TOP 6 AIRLINE TRENDS

1. Rising Passenger Demand and Rebounding Cargo Volumes
2. Boost from Higher Capacity Addition
3. Improving Operational Metrics
4. High Load Factors Driving Revenue
5. Intensifying Competition from LCCs and ULCCs
6. Ancillary Revenue Opportunities Gaining Center Stage
Until recently, the commercial aviation industry wasn’t considered to be a good investment avenue. In fact, in 2013, billionaire investment mogul Warren Buffett called the sector a “death trap” for investors. However, the industry seems to have caught a break at last. Despite poor macroeconomic conditions and rising voices against globalization, the growth of air travel has remained steady, if not more. According to the International Air Transport Association’s (IATA) annual review report,¹ the industry’s return on capital was more than its cost of capital, a trend that has emerged only for the second time on record. Is it any wonder that Buffett is now the biggest shareholder of four leading U.S. air carriers?

This vote of confidence reflects one unmistakable reality: the industry is slowly, yet steadily, turning the corner in earning back the financial community’s trust. For the third consecutive year, and only the third time in history, the average carrier posted a positive Return on Invested Capital (ROIC) in 2016. IATA expects the ROIC to come in at 8.8 percent in 2017, above the projected weighted average cost of capital of 6.9 percent.

Some of the key drivers of the sector’s revival have been the persistent growth in air travel since the 2008-09 global economic recession, and a concurrent relentless focus on reducing costs and enhancing resource utilization. The outlook on both these fronts is pretty sanguine for the industry, according to most observers.

So, what are the major trends that will shape the course of the aviation business going forward? How are chief executives addressing the challenges posed by the entry of new market players, rising fuel prices and rapidly evolving customer expectations? Will top-line and bottom-line expansion continue at the same pace as in recent years, or is there a hard landing ahead?

Here are six significant trends influencing strategy formulation and implementation across the sector today:

Rising Passenger Demand and Rebounding Cargo Volumes

Passenger numbers are estimated to increase by about 7.19 percent to 4.1 billion this year, matching the pace of expansion in 2016 and significantly outpacing the 20-year trend growth rate of 5 percent. Cargo demand, which has taken a hit in recent years amid a slackening of globalization and trade, should rebound as well, as an upturn in the economic cycle boosts business and consumer

¹ http://www.iata.org/Pages/default.aspx
confidence. As a result, airlines, on an aggregate basis, are likely to post a 5.3 percent growth in revenues, from USD 705 Billion to USD 743 Billion, this year.

**Boost from Higher Capacity Addition**

Capacity addition, measured in Available Seat Miles (ASM), has been growing at a much faster pace. Closely correlated with the growth of Gross Domestic Product (GDP), capacity addition increased by 6.3 percent globally during 2015-16, outstripping both demand and economic expansion, according to a recent study by Oliver Wyman. 2017 will be no different. The overall capacity growth is expected to outpace the demand expansion by nearly 50 basis points as per the forecast set out by Moody’s Investors Service. This growth will be driven by the still comparatively low fuel costs, supply of older aircraft coming off leases and the growth of Low-cost Carriers (LCCs).

**Improving Operational Metrics**

Intense investor scrutiny of balance sheets, particularly on the cost side, is something the industry has gotten used to, considering almost 100 airlines have gone bankrupt over the decades. Not surprisingly, management of all carriers have been laser-focused on trimming the fat wherever possible.

Consequently, the industry’s operating margins have been on a consistent upswing over the last few years, much to the delight of shareholders and creditors. This trend has been underpinned by a substantial decline in the price of Aviation Turbine Fuel (ATF), non-fuel unit cost decreases amid greater airplane seat density and large-scale industry consolidation.

However, Moody’s expects the cumulative operating margin of airlines (of those that it rates) to approach 9 percent in 2017 and

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reduce to 8 percent next year, as compared to 10.8 percent in 2016. This will largely be on account of an estimated 21 percent spike in per-barrel average oil prices, from USD 44.6 last year to USD 54, according to IATA.

In the U.S., major carriers will also be impacted by hikes in labor costs following the revised union contracts they entered into last year. However, they will still enjoy better operating margins compared to other airlines across the world, largely due to a strong dollar and the relatively more rational domestic market. Legacy airlines in Europe and developing nations, in contrast, will face significant headwinds as LCCs continue to mount pressure on them.

**High Load Factors Driving Revenue**

The trend of the past two years which saw occupancy levels hit all-time highs is likely to continue. IATA expects the average load factor to rise from 80.3 percent in 2016 to 80.6 percent this year.

Labor expenses have now overtaken ATF costs to emerge as the largest overhead for airlines, marking a return to the era before the fuel price surge in the early 2000s. Therefore, efficient capacity utilization has become a key focus area for chief executives looking to maintain high load factors in both peak and off-peak times.

### Intensifying Competition from LCCs and ULCCs

LCCs and Ultra Low-cost Carriers (ULCCs) will continue to eat into the market share of Full-service Carriers (FSCs). However, the value propositions offered by the two models are increasingly converging.

Many non-premium airlines have started providing optional, pay-as-you-go upgraded services to their clients. This trend is particularly prominent in emerging markets where passengers are becoming more sophisticated and demanding a broader range of services on board. For instance, in China and Southeast Asia, LCCs have been adopting a hybrid model to attract customers willing to pay a bit more for better service. In response, some FSCs such as American Airlines have tweaked their models to offer no-frills packages, eying value-conscious customer segments.

The reasons for this evolution in competitive positioning are not the same across different geographies. For example, in the U.S., the recent wave of consolidation has meant exercising higher discipline in fares and capacity addition. On the other hand, the fragmented European market is witnessing intense competition between the continent’s major legacy carriers and local LCCs as well as some Middle Eastern airlines. Consequently, many European operators have been slashing volumes on Europe-Asia routes, even as yields on intra-Europe flights keep declining.

### Ancillary Revenue Opportunities Gaining Center Stage

For many years, industry executives have been talking about reimagining the airline as an omni-channel retailer, with the in-flight component representing a key touch point in a personalized digital travel ecosystem. This vision, of course, stems from the business imperative to diversify revenue streams as innovative digital upstarts and online aggregators continue mounting serious competition to the incumbents.

The conventional route to up-selling and cross-selling across the industry has been to focus on earning ancillary revenues via priority boarding, onboard entertainment, bag fees, in-flight commerce, and so on. That

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approach is now being adapted for the 24x7 digital culture where “always on” customers, especially business travelers, expect carriers to provide superior in-flight connectivity options.

According to a recent report¹ published by strategy consulting firm Roland Berger, passengers on short-haul routes increasingly want Web access in air to enable the use of smartphones, tablets and other digital devices. And, a higher proportion of customers prefer in-flight Internet (54 percent) to those prioritizing in-flight meals (19 percent) or entertainment (16 percent), the report noted.

Airlines, therefore, are beginning to contemplate different ways of transforming their In-flight Entertainment (IFE) systems to in-flight engagement platforms, in order to offer personalized and contextual services based on connectivity.

The aviation industry looks all set to make a strong come back into the books of investors. The industry seems to have safely passed through patches of rough weather, at least for now. However, as digital technologies continue to transform the industry and reshape consumer expectations, airlines will need to regularly revisit their core operating assumptions to stay relevant. They will need to expertly navigate through uncertain political and economic conditions, while addressing safety and environmental concerns. Although 2017 has been good for the industry so far, airlines will need to continue delivering delightful consumer experiences and exploring new revenue streams to continue flying strong.

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