The flight is not over yet

- Despite a 137% price increase since 2011, we initiate our coverage of IAG with a BUY recommendation, given our 2017E fair value of 9.21 euros per share. This corresponds to an upside of 27% compared to the company's share price on the 29th of December 2017.

- IAG’s total revenues grew at a compound annual growth rate of 7% since foundation in 2011, being expected to grow at a 3.7% CAGR until 2022. This is mainly driven by an estimated capacity (ASK) increase set at 4.4%.

- The company's airlines will see jet arrivals to their fleets that will boost their networks and financials, by increasing fleet frequencies and destinations at lower unitary costs (CASK).

- The capacity expansion plan comes as a response to greater passenger demand (RPK), related with improved economic conditions forecasted across the company’s operating regions.

- We value IAG using the APV method, forecasting revenues and capacity of each subsidiary individually, while estimating the company's consolidated expenditures. Our price target is based on a Ru of 7.4% and a terminal growth rate of 1.5%.

Company description

International Consolidated Airlines Group, S.A. engages in the provision of international and domestic air passenger and cargo transportation services. The company is present in major European hubs located in the United Kingdom, Spain and Ireland, from which it offers services to the rest of the world. IAG operates a fleet of 551 aircraft flying to over 280 destinations, being its main subsidiaries British Airways, Iberia, Vueling and Aer Lingus.
Company overview

Company description

International Consolidated Airlines Group, S.A is an airline holding that combines airlines headquartered in the United Kingdom, Spain and Ireland, while operating several aircraft fleet services, covering the short, medium and long-haul transportation segments. The company, through its subsidiaries, is engaged in providing airline marketing, airline operations, insurance aircraft maintenance, storage and custody services, air freight operations and cargo transport services. IAG offers its services from major strategic European hubs, including London, Madrid, Barcelona, Dublin and Rome, running operations from its headquarters in London, while being domiciled in Spain for tax purposes. The company’s brands include British Airways, Iberia, Vueling, Aer Lingus, IAG Cargo, Avios and Level (created during 2017).

British Airways is the largest company within the group, accounting for 61.5% of the holding’s revenues estimated for 2017, while Iberia represented nearly a fifth of the total (19.8%). The more recent Vueling and Aer Lingus accounted for 9.3% and 8.8%, respectively, while revenues from the Others represented 2.7% (IAG Cargo and Avios). Most of IAG’s passenger traffic is intra-European, with the Domestic\(^1\) segment and other Europe jointly accounting for 33% of the estimated RPKs in 2017. North America represents 30% of the groups’ passenger demand, whereas Africa, Middle East & S. Asia category is expected to represent 16% according to our estimates. Latin America & Caribbean and the Asia Pacific are forecasted to represent, respectively, 12% and 9% in 2017. Finally, passenger revenue consists of the single most important contributor to the company’s revenues, with approximately 88% of the total value in 2016. The remaining 12% is distributed between cargo transportation and other revenue streams such as third-party maintenance services and frequent flyer product redemption.

As of 2016, IAG was the sixth-largest airline group in the world in terms of revenues collected, and a close second if only the European domestic market is considered, behind Lufthansa and Air-France KLM groups. Although IAG is registering lower revenues compared to its peers, in 2016 the group delivered the biggest ever operating profit and net income in Europe, which reflects the

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1 United Kingdom, Ireland, Spain and Italy
superior cost structure of the company. IAG’s expansion and operating performance has improved consistently throughout the years and, most importantly, supported by higher annual growth rates in all the relevant metrics versus its European competitors. Not only operating figures have increased at faster rates, the same has happened with capacity and traffic measures such as ASK\(^2\), RPK\(^3\), and number of passengers carried.

Since foundation in 2011, the company has managed to double its passenger figures, reaching the 100mn mark by 2016 from a 14.3% CAGR (the fastest growth within the top 5). Consequently, IAG improved its market share of passengers carried in Europe to 11.5% (+3.1%), while going from fifth to third in annual rankings. In fact, in the period between 2011 and 2016, IAG was the company gaining the most market share in the continent, while the company’s largest rivals Lufthansa and Air-France groups were the ones losing the most (-4.8% and -1.7%, respectively).

**Ownership structure**

IAG has a single class of shares that entitles each shareholder with the right to one vote. As of January 2018, the group has a total of 2 058 million shares, with 10 million consisting of treasury shares held by the company (0.5% of the total number of shares). Consequently, IAG has 2 048 million shares outstanding, of which 78.8% free float, with the following investment institutions holding a participation larger than 3%: Capital Group Companies, Standard Life Aberdeen, Legal & General Group and Deutsche Bank. Qatar Airways is IAG’s largest shareholder holding 20.5% of the shares, whereas management holds a 0.1% participation in the company. Dividends per share have increased of 0.125 € per in 2017, a 30% increase versus just two years ago. The company still has a dividend yield of 3.7%, with analysts expecting this to slightly increase in the next few years, posing an attractive option for investors looking for this kind of income stream.

**Shareholder analysis**

**Profile:** Qatar Airways is the national carrier of Qatar, founded in 1993 and wholly-owned by the Qatari government. The company is the second-largest airline in the Middle East’s (behind the Dubai-based Emirates), leveraging on its geographic position to operate an extensive network of international services to destinations across six continents. A member of the Oneworld global alliance, Qatar Airways received in 2017 its fourth ‘Airline of the Year’ award from Skytrax.

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\(^2\) Available seat kilometres: The number of seats available for sale, multiplied by the distance flown.

\(^3\) Revenue passenger kilometres: The number of passengers carried generating revenue, multiplied by the distance flown.
since 2011, being one of the world’s fastest-growing airlines group, with a modern fleet of more than 200 jets. The Gulf carrier has been accelerating its influence in the OneWorld alliance, by acquiring minority shareholdings in fellow members. Qatar’s investments include a 20% stake in IAG, a 10% stake in the number one South American carrier LATAM and a 10% stake in Hong Kong-based Cathay Pacific Airways. Moreover, Qatar Airways showed interest in obtaining a minority stake in the US-leading American Airlines, also from the alliance, an offer that was promptly rejected by the world’s second Dallas-based company, possibly due to the dispute between both carriers regarding Qatari government subsidies (addressed later in the report). The group is based and operates the Doha Hamad International Airport (HIA), one of the six international airports classified by Skytrax as a “five-star airport”. Despite only launching operations in 2014, the HIA has a target of serving more than 50mn passengers a year and was named the 50th busiest airport in the world in 2016, serving over 37mn passengers a (20% increase from 2015).

**Embargo:** Qatar is facing an air, sea and land embargo since June 2017, with several neighbouring countries cutting diplomatic ties with Qatar following alleged terrorism-supporting activities. After this unprecedented blockade, Qatar Airways saw bookings collapse, with several major airlines from the UAE, Egypt, Saudi Arabia and Bahrain suspending their services to and from the country (including region leaders Emirates and Etihad). Similarly, the Doha-based carrier suspended their flights to all of the blockading counterparts, losing access to 18 destinations in the Middle East in the aftermath of the regional political crisis. The airline was forced to reroute flights to avoid evading the airspace of blockading countries, a process that requires longer flight routes and increased operating costs. Qatar Airways refused to quantify the impact of the air embargo.

As with Qatar Airways, the Qatari Ministry of Development Planning and Statistics (MDPS) has not disclosed traffic data from the country’s leading HIA since the first month of the embargo. In June, HIA suffered a drop of 18% in arrivals versus 2016, while falling 32% from the previous month. Although June is usually a quieter month in terms of traffic in Qatar, the 2017 MoM fall was much steeper than in 2016 and 2015, where traffic fell respectively 12% and 3%, from May to June. The HIA reported that it served 19 million passengers from January to June 2017, an 8% increase versus the same period last year. From the blockade onwards, traffic data is inexistent. According to monthly statistics from the MDPS, the country saw a 19% YoY drop in the number of visitors until October, with the largest decrease expectedly coming from neighbouring GCC and Arabian countries (-38% and -24%, respectively).

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4 Qatar Airways also holds a 49% stake in the Italian Meridiana, which is not an OneWorld alliance member.
The embargo reinforced the airline’s acquiring strategy in an effort to drive further traffic to its worldwide hub in Doha. After initially obtaining a stake in IAG in January 2015, Qatar Airways announced in July 2016 an equity investment in LATAM ($608mn for 10%) - the company had been acquiring stakes at an average of one company per year until 2016. Only in the second half of 2017, the Gulf carrier tried to add American Airlines to its investment portfolio (June), obtained a 49% of the Italian Meridiana for an undisclosed value (September) and acquired a 10% participation in Cathay Pacific for $662mn (November).

**Relationship with IAG:** Ties between the two companies began in 2013 when the Gulf carrier became the first large Middle Eastern airline to join one of the global airline alliances. Qatar Airways entered the British Airways and America Airlines led OneWorld Alliance, with IAG’s CEO Mr Willie Walsh being instrumental in the process, according to several news sources. The state-backed carrier first acquired a 10% participation in IAG in January 2015, paying an undisclosed fee with a then market value of £1.15bn. The Qatari CEO Mr Akbar Al Baker stated that IAG would represent a great opportunity to further develop the company’s expansion to western aviation markets, while Mr Walsh relished on building a long-term relationship with the fast-growing carrier. Cooperation between the two companies was deepened during 2016, with the Doha-based carrier increasing their stake in the company to 12% in April, with a subsequent upgrade to 15% in May. Qatar Airways expanded its ownership to 20% after a fall in IAG’s share price following the UK Brexit vote. Again, no values were disclosed for the described investments.

The rationale behind the equity investment is not clear, as per the following facts. Airlines within both groups were already part of the same alliance, with established codeshare agreements between carriers from each other group by the acquisition date. This meant that both IAG and Qatar Airways were already benefiting from an extended network reach, driving increased traffic into their regional hubs. IAG had no history of paying relevant dividends, making it highly unlikely that Qatar invested with that perspective in mind. Likewise, such a minority stake in IAG would doubtfully provide Qatar Airways with a seat on the European group’s board. Finally, the European Commission defined a cap that forbids non-EU investors from holding a stake larger than 49% in EU-based carriers, making a majority participation impossible.

There is an ongoing discussion in the US and European aviation industries, on whether airlines from these mature markets should keep battling the well-financed Gulf carriers, or would be better off cooperating with them instead. The US airlines vocally claim about unfair competition practices from the UAE and Qatari state-held airlines, a position which is also defended by Lufthansa. The Air
France-KLM Group and IAG do not abide by this view, setting up partnerships with Etihad and Qatar Airways.

Despite the partnership, IAG’s share of the Middle East (and Africa) traffic still remains quite small in 2017, with a cumulative a 0.1% increase to 0.4% verified since the two groups began codesharing.\(^5\) IAG presence in the Middle East is inferior to its largest competitors, and the partnership with Qatar Airways has not been helpful enough. According to company reports and our estimates for 2017, traffic data between IAG and Africa, Middle East and S. Asia (the company does not report individual figures for each region) has not improved much over the years. Despite a load factor improvement of additional 4.1pp, passenger, ASK and RPK numbers in the region grew the least considering all the regions where IAG operates. One can conclude with this analysis that Qatar’s ownership of the shares has not contributed with a positive impact for the company’s flows in the region. Additionally, with the current diplomatic turmoil in the region, there could be a risk of Qatar Airways wanting to sell its participation in the European company, though it is very unlikely at this point.

### Share price analysis

IAG’s shares are primarily listed on the London Stock Exchange, while having secondary listings on the Madrid, Barcelona, Bilbao and Valencia stock exchanges in Spain. Since inception in 2011, the company has been a constituent of both the FTSE 100 Index and the IBEX 35 Index, the two major local indexes. In this analysis we will mostly focus on EUR-listed shares from the Madrid Stock Exchange, since the returns’ correlation between the EUR and the GBP shares, (IAG SM and IAG LN, respectively) is set at 1.01 since the merger. The company shares started trading in late January 2011 at €3.05 per share, yielding a total return of 137% ever since, that translates into an average geometric return of 8.9% to its shareholders.

Plotting the price movements of IAG versus three relevant European benchmarks, one can see that IAG’s share outperformed all three indexes. The Eurostoxx 600 and the FTSE 100 at a much slower pace, 3.2% and 2.6% annually, respectively, while the Spanish IBEX 35 registered a negative 0.6% compounded growth between January 2011 and the end of December 2017.

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\(^5\) Source: Euromonitor
Exhibit 13 plots IAG’s share price performance compared to its European peers. If we restrict the analysis to full service carriers (FSC) which are IAG’s most direct competitors, we can verify that both the German Lufthansa and the Franco-Dutch Air France-KLM trailed behind IAG in terms of cumulative returns (annualized geometric returns of 8.5% and 0%, respectively). Pure low-cost carriers (LCC) are clear industry leaders, Ryanair with a compounded annual growth of 16.3%, while easyJet’s was set at 16.4%. Although Wizz Air only became listed in 2015, it verified a sharp 12.2% annualized return, while Norwegian Air has eroded more than 50% of its price gains in recent years, yielding a modest 3.2% annual rate.

IAG Timeline

In 2008 British Airways announced a merger plan with the Spanish flag carrier Iberia, an agreement that would allow each airline to operate under its original brand. The deal was confirmed by the European Commission in 2010 and concluded in January 2011, being IAG the result of the merger. The two companies ceased to exist independently, being instead fully owned by the holding company. Since British Airways was the largest company in the merger, its shareholders received 55% of the merged entity’s shares.

Later in 2011, IAG entered the booming low-cost segment with the creation of the Madrid-based Iberia Express, to feed Iberia long-haul services with traffic from short and medium-haul connections from European cities. Moreover, Avios was created during the first year of operations to manage IAG airlines’ frequent-flyer programmes, being its points the transversal currency of the airlines in the holding. In 2012, the holding company agreed to acquire Lufthansa’s British Midland International (BMI), in a move that would increase IAG’s share of slots at the London Heathrow airport to 54%. During the same year, BMI’s fleet and routes were integrated by British Airways, while the group also consolidated the freight transportation services of its subsidiaries into a single business unit, IAG Cargo.

In 2013, IAG further expanded its low-cost offerings with the acquisition of the Barcelona-based Vueling, in which Iberia already had a 45.9% stake. IAG’s €9.25 per share offer yielded a takeover price of €123.5 million euros and a 90% participation. Vueling was not merged with Iberia, being incorporated as a standalone entity within the group.

IAG assumed control of Aer Lingus in late 2015 after months of negotiations and two rejected bids, whose major shareholders by the time were the Irish...
government and Ryanair, with 25% and 30% of the shares, respectively. The Irish flag carrier was acquired by €1.5bn, being the ideal vehicle to gain market share in the growing North Atlantic segment due to its geographic position.

Finally, during the fiscal year of 2017 IAG founded **Level** to compete in the long-haul low-cost market, flying from its base in Barcelona to destinations in North and Latin America.

### Business units

IAG’s portfolio of brands is expanding and diverse, with the holding operating three scheduled carriers and three LCCs (including Iberia Express) by the end of 2017. IAG combines leading airlines in Europe, empowering them to enhance their position in the aviation market while operating as individual brands within the group. By operating different subsidiaries, IAG is able to meet customer needs from all airline segments, offering air transportation services to short, medium and long-haul routes at different price points.

**British Airways**

**Profile:** The UK flag carrier was created by the UK government in 1974, following a merger between the four main British airlines at the time. The company was privatised in 1987, putting an end to thirteen years of state ownership. British Airways offers air transportation services departing from its three London hubs: Heathrow Airport, Gatwick Airport and the London City Airport. The company is headquartered in the Heathrow Airport, which is Europe’s busiest and the 7th worldwide in terms of passenger traffic. British Airways focuses on long-haul premium traffic, being a leader in the aviation’s most profitable transatlantic market. By 2016, the British carrier was the 3rd largest airline in the world by number of countries served, being also the 8th in terms of RPKs in worldwide rankings. The company is a founding and leading member of the Oneworld airline alliance in 1999.

**Network and fleet:** The company serves more than 180 destinations in around 80 countries, belonging to a restrict group of airlines operating in all of the six inhabited continents. Along with Air China, Korean Air and IAG’s largest shareholder Qatar Airways.

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6 Along with Air China, Korean Air and IAG’s largest shareholder Qatar Airways.
Exhibit 14: Airlines codesharing with BA

<table>
<thead>
<tr>
<th>Partner</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>American Airlines</td>
<td>United States</td>
</tr>
<tr>
<td>Latam Airlines</td>
<td>Latin America</td>
</tr>
<tr>
<td>Finnair</td>
<td>Finland</td>
</tr>
<tr>
<td>S7 Airlines</td>
<td>Russia</td>
</tr>
<tr>
<td>Qatar Airways</td>
<td>Qatar</td>
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<tr>
<td>Cathay Pacific</td>
<td>Hong Kong</td>
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<tr>
<td>Japan Airlines</td>
<td>Japan</td>
</tr>
<tr>
<td>China Eastern</td>
<td>China</td>
</tr>
<tr>
<td>China Southern</td>
<td>China</td>
</tr>
<tr>
<td>Qantas Airways</td>
<td>Australia</td>
</tr>
</tbody>
</table>

Source: Company data

Exhibit 15: British Airways short-haul and long-haul fleet

Sources: Company data, IAG Capital Markets Day 2017

The Boeing 777 family is the centrepiece of the company’s long-haul operations, with 58 in the fleet. The 2007 introduction of the A380s and the Boeing 787 Dreamliners marked the start of the carrier’s long-haul fleet replacement. British Airways already operates 25 Dreamliners, with an additional 27 expected to be delivered until 2022. Finally, the company has ordered 18 A350 aircrafts, to drive further replacement of the old B747 fleet (average age of 21.3 years).

Exhibit 16: British Airways performance in € millions (Company data, Analyst estimates)

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>11 483</td>
<td>13 312</td>
<td>13 337</td>
<td>14 456</td>
<td>15 413</td>
<td>13 889</td>
<td>14 049</td>
<td>14 549</td>
<td>15 019</td>
<td>15 555</td>
<td>16 110</td>
<td>16 686</td>
<td>3,1%</td>
</tr>
<tr>
<td>ASK</td>
<td>150 152</td>
<td>158 247</td>
<td>161 444</td>
<td>170 917</td>
<td>174 274</td>
<td>178 732</td>
<td>180 116</td>
<td>186 346</td>
<td>192 162</td>
<td>198 822</td>
<td>205 718</td>
<td>212 860</td>
<td>3,0%</td>
</tr>
<tr>
<td>RPK</td>
<td>117 348</td>
<td>126 436</td>
<td>131 333</td>
<td>138 431</td>
<td>142 016</td>
<td>145 170</td>
<td>147 208</td>
<td>152 300</td>
<td>157 573</td>
<td>163 034</td>
<td>168 689</td>
<td>174 545</td>
<td>3,1%</td>
</tr>
<tr>
<td>RASK</td>
<td>7,65</td>
<td>8,41</td>
<td>8,26</td>
<td>8,46</td>
<td>8,84</td>
<td>7,77</td>
<td>7,80</td>
<td>7,81</td>
<td>7,82</td>
<td>7,82</td>
<td>7,83</td>
<td>7,84</td>
<td>0,1%</td>
</tr>
</tbody>
</table>

Estimates: We estimate the company’s revenues to grow at a 3.1% average annual rate, after having improved by a 3.9% CAGR since the merger. This is driven by both an increase in capacity and unitary revenue per ask (RASK). BA is
a leading provider of flights to North America, with this market poised to be the main growth driver for the airline in the next years, through increasing flight frequencies and new destinations (Nashville, New Orleans and San Jose). Additional B787 arrivals to the fleet open potential profitable opportunities in Asia, namely India and Japan. In Latam, BA has secured a partnership with regional leader Latam (14% share), to capture increased traffic from improved macroeconomic conditions. Finally, digital improvements in BA’s platforms and the rise of ancillary revenues are expected to have a positive impact on unit revenues.

Iberia

Profile: Iberia is the flag carrier of Spain and IAG’s second largest scheduled airline. The company is one of the oldest airlines in the world, founded in 1927. After a troublesome period of political events in Europe that affected Iberia’s operations, the company managed to establish itself as one of the largest airlines in the world, with a particular focus in Latin American markets due to colonial links from the former Spanish Empire. In the 90s, Iberia suffered serious losses from its equity investments in Latin American counterparts, being bailed by the Spanish government and put into a restructuring programme to avoid bankruptcy. The company was reprivatized in 2001 and merged into IAG in 2011. Under the holding company, Iberia suffered further cost-cutting and fleet downsizing policies in an attempt to rebound from poor results following the 2008 financial crisis, while also establishing a low-cost airline to gain market share in Europe: Iberia Express. After years of restructuring and concentrating operations in the European regional markets and few connections with Latin America, Iberia is relaunching international expansion plans to Asia and Latin America. The company wants to reposition itself as a leading premium legacy carrier. Iberia Group airlines are headquartered in the Madrid-Barajas Airport, the 6th largest in Europe by passenger traffic and the 25th worldwide, and a strategic gateway to Latin America. The company is a Oneworld alliance member since 1999.

Network and fleet: Iberia Group airlines fly to around 120 destinations in more than 45 countries. Iberia Express provides low-cost routes to European cities departing from Madrid, while also serving as an important carrier between the Spanish Canary Islands and continental hubs. Iberia’s network also includes short-haul routes, with the addition of being a leading provider of flights between Europe and Latin America. Moreover, the company provides international services to destinations in North America, Africa, the Middle East and the Asia-Pacific region, though to a lesser extent. Iberia runs codeshare agreements with sister companies within IAG, namely the group’s LCC carriers (provide traffic for
the long-haul operations) and British Airways network (provide customers with destinations in the Caribe, Asia and Africa). Finally, the historical presence in Latin America has been supported by partnerships with local leaders, while codeshares with companies from North America, Africa, the Middle East and Asia allow for increased traffic in the Madrid-Barajas hub.

As of December 2017, Iberia operated a fleet of 99 Airbus aircrafts (average age of 10.8 years), with 62 serving short and medium-haul routes and the remaining 36 used employed on long-haul operations. Iberia has maintained little over 60 jets in its short-haul fleet since 2013, being exclusively composed of aircrafts from the A320ceo family. Within the short-haul fleet, Iberia Express operates 18 A320ceo and 3 A321ceo jets. New generation aircrafts from the A320neo family will be delivered starting from 2018, with 17 A320neo and 3 A321neo arriving to the short-haul fleet until 2022.

The long-haul fleet has already faced a partial renovation, being composed by 19 younger A330 jets that entered operations in 2013 and 2016, respectively, 8 A330-300 and 10 A330-200. The 17 remaining jets belong to the A340 family and started operations in 2003. To further expand long-haul operations, Iberia is expected to receive 16 A350 wide-body aircrafts starting next year, which were precisely developed by Airbus to succeed the A340 and provide longer routes and more efficient flight performances.

Estimates: Our forecast for Iberia is based on a 5.5% CAGR of RPK, driven by increasing flows with the company’s target markets, namely Latin America. Revenues are expected to increase at a 4.1% CAGR from capacity expansion. The company announced new routes to North and Central America (San Francisco and Nicaragua), while looking to increase flight frequencies to the region’s core markets of Mexico, Chile, Colombia and Argentina. Iberia also wants to increase frequencies to Tokyo, and explore opportunities in Africa and the Middle East with the arrival of the first A350s widebodies. We expect unit revenues (revenue/ask) to decrease for Iberia, following the expansionary plans to reposition Iberia as a market leader.
Vueling

Profile: Vueling Airlines is a Spanish low-cost carrier launched in July 2004. As with Iberia, the company suffered from 2007 onwards, affected by unfavourable economic conditions in Spain following the financial crisis. After completing a restructuring process in 2009, Vueling merged with rival low-cost Clickair from the same Barcelona hub. The merged entity operated under the Vueling brand, with the new airline becoming the second largest Spanish carrier after Iberia.

Vueling continued its internationalization process in the following years, supported by the acquisition of short and medium-haul jets from Airbus. This enabled the allocation of aircraft into additional hubs, with a consequent route network expansion and a greater presence in European markets. By 2013, the company occupied several bases in Europe, with Rome-Fiumicino Airport becoming the company’s second-largest hub. Thirteen years later, Vueling is the leading Spanish airline by passengers carried, flies a fleet of more than 100 jets and operates more than 15 bases aside from two main hubs in southern Europe: the Barcelona El Prat Airport is the 7th busiest in Europe, while Rome-Fiumicino is the 10th, transporting more than 44mn and 41mn passengers during 2016.

Network and fleet Vueling has built a network with direct flights to around 135 destinations in more than 40 countries. The majority of the company’s flights are intra-European, with the airline also offering its low-cost services to a few destinations in the Middle East and Northern Africa. Vueling codeshares with its sister companies within IAG, while also benefiting from a partnership with IAG’s largest shareholder Qatar Airways signed during 2016. Passengers from the Doha-based carrier profit from the European LCC’s extensive network, while Vueling sees increased traffic in its two major hubs from the Middle East.

As of December 2017, Vueling operates an all-Airbus fleet exclusively composed by 108 short and medium-range planes from the A320ceo family (average age of 7.2 years), offering Economy Class seats at three different fare options (basic, optima and excellence). The 88 A320 are the company’s central jets with an average age of 8 years. Vueling introduced new aircraft models to its fleet in 2015, namely 15 new A321 and 5 A319 with an average age of 10 years. In 2017 IAG ordered 47 A320neo for Vueling, in a clear sign that the Spanish LCC is the chosen vehicle to gain market share in European short-haul routes.

<table>
<thead>
<tr>
<th>Exhibit 23: Vueling performance in € millions (Company data, Analyst estimates)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
</tr>
<tr>
<td><strong>ASK</strong></td>
</tr>
<tr>
<td><strong>RPK</strong></td>
</tr>
<tr>
<td><strong>RASK</strong></td>
</tr>
<tr>
<td><strong>Revenues</strong></td>
</tr>
</tbody>
</table>

Source: CAPA

Source: Company data
Estimates: Our outlook for Vueling is very positive, based on the company’s robust performance over the years (around 19% CAGR for revenues and ASK), market conditions and future expansion plans. Our flat estimates for 2017 reflect the Catalan crisis’ whose impact in tourism and air traffic in the region negatively affected the company. We expect Vueling’s growth to pick up from 2018 onwards, driven by the arrival of new jets during the forecasted horizon. Capacity is expected to increase sharply, as a response to increased passenger demand (tourism) into and from Spain. The INE (Spain’s national statistics institute) estimates that tourist arrivals have surpassed 82mn in 2017, with Spain becoming the second-most visited country in the world after France. This is a great sign for Vueling, whose European network and jet arrivals will allow the company benefit from the increased traffic. We still see space for unit revenue improvement, driven by an increase in revenues that outpaces capacity.

Aer Lingus

Aer Lingus is the national carrier of the Republic of Ireland, founded in 1936 by the Irish government. The carrier focused on providing flights from Dublin to principal cities in the UK in the early years, launching flights to continental Europe after the WWII, while expanding into the transatlantic market during the following decades. Aer Lingus left the Oneworld alliance in 2007 (from which it had been a member since 1999), to pursue a low-cost strategy that was not in line with the alliance’s premium traffic focus. Ireland was one of Europe’s most affected countries in the global financial crisis, launching Aer Lingus into a restructuring following. After the turnaround in 2011, the company emerged operating a hybrid business model with a greater focus on service compared to traditional LCCs. By offering services based on a mixed strategy in between LCCs and legacy carriers, the company would avoid direct competition from Europe’s leading LCC Ryanair, with the benefit of capturing customers that are not satisfied with the offerings from the two extreme segments. Aer Lingus announced low-cost long-haul expansion plans into North America in 2013, representing today the carrier’s target market. Incorporated in IAG in 2015, the company is growing its presence in the profitable North Atlantic segment, through additional city pairs and weekly flight frequencies (by c.55% during 2017). Dublin Airport is the airline’s main hub, being the largest in the country and the third in the British Isles behind London’s Heathrow and Gatwick. Dublin is only the 15th busiest airport in Europe.

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7 Capital Markets Day 2017, IAG
with 28mn passengers carried in 2016, however, this hub ranked 23rd in 2014 and grew at a 13% CAGR in the past two years.

**Network and fleet:** Aer Lingus operates from major UK hubs to over 100 routes across more than 20 countries, mainly in Europe, the UK and North America. As an independent airline, it codeshares with carriers from the three major airline alliances, benefiting as well with partnerships with independent carriers. These codeshares allow for a network extension within its core markets while enlarging its customer’s options with flights to Africa, the Middle East and Asia-Pacific. The codeshare with United Airlines is worth mentioning, a top player in Aer Lingus’ key North American market, since it provides access to the companies’ domestic network in the US, via its headquarters in the Chicago O’Hare Airport (the 6th busiest in the world).

Under its hybrid business model, the company offers mixed fare services in Economy Class-only seats to its short-haul destinations in Europe, operating 37 jets from the A320ceo family. Although the 3 A321 have average ages over 18 years, there is no indication by IAG or Aer Lingus of a short-haul fleet renovation. According to data from Boeing, the A320 family has an average age of nearly 20 years when scrapped, meaning that the company may still operate the bulk of its short-haul fleet for the next decade. Moreover, IAG is investing in Vueling’s short-haul expansion in Europe, which helps explaining the stagnancy and (lack of) plans for Aer Lingus’ short-haul operations. Instead, Aer Lingus is seen by IAG as a vehicle to increase market share in transatlantic flights, via discounted fares compared to legacy carriers. Aer Lingus offers two-class flights to the US (Economy and Business Class), operating 4 B757, and 12 A330 jets under a dual configuration. The 4 A330-200 have an average age of 16 years, being the longest-range jets in the company’s fleet. These aircraft mainly operate flights to North America’s West Coast of the US, with the B757 and 8 younger A330-300 flying to the East Coast. To achieve greater efficiency and enhance operational performance on long-haul routes, the company ordered 9 A350-900 to replace part of the A330 fleet, with deliveries starting in 2018. Furthermore, the company has ordered 8 narrow-bodies A320neo LR (long range) to develop thinner transatlantic routes which would not be operated profitably using the larger capacity wide-bodies A330 and A350 jets. These will be delivered during 2019 and 2020, with IAG’s Chairman stating that he sees potential for 4 additional A320neo LR (totalling 12), to replace the old B757 (average age of 21.1 years).
Estimates: The Irish carrier aims to further strengthen its position in North America, leveraging on its Dublin hub to transport passengers between the two markets at a relatively low cost. Aer Lingus is aiming to enter into a transatlantic joint venture with Iberia, BA, American Airlines and Finnair, that allows carriers to coordinate schedules, share revenues and sell each others seats. As the joint venture includes sister companies within IAG, we see a strong possibility of this to happen, in what would be highly positive for Aer Lingus. The company is investing in its short-haul expansion to Europe as well, a crucial network in providing passengers for the more profitable North Atlantic operations. We see an average annual increase for revenues set at 3.5%, despite a fall in unit revenues. The company still enjoys RASK’s substantially higher than those of LCC’s (average if 4.87 €cents in 2016 according to our estimates), even when taking into consideration its hybrid business model.

Level

Profile: Level is IAG’s most recent subsidiary, operating the long haul low-cost subsidiary. The airline was launched in June 2017, a year before the initial date set for the start of services, as a response to increased competition from low-cost providers on the transatlantic markets. For instance, Norwegian is launching discounted routes to the US from multiple bases in Scandinavia, Spain and the British Isles, while Eurowings is offering long-haul routes from Central Europe, therefore affecting IAG’s long-haul operations. Although this answer from IAG may seem precipitated, sales from the airline exceeded the holding’s expectations, with more than 134,000 tickets sold between March and the launch date in June.

Network and fleet: Level operates from the Barcelona El Prat Airport, from which it offers transatlantic services to Los Angeles, Oakland, Punta Cana and Buenos Aires. The airline currently operates two wide-body A330-200 jets, codesharing and using Iberia’s resources in the first year of operations. To expand the company’s operations, IAG has ordered 3 A330 to be delivered in the summer of 2018, with Level already announcing a new route to Boston, as well as four additional destinations from a secondary base in Paris Orly airport: Montreal in Canada, Guadeloupe and Martinique in the Caribbean and Newark Airport in the US. Level’s services from Paris will be operated by personnel currently working for OpenSkies, a Paris-based subsidiary from British Airways (offering premium-class services) that will cease to operate in the end of next summer, with all the staff transferred to the new brand. Furthermore, Mr Walsh stated that the company’s fleet would grow to 30 jets by 2022.
Exhibit 27: Estimated data for Level (Revenues in thousands of €, passengers in thousands, ASK and RAK in millions)

<table>
<thead>
<tr>
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<th>2017E</th>
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<tbody>
<tr>
<td>Revenues</td>
<td>6 441</td>
<td>19 276</td>
</tr>
<tr>
<td>Passengers carried</td>
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<td>496</td>
</tr>
<tr>
<td>ASK</td>
<td>1 568</td>
<td>4 694</td>
</tr>
<tr>
<td>RPK</td>
<td>1 335</td>
<td>3 996</td>
</tr>
</tbody>
</table>

Sources: Analyst estimates, company data

Estimates: From the company’s flight schedule for 2017, we estimated a total of 20 weekly flights when accounting for roundtrips. According to company data, the A330-200s have a configuration that seats 314 passengers, meaning that 503 jets were sold during the pre-launch ticket sale (assuming an average load factor for IAG flows with the American market of 85%). Accounting for the different starting dates of the flights in June, we estimate that Level operated a total of 54 flights in its first month. The remaining 449 flights sold are equivalent to over 22 weeks of operations, representing the whole flying schedule of the company until the first half of December. Following the same rationale for the 2 remaining weeks of the year, the company is estimated to have carried 145k passengers in its first year, equating to 1331mn RPKs. The same procedure was implemented to calculate RPK estimates for 2018. We used Norwegian’s RASK of last year (4.82 €cents) to compute revenues for Level, since it is the best approximation for this business model (in line with the LCC segment average RASK of 4.87 €cents in 2016). We estimate Level’s revenues to grow at a 38% CAGR during the forecasted period, following the planned fleet expansion and consequent capacity increase.

IAG Cargo

Profile: IAG Cargo was founded in 2012 after IAG’s decision to merge its airlines’ cargo services into a single business unit. The company manages the cargo operations of the carriers, leveraging on the passenger airlines’ freight capacity and route network to deliver its handling services. The subsidiary has access to more than 500 aircraft, flying over 15.000 weekly flights to more than 350 destinations worldwide. Moreover, the Partner Plus programme of which seven additional passenger airlines are part, allows the company to use the member’s freight capacity to an additional 80 destinations. This programme makes IAG Cargo the global leader in wide-body capacity to the 120 top cargo destinations in the world. Along with this alliance, the company established partnerships with cargo airlines such as DHL Aviation and Korean Air Cargo that ensure available supplementary capacity.

Estimates: IAG Cargo’s revenues have become less significant for IAG over time, going from 7.3% of the total in 2011 to a reduced 4.5% in 2016. Although cargo revenue growth has been inconsistent in the past years, global cargo operations increased by 3.6% in 2016 according to Boeing (in line with IAG’s 4.1% growth), with an acceleration expected in the following years. Based on a pickup of economic activity with a consequent increment in GDP and world trade, we estimate IAG Cargo to grow at a 4.2% CAGR during the forecasted horizon.

Other
Profile and estimates: In the Other category we include the Avios brand, as well as other streams such as the BA Holidays programme and third-party point sales, maintenance and airport handling activity. Avios manages the reward currency of the frequent-flier programmes of several airlines, namely British Airways, Iberia and Aer Lingus. This segment represented 7.2% of the company’s sales in 2016, growing for the third consecutive year after an initial 12% drop in 2013. We expect the positive trend to continue in the next years, after a 13% increase in 2016 derived from an increased contribution from Iberia’s maintenance business and Avios product redemption. We forecast a 3.4% CAGR for this unit until 2022.

The Sector

Overview

In 2016, global air traffic measured in RPKs is estimated to have grown 6.3% according to both Boeing and Airbus figures\(^8\), with a record number of annual air passengers transported set at 3.7bn\(^9\). Over the years, air traffic has confirmed to be a robust industry, resilient to adverse factors such as moderate economic growth, terrorism, oil and financial crisis.

Data from ICAO show that the aviation industry has grown exponentially since its first days in the 1940s. The first year registering over 1bn passengers was 1986, and eighteen years were necessary for this figure to double. The 3bn mark was achieved just seven years later in 2012, meaning that in the past four years annual passengers transported by air increased at a compounded annual growth rate of at least 5.3%. The rising trend is projected to prevail in upcoming decades, with a large contribution coming from emerging market economies facing an expanding middle class. Additionally, global GDP growth is forecasted to pick up, largely driven by income growth and consumer spending in developing regions, with the air traffic industry benefiting from a larger share of investment in the tourism and travel sectors.

The two aircraft manufacturing giants, Airbus and Boeing, forecast global RPK to grow by 4.4% and 4.7% per year until 2036, respectively.\(^{10,8}\) above This

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\(^{8}\) Sources: World Bank and Boeing data, referring to estimates from ICAO (International Civil Aviation Organization)

\(^{9}\) Sources: Current Market Outlook 2017 – 2036, Boeing; Global Market Forecast 2017 – 2036, Airbus
passenger demand increase comes as a result from lower fares carried by airlines, which were driven by both the introduction of more efficient jets, as well as the drop verified in jet fuel prices to half of 2014 levels. In the following two decades, Asia is projected to become the major travel market in the world, led by China, whose domestic traffic flow (RPK) is set to be the largest by 2036 from an expected annual growth rate of 6.1%.\(^\text{11}\) Moreover, Airlines located in the Middle East have the unique geographic advantage of reaching European and Asian hubs with one-stop flights, while transporting passengers from one to the other. As a result, Europe and Asia traffic flow to the Middle East are forecasted to increase by 5.3% and 6.4%, respectively. Annual air traffic in Latin America is estimated to increase between 4.2% (Airbus) and 6.2% (Boeing), supported by a pick-up in economic activity in the region.\(^\text{12}\) Although Africa is the largest region on Earth, the political instability verified in the continent, terrorist episodes in Northern Africa and the lack of economic conditions and infrastructures, have hindered air traffic growth. Nonetheless, traffic flows within, to and from the continent are projected to rise by 5.2% (Airbus) to 5.9% (Boeing)\(^\text{13}\). The more mature markets of Europe and North America to the west will register lower domestic growth rates, nonetheless, improved aircraft flying fuel-efficiency and ranges allow for connections with fast-growing emerging market hubs. The manufacturers estimate a growth of 3.3% to 3.7% for Europe, and between 3.0% and 3.4% for North America. Flows within these two domestic markets accounted for 27.9% of the total RPKs in 2916, with an estimated market share drop to 19.6% according to data from Boeing.

Exhibit 31: Average distance flown by LCC’s within Europe (km).

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\(^{11}\) Source: Current Market Outlook 2017 – 2036, Boeing

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**Europe**

**Macro:** After a decade of stabilization following the financial crisis, European countries seem to be on track to recover economically, with growing consumer and business confidence throughout the continent. Estimates suggest that the upward trend in income growth and the consequent boost in private consumption will continue, despite political uncertainties in the region, namely Brexit’s outcome. Real GDP growth is expected to grow by 1.7% per year until 2036.
Market trends: According to our estimates from a sample composed by 13 listed airlines in Europe, not only passenger demand since 2011 increased at an 8.3% CAGR versus a lower airline capacity (ASK) increase of 7.3% annually, passenger load factors have improved 3.5pp to maximum historical levels. The growth in all metrics has been mostly driven by the LCC segment, including long-haul low-cost providers, with an increase of 14.3%, 12.6% and 6.8pp respectively, RPK, ASK and load factor. LCCs are flying distances 35% longer than 2002, reflecting the expanding policies of these carriers on intra-regional routes. Boeing estimates that European LCCs provide 37% of total seats offered in intra-regional routes, existing still room for growth in large markets where low-cost penetration rates are still relatively low. France (c.30%) and specially Germany (c.20%), currently have an LCC capacity share below the European average of almost 40%. The largest aviation groups in Europe are also establishing low-cost subsidiaries, to respond to market share loss in the domestic short-haul segment. The strategy carried by these network carriers has brought benefits to their long-haul operations, that have been fed by a larger flow of passengers from the low-cost subsidiaries.

Moreover, the exponential emergence of the low-cost long-haul business model has transformed transatlantic flights, flows with the Middle East and Asia. The long-haul low-cost segment in Europe is still small compared to Asia-Pacific, but this segment’s ASK market during the summer is expected to have doubled versus a year ago. For instance, North Atlantic connections provided by LCLH increased from 40 weekly flights to more than 800, in the period between 2013 and 2017, with an estimated market share of 9.5%. European full-service carriers are gradually embracing this business model by establishing subsidiaries to compete in the segment, responding to market share loss in this profitable long-haul operations.

Market concentration: Despite the consolidation process the European industry has suffered over the years, the big three groups (IAG, Lufthansa and Air France-KLM) only carried 35.5% of total passengers in 2016, a diminished figure versus 2011 (38.9%). If we add the two largest LCC’s Ryanair and easyJet to the analysis (Top 5), we can see that the enlarged group carried 57.2% of passengers travelling in Europe. A high concentration is only verified when we consider all the Top 10 airline, that provide air transportation services to more than 78% of total passengers carried by European airlines. This sharply contrasts

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14 Source: Annual Analyses of the EU Air Transport Market 2016, European Commission
15 Consisting of the Top 5 and the following: Turkish Airlines, Aeroflot, Norwegian, SAS and Pegasus
with the US market, where after a wave of merges the 4 four largest carriers currently control 80% of the market, compared with 48% a decade ago.\textsuperscript{16}

**Flows:** The aviation market in the region currently accounted for over 33.3% of worldwide traffic flows in 2016 (flights to, from and within Europe). This figure is forecasted to decrease to values around 28% by 2036 from a 3.7% annual average growth rate below the global average. Flows within Europe consist of the second biggest market in the world measured in RPKs (12.1%), being this share poised to fall to 9% by 2036. Europe is a mature aviation market located in between America and Asia Middle, thus it makes sense that many of the world’s largest traffic flows have the Old Continent at one side. Apart from the domestic market, flights between Europe and North America constitute the 4\textsuperscript{th} largest flow in the aviation industry, while traffic flows with the Middle East represent the 5\textsuperscript{th} largest worldwide connection in terms of RPKs. The former is expected to decrease to a 4.9% market share by 2036 (still, maintaining the 4\textsuperscript{th} position), and relations between Europe and the Middle East will increase to a 4.1% RPK market share. Exhibit 28 plots the RPK shares of flows between Europe and different markets to the east and to the west.

**Segments and airlines:** Most of the historical flag carriers of European countries still operate in the continent, though in this century the industry suffered consolidation into three main aviation groups: International Airlines Group, Lufthansa Group and the Air France-KLM group. IAG incorporated British Airways, Iberia and Aer Lingus, whereas Austrian Airlines, Swiss International Airlines and Brussels Airlines merged with Lufthansa. Air France and KLM were merged in 2004, forming the Franco-Dutch group. In addition, TAP Portugal, Finnair from Finland and the SAS Group from Scandinavia consist of smaller airlines competing in the segment. To the east, Turkish Airlines and Aeroflot from Russia have invested heavily, with revenues and capacity metrics growing at double digits with a consequent market share gain. The previous compose the list of scheduled carriers operating in Europe.

Regarding the low-cost segment, Ryanair and easyJet are by far the most mature and successful airlines, competing with the flag carriers in terms of passengers carried and capacity/demand measures. IAG’s Vueling, is gaining currently the number one airline in Spain in terms of passengers carried. Transavia is a subsidiary of Air France-KLM, while Wizz Air is eastern Europe’s largest LCC, with revenues and capacity metrics growing at double digits since 2011. The LCLHL segment is served by fewer players, namely Norwegian Air, Eurowings from Lufthansa and WOW from Iceland. Aer Lingus has transformed itself to from

\textsuperscript{16} Source: A lack of competition explains the flaws in American aviation, The Economist (April 22\textsuperscript{nd} 2017)
a scheduled carrier to fit into this segment, while additional airlines were introduced in 2017: Air France launched Joost in December, whereas IAG's Level started operations in June.

Recent bankruptcies: During 2017, the European aviation market suffered further consolidation with three European airlines filing for bankruptcy. The Italian scheduled carrier, Alitalia, declared bankruptcy in May, following rejected job-cuts by its employees. The government decided not to bail or nationalize the airline, with the carrier being put up for sale. Alitalia was the largest domestic player in Italy, with an estimated market share of 23% in the beginning of the year (though, 6 pp below the share in 2011). The vacuum will be partly filled by EasyJet (6% share in the country), which expressed interest in buying parts of the company in an effort to expand operations in Southern Europe’s largest aviation market in terms of revenues. Ryanair went for an already-dropped early bid in the company (15% market share in the country), while Lufthansa (2.9% share) stated an interest to acquire part of Alitalia’s global network traffic. 17

Monarch Airlines, a London-based airline mainly operating from Luton and Gatwick airports also entered into administration during October. Monarch was the largest airline to ever bankrupt in the UK, claiming the high competition and decreased fares on low-cost routes to southern Europe (mainly Spain and Portugal), terrorism events in northern Africa and Turkey, while Brexit and cost increase from the depreciation of the pound, as the main causes for the bankruptcy. IAG already secured the company’s slot in Gatwick for British Airways, while rival low-cost Wizz Air acquired slots in the Luton. EasyJet and Norwegian had also expressed interest for Monarch slots.

Germany’s second-largest airline, Air Berlin, also filed for administration in August, and later ceased operations during October. This was the result from consequent years of capacity, revenues and market share loss (1.3% loss in Germany, 3.2% in Spain and 0.5% in Western Europe since 2011)18, culminating with Etihad’s decision to stop financing operations. The Abu Dhabi-based carrier had been Air Berlin’s largest shareholder for the past six years. Lufthansa already agreed to acquire much of its German counterpart fleet by €210M, while also taking over its subsidiaries and employees. Moreover, easyJet announced in late October that it would buy 25 aircraft and other assets for €40M, taking over part of the bankrupt carrier’s operations at Berlin’s-largest airport. The company recently launched three routes from Berlin to Spain, capitalizing on the fewer competition in the short-haul segment from the region.

17 Source: Market shares from Euromonitor
18 Source: Euromonitor
On the 29th of December, IAG announced a €36.5mn acquisition of Niki from Aer Berlin, following a rejection from the EU of a Lufthansa takeover, over competition issues. Niki is an Austrian LCC with a fleet of A320 15 jets that will be incorporated by Vueling in the following years, that will see its position reinforced in Austria, Germany and Switzerland (not included in our estimates). Following the announcement, IAG share price improved 2.7% on the first trading day of the year, whereas Lufthansa’s dropped by 1.4% - a possible indication that Niki is a valuable asset in Central Europe, purchased at an incredibly low price.

### Flows within, to and from Europe

**Domestic:** Traffic flows within the domestic European market represent 36% of total RPKs in the region, being forecasted to increase at an annual growth rate of 3.2% over the next 20 years. Although this expected moderate growth is below the global average, it largely surpasses the GDP growth for the region set at 1.7%, which itself is c.1% below the global growth forecasted by international institutions.

The European aviation market is one of the most saturated markets in the world, with a large number of airlines operating in the region. The rise of European LCCs in short-haul markets, currently providing over 37% of intra-European seat capacity, is a determinant characteristic of the region.19 Facing limited capacity opportunities within the continent, European legacy carriers have to expand outwards to emerging markets where traffic flows are increasing at a faster rate. This explains the drop verified in domestic flows to 32% by 2036, at the expense of developing economies.

**North America:** GDP expansion in the region is becoming more stable with many sectors of the economy contributing to an expected economic growth of 2.1%. The better economic conditions come as a result of the central banks’ monetary policies, being supported by a decrease in unemployment rates and a consequent income growth and greater consumer spending. Flights between Europe and North America currently represent 21% of total flows involving the European aviation market, a percentage that is expected to decrease to 18% over the following two decades. Despite this drop, RPKs connecting the two largest aviation markets are forecasted to grow at a 2.9% CAGR.

Flows within, to or from North America accounted for 33.1% of total RPKs in 2016. North America is composed by two mature economies, with long-established aviation markets, whose highest level of trips per capital contributes to this domestic market being the largest flow in the world with 16% RPK market

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19 Source: Current Market Outlook 2017 – 2036, Boeing
Despite a higher than GDP expected growth of 2.6%, this flow will see a share reduction of 5% during the next twenty years. One must take into account the fact that this intra-regional market is already 30% larger than the second-best (Europe), and also the huge growth rates forecasted for the emerging regions where the propensity to fly is escalating. RPK's within North America represent 47% of total passenger demand, followed by flows with Europe (21%) and Asia-Pacific (16%). By 2036, intra-regional and flows with Europe will lose weight on total traffic, with Latin America benefiting the most.

**Asia-Pacific:** The region's economy is forecasted to grow at a 3.9%, largely due to an expanding middle class with higher propensity to fly. The fast growth verified in both emerging and developed economies in the Asia-Pacific region, has led to an immense expansion in the aviation sector. Open skies policies and the easing of visa policies in the region fostered tourism, trade, foreign investment and service exchanges in the region. Traffic between Europe and the eastern region constitute the third largest market for European carriers (16%). Flows with this booming aviation market are expected to increase at a 4.5% CAGR, incremented Europe’s allocation of RPK to the region to 18%.

RPKs to, from and within the region accounted for over 28% % of worldwide figures, with an expected increase to a 32% share by 2036. Domestic air traffic in the region accounts for 61%, with flows from North America, Europe and the Middle East jointly representing 38% of total RPKs (around 13% each). Domestic share is projected to increase to 65% by 2036, while traffic flows with the Middle East will represent 14%, both increases come at a cost of European and North American carriers.

Economic growth and aviation-related technologic improvements have contributed to the improvement of airline’s business models. The continuous improvement and success of the LCC business model within the region, has led airlines to adopt expansive policies to medium and long-haul destinations, while still offering discount prices. Long-haul low-cost carriers are gaining momentum in the region, supported by a new era of single aisle aircrafts that deliver longer routes with increased fuel efficiency. LCCs provide 25% of total seat volume in intra-regional routes, a value that lags Europe’s 42% and North America’s 31%, suggesting that there is still room for opportunities in this segment, namely in the Chinese (only 4%) and Japanese markets. A large contributor to the region’s growth has been the Chinese domestic traffic. Passenger traffic increased by almost 12% annually since 2009, with an expected 6.1% CAGR for the following

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20 Sources: Current Market Outlook 2017 – 2036, Boeing; Global Market Forecast 2017 – 2036, Airbus
years. The Chinese home market is poised to become the largest market worldwide by 2036, with a total market RPK market share of 11.6%.

Middle East: Flights between Europe and the region represent 11% of total passenger traffic in Europe. These are expected to benefit from a CAGR of 5.3%, with this flow reaching a 4.1% global market share by 2036 from an increased allocation of capacity by carriers from both regions. Passenger demand in the region is expected to grow faster that anywhere else across the world, supported by a forecasted GDP growth rate of 3.5%. Flows within, to and from the region accounted for nearly 11% of total RPKs in 2016, registred a record 2.5% market share gain since 2009. By 2036 this percentage is projected to grow to 13.5%. Traffic flows with Asia-Pacific accounted for 39% of total RPKs in the Middle East, while Europe’s percentage is set at 30%. Domestic traffic only represents 13% of total air traffic share within the region.

The region is located at a crossroad of major traffic flows, with its airlines connecting hubs and passengers from Europe, Africa and Asia-Pacific. An estimated 80% of the global population lives within flying range from the Middle East, enabling carriers to perform direct flights with hundreds of city pairs. Furthermore, many of the established destinations are positioned in emerging economies, namely South Asia, Southeast Asia and Africa, whose propensity to fly is going to increase exponentially in the next decades. Although, the drop in fuel prices badly hurt the oil-dependent Gulf states by diminishing investments in the region, analysts estimate a price recovery to levels that will boost economic activity and lessen the current problems affecting Gulf economies. Investment in the aviation infrastructure has been crucial for air traffic development in the area, with world-class airports supporting and enabling the growth of local carriers. For instance, the Dubai International Airport managed 83M passengers in 2016, seeing a 77% increase versus 2010 figures (10% CAGR). During the same period Dubai’s flag carrier Emirates Airline boosted its RPKs by 89%, at a CAGR of 11.2%. Gulf airlines have not only increased capacity and flight frequency, they have more than tripled the number of city pairs since the 90’s, with major increases in Europe and Asia.

Latin America: The region was among the most affected by the fall of commodity prices and the general economic slowdown verified in recent years. The region’s GDP saw no growth during 2015, while shrinking 1% in 2016. Economic progress appears to be picking up, and analysts forecast a GDP growth in the region to be 3% driven by economic reforms in Brazil and Argentina. Brazil is recovering from its worst-ever recession, with falling inflation and interest rates that encouraging consumer spending. Latin America and the Caribbean saw a 13.2% expansion in goods exported in the first half of 2016,
after two years of continuous contraction. Although signs are vastly positive, the region still has to boost its economic competitiveness, years trailing behind worldwide trade and GDP growth.

Despite all the economic struggle, overall air traffic in the region increased slightly (0.3%). The traffic reduction verified last year in Brazil, the largest domestic market in Latin America by far, was compensated by sustained growth from surrounding economies. RPKs in Latin America are expected to increase from 10.1% in 2016 to 11.6% of the worldwide market by 2036. Intra-regional air traffic in Latin America represents 33% of total RPK market share, while the Air Transport Agreement signed between the US and Mexico in 2016 set a 36% share of flows with North America. RPKs from European connections account for 29%, while there is immaterial traffic flows with the Middle East Africa and Asia-Pacific.

A factor contributing to future growth is the increased competition from a more liberalised market within the region, with airlines facing cross-border ownership, industry consolidation and intervention from the big three international alliances. For instance, South America’s biggest largest airline Latam Airlines Group, is a product of the merger between Chile and Brazil’s largest airlines by 2012, being a member of the Oneworld alliance. In addition, foreign equity investments from airlines based in the Middle East, China and the US are expected to bring stability and expansion opportunities for Latin American carriers.

Africa: Road network density, a major sign of investment in infrastructure, sees its lowest values in African. This fact, aided to the large average distance between secondary cities and more developed hubs, has contributed to this continent registering the lowest RPK share in the world. For instance, Latin America which currently ranks second, registers a share that more than doubles Africa’s 4.2% According to our estimates, the region lost market share between 2009 and 2010, despite a 4.5% CAGR in the period. Africa is the second largest continent in terms of population and size, however, its airlines only carry 3% of the passengers worldwide. Boeing forecasts RPKs in Africa to grow by an average annual rate of 5.9%, due to higher trade volumes, a larger middle class and overall GDP growth of 3.5%. Moreover, regulation plays a big role in the airline industry, and the slower pace of deregulation imposed by African governments to protect state-owned carriers from losing share, has not helped domestic and international flights. However, several member states who had not committed to market liberalization practices have declared their complete support for greater liberalisation. These are positive signs that promote competition and air traffic development, in a market deeply in need of improved safety standards and aviation services. Better days are expected to the continent’s air transport
services and infrastructure in terms of safety, access, capacity, flight frequency, tariffs and competition, aided by the issuance of a pan-African passport in the beginning of 2018.

African hubs are mostly served by international carriers from Europe due to strong links with former colonies, namely Air France, British Airways, Lufthansa and TAP Portugal (corresponding to 38% of total traffic). Turkish Airlines and the 3 major Gulf carriers also have expanded their networks in serving the continent (providing 27% percent of air traffic), while American and Asian-Pacific carriers also fly to a lesser extent. Nonetheless, some African-based airlines offer worldwide destinations, with South African Airways, EgyptAir, Royal Air Maroc, Ethiopian Airways and Kenya Airways standing out. The domestic market accounts to 20% of African RPKs, with several regional carriers operating in the continent.

Valuation

International Airlines Group combines multiple brands operating from distinct countries in Europe. Despite this, there is few discrimination of each brand's financial performance in the consolidated financial statements of IAG. This is of particular relevance when analysing and dealing with the balance sheet and free cash flow statements of the company, where there is no discrete allocation of any caption between brands. Regarding the income statement, IAG reports the group consolidated P&L results, while providing segment information on revenues, depreciation (jointly with amortization and impairment) and operating profit (EBIT) of each subsidiary. Apart from financial measures, IAG discloses each subsidiary traffic data on a monthly basis, without segmenting brand allocation per region. After explaining our estimates from each of the business units, we proceed with the explanation of the group’s costs as a whole. We then advance to the description and findings from our chosen valuation method for IAG. Capacity was estimated taking into consideration each airline network’s geographic composition and expected flows21 between Europe and the markets where they operate. IAG’s revenues are calculated based on the capacity of each airline, being the consolidated estimates as follows:

**Exhibit 41: IAG’s actual revenues between 2011 and 2016, followed by our estimates until 2022 (€ millions)**

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<td>1,094</td>
<td>1,022</td>
<td>1,064</td>
<td>1,109</td>
<td>1,155</td>
<td>1,203</td>
<td>1,254</td>
<td>1,307</td>
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<tr>
<td>Other revenue</td>
<td>1,431</td>
<td>1,528</td>
<td>1,338</td>
<td>1,353</td>
<td>1,434</td>
<td>1,621</td>
<td>1,720</td>
<td>1,791</td>
<td>1,863</td>
<td>1,941</td>
<td>2,024</td>
<td>2,110</td>
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<tr>
<td><strong>Total revenues</strong></td>
<td><strong>16,103</strong></td>
<td><strong>18,117</strong></td>
<td><strong>18,675</strong></td>
<td><strong>20,170</strong></td>
<td><strong>22,858</strong></td>
<td><strong>22,567</strong></td>
<td><strong>22,882</strong></td>
<td><strong>23,849</strong></td>
<td><strong>24,806</strong></td>
<td><strong>25,855</strong></td>
<td><strong>26,955</strong></td>
<td><strong>28,107</strong></td>
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</table>

Source: Company data, Analyst estimates

21 Boeing estimated flows described in “The sector”
**Costs:** Supplier costs consist of several costs, such as handling costs, airport landing fees, engineering and other aircraft costs, property and IT costs, among others. This cost category accounted for more than 42% of the company’s costs in 2016. We expect supplier CASK (cost/ask) to decrease by a during the forecast horizon, as a result of multiple programmes performed by the individual brands, as well from the further efficiency of IAG’s platforms that allow for further cost synergies in the group. The increased ASK capacity in the group will lead to a 3.6% CAGR for this expenditure until 2022.

**Exhibit 42: IAG’s actual costs between 2011 and 2016, followed by our estimates until 2022 (€ millions)**

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<tr>
<td><strong>Supplier costs</strong></td>
<td>-5,428</td>
<td>-6,195</td>
<td>-6,343</td>
<td>-6,721</td>
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<td>-8,424</td>
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<td>-9,087</td>
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<td>-9,722</td>
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<td>Fuel, oil costs and emissions charges</td>
<td>-4,999</td>
<td>-5,101</td>
<td>-5,951</td>
<td>-5,987</td>
<td>-6,082</td>
<td>-4,873</td>
<td>-4,981</td>
<td>-4,775</td>
<td>-4,941</td>
<td>-5,110</td>
<td>-5,287</td>
<td>-5,466</td>
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<td>Aircraft operating leases cost</td>
<td>-386</td>
<td>-432</td>
<td>-482</td>
<td>-551</td>
<td>-659</td>
<td>-759</td>
<td>-892</td>
<td>-892</td>
<td>-886</td>
<td>-879</td>
<td>-873</td>
<td>-866</td>
</tr>
<tr>
<td>Depreciation, amortization and impairment</td>
<td>-969</td>
<td>-1,071</td>
<td>-1,006</td>
<td>-1,196</td>
<td>-1,307</td>
<td>-1,287</td>
<td>-1,182</td>
<td>-1,307</td>
<td>-1,435</td>
<td>-1,574</td>
<td>-1,727</td>
<td>-1,893</td>
</tr>
<tr>
<td><strong>Total costs</strong></td>
<td>-15,581</td>
<td>-18,140</td>
<td>-17,905</td>
<td>-18,780</td>
<td>-20,523</td>
<td>-20,032</td>
<td>-19,904</td>
<td>-20,813</td>
<td>-21,606</td>
<td>-22,426</td>
<td>-23,291</td>
<td>-24,182</td>
</tr>
</tbody>
</table>

Source: Company data, Analyst estimates

Fuel, oil costs and emissions charges tend to constitute the largest expense for airline companies. This cost accounted for 24% of IAG’s overall expenditures during 2016, and we expect it to suffer a reduction in relation to capacity in the next years. This is due to larger component on young aircraft in IAG’s fleet, which arrive to substitute old jets with high fuel consumptions. IAG’s fuel CASK in 2016 was set at 1.63 €cents, in line with the European aviation groups according to our estimates (1.62 €cents).

Expenditures related to employee compensation represented 24% of total costs in the group, being expected to increase at a 4.1% CAGR. Even though the depreciation CASK has been increasing over the years (0.38 €cents), this cost figure is still superior compared to its European competitors. Therefore, we estimate an increase in term of ASK, that will be translated into a 9.9% CAGR for the company. This cost category represented 6% of IAG’s cost in 2016. The smallest cost for IAG in 2016 was operating leases costs (4%), which we expect to remain flat until 2022.

Finally, a note regarding our CAPEX forecast. Capital expenditures for an airline consist mainly of aircraft acquisition. The fact that airline companies acquire jets through two very distinct ways (purchase or lease), makes capex estimation a difficult exercise. Company data is not sufficiently clear on which aircraft orders have been paid, while manufacturing companies often concede large price. We used a simplified method to estimate this figure, namely setting the Capex value as a percentage of revenues. In our computations, we considered the Capex to revenues of 2016 since this was the first year where IAG’s 4 major carriers fully operated (Aer Lingus was incorporated in the group in mid-2015). Working capital was also set as a percentage of the company’s revenues.
Discount rate: We decided to value IAG following the Adjusted Present Value method, using the unlevered cost of equity (Ru) to discount the company’s cash flows. To compute this discount rate, we started by choosing the most appropriate risk-free rate. Although IAG is an Anglo-Spanish company, we decided to use the German risk-free rate, since it is the most riskless euro government bond in and IAG reports its financials in the common currency. As we believe current interest rates are ultra-depressed from the actions of the ECB, we used a 10 year forward rate for the German 10-year bond, set at 2.35%. Afterwards, we selected a group of appropriate peers of IAG, to study the aviation market correlation with the market. After examining these correlations for different periods of time (1, 2, 4 and 6 years), we choose as an input IAG’s own unlevered beta of 0.84, since we understood that the company has consistently had a higher correlation with the market compared to its peers (0.46), even when accounting only for the two most direct rivals (average of 0.53). The last input for the computation of the discount rate is the market risk premium, which we set at 6%. An Ru of 7.38% and a perpetuity growth rate of 1.5% were used for valuing IAG.

Adjusted present value: After computing the present value of both company’s unlevered free cash flows, as well as the present value of tax shields we obtained a total enterprise value of €24 361mn for the company (after adding minority investments and financial assets). To compute the equity value, we subtracted the company’s estimated net debt as of 2018 (€5 402mn), yielding a total value of €18 959mn. A final share price of €9.21 was obtained when dividing the equity value by the total number of shares. This BUY recommendation represents a 27% upside versus the IAG share price of €7.24 as of 29/12/2017.

Sensitivity analysis: To test our model and discount rate assumptions we estimated the share price following adjustments in the Ru and g inputs. We computed the Ru based on the average beta of both the industry and IAG’s most similar rivals, Lufthansa and Air-France-KLM, as well as the discount rate under an upside (-1%) and downside (+1%) scenarios. Regarding the growth rate for the terminal value, we tested a 0.5% window that reflects different economic conditions. The fact that our base scenario lies on the lower end of target prices, reinforces our idea that there is plenty of upside in IAG. The flight is not over yet.

---

22 Betas in relation to the Eurostoxx 600
23 In line with GDP growth forecasts for the Euro Area (Statista)
### Financial statements

#### Income Statement

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<td>Passenger revenue</td>
<td>13 496</td>
<td>15 372</td>
<td>16 264</td>
<td>17 825</td>
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<td>19 924</td>
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<td>Cargo revenue</td>
<td>1 176</td>
<td>1 217</td>
<td>1 073</td>
<td>992</td>
<td>1 094</td>
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<td>Other revenue</td>
<td>1 431</td>
<td>1 528</td>
<td>1 338</td>
<td>1 353</td>
<td>1 434</td>
<td>1 621</td>
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<td><strong>Total revenues</strong></td>
<td><strong>16 103</strong></td>
<td><strong>18 117</strong></td>
<td><strong>18 675</strong></td>
<td><strong>20 170</strong></td>
<td><strong>22 858</strong></td>
<td><strong>22 567</strong></td>
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#### Balance Sheet

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<td>Property, plant and equipment</td>
<td>9 584</td>
<td>9 926</td>
<td>10 228</td>
<td>11 784</td>
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<td>14 125</td>
<td>16 028</td>
<td>17 933</td>
<td>19 980</td>
<td>21 742</td>
<td>23 633</td>
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<td>Intangible assets</td>
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<td>1 965</td>
<td>2 196</td>
<td>2 438</td>
<td>3 195</td>
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<td>Investments accounted for using the equity method</td>
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<td>180</td>
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<td>27</td>
<td>41</td>
<td>29</td>
<td>35</td>
<td>41</td>
<td>47</td>
<td>53</td>
<td>59</td>
<td>65</td>
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<td>Available-for-sale financial assets</td>
<td>466</td>
<td>684</td>
<td>1 092</td>
<td>84</td>
<td>74</td>
<td>73</td>
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<td>Employee benefit assets</td>
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<td>606</td>
<td>485</td>
<td>855</td>
<td>957</td>
<td>1 028</td>
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<td>Derivative financial instruments</td>
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<td>26</td>
<td>35</td>
<td>80</td>
<td>62</td>
<td>169</td>
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<td>Deferred tax assets</td>
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<td>450</td>
<td>501</td>
<td>769</td>
<td>723</td>
<td>524</td>
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<td><strong>Current assets</strong></td>
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<td><strong>6 018</strong></td>
<td><strong>7 427</strong></td>
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<td><strong>9 785</strong></td>
<td><strong>9 413</strong></td>
<td><strong>9 801</strong></td>
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<td><strong>11 042</strong></td>
<td><strong>11 978</strong></td>
<td><strong>13 152</strong></td>
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<td>Non-current assets held for sale</td>
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<td>Inventories</td>
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<td>411</td>
<td>424</td>
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<td>458</td>
<td>464</td>
<td>484</td>
<td>503</td>
<td>525</td>
<td>547</td>
<td>570</td>
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<td>Trade receivables</td>
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<td>1 196</td>
<td>1 252</td>
<td>1 196</td>
<td>1 405</td>
<td>1 425</td>
<td>1 485</td>
<td>1 544</td>
<td>1 610</td>
<td>1 673</td>
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<td><strong>Total assets</strong></td>
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<td><strong>18 976</strong></td>
<td><strong>20 777</strong></td>
<td><strong>23 652</strong></td>
<td><strong>28 236</strong></td>
<td><strong>27 373</strong></td>
<td><strong>28 905</strong></td>
<td><strong>31 203</strong></td>
<td><strong>33 628</strong></td>
<td><strong>36 267</strong></td>
<td><strong>39 111</strong></td>
<td><strong>42 182</strong></td>
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#### Net income

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<td>Non-operating profit after tax</td>
<td>266</td>
<td>-170</td>
<td>-41</td>
<td>-143</td>
<td>-107</td>
<td>143</td>
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<td>Debt interest after tax</td>
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<td>-254</td>
<td>-175</td>
<td>-199</td>
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<td><strong>Net income</strong></td>
<td><strong>554</strong></td>
<td><strong>-185</strong></td>
<td><strong>430</strong></td>
<td><strong>868</strong></td>
<td><strong>1 539</strong></td>
<td><strong>1 990</strong></td>
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<td>388</td>
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### Report Recommendations

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<th>Description</th>
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<td><strong>Buy</strong></td>
<td>Expected total return (including expected capital gains and expected dividend yield) of more than 10% over a 12-month period.</td>
</tr>
<tr>
<td><strong>Hold</strong></td>
<td>Expected total return (including expected capital gains and expected dividend yield) between 0% and 10% over a 12-month period.</td>
</tr>
<tr>
<td><strong>Sell</strong></td>
<td>Expected negative total return (including expected capital gains and expected dividend yield) over a 12-month period.</td>
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</table>

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