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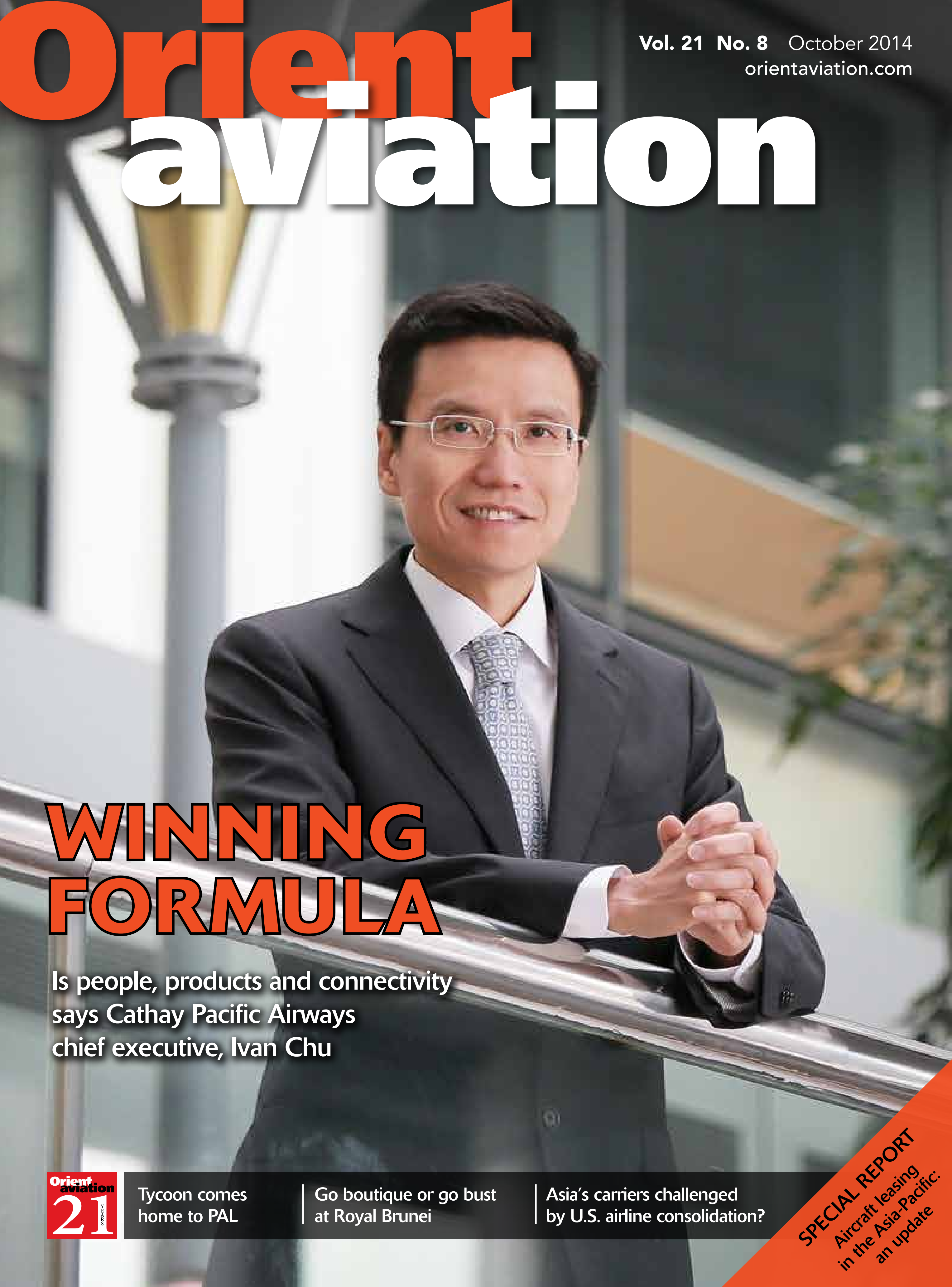

WINNING FORMULA

Is people, products and connectivity says Cathay Pacific Airways chief executive, Ivan Chu

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Asia's carriers challenged by U.S. airline consolidation?

SPECIAL REPORT
Aircraft leasing in the Asia-Pacific: an update

AWAS
ASCENDING

Orient aviation 21 YEARS

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A new wave of LCCs for China?

It is no surprise that China's airlines have hit a rough patch. The once over-regulated industry was bound to encounter challenges as it moved to the competitive global stage.

Although most of China's airlines still benefit from some form of subsidy, they are now largely corporate entities, which must deal with the same problems that face their regional and global rivals.

And so to 2014, when four factors outside the industry's control resulted in mostly losses or profit declines for China's carriers in the first half of this year.

The first setback was the unexpected reversal of the renminbi's exchange rate against the U.S. dollar. Secondly, the Mainland's ongoing crackdown on corruption was depleting the premium cabins of passengers as errant officials had their extravagant air travel habits curtailed.

At the same time, a new competitive threat emerged: the government's policy of supporting the development of low-cost carriers by Mainland operators, announced last December. These three factors, coupled with constant competition from an expanding, and cheaper, high speed national railway grid, have eroded airline yields.

Despite this difficult operating environment, the "Big Three" carriers – Air China, China Eastern Airlines and China Southern Airlines – are planning LCC subsidiaries. No doubt there will be more China budget start-ups as investors hope to emulate the success of regional LCCs such as AirAsia.

The new LCCs will struggle to find sufficient landing slots at Beijing, Shanghai and Guangzhou to launch their services, as Spring Airlines, the country's biggest existing budget flyer, has discovered. Nor will they find it is easy to operate the low-cost carrier model in a country where serious air traffic congestion, causing long delays, is a 24/7 problem.

But that is not the idea anyway. The government wants the budget carriers' growth to be focused in China's vast and underdeveloped Western provinces. And China's airlines seem prepared to do what they are told. LCC hopefuls have ordered dozens of new single-aisle jets from Boeing and Airbus.

Whether they can be operated profitably once these aircraft are delivered is another question altogether. Given the difficulties they face, it is hard to see budget operations in China growing at the pace seen in Southeast Asia or in other parts of the Asia-Pacific in the last decade. ■

TOM BALLANTYNE
Chief Correspondent
Orient Aviation Media Group

Gulf juggernaut gains momentum with US$32 billion airport expansion

*The arrival of **Qatar Airways'** first A380 at the airline's Doha headquarters last month gave the carrier's **chief executive, Akbar Al Baker**, the opportunity to be gracious about his client, and he took it. Qatar had rejected the first three of its 10-plane A380 order but said the delay was not the fault of Airbus. "The delay was caused by us because we demanded additional quality," Al Baker said. He added that "there is a possibility we will buy more because the airline's network could accommodate 20 to 25 of the airliners", especially if Airbus follows the urging of **Emirates Airline** and develops a NEO version. Qatar will initially use the A380s from Doha to London Heathrow and Paris, but like its airline neighbor, Emirates, winning slots for the aircraft in key markets such as China and India remain difficult. Recently, **Lufthansa**, another A380 customer, outbid Emirates for a slot at **Mumbai's Chhatrapati Shivaji International Airport**.*

*At Emirates, A380 services to Chicago commenced in August, the Dubai carrier's ninth destination in the U.S. with plans to place A380s on five of these routes from December. The carrier's global ambitions will be very well served by the September announcement that the emirate's government will invest US$32 billion in the expansion of the **Al Maktoum International Airport at Dubai World Centre (DWC)**. The expansion program envisages catering for 120 million passengers a year by 2022 and 220 million ten years later. Asia-Pacific carriers will be competitively effected by the DWC expansion as two thirds of the global population lives within eight hours flying distance from Dubai. However, DWC faces some competition in the Gulf itself. **Abu Dhabi International Airport** is expanding to handle a projected 40 million passengers annually and Doha's new US$15.5 billion **Hamad International Airport** can process 29 million travelers annually and has forward plans for expansion.* ■

New resolve at Air India

State-owned **Air India** has said it plans to cut the number of unprofitable routes to 19% of its overall network at the end of the current financial year, after reducing flights by 38% in the last fiscal year and 60% two years ago, reports **India's Business Standard**. "We have completely withdrawn flights not meeting ATF (aviation turbine fuel) costs. While there would be flights in which we would not be able to generate operational profits, we are looking at meeting cash costs on 81% of our network by the end of this financial year," a senior official at the airline said.

Air India has singled out 19 loss-making routes including Mumbai-Kolkata, Delhi-Bangalore, Sydney and Milan from Delhi. In September, the flag carrier sold five B777-200LRs to **Etihad Airways** for $67.3 million each after buying them for an average $127 million a plane seven years ago.

Vinod Rai, a former comptroller and auditor general at Air India, recently made the headlines when he revealed in an interview with **The Times of India** that the original order in 2004 was the brainchild of the **civil aviation minister, Praful Patel**, who wanted the airline to have direct flights from India to the U.S. and Canada. The upshot of this was virtually crippling for Air India."When any purchase has a debt proportion of 97%, there's no way it can be commercially profitable," Rai offered. ■

Commission to investigate MAS losses likely

Malaysia's opposition Pan-Malaysian Islamic Party, or PAS, has called on the government to set up a Royal Commission of Inquiry (RCI) into **Malaysia Airline System Bhd.'s (MAS)** losses over the years. "It's not that we want to see MAS bankrupt, or that it needs not be revived. We, as Malaysians, know that it needs to be salvaged because it is our national treasure. But we must question those who have brought down MAS over the last 10 to 15 years to its current state," **PAS information chief Omar** said without naming anyone in particular. **Khazanah Nasional**, the government investment arm that currently holds a 70% stake in MAS, last week announced a rescue plan for MAS titled "Rebuilding A National Icon". Khazanah said it would spend 6 billion ringgit (US$1.9 billion) to revive the airline, including 1.4 billion ringgit to take the carrier private by year-end, 1.6 billion ringgit for 6,000 layoffs and other cuts to operating expenses. ■

Mitsubishi and Embraer win over JAL

***Japan Airlines (JAL)** has signed a firm order with **Embraer** for a total of 15 E-Jets comprising the E170 and E190 models, in addition to 12 further options, valued at US$677 million at current list prices. "We have been operating our E-Jets for five years and the aircraft have achieved an outstanding 99.7% dispatch reliability. They are efficient and have displayed exceptional performance," said **Yoshiharu Ueki, representative director, president of Japan Airlines**.*

***JAL** has also agreed to buy 32 **Mitsubishi Regional Jets (MRJs)** worth almost US$1.5 billion at list prices, giving Japan's first domestically manufactured commercial passenger plane in half a century a sales boost. JAL said it will start operating the MRJs on domestic routes in 2021.* ■

IndiGo cuts $2.6 billion deal with China lessor

Indian low-cost carrier (LCC) **IndiGo** has signed a $2.6 billion deal with **China's Industrial and Commercial Bank of China Ltd. (ICBC)** who will finance the Gurgaon based airline's acquisition of 30 new A320s. IndiGo is India's largest carrier, with a market share of 32%, and the only airline on the subcontinent that has been continuously profitable since its 2006 launch.

In 2011, IndiGo ordered 180 A320 jets worth $15.6 billion – the then second largest single order in the commercial aviation industry. **Aditya Ghosh** (36), the airline's president, said some of the aircraft will service the Gulf state and south and Southeast Asia, but the majority of them will be for the carrier's domestic expansion. IndiGo operates a fleet of 80 A320s. ■

AirAsia Group loss-making as competition increases

***AirAsia Group** has turned in unexpectedly poor performance results for second-half 2014. While the group's Malaysian subsidiary, **AirAsia Malaysia**, remained profitable with a small operating margin, all of the group's overseas affiliates incurred losses. The group's performance is in line with results from other low-cost Asia-Pacific carriers as they struggle to maintain yields in a market with too much capacity.*

***Thai AirAsia (TAA)** posted a rare 318 million baht (US$10 million) loss in second-quarter 2014, following 18 consecutive quarters of profits.*

*The Thai market has experienced a huge capacity increase in recent months with start-up **Thai Lion Air** and Nok Air providing most of the added seats, whilst putting pressure on yields as growth outpaces demand. The timing for expansion has also been unfortunate, given Thailand's slump in overseas visitor numbers, particularly from East Asia and Europe because of months of political instability.*

*Meanwhile, the outlook at the group's two long-haul divisions is positive. **Malaysia's AirAsia X** reported a 128.9 million ringgit loss(US$40.9 million) in the quarter to June 30, attributing it to its strategy of capacity and network expansion. **Thai AirAsia X** was launched in May and its strong load factor and forward booking reports suggest it could be profitable. **Japan AirAsia Mark 11** is the group's only subsidiary that is not currently flying. Its re-launch is planned for 2015 from **Nagoya's Central Japan International Airport (Centrair)**. AirAsia Group is made up of eight airline affiliates: **Malaysia AirAsia, Thai AirAsia, Indonesian AirAsia, Philippines AirAsia, India AirAsia, Japan AirAsia**, and the two long-haul arms **Malaysia AirAsia X** and **Thai AirAsia X**.* ■

Lifeline for THAI

Thai Airways International (THAI) is struggling to make ends meet and has embarked on a restructuring mission aimed at turning its fortunes around after a net loss of 7.654 billion baht (US$236 million) in second-quarter 2014, more than double its 2.899 billion baht loss in the year-ago period, and the fifth consecutive quarter of losses for the legacy carrier.

The Bangkok Post says Thailand's Finance Ministry has asked the **Government Savings Bank (GSB)** to lend 87 billion baht to THAI, without collateral, to keep the carrier in the skies throughout September.

The loan is likely to be approved, when the GSB is holding its next board meeting, said **GSB board chairman Somchai Sajiapongse**.

In other news, THAI said it has reduced its fuel hedging for the rest of the year to 50% of fuel needs compared with 90% late last year, as global oil prices look to remain largely stable. ■

Gulf Air cuts losses

Bahrain's Gulf Air has cut its first-half 2014 losses "by more than 30%" compared to the same period a year ago, the airline said.

The better figures are the result of a major restructuring programme that has seen Gulf Air concentrate on high-demand, high-yield, regional point-to-point routes primarily aimed at the Gulf region's business community. Simultaneously, the carrier's long-haul network has been reduced to focus on a number of profitable trunk routes to feed its expanded short-haul network.

Gulf Air is a state-owned enterprise and under Bahraini law this exempts it from divulging actual figures.

Kamal Bin Ahmed, Minister of Transport and Chairman of Gulf Air's Board Executive Committee said: "We are pleased with these strong first half results, which are evidence of the on-going fiscal and operational improvements being made across the business. These early results are fully in line with our expectations as we continue to further strengthen the position of Bahrain's national carrier. To date, much has been achieved and we look forward to continuing this progress for the rest of 2014." ■

Profitable Juneyao applies for IPO

China's 'boutique' budget carrier, Juneyao Airlines, has bucked the trend of dwindling profits and losses at Mainland carriers in 2014. The airline posted a 191 million yuan (US$31.1 million) operating profit on revenue of 3.2 billion yuan for the reporting months. However, it has received government subsidies of 57.1 million yuan, which effectively reduced its net profit to 134 million yuan. Following in the footsteps of **Spring Airlines**, China's first low-cost airline, Juneyao has filed an application to go public with the **China Securities Regulatory Commission**. The Shanghai carrier flies 36 A320/321 aircraft to 38 domestic and regional destinations. ■

SHORTTAKES

AIRLINES: **Air India** has suspended a pilot and 10 cabin crew for habitually showing up late for work and delaying, amongst others, flight AI144 from Newark to Mumbai by over two hours on September 13. **Apsara International Air**, a new start-up financed by Chinese investors, has received its AOC and plans to commence domestic services out of Phnom Penh later this month using an A320. **China Airlines** plans to commence a codeshare partnership with **WestJet** from October 1, initially covering selected domestic Canadian routes via Vancouver. **China Eastern Airlines** has introduced a new livery after 25 years. **Garuda Indonesia** has invited bids for participants in the financing of an order for 18 A320s, consisting of eight A320ceo and ten A320neo, to be delivered between 2016 and 2018. **Hawaiian Airlines** will become the first passenger airline to install **Inmarsat's SwiftBroadband** for flight deck applications, including safety services on its B767-300ERs. **Philippine Airlines** will install **OnAir** wireless IFE on a further five A330s and six A340s. **Vietnam Airlines** has again identified Japan's **All Nippon Airways (ANA)** as a possible strategic partner for a 20% stake in the Vietnamese flag carrier. **Xiamen Air** has launched a Beijing branch company and allocated 13 aircraft on 10 routes to operate from the Beijing hub. Indonesian authorities have approved an **AirAsia X joint venture, PT Indonesia AirAsia Extra**,although its first routes and launch date have not yet been announced. **Cathay Pacific Airways** has received regulatory approval to allow passengers to keep their digital devices on during take-off and landing. **Hong Kong Airlines** has filed for the city's first-ever dual currency initial public offering, looking to tap a massive pool of yuan deposits in local banks. **Japan Airlines (JAL)** will introduce the B787 on its Tokyo – Beijing and –Delhi services from October 26. **Qatar Airways**' first of 80 ordered A350s has rolled out of the paint shop and is set for delivery in October. Meanwhile, the airline has introduced the B787-8 on the Doha-Vienna route, replacing an A320. Etihad will fly its new B787-9 aircraft to Dusseldorf, Doha, Washington DC, Mumbai, Brisbane and Moscow from December throughout June, 2015. Xi'an-based **Joy Air** has placed an order for 60 MA60 aircraft with **AVIC Xi'an Aircraft Industry Co.** worth US$437 million at current list prices. **Philippine Airlines** has announced it would not exercise an option to acquire eight of the 20 A321neo it had agreed to purchase last year. **Royal Jordanian** has received the first of 12 ordered B787-8s and will put it on its Bangkok, Hong Kong and Kuala Lumpur routes from October 1. **Qantas** has decided to hang on to its profitable Qantas Frequent Flyer programme after talks of selling it to raise capital. **Qantas and Virgin Australia** have received regulatory approval to allow passengers to keep their digital devices on even during take-off and landing. New Taiwanese LCC, **Tigerair Taiwan**, has started its first service, between Taiwan and Singapore.

AIRPORTS: Sri Lanka's **Colombo Bandaranaike International Airport** has launched the second stage of the second phase of its development that will see the airport's capacity raised from currently six to 15 million passengers by adding an additional pier and a new terminal by early 2017. The government has revealed plans to build a new **Dalian International Airport** on reclaimed land off the coast of Dalian as part of a 26.5 billion yuan ($4.3 billion) development project. **Abu Dhabi International Airport** has reported a 22% increase in passenger numbers and a 6% increase in cargo volume in July. **Delhi Indira Gandhi International Airport** has experienced a 12% year-on-year

increase in passenger numbers in June, while cargo was up 23%. **Dubai International Airport** has reported a 6.2% growth in first-half 2014 despite the refurbishment of two runways, which resulted in a 26% reduction in flights in May and June. The **Capital Airports Holding of China** has approved the development of a second international airport at Beijing. LENKE AeroConsult has been given the task to develop an operational concept for the new airport due to open at the end of the decade. **Darwin International Airport's** traffic has increased by 4.5%, with international traffic achieving double-digit growth of 14% this fiscal year. **Dubai International Airport** has reported a 6.2% growth in first-half 2014 despite the refurbishment of two runways, which resulted in a 26% reduction in flights in May and June. **Mumbai Chhatrapati Shivaji International Airport** has registered 12% more passengers and 5% more cargo in June compared to the same period a year earlier.

CARGO: **All Nippon Airways** and **Lufthansa Cargo** will launch a cargo joint venture on routes between Japan and Europe, following antitrust approval from the relevant **European Union** regulators and the Japanese **Ministry of Land Infrastructure and Transport. China Southern Cargo** will have started a Shanghai – Tianjin – Los Angeles B777F service. Air freight carriers in the Asia-Pacific have boosted global cargo volume 5.8% in July, the best July performance in four years, according to **IATA's** July air freight market analysis.

ENVIRONMENT: **Cathay Pacific Airways** has signed a long-term agreement to buy 375 million gallons of biofuel in the next decade. Last month, one of airline's three chosen suppliers, **Fulcrum BioEnergy** shared U.S. government grants of US$210 million given to **Emerald Biofuels, Red Rock Biofuels** and Fulcrum for the commissioning of construction of biorefineries.

IFE: **AirAsia** and its partners **roKKI and Inmarsat** are providing instant messaging services via mobile phones for all **AirAsia** passengers. roKKI is owned by Malaysian company, **Tune Box**, which is a subsidiary of the **Tune Group**, the ultimate parent company of AirAsia founder, **Tony Fernandes** and his business partner, **Kamarudin Meranun. Nok Air** became the first airline in the region to use **Thaicom's** new satellite based In-Flight Connectivity service, which now provides free broadband to all passengers of the energetic Don Meaung based carrier. ■


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Tycoon comes home to PAL

It was a case of back to the future for 80-year-old tobacco tycoon, Lucio Tan, last month when he paid $1 billion to buy the 49% stake he sold to brewing giant, San Miguel, in 2012. With PAL's former president, Jaime Bautista, installed as general manager, Tan is building a rejuvenated Philippine Airlines.

Tom Ballantyne reports

When Lucio Tan stood before Philippine Airlines employees – they fondly refer to him as the "Kapitan" - at a general meeting on September 15 it quickly became clear that this was going to be an emotional gathering.

"Like many of you," he told staff, "this is where I belong. This is where I spent many productive years – 21 years and counting. This is also where I will probably spend my last years. I am now 80 years old and in the twilight of my life. Yet PAL is never far from my thoughts. That is how dear PAL is to me. Whatever life's problems, this is a place you can always return to and feel safe, secure and loved."

This was why, he declared, that he decided to regain full ownership of PAL. "Because I love PAL and PAL loves me back. In today's cold and formal business world, this kind of close relationship between a chief executive and his employees is rare," he said.

After several weeks of tough negotiations, Tan finalized the deal that saw him pay $1 billion to Philippine's San Miguel for its 49% stake, double the investment the brewing company paid in 2012 for its PAL share.

Tan remained majority shareholder when San Miguel bought in the airline, but the brewer had full management control. As soon as he was back in charge, Tan wasted no time in appointing the airline's former president, Jaime Bautista, as general manager.

Bautista will be running PAL, but Tan has made it clear he will be an "active participant" in pursuit of the company's goals. Bautista, who has served Tan in various capacities for nearly three decades, told *Orient Aviation* he shared Tan's excitement about regaining full ownership of PAL.

"The first step is to conduct a review of our current situation, take an inventory of our current resources and then plan a new direction," said Bautista. "The work ahead includes determining the best use of the new airplanes, as well as the most prudent choice of the next new destinations; while maximizing the benefits of existing service innovations."

Beyond sustaining profitability, he added, PAL also needed to address its declining market share.

Bautista said the carrier might have to strike balance between reducing costs and improving productivity and employee performance. On a more positive note, there are promising opportunities for PAL to explore following the recent upgrading of the Philippines' FAA category rating and lifting of the EU ban - of which much of the groundwork was done during our previous administration, Bautista said.

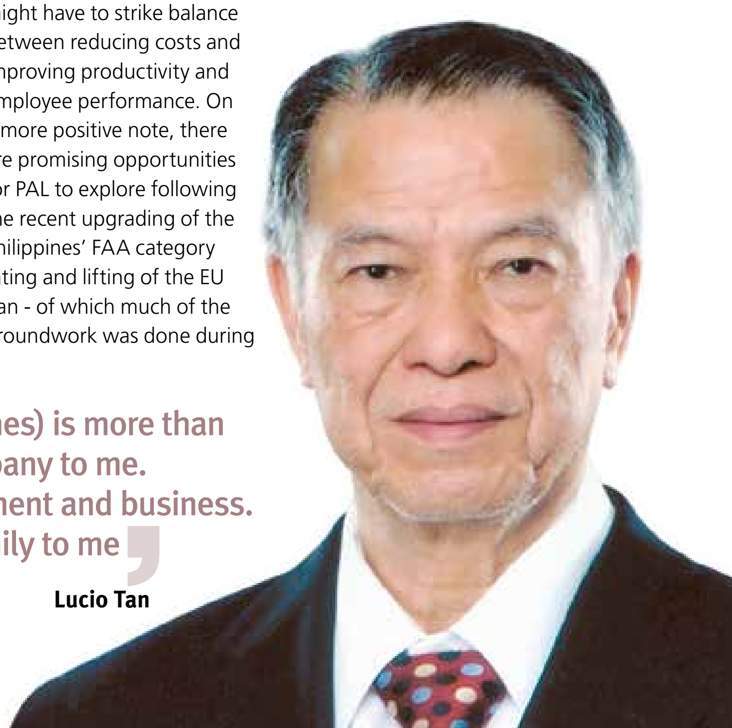
While PAL was being run by San Miguel and its enigmatic president, Ramon Ang, it embarked on a $9.5 billion re-fleeting program. Ang ordered 44 A320 family aircraft with options for 10 more, to be delivered through to 2020 and 10 A330-300s with options for another 10 for delivery from 2014 to 2016.

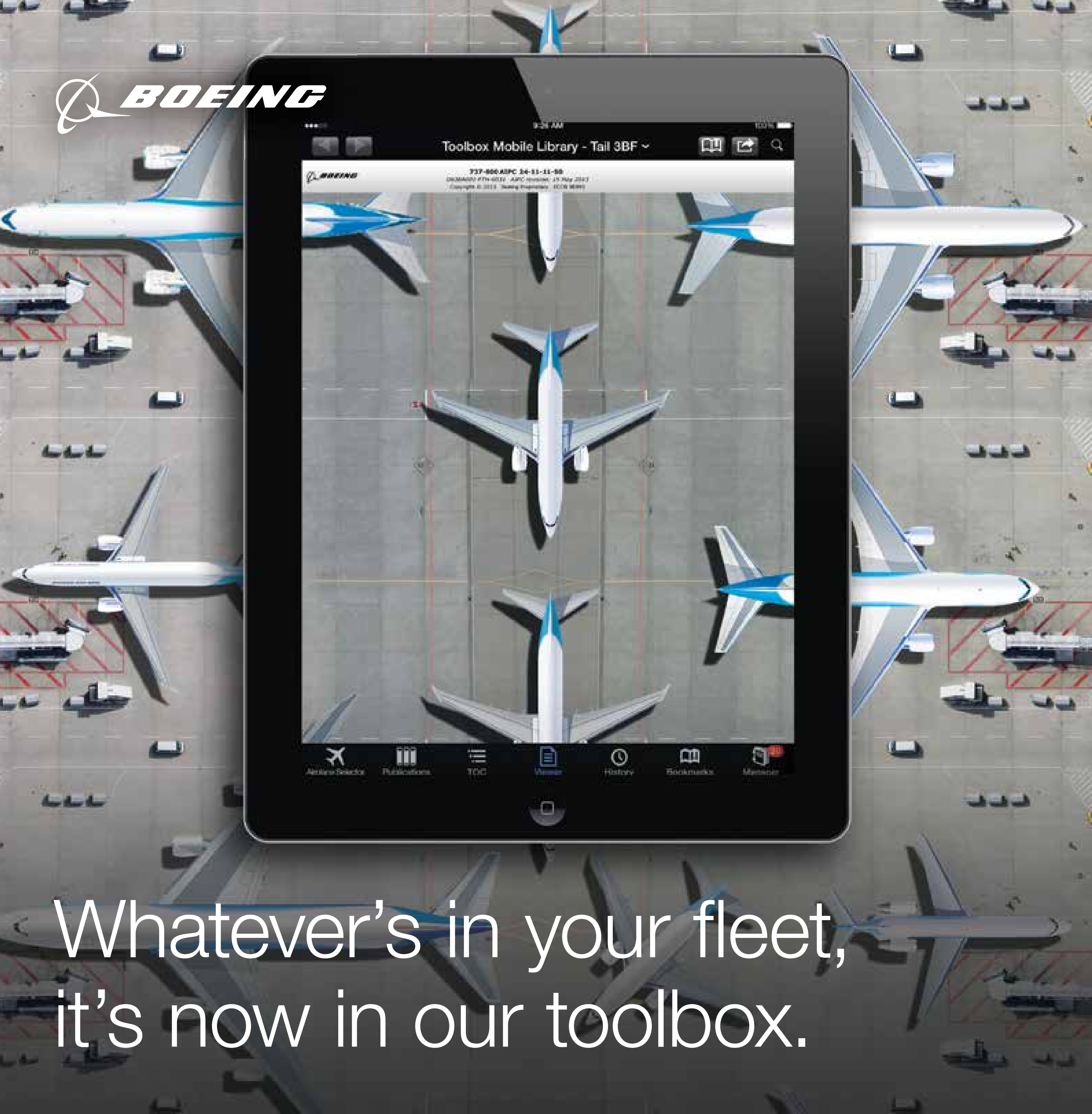
However, it recently reduced the number of options for the A320s and the overall commitment for the A330s from 20 to 15. PAL operates 53 aircraft: six B777-300ERs, four B747-400s, eight A340-300s, 13 A330-300s, 12 A320-200s, six A321s and four A319-100s.

Bautista said the delivery schedule needed to be revised with the arrival of some of the A321s deferred to 2015 and 2016. "We may consider more B777s for our long haul flights. Our six B777s ordered during my incumbency are the major profit contributors to our long haul routes, especially to Canada and the United States," he said.

Many industry insiders were surprised at the change of ownership because PAL's

> PAL (Philippine Airlines) is more than an airline company to me. It goes beyond investment and business. PAL is like family to me
>
> **Lucio Tan**





Your fleet's growing. Your fleet's changing. And the Boeing Maintenance Performance Toolbox is changing with you, providing new tools designed for the digital airline to meet your evolving needs. Tools for your entire fleet, no matter the OEM. Tools accessible anywhere—from web to tablet—with or without connectivity. New tools to keep your maintenance at the forefront of innovation and efficiency, and your airplanes in the air where they belong.

BOEING EDGE
Information Services

www.boeing.com/boeingedge/informationservices business appears to be turning around. Despite tough market conditions and increased competition from low-cost and foreign legacy carriers, PAL posted a second quarter profit, to June 30, of $33.4 million, compared with a $24.2 million loss the previous year.

Revenue for the quarter climbed 47.4%, to $612.4 million, on new routes and increased demand. Analysts report that the result, coupled with Ang's aggressive cost-cutting, has put the airline on track for a substantial full year profit.

Indeed, Tan has returned to PAL when critical developments at the carrier are taking effect. A downgrade of Philippines aviation by the U.S. Federal Aviation Administration (FAA), imposed in 2008, was lifted this year. The FAA ruling prevented PAL from expanding its U.S. operations or changing the type of aircraft it used on its U.S. routes. In April last year, a European Union (EU) ban on Philippine carriers flying into the EU was lifted, which allowed PAL to resume services to London.

Jaime Bautista: back where he belongs as Lucio Tan's right hand man at PAL

Ang had announced plans to fly to New York this year and to add European destinations, including Frankfurt, Rome and Amsterdam to PAL's network. Presumably, this strategy will have to be confirmed by the new management.

With a brighter future ahead, why did San Miguel sell? Ang has not answered that question directly, although he has indicated the brewer wanted to focus on buying into profitable foreign energy firms and said "oil and gas is our priority".

"A good investment is a company with stable cash flow and consistent profit," he told local media in a comment that seemed to suggest the airline industry was a little too volatile for his liking. Having said that, he added that there might be some interest in investing in a U.S. or Japanese carrier.

While PAL's fortunes seem to be improving, achieving and sustaining profitability will not be easy for Tan, Bautista and their team. However, analysts approve of PAL's focus on higher yielding, long-haul routes that should offset any weakness in domestic operations.

When Tan addressed the staff after his buyback, he said: "We have a big task ahead of us. "The challenges in the aviation industry are always formidable. But PAL is too important to the national interest to fail. PAL is important to every Filipino. It is not just another airline or corporation. It stands for the Philippines, here and wherever in the worvld we fly to. Let us, therefore, look to the future. Let us build a new PAL – an airline that all of us, the entire nation, can be proud of."

PEOPLE

Hogan handpicks 'New Alitalia' CEO and CCO

Sweeping changes have arrived at Alitalia after Etihad Airways' 49% equity investment in the struggling flag carrier was finalised. Last month Alitalia announced the appointment of Silvano Cassano as chief executive officer (CEO). A week later the board, led by Etihad's James Hogan, appointed Ariodante Valeri as chief commercial officer (CCO). Cassano will start his tenure as CEO as soon as the long-mooted deal between Etihad Airways and Alitalia is fully completed, most likely by December 31, 2014. Valeri assumed his duties this month.

Both men have years of experience in senior management roles across a number of industries, but mostly in transportation. Interestingly, Cassano's latest role was CEO at Italian shipping company Grandi Navi Veloci (GNV), where Valeri was previously GM.

MAS CEO contract extended

Malaysia Airline System Bhd. (MAS) has extended Ahmad Jauhari Yahya's contract as managing director and chief executive officer by one year, until September 19, 2015. MAS said in August that Yahya would stay on to facilitate a proper handover to his yet to be selected successor. The national carrier is seeking to reinvent itself following three years of red ink and the loss of two aircraft this year. Yahya has been at the helm of MAS since September 2011.

New CFO at AirAsia X

AirAsia X Bhd has appointed Chew Eng Loke as its chief financial officer (CFO) with immediate effect. Chew will report directly to chief executive officer, Azran Osman-Ran, and will succeed Yvonne Abdullah. Ms Abdullah will stay on with the company for an interim period to assist Chew with the transition. Chew is the former CFO of Ogawa World Bhd., an investment holding company with subsidiaries principally involved in health care equipment.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CHALLENGES OF CHANGE

China's airlines are at a watershed in their development as the government continues to loosen the levers of a once protected industry.

TOM BALLANTYNE reports

When China Eastern Airlines (CEA), the country's biggest operator, recently booked a disappointing first half profit of just $8 million, down from $93 million in the same period a year ago, it was only the beginning of the bad news for its shareholders this year.

The second half started badly when Chinese military exercises throughout July and early August caused widespread flight delays and cancellations across eastern and central China, including services from CEA's hub at Shanghai's Pudong international airport.

But the revenue hit brought on by military control of airspace is hardly the only challenge facing CEA and other carriers. Yet it epitomizes the complexities of operating in the local market for the country's airlines as changing economic circumstances and the arrival of up to 20 local budget carriers across China fracture yields as over capacity grows.

China's passenger numbers continue to rise, but yields are dropping. Planemakers are forecasting 6,000 plus new jets will be needed in China in the next two decades, but there are questions about the system's ability to cope with the predicted expansion of the Mainland commercial airline fleet.

Infrastructure insufficiencies are not being addressed fast enough, despite a massive government program of airport development. At the same time, a slowing national

economy continues to trim airline revenue.

Adding to the airlines' woes is the rapid expansion of the country's high-speed rail system. It has grown to nearly 10,000 kilometres since 2009 and will expand to 19,000 kilometres by the end of next year. The on ground competition has forced airlines to discount fares substantially to attract passengers away from more convenient and reliable long-distance rail journeys.

Last year, Guangzhou-based China Southern Airlines (CSA) saw domestic revenue decline by 5.5%. National flag carrier, Air China, headquartered in Beijing, experienced a 5% profit drop, despite a 7.3% increase in passengers carried. "The rapid development of high-speed railway and the evolution of low-cost carriers on the Mainland will further intensify competition on domestic routes," the company warned.

But the most dramatic recent development for the industry was Beijing's announcement last December that it would support the start-up of more local budget carriers. It is believed the Beijing bureaucrats like what they see at privately owned Spring Airlines, which now operates a fleet of 44 Airbus A320s. A recent report revealed that Spring, founded by a travel agent, enjoyed a net margin of 41%, which compared with a China airline industry average of 12%. Its load factor was 94%. The industry average is 76%.

The central government's enthusiasm for more local LCCs is interpretated by analysts as a way to catch up with Southeast Asia's rapid growth in budget operators as well as providing a boost to the country's slowing economy.

In the last 18 months, China's central government has introduced several aviation reforms, including relaxation of some air fare pricing controls, reduced airport charges and processes that simplify and speed up approval for budget carrier start-ups. The industry had to adjust to all of them - both good and challenging.

With Beijing aboard the budget bandwagon, there has been a virtual stampede of investors wanting to operate LCCs. And Airbus and Boeing are benefitting from the new business.

Spring is already an Airbus customer. Last year, the French manufacturer signed commitments with two new Chinese carriers, Qingdao Airlines and Zhejiang Loong Airlines, for 43 A320s.

At Boeing, more than 70% of its sales in China have been to LCCs. It has recently sold 93 B737s to three new operators, Ruili Airlines, 9 Air and Donghai Airlines. In addition, most of a CEA order for 80 B737s is expected to join the fleet of the airline's subsidiary, China United, which is being converted into an LCC. Rival, CSA, is reported to be converting its subsidiary, Chongqing Airlines, into a budget carrier.

While the planned large capacity increase would appear to pose a serious threat to the incumbents, analysts are quick to point out budget start-ups face several serious issues on their path to profit.

The first is infrastructure, said David Yu, the Beijing-based executive director Asia Pacific for the International Bureau of Aviation (IBA) group, a UK consultancy which provides independent business analysis to the aviation industry.

"The major airports are going to suffer congestion no matter what so unless you're the Big Three, you're going to have trouble getting slots at the major airports. It's a congestion issue more than anything else," he said.

In Yu's view Beijing's promotion of LCCs is really directed at the country's western regions, where the government wants to boost air traffic growth, and is not aimed at flooding the Beijing- Shanghai- Guangzhou triangle with budget competitors.

Skaiste Knyzaite, chief executive of AviationCV.com, a global provider of aviation specialist resourcing solutions for airlines, MRO providers and other industry players, agreed. "Efficiency will not be easy to achieve for these new entrants, as even Spring Airlines still has trouble securing prime slots and cutting turnaround time," he said.

"In other words, while demand may be growing for cheap air travel in China, tapping the potential of this market could come at a steep price."

A recent report by strategy consultancy, Roland Berger, said the cost of fuel, maintenance, gate usage fees and other fixed expenses accounts for about 60% of most carriers' operating expenses in the region. Large, established airlines entering the LCC sector with subsidiaries will find it a challenge to stay profitable in the budget travel segment given current industry conditions, it said.

"Budget aviation in China faces many of the same problems as regional aviation, for example, scarcity of runway slots at major airports and congested airspace along important routes. While these are all strong reasons for maximizing revenue for each aircraft, such an environment cannot be appealing if airlines have to allocate precious resources [airport slots] that are specifically designed to generate lower fares. Other difficulties included recruiting experienced pilots able to fly in crowded airspace controlled

by the military, Roland Berger said.

Knyzaite said the successful implementation of the low-cost business model, apart from appropriate infrastructure, would depend on finding qualified staff, not only pilots, to deliver on ground support.

"The low-cost business model is based on spending the shortest time possible on inspection-related works. Meeting that requirement of completing all required tasks in a 40-45 minute time frame can be a challenge for less experienced professionals, especially as it will take time to build the in-house capabilities required to support quick and competent turnarounds," he said.

In the meantime, while China's growth has slowed to between 6% and 7%, from the double digit expansion of recent years, air traffic continues on an upward trend. In the last five years, China's airline industry revenue has been growing at an annual rate of 14.4%, to $108.2 billion.

Passenger volume is expected to reach 391.1 million by year end, an increase of 10.3% over 2013. According to China's current five-year plan, which ends in 2016, 82 new airports will be built across the country. By then, 415 million Chinese are predicted to take an airline flight at least once a year, forecasts the International Air Transport Association (IATA). Although there are some doubts this would be achieved if the economy continues to slow in 2015.

Boeing's latest market outlook said China will need 6,020 new aircraft, valued at $870 billion, in the next 20 years, based on the country's forecast economic growth and the entry of more carriers into the market.

The new aircraft will account for 45% of the demand for all aircraft in the Asia-Pacific to 2033. Annual average passenger growth in China will be around 6.9%, while average GDP growth will be 6.2%, said Boeing.

"China's aviation market is going through dynamic changes," said Randy Tinseth, Boeing's vice president of marketing. "New business models like low-cost carriers and airplane leasing companies will provide the growth impetus. Low-cost carriers seem to be the most promising sector in terms of growth, due to government support. Though the number of low-cost airlines increased from just one to five this year, several other carriers are considering the change-over. The growth in low-cost carriers will stimulate air traffic and increase demand for single-aisle airplanes."

Tinseth is not fazed by the economic slowdown in China. He said Boeing's outlook is long-term and it is normal for the global civil aviation industry to go through ups and downs. "It is a flexible market and can recover very soon," he said.

IBA's Yu believed that the number of new aircraft will exceed Boeing's numbers. "Whilst there is no doubt China must meet dramatically increased flight demands, the forecast must also take into account government policies to promoting airline traffic, particularly that of the low-cost airlines, and improving airline access in ill-served western China," he said.

"It is also important to consider that more than 900 aircraft are expected to be retired over this period. According to JetData, IBA's commercial aircraft database, the Chinese fleet stands at least a 2,400 aircraft, with an average age of 7.8 years."

With a current outstanding backlog of 42 A320 family aircraft, 35 A330 aircraft, 24 A350 aircraft, 87 737 family aircraft, six 747 aircraft, 50 777 aircraft and 22 787 family aircraft, coupled with predicted aviation growth in the next 20 years, there will be an abundance of opportunities created for the supply chain, and especially for local aircraft leasing companies, who have steadily grown over the last five years. At present, 34% of the current fleet is on lease, said Yu.

Given the volatile nature of the industry, there are no guarantees any of these growth projections will ultimately be fulfilled. "There's always that threat that the growth might not hit the projections for whatever reason, be it shocks such as 9/11 or something else," Yu said.

"From an infrastructure point of view, the government is quite keen to promote airline growth. At the same time, they don't want to go superfast right away. That's why there are caps on the amount of growth per year for each airline. Understanding and navigating this aspect is important in understanding the market."

As for the rapid expansion of fast rail, which is carrying some two million passengers a day - twice as many passengers as domestic airlines - on trains that are rarely delayed, it isn't all bad news for airlines.

Consultancy CAPA has pointed out that even without a rail network, all these passengers wouldn't necessarily have chosen to fly. Some might not have traveled at all. Others may have taken their trips by car, bus or slow train.

There is no doubt, however, that airlines have been impacted by the development of high speed rail as airline expansion has slowed from its 2011 peak. Said Yu: "people sometimes take the train because it is more convenient. It's definitely a good option for the traveler. At the same time, rail can increase traffic flow because high speed trains are bringing people from the provinces, from second and third tier cities, to major cities like Shanghai and feeding them on to airlines. Pudong is an example of an aero-transport hub that links rail with air so it does create some additional flows. So it's not all bad."

And the policy changes keep coming. In September, the country's official news agency, Xinhua, reported China may open its skies to foreign carriers with no restrictions on their number or capacity. It cited a speech by Han Jun, head of the international division of the Civil Aviation Administration of China (CAAC), at an industry forum. Xinhua said Han revealed that traffic rights will be gradually liberalized in an orderly and controlled manner, but did not provide a precise timetable for the policy change.

Analysts caution that overseas carriers shouldn't get too excited about such pronouncements. "I think wider liberalization is going to take a while," said Yu. "Congestion is still a major factor. If you talk to the management of any foreign carrier and ask where they want to fly, they don't want to fly to Wuhan or Chengdu. They all want Beijing or Shanghai. So if you ask officials about open skies per se, its open skies everywhere except the major cities."

The latest CAAC statistics show 111 foreign carriers from 55 countries are flying to 46 Chinese cities at a rate of 2,705 flights a week. Nineteen Chinese airlines fly to 120 cities in 49 countries with an average of 2,854 flights each week.

The major Chinese airlines have made significant inroads onto international routes and are now flying A380s and B787s. However, many of the routes are unprofitable and while analysts agreed that equipment is now best standard Chinese airlines are not matching their foreign rivals in service.

As well, their profitability remains shaky. Much of the blame has been laid on the unexpected reversal of the renminbi's exchange rate against the U.S. dollar earlier this year but there have been other factors. "I definitely think the currency has had a major affect," said Yu. "Obviously, a slowdown of growth in the economy, the controlled growth, is another issue. But (Chinese government), austerity measures that are in place have affected the "Big Three". Given a lot of the folks who would be taking first or business class tickets have downgraded to economy, that has obviously created a slackening of the market and has a big effect because obviously up front is where these carriers make their money."

Fuel costs are also an issue. China's regulator banned its airlines from buying crude future contracts – a key form of protection against rising fuel costs – after they incurred heavy losses in 2009. But it is understood airlines are contemplating a resumption of fuel hedging activities.

Air China said in March that its board had approved a return to fuel hedging "according to market conditions", but it confirmed in August that it had not yet resumed the practice, said CAPA. China Eastern and China Southern won't comment on any plans to resume hedging.

John Grant, executive vice president of OAG, the global provider of aviation information and analysis, said the Chinese market and aviation in particular remain a paradox for many in the travel industry and that China is still perceived as an 'emergent' market.

Emergent it may be, but China is a country where dramatic change is likely in the next five years. Today's Chinese market is based on rock solid foundations of distribution, airlines, airports and traditional relationships across the market. Tomorrow's market will see revolutionary change in its structure, creating new business opportunities for everyone as travel increasingly becomes a commodity rather than a perceived luxury. Changes in technology will also fuel this growth, said analysts.

"Whatever the present problems, there is a universal belief that the future remains assured. "Even though economic activity overall has slowed a bit, this really won't affect the long term prospects for the industry's growth," said Yu. "People are now used to flying. It is getting more and more entrenched." ■

"Low cost carriers seem to be the most promising sector in terms of [China] growth, due to strong government support"

Randy Tinseth
Vice president marketing
Boeing Commercial Airplanes

WINNING FORMULA

The stars have been aligned for Ivan Chu since he took over as chief executive of Cathay Pacific Airways in March. Solid profits were announced, traffic growth is positive and the carrier was named Skytrax Airline of the Year for the fourth time. All he has to do is keep the good news coming.

Christine McGee reports

The first thing that strikes you about Ivan Chu is his energy. He walks fast. He talks fast. He reputably hikes and skis fast - and there is no doubt he is operating at top speed as Cathay Pacific Airways chief executive.

Six months into the job, after his promotion from chief operating officer, Chu is clearing enjoying running an airline that many of his airline peers would envy. Within a month in mid-summer, he accepted the Skytrax Airline of the Year award 2014 on behalf of Cathay Pacific at the Farnborough Air Show. It was the fourth time the carrier has won the award, also taking the title in 2003, 2005 and 2009, and the only airline to achieve this feat.

A month later, the carrier announced an interim profit of US$45 million, compared with a US$3.1 million profit a year earlier. Producing the results had been a challenge, especially with persistent high fuel prices and a slowing China market, but they were impressive when most other carriers of Cathay's size and stature lost money or saw profits dip.

Chu, a team player, accredits the results to the management team, especially his predecessor, John Slosar, and Cathay's employees for both the Skytrax award and profit result..

But as a 30-year veteran of Cathay Pacific – he joined the airline as a management trainee in 1984 – he knows there are some hard yards ahead for him if the airline is to remain one of best global carriers in the world.

He ticked off the main challenges. To continue to run a safe airline, to provide superior service and product quality, to build the average daily customer base of 85,000 to 95,000 passengers, tight cost control, including managing a high and volatile fuel price, arresting declining yields, building the momentum of the

Cathay to spend HK$1 billion on social media

"Social media is going to be more important and we will be investing about HK$1 billion in terms of providing the capability. We will improve our online booking systems and provide better services for our customers to book online, check in, redeem tickets and use our Asia Miles program to upgrade their seats. We need to have the behind the scenes systems to support passengers' expectation and also to allow us to develop our online ancillary business, such as purchasing insurance. It takes years and multi millions of dollars to do this."

air cargo recovery, adapting to the impact of the slowing China economy, dealing with relentless competition from both Gulf carriers and start-ups and expanding the Cathay network to new destinations that will build the airline's connectivity.

One battle looks won. Barring unforeseen developments, Hong Kong will build a third runway, scheduled to open in 2023, after a long, and at times conflicted, public consultation. "The majority of people support the third runway. But Hong Kong must balance its development objectives with environmental issues. We have got to look at air quality. We have got to look at noise and also the threat to white dolphins. We must have the space to look after them. I believe Hong Kong can do both and we can do it very well," Chu said.

Like airport congestion, competition, he said, is a given, but he does not believe the carrier should be obsessed with it, he said in the company's in house newsletter earlier this year. "We should watch the competition certainly, but the focus should be on ourselves. Cost is the issue," he said. "We can only win in the market place if we can get ourselves to produce the service more efficiently."

One example of that efficiency is fanfares, an ingenious competitive strategy that will be two years old this month. Cathay's average load factor is 84%, which means it has roughly 16% of it seats - 2,000 to destinations worldwide - to fill each week. Every Tuesday, the airline's website announces its fanfares, which sell these seats at close to budget carrier rates.

"They are all sold," said Chu. "We are addressing the low-cost market. We bring customers to us where they will have a better customer experience than at an LCC and hopefully they will stay with us. Students, retirees and young people love them because they are flexible about their travel times."

Another aspect of budget carrier competition that favours Cathay is its longevity. There is not much space left for budget start ups. "A factor to consider is that Hong Kong International Airport (HKIA) is getting very full. There are 100 airlines flying in and out of Hong Kong, including some 15 or so LCCs. The traditional model of turning an aircraft around very quickly cannot happen until 2023 (when the third runway is scheduled to open). So it is like setting up an LCC at Heathrow. It is not possible. And bear in mind that Hong Kong is not a low-cost environment so Cathay and Dragonair, with their premium full service models, work very well," he said.

Chu's rise to the top

At 52, Chu is a member of an outstanding generation of Hong Kong achievers who often came from modest circumstances. "We had quite a big family. My mom had five kids. Now they live everywhere," said Chu. "We were very lucky to have started our working life in Hong Kong in the eighties. Hong Kong was really booming. All the locals were benefitting from the tremendous growth of the city and China."

Chu did his undergraduate studies at the prestigious Hong Kong University, where he specialized in economics. He later completed his Master of Commerce in Australia. Describing himself as an "OK student", he had three job offers at graduation, including a bank, a multi-national consumer goods company and a management traineeship with Cathay Pacific.

"One job was with the biggest bank in the world, which was Japanese. Now Chinese banks are the biggest. I could have been in finance. Most of my classmates made that choice. I was the odd one out and picked the aviation industry and Cathay. So destiny picked me and I picked Cathay Pacific," he said.

There were 1,000 applicants for the traineeship. "Cathay was quite small at the time. I think we had 17 or 18 aircraft. It was a regional airline that had just started flying to London. Peter Sutch was the boss. A good leadership guy," he said.

The romance of travel appealed to Chu. "All of us, including John Slosar, Peter Sutch, Rod Eddington, we all started as management trainees. It was fantastic," he said. His first job was in ground services at Cathay's office at Kai Tak international airport, which closed in 1998 after Hong Kong International Airport at Chep Lap Kok opened. He has stayed with the company all his working life.

"You know, to be able to start at an airline in a services department was excellent basic training for understanding our business. We were small, but very interesting in what we offered," he said.

Chu said, however, that the most influential times in his career were the 13 years he spent working outside Hong Kong. A big part of that time was in Australia and New Zealand (six years) as well as stints in China, North and Southeast Asia, including Vietnam.

"I was posted to Beijing by Peter because we had bought Dragonair and I was working in Vietnam in 1990. My job was to transfer the operations from Dragonair to Cathay Pacific and build up Dragonair, he said.

"Beijing was very different then. There was no traffic in Changan Avenue, only bikes. So inner city travelling was easy, but inter city was hard. I looked after Tianjian as well as Beijing so I did a lot of driving between the two cities. It was a different world. You drove on roads with cows, horses, porters and bikes. It took two to three hours. Now it takes 30 minutes in a high speed train."

In a company with 67 nationalities and 32,000 employees worldwide, working outside his comfort zone in places with different cultures, language and religious differences and a lot less convenience was fundamental training for management of a multi-national airline, Chu said.

Regardless of the above, said Chu, Cathay competes very well with LCCs on many routes. "For example, we fly ten times a day to Singapore where there is a lot of budget competition on the route. We have kept our market share and grown our load factor by two per cent," he said.

Chu attributes this staying power to Cathay's strong business model. " We have a very high yield in the premium cabin. We get good yield from our belly cargo (a drawback for LCCs). We have a very good short haul network that feeds into our long haul flights. More than 50% of our customers feed onto other Cathay flights."

Winning more slots, an issue often blamed for curtailing airline expansion also is not high on Chu's "To Do" list. "There is a slot challenge for everyone, but compared with new entrants we actually have a lot of slots in a lot of airports. We have been in business for 68 years. I would not say we have spare slots, but we have the slots we need. If you fly to a city five times a day, like New York, then you have covered the key slots," he said.

Building frequency is a key tenet of Cathay's full service premium model. "I can see in five years that Cathay will be strengthening its network frequency to provide the largest number of choices for time of travel, time of arrival, connectivity, and the number of destinations in Europe, North America, Australia, New Zealand and the region. It's not just about inter-continental hubs, but small and big points. This is critical for a network carrier – that we link all of them together," he said. "That is a very strong competitive advantage."

To build that global connectivity, Cathay has made substantial investments in North America and has now turned to Europe where it will re-start services to Manchester and launch Zurich. "We will announce more new destinations as our ordered aircraft arrive. These new B777s will allow us to fly five times a day to London with a cargo capacity that is much bigger than the passenger payload."

Frequency benefits Cathay, said Chu. "People love our frequency. Five times a day to London and New York. Four times daily to Sydney. This is why we are not buying the super jumbo. It is not what passengers like about us. They like the frequency and connectivity we provide."

In the last 18 months, Cathay and its 100% owned subsidiary, Dragonair, have been adding more short-haul/long-haul connectivity to the network. "We will compete very well with new forces like the Middle East carriers because people don't like to fly, stop and then change planes to reach their final destination," he said.

"Also, we are very fortunate to be within five hours flying time of half the world's population, where there is a big demand for travel as well as freight."

To bring home the spoils in this huge new market, Chu believes that the quality of service that an airline offers is a crucial factor in winning over passengers. How then does Cathay differentiate itself from their rivals?

"If you look at the last ten years, everybody has improved so the competition is intense. Even the European carriers are improving," he said. "First of all, it is about both product and services. I think Cathay does

Cathay's China strategy

As a shareholder in Air China, Cathay can't help but be effected by the fall off in premium travel at Mainland carriers as well as the general economic slowdown. Again, Chu takes the long view. "We are big operators into China. We have a major strategic alliance with Air China. We have exposure from our investment in China air Cargo. So to us, the Cathay story is going forward with the China story," he said.

"Now, we have a downturn. But look at the last 20 years. Three to four hundred million people have moved into the middle class and the number is still growing. The economy is still vibrant. The fact that it is not growing in double digits does not worry me. It is still expanding at 7% a year.

"In the next decade, the production centre of the world may have moved away from the east coast of China to Bangladesh or Vietnam, but Asia will still be its centre. Creating that new middle class will continue to drive travel and tourism. Looking at the China inbound story, it will be the biggest in airline history."

Global tracking partnership

'We have been working with IATA and his team. We would rather use a global standardized system than do it on our own. We also think this will be beneficial in sourcing the right technology. It is better to work with airlines together," Chu said.

The threat from China's carriers

Chu said Chinese carriers have improved significantly on issues of safety, especially as they are investing new fleets. "China has a huge population and we can continue to do well even as other carriers are improving. We are confident we can compete with China's airlines and also the world's carriers," Chu said.

About Cathay Pacific

Cathay Pacific Airways operates a fleet 146 aircraft, with an average age of 8.5 years and employs 22,000 worldwide. It is a founding member of the oneworld alliance whose members service 1,000 airports in 150 countries. Dragonair, 100% owned by Cathay Pacific is an affiliate member of oneworld.

The carrier has firm orders for 85 airplanes, including 22 A350-900s, 26 A350-1000s, 21 B777-9Xs and 10 B777-300ERs.

The airline, established in 1946, operates to 88 passenger destinations in 46 countries with their own aircraft, and is the 19th largest airline in the world by operating revenue and the 14th largest passenger airline globally. At press time, it is the seventh largest cargo carrier worldwide in freight tonne kilometres. Its subsidiaries include regional carrier, Dragonair, Cathay Pacific Services Ltd, Cathay Pacific Catering Services (HK) Ltd, Cathay Holidays Ltd, Asia Miles Ltd, AHK Air Hong Kong (60%), Air China Ltd (20.13%) and 100% of Vogue Laundry Services Ltd.

very well on both. Many carriers focus on products. Getting the right seat and spending money on the biggest hardware. At Cathay, we really believe we serve the customer very well – from the chief executive to the general manager and middle management and airport managers, to our cockpit crew and our almost 10,000 cabin staff, " he said.

"It's a huge number. To deliver on that scale over a long period of time is very hard. It can only be done if you are totally focused on passenger service. Our customer must be our focus. A lot people say this but they don't do it."

Chu said the airline has been paying a lot of attention recently to this service delivery ethos. " As the CE I would not know if the cabin crew is looking after a particular passenger, but if we have a very good service culture, it is part of the DNA of cabin crew to do this. Our difference, at Cathay, is that in the last 60 plus years, we have not just convinced our customers that we do this, we have convinced ourselves."

Apart from giving depth to the service culture philosophy, Chu does not see the airline making big changes. "We will be strengthening our business model as a premium full service network carrier. We have created a lot of premium seats. We have a lot of choice in our seats – first, business, premium economy and economy. All our new B777s, including the B7779Xs and the A350s, will have new seats. In terms of full service carriers, don't forget we are one of the biggest airlines in the world."

And first class is safe – if only on some routes. Chu said despite the recent trend of eliminating the first class cabin, Cathay won't be going down that track. "We are a premium full service carrier so first class is important to us. The first class cabin is smaller than it was, but there is always demand for a first class seat. But we agree that not every route will have demand for first class so we will continue to offer it where there is a market for it, for example, London and New York," he said.

Air freight figures very prominently in Cathay's forward planning. "Do not underestimate the cargo business," said Chu, who now has the most efficient air cargo in the world to service the airline's air cargo business.

"When I look at the air freight market in the last two or three years, yes, there has been a slowdown in demand, but the need for air freight is still there. I am definitely confident we will start growing.

"If I go to any supermarket in a major city like New York, London or CitySuper in Hong Kong, I see all these products – fresh seafood, live seafood, cherries from America, cheeses from Australia, summer fruits from different countries. The world is becoming more affluent. So Asia, [with its expanding middle class], becomes our potential market and trade will go back to the normal curve."

Chu said the slowing of air cargo business since 2012 has brought some rationalization to the industry. Several airlines worldwide have closed their air freight divisions, air freight companies are closing and many airlines, including Cathay, are retiring old, fuel-hungry freighters. The world's economy is growing so air freight will be growing, but the airline industry will have to accept the new norm, which is slow growth, but nevertheless still growth," he said.

"This trade is moving increasingly from west to east, the reverse of the former air cargo business model. Nowadays, during the festive seasons of Christmas, Chinese New Year and Easter we are sending a big amount of high quality produce from Europe to Asia. In the last ten years, air freight from Asia was about setting up a production centre in Asia and sending it to the rest of the world. Now Asia is importing products for its middle class."

It is obvious that Chu is very proud to be part of Cathay and thrives on the challenges of the top job. He has come a long way since those booming eighties days and a management traineeship at an airline based at Kai Tak and headquartered in a dowdy building in Hong Kong's CBD. His story is the Cathay story. ■

Go boutique or go bust

Royal Brunei Airlines seeks survival in fierce Southeast Asian market

By Tom Ballantyne

Royal Brunei Airlines, one of the Asia-Pacific's smaller full-service operators, is reinventing itself as a boutique airline ready to take on legacy rivals and budget airlines alike. However, its management admits big challenges lie ahead.

The good news, said Karam Chand, chief commercial and planning officer for Royal Brunei Airlines (RBA), is that the airline's hub sits in the middle of Southeast Asia and its population of 600 million.

But "we are bordered by premium carriers such as Singapore Airlines and Thai Airways International, as well as being surrounded by the largest low-cost carriers in the world", he said. It is, Chand concedes, an interesting challenge for his carrier.

But it is one said the Fiji-born Australian and former senior executive with budget carrier, Virgin Blue, the airline is meeting head on. After a woeful period following the Global Financial Crisis (GFC), when RBA closed routes and cut staff, it has rebuilt and recently added to its prestige by becoming the first carrier in Southeast Asia to operate the B787 Dreamliner.

"We had a perfect storm some years ago, as so many other carriers did after the GFC as demand collapsed and then fuel prices hit, and maintained, new highs," said Chand.

> When you see US$1 and US$10 fares being dumped on the market every second week, it is really a challenge for full service carriers
>
> **Karam Chand**
> Chief commercial and planning officer
> Royal Brunei Airlines

"We are 40 years old. As you get older you start to show signs of age. You become high maintenance. You have problems with communications. You become extremely conservative. Given the GFC and the fuel situation we had no choice but to make some tough decisions."

They included drastic surgery in 2011, with the elimination of flights to Auckland, New Zealand, Brisbane and Perth in Australia, Ho Chi Minh City, Viet Nam and Kuching in Malaysia.

"We also had to start right-sizing. At one time, we had 2,000 staff with less than nine planes. We had to become staff right-sized for our longer term strategy. We also had to simplify our fleet to reduce operating costs. We are small, but we have a very supportive shareholder who saw merit in taking on our rebuilding," he said.

The result was an order for five B787s, four of which are in service with the fifth scheduled to arrive in 2018. Currently operating two A319-100s and four A320-200s, RBA has also ordered seven A320neos which will begin arriving in 2018. Built into these orders is an ability to scale up or scale down to match market demand. "That is paramount. For us, it is very fundamental to meet market demand rather than growing capacity ahead of demand," said Chand.

The Dreamliners are flying on long-haul routes to Jeddah, Saudi Arabia and from Melbourne to Brunei, then on to Dubai and London. Regionally, RBA operates A320s to Shanghai, Hong Kong, Manila, Kota Kinabalu, Bangkok,

Kuala Lumpur, Singapore, Indonesia's Jakarta, Surabaya and Bali, and Ho Chi Minh City from this month.

The Dreamliners are making a difference, said Chand. "You can't do much about the fuel price, but what you can have are fuel efficient aircraft. Our 787's round trip from Melbourne to London saves 100,000 litres of fuel and if you know the fuel price that's a lot of savings. The A320neos give us advantages on regional routes. We think we will see a 18% to 20% reduction in our fuel costs. That's a fantastic outcome for an airline of our size."

The new RBA is not only about new aircraft. It is about a transformation of an ageing legacy carrier into a boutique airline. "We had to go through a rebranding exercise to make sure people saw us in a different light," explained Chand.

"One of the first tasks was to establish ourselves as a boutique airline in Southeast Asia. What does that mean? We don't have the network of the big guys. We don't have the cost structure of AirAsia X. We also - and this is probably not widely known - are based in a country where the manpower costs are much higher than in the Philippines, Indonesia or even North Asia.

"That impacts our cost base. It's higher than those guys so we had to focus on service. We contracted a company that had helped Singapore Airlines (SIA) establish their highest standards of training and we went through a very significant program with senior management to change the mindset and introduce [greater] customer focus.

"All staff have gone through mindset and service training and we have invested in systems and processes to support customer service."

Chand said the theme is "warmth". "That means warmth from our staff. We are attending to our customers' needs. We are reliable, safe and are innovative. We need to be consistent and we need to resolve customers' problems and make sure they have a pleasant experience," he said.

"There is no way we can duplicate the SIA network. There's no way we can get AirAsia's cost structure. The only place we can make a difference is the service side with customer focus. 'Wow that was something different'."

One of RBA's major challenges is the size of its home market. Brunei has a population of 400,000 although its GDP per capita is the fifth highest in the world, primarily because a major part of its economy is crude oil and gas.

As a result, RBA relies on transit passengers for more than 60% of its business and these days it has a lot of competition. "Everybody wants to lower costs. Revenue is being driven by the low-cost guys and by Gulf carriers operating long-haul with huge capacity. Both these factors are driving down fares," said Chand.

"So if your revenue is outside your control, it is fundamental that we have focus on reducing the fuel burn cost."

The next imminent "interesting dilemma and challenge is the arrival of Asean open skies on January 1 next year. It will open up capacity in all the Asean countries and, of course, it opens up capacity to Brunei for competitors", he said.

Even before the arrival of open skies, capacity dumping by low-cost carriers has become an issue. "When you see $1 and $10 fares being offered in the market every second week it is a real challenge for full service carriers. Our cost structures are simply not there. This is something we are discussing with different governments. We want Brunei, as an example, to exercise its rights under the air fares agreement and deal with what we call predatory behavior," he said.

The airline has also been innovative on the freight front, last year contracting with a UK company, Air Logistics, to handle all its belly space. "We felt giving it to someone who really knows the freight business was the way to go. Every month we get a cheque, which is a very important outcome for us," he said.

"There are no delays in Brunei and we are promoting it as a hub. Air Logistics are able to give us global coverage and revenue manage our cargo, which a lot of small companies can't do."

RBA does not intend to significantly increase its long-haul flying but will continue to focus on expanding its regional markets. For example, the arrival of the A320neos, with their longer range, will open up opportunities for the carrier in North Asia and the Indian subcontinent.

"These are markets we will look at as these aircraft get closer to delivery. We will focus on short to medium haul regional flying and aspire to serve all the key Asean cities with a minimum daily service," Chand said.

Competition will be fierce. Chand pointed out that 27% of region's routes are served by at least five airlines of all models, compared with Europe where 45% of routes are served by just one or two airlines. "You can see how competitive it has become. It is inevitable that the LCCs will end up completely dominating these markets. But we feel, as a boutique airline and one aspiring to be a very strong boutique airline,that the model will do very well by offering a unique, high quality service that is relevant to the market." ■

The threat of open skies

"I pose this question to our competitors: Are they going to mount capacity based on sustainable economics or will they just place aircraft because they've got thousands of aircraft coming over the next several years?" asked Chand.

"It's a multi-million dollar question for us. It's a very important challenge for small airlines around the region. What do you do under these policy settings? You can have open skies, but open skies leads to capacity dumping and irrational pricing and that's not the best outcome you want."

Asia's airlines challenged by U.S. airline consolidation?

Are big U.S. airlines making it difficult for their Asia-Pacific alliance partners to tap into their lucrative domestic business? Yes, Hawaiian Airlines told Tom Ballantyne.

Recent developments in the U.S. airline industry are having a significant impact on Asia-Pacific carriers, said someone who should know, the CEO of Hawaiian Airlines, Mark Dunkerley.

To fly from Portland, Oregon to Seoul, in South Korea, via San Francisco, said Dunkerley at a recent regional conference, you should not expect that booking flights operated by members of a global alliance will offer the best deal. And he presented the figures to support his case.

Checking offered fares on a particular day, he said, travelers could buy a Portland-Seoul ticket with Skyteam member, Delta Airlines, for US$986. But if that same passenger flew from Portland to San Francisco with Delta and then switched to its alliance partner, Korean Airlines, for the second leg to South Korea, the fare is $2,871, or a 191% increase.

Alternatively flying from Portland to San Francisco with non-aligned Alaskan Airlines and then transitting to Korean Air to fly onto Seoul would cost $961.

"It would appear U.S. airlines are making it more difficult for carriers, in this case from Asia, to gain access to U.S. domestic business," Dunkerley said.

The Delta case is far from unique. Hawaiian Airlines' research found that a flight from Washington D.C. to Hong Kong, via San Francisco, on Star Alliance operator, United Airlines, cost $826.

Hawaiian Airlines' codeshare and interline partners have doubled, to 34 since 2009, said the CEO of Hawaiian Airlines, Mark Dunkerley

If that same traveler flew from Washington to San Francisco with United and then onto Hong Kong on Star alliance partner, Singapore Airlines (SIA), to Hong Kong, the fare was 182% higher, at $2,329.

Interestingly, ticket prices from San Francisco and Hong Kong hardly varied between United ($720) and SIA ($781). "We have a bunch of examples that tell essentially the same story," Dunkerley said. "We could demonstrate this with both international to U.S. carriers that involve two airlines in the same global alliance and those not in the same global alliance."

The fare discrepancies, Hawaiian said, are a consequence of the consolidation of the U.S. airline industry in the last six years. In 2008, Northwest Airlines merged with Delta Airlines, followed by United and Continental and Southwest Airlines and Airtran in 2010 and most recently, American Airlines and US Airways.

"As a result, about 85% of all U.S. domestic traffic is in the hands of four extremely powerful airlines. This is a seismic shift in the nature of the U.S. airline industry that is changing behavior at a very, very, very fundamental level. The four major carriers are free of the skirmishing that typified U.S. aviation for the 30 years since deregulation," said Dunkerley.

With consolidation has come domestic capacity discipline. Seats offered have been reduced, load factor is rising and yields and profitability are climbing. "To see U.S. airlines at the top of the league table of global financial performance in this industry is truly something I never thought I'd live to see, but we are there today," he said.

Since 2008, U.S. airline seats to and from Asia have increased by 18%. But Asian airline capacity has expanded by 26%. "You have constrained U.S. domestic supply while international supply into the U.S. is growing quickly," he said.

"The U.S. industry is sitting back and saying: 'if we are going to say no to any particular stream of traffic what traffic are we to decline'? I conjecture they will look at the traffic that is of the least strategic value to them. My further thesis is the traffic of least strategic value to the big four airlines are international connections onto their U.S. domestic networks.

"If I am right, you could expect U.S. airlines to reserve seats for their own international connections at the expense of seats provided to their international airline, often alliance, partners."

And that, according to Dunkerley, is precisely the conclusion he has reached from his research.

How people feel about that depends on where they sit, he said.

"Frankly, over the last 30 years, because of the complete shambles of the U.S. domestic airline market, it has been an enormously good time for foreign carriers seeking to do business in the U.S.

"Foreign carriers have been largely able to divide and conquer, accessing what is still the largest market in the world on extremely favourable terms. From a U.S. vantage point the present situation presents a more reasonable equilibrium. But if you are one of the international carriers flying to the U.S. this new reality could be a moment of tremendous difficulty for you."

One alternative for foreign carriers is to look at non-aligned operators such as Alaskan or Hawaiian for partnerships. "Although 85% of the U.S. domestic market is controlled by four carriers, that's not the same as 100%," he said.

"There are non-aligned carriers. If you do the same itinerary from Portland to Seoul with Alaska Airlines, the fare is cheaper. Clearly, the point I'm making is that non-aligned carriers have tremendous value." And foreign carriers are obviously looking for opportunities.

"Since 2009, Hawaiian's foreign codeshare and interline partners have doubled, from 17 to 34. "It's evidence of the number of carriers, inside or outside alliances, seeking to better access to U.S. domestic traffic."

Despite the significant growth projected for the Asia-Pacific air travel market, Dunkerley did not envisage a deluge of U.S. airline capacity surging into the region. "There is a new religion afoot [in the U.S.] and that is capacity discipline is good for the industry and for the individual carriers. I predict growth is going to be somewhat muted," he said.

There could be a tension building at U.S. carriers between those who recognize opportunities overseas but are confined by the capacity control mantra. "They are probably thinking: 'lets not start another rush to the bottom, which has characterized the U.S. domestic airline world for the best part of 30 years'. They are going to grow into Asia, but not at an explosive rate because of that capacity strategy," Dunkerley predicted. ■

MAS's rescue and resuscitation

Khazanah Naisonal's "airline doctors", put in charge of saving Malaysia Airlines (MAS), have opted for leadership stability as they begin corporate surgery at the nation's flag carrier.

Tom Ballantyne reports

Consensus has still be reached about the viability of Khazanah Nasional's US$1.9 billion rescue package for Malaysia Airlines (MAS) as critics contend that de-listing the carrier will not produce the reforms necessary at the distressed airline.

In late August, Khazanah's managing director, Azman Mokhtar, outlined plans for MAS after it becomes 100% owned by the government fund. His goal is to return the flag carrier to profitability by 2017 – without a change to its name.

Under the plan almost a third of the airline's workforce will lose their jobs as MAS is converted into a regional carrier stripped of several loss-making international routes often serviced by the airline's A380 fleet.

"The combination of measures will enable our national airline to be revived, said Azman.

Khazanah wants MAS's cost per average seat kilometre (CASK), a metric for cost efficiency, to be within 15% of low-cost carriers and be close to the performance of similar to carriers, such as Emirates Airline, but below regional competitors, Singapore Airlines and Cathay Pacific Airways. MAS flies to seven cities beyond the Asia-Pacific: Amsterdam, Dubai, Frankfurt, Istanbul, Jeddah, London Heathrow and Paris.


MAS withdrawal from long-haul routes could take AirAsia X back to Europe

Buenos Aires, Cape Town, Johannesburg and Rome were eliminated from the network in 2012 and Los Angeles was dropped in April. It is expected that Frankfurt and Paris may be the first to go, with MAS filling the network gap with its oneworld partners in Europe.

Azman also hinted that Khazanah could sell equity in the carrier to private sector investors, which suggests if MAS does rebound to profit, it could be open to a strategic investment by a foreign airline partner.

AirAsia Group boss, Tony Fernandes, said the revival strategy would benefit both MAS and his carrier. "We welcome it. Its good to have two strong carriers," he said.

But vehement critic of the Khazanah plan, Shukor Yusof, of aviation consultancy Endau Analytics, said the three-year plan was essentially a government bailout that was piecemeal and guilty of wishful thinking about returning to profit in three years. Yusof added that if the airline kept its six A380s, he "was convinced the airline would never make money".

Another analyst, who did not wish to be named, considered the rescue plan might succeed because it included massive job cuts, which were absent from previous MAS restructurings.

Aviation consultancy, CAPA, said the MAS privatization will only become realistic if the recovery plan is executed flawlessly and market conditions, which have been brutal in Southeast Asia in the last year, become more favourable.

It said cuts to the long-haul network could create a void in the market and persuade airlines like AirAsia X to reconsider Europe. It also could lead to an opening for oneworld partners, such as British Airways and Finnair, to become joint venture partners with MAS.

Tony Fernandes said: "It seems Khazanah Nasional genuinely wants MAS to be run commercially."

Fernandes said there is currently too much crossover between the two airlines routes networks, which was inefficient. MAS had been able to price its fares aggressively and beyond its means because it had the support of the Government, he said. Fernandes hoped the restructure would result in a healthy aviation industry and less taxpayer money being used to prop up the ailing MAS. AirAsia would "do its best" to absorb as many people as it could from those who had lost their jobs at MAS, Fernandes promised.

The restructuring was announced as MAS reported its fifth consecutive quarterly loss, a $97.5 million deficit in the three months to June 30. The results brought losses for the first half of 2014 to $238.3 million. Some analysts forecast the full year loss could reach $1 billion. ■

China agressively expands its lessor business

New and recently established Asian lessors are stepping up aircraft orders and negotiating to buy out established leasing companies as more airlines chose to lease rather than buy aircraft.

Tom Ballantyne reports

International aircraft lessors are being challenged for a greater piece of the global leasing pie by the financial giants of Greater China and their Japanese peers.

Last month, the aircraft lessors were focusing on the plans of Asia's richest man, Li Ka Shing, after it was revealed that the tycoon's flagship company, Cheung Kong Holdings, was one of the bidders for the sale of 100 Awas Aviation Capital jets.

Discussions are reported also to be well underway between Li's executive team and Japan's MC Aviation Partners, the leasing arm of Japan's Mitsubishi group, to form a joint venture lessor.

At press time, other buyers reported to be interested in the Awas portfolio were SMBC Aviation Capital Group and Orix Corporation from Japan, the HNA Group's Hong Kong Aviation Capital and Dublin-based Macquarie AirFinance.

Li's potential emergence as an investor in aircraft leasing is not the only sign that Chinese interests are enthusiastic about the profits airplane leasing offers.

Although there has been no official confirmation of the deal, it was widely reported that the China Investment Corporation (CIC) has teamed up with Aviation Industry Corporation of China (AVIC), a state-owned aerospace and defence company, to buy another Irish-based lessor, Avolon, also for a reported US$5 billion.

Tadas Goberis, chief executive of AviaAM Leasing: Emerging market aircraft lessors lack experience in managing the risk and operational factors of a lessor's fleet portfolio

Should all these deals successful, 2014 will be a landmark year in global aviation finance as Chinese banks increasingly focus on the leasing sector, said Tadas Goberis, chief executive of Warsaw-based AviaAM Leasing.

He pointed out that since China's financial regulator, the China Banking Regulatory Commission (CBRC), promulgated the Regulations on Financial Leasing Companies in 2007, which allowed banks to enter the financial leasing industry. Chinese financial institutions have been actively developing their aviation leasing activities. Domestically, they now control 75%-80% of the aircraft leasing market.

ICBC Leasing, a subsidiary of the Industrial and Commercial Bank of China (ICBC), has enlarged its fleet six times, to some 380 aircraft, since it went into business. Meanwhile, the leasing subsidiaries of the remaining Chinese "Big four" banks; CCB Financial Leasing Corporation (China Construction Bank), ABC Financial Leasing Co. (Agricultural Bank of China) and BOC Aviation (Bank of China), as well as CDB Leasing Company, China Aircraft Leasing and several smaller lessors are seeking growth opportunities beyond Mainland China.

Said Goberis: "the local banks domestic dominance of the sector evolved naturally from the strict market regulation of the past, especially since major aircraft lessors and lessees is government-owned.

"However, the success of China air travel has presented Chinese leasing companies with opportunities to expand and they are backed by the government.

AIRCRAFT LEASING IN THE ASIA-PACIFIC: AN UPDATE

Since the authorities announced last year they wanted to see more budget carriers launched, we might see a demand for extra aircraft, which should mean more business for lessors."

While the 2007 regulatory changes cleared the way for Chinese banks to form leasing subsidiaries, the real spur for expansion happened in 2010 when the CBRC allowed financial leasing companies to establish subsidiaries in tariff-free zones.

Until then, only airlines were permitted to import aircraft on a tariff-free basis. The revised regulations allowed lessors to set up subsidiaries in the tariff-free zones which put Chinese lessors on an equal footing with foreign financial leasing companies.

China's aircraft lessors are taking full advantage of their new competitive position. ICBC has announced it will deliver more than 300 airliners to customers by 2017. At the recent Farnborough Air Show, Hong Kong Aviation Capital signed a deal, estimated at $7.76 billion, for 70 A320neos, its first direct order with a manufacturer.

Last month, it also signed a Memorandum of Understanding (MoU) with IndiGo, which will provide US$2.6 billion for 30 new A320s for the Indian carrier. IndiGo, the biggest airline by market share on the subcontinent, has three funding option under the MoU: sale and leaseback, a financial lease or a commercial loan. To date, most of IndiGo's fleet expansion has been done on a sale and leaseback basis.

At the same time, another Chinese lessor, BOC Aviation, owned by the Bank of China but based in Singapore, ordered 43 A320 family aircraft, adding to the 38 A320ceos it has purchased in the last 18 months. In August, it ordered 80 B737 series

> ICBC Leasing, a subsidiary of the International Construction Bank of China, has enlarged its fleet by six times, to 380 aircraft, since it went into business

aircraft, for delivery from 2016 to 2021.

BOC is a leader among Chinese-owned lessors, with its global customer base, its healthy interim net profit of $163 million, to June 30 and its 250 plus fleet.

Said BOC's managing director and CEO, Robert Martin. "The focus is on building a pipeline of orders to meet our customers' needs, we demonstrated when we announced our 43-strong order of A320 family aircraft in July."

Indications that other Chinese lessors and financial interests are determined to make a splash in the wider global business include the failed bid for International Lease Finance Corp. (ILFC), which was owned by U.S insurance company, AIG, by a Chinese consortium in 2012. ILFC was ultimately sold to AerCap Holdings last December. Clearly, that setback did nothing to weaken the China's appetite for aircraft leasing, that, according to Boeing, will require funding of $112 billion this year.

With the percentage of airline fleets that are leased continuing to rise and with China alone expected to take more than 6,000 new aircraft over the next two decades, it is little surprise that Chinese investors are determined not to miss out on the bounty as airlines shed fuel hungry planes to cut costs.

AviaAM's senior project manager, Tomas Sidlauskas, pointed out to Orient Aviation, that the aircraft lessor/investment sector provides an average return of 10%-15% against an optimistic 4%-5% for airlines – in a good year.

But there are challenges for the up and coming Chinese lessors, said Goberis. "The majority of non-aviation investors and commercial banks, which are expected to fund almost half of this year's deliveries, don't possess sufficient skills to effectively manage the potential risks, including those related to aircraft operation, maintenance, registration and insurance, asset condition and its resources' control.

"Certain financial players from Europe (and also Japan) have accumulated significant experience in aircraft financing. However, the majority of financiers from the Asia-Pacific, particularly China, have been in the business for a short period of time and lack experience.

"As a result, the lessors and investors from emerging countries are exploring three-party deals between lessors, lessees and mediators with expertise in aircraft management. The mediators act as an advisor in creating and if required, managing the aircraft portfolio on behalf of the other partners."

It is assumed the Cheung Kong Holdings/MC Aviation Partners – the Japanese company has 20 years of experience in the field – is aimed at tapping into such expertise. MC Aviation owns and manages about 100 mostly-narrow body jets . It has been reported that Cheung Kong also has approached other aircraft lessors with a view to buying blocks of 20 aircraft. If he succeeds in pinning down AWAS, he will achieve his goal in fell swoop. ■

Leasing's allure attracts Japanese banks

At the Farnborough Air Show in July, SMBC Aviation Capital, the leasing arm of Japan's second largest bank, Sumitomo Mitsui Financial Group, ordered 110 A320neos and five A320ceos, valued at $11.8 billion. The order, which will bring the number of Airbus airliners in SMBC's portfolio to 260, was another step forward in the bank's diversification strategy in a business where traditional banking remains sluggish in Japan.

SMBC was established in 2012 when its parent bank purchased the Royal Bank of Scotland unit, RBS Aviation for $7.3 billion. Within 30 months, it has become the third largest aircraft leasing firm in the world, with a current fleet of 344 airplanes. Apart from its interest in the Awas fleet, it also is reported to be in discussions with Boeing to acquire 100 airplanes. If all these deals are consummated, the Japanese lessor will have more than 500 aircraft on offer for its customers.