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Building a foreign home base as a remedy against de-hubbing: the case of Lufthansa at Malpensa

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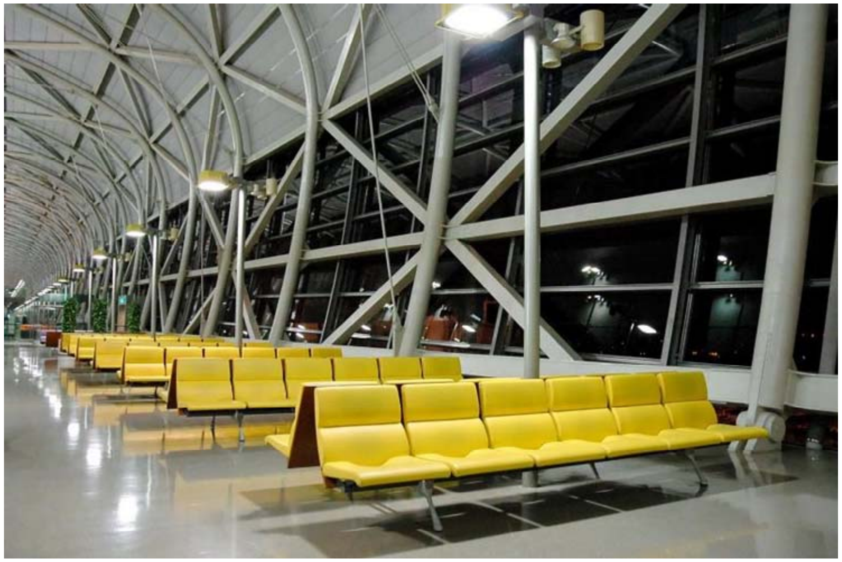
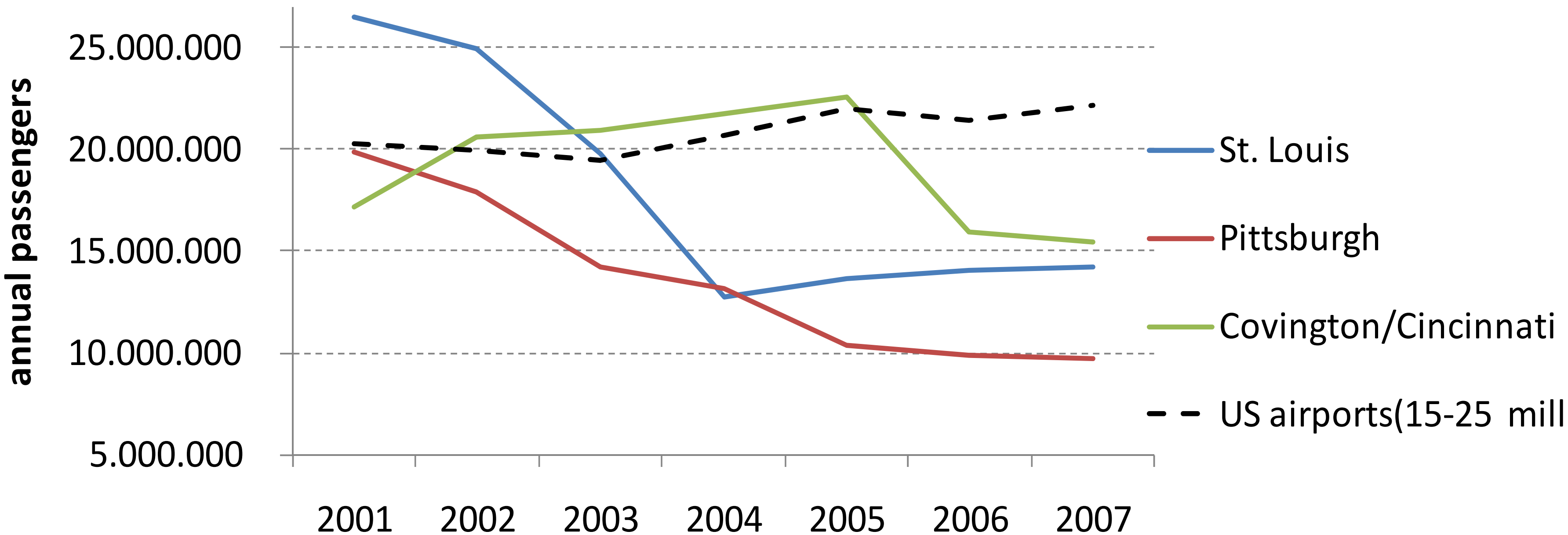
Airport de-hubbing

Empty infrastructures and Sunk costs are often financed by community



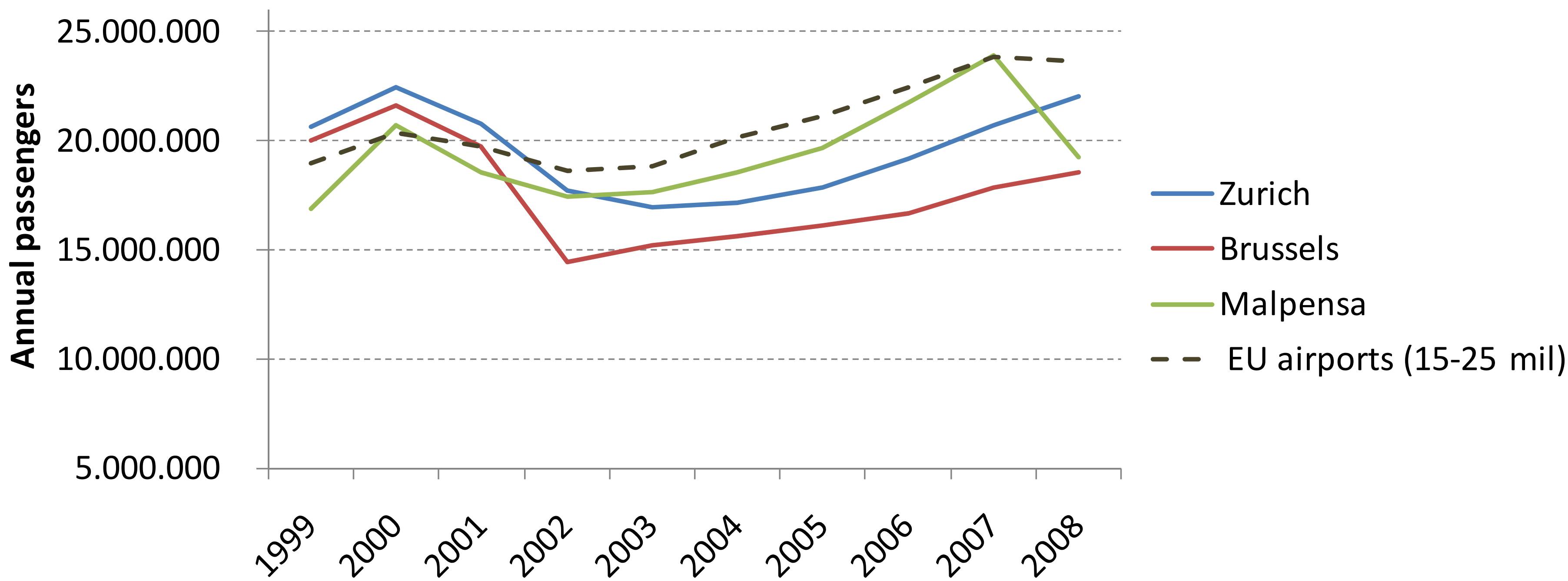
Recent US hub shrinking

- Cincinnati →(2005) Delta and its subsidiary Comair in chapter 11. It was the only US cargo and passenger hub. DHL has now also left
- St. Louis →(2001) TWA acquired by American Airlines
- Pittsburg → (2003-2005) US Airways shift to Philadelphia hub (high fees or low cost competition in Pittsburg?)



Recent EU hub shrinking

- Brussels →(2001) Sabena bankruptcy and renewal (SN Brussels)
- Zurich →(2001) Swissair bankruptcy and renewal (Swiss Int. Air Lines)
- Malpensa →(2008) Alitalia bankruptcy and withdraw



Hub shrinking: major causes

- Hub carrier bankruptcy
- Mergers and takeovers
- Airline network restructuring

Is it only the beginning of the phenomenon? (1/2)

- The determinants seem to be still at work

- In the last quarter of 2008 Airlines lost $4,5 billion

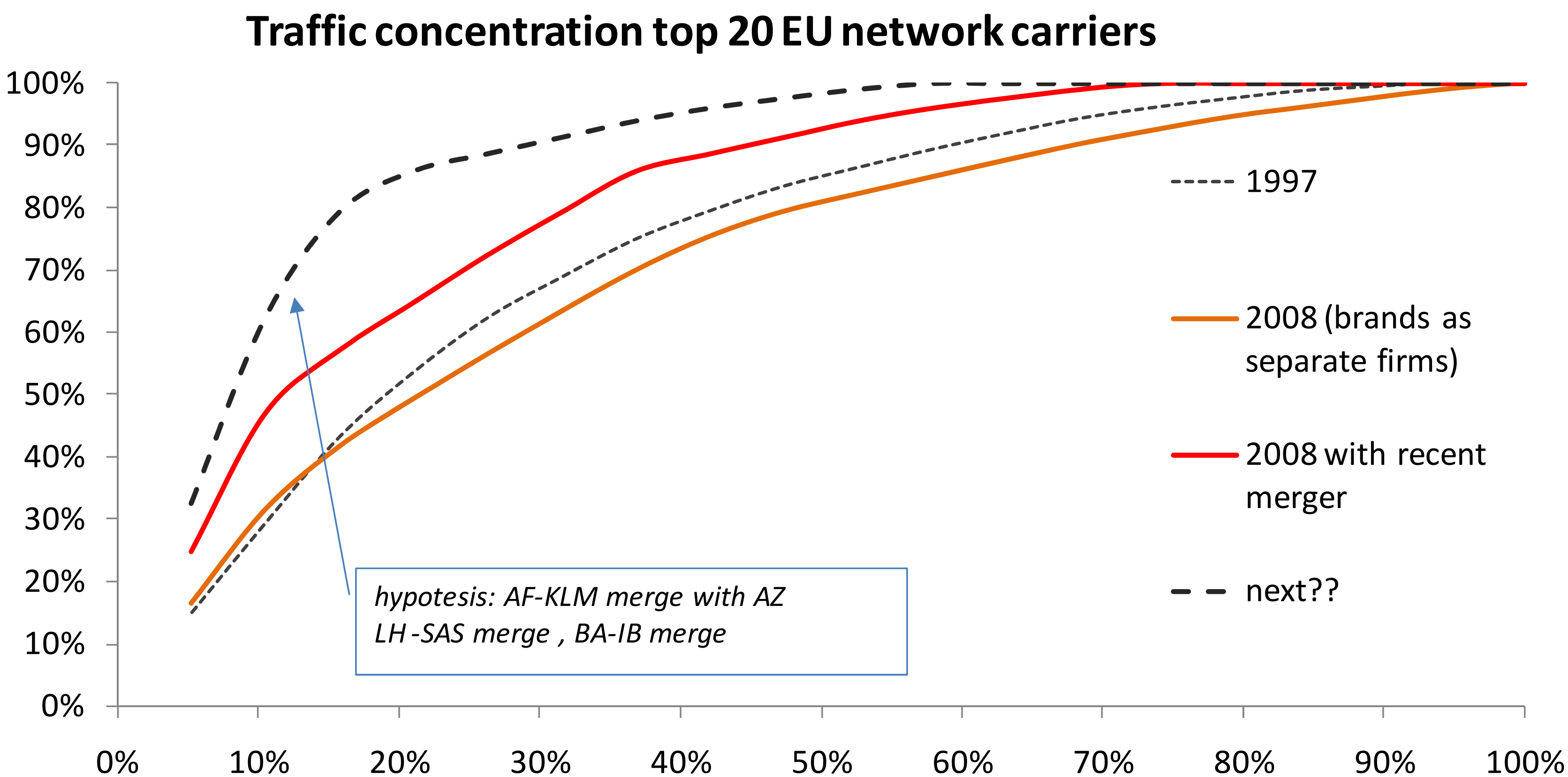
Q4 2008 versus Q4 2007 Profits, $ Million

# Airlines	$ Million	Q4 2007		Q4 2008	
		Operating	**Net post-tax**	Operating	**Net post-tax**
14	North Amercan airlines	499	**235**	(1,699)	**(2,081)**
11	European airlines	1607	828	(149)	**(1,463)**
9	Asia-Pacific airlines*	2,287	**1,808**	(1,032)	**(1,139)**
2	Other	174	**135**	316	**169**
36	**Industry total**	4,567	3,006	(2,563)	(4,514)

Source:IATA "Airlines Financial Health Monitor" feb-march 09

Is it only the beginning of the phenomenon? (2/2)

- 2008 Takeovers/mergers: Lufthansa over SwissAir (2005), and now over Austrian and SN Brussels. Alitalia-Airone. Delta-Northwest
- Rumored Mergers: Lufthansa-SAS; British Airways-Iberia; AF-KLM-Alitalia?

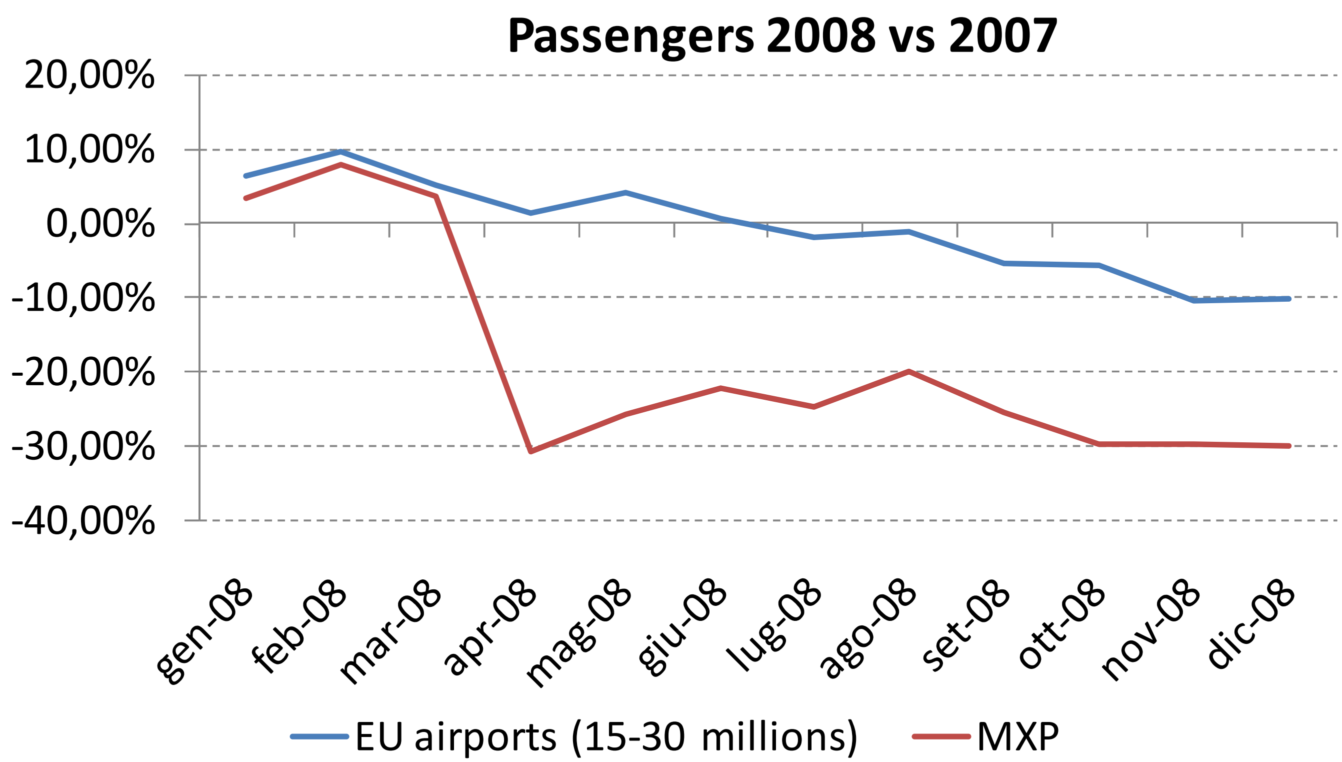


The de-hubbing of Malpensa

- July 2007 the new appointed AZ CEO, Maurizio Prato, announced the new plan for the "survival" of Alitalia through a privatization process
- Cornerstone of the efficiency program was the de-hubbing of Malpensa (from 350 to 170 weekly flights)
- Alitalia stated that their service at Malpensa was generating losses for €200 millions per year
- The Bidders for Alitalia (Air France and next CAI) confirmed their intention to divest in Malpensa as a hub in case of Alitalia takeover
- Before the de-hubbing, almost 55% of the ASK supplied from Malpensa was provided by Alitalia (less the 20% at the end of 2008 even considering Airone-Alitalia together)

Malpensa passengers data

- 2008 passengers traffic decreased by 19%
- 30% monthly traffic reduction, three times worse than similar EU airports



What Remedies for Malpensa?

- **Pressure on new Alitalia to invest in Malpensa**
  - Agreement only if Linate is downsized to the Rome –Milan service
  - Alitalia aircraft capacity in the short run is limited
  - Few chances for the new Alitalia to set up two hubs

- **Strategic preference for low cost carrier**
  - Loss of intercontinental service
  - Terminal-1 too expensive?
  - Competition with Milan Orio al Serio (76 km as a crow flies distance / 87,5 km by road)

- **What else?**
  - research of other foreign airlines?

What Remedies for Malpensa?

- **February 2009 the new Lufthansa subsidiary "Lufthansa Italia" started its service from Malpensa (1 Airbus A319 based at MXP)**
- It serves only European destinations

The set up of Lufthansa Italia at Malpensa is an original strategy

- First case of massive use of 7th freedom in Europe

  In 2007 European traditional carriers supplied less than 200.000 seats between non EU and EU countries not involving their own country

- Other major European hubs experienced difficulties following airline bankruptcies, but in Malpensa there was a break between the destiny of the hub and the national airline

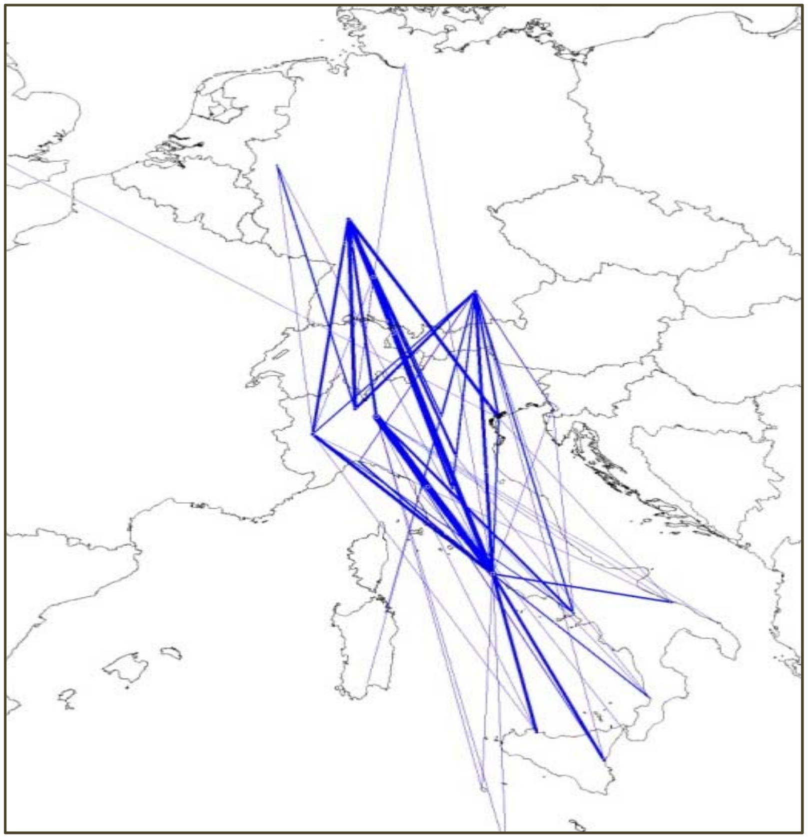
- Strategy differs from US de-hubbing, mainly involving the set up of domestic hubs

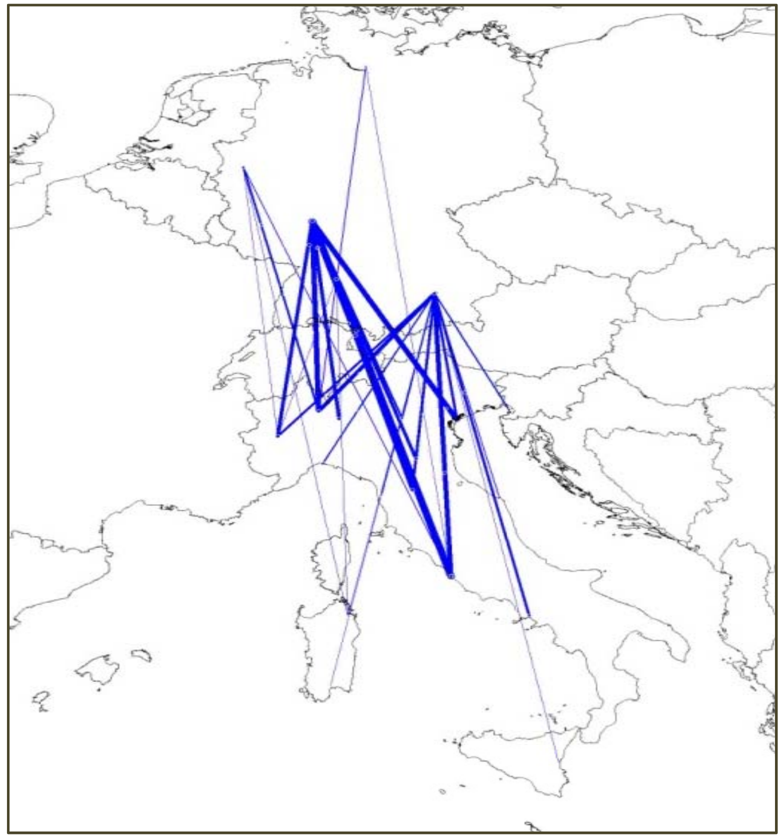
- **Why should Lufthansa be interested in setting up a foreign hub in Italy?**

Reasons supporting the opening of a foreign hub at Malpensa
(short -term)

- **To re-enter in the domestic Italian market** (previously a Airone-Lufthansa codeshare)
-

LH service from/to Italy summer 2007	LH service from/to Italy summer 2008





Reasons supporting the opening of a foreign hub at Malpensa (short-term)

- To re-enter in the domestic Italian market
- **To take over capacity vacated by Alitalia**
  - Preempting entry of new competitors

    In the first quarter of 2009 the share of traditional non-allied companies was over 13%

  - Preempting Skyteam monopoly on intercontinental flights from North of Italy

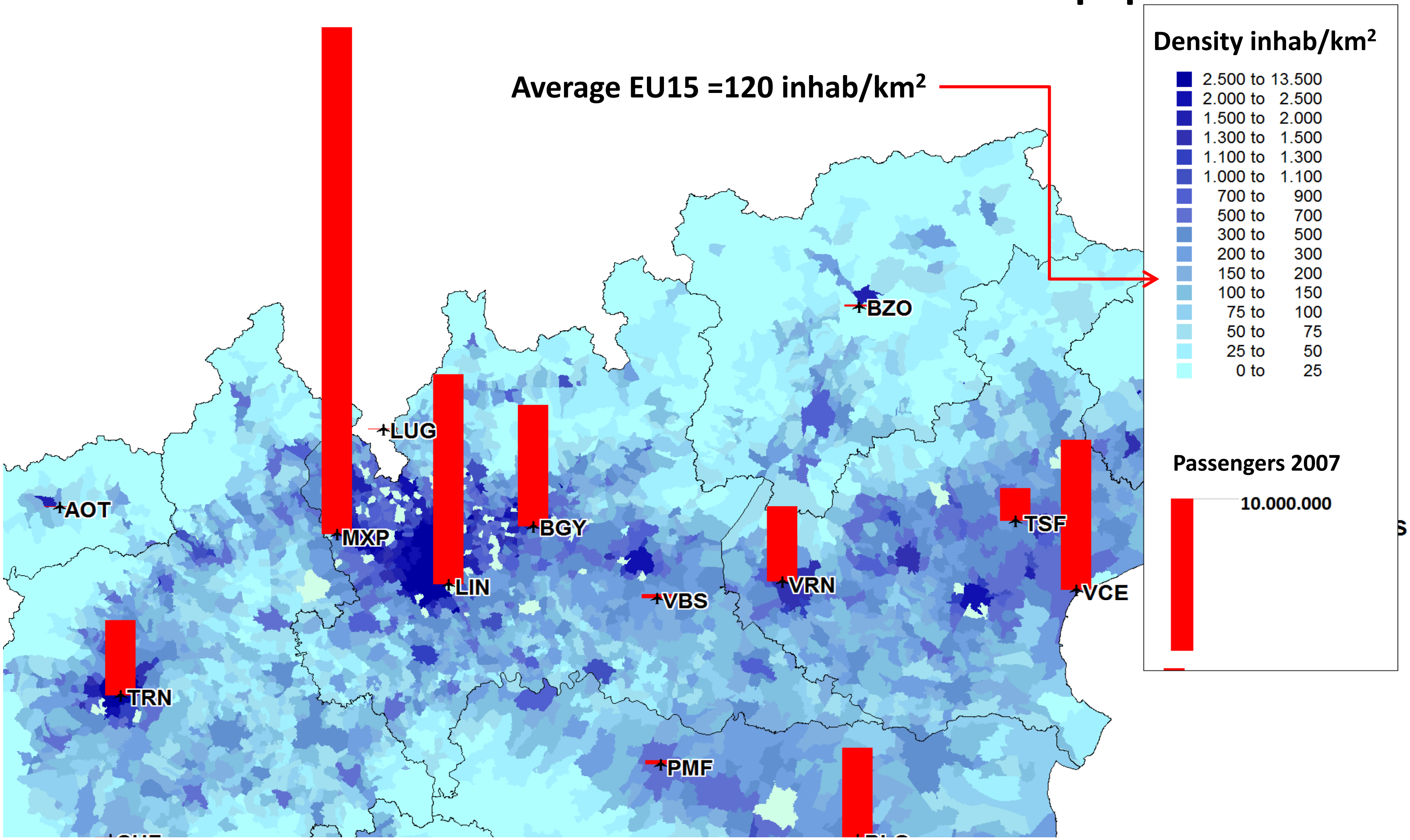
    In 2007 over 200.000 passengers from MXP hubbed through Frankfurt

  - Preempting further expansion of low cost carriers with an option on long haul routes

    Given that the low cost carriers could invest in Malpensa, MXP would eventually become the largest airport in Europe dominated by LCC with infrastructure and underlining demand for long haul routes

Reasons supporting the opening of a foreign hub at Malpensa (medium-term)

- **To offer direct service in one of the wealthiest and populated areas**

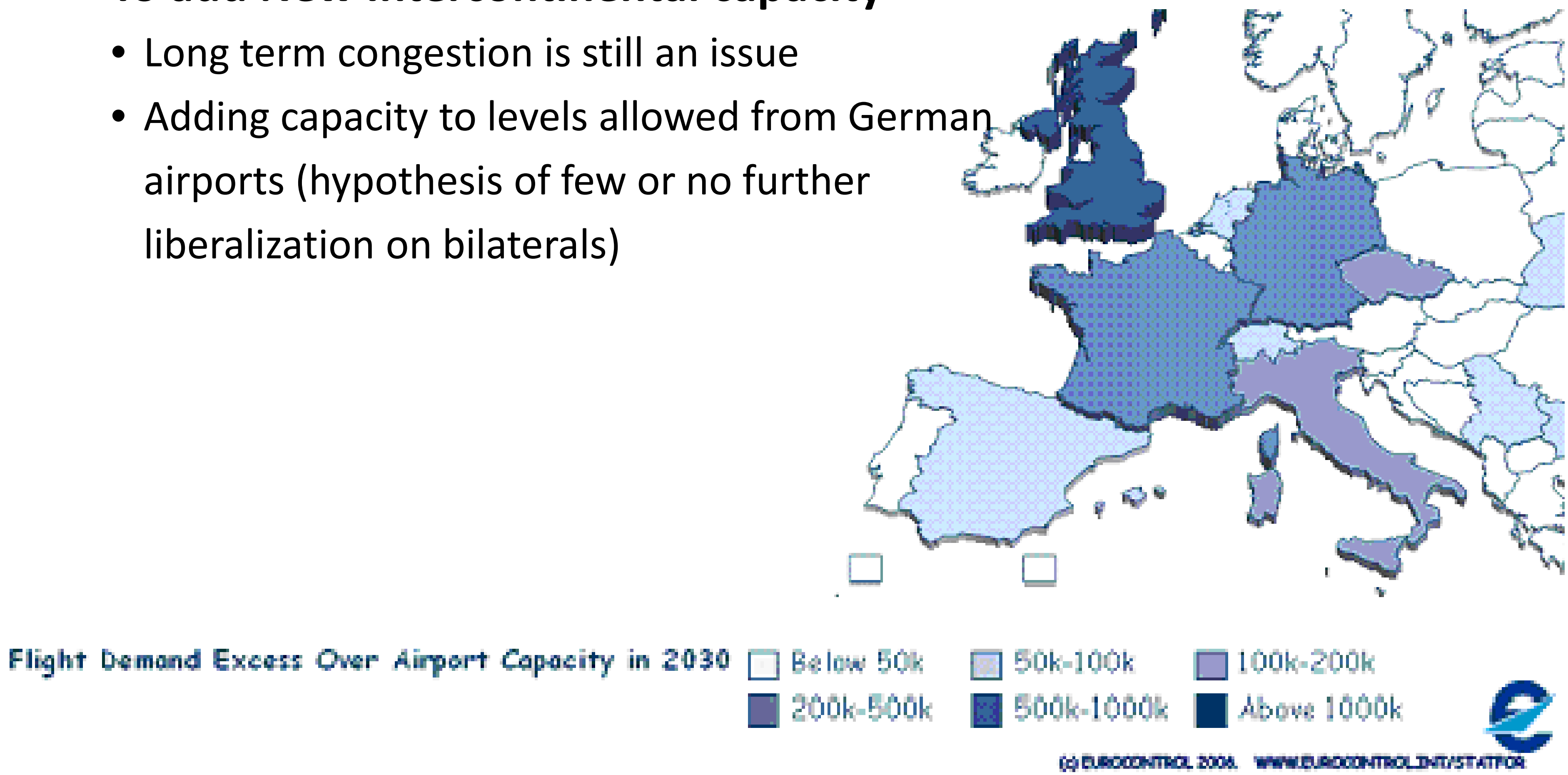


Reasons supporting the opening of a foreign hub at Malpensa (medium-term)

- To offer direct service in one of the wealthiest and populated areas
- **To be designated in bilateral service agreement**
  - 2,5 million passengers departed from Malpensa in 2007 to countries with an air service agreement allowing less than 3 carriers to be designated. Alitalia was one of these.
  - Multiple designation is also available from Malpensa to countries with bilateral air service agreement that in 2007 generated one million passengers

Reasons supporting the opening of a foreign hub at Malpensa (medium-term)

- To offer direct service in one of the wealthiest and populated areas
- To be designated in bilateral service agreement
- **To add New Intercontinental capacity**
  - Long term congestion is still an issue
  - Adding capacity to levels allowed from German airports (hypothesis of few or no further liberalization on bilaterals)



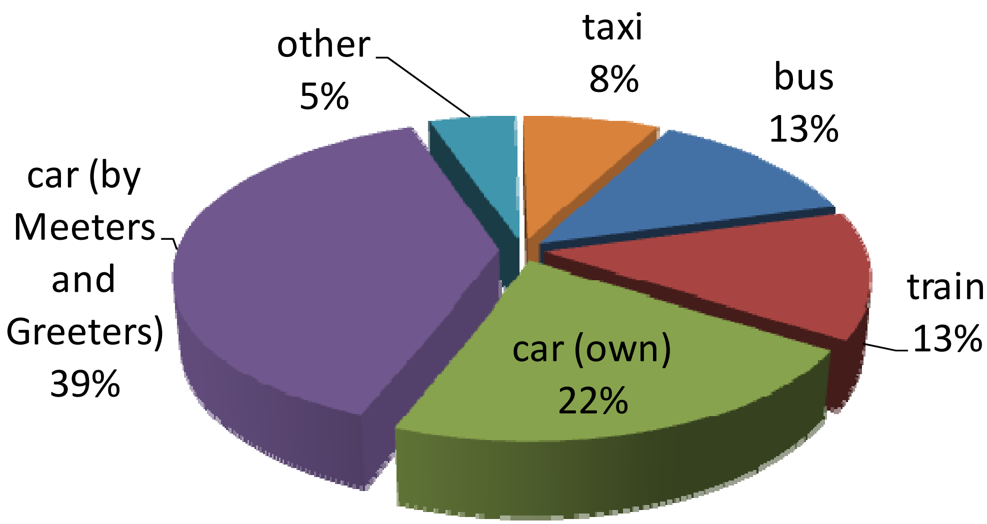
Reasons supporting the opening of a foreign hub at Malpensa (medium-term)

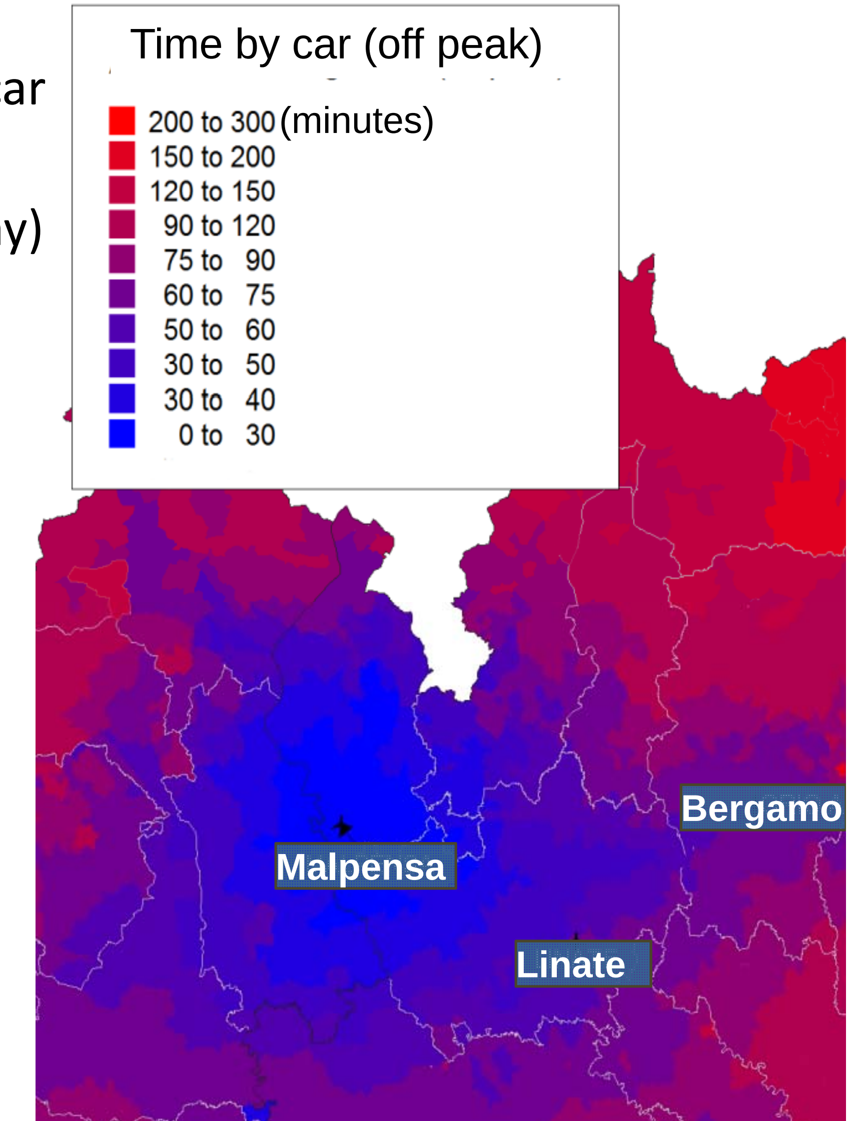
- To offer direct service in one of the wealthiest and populated areas
- To be designated in bilateral service agreement
- To add New Intercontinental capacity
- **To be ready for the 2015 EXPO**

Reasons against the opening of a hub (short-term)

- **Accessibility problems at Malpensa**
  - Passengers access to airport almost by car
  - Routes are congested
    (in 2008 >17.300 vehicle per lane per day)

Ground Access Mode Choice at Malpensa T1

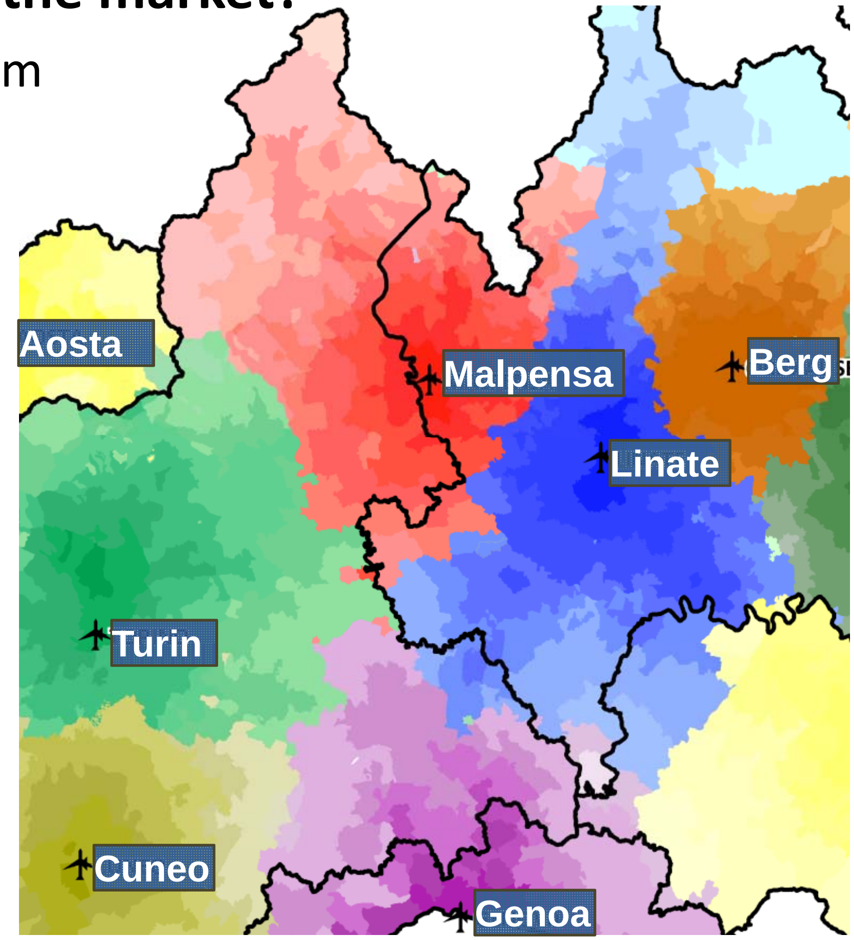




Reasons against the opening of a hub (short-term)

- Accessibility problems at Malpensa
- **Competition involved in the fragmented structure of the north Italian airport network may destroy the market?**
  - EU GDP easy to reach also departing from competitor airports
  - Strong catchment area overlapping

Depart Airport	%EU GDP within 2h	%EU GDP within 2-4h
Milan Malpensa	79,40%	19,35%
Bergamo	69,98%	15,44%
Turin	61,43%	23,05%
Venice Marco Polo	57,41%	32,78%
Verona	57,15%	18,32%
Milan Linate	53,70%	31,36%



Reasons against the opening of a hub (short-term)

- Accessibility problems at Malpensa
- Competition involved in the fragmented structure of the north Italian airport network may destroy the market?
- **No feeder structure**
  - Lufthansa would need to set up a feeder structure
  - Malpensa's major links are southern airports that already have a hub in Rome.

2007 passenger traffic with MXP			
Venice	236.747	Ancona	87.902
Florence	189.529	Genoa	59.585
Bologna	129.312	Perugia	35.582
Trieste	101.181	Pescara	15.729
Pisa	99.865	Bozen	9.622

Reasons against the opening of a hub (short -term)

- Accessibility problem at Malpensa
- Competition involved in the fragmented structure of the north Italian airport network may destroy the market?
- No feeder structure
- **Current designation in some bilateral service agreement**
  - Bilateral negotiation in a single country should be replaced by EU negotiation
  - Alitalia is the mono-designated carrier in 11 bilateral air service agreements involving, in 2007, 700.000 Malpensa passengers. Alitalia can maintain its designations by serving these destinations from Rome

Reasons against the opening of a hub (medium-term)

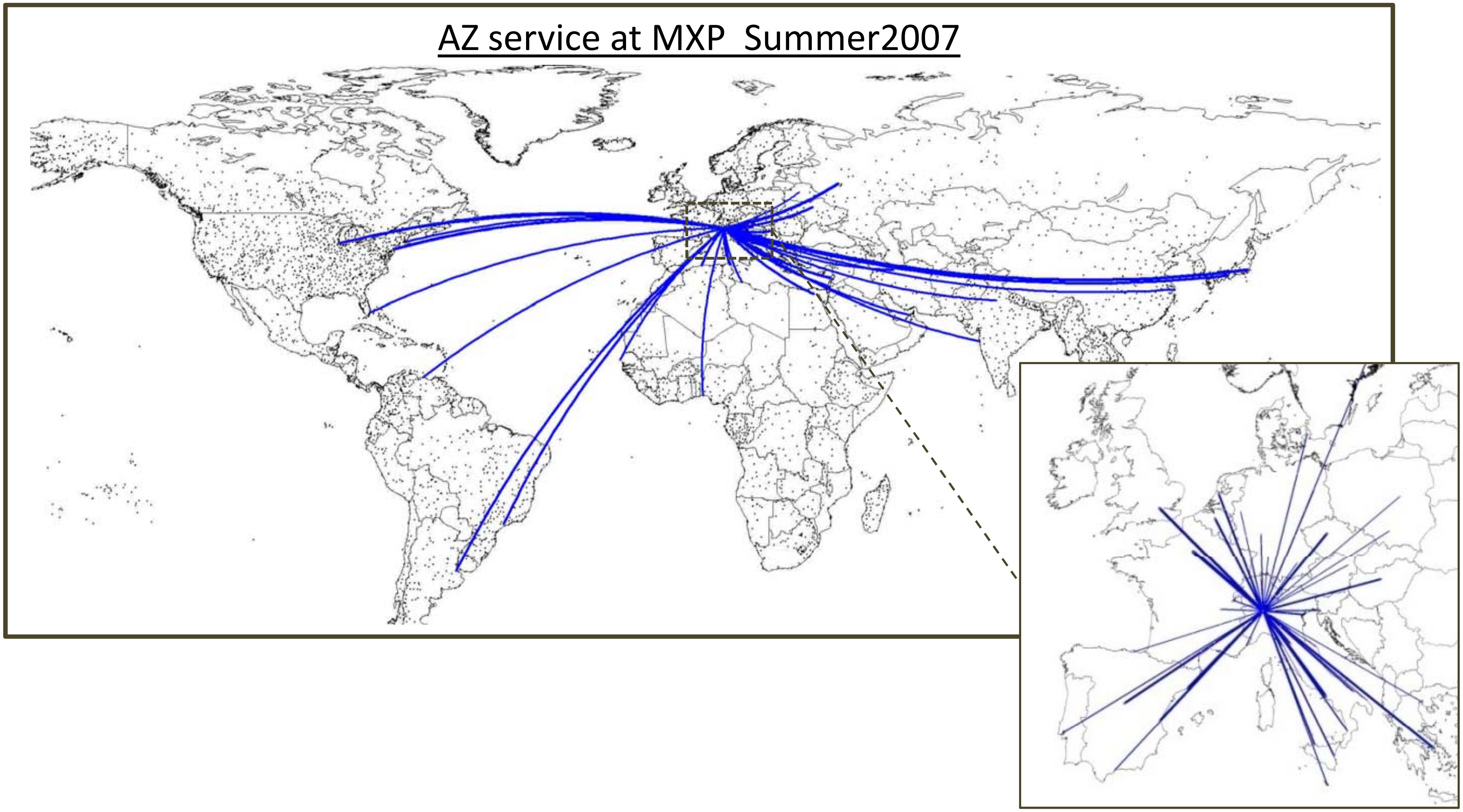
- **Full competition on intercontinental routes**
  - Barriers in bilateral air service agreements should fall quickly if they do not conform EU community law
- **It is unclear if the multi hub structure overcome the scale/scope economy of a single mega-hub in a competitive environment**
- **Failure to win the support of a foreign political body**
  - What if Alitalia and its Skyteam partners change their decision on Malpensa?

Conclusion

- Turbulence affecting Airlines is now affecting airports too
- Risk of de- hubbing /airports decentralization may be high in the next future
- The Lufthansa presence in Malpensa will test how much the European Common Aviation Area is really a single sky
- In the long run it is unclear if Lufthansa will develop strong hub activities in Malpensa, at the moment they bought the option to do so

The Malpensa de-hubbing

- In summer 2008 AZ reduced intercontinental destinations from 26 to 9 and cancelled 20 intra European and 6 domestic routes



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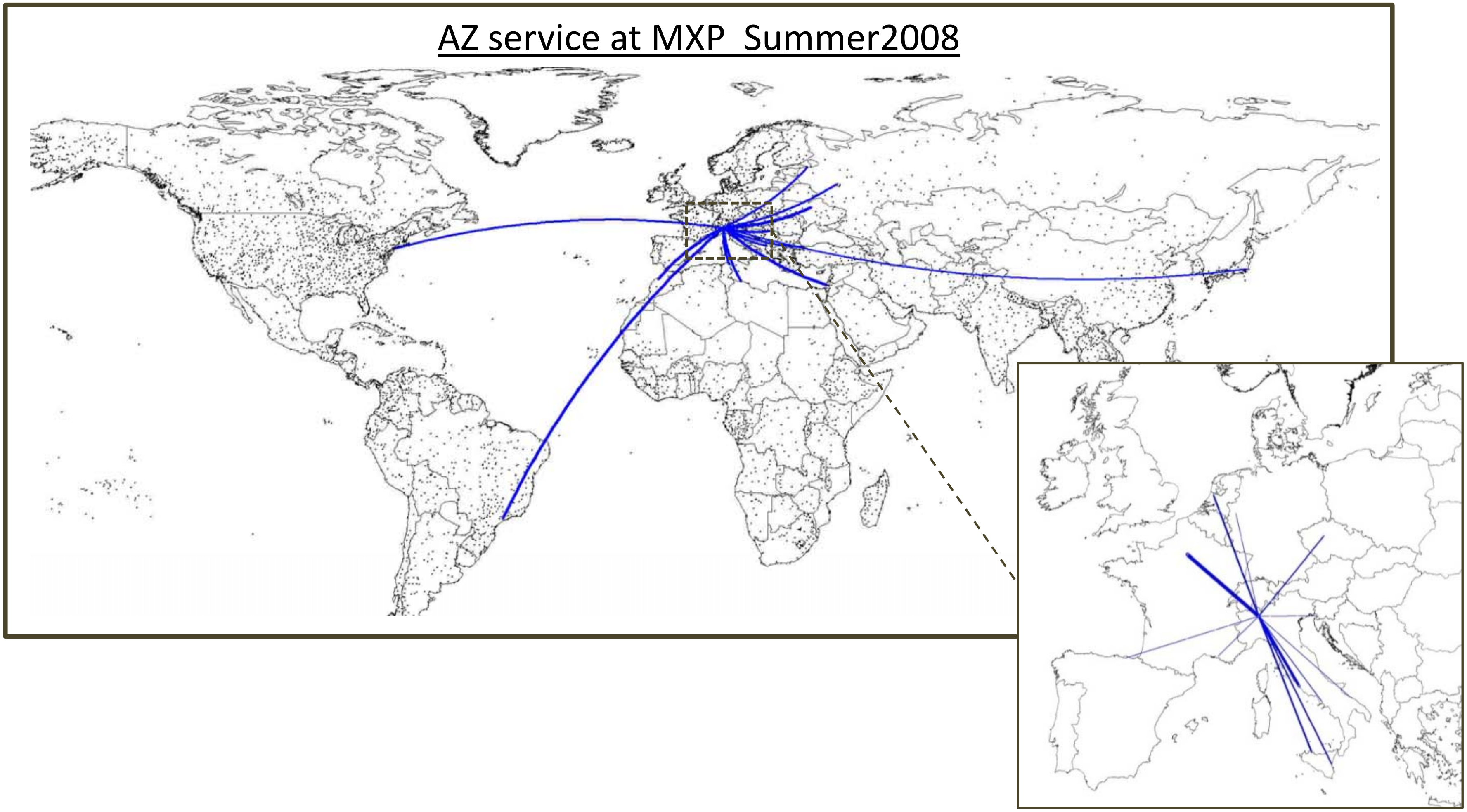
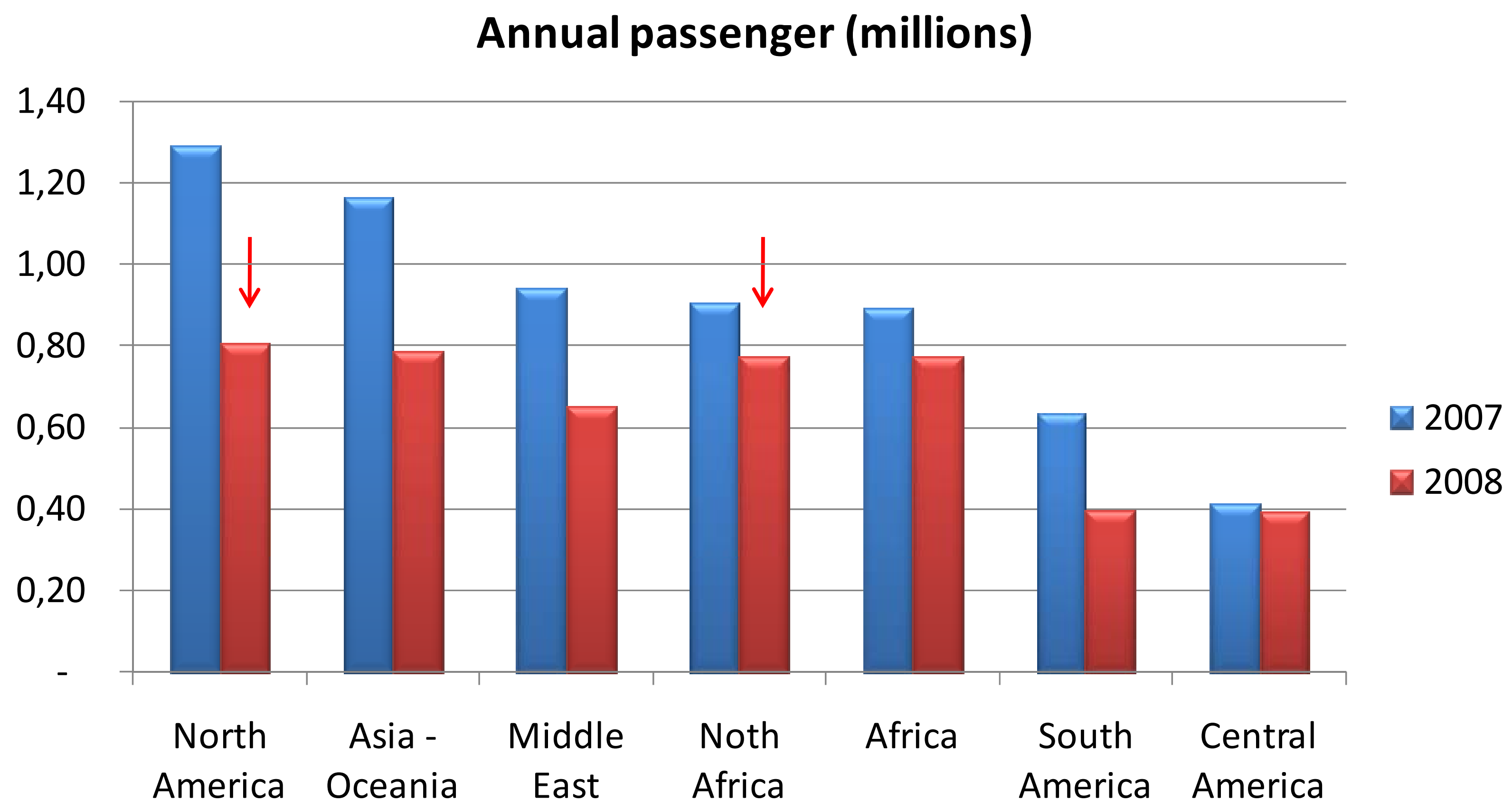


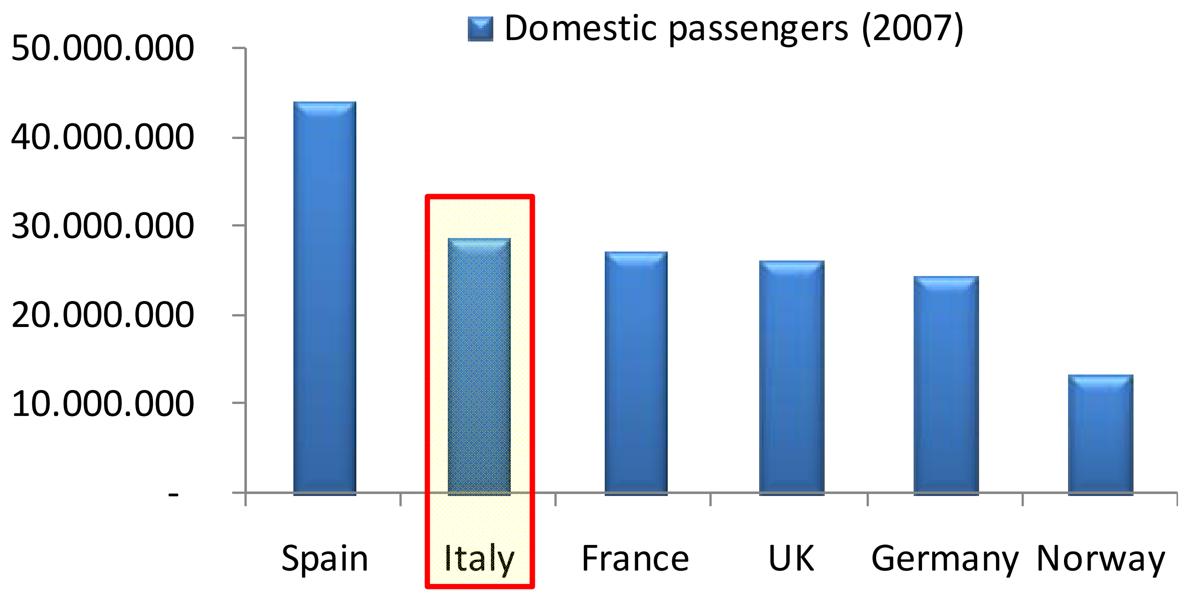
Malpensa passengers data

- Intercontinental traffic in 2008 decreased by 26,5%
- Long haul traffic toward North America at the level of traffc toward Africa



Reasons supporting the opening of a foreign hub at Malpensa (short -term)

- **To re-enter in the domestic Italian market**
  - Italian domestic market is the second in Europe by size

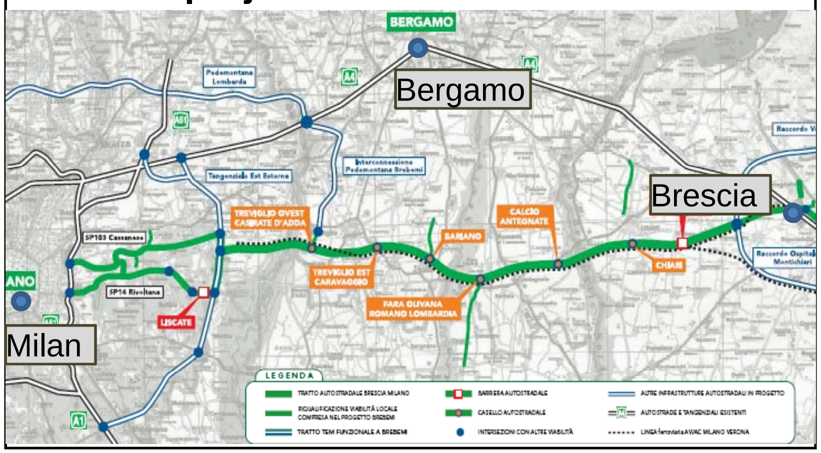


  - In Italy there is one of the densest European city pair (Milan-Rome) with yearly traffic about 3,5 million

Reasons supporting the opening of a foreign hub at Malpensa (medium-term)

- To offer direct service in one of the wealthiest and populated areas
- To be designated in bilateral service agreement
- To add New Intercontinental capacity
- **To be ready for the 2015 EXPO**
  - By 2015 new infrastructures will be completed (Pedemontana and Brebemi project)
  - By car Bergamo-Malpensa time travel will be less than 60’ rather than 90’
  - People within one hour drive from Malpensa should increase by about 2 mln

Brebemi project



Pedemontana project