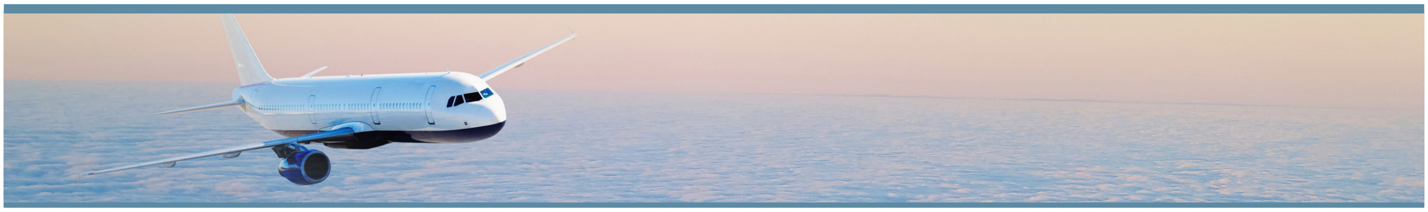

2017 State of the Industry: Airlines

The International Air Transport Association (IATA) is forecasting global profits for the airline industry of ~$30 billion in 2017,* down from a peak of ~$36B in 2016E given an uptick in expected fuel costs. With this backdrop, L.E.K. sees the next five years as critical for airlines to continue their transition from subsistence to sustainability via investments in both product and customer-facing services. While the capacity picture has behaved relatively well in regions like the U.S., airlines must resist the temptation to upset the more profitable balance the industry has achieved. In particular, capacity growth in markets such as China and Trans-Atlantic present significant potential risks.

What are the biggest challenges and opportunities facing the airline industry this year?

While each carrier will face a unique set of challenges, we see three that pervade the industry:

1. **Recalibrating revenue management.** Globally, carriers are increasingly adopting new fare structures, which are not just based on the traditional advanced purchase timelines but also include or exclude different features (such as checked bags or upgrades). As these products expand, airlines will need to adjust revenue management techniques to re-optimize inventory allocation and pricing. For example, carrier models must accommodate the surge in value fares, forcing a rethink of how demand has traditionally been forecasted. Moreover, the growing importance of ancillary revenue requires that revenue management teams increasingly incorporate a "full customer value" lens.
2. **Securing the right partners.** As the skies open and antitrust immunity (ATI) becomes more prevalent, airlines are revisiting the traditional alliance architecture and contemplating game-changing joint ventures (JVs). This remapping of alliances risks leaving some carriers in compromised positions as new lines are drawn around them. We see continued activity as various protagonists seek partners that can fill network gaps, provide enhanced customer offerings, and effectively achieve the virtual scale that all network businesses desire.
3. **Transforming customer experience.** Modern travelers are looking for greater control over their journeys and respond favorably when airlines assist them in this effort. Carriers that can get this right stand to gain on high-margin upsell opportunities as well as stronger customer satisfaction (and retention). Successful execution will involve substantial focus and resources, and requires, essentially, an evolution from an operations-based culture to a customer-centric one.

What's the current state of the industry?

We see four key developments with important implications this year:

1. **Long-haul LCC expansion.** As low-cost carriers expand over oceans, they are poised to disrupt existing long-haul architecture. They will also continue to stimulate new demand, enabling global connectivity like never before. Traditional carriers are employing different response tactics such as new fare classes, select densification, or even building their own long-haul LCC subsidiaries. Depending on the nature of the threat to each incumbent, different approaches may be appropriate.
2. **Contesting the business market.** In the U.S. JetBlue (a "hybrid" carrier) is rapidly adding lie-flat bed seating, targeting trans-con business travelers. In Europe, Ultra Low Cost Carriers (ULCCs) are using the Global Distribution System (GDS) and creating business-friendly fare products. The Full Service Carrier (FSC) response has been aggressive; e.g., introduction of more flatbeds (and dropping flatbed prices) in the U.S. markets and

*Forecast assumes 2017 full-year average price of $55/barrel, similar to trading in January 2017.

transforming the short-haul into a ULCC-like operation in Europe. The year 2017 will be an important test on whether the incumbents can defend their traditional power alley.

3. **The great loyalty reset.** A number of major frequent flier programs (FFPs) have now been rebooted to align rewards with revenue vs. distance. One outcome is that FFPs now offer relatively less value to members of the lower tiers. This raises the question of what exactly will happen with this collectively valuable constituency. Developing ways to retain these passengers profitably will likely be the next key battleground.

4. **Game theory in a consolidated market.** After the merger wave that hit many of the world's regions over the past decade, those that did not participate are now left trying to find their places. Some are attempting to carve out defensible positions by focusing on specific niches, while others are scrambling to find a niche at all. The next moves for unconsolidated carriers must be well-planned to ensure long-term survival. Other carriers that have achieved scale must also be circumspect, as competitive responses from their smaller rivals are likely to be increasingly disruptive.

How will senior executives respond?

In many ways, the stakes have never been higher for airline executives. An "expectation of sustained profitability" has changed the way many of the largest businesses are managed. In other corners, the world has suddenly gotten lonelier, or has just become a harder place in which to differentiate. All carriers are feeling increasing pressure to "toggle" their service standard to a flying public that is being conditioned to expect choice in every consumer-facing industry. Talent must be reequipped with the right tools and training to navigate this additional complexity, and strategy is paramount to ensure a defensible market position.

Our airline practice

L.E.K. Consulting works with many of the world's leading carriers to enhance strategic positioning and business performance, which ultimately increases shareholder value. We combine deep industry knowledge with rigorous analysis to provide clients with the insights required to make confident, fact-based decisions amid market uncertainty.

Meet our leaders

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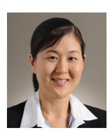

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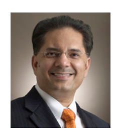

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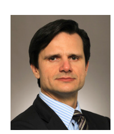

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