conversations on leadership

The Next Airline Downturn – How to Survive

By Josh Solera and Gizem Weggemans

Airline profits are flying high, thanks to healthy load factors, low fuel prices, and capacity discipline. But there's another downturn ahead, and airlines must prepare for it now – by leading the way in digital transformation, and boosting their future talent bench.

The airline business has been printing money as of late. With loads up, fuel prices down, and capacity discipline broadly holding North American carriers made 2016 another banner year with US ~$36B in EBIT. Despite ticket prices creeping down, IATA still forecast 2017 EBIT of nearly $30B.

Not bad for an industry whose profitability has been questioned for decades:

"A recession is when you have to tighten your belt; depression is when you have no belt to tighten. When you've lost your trousers—you're in the airline business." Sir Adam Thomson, founder of British Caledonian, 1984

"People who invest in aviation are the biggest suckers in the world." David Neeleman, after raising a record $128 million to start New Air (the then working name for what became JetBlue Airways), Business Week, 1999

"Indeed, if a farsighted capitalist had been present at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down." Warren Buffett, annual letter to Berkshire Hathaway shareholders, 2008

The reality is that despite the last few years of record profits, the airline business has indeed been a poor long term investment. A 2013 McKinsey study for IATA found that airlines had never returned their cost of capital between 1993-2013. The same study found that airline ROIC trailed nearly every other industry over a 40+ year period.

The structural drivers of the airline industry's historical profitability (or lack thereof) have been studied extensively. With a focus on fast, near term-fixes (e.g., fuel surcharges to offset $100 bbl oil), facing the bigger questions of how to effectively prepare airline executives for the next inevitable downturn have gone largely undeveloped. As challenging as the last downturn of 2001-2009 was for many carriers, today's executives almost certainly won't have it so "easy" for three major reasons:

- **Pensions are already gone for the US airlines** – While each US airline that entered Chapter 11 had unique circumstances, nearly every carrier leveraged bankruptcy protection to shed or renegotiate some of their highest legacy costs: pensions. This allowed every carrier to emerge from bankruptcy leaner than before. This time? There are no massive pension liabilities from which to receive relief.
- **Merger mania is over in the US and not so easy in Europe** – Nearly every US airline has merged with at least one other over the past decade. The US is left with only three or four global carriers of significant scale (American, United, Delta, Southwest), along with a smattering of smaller airlines. Sure, there could be one more round of smaller scale acquisitions. However, barring a significant shift in the Department of Justice's policy, there simply aren't any big deals with large synergies left to be had. In Europe, there is the backdrop of Brexit, which will confront its own regulatory implications and may stoke politicians' desire to maintain a national carrier (not just as a matter of national pride but as a matter of national economics). As a result, while technically there could be more acquisitions across the European landscape, M&A in the sector will be, by no means, easy. Asian airlines are still gauging the long term prospects of the expansion the region has been experiencing.

- **Alternative revenue/cost savings have already been tapped** – As airlines scrounged for sources of revenue during the last downturn, they created new ancillary products from baggage fees to change fees to seat assignments. They have leveraged technology and design to reduce cost by, for example, decreasing weight on aircraft significantly. By most measures, ancillaries and cost reductions have been a wild success, accounting for billions of dollars of revenue and cost reduction each year. There are some fees that have remained off the table for everyone except ultra-low cost carriers (ULCCs) (e.g., charging for water, carry-on baggage, check in at the airport), and perhaps those will come next when the airline cycle reverts again. However, it is hard to imagine carriers replicating the success of ancillaries again – there isn't that much left to squeeze.

Despite these challenges, airline executives do have levers they can (and, in our view, must) pull to prepare for the next downturn.

- **Lead the way in digital transformation:** As Egon Zehnder has been articulating in recent years, *"…in a world where consumers tweet complaints in public forums, shop online as much as on high streets, and express brand preferences on Facebook and Instagram, excellence in digital is critical for business success. Organizations that fail to embrace digital innovation in their core business will fall behind fast. Consumer-facing companies, governments, and B2B operators are all deeply affected… In this environment, traditional companies must grasp the challenge of making their organizations truly digital-savvy ... Even highly successful global corporations need to take bold steps to evolve their strategies, excel in a multi-channel environment, and deliver compelling digital experiences."*

  In sum, digitization both creates new opportunities and poses new challenges. This is true for airlines as well, and carriers must adapt to:

  a. **Bring the Customer to the Centre of the Business Strategy:** There is a new passenger out there and to respond to their needs, airlines need to define and articulate a clearer customer-centric strategy. There is an imperative to bring the online and offline customer experience closer together in an effort to generate and enhance true brand equity. According to WNS, market research data suggests almost 75 percent of air tickets today are bought online. On the one hand, e-commerce and automation (such as online check in) have increased the convenience of air travel. On the other, the interactivity with the customer through mobile devices requires investment in this interaction in terms of the product.

  b. **Unlock the next revenue stream through big data** – This interaction, in turn, opens up the possibility for additional revenue streams. Airlines capture an incredible amount of information on their customers, ranging from traditional (when people fly) to more interesting (search history and location data) to special (spend data from cobrand credit cards) to truly unique (willingness to pay at varying price points). The possibilities from using this data are nearly endless and critical to unlocking additional revenue potential. However our extensive experience working with airlines around the globe suggest that almost no carriers connect these data points together, much less analyze, interpret, and utilize them. Data reside in departmental silos "protected" by claims that legacy systems can't connect. This is almost always untrue; it's just that creating the link is hard. Those airlines that invest significant time and money in unlocking the insights hidden inside will create true competitive advantage for years to come. This additional revenue could make the difference between profits and bankruptcy. This may also require new or redefined roles: such as appointing a Chief Digital Officer to spearhead this push.

The Answer Lies in Leadership

Digital transformation is stretching businesses to the limit, not just in the aviation industry but across all sectors. One of the main challenges is making the transition from rigid, hierarchical structures to the flexible, innovative forms that are needed today. However, many carriers currently lack the in-house talent necessary to embark on this journey, which leads us to the following two talent imperatives:

- **Look more broadly for talent** – The broader business world can thank airlines for dozens of innovations, ranging from dynamic pricing to the advent of loyalty programs (AAdvantage). In the last decades, however, other industries from tech to retail have been innovating at a far faster clip. Why? Leading companies have realized that talent from other fields can add real value. Retailers have recruited hotel executives to help reinvent the customer experience. Healthcare providers have brought in senior leaders from the tech world to help with the transition to digital.

  Conversely, many airlines hold onto the belief that only someone who grew up in airlines (and particularly at that specific carrier) can understand the complexity and nuance of the business. This may be true for a subset of specific operational roles, but many others would benefit from a broader range of experience (e.g., customer experience, digital, analytics) as well as diversity in thinking and perspective. For Egon Zehnder's 2016 seminal study, we looked at nearly 1300 senior executives across 73 international airlines, representing around 80% of airline traffic. The analysis has shown that carriers with higher levels of diversity (including different career backgrounds, gender, ethnicity, etc.) outperform more 'homogenous' airlines. To thrive, executives would be wise to inject more diversity into their organizations, including talent from non-traditional backgrounds, to spur innovation.

- **Develop future leaders, for now *and* the future** – For decades, cyclical industries have demonstrated an inherent problem when the tides turn toward or against them. When times are good, they tend to over hire and pad the ranks; when economics change, they cut deeply into their talent base. This creates real problems in future years; for example, the ever present 'short bench' has become a familiar refrain among senior energy executives considering succession due to near-zero hiring in the 1980s. It is critical that carriers use this profitable time to identify and begin grooming their next generation of high-potential leaders. Tough decisions will have to be made in the years to come within a much more unstable context, and understanding the potential of your bench will help make informed decisions.

Breakthrough Thinking Applies Insight to Potential

Potential describes the ability to successfully take on larger leadership roles in both scale and scope (complexity) and the speed at which one can do so. Traits and motives underscore one's potential. The framework Egon Zehnder has created consists of four traits, which, when properly assessed, predict development of executive ability and the speed of that development: curiosity, insight, engagement and determination.

For the airline industry to re-inject talent at the pace of change required, investing in the early identification of potential and the development of those who display it, is imperative. Acting now is key. Airline executives navigating these challenges can take heart that they aren't behind: only a few carriers have started to make significant progress. Historical patterns suggest the next downturn is approaching and carriers need to ready their human arsenals to prepare for the impending lean times. The good news is that airlines have more than one valuable asset - in order to reap the true value of these assets, airlines will need to look beyond the walls of their headquarters, while investing in their talent to truly innovate and position themselves for continued success.

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