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# A 'new normal' for Gulf carriers?

One of the world's most successful aviation stories of the recent past has reached a more challenging chapter. For years, Gulf carriers charted a seemingly unstoppable course of double-digit growth in fleet, traffic, and revenue.[1] However, today, faced with both cyclical and structural challenges, these airlines must make some stark decisions about strategy, technology, and business model that will determine whether they can return to their previous stellar trajectory or whether they must adapt to a new, more moderate 'normal'.

## 'SUPER-CONNECTOR' MODEL

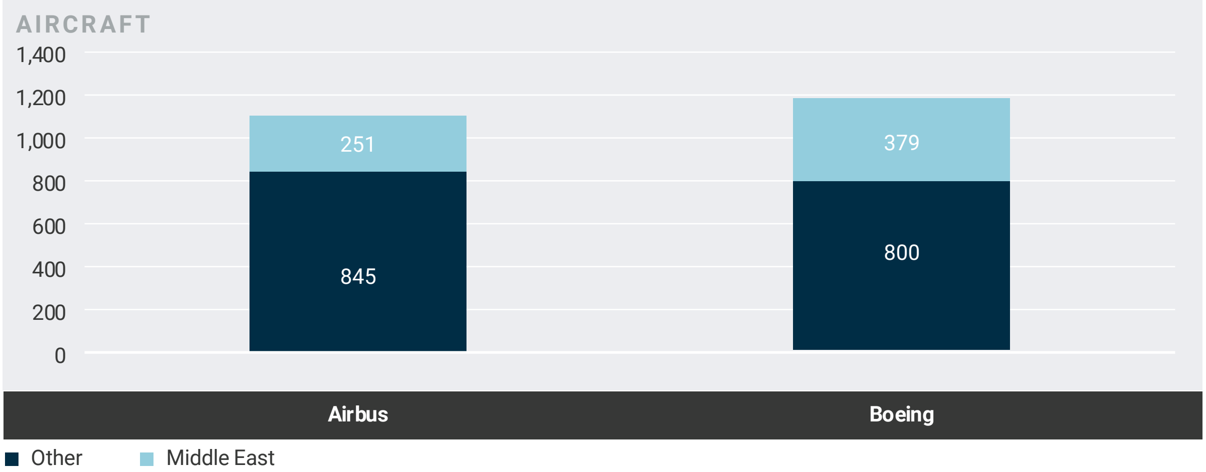
Beginning in the late 1990s, the Gulf carriers took advantage of their geographical position between Europe and Asia to build a 'super-connector' business model, which they enhanced with superior service and better-value fares. Following a hub-based strategy, these carriers were able to gain market share on all routes from North America and Europe to Asia-Pacific (APAC), competing head-to-head with legacy carriers in these regions. Their aggressive growth plans led them to become the largest purchasers of widebody commercial aircraft globally, culminating in the 2013 Dubai airshow, at which:

- Emirates made a firm order of 150 777Xs and 50 A380s;
- Etihad Airways ordered 50 A350s, 36 A320neos, 25 777Xs, and 30 787s; and
- Qatar Airways ordered 50 777-9Xs.[2]

To date, Middle East airlines represent 23% and 32% of Airbus[3] and Boeing[4] widebody aircraft backlog, respectively (figure 1). By way of comparison, they represent just 15% of current Airbus widebody fleet in operations.

[1] Company financial statements.
[2] Press release, Dubai Air Show, December 19, 2013, http://www.dubaiairshow.aero/press/press-releases/10-biggest-aircraft-deals-2013.
[3] http://www.airbus.com/aircraft/market/orders-deliveries.html#viewer.
[4] http://www.boeing.com/commercial/#/orders-deliveries.

**FIGURE 1:** WIDEBODY AIRCRAFT BACKLOG




Source: Airbus and Boeing websites

Airlines in Europe and the United States tried to hinder their expansion in various ways. For example, some carriers in the United States launched lobbying actions to contain traffic rights and slots access, alleging government subsidies to the Big Three Gulf carriers of more than $42 billion.[5] However, most of these efforts had little to no impact, largely because the US and European governments needed to balance their support for their legacy airlines with the needs of Boeing and Airbus, which received enormous orders from the Gulf carriers, helping to secure thousands of local jobs.

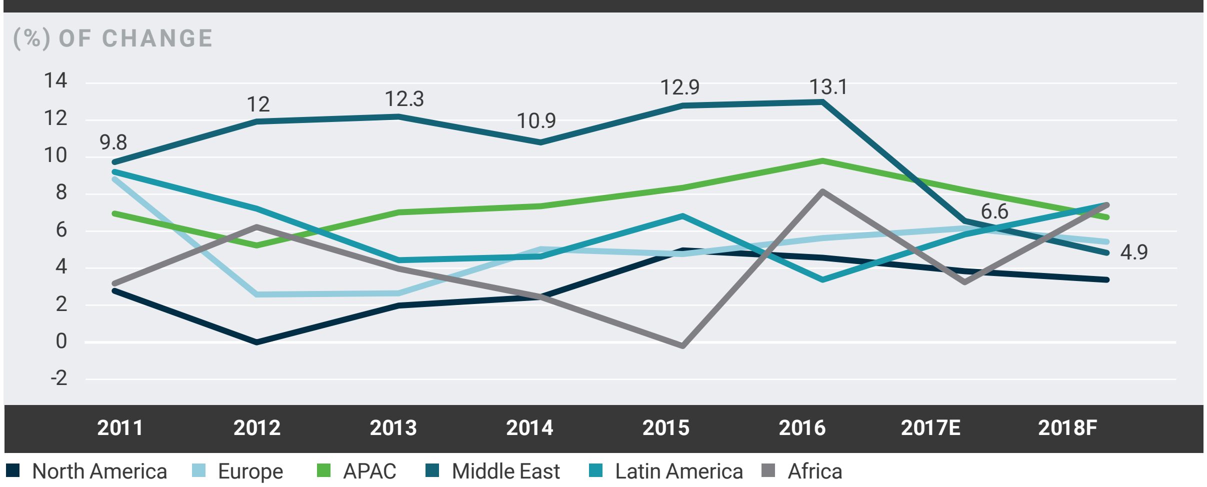
## MARKED DECELERATION

But in the past two years, the three Gulf airlines have seen a significant slowdown in growth. Capacity growth fell from an average of 11.8% in the six years from 2011 to 2016, to a meager 4.9% expected in 2018 (figure 2). At the same time, profits collapsed or even morphed into losses.

Beyond the obvious overall trend, with a profitability peak in 2015 for most players, a bit more context is needed for some:

- **Etihad Airways** is facing more than a simple slowdown in traffic degrading its financial performance. The $1.9 billion net loss in 2016 was mostly driven by one-off charges: $1.0 billion impairment on aircraft and $0.8 billion write-off on its equity stakes in Air Berlin and Alitalia.
- **Qatar Airways** has been hard hit by the embargo imposed by its Middle East neighbors in 2017. The airline announced it lost 20% of its revenues and that losses for its current fiscal year will be steep.

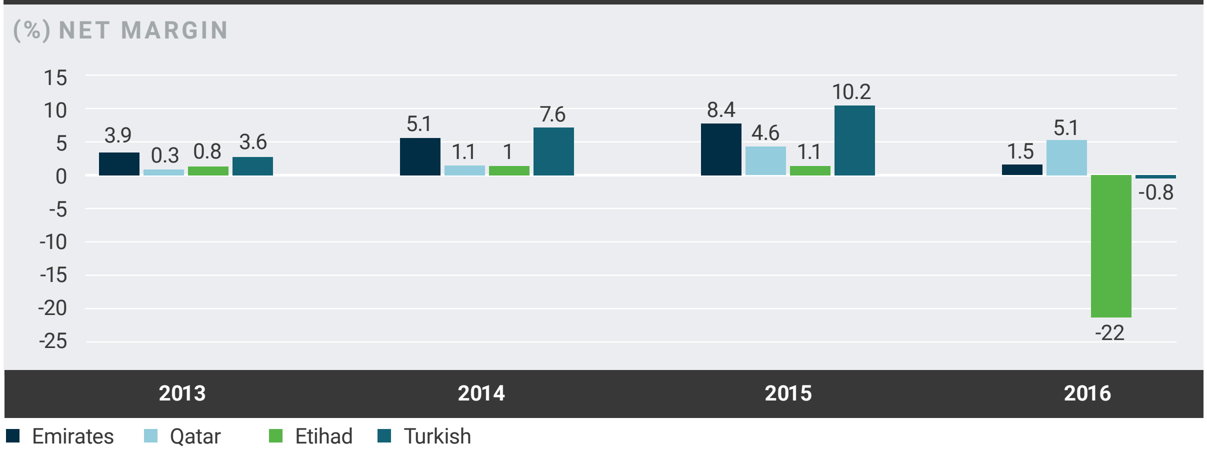
**FIGURE 2:** CARRIER CAPACITY CHANGE




Source: IATA facts sheet, December 2017
Note: Year-over-year % change to Available Seat Kilometers (ASK)

[5] Partnership for Open and Fair Skies, 'U.S. airlines, unions reveal evidence of $42 billion in subsidies and benefits by Qatar and the UAE to their state-owned carriers,' *PR Newswire*, March 5, 2015, https://www.prnewswire.com/news-releases/us-airlines-unions-reveal-evidence-of-42-billion-in-subsidies-and-benefits-by-qatar-and-the-uae-to-their-state-owned-carriers-300046283.html.

**FIGURE 3:** EXTENDED GULF CARRIERS – NET PROFIT MARGIN




Source: Companies' websites, financial statements
Note: Jan 1-Dec 31 FY for Etihad and Turkish and Apr 1-Mar 31 FY for Emirates and Qatar.

## IS THIS A TEMPORARY SETBACK OR A SYSTEMIC SHIFT?

At first glance, much of their woes in the last 18 months seem to be an unfortunate congruence of circumstances:

- Premium business traffic in the Gulf region, which is heavily driven by the oil and gas industry, dropped on the back of falling oil prices and subsequent cost cutting.
- Political and security factors have also played a key role. Terrorist attacks in Europe and the Middle East, along with the coup attempt in Turkey and the embargo on Qatar have hit their businesses hard.
- Finally, the Trump administration's tougher flight regulations and visa restrictions have also impacted passenger traffic.

And these factors are impacting the Gulf carriers at precisely the time when airlines in other regions are enjoying exceptional profits. Ironically, while low oil prices have had both pluses and minuses for the Big Three, carriers in the rest of the world have generally only benefited from low prices, driving profits higher.

In Europe intense competition from low-cost carriers, legacy structural issues, a lack of scale, and cost pressure caused the collapse of Alitalia, AirBerlin, and Monarch Airlines in 2017. Those airlines left standing will benefit from the less-crowded field. In the United States, profits have helped some airlines build an international network of equity stakes, exemplified by Delta Air Lines' four-way deal with Air France-KLM, Virgin Atlantic and China Eastern.

In addition, new aircraft, specifically 787s and A350s, now have made it profitable to connect secondary cities on some long-haul flights. While the longest routes still require a hub strategy, this has also impacted Gulf carrier traffic.

## ADJUSTING AND RIGHT-SIZING TO A 'NEW NORMAL' ENVIRONMENT

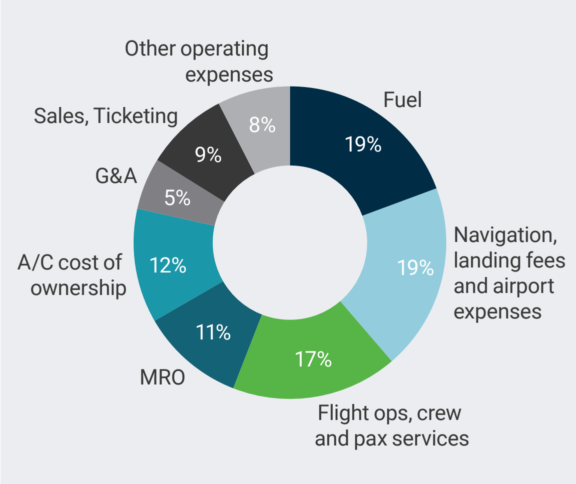
Although some of the factors may indeed be temporary, to what extent should the Gulf carriers' past strategy be challenged and revisited? In our view, a real transformation should be launched focusing on the following main areas.

**Right-size fleet plans:** What does the new market context mean for major orders they placed four to five years ago? Gulf airlines still have an aircraft backlog dating back to their double-digit growth days and should readjust fleet plans to the 'new normal' growth ahead. They should quickly act to either reschedule orders or adjust their leasing strategy to avoid too high a drop in load factors.

**Streamline their cost structure (figure 4):** For years, Gulf carriers' primary goal was to establish their brand and gain market share, which they did successfully. Profitability and cost control were not a top priority.

> …the long-term test will be these carriers' ability to transform their strategy and business and operating models, including technology…"

**FIGURE 4:** AIRLINE COST STRUCTURE




Source: AlixPartners analysis

That era is now over. Emirates and Etihad have launched cost reduction initiatives with low single-digit headcount reduction, mostly focused on overhead. But this exercise must be systematic and ambitious, targeting all operating costs, and sized to fit the 'new normal' growth plans, while retaining the service excellence which has enabled their commercial success.

**Leverage digital to improve operations and transform their business model:** Digital technologies must be more systematically utilized for all aspects of the airlines' business from the end-to-end passenger's journey, to revenue management, network optimization, and operations efficiency (for example, maintenance costs reduction, fuel burn optimization, and administrative tasks and reporting reduction).

**Develop regional collaboration, even consolidation:** Emirates and flydubai have taken a first step in collaboration, by launching codeshares that will allow Emirates to benefit from the low-cost carrier's strong regional network to feed its Dubai hub.

The Big Three should look more closely at their network structure and consider how they could generate more connections with other carriers, especially low-cost ones. Perhaps some less profitable routes could be assigned to their partners.

The next question is tougher. Is there a large enough market for three premium hub players in the region with similar strategies and positioning? Qatar will continue its standalone path. But some experts expect further cooperation among the Emirati airlines whose hubs are only 150 kilometers away from each other. However, we do not see any consolidation as likely in the near-to-medium term.

**Rethink strategic partnerships and equity investments:** The three airlines have had different approaches, and some strategies have failed while others have been much more successful:

- **Emirates** mainly focused on organic growth and did not invest in other carriers or join any alliance.
- **Etihad** invested in Alitalia, Air Berlin, and other second-tier and/or struggling carriers, leading to losses in the billions and ultimately in the departure of their chief executive.
- In contrast, **Qatar** took equity stakes in much stronger airlines, mostly in the Oneworld alliance it belongs to, such as the International Airline Group, Latam, and Cathay Pacific. Codeshare agreements aimed at increasing traffic through hubs followed these equity partners. For example, their codeshare agreement with Latam was signed in 2017, a few months after the equity investment.

This last strategy, which drives traffic into the hub, is the right approach and is similar to the one pursued by Delta Air Lines.

## FINAL THOUGHTS

In conclusion, although the growth trajectory of the Big Three appeared unstoppable only two years ago, lower fuel costs and a tough political and security context have tilted the balance back towards legacy airlines and low-cost carriers in Europe and the Americas. We expect Qatar, Emirates, and Etihad to continue growing, but the rate of growth will likely be slower than the past decade.

Whether or not these specific challenges prove temporary, the long-term test will be these carriers' ability to transform their strategy and business and operating models, including technology, to adapt to this 'new normal' environment. **A**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