The long march of the Middle East titans

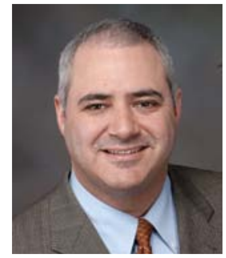
By Jonathan M. Berger, *Vice President – Aerospace & MRO Advisory – ICF International.*

On a recent business trip, I had a last-minute itinerary change and found myself needing to travel from Kuala Lumpur to Buenos Aires. The travel search engine came up with only a single one-stop option: Emirates via Dubai. And the price for a business-class seat was very reasonable given the three day advanced notice. Once onboard, the quality of the product was impressive; a 20" TV monitor, electric window shades, spacious fully lie flat seat – perhaps this grueling 20+ hour journey was not going to be so bad after all. The meal choices read like a fine dining menu - a myriad of options with something for all global palates. The in-flight entertainment (IFE) system boasted over 2,000 channels of movies, TV shows, music and games, on demand and in multiple languages (I was not only able to catch up on a few episodes of Mad Men, I binge watched a full three seasons!) As I changed planes in Dubai, I was directed to the business class lounge that was itself the size of most airport terminals. Throughout my subsequent connecting flight to Buenos Aires, I kept thinking to myself "how can any airline compete with this"?

I must admit, early on I was skeptical of the business models of the big three Middle East titans: Emirates, Qatar, and Etihad. I recall attending the 2003 Paris Air Show when Emirates announced the acquisition of 23 A380 and 26 Boeing 777 aircraft on top of its order for 22 A380s and 25 777's just one year prior. Etihad and Qatar made similar purchases worth billions of dollars. My business instincts could not accept the viability of three mega-carriers with hubs in small cities that are geographically so close together that it would be equivalent to the Florida cities of Miami, Tampa, and Jacksonville (or Hamburg, Berlin, and Dusseldorf) all starting their own global airlines. It just didn't add up. A decade later, it is clear that my trusted instincts failed me, as the three Middle East titans have all seen spectacular growth and become a force to be reckoned with in the highly competitive global aviation industry.

Interestingly, the three titan's business models have evolved differently as they each have carved out their own respective growth strategies. Abu Dhabi-based Etihad Airways has taken the M&A route, strategically leveraging its cost of (and access to) capital to acquire major equity holdings across a network of distressed airlines. Over the past few years, Etihad has acquired stakes in Air Berlin, Alitalia, Jet Airways, Virgin Australia, Air Serbia, and Air Seychelles to name a few. Doha-based Qatar Airways is the only titan to have joined one of the powerful global airline alliances, oneworld, which provides access to passengers and destinations aligned with partners British Airways, American Airlines, LATAM, Japan Airlines, and Cathay Pacific among others. Dubai-based Emirates Airlines with a fleet plan that includes over 140 A380s and 300 Boeing 777s has elected to go it alone. In 2014, its Dubai hub became the world's busiest international airport ahead of London's Heathrow. Emirates clearly aspires to remain the dominant carrier in the Gulf region.

While their growth strategies are clearly different, the titans do share the same core business model; leveraging their geographic location to connect Asia to the world – all on a convenient, time saving one-stop basis, utilizing the most modern aircraft, with high quality service and in-flight amenities. Given the growth of Asia's emerging economies and population, with tens of millions moving into the middle class every year, it appears that the business model is indeed sound.

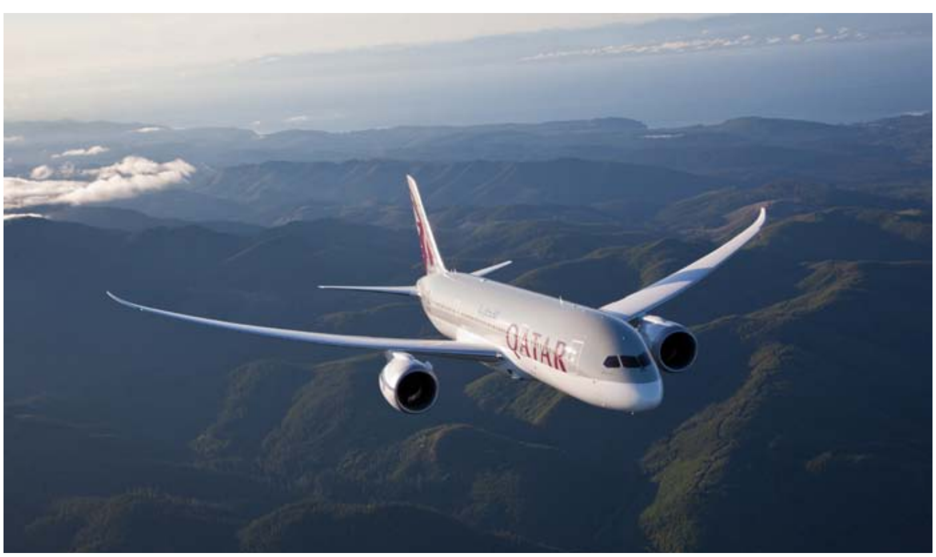


Berger - Middle East titans are on a long, patient march to an airport near you.

More importantly, the titans share another key attribute – they take the long view. In hindsight, the blind spot missed by the skeptics, myself included, is the time horizon and patience that the titan's shareholders have to achieve a satisfactory financial return on invested capital (ROIC). The Gulf carriers' primary goal is to support the development of their national economies, and therefore think about ROIC in terms of decades rather than fiscal quarters. Lastly, unlike their global competitors, the Middle East titans are not just creating competitive air carriers - they are building lifestyle brands exemplified by their sponsorships of elite marquee sporting events like Formula 1 racing, professional soccer/football, and even public transport (e.g. London's "Emirates Air Line" cable car). The ubiquitous Gulf carrier branded jerseys are worn by children from virtually every youth soccer pitch from Brazil to China. And today's FC-Barcelona-jersey-wearing kids are tomorrow's potential business travelers.

As a major global aviation consultancy, my employer ICF is continually asked by the investment community if the Gulf carriers pose an existential threat to legacy European, Asian, and US airlines. My response begins with an emphatic "yes." However, before the wolves of Wall Street have a chance to liquidate their positions in the legacy carriers, I add that I also believe that legacy carriers pose an existential threat to the Gulf carriers as well. In the highly competitive global aviation battlefield, any carrier who doesn't feel threatened by their competitors and loses focus on innovation and efficiency is doomed to fail.

That said, legacy carriers possess numerous arrows in their quiver with which to compete effectively with the Middle East titans, not unlike their adaptation to the previous "existential threat" posed by the fast growing low cost carriers (LCCs). For example, never underestimate the power of home carrier frequent flyer programs. Much like

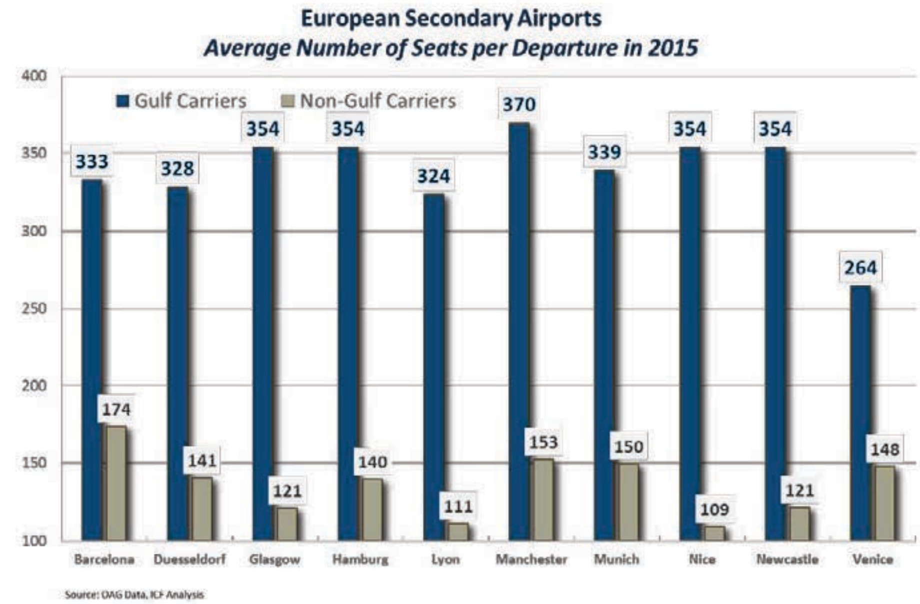


In terms of MRO, the major Middle East carriers each have forged a different path forward. *Photo: Boeing* the face-painting sporting fan zealots blindly loyal to their hometown clubs, nationalism and the desire to achieve elite loyalty program status remain powerful airline marketing tools. In addition, legacy airlines have the ability to further grow their alliances and JVs with Asian carriers to overfly the Gulf mega-hubs.

From a competition standpoint, the titan's natural first targets were the struggling European carriers. Unlike their US counterparts, European carriers have been slow to restructure and consolidate. Further, fast growing European LCCs (e.g. Ryanair and easyJet) continue to capture ever-more market share. Now that the titans have secured a presence in most of the major European airports, it's fascinating to watch how they are deploying their newly delivered wide body aircraft. As we all know, profit margins in the airline business are razor thin, often with the sale of just one or two business class seats making difference between a flight's profit or loss. Hence it's intriguing to see the titans now targeting secondary European airports in an attempt to poach the connecting business class traveler from the national carriers. It is difficult to imagine that the cities of Manchester, England and Munich, Germany could consistently fill an A380. But much to the European national carriers chagrin, Emirates appears to have these, and other secondary airports, in their cross-hairs. According to a recent article in the Economist magazine, Lufthansa's Frankfurt hub has lost nearly a third of its market share on routes between Europe and Asia since 2005, with more than three million people now flying annually from Germany to other destinations via Gulf hubs.

With statistics like these, it's no wonder the major US carriers have banded together to file a complaint with the US Department of Transportation accusing the Gulf carriers of violating the bilateral Open-Skies agreement. The US majors are hoping to halt the titan's US expansion plans until a level playing field is achieved. Similar to the decades-long subsidy dispute between Boeing and Airbus, it seems that for the time being, the tit-for-tat accusations between the Gulf carriers and their US counterparts will continue to play out in the court of public opinion. For example, Delta Air Lines CEO Richard Anderson recently gave a speech at the Detroit Economic Club where he compared the situation of US carriers to the "unfair trading practices" that devastated the Big Three auto manufacturers in the 1980s and 1990s. Regardless of which side of this corporate drama you believe has merit, the real winners of this politically charged dispute will be the respective PR firms, lobbyists, and lawyers.

That said, a very interesting wrinkle worth noting is how Qatar Airways responds. Qatar is not only a oneworld partner with American Airlines, but also a shareholder in IAG, whose oneworld member airlines British Airways and Iberia have, perhaps begrudgingly, publicly sided with Gulf carriers, stating that "To shield US airlines from their competitors would be to grant them the biggest subsidy of all.". Qatar has already threatened to leave the alliance, and given Emirates' successful go-it-alone strategy, there is good reason to believe that they are not bluffing.



On the MRO front, the titans each have forged a different path forward. While they leverage their volume and scale to negotiate competitive support agreements with the OEMs for engine and component maintenance, no airframe MRO has the capital required to build facilities capable of handling Emirates' wide body fleet. Therefore, Emirates had no choice but to go-it-alone for its airframe heavy maintenance requirements. Accordingly, and in classic Dubai fashion, Emirates has erected a massive complex of A380-capable hangars to perform its airframe heavy checks in-house. In contrast, Qatar has elected, at least for the time being, to outsource its airframe heavy maintenance (while also outsourcing its engines and components).

Etihad on the other hand, or more appropriately its owner Mubadala, the investment vehicle of the Government of Abu Dhabi, has charted a different MRO course. In 2006, Mubadala acquired the full service global MRO leader SR Technics and a year later assumed control of Gulf Aircraft Maintenance Company (GAMCO) that was rebranded as Abu Dhabi Aircraft Technologies (ADAT). Most recently, in 2014, the airframe heavy maintenance business of ADAT was transferred to Etihad to become Etihad Engineering. Today, Etihad relies on its in-house Etihad Engineering for airframe maintenance support, on SR Technics for the majority of its component support, and on engine OEMs and the Mubadala-owned Turbine Services & Solutions (TS&S) for engine support.

Given the growing technological complexity of maintaining new generation aircraft (e.g. A350 and Boeing 787), the transition of metal aircraft to composites, analogue instrumentation to digital avionics, and bespoke interiors and IFE systems which require the craftsmanship of a Swiss watch maker to maintain, it will be interesting to watch how Etihad's relationship with sister company SR Technics continues to evolve.

Like it or not, the Middle East titans are on a long, patient march to an airport near you - regardless of the continent where you live. And they will continue to disrupt the traditional home-court advantage enjoyed by the world's national carriers; complacency is the enemy, and innovation the solution. As a frequent international business traveler, I look forward to continue reaping the benefits brought on by the competition that Middle East airline titans are injecting into the global airline industry.

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