



China's Airlines: Flying higher

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Alex Dichter
Jin Yu
Steve Saxon
Mathieu Weber

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Alex Dichter, Jin Yu, Steve Saxon, and Mathieu Weber

China's airlines face opportunities and challenges from expected increased market competition and burgeoning latent demand for air travel. To adapt profitably to the changing industry landscape, China's incumbent carriers can make four deliberately responsive moves.

China's Big Three state-owned incumbent carriers—Air China, China Eastern Airlines, and China Southern Airlines— and their subsidiary airlines have been a bright spot in the airline industry globally, averaging until recently returns of 15 percent. Their success presents a marked contrast to the industry as a whole, which has averaged returns on capital of under 5 percent in recent years.¹ The industry in Europe and the United States was badly shaken when large traditional carriers were caught off-guard by regulatory changes, and low-cost entrants rapidly captured large market shares. While the forecast market evolution in China does not present as stark a picture, returns have been lately falling off and a number of factors are converging that promise to change the industry landscape.

China is moving ahead with reforms in state-owned enterprises, designed to promote efficiency and profitability. Regulations on new entrant airlines and the speed of growth of private airlines are being relaxed. The effect of the reforms will tend to increase market competition. As latent demand for airline travel is building in China, the stage is set for both market expansion and disruption. With the advantage of hindsight on the experience in Europe and America, Chinese carriers are in a good position to develop effective strategies to ensure that the more competitive environment also creates value.

AIR TRAVEL IN CHINA: SUBSTANTIAL LATENT DEMAND . . .

Travel in China is an enormous but disproportionately earthbound industry. Thirty-five billion long-distance domestic trips are taken each year on traditional (i.e., not high-speed) trains and motor coaches. Based on benchmarks for travel propensity, we estimate that the number of travelers in China could easily rise by 50 or 60 percent as market conditions relax.

The McKinsey Global Institute foresees threefold growth in the number of people in China able to afford airline travel in the next ten years. The upper strata of China's fast-growing middle class is poised to become the principal engine of consumer spending—including air-travel spending—over the

¹ McKinsey analysis for *Profitability and the Air Transport Value Chain*, IATA Economics Briefing Number 10 (June 2013), International Airline Transport Association

next decade. Combined with China's newly affluent class, this segment will account for 80 percent of urban consumption by 2022, up from 30 percent in 2012. Outbound international air travel has been historically constrained by relatively tight visa regulations imposed on Chinese travelers by destination countries; these are steadily being relaxed, further stimulating travel demand. With only 4 percent of the population owning passports, China still overtook the United States and Germany as the world's leader in international travel in 2012. In 2013 more than 97 million Chinese traveled abroad, spending \$129 billion in their destination countries. In 2014 the number of outbound Chinese tourists is expected to exceed 112 million.²

Meanwhile, inland tier-three and four cities have been developing rapidly, with stronger middle-class growth than in the urban strongholds of the eastern seaboard. These growth spots are creating opportunities for new air routes. Today China lags behind Brazil and India in passenger flights serving tier-three and tier-four cities; China's international connectivity is especially concentrated in a handful of tier-one cities. This picture is about to change dramatically. China's current five-year plan shows 70 new airports under construction and feasibility studies for 28 more. McKinsey's research indicates that the availability of air travel will grow all over China, but it will increase 20 percent faster in tier-three and four cities than in tier-one and two cities.

... WITH (SURMOUNTABLE) BARRIERS TO CAPTURING IT

China's Big Three carriers face significant but surmountable barriers in the coming years. Competition is increasing, putting downward pressure on the price of airline tickets. With yields per kilometer of around 9.5 U.S. cents, China's domestic fares rival those of the US market, where travelers have more disposable income. This contrasts with carriers in adjacent markets – notably South East Asia – where new entrant low cost carriers are offering very low fares. By offering lower fares on domestic travel, the Chinese incumbents can awaken latent demand, stimulate further consumption, and reduce exposure to any new entrants.

Incumbent carriers may have to shift their marketing strategy to handle the new demand. Presently, distribution is disproportionately centered on direct sales and traditional travel agencies, with little e-commerce. Branding similarly remains traditional and out of tune with a new generation of travelers. McKinsey's research on the Chinese millennial traveler (20- and 30-year-olds) shows a more globally minded generation that is confident, independent, and looking forward to traveling. They are also Internet-savvy: 58 percent of those surveyed reported they were likely to book online.

AVERTING A VALUE-DESTROYING SCENARIO

With potential demand building in the Chinese market and greater competition expected, a scenario is developing whereby new entrants could capture much of the latent demand. China is the largest remaining air-

² China Outbound Tourism Research Institute; *BusinessInsider*, 20 May 2014.

transport market without significant penetration from new entrants, including carriers with a low-cost business model. China's airline regulator, the Civil Aviation Administration of China (CAAC) has recently praised the efficiency of Spring Airlines, one of the few private new entrants. The CAAC has made it easier to set up a new carrier and for existing carriers to expand their fleets.

A lesson from the European and American experience with new entrants is that after the market was penetrated by low-cost carriers, traditional carriers fell into losses due to market overcapacity and inflexible cost structures. The latent demand was by and large captured by new entrants. After a competitive shakeout, some of the new entrants survived, including Ryanair in Europe and JetBlue in the United States. Incumbent carriers often went through bankruptcy or tough restructurings. In China today, incumbents do not face so extreme a danger, but they can study the experience of European and American carriers and make corresponding moves to adapt profitably to the changes.

FOUR MOVES TO WIN IN A MORE COMPETITIVE ENVIRONMENT

US and European carriers were unable to react fast enough to the new entrants in their markets. Their high cost bases were designed for an era when air travel was a luxury. Chinese incumbents are in a better position to act to counter the risk. Four moves will go a long way to securing a profitable future.

Grow to serve new demand. Latent demand is burgeoning and competition from low-cost entrants is looming. Incumbents can best prepare to capture this demand by restructuring and adding needed capacity now. They should do this even if it means two or three years of lower profitability, since the prize, in serving the new airports and the new demand in tier-three and four cities, will be large. The new strategy will need to address constraints to growth, including the price sensitivity of the new travelers, the time needed to train pilots, and slot restrictions in major airports. Each airline will have to allocate existing resources efficiently but expand early to serve the new customer segments and geographies, including new airports and existing secondary hubs.

Improve efficiency. We estimate that incumbent Chinese airlines operate at a 30 percent cost disadvantage against new entrant Spring Airlines. The primary reasons are lower daily aircraft utilization and lower-density seat configurations. A typical aircraft in the fleet of a Chinese incumbent will operate for 9 or 10 hours per day, while at Spring, planes operate for 12 hours on average. The incumbents can become competitive with better scheduling for pilots, crew, and aircraft. Similarly, processes both onboard the aircraft and in airports can be streamlined to adapt to the lower fare environment.

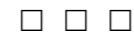
Modernize sales and branding. Chinese incumbents can modernize their sales and branding strategies. Incumbents have higher distribution costs because they use traditional travel agency channels and need more staff than low-cost carriers. Brands need revitalizing to ensure appeal to a newer generation of traveler. Incumbents can push for 50 percent Internet distribution, for example, both to reduce costs and to attract new self-directed customer segments. Last year, Spring Airlines exceeded 90 percent

in the share of sales made through e-commerce channels; 24 percent of their individual travelers booked with mobile devices.

Drive other sources of revenue. Internationally, customers have proved to be less sensitive to the pricing of ancillary services (such as baggage, seat selection, and meals) than to the core ticket price. Mindful of the need for lower ticket prices, the Big Three carriers can explore the willingness of their customers to pay for some of these ancillaries. They can also look for other sources of revenue: cross-selling travel products such as hotels, transfers, or tours, and—in recognition of the burgeoning demand from China’s express delivery market—carrying more cargo in the belly of the aircraft.

LOW-COST SUBSIDIARIES ARE A DISTRACTION

Some carriers globally have responded to the challenge by setting up their own subsidiary low-cost carriers to compete with new entrants. The philosophy behind this approach is that low-cost carriers serve a different customer segment than do mainline carriers. We believe this is a misconception and that the strategy it supports distracts management attention and company resources from the real solution. For Chinese incumbents, this solution is to expand and improve productivity in their core airlines. The direct route, of improving the existing airline, can be difficult, but we have seen carriers succeed. LAN in Latin America recognized the risk of new entrants capturing latent market demand. The airline underwent a major restructuring and developed from a traditional full-service carrier into a more productive, leaner carrier offering lower fares. The new business approach allowed LAN to capture growing demand for air travel, stimulate new volumes from bus travelers, and cement its leadership position in the market.



China’s Big Three carriers are well positioned to understand and surmount the new market challenges. They have a lot to win in capturing China’s large and growing latent demand for air travel. It is only natural, however, that big growth should require big efforts to capture it.

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Alex Dichter is a director in McKinsey’s London office and leads the firm’s airline practice globally, Jin Yu and Steve Saxon are principals in the Beijing office, and Mathieu Weber is a specialist in the Luxembourg office.

