Structural Changes in the European Airline Industry

Major Carriers' Reaction to Low Cost Airlines Competition

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&

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Outline

- Structure of the European airline industry
- Impact of low cost airlines on network carriers
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- Challenges faced by low cost airlines
- The future

Capacity share by airline business model intra-European scheduled market – June 2004

	ASK % of total Excluding charter
Network	58
Low cost	22
Regional	9
Leisure*	11
Total	100%

**carriers primarily serving the charter market but also producing a significant capacity in the scheduled domain*

Source: OAG, June 2004

Importance of largest EU airlines: Network (2004)

	% of total ASK	Cumulative % of total EU network airlines
British Airways	20.4	20.4
Lufthansa	17.8	38.2
Air France	14.9	53.1
KLM	7.6	60.7
Iberia	6.8	67.5
Alitalia	4.9	72.4
Virgin Atlantic	4.0	76.5
SAS	3.8	80.3
Swiss	2.8	83.0
Austrian	2.8	85.8

Source: OAG, June 2004

Importance of largest EU airlines: Low cost (2004)

	% of total ASK	Cumulative % of total EU low cost airlines
Ryanair	26	26
easyJet	24	50
Air Berlin	14	64
Volare Airlines	6	69
bmibaby	4	74
Germanwings	4	77
Hapag-Lloyd Express	3	81
Virgin Express	3	84
flybe	3	87
Norwegian Air Shuttle	3	89

Source: OAG, June 2004

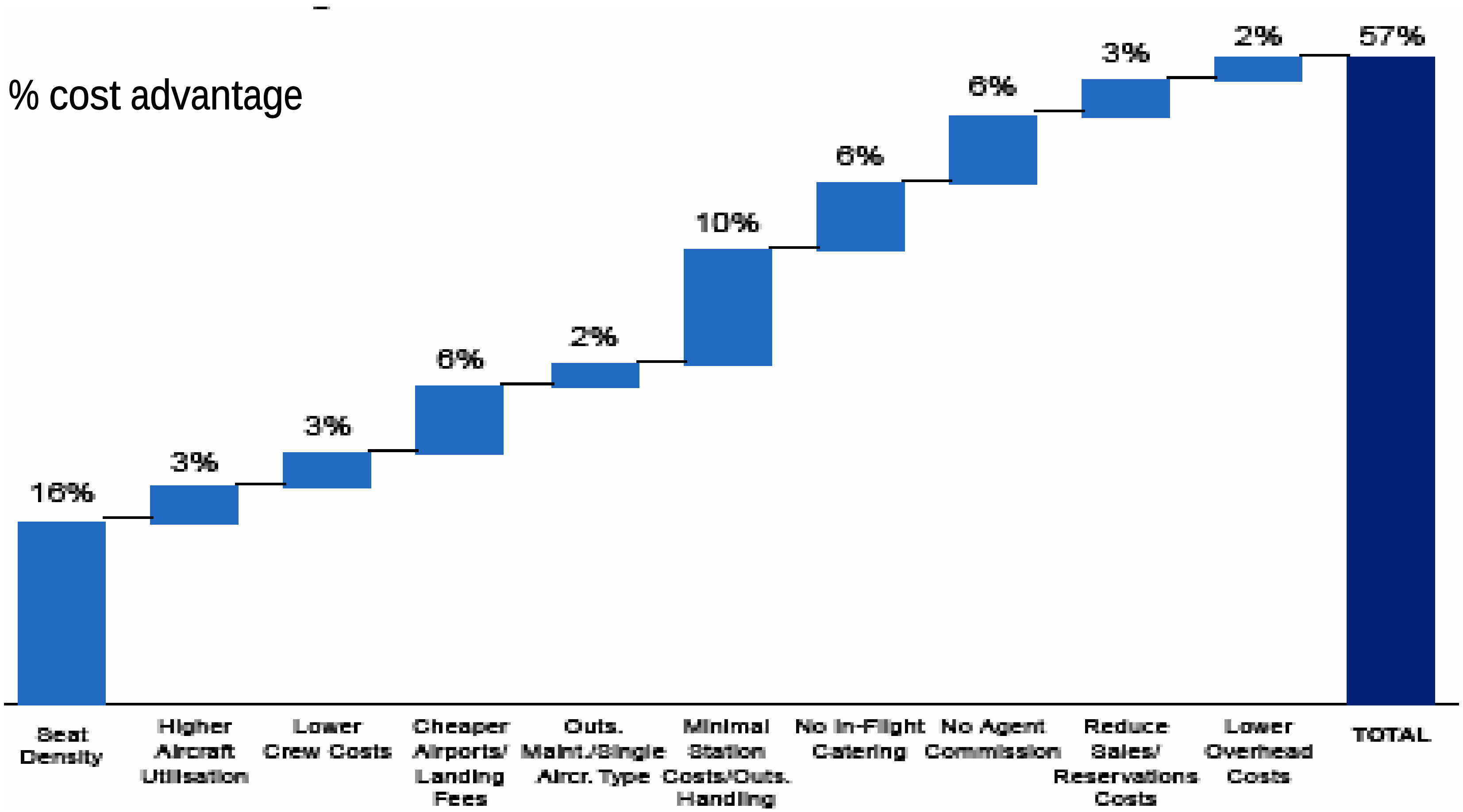
Key features of EU low cost airlines business model

- Simple and efficient operation
  - short haul (below 1000 km)
  - point to point
  - no interlining
- Operating mainly to secondary and uncongested airports
  - Around 20 minutes turnaround time
- Simple pricing policy
  - low prices
  - prices go up as the date of departure gets closer
  - no conditions
- Direct distribution
  - no travel agents (0% vs 5%-9% commission)
  - no GDSs, (0 fee vs $4 per segment)
  - mainly online
  - ticketless($1vs $10)

Key features of low cost airlines business model

- Low level of in-flight service
  - single class high density
  - no seat assignment
  - no meals
  - snacks/drinks on payment
- High productivity
  - motivated staff and strong leadership
  - single aircraft type with around 11 hours of utilisation
- Cost conscious culture
- Strong and visible brand
- Clear market positioning
- Growth rate at 20 – 30%

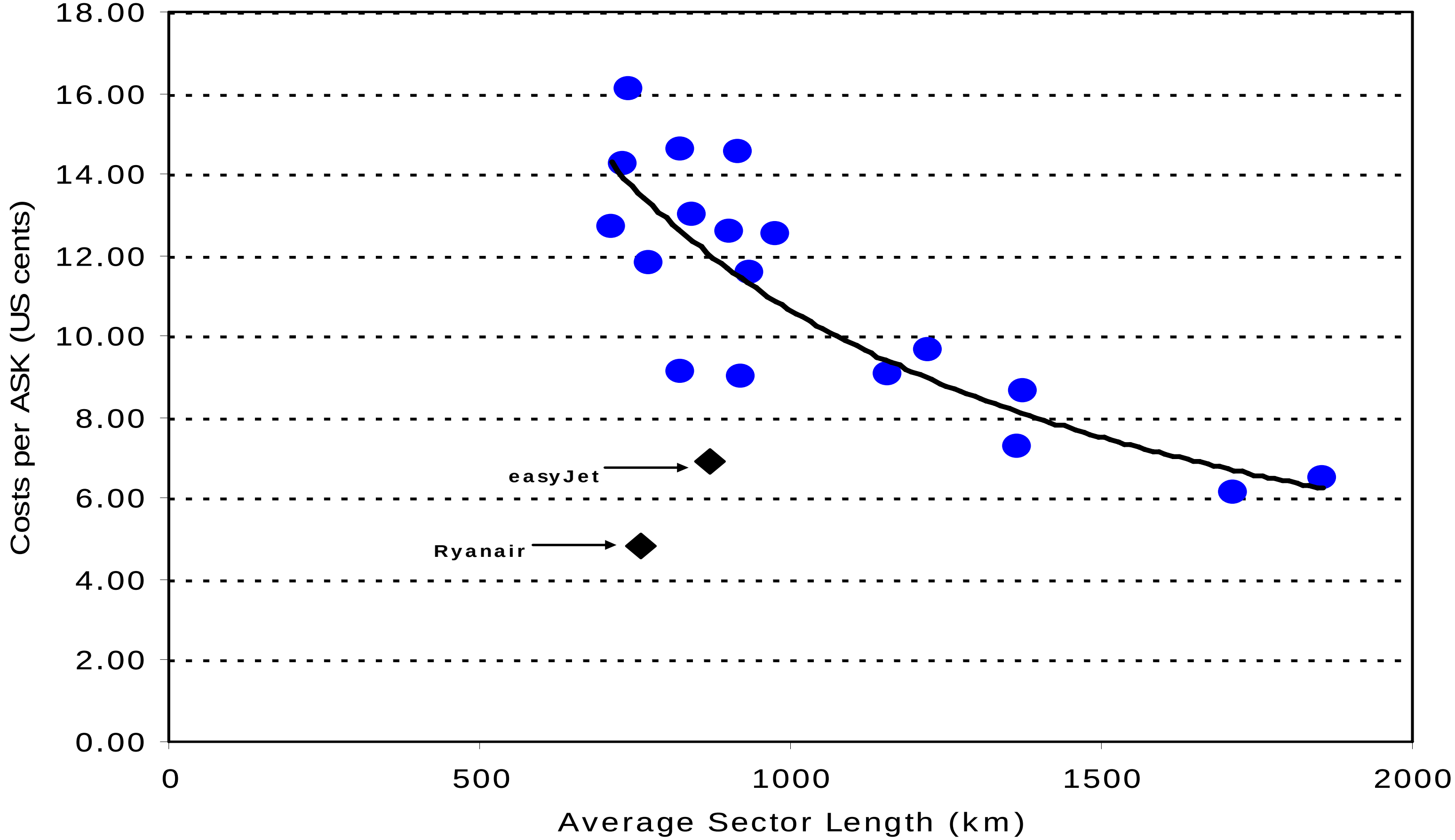
Low cost carriers' advantage over network airlines



Source: A.T.Kearney and AEA 2004

Unit Cost versus sector distance

Intra-European Services Selected Scheduled Airlines



Department of Air Transport, SOE, Cranfield University

Revenue advantages of low-cost carriers

- Simple fare structure and sales in only one or two currencies facilitates yield management
- All revenue in advance - if 100% direct sales
- No yield dilution from multi-sector tickets
- No refunds for cancellations
- High ancillary revenues from
  - on board food sales
  - ticket changes
  - cross sales on website (e.g. hotel, car rental commissions)

  e.g. 2002-03 Ryanair ancillary profits = £55 million or 21% of profits

BUT no freight revenue or costs!

Key low cost players in Europe

Ryanair

Established in 1986

easyJet

Established in 1995

It is not just Ryanair and easyJet

Nordic (Umea)
Passenger (m) 0.13
Fleet no. 6
Destinations 6

Iceland Express
Passenger (m) n/a
Fleet no. 1
Destinations 2

Norwegian (Oslo)
Passenger (m) 1.23
Fleet no. 11
Destinations 16

FlyMe (Sweden)
Passenger (m) n/a
Fleet no. 4
Destinations 5

Snowflake (Stockholm)
Passenger (m) n/a
Fleet no. 3
Destinations 21

Jet2 (Leeds)
Passenger (m) n/a
Fleet no. 11
Destinations 13

Basiq (Amsterdam)
Passenger (m) n/a
Fleet no. 16
(owned by Transavia)
Destinations 8

Maersk
Passenger (m) n/a
Fleet no. 24
Destinations 26

Ryanair (Dublin)
Passenger (m) 23.13
Fleet no. 72
Destinations 85

FlyBE (Birmingham)
Passenger (m) 3.73
Fleet no. 33
Destinations 26

BMI Baby (E. Midlands)
Passenger (m) 3.0
Fleet no. 15
Destinations 23

Sterling (Copenhagen)
Passenger (m) 1.34
Fleet no. 10
Destinations 15

Air Berlin (Berlin)
Passenger (m) 9.6
Fleet no. 42
Destinations 47

My Travel Lite (Birmingham)
Passenger (m) 0.09
Fleet no. 2
Destinations 13

EasyJet (Luton)
Passenger (m) 21.1
Fleet no. 87
Destinations 48

Germania (Berlin)
Passenger (m) na
Fleet no. 19
Destinations 25

Germanwings (Cologne)
Passenger (m) 2.4
Fleet no. 14
Destinations 38

Axis
Passenger (m) 0.15
Fleet no. 5
Destinations

Hapag-Lloyd Express (Cologne)
Passenger (m) 1.9
Fleet no. 3
Destinations 22

Virgin Express (Brussels)
Passenger (m) 2.53
Fleet no. 11
Destinations 13

DBA (Munich)
Passenger (m) 3.0
Fleet no. 14
Destinations 10

Meridiana (Sardinia)
Passenger (m) 3.78
Fleet no. 21
Destinations 18

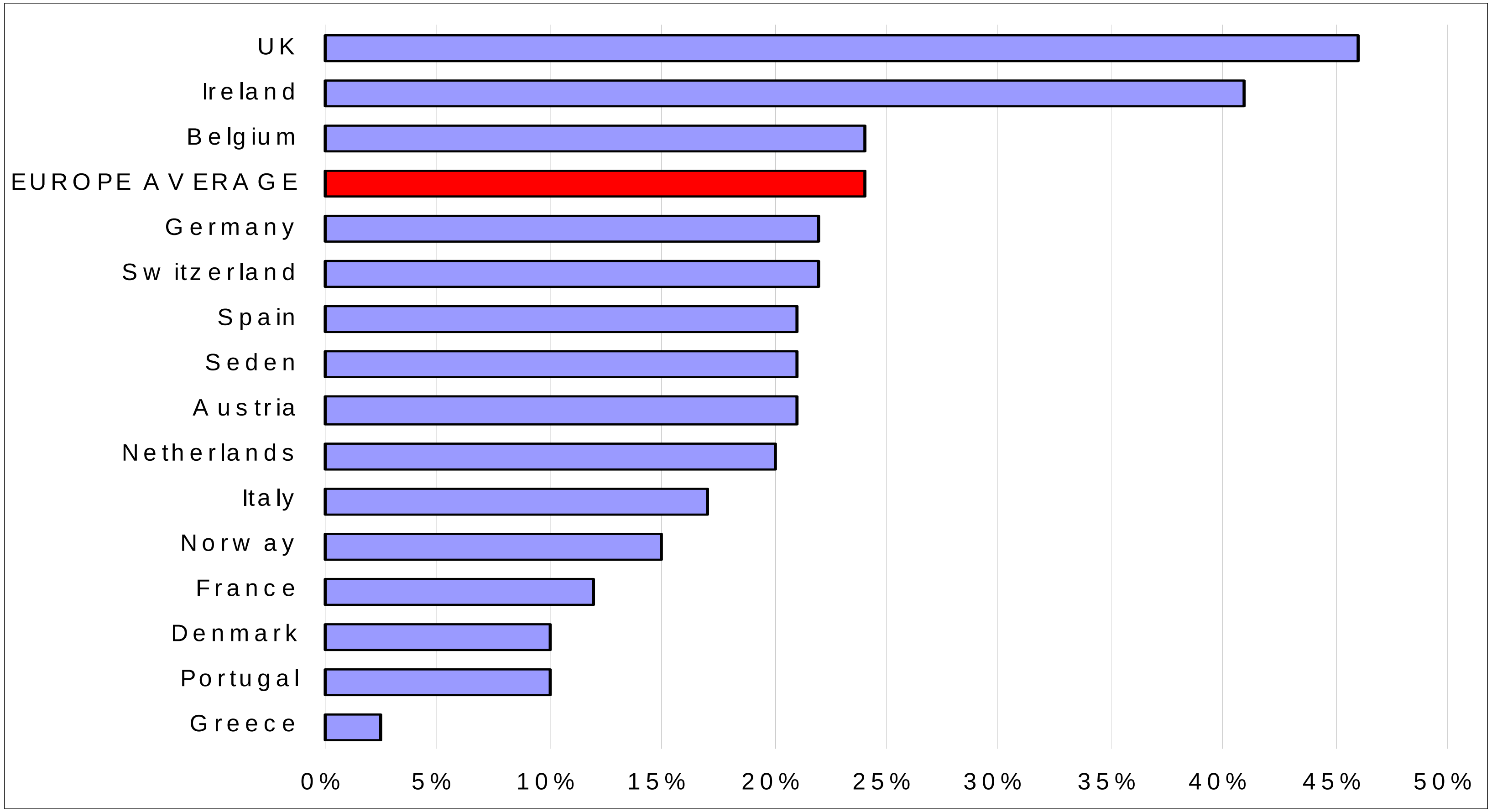
Wind jet (Cantania)
Passenger (m) n/a
Fleet no. 6
Destinations 9

Plane

Source: ABN AMRO

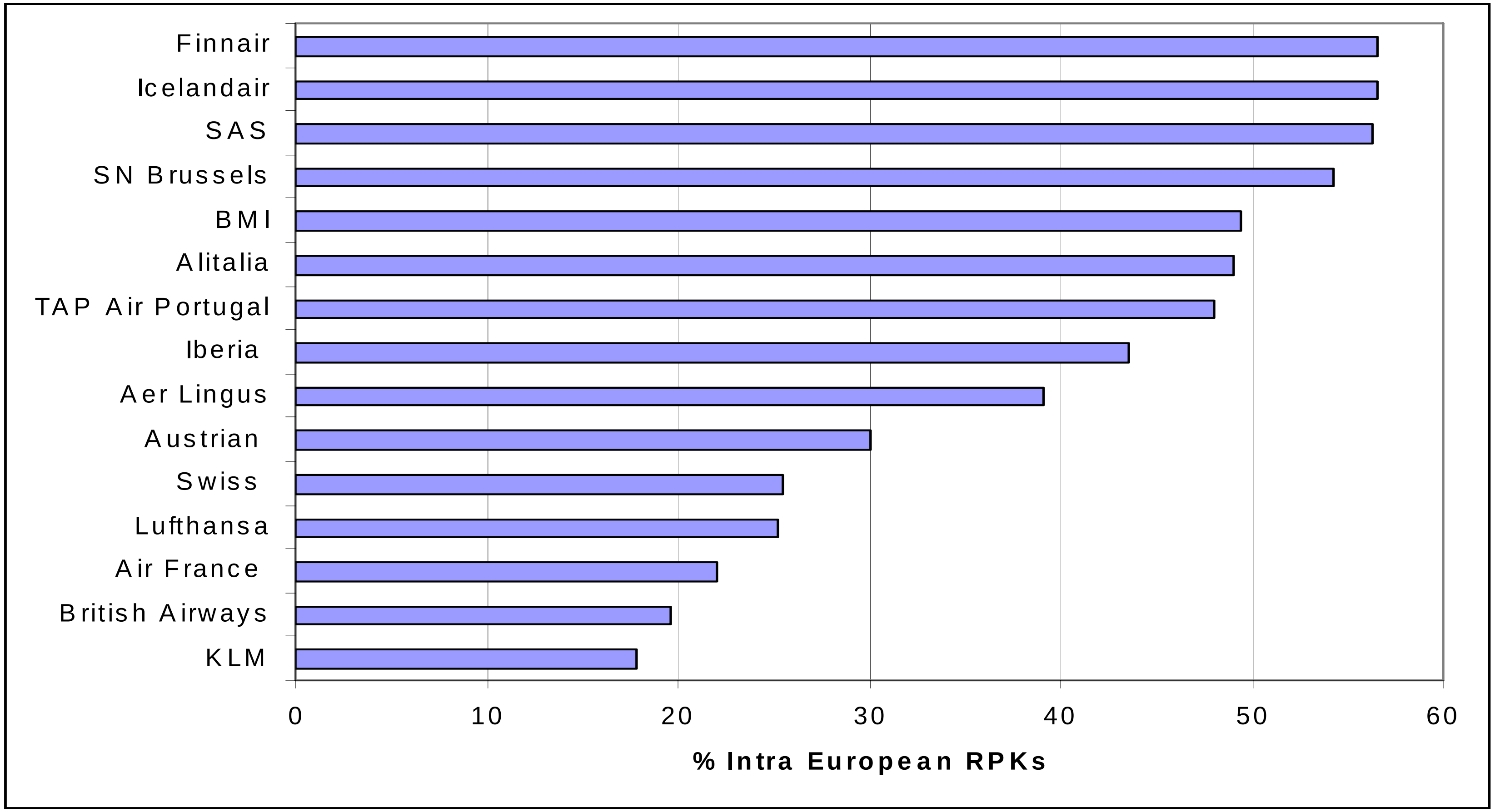
Penetration of low cost carriers in Europe

Seats (%) provided by LCCs on domestic and intra-EU routes



Source: compiled from OAG data (2005)

Dependency of EU carriers on short haul



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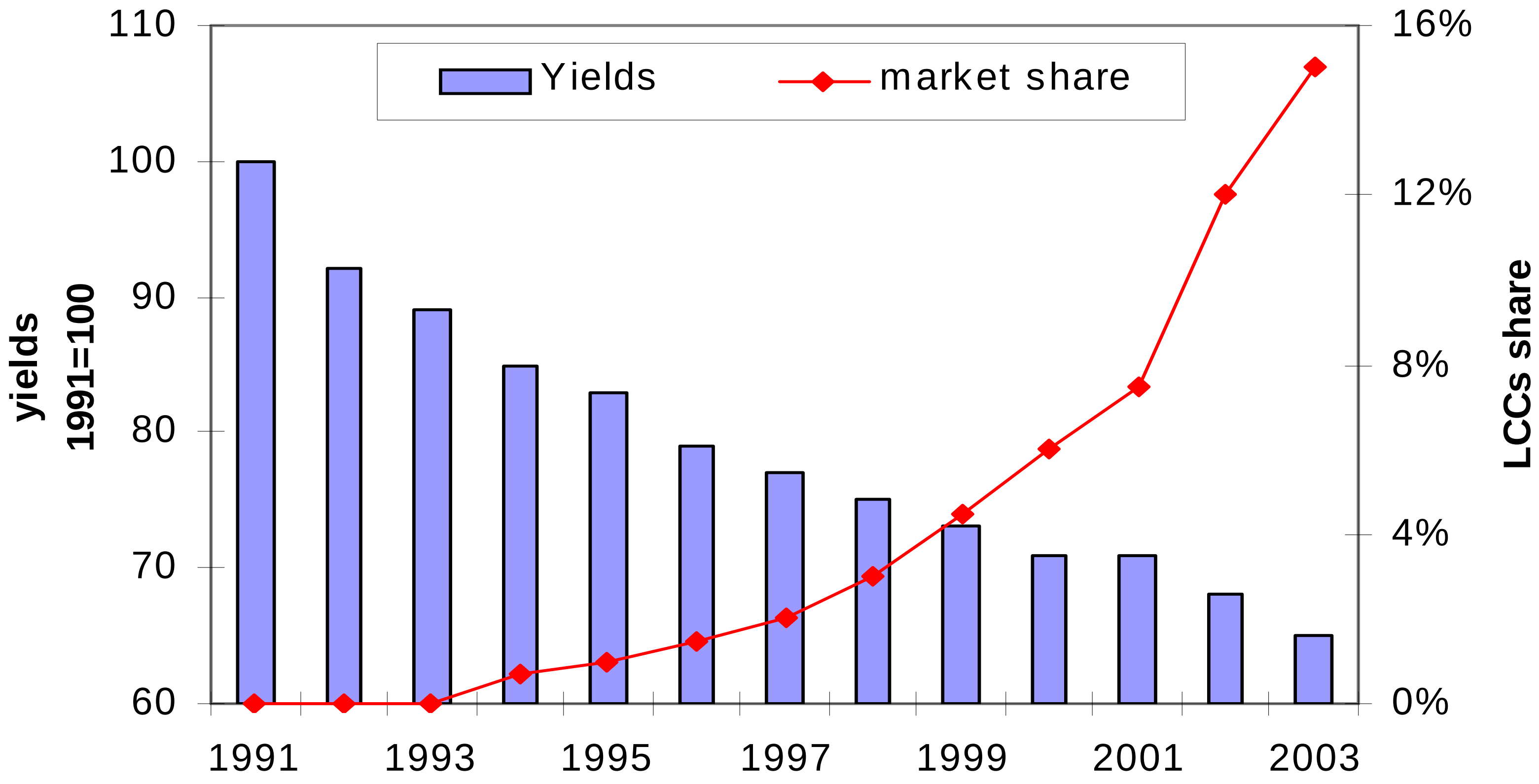
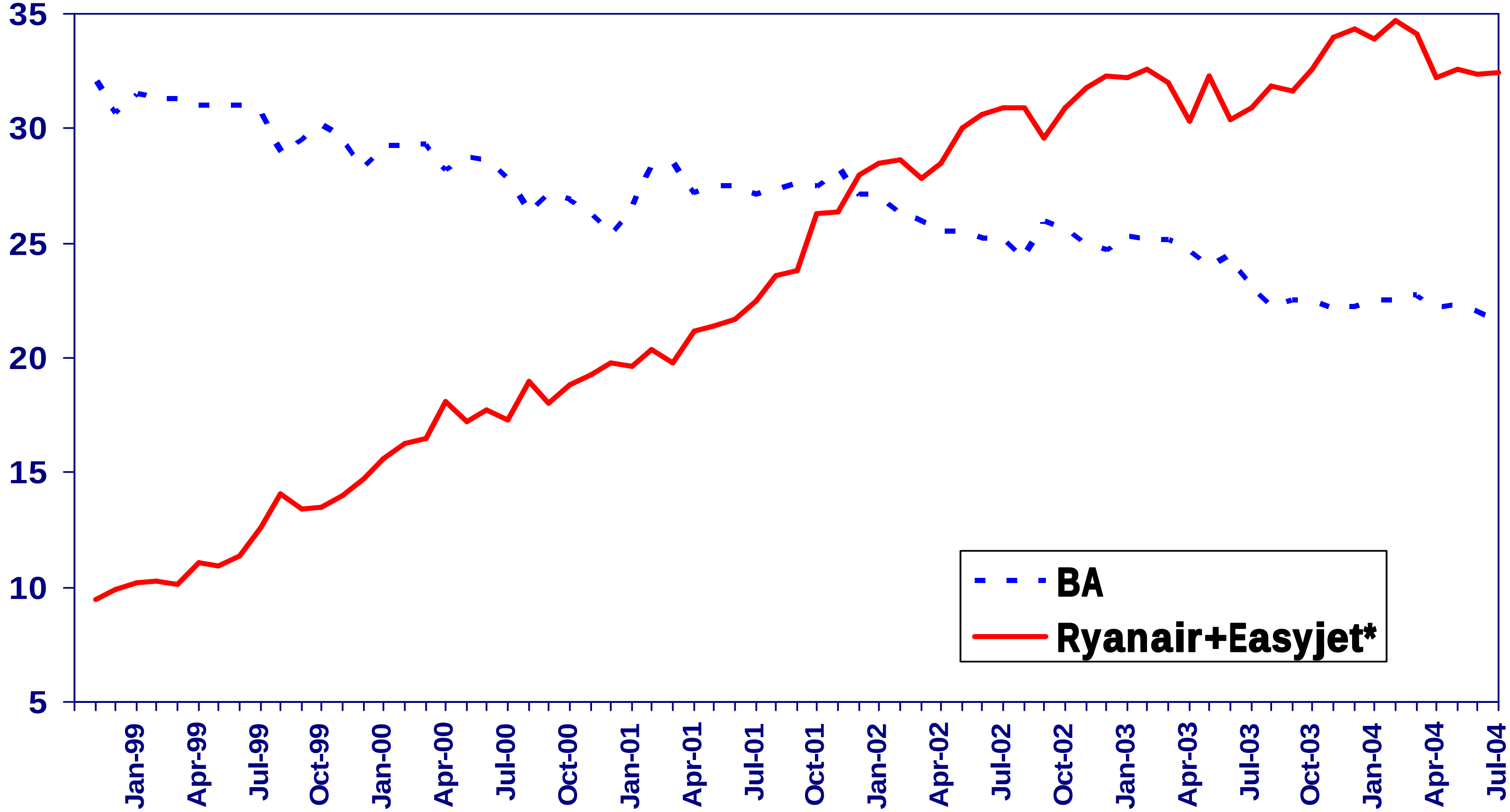
Decline in European short haul yields



Sources: AEA real yields, ABN estimates

Low cost carriers take lead in short haul

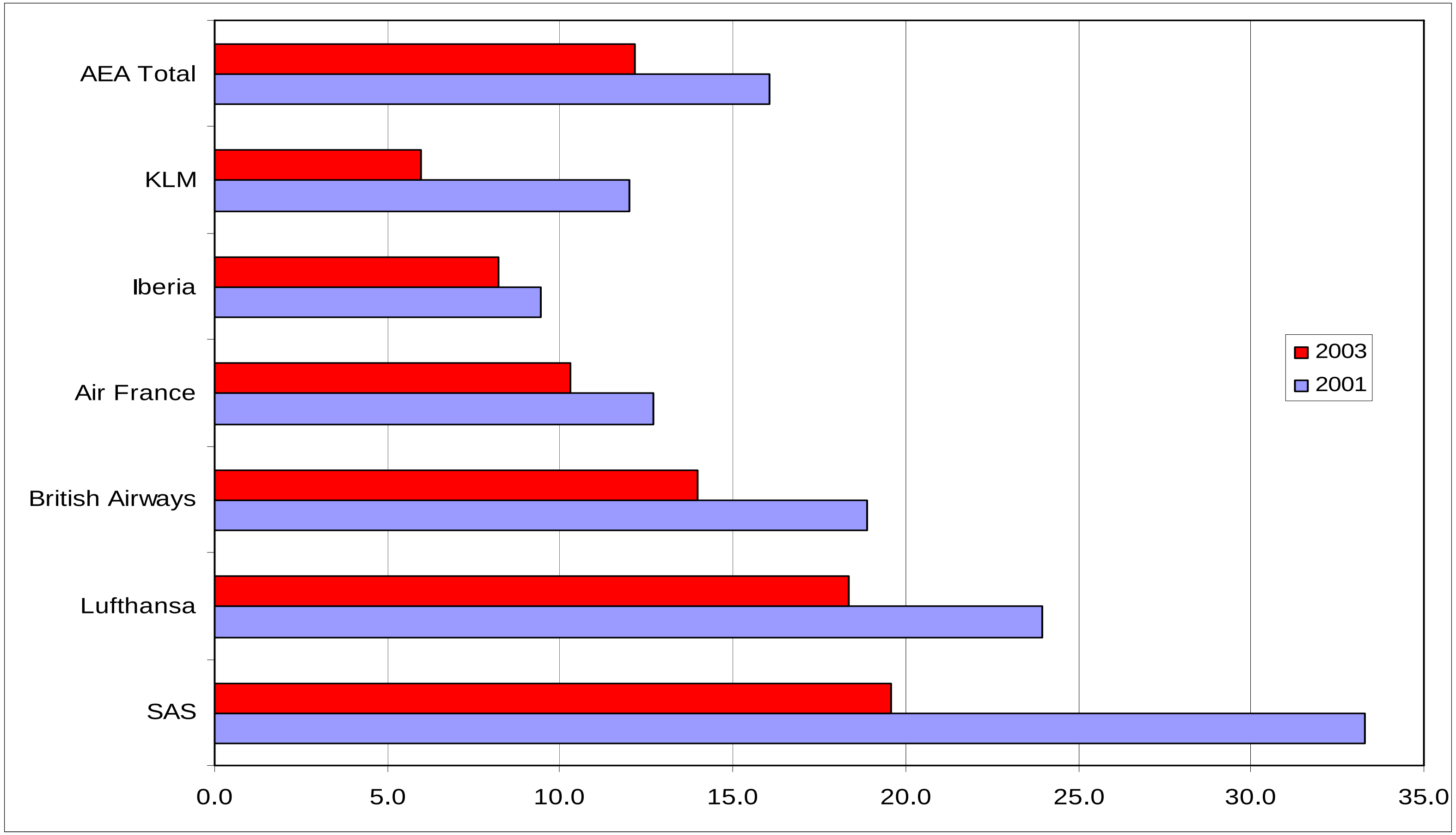
% share of passengers on board all UK short haul inbound, outbound and domestic scheduled flights



** Ryanair, Buzz, Easyjet, Go*

Source: British Airways Total Market Share 25.08.04

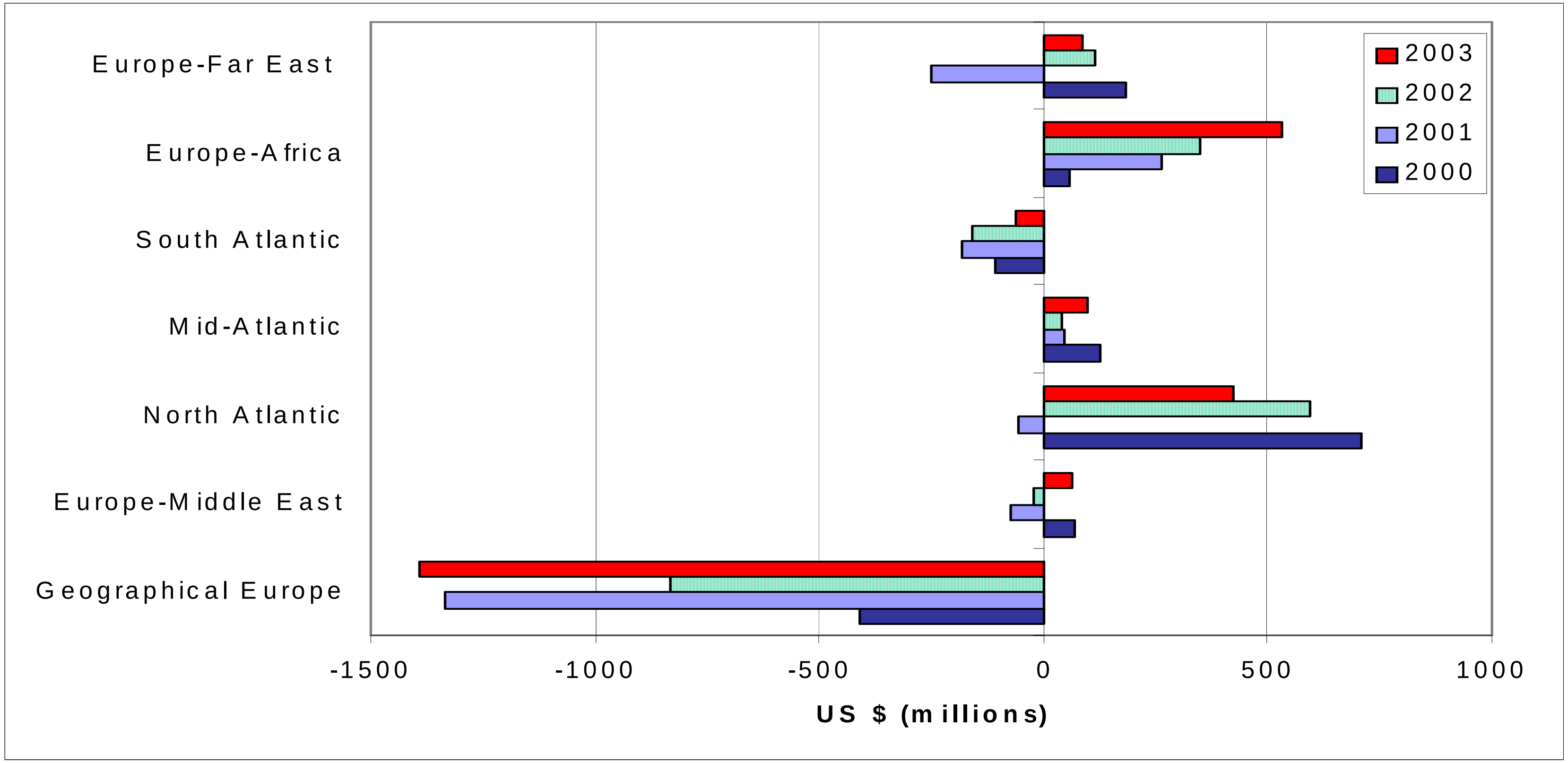
Business class passengers are downgrading and migrating



% of total passengers

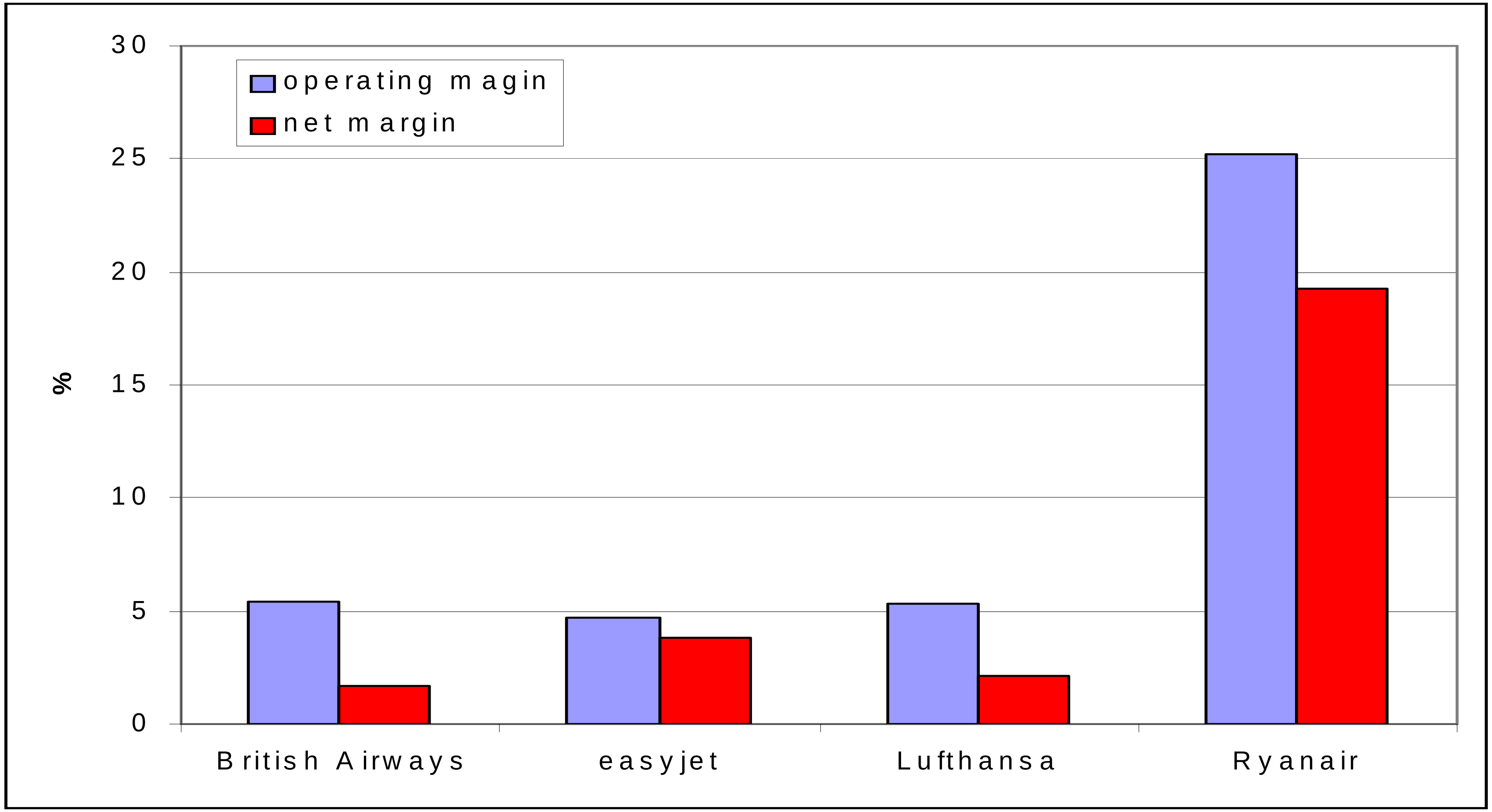
Source: AEA

European carriers net profit by regions 2000-2003

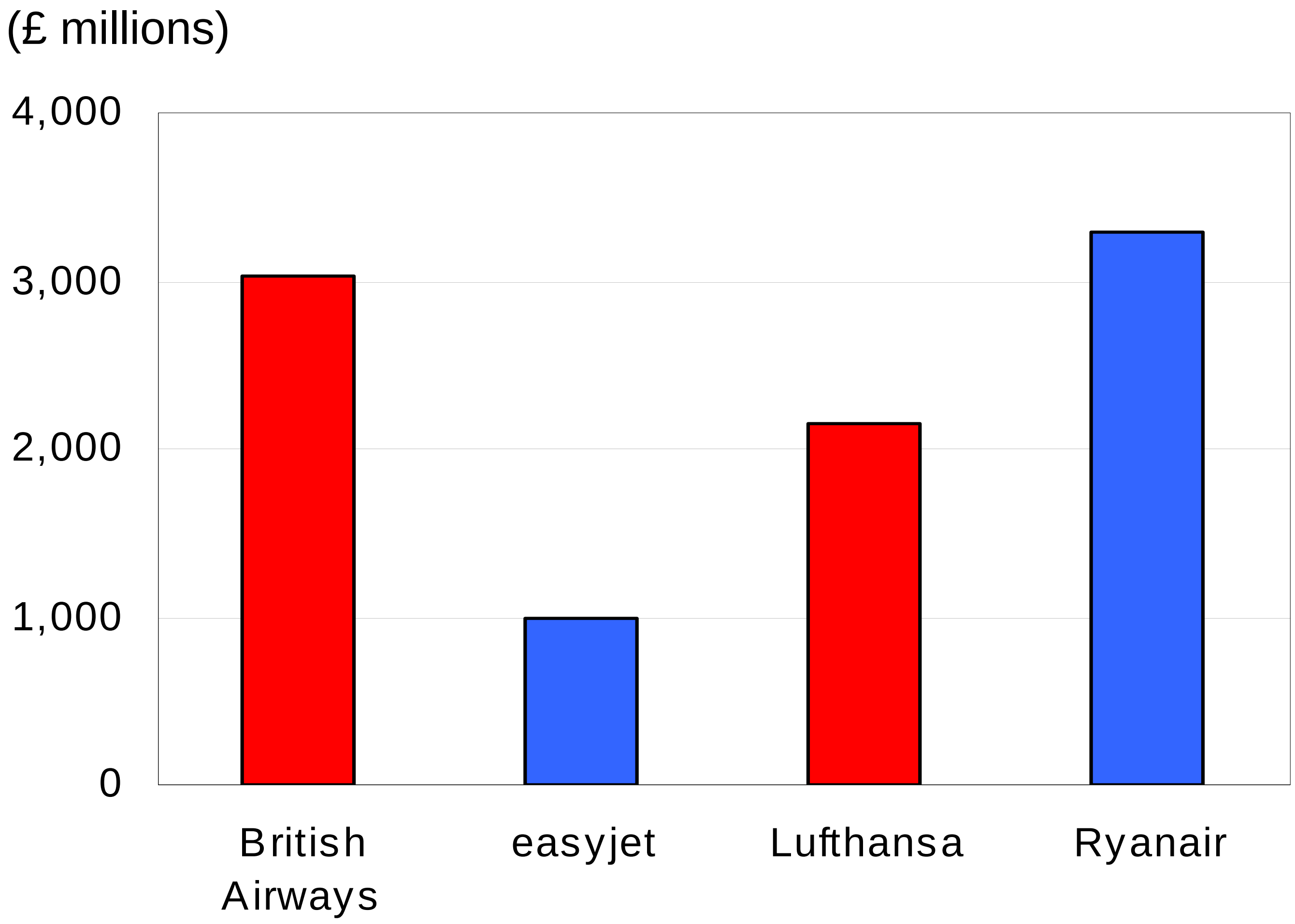


IATA forecast for EU carriers in 2005 is breakeven

Margins of selected European airlines 2004



Market capitalization June 2005



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Causes of difficulties faced by network carriers

Partly due to external factors

- Economic downturn
- Fear of terrorist attacks
- Iraq war
- SARS
- Lack of balance of power in value chain
- Regulatory obstacles to full deregulation
- High fuel prices
- Expansion of low cost carriers
- ………

Causes of difficulties faced by network carriers

Partly due to network carriers internal management

- Complex operation and pricing
- Rising labour costs/ strong trade unions
- Losing focus from their core product
- Obsession with market share and load factor growth at the expense of profit
- Ignoring the changes in customer purchasing behaviour
- Ignoring low cost carriers as viable competitors, especially on short haul routes
- Creating false expectation amongst passengers for low prices
- ……….

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Cost reduction

- Cutting routes
- Reducing capacity
- Reducing labour costs
- Applying features of low cost business model
- Setting up low cost subsidiaries

Staff reduction in 2000-2003

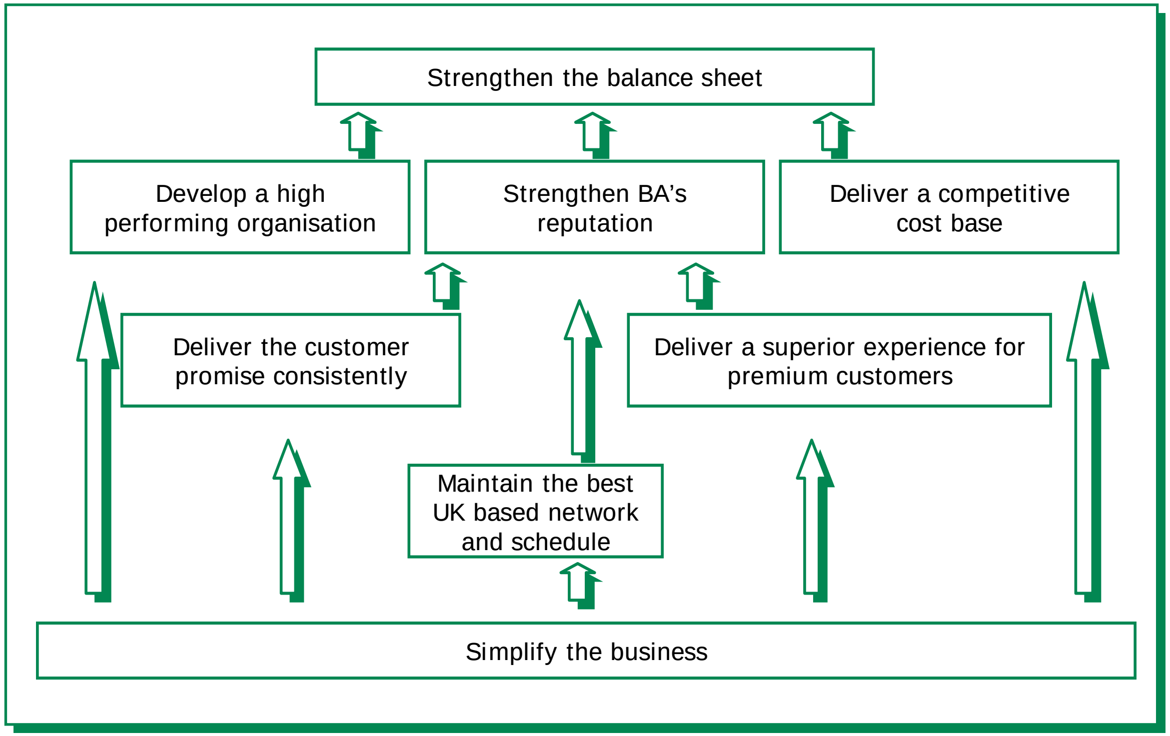
	Staff Numbers (000s)		Change %
United States	End 2000	End 2003	2000-2003
American	112.3*	78.3	- 30
United	101.8	62.7	- 38
Delta	72.3	59.7	- 17
Northwest	54.4	39.3	- 28
Continental	48.1	39.6	- 18
US Airways	42.1	26.8	- 36
Sub-total US	431.0	306.4	- 29
Europe			
Air France	56.4	59.9	+ 6
British Airways	55.3	49.6	- 10
Lufthansa	38.1	39.1	+ 3
KLM	27.5	24.8	- 10
Iberia	26.8	26.3	- 2
SAS	21.8	18.6	- 15
Alitalia	21.8	21.4	- 2
Sub-total Europe	247.7	239.7	- 3

"The low-cost carriers have grown over the past decade
from insignificance
to irrelevance
to concern
to threat"

Aer Lingus
Cost reductions achieved €340m

	2003 Versus 2001
Staff costs	-21%
Distribution	-56%
Fuel	-31%
Airport charges	-28%
En Route	-6%
Aircraft hire	-51%
Maintenance	-12%
Overheads	-36%
Depreciation	-21%
Misc DOCs	-49%

BA's strategic priorities

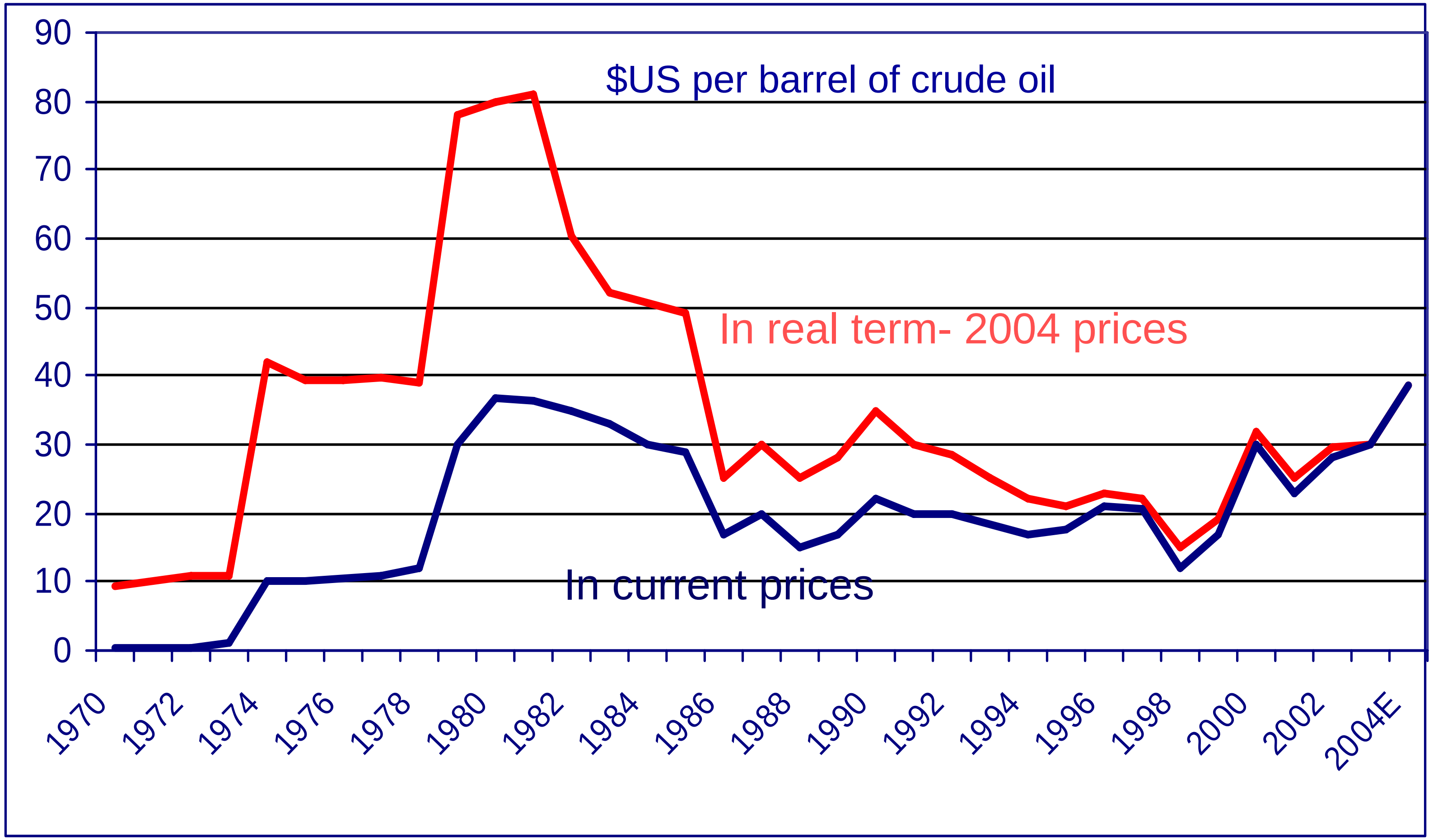


British Airways
Cost reductions achieved to date – £795 Million

	Achieved by December 2003	Target end March 2004
Staff reduction	12,652	13,000
Cost savings (£m)		
Employees	460	450
Distribution	212	100
Procurement/IT	123	100

Source Aviation Strategy, April 2004

Price of crude oil



Source: International Energy Agency

2005: $US 60 per barrel

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Not all LCCs have been successful

Recent failures in Europe include

- EUjet (September 2005)
- Volare Airlines (November 2004)
- JetGreen Airways (May 04)
- Duo (May 04)
- FlyingFinn (January 04)
- Jetmagic (January 04)
- Aeris (November 03)
- Buzz (May 03) - bought out by Ryanair
- Air Lib/AOM (February 03)
- GoodJet (January 03)
- Impulse Airlines (November 01)
- Debonair (October 1999)
- AB Airlines (September 1999)
- Color Air (September 1999)

Challenges facing low cost airlines

- Maintaining a lean organisation as the airline grows
- Increasing airport charges when start up tariffs are removed
- Increasing outstation costs
  - *local marketing expenditure has low productivity*
  - *credit card payment methods in some destinations not acceptable*
  - *lower internet penetration*
- Fuel prices
- Expansion
  - *protectionist behaviour of some governments*
- More head to head competition with network airlines

Challenges facing low cost airlines

- Arrival of other low cost carriers
  - *low cost subsidiaries of network, charter and regional carriers*
- Slot availability
  - *when targeting business passengers peak slots are essential*
- Customer protection legislation
- Losing focus on core business
- Market image

Challenges facing network airlines

- Oil prices
- Slowing of premium traffic growth
- US carriers shifting capacity to long haul, especially on the North Atlantic routes
- Gulf carriers' expansion on routes beyond the Gulf area
- Further expansion of low cost carriers, especially to network carriers' hubs
- Environmental pressure
- Industrial relations affected by recent cost cuttings

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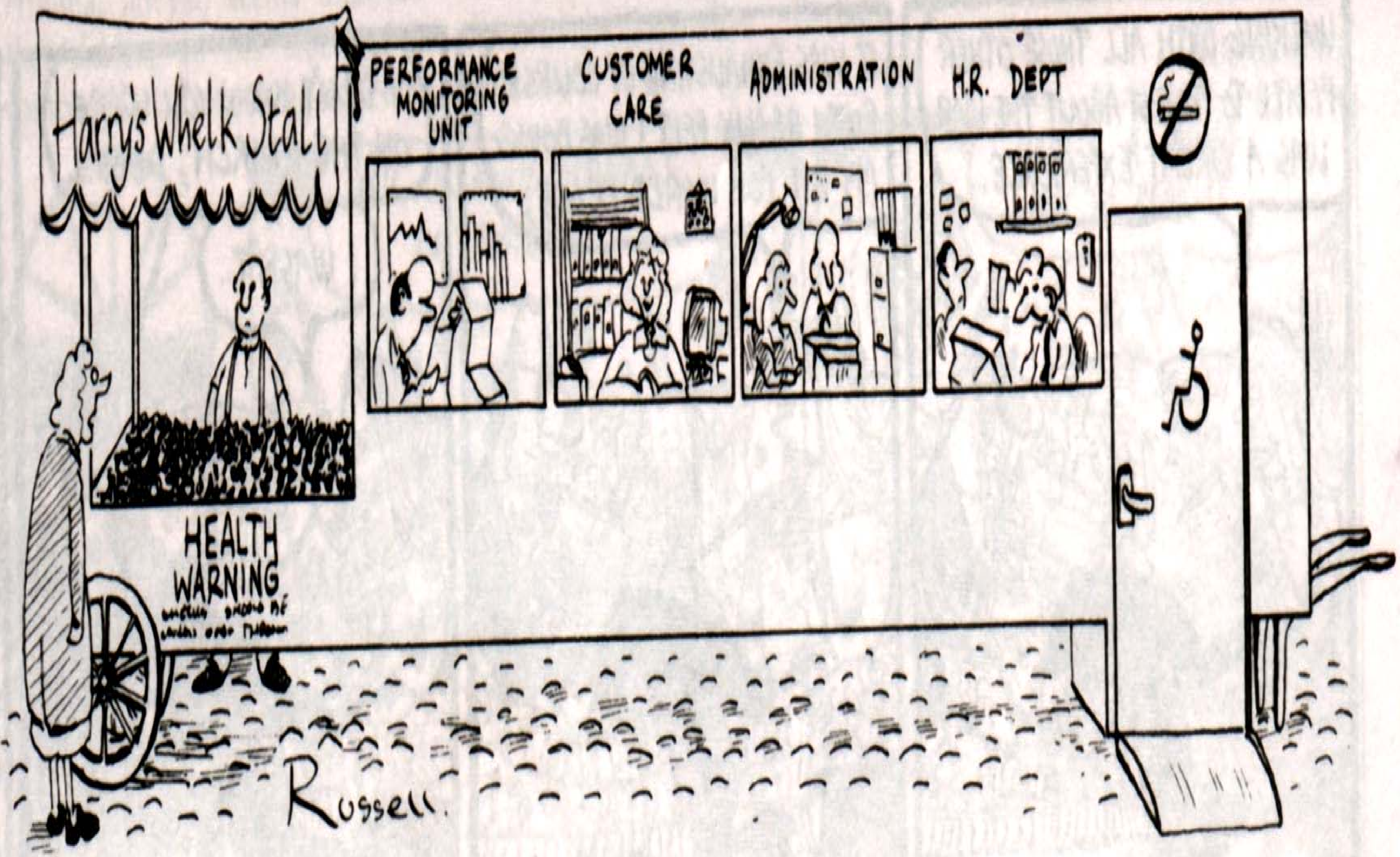
Future - network carriers

- No more than five European network carriers will survive
- They will increasingly focus on long haul and more direct services
- Use lower cost franchisees or smaller partners to feed their hubs
- They will have two distinguished business models - short haul and long haul
- Limited number of routes will be served with business class products
- Low cost subsidiaries of network carriers are unlikely to survive

Future - low cost airlines

- There will be two to three large EU low cost carriers
- At any point in time there will be around ten much smaller low cost airlines
- More than half of traffic within Europe will be carried by low cost airlines by 2015
- Low cost airlines will enter long haul with a modified low cost business model
- Some cannot resist the temptation to add service features in pursuit of product differentiation, leading to more complexity


Harry's Whelk Stall
HEALTH
WARNING



"Can I have some whelks, please?"