



## Global Airline Sector - Achieving Financial Stability through Consolidation

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### Fundamental theme:

In early 2011, we published "Laying the Foundation for Global M&A" which examined the trends in airline consolidation and took note of various cross-border transactions, a fairly recent phenomenon, but limited given foreign ownership restrictions. Over the course of the past year, we have seen British Airways and Iberia merge, United merge with Continental, Southwest merge with AirTran, and LAN and TAM are weeks away from finalizing their merger which will create the largest airline equity market capitalization. Consolidation, in our view, represents a latter stage for a mature industry that is seeking ways to address its financial volatility. Furthermore, we think there is a growing recognition that network size does matter, particularly to the most profitable revenue segments. Which names do we think are the best way for investors to participate in a consolidating global airline industry?



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## Fundamental Theme: Achieving Financial Stability through Consolidation

In early 2011, we published "Laying the Foundation for Global M&A" which examined the trends in airline consolidation and took note of various cross-border transactions, a fairly recent phenomenon, but limited given foreign ownership restrictions. Over the course of the past year, we have seen British Airways and Iberia merge, United merge with Continental, Southwest merge with AirTran, and LAN and TAM are weeks away from finalizing their merger which will create the largest airline equity market capitalization. Consolidation, in our view, represents a latter stage for a mature industry that is seeking ways to address its financial volatility. Furthermore, we think there is a growing recognition that network size does matter, particularly to the most profitable revenue segments. Which names do we think are the best way for investors to participate in a consolidating global airline industry?

### INDUSTRY Factors/Drivers

- Global airlines back to profitability, but outlook uncertain.** After two years of industry losses totaling \$31 billion in 2008 – 2009 brought on by the first global recession since the 1940s, global airlines returned to profitability in 2010 – 2011 with \$24 billion of net profits. However, the recovery has been erratic as evidenced by IATA's 2012 industry forecast which calls for only \$3 billion in net profits.
- Asia-Pacific, Middle East and US airlines were the biggest contributors to 2011 profitability.** In 2011, Asia-Pacific, Middle East and US airlines produced net profits of \$4.8 billion, \$1.1 billion, and \$1.0 billion, respectively, or 87% of the industry's net profits. Asia-Pacific financial results benefited from a strong domestic Chinese market; the Middle East was bolstered by the consistently profitable Emirates.
- US turnaround bolstered by consolidation, capacity discipline and a focus on ROIC.** We view 2011 as a watershed year for the US airline industry. Despite a sub-2% GDP backdrop, the US airline industry managed to more than offset a 40% surge in fuel expense with 12% top-line growth resulting in \$6.5 billion of operating profit and \$2.3 billion of net profit (and a similar amount of free cash flow). It is clear that consolidation has resulted in more rational capacity deployment leading to positive ROIC – WACC gaps for the past two years for Alaska, Delta and United Continental, among others.
- Global financial returns still less than adequate.** Despite the industry's profits, many global airlines still generate returns that fail to cover their cost of capital.
- Consolidation is the solution.** Based on some of the successes in the US and Latin America, we think consolidation (via M&A, JVs, alliances, etc.) may be one way for the industry to address its financial predicament.

### Key Thinking

- Airline consolidation is driven by financial and competitive concerns.** Airlines pursue mergers as a means to improve profitability (via cost and revenue synergies) and their competitive positioning via an expanded network. Historically, airline M&A was largely confined to domestic markets with international airline cooperation largely characterized by interlining/code sharing agreements. However, over the past two decades, new Open Skies agreements, the creation of the EU's Single Aviation Market, the granting of antitrust immunity ("ATI") by various countries, and the relaxation of foreign ownership restrictions have all facilitated closer cooperation among global airlines.
- Alliances may be preferable to mergers.** Because there is a high degree of execution risk associated with airline M&A due to the integration of aircraft, personnel, facilities and IT systems, an alliance (preferably with ATI in the event of a foreign partner) may be a more attractive means to combine forces with another airline.
- Will smaller airlines be forced to seek partners?** As the largest airlines capture more market share, by definition the smallest airlines will have less. In the past year, we have seen airlines flush with cash (such as those from the Middle East) invest in some of the smaller and financially weaker carriers. Are the smallest airlines at risk of becoming less relevant if they fail to team up?
- Labor can benefit from airline mergers.** Highly fragmented, fiercely competitive, cyclical and capital intensive industries are usually not associated with job security, stable wages, and attractive benefits. However, there are numerous examples of mature industries that have restructured and consolidated ultimately improving the professional livelihoods of their employees (e.g. air cargo, steel and railroads).
- Larger airlines wield leverage over aviation supply chain.** As the airlines further consolidate, one would think that their negotiating power with suppliers, vendors, and other partners is meaningfully enhanced.

### Thematic Winners & Underperformers

- If airline consolidation results in a more profitable, less debt-intensive, and therefore, less volatile industry (i.e. higher returns), then share prices should be valued at higher multiples due to reduced equity risk premium. That combined with improved access to lower-cost financing (i.e. free flow of capital across borders) should result in a lower weighted average cost of capital. As such, shareholders should benefit from wealth creation.**
- Buy-rated AirAsia, Air China, Delta, Qantas, United Continental, and US Airways are the stocks that we think are presently the best way to capitalize on the global consolidation theme (see separate company valuation and risks section for details).**
- Sell-rated Singapore and Hold-rated Southwest and Hold-rated LAN Airlines are the stocks that we think are likely to underperform, at least for the remainder of 2012. With respect to Singapore, we are concerned about their strategic positioning given the emergence of formidable competitors in their core markets. Regarding the other two stocks, we believe that their underperformance will be driven by near-term integration issues.**



# Executive Summary

## Key conclusions

- The global airline industry continues to consolidate. It is very clear that the US airline industry is experiencing the benefits of M&A as evidenced by its relatively strong financial showing despite numerous macro challenges.
- We believe that a merger between American and US Airways would be positive for both companies as well as the US and global airline industries.
- As promulgated in our initial M&A report published in early 2011, we believe the industry will become less capital intensive (and there are signs that this is already playing out in more mature markets) as deepening alliances/consolidation allow airlines to operate more efficiently.
- We also continue to believe that airline pricing will improve due to greater capacity discipline and a consolidated market. Currently we are seeing that in the US domestic and transatlantic markets. Also, we expect the merger of LAN and TAM to stabilize pricing in the Brazilian domestic market.
- A longer term development which we explored in our initial report is that we think the balance of power in the aviation supply chain should begin to shift back to airlines as they benefit from their improved financial position.
- Lastly, no change to our long-term view regarding consolidation and its correlation with industry returns. As the global airline industry continues to consolidate, we think the gap between ROIC and WACC will close in coming years, which, in our view, will lead to a re-rating of airline stocks.

## The purpose of this report

The purpose of this report is to discuss the latest trends in global airline consolidation. Major topics covered include the rationale for airline

consolidation, the impediments to airline consolidation (particularly cross-border mergers), how the industry has responded, what we think are some of the potential outcomes of a less fragmented global airline industry, and which stocks are best-positioned to benefit. However, before we get into a more comprehensive discussion regarding airline M&A, we think it is necessary to provide investors with our latest take on the industry which we discuss in “Industry Factors/Drivers” (see page 22). Complementing our latest view on the industry are two primary global products that are available to investors – our “Global Valuation Matrix” (see page 12) and our “Global Capacity Monitor” (see page 20). We have also included in this report an analysis of a potential merger between AMR and US Airways (see “Why AA/US Makes Sense” on page 44) as well as our latest views on the LAN – TAM merger which is expected to be finalized in mid-June 2012 (see “LATAM cleared for takeoff” on page 42).

## Achieving financial stability through consolidation

In early 2011, we published “Laying the Foundation for Global M&A” which examined the trends in airline consolidation and took particular note of various cross-border transactions, a fairly recent phenomenon but still limited in light of foreign ownership restrictions. Over the course of the past year, we have seen British Airways and Iberia merge to form International Consolidated Airlines Group SA (“IAG”) and subsequently acquire fellow UK competitor bmi (i.e. British Midland International) with further sights on Portuguese flag carrier TAP (although it appears Lufthansa is interested as well). In the US, United merged with Continental, Southwest merged with AirTran, and US Airways would like to merge with AMR, parent of American Airlines. In Latin America, LAN and TAM are weeks away from finalizing their merger which will create LATAM Airlines Group S.A., the world’s largest airline as measured by equity market capitalization. Additionally, the growing strength of the Middle East air carriers is starting to be felt around the world with their investments in carriers as disparate as Aer Lingus, Air Berlin and cargo specialist Cargolux. Consolidation, in our view, represents a latter stage for a mature industry that is seeking ways to address its financial volatility. Furthermore, we think there is a growing recognition that network size does matter, particularly to the most profitable revenue segments. Which names do we think are the best way for investors to participate in a consolidating global airline industry?



## Winners from the global consolidation trend

The Deutsche Bank Global Airline Team has identified six publicly-traded airline stocks from our coverage universe of 39 names that we think are best-positioned to benefit from a more consolidated global airline industry— **AirAsia, Air China,, Delta Air Lines, Qantas, United Continental and US Airways**. These airlines have been selected largely due to their track record in “pushing the envelope” in regard to strategic initiatives such as network development, unique vertical partnerships, information technology (“IT”), innovative branding solutions, incubation of new travel-related ventures, and cross-border ownership, among other things. As such, we think these stocks provide the most attractive means for investors to participate in an ever-consolidating industry for 2012.

### AirAsia – pushing the envelope on LCC franchising

- AirAsia has had much success expanding its hub-and-spoke strategy with joint-ventures throughout the Asia-Pacific region. In addition to its Thailand and Indonesia JVs, it started in the Philippines in April 2012, and will be launching its fourth JV in Japan in December quarter 2012.
- AirAsia has not been shy to develop key relationships with competitors; e.g. in August 2011 it announced a share swap with Malaysian Airlines (MAS). Although the government blocked the deal in May 2012, both airlines have entered into an agreement targeting cost savings.
- From 2002 – 11, AirAsia’s average EBIT margin was 17.6%, making it one of the world’s most profitable airlines.
- We expect AirAsia’s full year 2012 EBITDAR to grow 18%, at the high end of its peer group as the launch of strategic ventures in new markets should continue to drive long term, profitable growth.
- Our price target for AirAsia shares is MYR\$4.35, which implies 28% upside from last close of MYR\$3.39. We value AirAsia based on 8.9x 12-month forward adjusted EV/EBITDAR, in-line with the company's 5-year historical average of 8.9x adjusted EV/EBITDAR multiple and have added a SoTP for share of associate profits.

### Air China – long-term winner for its close-knitted relationship with Cathay

- As the most fundamentally sound and diversified airline in China, we think that Air China is well-positioned in the long run to benefit from

participating in the world’s fastest growing market (and also highly regulated with limited foreign competition) in every aspect including domestic/international, and passenger/cargo businesses.

- We like its strategic partnership with Cathay Pacific, which is cemented by cross shareholdings. With Cathay's international experience and Air China's foothold in China, long term growth potential looks exciting. We think Air China is the best managed of the three Chinese airlines.
- Even though Air China's year-to-date traffic growth has been muted due to high base and air space capacity bottleneck, we remain optimistic that it will re-emerge as a much stronger regional airline when the global economy recovers, especially with its young air cargo JV with Cathay Pacific (which has bases in both Shanghai and Beijing).
- Our price target for Air China is HKD\$6.80. We set our target FY12E P/BV valuation benchmark at 1.4x with a prudent 20% discount to its mid-cycle valuation. We believe that this is supported by our expectations that Air China can maintain FY12-14 core ROE of about 9-12%, which is above its historical average. The implied target FY 2012 EV/EBITDA of 7.8x is also not stretched, in our view.
- Note that in 12 month horizon, our Chinese airline top pick, however, is China Southern Airlines given its largest exposure in the stable domestic passenger business and the least exposure in air cargo business. Air China is a longer term buy idea which fits into the consolidation theme of this report.

### Delta Air Lines – leading the way to an investable sector

- Delta’s last-twelve-month return on invested capital (“ROIC”) at March quarter 2012 end was 10.6%, well in-line with its 10 - 12% target and higher than its WACC which we estimate to be 8% - 9%. Delta is on target to report three consecutive years of positive ROIC – WACC.
- Most compelling deleveraging story of any major US carrier. From 2009 through mid-2013, the company is projected to generate at least \$7 billion of free cash flow resulting in a reduction of net debt from \$17 billion to \$10 billion. Once Delta’s net debt hits \$10 billion, we believe some excess free cash flow could be “diverted” to shareholders.



- Delta is reducing its overall capital intensity with a willingness to look at “pre-owned” aircraft rather than buy 100% all new metal. Recent purchases of “pre-owned” aircraft include McDonnell Douglas MD-90s from Asia and a deal to acquire 88 Boeing 717s from Southwest.
- Our 12 month price target for Delta shares is \$16, which implies 51% upside from last close of \$10.58 and implies an EV/EBITDAR multiple of 5.7x our 2012/2013 forecast. Delta shares are attractively valued as EV is currently trading at 4.9x our 2012 and 2013 EBITDAR forecasts, at the low end of its historical range of 5x – 7x.

#### Qantas Airways – a track record of innovative, strategic initiatives

- Successful deployment of a two brand business: Qantas servicing the premium market and Jetstar (launched in 2004) catering to leisure. As such, Qantas can effectively tap into two different markets without suffering brand damage and to benefit from rapid LCC expansion.
- Qantas’ proximity to the Asia-Pacific region, which is expected to be the most profitable region in 2012 (a net profit forecast of \$2.3 billion per IATA) puts it in a good position to benefit from strength of the market - we expect Asia to exhibit higher passenger growth than the more mature markets of Europe and North America.
- Qantas’ Frequent Flyer division effectively operates as a stand-alone business generating cash flows from third party partners. The use of a frequent flyer program in this way is somewhat unique (TAM of Brazil is in a similar position) and provides stable earnings to Qantas which neutralize some of the volatility inherent in its aviation business.
- Qantas with British Airways was one of the first to implement an antitrust immunized agreement in 1995 which covered the “kangaroo routes” between the UK, Europe, Southeast Asia and Australia, allowing them to essentially operate as a single carrier.
- Our price target for Qantas shares is AUD\$2, which implies 36% upside from last close of AUD\$1.47. Our PE valuation uses the absolute QAN historical average PE of 11.3x and relative average PE of 11.0x based on QAN’s peers. Our valuation work also incorporates a DCF analysis.

#### United Continental – capturing \$1.0 - \$1.2 billion of merger synergies

- Since having closed its merger in October 2010, United Continental, the world’s largest airline, has achieved a single operating certificate

and moved to a single passenger service system (which included consolidating its loyalty programs, the largest in the world). Next up for 2012 is integration of the union workgroups.

- United’s focused on what matters: (1) generating consistent profits, (2) deleveraging the balance sheet, and (3) maintaining capacity discipline. The fruits of adhering to that basic “philosophy” were \$1.3 billion in net profits (underlying which was 5.9% operating margin) and \$500 million in debt repayments for 2012.
- Our 12 month price target for United shares is \$31, which represents 41% upside from last close of \$21.92 and implies an EV/EBITDAR multiple of 5.3x our 2012 and 4.7x our 2013 forecasts. United shares are attractively valued as EV is currently trading at 4.8x our 2012 EBITDAR forecast and 4.2x our 2013 EBITDAR forecast, at the low end/below its historical range of 5x – 7x.

#### US Airways – at the nexus of future industry consolidation

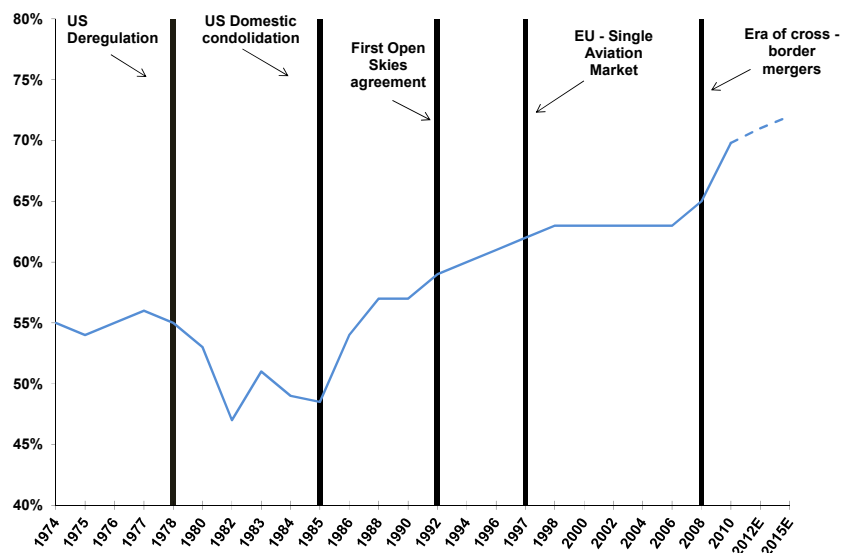
- US Airways is pursuing a merger with American Airlines; recent agreements with American’s three major labor groups represented a significant milestone toward that goal, in our view.
- US Airways has stated that a merger with American could generate at least \$1.2 billion in annual net synergies. Assuming that is an EBITDAR contribution with no accompanying debt added to the new capital structure, then we get about \$5.5 billion of value accruing to the new equity holders over a 2 – 3 year period (using a 4x – 5x EV/EBITDAR multiple). If we apply US Airways pro rata share to the new equity value, we get about \$7 per share of upside based on a fairly conservative forecast (and a stock currently trading at \$10.71).
- Two recent developments that we think bode well for US Airways’ shares are: 1) DCA/LGA slot/gate swap with Delta Air Lines; and 2) Southwest reduction of service in key US markets (such as Philadelphia) and its decision to “de-hub” Atlanta, a competitor to US Airways’ Charlotte hub.
- Our 12 month price target for US Airways shares is \$14, which represents 31% upside from last close of \$10.71 and implies an EV/EBITDAR multiple of 5.9x our 2012 and 5.8x our 2013 forecasts.



## The global airline industry continues to consolidate

The liberalization of global aviation bilaterals have provided for greater cooperation among global airlines. Furthermore, that phenomenon combined with the further development of the global alliances has resulted in a fertile backdrop for M&A. In that regard, we have seen alliance partners take their level of cooperation to the next level via a merger. Examples of this are the mergers of Delta – Northwest (as part of SkyTeam), Continental – United (as part of Star) and British Airways – Iberia (as part of oneworld). The consequence of all of the M&A activity has resulted in the market share of the top 20 global airlines (per IATA RPK data) having grown appreciably over the past two decades (see Figure 1).

Figure 1: Market share of top 20 global airlines: 1974 – 2015E

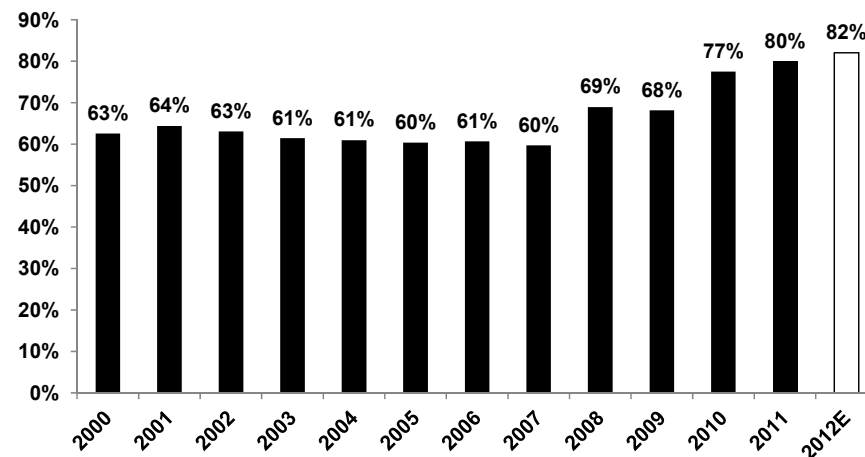


Source: IATA and Deutsche Bank Airline Research

## Top four US carriers now account for 82% market share

The wave of consolidation in the US over the past three years, in particular Delta/Northwest, United/Continental and Southwest/AirTran means that the top four carriers now account for 82% of the market (estimated based on June 2012 schedules). System seat capacity is 3% lower than it was four years ago (7% on a domestic basis) and this discipline is a key reason why US carriers reported two years of solid profits in 2010 and 2011.

Figure 2: Share of top four US carriers (based on system RPMs)



Source: Bureau of Transportation Statistics (BTS) and Deutsche Bank Airline Research

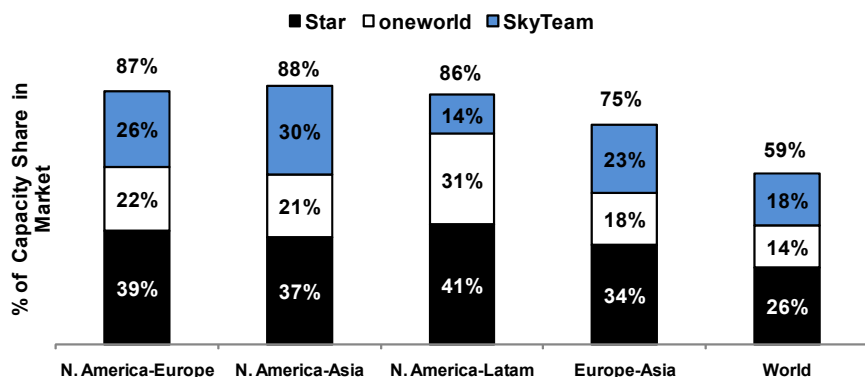
## Alliance market share gains several points over the past 18 months

Over the past 18 months, global alliances have gained additional share due to new members and growth among the incumbents. For example, in the North Atlantic market the three joint ventures now account for 87% of capacity, up two points from late 2010. Overall, the alliances account for a majority (59%) of global capacity (up four points versus a 1.5 years ago) and represent significant share (>75%) of several major air corridors (see Figure 3). In North America – Asia and North America – Latin America, the three major alliances now account for 88% and 86% capacity share, up five points and eight points, respectively compared to 18 months ago. Interestingly, oneworld saw its North America – Latin America share slip from 39% to 31% with the loss of Mexicana; Star’s market share jumped from 26% to 41% with the addition of Copa and Avianca Taca. The one major air corridor that saw a decline in the alliance capacity



share was Europe – Asia (down two points to 75%) due to growth of non-aligned airlines from Southeast Asia and the Middle East.

Figure 3: Alliance market share – June – January 2012



Source: Diio Mi and Deutsche Bank Airline Research

### Size matters – smaller airlines now face strategic dilemma

As the largest airlines capture more market share, by definition the smallest airlines will have less. The larger the network, the more attractive it is to the most profitable revenue segments such as business/premium travelers, cargo shippers, and long-haul travelers, among others. In the past year, we have seen airlines flush with cash (such as those from the Middle East) invest in some of the smaller and financially weaker carriers such as Air Berlin and Aer Lingus. Are the smallest airlines at risk of becoming less relevant if they fail to team up? As such, are the smallest airlines at risk of becoming less relevant if they fail to team up?

While we think there will always be room for niche airlines and formidable LCCs such as easyJet and Ryanair in Europe, Spirit in the US, WestJet in Canada, Volaris in Latin America, and AirAsia, we do believe that airlines that are positioned between LCCs and major network airlines may be forced to consider some form of consolidation in order to grow their footprint and enhance their product. Airlines that we think fall into this category are carriers such as Virgin Atlantic (which has publicly stated its desire to team-up with another carrier or alliance), SAS (who has been for sale for the past several years), and JetBlue, which, for now, has decided to pursue multiple partnerships (none all that deep, though) by leveraging its strong presence in both New York and Boston. In

Australia, Virgin Australia at one point may have been viewed as heading down a similar path, but it has sought to expand its international network by negotiating alliances with Air New Zealand (to maintain its trans-Tasman reach), Delta (for access into the US) and Etihad (to access Europe).

### Greater capital efficiency

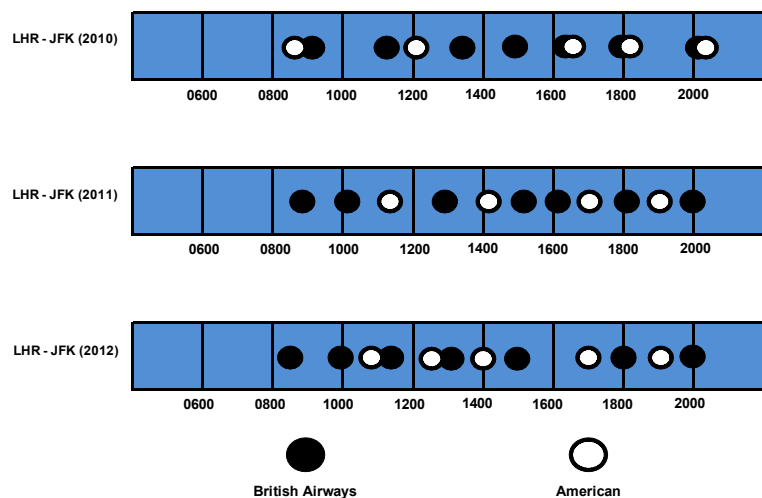
There are a multiple of reasons why the industry as a whole has been unable to generate healthy returns on a sustainable basis. However, one of the goals of this report is not to rehash past history on this topic, but to examine the industry's response to one of the leading causes of its chronic financial underperformance which is that the global airline industry is too fragmented. There are too many players deploying too much capital all making what appear to be key investment decisions within a vacuum. In our view, we think consolidation is one of the best ways to address the industry's predicament.

### Revisiting BA/AA - a classic example of how a JV brings greater asset efficiency

Consolidation is not just M&A and can take many forms, in our view, including code sharing, alliances, and joint ventures such as the AA/BA/IB JV. When we initially published our global M&A report in early 2011, we compared the AA/BA London – Heathrow to New York – JFK schedules before and post-implementation of the antitrust immunized joint venture (“ATI JV”). Pre-ATI JV, there were 12 flights in total with four having very close timing overlaps. We then compared that to the initial schedule post-ATI JV and noted the more even schedule with flights that were better spaced-out, almost on the hour during the peak part of the day. Not only was the new schedule more attractive for customers but the proximity of flights allowed AA and BA to fill the flights fuller through greater over-booking. Customers who were denied boarding would simply travel one hour later. Most importantly, the new schedule allowed American to save one aircraft which resulted in 11 flights in total instead of the previous 12. So in summary, our sense was that the new schedule resulted in more revenue with roughly a 10% reduction in capital committed to the route, clearly value accretive. Subsequently, we have seen AA and BA perform very well on the London – New York route which has warranted an additional flight. So for spring/summer 2012, AA and BA will not only have an additional frequency, but we believe that their overall market share and route profitability has dramatically improved over the past year (see Figure 4).



Figure 4: British Airways and American Airlines joint schedule – LHR-JFK



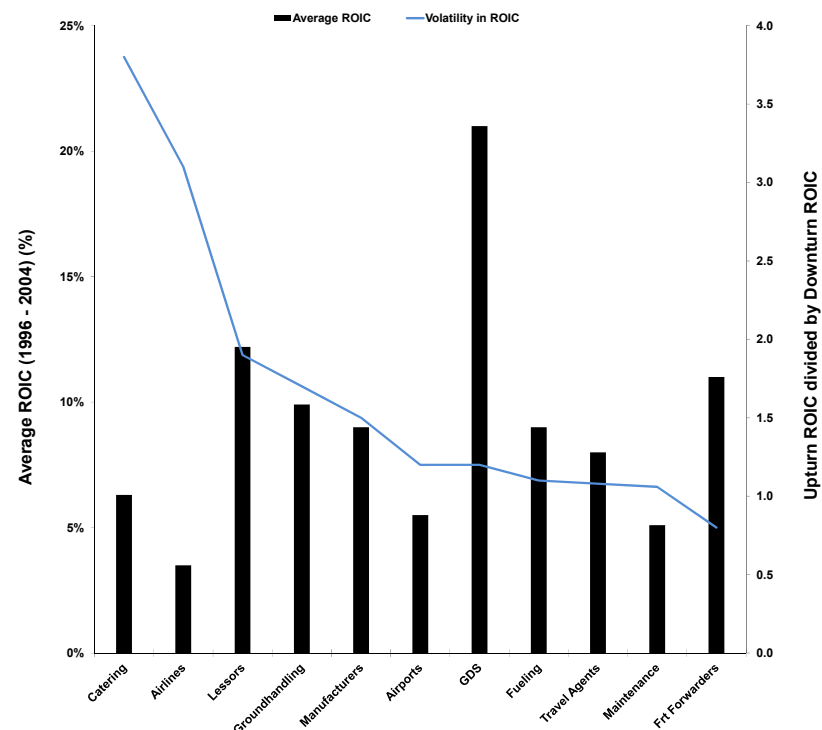
Source: Company schedules and Deutsche Bank Airline Research

## Shifting balance of power in the aviation supply chain?

### Consolidation drives improved leverage with suppliers

For years, the airlines have been the weakest financial link in the aviation supply chain as evidenced by higher earnings volatility and subpar returns compared to those of their suppliers and other partners (see Figure 5).

Figure 5: ROIC/ROIC volatility for selected aviation-related industries



Source: IATA and Deutsche Bank Airline Research

Also, because of the industry's less-than-stellar financial history, we are of the view that airlines generally have not had the upper hand when it comes to negotiating with their various suppliers and vendors. Furthermore, unlike most other highly competitive industries, airlines face significant costs due to their high degree of regulation (e.g. probably the safest mode of travel save for the tricycle) and operations that are subject to inefficient (and to some extent not accountable) monopoly service providers (airports and air traffic control). However, we are of the view that as airlines further consolidate, their negotiating leverage with suppliers, vendors and other partners is meaningfully enhanced.



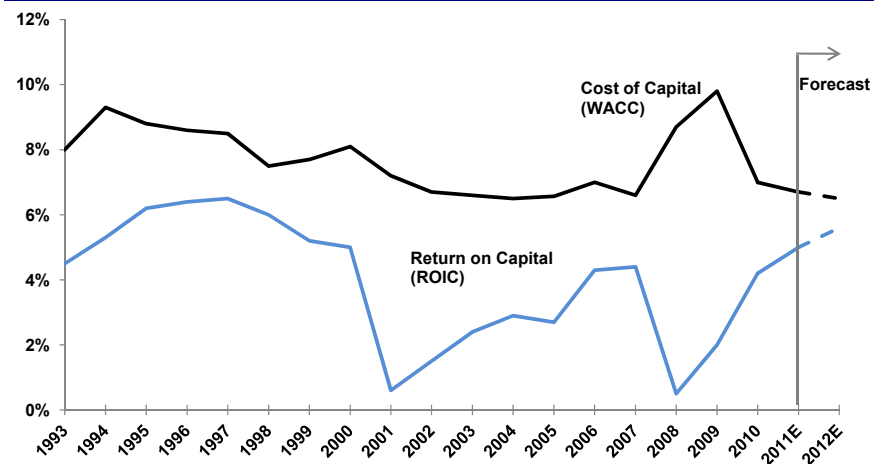
For example, in the case of the British Airways and Iberia merger, BA now has access to a home country market that appears to be much more willing to support airport and facility expansions (i.e., Spain). This reflects a very different backdrop than what BA has experienced in the UK where the airline for years has unsuccessfully lobbied for a third runway at London – Heathrow Airport. As such, we would not be surprised if going forward a disproportionate amount of the majority of International Airline Group’s (parent company of BA and Iberia) assets (as well as the associated job creation, revenue generation and tax receipts) are deployed to Spain and other regions rather than the UK.

Reducing airport overhead through increased utilization and elimination of excess gates and terminal space is another area of opportunity driven by consolidation. While it may be harder to wring cost savings from key airports such as London’s Heathrow, Paris’ de Gaulle, or New York’s Kennedy where there is a tendency to hold onto assets given their gateway status, there may be opportunities to rationalize smaller hubs. One of the consequences of consolidation is that merging airlines may find they have too many hubs or at least overbuilt ones (e.g. Delta merging with Northwest led to the realization that Memphis was arguably overbuilt given that it was in the shadow of the more powerful Atlanta hub.). Airport hubs that find themselves on the endangered list have proven to be pretty resourceful when it comes to finding cost savings for their major airline partners.

### Moving toward earning its cost of capital

The global airline industry earned \$24 billion of net profits in 2010 – 2011, according to the International Air Transport Association (“IATA”). That is a significant improvement compared to 2008 and 2009 when the global airline industry lost an aggregate \$31 billion. Regardless of the vast improvement, the global industry’s underlying returns on invested capital are still expected to be subpar (see Figure 6).

Figure 6: Global airlines ROIC vs. WACC



Source: IATA and Deutsche Bank Airline Research

The magnitude of the wealth destruction has been significant. In our estimation, the global airline industry’s shareholder base is in the range of \$150 billion - \$200 billion (includes both public and private airlines). So for years where the gap between return on invested capital and weighted average cost of capital is 8 – 10 percentage points, that can represent as much as \$20 billion of wealth destruction for company owners (and in some cases, all of the equity being wiped-out). Historically the closing of the negative ROIC – WACC gap has proven to be elusive, but there are reasons to believe this could change in the coming years.

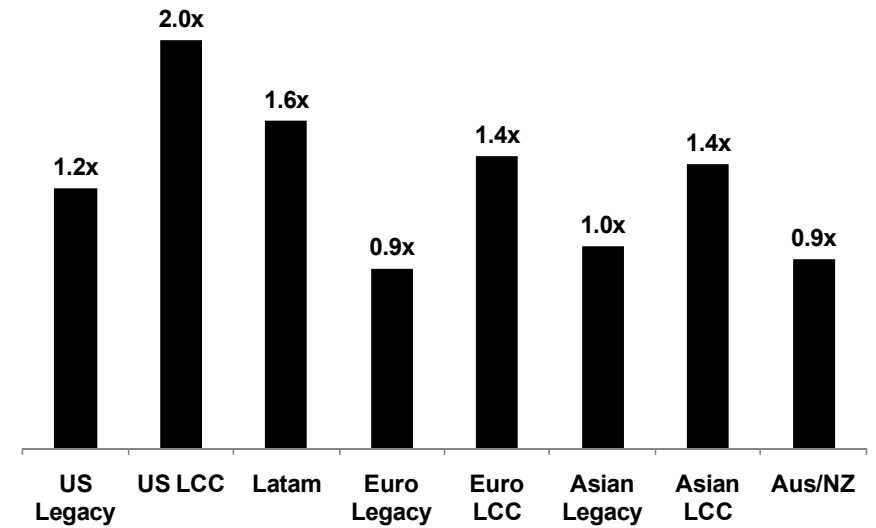
### Airlines due for a re-rating?

If airline consolidation results in a more profitable, less debt-intensive, and therefore, less volatile industry (i.e. higher returns), then share prices should be valued at higher multiples due to reduced equity risk premium. That combined with improved access to lower-cost financing (i.e. free flow of capital across borders) should result in a lower weighted average cost of capital. As such, shareholders should benefit from wealth creation. That said, current multiples are already high – in fact it is surprising given that the industry destroys value that most airlines trade above 1.0x EV/IC (see Figure 7). The reason for this, in our view, is because shareholder’s equity has been depleted by losses, write-downs of aircraft values and pension deficits, among other things. As such,



these multiples do not accurately reflect an industry that is undergoing meaningful structural change as well as some airlines (especially US carriers) that are benefiting from a major deleveraging cycle. If we look at valuations on an EV/EBITDAR basis (which focuses on debt and equity values relative to a future level of earnings), one would find the valuations for most groups as attractive (see Global Valuation Matrix – Figures 8 – 11).

Figure 7: Global airlines EV/IC valuations



Source: Deutsche Bank Airline Research



# Global Valuation Matrix

Figure 8: Airline Stock Price Valuation Matrix

Company	Ticker	Rating	Currency		Price 22-May-12	12-Month		Equity Market Value (mm)	YTD Change	52 Week		Div. Yield	Price/Earnings		Price/Cash Flow		Price/ Book <sup>1</sup>	EV/EBITDAR		Adj. EV / EBITDAR <sup>P</sup>		Adj. EV / Inv. Cap Sales		Debt/ Cap. <sup>1</sup>
			Reporting	Trading		Price Target	Return			High	Low		2012E	2013E	2012E	2013E		2012E	2013E	2012E	2013E	2012E	2013E	
<b>United States</b>																								
<b>LEGACY AIRLINES</b>																								
<i>Major Networks</i>																								
Alaska	ALK	Hold	USD	USD	\$32.76	\$40.00	22%	\$2,339	-13%	\$39.19	\$25.66	---	8.0x	7.3x	4.3x	4.0x	2.0x	4.2x	4.0x	5.2x	5.0x	1.2x	1.0x	73.7%
Delta	DAL	Buy	USD	USD	10.58	16.00	51%	8,946	31%	11.43	6.62	---	5.3x	6.6x	2.7x	2.7x	NM	4.9x	5.0x	5.7x	5.7x	1.4x	0.7x	107.0%
United Continental	UAL	Buy	USD	USD	21.92	31.00	41%	7,279	16%	26.25	15.53	---	6.4x	4.2x	3.0x	2.3x	4.0x	4.8x	4.2x	4.9x	4.4x	1.2x	0.7x	94.1%
US Airways	LCC	Buy	USD	USD	10.71	14.00	31%	1,736	111%	11.32	4.00	---	5.4x	5.1x	3.3x	3.2x	11.6x	5.7x	5.6x	5.7x	5.6x	1.2x	0.8x	98.8%
<b>Average</b>							<b>36%</b>		<b>36%</b>			<b>NM</b>	<b>6.2x</b>	<b>5.8x</b>	<b>3.3x</b>	<b>3.1x</b>	<b>5.9x</b>	<b>4.9x</b>	<b>4.7x</b>	<b>5.4x</b>	<b>5.2x</b>	<b>1.2x</b>	<b>0.8x</b>	<b>93.4%</b>
<b>GROWTH AIRLINES</b>																								
<i>Low Cost Carriers</i>																								
Allegiant	ALGT	Hold	USD	USD	62.66	60.00	-4%	1,196	17%	64.24	40.64	---	17.4x	15.7x	10.4x	9.4x	3.4x	6.1x	5.6x	6.1x	5.6x	5.2x	1.1x	32.2%
Hawaiian	HA	Buy	USD	USD	5.32	8.00	50%	270	-8%	6.96	3.78	---	5.3x	4.8x	2.2x	2.0x	1.2x	4.3x	4.4x	4.3x	4.4x	1.0x	0.8x	87.9%
JetBlue	JBLU	Buy	USD	USD	4.22	8.00	90%	1,190	-19%	6.26	3.40	---	8.4x	7.7x	3.5x	3.1x	0.7x	5.6x	5.3x	5.6x	5.3x	0.9x	1.1x	76.0%
Southwest	LUV	Hold	USD	USD	8.34	9.00	8%	6,446	-3%	12.14	7.35	0.4%	15.7x	10.4x	5.4x	4.5x	0.9x	5.4x	4.8x	5.4x	4.8x	1.0x	0.8x	59.6%
Spirit	SAVE	Buy	USD	USD	20.78	28.00	35%	1,507	73%	24.11	10.44	---	12.2x	9.9x	10.4x	8.7x	3.2x	6.1x	5.6x	6.1x	5.6x	1.7x	1.9x	75.9%
<b>Average</b>							<b>36%</b>		<b>12%</b>			<b>0.4%</b>	<b>11.8x</b>	<b>9.7x</b>	<b>6.4x</b>	<b>5.5x</b>	<b>1.9x</b>	<b>5.5x</b>	<b>5.1x</b>	<b>5.5x</b>	<b>5.1x</b>	<b>2.0x</b>	<b>1.1x</b>	<b>66.3%</b>
<i>Regional Airlines</i>																								
Republic	RJET	Buy	USD	USD	4.89	8.00	64%	237	43%	6.26	2.53	---	8.1x	6.5x	1.1x	1.0x	0.5x	6.5x	6.4x	6.5x	6.4x	1.0x	1.7x	91.4%
SkyWest	SKYW	Buy	USD	USD	7.74	12.00	55%	395	-39%	15.63	7.74	---	10.3x	5.9x	1.2x	1.0x	0.3x	5.4x	5.0x	5.4x	5.0x	0.8x	1.1x	77.3%
<b>Average</b>							<b>59%</b>		<b>2%</b>			<b>NM</b>	<b>9.2x</b>	<b>6.2x</b>	<b>1.2x</b>	<b>1.0x</b>	<b>0.4x</b>	<b>5.9x</b>	<b>5.7x</b>	<b>5.9x</b>	<b>5.7x</b>	<b>0.9x</b>	<b>1.4x</b>	<b>84.3%</b>
<b>Latin America</b>																								
Aeromexico	AEROMEX-MX	Buy	MXN	Ps	Pes\$20.86	Pes\$35.00	68%	Pes\$14,545	-12%	Pes\$29.18	Pes\$20.86	---	10.4x	8.3x	6.5x	5.2x	3.8x	5.5x	5.0x	5.5x	5.0x	1.4x	1.0x	88.4%
Copa	CPA	Buy	USD	USD	\$83.29	\$100.00	20%	\$3,688	42%	\$85.05	\$58.44	2.1%	11.1x	9.8x	8.9x	8.0x	3.1x	8.3x	7.5x	8.3x	7.5x	2.1x	2.1x	57.2%
GOL	GOL	Buy	BRL	USD	4.90	11.00	124%	1,320	-26%	13.34	4.71	4.5%	9.8x	5.8x	3.5x	3.0x	0.8x	4.9x	4.6x	4.9x	4.6x	0.9x	1.0x	75.4%
LAN	LFL	Hold	USD	USD	24.02	32.00	33%	8,174	3%	30.71	19.48	2.8%	17.8x	13.3x	9.1x	7.5x	6.1x	9.1x	7.7x	9.1x	7.7x	2.2x	1.9x	78.5%
TAM	TAM	Hold	BRL	USD	20.55	24.00	17%	3,210	6%	25.29	14.47	2.8%	15.8x	11.8x	5.0x	4.6x	2.0x	6.5x	6.0x	6.5x	6.0x	1.2x	1.2x	81.3%
<b>Average</b>							<b>52%</b>		<b>3%</b>			<b>3.1%</b>	<b>13.0x</b>	<b>9.8x</b>	<b>6.6x</b>	<b>5.7x</b>	<b>3.2x</b>	<b>6.9x</b>	<b>6.2x</b>	<b>6.9x</b>	<b>6.2x</b>	<b>1.6x</b>	<b>1.4x</b>	<b>76.1%</b>



Figure 8: Airline Stock Price Valuation Matrix (Continued)

Company	Ticker	Rating	Currency		12-Month			Equity Market		YTD Change	52 Week		Div. Yield	Price/Earnings		Price/Cash Flow		Price/Book <sup>1</sup>	Adj. EV / EBITDAR		Adj. EV / EBITDAR		Inv. Cap	EV / Sales	Debt/ Cap. <sup>1</sup>
			Reporting	Trading	Price	Target	Implied Return	Value (mm)	High		Low	2012E		2013E	2012E	2013E	2012E		2013E	2012E	2013E				
<b>Europe</b>																									
Air Berlin	AB1	Sell	EUR	EUR	1.80	1.40	-22%	153	-28%	3.22	1.77	---	NM	NM	NM	3.4x	1.2x	10.7x	7.5x	10.7x	7.5x	1.0x	1.1x	96.3%	
Aeroflot	AFLT	Buy	USD	USD	41.21	92.50	124%	45,768	-48%	72.77	39.93	0.1%	4.9x	5.1x	2.7x	2.4x	0.9x	5.7x	5.8x	5.7x	5.8x	1.0x	1.0x	75.2%	
Air France-KLM	AIRF	Sell	EUR	EUR	3.45	2.10	-39%	1,019	-13%	11.67	3.29	---	NM	NM	1.6x	1.0x	0.2x	9.5x	7.0x	9.5x	7.0x	0.8x	0.5x	77.5%	
Deutsche Lufthansa AG	LHAG	Hold	EUR	EUR	8.56	11.00	29%	3,920	-7%	15.37	8.35	2.9%	9.7x	7.8x	1.6x	1.6x	0.5x	2.3x	2.4x	2.9x	2.8x	0.7x	0.2x	49.0%	
Int'l Airlines Group (IAG) <sup>2</sup>	ICAG	Buy	EUR	GBP	144.80	220.00	52%	3,242	-2%	258.70	132.00	---	NM	21.1x	3.4x	2.8x	0.6x	5.4x	4.8x	7.2x	6.3x	0.9x	0.5x	64.3%	
Turkish Airlines	THYAO	Hold	TRY	TRY	2.75	3.10	13%	3,300	30%	4.35	2.01	---	16.6x	10.5x	3.2x	2.8x	0.8x	10.6x	13.5x	10.6x	13.5x	0.9x	0.8x	76.2%	
<b>Average</b>							<b>26%</b>		<b>-11%</b>			<b>1.5%</b>	<b>10.4x</b>	<b>11.1x</b>	<b>2.5x</b>	<b>2.3x</b>	<b>0.7x</b>	<b>7.4x</b>	<b>6.8x</b>	<b>7.8x</b>	<b>7.2x</b>	<b>0.9x</b>	<b>0.7x</b>	<b>73.1%</b>	
<b>LOW COST CARRIERS</b>																									
EasyJet	EZJ	Hold	GBP	GBP	494.70	540.00	9%	2,122	26%	534.00	301.00	8.9%	9.6x	8.3x	6.5x	5.7x	1.2x	5.4x	4.9x	5.4x	4.9x	1.1x	0.7x	57.1%	
Ryanair	RYA	Buy	EUR	EUR	4.04	4.60	14%	6,002	11%	4.49	2.82	---	12.5x	10.8x	7.6x	6.8x	1.7x	6.2x	5.6x	6.2x	5.6x	1.7x	1.5x	53.8%	
<b>Average</b>							<b>12%</b>		<b>19%</b>			<b>8.9%</b>	<b>11.0x</b>	<b>9.5x</b>	<b>7.0x</b>	<b>6.2x</b>	<b>1.5x</b>	<b>5.8x</b>	<b>5.3x</b>	<b>5.8x</b>	<b>5.3x</b>	<b>1.4x</b>	<b>1.1x</b>	<b>55.5%</b>	
<b>Asia</b>																									
<b>NETWORK CARRIERS</b>																									
Air China <sup>2</sup>	0753	Buy	CNY	HKD	4.95	6.80	37%	51,966	-14%	8.31	4.86	---	12.5x	8.5x	2.7x	2.6x	1.0x	6.8x	6.0x	6.8x	6.0x	1.0x	1.4x	71.5%	
All Nippon Airways	ALNYP	Hold	JPY	JPY	210	270	29%	526,902	-2%	272.00	210.00	1.4%	12.4x	8.2x	2.9x	2.4x	0.9x	5.7x	4.9x	5.7x	4.9x	1.0x	1.2x	71.6%	
Cathay Pacific	0293	Sell	HKD	HKD	12.30	11.00	-11%	48,388	-8%	18.70	11.88	2.5%	NM	34.7x	6.0x	4.6x	0.9x	7.0x	5.7x	7.0x	5.7x	0.9x	0.8x	51.3%	
China Airlines	2610	Hold	TWD	TWD	11.45	13.70	20%	53,032	-13%	19.80	11.15	---	NM	10.1x	4.8x	3.4x	1.1x	8.8x	8.3x	9.0x	8.5x	1.0x	1.5x	74.6%	
China Eastern Airlines <sup>2</sup>	0670	Buy	CNY	HKD	2.35	3.70	57%	21,579	-15%	4.08	2.11	---	7.2x	5.9x	1.6x	1.5x	0.9x	6.9x	6.4x	7.1x	6.5x	1.0x	1.2x	81.2%	
China Southern Airlines <sup>2</sup>	1055	Buy	CNY	HKD	3.31	4.80	45%	26,462	-16%	5.37	3.16	6.0%	8.3x	6.2x	1.8x	1.7x	0.8x	6.4x	6.1x	6.4x	6.1x	0.9x	1.3x	77.0%	
EVA Airways	2618	Hold	TWD	TWD	17.10	17.90	5%	55,728	-11%	29.55	16.25	2.2%	14.5x	8.1x	4.4x	3.4x	1.3x	7.3x	6.6x	7.3x	6.6x	1.1x	1.3x	72.0%	
Korean Air	3490	Sell	KRW	KRW	44,600	40,000	-10%	3,012,030	3%	72,300	38,550	1.1%	NM	19.4x	1.5x	1.7x	1.1x	7.3x	7.2x	7.6x	7.5x	1.0x	1.5x	86.1%	
Singapore Airlines	SIAL	Sell	SGD	SGD	10.31	8.65	-16%	12,318	1%	14.77	10.05	4.2%	46.7x	36.8x	6.1x	4.6x	1.0x	4.2x	3.9x	4.2x	3.9x	0.9x	0.7x	28.7%	
Thai Airways	THAI	Buy	THB	THB	21.60	45.00	108%	47,148	8%	36.75	18.00	7.1%	4.2x	5.0x	1.5x	1.5x	0.5x	4.0x	4.5x	4.1x	4.6x	0.8x	0.8x	63.9%	
<b>Average</b>							<b>26%</b>		<b>-7%</b>			<b>3.5%</b>	<b>15.1x</b>	<b>14.3x</b>	<b>3.3x</b>	<b>2.7x</b>	<b>0.9x</b>	<b>6.4x</b>	<b>6.0x</b>	<b>6.5x</b>	<b>6.0x</b>	<b>1.0x</b>	<b>1.2x</b>	<b>67.8%</b>	
<b>LOW COST CARRIERS</b>																									
AirAsia	AIRA	Buy	MYR	MYR	3.39	4.35	28%	9,402	-10%	4.14	2.76	---	9.7x	7.4x	5.5x	4.6x	1.8x	7.8x	6.4x	7.8x	6.4x	1.4x	3.2x	65.6%	
Cebu Air	CEB.PS	Hold	PHP	PHP	67.30	72.00	7%	41,271	4%	93.30	62.85	---	11.6x	10.8x	5.8x	5.1x	1.8x	7.3x	7.0x	7.3x	7.0x	1.4x	1.7x	60.6%	
<b>Average</b>							<b>18%</b>		<b>-3%</b>			<b>NM</b>	<b>10.7x</b>	<b>9.1x</b>	<b>5.7x</b>	<b>4.9x</b>	<b>1.8x</b>	<b>7.5x</b>	<b>6.7x</b>	<b>7.5x</b>	<b>6.7x</b>	<b>1.4x</b>	<b>2.4x</b>	<b>63.1%</b>	
<b>Australia/ New Zealand</b>																									
Qantas Airways	QAN	Buy	AUD	AUD	1.47	2.00	36%	3,330	1%	2.11	1.38	---	15.9x	7.7x	2.1x	1.8x	0.6x	4.2x	3.6x	4.2x	3.6x	0.8x	0.7x	64.9%	
Virgin Blue Group	VBA	Hold	AUD	AUD	0.42	0.45	7%	928	195%	0.47	0.12	---	12.9x	9.2x	2.9x	2.5x	1.2x	5.8x	5.6x	5.8x	5.6x	1.0x	0.9x	81.2%	
Air New Zealand	AIR	Buy	NZD	NZD	0.92	1.37	50%	1,003	2%	1.18	0.85	4.9%	20.4x	9.3x	2.6x	2.2x	0.7x	4.9x	4.4x	4.9x	4.4x	0.9x	0.7x	68.9%	
<b>Average</b>							<b>31%</b>		<b>66%</b>			<b>4.9%</b>	<b>16.4x</b>	<b>8.7x</b>	<b>2.5x</b>	<b>2.2x</b>	<b>0.8x</b>	<b>5.0x</b>	<b>4.5x</b>	<b>5.0x</b>	<b>4.5x</b>	<b>0.9x</b>	<b>0.8x</b>	<b>71.7%</b>	

Source: Deutsche Bank Airline Research, company filings, and FactSet  
(1) For the US and Latin carriers, represents value as of last pricing date. For other carriers, represents value as of forecasted FY1 end.  
(2) Market ratios adjusted to reflect difference in reporting / trading currencies.



Figure 9: Airline Stock Price Drivers

Company	Ticker	Price		Exchange	FYE	2012E Div.	EPS		EPS Growth		Cash Flow per Share <sup>1</sup>		CF per Share Growth		EBITDAR		EBITDAR Growth		Sales		Sales Growth		Invested Capital	
		22-May-12					2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E
<b>United States</b>																								
<b>LEGACY AIRLINES</b>																								
<i>Major Networks</i>																								
Alaska	ALK	USD	\$32.76	NYSE	Dec	---	\$4.10	\$4.50	NM	10%	\$7.65	\$8.15	NM	7%	\$1,079	\$1,159	2%	7%	\$4,649	\$4,845	8%	4%	\$4,917	\$5,056
Delta	DAL	USD	10.58	NYSE	Dec	---	2.00	1.60	42%	-20%	3.90	3.95	20%	1%	5,389	5,489	11%	2%	36,742	36,716	5%	0%	27,565	28,474
United Continental	UAL	USD	21.92	NYSE	Dec	---	3.45	5.25	-1%	52%	7.40	9.40	-1%	27%	5,994	6,707	-3%	12%	38,419	40,202	4%	5%	24,867	24,871
US Airways	LCC	USD	10.71	NYSE	Dec	---	2.00	2.10	NM	5%	3.20	3.35	NM	5%	2,026	2,080	17%	3%	13,972	14,445	7%	3%	10,036	10,204
<b>Average/Total</b>									<b>20%</b>	<b>12%</b>			<b>10%</b>	<b>10%</b>	<b>14,488</b>	<b>15,435</b>	<b>7%</b>	<b>6%</b>	<b>\$93,782</b>	<b>\$96,208</b>	<b>6%</b>	<b>3%</b>	<b>\$67,385</b>	<b>\$68,605</b>
<b>GROWTH AIRLINES</b>																								
<i>Low Cost Carriers</i>																								
Allegiant	ALGT	USD	62.66	OTC	Dec	---	3.60	4.00	33%	11%	6.00	6.65	23%	11%	\$170	\$191	24%	12%	933	1,046	20%	12%	199	220
Hawaiian	HA	USD	5.32	OTC	Dec	---	1.00	1.10	21%	10%	2.45	2.65	17%	8%	357	391	11%	10%	2,019	2,237	22%	11%	1,502	1,655
JetBlue	JBLU	USD	4.22	OTC	Dec	---	0.50	0.55	71%	9%	1.20	1.35	26%	13%	980	1,074	19%	10%	5,103	5,461	13%	7%	6,090	6,304
Southwest	LUV	USD	8.34	NYSE	Dec	0.03	0.53	0.80	24%	51%	1.55	1.85	15%	19%	2,501	3,028	10%	21%	17,083	17,986	9%	5%	13,881	15,073
Spirit	SAVE	USD	20.78	NYSE	Dec	---	1.70	2.10	29%	24%	2.00	2.40	38%	20%	0	0	31%	22%	1,378	1,650	29%	20%	1,596	1,882
<b>Average/Total</b>									<b>36%</b>	<b>21%</b>			<b>24%</b>	<b>14%</b>	<b>4,008</b>	<b>4,684</b>	<b>19%</b>	<b>15%</b>	<b>\$26,515</b>	<b>\$28,379</b>	<b>19%</b>	<b>11%</b>	<b>\$23,267</b>	<b>\$25,134</b>
<i>Regional Airlines</i>																								
Republic	RJET	USD	4.89	OTC	Dec	---	0.60	0.75	NM	25%	4.50	4.80	8%	7%	739	754	5%	2%	2,828	2,898	-1%	2%	5,001	5,025
SkyWest	SKYW	USD	7.74	OTC	Dec	---	0.75	1.30	NM	74%	6.35	7.55	55%	19%	795	899	16%	13%	3,759	3,916	3%	4%	5,224	5,406
<b>Average/Total</b>									<b>NM</b>	<b>49%</b>			<b>32%</b>	<b>13%</b>	<b>1,534</b>	<b>1,653</b>	<b>11%</b>	<b>8%</b>	<b>\$6,587</b>	<b>\$6,814</b>	<b>1%</b>	<b>3%</b>	<b>\$10,225</b>	<b>\$10,431</b>
<b>Latin America</b>																								
Aeromexico	AEROMEX-MX	MXN Ps	Ps\$20.86	BOLSA	Dec	---	Ps\$2.00	Ps\$2.50	-31%	25%	Ps\$3.20	Ps\$4.00	-24%	25%	Ps\$7,257	Ps\$8,578	6%	18%	Ps\$40,546	Ps\$46,098	13%	14%	Ps\$28,966	Ps\$31,880
Copa	CPA	USD	\$83.29	NYSE	Dec	\$1.79	\$7.50	\$8.50	6%	13%	\$9.40	\$10.40	7%	11%	\$570	\$666	9%	17%	\$2,251	\$2,482	23%	10%	\$2,248	\$2,513
GOL	GOL	USD	4.90	NYSE	Dec	0.22	0.50	0.85	NM	70%	1.40	1.65	NM	18%	1,028	1,025	422%	0%	5,099	5,003	13%	-2%	5,381	4,981
LAN	LFL	USD	24.02	NYSE	Dec	0.68	1.35	1.80	42%	33%	2.65	3.20	23%	21%	1,370	1,627	17%	19%	6,528	7,462	14%	14%	5,608	5,733
TAM	TAM	USD	20.55	NYSE	Dec	0.58	1.30	1.75	NM	34%	4.10	4.50	NM	10%	1,390	1,509	132%	9%	7,636	7,985	0%	5%	7,416	7,410
<b>Average</b>									<b>6%</b>	<b>35%</b>			<b>2%</b>	<b>17%</b>			<b>117%</b>	<b>12%</b>			<b>13%</b>	<b>8%</b>		



Figure 9: Airline Stock Price Drivers (continued)

Company	Ticker	Price		Exchange	FYE	2012E Div.	EPS		EPS Growth		Cash Flow per Share <sup>1</sup>		CF per Share Growth		EBITDAR		EBITDAR Growth		Sales		Sales Growth		Invested Capital			
		22-May-12					2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E	2012E	2013E
<b>Europe</b>																										
<b>NETWORK CARRIERS</b>																										
Air Berlin	AB1	EUR	1.80	GER	Dec	---	(1.10)	(0.22)	NM	NM	(0.61)	0.52	NM	NM	441	633	14%	44%	4,149	4,291	-2%	3%	4,707	4,691		
Aeroflot	AFLT	USD	41.21	MCX	Dec	0.02	0.27	0.26	18%	-5%	0.48	0.55	14%	13%	1,030	1,098	7%	7%	5,739	6,154	10%	7%	6,155	6,910		
Air France-KLM	AIRF	EUR	3.45	PAR	Dec	---	(3.39)	(2.11)	NM	NM	2.13	3.47	-34%	63%	1,414	2,002	-28%	42%	24,796	25,723	2%	4%	17,417	17,345		
Deutsche Lufthansa AG	LHAG	EUR	8.56	GER	Dec	0.25	0.88	1.10	NM	24%	5.22	5.41	29%	4%	2,987	3,113	7%	4%	31,440	32,225	9%	2%	12,795	13,125		
Int'l Airlines Group (IAG) <sup>2</sup>	ICAG	GBP	144.80	LSE	Mar	---	(0.01)	0.09	NM	NM	0.53	0.65	-37%	22%	1,604	1,902	-20%	19%	17,466	17,923	7%	3%	13,587	14,075		
Turkish Airlines	THYAO	TRY	2.75	IST	Dec	---	0.17	0.26	NM	58%	0.87	1.00	NM	14%	1,260	1,011	-20%	-20%	16,424	20,022	36%	22%	14,328	15,046		
<b>Average</b>																										
									18%	26%																
<b>LOW COST CARRIERS</b>																										
EasyJet	EZJ	GBP	494.70	LSE	Sep	44.09	0.51	0.60	-1%	17%	0.76	0.87	3%	15%	495	543	6%	10%	3,883	4,196	12%	8%	2,387	2,611		
Ryanair	RYA	EUR	4.04	ISE	Mar	0.00	0.32	0.37	29%	15%	0.53	0.59	22%	11%	1,017	1,114	18%	10%	4,302	4,833	19%	12%	3,767	3,759		
<b>Average</b>																										
									14%	16%																
<b>Asia</b>																										
<b>NETWORK CARRIERS</b>																										
Air China <sup>2</sup>	0753	HKD	4.95	HKEX	Dec	0.00	0.32	0.47	-16%	47%	1.52	1.58	-3%	4%	22,547	25,952	2%	15%	108,938	120,993	11%	11%	152,476	162,178		
All Nippon Airways	ALNPFY	JPY	210	TYO	Mar	3.00	16.95	25.68	NM	51%	73.46	85.77	28%	17%	300,218	348,241	14%	16%	1,411,504	1,510,529	4%	7%	1,882,957	1,927,488		
Cathay Pacific	0293	HKD	12.30	HKEX	Dec	0.30	(0.12)	0.35	NM	NM	2.04	2.68	-42%	32%	10,414	13,540	-30%	30%	97,384	109,250	-1%	12%	78,248	84,059		
China Airlines	2610	TWD	11.45	Taiwan	Dec	0.00	0.21	1.13	NM	NM	2.37	3.37	30%	42%	23,409	24,749	34%	6%	140,774	147,610	6%	5%	206,119	210,738		
China Eastern Airlines <sup>2</sup>	0670	HKD	2.35	HKEX	Dec	---	0.27	0.32	-9%	21%	1.19	1.29	7%	8%	17,694	20,281	8%	15%	102,436	114,695	11%	12%	127,552	139,551		
China Southern Airlines <sup>2</sup>	1055	HKD	3.31	HKEX	Dec	0.20	0.32	0.43	-1%	34%	1.47	1.56	5%	6%	21,052	23,656	10%	12%	100,464	111,657	11%	11%	143,137	157,229		
EVA Airways	2618	TWD	17.10	Taiwan	Dec	0.37	1.18	2.12	NM	NM	3.93	4.97	41%	27%	20,369	21,408	20%	5%	110,359	115,673	8%	5%	135,400	132,094		
Korean Air	3490	KRW	44,600	Korea	Dec	500.0	(166)	2,302	NM	NM	30	26	NM	-15%	2,525	2,590	29%	3%	12,606	12,989	7%	3%	18,864	19,341		
Singapore Airlines	SIAL	SGD	10.31	Singapore	Mar	0.44	0.22	0.28	-21%	27%	1.69	2.25	5%	33%	2,569	2,675	-5%	4%	15,324	16,571	3%	8%	11,463	11,132		
Thai Airways	THAI	THB	21.60	Thailand	Dec	1.53	5.10	4.29	26%	-16%	14.59	14.28	7%	-2%	45,326	44,632	5%	-2%	222,150	235,424	4%	6%	235,827	259,970		
<b>Average</b>																										
									-4%	28%																
<b>LOW COST CARRIERS</b>																										
AirAsia	AIRA	MYR	3.39	Malaysia	Dec	0.00	0.35	0.46	51%	32%	0.62	0.73	26%	19%	2,099	2,491	18%	19%	5,171	5,984	16%	16%	12,032	13,009		
Cebu Air	CEB.PS	PHP	67.30	PHS	Dec	0.00	5.79	6.25	10%	8%	11.56	13.09	14%	13%	9,283	10,814	18%	16%	39,692	46,417	17%	17%	49,180	61,417		
<b>Average</b>																										
									30%	20%																
<b>Australia/ New Zealand</b>																										
Qantas Airways	QAN	AUD	1.47	ASX	Jun	---	0.09	0.19	-51%	NM	0.70	0.83	-6%	19%	2,442	2,938	-2%	20%	15,779	16,472	6%	4%	12,837	13,274		
Virgin Blue Group	VBA	AUD	0.42	ASX	Jun	---	0.03	0.05	NM	40%	0.15	0.17	73%	14%	588	661	50%	13%	3,801	4,050	16%	7%	3,285	3,577		
Air New Zealand	AIR	NZD	0.92	NZX	Jun	0.04	0.04	0.10	-39%	NM	0.35	0.42	-2%	18%	708	845	7%	19%	4,615	4,751	6%	3%	3,943	4,271		
<b>Average</b>																										
									-45%	40%																

Source: Deutsche Bank Airline Research, company filings, and FactSet

(1) Cash flow in this case also known as cash earnings, or net income plus depreciation, amortization, and other non-cash expenses.

(2) Market ratios adjusted to reflect difference in reporting / trading currencies.



Figure 10: Airline Enterprise Value to 2012 EBITDAR

Company	Equity Market Value <sup>1</sup>	Min. Int. net of Assoc. <sup>1</sup>	Total Debt <sup>1</sup>	Capitalized Operating Leases	Cash & Market. Sec. <sup>1</sup>	Enterprise Value	Net Pension Obligation <sup>1</sup>	Adj. Ent. Val.	S/H Equity <sup>1</sup>	Invested Capital <sup>2</sup>	Pretax Income	Interest Expense	D&A	Aircraft Rentals	Other Rentals	2012E EBITDAR	Pension Cost	EBITDAR	EV/EBITDAR	Adj. EV/EBITDAR	Adj. EV/Inv. Cap.	
<b>United States</b>																						
<b>LEGACY AIRLINES</b>																						
<i>Major Networks</i>																						
Alaska	USD	\$2,339 +	\$0 +	\$1,307 +	\$1,984 -	\$1,141 =	\$4,489 +	\$1,594 =	\$6,083	1173.2	\$4,917	\$481 +	\$57 +	\$257 +	\$106 +	\$177 =	\$1,079 +	\$87 =	\$1,166	4.2x	5.2x	1.2x
Delta	USD	8,946 +	0 +	13,791 +	7,586 -	3,920 =	\$26,403 +	11,504 =	37,907	(1,396)	27,565	1,717 +	1,022 +	1,566 +	284 +	800 =	5,389 +	1,204 =	6,593	4.9x	5.7x	1.4x
United Continental	USD	7,279 +	0 +	12,735 +	16,288 -	7,802 =	28,500 +	1,840 =	30,340	1,806	24,867	1,312 +	803 +	1,552 +	1,016 +	1,311 =	5,994 +	226 =	6,220	4.8x	4.9x	1.2x
US Airways	USD	1,736 +	0 +	4,566 +	7,472 -	2,312 =	11,462 +	160 =	11,622	150	10,036	372 +	339 +	247 +	660 +	408 =	2,026 +	12 =	2,038	5.7x	5.7x	1.2x
<b>Average</b>																			<b>4.9x</b>	<b>5.4x</b>	<b>1.2x</b>	
<b>GROWTH AIRLINES</b>																						
<i>Low Cost Carriers</i>																						
Allegiant	USD	1,196 +	0 +	146 +	21 -	320 =	1,043 +	0 =	1,043	352	199	111 +	8 +	49 +	1 +	2 =	170 +	0 =	170	6.1x	6.1x	5.2x
Hawaiian	USD	270 +	0 +	462 +	1,152 -	335 =	1,549 +	0 =	1,549	223	1,502	86 +	32 +	75 +	100 +	64 =	357 +	0 =	357	4.3x	4.3x	1.0x
JetBlue	USD	1,190 +	0 +	3,574 +	1,988 -	1,229 =	5,524 +	0 =	5,524	1,757	6,090	263 +	176 +	257 +	137 +	147 =	980 +	0 =	980	5.6x	5.6x	0.9x
Southwest	USD	6,446 +	0 +	3,751 +	6,397 -	3,144 =	13,450 +	0 =	13,450	6,877	13,881	672 +	130 +	785 +	364 +	550 =	2,501 +	0 =	2,501	5.4x	5.4x	1.0x
Spirit	USD	1,507 +	0 +	0 +	1,472 -	343 =	2,636 +	0 =	2,636	467	1,596	199 +	0 +	20 +	142 +	68 =	430 +	0 =	430	6.1x	6.1x	1.7x
<b>Average</b>																			<b>5.5x</b>	<b>5.5x</b>	<b>2.0x</b>	
<i>Regional Airlines</i>																						
Republic	USD	237 +	0 +	2,359 +	2,552 -	371 =	4,777 +	0 =	4,777	461	5,001	47 +	130 +	197 +	255 +	110 =	739 +	0 =	739	6.5x	6.5x	1.0x
SkyWest	USD	395 +	0 +	1,815 +	2,721 -	647 =	4,284 +	0 =	4,284	1,334	5,224	62 +	80 +	265 +	349 +	40 =	795 +	0 =	795	5.4x	5.4x	0.8x
<b>Average</b>																			<b>5.9x</b>	<b>5.9x</b>	<b>0.9x</b>	
<b>Latin America</b>																						
Aeromexico	MXN P.	P/\$14,545 +	P/\$8 +	P/\$3,179 +	P/\$26,044 -	P/\$4,100 =	P/\$39,676 +	P/\$0 =	P/\$39,676	3835	P/\$28,966	P/\$1,905 +	P/\$1,096 +	P/\$536 +	P/\$3,721 +	P/\$0 =	P/\$7,257 +	P/\$0 =	P/\$7,257	5.5x	5.5x	1.4x
Copa	USD	\$3,688 +	\$0 +	\$1,068 +	\$507 -	\$506 =	\$4,756 +	\$0 =	\$4,756	1180.15	\$2,248	\$380 +	\$34 +	\$83 +	\$58 +	\$14 =	\$570 +	\$0 =	\$570	8.3x	8.3x	2.1x
GOL	USD	1,320 +	0 +	2,773 +	2,225 -	1,244 =	5,073 +	0 =	5,073	1,628	5,381	232 +	251 +	228 +	309 +	8 =	1,028 +	0 =	1,028	4.9x	4.9x	0.9x
LAN	USD	8,174 +	12 +	3,109 +	1,754 -	602 =	12,447 +	0 =	12,447	1,335	5,608	547 +	149 +	423 +	181 +	70 =	1,370 +	0 =	1,370	9.1x	9.1x	2.2x
TAM	USD	3,210 +	40 +	5,086 +	1,965 -	1,296 =	9,005 +	0 =	9,005	1,621	7,416	419 +	272 +	419 +	281 +	0 =	1,390 +	0 =	1,390	6.5x	6.5x	1.2x
<b>Average</b>																			<b>6.9x</b>	<b>6.9x</b>	<b>1.6x</b>	





Figure 11: Airline Enterprise Value to 2013 EBITDAR

Company	Equity Market Value <sup>1</sup>	Min. Int. net of Assoc. <sup>1</sup>	Total Debt <sup>1</sup>	Capitalized Operating Leases	Cash & Marketable Securities <sup>1</sup>	Enterprise Value	Net Pension Obligation <sup>1</sup>	Adj. Ent. Val.	S/H Equity <sup>1</sup>	Invested Capital <sup>2</sup>	Pretax Income	Interest Expense	D&A	Aircraft Rentals	Other Rentals	2013E EBITDAR	Pension Cost	EBITDAR <sup>3</sup>	EV/EBITDAR	Adj. EV/EBITDAR	Adj. EV/Inv. Cap.																
<b>United States</b>																																					
<b>LEGACY AIRLINES</b>																																					
<i>Major Networks</i>																																					
Alaska	USD	\$2,339	+	\$0	+	\$1,307	+	\$2,123	-	\$1,141	=	\$4,628	+	\$1,594	=	\$6,222		\$1,173	\$5,056	\$527	+	\$65	+	\$263	+	\$109	+	\$195	=	\$1,159	+	\$92	=	\$1,251	4.0x	5.0x	1.2x
Delta	USD	8,946	+	0	+	13,791	+	8,495	-	3,920	=	27,312	+	11,504	=	38,816		(1,396)	28,474	1,695	+	950	+	1,630	+	301	+	913	=	5,489	+	1,306	=	6,795	5.0x	5.7x	1.4x
United Continental	USD	7,279	+	0	+	12,735	+	16,292	-	7,802	=	28,504	+	1,840	=	30,344		1,806	24,871	2,017	+	745	+	1,618	+	1,037	+	1,291	=	6,707	+	258	=	6,966	4.2x	4.4x	1.2x
US Airways	USD	1,736	+	0	+	4,566	+	7,640	-	2,312	=	11,631	+	160	=	11,791		150	10,204	394	+	345	+	249	+	678	+	414	=	2,080	+	14	=	2,093	5.6x	5.6x	1.2x
<b>Average</b>																			<b>4.7x</b>	<b>5.2x</b>	<b>1.2x</b>																
<b>GROWTH AIRLINES</b>																																					
<i>Low Cost Carriers</i>																																					
Allegiant	USD	1,196	+	0	+	146	+	42	-	320	=	1,064	+	0	=	1,064		352	220	122	+	8	+	55	+	1	+	5	=	191	+	0	=	191	5.6x	5.6x	4.8x
Hawaiian	USD	270	+	0	+	462	+	1,305	-	335	=	1,702	+	0	=	1,702		223	1,655	94	+	30	+	81	+	109	+	77	=	391	+	0	=	391	4.4x	4.4x	1.0x
JetBlue	USD	1,190	+	0	+	3,574	+	2,202	-	1,229	=	5,737	+	0	=	5,737		1,757	6,304	297	+	190	+	273	+	153	+	161	=	1,074	+	0	=	1,074	5.3x	5.3x	0.9x
Southwest	USD	6,446	+	0	+	3,751	+	7,589	-	3,144	=	14,642	+	0	=	14,642		6,877	15,073	998	+	145	+	801	+	433	+	651	=	3,028	+	0	=	3,028	4.8x	4.8x	1.0x
Spirit	USD	1,507	+	0	+	0	+	1,758	-	343	=	2,922	+	0	=	2,922		467	1,882	251	+	0	+	22	+	169	+	82	=	524	+	0	=	524	5.6x	5.6x	1.6x
<b>Average</b>																			<b>5.1x</b>	<b>5.1x</b>	<b>1.9x</b>																
<i>Regional Airlines</i>																																					
Republic	USD	237	+	0	+	2,359	+	2,576	-	371	=	4,801	+	0	=	4,801		461	5,025	59	+	130	+	197	+	252	+	116	=	754	+	0	=	754	6.4x	6.4x	1.0x
SkyWest	USD	395	+	0	+	1,815	+	2,903	-	647	=	4,466	+	0	=	4,466		1,334	5,406	108	+	100	+	277	+	366	+	48	=	899	+	0	=	899	5.0x	5.0x	0.8x
<b>Average</b>																			<b>5.7x</b>	<b>5.7x</b>	<b>0.9x</b>																
<b>Latin America</b>																																					
Aeromexico	MXN P.	Pes\$14,545	+	Pes\$8	+	Pes\$3,179	+	Pes\$28,958	-	Pes\$4,100	=	Pes\$42,590	+	Pes\$0	=	Pes\$42,590		\$3,835	Pes\$31,880	Pes\$2,688	+	Pes\$1,150	+	Pes\$603	+	Pes\$4,137	+	Pes\$0	=	Pes\$8,578	+	Pes\$0	=	Pes\$8,578	5.0x	5.0x	1.3x
Copa	USD	\$3,688	+	\$0	+	\$1,068	+	\$771	-	\$506	=	\$5,021	+	\$0	=	\$5,021		1,180	\$2,513	\$428	+	\$44	+	\$84	+	\$53	+	\$57	=	\$666	+	\$0	=	\$666	7.5x	7.5x	2.0x
GOL	USD	1,320	+	0	+	2,773	+	1,824	-	1,244	=	4,673	+	0	=	4,673		1,628	4,981	350	+	203	+	212	+	253	+	8	=	1,025	+	0	=	1,025	4.6x	4.6x	0.9x
LAN	USD	8,174	+	12	+	3,109	+	1,879	-	602	=	12,572	+	0	=	12,572		1,335	5,733	728	+	150	+	480	+	192	+	76	=	1,627	+	0	=	1,627	7.7x	7.7x	2.2x
TAM	USD	3,210	+	40	+	5,086	+	1,959	-	1,296	=	8,999	+	0	=	8,999		1,621	7,410	532	+	286	+	411	+	280	+	0	=	1,509	+	0	=	1,509	6.0x	6.0x	1.2x
<b>Average</b>																			<b>6.2x</b>	<b>6.2x</b>	<b>1.5x</b>																



Figure 11: Airline Enterprise Value to 2013 EBITDAR (continued)

Company	Equity Market Value <sup>1</sup>	Min. Int. net of Assoc. <sup>1</sup>	Total Debt <sup>1</sup>	Capitalized Operating Leases	Cash & Marketable Securities <sup>1</sup>	Enterprise Value	Net Pension Obligation <sup>1</sup>	Adj. Ent. Val.	S/H Equity <sup>1</sup>	Invested Capital <sup>2</sup>	Pretax Income	Interest Expense	D&A	Aircraft Rentals	Other Rentals	2013E EBITDAR	Pension Cost	EBITDAR	EV/EBITDAR	Adj. EV/EBITDAR	Adj. EV/Inv. Cap.															
<b>Europe</b>																																				
<b>NETWORK CARRIERS</b>																																				
Air Berlin	EUR	210	+	0	+	999	+	3,661	-	97	=	4,773	+	0	=	4,773	128	4,691	(60)	+	77	+	94	+	523	+	0	=	633	+	0	=	633	7.5x	7.5x	1.0x
Aeroflot	USD	1,469	+	(0)	+	3,759	+	2,089	-	931	=	6,386	+	14	=	6,400	1,979	6,910	360	+	119	+	320	+	298	+	0	=	1,098	+	0	=	1,098	5.8x	5.8x	0.9x
Air France-KLM	EUR	1,019	+	(1,218)	+	12,032	+	5,965	-	3,846	=	13,952	+	0	=	13,952	4,413	17,345	(885)	+	385	+	1,650	+	852	+	0	=	2,002	+	0	=	2,002	7.0x	7.0x	0.8x
Deutsche Lufthansa AG	EUR	3,920	+	(1,320)	+	6,650	+	1,030	-	2,869	=	7,410	+	1,365	=	8,775	8,269	13,125	531	+	463	+	1,972	+	147	+	0	=	3,113	+	0	=	3,113	2.4x	2.8x	0.7x
Int'l Airlines Group (IAG) <sup>3</sup>	GBP	3,327	+	(372)	+	7,041	+	3,592	-	4,464	=	9,123	+	2,820	=	11,943	5,459	14,075	194	+	168	+	1,027	+	513	+	0	=	1,902	+	0	=	1,902	4.8x	6.3x	0.8x
Turkish Airlines	TRY	3,300	+	(13)	+	9,249	+	4,490	-	3,347	=	13,679	+	0	=	13,679	4,667	15,046	390	+	(914)	+	893	+	641	+	0	=	1,011	+	0	=	1,011	13.5x	13.5x	0.9x
<b>Average</b>																				<b>8.4x</b>	<b>8.9x</b>	<b>0.9x</b>														
<b>LOW COST CARRIERS</b>																																				
EasyJet	GBP	1,954	+	0	+	1,735	+	810	-	1,848	=	2,650	+	0	=	2,650	1,914	2,611	296	+	24	+	108	+	116	+	0	=	543	+	0	=	543	4.9x	4.9x	1.0x
Ryanair	EUR	6,002	+	(114)	+	3,093	+	662	-	3,375	=	6,268	+	0	=	6,268	3,493	3,759	639	+	55	+	326	+	95	+	0	=	1,114	+	0	=	1,114	5.6x	5.6x	1.7x
<b>Average</b>																				<b>5.3x</b>	<b>5.3x</b>	<b>1.3x</b>														
<b>Asia</b>																																				
<b>NETWORK CARRIERS</b>																																				
Air China <sup>3</sup>	HKD	52,727	+	(10,908)	+	96,374	+	36,866	-	18,279	=	156,780	+	218	=	156,998	57,907	162,178	8,059	+	1,774	+	10,853	+	5,267	+	0	=	25,952	+	0	=	25,952	6.0x	6.0x	1.0x
All Nippon Airw ays	JPY	527,721	+	0	+	860,228	+	518,000	-	195,445	=	1,710,504	+	123,400	=	1,833,904	621,305	1,927,488	103,241	+	20,000	+	151,000	+	74,000	+	0	=	348,241	+	24,000	=	372,241	4.9x	4.9x	1.0x
Cathay Pacific	HKD	48,386	+	(20,464)	+	51,835	+	9,300	-	11,520	=	77,537	+	216	=	77,753	54,692	84,059	456	+	2,615	+	9,140	+	1,329	+	0	=	13,540	+	0	=	13,540	5.7x	5.7x	0.9x
China Airlines	TWD	59,540	+	0	+	117,303	+	44,149	-	15,081	=	205,911	+	4,558	=	210,469	59,809	210,738	4,358	+	2,468	+	11,615	+	6,307	+	0	=	24,749	+	0	=	24,749	8.3x	8.5x	1.0x
China Eastern Airlines <sup>3</sup>	HKD	21,579	+	477	+	72,359	+	39,724	-	4,859	=	129,280	+	2,395	=	131,675	29,456	139,551	4,124	+	1,861	+	8,622	+	5,675	+	0	=	20,281	+	0	=	20,281	6.4x	6.5x	0.9x
China Southern Airlines <sup>3</sup>	HKD	26,462	+	3,637	+	76,292	+	50,206	-	12,350	=	144,247	+	203	=	144,450	39,242	157,229	6,095	+	1,318	+	9,070	+	7,172	+	0	=	23,656	+	0	=	23,656	6.1x	6.1x	0.9x
EVA Airw ays	TWD	55,728	+	0	+	54,298	+	44,733	-	14,350	=	140,408	+	525	=	140,933	46,889	132,094	4,570	+	1,169	+	9,279	+	6,390	+	0	=	21,408	+	0	=	21,408	6.6x	6.6x	1.1x
Korean Air	KRW	3,012,030	+	0	+	15,310	+	2,037	-	1,683	=	18,676	+	815	=	19,491	2,861	19,341	200	+	565	+	1,534	+	291	+	0	=	2,590	+	0	=	2,590	7.2x	7.5x	1.0x
Singapore Airlines	SGD	12,231	+	(283)	+	1,086	+	4,260	-	6,947	=	10,346	+	0	=	10,346	13,017	11,132	359	+	(50)	+	1,758	+	609	+	0	=	2,675	+	0	=	2,675	3.9x	3.9x	0.9x
Thai Airw ays	THB	47,053	+	289	+	154,315	+	32,015	-	34,610	=	199,062	+	4,573	=	203,635	103,388	259,970	13,722	+	4,576	+	21,760	+	4,574	+	0	=	44,632	+	0	=	44,632	4.5x	4.6x	0.8x
<b>Average</b>																				<b>6.0x</b>	<b>6.0x</b>	<b>0.9x</b>														
<b>LOW COST CARRIERS</b>																																				
AirAsia	MYR	9,402	+	(50)	+	9,570	+	841	-	3,764	=	15,998	+	0	=	15,998	6,413	13,009	1,346	+	371	+	654	+	120	+	0	=	2,491	+	0	=	2,491	6.4x	6.4x	1.2x
Cebu Air	PHP	41,271	+	(590)	+	28,171	+	15,814	-	8,997	=	75,670	+	216	=	75,886	26,802	61,417	3,919	+	925	+	3,712	+	2,259	+	0	=	10,814	+	0	=	10,814	7.0x	7.0x	1.2x
<b>Average</b>																				<b>6.7x</b>	<b>6.7x</b>	<b>1.2x</b>														
<b>Australia/ New Zealand</b>																																				
Qantas Airw ays	AUD	3,330	+	(487)	+	7,763	+	4,136	-	4,173	=	10,570	+	0	=	10,570	6,033	13,274	620	+	270	+	1,457	+	591	+	0	=	2,938	+	0	=	2,938	3.6x	3.6x	0.8x
Virgin Blue Group	AUD	928	+	(8)	+	2,570	+	1,351	-	1,159	=	3,682	+	0	=	3,682	823	3,577	144	+	60	+	265	+	193	+	0	=	661	+	0	=	661	5.6x	5.6x	1.0x
Air New Zealand	NZD	1,003	+	0	+	1,630	+	1,960	-	860	=	3,733	+	0	=	3,733	1,540	4,271	150	+	65	+	350	+	280	+	0	=	845	+	0	=	845	4.4x	4.4x	0.9x
<b>Average</b>																				<b>4.5x</b>	<b>4.5x</b>	<b>0.9x</b>														

Source: Deutsche Bank Airline Research, company filings, and FactSet

(1) For the US and Latin carriers, represents value as of last pricing date. For other carriers, represents value as of forecasting year end.

(2) Same formula as adjusted enterprise value, but replaces market value of equity with book value of equity.

(3) Market ratios adjusted to reflect difference in reporting / trading currencies.



# Global Capacity Monitor

Figure 12: System ASKs (in mm)

United States	2007	2008	% Chg	2009	% Chg	2010	% Chg	2011E	% Chg	2012E	% Chg	2013E	% Chg
<b>Network Carriers</b>													
Alaska	38,959	38,975	0.0%	37,247	-4.4%	39,323	5.6%	42,675	8.5%	45,181	5.9%	47,892	6.0%
AMR	273,437	263,179	-3.8%	244,257	-7.2%	246,617	1.0%	248,356	0.7%	248,295	0.0%	250,778	1.0%
Delta	344,226	342,585	-0.5%	318,205	-7.1%	323,179	1.6%	327,421	1.3%	319,283	-2.5%	322,476	1.0%
United Continental	394,336	383,648	-2.7%	354,286	-7.7%	354,147	0.0%	353,149	-0.3%	350,717	-0.7%	354,224	1.0%
US Airways	122,056	119,334	-2.2%	113,821	-4.6%	115,210	1.2%	116,843	1.4%	118,126	1.1%	119,307	1.0%
<b>Network Total</b>	<b>1,173,014</b>	<b>1,147,722</b>	<b>-2.2%</b>	<b>1,067,815</b>	<b>-7.0%</b>	<b>1,078,476</b>	<b>1.0%</b>	<b>1,088,443</b>	<b>0.9%</b>	<b>1,081,602</b>	<b>-0.6%</b>	<b>1,094,677</b>	<b>1.2%</b>
<b>Low Cost Carriers</b>													
Allegiant	6,221	7,149	14.9%	8,770	22.7%	10,053	14.6%	10,242	1.9%	12,799	25.0%	14,079	10.0%
Hawaiian	14,838	15,303	3.1%	15,637	2.2%	16,336	4.5%	19,373	18.6%	23,598	21.8%	25,958	10.0%
JetBlue	51,345	52,210	1.7%	52,396	0.4%	55,915	6.7%	59,919	7.2%	63,827	6.5%	66,380	4.0%
Southwest	196,868	204,516	3.9%	195,206	-4.6%	197,144	1.0%	206,854	4.9%	206,785	0.0%	211,954	2.5%
Spirit	13,618	13,297	-2.4%	12,046	-9.4%	13,068	8.5%	15,051	15.2%	18,433	22.5%	22,119	20.0%
Other LCCs	44,457	36,467	-18.0%	30,228	-17.1%	36,775	21.7%	40,094	9.0%	41,688	4.0%	44,723	7.3%
<b>LCC Total</b>	<b>327,347</b>	<b>328,943</b>	<b>0.5%</b>	<b>314,284</b>	<b>-4.5%</b>	<b>329,291</b>	<b>4.8%</b>	<b>351,533</b>	<b>6.8%</b>	<b>367,130</b>	<b>4.4%</b>	<b>385,214</b>	<b>4.9%</b>
<b>Regional Carriers</b>													
Pinnacle	10,628	11,878	11.8%	11,594	-2.4%	15,190	31.0%	19,036	25.3%	19,964	4.9%	19,565	-2.0%
Republic	18,526	21,265	14.8%	20,803	-2.2%	18,263	-12.2%	18,047	-1.2%	18,352	1.7%	18,719	2.0%
Skywest	36,965	35,439	-4.1%	35,635	0.6%	41,045	15.2%	40,023	-2.5%	41,232	3.0%	42,371	2.8%
Other Regional Carriers	89,538	88,945	-0.7%	85,994	-3.3%	84,949	-1.2%	78,078	-8.1%	78,033	-0.1%	76,154	-2.4%
<b>Regional Total</b>	<b>155,658</b>	<b>157,527</b>	<b>1.2%</b>	<b>154,026</b>	<b>-2.2%</b>	<b>159,447</b>	<b>3.5%</b>	<b>155,184</b>	<b>-2.7%</b>	<b>157,582</b>	<b>1.5%</b>	<b>156,809</b>	<b>-0.5%</b>
<b>US Total</b>	<b>1,656,018</b>	<b>1,634,192</b>	<b>-1.3%</b>	<b>1,536,125</b>	<b>-6.0%</b>	<b>1,567,214</b>	<b>2.0%</b>	<b>1,595,161</b>	<b>1.8%</b>	<b>1,606,314</b>	<b>0.7%</b>	<b>1,636,700</b>	<b>1.9%</b>
<b>Latin America</b>													
Aeromexico	-	-	NM	22,492	NM	23,597	4.9%	28,986	22.8%	31,732	9.5%	35,222	11.0%
Copa	12,743	14,235	11.7%	15,947	12.0%	17,622	10.5%	21,488	21.9%	26,291	22.4%	29,446	12.0%
GOL	34,780	41,108	18.2%	39,988	-2.7%	45,454	13.7%	54,602	20.1%	53,785	-1.5%	54,323	1.0%
LAN	31,556	35,176	11.5%	38,777	10.2%	42,355	9.2%	48,153	13.7%	54,429	13.0%	60,960	12.0%
TAM	47,600	57,091	19.9%	64,720	13.4%	71,445	10.4%	78,119	9.3%	78,260	0.2%	80,607	3.0%
<b>Latin America Total</b>	<b>126,679</b>	<b>147,610</b>	<b>16.5%</b>	<b>181,925</b>	<b>23.2%</b>	<b>200,474</b>	<b>10.2%</b>	<b>231,348</b>	<b>15.4%</b>	<b>244,496</b>	<b>5.7%</b>	<b>260,558</b>	<b>6.6%</b>
<b>Middle East</b>													
Emirates	117,032	133,464	14.0%	162,964	22.1%	187,775	15.2%	205,537	9.5%	241,479	17.5%	277,701	15.0%
Ethiad	25,382	32,249	34.0%	37,898	17.5%	44,323	17.0%	48,526	9.5%	55,059	13.5%	63,318	15.0%
Qatar	39,254	46,769	30.0%	53,473	14.3%	72,181	35.0%	80,372	11.3%	88,716	10.4%	102,023	15.0%
Turkish	41,618	46,319	11.3%	56,547	22.1%	65,053	15.0%	81,120	24.7%	98,150	21.0%	116,776	19.0%
<b>Middle East Total</b>	<b>223,287</b>	<b>258,801</b>	<b>15.9%</b>	<b>310,882</b>	<b>20.1%</b>	<b>369,332</b>	<b>18.8%</b>	<b>415,554</b>	<b>12.5%</b>	<b>483,404</b>	<b>16.3%</b>	<b>559,819</b>	<b>15.8%</b>

Source: Deutsche Bank Airline Research



Figure 12: System ASKs (in mm) (continued)

	2007	2008	% Chg	2009	% Chg	2010	% Chg	2011E	% Chg	2012E	% Chg	2013E	% Chg
<b>Europe</b>													
Aeroflot	33,573	36,170	7.7%	36,524	1.0%	42,935	17.6%	51,009	18.8%	62,281	22.1%	74,737	20.0%
Air Berlin	31,562	53,217	68.6%	44,348	-16.7%	48,914	10.3%	46,919	-4.1%	56,806	21.1%	59,646	5.0%
Air France-KLM	246,447	256,697	4.2%	253,082	-1.4%	248,537	-1.8%	262,991	5.8%	270,881	3.0%	279,008	3.0%
bmi	12,137	15,595	28.5%	12,957	-16.9%	10,938	-15.6%	10,468	-4.3%	8,053	-23.1%	6,442	-20.0%
easyJet	45,468	56,685	24.7%	59,306	4.6%	64,538	8.8%	70,148	8.7%	73,909	5.4%	79,082	7.0%
International Airline Group	216,114	211,183	-2.3%	206,301	-2.3%	199,228	-3.4%	213,193	7.0%	216,200	1.4%	220,524	2.0%
Lufthansa (inc Swiss, Austrian)	217,023	227,188	4.7%	219,076	-3.6%	228,667	4.4%	250,155	9.4%	257,352	2.9%	265,073	3.0%
Ryanair	61,374	76,456	24.6%	87,850	14.9%	103,105	17.4%	116,170	12.7%	123,598	6.4%	129,778	5.0%
<b>Europe Total</b>	<b>863,699</b>	<b>933,192</b>	<b>8.0%</b>	<b>919,443</b>	<b>-1.5%</b>	<b>946,861</b>	<b>3.0%</b>	<b>1,021,053</b>	<b>7.8%</b>	<b>1,069,080</b>	<b>4.7%</b>	<b>1,114,290</b>	<b>4.2%</b>
<b>Asia</b>													
Air China	89,234	91,810	2.9%	98,625	7.4%	132,075	33.9%	151,590	14.8%	166,670	9.9%	183,007	9.8%
AirAsia	14,536	19,217	32.2%	22,159	15.3%	24,362	9.9%	26,074	7.0%	28,681	10.0%	31,550	10.0%
All Nippon Airways	90,936	87,127	-4.2%	83,828	-3.8%	86,565	3.3%	91,163	5.3%	97,584	7.0%	105,494	8.1%
Cathay Pacific	102,462	115,478	12.7%	111,167	-3.7%	115,748	4.1%	126,340	9.2%	130,130	3.0%	137,938	6.0%
Cebu Air	5,763	7,365	27.8%	9,369	27.2%	10,379	10.8%	12,370	19.2%	14,909	20.5%	18,690	25.4%
China Airlines	43,591	41,140	-5.6%	40,650	-1.2%	40,447	-0.5%	40,622	0.4%	41,840	3.0%	42,677	2.0%
China Eastern Airlines	77,717	75,964	-2.3%	84,456	11.2%	119,451	41.4%	127,891	7.1%	140,420	9.8%	153,706	9.5%
China Southern Airlines	109,734	112,767	2.8%	123,441	9.5%	140,498	13.8%	151,074	7.5%	166,181	10.0%	182,443	9.8%
EVA Airways	29,785	28,853	-3.1%	29,311	1.6%	30,191	3.0%	30,314	0.4%	31,981	5.5%	32,621	2.0%
Korean Air	76,181	77,109	1.2%	78,941	2.4%	79,511	0.7%	84,285	6.0%	90,786	7.7%	94,418	4.0%
Singapore Airlines	113,919	117,788	3.4%	105,674	-10.3%	108,060	2.3%	113,410	5.0%	116,812	3.0%	122,653	5.0%
Thai Airways	76,833	75,391	-1.9%	72,031	-4.5%	75,600	5.0%	79,180	4.7%	83,648	5.6%	86,201	3.1%
<b>Asia Total</b>	<b>830,691</b>	<b>850,009</b>	<b>2.3%</b>	<b>859,652</b>	<b>1.1%</b>	<b>962,887</b>	<b>12.0%</b>	<b>1,034,313</b>	<b>7.4%</b>	<b>1,109,644</b>	<b>7.3%</b>	<b>1,191,397</b>	<b>7.4%</b>
<b>Australia/New Zealand</b>													
Qantas Airways	123,844	126,817	2.4%	123,218	-2.8%	128,963	4.7%	136,664	6.0%	142,003	3.9%	146,343	3.1%
Virgin Australia	22,497	25,584	13.7%	30,318	18.5%	36,274	19.6%	38,365	5.8%	39,883	4.0%	41,791	4.8%
Air New Zealand	36,052	35,653	-1.1%	32,946	-7.6%	31,965	-3.0%	32,631	2.1%	33,381	2.3%	34,268	2.7%
<b>Australia Total</b>	<b>182,393</b>	<b>188,054</b>	<b>3.1%</b>	<b>186,482</b>	<b>-0.8%</b>	<b>197,202</b>	<b>5.7%</b>	<b>207,660</b>	<b>5.3%</b>	<b>215,267</b>	<b>3.7%</b>	<b>222,402</b>	<b>3.3%</b>
<b>Global Total</b>	<b>3,882,767</b>	<b>4,011,859</b>	<b>3.3%</b>	<b>3,994,508</b>	<b>-0.4%</b>	<b>4,243,969</b>	<b>6.2%</b>	<b>4,505,089</b>	<b>6.2%</b>	<b>4,728,205</b>	<b>5.0%</b>	<b>4,985,166</b>	<b>5.4%</b>

Source: Deutsche Bank Airline Research

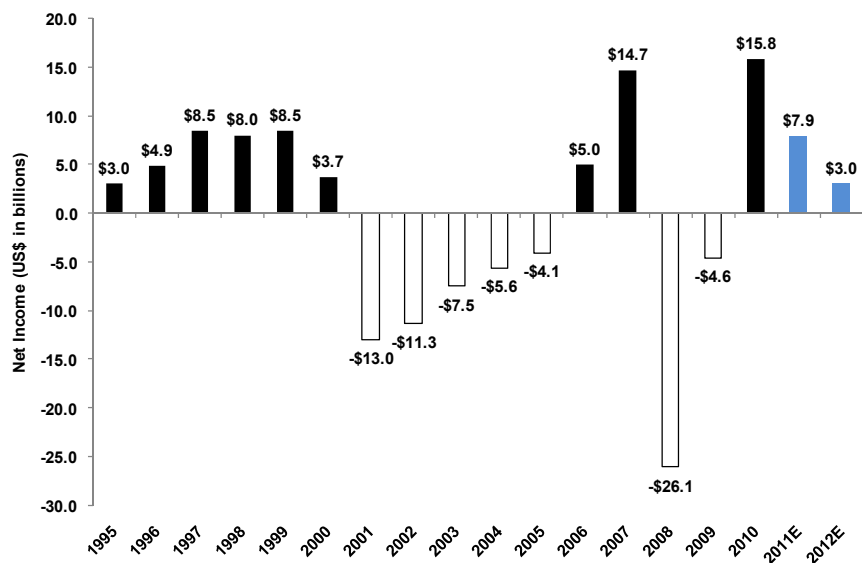


# Industry Factors/Drivers

## Global airlines back to profitability, but outlook uncertain

After two years of net losses approaching \$31 billion due to the global recession, the world's airlines returned to profitability in 2010 – 2011 with \$24 billion net profit (see Figure 13) according to IATA. However, the recovery has been erratic as evidenced by IATA's 2012 industry forecast which calls for only \$3 billion in net profits.

Figure 13: Global airline net profits (actual and projected per IATA)



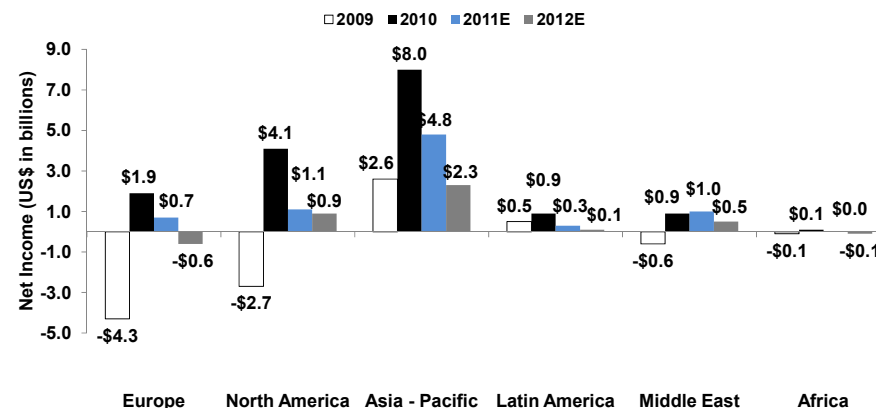
Source: IATA and Deutsche Bank Airline Research

This differs from the Deutsche Bank's Global Airline Team's bottom-up forecast of our coverage universe of publicly-traded airlines, which calls for net profits of \$9.7 billion in 2012. The primary reason for the difference is that our coverage universe includes several very profitable airlines that are not IATA members notably easyJet, JetBlue, Ryanair and Southwest.

## Asia-Pacific & US are biggest 2012 profit contributors

For 2012, we are forecasting Asia-Pacific airlines to contribute \$4.4 billion (vs. IATA's \$2.3 billion) of net profits and US airlines to produce \$3.9 billion (vs. IATA's \$0.9 billion) of net profits (see Figures 14 and 15). Although Latin American airlines are expected to contribute a lesser \$1.7 billion (vs. IATA's \$0.1 billion). In the Middle East, we expect the majority of profits to come from Emirates. Bringing up the rear are the European airlines which are struggling under a relatively challenging macro backdrop. IATA is forecasting a \$600 million loss for the region, which compares to our \$200 million loss forecast.

Figure 14: Airline net profits by region (actual and projected per IATA)

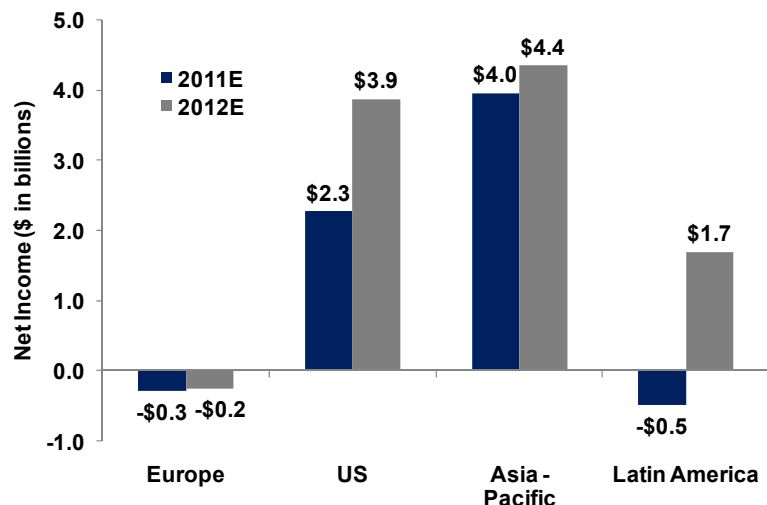


Source: IATA and Deutsche Bank Airline Research

As shown in Figure 15 below, Deutsche Bank's Global Airline Team forecast is more optimistic than IATA's forecast, but again we think this is largely a function of our coverage of several very profitable non-IATA airlines (and the exclusion of some very unprofitable, non-public IATA airlines).



Figure 15: Deutsche Bank airline net profit estimates by region

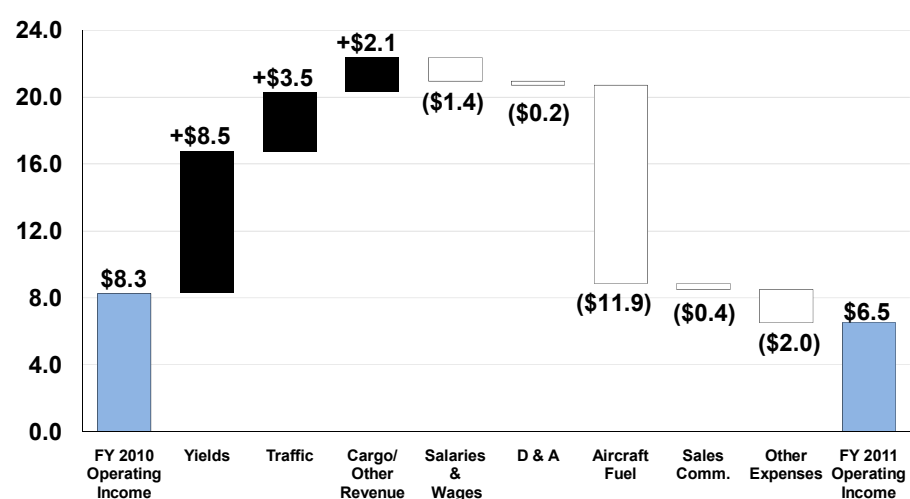


Source: Deutsche Bank Airline Research  
Note: All results/estimates represented in graph have been calendarized to reflect a 12/31 year end

## US turnaround bolstered by capacity discipline

The turnaround of the US airline industry has been remarkable as years of restructuring/consolidation combined with significant capacity cuts have resulted in solid margins despite a challenging macroeconomic backdrop. In fact, we view 2011 as a watershed year for the US airline industry. Despite a sub-2% GDP backdrop, the US airline industry managed to more than offset a 40% surge in fuel expense with 12% top-line growth resulting in \$6.5 billion of operating profit and \$2.3 billion of net profit (and a similar amount of free cash flow) – see Figure 16. It is clear that consolidation has resulted in more rational capacity deployment leading to positive ROIC – WACC gaps for the past two years for Alaska, Delta and United Continental, among others. Compared to other airlines around the world, US airlines have been the most aggressive in scaling back capacity growth which is highlighted in the Deutsche Bank Global Capacity Monitor located on page 20.

Figure 16: US operating income variance: FY 2011 vs. FY 2010 (\$ in billions)

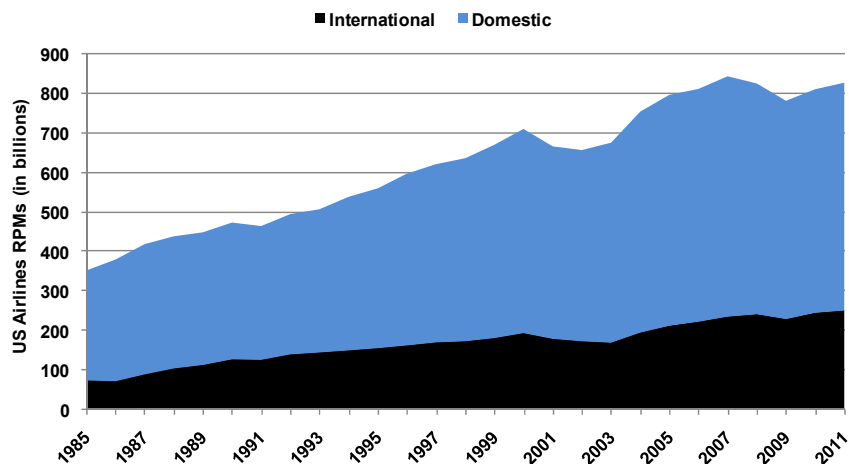


Source: A4A and Deutsche Bank Airline Research

US airline capacity deployed to international markets, on the other hand, has been rising steadily, and is currently at an all time high (see Figure 17). Furthermore, the US airlines have been reallocating more of their assets to international markets. For the most part, international markets: 1) are a means for US airlines to access regions with strong GDP growth rates; 2) can be characterized by higher barriers to entry than domestic markets; 3) can be a source of strong currency revenue/earnings; 4) tend to be devoid of low cost carriers (“LCCs”) and 5) have historically been more profitable than domestic markets. Therefore, it should come as no surprise that the US airlines have been gradually shifting their capacity to international markets over the past 25 years.



Figure 17: US airlines capacity deployment: domestic vs. international



Source: A4A and Deutsche Bank Airline Research

### But financial returns less than adequate

Despite the industry's return to profitability, global airlines still generate returns that fail to cover their cost of capital (see Figure 6 on page 10). Although most industry observers, investors, policy-makers, and regulators are well aware of the industry's financial predicament, most do not seem to be aware of the magnitude of the wealth destruction. In our estimation, the global airline industry's shareholder base is in the range of \$150 billion - \$200 billion (includes both public and private airlines). So for years where the gap between return on invested capital and weighted average cost of capital is 8 – 10 percentage points, that can represent as much as \$20 billion of wealth destruction for company owners (and in some cases, all of the equity being wiped-out).

### Is consolidation the solution?

We are of the view that consolidation including the rise of cross-border mergers may be one way for the industry to address its financial predicament. However, we think airlines have many vehicles to choose from in order to achieve their consolidation goals. Transactions such as JetBlue's agreement to interline with American in several northeastern US markets, Qantas' move to use its Jetstar brand as means to penetrate the rapidly growing Asia-Pacific region, as well as antitrust immunized JVs such as United/Air Canada/Lufthansa and American/British Airways/Iberia and Pacific ATI JVs such as United/All Nippon and American/Japan Airlines are all means to address a highly fragmented industry and lead to an outcome that share many similarities of a merger. Additionally, as indicated earlier, partners can intensify their cooperation to the extent that they decide to pursue a full merger. Lastly, we think it is worth noting that the first two agreements reflect cooperation between a legacy and an LCC airline, something that was unheard of just a few years ago.

The bottom-line is that the consolidation genie is well out of its bottle with Europe's network carriers having led the charge earlier this past decade. More recently, the US airlines have followed the lead of the European airlines, and in many cases pursued acquisitions that were partially motivated by existing alliances with their European alliance partners. Lately, it seems that Latin American airlines are on the vanguard of some of the most innovative and landscape-changing mergers as evidenced by the soon to close merger between LAN of Chile and TAM of Brazil.



# Global Consolidation Trends

In the sections below we examine trends in the primary aviation markets focusing on various forms of consolidation including, among other things, alliance development, joint ventures, and M&A. Airline mergers, alliances and joint ventures can create value to shareholders in the following ways:

1. Cutting competition resulting in higher yields
2. Reducing network overlaps resulting in greater capital efficiency
3. Improved schedule resulting in higher passenger volumes
4. Cost synergies by sharing joint costs such as IT and maintenance

## Consolidation trends in Europe

### Consolidation update – acceleration likely

Since our global report last year, we have seen a bit more consolidation but more importantly, more airlines dropping out of the system.

Figure 18: European consolidation in 2011/12 and potential for 2012/13

Ceased Operations:	M&A:	Potential Activity in CY12/13*:
Spanair (28)	bmi (37)	Capacity Pullback; Air-France (5)
Malev (42)	Finncomm Airlines (113)	Corporate; Air Berlin (6)
Cimber Sterling (57)		Corporate; TAP (17)
Sky Express (86)		Capacity Pullback; Thomas Cook (18)
ItAli Airlines (143)		Corporate; Aer Lingus (20)
		Capacity Pullback; Austrian (25)

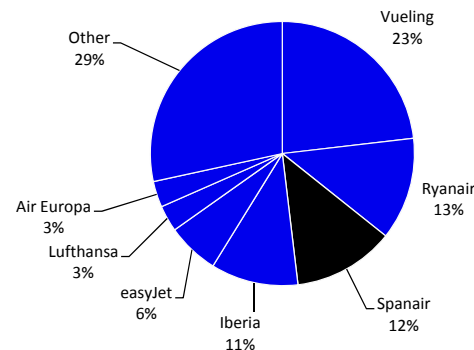
Format: "Aircraft Operator" (Rank by 2011 intra-European ASKs flown). \*Rank is from currently scheduled 2012 intra-European ASKs  
Source: Deutsche Bank Airline Research, Diio Mi, and Company filings

### Spanair – ceased operations January 2012

Previously seen as the flagship LCC of the Catalan state in Spain, Spanair ceased operations after talks to secure investment from Qatar Airways failed.

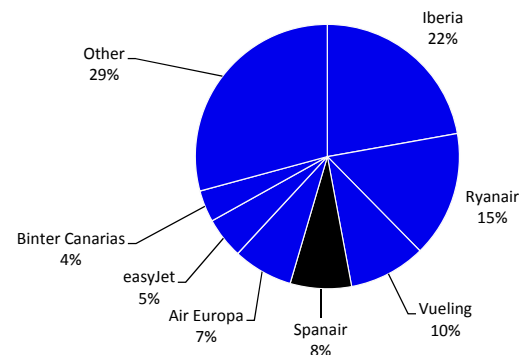
The group employed approximately 4,000 employees and was a significant player in the Spanish domestic market. For more detail see our note "*Spanair to cease operations*" (27th January 2012), in which we discussed the benefits to IAG, easyJet and Ryanair from Spanair's withdrawal.

Figure 19: Market share at Barcelona (El Prat), December 2011



Source: Diio Mi and Deutsche Bank Airline Research

Figure 20: Market share in Spain, December 2011



Source: Diio Mi and Deutsche Bank Airline Research

### bmi – acquired by IAG on April 20, 2012

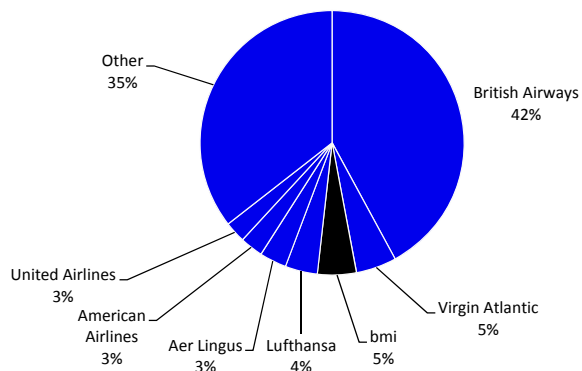
IAG purchased bmi from Lufthansa for a gross headline price of E207 million subject to significant restructuring discounts. bmi has historically been heavily



loss-making for Lufthansa (E200 million operating loss for CY11) so in our view the business valuation was largely driven by its Heathrow slot portfolio. We believe that subject to sufficient feeder traffic flow, IAG will look to utilize as many slots as possible for long-haul routes. Initially, the plan is to use one-third of the slots to develop trade, with the recently announced Seoul route the first to use the new bmi slots.

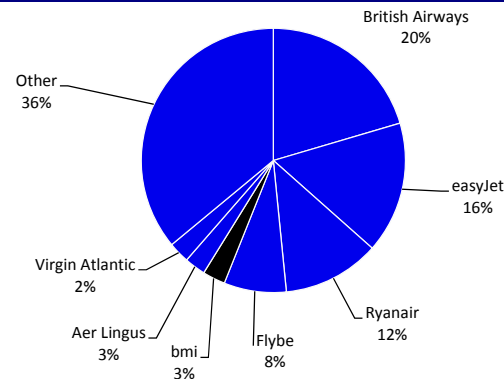
We think that eventually, IAG could use more than one-third of the new routes, and it is not out of the question that some of the 14 slots pairs (that are being put up as part of the agreement with the regulators) could come back to IAG – and these might boost the long haul businesses even further. For more details see our notes *“Lufthansa and IAG sign purchase agreement over bmi”* (22nd December 2011) and *“Impact and consequences of bmi completion”* (20th April 2012).

Figure 21: Market share at London Heathrow, March 2012



Source: Diio Mi and Deutsche Bank Airline Research

Figure 22: Market share in UK, March 2012



Source: Diio Mi and Deutsche Bank Airline Research

Malev – ceased operations February 2012

Malev was the Hungarian flag carrier – and part of the oneworld alliance - but was forced to cease operations when the European Commission ordered it to repay state aid allegedly received over the period 2007 – 2010. As a result, several of its planes were not permitted to depart from foreign airports and the Court of Budapest declared Malev insolvent on February 14, 2012. Only one day after Malev’s grounding Ryanair announced the creation of a new base in Budapest.

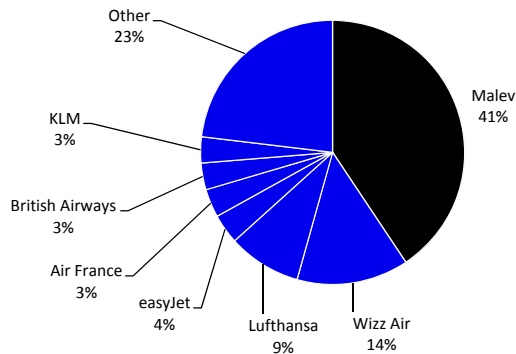
Figure 23: Market share at Budapest, January 2012



Source: Diio Mi and Deutsche Bank Airline Research



Figure 24: Market share in Hungary, January 2012



Source: Diio Mi and Deutsche Bank Airline Research

#### Turkish Airlines makes a bid for LOT Polish

Like some of its Middle East competitors to the south, Turkish Airlines (THY) decided to invest in a fellow European airline with their participation in the privatization of LOT Polish Airlines in January; currently the Polish government has a 68% stake in the airline. At the end of April, THY was the only bidder for LOT. It has been reported that THY will acquire LOT for TRY1.1 billion (US\$600 million); however, it has also been reported that the Polish government is talking to other potential bidders. The purchase of LOT also includes low cost carrier EuroLOT and airport operator LS Airport Services. LOT has 36 aircraft in its fleet and operates a network connecting 55 destinations. In 2010, the company generated a net loss of US\$17 million.

We think that it may be premature for THY to expand inorganically given the high pace of organic growth until the end of 2015. Despite positive comments from THY's management, we think that acquiring LOT would be challenging, given the difficulties in working with the Polish government in a highly competitive European environment. Our concern is that the LOT experience could be similar to THY's much smaller investment in Bosnia Airlines which has proven to be more difficult to manage and make decisions in the past year.

Furthermore, Polish LOT is domestically under pressure from major European LCCs, such as easyJet and Ryanair, and LOT does not have the scale in transatlantic routes to support THY's rapidly growing transatlantic business. Therefore, contrary to the Street, we think that acquiring LOT will not be value

accretive to THY. Thus, we maintain a cautious stance toward THY's potential LOT acquisition.

#### Potential corporate activity in 2012/13

In our view, high oil prices and persistent weakness in Eurozone economies will continue to drive second and third tier carriers into financial difficulties. Pressure on sovereign finances also increases the likelihood that state holdings in airlines will be sold down. Against this backdrop we believe the following significant corporate action could potentially occur through 2012/13.

- Air Berlin:** On December 19, 2011 Air Berlin announced that Etihad would take a total equity stake of 29.2% in return for arranging debt financing of approximately \$255 million. In our view, the synergies for Etihad are relatively low (connecting traffic will be low yield and cost synergies are largely on financing) and hence we see this as a strategic, rather than a financial investment. Strategically, we believe Air Berlin remains in a difficult situation with a long-haul network that has insufficient coverage to compete against specialists like Lufthansa and a cost base that is too high to compete against LCCs. In addition, Ryanair and easyJet are not yet targeting Germany but if this were to change it would result in a step-change deterioration of Air Berlin's outlook. Therefore we see potential for further corporate action in 2012/13.
- TAP:** TAP is wholly owned by the Portuguese state and is one of the dominant channels for European – LATAM traffic via its Lisbon hub. If, as expected, the Portuguese government privatizes national assets it appears likely that some if not all of TAP equity will come to market. Several groups have expressed interest, but in our view a tender process might receive a relatively lukewarm response. Of the larger ones, Lufthansa has its own significant E1.5 billion restructuring program (SCORE) to deliver, while IAG is in the midst of the Iberia turn-around – something that is not being helped by the Spanish economic outlook (although both IAG and Lufthansa have publicly expressed interest in TAP). Nevertheless, we think it is probable that TAP could come to market at some point in the next 12 - 24 months.
- Aer Lingus:** It was announced on May 1, 2012 that Etihad had purchased a 2.99% stake in Aer Lingus. This adds another dimension to an already interesting shareholder register since Ryanair owns 30%



of the equity, with the Irish government holding a 25% stake. Ryanair has previously made public offers for Aer Lingus but these have historically been rejected by the state on competition grounds. As a result, many see Etihad's entry onto the register as a potential opportunity for the Irish government to place its stake or otherwise facilitate a sell down. This is compounded by the Irish government being in a somewhat similar situation to Portugal in that there is pressure to divest state holdings. Hence we could see more to this story through 2012/13.

- **IAG:** Following on from the sovereign airline stakes point above, the Spanish government has recently nationalized Bankia, taking a 45% direct stake. Bankia has a 12% holding in IAG, following the BA/Iberia merger back in 2010. The Spanish state could be under pressure to improve Bankia's balance sheet by disposing of its IAG shares, though in our view, selling now would not achieve the best price given the medium-term attractions of IAG. Furthermore, on IAG, the CEO discussed IAG's interest in investing up to maybe 10% in a soon-to-be recapitalized Japan Airlines (JAL), to cement its relationship with its oneworld alliance partner.

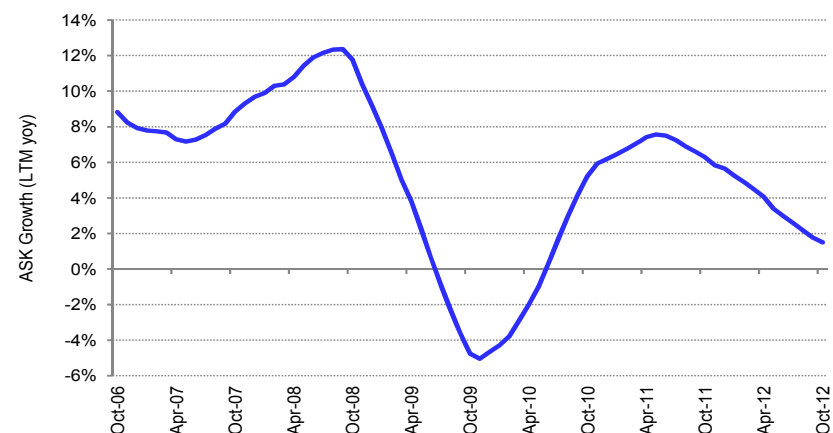
Figure 28 below shows where the current top 30 airlines by ASKs are in Europe, with the relevant cross shareholdings and ownership.

This is supportive of the view that industry concentration is set to increase.

## A brief word on capacity – discipline shining through

High oil prices and the weak Eurozone economy have kept European domestic and international growth constrained over the past year. We firmly believe this capacity discipline is both necessary and an important shift away from growth for growth's sake – a potentially value destructive strategy that has driven too many airlines' corporate thinking over the years.

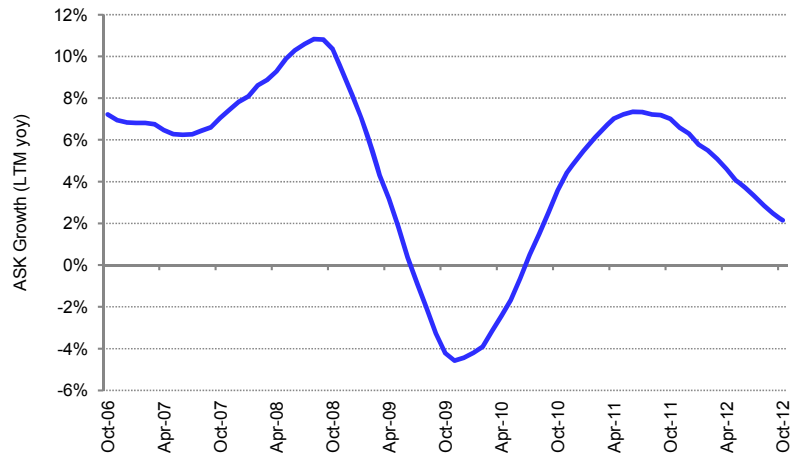
Figure 25: Intra-European (domestic) capacity growth



Source: Diio Mi and Deutsche Bank Airline Research

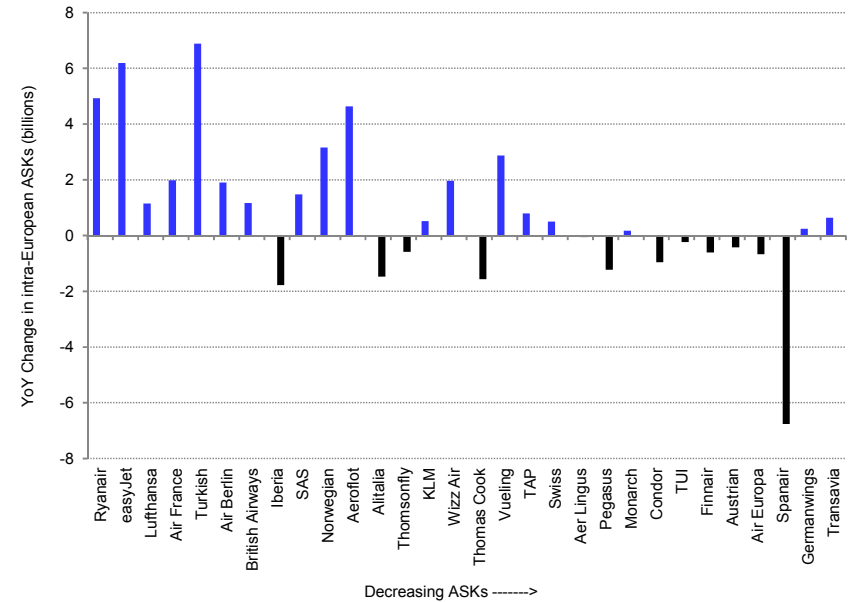


Figure 26: Inter-European (international) capacity growth



Source: Deutsche Bank Airline Research and Diio Mi

Figure 27: YoY intra-European capacity increase/decrease



Source: Deutsche Bank Airline Research and Diio Mi

Figure 28: Summary of European cross-holdings

		Top 30 Airlines by 2012 intra- European ASKs (Decreasing ---->)																															
		Ryanair	easyJet	Lufthansa	Turkish	Air France	Air Berlin	British Airways	SAS	Aeroflot	Iberia	Norwegian	Wizz Air	Vueling	KLM	Thomsonfly	Alitalia	TAP	Thomas Cook	Swiss	Aer Lingus	Monarch	Pegasus	TU	Condor	Austrian	Finnair	Jet2	Air Europa	Transavia	Germanwings		
Holding Group	Ryanair	100																			30												
	easyJet		100																														
	Lufthansa			100																	100					100						100	
	AF-KLM					100									100		25														100		
	IAG							100			100			46																			
	Etihad						29															3											
	Thomas Cook																			100						100							
	TUI Travel																100								100								
	Esas Holdings						12																	100									

NB: Numbers represent % equity ownership  
Source: Deutsche Bank Airline Research and Company filings



The year on year change in intra-European ASKs also shows that the majority of 2012 capacity growth is coming from larger operators. This is supportive of the view that industry concentration is set to increase.

#### Potential capacity activity in 2012/13

We believe there may be three significant capacity withdrawals over 2012/13.

- **Air France** could possibly be the most sizeable shift, where we see its regional capacity expansion plan as flawed. Air France short-haul has historically been heavily loss-making and hence we are skeptical over expansion at its French regional bases. Fundamentally there is some merit to increasing long-haul feeder flows but overall we believe new capacity will be loss-making. Air France is expected to detail extensive restructuring plans in June/July 2012 and we would not be surprised if capacity withdrawals were part of the measures put forward.
- **Austrian Airlines** (part of Lufthansa Group) has generally been loss-making for several years. It has become clear however that Lufthansa executive management is no longer willing to tolerate continued losses from the unit. A restructuring plan has recently been put forward but we would expect increased capacity reduction beyond what has already been announced.
- **Thomas Cook** is currently looking at ways to improve its underlying profitability after relatively weak financial performance over the last twelve months. We see the eventual appointment of a new CEO as a potential catalyst for capacity withdrawals from its airline business.
- **IAG** has agreed with the regulators to relinquish 25% of the bmi slots at London Heathrow as part of the clearance of the acquisition. The offer comprises the following daily slot pairs: (i) seven to Edinburgh and/or Aberdeen; (ii) five to Nice, Cairo, Riyadh, Moscow, Edinburgh and/or Aberdeen; and (iii) two that will be leased to Transaero for use on flights to Moscow. There will be an independent trustee who will assess the applicants and their bids for the slots, for which valid and economically viable business plans must be produced. The slots will be prohibited from usage to any other destinations and will be subject to time constraints as well. As we suggested earlier, it is not impossible that some of these slots could revert to IAG.

## Consolidation trends in Asia

### Review of China Eastern Airlines' merger with Shanghai Airlines

Under an industry consolidation, China Eastern Airlines (CEA) and Shanghai Airlines (SH Air), both based in Shanghai, merged in 2010. Following the merger, CEA's market share increased to ~50% at Shanghai Hongqiao Airport, one of the major hubs in Eastern China. The merger improved pricing in the market as SH Air was no longer a competitor. Such revenue synergies partly contributed to a jump in CEA's net profit from FY09's RMB169 million to FY10's RMB5.0 billion.

The consolidation with SH Air has also helped CEA to streamline its administrative expenses, reduce its non-aircraft related CAPEX, and lower the interest rate of the original SH Air debt. Going forward, CEA will still strive to further optimize its cost structures in areas like streamlining maintenance, centralization of part procurement and lowering of employee-to-aircraft ratio. All in all, CEA estimates that annual cost synergy could be about RMB500 million.

### CEA tie-up with Jetstar to establish a Hong Kong-based low cost carrier

CEA announced on March 25, 2012 that they signed a memorandum of understanding (MOU) with Jetstar in consideration of setting up a 50/50 JV low-cost carrier (LCC) based in Hong Kong (i.e., Jetstar Hong Kong) with investment of US\$198 million (over a three year period). The preliminary plan includes commencement of services in mid-2013 with an initial fleet of three A320 aircraft and a possible fleet of 18 A320's by 2015 to serve Asian routes such as China, Japan, South Korea and South East Asia. The two parties regard this JV as a means to tap the LCC business opportunities in the Hong Kong hub as they believe such opportunities are currently under explored.

Since the planning is still at a very preliminary stage and pending regulatory approval, a detailed route network has not yet been decided. According to CEA, once the LCC is up and running they would target to break even in three years. While this may imply some cost pressure to CEA in FY13-15E, we should not ignore the long-term value proposition of CEA bringing Chinese air travelers to Hong Kong and then sending them out via the future JV route network.



Special Disclosure: Deutsche Bank is acting as Sole Independent Broker and Transaction Facilitator to CEA and Qantas on the establishment of the Joint Venture.

#### [AirAsia – widening its regional footprint](#)

AirAsia is the leading low-cost carrier (LCC) in Asia. Together with its associates in Thailand and Indonesia, the group currently operates flights to over 140 destinations across the Asia-Pacific region. AirAsia Group currently operates a fleet of more than 100 Airbus A320s with an average fleet age of 3 years. At USD 4.11cents (FY11), AirAsia's cost per available seat kilometer is the lowest amongst its peers in the region. We think that below average LCC penetration rates in Asia-Pacific (19% versus 24% global) should allow AirAsia to sustain long-term growth given its extensive footprint and market leadership.

- **Expanding its hub and spoke strategies through joint-ventures:**

AirAsia's strategic ventures into new markets should drive the longer term growth of the company. AirAsia successfully turned around its Thailand and Indonesia JV in 2010, started operating from the Philippines in April 2012 and will be launching its fourth JV in Japan in the December quarter 2012. We believe that entering into such JVs would enable AirAsia to map out its route networks across Asia and gain access to both the domestic and international markets from where these new JVs are based, leveraging on their Open Skies policies. The initial equity investments in these JVs were small and we see AirAsia gaining significant operating leverage from the new ventures. Its orders for an additional 200 Airbus A320neo aircraft for delivery between 2016 and 2025 also augurs well for the expansion plans. We expect the company to be able to fund the new aircraft orders through a mixture of debt, export credit agency (ECA) financing, and through sale-leaseback agreements. Meanwhile, we also expect the associates in Thailand and Indonesia to fund some of their own future aircraft deliveries. This should ease AirAsia's balance sheet further in FY12 - FY13E to allow the company to take on the expansion plans in the new JVs.

- **Share swap deal with MAS terminated but collaboration continues:** In August 2011, the major shareholders of AirAsia and Malaysian Airlines (MAS) - Tune Air and Khazanah Nasional - announced a share swap of a 10% stake in AirAsia for a 20.5% stake in MAS. Both airlines agreed

to a collaborative framework to allow for a stable competitive environment, better bargaining power for fuel, maintenance, aircraft procurement and to prepare against the impending competition following the implementation of ASEAN Open Skies Policy in 2015 which allows for unlimited frequencies between 10 major cities in ASEAN for ASEAN-based carriers. However, given impending elections in Malaysia in 2012, the government stepped in to cancel the deal in May 2012, only nine months after the announcement of the share swap deal, following the protests from MAS' powerful unions. Despite the termination of the share swap, both companies have entered into a supplemental agreement and MOU to look into areas (such as procurement of equipment, etc.) where they can work together to enhance efficiencies and generate greater cost savings. MAS, AirAsia and AirAsia X have proposed to form a special purpose vehicle (SPV) on the basis of 50%, 35%, and 15% to undertake the collaboration. The decision to eliminate the contentious issue of the share swap and focus on working together is positive for both companies, we believe.

- **Investment implications:** We like AirAsia's JV growth model. It is expanding its footprint to North Asia by forming strategic joint ventures with local partners. With its experience in the low cost business model and regulatory inroads which can be achieved by its local partner, the expansion program looks financially promising. We would Buy AirAsia for this growth potential. Singapore Airlines will be affected by AirAsia's continued growth push. We think this will continue to pressure yields in their back cabin. We worry about the long-term structural threat AirAsia and other LCCs in South East Asia pose to SIA. We would avoid it over the longer term.

#### [Air China-Cathay Pacific tie-up: room for further development when global economy recovers](#)

- In June 2006, Air China, Cathay Pacific, CNAC Limited, CITIC Pacific, and Swire Pacific Limited ("SPAC") entered into an agreement to restructure Cathay Pacific's holdings of Dragonair. As a result, Air China and Cathay Pacific ended up with a strategic cross-shareholding relationship. After this transaction and some further shareholding changes, Cathay Pacific now fully owns Dragonair while Air China holds



30.0% of Cathay Pacific. For Cathay Pacific, their current shareholdings of Air China now stands at 19.5%.

- In February 2010, Air China and Cathay Pacific formed a cargo JV in which Air China's direct stake will ultimately be 51%, with Cathay Pacific effectively owning the balance 49%. Operations of the Air China Cargo JV started in 2011 with extra freighters injected by Cathay Pacific targeting the Shanghai air cargo market.
- All in all, we view the cross-shareholding and further cargo cooperation between Air China and Cathay Pacific as a long-term positive development. As currently structured, the partnership allows Air China to have access to the best practices in airline operations management via Cathay Pacific and that gives the airline a competitive edge vs. domestic peers in our view. The partnership also allows Cathay Pacific to play a larger role in tapping into the longer-term growth potential of China, not only for the air passenger business but also for the air freight business.
- The cross-shareholding cements the relationship in that their earnings are inter-dependent. In other words, Air China's near-term profitability would be negatively affected by Cathay's challenges in their premium passenger business and cargo business. In the long-run, however, we believe that Air China will ultimately benefited from a peer-leading growth in its cargo business when the global economy recovers.

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## Consolidation trends in Japan

### New low cost carriers established as JVs

Japan finally entered the low cost carrier (LCC) era in 2012. A joint venture formed by Peach Aviation (ANA, 38.67%; First Eastern Aviation Holdings Limited, 33.33%; Innovation Network Corporation of Japan, 28.00%), started flying between Osaka's Kansai International Airport and Fukuoka in March 2012, and international service, including flights between Kansai and Seoul (Incheon Airport) in May. The first-month load factor was 83%, a reasonable start. In July 2012, a four-company joint venture named Jetstar Japan (Qantas Group, 33.3%; Japan Airlines, 33.3%; Mitsubishi Corporation, 16.7%; Tokyo Century Leasing Corporation, 16.7%) will begin

flights between Tokyo's Narita and Sapporo (Shin Chitose Airport) and between Narita and Fukuoka, then fly on international routes from FY2013. Similar to Jetstar's Australian home market strategy, Jetstar Japan will not only adopt a differentiation strategy by emphasizing how inexpensive it is and guaranteeing the lowest prices in Japan, but it will also take an aggressive approach verging on being sensational by offering some seats at ¥1 (pennies in US\$ terms). In addition, a two-company joint venture, AirAsia Japan (ANA, 67%; AirAsia, 33%) plans to start flights between Narita and Sapporo (Shin Chitose Airport) and between Fukuoka and Okinawa (Naha) from August 2012. From October 2012 it plans to start international operations, such as to Seoul (Incheon) and Busan (both in Korea).

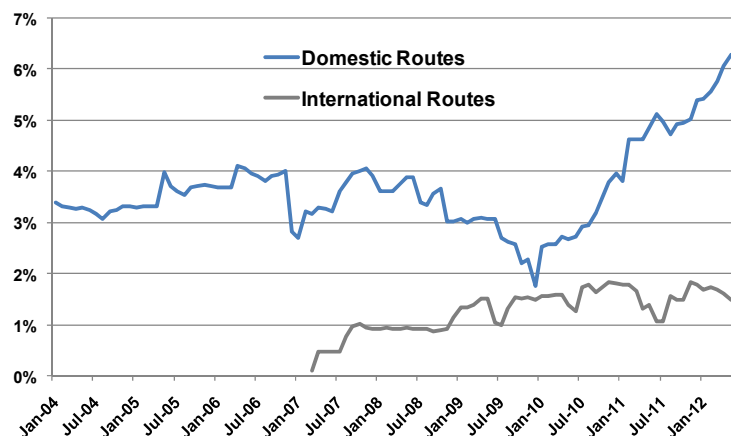
### New LCC issues

As shown in the figure 29, LCC's share of the Japanese market has remained low, particularly for international routes. Other than the Jetstar Group, few non-Japanese LCCs have tried to enter the Japanese market. The main reason for this is that airports serving metropolitan Tokyo, (Haneda and Narita), which have substantial potential market demand, are expensive airports to operate to/from given that some of the highest landing fees in the world are charged combined with the inability to get airport slots and gate/ticket counter space.

Narita is in the process of increasing annual slots from 200,000 in 2010 to 300,000 over the next several years, but it still may not be possible for LCCs to procure low cost usage fees (landing fees, slots, gates, etc.). According to ANA, even if Narita Airport cannot offer relatively low fees, a cost per available seat kilometer (ASK) of around ¥6 can be anticipated. As ANA's own FY3/12 cost/ASK was ¥12, we believe it is possible to lower fares to half or more from current fares offered by ANA.



Figure 29: ASK market share of LCCs in Japan market



Source: Deutsche Bank Airline Research and Dito Mi

Nevertheless, LCCs require convenient time slots. For price-sensitive Japanese travelers, who cannot afford to take long vacations, flight schedules can be a significant factor in choosing airlines. We believe growth in the Japan-based international LCC market will largely depend on whether or not incentives are given by hub airports, Narita and Kansai, and whether the incentives are continued.

We do not believe the risk of cannibalization between ANA or JAL and the new LCCs will be a serious issue. The three newly formed LCCs are likely to aim at expanding the scale of their operations via international service, where they can tap potential demand, rather than in domestic routes. The risk of cannibalization on international routes is also minimal, as both ANA and JAL had more or less withdrawn from the low-cost tourism market.

Accordingly, the main issue for the new LCCs will be how much potential demand for overseas tourism can be stimulated at less-than-half of normal fares. Interest in traveling overseas has been fading among young Japanese adults, who have the time, but not the money. On the other hand, people in older age groups, who have both the time and money, are interested in traveling to Europe, which has been a little too pricey, rather than to nearby resorts. However, to turn more potential demand into sales, we believe new

LCCs need also to promote travel to short-range resort destinations, which have to be publicized more than before as attractive destinations. To avoid price wars (and the danger of business failure they may create) due to the three companies starting operations at the same time, it will be necessary to adopt strategies that go beyond just transporting people by air.

#### JAL, resurrected with a high profitability, is a threat to ANA

JAL, now transformed into a highly profitable company through large-scale post-bankruptcy restructuring, achieved FY3/12 consolidated operating profit of ¥204.9 billion (US\$2.6 billion operating profit and operating margin 17.0%). ANA also disclosed favorable results. Operating profit was ¥97.0 billion (US\$1.2 billion operating profit and operating margin 6.9%), but its relative disadvantage is undeniable. JAL's superiority in cost and tax performance will likely continue for the next several years. Although it appears to reflect an unfair situation and presents the image of a moral hazard whereby a failed company can receive such preferential treatment, this superiority is undeniable.

Although it is hard to imagine that JAL will adopt a strategy of cutting fares for speedy recovery of market share, once market turbulence is significant enough, such as that following the Lehman Shock, fare levels may fall suddenly and profitability at ANA may drop substantially. At this point, we believe that ANA will achieve the operating profit targets set out in its medium-term plan (FY3/13 ¥110bn; FY3/14 ¥130bn), but this is presuming that there is no development that greatly disturbs the market. However, as such events have occurred every few years over the past decade, we cannot be certain that profit levels in its medium-term management plan are sustainable. This is the reason for our Hold rating on ANA. The shares are at an historical low level in spite of the company's achieving all-time high profits.

However, our opinion could change if ANA's profitability improves significantly by the two new ANA Group LCC companies taking over some of its unprofitable domestic routes. As mentioned above, as it has become more difficult for Japanese to take vacations, even if they plan to take a three-day domestic trip over the weekend, they tend to try for flights that leave early in the morning and return late at night. Thus, most demand from tourists that LCCs are targeting will be concentrated in the late evening and early morning time spans. In other words, as daytime demand for leisure is low, it may be better for ANA to use their LCCs at daytime hours for its low profit operations. While they do not appear to have such plans right now, we intend to monitor any new developments on how LCCs will be utilized by their major airline partners.



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## Consolidation trends in Australia/New Zealand

### Overview

Over the past 18 months, the Australasian carriers have continued to be very active in looking for increased consolidation – their activity has varied and has included entry into further alliances, utilizing offshore subsidiaries to capture growth in alternate markets and direct purchase of stakes in other carriers. Given that all three airlines under our coverage have been involved in this activity in some way, we set out below the details of each carrier’s involvement.

### Qantas

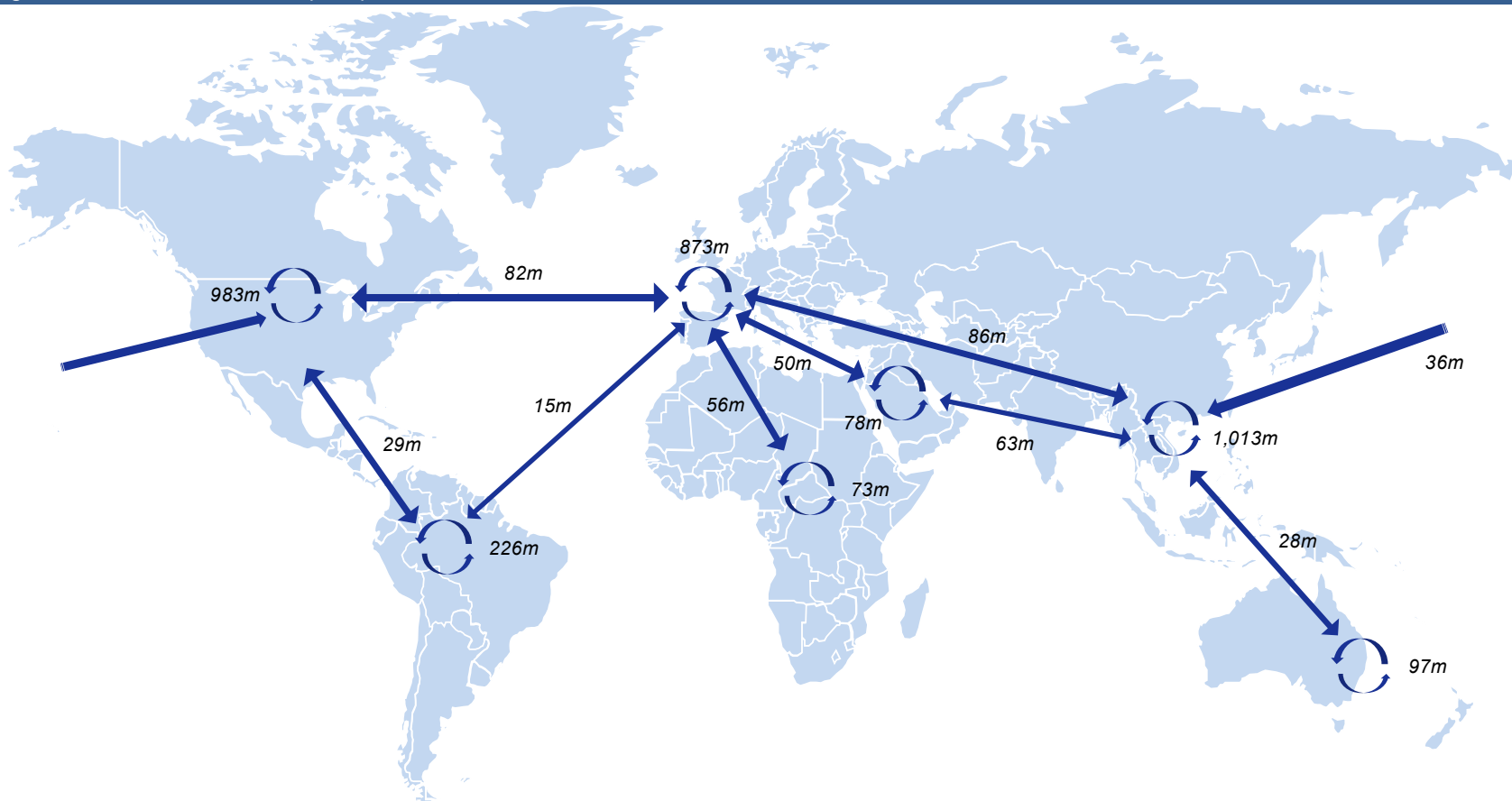
Qantas’ consolidation efforts can be classified as either utilizing the proven model of setting up Jetstar subsidiaries within Asia or relying on its premium carrier alliances.

### Jetstar subsidiaries

In our report *Global Airline Sector – Laying the Foundation for Global M&A* (dated January 13, 2011) we outlined our expectation that Qantas will continue to focus on growing Jetstar into Asia as a way to leverage the group into the anticipated growth of Asian air travel. This is based on the fact that Asia already represents the market with the largest intra-continental flow of airline traffic (see Figure 30).



Figure 30: Global airline seat capacity 2011



Source: Deutsche Bank Airline Research and Diio Mi

Consistent with our expectations, Qantas has over the last 18 months detailed plans to set up two further low cost subsidiaries within Asia (in addition to its presence in Singapore and Vietnam):

- In August 2011 Qantas announced that it will take a 42% equity interest in a new LCC in Japan to be called **Jetstar Japan**. Qantas will hold a one third voting right with its two other partners Japan Airlines and Mitsubishi Corporation. The business will originally start with 3 A320 aircraft servicing the Japanese domestic market with plans to

grow to 24 aircraft within the first few years. First flights for the new carrier are expected to commence in July 2012.

- In March 2012 Qantas entered into a new strategic alliance with China Eastern to form **Jetstar Hong Kong**, an LCC based in Hong Kong which will service short haul routes in Asia, including China, Japan, South Korea and South East Asia. The alliance is expected to commence operations in 2013 (subject to regulatory approval) with 3 aircraft, to increase to 18 aircraft by 2015.



### Premium carrier alliances

In 2011, Qantas also detailed plans to create an Asian based full service carrier in either Singapore or Kuala Lumpur. Malaysia Airlines was seen as the logical partner for Qantas in setting up such a carrier but discussions between the parties could not reach mutually agreeable terms. In our view, while this strategy has been delayed, it is by no means off the table. In particular, we note the deal with China Eastern (to form Jetstar Hong Kong), which helps solidify the relationship between the airlines and, in our view, adds another potential JV partner option to QAN as it considers the creation of a premium Asian carrier.

Finally, Qantas has continued to use its international partnerships in maximizing the strength of its network (and exiting loss-making routes), with progress including:

- **British Airways Joint Services Agreement** – further integration with British Airways which will see Qantas withdrawing from Bangkok-London and Hong Kong-London. These routes will be serviced by British Airways although it appears there will be an overall reduction in capacity on these routes.
- **LAN partnership** – Qantas has commenced direct flights to Santiago, Chile and has withdrawn from Buenos Aires, Argentina. Connectivity throughout South America is provided via LAN.
- **Malaysia Airlines** – Qantas is looking to develop closer ties with Malaysian Airlines to service other European destinations such as Rome, Istanbul and Amsterdam via the Malaysian network.

Over the past week, press speculation that QAN and Emirates may enter into an alliance (see Australian Financial Review 22 May 12) has led us to consider the potential structure of such an alliance. After considering the reports, we have formed the view that if implemented, an alliance could lead to Emirates investing directly in Qantas Domestic. For QAN, it (i) provides a read-through valuation of Qantas Domestic and (ii) raises capital to protect its balance sheet/credit rating. For Emirates, it provides a direct investment in an Australian feeder network with dominant corporate market share. Refer to our report *Courting Emirates – a scenario analysis* dated 24 May 11 for further detail.

### Virgin Australia

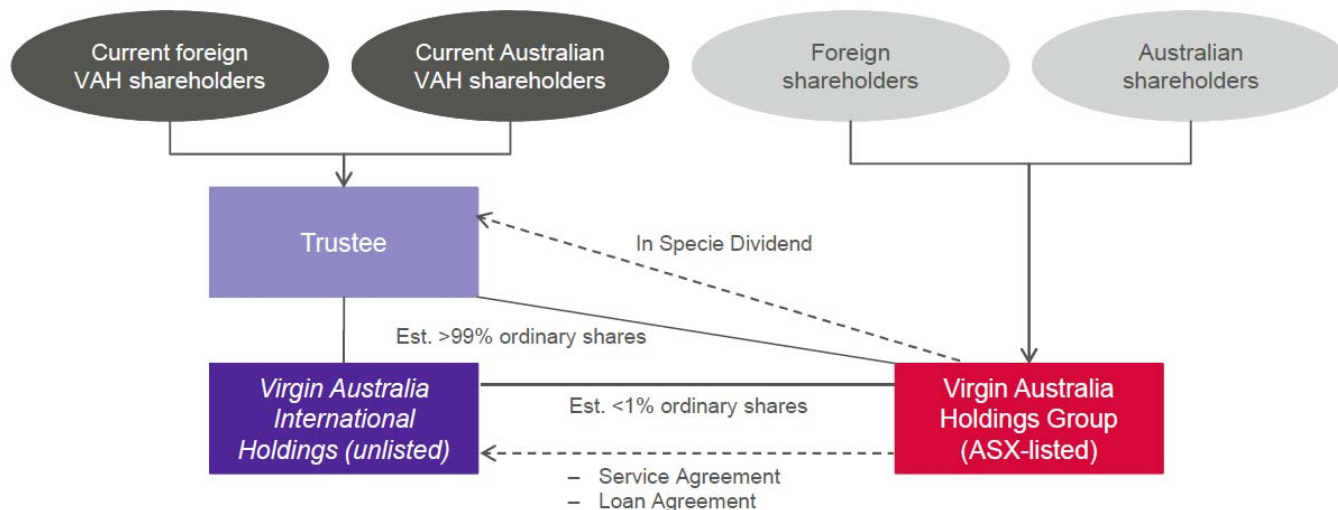
In addition to its alliances with Etihad and Air New Zealand, over the last 18 months Virgin Australia also obtained approval from the US Department of Transportation for an alliance with Delta and entered into an alliance with Singapore Airlines. The alliances effectively complete Virgin's "virtual" international network and provide a viable alternative as a competitor to Qantas.

In 2012, Virgin also implemented a new corporate structure (see Figure 31), which is intended to facilitate investment in the group by international institutions without breaching the 49% foreign ownership restriction applicable to investment in international airlines under the Australian Air Navigation Act.

Whilst the official justification for the new structure is to facilitate investment from international institutions, we suspect the company also wanted to put in place arrangements which allow for investment into Virgin by international carriers (particularly existing partners) without breaching the foreign ownership cap. In particular, we note that Air New Zealand already has a ~20% interest in Virgin and Etihad has expressed interest in investing in the company.



Figure 31: Virgin Australia – new structure



Source: Deutsche Bank Airline Research and Company filings

### Air New Zealand

On the consolidation front, Air NZ has largely focused on its revenue sharing alliance with Virgin Australia – first flights under the alliance commenced in July 2011, and a new schedule (which minimizes wingtip-to-wingtip flying) commenced in November 2011. The alliance is now Air NZ’s deepest and most extensive alliance.

In addition to the alliance, over the past 18 months Air NZ has also acquired a ~20% interest in Virgin Australia. Air NZ’s rationale for the stake is confidence in Virgin’s strategy and execution and a means to gain an economic (sans operating) exposure to a large and growing domestic market. In our view, Air NZ’s equity interest cements its relationship with Virgin (built on the Trans-Tasman alliance) and ensures they remain relevant should further industry consolidation occur - given the competitive dynamics, Virgin is a natural partner for Air NZ in Australasia.

### Potential beneficiaries

Ultimately, we see Qantas as the main beneficiary from the continued consolidation. Over time, they have proven that they can be at the forefront of consolidation, they have successfully adopted the Jetstar franchising model and offer an attractive partnership option for any carrier given their dominant domestic market/corporate market share. Given the strength of their frequent flyer program and the skills they bring in terms of being the only airline to have successfully implemented a premium/LCC model, there is a lot they can effectively “bring to the table” in a partnership. On this basis, we believe they will continue to attract high quality carriers looking for increased presence in the region.



## Consolidation trends in the US

The US has a rich history of M&A (see Appendix A), although for years it seems that the transactions did not really improve the competitive landscape. However, over the past six years, M&A transactions have been much better executed with significant synergies realized (see selected transactions in Figure 53). Over the past two years, we've seen two major M&A transactions close with United/Continental passing muster with the regulators in record time and the Southwest/AirTran merger closing in May 2011. The sections below revisit some of the key elements of both transactions.

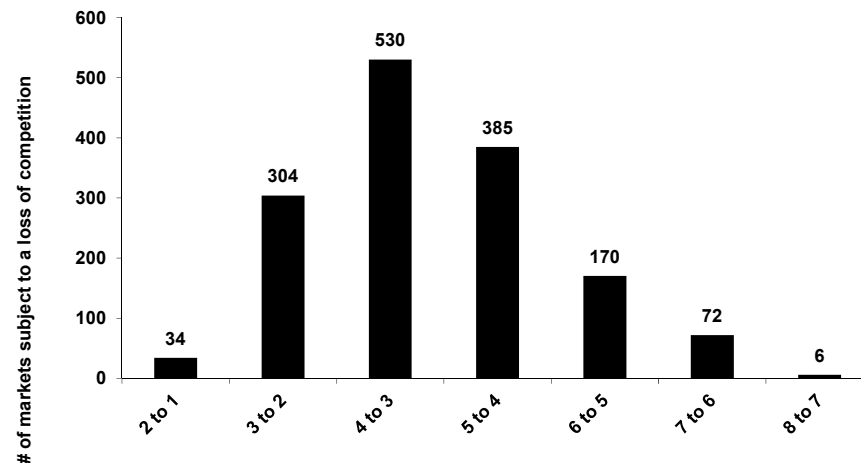
### United + Continental merger approved in record time

In May 2010, when the United – Continental merger was first proposed, many members of Congress opposed the combination on the grounds that it would reduce competition. Superficially, that would appear to be a reasonable assessment to make given that the proposed merger entailed the 3rd and 4th largest US airlines. However, given that both airlines had largely complementary networks, further analysis indicated that the actual potential reduction in service levels would actually be less than that was observed for the approved Delta – Northwest merger. This explains, in our opinion, why UA – CO was not challenged by the Department of Justice after a record review period of less than four months which resulted in only one material remedy: Continental's divestiture of 18 slot pairs to Southwest at capacity-constrained Newark Liberty International.

### A DOJ challenge would have been difficult given the minimal overlap

A closer examination of the data (Figures 32 and 33) would lead one to conclude that the likelihood that the DOJ would challenge the merger was quite low. In Figure 32, the universe of markets is defined as the Top 5,000 nonstop and one-stop city-pairs where Delta and Northwest competed in 2006.

Figure 32: Change in Effective Competition from DL – NW Combination

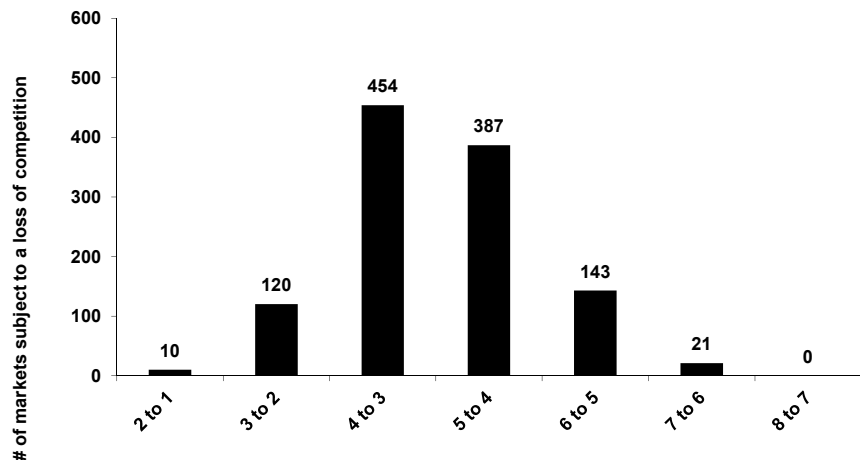


*Note: The market universe for the analysis is the top 5,000 nonstop and one-stop city-pair markets for 2006 where DL and NW competed.  
 Source: GAO and Deutsche Bank Airline Research*

In Figure 33, the universe of markets is a significantly larger 13,515 airport-pairs (selection based on a minimum annual passenger threshold of 520) where Continental and United competed in 2009 (given the number of markets, there are probably quite a few two-stop airport-pairs in addition to nonstop and one-stop airport-pairs).



Figure 33: Change in Effective Competition from CO – UA Combination



Note: The market universe for the analysis is the top 13,515 airport-pairs that meet the minimum threshold of 520 passengers per year for 2009 where CO and UA competed.  
 Source: GAO and Deutsche Bank Airline Research

**What we think was most notable was that even with a much larger universe of markets being examined in the CO-UA analysis, the number of markets that were subject to a loss of competition were less for CO-UA than the previously approved DL-NW merger.** Furthermore, the CO-UA analysis looked at airport-pairs rather than city-pairs. This is an important distinction as the DOJ typically considers the relevant market to be a city-pair combination as some of the larger cities (such as New York, Chicago, San Francisco and Washington, D.C.) have more than one commercial airport that can compete for passenger traffic (e.g. Newark – Los Angeles and JFK – Los Angeles are considered to be the same city-pair). In that regard, if we apply the city-pair approach rather than the airport-pair approach, then the number of markets (nonstop, one-stop, etc.) served only by Continental and United (i.e. “2 to 1 markets”) drops from ten to three. If we look only at nonstop markets (which the DOJ is most concerned about as nonstop service is superior to one-stop service and preferred by business passengers), then the number of “2 to 1 markets” falls to only a single market (that honor goes to the Cleveland – Denver market, although we think Southwest and/or Frontier, with their sizeable Denver operations, would be

well-positioned to enter the market and make up for the loss of service). So, in light of the fact that the number of markets potentially losing competition would be small (and this was true not only of domestic markets, but international markets as well), the regulators had no choice but to “green light” the deal.

#### Putting the domino effect to rest

One of the original arguments against approving the Delta – Northwest acquisition – which some referred to as the “falling domino argument” – was that it would lead to subsequent transactions (i.e. six airlines would become three mega airlines) that would result in a material reduction of consumer choice. And therefore, one could not analyze Delta - Northwest transaction in a vacuum, but rather had to assume other transactions would follow in response (like falling dominoes), and then measure the total impact in order to accurately assess whether the transaction would be anticompetitive. However, if we re-examine the data above, it is clear from the United – Continental analysis which reflects the competitive backdrop **after** the Delta – Northwest merger closed that that is clearly not the case (as evidenced by a very modest reduction in competition). We think part of this can be explained by proposed partner selection, e.g. an American/Continental combination would yield a very different and likely anticompetitive result in our estimation. And part of this reflects the growth of LCCs in markets that not too long ago were devoid of them (such as New York – LaGuardia, Washington – Reagan, Boston – Logan, and Newark – Liberty).

#### Additional transactions in the offing?

Over the past five years, there have been two major airline mergers – Delta/Northwest and United/Continental, that we think, to some extent, were in response to the consolidation occurring among their European alliance partners. (Our sense is that Southwest’s acquisition of AirTran, which closed in May 2011, was more about Southwest securing access to key business markets including Atlanta and Washington, D.C. (via Reagan National) and making further inroads into Boston and New York’s LaGuardia Airport.) Furthermore, we think some of the regional airline deals of late reflect those carriers reinforcing their commitment to their major airline partners such as SkyWest’s acquisition of ExpressJet. The one segment that seems ripe for consolidation is the middle tier – namely the LCCs – where there may be too many “niche” airlines for the market to support especially when they are all fighting over the 20% market share not held by the Big Four (i.e. United/Continental, Delta, AMR,



and Southwest/AirTran). Part of the 20% market share reflects Alaska and US Airways, although the former has already partnered-up with American/Delta. Other carriers such as Allegiant, Frontier, Hawaiian, JetBlue, Spirit and Virgin America, among others, are each pursuing different strategies that may prove to be less effective in a much more concentrated industry backdrop. Furthermore, we believe the major airlines are much stronger financially than they have been in years (e.g. who would have ever thought that the industry was capable of producing very solid results in 2011 despite sub-2% GDP growth in the US and a 40% rise in fuel expense?) and have much more diversified networks which will allow them to be more formidable competitors. As such, head-to-head competition between a major airline and an LCC may be much more impactful to the smaller airline. We think this would be especially true if the contested market represents a large share of the LCC's revenue base. In that regard, we think this may be one of the other considerations that drove Southwest to acquire AirTran.

We are of the view that there is at least another chapter or two to be written on US airline consolidation. In that regard, we discuss why we think an American – US Airways merger makes sense in the next section (see page 44).

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## Consolidation trends in Latin America

### Latin America has been the most active region for cross-border M&A

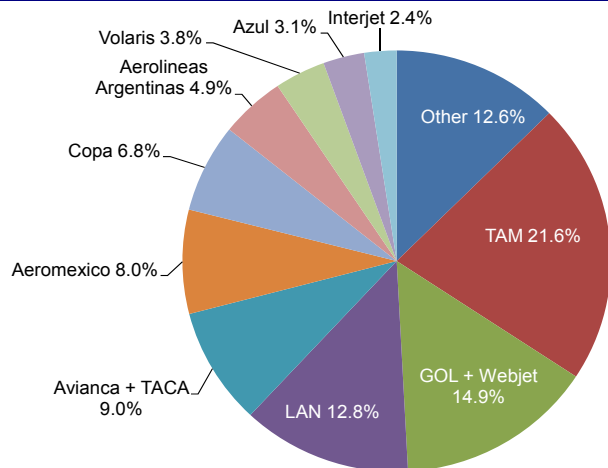
Latin America is not only one of the more active regions when it comes to airline M&A, but is one of the most liberal aviation markets as it relates to foreign ownership restrictions (see Figure 59). In fact, several countries such as Chile and Colombia allow airlines to be 100%-foreign owned with the only major stipulation that their headquarters are located in the country. Ironically, though, this has been somewhat offset by many of the largest Latin American markets such as Mexico, Colombia, Brazil and Argentina having fairly restrictive bilateral agreements with other countries. This is starting to change with both Colombia and Brazil initialing/targeting Open Skies agreements with the US, Canada and Europe over the past two years.

### LAN Airlines is one of the most strategic airlines in the world

LAN Airlines (formerly LanChile) has been the vanguard for cross-border mergers, strategic initiatives, and establishing unique partnerships. LAN has benefited from a government that has had one of the most open aviation markets which likely evolved out of necessity given the country's geographic isolation and relatively small population (~20 million compared to Brazil's population of ~200 million). As such, beyond its home market of Chile, LAN has established passenger operations in Argentina, Colombia, Ecuador and Peru. It also has established cargo subsidiaries in Brazil, Colombia and Mexico. And with its proposed merger-of-equals with TAM of Brazil which was announced in August 2010, the new LAN + TAM or LATAM Airlines will become the largest airline in Latin America with about 35% market share (see Figure 34). If we look at just South America, then the new LATAM Airlines will have approximately 55% market share (among local carriers; the number would be half as much if all non-South American airlines are included).



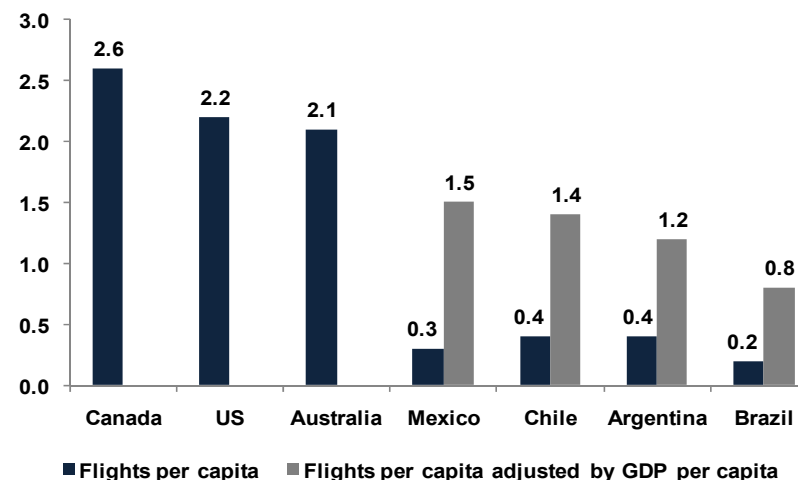
Figure 34: Largest Latin American Airlines – January – June 2012



Source: Diio Mi, Deutsche Bank Airline Research

In essence, the Latin American airline industry appears to be consolidating at warp-speed. This is very much unlike what was experienced by European and US airlines which took 50 years to get to today's level of concentration in Latin America. What is most interesting about this dynamic is that Latin America is still very much an immature market (see Figure 35). So while the Latin American airlines are likely to see significant growth opportunities over the coming decades, they may be better positioned to profit from them due to a more stable and less-fragmented competitive backdrop. This would be a far better outcome than what was experienced by their European and US counterparts who incurred years of losses, forced mergers, and airline liquidations before achieving stability.

Figure 35: Annual air trips per capita in 2009 for selected countries



Source: ANAC, GOL, and Deutsche Bank Airline Research

#### LATAM cleared for take-off

On May 10, 2012, LAN initiated a Public Purchase Offer (PPO) to finalize a merger with TAM: effectively, every share of TAM will be converted into 0.9 shares of LAN with the process scheduled to be completed by June 12, 2012. On June 15, 2012, the two airlines will officially join to form LATAM Airlines Group, which is expected to be the largest airline in the world in terms of equity market value (~\$12 billion).

At the time of announcement (August 2010), LAN and TAM identified four key areas of initial growth opportunities: increased service from Brazil to Europe/Africa, from Lima to North/Central America, the opportunity to create more hubs and to expand its cargo franchise in South America (see Figure 36); in total, the companies projected merger synergies of \$400 million.



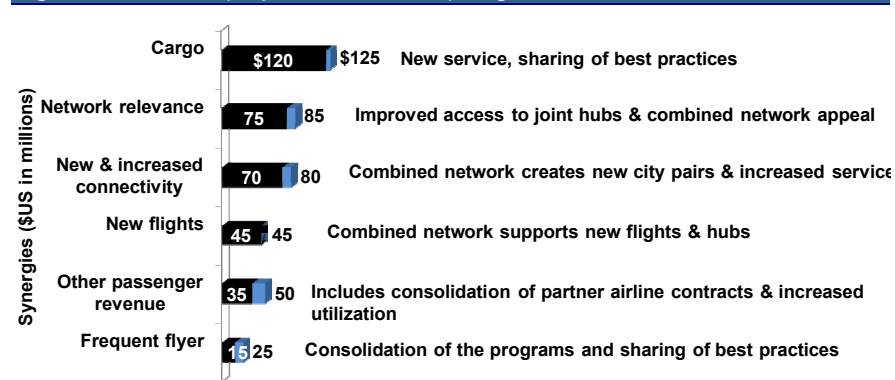
Figure 36: LATAM growth prospects



Source: LAN, TAM, and Deutsche Bank Airline Research

Since then, LAN and TAM have materially increased that synergy target from \$400 million to \$600 - 700 million. Estimated synergies from higher passenger revenue increased to \$240 - 280 million from \$170 million; expected cargo revenue synergies rose to \$120 - 140 million from \$110 million; and expected synergies from cost savings also increased to \$240 - 280 million from \$120 million (see Figures 37 and 38). The companies expect to realize about a third of the synergies (\$170 - 200 million) within the first year after completing the transaction, which is in line with their initial estimate.

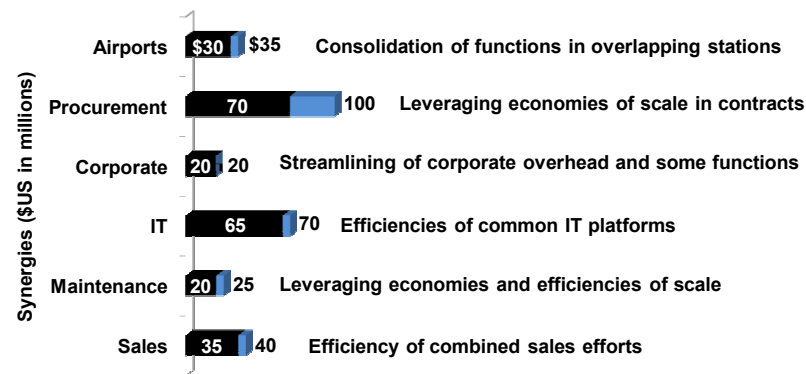
Figure 37: LATAM projected revenue synergies



Source: LAN, TAM and Deutsche Bank Airline Research

Overall, the additional synergies represent a significant positive for the combined company. We did notice, however, that they will now be fully implemented within four years versus the three years initially estimated.

Figure 38: LATAM projected cost synergies



Source: LAN, TAM, and Deutsche Bank Airline Research

In-line with the theme of this report, we view more consolidation as positive for the industry and especially positive for participating carriers. Moreover, given LAN's track record of generating consistent returns while executing a solid



growth strategy in Latin America, we are excited about the long-term prospects of the upcoming merger. In the short-term, however, we see increased risk to earnings estimates (especially in light of a potentially weak Brazilian domestic market, a weak BRL relative to the USD, and unforeseen costs tied to the integration).



# Why AA/US Makes Sense

## Key conclusions

We believe that AMR will successfully use Chapter 11 bankruptcy as a means to reorganize its business and emerge with a cost platform that significantly improves its profitability.

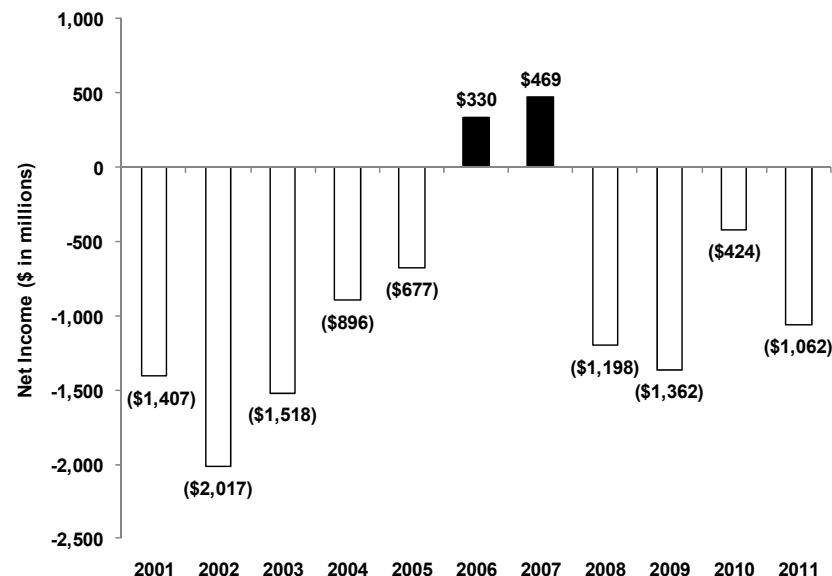
- However, we are not convinced that the AMR stand-alone plan will close the revenue gap, at least in the near-term. Over time, we see how rationalizing the fleet, expanding domestic code shares, implementing antitrust immunized joint ventures, and growing departures in key markets can be accretive to AMR's revenue production, but the extent of their success is somewhat dependent on the competitive response.
- We are of the view that a merger with US Airways will fairly quickly address AMR's revenue shortfall, diversify its fleet, enhance its alliance relationship, and put the company on par with the Big Two airlines (i.e. Delta and United); we think the latter benefit is critical to AMR maintaining its fair share of corporate revenue.
- We view the agreements between US Airways and AMR's three major unions (APA, APFA, and TWU) as a significant milestone. Furthermore, we think that a plan of reorganization needs support from two of the three major constituent groups (company management, labor, and unsecured creditors) in order for the plan to ultimately be approved by creditors.
- There is a view that merging in bankruptcy allows more to be accomplished than outside the process. Rationalizing fleet and facilities, harmonizing vendor/supplier contracts, and renegotiating with other key partners such as credit card companies are things that come to mind. Our sense is that absent a US Airways bid to pursue a merger with American while in bankruptcy, AMR unsecured debt would not have soared from ~20 cents on the dollar to its recent bid in the low 50s.

- We think that an AA/US merger will be positive for the US airline industry. We also think the implications of a merger are positive for global airlines, particularly those in the oneworld alliance.

## AMR will address profitability challenge in bankruptcy

The bankruptcy filing by AMR Corporation in November 2011 took the market by surprise in its timing. The airline was sitting on \$4.1 billion in unrestricted cash and short-term investments and had recently completed a public debt deal. Furthermore, many expected that the company would make one more attempt at reaching labor accords with its three major unions. However, years of losses (see Figure 39) and a failure to reach concessionary deals with labor finally exhausted the patience of the Board of Directors who proceeded to go the bankruptcy route.

Figure 39: AMR historical net income: 2001 – 2011



Source: Company filings and Deutsche Bank Airline Research

While the past decade has been a very challenging time for US airlines, in general, we did see the industry return to profitability in 2010 and 2011. AMR



failed to keep pace with the industry as below average financial returns prevented the company from re-investing in its fleet which subsequently had negative implications for the American/American Eagle network and product. American's competitive standing within the industry was further undermined following the bankruptcies of many of its peers who used the process to eliminate debt, lower costs, and re-fleet with aircraft more suitable to their changing networks. American's competitors became even more formidable following a spate of mergers that resulted in both Delta and United becoming roughly a third larger than American (based on revenue). One only has to look to last year to see how wide the profitability gap was between AMR and its primary competitors (see Figure 40).

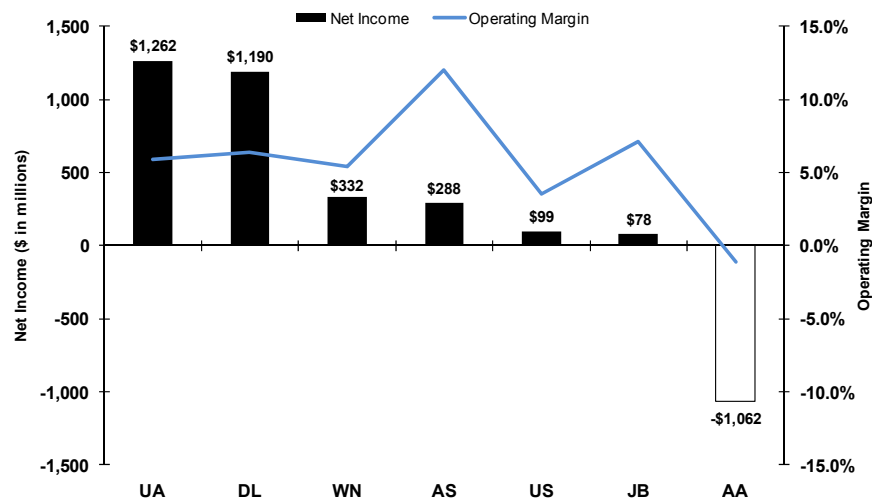
### Bankruptcy will not address AMR's revenue challenges

We are not convinced that the AMR stand-alone plan will close the revenue gap, at least in the near-term. Over time, we see how rationalizing the fleet, expanding domestic code shares, implementing antitrust immunized joint ventures, and growing departures in key markets can be accretive to AMR's revenue production, but the extent of their success is somewhat dependent on the competitive response. We think it may be somewhat presumptuous to extol the virtues of a plan that include the recapture of corporate revenue and market share when the competition already has a significant lead and is not standing still.

### AA+US: a more formidable competitor to the Big Two

We think that a merger with US Airways could fairly quickly address AMR's revenue shortfall, diversify its fleet, enhance its alliance relationship, and put the company on par with the Big Two airlines (i.e. Delta and United); we think the latter benefit is critical to AMR maintaining its fair share of corporate revenue.

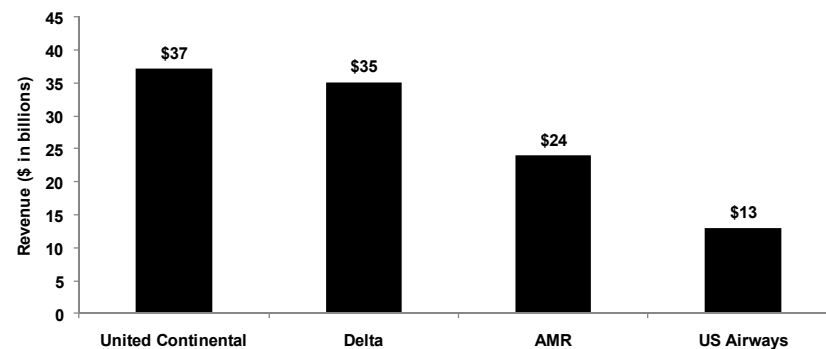
Figure 40: 2011 net income vs. operating margin



Source: Company filings and Deutsche Bank Airline Research

We believe that AMR will be successful in reducing its costs in bankruptcy (and already has with respect to aircraft and facilities) which will result in a platform that should allow for a significant improvement in the airline's profitability.

Figure 41: Legacy carrier FY 2011 revenue

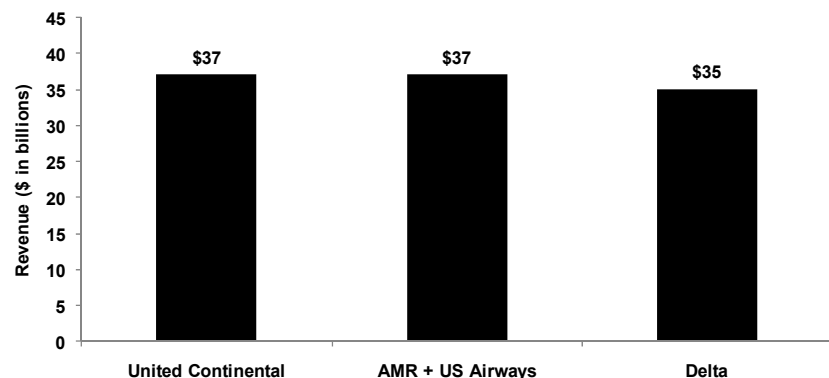


Source: Company filings and Deutsche Bank Airline Research

As shown in Figures 41 and 42, a merger between American and US Airways would result in a US airline industry where the top three carriers would generate close to \$40 billion of annual revenue.



Figure 42: Legacy carrier FY 2011 revenue pro forma for AMR/LCC deal



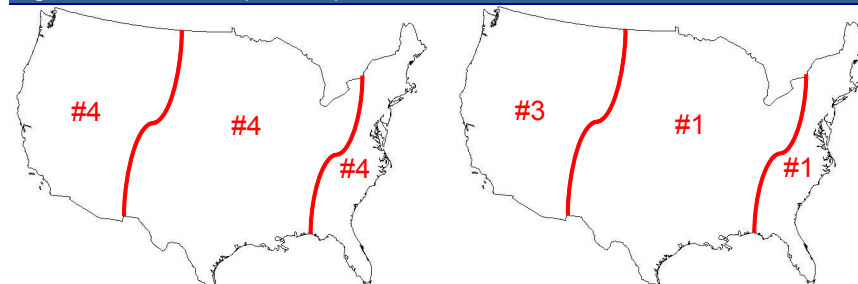
Source: Company filings and Deutsche Bank Airline Research

## AA/US will enhance East Coast presence

Over the past five years, American has seen its share of domestic revenue shrink relative to its primary competitors Delta and United. In fact, with the recent merger of Southwest and AirTran, American now ranks #4 in all three of the major geographic regions, East, Central and West (based on local domestic passenger revenue). Furthermore, if one includes San Juan, Puerto Rico as a domestic destination, American actually ranks 5th in the East behind JetBlue which highlights the extent of its share loss in the region over the past five years.

A merger with US Airways would significantly improve American's East Coast positioning as a tie-up would not only restore AA service to the three important Shuttle markets (LGA-BOS, LGA-DCA, and BOS-DCA), but provide new nonstop service to at least 30 US Airways cities, in our estimation (primarily East Coast markets) to American's Chicago and Dallas hubs. Conversely, we estimate that 55 American cities (predominantly in the Central region) would benefit from new nonstop service to US Airways East Coast hubs of Charlotte, Philadelphia and Washington, D.C. As a result, our analysis suggests that an AA/US combination would improve American's domestic market share in the three key geographies (East, Central and West) from #4, #4, and #4 to #1, #1 and #3, respectively (see Figure 43).

Figure 43: AMR competitive position: before/after AMR/LCC combo



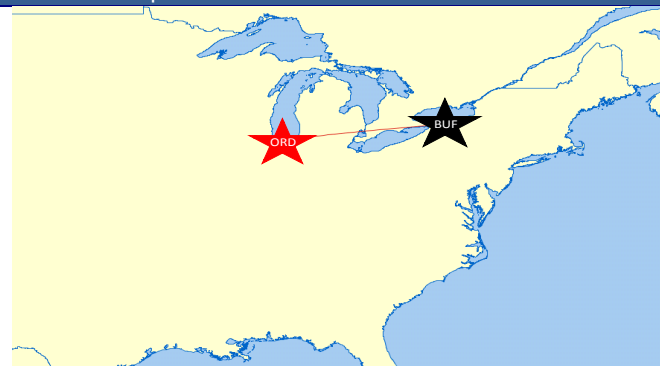
Source: Company filings and Deutsche Bank Airline Research

We have heard US Airways provide examples of East Coast markets such as Buffalo, NY and Charleston, SC where American is not competitive relative to Delta and United. In the two case studies below, we examine how an AA/US merger meaningfully enhances AA's market share.

## Case study 1: AA/US will enhance Buffalo market share

American/American Eagle presently provide five daily flights in the Buffalo – Chicago market. They are essentially not able to connect passengers up and down the East Coast (see Figure 44).

Figure 44: AA nonstop service to/from Buffalo

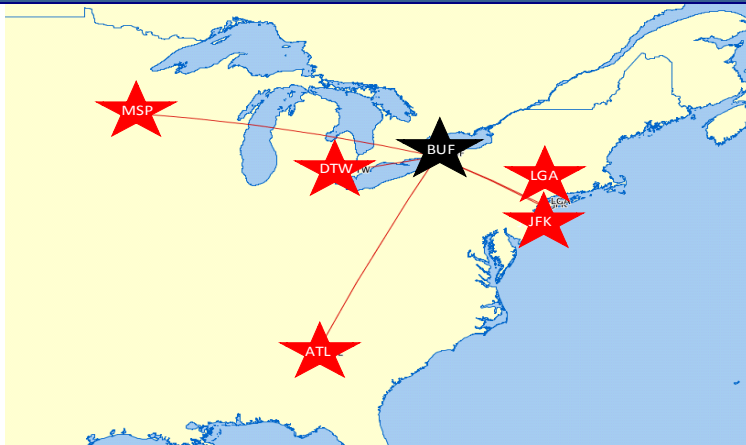


Source: Diio Mi and Deutsche Bank Airline Research



American's service from Buffalo is best-suited for connecting passengers to the Midwest and the West. Delta, on the other hand, provides 26 daily flights from Buffalo to five destinations giving it much better coverage.

Figure 45: DL nonstop service to/from Buffalo



Source: Diio Mi and Deutsche Bank Airline Research

United offers a similarly strong schedule from Buffalo with 19 daily departures to four destinations (see Figure 46).

Figure 46: UA nonstop service to/from Buffalo



Source: Diio Mi and Deutsche Bank Airline Research

An AA/US merger would put the combined carriers' Buffalo schedule on par with Delta and United (see Figure 47). With 23 daily flights to five destinations, AA/US would be able to provide connecting service to every major domestic region.

Figure 47: AA + US nonstop service to/from Buffalo



Source: Diio Mi and Deutsche Bank Airline Research

### Case study 2: AA/US will enhance Charleston share

American/Eagle presently provide four daily flights between Charleston, South Carolina and two markets: Dallas and Miami (see Figure 48).



Figure 48: AA nonstop service to/from Charleston



Source: Diio Mi and Deutsche Bank Airline Research

American’s service from Charleston is best-suited for connecting passengers to the Caribbean/South America and the West.

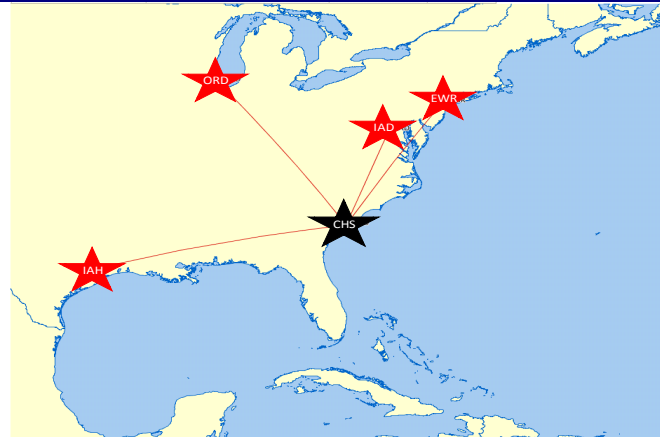
Figure 49: DL nonstop service to/from Charleston



Source: Diio Mi and Deutsche Bank Airline Research

Delta, on the other hand, provides 17 daily flights from Charleston to four destinations giving it significantly better market coverage (see Figure 49).

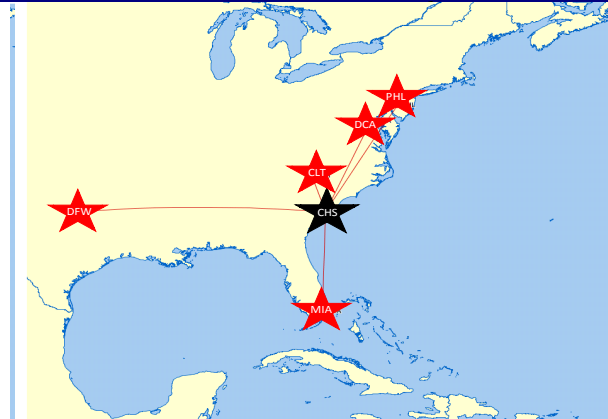
Figure 50: UA nonstop service to/from Charleston



Source: Diio Mi and Deutsche Bank Airline Research

And United, like Delta, connects Charleston to major East Coast markets (among others) with 14 daily flights to four destinations (see Figure 50).

Figure 51: AA + US nonstop service to/from Charleston



Source: Diio Mi and Deutsche Bank Airline Research

An AA/US merger would create a Charleston schedule that would be as good (even better from a frequency perspective) than both Delta and United (see



Figure 51). With 20 daily flights to five destinations, AA/US would be able to provide connecting service to every major domestic region.

### AA/US merger will “fix” American’s fleet

Currently American/American Eagle operate a fleet of approximately 850 aircraft with seats per aircraft ranging from the 44-50 seat Embraer regional jets (some, of which, are operated by contract carriers) all the way up to the 247-seat Boeing 777-200s (larger 777-300s are set to arrive later this year. However, there is a significant void between 63/65-seat CRJ-700s (only 47 in its fleet) and 140-seat MD-80s. Unlike its competitors, American has had to operate under a more restrictive pilot "scope" clause which has limited access to additional large regional jets (e.g. Delta can operate up to 255 large regional jets – 70/76-seat aircraft – and per a recent tentative pilot agreement increases to 325 aircraft). As a consequence, American has not been able to optimally right-size aircraft for many of its domestic markets.

A key part of American's restructuring plan envisions addressing its fleet deficiencies over the next several years via two significant narrowbody orders with Airbus and Boeing. However, a merger with US Airways would immediately resolve that issue as US and its regional partners operate 225 aircraft (out of a total combined fleet of 628 aircraft) that would fill that void: 14 67-seat CRJ-700s, 38 79-seat CRJ-900s, 20 69-seat Embraer 170s, 38 80-seat Embraer 175s, 15 99-seat Embraer 190s, 93 124-seat Airbus A319s, and 7 126-seat Boeing 737-300s (to be retired in 2012).

### AMR unions support AA/US merger

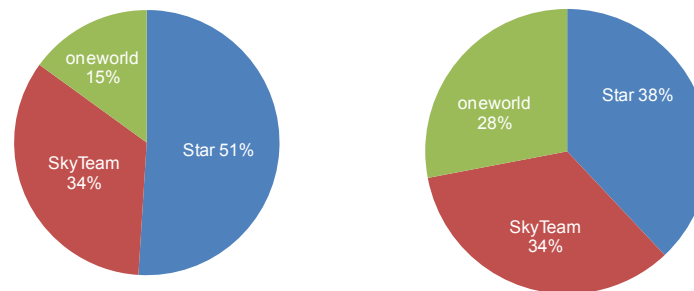
We view the agreements between US Airways and AMR’s three major unions (APA, APFA, and TWU) as a significant milestone. Furthermore, we see labor as one of the three key constituents that can meaningfully influence the outcome of an airline Chapter 11 bankruptcy – the other two are AMR management and the unsecured creditors committee which essentially represent the future equity holders of AMR. History has shown us that a plan of reorganization in an airline bankruptcy needs support from two of the three major constituent groups in order for the plan to ultimately be approved by creditors.

### AA/US merger will strengthen oneworld

Our sense is that the oneworld carriers would embrace an AA that not only possessed a larger network, but a partner that would be on par size-wise with its primary competitors Delta and United. Additionally, in 1992 oneworld carrier British Airways invested in US Airways and established a marketing/code sharing joint agreement. One of the key reasons for the tie-up was US Airways’ (then USAir) strong East Coast presence and the fact that as much as two-thirds of US transatlantic revenue originated east of the Mississippi River. We think that rationale for a tie-up between AA and US still holds true as we estimate approximately 60% of US transatlantic revenue still originates east of the Mississippi.

In Figure 52 below, an AA/US merger would rectify a lopsided revenue split between alliances in the US East Coast – Europe market. While oneworld would still rank 3rd among the global alliances, the revenue gap would be significantly smaller.

Figure 52: Alliance East Coast - Europe revenue penetration: before/after AA/US merger



Source: Company filings and Deutsche Bank Airline Research



## AA/US merger will drive \$1.2 billion of synergies

US Airways has publicly stated that a merger with American will result in at least \$1.2 billion in net synergies or about 3.3% of LTM combined revenue. Compared to other airline mergers, we think 3% conservative given that it is at the low end of the historical range (see Figure 53). What is notable among the prior deals is that the transaction that had the highest synergy percentage – America West/US Airways which exceeded its 2-year goal within the first year after merger close – was executed by the current US Airways management team.

US Airways has also stated that the \$1.2 billion of synergies do not include incremental savings that could be achieved while American is reorganizing under the bankruptcy process. Also, US Airways has estimated the split between revenue and cost synergies at \$1.0 billion and \$0.2 billion, respectively.

What's the potential upside for US Airways shareholders? If we assume that \$1.2 billion in annual net synergies is an EBITDAR contribution and includes no additional net debt added to the new capital structure, then we get about \$5.5 billion of value accruing to the new equity holders over a 2 – 3 year period (using a 4x – 5x EV/EBITDAR multiple). If we apply US Airways pro rata share to the new equity value (assuming an unsecured claims pool of \$11 - \$13 billion for AMR and unsecured debt bid in the low 50s with some additional premium to get creditors on board), we get about \$7 per share of upside based on a fairly conservative forecast (and a stock currently trading at \$10.71).

## AA/US merger would create an industry leading airline

The bottom line is that we believe a merger between AMR Corporation and US Airways would create a formidable competitor to both Delta and United. We also think that an AA/US merger would be positive for the US airline industry. Lastly, a deal would still need approval from the Department of Justice which typically focuses on city-pair concentration. In that regard, American and US Airways' networks are complementary with only a dozen or so overlap routes out of several 1,000 domestic city-pairs.

Figure 53: Selected M&A transactions

Date Announced	Acquirer / Candidate	Total Synergies	% of Revenue
September 2010	Southwest / AirTran	US\$400 million	3%
August 2010	LAN / TAM (a)	US\$400 million (b)	4%
May 2010	UAL / Continental (a)	US\$1.2 billion	4%
November 2009	British Airways / Iberia (a)	US\$600 million (c)	3%
April 2008	Delta / Northwest (a)	US\$2.0 billion	6%
April 2005	America West / US Airways	US\$680 million	7%

*Note: Unless noted, all of the above synergy totals reflect an annual run rate and were/are expected to be achieved by year three following transaction close. LAN / TAM merger is currently pending.*

*(a) Transaction structured as a merger of equals.*

*(b) In early 2012, LAN and TAM revised their synergy forecast to \$600 - \$700 million beginning four years after completion of the transaction and representing 4.5% - 5.0% of LTM combined revenue.*

*(c) At the time of the announcement, BA and Iberia identified €400 million of annual synergies (after five years) which we converted to US\$ at the time of the announcement.*

*Source: Company reports, SEC filings and Deutsche Bank Airline Research*



# Global Airline M&A Primer

## Rationale for airline M&A

### Consolidation should dampen industry volatility

Our view is that consolidation is part of a longer-term process that should ultimately allow the global airline industry to efficiently allocate capital and assets such that a positive return on invested capital can be achieved (which, has been an elusive goal as evidenced by industry net losses totaling \$16 billion over the 2002 - 2011 10-year stretch). On the surface, airlines pursue mergers as a means to improve profitability (via cost and revenue synergies) and their competitive positioning via an expanded network. Longer-term, consolidation should improve industry viability while mitigating industry volatility and consequently lower its cost of capital.

### Too much competition?

Airline mergers have historically faced much opposition from numerous constituents: regulators, consumer groups, communities, labor unions, and other partners, among others. While those most opposed to consolidation reason that it will be bad for consumers as it could result in less competition, our response is that they ought to take a look at Figure 6 on page 10. What that chart suggests to us is that maybe there is **too much** competition in the airline industry. As previously highlighted, the WACC – ROIC gap represents significant ongoing wealth destruction in the global airline industry. We previously estimated that the loss to shareholders in some years is as much as \$20 billion. While we think competition in the airline industry, in general, is a positive as evidenced by the significant amount of consumer surplus generated over the years, it would all be for naught, in our view, if the losses on shareholder wealth were in excess of the consumer surplus created. Because of this financial predicament, airlines are seeking ways to do more with less capital invested and assets deployed. There are many ways to achieve this objective such as divestiture of non-core assets and businesses; outsourcing of traditional in-house services such as ground handling, maintenance, and on-board catering; and greater reliance on aircraft and equipment leasing. However, it seems that consolidation may be the most powerful means to achieve that goal.

### Mergers can drive meaningful synergies

In order to address their financial gap, airlines have sought to merge with other carriers within their home markets with the objective of improving both their profitability and long-term viability. The source of profitability improvement is a function of both revenue and cost synergies with the contribution to pretax earnings 3% - 7% of combined revenue by the third year of the merger based on the most recent large transactions.

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*(c) At the time of the announcement, BA and Iberia identified €400 million of annual synergies (after five years) which we converted to US\$ at the time of the announcement.*

*Source: Company reports, SEC filings and Deutsche Bank Airline Research*

Revenue synergies are a function of improved revenue mix due to network expansion, capacity rationalization, and more attractive service pattern, among other things. Cost synergies include asset rationalization (aircraft and facilities), elimination of duplicative operations, improved negotiating leverage vis-à-vis supplier base, among other things. However, airline M&A is fraught with a high degree of execution risk as the integration of aircraft fleets, labor groups, facilities, and IT systems are all very challenging exercises. Furthermore, the proposed transaction has to pass muster with all of the various regulatory bodies including some outside of the merged carriers home market as well as put to a shareholder vote for most publicly-traded companies.

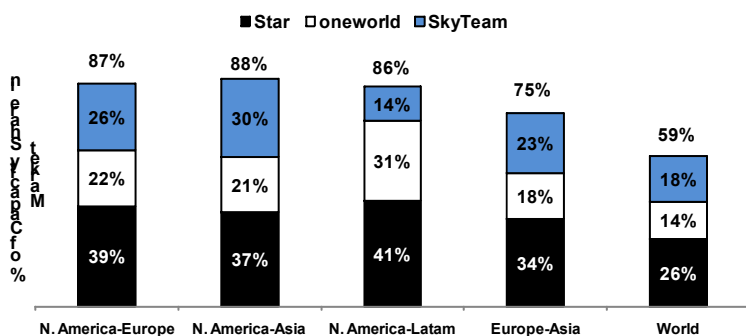


## The evolution of airline consolidation

### M&A historically limited to domestic market transactions

Airline consolidation has historically been limited to domestic markets as most countries (as well as most aviation bilateral agreements which govern route authorities between countries) have strict citizenship requirements for their flag carriers. So for many years, airlines were only able to pursue less intensive forms of cooperation such as interline agreements (facilitate flow of passengers/cargo on multi-airline itineraries), code sharing (allows for on-line “seamless” connections of passengers/cargo), pooling of revenue and minority equity ownership.

Figure 54: Alliance market share – January – June 2012



Source: Diio Mi and Deutsche Bank Airline Research

### Open Skies agreements allowed for more intense cooperation

This all changed in 1992 when the US and the Netherlands agreed to a new Open Skies bilateral air treaty, and the US granted Northwest Airlines (which has subsequently merged with Delta) and KLM full antitrust immunity (“ATI”), thus allowing the two airlines to market, schedule and price joint services – essentially operating as a single competitor. The growth of airline ATI joint ventures (“JVs”) coincided with the development of global airline alliances (e.g. oneworld, SkyTeam, and Star), and in most cases, ATI JVs represented the core of a global alliance (American/British Airways/Iberia the most recent example). Over time the antitrust immunized JV agreements within alliances grew from two to multiple airlines driven by the objective of “metal neutrality” or in other

words the airlines involved are indifferent to which aircraft or “metal” carries a passenger. Presently, airline alliances now account for a majority 59% of global capacity and represent significant share (>75%) of the major air corridors (see Figure 54).

However, alliance development including the growth of ATI JVs would not be possible without a more liberal global aviation regulatory backdrop. In that regard, since the first Open Skies agreement was signed between the US and the Netherlands almost two decades ago, the US has signed more than 100 Open Skies agreements. Europe and Canada have also pursued Open Skies agreements with their trading partners. Furthermore, we have observed the emergence of the EU’s Single Aviation Market which came into full effect in 1997 (when cabotage or domestic operations by a foreign carrier – the so-called 9th Freedom – was fully liberalized – see Appendix C: Freedoms of the Air) which effectively removed borders allowing for one EU to carrier to merge with another. On the other side of the globe, Australia and New Zealand created a Single Aviation Market effective November 1, 1996 which culminated into a full Open Skies agreement on August 8, 2002. The Open Skies agreement between both countries is more liberal than the US model as there are no longer any restrictions on flights to, from, within, and beyond the territory of the other party. The agreement allows for cabotage and 7th freedom air cargo rights (see Appendix C: Freedoms of the Air). In the same region, airlines from ASEAN nations last year agreed to remove all 3rd and 4th freedom restrictions on flights between capital cities. This agreement is expected to be followed by a more comprehensive, multilateral accord that will allow for 5th freedom services and a move to Open Skies by 2015.

### Global consolidation intensifying as restrictions are removed

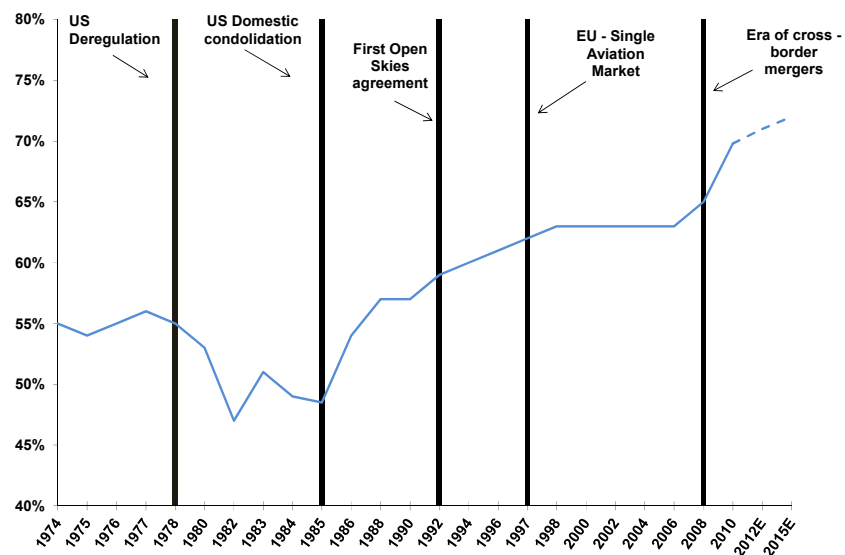
The aforementioned regional aviation accords (and many others that are too numerous to mention here), the liberalization of regulations underlying many of the 4,000+ aviation bilaterals, and the gradual relaxation of foreign ownership restrictions have provided for greater cooperation among global airlines. Furthermore, we are of the view that a more liberal global aviation regulatory framework combined with the further development of the global alliances will provide a fertile backdrop for M&A. In some cases, that has started to play out as alliance partners take their level of cooperation to the next level via a merger. Examples of this are the mergers of Delta – Northwest (as part of SkyTeam), Continental – United (as part of Star) and British Airways – Iberia (as part of oneworld). And recent press reports have indicated that Lufthansa could be



eyeing TAP as an acquisition candidate (as part of Star and following Lufthansa's take-outs of Austrian and Swiss – all members of Star).

restrictions, among other initiatives introduced over the past two decades, have all served to undermine the very restrictive aviation regulations that, for the most part, have prevented cross-border mergers.

Figure 55: Market share of top 20 global airlines: 1974 – 2015E



Source: IATA and Deutsche Bank Airline Research

The consequence of all of the M&A activity has resulted in the market share of the top 20 global airlines (per IATA RPK data) having grown appreciably over the past two decades (see Figure 55).

### Laying the foundation for cross-border mergers

In spite of all of the challenges that two airlines face in any home market merger (or single economic market such as the EU), M&A transactions involving airlines from two different countries face even higher hurdles. As pointed out earlier, airline M&A was largely confined to domestic markets with international airline cooperation largely characterized by interlining/code sharing agreements. However, as we pointed out previously, the introduction of Open Skies agreements, creation of the EU's Single Aviation Market, granting of antitrust immunity by the US DOT, as well as relaxation of foreign ownership

### The reasons underlying foreign ownership restrictions

In most countries, cross-border mergers are not allowed per foreign ownership restrictions which stipulate that the majority of the voting stock and the majority of key management positions have to be held by citizens of that country. Of course, there are exceptions such as Chile where airlines can be 100% foreign-owned so as long as they are domiciled in the country, but that is atypical (See Figure 56 – foreign ownership restrictions). One of the main reasons for the foreign ownership restrictions is that airlines have historically been viewed as an industry that is critical to a country's national security. During times of war, commercial aircraft are typically "conscripted" by the military into service as troop transports to support the effort. The concern from a national security perspective is that if a local airline is owned/controlled by foreign interests, how can they be forced to cooperate during times of war especially if the foreign owner does not agree with the geopolitical actions taken by the home country? (An interesting counterpoint to this is that many ships that the US has utilized in supporting its war efforts in the past have operated under foreign flags.) Another reason for foreign ownership restrictions is that they represent a form of protectionism for labor unions who see foreign competition (particularly if they are manned by lower-compensated employees) as a threat to their earnings power, own airline's viability, and ultimately job security. Labor unions are also loathe to give foreigners control over US airlines as they believe it will result in the off-shoring of jobs. These were some of the reasons why US labor unions fought the Virgin America application which they argued was not a US citizen since the majority of its funding (which they defined as debt and equity) was sourced from non-US entities. Labor unions feared that the new entrant (supported by foreign money) would destabilize markets and undermine their own airlines' ability to generate a positive return. Ultimately the US DOT deemed Virgin a US citizen as no more than 25% of the voting equity was held by foreign interests and the majority of key management positions were held by US citizens.

### From interlining to antitrust immunity

Because foreign ownership restrictions have been in place for years (the US has restricted foreign ownership of its airlines to 25% of the voting equity since the 1930s), global airlines have sought to cooperate with less intensive agreements.



One of the earliest examples of cooperation among airlines from different countries is the interline agreement. A traditional interline agreement is a voluntary commercial agreement between airlines to facilitate passenger travel on itineraries involving multiple carriers and provide for ticketing, baggage transfers, and other related services. Although there are thousands of interline agreements in place today globally, they have clearly been superseded by more comprehensive partnerships including code sharing, global alliances, minority stakes, antitrust immunized agreements and most recently joint ventures where each of the members have immunity from antitrust laws.

#### [What is antitrust immunity?](#)

Under an alliance or joint venture that has been granted antitrust immunity, the partner airlines are allowed to essentially operate as a single carrier. This includes jointly scheduling, marketing, pricing, and operating the air service in the approved markets. Under a joint venture arrangement, they can split the revenue or even the profits based on some agreed upon formula. Antitrust-immunized JV agreements are driven by the objective of “metal neutrality” or in other words the airlines involved in the JV (there can be more than two airlines participating in a JV) are indifferent to which aircraft or “metal” carries a passenger.

ATI is usually not granted unless a country is a signatory to an Open Skies agreement (which has been the case with US Open Skies agreements). However, it is important to note that an Open Skies agreement does not guarantee the granting of antitrust immunity (e.g. the initial rejection by the US DOT of a request for ATI by Delta and V Australia despite an Open Skies agreement between the US and Australia; ultimately the airlines’ ATI application was approved).

#### [ATI agreements may be preferable to a full merger](#)

Many have viewed ATI agreements as an interim “fix” to address the fact cross-border mergers, for the most part, are not permissible per foreign ownership restrictions. Some have suggested that ATI is in lieu of full cross-border mergers, and in fact, in some cases, may be desirable over an outright merger. We are of the view that there are many sound reasons for why an ATI agreement with a particular air carrier may be preferable to a full merger, but we do think the foreign ownership laws should be relaxed so as to at least provide the option so that carriers can choose their desired approach.



Figure 56: Airline foreign ownership restrictions for selected countries

Country/Region	Voting	Comments
<b>Argentina</b>	<b>100%</b>	The requirement is that an Argentine Sociedad Anonima (corporation) be incorporated even though 100% of the ownership can be foreign.
<b>Australia</b>	<b>49%/100%</b>	No more than 49% of the total value of the issued share capital of an Australian international airline can be held by foreign interests. The Qantas Sale Act also sets out additional restrictions including a 35% limit on foreign airline shareholders in Qantas, and a 25% limit on foreign individual shareholders in Qantas in addition to the 49% foreign shareholder limit.. Domestic airlines, however, can be 100% foreign-owned such as Tiger Airways Australia which is wholly-owned by a Singapore-based company that includes Singapore Airlines as a shareholder. Also, 2/3 of Board members of an Australian international airline must be Australian citizens and the Chairperson of the Board must be a citizen.
<b>Brazil</b>	<b>20%</b>	Maximum voting stake allowed by Brazilian law for foreign investment in national airlines. However, there is legislation working its way through the system that will raise the cap to 49%. Furthermore, one of the more interesting elements of the proposed Brazilian legislation to increase foreign voting rights from 20% to 49% is the inclusion of a right of reciprocity which means that the 49% cap can be waived for an airline from a country with a more liberal foreign ownership regime. There is currently no cap on total equity (non-voting) held by foreign interests.
<b>Canada</b>	<b>25%</b>	Maximum foreign investment, although maximum individual limit for Air Canada recently increased from 10% to 15% by Parliament and approved by shareholders in 2001.
<b>Chile</b>	<b>100%</b>	Airlines can be 100% foreign-owned so as long as they are domiciled in the country.
<b>China</b>	<b>35%/25%</b>	No single overseas investor can own more than 25% of a Chinese airline.
<b>Colombia</b>	<b>100%</b>	Similar to Chile's laws including the fact that an international carrier can invest in a domestic market carrier and operate its own routes such as Copa's purchase of Aero Republica and LAN's purchase of AIREs.
<b>EU</b>	<b>49%</b>	The EU reserves the right to lower US investment in EU carriers to 25% of voting stock.
<b>India</b>	<b>26%/49%</b>	The maximum 26% only applies to Air India. Prior to the merger of domestic carrier Indian Airlines and Air India, foreigners were restricted from owning the former. In 2004, foreign ownership of aviation interests was raised from 40% to 49%, but specifically excluded foreign airlines from investing locally. Not clear whether that has been relaxed.
<b>Israel</b>	<b>34%</b>	
<b>Japan</b>	<b>33.3%</b>	
<b>Kenya</b>	<b>49%</b>	
<b>Korea</b>	<b>50%</b>	Korea's limit was revised from 20% to 50% in 1998.
<b>Mexico</b>	<b>25%</b>	Foreign carriers cannot own more than 25% of the voting shares.
<b>New Zealand</b>	<b>49%/100%</b>	Similar to Australia which limits 49% foreign ownership of international airlines but 100% of domestic carriers.
<b>Singapore</b>	<b>100%</b>	No foreign ownership limits.
<b>Taiwan</b>	<b>33.3%</b>	
<b>Turkey</b>	<b>49.9%</b>	
<b>United States</b>	<b>25%</b>	Although there is no legislation that specifically caps total equity stakes held by foreign interests in US airlines, it has been generally assumed to be limited to 49.9%. However, the first stage EU – US Open Skies agreement which went into effect March 30, 2008 states that European ownership of "50% or more of the total equity of a US airline shall not be presumed to constitute control of that airline. Such ownership shall be considered on a case-by-case basis". Also, 2/3 of Board members must be US citizens and key management positions are required to be held by US citizens, among other things.

Source: Company filings, press releases, and Deutsche Bank Airline Research



## Pushing the M&A “envelope”

### Cross-border M&A ready for prime-time?

Airlines making investments in foreign carriers is not a new concept, and in fact, has actually been very common over the years. However, investments with full ownership and/or control have been relatively rare with many of the transactions taking place in Latin America and Australia/New Zealand (see Figure 57).

Figure 57: Selected cross-border investments w/full ownership/control

Date (a)	Acquiror / Country	Target / Country	Shareholding
October 2010	LAN Airlines / Chile	Aires / Colombia	99%
August 2010	LAN Airlines / Chile	TAM / Brazil (b)	100% / 20% (c)
October 2009	Avianca / Colombia	TACA / El Salvador (b)	66.7% (d)
November 2007	Tiger Airways / Singapore	Tiger Airways Australia	100% (e)
April 2005	Copa / Panama	Aero Republica / Colombia	85.6% (f)
November 2001	LAN Airlines / Chile	ABSA / Brazil	73.3% (g)
October 2001	Grupo Marsans / Spain	Aerolineas Argentinas	92% (h)
August 2000	Virgin Group / UK	Virgin Blue / Australia	100% (e, i)
September 1996	TAM / Brazil	LAP / Paraguay	80% (j)
1996	Air New Zealand	Ansett Australia	50% (k)
1987	Ansett Australia	Ansett New Zealand	50% (l)
1971	Gulf Air / Middle East	Bahrain, Oman, Qatar, U.A.E.	100% (m)
1946	Scandinavian Airlines System	Denmark, Norway, Sweden	100% (n)

Note: Although technically considered to be cross-border mergers, we have chosen not to include any of the European Union airline mergers that occurred after the formation of the EU's Single Aviation Market in 1997.

(a) Date M&A transaction announced.

(b) Transaction structured as a merger of equals.

(c) Proposed LATAM Airlines would have 100% economic interest in TAM but only hold 20% of the voting rights per Brazilian foreign ownership restrictions.

(d) Holding company structure with 2/3 controlled by Avianca's parent Synergy Group and 1/3 controlled by TACA.

(e) Australia government policy currently allows airlines that are 100% foreign-owned to operate domestic airline services within the country.

(f) Subsequently increased to 99.7% by September 2005.

(g) LAN owns 20% of the voting shares of cargo carrier ABSA and 100% of the non-voting shares per Brazilian foreign ownership restrictions.

(h) Spanish tour operator Grupo Marsans had no success in restructuring Aerolineas Argentinas and ultimately sold it back to the government in 2008. At the time of the sale, Marsans held a 94.4% controlling stake in the airline.

(i) Virgin group over time reduced its stake in Virgin Blue and currently owns 25% of the equity.

(j) The acquisition of LAP was made by a TAM subsidiary; today TAM owns 95% of the airline which has been renamed TAM – Mercosur.

(k) Air New Zealand initially acquired 50% of Ansett Australia (without management control), but subsequently acquired full ownership in February 2000. A condition of the buyout was Ansett's divestiture of its New Zealand division.

(l) Following the relaxation of foreign ownership restrictions, Ansett took full control (100%) of its New Zealand subsidiary.

(m) A truly multinational airline with ownership split evenly between four countries that could fly both domestically and internationally to/from, within and beyond all four countries.

(n) Another example of a multinational airline that could fly both domestically and internationally to/from, within and beyond all three countries. Sweden's 42.8% stake was the largest in SAS, Denmark and Norway each controlled 28.6% at the time of formation. Subsequently half of the company's equity was sold to public shareholders.

Source: Company filings and Deutsche Bank Airline Research

However, we are of the view that increasing intensity of consolidation in key markets such as Europe, the US, China and Latin America could act as a catalyst for cross-border M&A.

### US and Europe have experienced a merger wave

In recent years, airlines based in the more mature and developed markets, particularly Europe and the US, began to consolidate amongst themselves, and, in many cases, with their fellow alliance partners. Examples of the latter are the mergers of Delta – Northwest (both part of SkyTeam), Continental – United (both part of Star) and British Airways – Iberia (both part of oneworld). And recent press reports have indicated that Lufthansa could be eyeing TAP as an acquisition candidate (as part of Star and following Lufthansa's take-outs of Austrian and Swiss – all members of Star).

During this past decade, European airlines became appreciably larger via M&A transactions that would have been almost unthinkable before the EU's Single Aviation Market became a reality (became fully effective in 1997). Over the past five years, the US airlines have followed in the footsteps of their European brethren, and begun to consolidate in earnest. In fact, we believe no US industry sector has consolidated as much as the airlines have over the past five years. What is noteworthy is that the US airline industry experienced significant consolidation activity in the 1980s and 1990s and yet the market share of the top four airlines never seemed to get much higher than 60%. Presently, the top four US airlines account for 82% of total US traffic (see Figure 2 on page 7).

### ATI closest thing to cross-border M&A for US and European airlines

Antitrust immunized agreements have proven to be a successful way to get around foreign ownership restrictions for US and European airlines. For now, it seems that ATI agreements may be at the edge of the consolidation “envelope” for US and European airlines particularly since the second stage of EU – US Open Skies (signed in June 2010) failed to resolve the issue of airline ownership and control. (Although we think it is worth noting the innovative structure proposed by LAN and TAM to form LATAM Airlines – see below – is that structure a potential template which could be applied to US and European airlines?). Furthermore, the first stage of EU – US Open Skies addressed the possibility of a European airline holding more than 50% of the non-voting equity of US carrier – see Figure 57 – a key element which figures prominently in the LATAM structure.)



### Cross-border M&A most advanced in Latin America

Over the past year or so, we have seen Latin American airlines not only embrace consolidation, but structure some of the industry's more innovative transactions. For example, the soon to close merger between LAN Airlines of Chile and TAM of Brazil (to form LATAM) could be a future model for how to do a cross-border merger despite very restrictive ownership laws. As mentioned earlier, Chile has no foreign ownership restrictions, which is probably why LATAM decided on Santiago, Chile as its headquarters. Presently, foreign ownership of Brazilian airlines is very restrictive and capped at 20% of the voting equity (although there has been a proposal to change the 20% to 49%, which has been working its way through the legislative chambers) with no limit on total equity. As envisioned, the new publicly-traded shares of LATAM Airlines would have 100% of the economics of LAN and TAM, 100% of the voting rights of LAN, but only 20% of the voting rights of TAM (subject to the aforementioned changes assuming the proposed legislation is approved). We view this as a very innovative transaction and potentially a template to be used by other airlines considering cross-border mergers. Not surprisingly, LAN has been benefiting from a similar arrangement for years via its stake in Brazilian cargo carrier ABSA. LAN's ownership is limited to 20% of the voting equity, but it has 100% of the non-voting shares of ABSA which results in a total ownership stake of 73%.

### Brazil following in Chile's footsteps

For years, Chile has had one of the most open aviation markets which likely evolved out of necessity given that the country is somewhat geographically isolated. Brazil now appears to be following in Chile's footsteps when it comes to liberalizing aviation bilaterals as evidenced by its signing of Open Skies agreements with the US and EU as well as most other South American countries. Additionally, one of the more interesting elements of the proposed Brazilian legislation to increase foreign voting rights from 20% to 49% is the inclusion of a right of reciprocity which means that the 49% cap can be waived for an airline from a country with a more liberal foreign ownership regime. Or in other words if an airline from Chile or Colombia which allows 100% foreign ownership of its airlines wishes to acquire a Brazilian airline, the authorities can waive the 49% cap and allow for 100% acquisition of the voting equity.

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### Will smaller airlines be forced to seek partners?

As the largest airlines capture more market share, by definition the smallest airlines will have less. The larger the network, the more attractive it is to the most profitable revenue segments such as business/premium travelers, cargo shippers, and long-haul travelers, among others. As such, are the smallest airlines at risk of becoming less relevant if they fail to team up? While we think there will always be room for niche airlines and formidable LCCs such as easyJet and Ryanair in Europe, Spirit in the US, WestJet in Canada, Volaris in Latin America, and AirAsia, we do believe that airlines that are positioned between LCCs and major network airlines may be forced to consider some form of consolidation in order to grow their footprint and enhance their product. Airlines that we think fall into this category are carriers such as Virgin Atlantic (who has publicly stated their desire to team-up with another carrier or alliance), SAS and JetBlue, who, for now, has decided to pursue multiple partnerships (none all that deep, though) by leveraging its strong presence in both New York and Boston. In Australia, Virgin Australia may be deemed to fall under this category, but it has sought to expand its international network precisely by negotiating alliances with Air New Zealand (to maintain its trans – Tasman reach), Delta (for access into the US) and Etihad (to access Europe).

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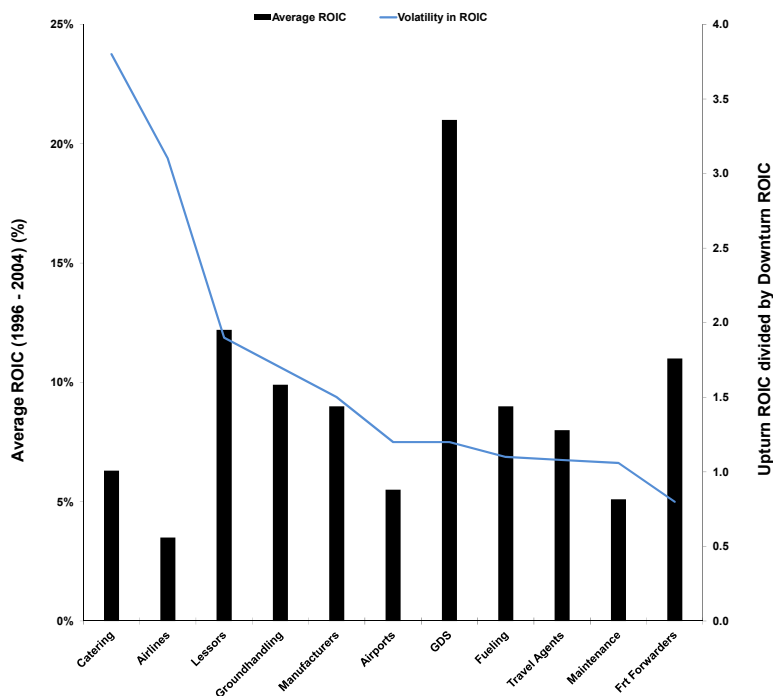
### Labor can benefit from airline mergers

Highly fragmented, fiercely competitive, cyclical and capital intensive industries are usually not associated with job security, stable wages, and attractive benefits. However, there are numerous examples of mature industries that have restructured and consolidated ultimately improving the professional livelihoods of their employees (e.g. air cargo, steel and railroads). For those who are not convinced, our response is to compare the total compensation package of a pilot who works for FedEx or UPS to a pilot of similar seniority working for one of the major US airlines. Not surprisingly, the total compensation of the FedEx and UPS pilots in many cases is as much as 50% higher than their counterparts at a major airline. If we were to adjust for age and career earnings, the gap would be much wider. The job security is much better as well (e.g. UPS has only furloughed pilots once in the company's history – in 2008 due to the global recession). And yet it was not too long ago when there were more than a dozen publicly-traded air cargo companies with many generating inadequate returns (anyone remember Seaboard World, Flying



Tiger, Emery, Purolator, Burlington Air Express?). While airline consolidation is not likely to address the fact that passengers are much more difficult to deal with than boxes (they don't whine and can't contract infectious diseases), it can, in our view, go a ways in addressing some of the deficiencies of the airline profession.

Figure 58: ROIC/ROIC volatility for selected aviation industries



Source: IATA and Deutsche Bank Airline Research

## Shifting balance of power in the aviation supply chain?

For years, the airlines have been the weakest financial link in the aviation supply chain as evidenced by higher earnings volatility and subpar returns compared to those of their suppliers, vendors and other partners (see Figure 58). Also, because of the industry's less-than-stellar financial history, we are of the view that airlines generally have not had the upper hand when it comes to negotiating with their various suppliers and vendors. Furthermore, unlike most other highly competitive industries, airlines face significant costs due to their high degree of regulation (e.g. probably the safest mode of travel save for the tricycle) and operations that are subject to inefficient (and to some extent not accountable) monopoly service providers (airports and air traffic control). However, we are of the view that as airlines further consolidate, their negotiating leverage with suppliers, vendors and other partners is meaningfully enhanced.

For example, in the case of the British Airways and Iberia merger, BA now has access to a home country market that appears to be much more willing to support airport and facility expansions (i.e. Spain). This reflects a very different backdrop than what BA has experienced in the UK where the airline for years has unsuccessfully lobbied for a third runway at London – Heathrow Airport. As such, we would not be surprised if going forward a disproportionate amount of the majority of International Airline Group's (parent company of BA and Iberia) assets (as well as the associated job creation, revenue generation and tax receipts) are deployed to Spain and other regions rather than the UK.

Reducing airport overhead through increased utilization and elimination of excess gates and terminal space is another area of opportunity driven by consolidation. While it may be harder to wring cost savings from key airports such as London's Heathrow, Paris' de Gaulle, or New York's Kennedy where there is a tendency to hold onto assets given their gateway status, there may be opportunities to rationalize smaller hubs. . One of the consequences of consolidation is that merging airlines may find they have too many hubs or at least overbuilt ones (e.g. Delta merging with Northwest led to the realization that Memphis was arguably overbuilt given that it was in the shadow of the more powerful Atlanta hub.). Airport hubs that find themselves on the endangered list have proven to be pretty resourceful when it comes to finding cost savings for their major airline partners.



# Valuation and Risks

## Asia ex-Japan

### AirAsia – Buy; PT: MYR\$4.35

We value AirAsia based on 8.9x 12 month forward adjusted EV/EBITDAR, in-line with the company's 5-year historical average of 8.9x adjusted EV/EBITDAR multiple and have added a SoTP for share of associate profits. At our target price, AirAsia would trade at 12x and 2.3x 1-year forward P/E and P/B multiples, in-line with its historical average since listing in November 2004.

Downside risks: (1) the delay of the listing of its associates, (2) high and volatile jet fuel prices which lead to losses for the airline, (4) aggressive hedging policies that could potentially go wrong, (4) incurring greater-than-expected losses in its new JVs in the Philippines and Japan and due to aggressive competition in the market.

### Air China – Buy; PT: HKD\$6.80

We set our target FY12E P/BV valuation benchmark at 1.4x. This is at a conservative 20% discount to its mid-cycle valuation and we believe that this is supported by FY12-14E core ROE of 9-12%, which is above its historical average. The implied target FY12E EV/EBITDA of 7.8x is also undemanding, in our view.

Key company-specific downside risks would be a loss of market share in its Beijing hub on competition and weaker-than-expected performance of the new cargo JV.

### Cathay Pacific – Sell; PT: HKD\$11

We have assigned a TP based on 0.8x mid 2013E P/B as we expect ROEs of -0.8% and 2.6% in 2012-13E to be much lower than the company's 6.8% cost of equity. We have pegged Cathay Pacific at a TP multiple that is lower than its 1.6x historical average because ROEs are lower.

Premium travel growth is a key risk as this is a market segment Cathay focuses on. Any unexpected growth here would benefit Cathay more than other carriers. Another upside risk to our rating is stronger than expected recovery in their China business.

### Cebu Air – Hold; PT: PHP\$72

Our price target is based on a 7.1x adjusted EV/EBITDAR multiple. The 7.1x multiple is a 20% discount to our 8.9x implied adjusted EV/EBITDAR multiple for AirAsia. We believe the discount is justified given that the operating landscape for Cebu Air has changed with increasing liberalization and competition in the industry. At our price target, Cebu Air would trade at a core PER of 12.4x and PB of 1.9x on the back of 16.9% ROE for FY12E.

Downside risks: 1) aggressive and irrational price competition leading to losses for Cebu Air, 2) volatile fuel prices, 3) competition on route rights from new foreign JVs in the Philippines market, 4) Peso weakness and 5) inability to secure funding at favorable interest rates for fleet expansion  
Upside risks: 1) Change of management at competitor results in organizational paralysis allowing for Cebu Air to gain market share 2) Consolidation in the domestic aviation market due to increased competition resulting in yield recovery, 3) lower fuel prices lifting cost pressure and 4) greater than expected demand driven by strong domestic consumption.

### China Airlines – Hold; PT: TWD\$13.70

We believe that improving operating margins will continue to drive CAL's earnings and bring its sustainable ROE above its previous peak level of around 7-8% and cost of equity of about 7%. We therefore peg our target forward P/BV at 1.30x. We believe this is justified given its strong fundamentals.

Upside risk: stronger-than-expected air traffic demand and yield recovery, unexpected positive development in cross-strait and lower-than-expected jet fuel price. Downside risk: worse-than-expected jet fuel price increase, slow recovery in cargo, government pressure on cross-strait ticket prices.

### China Eastern Airlines – Buy; PT: HKD\$3.70

We set our target FY12E P/BV valuation benchmark at 1.4x, on par with its mid-cycle valuation. We believe that this is justified as CEA is on track to achieve a FY12-14E core ROE of about 13-15%, which is above its own historical average. The implied target FY12E EV/EBITDA of 7.8x is not stretched either, in our view.

They key company-specific risks to our recommendation are: 1) weaker-than-expected growth in passenger traffic and 2) weaker-than-expected cost control results.



#### China Southern Airlines – Buy; PT: HKD\$4.80

We set our target FY12E P/BV valuation benchmark at 1.1x, on par with its mid-cycle valuation. We believe that this is supported by our expectations that CSA is on track to maintain FY12-14 core ROE of about 10-12%, which is above its own historical average. The implied target FY12E EV/EBITDA of 7.4x is also not stretched, in our view.

Key downside risks are deterioration of domestic air travel demand and worse-than-expected threats from future high-speed railway lines.

#### EVA Airways – Hold; PT: TWD\$17.90

We believe that improving operating margins will continue to drive earnings and bring EVA's sustainable ROE above its previous peak level of around 7-8%. We peg our target forward P/BV at 1.4x FY12E. We believe this is justified given its strong fundamentals. Our target price is set at TWD17.9.

Key upside risks: stronger-than-expected air traffic demand and yield recovery, unexpected positive development in cross-strait and lower-than-expected jet fuel price. Key downside risks: worse-than-expected jet fuel price increase, slow recovery in cargo, government pressure on cross-strait ticket prices.

#### Korean Air – Sell; PT: KRW\$40,000

Our TP is based on 1.0x 2012E P/B. We have assigned a TP equaling to KAL's BVPS because we expect its ROEs to trend towards its cost of equity of 9.7%.

Key risks: Korean Air's 60% debt is US\$ denominated, hence a stronger Won could result in translation gains, thereby impacting overall earnings. Korean Air is more focused than its peers on the air cargo market (30% of its revenue comes from the cargo business, compared to the 20% average of peers) and would therefore be more affected by any unexpected strength in this area. Unexpected movements in jet fuel would impact KAL's profitability as fuel expense accounts for about 40% of total operating costs.

#### Singapore Airlines – Sell; PT: SGD\$8.65

We have valued the stock at 0.8x 12m forward P/B. Our TP is below book value as we expect ROEs of 2.1% and 2.7% over FYMar13-14 to be lower than 6.9% cost of equity. The TP multiple we have assigned is also below historical average as we expect ROEs to be below historical average.

Key upside risk: Should the premium business pick up unexpectedly, SIA would benefit more than other regional airlines given that SIA is a strong premium carrier. Another upside risk is a surprisingly large dividend payout.

#### Thai Airways – Buy; PT: THB\$45

Our target price of Bt45 is based on the assumption that THAI will achieve an average core RoE of 10-12% in 2011-2012E. The target price is based on a P/B rating of 1.1x for 2011. While we see further potential upside (should the national carrier be successfully privatized) we have left these factors out of our valuation pending confirmation from the company.

THAI remains a high-risk story given the volatility in jet fuel prices and FX movements both of which can directly affect its RoE and BVPS. Company specific downside risks include: 1) Strengthening of the Euro against the Thai Baht, which would lead to sharp FX losses and reduce our Book value forecast, or weakening of the US dollars against Thai Baht, which would lead to higher Jet Fuel cost; 2) higher than expected operating costs 2011; 3) failure to implement reforms that would permit further cost-cutting due to lack of political support (possibly caused by an early dissolution of the Democrat Party or Parliament). Industry Specific downside risks include: 1) a sharp decline in passenger traffic if a new bout of civil unrest occurs (especially during the tourism high season of Dec-Feb); 2) if the global economic recovery loses steam as this would have a damaging impact on tourism; 3) an upsurge in oil price which THAI may be unable to offset by raising its fuel surcharge; and 4) a price competition between airlines in the region leading to lower yields.

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## Asia – Japan

#### All Nippon Airways – Hold; PT: ¥270.

Our TP is ¥270. We use ROE of 9.5%, which we think is attainable over the medium term, multiplied by forecast average TOPIX P/E of 12.7x to derive a target P/B of 1.20x. We apply a discount to our FY3/14 ROE forecast of 10.9%, to reflect substantial earnings volatility. We apply this to our BPS forecast of ¥225.15 to obtain our target price.

Upside risks include substantially greater impact on customer appeal from the introduction of B787 aircraft than we assume. Downside risks include JAL using a temporarily high earnings structure on established routes to lower its prices in pursuit of higher market share.



## Australia and New Zealand

### Qantas Airways – Buy; PT: AUD\$2

Our valuation is based on a weighted average of DCF & PE valuations using spot AUD-USD FX rates (on a one year forward view). Our DCF model (resulting in a valuation of \$2.43/share) incorporates a multiyear cash flow forecast, 13.5% after tax cost of equity and a terminal EV/EBITDA-net Capex of 7.0x reflecting the volatility in airline earnings. The cost of equity is based on the capital asset pricing model, incorporating a risk free rate of 6.5%, equity beta of 1.3 and a market risk premium of 5.2%. Our cost of debt is currently 6.0%. Our PE valuation (resulting in a valuation of \$1.85/share) uses the absolute QAN historical average PE of 11.3x and relative average PE of 11.0x based on QAN's peers. The absolute average is at a 31% discount to the ASX200 All Industrials (ex banks) which reflects QAN's historical trading relative to the market.

Key downside risks include (1) Execution of International Transformation program, (2) Execution of the proposed \$1.5bn Q-Future cost reduction program; (3) Significant further increase in both the Brent crude price & jet fuel refiner margins; (4) Any material worsening in the market share position (both domestic & international) for the Qantas Group; (5) Execution of the Jetstar growth strategy, particularly in the international markets; (6) Significant capacity growth & yield dilution beyond what we have projected; (7) Workforce relations, with worst case scenario of industrial actions grounding the airline; (8) Global shocks (terrorism, health pandemic, etc.) impacting at macro-economic level; (9) Any event causing significant damage to the Qantas brand; and (10) Adverse interest rate and currency fluctuation concerns.

### Virgin Blue Group – Hold; PT: AUD\$0.45

Our valuation approach is a combination of DCF (\$1.00) and peer PE methodologies (\$0.34) on a 20%/80% weighting, applied on a 12 month forward basis. The PE method uses an absolute average peer PE ratio of 10.7x and a relative average peer PE ratio of 10.4x. Our DCF valuation involves the application of a 13.7% tax-affected cost of equity on long-run debt serviced equity cash flows from the various VAH businesses. The cost of equity includes an Australian risk free rate of 6.5%, asset beta of 0.6 and market risk premium of 6.0%. We also consider business specific terminal growth multiples (e.g. 5x

EBITDA for VAH domestic) which reflects the underlying long run growth potential in the business.

Key upside risks include: (1) Potential speculation that an offshore investor may acquire VAH following the group restructure (which was proposed in February 2012); (2) Better than expected execution of strategy to obtain a greater share of the corporate/premium market; (3) Better than expected execution success in the growth of the international operations; (4) Improvement in domestic leisure travel climate, causing a strong demand upside; and (5) Material reduction in competitor capacity in the market thereby improving the current demand-supply imbalance.

Key downside risks include: (1) Inability to continue execution of strategy to obtain a greater share of the corporate/premium market; (2) Poor execution of the international strategy resulting in lower revenues from international operations; (3) Inability to maintain an above competitor on-time flying performance in the Australian domestic market (which is critical to growing VAH's corporate accounts); (4) Any near term unexpected global shocks such as a major terrorist event, health pandemic, etc. affecting general market propensity to travel; (5) Significant capacity growth beyond our projections, thereby affecting the supply demand mix and constraining yield improvement opportunities; (6) Operating cost containment challenges; and (7) Adverse interest rate and currency fluctuation concerns.

### Air New Zealand – Buy; PT: NZD\$1.37

We use 1x FY12E P/Book to derive our target price, which is in line with AIR's historical (FY04-11) trading range. Our book value is based on book equity although we note this is not dissimilar to the market value of aircraft as disclosed in AIR's FY11 annual report. We also value AIR using a DCF valuation. Our DCF valuation is based on a WACC of 10.4%, equity beta of 1.3, risk free rate of 5.5%, market risk premium of 6.5% and terminal growth rate of 2% (reflects long run inflation expectations).

The key risks to our target price are: 1) a significant increase in fuel costs from current levels, 2) increased competition on the routes it operates, 3) a sustained and severe slowdown in global growth, 4) global shocks (terrorism, health pandemics etc), 5) adverse currency fluctuations, 6) any events that detract from NZ's attractiveness as a tourism destination.



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## Europe

### IAG – Buy; PT GBp\$220

Our TP is based on a FY13E EV/EBITDAR multiple of 6.5x which compares to a mid-cycle average of 6.0x and a 5-year average of 7.4x. Downside risks to our forecasts and valuation would include weakening economic growth prospects in the Eurozone and/or US, further industrial action by Iberia staff and oil price volatility.

### EasyJet – Hold; PT GBp\$540

We value easyJet using a FY12E EV/EBITDAR multiple of 5.7x which compares to a mid-cycle average of 7.3x and a 5-year average of 7.7x. In our view the discount to historical multiples is fair given the European economic outlook. Upside risks to our valuation include further significant capacity withdrawal in Europe or an improvement in Eurozone outlook. Downside risks include a sudden spike in the oil price, severe European recession and/or ATC or staff strike action.

### Ryanair – Buy; PT: EUR\$4.60

Our €4.6 price target is based on a FY13E EV/EBITDAR multiple of 6.0x which compares to a mid-cycle average of 7.0x and a 5-year average of 8.0x. In our view the discount is somewhat justified due to lower long-term growth prospects. Downside risks include further rises in air passenger tax, industrial action by ATC or staff and significant intra-European capacity increases.

### Lufthansa – Hold; PT: EUR\$11

Our target price is based on an EV/EBITDAR multiple of 5.0x for the current fiscal year, which is in-line with the historical average and also in-line with Lufthansa's peer group (international network carriers in mature markets). Key downside risks: yield pressure in the European market, problems in the restructuring progress of Austrian Airlines, as well pressure on yields at Lufthansa's major hub Frankfurt (due to rising capacity and/or new market entrants). Key upside risks: an ongoing boom in the German economy (supporting both the Passenger and the Cargo segment), successful defence (or expansion) of its dominant 60% market share at Frankfurt Airport, as well as competitors cancelling destinations or reducing frequencies.

### Air France-KLM – Sell; PT: EUR\$2.10

Our price target is based on a 2012E EV/Sales multiple of 0.5x (trough 0.5x, peak 0.9x). Given the uncertainty over the company restructuring and the economic outlook, we think this multiple is reasonable. Risks include better than expected delivery on cost savings promises; the disaster in Japan and civil unrest in Africa and the Middle East have negatively affected 2011 earnings, and it is possible that these regions (which have historically been very profitable for AF-KLM) could rebound in 2012 and beyond.

### Air Berlin – Sell; PT: EUR\$1.40

Our target price is based on a 2014E EV/EBITDAR multiple of 6.7x. We consider this a suitable mid-cycle multiple based on the last six years (the company does not have a longer listed track record) where the trough multiple was 5.7x and the peak multiple was 8.4x. Key risks: bigger-than-expected benefits from joining the Oneworld alliance or from the cooperation with Etihad; higher-than-expected cost savings being realized; the abolition of the air traffic tax in Germany.

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## Latin America

### Aeromexico – Buy; PT: Ps\$35

Our price target for AEROMEX shares is Ps\$35. Our valuation work incorporates EV/EBITDAR and P/E multiples with an equal weighting. Our PT is derived from applying an EV/EBITDAR multiple of 6.6x to our 2012 EBITDAR forecast. We view the multiple as reasonable, given that EVs of Latin American airline stocks have historically traded at 6x-8x forward EBITDAR. Using P/E, our Ps\$35 price target is derived from applying a multiple of 17.5x to our 2012 EPS estimate. The multiple is near the midpoint of Latin American airlines' historical P/E trading range of 10x-20x. However, the issue with P/Es is that there is no consistency with respect to tax rates across the region. For example, some airlines such as Copa are projected to book a tax rate of 12% for 2012E compared to the much higher 25% 2012E tax rate we are forecasting for Aeromexico. P/E shortcomings notwithstanding, we feel it is necessary to utilize more than one valuation methodology in order to triangulate an appropriate and reasonable valuation.



Turning to risks, fuel price volatility is a key risk for Aeromexico – every 10% move in jet fuel (ceteris paribus) impacts our 2012 EPS estimate of Ps\$2.00 by Ps\$1.40. Aeromexico also faces risks related to emerging markets, a potential decline in business travel, execution of a rapid growth plan, increased competition (e.g., low-cost carriers plus the potential return of Mexicana, Aviacsa, and others) and the fact that it is a fairly illiquid small-cap stock (float only accounts for 16% of shares outstanding; market capitalization is Ps\$15 billion). Other risk factors are economic weakness, government regulation, labor issues, taxation, airport constraints, safety concerns, the threat of terrorism and war, and a higher equity risk premium being applied to airline shares.

#### Copa – Buy; PT: \$100

Our 12 month price target is \$100. Our valuation work primarily incorporates P/E and P/CF multiples. Our price target is derived from applying P/E multiples of 13 and 12 to our 2012 and 2013 EPS estimates, respectively, slightly higher than its historical average FY1 P/E of 11 and FY2 P/E of 10. At our \$100 PT, Copa's P/CF multiples would be 11x and 10x our 2012 and 2013 estimates, respectively, also slightly higher than its historical averages of 9x FY1 and 8x FY2 CF estimates. We think the use of higher multiples is warranted, given Copa's increasing track record of executing a solid growth strategy while consistently producing industry-leading returns.

Turning to risks, fuel price volatility is a key risk for CPA: every 10% move in jet fuel (ceteris paribus) impacts our 2012 EPS estimate of \$7.50 by \$1.55 per share. Copa also faces risks related to emerging markets, a potential decline in business travel (which is a major revenue segment for Copa), and mis-execution of its rapid growth plan. Other risk factors are economic weakness, government regulation, competition, labor issues, taxation, airport constraints, safety concerns, the threat of terrorism and war, and a higher equity risk premium being applied to airline shares.

#### GOL – Buy; PT: \$11

Our 12 month price target for GOL is \$11; it is derived by applying a 13 P/E multiple (in-line with its historical average of ~13) to our 2013 EPADS estimate of \$0.85 (22x to our 2012 EPADS of \$0.50 which reflects implementation of restructuring). We also look at EV/EBITDAR; in this regard, our PT implies an EV/EBITDAR multiple of 6.4 our 2012 forecast and 6.1 our 2013 forecast (which are near the stock's historical average of 7x).

Turning to risks, fuel price volatility is a key risk for GOL – every 10% move in fuel (ceteris paribus) impacts our 2012 EPADS of \$0.50 by \$0.50. GOL also faces risks related to FX rate volatility, emerging markets, a potential fall-off in business travel, competition, and the fact that it has a small float.

#### LAN Airlines – Hold; PT: \$32

Our 12 month price target for LFL shares is \$32. Our price target is primarily derived from applying an EV/EBITDAR multiple of 9.4 to our 2013 EBITDAR, at the high end of its historical trading range of 5x - 10x. However, our forecast currently gives the company no credit for expected synergies from its TAM merger (we will not adjust our forecast/model for this until the merger has been finalized); if we were to account for synergies, our price target would imply a multiple closer to the midpoint of the abovementioned range. Moreover, our valuation work could be viewed as conservative, as our analysis does not take into consideration the value created by combining TAM's 73% stake in Multiplus with LAN's 100% stake in LANPASS forming Latin America's largest frequent flyer program.

Turning to risks, fuel price volatility is a key risk for LFL- every 10% move in fuel impacts our 2012 EPADR estimate of \$1.35 by \$0.50. Also, LAN could be exposed to significant execution risk on its planned merger with TAM (although we are long-term positive on the proposed transaction). Other downside risk factors are risks related to emerging markets, exchange rate volatility, economic weakness, regulation, labor issues, taxation, airport constraints, safety concerns, the threat of terrorism and war, and the revaluation of the stock market resulting in a higher equity risk premium being applied to airline shares. An upside risk to our price target would be an acceleration in achieving and/or an expansion of the annual synergies expected from its merger with TAM.

#### TAM Airlines – Hold; PT: \$24

Our 12 month price target for TAM shares is \$24. Our price target is derived by applying EV/EBITDAR multiples of 6.9x our 2012 EBITDAR forecast and 6.3x our 2013 EBITDAR forecast. That is in-line with TAM's historical trading range of 6x - 7x forward EBITDAR. Also, we are not yet giving the company credit for its proposed merger with LAN (which we expect to close on June 15, 2012). Furthermore, we do not think TAM's share price fully accounts for its 73% stake in Multiplus, Brazil's leading loyalty program (presently, TAM's equity stake in Multiplus is equal to ~70% of its equity value).



Turning to risks, fuel price volatility is a key risk for TAM – every 10% move in jet fuel (ceteris paribus) impacts our 2012 EPADS forecast of \$1.30 by approximately \$1.10. Also, TAM could be subject to significant execution risk following the closing of its merger with LAN next month. TAM also faces risks related to emerging markets, exchange rate volatility, execution of its rapid growth plan, competition and its small float. Other risk factors are economic weakness, government regulation, labor issues, taxation, airport constraints, safety concerns, the threat of terrorism and war, and the revaluation of the stock market resulting in a higher equity risk premium being applied to airline shares. An upside risk to our price target would be an acceleration in achieving and/or an expansion of the annual synergies expected from its merger with LAN.

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## United States

### Alaska – Hold; PT: \$40

Our 12 month price target for ALK shares is \$40. Our valuation work incorporates EV/EBITDAR, P/E, and P/CF multiples with an equal weighting of all three valuation frameworks. Our price target is derived by applying EV/EBITDAR multiples of 4.6 and 4.4 to our 2012 and 2013 EBITDAR estimates, respectively (compares to group's historical average of 5x – 7x). Our price target is also computed by applying P/Es of 9.8 and 8.9 to our 2012 and 2013 EPS estimates, respectively. When major airlines are profitable we tend to see forward P/Es in the 8x – 10x range. Turning to P/CF, underlying our price target are our multiples of 5.2x our 2012 and 4.9x our 2013 CF (i.e. cash earnings) estimates. Although this is at the high end of/slightly above the group's historical average of 3x – 5x, Alaska has historically commanded a premium P/CF multiple relative to the group (likely due to its strong track record of cash earnings).

Turning to risks, a potential upside risk to our price target is a more extensive code share with AMR on the West Coast as AMR reconfigures its network during its Chapter 11 restructuring. A key downside risk is rising fuel prices: every 10% move in jet fuel impacts our 2012 EPS estimate of \$4.10 by \$1.20. Other downside risks include increased competition, economic weakness, government regulation, labor issues, taxation, airport constraints, safety concerns, the threat of terrorism and war, and market risk.

### Allegiant – Hold; PT: \$60

Our 12 month price target for ALGT shares is \$60. Our valuation work incorporates EV/EBITDAR and P/E multiples, with an equal weighting of both methodologies. Considering the company's current EV/EBITDAR valuation, it is trading within its historical range of 5x – 6x (ALGT has historically traded at a discount to the LCC's average of 6x – 8x given concerns regarding a major CAPEX hurdle, and therefore, a much larger debt load, in our view). Because of the CAPEX hurdle mentioned above plus execution risk tied to the start-up of its Hawaiian operation, we think Allegiant will likely trade at the lower end of the historical P/E trading range of profitable LCCs (15x -25x). Our \$60 price target reflects that concern as evidenced by our application of 17 and 15 P/E multiples to our 2012 and 2013 EPS estimates, respectively.

Turning to risks, a potential upside risk to our price target would be the successful launch of the carrier's Hawaii service in summer 2012 in addition to profitably adding new service to some of the 50+ small cities currently being evaluated by management. Another upside risk would be a faster ramp-up (than presently envisioned) of the company's enhanced online platform which management hopes to transform into an online travel agency ("OTA"), which could add significant, high margin revenue to the existing business (and value creation to the enterprise). Fuel price volatility is a key downside risk for ALGT- every 10% move in jet fuel impacts our 2012E EPS of \$3.60 by \$1.35. However, ALGT produces some of the industry's highest margins. As such, it benefits from less operating leverage than the competition, and therefore, combined with a very flexible aircraft utilization model, can more readily absorb fuel price spikes (hence no fuel hedge protection). Other downside risk factors are economic weakness, government regulation, taxation, airport constraints, safety concerns, the threat of terrorism and war, and the revaluation of the stock market resulting in a higher equity risk premium being applied to airline shares.

### Delta – Buy; PT: \$16

Our 12 month price target for DAL shares is \$16. Our valuation incorporates EV/EBITDAR, P/CF multiples, and FCF yield with an equal weighting of all three methodologies. On an EV/EBITDAR basis, our \$16 target is derived from applying a 5.9 multiple to our 2012 estimate (which we view as reasonable given that airlines historically trade 5x – 7x forward EBITDAR during stable earnings periods and 7x – 11x during recessions/recoveries). However, if Delta achieves \$300 million in annual savings, that could mean another \$2/share of



upside. Moreover, the multiple is based on the company's current enterprise value, and therefore doesn't incorporate further deleveraging. Our PT is also derived from applying a 4.1 P/CF multiple to our 2012 cash flow per share forecast (near the midpoint of the group's 3x – 5x range). Our 2012 free cash flow (FCF) estimate for Delta is \$2.0 billion, which implies a FCF yield of ~25%.

Turning to risks, fuel price volatility is a key risk for Delta – every 10% move in jet fuel (ceteris paribus) impacts our 2012 EPS estimate of \$2.00 by \$0.90. Other risks include economic weakness, government regulation, labor issues, the threat of terrorism and war, and the revaluation of the stock market resulting in higher equity risk premiums for airline stocks.

#### Hawaiian – Buy; PT: \$8

Our 12 month price target for HA shares is \$8. Our valuation work incorporates EV/EBITDAR, P/CF and P/E multiples with greater weightings on the former two. Our \$8 price target is derived from using an EV/EBITDAR multiple of 4.7x our 2013 EBITDAR estimate. We view the multiple as conservative given that airlines historically trade 5x - 7x forward EBITDAR during stable earnings periods (with growth names trading between 6x – 8x) and 7x – 11x during recessions/recoveries. On the basis of P/CF, our \$8 PT is derived using multiples of 3.3x and 3.0x our 2012 and 2013 cash flow per share estimates, respectively (at the low end of the group's historical 3x – 5x range).

Turning to risks, fuel price volatility is a major risk for Hawaiian –every 10% move in jet fuel (ceteris paribus) impacts our 2012 EPS estimate of \$1.00 by \$0.80. Other risk factors are economic weakness, government regulation, labor issues, taxation, airport constraints, safety concerns, the threat of terrorism and war, and the revaluation of the stock market resulting in a higher equity risk premium being applied to airline shares.

#### JetBlue – Buy; PT: \$8

Our 12 month price target for JBLU shares is \$8. Our PT is derived from using EV/EBITDAR and P/E multiples. On an EV/EBITDAR basis, our PT is derived from applying a multiple of 6.8 to our 2012 EBITDAR forecast. We view the multiple as reasonable given that profitable LCCs with earnings growth historically trade 6x – 8x forward EBITDAR. Also, on a P/E basis, our \$8.00 price target is 16.0x our 2012 EPS estimate which falls towards the lower end of the historical trading range of 15x – 25x forward P/Es commanded by profitable LCCs during stable earnings periods.

Turning to risks, fuel price volatility is a key risk for JBLU as evidence by a \$0.35 impact to our 2012 EPS forecast of \$0.50 from a 10% change in the price of fuel. Others are economic weakness, government regulation, labor issues, taxation, airport constraints, safety concerns, the threat of terrorism and war, and the revaluation of the stock market resulting in a higher equity risk premium being applied to airline shares.

#### Republic – Buy; PT: \$8

Our price target for RJET shares is \$8. Our valuation work is derived from using P/E and EV/EBITDAR multiples with an equal weighting of both. On a P/E basis, our \$8 PT is derived from applying a 10.6 multiple to our 2013 diluted EPS forecast. While this represents a modest premium to the stock's historical trading range of 7x - 10x, we are assuming no benefit from the divestiture of Frontier or rationalization of its 50-seat RJ flying. On an EV/EBITDAR basis, our price target is derived from applying a multiple of 6.7 to our 2013 estimate, within the stock's historical 6x - 7x trading range.

Turning to risks, the key risk for the company is fuel price volatility and its impact on the Frontier branded business, which is sensitive to fuel price swings; every 10% move in fuel (ceteris paribus) impacts our 2012 EPS estimate of \$0.60 by \$0.90. However, that is all things being equal, and therefore, assumes no response from the company to address higher fuel prices. Risks to RJET's fixed-fee operation include consolidation among the major carriers, which is likely to result in less hubs, and therefore, a need for less regional jets to feed those hubs. In that regard, we think the carriers with the weakest contracts could be susceptible –our view is that RJET is well-positioned to deal with this.

#### SkyWest – Buy; PT: \$12

Our 12 month price target for SKYW shares is \$12. Our PT is derived using an EV/EBITDAR multiple of 5.1 and a P/E multiple of 9.2 on our 2013 estimates, both in line with historical averages (10+ years). We believe the application of historical averages is appropriate, as we think the uncertain economic outlook and high beta nature of airline stocks reduces the likelihood of near-term multiple expansion.

Risks to our rating include "speed bumps" encountered as the company executes its turnaround plan, integration issues tied to ExpressJet/Atlantic Southeast merger, and the deteriorating economics of 50-seat jets, of which, SkyWest has approximately 500 in its fleet.



#### Southwest – Hold; PT: \$9

Our 12 month price target for LUV shares of \$9 is derived by applying an 17 P/E multiple to our 2012 EPS estimate, which is at the lower end of the company's historical trading range of 15x – 25x forward earnings. We believe that multiple is more suitable for Southwest shares given the increased execution risk associated with the acquisition and our view that the company will not be able to achieve its financial return objectives (e.g. 15% pretax ROIC) until 2014 at the earliest.

The key downside risk factor for LUV, in our view, is integration risk given that airline mergers are complex and time consuming as disparate technology systems, labor groups, cultures, fleets, and facilities are combined. Another key risk (downside/upside) for LUV is fuel price volatility (every 10% move in jet fuel impacts our 2012 EPS estimate of \$0.53 by \$0.50). An upside risk to our price target would be an acceleration in achieving and/or an expansion of the \$400 million of annual synergies (anticipated by 2013). Other downside risk factors are economic weakness, government regulation, labor issues, taxation, airport constraints, safety concerns, war and terrorism threats, and market risk. Upside risk factors to our thesis include a less gradual ramp-up of earnings synergies than we are currently assuming. Another upside risk to our forecast is a meaningful decline in fuel prices without a commensurate decline in GDP.

#### Spirit – Buy; PT: \$28

Our 12 month price target for SAVE shares is \$28. Our PT is derived from the application of EV/EBITDAR multiples of 7.4x and 6.6x our 2012 and 2013 estimates, respectively, reflecting the midpoint/lower-end of the 6x – 8x range typically commanded by LCCs. We also like to look at P/E multiples in order to assess value which are useful particularly for consistently profitable airlines that are also full taxpayers. At \$28, SAVE would be trading at 16x our 2012 EPS estimate and 13x our 2013 EPS estimate, within/below the 15x - 20x P/E range historically commanded by profitable LCCs during stable earnings periods (note Spirit's peers are currently trading at 13.9x our 2012 estimates and 11.4x our 2013 estimates; we believe SAVE deserves a premium multiple for its above average profitability).

Turning to risks, like most airlines, fuel price volatility is a key risk for Spirit – every 10% move in jet fuel (ceteris paribus) impacts our 2012 EPS estimate of \$1.70 by \$0.35. We think it is worth noting that although Spirit's customer base is more discretionary than most other airlines, and therefore, more

impacted by rising air fares, it does help that because of its healthy margins, it can manage through fuel price spikes fairly well. With regard to labor risk, Spirit has three union-represented employee groups (representing ~50% of Spirit's total workforce). Strikes that may result from disputes with the union groups present a material risk to the company (note pilot strike in 2010 which was subsequently settled with the signing of a 5-year agreement in July 2010). Other risk factors are economic weakness, government regulation, taxation, airport constraints, safety concerns, the threat of terrorism and war, and the revaluation of the stock market resulting in a higher equity risk premium being applied to airline shares.

#### United Continental – Buy; PT: \$31

Our 12 month price target for UAL shares is \$31. It is derived primarily from applying an EV/EBITDAR multiple of 5.3 to our 2012 EBITDAR forecast (at the low end of the group's historical 5x – 7x range). Also, we could see multiples expand as UAL reduces its financial gearing. At \$31, UAL's P/CF multiple for 2012 would be 4.2, at the midpoint of the historical trading range of 3x – 5x for major US airlines. Lastly, we think UAL could easily generate ~\$1 billion of free cash flow in 2012, which, compared to its current equity value of \$7.3 billion, would represent a free cash flow yield of ~15% to the equity holder.

Turning to risks, fuel price volatility is a key concern; every 10% move in fuel impacts our 2012 EPS estimate of \$3.45 by \$2.20. The integration effort presents another key risk for the company. Others are economic weakness, government regulation, labor issues, the threat of terrorism and war, and the revaluation of the stock market resulting in higher equity risk premiums for airline stocks.

#### US Airways – Buy; PT: \$14

Our 12 month price target for LCC shares is \$14. Our valuation work incorporates EV/EBITDAR and P/CF multiples with an equal weighting of both methodologies. Our \$14 price target is derived from applying an EV/EBITDAR multiple of 5.9x 2012 EBITDAR forecast. We view this multiple as reasonable given that airlines historically trade 5x – 7x forward EBITDAR during stable earnings periods and 7x – 11x during recessions/recoveries. Our PT implies P/CF multiples of 4.4x and 4.2x 2012 and 2013 cash flow per share, respectively, which falls within the historical 3x - 5x P/CF range for major US airlines.



Turning to risks, fuel price volatility is a key risk for US Airways in achieving our earnings forecast, as US Airways has no fuel hedge protection – every 10% move in jet fuel (ceteris paribus) impacts our 2012 EPS of \$2.00 by \$2.70. Other risks are economic weakness, government regulation, labor issues, taxation, airport constraints, safety concerns, the threat of terrorism and war, and market risk.



## Appendix A: Selected Airline M&A Comparables

Figure 59: Selected airline M&A comparables

Date announced	Target	Acquiror	Adj. EV / Revenues	Adj. EV / EBITDAR	Comments/Rationale
September 2010	AirTran Holdings	Southwest Airlines	1.2x	6.4x	Acquisition gave Southwest presence in key business markets including Atlanta
May 2010	Continental Airlines	United Airlines	0.5	3.1	Deal passed muster with the regulators in record time; < 4 months
November 2009	Iberia (a)	British Airways	0.9	8.8	Created International Airlines Group; seeking to invest in other airlines
June 2009	Frontier Airlines	Republic Airways	0.4	9.1	Successfully outbid Southwest Airlines for Denver-based operator
August 2007	Midwest	TPG/Northwest Airlines	0.5	9.8	Majority of stake written-off due to losses at Midwest; sold to Republic
April 2007	Midwest	AirTran	0.4	9.2	Bid withdrawn after AirTran bid was topped by offer by TPG/Northwest
January 2007	Delta Air Lines	US Airways	0.9	12.1	Bid was withdrawn; not supported by Delta pilots
December 2006	Qantas	Investor Consortium	1.1	7.3	Deal was withdrawn; envisioned float/divestitures of non-aviation assets
October 2006	Aer Lingus	Ryanair	1.3	11.5	The first of several bids; ultimately withdrawn following EU rejection
August 2005	ASA (Delta-owned)	SkyWest	NA	8.9	One month before Delta Ch. 11; included leasehold on 24+ Atlanta gates
May 2005	US Airways Group	Investor Group	0.2	4.4	Investor group included America West; US Airways was in Ch. 11
March 2005	Swiss Intl Air Lines	Deutsche Lufthansa	0.2	3.5	The financially weak successor (nee Crossair) to once mighty Swissair
September 2003	KLM	Air France	0.7	9.7	The creation of a dual-hub powerhouse and world's largest airline co.
November 2002	Air New Zealand (22.5%)	Qantas	0.8	8.3	One of many attempts to strengthen the Trans-Tasman alliance
May 2002	GoFly	EasyJet	1.1	NA	British Airways divestiture of wholly-owned LCC
October 2001	Air New Zealand (76.5%)	New Zealand Government	0.5	7.9	A financially-weak ANZ was restructured via a government investment
September 2001	Japan Air System (91.7%)	Japan Airlines	0.9	NA	Created one of the world's largest airlines; poorly executed integration
March 2001	Trans World Airlines	AMR (American Airlines)	0.4	10.3	A purchase of the majority of TWA's assets; the TWA "rump" filed Ch. 11
March 2001	Malaysian Airline System (29.1%)	Malaysian Ministry of Finance	2.4	NA	A cash infusion to bolster MAS' balance sheet
February 2000	Ansett Australia (50%)	Air New Zealand	NA	NA	ANZ acquired remaining 50% from Murdoch's News Ltd.
October 1999	Comair Holdings	Delta Air Lines	3.5	7.7	Following a strategy to bring some regional flying in-house
February 1999	ASA Holdings	Delta Air Lines	2.6	6.8	Following a strategy to bring some regional flying in-house
November 1998	Reno Air	AMR (American Airlines)	1.9	8.3	Driven by desire to bolster West Coast presence
July 1998	Executive Jet	Berkshire Hathaway	0.8	NA	Berkshire's 2nd foray into aviation; world's largest fractional jet operator
February 1994	America West Airlines	Am West Partners	1.8	5.4	Investor group that facilitated emergence from Chapter 11 bankruptcy
July 1992	Continental Airlines	Air Partners/Air Canada	1.2	7.4	Investor group that facilitated emergence from Chapter 11 bankruptcy



Figure 59: Selected airline M&A comparables (continued)

Date announced	Target	Acquiror	Adj. EV / Revenue	Adj. EV / EBITDAR	Comments/Rationale
March 1989	NWA, Inc.	Wings Holdings	1.0	6.9	One of the largest airline LBOs; a diverse asset base available to lever up
October 1988	Eastern Air Shuttle	Trump Organization	1.9	NA	A transaction that seemed to be driven by hubris more than anything else
February 1987	Piedmont Aviation	USAir Group	1.3	6.2	Capped several years of deal-making for USAir
December 1986	PSA (PS Group)	USAir Group	1.7	8.2	Enhanced USAir's presence on the West Coast
November 1986	Horizon Air Industries	Alaska Air Group	1.9	10.1	Supported Alaska in the Pacific Northwest especially in small markets
November 1986	AirCal (ACI Holdings)	AMR (American Airlines)	1.7	8.3	Driven by desire to bolster West Coast presence
September 1986	People Express	Texas Air Corp.	1.4	NM	Created the largest airline holding co.; People Express nearly bankrupt
September 1986	Western Airlines	Delta Air Lines	1.3	8.5	Greatly improved West Coast presence with LAX/Salt Lake City hubs
February 1986	Ozark Holding	Trans World Airlines	1.0	12.5	Primary St. Louis hub competitor; DOT criticized for approving
February 1986	Eastern Air Lines	Texas Air Corp.	0.9	6.9	Created a single holding co. which included Continental and New York Air
January 1986	Republic Airlines	NWA, Inc.	0.9	5.7	Primary Detroit/Minneapolis competitor; DOT criticized for approving
May 1985	Trans World Airlines	Icahn Group	0.9	4.7	Major airline LBO; valuable assets such as Heathrow which were sold off
March 1985	Muse Air Corp.	Southwest Airlines	2.2	17.9	Competitor and led by former Southwest President M. Lamar Muse
	<b>High</b>		<b>3.5x</b>	<b>17.9x</b>	
	<b>Mean</b>		<b>1.2x</b>	<b>8.2x</b>	
	<b>Mean (Excluding withdrawn bids)</b>		<b>1.2x</b>	<b>8.0x</b>	
	<b>Median</b>		<b>1.0x</b>	<b>8.3x</b>	
	<b>Low</b>		<b>0.2x</b>	<b>3.1x</b>	

NA = Not available; NM = Not meaningful.

Note: Adjusted EV accounts for off-balance sheet leases capitalized at 7x. Revenue and EBITDAR reflect last twelve months ("LTM") at time of merger announcement.

(a) Although deal not formally announced until late 2009, British Airways and Iberia had initiated merger discussions in 2008 and so multiples reflect 2008 data. Financials for 2009 deteriorated significantly due to the global recession and would otherwise result in not meaningful multiples.

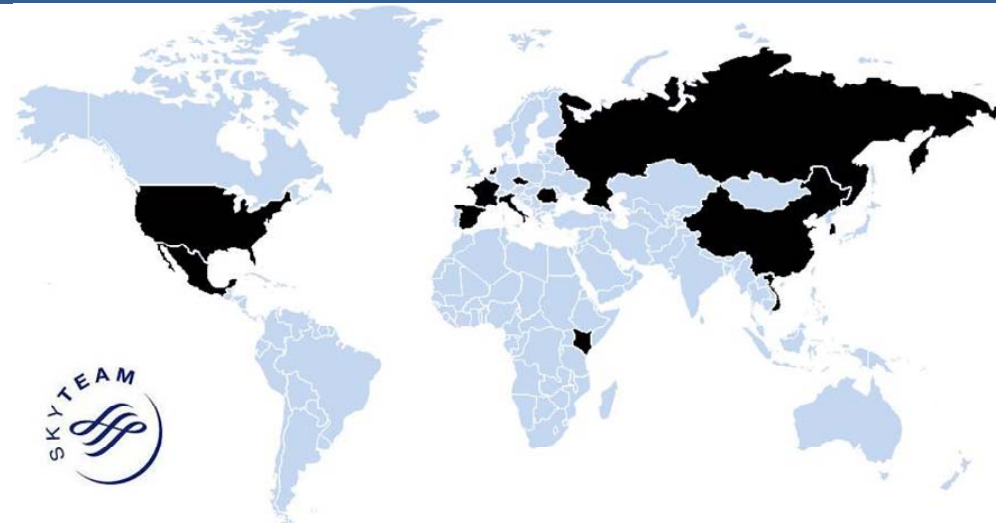
Source: Company filings, SEC filings, press reports and Deutsche Bank Airline Research





## SkyTeam

Figure 62: SkyTeam's geographic footprint



Source: Deutsche Bank Airline Research and Skyteam

Figure 63: Skyteam Alliance

North America	South America	Europe	Middle East & Africa	Asia	Australasia
Aeromexico	Aerolineas Argentinas*	Aeroflot	Kenya Airways	China Airlines	
Delta		AirEuropa	Middle East Airlines*	China Eastern	
		Air France	Saudi Arabian Airlines*	China Southern	
		Alitalia		Garuda Indonesia*	
		Czech Airlines		Korean Air	
		KLM		Vietnam Airlines	
		Tarom		Xiamen Airlines*	

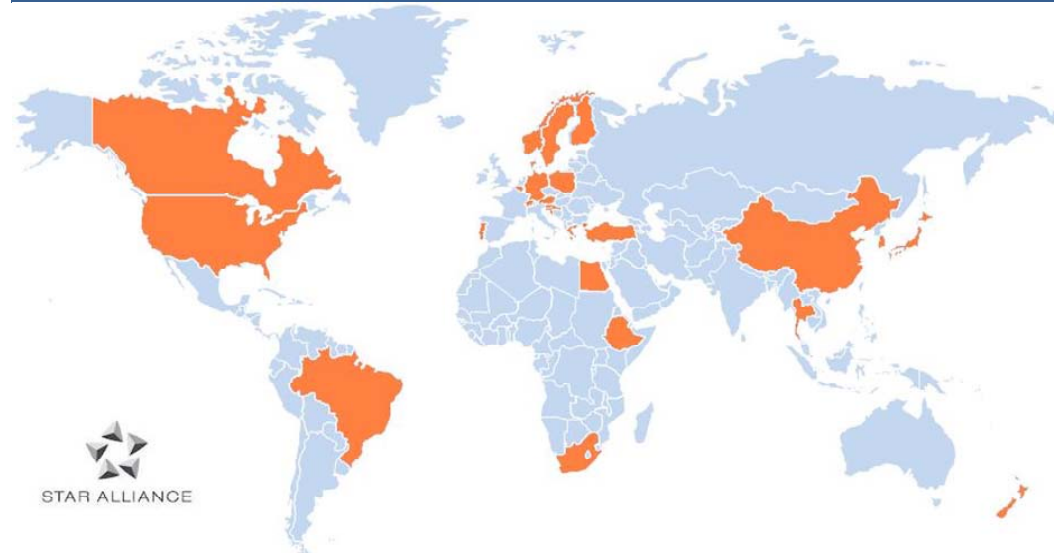
Source: Deutsche Bank Airline Research and Skyteam

\*Represent potential members/carriers who are in the process of getting alliance membership.



## Star

Figure 64: Star's geographic footprint



Source: Deutsche Bank Airline Research and Star

Figure 65: Star Alliance

North America	South America	Europe	Middle East & Africa	Asia	Australasia
Air Canada	Avianca-Taca*	Adria Airways	Egypt Air	Air China	Air New Zealand
United Continental	Copa Airlines*	Aegean Airlines	Ethiopian Airlines	ANA	
US Airways	TAM	Austrian	South African Airways	Asiana Airlines	
		Blue1		Eva Air*	
		Brussels Airlines		Shenzhen Airlines*	
		Croatia Airlines		Singapore Airlines	
		LOT Polish Airlines		THAI	
		Lufthansa			
		SAS			
		SWISS			
		TAP Portugal			
		Turkish Airlines			

Source: Deutsche Bank Airline Research and Star

\*Represent potential members/carriers who are in the process of getting alliance membership.



## Appendix C: Freedoms of the Air

The **first freedom** is the right to fly and carry traffic (defined as passengers and/or cargo) nonstop over the territory of the grantor state. First-freedom rights, for example would include that of United Kingdom carriers to overfly the Irish Republic en route to some destination in the United States.

The **second freedom** is the right to fly and carry traffic over the territory of the grantor state, and to make one or more stops for non-traffic purposes (e.g. for refueling). Before the availability of long-range aircraft, for example, transatlantic traffic may have been required to make a refueling stop at Shannon in Ireland.

The **third freedom** is the right to fly into the territory of the grantor state and set down traffic coming from the flag state of the carrier. This would, for example, apply to United Kingdom airlines carrying traffic from the United Kingdom to the United States.

The **fourth freedom** is the right to fly into the territory of the grantor state, and take on traffic destined for the flag state of the carrier. This would apply to United Kingdom airlines carrying traffic from the United States to the United Kingdom.

The **fifth freedom** is the right to fly into the territory of the grantor state, and take on or set down traffic to or from third states. This right is, however, confined to services which originate or terminate in the territory of the carrier's flag state or which serve its flag state as an intermediate stop. For example, some US carriers such as Delta and United have "fifth freedom" rights to carry traffic from Tokyo to Singapore on services which stop at Tokyo en route between Atlanta and Singapore and between Seattle and Singapore, respectively. This right may also allow for a "change of gauge" in which through passengers transfer from a larger aircraft to a smaller aircraft and vice-versa. For example, Delta flies from Portland to Seoul via Tokyo – Narita

Airport. The transpacific segment of the direct flight is operated with a widebody Boeing 767-300; for the shorter Tokyo – Seoul leg, Delta utilizes a smaller, narrowbody Boeing 757-200.

The **sixth freedom** derives from the exercise of rights granted under the third and fourth freedoms, and was not specified as such in the 1944 Chicago Convention conferring freedoms of the air. It is the right to fly into the territory of the grantor state, and take on (or set down) traffic for the carrier's flag state - which is subsequently carried to (or previously originated from) a third state on a different service. For example, KLM, which operates a major connecting hub at Amsterdam Schiphol carries sixth-freedom traffic between Dubai and New York as passengers travel from Dubai to Amsterdam to connect to the Amsterdam to New York flight.

Three further "freedoms" are sometimes quoted, but are less frequently granted. The **seventh freedom** is the right for a carrier operating entirely outside the territory of its flag state. For example, Federal Express currently flies an Airbus A310 freighter 5x weekly between Guangzhou, China and Delhi/Mumbai. The **eighth freedom** is the right to carry traffic between two points within a foreign country (i.e. domestic traffic) as an extension of service commencing/terminating in the airline's own country (referred to as "cabotage" in general and more specifically "consecutive cabotage"). Examples of eighth freedoms are rare (assuming we do not include airline flights within the EU as that is a single aviation market despite the fact that it is technically composed of many countries with their own sovereign rights). Several years ago, Singapore Airlines operated a Wellington - Auckland – Singapore flight with local traffic rights over the Wellington – Auckland sector. The **ninth freedom** is the right to carry traffic between two points within a foreign country with no requirement to start or end the service in the airline's own country – this is also referred to as "pure cabotage". Ninth freedom rights are not typically granted. One example from the past is the Internal German Shuttle operated by Pan Am for more than 40 years flying to/from Berlin and half-a-dozen key German cities such as Frankfurt, Munich and Stuttgart. Also, Tiger Airways which is owned and controlled by citizens of Singapore presently utilizes ninth freedom rights for its Australian domestic operation.

*Source: Monopolies and Mergers Commission Report on the proposed merger of British Airways PLC and British Caledonian Group PLC.*



# Appendix 1

## Important Disclosures

Additional information available upon request

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Equity rating key

Buy: Based on a current 12- month view of total shareholder return (TSR = percentage change in share price from current price to projected target price plus projected dividend yield ) , we recommend that investors buy the stock.

Sell: Based on a current 12-month view of total shareholder return, we recommend that investors sell the stock

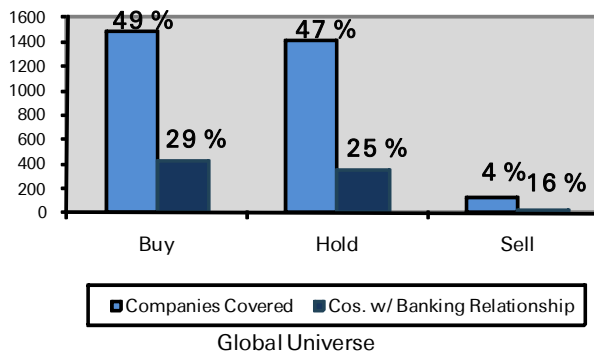
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Notes:

1. Newly issued research recommendations and target prices always supersede previously published research.
2. Ratings definitions prior to 27 January, 2007 were:

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- Sell: Expected total return (including dividends) of -10% or worse over a 12-month period

Equity rating dispersion and banking relationships





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# Deutsche Bank Global F.I.T.T. Research

## Global Airline Sector

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