Perspectives: Outlook for the Brazilian Aviation Market

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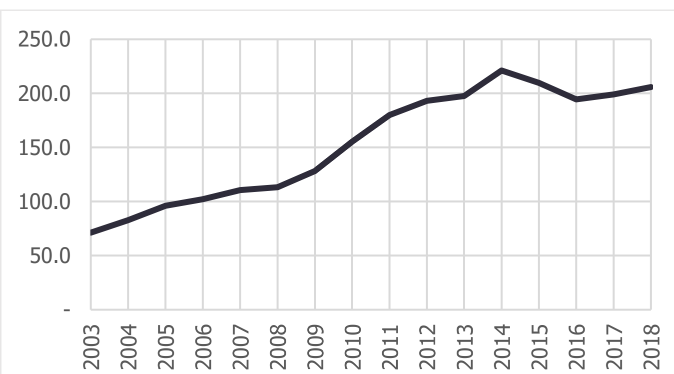
Introduction

Demand at Brazilian airports is in its third year of sustained growth. In the near term, demand growth will vary by airport dictated by airline network capacity allocation. Smaller airports will benefit from the evolution of airline business models from more linear route structures to hub-and-spoke networks. The dynamics of evolving airline partnerships such as LATAM – Delta and Iberia's proposed acquisition of Air Europa will benefit larger airport markets. Finally, the deployment of the Airbus 321 LR and XLR will benefit markets in the North and Northeast of Brazil.

Signs of a Sustainable Recovery in Brazil

Following the political and economic crisis that beset Brazil, total passenger traffic decreased 12.1% from the record set in 2014 of 221.1 million to 194.4 million in 2016 as shown on the graph below. Passenger traffic at Brazilian airports began to increase again in 2017, a trend which continued in 2018 as passenger traffic reached 205.8 million. Passenger traffic continues to post increases through the first eight months of 2019. Demand at Brazilian airports will continue to increase so long as the Brazilian economy continues to expand, but performance will vary by airport dictated by airline network capacity allocation.

Total Passengers (Millions) – Brazilian Airports

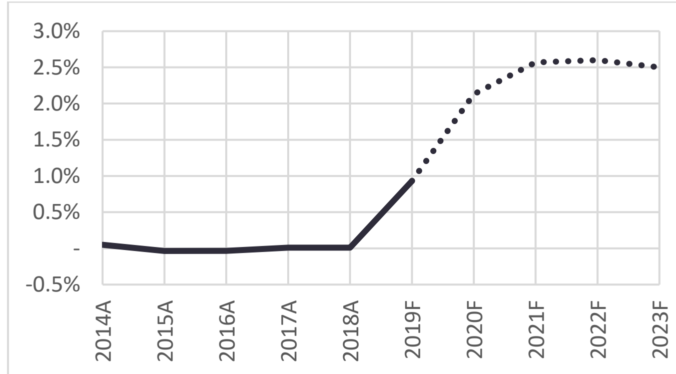


Sources: INFRAERO and BSB, CNF, FLR, FOR, GIG, GRU, POA, SSA, and VCP airport websites.

The Brazilian Economy

Increases in passenger traffic are consistent with a return to increases in economic activity as measured by Brazilian Gross Domestic Product ("GDP") by the Brazilian Central Bank. Economic growth has been positive in 2017 and 2018 as shown on the graph below, and has built momentum during the first half of 2019.

Annual Growth of Brazilian Gross Domestic Product



Source: Brazilian Central Bank, 8 November 2019.

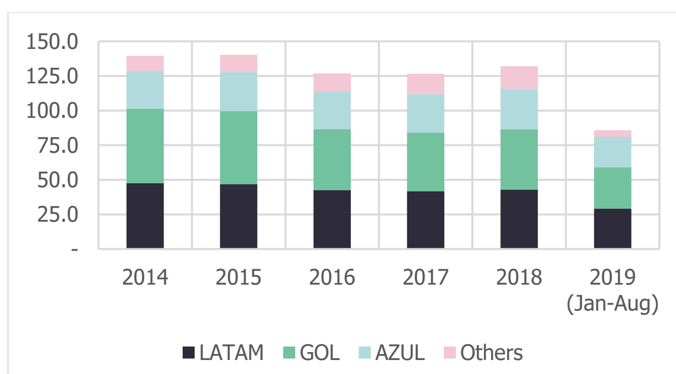
The Brazilian Central Bank forecasts that the Brazilian economy will increase 0.9% in 2019, and between 2.2% and 2.5% from 2020 through 2023. With positive increases in economic growth, the environment is right for a return to sustained increases in passenger demand.

Airline Capacity Developments

In addition to economic growth, increases in supply of airline seats are required to accommodate additional passengers. The structure of the airline industry in Brazil has changed over the last four years. The outlook for the key airlines will cause passenger growth among Brazilian airports to be uneven in the near term.

The graph below and the table that follows illustrate the evolution of airline seat capacity at Brazilian airports and airline market share. In 2018, departure seats remain below peak levels in 2014 and 2015. In 2019, departure seats have been negatively impacted by the demise of AVIANCA Brasil and the Boeing 737 Max grounding.

Brazilian Airport Domestic Departure Seats (Millions)



Source: ANAC

Brazilian Airline Domestic Seat Share

	LATAM	GOL	AZUL	Others
2014	34.1%	38.6%	19.5%	7.8%
2015	33.4%	37.6%	20.1%	8.8%
2016	33.6%	34.6%	21.3%	10.5%
2017	33.0%	33.3%	22.1%	11.6%
2018	32.5%	32.9%	22.2%	12.4%
2019 (Jan-Aug)	34.0%	34.7%	25.7%	5.6%

Source: ANAC

The Evolution of Airline Network Models

For the vast majority of Brazilian airports, a growing economy and the evolution of airline fleets and networks will drive increases in passenger activity. To date, LATAM and Gol have operated a narrow-body domestic fleet focused on the largest sixty or so markets in Brazil. They serve these markets well, but high growth opportunities will continue to come from serving smaller markets with smaller turbo-prop equipment, and international markets with a combination of narrow-body and wide-body equipment.

Azul has a unique network serving a broader array of markets, which has contributed to the airline's growth and diversified revenue streams. Realizing the network and revenue opportunity in smaller markets, Gol recently signed agreements with Two Flex to coordinate activities in the state of Rio Grande do Sul, the middle-west, and the North of Brazil, and with Passaredo to provide connections to smaller markets. In the past, LATAM has coordinated with airlines such as Pantanal, which it bought in 2009, and Passaredo to develop smaller markets. It is only a matter of time before Gol and LATAM, or new airlines, take advantage of these opportunities.

- The merger of LAN and TAM into **LATAM** formed the largest airline in Brazil and South America, but one that has a management bias toward yield improvement rather than growth.
  - LATAM has focused its Brazilian operations on its international gateway at São Paulo's Guarulhos International Airport ("GRU"), and domestic hub at Brasília's Juscelino Kubitschek International Airport ("BSB").
  - LATAM's proposed partnership with Delta Air Lines and concurrent exit from the oneworld alliance should result in additional seat capacity between Brazil and North America as the new partnership competes with American Airlines for Brazil – North America demand.
- **Gol** has a partnership with Air France-KLM and is expanding its network at GRU to improve connections with its partners. Gol is also focused on bolstering its domestic hub at BSB. Gol is widely expected to negotiate a partnership with American Airlines to improve its competitive position vis-à-vis LATAM and Azul to North America. The airline's breadth is limited by its all Boeing 737 fleet, including 7 MAX's that remain grounded.
- **AVIANCA Brasil** ceased operations, and its assets are being sold and reallocated to other airlines, particularly Azul. It bears note that AVIANCA-TACA, headquartered in Colombia, is going through a restructuring led by a new management team largely from the former TACA organization that is focusing the company's operations in Central America and Colombia while reducing capacity in other countries including Peru.
- **Azul** merged with **Trip**, and now serves the most cities of any airline in Brazil. The airline has a versatile fleet that includes turbo-props, Embraer regional jets, Airbus narrow-bodies, and Airbus wide-bodies as shown on the table below. Azul is unique among Brazilian airlines in that it has regional operations that allow it to serve smaller communities with more limited demand efficiently. Azul is in a growth mode having acquired take-off and landing slots at São Paulo's Congonhas Airport ("CGH") and Rio de Janeiro's Santos Dumont Airport ("SDU") formerly operated by AVIANCA. The airline is building its market position at GRU to leverage its relationships with TAP and United Airlines, and is rumored to be joining the Star Alliance.
- **Passaredo** acquired **MAP Linhas Aereas** in August; both regional airlines that operate ATR turbo-prop aircraft. The MAP network is focused on North region in Brazil, while Passaredo's is focused on a base in BSB and smaller markets in the states of Sao Paulo, Mato Grosso, Minas Gerais, and Bahia.

Brazilian Flag Passenger Airline Fleets

Airline	Wide-body	Narrow-body	Regional jet	Turbo-prop
AZUL	10	34	59	33
GOL	--	132	--	--
LATAM	32	128	--	--
MAP	--	--	--	7
PASSAREDO	--	--	--	6

Sources: Airline Investor Relations sites, airfleets.net, planespotters.net.

Airports with Near-term Upside

São Paulo – The State of São Paulo has reduced fuel taxes from 25% to 12% to incentivize new routes, and created opportunities for airlines to add 490 new flights per week to 21 states and to inaugurate six new routes in the State of São Paulo.

GRU – In 2017, domestic and international traffic at GRU exceeded previous records set in 2014, set new records in 2018, and has posted increases in domestic and international passenger traffic in the first seven months of 2019. This extremely strong performance is a result of Azul, LATAM, and Gol all adding capacity at GRU as well as the airport attracting new service from foreign airlines.

CGH – Since 2003, passenger traffic has nearly doubled at CGH, reaching 22.0 million passengers in 2018. While aircraft operations were only slightly higher in 2018 than 2003, airlines are operating higher-density aircraft with higher occupancy factors, which has allowed for the strong passenger increases at the constrained airport. In addition, INFRAERO has reallocated general aviation slots to commercial airlines over time, allowing for more airline operations.

Last July, ANAC redistributed AVIANCA´s slots at CGH to Azul, MAP, Passaredo, and Two Flex. Turbo-prop aircraft will be able to use the secondary runway, which will increase aircraft operations at the airport. Following its merger with MAP, Passaredo started to operate from CGH to seven airports in Sao Paulo, Minas Gerais, Mato Grosso do Sul, and Rio de Janeiro within twenty-six frequencies, effectively creating a regional hub at CGH.

CNF – Passenger traffic has experienced strong growth as Azul has increased service at Belo Horizonte's Confins International Airport ("CNF"). In 2018 CNF accommodated 10.6 million passengers, having added one million passengers since 2016. Azul is able to connect passengers from small markets in the states of Minas Gerais, Rio de Janeiro, and São Paulo to major domestic and international markets. Unlike Gol and LATAM, the airline is able to optimize volume and revenue to and from markets of all sizes by virtue of a fleet that includes aircraft from turbo-props to wide-bodies.

REC – Record traffic of 8.4 million passengers were accommodated at Recife's Guararapes Gilberto Freyre Airport ("REC") in 2018. The airport serves as a regional gateway and hub to the Northeast Region, with Azul providing service to a variety of large and small markets on turbo-prop and jet equipment. Additional capacity to Europe and North America will likely result if (a) Azul joins the Star Alliance, (b) Iberia successfully acquires Air Europa, and (c) airlines, particularly TAP and American Airlines deploy the Airbus 321 LR and XLRs to markets in the North and Northeast of Brazil.

FOR – Fortaleza's Pinto Martins Airport ("FOR") reported that strong performance has been driven by additional international capacity offered by Air France-KLM and their partner Gol. Should Gol negotiate a partnership with American Airlines, or should Iberia successfully acquire Air Europa, additional capacity to North America and Europe are likely.

Markets with Longer-Term Upside

Other markets will experience more muted increases in passengers in the near term, but as the underlying demand in the markets increases and airlines invest additional capacity, the passenger performance will increase.

- **Petroleum Based Economies** – Rio de Janeiro, Vitoria, Campos, Macaé, and Cabo Frio have significant amounts of demand related to the petroleum industry. Should oil prices rise, demand in these markets will increase as the economics of drilling for oil will incentivize more extraction and refinery. There are significant opportunities for the airports serving the off-shore oil platforms in the State of Rio de Janeiro.
- **Tourism Based Economies** – Rio de Janeiro, Florianopolis, and markets in the Northeast of Brazil are likely to benefit from the elimination of the visa requirement of United States Citizens entering Brazil.
- **Airline Fleet and Network Plans** – Brasília and other airports dependent on Gol and LATAM for capacity increases will have delayed increases in capacity. After the Boeing 737 MAX aircraft return to the skies, Gol will add a significant amount of capacity that is likely to benefit BSB and FOR. As LATAM adjusts its management bias more to include more growth, BSB is likely to benefit.

Conclusion

Demand at Brazilian airports will continue to increase so long as the Brazilian economy continues to expand, but performance will vary by airport dictated by airline network capacity allocation. Smaller airports will benefit from the evolution of airline business models along with hub and gateway airports in the near term. Airports in markets reliant on petroleum-based and tourism-based demand will see upside in the longer term. The Airbus 321 LR and XLR aircraft will create new international opportunities to Europe and North America from the North and Northeast of Brazil.

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Ken heads Skylark's Americas operations. Having successfully managed projects throughout Asia, the Caribbean, Europe, the Middle East, and North and South America, Ken is an expert in activity forecasting and business plan development. He focuses on legal and economic analysis of airline and airport issues, with particular emphasis on operating economics, the regulatory system, and the international competitive framework of the industry. He also has a wealth of experience in the use of aviation statistics to forecast aviation activity, air service development, and airline and airport revenue and cost issues.

Ken earned a Juris Doctor from the University of Texas School of Law, and a Bachelor of Arts in Economics from Wesleyan University.

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About Skylark

Skylark is a management consultancy established by senior transportation and infrastructure experts in May 2018, forming a team with decades of experience in the industry as both practitioners and advisers. As a fully independent consulting business, the team represents one of the leading global transaction consultants in the aviation, marine and infrastructure sectors.

The team has established a strong track record working for private-sector clients, government-related clients, IFIs, and commercial banks for significant airport, ferries and other related transportation sale processes and developments. Skylark’s approach to the execution of strategic and transaction projects is comprehensive, with a deep understanding of the critical drivers for both the passenger experience, client returns and risk evaluation. The team includes people with backgrounds in retail development, investment banking, financial advisory, transaction advisory, transportation and air traffic forecasting, airport operations, airline strategy, and government regulation.

Skylark provides consulting services on a global basis. Its staff have extensive experience in Europe, Asia, Africa, North America, and Latin America, with offices in London, New York, and San Francisco, and an expert network based in Athens, Boston, Washington, and Sao Paulo.

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