

## 2010 perspective for the global airline industry

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While many in the global airline industry are rightfully concerned about the current recession, as well as the uncertainty surrounding how the industry becomes (appears to be) 'greener', there are some more fundamental issues that will severely test the business models of the industry.

**HOWEVER, BEFORE THE** issues confronting the industry, let's first recognise that even in an industry that perpetually destroys economic value, some carriers have been able to execute strategies that have consistently (i.e. over the 10 years to 2007) delivered positive economic returns. If you include the two integrated freight companies (UPS and Fedex), the list is a healthy 19 airlines and includes the likes of Lufthansa, Singapore Airlines, Ryanair, Cathay Pacific, Southwest, Iberia, Aeroflot, Thai and Virgin Blue. And some of the numbers are impressive - Lufthansa over this period generated an economic profit (i.e. profit after applying a capital charge against its invested capital) of over US\$200 million per annum. Also interesting to note is that no one business model was the panacea - it is not just low-cost carriers that can earn economic returns. As always, one needs to remember the age-old caveat that past performance is not necessarily a guarantee of future success. But averaging out over the difficulties of the Asian economic crisis, 9/11 and SARS, a number of carriers have been able to generate adequate returns.

There are however some serious structural issues facing the industry, namely:

1. Past experience has shown that during a recession there are permanent changes in people's travel patterns that ensure the industry never returns (or takes an inordinate amount of time to return) to its pre-recession state. This current recession is no different and some may say it is a lot worse in terms of the permanency of these changes. While the threat of video conferencing has always lurked around the industry, few have been seriously concerned by its effects. L.E.K. recently undertook a survey of over 1,500 corporate travellers in the US and the overwhelming response was that within three years, over 20 per cent of their current travel would be substituted by video conferencing. Anecdotally we have heard that traditional big corporate spenders on international premium travel are using the current recession and video conferencing to mandate upwards of 50 per cent reductions in travel. And the competition is well funded - Cisco has all to gain and nothing to lose by this, so is aggressively pushing this trend through such things as public 'telepresence' centres that allow people to take advantage of the technology without the upfront investment. But even with the upfront investment, many companies claim a payback period as low as 12 months.
2. There is massive inequality in how the value chain of the industry is 'shared' between the participants. And yes, while airlines will gripe about airport charges and cost of aircraft, the dirty little secret is that the real

problem is with governments. While they freely impose costs and burdens onto the industry they take a disproportion of the value created by the industry. L.E.K. estimates that based on the economic activity that is widely recognised (and documented) as being created by the global airline industry, governments' direct tax revenue on this economic activity is over \$500 billion per year. This amount dwarfs the average annual negative economic profit generated by the global industry of approximately \$8 billion.

3. The industry is becoming far more segmented in terms of its customer base and most airlines struggle commercially and operationally to cater to a much more segmented customer base (and just having a low-cost carrier in the stable is insufficient).
4. Social networks are the new distribution channel and few airlines have embraced what this really means. For those who 'get it', it will give them a sustainable competitive advantage - for those who don't, their established distribution channels will become increasingly irrelevant (and as they lose scale, more expensive).
5. Onboard connectivity is becoming table stakes to play in the game and can provide the airlines with a significant financial resource but few have yet to realise how to monetise the opportunity (think captivity).
6. And finally the whole area of ancillary revenue will separate the winners from the losers in years to come. Those who embrace it now and tap into the \$50 billion annual global opportunity will have the financial resources to re-invest in the business and to gain significant market share over those that are too timid to execute a well-thought-out ancillary revenue strategy. So nothing changes. An industry that faces constant challenges, and where there is a very real need to re-invent yourself every few years, when many stakeholders (e.g. government and employee groups) are stuck in the past.

