
The Changing Paradigm of the Aviation Sector

PECC International Roundtable

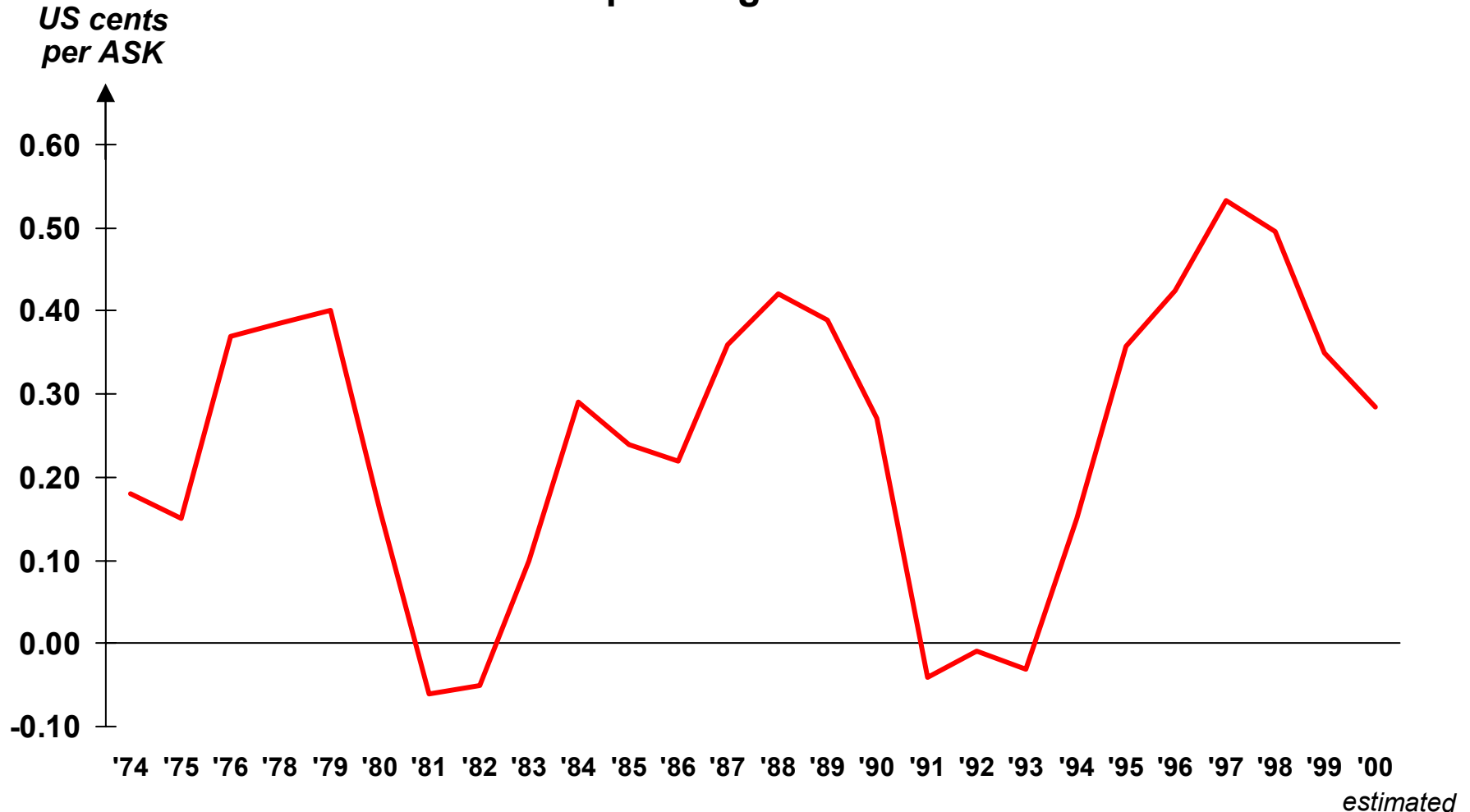
Role of Airports and Airlines in Trade Liberalisation and Economic Growth

4-6 September 2003, Singapore

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The airline industry has had to cope with severe cycles over the past 25 years

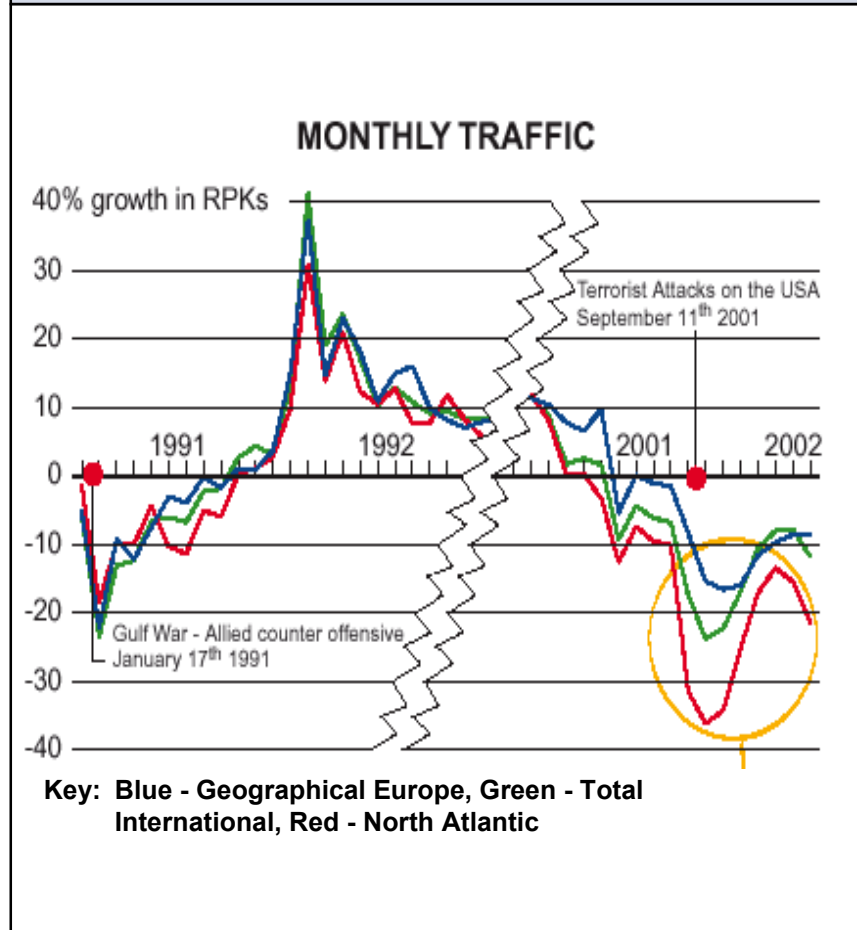
World Airline Operating Profit Per ASK ⁽¹⁾



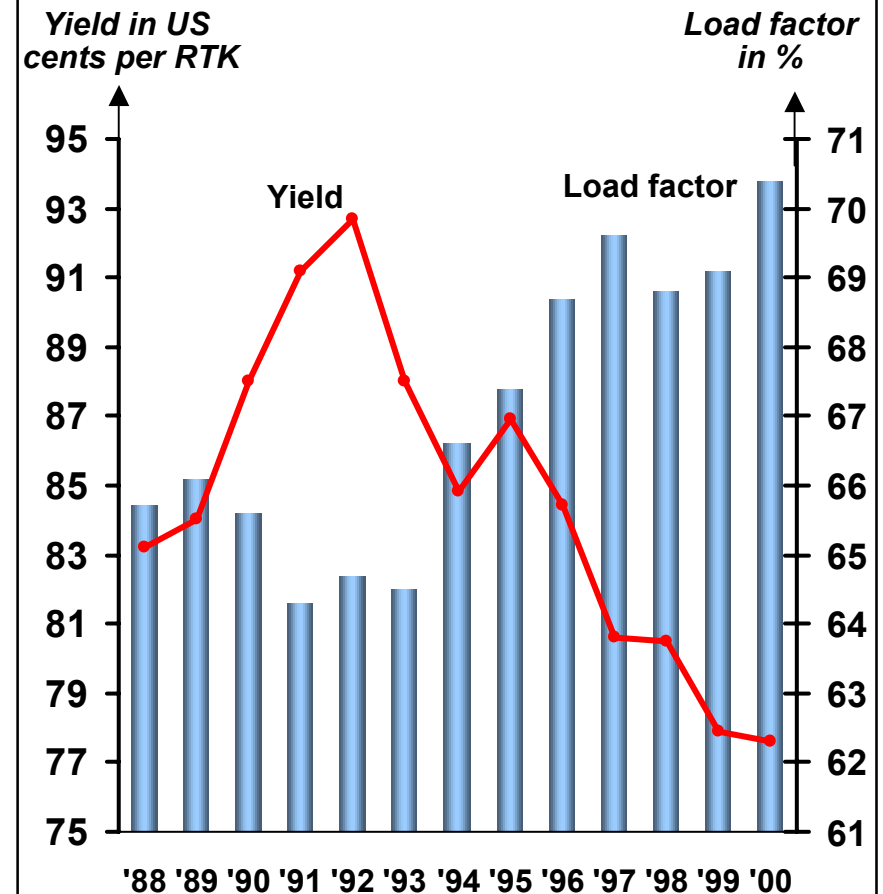
Note: (1) ASK = Available seat kilometers,
Sources: Warburg Dillon Read, IATA

The sector was in a down-cycle even before 911

Global Downturn In The Airline Industry



Development Of Yield And Load Factor



It appears the sector is perpetually in reactive mode

“...Airlines have not earned enough profit to cover the cost of their capital for over the past 30 years...”

Alan Mulally; Chief Executive , Boeing Commercial Airplane Group

“...It’s a case of ‘constant-shock syndrome’...”

“...the industry has shifted into a new paradigm in which each crisis is no longer an isolated event..”

Peter Harbison; Managing Director, Centre for Asia Pacific Aviation

This has remained one of the few inflexible sectors – but is beginning to be forced into fundamental changes

Inflexible Industry

“...Aviation has been incompletely deregulated, and in only two markets: America and Europe. Everywhere else deals between government dictate who flies under what rules. These aim to preserve state-owned national flag-carriers, run for prestige rather than profit. And numerous restrictions on foreign ownership impede cross-border airline mergers...”

The Economist

Perceived Uncontrollable Factors

- Slow-down in the global economy
- Terror attacks – e.g. 911; Bali bombing, etc.
- War and regional conflicts
- Epidemics
- Internal airline management capabilities
- Labor disputes – e.g. pilot and airline mechanic strikes

Forces For Change

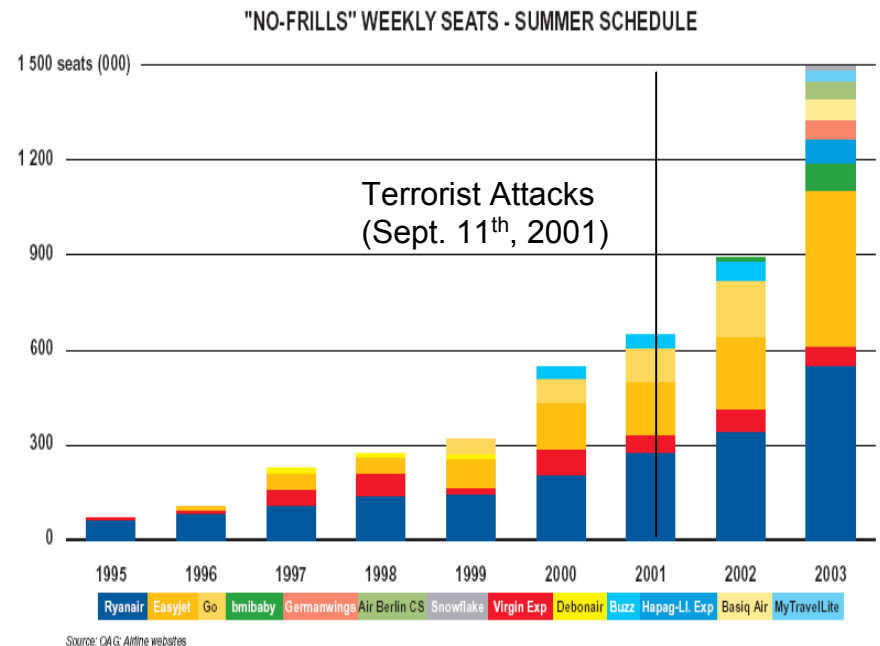
- Advance and proliferation of Low Cost Carriers (LCCs)
- Greater transparency of fares provided by the internet

Low Cost Carriers (LCCs) have out-performed the market despite “uncontrollable” factors

“Uncontrollable Factors”

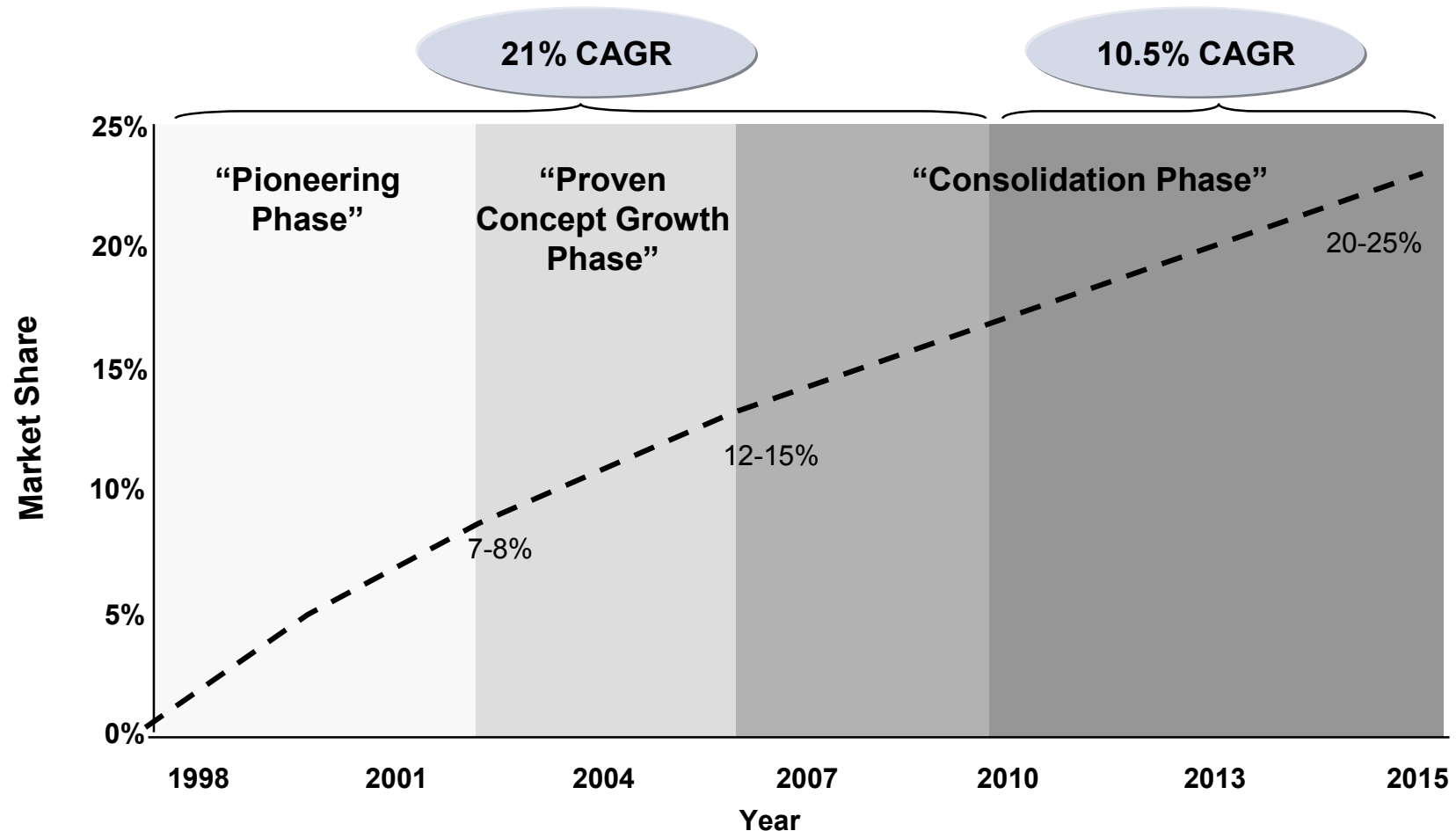
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Significant Growth For Low Cost Carriers

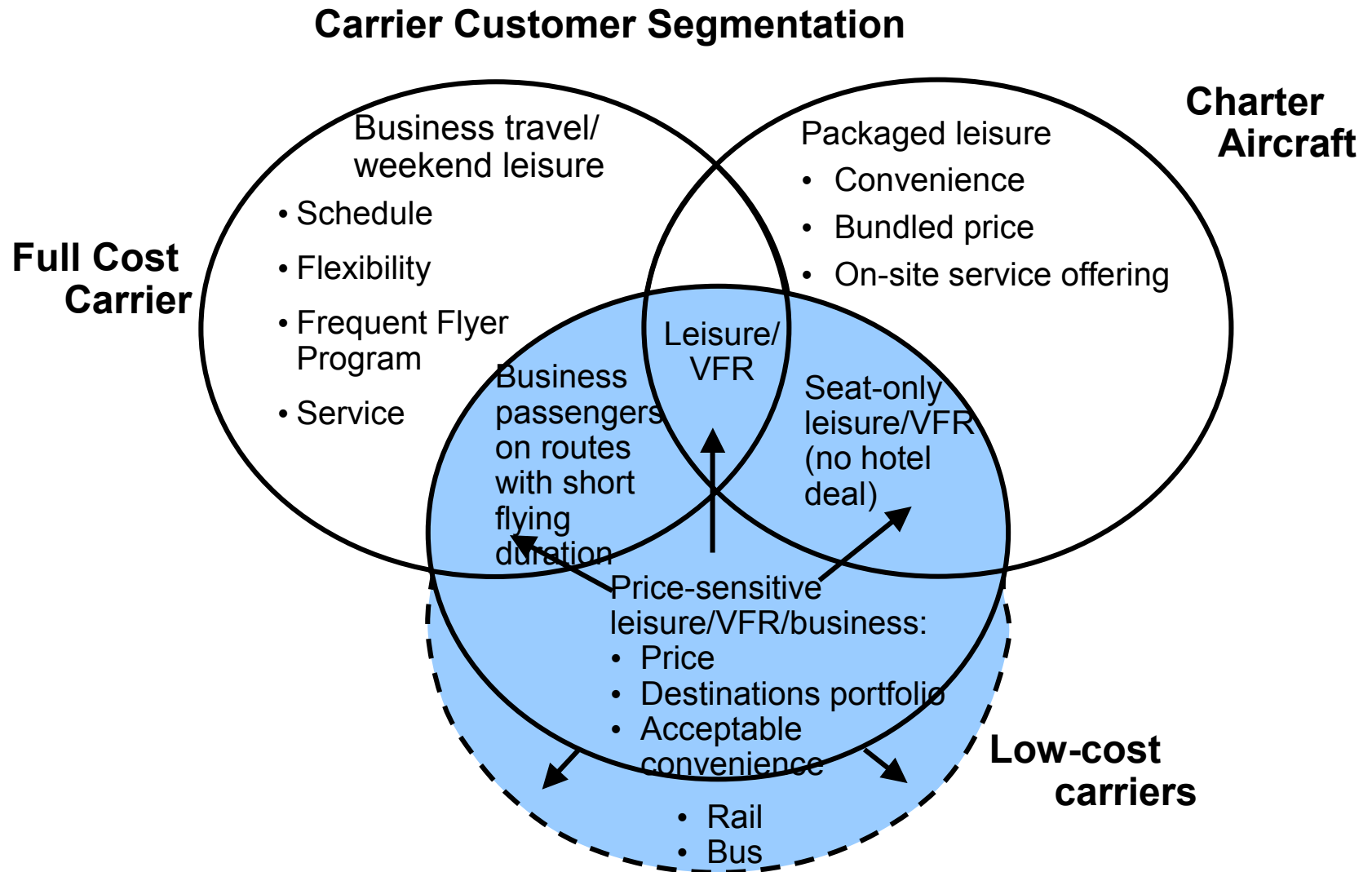


And, these LCCs are expected to continue growing at a rapid pace over the next few years

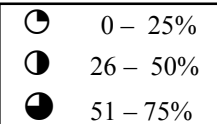
Low Cost Carrier Market Growth (% of Total Global Airline Market)



LCCs have altered traditional segments of air travelers



LCCs reduce complexity throughout the value chain ...

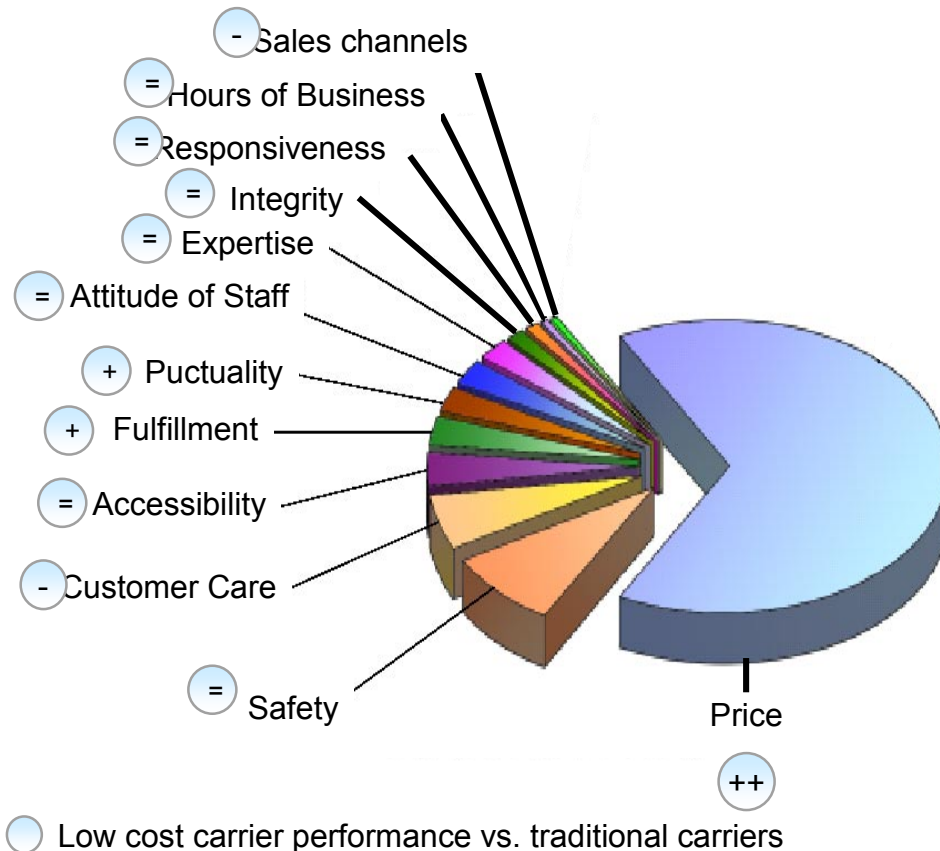


Low Cost Carriers v/s Traditional Carriers

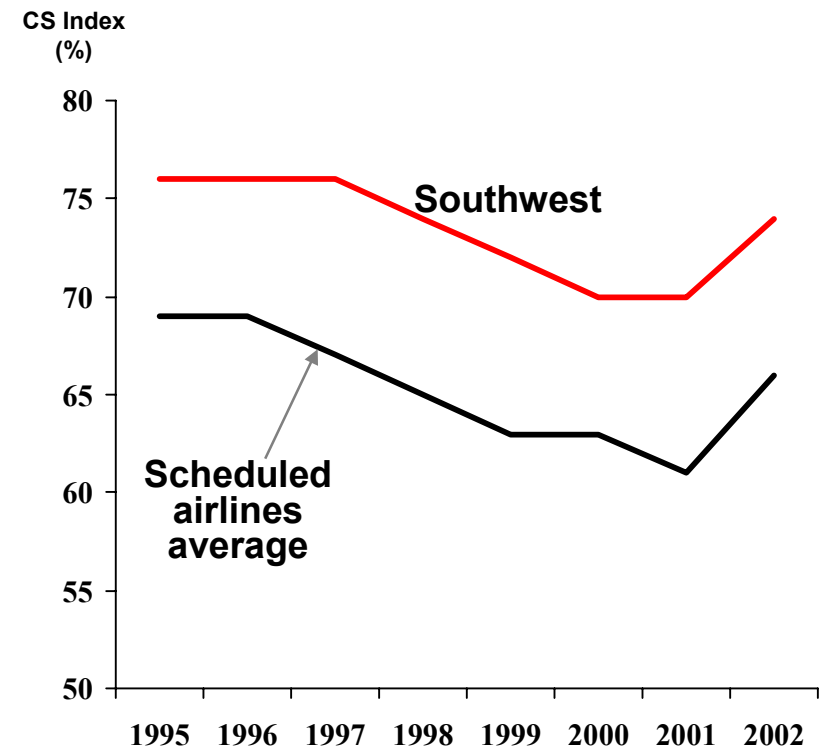
Cost Driver	Capacity	Sales & Marketing	Services	Flight Ops / MRO	IT	Overheads
Low cost carrier specifics	<ul style="list-style-type: none"> • <u>Single aircraft type</u> • Low purchase price • Low spare parts inventory • 1-class seating - high density • No complex buyer furnished equipment • <u>High utilization</u> • High number of rotations per day/ fast turnaround • No feeder traffic 	<ul style="list-style-type: none"> • <u>No agent commission</u> • No GDS-fee • No FFP • No discounts • No key account • No field team • Internet booking • No pro rating / interlining • <u>Simple fare structure</u> • <u>Effective yield management</u> 	<ul style="list-style-type: none"> • <u>Free seating</u> • Simple check-in • No transfer services • No lounges • No special services (kids, elderly, ...) • No free catering • No in-flight entertainment • <u>Secondary airports</u> 	<ul style="list-style-type: none"> • <u>High labor productivity</u> • One crew body • No transition training • Simple patterns • Lean Mgt • Lean MRO engineering • One type of MRO floor qualification • MRO equipment • Punctuality cost 	<ul style="list-style-type: none"> • <u>No complex network management tools</u> • Simple core applications • Simple Yield Management • No FFP • Simple flight ops systems • Simple MRO Systems • Simple Revenue Accounting 	<ul style="list-style-type: none"> • <u>Simple functional structure</u> • Simple governance • Simple revenue and cost accounting • No alliance coordination cost
Cost advantage vs. Scheduled Airlines	◐	◐	◐	◐	◐	◐

... while offering services highly valued by customers

The Most Important Factors When Choosing An Airline



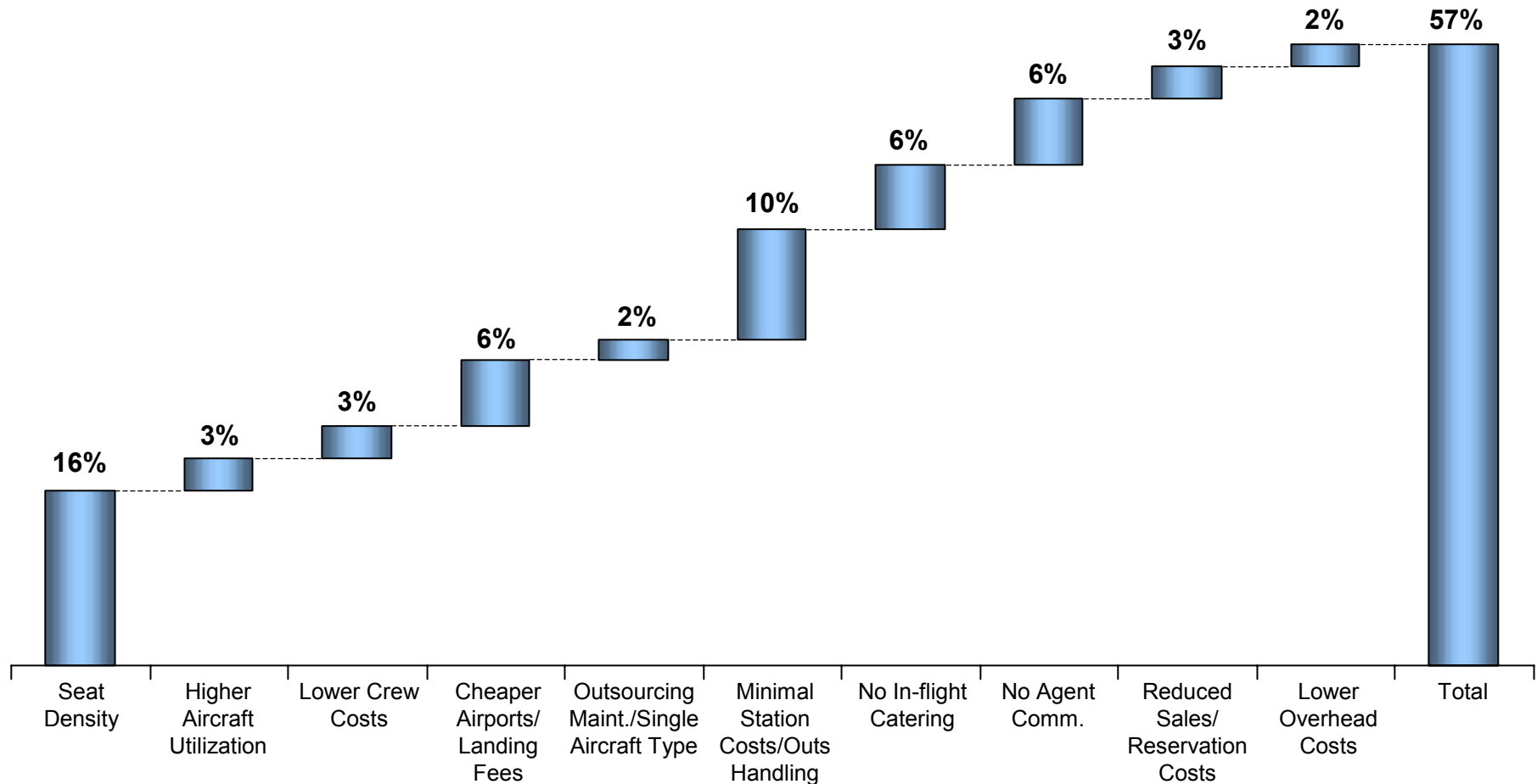
Example of Customer Satisfaction Index US Scheduled Airlines



Low cost carrier's attractive service/price value proposition is a major threat to traditional carriers

Consequently, LCCs are able to operate at close to 57% less cost than network carriers

Low Cost Carrier Advantage v/s Full Cost Carriers (% Cost Advantage)



LCCs are now beginning to expand beyond their original niche model...

- Separate business class cabin for a small incremental fee
- Transcontinental services in North America
- Possible regional services in Asia

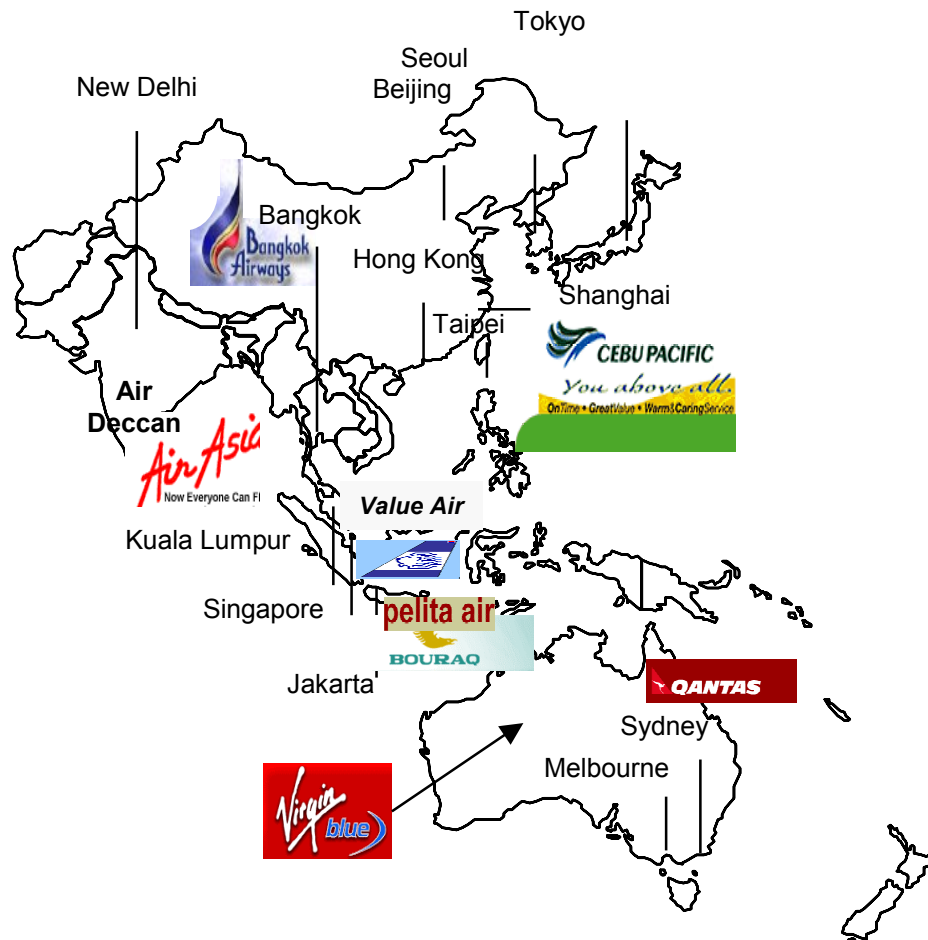
...Offering “frills” while continuing to deliver superior performance

Comparison Of Different Low-Cost Carrier Models

	Ryanair	Easy Jet	Virgin Express	South-west	jetBlue
Seat Pitch	29-31	29	31	32	32
Leather	N	N	N	Y	Y
TV	N	N	N	N	Y
Frequent Flyer	N	N	Y	Y	Y
High Fare Variation	Y	Y	Y	N	N
Connections	N	N	Y	Y	Y
Customer Focus	N	N	Y / N	Y	Y
Low Price	Y	Y / N	Y / N	Y	Y
Pass Growth	38%	36%	-18.6%	1.2%	172%
Revenue	E 624.1	E 580.6	E 212.1	E 5 488	E 326.9
Profit Margin	24.1%	10.6%	0.1%	9.2%	9.8%
Founded	1986	1996	1996	1971	2000

Asia too has begun to see expansion of LCCs

Examples Of Low Cost And Budget Carriers in Asia



Observations

- Budget airlines operate mostly on domestic routes within Asia Pacific region, such as in Australia, Japan, Malaysia, New Zealand, Philippines, Thailand and Indonesia
- There is still the Restrictive Air Service Agreements for international routes that prevent a carrier from developing a pan-Asian network
- Air Asia is exploring the introduction of flights to/from Malaysia with destinations in SEA and China
- Virgin Blue is considering expanding operations in SEA
- Cebu Pacific has recently expanded its international routes to Hong Kong and Seoul
- Qantas acquired a former competitor and low cost carrier Impulse Airlines in 2001 and will operate the budget airline on domestic routes in Australia
- Earlier this year, SIA warned it was ready to launch a low-cost carrier in short period if any budget carriers try entering its home turf. Since then, SIA has mentioned the possibility of recasting SilkAir into a low cost carrier
- SIA is also exploring the opportunity to build a low cost carrier with Bangkok Airways, to be based out of Chiang Mai
- Value Air of Singapore is also expecting to launch a regional low cost carrier

Network carriers have generally been slow to take the appropriate actions to address the “constant-shock syndrome”

- Costs have not decreased in proportion to the drop in revenues
- Continue ordering aircraft based on historical growth that may not necessarily be valid for the current environment
- Continue to slash variable costs to weather the cycle
- Network carriers have been slow to address structural costs and the fundamental way in which they operate

A select few network carriers have recently embarked on programmatic change to reinvent themselves

Qantas

- Aggressive cost cutting plan that splits operations into three separate divisions
- Changes are designed to address domestic competition from operators such as Virgin Blue, as well as international threats from Emirates and Virgin Atlantic
- The proposed structure will separate passenger operations from supporting services and other businesses

**Estimated Savings of
US \$ 659m**

British Airways

- Launched “Future Size and Shape” program aimed at reducing costs, restructuring short haul operations and removing complexity Introduced low fares for short haul flights to directly challenge no frills operators. Implemented online booking engine and reduced agency commission through initiatives such as increased e-ticketing

**Estimated Savings of
US \$ 1,030m**

The sector requires agility, facilitated by regional governments – to serve the greater good of spurring economic growth

- Reassess regulations that limit open skies
- Facilitate possibility to establish cross-border airline mergers
- Review partnership equation between airports and ancillary service providers with airlines
- Open up second and third tier airports to facilitate the proliferation of LCCs
- Facilitate dialogue and collaboration between all related industry players on specific ideas to reinvent the sector