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Back to the future? Airline sector poised for change post-COVID-19

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As they look beyond the pandemic, airlines need to grapple with five new realities—and devise strategies to adapt.

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It's difficult to overstate just how much the COVID-19 pandemic has devastated airlines. In 2020, industry revenues totaled $328 billion, around 40 percent of the previous year's. In nominal terms, that's the same as in 2000. The sector is expected to be smaller for years to come; we project traffic won't return to 2019 levels before 2024.

Financial woes aside, the pandemic's longer-term effects on aviation are emerging. Some of these are obvious: hygiene and safety standards will be more stringent, and digitalization will continue to transform the travel experience. Mobile apps will be used to store travelers' vaccine certificates and COVID-19 test results.

Other effects, though, are more profound. Unlike the 2008 global financial crisis, which was purely economic and weakened spending power, COVID-19 has changed consumer behavior—and the airline sector—irrevocably.

This article will explore five fundamental shifts in the aviation industry that have arisen from the pandemic. For each of these shifts, we also issue a call to action. By responding to these shifts decisively now, carriers should be able to look beyond the pandemic and adapt to the long-term realities of COVID-19.

1. Leisure trips will fuel the recovery

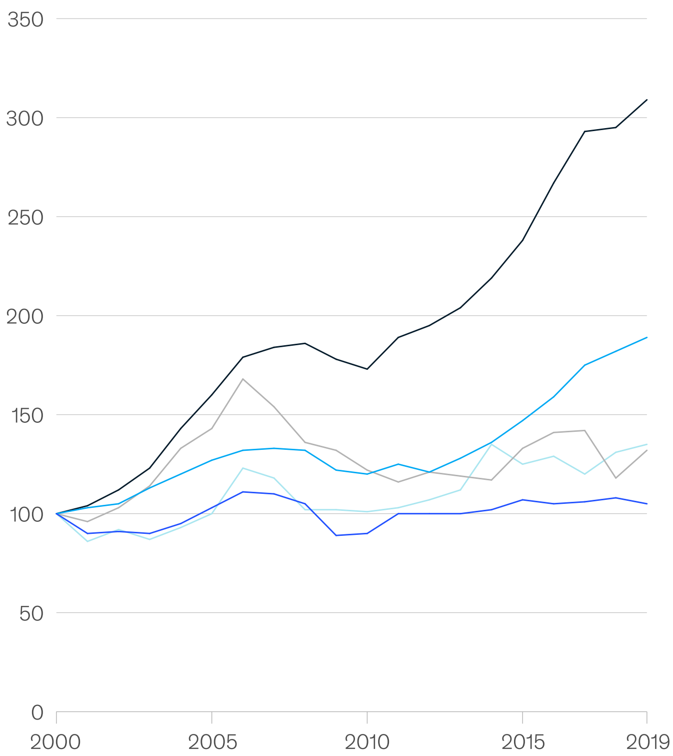
Business travel will take longer to recover, and even then, we estimate it will only likely recover to around 80 percent of prepandemic levels by 2024. Remote work and other flexible working arrangements are likely to remain in some form postpandemic and people will take fewer corporate trips.

In previous crises, leisure trips or visits to friends and relatives tended to rebound first, as was the case in the United Kingdom following 9/11 and the global financial crisis (Exhibit 1). Not only did business trips take four years to return to precrisis levels after the attacks on the World Trade Center but they also had not yet recovered to pre-financial-crisis levels when COVID-19 broke out in 2020. Therefore, we expect that as the pandemic subsides, the rise in leisure trips will outpace the recovery of business travel.

Exhibit 1

Business travel takes the longest to recover after an economic crisis—if it fully recovers at all.

International flights to/from the United Kingdom by purpose, 2000 = 100%, %



Volume to reach precrisis levels, years

	9/11	Global financial crisis (2008)
Visits to friends and relatives	0	3
Holiday	0	6
Study	4	6
Miscellaneous	0	Not recovered yet
Business	4	Not recovered yet

Source: Travelpac, UK Office for National Statistics, 2000–19

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Some carriers are highly dependent on business travelers—both those traveling in business class and those who book economy-class seats right before they need to travel. While leisure passengers fill up most of the seats on flights and help cover a portion of fixed costs, their overall financial contributions in net marginal terms are negligible, if not negative. Most of the profits earned on a long-haul flight are generated by a small group of high-yielding passengers, often traveling for business. But this pool of profit-generating passengers has shrunk because of the pandemic.

The call: Revisit flight economics

Airlines should reevaluate the economics of their operations, especially long-haul flights. First, a smaller contribution from business traffic could necessitate a different pricing logic. For example, today most carriers price point-to-point nonstop flights at a premium. Travelers who value time over price—mostly business travelers—book these nonstop flights. Leisure travelers, even those traveling in premium classes, are more price sensitive and may choose an indirect routing. This large gap between nonstop pricing and connect pricing may need to narrow.

Second, lower business traffic may require network changes. Airlines added many flights over the past few years between hubs and smaller cities, using small-size widebodies such as the Boeing 787. These flights work because of the high-yielding business demand. With business demand subdued, economics favor larger aircraft flying less frequently. Airlines may find that larger aircraft such as Airbus A350s or Boeing 777s—which have lower unit costs—become the base of the long-haul network.

Third, airlines may also look at reconfiguring the layout of their cabins to address the increased share of leisure traffic. At the simplest level, lower business-class demand may warrant smaller business-class cabins. Taking this further, products may shift to better cater to premium-leisure passengers, such as growth of premium-economy cabins or development of business-class seats more suitable for traveling as couples or groups.

2. Staggering debt levels will lead to ticket price increases and a larger role for government in the sector

Many airlines have had to borrow huge sums of money to stay afloat and cope with high daily cash burn rates. Tapping into state-provided aid, credit lines, and bond issuances, the industry collectively amassed more than $180 billion worth of debt in 2020,[1] a figure equivalent to more than half of total annual revenues that year. And debt levels are still rising (Exhibit 2). Repaying these loans is made even harder by worsening credit ratings and higher financing costs.

Exhibit 2

These costs will need to be recouped. Therefore, we'll likely see ticket prices rise. By our estimates, this could amount to a rise in ticket prices of about 3 percent, assuming a ten-year repayment window for only the additional debt taken on.

Furthermore, when demand for air travel returns, it will likely outpace supply initially. We see a glut of latent demand of people eager to travel. It will take time for airlines to restore capacity, and bottlenecks such as delays in bringing aircraft back to service and crew retraining could lead to a supply–demand gap, resulting in higher short-term prices.

In many cases, airline rescue efforts come in the form of government bailouts—with strings attached. We're seeing a reemergence of, or increase in, the level of state ownership and influence. In Europe alone, TAP Air Portugal, Lufthansa Group, and Air Baltic all received state aid combined with an increase or reintroduction of government shareholdings.

The call: Be a constructive collaborator

As the state becomes a more active player—whether as a creditor, a direct shareholder, or as part of the board—airlines will find themselves having to deal more closely with the authorities. Instead of seeing this as a necessary restriction to access much-needed funds, airlines can treat it as an opportunity to shape how the sector evolves with a key stakeholder.

Airlines can work with regulators to set standards across a gamut of issues. These could include committing to reductions in greenhouse-gas emissions in return for more labor flexibility; increasing the cash-on-hand requirements to make airlines more resilient against future shocks; more balanced value sharing between airlines and other sectors such as airports; or changes in the ownership caps to allow greater inflows of foreign capital, reducing the reliance on state capital further down the road.

3. We will see a greater disparity of performance among airlines in the future

Some airlines have responded to the pandemic by restructuring for greater efficiency; others are merely muddling through. Occasionally, this is linked to state-aid programs, which may reduce the incentive for much-needed measures such as cost, organizational, and operational restructuring. Airlines that are not proactively transforming risk failing to set the business up for longer-term structural value creation.

As such, we're seeing some airlines pull ahead. Before COVID-19, an airline boasted an ROIC well ahead of the overall industry's rate of 5.8 percent. Not only did its stronger position pre-COVID-19 enable it to navigate the crisis thus far without taking on government loans of the scale relative to other airlines, it also made it possible for it to restructure to emerge with an even more competitive cost base.

Another group of carriers that have an opportunity to transform their business are airlines that have access to a restructuring process, such as Chapter 11 in the United States. These carriers can renegotiate midlife leases, shed excess debt, and emerge leaner. They will be fierce competitors going forward.

The call: Aim higher when it comes to IT and digital investment

Becoming better can necessitate investment. Even though many airlines find themselves in financial straits, we recommend investing more in IT and digitalization, not less. Before the pandemic, airlines spent roughly 5 percent of their revenue on IT. This is relatively low compared with other sectors. By means of comparison, the retail industry spends around 6 percent on average, and financial services 10 percent.

Airlines could consider stepping up IT and automation investment now. For example, airlines can respond to the quicker recovery of domestic and short-haul flights by investing in direct sales and owning the customer relationship. Relationships with IT and distribution providers could be reexplored. Carriers can also invest in the customer experience—such as making check-in and boarding processes more seamless—and support services—from revenue accounting to invoicing—to drive the next level of efficiency. Beyond this, the next horizon is analytics, which involves, among other efforts, using data in smarter ways to enhance decision making, requiring some investment but yielding significant payoffs.

4. Aircraft markets may be oversupplied for some time to come

In the years before COVID-19, aircraft OEMs ramped up production in the anticipation of continued growth. This has led to a glut in aircraft availability. Furthermore, some carriers have returned relatively new aircraft to lessors, such as Norwegian Air Shuttle when it exited the long-haul market. Prices for used-aircraft leases have plummeted and are likely to remain lower. For instance, the monthly lease rate of a 2016 vintage Boeing 777-300ER aircraft was around $1.2 million in 2019. In 2020, the rate fell to less than $800,000. New aircraft are rumored to be available at even deeper discounts.

The call: Act countercyclically now, if you can

If finances permit, carriers can consider acting countercyclically: locking in orders for new aircraft or confirming operating leases now when demand is low. Aircraft are a significant expense for an airline, making up 10 to 15 percent of a carrier's cost base. As lease rates and OEM pricing fluctuate with supply and demand levels, inking deals during a crisis could allow carriers to enjoy a cost advantage for years to come.

5. Air freight will see undersupply for some time

Over the past ten years, low cargo rates and the unprofitability of the cargo business have led many airlines to relinquish or scale back their dedicated cargo freighter fleets. However, cargo has been a lifeline for the aviation industry during COVID-19. Before the pandemic, cargo typically made up around 12 percent of the sector's total revenue; that percentage tripled last year. Based on data from the Airline Analyst, only 21 (down from 77 in 2019) of the airlines around the world that disclosed their operating performance achieved positive operating profits for the third quarter of 2020, traditionally the industry's most profitable quarter. Among these 21 airlines, cargo revenue accounted for 49 percent of total revenues on average.

During the pandemic, e-commerce sales soared while many passenger flights—which are responsible for delivering around half of total air cargo—were grounded. As a result, cargo yields increased by about 30 percent last year. As commercial flights gradually return, belly supply will increase, although not to pre-COVID-19 levels for at least a few years, as the industry is expected stay smaller than before the pandemic for several years.

The call: Bring back freighters, carefully

In response to the high demand and low supply of air freight right now, carriers could investigate short- to medium-term opportunities to boost their cargo services. Airlines can enhance their flexibility through measures such as increasing the deployment of so-called preighters, or passenger airplanes that are used to transport cargo. Airlines may look at freighter conversions, especially as their passenger fleets reduce in number.

Airlines need to be agile. Rushing headlong into developing and maintaining a large freighter fleet again comes with risk. Airlines need to grow cargo in an agile way that allows for quick adjustments; pursuing such a play should be seen as part of a wider theme of establishing a more flexible production setup. High fixed costs combined with unpredictable demand levels outside an airline's control increase the need for airlines to be able to scale down supply nimbly.

The impact of the COVID-19 pandemic is far from over. There is some relief to be found in various parts of the world now that vaccinations have begun, but the road to recovery for air traffic will take several years. The shape of the post-COVID-19 airline sector is becoming clearer and holds lessons for airlines today. Multiple longer-running trends have been accelerated, such as digitization and the phasing out of less efficient aircraft. Burdened by debt, many carriers have depleted their cash reserves. But the forecast is not without bright spots. Travel will become greener and more efficient, and people are itching to travel again for holidays. Taking steps now will help airlines thrive in this transformed sector.

1. "COVID-19 lowers airline credit ratings and raises the cost of debt," International Air Transport Association, August 21, 2020, iata.org.

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