Aviation Strategy

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Europe's LCCs: Evolutionary surge

MICHAEL O'Leary's pronouncement last Autumn that Ryanair would start cuddling up to customers and increasingly operate from prime airports closer to where passengers actually want to go seems to have been seen as a radical change of strategic direction for the Irish ultra low cost carrier.

The move may more be an acceptance that Ryanair underestimated the success of other LCCs' (and in particular easyJet's) entry into mainstream markets and is a sign that the low cost model in Europe is maturing (or at least that the passenger base is becoming more sophisticated at determining product differences at the low end of the price/demand curve); it is becoming increasingly difficult for the LCCs in Europe to stimulate demand efficiently purely by low prices.

Hitherto the Ryanair philosophy was to operate at the lowest possible cost base, between airports offering the lowest possible handling cost per passenger, with flight timings organised to maximise schedule efficiency rather than demand convenience. It has used the pricing of unbundled "ancillaries" to change customer behaviour and help reduce costs further. In essence, the company operates a bus service in a commodity market; and held to the mantra that the lowest cost provider in a commodity market would always win.

In September last year, the UK's consumer organisation magazine *Which?* published a survey damning Ryanair as the worst brand in the country (out of the top 100) for customer satisfaction. Naturally Ryanair rebuffed the criticism by emphasising that it has the best on-time performance, punctuality, reliability, lost-bag statistics and fewest official customer complaints of any European airline, but it then set out determinedly to improve its image.

The change of attitude appears pronounced. In October 2013, Ryanair announced a series of strategic initiatives to improve customer service, experience and satisfaction (the first step being to open a twitter account). In November it launched a significant redesign of its website. The old design was tired, garish and hardly seemed to have changed since first introduced in the 1990s (designed for a couple of thousand punts by a Dublin student). The redesign reduces the number of "clicks" required to complete a booking from 17 to five, while the annoying "recaptcha" security code was removed for individual bookings. It introduced a 24 hour "grace period" for minor alterations to website bookings (previously charged for), and a "My Ryanair" customer registration profile. At the same time, the company introduced a free mobile "app", and plans to offer mobile boarding passes and a new fare finder website in the Spring of this year. It has also opened its tariff inventory to Google Flight Search and is in negotiation with the GDSs to enable its fares to be shown on their distribution channels.

Penalty fees have been significantly reduced (eg from €70 to €15 for the reissue of a boarding card at the airport), bag fees cut from €60 to €30, and passengers are now allowed a second small carry-on bag (which might please the airports' duty-free operations). It has also introduced "quiet flights" (for those departing before 8am or after 9pm). Fully allocated seating was introduced in February. It launched a groups and corporate travel service in January with plans to introduce a new busi-

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European LCCs – Expanding the Product

		Ryanair	Wizzair	easyJet	norwegian	airBerlin	Vueling	flybe	Aer Lingus
Hard Complexities	Pure KISS	✔	✔						
	Secondary/tertiary airports	✔	✔					✔	✔
	Single aircraft type	✔	✔	✔			✔		✔
	Primary/congested airports	✔		✔	✔	✔	✔		✔
	Corporate accounts	✔		✔	✔	✔	✔	✔	✔
	GDS/Travel Agent distribution	✔		✔	✔	✔	✔	✔	✔
	Transfer traffic				✔	✔	✔		✔
	FFP				✔	✔			✔
	Code share					✔	✔	✔	✔
	Global Branded Alliance					✔			
	Class/Seat differentiation					✔	✔		
	Long haul				✔	✔			✔
Soft Complexities	Loyalty card (paid for)	✔	✔	✔			✔		
	Special seat allocation (paid for)	✔	✔	✔	✔	✔	✔	✔	✔
	Full plane seat allocation	✔		✔	✔	✔	✔	✔	✔
	Priority boarding	✔	✔	✔					
	Flexible business fares	✔		✔	✔	✔	✔	✔	✔
	Credit card	✔	✔	✔	✔	✔	✔	✔	✔
	In house bank				✔				

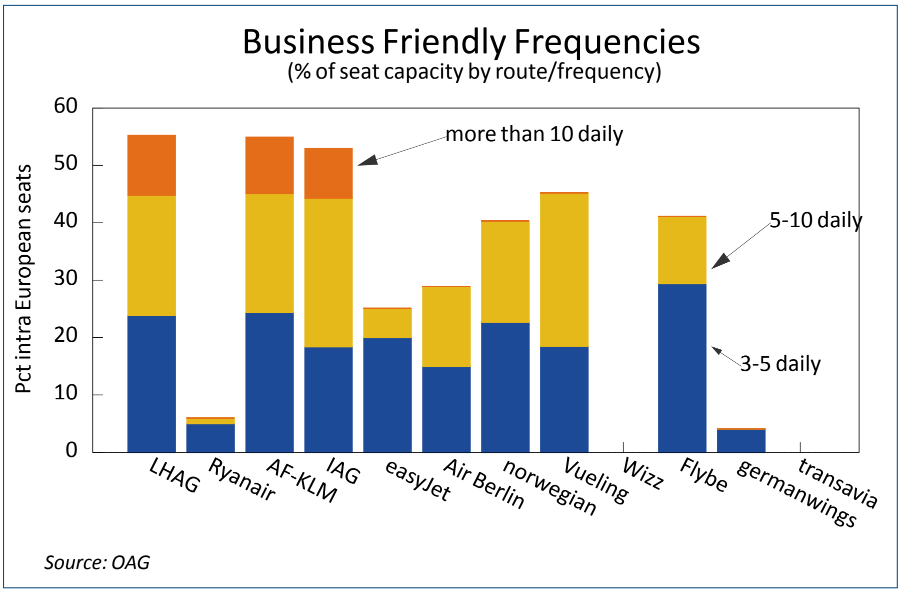
ness product – with reserved seating, flexible tickets and fast-track access through selected airports.

There have been important innovations in the Ryanair network in recent months. It has announced new bases at *primary* airports in Europe: Rome Fiumicino (attacking Alitalia, easyJet and Vueling which had just started operations there); Athens (one of the most expensive airports in Europe for landing charges) and Thessalonica (attacking Aegean and easyJet); Lisbon (albeit at the low cost terminal); and Brussels Zaventem (taking on easyJet, SN Brussels and Vueling which again had just opened a base there).

In each of these cases it seems that it has accepted that it will not be able to do a special discount deal with the airport and that it will have to pay a per passenger handling charge well above its €5 target – *and* that this is worth doing. No doubt more primary airports are to come.

In any case there is a new EU regulatory framework on state aid to airports (and consequently covering state-aided airports providing support to airlines to encourage traffic) which may undermine some of the deals that Ryanair has in the past been able to negotiate with smaller regional airports.

What does this all portend for the LCCs in Europe? Ryanair and easyJet had first mover advantages: they



each managed to secure favourable aircraft acquisition deals in the early 2000s respectively with Boeing and Airbus to allow them to grow into the vacuum of despair at the time and develop pan-European brands and networks. Since then other LCCs have started and failed, but a new generation with high growth plans have developed – each trying to find their own market position – and are starting to pose a real threat to the perceived LCC duopoly.

Moving up-market – the hybrid model

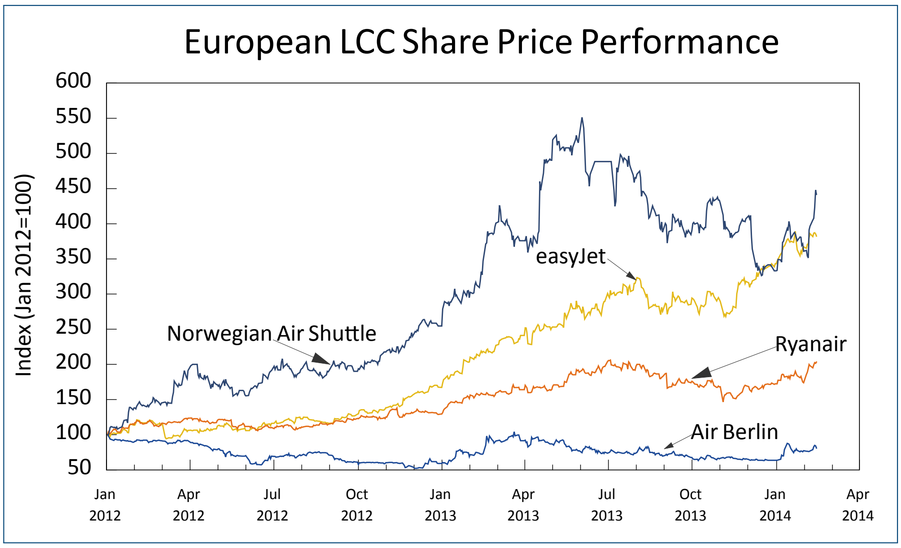
An airline is an airline – providing a pure commodity product of transporting a passenger (and with luck his baggage) from where he doesn't want to be to where he wants to go to (and possibly back again). The original LCC model in Europe was based on the Southwest KISS principles:

- ✈ high seating density,
- ✈ high aircraft utilisation,
- ✈ single aircraft type,
- ✈ low fares including exceptionally low promotional fares,
- ✈ single class configuration,
- ✈ point-to-point services, no (free) frills,
- ✈ short-/medium-haul services,
- ✈ frequent use of secondary and tertiary airports,
- ✈ quick turnaround.

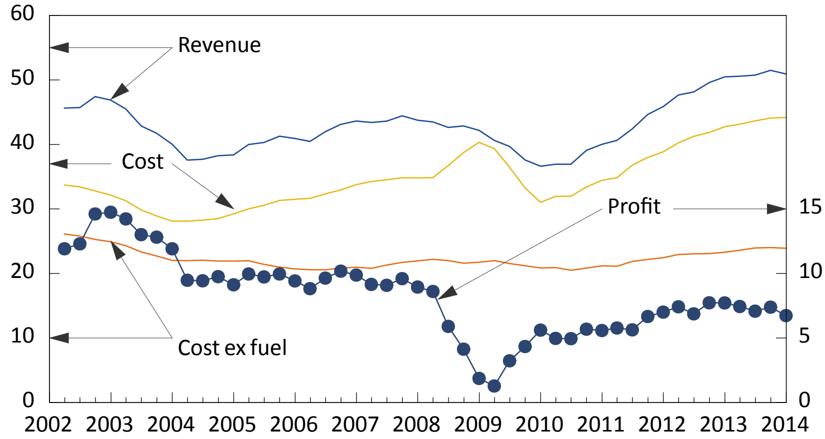
Increasingly, the new entrant LCCs have been trying to find a sense of differentiation – leading to the "hybrid" model (see table opposite). One of the first elements of this is to eye the potential of yield uplift by providing a service targeted at "business" passengers. This leads to a traditional offer of at least three flights a day on a route to be attractive – a minimum of a morning and evening flight (with a mid-day infill) – while the origin and destination airport need to be relatively mainstream. In addition there is seen to be a requirement to have presence in the global distribution systems (to gain access to corporate bookings and travel agent distribution), and create a marketing team to develop relationships with corporate accounts. All this of course adds to complexity and cost.

Once you have the idea that you need to attract corporate business accounts you start to get the idea that you need to retain them through some form of loyalty programme – if only because the legacy competitors do. Most of the European LCCs have created an opt-in charged-for programme with defined benefits. Some have even been offering uncharged-for frills for those willing to pay higher "flexible" fares, effectively providing an on-board class differentiation in a single class cabin.

Some of these aspects of the departure from the KISS principle have limited or no impact on costs. These we might describe as "soft" complexities and may include items such as paid for special seat assignment, full-plane seat allocation, priority boarding, branded credit cards – all of which can be either cost neutral or self financing.



Ryanair per seat data
€/seat (12 month rolling average)



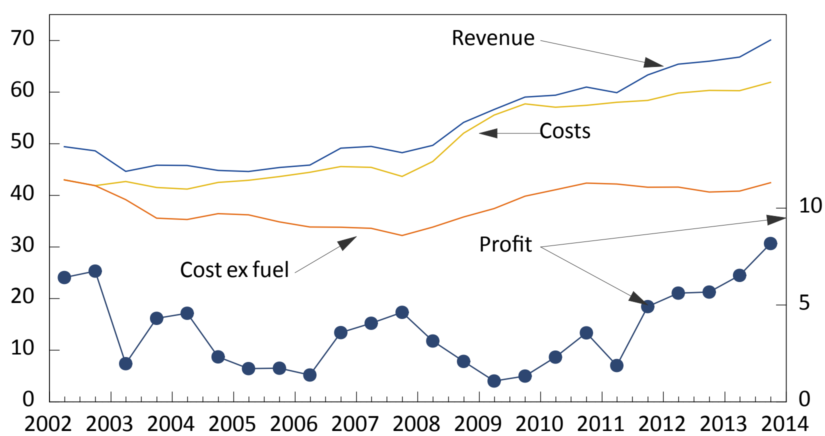
Others – which we might call “hard” complexities – are those items that impose a cost penalty against best in class if not absolutely; and here the operator’s hope is that there will be a sufficient improvement in yield to offset the effective increase in costs required to provide or use the service. These will include the use of primary airports, different aircraft types/sizes, access to global distribution services, provision of intra-line (or transfer) services, frequent flyer or loyalty plans, inter-line or code share agreements, membership of global branded alliances, class differentiation, and operation of long haul services.

Vueling (now a part of IAG) positions itself as a high quality low cost Catalonian “flag carrier” targeting SME business travel and mixing the traditional simple low cost model with elements of the legacy operation – transfer traffic at Barcelona, GDS access, quasi “business class”, code shares. As shown in the chart on page 3, Vueling has the highest proportion of capacity flown on “business friendly” routes among the LCCs with around 45% of its seats on routes with more than three daily frequencies. Norwegian is pushing boundaries in developing long haul low cost while trying to replace SAS as the Scandinavian flag. germanwings and transavia are increasingly being used by their parent companies to replace under-performing intra-European routes. Wizz quietly (because it remains privately owned) is trying to survive and grow as an Eastern European VLCC.

Quantifying the real net benefit of this hybrid model is not easy: from public information (where available) it is difficult to compare operating costs on a like for like basis to see where real difference lies. The long term net benefit if any should be seen in the airline’s operating margins; but there are many elements outside the control of the carrier that can affect any one year’s returns. In the charts on this page we show the per passenger data for Ryanair and easyJet on a rolling 12 month basis. Without allowing for currency differences, the performance in easyJet’s per passenger operating profit has shown consistent strong performance since introducing the more business friendly orientation – whereas that of Ryanair has remained fairly steady in the past four years. The stock markets have liked it too – and the out-performance of the easyJet share price has been gratification enough for the hybrid model (see chart on page 3).

From Ryanair’s perspective, the move “up-market” is fairly low risk: its new bases at primary and expensive airports form only a handful of its 65 bases and 1,600 routes throughout Europe, and it is obviously confident enough that its own cost base is still the lowest. Even paying rack rates at its new bases, the rest of its cost structure affords it a 30% advantage over its closest competitor.

easyJet per seat data
£/seat (12 month moving average)



Qatar Airways: Banking on steady expansion

With plans for an IPO now on hold, Qatar Airways is concentrating on organic growth via more aircraft orders, developing a new hub airport at Doha and joining **one**world. What are the prospects for the second-largest of the Gulf's "Big Three" airlines?

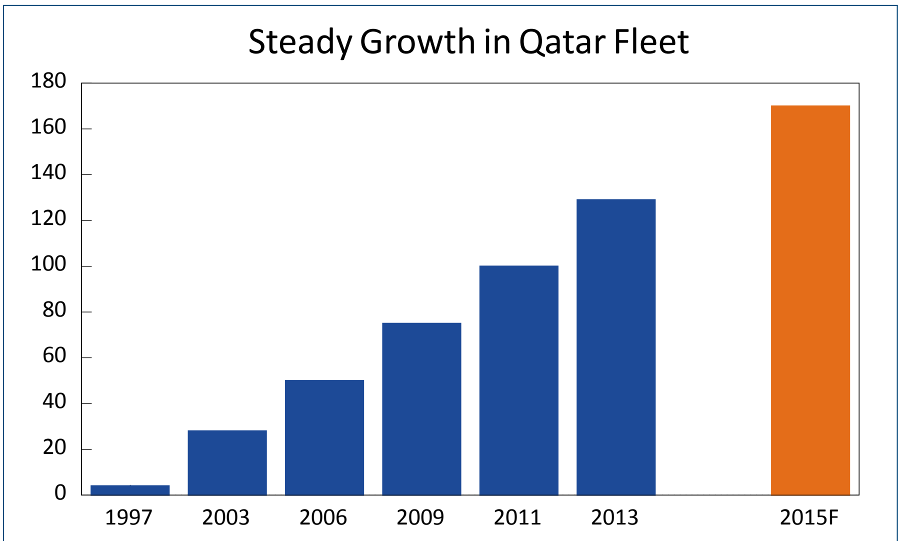
Qatar Airways was founded in 1994, although it was effectively relaunched in 1997 under new chief executive Akbar Al Baker, who has developed the airline into the Gulf mega-carrier that it is today. The flag carrier of Qatar now operates to 134 destinations, comprising 45 in the Middle East and Africa, 43 in the Asia/Pacific region, 30 in Europe and seven in the Americas (with the rest being specialist cargo destinations).

Qatar Airways is part of the Qatar Airways Group, which employs more than 30,000 worldwide (with the airline accounting for more than 17,000 of these), in everything from ground handling, catering and tour operating to Doha International Airport (which it owns 100%). 50% of the group is held by the Qatar state (via the Qatar Investment Authority, which is the country's sovereign wealth fund) and the other 50% is owned by private Qatari investors, but a planned IPO via a dual listing in Doha and London was postponed in early 2012 given the poor global economic environment.

Al Baker says that the IPO will now not happen until 2017 at the earliest, so in the meantime it's back to Plan 'B' for the airline (though executives argue this has always been its strategy) – steady but significant organic growth.

Fleet Growth

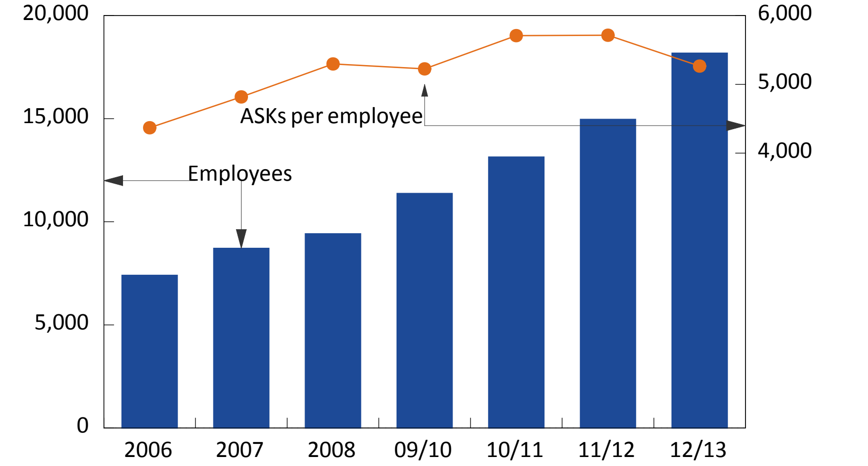
The driver for that strategy is fleet growth. As can be seen in the chart below, Qatar's fleet has been growing steadily over the past 20 years and today stands at 129 aircraft (with an average age of less than five years), comprising 82 Airbus models – 32 A320s, 16 A330-200s, 13 A330-300s, 12 A321s, four A340s, three A330 freighters and two A319LRs – and 47 Boeing aircraft: 24 777-300ERs, nine 777-200LRs, nine 787s and five 777Fs. Qatar Airways also has a corporate jet subsidiary, which operates seven Bombardier aircraft – three Global 5000s, three Challenger 605s and one Global Express XRS.



However, the airline has significantly increased its orders over the last two years, with the outstanding firm order book growing from 136 aircraft as of 2011 to 172 today. They comprise 36 A320s, 14 A321s, five A330-200Fs, 43 A350-900s, 37 A350-1000s, 10 A380s, 21 787s, three 777-300ERs and three 777Fs.

At the Dubai air show in November Qatar announced a letter of intent to for 50 777-9x aircraft, worth $19bn at list prices, and to be delivered over a six year period starting in 2020. As of January 2014 that has not yet been turned into a firm order, though it is expected to be converted sometime this year.

Qatar negotiated jointly with Emirates for the 777 order (Emirates also bought 50 of the type at the Dubai air show) in order to get better terms and performance specifications, and the two airlines stood side-by-side at the show to announce their orders together. Further co-operation on jointly-beneficial issues is likely, with Al Baker saying that "we are close to Emirates vis-à-vis relationships, both at the management and at the top level". Intriguingly Al Baker also hints at the possibility of a long-term merger between the



Qatar Airways Employee Productivity

airlines, although Tim Clark, Emirates president, has stated that this was unlikely as it would have "seismic repercussions ... you would face the most formidable international airline group that has ever been formed. That's why it will never happen."

In terms of other widebodies, the first A350 should arrive in the second half of 2014 while the first A380 will arrive in April – though Al Baker says the airline won't buy any more A380s to add to existing order of 10 aircraft.

At the Dubai air show Qatar also ordered five A330-200 freighters, with options for eight more, which Al Baker said would be converted into firm orders pretty soon. The first two aircraft arrive in 2014 and will be used alongside three existing aircraft of the same model on the airline's network of 40 cargo routes. The A330-200F offers up to 70 tonnes of payload, which is less than some of the larger freighter alternatives but gives Qatar Airways more flexibility in the destinations it serves – particularly medium-sized cities that are underserved by cargo competitors.

With three 777Fs also on order, Akbar says that Qatar Airways aims to become one of the top five global cargo carriers over the next four years. Cargo (including dedicated freighters and belly-hold capacity in passenger aircraft) accounts for almost 30% of Qatar Airways' total revenue, which is much higher than average for large carriers. Incidentally, Qatar's busiest cargo route is between Doha and Hong Kong.

By 2015 Qatar's fleet will increase to more than 170 aircraft, operating to 170 destinations, and with new aircraft arriving at the rate of two per month Qatar Airways will grow by 20% each year for the next five years.

Route network

The airline believes there are more than enough routes and destinations that can accommodate the new arrivals. Last year 12 new destinations were added – including Chicago, Clark International (Philippines), Addis Ababa and Chengdu – while in the first half of 2014 seven destinations will be launched, comprising Sharjah, Dubai World Central, Larnaca, Istanbul (Sabiha Gokçen airport), Edinburgh, Philadelphia and Miami.

Further destinations will be added in the second half of the year, the first of which to be confirmed is Dallas/Fort Worth. That will be Qatar's seventh US destination and the country is a major target for expansion, with destinations served almost doubling in 2014. That expansion accompanies a codeshare alliance with US Airways first signed in 2009 that was upgraded in December 2012, closely followed by a codeshare with American Airlines in 2013, as well a codeshare with JetBlue agreed in 2012.

China is another priority for Qatar Airways – a route from Doha to Hangzhou was launched in December that brings total mainland China destinations to seven, served by 45 non-stop flights a week, and further expansion into China is certain.

India is also of interest, but after the Indian government allowed foreign airlines to own up to 49% of local carriers from September 2012 Etihad's purchase of a stake in Jet Airways led to persistent rumours of a

Qatar Airways Fleet

Aircraft	In Service	Order	Options	LoI	Storage	Total
777	38	6	8	56		108
787	9	21	30			60
A320 family	46	50	32		2	130
A330	32	5	8			45
A340	4					4
A350		80				80
A380		10	3			13
Total	**129**	**172**	**81**	**56**	**2**	**440**

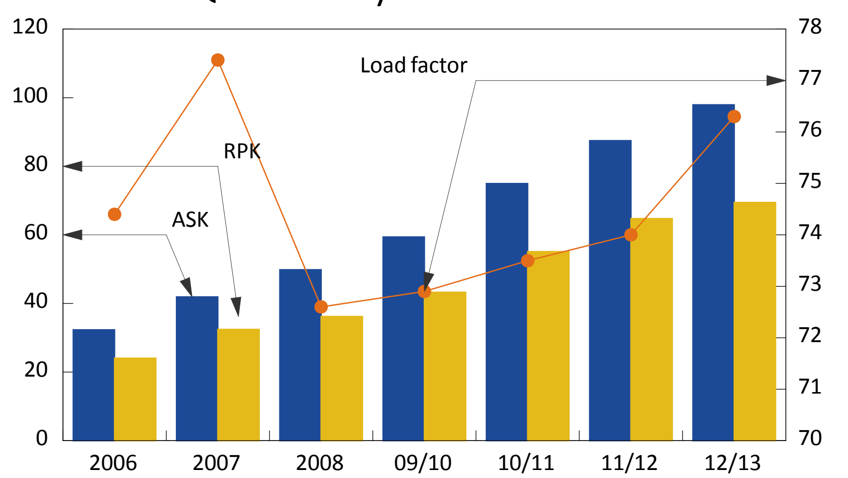
potential acquisition by Qatar of a stake in an Indian airline (with SpiceJet regularly mentioned) – but these are nothing more than rumours according to airline sources. For the moment Qatar Airways is only interested in codeshares, with LCC IndiGo top of its wish list – although it is also talking with Go Air, Indigo, SpiceJet and even Air India. A major Indian codeshare deal may be announced this year, it is believed.

In Europe, central and eastern destinations are the priority, although Qatar Airways is reportedly close to agreeing the $20m purchase of an additional landing slot at London Heathrow Airport from Cyprus Airways – although the Cypriot airline's pilots' union is opposing the sale, saying that airline should find other methods to shore up its struggling balance sheet. Last year Qatar also opened a centralised customer contact centre covering the whole of Europe in Wrocław, Poland

Closer to home, following the opening up of the aviation market there Qatar is launching a domestic airline in Saudi Arabia in the first half of this year, to be called Al Maha Airways. The carrier will initially operate between Riyadh, Jeddah and other major cities before expanding into secondary destinations. Saudi Arabia has a population of 27m, but is currently only served by flag carrier Saudi Arabian Airlines and National Air Services. However, Al Maha will have to overcome significant burdens, most particularly a price cap on domestic routes and the discounted fuel subsidies enjoyed by the flag carrier – although the Saudi government has apparently promised to resolve these issues. The long-term plan is for Al Maha to add international routes once a domestic operation is established.

Qatar Airways' Route Network

Qatar Airways' Traffic Statistics



New airport

As with the other Big Three carriers, Qatar Airways' strategy is to connect destinations in the east, west and south with multiple frequencies to a core hub airport, which for Qatar is Doha – approximately 80% of Qatar Airways' passengers transit through Doha.

However, the current Doha International airport is close to full capacity and so Qatar Airways will move its hub operation after it closes and is replaced to the new Hamad International airport in Doha (previously known as New Doha International Airport), which partially opened in December 2013 on land reclaimed from the Arabian Gulf at a cost of $14.5bn.

The airport is being managed by the Qatar Airways group and is just four kilometres from the existing Doha International airport. It is opening in phases, with an initial capacity of 24m passengers a year growing to 50m passengers a year by 2015. The airport was originally scheduled to open back in 2010 but faced a series of problems and delays, which Al Baker partly blamed on contractors. Hamad International will formally open in April 2014, at which date Qatar Airways will move its entire hub operation from the old airport in a huge logistical exercise for which the airline has been preparing for many years.

Additionally a 77,000m^2 new cargo terminal at Hamad International that opened in December 2013 will become one of the largest freight facilities in the world, handling around 1.4 million tonnes of cargo per annum once it is completed by 2015.

Alliances

Qatar Airways currently codeshares with 13 carriers, but crucially joined **one**world in October 2013, becoming the first of the Big Three Gulf airlines to join a global alliance. Initially there were some teething problems – the airline received adverse press coverage when it allegedly denied access to top-tier frequent travellers from **one**world partners into Qatar's lounges at Doha and London. This may be a consequence of the brief one year period between Qatar being invited to join the alliance and actually joining – the usual preparation period is between 18 and 24 months. Unlike the views of Emirates and Etihad, joining an alliance is seen by Qatar Airways as being vital to its future since it secures access to a global network that even a giant Gulf carrier can't develop on its own.

With significant organic growth the emphasis for Qatar Airways for at least the medium-term, Qatar may not be the most attention-grabbing carrier of the Big Three, and that profile isn't helped by the fact that Qatar is traditionally reluctant to release any details about its financial results – though it says it has been profitable for the last few years. All we know about the 2012/13 financial year (ending March 31st), is that Qatar carried more than 18m passengers – some 1m more than in the previous 12 month period. This would indicate a revenue total of around US$9bn.

Qatar Airways will inevitably gain exposure given that Qatar has won the rights to host the 2022 FIFA World Cup (which were awarded to Qatar in December 2010) – even despite the growing concern over whether the event may have to be switch from the boiling Gulf summer to the cooler winter months. Building on that, last year Qatar Airways made a significant marketing move by signing a three year sponsorship deal with Barcelona FC (costing some £30m a year), and that has apparently boosted the airline's profile not only in Europe, but in Asia and Africa as well.

The IPO postponement has also derailed any plans Qatar may have had for a major acquisition of a European carrier (see *Aviation Strategy,* December 2011), although there is talk that an investment into IAG might make sense for Qatar in the future. Unconfirmed reports suggest that early last year Qatar Airways offered to purchase the 12.1% held in IAG by Spain's nationalised bank conglomerate Bankia, which was looking to offload its equity positions in several companies in order to raise capital after its near financial collapse. Bankia eventually exited its stake in June 2013 via a placement, and so for the moment organic growth is the focus for Qatar Airways.

Delta: Now joining the "high quality industrial transports"

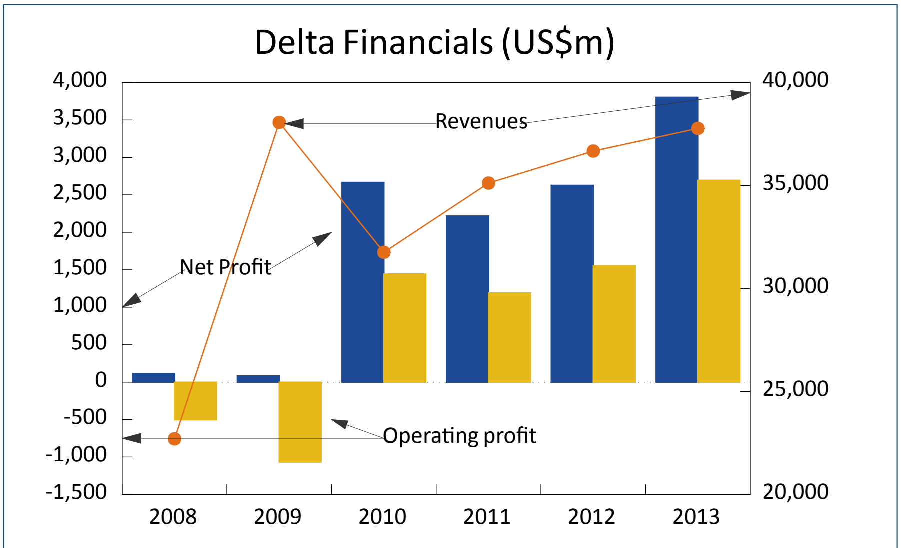
IN the past year Delta Air Lines has beaten its US legacy carrier peers handsomely on all financial fronts, be it profit margins, ROIC, debt reduction or returning cash to shareholders. But that was just the start. The airline indicated at its investor day in December that it is focused on "taking performance to the next level", as it strives to become like any other "high-quality S&P 500 enterprise with consistent earnings, double-digit returns on capital and strong free cash flow".

Delta was fortunate in that it had a multi-year head-start over its peers on the merger front. It completed a successful merger with Northwest in May 2008 and accomplished a quick and smooth integration. Since then it has enjoyed a long period of relative calm, during which the management has been to focus fully on managing the airline to the best of their abilities. In contrast, UAL and AAL both still face major challenges and risks associated with merger integration (see *Aviation Strategy*, November and December 2013 issues).

So Delta was able to quickly reap the benefits of the merger and start generating healthy cash flow and profits. 2013 was its fourth consecutive year of $1bn-plus pretax earnings. Delta earned a record $2.7bn ex-item net profit last year, more than twice as much as any other US airline. Its adjusted operating margin was 10% and ROIC 15%.

Probably the key reason for the post-merger Delta's success is that it has exhibited remarkable capital spending restraint, despite having a relatively old fleet. There have been some new aircraft orders – most recently, in September 2013 Delta ordered 10 A330s and 30 A321s for delivery in 2015-2017 – and, of course, many interesting strategic investments (an oil refinery and equity stakes in three foreign airlines). But Delta has used the bulk of its free cash flow (FCF) to reduce debt. It has led the industry on that front, having reduced its adjusted net debt from $17bn at the end of 2009 to $9.4bn at year-end 2013.

In May 2013 Delta became the first of the big networks to announce a programme to return capital to shareholders. So far the programme has included $500m of share buybacks (due to be completed by this June, two years ahead of schedule) and the carrier's first quarterly dividend payments in a decade in November (totalling $200m in the first year).



New financial goals

As explained at the investor day, Delta's management has benchmarked the airline against "high quality industrial transports" – companies that are part of S&P 500 and Dow Transportation indices such as FedEx, UPS, Union Pacific, CH Robinson, CSX Corp and Kansas City Southern – and formulated new financial targets.

First of all, Delta is aiming for annual EPS growth of 10-15% and a ROIC of 15%. Those targets are slightly higher than the five-year averages for the industrial transports sample (10% EPS growth and 14% ROIC). Delta's long-term annual operating margin goal is 10-12%.

Second, Delta aims to generate at least $5bn of annual operating cash flow. Last year it generated $4.8bn, though that represented a significant increase from the annual average of $2.5bn seen in 2009-2012.

Third, Delta's five-year plan calls for capital spending of $2-2.5bn per year, down from $2.7bn in 2013. There will be a "rigorous" decision process for capital projects, with senior leadership involved in all decisions of $1m or higher to ensure that projects meet a minimum 15% return target with less than two-year pay back. The current projection for 2014 capex is $2.3bn – a level significantly lower than UAL's or AAL's.

Fourth, Delta wants to deleverage more. Having achieved its previous $10bn adjusted net debt target in mid-2013, the management has set a new lower target of $7bn, which it expects to reach sometime in 2015.

Fifth, Delta is now striving for investment grade credit ratings – something that only Southwest among the US carriers has attained.

The debt reduction strategy led to a material $153m reduction in Delta's interest costs in 2013. It was also a key reason behind S&P's decision to raise Delta's corporate credit rating from B+ to BB- in December – something that will facilitate lower-cost financings or refinancings. That said, based on Delta's current metrics (for example, a debt/EBITDA ratio of 4.4x at year-end, projected to fall to 3.7x-4.2x in 2015), even if all goes well, it is likely to take several years to reach the coveted BBB-/Baa3 investment grade ratings.

Sixth, Delta is determined to address its pension obligations. In 2013-2014 it is contributing an incremental $500m to its defined-benefit pension plans (which, unlike at some competitors, were not terminated in Chapter 11). That would be in addition to the $650-700m annual required contribution. The additional funding, combined with higher discount rates, reduced Delta's unfunded pension liability last year by over $3bn to $10bn.

Seventh, shareholder returns feature prominently in Delta's plans. The executives noted at the investor day that returning cash to shareholders is a key attribute of high quality companies. Delta expects to announce its next repurchase authorisation and a new divided policy by its late-June annual meeting.

Delta executives describe the overall approach as "balanced capital deployment". It means continuing to invest in the business when the returns justify it, paying down debt, and using the remainder of FCF to reward shareholders and reduce pension liability.

Delta expects to "significantly" improve its operating and pretax results in 2014. Having brought costs under control last year with the help of a new $1bn structural cost cutting programme, the airline expects to keep ex-fuel CASM increases below 2%, or below inflation, in 2014 and beyond. Employee relations are among the best in the industry (the 2013 results included $506m in profit sharing payments, or 8% of employees' pay). And there are many new revenue initiatives under way.

Analysts like the cash flow, profit and ROIC targets and consider them realistic. After all, Delta is already (more or less) achieving many of the targets. Delta is regarded as a much safer bet than UAL or AAL. Remarkably, even though the stock surged by 131% in 2013 and by another 13.3% in the first six weeks of 2014, it is still recommended as a "buy". As of February 13, the stock had a mean target of $39.69 among 16 analysts, meaning that it is expected to appreciate by more than 27% over the next 12 months.

Of course, achieving the targets will depend on the successful execution of a number of key cost and revenue initiatives. The main ones are domestic re-fleeting, various product and facility improvements, commercial cooperation with JV and other partners, gaining corporate market share in New York, making Trainer refinery profitable, and growing the network at key locations.

Domestic re-fleeting

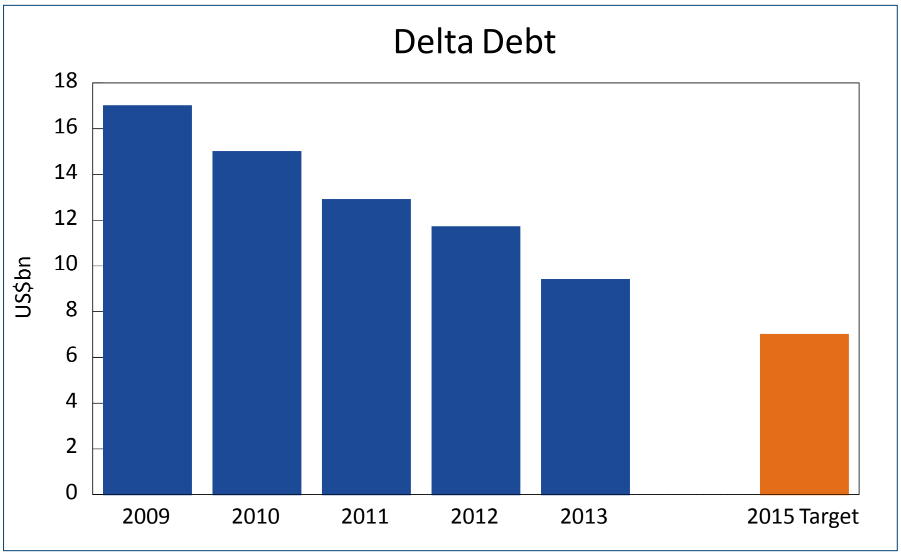
As one of the key measures to keep CASM increases in check, Delta is in the middle of an extended domestic fleet restructuring. The programme kicked off with the closure of regional subsidiary Comair in 2012 and will mean a dramatic reduction in small RJs in favour of operating more mainline aircraft and larger RJs. By 2015 Delta's fleet will have only 100-125 50-seat RJs, down from nearly 500 in 2008. The average gauge (seats per aircraft) in domestic operations will increase from 119 to 138 in the same period.

Delta is bringing in both new and used aircraft. It is deploying 737-900s, 717s (ex-AirTran, which Southwest did not want) and large two-class RJs (such as CRJ900s) to replace 50-seaters. The new fleet improves both cost efficiency and customer experience. Delta has seen solid margin improvements in markets where the larger aircraft have been deployed.

Product and facility investments

Delta has invested heavily in aircraft interiors and the product generally, because such investments extend the life of its existing fleet and allow it to avoid new aircraft purchases. Since 2010 there has been what the airline calls a "multi-year focus on passenger comfort", with more than $3bn spent to improve the customer experience onboard and at airports.

First, like the other US global car-



riers, Delta focused on its international product. The key project has been the installation of full flatbed seats in international premium cabins – a process that will be complete by mid-2014.

Second, Delta has focused on the transcontinental market, where competition intensified last year when JetBlue brought out a premium offering. To start with, Delta added flatbeds to the premium cabins of its 757s and 767s on the key transcon routes and offered more dining and entertainment options. All transcon flights will have full flatbeds in premium cabins by summer 2015.

Third, Delta has spent heavily on customer offerings at LaGuardia, JFK and Atlanta airports as part of new international terminal openings (JFK and ATL) or major expansion and renovation projects (LGA). The New York airport investments are part of a "Win in New York" strategy (discussed below).

Fourth, Delta announced plans recently to spend $770m over the next three years to refurbish and upgrade the interiors of 225 domestic narrowbody aircraft, including 757-200s, 737-800s, A319s and A320s. All domestic two-class aircraft offer access to Wi-Fi (as will the entire international fleet by 2015).

Investments in airline partners

In addition to the continued development of the JV with Air France-KLM and Alitalia, which is probably the most deeply integrated of the transatlantic JVs, in the past two and a half years Delta has acquired minority equity stakes in three foreign carriers, as part of long-term "exclusive" commercial alliances". First, there was a $65m investment for a 4.2% stake in Aeromexico and a seat on its board (August 2011). In December 2011 Delta invested $100m for a 3% stake in Gol; the deal also gave it a board seat, two 767s and an exclusive codesharing agreement in the US-Brazil market. And in June 2013 Delta completed its acquisition of a 49% stake in Virgin Atlantic; the airlines' immunised JV became effective on January 1.

The Aeromexico deal has extended Delta's network into 36 Mexican domestic markets and increased Delta's US-Mexico profit margins by nine points. The next steps are to improve schedule connections, launch joint corporate contracts and start maintenance work at a joint-venture MRO facility in Mexico. The airlines disclosed back in 2012 that they had invested $50m to build the facility, which Delta said would "usher in lower maintenance costs" without compromising quality.

The Gol investment was an important strategic move, helping ensure that Delta has a partner in Latin America's largest domestic market. Delta has gained exposure to 24 additional markets and improved its profitability in Brazil by 19%. Delta and Gol are looking to expand their codesharing and selling of joint corporate contracts and to "capitalise on co-location opportunities".

Delta describes the Virgin Atlantic deal as a "unique opportunity to build network scale in the top US-Europe travels markets". Heathrow is the world's top business destination; of the ten largest transatlantic corporate markets, eight are to/from LHR. New York-LHR is the world's most important business market. Combining Virgin's LHR slots and UK brand strength with Delta's powerful US network should create an effectrive North Atlantic competitor to BA/American; together Delta and Virgin will represent about 25% of the LHR-US seats.

The benefits have been immediate: in the five months of so since the July 2013 start of codesharing, Delta collected $25m in incremental revenues and saw 0.5 points of increased market share. As cooperation is developed under the immunised JV, Delta expects the venture to produce $120m annual run-rate benefits.

The first coordinated schedule, effective this April, will see nine daily LHR-New York flights (of which two are to EWR), 24 LHR-US flights and 33 transatlantic flights. Delta will launch new service from Seattle and Detroit to LHR. The airlines have co-located at JFK and LHR for key markets. They will have joint corporate and agency sales programmes and expect cost savings from more efficient ground handling, maintenance and cargo operations.

Delta is counting heavily on the Virgin Atlantic JV for future revenue growth. In response to a question in the 4Q earnings call in January, the executives said that there had been a significant surge in interest from corporate customers, particularly from the banking community in New York, since the Virgin deal. "We now have a competitive shuttle product between JFK and LHR", they noted.

Win in New York

In recent years Delta has invested heavily in the New York area airports. In 2012 Delta had an opportunity to expand significantly at LGA, following an earlier slot swap with US Airways. The deal involved Delta taking over most of US Airways' Terminal C and gaining 132 daily slot pairs. Delta has spent $100m-plus to renovate and create an expanded two-terminal facility at the airport. All of that has enabled Delta to double its destinations from LGA and create the first true connecting hub there, with 260-plus daily departures to 60 cities.

At JFK, after long been handicapped by an ageing terminal (T3), Delta is benefiting from a new state-of-the-art facility (T4) that opened in May 2013. That first phase of a five-year $1.4bn project gave Delta nine new and seven renovated international gates and top-notch facilities.

The New York investments are beginning to pay off. Delta believes that its market share gap (passengers versus seats offered) has closed by 50%. LGA operations turned profitable in 2013. In the fourth quarter, the New York market led Delta's domestic unit revenue improvement with an 8% increase, while Atlantic RASM out of New York was up by 7%. LGA had a spectacular 15% RASM gain.

But work remains to be done to fully close the market share gap in New York and to achieve profitability at JFK. Delta is determined to accomplish the latter in 2014 with the help of the Virgin JV, corporate share gains (particularly in the banking and financial services sectors), improved products and facilities, 50-seater retirements and the Gol and Aeromexico partnerships.

Selective network expansion

While Delta's overall capacity growth will remain very modest (0-2% in 2014), there are pockets of opportunity, especially in Latin America, which currently accounts for only 9% of Delta's capacity. The main growth areas will be Brazil, Mexico and the Caribbean. The Gol and Aeromexico partnerships will be important for maximising Delta's reach in that region.

Delta's efforts also focus on improving its positioning and profitability in Asia, which accounts for 12% of its total capacity. The airline has revised its thinking in light of the yen's depreciation (which led to a $250m revenue hit in 2013), the liberalisation of Haneda and increased market demand for nonstop service to Asia. New strategies include reducing reliance on the Tokyo Narita hub, building Seattle as a key Asia gateway, developing new Pacific service also from other West Coast and mid-continent hubs and building relationships with leading carriers in the region (including China Eastern, China Southern, Korean and Virgin Australia).

Making Trainer refinery profitable

Two years ago Delta found a possible solution to reducing and limiting volatility in fuel prices: acquiring its own oil refinery. The airline predicted at that time that the Trainer facility in Pennsylvania would become profitable almost immediately and save it $300m-plus annually on fuel expenses.

As it turned out, profitability at Trainer has been elusive; the facility incurred a $116m loss in 2013. But Trainer has lowered jet fuel market prices, reducing Delta's total fuel costs. Delta says that there are now initiatives in place to bring Trainer to modest profitability in 2014.

Are the improvements sustainable?

Delta is blazing the trail for the US legacies to become, in its management's words, like any other "high-quality S&P 500 enterprise with consistent earnings, double-digit returns on capital and strong free cash flow". In a few years, it is likely to become the second US airline (after Southwest) to enjoy investment-grade credit ratings.

Of course, while significantly behind, UAL and AAL are also heading in the same direction. At some point they can be expected to start growing their earnings at a faster rate than Delta, and it will only be a matter of time before they catch up.

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US Consolidation

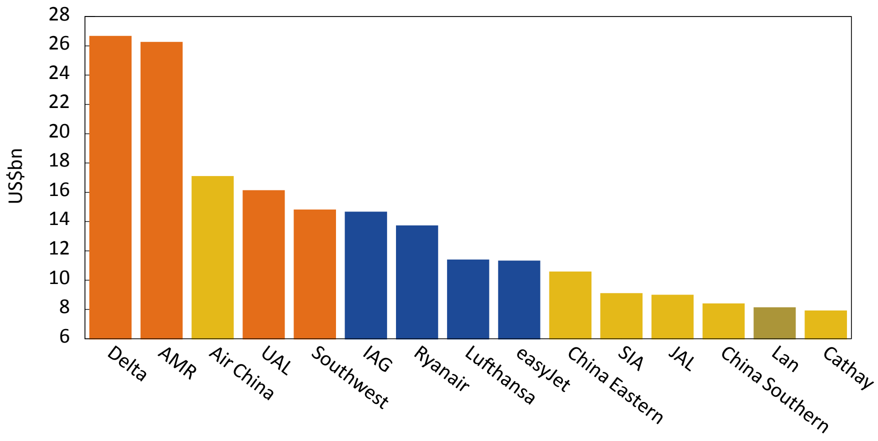
DELTA, American, United and Southwest are now four of the top five largest airlines in the world by market capitalisation. Who could have thought it possible? Delta and American each in turn are nearly twice as highly valued as the next largest in the world – Air China (inflated by the differential valuation of 'A' and 'H' shares). Thirty years ago we could have said the same about the Japanese carriers – but now the recapitalised JAL is merely the twelfth largest carrier and ANA does not quite appear in the top 15.

Even five years ago the joke went that you could buy all six of the top US network carriers for a truck-load of Mars bars. In that time we have seen the long-awaited consolidation in the US come to fruition: all of the majors have gone through Chapter 11 and merged with the obvious partners and the six have become three. The industry has significantly reduced capacity and has exhibited a remarkable constraint marked as "capacity discipline".

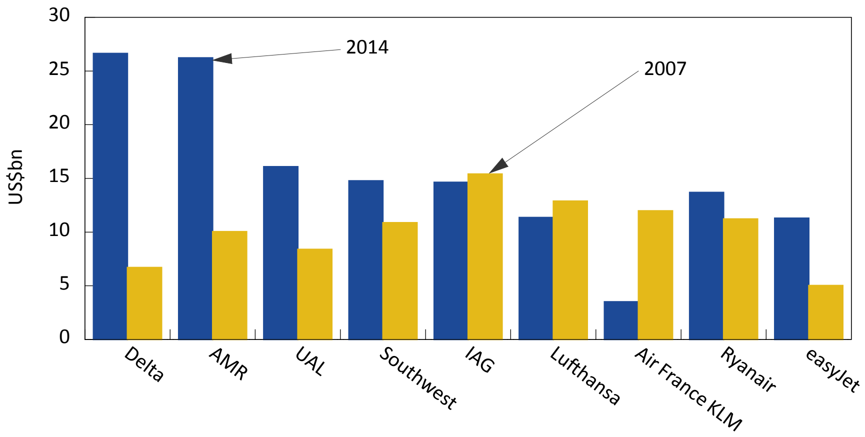
In the charts opposite we are comparing like for like, amalgamating the capitalisations of merged airlines eg Delta = Delta *plus* Northwest, AMR = American *plus* US Airways, UAL = United *plus* Continental.

As the articles in *Aviation Strategy* in the past three issues have emphasised, Delta, United and the new American are all pursuing strategies to provide returns above their repective weighted average cost of capital; and the stock markets have begun to believe that strong consistent returns may finally be achievable.

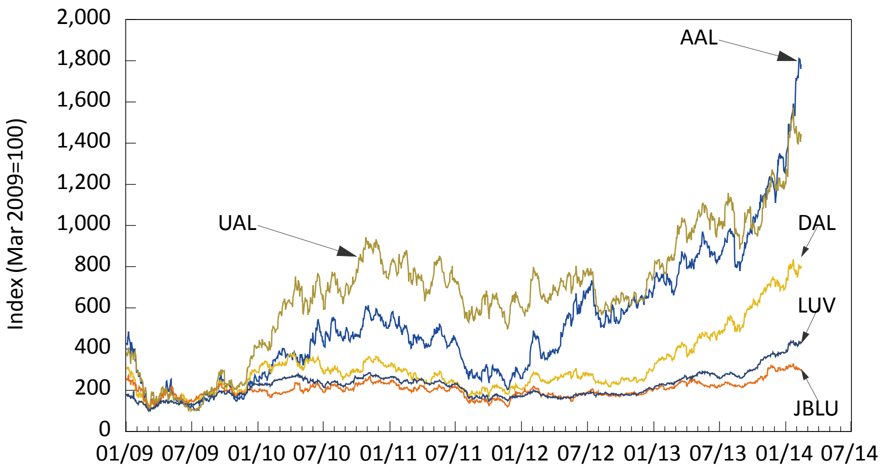
World's top airlines by market cap



US & European Airline Market Cap from 2007 Peak



US Airline Share Price Performance from Trough



Airbus: the long road to being normal

Airbus entered 2014 with a new name, new owners, a new head office and a record backlog. The parent company EADS now calls itself Airbus Group, recognising that a global brand is better than an ugly acronym and that commercial jetliners bring in the large majority of profit and sales. Nearly three quarters (73%) of its shares are now freely floated; of the rest, French and German state investors each have 11%, while a Spanish entity has 4%. Daimler and Lagardère sold their stakes and, although the three governments' combined stake rose slightly, they no longer have any blocking shares and are not supposed to have any say in strategy, as a previous shareholders' pact was dissolved. The new group head office "campus" is being built beside the Airbus division base at Blagnac airport, Toulouse.

The backlog of more than 5,000 orders will keep Airbus busy for over eight years at current and projected production rates. Airbus went into last year forecasting orders of around 700, and was surprised as the rate rose through the year to yield more than double: with 1,503 net orders, it outsold Boeing, which recorded 1,355 orders (see pages 17 and 18). Of course, such yearly score cards are a crude measure and can be misleading: Boeing has at least one huge widebody order pending that should have been sealed in November and given it a big lead. This year Airbus says its aim is to keep its book-to-bill ratio over one as it lands slightly more orders than the 700 or so aircraft it is due to deliver. Both manufacturers expect the market to soften after last year's rush of deals.

So, in its 44th year of existence, what trends will shape Airbus's future? Airbus group Thomas Enders has long been keen to turn Airbus into "a normal company". That was supposed to have started back in 1999 when the EADS structure was created and Airbus ceased to be a marketing consortium. But progress stalled after BAE Systems sold its one-fifth stake, and the French and German partners, with no one left to referee their disputes, began to quarrel over practically everything. Things calmed down in the past five years under the leadership of Frenchman Louis Gallois at the helm of EADS, while the former German paratrooper Tom Enders ran Airbus.

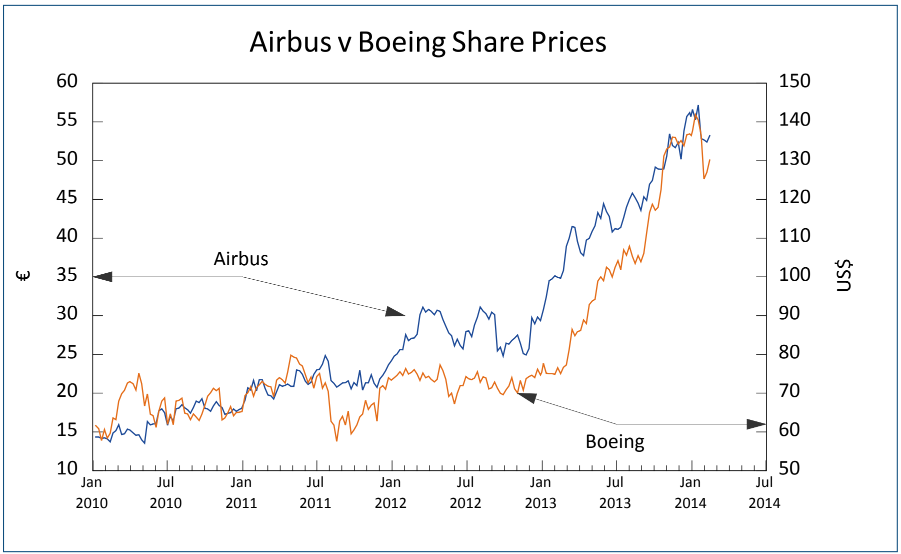
When Enders stepped up in 2012 to run the parent company he tried to seal a merger with BAE Systems to form a civil and military aerospace company that would have been bigger than Boeing. The British company, anxious about shrinking defence budgets in America and Europe and regretting the previous management's decision to sell out of Airbus (a move which drove then-Prime Minister Tony Blair into a rare fit of temper), was keen, but Angela Merkel, the German Chancellor, whose disdain for all things military is strong, vetoed the deal. Another reason was her fear the French and British would lord it over the Germans in the combined group.

The irony now is that Enders is moving headquarters into France and cutting defence jobs heavily in Germany. Some anxious souls in Toulouse, however, now fear that the Germans are taking over at Airbus, albeit on French territory. Fabrice Brégier, the soft-spoken engineer running Airbus, could be relegated to co-pilot by the hard-driving Enders, who looks and acts like central casting's idea of a paratrooper. For the moment things are quiet and Airbus refuses to comment any longer on the German government's refusal to cough up its full share of the launch investment for the A350, Airbus's new white hope in the widebody market.

Enders has as his other goal to bring Airbus Group's financial performance up to that of Boeing, whose gross margin of around 10% is double Airbus's. That will be difficult, with a much weaker defence business, but profits are moving in the right direction, with group earnings before tax, interest and exceptional items up 41% to €2.3 billion in the first nine months of 2013.

Duopoly rules

By its 25th birthday in 1995, Airbus had grabbed a fifth of the commercial jet market from Boeing and driven McDonnell Douglas virtually out of the jetliner business and ultimately into the hands of Boeing. Nowadays duopoly rules apply with the Americans and Europeans roughly sharing the market, with Airbus dominating narrowbody sales and Boeing stronger in widebodies. Airbus's ebullient sales chief, the American John Leahy, likes to point out that since 2008 Airbus has ac-



tually sold more twin-aisle planes than Boeing (1,056 vs 1,042) but such point-scoring may be aimed at hiding a weakness of Airbus: the gaps in its twin-aisle product range.

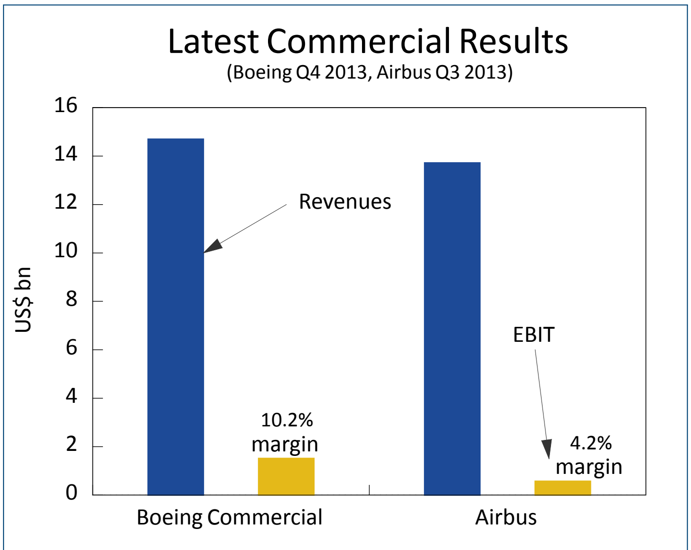
The strong performance in widebodies in the past five years was partly due to strong sales of the A350, the first of which is due to be delivered to Qatar Airways by the end of this year, but Airbus matched Boeing only thanks to airlines unexpectedly turning to that faithful old workhorse of the widebody fleet, the A330, to fill gaps caused by the delays to the 787 Dreamliner.

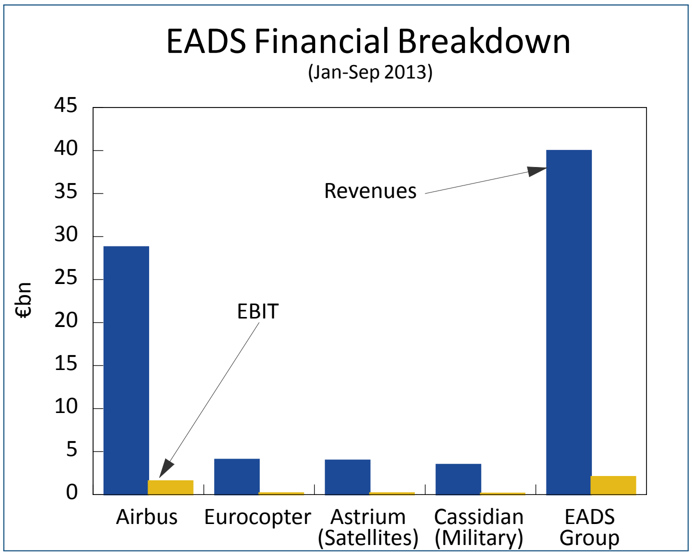
In contrast to the four-engined A340, which went out of production several years ago, the A330 became a star performer, the best widebody Airbus has ever produced. But sales dipped below 80 last year, and Boeing is now smoothly ramping up production of 787s, so the late flowering of the A330 (launched in 1993) could soon come to an end. At the lower end of twin-aisles (200 to 300 seats) the A330 is up against the smallest version of the 787, with its superior fuel economy thanks to its lightweight composite body. At the larger end of widebodies, Boeing's planned new version of the 777, the 777X (as it is still called) outperforms the biggest version of the A350. So what will Airbus do about this?

The clues lie in what has already happened in the single-aisle market, where Airbus extended its lead over Boeing when it launched an A320neo, with improved engines from CFM International and Pratt & Whitney. Boeing dithered over following suit, because it wanted to stick with the 737NG until it was time to launch an entirely new single-aisle in the mid 2020s. Eventually Boeing bit the bullet and its re-engined 737MAX has proved to be as successful as the A320neo.

As Airbus has a more normal shareholding structure, it is coming under the same pressures as Boeing to deliver financial performance; investors are both companies have reason to be cheerful as their share prices have both at least doubled over the past two years, well outperforming market indices.

Given the painful experiences of delays to Airbus's A380 and to Boeing's 787, there is a reluctance to launch all-new products. Boeing had hoped to reduce risks on the





Dreamliner by bringing in risk-sharing partners, but the complicated supply chain of this distributed manufacturing merely multiplied delays and swelled costs.

The success of the re-engined A320 is causing Airbus to consider using the same tactic to prolong the life of the A330. Airbus managers admit only that re-engining the plane is an option. However, in a world where an all-new aircraft costs around $15 billion to develop there is a strong motive to upgrade existing offerings. That is what Boeing is doing with the 777X, which will carry as many as far as the earlier 747s did, with much better economics. Airbus has already an A350-1000 under development and is widely expected to unveil another derivative to rival the biggest Boeing twin-jet. That project will compete internally with an A330 neo to get investment funds.

With new engines (and development costs paid by engine-makers Rolls-Royce, or even General Electric, in return for exclusivity) and a lower list price reflecting its long production run and written-down costs, an A330neo could compete with some of the smaller 787s. Other A330 options for Airbus are a heavier version for more load and range and a de-rated lighter version (smaller fuel load making the difference) aimed at being a shorter-range high-capacity regional aircraft primarily for the Chinese market.

Since Tim Clark, chief executive of Emirates, has been responsible for most of the A380s on order, Airbus has to pay attention when he starts talking about putting new engine technology into the superjumbo to improve its fuel economy. This demand to keep feeding the latest technology of new planes into older members of the fleet could be changing the dynamics of the aircraft business, bringing the engine-makers more closely into product development.

This was first obvious when GE helped get the best-selling version of the 777, the -300ER into the air, a move now being followed by Rolls-Royce with the biggest version of the A350. “Give us exclusivity and we’ll come up with a better engine just for you and radically upgrade your products.”

Airbus and Boeing Orders 2013

ORDERS continued to pour into all manufacturers last year. Total jet orders reached a total of a record 3,681 units.

Orders have been booked at more than double the rate of deliveries. Both Airbus and Boeing are planning to increase production rates.

Output of the updated A320neo could rise from 42 a month currently to about 50 after 2018 and that of the 737 from 37 a month currently to 47 in 2017. Boeing's production target for the 787, and Airbus's for the A350, is now 14 a month by 2019.

Boeing Orders 2013

Customer	737	747	767	777	787	BBJ	Total
Air China Cargo				8			8
All Nippon	4			3			7
Cathay Pacific		4		24			28
Korean Air		5		6	1		12
Qantas	5						5
SIA					30		30
Xiamen Airlines					6		6
Asia Total	***9***	***9***		***41***	***37***		***96***
Air Europa	8						8
British Airways					18		18
Icelandair	16						16
KLM				1			1
Lufthansa				20			20
Ryanair	175						175
Silk Way Airlines		2					2
SWISS				6			6
Transaero Airlines		4					4
Travel Service	3						3
TUI Travel PLC	60				2		62
Turkish Airlines	70			5			75
Europe Total	***332***	***6***		***32***	***20***		***390***
Aerolineas Argentinas	20						20
Latin America Total	***20***						***20***
EL AL Israel Airlines	2						2
Etihad Airways				26	30		56
flydubai	86						86
Qatar Airways				2			2
Middle East/Africa Total	***88***			***28***	***30***		***146***
Alaska Airlines	5						5
American Airlines	100			1	42		143
FedEx			2				2
Southwest Airlines	55						55
United Airlines	14				10		24
United States Navy	14						14
WestJet	75						75
North America Total	***263***		***2***	***1***	***52***		***318***
Air Lease Corporation	9			10	33		52
CIT Leasing Corporation	30						30
GECAS	4				10		14
Sberbank Leasing	12						12
Leasing companies total	***55***			***10***	***43***		***108***
Business Jet / VIP Customer(s)				1		3	4
Unidentified Customer(s)	438	2		8	1		449
Total Gross Orders	**1,205**	**17**	**2**	**121**	**183**	**3**	**1,531**
Changes / cancellations	-159	-5	0	-8	-1	0	-176
Total Net Orders 2013	**1,046**	**12**	**2**	**113**	**182**	**3**	**1,355**

In the narrowbody segment last year we saw the European LCCs embark on their latest phase of re-fleeting, emergent Asian carriers like Lion Air make huge A320 investments and the potential Super Connector, THY place a 70-unit firm order for 737s. In the widebody segment, the 787 sold notably to SIA and American, while SIA, again, and Etihad were major customers for the A350. Only Emirates ordered A380s, 50 in total.

Airbus Orders 2013

Customer	A318/319	A320	A321	A330	A350	A380	Total
Air China				6			6
AirAsiaX				25			25
China Eastern				8			7
China Southern				1			1
Hainan Airlines				2			2
Indigo		30					30
JAL					31		31
Lion Air		169	65				234
Nepal Airlines		2					2
SIA					30		30
Sri Lankan Airlines				6	4		10
Asia Total		***201***	***65***	***48***	***65***		***378***
Air Caraibes					3		3
Air France-KLM Group					25		25
British Airways					18		18
easyJet		144					144
Lufthansa		65	35		25		125
SAS				4	8		12
Turkish Airlines		4	85	9	8		106
Vueling		62					62
Europe Total		***275***	***120***	***13***	***87***		***495***
Vivaaerobus		52					52
Latin America Total		***52***					***52***
Syphaxair		6					6
Emirates						50	50
Etihad		10	26	1	50		87
Qatar				5			5
Middle East/Africa Total		***16***	***26***	***6***	***50***	***50***	***148***
American			130				130
Delta			30	10			40
Hawaiian			16				16
jetBlue			35				35
Spirit			25				25
United					10		10
North America Total			***236***	***10***	***10***		***256***
BOC Aviation		10	15				25
Aerospace Intl Group		10	4				14
Air Lease Corporation			14		25		39
CIT	3		10		10		23
ILFC		50	15				65
Lerner Enterprises	1						1
OHA Centre Street Aircraft Holdco	2						2
Texas Aviation Group	3						3
Z/C Aviation Partners One LLC	1						1
Lessor Total	***10***	***70***	***58***		***35***		***173***
Private Customer	1	3					4
Undisclosed customer	15	85	20	4			124
Total Gross Orders	**26**	**702**	**525**	**81**	**247**	**50**	**1,630**
Cancellations	-21	-64	-6	-12	-17	-8	-127
Total Net Orders 2013	**5**	**638**	**519**	**69**	**230**	**42**	**1,503**

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