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Flying through
Stormy Skies
*How Airlines Can
Navigate the Global
Recession*



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EXECUTIVE SUMMARY

The global airline industry was unprepared for the current recession. Regulation and local interests inhibited the consolidation necessary to achieve strategic scale. Record fuel costs decimated margins. And the financial condition of the industry as a whole had barely recovered from the downturn precipitated by the events of 9/11.

Staying aloft in the current conditions will require that all airlines aggressively pursue short-term cost programs and midterm profitability initiatives. But the market situation also creates a unique opportunity for airlines to reshape their industry through a newly formulated strategy of consolidation and alliances.

Such a strategy will enable network and low-cost carriers with a sound financial and cost basis to solidify and expand their positions in existing markets and emerge as winners when the economy recovers. Less stable and smaller players, which are now facing the critical question of how to secure sufficient financing to survive the credit crisis, can also benefit from taking a proactive role in shaping their futures.

CAUGHT OFF BALANCE BY A GLOBAL RECESSION

Airlines are confronting a dire outlook. In December 2008, the International Air Transport Association (IATA) forecast a 3 percent decline in worldwide traffic and \$2.5 billion in industry losses for this year. Given decreasing passenger numbers in the first quarter of 2009 and slowing GDP growth worldwide, this may prove to be a best-case scenario.

Few airlines are prepared for even this best case. Almost all carriers have been focused on short-term results in response to the last crisis. Thus, they are entering this recession with fundamental and capital-intensive legacy problems including over-aged fleets, the wrong mixes of leased versus owned equipment, and misaligned systems and processes that constrain operational and service performance.

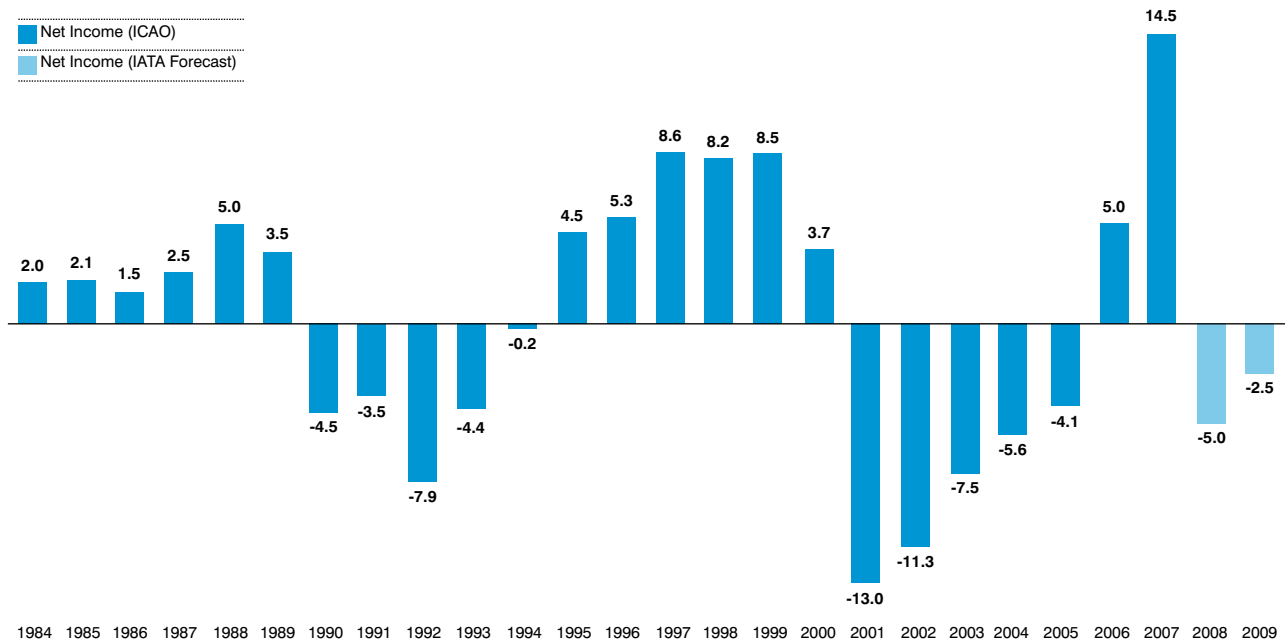
The airline industry has never been profitable over the entire business cycle. Instead, short periods of profit, fueled by market growth, are typically followed by periods of heavy losses, which, on an accumulated basis, drag the industry below breakeven. In the

past decade, the airline industry saw only three years of positive net profit while overall losses exceeded US\$25 billion (*see Exhibit 1*).

Although the airline industry returned to profitability in 2006 after the precipitous drop that followed 9/11, the blue skies were short-lived. In 2008, net income dropped back to 2004 levels, and the industry recorded a \$5 billion loss. Even the top performers experienced a drastic reduction in margins, mainly the result of the financial meltdown, record high fuel prices, the impact of a stronger dollar on the results of European carriers, and a sharp fall in Asian economic growth.

Exacerbating the current outlook is an additional set of medium-term challenges. Forecasts call for oil prices to rise to \$60 to \$70 per barrel again. Environmental taxation is on the rise. And persistent capacity bottlenecks at critical airports create delays, missed connections, and scheduling inefficiencies in aircraft rotations that result in rising operational spoilage costs.

Exhibit 1
Annual Net Income of the Global Airline Industry (in US\$ billions)



Source: International Civil Aviation Organization; IATA; Booz & Company

Highlights:

- Many of the world's airlines are in poor financial health and are ill-equipped to weather the global recession.
- Consolidation is the best industry response to recession, but the ability to consolidate is affected by the level of market regulation.
- Leading carriers can reshape their markets and emerge strengthened from the current crisis; weaker carriers must secure desperately needed financing if they are to survive.

THE INTERNAL CONDITION OF AIRLINES

The current economic environment and market conditions are reflected in the financial health of many airlines. In January 2009, Booz & Company analyzed key financial indicators of 37 large, publicly listed airlines, assigning each a financial health rating that reflects its ability to sustain its business in the short term. The health rating is derived from each airline's liquidity and capital leverage (*see Exhibit 2, page 4*). Our analysis revealed that more than 40 percent of airlines in the sample are in poor financial health.

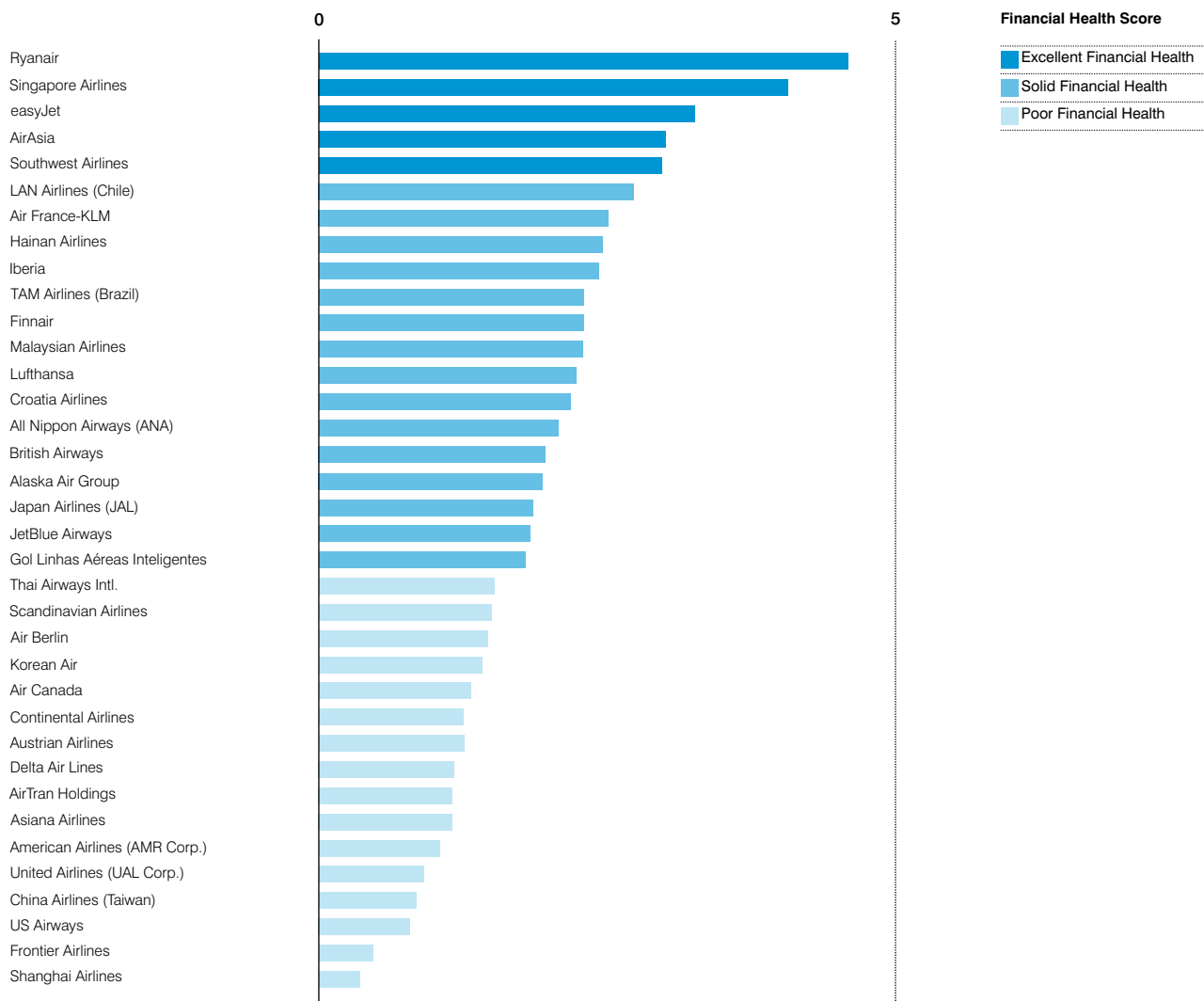
The airlines with the best financial health ratings (the top segment of Exhibit 2) are mainly low-cost carriers (LCCs). It is likely that these carriers will not need significant amounts of short-term cash to safeguard their businesses, because they typically focus on short-haul traffic and have the lowest operating costs in the industry. They also often represent the most economical travel choices for increasingly price-sensitive travelers.

Airlines in solid financial health, which include many of the world's largest flag carriers (the middle segment of Exhibit 2), do not have the same flexible cost structure as LCCs, but as long as their fundamental business remains fairly resilient, they, too, will have room to maneuver and actively shape their positions in their respective markets.

More than 40 percent of the airlines in the sample have poor financial health ratings (the bottom segment of Exhibit 2). To add perspective to this fact, the highest-ranked airline in the poor health sector, Thai Airways, had an operating-cash-flow-to-revenue ratio of 5.7 percent in the first three quarters of 2008, an EBIT margin of -2.3 percent, and a current ratio of 50 percent. And, in fact, the list of airlines in the poor sector is probably longer and in worse shape now given market conditions since the third quarter of 2008.

Although it is true that airlines are rarely star financial performers, our analysis confirmed that the current condition of airlines in this bottom segment places them in serious jeopardy. They have little room to maneuver; it is doubtful that even substantial efforts to improve their performance will be able to put them on solid footing in the current environment. For many of these airlines, government intervention or external financing may be the only alternatives to bankruptcy.

Exhibit 2
Analysis of Selected Airlines' Financial Health



Source: Bloomberg; financial statements; Booz & Company

THE USUAL RESPONSES WILL NOT SUFFICE

All airlines will have to critically revisit their cost structures in response to this recession; many are doing so already. They will have to slash costs in the short term to protect their liquidity and launch medium-term programs designed to protect what little profitability they have left. Unfortunately, for many, these programs will not solve their problems.

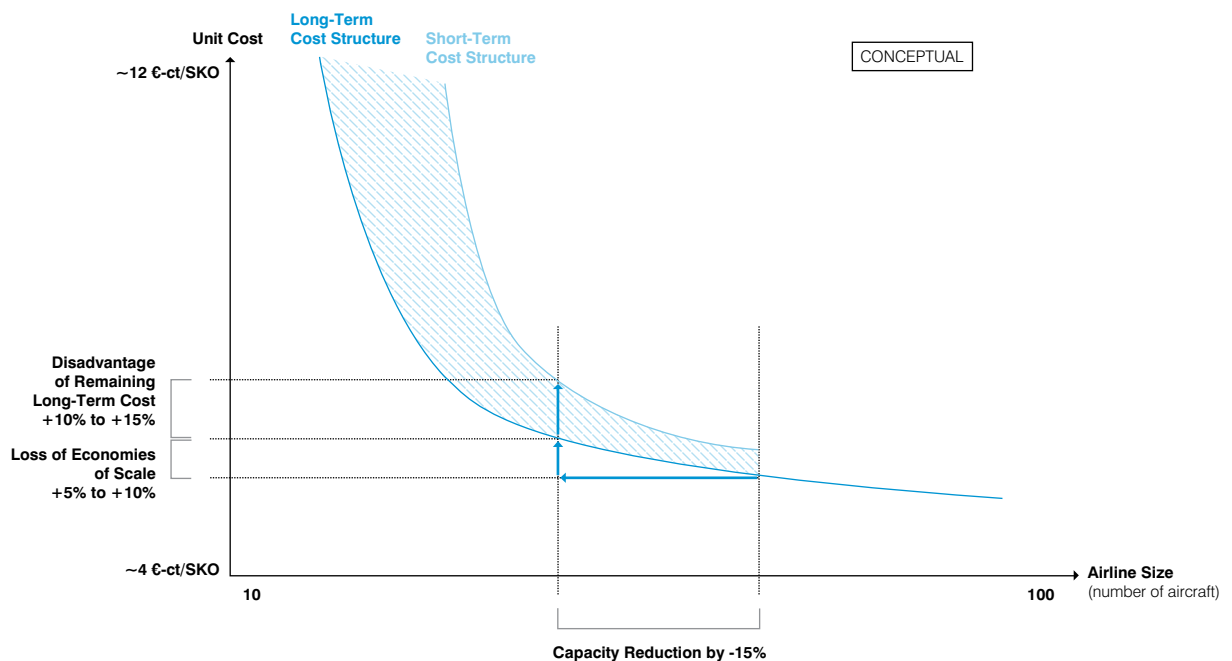
The fastest, most effective measure that airlines can take is to reduce unsold capacity by cutting the number of flights and, if necessary, grounding planes. This is because approximately 50 percent of an airline's costs are related to capacity production, including fuel and en route charges.

While all airlines are expected to reduce capacity, if their past behavior is any indication, they will underestimate the impact of this crisis and do so too slowly. Although the IATA forecasts that 2009 traffic demand in most regions will experience declines between 2 and 5 percent, airlines are not expected to reduce their capacity

by that much, which means the levels of surplus capacity will rise. The result in such situations is often a downward price spiral that further endangers the remaining yield and increases competitive pressures.

Even if airlines do make the necessary cuts in capacity in a timely manner, there are serious problems inherent in the process, especially for smaller carriers. When airlines reduce capacity, they lose the economies of scale associated with efficient scheduling of planes, crew rotations, etc. Additionally, their remaining fixed costs must be distributed across the lower production volume, further increasing their unit costs (see Exhibit 3). Furthermore, this effect is disproportional for small carriers, which are already at a structural disadvantage relative to large carriers.

Exhibit 3
Increase of Unit Cost through Capacity Reduction



Note: €-ct/SKO = euro cent per seat kilometer offered
Source: Booz & Company

THE CONSOLIDATION IMPERATIVE

In the face of these conditions, consolidation in the airline industry appears inevitable. The only alternative would be a return to the era of state-owned carriers and regulated markets, a highly unattractive prospect.

Consolidation can be achieved in two ways: Airlines can simply exit their unprofitable markets, or they can pursue mergers, acquisitions, and alliances to improve their market positions. In either case, the result is a healthier industry. Increased share allows the remaining competitors in each market to offer more efficient service and raise their margins, which, in turn, enables them to invest in new opportunities.

One of the main reasons that M&A works for the airline sector is the economies of scale and cost synergies it creates. When flights are consolidated, the merged airline gains market power and can apply its unused capacity to serve additional destinations. The added customers on consolidated routes also allow an airline to use planes that are larger

and thus more cost-efficient and to bundle more traffic from more destinations through large hubs, increasing utilization and yield. This is exactly what occurred in Europe's long-haul flight market, which today is essentially directed through three major airline gateways by British Airways, Lufthansa, and Air France.

History proves that consolidation can also provide airlines with a variety of functional synergies, as evidenced by the first wave of consolidation in the U.S. market in the 1980s and more recent European mergers, such as Air France-KLM and Lufthansa/Swiss. Lufthansa and Swiss were able to create substantial value in the short term by integrating their networks, as well as sales and marketing initiatives. Two years after the merger, the market capitalization of the combined airlines had risen 70 percent and they outperformed the industry benchmark index by 10 percent. Additionally, in the medium term, Lufthansa/Swiss has many significant opportunities for functional consolidation in areas such as aircraft maintenance, purchasing, and IT.

REGULATED SKIES IMPEDE CONSOLIDATION

While the promise of airline consolidation is bright, its full potential remains unrealized because of regulatory restrictions. The aviation industry has been moving toward open markets since the 1980s, but progress has been slow, especially outside the developed nations, even in the face of major carrier bankruptcies and fundamental shifts in industry structure and conditions. More than half of the world's 50 largest economies have not yet either privatized or released state ownership of their flag carriers.

There are legitimate reasons that so many governments are reluctant to relinquish this control: Air transport and the flow of passengers and goods are cornerstones of any country's economic development; aviation safety and security are key concerns; and so-called flag carriers literally carry a nation's flag, making them a tangible

symbol of a nation's reputation and strength. Nevertheless, in order to leverage the benefits of consolidation, there must be continued and expanded liberalization of air traffic.

Meanwhile, despite increasing efforts on behalf of the airlines, the industry remains heavily regulated and liberalization efforts proceed slowly (see "The Tedious Path to International Liberalization", page 9). And airlines must adjust their strategies to account for the differing rates of progress toward deregulation on national, regional, and global levels.

The global recession will promote a growing rift between more and less regulated nations. This rift will, in turn, affect the ability of airlines to consolidate and thus to secure their futures in both the short and long terms (*see Exhibit 4*).

Exhibit 4
Market Segmentation and Expected Industry Dynamics

	Flag Carriers	Private Carriers/LCCs	Potential Future Examples
Liberalized National Economies	Accelerated consolidation driven by major network carriers	Accelerated consolidation driven by major low-cost carriers	- United + Continental - Ryanair + Aer Lingus - Air China + China Southern
Deregulated Open Skies Cluster with Unrestricted Ownership			- Lufthansa + Austrian - British Airways + Iberia - Lufthansa + BMI
Transcontinental Markets	New global alliance models enforced by slowing deregulation		- Extension of transatlantic antitrust agreements, e.g., United + Lufthansa + Continental

Source: Booz & Company

Liberalized aviation markets and those nations whose Open Skies clusters do not limit traffic rights or excessively regulate ownership will likely see consolidation accelerate as airlines seek to improve profitability in the face of recession. Indeed, this process has already started in the U.S. and Europe: In the past year, there have been multiple merger attempts and an increasing number of successful transactions, such as the recent Lufthansa acquisitions of Brussels Airlines and Austrian Airlines (subject to regulatory approval) and the Delta-Northwest merger, which created the world's largest airline.

If there are exceptions to the consolidation trend in open markets, they will probably arise in deals that involve national interests, such as the potential bankruptcy or proposed acquisition of a former flag carrier. Government intervention in such cases is most likely in European countries

that have strong relationships with current or former flag carriers and in Asian nations with very fragmented markets.

In highly regulated aviation markets, the drive toward liberalization will likely slow as governments try to protect their airlines from the effects of recession. As a result, consolidation will be further delayed and airlines will be forced to pursue alliances to secure their futures.

For several reasons, this slowdown in deregulation is also likely to negatively affect the liberalization and consolidation of international and transcontinental markets.

- The recession could lead policy-makers to intensify their efforts to safeguard local employment and secure the short-term stability of their airlines. An extreme example can be found in Argentina, where,

in 2008, the government expropriated flag carrier Aerolineas Argentinas from a foreign owner, Spanish travel group Marsans.

- The benefits of transcontinental mergers are not as clear as those of regional and national mergers. For instance, economies of scale in airline mergers are typically derived from network overlaps, which are less likely to exist in international networks. Thus, at the end of 2008, when British Airways and Qantas considered consolidation, industry experts were unenthusiastic and the deal was tabled.
- Transnational mergers create complex issues regarding traffic rights. When an airline changes its country of ownership, it risks losing many of the traffic rights negotiated by its country of origin. This makes ownership transitions very tedious. For example, both Air France-KLM

The Tedious Path to International Liberalization

The path to an open global airline market requires that nations move through four progressive phases in the journey to deregulation. The pace and efficiency of this journey are heavily dependent on the willingness of governments and other interests to change—which, of course, varies widely (see *Exhibit A*).

The national liberalization of air travel first began in the U.S. with the passage of the Airline Deregulation Act in 1978 and has continued apace. The European nations joined together to form a single deregulated regional market. A number of Asian and Latin American nations have recently liberalized their markets, which has stimulated the adoption of new business models, especially low-cost airlines. However, in many nations, including China, Russia, and countries in the Middle East and Africa, air travel remains tightly regulated and controlled by the state.

and Lufthansa/Swiss had to initially create interim holding companies to avoid a change of carrier nationality until traffic rights had been renegotiated.

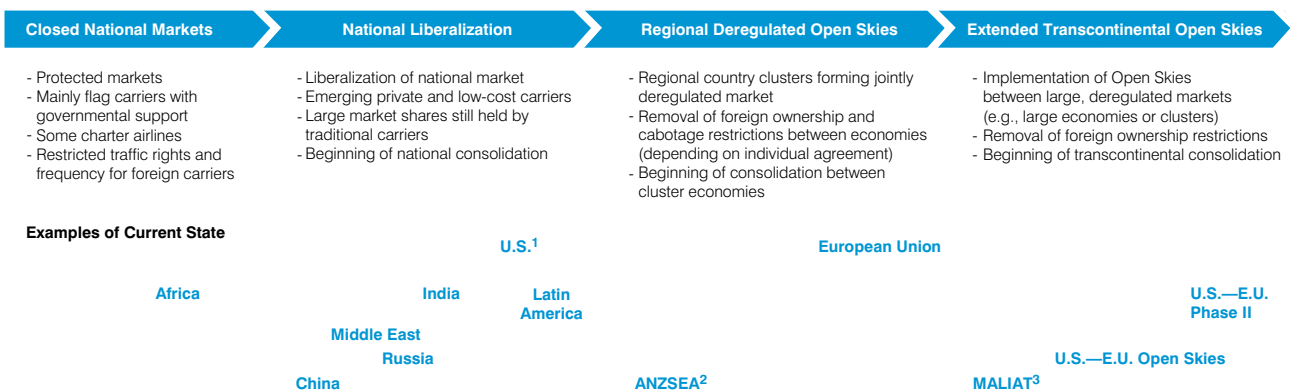
If, as we expect, the recession slows international liberalization, it will also inhibit transnational and, especially, transcontinental consolidation. In this case, and since the economic pressures will not change, airlines will have to expand the mandate of their global alliances, in which early forms of intensified cooperation have already been developed.

Historically, international air traffic has been regulated by restrictive bilateral traffic rights agreements (based on the 1944 Convention on International Civil Aviation, or Chicago Convention), which, among other things, specified allowed capacity, number of flights, and types of traffic. During the 1990s, two major developments shaped this structure of international traffic rights: First, Open Skies agreements, which granted unrestricted market access between two countries, were established. Next, they evolved into multilateral agreements, in which unilateral access rights were granted to all nations participating in an agreement.

The first Open Skies agreement was signed between the U.S. and the Netherlands in 1992 and granted the carriers of both countries unrestricted landing rights at each other's airports. In parallel, the European Union formed the Single European Air Transport Market, which progressed in three phases toward de facto Open Skies. Today, there are many Open Skies initiatives, the largest and most important being the U.S.—E.U. Open Skies agreement, which links E.U. member states and the United States.

Open Skies agreements are an important step toward international deregulation, but they are neither standardized nor all-encompassing. In their most basic form, they lift restrictions on basic traffic rights (e.g., the right to fly to and from a city or country). But they do not necessarily change regulations governing advanced traffic rights or foreign ownership. There is still much work to be done before airline markets are fully liberalized.

Exhibit A The Development Path and Current State of Global Airline Deregulation



¹U.S. with more than 92 bilateral agreements. ²ANZSEA: Australia, New Zealand, and Southeast Asia.

³MALIAT: Multilateral Agreement on the Liberalization of International Air Transportation.

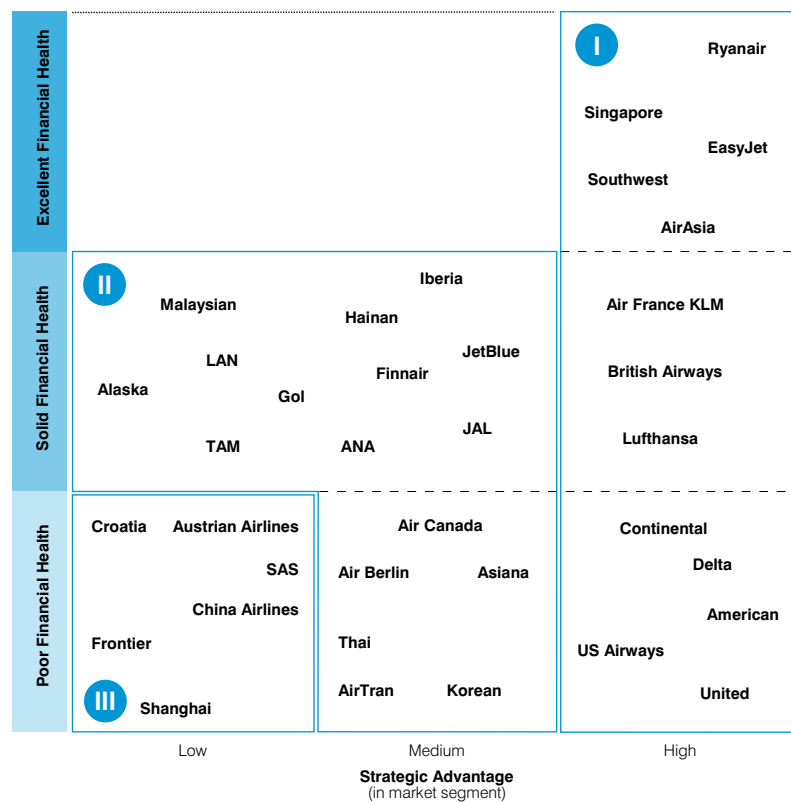
Source: Booz & Company

THE CHOICES FOR AIRLINES

The ability of airlines to respond to the current recession and secure their futures is highly dependent on their financial health and strategic advantage. Strategic advantage is determined by the regulatory basis of an airline's markets, as well as its market positioning, which encompasses its network,

size, and competitive rank. When we consider the alternatives for airlines in the current recession according to their financial health and strategic advantage, three major groups of carriers emerge (*see Exhibit 5*): market leaders that could dominate the upcoming recession cycle

*Exhibit 5
Industry Segmentation by Airlines' Strategic Positions*



Source: Booz & Company

(Segment I), carriers at a crossroads whose positions will be determined by their near-term actions (Segment II), and airlines that are in true jeopardy (Segment III).

Market Segment Leaders can Reshape the Industry:

No matter what their business model, market-leading airlines with a sound financial basis should be aggressively considering the opportunities for consolidation on a national level or within the Open Skies clusters that have emerged since the economic meltdown. Despite their financial dilemma, those North American carriers that are “too big to fail” should also pursue consolidation to improve their positioning.

These Segment I airlines have many attractive acquisition targets because weaker carriers’ valuations have decreased rapidly and at a disproportionate rate compared with healthier carriers due to the crisis in confidence among investors. Furthermore, majority shareholders of targeted and endangered airlines must also cope with the recession, which often translates into an increased willingness to sell off their holdings.

This is not to say that market leaders should buy indiscriminately: They must still select their targets strategically and integrate them quickly in order to maximize asset profitability. Major network carriers, for example, must seek targets that offer network

synergies, such as route consolidation and traffic bundling, to increase their economies of scale. All carriers, network and low-cost alike, should seek out acquisitions that provide access to new regional markets or customer segments. It is important to be aware of how synergies can be created. In regional markets, for example, the closer the connections in the core businesses of the acquired and the acquiring airlines, the greater the synergies that can be gained by actions such as the consolidation of bilateral routes. Operational economies of scale, such as fleets and maintenance, can also be leveraged.

Undoubtedly, the airlines with excellent or solid financial health and high

“Market leaders should not buy indiscriminately.”

levels of strategic advantages (the upper two portions of Segment I in Exhibit 5) will be the true winners in the next stage of the airline industry's development as they reshape the industry to their advantage. In Europe, it is likely that the three large airlines—Air France-KLM, British Airways, and Lufthansa—will continue to build on their previous successes. After the announcements of the Lufthansa-Austrian deal and Air France-KLM's minority interest in Alitalia, there are only a few airlines that are not affiliated with one of these three regional champions. Europe also has two very strong low-cost carriers, easyJet and Ryanair, which are also in a position of strength to drive consolidation within their markets.

Even though the largest airlines are based in the U.S., many of them have not reached sustainable profit levels since the crisis in 2001. These carriers are in poor financial health but enjoy

high strategic advantage (the lowest portion of Segment I in Exhibit 5). Further, the U.S. government may see them as too big to fail because of the impact their failure could have on the industry both nationally and globally. These airlines should search for consolidation options in their markets, such as the Delta-Northwest deal or Continental's switch to join the Star Alliance following merger talks with United (which are currently postponed), in order to build on their economies of scale.

Airlines Entering the Recession at a Crossroads:

The outlook for the airlines in the middle ground (Segment II in Exhibit 5) is mixed. Depending on their financial health and level of strategic advantage, some of these airlines could survive the recession on their own. Others, however—especially those in weaker financial positions in deregulated markets—could descend

into the ranks of troubled airlines, where bankruptcy is a very real possibility.

The airlines in Segment II do not have the power and position to drive large-scale international consolidation, but they can consolidate and help shape their markets on a national scale. In Asia, for instance, the lack of liberalized Open Skies clusters will probably prevent large-scale consolidation. But it is likely that national consolidation will continue, as in India with the Kingfisher Airlines and Air Deccan deal and in China with the rumored merger of Air China and China Southern Airlines. The high degree of overlap in airline networks and slowing growth in the Middle East make that region's carriers solid Segment II players. However, the regional consolidation among flag carriers—for example, the rumored merger of Emirates and Etihad Airways—will most likely be government-driven,

International Markets Require Alliances

In international and transcontinental markets, which have not yet been deregulated, market-leading airlines will have to pursue new models of cooperation instead of outright consolidation.

Flag carriers addressed the need for international cooperation in the mid-1990s with the creation of global airline alliances. Today, the three leading alliances—Star Alliance, SkyTeam, and oneworld—cover approximately 70 percent of the world's passengers. Lufthansa and United Airlines took their cooperation under the Star Alliance model one step further in 2003: After being granted antitrust immunity, they created Atlantic Plus, a revenue joint venture that encompassed their combined transatlantic routes. Currently, the major carriers of all three global alliances are trying to create or expand similar joint ventures for the transatlantic traffic within their alliances (see *Exhibit B*).

These enhanced forms of transatlantic cooperation enable participating carriers to align their networks, sales, and revenue management systems to maximize performance (although each is left to manage its own costs). If the regulatory issues can be resolved, these models might also provide a blueprint for alliance cooperation in other regions, which may well result in tomorrow's Eurasian transpacific joint ventures.

and due to regulatory barriers, private and low-cost carriers will have to find alternative structures for deals, such as the creation of joint holding companies.

The private carriers in Segment II should also consider responding to flag carriers' alliances by pursuing transcontinental cooperation pacts, such as the alliances between JetBlue Airways and Aer Lingus and between Hainan Airlines and Air Berlin. One notable aspect of these two pacts is that these airlines are attempting to avoid the process and IT integrations that are major cost factors in joining an alliance. If they succeed in obtaining a large share of alliance benefits with significantly lower integration cost, we will likely see more cooperative partnerships.

Exhibit B Current Status of Transatlantic Joint Ventures

Alliance	Airlines in Existing Joint Venture	Planned Additions	Status
oneworld		American Airlines, British Airways, Iberia	Expecting approval in first half of 2009; two prior attempts denied by regulators
SkyTeam	Air France, Delta	KLM, Northwest	Currently applying for approval
Star Alliance	Lufthansa, United	Air Canada, Continental	Proposed mid-2008; application outstanding

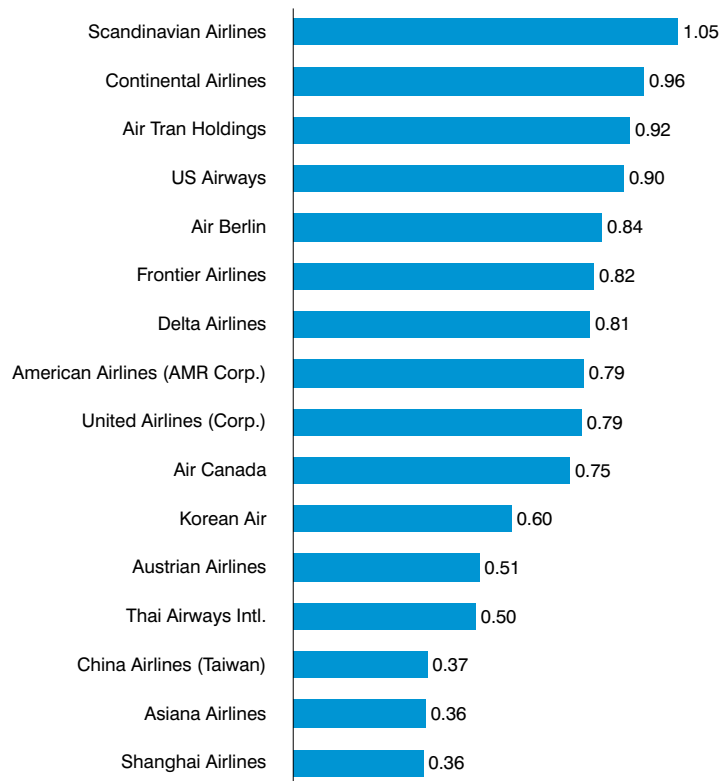
Source: Booz & Company

The Limited Options for Less Healthy Airlines:

Airlines in poor financial health with low levels of strategic advantage (Segment III in Exhibit 5) must face the realities of their condition in light of the global recession in a fast and forthright manner.

A closer look at the current ratios of the airlines in poor financial health that we studied reveals that for most of them, current liabilities outweigh current assets (see Exhibit 6). This suggests that short- and medium-term improvement programs will not be enough to generate the financial strength many of these airlines will need to survive the current recession. Additionally, the heavy dependence of many of the smaller carriers in this segment on leased aircraft (there are more than 6,300 leased commercial jetliners worldwide) is likely to further strain their financial stability. Leasing companies are facing increased financing costs, and as they negotiate extended and new leases, airlines will find that the cost of leased aircraft has increased substantially. All of this adds to the need for external financing if many Segment III airlines are to avoid bankruptcy.

Exhibit 6
Current Ratio of Airlines with Poor Financial Health Rating



Note: 2008 data, Q1–Q3 where available or as of last available statement.
Source: Bloomberg; financial statements; Booz & Company

These airlines must honestly confront the possibility of bankruptcy, make every effort to identify and utilize all available operational improvement levers, and carefully consider their strategic alternatives. Some airlines, the “lucky” ones in highly regulated markets or those that are too big to fail, may be able to depend on government support. The rest will have to consider how to secure fresh financing at a time when private capital is very scarce. Segment III airlines will have four main alternatives, which can be combined to match their unique situations:

- Merge or engage in a strong commercial partnership with a leading airline in their geographic region.
- Merge with a financially sound airline of comparable size to gain market relevance and economies of scale.

- Secure private financing by selling a stake to financial investors.
- Consider whether discrete parts (maintenance, ground handling) are viable for a spin-off or joint venture.

Although none of these alternatives is very appetizing, struggling airlines must realize that time is short. The number of leading players interested in acquisitions is on the rise, but potential buyers and possible transactions are limited. Those airlines that do not move to secure their futures quickly may be left out in the cold.

“Struggling airlines must realize that time is short.”

THE TURBULENCE AHEAD

It is likely that 2009 will mark a major turning point in the global airline industry. In the face of a major recession, the financial strength of the leading airlines and the weakness of the rest will stimulate consolidation within the liberalized space and formation of alliances in the international arena. At the same time, regulated markets may become more exclusionary and protectionist, eliminating potential growth opportunities.

All carriers will have to respond to the recession with yet another round of operational cost-cutting and profitability programs, but the financially sound market leaders will also have a unique opportunity to reshape their market segments and consolidate their positions. Meanwhile, many less sound carriers will face the danger of bankruptcy, and should act quickly to secure their futures.

“Industry consolidation is the correct response to recession.”

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