International Journal of Case Method Research & Application (2005) XVII, 4
 ISSN 1554-7752

CATHAY PACIFIC AIRWAYS – WHAT NEXT?

Madhu Malkani, John Hulpke, Cubie Lau
Hong Kong University of Science & Technology
HONG KONG, CHINA
Teresa Ho
Teleadapt
HONG KONG, CHINA

Abstract

Cathay Pacific Airways has grown from humble beginnings in Hong Kong in 1946 to become one of the world's premier airlines. After tough times in the early 2000s, the airline faced the future. NOTE: The case hints but does not state that Cathay faces choices and challenges in China, and must decide to remain a premium carrier or somehow get into the low cost carrier arena. Exhibits and video of Philip Chen's speech are available to those interested.

The case is best suited for an undergraduate strategy or international business course. A detailed Teaching Note is available from the authors.

KEY WORDS: Cathay Pacific Airways, airline industry, China

INTRODUCTION

What an industry! A hundred years after the first powered flight by the Wright Brothers an industry had developed that shrunk the globe, allowing millions of people to travel distances never imagined before. And as Chief Executive Officer of Hong Kong's flag carrier Cathay Pacific, Philip Chen knew his airline had been a part of the amazing history of the industry. After humble beginnings in Hong Kong immediately after World War II, Cathay had become one of the world's most respected carriers. Cathay serves more than 75 destinations world wide with cargo routes and award winning passenger service. The industry had achieved amazing success, as had Cathay. What a ride it had been, up, down, up, down… and what would be next?

Chen thought to himself as he walked towards the conference room for the yearly senior executives Planning Conference. The 21st century had gotten off to a rough start. But with amazing economic growth in Asia, Cathay's home territory, could this be "The Pacific Century", Cathay's century? Cathay had certainly come a long way in becoming one of the leading airlines in world, competing effectively on quality and service. However, the outbreak of a strange "SARS virus" in 2003 in Hong Kong was only one of a slew of events that created challenges which had to be faced by Cathay: the impact of the September 11, 2001 attacks on the World Trade Centre in New York on the airline industry, the continuing threat of terrorism globally, the Iraq war which began in 2003, skyrocketing fuel prices. These events had an adverse impact on the company. Cathay had weathered these storms and probably become stronger as a result. The critical question now was: how to position the company to remain successful in the future? While one school of thought suggested "if it ain't broke, don't fix it," Chen also knew about "the winner's curse." Those on top, too often opt for a continuation of a steady course, while the world changes and new leaders take over. What would the next half century bring? Chen knew that

his senior management had to review the core strengths of Cathay Pacific and determine the future direction of the airline. The potential would be great, but the global economic environment suggested the era of turbulence was not over. Cathay could aim high, but should not expect smooth flying. As he continued his train of thought, Chen almost walked past the conference room. Then, checking himself, he entered what he knew would be a critical strategy meeting with the senior management team of Cathay Pacific.

Sometimes a look into the past is useful in anticipating the future. The pages that follow start with thoughts on the history of the aviation industry, with a focus on the impact deregulation had on the industry. After an introduction, describing the rise of budget airlines, the case presents Asia, in general, followed by Hong Kong, and Cathay Pacific Airways.

HISTORY

After the historic flight by the Wright brothers in 1903, the civil aviation industry grew rapidly. Soon there was widespread recognition that a uniform global regulatory system was required to cope with the proliferation of the airline industry. In 1919, twenty-six countries joined to sign the *Convention Relating to the Regulation of Air Navigation*. Each nation was to have complete and exclusive sovereignty over the airspace above its territory. It was not until 1944, at the International Civil Aviation Conference in Chicago, that a multilateral framework was established to regulate the global airline industry. “On December 7, 1944, fifty delegates adopted the Chicago Convention, a landmark compromise consisting of two freedoms of the air as well as many other provisions. The first freedom was the right to fly over another country without landing. The second freedom allowed a plane to stop for fuel or repairs without boarding or leaving passengers or cargo” [Done and Speigel, 2003].

The 1944 Chicago convention and the subsequent 1947 Geneva Convention allowed government officials and airline representatives to negotiate the exchange of traffic rights. As a result of these agreements, government bodies also controlled the level of competition their domestic carriers were exposed to, a key factor in an airline’s profitability. A steady increase in passenger traffic in America from about 40 million passengers in the 1950’s to over 200 million passengers in the 1970’s [Done and Speigel, 2003] placed severe strain on the Civil Aeronautics Board (CAB), the American federal regulatory body. By the mid-1970’s, the CAB recognized its inability to cope with the “increasingly complex airline industry and the macroeconomic problems that were plaguing it” [U.S. Centennial of Flight Commission, unknown].

The *United States Airline Deregulation Act* in 1978 was a major turning point in the civil aviation industry. The main purpose of the act was to remove government control and open the deregulated passenger air transport industry to market forces. The Act introduced fare and route competition and permitted unrestricted entry into the air passenger marketplace by new domestic carriers. The subsequent *Civil Aeronautics Board Sunset Act* of 1984 further led to the deregulation of the United States airline market through the “decontrol of prices, freedom of entry into and exit from the marketplace, complete freedom for mergers and alliances, elimination of service standards and requirements, and an end to route authorization.” [Thierer, 1998].

Taking a cue from the liberalization effects in the US and despite tremendous opposition from several European countries wanting to protect their own state-owned airlines from competition, the *European Commission* introduced its three-phase, ten-year reform process for the European airline industry in 1987. Today no airline holding a valid *Air Operators Certificate* in the *European Union* (EU) can be prevented from operating on any route within the European Union, including flights entirely within another country [International Chamber of Commerce, 2000].

The “open skies” policy, adopted by the US in 1992, allowed for, at least in theory, unlimited market access and unregulated prices, thereby further deregulating the civil aviation market. The US has subsequently succeeded in negotiating open skies agreement with various other nations.

EFFECTS OF DEREGULATION

This period of liberalization facilitated the entry of a number of new airlines into the industry. The resulting increase in competition also led to benefits for consumers including greater choice, lower fares and opening of routes and services to new cities. These developments manifested themselves in a surge

in the number of passengers on flights. Passenger traffic increased on average by about 6.3% annually between 1970 and 1990. Deregulation in the industry initiated the advent of computer reservation systems (CRS). These systems enabled airlines to optimize yield management (the mix between load factor and unit fare paid by each passenger), a key driver of airline profitability. CRS also helped to spur the development of code sharing agreements in the mid 1980's between the major national airlines and smaller regional airlines. Both national and regional carriers continue to benefit from code sharing by developing traffic into major hubs. Code sharing also has spread to international routes. Many US and foreign airlines now have code sharing agreements that essentially enable them to expand their global reach [Air Transport Association, 2001].

PROLIFERATION OF ALLIANCES

Over the years, airlines alliances have proliferated in the industry. Since airlines are required to have a citizenship to maintain their operating rights, airlines have, therefore, created alliances to capture revenue synergies of an expanded network. By doing this, they gain as much as 70-80% of outright merger benefits. In the drive to reduce costs, particularly given challenging operating conditions, airlines can achieve substantial efficiencies through closer cooperation. Alliances help boost airlines' revenues and provide opportunities for growth by feeding passengers between members' networks. Individual passengers and corporate customers are increasingly recognizing the value and benefits which alliances can offer them. North American airlines have been at the forefront of the trend of forming alliances and today, much of the world aviation market is shared between several large global alliances, e.g., STAR Alliance and the **One**World alliance, which includes airlines such as Cathay Pacific, British Airways and Qantas.

Alliances have become increasingly significant because they are very effective at redirecting traffic and, therefore, increase revenue. Alliance members also benefit from sharing operating facilities, maintenance and handling facilities, resulting in savings for all members. Further cost savings come from joint aircraft purchasing (sizeable discounts) and fleet standardization.

The advent of airline alliances has also contributed to the popularity of frequent flier fidelity programs, which have captured the imagination of consumers. By offering the promise of free holiday travel to a faraway exotic locale or an upgrade on a long-haul flight, these programs have helped encourage greater brand loyalty amongst customers. Airlines have leveraged alliances by allowing customers to continue to earn rewards by flying with member airlines.

FACTS & FIGURES

Beginning in the 1970s, the worldwide airline industry has grown six fold. By any measure, the industry is big and important. Air transport employs four million people and generates US$400 billion in output. According to industry spokesmen, the industry indirectly creates 24 million jobs with nearly US$ 1.4 trillion in output, representing 4.5% of global GNP [Bisignani, 2005].

The present turbulent period is very different from the boom enjoyed by the world airline industry in the late 1990's when airlines ordered large numbers of new aircraft from Boeing and Airbus Industries. During the three years before 2001, when the fortunes of the airline industry were declining, world passenger movements had grown by an average of 4.5% per annum and the North American region experienced an average rate increase of 3.3%. Europe outpaced the overall world average with a rate of 7.2% p.a. [Morris, 2003]. Despite the crises during the period from 2000 to 2006, Europe is expected to grow another two and a half times by 2020. Asia-Pacific grew at the rate of 5% in 1999 and 8.2% in 2000. Although it slumped to 2% after the 9/11 attacks, the growth rate rose to 5.6% in 2002.

After the First Gulf War in 1991 a major crisis developed in the airline industry. During the first half of the 1990's, the industry suffered not only from a world recession, but travel was further depressed by the unrest in the Middle East. In 1991, the number of international passengers dropped for the first time. The financial difficulties were exacerbated because airlines had ordered too many aircraft during the boom years of the late 1980's creating significant excess capacity. *International Air Transport Association's* (IATA) member airlines suffered cumulative net losses of US$20.4billion in the years from 1990 to 1994. Since then, airlines have recognized the need for radical change to ensure their survival and profitability. Many have tried to cut costs aggressively, slow down capacity growth and increase load factors. As

economic growth returned, these actions also permitted the industry as a whole to return to profitability. IATA airlines' profits were $5 billion in 1996, less than 2% of total revenues. This was below the level IATA believed necessary for airlines to service and reduce their debt, build reserves and sustain investment levels. In addition, many airlines remain unprofitable [Air Transport Action Group, 2001]. While airlines globally faced a more difficult environment following the end of the stock market boom in the late 1990's, 9/11 radically changed the landscape of the industry. In the wake of 9/11, passenger traffic fell sharply and pushed a number of US airlines into financial distress. In December 2002, United Airlines, one of the largest US carriers, filed for Chapter 11 bankruptcy in an effort to curb its losses [BBC News, 2002]. In Europe, the post 9/11 dip in passenger numbers contributed to the collapse of Swiss national carrier Swissair and its Belgian subsidiary Sabena in 2002.

Globally, airline industry losses in 2001 and 2002 were US$25 billion. Further losses resulted from the SARS outbreak and the Iraq War. As a result of rising oil prices, between 2001 and 2004, the industry lost over US$35 billion. Despite the current crisis affecting the airline industry, there has been one niche market, which has been relatively unaffected: Budget Airlines.

THE GROWTH OF BUDGET AIRLINES

When Rollin King and Herb Kelleher decided to start an airline in 1971, they were determined to get passengers to have fun while getting to their destinations on time and at the lowest fares possible. 1971 marked the launch of their dream child Southwest Airlines and the beginning of the budget airline. From the beginning, Southwest was steered by one major principle: fares should be low. The airline managed to achieve incredibly low prices by focusing mainly "on short-haul flights. Southwest did away with meals, in-flight films, designated seats, multiple seating classes, membership in an airline reservation system, central airports, and a hub-and-spoke route system - all previously assumed to be indispensable to success" [Kim and Mauborgne, 1999].

The no-frills approach guaranteed that the costs were kept to a minimum, allowing fares to be up to 60% below those of its competitors. In just two years the airline turned a profit and has done so consistently every year since then [Birger, Lee, and Nash, 2002; Transport International, 2003].

The much-documented success of Southwest Airlines resulted in the establishment of numerous low-budget airlines in the United States and Europe each holding out the promise of offering low fares and good service. Ryanair, the Dublin-based airline, is an example of an airline that replicated Southwest's business model. From 1985 to 1989, Ryanair expanded rapidly and although airfares were kept low, costs weren't. Although Ryanair was successful in the European market and had over 600,000 passengers by 1990, the company was in the red due to high costs and poor cash management. Under a new management team, a major overhaul of the airline was undertaken during 1990 and 1991. Ryanair re-launched itself as a "low fares/no frills" airline, adopting the Southwest Airlines formula. Non-profitable routes were eliminated. The network was cut back from 19 to just 5 routes and airfares across the remaining network were substantially reduced with 70% of all seats offered at the two lowest fares. By 1991, Ryanair was carrying 700,000 passengers on just five routes. Despite the impact the Gulf War in 1991 had on the airline industry as a whole, Ryanair recorded a profit. With the European Union's deregulation of air transportation in 1997, Ryanair was allowed, for the first time, to open up new routes to Continental Europe. Again Ryanair entered these markets by offering airfares, which were more than 50% lower than the cheapest fares offered by competing flag carriers. Passengers responded enthusiastically and in great numbers to the arrival of low fares for the first time in the European market. 1997 also saw Ryanair Holdings Plc getting listed on the Dublin and Nasdaq Stock Exchanges. Furthermore, taking advantage of the Internet, Ryanair launched Europe's largest travel website which within three months of its launch took over 50,000 bookings per week [Capell, 2003].

The number of low-cost airlines has grown to over 50 in Europe and it is estimated that low-cost airlines, which carried 4% of all domestic and international passengers within Europe in 1999, will be carrying 12-15% by 2010. Low cost airlines also have made inexpensive holidays abroad possible and have made business travel less expensive. It has been estimated that low-cost airlines in Britain account for 43% of all seats on domestic flights and 32% on routes to continental destinations [Gouldman, 2003].

Some low cost airlines have failed. Examples are CaLite, a low-cost subsidiary of Continental Airlines, and Delta Express, a spin-of from Delta Airlines. They were launched in 1996 in the US to compete with no-frills airline ValuJet. Both airlines, however, suffered from over expansion into "major

airline" territory and from competing head-on with well-established airlines: "competing with too many airlines, in too many markets, and losing the battle" [Brodbeck, 1997]. While some fail, others thrive. The success of budget airlines amidst deteriorating operating conditions has been attributable in large part to two factors, successful management of employees and relentless focus on cost control.

SUCCESSFUL MANAGEMENT OF EMPLOYEES

Southwest Airlines chairman Herb Kelleher once said that the secret of budget airlines' success "is available for anyone to see, including our competitors. It's an obsession with keeping costs low and treating employees well and a commitment to managing the company during booms with an eye to the busts that will inevitably follow." Success is based on the airlines' treatment of its employees. "It's sometimes been held out to be a conundrum in business – 'Who comes first, employees, customers or shareholders?' We've never thought it was a conundrum. If employees are treated well, they'll treat the customers well. If the customers are treated well, they'll come back, and the shareholders will be happy." Southwest executive VP of customer service Donna Conover admits that Southwest is "a customer service business that just happens to fly airplanes". Southwest officers receive pay increases that are no larger, proportionally, than what other employees receive. "And in bad times, we take reductions," Kelleher said. "Every officer of Southwest Airlines is paid less today than in 2001." Not surprisingly, Southwest is one of few airlines to post a profit in the wake of 9/11. Good treatment of employees also includes the company's no-layoff policy. Kelleher says it ends up serving as a form of financial discipline, because it prevents managers from hiring too many people when the industry is thriving. Having happy employees saves money, too. Despite the fact that the airline is the country's most unionized, it has been successful in preventing disruptions caused by strikes. "Once labor leaders realize that you're trying to take care of your people, most of the edge…is gone" [Cannon, 2002].

RELENTLESS FOCUS ON COST CONTROL

No-frills carriers have managed to keep costs low by espousing a few simple tenets. Passengers, including those from abroad, are encouraged to book online, saving distribution costs and travel agent fees. For example, Easy Jet, a popular low-cost carrier in Europe, reports that 90% of its bookings are made online. Budget carriers also typically use a ticketless system. A confirmation is sent by e-mail to passengers who print the confirmation and present it at check-in. Most low cost carriers do not assign seats and most charge extra for in-flight food and drinks.

In addition, budget airlines tend to fly one type of plane. This allows them to keep training and maintenance costs down. As a result, for low budget airlines, labor costs account for 5% of total operating costs, whereas for network airlines it can account for up to 40%. Moreover, the higher load factor achieved by budget carriers generates greater revenues per flight, which in turn translates into higher yields.

Budget carriers tend to use secondary or tertiary airports, further away from larger cities resulting in lower airport taxes and operating costs. These factors combined, allow budget carriers to offer fares, which are up to 50 percent below those offered by traditional airlines [Kapner, 2002]. According to aviation analysts, low-cost carriers will account for 30% of the global short-haul market by 2013 [www.iafrica.com, 2002].

THE AIRLINE INDUSTRY IN ASIA PACIFIC

The airline industry has experienced incredible growth globally. The Asian air travel market has experienced growth rates of 10% and 11% during the 1970's and 1980's respectively. During this time, Asian Airlines such as Cathay Pacific, Singapore Airlines (SIA), Japan Airlines (JAL) developed into major international carriers and several state-owned airlines, Qantas, Air New Zealand, Thai International, Korean Air and China Airlines (Taiwan) were started.

During the 1990's, the market took a turn for the worse. The Gulf War further accentuated the global economic recession in 1991. Post-Gulf War recovery for Asia seemed elusive, as Japan, which accounted for 60% of Asian international air travel, faced further economic turmoil. Profit margins decreased across the board in Asia during this period. The crisis became the global airline industry's

wake-up call. Until the 1990's, Asian airlines had operated in tightly regulated environments. Many Asian governments had focused on bilateral agreements to protect their flag-carriers, which could not "match the size and efficiencies of global competitors" [Yergin, Vietor, and Evans, 2000]. Subsequently, Asian governments started to see the need to make their airlines more competitive in the international market.

Asia's economic growth benefited the growth of the airline industry in the region during the 1990's. In 1994 Asia accounted for 30% of the world's air travel. In 1996, the Asia Pacific air travel industry was valued at US$10 billions. By 2002, while the world was recovering from the shock and economic fallout of the 9/11 World Trade Centre attacks in 2001, and while most airlines were struggling to stay afloat, air traffic within the Asia Pacific region grew by 4.9%. Although this represented a decline from 5.2% in 2001, it was the highest average growth rate globally [Stirland, 2002].

In 2002, for the first time, the Asia-Pacific region, with 131 million international tourist arrivals, overtook the Americas to become the second-most visited region in the world after Europe [Centre for Asia Pacific Aviation, 2003]. Most airlines in the Asia Pacific region were significantly impacted by the Asian Economic crisis and the worldwide downturn following 9/11, however passenger traffic soon recovered and airfreight, in particular, demonstrated continued growth. Forecasts suggest that air travel, and air cargo shipments within Asia will become one of the most dynamic segments of the world's aviation business. According to the *Air Transport Action Group's* 2001 report on 'Asia/Pacific Air traffic – Growth and Constraints', the Asia Pacific air travel industry is expected to grow by 4.8% per year until 2014.

US interest in expanding the success of its open skies policy to Asia, further accelerated the need for regional deregulation. In January of 1997, the US signed an open skies agreement with Singapore, followed by agreements with Malaysia and Taiwan in 1998. In May 2001, the US signed a Multilateral Agreement with six members of the Asia-Pacific Economic Cooperation (APEC), which included Brunei and New Zealand. Japanese and other authorities have been reluctant to join, largely because of the perception that the agreement was favoring the US. "The ultimate target for the Americans, though, is Japan which is probably the most significant opponent of the open skies concept, arguing that such agreements just lead to monopolistic alliances which are dominated by US mega-carriers. In addition, the Japanese remain aggrieved by the fact that the original US-Japan bilateral airline pact was skewed in favor of US carriers." [Jerram, Hodges, Turner, and Kurz, 1997].

There is a consensus that the Asian market will grow from around 25% of the world's international traffic to around 50% by the year 2010. This represents a major opportunity for Asian airlines. To remain competitive, Asian airlines have begun to pursue network scale through code-sharing & alliance relationships with US and European carriers. Despite the threat of terrorism, war and the poor economy, global passenger traffic is expected to grow. By 2014, the numbers of passengers traveling to, from and within Asia Pacific are expected to reach 817 million [Air Transport Action Group, 2001].

REGIONAL GROWTH

The Chinese market drives a large part of the growth prospects of the aviation industry. China will continue to grow strongly as its civil aviation industry market becomes more accessible; its airlines consolidate into three main airline groups with over 300 Airbus and Boeing aircraft. Projected growth in the Chinese domestic and international market is expected to increase to 214.7 million passengers in 2014, a 208% increase from 1999, making it the largest Asia Pacific country for both domestic and international scheduled passengers combined.

With China's domestic air traffic growing at the annual rate of 7.6-8%, it is poised to become the world's second largest commercial aviation market outside of United States by 2013 [The Boeing Company, 2002]. China Southern Airways (CSA) has already started to prepare for the improved growth prospects by focusing on cost reductions [Reuters, 2003]. CSA's greatest strength is its position in China. The company has a 60% investment in five other Chinese airlines: Fujian Airlines, Guangxi Airiness, Shantou Airlines, Xiamen Airlines and Zhuhai Airlines. By 2002, CSA operated more than 300 routes. Forty were international routes. CSA operated in almost 100 cities [China Southern Airlines, 2005].

China Eastern Airways (CEA) mirrors CSA's success. By 2002, CEA operated 209 mainly domestic routes. In 1996, in an effort to better serve its customers, CEA was the first airline in China to employ non-Chinese stewardesses. Buy the beginning of the year 2000, over 70 flight attendants from countries including Japan, Spain, France, the United States and South Korea worked for the airline. A direct result

of this increase in number of foreign flight attendants was a drop in passenger complaints regarding language problems [Bao, 2002].

The Civil Aviation Administration of China continues to encourage consolidation and restructuring of the domestic airlines. It has ordered 10 airlines to consolidate under flag carriers Air China, China Eastern Airlines and China Southern Airlines [China Daily, 2003]. Intensive competition within and outside China, higher fuel costs and Yen and Dollar exchange rate fluctuations continue to be challenges for CSA and other airlines in the region.

China Northwest Airlines (CAN) also hopes to benefit from the increasing passenger growth in China. Initially focused on inland routes, in 1994, CNA expanded its northeastern base with the acquisition of Nanjing Airlines and in 1998 its international presence with routes to Japan [Cheung, 1998]. In March of 2003, Shandong Airways was given approval to open international routes to South Korea, Japan, Hong Kong and Macau. Other airlines in the region are also pushing for new routes. Thai Airways recently expanded connections to Xiamen, China, Johannesburg, South Africa, Chittabong, Bangladesh, Abu Dhabi, UAE, Bahrain and Geneva, Switzerland. Qantas Airlines' takeover of Air New Zealand is seen as further sign of the consolidation among airlines in the region. The Qantas takeover is also expected to affect Asia-Europe long haul routes for SIA, Cathay Pacific, Malaysian Airlines, and Thai Airways.

Increasing competition from restructured, customer oriented Chinese airlines approaching international standards, present escalating concerns for Cathay Pacific.

BUDGET AIRLINES IN ASIA PACIFIC

Deregulation in Asian opened the market for low-cost carriers who hope to mirror the success of their counterparts in USA and Europe. Analysts are predicting substantial opportunities for no-frills, no-meals low-cost carriers in the region. Low cost carriers are expected to thrive in Asia by providing cheap short-haul flights to previously unreachable holiday destinations at secondary airports.

Among the established and successful low cost carriers in Asia are AirAsia, Bangkok Airways and Cebu Pacific. Launched in 2001, AirAsia, the Malaysian low-cost carrier, is already posing a threat to government-controlled carrier Malaysian Airlines. In December 2002, AirAsia had a monthly cash flow of US$44.7 million. At the same time it added three planes to its existing fleet. In 2003, the carrier added international routes and announced plans to fly to Indonesia and Thailand [Yoong, 2002]. It is expected to soon compete directly with all of Malaysian Airlines' short-haul routes.

Bangkok Airways, Thailand's largest privately owned carrier, initially started with domestic flights to Koh Samui. In 2000, it gained exclusive rights to fly tourists from Bangkok to Siem Reap, home to Angkor Wat. In January 2002, it as admitted as an IATA member gaining international recognition. By the end of 2002, the airline offered 42 flights per week to Siam Reap and flights to the Chinese provinces of Xian and Jinghong. By 2003, Bangkok Airways was flying to a total of thirteen destinations in five countries including: Bangkok, Samui, Phuket, Sukhothai, Pattaya Beach (Utapao), Chiang Mai, and Hua Hin in Thailand. In addition, Bangkok Airways had routes to Phnom Penh and Angkor Wat (Siem Reap) in Cambodia, Luang Prabang in Laos, Ho Chi Minh City (Saigon) in Vietnam and Singapore. The airline has also secured rights to operate direct flights from Bangkok to Hangzhou, Shenzhen and Nanjing in China. Besides using secondary airports to reduce costs, Bangkok Airways went a step further and built its own secondary airports in Sukhothai, Samui and Trat [Corson, 2003]. In 2002, Bangkok Airways carried 1.24m passengers generating revenues of 4.5billion Bhat and a net profit of 150m Baht. The latest entry in the Thai domestic market, hoping to replicate Bangkok Airways' success, is Phuket Air. The airline is already considering routes to London, Rome, Paris and India [Murphy, 2003].

In the Philippines, Cebu Pacific Airways claims to have garnered over 30% of the domestic market. Domestic market saturation eventually pushed Cebu Pacific to expand into the international market. In November 2001, Cebu Pacific launched services to Hong Kong, thereby entering into direct competition with Cathay Pacific Airways. Cebu Pacific Airways has since expanded its routes to Seoul, Bhutan and plans to expand its network to China and Singapore [Lawson, 2002].

Shenzhen Airlines is another new entrant into the low-cost carrier arena. By 2005, it operated more than 25 Boeing 737-700 aircraft leased from GE Capital Aviation Services, serving over 20 destinations in China Chen, 2005. Long anticipated, private carriers emerged in China. First in the air was Okay Air, which started commercial service in 2005 from Tianjin to Changsha and on to Kunming. Other carriers received approval about the same time, Spring Air, Eagle Airlines, and HuaXia Air (Dennis, 2005). Not all

of these carriers will survive. All seem to echo the CEO of one of the new airlines, who said the goal was to become the "Southwest Airlines of China."

The phenomenal success and the increase in low-cost carriers in Asia is yet another concern for Cathay Pacific.

THE AIRLINE INDUSTRY IN HONG KONG

More than sixty international airlines and more than a dozen additional all-cargo carriers serve Hong Kong, a major international and regional aviation hub. In 2000, over 4,100 flights per week providing serviced some 140 destinations worldwide. Hong Kong is the gateway Mainland China. Some forty cities in mainland China have scheduled and/or non-scheduled service to Hong Kong. It is estimated that air transport accounts for at least 8.1% of Hong Kong's Gross Domestic Profit. More than 300,000 persons are employed in key industries such as imports/exports and tourism relying on air transportation. Hong Kong International Airport (HKIA) is one of the world's busiest. In a typical year, more than 35 million passengers pass through the HKIA and some 3 million tons of air cargo are processed [Hong Kong International Airport, 2005].

Today, as in the past, the Hong Kong Air Transport Licensing Authority grants airline operation licenses in Hong Kong. There are three main licensed air carriers in Hong Kong: Cathay Pacific Airways, Hong Kong Dragon Airlines Limited (Dragon Air) and Air Hong Kong Limited (AHK). Launched in 1946, Cathay Pacific has grown into one of the largest and most successful airlines in the world and is Hong Kong's designated flag-carrier. Dragon Air, which mainly operates routes to cities in China, has expanded its network over the years to cover cities in Southeast Asia and Japan. Air Hong Kong is the only all-cargo airline in Hong Kong. It was established in 1986, and began charter cargo flights in 1988. In February 2002, Cathay Pacific took complete control of AHK, making it a wholly owned subsidiary. A month later, Cathay sold 30% of AHK's stake to DHL, thereby enhancing Hong Kong's position as Asia's cargo hub. In June 2003, CR Airways was given a varied Air Operator's Certificate (AOC) for the operation of its first Bombardier CRJ-200 regional jet. With the granting of this AOC variation, CR Airways became the third Hong Kong-based airline to operate commercial air transport using fixed-wing aircraft for passengers. CR Airways now plans to fly mainly to cities in China and some Southeast Asian destinations.

Under the Hong Kong Basic Law, authorized by the Chinese Government, the Government of Hong Kong negotiates air service agreements to, from or through Hong Kong. The Basic Law also gives the Government of the HKSAR the authority to negotiate and conclude other air services agreements. As of the early 2000, Hong Kong had such air services agreements with about 50 countries [http://www.edlb.gov.hk/edb/eng/related/atla.htm].

CATHAY PACIFIC AIRWAYS

Cathay Pacific Airways is Hong Kong's largest international airline offering scheduled cargo and passenger services to over 140 destinations worldwide. American Roy Farrell and Australian Sydney de Kantzow established the airline in September 1946. In 1947, the British government told Farrell that as an American he could not hold a major stake in an airline based on British soil. Butterfield & Swire, one of Hong Kong's major trading companies, which operated cargo worldwide, came in to take control of the airline.

On October 18, 1948, the new company was registered as Cathay Pacific Airways Limited with nominal capital of HK$10 million. By the 1960s, the company had firmly established itself as one of the most successful carriers in the region. In April 1986, the Company was listed on the Hong Kong Stock Exchange. In 1987, Cathay Pacific's status as one of the world's premier carriers was recognized when it received one of the industry's most coveted awards: *Air Transport World* magazines' Airline of the Year Award [http://attc.de/images/CX.pdf].

In January 1990, Cathay Pacific and its parent company Swire Pacific bought a significant shareholding in DragonAir. In 1994, the company acquired a 75% shareholding in Air Hong Kong Limited (AHK), which operated scheduled air cargo services to Europe and Japan. Over the years Cathay Pacific has diversified its interests and became a significant shareholder in various other companies.

Between 1991 and 1997, the Company registered a 33% growth in passenger service revenues and a 36% increase in passengers carried. In April 1996, prior to Hong Kong's return to China on 30 June

1997, the Chinese government, like the UK government in 1947, did not permit control of an airline by foreign interest on what was to be Chinese territory. Through a share issuance to CITIC Pacific, China's largest foreign investment arm, Swire reduced its stake in Cathay Pacific from 53% to 43.9%. At about the same time, China National Aviation Corp (CNAC), announced plans to launch an airline in direct competition with DragonAir, which mainly flew HK-China routes. This essentially meant that Cathay Pacific, as a majority shareholder in DragonAir, would be competing with China's aviation regulatory body. Cathay decided to resolve this conflict by selling 36% of DragonAir to CNAC for HK$1.2billion (US$156m). CNAC subsequently abandoned plans to launch a competing airline [Flint, 1996].

The Asian Economic crisis of 1997 had a significant effect on Cathay's earnings. The crisis, followed by forest fires and haze in Southeast Asia and the 1997 bird flu scare in Hong Kong, severely impacted Cathay's positioning and financial strength. Attributable profit fell by 55.5%, in 1997, compared to the previous year and turnover was down by 2.9%. Annual passenger load fell by 5.8% to 68.2%. The economic crisis had impacted both inbound and outbound visitor arrivals in the region and led to a significant decrease in demand for air travel in the Asia Pacific region. A further decrease in turnover the following year by almost 13% led Cathay to one of its worst years in recent times with a recorded net loss of HK$542 million. The financial turmoil and the drop in tourism led Cathay to lay off 760 employees worldwide (460 in Hong Kong alone) in January 1998. The company later announced a recruitment freeze in the face of the weakening Asian economy and another 110 employees were made redundant in March 1998. The turnover in cargo had decreased 9.5% from 1997. However, despite low earnings, the company continued to take delivery of 10 new Boeing and Airbus aircraft. As a result of being able to increase passenger loads without increasing costs, Cathay announced in 1998 that it was considering joining an alliance. The airline hoped that the increased visibility in the world market would lead to increased revenues. With the opening of the new Hong Kong International Airport at Chek Lap Kok in 1998, the airline had to face increases in operating costs by at 20% due to the higher landing, parking and maintenance costs at the new airport.

In 1999 Cathay Pacific became a member of the OneWorld™ global alliance and launched its frequent-flier program AsiaMiles. Joining the international alliance OneWorld™ provided an extensive range of benefits to Cathay Pacific. Cathay Pacific extended its global network to over 550 destinations worldwide. Entering into code share agreements allowed Cathay Pacific to offer greater frequency of flights. Although 1999 was a significant year for Cathay in securing a foothold in the global airline industry, the company continued to face problems at home.

A cut in automatic pay increases for flight attendants resulted in the flight attendants launching a "no-smiles" campaign. Other options offered to the employees were to work an extra four hours a month in return for a three and a half per cent pay rise or to take voluntary redundancy. Additionally, the airline experienced two weeks of flight disruptions due to an on-going salary dispute with its pilots. A thirteen-day sickout by pilots resulted in about 1000 flights being disrupted. Until the strike, Cathay pilots were considered to be among of the best-paid pilots in the world, earning up to US$400,000 annually in salary and allowances. The pilots eventually agreed to pay cuts of as much as 22 percent over three years in exchange for stock options. The agreement is estimated to have saved the airline HK$1.4 billion (US$180.6 million) over 10 years [Segal, 1999].

The airline continued to streamline its operations by implementing better cost-control measures by reducing in-flight service and passenger expenses. In 2000, Hong Kong International Airport announced a 15% decrease in landing and parking charges. Cathay Pacific in turn announced an increase in operating profit of 88.2% with an increase in turnover of 20.3%. The crew shortage that year prompted the airline to ask pilots to forgo vacation time for cash and thereby alleviating the impact of the personnel shortage. The company hired over 1,100 staff including over 600-cabin crew, 200 pilots and 300 ground staff.

On July 3, 2001, pilots at Cathay Pacific embarked on a limited industrial action (a work-to-rule campaign) in face of the long-running pay and rostering disputes. The industrial action led to the cancellation of numerous flights and a decrease in revenue for the airline. The airline eventually fired 52 pilots. The industrial action, the global economic downturn, weak demand in cargo traffic was further exacerbated by the outfalls of September 11, 2001 [Hopkins, 2002].

The September 11 attacks on the World Trade Center in New York plunged the world economy and in particular the airline industry to one of its lowest levels. The drop in business and lack of public support eventually led the pilots to call of the industrial action in October. Turnover decreased by almost 12% and operating profits fell by 84.3%.

Although the September 11 attacks and terrorist bombings in Bali in October 2002 had a major impact on the airline industry, Cathay Pacific reported an 8.7% increase in turnover and a 28.4% rise in cargo operations in 2002. However, Cathay, like most other airlines saw a decline in the profitable business travel segment. Dwindling profits and severe economic strain prompted many companies worldwide to reduce costs – business travel chief amongst them.

In 2002, Cathay Pacific resumed bonus and profit share payments and recruited 200-cabin crew and announced plans to hire 800 more over the next few years. In November 2002, Cathay Pacific was the first Airline in Asia to take delivery of the new long range Airbus 340-600. The airline also announced plans to further expand its fleet over the coming years in anticipation of passenger and route growth. In early 2003 Cathay experienced one of its biggest setbacks in recent history and had to face one of the worst crises in the last 26 years. The war in Iraq was already impacting the airline industry globally, but it was the outbreak of SARS (Severe Acute Respiratory Syndrome) that gravely affected the airline industry as a whole and Cathay Pacific in particular as Hong Kong was one of the areas most severely affected by SARS.

In March 2003, Cathay Pacific was forced to cut 45% of its schedule. Deputy Chairman and Chief Executive, David Turnbull stated on 11 April, "Cathay Pacific is being badly affected by the fall in passenger demand and we must, therefore, take action to conserve cash and minimize spending."

On 11 April, Cathay issued its first ever profit warning, stating that "results for the first half of 2003 are expected to be materially adversely affected by the recent sharp fall in passenger demand for air travel caused by the Iraq war and widespread public concerns over the outbreak of atypical pneumonia in Hong Kong and other parts of the world." [Centre for Asia Pacific Aviation, 2003]. Cargo traffic, however, was relatively stable in April and the airline continued to run a full freighter schedule. On 23 May, 2003, the World Health Organization (WHO) lifted its warning against travel to Hong Kong. By June the airline had returned to 71% of its normal capacity and was back to a full schedule by September 2003 [Yields, 2003].

In April 2003, Hong Kong's Air Transport Licensing Authority (ATLA) allowed Cathay Pacific to apply for flights to Beijing, Shanghai and Xiamen despite objections from local rival DragonAir, which had been the only Hong Kong-based airline with rights to fly scheduled passenger services to China [Lawson, 2002].

THE ROAD AHEAD

Cathay Pacific has come a long way to become one of the world's leading airlines. Cathay has demonstrated clear direction over the years and has been successful in improving its quality and service. The airline has continued to be successful in the face of much adversity over the years: labor actions, the Asian economic crisis in 1997, the impact of the 9/11 attacks, the war in Iraq, and the SARS breakout.

As Cathay recovered from the staggering effect the SARS scare had on the industry, Philip Chen knew that the airline had to carefully analyze its strategic position, evaluate its core strengths and decide on future directions to position the company to overcome challenges in a turbulent economic environment. He and his management team were faced with the task of identifying these challenges and determine how the company could remain competitive and profitable. Chen walked into the conference room to convey to his management team the significance and the urgency of this moment in time for Cathay Pacific and to move the team to action.

REFERENCES

Air Transport Licensing Authority. Available from:http://www.edlb.gov.hk/edb/eng/related/atla.htm. (Accessed on 13 July 2003).

Air Transport Action Group. "Asia/Pacific Air Traffic Growth & Constraints, " Air Transport Action Group (ATAG, 2001).

Air Transport Association, The Airline Handbook (2001 edition).

"Airlines Waging Fare Dogfight over France," www.iafrica.com (26 Mar 2002).

Bao, X., "Peacocks' Fly Southward," Shanghai Star (March 28, 2002).

Birger, J., J. Lee, and J. Nash, "What's Right with this Market: 5 Stocks," MONEY Magazine (April 5, 2002).

Bisignani G. "Aviation and the Environment," Speech to Environment Summit, (17-18 March 2005). Available from: http://www.iata.org/pressroom/speeches/2005-03-17-01.htm. [Accessed on 29 November 2005].

Brodbeck, M., "US Airline Industry, 1980's and Beyond," (Spring 1997).

Burton, J., "AirAsia Sells $26m Stake," Financial Times (June 30, 2003).

Cannon, J., "Southwest Airlines: Service for Smiles and Profits," RealCRM Case Study (October 10, 2002).

Capell, K., "Ryanair Rising," BusinessWeek (June 2, 2003).

"Cathay Gets Approval to Start HK-Beijing Service," The Business Times (Singapore). (June 20, 2003).

Cathay Pacific: History Inside CX. Available from: http://www.attc.de/images/CX.pdf. [Accessed on 13 July 2003].

Centre for Asia Pacific Aviation. "SARS Impact on Airlines, Airports and Tourism," Centre for Asia Pacific Aviation (April 24, 2003).

Chen, H. "Shenzhen carrier switches allegiances," China Daily (April 3, 2005)

Cheung, A., "Mainland Airline Bounces back from Disaster," South China Morning Post (March 24 1998).

China Southern Airlines 2002 Interim Results, Available from: http://www.cs-air.com/en/. [Accessed on 13 July 2003].

China Southern Airlines 2004 Results, Available from:http://www.cs-air.com/en/ [Accessed on 13 July 2003].

Corson, J., "How Bangkok Airways Became a Runaway Success," available from www.ttg.com.sg [accessed on January, 26, 2003).

Dennis W., "China's First Low-Fare Airline Starts Service To Kunming," Aviation Daily, (14 March 2005).

Done, K. and P. Speigel, "Air Transport Sector Faces its Biggest Challenge," Financial Times (June 16, 2003).

Flint, P., "Ferrell's Revenge," Air Transport World (June, 1996).

Gopalan, N. "Cathay Pacific Sees Improved Bookings; Low Yields," Dow Jones Business News (June 27, 2003).

Gouldman, A., "The Rise and Rise of Low-Cost Airlines, Special Reports," Internet Travel News (May 9, 2003).

Hong Kong International Airport. "Finalized Civil International Year 2004 Air Traffic Statistics at HKIA," [online] (March 2005). Available from: http://www.hongkongairport.com/eng/aboutus/statistics.html,[Accessed on 29 November 2005].

Hopkins, G. E., "Cathay Pacific Pilots on the Brink, Does ALPA Have a Dog In This Fight? (Or Is Their End Of the Titanic in the Water)," Air Line Pilot (May/June 2002)

International Chamber of Commerce, December 7 2000. "The Need for Greater Liberalization of International Air Transport". [online] International Chamber of Commerce. Available from: http://www.iccwbo.org/home/statements_rules/statements/2000/need_for_greater_liberalization.asp [Accessed on 13 July 2003].

Jerram, R., M. Hodges, L. Turner, and R. Kurz, "Political Environment for Global Business - Course Guide," (1997).

Kapner, S., "Budget Airlines Grow in Europe," New York Times (March 17, 2002).

Kim. W. C., and R. Mauborgne, "How Southwest Airlines Found a Route to Success," Financial Times (May 13, 1999).

Law, C.K., R. Yeung, "The Reality of "Open Skies" and Its Relevance for Hong Kong," Research Press Briefing (5 April, 2000), Hong Kong Policy Research Institute.

Lawson, T.C., "Cleared for Take-Off: Structure & Strategy in the Low-fare Airline Business.(2002).

Morrison D, "Dark Clouds over Airlines, but Bright Days for Bauxite," The Jamaica Observer (April 13, 2003).

Murphy, C., "Small Local Airlines Adapting to Turbulence," Bangkok Post (June 5, 2003).

Reuters "Profits Fly Higher at China Southern, " Airwise News (March 17, 2003).

Segal, P., "Cathay Pacific Avoids Strike as Its Pilots Blink," International Herald Tribune (June 11, 1999).

"Shandong Airlines to Operate Overseas Routes," China Daily (March, 25, 2003).

Stirland, R. , "Uncertainty And The Outlook For World Air Travel - The Asia Pacific Region, Speech By Richard Stirland, Director General, Association Of Asia Pacific Airlines (AAPA)," 27th Annual FAA Commercial Aviation Forecast Conference In Washington, DC (March 12, 2002).

The Boeing Company. "Boeing Forecasts Continuous Growth for China's Aviation Market," The Boeing Company, [online] (November 3, 2002). Available from: http://www.boeing.com/news/releases/2002/q4/nr_021103g.html [Accessed on 29 November 2005]

Thierer, D., "20th Anniversary of Airline Deregulation: Cause for Celebration, Not Re-regulation," (April 22, 1998), The Heritage Foundation. Available from: http://www.heritage.org/Research/Regulation/BG1173.cfm . [Accessed on 13 July 2003].

Transport International. "Flying High On A Budget," Transport International, (April 2003).

U.S. Centennial of Flight Commission.. "International Civil Aviation" [online]. U.S. Centennial of Flight Commission. Available from: http://www.centennialofflight.gov/essay/Government_Role/Intl_Civil/POL19.htm. [Accessed on 13 July 2003].

"United Airlines Files for Bankruptcy," BBC News [online] (December 9, 2002). Available from: http://news.bbc.co.uk/1/hi/business/2556225.stm. [Accessed on 29 November 2005]

Xinhua News Agency, "WTO Assembly to Convene in Beijing," People's Daily (July 15, 2003).

Yergin, D. R., H.K. Vietor and P.C. Evans, "Fettered Flight: Globalization and the Airline Industry," (2000). Available from: http://www.aviationglobalization.net/. [Accessed on 13 July 2003].

Yoong, S., "Cheaper Tickets: Malaysian Airline Tests Asia's Resistance to No-frills Flights," Associated Press (December 2, 2002).