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# PANORAMA SECTORS

THE COFACE ECONOMIC PUBLICATIONS

SEPTEMBER 2014

By Coface Group Economists in Paris



**T**his panorama at the end of the summer holidays focuses primarily on assessing sector risk in 14 sectors of business in three major geographic regions. What are the main trends? North America's economy remains robust and dynamic, despite the rough winter weather in the first quarter of 2014. US companies have a strong capital base that enables them to keep risks at relatively low levels and to conquer new markets. The sectors in emerging Asia are enjoying steady growth, but the sword of Damocles - overcapacity - that is hanging over business activity in sectors like construction, chemicals or metallurgy is a risk which Coface's economists are factoring in. Restructuring will, therefore, take time.

Accordingly, we are downgrading the assessments of the construction sector to high risk and that for paper-wood to medium risk. In Western Europe, companies are gradually getting their heads above water. Without ignoring the difficulties associated with a recovery that has been too slow and uneven, depending on the country, we are upgrading the assessments for the metallurgy and automotive sectors in this region from very high risk to high risk.

This section is followed by a focus on the future of Europe's airlines. These companies are entering a pivotal period, which is prompting them to change. Since the liberalisation of the European domestic market in 1997, competitive pressures have been growing at a frenetic pace, which is making things diffi-

cult for the legacy airlines. On the one hand, they have not sufficiently developed their low-cost services, and on the other hand, foreign airlines from the Gulf, Asia or Turkey are gaining an ever-larger share of the long-haul market. The time has come for the major European players, which have now become the least profitable airlines in the world, to change. Changes on the US domestic market, where liberalisation took place in 1978, show the advantages and disadvantages of ever-greater concentration. What is the scenario for the single European sky? Will the Community institutions push for more openness in this very particular market or will we see the emergence of «mega players»?

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**coface**  
FOR SAFER TRADE

SEPTEMBER 2014

# SECTOR BAROMETER

BY OUR ECONOMISTS



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## Major trends :

- Improving sector risks in Western Europe and North America is stable
- Alertness on sector risks in Emerging Asia

Despite stagnant growth in the 2<sup>nd</sup> quarter of 2014 in the euro zone, sector risks in Western Europe are improving, according to Coface, which has reclassified the metallurgy and automotive sectors as high risk. In North America, growth remains

buoyant and Coface is maintaining stable sector risk ratings. Finally, it remains vigilant as regards Asia, downgrading the construction and wood-paper sectors, in view of the industrial restructuring being pursued in order to address over-capacity.

Below you will find a sectorial risk assessment table completed by a 6 sectors detailed analysis.

SECTORIAL RISK ASSESSMENT			
Sectors	Emerging Asia	North America	Western Europe *
Agro-food	●	●	●
Automotives	●	●	●
Chemicals	●	●	●
Construction	●	●	●
Electronics, IT **	●	●	●
Energy	●	●	●
Engineering	●	●	●
Metals	●	●	●
Paper-Wood	●	●	●
Pharmaceuticals	●	●	●
Retail	●	●	●
Services	●	●	●
Textile-clothing	●	●	●
Transportation	●	●	●

Sources : Datastream, Coface

● Moderate risk ● Medium risk ● High risk ● Very high risk

\* See credit risk chart page 6

\*\* Electronics, information technology and telecoms

## 1 AGRO-FOOD

World production of cereals and oilseeds in 2014 is forecast to reach record volumes, resulting in lower prices. This is due to favourable meteorological conditions since the spring. North America will benefit from exceptional soya production in the United States. Europe too is expecting high rapeseed production, but will have to cope with the consequences of the Russian embargo on some of its companies. Meanwhile, production continues to grow in Asia, in conjunction with the rise of the middle class.

### Western Europe

Activity remained very dynamic in the second half (+9.0% year on year) accompanied by a rise in production volumes. Nonetheless, some markets are still struggling, particularly in Italy and in France. In a context of abundant harvests, prices for food products (excluding alcohol) will continue to fall in Europe, which could weaken the sector during the second half of the year. With France being the country most affected, consumer prices entered into a spell of deflation in July 2014 (-0.3% year on year). On a quarterly basis, the scale of the decline in prices at the end of July for fruit (-7.3%) and vegetables (-7.5%) was substantial in the euro zone and most marked in France where fruit prices fell by 11.6%. Moreover, the Russian embargo on western food products poses the risk of bottlenecks in Europe. The dairy industry, with €1.3 billion in exports<sup>(1)</sup> in 2013 (+10.3% compared with 2012) appears to be hardest hit. The risk remains medium but the impact of the Russian embargo must be watched.

### Emerging Asia

Growth in this market has held up (+4.3% year on year), despite the weak start to the monsoon season. In India, rainfall at the end of August was 18% below the average for the past five years. The next few weeks will, therefore, be decisive. India, home to a quarter of all undernourished people worldwide, is expanding its production capacity. According to the FAO, fish output has, accordingly, doubled over the last decade and the fishing industry is now second in the world after China. Regionally, the sector's profitability<sup>(2)</sup> has stabilised since late 2012 to settle at 18.1% year on year, but is still below that of the other regions. This is because emerging Asia is characterised by small-scale operations, which limits their profitability. Meanwhile, the Pacific region is likely to be hit by an El Niño-type weather effect. The risk rating remains medium.

### North America

The United States is heading for record outputs of soya and maize, which has driven the prices of these foodstuffs down to their lowest levels since September 2010. Soybean production volumes could reach their highest level since 1998. While sales growth weakened in Q2 2014 (+1.8% year on year), the industry is storing up massive stocks to limit the fall in profitability, which stabilised at 12.7% year on year at the end of June 2014.

## 2 AUTOMOTIVES

Western Europe seems to be back on track, after several very difficult years. North America continues to recover, while emerging Asia is still posting good results.

### Western Europe

At the end of June, automotive sales in Western Europe showed 10 successive months of increasing sales. German manufacturers are still benefiting from their positioning in the premium market, as well as their top spot for sales in China. As regards auto parts suppliers, they benefit from their access to the most dynamic markets. In the UK, the market is now in its second year of continuous growth, while the British automotive industry is a powerful export engine. Cash flows are up 10% over one

year (end June 2014), and profitability is up by 2.2%. However, several segments are still performing poorly, in particular the distributors, first victim of the price war, which is eroding their margins. Finally, the second and third rank component suppliers are suffering from severe constraints limiting the sectors major clients. This start to the recovery improves our credit risk assessment so the sector has now moved to high risk.

### Emerging Asia

In China, automotive production continues at a frenetic rate. In the first 7 months of 2014, new car sales rose by 11% compared with the same period in 2013. Cash flow was up by 7.5% at the end of June 2014, year on year, while turnover

(1) Milk, dairy products, cheese, butter,

(2) EBITDA/Turnover

figures recorded a double-digit rise of 12%. Risk remains modest. Nevertheless, the steps taken by the authorities to reverse the environmental degradation experienced by China's major cities entails a risk for automotive manufacturers, as it could hamper the vitality of the market.

#### North America

US automotive sales increased by a total of 4.6% at the end of July 2014 year on year. An increase due to a sound economic environment, low interest rates, as well as consumers' desire for new

models to replace an ageing fleet. Some segments of the market seem to be flourishing, such as SUVs. American consumers clearly want new cars, but there is also demand from businesses, encouraged by pricing discounts. As a result, automotive plants continue to operate at full capacity, achieving almost 90% utilisation. Cash flow climbed 24%, year on year, as at end June. Net debt diminished by 9%, and profitability continued upward, rising by 3.7%. Risk, therefore, remains moderate.

## 3 CHEMICALS

Growth in the sector is subdued in Western Europe, where German industrialists are holding the fort while the others continue to suffer. In Emerging Asia, there is overcapacity in the sector, so there is little visibility regarding the financial stability of chemical companies. Finally, in North America, the short-term outlook is favourable.

### «Aggressive commercial approach of companies in Asia and the Middle East in the basic chemicals sector»

#### Western Europe

German companies are expecting timid growth in output (+1% between 2013 et 2014) thanks to their positioning in speciality chemicals. However, the difficulties faced by the large majority of companies in Western Europe do not give grounds for optimism. The aggressive commercial approach of companies in Asia and the Middle East in the basic chemicals sector is putting downward pressure on prices, which equally impacts on margins. Moreover, the fragile macro-economic climate means we are unable to change our risk assessment, which is still rated high.

#### Emerging Asia

Risk is still high in emerging Asia, especially in China. Difficulties in obtaining credit are making life difficult for SMEs in the sector. Meanwhile, still high production capacity, together with the severe downturn in the construction sector is preventing Chinese chemicals companies from realising their hopes. Stocks are building up, especially stocks of ethylene derivatives. Net debt was up 5%, year on year, as at end June 2014. In the short-term, the outlook for a sector with clear overcapacity issues is not good.

#### North America

North American chemicals companies have a cost advantage over their European competitors, as is reflected by their profitability which increased by almost 12% as at end June, year on year. This region is highly prized by chemicals firms from across the world, thanks to the availability of cheap energy, which is also a plentiful and cheap raw material. Moreover, the health of the construction and, above all, the automotive sectors, provides the companies in this sector with outlets for their products. Risk remains medium, but the outlook is positive in the near term.

## 4 CONSTRUCTION

The assessment of sectorial risk differs according to the region. Western Europe continues to see activity contract. North America is bullish about its expansion, with businesses profiting from solid growth. Emerging Asia is contending with a downturn in activity, especially in China.

#### Western Europe

Construction in Western Europe continues to contract, except in the United Kingdom and Spain Eurostat figures show output in the industry continuing to fall (-0.5% in June 2014 compared to June 2013). The decline is even more

marked in the Eurozone (-2.3%). According to Markit, the sector remains in contraction territory in Germany, with no positive news regarding building permits. In France, the situation is problematic, the number of building permits were down as at end July 2014 by around 15.7%. Housing starts also continued to fall over the same period, by 10%. Spain has done better, with four quarters of successive growth, which, however, conceals a market in convalescence, given the seriousness of the previous crisis. Inter-company risk is still high.

### «The images of ghost towns in China are now haunting investors»

#### North America

Companies are benefiting from the economic momentum. All signals are on green according to the Census Bureau, with a rise of 8.1% in residential building permits in July 2014 compared with July 2013. Lower unemployment and low interest rates make it easier for households to own property. Nonetheless, pre-crisis levels are

a long way from being achieved and companies remain weak following a difficult winter and with a very probable rise in interest rates to come. Profitability stagnated at around 1% in late June 2014, over a one-year period, as did cash-flows (+0.8%) Risk remains medium.

#### Emerging Asia

China's property sector is beset by overcapacity. Property developers in several of the country's large cities are facing huge difficulties in selling off their stock (vacancy rate of almost 10% in the major cities), despite price discounting. Prices are, therefore, heading south, which is having an impact on the construction sector. This is explained by increasingly stringent credit conditions, and by the fact that local authority debt has risen in recent years such that they are unable to participate in financing the acquisition of land for construction. The images of ghost towns, already known in Southern Europe are now haunting investors. As a result, construction sector companies showed a net rise in indebtedness of around 7% at the end of June 2014, year on year. Intercompany risk is deteriorating and has become high.

## 5 METALS

During the first six months of 2014, world steel production reached 821.3 million tonnes (Mt), representing an increase of 3.1% compared with the first six months of 2013. Growth was driven mainly by the EU28 (+3.8%) and Asia (+2.9%). As for Ukraine, production shrank by 6% in June. Although the environment is favourable to a rise in global demand, overcapacity is having a lasting impact on the sector.

#### Western Europe

The first half of 2014 confirmed the slight upturn which became apparent at the start of the year. Company sales figures began to rise again (+3.9% over a 12-month period), and company debt was down, declining by 2.42% over the first quarter and hardly increasing over the second quarter. At the same time, their profitability has strongly improved. This is due, in particular, to the recovery of the automotive sector in various European countries, such as Germany, Spain, Italy and Poland. Automotives represent 18% of the steel industry's outlets. Although investments are picking up, Europe remains hampered by overcapacity (estimated by UBS at 20Mt), although restructuring of the Ilva site (partial closure) could result in moderating this overcapacity.

#### North America

The decline in the sales figures for companies in the sector continues (-6.4% over a 12-month period), while their debt levels are rising sharply. Production in the United States remains stable, despite pressure from imports, which are 34% up on the same period in 2013, in particular in the pipe and tube sector.

#### Emerging Asia

China has consolidated its position as the world's leading steel manufacturer with a market share of over 50%. In June 2014, output rose by 4.5% compared with June 2013. Despite the slowdown in construction, companies in this sector have recorded an 8.4% increase in sales over the past 12 months. The closure of some non-profitable sites has resulted in improved profitability (+13% over a 12-month period). However, Chinese overcapacity is affecting the market by driving down global steel prices.

## 6 PAPER/WOOD

Internationalisation, environmentally friendly, and innovation are the three terms which best characterise this sector. Over the past twelve months, companies in the sector have seen, at world level, both their turnover increase - by 5.5% - as well as their profitability (+6.5% over a 12-month period). Several factors are behind this growth: the dynamism of some sub-sectors, such as hygiene products, the Chinese authorities' wish to close obsolete sites (3.97 million tonnes/year of capacity are expected to vanish in 2014) in order to restructure the market. However, these factors have impacted on prices. Their downward trends are weakening company margins and are indirectly favouring the trend towards consolidation which has been taking place over recent years.

### Western Europe

Rationalisation is continuing in Europe with the closure of non-profitable or non-strategic sites. Companies in the sector have seen turnover rise again (+7.9% over a 12-month period), and a slight increase in cash flow (+1.7%). The difficulties in the construction sector in turn are affecting the wood sector.

### North America

Driven by growth in the US construction sector, wood production is expected to grow by about 5% with positive repercussions on prices and on companies which have seen their turnover rise by 4.2%. Nonetheless, profitability remains weak.

### Emerging Asia

China has overtaken the United States as far as paper production is concerned. The growing role of innovation in the paper industry as well as the start up of new production plants means it is able to position itself on the «low-cost» paper market. Companies in the sector have posted a 10% increase in profits over the past twelve months and debt is reducing by a similar amount (-11%). However, an increase in Chinese insolvencies in the paper sector leads us to downgrade the sector in medium risk.

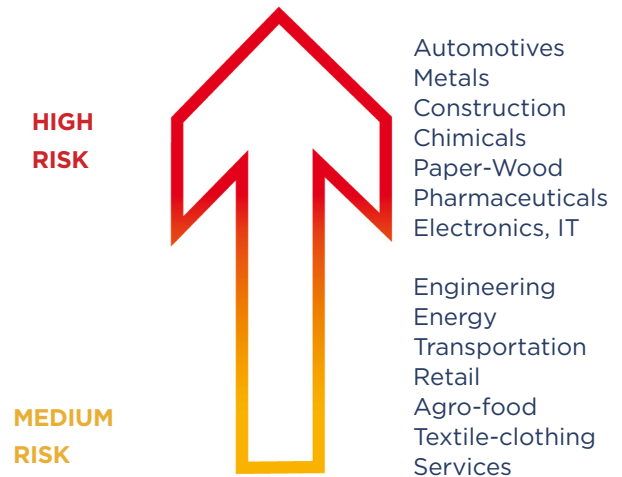
### Sectorial risk assessment methodology

Coface's assessments are based on the financial data published by over 6,000 listed companies in three major geographic regions: Emerging Asia, North America and the European Union 15.

Our statistical credit risk indicator simultaneously summarises changes in four financial indicators: turnover, profitability, net indebtedness, and cash flow, completed by the claims recorded through our network.

### Sectorial risk assessment

Hierarchy sectors in Western Europe



DOSSIER

# EUROPEAN AIRLINES: CONSTRAINTS ON CHANGE

BY OUR ECONOMISTS



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«European carriers have been hit by aggressive competition from Middle East and Asia and, they are among the least profitable in the world»

The single European Union (EU) market for air transport was formed only in 1997. Since then, the traditional airlines have had to compete with low-cost carriers on their short and medium-haul flights. But now, new competition has been developing even more rapidly with regard to long-haul flights: the Gulf carriers. Their traffic, capacity and profitability are expanding more rapidly than in any other region of the world. And,

because they have been unable to acquire new air traffic rights, they have stepped up their acquisition of stakes in EU carriers. At a time when it seems vital to tap into Asia's growth potential, European carriers have been hit by this aggressive competition and are among the least profitable in the world. There is much to be learned from the changes observed on the US internal market, liberalised since 1978. Increase prof-

itability, tap into demand where it exists and do better than the new entrants - these are the three main challenges faced by Europe's major, traditional players. Are we seeing the start of a new wave of consolidation like that which occurred in the United States?

## 1 AIR TRANSPORT COMPANIES: LIBERALISATION... HOW FAR?

The global air passenger transport business developed after the First World War for a well-to-do or professional clientele. At that time it was characterised by weak demand, chiefly because of operational risks which amplified the costs. Generous government support was given to the whole sector to ensure its viability. In this context, there was no price competition and the airlines offered inefficient high service quality<sup>(1)</sup>.

Since 1944 the Chicago convention has regulated the development of global air transport. Adopted then by 52 countries, it now has 191 members. It grants states full sovereignty over managing the conditions governing services and overflying of their air space. Moreover, it defines nine Freedoms of the Air on which the states agree<sup>(2)</sup>.

Table n° 1  
Passenger traffic by region

2013	Passengers carried (millions)	#	Passengers/km (billions)	#
Asia and Pacific	1 008	1	1 785	1
Europe	817	2	1 556	2
North America	815	3	1 505	3
Latin America	230	4	303	5
Middle East	161	5	500	4
Africa	76	6	134	6
<b>Total</b>	<b>3 103</b>		<b>5 782</b>	

Source : ICAO, domestic and international

(1) T.H. Oum, A. Zhang, X. FU (2010), Air transport liberalization and its impact on airline competition and air passenger traffic, December  
(2) ICAO (2004), Manual on the Regulation of International Air Transport

Market liberalisation has played a large part in the democratisation of air transport. Since 1978, the «Airline Deregulation Act» in the United States has boosted the domestic market. European countries then had a strong incentive to develop bilateral agreements, leading to a doubling of traffic in the EU between 1982 and 1993<sup>(3)</sup>. Europe is now the second largest market in the world (table No 1) behind Asia and Pacific, which has occupied first place since 2011. The sector provided 7 million jobs (1.9% of total jobs) and €440 billion in economic benefits in 2013 (2.8% of European GDP<sup>(4)</sup>).

### «Since 2011, Europe is the second largest market behind Asia and Pacific»

#### Trend towards economic globalisation

The liberalisation of the air transport sector is a trend in line with the globalisation of the economy, leading to the emergence of new players, regardless of nationality. It is, moreover, the primary catalyst for the development of air traffic, which in its turn stimulates a new demand, because liberalisation leads to lower prices. But in an environment limited by the 1944 Chicago convention, the regulatory frameworks between countries are organised around bilateral agreements<sup>(5)</sup> (chart N° 1) the very existence of which creates obstacles to an optimal development of the market.

Against this backdrop, airline companies are organised in the form of alliances in order to guarantee continuity of service to the consumer for long-haul flights: Star Alliance (27% market share), SkyTeam (20%) and Oneworld (15%). The networks have therefore expanded in spite of the bilateral agreements thanks to the sharing of traffic rights between companies in the same alliance.

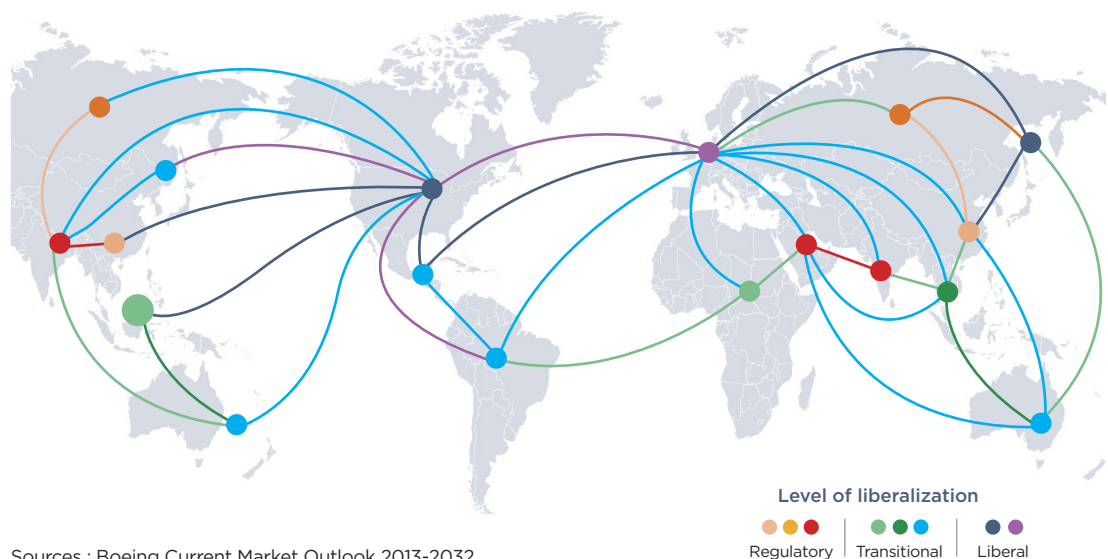
#### A single market in the European Union

While the American domestic market opened to competition in 1978, the EU liberated its own market from 1987 to 1997. Since then all the European airline companies have been able to establish connections between EU airports without restrictions on traffic and freely fix their prices. However, domestic routes remain inaccessible to foreign companies not domiciled in the EU. The creation of the single market has brought new players onto the market, essentially at the low-cost end (text box 1, page 3). The number of air carriers thus rose from 135 to 152<sup>(6)</sup>. This situation even created competition on certain routes underserved, leading to substantial price cuts. Because of this, the number of routes served by more than two competitors increased by 415% between 1992 and 2012 to reach 479 routes.

But liberalisation has limits: the European framework preserves airline companies' control and ownership rules in order to guarantee the protection of community interests. The acquisition of a stake in an EU airline by a foreign shareholder (non EU) is capped at 49.9% against 25% in the United States. If the concept of restrictions

Chart n° 1

Level of air transport liberalisation in different regions of the world



Sources : Boeing Current Market Outlook 2013-2032,  
World Economic Forum Travel and Tourism competitiveness 2009

(3) N. Lenoir (2007), Is competition possible in the airline industry? September

(4) Europe in the broad sense with Turkey and Russia, ATAG Economics (2014), Aviation: Benefits Beyond Borders, April

(5) Air services Agreements (ASAs)

(6) OAG data



on ownership seems clear, the concept of control is less so. It is in fact difficult to control the influence even of a minority shareholder. For example, the Swiss airline, Darwin, now operates under the name of Etihad Regional following the acquisition of a 33% stake by the United Arab Emirates airline of the same name.

But some officials in the European Commission are calling for more liberalisation, particularly the Transport Commissioner, Slim Kallas, who considers the capital restrictions outdated and harmful <sup>(7)</sup>. Even if the airline market is by definition globalised, not a single aviation company is owned by international shareholders regardless of nationality. The European Commission is in favour of greater liberalisation of the air transport market - a liberalisation which it describes as «the best basis for developing international aviation relations <sup>(8)</sup>», while emphasising, however, the importance of fair competition, based on regulatory convergence.

Currently, numerous open skies agreements have been adopted bilaterally with non-EU countries. For this reason the European Commission has reminded the need to adopt a community position. The bilateral agreements with non-members weaken the coordination of bolder liberalisation. This uncontrolled pace of new agreements could sharpen the competitive pressures on the traditional European players. According to the honorary president of Air France-KLM, Jean-Cyril Spinetta, «23 or 24 EU countries have already signed open skies agreements <sup>(9)</sup> (with the Gulf countries, editor's note)». But France and Germany continue to hold out.

## Growing competitive pressure

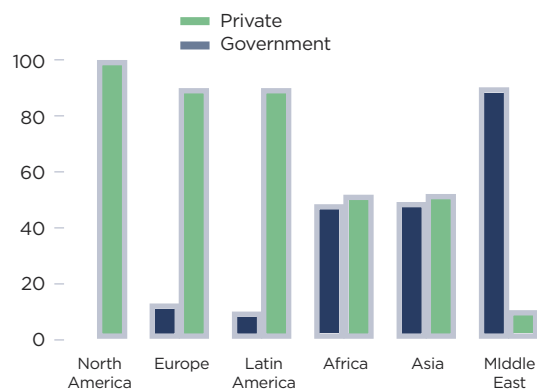
Competition on the long-haul market has been profoundly changed by new entrants from the Gulf. Although the existence of unfair practices on the part of these airlines cannot be shown, particularly because of their opacity concerning Etihad and Qatar Airways, their majority public shareholding (chart No 2) reflects the government willingness to promote their region across the world thanks the expansion of state-owned airlines.

Faced by acceleration in equity participation by foreign companies, particularly from the Gulf, the European Commission has stepped up its investigations. In April 2014, it began investigations <sup>(10)</sup> into a series of operations (table N° 2) aimed at checking the effective control linked to these transactions. In September it will also study the acquisition of 49% of Alitalia by the Etihad Company of the United Arab Emirates.

In June 2014, Air France-KLM and Lufthansa together sent a letter asking the European Commission to take all suitable measures to ensure a level playing field. These remarks were aimed directly at the Gulf countries. The President of Etihad, James Hogan, moreover declared that «some legacy carriers are using the European Commission to challenge us rather than challenge us through competition <sup>(11)</sup>».

Chart n° 2

Shareholding (regional average weighted by available seats kilometres)



Source : IATA

Table n° 2

European Commission's Investigations (April 2014)

Shareholder	% capital	Target	Date
Etihad	29 %	Airberlin	12-2011
	33 %	Darwin Airlines	11-2013
Delta Air lines	49 %	Virgin Atlantic	12-2012
Korean Air	44 %	CSA Czech Airlines	03-2013
HNCA	35 %	Cargolux	04-2014

Source : Coface

(7) EU-ASEAN Aviation summit, Singapore, February 2014

(8) European Commission (2012), The EU's External Aviation Policy - Addressing Future Challenges, September

(9) Paris Air Forum, July 2014, Paris

(10) CAPA (2014) Airline ownership & control. Why might Europe uphold something its officials call stupid, May

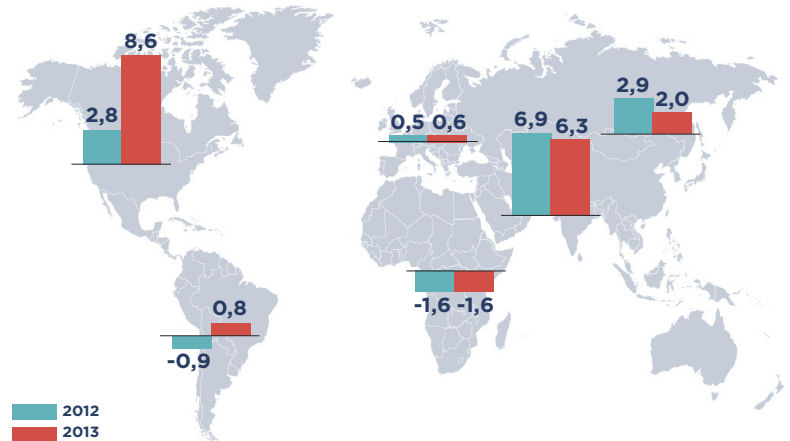
(11) Reuters (2014), Etihad says is buying stakes in Europe to compete, not control, 4 May

## Some European airlines among the least profitable in the world

The whole European sector seems lastingly weakened by this new competition. Their earnings have been reduced to make it one of the least profitable regions in the world (chart N° 3). In 2014, the situation does not seem to be improving, as, in early July, Air France issued a profit warning, linked to overcapacity on some of its routes in North America and Asia <sup>(12)</sup>. Lufthansa had reported the same problem in the previous month citing strong competition from the stat-owned airlines of the Gulf <sup>(13)</sup>.

Apart from these competitive pressures, the EU suffers from airport under-capacity associated with a lack of investment. This saturation is expected to reduce the prospects of identifying potential demand and to increase operating costs by 50% between now and 2050 <sup>(14)</sup>. The main challenge is that of replacing the air traffic management system, whose technology dates from the 1950's. The deployment of the SESAR programme will take place between 2015 and 2030 for a total budget of €2.1 billion.

Chart n° 3  
Net post-tax profit (USD, per passenger)



Source : IATA

### Text box 1

## LOW COST CARRIERS

Liberalising a market leads to the emergence of new players capable to capturing market share thanks to an original positioning. Disrupting a monopolistic situation can have considerable economic repercussions. For the air transport sector this phenomenon came about through the «Southwest effect <sup>(16)</sup>», which refers to the consequences of the entry of the Southwest Airlines company into the American market:

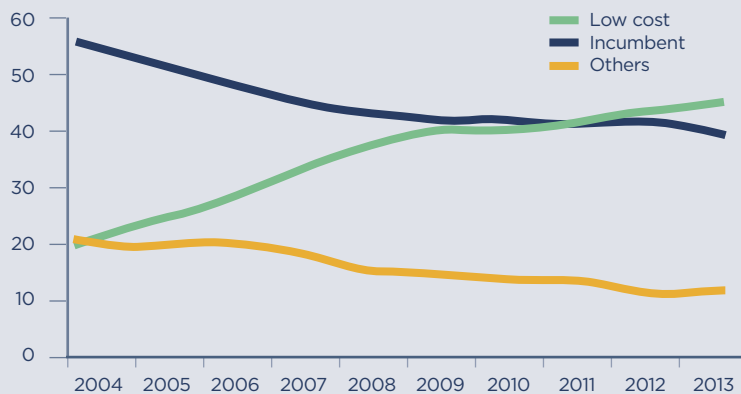
- (i) a new entrant increases supply thanks to lower prices;
- (ii) legacy players lower their prices to meet this new competition;
- (iii) Demand is stimulated and revenues increase for the whole sector.

The strong growth of the low cost airlines stimulates the competitiveness of the whole aeronautical industry, which bring about greater liberalisation of domestic and inter-

national markets. Within the EU the market share of the low cost airlines exceeded that of the legacy airlines for the first time in 2012 (see chart No 4). The development of the low cost model could be limited to short and medium-haul carriers, particularly because of the limited number of rotations on long-haul flights, which is the main source of saving. But in Europe, Lufthansa announced in July 2014 the impending launch of long-haul routes on the low cost model through its new Germanwings carrier. The first departures are planned for the winter of 2015, favouring the tourist destinations of South East Asia, while the Norwegian low cost carrier proposes to fly to the United States from London since the beginning of July.

This new competition has weighed heavily on the profitability of the traditional airlines, particularly in Europe and is encouraging them to develop a low cost offer in their turn. Indeed, consumer habits seem to have permanently switched to this model for short and medium-haul flights.

Chart n° 4  
Market share in the EU (% of seats available)



Source : European Commission

(12) Air France-KLM (2014), June 2014 Traffic Results

(13) Lufthansa (2014), Lufthansa Group adjusts earnings forecast, June

(14) SESAR, <http://www.sesarju.eu>

(15) Single European Sky Air traffic management Research

(16) DOT (1993), The Airline Deregulation Evolution Continues: The Southwest Effect, May

## 2 NEW DEMAND, NEW ENTRANTS

According to the International Civil Aviation Organization (ICAO) in 2013 air transport will have carried more than 3 billion individuals. When households are more prosperous, their spending on travel increases. Hence 60-80% of air travel growth is attributable to the economic growth<sup>(17)</sup> measured by GDP (chart 5), with lower prices or the quality of the infrastructures also having positive repercussions on the sector's penetration rate. Thus global passenger traffic doubles every 15 years.

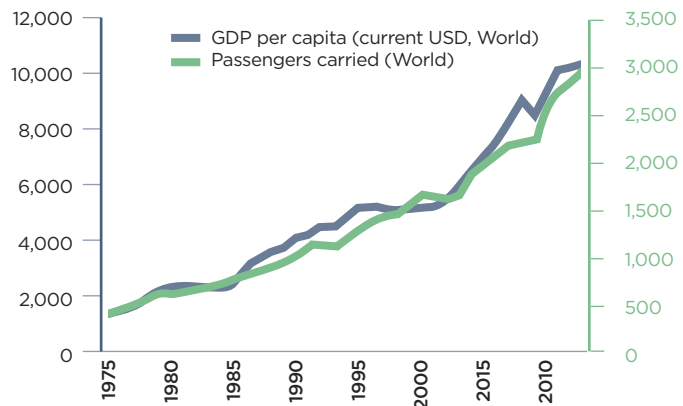
### Increase in wealth is accompanied by an increase in passenger traffic

The level of market penetration can be measured by the passenger carrying capacity, defined as the number of seats available per inhabitant. Countries with a high per capita income tend to have a larger number of seats per inhabitant<sup>(18)</sup>. But this market penetration varies according to the regions of the world (chart 6). In North America, it seems to have reached a ceiling. In other words, beyond per capita GDP of \$53,000 an increase in the average wealth of a country's inhabitants no longer stimulates the growth of air travel (+0.5% of passengers and +3.6% in passenger-kilometers<sup>(19)</sup> in 2013). On this market, it is only possible to win new customers if prices fall or if there is an increase in the number of routes.

With nearly 51,000 seats per million inhabitants, the European market seems to be relatively well developed. The ratio between the number of seats per million inhabitants and the GDP level is 1.75 for Europe against 1.20 for North America or 2.60 in the Middle East. The domestic liberalisation of the EU and the multiplication of low cost service partly explain this situation. It must be emphasised that area covered also includes Turkey and Russia, which reduces average GDP per capita.

The Middle East shows excellent but unique performances. They are the result of a government strategy aimed to stimulate the region. The Gulf countries have invested massively in their airport infrastructures, while the state-owned airlines have become instruments for promoting the region throughout the world. This means capacity is in fact not at all correlated with the rather sluggish internal market, which accounted for only 5.7% of total traffic in 2013<sup>(20)</sup> against 65% in North America. Qatar thus has 610,000 seats for 1 million inhabitants against fewer than 150,000 in Switzerland.

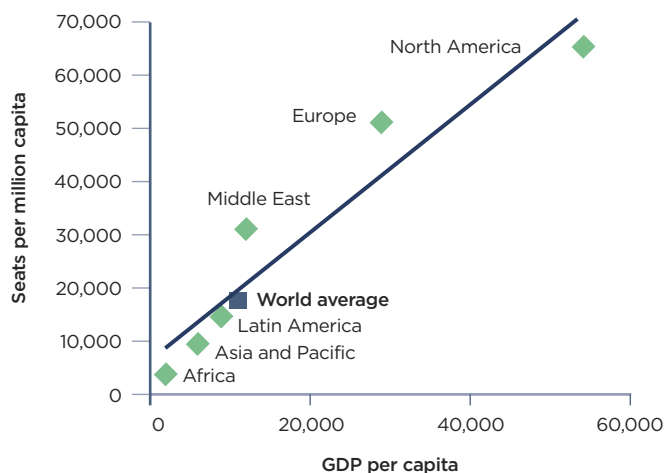
Chart n° 5  
GDP growth and number of passengers carried by plane



Source : World Bank

However, we must note the strong potential of India whose penetration rate remains weak, as the country suffers from limited infrastructures but also from high taxes on petroleum products, which limit the population's access to air travel. Since September 2012, foreign airlines can hold a stake of up to 49% in a national airline. It is a Gulf airline, Etihad Airways, which carried out the first transaction initiated in January and formalised in November 2013, acquiring a 24% stake in the fourth biggest Indian company, Jet Airways (17.1% of market share<sup>(21)</sup>) for \$330 million.

Chart n° 6  
Market penetration and maturity



Source : CAPA Centre for aviation

(17) Boeing (2013), Current Market Outlook 2013-2032

(18) CAPA (2014), Air travel rises with a country's wealth. Law of nature, or can government policy make a difference? June

(19) Number of passenger multiplied by the length traveled

(20) Domestic market by passenger-kilometers, ICAO (2013), Annual Reports of the Council

(21) IATA (2007), Estimating air travel demand elasticities, December

### Tomorrow, predominantly Asian demand

The elasticity between rising personal wealth and air passenger travel seems to be much greater in the emerging countries. For a rise of 10% of GDP, demand increases by 20% against 15% for the developed countries<sup>(22)</sup>. The emerging middle class expects to enjoy a standard of living comparable with the developed economies. Their demand for leisure will make them the biggest market for air travel by 2020.

### «Within 5 years, half of the middle classes will be located in Asia»

Moreover, these new middle classes, whose daily spending will amount to between \$10 and \$100 at purchasing power parity, will be mainly in emerging Asia (chart N° 7). To cope with the speed of development in this region, between 1992 and 2012, the number of weekly flights in rocketed from 2,184 to 52,651<sup>(24)</sup>. This shift in demand requires an effective response on the part of Europe's legacy airlines, if they want to guarantee their competitive position because the Asian internal market is developing at the same time. ASEAN is preparing to set up a liberalised single market among its members by 2015 on the same model as that of the 28 EU members.

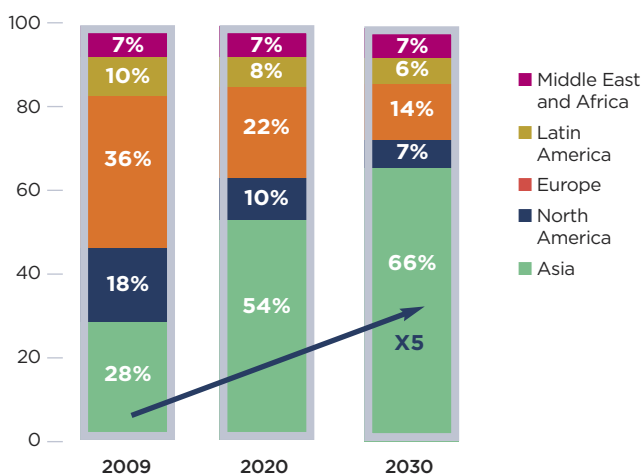
### Towards a relocation of the hubs

Since 2007, demand in North America has remained sluggish with a weak growth of 6% testifying to the maturity of its market. Although the situation in Europe is more encouraging with growth of 34% (see chart 8), it results essentially from the performance of the low cost airlines. The traditional airlines are also having to face the substantial development of international traffic to or from emerging countries, particularly in the Middle East where traffic has more than doubled in 5 years.

The greatest growth potential is located in Asia. By making stopovers at the Middle Eastern hubs, the routes are 20 - 30% longer than a direct connection starting from an EU hub. Although passengers may prefer to travel without a connection, the elasticity of prices depends on the customer segmentation. Indeed, business travellers are ready to pay more to avoid a connecting flight. But, this behaviour is rarer for leisure travellers whose are ready to spend four times less (study conducted on the domestic market in the United States<sup>(25)</sup>). In other words, the competitive advantage linked to the EU's proximity to Asia must be moderate and would not justify too great a price difference.

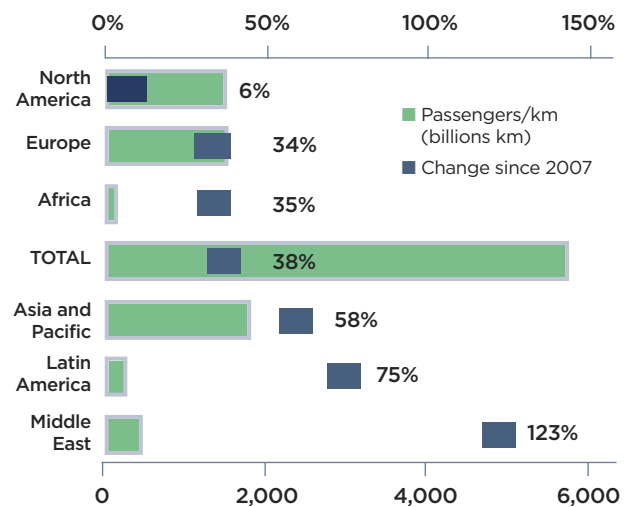
Turkey is on this same route. Thanks to the development of Turkish Airlines, and its 48 million passengers carried in 2013 (+24% on 2012), the country aspires to a share of the EU/Asia market (text box 3, page 15). It is already the second most popular destination from the EU after the USA.

Chart n° 7  
Global distribution of middle classes (% of total)



Source : OECD<sup>(23)</sup>

Chart n° 8  
Regional traffic



Source : ICAO

(22) IATA (2007), Estimating air travel demand elasticities, December  
 (23) H. Kharas (2010), The emerging middle class in developing countries, OECD  
 (24) Boeing (2013), Current Market Outlook 2013-2032  
 (25) S. Hess (2010), Evidence of passenger preferences for specific types of airports

Text box 2

AIR FRANCE KLM

Europe's airlines are among the least profitable in the world. Do you share the opinion of the European Transport Commissioner, Siim Kallas, as expressed in *Les Echos* on 16 July 2014 «consolidation is necessary [...]. It has to be said that 150 airlines in Europe are far too many»?

Well, compared with the situation in the US, the situation in Europe is completely different. After the liberalisation of the market in the 80s, the US aviation industry had high overcapacity and experienced a significant drop in yield (of about -25%) between 1990 and 2000. With the strong growth of low-cost carriers, legacy airlines filing for bankruptcy protection under chapter 11 between 2002 and 2007. From 2007, the process of consolidation began with the Delta and Northwest merger. Today, each of the 3 main legacy airlines holds 20% of the market, while the legacy airlines together have a total market share of 74%. There has also been concentration of the low-cost carriers; Southwest is the main operator with 18% and JetBlue is the only other operator with a market share above 5%. The other ultra low-cost carriers, Spirit and Frontier have shares below 2%. In total, 8 operators hold 96% of the market and only 4% is shared among the smallest operators.

In Europe, the legacy operators have 54% market share and none has more than 11%. The largest low-cost carriers (Ryanair and Easyjet) have 13% and 8% respectively. Of the total 150 airlines, 21 represent 84% of market share.

The consolidation in the US is characterised by very stable capacity (-0.4% average growth a year over the past 10 years), while, in Europe, growth is considerable (average of +5.4% a year). The European market is much more fragmented and has a lot of small, very active companies! Maintaining stable capacity has helped maintain revenue levels (yield). This phenomenon has not yet been observed in Europe. A move towards consolidation has, however, started with the formation of Pan European players and is expected to lead in the end to 2 or 4 large Pan European point-to-point carriers and 3 regional point-to-point carriers operating in niche markets.

Finally, it should be pointed out that the US authorities have de facto and de jure driven the consolidation of their national airlines by strictly applying their legislation limiting access to the capital of US airlines by foreign nationals, and letting them restructure and merge in the framework of the particularly advantageous provisions of the US bankruptcy law (known as chapter 11). The situation is different in the European Union, where state capital of EU or non EU origin is regularly invested in airlines whose market viability is not assured.

In a little more than a decade, the Gulf airlines have succeeded in partially shifting Europe's main hubs to the Middle East. How might European players respond in order to preserve their market share on long-haul routes?

The Gulf airlines have significantly increased their market share on routes between Europe and Asia, especially in Southeast Asia where they have more than 25% of the market (their share in Japan and Korea rose from 4% to 15% between 2008 and 2014, in China from 4% to 13%, and from 20% to 40% in Australia). All the natural growth in these markets has particularly benefited the Gulf airlines operating in Southeast Asia. As a result, the major European airlines have seen their results plummet on their routes to Asia, whereas these had hitherto been profitable.

Journey times to Southeast Asia are almost the same via the Gulf hubs. European airlines still have the edge on routes to Northern Asia, despite the financial terms imposed by the Russian authorities for flying over their territory. The competition, especially on routes between Europe and Asia, will sharpen considerably in view of the aircraft orders placed by the Gulf airlines; these are set to total 600 by 2017.

The strategies for dealing with the expansion of the Gulf airlines are built around the following elements:

- Recognition and acceptance of the competitive disadvantage and potential withdrawal from the most loss-making routes.
- Improvement of competitiveness of European airlines, where required through sectorial programmes specific to the aviation industry, aimed at enabling them to compete with these carriers. The input price variance is currently estimated to be about 30% to 40%.
- Development of effective partnerships with Asian airlines, in particular to replace the traffic lost on routes to Europe with connecting flights from Asia to the hubs of these Asian partners. Guaranteeing efficient connections.
- Developing a high-quality service, setting it apart from the quality of the service provided by the Gulf airlines.
- Controlling access to the Community market (air traffic rights) while waiting for the establishment of a regulatory environment ensuring the conditions for fairer competition between the European Union and the Gulf states.

In a joint letter addressed to the European Commission, the European airlines pleaded for a strong joint response to what they consider to be unfair competition from the Gulf airlines. How do you think the European Commission will respond?

European airline companies generally support the development of fair competition, undistorted by state subsidies. In this regard, the extremely rapid expansion of state-owned airlines, some of which are based in the Persian Gulf, is raising concerns. With regard to this topic, in December 2012, the European Council of Ministers of Transport asked the European Commission to enter into dialogue with the countries of the Gulf Cooperation Council with a view to considering the conditions for developing fairer competition. This dialogue began in autumn 2013 and will continue in the coming months.

The question of including aviation in a multilateral scheme similar to that of the World Trade Organisation in order to deal with the problem of competition distortion resulting from state aid has, of course, also been asked. The European Commission are, in particular, pushing for such an approach within international organisations.

Finally, in 2013 the European Commission launched a consultation on the opportunity to modernise the existing European Trade Defence Instruments, which dealt with the problem of airlines from third countries benefiting from subsidies granted by their State of origin (Revision of Regulation 868/2004). Such a proposal is expected in the coming months. In this context, the airlines in the Air France KLM and Lufthansa groups have asked the Commissioners for air transport and competition to ensure that Europe's existing rules reserving the majority of the capital and effective control of carriers established within the European Union for European Union nationals are strictly applied when third country investments are concerned.

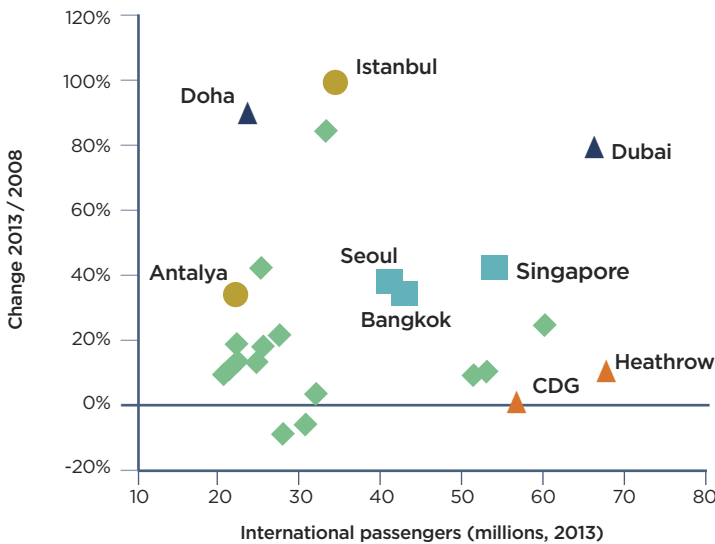
The European Commission have, in particular, the ability to check that these rules are observed and, if necessary, take appropriate measures to limit the degree of influence a non-EU investor has in defining the strategy of a European carrier.

Air France and KLM support strong action by the European Commission on these issues and are in favour of initiatives which could, moreover, be taken by the European institutions to improve the competitiveness of the European airlines (similar to the guidelines adopted by the Commission in 2004 regarding the maritime sector authorising specific social protection schemes for seafarers).

### The Gulf countries - brimming with momentum

The Middle East is a unique market to the extent that internal demand is almost non-existent. The region benefits from an ideal geographic position since two billion people live within a radius of 4 to 5 hours flight from Dubai. The national airlines share the region's image across the world. Tourism now represents 30% of Dubai's GDP in line with their strategy of diversifying revenue sources. Indeed, the Emirate will continue developing airport infrastructures. The absence of night flight restrictions or taxes for the national airlines also helps increase the region's capacity. In 2013, this capacity grew by 12%<sup>(26)</sup>, the best performance in the world, to reach 9% of the world capacity behind the Asia Pacific region (32%), North America (25%) and Europe (27%).

Chart n° 9  
Top 25 airports by international passenger traffic



Source : ICAO

Table n°3  
The world's top 5 on the international market

Passengers carried (millions)		Passengers - km (billions)	
Ryanair	81	Emirates	209
EasyJet	53	United Airlines	141
Lufthansa	51	Lufthansa	139
Emirates	43	Delta Air lines	129
British Airways	34	Air France	128

Source : IATA

Dubai international airport is the world's seventh busiest airport with 66 million passengers and second busiest of solely international passengers. In 2013 it hosted more passengers than Paris Charles de Gaulle Airport. At this pace it is expected to overtake, within two years, Europe's busiest airport, Heathrow, with its 72 million passengers in 2013. In only 5 years the two main Middle Eastern airports, Doha and Dubai, have been able to capture a large part of the increasing demand (Chart No 9).

But the development of the Gulf airlines began as one-way process with the opening of the EU market. The ability of foreign airlines to serve the Gulf airports was indeed restricted. In this context, legacy airlines being unable to respond effectively to this competition, and they have lost a large number of their direct routes by joining up with a Gulf partner. For instance, the Australian Qantas formed a partnership with Emirates in September 2012. Since then, the majority of its European destinations are carried via its Dubai hub by Emirates.

Emirates is the world-leader with regards to international passengers-kilometres with a performance of 16% in 2013, beating the US carrier United Airlines by 50% (table No 3). It has a fleet of 217 jumbo jets, or twice the fleet of Air France, which has 110. Moreover, Etihad Airways, the national airline of the United Arab Emirates, carried some 12 million passengers in 2013 (+13% on 2012) against 18 million (+6% on 2012 and +50% since 2009) for Qatar Airways. In response to the difficulties of penetrating the international markets, Qatar Airways joined the One World alliance in 2012. But the strategy of the other two companies is to focus on their brand image and does not therefore consist in seeking to join one of the three alliances.

In this context, western airlines, claiming distortion of competition, have questioned these state-owned airlines' sources of finance, especially concerning Qatar Airways and Etihad, which do not publish their financial statements, unlike Emirates. But for the least opaque of the three, it must be emphasised that its chairman, Sheik Ahmed al-Makthoum, is also chairman of Dubai airport, Minister of Transport, and Chairman of the Noor Bank which finances, among others, the Emirates fleet.

(26) In number of seats available by kilometres travelled ICAO (2013), 2013: Air Transport Yearly Monitor

## Text box 3

## THE IRRESISTIBLE RISE OF TURKISH AIRLINES

## Efe KALKANDELEN

Associate Research at Is Investment, Turkey

Interview by Seltem IYIGUN, Economist at Coface, Turkey

**What are the main characteristics of the Turkish aviation sector?**

Turkish Airlines is the national flag carrier airline of Turkey. Istanbul is situated between Europe and Asia which gives the city a very strategic geographical position concerning the transit passenger traffic. Passengers who travel from Europe to Asia, from Asia to America, from Europe to Middle East and Africa, they all prefer to make transfer in Istanbul as geographically the city allows them to make this transfer right in the middle of a long flight. This gives an advantage to Turkish Airlines as the other airlines in Europe make this kind of transfer in cities like Paris, Amsterdam or Munich which force passengers to do a short flight in the first place, then make a very long flight in the second place.

In order to increase the number of transit passengers, Turkish Airlines aims to raise the flight frequency. This reduces the waiting time between the connected flights. The narrow body aircrafts owned by Turkish Airlines enables the company to serve easily the totality of Europe, Middle East, West Asia and 80 percent of Africa at lower cost compared with wide body aircrafts. The company is able to gather all the transit passengers in Istanbul through these narrow body aircrafts, which is a very effective cost saving strategy and send them to their final destination with wide body aircrafts. This strategy gives an important advantage to Turkish Airlines.

Besides, geographically Middle Eastern cities remains away from the major destinations compared with Istanbul.

**How will the European airlines grow in the next 20 years?**

Airline companies in emerging markets have longtime examined European companies in order to avoid the mistakes of their business models. In emerging markets, the most important advantage of the airline companies is the lower labor costs compared with the European airlines. In the aviation sector, the highest cost item is the fuel and the second highest cost item is the labor cost. The control over one of the most important cost item gives a serious advantage to the airline companies in emerging markets. This is one of the reasons why the airlines companies in emerging markets continue to grow while their rivals in Europe meet some difficulties in recent years.

**How do we define the strategic positioning of Turkish Airlines?**

Turkish Airlines aims to create an aviation holding. Therefore it has implemented a strategy to control costs and provide better service through its affiliates and subsidiaries specialized in different aspects of the aviation business. For instance DO&CO for catering services, TGS for ground services, THY Opet for fueling aircrafts and Turkish Technic for maintenance. Usually Turkish Airlines owns 50 percent of capital. In total, Turkish Airlines has 12 affiliates.

**What are the main growth drivers of Turkish Airlines?**

The number of transit passengers is increasing at a high speed. The fall in ticket prices of domestic flights support the domestic demand. As Turkey has wide and mountainous lands, citizens usually prefer to fly to their final destination instead of driving. The lack of railway infrastructure also adds to the demand for airline transport in the country. The government plans to construct an airport close to each city. This also would increase the demand.

**How does Turkish Airlines face competition from Gulf airlines?**

The airline companies in Gulf countries have the advantage of using cheaper fuel. Usually the owners of these companies are extremely wealthy and these companies don't have any financing difficulties. There will always be a competition with these companies as they want to become the world's biggest airlines. The fact that Turkey attracts more tourists than these countries, the strong demand for domestic flights in Turkey, the strategic geographical position of Istanbul are Turkish Airlines' advantages in this competition. Turkish Airlines wants to become a 5-star airline company. If it succeeds to become one, we will see how this will contribute to the competition.

## 3

## HOW TO ADAPT?

The United States, world's largest domestic market, was the precursor to the liberalisation of air transport of passengers. In October 1978 the federal «Airline deregulation act» put an end to federal government control over the granting of lines, the fixing of tariffs and the entry of new companies to the market. Whereas 11 companies controlled 90% of the market, 47 new entrants appeared between 1978 and 1984. Only Southwest Airlines is still operating today. This is because the 2000s were marked by a wave of consolidations and liquidations. In 2013, only 4 of the 11 legacy airlines remain, while market

concentration has increased. The top 4 American airlines share 69%<sup>(27)</sup> of the domestic market against about 45% for the top 5 European companies<sup>(28)</sup>.

**The United States: a precursor?**

Liberalisation shook up the organisation of airline companies. It led to a move from the point-to-point to the hub-and-spoke model, in which short-haul flights take passengers to a hub from which an airline's long-haul flights are concentrated. Such an approach optimises profitability

(27) American Airlines (et US Airways), Delta Air Lines, Southwest Airlines and United Airlines, [www.transtats.bts.gov](http://www.transtats.bts.gov)

(28) Ryanair, Lufthansa, Airfrance-KLM, Easy jet and IAG, CGSP (2013), Are Airline Companies mortal? July

and the load factor. This reorganisation led to an improvement in services at the large airports but also to a reduction of services at the less frequented small airports. The freedom to set prices allowed greater diversification of tariffs. Load factor have steadily increased (chart N° 10). This is partly the consequence of yield management <sup>(29)</sup> invented by Delta Airlines in 1984 and generalised throughout the sector. These innovations have now become universal.

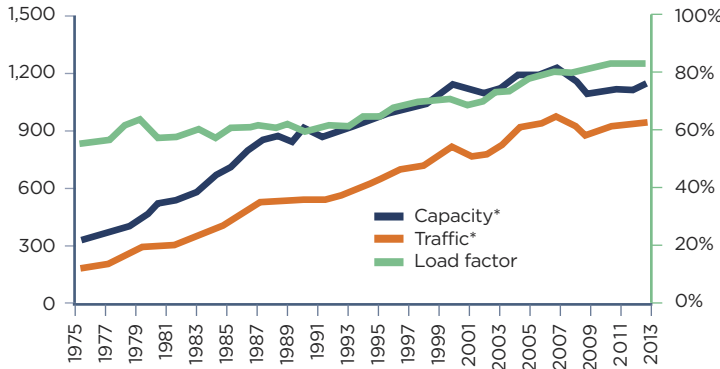
During the 1990s, companies benefitted from a strong rise in demand: domestic traffic grew by 4.1% a year on average over the 1990-2000 decade. This led them to excessively increase their capacity and therefore their fleet, which contributed to their later difficulties.

### The effects of contemporary crises

Following the terrorist attacks of 11 September 2001, demand fell sharply over two consecutive years (-6% in 2001 alone in kilometres flown by passengers) for the first time in more than 30 years. The financial crisis of 2008 and the recession in 2009 led to a further drop in demand (-4.7% between 2007 and 2009) and, in spite of the recovery of demand from 2010, the 2007 levels have still not been reached.

On this background, the sector's financial situation has sharply deteriorated. The airlines recorded 5 consecutive years of net losses between 2001 and 2005 and the accounts again went into the red in 2008 and 2009 (chart No 12). They have been forced to make substantial reductions in capacity and therefore to reduce their fleets, which fell by 16 % between 2000 and 2010 (not including regional airlines). All the major airlines underwent a period of judicial restructuring in the 2000's. They were often able to negotiate a substantial reduction in social costs (salaries and, above all, pensions) with staff representatives by filing under chapter 11 of the American bankruptcy law. Thus weakened, the airline companies regrouped to rationalise their networks and better control the growth of capacity.

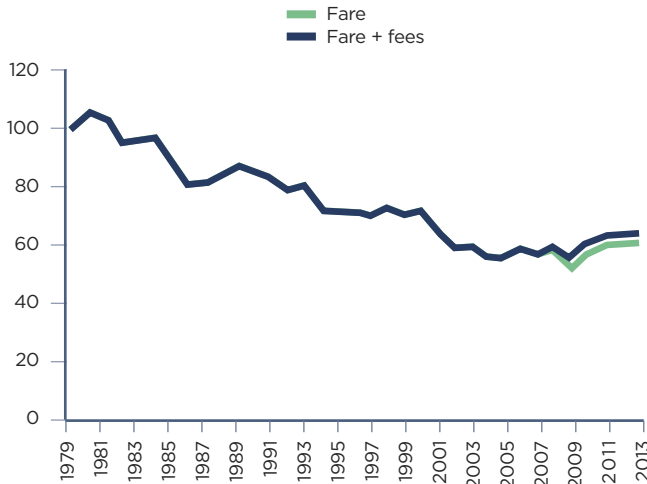
Chart n° 10  
Performance indicators in the United States on the domestic market



\* billions of passengers-kilometres  
Source : Bureau of Transportation statistics (BTS)

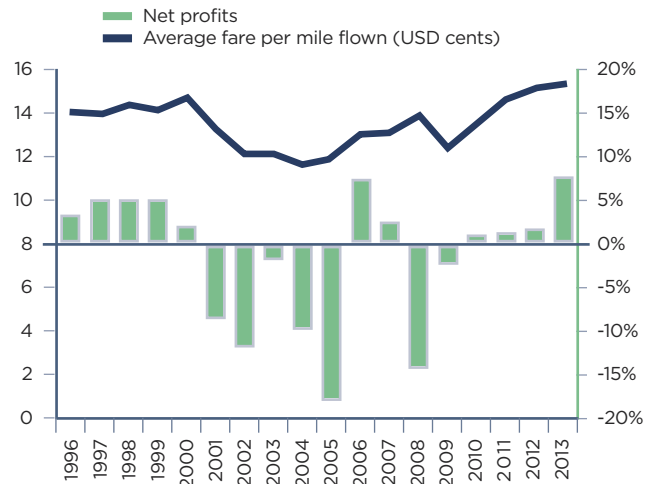
The average price for a domestic flight continued to fall until 2005 (chart N° 11) in conjunction with the appearance of low cost airlines in the 1980s. The real cost has thus decreased by 40% since the liberalisation of the domestic market.

Chart n° 11  
Change in the real prices of domestic flights in the United States (100 = 1979)



Source : Airlines for America

Chart n° 12  
Profitability and revenues of American airline companies (domestic market)



Source : Bureau of Transportation statistics (BTS)

(29) Optimisation of revenues depending on the evolution of the structure of demand thanks to price adaptation



### Advantages and disadvantages of further consolidation

From 2008, the American airlines embarked on a major concentration process (chart N° 13). Delta acquired Northwest following the latter's successful filing for bankruptcy. In 2011, the low cost airline, Southwest, acquired Airtrans (another low cost player), whose integration was expected to be completed at the end of 2014. Finally American Airways, which was undergoing bankruptcy proceedings (chapter 11), obtained agreement from the authorities for its merger with US Airways in 2014. This merger was intended to create the biggest global company, ahead of Delta, with slightly more than 100,000 employees.

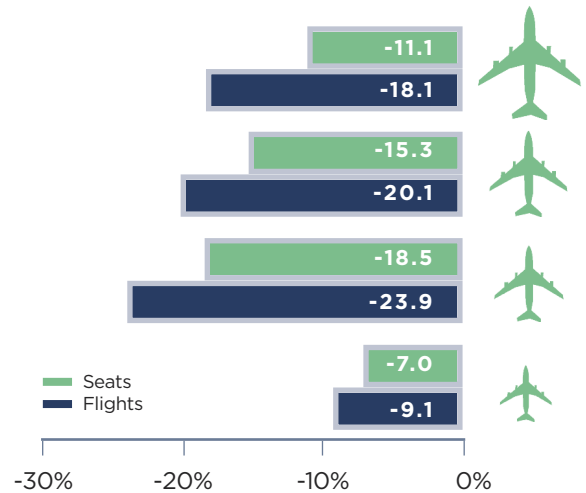
Finally, through successive mergers/acquisitions, the 7 major companies of the 1990s formed 3 air transport giants (Delta, United Airlines and American Airlines) alongside Southwest. The market share of the four biggest companies, which has reached 69% (against 55% in 2009), is at its highest level the liberalisation of the market.

This unprecedented concentration raising the prospect of an oligopoly on the air transport market, which would push up prices. In fact, since 2009, the real prices of domestic flights have risen by 15%<sup>(30)</sup>. Almost inexistent in the early 2000's, fees (Wifi, choice of seat, additional baggage, priority boarding...) now represent nearly 6% of the average ticket price for a domestic flight, which pushes up the final price (chart N° 11). This price rises are explained

by a growth in supply (measured in seat-kilometres offered) below that of demand. In other words, capacity is growing less slowly than the traffic (chart N° 10). At the same time the mergers have made it possible to rationalise the major airlines' networks, particularly through the reduction in the number of hub (chart N° 14).

Chart n° 14

Variation of flights and seats offered by American-type airport\* on domestic routes (between 2007 and 2012) in %



\* By airport size as % of total passenger numbers (>1%, 0.25% to 1%, 0.05% to 0.25%, >0.05%)

Source : United States government accountability Office<sup>(31)</sup>

Chart n° 13  
Main acquisitions since 2008



\* market share at the end of the operational year  
\*\* market share in May 2014

Source : Bureau of Transportation statistics (BTS)

(30) Average annual price, Airlines for America

(31) US GAO (2014), «The average number of competitors in markets serving the majority of passengers has changed little in recent years, but stakeholders voice concerns about competition», June

Reduced competition is thus unfavourable to consumers if the companies develop sufficient market power to impose high prices on certain routes. On the other hand, the pressure on prices linked to the growth of low cost companies is tending to decline. They are increasingly establishing themselves at big airports or improving their services in order to capture a new customer segment. For this reason, Southwest has modified its strategy by developing its offer aimed at attracting business customer. On the European market, Ryanair launched its «business plus» service in August 2014.

Thus, the liberalisation of the American domestic passenger transport market has undergone three distinct phases:

- 1 **Increase in passenger numbers** in line with new entrants' deployment at the low cost end and the price decline;
- 2 **Concentration of the market** as a result of a growing number of actors affecting the sector's profitability;
- 3 **Restriction of capacity** to make economies of scale linked to the rationalisation of the networks;  
**higher revenues** thanks to additional charges.

## 4 CONCLUSION

The EU's sky has been open without restriction to member states only for 17 years. Since then, the legacy airlines have been subject to internal and external pressures linked to rising importance of the low cost and Gulf carriers. With low profitability, the EU airlines must adapt their growth model to capture the high growth potential markets, chiefly in Asia.

The global liberalisation of air transport sector seems far-off but it remains foreseeable. The European players will have to contend with this new foreign competition, which is already undermining the entire European air transport industry, a little more every day. These com-

## In Europe: a necessary transformation

A first phase of consolidation was successfully completed with the mergers between Air France and KLM (2004), of Lufthansa and Swiss Airlines (2005) or IAG following the mergers between British Airways and Iberia (2010) then BMI (2004). But at European level, expected profitability remains too weak. At the same time occupancy rates are still below those of North America at 80% against 83% in 2013. And total available capacity in Europe grew by only 2.8% in 2013, or the second weakest performance before North America <sup>(32)</sup> (+2.1%).

Even if we have to consider the biggest fragmentation of the air transport market in the EU, there seems to be room for manoeuvre to improve the sector's efficiency. This occurred in the United States with the liberalisation of the market, 19 years earlier than in the EU, suggesting that a future move towards concentration (described by the phase 2 experienced by the American market) will occur in Europe. This scenario is shared by the European Commission through its transport commissioner, Slim Kallas, for whom «150 companies in Europe are far too many. Consolidation is necessary and should take place <sup>(33)</sup>». Such a scenario will also be accompanied by new problems. The consequences of an excessive move towards consolidation will first of all affect the consumer through a lowering of the quality of the service (reduction of capacity and services road) and a rise in prices.

petitive pressures have never been so strong for the EU. The acceleration of foreign investments in EU airlines is prompting the European Commission to react without compromising the viability of these airlines. The size of the sector in the economy makes it difficult to predict a liberalisation of the long-haul segment as it could lead to a massive destabilisation of the sector. It is also necessary to avoid the emergence of a flag of convenience, like that which affects maritime trade.

The most predictable scenario is that of sector consolidation. The emergence of the EU super players will make it possible to confront the foreign competition.

(32) As number of available seats by kilometres travelled, OACI (2013), 2013 : Air Transport Yearly Monitor

(33) Les Echos (2014), Slim Kallas: «for the Commission, the reform of the French railways is going in the right direction», 17 July

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