



Worth Noting

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Worth Noting is the journal of research and conferences company L21. It is focused on issues of relevance and interest to senior executives.

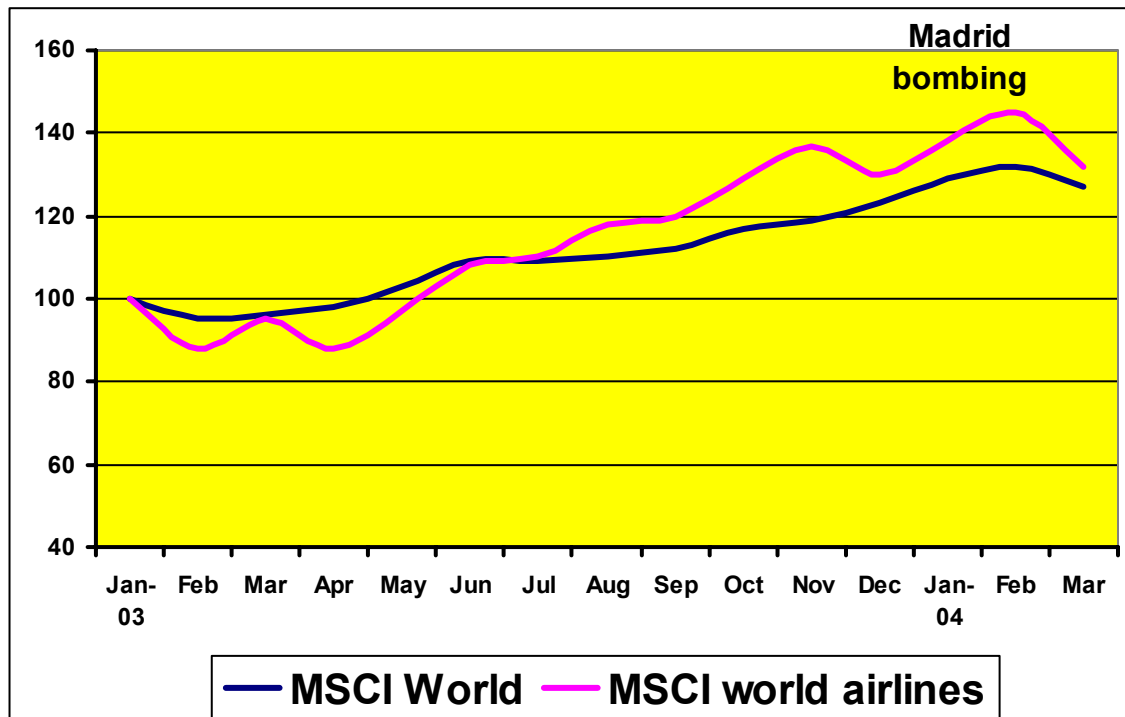
September 11, 2001 and the threat of aviation terrorism ever since has been marked down as the beginning of the dark days for the global airline industry.

In the U.S., when the Department of Transport grounded all flights, and when permission to fly was granted a few days later, it was estimated that revenue losses in the U.S. could reach as high as US18billion within one year. The impact was global. Barely months later, a number of major airlines filed for bankruptcy: U.S. Airways, Swissair, Sabena.

Although the impact was not as severe as forecasted (revenue losses was about U.S.12 billion in the U.S.) in 2001, poor profits within the industry are continually blamed on persistent threats of terrorist attacks.

There is no doubt that major terrorist attacks do lead to immediate falls in the share prices of airlines. The chart below demonstrates this.

Stockmarket index performance (U.S.\$ terms)



Source: Thomson Datastream

Moreover, there is no doubt that investor confidence in airlines was increasing prior to the Madrid bombings.

In this edition of Worth Noting, we will look at the situation in the airline industry. We will see that even though threats and actual instances of terrorism can account for difficulties within the airline industry, terrorism is only one of the factors causing problems in the industry.

State of play in the airline industry

The International Air Transport Association (IATA) is forecasting a U.S.\$2.4 billion profit for the industry worldwide, after losses totaling U.S.\$30 billion since 2000.

The airline industry figures makes for glum and ugly reading.

In the U.S., United Airlines is hoping to get out of Chapter 11 bankruptcy some time around July. It will only be able to do so if the company persuades the Air Transportation Stabilisation Board (the body formed to deliver subsidies to airlines after September 11) to guarantee \$1.6 billion of debt. The Board turned down United 15 months ago because it believed United's business plan was

unworkable. No one is therefore unduly optimistic that the Board will think differently this time.

U.S. Airways, also emerging out of Chapter 11 last year is struggling with an operating loss of \$250m in the most recent quarter even though the company had forecast a \$44 million profit in the recovery plan. There is little doubt U.S. Airways will have to sell off some assets, and even some routes, just to comply with the terms of the \$900 million bailout.

The industry in Europe hardly looks much better. Lufthansa suffered a \$1.2 billion loss. Air France, although profitable as a stand alone airline, is suffering from the merger with KLM which is still experiencing heavy losses. Alitalia made a loss of about \$500 million last year which is the fifth year of losses in a row. SAS and Iberia (although recovering quickly) all made losses which means only BA and Air France are profitable.

The story in Asia is slightly better but not inspiring. Cathay Pacific, Singapore Airlines and Thai Airways are bouncing back, Japan Airlines is still losing money fast and QANTAS is still the star in the region.

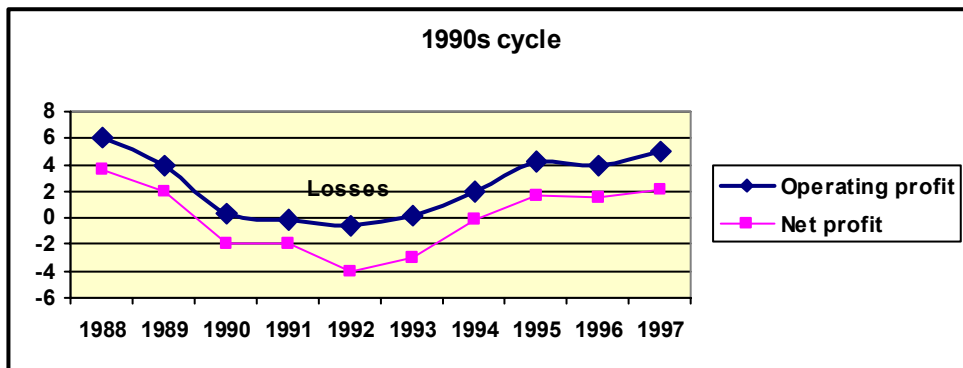
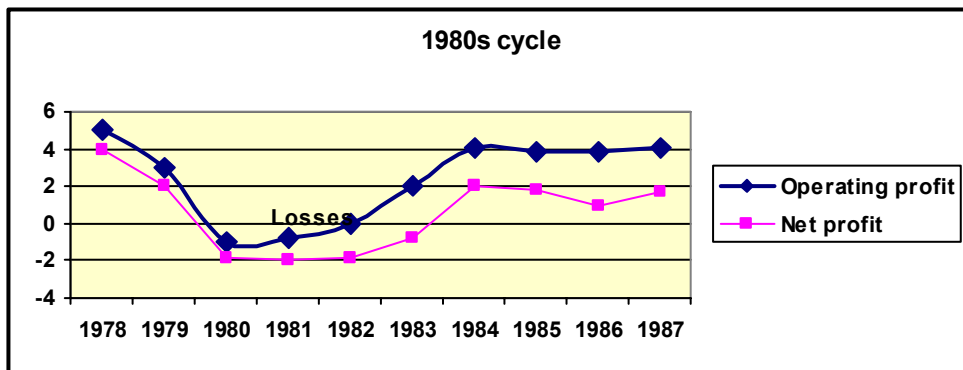
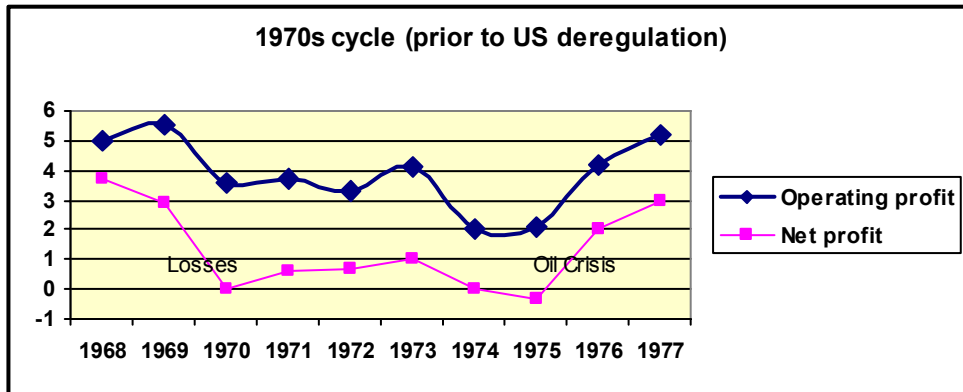
Which airlines worldwide are doing well? As you've probably guess, the low cost ones are streets ahead.

Briefly, Ryanair, EasyJet, Southwest, AirTran and JetBlue continue to be embarrassing for established, national carriers. In Asia, the new low cost AirAsia is creating excitement for investors and fear for competitors. And while the jury is still out on VirginBlue, investors seem generally optimistic about the Branson-backed venture.

What's going on?

Evidence shows that slumps in the airline industry are cyclical ones that arise about every decade and can last for years. Prior to the current slumps, there have been slumps in 1970, early 1980s and early 1990s.

Global Airline Profitability Charts



Source: Airline Monitor; IMF

The charts suggest that historically, at least, a global slump was emerging around 2000-01.

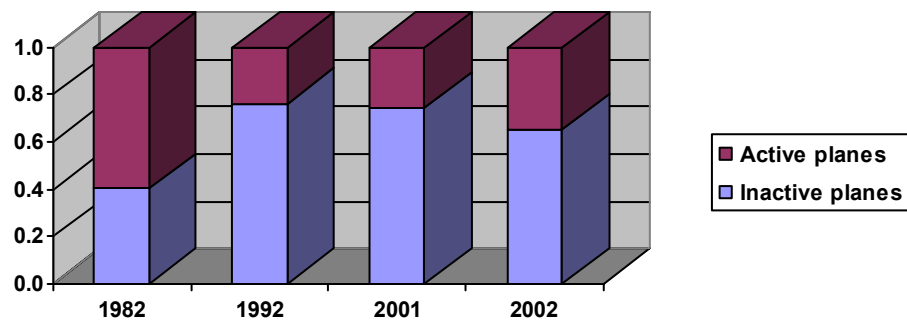
From Jan-Aug 2001, passenger traffic for U.S. airlines rose a minute 0.7%. This occurred despite aggressive price cuts by all airlines. Net profits dropped from margins of about 4% between 1998-2000 to losses of over 3% in the first half of 2001.

To understand what is going on, we have to look at the cost dynamics of the airline industry.

There are several key indices in determining the state of the airline industry. These are below.

a) Unused aircraft

Active vs. Inactive Commercial Planes During Downturns



Source: Airline Monitor

From the above chart, we can see that the planes that were inactive in 2001 and 2002 as a percentage rivaled levels during the 5 year downturn of the early 1990s.

While inactive planes that are in storage saves money as variable costs such as fuel, maintenance and catering etc. are not incurred, fixed costs such as lease and debt repayments remain.

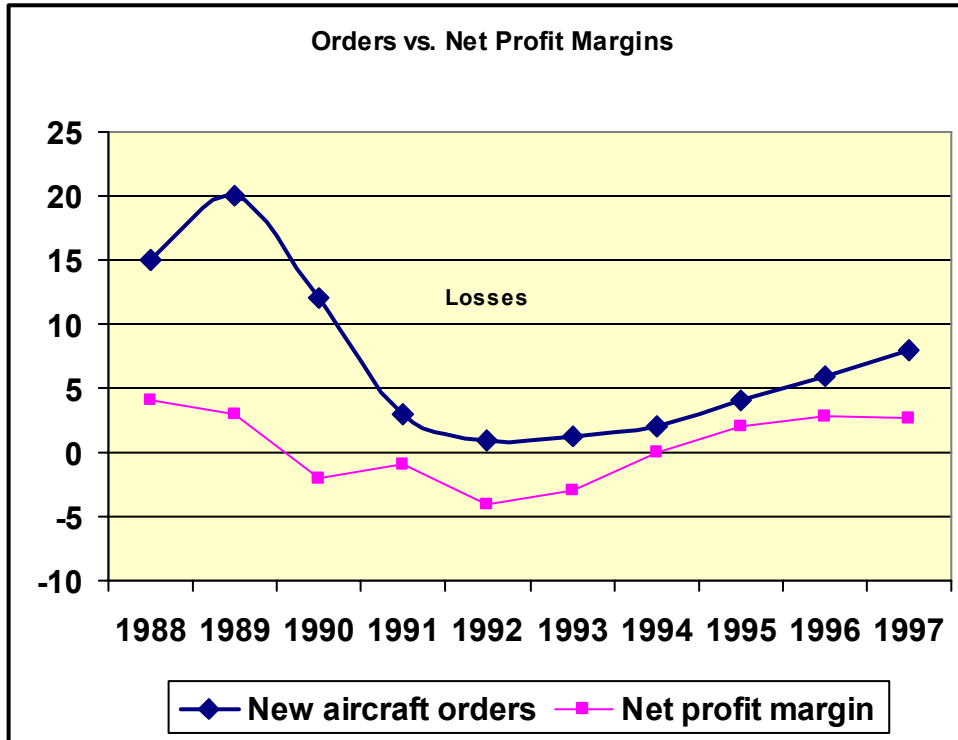
Moreover, September 11, 2001 cannot be used as the reason for the high number of unused planes. In the U.S. for example, from Jan-Aug 2001, passenger traffic for U.S. airlines rose a miniscule 0.7%. This compares with growth of about 4% per annum over the previous decade.

No doubt, September 11 did make the situation worse. After the terrorist attack, passenger traffic in the U.S. dropped 6.8% for the year, while traffic dropped 4% worldwide.

However, overly aggressive plane capacity levels were endemic in the industry prior to September 11 despite strong evidence of a cyclical downturn. September 11 caused the industry which was already struggling to nosedive. Even though orders for new

Even though airline executives could not predict September 11, they could and should have foreseen the rapidly emerging cyclical downturn.

aircraft slowed in the late nineties, aircraft capacity still rose almost 3% in early 2001 despite the stagnant passenger growth scenario. From 1995-1997 during the period in the decade of the greatest profits, new aircraft orders began to increasingly outstrip growth in profit margins.



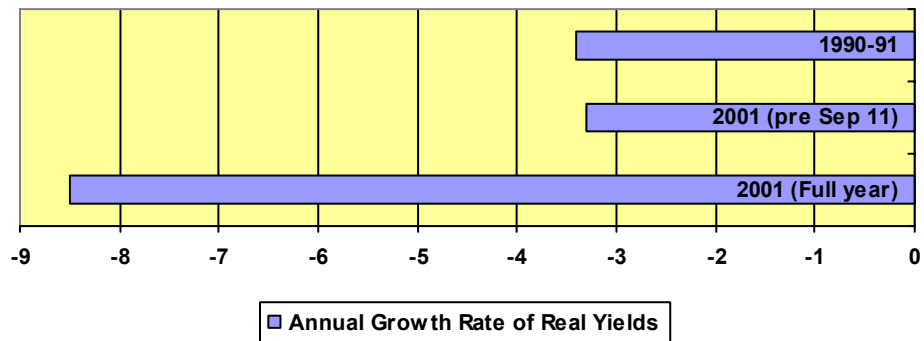
Source: Airline Monitor

b) Profit margins of passengers

Simply the number of seats filled tells us very little. What matters is the profit margin for each passenger.

The annual growth rate of real yields (from each passengers/kilometer flown) reached cyclical downturn levels immediately prior to September 11 and plunged to unprecedented depths shortly after September 11.

Average Growth Rates of Real Yields per Passenger-Kilometer



Source: Air Transport Association

Why? Some reasons for lower yields are September 11 based and will pass with time. Others, we believe, are more permanent and point to chronic challenges facing the industry.

Following September 11 where there was a general fear of flying. Moreover, subsequent security measures made flying more of a hassle for passengers. Other ways of communication, such as video conferencing, rather than physically flying executives around became more widespread. Airlines predictably slash prices in order to get back customers. This obviously reduces the yield per customer-kilometer. The effect of this is demonstrated clearly on the chart above.

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However, as we can see above, negative yield rates prior to September 11 were already reaching 1990 downturn levels.

Established airlines rely heavily on business class fares to support their margins. Before September 11, at the decade's peak in the mid 1990s, business travel accounted for 35% of travel. Just prior to September 11, business travel accounted for only 23% of travel.

The drop was partly cyclical but the drop began before expectations of a general economic downturn. Indeed, airlines failed to react proactively to evidence of a systematic shift away from businesses uncomplainingly forking out thousands for executive travel.

Large corporations began to use their purchasing power to negotiate volume discounts on fares with the largest companies achieving discounts of 20-30%. Shared corporate jets became more popular. Video-conferencing was increasingly used. The Internet and the speed of sending large amounts of information began to have an impact. Indeed, a recent study by McKinsey and Co has estimated that corporate jets will decrease first class business travel by 10% in 2005.

Whilst increasing yields from business and first class travel pushed the airline industry out of the early 1990s recession, there is little evidence that this will be the fix-all solution this time.

We believe that there is a fundamental shift in the industry. The emphasis will not just be on getting consumers to pay more.

To emerge from the current downturn, the emphasis and talk will be about reducing structural and variable costs.

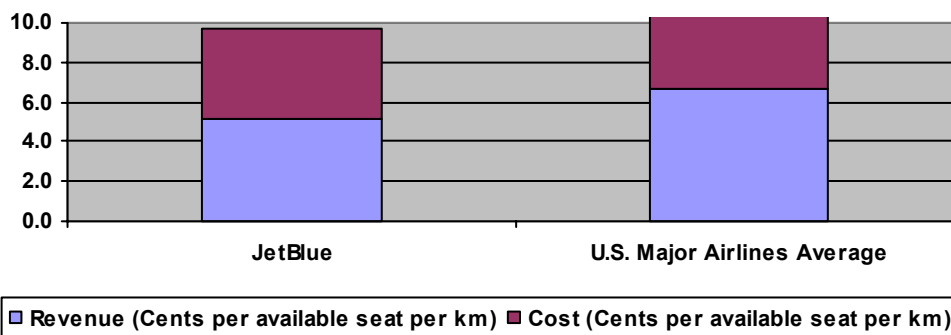
Already, this is happening to an unprecedented degree in the industry.

Is this the time of the Low Cost Airline?

The importance of the cost factor is demonstrated in the chart below.

JetBlue is fairly representative of a low-cost airline model. There was a profit of about 0.7 cents per customer-per-km compared to a loss of 0.3 cents per customer-per-km for the major U.S. airlines. That is a huge difference.

Revenue and Costs per available seat per km (2002)



Source: US Department of Transportation

Cost efficient airlines use two basic strategies:

More efficient use of existing aircraft

Purchasing cheaper used aircraft

a) More efficient use of existing aircraft

We will look at this strategy as it is the more interesting one.

EasyJet would be a good example of this strategy. These airlines are careful to only offer destinations that suit the suite of airlines they have; they often choose smaller, less congested airports that are cheaper; they maximise use of the plane by flying back and forth on the same

routes using the same aircraft multiple times a day; and they generally use only one or two kinds of aircraft to save on maintenance and training costs. These airlines have a simple operational mantra: one kind of aircraft; one class of passenger; more passengers in the plane; no airport lounges; no newspapers; no

These low cost airlines also have another huge advantage over many traditional carriers. They have not been locked into long-term, hugely uncompetitive contracts with air and ground staff which has been the case with many established airlines. These established airlines face the constant threat of industrial action if they try to lower staff wages and benefits.

In Europe, low cost carriers have a cost advantage of between 40-65% compared to major carriers. The global figure is about 30-40%. This allows them to offer fares about 50-70% lower than major carriers.

free food; no frequent-flyer programs; no refunds; no possibility of rebooking to other airlines; no travel agent commissions; and no expensive computer reservation systems.

Because routes are back and forth, logistics is simple; turnaround times are fast and revenue-generating air-time is maximised. For example, EasyJet is in the air about 12 hours a day compared to similar major carriers on the same routes.

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However, it would be a mistake to think that the rise of low-cost airlines led to a direct reaction in the fall of major carriers. These major carriers, artificially buoyed by a decade of easy profits from business and first class fares, were in structural trouble before low cost airlines took hold. Unsustainable cost structures were evident before the EasyJets and RyanAirs took hold. It is more that the

leaner, meaning low-cost airlines brought attention to the complacent business models of established carriers.

Rather than merely stealing passengers from established airlines, low-cost airlines have actually dramatically increased passenger numbers overall. Rather than catching a train or bus, low-cost airlines make air travel an attractive alternative.

Established airlines lamenting the emergence of low-cost airlines need to examine the facts again. Research shows that overall air traffic rises sharply every time a major low-cost airline enters the market. For example, when low-cost carriers entered the London-Barcelona market in 1997, traffic rose from 600,000 passengers in 1996 to 1,500,000 passengers in 2001. Traditional airlines actually flew 380,000 of those extra passengers with the low-cost carriers capturing the rest.

What is happening now?

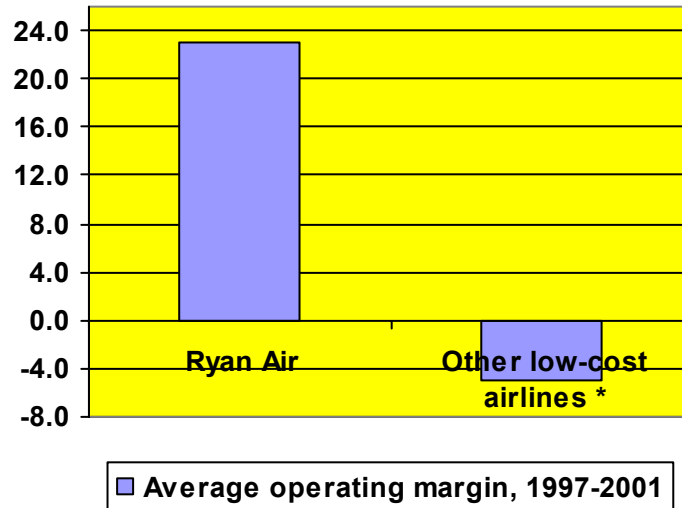
Low cost business models, besides being a more cost effective model, have a further advantage. They are more resistant to economic downturns because during such downturns, more passengers seek cheaper travel.

What low-cost airlines cannot offer are multiple, coordinated routes, ticket flexibility and those added services that business executives tend to want such as lounge access. Hence, established airlines, as long as they keep their cost-base under control have a place in the industry.

However, a new game is emerging. The battle is less and less one between major carriers and low-cost airlines and more and more one between low cost airlines themselves. These airlines target the same kind of passengers as each other, the same routes as each other and use similar business and operational models. And new ones keep emerging. Something therefore has to give.

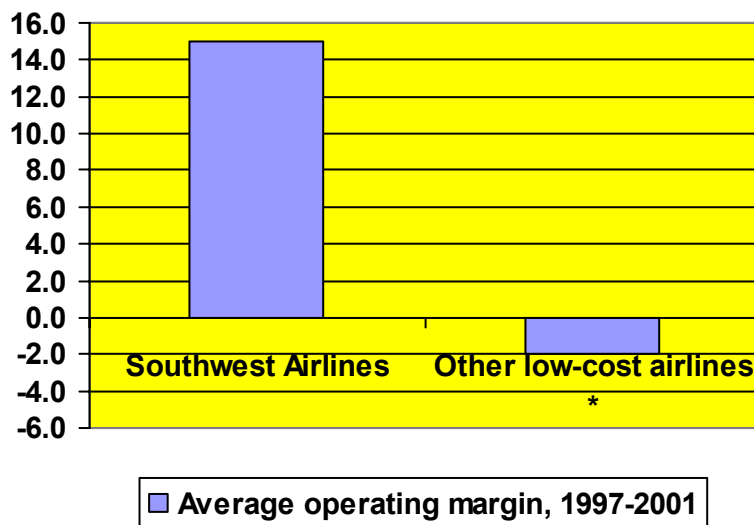
Just as consolidation and merges is occurring between established carriers to reduce costs, consolidation is inevitable between low-cost carriers. Although low-cost airlines have a cheaper cost base, this does not mean that they will all make profits. In fact, it is only the top one or two low cost players in each region that appears to be profitable.

Operating Margin of Low-Cost Airlines in Europe (%)



* Includes Buzz, easyJet, Go, Virgin Express

Operating Margin of Low-Cost Airlines in U.S. (%)



* Includes AirTran Airways, Frontier Airlines, JetBlue, Spirit Airlines

Source: Airline Business; Association of European Airlines; US Department of Transportation

We believe there will be two developments in the airline industry: consolidation of low-cost, single route carriers and the consolidation of multi-route, service added, established carriers. The dynamics of low-cost airlines will not be the same as established airlines.

For traditional carriers, the name of the game is lower costs through consolidation and restructuring of other costs (i.e., more competitive contracts with employees.) For low-cost carriers, the key is sufficient market penetration in terms of capturing enough passengers and securing key routes and landing slots.

We see, for instance, that QANTAS is competing with VirginBlue by forming a new entity JetStar. This is not just for branding purposes. Our guess is that JetStar will not be tied to the same staff contracts as QANTAS employees and will utilise a different business model from its parent.