

You Can Prosper in the Next Recession

Are airlines really prepared for the inevitable next recession? Most are not. The traditional levers for surviving a downturn, such as taking on debt and lowering wage rates, will not be available this time. A more fruitful approach will be to broaden the range of moves to include consolidation, strategic spinoffs, productivity increases, and simplified value propositions. Those airlines that get a jump on the inevitable stand the greatest chance of improving their competitive position and thriving during the downturn.

As airline executives know, but perhaps don't like to think about, growth in air travel is strongly linked to overall economic growth and, therefore, air travel is a cyclical business. At this point in the economic cycle, the pressing question is not if the next recession will hit but when.

Are airlines prepared? To be sure, most do incorporate a recession scenario into their multi-year revenue forecasting, in order to see the potential impact on operating and capital budgets. However, few airlines are thinking about the strategic implications of the next recession and what potential business design moves could be made now to improve both profitability and market position. Those that are well prepared may even find a downturn the best time to eat their competitors' lunch.

In recent months, there have been increasing signs that the 60-month-old U.S. economic expansion is weakening. The past two economic expansions at 120 and 92 months were long by historical measures and featured mid-expansion pauses, characterized by several quarters of low growth. The optimist says the same thing is happening now. The pessimist points to the inverted yield curve, where short-term rates are higher

than long-term rates, and its similarity to the curves six months before the previous two recessions in 1990 and 2001.

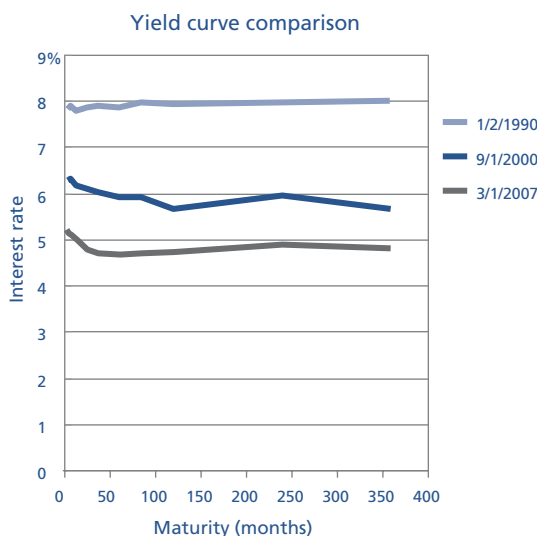
Given the uncertainty around the dramatic decline in the U.S. housing market, it would be risky to assume that this is merely a pause, even if we are not facing a full-blown or deep recession. Indeed, barely positive GDP growth would still put great stress on the airline industry.

Ghosts of Recessions Past

While the next recession might not be exceptionally severe, the condition of the U.S. airline industry could make the downturn exceptionally difficult. Airlines, regulators, and others took drastic measures after 9/11, and the industry is still living with the consequences. As a result, the traditional management levers for surviving a downturn are not readily available. These include:

- *Debt levels.* Almost all airlines used debt to fund operating losses in the most recent downturn, and those that did not wipe the slate clean through bankruptcy often have more debt than revenue. This effectively eliminates the option of additional borrowing.
- *Interest rates.* In the recent era of high liquidity and low interest rates, airlines have had an opportunity to get the lowest-cost debt that their ratings would allow. Besides showing the similarity in the shapes of the yield curves, Exhibit 1 also highlights the drop in rates over the past 15 years. There is not a lot of room for rates to drop further come the next recession, making refinancings less useful.
- *Labor rates.* As part of many post-9/11 restructurings, collective bargaining agreements have been revised to lower labor rates so that network carriers often have lower rates than low-cost carriers. Unions are spoiling for a fight to raise rates, making consensual discussions to lower wages unlikely.

Exhibit 1 While no forecast is infallible, there are parallels with the past two recessions



- **Aircraft ownership costs.** As with labor, airlines drove dramatic reduction in their fleet costs that are likewise locked up in new contracts. In addition, the booming global market for aircraft eliminates any leverage to negotiate lower rates.
- **Facilities costs.** The airlines that recently went through Chapter 11 bankruptcy discovered how to reject their facilities leases. With those revised new costs, even another trip through Chapter 11 probably would not lower facilities costs further.

New Recession-Savvy Moves

While many of these traditional levers for managing through a downturn have been rendered unavailable or unattractive, airlines can improve their competitiveness by broadening the range of possible moves for the recession and the rebound that is sure to follow.

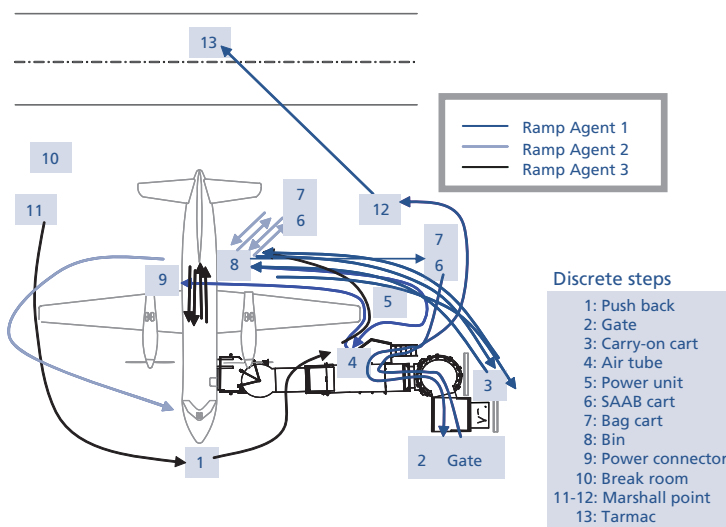
Consolidation. While airline consolidation has been widely discussed over the past decade, it has proceeded slowly. Regulatory scrutiny was per-

ceived to relax after 9/11, but airlines were not in a financial position to take advantage of it. With improved financial health and private and public capital looking for targets, many airlines are in position to act rather than react to this opportunity. In this game, you don't want to be the last one at the buffet table, where the choices grow less attractive as regulatory scrutiny rises with each transaction.

Bigger does not guarantee better, of course, but a well-designed and well-executed consolidation can improve both revenues and profits. No carrier today is truly national, much less global, and all find themselves sub-scale in many cities. A classic example is Boston, with a large population and strong business market. Many airlines claim to be "big in Boston," yet the city does not have a home-town airline in the manner of Charlotte, Chicago, or Denver. Achieving that presence in Boston and other cities makes an airline more attractive to business travelers, improving the top line. If an airline has prepared for this increased activity through more efficient airport labor and infrastructure,

Exhibit 2 **The typical aircraft turn procedure involves a large amount non-productive time, even if the aircraft itself is turned around quickly**

Current discrete steps in aircraft turnaround



Only 34% of time adds value

Description	Value-added?	Minutes	Percent
Productive	Value-added	210	34%
Walk	Non value-added	112	18%
Wait	Non value-added	82	13%
Non-productive	Non value-added	217	35%
		621	100%

Lack of standardization, excessive walking due to poor allocation and sequencing of tasks, location of equipment, and limited use of productivity aids all added to inefficient aircraft turnarounds.

that will lower costs and allow more of the new business to drop to the bottom line.

Spinoffs. Rather than wait for the depths of a recession and a potential liquidity crisis, acting early and with strategic intent to pare the scope of the enterprise will garner higher interest from potential buyers. As is evident from some airlines' partial spinoffs and consolidation in the supplier base, there is a strong market for airline service assets. Investor interest ranges from customer-facing loyalty programs to pilot training programs to maintenance, repair, and overhaul businesses.

Besides the benefit of monetizing assets, such actions can improve the health of the remaining enterprise by reducing its complexity, scope, and asset base. Management attention, often the most scarce of resources, then can focus more sharply on improving the operations of the core business rather than support functions.

Dramatic productivity increases. The gap between competitive wage rates and uncompetitive unit labor costs indicates an alarming gap in productivity for the network carriers relative to low-cost carriers. Moreover, if we look at simple measures like headcount per aircraft and utilization, we see a wide variation in performance. While many airlines have investigated operational excellence tools (including Lean and Six Sigma) as a way to improve their operations, few have aggressively applied these concepts across the enterprise or into the supply base. One must determine how processes cut through the airline, determine which ones are critical to improve, and give people the right tools with which to solve problems.

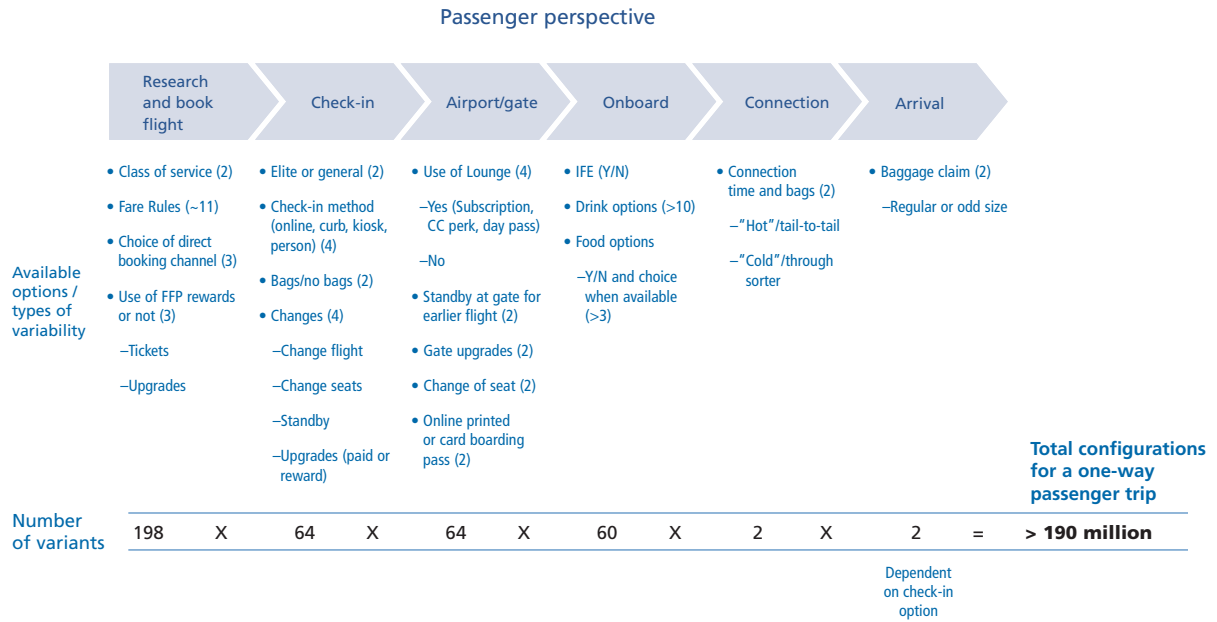
Taking cues from big auto or aerospace, we can envision higher quality, less waste, and increased productivity. With aircraft engines performing at Seven Sigma and the final assembly of a new 787 targeted at three days, airline executives should rethink their notion of what is value and what is waste from a customer point of view.

Opportunities reside in operational areas (baggage, cargo, and maintenance) as well as customer service and revenue generating activities (sales forces, call centers, and customer service agents). Airlines that embrace these techniques are likely to enjoy higher productivity, asset utilization, and enhanced service.

Simpler value propositions. While an airline ticket is increasingly viewed as a commodity, most airlines offer a highly customizable product with many frills, an approach better suited to a luxury product. Airlines have fallen into the trap of offering an incremental frill or option, hoping to attract an incremental passenger. Adding up the combinations of customer options for the most basic elements of the travel chain—including fare rules, booking channels, check-in, waiting, boarding, seating, on-board service, connections, baggage return, and so on—the number of “SKUs” for this commodity reach more than 190 million, as shown in Exhibit 3. Add on the inherent variability of a service business and you are guaranteed a cost penalty.

When product manufacturers find that SKUs and complexity get out of hand, they don't revert back to selling just one product, but determine scientifically which features drive customer choice and purchase and which do not, then trim the product bundle to what can be offered profitably. Such an approach leads you to offer just a seat on the plane for those who want just a seat, and then to determine the right mix of features for those who are willing to pay more. Instead of cutting corners for all customers, you can take away drinks, cabin baggage allowance, and seat assignments for those who want just a seat, and give guaranteed overhead space, nice meals, and personal service to those willing to pay a premium price. Airlines that do this with analytical rigor will likely emerge with lower costs and a sharper value proposition that attracts more business from their target customers.

Exhibit 3 Airlines have made a passenger flight too variable and customizable



Pull Away from the Pack

Few managers enjoy a recession. But great managers embrace a recession because of its opportunities. Being the first to anticipate the recession’s impact allows an airline to act quickly and launch moves that will lead to dramatic improvements in relative positioning and performance.

Timing is important. Incorporating the recession scenario now as part of a strategic plan, not just a long-term revenue forecast, will be critical preparation. The airlines that enter the inevitable next downturn prepared will be best suited to profit from the opportunities created by those airlines that did not plan ahead. ❖

About Oliver Wyman

Oliver Wyman's Aviation, Aerospace, and Defense practice helps passenger and cargo carriers, OEM and parts manufacturers, aerospace/defense firms, and MRO and other service providers develop value growth strategies, improve operations, and maximize organizational effectiveness. Oliver Wyman has completed hundreds of engagements for aviation, aerospace, and defense industry clients in the past five years alone and has consulted to nearly three-quarters of the Fortune 500 firms in these sectors. Oliver Wyman serves these firms worldwide with consultants in the Americas, Europe, Asia, and the Middle East.

This white paper was prepared by **Andrew Watterson** and **John Seeliger**, both Dallas-based directors of Oliver Wyman. They can be reached at andrew.watterson@oliverwyman.com and john.seeliger@oliverwyman.com.

www.oliverwyman.com