Home Sweet Home: identifying potential ‘winners’ in domestic-led aviation recovery and crafting the right strategic response

As passenger traffic gradually lifts off around the world in June, the recovery is strongly led by domestic air service. This puts certain airlines in a natural position of strength, and requires an appropriate strategic response from other airlines which may be more reliant on international traffic. This article identifies six ‘starting positions’ for an airline in an aviation market, and the resulting strategic implications.

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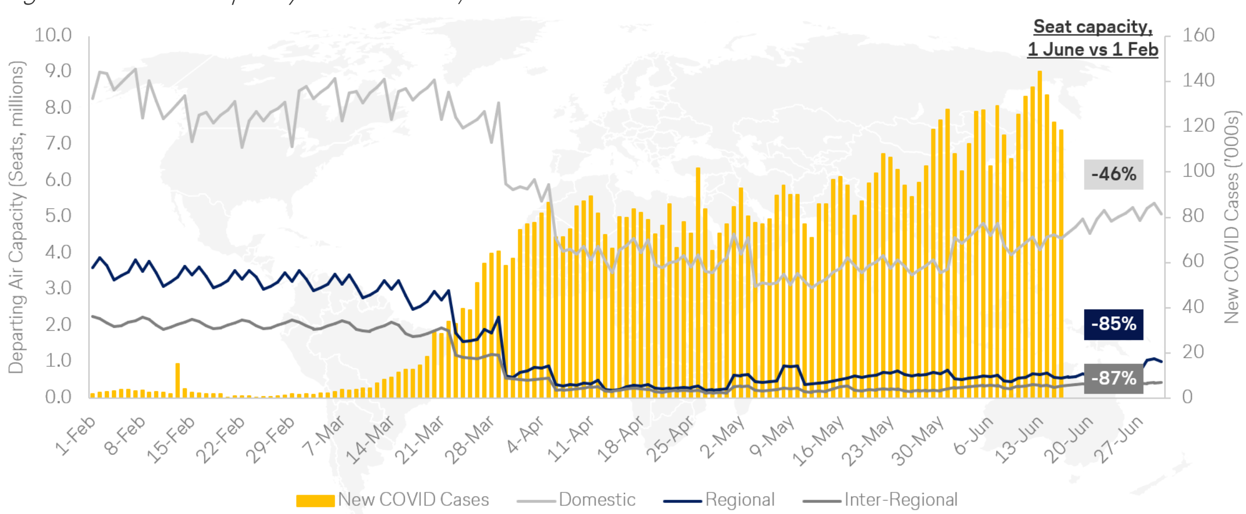
The global aviation industry is cautiously taking to the skies once again. Travel restrictions are being eased as several countries pass the peak of their COVID-19 infection cycles. In nearly every region, air passenger capacity (seats) is rising in June as compared to previous months. And, across the board, domestic air capacity is leading the way.

Figure 1: Aviation capacity vs COVID-19, Global



Source: IATA Airport IS, European Center for Disease Prevention and Control, Lufthansa Consulting
Note: Regions as defined by IATA; Asia, Australasia, Caribbean, Central America, Europe, Middle East, North America, South America

There are several reasons why the return of international capacity will lag that in domestic aviation. For any country, opening up international travel generally comes with greater risk of importing new COVID-19 cases; Governments are, therefore, proceeding with caution. International flights may also require bilateral or multilateral agreements on passenger processing and medical requirements, making recovery inherently slower. Domestic market reopening and growth, on the other hand, can be closely controlled by regulators and Governments through policy decisions and tailored to a country's specific health and economic considerations. Initial reports also suggest that customer preferences are tending towards domestic travel in the short term in order to minimize health risks and avoid entering quarantines when crossing borders.

In fact, IATA estimates that domestic air travel could see a rebound to pre-crisis levels by 2022 while international air travel may take up to 2023 or 2024.

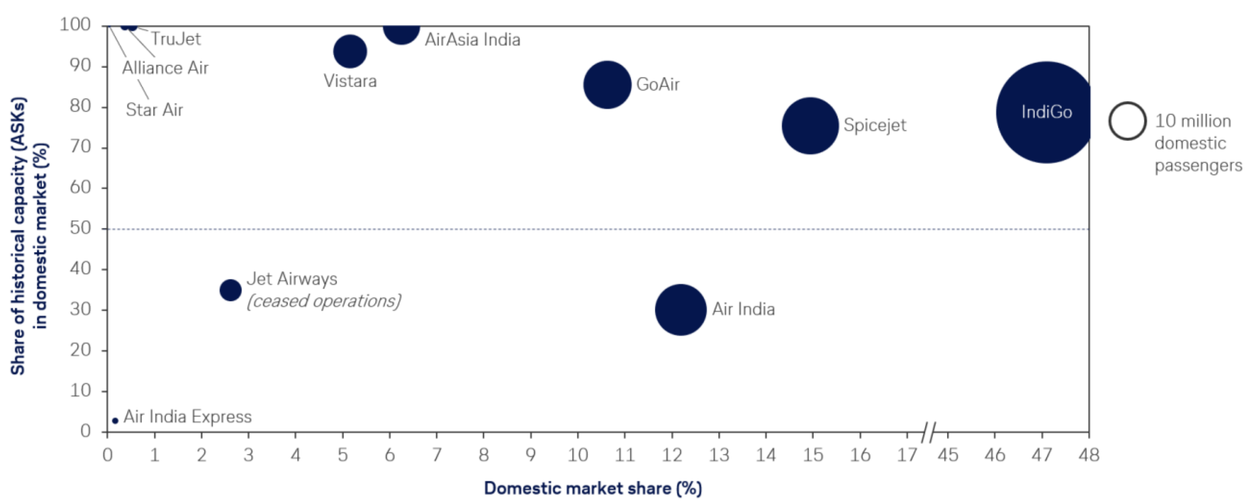
Airlines are, of course, eagerly awaiting the resumption of service as a means to generate cash flows once again. Many airlines have little or no cash on hand, or have in some cases received Government funds that come with strings attached. A resumption of flights is a welcome signal of the industry turning a corner and returning to business, though certainly not business as usual.

Some airlines are better placed to reap the benefits of domestic-led recovery

In this context, airlines that were heavily domestic-oriented in their operations pre-COVID-19 would have a strong starting point, as they can expect to bring back more of their pre-crisis capacity. Putting aside for the moment the current financial health of an airline, a historic position of strength in its domestic market may be indicative of its ability to win relative to competition in the coming months.

Let us consider, for example, the aviation industry in India, taking into account two factors - the share of an airline's business that comes from its domestic market, and its domestic market share.

Figure 2: Domestic aviation market, India, 2019

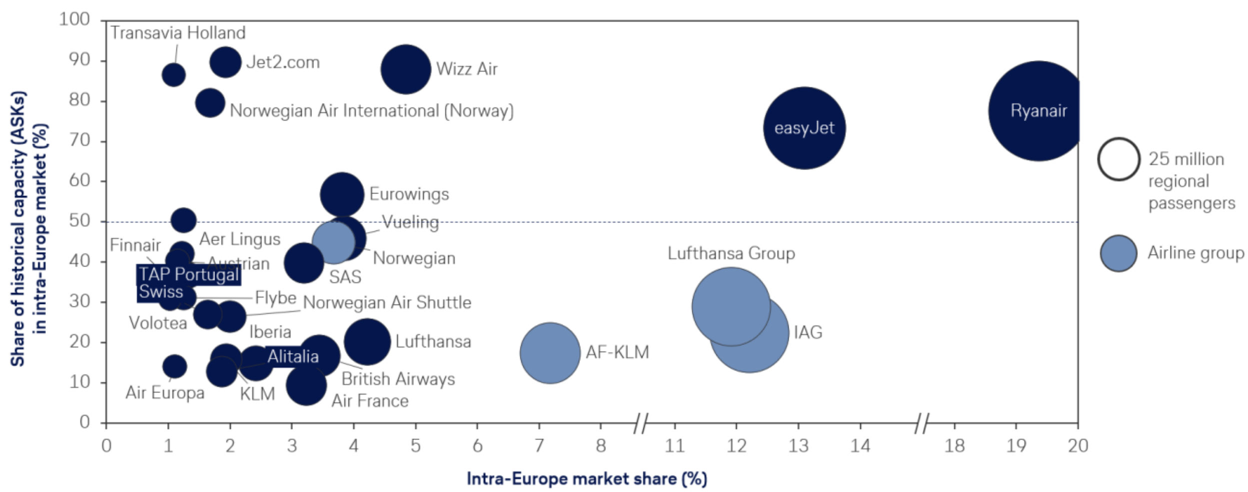


Source: IATA Airport IS; Directorate General of Civil Aviation, India

IndiGo Airlines is the clear market leader, garnering ~45% market share in 2019. (This share rose further in the latter half of the year after the grounding of *Jet Airways*.) Although it has large - and growing – international operations, it still boasts a very strong domestic base that it can leverage to ride out the crisis. It can bring in more capacity, schedule operations more flexibly and address the market in a more aggressive manner than its competitors. Compare its position with airlines such as *Vistara* and *GoAir*. These airlines were heavily domestic oriented in 2019; in fact, Vistara only launched international services in the second half of the year. However, their relatively low domestic market share leaves them vulnerable to pressure from the market leader. Their small size – further shrunk due to lower demand – also affords fewer economies of scale and complicates their return to financial stability. Towards the top left, one finds the regional airlines such as *TruJet* serving specific niche routes. Their unique positioning could be an advantage in local markets. *Air India*, on the other hand, is much more dependent on international operations and has a middling market share in domestic operations. The situation is even more stark for its low-cost subsidiary, *Air India Express*. There may be some unique opportunities arising from their position – for example, *Air India* could deploy widebodies on domestic routes if there was a demand for it – but also presents challenges in using its domestic operations to maintain liquidity for the airline as a whole.

Europe offers an interesting case study. If one considers all of Europe as effectively being a single 'domestic' market, the dominance of the low-cost airlines such as *Ryanair* and *easyJet* (and, to a lesser extent, *Wizz Air*) is clear. With operations almost entirely within Europe from multiple bases, they stand to gain as the continent opens up over the summer. However, the large airline groups in the continent – *Lufthansa Group*, *IAG* and *Air France-KLM* – could have a range of options at hand depending on how they choose to balance capacities across their constituent airlines.

Figure 3: Intra-Europe aviation market (excludes Russia and Turkey), 2019

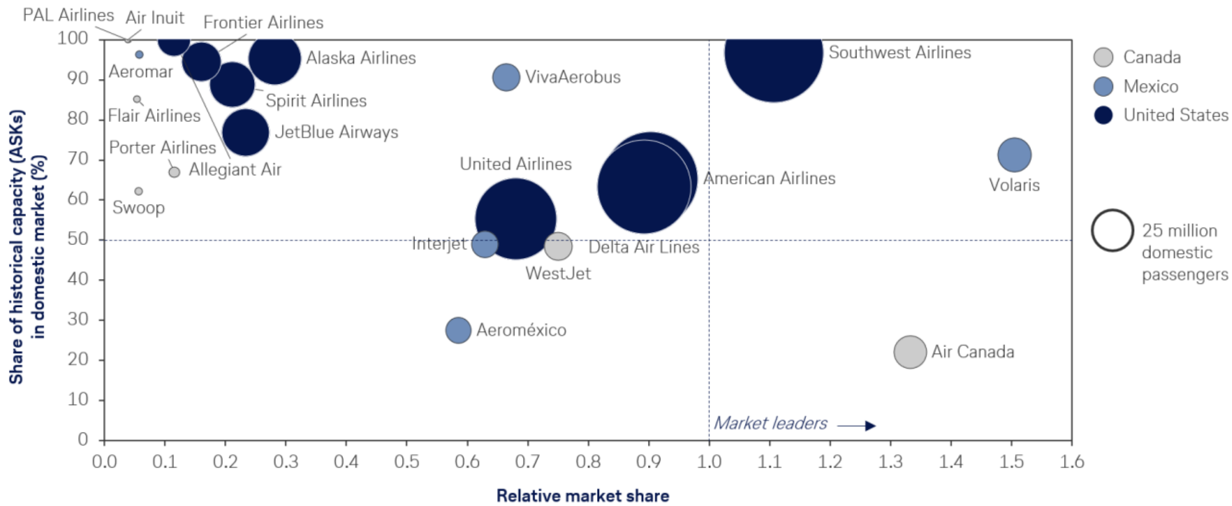


Source: IATA Airport IS
Note: Reflects only airlines with at least 1% market share. Reflects O&D volumes

One can also examine these dynamics in countries across a region. To make the country markets comparable, one must consider the Relative Market Share[1] of each airline within its home market.

[1] Relative Market Share (RMS) for an airline = Market share of airline / Market share of market leader. For the market leader, RMS = Market share of market leader / Market share of next largest airline.
The market leader, therefore, will always have an RMS value greater than 1

Figure 4: Domestic aviation markets, North America, 2019



Source: IATA Airport IS
Note: Only includes airlines with at least 1.5% share of the domestic market; Reflects O&D volumes

Take, for example, the North American market. *Volaris* is the clear leader in Mexico and well placed for recovery, with a market share 1.5 times that of its nearest competitors (~33%, against 19-22% for *Aeromexico*, *Interjet* and *VivaAerobus*). However, it still has some exposure to the international market. *Aeromar*, already teetering on the brink, may not survive at its small scale.

The US market is much more evenly distributed; not surprising, given its scale and the hubs or niches occupied by most airlines. Southwest is the largest and strongly poised to leverage the domestic recovery. However, it could find itself under continued pressure due to the rules under which it has received state aid that require it to continue flying routes with low passenger volumes. *United*, *American* and *Delta* feature a more balanced portfolio, although their historic dependency on operating a hub network will be challenged as international traffic slows.

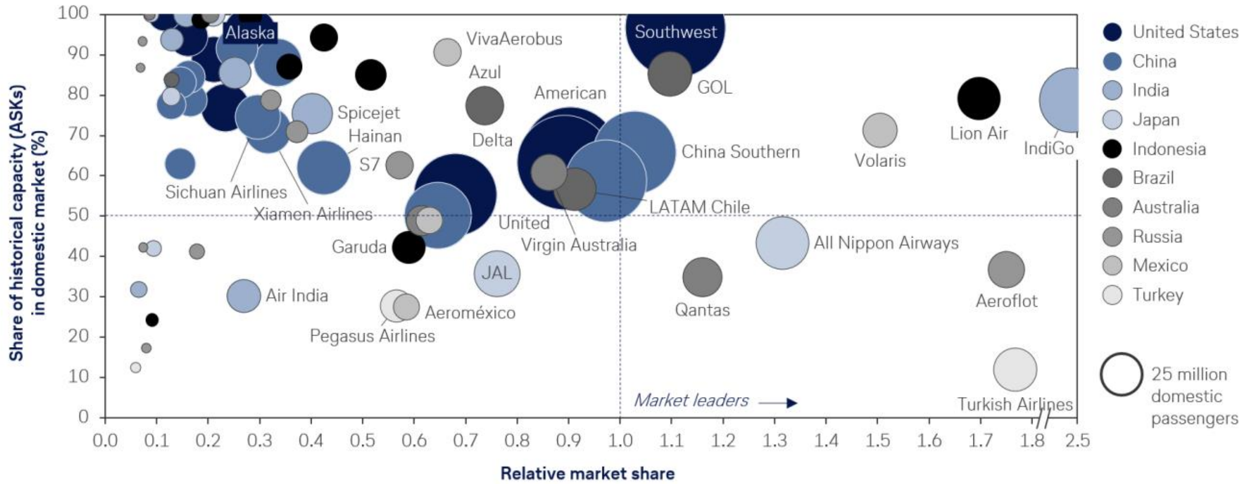
In Canada, *Air Canada* has a very strong market share but will be heavily dependent on international flights once they pick up pace.

The domestic market position has implications for the near to mid-term strategy of an airline

The individual dynamics and competitive intensity of each country's domestic aviation market will vary from others. In general, however, the domestic starting position of an airline plays heavily into its challenges and opportunities in the coming months and years. Each airline should, therefore, clearly identify its position and plan accordingly.

Let us consider the ten largest domestic markets in the world to illustrate this point.

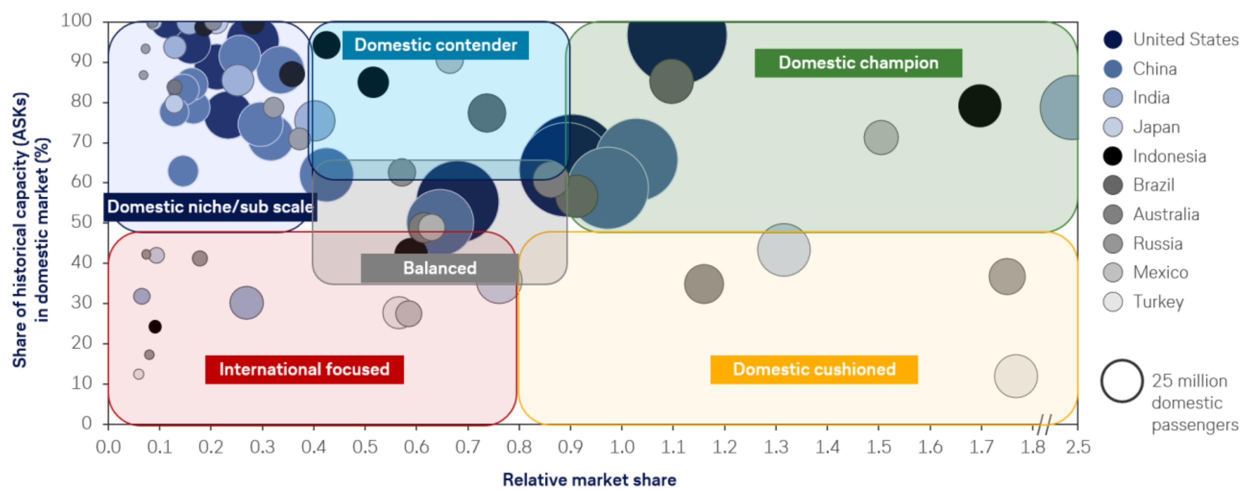
Figure 5: Ten largest domestic aviation markets, 2019



Source: IATA Airport IS, Lufthansa Consulting
Note: Only includes airlines with at least 2% share of the domestic market; Reflects O&D volumes

There are six distinct starting positions that airlines find themselves in as they face the resumption of air service. Each requires a differentiated, nuanced approach to planning and preparation in order to lay the groundwork for financial sustainability and market share gain.

Figure 6: Airline clusters based on domestic strength



Source: IATA Airport IS, Lufthansa Consulting

<u>Domestic champions</u> such as *IndiGo* (India), *GOL* (Brazil) and *Lion Air* (Indonesia) are typically best positioned to capture passenger volumes as they recover. These airlines should seek to bring back capacity aggressively to maintain historical market share and make further inroads where possible, leveraging pricing power and, possibly, stronger cash positions.

<u>Domestic contenders</u> such as *Azul* (Brazil) and *VivaAerobus* (Mexico) should seek to maintain their domestic market position, doubling down on selected strong routes or niches, matching the market leader where possible and taking share from smaller airlines.

Domestic sub-scale airlines such as *AirAsia India* (India) are at risk of losing share to larger and more robust domestic players. They may also find themselves under pressure from airlines redeploying their international capacity to domestic markets opportunistically. Domestic niche operators might be better placed from a competitive perspective, but these are also often smaller airlines that are at risk of bankruptcy as cash flows dry up. In either case, however, having a clear definition of the core business or distinct niche and protecting those routes and passengers is key to emerging successfully. Regional airlines such as *Regional Express* (Australia) are strong examples of such a model. Not all airlines in this category, however, will survive the COVID-19 crisis.

International focused airlines, such as *SunExpress* (Turkey) and *Nord Wind* (Russia) could be among the hardest hit, especially for small airlines and/or those with a weak financial position at the start of the crisis. Airlines in this category should seek a cautious restart of their networks, selecting a cluster of "optimal" routes, leveraging areas of domestic strengths and rebuilding key connections. This will also require constant monitoring of demand indictors and route performance for network expansion and capacity redistribution. There could also be an opportunity for them to turn their gaze homewards and deploy additional capacity to the domestic market on targeted routes.

Domestic cushioned airlines, such as *Aeroflot* (Russia) and *Turkish Airlines* (Turkey), have the benefit of a dominant domestic position that could help offset their relatively high dependence on international passenger volumes. Apart from developing a structured return to the market like the international-focused airlines, airlines should also use the opportunity to leverage the 'security' of the domestic market to rethink and restructure the international business.

Finally, Balanced airlines such as *Garuda* (Indonesia) and *United* (USA) have networks that are more evenly split between domestic and international operations, and typically enjoy a reasonable domestic market share. They should seek to maintain their market position through an optimized point to point network with selective opening of international routes and transfer flows.

There is most certainly no 'one-size-fits-all' approach. These six categories could have slightly different dynamics in each market. However, it is clear that certain airlines are in a position of strength as the domestic-led recovery unfurls over the coming months. This should spur action for all airlines in a market, reflecting the reality of their starting position and executing what is required to ride out the storm to calmer skies.

To learn more and discuss how your organization could benefit from Lufthansa Consulting's expertise on Crisis Recovery, please get in touch at ALcrisis-solutions@LHConsulting.com.

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