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HOW AIRLINES CAN WIN IN THEIR POST-PANDEMIC RECOVERY

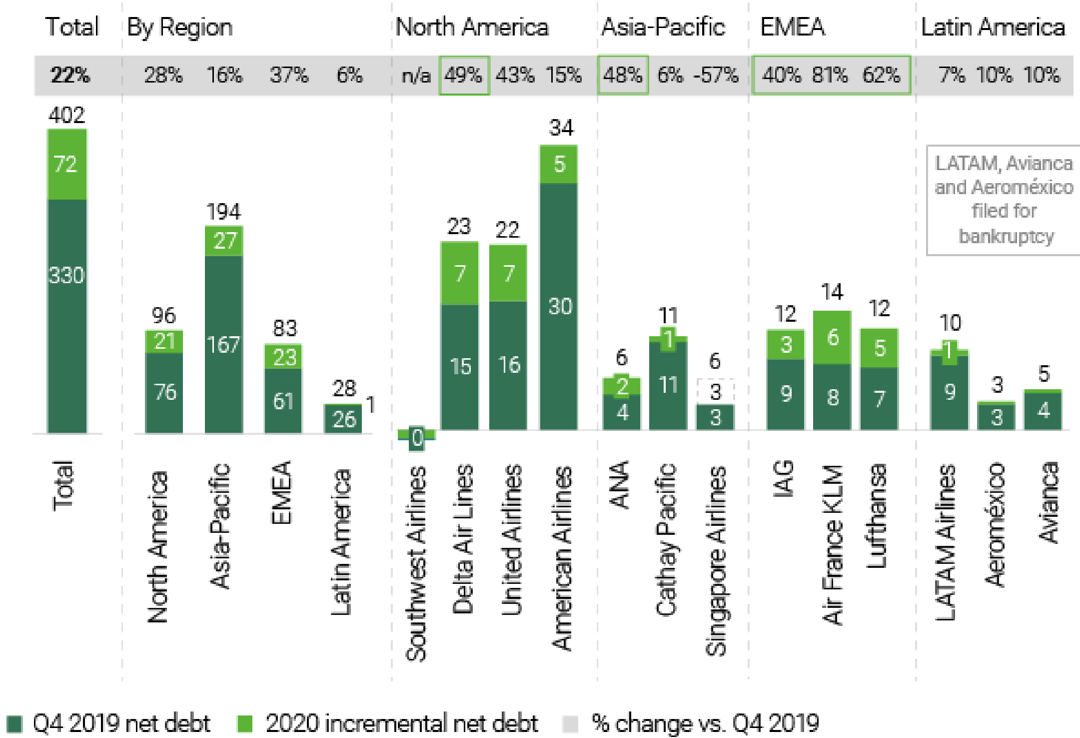
The AlixPartners A&D Minute

As the rollout of COVID-19 vaccines continue, there is optimism that the airline industry has left last year's turbulence behind. But unanswered questions remain. For carriers in the northern hemisphere, the summer travel season should offer some indication of challenges that lie ahead. While leisure travel, especially in the U.S., may return quickly, it still seems unlikely that the international business segment will come back to pre-pandemic levels anytime soon. Full-service carriers (FSCs) that get most of their profits from premium business travel must rethink their long-haul offerings, potentially expand premium economy, and fully leverage the cargo window of opportunity while competing on short-/medium-haul with low-cost carriers (LCCs).

Last year, airlines worked hard to ensure they had sufficient liquidity to see them through the crisis. Through a combination of government support, financing from debt and equity markets, sale-and-leaseback transactions, deferrals of aircraft deliveries and capital expenditures, and aggressive cost-out plans, many airlines have made it through.

But this has come at a price. Airline leverage has increased significantly over the last year, resulting in more cash being used to service debt rather than being available to invest in fleets, systems, and people -- all of which are ultimately needed to help meet investor expectations of continued growth. Net debt for a sample of leading global airlines has increased by 22% (Figure 1), with much of this debt being guaranteed by various governments.

FIGURE 1: NET DEBT HELD BY AIRLINES AS OF Q4 2020



Note: $ billion; Net debt = total debt – cash. Analysis includes only airlines with public financials - approximately 80 airlines total; EMEA doesn't include Emirates, Qatar, Etihad, FlyDubai; Singapore Airlines net debt decreased from $6 billion to $3 billion following share issues
Source: Capital IQ, AlixPartners analysis

The situation will get worse in 2021, with estimates suggesting up to $95 billion of total additional cash expenditures, which will add to the debt load. Any strategic or financial plan developed before the pandemic is clearly no longer relevant. Management teams must now undertake the hard task of reevaluating their business models as well as fleet and financing strategies. How can they set themselves up for success? Here are some practical steps:

Invest in data-led, flexible forecasting: Creating budgets and forecasts during the pandemic has been a moving target, with airlines sometimes having to rewrite plans on a weekly basis. But the big lesson has been that building a flexible and robust business planning model that is integrated with operations enables management teams to steer through the fog of uncertainty.

Demand forecasting has historically relied on macroeconomic factors and GDP as well as historical booking curves and quality of service index models. These historical relationships disappeared in the pandemic, and whether they will return is uncertain. However, when demand forecasting is supplemented with real-time data (e.g. bookings, web searches, local travel restrictions), accuracy improves significantly and may also enable decisions around pricing and revenue management.

Review capital structure and alternative options: Because airline leverage levels have increased significantly, there is pressure on management teams to repay debt as soon as possible. Leadership must determine what the future balance sheet should look like and create an actionable plan to deliver on this. Key considerations include appetite of existing lenders to extend debt maturities, impact on credit ratings and other financial metrics, and the airline's fleet ownership policy.

Airlines should also revisit their operating model, identifying non-core operations (e.g., MRO, catering, training) or subsidiaries and divesting them to generate much-needed cash while flexing their cost structure.

Airlines can also turn to local restructuring tools, such as the UK's new Restructuring Plan or Chapter 11 in the U.S., to reduce financial liabilities. While restructuring tools may not be suitable for every organization, they offer breathing space to undertake financial and operational reorganizations.

Keep focus on cost: Every airline has had to reduce its cost base during the pandemic. The key question is whether this would be a one-off act driven by volume, or a sustainable, structural reduction. As demand recovers, the temptation will be to grow and add back costs rather than continue the painstaking work of taking costs out. For the foreseeable future, most airlines will be competing for low-yield leisure travel. As a result, LCCs with healthier balance sheets than FCSs will compete aggressively to increase their market share. FSCs face the additional challenge of keeping service and product levels high for when premium business traffic does return. A good compromise would be for all carriers to aggressively focus on costs that do not directly impact the passenger experience, such as maintenance, indirect spend, and marketing costs.

Creatively reset fleet strategy: Many airlines have reduced unit costs by steadily upgauging their fleets, especially in domestic markets. But this strategy has its limits. In an uncertain demand environment, making the right trade-off between total trip cost and per seat cost will be critical. Fleet flexibility, both on mix of aircraft types and number, and real-time scheduling have never been more important.

The aircraft market will be a buyer's or lessee's market. Excess supply of aircraft will continue to force lessors to offer "power by the hour" and other deals. OEMs will likely revert to aggressive discounting to keep production lines moving, while lessors with older aircraft will have to be enterprising in the secondary market as jet fuel prices keep rising. In short, for both OEMs and lessors, the market will be intensely competitive. Airlines must look to minimize the total cost of ownership and consider maintenance and operating costs, not just purchase or lease costs.

Create a smarter network strategy: As demand fell in 2020, airlines closed major stations and pruned their network of destinations. Meanwhile others used available gate and slot capacity to enter new markets, such as United Airlines restarting service from New York's JFK Airport and Southwest moving into Chicago's O'Hare. Hub and spoke carriers also grew their non-hub flying to serve leisure demand during the pandemic.

As airlines enter a phase of network regrowth, a major challenge will be to balance adding service to leisure destinations and rebuilding large global connecting networks. Connectivity and convenience are much less important to leisure travelers, who prioritize cost. But FSCs must offer convenient schedules to attract the highly prized business travelers.

While network decisions are typically driven by passenger demand and cargo is a secondary consideration, airlines must rethink this strategy as flying cargo-only flights has proven a critical source of revenue.

Match service offerings to consumer demand: It is possible to stay cost-competitive while competing on product and service. Airlines must understand what their consumer values and will pay for and then rigorously strip out any product or service complexity that is not valued. Deeper integration with vendors can also deliver greater innovation and better service at lower costs. This is a great time to rethink your brand, product offerings, and service levels.

There is, of course, crossover and interdependencies between all these areas. The path to recovery is multifaceted. But despite these complexities, now is the time to be proactive and boldly address these issues as part of a holistic transformation.

FOR A DEEPER DISCUSSION ABOUT THE CHALLENGES AND SOLUTIONS ASSOCIATED WITH THIS TOPIC, CONTACT:

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These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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