Economic Update

As discussed in the August 2009 issue of Navigating 360, we continue to note that business opportunities are emerging on a regional basis, with Asian economies - particularly China and India, but now joined by Japan, South Korea, Australia and Singapore - leading the way. Paced by growth in Germany and France, the European Union appears to be on the path to better health, although regional disparities in performance remain a thorny policy issue. In North America, Canada has reported that 2nd Quarter GDP growth was positive, and its banking industry has been cited as a model for others to emulate.

In the United States, stimulus programs are having noticeable impacts on consumer spending, but these surges (led by automotive sales to clear off unsold inventory) are short-term by nature and necessity. Many (if not all) eyes are on the U.S. consumer, who is responsible for some 70% of economic activity. With high personal debt loads, rising unemployment, and issues over access to credit, personal savings rates have climbed, and spending has been pared across a spectrum of goods and services, including discretionary air travel.

An Assessment of Business Jet and Airline Fleet Strategies

Strategic by nature, fleet planning and deployment strategies are at the heart of the business – and cost structure - of large business jet operators and airlines. Fleet decisions (size, model, manufacturer, and age) ultimately permeate an organization, and are critical components of a brand and service promise.

The chart below depicts various business jet operator fleet strategies. The X-axis measures the number of total aircraft in operation, and the Y-axis is an estimate of ‘fleet complexity’. In this case, we calculate complexity with 3 variables – the number of distinct aircraft models multiplied by the number of aircraft manufacturers multiplied by the average age of the aircraft. The logic? While offering market gauge and customer benefits, there are diminishing returns associated with small fleets of multiple types. Complexity increases as additional manufacturers are included, as these necessitate different training, spares pools, supply chains, and business relationships. Aging aircraft then add...
to the mix, with higher operating costs (especially fuel and maintenance), lower schedule completion rates, and the potential for customer dissatisfaction.

There is not one “best” fleet strategy for the industry, just as there is no ideal quadrant to occupy in these charts. Multiple factors coalesce to influence success, including daily operating efficiency, yield and cost management, people selection and training, and customer service delivery.

In stark contrast to the airline environment, the deployment of business jet fleets is on-demand, with a wealthy customer base and premium yields. The industry (and overall fleet) is still comparatively young, and only NetJets has reached intercontinental scale. With an early focus on generating margin through the buying and selling of aircraft, the industry has invested heavily in systems to optimize scheduling and to balance earnings with profits from aircraft operations and lease products.

Fleet complexity is an important driver of performance and cost at large business jet operators. With the economic downturn, asset writedowns, and a rupture in share sales, operators are cost focused as never before. The advantages of a larger, younger, simpler fleet - sourced from one or perhaps two manufacturers - are compelling and deserve consideration as companies position for a rebounding economy.

**Airline Fleet Complexity**

In the commercial airline market, some of the largest carriers are reducing the number of aircraft types and manufacturers as new equipment is brought on-line. American Airlines, for example, having just retired the last of its Airbus A300s, is on the path to remove the McDonnell Douglas Super 80 fleet in favor of the Boeing 737. We see significant operational benefits in these decisions.

Only three airlines are currently rated as ‘investment grade’ by Standard & Poor’s – Southwest, Lufthansa, and Qantas – and it is telling that each occupies different fleet complexity quadrants in this analysis. Clearly, many factors are at play in assessing the competitiveness – and financability – of an airline. In the hyper-competitive North American and European markets, however, market share is shifting towards lower-cost carriers, many of whom follow the simplified fleet model originally developed by Southwest Airlines.

Transport Association (IATA) reported that premium passenger traffic (i.e. first- and business-class travel) fell 21% year-over-year (YOY) through June 2009. International airline passenger revenues are down 30% YOY, with international passenger demand in all fare classes down 7% YOY. As in the United States, many seats are being filled only with significant discounting.

After accounting for inflation, average airfares in the United States have declined 30% since airline deregulation in 1978, or an average of 1% per year. Responding to fierce competition, airlines have built large hubs, increased frequencies on mainline routes, renewed their fleets with more fuel-efficient aircraft, and shifted short-haul and smaller market capacity to lower-cost regional carriers.
The airlines have also generated more productivity out of their aircraft, supported by heavy investments in capacity and yield management systems. According to ATA and the U.S. Bureau of Transportation Statistics, average load factors (the % of revenue passenger miles flown as a proportion of available seat miles) were just 50% in 1970. By the time of U.S. airline deregulation in 1978, load factors had increased to 58%. By mid-2009, they had reached 81%, with an on-time arrival rate (within 15 minutes of published schedules) of 76%.

Giovanni Bisignani, IATA’s Director General and CEO, highlighted the current predicament – and the opportunity (my emphasis):

“Our industry is in survival mode. Whether this crisis is long or short, the world is changing. Even if we try to look beyond the crisis we must recognize that it will not be business as usual. Change is critical. We must use this crisis as an opportunity for governments, partners and airlines to build a stronger industry.”

IATA Annual General Meeting and World Air Transport Summit, Kuala Lumpur, Malaysia, June 8, 2009

Against these headwinds, airlines have been forced to reduce staff, cut flight schedules, and eliminate capacity by placing aircraft into storage and retirement. In a sign of the times, the deserts of the U.S. Southwest are full of aircraft that no longer meet the demanding market, operational, and financial requirements of their owners. Many with high operating and restoration costs will not fly again, spurned on by an arid financing environment for older aircraft. Most will be ‘parted out’, with high-value components removed and re-used to stock spares shelves.

Some components and structures are already being creatively recycled into new products – continuing their useful life and inspiring a new generation of aviation enthusiasts in the boardrooms and executive suites of the future.

Sources: Reuters, Forbes, ADVFN – August 27, 2009. (‘Industry’ includes both civil and defense.)

Rolland Vincent Associates, LLC is an aviation consulting firm. Drawing from over 25 years of aviation experience, we deliver trusted insights in market research, strategy, business and product development, industry analysis and financial modeling. We are here to help you understand customer needs and preferences, design products and services to delight your customers, and discover and seize business opportunities. We provide you with practical, intelligent solutions to unleash the power of your business and navigate for global aviation leadership.

Rolland Vincent Associates, LLC
7000 Independence Parkway, Suite 160-3, Plano, Texas 75025 USA
Tel: 972-439-2069 (U.S. Central Time) rvinch@rollandvincent.com www.rollandvincent.com