

# Airbus faces tough midmarket choices

Airbus's A350 midmarket jetliner, an advanced derivative of the A330 launched in 2005, seemed an adequate response to the challenge of Boeing's 787. While the 787 featured newer technology and an all-new design approach, the A350 offered competitive economics, equally long range, and a lower development price tag.

Yet over the past few months, it has become clear that Airbus needs to reexamine its options in this crucial market segment. Statements from customers indicate a preference for a more ambitious jet with a higher development price tag. Airbus will need to consider any new plane in light of the broader challenge of major corporate restructuring.

### Changing course?

After Boeing commercially launched its 787 Dreamliner in late 2003, Airbus simultaneously denigrated the new Boeing plane's market prospects and insisted that any competitive response would be easy and inexpensive. In 2004, Airbus announced its A350, a heavily upgraded A330 with new engines and a new composite wing. There would be two versions: the 245-passenger 800, with a range of 8,600 n.mi. (15,900 km), and the 285-passenger 900, with a 7,500-n.mi. (13,900 km) range.

The A350 spent 2004 going through several redesigns (or reproposals), but the fourth incarnation received board Authorization to Offer on December 10 of that year. It was scheduled to enter service in mid 2010, but design changes early this year delayed that date until 2011.

By March 2006, the A350 had garnered 100 firm orders and scores of additional commitments. While this was a respectable level of commercial interest, the order book lacked any blue-chip airlines. There were several quality carriers, especially Finnair and Brazil's TAM, but no first-tier airlines that would confer a major endorsement on the new offering. The 787, by contrast, had attracted numerous



*At first, the Airbus A350 seemed to be an adequate response to the introduction of the Boeing 787 Dreamliner (left). The Dreamliner premiered to great praise and large numbers of orders.*

large, global carriers with a strong brand presence.

Doubts about the A350 were confirmed in March, when ILFC (International Lease Finance) chief executive Steven Udvar-Hazy praised the Airbus design but then damned it with a "silver medal" (versus the 787's gold). He implied it would garner a 25% market share and would probably suffer from weak pricing. GECAS (GE Commercial Aviation Services) chief executive Henry Hubschman then endorsed Udvar-Hazy's message.

After the comments, Airbus officials stated that this was merely a negotiating ploy. Since ILFC had already ordered 12 A350s, this comment had some limited credibility. Yet a few weeks later in April,

Singapore Airlines chief executive Chew Choon Seng reiterated the advice given by Udvar-Hazy and Hubschman, suggesting that an all-new design would be a better way to counter the 787.

At this point, Airbus changed its course. Chief executive Gustav Humbert stated that Airbus was listening to its customers and would "consider all its options." However, he did not imply a commitment to a different, new jet.

The airline reaction to the A350 has been accompanied by increasingly negative sentiment about Airbus's other mid-market widebody, the A340. The competing Boeing 777 outsold the A340 by 155-15 in 2005, and the A340 backlog is dwindling.



Also in April, the biggest A340 customer, Emirates, indicated that it might cancel its outstanding orders if Airbus does not launch an improved version. Airbus has considered this option, using new engines and other upgrades. Yet since this would be the third incarnation of a family that has never enjoyed a strong market presence, the odds are against the new version moving forward.



*Emirates Airlines, the A340's largest customer, is pressuring Airbus to launch an improved version of the aircraft.*

### The market that matters

The A340 and A330/A350 constitute Airbus's midmarket presence. The decline of the A340, accompanied by an uncompetitive A350, would be a notable failure for Airbus, which historically has been very strong in the midmarket segment. The 250-seat, 6,500-n.mi. A330-200 has greatly boosted Airbus's widebody market fortunes since it arrived in 1998. And the jetmaker got its start in this segment—the original A300, slated for program termination in mid-2007, was a shorter ranged 250-seater that allowed airlines to serve numerous midmarket city pairs with then-revolutionary economics.

Failure in this market arena is clearly not an option. The numbers show that this midmarket widebody segment is growing in size and importance. By share of total jetliner market value, it went from approximately 25% in 1990 to almost 50% in 2005.

Meanwhile, the 747 niche, which will be occupied in the future by the A380 and the 747-8, is shrinking to around 5% of the market. Although it might rebound somewhat as new technology comes on line, it will likely stay at around 35-45 planes annually.

The narrowbody segment, although large and relatively consistent, tends to offer lower profits than the widebody market. This is largely because the domestic carriers that use the narrowbodies are offering a commodity service. It is also because the two plane families—Airbus's A320 and Boeing's 737—are effectively commodity products. In terms of operating economics or residual values, neither looks consistently better than the other.

All told, the 200/400-seat widebody long-range market will be good for at least \$600 billion in orders over the next 20 years. If Airbus loses the 300/400-seat segment with the demise of the A340, and wins only 25% of the 200/300-seat segment, that will mean getting less than \$100 billion of this market. If Airbus launches an all-new family, it can get back to 50% of this segment, if not more, after 2012.

To accomplish this, Udvar-Hazy has recommended a family of middle-market planes that leapfrog Boeing's 777 and 787 (a strategy also backed by a faction within Airbus). He adds that he wants to see a commitment to this family by this July's Farnborough Air Show, implying that an ILFC order for either the 787 or the new Airbus jet could be imminent.

### The crunch

From a market size and customer reaction perspective, the Airbus decision to go with an all-new jet family is a no-brainer.

*The A380 development program remains a major financial drain, while its market niche appears to be shrinking.*



After all, this is a guaranteed market, with hundreds of billions of dollars at stake. But an all-new jetliner family would cost about \$9 billion-\$10 billion to develop, almost twice the expected cost of the current A350. There are numerous other factors that will make that decision difficult.

The weakest obstacle is psychological. From a credibility standpoint, a move to a new jet would require a complete change in the strategy and messaging Airbus has used for the past three years. It would represent a complete admission of failure, the only time in Airbus's history (or in Boeing's) that a plane was commercially and industrially launched, with over 100 orders and commitments, and then canceled before it went anywhere.

But of course that customer credibility issue pales in comparison with the question of financial resources. The A380 development program, likely to cost over \$15 billion by the time all currently planned versions enter service, is still a major financial drain. This will still require considerable cash and engineering resources through next year. Meanwhile, Airbus Military's A400M is starting to ramp up. While most of the development costs for this aircraft will be taken care of by the European government customers, Airbus will be responsible for overruns. Also, the A400M development program demands engineers, a finite resource.

Then there is the A320 replacement

requirement. Both Airbus and Boeing will introduce new narrowbody families in the 2012-2014 timeframe, and leaving Boeing alone in this market is unthinkable. While narrowbodies are more of a commodity product, they are still hugely important in terms of business volume. It is important that any new Airbus midmarket widebody development program wind down in time to allow a shift of resources to a new narrowbody, to meet any Boeing challenge.

**Stockholder issues**

The very biggest issues concerning Airbus's new product development funding, however, are out of the company's control. Its parent majority stakeholder, EADS (European Aeronautical, Defence and Space) has numerous resource constraints of its own.

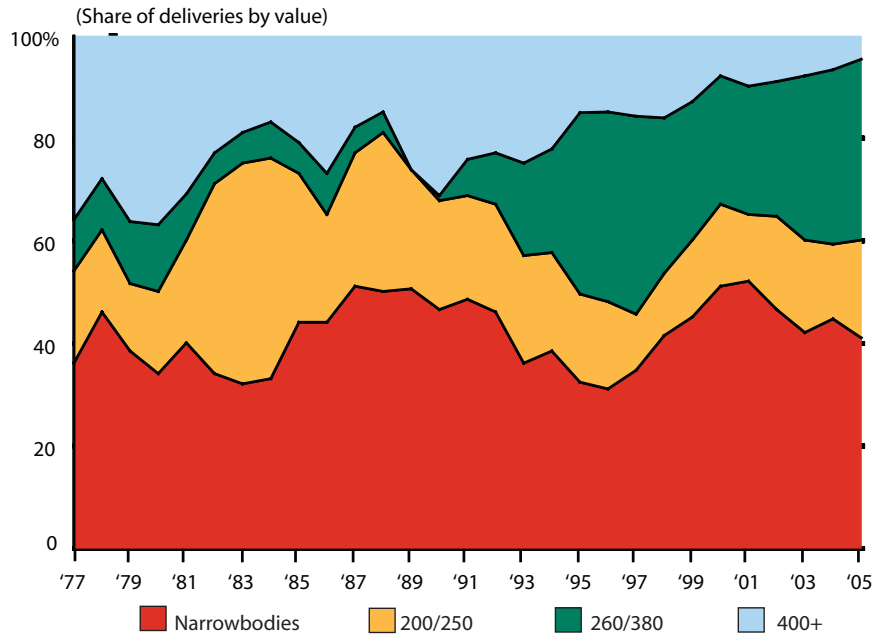
Also in April, while customers were expressing their doubts about the A350, BAE Systems—the 20% minority Airbus stakeholder—announced that it wanted to divest its Airbus share. The ostensible reason for this was to focus resources on the U.S. defense market, although some interpreted the move as a decision to leave Airbus before the bill for the new jet family arrived.

One of EADS's highest priorities has long been acquisition of this BAE share, but it will require about €3.5 billion (\$4.2 billion). This, of course, is money that would be diverted from any Airbus new product development effort.

EADS might have other acquisition goals that would also serve to divert resources. Among the company's highest priorities is to bulk up its defense and electronics market presence, and to cement its status as Europe's national defense champion. In particular, EADS has discussed acquiring Thales, a very expensive prospect (Thales had 2005 sales of €10.3 billion, or \$12.4 billion). Most worrying for Airbus, EADS not only wants to acquire defense assets as part of a new strategy; it has also said it wants to reduce its dependence on its commercial aircraft business. This too implies fewer product development resources for Airbus.

As EADS decides how to spend its money, it might find that it faces equally big challenges in satisfying a more diverse shareholder base. As BAE announced its intention to sell its Airbus stake, EADS stakeholders Lagardere and Daimler-

**JETLINER SEGMENT DELIVERIES, 1977-2005**



Chrysler announced they would sell some of their EADS shares. Daimler will sell 7.5%, and implied that another 7.5% tranche could be sold in the next few years (leaving a 15% stake, half Daimler's current EADS share). Lagardere will also sell 7.5%. The French government has announced no immediate plans to sell its 15% share, but its stated long-term goal is to privatize this as well.

There will likely be no problem floating these shares. EADS, thanks largely to Airbus, can offer a sizeable order book and expanding revenues, which are likely to attract new investors. But a more widely held company typically exhibits behavior very different from that of a company that is majority held by large stakeholders.

When a company is majority held by a diffuse public investor base (that is, when large stakeholders such as Daimler-Chrysler together hold a minority of the shares), its shares are more volatile. If the company announces moves that imply risk, the public shareholders can sell their shares far more easily than the large stakeholders can. The new investors have no legacy loyalties, nor do they face any unusual tax hurdle in selling their shares. They are merely looking for the best return on their money.

For this reason, a widely floated company typically finds it harder to launch

new programs. The decision to launch the A380 in 2000, for example, might not have occurred if Airbus's parent company had been fully privatized and in the hands of a diffuse investor base. If EADS evolves along these lines, Airbus planners will find that launching a new and expensive jetliner family is a much more complicated affair. They will need a very carefully prepared business case, and considerable technical research identifying the enabling technologies. This would further delay the new jet project.

In short, a widely floated EADS would mean major changes in Airbus, and in the way it launches risky new projects. It may behave more the way Boeing has over the past 15-20 years.

Therefore, despite the tremendous promise of the middle market, Airbus faces an uphill battle in obtaining the resources it will need to compete effectively in that arena. The next 12 months will determine whether Airbus can continue to compete as a jetliner manufacturer with a complete portfolio of products, or whether it will be reduced to a niche player for the next 7-8 years, with only a family of 100/200-seat jets, a second-class 250/300-seat jet, and one very expensive 550-seat jet.

**Richard Aboulafia**  
Teal Group  
raboulafia@tealgroup.com