



Comparison between Low-cost and Traditional Airlines

Case study: easyJet and British Airways

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<p>Abstract:</p> <p>This thesis work is conducted with purpose to make an analysis of the financial results of traditional and low cost airlines and compare them. The comparison is done through analysis of the representatives of traditional and low cost airlines – British Airways and easyJet. In addition, the investigation provides an overview of the airline industry as a whole.</p> <p>Researcher applies fundamental analysis, which includes four components: business strategy analysis, accounting analysis, financial analysis and prospective analysis. However, the research is not covering the prospective analysis.</p> <p>Data for this thesis is collected by reviewing literature related to the topic and by analyzing the data from annual reports of chosen airlines. In order to answer research questions, the collection of numerical data, its evaluation and analysis of existing financial theories is done. Consequently, quantitative research method is applied throughout the investigation.</p> <p>The research concludes that the competition between airlines is vast nowadays and it continues to grow with the fast developing airline industry. Eventually, the study proves that low cost airlines do have better financial results and they are the consequence of the strategy of low-cost carriers, the main aspect of which is the reduction of costs at the possible higher degree.</p>	
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1 INTRODUCTION

1.1 Problem Background

“Air transport is big business. Its origins can be traced back so far as 1919, just after the First World War; but it was not until peace was restored after the Second World War that the era of major expansion really began. More than half a century on an air transport is now a key element in the “world’s largest industry”, travel and tourism, which takes almost 11 per cent of consumer spending, and employs roughly one in every nine people in the global labor force. But air transport is also a significant industry on its own, contributing much to economic development.” (Hanlon, 2007, p. 1)

According to International Air Transport Association air travel is likely to double over next 20 years. The growth percentage will differ widely and developing economies are going to show fastest growth. It is important to mention, that trend in cost of travel is still going downwards. (Pearce, 2015)

Every airline is now can be named a lower-cost airline. The worst financial crisis in the industry’s history has forced all carriers to achieve cost efficiencies and higher productivity if they are to survive. (Bisignani, 2006)

The relevance of the research topic is determined by the fact that financial stability of the company is the guarantee of development and stable position of the enterprise in conditions of the market. If the company is financially steadily, solvent, it has number of advantages over other companies in the same field, concerning attraction of investments, choice of suppliers and selection of qualified personnel.

The higher stability of the enterprise is the more independent it becomes to unexpected changes in market conditions. Therefore, the probability of the risk being on the edge of bankruptcy is less. All aspects, mentioned above, increase the role of the financial analysis in the process of assessing company's position. The results of that analysis are essential for the owners (shareholders), creditors, investors, suppliers, tax authorities, managers and heads of companies.

The competition between low-cost and traditional airlines in framework of business industry is harsh. In addition, the competition between airline companies of the same type is also severe and it continues to increase. That rivalry forces airlines to use certain price strategies, promotions in order to uphold existing customers and attract new ones.

1.2 Research Aim and Research Questions

Firstly, the study aims to make a general review of airline industry, focusing on financial performance of the industry and its future growth.

Secondly, the study intends to make and analyze financial ratios of chosen airline companies – easyJet and British Airways, as representatives of low-cost and traditional airlines, and to explore the difference of their operating performance between years 2013 – 2015.

Thus, researcher has determined following research questions:

1. Do low-cost airlines perform better financial results than traditional airlines?
2. What are the resources, elements and instruments that derive better financial results?

1.3 Definitions

It is substantial to define “low-cost airline” and “traditional airline” in the framework of the investigation. The low-cost carrier can be defined as the one that mainly has lower fares and fewer comforts, the tickets price are fixed and non-refundable and in most cases this type of airlines are using secondary airports and flying a single airplane type. On the contrary, traditional carrier, also called legacy carrier, is a large, full-service airline, which offer checked bag allowance, an allocated seat and other services.

1.4 Demarcation

The researcher is going to analyze airline industry and make the comparison of two airline companies, representatives of low-cost and traditional carriers, creating the financial statements analysis – fundamental analysis.

The fundamental analysis attempts to evaluate the current market price relative to projections of the firm's future earnings and cash flow generating potential. (Palepu 2013)

The structure of fundamental analysis includes four components: business strategy analysis, accounting analysis, financial analysis and prospective analysis.

“Ratio analysis and cash flow analysis are the two most commonly used financial tools. Ratio analysis focuses on evaluating a firm's product market performance and financial policies; cash flow analysis focuses on a firm's liquidity and financial flexibility”. (Palepu 2013, p. 36) Thus, the investigation will be focused on strategy analysis, accounting analysis, financial analysis, including ratio and cash flow analysis. However, the research is not going to cover the prospective analysis. In highly dynamic developing world it is hard, or sometimes even impossible, to make any kind of forecast, prediction or prospective analysis of the industry in a whole or its part. Moreover, precise mathematical calculations are not taking into account political, demographic, social aspects of life as well as changes in climatic conditions. For example, the eruption of volcano that had a huge impact on the airlines; political regulation of the industry, which can result in closing of air corridors in a number of countries; Ebola disease; climate crisis in China and many other facts. Mathematical prospective analysis assumes idealistic investigation. In the opinion of the author of this research, this will lead to idealistic model of future development of chosen airlines, not taking into consideration the factors mentioned above. Thus, researcher is not going to focus on the prospective analysis throughout the study.

2 RESEARCH METHODOLOGY

2.1 Research Approach

Research approaches are generally classified to be deductive or inductive.

“The deductive approach – known as testing a theory, in which the researcher develops a theory or hypotheses and designs a research strategy to test the formulated theory, second, the inductive approach – known as building a theory, in which the researcher starts with collecting data in an attempt to develop a theory.” (“Research approach”, 2015)

“Deduction begins with a universal view of a situation and works back to the particulars; in contrast, induction moves from fragmentary details to a connected view of a situation.” (“Research approach”, 2015)

In consideration of mentioned above, the aim of the research is to move forward from theory to actual examination of quantitative data to reveal the results that prove hypothesis. Thus, the deductive approach is suitable for investigation.

2.2. Research Method

Depending on the research objective, qualitative and quantitative methods are applied for analysis. Berg (2001) differentiated between qualitative and quantitative research methods clarifying that qualitative research referred to the meanings, concepts, definitions, characteristics, metaphors, symbols and descriptions of things, while quantitative research referred to the measures and counts of things. (Berg, 2001) In order to answer research questions, the collection of numerical data, its evaluation and analysis of existing financial theories is going to be done. Consequently, quantitative research method will be applied throughout the investigation.

2.3. Data Collection

The research is going to be based on the analysis of financial information of airline industry and chosen airline companies. Each airline company publishes the official financial data on the web page, in the framework of annual report or separately. Investigation also relies on books and scientific articles, which are related to accounting and financial theories.

3 GENERAL REVIEW OF THE AIRLINE INDUSTRY

3.1 Industry Overview

Airline industry provides service basically to every country in the world and it plays an essential role in global economy. The airline industry itself is a major economic force, from point of view of both its own operations and its impacts on related industries such as aircraft manufacturing and tourism. (Belobaba, 2009) The air transport has steadily grown for long period.

“The growth of world air travel has averaged approximately 5% per year over the past 30 years, with substantial yearly variations due both to changing economic conditions and to differences in economic growth in different regions of the world.” (Belobaba, 2009, p. 2)

The tenfold expansion of the volume of air travel during the last 40 years has been measured by worldwide scheduled RPKs (Revenue Passenger Kilometers). “This is an expansion three times greater than the growth of the world’s economies, which partly reflects the high income elasticity of air travel. It also reflects, and has facilitated, globalization. Air travel has risen broadly in line with world trade during the past 40 years. It has been one of the fastest growing economic sectors.” (IATA, 2011)

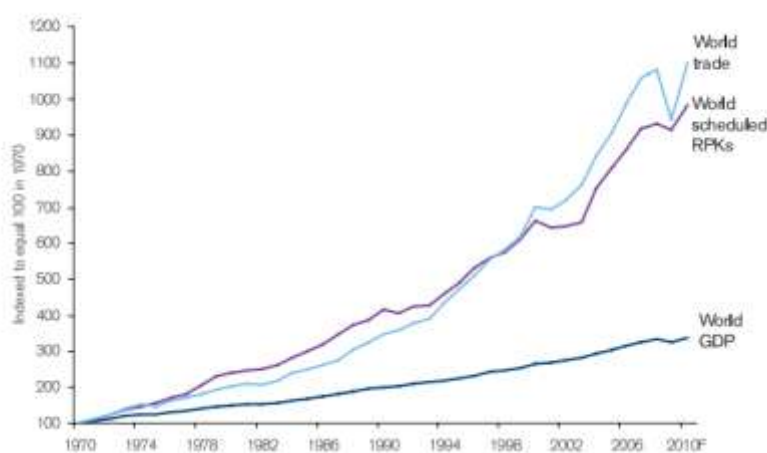


Figure 1: Air travel has expanded tenfold in the past 40 years

(Source: ICAO, IATA, Haver)

“Airline passenger traffic grew nearly six percent in 2014 despite relatively weak global GDP growth”. (Boeing, 2015) The regions with double-digit traffic growth are Middle East and China. “Europe traffic grew at five percent in 2014, far outpacing economic growth, while North America traffic grew more than two percent”. (Boeing, 2015) In addition, in 2014 due to a softer economy than prior years, airlines in Latin America and Asia Pacific region, not including China, saw slower growth.

The better economic environment and price reduction for fuels, passenger traffic is forecasted to grow above the long-term trend.

Taking into consideration the fact that the amount of travelers is increasing, it is crucial to mention that the real cost of travel has fallen by about 60% over the last four decades. (IATA, 2011) The downwards trend of cost is presented at *Figure 2* below.

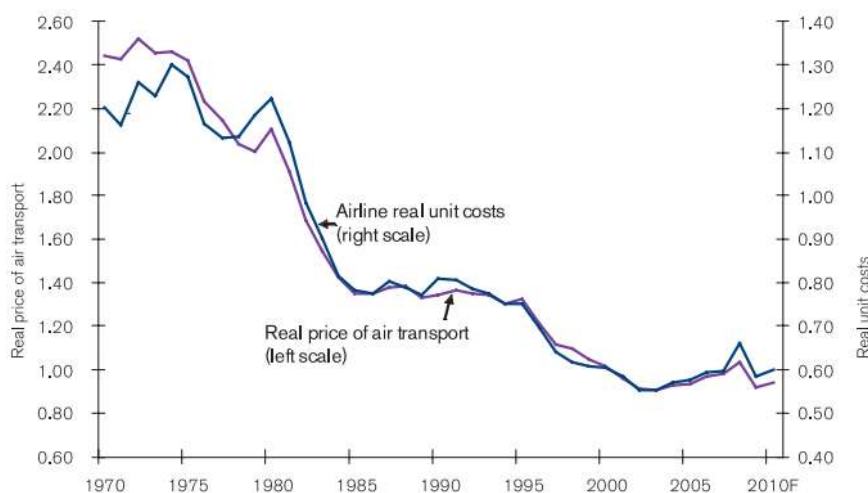


Figure 2 : The real cost of air transport has more than halved

(Source: ICAO, IATA)

Furthermore, the low-cost carrier business (LCC) model is progressively growing and as a consequence of that more point-to-point flying is occurring (*Figure 3*). “In 1994, LCCs provided less than 10 percent of all short-haul flights (less than 3,000 miles), the majority of which Southwest flew. Today, LCCs fly almost 30 percent of short-haul flights.”(Boeing, 2015) The trend is more common in certain regions of the world – North America, Europe, Southeast Asia. Besides, as Latin America, Middle East and

Asia Pacific regions maintain their rapid growth, more point-to-point flying in these areas is expected.

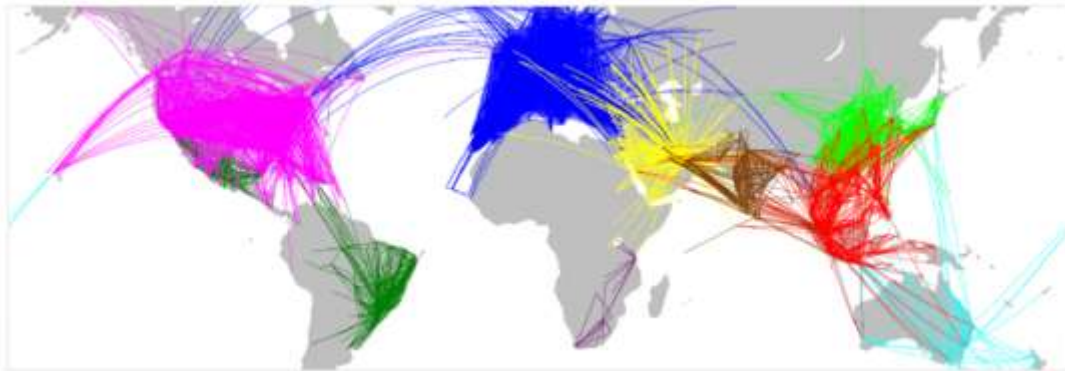


Figure 3: Today LLC's driving an increase in point-to-point flying

(Source: Boeing, Market fragmentation, 2015)

3.2 Competitive Issues

3.2.1 Deregulation

Today's airline industry is completely dissimilar from what it was back in 1978. "At that time, the industry resembled a public utility, with a government agency, the Civil Aeronautics Board (CAB), determining the routes each airline flew and overseeing the prices they charged." (Avjobs, Inc., 2015) Nowadays, airline industry – market-driven industry, where the levels of service and price are determined by customer.

As a consequence the service of business has improved and fares became competitive and affordable. Deregulation opened the business to the newcomers, who are in most cases low-cost carriers. In 2006, there were over 1,400 airlines in the world including traditional airlines, low-cost airlines, charter operators, freight carriers, etc. (Hanlon 2007) The fast growth of the business into new markets in connection with the appearance of new carriers developed unprecedented competition in airline industry.

One of the essential advantages of deregulation is that customers have more affordable fares and more alternatives. "Today, 85 percent of airline passengers have a choice of two or more carriers, compared with only two-thirds in 1978." (Avjobs, Inc., 2015)

Low-cost carriers present big discounts to travelers, form competition and disrupt the market share of traditional airlines. Thereby, growth of low-cost airlines obliges traditional ones to modify their strategies in order not to lose extra market shares.

3.2.2 Cost strategy

Over the past two decades the low-cost airline business model has grown excessively. Among the successful low-cost carriers Southwest Airlines, which operates in the United States and Ryanair, which operates in Europe can be named.

The LLC model addresses to business strategies, which lessen the cost of the airline. Typical cost-saving practices include (Boeing, 2015):

- operating at secondary airports;
- flying a single airplane type;
- increasing airplane utilization;
- relying on direct sales;
- offering a single-class product;
- avoiding frequent-flyer programs;
- keeping labor costs low.

Such tactics helped LCCs reduce unit cost by 20 percent to 40 percent compared with network carriers. (Boeing, 2015) Low-cost carriers substantially stimulate traffic by reducing fares. Hence, LLC business model has demonstrated success all around the world and has encouraged the increase in air travel.

Substantially, there are two kinds of low-cost business models in Europe: Ryanair on the one hand and Easy Jet on the other. easyJet uses high-cost airports in most cases and secondary airports at rather low regularity. It concentrates on existing leisure and business markets and new leisure markets with no direct competition.

In contrary, Ryanair focuses mostly on costs, not on the markets. Airline company steadily convinces airports and suppliers to lower charges.

The elements, which are mentioned above concerning the strategies of LLC business model, compose the vital difference between traditional carriers and low-cost ones – that is, the difference in the cost.

Cost per available seat kilometers (CASK) or cost per available seat miles (CASM) are most universally used metric to determine the cost of the airline. “CASM calculates the cost of operating one available seat per mile/kilometer. This metric can be used to compare a variety of costs, ranging from fuel to labor. Total CASM or CASK normally includes all direct operating costs such as fuel, labor, maintenance, and other direct expenses (landing fees, capital equipment charges, and so on), as well as indirect or nonoperating costs, including station and ground expenses, passenger services, ticketing, sales, promotion, and general administration costs.” (Schlumberger, 2014, p. 15) Indirect operation costs are fixed costs, when direct operating costs are variable costs, which depend on many factors, such as type of aircraft used, number of flights, stage lengths ect. Even though CASM is relevant indicator in the analysis of airlines performance, it can demonstrate obstacles to examine unit costs on the global level because of abundant variation in basic costs across the regions. A traditional airline can operate at analogous unit cost to a European low-cost carrier, making a collation only based on unit cost futile. (Schlumberger, 2014) This has to be considered while making a comparison between low-cost airlines and traditional airlines across the regions.

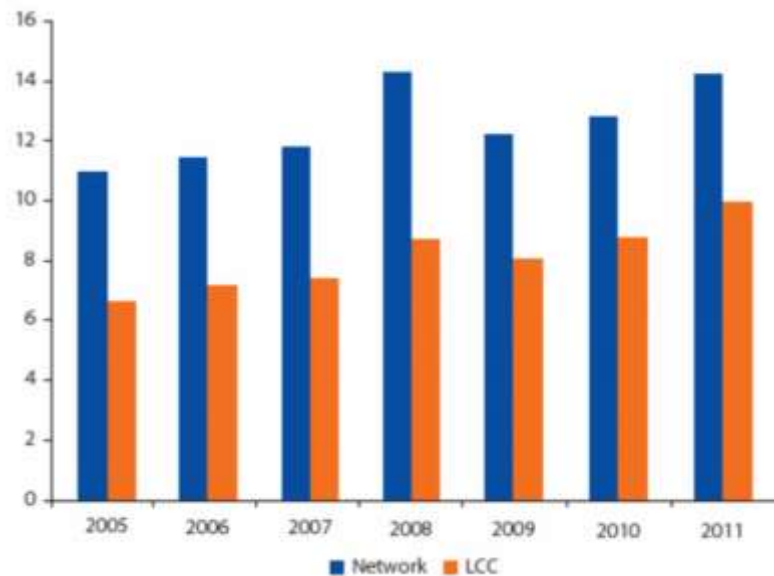


Figure 4: Comparison of U.S. CASM, Traditional Carriers (Network) and LLC's, 2005-2011

(Source: Global Airline Industry Program "Airline Data Project")

Figure 4 shows the comparison of CASM between traditional airlines and low-cost carriers, during 2005 and 2011. As it can be seen in the graph, low-cost airlines have been operating with significantly lower unit costs than traditional carrier.

3.3 Financial Performance of the Industry

Global spend on air transport reached \$789 billion in 2014, which equals 1% of world GDP. (IATA, 2014) International Air Transport Association predicts the numbers to grow even more, in 2015 global spent on air transport is expected to be \$820 billion, which shows 4,3% change over year.

<i>Worldwide airline industry</i>	2013	2014	2015
Spend on air transport, \$billion	753	789	823
% change over year	1.9%	4.8%	4.3%
% global GDP	1.0%	1.0%	1.0%
Return fare, \$/pax. (2014\$)	498	483	458
% change over year	-6.2%	-3.0%	-5.1%
Freight rate, \$/kg (2014\$)	2.35	2.25	2.11
% change over year	-7.3%	-4.3%	-5.8%
Passenger departures, million	3,134	3,306	3,530
% change over year	5.3%	5.5%	6.8%
RPKs, billion	5,793	6,126	6,552
% change over year	5.4%	5.7%	7.0%
Freight tonnes, million	49.3	51.3	53.5
% change over year	2.3%	4.1%	4.3%
World GDP growth, %	2.5%	2.6%	3.2%
World trade growth, %	2.7%	3.0%	4.0%

Note: RPK = Revenue Passenger Kilometers, FTK = Freight Tonne Kilometers, y-o-y = year on year change. GVA = Gross Valued Added (firm level GDP).

Figure 5: Worldwide airline industry (Source: "Economic performance of the airline industry". (December, 2014) IATA)

As it can be seen from Figure 5, the number of passengers in 2014 has reached 3.306 billion as travelers benefit from a growing global network and airfares. Air travel is speeding up, with growth of 7% expected in 2015, the best since 2010, well above the 5.5% trend of the past 20 years. (IATA, 2014)

As a global industry, financial performance of the airline industry does not yet match the value that it delivers. As Tony Tyler (2014), the CEO of International Air Transport Association, noted in his speech "State of the Industry", in 2014 airlines were expected to achieve an impressive collective global profit of \$18 billion. However, the severe

economic reality is that on the revenues of \$746 billion the industry will earn an average net margin of 2,4% , which accounts to less than \$6 per passenger.

“There is a mismatch between the value that the industry contributes to economies and the rewards that generates for those who risk their capital to finance the industry.” (Tyler, 2014)

Financial performance varies from one airline to another. Even if the strategy is correct and there is a presence of an element of luck, companies still work hard to keep revenues ahead the costs. Through improved industry structure airline companies are keep on developing their performance.

In spite of economic conditions and issues, typical for some particular regions, airlines throughout the world showed the progress in profitability in 2014 over 2013.

System-wide global commercial airlines	EBIT margin, % revenues						Net profit, \$ billion					
	2010	2011	2012	2013	2014	2015	2010	2011	2012	2013	2014E	2015F
Global	4.9%	3.1%	2.6%	3.5%	4.6%	6.9%	17.3	8.3	6.1	10.6	16.4	29.3
Regions												
North America	5.7%	3.0%	3.4%	6.8%	9.7%	12.1%	4.2	1.7	2.3	7.4	11.2	15.7
Europe	2.4%	0.8%	0.7%	2.0%	3.0%	5.0%	1.9	0.3	0.4	1.0	3.3	5.8
Asia-Pacific	8.0%	6.6%	4.7%	2.9%	2.6%	5.3%	9.2	5.0	2.7	1.9	1.2	5.1
Middle East	3.7%	3.1%	3.0%	0.9%	1.5%	3.7%	0.9	1.0	1.0	0.3	0.7	1.8
Latin America	5.1%	2.0%	1.5%	2.2%	1.8%	3.9%	1.0	0.2	-0.2	0.2	0.0	0.6
Africa	1.7%	0.6%	-0.4%	-0.5%	0.1%	1.2%	0.1	0.0	-0.1	-0.1	0.0	0.1

Figure 6: System-wide global commercial airlines, EBIT margin and Net Profit

(Source: International Air Transport Association (December 2014) “Industry Economic Performance Forecast”)

Airlines in North America have delivered strongest financial performance. Net post-tax profits were the highest in year 2014 - \$9.2 billion. That illustrates a net profit of \$11.09 per enplaned passenger, which is a notable increase in comparison with previous years. However, it accounts a net profit margin of 7,6% on revenues. (IATA, 2014)

Airlines in Europe are loaded with high regulatory and infrastructure costs. As a consequence it can be seen from the *Figure 6*, airline companies in Europe generated a net profit of \$2,7 billion in 2014, that illustrates a margin of 1,9 %. It also accounts as \$3.23 per passenger. (IATA, 2014)

At the end of 2014 airlines of Asia-Pacific region earned \$3.2 billion. International Air Transport Association (2014) has noted that profit per passenger is below the industry average - \$2.98. The difficulties in the Indian market weighted down the financial performance of the whole region.

Airlines of Middle East and Latin American regions in 2014 showed the net profit of \$1.1 billion and \$0.7 billion. Margin on revenues accounts for 2,6% and 3,5%. Whereas, huge developments concerning airport infrastructure took place on Middle East region resulting in its strong growth. In contrary, in Latin America region governments are trying to adjust the demand with efficient airport infrastructure and “are increasingly turning to partnerships with the private sector to fund development”. (IATA, 2014)

During the past years Africa has been the weakest region in the industry. Region’s profits are slightly positive – \$100 million, showing a 0,4% margin on revenues. African region is still showing the improvement from year to year, but airlines are experiencing high taxation, insurance and fuel costs. (IATA, 2014)

3.4 Future Growth of the Industry

It is interesting to know what the future will bring for airline industry. Fojt (2006) has stated several questions concerning this issue: are we about to see price wars that will send costs spiraling out of control and leave many airlines out of the business? Or present situation is the beginning of slow recovery as airlines are getting benefit from rising number of travelers? (Fojt, 2006)

Responding to those questions Fojt (2006) has named problems that airlines are facing now and that will stay in the closest future. First of all, continuously rising costs of the fuel are pressing airlines “into the red”. Carriers, which have enough funds, have been progressively modernizing their fleet to integrate more fuel-efficient aircraft. (Clayton, Hilz, 2015) Even if new planes are expensive, this approach has a real value when it stands in a line with airline’s long-term goals for the configuration of its network in a certain number of years. (Clayton, Hilz, 2015)

In addition, the reduction of cost can be also achieved by enhancing the organizational structure, operating model, and work practices. (Clayton, Hilz, 2015) Notably, traditional airlines generally use complex processes for decades, which cost much more than modernized processes of the low-cost carriers.

Moreover, “the amount of regulation and unionization that exists in the sector” is another factor that is responsible for the instability of the industry. Strikes of the airline’s staff

are really frequent, the consolidation is difficult and pilots have a possibility to command inflated wages because of work rules that date back to the time when industry was under heavy regulation. (Fojt, 2006)

Despite the negative facts, Fort (2006) says that there are positive ones that will bring bright future for the airlines industry. The co-operation strategy has been and is still successful. Nowadays, there are three major alliances (Fojt, 2006):

- Star Alliance – the largest airline alliance in the world, which consists of 28 member airlines (Air China, Air Canada, Austrian, Lufthansa, Singapore Airlines, ect.). (Star Alliance, 2015)
- Sky Team – has 20 member airlines, such as Aeroflot, KLM, Delta, Air France, ect. (Sky Team, 2015)
- oneworld – includes 15 airlines such as Air Berlin, American Airlines, Finnair, British Airways, Qatar, ect. (oneworld, 2015)

This model allows airlines to “code-share, sell tickets from the same office and link their frequent flyer programs”. (Fojt, 2006) Many other authors and analysts consider that that cooperation will continue to grow in the future.

Developing markets, such as Asia and Latin America, are showing fast growth in air travel that entails shift in industry’s “center of gravity”. Traditional airlines, such as Emirates, Etihad Airways and Qatar Airways, are taking profit from previously profitable Europe – Asia traffic from those continents’ airlines. (Clayton, Hilz, 2015)

“The Middle East carriers are highly dependent on connecting traffic, because their home markets are limited by the smaller population of their region”. (Clayton, Hilz, 2015) However, the unique geographic position of the region, which enables to reach most of the world’s population within eight hours, leads to the point that airlines can grab “a disproportionate share of long-haul market growth”. (Clayton, Hilz, 2015)

Furthermore, low-cost airlines are still experiencing growth rates that are above average in the industry. This type of carriers is also facing customers expectation that tend to increase even more, especially in developed markets. Thus, it is crucially important for low cost airlines to find the balance between investing into experience improvement and preserving their cost advantage. (Clayton, Hilz, 2015)

This section signifies the end of the “General review of airline industry” chapter, where the observations and analysis of the literature has proven the global importance of the airline industry, which develops fast and with a high degree of growth yearly. Particularly, the chapter has covered a cornerstone of the airline industry’s history – deregulation. Moreover, the researcher has described and analyzed the main competitive advantage between airlines of all types, has characterized present financial performance of the whole industry and forecasted its future development. The upcoming chapter will provide a detailed description of the financial analysis as a basis of the airline comparison in the framework of this thesis.

4 THEORETICAL FRAMEWORK

4.1 Financial Statement Analysis

“Fundamental analysis or intrinsic value analysis uses financial and other economic information to determine the firm’s value. Analysts use basic fundamentals, which generally based on publicly available information, such as accounting earnings, dividends, growth factors or leverage ratios, etc. to infer the intrinsic value and compare whether it is over or under the firm’s stock price”. (Lee, 1987)

There are four key steps of effective fundamental analysis: business strategy analysis, accounting analysis, financial analysis and prospective analysis.

The first component, business strategy analysis, concerns the understanding of the business and competitive strategy of the company, which is analyzed. “It is critical to begin financial statement analysis with a company’s strategy because it provides an important foundation for the subsequent analysis. The strategy analysis section discusses contemporary tools for analyzing a company’s industry, its competitive position and sustainability within an industry, and the company’s corporate strategy”. (Palepu 2013, p. 14)

“Accounting analysis involves examining how accounting rules and conventions represent a firm’s business economics and strategy in its financial statements”. (Palepu 2013, p 14). The analysis of assets, liabilities, entities, revenues, and expenses enables effectively evaluate a company’s accounting choices and accrual estimates.

“Financial analysis involves analyzing financial ratio and cash flow measures of the operating, financing, and investing performance of a company relative to either key competitors or historical performance”. (Palepu 2013, p. 14) Financial analysis is a specific approach to evaluate the effectiveness of a company’s strategy.

The last component of financial analysis, prospective analysis, demonstrates how to evolve forecasted financial statements and how to apply these to make estimations of a firm’s value.

4.1.1 Strategy Analysis

As world's leading manufacturer of commercial jetliners, Boeing (2015), has noted, the process of strategic planning is continual for airlines; plans have to consider the “challenging and ever-changing competitive environment” as well as how value is defined by passengers. For instance, business travelers are more sensitive concerning flight times and expect a higher level of service, short-haul business travelers tend to be more precise with ticket prices than long-haul business travelers. (Boeing, 2015) Whereas, “leisure travelers are more sensitive to price but less demanding about service levels”. (Boeing, 2015)

While making an overview of the airlines planning process, Peter P. Belobaba (2009) has designated principal characteristics of steps in airline planning process. In addition, Peter P. Belobaba (2009) indicates that the most important planning decisions that airline managers face can be categorized to:

- Fleet planning
- Route planning
- Schedule development

Fleet planning

The composition of fleet of the airline can be named as one of the most important long-term strategic decisions, from the point of view of planning process and operations itself. “An airline’s fleet is described by the total number of aircraft that an airline operates at any given time, as well as by the specific aircraft types that comprise the total fleet”. (Belobaba, 2009, p. 153) Airline overall financial position, operating costs, the ability of the company to serve specific routes in a profitable way are directly affected by the decisions made regarding the acquisition of new aircrafts or retire existing ones in airline’s fleet. (Belobaba, 2009)

The decision to buy a new aircraft by an airline symbolizes an immense capital investment with a long-term operational and economic prospect. This has an impact on company’s financial position of such an investment encompass depreciation costs that generally are incurred for ten to fifteen years, as well as the rise in long-term debt and related interest expenses. (Belobaba, 2009)

The composition of airline fleet is established for a certain point of time, but it changes with every additional airplane purchased and every existing airplane that is eliminated from the fleet. (Belobaba, 2009)

In addition, Peter P. Belobaba (2009) explains that major categories of commercial aircraft, which nowadays are available for airlines, are in most cases defined by airplane type's size and range. The "size" of an airplane can be defined by measures such as weight, its seating capacity, the amount of payload that it can carry. Whereas, the "range" of an airplane is assigned by maximum distance that it can fly without stopping to fill in additional fuel, at the same time carrying a prudent payload of passengers or cargo. Hence, more vast categories, for instance "small, short-haul" or "large, long-haul" airplane, can comprise number of different airplane types, which are possibly manufactured by different producers. Concerning the fact that airplane types within each category are able to give identical capabilities to airlines, they are considered as "competitors" in the fleet planning of the airline. (Belobaba, 2009) For instance, airplanes Boeing 737-800 and Airbus 320 are competing types, because both aircrafts are single-aisle, twin-engine and have nearly 150 seats.

The purchase of the new aircraft by an airline depends on the existence of needed financing, which can be an internal or external source. Full payment to the manufacturer of the aircraft can come from cash on hand, retained earnings, loans or equity for aircraft acquisition. Another option that exists and that is used by many airlines today is leasing. Still, leasing can be more costly from a point of view of monthly payments. Despite that fact many airline companies lease their aircrafts, because it allows more frequent renewal of fleet and "requires less up-front capital investment". (Belobaba, 2009, p. 157)

Route planning

The next step in the airline planning process is to decide on the flying routes. Sometimes, the sequence of the decisions (firstly fleet planning than route planning) changes, because the identification of beneficial route may require the purchase of a new aircraft type that is not present in airline's fleet at the moment. (Belobaba, 2009)

Factors that are significant for most of the airlines in route evaluation process are economic considerations and expected profitability. "Route profitability estimates require

demand and revenue forecasts for the period under consideration.” (Belobaba, 2009, p. 162)

Peter P. Belobaba (2009, p. 168) is highlighting that the decision of route selection is both tactical and strategic and that is fundamental component of “vision” of the airline or its integrated network strategy, which have to determine whether to focus on “short-haul or long-haul services, domestic or international operations”. Moreover, routes selected by an airline have a direct influence on the type of service offered to travelers. For instance, in order to keep a competitive position on market, the choice of an international route network in most cases entails a selection of business-class and first-class services to offer.

The distance of routes selected by airline company also affects airline cost structure, in other words longer routes are usually flown by bigger airplanes, which have lower unit cost per seat and per Available Seat kilometers (ASK). (Belobaba, 2009)

It is important to notice that route planning is not always a long-term strategic process, as unforeseen route opportunities can appear due to the changes in the market. For instance, a competitor airline can become bankrupt and derivation of a competitor from a route can give a new route possibility that airline company has to deal with the certain time limit – weeks or month. Furthermore, Peter P. Belobaba (2009) names “a newly negotiated bilateral agreement with another country” as another opportunity to have a new destination.

Generally, the economic evaluation of prospective route involves accurate and precise judgment, which stays in a line with fleet planning. Airline accepts certain route that will be flown within years in the future, thus forecasts upon demand, revenue and operating costs are essential to consider. Another critical point is an estimation of the airline’s own market share of total demand, which is based on schedule options and travelers choice of different airline. The forecast, future demand and market share together will depend to a large degree on the existence of competitors to the planned route entry. (Belobaba, 2009)

Schedule development

Taking into consideration the data obtained in previous stages of strategic planning process about the existing fleet of the aircraft and routes to be flown, airline starts next essential step – schedule development, which includes four tasks (Belobaba, 2009):

- Frequency planning: How often the airline should perform flights to chosen destinations?
- Timetable development: creation of schedule of flight departments.
- Fleet assignment: Which type of airplane should be used for each departure?
- Aircraft rotation planning: decision on assigning airplane types for each destination, paying attention to an overall balance of airplane departures and arrivals at each airport.

Typically, the process of schedule development starts “a year or more in advance of flight departure” and can continue until the moment of a real departure time. (Belobaba, 2009, p. 174) Primarily, frequency plans are created concerning routes and types of aircraft. Certain timetables of departure time and airplane rotations defined 2 – 6 month in advance. Moreover, closer to the actual departure, final revisions of timetable and airplane rotation plans are reviewed, while unforeseen operational constraints such as weather can enforce changes in schedule. (Belobaba, 2009)

For passengers the more frequent are departures for a certain destination, the more convenient air travel is. Moreover, the airline itself can benefit from higher traffic and revenues based on that increased frequency. (Belobaba, 2009) Early morning and late afternoon time are called “peak departure times”, because they are more attractive for large percent of travelers, especially business travelers. Still, not all departures at that period of time can be established for all possible routes, given airplane fleet and rotation deliberation. In other words, airlines mostly do not have sufficient amount of airplanes to be able to schedule departures to each destination of company’s network in the morning time, for instance. (Belobaba, 2009)

Airlines also facing an issue while assigning which type of airplane to be flown “on each flight leg departure, given a planned network of routes and specified timetable of flights”. (Belobaba, 2009, p. 178) Taking into account the existing fleet of the airline, the choice of the airplane types in fleet assignment is limited. The main objective of this stage of planning is to minimize airplane operating costs and combined costs of rejected demand, which takes place when the airplane assigned to a flight departure is too small and possible revenues and demand are missed by the airline. The rejected demand can be decreased or even eliminated by appointing a large enough plane to sustain all potential peak day demands for a flight. (Belobaba, 2009)

Peter P. Belobaba (2009) explains that aircraft rotation constraints guarantee implementable airplane cycles and balance of airplane inflow/outflow at each airport.

4.1.2 Accounting Analysis

The aim of the accounting analysis is to assess the accounting quality of the company, evaluate the degree of misrepresentation in the accounting numbers. (Palepu et al., 2007)

Krishna G. Palepu et al. (2007) specifies following steps that analysts are advised to follow in accounting analysis:

1. Identification of key accounting policies and estimates that company is using to determine its risks and decisive factors.

In other words, the analyst identifies accounting measures, which company uses to enfold business constructs, “the policies that determine how the measures are implemented” (Palepu et al., 2007, p. 95), and the key estimates inculcated in those policies.

2. Asses accounting flexibility.

There are firms, where managers have a small degree of flexibility concerning the choice of accounting policies and estimates related to their success factors, hence the accounting data are likely to be uninformative. However, accounting choice for some companies is strictly constrained with accounting conventions and standards.

Despite the degree of flexibility in accounting, company’s managers have certain versatility in defining their risks and success factors, “they will have some flexibility with respect to several other accounting policies” (Palepu et al., 2007, p. 95-96). For instance, all companies have to make their decisions with respect to depreciation policy.

3. Evaluate accounting strategy.

At this stage analysts can use following questions to assess company’s accounting strategies:

- Can company’s accounting policies be compared with others in the industry?

- Do managers of the company meet strong inducements to hide some information to manage earnings?
 - Has the company changed any of its accounting policies or estimates?
 - Were the firm's accounting policies and estimates pragmatic in the past?
4. Evaluate the quality of disclosure.
- Usually, certain degree of disclosure is obligatory for financial statements. However, the decision to present adequate information to evaluate company's strategies and economic results is in regard of the company.
5. Identification of potential red flags of questionable accounting quality.
- "Red flags" or indicators help analysts to see certain items, which need to be investigated more carefully. For instance, unexplained transactions that boost profit, unexplained changes in accounting. (Palepu et al., 2007)
6. Undo accounting distortion.
- If the result of accounting analysis shows that the company's financial data is misleading, analysts are advised to adjust the reported numbers to reduce distortion to the extent possible. (Palepu et al., 2007) In order to restate the financial data analyst can use cash flow statement and financial footnotes.

4.1.3 Financial Analysis

4.1.3.1 Ratio Analysis

Ratio analysis covers the evaluation of how various line items in a company's financial statements relate to one another. Moreover, ratio analysis of a firm present and past performance gives a basis for making forecasts of future performance. (Palepu et al., 2013) Efficient ratio analysis is about the relation of financial data with the basic business factors.

Krishna G. Palepu et al. (p. 181, 2013) specifies that in ratio analysis researcher can:

- Make a time-series comparison (compare ratios for a company over several years)
- Make a cross-sectional comparison (compare ratios of the company and other companies in the industry)
- Compare ratios to some absolute benchmark.

Ratio analysis is applicable to compare the companies of different sizes. “Ratios are ways of comparing and investigating the relationships between different pieces of financial information”. (Ross et al., 2008, p. 45)

However, the usage of ratio analysis for comparison of companies derives some issues. Different authors and sources usually do not calculate ratios in exactly the same way, which entails a certain degree of confusion.

Financial ratios are generally grouped to the following categories (Ross et al., 2008):

- Short-term solvency or liquidity, ratios.
Ratios of this category are meant to give information concerning company’s liquidity – the ability of the company to pay the bills in a short run without undue stress. (Ross et al., 2008)
- Long-term solvency ratios.
Long-term solvency ratios show company’s ability to meet its obligations in a long run.
- Asset management, or turnover, ratios.
The measures in this category are intended to demonstrate how efficiently the company uses its assets to generate sales. (Ross et al., 2008)
- Profitability ratios.
Profitability ratios determine how effectively the company manages operations and uses its assets.
- Market value ratios.
Last, but not the least category of ratios is based on the market price per share of the stock. Those ratios are calculated directly only for publicly traded firms. (Ross et al., 2008)

This investigation is intended to make a comparison of two airline companies, measuring their profitability to explore the difference of their operating performance. Thus, the researcher will calculate profitability ratios.

As a profitability measures researcher has chosen three most widely used of financial ratios, which are named by Stephen A. Ross et al. (2008). Those profitability ratios determine how efficiently the company uses its assets and how it manages operations, focusing on company’s net income.

Profit Margin

First, all companies are paying attention to their profit margin, which can be calculated by the following formula (Ross et al., 2008):

$$\text{Profit margin} = \frac{\text{Net income}}{\text{Revenue}}$$

Undoubtedly every company strives to a high profit margin. This situation conforms “to low expense ratios relative to sales”. (Ross et al., 2008, p. 52) It is also important to remember that profit margins can be different for various industries and regions. For example, the airline industry has a profit margin of about 4% (IATA, 2014), when the other industries, such as software industry, can have a profit margin up to 90%.

Return on Assets

Return on assets (ROA) is “a measure of profit per dollar of assets”. (Ross et al., 2008, p. 53) It defined in various ways by different authors, but the general formula is:

$$\text{Return on assets} = \frac{\text{Net income}}{\text{Total assets}}$$

Return on Equity

Return on equity (ROE) is the evaluation of how the stockholders fared throughout the year. (Ross et al., 2008) One of the main goals of the company is to benefit its shareholders. ROE can be called “the true bottom-line measure of performance”. (Ross et al., 2008, p. 53) ROE is calculated by the following formula:

$$\text{Return on equity} = \frac{\text{Net income}}{\text{Total equity}}$$

Although, the ratio analysis focuses on investigating a company’s income statement, the analyst can get better picture of the company’s operating and financing policies by analyzing its cash flow. The following section of the chapter will describe cash flow analysis more detailed.

4.1.3.2 Cash Flow Analysis

Cash flow analysis allows assessing the company's liquidity, how the company manages its operating, investment, and financing cash flows. (Palepu et al., 2013)

Cash flow analysis is here to answer different questions concerning firm's cash flow dynamics (Palepu et al., 2013):

- How solid is the company's internal cash flow generation?
- Is the company able to meet short-term obligations from its operating cash flow?
- What amount of cash did the company invest in growth? Are these investments compatible with the business strategy of the company?
- Did the company use internal free cash flow or it relied on the external financing to pay out the dividends?
- Does the firm have cash flow surplus after making investments?

Going further, the ratios of cash flow analysis define how much cash the company is generating from sales, the amount of cash it generates free, and the amount of cash it has to cover obligations. (Loth, 2016) For the present investigation the researcher is going to use the ratios described below.

Operating cash flow / Sales ratio

This ratio shows the firm's ability to turn sales into cash by comparing firm's operating cash flow to the net sales. (Loth, 2016) It is expressed as a percentage and calculated by the following formula:

$$\text{Operating cash flow (Sales Ratio)} = \frac{\text{Operating Cash Flow}}{\text{Net Sales (Revenue)}}$$

Free cash flow ratio

Free cash flow ratio assesses the connection between free cash flow and operating cash flow. (Loth, 2016) Many authors define free cash flow as operating cash flow minus capital expenditures. The cash flow after the ratio calculation is expressed as a percentage and the higher the percentage is, the greater financial strength of the firm. (Loth, 2016) Richard Loth (2016) advises to use the following formula for ratio calculation:

$$\text{Free cash flow} = \frac{\text{Free Cash Flow (Operating Cash Flow – Capital Expenditure)}}{\text{Operating Cash Flow}}$$

Eventually, cash flow analysis allows the analyst to judge upon the company's overall performance, looking closer on how the company spends money and where the money comes from.

4.2 Overview of the Airlines

British Airways

British Airways is United Kingdom's largest scheduled airline and one of the world's leading global airline. It provides international and domestic air services for passengers and cargo. It flies to relatively 400 destinations across the globe. In addition, the airline is the member of oneworld alliance.

The vision of British Airways is to be "the most admired airline". (British Airways, 2015)

The airline company was formed in April 1974 as a merger of British Overseas Airways Corporation, British European Airways, and their associated companies. (Encyclopedia Britannica, 2015) The airline, which from its creation was state-owned, was privatized in 1987. The company's headquarters is based in London.

For the present moment British Airways operates a fleet of 264 aircraft, which is planned to increase for approximately 14 airplanes more this year. (Planespotters.net, 2016) The fleet ages of the airline vary from 1,4 years to 21,8 years, with the total fleet average of 12,7 years.

During the years 2009-2010 British Airways has faced financial difficulties due to the management change, who introduced new view and strategy for the airline. Another aspect of the problematic financial situation of the company – the airline was fined €104 million for price-fixing a couple of times and at last in November 2010. (David Kamin-ski-Morrow, 2010)

In January 2011, British Airways merged with Iberia, national airline of Spain, and has formed the International Airlines Group (IAG). IAG is nowadays one of the largest airline groups in the world with 525 airplane flying to 255 destinations. (IAG, 2016) By 2016 International Airlines Group is the parent company of British Airways, Iberia, Aer Lingus and Vueling. IAG is registered in Spain, whereas the company's headquarters is situated in London, United Kingdom. In 2015 IAG airlines carried around 95 million passengers. (IAG, 2016)

In the annual report of the year 2014, British Airways has reported an operating profit of £975 million, which can be seen as a considerable achievement in comparison to the year 2013, when the operating profit was £708 million. (British Airways, 2015)

Furthermore, the company explains its development as a proper investing in products, where it matters most to its customers, by making the travel more convenient, strengthen the net-work offered, involving the possibility to book flights with Vueling and Iberia.

easyJet

easyJet, established in 1995, is a Europe's leading low-cost airline and the largest United Kingdom's low-cost airline. The headquarters of the company is based at London Luton Airport. The airline generally concentrates on Western and Northern Europe, where there is a high tendency of travelling and rich markets. On the whole, it operates over 600 routes across more than 30 countries. (easyJet, 2015)

At 30th of September 2015, the official financial year end in the company, the airline comprised a fleet of 241 aircraft. There are 163 aircrafts owned by the company, 67 aircrafts are under operating lease agreement and 11 are under financial lease agreement. The average age of fleet is 6,2 years. In addition, the company plans to change the whole fleet mix to reduce costs. In 2014 easyJet has announced that the company strives to apply new technologies to its airplanes, thus the deal of buying the new generation A320 neo airplane from year 2017 was placed. (easyJet, 2015)

In the annual report of 2014 easyJet has reported that the passenger volumes grew by 6% to 68,6 million passengers and the revenue increased by 3,5% to £4,686 million.

Furthermore, the airline stated that in 2014 profit grew “to record levels for a fifth consecutive year, up 18% to £686 million”. (easyJet, 2015, p.1)

For the year 2016, easyJet aims to increase its capacity by 7%, taking into consideration company’s investments in profitable growth. Moreover, the airline stays confident in its ability to deliver growth and returns for shareholders by fulfilling the company’s strategy.

This section indicates the end of the theoretical part, which intends to provide understanding of how the financial analysis is conducted and how the analyst is expected to evaluate the operating performance of the airline company step by step. Moreover, the author has presented the overview of the airlines, which were chosen for analysis in the upcoming chapter.

5 ANALYSIS AND RESULTS

5.1 Strategy Analysis

Fleet and route planning have to be organized in advance, even though the preferences of travelers can fluctuate and evolve. Many different factors, for instance, economic and political factors, have a direct and considerable effect on various areas of operations. Therewith, the presence of competitors stays strong and ubiquitous.

British Airways

For British Airways strategy “is about asking the fundamental questions any business must address if it is to possess a clear sense of direction”. (British Airways, 2012) As British Airways strives to be a leading international airline for the 21st century, the company has done some important development of strategy.

According to British Airways (2012), one of the most vital goals in designing company’s strategy is to designate and track the company’s strategic priorities, which lead to creation of corporate strategy and an outline plan for the next five years. This includes financial goals and estimations, departmental targets, the fleet plan of the airline, its alliance strategy, major investment projects and market predictions. (British Airways, 2012)

First of all, fleet planning is crucial aspect for the airline. British Airways carefully evaluates what airplane should be operated and in what number to satisfy the needs of the business. (British Airways, 2012) The airline thoughtfully evaluates existing and new airplane types, examining all the costs and investigates the compatibility with the existing fleet and route network. (British Airways, 2012)

To the present moment the airline operates a fleet of 264 aircraft, which is planned to increase for approximately 14 airplanes more this year. (Planespotter.net, 2016) In addition, in 2014 the airline expanded its fleet by 25 new airplanes. The fleet ages of the airline vary from 1,4 years to 21,8 years, with the total fleet average of 12,7 years. (British Airways, 2014) The fleet matrix of the airline is presented on *Figure 7*.

Aircraft Type	Current	Future	Historic	Avg. Age	Total
Aérospatiale/BAC Concorde			7		7
Airbus A318	2			6.4 Years	2
Airbus A319	44			14.1 Years	44
Airbus A320	66	1	11	9.6 Years	78
Airbus A321	18			10.3 Years	18
Airbus A380	10	2		2.1 Years	12
Boeing 737			123		123
Boeing 747	41		60	20.1 Years	101
Boeing 757			56		56
Boeing 767	12		19	21.8 Years	31
Boeing 777	58		3	13.6 Years	61
Boeing 787 Dreamliner	13	11		1.5 Years	24
British Aerospace BAe 146/Avro RJ			4		4
British Aerospace BAe ATP			16		16
De Havilland Canada DHC-6 Twin Otter			2		2
De Havilland Canada DHC-8 Dash 8			2		2
Fokker F70 / F100			6		6
Lockheed L-1011 TriStar			6		6
McDonnell Douglas DC-10			8		8
Total	264	14	323	12.7 Years	601

Figure 7: Fleet Matrix of British Airways.

(Source: Planespotters.net, 2016)

The number of destinations, which British Airways flies to, is more than 400 all over the world. Each year the airline broadens its destinations both independently and with the help of partners. In the closest future, the airline company opens new routes to destinations in Spain, Greece, Malaysia and elsewhere. (British Airways, 2014)

In addition, the year 2014 brought number of awards for British Airways. Premium travel publication Conde Nast named BA as best short-haul airline of the year, The Times and Business Traveller both voted British Airways as the best airline, at the same time The Daily Telegraph called the airline the best long-haul business class service. (British Airways, 2014)

Furthermore, the airline stands for responsible aviation. In 2014 the airline company was working together with Solena Fuels in creation of world's first facility, which converts landfill waste into jet fuel. (British Airways, 2014)

Throughout the investigation of the British Airways's annual reports of the last three years, the following major strategies were identified:

- Continuous modernization of aircraft fleet;

- Minimization of the environmental impact;
- Innovation and enhancement of customer loyalty;
- Continuous increase the number of destinations;
- Grew company's presence in existing destinations;
- Improve the quality of business travel;
- Improve margins through new revenue channels;
- Deliver differentiated service for all type of customers.

In general, British Airways has a stable strategy that allows the company to continuously grow, develop and achieve great results.

easyJet

easyJet performs in the short haul European aviation market, which in 2015 has seen solid demand during the whole year. (easyJet, 2015)

As a part of the strategy, airline operates at primary airports, unlike other low-cost carriers, which usually fly to secondary airports. The company explains that flying to the “right” airports is a great opportunity to “serve valuable catchment areas, that represent Europe’s top markets by GDP, driving both leisure and business travel”. (easyJet, 2015, p. 4)

The airline flies to almost all top 100 routes in Europe, offering good route frequencies to provide its customers flexibility and possibility of choice. easyJet (2015) reports that it repeatedly analyzes the route network with an aim to augment returns and take benefit from new demand opportunities in the market. In 2015 the company has added a net 60 routes to the network. (easyJet, 2015)

The airline operates only Airbus A320-family fleet. This gives an operational versatility to easyJet as well as effectiveness in engineering, service, crew and fuel. In the whole, airline operates a fleet of 241 aircraft and the fleet’s average age is 6,2 years. Due to the fact that demand for easyJet flights is high and it continues to increase, the airline signed an agreement with Airbus to accept the delivery of extra 36 A320 aircraft between 2018 and 2021. (easyJet, 2015) In addition, easyJet placed a deal to buy 30 next

generation A320 neo airplanes from year 2017. Current fleet of the airline is presented on the *Figure 8*.

Fleet as at 30 September 2015:

	Owned	Operating leases	Finance leases	Total	% of fleet	Changes in year	Future committed deliveries at 16 November 2015	Unexercised purchase rights
A319	93	49	6	148	61%	(5)	-	-
A320	70	18	5	93	39%	20	56	-
A320neo	-	-	-	-	-	-	130	100
	163	67	11	241		15	186	100

Figure 8: easyJet's fleet matrix.

(Source: easyJet, Results for the twelve months ended 30 September 2015)

Moreover, substantial part of easyJet's strategy is customer-focused. The airline company attracts new customers and keeps the relationships with existing ones, by developing customer loyalty. easyJet sees its digital platform as a competitive advantage, which distinguishes the airline from competitors. The airline's web platform allows customers to take an advantage from growing level of personalization via multiple channels, for instance saved passport details and targeted marketing campaigns via email. (easyJet, 2015)

easyJet remarks in the annual report 2015 that it stays concentrated on its network advantage, digital leadership and offering its customers excellent low fares and service. Furthermore, easyJet formulates the flowing principles that guide the airline (easyJet, 2016):

- Never compromise on safety;
- Assign the level of importance to each aspect;
- Work together as one team to always find best solutions;
- Stand by its word and do what has been said;
- Have a passion for its customers and employees;
- Find new ways to make travel easy and affordable.

Finally, easyJet remains highly competitive in the market thanks to the implementation and continuous development of its strategy. In the future, the airline sees more opportunities to deliver sustainable further growth and returns for shareholders.

5.2 Accounting Analysis

There are certain estimates and policies, regarding accounting analysis, which are inherent only to airline industry. As most significant are airplane lifespan and airplane lease.

Unfortunately, commonly established standard metric to evaluate the economic life of the aircraft does not exist. The research made by Helen Jiang (2013), aviation system analyst at Boeing Commercial Airplanes, has demonstrated that economic life of the airplane is designated contextually according to the aim of the evaluation and the view of the investigator. However, Helen Jiang (2013) specifies several surrogates that are applicable to quantify the lifespan of the airplane and the following two are generally used:

- the average age of aircrafts when they are constantly removed from service;
- the time interval for a cohort of aircrafts to be diminished by half.

The other concern that is vital for airline business is airplane lease. Two types of leases exist: operating lease and finance lease. According to International Accounting Standards 17 (IAS, 2010), finance lease is “a lease that transfers substantially all the risks and rewards incidental to ownership of an asset” and an operating lease is a lease that “does not transfer substantially all the risks and rewards incidental to ownership”. (IAS, 2010, p.3) Under the U.S. Generally Accepted Accounting Principles (GAAP) the finance lease is called capital lease.

Sections below will describe more British Airways’s and easyJet’s features of accounting estimates and policies.

British Airways

British Airways implements an authoritative analysis of the airline's vital global markets along with inflation forecasts and economic observations. Moreover, the company tracks the economic and political situation in areas that are specifically important for the airline and its partners.

British Airways prepares its annual report financial results in accordance with International Financial Reporting Standards (IFRS), which also involve International Accounting Standards (IAS).

Financial statements of the airline are produced on a historical cost convention with the exception of certain financial assets and liabilities. (British Airways, 2014)

Financial Statements development obligates managers of the airline to make judgments, estimates and assumptions, which directly affect the application of policies and disclosed amounts of assets and liabilities, income and expenses. These estimates and correlated suppositions are based on historical knowledge and different other aspects that are considered to be reasonable under the circumstances.

The airline's financial statements are introduced in pounds sterling. In addition, British Airways's transactions in foreign currencies are first recorded in the airline functional currency - pounds sterling, and later converted exchange rate existing at the date of the transaction.

"Passenger revenue is recognized when the transportation service is provided". (British Airways, 2014, p.25) The unused tickets, which are not supposed to be used for transportation are recognized as income utilizing estimates concerning the timing of recognition based on the terms and conditions of the ticket and historical trends. (British Airways, 2014)

All airplanes of British Airways are declared at the fair value of payment. Aircrafts owned, or held on finance lease are depreciated at rates computed to record the cost to the predicted residual value over a depreciation period of between 18 and 25 years. (British Airways, 2014)

easyJet

The formation of accounts in accordance with Generally Accepted Accounting Principles requires the utilization of estimates and assumptions, which affect the amounts of assets and liabilities reported and amounts of income and expenses reported during the disclosing period. Mainly those estimates and assumptions are based on airline management's experience and awareness of the amount; certain circumstances may mean that actual results eventually vary from those estimates and these variations can be significant. (easyJet, 2015) In addition, management of easyJet frequently reviews estimates and the fundamental assumptions.

Aircraft maintenance provisions, goodwill and landlord rights are viewed as critical accounting policies by easyJet, because they require a substantial degree of management judgment and the results are material to easyJet's accounts. (easyJet, 2015)

The airline incurs liabilities for maintenance costs in regard to airplane leased under operating leases throughout the time of lease. "A charge is made in the income statement, based on hours or cycles flown, to provide for the cost of these obligations". (easyJet, 2015, p. 24) The utilization of the airplane, its condition and lifespan are included in the estimates.

easyJet (2015) claims that the fundamentals of all estimates are examined annually as well as at the time the certain information reveals, which is capable to cause a significant change to an estimate, for instance, renegotiation of end of lease return conditions.

Furthermore, in annual report 2015 the airline states that goodwill and landing rights are tested for impairment every year. easyJet's route network is assumed by the airline as one cash-generating unit. Making this estimation, the company has recognized the approach, in which the business is managed, involving centralized style of its operations as well as the capability to open or close routes and redeploy aircraft and crew across the whole route network. (easyJet, 2015)

5.3 Financial Analysis

5.3.1 Ratio Analysis

This section will describe the financial ratios of both airlines, providing the detailed analysis and comparison.

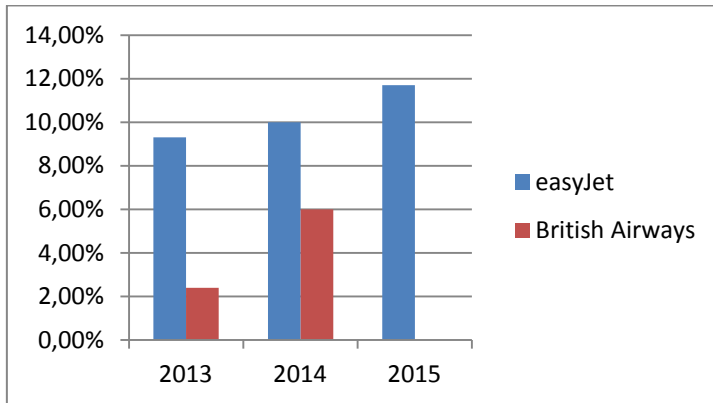


Figure 9: Profit margin ratio in percentage of easyJet and British Airways

(Source: own calculations¹)

First of all, the profit margin ratio, which is presented in percentage, tells the analyst the amount of profit that was gained by the company at a certain level of sales. The calculations and *Figure 9* show the profit margin ratio calculated for easyJet and British Airways, relying on the financial data disclosed by the airlines in the annual reports.

British Airways shows relatively low ratio percentage (2013 – 2,4%; 2014 – 6%) in comparison with easyJet (2013 – 9,3% ; 2014 – 10%). The low profit margin of British Airways is a trace of the financial difficulties that the company had during years 2009-2010, when the management of the company changed and introduced new view and strategy for the airline. Another aspect is that the airline was fined €104 million for price-fixing a couple of times and at last in November 2010. (David Kaminski-Morrow, 2010)

In addition, the proposal of the airline's management to work unpaid during one month to help the airline overcome financial crisis did not have success among workers. Thus,

¹ British Airways (2013) $281/11421 \times 100\% = 2,4\%$; (2014) $702/11719 \times 100\% = 6\%$
easyJet (2013) $398000/4258000 \times 100\% = 9,3\%$;(2014) $450000/4527000 \times 100\% = 10\%$; (2015) $548000/4686000 \times 100\% = 11,7\%$

British Airways faced a strike by thousands of cabin crew. (BBC, 2009) As long as situation tightened the company for quite a long time, more strikes happened throughout the 2009 – 2010.

Those factors directly affected the airline performance and undoubtedly its financial results. However, it is important to underline that the profit margin of British Airways is increasing from year to year, which shows that the management of the company chose the correct strategy to overcome crisis.

High percentage of easyJet's profit margin indicates that the airline is efficiently manages its expenses and generates revenue.

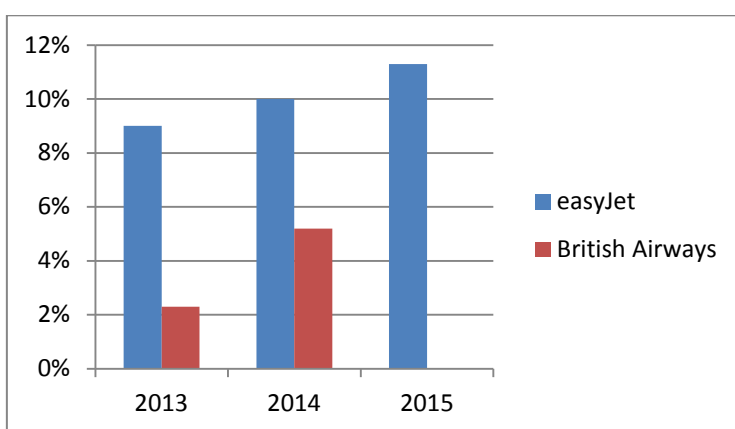


Figure 10: Return on assets ratio in percentage of easyJet and British Airways

(Source: own calculations²)

The return on assets ratio gives an analyst an idea how well the airline can convert the investments in assets into profit. The results of the calculations on *Figure 10* show that the ratio percentage of both easyJet and British Airways is growing year after year. As it was discussed above, the British Airways has overcome a severe crisis and now still recovering from it, thus the percentages are lower (2013 – 2,3%; 2014 – 5,2%) than its competitors.

It is vital to mention that easyJet has increasing high ratio percentages (2013 – 9%; 2014 – 10%; 2015 – 11,3%), which is an evidence of the company's health.

² British Airways (2013) $281/11921 \times 100\% = 2,3\%$; (2014) $702/13426 \times 100\% = 5,2\%$
 easyJet (2013) $398000/4412000 \times 100\% = 9\%$; (2014) $450000/4482000 \times 100\% = 10\%$; (2015) $548000/4828000 \times 100\% = 11,3\%$

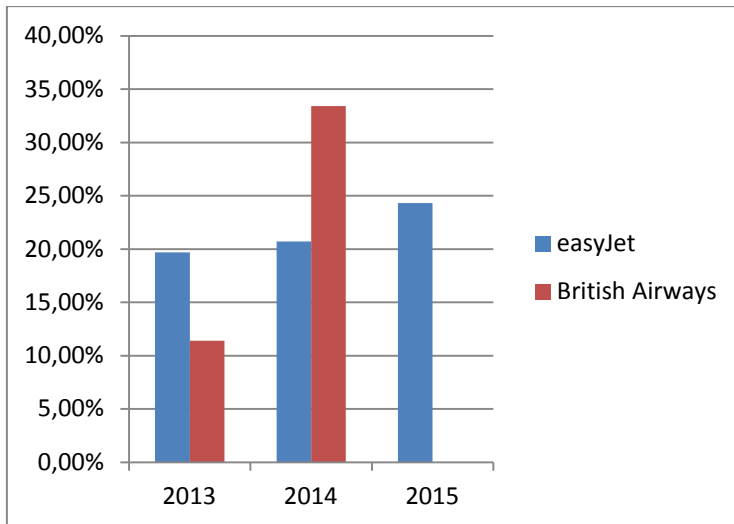


Figure 11: Return on equity ratio in percentage of easyJet and British Airways

(Source: own calculations³)

The next profitability ratio is return on equity. It determines how effective the company is in generating revenues from shareholders investments. The result of the year 2014 indicate that British Airways has a sharp increase in return on equity percentage (2013 – 11,4%; 2014 – 33,4%), which relates to the investments made by the airline in the past years. As the airline mention in the annual report 2014, it strives to concentrate on satisfaction of the customer and develop the operating performance, by investing more in technology, which enhances travelling. British Airways continue to “invest in technology, which is a key element to revenue growth”. (British Airways, 2014, p.4)

The analysis of return on equity ratio of easyJet between years 2013 – 2015, proves that the airline is following the right path, using the shareholders investments properly and increasing the revenue.

All in all, EasyJet demonstrates the strength of the strategy and its implementation, delivering a strong performance against the competitors. (easyJet, 2015) As the company underlines “with a track record of high growth across economic cycles, strong underlying demand, as well as our relatively low current market share, we continue to see opportunities to deliver further growth over the medium term”. (easyJet, 2015, p. 4)

³ British Airways (2013) $281/2455 \times 100\% = 11,4\%$; (2014) $702/2100 \times 100\% = 33,4\%$
 easyJet (2013) $398000/2017000 \times 100\% = 19,7\%$; (2014) $450000/2172000 \times 100\% = 20,7\%$; (2015) $548000/2249000 \times 100\% = 24,3\%$

Although, British Airways has faced serious crisis inside the company in past years, today at the recovery stage the airline show gradual development of operating performance of the airline and the increase in revenue, focusing on proper investments and management of costs.

5.3.2 Cash Flow Analysis

This section will give a deeper insight on the cash flow ratios of both airlines, providing the detailed analysis and comparison.

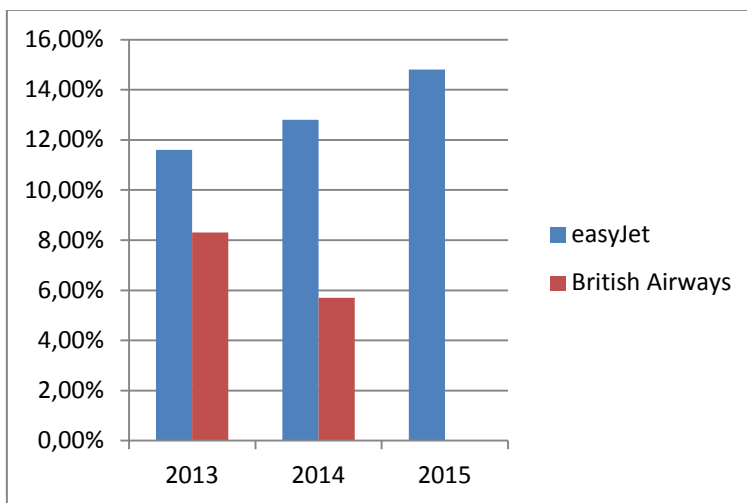


Figure 12: Operating cash flow ratio in percentage of easyJet and British Airways

(Source: own calculations⁴)

Operating cash flow ratio represents the ability of the company to produce enough cash to meet its obligations. (Hornrgren et al., 2012)

The drop in operating cash flow ratio percentage of British Airways (2013 – 8,3%; 2014 – 5,7%) is explained by large investments, which were made by the airline in years 2013 and 2014. The airline invested “more than £5bn in new airplanes, smarter cabins, elegant lounges, and new technologies to make life more comfortable in the air and on the ground”. (British Airways, 2013) Thus, the low ratio percentage in 2014 cannot be viewed as a bad sign, because the investments of the airline are expected to be paid-off and increase the revenue.

⁴ British Airways (2013) $975/11719 \times 100\% = 8,3\%$; (2014) $651/11421 \times 100\% = 5,7\%$
 easyJet (2013) $497000/4258000 \times 100\% = 11,6\%$; (2014) $583000/4527000 \times 100\% = 12,8\%$; (2015) $697000/4686000 \times 100\% = 14,8\%$

Referring to easyJet, the continuous ratio percentage growth (2013 – 11,6%; 2014 – 12,8%; 2015 – 14,8%), particularly the percentage increase in 2015, the airline explains by reducing the gearing to 14%, which additionally strengthen the balance sheet. (easyJet, 2015)

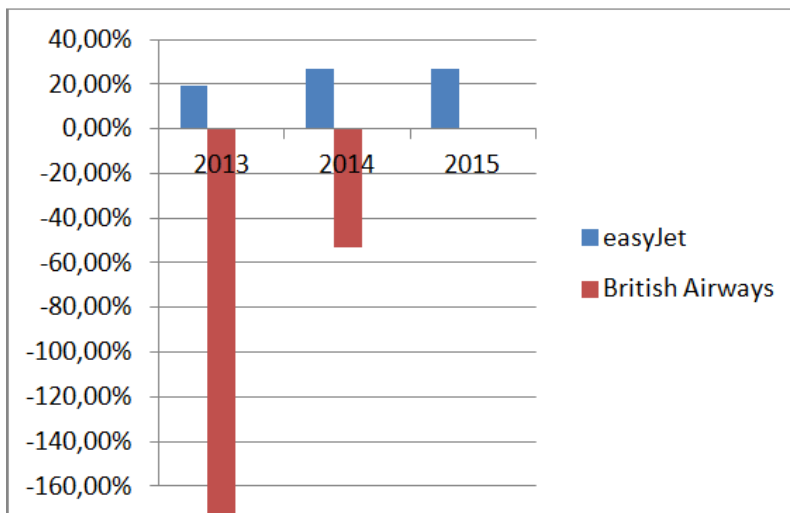


Figure 13: Free cash flow ratio in percentage of easyJet and British Airways

(Source: own calculations⁵)

Free cash flow assesses the amount of cash available from operations of the company after making projected investments in long-term assets and after paying dividends to the shareholders. (Horngren et al., 2012) Thus, free cash flow ratio tells the analyst how much free cash flow the company generates for every pound of operating cash flow. (Loth, 2016)

Figure 13 shows that British Airways has shockingly low ratio percentages (2013 – -155,4%; 2014 – -53%), which firstly force the analyst to think about tough financial situation of the airline. However, considering the fact that British Airways has changed the strategy and has made large investments, those results are understandable. In addition, it is important to notice that the difference in percentage between year 2013 and 2014 is vast (1501%), hence in year 2014 the airline is already compensating its expenses. Thereby, the absence of free cash flow in the company is seen to be temporary.

⁵ British Airways (2013) $(-10119)/651 \times 100\% = -155,4\%$; (2014) $(-519)/975 \times 100\% = -53\%$
 easyJet (2013) $97000/497000 \times 100\% = 19,5\%$; (2014) $157000/583000 \times 100\% = 27\%$; (2015) $188000/697000 \times 100\% = 27\%$

In contrary, the high ratio percentage of easyJet (2013 – 19,5%; 2014 – 27%; 2015 – 27%) implies that the company does not have high capital expenditure, meaning that the airline’s investments are minor than, for instance, British Airways’s investments. This directly correlates with strategy of the airline – to be viable in its operations, creating sustainable long-term revenue. (easyJet, 2015) Moreover, the airline’s management makes sustainable savings as a strategic move in order to cover unforeseen expenses and at the same time to keep the financial situation of easyJet under control. In 2015, the airline has experienced “cost pressures that include regulated airport price increases, increased de-icing costs and significant disruption costs” that have been diminished through £46 million of sustainable savings. (easyJet, 2015, p. 3)

The financial analysis of operating performance of both easyJet and British Airways in this chapter is intended to show the results of the operating performance not only each company in particular, but also enable to generalize those results to see how the business model of the airline in functioning. The outcomes of the analysis allow the thesis author to answer research questions and prove the fact that low cost airlines are showing better financial performance than traditional ones. The table below demonstrates the brief answers of the research questions based on the analysis results.

Research question ⁶ :	1.		2.
	easyJet	British Airways	Elements and factors that drive the result
Profit margin	High percentage and continuous increase from year to year	Relatively low ratio percentage with a slight increase from 2013 to 2014	<i>easyJet</i> : efficient management of expenses; <i>British Airways</i> : financial difficulties, fines, strikes;
Return on assets	High percentage and its annual growth	Low percentage with annual increase	<i>easyJet</i> : thoughtful evaluation of each decision; <i>British Airways</i> : financial crisis;
Return on equity	Sharp increase in percentage	Stable and increasing percentage	<i>easyJet</i> : proper use of shareholders investments; <i>British Airways</i> : previous

⁶ 1. Do low-cost airlines perform better financial results than traditional airlines?

2. What are the resources, elements and instruments that derive better financial results?

			investments are paid-off;
Operating cash flow	Continuous percentage growth and a particular increase in 2015	Percentage drop from year 2013 to 2014	<i>easyJet</i> : reduced gearing to 14% strengthening the balance sheet; <i>British Airways</i> : recent large investments;
Free cash flow	Stable high percentages	Shockingly low percentages	<i>easyJet</i> : no high capital expenditure, minor investments; <i>British Airways</i> : large investments made, thus absence of free cash flow is seen to be temporary;

6 DISCUSSION

In order to understand the real position and role of low-cost and traditional airlines, we can imagine the situation when EasyJet or another low-cost company like Ryanair is the only airline that is present in the market. The consequences of that situation can be severe. As long as low-cost companies are usually use secondary airports, the presence of the only one low-cost airline, which is not able to cover all the costs in airports used, can lead to massive bankruptcy and closure of great amount of airports.

Furthermore, aircraft manufacturers like Boeing and Airbus, would need to shorten or even close production of certain airplane types, for instance Boeing 747-400, Airbus A380-800, due to the fact that low-cost carriers mostly require only two or three types of the aircraft, such as Airbus A320, Boeing 737-800 and Airbus A319.

In addition, low-cost carriers, as it was described in the research, are using point-to-point flying model. In other words, this type of airlines is not flying to the long-distance destinations – they prefer to use connection flights. Hence, there is no possibility for a passenger travelling from London to Washington to take a direct flight, he/she would need make a transfer in another city airport, such as Reykjavik.

Thus, if we weight all the consequences of the situation above, it is easy to understand that the presence of only one or several low-cost airlines is ruinous not only for airline industry itself, for the travelers, but for the other industries that are in close connection.

Going back to a real situation at the market, there are some more interesting questions concerning the presence of low-cost and traditional airlines in the market. I would like to present two different schemas (*Figure 14, Figure 15*) and describe how the situation in market can change.

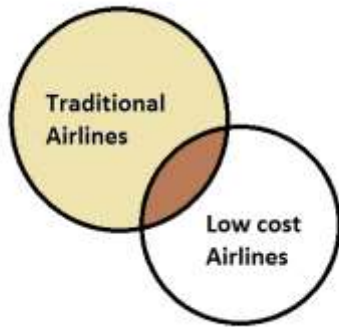


Figure 14: Assumption № 1 of presence of traditional and low-cost airlines in the market

Figure 7 is the first assumption of the situation in the market and correlation of low-cost and traditional carriers in closest years. This supposition has a positive effect on the market, because the intersection between different types of airlines is small-scale, which means that both traditional and low-cost airlines can operate in the market and make profit. In addition, the existence and development of low-cost carriers in this assumption will bring more customers to market as a whole leading to its expansion and economic growth.

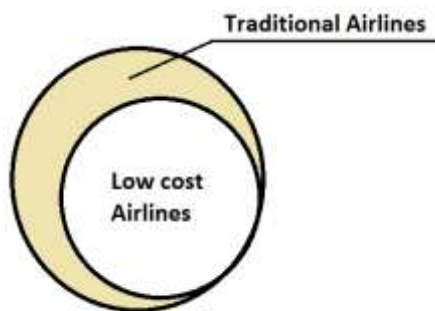


Figure 15: Assumption № 2 of presence of traditional and low-cost airlines in the market

As it can be seen on the Figure 8, there is no actual intersection of two types of carriers. In this assumption low-cost carriers almost eliminate the profit of traditional airlines, which leads to market collapse.

Eventually the author regards that the balanced presence of both traditional and low-cost carriers at the market will entail the healthy development of the market, airline industry and closely related industries. Moreover, that will make possible for all types of airlines to stay competitive and develop internally.

7 CONCLUSION

Airline industry is a seasonal industry, where revenue of the airline can be affected severely by instability of fuel prices or economic recessions. Thus, the competition amid the airlines is vast.

In order to resist the competition and be sustainable, the airline has to take in account the cornerstones of the industry, apply appropriate strategy and develop continuously.

Reviewing the investigation critically, the researcher regards that financial analysis as a tool of assessing the profitability of the company has certain interpretation issues. In other words, while using the financial analysis investigator must be aware of the high chance that the comparative data is distorted. This study has analyzed the operating performance of British Airways and easyJet, both airlines have different financial year end⁷, which has a direct impact on ratio analysis. easyJet's financial year ends at the end of the high season, hence the percentages of the ratios are initially higher than British Airways, whose financial year ends at low season.

Although, airlines follow the same accounting standards to disclose the data, certain variations in accounting treatment arise. Therefore, the result of financial ratios depends on the presence of the leased airplanes in the balance sheet as well as particular depreciation period for those planes.

Moreover, it is important to consider that extensive guidelines of IAS 7 upon the framework of cash flow statement still give a relative freedom of disclosure for the companies, which use that freedom according to company's interests.

Thus, the results of every comparative financial study, including this thesis, can be treated as a faithful assumption and not as complete affirmation.

The results of financial analysis of this thesis allow the researcher to make the following faithful assumption. easyJet has higher percentages in almost all ratio percentages that were calculated by the researcher, which is explained by careful examination of costs inherent to low-cost carriers business model. Thus, easyJet can be named an appropriate

⁷ British Airways financial year end – 31 December; easyJet financial year end – 30 September;

representative in order to compare the performance of low-cost carriers with traditional ones and answer the research questions.

However, British Airways is also a true representative of the traditional airline, thesis author regards that recent years of history of the airline with the management change and severe financial consequences do not allow treating the airline as an idealistic concept of traditional airline throughout the research. Thus, in the analysis of the results the researcher did not focus specifically on details of British Airways, generalizing the airline as archetype of traditional airlines business model.

Answering the first research question the study has proven that low-cost airlines perform better financial results than traditional carriers. In addition, responding to the second research question, the investigation showed that better financial results are the consequence of the strategy of low-cost carriers, the main aspect of which is the reduction of costs at the possible higher degree.

The predominance of low-cost airlines in the market leads to collapse of the market itself and the airline industry. Since, that situation will be harmful for the low-cost carriers as the market leader, the researcher regards that the prevention of the collapse can be reached by the creation of alliance of low-cost airlines or the appearance of absolutely new type of carriers, certain mix of traditional and low-cost business models.

7.1 Recommendations for future research

The future instigation of the topic can be broaden by:

- involving more airlines in the study, to get deeper insight on low cost and traditional carrier's business models as well as reducing the risk of drawing conclusions about the entire industry relying on a single airline company;
- covering the analysis of different regions across the globe to get the all-encompassing picture;
- researching on the environmental aspect of the airline performance, looking closer to eco-efficiency of low cost and traditional airlines.

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APPENDICES

Financial ratios detailed calculations.

British Airways

Numbers for airline are presented in £ millions.

	2013	2014
Profit Margin	$\frac{281}{11421} \times 100\% = 2,4\%$	$\frac{702}{11719} \times 100\% = 6\%$
Return on Assets	$\frac{281}{11921} \times 100\% = 2,3\%$	$\frac{702}{13426} \times 100\% = 5,2\%$
Return on Equity	$\frac{281}{2455} \times 100\% = 11,4\%$	$\frac{702}{2100} \times 100\% = 33,4\%$
Operating Cash Flow	$\frac{975}{11719} \times 100\% = 8,3\%$	$\frac{651}{11421} \times 100\% = 5,7\%$
Free Cash Flow	$\frac{-10119}{651} \times 100\% = -1554\%$	$\frac{-519}{975} \times 100\% = -53\%$

$$\text{Operating Cash Flow (2013)} = 11421 - 10770 = 651$$

$$\text{Operating Cash Flow (2014)} = 11719 - 10744 = 975$$

$$\text{Free Cash Flow (2013)} = 651 - 10770 = -10119$$

$$\text{Free Cash Flow (2014)} = 975 - 1494 = -519$$

easyJet

Numbers for airline are presented in £ thousands.

	2013	2014	2015
Profit Margin	$\frac{398000}{4258000} \times 100\% = 9,3\%$	$\frac{450000}{4527000} \times 100\% = 10\%$	$\frac{548000}{4686000} \times 100\%$ = 11,7%
Return on Assets	$\frac{398000}{4412000} \times 100\% = 9\%$	$\frac{450000}{4482000} \times 100\% = 10\%$	$\frac{548000}{4828000} \times 100\%$ = 11,3%
Return on Equity	$\frac{398000}{2017000} \times 100\% = 19,7\%$	$\frac{450000}{2172000} \times 100\% = 20,7\%$	$\frac{548000}{2249000} \times 100\%$ = 24,3%
Operating Cash Flow	$\frac{497000}{4258000} \times 100\% = 11,6\%$	$\frac{583000}{4527000} \times 100\% = 12,8\%$	$\frac{697000}{4686000} \times 100\%$ = 14,8%
Free Cash Flow	$\frac{97000}{497000} \times 100\% = 19,5\%$	$\frac{157000}{583000} \times 100\% = 27\%$	$\frac{188000}{697000} \times 100\% = 27\%$

Total Equity (2013) = 4412000 – 2395000 = 2017000

Total Equity (2014) = 4482000 – 2310000 = 2172000

Total Equity (2015) = 4828000 – 2579000 = 2249000

Operating Cash Flow (2013) = 4258000 – 3761000 = 497000

Operating Cash Flow (2014) = 4527000 – 3944000 = 583000

Operating Cash Flow (2015) = 4686000 – 3989000 = 697000

Free Cash Flow (2013) = 497000 – 400000 = 97000

Free Cash Flow (2014) = 583000 – 426000 = 157000

Free Cash Flow (2015) = 697000 – 509000 = 188000