



# The airspace race

In the third of a series of aviation sector updates, BTG Global Advisory looks at key trends that have boosted the industry and helped low-cost carriers thrive, including lower oil prices, fuller planes, and record numbers of tourists.

## Global and UK Aviation

Despite high-profile tragedies, 2014 was a strong year for commercial aviation and tourism and airlines recorded increases in passenger traffic and financial earnings. The World Tourism Organization (UNWTO), a United Nations agency, reported the number of 'overnight visitor' international tourists reached 1.1 billion in 2014, an increase of 51 million (4.7%) over 2013. Europe was the most visited region in the world, with 588 million tourists, a 4% increase. UNWTO put such trends in perspective: "Thanks to these results, tourism has been a major contributor to the European economic recovery."

As for the UK, UNWTO's detailed statistics for 2013 showed modest growth in tourism, but the UK is being passed by other countries posting more vigorous growth. The UK still ranked eighth with 31.2 million international tourist arrivals (+6.4%), but fell to ninth with \$40.6bn tourism receipts. Furthermore, the UK ranked fifth in international tourism expenditures (\$53bn), falling from fourth place.

The International Civil Aviation Organization (ICAO), also chartered by the United Nations, reported flight departures worldwide reached 33 million last year, a new record. Passenger traffic grew by about 5.9% in 2014. ICAO noted the Asia/Pacific region was the world's largest air travel market with 31% of revenue passenger kilometres, followed by Europe (27%), North America (25%), the Middle East (9%), Latin America/Caribbean (5.9%), and Africa (1.5%).

The data provides additional insights into European aviation. According to ICAO, Europe's 38% share of international passenger traffic topped all other regions, easily outpacing Asia/Pacific at 27%. Conversely, Europe's 9% share of domestic passenger traffic ranked well behind North America (44%) and Asia/Pacific (38%).

In October 2014, the International Air Transport Association (IATA) published a growth forecast. Between 2014 and 2034, IATA predicts that US and China will remain the two dominant airline markets, but will switch places in 2030. The UK, currently ranked third with 189 million passengers annually, will grow to 337 million by 2034, yet still fall behind India, currently ranked ninth.

In fact, among the world's six major regions, IATA estimates Europe will have the slowest annual growth rate, at 3.3%.

In other news, OAG declared Bristol was the world's most punctual airport during 2014, boasting an on-time record of 94.4%. And Skytrax World Airline Awards declared the Best Airline in Europe in 2014 was Turkish Airways; British Airways ranked fourth and Virgin Atlantic ranked ninth.

## Financial Outlook

In December 2014, IATA predicted improved industry profitability, citing lower oil prices and stronger worldwide GDP. IATA anticipates a global net profit of \$19.9bn for 2014, and \$25bn in 2015.

As for Europe, IATA estimates airlines will "continue to struggle" compared with other regions worldwide, noting that European airlines are hampered by "high regulatory costs, infrastructure inefficiency, and onerous taxation". IATA stated: "Net profits of \$4bn next year (up from \$2.7bn in 2014) represent only \$4.27 per passenger and a net profit margin of 1.8%."

## Fuel Costs

IATA specifically cited substantially falling oil prices as the most important factor in the industry's economic revival, and stated that lower oil prices are "expected to continue into 2015". This would mark the first time the average oil price has fallen below \$100/barrel since 2010. As for jet fuel, IATA estimates it to be 26% of total industry costs.

## Distressed Carriers

While many airlines worldwide were successful in 2014, others encountered extreme difficulties. These are three severe cases:

**Cyprus Airways:** In January 2015, the company announced the suspension of all operations after 68 years of service. This followed a lengthy investigation by the European Commission, which found a restructuring aid package of over €100m by Cyprus violated EU state aid rules and gave the airline "an undue advantage".

When the Commission ordered Cyprus Airways to pay back the aid, the company shut down.

**Malaysia Airlines:** It's safe to say no airline ever endured a year quite like Malaysia did in 2014. The complete disappearance of Flight 370 in March was compounded by the shooting down of Flight 17 in July, with a combined 537 people lost. These extraordinary events led to a dramatic drop in bookings and an increase in resignations. In August 2014, Khazanah Nasional Berhad – the majority owner and an arm of the state – announced a 12-point 'recovery plan' aimed at a return to profitability by 2017.

**Indonesia AirAsia:** After the tragic loss of Flight 8501 in December 2014, regulatory licences for two routes were suspended, but the carrier continues to operate. (Up until 2010 AirAsia and other Indonesian airlines were banned from flying within the European Union due to safety violations.) That said, Indonesia AirAsia is an affiliate of Malaysia's AirAsia, one of the most successful LCCs globally, with the world's lowest unit cost (\$0.023/available seat km). Analysts anticipate Indonesia AirAsia will recover from the Flight 8501 debacle.

## Ryanair and Low-cost Carriers Surge

A dramatic development in European aviation has been the growth – and sustainability – of low-cost carriers. LCCs have remade the face of the industry by spurring competition, lowering average airfares and enticing more passengers to fly.

As the European Commission noted: "In 2011, LCCs achieved a market share of 42.4% and thus exceeded the market share of incumbent air carriers (42.2%) for the first time." This trend has continued. In 2012, LCCs achieved 44.8% market share vs. 42.4%, and in 2013 the LCC advantage increased to 45.9% vs. 40.4%.

In mid-2014, the European Low Fares Airline Association (ELFAA) noted its members carried 7.9% more passengers than one year earlier. ELFAA stated: "These figures are extremely heartening and show that low fares airlines are best placed to offer passengers reliable and affordable travel."

No single LCC has had a greater impact than Ryanair. In January 2015, the Irish airline celebrated its 30th anniversary on a high note, predicting profits of €840m to €850m for the year. Ryanair carried more than 86 million passengers last year, and claims it saved them "over €10.1bn".

## Passenger Load Factors

One key reason for stronger earnings was airplanes flying fuller. According to the Association of European Airlines, members posted an all-time record high load factor of 81% in 2014; AEA noted it was "thanks to the commercial strategies of the airlines and better aircraft utilisation".

Statistics provided by ICAO underscore just how crowded European flights have become, with an estimated load factor of 80.4% for the Europe region in 2014. This was second only to North America's record-breaking 83.5% mark, the highest since US airlines were troop carriers during World War II.

## Ancillary Revenue

European airlines continue to experience tremendous growth through 'ancillary revenue', primarily fees for checked baggage, onboard amenities, and other services. IdeaWorksCompany proclaimed in mid-2014 that ancillary revenue grew by 1,200% just since 2007.

Among 59 carriers worldwide, US-based Spirit posted the highest ancillary revenue as a percentage of total revenue in 2013, at 38.4%. However, the top ten included four European LCCs: Wizz Air, 34.9% (#2); Jet2, 27.7% (#4); Ryanair, 24.8% (#5); and Jetstar, 20.6% (#7). Jet2 generated higher revenue per passenger – €41.05 – than any airline worldwide. Ryanair ranked fourth as 'Top Revenue Innovation Champ for 2014'.

## Big Picture Factors

In 2014, several key developments arose, including some the airlines welcomed, and some they did not.

### *EC Regulation 261*

The EU's Air Passenger Rights Regulation 261, in force since 2005, provides assistance and compensation for passengers denied boarding or during lengthy delays or cancellations. In December 2014, the Commission updated a proposal to clarify and expand "key aspects" of EU law, referencing a survey from the UK citing passenger frustration with implementation of Regulation 261. However, the Association of European Airlines requested Parliament modify the rules, calling for "a list of Extraordinary Circumstances which is appropriate and flexible".

Meanwhile, the judiciary clarified key provisions. In June 2014, the Court of Appeal ruled in favour of a passenger in Huzar vs. Jet2. The ruling established that technical issues on aircraft are not 'extraordinary circumstances'. An appeal by Jet2 and Thomson Airways was rejected by the Supreme Court in October 2014. Jet2's defenders claimed this ruling ultimately will lead to higher fares for passengers. And the British Air Transport Association called the Supreme Court's decision "both surprising and disappointing".

Concurrently, the Dutch carrier KLM is fighting the technical claim issue in Holland. The financial stakes are quite high, since analysts estimate airlines could pay £3.89bn for cases dating back six years. Yet a survey conducted by *Which?* Travel in December 2014 found only 38% of passengers claimed compensation for flight delays.

### *Air Passenger Duty*

In December 2014, the Chancellor announced a major revision to Air Passenger Duty (APD) and effective from 1 May 2015, children under 12 will be exempt, as will children under 16 on 1 March 2016. The tax will remain in force for travellers over 16.

The travel industry cheered the news. The Association of British Travel Agents welcomed the abolition of a "blunt and harmful tax". But the British Air Transport Association added:

"It also makes no sense for the UK to still have the highest tax on flying in the world".

But not all airlines view APD equally. In March 2014, Ryanair CEO Michael O'Leary said that "the principle" was wrong, saying: "It should be in proportion to fares. Passengers on BA would pay much more, Ryanair passengers would pay much less."

### *Airport Issues*

As international air travel booms, Heathrow Airport – and the UK itself – fights to remain as the world's leading global aviation gateway. The problem of congestion has spurred multiple proposals.

Heathrow still has influential backers eager to see LHR's expansion; authorities contend it could serve 40 new destinations with the construction of a third runway. In a report issued in September 2014, the Confederation of British Industry threw support behind expansion, saying that Heathrow acts "as a catalyst for new routes".

But many lobby for a fourth airport. Boris Johnson, Mayor of London, wrote in September 2014 that "a new hub in the east would have a sensational and beneficial effect on the UK economy".

Meanwhile, at least some relief comes from airlines operating outside London:

- In December 2014, Cathay Pacific launched a Manchester-Hong Kong service, the first scheduled flight from the UK to China outside of London.
- Newcastle offers daily service to Dubai on Emirates, and now plans a transatlantic service (New York).
- Birmingham invested £40m to attract flights to the US and China; in July, China Southern Airlines launched the first charter service from the UK to Beijing.
- Cardiff received a government loan of £3.5m to attract long-haul routes.

### *Aviation Package*

In December 2014, the Commission announced a new Aviation Package; it included improving competitiveness and revising the European Aviation Safety Agency. It also announced the withdrawal of two contentious proposals, the Ground Handling Regulation and the Aviation Security Charges Directive.

The Association of European Airlines welcomed the new measures but also said it was "unfortunate" that the proposals were withdrawn. This view was echoed by the European Regions Airline Association, calling it "less gratifying".

### *Single European Sky*

British carriers were directly affected by disruptions, price hikes, and labour actions.

Hundreds of flights to and from London were disrupted in December due to technical glitches, for the second time in a year. Airlines pushed back against further price increases after

Germany proposed a 16.6% increase in airline charges, which aviation organisations called "outrageous" and "not acceptable". Meanwhile, labour actions continued with a strike by French controllers and a work stoppage by Belgian controllers.

The effort to unify Europe into a single airspace stalled again last year, with the Commission acknowledging that "actual progress" has been slow. In July 2014 the Commission formally requested 18 nations – including the UK to increase their efforts to improve common airspace arranged around air traffic flows rather than state boundaries.

In November, the Association of European Airlines offered its full support for SES, stating "passengers and airlines suffer because of chronic delays, endemic throughout the system". This amounts to 11 million minutes of flight delays costing €5bn annually.

In December 2014, IATA issued a status update and concluded progress "is not on track". IATA pledged to work with other aviation organisations for "further regulatory reform".

## **Consolidation**

The airline industry continued rapid consolidation in 2014, internationally and within the UK. This took three forms: mergers/acquisitions, global alliances, and ownership issues.

### *Mergers and Acquisitions*

European airlines are re-examining consolidation. Mergers and acquisitions have far-reaching effects for shareholders, employees, passengers, regions, and even countries, so understanding Europe's regulatory structure is critical.

In June 2014, the EU addressed airline mergers and alliances by noting that antitrust violation remains a key concern, adding that "in practice" the Commission "focuses its investigations and assessment on the routes where the cooperation is likely to produce anti-competitive effects". Furthermore, its suggested remedies included airlines voluntarily giving up airport landing slots when there's a significant decrease in competition: "By giving up slots, the Parties provide other airlines with the opportunity to enter the market." A paper on airline liberalisation noted the Commission issued 32 decisions under the Merger Regulation and in most cases has permitted consolidation.

The renewed interest is due in part to the profitability of US carriers in a post-merger market. It has been noted that the three big European airline groups – which have all been through mergers or acquisitions – have not yet achieved the same level of integration or consolidation benefits as the US carriers. For comparison, four airlines control about 80% of the US market, while about 24 control the same percentage of the European market.

According to Coface, a leading French aviation financier, Europe's major airlines face growing competitive pressure from domestic LCCs and international carriers. Guillaume Baqué, Coface economist, presented two scenarios: invest massively or merge. "This second hypothesis seems to us to be the most probable, if we consider the changes observed in the American domestic market, which has experienced extensive mergers," he commented.

Coface notes a “first wave” of mergers already has taken place in Europe, citing Air France/KLM, Lufthansa/Swiss/Austrian, and BA/Iberia, and suggests a “further merging movement” is probable. But Coface also recognises that this “would be accompanied by new issues such as a possible reduction in destinations and a rise in prices”. In the wake of a proposed British Airways/Aer Lingus coupling, talk spiked of new mergers. Among the carriers cited as particularly ripe are Finnair, TAP Portugal, and Wizz Air.

- British Airways/Aer Lingus: Aer Lingus continually rejected acquisition bids, but finally recommended a fresh offer in January 2015. IAG – BA’s parent company – offered a £1bn bid approved by the Irish carrier’s board. BA’s hot pursuit is fuelled by several factors, including 24 Aer Lingus landing slots at Heathrow and transatlantic routes.

The deal will require approval from multiple parties, including government regulators, Irish trade unions, and Parliament. Adding to the complexity is Ryanair’s stake in Aer Lingus: in 2013, the Competition and Markets Authority concluded the LCC’s 29.82% share in Aer Lingus “created a substantial lessening of competition”, a finding that remains under appeal.

- Etihad/Alitalia: In November 2014, Etihad and Alitalia announced merger clearance from the Commission, finalising the largest foreign investment ever made in Alitalia. The 49% stake cost €1.75bn, and signifies the growing influence of Middle East aviation.

### Global Alliances

The EU also addressed how it views airline alliances: “In antitrust cases, the Commission aggregates the shares of the integrated joint venture parties with the shares of their subsidiaries and those of other carriers with which they enjoy antitrust immunity. In the US, by contrast, regular alliance members are treated as competitors.”

While there are dozens of codesharing agreements among airlines worldwide, the three major global alliances still retain importance due to sheer scope. As one white paper noted: “Joining in alliances allows the airlines to expand their network without investing new resources.”

Once again, the Oneworld, SkyTeam, and Star Alliance partnerships were in flux:

- Oneworld welcomed SriLankan and Brazil’s TAM.
- SkyTeam also expanded, adding Garuda Indonesia. The alliance states it is “actively searching for partners in the key growth areas Brazil and India”.
- Star Alliance lost TAM, but added Air India and still remains the largest alliance with 27 members.

### Global Airline Alliances

oneworld	SkyTeam	Star Alliance
airberlin	Aeroflot	Adria Airways
American Airlines	Aerolineas	Aegean Airlines
British Airways	Argentinas	Air Canada
Cathay Pacific	Aeromexico	Air China
Finnair	Air Europa	Air India
Iberia	Air France	Air New Zealand
Japan Airlines	Alitalia	ANA
LAN Airlines	China Airlines	Asiana Airlines
Malaysia Airlines	China Eastern Airlines	Austrian Airlines
Qantas	China Southern Airlines	Avianca
Qatar Airways	Czech Airlines	Brussels Airlines
Royal Jordanian	Delta Air Lines	Copa Airlines
S7 Airlines	Garuda Indonesia	Croatia Airlines
SriLankan	Kenya Airways	EGYPTAIR
TAM	KLM	Ethiopian Airlines
	Korean Air	EVA Air
	Middle East Airlines	LOT Polish Airlines
	Saudia	Lufthansa
	TAROM	Scandinavian Airlines
	Vietnam Airlines	Shenzhen Airlines
	Xiamen Airlines	Singapore Airlines
		South African Airways
		Swiss International Air Lines
		TAP Portugal
		Thai Airways
		Turkish Airlines
		United Airlines

Source: Alliances

### Ownership Issues

An industry paper noted state ownership of major airlines “has now almost entirely disappeared”. In many cases that financing gap has been filled by other airlines. In 2014 the Commission launched an investigation into foreign control of European carriers, and the results may prove critical.

The probe focuses on foreign investments of less than 50%:

- Delta/Virgin Atlantic (49%)
- Etihad/Air Serbia (49%)
- Korean Air/Czech (44%)
- HNCA/Cargolux (35%)
- Etihad/Darwin (33%)
- Etihad/Air Berlin (29%)
- Etihad/Aer Lingus (4%)

Flightglobal summed it up: “The issue is whether foreign parties effectively control these European airlines through some means other than majority ownership.” The results of the investigation are due in 2015.

In conclusion, the UK aviation market remains poised for continued growth and financial improvement, even as other regions grow more rapidly.