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'Attack' of Airlines from Emerging Countries – Threat for Established Carriers or Blessing for Passengers?

By Dr. Markus Franke, Owner FATC

EBS Business School, Series of Lectures: „Aviation Management – Current Challenges and Trends“

Oestrich-Winkel, November 15, 2011

EBS  Business School

Agenda

- **Introduction of FATC – Consulting in the Aviation Industry**
- Players in the Intercontinental Arena
- Future „End Game“ Scenarios – Winners and Losers
- The New Equilibrium – Benefits for the Client

FATC is a small, but focused transportation consultancy with a stronghold in strategic aviation advisory...

Profile



Franke Aviation & Transportation Consulting offers classic strategy consultancy. Proven success is built on:

- Leading **expert knowledge** across all industry sectors
- Long-standing, **international project experience**
- **Analytical rigour** and **methodological excellence**
- **Social competence**

Beyond the senior expertise of Dr Franke, Franke Aviation & Transportation Consulting has access to a network of additional resources:

- Freelancers for data mining, analytics, documentation, etc.
- Senior Experts for particular contributions in functional areas such as network optimisation or airport operations
- Case-by-case collaboration with selected mid-sized or major consultancies to facilitate larger projects

Service portfolio

FATC offers support in five functional areas:

- **Strategy & Structure:** Corporate strategy, business models, functional strategies, governance models, organisational structure, partnership concepts, etc.
- **Planning & Steering:** Planning paradigms and processes, steering logics, central vs. de-central accountability, etc.
- **Growth & Revenue:** Optimisation of commercial processes such as network planning, revenue management, pricing, offer & capacity steering, sales
- **Efficiency & Cost:** Redesign of operational processes such as maintenance, load planning, transit handling
- **Reporting & Controlling:** Redesign of cost calculation structures, allocation of intracompany services, reporting blueprints, Management Information Systems

...based on the long-standing industry expertise of Dr Markus Franke (Owner of FATC)



Dr Markus Franke is an independent transportation consultant and senior aviation advisor, with a functional focus on strategy, organization/ governance, and commercial functions (such as network management or pricing). He owns 16 years of experience in top management consulting for major airlines, airports, private & state-owned investment companies, as well as for public authorities like national MoTs. Besides aviation, he also has a decent track record in transport, logistics, and rail traffic

Background

- After 15 years with international top management consultancies (last eight years as Partner / Associate Partner in charge of aviation business) at Oliver Wyman, Booz Allen, Boston Consulting Group, and Roland Berger, he founded his own consulting business (Franke Aviation & Transportation Consulting, FATC)
- Ever since, he supports major clients as senior advisor, with freelancer teams, or with collaboration partners

Education

- Diploma in Aerospace Engineering (RWTH Aachen, with distinction)
- Diploma in Economic Sciences (RWTH Aachen)
- Doctorate (Ph.D.) in Engineering Sciences (RWTH Aachen, Summa cum laude)

Languages

- German (native speaker), English (fluent), French (advanced), Spanish (basic)

Dr Franke and FATC have worked for leading aviation clients in Europe, the U.S., and the Middle East / GCC

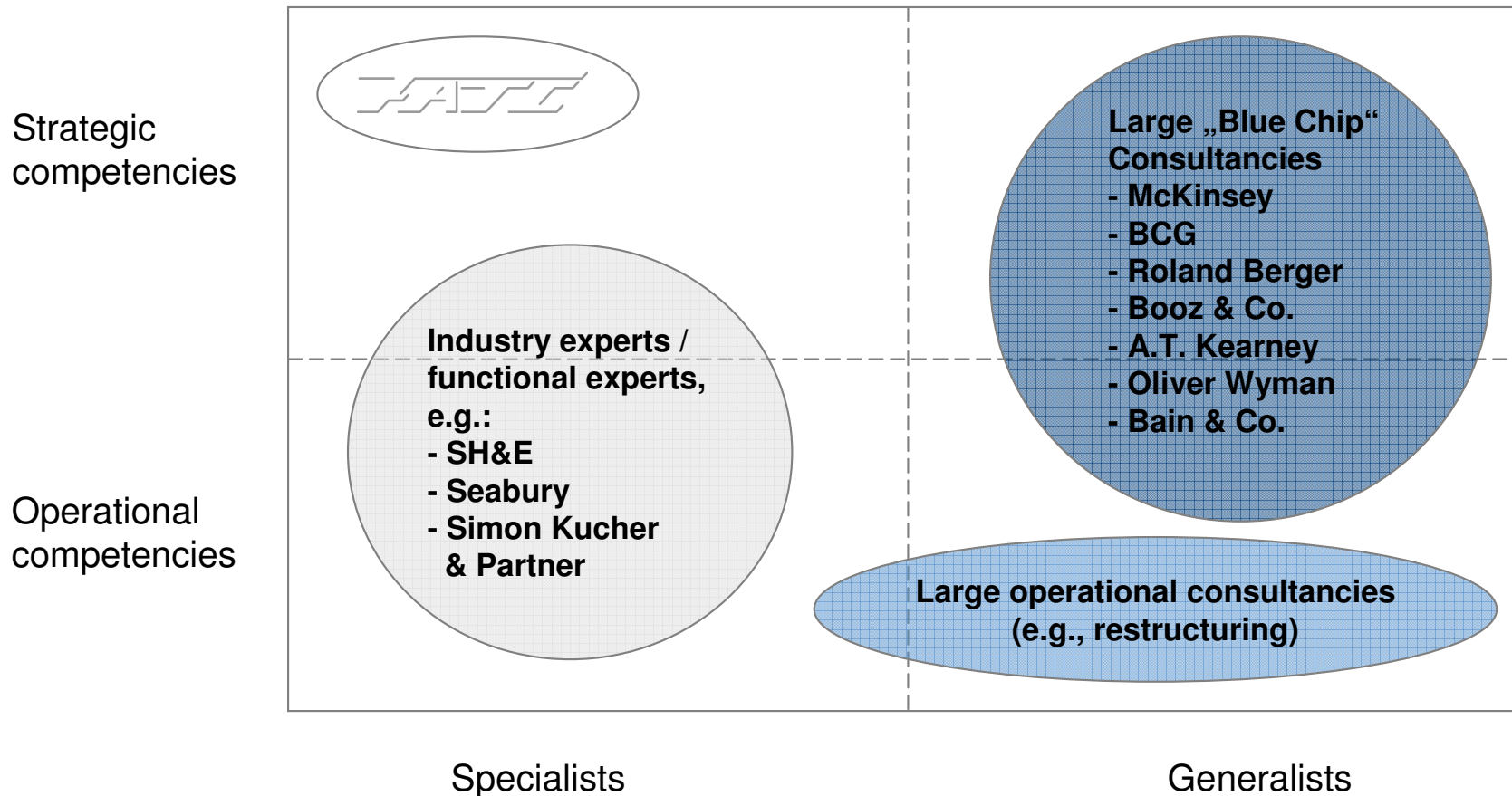


Source: FATC

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Industry landscape: FATC covers an attractive niche within the strategist consultant segment

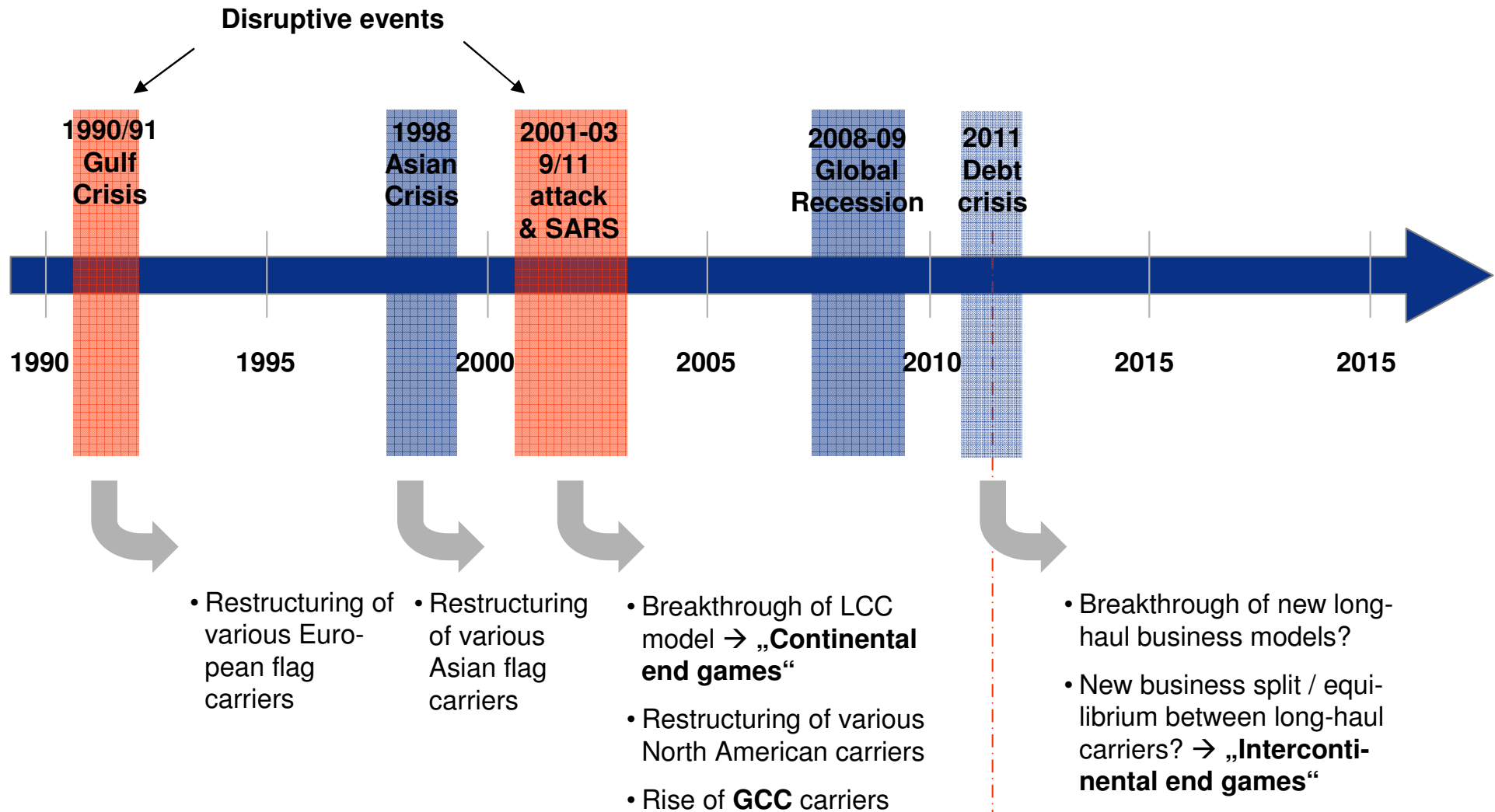


Source: FATC

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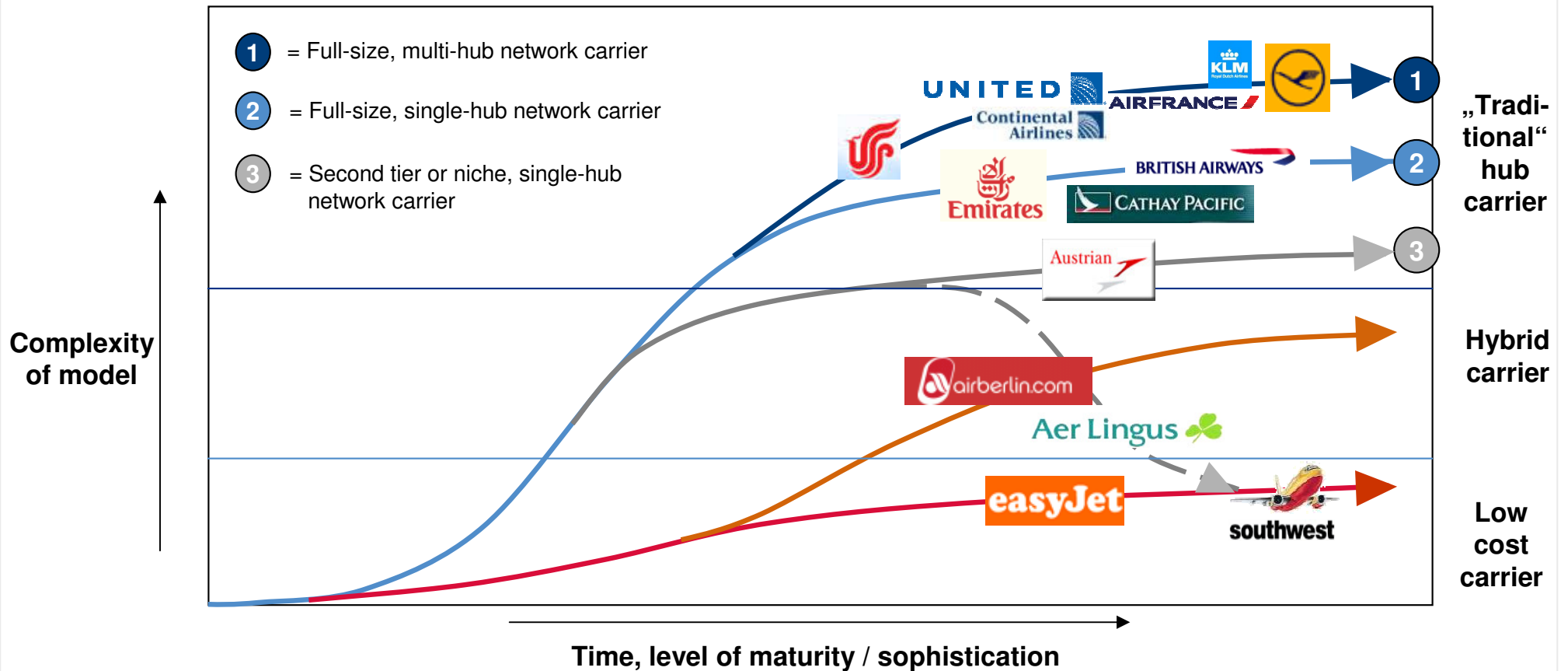
Major trends in the airline industry used to be stirred by crises – long-haul business would be the next battle field



Source: Analyses FATC

Over time, major airlines have developed different business and management models

Development cycles of airline (management) models



Source: Analyses FATC

Questions with respect to intercontinental air travel

What are the relevant players in the intercontinental (long-haul) air traffic business?

- Can they be classified into homogeneous clusters?
- What are the strengths and weaknesses of these players?

Which are likely „end game“ scenarios for long-haul air traffic?

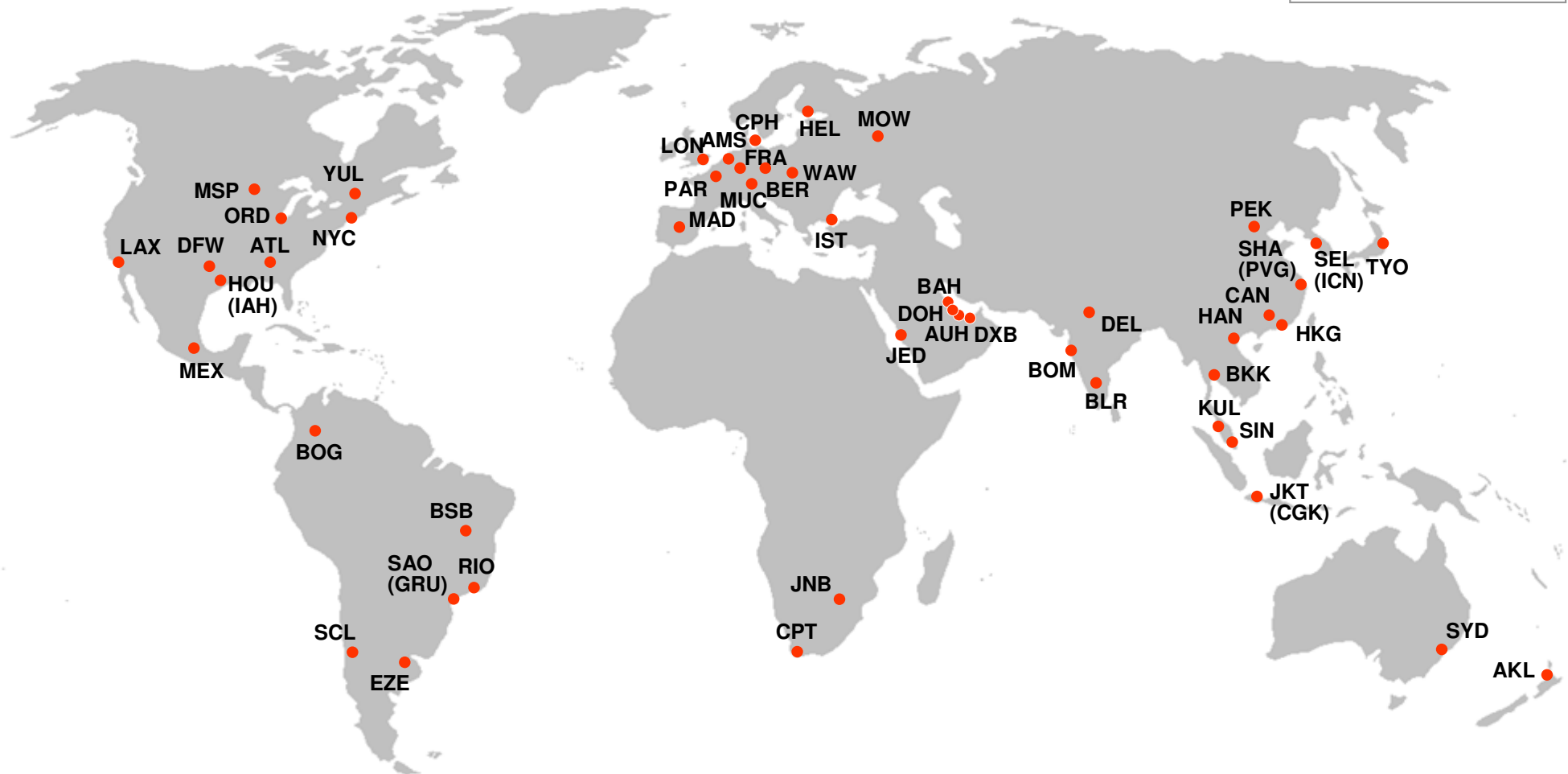
- What are the growth prospects and capacity additions of major carriers?
- Who may be winners and losers of „end game“ evolution?

Will there be a new equilibrium between major carriers?

- What is the effect of massive capacity additions on competition?
- What are the benefits for the clients of overcapacities and intensified competition?

Players in the aviation arena – hubs and home bases of Top 50 airlines with intercontinental business share

Selection from Top 50 long-haul carriers



Source: Analyses FATC

Players in the aviation arena – hubs and home bases of Top 50 airlines with intercontinental business share

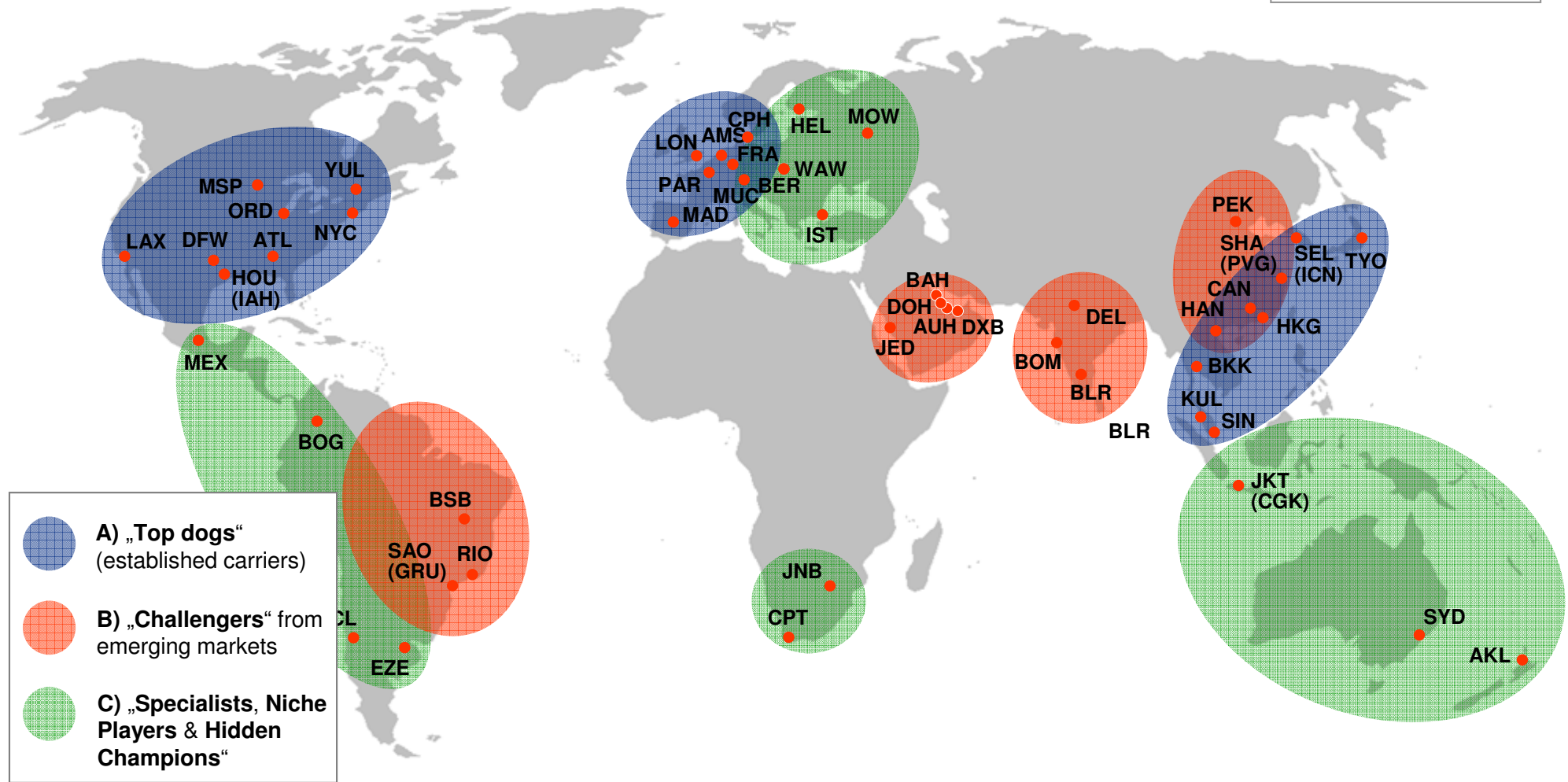
Selection from Top 50 long-haul carriers



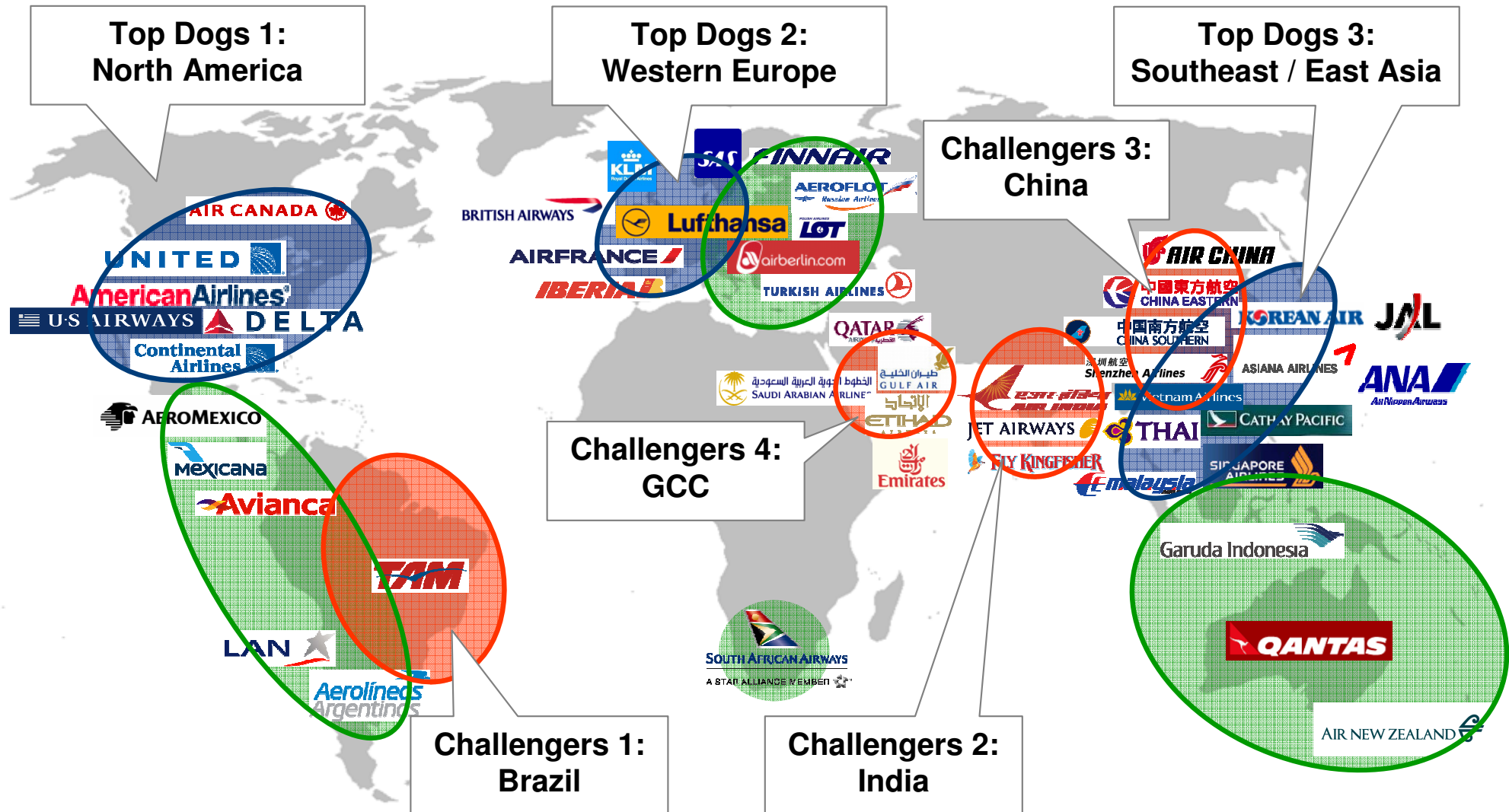
Source: Analyses FATC

Intercontinental carriers can be classified into „Top dogs“, „Challengers“, and other carriers

Selection from Top 50 long-haul carriers



Intercontinental carriers can be classified into „Top dogs“, „Challengers“, and other carriers



Source: Analyses FATC

„Top dogs“ benefit from efficient multi-hub structures and a significant share of major traffic flows within the triad

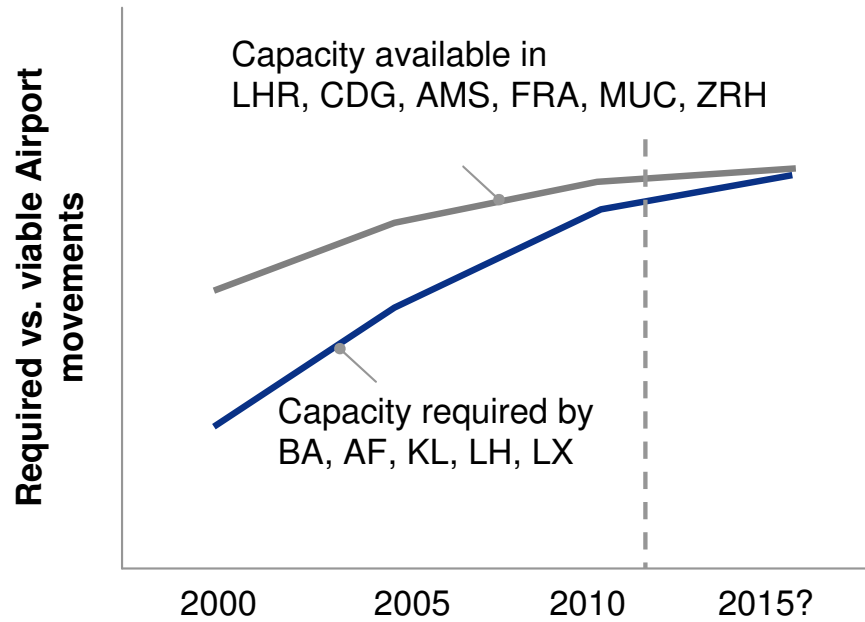
		Examples	Strengths	Weaknesses
Top Dogs	1) North America	<ul style="list-style-type: none"> • United / Continental • Delta / Northwest • American Airlines • Air Canada 	<ul style="list-style-type: none"> • Established industry leaders for decades • Large domestic market • Multiple hub systems with broad destination portfolio 	<ul style="list-style-type: none"> • High complexity of multi-hub systems • High unit cost • Strong focus on domestic market weaker presence on intercontinental routes
	2) Western Europe	<ul style="list-style-type: none"> • LH / Swiss / Austrian • British Airways / Iberia • Air France / KLM • SAS 	<ul style="list-style-type: none"> • Established industry leaders and flag carriers for decades • Large regional market • Multiple hub systems with very broad destination portfolio 	<ul style="list-style-type: none"> • High complexity of multi-hub systems • High unit cost • Dependence on complex feeder networks • High density of competitors on limited area
	3) Southeast / EastAsia	<ul style="list-style-type: none"> • Cathay Pacific • Singapore Airlines • Thai Airways • Korean Air • JAL • ANA 	<ul style="list-style-type: none"> • Established industry leaders and flag carriers for decades • Large regional market • Major hubs • Superior reputation for service quality 	<ul style="list-style-type: none"> • Rim position within triad, direct vicinity to strongly growing Chinese carriers • High unit cost • High density of competitors on limited area

Source: Analyses FATC

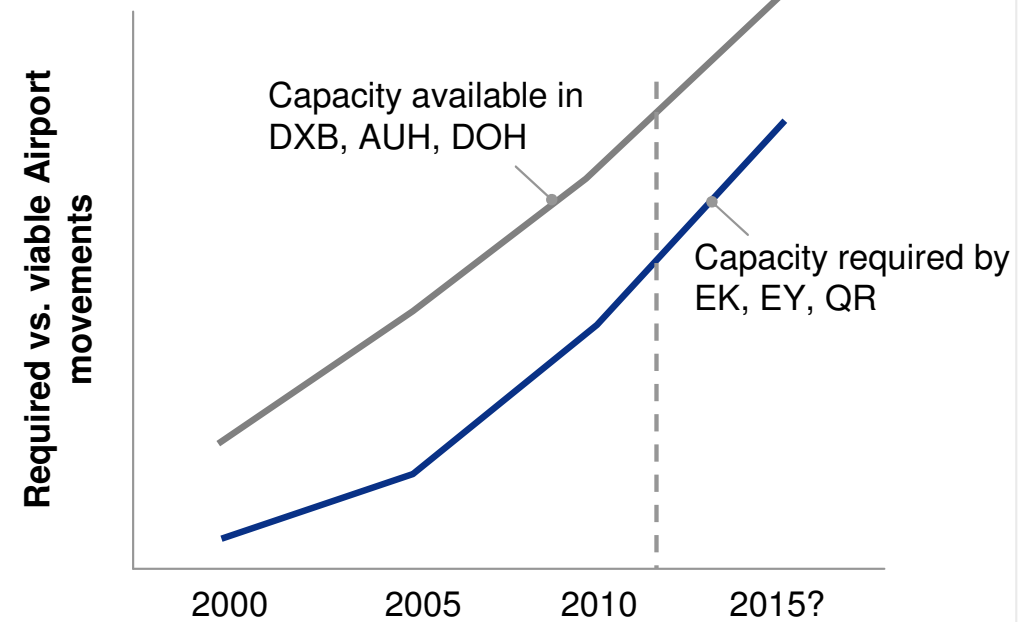
Besides demand, hub capacity availability is one of the most significant limitations for the growth of European mainline carriers

Illustrative

Major European carriers
AF-KL, LH-LX-OS, BA

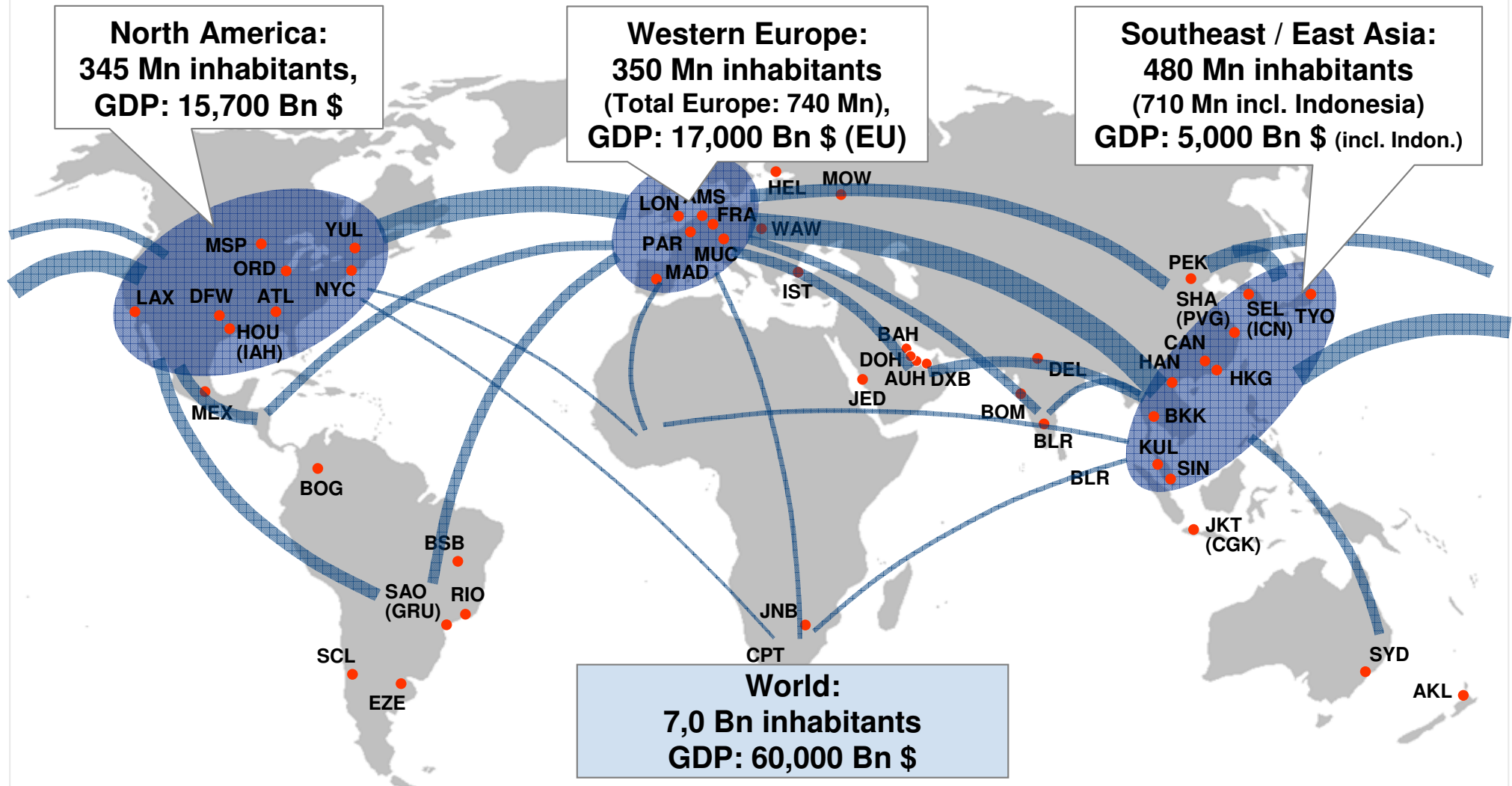


Major GCC carriers
EK, EY, QR



Source: Analyses FATC

„Top dog“ home markets represent 25% of global population, but 63% of GDP – strong coverage of traffic flows within the triad



Source: IMF, World Economic Outlook Database, April 2010

Note: traffic flows are illustrative and only a rough representation of actual flows (e.g. from IATA statistics)

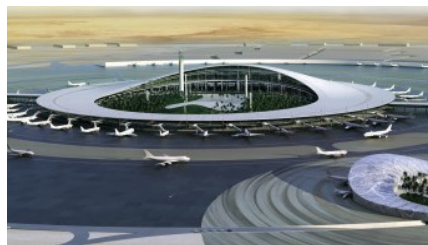
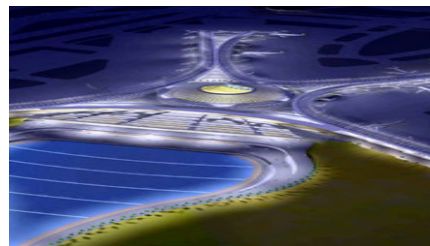
„Challengers“ rose in emerging countries with huge population and strong growth – or with excessive monetary resources (GCC)

		Examples	Strengths	Weaknesses
Challengers	1) Brazil	<ul style="list-style-type: none"> • TAM 	<ul style="list-style-type: none"> • Growing national economy (200 Mn inhabitants, strongly growing GDP (No. 8 ww)) 	<ul style="list-style-type: none"> • Limited experience as hub carrier • Mediocre affinity to fly of Brazilians • Geographic rim position
	2) India	<ul style="list-style-type: none"> • Air India • Jet Airways • Kingfisher 	<ul style="list-style-type: none"> • Skyrocketing national economy (1,200 Mn inhabitants, strongly growing GDP (No. 10 ww)) • Favourable geogr. Pos. 	<ul style="list-style-type: none"> • Limited experience as hub carriers • Poor efficiency of national administration, limited infrastructure
	3) China	<ul style="list-style-type: none"> • Air China / Shenzhen Airlines • China Eastern • China Southern 	<ul style="list-style-type: none"> • Skyrocketing national economy (1,340 Mn inhabitants, strongly growing GDP (No. 2 ww)) • High investments in infrastructure 	<ul style="list-style-type: none"> • Limited experience as hub carriers • Close vicinity to established Asian carriers • Development of Central China lags behind
	4) GCC	<ul style="list-style-type: none"> • Emirates • Qatar Airways • Etihad • Gulf Air • Saudi-Arabian Airlines 	<ul style="list-style-type: none"> • Strong support from national rulers, excessive monetary resources • Favourable geographic position, strong hubs 	<ul style="list-style-type: none"> • Very small local population (except Saudi-Arabia) • Poorly developed feeder networks • Strong local competition

Source: Analyses FATC

Huge airport capacity additions in the Middle East

Backup

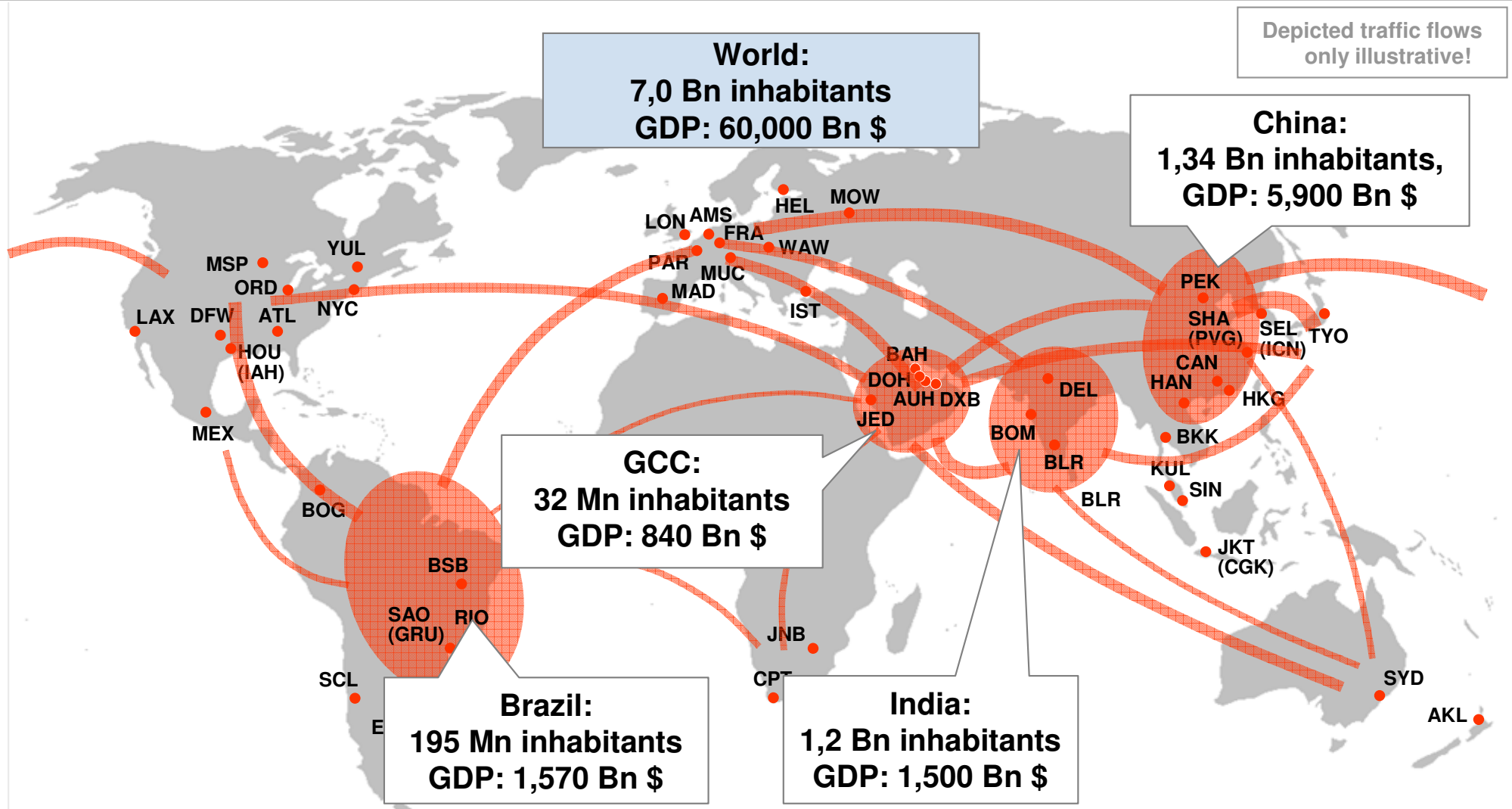


Airport	Current Capacity (mn pax)	Long-Term Capacity (mn pax)	Investment (USD bn)
Jebel Ali	n/a	120	\$8.1
Dubai International Airport	22	70	\$4.1
Doha	7.5	50	\$5.5
Abu Dhabi	7	50	\$6.8
Jeddah	13	21	\$1.5
Top 4	49.5	311	\$26.0

+520%

Source: Chiplime, Airport's Website, Oliver Wyman Consulting

„Challenger“ home markets represent 40% of global population, but still only 16% of GDP – mediocre share of major traffic flows



Source: IMF, World Economic Outlook Database, April 2010 Note: traffic flows are illustrative and only a rough representation of actual flows (e.g. from IATA statistics)

Other carriers leverage specialist roles, niche positions, or hybrid business models

		Examples	Strengths	Weaknesses
Others	1) Specialists	<ul style="list-style-type: none"> • Qantas • Finnair • South African Airlines 	<ul style="list-style-type: none"> • Focus on specific business model / segment (e.g. Qantas: long-haul connections from / to Australia) • Limited competition in these segments 	<ul style="list-style-type: none"> • Geographic rim position • Significant risk exposure due to focus, limited access to other business segments
	2) Hidden champions	<ul style="list-style-type: none"> • Turkish Airlines • Aeroflot 	<ul style="list-style-type: none"> • Local top dogs in prospering regions • Sizeable local customer base (e.g. Turkey: 74 Mn, Russia: 143 Mn inhabitants) • Potential for growth 	<ul style="list-style-type: none"> • Limited propensity to pay of local clients • Strong competition from various new entrants • Vicinity to established carriers
	3) Hybrid Carriers, Niche Players	<ul style="list-style-type: none"> • Air Berlin • LOT • Avianca 	<ul style="list-style-type: none"> • Decent home markets • Certain scale 	<ul style="list-style-type: none"> • Size may still be sub-scale for inter-continental business • Second tier position compared to local top dogs (→ lower yields)

Source: Analyses FATC

Summary: „Top dogs“ benefit from their experience and their home markets, „Challengers“ from their growth potential

		Strengths	Weaknesses
Top Dogs	1) North America	<ul style="list-style-type: none"> • Established industry leaders / flag carriers for decades • Large domestic / regional market • (Multiple) hub systems with very broad destination portfolio 	<ul style="list-style-type: none"> • High complexity of hub systems • High unit cost • Dependence on complex feeder networks • High density of competitors on limited area, limited growth prospects
	2) Western Europe		
	3) Southeast Asia		
Challengers	1) Brazil	<ul style="list-style-type: none"> • Skyrocketing national economy, strongly growing GDP • Favourable geographic position (India) • High investments in infrastructure • Strong support from national rulers, excessive monetary resources 	<ul style="list-style-type: none"> • Limited experience as hub carriers • Close vicinity to established carriers (Asia) • National development limited to certain areas, rest of country under-developed • Geographic rim position (Brazil) • Very small local population (exc. S.-Arabia) • Strong local competition
	2) India		
	3) Greater China		
	4) GCC		
Others	1) Specialists	<ul style="list-style-type: none"> • Focus on specific business model / segment • Limited competition in these segments • Decent home markets • Certain scale 	<ul style="list-style-type: none"> • Partly geographic rim position • Significant risk exposure due to focus, limited access to other business segments • Size may still be sub-scale for inter-continental business
	2) Hidden champions		
	3) Hybrid Carriers, Niche Players		

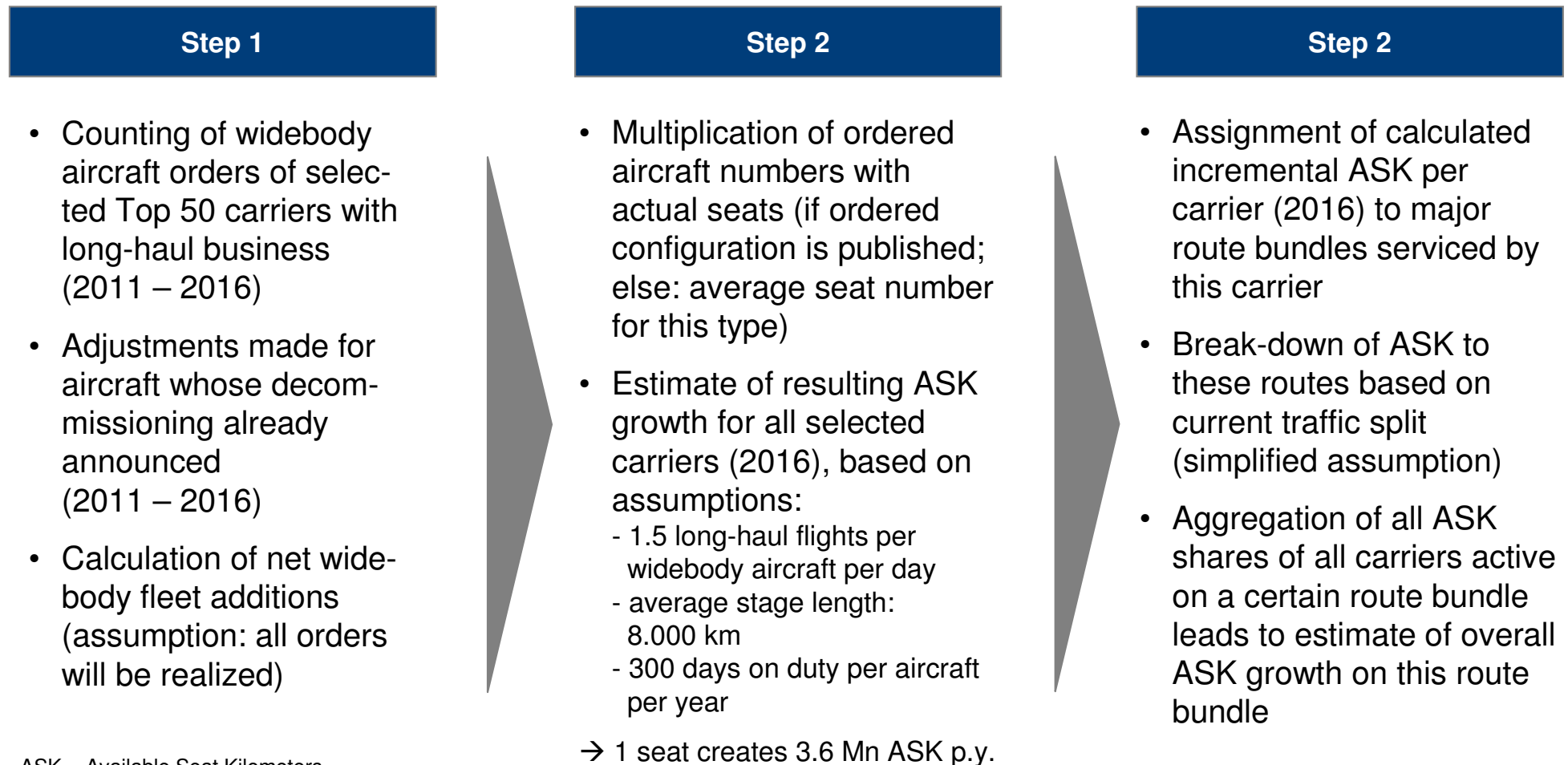
Source: Analyses FATC

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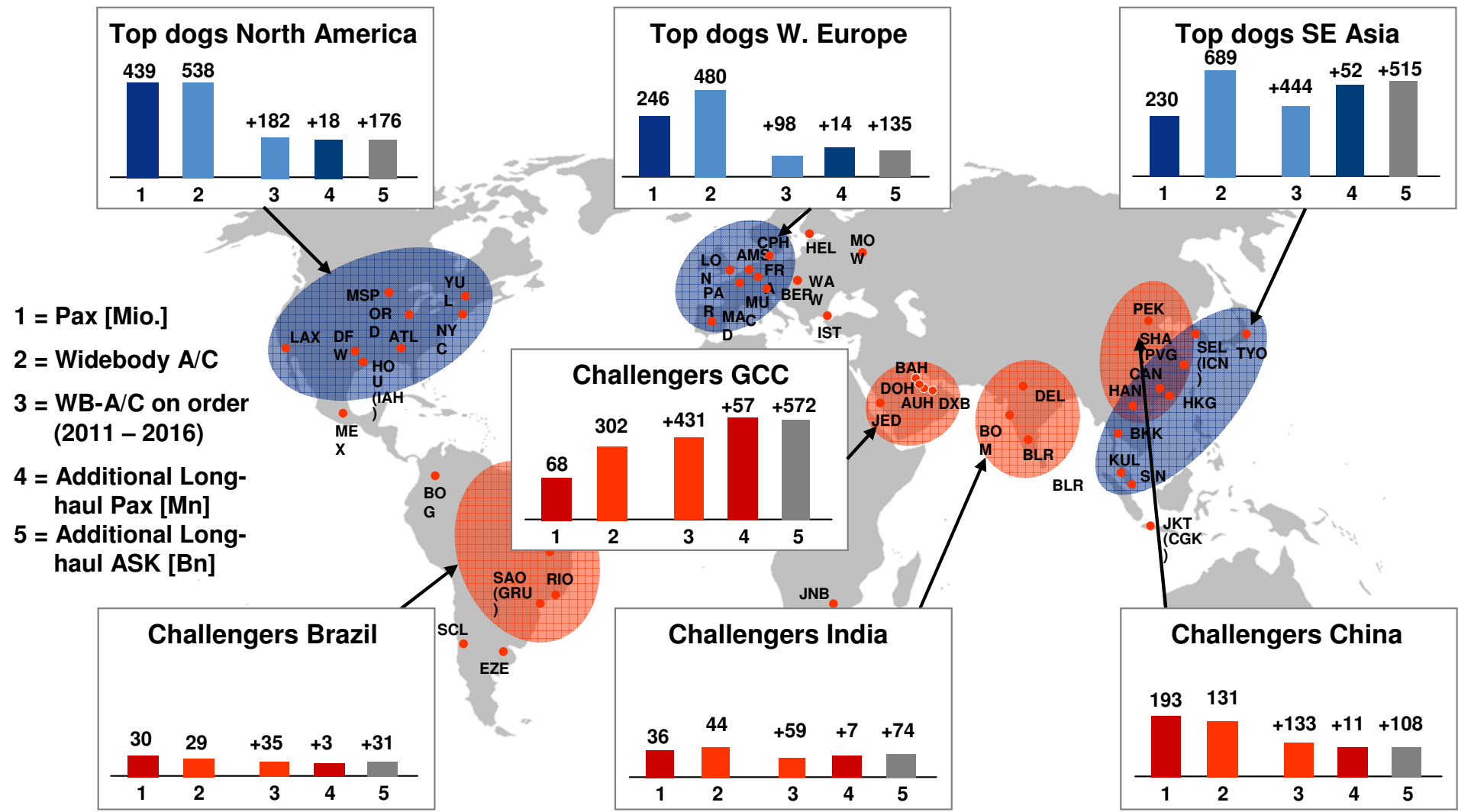
Although aircraft orders are rather aspirational, they are a first indication for future growth

Description of chosen analytical approach



ASK = Available Seat Kilometers

Installed base of „Top dogs“ is huge – massive capacity growth primarily in Asia, then GCC



Source: Company websites, Boeing.com and Airbus.com: Orders & deliveries 11/2011

Note: ASK growth estimated based on widebody aircraft orders 2011-2016

Traffic data and capacity additions

Backup

- Overall global RPK (2010): 6,000 Bn
- Overall global ASK (2010): ~ 7.500...8.000 Bn
- Break-down of ASK (2010):
 - Intra-regional traffic: 40% or 3.200 Bn
 - Traffic between North America and Europe: 7% or 560 Bn
 - Traffic between Southeast Asia / East Asia / China and Europe / North America: 9 % or 720 Bn
 - Traffic between GCC region and Asia, North America, Europe: 4...5% or 360 Bn
- Break-down of ASK growth (long-haul capacity only, 2011 - 2016):
 - North America: + 176 Bn
 - (Western) Europe: + 135 Bn
 - Southeast Asia, East Asia, China: + 623 Bn
 - GCC region: + 572 Bn

Source: Company websites, Boeing.com and Airbus.com: Orders & deliveries 11/2011

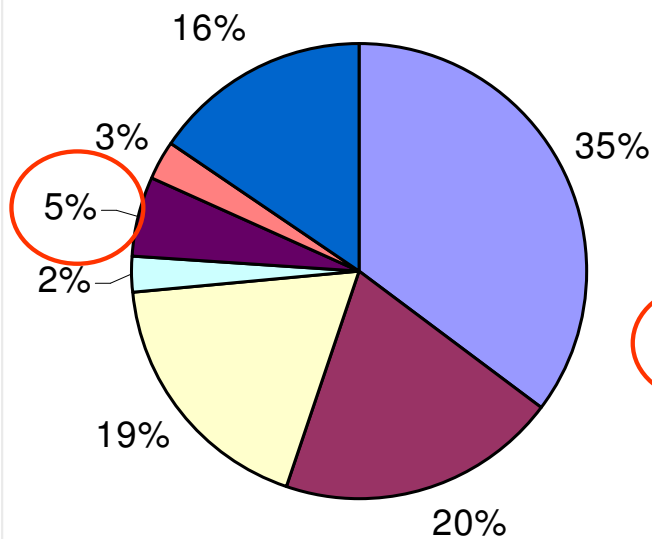
Note: ASK growth estimated based on widebody aircraft orders 2011-2016

Widebody A/C orders of GCC carriers would establish a disproportionately high share of long-haul ASK growth

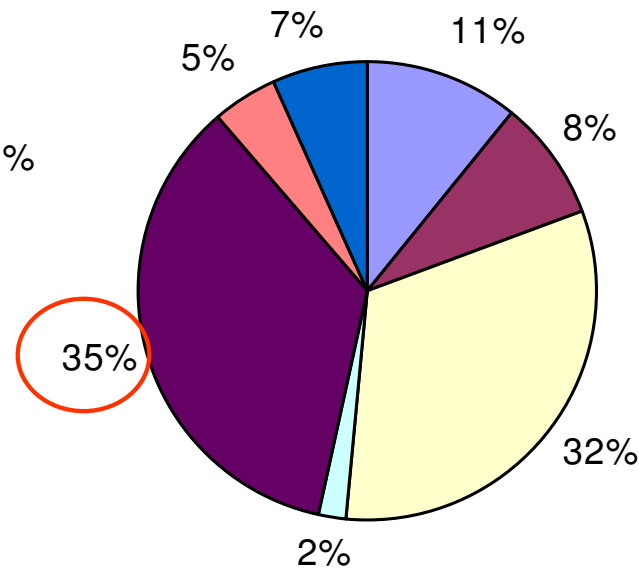
2010 traffic data; aircraft orders 2011 - 2016

Split of today's passenger numbers...

...and of additional long-haul ASK



Total of included airlines: 1,242 Mn



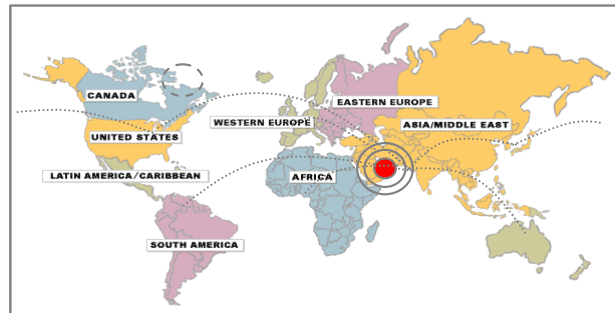
Total of included airlines: 1,610 Bn
(> 20% of overall ASK in 2010)

- Top Dogs North America
- Top Dogs Western Europe
- Top Dogs Southeast Asia
- Challengers Brazil
- Challengers GCC
- Challengers India
- Challengers China

Source: Company websites, Boeing.com and Airbus.com: Orders & deliveries 11/2011, analyses FATC

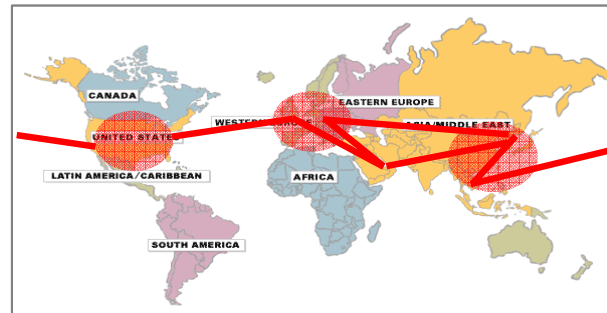
According to “End game” scenario analysis, European main-line carriers may lose their intercontinental dominance...

“Middle East Bypass”



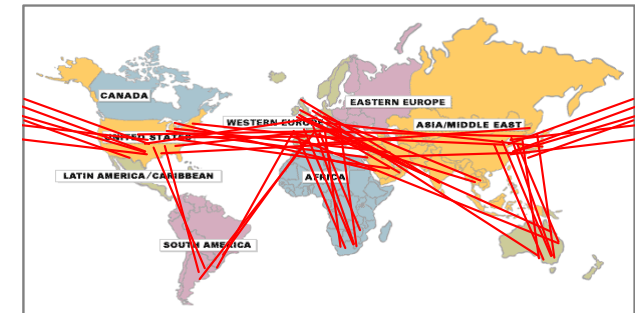
- B787 and A350 aircraft allow economically viable long-range service from emerging hubs into established markets
- Middle East / India hubs connect NA, SA, AF and EU with the Far East
- Europe and Asia lose significant share to M.E. mega-hubs

“EU + ME Hub Backbone”



- The A380 is deployed successfully on trunk routes from ME to EU and Asia
- Intense competition for feeder markets in M.E. and Europe, Asia
- Price wars on key routes due to overcapacity

“Point-to-Point”



- M.E. and India markets are served by carriers from EU, NA, FE with point-to-point services
- Former smaller transit markets become viable with direct service
- M.E. hub carriers airlines lose the network advantage, will rely on service and price

Source: FATC, Oliver Wyman Consulting

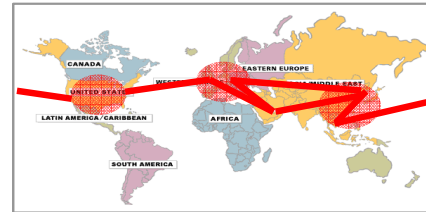
...depending on a variety of external and internal drivers

Illustrative

“Middle East Bypass”



“EU + ME Hub Backbone”



“Point-to-Point”

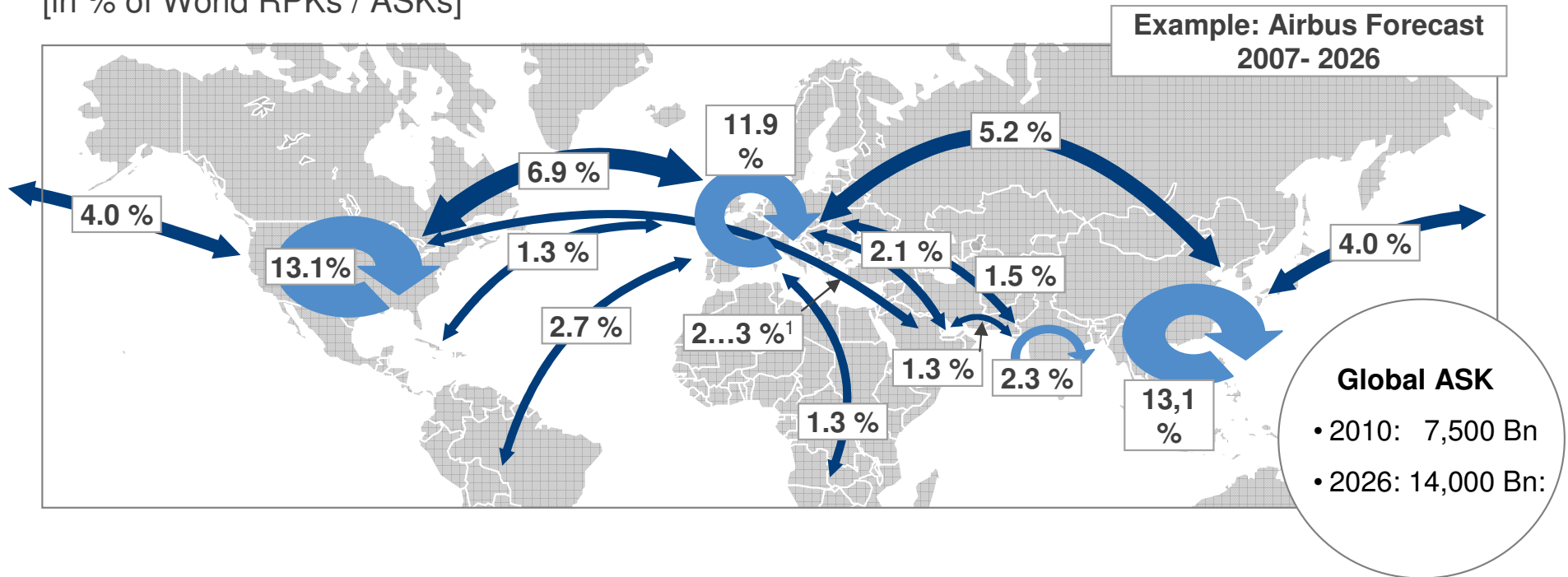


Further increase of oil price	➔	➔	➔
Further liberalization (e.g., Open Skies)	➔	➔	➔
Ongoing weakness of U.S. economy	➔	➔	➔
Delay of A380 deliveries	➔	➔	➔
Delay of B787 deliveries	➔	➔	➔
Emergence of successful intercontinental low cost models	➔	➔	➔
Congestion of major European hubs	➔	➔	➔
...			

Source: FATC, Oliver Wyman Consulting

However, experts like aircraft OEMs predict that Europe will maintain a crucial role in air transport – how comes?

Major Traffic flows in 2026
[in % of World RPKs / ASKs]



▶ Europe is still involved in 33% of global air traffic in 2026 according to Airbus forecast; 28,5 % are intra- regional traffic in U.S., Asia and India

Source: Airbus traffic forecast 2007 – 2026; analyses FATC

Success factors and killers determine whether a carrier will play a crucial role in the intercontinental business

Success factors

- Strong home base, large catchment for local traffic
- Dominant market share within hub(s) and on major routes
- Effective feeder networks
- Differentiating business model (“excel the competitors”), premium yields
- Efficient hub operations (MCT, handling cost, low irregularity rate, etc.)
- Superior product quality (in the perception of the passengers → e.g., SkyTrax index)
- Strong partnerships, alliance membership
- Widespread traffic rights, limited regulation

Killers

- Poor local catchment
- Subscale operations / market share (→ niche player)
- Insufficient regional feed
- Poor differentiation (“me too” positioning), below-average yields
- Deficient hub operations, high unit costs
- Mediocre product / service perception
- Stand-alone position
- Regulatory limitations

Source: Analyses FATC

Which long-haul carriers are going to succeed? - Winners and losers

Potential winners

- 2...3 carriers from the GCC region
- Major 3 European network carriers with their affiliates
- 3...4 major North American carriers
- 4...5 major Southeast /Eastern Asia carriers
- 2...3 major Chinese carriers
- 1...2 Brazilian carriers
- 2...3 Indian carriers
- A variety of strong specialists and „Hidden Champions“ (e.g. Qantas, Turkish Airlines, Saudia, Vietnam Airlines)

Potential losers

- 2...3 carriers from the GCC region
- Various European subscale niche players
- 1...2 North American carriers with poor intercontinental portfolio / service
- 3...4 major Southeast /Eastern Asia carriers
- Other carriers with unclear profile, lacking differentiation, poor efficiency / unit cost position, fierce regional competition, etc.

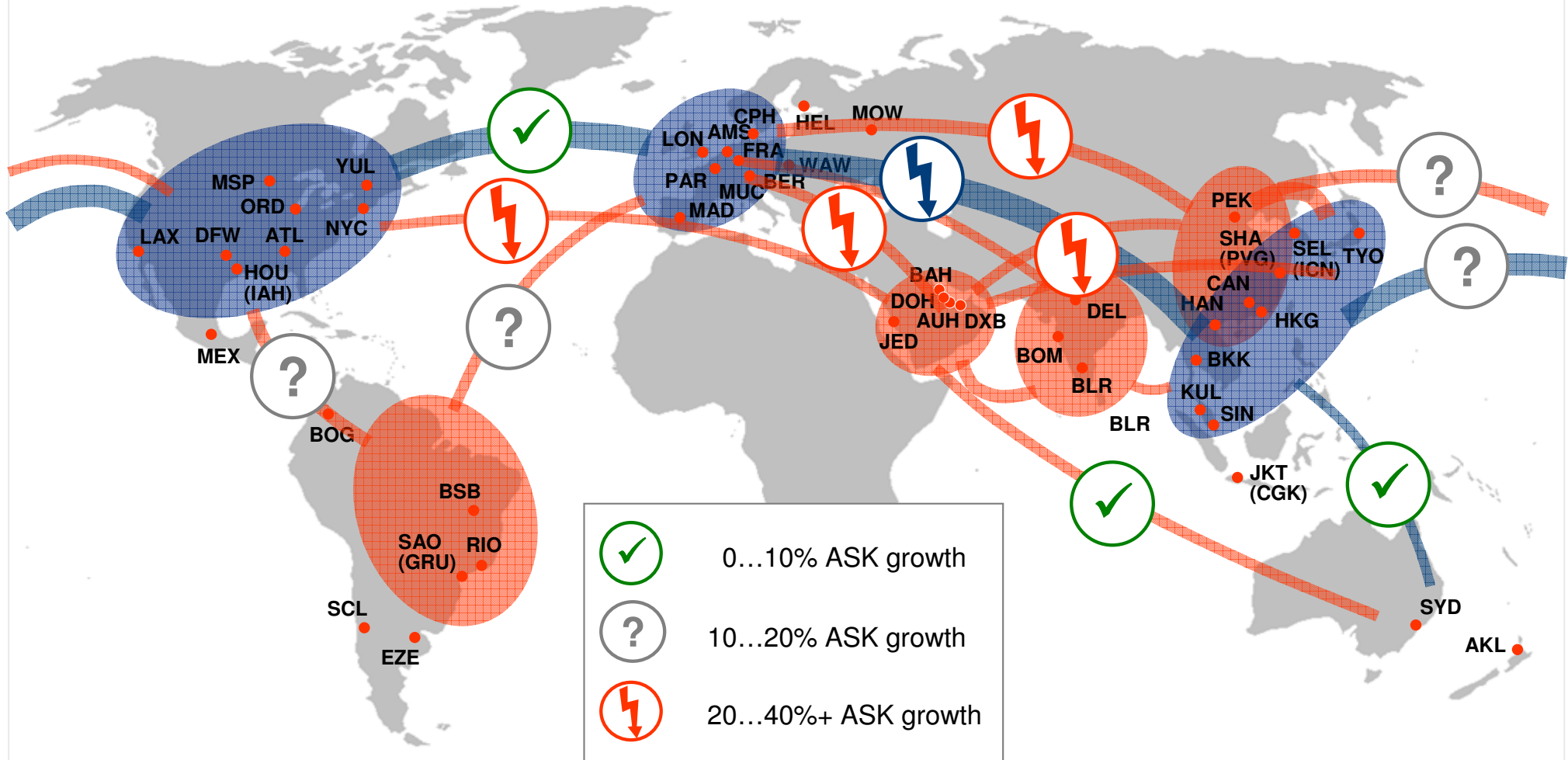
Source: Analyses FATC

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Massive growth of „Challengers“ focuses on a few major traffic flows between Asia, the GCC region, and Europe...

Illustrative

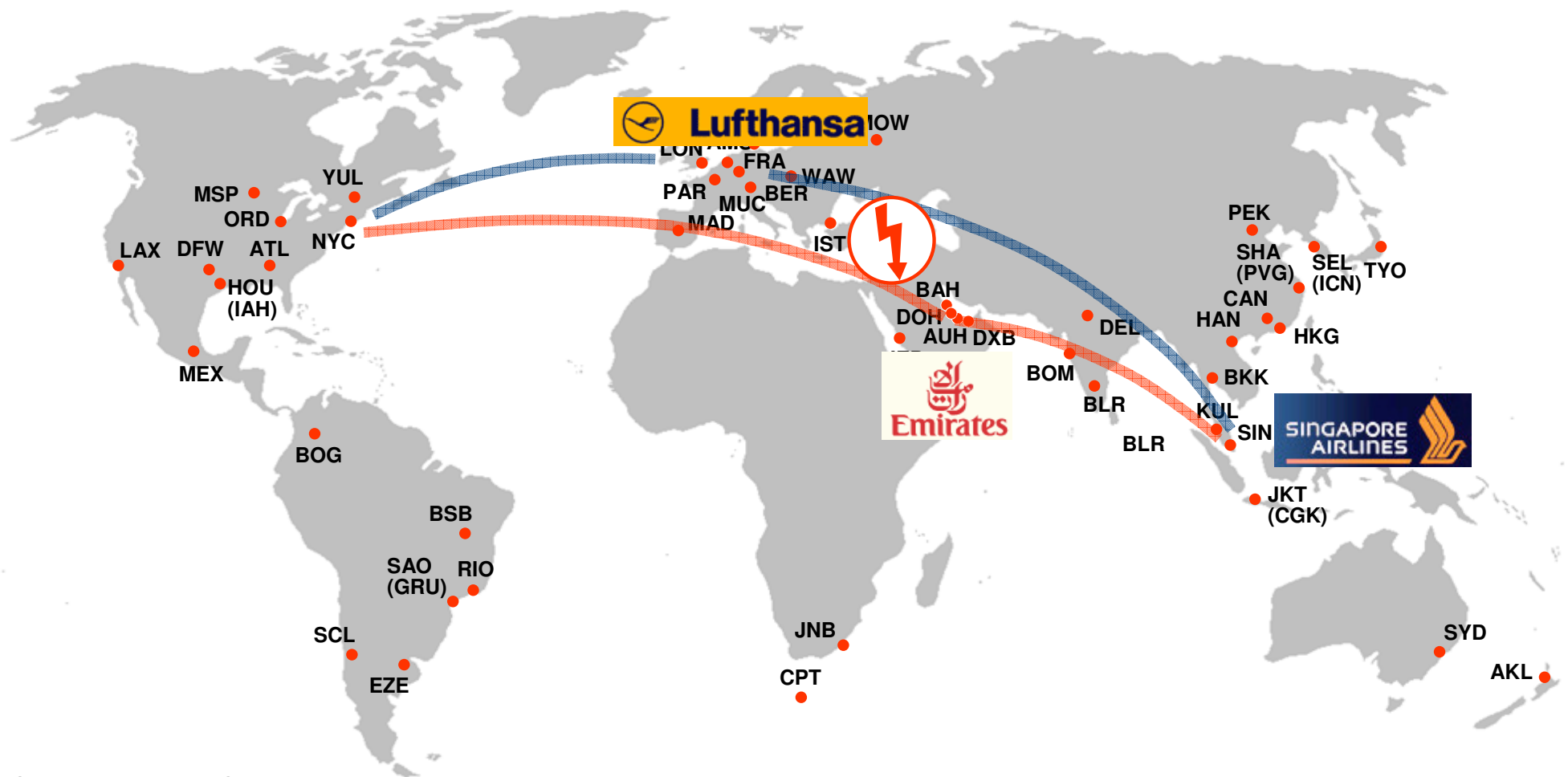


Source: Analyses FATC

...resulting in extensive overcapacities on selected O&Ds

Example: O&D SIN-NYC (via FRA or DXB)

Illustrative



Source: Analyses FATC

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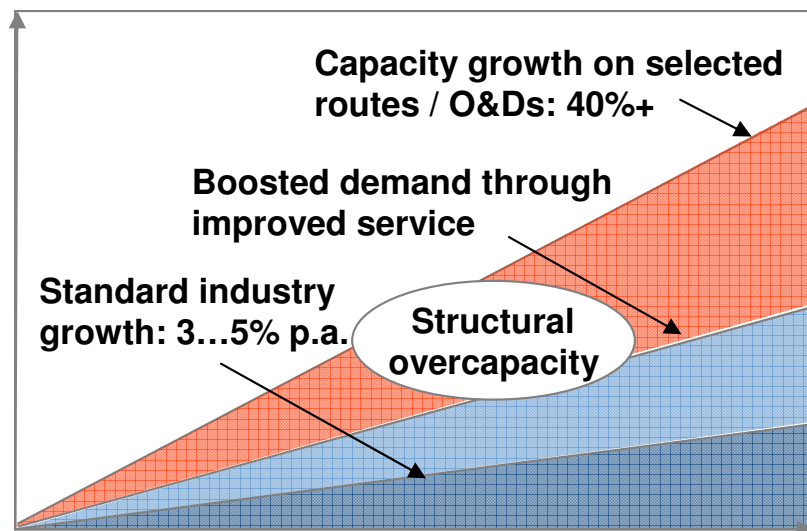
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Unless overcapacities stir additional demand, they will lead to fierce price wars, and subsequent drop-outs

ASK growth beyond demand creates overcapacities...

...structural overcapacities result in price wars and drop-outs

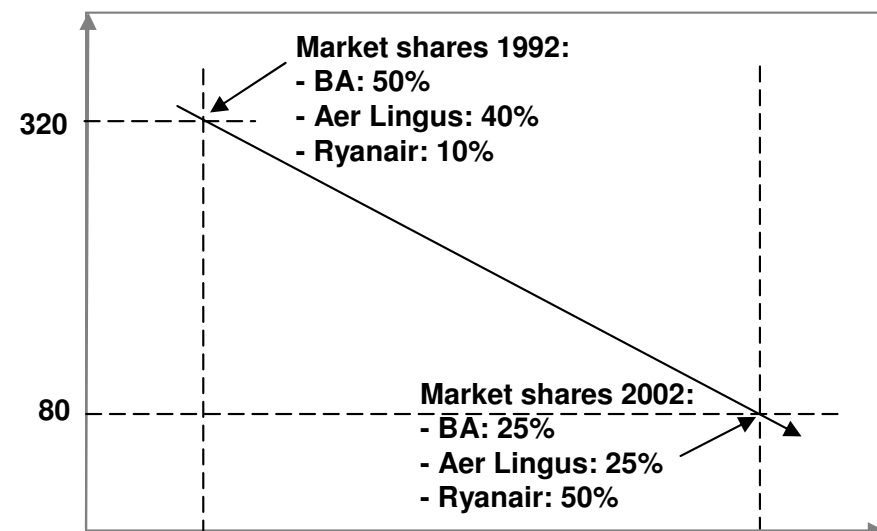
Capacity



Time

Average ticket price (two-way, GBP)

Example: DUB-LON 1992 – 2002 after market entry of Ryanair



1 Mn

Demand (pax p.a.)

4 Mn

→ Budget of clients on this O&D remained constant!

Source: Analyses FATC

Summary and Conclusion

- Major trends in the airline industry used to be stirred by crises – long-haul business would be the next battle field
- Intercontinental carriers can be classified into „Top dogs“, „Challengers“, and other carriers
- „Top dogs“ benefit from efficient multi-hub structures and a significant share of major traffic flows within the triad – their home markets represent 25% of global population, but 63% of GDP – strong coverage of traffic flows within the triad
- „Challengers“ rose in emerging countries with huge population and strong growth – or with excessive monetary resources (GCC) – their home markets represent 40% of global population, but still only 16% of GDP; still mediocre share of major traffic flows
- Installed base of „Top dogs“ is huge – massive capacity growth primarily in Asia, then GCC
- According to “End game” scenario analysis, European main-line carriers may lose their long-haul dominance - however, experts like A/C OEMs predict that Europe will maintain a crucial role in air transport due to their favourable position in the center of major traffic flows
- Massive growth of „Challengers“ will result in extensive overcapacities on selected O&Ds - unless overcapacities stir additional demand, they will lead to fierce price wars, and subsequent drop-outs

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