CAPA's Global Airline Outlook for the 2020s. Revolution!

Analysis *3-Jan-2020 1:08 PM*

If the first two decades of the 21st century were transformational for the aviation industry, the 2020s will be revolutionary.

There are some givens for the coming decade: Asia will come to dominate the global airline industry, oil and other external costs will make cost management challenging (although oil prices appear to have been tamed for now), a lack of skilled resources will continue to hamper the growth of the industry, and, with a few standout exceptions, airlines will continue to fail to make a significant return on invested capital.

At some stage during the first half of the decade there will also be an economic downturn, possibly very substantial. On historical trends it is already well overdue, and with unprecedentedly low interest rates and astonishingly massive levels of private and public debt, there is little to predict just how great the scope will be.

If there ever were uncharted waters in the economic sphere, that is where we are now.

But the likely resulting combination of an airline and supplier debt shock, together with a slump in consumer demand, will almost undoubtedly trigger a more significant move towards industry consolidation (by combination and market exit) than has ever been seen.

This outlook report will deal with what we see as the four key issues that will underwrite the most marked industry transformation.

Two of them will occur gradually, more or less under the surface; the other two could well shake the foundations of the industry within the next five years.

The foundation shakers

If the industry had been a horse race, the two most important issues would have been the dark horses, only now making their appearance in the finishing straight.

These are:

- The impact of environmental pressures; and
- Disruption of the airline distribution systems.

Two other transformational issues we anticipate are:

- Progressive network transformation as long haul narrowbody aircraft are introduced, engaging smaller city pairs and stimulating widespread new route networks; and
- The accidental erosion of controls on foreign ownership of airlines as close airline partnerships grow, accompanied by equity acquisitions.

1. The environment and aviation: “Flight Shaming”, government taxes and more

Despite the relatively small environmental footprint of the airline industry, its sheer visibility and attractiveness for demonstrators against commercial carbon emissions makes it an extremely attractive and vulnerable target.

Depending on the context, airlines emit approximately 2% of global carbon emissions. That is half the level of emissions by maritime shipping and a fifth of the proportion generated by the fashion industry.

Yet aviation is still perceived as a somewhat exotic luxury and is growing at a much more rapid rate than most of the other significant emitters of noxious gases. That said, aviation and travel give rise directly to one in every five new jobs created.

The anti-flying movement has gained greater momentum in the past year. This comes almost as a surprise, but it should not have. This is a story that has been brewing for years.

In particular, flight shaming, the practice of “shaming” individuals into not flying, will become more important in Europe. A young Swedish girl has captured the imagination of much of the public and given a major boost to the environmental movement. It is a grass roots, individual-responsibility call to action, which makes it potentially far more pervasive than typically slowly developed regulatory and legislative initiatives.

It has already seemingly had an impact on air travel in Sweden, as passenger numbers and airline capacity have declined in 2019 – at the same time as numbers in most other European countries continued to grow.

As a result of this pressure, in Europe several things are likely to occur in the near future:

European governments will impose emission taxes on airlines, designed to raise costs and prices, with a view of discouraging travel; and

Short haul flights - where the pressure not to fly is most powerful - will increasingly be substituted by surface travel, trains and buses (even though it may often be questionable whether in fact the unit emissions per passenger km are lower). These options are often readily available in Europe, at reasonable frequency and prices.

Inevitably this would have a higher proportional impact on low fares and low fare operations. To the extent that this blunt instrument is intended to reduce the attractiveness of flying, it would be effective, instead reverting to the days where it really was elitist to travel.

Generally, however, it frequently should make sense to change behaviour in this way.

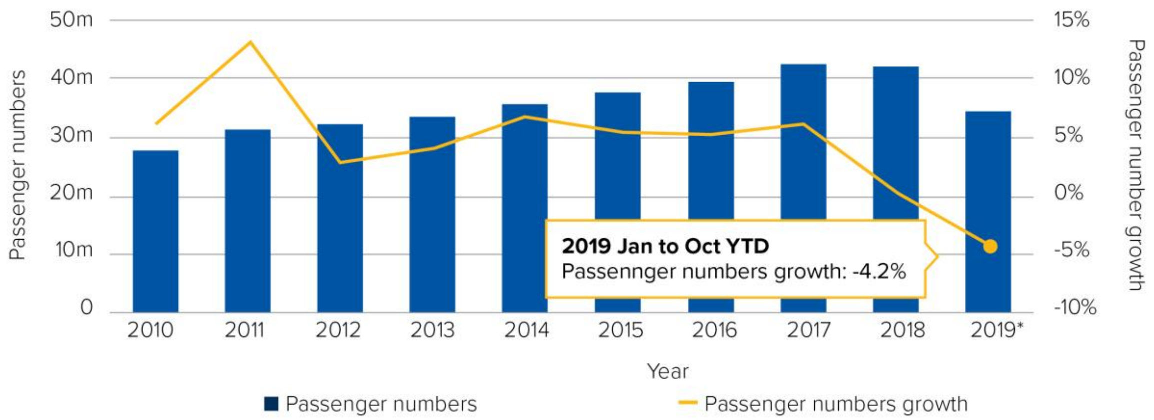
The change would be even more effective if governments were to apply 100% of any such revenues raised to reducing aviation emissions, but history suggests that to be unlikely, and they would simply disappear into consolidated revenues.

Another major reduction in European airline emissions would be very simply achieved if governments across Europe were to agree to introduce a single air traffic control system.

Instead, the fragmented national-based systems cause massive delays and circuitous routings that unnecessarily cost millions of tonnes of emissions annually. Instead, a combination of national financial greed and union resistance prevents this. The mandated inefficiency applies to short and long haul services alike, passing through European airspace.

SWEDAVIA ANNUAL TRAFFIC PASSENGER NUMBERS*

SOURCE: CAPA - CENTRE FOR AVIATION AND SWEDAVIA



*Note: *Jan to Oct YTD. Swedavia traffic year ends in December. Traffic data is for Sweden airports*
While there are other issues at play, Sweden's international air traffic is well down in 2019 – probably thanks to flight shaming

The battle has escalated extraordinarily rapidly in Europe – and airlines are fragmented

Attempts at a global consensus are – understandably – lagging. IATA, previously a proud leader in developing an industry standard of halving emissions by 2050 (more or less in line with the Paris Agreement goals), has quickly been overtaken by events.

Over the European summer, the usually quiet news period fuelled Swede Greta Thunberg's momentous sailing trip across the North Atlantic – instead of flying – for a UN Climate Summit in New York. There will be few, in Europe at least, who have not seen or heard her say "how dare you!" to the complacent political notables.

European airlines then rapidly bid up the stakes. Recognising the potential power of this fast-spreading movement, individual airlines, who see their businesses threatened, have moved fast to take the high ground. Understandably, in each case, the airline sought to maximise its own virtues and, as a result the public is receiving very mixed messages.

KLM, in its usual measured and rational way, supported many of the more sensible tenets around reducing short haul travel. In Jul-2019 CEO Peter Elbers suggested passengers ask themselves, "Could you take the train instead?", talking of the "shared responsibility" for everyone to "fly more responsibly…(and to) create a sustainable future for aviation". KLM's Schiphol hub is congested, but it has the benefit of a seamless in-airport rail connection, and transferring short haul point-to-point and connecting travellers makes good sense all round, including for KLM.

The divided messages from the airline industry

At opposing poles are LCC Ryanair and full service airline Lufthansa, raising issues that will reverberate around the world.

Europe's biggest airline, Ryanair stresses that its carbon emissions per passenger km are lower than any others, a result of high seating density and a (relatively) new, efficient single aircraft fleet. In Oct-2019 it announced its pax/km emissions of CO2 were 67 grams, "half the rate of other flag carrier European airlines" (more recently, easyJet announced a level of 77 grams for its services).

In steep contrast, Lufthansa has argued strongly in the German market that it dominates that LCCs are bad for the environment because they stimulate more travel.

To illustrate the point, at CAPA's recent long haul low cost event in Oct-2019 in Hamburg, Lufthansa Executive Board Member Harry Hohmeister likened it to the difference between selling shirts for one dollar, compared with selling a more sustainable, higher quality, one for ten dollars.

Later, in Nov-2019, Wizz Air, another very large European LCC, called for "a total ban on business class travel for any flight of under five hours".

The industry chasm in public messaging is obvious, as is the self-interest – but also the common ingredient of the financial importance in getting the message right.

Most recently, in late-Nov-2019, easyJet trumped the market by announcing that it would, with immediate effect, go carbon neutral: "We're the first major airline to offset the carbon emissions from the fuel used for every single flight". (Sweden's regional airline, Braathens, was the first to do this). The measure will reportedly cost easyJet GBP25 million in the first year of operation. Its move is unlikely to remain unique for long.

A populist UK government may grasp the initiative: ban FFPs too!

At government level a set of recommendations has now been presented to the UK's Committee on Climate Change (the CCC), which is an independent, statutory body established under the Climate Change Act 2008 to look across the board.

In mid-2019 the CCC commissioned a report from London's Imperial College. The resulting academic report recommends the government should "Introduce an Air Miles Levy which escalates as a function of air miles travelled by the individual traveller" (and "factors in larger emissions for First Class tickets"), adding, "This would send strong price signals against 15% of the UK population responsible for 70% of flights… It would also encourage shifting from long haul to short haul leisure destinations…".

More threateningly, in many ways, as airlines across the board rapidly improve their revenue streams through leveraging Frequent Flyer Programmes, the report recommends “Introduc(ing) a ban on air miles and frequent flyer programmes that incentivise excessive flying”.

Although it is an academic report and a long way from becoming legislation, it was commissioned by a key government authority. Perhaps more importantly, it has been seized upon by the media and by climate activists.

Whatever happens in the Dec-2019 UK General Election, the outcome is likely to produce some form of populist government, which would probably be eager to take up recommendations that make it appear to be taking the lead on such a crucial and popular issue. As a result, the recommendations need to be treated with more care than would usually attend an academic report.

Where to next for airlines? Offsets and an Efficiency Register and more

In early Nov-2019 Australia’s Qantas was the world’s first airline to commit to “zero emissions by 2050”, using a combination of carbon offsets and technological advances, but within a matter of mere days the pace of developments swiftly escalated to easyJet’s “immediate zero” proposition.

With easyJet’s subsequent lead, many airlines, at least in Europe, will now find it difficult to avoid a similar proposition in the short term. That is of course recognised as a short term fix, as offsetting is not the same as reducing emissions (easyJet itself recognises it is “only an interim measure”).

Nonetheless it would be a major step up from the decidedly half-hearted efforts that most airlines have previously adopted – as witnessed by the mediocre uptake by passengers of website offsets. Yet it still begs the question of how the offsets are used, usually for planting trees (an irony that is lost on Brazil’s President Bolsonaro).

Most travellers remain suspicious of doubtful and poorly described uses of any contributions they might make, so it will be important to establish absolute clarity if the actions are to address climate concerns in a serious way. Ideally, industry standards would be established to provide complete transparency, accompanied by alternatives that are attractive and understandable to travellers.

Another likely step, again led by individual airlines, will be to establish a register of emission levels, as Ryanair and easyJet have done. Full service airlines will inevitably be much less attracted to publishing comparisons.

Third parties will also increasingly play a role, now that the fire has been lit. Metasearch Skyscanner, for example, has already experimented with highlighting “greener choices”, for example saying, beside a fare quote, “This flight emits 8% less CO_2 than the average for your search”.

Then there are the dangerous unknowns: investors, corporate buyers and…..

There will be more subtle, but even more irresistible pressures to face too.

Large investors, whose strategies are exposed to publicly visible guidelines, can easily withhold funds or reallocate them to more environmentally friendly (and perhaps more profitable) companies.

Where they often tend to have sector strategies that involve placing a certain percentage of their portfolio in the transport industry, this broader investment could be culled. Such a heavy-handed, blunt instrument approach to shareholdings can quickly ricochet across the market. So airlines – and airports – are going to have to be visibly greener than green if they are to avoid this form of investor risk.

As if that weren't enough to occupy the aviation business, there's yet another layer.

Similar environmental criteria will be applied to corporate travel buyers in companies that are anxious to display their own green credentials. Already some companies have adopted policies that restrict same-day travel, replacing it with audio-visual alternatives.

Almost inevitably, corporates will, after casting a careful eye over their own travel budgets, need to reduce expenditure – and even probably include it as part of their green audit. Travel Management Companies too will be asked to provide low emission options and to monitor activity.

This impact can only go in one direction, to dampen travel expenditure – or to be more accurate, to slow the inevitable growth.

But for the forward thinking airlines, there will be opportunities, as emission rankings show up more environmentally friendly partners. And to end where we started this story, finally, the travellers themselves will become more concerned about their own personal emission footprint.

If not "shamed" into flying less, they will at least take greater care to seek out more efficient airlines – usually with the newest fleets, but also perhaps even with the highest seating density.

The rest of the world watches and waits; Asia is a new and different market

What happens in Europe tends to be radiated globally. Combining the facts that English is the airline industry's central language and the high level of publicity that the European Union countries and the EU itself generate, the potential for distortion is magnified.

Assuming such homogeneity of behaviour of course is potently misleading.

The United States, for example, is officially fortunate enough not to suffer from global warming; the prospect of government imposed taxes to discourage air travel is (perhaps with the exception of California and one or two other states) negligible in the short term.

But more seriously, and more importantly, when it comes to air travel, defining the global reality must necessarily be much more heavily weighted towards Asia, the source of much of the world's rapid growth and its population. In terms of sheer numbers, the population of the EU is approximately half a billion; Asia's is nine times that number. Aside from accounting for a very significant and proportionately increasing volume of global emissions, the great bulk of the Asian population is very different aspirationally from its European counterparts.

Among Asia's emerging nations, one of the greatest aspirational goals is simply the ability to fly internationally. It is a sign of social and economic maturity and permits experiences which were unthinkable for their parents. Even the social status of owning a passport is, for hundreds of millions of people, a massive advance.

For these new would-be flyers, the whole concept of "flight shaming" at a grass roots level is grossly alien.

Consequently, in Asia flight shaming is unlikely to gain much traction. It will have limited traveller impact - and as there are no easy surface alternatives for international travel, a different response is likely.

But some Asia Pacific countries might follow suit with "environmental" taxes. And airlines, particularly long haul full service carriers, will literally feel the heat, probably being forced to improve and accelerate their offsetting plans. As illustrated above, there are many and varied pressures coming into play now. Combined, they will aggregate to force airlines into a much greater focus on the issue.

(Note: Issue #51 of Airline Leader was devoted to a more in depth exploration of the Environmental issues around the airline industry. See centreforaviation.com/analysis/airline-leader)

2. Disruption of the airline distribution systems. How data is changing the world

For some years now IATA's New Distribution Capability (NDC) has been forcing the airline industry to focus on a coordinated leap ahead in airline distribution.

Advances have been made possible by developments in automation but, more subliminally, by the eventual recognition by many in leadership of airlines that "IT" was not just something for the IT department.

In fact, it is really about the most important – arguably the only important – part of the business: selling stuff.

Initially motivated largely by a desire to reduce the very significant costs paid to GDSs, the NDC process rapidly evolved into a revenue enhancement operation, designed to present "rich" content to would be travellers.

Coupled with intelligent use of personal data (another area where an industry obsessed with big boys toys had previously been profligate), the move away from intermediary-driven commoditised selling is becoming possible as airlines became able to deliver products directly (via "airline.com" sites), just as LCCs had been doing for almost 20 years. There is much more to it than that; no international airline can hope to distribute as widely outside its own home market as well as the intermediaries do.

But that is just the tip of the iceberg of how airline retailing is changing.

At the heart of it is tech-enabled solutions for helping airlines "know their customers" better. Yet here enter from stage left other players in this engaging cycle. As data aggregation and improved analytics increasingly intrude into this process, the airlines are not the only ones to be contemplating how to play in this marketplace.

In fact, any of the major online consumer-facing companies has adequate data and analytics to disrupt the airline sales process.

Companies, from Google (already playing around the margins of distribution for many years), through Amazon, Facebook, Alibaba, or any number of online operations whose main businesses have morphed into data aggregators, highly skilled in interpreting personalised needs.

They do not even need to enter the direct supply chain; the information they hold can be priceless for airlines and, sooner or later, priceless will convert to a price payable.

Tragically, for so many years, airlines had ignored the treasure trove of customer data they sat on. And equally, it is still the case that airlines and airports, who between themselves hold remarkably valuable data sets, refuse to coordinate their activities. Together they could fend off most competition.

Partly as a consequence of this, there is now the potential for airports to drive the booking machinery themselves. At least one airport is talking openly about taking on this role – after all airports have considerable physical possession of every airline customer passing through its property. It is a short step from there to creating virtual airlines from the airport’s customers.

Airports can have a role too

If airports are able to interpose themselves between airlines and the customer – they have hands-on knowledge of all flight movements and the platform to advertise them – the technology exists for them to be able to make offerings to airlines. They may come to be offers the airlines can’t refuse.

Whether or not these various evolutions happen quickly, or even in these forms, the airline system is one of the few big targets not to have been substantially disrupted yet. Recent history suggests this will be inevitable rather than merely likely over the coming decade.

3. Gamechangers. Long haul narrow body will reshape networks in the 2020s

Aviation is necessarily a function of the technology that allows ridiculously large pieces of metal to move into the air and fly long distances. There have been several revolutions which shifted the balance of aviation, most recently the very long haul widebody aircraft that made possible the rise of the Gulf carriers.

Since then, in order to achieve competitive long haul unit seat economics it has been necessary to apply the benefits of very large aircraft, more recently as engine technology improved, using twin-engined jets which consumed less fuel.

Because of their size, these aircraft were mostly suitable only to service large hubs – at least until Emirates showed how it was possible to stimulate large amounts of traffic out of previously "regional" airports, such as Manchester in the UK. But there is a limit to the number of these until-now nascent large volume airports.

Now, the new technology that is about to transform medium to long haul travel comes in a much smaller size: single aisle aircraft which have an even better seat economics profile. The result is to allow frequent connectivity between much smaller cities.

The longest potential range of this new breed is claimed by Airbus' new A321XLR, which promises the capability of carrying only 200 seats across a range of well over 8000km.

Airlines appear to believe it can be a gamechanger. Since its release at the Paris Airshow in Jun-2019, it has achieved 250 orders in a matter of a few months, from a mix of full service and low cost airlines.

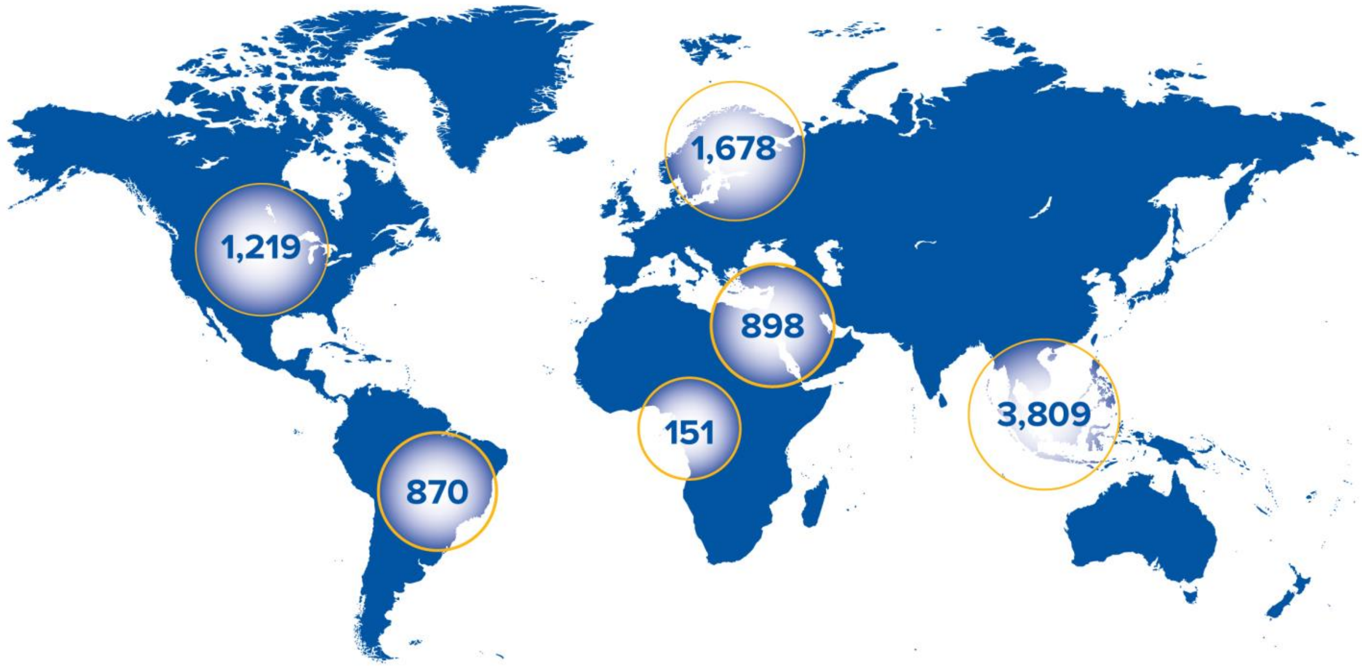
There is also an array of other Airbus A320 family neos and Boeing 737 MAXs (back in the air in 2020) which promise far longer stage lengths than earlier models. Quietly sneaking up on the long range 200 seaters is an aircraft half their size which is potentially capable of flying 6000km with similar unit economics, carrying only 100 seats: the A220, formerly the Bombardier C-Series. Embraer too is playing in this park.

These very long haul narrowbody aircraft will revolutionise network planning over the coming decade. They will open up new smaller cities to regular services that were previously deemed unthinkable.

Unsurprisingly, the great bulk of these new aircraft are on order to Asia Pacific airlines. Of those the great majority are destined for LCCs. The new narrowbodies usher in a true generational change.

GLOBAL NARROWBODY ORDERS BY REGION*

SOURCE: CAPA FLEET DATABASE



Note: *Week Commencing 20-Nov-2019

4. Alliance shifting sands are undermining strict foreign ownership lines

Foreign ownership rules, established some 75 years ago, have been the scourge of the international airline industry, used selectively as protectionist tools, but also preventing rationalisation of a highly fragmented and unprofitable industry.

Their original purpose was to allow smaller countries to establish and maintain their own flag carriers, so that they could guarantee continued international access.

According to the widely established principles, no international airline can be more than 49% owned by foreign interests and remain confident of being granted access to another country's territory.

There is also a similar prohibition against foreign “control”, although that element is more subjective and increasingly widely flouted (there has been only a handful of recent cases where the authorisation was rejected on the grounds of non-local control, including Hong Kong’s rejection of Jetstar Hong Kong and Australia’s of Tigerair Australia).

Ironically, it is perhaps Delta, a bastion of selective protectionism, which is moving fastest to undermine the restrictions, although it is doing it with quite different motives.

In doing so, Delta and others are redirecting three decades of global alliance development towards much more intimate and specific bilateral partnerships.

Delta is the world's most prolific foreign airline investor

In Sep-2019 Delta Airlines rattled the oneworld global alliance’s dominance of Latin America by announcing plans to acquire a 20% share in LATAM airlines, making it the largest shareholder (followed by Qatar Airways’ 10%). Delta already owns 49% of Aeromexico, along with large shareholdings in airlines in Canada, Europe and China.

At the same time Delta announced plans to divest itself of its 8% shareholding in Brazil’s GOL.

This follows a major battle a few years ago to ensure LATAM would be part of the oneworld alliance, but it will now leave and become part of Delta’s spreading portfolio.

In this case, Delta is reportedly intent on using the partnership to expand its frequent flyer programme and to support its premium cabin strategy. In a broader scope, while Delta remains as a leader of the SkyTeam alliance, Delta CEO Ed Bastian told analysts at the time that: “We are not going to sit around and wait for the alliances to develop their technologies”.

As one of the largest and most profitable airlines in the world, a statement like that has more than passing significance for the future of international partnerships. Which addresses one of the major forces in international law and trade: the power of the strong to change norms – as they have more to “trade”.

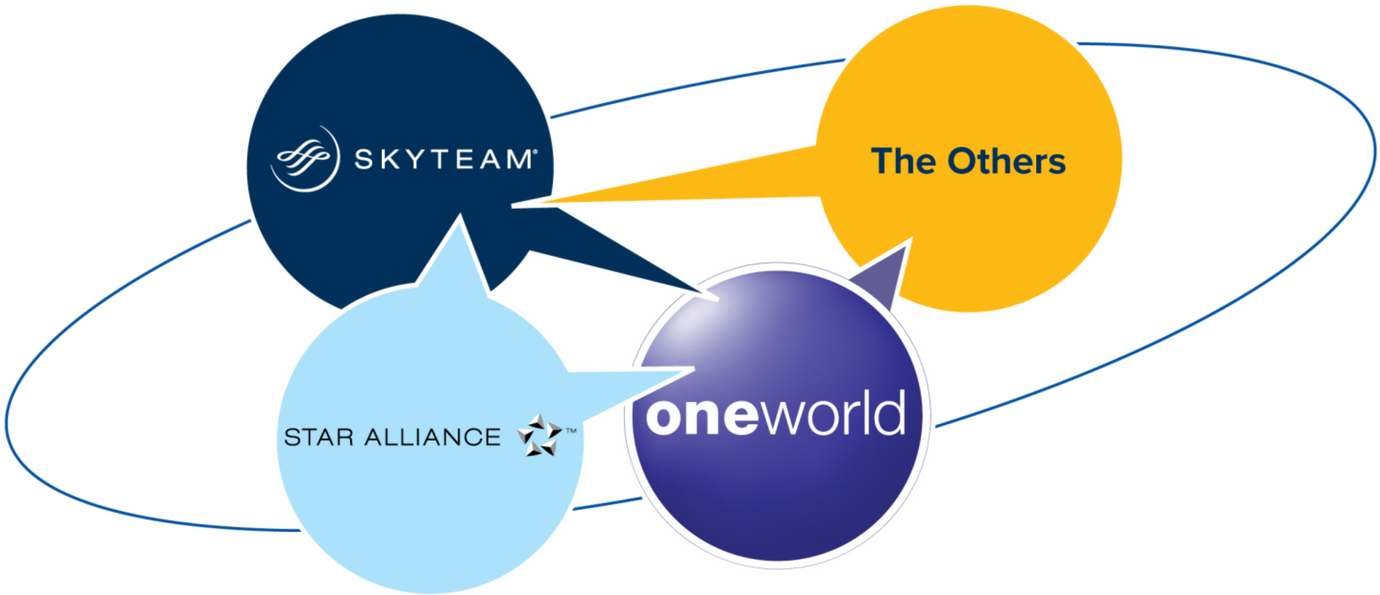
In fact, Delta management would be derelict in their corporate duties if they were NOT to achieve a considerable level of control over the airlines where it has acquired 49% shareholding. Where, for example, it owns 49% of the airline and places a Delta executive as CEO of Virgin, the perception at least is clear.

It is notable that neither the European Commission nor the UK government has raised serious concerns that the “effective control” mechanism was being breached.

The Hong Kong authorities, at the end of one of Virgin’s more lucrative routes from London, continue to accept the Virgin designation. This is despite the fact that a couple of years earlier it had rejected the establishment of Jetstar Hong Kong for similar reasons, essentially in that case to protect home carrier Cathay Pacific from competition.

EVOLVING ALLIANCES

SOURCE: CAPA - CENTRE FOR AVIATION



Certainly one difference in that case was that Virgin was already operating, whereas Jetstar Hong Kong was planning to start up. But another, key, difference was that Delta is one of the world's largest airlines, coming from one of the world's most powerful negotiating jurisdictions.

A similar position exists with Delta's 49% ownership in Aeromexico: where the 800 pound gorilla wants to sit, he sits.

The reason these moves are important is in the way they progressively erode the very limitations of ownership and control.

After a hiatus in cross border equity purchases (Etihad aside), there is now a clear emerging international strategy among the US majors both to use metal neutral JVs and equity acquisitions to cement a stronger market position that more accords to their lower risk profiles.

Combined with the proliferation of international cross border JVs in Asia and Latin America and the nod-and-a-wink at Europe's large full service consortia, the seeds have perhaps been sown for the ending of the archaic bilateral trading system.

If this sits uncomfortably with the seeming rise of protectionism promoted by these same large full service airline groups (IAG excepted), as it probably does, then it may only need a further spread of equity purchases to bring matters to a head. But, after 75 years of regulatory stagnation, the 2020s could just be the decade when rationalisation occurs.

One more prospect – and in hushed tones

One quietly nagging concern hangs over the issue of safety. Over the past 20 years aviation safety has with one or two exceptions become a given, thanks to constant regulatory vigilance and the high standards of the major airframe and engine manufacturers.

Recent disclosures surrounding the authorisation processes for Boeing's MAX and the commercial pressures that were one ingredient of the failings have however temporarily shattered that confidence.

That it took two serious accidents to bring the issues to light, and the fact that the US Federal Aviation Administration failed to move to ground the aircraft until most major foreign regulators had already done so was a further indictment of the seemingly perilous track now being followed.

One result has been a shift in the world order, displacing the FAA from its previously unquestioned leadership role. China's CAAC was first to ground the MAX and will undoubtedly gain in stature and confidence as a result. EASA, the European regulator quickly followed suit and in future they and other national safety bodies will by corollary feel a need to intensify their oversight roles.

But that does not fully satisfy the concerns raised over whether the world's largest and most important regulatory body had been derelict in its duties, along with the role Boeing played in reaching that position.

If, in fact one ingredient in the failings was the commercial pressure to get to market and whether, as has been suggested, the financial priority had overcome an obsession with safety, then simply getting the MAX back in the air will not be enough. It will need a fundamental and transparent indication that things have changed for the better.

The travelling public is far from losing faith in the system, but any repeats, or similar incidents may well erode the trust that has been built up over so many years.

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