

# The airline industry - beyond recovery?

## ***An introduction to the airline industry and the ecosystem around it***

When assessing the state of the economy of a country, sometimes we overlook the importance that the airline industry plays in its smooth functioning. This is due to the fact that its contribution to GDP is only a minor part in most developed nations (0.3% in OECD countries). However, a more careful analysis would reveal the vital role it has in stimulating the economy via all of its connected “upstream” businesses that surround the strictly retail airline business, such as the airport management industry, aircraft manufacturing and also the production of refined petroleum. But, even more importantly, air transport is of crucial significance to “downstream” activities such as the trade of goods and the transportation of people internally and internationally, facilitating business as well as tourism.

In particular in this article we will focus on the retail airline industry in EMEA, exploring all of the different strategic responses to the pressure from the pandemic. In the second part of the analysis (published [here](#)), however, we will focus on the infrastructure business of managing an airport and how their owners are facing these hard times.

## ***Strategic responses of European airline companies to the pandemic***

It is no secret that the airline industry was one of the industries hit the hardest during the COVID-19 pandemic. Passenger travel has dropped by more than 90% year-on-year in April 2020 and, by August, it has just barely recovered to a dip of 75% YoY. It is needless to say that this unprecedented drop in demand has put a huge strain on the liquidity buffers of airlines. Even though roughly half of the costs these companies usually incur are variable, one can imagine that this offers just little consolation given the size of the economic downturn. Furthermore, operating costs are bound to rise in the near future due to the cost of health-related measures, such as temperature checks and disinfection.

It goes without saying that the different airlines varied considerably in shape at the time of the impact of the pandemic. Indeed, air transport is one of the industries with the highest dispersion in terms of productivity and profitability. Therefore there exists a difference in the ability of various companies to cope with the shock, which in turn will lead to them adopting divergent strategies. Which approach they adopt now, will infallibly determine their competitive position in the industry in the “new-normal” world after the pandemic.

In times of crisis companies can be classified according to the strategies they choose to cope with the economic shock. These usually include: retrenchment, perseverance, innovation and exit. As it turns out, the current COVID-19 pandemic is no different in this regard. In the following we will outline the effects of each strategic response along with giving examples as to which airlines fall into which category.

### ***Retrenchment***

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Generally, this method aims at considerably reducing overhead cost and in some cases, assets. A notable airline which pursues this approach is Emirates. It experienced its first half-year loss in 30 years, with its revenue down 75% due to coronavirus travel restrictions. In the first six months of its financial year it was \$3.4bn in the red, compared to a profit of \$235m in 2019. As a consequence, Emirates engaged in a headcount reduction of 24%, which leaves it with approximately 81,000 employees. Furthermore it has received \$2bn from its government to sustain the business.

There are other companies which reported longer-term retrenchment actions, such as Air France, which has retired its entire A380 fleet or Austrian Airlines, which reduced its fleet by 25%.

## **Perseverance**

This strategy refers to measures that intend to preserve the status quo of both the organizational structure and the activities. Since these companies accept higher costs in order to stay operational, they require a degree of liquidity that only those can afford that were in a solid financial situation before the pandemic. Examples here include Ryanair and Alitalia. The former has reported a second-quarter loss of €22.6m, which, although not desirable, is nowhere near to what some other airlines had to disclose. In fact, thanks to equity and bond offerings, the carrier currently possesses cash reserves to the extent of €4.5bn. This is more than enough to address the €1.5bn in debt due in 2021. As a consequence, Ryanair has so far held on to all of its staff and is still committed to fulfilling its order of more Boeing 737 Max jets. The company plans to further increase price competition post-crisis. Alitalia pursues this strategic approach as well, although not necessarily thanks to its own financial strength. It benefits from the Italian government's commitment to safeguard the airline in order to use it as a launching pad for the revitalization of the Italian economy.

## **Innovation**

The third strategic approach is innovation and is characterised by renewal of the organisation in strategically important segments. If carried out wisely such a response can prove to be of substantial impact in the long-term. A prominent example in this instance would be Wizz Air, which has plans to aggressively expand into new European markets during the crisis. More precisely, the company has declared plans to open a total of 13 new bases, attempting to exploit the current situation by increasing its presence in Europe while other airlines retrench. The rationale behind this decision is that it expects a sharp increase in demand by April. According to Wizz Air's chief executive Jozsef Varadi, at that point a lot of the incumbents in the industry will have difficulties to revamp their operations, with some of them never being able to achieve it. In any case, the process will require some time. This gives Wizz Air the opportunity to expand its market share in the territories in which it has built a presence during the crisis. The airline has a realistic chance of achieving this ambitious goal due to its low monthly cash burn of around €80m, which compares favourably to e.g. Ryanair's at €193m per month.

This does not go to say that the Hungarian company is not impacted by the Coronavirus, as it has had to record a loss of €237m in the first half year. However, it claimed to possess cash reserves worth €1.6bn, which analysts say is enough to survive through the winter and beyond as a quick computation can suggest. Proof that investors can get behind this approach is reflected in Wizz's share price, which, as we will see has surpassed the pre-covid valuation and now sits at an all-time high.

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Some other European innovators are, among others, Swiss Airlines and Lufthansa that have reconfigured their passenger carriers for cargo in order to make up for some of the lost revenue.

## **Exit**

Should a company not have any option of continuing its activities left, it can free up its resources for other business opportunities. Examples in the airline industry include Air Italy, which has ceased operation completely or Lufthansa, which has permanently closed its subsidiary Germanwings. Another operator that might have to file for bankruptcy soon is Norwegian Air. This innovative carrier has followed an aggressive growth plan, which left it strapped for cash at the beginning of the crisis. Despite a rescue deal where it converted \$2bn of debt into equity, it is fighting for survival as its debt levels are still very high.

## **Conclusion**

It is still too early to conclude which strategies will produce the winners and losers after the pandemic. However, we might try to infer what the market believes from the stock price performances of some of the previously mentioned companies. Emirates has experienced a 50% drop in its share price at the beginning of the pandemic, and has now recovered to roughly half of the lost amount, signaling that its entrenchment strategy combined with its premium brand was enough to at least calm the market. Even better for Ryanair, whose stock price initially fell by 47%, but has now regained all of its losses and even added 1.6% to its pre-pandemic level. It is clear that investors believe that once people will start to travel again Ryanair will have a more dominant position in the market. The situation is similarly optimistic with Wizz Air, whose stock price declined by 54% in February but has since then risen to an all-time high, adding 3.4% to the pre-pandemic value. Lastly, Norwegian Air's stock price has originally plummeted by 83%, however, it has not recovered like other airlines' have, but instead decreased further to near-zero. It is thus clear that a proactive and risk-taking stance has been rewarded by the market that are willing to accept the losses expected for the year to come, waiting for a more dominant position in a market free of a lot of competition after the pandemic.

TAGS: Airlines, transportation, industrials, COVID-19, pandemic, industry analysis, Wizz Air, Ryanair, Norwegian Air, Alitalia, Airitaly, Emirates, Crisis, Pandemic, Recovery, Lufthansa, Swiss Air, Losses, stocks, Innovation, Retrenchment

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