Tailwinds report
2018 airline industry trends
Welcome to our 2018 Edition of Tailwinds

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The global airline industry is strong. 2017 was the third straight year of net profits exceeding $34 billion. The fastest global economic growth since 2010 helped the industry in 2017, as passengers and freight both set records.

These results helped global airline stocks surge: up 29% on average in 2017, far more than global markets as represented by the FTSE All World dollar index (+22%). European airline stocks were especially strong, up 68% on average.¹

Yet growing challenges are on the horizon. Oil and labor costs are rising. Competition remains fierce, and some carriers face structural challenges, as recent bankruptcies in Europe illustrate. In addition, airlines will have to position themselves carefully in a rapidly evolving scenario for distribution, as we’ll discuss in part two.

Currency movements partly explain this increase in Europe, as the euro rose against the dollar in 2017. Within the European market, the growth of low-cost and Middle Eastern carriers continued to pressure margins. But a strengthening Eurozone economy and strong passenger demand led to stronger-than-expected results, which booming stock market prices reflected.

Globally, 2017’s profits and profit margin were both better than expected. IATA (International Air Transport Association) in late 2016 predicted only $29.8 billion in net profit and a 4.1% net margin for 2017—more than 10% below the actual results.⁴ Revenue was the big positive surprise in 2017. It was $18 billion higher than forecasted, largely due to stronger than expected global GDP Growth: 3.0% instead of the 2.5% that IATA had predicted in late 2016.⁵

Yield was another bright spot. Cargo yield finally turned the corner, rising 5.0% last year after five years of decline. Although passenger yield had its sixth straight year of decline, it only fell 1.5% compared to the previous year’s -8.8%. IATA expects both cargo and passenger yield to improve in 2018: +4.0% and +3.0% respectively.

2017’s results are especially strong when viewed in historical context. Between 2006 and 2014, net profits never rose higher than $17.3 billion, and net profit margin never rose higher than 3.1%.
**Will same day delivery boost air freight?**

Air freight had an excellent 2017. Industry-wide freight ton kilometers (FTKs) rose 9.0%, up from 3.6% in 2016 and the fastest growth since 2010. It was also three times greater than the growth in capacity. Strong global GDP growth, trade growth, and still-reasonable fuel prices all supported a good year. Yet IATA expects the growth in FTK to moderate in 2018 to 4.5%, and concerns are growing about a possible trade war.

For long-term growth in cargo, one key question is: will the growth in e-commerce, with its frequent promise of next or same-day delivery, cause a secular boost in air freight?

PwC’s consumer markets analysts see some short-term pressure for retailers to increase their use of air freight but, over the medium term, a different scenario is possible. Improvements in predictive analytics and a likely growth in network density may enable retailers to position more inventory close to the consumer before the purchase takes place. As a result, the need for air freight to achieve rapid delivery may diminish.

If e-commerce continues to grow, then air freight could continue to grow in volume even if its share of e-commerce delivery falls. But carriers should not count on e-commerce to drive secular growth in air freight.
Costs are rising

The biggest reason why profits moderated in 2017 was costs, which rose faster (+7.3%) than revenue (+6.3%.) Most airlines can’t blame fuel prices for this rise. Prices were up—jet kerosene averaged $65.60/barrel in 2017, compared to $52.10/barrel in 2016—but the industry’s overall fuel costs actually dropped to $130 billion in 2017 from $132 billion in 2016. Hedging contracts helped some airlines. More efficient aircraft helped others.

Non-fuel costs surged nearly 10% in 2017, to $561 billion. Labor costs are rising especially quickly. They are expected to account for over 30% of global airline costs in 2018, while fuel costs should only be about 20%. But as hedges roll off next year, fuel costs could hit industry profits if prices continue to rise.

If global economic growth and airline revenues continue to rise as we expect, rising costs won’t prevent rising profits. But they are a sign that the industry must plan for a more efficient future.

The disruption in Asia: low-cost and mainland Chinese carriers

The Asia Pacific region had a healthy $8.3 billion in profit in 2017, up from $8.1 billion in 2016, and IATA forecasts $9 billion in profit for the region in 2018. Yet beneath this region-wide prosperity are pockets of severe turbulence.

Several major Asian airlines are undergoing restructuring. The reasons vary, but two trends are significant across the region: the growth in low-cost carriers and the aggressive expansion of mainland Chinese airlines.

Low-cost carriers aren’t new to Asia, but legacy carriers have had mixed results in responding to this growing competitive threat. Many have chosen to compete head-on in pricing, pressuring yield, but cost structures have often proven hard to cut, compressing margins. Some carriers have also been slow to unbundle fares, thus failing to grow ancillary revenue streams that have become so fundamental for European and North American airlines. Several Asian legacy carriers have set up low cost subsidiaries, but in some cases these are cannibalizing existing revenue.

Mainland Chinese carriers are offering more direct routes to other parts of Asia as well as to Europe, Australia, and North America; they are also including many second-tier Chinese cities in their growing long-haul networks. This will result in more competition and pressure on yield for several Asian routes, as well as more traffic bypassing established hubs.

For now, economic growth and the uptick in cargo are enabling strong regional profits. But challenges are intense and Asian airlines will have to increase efficiency and consider new strategies for distribution (see part two) in order to thrive in the years to come.
Amid the current prosperity, the industry has for the most part shown discipline and not overexpanded. Capacity grew a reasonable 5.4% in 2017. That’s down from 2016’s capacity growth rate of 6.4%. It’s also lower than the growth in passenger traffic (7.5%) and cargo (9.3%).

Will this discipline continue? Investors appear on edge about the possibility for overcapacity in a traditionally cyclical industry. Markets reacted negatively to several recent announcements of major capacity growth. This reaction may have some justification: previous PwC research has shown that when the US airline industry’s capacity grows faster than GDP, RASM (revenue per available seat mile) growth usually slows.¹⁰

With global growth strong, capacity growth moderate, and fuel prices still reasonable, the airline industry’s near-term prospects are strong. But carriers should use the good times to prepare for a challenging future. The current economic upswing has lasted nearly nine years, dating from its start in the US in June 2009. It won’t last forever. Fuel prices are also hard to predict. Sudden spikes are always possible.

Despite these uncertainties, the industry can know several things for certain about its future. One is that new competitors will appear, as they always have. The other is that digital disruption will spread further in the airline industry, as it is doing in every sector of the economy.

The successful airlines of tomorrow will be those who stay ahead of global trends and invest in a digital future today. We’ll provide some guidelines for how distribution can play a role in that future in part two.
Airline distribution is in flux. Both business and leisure travelers, accustomed to seamless and personalized purchase experiences from the digital retail giants, increasingly expect the same when they shop for and purchase travel. This expectation is raising the bar for airline distribution—and it is raising costs for airlines as they compete for bookings.

If costs are rising, so are the benefits of success: a richer retail experience offers the potential to de-commoditize, build new revenue streams, and get the most out of existing ones. At the heart of these new benefits is the increasing value of the data that the relationship with the customer can provide.

With both competition and possibilities for value generation rising, many carriers will have to revisit distribution strategies. New technologies, more accurate insights into costs, and enhanced capacities to measure and leverage the value of data will all support success in this rapidly evolving marketplace.

Data’s new value

Data is often called the “new oil” for a reason: it can power dramatic cost cuts and more revenue in many industries, including air travel. Advances in analytics now enable carriers to mine data from distribution for cross-selling, customization, and more effective dynamic ticket pricing, among many other benefits.

Carriers that invest in owning this data, and in the top-notch analytics needed to mine it, could do as digital leaders in the retail sector do: anticipate customer desires and their willingness to pay with astounding precision. They could also track the effectiveness of nearly every offer and decision—from marketing to pricing to partnerships—throughout the value chain.

Some carriers have been slow to understand data’s full value, but the major online travel agencies (OTAs), along with the search and metasearch players, haven’t been as passive. These digital natives haven’t stopped at developing frictionless, appealing user interfaces. More importantly, resources to acquiring data and developing the analytics—increasingly based on artificial intelligence—to make sense of it all.

Keeping ownership of the data and complex tools to analyze it are expensive undertakings. It can even be challenging to accurately measure these costs.
What’s the real cost?

It’s easy to measure one cost of indirect booking: the intermediary’s fee. Additional costs are likely on their way—both for fees and technology—related to IATA’s New Distribution Capability (NDC) and ONE Order initiatives, which we’ll discuss in detail below.

Another cost of indirect distribution is tricky to measure, although it’s vital to do so: the cost of losing full ownership over customer data. Accurately measuring data’s value, with new techniques and metrics that are now available, may help airlines develop better strategies for partnerships with OTAs and other intermediaries.

Direct bookings’ real total cost to airlines is also complex, with many elements that are easy to overlook. Besides the expense of building a competitive front end to both acquire and convert traffic—the frictionless retail experience that customers prefer doesn’t come cheap—carriers that decide to grow direct bookings aggressively will also need to invest in:

- **People.** Competing in digital distribution requires talented engineers, developers, and data scientists. Acquiring and servicing more direct customers also requires greater capabilities in marketing, customer service, and back office administration.

- **Technology.** Carriers will need technology for more than just creating an appealing digital front end. They’ll also need more robust enterprise architecture, seamless payment systems, and the right third party providers to help service and operate it all.

- **Processes.** Bookings in a direct digital environment will require enhanced capabilities in data governance, cybersecurity, privacy, and fraud prevention; more robust mid- and back-office reporting systems; new processes to connect IT with the business; and new metrics that account for data’s true value.

To get business travelers to book direct, carriers face further costs. Examples include processes to apply corporate travel policy parameters at the point of sale, and application programming interfaces (APIs), to provide data for expense management and corporations’ duty of care.

Further costs are on the horizon, as digital competition is likely to intensify. Customer expectations do not sit still. The OTAs and other intermediaries, many of whom have deep pockets, will continue to invest and improve their own digital offerings and data analytics. It will cost money for carriers to keep up.

It’s crucial for carriers to achieve a realistic, complete understanding of all the costs involved in all distribution channels. Only then can they make suitable decisions about how best to utilize their strengths—of which they have many.
How airlines can win direct bookings

Most major airlines have three big advantages when they seek to grow their direct bookings: a pool of loyal customers, often members of frequent flyer programs; infrastructure such as call centers to provide post-sales care (which OTAs often lack); and a brand that inspires trust, especially in carriers’ home markets.

An effective direct booking strategy starts with identifying these loyal customers, who trust the airline brand and value post-sales service. The carrier can then use advances in data analytics to determine both the cost and the value of maintaining or bringing these customers inside the airline’s own booking channel.

With data analytics, it’s possible to pinpoint the most profitable customers for direct bookings. One customer may be a big spender across the board. Another may be price conscious when shopping for a ticket, but likely to make a high margin last minute ancillary purchase.

This pinpoint marketing and rigorous cost analysis will become even more important if carriers seek to go beyond their existing, loyal direct customers to win new ones to their direct booking channels. For travelers who simply want the lowest price and rarely purchase ancillary products, many carriers—after accounting for all the direct and indirect costs of acquiring and servicing this customer—may find it more profitable to let intermediaries do the bookings.

Airlines should also consider strengthening their digital brands in a privacy-wary world. The companies in the news for aggressively marketing user data are almost all digital natives—not legacy organizations such as airlines. Carriers that effectively establish robust data privacy standards for their direct booking environments, and publicize these standards in language easy for customers to understand, may find a competitive edge.
New tools to do indirect better

While many airline leaders dream of a world where all customers come direct to them, this may not be realistic or even advisable for most. Travel management companies (TMCs), OTAs, and other intermediaries offer real value. When airlines look at the full costs of direct bookings, this value will likely be even more apparent.

Airlines could draw more value out of partnerships than they currently have, and here IATA’s NDC and ONE Order initiatives may have a role to play. Using APIs to connect airlines and travel agencies, NDC offers airlines greater access to data, and the ability to enable full and transparent shopping of all their goods and services on intermediaries.

ONE Order aims to modernize airline order management by creating a single customer order record that will replace multiple reservation records, including the Passenger Name Record (PNR), e-tickets, and the electronic miscellaneous document (EMD) which contains purchase information on ancillary services such as lounge access or seat upgrades.

Together they could both enhance and simplify indirect distribution.

With NDC already operational, and ONE Order expected to go live in 2019, here are some indirect booking strategies for carriers to consider:

1. **Build richer content** in the global distribution systems (GDSs). Adding more content to GDSs, as NDC can facilitate, could drive more revenue, establish consistent content across distribution channels, and strengthen the brand.

2. **Improve information transfer** between OTAs/TMCs and carriers. Better collaboration with OTAs, as ONE Order supports, on everything from checking in to loyalty program numbers and seating requests will make the customer experience more seamless.

3. **Cooperate on add-ons and amenities.** With NDC, carriers have an easier path to sell ancillaries in cooperation with OTAs and other intermediaries.

4. **Forge deeper partnerships** with digital natives. For some carriers—especially those without deep pools of loyal customers—it may make sense to let the OTAs do most of their distribution. Airlines equipped with accurate insights into distribution’s costs and data’s value could secure favorable terms, especially if they are first movers.

**Will NDC and ONE Order take off?**

NDC and ONE Order are powerful tools. But fees and implementation costs are high, and both initiatives are voluntary. NDC also has varying levels of certification and capability, with different costs. Supplier organizations therefore won’t all invest at the same level and pace, so even different NDC-certified airline platforms could look and act differently.

The result is that, unless a carrier’s alliance partners, suppliers, agents, aggregators, and IT providers are all also participating to the same extent at the same time, an NDC investment may not provide its full possible benefits.

ONE Order faces a similar challenge: if a given itinerary has multiple suppliers, these suppliers will be part of ONE Order’s single passenger record only if they too participate.

NDC and ONE Order are one possible answer to customers’ demand for a better retail experience. But airlines’ pace of adopting these new tools must be a careful strategic choice that looks not only at their own needs and priorities, but also at those of all their partners.
Questions to answer before proceeding

Every airline will have a unique strategy for distribution. To help determine and implement that strategy, leaders should think carefully about these three strategic questions:

• **Where do we want to play?** Develop a clear understanding of your position today in the evolving travel distribution ecosystem, with a look at competitors, channel partners, alliance partners, and customers. Then decide, based on rigorous data analysis and a long-term strategic roadmap, the role you want to play tomorrow.

• **Where is our “right to win”?** Determine three to six capabilities in which to invest in order to win in a digital, data-driven travel distribution ecosystem. These capabilities should differentiate the carrier and build competitive advantages in your chosen role for tomorrow. Determine which non-differentiating capabilities to dial back, outsource or eliminate.

• **How can we get the most out of partnerships?** Strategic partnerships with OTAs, TMCs, and others can maximize revenue, minimize costs, and provide greater ownership of data and the customer experience. Investments in NDC and ONE Order will offer maximum benefits only if a carrier fully invests and coordinates adoption with its alliance partners and suppliers.

To support these strategic decisions, carriers also need to pay extra attention to two tactical questions:

• **What are our true channel costs?** Move beyond easily quantifiable, direct costs and look more holistically at the distribution channels. Be sure to include a) the cost to acquire customers and b) the cost of investing in the internal capabilities that you’ll need to deliver against your chosen strategy.

• **What’s the value of the data?** Carriers must fully understand the value of the traveler data that distribution creates in order to make strategic decisions. That requires understanding and quantifying all the possibilities that come from “owning” the customer, including (but not limited to) personalized offerings, cross-selling, and precision pricing.

The future of the airline industry itself

Airline customers increasingly want a frictionless, seamless shopping experience that gives them expansive yet personalized offerings. Meeting these rising expectations requires new technologies and capabilities—and therefore new costs. Digital distribution also offers powerful new opportunities to win customers and draw value from the data that distribution creates.

To determine the best strategy for this rapidly evolving scenario, carriers will need to apply rigorous cost/benefit analyses which outline both direct and indirect costs of every channel, and which quantify the value of data.

The results of these analyses will help indicate a unique strategy for each carrier. This strategy will define their position in the distribution ecosystem, the specific capabilities in which the carrier should invest, and an approach to partnerships to help deliver the rest.

Such a strategy will require agility: to build new partnerships, renegotiate old ones, and pilot new technologies and approaches. With industry profits high, the time is ripe to invest not just in products, technology, and talent, but also in the culture and processes that this agility requires.

In 2016, IATA wrote, “The future of airline distribution is, to a great degree, the commercial future of the airline industry itself.” Carriers who want to thrive in that future should start rethinking their distribution strategies today.
Endnotes
4  http://www.iata.org/pressroom/pr/Pages/2016-12-08-01.aspx
6  IATA, Air Freight Market Analysis, December 2017
7  IATA, Air Freight Market Analysis, February 2018
8  http://www.iata.org/pressroom/pr/Pages/2017-12-05-01.aspx
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