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Love on the Rocks?

A closer look at global alliances

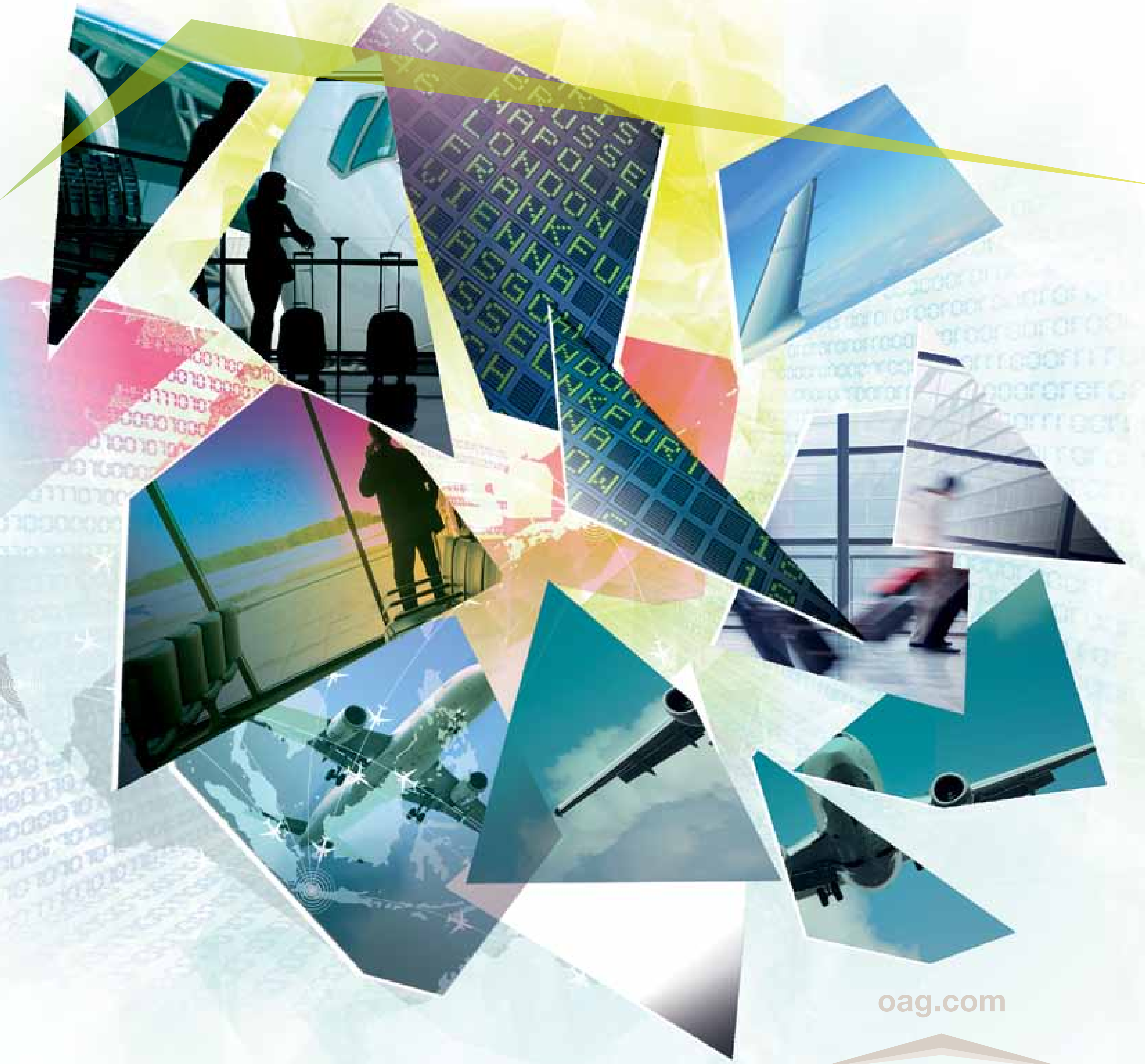

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Table of Contents

A new era for global airline alliances?

> If proper consolidation was permissible alliances wouldn't exist.
>
> *Willie Walsh, International Airlines Group*

When the Star Alliance formed back in 1997 it marked a new era in airline strategy. Airlines with global ambitions sought to form alliances which would give them access to larger networks, provide economies of scale and the opportunity for coordinated marketing, while circumventing the rules preventing international airline mergers and take-overs.

Today, we are in the midst of a new spate of airline strategic activity, some of which appears to undermine the existing alliance model. Once committed alliance members are becoming increasingly promiscuous.

- Qantas, a founder member of Oneworld, announced a partnership with unaligned Emirates, abandoning its 17-year revenue and cost sharing pact with fellow Oneworld member British Airways.
- Etihad Airways, another unaligned Middle East carrier, bought a 29% stake in German Oneworld carrier Air Berlin, and is pressing the German carrier to work with another of its own partners, SkyTeam's Air France/KLM.
- The admittance of Qatar Airways into Oneworld in 2014 could create further instability within the alliance.

The examples above are responses to the rapid rise of the hub carriers in the Middle East and reflect an 'if you can't beat them, join them' approach, replacing fervent competition with partnerships which provide access to key growth markets – at least for some of the big global alliances.

Oneworld, in particular, now has a plethora of competing interests among its members but has always been a 'looser' federation of airlines than the somewhat stricter groupings which are the Star Alliance and, to a lesser extent, SkyTeam.

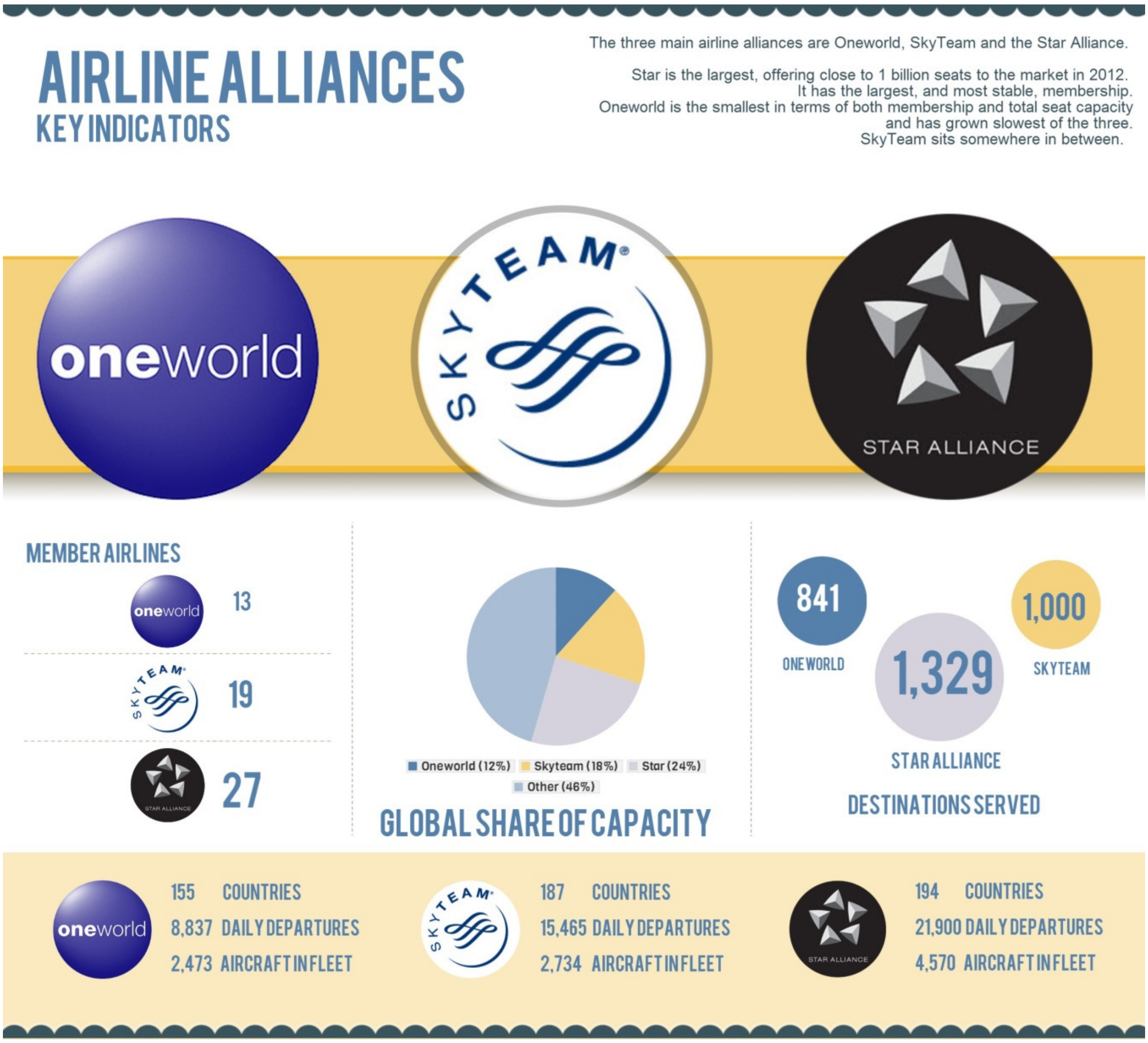
Although the airline alliances continue to grow and add new members, are these new partnerships a sign that the model is breaking down? CAPA – Centre for Aviation, in its recent paper 'Radial Alliances and Virtual Airlines: Reshaping the Partnership Model in a New World', provided valuable insights into what might be occurring, suggesting that some carriers are looking to develop a more 'ego-centric' model based on bilateral agreements between carriers which serve specific geographic and market goals.

In essence, the new airline partnerships prioritise network flow and benefit above all else, and certainly over the economies of scale and common branding which were explicit among the goals that the global alliances set out to achieve.

In this analysis we trace the history of the main global airline alliances and provide a comprehensive view as to where they are today, where their geographic strengths are and where they have gaps in their global coverage. In so doing we debate the different strands of strategic thinking that have guided them until now and identify how those strategies may be changing.

Evolution of global airline alliances

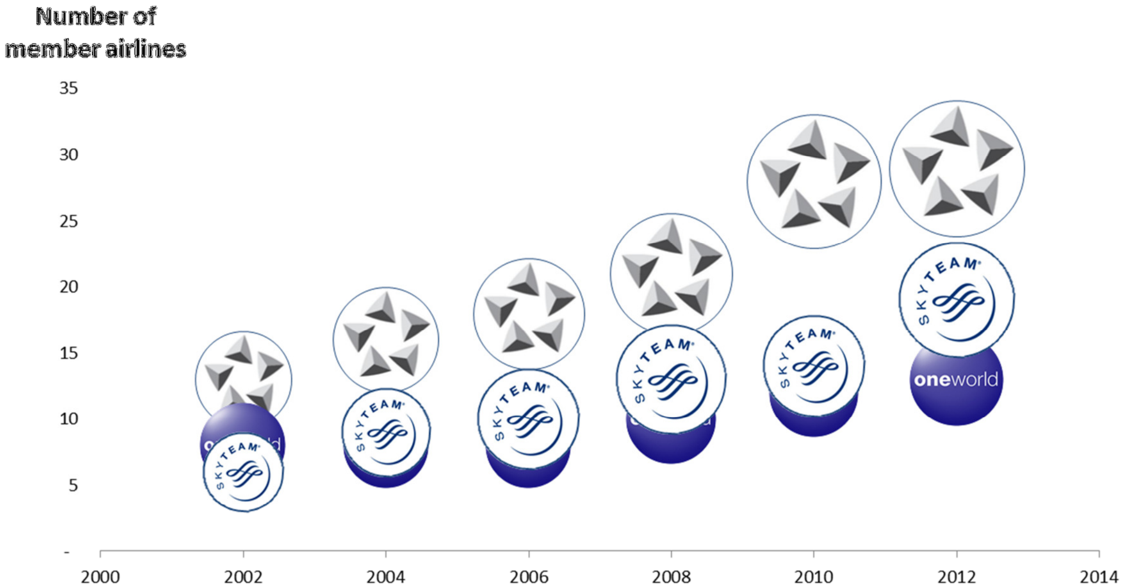
Hot on the heels of the formation of the Star Alliance in 1997, Oneworld was launched in 1999 and SkyTeam in 2000. Each has grown in terms of membership, share of global capacity and the reach of their networks since then. Despite similarities there are some striking differences between them.



Source: Oneworld.com, Skyteam.com, staralliance.com

The Star Alliance is by far the biggest alliance with 27 member airlines serving 193 countries and offering nearly 1 billion seats to the market in 2012. Star has almost double the number of aircraft at their disposal than either Oneworld or SkyTeam and has 24% of all airline seats worldwide. Star has 15 more member airlines than Oneworld and 7 more than SkyTeam and with the addition of US Airways in 2004, Air China in 2007 and Continental in 2009, Star increased the overall alliance capacity by between 8-12%. Star operates with a greater level of integration from its members than the other alliances and has gone furthest in creating a common brand.

EVOLUTION OF SEATS BY ALLIANCE 2002 - 2012



Source: OAG

Since their early beginnings, all three alliances have grown in size and membership. Oneworld has seen the slowest growth of the three main alliances in the last decade, with just 1% growth per annum, compared to around 8% each year for the other two. In the last 5 years, Oneworld has actually seen capacity decrease marginally by (an average of) 0.3% over the last five years whilst SkyTeam has grown by 6% per annum and Star by 10%.

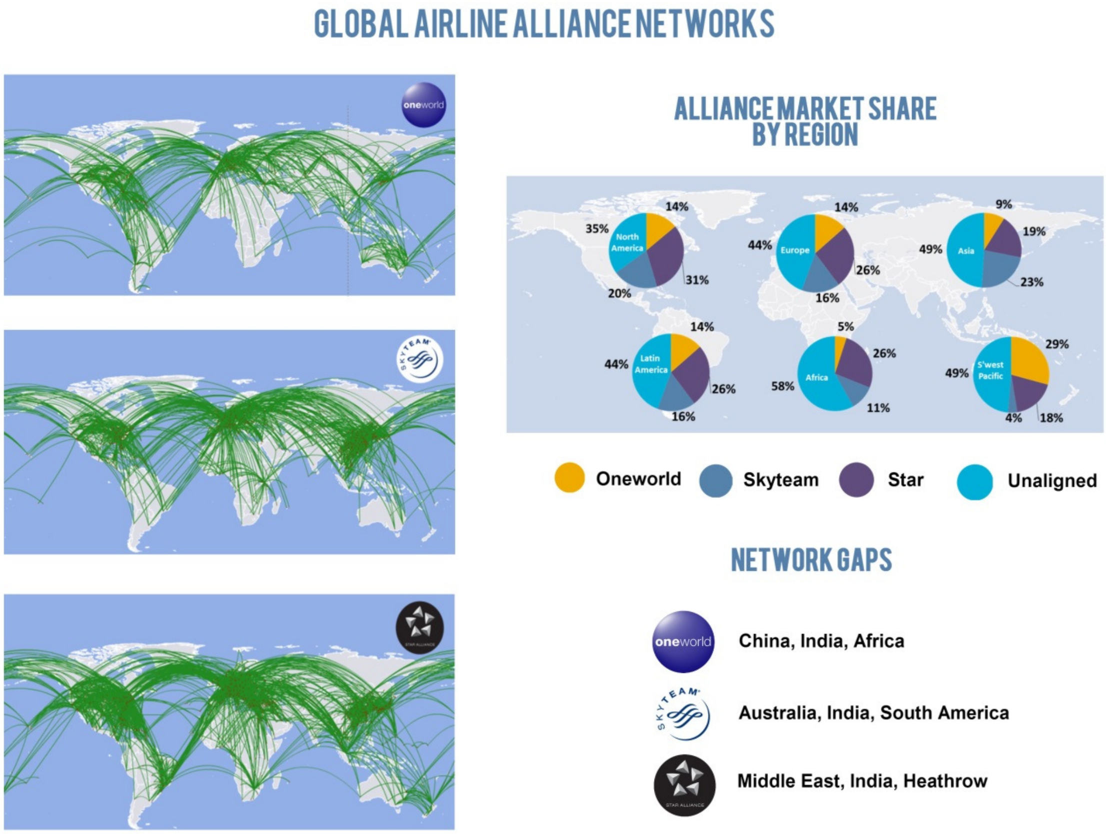
Of all the alliances, Oneworld is remarkable in that the majority of capacity remains with the original founding members: Japan Airlines (JAL) is the only large airline to have joined since 2002; S7 (which joined in 2010) being the next largest at around a fifth of the size of JAL. However, Oneworld has fallen behind its rivals in the past few years. The alliance has had to contend with the failure of Mexicana in 2010 and of Malev in 2012, as well as the bankruptcies of both American Airlines and Japan Airlines. The recent demise of member-elect Kingfisher and the restructuring of Iberia have also impacted the alliance's desire to grow and move forward.

SkyTeam has had a more turbulent membership than Oneworld with 15 airlines leaving the alliance over the past 10 years, compared to seven leaving Oneworld. Despite this, SkyTeam today has more airline members than Oneworld, serves more countries and has a larger share of global capacity and the SkyTeam alliance has more than doubled seat capacity since 2002.

Global reach of the big 3

The composition of each of the three global alliances means that each has near global reach, but there are also gaps in each of their networks.

Star is strongest in North America, but weaker in the Middle East, while Oneworld is particularly strong in Oceania and SkyTeam has strength in Asia Pacific.



Source: OAG

The sheer depth of the route lines above reflects the competitive position with the market share providing the hard facts.

Oneworld today may appear a somewhat disparate collection of airlines in need of some strategic direction. From the outside looking in, Etihad's stake in Oneworld carrier Air Berlin, Air China's stake in Oneworld carrier Cathay Pacific, Emirates' new partnership with Oneworld carrier Qantas, and the competitive impact on Oneworld carrier Royal Jordanian from new member Qatar Airways all serve to muddy the waters for the alliance.

In terms of network reach, Oneworld is well connected on the transatlantic market and in Europe and Japan, but has a number of gaps, with China and South America of particular note. While the arrival of the LATAM Airlines Group (following the merger of LAN and TAM), Malaysia Airlines and SriLankan Airlines may be a sign of strategic direction taking shape, the alliance is still somewhat disparate and establishing better coverage in China remains a challenge. Oneworld is also the only one of the three major alliances with no African member.

With Malaysia, SriLankan and Qatar Airways joining Oneworld in 2013/14, and the merged entity LATAM also now confirmed, Oneworld may be well positioned to return to stronger growth and build a greater presence in the rapidly and continually growing economies of South America and Asia. Indeed, on the basis of current capacities, these new members will increase Oneworld's total seat capacity by 25% (ahead of any market consolidation).

Back in 2010, on its 10th anniversary, **SkyTeam** identified where the priorities would be in terms of network gaps. These were Latin America, India, South East Asia and the wider Asia Pacific region. Most of the SkyTeam members to have joined the alliance since then clearly fit this strategy. Vietnam Airlines joined later that year and Garuda joined in 2012, providing much improved access across South East Asia. The remit to improve the network across the wider Asia Pacific region has been partially addressed through SkyTeam's continually improving presence in China and the addition of China Airlines in September 2011. However, SkyTeam has no members from Japan or Australasia.

Following their recent joint venture with Delta there is a possibility that Virgin Atlantic may join SkyTeam. Aside from the strategic value of access to London Heathrow, it is not clear what benefit this would bring to SkyTeam.

Finally, in Africa, Kenya Airways is a member of SkyTeam, giving extensive – but not comprehensive – networking across the Continent.

Although **Star Alliance** is the dominant alliance by sheer number of members and global seat capacity, there are still some significant gaps in their network coverage. Most notably, they lack a Middle East partner in the way that Oneworld and SkyTeam do, and Lufthansa in particular has been vocal about the need for greater 'control' on market access.

Arguably, Turkish Airlines could fill the 'Middle East' role for Star as Istanbul has the potential to offer customers travelling between Europe and Asia Pacific a similar level of connectivity to that which carriers operating from the Middle East region do. With the new mega airport planned for the Istanbul market due to be operational in 2017, Turkish Airlines' intentions are very clear.

Four Star carriers – ANA, Asiana, Turkish and US – currently codeshare with Qatar Airways, a member-elect of Oneworld, providing the airlines, if not the Star alliance, with a degree of Middle East connectivity. Whether these codeshares will continue once Qatar joins Oneworld in 2014 remains to be seen.

Star is also facing a network gap at London Heathrow. When Lufthansa sold unprofitable BMI to IAG, British Airways' parent company, IAG (and by association Oneworld) gained the BMI slots at Heathrow. Star would certainly benefit from finding new partners that can provide short haul network capacity at Heathrow and has courted Aer Lingus, amongst others, to this end. However the 'others' pool is certainly very shallow! This becomes all the more important with the renovation of T2 at Heathrow, which is designated to become the Heathrow home of Star Alliance airlines when the terminal re-opens in 2014 with an initial annual capacity of 20 million.

? What will Star do for short haul feed when it occupies T2 at LHR?

In North America, the merger of Continental Airlines with United has strengthened Star's network to the detriment of SkyTeam, which Continental had joined in 2004 but left when it joined Star.

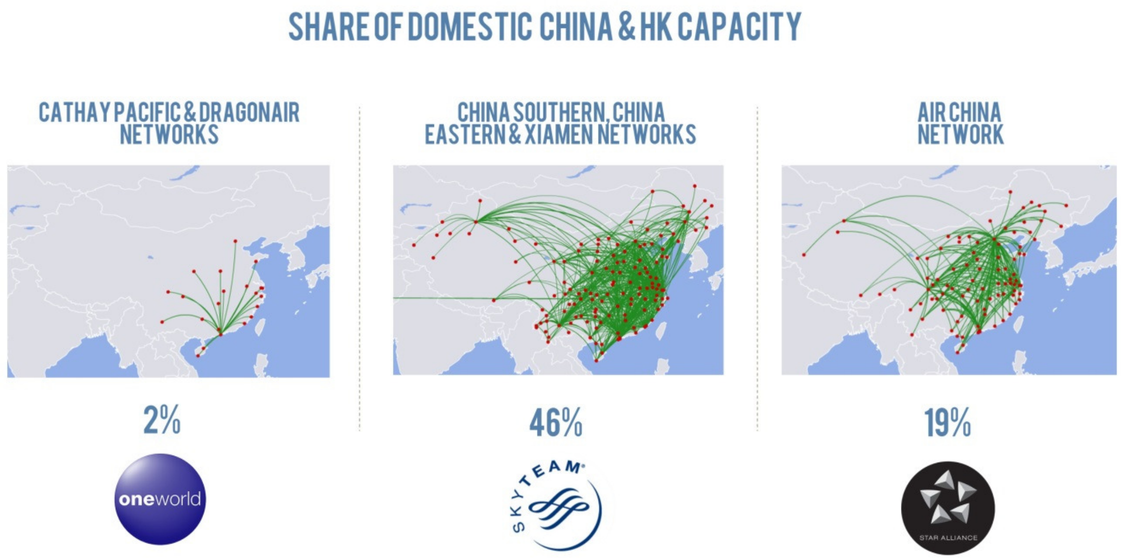
Star has the strongest presence in Africa having brought several of the continent's biggest airlines into its family through South African Airways, Egyptair and Ethiopian. More than any other alliance it has depth and breadth of network in Africa, which means it is well placed now for the air traffic growth that could yet occur given the relatively strong economic growth in Africa.

China – has Oneworld missed its chance?

For the big 3 alliances, China still represents one of the global markets where there remains scope to grow and secure market share. China's huge domestic market is dominated by the three largest Chinese carriers – Air China, China Eastern and China Southern – which represent over 50% of seat capacity.

The major alliances have made some headway into the domestic market in China (these figures include Hong Kong), with SkyTeam member carriers China Eastern, China Southern and China Southern's partner Xiamen Airlines accounting for 46% of China's domestic seats. Star has 19% through the membership of Air China, whilst Oneworld, with no 'mainland' Chinese member, has very little coverage and only 2% of domestic seats.

China's fourth largest domestic carrier by seat capacity, Hainan Airlines, has 7% of the domestic market and is unaligned with the big three alliances. Hainan could prove a potential target for Oneworld but it is doubtful whether the network reach of Hainan is sufficient to make it attractive enough and Oneworld may decide that its best strategy is to further pursue the Chinese market via Cathay Pacific (and Dragonair).



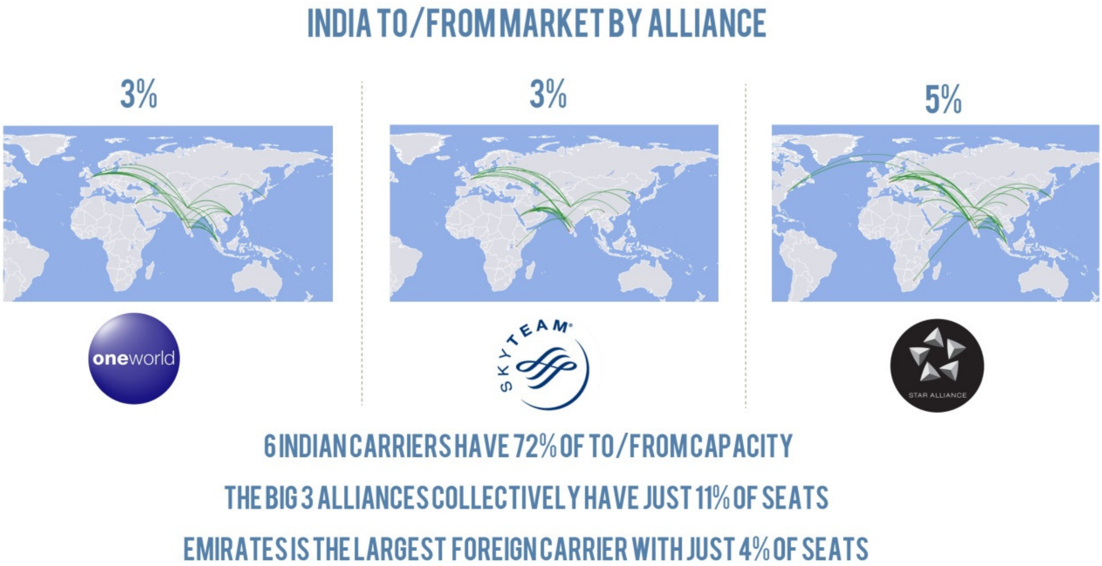
Source: OAG

What to do with India

Each of the alliances have been wary of the Indian market. Despite Indian government moves towards liberalisation, alliances view with trepidation the volatility in the market and recognise the challenges concerning airport infrastructure.

SkyTeam has made little progress in establishing a presence in India, although the addition of Saudia in May 2012 did provide new routes into India from the Middle East. Star also has no significant presence yet in India and although Air India has been considering (or been considered for) joining Star for many years, this has not yet come to fruition. Oneworld came closest in 2012 when Kingfisher Airlines was due to join, but the carrier collapsed due to financial pressures before becoming a member airline.

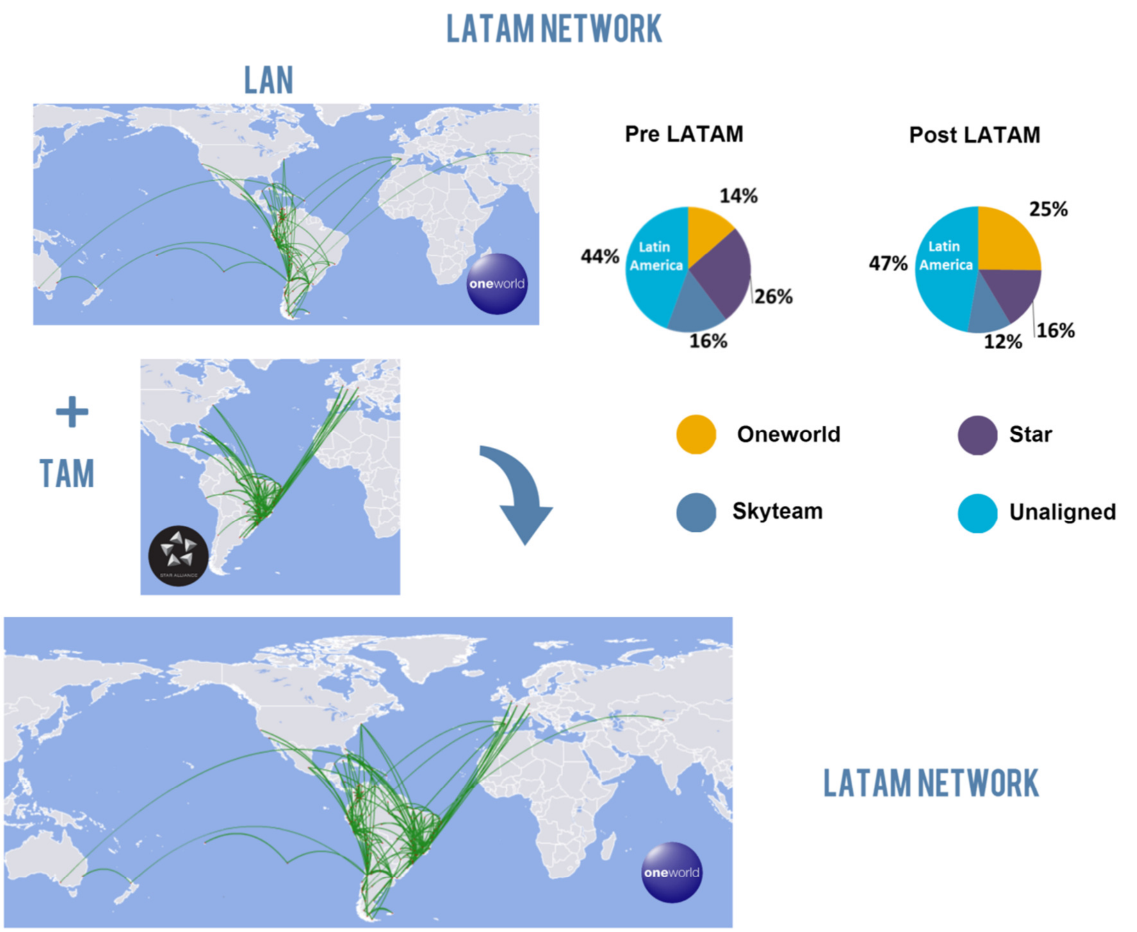
Until the Indian market settles down, it would appear that all the alliances are focusing on lower hanging fruit.



Source: OAG

Does Oneworld have the edge in South America?

The decision in February 2013 that the LATAM Airlines Group would join Oneworld (following the merger of LAN-TAM in June 2012) has been pivotal in establishing Oneworld as the leading alliance in South America. The Chilean flag carrier LAN was a founder member of the Oneworld alliance, while Brazil's TAM was with Star Alliance. The two airlines now form the world's largest carrier in terms of market capitalisation. Prior to the merger they had very little network overlap and so virtually the whole TAM network comes as an addition to Oneworld, and significantly strengthens Oneworld capacity between South America and Europe.



Source: OAG

LATAM's South American rival, Avianca-TACA, is part of the Star Alliance. Star will now see its market share of Latin American capacity drop from 26% to 16%, while Oneworld grows its capacity from 14% to 25%, a clear coup for Oneworld. Had LATAM decided to go with Star rather than Oneworld, the Star Alliance would have controlled 35% of capacity while Oneworld would have managed just 6%. Star continues to dominate capacity at some of Latin America's largest hubs – with 44% of capacity at Sao Paulo (GRU), 72% at Bogota, and 46% at Sao Paulo (CRH) - Star benefits from Copa Airlines' strength in the region.

> ? Is Oneworld looking for ways to grow the North America-South America connectivity? Which carriers could help it dominate this market?

Meanwhile, the goal of strengthening SkyTeam's presence in Latin America was partially met last August when Aerolineas Argentinas became a member of the alliance. Despite this, much of South America remains outside of SkyTeam's reach.

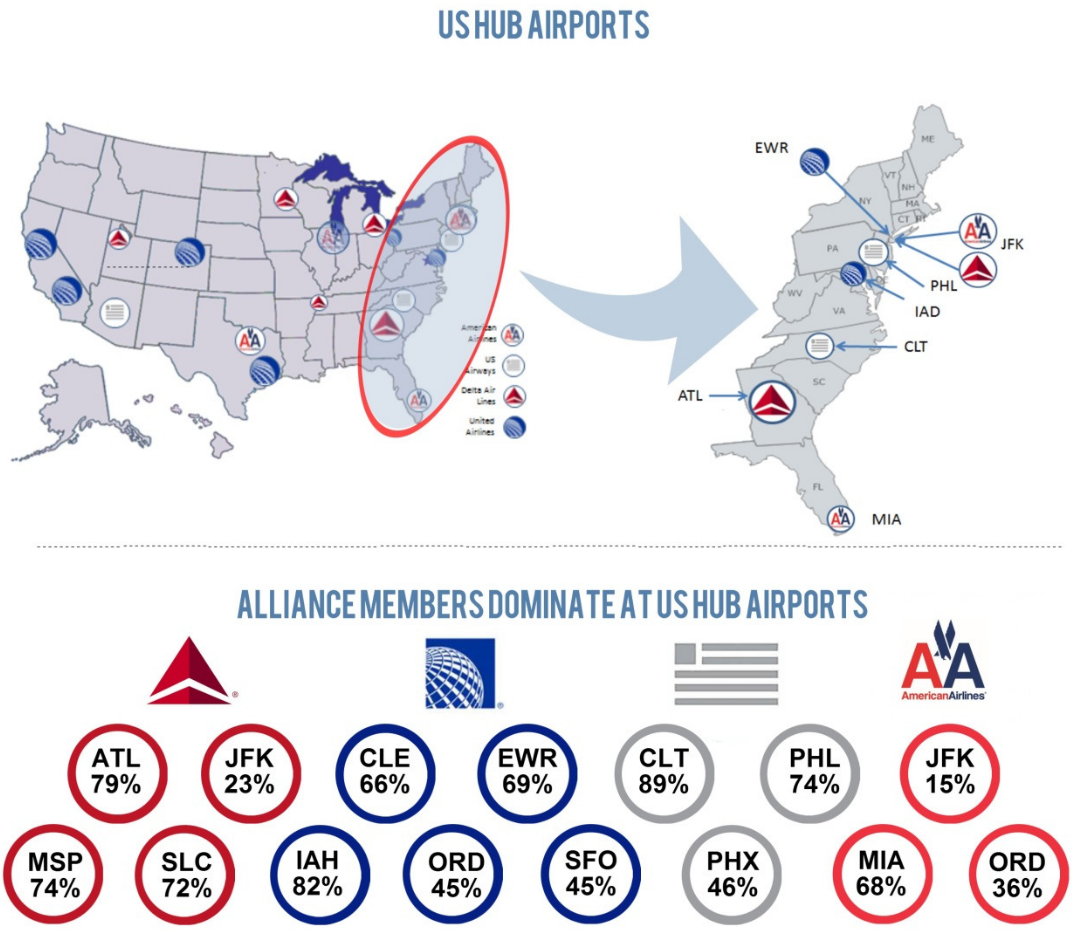
Shake up in the Americas

> **Will US Airways hubs at Philadelphia and Charlotte become marginalised?**

The merger of US Airways and American Airlines during this year will create the world's largest airline by passenger traffic. The inevitable consolidation that will take place when these two giants merge will undoubtedly lead to consolidation among some key US hub airports. By way of example, when US Airways and America West were merged back in 2005, the America West hub at Las Vegas was wound down and marginalised. Should we expect a similar outcome now, this time with the US Airways hubs at Philadelphia and Charlotte being diminished in the new network?

Despite the size of the JetBlue and Southwest Airlines operations, it is the airlines which are members of global alliances that continue to dominate the US hub airports. In April 2013, Delta (SkyTeam) operated 79% of scheduled capacity at Atlanta Hartsfield International Airport, United (Star) operated 82% of scheduled capacity at Houston, and American (Oneworld) operated 68% of scheduled capacity at Miami.

Despite the dominance of US Airways at Charlotte, the airport is overshadowed by the massive Atlanta Airport hub, while Philadelphia is squeezed on either side by the larger Washington and New York metropolitan areas.



Source: OAG Analyser

Middle East Moves and Impact on Europe – Asia Flows

The rapid rise of the three big Middle East carriers is one of the key drivers shaping the strategies of the airline alliances, or at least the airline members within them. While the convenient geography plays a part in their success, as the image from Dubai International Airport's Strategic Plan to 2020 (overleaf) shows, they have also benefitted from huge investment in both the airline and airport sectors.

EIGHT HOURS FROM DUBAI

Source: Dubai Airports – Strategic Plan 2020

Until recently, all three of the big Middle East airlines were distinctly 'hands-off' in their approach to airline alliances. If the purpose of alliance membership has primarily been about extending network reach while overcoming regulatory barriers, these carriers simply didn't see the need for that.

It would appear that now they have reached a size where they, too, are asking how to extend their reach beyond the range of a non-stop flight, or perhaps beyond a sector of eight hours, which seems to be the point at which the opportunity for financial returns given fuel prices and airline competition diminishes. These big Middle East airlines are not necessarily coming to the conclusion that joining an existing alliance is the best way forward.

> "I think they're fractured (the major alliances)
>
> *James Hogan, Etihad*

Emirates continues to pursue a strategy which is independent of airline alliances, preferring to work with key partner airlines where it is mutually beneficial. Etihad will be 10 years old later in 2013 and, like Emirates, eschews alliances and publicly states that it intends to remain unaligned. However, with a stated priority of increasing network flows, it is happy to work with other airlines and has in place 38 code-sharing arrangements with other airlines, the most recent being with Garuda Indonesia.

Were it to ever join an alliance it might fit best in SkyTeam given its current partnership with Air France/KLM.

Extract from Sunday interview: Etihad CEO James Hogan

The Telegraph, 9 March 2013

"Although Hogan has ambitions in the UK, it is his global alliance with partner airlines of which he is most proud. The strategy has seen Etihad take equity stakes in four airlines around the world – 29.9pc in Air Berlin, 3pc in Aer Lingus, 10pc in Virgin Australia and 40pc in Air Seychelles.

Hogan refers to it as the airline world's first "equity alliance", and argues this is a far better model than simply joining one of the large airline alliances, such as oneworld , whose members include British Airways, Cathay Pacific and American Airlines.

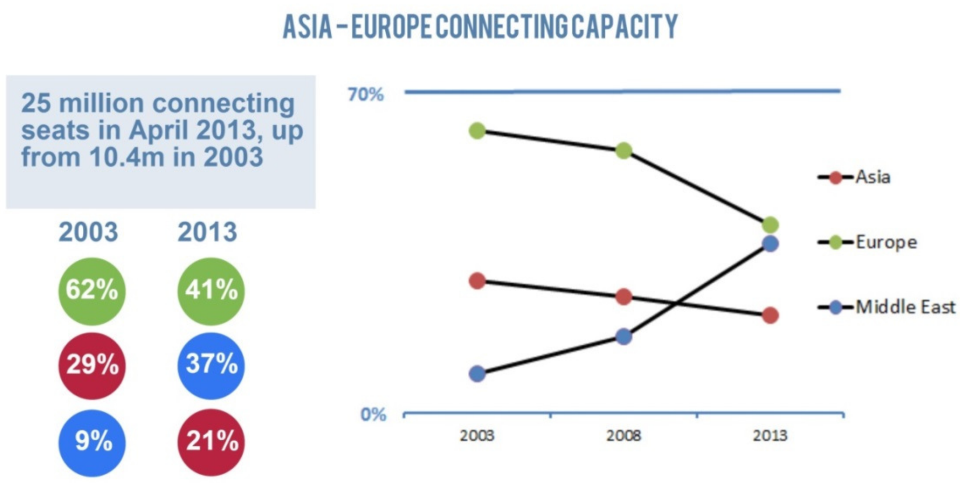
"I think they're fractured," he says of the major alliances.

"The one thing we've been able to do is we move fast, we don't have the bureaucracy of an alliance. Because we have 'skin in the game' of our equity partners, we're as focused on their profitability as our own profitability. Whereas in the alliances, they're all competing with one another."

In contrast, Qatar Airways is a member-elect of Oneworld, and due to become a full member in late 2013 or early 2014. The airline had only four aircraft 15 years ago yet now has a fleet of 124 aircraft with a further 173 on order.

While the three major Middle East hub carriers have been growing, legacy carriers initially sought to reduce the impact of the new competitors by seeking limits to traffic rights, lodging complaints about state subsidies and citing unfair competition (in some markets). However, it is the realisation that they are here to stay and also the relative cost / network benefit of operating longer-haul non-stop sectors independently which is forcing a change of approach by airlines.

The impact of the new hub airports created by the Middle East hub carriers is demonstrated in the way they have changed the routing of air passengers travelling between Asia and Europe.



Source: OAG Connections Analyser – Gateway Report, April 2013

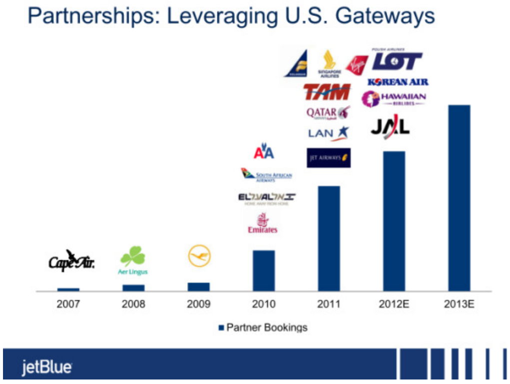
Note: Connections in this example are defined as single online connections, origin Europe, destination Asia, maximum circuity 180.

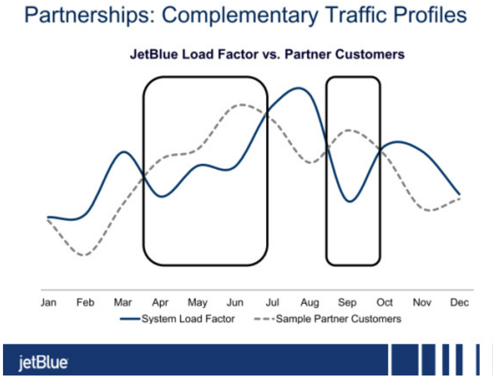
Time for the mature LCCs to join the grown-ups?

JetBlue Airways is perhaps the best example of a mature LCC which has continued to evolve and seek new partnerships and business models. Three years ago, JetBlue converted its reservation systems over to Sabre, with a desire to more easily align with other carriers' booking systems, and currently has commercial deals with over 20 international carriers.

JetBlue believes that by partnering with these carriers, they can create complementary relationships, for example, flattening their seasonality profile as the charts below highlight.

JETBLUE BENEFITS OF AIRLINE PARTNERSHIPS





Source: Jetblue Investor Relations 2012

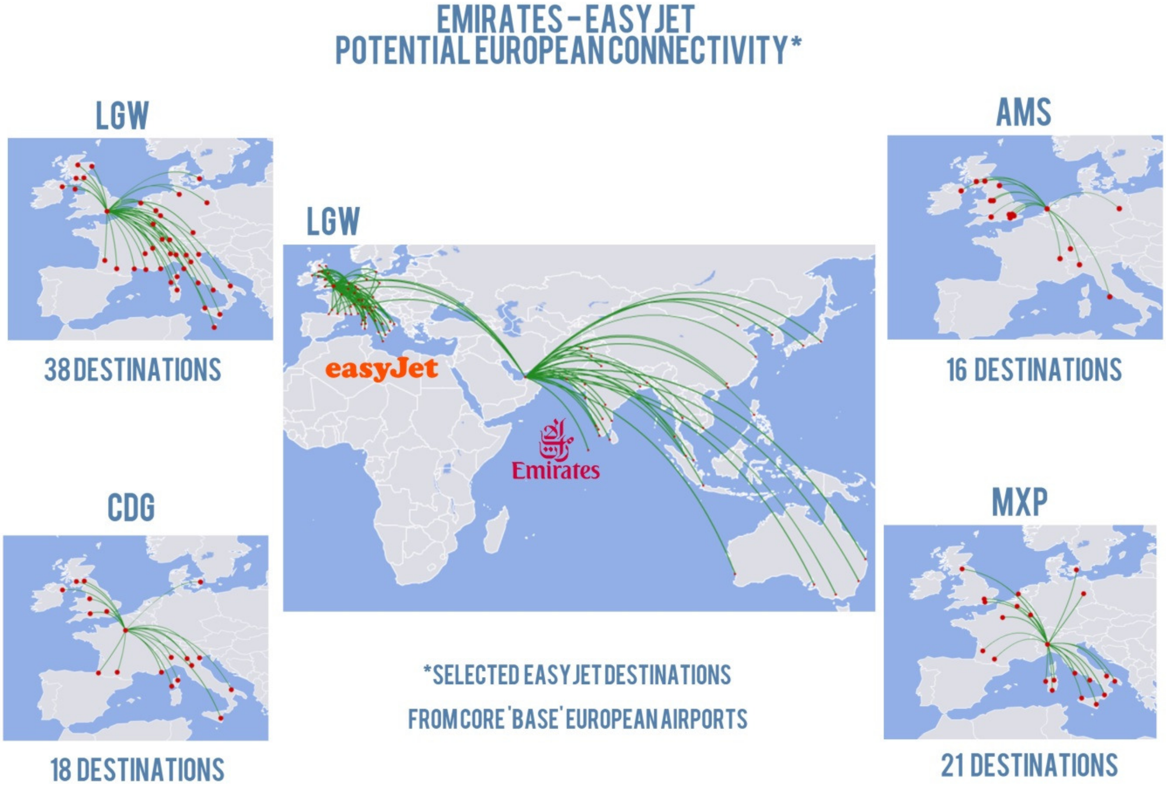
EMIRATES SKYWARDS PARTNERS

Alaska Airlines
easyJet
Japan Airlines
Jet Airways
JetBlue
Korean Air
Qantas
South African Airways
TAP Portugal

Source: www.emirates.com

Jetblue point to their partnerships with other airlines as a way of not only leveraging their position at key US gateways, but also as a means of flattening their seasonal load factor profile as the chart above demonstrates. Taking this to its next step could mean a deeper relationship with an alliance offering a very specific benefit for an LCC.

In late 2012, easyJet announced a partnership with Emirates that allows Skywards customers (Emirates' frequent flyer programme) to put Skywards miles towards easyJet flights. Emirates has agreements like this with eight other carriers, including JetBlue. Could we see a deeper relationship emerge between Emirates and easyJet with easyJet providing connectivity at European hubs?



Source: OAG

With arrangements such as these becoming more commonplace between low cost carriers, or LCCs, and legacy carriers, is the use of LCC meaningful anymore? Is JetBlue really an LCC? Perhaps such terminology is already redundant and we would do better to recognise that there is a wide spectrum of airline business models in place today.

> Is it meaningful to talk of LCCs (low cost carriers) anymore?

Turning to Asia, back in 2010 there was the possibility of a share swap between AirAsia and Malaysia Airlines which would have seen the possibility of a four-way tie up between Malaysia Airlines, AirAsia, Qantas and Jetstar (on the basis of the non-equity arrangement that was put in place between AirAsia and Jetstar). That didn't happen, but are there other possible tie-ups? Is Asia taking a different route from the one taken by legacy carriers via alliances?

AirAsia is no longer the new kid on the block. The carrier has been operating for 10 years, has six AOC's with a JV to come in India and its network reach is extensive. AirAsia is now the second biggest carrier in terms of seat capacity in the South East Asia region (after Lion Air), has the largest fleet with 135 aircraft and the biggest order book with 383 aircraft on order (Lion Air aside!). Of South East Asia capacity, AirAsia represents 17%, growing 16% on last year.

The airline is clearly starting to operate and 'think' in a more structured and, dare we say, legacy fashion. Although the agreement with All Nippon Airways (AirAsia Japan) was recently abandoned (with ANA set to purchase AirAsia's 49 per cent stake in the venture) it is a sign of things to come – LCCs, or what we have come to know as LCCs, will increasingly be looking to find ways to not only access new markets that cannot be successfully penetrated on their own, but also learn new practices from the established airlines. As we have seen with JetBlue and its relationships, particularly with Lufthansa, there is significant merit in learning from experience.

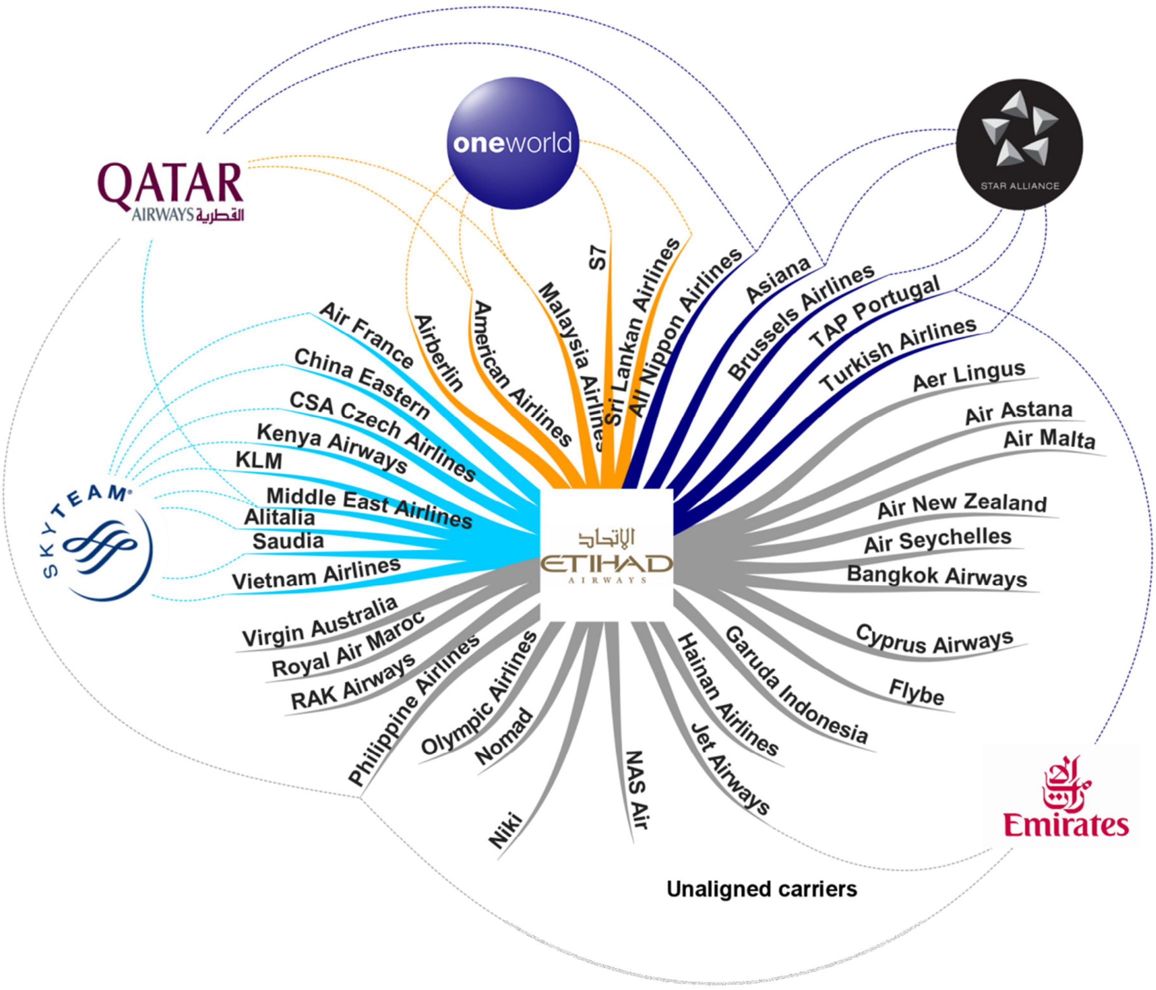
So what does the future hold?

Star Alliance is the largest and arguably most stable of the big 3 alliances, but is it possible that Star is becoming a legacy alliance in a world where new forms of partnerships will better deliver the benefits that alliances were initially created to bring? Certainly some of the leaders of the world's most successful unaligned airlines have been making that point in recent months.

Both SkyTeam and Oneworld appear to be more capable of adapting their modus operandi in the face of market developments. SkyTeam has managed to develop a network which has extensive coverage in some of the high growth markets of tomorrow, particularly China and Africa. Oneworld has come through turbulent times but now appears to be thriving from its looser approach to affiliation. With the decision by LATAM to join Oneworld and the massive capacity boost provided by Qatar Airways' membership, Oneworld will have the strongest presence in South America and the Middle East.

As Oneworld has discovered, the big Middle East carriers hold a key to the future strategic direction for the alliances but not every Middle East carrier is interested in being locked into an alliance, at least not yet. A look at Etihad's network of code-sharing agreements shows that it is prepared to work with carriers in each of the big 3 alliances, as well as unaligned carriers, and they don't seem to mind too much if an airline partners with another Middle East carrier. Of course, that may change with Qatar joining Oneworld.

ETIHAD'S MULTI-LAYERED RELATIONSHIPS



Source: OAG

> *It is easier, faster and far more cost effective to grow through one-on-one partnerships with established, respected carriers than it is to rely totally on our own resources, and to start from scratch in every market we serve……We have hand-picked like-minded partners with whom we can work collaboratively to build revenue across a broader network and reduce operating costs.*
> *James Hogan, CEO Etihad*

Might we one day see Etihad and SkyTeam strengthen their cooperation, resulting in Etihad joining SkyTeam, or possibly more SkyTeam members forming independent equity arrangements with Etihad (as Etihad's CEO James Hogan seems to imply is the preferred direction)?

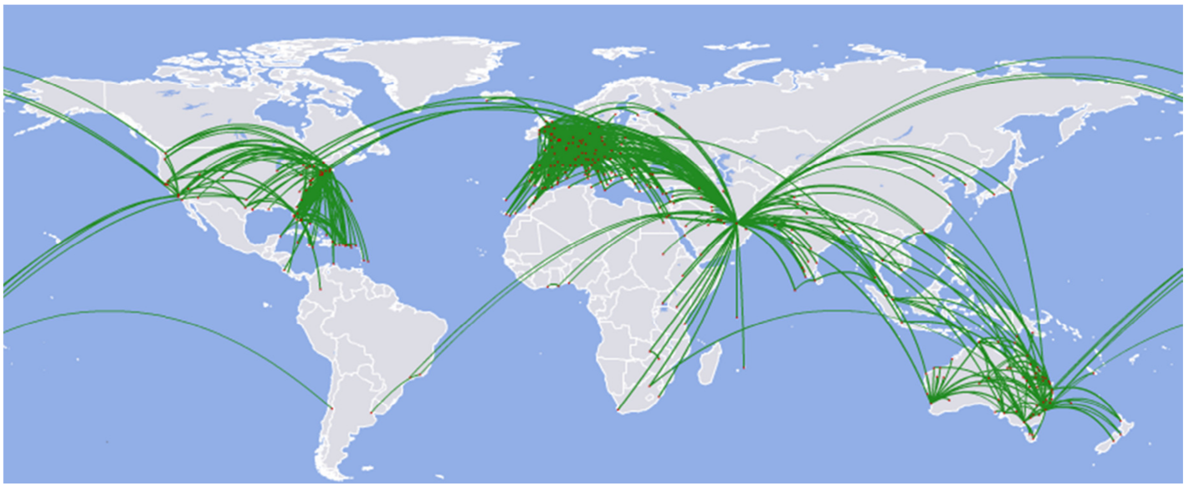
Oneworld may be smaller and looser, but recent developments such as LATAM and Qatar joining the alliance mean that it may be on the way up. However, repeating the comments made recently at CAPA's 'Airlines in Transition' summit near Dublin, alliances are not marriages and we should not be surprised to see new partnerships forming, sometimes brief, sometimes with real commitment.

? What might a combined Emirates, easyJet, JetBlue and Qantas network look like?

Meanwhile, there is no sign of Emirates warming to the notion of alliances. But what if it created further partnerships with selected carriers with distinct, strategic network benefit?

What might a combined Emirates, easyJet, JetBlue and Qantas network look like? It certainly wouldn't have the reach of the current big 3 global alliances, but would deliver impressively strong networks in some of the world's largest air traffic markets.

EMIRATES, EASYJET, JETBLUE AND QANTAS NETWORK MAP – APRIL 2013



Source: OAG

Signs of promiscuity among airline members should simply be read as the natural evolution of alliances as they continue to adapt to the forces of competition, liberalisation and the ongoing quest for profitability. If the founding or fundamental purpose of an alliance was global network reach, as we are seeing, the model has changed and the emerging, dominating partnerships are being built on flexibility rather than structure.

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All charts based on April 2013 data sourced from OAG Analyser and Mapper

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