Aviation Strategy

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Flybe: shareholder confidence

This issue includes

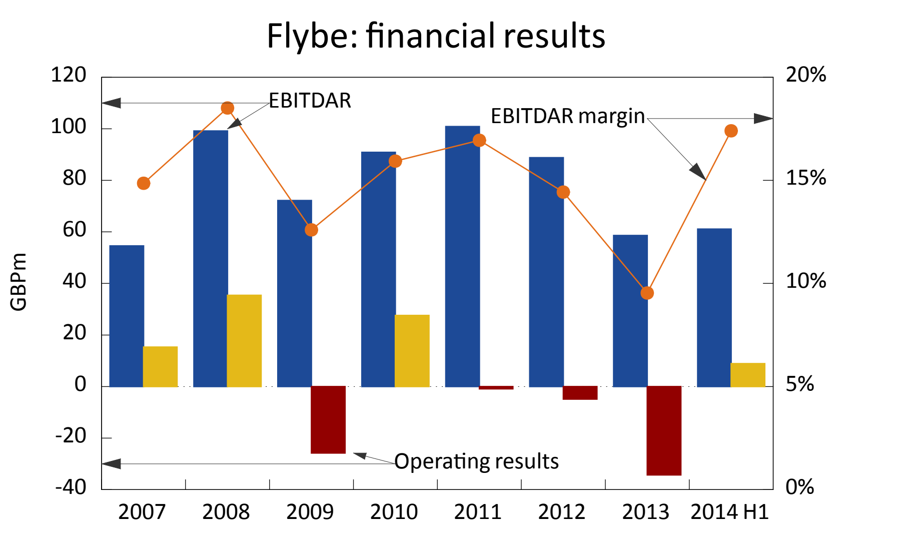
WITH a new management team, a simplified organisational structure and signs that initial restructuring and turnaround plans have started to work, Flybe has been given a significant boost of confidence by its shareholders. It has just managed to raise £150m in new equity through a market placing – a sum almost equivalent to twice its market capitalisation before the issue. The hope is that this will provide sufficient space for the UK regional carrier to survive and grow.

Flybe started operations in 1979 as Jersey European Airways based in the UK's Channel Islands, flying on inter-island routes and to the UK mainland. It was acquired in 1983 by multi-millionaire Jack Walker and merged with his corporate air taxi service in 1985 at which time the airline re-based to Exeter. In 2000 it was renamed as British European. After a series of losses in the downturn at the beginning of the noughties it reinvented itself again as a "hybrid" regional carrier – retaining some elements of the short haul legacy business model but introducing some elements (particularly one-way fares, yield management and pricing) of the emerging low cost airline model: a full-service low fares airline. In the process it once again renamed itself as "Flybe". At this time it was operating 31 aircraft on 38 routes to 21 destinations and carrying 2.2m passengers.

In 2007 it was handed a step change in its development with the acquisition of British Airways' regional services BA Connect. In fact BA effectively paid £130m to Flybe and took a 15% equity stake in the airline to ensure it could get rid of its loss making UK regional services. Flybe was able to incorporate the operation quickly: in its financial year to March 2008 it achieved an EBITDAR margin of nearly 19% (see chart below) and profits of £35m on revenues of £536m (nearly 50% up on the year before). The acquisition provided a significant increase in fleet, a well-trained workforce, and access to slot constrained airports such as London Gatwick, Paris CDG, Düsseldorf and Frankfurt.

In 2010 the Flybe group listed on the London Stock Exchange main market through an IPO priced at £2.95 a share, valuing the company at £215m and raising £60m in the process.

The following year it signed a 60:40 joint venture agreement with Finnair through which it acquired a Finnish regional airline Finncomm



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Publisher:

Keith McMullan
James Halstead

Editorial Team

Keith McMullan
kgm@aviationstrategy.aero

James Halstead
jch@aviationstrategy.aero

Heini Nuutinen
hn@aviationstrategy.aero

Nick Moreno
nm@aviationstrategy.aero

Tel: +44(0)207-490-4453
Fax: +44(0)207-504-8298

Subscriptions:

info@aviationstrategy.aero

Aviation Strategy Ltd
Registered No: 8511732 (England)
Registered Office:
137-149 Goswell Rd
London EC1V 7ET
VAT No: GB 162 7100 38
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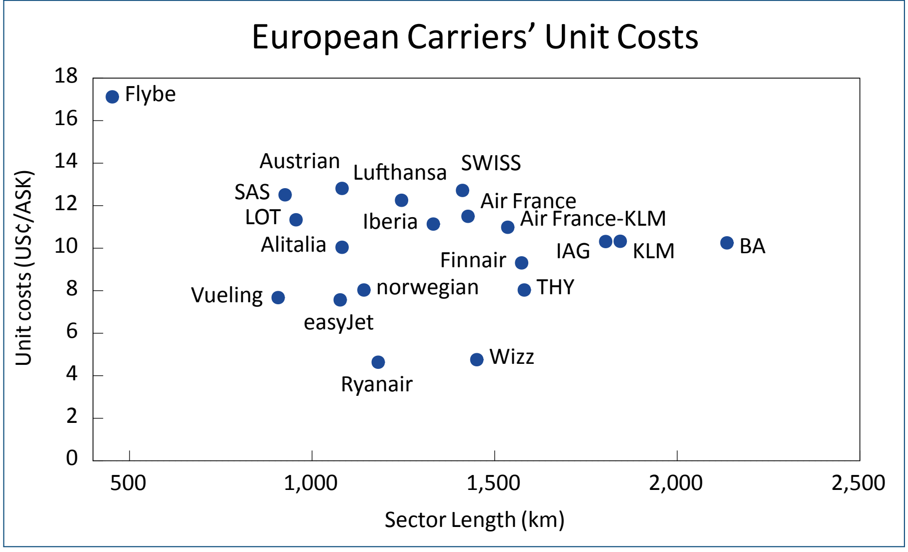


with 16 aircraft operating a mixture of commercial and ACMI services on behalf of Finnair. The following year Finnair injected another 12 aircraft into the operation all operated as ACMI "white label" services.

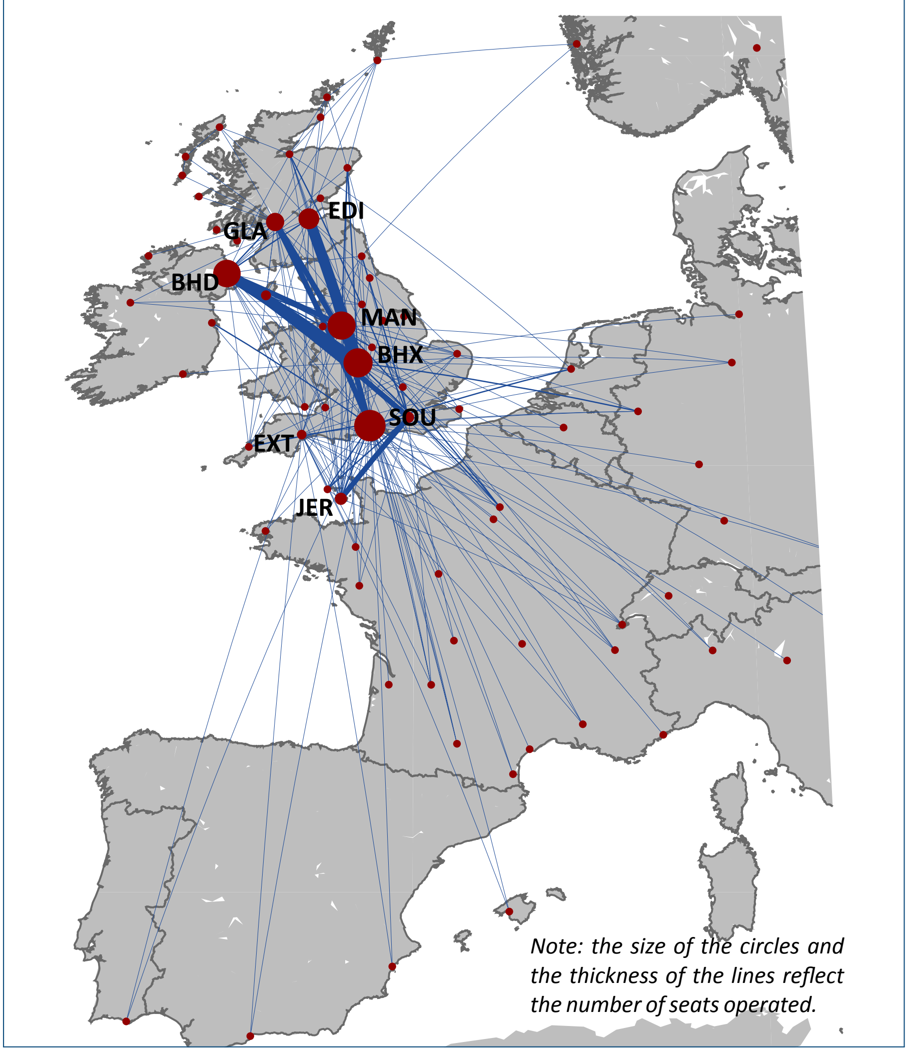
By 2013 Flybe had grown to carry 7.6m million passengers, operate 98 aircraft (E175, E195 and Q400s) on 242 routes to 112 destinations. However, since its IPO it had lost significant amounts and its share price touched a nadir of 48p in mid 2013. For the year ended March 2013 it announced an annual net loss of £42m on turnover of £614m; net equity (excluding imputed capitalised lease obligations and intangible assets) had fallen to £36m and the group only had £4.6m in net unrestricted cash – somewhat short of the three months' of revenue reserve implicitly required under its UK AOC license.

Restructuring

Early in 2013, faced with significant losses on operations, Flybe announced restructuring moves to attempt a turnaround in fortunes. As part of this – angered by a change of charging structure which severely changed the economics of operating smaller aircraft operations at the airport – the company sold all its Gatwick slots to easyJet for £20m (25 slot pairs = £0.8m a pair). It also reached an agreement to defer 16 E175 deliveries originally due from Embraer in 2014 and 2015 until 2017-2019. In addition it announced plans to reduce total headcount by 22% (out of 2,730) with a 20% reduction in administrative positions, forced and voluntary redundancies of 290 positions and outsourcing (of line maintenance, ground handling and check-in) involving a further 300 people. The target was to provide a reduction in total running costs of £35m in the financial year 2014/15.

In August 2013 the company hired Saad Hammad as CEO (formerly COO at easyJet from 2005 to 2009) replacing one of the roles of Jim French who had joined the airline in 1990, became Chief Executive Officer in 2001 and Chairman in 2005. Hammad initiated a complete change of senior management. A new non-executive Chairman was brought in to replace Jim French; the existing management board was culled – with the exception of the CFO Andrew Knuckey (who promptly said he would leave once a successor were found). The group's organisation was significantly simplified into two op-

Flybe route network



Note: the size of the circles and the thickness of the lines reflect the number of seats operated.

erational reporting units: the Flybe UK and Flybe Finland. Saad Hammad brought in new blood with Paul Simmons as Chief Commercial Officer and Ronnie Matheson as Director of Revenue Management – both ex easyJet. Meanwhile, Rosedale Aviation, the investment vehicle of the Walker Trust disposed of its entire 48% shareholding. All change.

The restructuring plans put in place by the former management seemed to have been starting to work. In the six months to September 2013 the group saw a return to profits of £13.6m (after restructuring costs) on turnover up by 3% to £351m reflecting a 5.6% increase in passenger numbers and a 3.6 improvement in load factors to 68.6%. Having said that the UK airline was operating with an average revenue per seat of only £50.35 against operating costs of £51.17 per seat. The Finnish join venture meanwhile returned a small profit for the first time. In the third quarter interim management statement the company highlighted that it was on schedule to provide full year cost savings of £40m.

However, as the new CEO emphasised in an investor briefing, Flybe was still woefully inefficient in comparison with peers. As a regional airline with low capacity aircraft operated on very short haul routes it will automatically have a relatively higher cost base. However, it had been achieving a paltry 5.2 hours a day aircraft utilisation and its pilots were only flying a meagre 374 hours a year. Overall 40% of its routes were badly loss-making – not even covering DOCs, crew and aircraft costs.

Having said that, Flybe UK does appear to have a strong regional niche position. It is the largest operator at Southampton, Exeter and Belfast City by frequency and passenger numbers (and Southampton has the advantage of a short runway where larger aircraft such as the A320 or 737 can only operate with weight restrictions, providing defence against attack from LCCs). Flybe is also the largest operator by frequency at Birmingham and Manchester. It has a 26% share of total UK domestic air traffic, and a near 50% of total UK domestic traffic when excluding London.

Hammad emphasised an immediate concentration on optimising the structure at Flybe UK to get it into a position to be able to grow. He initiated a new round of cost savings: an additional 450 job cuts; rationalisation of the Summer 2014 network affecting 55 routes including the cutting 30 loss-making routes; the closure of six out of 13 aircraft bases in the UK; grounding 10 aircraft (out of a total fleet of 70 aircraft at the end of December) at the beginning of the Summer season, and a further four at the end.

The £150m new equity raised is being used primarily to boost liquidity – nearly half of the funds earmarked to boost working capital. In addition the new management wants to rebalance the ownership structure of the fleet (currently all but ten aircraft are

Flybe fleet

	No of seats	Owned	Operating lease	Total *(Orders)*	Disposals†
UK Airline					
Bombardier Q400	78	2	43	45	26
Embraer E175	88	7	4	11 *(24)*	
Embraer E195	118		14	14	5
		9	61	70	
Flybe Finland					
ATR 42	48		2	2	
ATR 72	68-72		12	12	
Embraer E170	76		2	2	
Embraer E190	100		12	12	
			28	28	
Total		9	89	98 *(24)*	

†Lease expiry and planned disposals over next five years.

on operating leases) and it is looking to use £14m to reduce ownership costs. A further £5m each are to be targeted at IT and customer service (aka brand image). The remainder is to be used to grow: £35m to expand the Flybe UK commercial operations with new routes and bases over the next two years (it states that it has identified nine new routes through its route allocation model for which it would need ten aircraft); £25m to seek expansion of white label ACMI flying for other legacy flag carriers in Europe (in the prospectus the company states that it is in on-going commercial discussions with several airlines). These two latter sums refer to a 25% equity investment in new aircraft needed to operate the new routes.

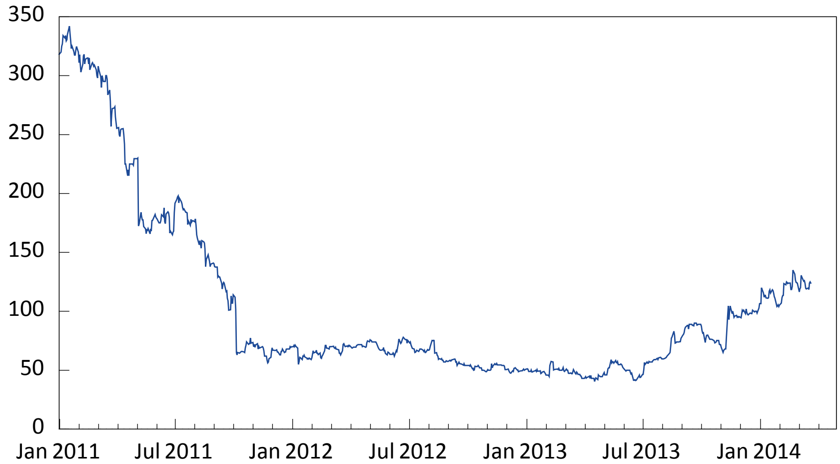
The first signs of a resumption of growth has come with the announcement of a major expansion at Birmingham: Flybe is opening six new routes with an additional 3 E175 based at the airport for the Summer 2014 season. This will now make Birmingham Flybe's largest UK base with a total of 12 aircraft at the airport (and incidentally making Flybe Birmingham's largest customer).

There is a basic problem for any airline pursuing a niche strategy: if you are any way successful at it you will attract competition. With regional aircraft with their naturally higher unit costs of operation, you cannot afford direct competition from operators of full size single aisle jets, and need to have a route network where the higher unit costs of regional aircraft can be sustained and there are sufficient defensive barriers to entry to keep out the LCCs. Flybe is concentrating regional connectivity, operating niche routes which are below the radar screen of larger jet operators – and retains a significant defensive position at Southampton.

However, in the prospectus the company also states that is will target routes with traffic volumes below 400,000 pax pa (that upper level of traffic volumes would still be attractive to a 737 or A320 operator) and that it is "pursuing opportunities at airports such as Manchester to to develop their capacity as domestic and international hubs".

Applying the low cost hybrid principles from the easyJet model should provide the increase in load factors and revenues per seat that it needs to return the UK airline to profitability. Meanwhile as the European flag carriers continue to withdraw from small aircraft regional operations, there may well be a good opportunity to expand ACMI white label services. The new and old shareholders obviously believe so.

Flybe share price



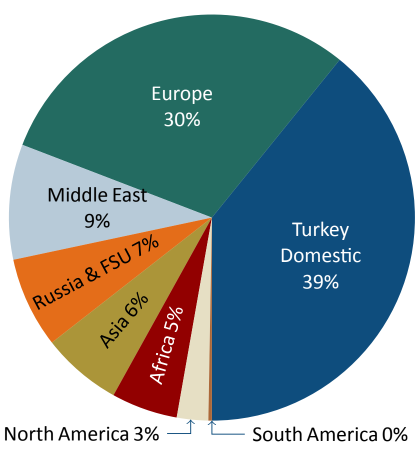
THY: Intercontinental narrowbody super-connector

TURKEY is one of the MINTs (Mexico, Indonesia, Nigeria and Turkey) which are being promoted as forming the second wave of dynamic emergent economies after the BRICs (Brazil, Russia, India, China). THY is a potent symbol and driver of Turkey's resurgence, and one of the most innovative global airlines.

2013 was the tenth consecutive year of traffic growth for THY, producing a remarkable set of statistics:

- Total passengers carried increased by 24%, to 48.3 million; domestic passengers were up 26% and international 22%.
- Premium passengers increased by 23% while international-to-international transfer passengers increased by 29%
- System load factor increased by 1.4 points to 79.0%.
- Nearly 370,000 sectors were flown, up 22% on 2012, and the number of destinations served grew to 243 compared to 217 in 2012
- Cargo/Mail was strongly up as well – by 20% to 565,000 tons

THY Network by Seats Deployed

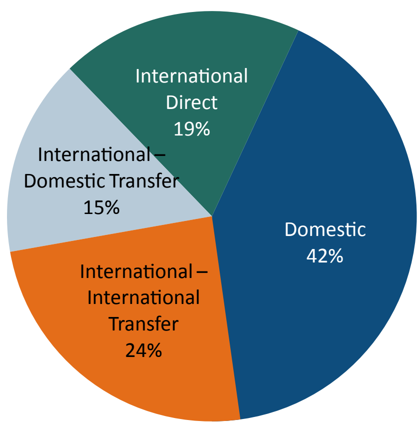


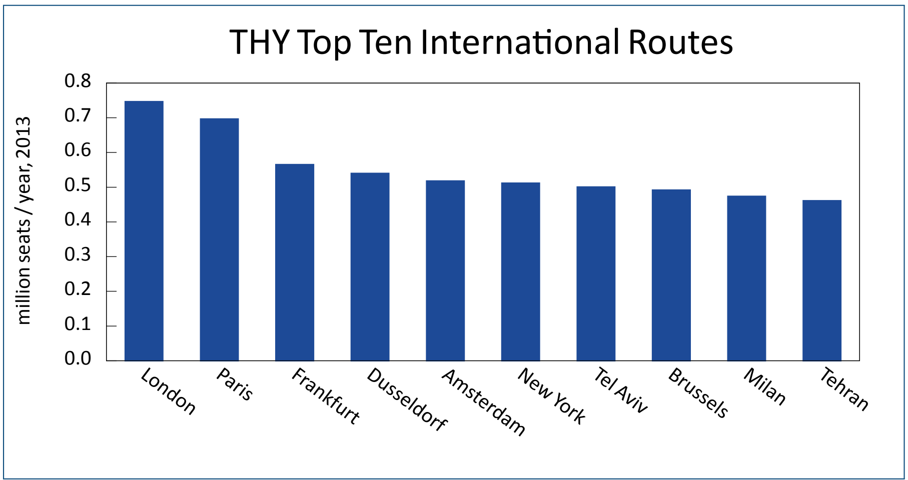
In early March THY released its 2013 financials which generally were also impressive, though slightly disappointing on the bottom line. Revenue grew strongly by 19% to US$9.83bn in 2013 (THY normally reports in US dollars), but operating expenses boosted by higher fuel and lease costs rose by 21%, with the result that operating profit slipped to $577m, 7% down on 2012's $648m; the operating margin, 5.9%, was respectable, given the large amount of capacity added in 2013. Below the operating line, THY's accounts get a little opaque but financial charges and exchange rate losses amounted to $307m pushing pre-tax profit down to $502m, 36% down on the previous year. After taxes the result was a net profit of $357m, about half that of the previous year.

THY issued some guidance for 2014 – notably passenger volume to grow by 24% to 59.5m and revenues up 16% to $11.4bn – with the caveat that these projections were made before the recent financial problems that have hit the Turkish economy. Turkey has been the emerging market success story, with GDP rising from $230bn in 2002 to $800bn last year. However, markets have begun to question how much of this 8% pa growth in dollar terms has been due to an overvalued lira and to worry about the country's widening balance of payment deficit. Also, the strong lira had started to undermine Turkey's competitiveness with wage rates now comparable to those in the Baltic states, for example. In February the lira fell to record lows against the dollar and euro forcing the government to respond by pushing up base interest rates to 10%. The economic effect may be to normalise Turkey's growth rate – to around 3% a year for the next few years, less than half the super-growth levels. THY's mix of currencies in its P&L naturally hedges it against the impact of lira depreciation, but the economic slow-down might dent its prospects. Politically, there have been the protests in Taksim Square this year and an horrendous civil war in Syria just to the south, plus unresolved Kurdish issues (and the government attempting to ban twitter, futile but damaging to its liberal credentials).

Although THY used to be a traditional state-run airline its strategy

THY Traffic Segments 2013 by Revenue





now is that of a super-connector, competing against Emirates, Qatar, and Etihad. The operating model was developed under Temel Kotil, who joined THY in 2003, just after the state sold off a 50.9% share in the airline, and became CEO in 2005. Essentially THY takes advantage of Istanbul's geographical position in the middle of what it calls the "Europe–Asia corridor" — more than 40% of global international traffic and over 55 capital cities are within narrowbody range from the city.

In 2013 24% of THY's passengers were on international to international connecting flights and a further 15% were international-domestic transfers. Only 19% of passengers were international direct.

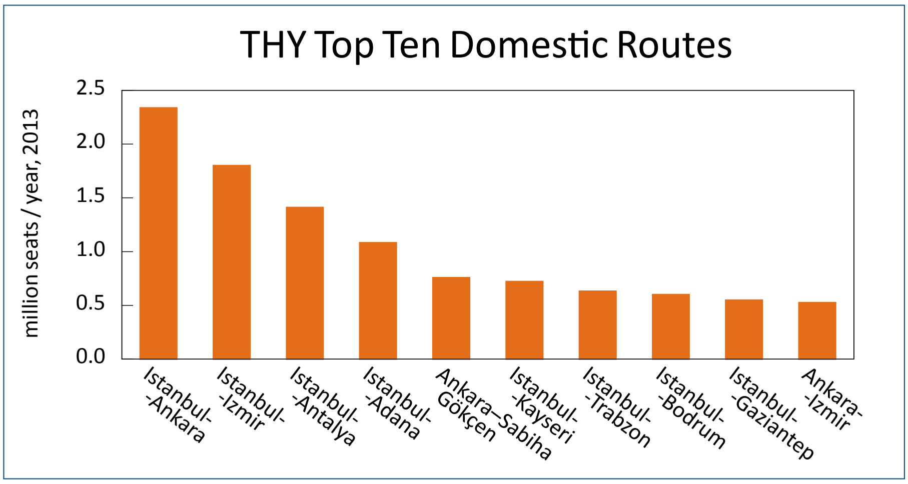
Domestic passengers accounted for 42% of the total. Unlike the Gulf carriers THY has a huge home market. Turkey's population is about 75 million and total domestic passengers were estimated at 37m last year, and are forecast to rise to 54m by 2016, according to the DHMI (the Turkish airport authority). With 77m total international passengers, underpinned by Turkey's position as the sixth most popular tourist destination in the world, the total Turkish market amounted to 114m; so a ratio of 1.5 air passengers per head of population which compares to 3.2 for the UK, and is perhaps an indicator of the potential business for THY.

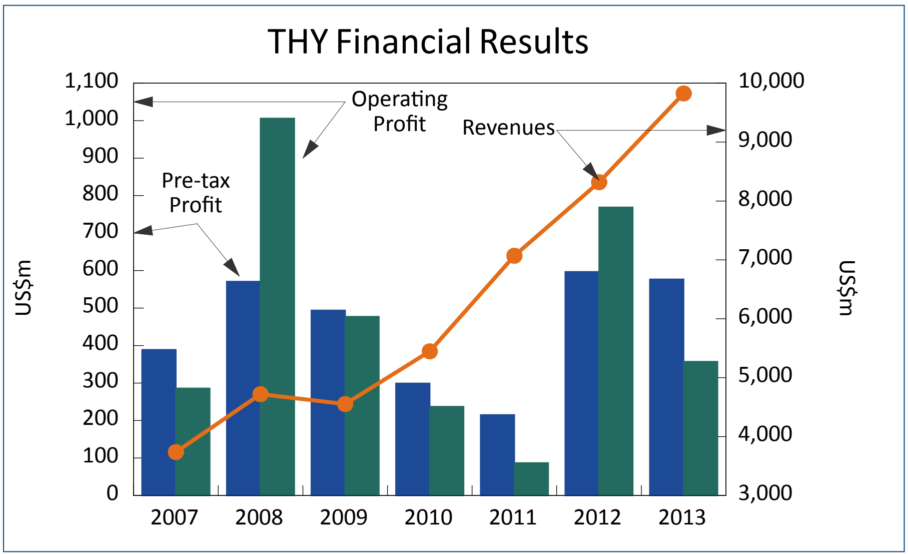
However, the domestic market contributes only 14% of THY's revenues. Europe is the most important market with 33% of the total, followed by Asia, 21%, Middle East, 13%, Americas, 10% and Africa, 8% (these figures refer to true O&D passenger revenues rather than point of sale revenues). This geographical split refects Istanbul's strategic position – partly in Europe, partly in Asia with historic links to central Asia and a new foothold in Africa.

Relations between THY and the Turkish government are close – too close according to Pegasus, its main local rival and another very successful airline, which complains about preferential treatment afforded to THY. Turkey is not in the EU common aviation area, but it has a "horizontal" bilateral agreement with the EU, which allows any European airline to operate between a EU member state and Turkey, so in effect a series of open or almost open skies agreements. Turkey has a longstanding open skies agreement with the US while its other bilaterals are a mix of the liberal and the restrictive, but THY almost always is the sole Turkish carrier operating non-EU routes. What is not clear is when Ryanair, Wizzair or easyJet will be allowed to penetrate the domestic market.

From a brand recognition perspective THY Turkish somehow does not rank alongside the international images projected by Emirates and Etihad, with the prestigious football stadiums in the UK and high profile advertising. THY is rightfully proud of its Skytrax award for Europe's best airline in 2013 and again uses sports stars in its advertising – Lionel Messi and Kobe Bryant (the problem is the former probably won't be widely recognised in North America, the latter isn't instantly identifiable in Europe).

In terms of passenger numbers Business Cabin passengers accounted for only 4% of THY's total last year, 5% if the premium economy (Comfort





Almost all these routes will be operated with narrowbodies – A319s, A320s, 737-800s, 737-900ERs – which is a unique feature of the THY intercontinental network. The contrast between THY's orderbooks and those of the three super-connectors is illustrated below. While all four have phenomenal number of aircraft on order or option, the three Gulf carriers are focusing heavily (totally in Emirates' case) on widebodies for their growth, THY's plans are centred around narrowbodies, although this year a significant part of the planned growth will comes from widebodies – A330s and 777s – on the Atlantic.

THY can avoid direct competition with the super-connectors on most of its network as their equipment is too large for the THY routes, but it also means that THY is at a disadvantage in terms of economies of density. THY's average load factor has improved from 72.7% in 2007 to 79.0% in 2013, which indicates that demand has significantly exceeded its 20% annual capacity increase. Unit revenues have declined slightly – 8.67US¢ to 8.30US¢ – while unit costs have been stable – 8.04US¢ in 2007, 7.94US¢ in 2013.

In what it describes as its peer

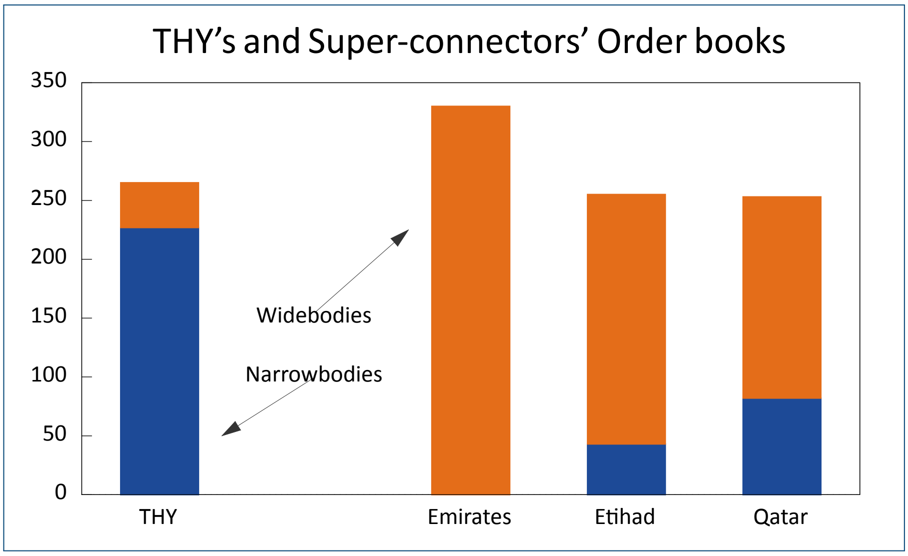
class) passengers are included. But in revenue terms these business passengers contributed 20%. This suggests a major upside for THY given that the super-connectors and European carriers like BA rely on premium passengers for almost half their revenue.

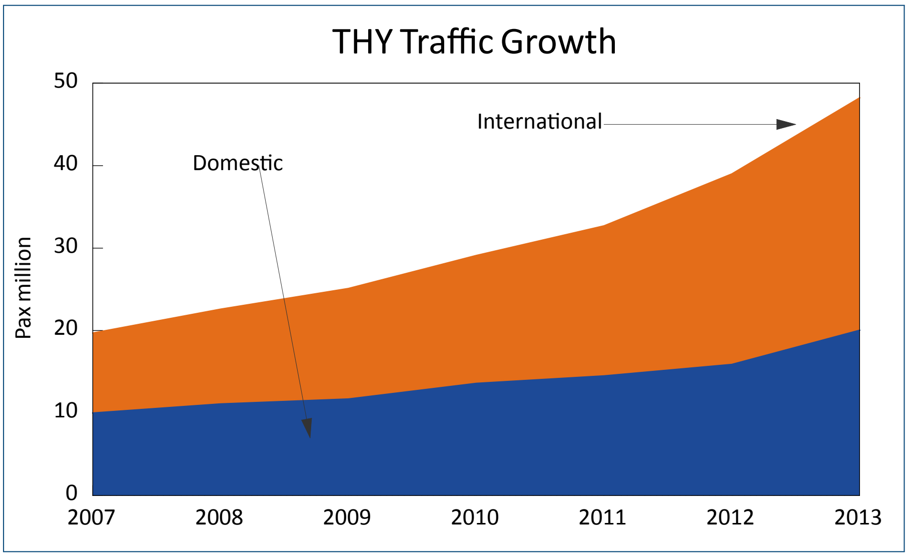
THY benchmarks itself against the super-connectors and contrasts its performance with that of the European and US legacies. In the 2013 results presentation THY used the slightly unusual metric of share of world scheduled traffic (as indicated by ASKs). THY's is 1.6%, just above Qatar's though only half of Emirates'. More importantly, the rapid upward trend over the past ten years for THY and the super-connectors is very similar, while the US majors and European network carriers' shares have stagnated or declined.

In what it describes as diagonal growth, THY's passenger growth – from 11.9m in 2004 to a planned 59.5m this year – is linked to an increase in destinations served – from 73 to a planned 265. Remarkably, this means that the THY hub network, in terms of cities served, is now larger than Delta's at Atlanta; indeed on this measure it is number one globally.

The network incorporates many minor cities which could not support intercontinental service without the Istanbul hub system. In 2013, for example, the new points instigated by THY were:

- ✈ Africa: Libreville, Douala, Kano, N'Djamena
- ✈ Asia: Colombo, Kuala Lumpur, Kathmandu, Mazar-i-Sharif, Lahore
- ✈ North America: Houston
- ✈ Middle East: Aqaba, Gassim
- ✈ Europe: Freidrichshafen, Salzburg, Santiago, Malta, Marseille, Constanta, Tallinn, Vilnius, Luxemburg
- ✈ Turkey: Isparta, Kastamonu, Bingol, Sirnak





group – Air France, Lufthansa, IAG, United Delta, American and Emirates – THY, unsurprisingly, emerges as the lowest cost operator (see chart on page 2). Air France's unit operating costs, for example, were nearly 60% higher than THY's in 2013; Emirates unit costs, despite the advantage of having an all-widebody fleet, were slightly above THY's. Interestingly, THY's labour efficiency is much superior to Emirates' – 2,084 passengers per employee against 826.

When THY announced in 2008 that it intended to become Europe's largest airline by 2020, surpassing Lufthansa, this was widely dismissed as a publicity stunt, or just not understood. The target passenger volume is around 100m; given that THY's 2014 total will probably be nearly 60m its takes only 10% pa growth, much lower than in the past decade, to attain this total. Meanwhile, Lufthansa Passenger Airline has stated that it will grow at "market" rates, say 4% pa, and as a result the two traffic curves (see page 9) cross at around 2020. (THY seems to have given up on the idea of developing a THY Group like the Lufthansa Group as none of its rumoured European airline purchases came to fruition, and it has left that strategy to Etihad.)

In fact THY has revealed some quite detailed medium term expansion plans. As at the end of last year 37 new points were expected to be added to the network: 13 in Africa, 10 in Europe, 8 in the Americas, 4 in Asia and 2 in the Middle East. Almost all the European and Asian service will go to minimum daily service, from about 80% today, Africa, America and the Middle East will have daily services on about 75% of city-pairs, compared to about 60% today. Overall planned capacity increases to 2021 are: Asia, 92%; Americas, 65%; Middle East, 58%; Africa, 56%; Europe, 41%.

The phenomenal traffic growth rates have meant that Istanbul is starting to face serious capacity constraints. At Ataturk airport, THY's main hub, annual throughput is around 52m passengers while capacity is just over 60m; at Sabiha Gökçen, where THY has recently expanded throughput is nearly 18m passengers. At projected growth rates they both will be full around 2016. There is, however, a second runway scheduled for 2016 at Sabiha Gökçen, which should double capacity there.

The, as yet unnamed, new Istanbul airport is planned to become operational in 2018, though this may drift to 2020. Costing $30bn, the BOT project was won by a Turkish civil engineering consortium; capacity is planned for 150m passengers a year, making it potentially the largest airport in the world. One of the advantages that THY holds over its European rivals is that the infrastructure planning process in Turkey is speedier than in western Europe, although environmental objections to the new airport have been raised and construction of the airport has not yet begun.

Currently, THY operates a fleet of 233 aircraft – 182 narrowbodies, 42 widebodies and 9 cargo jets – at high levels of efficiency. The narrowbodies on medium haul routes achieve 12.14 hours utilisation a day, comparable to the best of the European LCCs while the widebodies average 14.53 hours, comparable to the best of the network carriers.

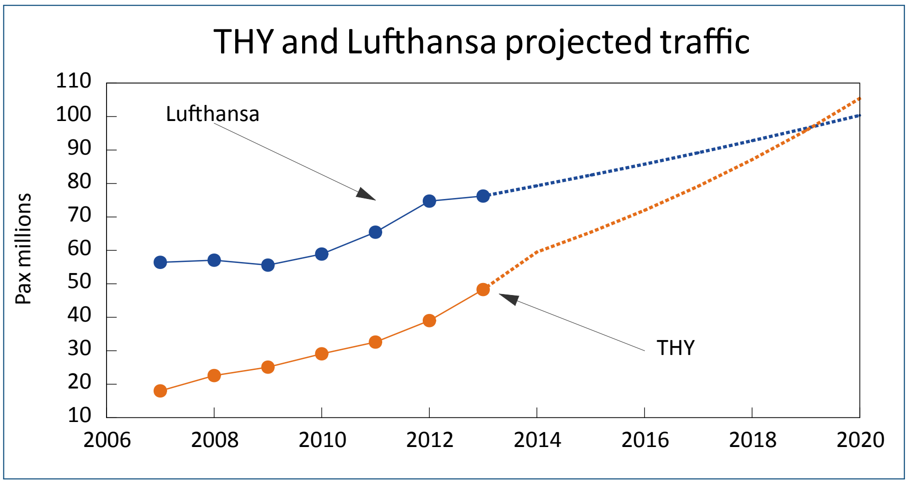
THY's fleet plans are compatible

THY Fleet

		In Service	Orders	Options
Widebodies	A330	20	18	
	A340	7		
	777–300ER	12	20	
	Wet leased	3		
	Sub-total	*42*	*38*	
Narrowbodies	737-8/900	94	35	
	737-8/9MAX		50	25
	A320/321/319	88	25	
	320/321NEO		57	35
	Sub-total	*182*	*167*	*60*
Cargo	A310/330F	7		
	Wet leased	2		
	Sub-total	*9*		
TOTAL		**233**	**205**	**60**

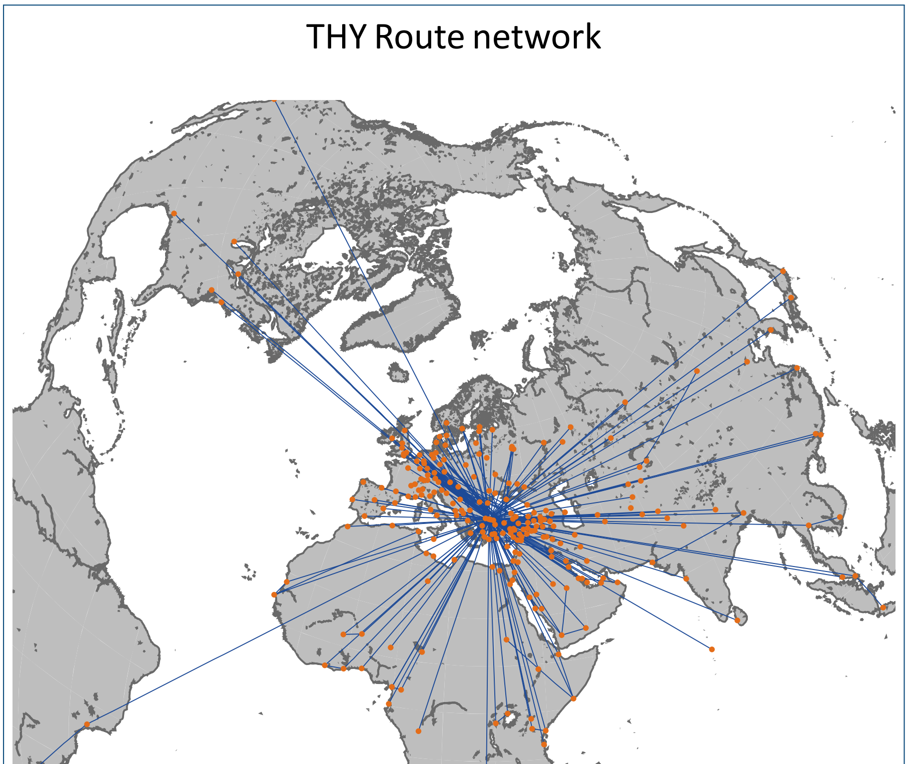
with a passenger volume of around 100m by the end of the decade. The target is a net addition of 202 aircraft by 2021, bringing the total fleet to 435 units. Almost exactly the same proportion of narrowbodies and widebodies will be retained. Firm orders and options (that THY states it will convert) add up to 265 units, including mega-orders, for both the A320/321NEO and the 737-800/900MAX, more than enough to cover the additional capacity requirement. Despite persistent rumours, the A380 does not fit into THY's future, at least for the present.

However, this is a huge financial commitment, in the order of \$18bn, for a carrier with a net profit of \$357m in 2013 and financial expenses of \$307m. THY will have to manage its balance sheet carefully. At the end of 2013 it had net debt (including lease obligations) of \$8.0bn and \$3.3bn of equity, a debt/equity ratio of 2.4/1, which could be regarded as high.



The other problem facing THY is that of finding the optimal balance between competing with and cooperating with the European network carriers. Lufthansa had sponsored THY's membership in the Star Alliance and formed an own extensive codeshare and frequent flyer agreement with THY (Germany is by far the most important country market for THY, largely because of the gastarbeiter traffic). Then at the end of last year Lufthansa announced it would terminate the codeshare agreement with THY by the end of this March, brutally stating that it didn't make commercial sense. This in effect ended THY's expectation that it could be Star's super-connector partner, in the same way as Etihad has linked with Air France in SkyTeam and Qatar has allied with IAG in oneworld.

For the European network carriers, particularly Air France and Lufthansa, Emirates and THY pose the same sort of challenge; they bypass their global hubs at Paris, Amsterdam, Frankfurt and Munich, collecting traffic from European points behind these hubs and funnelling traffic to a range of destinations beyond their own Dubai and Istanbul hubs, offering connectivity that the Europeans just cannot match. To illustrate: THY offers services from 11 German cities to Istanbul while Lufthansa concentrates all its operations on Frankfurt, Munich and Düsseldorf. Hence it loses its feed traffic not just to Turkey but to Asian and African points as well.



Note: Azimuthal Equidistant projection of the world centered on Istanbul. Great circle routes appear as straight lines.

flydubai: Aiming to be an LCC giant.

Already the largest LCC in the Middle East, flydubai signalled its long-term ambitions by placing a firm order for 86 737s earlier this year. How much further can the Dubai-based carrier grow – and will it remain an LCC?

Based at Terminal 2 of Dubai International airport, flydubai was launched by the Dubai emirate in July 2008 and made its maiden flight in June the following year. Though not part of the Emirates Group, flydubai and Emirates have common owners and the latter gave considerable assistance during the launch phase of the LCC.

An order for 50 737-800s (with flexibility to change future models to the 737-900ER) was placed at the Farnborough air show in 2008, with the first aircraft arriving in May of 2009. Based on that initial order, today the airline operates to 68 destinations across the Middle East, Europe, Africa and Asia. These comprise 25 destinations in the Middle East, 20 in eastern Europe and the Caucasus region, 17 in Asia (of which 11 are in the Indian sub-continent) and six in Africa.

In late 2010 flydubai signed a sale and leaseback deal with Avolon for four more 737-800s, and today the fleet stands at 35 737-800s with an average age of 2.6 years. Deliveries from that initial order of 50 aircraft will be completed later this year, and so in November 2013 – at the Dubai air show – flydubai committed to an order for 75 737 MAX 8s and 11 737-800s, valued at some US$8.8bn at list prices and the largest ever narrow-body Boeing order in the Middle East.

flydubai apparently considered replacing its 737 fleet with A320neos, but this is unlikely to have been anything other than a negotiating tactic by the airline, and the Boeing order was confirmed in January 2014. The first of the 737-800s will arrive in 2016 or 2017, with the MAX8s arriving from second half of 2017 and the last aircraft arriving towards the end of 2023.

Currently the MAX development is on schedule according to Boeing, with the first flight scheduled for 2016 and deliveries to customers beginning the year after. flydubai also has purchase rights for an additional 25 737 MAXs. The actual price paid for the 86 aircraft is believed to be in the region of US$6.2bn, some 30% less than list prices, according to one source.

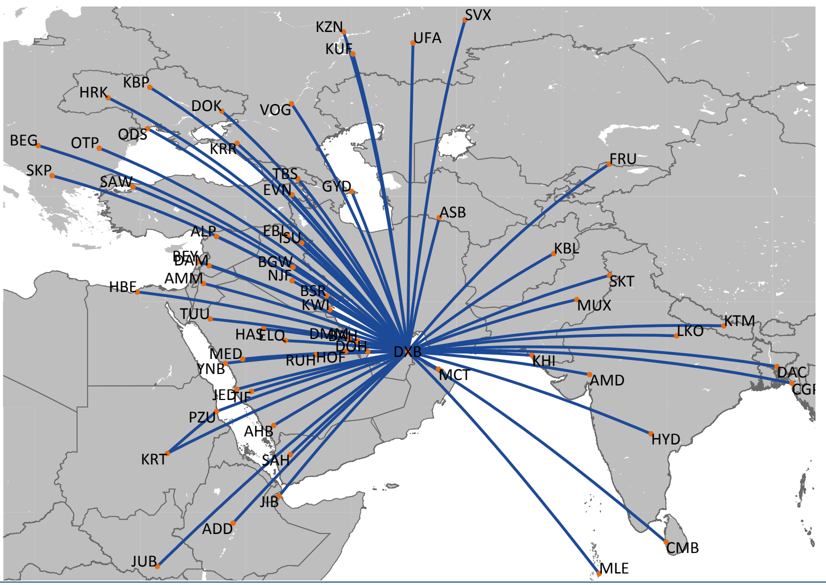
Route hunt

Altogether flydubai has 26 737-800s and 75 737 MAX 8s on order, but the airline believes it will have no problem in finding routes to place them on within its strategy of focussing on destinations within a five and a half hours flying radius from Dubai – a radius within which 2.5bn people live. flydubai believes there are a multiple of underserved point-to-point routes out of Dubai, and indeed more than 70% of its existing destinations never previously had a direct link to Dubai via a UAE national carrier (i.e. Emirates). Ghaith Al Ghaith, flydubai's CEO, says: "There are not enough flights in the region compared to places likes Europe, but there is demand. People of these cities have barely flown to the Middle East, or anywhere outside these countries, for that matter."

The immediate target is to increase destinations served to 100, and during 2013 flydubai launched 17 routes, including Dubai to Malé (Maldives), Ha'il and Medina (Saudi Arabia), Odessa, Juba (South Sudan), Sialkot and Multan (Pakistan), and Volgograd and Krasnodar in Russia. During the year flydubai doubled its network in Russia to eight destinations, and it also operates to four cities in Ukraine.

Already this year flydubai has launched routes between Dubai and Al-Ahsa airport in Hofuf, Saudi Arabia (its eleventh destination in a country that opened up is aviation market in 2012). Looking forward, India is a key expansion target for flydubai, and late last year the LCC held talks with Indian aviation officials over an expansion of services, although the current bilateral is restrictive and flydubai (and other airlines) are waiting for a new bilateral to be signed between India and the UAE so that routes can be expanded into secondary destinations in India.

In fact within its target five and a half hour flying radius there are many countries with which flydubai is restricted by current bilaterals with the UAE, such as Pakistan, Iran and India. The UAE of course is pressing those countries to sign new bilaterals, and the state is also helping flydubai (and flydubai route network



other UAE airlines) by gradually easing visa restrictions on visitors to the country, either by abolishing them altogether or by simplifying the process of getting a visa.

Interestingly, last summer flydubai said it was open to the idea of entering into an alliance with easyJet in order to open up routes into western Europe. flydubai operates a route to Amman in Jordan, a destination that easyJet has been serving from London Gatwick since 2011. However, flydubai's ambitions here have been thwarted by easyJet's recent announcement that it will be closing the three times a week route to Amman in May this year, a move that is believed to be related to increased air taxes, with a departure tax of JOD40 (US$56) per person at Amman, plus another JOD6 (US$8) in 'terminal usage fees'.

Airport move

Although Terminal 2 at Dubai International is now used exclusively by flydubai and is being refurbished and expanded, the airport is at full capacity and so flydubai is likely to move its base to the new Al Maktoum International at Dubai World Central at some point later this year. Al Maktoum International opened late last year with capacity for 7m passengers a year, but this will rise to 160m passengers a year by the mid 2020s.

Although Emirates is not planning to move operations there until 2020, flydubai will switch later this year according to the Director General of the UAE General Civil Aviation Authority, speaking in January – though flydubai has not yet officially confirmed this schedule.

With unofficial sister airline Emirates operating a widebody-only fleet, flydubai might be expected to develop a feeder role, and so operating out of a different airport for so many years would be illogical. The two facilities are 40km (25 miles) apart. However, the vast majority of flydubai's passengers will be flying point-to-point, with many incoming passengers to Dubai visiting friends and relatives, taking a leisure trip or going as foreign workers in the UAE's major construction projects.

flydubai carried 6.8m passengers in 2012 (38% up on 2012), making it the second largest carrier – by passengers carried – operating out of Dubai International. However 57m passengers travelled through Dubai International in 2012 (the last full year with available figures), with 39.4m on Emirates aircraft, which dwarfed the 5.1m carried by flydubai in that year. The other 12.5m were carried by more than 100 foreign airlines, though rival LCC presence at Dubai is small. They include LCC WizzAir, which operates routes into Dubai from eastern Europe, and Norwegian, which operates to Oslo, Stockholm and Copenhagen. A more local competitor is Air India Express, the quasi-LCC subsidiary of Air India, which operates 21 737-800s and has routes from Dubai International to 11 destinations in India.

flydubai competes against four other LCCs in the Middle East – Air Arabia, Jazeera Airways, Flynas and Felix Airways. Air Arabia is based in Sharjah and operates 34 A320s (with 10 on order) to approximately 90 destinations in the Middle East, Africa, the Indian subcontinent, Europe and Asia, while Kuwaiti-based Jazeera Airways operates eight A320s to 19 destinations in the Middle East. Flynas was previously known as Nas Air and is a Saudi airline based in Riyadh that operates 24 A320s and assorted Embraer types domestically and to Middle East destinations, while Felix Airways is a Yemeni carrier with four Bombardier aircraft.

LCC to hybrid?

flydubai operates a standard LCC business model, with high utilisation of a young, single type fleet (with the carrier saying it will dispose of all aircraft before they reach eight years of age) but there are signs that flydubai may be turning into a hybrid carrier. Frills have also been creeping into the economy product and passengers can now pre-book in-flight entertainment and meals on select routes online. And while the majority of bookings are made direct via its website, in 2012 flydubai signed deals with three major global distribution systems – Amadeus, Sabre and Travelport. flydubai also began cargo operations in 2012, carried in its 737-800 hold capacity as well as to another 150 destinations through cargo interline agreements.

Most significant though was the launch of a business class product in June 2013, which the airline says was motivated by the fact that few of the routes it operates on have ever had a business class option.

The product includes a dedicated check-in, a business class lounge, a business cabin with 12 42-inch pitch leather seats, and in-flight meals and entertainment. Business class had been added to 13 aircraft by the end of 2013, operating on selected routes such as Dubai to Baghdad, Kuwait, Riyadh, Istanbul, Kabul, Kiev and Bahrain. The business cabin will be standard on all new aircraft joining the fleet. In introducing a business class, overall seats on the 737-800s will decrease from 189 to 174, though clearly flydubai believes overall revenue will increase through the higher margin business class passengers.

flydubai says it moved into profit during the second half of 2011, after just three full years of operation, and it has just announced a net profit of AED 222.8m (US$ 60.7m) for 2013, 46.7% up on 2012, based on revenues of AED3.7bn (US$1bn), a third higher than the year before. Ancillary revenue for 14.6% of total revenues in 2013.

A cost breakdown has not been released, other than the fact that fuel accounted for 39.5% of all costs in 2013. flydubai currently employs 2,250 staff (including 499 pilots and 922 cabin crew) from almost 100 different nationalities, and is in the middle of a recruitment drive to attract 600 pilots by 2016. The airline has also launched its own internal "Cadet" training programme for young Emiratis to produce licensed pilots, with 100 pilots expected to come through this route over the next five years.

flydubai has been diversifying its funding sources and – after financing thee 737-800s via an Export-Import Bank loan – last November flydubai agreed a US$228m deal with five local and international banks to finance six 737-800s on order – two of which had recently been delivered and the rest of which are arriving this year. The funding is structured as a finance lease with loan repayments over a 10 to 12 year period. As at the end of 2013 a total 42 aircraft out of its initial order of 50 Boeing aircraft had been funded.

The airline is also planning a major fund raising in 2015, possibly through the issue of sukuk (Islamic bonds), and a sum in excess of US$500m is expected to be raised that will finance general operating expenses as well as to fund some of the new aircraft orders.

With more than 100 new aircraft arriving over the next few years flydubai will gradually establish itself as a major airline in the region, though whether it will still follow an LCC model by the end of the decade is debateable. In some respects the business model it follows is irrelevant – based at a new airport with massive capacity (and without legacy infrastructure and business models to hold it back) and with the deep pockets of the Dubai emirate behind it, flydubai is a carrier that will keep growing however and at whatever pace it wants to.

Virgin America: profits/growth dilemma as IPO nears

Virgin America, the award-winning San Francisco-based LCC, faces an interesting challenge: how to consolidate profitability and go public successfully in late 2014 or early 2015, while taking advantage of some unexpected, rare growth opportunities.

Virgin America has at last become profitable. After net losses totalling $651m since the beginning of 2008, when it began reporting its results (operations launched in August 2007), the carrier has now had three consecutive profitable quarters (including Q4 2013, which as of March 19 had not yet been reported). 2013 is likely to have been Virgin America's first profitable year.

The turnaround was a direct result of Virgin America's late-2012 decision to halt ASM growth, which had been running at a dizzying 30%-plus annually. In 2013 Virgin America's capacity declined by 2.2%.

The idea was to maintain strict capacity discipline at least a while longer, so that there would be a nice string of profitable quarters to present to potential IPO investors.

The IPO cannot be delayed much longer, because Virgin America's original investors have bailed out the company on several occasions and because new aircraft deliveries from Airbus are scheduled to begin in the second half of 2015.

Indeed, in recent months Virgin America has stepped up preparations for a potential IPO. In February it named the investment banks that will lead the offering (Barclays and Deutsche Bank). There have been moves to strengthen the board and management team (notably the appointment of Intel's CFO Stacy Smith to the board). Both CEO David Cush and minority investor Richard Branson have talked of Q3 or Q4 2014 being the target periods for an IPO (subject to favourable market conditions, of course).

But now there is a potential spanner in the works – something that could make it harder for Virgin America to consolidate profitability this year: major new route expansion. This is because, surprisingly, Virgin America is poised to become a major beneficiary of the AMR-US Airways slot and gate divestitures.

First, Virgin America won permission to buy six daily slot pairs at LaGuardia (LGA) and four slot pairs at Washington Reagan National (DCA). Since these slots are subject to the rules prohibiting flights beyond a 1,250-mile perimeter, Virgin America will not be able to use them for transcontinental service; instead, it will have to add riskier new service in markets that do not involve its SFO and LAX hubs.

Second, Virgin America is now bidding for the two gates that American is required to relinquish at Dallas Love Field (DAL). If successful – and the chances seem high – Virgin America would expand significantly in the Dallas market from October, aggressively taking on Southwest and American on their home turf.

These are the sort of rare growth opportunities that an airline in Virgin America's position cannot turn down. In the past Virgin America has had terrible difficulties in obtaining gates and slots at desirable airports.

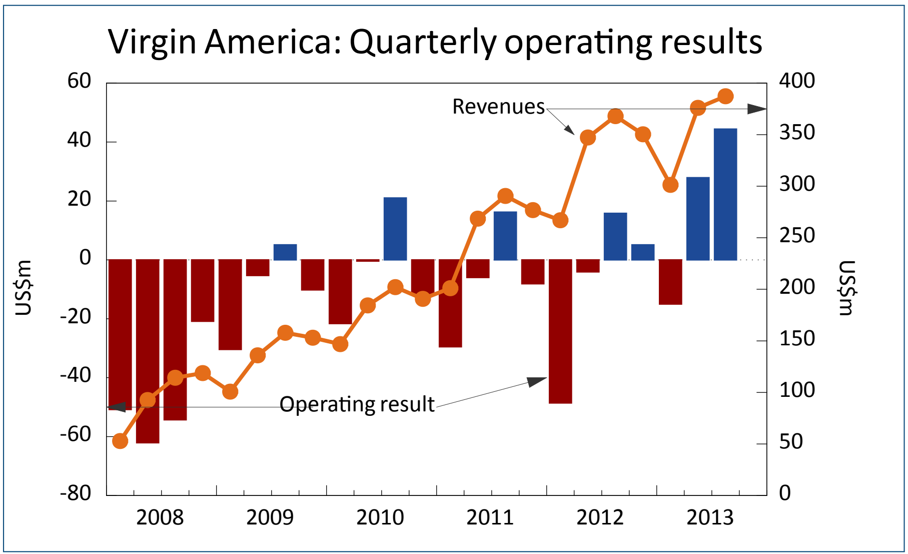
Of course, there is much Virgin America could do to minimise the adverse short-term financial impact of new expansion. Among other things, it could shed less profitable existing routes. Virgin America has already announced that it will pull out of the LAX-San Jose market in May, after just one year there, in favour of focusing on more lucrative longer-haul expansion.

But the upcoming growth spurt, which may require the airline to lease additional A320s, is certainly something that needs to be kept in mind, as Virgin America announces strong 2013 results in the coming weeks and as the IPO process gathers pace.

Profitability, at last

An IPO has been on the cards for Virgin America for at least a couple of years. After all, the airline became a "major carrier" in 2011, with annual revenues exceeding $1bn. It will be celebrating its seventh anniversary this August. Last year its revenues were around $1.4bn.

Virgin America has been a huge hit in the marketplace. It has differentiated itself with its blend of friendly, hip upscale service and competitive fares. It has continued to sweep the "best domestic airline" type awards. Like JetBlue, it enjoys significant customer loyalty. After the LAX-San Jose termination announcement, several passengers were quoted saying that



they would go a "roundabout" way into SFO International so that they could continue to fly Virgin America, even though the LAX-San Jose route will continue to be served by five other carriers (Alaska, American, Delta, Southwest and United).

Virgin America has developed an attractive niche as San Francisco's hometown or business airline. The product has been keenly embraced by the typical younger Silicon Valley business travellers, as well as small and medium-sized businesses in the Bay Area generally.

But the lack of profits kept the IPO a pipe dream and necessitated repeated bailouts from Virgin America's deep-pocketed and patient investors. Cyrus Capital, the airline's main US investor, played a pivotal role in recapitalising it in late 2009 and helping it raise $150m through a debt offering in December 2011.

In November 2012, after seeing its cash reserves dwindle alarmingly during that year, and with investors evidently unwilling to inject more funds as long as the losses continued, Virgin America finally did the sensible thing: reduced and deferred its substantial A320 order commitments, to drastically scale back growth and preserve its balance sheet.

Under the revised agreement with Airbus, Virgin America's firm A320 orders were reduced from 30 to 10 and deliveries rescheduled from 2013-2016 to 2015-2016. The 30 A320neo positions were deferred by four years, from 2016-2018 to 2020-2022.

So, after adding 24 aircraft or almost doubling its fleet between Q2 2010 and Q2 2012, Virgin America is taking a 2.5-year pause in fleet growth. Its fleet has remained unchanged since its 53rd A320 arrived in March 2013, and it is not due to take more aircraft until the Airbus deliveries begin in the second half of 2015 (five in 2015 and five in 2016).

The no-growth strategy paid dividends. In Q4 2012 Virgin America saw its first-ever fourth-quarter operating profit. In Q1 2013, when its ASMs fell by 4% as a result of much culling of seasonally weak flights, the airline's unit revenues surged by 18% and its operating loss narrowed significantly.

In Q2 2013 Virgin America recorded its first-ever Q2 net profit of $8.8m. And the Q3 2013 results were a cause for celebration: an operating margin of 11.5% and a net profit of $44.4m.

Assuming a similar rate of improvement in the fourth quarter (for which a small profit was expected), Virgin America is likely to report a reasonably healthy operating margin (perhaps in the 5-7% range) and possibly a small net profit for 2013.

The past year's turnaround has been driven by a spectacular RASM performance. Having curtailed growth, Virgin America quickly went from an industry-laggard to an industry leader in unit revenue growth. In 2012, when its ASMs surged by 27.3%, it trailed the industry with a mere 1% RASM increase. In January-September 2013, its when ASMs declined by 2.5%, its RASM shot up by 11.1%. The RASM improvement also reflects increased focus on business-oriented routes and strong demand for Virgin America's product and service.

Thanks to the positive results from the no-growth strategy, Virgin America's investors agreed to another major financial restructuring in the spring of 2013. The shareholders agreed to eliminate $290m of the carrier's debt in return for future stock purchasing rights and to provide an additional $75m of debt.

The investors will obviously be looking to sell at least part of their stakes in the IPO. Virgin America's shareholders include the UK's Virgin Group (25% of voting stock) and US-based VAI Partners (75%). The latter has four partners, with Cyrus Aviation Investors being the largest.

The result was a significant improvement in Virgin America's unrestricted cash position, to $148.2m in mid-2013 (though that was still only 11% of 2012 revenues, very low by US major carrier standards). Also, the airline expected a substantial reduction in interest expenses, to around $20m in the second half of 2013, roughly a third of the prior year amount. Virgin America described the changes as a "first step toward preparing the company for access to the public markets at a future date".

Rare growth opportunities

After years of struggles to access certain key airports, Virgin America began to have better luck three years ago, largely thanks to airline mergers. Its 2010-2012 growth spurt included some of the country's largest business markets: Dallas Fort Worth (December 2010), Chicago O'Hare (May 2011), Philadelphia (April 2012) and Washington DCA (August 2012).

Those are the type of markets that Virgin America needs for long-term success, given its upscale service. But the higher costs at such airports and the need to aggressively court business traffic amid intense competition may have added to the delays in attaining profitability.

Fortunately, that does not appear to have been the case with Newark, one of the nation's top business markets, which Virgin America was able to add as its 20th destination in April 2013, with three daily flights from both SFO and LAX. By late summer the Newark operations were already profitable, with Virgin America's revenue share exceeding its capacity share in both markets. The carrier may have been helped by the strong following it had already built on the transcon sectors out of JFK. Before its entry, SFO-EWR had only one carrier (United) and LAX-EWR had no LCC. After Virgin America began selling its Newark services, fares on the routes dropped by as much as 40%.

Otherwise 2013 was a good time to pause growth, because Virgin America's management had begun to feel that the airline had reached critical mass. CEO David Cush reportedly said last year that although cities such as Houston and Atlanta were definitely on Virgin America's list, he was already quite happy with the way the network looked. He has frequently noted that Virgin America now serves nine of the top 10 business markets from SFO and eight of the top 10 from LAX.

But the opportunities arising from the AMR-US Airways divestitures, and the coincident full expiration of the 1979 Wright Amendment restrictions on long-haul flights from Dallas Love Field in October, are simply too good to miss. As CEO Cush observed, "the opening of access to these slot-constrained and gate-constrained airports is an infrequent occurrence at best".

In its bid for the two gates at Dallas Love Field, Virgin America is proposing to operate a total of 16 daily flights to LGA, DCA, Chicago O'Hare, SFO and LAX. It would be starting new services from Dallas to three major business destinations (New York, Washington and Chicago) and increasing flights to its two current destinations (SFO and LAX). The current operations to LAX and SFO would be moved from DFW – not a sacrifice at all since Love Field is closer to the downtown area. Most of the new flights would start in October, but the Chicago flights would start in early 2015.

Virgin America would use the newly acquired LGA and DCA slots for service from Dallas. It is unclear at this point if it will also bid for the gates that AMR has to give up at ORD.

Southwest, which dominates Love Field (its home base) and currently operates 16 of the airport's 20 gates, is also bidding for the two AMR gates. It has put forward an impressive proposal to add nonstop service to 12 new destinations from the airport. However, if the DoJ sticks to its stated aim of using the AMR-US Airways divestitures to give LCCs better access to slot or gate constrained airports, Virgin America will win hands down.

IPO prospects

Importantly, the no-growth strategy has been effective in making Virgin America profitable. The airline has proved that there is nothing wrong with its network or business strategy and that the earlier problems could entirely be blamed on too-rapid growth and too-low a percentage of mature markets in the network. Another one or two profitable quarters, and the airline could be reasonably well positioned for an IPO.

However, a major new growth spurt at Dallas, and to a lesser extent New York and Washington, from October might be just a little too early from the IPO viewpoint. It could mean a tight balancing act for the airline.

Virgin America would have to find a way to convince a sceptical investment community that it would be able to manage the growth better than in the past, while remaining consistently profitable. Assurances of future ASM growth amounting to a "manageable" 8-10% may not be enough.

Then again, having some growth lined up at primary airports could be a positive thing for the IPO. Virgin America is looking to expand its fleet to nearly 100 aircraft over the next decade, and it can only do that if it can access the public markets (equity or debt) for funds.

By Heini Nuutinen
hnuutinen@nyct.net

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