2016 commercial aviation industry trends

U.S. carriers need to reward their stakeholders
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Introduction

Could things seem any better for domestic U.S. airlines? Low oil prices, industry consolidation, and robust demand have given the big carriers surging profits and some of their largest cash reserves ever. Given the industry dynamics of the past — particularly the hypercompetitive price wars that former American Airlines CEO Robert Crandall colorfully likened to “the old game of Christians and lions” — it would be understandable if the people who make their living in aviation were pinching themselves. In the coming years, the challenge for industry executives will be to figure out what can be done to keep the momentum going.

If you are tempted to share the spoils of this prosperous period with a few key stakeholder groups, that would be understandable. Your customers, employees, suppliers, and shareholders have all stayed with you in the bad times. Now you would naturally want to build — or buy — their loyalty and goodwill. But going too far in this direction, at least at this point in airline industry evolution, would be a mistake. In fact, it would be short-lived, generic, and wasteful. After all, the positive macroeconomic factors the industry is currently experiencing won’t last forever. Consequently, airlines should be adopting distinctive, well-honed strategies to strengthen their offerings and their ability to be profitable over a long period — preparing for the good and bad situations of the future. Put another way, you should think less about splitting the pie among a few stakeholders and more about making the pie bigger.
As fuel costs have tumbled . . .

Reports from 25 airlines in 2015, in millions of U.S. dollars

Source: United States Department of Transportation
Airline profits are skyrocketing . . .

Reports from 25 airlines in 2015, in millions of U.S. dollars

Source: United States Department of Transportation
And cash flow is sufficiently healthy to invest in long-term initiatives.

Free cash flow growth for the 12 months ending in Q4

Source: CSIMarket.com
When one examines possible givebacks to stakeholder groups more closely, the pressures undermining long-term investment come into focus. For example, as oil prices decline, many carriers are inclined to pass along lower energy costs to consumers in the form of reduced fares. In decades past, airlines often took this path, especially as upstart carriers tried to claw their way to relevance and legacy carriers battled to maintain their lead. Although strategic fare adjustments in key markets always make sense, you must now resist the pressure to base prices solely on input cost changes. Otherwise, you risk giving up much of the fiscal gain they have enjoyed in the last few years by entering a new “race to the bottom.”

Another option would be to allocate more profits to employee groups, a seemingly attractive choice given how acrimonious the disputes over wages and benefits have been in the airline sector. But it is likely that you would rue that decision as well: History shows that structurally increasing compensation at a time of plenty backfires when the economy weakens or circumstances change.

Investing more in the airline's supply base, a third stakeholder group, may also seem reasonable, particularly after years of underfunding assets and pent-up initiatives. Certainly, by earmarking some of your added resources for new aircraft technology, and for differentiating amenities, you could theoretically create a competitive tailwind and leave the era of price competition even farther behind. But this can be an errant approach if it is not carefully thought out and backed with a strong ongoing commitment — and it will only work if your goal is not just achieving parity, but competitive differentiation.

Finally, airlines have already shared some of their good fortune with shareholders in the form of increased dividends and stock buybacks. Although we think the quantity of cash used in this way has been reasonable so far, we suspect the benefits of this tactic may soon be played out. If investors get the sense that you don’t have any new ideas about how to invest in your company to generate sustainable growth, their investment dollars will begin to go elsewhere.

**Possible givebacks to stakeholders**
Four strategic alternatives

The shortcomings and pitfalls in these approaches frequently outweigh the benefits. But that doesn't mean that satisfying the needs of stakeholders is not important. Stakeholders should be served, but it can be done as part of a larger plan that uses current gains to drive the development of sustainable and differentiating capabilities. These capabilities will help airlines develop a market-focused business model that maintains and extends recent growth. Here are four strategic alternatives to consider:

• **Ultra-reliability.** For many business and some leisure travelers, the price of a seat can be secondary to the assurance that they will arrive at a destination at the expected time, and that the airline they choose is able to reliably make scheduled connections and maintain its fleet without a hiccup. Airlines do not do these things uniformly well. The combination of logistics, data analytics, information systems, and process excellence that allows some airlines to excel at reliability can be a crucial competitive difference.

Executed well, developing (or further developing) ultra-reliable operations and networks benefits all stakeholder bases: It’s good for technology suppliers whose products are essential to this effort. It benefits employees by giving them the tools they need to do their jobs and reducing the number of exceptions they have to deal with (such as lost baggage and missed connections). Meanwhile, consumers enjoy the security of more reliable travel plans, and investors can expect that these improvements will be reflected in equity gains.

• **Unit cost efficiency.** Price may have lost its pole position as airlines’ preferred competitive weapon, but it remains among the top strategic tools in the industry. However, pricing flexibility can be sustainable only for companies that have firm control over their costs.

One way to achieve unit cost efficiency is through structurally faster aircraft turn times, allowing for an additional flight or two per day from many of your planes. Airlines can also improve day-of-operation capabilities that go straight to the bottom line if executed well;
namely, rational on-board fuel storage practices; better decision support for operations recovery that minimizes downtime; and the ability to make automated real-time flight dispatch and plan changes in order to recover schedule integrity. Moreover, you can acquire newer, more efficient aircraft; negotiate better lease arrangements at the airports where you operate; and treat noncore flight services (including baggage check and onboard meals and drinks) as ancillary revenue opportunities. And you can strike better deals with labor unions; for example, not by paying employees less but by negotiating work rule changes that allow you to deploy labor more flexibly in the service of cost containment and recovery.

From the stakeholder perspective, a unit cost leadership strategy deftly integrated with the other strategic alternatives is good for the supply base, good for customer experience, and good for investors. And often, the improved labor flexibility is a plus for employees as well.

**Network preeminence.** An efficient yet robust network goes hand in hand with ultra-reliability, but effective execution of it also requires superior operational management capabilities — having planes, crews, on-board supply, and maintenance infrastructure in place to support both consumer demand and fine-tuned interconnections as well as offering a diverse set of connecting points.

If you are working in the context of global carriers, this effort requires excellent coordination with partners and the ability to structure agreements that distinguish your airline from its competitors. The ability to structure advantageous codeshares, alliances, joint business arrangements, and strategic investments can yield superior networks, whether those partnerships are with other domestic carriers or overseas airlines.

Viewed from the stakeholder perspective, aiming for network preeminence demands long-term commitment and investments in advanced and proprietary technology, which, of course, is a boon for suppliers. In addition, employees benefit because through these network technologies, airlines are opening the doors to global markets not accessible a few years ago, offering labor fresh opportunities within the organization.

**Top customer experience and convenience.** In the inherently challenging and occasionally trying arena of air travel, some airlines have attempted to differentiate themselves on the basis of preflight or in-flight service or technology. It has not been easy to sustain an edge in this area, but the current environment may let certain carriers redouble their efforts and stand out in terms of customer experience.
For instance, boarding pass kiosks are no longer the novelty that they were years ago; virtually every domestic airline has them now. But imagine a preflight experience in which an airline’s mobile app alerts the passenger to traffic conditions and TSA wait times, recommending an ideal departure time from home and mode of travel to the airport. Once at the airport, a proximity sensor could automatically check in the passenger via a specialized tag in the passenger’s bag or the app on the passenger’s smartphone. The system might also curate a menu of dining options near the passenger’s departure gate, and by the time the passenger got through a streamlined VIP security line, his or her food would be paid for, packed, and ready for pickup.

Or consider a scenario in which frequent flyers find their preferred refreshments and reading materials waiting for them in their seat as soon as they board. Or a re-accommodation system that, in the event of a canceled flight or other disruption, is tailored to serve high-profitability passengers first. These ideas all exist in some nascent form now, but they should be sharpened and expanded to pay off in a significant way, creating “brand zealots” for the airline. To achieve these levels of traveler experience, carriers must upgrade their capabilities involving customer information analytics, operational transparency, and customer movements within the carrier ecosystem.

It’s no secret which stakeholder group benefits most from a strategy of enhanced customer convenience — and satisfied customers are often an indicator of companies that do well in equity markets. Moreover, there are cascading effects for employees, because research shows there is a measurable impact on employee job satisfaction at companies whose customers speak highly of them.

Before the recent good times, any strategy advocating the development of these types of capabilities in the airline industry would likely have been met with healthy skepticism. It’s hard to sell an ambitious and distinctive innovation and expansion approach when everybody around you is cutting prices; the natural and perhaps only intelligent move in that situation is to cut prices yourself. But as the “survivalist” strategies built mostly around price competition have finally waned in the U.S. aviation industry, the notion of making a unique strategic statement has again become a legitimate topic of discussion.

This puts the onus on airline companies to decide who they are and where they want to focus their investments in the future. “What are we great at that really matters?” is the question you should be asking. With the right answers come the right investments, done for the right reasons, and benefits that accrue not to any single stakeholder group, but to multiple stakeholders simultaneously.
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