Paris Air Show: Aftermath

Now that the dust has settled on the Paris Air Show and Boeing’s 787 unveiling ceremony, it is worth considering the implications of both events on the aviation world. There is no doubt that the 868 gross orders (767 net) for Boeing and Airbus combined at Le Bourget far exceeded most people’s expectations. The sales tallies would certainly persuade one that Airbus is on the road to recovery following the difficulties it has faced over the past two years.

The question on everyone’s mind relates to the timing of the next downturn. Most forecasts provided for a slight fall in aircraft orders this year compared with 2006 in what could be seen as a slippery slope towards a further fall in ’08 and ’09. However, the explosion of orders over the past month makes it almost certain that the 2006 tally of 1,874 orders will be matched or beaten. It is worth noting that a third consecutive year of around 1,500 orders represents 13-15% of the world’s total installed fleet, someway below the 1989 peak when orders represented about 20% of the world’s installed fleet at that time. The backlog at Airbus and Boeing is now likely to extend into 2011, which should equate to deliveries peaking in 2011 (assuming that orders fall in the next two years). Regardless of whether a downturn takes place, both manufacturers face differing fortunes, and their product profiles, particularly in the widebody segment, look to be on diverging paths.

2007 was billed confidently by Airbus COO John Leahy as the ‘Year of the 350’. However, despite a successful Airshow that saw key orders from Qatar Airways (which looks to have quietly hedged its bet by placing an order for 30 787s) and US Airways, many of the Airbus orders may have been induced through heavy discounting rather than a clear vote of confidence on behalf of its airline customers. 2007 has been another terrific year for the 787. During the week long media circus surrounding the roll-out of the first assembled and painted unit, 75 new orders were announced including Airbus defectors LAN and Air Berlin.

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This takes 787 orders to 235 for 2007, and the backlog to 750. And the 787 has yet to make its inaugural flight (this is expected to occur end August/early September). To put the backlog into context, the A330 has recorded about 786 orders since its inception in 1998 and the 767 has recorded 1,011 orders since United launched the programme in 1978. The 787 could conceivably attract over 1,000 orders.
orders by the time it enters service with ANA in June ‘08. At an estimated production rate of 110 per year, it will take Boeing until 2014 to clear the current backlog in the absence of a second production line. So it is very likely that Boeing will open a second line in order to help clear the huge backlog and also to free capacity for the yet to be unveiled -10 stretch version of the 787. Improved delivery slots for the aircraft could therefore be available in the 2010-2011 timeframe which would be well timed for the likes of British Airways and the US network carriers which have yet to place widebody orders (namely American, Delta and United). These four carriers alone could order close to 200 frames and tie up the second line for two years. This isn’t taking into account likely interest from Qantas for the 787-10 and a potential 100 aircraft order from Emirates.

Both Airbus and Boeing are anxious to exploit the current demand in the narrowbody segment as the A320 and B737NG are now cash cows, long ago having covered their amortised development costs. Airbus is set to increase production of the A320 family to 40 per month from its current level of 31. Both manufacturers are using narrowbody profits to fund their more capital intensive widebody programmes.

The A350 has gone through various iterations since its unveiling at Le Bourget in 2005. At the insistence of Steven Udvar-Hazy of ILFC (among others), the initial design (A350 v 1.0, essentially an A330 with new wings and engines) was replaced by a ground-up redesign that takes us to the current A350XWB (unveiled at Farnborough last year). ILFC still seems unhappy about Airbus’ reluctance to embrace the concept of an all-composite fuselage, and its order for 52 787s in June ‘08 was arguably the most significant of all the orders placed. An ILFC A350 order would have been a massive boost for the programme from a customer who orders on merit.

Boeing retains the upper hand in terms of developing a strategy to counter whatever competitive threat the A350 may pose down the road. Entry into service for the larger A350-1000 is not until 2015 at the earliest assuming the A350 programme doesn’t encounter any of the delays that hindered the A380. Once the
specifications for that aircraft are known, Boeing has a six to seven year lead time to counter with a 777 replacement (known as the ‘Y3’). The strides made in composite usage on the 787 and the new production and procurement methods will undoubtedly flow through to Y3 in addition to any as yet unknown efficiencies. Therefore, Y3 could marginalise the A350 almost as soon as it is unveiled.

Airbus also needs to keep focused on the A380, which looks set to enter service with Singapore Airlines in October. The next challenge facing the A380 will be when it goes into series production. Airbus CEO-to-be Thomas Enders told German business weekly, Focus Magazine "we can't allow to make any howlers when production is stepped up." Indeed. The A380 programme has not secured orders from any new airline customers since Kingfisher placed an order for five frames back in June 2005.

Southwest: Major remodelling or just tinkering?

This is turning out to be a difficult year for low-cost pioneer Southwest Airlines. The hitherto hugely successful carrier, which has been profitable for 34 consecutive years and recorded stellar earnings growth in 2005 and 2006, has seen its profits plummet in the past two quarters. In the three months ended June 30, Southwest's economic net income fell by 28.6% to $195m and its operating margin plunged by 4.8 points year-over-year.

Southwest has been hit by the double whammy of rising fuel costs and declining unit revenues. Its average fuel cost per gallon, including hedges, was up by 14.1% in the second quarter, while its PRASM fell by 4.8 points year-over-year.

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The airline's profits are falling mainly because its industry-leading fuel hedges are wearing off. In the wake of September 11, Southwest was the only US airline with the cash (and the foresight) to take on extensive new fuel hedges at crude oil prices in the $20s and $30s (per barrel). Those hedges paid off handsomely when oil prices subsequently surged.

Fortunately for Airbus, 92% of European airlines surveyed recently by UBS are currently in discussions to buy new aircraft within the next year compared with only 22% of U.S. respondents. Scott Carson, CEO of Boeing Commercial Airplanes (BCA), has described the current environment as an "unbelievable cycle" that defies "traditional indicators". Network carriers in Western Europe and the US had driven previous cycles but the current driver is now emerging markets carriers. In a signal that memories of the catastrophe that derailed Boeing in the late 1990s when they last increased production rates, Carson goes on to state "the worst thing we could do in this industry is dump excess capacity on the market...If we knee-jerk and move too fast (with production increases), we do real damage to the industry." Hopefully, Airbus won't make the same mistake a decade after Boeing learned its lesson.

By Robert Cullemore
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again closing in on $14, before bouncing back to the $16 range ($16.35 on July 20).

Many analysts have lost confidence in Southwest's prospects. Until a few months ago, there was a near-universal "buy" rating on the stock; now it is mostly "hold" and some "sell" recommendations. "A growth story comes to a close", noted one particularly bearish analyst in April, in reference to the diminished earnings prospects.

Southwest has faced criticism from Wall Street that its ASM growth rate is too high for the current demand conditions, which has made it difficult to raise fares to boost earnings.

Calyon Securities issued a memorable research note in early May that sounded like a direct appeal to Southwest: "Raise ticket prices... seriously". Analyst Ray Neidl argued that Southwest's resistance to fare increases, which was resulting in a low return on equity, was the key driver behind the stock's lacklustre performance over the past five years.

Southwest has long had a strategy of growing at a brisk pace - 8% annual ASM growth is the target these days - and resisting fare increases so as not to drive away traffic. The management has made it very clear that they fear any retrenchment could embolden competitors.

But this strategy, which Calyon Securities summarised as being "willing to sacrifice short-term profitability for market share and what they believe to be a long-term strategic advantage" clashes with the objectives of shareholders and analysts, who often take a relatively short-term view.

It is hard not to sympathise with Southwest: why should it forgo good growth opportunities to strengthen its strategic position when it has ample resources and a strong balance sheet to support such growth?

To add insult to injury, Southwest has had to worry that it may be underleveraged. In April there was much speculation that it might become a target for an LBO. The reason was that, technically speaking, it fit the criteria of an LBO candidate: ample cash flow and reserves, modest debt, high percentage of aircraft ownership, cheap stock and good growth opportunities.

No-one actually came forward to support the idea; the management and Wall Street were in broad agreement that piling on debt would be disastrous in a volatile industry and that an LBO would be detrimental to Southwest's unique corporate culture. However, the management has nevertheless felt it necessary to change some of their financial goals to make Southwest look less attractive as an LBO target.

First, Southwest plans to increase its debt leverage from the current 35% (lease-adjusted debt-to-capital ratio) to the 35-50% range by issuing additional debt before year-end. The current level is at a record-low, having declined steadily from about 50% nine years ago. However, the airline indicated that it is not comfortable with leverage above 50%.

Second, Southwest is continuing aggressive share repurchases. It has bought back $1.6bn of its stock since January 2006 and expects to authorise new programmes. The shares are either retired or used to fund the company's employee stock plan.

Kelly noted recently that Southwest's management has never been this busy. The executives have been scrambling to try to please everyone.

The results of some of those efforts - all aimed at improving near-term profit growth - have been outlined in recent weeks, beginning at an "Investor Day" held at the NYSE on June 27 and continuing in Southwest's second-quarter earnings conference call on July 18.

Southwest is talking about pursuing an aggressive "transformation plan" that targets $1bn-plus in incremental annual revenue by 2009 or 2010 to offset higher fuel costs and reach its financial targets. The airline is trimming capacity growth, introducing a voluntary early-out programme, making some route changes, developing ancillary revenues, revamping its fare structure and planning to expand internationally through code-sharing.

The key questions are: How much of it will be major remodelling and how much just tinkering? Is it all really necessary and helpful to Southwest's future prosperity, or is...
some of it merely aimed at pleasing analysts and shareholders?

**Still highly profitable**

In many respects, the concerns about Southwest are overblown. The airline continues to be highly profitable, with industry-leading margins. The second-quarter operating margin, at 12.7%, was still in a different league from AMR’s and Continental’s 7-8% margins. Delta came closer with 10% and Northwest is expected to do likewise. But the other US LCCs are not likely to report margins higher than 5-7% for the second quarter.

Southwest’s management is confident that, with the help of the $1bn revenue initiatives and other measures, the airline will achieve its 15% EPS growth target in 2008 and also its 15% ROIC target by 2009. In other words, 2007 could be just a small dip in an otherwise steady upward profit-growth trend.

In the past four years, Southwest’s operating margins have improved steadily from 8.8% in 2003 to 10.8% in 2006. The consensus estimates suggest that 2007 could see the margin dip to the mid-8s - not exactly a worrisome scenario - and 2008 would see a return to near-10%.

Southwest remains a low-cost producer, with industry-leading CASM (though AirTran has almost caught up) and incredible efficiency levels. Despite labour and other cost pressures, the airline has held its non-fuel CASM at around 6.5 cents for the past seven years. This has been accomplished through continued productivity improvements; for example, headcount per aircraft declined from 86 in 2003 to 68 in 2006.

Of course, Southwest still has good fuel hedges compared to the rest of the industry. A decision to add to this year’s hedge positions in the fourth and first quarters, when crude oil prices dipped briefly, is paying off handsomely now that the price again exceeds $70 per barrel. Southwest has hedges in place to cover 90% of its second-half 2007 needs at an average price of $51. It has also hedged 65% of next year’s needs at $49, 50% of 2009 needs at $51 and 15-25% of 2010-2012 needs at $63-64.

Southwest’s culture, staff morale, popularity and brand are as strong as ever. The airline has staged a very smooth and successful leadership transition since 2001, with Gary Kelly taking over from Herb Kelleher. The company has an unbeatable balance sheet and continues to pay dividends (having done so for 124 consecutive quarters).

In other words, Southwest’s operating model is obviously not broken and the company continues to present an attractive opportunity for the longer-term investor.

**Structural and other issues**

But Southwest does face some structural issues, in addition to the fuel and demand challenges. And those structural issues have worsened in recent years - essentially the reason why the airline is now taking extensive action.

Because it is based on low costs, the Southwest model is very recession resistant, always coming on its own in hard times. By contrast, the legacy model comes on its own in boom times when the emphasis shifts to revenue generation. The legacies have more fare buckets to play with and international markets to turn to when the going gets tough domestically.

However, the legacy carrier’s deep cost cuts in recent years, in or out of Chapter 11, have narrowed Southwest’s cost advantage, particularly on the labour front. Southwest now has the highest-paid pilots for narrowbody aircraft in the industry.

Although Southwest continues to have excellent labour relations, its upcoming pilot contract negotiations may be complicated by the continued weakness in the share price (some of the compensation is tied to stock performance). On the non-labour front, Southwest may simply be running out of cost-cutting options.

The other major structural change, of course, is the surge in competition, both from the revitalised legacies and LCC copycats.

Consequently, to prosper in a changing
and more competitive domestic environment, Southwest needs to make adjustments to its business model.

The remedies

Southwest, which takes great pride in the fact that it has never laid off staff or cut pay, has found a potentially very good way to tackle the labour cost challenge: a voluntary early-out programme. It has offered early-out packages, consisting of a $25,000 cash payment plus some benefits, to about 25% of its workforce - some 8,700 operational employees (excluding pilots and mechanics) who have been in their jobs for at least ten years.

The aim is not to cut the workforce but to reduce the number of highly paid workers so that they can be replaced by people on entry-level rates. It can be done without alienating labour; in fact, employees suggested it, and it was thoroughly discussed with the unions. The eligible workers have until August 10 to decide.

Southwest has also bowed to Wall Street pressure and slightly slowed its growth rate. The airline is reducing its planned ASM growth in the fourth quarter of 2007 and in 2008 from 8% to 6%. Southwest said that it was also reviewing growth plans for 2009 and 2010 but that it continued to see "tremendous long-term growth opportunities".

The ASM growth adjustment and more efficient schedules will mean Southwest taking 15 fewer aircraft in 2008 (19 rather than 34). As of July 18, the airline had agreement with Boeing to defer five 737-700 deliveries to 2013 and was exploring alternatives for the other ten 737-700s. The 15 fewer aircraft will free up $200-300m in cash to support additional share repurchases.

Southwest is also shifting capacity to more profitable markets. In the fourth quarter, it will eliminate 39 roundtrip flights, including long sectors such as Philadelphia-Los Angeles and Baltimore-Oakland, while adding 45 new flights in growth markets such as Denver and New Orleans. This is expected to boost fourth-quarter earnings by $10m.

To achieve the $1bn annual revenue improvement target, Southwest is looking to develop ancillary revenues, expand internationally through codesharing and implement measures that will help attract more business traffic.

Southwest expects to disclose details of many of those initiatives in the fourth quarter - somewhat later than had been anticipated. The early announcements are likely to include assigned seating or priority boarding for a fee. The airline is also considering in-flight offerings, such as wireless internet access, and selling travel-related products and services through its website.

Raymond James analyst Jim Parker suggested in a recent report that Southwest has enormous potential to generate incremental revenue and earnings. Ancillary revenues currently account for only 2% of its total revenues. Parker calculated, as a hypothetical example, that if 20% of Southwest’s 92m passengers in 2008 purchased an assigned seat for $10, it would generate incremental revenue of $184m. Assuming a pretax margin of 90%, there would be $103m additional net income.

Southwest's management also sees "hundreds of millions of dollars" revenue potential from expanded codesharing. The airline will have upgraded systems in place by 2009 to accommodate international ticketing. The plan is to initially expand codesharing with ATA to the Caribbean and Canada (Mexico and Hawaii are already served). Later Southwest may look for additional partners to fly from Baltimore to Europe and Asia.

Other planned initiatives include major enhancements to the fare structure and revenue management, upgrading the FFP and a new business traveller-focused ad campaign. CEO Kelly said that some of it is simply "catching up" with competitors but that there would also be innovation.

It is not clear at this point to what extent Southwest’s business model will change. Its future position will definitely be a little more upmarket, but Kelly also noted in the second-quarter call that the new initiatives would maintain the airline’s "low fare, low cost leadership".

By Heini Nuutinen
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Skybus: Will the Ryanair model work in the US?

Despite the tougher environment for low-cost carriers in the US, this summer is seeing the first significant additions to the LCC ranks since JetBlue in early 2000: Skybus Airlines, which began A319 operations out of Columbus, Ohio, on May 22; and Virgin America, which is gearing up for takeoff from its San Francisco base in August.

While Virgin America will undoubtedly have much greater initial industry impact (because it has a global brand and is heading straight for the key transcontinental markets), Skybus may contribute more to the LCC sector as a pioneer of innovative strategies. The Columbus-based new entrant is uniquely interesting for several reasons.

First, Skybus will be the first airline to test a Ryanair-style business model in the US. The model features ultra-low costs, web-only bookings, bare-bones service, $10 fares, a focus on ancillary revenues and use of secondary airports.

As an interesting twist, Skybus also wants to build a Southwest-style people-centric culture. In other words, it aims to combine the best practices of the world's most successful LCCs. It may succeed because its top management includes several former long-time Southwest and Ryanair executives.

Second, Skybus raised a record $160m in start-up capital, making it the best-financed new airline entrant in US history. Its backers include major financial institutions in New York and Boston, as well as prominent members of the Ohio financial and business community.

Third, Skybus has an unusually aggressive growth plan. The airline placed a $3bn firm order for 65 A319s in October 2006 - the largest order Airbus has received from a US start-up. Those deliveries commence in late 2008, and in the meantime Skybus is rapidly building a fleet of leased A319s.

Fourth, with all of those A319s to finance, Skybus will be an early candidate for an IPO. The current thinking at the airline is that it would go public within three years.

Skybus has had a promising start, seeing a strong response to its low fares and nonstop flights. But its longer-term prospects will depend on essentially three things: proper execution of the plan, whether the Ryanair-style fare/service concept will work on a larger scale (rather than just as a niche) in the US, and whether the Columbus market can generate enough O&D traffic.

Skybus' background

Skybus originated as Heartland Airlines, formed in 2000 by John Weikle, a 29-year veteran of the FAA who also worked at UPS and Airborne Express. The plan had been to operate 717s out of a hub at Dayton, Ohio, but Heartland never got off the ground due to September 11 and other factors.

In 2003 Weikle resurrected the venture as Skybus Airlines and switched the base to Columbus, Ohio, to take advantage of America West's decision to close a hub there that year. In 2004 he was joined by Kenneth Gile, a 25-year veteran of Southwest (most recently, director of flight operations), who assumed the position of president/COO and interim CEO. The two men began raising start-up capital and putting together a management team. Skybus applied for DOT certification in January 2005, with the aim of starting operations in early 2006.

The DOT certification process was a breeze (at least compared to Virgin America's): there were no outside objections or major issues and approval was granted in March 2006. However, Skybus wanted to raise more funds, and in the end it needed a waiver from the DOT to prevent its certificate being revoked based on the one-year dormancy rule.

Like JetBlue in New York, Skybus has enjoyed strong local support as the "hometown airline" for Columbus. Its original $3.5m seed money came from three Columbus-based entities: Huntington Bancshares (a regional bank),
Nationwide Mutual Capital (a private equity fund owned by an insurance company) and Wolfe Enterprises (a private company with interests in local media enterprises). In 2005 the three original investors contributed an additional $3.25m. Skybus also secured $57m worth of incentives from the city, state and Columbus Regional Airport Authority.

A private placement in February 2006, arranged by Morgan Stanley, raised more than $90m, giving the airline start-up funds that far exceeded the $60m required by the DOT and facilitated the Airbus order. However, to be extra safe, Skybus raised another $72.7m from institutional investors in a private placement in March 2007.

With a total of $160m in equity capital raised when it began operations, Skybus is in a strong position to grow the business and weather any setbacks. It is even better funded than JetBlue, the previous record holder, which raised $130m prior to its launch in February 2000 (or $159m adjusted for inflation).

Skybus has a nicely diffuse ownership structure: as of late March, there were 51 individuals and 32 institutions, and only one entity held more than 7% of the voting stock. The three largest shareholders were Fidelity Investments (12.6%), QVT Financial (a New York-based hedge fund, 6.7%) and Morgan Stanley (6.4%). US institutions and funds held 78.4%, non-US institutions 13.5% and individuals 8.1% of the voting shares.

The nine-member board looks exceptionally strong - a "who's who of heavy hitters", as one local business column described it. It is mostly made up of finance executives and includes several principals from the key investors. Chairman is C. Robert Kidder, principal of 3Stone Advisors (a Columbus-based private investment firm linked to Nationwide, one of the original backers) and also a board director of Morgan Stanley.

The management team is made up of individuals with the right credentials for starting an LCC - mostly seasoned airline managers, including several with long careers at Southwest or Ryanair - but who are unproven in top executive positions.

There are two ex-Southwest veterans, including president/COO Gile, to help instil a Southwest-style culture. Ex-Ryanair veteran Charles Gibson was brought in as consultant and board member to provide the "DNA of Ryanair". Gibson spent 16 years at Ryanair (1986-2002), most recently as director of ground operations, and in 2003-2004 was interim CEO of Tiger Airways, the Singapore-based LCC modelled after Ryanair.

Gibson has a small equity stake in Skybus, as does ex-Ryanair/Tiger Airways executive Declan Ryan. A couple of years ago Declan Ryan also invested in Allegiant Air, the Las Vegas-based niche LCC that has emulated Ryanair’s ancillary revenue strategy (see Aviation Strategy briefing, Jan/Feb 2007).

Skybus picked Michael Hodge of New York-based hedge fund Tiger Management (an early investor) as its CFO - a sign that it anticipates significant future capital needs to fund growth. Among other things, Hodge previously oversaw Tiger Management's Ryanair investment.


Ultra-low operating costs

Like many LCCs, Skybus plans to keep its costs low by operating an all-new single-type fleet, offering one-class no-frills service, using cheaper and less congested airports, maximising productivity and relying heavily on technology and the Internet. But Ryanair and Skybus take many of those strategies further than other LCCs in order to achieve the lowest unit costs in the industry. Skybus expects its CASM to be below Southwest's and AirTran's - currently the low-cost leaders in the US on a stage-length adjusted basis.

Skybus strives for "unprecedented efficiency and productivity". Its owned A319s will have 156 seats; this is the same as European LCC easyJet has on its A319 but 18% more than the 132 seats Frontier, the Denver-based LCC, has on its A319s in single-class operation (the typical two-class configuration on the A319 is 124 seats).

Skybus targets average daily aircraft utilis-
tion of 15 hours, which would exceed the industry-leading 13-14 hours achieved by JetBlue and Gol. The airline believes that its business model and scheduling approach make that kind of utilisation possible. For example, turnaround times are shortened by boarding and disembarking passengers on the ramp, through two doors, rather than using a single airbridge. Of course, lesser airport infrastructure requirements also mean cost savings.

Skybus designs its flight schedules so that aircraft return to Columbus at night, thereby minimising maintenance and flight crew overnight costs and providing a "quality of life" benefit to employees. Allegiant Air introduced something similar a few years ago, calling it a "cost-driven schedule". The strategy is possible because leisure travellers tend to be less concerned about departure and arrival times.

The combination of being a new airline, employing young workers and Columbus being a relatively low-cost location means that Skybus' labour costs must be among the lowest in the industry. Its pilots start at $65,000 annually - less than half of the national average pilot salary. Like Southwest, Skybus is very incentive-oriented. Its flight attendants are on relatively low wages but get commissions on in-flight sales. All of its employees have stock options.

Skybus is the first US airline to function as an e-commerce company, resulting in significant cost savings. The airline sells tickets only through its own website; like Ryanair, it has no call centres.

Skybus also benefits from extremely low airport costs, resulting from the use of small secondary airports.

A new value proposition

Skybus' product and fare strategies represent a new value proposition to US air travellers, who are used to a much more upscale product on LCCs than European travellers are seeing.

The airline does not offer connections, codeshares, FFPs, airport lounges, seat assignments or free catered items. Nor does it offer an in-flight entertainment system. US travellers have become accustomed to LiveTV or XM Satellite Radio on LCCs, but Skybus's website simply tells customers to "bring a book".

Also, Skybus' aircraft are more cramped than what US travellers are used to. The airline follows Ryanair's example and leaves out seat-back magazine pouches, which apparently adds two inches of legroom. But even then it will only have a 30-31 inch seat pitch, compared to Frontier's 33 inches (or JetBlue's 34 inches on A320s).

The basic premise is, like the Europeans who fly Ryanair, US leisure travellers will not mind the bare-bones product and service, reduced legroom and less convenient airports because they are getting what they really want: extremely low-cost, hassle-free, reliable, non-stop service on clean new aircraft.

Skybus' one-way fares range from $10 (or about $20 including taxes and fees) to last-minute fares on the longest sectors as high as $390. The airline has made a commitment to offer at least 10 seats on each flight at the $10 fare. Overall ticket prices are about half of the average cost of flying on competitors. The tickets are non-refundable; the change fee is $40.

The airline has inevitably faced criticism that the $10 fares are gimmicky, impossible to get and could be seen as a bait-and-switch. However, if the European experience is anything to go by, customers will quickly learn that to get the really low fares at peak or holiday periods or on popular routes, bookings must be made months in advance.

In early July, the website showed that the $10 fares were sold out to key long haul destinations in California and Florida through mid-December, though they could be obtained to other cities from September. (On July 11, Skybus began taking reservations for the December 16-March 6 period, thus releasing thousands more $10 fares.)

To earn customer loyalty, it is more critical for Skybus to ensure that fares in the $50-$80 range are available on a consistent basis. That appeared to be the case in early July. One-way fares on the Columbus-Los Angeles (Burbank) route in September-October were $50, $75 or $100 (depending on the date), which compared very favourably with the $99-$149 internet fares that Southwest was offering on one-stop flights via Las Vegas, Phoenix or Chicago.
Skybus wants to emulate Ryanair’s highly successful ancillary revenue strategy: maximising onboard sales, charging extra for flight-related items that were traditionally often included in the air ticket price, and selling travel-related products through its website. The basic idea is to be able to market an attractive low fare and then sell those additional services that each passenger values.

The extra charges include checked bag fees of $5 each for the first two bags and $50 for each additional bag. Passengers can board early for a $10 fee per flight. Onboard everything from food and drinks to pillows and blankets costs extra. Skybus offers a variety of dishes for $8 or $10, promising “a tasty departure from traditional airlines”.

Skybus actually prohibits passengers from bringing their own food or beverages. Ryanair appears to have given up on that policy — according to its website, “passengers are welcome to bring their own food on board” — but Ryanair only sells sandwiches and snacks.

Since some of this is totally new to US travellers, Skybus goes to extra lengths to explain it on its website. There is a section called “the Skybus rules of flying” which, fortunately, comes across as informative and entertaining, rather than cringe-inducing.

One of the most controversial aspects of Skybus is that its customer service is not reachable by phone. But that is one of the “rules” and clearly explained on the website: “Don’t call us. We don’t have a phone number. Seriously. We’d love to chat, but those phone banks are expensive. And a good website like www.skybus.com is even more convenient.”

The in-flight menu section of the web site is full of reminders of the new value proposition: “Fares from $10. Now, there’s a reason to celebrate. Pop the top on some Asti Spumante” (which also costs $10; other alcoholic drinks are $5 and soft drinks $2). Another reminder: “No, drinks aren’t free. Give us a break - some of you paid just $10 for your seat.”

The website is impressive: simple, informative and easy to navigate (Ryanair could learn from it). There are six prominent buttons: Book a flight, Avis/Budget, Hotels, Cruises, Attractions and Vacation packages; plus “Check-in now”, “View/change reservations” and “Help” buttons. The “search flights” section includes a unique monthly fare calendar, allowing customers to see at one glance which dates in any particular month have the lowest fares.

Some of the early comments on internet discussion forums indicate, as might be expected, a mixed response to Skybus’ policies. Some people feel that the airline is simply going too far, that it is taking humanity out of air travel, while others note that existing service levels are so bad anyway that doing away with them and charging less is a good idea.

Those are the seasoned travellers. But Skybus’ low fares will make regular air travel possible for a whole new segment of the population. The internet forums included a posting from a single mother in Columbus who can now, for the first time, afford to fly herself and her five kids to visit grandparents in California.

This type of business model has to be feasible in the US, where so many people have relatives and friends scattered all over the vast country.

However, Skybus may have to modify aspects of the model down the road, such as the no-phone policy. In the wake of JetBlue’s service meltdown in February and what one commentator referred to as a "trigger-happy Congress", it may not be possible to be a 100% e-commerce airline in the US.

Skybus has emulated Ryanair’s “aircraft branding” strategy, namely selling advertising space inside and outside its aircraft. Fuselage advertising is not totally new in the US - Southwest has a marketing deal with Orlando’s SeaWorld, under which one aircraft is painted like the killer whale Shamu - but Skybus is going further by actively promoting it as a revenue source. The going rate is reportedly $500,000 per year per co-branded aircraft.

The first such deal (at a special rate) was clinched with Nationwide Mutual Insurance, one of the original local backers. Under the one-year contract, Nationwide’s logo and slogan will appear on the inside and outside of one aircraft. Inside, the ads will be on tray tables, overhead bins, restroom doors and refreshment carts. The rest of the fleet will be in Skybus’ standard livery featuring an orange colour scheme similar to easyJet’s with a butterfly logo.
Ancillary revenues account for about 15% of Ryanair’s total revenues but 25% of its profits. Allegiant’s percentages are similar. Ancillary revenues are the highest-margin business; Merrill Lynch estimated in a late-2006 report on Allegiant that such activities have pretax margins in excess of 75%.

People-centric culture

Skybus said in its DOT filings that it would try to create a Southwest-style culture, which it considered critical in making the difference between a successful carrier and one with employee relations challenges. The airline probably has a better chance than most to emulate Southwest, because two of its key executives lived in that culture for many years.

But, while LCCs around the world have copied many aspects of Southwest’s business model, no-one has been able to emulate the special “Southwest spirit”. It was built and maintained with the help of a personality cult around former-CEO Herb Kelleher. It has a lot to do with going to great lengths to attract the right-quality staff, training them well, treating them well, paying good salaries, creating a fun work environment and motivating workers to outperform their counterparts at other carriers. All of that has been done consistently for over 30 years, allowing trust to build.

Consequently, Skybus’ management now puts more emphasis on developing a culture that is unique to Skybus. Among other things, it means hiring people who are competent, very enthusiastic and willing to take a chance with a new service concept.

Growth plans and prospects

Skybus plans to link Port Columbus International Airport with key business and leisure destinations throughout the country that are underserved or have only turboprop or RJ service. The airline also expects to fly to selected destinations in Canada and the Caribbean (it has applied to serve Cancun in Mexico and Nassau in the Bahamas).

There are many good market opportunities because, even though Columbus gets plenty of air service, travel to numerous cities from there involves one-stop flights via hubs such as Atlanta, Chicago and Phoenix. Most of the 12 initial routes introduced by Skybus between May 22 and the end of July did not previously have non-stop service.

The initial growth spurt has taken Skybus all around the country. Its network already includes points in the East and West coasts, the Southeast, the Midwest and the Pacific Northwest.

The airline talked about the initial destinations as falling into three types. First, there are the “primary metropolitan areas” such as Kansas City, San Diego, Fort Lauderdale, Richmond (Virginia) and Greensboro/Winston-Salem (North Carolina). Of course, none of those are congested hubs.

Second, Skybus operates to what it calls “convenient, well-known airports that are alternatives to congested gateways”. These include Burbank in the Los Angeles area and Oakland in the San Francisco Bay area.

Third, like Ryanair, Skybus is testing the alternate access point potential of various small, low-cost airports that are further away from key cities. These include Bellingham (Washington), which is located between Seattle and Vancouver; Portsmouth (New Hampshire), which is 55 miles from Boston and also convenient for Portland, Manchester and Concord; St. Augustine (Florida), which is a 30-minute drive from Jacksonville; and Chicopee (Massachusetts), which can serve the cities of Hartford and Springfield.

Southwest has shown that out-of-the-way airports can work well in the US when low fares are offered. For example, Southwest has successfully developed Manchester (New Hampshire) into a major gateway - an airport that, like Portsmouth, is 55 miles from Boston.

But Skybus is moving in unchartered territory with airports such as Chicopee and St. Augustine. Chicopee has not had regular passenger service since the 1980s, and before Skybus St. Augustine was not even certified as a commercial airport. Skybus is a dream-come-true for these airports, which have been scrambling to upgrade facilities with the help of state or local grants.

In addition to potential geographical challenges, traffic generation may be hampered...
by difficult schedules. The once-daily flights are scheduled for the convenience of Columbus-originating passengers (or crews); for example, the 19:18 hour departure time from Chicopee means that New England-originating passengers cannot connect to Florida or the West coast - they have to stay overnight in Columbus.

Like the European LCCs, Skybus offers no connecting flights "at this time" - something that facilitates tighter scheduling and helps keep costs low but will hamper traffic generation, so the policy may well be reconsidered in the future.

In the meantime, many passengers will be creating their own multi-point trips through Columbus, paying separately for each sector and moving their baggage between flights. Skybus says on its website that it does not recommend it, but in reality connecting traffic will help make marginal routes profitable.

Of course, like LCCs typically, Skybus is nimble enough to pull out of a route after a couple of months if the route is doing very badly.

Connecting traffic will grow when frequencies are increased. Most of the routes introduced so far have a daily service, though three markets (Burbank, Ft. Lauderdale and Portsmouth) have two daily flights. However, Skybus expects to eventually operate high-frequency service in many markets, because it is counting on the "Southwest effect" (of traffic multiplying in response to low fares, benefiting all carriers).

The growth plan is ambitious. Having commenced service with two aircraft (both leased from Virgin America), Skybus expects to operate eight leased A319s by year-end and 12 or 13 by the fourth quarter of 2008, when deliveries commence from Airbus. The 65 A319s to be purchased from Airbus will be delivered between late 2008 and 2012, at a rate of 13 or 14 per year.

In a 2003 study commissioned by the Columbus Regional Airport Authority, BACK Aviation Solutions concluded that the Columbus market would respond well to additional low-fare service and that Skybus’ plan presented an opportunity to leverage that potential. Skybus’ forecasts are based primarily on BACK’s estimates and use conservative assumptions (including the assumption that its low fares will be fully matched by competitors). BACK utilised a model that has successfully predicted passenger volumes for LCCs in European markets.

Columbus suffered a major blow when AWA (now US Airways) reduced its operation there from 49 daily flights (mainly RJs) to just four mainline flights in 2003. But that operation had existed only to enhance AWA’s presence in the East, and direct flights to the East Coast from Phoenix and Las Vegas had made it redundant.

After AWA, Columbus had many of the pre-requisites for successful LCC entry: limited destinations, no hometown LCC, low-fare service accounting for only 20% of total traffic, a growing metropolitan area and a large potential catchment area. The airport may draw traffic from cities such as Akron, Cincinnati and Cleveland. Columbus is the 15th largest city in the US, with a population of 1.6m, and nearly 6m people live within 100 miles.

But Columbus is not New York, Atlanta or London - huge population and business centres that have facilitated the rapid growth of JetBlue, AirTran and Ryanair. Consequently, there has been some scepticism on Wall Street about Skybus’ plans. Calyon Securities analyst Ray Neidl said recently that he found it "difficult to see how enough O&D traffic can be generated out of a city the size of Columbus". JP Morgan’s Jamie Baker noted in April (in a research note on Southwest) that "Columbus has already been proven too small to support a low-cost carrier hub, at a time when demand trends were significantly higher".

Also, there is already a fair amount of competition at Columbus - something like 12 other airlines, including Southwest, JetBlue, Delta, US Airways and American. Southwest has a not-insignificant 23% traffic share and operates nonstop from there to nine cities.

Skybus has indicated that it intends to avoid a head-on confrontation with Southwest. Also, the airline sees the possibility of opening a couple of "focus cities", where it could base several aircraft - in other words, reduce dependence on Columbus. Those would probably be wise strategies.
Despite scepticism from many in the industry, specialist all-premium airlines are carving out a niche in the lucrative transatlantic market. But can these airlines make a profit and, if they do, will their success be short-lived, given that some of Europe's majors look set to launch all-premium services of their own?

Though transatlantic business fares have slowly come down in the last decade, there's little doubt that business passengers underpin the economic return of transatlantic routes. As Andrew Lobbenberg, aviation analyst at ABN Amro points out, it's premium passengers that "really support the legacy airline profits, and that's why we are seeing all-business class start-up airlines". In this article Aviation Strategy takes a look at the key all-premium entrants: Eos, MAXjet and Silverjet on US-London routes and L'Avion, which has just launched on Newark-Paris; and also considers the response of some of the European majors.

Eos Airlines

New York-based Eos Airlines arose from Atlantic Express, a proposed low cost point-to-point transatlantic airline that David Spurlock, a former director of strategy at British Airways, planned to launch back in 2005. At that time the airline was funded with around $90m, with a majority of the carrier's equity held by three US west coast private equity firms - Golden Gate Capital, Maveron (co-founded by Howard Schultz, the chairman of Starbucks) and Sutter Hill Ventures - with the rest owned by the Spurlock family and other investors.

However, in 2005 the airline suffered a spate of managerial resignations and its launch date was postponed after a delay in receiving US FAA certification. But encouraged by the success of PrivatAir's all-premium transatlantic service run on behalf of Lufthansa, in 2005 Spurlock and the other investors decided to change strategy, and the rebranded Eos became the first all-premium transatlantic airline, launching its first service in October 2005, just two weeks before the inaugural service from rival MAXjet.

Today Eos employs around 230 staff and operates three 757-200ERs (on five-year leases from ILFC) between London Stansted and New York JFK, with a fourth aircraft being added in September that will increase frequency on the airline's sole route to 40 flights a week. Eos will receive another 757 in December and a sixth aircraft is currently being "negotiated"; these will be used not just to add frequency on Stansted-JFK but also for two new city pairs that Eos plans to launch before the end of the year.

The first new route will be between Stansted and either Chicago, Boston and Washington DC (with Chicago the most likely candidate), with a probable launch date of November. West coast US routes are not possible with 757s, so if the airline wants to extend its network westwards it will have to acquire 767s (which Eos says may be a possibility at some point).

The second route will be from JFK to a continental European destination, most likely to Italy or to Paris CDG, Frankfurt, Amsterdam or Zurich. Last year Eos said it wanted to commence flights to Paris CDG in March and Zurich in April 2007, but these ambitions have had to be postponed. Nevertheless, the longer-term plan is to add all of these US and European destinations into the Eos network, with a target of around three new destinations a year in 2008-2010. Most of this expansion will be between continental Europe and the US, rather than out of UK airports, and earlier this year Eos applied for the so-called "blanket" open skies certification, which would allow the airline to operate to each and any of the European countries that are in the new
open skies deal with the US (without the need for any other application to the US DoT).

In contrast to the lower cost (though still premium) services from its start-up rivals, Eos - named after the Greek goddess of dawn - is firmly aimed at the top end of the premium segment, with an upmarket, luxury product that more closely resembles first-class than business class. Each 757 has 48 lie-flat seats, and among the frills offered are an FFP and personal escort through fast-track check-in. The airline also tries to differentiate itself via on-time service - according to analysis of CAA statistics, the airline was the most punctual of nine scheduled airlines serving New York and London in 2006, with an average delay per flight of 18 minutes (as opposed to the 39 minutes of MAXjet).

This upmarket offering enables Eos to have average fares that - while still cheaper than those offered by BA and Virgin - are higher than its all-premium rivals MAXjet and Silverjet, with some fares starting at around £1,046 ($2,000), but more typically from around £1,499. Interestingly, to encourage trade sales Eos pays UK travel agents a hefty 10% commission on all tickets they sell.

Yet despite this price point, and while Eos says it has a considerable cost advantage over MAXjet and Silverjet as it uses 757s rather than 767s, the airline posted heavy losses in its first year of operation. According to a US DoT filing, in the first six months of 2006 Eos recorded an operating loss of $36m on revenue of $10.5m, which comes on top of a $36.9m operating loss in the six months to the end of 2005.

In October 2006 Eos closed a second tranche of funding, this time raising $75m in a round arranged by Morgan Stanley, in order to fund route and fleet expansion in 2007. Worryingly, Eos continues to reshuffle its management: after CEO and founder David Spurlock moved to become chief strategic officer in June 2006, his replacement as CEO, David Pottruck - who was previously CEO of financial services giant Charles Schwab - lasted just eight months (although he stayed on as Eos chairman) before being replaced as CEO by Jack Williams (who has 23 years’ experience with American Airlines and seven with Royal Caribbean Cruises) in February this year.

Williams wants to build up Eos into a "lifestyle brand" - i.e. position Eos even more as a first class rather than business class product. Although the airline is starting to differentiate itself via on-time service - according to analysis of CAA statistics, the airline was the most punctual of nine scheduled airlines serving New York and London in 2006, with an average delay per flight of 18 minutes (as opposed to the 39 minutes of MAXjet).

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Yet despite this price point, and while Eos says it has a considerable cost advantage over MAXjet and Silverjet as it uses
though adding an extra amount to fares) as “putting lipstick on a pig”. This was a none-too-subtle attack on Silverjet, which has declared itself carbon neutral (see page 16).

The comment may betray the growing pressure on Eos’s latest management to deliver a profitable exit opportunity to its private equity owners, who are no doubt looking for an IPO or trade sale in order to make a hefty profit on their initial investment. Williams claims that the airline is now breaking even on a per-flight basis (i.e. including flight operating costs only), and is aiming to make a net profit in 2008. But load factors are believed to be at around the 70% level, and whether Eos can raise these into the 80s in order to deliver a significant net profit and provide a basis for a successful investor exit remains to be seen.

MAXjet Airways

MAXjet Airways is based in Washington DC and launched operations on a New York JFK to London Stansted route in November 2005, just a few weeks after Eos.

Like Eos, MAXjet has also had its fair share of challenges. It was originally called SkyLink Airways and wanted to operate out of Baltimore/Washington airport both domestically and internationally as a low cost, low fare airline, and also as a charter operator. However, it changed its name in April 2005 after a legal challenge from SkyLink Aviation of Canada, and in the same month carried out a major management reshuffle when Kenneth Carlson - its co-founder and first CEO - resigned, and was replaced by Gary Rogliano.

Rising fuel costs, a delay in US FAA certification and difficulty in persuading the US DoT of its “financial fitness” forced the airline to postpone its launch date, and its proposed strategy evolved into an all-premium concept at the same time as it scaled back its initial fleet size (it had originally targeted a fleet of eight 767s by the end of 2005).

After the initial JFK-Stansted route, MAXjet added services from Stansted to Las Vegas and Washington Dulles in 2006. The non-stop Las Vegas route began in November, in direct competition with a Virgin Atlantic service from London Gatwick, but demand is strong enough (with load factors on the route around the 75% level) that MAXjet will increase frequency to four flights a week this September.

The Washington Dulles-Stansted route has been more problematical. After a series of delays it was launched in April 2006, but was unexpectedly suspended in January this year as part of a "seasonal revision", with capacity transferred to Stansted-Las Vegas until May, when the Dulles service was restarted on a four-times-a-week basis. The problem that MAXjet faces is that it is not a route with particularly high demand, with less than 1m passengers a year from London - and many of those are US federal employees, who are mandated to travel on US airlines that the government has block deals with.

MAXjet's three routes are served with a fleet of four 767-200ERs and a single 767-200 (all of which are leased), with the last two 767-200ERs being added in June and July of this year.

MAXjet defines its market as price-sensitive business customers - often employees of small companies that cannot get corporate discounts (large corporates can get anything up to a 50% discount on fares); standard business travellers at corporates, and affluent leisure travellers who want to experience business class product.

They are served with a 102-seat configuration on the 767s, but crucially MAXjet decided not to equip its aircraft with lie-flat seats, and instead uses standard business seats that recline to "only" 160°. In relative terms (for an all-premium service provider) it is "low-cost" in other areas as well - for example, 85% of tickets are sold via the internet and call centres, with just 15% through travel agents.

MAXjet positions itself as offering the cheapest business class fares across the Atlantic, at a price point that is less than Silverjet and considerably less than Eos. In February it announced a major fare sale, with transatlantic fares as low as £299 one way, including taxes and fees, and MAXjet says that at these prices it attracts leisure passengers that are willing to try business
class for the same cost as they would pay for a flexible economy fare on a major airline. Strategically, MAXjet is different from competitors in that it has decided to expand its network rather than primarily build up frequency on its core New York to London route. Now that the two latest aircraft have arrived, a four-times-a-week Stansted-Los Angeles route will be launched in August, which will compete against services out of Heathrow from BA, Virgin, American and United, while a fifth route may be launched either to Florida or the US west coast. MAXjet believes the longer range of the 767-200ER gives it a marked advantage over Eos, and other west coast destinations such as San Francisco are under consideration.

The airline aims to add a sixth 767 in the second half of this year and a seventh in early 2008, and it is likely that these aircraft will be used for expansion on routes to the Middle East, Africa and Asia, which is possible now that the open skies deal allows on-flight rights from the UK to non-EU countries, providing permission is given by that third country. In effect this will turn Stansted into a mini-hub operation for MAXjet, and to facilitate this the airline is reportedly considering moving its base over to Stansted from the US.

However, this expansion will be expensive, and Jarions Investors, its original 100% owner, has already seen mounting losses. Despite carrying more than 75,000 passengers in the period from November 2005 to December 2006, MAXjet made a net loss of $80m for 2006, which came on top of a net loss of $30m in 2005. Revenue grew from $2.3m in 2005 to $41m in 2006, its first full year of operation, but the operating loss increased from $28m in 2005 to $73m in 2006.

MAXjet too has been reshuffling its management, including the appointment of William Stockbridge - who has been at MAXjet since it was founded, and was previously CEO of a cargo company - as CEO in November 2006 (moving over from chairman, and replacing Gary Rogliano). In April this year Richard Sharp was replaced as chairman after five months by Kenneth Woolley (the majority investor in the airline; and who was also an early investor in JetBlue) while John Severson, previously with Spirit Airlines and Jet USA, was made CFO.

There has been unconfirmed speculation that Jarions is looking for an exit, though this is denied by the airline, and last summer there were reports that Indian airline Kingfisher wanted to buy MAXjet (in order to get past Indian government restrictions on international competition - see Aviation Strategy, June 2007), but again this was denied by the US airline. Yet in 2006 the airline also denied reports that MAXjet wanted to float on the Alternative Investment Market (AIM), the junior market of the London Stock Exchange - but that is exactly what it has just done this year.

In early June MAXjet raised £47.3m (net of £3m of fees and costs) from institutional investors through a placing of 36.6m shares at £1.38 arranged by Panmure Gordon. This represents 53.6% of the enlarged equity, and values the airline at £96m. AIM trading started on 14 June, but the share price fell immediately, and stood at £1.29 as at mid-July.

The money raised will be used to fund both fleet and route expansion, as well as for retiring debt, but it is too early to make a call on whether this fundraising will be enough to see the airline through into profit, given increasing competition. Load factor in May was 74.9%, which Stockbridge says is ahead of estimates, but the airline is still not believed to be breaking even.

Silverjet

Silverjet is based at London Luton airport and launched its first flight, on Luton-Newark, in January this year. The airline
was founded by the entrepreneur and Silverjet's new CEO Lawrence Hunt, who spent two years researching what budget-conscious business passengers want from a transatlantic service before setting up the company last year. In a pre-launch IPO on AIM in London in May last year, Silverjet raised a total of £25.3m ($48.6m), net of costs and fees. The float valued the airline at £33.6m, with 81% of the airline held by institutional investors and 19% by the airline's directors (including Silverjet chairman Peter Owen, previously CEO of Aer Lingus).

In October last year, Silverjet made the tactical purchase of Gatwick-based charter carrier Flyjet and its associated lessor Skylease for a price of between £4m and £5.5m, depending on certain conditions and targets being reached (and payable in stages up to 2009). Launched in 2003, Flyjet operates charters out of Gatwick and Manchester to holiday destinations around the world, and although Flyjet did have plans to launch a low cost, low fare service on Newark-Luton, the acquisition was made primarily to give Silverjet an air operator's certificate (AOC), although it also benefited from charter flight revenue and the acquisition of some key staff. Skylease was a means to acquire Silverjet's initial aircraft, a 767-200ER that Skylease leases "at a rental which represents a significant discount to current market rates". Skylease also leases two 757s, though these are currently charted to European tour operators until October of this year.

Prior to the Skylease deal, last year Silverjet signed a letter of intent to acquire two 767-200ERs from Thomsonfly, with the first aircraft delivered this April and the second due to be delivered in October. They are costing Silverjet $14.1m each, and are being financed via a sale and leaseback deal with Novus Capital. After refitting, the first aircraft began operations in July, being used for a second daily frequency on the Luton-Newark route, and when the next one arrives it will enable a third frequency or potentially a second US destination; in May Silverjet applied for permission from the US DoT to start a Luton-Chicago route in November.

This June Silverjet also signed an LoI to receive another pair of ex-Thomsonfly 767-200ERs, in March of 2008, and in the medium-term the airline wants to launch at least three further routes by 2009, operated with a fleet of up to 10 aircraft. The airline currently employs just over 150, and this will double by the end of 2007.

However, Silverjet also has ambitions to expand considerably in the longer term, and Hunt says that the airline has identified more than 30 routes that it would like to serve out of Luton, with plans to grow the fleet to 40 aircraft inside a decade. Linked to these ambitions, Silverjet is reportedly considering a move to Heathrow when the new Open Skies deal kicks in, though it would be faced with the normal problem of finding slots there, and operations are likely to remain at Luton in the medium-term.

In the US, other potential destinations include Boston, Miami and San Francisco, but long-term Silverjet is looking to expand to non-US destinations, with South Africa a possibility as well as Asian destinations such as China (Beijing, Shanghai and Hong Kong) and India (Mumbai and Delhi). Although these cities are reachable with 767s, the airline is contemplating acquiring A350 or 787 equipment for the operation of these routes, and if the airline went down this strategic path it would switch all its fleet over to A350s or 787s, as it says that it will always operate a single model policy. However, these non-US routes are unlikely to be launched before 2012, although the airline is believed to be talking with prospective airline partners in these countries already, based on partnerships with local
airlines that can link up their domestic networks with long-haul flights from Silverjet.

Silverjet's focus is very much on delivering a premium service at the lowest possible cost, making it "difficult for the legacy carriers to compete", according to Hunt. It offers 100 lie-flat seats on its aircraft (which costs £1.9m per 767 to equip), as well as women-only toilets and no overhead lights (which it says bother sleeping passengers). The airline says a major point of differentiation with its competitors at Stansted is that it has copied the separate check-in and security facilities enjoyed by private jet passengers. At Luton it has secured a dedicated terminal (through the 10,000 square feet of Luton's original terminal building) that can handle up to 200 passengers at the same time, while it has contracted with Newark airport for a similar "private area" there.

Similar to MAXjet, Silverjet is targeting corporate executives, upmarket leisure travellers and employees at small and medium-sized businesses. The vast majority of Silverjet's business is believed to be in the latter two categories, although the airline has initially been hampered by its lack of deals with travel management companies (TMC), with whom small and medium businesses traditionally arrange their corporate travel. Since the start of the year the airline has prioritised this area, and has now signed a series of deals with most of the leading TMCs. Silverjet had also been affected by not being live on the main global distribution systems (Amadeus, Galileo, Worldspan and Sabre) until this Spring, which is believed to have hit trade sales in the first few months of 2007 (as the lack of GDS access forces agents to use the airline's website, which they are traditionally reluctant to do).

Silverjet does not operate a FFP and says it has no plans to introduce one as it will merely increase costs. However, this does not preclude future partnerships with other airlines, and sources suggest that informal discussions have been held with easyJet, which has a large presence at Luton. Silverjet has also linked up with a company called CarbonNeutral for a carbon offsetting scheme (with a mandatory offset contribution included in on all fares) that Silverjet claims makes it the first airline to be carbon neutral on all flights.

Other cost-saving initiatives include an unusual "profit share" deal with Talk PR, its public relations agency, which is based on a low monthly retainer fee. However, Silverjet is believed to have a more conventional contract with its blue chip advertising agency, M&C Saatchi, which is running a campaign targeting the SME sector.

Like its rivals, Silverjet has faced losses in its initial operations. It recorded a pre-launch operating loss of £1.5m and net loss of £1.1m in the six-month period to the end of September 2006, and since the IPO says it has faced $11.6m of "unforeseen" expenditure, including the costs of fitting out the Luton terminal and its private lounge at Newark; the acquisition of Flyjet and Skylease; down payments on extra aircraft and an increase in its capital adequacy deposit with the UK CAA (which Silverjet says is due to higher-than-anticipated levels of business).

After originally saying that the £25m raised in 2006 would be enough to take the airline through to break-even, in April Silverjet unexpectedly went back to the market. A placement with institutional and existing investors arranged by Arden Partners and Kaupthing Capital of 14.4m shares (representing 32.5% of the enlarged equity) at a price of £1.80 raised a total of £25.9m, or £24.6m after financing costs and fees. This sum will pay the unexpected costs already incurred and enable other new expenditure (such as increasing the number of cabin crew per flight) and an acceleration of expansion plans.

The airline says it needs just 20,000 passengers each year (less than 0.5% of the total New York-London business market) to break even. According to its calculations, break-even load factor is 65%, with the fully loaded costs of a return Luton-New York flight being £65,000 (of which £24,000 is for fuel), all based on an average return fare of £999. At an 80% load factor, this would mean an annual profit of £5.2m per aircraft.

Silverjet says its average fare has actually crept up from £999 to £1,050, but load
factor on Newark-Luton in May was only 62.6% - which is not quite the "resounding success" that the airline claims it to be, although figures just released reveal a load factor of 70% for June.

Despite two major rounds of financing, there is believed to be some unease among some of the original Silverjet investors. The airline floated in May 2006 at a price of £1.12 per share, but this fell to £1.01 in September (see chart, page 17) before a steady rise to £2.09 in March 2007, before falling back yet again. Some of the IPO investors, such as the GAM Star investment fund (which bought 6.6% of the company at the float) and the Rathbone Special Situations fund (which bought 5.3%), are believed to have taken profits as the price rose after the IPO, but with the share price currently at £1.56 as at mid-July - i.e. well below the offer price of the recent placement - concern may be growing. In late June a UK newspaper reported that Goldman Sachs had approached Silverjet about a possible investment, but the talks were apparently unsuccessful.

However, Hunt (who owns 8.99% of the airline after the April placement) is bullish about the prospects for Silverjet, and is aiming for turnover of around £38m-£40m in 2007/08, with a small profit.

**L'Avion**

The latest addition to the all-premium transatlantic sector is L'Avion, which began as a concept back in 2002 but was formally launched as Elysair in July 2006 by Société de Participation Aérienne (SPA) with start-up capital of €25m ($32m). SPA is owned by a number of investment companies and individuals, one of which is CEO Marc Rochet (who owns 6.5%), with Christophe Bejach, Elysair chairman, controlling another 5%.

Rochet was previously CEO at AOM-Air Liberté, but became chief executive and president of Elysair in late 2006, where he was faced with a series of problems. Most seriously, Elysair faced a battle to secure sufficient slots at Orly to launch a transatlantic service, as its application to COHOR, the French slot co-ordinator, faced resistance from US airlines, in particular Continental. The US airline pointed out that it and other US carriers had been forced by the French government to move operations from Orly to CDG in the 1990s and that it had since been banned from restarting services out of Orly. Continental therefore objected formally to Elysair's proposed route to Newark (which is a hub for Continental), but COHOR eventually granted the airline more than 600 slots at Orly, which was enough for the French airline to launch its service.

In January this year the airline was rebranded as L'Avion (although Elysair has been retained as the name for the airline's holding company) and launched its inaugural route under the L'Avion brand between Paris Orly and Newark on a 12-flights-a-week basis (compared with 98 flights a week on the sector from Air France). Based in Orly, L'Avion operates a single 757-200, a 15 year-old aircraft leased from GOAL (German Operating Aircraft Leasing) and fitted with 90 seats that have a 140° recline. L'Avion has around 60 employees and offers return fares from €1,599 ($2,130), which the airline claims is 50% less than competitors' fares, and it is targeting 28,000 passengers in its first year of operation. It will add another leased 757-200 at the end of October, initially to be used on boosting frequency on the existing route. However, L'Avion wants to add a second US destination to its network, and the French airline...
has already formally applied to the US DoT for permission to fly a route to/from Boston. L’Avion says that a third, non-US route will be added in 2008, with destinations in east Europe and the Middle East under consideration.

L’Avion’s tickets are distributed via the internet and French travel agents, and the airline plans to break-even by the middle of 2008, for which it says it needs a 70%-75% load factor. Yet if Virgin and/or BA start operating all-premium services out of Paris in 2008 (see below), the airline might struggle to achieve this, and according to unconfirmed reports some of its flights out of Paris have had only a handful of fare-paying passengers. L’Avion denies this, and says that in the first six months of operation it “exceeded projections”, with a 78% load factor in June.

The incumbents respond

Though there have been tentative attempts in the last couple of years to set up premium transatlantic airlines (for example Blue Fox Executive Airlines on Stansted-JFK and Fly First on Luton-Newark, neither of which made it past the planning stage), the challenge this time around to the European (and US) majors from the new breed of all-premium airlines is more serious.

Together, Eos, Silverjet and MAXjet offer 70 flights a week on London-New York, compared with the more than 400 flights a week that other airlines on the sector offer (see table, page 19). These services compete for between 4m and 4.2m passengers a year that travel on New York-London routes, of which around 30% are business and first-class passengers. However, in the other 70% of economy passengers around 0.6m leisure passengers pay more than £500 per return flight, and these are also a target for the all-premium airlines, thus giving a total “premium market” of around 1.8m a year.

Chris Avery, aviation analyst at JP Morgan, estimates that the three all-premium airlines have already won a 17% share of the transatlantic premium market, and other analysts believe that the specialist premium airline could take as much as 20% to 25% of the transatlantic premium market.

Irrespective of whether the start-up airlines are making a profit, as long as they are carrying passengers that would otherwise travel on BA, Virgin and the other major airlines that operate out of London Heathrow and Gatwick, they are at the very least an irritation to these majors. The larger airlines point out that the start-ups have little or no back-up aircraft if there are technical problems, a restricted timetable and poor connections compared with Heathrow and Gatwick, but that hasn’t stopped these new airlines gaining a small but growing following among some executives and leisure travellers. And while Luton and Stansted are not as central as Heathrow, they are not as busy either, thereby allowing quicker passenger processing times and enabling less chance of flight delays. Undoubtedly the new airlines are also benefiting from being at the top of the aviation cycle, as well as from softening fuel prices, but they simply could not establish themselves unless there was a latent customer demand that BA, Virgin and others are not meeting.

This leaves the majors in a dilemma. They are loathe to publicly acknowledge the effect that the start-ups have had on their transatlantic business, but passengers are leaking away, as most (though not all) of Eos, MAXjet and Silverjet’s customers previously travelled with one of the four Bermuda II designated airlines allowed into Heathrow.

BA faces a serious challenge, as it is so dependent on premium traffic on New York-London for the majority of its profits. Executives at all three start-ups on London-New York routes barely contain their glee at the continuing bad publicity that BA and Heathrow somehow manage to generate, which provides a steady stream of disgruntled BA passengers prepared to try alternatives. BA, naturally, is very reluctant to drop transatlantic business fares, also it has been increasing the number of premium seats on its transatlantic services and is currently spending £100m in upgrading its premium classes with wider beds and sliding
privacy screens.

In May, BA applied to US regulators for permission to offer all-premium services (with either one or two classes) next year between "key European business cities" and the US, which it said would allow it to grow "the most profitable part" of its business - i.e. its premium passengers. BA is believed to be looking at using 757s or 767s, potentially in a two-class configuration, although this service will not be extended into Heathrow flights in the short- and medium-term, as this would obviously cannibalise existing premium revenue.

Meanwhile Virgin Atlantic is spending $23.5m on refurbishing its premium economy product, and in June unveiled plans for an all-business airline that it wants to launch before the end of 2008 at the very latest, operating between London and major European cities to key US destinations. The airline will specifically target the market developed by Eos, MAXjet and Silverjet, and is likely to be launched out of continental Europe first before expansion into the London market, although Virgin has not yet revealed which London airport the airline will operate out of.

However, some analysts are sceptical as to whether an all-premium Virgin airline will ever operate out of London, as again it would cannibalise existing revenue. Richard Branson claims that the airline has had plans for such an airline for a decade, and that as it will be a "hybrid carrier" it will not compete with Virgin Atlantic. But unless Virgin Atlantic and the new airline operate on different route networks, that will be impossible to avoid.

The new airline will probably use some derivation of the Virgin Atlantic brand and be part of the existing FFP, according to Virgin sources, and will operate a fleet of up to 15 narrowbody aircraft. These are likely to be new additions to the Virgin Atlantic fleet, and Virgin is currently negotiating with Airbus and Boeing, although the all-premium airline may also use some of the 15 787s ordered by Virgin Atlantic in April.

Paris, Milan, Madrid, Frankfurt and Zurich are likely to be among the cities linked on the European side, with routes initially going into New York before other US cities are added. It's likely that Virgin's all-premium flights will connect with Virgin America's domestic network, which given the inability of the EU to win rights for European airlines to fly intra-US sectors, may prove very attractive to UK and European business travellers.

Other European majors are expected to follow BA and Virgin's example in setting up all-premium services, although some of them may prefer to go down the outsourcing route, as currently practised by Swiss, Lufthansa and KLM, all of which contract Swiss VIP charter airline PrivatAir to operate all-premium services on their behalf. PrivatAir was founded in 1977 and operates a fleet of A319s, 737s, 757s and 767s for private VIP operations as well as transatlantic all-premium services for third parties. These include Lufthansa (since 2003, using 44-seat or 48-seat A319LRs and BBJs on three routes - Dusseldorf to Newark and Chicago, and Munich-Newark, although the latter service will operate out of Frankfurt from October), Swiss (since 2005, between Zurich and Newark, using a BBJ), and KLM (since 2005, using a BBJ between Amsterdam and Houston).
## Aviation Strategy

### Databases

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<th>Group</th>
<th>Year</th>
<th>Revenue US$m</th>
<th>Costs US$m</th>
<th>Oper. Profit US$m</th>
<th>Net Profit US$m</th>
<th>Total ASK m</th>
<th>Total RPK m</th>
<th>Load Factor</th>
<th>Total Pax. 000s</th>
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**Note:** Annual figures may not add up to sum of interim results due to adjustments and consolidation. 1 ASM = 1.6093 ASK
### EUROPEAN SCHEDULED TRAFFIC

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#### JET ORDERS

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<td>Lion Air</td>
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**Note:** Only firm orders from identifiable airlines/lessors are included. | Source: Manufacturers
The Principals and Associates of Aviation Economics apply a problem-solving, creative and pragmatic approach to commercial aviation projects.

Our expertise is in strategic and financial consulting in Europe, the Americas, Asia, Africa and the Middle East, covering:

- Start-up business plans
- Turnaround strategies
- State aid applications
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