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Big time

2010-02-01: Chinese airlines live or die by government policy, but some carriers are trying to create a healthier market

Despite the legacy of the credit crunch continuing to haunt the airline industry, Chinese carriers are performing well. The growing wealth of the local population has increased demand for both business and leisure air travel. The World Bank and the International Monetary Fund (IMF) have predicted GDP growth of 7-9% in China in 2010.

Although the "Big Three" (China Southern, China Eastern and Air China) all turned a profit in the first half of 2009, this was not achieved without difficulty.

Last year, both China Eastern and China Southern received massive capital injections from the government. They were mainly affected by fuel hedging contracts, the slump in demand and other operating costs. China Eastern Air Holdings, the parent of China Eastern, won a capital injection of US$290 million in March. China Southern's state-owned parent firm received a US$440 million bailout in 2008 and the nation's biggest carrier by fleet size is seeking further financial assistance from the government.

Operationally speaking, Chinese carriers are now becoming more market-oriented. We are starting to see less efficient, smaller carriers (mainly privately owned) being phased out. Wuhan-based East Star Airlines was one of the casualties, going into liquidation in March 2009.

Other carriers have turned to local governments for help as they restructure in an attempt to avoid the same fate as East Star. For example, United Eagle Airlines, once a privately owned airline based in Chengdu, is now owned by Commercial Aircraft Corp of China (COMAC), Sichuan Airlines and Chengdu Communication Investment Group, all of which have close links with the local and central governments. Okay Airways may go the same way. The carrier is in negotiations with Tianjin's municipal government over possible aid to help it ride through the financial storm.

Local authorities are the natural first port of call for distressed privately owned carriers, partly because government-backed airlines tend to get better financing terms. This point is particularly important when it comes to issues such as seeking finance for buying aircraft and other expensive aviation assets.

However, not all privately owned carriers are in trouble. Spring Airlines is taking steps to boost its market share by expanding its fleet, launching more outbound flights and looking at a public float next year. The success of the Shanghai-based civil operator is closely related to the success of its sister travel agency, Spring Tours, which benefits from the enormous demand for travel in China.

Mergers and acquisitions

The recent consolidation between loss-making Shanghai Airlines and China Eastern is probably the best example of how airlines in China are becoming more market driven. In early December 2009, China Eastern's merger with Shanghai Airlines received final approval from the China Securities Regulatory Commission, giving clearance to grab about 50% of the Shanghai market.

Air China's move to raise stakes in Cathay Pacific and Air Macau is a clear sign of Beijing's goal to capture a larger share of the global aviation market. Air China and Cathay Pacific will also jointly set up China's biggest cargo joint venture in Shanghai this year, in a move to secure the airlines' interests in the lucrative Shanghai market, especially after the Shanghai Airlines-China Eastern consolidation.

Global airline alliances would be more than happy to have any of the Chinese majors come on board, as it would help member airlines in the China market. This would also be beneficial to Chinese carriers that want to learn about Western airline management styles in order to expand their operating networks internationally. Air China and Shanghai Airlines have already joined Star Alliance, China Southern has joined Skyteam, and China Eastern is still contemplating which alliance to join. We also expect to see more code-sharing agreements between Chinese and Western carriers.

Beijing has a key role to play in fostering the healthy growth of the airline industry in China. However, Chinese airlines are not without difficulties. Internationally, they are subject to the bilateral agreements between China and other nations, and it is hard at this stage to predict the government's future attitude in this area.

The "Big Three" - not to mention their private competitors - need to be proactive and become more market-oriented to stay competitive, especially if the air transport market in China opens up to foreign carriers. At the same time, air travel is also facing competition from high-speed rail on certain routes. The Ministry of Transport and the Ministry of Railways must consider how this will impact domestic air travel and seek balance between the two.

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