

A PRIMARY SPOTLIGHT ON INDUSTRY DISRUPTION

Is Aviation A Special Case?

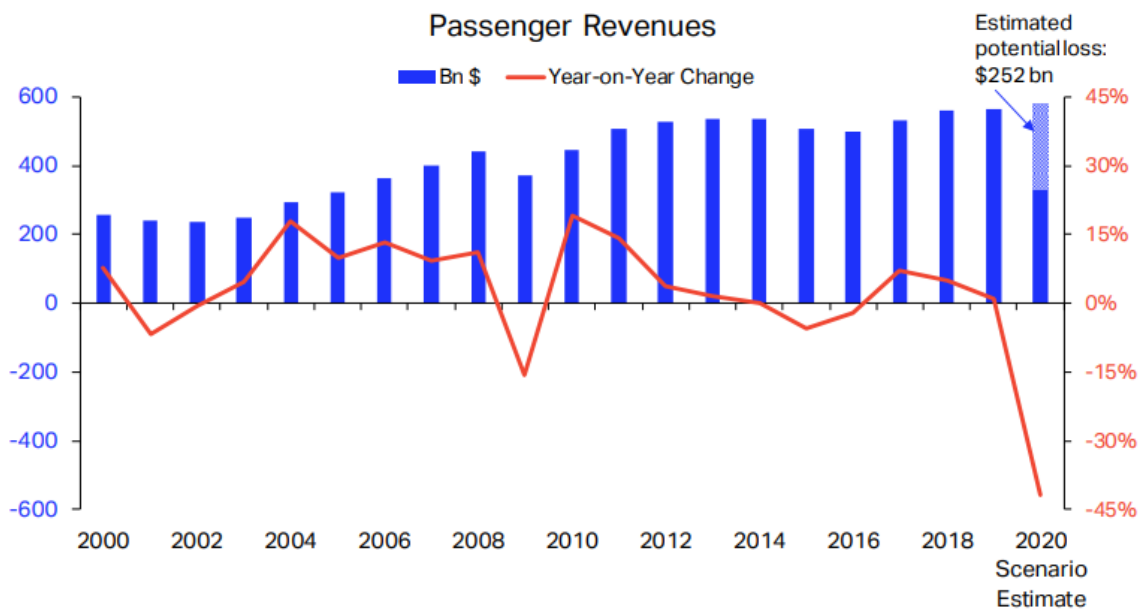
A Primary Interview with aviation consultant John Strickland

30th March 2020

IATA Economics' Chart of the Week

27 March 2020

COVID-19 delivers unprecedented shock



As recently as last December Airline CFOs and heads of cargo were reporting positivity about future growth in air travel, although they were less positive about cargo due to the slow-down in world trade as a result of trade disputes. The pandemic has ripped that moderate optimism to shreds, as graphically illustrated in the chart above. 2019 of course featured 'the fastest growth in airline failure in history' according to the International Bureau of Aviation, with at least 18 operators going bankrupt. In the UK this included Thomas Cook Airlines and Flybmi. But these 'peacetime' casualties may come to be forgotten if the economic consequences of the response to COVID-19 result in more (and bigger) firms collapsing. The US government has just passed a stimulus package bailing out airlines and air cargo businesses. Now many politicians hope recipients will reform the way they operate in return-stock buybacks have been prohibited temporarily for beneficiaries of the stimulus, and many lawmakers see this as just a starting point. Similar measures may be pursued in Europe, where mass-employed airlines like Lufthansa and Air France-KLM are at risk, along with the continent's major aircraft manufacturer Airbus. We spoke to the aviation consultant John Strickland to determine more about the future of air travel in a world of destabilising pandemics.

Why are the airlines a special case? Will people begrudge the airline industry being favourably treated relative to others? What is fair?

Airlines are a key economic tool in global 21st century life. It's only when something dramatic happens, and COVID-19 is certainly the most extreme, that we realise just how important they are. Not only are airlines major employers, accounting for over 10m direct jobs and a further 11m indirect jobs*, but they are the catalysts for a whole value chain of indirect employment including airports, manufacturers, engineering and a myriad of suppliers too. Of course, airlines are critical economic enablers too, be it for business and freight purposes or for leisure and are frequently the only means of developing and supporting tourism in many markets and countries (almost 40m tourism jobs supported by aviation*). It is essential therefore that the future of the industry is protected but the challenge is how to do it.

IATA recently reported how relatively few airlines are well-managed, financially sound and have strong cash reserves. Many couldn't weather lesser storms than the maelstrom now being thrust upon the industry and are arguably not worth saving. Equally there is a need to protect the industry's ability to come back to life when the moment requires, but that is not necessarily about showering them with taxpayer funding. Strong players are shedding cost as quickly as they can - a grounded airline is still burning cash on aircraft, maintenance and crews - but they can draw on their own cash reserves, lines of credit, turn to shareholders and undertake other self-help measures.

There will be inevitable failures and consolidation, especially in Europe where there are still a number of state-backed inefficient national carriers. There are broad measures which can and are being taken to help all airlines such as: waiving rules on slot usage (normally 80% of slots have to be flown in order to keep them for a following season) to allow greater operational flexibility; industry groups are also advocating waiving of airline ticket taxes, en-route navigation charges and the onerous consumer compensation legislation which applies in Europe; non-aviation specific measures to pay a percentage of employees' salaries are also highly valuable of course.

How much airline capacity is mission-critical to the economy functioning, for business and trade? Think how Medtronic moves its ventilators from their manufacturing plant in Ireland to New York where they are badly needed. Airplanes are crucial to the likes of Fedex, delivering traded goods globally. But what about leisure capacity and why isn't that largely expendable or able to restructure itself with the private sector?

Airlines are embedded in the life blood of the modern world and at their best we have seen the emergence of efficient hub carriers providing competitive quality air services from their bases to a cornucopia of global destinations for passengers and freight. Equally, the emergence of large profitable low-cost carriers [LCCs] has made flying affordable for a larger public both for business and leisure purposes, as well as being particular contributors to tourism development, so critical to many economies.

None of this is to say that there has not been over capacity in some cases. What we are witnessing now is unparalleled for humanity and will result in a massive re-set for economies worldwide, I would project that the size of the airline sector is likely to be considerably smaller for some time to come, dramatically throwing off the normal long-term growth trends.

Commenting on leisure airlines, we have seen significant failures in recent years including the UK's Thomas Cook and Monarch. Broadly speaking this segment of the market has been more fragile, susceptible to both increased LCC competition and to the ups and downs of economic cycles, as well as to terror attacks. That said, those that remain such as TUI and Jet2, have radically changed their business models and are better placed to withstand shocks. It's impossible to say how much, or at what pace, leisure demand will come back and how these carriers will fare but frankly, no airline regardless of business model will come out of this unscathed.

Where do airports stand in the current situation?

We must not forget airports in this value chain too, who are also bleeding from the loss of airline landing and passenger charges and commercial revenues such as retail and car parking. They are having to cancel capex plans and try to limit daily opex too whilst seeing airline customers coming to them, understandably, to waive charges or even to provide free or cheap long-term aircraft parking. We've seen some, such as London City and Paris Orly, close entirely to commercial traffic to cut costs in the absence of throughput.

Large airports are better equipped to survive the battering, provided that they have either strong shareholder backing, or in many cases Government support. Others, especially regional or very small airports, were loss-making at the best of times, there is a risk that some of these may now be lost for good. Whilst in some areas that may reflect excess capacity, in others it could create a serious problem of access to essential travel and markets for many regional communities.

Trump's administration has signed into law a c.\$60bn package for the US airline industry. Is this the sort of number necessary to backstop the European airlines? How (given the absence of a co-ordinated fiscal union) are such remedies to be implemented in the EU, or nationally?

It's difficult to put a figure on what the right level or structure of a support package might be, but the type of broad measures I mentioned above such as tax waivers, would be the most valuable. We are not seeing a coherent pan-European response currently, with each country seeing different priorities and there are many obstacles to achieving a fair and consistent approach. There is also the question of European State Aid regulation, whether that is thrown aside or is ignored currently, remains to be seen.

One of the areas where support would be most justified is the regional airline space. It's always been a difficult segment to survive in, hence the many failures we've already seen in recent years. Some routes are already operated on a subsidised basis but there are a number of well-run airlines providing very important regional services, who are now in need of significant help if they are to survive. The UK's Loganair or Binter Canarias (Canary Islands) are good such examples. The reality is that a one-size fits all approach cannot be taken to direct financial support and ideally each demand should be assessed on a case by case basis.

Who in Europe will be prioritised for partial nationalisation, in your view?

As I've indicated, there is a risk in some cases that inefficient state-subsidised carriers may be kept alive. That would be a retrograde step when what is needed now is more consolidation. I do not believe further nationalisations are what is required, other than for Governments to secure influence over any investments they may make now, but only up until the time that an airline is able to once again stand on its own feet. We have seen enormous advantages as airline privatisations have developed across Europe, but the landscape still remains fragmented and further intervention of this sort now has high risks of setting the clock back, distorting the market and damaging those carriers who have proven themselves able to succeed without state support.

Will some airline capacity be allowed to fail?

I believe it is certain that there will be failures and that even the strongest airlines have a high probability of coming back in the aftermath of the virus in a much smaller guise than today. I have highlighted the weakness of several state-run flag carriers (Alitalia or Taroni illustrate the point) and the challenges faced in the regional sector, but there are other airlines across many market segments who are at high risk of collapse.

The long-haul low-cost model, popular with customers but demonstrably unprofitable, is likely to come under pressure and here Norwegian is highly exposed. Even with probable Norwegian Government intervention it could shrink to a fraction of its current size if it is to survive, with most or all of its long-haul activity being dropped. We are likely to see the strongest players such as IAG, Ryanair and Wizz consolidate their positions. Given the rise of the environmental challenge we are likely to see an acceleration of the retirement of older, less efficient aircraft, frequently operated by smaller and weaker airlines, especially in the charter segment, who themselves are vulnerable to failure. All of this will place downward pressure on market capacity.

Will the OEMs, Boeing and Airbus (with complex supply chains etc) who are big exporters and employers also be protected?

Boeing has faced criticism on executive bonuses and share buy-backs, against the backdrop of the MAX crisis. Airbus has been landed with massive fines over its sales corruption scandals, but both are critically important as employers and exporters in their respective home markets. There is still the ongoing WTO dispute under which each side has accused the other of illegal subsidisation to add further complexity to the question of any government intervention. As with airlines, the challenge is complex, not least due to the vast number of dependent sub-suppliers who are involved, many of which are not located within the home geographies of the manufactures. Notwithstanding these factors any recovery in aviation will depend on both these manufacturers being in rude health to deliver the more efficient aircraft types which will support future airline fleets in a newly shaped and structured industry.

Some argue “Nature is sending us a message”. Covid 19 impact adds to the climate change crisis the pressure mounting on business to reform and growth perhaps to slow, surely this pressure will intensify on aviation?

I believe this crisis will expedite the need for more rapid change in the sector. We are likely to see smaller fleets of more modern aircraft, with lower emissions and older large aircraft like the 4-engined Boeing 747 retired more quickly by airlines still operating them (British Airways for example). There could well be more pressure to reduce short haul flying, especially where rail is a viable alternative and topics such as the building of a third runway at Heathrow could become academic.

John Strickland is Director of JLS Consulting and can be reached at john@jlsconsultancy.com. To see John in discussion with many of the leaders who are navigating the airline industry through this uncharted territory click [here](#). His next webinar can be signed up for [here](#).

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