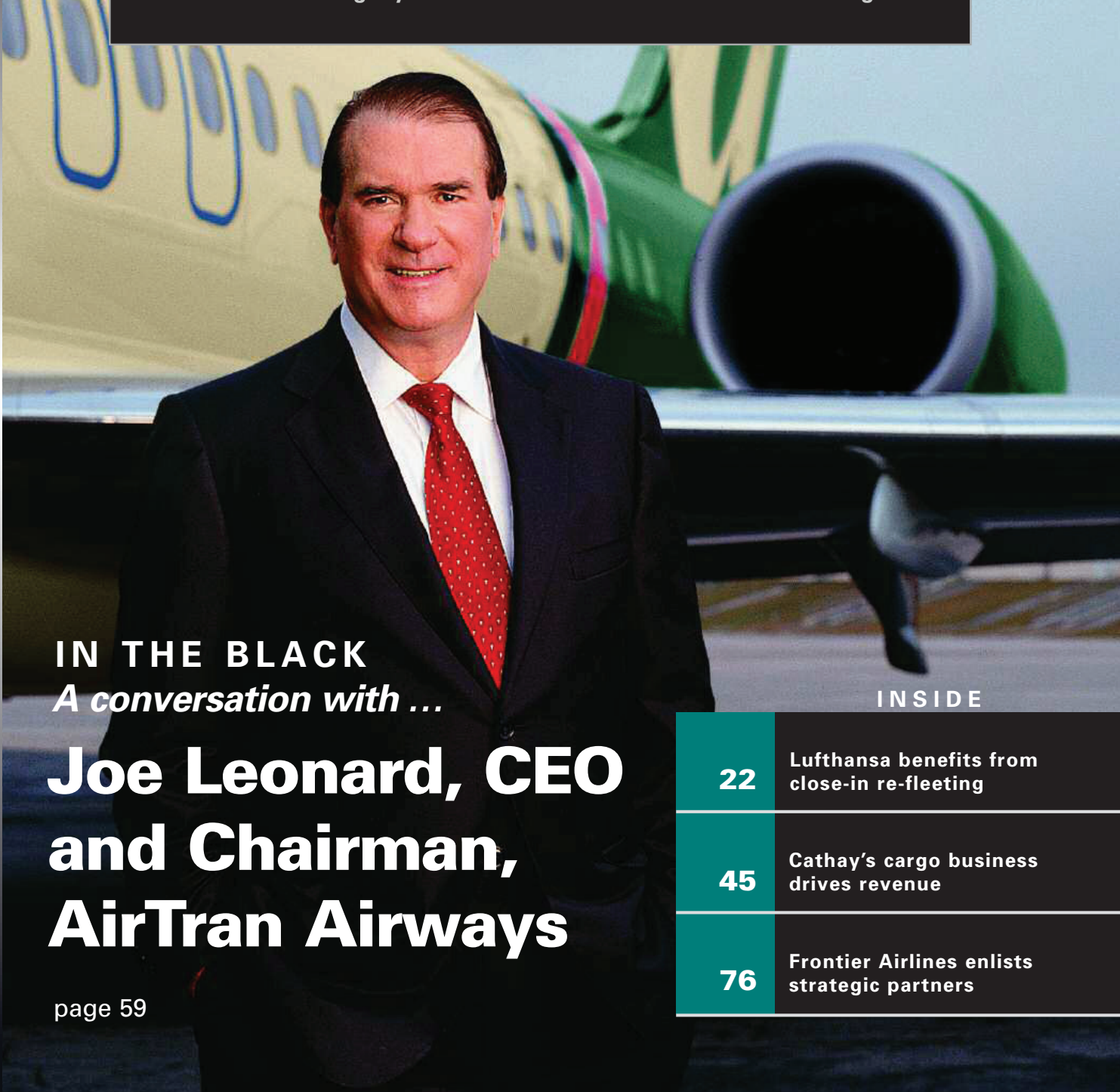


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Choosing its Battles: Low-Cost Carriers Enter Asia/Pacific

Low-cost carriers have finally made their way into Asia/Pacific, but there is some skepticism about long-term victories in specific parts of the region.

■ By Karen Dielman | *Ascend* Contributor

Low-cost carriers have penetrated nearly every market with varying degrees of impact to network carriers. Traditional network carriers around the world are facing stiff competition from LCCs, with the Asia/Pacific region being the most recent to experience that change in the competitive landscape.

Looking at regions that have a more mature low-cost carrier market may help Asia/Pacific carriers understand and prepare for future changes and opportunities.

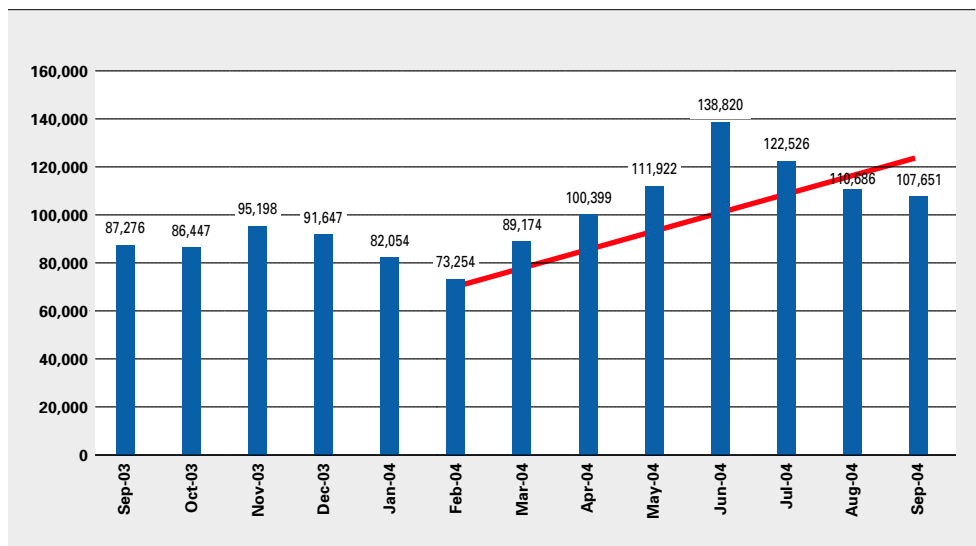
LCCs Around the World

In North America, the growth of LCCs has clearly affected the profitability of the region's traditional network carriers. As of December, several network carriers have either entered bankruptcy or face strong financial difficulties. Meanwhile, the region's low-fare airlines have shown strong performance, including the continually profitable Southwest Airlines, jetBlue and AirTran Airways.

A prevalent trend in the North American low-fare market is the shift of LCCs away from strictly short-haul operations and toward longer-range routes, which have traditionally been the mainstay of network carriers. As LCCs invade this space, traditional network carriers struggle to stay above water. As a result, traditional network carriers have concentrated more on the development of international routes, which demonstrated much stronger performance last year.

In Europe, the introduction of low-fare airlines has trailed the development in North America, but the low-cost segment is growing very rapidly. As it grows, LCCs are not only competing with network carriers, but they are also competing with each other. This is producing even lower yields and increased finan-

**Seasonality of Demand
BKK-SIN**



The Bangkok-Singapore market experienced substantial demand stimulation after the introduction of low-cost carriers, which is clearly boosting travel in new market segments.

cial difficulties in the European aviation marketplace. Although there have been many low-fare start-ups in Europe, there have also been many closures. And, it is thought the 2005 marketplace will continue to be very volatile this year.

There is also a consolidation within Europe of tour operators and low-cost carriers. Until the advent of LCCs, tour operators were the traditional outlet for low-yield regional travel, and they had a strong market share in Europe. Increasingly, tour operators run their own airlines. For example, LTU, TUI and MyTravel all operate airline subsidiaries. These tour operators are not restricted to vacation packages and can offer air-only services.

Similarly, tour operators frequently operate from secondary airports that are the traditional domain of low-cost carriers; therefore, their ticket prices are consistent with low-cost carrier competitors. Finally, low-cost carriers are increasingly consolidating packages online, thereby invading the traditional tour operator segment to increase revenues. The result is a consolidation of low-cost carrier and tour operator traffic within Europe.

In the Middle East, it has become fashionable to start a low-cost airline. However, unlike other regions, low cost in this region does not mean low service. The service standards within the region are high, and low-cost airlines have maintained these standards. El

Etihad, for instance, offers full meal services, in-flight entertainment, connecting baggage, long-haul services and serves primary airports such as London Heathrow International Airport. The only similarity Etihad has to low-cost carriers is low fares. Similarly, Air Arabia, which announced profitability in its first

Singapore — show differences in the impact LCCs have in this region.

In the Bangkok-Hong Kong market, low-cost Orient Thai has gained a substantial market share by offering average fares that are 25 percent to 35 percent of the published fare of the market leaders. This aggressive pricing

Overall, the Bangkok-Hong Kong market is not seeing any travel demand stimulation due to the introduction of LCCs, which demonstrates that the increased market share by LCCs on that route is purely at the expense of network carriers. Much of the growth for LCCs in this market is through discretionary

“Asia/Pacific is the new battleground between low-cost airlines and network carriers, with many traditional network carriers starting low-fare subsidiaries.”

full year of operation, offers meal service, connecting baggage and other full-service amenities. The airline operates from a home base at a secondary airport, but its model is much closer to a full-service carrier than low-cost carriers in Europe or the United States.

Asia/Pacific is the new battleground between low-cost airlines and network carriers, with many traditional network carriers starting low-fare subsidiaries — a risky move because, to date, traditional network carriers have not produced a long-term, successful low-cost subsidiary.

LCCs have an increased influence in Southeast Asia. The general methods used to establish market presence are similar to tactics used by European low-fare airlines — enter a market with high frequency on narrow-body aircraft with tight seat pitch (29-inch pitch is common among LCCs in the region).

They charge fares that are a fraction of those offered by traditional carriers, and they also take advantage of industry tools such as Internet distribution, tight turn times and high equipment utilization. There is, however, a deviation with the European model in that Asian low-cost carriers maintain higher service levels than in Europe. Low-cost carriers in the Far East are copying many of the operating characteristics of the European and American models, but are still offering higher service standards in visible areas such as catering and in-flight entertainment.

The region's LCCs have varying degrees of effect in key markets. In almost every market — except for Hong Kong-Singapore where the brand strength of traditional carriers is very strong — they are gaining market share compared to traditional carriers.

Three key markets — Bangkok-Hong Kong, Bangkok-Singapore and Hong Kong-

strategy has hurt market share for some network carriers while not impacting others as all. The difference directly ties to brand strength in that market.

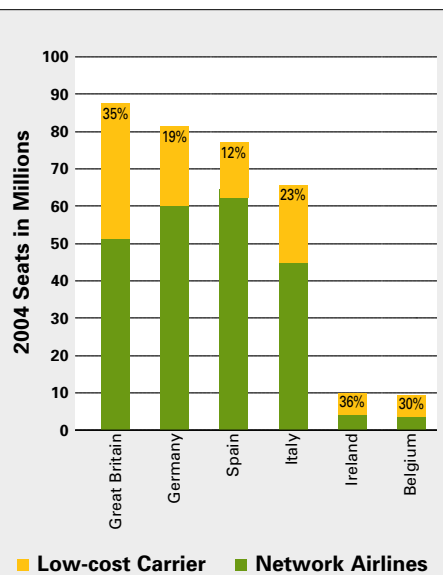
travelers, particularly the “visiting friends or relatives” segment.

The Bangkok-Singapore marketplace is interesting because of the direct competition between two low-cost airlines: Thai Asia (a subsidiary of Air Asia) and Valueair, which have both earned market share based on high frequency operations using smaller equipment. These two low-cost carriers command nearly 20 percent of the market capacity. The fares for the two LCCs in this market are comparable because of the competition between the two, and again, the fares are 25 percent to 35 percent below traditional carriers in the market. The result is that the traditional network carriers are losing share rapidly in the face of price and capacity competition.

The Bangkok-Singapore market has grown significantly through demand stimulation. This is not just related to the addition of capacity but also due to the fact that low fares are now offered in this marketplace, clearly stimulating travel in new market segments.

LCCs in the Hong Kong-Singapore market have also stimulated travel demand. Valueair entered the Hong Kong-Singapore market last June and is gaining market share at the expense of other carriers. Mainline carriers have not been significantly impacted and have been able to increase yield of published fares as price-sensitive passengers flock to LCCs. With the market growth caused by market stimulation, the price-sensitive passenger segment has grown. Because this passenger segment has grown more rapidly than capacity, high-end service providers have benefited. Because the low-yield passenger segment has flocked to the LCCs and the market size has substantially increased, the higher-yield passengers have no choice but to use the high-end service providers who have thus

Low-Cost Capacity Share in Europe

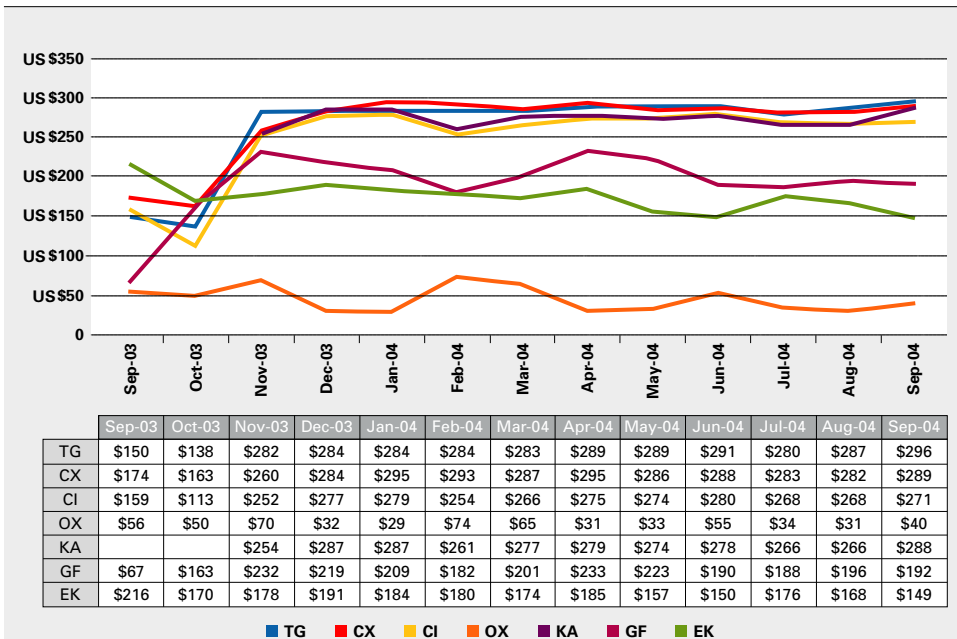


Source: Focus 12/2004

Although the development of low-cost carriers in Europe has gotten a later start than those in North America, the region's LCCs are rapidly catching up. As these LCCs expand, they are not just competing with the network carriers, they are also competing with each other, producing even lower yields and increasing financial difficulties in the European aviation marketplace.



Average Carrier O&D 13 Month Fare Trend BKK-HKG



In the Bangkok-Hong Kong market, low-cost Orient Thai has established a substantial market share by offering average fares that are 25 percent to 35 percent of the published fare of the market leaders. This aggressive pricing strategy has hurt market share for some network carriers while not impacting others as all. The difference directly ties to brand strength in that market.

been able to increase yield. However, the average fares for this market have come down overall due to LCCs and key U.S.-based carriers offering lower prices.

Overall, the introduction of low-cost carriers has had a significant impact in the region. Adding in the growth and privatization of Chinese carriers and the continued lack of stability among fifth freedom airlines (notably from struggling U.S.-based carriers), there could undoubtedly continue to be reductions in yields in Asia/Pacific. However, carriers with a strong brand presence will be able to stave off the worst effects of dilution for some time. But, ultimately, declines in yield — particularly among Japanese premium travelers — is expected in the foreseeable future. Carriers that maintain share through fare reductions will maintain share in the short term. However, price, as a motivator, ultimately leads to dilution.

LCC Growth

Many industry experts believe that the low-cost carrier phenomenon in Asia/Pacific is just beginning. The huge potential passenger volumes in India and China will fuel the develop-

ment of more and stronger low-fare airlines in the region.

India has seen the announcement or commencement of services of four new low-cost carriers in 2004, many of which are properly financed and have a great chance of success. China is taking a notably conservative approach to the licensing of new low-fare airlines. As demand for air travel grows in domestic China, however, the government may take a more relaxed view and withdraw protection from the state-held carriers.

Undoubtedly, top LCCs will continue to grow in Asia, and it's likely these carriers will receive licensing to serve Chinese stations in the near future. Still, the strength of the volume and the increasingly mobile Indian and Chinese middle class will indisputably make domestic low-fare airlines in these two countries powerful forces during the next decade.

Japan

In Japan's travel market, the growth of LCCs will be stimulated by changes in the domestic aviation infrastructure, meaning that the largest threat of LCCs will occur in the domestic marketplace rather than internationally.

Low-cost carriers have a difficult time operating long distances due to the low yield and price of low-cost travel. Therefore, low-cost airlines must operate in high density domestic and regional international markets. Given the geography of Japan and the region as well as the existing rail infrastructure, there is very little opportunity for LCCs to establish a foothold in either the domestic or the regional marketplace.

Some of the region's major carriers are experimenting with the introduction of smaller equipment types, enabling frequency to increase into regional markets while allowing for flow-over hubs, which will make the introduction of LCCs even harder in the marketplace.

Another consideration is that the cost of airports is very high and the congestion at major hubs — notably Narita and Osaka, Japan — prohibits the introduction of high-frequency operations. While new airports are being developed, these airports will soon be congested and will not support the low cost of operations required by low-fare airlines.

Perhaps the most important reason low-cost carriers will not soon find a secure hold in Japan is because of its position at the eastern edge of Asia. To be successful, low-cost airlines must generate a large amount of volume. Fares are unrelated to distances among LCCs. In Europe, for instance, the range of fares in the marketplace is from €75 (US\$96) and €125 (US\$160) per leg, regardless of distance, meaning LCCs must be centrally located to be most successful. Since fares are not related to distance, highest revenues can be achieved by flying the shortest distance flights and "turning" the seats on the plane as often as possible. Average stage lengths must be less than three hours, and the most successful low-fare airlines have average stage lengths less than two hours.

While LCCs might be able to establish a domestic presence in Japan — subject to the country's constraints — Bangkok, Hong Kong, Singapore and new Chinese hubs present better geographic locations for start-up low-cost carriers because of their relative proximity to several large regional markets. Therefore, it is unlikely that existing LCCs in Southeast Asia will extend their networks to include Japan. These conditions may change fairly rapidly if any of the constraints are reduced.

The dominance of the primary carriers could be lessened as they are forced to restructure in the face of lower profitability. Also, if demand does not grow, the new aviation infrastructure might be sufficient and airport operations prices could be reduced.

Airports' Impact on LCC Growth

There have been discussions about investing in LCC terminals, which are designed to allow for high-frequency operations with tight turns. However, most of the world's hub airports contain constraints on runway space. Therefore, while hubs could allow for low-cost terminals, LCCs would be unable to take advantage of the tight ground times unless additional runway space is added.

With the addition of runways at hubs, privatized airports will concentrate on the highest yield opportunities, which will be legacy network carriers as opposed to LCCs. Very few airport hubs have the ability to increase runway space sufficiently to allow for LCCs to take a strong hold and, therefore, make adequate use of LCC terminals.

Also, LCC terminals are designed to have fewer baggage facilities, catering facilities and service infrastructure (no lounges or premium facilities). While this certainly caters to the LCC model, what will keep traditional carriers from wanting to take advantage of the lower cost of LCC terminals for regional point-to-point operation?

It is doubtful that the purveyors of terminal space will be able to limit access to facilities based on the corporate service model of an airline; therefore, airlines willing to operate with fewer facilities will be able to petition and receive

“During the past three years, there have been more than 40 start-up carriers created by legacy airlines, and not one of them has been fully successful.”

space at LCC terminals. If the hub wants to limit access to the LCC terminal, it will have to reduce costs at its other terminals to give traditional airlines equal savings opportunities.

The outlook for LCC terminals is unlikely to translate to most hubs in the Asia/Pacific and other regions.

LCC Subsidiary

Many industry experts believe the attempted introduction of low-cost subsidiaries by existing network carriers is a management diversion. Unless legacy carriers are prepared to divest of their local competitive markets, the LCC arms of the network carriers are, at best, a distraction and, at worst, a drain on legacy carriers' capital and profits.

To date, network carriers have been unable to launch a successful low-cost subsidiary. During the past three years, there have been more than 40 start-up carriers created by legacy airlines, and not one of them has been fully successful. The reasons for the failure are quite varied.

First, LCCs require a lot of start-up capital, which traditional airlines don't possess. Therefore, when legacy carriers start low-cost subsidiaries, they tend to starve the new carrier of capital. A primary way LCCs retain their low-cost structure is through substantial capital and cash resources.

Second, legacy carriers underestimate the amount of management attention that is required to start a subsidiary airline. Therefore, when troubled legacy carriers enter in the LCC

Asia/Pacific Travel Trends

■ By Karen Dielman | *Ascend* Contributor

The current close-in trends for air travel in Japan, China and Asia/Pacific show a considerable amount of growth and local volatility, supporting the belief that this region is experiencing a time of industry change. Local volatility, for example, can be seen in Japan's domestic air travel, which is recovering but still volatile due to a struggling economic recovery.

The unprecedented poor weather in the third quarter of 2004 has had a dramatic impact on airline profitability and, therefore, limits the introduction of new capacity this year. Although recent domestic economic and passenger volume trends are encouraging, the marketplace continues to be highly elastic.

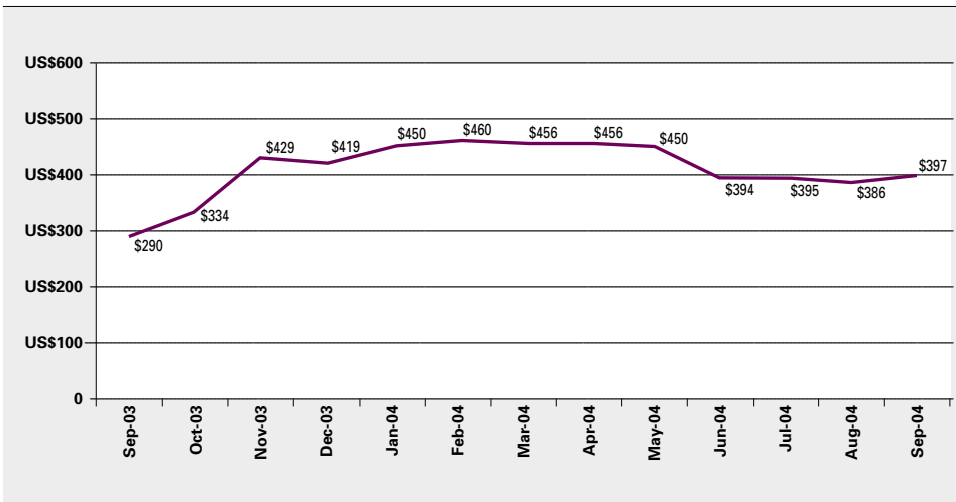
China continues to be a very high-growth air travel market, with its economic growth fueling double-digit air travel growth rates (10.1 percent normalized for severe acute respiratory syndrome). This trend is expected to continue at least through the end of the year.

The Asia/Pacific region as a whole is enjoying more than 15 percent year-over-year growth compared to 2003, strongly fueled by recovery from the SARS crisis. A normalized growth rate of 7.4 percent is seen in the Asia/Pacific region, which is greatly influenced by China's numbers.

The short-term growth of air travel in the entire region is tied to the individual carriers' response to rising fuel costs. The increase of fuel surcharges will cause a cooling in passenger demand, especially if struggling U.S.-based airlines with fifth freedom rights in the region do not adopt the policy of increasing fuel surcharges. The overall outlook for short-term growth is "cautiously optimistic." Growth will continue, but recovery is fragile and can be derailed by inclement weather, increasing fuel prices and the slowdown of economic recovery. [E](#)



Average O&D 13-Month Fare Trend HKG-SIN



With the development of low-cost carriers, the average fare in the Hong Kong-Singapore market has been reduced by more than 10 percent. With the market growth caused by market stimulation, the price-sensitive passenger segment has expanded, which has benefited high-end service providers since it has grown more rapidly than capacity.

marketplace to compete with existing entrants, they become torn between building the new airline and managing the competitive position of the legacy carrier. This may be the reason 34 low-cost airlines were created and 41 failed last year alone.

Finally, legacy carriers often believe they can cut their own costs by outsourcing certain functions, such as airport handling, ground handling, catering and maintenance, to their LCC subsidiaries. Unfortunately, these tend to increase the unit costs of LCCs, lowering their viability. If legacy carriers had sufficiently low costs to support the needs of an LCC, it would probably not see the need to

create an LCC subsidiary.

For these reasons and also because there has not been a single example of a fully successful LCC start up from a legacy carrier — despite some of the largest and most successful carriers attempting this approach — most experts continue to feel this approach is unproductive.

Preparing for the Future

To sustain long-term success, network carriers around the world should concentrate on several key areas:

- Revenue enhancement — Network carriers need to increase revenues through best

practices techniques including origin and destination revenue management, close-in re-fleeting, elasticity control, restriction-free one-way pricing and distribution channel management, all of which have only just begun to be utilized,

- Cost containment — Traditional airlines should continually search for ways to reduce costs, despite seemingly exhaustive containment exercises,
- Price competitively — Legacy carriers need to keep fares competitive with incumbent network carriers, although it is unnecessary to cut prices to the levels of LCCs,
- Service differential — Network carriers must use their brand and image to drive market share, which is best accomplished by maintaining a high-quality, low-cost approach to service provision,
- Asset utilization — Traditional airlines need to ensure dynamic use of available data to better forecast, manage assets and map capacity to demand,
- Network flow — Legacy carriers can retain viability by operating in markets that cannot be reached by LCCs.

Many industry experts remain optimistic about the performance and future of legacy carriers. Although these carriers must adapt to a changed environment, they have the distinct ability to prosper in the current and future commercial aviation marketplace. **E**

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+count it up

1.6 Billion — U.S. dollars, on average, that are spent annually for mis-handled baggage by the world's airlines. According to SITA, it costs the industry an average of US\$87.50 when a bag fails to arrive at its destination on time.

1 — Number of airline fatalities per passenger kilometer for every million flights. Despite the rapid and constant growth in air traffic, accident rates have been reduced by more than 50 percent during the past 20 years.

12 — Percent of the more than 2.27 million scheduled flights worldwide that are operated by discount airlines. In 2001, low-cost airlines only accounted for 6 percent of the world's flights and 8 percent of available seats.