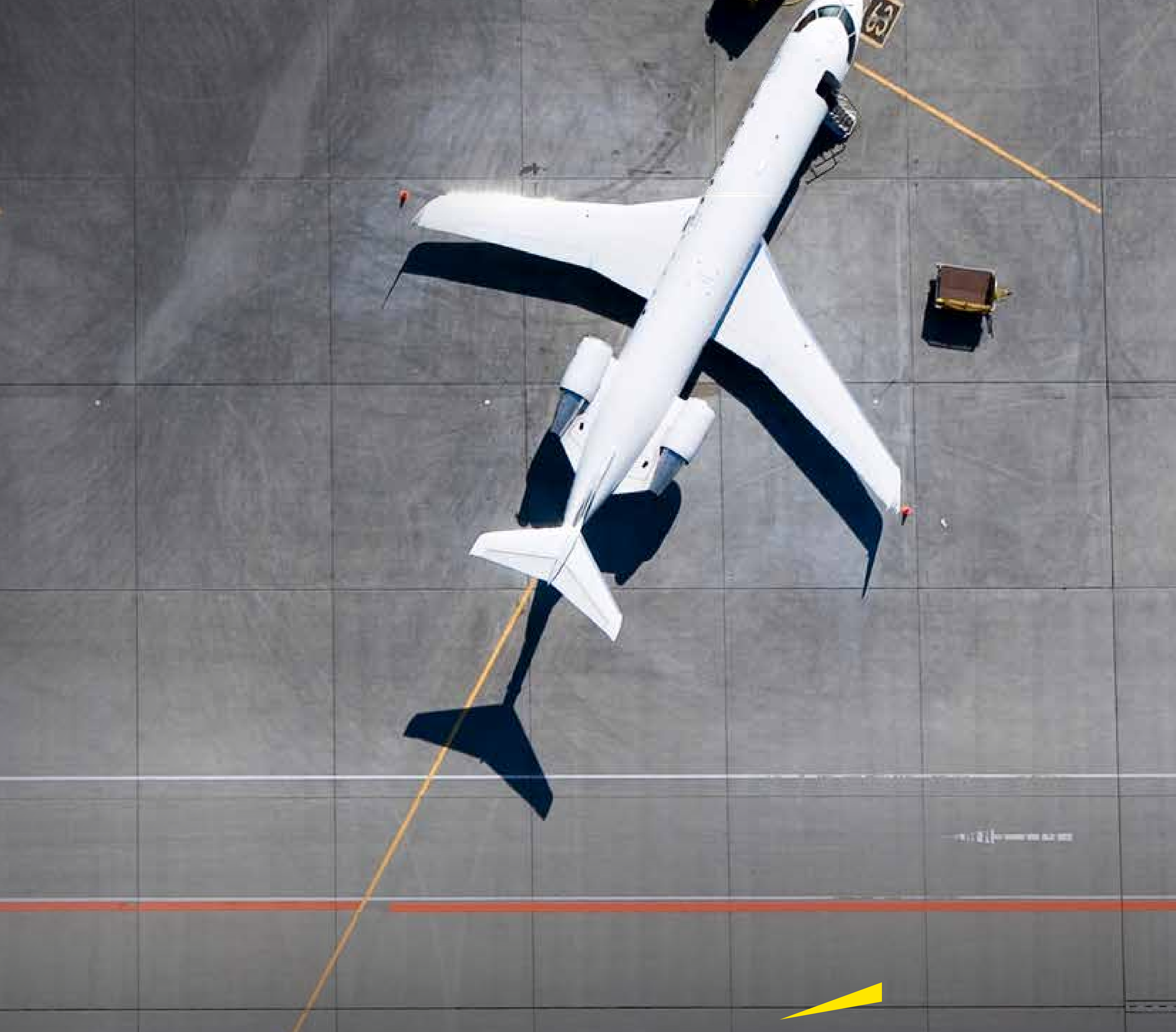
How does the airline industry brace for an uncertain recovery?

Strategy realized



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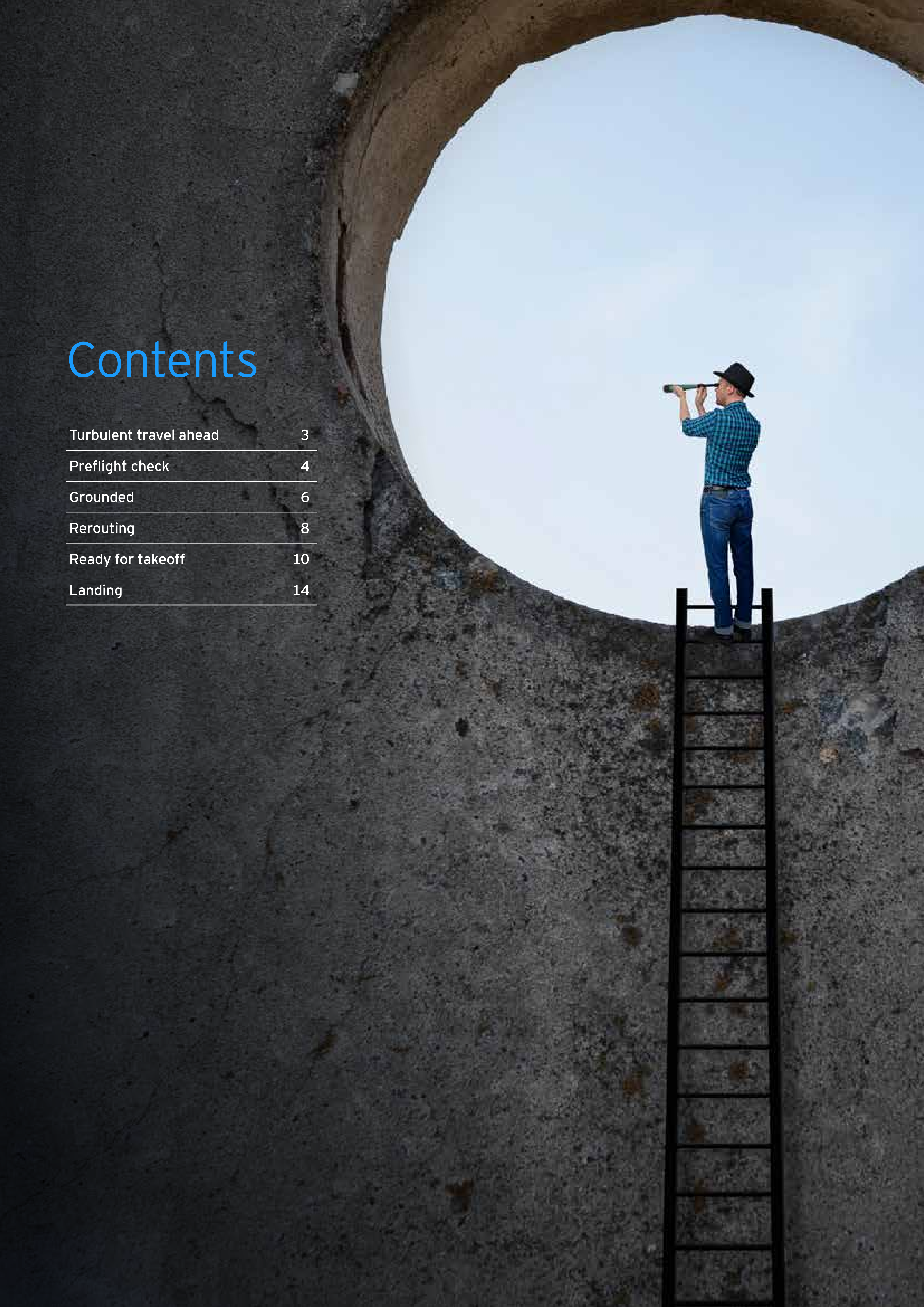


Turbulent travel ahead

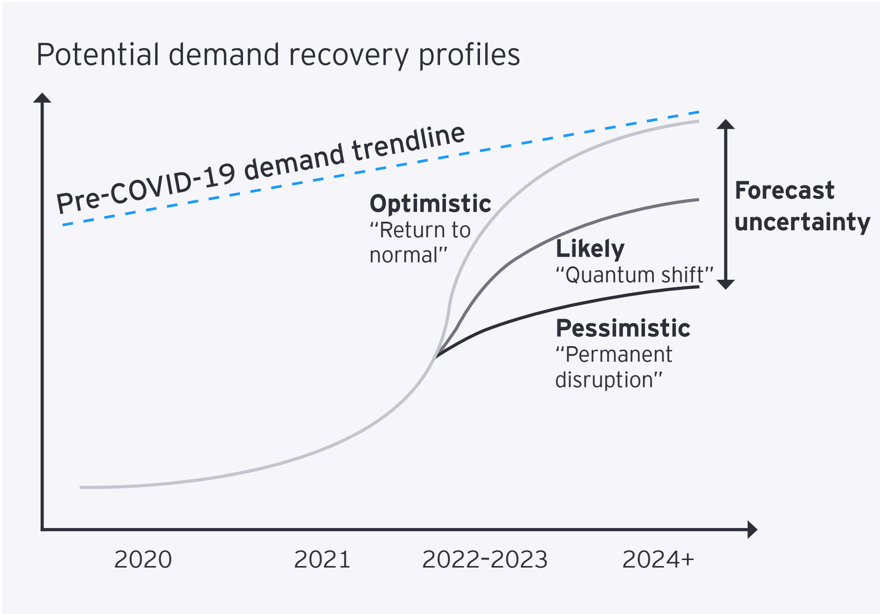
A variety of COVID-19 vaccines are here, but unfortunately, we are still a long way from a return to "normal" life. What is also clear is the significant disruption experienced in the travel industry and the continuing effects that will be evident for years to come. The pandemic's temporary elimination of virtually all demand for air travel sent shock waves throughout the industry, starting with the airlines and cascading throughout the broader commercial aerospace ecosystem. The immediate impact was severe, and the long-term implications will be material. The industry must brace for transformational change to be ready for an eventual, but uncertain, recovery. In the first of a coming series of articles, we focus specifically on the impacts to airlines, with subsequent publications focusing further upstream in the commercial aerospace sector.

Commercial aerospace supply chain

- Airlines
- Tier 1 and tier 2 suppliers
- Airframers
- Maintenance, repaire and overhaul (MRO) and aftermarket

Preflight check: disruption is here to stay

We are at an inflection point, brought about by the onset of COVID-19. The airline industry is facing massive disruption, and these impacts will be severe and long-lasting. While the previous twelve months have focused on pandemic response and contingency planning, it is now necessary to plan for the industry's future, a future in which consumer habits will change.



Source: EY-Parthenon Analysis, 2021

While every forecast assumes some level of recovery from the demand levels experienced in 2020, opinions on how the recovery ultimately plays out vary widely. Industry forecasts generally assume that leisure demand will return to pre-COVID-19 levels, though they differ on how quickly that will be achieved. A broader and potentially more consequential debate exists with respect to whether there will be a permanent impairment to business travel demand. Even after wide vaccine availability within a certain geography, the public's confidence in the safety of air travel is a wild card. Further, the timeline on which governments will loosen restrictions or regulations on both domestic and cross-border travel presents another variable to account for when predicting a return of demand. Ultimately, most projections follow an "S-curve" trajectory as shown previously, with the most rapid recovery occurring in the late 2021 to 2022 time frame and a return to historical average annual growth rates of 5%–6% afterward. The critical question for the industry is where exactly the top of the "S-curve" is and how far it is from where demand would be if COVID-19 disruptions never occurred. Indeed, many in the industry feel that we are merely at the "end of the beginning," as the severity of impacts experienced will prompt a reshaping of the competitive landscape for years to come.

Grounded

Despite being the "end of the beginning," COVID-19's impacts on the airline industry have already been dramatic.

No one could have anticipated just how extreme and sudden the impacts of COVID-19 would be for commercial aviation, illustrated by the change in industry sentiment from month to month since the onset of COVID-19.

Q2 2020
Uncertainty and an ever expanding crisis

"COVID-19 has sent airlines reeling, but the supply chains that enable their operations are facing an even more acute and uncertain future.[1]

The Air Current

"Our load factors fell steadily to single-digits by the last week of (March), and that's where they are today.[2]

Tom Nealon
Southwest Airlines

June
Brief hopes of recovery

"As several states began to reopen, we began to see demand increase ... load factors jumped from 15% in April to 64% in June.[3]

Doug Parker
American Airlines

"Surging COVID-19 infection rates aren't slowing the US air travel rebound yet. The US airline industry is still deep underwater.[4]

The Air Current

July
Smaller planes, fewer people and lower fares

"Demand will likely plateau at 50% of 2019 levels until a vaccine is widely distributed.[5]

Scott Kirby
United Airlines

"Airlines are burning the candle at both ends, adding back expensive capacity while cutting fares to fill planes and win market share.[6]

The Air Current

August
Structural change underway

"Airlines are prioritizing cash management over aircraft size and performance, as used aircraft values remain depressed.[7]

The Air Current

"The mainline-regional model has been broken for many years, and rising costs eliminate some advantages.[8]

Leeham News

September
A new reality sets in

"Six months into the pandemic, it's even worse for airlines than we thought, as worst-case scenarios take hold heading into fall.[9]

The Air Current

"Commercial aviation — airlines, airframers, original equipment manufacturer (OEMs) and suppliers — faces a lost decade due to COVID-19.[10]

Leeham News

Q4 2020 and Q1 2021
Capacity consensus awaiting a vaccine

"It's really important that we stay in tune with the market dynamics, making the adjustments we need ... and not lose sight of the future.[11]

Greg Smith
Boeing

"The indications are that we are once again becalmed around the sixty million (weekly seat) mark waiting for some vaccine breakthrough moment.[12]

OAG

Throughout this period, US airlines alone burned an average of US$5.7b per month after adding over US$60b in collective debt.[13] This financing has been used merely to sustain operations and cover cash burn instead of more traditional uses such as enhancing the passenger experience, improving efficiency or other investment. Even after a safe and effective vaccine is widely available, the airline industry will have significantly more debt in parallel with a smaller operation and near-term reductions in passenger demand.

1 The financial crisis brewing in the supply chain underneath the world's airlines, The Air Current, 19 March 2020, Jon Ostrower.
2 Southwest Airlines Co (LUV) Q1 2020 Earnings Call Transcript, Summary taken from Q2 Earnings call, 28 April 2020, The Motley Fool.
3 American Airlines Group (AAL) Q2 2020 Earnings Call Transcript, Summary taken from Q2 2020 Earnings call, 30 June 2020, The Motley Fool.
4 Surging coronavirus infection rates aren't slowing U.S. air travel rebound, yet, The Air Current, 24 June 2020, Courtney Miller.
5 United Airlines Holdings, Inc. (UAL) CEO Scott Kirby on Q2 2020 Results, Summary taken from Q2 2020 earnings transcript, Seeking Alpha.
6 Airlines seek 2019 rebound, but fares are missing link to recovery, The Air Current, 28 July 2020, Courtney Miller.
7 Aircraft out of storage and into the frying pan, The Air Current, 17 August 2020, Courtney Miller.
8 US Regional Consolidation Began Before Covid, Leeham News, 6 August 2020, Kathryn B. Creedy.
9 Six months into the pandemic, it's even worse for airlines than we thought, The Air Current, 15 September 2020, Courtney Miller.
10 A lost decade for aircraft manufacturers, suppliers, Leeham News, 21 September 2020, Judson Rollins, Bjorn Fehrm & Scott Hamilton.
11 Pontifications: Don't lose sight of the future, says top Boeing exec, Leeham News, 7 December 2020, Scott Hamilton.
12 2021 Capacity Starts Slowly – Can We Close Our Eyes For A Few Months Please, OAG Blog, 4 January 2021, John Grant.
13 Figuring Out How Much Cash the Airlines are Really Burning, Crankyflier.com, 30 July 2020, Raymond James.

Rerouting

The need for new and more resilient scheduling

In most cases, the initial response of airlines to the shock of COVID-19 centered around safeguarding business continuity and effective crisis response planning, including government support, protecting people and workforce, securing short- to mid-term financial stability and continuing operations. Airlines retreated to core networks, cut capacity to nearly 20% of 2019 levels, eliminated all nonessential spend and accelerated the retirement of older aircrafts. While demand stabilized through the latter half of 2020 and into early 2021 at around 55% of pre-COVID-19 levels, these retirements and other cost cutting measures enacted by airlines, coupled with significantly increased debt levels, will impact their operating models for decades to come.

The post-pandemic airline industry will see permanent fundamental changes in nearly every aspect of its current existence. The path to recovery is dependent on a variety of factors, many of which have their own time lines that are mostly uncertain. And while a return to pre-COVID-19 passenger travel levels is expected at some point, the time horizon is being discussed in years, not months, and comes with new travel preferences by their customers.

Key drivers of recovery

Driver	**Impact on the aviation industry** **Short-term (YE2020)**	 **Medium-term (2021-23)**	 **Long-term (2023+)**
Public health environment	↓	↑	↑
Ability of airlines to implement safety measures	n/a	↑	↑
Passengers' reluctance to fly	↓	→	↑
Disposable household income	↓	→	↑
Change in leisure travel preferences	→	↑	↑
Change in work practices	↓	→	→
Political environment	→	↑	↑

↑ Positive impact → Neutral impact ↓ Negative impact

Source: EY-Parthenon Analysis, 2021

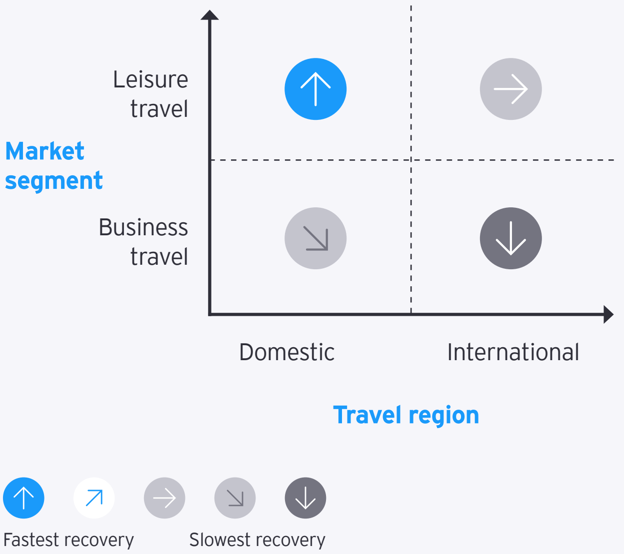
The COVID-19 pandemic is testing the resilience of organizations and adding increasing pressure on systems, plans and operations. The anticipated slower pace of recovery and broader transformational change within the sector will also challenge airlines to be agile, and ignite their recovery through business adaptation and stronger enterprise resilience.

Ready for takeoff

Low visibility on the journey ahead

Just as the industry is broad, so too is the solution set. There is no one-size-fits-all response to COVID-19 for airlines. Even well-performing, well-capitalized companies are experiencing disruption, unable to operate "business as usual." The recovery time line for each segment of the market will differ, with carriers that are more focused on domestic or short-haul leisure travelers likely arising as the early winners. Country-by-country differences in vaccine acceptance and distribution rates will also result in varying recovery time lines and international travel recovery lagging behind that of domestic travel.

Anticipated recovery time line upon availability and distribution of a vaccine



Source: EY-Parthenon Analysis, 2021

It is likely that, upon the successful distribution of the COVID-19 vaccine within a given geography, domestic leisure travel will restart quickly. Pent-up leisure demand exists across the world, and travelers will be eager to return to traveling once it is safe in their local country or area. In a recent survey of travelers, 94% indicate plans to travel again once COVID-19 restrictions ease, with 66% saying they will stop putting off their dream vacation and make it a priority when they resume traveling.[2]

While leisure demand will be quick to restart, demand for business travel is expected to ramp up slowly. Whether business demand will return to pre-COVID-19 levels is up for debate, but most agree that it will take companies longer to feel comfortable with their employees resuming travel. In addition, with remote working being a fact of life for many businesses, along with technological advances and an increasing focus on environmental sustainability, corporations around the world are rethinking their travel and meeting policies, providing a headwind to the return of corporate travel. During the 2008–2009 financial crisis or in the aftermath of the September 11 terrorist attacks – events that temporarily depressed air travel demand – there was no wide availability of the virtual collaboration tools that have become a staple of everyday life during the COVID-19 pandemic. The proliferation and broad adoption of these collaboration tools, in addition to trends in corporate travel budgets and environmental sustainability, will result in a permanent headwind to business travel demand. Whatever the level of business travel demand recovery, it is likely to be similar to leisure travel for the reason that domestic or short-haul travel will resume more quickly than cross-border travel.

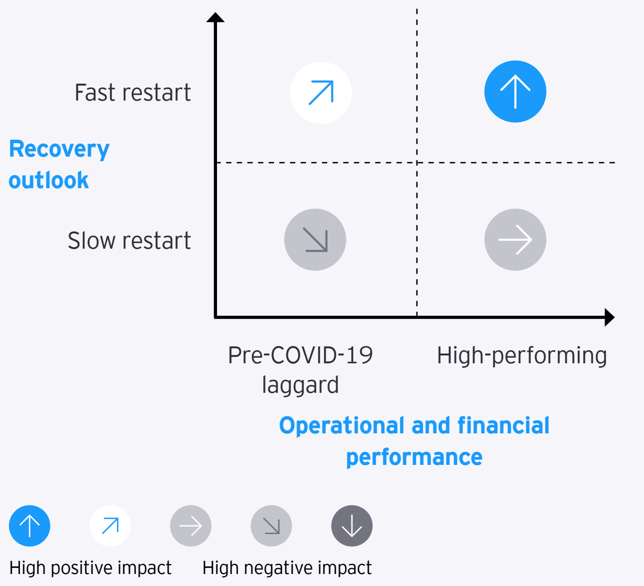
2 New Survey Reveals What Americans Are Missing the Most: Travel", Hilton.com, https://newsroom.hilton.com/corporate/news/survey-finds-americans-missing-travel-most, accessed 30 April 2021

Low-cost and ultra-low-cost carriers (LCCs) are well positioned to gain market share as domestic or short-haul leisure demand returns quickly after the distribution of vaccines. For ultra-low-cost carriers especially, their domestic or short-haul focus combined with their ability to undercut competitors on price provides tremendous upsides to the next 2–3 years. Being in a stronger position once domestic or short-haul business travel levels pick up will put more competitive dynamic in that part of the market too and enable LCCs to increase pressure on their network competitors.

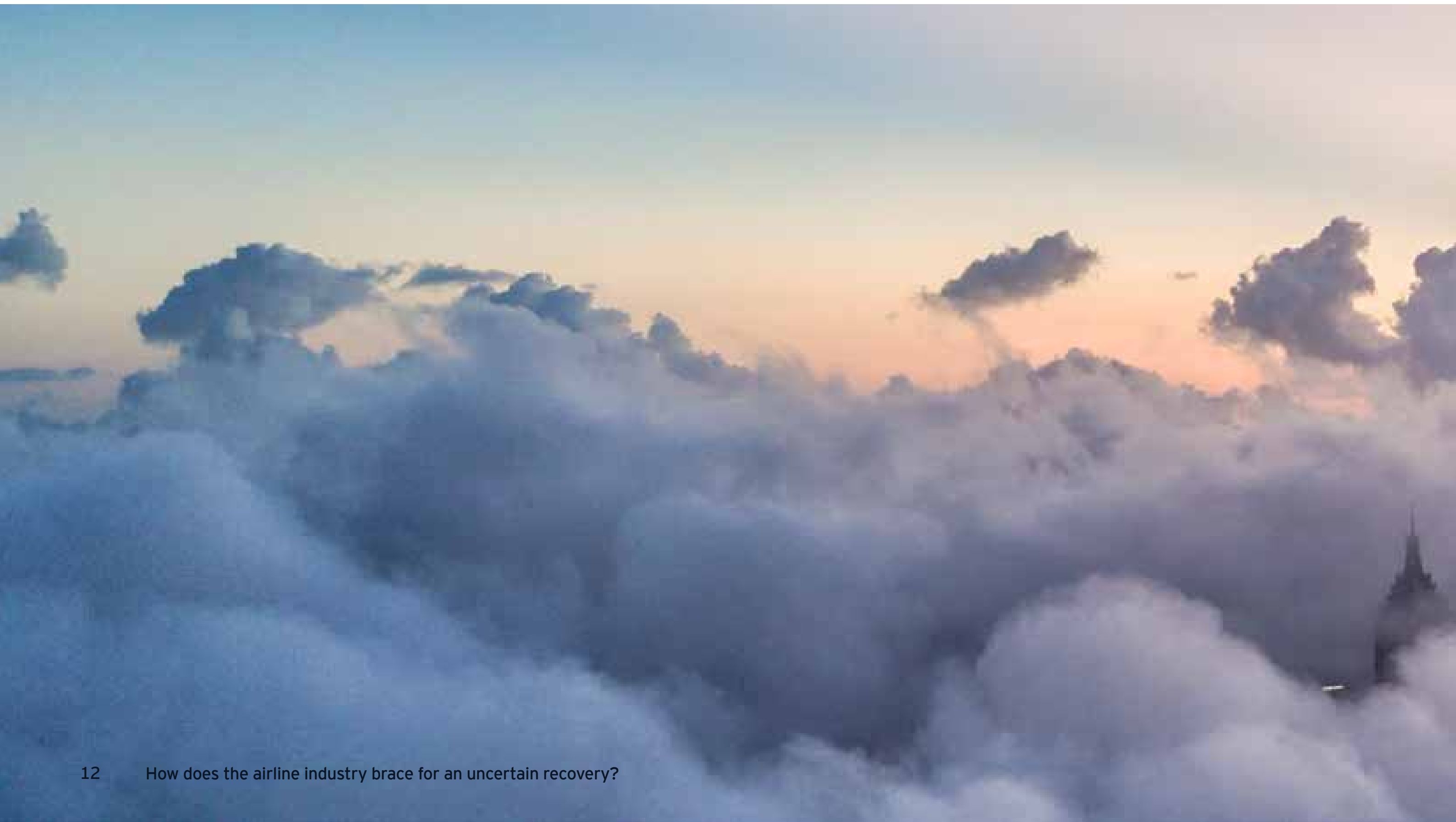
Network carriers will require greater creativity to adapt to the changing demand environment in the absence of steady business demands that typically drive their profitability. Even among network carriers, however, the implications for domestic versus international demand recovery impact the outlook for operational recovery.

The factors impacting any recovery also inform the strategy for airlines as they plan to emerge from the COVID-19 crisis. While much is uncertain, one thing is sure: with vaccines on the horizon, airlines need to begin to move their focus beyond the downturn and plan for recovery. Airlines should consider both their relative performance prior to the onset of COVID-19 and their potential to resume normal operations quickly based on their role in the market as they plot out their recovery strategy.

Outlook for airlines' return to profitability



Source: EY-Parthenon Analysis, 2021



- **Well-equipped to weather the storm**: Airlines that were high-performing before the pandemic will need to redeploy their capacity effectively to capitalize on new opportunities while demand stays down. Those that are favorably positioned in the market to capture demand quickly upon recovery, such as low-cost carriers and domestic-focused airlines, will experience growth near pre-COVID-19 levels quickly. Network carriers and those with a higher cross-border focus will struggle to maintain market share and return to profitability as quickly.
- **Historical stability under threat**: Underperforming airlines that are suffering liquidity shortfalls must find ways to preserve and create value while improving liquidity and working capital. Airlines have already been forced to make a series of impossible decisions to reduce costs throughout this pandemic. A return to operations means even more tough decisions with regards to airlines' networks and commercial outlook. For airlines with low cash reserves, the stakes riding on these decisions are historically high.
- **Pre-existing weakness in operating models exacerbated by COVID-19**: Many airlines have taken on substantial debt (both private and public) in light of a shrinking market. It is inevitable that some of them — those already challenged before the pandemic — will face restructuring as the best avenue for future growth and value creation. This applies to those airlines in particular that are likely to face a slower ramp-up of operation upon recovery.

Landing

Concrete action and opportunities for restructuring ensure a smooth landing after a bumpy ride.

In an industry characterized by the wide array of business models, the mix of "pre-existing conditions, the strategic challenges already present at the start of the current crisis and uncertain development for the foreseeable future, means that individual airlines require a response that not only focuses on the shot-term changes ahead, but also takes into account mid- and long-term disruptions. All the while, the increased debt levels put a heavy burden on all players and limit their ability to invest, thus posing an "endgame scenario" for many.

The COVID-19 pandemic has had a significant impact on airline profitability and liquidity and has not been factored into current airline business planning. Three notable impact include an overall decrease in volumes, profitability and liquidity compared to pre-pandemic levels. Seasonal cash troughs are likely to be amplified as airlines develop an increased dependency on leisure travel. As a result, airlines are facing reduced capital to address the sustainable fuels transition and technology investment required to build a long-term security.

With disruption emerging in every corner of the globe, having a more resilient (financially and operationally) enterprise is key to ensuring better near-term crisis response and maintaining competitive positioning for sustainable success in the future.

Players in the airline industry need to **improve** their position by focusing on their strengths and leveraging all the internal resources they have, **change** their operations where necessary and restructure to ultimately **protect** value.

In our view, there are four steps that airlines can follow to position themselves for the short to medium term:

- **Scenario plan**: With the level of uncertainty existing in the market now, dynamic scenario planning is vital for airlines to be agile enough to respond to changing conditions.
- **Strategize**: On the basis of the range of most likely scenarios available, airlines will need to articulate a clear, concise strategy to explain to staff, regulators, shareholders, governments and the general public how they will return to regular operations.
- **Map course**: Create a clear plan to bring the strategy to life and a checklist to show how it will be followed and measured.
- **Action**: Implement the financial and operational changes necessary to execute the strategy.

Regardless of their current situation, all airlines can follow these steps, though how they follow them will vary. What is certain is that the post-COVID-19 world will look different — we are at the beginning of a wave of disruption that will reshape industries for a generation. Airlines, and all businesses, need to actively prepare to manage this change or the change will manage them.

For more information about how EY-Parthenon can help you reshape your organization — visit www.ey.com/reshapingresults

Contacts

Andrew Wollaston
EY Global Reshaping Results, Restructuring and Strategy and Transactions Private Equity Leader
awollaston@uk.ey.com

Bill Malczyk
Senior Managing Director
Turnaround and Restructuring Strategy
bill.malczyk@ey.com

Gaurav Malhotra
EY Americas Reshaping Results and US Restructuring Leader
gaurav.malhotra@ey.com

Falco Weidemeyer
EMEIA EY-Parthenon Leader
falco.weidemeyer@parthenon.ey.com

Christopher Mack
EY APAC Reshaping Results and Japan Restructuring Leader
christopher.mack@jp.ey.com

Mike Parr
EY EMEIA Reshaping Results Aviation Lead
mparr@parthenon.ey.com

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