European airlines and the Asian market

A Lufthansa Consulting outlook towards the middle of the next decade

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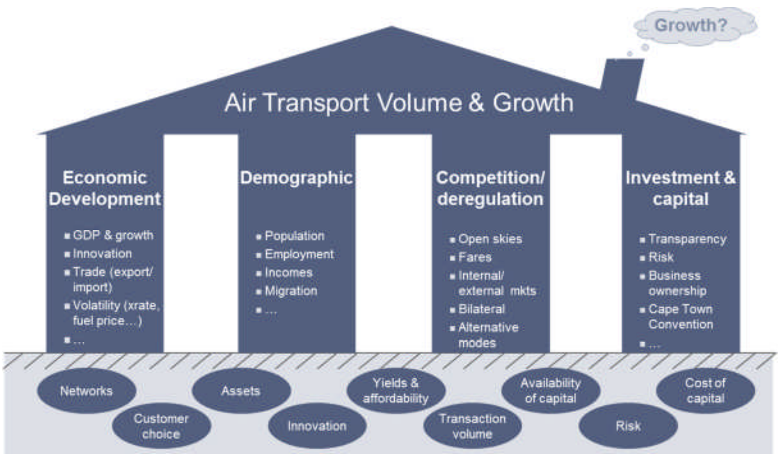
Perspectives for growth

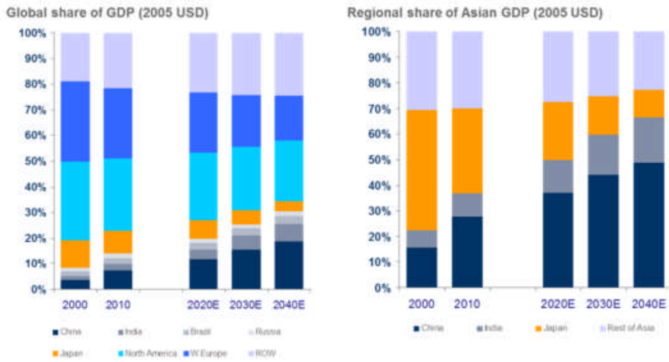
Much has been written about the development of the Asian market, the large order books of the Middle Eastern airlines and the respective positioning of the European airlines in an effort to deal with new opportunities and threats. Indeed, the synopsis regarding potential outcomes is a classic strategic question with no single answer and with European airlines all facing some unique problems specific to their business model risks.

Lufthansa Consulting adopts a four-pillar approach to assess growth, which takes into account economic development, demographics, the level of regulation and investment. This enables regions, countries, and cities to be segmented into specific growth and risk clusters and to make forecasts based on the factors that ultimately underpin growth.



Global growth has been led by the BRIC nations over recent years, with Asia proving the most significant region and China the catalyst within Asia. These will grow rapidly until 2040 and therefore lead the demand for long-haul services to and from Europe. The European airlines will adapt their network portfolios and strategy accordingly to address the regional opportunities and risk perspectives of the new growth markets.

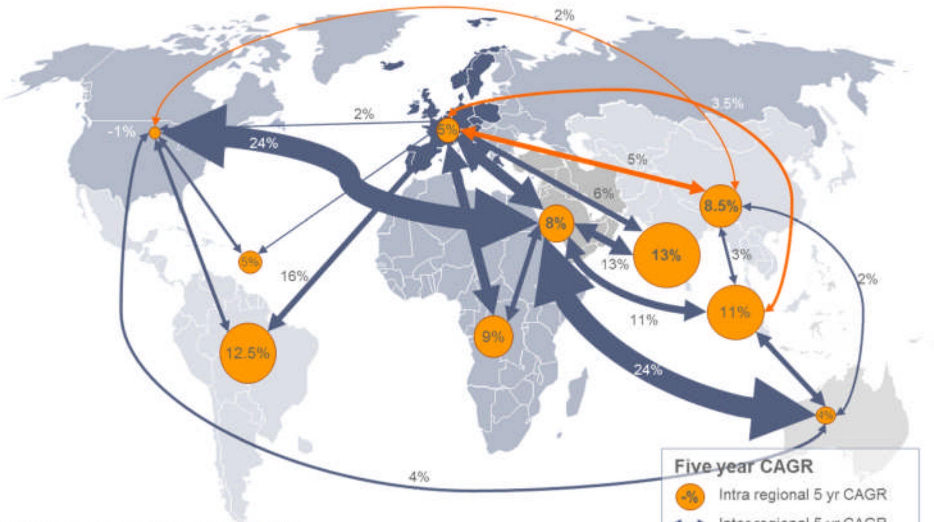
Real World GDP development by global share (Global Insight, 2005 USD equivalent)



European airline perspective

Europe's perspective is perhaps unique due to the diverging economic outlooks of the region and the presence of Middle Eastern operators on the air traffic routes between Europe and Asia. Indeed, an airline's ability to develop is highly dependent on its operating base, its network structure and the geographical restrictions imposed. So what can be said about the current status quo and the trends that are forcing change?

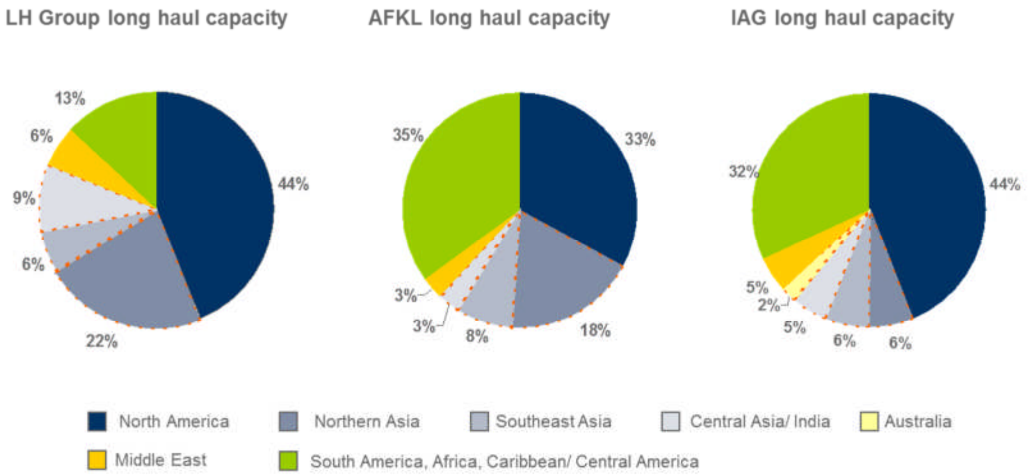
Five-year regional and intra-regional air transport compound annual growth rates



Note: CAGR = Compound annual growth rate

The European airline sector has a mix of airline business models that are either in retrenchment or expansion mode. Niche players such as Finnair and Turkish Airlines are using their specific geographic locations to underpin their current hubs and link intra-regional opportunities. Meanwhile, the major European hub operators are going through a period of change. The Lufthansa Group and IAG have strong markets in North America, with the former currently the most active in the Asian markets.

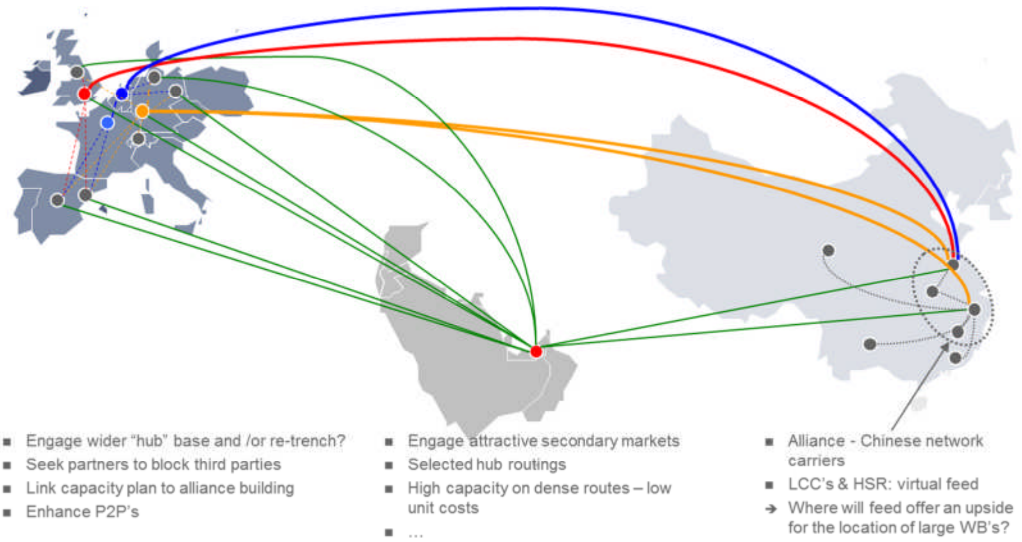
Long-haul capacity sector share of the major European airline groups



To some extent, the observations reflect their hubs and the key differences between LHR and the other airports. LHR operates at 98% capacity and arguably faces a lower threat from aggressive competition targeting new slots. Airlines operating out of London are therefore retrenching more sharply in order to develop and evolve their existing business. The Lufthansa Group has a contrasting exposure, due primarily to the nature of the domestic German market, as in Germany the population and the economy are not focused on any particular city.

IAG is arguably the weak link regarding Asia (China) with a very low presence in terms of its share of long-haul capacity. Moreover, the recent merger of BA and IB now offers two hubs in Madrid and London respectively. Most management statements imply a core focus on synergies on routes into Latin America. Less has been said of the routes to Asia although this does not automatically imply less focus. Meanwhile, Air France/KLM has had time to develop synergies and now utilizes both the Paris and Amsterdam hubs. It currently has a different focus, with Latin America and Africa more dominant segments on its long haul network.

Schematic route and network map "Europe, China and Middle East" – P2P vs. Hub



Strategies for the future

Not much has been said so far about the Middle Eastern operators. These have aggressive growth plans with their order books showing a roughly threefold increase in available capacity assuming that there is no rollover. Placing all of the new equipment onto new routes will be quite a challenge. Their order book portfolio can therefore be projected onto a future network and risk portfolio whereby some orders incur higher risks than others. Aligning these portfolios is a very important exercise in order to define activities for risk mitigation.

The Middle Eastern airlines' lever will be to develop and strengthen their own hubs while undermining and attacking European (and also Asian) airlines, preferably at their weak points. The airlines participating in this market are faced with a classic mix of defence and offence strategies, with each company playing different games. Middle Eastern carriers, which have acquired good -quality management from Europe to complement their local staff, will minimize their own weakness or use their strength to take advantage of opportunities to operate into airports that are not part of the European airlines' hub systems. European airlines will employ a different tactic, and will either use their strengths or minimize weaknesses to avoid threats. In simple terms, this means that Middle Eastern operators will tend to target routes that do not serve European hubs. The current networks offer some opportunities here as airlines enter a fluid development phase as each carrier acts and reacts according to its perceived strengths and weaknesses.

European operators will always claim an advantage in the event that they offer point-to-point services to their hubs. Middle Eastern operators cannot compete here as they their passengers always face a transfer. A pure strategic prognosis leads to the conclusion that they will target the off-hub routings on an opportunistic basis. IAG would appear vulnerable in Madrid and Barcelona while the other alliances must question certain airports with high proportions of transfer traffic. The dilemma for European airlines is whether a defence of the current status quo is fully feasible – this depends on whether the emerging competition can successfully deploy into new markets and therefore the future market size of non-hub airports. The key question is therefore: To what extent do current investment strategies reflect the risks posed by the Middle Eastern airlines? Lufthansa Consulting suspects that adjustments to fleet plans need to address the play-off between high and low capacities in order to offer more flexibility to deal with off hub traffic and the threat posed by Middle Eastern operators.

Opportunities

Asian airlines have similar problems on routes to Europe and will possibly more serious issues on routes into Africa, should this develop into a major market. Moreover, opportunities are arguably much more significant with growth currently exceeding 8% per annum and the Middle Eastern order book expected to be slanted to the significant market potential of the region.

Both European and Asian airlines therefore share a similar enemy and will seek partnerships to leverage networks, raise entry barriers and jointly combine their network structures. Indeed, it is arguably vital that carriers seek partners and attract the most attractive option as soon as possible if they want to also increase their strength vis-à-vis competing alliances. he major European hub operators are expected to prioritize this activity as a matter of urgency in their respective global alliances.

Risks

One can argue that governments may be less willing than before to offer additional slots to Middle Eastern operators in order to protect locally based companies. Indeed, Berlin has recently blocked a new route request from Emirates, implying that entry barriers are increasing. While this can be seen as a form of defence, it does raise a few questions about some of the growth projections, particularly when one considers that deregulated markets have been the lynchpin for new business models and capacities. This was raised at the beginning of the article and may hinder growth and potentially harm all players in the market if it is not addressed in the right manner

Lufthansa Consulting therefore expects a changing market and a very different status quo towards the middle of the next decade, a time when much of the current order backlog should be in operation. This is also a time when the current economic crisis is expected to unravel, creating many unknowns with regard to economic growth projects, a risk to traffic development, and the fact that finance is becoming either more expensive or more difficult to find. The macro developments are difficult to predict but will surely increase the portfolio risk for investors.

Further mergers and acquisitions are expected as consolidation evolves. Indeed, one opportunity is for Middle Eastern operators to acquire a European low-cost operator or to seek ways to access synergies and target more coverage into European markets. Their current strategy is limited in this respect.

This would move away from the current strategies but may be seen as a way of more aggressively engaging the European challenge. Nevertheless, as with any acquisition target, all opportunities must be weighed up against the risks. One would expect strong pressures to force any deal to address the concerns of European airlines for an open and fair competitive environment and more transparency regarding investments and business models. Any deal will therefore take time to materialize, will pose risks and may be more of an opportunity than a threat for European airlines.

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