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THE PILOT

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MIDDLE EAST ON THE RISE

With well over 600 new aircraft orders at the Dubai Air Show, double-digit annual traffic growth and a number of new airports planned, the Middle East is exceeding all airline industry expectations — although various factors could influence sustainability of medium-and long-term growth.

■ By Christophe Ritter | *Ascend* Contributor

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During the Dubai Air Show last November, 662 aircraft orders worth more than US$100 billion were placed. Combined, Emirates Airlines and Qatar Airways exceeded 220 aircraft orders, representing approximately 33 percent of the show's total orders.

There's no arguing the fact that revenue passenger traffic is growing at a phenomenal rate in the Middle East.

Last year, the Arabian peninsula (from Syria to Oman) exhibited a year-over-year increase of more than 18.8 percent in total air revenue passenger traffic, compared to a 7.5 percent market growth rate worldwide.

And even though Middle East air traffic market share represents only 8 percent of total passenger traffic globally, it also represents the fastest-growing market for scheduled airlines.

While this market growth has, to a large extent, been fueled by a significant increase in capacity with the rapid development of low-cost airlines and continuously added total available seats by the region's large network carriers, the latest figures provided by the International Air Transport Association also show a significant load-factor increase.

With such growth, the Middle East — along with India and China — remains at the forefront of the fastest-growing markets worldwide. That's a remarkable achievement because the growth has occurred on the international passenger market. There's simply no strong intra-domestic Middle East market that would support the high level of growth.

The dynamism of the Middle East is supported by market-oriented economic policies and strong government investments in infrastructure as well as diversification of the traditional petroleum-based economy into financial hubs and leisure destinations. Development of free-trade zones, which have created an international investor-friendly environment, and regional government spending have enhanced the competitiveness of non-energy sectors.

Surges in petroleum revenues have enabled the various Middle East countries to invest heavily in infrastructure, industrial projects and tourism, providing stimulus for the private sector to expand.

In addition, the geographical location of the Middle East — at a maximum range within 8,000 nautical miles of all continents — has boosted international traffic flow, positioning the Middle East region as a major global hub for both business and leisure travelers.

During the past decade, for example, Dubai International Airport advanced from the 26th-largest to the 10th-largest international hub in the world, with more than 34 million passengers handled (a year-over-year growth rate of 19.3 percent) and 260,000 aircraft movements (a year-over-year growth of 9.8 percent) in 2007, and is the world's fastest-growing airport.

Leveraging the Middle East's proximity to fast-developing regions and emerging markets, such as southern Asia (primarily India and Pakistan) and northern and western Africa, international passenger traffic to and from the Middle East is growing rapidly in all world regions.

While one of the European and North American challenges is a relative lack of capacity to address strong domestic and international demand, the Middle East has invested in and will continue to heavily invest in airport infrastructure.

Recently, a half dozen new airports have been announced. These include Oman as well as the Qatar New Doha International Airport project that will triple the airport's capacity to 50 million passengers annually by 2015. Abu Dhabi Airport will rapidly expand with the addition of a second runway and a third terminal. And Jeddah will benefit from four new terminals and capacity for up to 80 million passengers a year.

The Dubai World Central International Airport — currently under construction — has been designed to handle more than 120 million passengers a year, representing 40 percent more than Atlanta Hartsfield-Jackson International Airport, currently the world's largest airport.

Leveraging these gigantic infrastructure-enhancement projects, airlines have been investing heavily in additional capacity.

Last year, more than 720 aircraft were ordered (either firm orders or options) by 15 Middle East airlines or leasing companies, establishing a new record year for both Airbus and Boeing in the region.

During the November 2007 Dubai Air Show, 662 aircraft orders were placed — for a value exceeding US$100 billion. Emirates Airlines added 120 Airbus A350 aircraft orders and 11 Airbus A380 orders to its already-secured 47 orders — followed by Qatar Airways with more than 90 orders of Boeing 777 and 787 models.

With such major capacity investment, the Middle East leads the world in capacity expansion, with 14.8 percent year-over-year available seat kilometer growth — more than twice the overall industry growth rate according to the latest IATA figures.

Just in the past five years, the capacity flown from the Middle East to Africa and Asia has doubled and has increased 36 percent to Europe and 23 percent to North America. Stimulated by the rapid development of low-cost carriers such as Air Arabia and Jazeera Airways, the capacity within the Middle East has increased by 56 percent during the same period.

While the lost-cost phenomenon is relatively new in the region (in comparison to North America, Europe and even Asia), major expansion plans from already-established low-cost carriers — as well as the arrival of several new entrants in Saudi Arabia, the United Arab Emirates and Yemen — are expected to significantly stimulate the intra-Middle East market.

Fortuitous circumstances relating to a dynamic economy, major infrastructure investment and fast-growing aircraft capacity (leading to extensive worldwide network coverage) is making the mid-term Middle East outlook fairly promising. The International Civil Aviation Organization forecasts that Middle East passenger traffic will grow at an average annual rate of 6.4 percent until 2015, which is well above the 4.5 percent world average of all other regions, including Asia.

The presence of multiple major network carriers (Emirates, Qatar Airways, Etihad, Gulf Air and Saudi Airlines) and the strong ambitions of several regional carriers (Oman Air, Kuwait Airways, Yemenia and Middle East Airlines) will enable the region to remain the leader with the fastest-growing increase in passengers per aircraft movement, according to Airports Council International.

Supported by a mix of narrow-body and wide-body aircraft deliveries in the coming year, as well as by the development of secondary airports, the high percentage of medium- to long-haul operations will continue to increase in the Middle East.

In addition, the Gulf Cooperation Council countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates and associate member Yemen) will continue to pursue the GCC's liberalization program, leading eventually to full open skies in the Middle East as well as enhancement of the efficiency of its air transportation industry.

Therefore, the intra-Middle East market (along with Pakistan and India) should continue its rapid growth with the development of the already-established low-cost carriers and several potential new regional entrants using single-aisle aircraft.

Based on these massive investments in infrastructure and capacity, the Middle East appears to be raising its limits every year, with a growth rate surpassing analysts' forecasts.

The recent success of Royal Jordanian's initial public offering — resulting in market capitalization for Royal Jordanian of US$366 million — illustrates that investors have confidence in the region's air transportation fundamentals for the short and medium terms.

But for the truly serious investor, there are still key questions: Is the high growth rate in the Middle East sustainable in the medium to long term? What might be the result if market growth unexpectedly levels off?

It's fairly obvious that geopolitical risk is the most prominent threat to the region's economy. To one extent or another, most countries in the Middle East endure political tensions at various levels.

Investors, however, have already priced geopolitical risk into the equation, resulting in broader market volatility in comparison to other regions. The risk has been mitigated somewhat by the region's financial flow patterns and integration into international trade.

In fact, the region's airline industry recovery since 2003 has been significant, despite the high concentration of political issues. The impact of those issues on international traffic has so far proven marginal and has been more than overcome by the economic strength of the region.

And barring an unlikely plummet in oil prices, Middle East governments will continue to increase the diversification of their economies and massively invest to

While Middle East air traffic market share accounts for only 8 percent of the world's total passenger traffic, it also represents the fastest-growing market for scheduled airlines. The growth has been largely driven by a substantial rise in capacity from the advent of low-cost carriers and additional total available seats by the region's network carriers.

enhance the overall attractiveness of the region to business and other interests.

But even more than external geopolitical factors, the biggest risk the Middle East air transportation industry faces in coming years is the potential for overcapacity.

Massive wide-body and single-aisle aircraft orders — booked during the last three years — will come to fruition starting in 2010 and continuing through 2015, leading to a double-digit capacity increase in the Middle East. Despite demand still running at a fairly high level, it seems somewhat unlikely that the current traffic-growth rate can continue at such a frenetic pace in the medium and long terms.

Rather than following normal market cyclicality, largely offset by the stimulation of demand on newly operated routes, the tailing off of the current Middle East air transportation growth rate will probably happen due to lower-than-expected demand-elasticity ratios against capacity growth and yield variation.

Capacity increases in the Middle East — leveraging regional hub-and-spoke networks —have allowed airlines based in the Middle East to grow traffic well outside their local catchment areas.

But network carriers such as Emirates, Qatar Airways, Etihad and Gulf Air have performed best on dense routes at major airports rather than regional destinations, with the exception of India, where strong economic development has dramatically increased demand for both domestic and international air travel.

Addition of frequencies and capacity (particularly with the introduction of the huge new Airbus A380 aircraft) will continue to stimulate traffic, but at a much slower pace and will most likely tend to dilute existing demand.

A recent study performed by *Sabre Airline Solutions®* on the North America/India market, for example, showed that enhanced elapsed flight time (due to improved connections and additional capacity) stimulated traffic by up to 14 percent until 2005. Since then, this figure has decreased to less than 5 percent on average for markets already operated by an airline.

Most traffic generated by airlines' increasing capacity was due to the natural market growth of demand as well as passenger recapture versus competition.

Network carriers will most likely continue to be dominant at major airports, but "thin" markets out of regional airports will be more challenging because the potential route capacity that will be added may far exceed the overall market potential.

Additionally, development of low-cost and regional carriers operating at main and secondary airports will continue to siphon off a significant portion of the local traffic that was previously served by network carriers.

So the peak of added capacity in the Middle East region from 2011 onward on major routes — in conjunction with lower market-stimulation factors — promise the airlines challenging times in filling seats.

Naturally, airlines in the Middle East will still benefit from hot markets in India and Southern Asia, where slower-than-expected liberalization has somewhat limited new airlines' ambitions to grow internationally.

But this situation may not last very long. Several Indian carriers, for example, are planning to open new nonstop routes to Europe (particularly to the United Kingdom) with a more aggressive commercial approach than current competitors.

Direct services that provide both competitive elapsed flight time and aggressive fares will limit the potential growth of neighboring Middle East carriers to feed their hubs, while the region is currently one of the main providers for international traffic.

Kingfisher Airlines, for example, will likely operate most of its 10 Airbus A380 aircraft (which are to be delivered from 2011 onward) on key European routes, leading to a redistribution of airline market share at the expense of current leaders Air France/KLM, Lufthansa, Emirates, British Airways and Qatar Airways.

Since Middle East airlines have been performing better on dense routes, it is more likely that carriers adding capacity will first focus on these markets, increasing overall competition with a potential negative impact on the routes' yields.

At the same time, the average growth rate is tailing off. IATA and the Airports Council International see the strong current demand in international air travel in the Middle East region rapidly slowing from a double-digit growth rate down to less than 5 percent by year-end 2010, which would be just before a large number of wide-body aircraft are scheduled to be delivered.

So airlines will need a more aggressive approach to fill their seats — limiting, at best, any increase in average passenger fares. This represents the biggest challenge Middle East airlines are likely to face in the near future, since price elasticity requires significant fare changes to positively influence demand in a market in which airline preference is a fairly volatile factor to customers.

Large capacity increases, strong demand (but growing at a much slower pace with operating costs remaining high due to fuel prices and complex network-carrier operations) will most likely negatively affect Middle East airline profitability in the medium term.

Push from investors to improve industry returns — as most Middle East airlines either are or will be privatized by the end of this decade — will probably drive consolidation in the Middle East airline industry in the medium term to cut overlapping operations and reduce capacity, making it easier to improve yield and opening a new era in the Middle East.

HIGHlight

Just in the past five years, the capacity flown from the Middle East to Africa and Asia has doubled and has increased 36 percent to Europe and 23 percent to North America.

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