
AerLingus

The man ...

Andrew Macfarlane joined Aer Lingus as CFO in December 2009. Prior to his appointment he most recently served as chief financial officer of Rentokil Initial. His early career was with Ernst & Young, and he has held the position of chief financial officer at Land Securities Group plc and Holiday Inn.

Established in 1936, Aer Lingus Group Plc is the flag carrier of Ireland. The company employs 4,000 people and in 2010 had revenues of EUR 1.2 billion. Aer Lingus flew 9.3 million passengers in 2010.

By Steven Arons

The sky over Dublin is a brilliant blue. But the clouds hanging over the Irish economy are dark and threatening. Just a day earlier, the rating agency Moody's slashed the country's sovereign rating, reducing it to junk status. The headlines at the news stands are screaming; Ireland is stunned. The decision is a severe setback for the country.

In spite of the bad news, Andrew Macfarlane remains calm. "[An Irish default] is not my core expectation," says the CFO of Aer Lingus, one of Ireland's best-known companies. Indeed, Mr Macfarlane is eager to set the record straight on his home country. "Ireland has a few things going for it. Export performance has been good, especially in the IT and pharmaceutical sectors," he says. "The Irish government has been very serious about its austerity measures. The performance of the economy so far in 2011 has been pretty much where they expected it to be." The IMF's latest World Economic Outlook report, issued in April, forecasts Ireland to grow at 0.5 per cent this year, barely above stagnation, after contracting by 7.6 per cent in 2009 and by 1 per cent last year.

An extreme assumption

If the worst-case scenario were to unfold, the impact on the Irish flag carrier would be extremely painful. "I imagine consumer behaviour would be very defensive and demand would go down significantly," Mr Macfarlane says. This plunge in demand would come hard on the heels of last year's decline in passenger numbers – to 9.3 million, down from a peak of 10.4 million in 2009.

These numbers notwithstanding, the CFO insists the aftermath of a default would be manageable. "[O]nce debt would have been restructured, which I would presume to happen rather quickly, things would start to go back to normal," he says.

The Cloudy Skies of Ireland

Aer Lingus is under the triple pressures of the eurozone debt crisis, rising fuel prices and relentless competition from Ryanair.

CFO Andrew Macfarlane tells FINANCE how the Irish flag carrier is coping with the enormous challenge.

He also points out that Aer Lingus is fairly insulated against the threat of rising borrowing costs: "We're in the happy position of having significant net cash, and most of our debt [...] is at fixed and fairly cheap rates."

Rather than dwelling on the worst case, Mr Macfarlane draws attention to the fact that Aer Lingus is set to benefit disproportionately from an Irish recovery. "The change in our passenger numbers tends to be twice the change in GDP," he explains. "We have a large fixed cost base so a good part of top-line growth goes straight through to the bottom line." The strong reaction of demand to a better outlook, he says, is rooted in Ireland's culture. In spite of its small population of only about 4 million, the country plays host to many of the world's largest aircraft leasing firms and is home to two major airlines, Aer Lingus and Ryanair. "The Irish love to travel," he says, with the average adult boarding an airplane up to five times as often as other Europeans per year.

Their passion for air travel aside, the Irish have not been easy customers for Aer Lingus. The ascent of low-cost carrier Ryanair, now Europe's highest-volume passenger airline headquartered a stone's throw from Aer Lingus at Dublin airport, has made Irish tourists extremely sensitive to ticket prices. A formidable rival has been created who competes with Aer Lingus on a whopping 85 per cent of the latter's routes.

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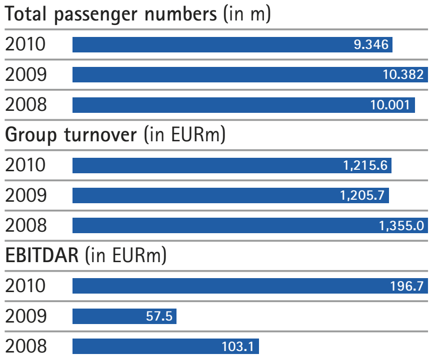
Ryanair's success also propelled the Aer Lingus, which celebrates its 75th anniversary this year, into an ill-fated attempt to emulate the low-cost competitor. Due to Ryanair's "structurally lower cost base", says Mr Macfarlane, the strategy was doomed to failure, resulting in deep losses in 2008 and 2009 and the replacement of the entire top management in 2009. The current CEO, Christoph Mueller, joined Aer Lingus in September 2009, followed by the appointment of Mr Macfarlane to the CFO post three months later.

Having abandoned its copycat strategy under the new CEO, Aer Lingus is now seeking to reposition itself between the low-cost carrier on the one side and what it calls the "full-service flag carriers" on the other. The fundamental aim of this strategic overhaul is to cater simultaneously to both the Ryanair-conditioned Irish tourists and the less price-sensitive business travelers >>

Moving figures: Aer Lingus in numbers



Source: Aer Lingus

An uncertain outlook: an Aer Lingus A320 lands in front of the new Terminal 2 at Dublin Airport.

Getty

on their way to London. "The same physical equipment served by the same crew has to work equally well for the visiting friends and relatives versus the businessperson," Mr Macfarlane explains. "At the core is a reasonably-priced, comfortable seat. If you're prepared to pay for more, we'd like to give you the opportunity to buy extra services."

A margin climb

Early signs suggest the new strategy is paying off. Yield per passenger, a key performance indicator for Aer Lingus, soared in 2010, with average fare per short-haul passenger climbing by 11.4 per cent and per long-haul passenger by 19 per cent. However, with fuel prices rising again – crude prices have surged from a low around USD 70 per barrel last year to a high over USD 120 earlier this year – the carrier's profitability is expected to remain flat or even sink in 2011 and beyond, the CFO cautions. Higher airport charges at Dublin and Heathrow, its two most important hubs, are also buffeting the carrier and compounding the need to whittle away at its cost base.

The Irish propensity to spend their money on flights was also the cause for the construction of a gleaming new terminal at Dublin airport, inaugurated last November, which has raised the passenger capacity of the airport from 18 to around 30 million passengers a year. At the time the project was commissioned, during the heydays of the Irish boom, that much capacity seemed like a reasonable investment. Over 23 million passengers passed through the hopelessly overcrowded airport in 2007, making it one of Europe's most dreaded. But then the bubble burst – and the number of passengers plunged to a mere 18.4 million last year, in some ways giving the new terminal the atmosphere of a large grocery store during night hours. Albeit bad news for the airport operator DAA, the emptiness actually makes for a pleasant and easy travel experience. Few airports in Europe can boast shorter queues.

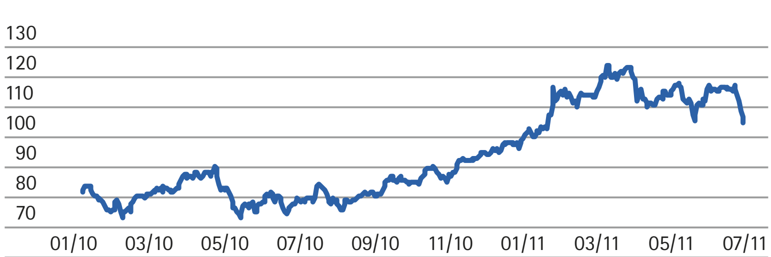
It's his job

The twin challenge of fostering Aer Lingus's transformation into a "value carrier" while adapting the new strategy to a steep reduction in demand has been taking up almost all of Mr Macfarlane's time. But bringing down costs is no easy feat for the Irish flag carrier. Fuel prices can be hedged, which the CFO has been doing with reasonable success, but are impossible to influence. Airport charges, the third largest cost factor after fuel and staff expenses, are regulated and thus equally difficult to cut.

As a result, most of the carrier's cuts have been in capacity. The rejuvenation of its aircraft fleet has been postponed, routes have been cancelled and labour costs slashed. This included a 10 per cent pay cut for all but the lowest earning employees and 300 layoffs from a total staff of around 3,500, thereby reducing staff costs by 17 per cent in 2010.

The combined measures, collectively labelled the Greenfield cost reduction programme, have produced good results. In spite of the Irish debt meltdown, Aer Lingus returned to the black in 2010, achiev-

Dangerous curves: Brent crude price (in USD)



Source: BP

ing an operating profit of EUR 26.6 million. Although the carrier did dive back into the red in the first quarter of 2011, it was an incredible overall reversal considering its operating losses of EUR 170 million and EUR 161 million in 2009 and 2008, respectively. Even if the turnaround owed much to falling fuel prices, it is undeniable that the increase in efficiency has been pronounced.

Strike looms

Confident in a recovering Irish economy, Mr Macfarlane hopes to avoid further cuts to capacity, for good reasons. Such moves would not only jeopardise Aer Lingus's ability to benefit from an upswing; further staff reductions would also threaten to rekindle restive labour relations with its cabin crews. A bruising conflict with IMPACT, Ireland's largest services trade union, cost the airline an estimated EUR 15 million in the first quarter of 2011 after the union reneged on an agreement signed in 2010. Asked if he worries about future unrest if further staff cuts had to be implemented, Mr Macfarlance only comments that the "substantial dispute with our cabin crew [is] behind us now".

The reluctance with regard to further staff cuts does not mean Mr Macfarlane has abandoned his relentless pursuit of tapping potential savings. His next big project: finding a remedy to the carrier's notorious seasonality. "We fly about a million passengers in our busiest month, July, but only 600,000 in February," he says. "At present we have too many short-haul aircraft in winter. We want to know whether we can rent them out to someone who has the opposite seasonal demand." Though implementation of the plan is unlikely to be quick enough to begin this coming winter, the CFO sees a good chance of that happening the following year.

In view of Aer Lingus's vulnerability to rising fuel costs – a change in price by one dollar raises or reduces costs by around USD 450,000, the carrier estimates – raising efficiency is high on the CFO's agenda too. For example, instead of purchasing Airbus A330 aircraft, Aer Lingus will buy the A350s, he says. The latter model costs between EUR 236.6 million and EUR 300 million, or 15 to 50 per cent more than the A330 according to Airbus list prices, but consumes 15 per cent less fuel. "We're very sensitive about the price we pay for an aircraft," he explains. "But 15 per cent of fuel savings is absolutely worth it. Every tonne of fuel that we don't burn saves us a thousand dollars." He adds that Aer Lingus has a list of 23 initiatives to help them reduce their fuel consumption, including cleaning the jet engines and using lighter trolleys.

Incidentally, raising fuel efficiency has the pleasant side effect of enhancing Aer Lingus's green image and preparing the carrier for the introduction of the so-called EU Emissions Trading Scheme (ETS) to the aviation industry. This new scheme will force airlines to pay for carbon emissions that are in excess of a free allowance, which Mr Macfarlane projects to cover around 90 per cent of their total emissions, though the EU will not publish the precise proportion of the allowance until September. The CFO expects this to shave between EUR 5 and 10 million directly off of his bottom line – and adversely affect Aer Lingus's competitiveness if non-EU airlines succeed in their fight for exemption from the scheme. "What we don't want to do is find ourselves competing with a carrier on the same route who doesn't have to pay carbon taxes," he says.

A side question

However, the introduction of the ETS does not amount to much more than a little afterthought. What really counts for Mr Macfarlane and Aer Lingus is whether the Irish will soon have the economic certainty again to start spending their money. The fact that many passengers on return flight EI 656 from Dublin to Frankfurt buy a sandwich and a drink – the complimentary snack having fallen victim to the Ryanisation of the Irish aviation industry a long time ago – demonstrates that people are willing to pay for extra services. But will they reach for their wallets often enough for Aer Lingus to withstand the triple onslaught of Ryanair, the eurozone crisis, and rising commodity prices? The question hangs in the air as the A320 ascends into the blue sky. ||

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