Successfully Flying Through the Danger Zone:

In the eye of the perfect storm, bolder moves are needed to manage the challenges ahead for UK and European airlines

In our previous August 2021 analysis, we predicted that the next 24 months would be mission critical for both airlines and airports, as ongoing revenue pressure and risks of COVID-related disruptions remain high.

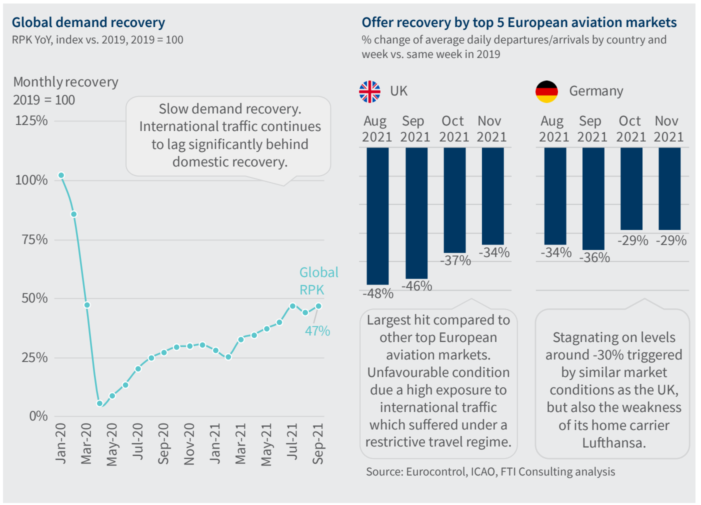
Our latest research which now considers data from Q3 2021 shows that the airline industry indeed remains in a fragile position, particularly given the latest global developments with the Delta and Omicron COVID-19 variants and as a result, the ongoing restrictive governmental travel regulations.

Despite a significant improvement vs. 2020, when comparing with 2019 (pre-crisis) levels, airlines are in a much-weakened position. Airlines continue pushing capacity forward in hope of a fast recovery, but have experienced very weak performance (compared to the usually profitable summer quarter), underlining the depth of the crisis and the challenges ahead.

The data also shows that the airlines' response to these challenges has been variable — and although airlines have made significant efforts, the financial results suggest this has not been enough. The overall need for restructuring and transformation remains high, and bolder moves are now required to ensure resilience in the long-term.

The delayed demand recovery

European demand still lags significantly behind pre-crisis levels with a large gap vs. North America. Demand has been particularly hit on long-haul and remains soft on intra-European flows.



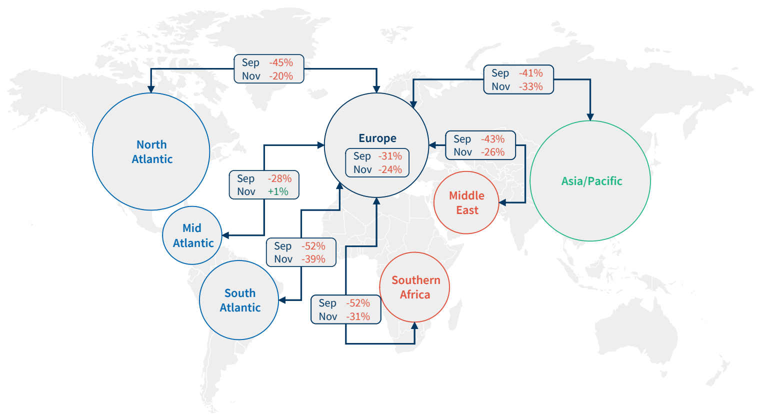
UK and Germany are facing a more challenging recovery due to their relative small domestic markets, high exposure to intercontinental markets, and a partly more restrictive travel regulation.

An uneven offer development

The delayed opening of profitable long-haul markets continues to disproportionally hit European network carriers. "Offer" (available flights) between Europe and the Americas/Asia-Pacific continues to be significantly depressed vs. 2019 pre-crisis, whereas intra-European offer is slightly better.

Since November, carriers have benefited from the opening of the US and opportunistic services i.e. Europe-Caribbean, to generate cash.

Offer recovery by traffic flows from/to Europe
% change of daily departures/arrivals vs. 2019 (pre-crisis)



Source: Eurocontrol

A need to solve top line weakness

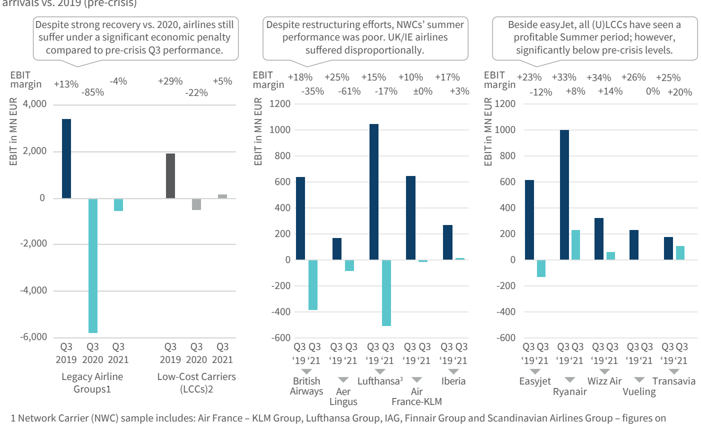
The majority of airlines continue to face significant issues in their revenue mix while also facing an increased unit cost situation. Only a few — mainly Low Cost Carriers — have managed to improve their cost position.

Despite the measures taken, European airlines continue to see ongoing high economic penalties — the sector is in a performance trap with falling unit revenues and increasing unit costs. The normally highly profitable Q3 has been soft compared to pre-crisis performance. UK and Irish airlines continue to suffer considerably more than peers.

Q3 profitability by European airline clusters[1,2] % change of daily departures/arrivals vs. 2019 (pre-crisis)

Q3 profitability of selective NWCs EUR MN, EBIT margin in % of revenues

Q3 profitability of selective (U)LCCs EUR MN, EBIT margin in % of revenues



1 Network Carrier (NWC) sample includes: Air France – KLM Group, Lufthansa Group, IAG, Finnair Group and Scandinavian Airlines Group – figures on group level incl. respective low-cost activities. 2 Low-Cost Carrier (LCC) sample includes: easyJet, Ryanair, Wizz Air. 3 Lufthansa Network Carrier include Lufthansa Passenger Airline, SWISS, Austrian and Brussels Airlines.

Liquidity currently appears stable… but for how long?

Despite operating losses, many airlines have actually increased their cash funding. Given the strong focus on cash management and availability of capital, the balance sheet position at first seems to be relatively comfortable.

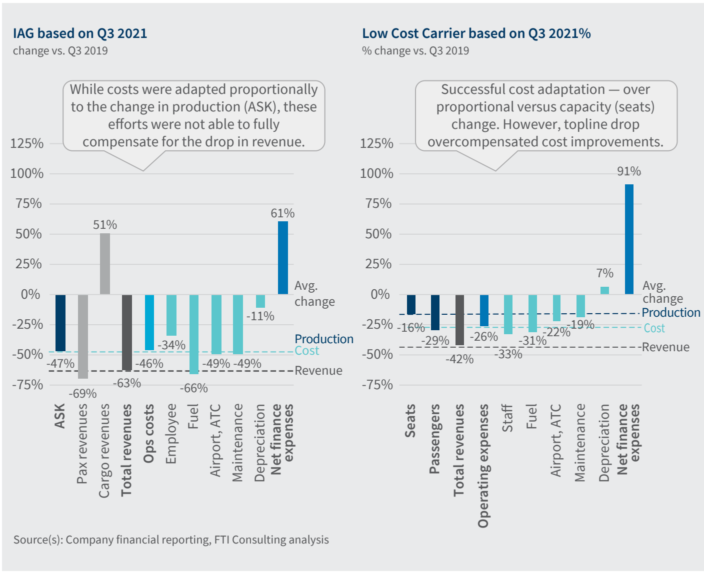
However, the cost of liquidity is now starting to rise and some players are experiencing increasing financing pressure, with the need to (re)finance the ongoing losses, reduce debt levels and improve equity ratios.

This, combined with a potential penalty of the Omicron virus, could put an additional burden on airline recovery and cash needs ahead.

This may also lead to shareholders applying additional pressure on management to restructure.

Ongoing need for transformation

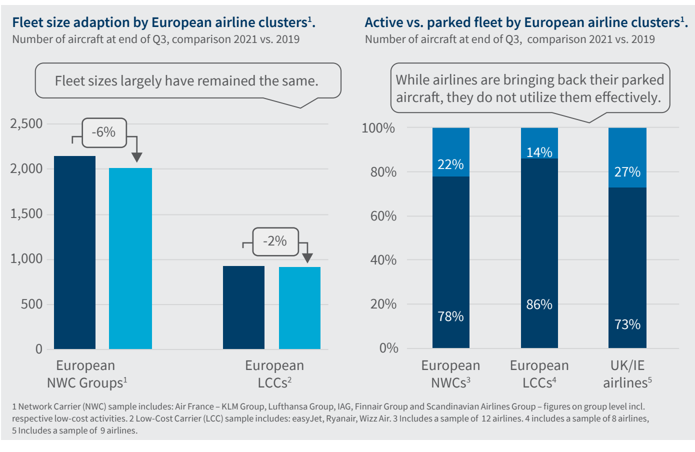
Airlines have struggled to reduce costs on the same trajectory as revenue declines. Maintenance costs have been addressed vigorously and fuel costs have fallen from demand and supply side drivers. Staff costs have been reduced but not at the required trajectory.



A variable approach to rightsizing within the industry

Airlines in Europe have so far made only moderate fleet cuts — LCCs even increasing their fleets. Given the ongoing moderate demand recovery, airlines could face increasing pressure to start a bolder rightsizing task to ensure their financial recovery.

Interestingly, fleet sizes overall are remaining stable — suggesting that operators are not offloading assets.



1 Network Carrier (NWC) sample includes: Air France – KLM Group, Lufthansa Group, IAG, Finnair Group and Scandinavian Airlines Group – figures on group level incl. respective low-cost activities. 2 Low-Cost Carrier (LCC) sample includes: easyJet, Ryanair, Wizz Air. 3 Includes a sample of 12 airlines. 4 includes a sample of 8 airlines, 5 Includes a sample of 9 airlines.

The next 24 months are mission critical for both airlines and airports as production ramp-up will increase OPEX, revenues will follow only with a time gap, the cash situation might further deteriorate before improving, and risks of virus disruptions remains high.

1. Volatile travel & regulatory regime
2. Fragile and unstable top-line ramp-up
3. Relentless need for cost efficiency
4. Financials continue to be under pressure
5. Strategic and operational danger zone

In response to these ongoing challenges, we think bolder moves are now required:

Reconsider priorities of the broader business model
to solve challenges ahead i.e., focusing top-line, cost and tech alliances/co-operation, pushing sustainability and emission reduction and offsetting, among others.

Consider bolder rightsizing
including network adaptation, closure of hubs and bases, reduced and simplified fleet, among others.

Accelerate cost alignment to new top-line levels
i.e. through simplified and flexible working agreements, flexibilization of fixed cost (i.e. power by the hour concepts), collaboration with value chain partners to reduce overlaps.

Push for structural changes
to radically simplify processes and organization (zero-based) to achieve step change effects in productivity and efficiency.

Increase cash management and optimise financing
to avoid financial stress levels in cases of ongoing demand shortfalls/higher cash needs. Repay debt from sale of non-core company parts to secure support from capital markets.

Consider new financing models
i.e. involve government and private investors for funding but also allow for more flexible participation (incl. consolidation) schemes.

FTI Consulting works with clients operating in or investing into the aviation industry to rapidly assess the challenges and devise plans for making the necessary bold moves required to weather this ongoing storm.

To discuss this research, or what these findings mean for you and key players in the industry, please contact:

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