Responding to COVID-19 | The Aviation Industry

"Too Big to Fail" – Six themes from the financial crisis of 2008 that are relevant to the airline sector

Aviation is experiencing an existential challenge. The situation is worse than any other recent sector recession or shock. It is uncertain how long airlines can survive an extended period of near complete grounding of their fleets, that creates an acute liquidity shortage. The collapse of the airline business model is akin to the situation banks faced in 2008. While the causes of the respective crises were different, we see some common themes based on Teneo's work with banking clients, that apply to the airline sector.

What COVID-19 means for aviation – Six keys themes

Themes	***Lessons from 2008***	***Relevance to aviation***
Too big to fail	• During the financial crisis of 2008, the banks were regarded as "too big to fail" • A broad collapse of the banking sector would have had such an impact on both local and global economies that governments were "forced" to step in and support the sector; the cost of failure was simply too high	• Aviation contributed an estimated $2.7 trillion to the world economic activity in 2019 and is one of the only options available for international travel (be it business, family or leisure), particularly over long distance • **Are airlines too big to fail? Yes.** A broad failure of the airline sector would have severe implications on global connectivity and economic growth prospects • However, this does not mean that every airline will be bailed out, but only that a critical level of airline capacity will be protected
Catalyst for sector consolidation	• The banking market consolidated through three main types of events: – Stronger positioned banks acquiring weaker competitors (e.g. BofA / Merrill Lynch) – Collapse of banks (Bear Sterns) – Government facilitated mergers of bailed out banks (e.g. Lloyds and HBOS)	• A similar scenario can play out in the aviation sector – Stronger airlines, including those who can secure early funding, can take advantage of their position to acquire weaker competitors – Weaker airlines that are not bailed out might not survive an extended crisis – Countries with bailed out airlines can facilitate mergers to create a stronger combined entity
New capital inflow	• The financial crisis saw new forms of investments, and investors, to explore the discounted asset values • PIPEs (Private Investment in Public Equity) allowed private equity to take stakes in public companies • The distressed debt market also attracted capital into bond valued below par	• Airlines might have to explore new sources of capital to avoid dependency on state aid, with this capital likely to be more expensive as lenders re-evaluate the risk profile of the sector • Funding from lessors or commercial lenders will become restricted as profits decline and credit ratings are downgraded • Alternative sources of capital, including private equity, could be deployed in a higher risk environment, seeking to capitalise on potential large upsides when the sector recovers

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Conditions for state aid	• State aid to banks came with conditions to prevent a similar crisis recurring, including higher levels of regulation • Governments also imposed measures in line with the public's perceived 'social contract' for the bail out, such as a 50% 'banker bonus' tax introduced in the UK in 2009 to prevent the impression that bankers had profited from public money	• Governments may attach conditions to bail out deal for airlines, such as: – Forcing airlines to meet sustainability targets, and potentially implementing a policy to reduce levels of unnecessary air travel – Focus network development on domestic connectivity rather than building more extensive international networks
End of 'cheap' capital	• Leading up to the crisis, the banks had offered capital and other products at low interest rates • The crisis demonstrated that the banks had under-priced the risks • Subsequently, the banks had to be more restrictive with their balance sheets and hold larger equity buffers that increased prices	• Airline passengers have benefited from declining fares after years of increased market capacity and extended networks • Relatively low funding costs have allowed new low-cost carriers enter the market • Airlines' funding costs will now increase, and larger share of cash flows will be used to amortise debt rather than growth capex • As a result, passengers will face higher fares and more restricted networks
Recovery will take time	• The banking sector did recover but it took time. US banking profits took 5 years to reach pre-crisis levels • The slow recovery was impacted by not only the economic recession, but weaker consumer confidence and stricter regulations imposed on the sector • The public perceptions of the banks were negatively impacted due to the large amount of cash being spent on the sector Source: FDIC	• The airline recovery phase of capacity and profits will be more extended than a fast "V shaped" ramp up • Once the immediate travel restrictions are lifted, customer demand will also be impacted by the economic recovery and structural changes to customer travel demand as society adjusts to the "new normal" • From a capacity perspective, increased debt levels and restrictions associated with state aid grants, will restrict how quickly airlines are able to rebuild the networks operated before the crisis`

How Teneo can help

Airlines are currently focused on how they can reduce cash flows and increase funding to survive the immediate period of no or very limited flying. However, airlines will soon need to consider the broader implications of the crisis and develop revised strategic plans to position themselves for the recovery phase and the "new normal". The ability to adapt quickly to the new reality, and capture new opportunities, will be critical to long-term success after the crisis. Teneo is working with aviation clients on developing ***dynamic demand forecasting****, creating more* ***agile business models****, assessing structural impact on* ***business and leisure passenger demand****. Airlines also need to consider the* ***new competitive landscape*** *and review* ***M&A opportunities*** *that will emerge following the crisis.*

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