Prospering in the Next Normal for Airlines

Article 2 – How to Expand Revenue Sources, Setting Leadership Imperatives and Financial Priorities

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Overview:

In our first article, we looked at the timing for the airline recovery, including what airlines are doing now to restructure and to better position themselves for the "Next Normal" in a post COVID-19 market. This article takes an in depth look at the direction some airlines are taking to prosper in the Next Normal. For example, Air Asia's CEO, Karen Chan, wants to see 50% of her airline's revenue come from non-aviation sources.[1] *Ms. Chan is looking for Air Asia to become a full-fledged online travel agency which, in addition to offering hotels, will offer a full range of travel and lifestyle products and experiences. In other words, airlines are looking to tap into a greater percentage of their customer's "Total Travel Spend."*

This concept will continue to drive down base airfares to nearly zero, putting competitive pressure on airlines that have not integrated a full travel service offering into their on-line presence.

In this article we list six revenue sources airlines should be developing. Additionally, we take a short look at required post COVID-19 leadership team imperatives and the financial priorities necessary to support the pending recovery.

Revenue Sources

Photo from E &S Group[2]

Since the 1970's, inflation adjusted base airfares have dropped by 50%.[3] Of course, today's economy air travel has less leg room, generally no free meals and the passenger may need to pay separately for their checked luggage. Particularly in the last fifteen years, cheaper base fares led by low-cost carriers and more precise revenue management have driven a surge in total passengers flying. However, all airline models now offer discounted airfares. Therefore, the base fare is no longer a competitive advantage, but simply a "tool" to attract customers. As a result, the post-COVID-19 airline product will need to increase revenue from as many sources as possible. Here are six categories airlines should consider:

1. Base Fares: This is the ticket price charged to the passenger minus all other airline or airline partner fees. In many countries now, the basic price normally includes government fees. This is a dynamic charge that changes daily and sometimes hourly. Customers are conditioned to see these fares increase as they approach the departure date (a positive offering). However, as airlines look to place their pre COVID-19 seat capacity back into the market, there will be pressure to reduce or maintain low base fares to initially attract returning passengers leading to advertised price wars. Traditionally, airlines have depended on base fares for around 90% of their total revenue. Given the downward pressure on base fares, many airlines that are highly dependent on base fare revenue are forecasting losses.

Going forward, for low-cost airlines and even other major airlines, the base fare should be seen simply as a way to attract customers onto their sales platforms. It is simply the airline's billboard. Other revenue sources should be increasing as a percentage of an airline's total revenue. It is conceivable in the near future that if a customer purchased enough items, including non-aviation items (e.g. computers, clothing, furniture) on an airline's sales platform that the carrier will provide a free ticket as part of the purchase.

2. Ancillary Revenue: This is the extra fees passengers pay for items like checked baggage or seat selection. Normally, the lower the base airfare, the more ancillary revenue items are presented to the passenger for sale. Within low-cost airlines, where lower airfares are offered, the ancillary and club revenue (non-ticket) portion of the overall passenger costs can be as high as 47%.[4] Traditionally, ancillary fees have been static and are considered a negative offering by their customers. However, more revenue could be obtained if a "dynamic" approach is used to ancillary fees that would change pricing based on demand and factors such as the stage length of the flight.

3. Club Programs: Advanced low-cost (and ULCC) airlines have developed monthly fee-based club options for their customers to belong. This positive offering allows the customer to have access to lower airfares and upgrades to larger seats or to ancillary items with no or a greatly reduced fee cost. For the airline, the monthly income stream addresses yearly cash functions and provides valuable customer data.

Major airlines have more sophisticated passenger loyalty programs. In both cases these programs add value to the airline. For example, in 2020 one USA airline had its loyalty program appraised at over USD $20 billion.[5] A July 15, 2020 Forbes article stated, ***"Over the past few decades, airline mileage programs have transitioned from a way to generate a bit more loyalty to a massive profit center for airlines."***[6]

4. Partnership Revenue: The concept of partnership revenue is that once an airline has attracted a passenger for a flight, the airline then offers that person other non-air travel and other products and services from its network of partners. The airline earns a commission or generates a margin on that sale for each transaction. Some airlines have done this well by being more of an online travel company than an airline, but many airlines have not focused on this revenue stream. At issue is the binding technology required to integrate all partners to the airline selling platform. This is the area of greatest revenue growth, but only to those airlines that can transition the fastest. Further, this revenue stream creates a greater competitive advantage over the more traditional airline models, including low-cost and ULCC models.

In a December 17, 2020 Business Insider article, Tony Fernandes, founder of Air Asia and Group CEO, is quoted as stating, ***"As I always say, you have to evolve, or you die in this industry. The decision to pivot into a digital travel and lifestyle platform actually commenced in 2018, well before COVID-19 hit. I've always been a firm believer in the digital revolution. Today, data is king, and we realised we had a huge opportunity to extend our own assets and leverage our strong brand in Southeast Asia with our own big and rich data."***[7]

5. Cargo Revenue: Most of the world's air cargo is moved in the bellies of passenger jets. With these flights not operating due to the current COVID-19 crisis, there is a timely opportunity to venture into, or grow, an airlines' cargo revenue capabilities using existing aircraft with some modifications. IATA is reporting that cargo continues to recover faster than passenger service and is in fact restricted in its growth by the reduced amount of passenger aircraft carrying belly cargo.[8]

6. Incentives (lower costs/fees & straight cash): By carrying passengers from city to city all over the world, airlines create valuable income streams for governments, hotels, restaurants, airports, airline vendors, taxi drivers, etc. This income is translated into jobs and lots of them. So not only does the airline itself employ hundreds to thousands of in-company jobs, but it spins off thousands of other indirect jobs. Given this overall benefit to society and the economy, airlines can and do receive either reductions to their direct costs (e.g. airport landing fees) or actual cash incentives to operate specific routes. Given the financial losses airlines are taking now, it is perfectly acceptable for airlines to seek out all government/airport/community incentives possible.

Also, airlines should be seeking long-term incentives and discounts from their vendors and labour providers to off-set investor fatigue in supporting and expanding airlines through this COVID-19 crisis and recovery.

Leadership Team Imperatives

The post-COVID-19 leadership team will need to focus on the following issues:

Customer Confidence: The COVID-19 crisis has damaged the public's confidence in travel and with airlines. First is the safety aspect of passenger flying. Airlines will have to prove to the customer that there is little to no chance of contracting a contagious disease aboard their flight. At the same time, the airlines will need to treat their customers with more respect and resist the role of health enforcer. Next, airlines need to once again run their schedules on time and as published. The COVID-19 crisis has allowed airlines to make major adjustments to their schedule on a daily and sometimes hourly basis. Reliability and dependability will need to be restored. Lastly, airlines must refund passengers' money, if requested, when the airline cancels a flight, and the passenger does not want a voucher. This has been the position of passengers, advocate groups and the media from the onset of the pandemic.[9]

New Revenue Sources: Cost cutting is a given during a recession, including the current COVID-19 airline crisis, and spending investors' new funding or the company's cash reserves waiting for better times is not a good option post COVID-19. The question is where will the leadership team find new revenue sources as the COVID-19 airline market improves? Who is their customer and what are these passengers prepared to spend money on other than airfare? The post COVID-19 airline leadership team should be tapping into all forms of revenue to survive the upcoming base airfare wars and/or downward price pressure from the likes of Air Asia, and to dominate the market in the coming years. They should understand their changing customer base and present them with value products and services. The leadership team will need to have a good understanding of millennials and centennials as they replace the baby boomers, and even some generation Xers (born 1964 to 1976), in the work force. Going forward, the customer will need to trust that the airline has the brand and technology to be worthy of their recommendation to their friends and via social media. Also, the airline customer should feel comfortable that the airline is the source of the lowest costs for 3rd party travel products and services. Public shaming of airlines, aimed at reducing the environmental impact of aviation, will begin again and the leadership team will need to show that their airline in a leader in emission reductions. [10]

Technology Improvements: Much of the revenue derived from new sources and achievements in cost cutting will be the result of improvements in technology. The leadership team will have to map out and execute on the path to best-in-class technology, including new aircraft and distribution systems. The airline of 2025 will look and feel completely different than the airline of 2020. Today's leadership team is responsible for driving their airline to that new destination and technology. This requirement moves from a necessary cost to a strategic imperative.

Profits: All airlines go out of business for the same reason – they run out of cash. The COVID-19 crisis has drained airlines of funds and simply staying in operations waiting for more passengers again is not a business plan. Repeating the play book of the pre-COVID-19 airline structure is also not a viable option. The split between total cost and total revenue is the driving force. Unprofitable capacity in the market needs to be carefully measured against an eventual rate of return. In other words, simply placing money losing seat capacity back into the market too soon could lead to losses that will eventually destroy the airline. The drive to be profitable sooner requires a leadership team that is not afraid of new ideas and operating methods.

Company Culture: Airlines have taken a beating because of the pandemic. Employee layoffs, stay at home working conditions, reduced wages for the remaining staff, along with constant and uncontrollable changing conditions maybe creating an "everyone for themselves" culture. The leadership team will have to regain a trusting and motivated workforce with a noble cause culture. Direct, frank, and frequent communication is required with staff along with a reason why the company is needed in society over their competitors – the noble cause. Airline staff will want to know how they are contributing to this noble cause and why their efforts are important. The leadership team should take the hardest hits to their personal company benefit packages to demonstrate their commitment to the company, which can then be followed by the staff. Everyone will gain and prosper together – as a team.

Financial Priorities

Like the Y2K crisis in the late '90's, the COVID-19 pandemic has created some financial priorities that cannot be put off any longer. These are:

Seat capacity discipline: As the COVID-19 recovery begins in the second half of 2021, there may be a rush to place additional seat capacity into the market. The justification will be market presence, market share, reducing fixed costs and protecting or acquiring airport slot positions. Anytime there is more seat capacity in the market than demand, the basic airfare ticket price decreases to stimulate demand or steal passengers from other airlines. In any event, there are losses associated with this activity. The opportunity to gain an airport slot position or protect market share may be compelling. However, any such plan will need to be measured on a rate of return basis to determine how and when these actions will lead to profits. Investment firms and airline Boards of Directors will need to wean the airline off “acceptable” losses and into an era of profitability.

Cost Control: The COVID-19 crisis has allowed airlines to reduce costs with vendors and employees that would not normally have been possible. These arrangements should be placed into long term agreements, but with a risk/reward offset for the vendors and employees. To ask investors to place more money at risk during a prolonged airline industry recovery should be in sync with other stakeholders who will also participate in that risk, but with a monetary or stock upside to create synergy among all stakeholders.

Revenue Premium: An airline under traditional means can generate a certain amount of revenue. A revenue premium index is the amount of revenue contributed by partnership sales commissions, cargo, incentives and other non-traditional airline revenue. By defining, recording, measuring, and rewarding a revenue premium index, the post-COVID-19 airline will be able to better focus on new sources of cash as their older sources (base airfares) decrease. Under this model, airlines will be able to report their traditional airline market share and revenue along with their share of each customers’ Total Travel Spend.

Technology Advancements: The COVID-19 crisis has lowered the cost of fuel, vendor services and labour. As a result, airlines may feel the pressure is off for long-term cost savings. Modeling shows the advantage of new technology aircraft when the cost of fuel increases again. Advancements in technology also improves the customer overall travel experience and lowers staff counts per passengers. Nevertheless, there will be a cost to obtain and deploy new technology. A clear road map is required now and needs a funding plan for the next five years.

New Financial Measurements and Reporting: The current financial measurement and reporting systems accurately assess the health of a traditional airline. However, CASK or CASM compared to RASK or RASM only tells part of the picture.

For the post-COVID-19 airline, additional measurements and reporting elements are required to access other items such as revenue premium ratios, cost to total revenue ratios, customers to club conversions and the impact of technology investments. Until these items are observed, measured, and reported, airlines will not have the tools to drive new programs forward.

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End Notes

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