TENEO - Consulting

European Aviation Perspective

Confronting the brutal facts

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An introduction to Teneo

Who We Are

Teneo is the global CEO advisory firm. Working exclusively with the CEOs and senior executives of the world's leading companies, Teneo provides strategic counsel across their full range of key objectives and issues. Our clients include a significant number of the Fortune 100 and FTSE 100, as well as other global corporations.

Integrating the disciplines of strategic communications, investor relations, digital advisory, diversity & inclusion, management consulting, physical & cyber risk advisory, financial advisory, corporate governance advisory, political risk advisory, and talent advisory, Teneo solves for the most complex business challenges and opportunities.

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Fredrik is an accomplished strategy development and corporate finance executive with experience across the aviation industry, strategy consulting and corporate finance advisory. He has in-depth expertise in the aviation sector and particular expertise in the European aviation market. Fredrik has a proven track record of delivering effective and sustainable commercial solutions with material financial benefits and substantial added shareholder value.

European aviation perspective – "Confronting the brutal facts"

The financial health of the European aviation sector has improved markedly over the last five years. But it is a handful of large airlines that have disproportionately benefited. Many airlines struggle to generate adequate financial returns and several have failed recently. As competition intensifies, airlines need to objectively assess their positions and ability to successfully compete. This applies in particular to weaker and smaller airlines. Failing to "confront the brutal facts", and subsequently failing to take action, will likely lead to further collapses.

On 23rd September 2019, Thomas Cook announced it had ceased trading after failing to secure required funding. Other recent failures in the European aviation sector include Monarch, Air Berlin, Aigle Azur, Germania and Primera Air. Alitalia remains in administration after more than two years, and Flybe's equity value was almost wiped out in a distressed sales process. In this paper we review the driving factors of these failures and conclude that airlines could have done better if they applied a more rigorous, fact-based approach to their strategic plans, and had acted more swiftly to avoid failing.

The stronger are getting stronger…

The European aviation market remains fragmented, but “the Big Five”: Lufthansa Group, Ryanair, IAG, easyJet and Air France-KLM have increased their market share of intra-European seat capacity to 54%. The consolidation is an outcome of above-market growth, both organic and inorganic, but also from failed airlines exiting the market. The scale of the largest airlines provides them with the ability to compete more effectively and capture a larger share of the economic profit pool. The advantages come from larger and more concentrated network positions, better brand awareness, cost benefits from increased negotiation power and scale, which combined lead to better capitalised balance sheets.

Figure 1: LCC share of intra-European capacity by seats, 2019

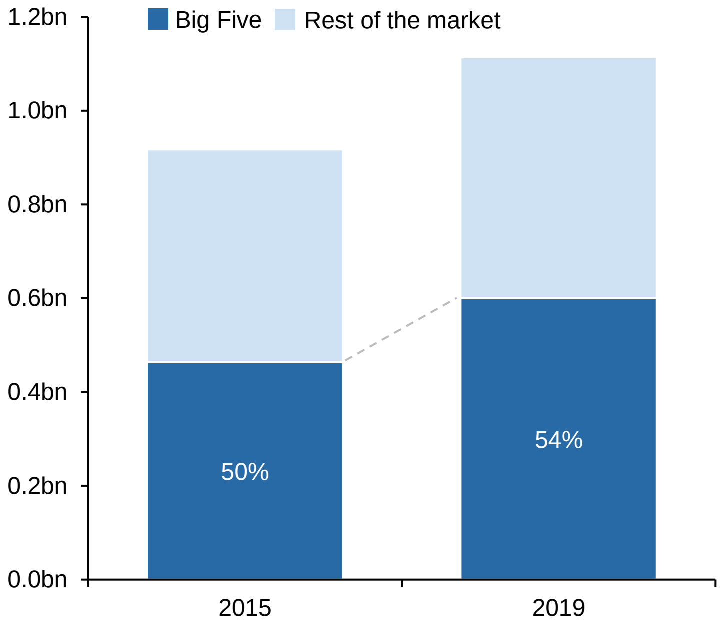
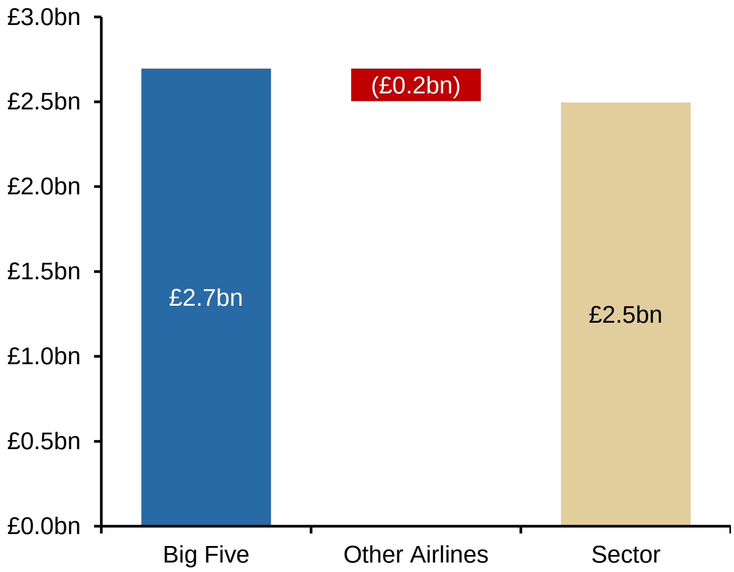


Figure 2: Change in Economic profit (GBP bn), 2013 v 2018



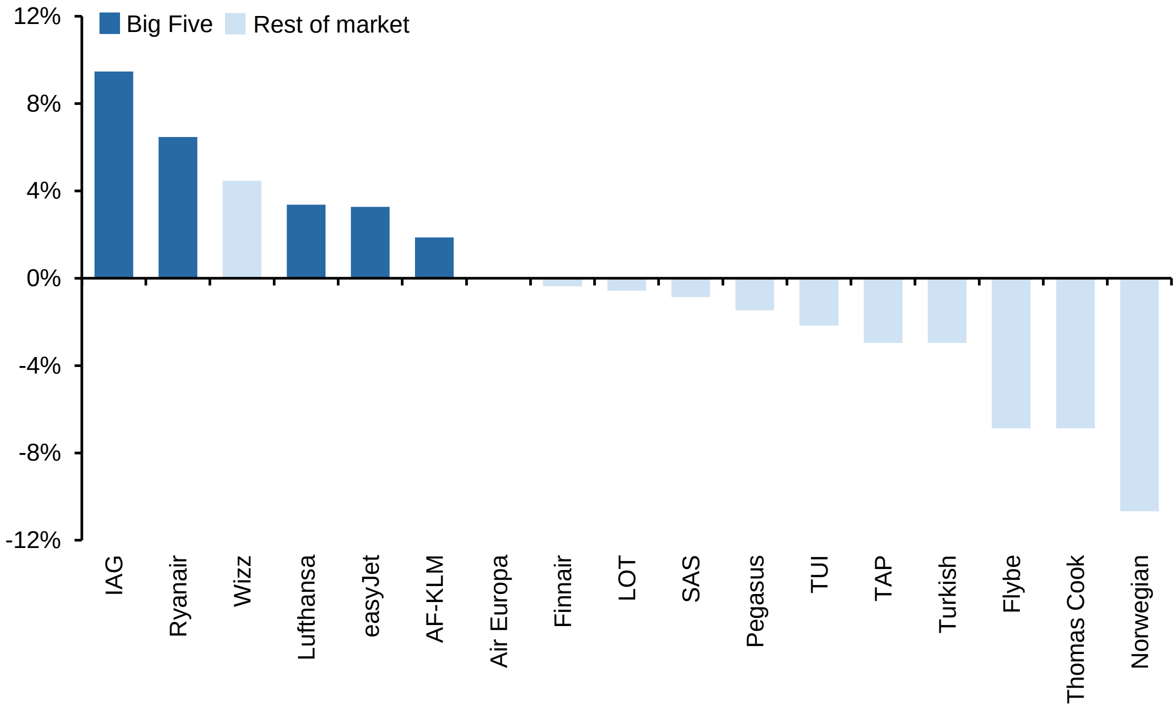
The financial health of the European airline sector has materially improved over the last five years[1]. We have used Economic Profit[2] to measure the sector profitability. The metric captures the implied cost of assets (e.g. aircraft) and is therefore better aligned with shareholder returns than with accounting profits. Between 2013 and 2018, the sector’s accumulated Economic Profits increased by GBP 2.5bn. However, £2.7bn of the improvement was generated by the Big Five airlines despite only representing c. 50% of intra-European capacity.

[1] Based on a sample of 22 European airlines, representing c. 85% of total intra-European capacity.

[2] Economic Profit is defined as (ROCE – WACC) * Invested capital. Where ROCE is Return on Capital Employed, and WACC is Weighted Average Cost of Capital, i.e. the average blended cost of debt and equity.

The Big Five airlines generate superior economic profits by a combination of larger asset bases and higher Returns on Capital Employed (ROCE). Wizz is the only airline outside of the Big Five that generates upper quartile ROCE. Several airlines generate returns on capital below their cost of capital (WACC) and therefore destroy economic value.

Figure 3: Excess returns on capital (ROCE – WACC), 2018



…which puts further pressure on weaker airlines

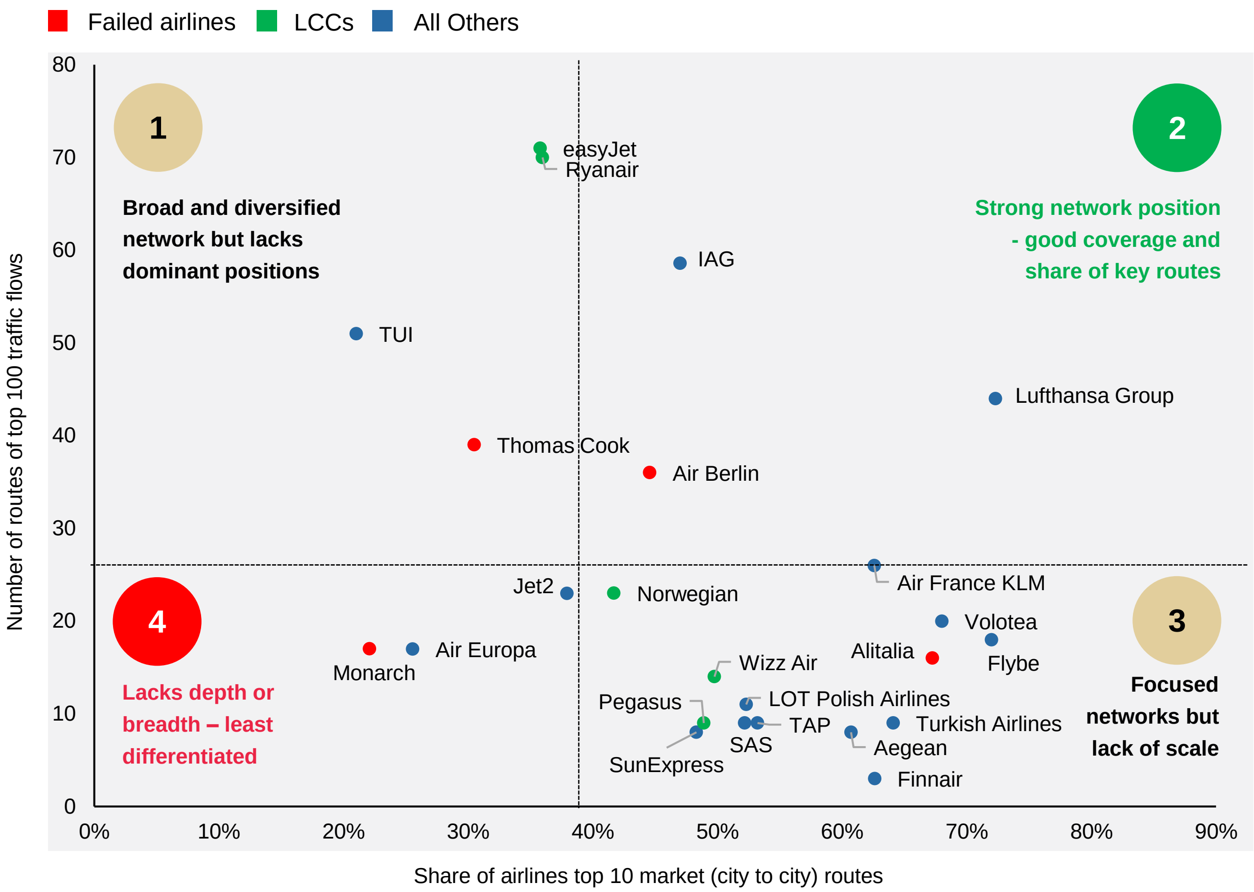
Our analysis of the recent failures highlights the need for a clear strategy with relative competitive advantages across network, unit cost position and balance sheet strength. This is a simplified approach as brand, customer proposition and revenue model also can create differentiation. However, our simplified model focussed on core factors still helps to explain most failures:

A. Strong network position: A strong network position drives customer awareness and offers a more comprehensive schedule. Airlines can thereby capture a disproportionate share of the profit pool and enjoy increased entry barriers. A review of capacity allocations and market share reveal that many airlines lack scale to differentiate their network, often operating too many thin routes out of highly competitive hubs. Without a distinctive network, these airlines must rely on other differentiating factors to compete effectively.

Figure 4 below illustrates the network characteristics across (a) the average market share of the top 10 routes to illustrate network depth and (b) presence on top country flows to illustrate breadth. Similar analysis can also be done at airport level or city level, but we have used routes and country flows in this example.

Starting clockwise from the top left quadrant (1), Ryanair and easyJet operate pan-European networks where they target thick routes operated by Full Service Carriers (FSCs). They rarely have more than 50% share of any route (or city). IAG, Lufthansa and AF-KLM achieve a high market share from strong positions at home hubs but have less diversified networks (2). Then there are the regionally-focused airlines, with solid market shares across thinner routes and smaller network footprint (3). Finally, in the bottom left quadrant, there are airlines with below median depth and breadth (4). Monarch, which was the largest UK airline collapse when it failed in September 2016, occupies this quadrant. Its undifferentiated network position, lacking scale vs other UK airlines, heavily contributed to the airline's failure. Ironically, the slots that Monarch were unable to generate profits from were subsequently sold at significant prices to competitors keen to reinforce their network positions.

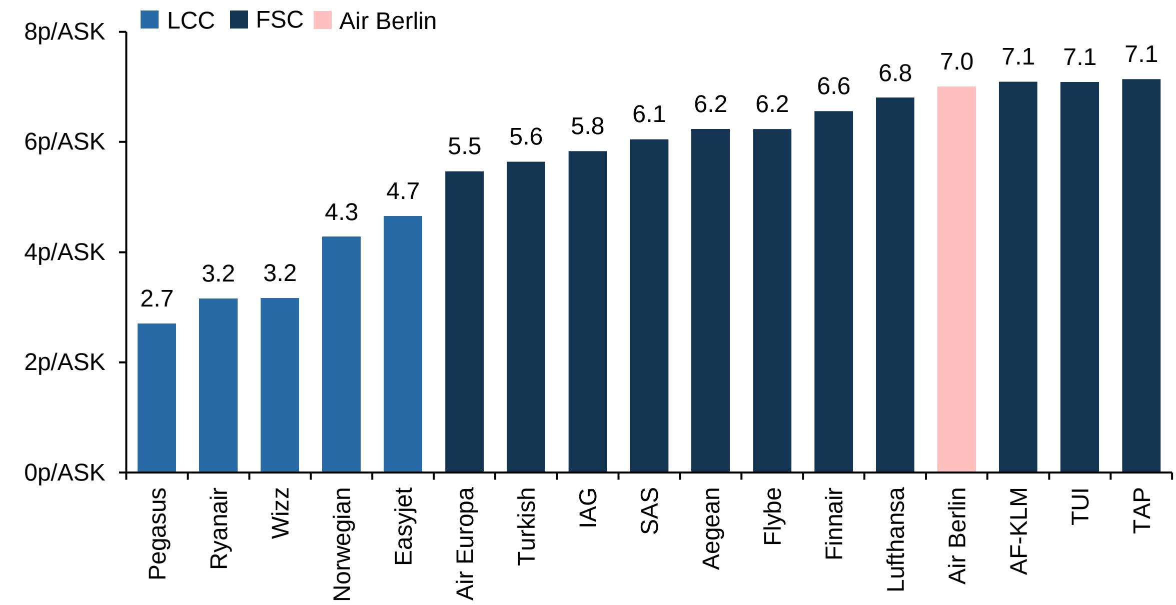
Figure 4: Number of routes on top 100 traffic flows vs share on top 10 market routes, intra-European



B. Cost is critical: Unsurprisingly, cost is another important competitive factor. In particular, on short haul flights where product offerings are increasingly similar and commoditised. Operating newer, larger, harmonized fleets with high seat density and utilisation rates helps to achieve lower unit costs. Efficient processes with high productivity and lean overhead structures also count. Passengers are willing to pay a premium for certain differentiating offerings, e.g. conveniently located primary airports. But passengers are not willing to pay for costs incurred though airline inefficiencies.

The chart below shows that there is large gap between the most cost efficient LCCs (Low Cost Carriers) and higher cost FSCs (Full Service Carriers). The LCCs are positioned well below the FCS airlines.

Figure 5: Stage length adjusted CASK, 2018



RASK – CASK[3]	0.3	0.4	0.4	0.3	0.4	0.3	0.5	0.9	0.3	0.6	0.1	0.2	1.0	0.6	0.5	0.1	0.3

Air Berlin, which failed in 2017, positioned itself as a low-cost airline despite having a cost position more similar to a FSC. The high cost base was a leading driver of failure. Some airlines in the upper end of the cost curve are able to generate revenue premiums to offset the cost disadvantage, but this requires the ability to differentiate. Not all airlines have this ability.

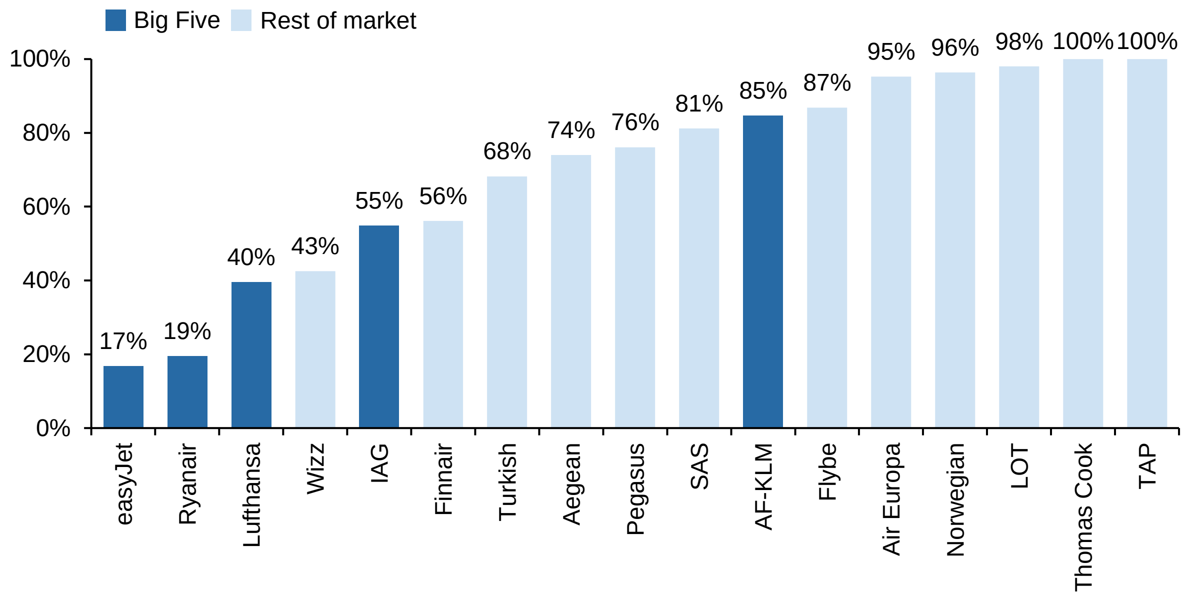
C. Financial strength and flexibility: Industries with high operating leverage should, in theory, target lower financial leverage. Despite a highly volatile environment, several airlines operate with inadequate cash levels and too high gearing. A weak balance sheet position is the result of poor profit and cash flow generation and not a deliberate choice. But it highlights the need to take action, and indeed avoid getting into a position of financial distress in the first place. Unfavourable FX movements, fuel prices or lower demand as passengers opt for "staycations" are difficult to predict but occur frequently. Thomas Cook mentioned weaker sterling and impact from heatwaves as contributing factors to its demise. But in a volatile sector, buffers are required to withstand these types of events.

Figure 6 shows the gearing[4] ratio and cash holdings for a number of European airlines. Again, with the exception of Air France – KLM, the big five have the strongest balance sheets. Several airlines operate with gearing levels that are too high. Norwegian has recently taken action to improve its balance sheet but remains at unsustainable gearing levels. Thomas Cook was unable to recapitalise its weak balance sheet and subsequently ceased to operate.

[3] CASK: Cost per Available Seat Kilometre. Adjustment factor applied to normalise for different average sector lengths.

[4] Gearing calculated as (Net Debt + Capitalised operating leases) / Capital Employed. 100% gearing implies zero or negative equity.

Figure 6: Gearing ratio, 2018



	easyJet	Ryanair	Lufthansa	Wizz	IAG	Finnair	Turkish	Aegean	Pegasus	SAS	AF-KLM	Flybe	Air Europa	Norwegian	LOT	Thomas Cook	TAP
Net cash as a % of revenue	23	41	9	57	26	37	17	22	33	22	14	12	11	5	14	7	7

Confronting the facts to develop a viable strategic plan

The book "Good to Great"[5] identifies six common factors that are critical for companies to become successful. One of these factors is to “confront the brutal facts”, i.e. to have the discipline to unemotionally confront the facts of the current reality, even when facing adversity. Based on these facts, companies then need to take actions which often require bold moves to transform the businesses. Failing airlines have consistently been unable to confront the facts.

Admittedly, there is no crystal ball to perfectly predict the future. But there is no shortage of data to make informed decisions in aviation. Fleet orders and GDP forecasts can be used to predict capacity and demand outlook. Customer demand can be further modelled based on granular segmentation and using data (including mobile phone data) to track travel patterns. Competitors’ network developments are possible to predict from current and past behaviour. For example, easyJet announced its intention of growing in regional France before subsequently opening bases in Bordeaux and Nantes. The LCC airlines have a history of predatory behaviour targeting weaker carriers. It was hardly a coincidence that both Ryanair and easyJet made significant investments in Berlin, home of Air Berlin, rather than Munich, a Lufthansa hub. But the FSCs also display predictable patterns of competitive responses.

From a cost perspective, data is available to model relative cost position and profitability vs competitors down to route level. Announced fleet plans and crew deals can be used to predict how relative cost advantages will evolve over time.

[5] Collins, Jim. *Good to Great: Why Some Companies Make the Leap... and Others Don't.* William Collins, 2001.

Exhibit - Confronting the brutal facts – Illustrative questions to address

Network position	• Do we have sufficient scale in our main network points and routes? • Are these network points serving sufficiently large and rich catchment areas? • What is the threat of competitive incursion from LCCs on point to point traffic, or FCSs to target increased feeder traffic?
Cost base	• Is our cost base sufficiently low to compete with current and future competitors? • Do we have control over the cost trajectory to ensure we remain competitive?
Financial flexibility	• Do we deliver ROCE and cash flow to meet targets and maintain a strong balance sheet? • Do we have financial flexibility to withstand external shocks, and make required investments in fleet and other areas to maintain competitive?

And finally, the airlines can assess their financial strength including projected ROCE, cash flows and financing requirements as part of their five-year plan. Building a robust financial plan, leveraging all available data and understanding sensitivities, is critical. It could be tempting to make assumptions of revenue gains to offset cost inflation or play down the threat of competitive incursion, but the plans need to reflect reality even if the facts are harsh. Importantly, the plans do not only need to incorporate external factors, but also capture internal challenges including resource constraints and discipline to execute the plan.

Yet, airlines often fail to develop robust and executable strategic plans. For example, Air Berlin announced its last of several restructuring plans called "New Air Berlin" in September 2016 before going into administration in August 2017. Alitalia received board approval for their last plan in March 2017 and entered into administration only two months later. Common themes in these plans are that they understate the level of competition and overstate the ability to transform network, cost position and financial trajectory. They did not 'confront the brutal facts'.

If a realistic and executable strategic plan cannot be developed to allow the airline to successfully operate independently, there is value from proactively reviewing strategic options to seek partnerships or a buyer. However, airlines often fail to take this action before it is too late, so end up destroying shareholder value, disrupting customers and impacting employees.

In March 2018, Stobart walked away from strategic discussions with Flybe. Flybe's board stated that it "remains highly confident in the prospects of Flybe and believes that the Group continues to have an exciting future as an independent company". Having been valued at close to £200m in 2015, any potential offer would likely appear low compared to Flybe's then market cap of c. £80m. However, as Flybe's performance deteriorated the company was sold for only £2.2m less than 12 months later. Anchoring expectations at historical values is emotional, not rational. Valuations are based on current performance and, importantly, expected future performance, not past performance.

In the competitive aviation market, confronting the brutal facts and acting on these will be critical to ensuring a long-term sustainable, and profitable, position. Our analysis shows that it is possible to capture value in the airline sector, but that only a handful of airlines are able do so. In an increasingly competitive sector, weaker carriers will continue to fail unless they act swiftly and purposefully.

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