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Airlines Today: How to Manage COVID-19 Disruption

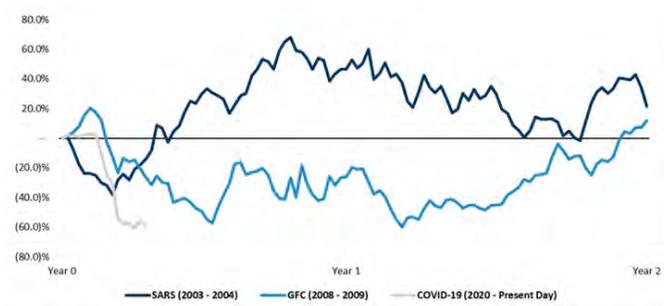
In a few short weeks, the prospects for the global airline sector have transformed from stabilized with growing profit margins to profound uncertainty, a likely long-lasting crisis and a potential reshaping of the industry beyond.

Background

The airline sector is facing chronic uncertainty in terms of the length of domestic and international route closures and the shape and timing of the recovery. The International Air Transport Association (IATA) has estimated that the COVID-19 crisis is likely to result in a \$314 billion drop in airline passenger revenues in 2020 — a 55% decline compared to 2019 — in a scenario where domestic markets open in Q3.

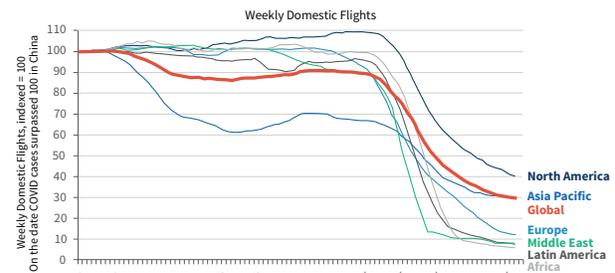
Airlines are also having a ripple effect on the global economy, as they are at the core of a value chain that supports some 65.5 million jobs worldwide.

Exhibit 1 - ARCA Airline Index



Source: FTI Research, Yahoo Finance, NYSE (XAL) is an industry index, tracking market performance of major US and International Airlines. Each time series has been indexed as of the first trading day during the initial year of each crisis and compares the share price fluctuations through the end of the following year.

Exhibit 2 - Worldwide domestic flights are down 70% today Domestic markets grounded outside of North America and Asia



Source: IATA Economics analysis based on data provider under license by FlightRadar 24. All rights reserved.



At the time of writing, there is little consensus on how quickly the sector will recover. Previous nearly analogous events (9/11, SARS, GFC) may offer some indication, but this has been a steeper and deeper decline, and the factors impacting recovery are complex. Equity markets have reacted accordingly, with an almost 80% decline by early April, easily surpassing those events, in just a few short weeks.

As a result, management teams need to be both stabilizing and protecting their business as they simultaneously prepare for the post-pandemic environment. This requires both sufficient liquidity and the support of multiple stakeholders

— customers, employees, labor unions, operating partners, suppliers and service providers, financing parties and government.

Governments across the globe are enacting support measures, with fiscal support made available to airlines in Europe and Australia to date. In the United States, the announcement of \$58 billion allocated to the sector from the CARES Act stimulus was well received initially. The recent move from a \$25 billion payroll grant to a part-grant/part-loan structure, however, and the ongoing discussions regarding the financial conditions and operating limitations associated with the \$25 billion loan facilities, mean that careful balancing between immediate liquidity, ongoing governmental oversight and the potential for frustrating otherwise longer-term value engineering will be required.

Immediate stabilization – liquidity, fleet, people

Once COVID-19 reached pandemic status, governments began grounding international flights and domestic flights became impacted by restrictions on public gatherings. Airlines reacted immediately to withdraw capacity from the market and shore up liquidity, drawing down on committed revolvers and other lines and raising billions in cash from the market. Others have sold forward miles to their credit card partners as a source of cash. The first significant restructurings have appeared with Lufthansa's closure of Germanwings and the bankruptcy filings of Ravn Air in the US and Virgin Australia.

At the same time, major airlines have repurposed some passenger airliners to cargo, generating income through shipment of essential medicines, PPE and other medical equipment.

This liquidity, together with governmental support, should be sufficient to provide a platform from which to operate and navigate the period up to the “all clear” and into the market recovery.

The outlook for the recovery is complex ...

Although some market participants and commentators have derived comfort from the recovery in Chinese domestic travel, most see a prolonged period with low demand, and others are speculating that that a recovery to 2019 levels of international travel could take up to 4-6 years. FTI's polling research suggests that over the long-term 45% of respondents are likely to take fewer international flights (29% very likely) while 44% are likely to take fewer domestic flights (24% very likely).

The divergence of views is to be expected; the path of recovery from COVID-19 effects will be complex, depending on:

- The timing of any “all clear” for both domestic and international flights.
- For consumer travel:
 - Psychology – Recoveries from SARS and other outbreaks were relatively “V” shaped, but these were quickly contained outbreaks and of limited impact globally. The recovery from 9/11 was significantly longer; even so, the recovery from 9/11 was to some extent accelerated by a desire to resume “life as we know it,” and so travel was promoted — whereas the post COVID-19 environment could be slowed by ongoing self-isolation.
 - Accelerated societal uptake of video technology as an alternative to short visits involving travel by air.
 - The second-level impact of any business recession (see below).
- For business travel:
 - The depth and shape of the accompanying business recession.
 - How we reference the time to recover from great financial crisis.
 - The impact of an accelerated uptake of remote working.
 - Potential partial retrenchment of globalization in supply chains, etc.
- The potential for repeated outbreaks before any vaccine or other treatment protocols are established.

Given this complexity, we believe that we are more likely to see a “U-shaped” recovery.

... but there is a path through the crisis period

The challenge for leadership is to both stabilize and protect the business while at the same time prepare for the post-pandemic environment.

This requires maintaining both sufficient liquidity and the support of multiple stakeholders — customers, employees, labor unions, operating partners, suppliers and service providers, financing parties and government. This support will need to be carefully managed through engagement of

internal and external stakeholder groups with consistent and transparent messaging.

We would expect that management has already begun to transition to maintenance of the day-to-day business and (notwithstanding the limited data points available) is beginning the process of forward planning.

Once greater visibility over the trajectory of the pandemic is established, this work can be married to demand forecasts to create a viable and strengthened business plan.

Leading these activities through this period of crisis requires a different approach from “business as usual.” There is an opportunity to utilize this on-ground time as a focused window to effect immediate, yet lasting, improvement, but it requires coordinated efforts from across (and up and down) the organization, guided by a small core group with a clearly articulated plan.

At the heart of this go-forward plan is creating a **Minimum Viable Platform** that aligns functional areas against revised forecasts; developing a liquidity platform from which to operate, including evaluating and securing access to relief funding; and ensuring clear, consistent and continual stakeholder engagement, both internally and externally.

The immediate playbook remains focused on stabilizing and protecting the business.

Stabilize and Protect the Business | Immediate to Near-Term

Respond to Crisis | Stakeholder Engagement

- Airlines are making difficult decisions to ensure survival through the pandemic; brands will be defined by how they treat people in communicating the news and how they step up to be part of the solution.
- Develop a strategy to stay in front of employees, customers and vendors — even while flights are grounded.
- Coordinate with business units and functional leaders to ensure risks are anticipated and issues are quickly escalated.
- Develop a communications architecture, including core messages and tailored content for each stakeholder group.
- Review channels and decide recommendations on message delivery/engagement techniques.
- Use examples of how the government aid is being leveraged to benefit the U.S. economy and the American worker.

Respond to Crisis | Liquidity

- Proactively manage daily cashflows, including rolling daily short-term forecasts:
 - stress-test for lower receivables/refunds, flexing significant lessor and supplier payments and surplus asset sales;
 - identify near-term cash improvement options – lessor/lender concessions, refunding/reallocation of MRO surpluses, working with supply chains/OEMs, asset realizations, and other non-core assets – tax refunds, inventory consolidation; and
 - review ongoing initiatives for strategic impact, projected benefit, time to run-rate improvement, cash and other resource requirements.
- Assess opportunities/risks in alliances, JVs, loyalty programs and partners.
- Develop funding approach to government as appropriate, including treatment of potential trade-offs, (e.g., deep reorganizational activities, including route cancellations, personnel cuts and/or renegotiation of CBAs against potential restrictions within government support conditions).
- Execute other CARES Act funding opportunities, such as immediately deferring the employer portion of payroll taxes.
- Assess tax benefits and liquidity available as a result of tax deferral provisions and extended NOL carrybacks per the CARES Act.

Respond to Crisis | Operations

- Communicate with customers – maintain touch points, protect core base.
- Develop cargo options to maintain flights (domestic and international, especially healthcare-related supplies).
- Optimize fleet usage and protect airport slots — parking aircraft/engine close to limits for next maintenance; higher utilization of smaller, owned aircraft to minimize fixed costs in the current period, releasing for retirement when demand begins to return. Review of banking policy at major hubs during the low demand period.
- Create a Minimum Viable Platform — a footprint for the organization to maintain the business during the shutdown.
- Define promotional strategy and cadence for remainder of year.

Respond to Crisis | People, Infrastructure and Systems

- Create a **Minimum Viable Platform** — a footprint for the organization to maintain the business during the shutdown:
 - liquidity and near-term forecasting team, including protection of strategic suppliers and service providers;
 - business operations and “day-to-day” team; and
 - strategic development team, from which to create, evaluate and implement options for the post-pandemic environment, including achievability of plans under a variety of likely and “could never happen” scenarios. For some, this will need to include consideration of protective measures, including Chapter 11 or other equivalent in court processes (see “Contingency Planning” below).



Once the business is stabilized, companies must shift their attention to manage through the downturn and be well positioned to emerge from the pandemic environment. There are a number of important steps that businesses should take to protect and strengthen their position, including communicating with customers; optimizing operations; monitoring the likely state of recovery; strategizing and stress-testing exit plans; launching a public affairs program to mitigate any scrutiny associated with government relief assistance; and clearly articulating mitigation plans to stakeholders.

Leading Through the Downturn | Near-Term to Post-Pandemic

Strategize

- Actively monitor and model potential recovery scenarios, based on:
 - current pandemic-related news flow;
 - best available data from other regions and from previous downturns;
 - signals of broader economic recovery (acceleration/deceleration);
 - traditional and social media, analyst reports and other forums to understand how stakeholders are thinking and what competitors are doing; and
 - active feedback from engagement with customers to understand implications for long-term spending and purchase drivers of key customer segments.
- Explore all areas for operational optimization within scenario parameters:
 - pricing models;
 - unprofitable routes;
 - fleet deployment and retirements;
 - optimization of hub network;
 - MRO efficiency within MPD parameters; and
 - strategic procurement and supply chains.
- Revitalize / review / exit alliances — JVs and partnerships.

Engage

- Communicate a clear vision for the future, specifically highlighting steps the company is taking to care for employees, customers and other partners, while also protecting enterprise value.
- Develop communications and change management program to help teams understand the shifts that need to happen in order to more quickly implement plans.
- Train and support functional and field leaders in establishing clear expectations, accelerating the adoption of any new ways of working, and keeping teams motivated and sharing progress.
- Engage, as appropriate, with media, investors, analysts and other third parties to shape the narrative around the business, mitigate any criticisms and build confidence in the future.
- Use opinion leaders to showcase commitment to stewardship and responsibility.

Creating “Fit for Purpose” Support | People, Infrastructure and Systems

- Optimize support functions within planning scenarios:
 - alignment and integration of corporate strategy and function strategy; and
 - “fit for purpose” decision-making and reporting processes (appropriate effort, accuracy, timeliness, usefulness).

Securing the Long-Term Base | Capital and Liquidity

- Model appropriate long-term funding based on scenarios and associated reorganized business models and prepare for appropriate recapitalization efforts:
 - provide recurring business updates to clearly articulate actions taken to stabilize the business and strengthen the balance sheet;
 - begin repositioning the long-term equity story to further differentiate from peers and identify other investment opportunities; and
 - assess and monitor shareholder base to mitigate activism risk.



There is little doubt that the industry that emerges from this crisis will be different. For some time, there will be reduced air travel, there will be fewer airlines, and those that come through will likely have a smaller footprint. For those that emerge, there is the opportunity to improve offerings and efficiency, and enhance brand and market positioning.

We do not underestimate the challenge — especially given the time elapsed since the nearest comparable events. For many leadership teams, this will be the first real market challenge faced in their roles. Even for those that successfully navigated 9/11, SARS and the GFC, this crisis is deeper, more severe, likely longer and potentially more transformational.

Despite these obstacles, employees, customers, partners and other stakeholders expect leadership to deliver. Incorporating sound crisis management, rapid transformation and strategic communications strategy could be the difference between mere survival and emerging as a revitalized, successful competitor in the new environment.

Contingency Planning

Not all airlines will have the balance sheet or the stakeholder support required to navigate this crisis as a going concern; for some, a combination of some or all of pre-crisis underperformance, pre-crisis legacy issues, uncertainty of liquidity or lack of stakeholder support may mean that more radical strategies are appropriate.

That could include a protective filing, and, for many, the U.S. Chapter 11 process may present the most protective, recognizable and predictable process.

However, even in the current environment, an unplanned filing for Chapter 11 of such a highly complex, highly regulated business could be catastrophic in terms of overall value preservation, whether directly for investors and financial stakeholders or indirectly in terms of employees, government, etc.

Between the two extremes of a certain, going-concern resolution of the current crisis and an unplanned filing lies the most likely scenario — that management will need to negotiate with stakeholders the conditions under which support will be secured. It is possible that recalcitrant or unwilling stakeholders will need to be shown a credible and ready-to-launch Chapter 11 plan in order to obtain that support.

Either way, unless there is certainty of liquidity and broad stakeholder support, management should consider preparing the groundwork for a Chapter 11 filing.

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