Airport commercial income: driving returns for China's airport operators

LEK Consulting partners **Michel Brekelmans** and **Stephen Sunderland** analyse the commercial development at China's airports over the past five years

China's breathtaking economic development has seen household disposable income rise at record rates and the emergence of a middle class with rising disposable income. Furthermore, the government's aspirations to move towards a more consumption-led economy can be expected to further fuel this engine of growth in the coming years. Consumer spending growth is estimated at around 18% per annum since 2007, with strong further growth forecast in the coming years.

At the same time China's ongoing investment in airport facilities is delivering a step change in capacity across its aviation system. Airport finances are likely to remain under pressure for some years as demand catches up with investment. Incremental profit opportunities are valuable in supporting the wider economics of airport operators.

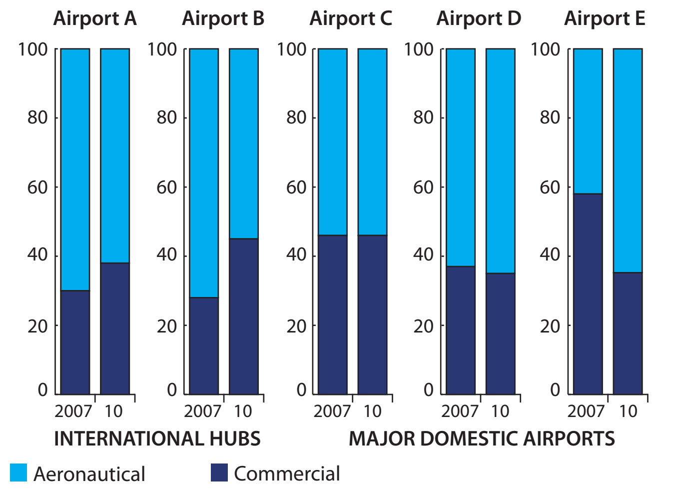
How has the commercial offer developed in China since 2007?

In our 2007 paper we found that there was a significant performance gap between Chinese airport operators and their peers in Asia. We would have expected that a broad swathe of China's airport operators would by now have moved to enhance their commercial offer, and hence enrich their income stream with more commercial revenues.

It is clear that overall quality of goods and services offered has improved substantially since 2007. The offering is generally more varied and more recognisably branded, with the important consequence that the passenger perception of airport retail in China has been transformed. When we first started to work with Chinese airports the typical consumer attitude was outright negative towards shopping at airports, primarily due to the poor range and overpricing. Today, the passenger is far more engaged, with most passengers recognising there can be good deals found at Chinese airports. These attitudinal changes are a major breakthrough for the airport industry in China and provide an essential foundation for further development.

However, it seems that commercial performance has seen mixed development among China's largest airports since 2007; only a select number of international hubs have been able to improve the mix of commercial revenue versus aeronautical revenue, with airports in tier-two cities (serving predominantly domestic routes) remaining at the same level, or even weakening, relative to aeronautical incomes.

Share of revenue derived from commercial activities at selected airports in China



Source: Airport financial returns; LEK analysis

Such mixed progress reflects a variety of obstacles that exist for China's airport commercial managers, including:

- insufficient awareness among China's senior airport management of the scale of profit potential from enhancing commercial practices;
- focus of senior management attention on airport operations, to the detriment of commercial development;
- airports' capital programmes have been orientated towards capacity enhancement, with commercial revenue considerations not prominently considered in terminal design;
- the specific needs and wants of China's airport users can differ somewhat compared with international norms—with the need to interpret international best practices with caution;
- limited appetite for partnerships with world-class travel retailers or limited number of trusted quality partners with whom to work on developing the airport retail proposition; and
- weak profit motives or incentives to reduce funding requirement on state-owned enterprise senior managers.

Collectively these issues pose a considerable challenge to those attempting to improve the financial performance of their airports.

How do China's airports perform relative to their peers today?

There is still a long way to go to seize the full commercial revenue opportunity in China: the average passenger at China's major airports spent $5 compared with $14 across a set of regional airports. As a proportion of overall income, these regional peers still generate 18% more commercial revenue share than large airports in mainland China, albeit that this represents major progress compared with a 29% gap in 2007.

There are a number of structural reasons why commercial revenues might be lower for China's airports, such as:

- average incomes are lower in China than in comparative locations, although airline fares are typically in line with international norms and China's passengers tend, therefore, to have higher purchasing power than average income statistics might suggest;
- the high incidence of domestic and business passengers using China's airports, who are typically lower retail spenders. International leisure

DFNI's & m1nd-set's Question of the Month

In general, do you find duty-free shops at airports boring?

Yes: 19%

No: 81%

Globally, every fifth traveller finds duty-free shops at airports boring. The highest rate is found in Europe with 23%, followed by the Americas with around 20%. The region where the least travellers find duty-free shops boring is Asia, with only 16%.

Most of these travellers claim they only go to duty-free shops if they really need something. Many of them also mention they find all the duty-free shops are the same and offer little variation.

travellers (typically the highest-spending group), while fast-growing, are rarer as travel remains a luxury for relatively few to enjoy;

- the majority of China airport commercial income is derived from airport retail activities, whereas airport peers in other countries would also typically count a range of other important revenue sources, including car parking, income from non-terminal property, and more.

Nonetheless, even considering these differences, it appears that there is still a significant performance gap that Chinese operators can work to address.

Putting things into practice

Domestic airports are putting increasing efforts in developing their commercial performance. Take Xiamen Gaudi International airport as an example, where management is aiming to make food price levels at the airport similar to that in local restaurants, allowing more passengers to enjoy a meal without paying a premium. This is quite different from international practice. For example, food and beverage prices in airports can be very significantly higher than in high street outlets, reflecting the effective monetisation of a less price sensitive consumer. At present, these outlets represent 27% of the airport's total commercial space.

At Xiamen airport, there are 35 branded stores (including bookstores and duty-free stores), occupying around 62% of the commercial space. However, the layout and ambience still lags behind that of its international counterparts and more work is required to elevate this to international standards.

Xiamen airport has been expanding its commercial zone area and invested in continued renovation, accordingly growing its rental revenues. A new parking area will be put into operation in June 2013 and the current 20,000sq m parking area is now being redesigned into restaurants and offices. The renovated terminal two now has a commercial zone area of 1,000sq m, 17% larger than the previous one. By mid-2012, the majority of store leases have expired and rent is expected to increase by around 30%.

We estimate that commercial revenue remains an incremental opportunity of at least Rmb10bn ($1.57m) per year for China's airports. Not all of this gain is achievable overnight: many international operators have taken decades to develop their commercial propositions, growing up alongside their passengers and business partners, but it remains clear that the airport commercial revenue opportunity in China is massive and has the potential to provide higher investment returns and lower subsidy requirement than would otherwise be the case. Furthermore, a successful commercial revenue strategy provides airports with the ability to reinvest in their aeronautical activities and hence drive a virtuous circle of improvement by attracting greater passenger flow and commercial spend.

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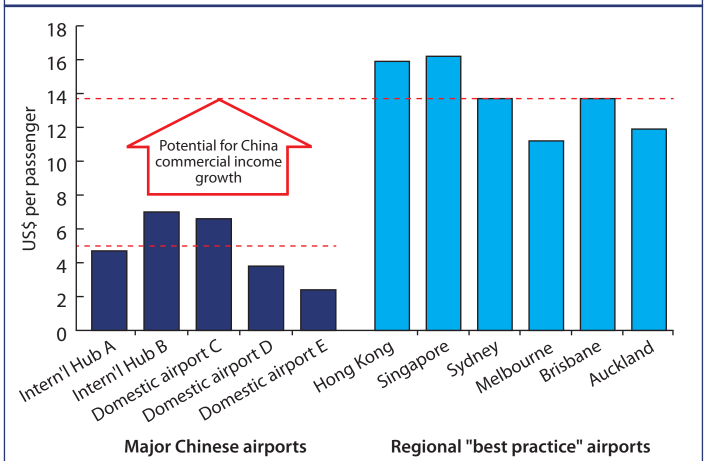
Commercial income per passenger: mainland China vs. regional best practice



Source: Airport financial reports (2010/11) LEK analysis

Editorial

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This year's *DFNI Database & Directory*, due for publication later this month, will reveal that the top 10 retailers globally last year accounted for 52.3% of total global travel-retail turnover (see page 6).

The year-on-year proportional growth of 1.3% is half the rate of growth in 2010 but the effect is brought on by the consolidation among retailers and suppliers, which had been gaining pace within a few decades of the original formation of the duty-free channel. The past year has seen the trend in consolidation continue with the acquisition by Dufry Group of four companies including Argentine airport retailer InterBaires as well as operations in Uruguay, Ecuador, Armenia and Martinique.

And in January this year the retailer went on to conclude a deal to acquire a majority shareholding in Russian operator RegStaer at Moscow Sheremetyevo airport, although under the strategic partnership, the stores—which generate more than $50m annually—continue to operate under the RegStaer logo.

Industry consolidation is becoming popular among the issues discussed on the industry conference circuit, having for example been raised at the Trinity Forum in Seoul in March this year. There has been nothing quite as dramatic as the series of takeovers undertaken by Italian travel retailer Autogrill culminating in the purchase of World Duty Free in March 2008 after a cluster of associated activities including airports group Ferrovial's sale of BAA-owned retail division World Duty Free (WDF).

In October that year Dufry Group also signed a contract to take over the duty-free assets and contracts belonging to Latinoamericana de Duty Free, with the acquisition including operations in the core product categories at airports including Mexico City, Acapulco and Guadalajara.

Consolidation isn't confined to airport stores. Observers also considered the victory by inflight concessionaire Tourvest Duty Free in winning the British Airways retail contract last year to be symptomatic of further industry consolidation, leaving the retail operations of the United Kingdom's two largest carriers BA and Virgin Atlantic in the hands of one concessionaire.

Consolidation does not always lead to immediately positive results, Autogrill for example reporting a 1.1% drop in revenues in 2009 following the full consolidation of Aldeasa and World Duty Free.

And of course with each takeover there is at least one fewer supplier or delegate place at the corresponding regional exhibition and in that respect less capital to share across the industry.

But there is no stopping the gravy train. DFNI

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