

Buy Low, Sell High, where's that theory gone? A review of the current trading conditions in the European Regional Aviation Market.

BIOGRAPHY - PETER CRUTCHFIELD

Peter Crutchfield is joint managing director and co-founder of Airstream International Group, based in Guildford, England.

Airstream provides financing, remarketing and advisory services to the aviation industry. Since its formation in 1989, Airstream has concluded transactions involving over five hundred aircraft, including three hundred and fifty regional aircraft.

Major projects undertaken by the company have included part owning and managing a fleet of one hundred and forty British Aerospace manufactured aircraft, advising the UK government on the management and disposal of over one hundred Shorts manufactured aircraft, and advising Embraer on the launch of the ERJ-145 in Europe.

Airstream has arranged financing for over fifty aircraft in the last three years, including thirty new generation regional jets. It is the leading provider of financial services to regional airlines in Europe and is a member of the European Regions Airline Association. In addition to its financing activities, the company is a major provider of ACMI leases and remarketing services and has successfully placed more than thirty aircraft in the last three years, including new generation Boeing and Airbus aircraft as well as regional jets and turboprops.

Peter Crutchfield has had many years of experience in the aviation industry, having previously been employed by British Airways, British Aerospace and the Hong Kong and Shanghai Bank. He is a qualified private pilot and graduate in Marketing and Economics.

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Introduction

Good morning ladies and gentlemen.

The subject of my presentation today is buy low, sell high - where has that theory gone? The focus of my presentation will be regional aircraft. I will look at the changing regional airline scene in Europe, assess the implications of these changes for airline fleet policy and then look at the market position of various categories of regional aircraft.

My presentation will conclude with some thoughts on where the market is going, and what changes are likely to occur in the future.

1. The Dynamics of the Regional Airline Industry

Nobody can say that we all work in a dull and uninteresting industry. There have been massive changes, particularly over the last five years or so, and the pace of changes shows no signs of abating.

Not even 'Mystic Meg' could have predicted what has happened to the regional sector in this timeframe. Leading manufacturers such as Saab, British Aerospace and Fairchild Dornier are no longer producing aircraft. Leading names in the regional airline industry such as Crossair, Regional (France) and City Flyer/British Regional no longer exist or have been swallowed up by majors, and the likes of Ryanair and Easy Jet have emerged to be major forces in inter European travel.

The definitions of what used to be regional airlines have been blurred by the proliferation of new entrants and acquisition by major airlines.

If I focus my analysis those airlines that operate regional aircraft, that is those which have less than 110 seats, the pattern that has emerged today is as follows:

A. The Major Airlines

The involvement of the major airlines in regional airlines started with franchising, which became the trend of the 1990's. This was encouraged by the growth in alliances such as STAR and Oneworld. Many franchise airlines were subsequently acquired and fully integrated into the major airlines.

The majors now operate the largest number of regional aircraft in Europe.

B. The Established Independents

As a result, there are now relatively few established independent regional airlines operating in the sector. Some such as Air Nostrum continue to operate as successful franchise partners of major airlines; others such as FlyBe operate now as low fares independents, re-branding accordingly. Otherwise, the majority of the larger independently owned regional airlines in Europe have all but disappeared.

C. New Entrants

The changes that have been taking place in the industry, and specifically the rationalisation of services by some of the majors has spawned a number of start ups. These airlines have been able to benefit from cheap available aircraft and cost structures that are the envy of many of their more established competitors. There are many examples in the UK (Air Southwest, Eastern, Air Wales) and throughout Europe (Intersky etc.).

We have therefore seen the industry come almost full circle. Independent regionals have been acquired by major airlines which in turn have rationalised, and this has led to a proliferation of new regionally based independent start ups.

2. Fleet Policy

The changes that have taken place in the regional airline sector have had a significant effect of the demand for the various regional aircraft types. This has ultimately been the main driver that has affected aircraft trading conditions.

What I would like to do is to look at the three sectors identified previously, and discuss trends in fleet policy using specific industry examples.

A. The Majors

The majors in Europe have all suffered from high fuel prices, 9/11 and competition from low cost carriers. They have been forced to cut costs in the face of declining traffic and declining yields across their entire operations.

Looking at British Airways as an example of what has happened throughout Europe, the significant changes that have taken place are as follows:

1. BA's acquisitions of franchise partners Brymon, CityFlyer and BRAL brought with it a diverse fleet of aircraft, many of which were originally financed on long term leases that have since proved difficult to terminate.
2. BA has found it uneconomic to operate small turboprops in their fleet. As a result a number of aircraft and/or routes have been transferred to other operators. Eastern Airways has taken over the entire Jetstream 41 operation, including crews, maintenance facilities and routes. Air Southwest, a new entrant using Dash 8's, has taken over routes from Gatwick to the south west of England. BA are phasing out remaining turboprops where lease terms

permit, although will retain a core of Dash 8 Q300's until fleet renewal plans are finalised.

3. An intended replacement order for new generation regional jets has been deferred. The airline is retaining existing RJ-100 and ERJ-145 aircraft until conditions improve.
4. Some point to point services have been dropped in favour of consolidation at certain regional hubs. The operation has been simplified considerably.
5. One franchise agreement has been terminated and no new ones are envisaged. Franchising is no longer a key component in the airline's regional strategy.

What has happened at BA is very similar to that of Air France and other European major carriers. These major airlines are refocusing their business in order to remain competitive in the face of increased competition and declining yields.

Their fleet policy is to dispose of smaller and older aircraft and operate modern efficient larger jet aircraft. Re-equipment decisions have been delayed by the general down turn in the industry as a whole, although some new orders are now imminent.

B. The Established Independents

Boeing Chairman, Phil Condit, said earlier this year when asked what future for the majors said 'restructure or die'. The same can be said for the few remaining independents in Europe.

Those that have remained have had to cut costs to remain competitive. A good example of an airline that has done this is FlyBe, formerly Jersey European.

The airline previously operated both as an Air France code share partner and a point to point regional operator. It quickly found that competition was diluting yields, it was operating too many aircraft types which were both inappropriately financed and expensive to operate.

Three years ago it embarked on a re-branding programme, focussing on internet sales, lower cost of operation and better utilisation of its aircraft. Aircraft types have been rationalised to the Dash 8 -Q400 and the 146-300; others have been sold or returned to lessors. A number of point to point services have been started from regional airports in the UK, specifically Birmingham, Southampton, Exeter and Liverpool.

FlyBe has therefore attempted to take what it perceives as the best features of the low cost carriers (internet sales, fleet standardisation, high fleet utilisation) and apply them in a regional context using regional aircraft. What has been achieved in a short space of time is commendable; whether this can be translated into sustained profitability remains to be seen, although the signs do appear to be promising.

FlyBe has therefore concentrated its fleet on the aircraft where seat mile costs are lowest. Although this airlines experience has not been mirrored across other

European independent regionals, it does show how restructuring has been a feature of this sector, and that fleet consolidation has been an important factor in the transition.

C. New Entrants

New entrants have benefited from the rationalisation of the majors and an increase in the availability of used aircraft, particularly from manufacturer leasing portfolios. It is this sector that has been one of the most dynamic and successful over recent years.

Aer Arran Express as an example has taken a significant portion of the domestic and Irish regional market.

Aer Arran started in 1970 operating nine seat Islander aircraft to the Arran Islands on the west coast of Ireland. The airline transformed itself in the mid 1990's into a significant regional airline, encouraged by the Irish Department of Public Enterprise and the retrenchment of the national flag carrier.

Domestic and international routes into Dublin were subsequently added and the airline is now the third largest user of Dublin airport.

Aer Arran's growth would not have been possible if it could not have leased aircraft, in its case the ATR-42 and ATR-72. It has thus benefited from the availability of used aircraft on attractive terms, whilst maintaining an overall low cost base.

Air Southwest started operations in 2002 when it took over the Plymouth-London Gatwick route previously operated by British Airways.

It was able to secure leased aircraft, in this case DHC-8 300's on attractive terms and benefited from the fact that the routes it flew were already established.

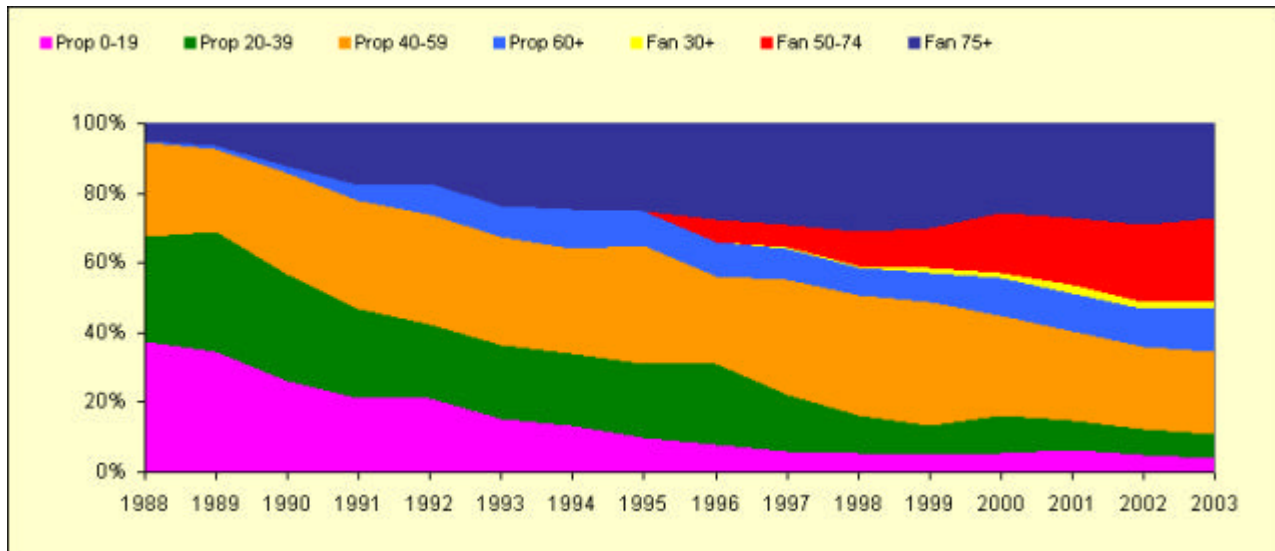
Since then, it has expanded its services to include Manchester, and has recently acquired a third aircraft. In common with many other new entrants, it has been able to keep costs low and make extensive use of the internet as the major distribution tool.

The examples I have chosen illustrate the changing structure of regional aircraft operation in Europe. This has been reflected in fleet policy and the demand for the various regional aircraft types which I will now look at in more detail.

3. Aircraft Review

ERA Fleet Share

This data relates to the ERA Passenger fleet



Data correct as of 01 January 2004

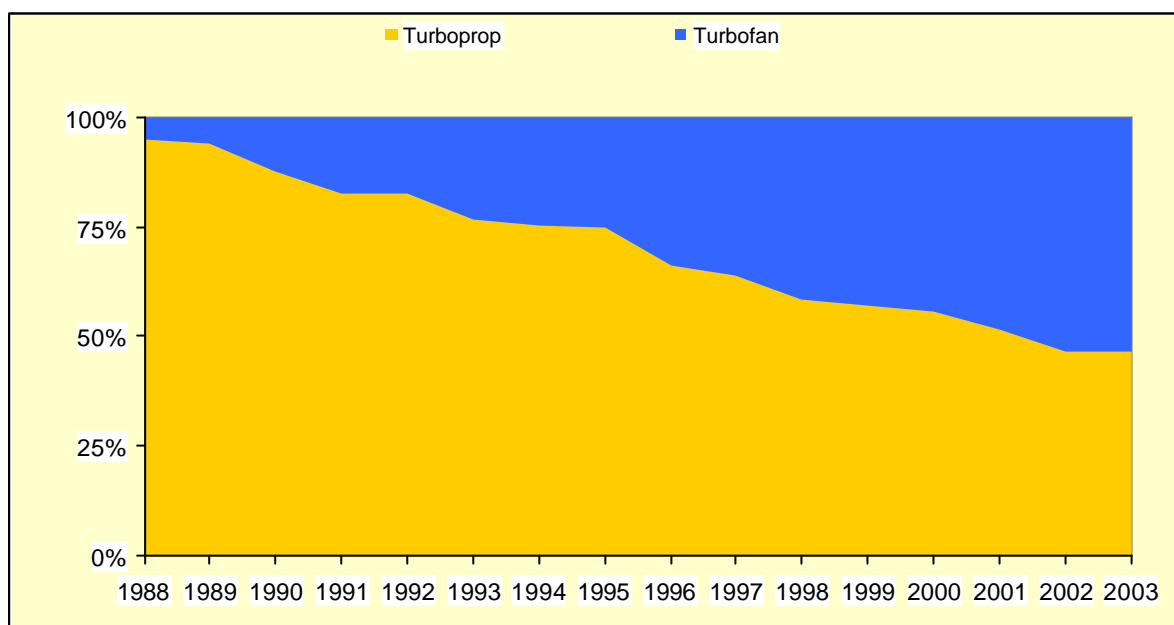
Source: Airclaims

The chart shows the relative changes in the composition of the European regional aircraft fleet by category.

From this, you will see that the population of smaller turboprops has continued to decline. The numbers of 70 + seat regional jets has remained fairly constant, with the 50 seat jet category increasing significantly.

ERA Passenger Fleet - Turboprop/Turbofan Split

This data relates to the ERA Passenger fleet



Data correct as of 01 January 2004

Source: Airclaims

The growth in jets when compared to turboprops is particularly marked over the past five years as the chart shows. The split in Europe is now about 50% turboprops, 50% jets with a trend towards an increasing proportion of jets operating.

What I will now do is look at each specific sector and look at some of the trends that are emerging:

70 - 120 Seat Category

It was only three years ago that there were five competing jet aircraft manufacturers in this sector; Boeing, Embraer, British Aerospace, Bombardier and Dornier. This has now been reduced to three; Embraer, Bombardier and Boeing.

The market now facing those manufacturers that remain has changed considerably since their respective programmes were launched. The consolidation of the industry has dramatically reduced the number of potential customers. The market has further been reduced by the fact that financing for new aircraft acquisitions is now available to fewer airlines, and the manufacturers that remain are now less willing to bridge the financing gap by offering the levels of financial support that they did in the past. When we add to this the trend of airline alliance partners to acquire common types, we can see that there are fewer but larger orders out there to be had.

Because of the down turn, many of these orders have been deferred, examples being both BA/Oneworld and STAR alliance partners which have both delayed re-equipment decisions.

Orders for new aircraft will inevitably pick up, and we are forecasting a significant increase in orders in this sector in 2005.

The delays in introducing new types in this sector has benefited the existing used aircraft types, specifically the Fokker 70/100 and BAe 146/RJ series. Airlines have retained these types in operation for longer than they may have originally envisaged, and with no additional production increasing market competition, demand has remained stronger than it could have.

50 - 70 Seat Category

The 50 seat regional jet boom in Europe is over. Those airlines that committed to aircraft in this sector in the past are not now increasing their fleets; indeed some are making reductions.

Used aircraft that have come onto the market have up to now been placed quickly, principally in the US where the economics of operating these types remain good. The structural changes in the US market could however have an adverse effect on used 50 seat aircraft values in the mid term, particularly if one or more of the larger operators is forced to dispose of aircraft in a bankruptcy filing.

Demand for new regional jets in the 50 seat sector will become less and less. Competition will come from both the larger new aircraft and an increasing number of used aircraft available on attractive terms.

We have however seen the market for new turboprops in this category strengthen. Aircraft such as the ATR-72 and Bombardier Q300/400 have seen production rates increase in recent months. Much of the increase in demand is due to the fuel efficiency of these types when compared to jets.

The market for used turboprops has remained pretty resilient, fuelled largely by the growth of start up and emerging airlines. As these markets are dominated by the manufacturers, specifically ATR, Saab, Bombardier and British Aerospace, which continue to own large fleets of aircraft, airlines can secure aircraft on attractive terms. The availability of used aircraft from manufacturers who can offer leases has been an important factor in encouraging the growth of the independent regional airline sector.

20 - 50 Seat Category

Opportunities for new aircraft sales of jet aircraft, specifically the ERJ-135, have always been limited by the higher airport and en route charges when compared to the US. However, the recent certification of this type at London City could encourage more orders.

With no new turboprops currently being manufactured in this category, market activity is centred around BAe, ATR, Dornier and Saab aircraft mainly owned by the manufacturers. The ATR market in particular has benefited from the potential of cargo conversion which has stimulated otherwise declining demand.

There have always been relatively few smaller turboprops in Europe when compared to the US. Some airlines such as Eastern continue to operate them successfully. However, higher operating and maintenance costs will inevitably force these aircraft into retirement over time.

4. Conclusion

It is our experience that a changing market creates market opportunity both for aircraft financiers and traders. Certainly it can be said that this particular sector of the market has changed considerably in recent years and opportunities have arisen as a result.

In terms of buying and selling aircraft, it is still difficult to draw any specific conclusions. Used new generation regional jets have not found their way onto the market in great numbers as yet and trading opportunities have been scarce. The used turboprop market continues to be dominated by the manufacturers and is predominantly an operating lease market. The trading opportunities that have emerged have been restricted by a lack of available financing and an unwillingness on the part of many banks to lend against regional aircraft assets, particularly turboprops. The theory of buying low and selling high can therefore not be applied universally across the regional market.

What I would say to the banks present today is that this sector offers good opportunity to lend against assets where values have historically not been as volatile as in other areas of the market. The sector is not compromised by a large number of independent operating lessors and is now less influenced by manufacturer sales financing. Good financing opportunities will continue to emerge in this sector, and we see a number of potential transactions likely to advance in 2005.

We do hope that we will be able to work with some of you in the near future.

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