The fight for Global Markets
Is three the magic number?
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Delta Air Lines, United Airlines and American Airlines have presented a case for unfair competition from some of the Gulf-based airlines. Whatever the rights and wrongs of their case, which is based on subsidies that contribute to rates of growth which they claim cannot be justified by market demand, what we are seeing is the next stage of the battle for global air passenger markets.

This article doesn’t consider whether the US carriers have cause for their grumbles, but rather looks at why they’ve taken this action – and why now. There are two broad answers: the first is that they’ve taken many years to sort out their huge domestic market and reach a point where they are not haemorrhaging money. Having finally got domestic airline capacity under control and now that airline stocks are rising, it is time to look overseas for where future growth will come from.

The second answer is that the rest of the world’s aviation markets have moved on in the time that the US carriers have been inwardly focussed. Low-cost carriers (LCCs) have become an essential part of the aviation system, and air travel continues to become more accessible to more of the global population as a result. Fifteen years ago, the three big US airlines (Delta, United and American) were each founder members of the three large airline alliances which span the globe today (SkyTeam, Star Alliance and Oneworld respectively). Airline alliances were embraced as the means to overcome regulatory hurdles in international competition and become global international players.

However, since then, the largest carriers in other parts of the world have been experimenting with other means to compete – through joint ventures in local markets combined with common branding, through equity stakes and by creating multiple partnerships outside of formal alliances. In each continent there are now a small handful of successful airlines emerging which have the potential to become global competitors. As the US carriers look to their international markets they see a variety of new competitors and commercial partnerships. It’s not surprising Delta, United and American are spooked.

To understand the scale of threat we look first at how dominant airlines have arisen in country markets. We draw comparisons with other sectors and consider the ‘Rule of Three’, which is the observation that many mature markets have three dominant players. We then look at some dominant carriers emerging in each continent.

Finally, we ask if there are indicators now that might point to the successful winners in a truly global aviation market. If there were just three, which airlines would they be? Furthermore, what will it take to be a truly global competitor?

1 Restoring Open Skies: Addressing Subsidized Competition from State-Owned Airlines in Qatar and the UAE, American Airlines, Delta and United, January 2015
Not so global?

To the outsider, it might seem there can be few industries as global as aviation. Yet the history of airline development, based as it has been on flag carriers and national interests, means that it continues to operate within regulatory systems designed to protect airlines from competition, especially international competition. This means that industry development has not necessarily followed the trajectories seen in other industries, especially towards consolidation and the creation of global brands.

Of course, many countries, and even groups of countries, have made significant progress towards a more open operating environment for aviation. Indeed the US is one of those with its push for Open Skies agreements with its trading partners around the world. The US has been one of the strongest advocates of open skies, with over a hundred such agreements in place today.

The ‘Rule of Three’

The trend towards a few major players is not unique to aviation. Many industries are dominated by just a few large players, which compete alongside a number of much smaller product or market specialists. Academics have labelled this the ‘Rule of Three’, as many sectors have seen three successful companies emerge.

Source: Ivey Business Journal

These are far from isolated examples but a powerful empirical reality supported by research, the implications of which need to be factored into corporate strategy. The research points to one of two outcomes for successful businesses: either as dominant players offering a full range of services, or as product or market specialists. In between is ‘the ditch’ where firms fail to thrive, achieving neither strong financial performance nor significant market share.

The smartphone industry offers a good example of this: Samsung and Apple, each with more than a 20% of the market, are followed by Lenovo (which includes Motorola) with 6.5%. Nokia, once a familiar name, appears to have fallen in the ditch with their share of the global smartphone market falling from 48.7% in 2007 to just 3.1% by the middle of 2013.

Another sector with a few dominant players is the global sports footwear market where Nike have 33.6% global share and Adidas 19.1%. The story of Brooks, another firm making sports footwear, provides a lesson. Recognising that the business was on the brink of bankruptcy in 2001, the new CEO changed the strategy and refocused the business on just running shoes. Today Brooks has a 29% share of the speciality high performance running shoe market.

The airline industry is littered with aviation failures, businesses that ‘fell in the ditch’. Remember Kingfisher, Spanair and Cyprus Airways, all recent failures? However, there are more than a few airlines that would have disappeared by now if it wasn’t for the United States Chapter 11 Bankruptcy protection, enabling restructuring rather than failure, and European pride in their national carriers which has enabled the likes of Alitalia and TAP Portugal to stay afloat despite financial losses.

Observations of the market shares of top three firms in a number of industries show a pattern in which the market share of the top three players is typically around 40% : 20% : 10%, and together they serve 70% to 90% of the market. Furthermore, market evolution typically goes from small and unorganised through to consolidation and standardisation, and this can take place during periods of market expansion as much as when markets mature.

If this analysis holds true for airlines, it is only to be expected that we should see the emergence of three carriers in the mature aviation markets, be they country markets or regional markets. But is this true? To what extent has this happened, or is this happening, in aviation?

**Is three the magic number in aviation?**

The answer is probably yes.

In each of the top 10 commercial passenger air transport markets, based on seat capacity, the top three airline groups operate between 50% of all airline seats in the UK and 82% in Brazil. In every one of the top 10 markets, except China and the US, there is at least one LCC among the top three carrier groups.

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3 IDC Smartphone Vendor Market Share, Q4 2014
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Source: OAG Schedules Analyser

Capacity Share of the Top 3 Carriers* in the Top 10 Countries**

Top 10 Countries by Seat Capacity in 2014

* Top 3 Carrier Groups in each country
**Top 10 Countries determined by seat capacity.
All data sourced from OAG Schedules Analyser

Source: OAG Schedules Analyser, CAPA
The US – the world’s most mature market

The US is the world’s single largest air transport market. Having been deregulated back in 1978 the domestic market has been able to grow and mature like many other industries. New entrants have emerged (e.g. JetBlue), existing carriers have merged and some carriers have failed. However, the overall market has stagnated and even reduced in size. Total seat capacity, both domestic and international, is 9% smaller today than it was in 1996.

Airline capacity data from OAG Schedules Analyser shows that the US market has been through a period of consolidation, as would be expected in other mature industries. The three leading US carriers – based on seat capacity – are American, Delta and United – (with Southwest a close fourth), which together operate 59% of all US seat capacity, up from 37% nearly 20 years ago.

When we consider domestic capacity, this share becomes 62%. These three airlines are also ranked as the top three in the world with a combined share of 13% of global capacity.

Comparison of the Big 3 US, Chinese and Gulf Carriers

Source: OAG Schedules Analyser, CAPA
While Southwest sits close to the top three players now (15.9% share of capacity compared to United’s 16.0%), it has not always been so. When it started operations, the world of full service carriers was viewed as separate to the market which LCCs created and operated in. While the low-cost market has grown, Southwest has maintained its place as the dominant player. The top three LCCs in the US – Southwest, JetBlue and Spirit – now share over 80% of the LCC market. With market maturity has come some convergence of the business models. LCCs now provide over a quarter of capacity and when combined with the big three alliances, they account for 93% of US domestic capacity.

The merger of Delta and Northwest (now operating as Delta) in 2008-2010, United and Continental (now operating as United) in 2010-2012, and the merger of American and US Airways (now operating as American) in the last two years have been the most recent contributing factors to market consolidation.

However, the market has seen some consolidation both at this top end, as well as in the tail end. The total number of airlines operating to, from and within the US has fallen from 252 back in 1996 to 173 today – although in reality the top 10 carriers account for 87% of capacity. The sheer number of airlines in the tail end means that the airline industry can perhaps be likened to a sector such as the beer market with a few large players and a long list of much smaller craft and specialist beers catering to specific tastes and localised markets. American, United and Delta are the Budweiser, Coors and Miller of the US market.

The US carriers have been largely focused on their domestic markets in the last decade. After years of weak financial performance, they are finally – through consolidation and a favourable oil price – in a position where they appear to have come to grips with how to keep a lid on supply and push yields up. For the past year airline stocks have been rising. As a consequence, it is to be expected that the focus should shift to growth and to international markets.

A look at the latest schedule for a week in April compared to the same week in 2010 makes it clear that whilst US carriers have been growing international markets, foreign carriers have been growing faster. International capacity share for US carriers, of which the Big Three account for 83% seats has fallen from 57% to 53% allowing Gulf, Chinese and other carriers to increase their respective shares.
In particular, looking at the US-UAE market, it is highlighted very clearly that the US carriers have perhaps taken their eye off the ball, while the Gulf carriers have sought new markets to serve from their hubs.

Whilst international seat capacity still makes up only 13% of total US capacity, it cannot be ignored. US carriers are pursuing international growth, just not in all markets. Their focus appears to have been on those markets geographically closest, with Mexico featuring prominently as the country currently experiencing the largest volume of capacity growth from the US.

For long-haul markets, the airline alliances appear to have been the preferred tool for network expansion for the US carriers. For a week in April 2015, the three global alliances account for over half of all airline seat capacity (51%) and the US airlines are major players within them. In Star Alliance, United accounts for 19% of all seats. At SkyTeam, Delta accounts for 26% and American operates 45% of all Oneworld seats.
United, one of the three US airlines bringing the recent complaint became a founder member of the Star Alliance back in 1997. They saw this as a mechanism by which to extend international air services, in a world where rules and regulations prohibited international expansion in ways that other industries could. This move was quickly followed by American which was a founder member of Oneworld in 1999, and by Delta which was a founder member of SkyTeam in 2000.

It’s interesting that the case being made against the Gulf carriers does not recognise the use of alliances as part of the international strategy of US carriers.

**The Middle East Carriers – Capturing Growth**

Moving on to consider the major Gulf carriers and the focus of the recent complaints by US airlines, they are undoubtedly a growing force in global aviation. Although accounting for just 4% of global seat capacity, the Middle East has seen the greatest increase in airline seat capacity of any region over the last two decades, and is now more than three times bigger than it was in 1996.

The history of their market development is very different to the US carriers. Generally, without large domestic population bases to build a local market on, the approach of some of the Middle East based carriers has been to build market share through connecting long-haul and regional markets and facilitating connectivity at their hubs.

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8 As defined by IATA, OAG’s Schedules Analyser uses the ‘ME1’ category for the Middle East region.
This applies particularly to the Gulf’s big three: Emirates, Qatar Airways and Etihad and this is what is causing the headache for US airlines. Saudi Arabian Airlines actually operates more seat capacity than Etihad but they are the exception in that they have a substantial domestic and regional market, largely based on Hajj and pilgrimage traffic.

The approach to strategic development taken by these three carriers is supported by their governments, the focus on growth markets and a lack of low-cost competition. There are LCCs in the Middle East and they have developed in parallel to the Gulf’s big three, mostly operating complementary routes. In less than 20 years, Emirates has made the transition from niche player to full service generalist. Parallels could be drawn with the online travel booking industry which was in its infancy two decades ago, but has seen online bookings become the norm in the US and Europe where 44% of bookings are now made online. Online bookings are another sector dominated by a few brands – the US online travel booking market has just four players9 – Expedia, Priceline, Orbitz Worldwide and Travelocity, who share 95% of the market.

However, seat capacity analysis for all carriers operating to, from and within the Middle East shows the top three carriers to be Emirates, Saudi Arabian and Qatar Airways. Etihad is not among them. Etihad may be ranked 22nd in the world based on ASK’s but it is placed 61st in terms of airline seats operated, behind the likes of Vietnam Airlines and Jetstar.

While the whole Middle East market has grown substantially, the market share of the top three carriers has ranged between 35% and 40% over time, although in recent years it has moved upwards, exceeding 40% in 2013 and 2014. In other words the largest players at any one time have been growing broadly in line with the market. Emirates, the largest carrier, operates 19% of seats in the Middle East, almost twice as many as third placed Qatar Airways with 10%.

Without a significant local market, Emirates has embraced the need to grow internationally. As part of that, it signed an Open Skies agreement with the US in 1999. Qatar Airways signed a provisional agreement in 2001.

Doing it the Chinese way

While the target of the US concern has been Gulf carriers, it could equally have been Chinese carriers. After all, the Chinese carriers will operate 140% more seats to the US in a typical week in April 2015 compared to 2010. In contrast, the US carriers will have increased capacity by 80% in that time. This still leaves the US carriers with slightly more capacity on China-US routes but the Chinese carriers are closing in. However this is not surprising as it is indicative of the balance of the traffic (outbound Chinese passengers) and the cultural nuances of service difference.

While the US domestic aviation market has been deregulated for decades, the Chinese government has only slowly loosened its grip on the market. In a move to encourage strong domestic airlines, the Civil Aviation Administration of China (CAAC) announced in 2000 that the ten airlines it controlled would be merged into three airline groups, giving a boost to the three carriers which dominate Chinese aviation today.

The effect is evident in the greater capacity share of these three airlines from 2003. China Southern, China Eastern and Air China have been encouraged to grow but now more new entrant carriers are emerging and they are losing seat capacity in the face of rapid growth.

Back in 2010 there were 114 airlines operating scheduled air services to, from and within China, and the largest ten of these operated 82.9% of seats. By 2014 there were 144 carriers and the top ten operated 74.8% of seats.

Although there are plenty of foreign carriers looking for a piece of the Chinese action, much of the competition is coming from home-grown or Chinese domiciled airlines including a few LCCs. The share of Chinese capacity operated by Chinese carriers to and from China remains very high, and has increased from 89% in 1996 to 92% today.

The Chinese are clearly aware of their vast domestic market, and like the American carriers before them, are focusing on domestic development, but doing it their way. Aviation is not the only sector where the Chinese have taken their own approach to developing home-grown companies. In online retail they have developed TaoBao, a rival to eBay China and Amazon China. Similarly, Weibo is the Chinese answer to Twitter. Likewise, development of the LCC sector in China is happening the Chinese way with low levels of international LCC penetration (just 1% of international capacity to and from China) and the cautious development of Chinese LCCs such as Spring Airlines in Shanghai and most recently 9Air in Guangzhou.

One of the few attributes that the US and Chinese aviation markets have in common, perhaps, is the fact that their operations continue to be dominated by the needs of the domestic market. In both countries around nine in every ten seats operate on a domestic route.

An additional dimension in China is the emergence of Comac, the Chinese commercial airplane manufacturer, which has a strategic agreement to work with Bombardier and has considerable experience in manufacturing aircraft components. In another example of a market dominated by a few big players, Boeing provides 39.6% of commercial aircraft, and Airbus provides another 25.2%\textsuperscript{11}. The latest Boeing Current Market Outlook projects the need for 36,700 new aircraft between 2014 and 2033 of which 25,680, or 70%, will be single aisle aircraft and 6,020, or 16%, will be needed by China. China is expected to overtake the US as the world’s largest aviation market by 2033\textsuperscript{12}. Comac is developing a single aisle aircraft, the C919 and a smaller regional jet, the ARJ21 in recognition of this huge home grown demand for aircraft. The first customer deliveries of the C919, the single aisle aircraft being developed by Comac, are due in 2018 at which point the Americans, and Boeing in particular, may have more to worry about.

\textsuperscript{10} Includes Hong Kong, Macau and Chinese Taipei
\textsuperscript{11} Flightglobal ACAS database via https://novaworkboard.wordpress.com/2013/05/19/competition-in-the-aircraft-industry/
\textsuperscript{12} http://www.ft.com/cms/s/0/df239f40-68ba-11e4-af00-00144feabcdc0.html#axzz3XH97uAfH
Regional markets and the ‘Rule of Three’

Having shown that the ‘Rule of Three’ does appear to hold broadly true at a national level, at least in the more established markets, can the same be said about regional markets? Clearly the US, Middle East and China have each established three or four carriers which account for a major part of the market, but what about elsewhere?

While market concentration appears to be lower when we move from countries to regions, there still appears to be a few strong carrier groups emerging in each region. These groups detailed below are the largest 3 operators and/or groups by seat capacity in each of their respective markets.

In Latin America there are three carrier groups: LATAM, Avianca and Gol, who now operate 38% of all seat capacity. In Africa, South African Airways, Egyptair and Ethiopian operate 20% of capacity. In Europe the Deutsche Lufthansa, Air France/KLM and IAG groups operate 28% of capacity. In Asia Pacific as a whole, the China Southern, China Eastern and Air China carrier groups operate 22% of all seats.

With the exception of Europe, in each of these regions, there is little in the way of air liberalisation, let alone regional open skies agreements. The top three carriers each tend to be large national airlines with a strong position in their home market.

* Top 3 Carrier Groups in each region

Source: OAG Schedules Analyser
In Europe it is perhaps more surprising that the top three airlines only account for just over a fifth of the market given the creation of the European single market for aviation in the 1990s. Interestingly, the European hotel industry is also fragmented. The largest of the top ten hotel brands is Ibis which only provides 3.8% of hotel rooms. However, the hotel chains have a 38% share of the market and Accor, the largest chain, owns four of the brands in the top ten – Ibis, Novotel, Mercure and Sofitel.

However, the EU would argue that the internal market has enabled prices for passengers to fall and the number of routes offered to rise significantly, even if the number of airlines remains high. In 1996 there were 380 carriers operating in Europe but by 2014 this had fallen to 329. Nevertheless it appears that the process of consolidation through cross-border mergers and acquisitions which happens in many European sectors, has been slow to take hold. The likely reason is that airlines recognise the power of consumer brands and national identity and so the route to creating airlines which can compete internationally has been through airline ownership. Like Deutsche Lufthansa’s ownership of several airline brands, IAG is now the holding company for British Airways, Iberia, Vueling and is seeking to add Aer Lingus to its portfolio. The airlines continue to appear as distinct brands to consumers but are actually part of larger airline structures.
Is global aviation a special case?

If the ‘Rule of Three’ applies to domestic and regional air transport markets, does it apply to global aviation markets too? A glance at the major airline alliances might indicate that it does. With more than half of global airline seats provided by members of one alliance or another, there’s a compelling case. At the same time the alliances are simply an artifice, created to find a way around the many rules and regulations which prevent airlines from providing a truly international air service. In another industry without such rules, cross border mergers and acquisitions would be the norm. The carrying of fifth freedom\(^\text{14}\) traffic would be commonplace.

The airline alliances have, without doubt, served a purpose, but there are signs that they may be more fragile than they appear. The announcement earlier this year that Korean Air, a SkyTeam member, would be code-sharing with American, a key member of Oneworld, highlights how alliance members will still make decisions in their own best interests, and ahead of the alliance interests. Where that leaves the second tier players in alliances is unclear. At what point will the merits of being aligned to a few major carrier brands via an alliance be outweighed by the need to be more flexible and make strategic partnerships on a case-by-case basis. Carriers such as Virgin Australia, JetBlue and Air Baltic have eschewed membership of the traditional alliances for these sorts of strategic partnerships.

Furthermore, the rising stars of air transport are finding alternative means to expand their businesses on the global stage. Until recently, when Qatar joined Oneworld, none of the big Gulf carriers had joined alliances but Etihad has created multiple partnerships and has minority investments in airlines in Europe, India and Australia. For AirAsia and Avianca, global expansion has been through the creation of joint ventures operated under a common brand. In Europe, we’re seeing dominant carriers buying or taking equity stakes in other airline brands. There is no right way.

These models of global expansion have much more in common with other industries which have navigated the ‘Rule of Three’ at a global level than the airline alliance model, made up as they are of equity holdings and strong consumer brands. Airlines which have been particularly focused on their alliance membership as a conduit for their international strategy may have taken their eye off the market and the rapid changes taking place.

\(\text{14}\) http://www.icao.int/Pages/freedomsAir.aspx
Spotting the future global players

While it appears that the emergence of three dominant global airlines is still some way off, is it possible to see among the airlines of today which carriers might be the truly global players of tomorrow?

The US carriers may be the largest airlines globally for now, but would anyone place a bet on them being in pole position ten years from now? With a sluggish domestic market and a relatively small international market, it’s hard to see where the momentum for international expansion will come from.

In Europe, IAG is working towards being a global airline group, especially with the recent investment by Qatar Airways. Deutsche Lufthansa may be bigger but it is arguably more dependent on its Star Alliance membership.

What about the Gulf carriers? Could one or more of them be the leading global airline of the future? They are certainly expanding fast but with small home bases growth depends on access to international markets, and it’s hard to envisage when foreign carriers will have access to the vast domestic markets of other nations, such as the US or China.

The US carriers, in highlighting the ASK growth of the Gulf carriers, have drawn attention to airlines with bases a long way from home, but in a position to compete for traffic if they have the right aircraft. One of which is Turkish Airlines now ranking 11th in the world for ASK’s, ahead of Air China and Ryanair, and ahead of British Airways in terms of seat capacity. Turkish Airlines is a carrier which has made its way from niche carrier to full service provider on a massive scale and with the benefit of a large domestic market and strategically placed hubs, who knows how large it could grow.

The dominant Chinese airlines are well placed to take on a truly global role, with the strength and sustainability of a large domestic market.

The rapid growth of the LCCs might make them contenders to be global leaders, except they have the wrong fleets to develop long-haul networks, at least in the short to medium term. It would take some change of direction for them to become long-haul carriers although the convergence between legacy and low-cost business models, which is taking place, might make that transition easier. The focus on common branding alongside joint ventures, such as those that AirAsia utilises, might be the means to take this forward. What we do know is that in all major markets LCCs are playing a major role.

As the legacy and low-cost business models converge, inevitably some airlines will fall in the ditch, achieving neither a full service position in the market nor a specialist role. Can the low-cost and regional subsidiaries of legacy carriers, such as Germanwings and Hop!, survive? In markets such as Indonesia, can legacy carriers compete against the successful LCCs, such as Lion Air? And what about carriers such as Singapore Airlines, with a single hub airport and no domestic market? It too is creating its own form of alliance, albeit mostly ‘in-house’ at this stage with its range of subsidiaries.
Whilst it is perhaps impossible to predict the future of the airline industry, the evidence suggests that China, Indonesia and Turkey might be the places where three globally dominant airlines are based in ten years’ time, benefitting as they do from large domestic markets, growing economies and advantageous geographic position. What would your prediction be?
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