
The European airline landscape is changing: Can airports keep up?

Anna Sargeant

Executive summary

The recent turbulent history in the European airline industry has presented operators with challenges across their business environment. Since the creation of the Common Market for air services in 1997, privatisation of carriers and removal of state support, consolidation of airlines has gained some momentum within Europe. Moreover, new business models have emerged, not only in terms of low-cost operations but also in the form of truly “multi-national” carriers operating throughout the EU. These carriers are locating their operations on the basis of market opportunities rather than in a fixed base country. Add to this mix volatile fuel prices, new security measures and environmental concerns, and airlines need to adopt new tactics for controlling costs and boosting revenues in order to protect their already slim profit margins.

The volatility of the business operating model has huge implications for airports. Today, European airlines are no longer captive customers for airports. Carriers can—and do—pull up stakes and leave. And their owners can—and do—demand operational improvements at airports to protect their own interests. Just as airlines have had to sharpen their business acumen, so now must the airports. That means airports can no longer simply be providers of infrastructure—perhaps with a retail offering of a few shops and restaurants. Instead, they must work to retain their passenger and airline customers. In addition, airports must recognise the limits of their market power and their dependence on a shrinking group of successful carriers. To succeed under these circumstances, they will need to become sophisticated self-contained businesses.

To succeed under challenging circumstances, airports will need to become sophisticated businesses.

Airlines: A shifting business landscape

European airlines are facing challenges on several fronts—including shrinking operating margins, an ever more difficult yield environment, privatisation and consolidation. All of this is setting the stage for an uncertain future for airlines—privatised and state-owned alike. And it has catalysed a scramble to explore new avenues for survival.

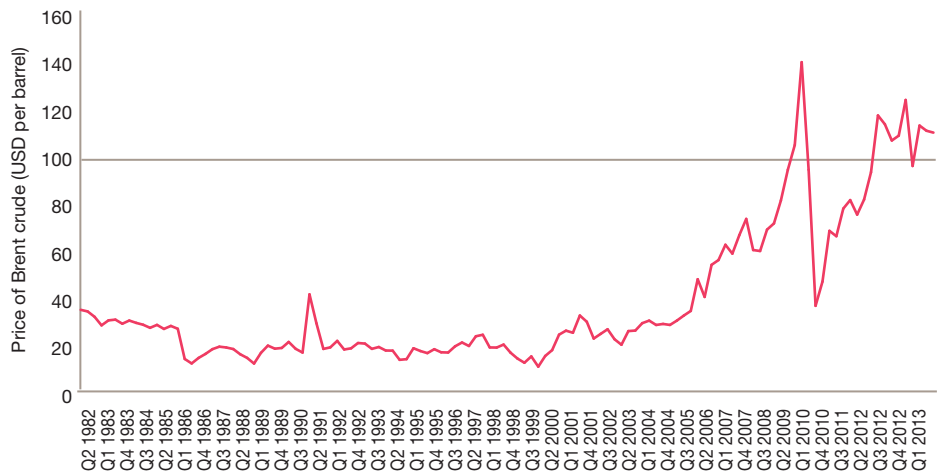
A more sophisticated, dynamic and competitive market

Historically, airlines have been the least profitable link in the air transport supply chain. Today, the situation is critical: Rising costs—primarily for fuel but also from increases in taxes, airport and flight charges, and overall inflation—are squeezing airlines' already slim operating margins more tightly than ever. (See Figures 1 and 2.)

Furthermore, airline operators face challenges to their yield, particularly in Europe. Soaring fuel prices, tax burdens, declining social security payments and constrained household incomes are collectively depressing leisure spending. All this is putting downward pressure on economy class fares and low-cost carrier (LCC) ticket pricing, eroding airlines' revenue passenger miles (RPM). At the same time, seat capacity in Europe has kept expanding, thanks to the introduction of a new (and up-gauged) fleet. This has further raised the hurdles confronting airlines as they strive to improve yield.

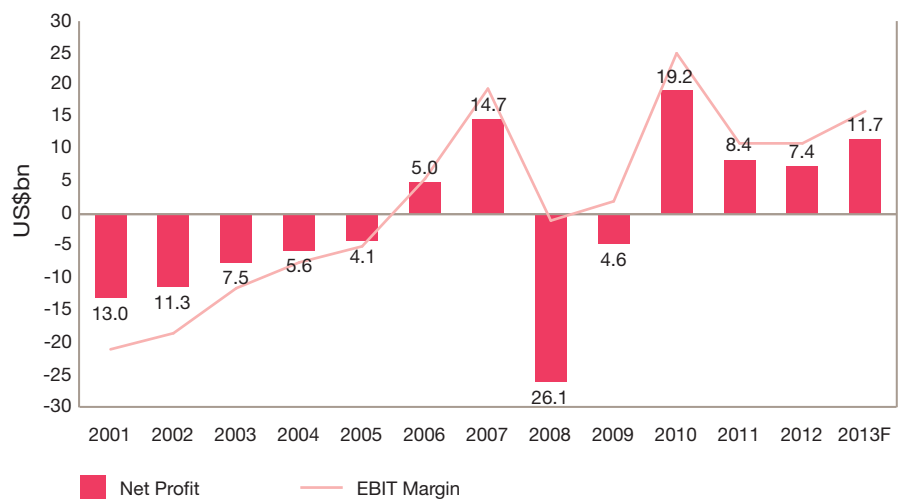
Both the full-service and LCC models face challenges. The network carriers, who have largely lost the battle with LCCs for intra-Europe travel, still need to operate those services to feed their hubs and international networks.

Figure 1: Brent crude oil price (USD per barrel), 1982–2013



Source: Thomson Reuters

Figure 2: Global commercial airline profitability, 2001–2013F



Source: IATA (September 2013)

At the same time, their long-haul networks have come under pressure from the Gulf carriers, who have made inroads into the European market. These inroads have further eroded European network carriers' ability to stabilise their yields.

The economic benefits of hubs are well known—hubbing enables airlines to operate thinner routes

more profitably, with the support of connecting traffic. Costs are inevitably higher, but they are often outweighed by higher revenues. Still, to be viable, a hub needs a significant level of local demand as well as an extensive network of feeder services. That's why the most successful hubs are situated at major cities.

Just as airlines have had to sharpen their business acumen, so now must the airports.

However, airport capacity at some European hubs, London Heathrow being the starkest example, is already limiting the number of key feeder routes that can be operated. This is gradually reducing the proportion of transfer passengers, as airlines are forced to focus more on point-to-point traffic and are increasingly unable to launch services to new destinations. Owing to the withdrawal of connecting services over Heathrow, for example, several Gulf airlines now operate wide-body aircraft directly to their hubs from numerous regional cities, and sometimes at a more than daily frequency.

LCCs, on the other hand, tend to have multiple bases within their geographic market rather than hubs. But even for them, the market is changing. As LCC networks expand, the opportunity to use connecting services inevitably increases. The growth of so-called “self-connecting” by passengers has prompted some LCCs to amend their basic model and start catering to this segment of the market.

M&A and investment moves

The last few years have seen a number of high-profile merger and acquisition (M&A) transactions that have further reshaped the airline industry. (See Table 1.) This reflects a push for consolidation and a drive for scale among top-tier global carriers. With these moves, carriers are trying to gain access to growing markets or expand their share in mature markets, reduce costs and deliver sustainable profitability, with an appropriate return on capital, and by capturing revenue and cost synergies.

Would-be acquirers face considerable legal and regulatory barriers to full mergers, including limits to foreign ownership and ongoing government shareholding. Still, a number of non-European carriers have succeeded in making strategic investments in European airlines. Etihad’s 29% stake in Air Berlin and 3% share in Aer Lingus and Qatar’s 35% stake in Cargolux are just a few examples. Foreign investment limits for European airlines remains unchanged, however,

at 49%. The test of “effective control” could restrict this further.

Arguably, government regulation has not kept pace with the commercial realities of operating a global airline and the need to generate a consistent return on capital. If the development of international aviation had followed the pattern of other industries, airline alliances would probably never have matured to the levels they are today. Airlines would almost certainly have engaged in cross-border mergers and investments, probably resulting in the creation of global companies rather than the nation state-based organisations that still dominate air transport. Airline alliances are a second-best solution to the fundamental need for greater consolidation. They enable airlines to extend their geographical reach and achieve certain economies (notably of scope), with varying degrees of effectiveness, without the need to engage in full mergers.

Today, more than 50 airlines are members of the three global alliances: Star Alliance, oneworld and SkyTeam. These alliances differ markedly in the degree of their overall integration, just as individual members have varying levels of commitment. Star Alliance is probably the most fully integrated team of the three, and oneworld the least integrated. However, all alliances exhibit a significant degree of instability. It has become extremely difficult to forecast with any certainty whether they will survive in the long term, let alone what they will look like if they do.

We can reasonably assume that progressive liberalisation of airline ownership and control restrictions will take place over time. What then will happen to the global alliances? Full mergers create far more economic benefits for the participants than even the most integrated form of alliance.

Table 1: Airline M&A activity in 2012–13

Minority investment	Acquisition/merger
	Aug 13 IAG/ Vueling
	Jul 13 Tiger Airways/Virgin Australia
Delta/Virgin Atlantic	Jun 13
Air Asia/Zest	May 13
Korean Airlines/Czech Airlines	Apr 13 Skywest/Virgin Australia
	Apr 12 IAG/BMI
	Jun 12 LAN/TAM
Etihad/Air Berlin	Jan 12
Etihad/Air Seychelles	Jan 12

Furthermore, it is by no means certain that the partners chosen for alliances will be the same airlines a particular carrier might want to merge with. So the long-term structures and even existence of the global alliances aren't at all guaranteed.

An uncertain future

All these changes spell an uncertain future for the European airline market. For a number of years, industry commentators have predicted a shakeout in the market and the rise of four or five mega-airlines.

Between 2001 and 2010, at least 94 airlines went bankrupt in Europe. The majority of these were in the low-cost, regional or leisure/charter sectors. However, there have been casualties among 'national airline' network carriers too—perhaps most prominently that of Alitalia in 2010. Hungary's national carrier, Malév Airlines, and Spain's Spanair S.A. in 2012.

Our analysis suggests that we may see a stratification of the European market, with short-haul routes dominated by low-cost specialists. European long-haul carriers will focus their short-haul operations on feeding their long-haul operations at a limited number of hubs. The rebranding of Lufthansa's non-Frankfurt and Munich flights to Germanwings and Iberia's use of Vueling seems to confirm this trend. This scenario could create more sharply focussed business models, optimised for short- or long-haul networks, and it could give a clear choice to air travellers.

We also think that things will need to change for European airlines that are still wholly and partially state-owned. Most of these have recently signalled that they are investigating options for privatisation or are searching for strategic investors. (See Figure 3.) This isn't surprising,

given that governments no longer have pockets deep enough to support airlines struggling with ongoing losses. While some potential investors have materialised, no real money has. That is in part because these airlines are not particularly differentiated in the eyes of passengers and other customers. As such, they are struggling to compete with the LCCs that are pushing into their airspace and the full-service offering coming from better-invested carriers.

European legislation prohibits government subsidies. This is making it harder for states to continue to fund ongoing losses. (Malév's demise came in part from the need to repay illegal state support following an EU ruling in 2011. Even if governments can find a way to support their flag carriers, sovereign funding constraints make continued support of loss-making, capital-intensive airlines fiscally and politically unpalatable.

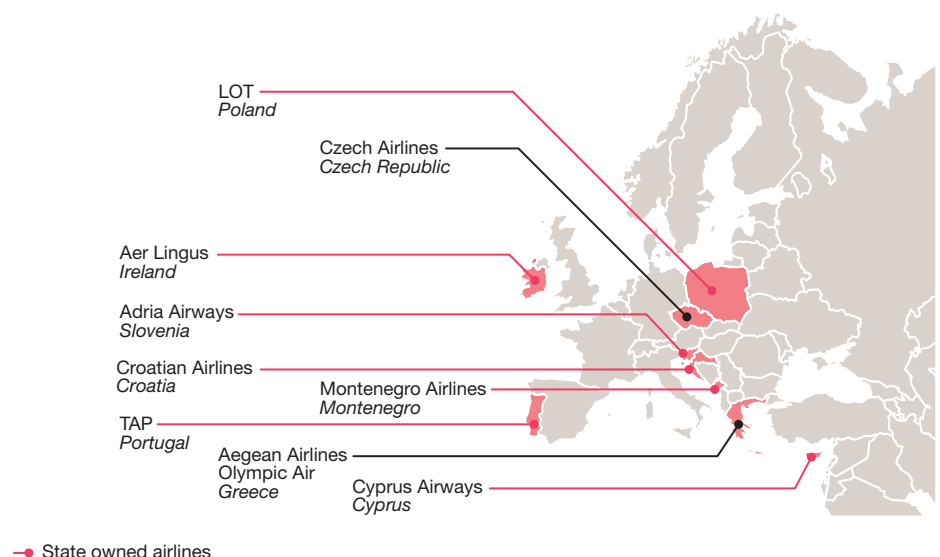
Airlines' responses

How can airlines best protect their future amid all the uncertainties they're facing? It is expected that they will have to adopt new management practices, redefine their market position and create unique offerings that will generate real strategic value for new investors. The following moves may help, and many airlines are already making them:

More extensive alliances and code sharing

Alliances and code shares can help airlines satisfy customer demands for global connectivity, often in tandem with joint sales and shared aircraft. We expect to see further participation in alliances and joint business arrangements in 2012 and beyond, as well as more competition between the big three alliances for new members. Though code-sharing agreements deliver limited cost synergies, they give participating airlines an

Figure 3: European airlines seeking investment



Source: PwC analysis

opportunity to “get to know each other better.” These agreements can thus serve as a precursor to a merger, acquisition or strategic investment that might be feasible if the regulatory landscape changes.

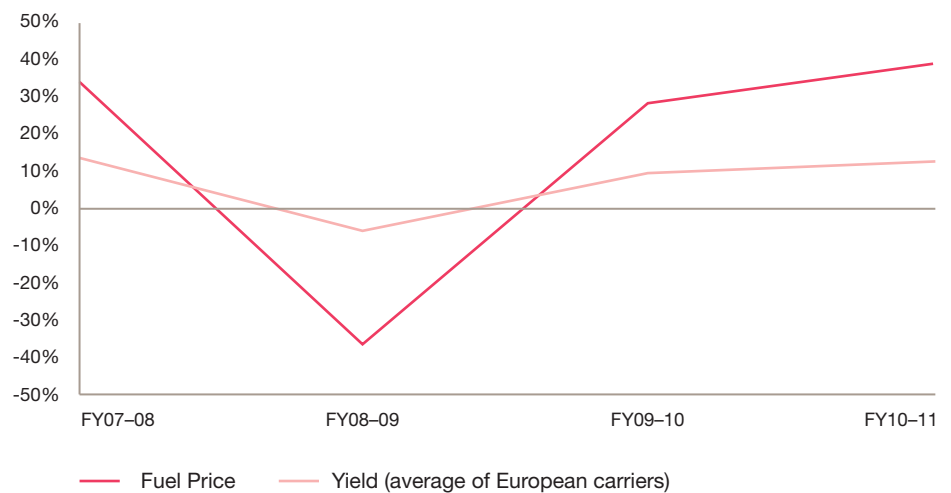
Longer-term cost control

The downturn in demand for air travel in 2009 and major increases in fuel prices since then have catalysed cost-reduction programmes across the airline sector. These efforts have mainly targeted non-fuel costs, such as catering and distribution fees. Airlines have presented a lot of these programmes as transformational and have reported the potential for significant savings to the market. For instance, Air France/KLM’s “Transform 2015” scheme is intended to generate an additional euro 1 billion of free cash flow by 2015. And Lufthansa’s “SCORE” programme promises to deliver euro 1.5 billion in improved earnings for the group by 2015.

Some programmes are more tactical than transformational. They consist mostly of low-value initiatives and one-off cost cuts, such as slashing marketing spend, reducing rates with existing suppliers and reducing staffing levels. The Air France programme does include sustainable changes relating to boosting workforce productivity, but it also stipulates pay and hiring freezes for the next couple of years, which will translate into only temporary savings. Such tweaks don’t lead to longer-term transformational change.

To drive more enduring change, an airline must reconfigure its operating model to extract greater efficiency from existing processes, make more sustainable improvements to profitability and cash flow, and motivate the right behaviours in a large, often highly unionised

Figure 4: % Change in yield vs % change in fuel price



Source: PwC analysis

workforce. It must also ensure effective execution of its change programmes. It can do this by establishing the right governance structures to realise the full range of benefits identified and by allocating sufficient resources to execute the initiatives throughout the organisation. Finally, the airline industry can leverage insights from other capital-intensive industries, such as automotive, on how to achieve long-term improvements in their cost bases and operating models.

Yield improvements to offset cost pressure

In 2011, the Indian aviation market learnt a hard lesson about the perils of chasing volume. For most of that year, Air India, the national carrier, pursued a volume-based strategy driven by aggressive yield discounting. That destroyed yields in the market at a time when oil prices were spiking and the rupee was depreciating against the US dollar. As a result, analysts expected the aviation market in India to deliver a loss of US\$2.5 billion in 2011, in large part driven by a decline in yield. Ongoing turbulence in the Indian airline market largely bears this out.

This situation underscores the importance of focusing on yield improvement to boost profitability, rather than using low prices to chase volume. Seat capacity constraint is starting to provide the right environment for yield improvement, and most airlines have made this a priority in recently announced restructuring plans. We are also seeing LCCs sharpening their focus on yield development. For instance, easyJet has targeted the business travel market, in part to improve yield. Meanwhile, Ryanair has reduced its capacity to focus attention on routes most profitable over the winter season, a move that increased yield by up to 14% over late 2011 and early 2012.

What led to these developments? With the spike in oil prices from November 2010 to February 2011, many airlines took the opportunity to increase their passenger fares or their airline fuel surcharges. These increases were not enough to fully offset the rises in fuel price. (See Figure 4.) Many airlines anticipated just a temporary spike in fuel prices coming from the Arab Spring, but oil prices have stayed

between US\$100 and US\$120 per barrel. Equally important, the average passenger isn't paying a fare sufficient to cover the cost of flying and to deliver a reasonable economic return to the airlines and their stakeholders. Raising fares further isn't palatable in the current economic environment. But it may be necessary to secure the industry's long-term future.

Airports: Under pressure to evolve

Changes in the airline industry's landscape have big implications for airports—which must plan their long-term investments around their major airline customers or alliances. Airports are vulnerable when their fortunes depend on a single airline that faces an uncertain future.

Impact of airline bankruptcies

Several airports, whose businesses had developed hand in hand with their national carrier, have discovered how risky that interdependence can be. Bankruptcy of an airline is a major problem for the hosting airport on several fronts. On the one hand, the airport may end up having to deal with masses of stranded passengers. In addition, an airport will often be left without coverage of operating cost as a result of bankruptcy protection. Airlines willing to pick up the void left by these airlines will most often have very different ideas of what they are willing to pay. For example, when Malév (Budapest) and Spanair (Barcelona) liquidated, competitors were waiting to fill the void, many of them armed with available spare capacity of their own. But these carriers' requirements, the networks they'll serve, and the depth of their pockets differ widely from those of the national hub carriers.

Italy's Milan Malpensa (MXP) faced a similar situation when Alitalia ceased hub operations in 2008 because of its deteriorating financial situation. LCCs snapped up much of the excess capacity, leaving the airport dependent on more financially aggressive players seeking discounts and incentives. While passenger numbers may return after such a situation occurs, it's often at the expense of reduced aeronautical yields.

not able to accommodate all of its operations into the single terminal—its operations have spread across three terminals. The demise of BMI has also affected the planning for Heathrow's new Terminal 2—which was envisaged as a Star Alliance hub, but now without that alliance's key domestic member.

A non-Europe example is the merger of TWA and American Airlines,

Airports' relationships with their key customers—airlines and passengers—need to change, because airports now have new competitors.

This scenario isn't new. For example, Brussels National Airport (BRU), formerly the ninth-busiest airport in Europe, dropped out of the Top 20 when Sabena went bankrupt in 2001. Traffic plummeted from 21.6 million passengers per annum (MPPA) in 2000 to just 14.4 MPPA in 2002 and then picked up only slowly, leaving the airport with a lot of excess capacity. The rapid growth of LCC business at Brussels South-Charleroi (CRL) and leakage of passengers to high-speed rail links worsened the financial damage inflicted on the airport.

Impact of airline M&A

Bankruptcy of a key airline is not the only potential pitfall for an airport that is striving to craft capital investment strategies. M&A moves among airlines can also disrupt airport operations. As a case in point, the building of Terminal 5 at Heathrow to house British Airways global operations is affected by the acquisition of BMI in April 2012. With this merger BA is now

which resulted in St. Louis losing its hub status and American Airlines reverting to an origin/destination (O&D) operation. An airport that had been built to handle 30 million passengers a year saw that number drop to 10 million, because 20 million passengers were being transferred through Chicago and Dallas rather than through St. Louis. This left St. Louis struggling for business despite its highly efficient airfield design—which had come with significant capital investment. The identical situation took place in Cincinnati when Delta pulled its hub after the merger with Northwest.

Wanted: a better business mindset

While European airlines have worked to adapt to their more competitive, dynamic market, airports have often been slower to adjust. On the whole, even as many European airports have embraced private investment, their mindset has remained within the public sector—often because

of enforced legacy arrangements, state controls and regulations. Some airports have been able to replace the traffic lost from the shrinking or closure of their traditional base carriers, as demonstrated by the Milan Malpensa example mentioned previously. But others, such as airports at Budapest and Athens, have struggled to regain the long-haul connections once provided by their home carriers. These airports are now at the mercy of LCCs who can drive a hard bargain, and they have to court Gulf carriers to provide some level of long-haul connectivity.

Today, airports must adjust to a new reality—one defined by cost pressures, revenue challenges and the need for better customer service. That calls for more of a business mindset than airports have traditionally demonstrated. The following tactics have been employed by some of the more successful players in the market.

Revisit the revenue model

Airports are seeking to shift the balance between aeronautical revenues and non-aeronautical revenues (retail, car parking, property) toward the more commercial sources. If an airline goes bankrupt, upends its operations or reconfigures a hub by pulling out of an unprofitable route, the airport may be able to recover traffic, but its yields will suffer as discounts and incentives kick in. The airport must increase its non-aeronautical take from each passenger just to stand still. It has to develop new products and services that provide value to passengers as well as to airlines. Many airports have begun offering premium services to passengers (such as lounges) as airlines have reduced services.

Foster new relationships with airline and passenger customers

Airports' relationships with their key customers—airlines and passengers—

need to evolve. Airports, like airlines, are now faced with market competitors, a concept that was once non-existent. Their previous monopoly position has come under threat, with airports often competing for the same passenger demographics owing to the opening of borders and improvements to surface transport links. For example, Ryanair has 30-plus bases in Europe and is not reliant on any single country market or base airport. If something unfavourable to its operations occurs in a particular airport—a national government raises taxes on airlines or an airport raises surcharges—Ryanair can pull its aircraft out of that location and move the fleet somewhere friendlier. Thus airlines that seem well entrenched at a particular airport one year may be gone the following year.

Passengers have more choices, too. Improved surface transport links give them access to alternative airports. And within Europe, passengers are increasingly crossing borders to get cheaper flights or better connectivity. Even the creation of the eurozone has increased competition by making it easier for passengers to compare pricing. In choosing which airports to use, passengers now consider not only price but also factors such as processing times, retail offerings and transport access, as well as connectivity and flight frequency. Thus, like airlines, passengers can be here today and gone tomorrow as airport customers.

All these issues imply that airports need to work harder to attract and keep their airline and passenger customers. One thing airport managers can remember is that in the aviation industry, no single airline or airport “owns” the passenger. Passengers' experiences are influenced from the moment they arrive at an airport to the moment they step off the plane at their final destination. Now more than ever, airlines and airports must work together to enhance passenger experience.

Airports can also link the business models they use to serve their two customer groups. For instance, if better merchandising strategies inspire travellers to spend more on retail while they're waiting for their flight, the airport may be able to lower the fees it charges airlines. These moves could keep airlines loyal and even attract new airlines to the airport, further increasing passenger traffic.

As such, some airports are involving their airline customers in terminal development—as design or even as financing partners. Munich and Frankfurt, for example, work closely with Lufthansa in new terminal developments. London Heathrow worked and is continuing to work very closely with British Airways. Such close cooperation allows a more seamless development of the passenger experience and should reduce operational costs for both parties. But it also places more risk on the airport operator. If the partner airline fails or changes its business model, the airport may be left with a white elephant.

Use data to understand customers

Instead of simply presenting services to their customers and expecting them to “take it or leave it,” airports must gather and analyse market data to understand the changing priorities of their airline customers as well as the shifting needs, preferences and demographics of their passenger customers. For example, by understanding what products and services passengers are consuming while waiting for their flights, an airport can develop better retail offerings. Similarly, data on passengers' preferences in surface access can generate insights for improving car-parking usage and yields.

Leverage outside expertise

Our analysis shows that airports have increasingly hired senior executives from customer-oriented industries, such as hospitality and retail, as well as from industrial operations to strengthen their management and operational performance. This process can be facilitated by new ownership. For instance, Global Infrastructure Partners has demonstrated innovation at its holdings at London City and Gatwick Airports, often by bringing expertise from its links with GE's stable of businesses. Fresh insights and innovation from such outside expertise can help airports adapt to their new market conditions.

Next steps

With the European airline landscape far more competitive today than it was 20 years ago, carriers are making bold moves to secure their future. These moves have presented new challenges to the airline sector. And just as competition has transformed the airline market, it will transform airports as well. Today, airports can no longer see themselves simply as transport infrastructure—they need to become sophisticated businesses if they hope to navigate successfully in the new landscape.

About the author: Anna Sargeant is a PwC aviation strategy professional based in London (anna.sargeant@uk.pwc.com, +44 (0) 20 7804 4127).

Key contact for Deals Strategy: Neil Hampson, Partner, PwC (neil.r.hampson@uk.pwc.com, +44 (0)20 780 49405).