



Transcription for PEGASUS AIRLINES

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Corporate Participants

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Conference Call Participants

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Kerem Tezcan

BGC Partners

Gorkem Goker

Erste

Presentation

Operator

Ladies and gentlemen, welcome to Pegasus Airlines Third Quarter 2014 Earnings Call. Following today’s presentation, there will be a formal question and answer session. I would like to introduce today’s conference host, is Mr Serhan Ulga, CFO, and Mr Sertaç Haybat, CEO. I now hand over to Mr Sertaç Haybat, CEO. Sir, please go ahead.

Sertaç Haybat

Thank you. Good afternoon everybody, we will just a short presentation, actually the presentation is already on our website, so you probably have seen it before, so I'm not going to spend so much time on the numbers. I am just going to highlight the important ones.

As for the first nine months of the year, as you can see on the first bullet point on page two, the number of passengers increased by 19%. This is well above the market average. Load factor has remained almost the same, although we had a slight decrease on international load factor and a slight increase on domestic load factor. Overall, it's remained almost flat. The revenues went up by 33%, mainly driven by international sales and ancillary revenue, and the ancillary revenue per PAX went up by 15%, over €9. This is mainly due to increased penetration in existing products. CASK went slightly up, but we have reasons for that and we will explain this on the CASK slide. Overall, the net profit for the first nine months has been TL 234 million.

Well, slide number three is just showing these numbers in graphics, so I'm not going to spend too much time on that.

On the operational performance, the first nine months, domestic passenger was over 9 million and international passenger in the first nine months almost reached 6 million. All together, we carried 15 million passengers as we forecasted. The overall load factor is 80.6%. PAX per cycle went down by one passenger; it's mainly due to the decreased load factor on international flights, and utilisation remained flat.

When we look at how we performed against the market, on the third quarter, domestic market grew by 6.8% where we grew by 12.4%, almost double of the market growth. On international, the market grew by 9.1% and we grew by 10.2%, slightly above the market level, but as you all know, we are on international expansion, we are limited by the traffic rights, as we often disclose. In the first...I mean in the coming days, we will have new destinations, but we will have flights to Nice, Oslo, Lyon, Malpensa, and of course these are all European destinations. We already started flying to Sharm el-Sheikh and Hurghada in Egypt in October, and in the coming months we are planning to start operations to Türkmenbaşı, Tunisia and Dammam in Saudi, and in the coming next years there will be frequency increases in some of our destinations. This year, as we disclosed, we are operating 54 airplanes with an average of 4.6 years of age.

Here I will hand over to Serhan Ulga, who is our CFO, to talk about slide number seven, the EBITDAR Bridge.

Serhan Ulga

Hello everybody. If you look at quarter three, it has been a rather good performance for the company. EBITDAR percentage went up by almost one percentage point. There are, as you can see, three big contributors. One of the largest being the increase in volume in production that has an impact. Ancillary revenue per PAX has a positive impact, as well as the effects on the

overall EBITDAR performance. This was offset by a component of items which most of you already have known by heart now are the usual engine overhaul provisioning due to the [inaudible] increase in the production and more mix of dry lease, operational lease aircraft structure, and we have also some delayed flight costs that we have experienced in the third quarter.

If you look at it from a nine-month perspective, the similar culprits are in place, even though the EBITDAR margin is lower compared to last year's, the biggest contributor is the increase in volume, the production. We have, again, ancillary per PAX contributing about TL 60 million and, again, offset by a number of items on the commercial side, one of them being scheduled flight RASK mostly from international flights, as well as the impact of our switching of structural in Sabiha Gökçen handling and a mix of host of things that we have just talked about in the third quarter. Normally, it went up from TL 482 million to TL 523 million.

More importantly, when you look at CASK, we continue to have the impact of...if you look at actually CASK ex fuel, we continue to have headwinds coming from the same contributors that we have just discussed on the quarter basis, fleet structure, operational...financial resources, operational lease; the engine provisioning that we have always provided, but also we have had delayed flight costs that are coming into place due to, as you would know...that's less than our expectation or less than our standard of on-time performance, which resulted in extra delayed flight costs that have also contributed to the step-up and the CASK ex fuel, and for the nine months, we have similar contributors, as you will see on the left, and...but this time a net-net basis, a better FX impact on the CASK, even that is offset by TL base costs and delayed flight costs also adding onto the cost base, so it went up by \$0.06 for the nine months. I am sure we will talk about in Q&A our expectation of how we're going to be...how we are seeing the CASK, how for year-end and into the coming year, we will talk about it then.

I will move onto the next slide. It just gives you a flavour for the trends that we are seeing compared to the previous two years. It seems like graphically we will be ending up somewhere in the middle in both cases on nominal CASK and CASK non-fuel, [on figuring out the] relationship.

On the balance sheet, one thing we have done is we have been talking above over the past so many months, we have converted out cash on hand, practically almost all TL, to...half of it now is in US Dollars and there is also Euro, 25%, and some other hard currencies, ending up only about 20% TL. What does this mean, is that we are less...is we are short in US Dollars and long in TL, this means...this composition means we are less exposed to volatility and foreign exchange rates, mostly to the Dollar. On the currency exposure, again if you...we have highlighted this with some of our meetings before and there is also...there is the table on the right hand side, upper

right hand side, but what we were able to do compared to last year is first of all we were able...for the same period we were able to increase our Dollar earnings from 11% last year to 13%, obviously with a bigger nominal value, also, as we are increasing our TL based expenses from 18% to 19%, so those are natural hedges that will negate the negative impacts of the US Dollar fluctuation. We are hedged at the rates that we have disclosed on the slide. For the fuel, it's pretty much hedged for 2014 and '15, but for 2015, we are still trying to secure our US Dollar shortage on a percentage basis, which is only at 11% at this time.

The next slide now, I will hand it over to our CEO, and he will talk about the fleet update and then the outlook.

Sertaç Haybat

Okay. Well, there is not much to say on the fleet update. As you know, we still have...these aircrafts that we show on the slides are only contracted airplanes, so of course in the meantime there will be operational leases added to the fleet. As you know, the Airbus neos will only be coming in 2016 and on the comments, we said that the first batch of these airplanes will be financed through ECA backed financing, so we will add them to our balance sheet.

Coming to the outlook and trends, we expect a continuation of passenger growth both on international and domestic markets. The total passenger growth for 2014 is going to be around 18% and this 18% we'll expect to continue in the coming years. DHMI forecast is about 10% until the end of 2015.

On the capacity increase, so in parallel with the passenger increase and with an increase of ASK by 18%, and utilisation will remain the same.

On the load factors and yields, we are expecting a slightly higher yield in the coming months and a stable load factor of domestic. On international, we expect flat yields and I think that the pressure on the load factor will continue. The ancillary revenue, in the first nine months we achieved €9, so we are expecting to end the year over €9 and, of course, the target for the next three years is €10-12 per PAX range.

Operating costs in CASK we expect in the near-term to be stable. EBITDAR margin for 2014, we did not change our previous forecast which is 17-19%. On the CapEx and cash flow, we do not expect any sizeable non-aircraft CapEx, so this is our forecast.

I think now we are ready for the Q&A session.



Question and Answer Session

Operator

[Operator instructions]

Our first question is from Donal O'Neill from Redburn. Please go ahead.

Donal O'Neill

Hi guys and good afternoon and congratulations on a very good set of results. I will ask three questions, if I can. The first one: I wonder, can you give us a breakdown of what proportion of your growth over the next two to three years will come from new routes versus increased frequencies on existing routes? My second question: just in terms of cost visibility, can you give us a sense of how much visibility you have particularly on airport charges, how many years of visibility you have, and what confidence you have that you can contain growth in regulated airport charges? The last question, just to touch on your comment about yields, why do you expect yields to be stronger in the next few months on the domestic market, is there any contribution there from strong or late bookings? Thanks.

Sertaç Haybat

All right, the first question is where the growth is going to come from. Of course, as we have been explaining all along these years, on international we have an obstacle of bilateral agreements and, therefore, it's very difficult for us to predict new routes we're going to be able to obtain traffic rights for, and so the growth as I mentioned earlier, there are some new destinations that we mentioned, but other than those, the growth will mainly come from the increase of frequencies. On domestic markets, there are only a couple of new routes that we can explore, but we do not plan any additional destinations for next year.

The second question was the airport charges; as you know, in Turkey, all the airports are owned by DHMI, the State airport authority, except for Sabiha Gökçen, our main hub, and Sabiha Gökçen Airport has a tendency to follow the DMI rate, and what we have seen, DHMI has only been increasing their airport charges slightly every year, the TL charges according to the inflation rate, and mostly the Euro charges will remain stable and they may be adjusted to according to Euro inflation rate, but overall we do not expect any surprises on that. I mean this is...in any case, any increase is going to be valid for all the players in the market.

The third question was...

Donal O'Neill

The strong yields on the domestic market.

Sertaç Haybat

The strong yields on the domestic market. As you know, Turkish Airlines increased their presence in Sabiha Gökçen Airport and at the beginning of their operations, they came in with crazy rates that you had to compete with, and lastly, what we are...seeing that they are coming to their senses and there is a return to normal market levels, therefore we do not expect any additional pressure on the domestic yields, and on international yields, the same applies actually, and as we have so many new destinations and the opening of these destinations, we always offer very attractive rates to attract attention from the market, and therefore we see that on the next months, the domestic yields, there won't be any more additional pressure on domestic yields and the load factors will remain stable.

On the international flights, we expect the drop in load factor to continue flat in the coming months and no additional pressure on yields. Does this cover your questions? Did we miss anything?

Donal O'Neill

No, that's great, thank you very much.

Sertaç Haybat

Thank you.

Operator

Our next question is from Alex Kazbegi from Renaissance Capital. Please go ahead.

Alex Kazbegi

Yes, good afternoon. Can I start with clarifying your answers to the previous question on the yields, just to understand? When you say stable or when you say increase, is it year-on-year you mean or is it vis-à-vis the last quarter; is it sequential or is it year-on-year, and in which currency? My second question would be on your fuel pricing; I mean you mentioned there that for 2015 you have basically already 66% of your fuel purchases hedged. Could you give us again some colour maybe in terms of what kind of prices are



those hedged and have you been managing to utilise the low fuel environment over the past two months, and any colour on that would be great? The last one, also connected maybe to that, is that there is, of course, a portion of the pricing which usually comes from these surcharges. Do you expect if, again, the fuel prices continue to be low that you will actually have to adjust your pricing downwards to reflect the lower surcharges? Thank you.

Sertaç Haybat

Well, talking about the year, maybe I should be more specific here. As you know, THY increased their presence at Sabiha Gökçen and normally the competition authorities in Turkey would allow them to charge fares lower than the market level for the first six months of their operation, so they would accept this as a market entry and they won't penalise THY for doing so, but after six months, if they continue to offer lower fares than Atatürk Airport, their main hub, then it might again be a competition board case. What we are seeing is that after the first six months of operations, THY return their fares to their normal level and we continue...we expect this to continue.

On the hedge question, I think maybe Serhan should cover this, he is better informed than me, but we are hedged around 66% for the time being, and the average hedge price is...

Serhan Ulga

About \$890.

Sertaç Haybat

\$890 per ton.

Alex Kazbegi

And on the surcharges?

Sertaç Haybat

On the surcharges, I mean the surcharges will very much depend on market conditions, so we have no intention of taking those back.

Alex Kazbegi

Okay, very good, thank you very much.



Sertaç Haybat

Thank you.

Operator

Our next question from Alper Paksoy from BNP Paribas. Please go ahead.

Alper Paksoy

Good afternoon gentlemen, thanks a lot for the presentation. I wanted to follow-up on that fuel-related question. In the third quarter it seems like there wasn't any benefit at all from declined fuel prices. Can you elaborate on that, because fuel prices started coming down in September, but we haven't seen any such declines in your unit fuel costs from what I can see? Serhan Bey mentioned the average hedge price at \$890 per ton. Is this a straight hedge? Is this just a simple future or is it based on options, i.e. if the price, the [actual] refinery price is below 890, should we expect 66%, for example to be at that price or are there different mechanisms in place, which makes the calculation not so simple. About the growth plans, I think if I have the correct news, Turkish Airlines General Manager said they plan to have 100 aircraft in the long-term at Sabiha Gökçen even after the new airport is opened. Would such a presence have any impact on your growth plans? One more question if I may, there wasn't any change in the EBITDA margin guidance, but from what we can see in the third quarter, there has been an expansion, don't you think this is a bit too cautious? Thanks very much.

Sertaç Haybat

Alper Bey, we like to be cautious, so we will keep it this way until we have the yearend results, and on your first question about the fuel price, as you know the fuel contracts, you pay...is designed in a way that in September, for example, you pay the average, plus average of August, so the reflection of the fuel price will come one month in delay.

Serhan Ulga

There is also Euro/Dollar FX parity that came down as well starting in September and October.

Sertaç Haybat



Exactly, and on THY's intention to have 100 airplanes, talking about year 2020, it is very long-term, so I don't want to comment on those, but whatever Turkish Airline's presence is in Sabiha Gökçen, the important thing is as long as we keep the CASK difference, we do not have anything to worry, because...so Turkish Airlines are not disclosing their Sabiha Gökçen operational results separately, as you know, and presently they have about 25, 26 airplanes flying out of Sabiha Gökçen and it is a very small portion of their total operation, and as they increase this presence, the impact on Turkish Airlines will be higher, I should imagine.

Serhan Ulga

On the question that you had about, if these are outright swaps, a substantial amount of these are what we call chooser forwards, which is as we have discussed quite a few times before our...basically, we sell the bank a call option to either call on to sell fuel or call on to sell FX. Based on the [strike] prices of the structures, these are the numbers mark-to-market and calculated in that manner. There is a small portion that makes up this 66%, which is an outright swap, so we may consider restructuring some of these chooser forwards to make them reflect the current market prices, and we are in the process of engaging to do depending on this, with the current \$80 range swap contracts as well, but I cannot tell you an amount right now, it hasn't been determined.

Alper Paksoy

Thank you very much.

Operator

We have a question from Hanzade Kilickiran from Barclays. Please go ahead.

Hanzade Kilickiran

Serhan Bey, Sertaç Bey, thank you for the presentation, actually, most of my questions were answered, but I would like to focus on 2015, rather than 2014 at the moment. I wonder if there is any kind of ASK guidance that you can share with us with this new fleet programme. Do you expect a slowdown in the passenger growth in 2015 versus 2014 in terms of growth? The second thing is that, yes, there are lots of questions about the fuel hedging and you mentioned that you expect the CASK to stay stable in 2014, but do you expect any kind of decline in the CASK in 2015, because of the fuel, if the oil stays here or this hedging will never work in favour of the unit cost. The final question is that, how flexible are you now in Europe, particularly to the fact of the strengthening Dollar in your yields?



Sertaç Haybat

Hanzade, I didn't get the last one, so can you repeat that?

Hanzade Kilickiran

How flexible are you, particularly in the European market to reflect the strength in Dollar against Euro?

Sertaç Haybat

If we start from the last part, I think, as you know all our competitors in Europe, also in Turkey, are facing the same problem. All the airlines, they are in general short of Dollars, long in Euros and other local currencies, all European airlines. Therefore, what we would see as this will also cause stress on them and the Euro yields may go up in the coming months in the European market.

2014, the ASK growth as we expect the passenger growth around 18%, you should assume that the ASK growth...

Hanzade Kilickiran

No, it was for 2015, rather than 2014.

Sertaç Haybat

I think I said the same in 2015, we also expect ASK growth around 18, 20% in parallel with passenger growth.

Hanzade Kilickiran

But you don't get in that much fleet (aircraft) in 2015, as far as I see from your fleet programme.

Sertaç Haybat

Exactly, but I said during the presentation, the fleet programme is only showing the contracted airplanes.

Hanzade Kilickiran

You may operational lease the aircraft.



Sertaç Haybat

That will – operating leases added to the fleet.

Hanzade Kilickiran

All right thank you. Do you also expect the same load factor in 2015 with these increases in the frequencies or you may see some decline in the load factor in 2015?

Sertaç Haybat

I think we are expecting a stable domestic load factor and we are expecting the new levels of international load factor to continue.

Hanzade Kilickiran

All right, thanks a lot. Serhan Bey, can you elaborate a bit on fuel hedging?

Serhan Ulga

Fuel hedging, like I said on the existing contracts are mostly in chooser forward type structures where – am repeating myself – but where we are selling the call option to the bank to either call us to sell Dollars or to sell fuel and it is a synthetic settlement. If you look at...because of the recent swift change in the – or the volatility in both currency and the fuel, this time obviously it is downside risk, downside volatility. We see more of our also existing FX intended contracts also sway, and based on the mark-to-market conditions right now, the existing pay-out structure end up in fuel, so the fuel, as you will see for example is 66%, which is what is beyond our normal guided threshold. This is because of that, because of intended FX structures, now, in this contract, now, is going to be probably called on to sell us fuel, that is more advantageous to the bank.

That is why I said we are in the process of restructuring some of these contracts, because these are not straight out outright swaps and we think we could come very close to the current market condition on the existing ones and move them over to the FX side, and then also be able to engage with the current levels of fuel price levels, on direct swap type structures, which is [audio] than the current overall portfolio.

Hanzade Kilickiran

Okay, so you have the flexibility to benefit from the declining oil prices, particularly in the first quarter of 2015, I understand.



Serhan Ulga

That is the plan we are working on and we will let you guys know about that plan when it becomes available.

Hanzade Kilickiran

Thank you, thanks a lot.

Operator

Our next question from Kerem Tezcan from BGC Partners. Please go ahead.

Kerem Tezcan

Thank you for the presentation Sertaç Bey, Serhan Bey. One question – most of my questions are already answered as well. The question that I would like to focus mainly on the capacity problems or potential capacity problems at Sabiha Gökçen. When I look at the two big players next year – 2015, and 2016, there will be 27 additions in 2015 and 52 aircraft additions in 2016. We know the expansion plans both at Ataturk Airport and Sabiha Gökçen. The first question is, do you think that the runway will be up and running in 2016 at Sabiha Gökçen? If not, considering the amount of aircraft that those two companies will add in the next two years, do you think that the capacity problem at Sabiha Gökçen would continue to squeeze your margins in an increasing fashion?

Sertaç Haybat

I think this is an important question, and you know that the second runway...at Sabiha Gökçen, the limiting factor is the runway capacity, first of all, it is still a single-runway airport and the second runway project is on its way, the tender process has started, I think the bids are collected etc, but we are still awaiting a decision by DHMI because DHMI is leading this process. If this runway is not ready by 2016 or latest 2017, I think both Turkish and us will have a capacity problem in Istanbul. In general, Istanbul will have an airport capacity problem, so we are hoping that the second runway is constructed according to the plans and when we talked to the contractor, they are saying that it will take one and a half years to two years to complete this second runway, so we are waiting an announcement from DHMI for the successful bidder.

Kerem Tezcan

To put it into numbers, do you have any kind of sensitivity analysis for 2015 that the capacity may further cause problems at Sabiha Gökçen, plus, are you expecting Turkish Airlines to move additional capacity to Sabiha Gökçen in 2015?

Sertaç Haybat

Of course, I mean, as they cannot put any additional capacity to Ataturk Airport as far as we know, they may increase their presence in Sabiha Gökçen, this is something that we are expecting. We are not much worried about this, except for airport slots, taxi times or the landing times etc.

Kerem Tezcan

Just one last question, the ownership at Sabiha Gökçen Airport is still insignificant in the past six months, I can say. Considering that Malaysians has been kind of a silent partner about six months ago or a year ago, do you see any operational risk at the airport's management, given the fact that Malaysians are the sole partner or the sole owner at Sabiha Gökçen now.

Sertaç Haybat

I think we have to make a correction here, as first of all, the Malaysians...the new owners, it seems that it is going to be the Malaysians, they will own 100% of the terminal, so they are not the airport operator, but they are only the terminal operator, the airport will be operated in the coming years by [Hersh], this is a company which belongs to the Military Fund. After making this correction, I should relate this to your previous question, as the Malaysians are paying €285 million for the 40% remaining shares at Limak, this amount can only be justified with the second runway.

Kerem Tezcan

All right, thank you, thanks so much.

Operator

We have a question from Gorkem Goker from Erste. Please go ahead.

Gorkem Goker

Sertaç Bey, could you please reiterate your comments about the Competition Authority's statements regarding Turkish Airlines Sabiha Gökçen based flights, I couldn't get that part clearly.



[All talking]

Okay, if you got the question, okay.

Sertaç Haybat

I got the question. You know that we have an on-going case with Turkish Airlines from 2009. In 2009, Turkish Airlines again had started some flights from Sabiha Gökçen and the way they did it, they priced these prices much lower than the same flights from Ataturk Airport, so we made a complaint to the Competition Board, the Competition Board started an investigation on the matter and the report came out that...the report came out proving our case, but the Competition Board decided not to penalise Turkish Airlines. This decision was taken to the Court and the Court rejected the Competition Board's decision and the case now is reopened and we may hear it in near-term result.

What we are saying here is on this report, the Competition Authority said that for the six months after the beginning of the operation, a newcomer should be allowed to offer below market rates even rates below their cost structure, but this is only for the introductory phase of the flight, and after, the rates should return to normal. Returning to normal meaning that they should be offering the same kind of fares from Ataturk Airport as they offer from Sabiha Gökçen.

Is this clear?

Gorkem Goker

Okay, but there is no binding article for Turkish Airlines, as of today, as far as I understand, right?

[All talking]

This is just suggestion from Competition Authority'?

Sertaç Haybat

It is a principle put down by the Competition Authority, but it is not a binding principle as you can see, but what we have seen recently, we have seen that Turkish Airlines has been following that principle.

Gorkem Goker



Okay, I got it now, thanks very much.

Operator

[Operator instructions]

We have a question from Alper Paksoy from BNP Paribas. Please go ahead.

Alper Paksoy

Hi again, I have a question on on-time performance, during 2014, on a monthly basis, there have been ups and downs, sometimes 70% plus, sometimes 80% plus and you mentioned Sabiha Gökçen is getting congested a bit, will get congested in the coming years. Do you expect the on-time performance, do you expect any trouble on the on-time performance because of the congestion at Sabiha Gökçen in the coming years, at least until the new runway is opened? Thank you.

Sertaç Haybat

Alper Bey you are able to ask this question, because we are announcing our on-time performance on our website, but please check the others, there is no data given on the on-time performance, but coming back to your question, yes, of course Sabiha Gökçen congestion and the passport control formalities and the failure of our handling company at Sabiha Gökçen brought down our on-time performance in the last months. For the coming year, we are taking some measures where we will be doing part of our own ramp handling in order to fill in the gaps if the handling company has still shortages. Of course this is something that we can do, but on the other hand, on the congestion side, we slightly redesigned our schedule so that the number of movements at the peak times are slightly reduced, so expecting...I mean trying to prevent the congestion delays. Next year we are expecting to bring our on-time performance, or we are aiming to bring our on-time performance over 90%. When you look at last month we already achieved that, but of course this is low season months, so we have to see if we will still be able to achieve this in the high season months.

Alper Paksoy

Thanks a lot.

Serhan Ulga



It sounds like there aren't any other questions, so this should wrap up our third quarter webcast. Thanks for joining and we will be talking to you again in three/four months.

Sertaç Haybat

You will be talking.

Serhan Ulga

[Laughter]

I will be talking, bye-bye.

Operator

This concludes our conference call. Thank you for participating. You may now disconnect.
