

A MAGAZINE FOR AIRLINE EXECUTIVES

OCTOBER 2003

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EXTREME AIRLINE MANAGEMENT

A conversation with ...

**David
Siegel,
CEO,
US Airways**

INSIDE

Traditional carriers launch
low-fare subsidiaries

How airlines weathered
"the perfect storm"

Cathay Pacific Airways'
crisis management process

Riding the Storm Out

For nearly three years, various elements have converged to form a “perfect storm” for the airline industry. Addressing some of the causes and effects of the storm will result in changes that will reshape the industry.

■ By B. Scott Hunt | Ascend Editor



The “perfect storm” that impacted the airline industry had a dramatic effect on the financial performance of carriers around the world. In 2001 and 2002, the world’s airlines combined to lose nearly US\$25 billion.



Like many spectacular tempests, the so-called “perfect storm” that hit the airline industry was preceded by deceptively beautiful weather.

Although it may seem like an eternity has passed, the airline industry once found itself flying through the clear skies of relative prosperity as recently as three years ago. According to Steve Hendrickson, a partner with Sabre Airline Solutions Consulting, “things were calm and sunny” as recently as 2000.

“The economy was riding high in ‘99 and 2000,” he said. “You had your ‘dot.com’ venture capitalists throwing (around) money, and people were saying, ‘Don’t worry about being profitable, just generate more eyeballs.’ Of course, we had Y2K grabbing a lot of activity. Even into 2000, they were still wrapping up Y2K projects. Then a lot of those projects were used as justifications for other modernization efforts: ‘As long as we’re going to clean up the code on the two-digit year, let’s also put a data warehouse behind this thing.’ So there were a lot of things helping the economy peak and even bubble, and we were enjoying the excesses of that period.”

Signs of Trouble

But in March 2001, a few clouds started to gather, said Ray Neidl, an

airline industry analyst for Blaylock & Partners in New York City. Nothing too alarming — the booming North American economy began to cool. Following that, though, the storm clouds thickened as fuel prices rose and high-margin business travel slackened, Neidl said. Meanwhile, he added, airlines continued to add capacity, and labor costs in the United States jumped, sparked in part by an industry-leading contract United Airlines gave pilots to

“It was just like a perfect storm. It was a whole bunch of different things that were coming into play at the same time ... none of them good.”

win support for its ill-fated merger attempt with US Airways.

And then came the lightning bolt — the events of Sept. 11, 2001, when four commercial aircraft in the United States were commandeered and crashed into the two World Trade Center towers in New York City, the Pentagon in Washington, D.C., and a field in Pennsylvania.

Dramatic and damaging as it was, that lightning strike only marked the storm’s flashpoint. It was followed by conflicts in Afghanistan and Iraq and

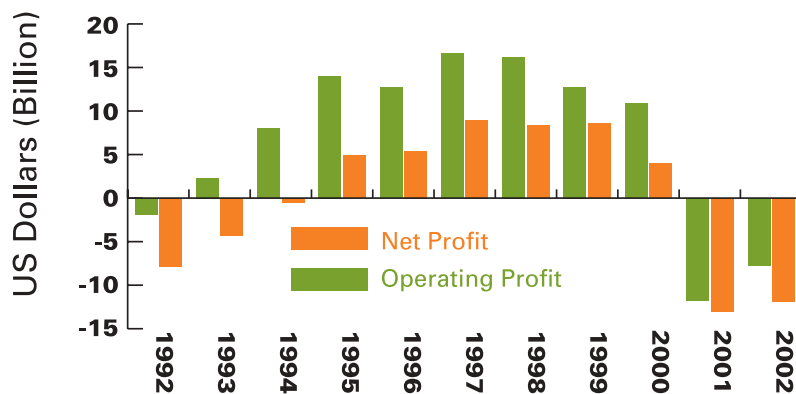
the outbreak of the deadly severe acute respiratory syndrome in Asia — all of which combined to keep an already skittish traveling public at home.

“It was just like a perfect storm,” Neidl said. “It was a whole bunch of different things that were coming into play at the same time ... none of them good.”

The constant piling on of adverse circumstances seemed to some in the

“In my view, it’s the confluence of several factors aligning in time and then triggered by some pretty severe catalysts such as 9/11 that has probably brought the industry to its knees like it has,” Hendrickson said. “You can measure the storm by the damage it’s caused, and the damage is showing up on the bottom line and the top line. It’s not just the bottom line. The revenue line has fallen apart.”

World Airlines Profits (Income) 1992-2002



IATA Aviation Information and Research source: IATA Monthly International Statistics

The profitability of airlines during the last 10 years has swung dramatically, ranging from losses following the first Gulf war to healthy levels in the late '90s and back to losses with the start of the “perfect storm.”

industry to parallel the ancient story of the plagues that once afflicted Egypt. “I hope we don’t have a wave of locusts,” Northwest Airlines Chief Executive Officer Richard Anderson remarked to a reporter during the SARS outbreak. “We’ve had war, and we’ve had plague, I guess, and we seem to have sort of one event after another.”

Individually, the elements in the storm would have each had an impact. Working in combination, however, they drenched the industry, flooding it with financial setbacks during what many call the worst period in commercial aviation history.

The Storm’s Effects

The damage report, according to the International Air Transport Association, indeed paints a stark picture.

In 2001, seemingly every performance measure kept by IATA fell: kilometers flown, aircraft departures, hours flown, passengers carried, freight tons carried, passenger kilometers flown, available seat kilometers and passenger load factors. The picture didn’t improve much in 2002. The total number of passengers carried by IATA members fell another 2.1 percent in 2002, and, on top of that, they paid less to fly: yields shrank by 0.3 per-



The flashpoint of the perfect storm — the events of Sept. 11, 2001 — compounded the conditions already facing the aviation industry, forcing it into perhaps the most challenging period in its history.



cent for the year. Kilometers flown, which had increased by at least 5 percent from 1998 to 2000, dropped 0.5 percent in 2001 and an additional 1.1 percent in 2002.

The financial impact, naturally, was almost incomprehensible. In 2001-02, according to IATA, the world's airlines combined to lose US\$24.7 billion — more than the gross domestic product of Nicaragua for the same period.

Nearly three years into the industry's

were good, was profitless growth. Yes, it was growth, but we were giving the product away.

"It's not that these things were not detected before; it is just that our focus was not on them," he continued. "We're now more focused on them. We've always known that we have carried some traffic at below cost. We've always known that we added complexity to our business, and the complexity that we

try, "Driving Airline Business Strategies Through Emerging Technology" and "Airline Survival Kit: Breaking Out of the Zero Profit Game" — said the availability of low-cost carriers on more routes has given travelers a viable alternative to the traditional carriers, and they were well-positioned to draw traffic during an economic slowdown. Indeed, some low-cost carriers have continued to earn profits despite the raging storm.

Another pre-existing factor also helped magnify the effects of the storm, Taneja said.

"The development of the Internet (as a distribution channel) completely changed the industry," he said. "It made fares transparent, that there is a lower fare available to the business traveler."

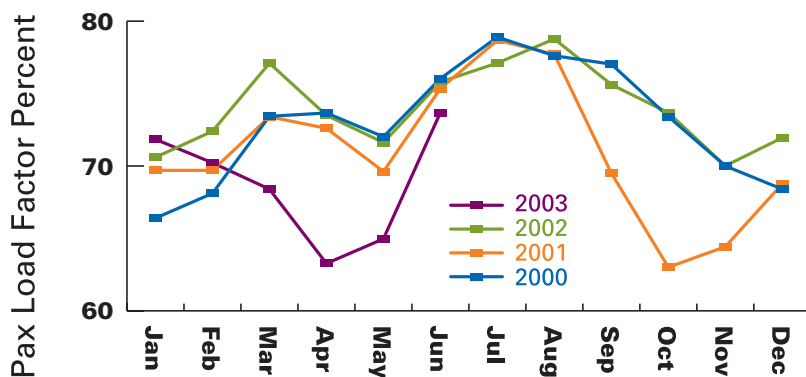
The Internet also revealed the conditions required for a business traveler to take advantage of lower fares. They might have to travel to an alternate airport where a low-cost carrier is based, or make a connection as opposed to a non-stop. But, with the volumes of fare information available on the Internet, Taneja said travelers could now make "a choice based on knowledge they had gotten" rather than relying on an intermediary who had a vested interest in steering customers to a higher fare.

With the growth of the Internet as a distribution channel, practices travelers developed while shopping online for the family vacation soon spilled over to planning corporate travel.

"People flocking to the Internet learned how to do their comparison shopping," Hendrickson said. "I believe we're seeing the consumer paradigm change. I used to accept the US\$1,600 fare if I was booking two or three days in advance of my trip. Today, I find that unacceptable."

Of all the elements of the storm, the development of online distribution packed the most powerful punch,

Passenger Load Factor IATA International Scheduled Services



IATA Aviation Information and Research source: IATA Monthly International Statistics

Data from IATA shows that historically, passenger load factors have followed a consistent pattern that was disrupted by events such as Sept. 11, 2001, and the outbreak of SARS in early 2003.

perfect storm, analysts have examined its origins and have found that perhaps the underlying "meteorological" conditions that set the stage for the turbulence go back well before the first drops of rain.

The Early Factors

Even during the boom times, there were underlying problems in the industry, said long-time industry analyst Nawal Taneja.

"Prior to '97-'98, the industry was making gobs of money," he said. "But some of the growth, even when times

added raised the cost. The only difference is that before we were able to get away with charging higher fares to a certain segment of the traffic."

Other pre-existing conditions also magnified the effects of the storm.

"The proliferation of low-cost carriers is one of the aspects, and that goes back quite a bit," Taneja said. "I would say that by the early '90s, they really got going and really started becoming more prominent. That's my definition of the first event (of the storm)."

Taneja — who has recently authored two books on the airline indus-

Taneja said, because “the Internet simply changed travel distribution and passengers’ behavior.”

Seeking Cover

The response by a thunderstruck industry to the deluge was swift and drastic. Thousands of employees were furloughed, hundreds of aircraft were parked and marginal routes were cut.

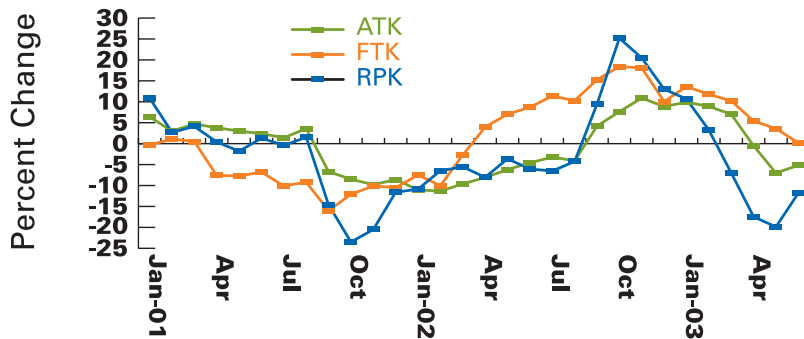
Around the world, governments

above the rising water, some could not escape the storm. The fallout included the failure of weaker airlines and bankruptcy court protection for others seeking to restructure their businesses.

Those who have survived have made needed changes, Taneja said.

“The general direction is correct,” he said. “My only question would be the speed with which they are moving and the depth to which they are moving.

Traffic and Capacity Trends International Scheduled Services Percent Change on same month pervious year (02/01/00)



IATA Aviation Information and Research source: IATA Monthly International Statistics

According to IATA, the main traffic and capacity trends — revenue per kilometer, freight ton kilometers and available ton kilometers — dropped significantly following the events of Sept. 11, 2001, and again earlier this year after the outbreak of SARS.

attempted to provide some shelter for airlines. In the United States, the government put together a package of US\$5 billion in cash and US\$10 billion in loan guarantees to compensate for the effects of 9/11. Both U.S. and European governments helped underwrite terrorism insurance for airlines. After the outbreak of SARS had subsided, and travel advisories for affected Asian countries were lifted, area governments began aggressive campaigns to bring back tourists.

Even though the airlines themselves took radical steps to keep their heads

Only a few carriers are moving pretty rapidly and going pretty deeply. Most are not doing it as quickly or as deeply.”

He also said airlines have not been quick enough to adopt technology to assist with making changes.

“Technology, I believe, is not being utilized to the fullest to help them restructure,” he said. “I think that it could not only be an enabler of some of these changes, but perhaps a driver. There is no question in my mind that technology has become much more of a tool that they can use. And I’m using technology in the broader sense.



Heightened airport security has put another burden on airlines as they have struggled to cope during the perfect storm. According to IATA, new security regulations cost airlines US\$5 billion in 2002.



Airplanes are technology (as well as) information technology and technology such as mobile communications.

"I think the most fundamental part of all of this is information — having access to information in almost real-time in a very pervasive manner," he said. "There should be one unified view of this information available across the board."

The cost of investing in technology, he said, will pay off for airlines. "In the long run, (the cost) is minute compared to the benefits it can provide, assuming you are willing to capitalize on that benefit. You do not just need a new system, but you need a new culture."

By investing in technology and making necessary changes, airlines can position themselves to stand on solid ground when the sunny skies return, Taneja said.

A Changed Environment

While the worst may have passed, the storm lingers. According to IATA, overall passenger traffic for the first half of 2003 was 7.1 percent below 2002 levels. And capacity remained significantly down, led by the Asia/Pacific region (a decrease of 27.2 percent) and North America (12.5 percent).

Yet, the end of the storm may be in sight.

"Now, I see a rainbow," Neidl said. "I'm looking for an improved economy. I'm looking for cost cutting to really take effect later on this year or early next year. I'm looking maybe for even some continued reduced capacity by the major carriers. All those things combined, I'm looking for the industry to return to profitability maybe in the third quarter of next year."

But, even after it subsides, the severity and duration of the storm will

have lasting effects.

"The industry has changed," Neidl said. "The Internet makes it easier to shop. The low-cost carriers are really gaining significant market hold, and the big carriers are never going to be able to get the revenue premium they had before."

Some of the changes have had immediate impacts. Following the events of 9/11, increased security — and its

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THE HIGH • LEVEL view

News Briefs from Around the Globe

Who

Royal Brunei Airlines and Regional Express Airlines

What


Successfully implemented the *Sabre® Traverse™* loyalty management system to automate their frequent flyer programs, Royal Skies and Regional Express Flyer, respectively. The airlines access the *Traverse* system via the *Sabre® eMergo®* Web-enabled and dedicated network solutions, an applications service provider model that eliminates

the need for costly and complicated in-house data center infrastructure and support.

Why

Royal Brunei — "We want to reward our Royal Skies members with a full range of features and benefits through new partnerships and multi-faceted promotions and awards. The *Traverse* system has enabled us to do all this and more, and we are extremely pleased with the positive feedback from our customers from the date Royal Skies was launched," said Hj Omar Ali

Hj Mohd Daud, director of marketing at Royal Brunei.

Regional Express — "With the addition of the *Traverse* system, we will be able to provide our Regional Express Flyer members with greater customer service than we could previously," said Hans Van Pelt, chief information officer at Regional Express, a domestic regional carrier in Australia with 1,500 flights per week. "The ASP interface also enables us to eliminate the burden of maintaining a costly infrastructure to support our loyalty program; now we have an effective customer self-managed program completely online." 

accompanying costs — have directly impacted airlines.

“The extra security that is needed at airports now has done two things,” Taneja said. “One, it has raised costs. The other one is simply having to show up at the airport a lot earlier to make a flight. Short-haul travel is going to be (particularly) impacted. If you are only traveling from Cleveland to Chicago, and you have to show up an hour and a half early on each end, that’s going to add a lot more time.”

But there are other long-lasting results as well.

According to Hendrickson, the industry “might be looking at climate change here.”

“Take fare transparency,” he said. “Initially the airline industry thought it was a great idea; bypass the global distribution system, give customers the ability to use online bookings, avoid commissions, lower distribution costs. But at the same time, they introduced the start of a revolution, which brought comparison shopping and completely emphasized price. That genie has come out of the bottle and will not go back in. There’s no way you’re going to reverse that trend, so that’s here to stay.”

Hendrickson also noted that, historically, there was a strong relationship between GDP and industry revenues. During the past few years, however, that relationship seems to have been broken.

“That strikes me as something that may not be cyclical,” Hendrickson said. “That might be a fundamental change in the way this economy looks at the value of air travel. It’s a pretty startling change. That’s what I think is most alarming. We can always fight over share, but if the economy is switching its view of travel as a facilitator of commerce to something else, then

we’ve got some real problems.”

Taneja agreed the look of the industry has been irreversibly changed. The severity of the storm revealed underlying conditions in the industry that could no longer be ignored, he said.

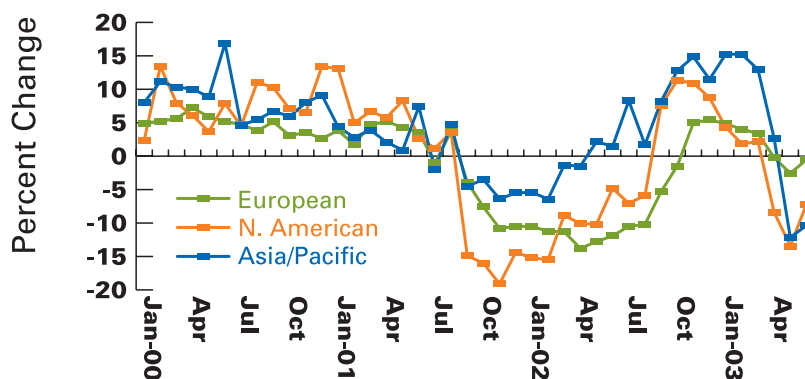
“I don’t think we’re ever going back to the way we were,” he said. “I’m not saying that airlines will continue to lose money at the rate they are forever and ever and ever. They will turn around.

what your scope is going to be and the type of network and the type of fleet and the type of customer service and onboard products and so on,” he said.

For low-cost carriers, increasing competition among themselves — and from revamped traditional carriers — will force them to change as well, he said.

“Their competitive advantage is

International Capacity Trends ATK Performance by Carrier Regional



IATA Aviation Information and Research source: IATA Monthly International Statistics

A drop in available ton kilometers across the Asia/Pacific, North American and European marketplaces reflected the events that had a dramatic impact on the industry, according to IATA.

But in order for them to turn around, they are going to have to change their business models significantly.

“If you are a traditional legacy carrier, the change will be more drastic and dramatic,” he said. “But even the new paradigm airlines are going to have to change.”

Traditional carriers will “have to reduce their costs and not just labor costs,” he said, but also will have “to pick very carefully the customers that they want to serve.”

“If you decide you are going after a kind of customer, that will determine

low cost,” Taneja said. “If the legacy carriers reduce their costs and approach the low-cost carrier, then the latter may have to go even lower. And, second, they are going to have to differentiate among themselves. AirTran, for example, offers two classes of service and flies into more conventional airports.”

Differentiation will also be the key to regaining pricing power, Taneja said.

“One way you get to a commodity business is if you don’t set up differentiated products and services,” he said. “But, if there is a difference, then you



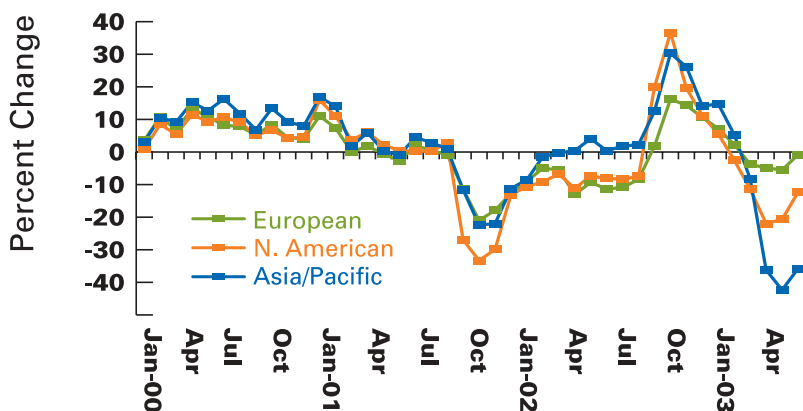
would be able to charge for it. But even when you do, the price has to reflect, to some extent, the perceived value that a person is willing to pay for the feature. The feature has to be something the customer wants to buy. Second, it has to have a reasonable value for that customer."

The low-cost carriers, which today are better capitalized and better managed than ever, will continue to drive

type of system airlines had worked long and hard to perfect, but it won't work anymore.

"What the low-cost carriers are doing is coming into markets, and they are not using those restrictions," Hendrickson said. "So, carriers' ability to fence off the business segment is gone, plus passengers have the expectation that they shouldn't have to pay the higher fares anymore."

International Passenger Trends




IATA Aviation Information and Research source: IATA Monthly International Statistics

A downturn in the airline industry began in early 2001 with a decline in revenue passenger kilometers, according to statistics from IATA. The declining performance plummeted in late 2001 and again in early 2003.

change in the industry, particularly in pricing.

"A lot of us find it a little counter intuitive to fly on a ticket one day with a briefcase in our hand and pay some astronomical price and fly on the weekend and get it for a fraction of that," Hendrickson said. "Imagine if you went to buy a notebook, and the store looked at whether or not you were in a business suit. 'This is a businessman, let's make the price \$2.' But you come in with your kids at back-to-school time, and you get the same notebook for 99 cents. You'd be furious. That's essentially the

Despite the pressures of the past few years, airlines can take solace in that having survived the worst, they'll be better equipped to succeed in the future.

"I think that airlines that survive the storm are going to be stronger and profitable and are going to do very well," Taneja said. "It's not like demand for air transportation and services has disappeared. Those that survive are going to find the optimal mix to provide a reasonable return to shareholders, reasonable wages to employees and reasonable fares to customers." 

Although the effects of the perfect storm continue to linger, there are positive signs on the horizon, analysts say. Analysts predict that some airlines will return to profitability in 2004.