ALLIES IN THE SKIES: TACKLING TURBULENCE FOR A SMOOTH TAKEOFF

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Winds of positive change are blowing through the airline industry after nearly two decades of fluctuating fuel prices and sluggish macroeconomic conditions. Airlines have started to deliver better results to their shareholders, and are increasingly investing in infrastructure and technology upgrades.

However, it’s not time to party just yet. The average earning per passenger will continue to be low at around USD 7.54, and this figure is highly sensitive to the slightest change in fuel, labor and other costs. Additionally, with labor and oil prices expected to rally upward and passenger yield going down for the fifth consecutive year, expectations of a full recovery should be taken with a grain of salt.

This underlying sense of caution, along with intensifying competition from Low-cost Carriers (LCCs), will force Full Service Carriers (FSCs) to take relevant steps toward better efficiencies and cost rationalization. Consolidation through carefully structured Mergers and Acquisitions (M&As), and tie-ups will continue to be the preferred manner in which airlines will aim to achieve higher operational synergies and profitability.

The U.S. market has witnessed a remarkable number of airline mergers since the sector was deregulated 40 years ago. One notable merger was that of Delta Airlines and Northwest Airlines between 2008 and 2010, which created the world’s largest carrier at that time. The number of large and mid-size carriers in the market today are just 10, as against over 400 in 1978 reflecting the consolidation wave. Although these airlines have niche operations today, there are still possibilities of alliances amongst them as they try to aim for higher revenues and market share.

The U.K. and Europe markets are another goldmine for M&As in the next five years. Unlike the U.S., Europe’s airline sector is highly fragmented, with 38 carriers operating across the continent. Many European airlines will need to look at consolidation to secure their positions amid cut-throat competition from LCCs and increasing penetration by Middle Eastern and Asian FSCs. In Asia, eight major LCCs have come together to form the Value Alliance to offer greater connectivity between 20 countries in the region.

A closer look at what’s driving this intense level of consolidation activity in the airline industry reveals six key factors:

1. Emergence of LCCs and Ultra LCCs (ULCCs): Carriers such as Southwest Airlines, one of the largest LCCs in the world, have traditionally focused on short-haul flights. Now they are...

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1http://www.iata.org/pressroom/pr/Pages/2016-12-08-01.aspx
3https://www.bcgperspectives.com/content/articles/transportation-travel-tourism-merger-acquisitions-consolidation-europe-airline-industry/
4https://www.vanilla-air-en/value-alliance/
starting to venture into the profitable long-haul routes. As if these were not disruptive enough, ULCCs, the new kids on the block, are unbundling services to offer even lower prices than the LCCs.

The industry has conventionally been capital-intensive, with low tolerance to outsourcing exposure. That is changing now. A newer model, involving low-to-medium capital expenditure and medium-to-high outsourcing, is emerging. In the future, airline business models may further evolve beyond LCCs and ULCCs to a no-asset-owned, focused-outsourcing model, where airlines just lease from each other to increase market share.

2. Changing Customer Landscape:
Rising disposable incomes and the increasing affordability of LCCs and ULCCs have raised the number of passengers choosing air travel. While this has increased the overall demand, changing passenger demographics have also resulted in higher, and often different, service expectations. This is driving airlines to compete on both prices and service levels, undercutting the expected price-value margin.

3. Ultra-long Routes with Code-share:
More airlines are now offering connected flights under the same brand through code-share and interline agreements to ensure better route coverage to passengers. LCCs are also working with FSCs to introduce dedicated feeder flights to capture the profitable long-haul business.

4. Emergence of Long-haul Low-cost (LHLC) Model:
The International Airlines Group (IAG) recently launched its LHLC brand ‘Level’ signifying the change in the airline landscape. Air Asia, Air France, Lufthansa and Norwegian have also entered this space. Norwegian is all set to become the largest LHLC operator in terms of number of destinations and routes.¹

5. Imperfect Competition Through Multi-market Contact:
In markets dominated by fewer players, there is a slow emergence of multi-market contact, where competitors do not price aggressively on one route, in order to safeguard their positions against competition in another. This results in collusive pricing, which is not beneficial to the end consumer in the long run.

6. Technology Transformation:
Irrespective of the strategies that airlines choose to retain a competitive edge, they need to continue investing in technology improvements to enhance passenger delight, increase performance and decrease costs. Developments such as next-generation revenue management solutions, chatbots, advanced loyalty analytics, Artificial Intelligence (AI), Robotic Process Automation (RPA) and connected aircraft can significantly improve sales and help diversify revenue opportunities.

The cumulative effect of the above factors on traditional carriers has been compelling them to reimagine their business models and respond to the changing dynamics with transformed operations. Enhancing customer engagement, increasing revenue margins and improving operations will continue to remain the core focus areas for the airline industry. A large part of this will be relatively easier to achieve through strategic M&As, joint partnerships and alliances, making cautious consolidation a sensible choice for serious contenders.

So, a partner might be the antidote to airsickness on a turbulent flight!

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