

## Rethinking Retail Relationships in a Volatile World

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*To deal successfully with the increasing volatility of airport traffic, managers need to develop flexible lease arrangements and use them to manage concession risks.*

The food and retail business at airports is changing dramatically. In Europe, the traditional perception was that shopping at the airport was always advantageous because of the duty-free opportunities. With the European Union, duty-free opportunities are much lower, and the business model for retail sales has to change. In the United States, airports are becoming much more sophisticated about retail. Increasingly, American airports -- such as Pittsburgh, Philadelphia, and Los Angeles -- are placing more emphasis on complex programming goals. More and more, airports are moving away from single operators of their food or retail operations, to programs that include local businesses and signature restaurants. Additionally, great turmoil in the aviation industry tops off these changes within the industry.

Our thesis is that risk at airports is increasing because of both greater competition and greater volatility. Although volatility has always been part of the airport scene, it is now moving to new levels. In this context, airport managers need to rethink their financial relations with their food and retail operators.

Airports traditionally shifted risk to large operators. The industry giants could afford to assume risk for two reasons. Being big, they diversified their risk over many airports in different markets. To the extent they had local monopolies; they raised prices and margins as a cushion against risk. Local operators are in a much different situation. Competition between multiple local tenants holds prices and margins low. Also, local firms cannot spread their risk broadly over geographic reasons. Local operators are thus much more sensitive to risk. As airports foster local tenants, they need to rethink their financial relationships with their retail and food operators. Airport managers particularly need to rethink the allocation of risk.

Meanwhile, it is becoming more obvious that the retail business is volatile. We have always known that growth fluctuates. Since September 11 and over the contemporary recession, we have increasingly recognized the downward possibilities. Food and retail operators that relied on forecasts may be seeing diminishing returns even to the point that they jeopardise their businesses.

In the United States, food revenues are generally up, as travelers spend more time in airports. However, short-term parking and rental car revenues are down. Retail is up and down, depending on the sites. The number of passengers is obviously down compared to previous years. More to the point, traffic is substantially below forecasts made a few years ago. Traffic that is down by some amount compared to 2000 will be down far more on the numbers used to justify investments in concessions. For example, the traffic at Toronto International at the end of 2002 had dropped 10% from 2000 to fewer than 26 million passengers -- below the level of 1998. However, in the context of 4 to 5% annual growth, and the expectation of 33 million passengers by the end of 2002, the actual traffic at Toronto was 20% under reasonable earlier forecasts. The forecasts, on which airports managers and concessionaires based their expectations and business plans, were wrong.

Operations on the West Coast of the United States also illustrate this pain. DFS originally had a contract with San Francisco/International for a guaranteed rent of about \$26 million and a percentage of revenues. The contract seemed reasonable when the annual sales forecast was roughly \$100 million. It became problematic when the drop in Pacific Rim traffic halved actual sales. After difficult negotiations, San Francisco agreed to drop the minimum rent. Faced with a similar situation in Hawaii, DFS has been working with the state government to arrange more favorable leases. Meanwhile, smaller operators had neither the resources nor the leverage to escape the squeeze. Within a year of the opening of the International Building at San Francisco, a number of stores had folded. Such agony is not good for airports or airport concessionaires.

Two things have changed in the food and retail business at airports. Airports and their operators are much more aware of the volatility and its risks. They are also much more aware of competition. In the United States, the competition most obviously is with multi-airport systems operating under different managements such as San Francisco, Oakland and San Jose in the Bay Area, or between Baltimore, Washington/Dulles and Washington/Reagan around the capital. Within airports, multiple operations now compete with each other. In Europe, now that duty-free advantages have largely disappeared, the competition is with the 'high street', that is the retailers in the metropolitan area.

Are we facing just another recession like any other? Are our current economic woes simply a replay in a different key of the experience of the early 1990s? Maybe not. An argument can be made that there could be a major recalibration in the role of air transport in the global economy. Business travel may perhaps no longer subsidize the leisure travel on the traditional airlines. Leisure travel may increasingly shift to the Southwests and Ryanairs of the world, and the major

airlines may change drastically, as they already are doing in North America. We believe that a combination of long-term changes in the air travel industry have substantially increased the economic risks associated with airport businesses. The nature and location of the passenger traffic is now much more risky than ever before. This volatility is almost certainly likely to persist well beyond the current downturn. This reality requires that we rethink the contractual relationships between airports and their retailers.

Privatisation and deregulation are a root cause of volatility in the air travel business. These factors allow airline managers to take decisions quickly, in tune with the market. Freed from long governmental inquiries or administrative reviews, managers in the private sector can start up airlines and close them; try out new routes quickly -- and drop them if they are not profitable. Privatisation removes the dampening effect of sluggish bureaucratic procedures. It is like removing the shock absorbers on a car -- instead of cruising along protected from the bumps in the road; riders feel every bounce and hole. Simply put, Privatisation and Deregulation equals Volatility.

Deregulation associated with privatisation causes massive economic readjustments. It permits entrepreneurs to develop new services and industries. The hugely successful history of UPS and Fedex -- now by far the biggest airlines in terms of market capitalisation -- is a direct consequence of market liberalisation. Conversely, new services may destroy old ones. Southwest, Ryanair and other new airlines now pose a substantial challenge to weaker traditional airlines such as US Airways and United Airlines (both in bankruptcy as of 2002). In the airline business, it looks like we are now entering the period when big changes will happen.

What is different now? Why would big changes be happening now, and not earlier? Why is this recession different from the last? A crucial factor is that the cheap fare airlines are now substantial market powers and credible competitors in the eyes of the travelling public. A decade ago, Southwest was an interesting but marginal player; Ryanair was not a factor. In 2002, Southwest carried 64 million passengers. In those terms, it was the fourth largest airline in the world -- 50% ahead of Air France and 80% ahead of British Airways. Southwest and Ryanair are now the two strongest passenger airlines in the world in terms of market capitalisation, respectively 5 and 3 times ahead of British Air. A decade ago, the traditional network airlines such as United, American, Air France and Lufthansa had tremendous market power. They controlled airport gates, frequent flyer programs, and the distribution of tickets. Whereas in the 1990s the new airlines could only dream of displacing the traditional network carriers, now there is a real battle. It may last a long time. While it does, the situation will be fluid and volatile.

**Market Capitalisations for Major Traded Airlines**

(Market Cap = Share price x number of shares)

<b>Airline</b>	<b>Share Price US \$</b>	<b>Market Capitalisation US \$, billions</b>
UPS	59	66
Fedex	52	15.5
Southwest	13	10
Ryanair	39	5.9
British	19	2.1
Delta	9	1.2
Airborne Freight	15	0.7
Northwest	6	0.5
Alaska	19	0.5
American	3	0.4
Continental	6	0.4
KLM	7	0.4

Source: Yahoo finance, Feb.10, 2003

Uncertainty about which airlines will carry the traffic leads to uncertainty about which airports will get the traffic. Cheap fare airlines typically locate at secondary airports offering inexpensive operations. They prefer uncongested runways, simple passenger buildings, and airport managers happy to offer them bargain rates in exchange for the business. Ryanair is at Lubeck instead of Hamburg, for example. As they grow, cheap fare airlines take traffic away from the hubs of the traditional network airlines. Southwest, for example, expanded Boston/Providence airport from 1 to over 5 million passengers in about 4 years. Concurrently, the market share of New England traffic for the dominant Boston/Logan airport dropped to 59% -- from a high of 78% not too ago. Likewise, Westjet built traffic at Toronto/Hamilton up to nearly a million passengers a year in two years, much at the expense of Toronto/International. In Europe, Ryanair, Easyjet and other cheap fare airlines are similarly creating traffic at Frankfurt/Hahn, Rome/Ciampino, and other secondary airports. Moreover, as major network airlines such as TWA and Swissair disappear, their hub traffic goes to other airlines at competitive airports far away. Airports and their concessionaires cannot count on traffic remaining at their airports as carriers come and go.

Security issues overlay these fundamental drivers of risk and uncertainty in the airline business. They affect the travelers' disposition for shopping at the airport. Passengers may not be available; they may be spending their time in screening procedures and secure holdrooms as at Amsterdam. Passengers may not feel like shopping when they have to have their parcels inspected, especially when they must confess to not having packed the items themselves. We have witnessed a variety of behaviours since September 11, and will surely see more changes.

Traffic volatility is the reality we must learn to live with. The food and retail business at airports is risky. That is the starting point. The question then is: what can we do about it? How can we manage risk and maximize our chances of success? Many airport managements, particularly those operated by governmental agencies, have acted on the basis that they should pass on the risk to tenants. To the extent that they contracted with big operators, they could do this – at least in principle. But they cannot do this so well with the smaller, local operators who make up the newer, more interesting retail programs. Moreover, it is not necessarily advantageous for airports to shift risk to the retail operators. The well-known relationship between risk and reward implies that airport operators stand to make more money if they assume more risk – provided of course that they manage the risk well.

The way to manage risk is to build in flexibility. Managers have a range of ways to hedge their risks. Specifically, airports and their tenants should have options available. These may be calls, giving them the right to use more units if business is good. Or they may be puts, enabling them to void obligations if business is poor, and thus insuring them against economic catastrophe.

These options can be purely financial. Or they may be 'real' in that they are embedded in the infrastructure. Thus, an airport operator might build the possibility of a broadband intranet into a building, in advance of specific commercial requirements -- giving the airport the option to provide this service as and if desired. Such options have, over the last generation, become standard business tools in many industries. Sophisticated property developers, such as those for the Canary Wharf enterprise, use them regularly.

Using options to manage risk sounds exotic, but is common sense. It is our ordinary way to deal with uncertainty. As drivers for example, we may lease our car with an option to buy at the end of the lease, at a price fixed by the mileage and condition of the car. When we drive, we have insurance and may belong to an automobile club that will provide roadside service. We also have a spare tyre as a 'real' option that will enable us to recover when we have a puncture. All these arrangements are forms of puts on risk and calls on opportunities. These options do not guarantee that drivers will not have problems on the road, but they allow them to cope with these risks easily as they come along and thus maximise the overall expected returns. We would not want to drive without them.

Common sense, experience, and textbooks all tell us that developing flexibility in retail relationships is the right thing to do. In principle, it should be clear that lease arrangements should have various forms of options written into them. These agreements should align the incentives of the airport owners and the concessionaires so that they can mutually adjust to changing circumstances on a regular basis, without having to face bankruptcy or seeking legislative redress.

As a practical matter, many airports will find it hard to think in terms of options. The organizational culture at most airports goes against flexibility. As a rule, the middle-level managers responsible for commercial leases are neither used to nor rewarded for assuming risks. Moreover, they may be used to a public, political culture of simple, transparent rules for awarding contracts. Airport practice has favored best bids as seen by simple criteria. This culture will find it hard to understand and accept leases with many options with a range of outcomes.

Dealing flexibly with airport retailing in a volatile world will require significant organisational changes. Management will have to rethink how it goes about this business. It will have to stop relying on simple leases featuring guaranteed minimum rents and a percentage. It will have to develop a range of lease options, learn how to value and define them, and train its staff in their use. Dealing with a volatile world requires agile airport management.

This change in attitude and practice will be hard to implement. It requires sustained leadership from the top of the airport organization. It represents a major sea change, and mid-level staff will not be able to carry it out on their own. Moreover, in the public agencies that run airports in the United States, the legal system will resist this change. Public service lawyers are different from corporate lawyers. Generally speaking, they do not seek to innovate. They represent the law, which is difficult to change.

In a volatile world, all forecasts are 'wrong'. We cannot say for sure what will happen. Yet it does seem that the airport industry is faced with long-term volatile conditions such as it has not encountered before. Experience shows that those that adapt most readily to new conditions are those who will be most successful in the new environment. Thus, while the details are unclear, it seems likely that in our new volatile world, airport managers need to rethink their retail relationships aggressively. They need to learn how to incorporate and use flexibility in their lease arrangements.

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