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2008 Wharton Aerospace Conference

Commercial Aviation Panel: Demand Is Strong, but Consolidation, Global Competition and Infrastructure Cloud the Horizon

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In February, the commercial aviation world was looking to the skies in anticipation of a deal that promised to transform the industry. A proposed merger between Delta and Northwest Airlines dominated the attention of analysts and executives alike, fueling discussion about how the creation of the world's largest carrier -- and the major round of consolidation that would likely follow -- would impact consumers, employees and low-cost carriers.

Despite the murmuring and speculation, consolidation was only one of several topics discussed by a panel of commercial aviation experts at the 2008 Wharton Aerospace Conference, which took place in February. Other subjects included the potential impact of the economic slowdown in the U.S., the rise of global competition and the need to improve infrastructure. Amid the increasing threats and obstacles, however, several panelists indicated that, at its base, aviation is still a growth industry with demand currently outpacing supply.

Todd Freeman, senior vice president and manager, sales and marketing at GE Commercial Aviation Services in Stamford, Conn., moderated the panel, which included insights from Scott E. Ashton, former vice president, aircraft sales and acquisitions for PrivatAir in Stratford, Conn. (now vice president, aircraft sales and acquisition for Gama Aviation in Hartford, Conn.); Martin J. Bollinger, senior vice president of Booz Allen Hamilton in McLean, Va.; Luiz Sergio Chiessi, vice president, market intelligence for Embraer's Commercial Aviation Division in Brazil; Ronald J. Epstein, senior aerospace and defense analyst with Merrill Lynch in New York City; Alan Klapmeier, co-founder, CEO and chairman of Cirrus Design in Duluth, Minn.; and Rick Leach, president of Trans States Holdings, Trans States Airlines and GoJet Airlines in St. Louis, Mo.

An Order Bonanza Gone Bust?

Perhaps foremost on the minds of the conference participants was the flagging U.S. economy and the potential fallout in commercial aviation. GE's Freeman pointed out that the industry has enjoyed nothing short of an order bonanza in recent years, with many aircraft manufacturers reporting healthy backlogs and a book-to-build ratio -- an important industry metric -- of greater than two for three straight years. "We've never seen anything like that curve, but there are clouds on the horizon," warned Freeman. "Orders are expected to go down from about 1,400 for Airbus and Boeing last year to about 1,000." Where is the industry in its economic cycle, particularly as the U.S. and global markets become more volatile?

Epstein from Merrill Lynch admitted that the recent erratic behavior of the global equity markets signals change, but a certain downturn in commercial aviation? His outlook is decidedly more bullish. "I'm optimistic," he said. "When I think about the cycle, I think 'demand cycle.' Is the demand for airplane seats greater than or less than the supply of airplane seats hitting the market? If the supply of airplane seats is greater than demand, you'll have too many airplane seats hitting the market, you'll see the parked fleet grow, you'll see lease rates fall, you'll see aircraft values fall. We haven't seen that yet.... Until I see some sort of fundamental indicator that there are too many airplanes out there, then I will become more bearish."

Added Bollinger of Booz Allen: "We have a chance for the first time since I've been tracking the business for 25 years to do something that's never been done, and that's to take the cycle out. We have companies with such a huge [order] backlog. The biggest question, if I'm Boeing and Airbus, is: Do I base my business strategy on constant share or constant volume? There may very well be, for the first time, an economic argument that says you [should] run the business at constant volume and let the other guy take the swings up and down. Historically, that hasn't paid off. It may now be paying off."

Klapmeier of Cirrus Design, a manufacturer of single-engine, piston-powered aircraft which generated \$365 million in revenue last year on the delivery of 710 airplanes, noted that, in the case of smaller aircraft, he expects demand to remain strong. "This is a growth industry. If you look at broad demographics or economic data, you realize that what we have is increasing miles traveled, whether its airplanes or automobiles, we have increasing economic wealth around the world, increasing disposable income and decreasing time available for middle management. We have greater numbers of second homes, we have children at later stages of life. These kinds of pressures combine to tell people that they don't have enough time in their lives -- and that's what we really do: We sell little time machines in a handy dandy carrying case called an airplane."

Of Rabbit Holes and Profitability

A discussion of the financial health of commercial aviation can't exclude consolidation, both among airlines and manufacturers. Industry watchers speculate that a Delta/Northwest marriage would surely lead to more carrier consolidation as competitors scramble to claim as much market share as the merged companies. The Wharton conference panelists, while not touching on specifics, weighed in on the potential for consolidation and how it might affect their industry.

As an airline insider, Trans States Holdings' Leach raised questions about the operational impact of mergers over time. Post-merger integration, he suggested, is the true managerial challenge. "There's a lot of low-hanging fruit that happens through consolidation that benefits you as far as value goes: You reduce overhead so you do more with less -- you bring systems together. But there's a big cultural barrier that never seems to get resolved. The challenge is bringing labor together. There are cultural differences between airlines that need to be bridged. How do we do that? Our company faces that everyday just trying to bring labor in line with a single corporate culture, much less a combined culture."

Klapmeier disputed the strategy behind consolidation, questioning whether customer-service-driven airlines are considering the right solutions for financial success. "One thing that concerns me about airline consolidation," he said, "is that I think they're chasing down the wrong rabbit hole. Profitability is not about having the lowest cost; it's about having the greatest difference between revenue and cost. If you don't focus on the revenue line, which is about product differentiation and customer service, then you're not necessarily going to go in that direction."

Bollinger expressed similar reservations about the consolidation model. "The benefits of consolidation accrue to the industry as a whole, but the cost of the complexity of actually managing the transaction goes only to a couple of airlines," he noted. "I'm not sure why anyone would want to endure all that cost and complexity and see all the benefits flow to themselves and all their peers."

Epstein offered an analyst's view on how consolidation would impact the big airplane manufacturers, a question he often hears from clients. "In the short-term, it probably means there's a smaller fleet and they sell fewer planes. Longer-term, I'm very bullish if it were to happen for commercial aerospace because you take some of the volatility out of the airplane order cancellation cycle."

Global Business Boom

Globalization in commercial aviation has led to tougher competition, regulatory issues and, particularly in the case of corporate aviation, increased demand. For Embraer, the international landscape has delivered both opportunities and threats. For instance, the company has a successful joint venture in China through which it produces its 50-seat regional jets. At the same time, China is among the countries vying for business in Embraer's newer market segments. "New competitors are coming into the 70-to-100-seat market," explained Chiessi. "They are the Chinese, the Russians and the Japanese. We don't expect them to increase their production rates very quickly. We are not worried about the competition in terms of products and customer support because those guys are newcomers, but they will bring the challenge of price pressures."

Embraer figures prominently in the growing competitive landscape of manufacturers, which has of late been dominated by Boeing and Airbus. These companies have not maintained this duopoly for very long -- and may not for much longer, suggested Epstein. "My hunch is that you're going to see [the competition] align somehow on a global consortium. Boeing is already aligning with the Japanese" and Airbus could align with the Chinese and the Russians, he said. Added Bollinger: "It wouldn't surprise me if in 20 years you see Boeing or Airbus designing and building a jet entirely outside the United States. You could see a very different industry structure that brings non-European, non-American parties to the table but not as different countries."

Ashton (formerly) of PrivatAir, a full-service corporate aviation provider, pointed out that less than 10 years ago, 70% of the corporate aviation space was in the U.S., primarily in California, Florida, New York and Texas. Today, the majority of new corporate aviation business is happening outside the U.S. As corporate aviation becomes increasingly global, Ashton suggested that the regulating bodies have to figure out how to unify regulations. "The globalization of the industry creates major challenges for us as we start to do business inside some of these countries -- everything from registering aircraft, cross-border transactions, financing, securing liens, importing and exporting airplanes," noted Ashton. "It has become a very complex enterprise to move an airplane from one country to another. If you really want a fun challenge sometime, try to bring a Falcon 2000 back into France after it's been outside the country."

Ashton added that as the world embraces business aviation and growth in the business jet market continues to boom, the wealthy overseas markets no longer want America's aircraft cast-offs. Old aircraft that had aged 20 years and were past their usefulness in the U.S. used to have a second life as hand-me-downs in overseas markets. Now, commercial aviation must come up with new solutions for its retired airplanes.

Globalization is not alone in helping to create the spike in demand for business jets. Very Light Jets (VLJs), small jet aircraft approved for single-pilot operation that seat four to eight people, are considered to have huge market potential. Embraer, for instance, has forecasted manufacturing 11,000 corporate jets in the next 10 years, with 23% of that expected to be VLJs.

Ashton suggested that the industry is witnessing the first pitch of the first game of the World Series when it comes to the lifecycle of VLJs. While it's early, he and others, including Bollinger, recognize a true latent demand for this type of aircraft. "Real wealth in this country is created by small business," noted Ashton. "Small businesses today, with the exception of light aircraft like [Cirrus Design's], really have no access to a private aviation solution. They wouldn't even know whom to call if they had to charter an airplane because the market is so fragmented for that type of a product. The real opportunity with VLJs is to go after the five-to-50-person company that is putting its best salespeople on airlines to visit high-growth customers."

Wanted: Air Space and Runways

As the commercial aviation industry looks to global markets and expands its offerings, it must remain vigilant about infrastructure development in the U.S., the panelists urged. The industry, said Bollinger, is fundamentally broken when it comes to its air traffic management (ATM) system. Booz Allen has looked into this issue as the support contractor for the U.S. Federal Aviation Administration on its next-generation ATM system. "We've gotten a look at the numbers and the scenarios, and it's frightening," concluded Bollinger. "The issues around access to air space today are reaching their limits; if we thought about air space differently, it would open up a lot of capacity. Until we fix the ATM system in the U.S., I think the airlines won't be able to control their experience enough to really differentiate their products. At the end of the day, that's a sad thing."

Klapmeier echoed concerns about air-space access, adding that it is as much an issue of public perception as it is a concern for the regulating agencies. "CNN and the weather channel show you how the air is clogged with airplanes. But I have not yet seen an airplane that has a 50-mile wingspan," he said. "I also notice airplanes flying right over me, but we don't hit each other -- it might be several thousand feet up. That's not the perception of the general public. The general public believes, given the quick snapshot on CNN in the morning, that the skies are overcrowded. They are not. We have plenty of volume. We need to change the way we manage the air space."

That directive extends to how well planes are managed on the ground. "The bigger problem is that we don't have enough runways," added Klapmeier. "The top 15 airports all need at least one more big runway so we can get more airplanes down on the ground. It's time for the industry to get together and accurately communicate to Congress and the general population what the real problems are. If we can fix them, then we will be able to have significant growth in this industry inside the United States."

Just as better runways and improved air traffic management speak to customer value, so, too, do well trained employees. Workforce development is becoming critical as pilots and other staffers retire and exit the industry, Leach indicated. "Those companies that are trying to generate growth and keep up with turnover have been pulled in many different ways, and it's kept them from meeting their

scheduled demands," he said. "There are challenges in that area from a regional perspective. We've lost some of our talent in the industry to other businesses. We've attempted, as an industry, to try to stop some of the flow by keeping some of our most talented pilots around, those who are over 60. We have to get some good information out there about our industry.... We have to do a better job of promoting this as a career path."

Perhaps Bollinger left the conference participants with one of the greatest challenges to ponder -- one to which industry insiders and general aviation consumers alike can relate. "An airline is about service, yet the typical customer experience moving from point A to point B by air is not very pleasant," he said. "Most of it has nothing to do with what the airline can control. It's about finding a place to park at the airport, it's going through lines and being strip-searched, and it's waiting for ATM to allow somebody else on the runway. An industry that delves into customer service at the end of the day has to control its customer experience, and airlines do not control their customer experience."