THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

IAG.L - Q3 2017 International Consolidated Airlines Group SA Earnings Call

EVENT DATE/TIME: OCTOBER 27, 2017 / 8:00AM GMT

THOMSON REUTERS

CORPORATE PARTICIPANTS

Enrique Dupuy de Lôme Chávarri *International Consolidated Airlines Group, S.A. - CFO and Executive Director*

William Matthew Walsh *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

CONFERENCE CALL PARTICIPANTS

Anand Dhananjay Date *Deutsche Bank AG, Research Division - Research Analyst*

Damian Brewer *RBC Capital Markets, LLC, Research Division - Analyst*

Daniel Röska

James Edward Brazier Hollins *Exane BNP Paribas, Research Division - Senior Transport Analyst*

Jarrod Castle *UBS Investment Bank, Research Division - MD, Head of the Travel and Leisure Sector, and Co-Head of the Global Transport Sector Team*

Johannes Braun *MainFirst Bank AG, Research Division - Director*

Mark A. Simpson *Goodbody Stockbrokers, Research Division - Analyst*

Michael Kuhn *Societe Generale Cross Asset Research - Equity analyst*

Neil Glynn *Crédit Suisse AG, Research Division - Head of the European Transport Team and Global Transport Sector Coordinator*

Savanthi Nipunika Syth *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

Stephen Furlong *Davy, Research Division - Transport and Logistics Analyst*

PRESENTATION

Operator

Good day, and welcome to the Q3 2017 IAG Earnings Conference Call. Today's conference is being recorded. At this time, I would like to turn the conference over to Willie Walsh. Please go ahead.

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Thank you, and good morning, everyone. So, pleased to announce another strong quarter, third quarter of this year. All of our companies are performing well with improved operating profits and margins, and clearly, we're very pleased to announce our interim dividend yesterday of EUR 0.125 per share, which is 13.6% up on the EUR 0.11 that we announced this time last year. So I'm going to hand over to Enrique now to take you through the standard presentation. Enrique?

Enrique Dupuy de Lôme Chávarri - *International Consolidated Airlines Group, S.A. - CFO and Executive Director*

Thank you, Willie. Good morning, everybody, so as Willie said, another strong set of results for Q3 with an operating profit of EUR 1,455 million, which is exceeding last year's figure by EUR 250 million. A similar improvement as the one that we recorded on Q2. This time, we have had a combined positive FX impact worth EUR 37 million embedded in the EUR 250 million that I have mentioned.

So differently from last quarter, this quarter we have seen a low level of capacity growth for the group. And then here, 2 of our companies still growing, and I'm mentioning, Aer Lingus and Iberia; and other 2 companies reducing slightly as British Airways capacity or more intensively as the case is for Vueling. So a low capacity increase for the full group.

Passenger unit revenues in constant currency terms have improved by 2.2 percentage. And this is close to the underlying trend that we mentioned 3 months ago, it's the one we thought prevailing at Q2. When we aggregate to this passenger unit revenue performance, our other revenues, which have been strong, as you will see, especially in the case of Cargo and Iberia third-party business on MRO, we will be reaching constant currency total unit revenue improvement of quasi 3%, 2.9%. So this is also a strong performance for the group in Q3.

On the cost side, the outturn total constant currency nonfuel unit cost increase accounts for 2.5%. Again here, we have to mention that if we carve out the costs that are not related to ASKs, so in this quarter, especially, Iberia third-party MRO business, we will be getting to an underlying nonfuel cost increase, constant currency terms, of 1.4%.

When we bring into consideration the performance of fuel, our total unit cost has been decreasing in constant currency terms by 0.3%. So combining total unit revenues and total unit cost, our operating profit margin has been improving by 3.4 percentage points through Q3 in respect to the same period in last year. And even if we don't consider the fuel cost improved savings, so operating profit before fuel cost, have also increased by 1.7% if we compare them with the same result in 19 -- in 2016.

Getting now to a little bit closer explanation of our operating profits. In this next chart, we are showing basically passenger revenues and mostly related to the passenger price and mix has been responsible of a very significant part of the whole improvement of the quarter, EUR 129 million, together with the already mentioned nonpassenger revenues, again related to cargo improvement -- improved revenues and Iberia MRO business.

Fuel cost on -- in terms of price has also been still a tailwind for our performance in this third quarter.

And then on the ex fuel cost side, we'll be mentioning in the following chart impacts having to do with our employee cost, our supplier cost and our ownership costs. As a whole, together with this positive foreign exchange currency improvement of EUR 37 million is how we explain the EUR 250 million.

So getting to the ex fuel unit cost analysis. We start with employee costs. And here we have to mention that as I already stated, both in Vueling, especially in Vueling, but also in British Airways, capacity has been decreasing through Q3. And that's part of the responsibility of higher unit cost performance.

The rest has to do mainly basically, in the case of British Airways, with extraordinary low interest rate cost through the first quarter -- first half of the year, which have been the ones that we have been using as a reference for the calculation of pension fund charges. So with very low interest rate cost as a reference pension fund charges in British Airways have been increasing. Through the remainder of the year and probably through quarter 1 of next year, we'll probably be seeing a reverse in this trend because already reference interest rates, AA bond yields have been increasing since the reference that we have been using.

The other significant reason behind these employee costs have been about the variable pay awards. So last year of course, on a post-Brexit situation, variable pay awards were very low at this point of the year. This year, we've been accruing variable pay award bonuses, and that's the main reason that we are increasing our labor cost in British Airways.

For both Aer Lingus and Iberia, labor costs in terms of unit labor costs, have been improving through Q3, and again through a combination of efficiency and growth.

The rest of the costs that I think we will be mentioning have to do, on one side, with engineering. And engineering costs, again, have very much to do with increase in works being done by Iberia for third parties which have been also peaking through Q3.

Talking about selling costs, this is also an interesting type of performance. So basically, this quarter 3, we are recording the initiation of our new distribution model, basically have been the new distribution model with some of the incumbent GDS, especially Sabre.

The other source of increases in selling costs have to do with our -- the intensification of our commercial efforts on point of sale in the U.S. Point of sale in the U.S. has been proven to become a very interesting source of increased yields for British Airways and for the group. But selling costs, on the other side of the ocean, are higher.

Finally, ownership costs have been improving, although, there is a combined effect of lower depreciation cost and higher leasing cost, which result on a moderate increase. On outturn rates, the increase is practically 0. If we take into account constant currency terms, there is a mild deterioration.

So if we change into the next slide and get into the fuel scenario. Basically, what we are seeing for Q4 is still a mild improvement in euro terms at actual market prices in the prices of fuel and also in the value of the dollar. And this mild improvement in euro terms will also probably be the question for the first quarter in '18. Since then, we will be seeing a more breakeven situation against similar periods on year 2017. So basically, what we have to say is we are hedged for the last quarter of the year at 84%. And we are seeing a total fuel bill for the year which will be close to EUR 4.6 billion.

Getting to our capacity developments, as we show in the chart and have been advancing, both Iberia and Aer Lingus were growing through Q3, Iberia, 5.7%; Aer Lingus, 10.5%. And again Vueling was reducing their capacity by 6.6% and this compares with the disruption and difficulties affecting Vueling through the last year, same quarter. British Airways has been basically flat, slightly negative 0.5% through Q3, also affected by hurricanes and weather disrupting conditions through basically over September. What we are seeing for Q4 is coming back to a growth scenario, 4.3%, which will be making for the full year at 2.7%.

Talking about the different companies, we will be seeing Aer Lingus growing 11% in Q4; Vueling coming back to growth, 9.4%; Iberia, 4.9%; and British Airways is staying at that 0.9% increased capacity level.

So the pattern of growth that we are foreseeing for Q4 is probably more balanced in terms of frequency increases and the opening of new routes. So especially in the case of Aer Lingus and also Vueling, the balance would be maybe more towards increases in frequency, that's also the case for Vueling with a 12.3 percentage of frequency increases if we compare them with the opening of new routes.

Opening of new routes for British Airways will have to do with Santiago de Chile, New Orleans, Oakland and Fort Lauderdale. In the case of Iberia, it mainly has to do with LEVEL routes, so you know about Oakland and Los Angeles and República Dominicana and Buenos Aires.

So we get to capacity and unit revenues. So capacity has been explained, has been 0.9% for the group. There has been an increased capacity both in North Atlantic and South Atlantic. And this has very much to do with increased capacity and growth that both LEVEL and Aer Lingus have been achieving through the period.

In the case of domestic performance, in terms of capacity has been modest increase. And Europe has been experiencing a significant reduction, minus 3%, basically related to Vueling capacity adjustments.

Asia Pacific has been mildly reduced by 1.3%. And Middle East and South Asia has been improving capacity by 2.6%.

In terms of unit revenue performance, both the domestic and the European networks have been improving significantly unit revenues. And that has very much to do with the strong routes between Spain and Europe through the quarter.

Asia Pacific has had very strong performance in terms of unit revenues as well, and we have to mention here basically strong performance of Japanese routes both for British Airways and Iberia, and also stronger performance of China. Most of China routes have been improving unit revenues against the same period last year.

Worth to mention, very significant improvement in unit revenues in Latin America. And this one is basically related to the South Cone countries. So it has to do basically with Brazil recovery, but also Argentina, Chile and also Colombia, and this is basically affecting Iberia, LEVEL and British Airways as well.

The North America performance appears to be slightly negative. But then we have to take into account that unit revenue here is basically affected by the averaging of the growth in Aer Lingus and LEVEL. As you know, the average unit revenues of these 2 companies are significantly below the average of the group, and that's why the mix is getting affected. Without considering LEVEL impact and Aer Lingus and also the opening of new routes, the North America unit revenue performance would have been positive, slightly above the 1% level.

If we follow now the performance by our different products and segments of business, we have to take into consideration, in the long haul, the strong performance of premium traffic. And this is basically affecting British Airways and Iberia. And this is something that has to do with the strong performance of our corporate and business traveler segments of business. And I have to say that's something that we are seeing also flowing into Q4.

Long haul nonpremium, again, we have to mention to the, I would say, averaging negative impact of both Aer Lingus and LEVEL, which economy class content into their flights, it's much, much higher than the average.

If we carry through the short-haul business, again, we need to recognize the strong performance of both Iberia and Vueling, and this is again having to do with the strength of the Spanish market and also the intra-European market, we have to say.

On the nonpassenger side, again, the significant improvement, that has to do with Cargo performance. And this is the second strong quarter of Cargo performance through year 2017, also again Iberia MRO business.

So if we get to the performance in terms of operating profits and ROIC, which we regularly show in this chart, we have to recognize a significant improvement across the board. So if we make this reference to adjusted operating margin, lease-adjusted operating margin, for the group it has been improving by 3.6 percentage points and reaching in Q3 a margin of 23.1%, which is what I would say a record margin for the group.

In terms of ROIC and then referring to the last 4 quarters, we also are getting record figures at 16.3%, which is 1.2 percentage points above the same reference last year.

And then when we go through our different companies, we are recognizing significant improvements across the board. I think we need to mention that especially the 11 points -- percentage points of improvement in operating margin for Vueling in Q3. And we have to recall that this improvement is greater and, I would say, significantly greater than the fall that we were accounting for Vueling in Q3 last year because of the heavy disruption in their operations. So Vueling is achieving ROIC figure of 13.7% versus 9.7% in the relevant period last year.

For Iberia, again, 2.7% improvement in operating margin. And again, 1.5% improvement against ROIC last year and up to 13.5% for British Airways plus a 2% improvement in operating margin and reaching 16% at the level of ROIC. And Aer Lingus holding ROIC at 22.9% even through this very significant growth in terms of ASKs. So a very profitable quarter for Aer Lingus.

Getting to below the operating profit line, there's no major issues or surprises this quarter. So we see a positive and a negative in reference to last year Q3. The negative has to do with, last year, we had an extraordinary gain having to do with a sale and leaseback transaction on our A319 fleet, creating some positive capital gains. The negative last year and positive this year has been ForEx, and as I told you, ForEx impact for the group has been turning positive against, of course, a negative situation post Brexit in Q3 year 2016.

So as a whole, profit before tax and preexceptional has been reaching EUR 1,436 million, so a 22.5% increase against last year. Tax ratio has been getting to 20%, so very similar to last year. Profit after-tax improving to EUR 1.146 billion. This is preexceptional again. And fully diluted earnings per share, preexceptional, for the period, improving by 19.4%. So very strong improvement figures on these metrics through the quarter.

Balance sheet. Again, improving our financial strength. In balance sheet, net debt getting to a very low figure of EUR 55 million, after including notional value of aircraft leases capitalizations, we are getting to an adjusted net debt of EUR 7.183 billion. And when we get to adjusted net debt to EBITDAR, the ratio has been falling since the beginning of the year from the starting 1.8 to the 1.4 at the end of September. So again, a very strong performance in terms of the deleveraging of balance sheet.

So as a whole, the guidance for year 2017, full year, at current fuel prices and exchange rates, we are expecting an operating profit for the full year to be around EUR 3 billion before exceptional items.

So thank you, Willie (inaudible).

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Okay, thank you very much, Enrique. I now hand back to the operator and we'll take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) We will now take our first question from Jarrod Castle from UBS London.

Jarrod Castle - *UBS Investment Bank, Research Division - MD, Head of the Travel and Leisure Sector, and Co-Head of the Global Transport Sector Team*

Just a couple of questions. Firstly, just on the guidance for around EUR 3 billion. Just given the performance that you did last year in Q4 and the current run rate, I mean that would suggest over EUR 3 billion. So just a bit of color for why you're kind of sticking around the EUR 3 billion mark rather than over the EUR 3 billion mark? Secondly, you spoke a little bit about U.S. point of sale. And I'd be interested to get some color in terms of how the marketing relationship works in the U.S. with American Airlines? And what costs they pay versus what costs you pay for the marketing effort? And then lastly, any further update on your views when it comes to airberlin and now Monarch?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Obviously, our guidance is our guidance, and I'm not going to add any color to it. So we're clear in terms of the challenges, if you like, that we face in the fourth quarter. Fourth quarter's going to be good, and we are expecting positive unit revenue. The one thing that I would say and Enrique mentioned this in relation to third quarter is the bonus provision. So clearly, our performance this year is better than our performance last year. Last year, we would have released provisions as we went through the year. And this year, clearly we're making provision for bonus payments. So that's -- that is the difference between this year and last year. In terms of the U.S. point of sale, the point that Enrique is making is that the distribution charges that we have in the U.S. are higher than we would have in the U.K. And this is the, if you like, the structure of the arrangements with the GDSs. It's not a uniform charge. So as we switch the point of sale and have more volume being sold in the U.S., it comes at a higher cost of distribution. So this is, if you like, a BA charge. It's nothing to do with the joint business versus the GDS charge that we would have in the U.K., which is significantly lower. And that's the difference in the cost of distribution. It's a GDS cost. And in relation to airberlin, we -- as you know, we said publicly that we did make a bid for parts of airberlin, principally the parts that went to Lufthansa. It was NIKI that we were interested in. We're not participating in any of the residual aspects of airberlin. And I understand from media reports that, that's something going on between airberlin and easyJet. And I think there may be 1 or 2 other parties involved in that, but we're not involved in it. We're clearly going to watch with interest how the competition regulators view the Lufthansa acquisition of NIKI in Austria and the residual parts of airberlin in Germany to see what remedies they believe are appropriate. I've seen comments from the Austrian government. So there's going to be, I think, a lot of interest in how competition regulators assess the situation. But in general, we're now just observers to the process. We're not in any way involved in the process.

Jarrod Castle - *UBS Investment Bank, Research Division - MD, Head of the Travel and Leisure Sector, and Co-Head of the Global Transport Sector Team*

And any comments on Monarch please, Willie?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Yes, so on Monarch we are interested in the Gatwick slots, we did have conversations with the administrator. We are aware, as everybody is now, that ACL has determined that the administrator doesn't have the right to sell those slots. And that is being now challenged through judicial review.

I'm not sure whether that process will be able to run in time. Our understanding is the slot conference that will distribute or assign the slots at Gatwick will be done in early November. So we'll see what happens there. But if there are slots available at Gatwick, we're certainly interested in slots, whether that's through an acquisition from the administrator of the Monarch group or through allocations from the slot pool at Gatwick. So we will be making requests for additional slots at Gatwick through the normal process as well as looking at the alternative of purchase of slots from the administrator if that situation changes.

Operator

Our next question is from Stephen Furlong from Davy.

Stephen Furlong - *Davy, Research Division - Transport and Logistics Analyst*

Maybe you can just give me some color, just talk about the competitive dynamics on the transatlantic market, both inbound and outbound, premium and nonpremium. I know your U.S. airlines have been pretty positive on the market. And then just secondly, maybe for Willie, I mean, you might touch on it next week so -- but obviously the returns across all the airlines are very good and at record levels. Do you think that's kind of broadly -- where do you think we are in terms of the cycle of the market really in terms of returns?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Okay. We are pretty positive about the transatlantic as well. Corporate activity is good and I'd say it's slightly stronger than we had expected. The issue, as Enrique pointed out, is the dilutive effect of the growth in Aer Lingus and in LEVEL. Aer Lingus is obviously now a higher proportion of our total capacity and revenue on the transatlantic and will continue to grow at a strong pace and significantly ahead of what BA and Iberia will do. And clearly, we are committed to growth in LEVEL, which is proving to be very attractive. We will announce, probably towards the end of November, early December, where the 3 additional aircraft for LEVEL will go. We won't be announcing that at capital markets, I think it's probably going to be the end of November or early December. So we see the transatlantic performance has been good. The demand environment is good. U.S. point-of-sale is good. U.K. corporate activity is good. Right across the board, I think this is a positive situation. Aer Lingus is facing increased competition out of Ireland, but that competition is clearly struggling from a profitability point of view. And when you compare that to what Aer Lingus is doing with very strong growth and maintaining margins, in fact growing its operating margin, maintaining its ROIC, it just shows you the difference between the Aer Lingus model and the other airlines that are trying to compete with them. And in terms of returns, yes, we will talk more about this next week at Capital Markets Day. But our view is that there's still more to come here. We don't believe we're anywhere close to the peak in terms of margins. We set ourselves challenging ROIC targets and operating margin targets. We are clearly exceeding those and exceeding those by some distance at the moment. And we believe that there is more to come. And we'll give you visibility and color around this when we talk to you next week.

Operator

Our next question is from Daniel Röska from Bernstein Research.

Daniel Röska

Two questions from me, please. First on the intra- European market where you slowed down ASK growth or are not growing. Competitors are growing a lot faster intra Europe. And I think 2 parts to the question, number one, how do you think about your intra-European exposure in the next 1 to 2 years? And how important do you think a pan-European point-to-point proposition is for you in the medium- to longer-term? And then the second question on international, we talked about North America, maybe towards China and especially also Asia Pacific, what will be your outlook in terms of capacity growth there? How much do you think will you accomplish with organic growth? How are you thinking about partnerships and joint ventures on those routes, especially to China, maybe through Finnair, through Qatar, basically, how are you viewing that market also on a medium-term outlook?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Okay. I think some of the questions you've asked would be better addressed next week, but let me just talk about intra EU. We made it clear that we were going to correct some of the network issues that Vueling experienced last year, which led to like a cascade effect of disruption following the air traffic control strikes that particularly impact them given the number of their flights that go through French airspace. And I think you can see that this year, in fact, ATC regulations in Europe this year were higher than last year and yet Vueling's performance significantly better. They have outstripped the competition at Barcelona, direct competition from Ryanair, easyJet and Norwegian in terms of punctuality and regularity. So it shows the strength of the network and clearly that is also now reflected in the strength of their profitability in the quarter. And while some of our competitors are pursuing higher growth, they're also doing it at a ridiculous cost, they're facing increased disruption. In the case of some of them, they're having to do at expensive wet leasing, which I don't think is sustainable. And we are very clear that this is a growth market for us but we're going to grow in a manner that is positive from a profitability and margin point of view. So I see lots of airlines pursuing rapid growth at ridiculous cost. It's not a sustainable situation. And we're not going to participate in that. We've learned from our experience that while the growth figures may look impressive, the profitability figures look very unimpressive. And I think you'll find more and more airlines will do what we've done this year and will calibrate their growth to what it is they can do within their own means. So you're aware of a particular strong airline in the low-cost segment in Europe is out there, desperately looking for wet lease capacity for next year. They're so desperate that they're actually asking us for capacity. So when I see this going on, I really do question why some of our competitors are pursuing the growth that they're doing, because they clearly can't do it within their own resources and will incur very significant additional costs to sustain it. On China and the rest, we'll talk more about this next week. But China, for us, is about organic growth. We're doing some code sharing with other carriers into China, but we're not looking at any joint ventures at this stage.

Operator

Our next question is from Neil Glynn from Crédit Suisse.

Neil Glynn - *Crédit Suisse AG, Research Division - Head of the European Transport Team and Global Transport Sector Coordinator*

If I can ask 2 questions, please. Firstly, the headline pricing on the transatlantic is getting some attention this morning, but it does seem the pricing underlying looks actually quite similar to your U.S. peers despite their product upgrades. But the investments in U.S. point of sales, which is on a couple of prevailing concerns. One, is part of that investment designed to bridge the gap until you make a final decision on the next generation for Club World? Or conversely, does it help absorb challenges in the U.K. point of sale given consumers spending question marks? So just interested in your views on that given they are topical concerns at the moment. And then the second question, just interested in your take on capacity plans for LatAm versus APAC at the moment. Clearly, both markets are enjoying recovery. How do you weigh up the opportunities there? And who's best to serve them, whether it be Iberia, LEVEL or British Airways?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Okay, thank you. Pricing on the transatlantic underlying is good. As Enrique said, if you strip out the dilutive effect of Aer Lingus and LEVEL and recognizing as well that British Airways launched 3 new transatlantic routes that are in this quarter, the revenue performance is positive, slightly over 1%. So we are -- we see this as a solid market, solid performance. We have outlined in general terms our plans to upgrade the product on the transatlantic. Some of those upgrades have already started with the new catering proposition in Club World and feedback on that is extremely positive. We will give further detail on the cabin configuration that you'll see when we give the presentation. Alex will outline that next Friday. And other initiatives that we're doing. So this is a very important segment for us, but it's one that's performing very well and our positioning is one that we are very comfortable with at the moment. Some of our competitors have decided to improve their product offering. But despite some of the media hype around this, they still haven't got it on much of their operation. So we are competitive, and we believe going forward we'll be more than competitive both in terms of the product, the network and the overall customer proposition. And on LatAm, yes, the market is good, the economic environment is positive. Iberia clearly has very strong position and good growth opportunities. And LEVEL, as we've seen with the performance in Buenos Aires, has been stunning. So we are really pleased with that. So I think we see underlying demand in Latin America being very positive. We were a bit bearish on the economic situation in Brazil. I think that was -- we were cautious and maybe we were a little bit behind others. But the Brazil environment is certainly more positive this year than we thought it would be. And as Enrique mentioned, we're seeing that in Argentina, Colombia and Chile as well. So I think the growth opportunity is principally Iberia, LEVEL, but there is some BA growth opportunity as well.

Neil Glynn - *Crédit Suisse AG, Research Division - Head of the European Transport Team and Global Transport Sector Coordinator*

Understood. Just to follow up on that, how concerned are you for next year that the market as a whole throws a lot more capacity into a recovering LatAm market?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

No. We are not concerned. In fact, I think we've been quite positive about the trends that we've seen so far this year and what we see for next year. There clearly will be more capacity but the underlying demand I think continues to be very strong and will justify the capacity. So we're not seeing any evidence at this stage of activity that would be considered irrational. I think everything that we've seen so far and based on what has been publicly stated in terms of next year looks perfectly rational to us given our take on the underlying economic environment there and the impact that, that's going to have on demands through 2018 and 2019.

Operator

Our next question is from Mark Simpson from Goodbody.

Mark A. Simpson - *Goodbody Stockbrokers, Research Division - Analyst*

Three questions. One, if you could give us your view on capacity growth looking out over the medium-term 2018, 2019? Then if you'd be willing to do that by brand as you sort of currently look at that. CapEx, this year and next, maybe just an update. Obviously you've had a bit of a CapEx holiday this year. Just wondering if there's any changes into next. And then I think probably Aer Lingus as a component of that ex BA, Iberia North Atlantic yield decline. Can you just tell us what the yield development has been at Aer Lingus over the last quarter? And how you see that shaping up into next year?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Okay. Well, your questions I think are more appropriate to next week, and we're going to outline all of those. So we will give you visibility in terms of capacity CapEx. Just in relation to Aer Lingus, the Aer Lingus unit revenue on the transatlantic clearly declined this year versus last year. That's the plan. With the capacity that they are putting in there, the profitability of Aer Lingus has improved. So Aer Lingus' model is very clear. The value proposition that they have involves them being able to continue to reduce their unit cost, which is what they have been doing. So they've had a very strong unit cost performance. And that enables them to be even more price competitive. And the fascinating thing about Aer Lingus, is Aer Lingus goes into these new transatlantic markets, and is profitable from the very beginning. It's not the traditional model of where they need to be on the market for some time to move the route into profitability. And that, I wouldn't say it's a unique feature of Aer Lingus business model, but it's certainly a strong feature of the Aer Lingus business model that they can launch these new routes and be profitable from day 1. So as we've mentioned, that does have a dilutive effect on the reported unit revenue, but that is the business model that Aer Lingus has. And it's a business model that we support. And it's the reason why you've seen Aer Lingus knock it out of the park in terms of the ROIC that they've reported so far and that will continue to be the case with Aer Lingus. It is sustainable. And so there's a lot of work to be done there. But the business model that they have is sustainable and has proven to be very effective.

THOMSON REUTERS

Mark A. Simpson - *Goodbody Stockbrokers, Research Division - Analyst*

Just following that up, can you identify specifically on the unit cost front where the biggest wins have been seen? And why that structurally is so successful?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

We'll talk more about this, but I'm not going to educate my competitors on how to do it. But clearly, they've got a very effective aircraft model that works extremely well for them. And that is sustainable because of how they can use the 321LR -- or the combination of the 330-200, 330-300 and going forward, the 321LR given their geographic position is something that, for us, demonstrates that the model is a sustainable one for them.

Mark A. Simpson - *Goodbody Stockbrokers, Research Division - Analyst*

So it's aircraft type as the same with the success of LEVEL?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

There's a lot but aircraft type is one of the positives that Aer Lingus has. But it's performing well. They work hard to do it. It's a very impressive model, but There's a lot of hard work behind the scenes. But their cost base is competitive and the aircraft utilization that they get and going forward aircraft utilization they will get so the asset utilization, the asset turn, the capital that they have invested in the business, these are all important parts of the business model and they are all very effective.

Enrique Dupuy de Lôme Chávarri - *International Consolidated Airlines Group, S.A. - CFO and Executive Director*

I guess being neighbors of Ryanair for so long have also helped them to be really efficient and lean to survive. That's how they're getting there.

Operator

Our next question is from Damian Brewer from Royal Bank of Canada.

Damian Brewer - *RBC Capital Markets, LLC, Research Division - Analyst*

Two questions please again, sorry, coming back to North Atlantic, if I can ask the question a slightly different way. Obviously, did see ex FX RASK down 3.1%, but given the mix of businesses, could you give us a feel for what the unit cost ex fuel did on Atlantic given the growth of LEVEL and Aer Lingus. And also given the comments from American Airlines yesterday, can you give us a little bit more flavor or elaboration on what happened with the premium versus nonpremium cabin RASK? And then the second question, just probably one for Enrique, but again going back to that sort of balance sheet slide, the lease utilization of the business has gone up, clearly that's something to do with LEVEL and some of the other expansion there. But could you talk a little bit more about how you're thinking more generally about lease versus buy either for Q3 or in a more structural context?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

So unit cost performance of the transatlantic, I'll go back to what I said. If you look at Aer Lingus, the business model is -- assumes the unit revenue reduction, but the unit costs reduce greater than the unit revenue, which increases the margins, and that's what they've done. Same with LEVEL, the unit cost reduction is very significant. The unit revenue clearly is lower. But the reduction in unit cost outweighs the reduction in unit revenue and that leads to margin growth, and that's what we see on the transatlantic for us. The premium demand, as I've mentioned earlier, we've seen good premium, particularly U.K. corporate activity. So the general comment I would have on the transatlantic is that the market is performing strongly. Capacity overall, we think, is benign in an overall context, certainly in the markets that we are operating in. In the Aer Lingus context, clearly, there has been growth there from competitors but also significant growth from Aer Lingus. Aer Lingus growth is probably outstripping the competitors' growth and they're gaining market share and they're doing so while improving their margins. And so overall, we are pleased with the way the North Atlantic is operating. Many of the underlying trends and comments that you hear from American are similar to ours. What is different in our model is the operation of Aer Lingus and LEVEL, that's different to, if you like, the traditional transatlantic network of British Airways and Iberia, American, United, Delta, Virgin and all of these. But it's appropriate for the markets in which they're operating in, and it's clearly a successful model that -- as we have demonstrated. In terms of the balance sheet, Enrique?

Enrique Dupuy de Lôme Chávarri - *International Consolidated Airlines Group, S.A. - CFO and Executive Director*

Balance sheet and the lease, probably that's something that we will expand on the Capital Markets Day, because it's more of a strategic type of question. But very, very briefly, as you know, we have a general guideline around new deliveries, 50-50. But this one is every time fine-tuned through basically 3 considerations. On one side, it's about flexibility needs in each fleet. Secondly, it's about residual value exposures that we need to control and mitigate; and thirdly, it's always about the rationale -- financial rationale of buy or rent decisions. So these 3 pillars are the ones that we use to fine-tune this general rule of 50-50 proportion. We will tell you more on the Capital Markets Day.

Damian Brewer - *RBC Capital Markets, LLC, Research Division - Analyst*

Okay. Can I just come back to Willie's response on the North Atlantic? Could you, again, could you say a little bit more the ex, the growth impact in North Atlantic RASK was up 1%. Was the differential of the premium traffic versus the average similar to Q3 '16? Or actually above or below it in Q3 '17?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

It was from memory, I'd need to check for this, slightly above, from memory. But the bottom line on the transatlantic is that, although we said that the unit revenue declined constant currency, our profitability improved.

Operator

Our next question is from Anand Date from Deutsche Bank.

Anand Dhananjay Date - *Deutsche Bank AG, Research Division - Research Analyst*

I was wondering if you could update us on the BA pension situation or your latest thoughts on that, we've had a couple of other large U.K. corporates like BT saying some interesting things about what they're looking to do. So just wondering if there is anything you can comment on there? And then secondly, might be a bit more Capital Markets Day, but on the cost side, if sort of for BA in particular, if lower growth is kind of the way forward, do we need to reassess the rule of thumb for the group of sort of minus 1 is what we aim to do every year? And separately, if we're going to have to keep -- if we need to keep ex-ing out other revenues and other costs, is there something you're looking to do with that going forward?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Okay, there's not a lot I can say in pension because we're in consultation and clearly that's an ongoing process and will continue for a number of weeks yet. And I think we need to respect that consultation. So it would be inappropriate for me to comment in relation to that. On the cost, the cost target that we have for the group continues, and it is a target. There will be years where we won't achieve it and there will be years when we will exceed it. But what we're saying is that we set ourselves a target for a nonfuel unit cost reduction of 1% annually. The business plan that we've just completed and approved by our board includes that target in it. We believe that, that is achievable. It is something that we are focused on.

And as I've said, it's one that we look at, if you like, over a period of years. We are not driven to do it in any one year because we think that there will be years when it's appropriate for us to have a different actual target than that. But the 1% nonfuel unit cost reduction through our business planning cycle is still the target that we have for the group, and that has not changed.

Anand Dhananjay Date - *Deutsche Bank AG, Research Division - Research Analyst*

And then, just -- sorry, on the other revenue, other costs?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Oh, yes, sorry -- we're conscious that this is something that we've talked about quite a lot. And we've said the 2 main areas that impact on the nonfuel unit cost that are non-ASK related are British Airways Holidays and Iberia MRO and both of these are profitable parts of the business. So we continue to give you color around it and we continue to debate internally whether there's a better way of stripping it out to give you a clearer visibility on the underlying nonfuel cost performance that is related to ASK. So we'll have a continuing look at this. It is a challenge we have internally, and we accept that it's something we comment on every quarter, but we will give you more detail when we talk to you at Capital Markets next week.

Enrique Dupuy de Lôme Chávarri - *International Consolidated Airlines Group, S.A. - CFO and Executive Director*

One of the problems we have to deal with is, especially with MRO third-party revenues is it's basically a very opportunistic approach. So we really are filling the gaps of our scheduled maintenance programs for the different fleets through third-party business. So that one is really difficult to plan in the medium, long term. But we're trying to find solutions to get to more type of smooth performance in terms of projecting revenues and costs, and we'll be getting back to you with our solutions.

Operator

Our next question is from James Hollins from Exane.

James Edward Brazier Hollins - *Exane BNP Paribas, Research Division - Senior Transport Analyst*

Two for me, please. Just if you can update us on the mixed fleet cabin crew deal, I think I read somewhere that it seemed to be coming to a successful conclusion, perhaps let us know where we are on that. And the second one is just interesting on obviously the Aer Lingus growth on long haul has been fairly sort of mix effect dilution on overall RASK. Should we expect something similar in intra Europe next year from Vueling growing proportionally much more than BA and Iberia assuming around 10%? Is that sort of dilution impact going to be quite significant or relatively minor?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

The negotiations with the Unite officials concluded I think a couple of weeks ago and it is going to ballot with a strong recommendation for acceptance. So we remain positive in relation to the mixed fleet issue. In relation to the intra EU growth next year, I think the one comment I would make is that we see the capacity environment being more positive next year because of obviously the consolidation that has taken place and the comments that some of our competitors have made around pulling back on capacity plans because of internal issues. So we don't think that the Vueling growth next year will be as significant as what we've commented on, on the transatlantic. So we think Vueling will be able to grow in an environment that should exist in Europe next year that will be generally positive for efficient carriers who can operate their capacity plans within their own means. So as I said, I think for us, we're looking at improved profitability in our intra EU operations next year.

Operator

Our next question is from Johannes Braun from MainFirst.

Johannes Braun - *MainFirst Bank AG, Research Division - Director*

Three questions for me, 2 on the cost side, one of the revenue trend. Firstly, on the unit cost development going into next year, how do we have to think about this after this year was not as good as the minus 1% target? So any update on the phasing of Plan de Futuro II and the measures in MRO and also in the GDSs and all the other measures you gave us at the past Capital Markets Days? And secondly on labor, obviously union talks are still going on at Aer Lingus, can you please give an update on those, especially I think the Aer Lingus pilots have pretty ambitious demands here? And then lastly, would you be able to give us the RASK performance of BA only on the transatlantic in Q3?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

No, we don't split out the unit revenue performance by operating company. So we're not going to do that. In terms of unit cost, I go back to what I said, a lot of the plans that we announced we are very clear that our initiatives where we're bearing the cost now but we will see the benefit in the future. So as you see in Q3, we've made provision for second phase Plan de Futuro with Iberia and we'll see the benefit of that plan coming through over the coming years. It's not a 2018 or 2019, it's actually through to I think 2021, 2022 that we'll see the delivery of that. I go back again to reinforce the comments we've continued to have a target in the business for nonfuel unit cost reductions of 1%. We won't achieve that every year. It's clearly easier to achieve in a year where you're pursuing stronger growth. This year, our growth was pulled back quite a bit from what we would have traditionally seen. But we believe it's achievable. And if you look at it through a cycle, what you'll see is that we will not just achieve it, but we believe we can exceed it. So we think it's a relevant target. It's easier for some of the airlines in the group than in others, but it's an appropriate target and it's one that we're sticking to. And you'll see evidence of that when we talk to you next week at Capital Markets Day. And in relation to labor issues, I don't want to comment. These are ongoing issues, but we remain confident in relation to our ability to address these issues and to reach negotiated agreements with our labor group. So we tell you when the results of these come through and the actions that we are taking. But we are positive in relation to the initiatives that we have.

Operator

(Operator Instructions) We will now take our next question from Savi Syth from Raymond James.

Savanthi Nipunika Syth - *Raymond James & Associates, Inc., Research Division - Airlines Analyst*

Three questions for me. First one just I know you mentioned that the business trends on the transatlantic, just wondering generally if you can comment on kind of the recovery in business demand and maybe where we are in the recovery versus the declines that we've seen more recently? Second question, I know that some of the pilot issues that we've been hearing at one of your competitors seems to be more of an internal item, but just wondering as you look at the next kind of 2 to 5 years, are you -- how comfortable you are with kind of supply of pilots for the various businesses? And if you see any issues there? And then the last question just given your comments on Spain and being strong and I'm guessing kind of the Catalan issues haven't really had an impact but just wondering what your thoughts are on that from a demand perspective and as well as from a corporate perspective?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

The transatlantic, the only issue that we've commented on in terms of transatlantic business demand was post the referendum on Brexit. So in the lead up to that probably going back to May '16 through to maybe the end of the year, but certainly, through October, November of '16 we saw softening U.K. corporate activity, but that has recovered and fully recovered. So we're back to what I would describe as normal levels of corporate activity on both sides of the Atlantic. And it's generally a positive environment. On pilots, I started in this industry 38 years ago as a pilot. I heard then that there was a shortage of pilots. 38 years later, I still haven't seen this. We are not seeing any issue in terms of supply. All of our airlines are recruiting pilots. There's plenty of capacity in the markets, good quality. We haven't seen any issues. I don't think anybody is, to be honest with you. I think the issues are specific to airlines that have pursued strong growth where they need captains. So it's not a pilot issue. For some people, it's being that they haven't been able to get their copilots promoted fast enough to fill the left-hand seat, and that's I think the bottleneck and it's probably specific to a number of airlines. But we've not seen any issues. And looking forward, I don't see any issues developing, to be honest with you, based on what we see in terms of supply in the markets and our projected demand. But we have not encountered any challenges recruiting pilots into any of our airlines in the group. And Spain, I think it's fair to say that there has been some impact in Barcelona, but it's really pulled down the rate of growth. We're still ahead of last year, but maybe it's not as strong as it would have been. So it's having a -- I would describe it has been impacting at the margins, it's not of any significance at this stage. And we believe that Barcelona will continue to be a very attractive destination and indeed very attractive origin and are absolutely committed to our strong presence to Barcelona through all of the airlines in the group, but particularly through Vueling where Barcelona is their hub airport. So we're clearly watching it like everybody else, but we are not really seeing any issues at this stage.

Operator

Our next question is from Michael Kuhn from Societe Generale.

Michael Kuhn - *Societe Generale Cross Asset Research - Equity analyst*

Two questions also for me. Firstly, on current trading. How do your current forward load factors compare with the same point of time 1 year ago? And the second one, probably a bit unpopular question, still Brexit negotiations don't seem to progress that well. How do your current contingency plans look like? And what would from your point of view be a best-case outcome and a worst-case outcome? Maybe a few thoughts to share here.

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Current booking trends are in line -- slightly ahead of last year. So there are certainly -- we are not seeing any trends there that would cause us to comment. So everything we're seeing at the moment is perfectly in line with what we would have expected to see and is with the issue that I mentioned about Barcelona slightly less than maybe we were seeing. But we've been seeing very strong growth at Barcelona, we're still positive. In terms of Brexit, there'll be an outcome and we will continue to fly. So we're not looking at best case, worst case. Whatever the outcome is, we will manage our business, manage it without any difficulty. And it's the great thing about the airline industry, we've had plenty of practice of managing these sort of things. So we're confident that the negotiations around aviation will be dealt with and will enable us to operate exactly as we have been. It may -- it has required some other airlines to do different things. You've seen Wizz apply for a U.K. AOC, easyJet apply for an Austrian AOC, we don't need to do that. And so we're not making those sort of contingency plans because we have structures in place that are already appropriate. So we don't need to do anything on that level of hand. We'll leave this to the politicians to resolve it. But I'm confident that there'll be a comprehensive agreement between the U.K. and the EU on air travel. And we'll wait to see what the details of that are. But it's something that we believe will enable us to continue to operate as we currently do and isn't in any way interfering with any of the plans we have for the group.

Operator

(Operator Instructions) Our next question is a follow-up from Anand Date from Deutsche Bank.

Anand Dhananjay Date - *Deutsche Bank AG, Research Division - Research Analyst*

Just a couple more follow-ups. On NDC, could you update, so I think we started to see the costs coming through from that, one of your competitors is very bullish on the prospects. I think your technology at BA is actually better. Can you give us an update on what you're thinking and what kind of time frames you're thinking that the benefits start to come through? And then on cash flow, it feels like for this year you should have an excess, over EUR 500 million. Any acquisitions you make that seem to be available won't really make much of a dent in that. With Brexit and where we are in the cycle, can you give us a sense of where you stand on do you just sit with that on balance sheet at this point in time? Or is it still likely to come out in February?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

On NDC, what we're seeing is with one of our GDS suppliers, we are back to rack rates as of the 1st of August and that goes to what Enrique said about the increase in distribution charges. We are clear that the transition involves an increase in cost, and it's partly behind what we see in our nonfuel unit cost increase. That's exactly as we had expected. So this is, in the short and medium term, is not a cost reduction issue. In fact, it will add to our costs. And I think that's what you're seeing the GDSs saying, that it's not going to impact on their revenues, but they'll see revenues increase, which is what I would expect to see but it's short term. And then the situation changes. And it very much develops into what we want which is revenue and customer proposition which will be much more positive for us going forward. So yes, I've been very clear. We'd like to have a relationship with the GDSs, but we think the traditional model is no longer fit for purpose, and we need a model that works to the future and not one that's structured around the past. And we remain confident that our actions and initiatives in this will be positive for the group looking at the medium to long term. And cash flow, we say this all the time. If we have an excess of cash and we're not clear on something that is specifically positive for the group in terms of the use of that cash, then it goes back to our shareholders. And that's something that we will discuss with you when we release our full year results at the end of February, which is consistent with what we did last year. I think in terms of the share buyback this year, we've completed about EUR 430 million of the EUR 500 million, so we expect that to clearly be completed before the year-end. And if when we release our full year results, we are still in a situation where we have an excess of cash and we do have an excess of cash, let's be honest, well then -- we'll tell you what we're going to do with that. And if it's not something that we're going to use, then it's shareholders' cash and the only debate then is the manner in which that gets returned to shareholders. So as I said, we look forward to having that discussion with you in February.

Anand Dhananjay Date - *Deutsche Bank AG, Research Division - Research Analyst*

Yes, Willie, sorry on the NDC issue, so we know that so yes, I wasn't clear, so costs go up in the short term. But in terms of getting that back on -- fully flexible pricing, upgrading people, giving them more things that they can buy, does that start to offset it in year 1? Or is this a more longer-term revenue benefit?

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Yes. It's probably year 2. So we see this as an investment in the first year and return from the second year onwards. So transition costs, there is -- we've already had some investment in the technology, but we would see this as a payback starting in the second year. And we've not changed our view in relation to that.

Operator

That will conclude this Q&A session. I would like now to turn the call back to the speakers for any additional or closing remarks.

William Matthew Walsh - *International Consolidated Airlines Group, S.A. - CEO and Executive Director*

Thank you. So it's a good quarter for us, strong underlying demands, very pleased with transatlantic performance, pleased that we are pursuing the growth that we are doing in a very efficient way with margin improving in all of the groups. And clearly, we've already exceeded the long-term targets for ROIC and operating margin, and we are clear that this is sustainable and we'll grow on it into the future and we look forward to talking to you next Friday at Capital Markets Day. So thank you very much for joining the call.

Operator

Thank you. That will conclude today's conference call. Thank you for your participation. Ladies and gentlemen, you may now disconnect.