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Frustrating questions of ownership and control

Dublin early in April saw an influx of aviation professionals to CAPA's Airlines in Transition 2014 conference to debate a key element of the industry's development: that of national ownership and control. On the dais were Willie Walsh, CEO of IAG; Bjørn Kjos, CEO of Norwegian Air Shuttle; Conor McCarthy, co-founder of Air Asia and Chairman of Dublin Aerospace; Matthew Baldwin, the EC's Director of Aviation and International Transport Policy; and Eamonn Brenan, CEO of the Irish Aviation Authority. The session was chaired by John Byerly, the former Deputy Assistant Secretary the US DoT (and a key negotiator in the EU-US Open Skies agreement).

John Byerly set the scene for the discussion. He outlined the arcane restrictions on foreign ownership and control that date back to the 1945 Chicago Conference, and are inherent in most bilateral and multilateral air service agreements (and especially in all the "Open Skies" agreements negotiated by the US): a scheduled airline must be "substantially owned and operated" by nationals of the home country. He pointed out that in a global industry, corporations benefited from economies of scale, market access, purchasing power and diversification of risk. In most industries they could merge and create subsidiaries with relatively little impediment while the airline industry is "tied in legal knots".

With a very few exceptions countries round the world have laws in place limiting foreign ownership and control, and these statutes remain in place for reasons of national pride, defence, labour protectionism, and (probably above all) inertia. As a result they act as an impediment to cross-border mergers and acquisitions in the industry – or at least add a significant element of risk. Meanwhile, although questions of ownership are relatively easy to determine (despite, we may add, arguments of how to treat convertible loan stock in calculations of equity) the question of *control* by a foreign entity is more complex – many bilateral air service agreements will preclude "effective control" by a foreign national even if their equity position is below the proscribed maximum.

Byerly did not think that there would be any legal changes to the system. The EU-US Open Skies treaty missed the opportunity to remove ownership restrictions. Initially it was an *a priori* requirement from the EU in 2008, but with protectionist attitudes from Washington it then was pushed into the second round of negotiations in 2010 and conveniently side-lined (after all the US had overturned Bermuda II and gained access to Heathrow, which was all it really wanted). The EU is still hopeful that it can include the question in the forthcoming Transatlantic Free Trade negotiations: but Byerly bluntly stated, "I am not putting any money on success".

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On top of this he noted that the existing rules are being strongly enforced – especially in the more protectionist nations. For example, Virgin America encountered significant opposition to its application for an AoC in the US, where the DoT not only refused to accept that Branson only had a minority stake , but that also decided that the CEO, Fred Reid, despite being a US National, was too closely involved in the UK's Virgin Group. The EC has started investigations into Delta's 49% stake in Virgin Atlantic, Etihad's involvement in Air Berlin, Air Serbia, Darwin (and possibly Alitalia), and Korean's investment in CSA. This is a further example of regulators taking the question of control beyond a simple view of equity involvement. Meanwhile, Delta seems to have per-

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suaded the Italian courts to dismantle Emirates' fifth freedom route rights between Milan and New York.

The solutions that exist involve "threading the legal needle". These include the mergers (such as between Air France and KLM, BA and Iberia, or Lan and TAM) with a special purpose vehicle that skirts the legal niceties of equity control to allow the holding company to retain all the economic benefits of the merger but "national" companies to officially hold a majority of the equity. In addition there are the models used in SE Asia, such as by Air Asia, with local majority owned subsidiaries providing the legal ownership requirement to allow brand expansion. Of course only Lufthansa would have had the *chutzpah* to persuade the governments of Switzerland and Austria to renegotiate their bilaterals to allow German ownership of the national carrier.

Why merge? Byerly pointed out that global branded alliances were all very well for developing market access, but membership of an alliance came at a cost. Willie Walsh re-emphasised this comment saying that only through a merger or acquisition could cost synergies really be achieved; and that alliance membership would *add* costs.

Among the panellists there was broad agreement that the whole system is "stupid". Walsh said that he's argued consistently for years that foreign ownership laws need loosening and until recently felt confident that this would happen. However, now he was more pessimistic as there were increasing moves towards protectionism. He praised Bjørn Kjos and norwegian for what they were doing with the establishment of the Irish long haul subsidiary, pointing out that this was one of the very things that the liberalisation inherent in the US-EU open skies agreement was meant to allow. In fact, British Airways had been the only other carrier to set up an airline – Open Skies – outside its home country to operate on the Atlantic (although it was not performing particularly well and now only operating between New York and Paris). What particularly seemed to annoy him was that the objectors to norwegian's plans were using Article 17*bis* of the 2010 EU-US protocol as a prime reason to deny access. This states that *"The Parties recognise the importance of the social dimension of the Agreement and the benefits that arise when open markets are accompanied by high labour standards. The opportunities created by the Agreement are not intended to undermine labour standards or the labour-related rights and principles contained in the Parties' respective laws."*

Meanwhile on the question of labour issues driving corporate activity Willie Walsh pointed out that the obvious labour-management conflict is that labour unions are there to *protect* employment while the airlines are there to *create* employment. Ultimately an airline is interested in being increasingly efficient and growing profitably.

In a recent speech at the Washington Aviation Club ALPA's president Lee Moak hit out at state-owned foreign carriers, provision of customs pre-clearance at foreign airports and at norwegian's Irish subsidiary as "unfair" competitive positioning saying "ultimately this is about saving the US airlines... if the US Government does not allow the US airlines and their workers to compete fairly, the US airline industry as we know it today will disappear". He is now calling for "fair skies, not open skies" and using terms like "flags of convenience" and a "race to the bottom".

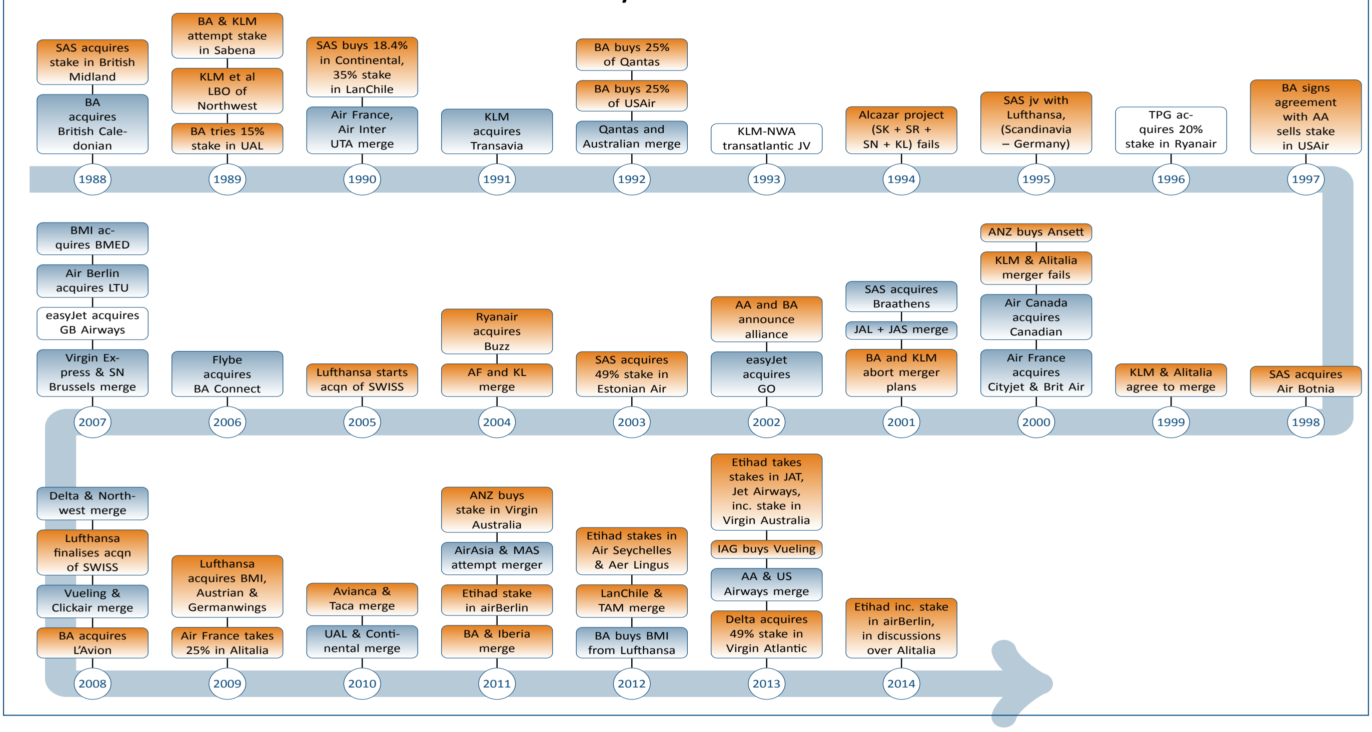
Norwegian's Bjørn Kjos denied that his plans to base his subsidiary airline in Ireland (with some staff recruited from Asia) went against any regulations. He pointed out that Oslo only has a direct catchment population of 0.7m, and emphasised that he had a choice of going to another European base area and creating employment or giving everything away to "to the Asians or others". Expanding competition creates a huge number of jobs – not only in the aviation industry but also in related tourism and support industries, particularly hotels and restaurants.

The question of minority cross-border airline investment appeared in a later session in the conference. Here was particular interest in Etihad's model of investing in those airlines no-one else would touch – with CAPA's Peter Harbison applying the soubriquet of an Egocentric Equity Alliance. It was a model described as providing a composite designed to create near global reach for the central stakeholder, with some benefits for the other participants. For Maurizio Merlo, CEO of Darwin Airlines (now Etihad Regional), the presence of a strong partner as a shareholder provided significant benefits: a major improvement in buying power and relationships with suppliers; and, perhaps surprisingly, the ability to offer staff more of a career path through the "family" of related airlines. In that session the conclusion seemed to be that the minority investment route will be the principal driver of industry transformation over the next few years. However, the EC's investigation into whether Etihad actually exercises control (and its recently-announced €300m emergency investment in convertible loans in Air Berlin won't help) may provide a brake on activity.

The airline industry is one of the few industries that is restrained from becoming truly global. Over a decade ago ICAO proposed a new model airline designation clause for bilateral air service agreements separating the question of ownership from that of effective control, whereby nationality would be determined by where an airline "has its principal place of business and permanent residence in the territory of the designating country"; with the footnote that criteria for determining the principal place of business would include local incorporation, base of operation and capital investment in facilities, payment of tax, aircraft registration and employment of nationals.

This definition has not been widely used – a notable exception being Chile. All the attempts at developing code shares, global branded alliances, linking frequent flyer programmes are part of the process for airlines to try to overcome the regulatory hurdles and join the trend towards globalisation; but they are a poor substitute for the real thing.

Airline industry cross-border timeline



SIA battles perfect storm of LCCs and Superconnectors

With increasing competition from both full-service Asian and Superconnectors, as well as from LCCs, the SIA Group has seen yields fall steadily over the last two years. Can the Singaporean flag carrier's attempts to diversify its portfolio stop this decline?

At first sight the SIA Group's financial results look fine. In the first three-quarters of SIA's 2013/14 financial year (the nine month period ending December 31st 2013), the Group recorded a 1.6% rise in revenue to S$11.6bn (US$9.2bn). Operating profit during the period increased by 16.9% to S$319.6m (US$253.4m), though profit before tax was S$402.7m (US$319.3m), some 4.3% down on the figure for April-September 2012.

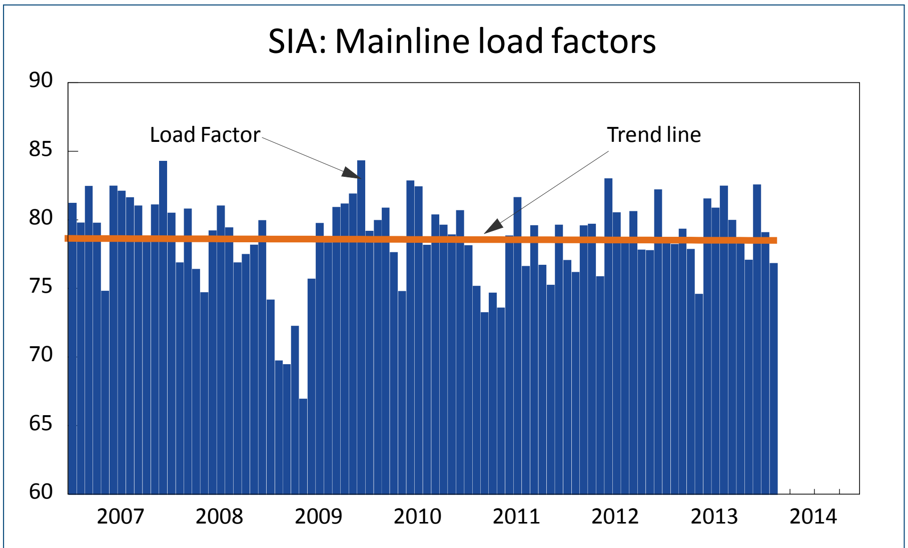
The net profit figure was hit by an increase in exceptionals during the nine month period, including an impairment loss of S$293.4m on four surplus freighters that were removed from the operational fleet and put up for sale, as well as an offer of S$78.3m to plaintiffs to settle class legal action against its historical cargo business operation in the US. On the other hand these were partly offset by an exceptional gain of S$339.9m received from the sale of SIA's stake in Virgin Atlantic to Delta Air Lines.

During Q1-Q3 2013/14 fuel accounted for 38.2% of Group costs, down slightly from the 40% it represented in the previous comparative period; SIA said that average jet fuel prices fell 5.6% in the October-December 2013 quarter compared with the same quarter in 2012.

Yet those results don't tell the whole story, because underneath them the Group is facing steady erosion in some key fundamentals. Though not a problem in its own right, the vast majority of the Group's revenue and profitability comes from the mainline operation. In the first nine months of 2013/14, of the group's S$320m operating profit the mainline accounted for S$315.6m, SIA engineering Company for S$81.4m and SilkAir for S$27.5m – with SIA Cargo contributing an operating loss of S$70.5m to the overall net figure.

For decades that mainline has been known for its reputation for carrying high-margin first-class and business travellers around the globe (with premium traffic accounting for around 40% of total revenue) – but that reputation counts for much less in a world where global recession has slashed corporate travel budgets and where competitors care little about SIA's reputation. That competition comes not just from traditional full-service airlines such as MAS, Cathay Pacific and British Airways, but increasingly from the "Big Three" Gulf carriers flying on east-west routes through their Middle Eastern hubs. To make matters worse for SIA, it's also facing increasing competition from Asian LCCs, including Lion Air of Indonesia and AirAsia of Malaysia, which operate fleets of 150 and 169 aircraft in turn, but also have massive firm order books, of 571 and 337 aircraft respectively.

As can be seen on the chart to the left, mainline load factor trend line has remained stubbornly in the 70s for the last few years and – most worryingly – competitive pressure is manifesting itself in a squeeze on mainline yield, which has been falling relentlessly since the fourth quarter of 2011 (see chart, opposite). Mainline yield per RPK has fallen from S¢12.1 in October-December



2011 to S¢11.0 in July-September 2013, though it recovered to S¢11.2 in October-December 2013.

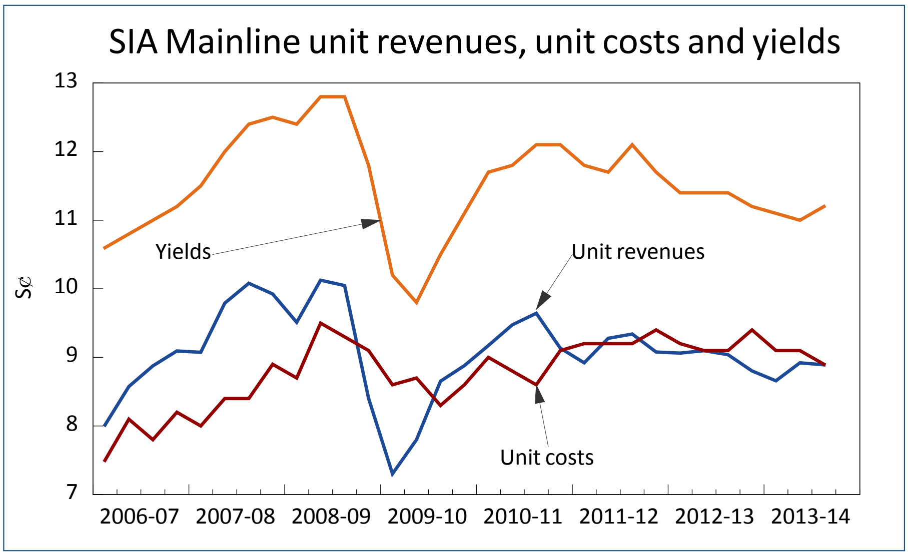
At the same time the mainline has been struggling to make further inroads into costs, with unit costs only falling from S¢9.2 in October-December 2011 to S¢8.9 in October-December 2013, and as a result the gap between unit revenue and unit cost that was so clear in the pre-2009 era has now all but disappeared. If that gap can't be opened up again then the mainline could dip into the red, which will inevitably plunge the entire SIA Group into a loss.

SIA's management has been trying to overcome these worrying trends for some time, most notably by surrounding the mainline airline with a constellation of lower cost carriers – SilkAir, the Tiger Group, Scoot, a new joint venture in India and a substantial investment in Virgin Australia.

The SIA mainline

The mainline operates fleet of 102 aircraft to 65 destinations globally out of its hub at Singapore. Interestingly, the biggest rise in costs at the Group level over the April-December 2013 period was in aircraft maintenance and overhaul, which rose by 21.5% to S$478.2m (US$379.2m), and that's a clear indication that SIA's fleet is starting to age. The Group fleet currently stands at 146 (see table on page 7), and the mainline aircraft had an average age of 6 years and 8 months as at end 2013.

The mainline operated A340-500s until they were taken out of service last year, as a result of SIA closing two non-stop routes operated from Singapore to Los Angeles and New York Newark. These were the two longest non-stop routes in the world, (the latter was a 19 hour trip), but clearly SIA couldn't make them profitable with an A340.



On order at the mainline are 113 aircraft, including 70 A350-900s (plus options for another 20, though these can be converted to the larger 1000 model), which will start replacing the 777-200ERs from the second half of this year. Thirty 787-10s are also on order – for which SIA is the launch customer – and they will arrive from 2018 or 2019 onwards. SIA is currently deciding between the 777X and A350s for a new order for as many as 40 widebodies, it is believed, though a final decision is not imminent.

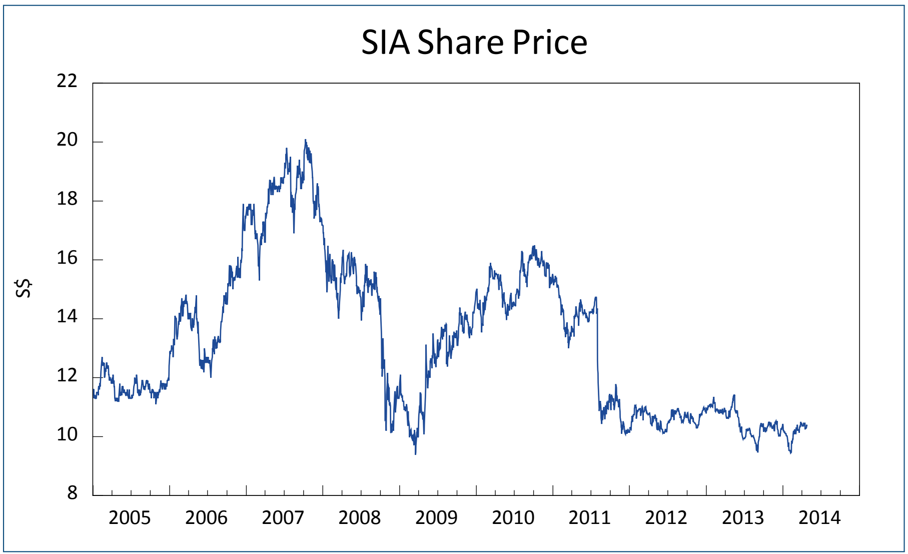
Providing feed for the mainline is the long established SilkAir, which operates a two-class service to more than 40 regional destinations in Asia. It operates 25 aircraft and has 53 737s on order, and has just received the first aircraft from an order for 23 737-800s, which will be configured with 12 business class and 150 economy seats. They will directly replace A319s and A320s. Also on order are 31 737 MAX 8s.

The SIA Group also has a standalone cargo business unit that operates 13 747Fs, but this is under severe pressure at the moment – after posting a significant loss for the first three-quarter of the year SIA says that air cargo demand is projected to be relatively flat through 2014, with "cargo yields likely to remain under pressure as the cargo business continues to face overcapacity".

Diversification woes

A new attempt at diversification away from a tiny home market and dependence on premium revenue came back in 2004 – as the first wave of LCCs hit Asia – when the SIA Group to set up LCC Tiger Airways. Today the Group owns 40% of Tiger Airways Holdings, but the group's attempt to mirror the joint venture/franchise strategy adopted by rival LCC groups AirAsia and Jetstar Airways has not had much success thanks to stiff competition and the fact that its operations are not large enough to achieve significant economies of scale.

The Tiger group wholly owns Tigerair (previously known as Tiger Airways Singapore until a rebranding in 2013), which operates 25 A320s out of Changi and which has with a further 10 A320s on firm order. The group also owns 40% of Tigerair Philippines, which has five A320 fam-



ily aircraft, but this is currently being sold to Cebu Air (which operates the LCC Cebu Pacific) after accumulating significant losses since launching, it is believed. The Tiger holding company will receive just US$7m for its 40% stake in Tigerair Philippines.

The Tiger Group also has a 40% stake in Tigerair Mandala, based in Indonesia and which operates nine A320s, and a 40% stake in Tigerair Australia, also with 12 A320s (and with seven on order), which is 60% owned by Virgin Australia.

The Tiger group also has plans to launch an LCC in Taiwan late this year, in co-operation with China Airlines. The group still appears sub-scale however – excluding Tigerair Philippines it operates 46 aircraft, compared with 77 at Jetstar and 169 at AirAsia. The Tiger holding group made a net loss of S$127.5m (US$101m) in the nine months ending December 31st 2013, and in its third quarter 2013/14 figures the SIA Group took a one-off S$46m (US$36m) hit from an impairment charge in Tigerair Mandala and losses related to assets held for sale in Tigerair Philippines.

In the summer of 2012 the SIA Group also set up a medium- and long-haul LCC – the bizarrely-named Scoot. Scoot operates six 777-200s borrowed from its parent between Singapore and 12 destinations in China (five) and Australia (three), plus Tokyo, Seoul, Taipei and Bangkok – the latest additions being routes to Hong Kong and Perth, which were started in November and December 2013 respectively.

The Scoot fleet will grow to 14 aircraft by 2016, with the current ageing 777s being retired and replaced by an all 787 fleet, with 10 787-8 and 10 787-9s on order (initially placed by the SIA Group, but now allocated to Scoot) , the first of which will arrive in November this year.

However, the 777s are operated not with a single class but rather a two class configuration – 370 economy seats and a 32-seat “ScootBiz” class; this business product includes a 38 inch pitch and in-flight meals and entertainment.

In December last year Scoot also signed an MoU with Nok Air to establish an LCC in Thailand, to be based at Don Mueang international airport in Bangkok. Under the name NokScoot, the airline will operate widebodies on medium- and long-haul routes in the second half of 2014.

Altogether the SIA Group is believed to have invested an estimated S$300m in Scoot so far, but this operation is a long way behind AirAsia X, which operates 19 aircraft (with 49 on order) from its Kuala Lumpur base to destinations in China, Japan and Australia within a four to eight hour flying distance.

Indian adventure

Following the decision by the Indian government in late 2012 to allow foreign carriers to buy up to a 49% stake in Indian airlines, last September the SIA Group and India’s Tata Sons (part of the Tata Group, the giant Indian conglomerate) signed a deal to launch a joint full-service airline in India. Two previous attempts by SIA and Tata start an airline In India have come to nothing but – assuming Indian government approval – the Delhi-based joint venture airline aims to start operations sometimes towards the end of this year at the latest.

Under a yet-to-be-announced new brand the carrier will operate a fleet of 20 leased A320s domestically in a two-class configuration, probably on routes between Delhi, Mumbai and other major Indian cities. One analyst believes that the new airline may receive the newer A320s currently used by SilkAir that will gradually be replaced by the new 737s on order.

The two partners will put S$100m into the joint venture, with SIA Group owning a 49% stake. It’s clear that SIA’s strategy with this move is to open up India as a major source market it can “own”, potentially with Delhi becoming a second hub for the SIA Group and generating a significant stream of Indian passengers travelling westbound to the Middle East and beyond, and eastbound into Asia. Currently the SIA mainline operates to six cities in India from Singapore and SilkAir operates to eight Indian cities.

Under current India regulations the start-up will be able to operate on domestic routes only until it has a five year track record, at which point it can launch international services. Apparently there are significant efforts being carried out at both the aviation and political levels to overturn this regulation, and it's likely the stipulation will be abolished sooner rather than later.

But freedom to operate internationally will not guarantee success for the new SIA/Tata airline. The carrier will compete against full-service Air India and Jet Airways, as well as LCCs such as IndiGo, SpiceJet and GoAir, and the chances that the joint venture can successfully operate full a high quality, premium product in a very price sensitive market appears optimistic, with fare differences between Indian full-service and LCCs operations having narrowed dramatically recently (and which led to the closure of full-service Kingfisher Airlines in 2012).

Another problem may be that Tata has also agreed a deal for a joint venture LCC with AirAsia called AirAsia India, which will result in yet another competitor. A third partner in the AirAsia India airline – Arun Bhatia, a Delhi businessman, with a 21% stake in the venture – has already criticised the Tata-SIA venture, saying that it was unethical for Tata to go into two Indian aviation start-ups at the same time. Tata may well be hedging its aviation bets, but the SIA Group can't afford to fail with its lone foray into the Indian market.

The other major attempt by the SIA Group to find new revenues in Asia is in Australia. After finally disposing of its troubled 49% stake in Virgin Atlantic for US$361m, in the summer of 2013 SIA Group spent US$125.8m to double its investment in Virgin Australia to 19.9%. SIA first bought a stake in Virgin Australia in late 2012, and in a direct challenge to Qantas Virgin Australia introduced business class seats to its aircraft.

A critical 24 months

As at December 31st 2013 the SIA Group's total debt stood at S$983.8m (US$780m), a fall of S$30.2m compared with the situation as at March 31st. The debt level is very manageable, particularly given that the SIA Group had a massive cash and bank balance of S$4.9bn (US$3.9bn) at the end of 2013.

Balance sheet aside, whether the SIA Group will weather the competitive storm and pressure on yield will become clear one way or another over the next two years. The market, however, may not want to wait that long. As can be seen in the graph on page 6, the SIA Group share price has been under huge pressure since late 2007. Since listing, the SIA Group has never reported a loss for a full year, but if it does slide into the red then free-float investors may lose patience altogether, even if support is assured from Singaporean state holding company Temasek Holdings, which owns 55.8% of the SIA Group.

In some ways SIA's situation is not helped by the bright outlook for the Asian aviation market in general. In its latest forecast Boeing says that nearly half the world's entire air-traffic growth over the next 20 years will come from the Asia/Pacific region, which will encourage airlines in the region to buy 36% of all commercial aircraft manufactured over the next 20 years. That's 12,800 aircraft being bought by Asia/Pacific airlines through to 2034, and with only 25% of these being replacements for older models. Unfortunately for SIA much of that aircraft demand will come from LCCs – which already account for around 50% of all seat capacity in southeast Asia and for 25% in Asia as a whole – and whose challenge to SIA will only get stronger over the coming years.

SIA Group fleet

Fleet (Orders)	Mainline	SilkAir	SIA Cargo	Scoot
737-800		1 (22)		
737 MAX 8		(31)		
747-400F			13	
777-200	17			6
777-200ER	12			
777-300	7			
777-300ER	21 (6)			
787-10	(30)			(20)
A319		6		
A320		18		
A330-300	26 (2)			
A350-900	(70)			
A380-800	19 (5)			
Total	**102 (113)**	**25 (53)**	**13**	**6 (20)**

Lion Air: 1,000 aircraft dream or delusion?

Lion Air should have astounded the aviation industry by placing huge orders in 2012 and 2013, and stating a target of a fleet of 1,000 aircraft over the next decade. Actually, it was largely ignored, but should Lion Air be taken seriously?

Lion Air was launched in 2000 by brothers Rusdi and Kusnan Kirana, and though it gradually grew through the 2000s it was just another Asian LCC that trailed well behind the giant AirAsia.

However, Lion Air's profile changed significantly in 2012 when it placed an astounding order for 201 737-MAX 9s and 29 737-900ERs in February of that year, worth some $22.4bn at list prices – which was the largest ever order for Boeing aircraft in the manufacturer's history. That was followed in March 2013 by an order for 234 Airbus aircraft, comprising 60 A320-200s, 109 A320neos and 65 A321 neos and worth $24bn at list prices. Sources suggest Lion Air may have got around a 50% discount on the Airbus list prices, and a similarly deep discount is likely on the Boeing order, so a total commitment of say $23bn.

The total Lion Air order book now stands at 538 jet aircraft (see table to the right), comprising 304 Boeing and 234 Airbus aircraft. 737 MAX 9s and 737-900ERs form the bulk of the Boeing order book, but there are also five 787s on order – though unconfirmed reports suggest that Lion Air will soon be cancelling that particular order. Of the Airbuses, 60 A320-200s will start being delivered later this year, but further ahead Lion Air has 174 new generation A320 family aircraft on order.

Lion Air still has a handful of older 737 models, which are being phased out, but Lion Air will take delivery of 34 aircraft throughout 2014 and the total 500+ aircraft on order will be delivered over the next decade. However, Lion Air wants a fleet of at least 1,000 aircraft, and further orders for 737s and potentially A320s are expected in 2015. While that's a prospect that no doubt has the manufacturers excited, the question has to be asked as to whether the Lion Air group can realistically achieve such an ambitious plan?

A growing group

Under the guidance of Rusdi Kirana, (now chief executive of the Lion Air Group after recently stepping down as CEO of Lion Air to concentrate on politics) the company has evolved from being a single airline into a group of airlines, each with its own AOC. The group consists of three carriers (Lion Air, Wings Air and Batik Air) that operate to around 80 destinations in Indonesia and five international destinations.

In March this year Rudy Lumingke – previously general manager sales and marketing – was promoted to CEO of Lion Air to replace Rusdi Kirana, and that airline remains the core of the group, operating 97 aircraft from its home base at Jakarta, with other hubs at Batam, Surabaya, Bali, Ambon, Makassar and Manado in Indonesia.

Lion Air is now the largest domestic airline in Indonesia, accounting for some 50% of the market according to one analyst, and taking advantage of a robust Indonesian economy that is the largest in Southeast Asia and which has recorded GDP growth of

Lion Air Group and Subsidiary Fleet

Fleet (Orders)	Lion Air	Wings Air	Batik Air	Malindo Air	Thai Lion Air
737-300	2				
737-400	2				
737-800	24 (18)				
737-900ER	68 (80)		6	6	4
737-MAX 9	(201)				
747-400	2				
787	(5)				
A320-200	(60)				
A320neo	(109)				
A321neo	(65)				
DHC-8-300		2			
MD-82		1			
ATR 72		27 (33)		6	1
Total	**97 (538)**	**30 (33)**	**6**	**12**	**5**

around 6% over the last four years, partly due to increased consumption from a growing middle class.

The Lion Air Group also owns Jakarta-based Wings Air, which brings in feed from Indonesia's extensive island network with a fleet of 30 turboprops and MD-80s. Wings Air has 33 ATR-500s and -600s on outstanding order, and the Lion Air Group is apparently also interested in acquiring up to 100 Indonesian Aerospace N219 19-seat turboprops, which would enable it to service much smaller airport that are dotted around the Indonesian islands. The N219 is under development and the first models may roll off the production line in 2016.

Completing the group structure is Batik Air, a full-service subsidiary that began operations in May 2013 and which is also based at Jakarta airport. It currently operates six 737-900ERs to 10 domestic Indonesian destinations, but will increase the fleet to 16 by the end of 2014, with the new aircraft comprising four 737-800s (arriving in the second-half of the year) and six A320s, the first of which will arrive in July. These aircraft will come from the outstanding group orders for Airbus and Boeing aircraft, and Batik also plans to add between 20 to 30 aircraft in 2015 as well.

These new additions will enable Batik Air to add 12 more domestic destinations by the end of the year, while a first international route – to Singapore – is also scheduled to launch before the end of 2014, before routes to Kuala Lumpur, Hong Kong and various Chinese cities are added in 2015. The 737-900ERs operate with a configuration of 169 economy and 12 business seats, and the airline follows a standard full-service business model.

Batik Air says its load factors are currently in the 90s, and that it has lots of scope for expansion In Indonesia, given that it is archipelago of more than 17,000 islands and is – according to the airline – vastly underserved. Whether routes to many of those island will produce premium traffic feed is open to debate.

Affiliate stakes

The Lion Air Group also has interests in two other airlines – a 49% stake in Malindo Air and a 49% share of Thai Lion Air. Malindo Air is an LCC based at Kuala Lumpur that is a joint venture with Malaysia's NADI – National Aerospace & Defence Industries.

Malindo started operations in March 2013 as a so-called hybrid carrier that challenges both MAS and AirAsia, with a product that includes business class, meals, large seats and touch-screen entertainment system – but offered at low fares on a fleet of six 737-900ERs and six ATR 72s.

According to Chandran Rama Muthy, chief executive of Malindo Air, there is a niche market in between premium and low-cost carriers, but the reality is that few other airlines that have tried to operate as a hybrid have made the business model a success. However, Malindo Air insists it can keep fares low thanks to cheap aircraft provided from the Lion Air Group.

Thai Lion Air is an LCC based at Bangkok that was launched in December 2013. The carrier operates four 737-900ERs (in an all-economy 189-seat configuration) and a single ATR 72-600 to five domestic and three international destinations (in Indonesia and Malaysia). Thai did have ambitions to increase its fleet by around 10 737-900ERs each year and gradually extend its reach to destinations such as Japan, China and South Korea, but those medium-haul routes would have been operated by the 787s on order, and reports suggest that order may be cancelled.

Additionally, the Thai affiliate has recently cut back frequencies on international service from Bangkok to Jakarta and Kuala Lumpur and is focussing more on domestic routes, largely as a result of civil interest and political turmoil in Thailand, which has resulted in load factors on the routes barely hitting the 50s mark. More and more of those domestic routes will be operated by 72-seat ATR 72-600s secured from Lion Air Group orders.

Inevitably the launch of Thai Lion Air provoked a reaction from Thai AirAsia, which immediately reduced its ticket prices and which has led to a fares war between the two. Interestingly the main marketing push of Thai Lion Air is not around individual ticket sales but rather about bundling air tickets with package tours, and that's potentially due to the fact that the other 51% of the airline is owned by Thai travel companies.

But even after including the fleet of its affiliates, the Lion Air Group comprises just 150 aircraft, of which a quarter are turboprops, operating to a handful of international destinations. However Lion Air does have plan to develop the airport at Batam – an Indonesian island just a 45-minute ferry ride from Singapore – as an international transit hub that will connect Indonesia with destinations to the west and east, from China to the Middle East and the Indian sub-continent. Lion Air is now constructing four hangars and extensive repair and maintenance facilities on the island.

A revolutionary leap

Realistically though, going from what it does currently to a 1,000 strong fleet will need a revolution in management scope and control, let alone finding a solution to how a relatively tiny company will be able to afford such a massive investment.

In terms of finance the Lion Air Group has raised a number of US Export-Import Bank (Ex-Im) guaranteed bonds since 2012, but it's clear that with the massive scale of orders it has that it needs substantial amounts of new funding, and that probably means an IPO. The group is looking to carry out an IPO sometime in 2015, and initial discussions have already taken place with banks and advisory companies. If successful the IPO would raise as much as $1bn for much-needed investment for its ambitious expansion plans, and give it an opportunity to improve its capital base further over the next decade.

But while bankers will encourage Lion Air to float sooner rather than later, some analysts believe the group is not ready even to begin contemplating an IPO. The need to hire a huge number of experienced managers is paramount, one believes. In some ways Lion Air is surprisingly unprofessional – its website is many years out of date (its fleet page states that it "will take delivery of another 15 737-900ERs by December 2008") and – much more worrying for any potential investors in an IPO – it is still on the list of airlines banned from operating within the European Union airspace because of safety standards concerns.

While Lion Air doesn't operate to Europe, the ban means that European travel agents are required to notify potential passengers that the airline is blacklisted at the point and time of sale, which significantly impacts bookings out of Europe. Although that EU ban applies to most Indonesian airlines, the key exceptions are Lion Air's main rivals – Garuda Indonesia and local subsidiaries of Tiger Airways and AirAsia. Significantly, the Lion Air Group has also suffered a number of aviation incidents and crashes since it was launched, including 25 fatalities.

If Lion Air does come off this EU ban list, does become more professional, does hire more experienced aviation executives, does successfully carry out an IPO and does finance and build an 1,000 aircraft fleet (and there are a lot of ifs in that statement), then the group will still have to find enough markets and routes to place those aircraft profitably.

That won't be easy. Garuda has already responded to the growing threat of Lion Air by expanding the scope of its LCC, Citilink – which operates 30 A320s – and the launch of full-service Batik Air will inevitably provoke further reaction from the Indonesian flag carrier. But the bigger challenge to Lion Air's ambitions will come from AirAsia, both from Jakarta-based Indonesia AirAsia and from the larger AirAsia group. AirAsia has deep experience in the LCC model and even deeper pockets, and it will compete fiercely to prevent Lion Air from achieving it very ambitious targets.

Latam: Turnaround accomplished, investment-grade by 2015?

LATAM Airlines Group, created when Chile's LAN completed its cross-border acquisition of Brazil's TAM in June 2012, is staging a promising financial recovery after two very difficult years, despite depreciating local currencies and continued weak demand in key markets such Brazil and cargo. How is the acclaimed LAN management team making it happen?

Airline mergers are typically undertaken for their long-term strategic benefits. In Latam's case, there was a unique opportunity to create a dominant airline combine for one of the world's fastest-growing regions.

But such mergers are tough to execute and can wreak financial havoc in the short term, when one-time costs are incurred and revenue and cost synergies have not yet kicked in. In Latam's case, the merger integration challenges were compounded by adverse developments in the marketplace: rising costs, declining yields and weak demand in certain key markets.

The result was that, first of all, LAN lost the double-digit operating margins and the solid net profits it had been earning since the mid-2000s. In 2012 and 2013 the combine achieved only marginal operating profits (0.7% and 5.1% of revenues) and incurred net losses totalling $804m.

Second, LAN lost its investment-grade international credit ratings, which it had enjoyed since 1997. When the merger closed, Fitch assigned Latam a junk-grade "BB+" rating, citing TAM's weaker credit profile and heavier debt load.

Third, Latam lost more than half of its stock market value between June 2012 and August 2013. The New York-listed ADRs plummeted from $24-plus in late 2012 to around $12 in August 2013. (Since then the shares have recovered to the $15-16 level.)

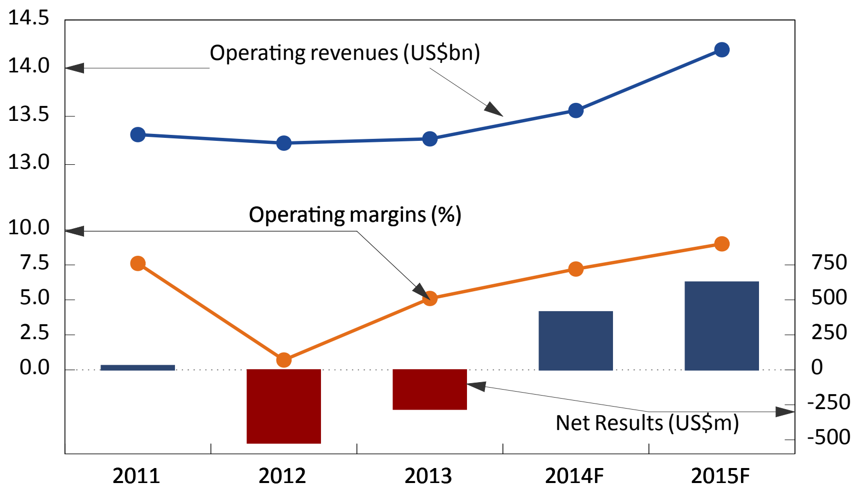
All of that was disappointing, given that LAN had been the embodiment of airline efficiency, with a highly diversified and flexible business model and a management team that has been regarded as the very best in the industry (a team that is now steering Latam). The business model had proved recession-resistant, thanks to a sizable cargo component and domestic operations in many different South American countries (now Chile, Peru, Argentina, Colombia, Ecuador, Paraguay and Brazil).

The post-merger cost headwinds have included continued high fuel prices, labour cost pressures (especially at TAM in 2012), the effects of the Brazilian real's depreciation at TAM, lingering negative effects from LAN's Aires acquisition in Colombia in 2009, and the start of merger integration expenses.

On the revenue side, Latam saw negative trends in most of its segments. International passenger markets, which account for half of its passenger revenues, have been relatively weak, especially to and from Europe and Brazil.

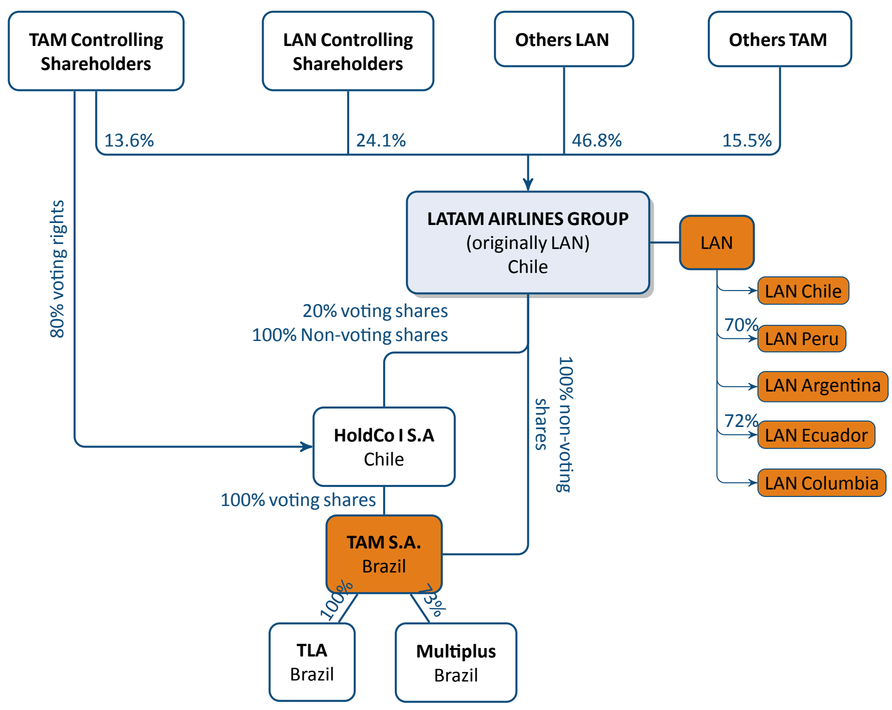
Brazil, Latin America's largest air travel market, began to see a dramatic slowing of economic and air traffic growth in 2011-2012, while competition domestically had increased. Brazil is now seeing its

Latam's Financial Results



Notes: 2011 and 2012 are pro forma figures (LAN and TAM merged in June 2012).
2014 and 2015 revenues and net results are analysts' consensus estimates.
2014 and 2015 operating margins are BofA Merrill Lynch's forecasts.

Latam ownership structure



Source: company reports

fourth consecutive year of modest GDP growth; the IMF is currently projecting only 1.8% growth in 2014 (after 2013's 2.3%, 2012's 0.9% and 2011's 2.7%). It meant domestic losses and sharply reduced total earnings for TAM in 2012 and first-half 2013. Domestic Brazil accounts for about 34% of Latam's passenger revenues.

Latam has also been hit by a multi-year cargo slump, reflecting weaker southbound demand to Latin America and increased competition in that segment. 2012 was bad and 2013 even worse, even though LAN and TAM were quick to integrate their cargo operations. Cargo was historically one of LAN's key strengths.

While demand has held up well in most of Latam's Spanish speaking domestic markets (16% of passenger revenues), yields have been under pressure because of the depreciation of local currencies in all of those markets. Q4 2013 saw a 5.5% RASK decline in the six countries, as Chile's and Peru's currencies each weakened by 8%, Colombia's by 6% and Argentina's by 25%.

The stock's decline also reflected analyst and investor scepticism about Latam's ability to achieve its merger synergy targets. Many analysts had felt that the carrier's projections were overoptimistic.

However, Latam managed through those challenges effectively. The turnaround was first evident in last year's third quarter and was consolidated in Q4. In the second half of the year Latam's operating margin was running at the 7.5%-level, though net earnings were affected by huge foreign exchange losses (mostly recognised by TAM).

Analysts attribute Latam's recovery to successful efforts to streamline costs, manage PRASK, execute the merger and repair the balance sheet. The turnaround had four key components:

✈ First, against all odds, Latam has delivered a strong turnaround on TAM's domestic operations in Brazil.

✈ Second, there has been a significant restructuring of international passenger operations. Latam has reduced long-haul capacity, contracted sharply at Rio de Janeiro, begun to develop a hub at Sao Paulo's Guarulhos Airport and implemented major fleet changes.

✈ Third, against expectations, Latam has met or exceeded all of its original interim merger synergy targets.

✈ Fourth, Latam implemented some very successful cost-cutting in 2013, especially in Brazil and in the labour, maintenance and commissions categories (though many cost categories have also benefited from the weakening of the local currencies, because Latam reports its results in US dollars).

✈ Finally, Latam made progress in three other important areas that will help its future results. At the end of 2013 it raised almost US$1bn through a primary share offering, which brought liquidity to much more comfortable levels and should help Latam regain an investment-grade credit rating in the next couple of years.

In late 2013 Latam also accelerated its fleet restructuring – a strategy that will pay dividends over the next three years.

And, significantly, after two years of hard work, Latam has almost eliminated the exposure to the Brazilian real in TAM's balance sheet.

Turnaround in Brazil

Brazil was one of the key reasons why LAN was interested in TAM, but making that part of the acquisition pay off has required a major effort. TAM's domestic operations are now profitable. This is a result of, first, the sharp capacity reductions implemented by both TAM and Gol since 2012, which have created a much healthier pricing environment. Second, TAM has benefited from LAN's expertise in yield management and market segmentation. Third, TAM has implemented much cost cutting, including headcount reductions last year.

TAM reduced its domestic ASKs by 8.4% in 2013. As demand remained flat, the domestic load factor surged by six points to 79.4%. That and the better yield management have resulted in double-digit growth in unit revenues since mid-2013, reversing the previous declining trend. TAM's RASK surged by 19% in Q3 2013 and by 11.3% in Q4, as measured in reals. TAM has maintained its domestic market share at about 40% and claims to have maintained its leadership in corporate passengers.

TAM will not be adding capacity in Brazil in 2014 and expects double-digit RASK growth to continue. So, even though economic growth will be anaemic, TAM seems positioned for a reasonably good year (as is Gol). BofA Merrill Lynch recently described the Brazilian market as "still highly competitive" but "in a better shape than in previous years".

Latam's Fleet Plan

at year end	2013	2014	2015
Passenger aircraft			
Dash 8-200	7	7	2
Dash 8-Q400	3	0	0
737-700	5	0	0
A319-100	54	51	48
A320-200	160	159	160
A321-200	10	20	32
A330-200	20	13	4
767-300	43	38	38
A340-300/500	6	3	0
A350-900	0	0	1
777-300ER	10	10	10
787-8/9	5	10	17
Total	323	311	312
Cargo aircraft			
777-200F	4	4	4
767-300F	12	11	10
Total	16	15	14
Total Fleet	**339**	**326**	**326**

Long-haul restructuring

Latam has reduced its long-haul passenger operations quite drastically, especially out of Brazil. In December 2013, Latam's total long-haul ASKs were 11% lower than a year earlier and TAM had cut its Rio de Janeiro-Europe/US capacity by 52%.

TAM plans to develop Sao Paulo's Guarulhos as its main hub for regional and long-haul traffic in South America. It essentially means improving itineraries to make them more attractive to connecting passengers. Having recently received approval from the Brazilian authorities to better allocate slots at Guarulhos, TAM hopes to implement the changes in the second half of 2014, when more capacity becomes available at the airport. The management regards it as a "big opportunity for Latam", though the exact impact cannot be estimated until the airport's total capacity is known.

The restructuring has involved fleet changes. TAM's 10 oldest A330s have been grounded and replaced with LAN's 767s, which are freed as more 787s arrive. The 767s offer lower CASK and a better product, with full lie-flat business class seats.

New codeshare agreements between TAM and American, implemented in August 2013, have improved TAM's network, connectivity and RPK generation.

On the cargo front, because of the addition of TAM's bellyhold capacity and weaker demand, Latam has been reducing freighter capacity (a trend seen at many global airlines). Latam's freighter/bellyhold ATK split is now about 50/50 and cargo accounts for 14% of total revenues, down from LAN's pre-merger 24%.

Merger integration

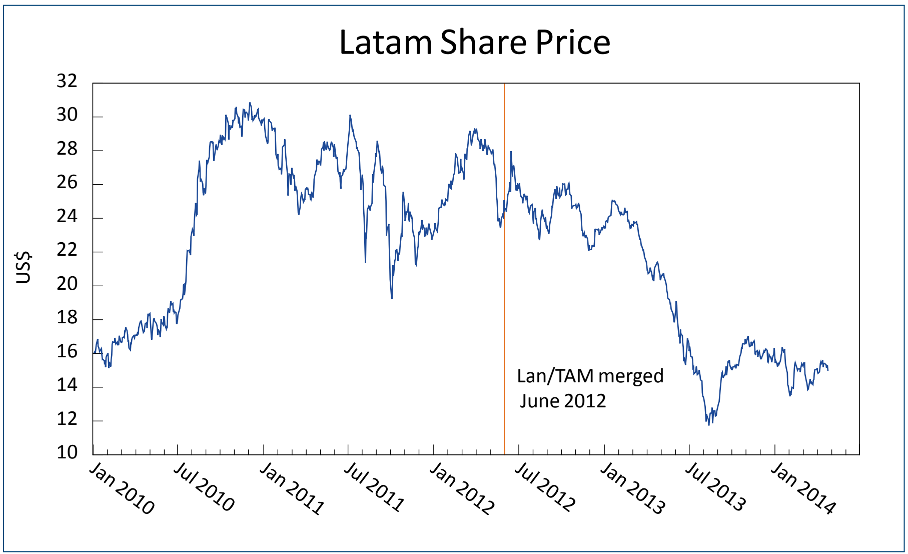
Latam reported about $300m in total merger synergies in 2013, which puts the combine on track to achieve the total targeted $600-700m annual synergies by the June 2016 target date. BofA Merrill Lynch's "conservative" March 18 forecast was $200m of revenue synergies and $143m cost savings in 2014, to be partly offset by merger-related costs of $100m. The cost synergies will come from renegotiation of fuel contracts, procurement, overhead reductions and suchlike.

That is all very impressive, considering the potential pitfalls in combining airlines from different cultures and making the complex multi-country ownership and management structures work.

Roberto Alvo, Latam's Chief Corporate Officer who spoke at a Wings Club lunch in New York in mid-April, noted that it was impossible to plan for such a "very complex endeavour". He also suggested that Latam is the only true cross-border airline merger so far and a precedent for what may come in the future.

Even though their economic interests are consolidated under Latam, LAN, TAM and their affiliates continue to operate under their own brands and identities. Alvo said that the decision on whether to adopt a single brand has not yet been made; it is a "very complicated question" because both brands are so strong.

Last year's global alliance decision was evidently a very tough one.



It meant TAM switching from Star to **one**world, which took place in March. Analysts have praised it as the correct decision, because Latam will avoid direct competition with American, which is the largest carrier on US-Latin America routes and has over 30% of the Brazil-US market.

But combining the two powerful FFPs may be impossible to accomplish. TAM's Multiplus Fidelidade is much larger than LANPASS and has been a listed company in Brazil since 2009. The airlines quickly harmonised the main features of their programmes and have just embarked on phase two of that process, but Latam executives stated in March that at this point there were no plans to integrate the Multiplus and LANPASS businesses.

There are still many processes to integrate. The management has its hands full and, despite rumours, is unlikely to be interested in any further airline investments in the short or medium term.

Balance sheet progress

In light of its substantial fleet renewal plans, Latam is keen to return to investment grade. The internal target for that is late 2015.

Last year's fourth quarter saw good progress on that front. First, Latam completed a $450m ticket securitisation. Subsequently it raised $940.5m through a rights offering, using the funds to repay short-term debt and boost cash position. The result was a significant improvement in financial ratios. Cash as a percentage of annual revenues rose to 19.3% (from 8.5% a year earlier), while adjusted net debt/EBITDAR ratio declined from 7.2x to 4.9x.

Also importantly, TAM's balance sheet exposure to the Brazilian real was cut in half during 2013, from $4bn to $2bn, and should only amount to $500m by June. This was accomplished by moving aircraft and related debt from TAM's to Latam's balance sheet, which has the US dollar as its functional currency, and by reducing TAM's debt in US dollars. Latam has also reduced its exposure to the real via forward contracts.

Fleet restructuring

The fleet restructuring aims to reduce the number of types, phase out less efficient models and better allocate aircraft to different markets. Latam will phase out five aircraft types over 30 months, many before their leases expire: its A330s (20 in the fleet at year-end 2013), A340s (6), 737-700s (5), Dash 8-Q400s (3) and Dash 8-200s (7). The 737s and the Q400s and half of the A330s have already been grounded. The cost is not yet clear as in April Latam was still in negotiations with lessors.

So Latam will focus on the A320-family in all of its domestic markets, while its long-haul fleet will consist of 767s, 777s, 787s and A350s (the latter from late 2015). Of the 32 ordered 787s, five had been delivered by year-end 2013, five more will arrive in 2014 and seven in 2015.

Latam's total fleet will decline by 13 units this year to 326 and will remain unchanged in 2015. But the turnover rate will be high: 19 deliveries and 32 exits in 2014, followed by 28 deliveries and 28 exits in 2015. Fleet capex will be $1.17bn in 2014 and $1.89bn in 2015. All new widebodies will be funded with ECA or Ex-Im guarantees, but Latam recently completed sale-leasebacks for its eight owned 777-300ERs that it wants to retire towards the end of the decade.

Brighter outlook

The consensus is that Latam has turned the corner and is enjoying strong earnings momentum – something that has created more enthusiasm for the stock, which is now typically recommended as a buy.

But Latam is not expected to return to double-digit operating margins this year or in 2015. There are still many headwinds and risks, including a weak cargo market and potential setbacks with merger integration. Latam is keeping its total capacity basically flat in both passenger and cargo operations this year.

In the short-to-medium term, there are three potential growth areas: the largest Spanish speaking domestic markets, the US routes and capturing connecting traffic because of the network and schedule enhancements resulting from merger integration and the Guarulhos hub-building.

Despite yield pressures, demand in the largest Spanish speaking domestic markets has remained strong, reflecting those countries' more robust GDP growth. The IMF is still expecting Peru's economy to expand by 5.5%, Colombia's by 4.5% and Chile's by 3.6% in 2014. Latam is planning 6-8% ASK growth in those markets this year, while keeping capacity flat in the weaker countries – Venezuela, Argentina and Ecuador. Latam is fortunate in that it has relatively modest exposure to Venezuela – less than 1% of its revenues. As of late April, it had about $140m of cash trapped in Venezuela.

Chile-US routes are expected to see increased demand, among other things, because of the recent waiving of US visa requirements for Chilean nationals.

Contrary to what one might expect, this summer's World Cup in Brazil is actually going to be a financial negative for airlines. This is because June is typically a strong month for business travel, which will be down sharply during the Cup. The airlines are scrambling to cater for what will essentially be low-yield traffic. Latam executives said that they were "working hard to neutralise the impact". Of course, as the Latam executives noted, the long-term impact of the World Cup (and the 2016 Olympics) is good because of the increase in airport capacity in Brazil.

Latam's longer-term prospects remain excellent. The combine should be uniquely well positioned in both the passenger and cargo segments to benefit from robust demand growth in Latin America, boosted by surging disposable incomes and swelling ranks of middle classes.

By Heini Nuutinen
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UK GDP and UK airport trends

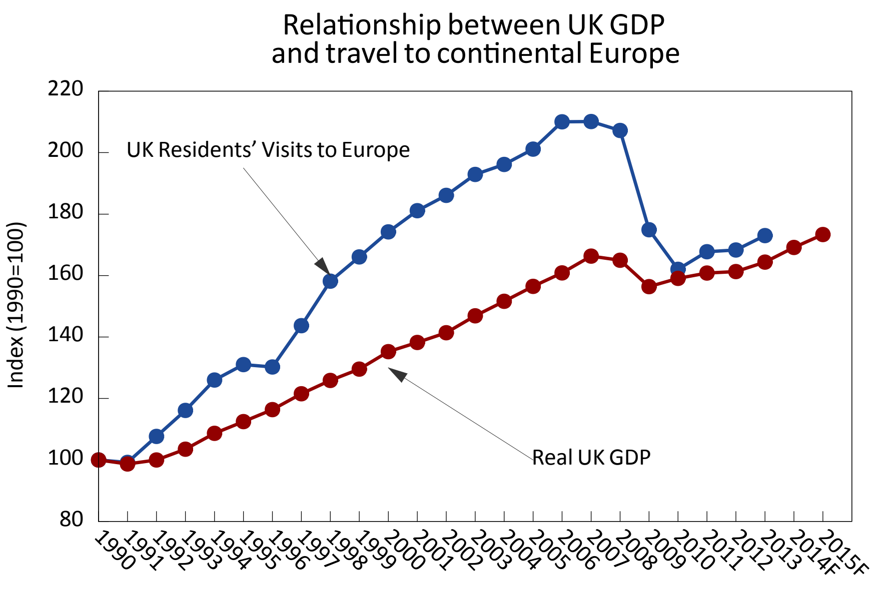
From the early 90s through to 2007 one traffic trend seemed crystal clear – UK to continental Europe leisure traffic consistently grew at 1.5 times UK GDP. Then the recession hit and UK residents visits abroad plummeted by nearly 20%, and, despite the economic recovery which started last year, there is little chance that growth will return to the former trendline.

This is bad news for the infrastructure funds that invested and traded in UK regional airports over the past two decades as they were liberated from local authority ownership. To varying degrees the long term revenue projections for these airports relied on a continuation of the pre-2007 traffic pattern. It was not simply a collapse in demand; there was also a supply-side adjustment as the LCCs, mainly Ryanair and easyJet, decided to relocate capacity to continental European bases, in part to get away from APD (Air Passenger Duty).

The six charts opposite summarise what has happened to total traffic at the main airports in the UK regions. A brief commentary:

Scottish airports as a group have seen a relatively modest traffic decline. Edinburgh, sold by BAA to the Global Infrastructure Partners (GIP)-led consortium in 2010, has performed strongly in recent years while Glasgow, still part of the BAA (or Heathrow Airport Holdings as it has tellingly rebranded itself) has languished.

Northern Irish airports have experienced the severest decline, partly because the local economy is closely tied to that of the Irish Republic and its financial disaster, partly because Ryanair quit Belfast City after a disagreement about runway extension.



Sources: UK Treasury and International Passenger Survey

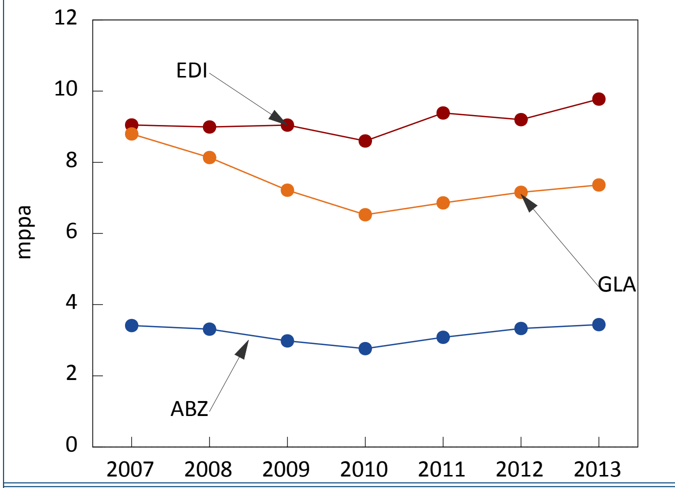
The north of England was particularly hard hit by the recession. Liverpool was in addition undermined by a change in strategy at its much larger rival Manchester, which suddenly decided actively to seek LCC business after years of concentrating on charters and hoping that it could create a northern hub once Heathrow was full. Newcastle suffered as both easyJet and Ryanair pulled back though Leeds Bradford has found some additional LCC business to supplement its core Jet2.com traffic.

East Midlands, Birmingham and Cardiff have all been affected by the demise of bmi and bmibaby. Bristol has dominated South West traffic to the extent that Cardiff has been renationalised by the Welsh authorities.

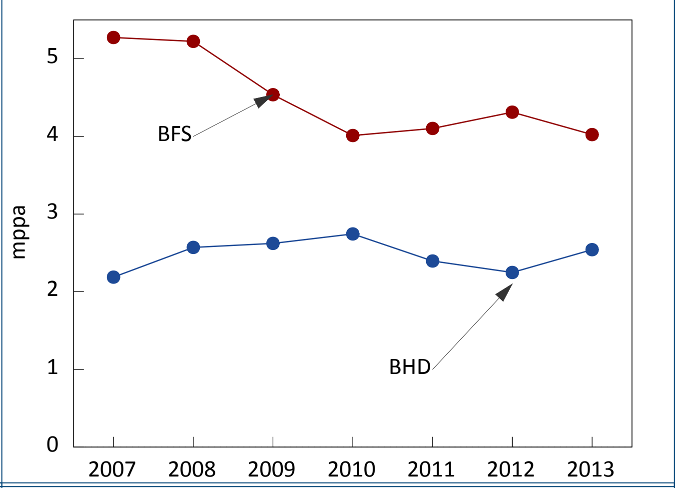
The scale on the London region chart is of a completely different order to the other regions but here too the non-hub airports have been in decline. Stansted, Ryanair's main base, has seen traffic decline by 25% since 2007, though a deal between the new owners, the Manchester Airport Group-led consortium, and Ryanair promises to restore strong growth, as does a new easyJet agreement at Luton and, perhaps, a new Flybe contract at London City. Gatwick, forcibly sold by BAA in 2009 to a GIP-led consortium, marginally bypassed its 2007 traffic throughput last year.

Finally, since 2007 Heathrow, an airport apparently operating to maximum capacity, has grown its passengers by 4.3m, while the 15 other main, uncongested UK airports have lost 10.2m.

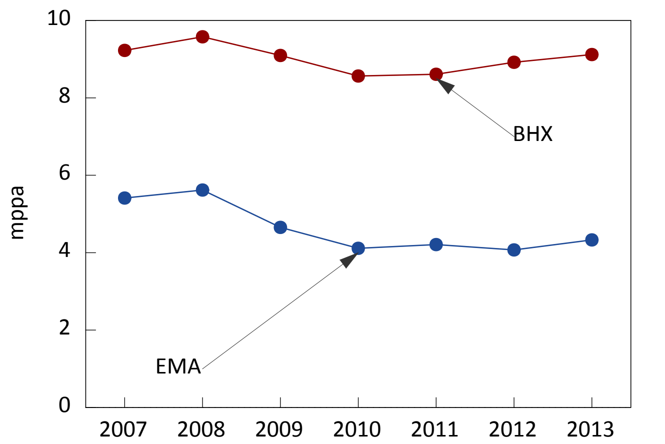
Scotland:
down 3.2%



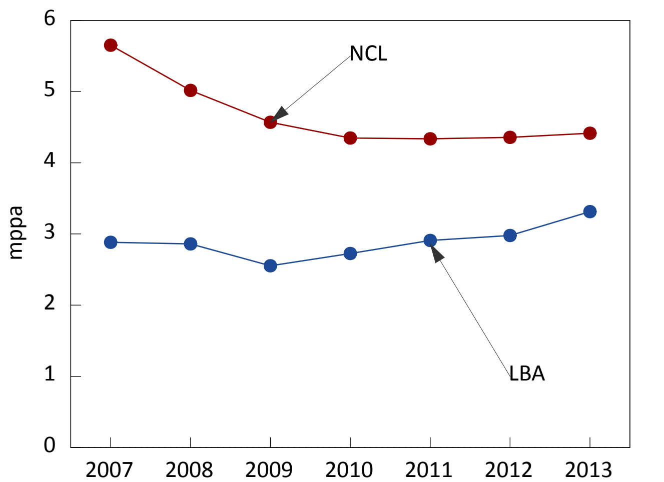
Northern Ireland:
down 12.0%



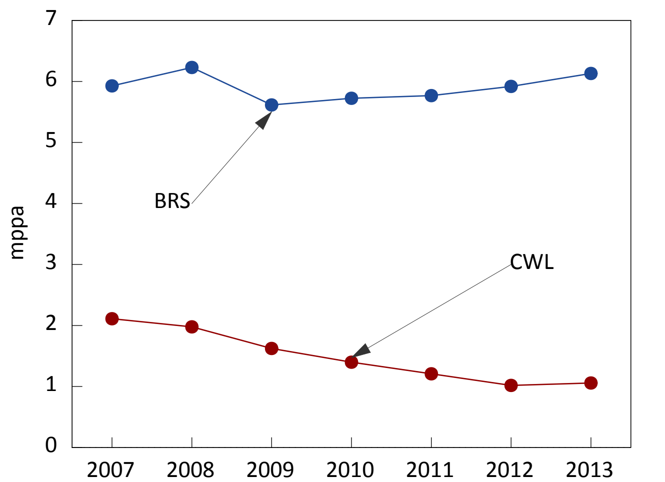
Midlands:
down 8.1%



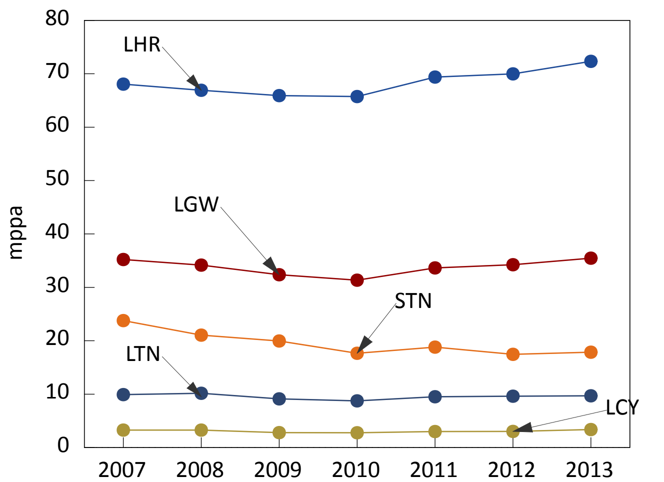
North:
down 9.4%



South West:
down 10.6%



London region:
LHR up 6.3%, others down 8.0%, total down 1.1%



Sources: UK Treasury, CAA, International Passenger Survey, anna.aero

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