus was particularly intense. Milton said at that time that he was confident nobody had ever done better on a deal.

Airbus is probably not seriously back in the running for new orders from Air Canada, because the airline rejected the A350 as too large and because fuel efficiency was one major factor swaying the decision in favour of twin-engine aircraft. Then again, if Air Canada cannot negotiate satisfactory contracts for new aircraft types, in the end it could be forced to order types covered by existing contracts.

Credit considerations are a factor in the current environment. American, for example, said last month that it is unlikely to order the 787 until it returns to profitability and can get better credit terms. Dominion Bond Rating Service, when recently raising Air Canada's outlook to "positive", urged the airline to exercise prudence in major investment decisions. The Canadian rating agency mentioned ACE's still-significant debt, growing competition and other challenges.

Then again, the Boeing order would have given Air Canada a real lead over other North American international operators in terms of cost efficiency and ability to expand globally. With the strong cash position and further prospects for spinoffs, it is a pity that the management could not risk paying the US$200m deposit to Boeing without a specific pilot contract in hand.

By Heini Nuutinen
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Alitalia: AZ Fly/AZ Services rescue mission

The rescue plan approved by the European Commission in June splits Alitalia into two parts - one for flight operations (AZ Fly) and one for ground handling (AZ Services), the first of which will be privatised. After almost 60 years of operations, is this the moment that the troubled Italian flag carrier finally breaks free from government control and becomes truly competitive - or is this yet another false dawn for an airline that is doomed to bankruptcy whatever happens?

For years Alitalia has suffered from a reliance on state aid, the dubious influence of all-powerful unions and - most crucially of all - abysmal management appointed largely for political reasons by ever-changing Italian governments (see *Aviation Strategy*, March 2004). From the late 1990s Alitalia reported increasingly large operating and net losses, culminating in a net loss of almost €1bn in 2001 (see chart, opposite). The airline recovered in 2002 and recorded a small net profit, although this figure was boosted by asset sales and €172m compensation paid by KLM for abruptly ending a partnership between the two airlines. Alitalia plunged back into a €0.5bn net loss in 2003, and beat that in 2004 with another colossal net loss of €812m (due partly to restructuring costs). Even in the slight recovery of 2002 Alitalia had an operating loss, and it now hasn't made an operating profit since 1998. For 2004, Alitalia initially announced an operating loss of €402m - its highest loss since the late 1980s - but this was revised even higher, to a loss of €412m, in May this year. Revenue fell 6% in 2004 to €4.1bn, with a 1% fall in passengers carried, to 22.2m.

It's been apparent for the best part of a decade that Italy's flag carrier needs a major overhaul, and in fact every time the state pumped in further money this was accompanied by a restructuring or "industrial plan" of some sort. But thanks to weak management, either these plans were not implemented properly, or - much more common - the restructuring plans were not radical enough to begin with. Now, however, both the Italian state and Alitalia's management claim that the latest restructuring effort - the so-called "rescue plan" - will improve Alitalia's cost base and its fortunes once and for all.

The rescue plan

The rescue plan was unveiled by Alitalia in October 2004 and covers a three-year period, from mid-2005 to 2008. It envisages two stages for Alitalia: restructuring and recovery in 2005 and 2006 (with break-even in the latter year), followed by a "relaunch" and significant capacity expansion in 2007 and 2008. At the heart of the plan is cost-cutting - the aim is to reduce the cost base by €830m by 2006 and €1bn by 2008, with an overall reduction in unit costs of 20% in 2008 compared with 2005.

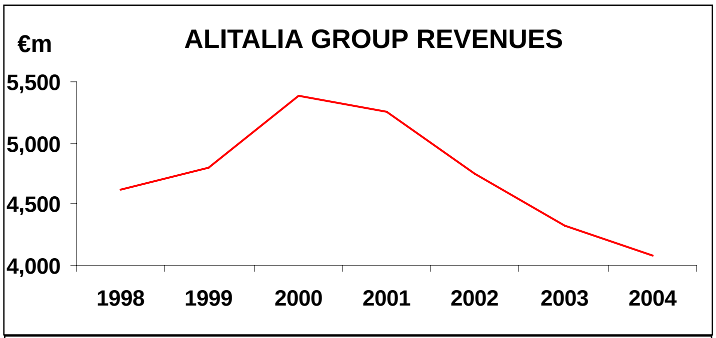
Key to the cost-cutting is reducing the size of the workforce, which stood at 20,700 when the rescue plan was announced last year (with 9,000 of them nominally in AZ Services and 11,700 in AZ Fly). The plan initially envisaged saving €315m in labour cost in 2005 and 2006 by the culling of 5,000 jobs - 900 in ground operations, 1,570 in flight operations (450 pilots, 1,050 cabin crew and 70 ground staff); 1,440 in maintenance, 360 in sales & marketing, 610 in corporate & IT, and 120 in cargo operations.

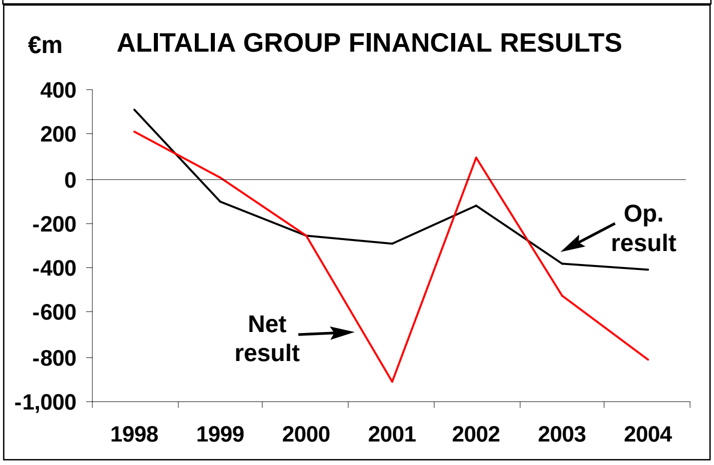
However - and this is a crucial point - this redundancy target has since eased back to 3,700 at best, thanks to resistance by unions and an inability by management to push through the restructuring they wanted at a time when they had the upper hand in applying pressure. In later 2004, after negotiations with six pilots' unions that had started 13 months' previously, a figure of 389 pilot job losses was agreed. The pilots also agreed to productivity improvements that see working hours rise by up to 22%. Altogether, Alitalia claims the pilot job losses and new conditions will save the airline an estimated €52m a year. A few days later the ground unions agreed to shed 2,500 positions in a deal that will cut costs by another €150m a year.

However, it took longer for the more militant cabin crew unions to agree their deal, which was eventually completed in February 2005. Although initially the rescue plan stated 1,050 cabin crew redundancies, after negotiations between management and unions this was pegged back to 900, then down to 800, and by the conclusion of negotiations redundancies were avoided altogether. Instead, cabin crew staff have agreed to an increase in productivity, greater relocation to Alitalia's Milan hub and a reduction in cabin crew salaries and benefits that management says will save € 75m a year.

Despite these agreements, relations with the unions are not great, and many of the workforce remain suspicious about the longer-term impact of the rescue plan. Crucially, one cabin crew union did not sign the agreement with Alitalia - SULT, which represents approximately one-third of cabin crew. It argues that the new deal is harsher than similar cabin crew at other European flag carriers, and that it also compromises safety. Its members believe that if other cabin crew unions had resisted the new deal, then management would have had no choice but to give further concessions to unions. In protest, SULT members are continuing to carry out a series of industrial actions this year, and are due to carry out a one-day strike on July 18. To make matters worse, in May the right-wing Italian government introduced a law to "guarantee minimum services" in the public sector. This was supposed to prevent further action, but it merely prompted solidarity between workers at Alitalia, and pilots, cabin crew and ground staff are threatening to strike this summer in protest at the government's restriction on the right to strike. Alitalia has also been hit in 2004 and 2005 by strikes by air traffic controllers and airport ground staff, as well as a general strike against the government.

SULT also represents employees at Alitalia call centres, and they too have held industrial action this year in protest at the possible outsourcing of the call centres as part of the rescue plan. In March Alitalia's management responded to increasing strike action by taking out adverts in Italian newspapers that stated that "it would be a paradox if we were to be defeated not because of external difficulties … but due to the foolishness of a few". Yet SULT's resistance and the government's overreaction is encouraging pilot and ground staff unions that did sign agreements for redundancies with Alitalia last year to have second thoughts. In May staff at three other cabin crew unions held a four-hour stoppage in protest over what they see as management's continuing failure to implement





previous collective agreements, and pilot unions are believed to want to renegotiate the previously-agreed 389 redundancies in the light of the cabin crew deal that included no job losses whatsoever.

Even excluding the possibility of renegotiated agreements, it's almost impossible to reconcile the figures of actual versus planned job losses at Alitalia. The widely quoted current figure from management is 3,700 redundancies, but even if that is accurate it just isn't enough to make Alitalia competitive in Europe, because the company starts from a very high labour cost base. In April this year UBS said that Alitalia's labour unit cost was among the highest of the major European airlines (its labour costs have increased by 17% since 2002) and its productivity was below the European average. Another analyst estimates that the company would needs to cut another 7,000 or so positions (bringing the workforce down to 10,000) for its unit labour costs to become competitive with other major European airlines.

End of state aid?

Putting concerns about labour costs aside for a moment, will the rescue plan solve another of

Alitalia's historical problems - the reliance on state aid?

The plan includes a €1.2.bn rights issue for AZ Fly, which will be guaranteed partly by the Italian state and partly by Deutsche Bank, which is jointly leading a consortium of private banks with Italy's Banca Intensa. After the rights issue (which is now likely to be completed in October and November, even though it was supposed to be carried out by the end of July) the Italian state's share in AZ Fly - held via the treasury ministry - will fall from 62.3% to less than 50%.

After a formal investigation into the rescue plan launched in January on the Commission's behalf by Ernst & Young, in June the Commission ruled that the plan includes enough elements of private finance to ensure it is not state aid, although it made clear it would examine the rescue plan closely as it was adopted, to ensure that no aid crept in. The Commission also applied conditions that the state and private sector parts of the capital increase occur at the same time and at the same price, and that the state could not guarantee the private sector rights issue if it was not fully subscribed. The Commission also wants the current Deutsche Bank guarantee - which is in the form of a Letter of Intent sent in April - firmed up into a tighter commitment.

The Commission also looked at Alitalia's use of an emergency €400m bridging loan approved in July last year, which was allowed under the conditions that it was used only to win enough time for Alitalia to restructure, that the government became a minority shareholder within 12 months, and that it was repaid by the end of this year with interest at a rate of 4.43%. Again, the Commission found in Alitalia's favour, concluding that the loan has not been used illegally.

Other European airlines - both flag carriers and LCCs - are outraged at the Commission's clearing of the rescue plan, which they see as a flagrant breach of the EU's "one time, last time" rule on state aid for airlines. For Alitalia, this was supposed to have been in 1997 when it received state aid of €1.4bn - although another €1.4bn was pumped into Alitalia in 2002 after a controversial rights issue, of which €900m came from the Italian ministry of finance.

Although it is believed that some of the Commissioners - particularly those for trade and competition - were against approving the rescue plan, many of Alitalia's rivals blame (off-the-record) the Commission's approval on a change in policy by the new EU transport commissioner, Jacques Barrot. He appears to be taking a much softer line on state bailouts than his predecessor, Loyola de Palacio, from whom he took over in November 2004. Interestingly, in June the competition commissioner, Neelie Kroes, proposed a reform of state aid rules over the next five years. If adopted - and that's a big if - her proposals could force the Commission to reverse its approval of the Alitalia rescue plan.

In October 2004 eight major European airlines (unsurprisingly, mostly Star or oneworld alliance members) wrote a letter to the Commission to complain against the $400m bridging loan, and in March this year they followed that up with another letter accusing Alitalia of aggressive pricing, which was causing "severe" damage to competitors. The European majors are now considering their position given the Commission's approval of the rescue plan, although Lufthansa is known to be one of several carriers that are contemplating legal action.

In May European LCCs sent their own letter of complaint to the Commission, their point being that approval of the Alitalia rescue plan sets a dangerous precedent - i.e. that other flag carriers in trouble can get "state aid" if it is dressed up in a way similar to Alitalia's plan. The same LCCs previously threatened to take the issue to the European Court of Justice if necessary.

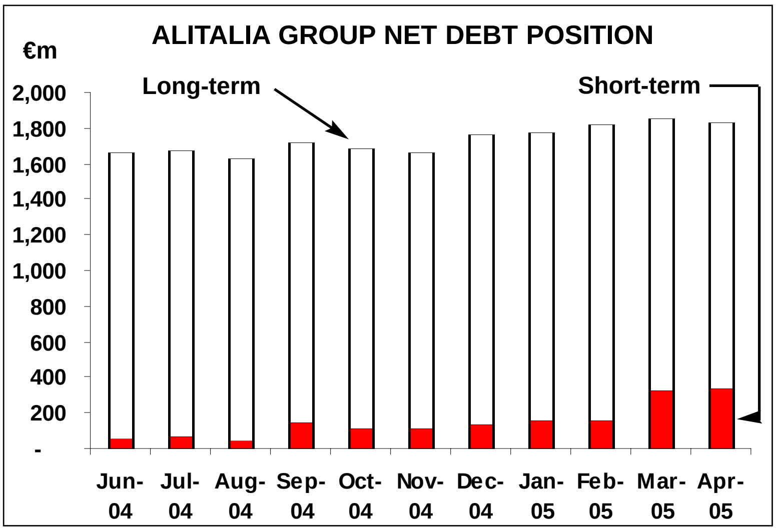
Putting the traditional bluster of rivals aside, does the rescue plan stand up to the charge that it is state aid by another name? Alitalia is using Mediobanca and Goldman Sachs as advisors on the recapitalisation, while Merrill Lynch is advising the Italian government, and until the fine print of the rights issue is available, it's difficult to assess whether the government and private part of the recapitalisation are being carried out on exactly the same terms. One area of concern is that in giving the go-ahead for the rescue plan in December, the Italian parliament's transport committee said that the state's share should not go under 30% and that it should keep "veto powers" through holding a golden share. If that were to be the case, then the public and private part of the recapitalisation would take place on very different terms.

But while much attention is focussing on AZ Fly, it is the structure of AZ Services that gives much cause for concern to some critics. Italian state holding company Fintecna is in negotiations to buy 49% of AZ Services, but the price paid must be justified in terms of what the company is truly worth on an open market. Fintecna is used by the government to restructure and privatise former wholly state-owned companies, and was brought into the deal partly due to pressure from unions concerned over the possibility of job losses over and above the 5,000/3,700 already going. Unions were insistent that state-holding company Fintecna be the main "new" investor into AZ Services.

AZ Services was formally incorporated in November last year, although Alitalia's flight operations were not transferred across until May 1st 2005, when Roberto Renon, previously head of Italian rail company Trenitalia, was appointed chairman and CEO of AZ Services. At that date contracts were also signed between Alitalia and AZ Services with - according to Alitalia - "prices and level of service in line with market standards". AZ Services has four business units - engineering & maintenance; airport services; centralised services; and IT and telecommunications services.

There was initially a lot of concern about how Alitalia's debt was to be divided up between AZ Fly and AZ Services. AZ Services accounts for approximately 20% of the former Alitalia business, and the worry was that if it takes more than its fair proportion of Alitalia's debt with it, the interest burden will mean the ground services company will be hard pressed to make a profit for many years - if ever - while giving AZ Fly a much less burdensome share of debt.

In October Alitalia said that AZ Fly would retain medium- and long-term debt relevant to flight operations, including the €400m bridging loan, and according to Alitalia's pro-forma accounts as at end 2005, a total of €425m in assets are being transferred to AZ Services, of which €245m are tangible assets, €87m are "raw materials" and €75m "equity holdings". But liabilities of €331m are also being transferred to AZ Services, and these include €36m of supplier debt, €82m of provisions for redundancies and €197m of "allowances for risks, contingencies and charges". Quite what this last category includes is unclear, and it will be interesting to see how the net accounting assets figure for AZ Services of €94m compares with the price that Fintecna eventually pays for its 49% stake, given unconfirmed reports that Fintecna is likely to pay anywhere in the region of €150m to €300m. However, this could be less if - according to Italian newspaper reports - AZ Services sells off its IT



business to IBM for up to €50m prior to Fintecna's investment. Negotiations on Fintecna's stake are still continuing, although the deal is due to be completed by the end of July. Fintecna may also acquire an option to buy another 2% of AZ Services, thus giving it majority control before a flotation of part of the business sometime in the future.

However, it's clear that whatever price is paid, as Fintecna is a government entity then AZ Services will effectively remain state-controlled (given Fintecna's 49% or 51% share, added to the government's major stake in AZ Fly, which will own the remaining 51% or 49% of AZ Services).

Another contentious part of the rescue plan is that the 3,700 job loses will be paid for by a state-funded social package costing anything between €100m and €450m, depending on whose estimate you believe. Alitalia's argument is that this is not technically state aid since it is "structural support" to a restructuring industry and an extension of "Cassa Integrazione", an existing scheme that gives a minimum wage for a limited period to workers laid off in the car manufacturing industry.

Expansion goal

Even if Alitalia cuts costs as targeted, does the second part of the rescue plan - which envisages expansion in 2007 and 2008 - make sense? Alitalia currently operates to almost 100 destinations with a fleet of 180 aircraft (see table, opposite), two-thirds of which are fully-owned by Alitalia, but capacity is expected to increase by 12% in 2005, with even greater growth on both short/medium-haul and long-haul from 2007 onwards.

Much of the capacity increase this year is coming from better fleet utilisation, which Alitalia CEO and chairman Giancarlo Cimoli (incidentally, the third CEO at Alitalia in less than a year) says is like "adding five more aircraft to our fleet". But there's a limit as how much utilisation can improve further given that the fleet is made up of 12 different types and has an average age of 10 years.

In the relaunch phase of the rescue plan (2007-2008), the long-haul fleet will be expanded by at least five new aircraft, to a total of 34 aircraft by 2008, and the short- and medium-haul fleet by at least 10 aircraft, bringing the total to 162 by 2008. At that date Alitalia plans to have a fleet of 196 aircraft. The question has to be asked - is this a sensible move given the falling yields at Alitalia and the relatively low load factors on many routes? Surely Alitalia should be cutting back on inherently loss-making routes first, reallocating capacity to routes that have immediate prospects of being profitable? To state that in four years' time Alitalia will expand capacity by 13% sounds like poor planning - or rather making capacity promises for the sake of doing so. And that's not to mention the problem of how Alitalia will afford to pay for the aircraft needed for new capacity, let alone the aircraft needed for fleet renewal.

Perhaps instead of planning expansion, Alitalia's management should take a closer look at defending its position in the Italian market, where it admits it is coming under fierce attack from LCCs and almost 30 other Italian airlines. In May Alitalia said that there was continuing overcapacity in the domestic and international markets, yet bizarrely it believes it can increase its share of the domestic market, which (in terms of available capacity) stands at just over 50%. In June of this year Giancarlo Cimoli said that "a national flag carrier should not fall below a 60% to 70% stake of a domestic market", and added that Alitalia wanted to re-establish its dominance domestically.

That seems almost impossible, particularly as Ryanair is looking eagerly at the Italian market, which is one of its key domestic targets on the continent. Ryanair has been operating to the Italian market since 1998 and currently operates more than 60 routes out of 15 Italian airports. This makes Ryanair the second-largest carrier in Italy, and it will carry an estimated 10m passengers to/from and within Italy in 2005.

Ryanair operates substantial hubs at Rome Ciampino and at Milan Orio al Serio, and these are a direct challenge to Alitalia, whose two main hubs are Rome Fiumicino and Milan Malpensa. Nevertheless, Alitalia will press ahead with expansion at Fiumicino if Aeroporti di Roma approves a plan to give Alitalia exclusive use of Terminal A, with the other two terminals dedicated for all other airlines. However, if this move goes ahead then competitors such as Air One (which has 30 aircraft) and Meridiana (which has 21 aircraft) will have to leave Terminal A, a decision these airlines are likely to resist greatly.

In April Ryanair launched services from Rome to Venice, Verona and Alghero (in Sardinia), at average fares of €10-15 per ticket, which Ryanair claims is 80% less than Alitalia's fares on those routes. At the press launch of the services, Michael O'Leary - Ryanair's CEO - wore a t-shirt with "Arrivederci Alitalia" on it, and he added that he was aiming for at least 0.5m passengers on the three routes in the first year of services.

Other competition comes from easyJet, which operates 27 routes to Italy, and Milan-based Volare, the Italian group that included LCC Volareweb.com and charter carrier Air Europe. Although Volare went into bankruptcy administration in November 2004, it resumed flights in December and relaunched in June as a primarily domestic non-LCC airline connecting Milan Linate and Malpensa with regional airports in the south of Italy. With a slimmed down workforce of less than 200 employees and leased A320 aircraft, Volare's seats are distributed via the internet and call centres. In March, however, an Italian cabinet minister said Volare was likely to sign a commercial agreement with Alitalia.

Although more than half of Alitalia's 22m annual passengers fly on domestic routes, Alitalia appears relatively unconcerned about the threat from Ryanair and others, and instead appears to be confident that it can somehow increase market share. If that's to happen, much depends on expansion plans for fully-owned subsidiary Alitalia Express, which was launched in 1997 and operates regional feeder routes and charter operations for its parent.

Alitalia Express operates a fleet of 35 ATR and Embraer aircraft, and in March 2004 acquired the assets of bankrupt regional carrier Gandalf Airlines for a reported sum of €7m. Gandalf was launched in 1999 and operated a fleet of 328JETS and

Fairchild Dornier 328s, but never came close to making a profit. Under the rescue plan Alitalia Express will become part of AZ Fly, and management at the regional airline say that their operations will be not be affected by the reorganisation. Alitalia Express employs 700 staff, and may increase that to 800 as services expand (with, ironically, the extra flight staff coming from the 3,700 made redundant at Alitalia). In 2004 Alitalia Express received six Emb170s, but let options for six more of the type lapse. However, the airline says it needs further aircraft, although fleet expansion will only take place once/if the finances of AZ Fly are sorted out under the rescue plan.

In Europe too, Alitalia is facing what is describes as "further pressure on ticket prices especially due to the further establishment of the LCC phenomenon and the extremely aggressive pricing policies adopted by leading full service competitors". Yet Alitalia is trying to build up business into eastern Europe, and in 2004 increased frequencies on routes to Romania, Albania, the Czech Republic, Serbia and Poland, and launched new services to Russia, Hungary, Croatia and Macedonia. From June 2005 Alitalia also began codesharing with Aeroflot on seven flights-a-week on the Milan-Moscow route; this is part of the process by which Aeroflot is being drawn into the SkyTeam alliance. But despite a 40%+ increase in capacity to eastern European destinations in the last quarter of 2004, traffic has only increased by a quarter - which either indicates there is just not enough traffic to go round these new routes, or else Alitalia is overpriced compared with its competitors.

For short- and medium-haul Alitalia has 70 MD-80s, but these could be a massive liability if, as some analysts expect, European airports start to ban the aircraft in order to comply with new environmental regulations on noise and air pollution that come into force in 2006. A short-term solution can be found by using A320 family aircraft to/from airports that introduce an MD-80 ban, but at some point Alitalia will have to decide either to fit quieter engines - which will cost around €3m per aircraft - or replace the fleet. The former option may be too expensive for the airline, and it is more likely to gradually retire or sell the MD-80s, which have an average age of more than 20 years.

On long-haul, Alitalia has a fleet of 29 aircraft, but its network is not focused, with a handful of routes in each of Asia, Africa, North America and South America. However, it added a substantial 20% in long-haul capacity last year, thanks to the launch of routes to Delhi and Washington out of Milan in the summer of 2004, followed by a three-times-a-week service on Milan-Shanghai in December - a return to the Chinese market since Alitalia withdrew four years ago. In November United and American complained that the Italian government was violating the US-Italian bilateral by refusing to allow them to codeshare at Milan Linate - whereas Alitalia operates to the US with its codeshare partners. American wants to codeshare with oneworld partner British Airways on London Heathrow-Linate and United would like to codeshare with Star partners BMI on Heathrow-Linate and with Lufthansa on Frankfurt-Linate.

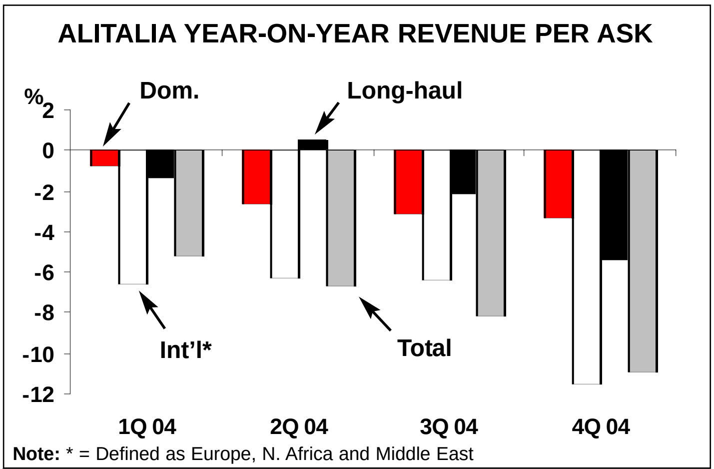
ALITALIA GROUP FLEET

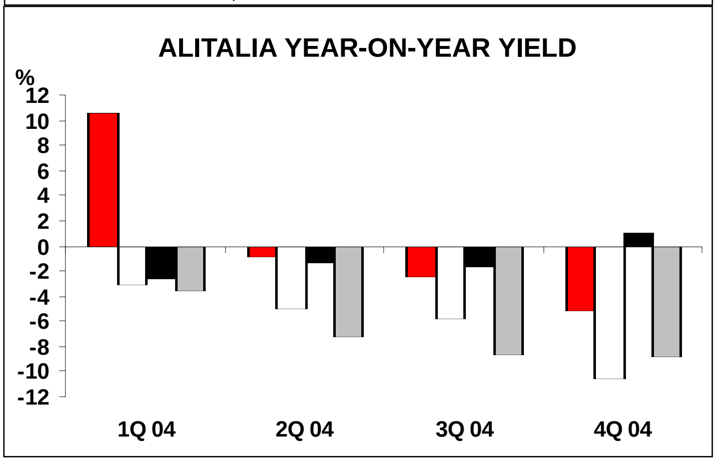
	Fleet	Orders	Options
Alitalia			
A319	12		
A320	11		
A321	23		
747-200F	1		
767-300ER	13		
777-200ER	10		
MD-11	5		
MD-80	70		
Total	**145**	**0**	**0**
Alitalia Express			
ATR-42	5		
ATR-72	10		
Emb-145	14		
Emb-170	6		6
Total	**35**	**0**	**6**

Air France/KLM?

Air France/KLM has long been considered a white knight for Alitalia by some observers - most of them in successive Italian governments - but the reality is likely to prove different. Alitalia began codesharing with Air France in 2001, joined SkyTeam the same year (12 months after the global alliance was launched) and in 2003 acquired 2% of Air France. However, relations with the "KLM part" of the merged airline are more complicated - Alitalia's previous partnership with KLM was terminated in 2000 after serious disagreements about a delay in privatisation and problems at Milan Malpensa.

Air France/KLM is reportedly interested in increasing its stake to 20% prior to a full merger, but this is probably wishful thinking on the behalf of controversial Italian prime minister Silvio Berlusconi, who has often called for the two airlines to become a single company. In January this year he said that Air/France KLM and Alitalia are "aiming for integration towards a single airline" - a remark that caused Alitalia's share price to rise 10%, forcing the Milan stock exchange to suspend the airline's shares. (And Berlusconi almost scuppered the Commission's approval of the Alitalia





rescue plan in April by announcing in it had approved it actually had been!)

Although the subject has been discussed by the two countries' politicians, Jean-Cyril Spinetta - CEO of Air France/KLM - says: "The subject is not on the table at all." Air France/KLM sources indicate that another investment in Alitalia is inconceivable until solid evidence that the rescue plan is not only being carried out, but also is being carried out successfully.

A full merger of Alitalia into Air France/KLM is even further away, primarily because Alitalia needs Air France/KLM rather more than Air France/KLM needs Alitalia. The only real asset that Alitalia offers Air France/KLM is its domestic network - a network that is increasingly under fierce attack from competitors. In any case, Air France/KLM can probably get as much out of Alitalia via codesharing and other agreements rather than the commitment of a risky full merger. A pointer to what can be done short of a merger comes from a revenue and cost sharing programme that the airlines carry out on Italy-France routes. Alitalia sources have suggests that this deal may be renegotiated once the rescue plan is implemented, in order to get more favourable terms for Alitalia (the current deal is reviewed by both airlines every six months), but that may be pushing Alitalia's luck too far. The Air France/Alitalia deal has already been criticised by easyJet as ensuring a virtual monopoly on France-Italy routes. easyJet previously tried to win slots at Paris Orly that the Commission forced Air France and Alitalia to give up as a condition for approval of their alliance, but the slots were awarded to Volare, and easyJet appealed unsuccessfully against the decision in April 2004.

Other potential merger candidates are being bandied about in Italy, but most of these are nothing more than unsubstantiated rumours. Last year Lufthansa was mentioned by the Italian transport minister as a potential partner for Alitalia, and one that would be better strategically than Air France. Again, this appears to be a less than useful comment by a member of the Italian government, and Lufthansa codeshares with Alitalia rivals Air One and owns regional airline Air Dolomiti. There have also been repeated reports that government sources indicate that Emirates may be interested in a stake in Alitalia - a claim that the Middle Eastern airline denies. However, according to other reports in May this year SULT - the cabin crew union - had tentative discussions with a Dubai-based investment company called Istithmar over a potential investment.

A future?

Alitalia expects a more "positive" performance in 2005, underpinned by the saving of €170m in labour costs this year thanks to the new agreements with unions (assuming they are not renegotiated). Nevertheless, The airline will not break-even, and is forecasting an operating loss of €100m, This still implies a significant improvement for the rest of 2005, since in the first three months of the year Alitalia racked up an operating loss of €120m (although that was better than the €190m operating loss in 1Q 2004), despite a 9% rise in revenue during January-March 2005. The first quarter pre-tax loss before extraordinary items totalled €134m, compared with a €206m loss in 1Q 2004. Alitalia says the improved result is due to a combination of an increase in productivity, cost savings and better fleet utilisation. Labour costs fell

7% in the first quarter of 2005, based on an average staff number of 19,075 (compared with 20,700 in 1Q 2004). Overall unit costs fell 1.3% in the quarter.

RPKs rose 13.9%, slightly ahead of the growth in capacity and resulting in a 0.2 percentage point increase in load factor, to 65.3%. There was a 10.1% rise in capacity on European, north African and Middle East routes and a 21.6% rise in ASKs on long-haul routes - although on the latter this only resulted in a 16.7% rise in RPKs. On the domestic market Alitalia achieved a 11.1% rise in RPKs, although AKS grew by just 2.1%, leading to load factor growing by 4.5 percentage points. This was due to the temporary troubles at rival Volare, which helped Alitalia increase its domestic market share in the first quarter of 2005 slightly, to 52.4%.

However, at the same time Alitalia also spoke of "persistent weakening of yields" through the quarter, which were 1.3% down compared with 1Q 2004, continuing a worrying trend (see chart, opposite). The pre-tax loss before extraordinary items for the first half of 2005 is expected to be in the region of €120m, compared with a loss of €329m in January-June 2004.

Looking to the longer-term, in private few analysts give Alitalia much chance of breaking even at the net level in 2006, as the rescue plan promises. There are many reasons for that lack of confidence, not least of which was the redrafting of Alitalia's three-year rescue plan in March, just six months after it was launched. Alitalia says this was necessary due to higher fuel costs (which are projected to be 30% higher than the fuel prices assumed in the previous plan) and the increasing threat of "low cost airlines entering the Italian domestic market", which will hit previous unit revenue estimates on short-and medium-haul routes.

No details have been released, but essentially these "new variables" mean the company has to be even more aggressive in cutting costs. But it is hard to see how Alitalia can achieve even greater cost cutting given that it didn't achieve its original cost cutting target - i.e. the plan to cut 5,00 jobs (which has now been reduced to 3,700, and may be even lower than that).

If Alitalia doesn't hit its cost-cutting targets - and presuming that no more "state aid", of whatever form, is allowed - then serious questions marks remain over the viability of the airline. Specifically, how will AZ Fly and AZ Services be able to service the ever-increasing debt? Alitalia's debt has become so large that the Italian stock market regulator now requires the airline to report its net debt position every month (see chart, xxx).Group net debt (defined as financial debt minus liquid assets) at the end of April stood at a massive €1.83bn. This is €21m better than the month before but as Alitalia point out this "was mainly due to the positive effects of seasonal revenues - the start of the high season". The figure was higher than the net debt figure of €1.76bn as at the end of 2004. And of the net debt total, a massive €609m is the current part of long-term debt, and is due to be repaid within the next 12 months (such as the €400m bridging loan, which according to the Commission now has to be paid within eight working days of the recapitalisation of AZ Fly, and in any case by December of 2005 at the latest).

It shouldn't be forgotten that the bridging loan was desperately needed by Alitalia as in October there was only enough cash to pay the salaries of its workers for one more month. Although in fact Alitalia did avoid tapping into this facility until January this year, as at mid-April Alitalia had spent the first €155m of the loan, forcing it to drawn down the remaining €245m (which is a line of credit with the Milan branch of Dresdner Kleinwort Wasserstein, and guaranteed by the Italian government). That implies a burn rate of around €40m-€50m per month. And the $1.2bn of the rights issue will not go far at AZ Fly once the bridging loan is repaid as well as other parts of the long-term debt due within the next 12 months. It's tempting to think that the rescue plan will solve Alitalia's underlying problems. AZ Fly will no longer be able to rely on state aid and - presumably - there can be no further weak management appointed by whichever government is in power at the time. But Alitalia's high cost base still remains, with fewer job losses being made than envisaged when the rescue plan was put together. Despite Berlusconi's speeches, Air France/KLM is unlikely to bail out Alitalia, and in hindsight Alitalia should have found a strategic partner during one of the few periods of profitability it had over the last two decades. But it didn't, and its hopes now rest on the success of the rescue plan. If this doesn't work, there can be no further state bailout, and one of the oldest names in aviation history will inevitably disappear.

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
Alaska	**Year 2003**	**2,445**	**2,456**	**-11**	**13**	**-0.4%**	**0.5%**	**37,614**	**26,061**	**69.3%**	**19,981**	**13,401**
	Apr-Jun 04	699	719	-20	-2	-2.9%	-0.3%	9,068	6,605	72.8%	4,116	10,255
	Jul-Sep 04	702	626	76	41	10.8%	5.8%	9,675	7,356	76.0%	4,589	10,201
	Oct-Dec 04	656	714	-58	-45	-8.8%	-6.9%	8,774	6,399	72.9%	3,998	9,433
	Year 2004	**2,724**	**2,804**	**-80**	**-15**	**-2.9%**	**-0.6%**	**35,849**	**26,121**	**72.9%**	**16,295**	**9,968**
	Jan-Mar 05	643	723	-81	-80	-12.6%	-12.4%	8,642	6,271	72.6%	3,851	9,219
American	**Year 2003**	**17,440**	**18,284**	**-844**	**-1,128**	**-4.8%**	**-6.5%**	**279,706**	**202,521**	**72.4%**		**96,400**
	Apr-Jun 04	4,830	4,634	196	6	4.1%	0.1%	70,804	53,627	75.7%		92,500
	Jul-Sep 04	4,762	4,789	-27	-214	-0.6%	-4.5%	71,638	55,777	77.9%		93,300
	Oct-Dec 04	4,541	4,896	-355	-387	-7.8%	-8.5%	69,049	51,325	74.3%		90,700
	Year 2004	**18,645**	**18,789**	**-144**	**-761**	**-0.8%**	**-4.1%**	**280,042**	**209,473**	**74.8%**		**90,700**
	Jan-Mar 05	4,750	4,727	23	-162	0.5%	-3.4%	68,965	52,024	75.4%		88,500
America West	**Year 2003**	**2,255**	**2,222**	**33**	**57**	**1.5%**	**2.5%**	**44,880**	**34,270**	**76.4%**	**20,050**	**11,326**
	Apr-Jun 04	605	584	21	6	3.5%	1.0%	12,153	9,519	78.3%	5,343	11,936
	Jul-Sep 04	579	607	-28	-47	-4.8%	-8.1%	12,305	10,021	81.4%	5,556	11,936
	Oct-Dec 04	579	602	-24	-50	-4.1%	-8.6%	12,236	9,471	77.4%	5,336	11,845
	Year 2004	**2,339**	**2,357**	**-18**	**-90**	**-0.8%**	**-3.8%**	**48,525**	**37,550**	**77.4%**	**21,132**	**11,904**
	Jan-Mar 05	723	673	50	34	6.9%	4.7%	11,749	9,126	77.7%	5,172	11,869
Continental	**Year 2003**	**8,870**	**8,667**	**203**	**38**	**2.3%**	**0.4%**	**139,703**	**104,498**	**74.8%**	**39,861**	**37,680**
	Apr-Jun 04	2,514	2,471	43	-17	1.7%	-0.7%	34,676	27,083	77.6%	10,809	
	Jul-Sep 04	2,564	2,540	24	-16	0.9%	-0.6%	35,371	28,843	81.5%	11,182	
	Oct-Dec 04	2,397	2,558	-161	-206	-6.7%	-8.6%	37,962	29,350	77.3%	14,253	
	Year 2004	**9,744**	**9,973**	**-229**	**-363**	**-2.4%**	**-3.7%**	**95,082**	**73,151**	**76.9%**	**56,482**	**38,255**
	Jan-Mar 05	2,505	2,676	-171	-184	-6.8%	-7.3%	37,955	29,148	76.8%	14,122	
Delta	**Year 2003**	**13,303**	**14,089**	**-786**	**-773**	**-5.9%**	**-5.8%**	**216,263**	**158,796**	**73.4%**	**104,452**	**70,600**
	Apr-Jun 04	3,961	4,202	-241	-1,963	-6.1%	-49.6%	62,151	47,610	76.6%	28,616	70,300
	Jul-Sep 04	3,871	4,294	-423	-646	-10.9%	-16.7%	63,031	48,952	77.7%	28,247	69,700
	Oct-Dec 04	3,641	5,897	-2,256	-2,206	-62.0%	-60.6%	61,384	45,237	73.7%	27,794	69,150
	Year 2004	**15,002**	**18,310**	**-3,308**	**-5,198**	**-22.1%**	**-34.6%**	**244,097**	**182,351**	**74.7%**	**110,000**	**69,150**
	Jan-Mar 05	3,647	4,604	-957	-1,071	-26.2%	-29.4%	60,955	45,344	74.4%	29,230	66,500
Northwest	**Year 2003**	**9,510**	**9,775**	**-265**	**248**	**-2.8%**	**2.6%**	**142,573**	**110,198**	**77.3%**	**51,900**	**39,100**
	Apr-Jun 04	2,871	2,923	-52	-175	-1.8%	-6.1%	36,634	30,215	82.5%	14,289	39,154
	Jul-Sep 04	3,052	2,973	79	-38	2.6%	-1.2%	38,324	31,774	82.9%	14,800	38,178
	Oct-Dec 04	2,753	3,177	-424	-412	-15.4%	-15.0%	36,964	29,107	78.7%	13,775	
	Year 2004	**11,279**	**11,784**	**-505**	**-848**	**-4.5%**	**-7.5%**	**147,055**	**117,981**	**80.2%**	**55,374**	**39,342**
	Jan-Mar 05	2,798	3,090	-292	-450	-10.4%	-16.1%	36,636	29,238	79.8%	13,502	39,105
Southwest	**Year 2003**	**5,937**	**5,454**	**483**	**442**	**8.1%**	**7.4%**	**115,532**	**77,155**	**66.8%**	**65,674**	**32,847**
	Apr-Jun 04	1,716	1,519	197	113	11.5%	6.6%	30,212	23,054	76.3%	18,864	31,408
	Jul-Sep 04	1,674	1,483	191	119	11.4%	7.1%	31,359	22,794	72.7%	18,334	30,657
	Oct-Dec 04	1,655	1,535	120	56	7.3%	3.4%	32,540	21,140	65.0%	17,709	31,011
	Year 2004	**6,530**	**5,976**	**554**	**313**	**8.5%**	**4.8%**	**123,693**	**85,966**	**69.5%**	**70,903**	**31,011**
	Jan-Mar 05	1,663	1,557	106	76	6.4%	4.6%	32,559	21,304	65.4%	17,474	30,974
United	**Year 2003**	**13,274**	**15,084**	**-1,360**	**-2,808**	**-10.2%**	**-21.2%**	**219,878**	**168,114**	**76.5%**	**66,000**	**58,900**
	Jan-Mar 04	3,732	3,943	-211	-459	-5.7%	-12.3%	56,181	42,287	75.3%	15,923	
	Apr-Jun 04	4,041	4,034	7	-247	0.2%	-6.1%	58,313	47,840	82.0%	18,444	59,700
	Jul-Sep 04	4,305	4,385	-80	-274	-1.9%	-6.4%	61,403	50,439	82.1%	19,360	59,000
	Oct-Dec 04	3,988	4,481	-493	-664	-12.4%	-16.6%	58,033	44,824	77.2%	17,143	57,500
	Year 2004	**16,391**	**17,168**	**-777**	**-1,644**	**-4.7%**	**-10.0%**	**233,929**	**185,388**	**79.2%**	**70,914**	**58,900**
US Airways	**Year 2003***	**5,312**	**5,356**	**-44**	**-174**	**-0.8%**	**-3.3%**	**85,673**	**62,408**	**72.8%**	**44,373**	**26,797**
	Apr-Jun 04	1,957	1,874	83	34	4.2%	1.7%	24,991	19,336	77.4%	25,953	26,880
	Jul-Sep 04	1,799	1,976	-177	-232	-9.8%	-12.9%	25,462	19,382	76.1%	14,274	26,835
	Oct-Dec 04	1,660	1,802	-142	-236	-8.6%	-14.2%	24,514	17,622	71.9%	14,097	24,628
	Year 2004	**7,117**	**7,495**	**-378**	**-611**	**-5.3%**	**-8.6%**	**98,735**	**72,559**	**73.5%**	**55,954**	**24,628**
	Jan-Mar 05	1,628	1,829	-201	-191	-12.3%	-11.7%	24,976	17,779	71.2%	14,068	23,696
JetBlue	**Year 2003**	**998**	**830**	**168**	**104**	**16.8%**	**10.4%**	**21,950**	**18,550**	**84.5%**	**9,012**	**4,892**
	Apr-Jun 04	320	275	45	21	14.1%	6.6%	7,494	6,333	84.5%	2,921	5,718
	Jul-Sep 04	323	300	23	8	7.1%	2.5%	7,950	6,753	84.9%	3,033	6,127
	Oct-Dec 04	334	322	12	2	3.6%	0.6%	8,200	6,802	82.9%	3,179	6,413
	Year 2004	**1,266**	**1,153**	**113**	**47**	**8.9%**	**3.7%**	**30,434**	**25,315**	**83.2%**	**11,783**	**6,413**
	Jan-Mar 05	374	349	26	7	**7.0%**	**1.9%**	8,318	7,136	85.8%	3,400	6,797

***Note**: US Airways' financial results are for the 9 months up to Dec 31, 2003. Operating statistics are for the full year.

Note: Annual figures may not add up to sum of interim results due to adjustments and consolidation. 1 ASM = 1.6093 ASK. All US airline Financial Year Ends are 31/12.

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
Air France												
YE 31/03	Jul-Sep 03	3,715	3,598	117	56	3.1%	1.5%	35,255	27,544	78.1%		
	Oct-Dec 03	3,933	3,855	78	35	2.0%	0.9%	33,380	25,329	75.9%		71,900
	Jan-Mar 04	3,668	3,680	-12	16	-0.3%	0.4%	33,917	25,026	73.8%		
	Year 2003/04	**15,024**	**14,855**	**169**	**113**	**1.1%**	**0.8%**	**134,444**	**101,644**	**75.6%**		
KLM												
YE 31/03	Jul-Sep 03	1,878	1,725	152	104	8.1%	5.5%	18,905	15,874	84.0%		32,853
	Oct-Dec 03	1,838	1,801	36	10	2.0%	0.5%	17,969	14,378	80.0%		31,804
	Jan-Mar 04	1,677	1,645	32	-24	1.9%	-1.4%	17,963	14,455	80.5%		
	Year 2003/04	**7,157**	**7,011**	**146**	**29**	**2.0%**	**0.4%**	**72,099**	**57,784**	**80.1%**		**31,077**
Air France/												
KLM Group*	Apr-Jun 04	5,394	5,205	189	115	3.5%	2.1%	48,944	38,025	77.7%		
	Jul-Sep 04	6,328	5,964	364	248	5.8%	3.9%	57,668	46,767	81.1%		
	Oct-Dec 04	6,628	5,745	883	83	13.3%	1.3%	54,144	42,042	77.6%	15,934	
	Year 2004/05	**24,641**	**21,744**	**2,897**	**453**	**11.8%**	**1.8%**	**214,606**	**168,998**	**78.7%**	**64,075**	**102,077**
BA												
YE 31/03	**Year 2002/03**	**12,490**	**12,011**	**543**	**117**	**4.3%**	**0.9%**	**139,172**	**100,112**	**71.9%**	**38,019**	**51,630**
	Jul-Sep 03	3,306	2,980	333	163	10.1%	4.9%	35,981	27,540	76.5%	9,739	47,702
	Oct-Dec 03	3,363	3,118	244	148	7.3%	4.4%	35,098	25,518	72.7%	8,453	46,952
	Jan-Mar 04	3,386	3,327	164	22	4.8%	0.6%	35,232	24,932	70.8%	8,142	46,551
	Year 2003/04	**13,806**	**13,067**	**739**	**237**	**5.4%**	**1.7%**	**141,273**	**103,092**	**73.0%**	**36,103**	**49,072**
	Apr-Jun 04	3,479	3,208	271	127	7.8%	3.7%	36,150	27,083	74.9%	9,288	46,280
	Jul-Sep 04	3,645	3,213	432	221	11.9%	6.1%	36,639	28,749	78.5%	9,822	46,179
	Oct-Dec 04	3,801	3,589	212	94	5.6%	2.5%	35,723	25,999	72.8%	8,428	45,888
	Jan-Mar 05	3,549	3,474	96	17	2.7%	0.5%	35,677	26,062	73.0%	8,178	45,914
	Year 2004/05	**14,681**	**13,666**	**1,015**	**472**	**6.9%**	**3.2%**	**144,189**	**107,892**	**74.8%**	**35,717**	**46,065**
Iberia												
YE 31/12	Apr-Jun 03	1,348	1,265	83	60	6.2%	4.5%	13,516	9,982	73.8%	6,472	
	Jul-Sep 03	1,434	1,301	133	93	9.3%	6.5%	14,819	11,846	79.9%	7,073	
	Year 2003	**5,800**	**4,459**	**202**	**180**	**3.5%**	**3.1%**	**56,145**	**42,100**	**75.0%**	**25,613**	
	Jan-Mar 04	1,325	1,356	-32	-1	-2.4%	-0.1%	14,563	10,721	73.6%	6,136	
	Apr-Jun 04	1,461	1,371	90	95	6.2%	6.5%	14,743	11,106	75.3%	6,913	
	Jul-Sep 04	1,593	1,452	141	110	8.9%	6.9%	16,053	12,699	79.1%	7,314	25,839
	Oct-Dec 04	1,660	1,605	55	74	3.3%	4.5%	15,700	11,398	72.6%	6,329	24,783
Lufthansa												
YE 31/12	Apr-Jun 03	4,423	4,214	209	-39	4.7%	-0.9%	30,597	22,315	71.7%	10,758	
	Jul-Sep 03	4,923	4,783	140	-20	2.8%	-0.4%	32,895	24,882		12,020	
	Year 2003	**20,037**	**20,222**	**-185**	**-1,236**	**-0.9%**	**-6.2%**	**124,000**	**90,700**	**73.1%**	**45,440**	**94,798**
	Jan-Mar 04	4,742	4,883	-141	76	-3.0%	1.6%	31,787	23,030	72.5%	11,414	93,479
	Apr-Jun 04	5,269	5,045	224	-28	4.3%	-0.5%	36,440	26,959	74.0%	13,336	
	Jul-Sep 04	5,511	5,164	347	154	6.3%	2.8%	38,115	28,883	75.8%	14,053	92,718
	Year 2004	**25,655**	**24,285**	**1370**	**551**	**5.3%**	**2.1%**	**140,648**	**104,064**	**74.0%**	**50,300**	**90,763**
	Jan-Mar 05	5,041	5,079	-38	-150	-0.8%	-3.0%	32,477	23,793	73.3%	11,190	89,939
SAS												
YE 31/12	**Year 2003**	**7,978**	**8,100**	**-122**	**-195**	**-1.5%**	**-2.4%**	**47,881**	**30,402**	**63.5%**	**31,320**	**34,544**
	Jan-Mar 04	1,652	1,823	-171	-184	-10.4%	-11.1%	11,852	7,031	59.3%	7,238	
	Apr-Jun 04	2,007	1,979	27	13	1.3%	0.6%	13,456	8,960	66.6%	8,879	
	Jul-Sep 04	2,099	1,860	239	9	11.4%	0.4%	13,557	9,198	67.8%	8,591	
	Oct-Dec 04	2,271	2,293	-22	-96	-1.0%	-4.2%	12,667	7,649	60.4%	7,645	32,600
	Year 2004	**8,830**	**8,967**	**-137**	**-283**	**-1.6%**	**-3.2%**	**43,077**	**28,576**	**64.0%**	**32,354**	**32,481**
	Jan-Mar 05	1,842	1,990	-148	-137	-8.0%	-7.4%	12,465	7,342	58.9%	7,299	31,797
Ryanair												
YE 31/03	**Year 2002/03**	**910**	**625**	**285**	**259**	**31.3%**	**28.5%**			**84.0%**	**15,740**	**1,900**
	Jul-Sep 03	407	237	170	148	41.8%	36.4%				5,571	2,200
	Oct-Dec 03	320	253	67	51	20.9%	15.9%				6,100	2,356
	Year 2003/04	**1,308**	**978**	**330**	**252**	**25.2%**	**19.3%**			**81.0%**	**23,133**	**2,300**
	Apr-Jun 04	366	288	78	64	21.3%	17.5%			83.0%	6,600	2,444
	Jul-Sep 04	516	305	211	181	40.9%	35.1%			90.0%	7,400	2,531
	Oct-Dec 04	402	335	68	47	16.9%	11.7%			84.0%	6,900	2,671
	Year 2004/05	**1,727**	**1,301**	**426**	**345**	**24.7%**	**20.0%**			**84.0%**	**27,593**	
easyJet												
YE 30/09	**Year 2001/02**	**864**	**656**	**111**	**77**	**12.8%**	**8.9%**	**10,769**	**9,218**	**84.8%**	**11,350**	**3,100**
	Oct-Mar 03	602	676	-74	-76	-12.3%	-12.6%	9,594	7,938	82.2%	9,347	
	Year 2002/03	**1,553**	**1,472**	**81**	**54**	**5.2%**	**3.5%**	**21,024**	**17,735**	**84.1%**	**20,300**	**3,372**
	Oct-Mar 04	803	861	-58	-36	-7.2%	-4.5%	10,991	9,175	83.3%	10,800	
	Year 2003/04	**1,963**	**1,871**	**92**	**74**	**4.7%**	**3.8%**	**25,448**	**21,566**	**84.5%**	**24,300**	

Note: Annual figures may not add up to sum of interim results due to adjustments and consolidation. * = Preliminary consolidated figures for Air France Group from May-June, KLM Group from May-June

		Group revenue US$m	Group costs US$m	Group op. profit US$m	Group net profit US$m	Operating margin	Net margin	Total ASK m	Total RPK m	Load factor	Total pax. 000s	Group employees
ANA												
YE 31/03	**Year 2001/02**	**9,714**	**9,529**	**185**	**-76**	**1.9%**	**-0.8%**	**87,908**	**57,904**	**64.7%**	**49,306**	
	Apr-Sep 02	5,322	5,194	127	-69	**2.4%**	**-1.3%**	44,429	29,627	66.7%	25,341	
	Year 2002/03	**10,116**	**10,137**	**-22**	**-235**	**-0.2%**	**-2.3%**	**88,539**	**59,107**	**66.7%**	**50,916**	**14,506**
	Apr-Sep 03	5,493	5,362	131	186	2.4%	3.4%	32,494	19,838	61.1%	22,866	
	Year 2003/04	**11,529**	**11,204**	**325**	**234**	**2.8%**	**2.0%**	**87,772**	**55,807**	**63.6%**	**44,800**	**20,530**
Cathay Pacific												
YE 31/12	**Year 2002**	**4,243**	**3,634**	**609**	**513**	**14.4%**	**12.1%**	**63,050**		**77.8%**		**14,600**
	Jan-Jun 03	1,575	1,672	-97	-159	-6.2%	-10.1%	26,831		64.4%	4,019	14,800
	Year 2003	**3,810**	**3,523**	**287**	**168**	**7.5%**	**4.4%**	**59,280**	**42,774**	**72.2%**	**12,322**	**14,673**
	Jan-Jun 04	2,331	2,046	285	233	12.2%	10.0%	35,250		76.1%	6,404	
	Year 2004	**5,024**	**4,350**	**674**	**581**	**13.4%**	**11.6%**	**74,062**	**57,283**	**77.3%**	**13,664**	**15,054**
JAL												
YE 31/03	**Year 2001/02**	**9,607**	**9,741**	**-135**	**-286**	**-1.4%**	**-3.0%**				**37,183**	
	Year 2002/03	**17,387**	**17,298**	**88**	**97**	**0.5%**	**0.6%**	**145,944**	**99,190**	**68.0%**	**56,022**	
	Year 2003/04	**18,398**	**19,042**	**-644**	**-844**	**-3.5%**	**-4.6%**	**145,900**	**93,847**	**64.3%**	**58,241**	
Korean Air												
YE 31/12	**Year 2001**	**4,309**	**4,468**	**-159**	**-448**	**-3.7%**	**-10.4%**	**55,802**	**38,452**	**68.9%**	**21,638**	
	Year 2002	**5,206**	**4,960**	**246**	**93**	**4.7%**	**1.8%**	**58,310**	**41,818**	**71.7%**		
	Year 2003	**5,172**	**4,911**	**261**	**-202**	**5.0%**	**-3.9%**	**59,074**	**40,507**	**68.6%**	**21,811**	
Malaysian												
YE 31/03	**Year 2001/02**	**2,228**	**2,518**	**-204**	**-220**	**-9.2%**	**-9.9%**	**52,595**	**34,709**	**66.0%**	**15,734**	**21,438**
	Year 2002/03	**2,350**	**2,343**	**7**	**89**	**0.3%**	**3.8%**	**54,266**	**37,653**	**69.4%**		**21,916**
	Year 2003/04	**2,308**	**2,258**	**50**	**121**	**2.2%**	**5.2%**	**55,692**	**37,659**	**67.6%**	**15,375**	**20,789**
Qantas												
YE 30/06	**Year 2001/02**	**6,133**	**5,785**	**348**	**232**	**5.7%**	**3.8%**	**95,944**	**75,134**	**78.3%**	**27,128**	**33,044**
	Jul-Dec 02	3,429	3,126	303	200	8.8%	5.8%	50,948	40,743	80.0%	15,161	34,770
	Year 2002/03	**7,588**	**7,217**	**335**	**231**	**4.4%**	**3.0%**	**99,509**	**77,225**	**77.6%**	**28,884**	**34,872**
	Jul-Dec 03	4,348	3,898	450	269	10.3%	6.2%	50,685	40,419	79.7%	15,107	33,552
	Year 2003/04	**7,838**	**7,079**	**759**	**448**	**9.7%**	**5.7%**	**104,200**	**81,276**	**78.0%**	**30,076**	**33,862**
	Jul-Dec 04	5,017	4,493	524	358	10.4%	7.1%	57,402	43,907	76.5%	16,548	35,310
Singapore												
YE 31/03	**Year 2001/02**	**5,399**	**4,837**	**562**	**395**	**10.4%**	**7.3%**	**94,559**	**69,995**	**74.0%**	**14,765**	**29,422**
	Year 2002/03	**5,936**	**5,531**	**405**	**601**	**6.8%**	**10.1%**	**99,566**	**74,183**	**74.5%**	**15,326**	**30,243**
	Year 2003/04	**5,732**	**5,332**	**400**	**525**	**7.0%**	**9.2%**	**88,253**	**64,685**	**73.3%**	**13,278**	**29,734**
	Apr-Jun 04	1,588	1,409	179	159	11.3%	10.0%	25,249	18,167	71.9%	3,800	
	Jul-Sep 04	1,780	1,587	193	215	10.8%	12.1%	26,357	19,959	75.7%	4,050	
	Oct-Dec 04	1,956	1,697	259	291	13.2%	14.9%	26,768	20,274	75.7%	4,201	

Note: Annual figures may not add up to sum of interim results due to adjustments and consolidation. 1 ASM = 1.6093 ASK

AIRCRAFT AVAILABLE FOR SALE OR LEASE - MONTH END

	Old narrowbodies	Old widebodies	Total old	New narrowbodies	New widebodies	Total new	Total
Dec-1999	243	134	377	101	53	154	531
Dec-2000	302	172	474	160	42	202	676
Dec-2001	368	188	556	291	101	392	948
Dec-2002	366	144	510	273	102	375	885
Dec-2003	275	117	392	274	131	405	797
Dec-2004	185	56	241	194	48	242	483
Mar-2005	193	51	244	187	40	227	471

AIRCRAFT SOLD OR LEASED

	Old narrowbodies	Old widebodies	Total old	New narrowbodies	New widebodies	Total new	Total
1999	582	230	812	989	170	1,159	1,971
2000	475	205	680	895	223	1,118	1,798
2001	286	142	428	1,055	198	1,253	1,681
2002	439	213	652	1,205	246	1,451	2,103
2003	408	94	502	1,119	212	1,331	1,833
2004	321	177	498	1,815	325	2,140	2,638
Mar-2005	18	8	26	160	18	178	204

Source: *BACK* **Notes:** *As at end year; Old narrowbodies = 707, DC8, DC9, 727,737-100/200, F28, BAC 1-11, Caravelle; Old widebodies = L1011, DC10, 747-100/200, A300B4; New narrow-bodies = 737-300+, 757. A320 types, BAe 146, F100, RJ; New widebodies = 747-300+, 767, 777. A600, A310, A330, A340.*

EUROPEAN SCHEDULED TRAFFIC

	Intra-Europe			North Atlantic			Europe-Far East			Total long-haul			Total Int'l		
	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %
1997	174.8	110.9	63.4	176.5	138.2	78.3	130.4	96.9	74.3	419.0	320.5	76.5	621.9	450.2	72.4
1998	188.3	120.3	63.9	194.2	149.7	77.1	135.4	100.6	74.3	453.6	344.2	75.9	673.2	484.8	72
1999	200.0	124.9	62.5	218.9	166.5	76.1	134.5	103.1	76.7	492.3	371.0	75.4	727.2	519.5	71.4
2000	208.2	132.8	63.8	229.9	179.4	78.1	137.8	108.0	78.3	508.9	396.5	77.9	755.0	555.2	73.5
2001	212.9	133.4	62.7	217.6	161.3	74.1	131.7	100.9	76.6	492.2	372.6	75.7	743.3	530.5	71.4
2002	197.2	129.3	65.6	181.0	144.4	79.8	129.1	104.4	80.9	447.8	355.1	79.3	679.2	507.7	74.7
2003	210.7	136.7	64.9	215.0	171.3	79.7	131.7	101.2	76.8	497.2	390.8	78.6	742.6	551.3	74.2
2004	220.6	144.2	65.4	224.0	182.9	81.6	153.6	119.9	78.0	535.2	428.7	80.1	795.7	600.7	75.5
May-05	26.8	18.5	68.7	20.5	17.1	83.6	14.0	10.3	73.7	48.1	37.3	77.6	71.3	53.3	74.8
Ann. chng	3.5%	6.9%	2.2	2.8%	5.9%	2.4	8.0%	10.5%	1.7	5.5%	6.9%	1.0	4.7%	7.1%	1.7
Jan-May 05	123.8	78.8	63.7	89.0	71.2	80.0	67.2	52.2	77.6	225.3	178.4	79.2	332.3	247.7	74.5
Ann. Change	3.0%	4.5%	1.0	0.8%	2.0%	0.9	10.3%	11.5%	0.9	5.1%	6.2%	0.9	4.6%	6.1%	1.1

Source: AEA

US MAJORS' SCHEDULED TRAFFIC

	Domestic			North Atlantic			Pacific			Latin America			Total Int'l		
	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %	ASK bn	RPK bn	LF %
1997	953.3	663.7	69.6	138.1	108.9	78.9	122.0	91.2	74.7	71.3	46.4	65.1	331.2	246.5	74.4
1998	960.8	678.8	70.7	150.5	117.8	78.3	112.7	82.5	73.2	83.5	52.4	62.8	346.7	252.7	72.9
1999	1,007.3	707.5	70.2	164.2	128.2	78.1	113.2	84.7	74.8	81.3	54.3	66.8	358.7	267.2	74.5
2000	1,033.5	740.1	71.6	178.9	141.4	79.0	127.7	97.7	76.5	83.0	57.6	69.4	380.9	289.9	76.1
2001	1,025.4	712.2	69.5	173.7	128.8	74.2	120.1	88.0	73.3	83.4	56.9	68.2	377.2	273.7	72.6
2002	990.0	701.6	70.9	159.0	125.7	67.2	103.0	83.0	80.5	84.1	56.8	67.5	346.1	265.5	76.7
2003	963.1	706.6	73.4	148.3	117.6	79.3	94.8	74.0	80.5	84.2	59.3	70.5	327.2	251.0	76.7
2004	1,014.5	763.6	75.3	164.2	134.4	81.8	105.1	87.6	83.4	96.4	68.0	70.5	365.6	289.8	79.3
Jun- 05	86.7	71.9	82.9	16.0	14.2	89.1	9.9	8.8	88.9	8.6	6.3	73.4	34.5	29.4	85.1
	0.5%	2.3%	1.5	6.8%	6.6%	-0.2	13.2%	11.4%	-1.4	9.5%	15.1%	3.5	9.2%	9.8%	0.4
Jan-Jun 05	502.1	387.9	77.3	83.7	68.4	80.3	50.0	42.4	84.9	48.2	33.6	69.7	176.0	138.5	78.7
Ann. Change	-0.1%	4.0%	3.0	7.7%	9.5%	1.4	14.3%	11.0%	-2.5	12.2%	16.9%	2.9	10.8%	11.7%	0.78

Note: US Majors = Aloha, Alaska, American, Am. West, American Transair, Continental, Cont. Micronesia, Delta, Hawaiian JetBlue, MidWest Express, Northwest,Southwest, United and US Airways **Source**: ATA

JET ORDERS

	Date	Buyer	Order	Delivery	Other information/engines
Boeing	07 June	China Eastern	2 x 747F	07/2006	
	13 June	Ryanair	5 x 737-800	3Q 2006	
	14 June	GECAS	20 x 737	2006-08	
	14 June	ILFC	20 x 737/8 x 777	4Q 2006 onwards	
	15 June	WestJet	2 x 737-600	2006	
	15 June	Alaska Air	35 x 737-800	2006 onwards	plus 65 options
	21 June	Vietnam Air	4 x 787	2009-10	plus 11 options
	30 June	JAL	6 x 767-300ER	2007-08	
	05 July	Guggenheim	6 x 747-400ERF	2066 onwards	
Airbus	15 June	Tiger Air	8 x A320	1Q 2006 onwards	
	15 June	Kingfisher	5 x A350, 5 x A380, 5 x A330	3Q2007 onwards	
	16 June	IndiGo	100 x A320	4Q 2006 onwards	
	16 June	Interjet	10 x A320	2Q 2007	plus 10 options
	16 June	TAM	20 x A320	2007-10	plus 20 options
	17 June	Germanwings	18 x A319	2006 onwards	plus 12 options
	27 June	Air Mauritius	3 x A340-300E	4Q 2006	plus 2 options
	08 July	Iberia	30 x A320		plus 49 options
Embraer	15 June	GECAS	20 x E190	2006 onwards	

Note: Only firm orders from identifiable airlines/lessors are included. *Source: Manufacturers*

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