Challenges and opportunities in a changing market

The European market continues to be a challenging operating environment but despite this, a flexible and nimble approach to business is ensuring that a number of ERA members continue to seize new opportunities. John Strickland, Director of JLS Consulting, explains

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Brexit

Considerable uncertainty remains for the airline industry about what exactly will happen on 29 March next year when the UK leaves the European Union. There are no winners to be found in the unlikely event of an air services shutdown between the UK and the EU. That doesn't make it any easier for airlines as they try to plan ahead, especially with regard to getting next summer's schedules on sale in full confidence. There are still many uncertainties concerning traffic rights along with ownership and control issues.

I am cautiously optimistic that common sense will prevail and a solution will be found, but there's an awful lot of management time and energy being consumed as well as cost incurred to reach that point. Several airlines have now secured additional AOCs and some are looking at shareholder structures to remain compliant with the EU regulatory framework.

Fuel

After a prolonged benign period, the price of fuel has been on the rise over the last 12 months, delivering price hikes of around 40–50 per cent. Some larger airlines are well protected via extensive hedging whilst others have been immediately hit with cost increases. For many it is difficult, if not impossible, to pass on the higher costs in ticket prices to customers. I would certainly expect this to create significant difficulties for some European airlines and possibly lead to some failures with the onset of winter.

Consolidation

In the last year, we've seen the bankruptcy of two well-known airlines, Germany's Air Berlin and the UK's Monarch. Within the regional sector, Darwin Airways, which had for a time traded as Etihad Regional, also ceased operations. Emotionally, it has been sad to see their disappearance but, arguably, this is part of the ongoing and necessary consolidation of the European airline industry. In the case of Air Berlin and Monarch, assets and slots have been picked up by a number of network and LCC airlines but there has been some overall reduction in capacity. Meanwhile, the uncertainty of Alitalia's future continues to extend with the new Italian Government seeking bids from prospective buyers but now looking to retain a state stake. There may be more clarity on this subject before 2018 draws to a close but let's see! There still remains excess capacity in the market and a number of ERA members have had to take proactive and decisive actions to adjust their offer and reduce costs in the face of this challenge. Others have actually seen new opportunity resulting from the failures.

Within the regional sector, there is big news on the consolidation front with the announcement of the planned merger between Air Nostrum and CityJet. Both airlines are increasingly successful capacity providers with a sizeable combined fleet and should see stronger market presence and financial results once the merger is finalised.

Air traffic control

As 2018 has played out, there has been a sharp increase in the number of flights delayed or cancelled due to ATC disruptions, in some cases stemming from manpower shortages but particularly from strikes by French controllers. Customers have been inconvenienced,

revenue has been lost and additional costs incurred. Companies exposed to the French market or those that have to overfly France to reach Spain and Portugal have been especially affected and the impact will be seen in the financial results of many. Airlines tend to 'carry the can' in such situations but understandably are having to become more vocal and forceful in lobbying to limit the future scale of such events.

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LCC developments and problems

Low-cost carriers still dominate, with Ryanair and easyJet remaining the leaders in the segment. Both are growing capacity, as is Wizz Air, supported by a substantial order for more Airbus A320 family aircraft from its shareholder Indigo Partners. As mentioned earlier, all three have strengthened their market positions as part of the consolidation process. easyJet has acquired a substantial part of Air Berlin's assets whilst Ryanair has become a majority shareholder in Laudamotion, (formerly Air Berlin associate company, Niki). Wizz Air has acquired Monarch slots at Luton, facilitating the establishment of its first UK base. The other large LCC, Norwegian, has not participated in the consolidation process, but has grown organically with massive ongoing fleet expansion. It differs from the others due to its accelerating development of long-haul low cost services.

LCCs have not been without their own challenges. Since its pilot rostering debacle in autumn 2017, Ryanair has been in the spotlight as it wrestles with establishing union relationships with its pilots and cabin crew across Europe. This is a massive challenge but is something I believe the airline will ultimately succeed in doing. It has seen cost increases as pilot salaries have been raised, though it cannot accede to any union demands which would reduce its levels of crew productivity. It does, however, remain in a very advantageous position compared to its competitors.

There is also much industry discussion about Norwegian's financial health after it reported a loss for 2017 but its break-neck pace of expansion continues. IAG acquired a surprise stake in the airline earlier this year, with a view to a takeover bid, but indicated recently that it would sell its shares if there was no progress on this.

In my view, an IAG takeover could be transformational for the airline, but without it, the 2018–19 winter season is likely to put considerably more pressure on its financial results as fuel prices rise and yields remain under pressure. Long-haul LCC is arguably the 'flavour of the month' airline business model, but whilst it is proving its popularity with customers and has been successful in opening up new markets, no practitioner is yet delivering sustainable long-term profitability.

Network airline groups

The three major European network groups find themselves in very different places. IAG's portfolio of airlines, led by British Airways and Iberia, are leading the pack in terms of solid financial performance, while Lufthansa Group is also delivering much improved, if not yet sufficient, results. Air France KLM, on the other hand, is being dragged down by strikes and industrial relations battles. Nothing new there, but a big frustration on the KLM side of the tracks who have made much more progress on costs and efficiency improvements. These strikes cost former Air France CEO Jean Marc Janaillac his job when he failed to obtain majority employee backing for his reforms in a referendum. Maybe there is a hint of optimism for the airline with the recently announced appointment of Air Canada COO, Benjamin Smith, as his replacement. Backed by France's Macron Government, this is the first time a non-French executive has filled the role and maybe with a greater political willingness he will succeed in dragging Air France into the 21st century. It will certainly take some doing though!

Aircraft manufacturers

I can't leave this reflection on the industry without reference to the changes underway in the manufacturing sector. A certain level of consolidation is also taking place there. First, we learned that Airbus was to take a majority stake in Bombardier's C Series programme and that was hotly followed by Boeing announcing a planned collaboration with Embraer commercial aircraft. The Airbus move has now been completed with the C Series being rebranded as the A220. The technical and payload capability of this aircraft is welcomed by many airlines but orders have been limited. With Airbus resources behind it, the programme should see renewed impetus. The Boeing–Embraer collaboration is only in its early stages, with regulatory and political hurdles to be cleared before an anticipated conclusion in late 2019. As Embraer roles out its new E-Jet product range to build on its successful current generation regional jet family, the consolidation steps will ensure security for aircraft programmes, both of which are important to ensuring a strong, competitive future equipment offer for regional carriers.

Market outlook

Against this backdrop, there is plenty to occupy the minds of airline management teams but many are successfully taking the challenges in their stride, with a number of ERA members tackling costs, competitive battles and showing innovation in their business models. Where there is adversity, there is also opportunity, and we can expect to see more examples of this in the year ahead. ■