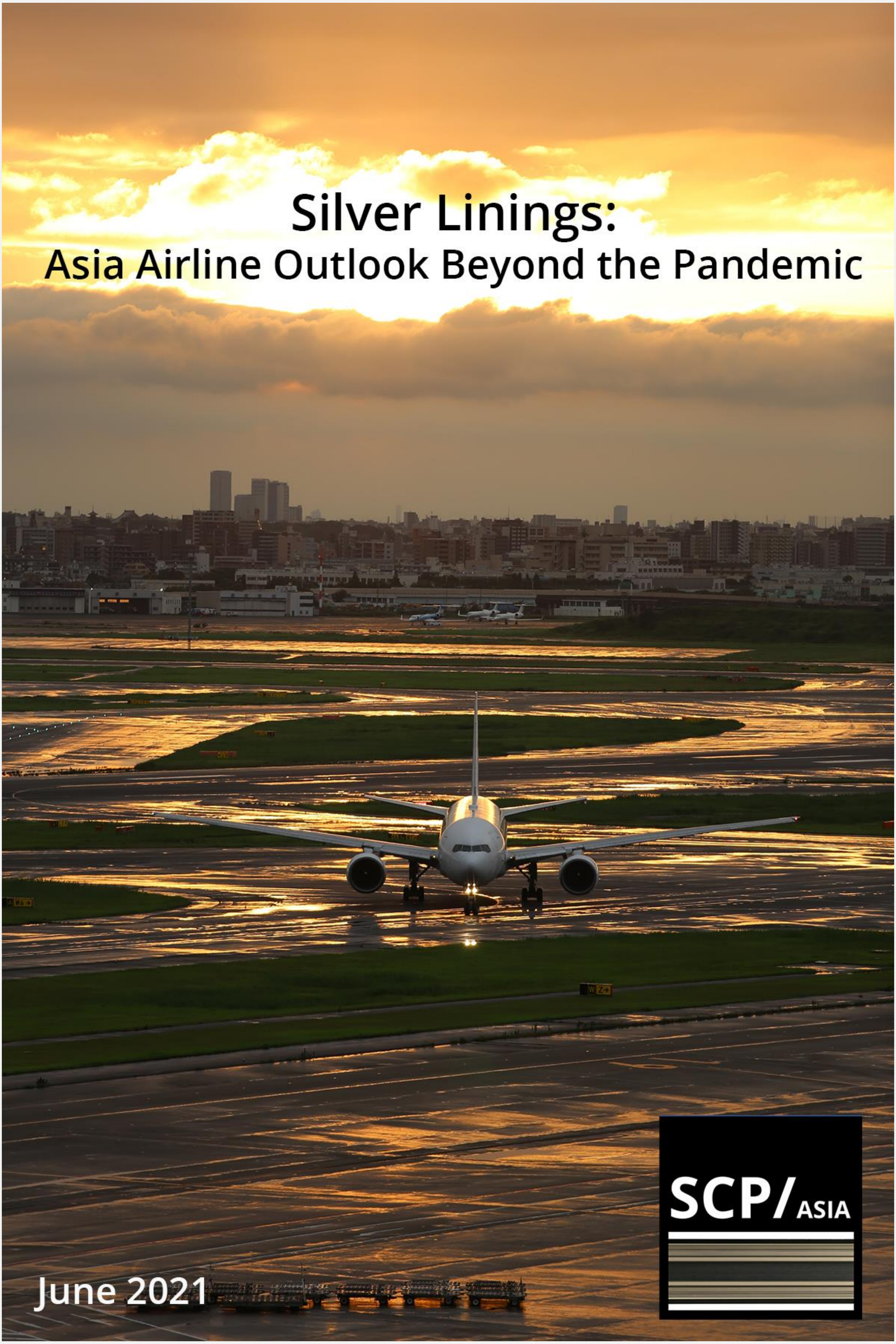
Silver Linings:
Asia Airline Outlook Beyond the Pandemic



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Asia Aviation Perspectives:
Outlook Beyond Covid-19

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Few industries in Asia have been hit as hard by Covid-19 as the airline and tourism industries. But already prior to the pandemic several major developments were underway that were shaking up the industry such as the grounding of the Boeing 737 Max 8 fleet and a consolidation and expansion trend amongst some of the leading players in the region.

In this article we take a look back at some of the these key developments and lay out what the post-Covid-19 world may look like for the aviation industry in Asia.

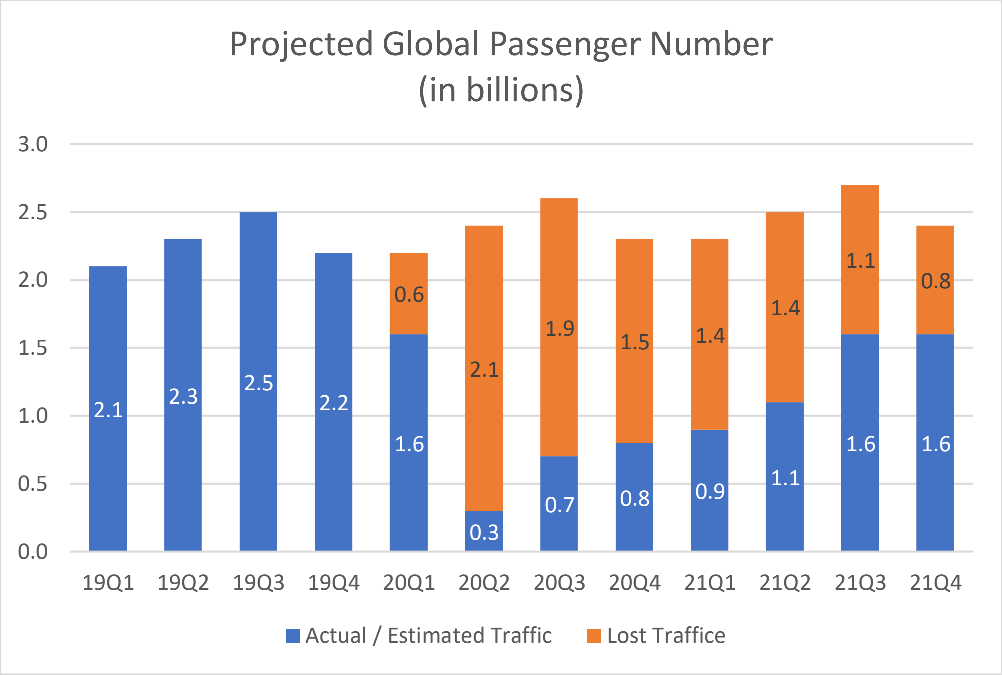
Covid-19 Devastation

Undoubtedly the biggest impact on the aviation industry has been the onslaught caused by Covid-19 related to travel restrictions. The airline industry is never short of a major crisis but even by airline-crisis standard, the impact of Covid-19 is not something anybody in the industry had ever seen before.

For planning purposes aviation executive teams regularly look at 'extreme' downside scenarios of -30%, typically followed by a relatively fast recovery. Nobody ever seriously factored in revenue drops of 90+%, which is exactly what has happened at the height of the pandemic.

In 2020, global industry revenues declined 60% putting the scale of the sector back to where it was 20 years ago with a loss of almost 5 million jobs. Furthermore, there have been a massive indirect effects, especially on global tourism sectors, as a result of a loss of 1 billion tourist trips representing a loss of $1 trillion in global GDP.

And whereas previous crisis (think 9/11 or SARS) witnessed relatively fast recoveries back to pre-crisis levels, the recovery out of the Covid-19 pandemic is booth more gradual and longer compared to before. Most industry observers expect a full recovery back to 2019 levels may not happen until 2023 or 2024 at the earliest as can be seen from the latest projection by ACI below:



The global picture masks that individual countries can see faster recoveries when the pandemic is brought under control through a combination of strict lockdowns and widespread vaccination. This is especially true for markets with large domestic demand that are relatively less dependent on international flows. The US has recently witnessed a surge in demand and in Asia, China managed a recovery of travel volumes back to 2019 levels already in the second half of 2020. Vietnam is also experiencing relatively strong domestic demand as the country managed to maintain positive economic development as one of the few countries in the world.

737 Max 8 Troubles

Before Covid-19 came to dominate discussions in airline boardrooms around the world, the grounding of Boeing 737 Max 8 aircraft was causing major headaches, especially for airlines that had a large number of these planes in their fleet or on order.

In October 2018, the first crash involved a plane from Indonesia's Lion Air. At the time I shared my perspectives in an article by Nikkei Review on the impact of the crash on Asia's low cost carrier (LCC) sector [(click here for article)]. At the time the thinking was that the crash may have been caused by short-cuts taken by Lion Air rather than any fundamental issues with the aircraft itself.

Airline crashes have had only short-term impact on travel – demand remains resilient

My perspective at the time was that the majority of domestic passengers would see Lion Air as one of the few available options for cheap domestic travel in Indonesia. With its scale and extensive domestic network many passengers have limited alternative options to travel domestically in a fast and relatively cheap manner. The expectation at the time was that the crash would put short term caution into the market but the majority of passenger in Indonesia would discount the risk of incidents and accidents associated with air travel to a low probability and continue to fly.

After a first investigation report on the crash was released in November 2018, I reiterated my believe that passengers would likely continue to fly with Lion Air in a subsequent article in Nikkei Asian (click here for article). The long term impact on Lion Air would be dependent on the outcome of the investigation and how management handles the aftermath of the crash. If the investigation had concluded the crash was the result of maintenance or pilot errors then that would have impacted consumer trust. The airline would need to over-respond in terms of its emphasis on safety and its treatment of the families of the victims. Only by doing that will it be able to limit the impact of customer trust on the company.

A second crash of the 737 Max 8 in March 2019, this one operated by Ethiopian Air, exposed a number of the fundamental flaws associated with the aircraft and resulted in aviation authorities around the world grounding the jet and many carriers starting evaluations around their commitments to purchase the plane in the future.

In another article for Nikkei Asian I shared my perspectives on the impact of the grounding of the Max-8 on carriers which have the jet in their fleet (click here for article). The Max problem would lead to short term disruptions and financial impact for the carriers, especially those carrier where the Max represents a large share of the fleet. In the short term the airlines had to made schedule adjustments and potentially look at short term leases or delay the retirement of older aircraft. For carriers where the Max is not a very large share of the fleet they would be able to manage disruptions quite well albeit with some short term financial impact.

So unlike Covid-19, which fundamentally put the aviation sector into a horrific downward tailspin, the Max 8 crisis was something that most carriers where able to manage through quite well since underlying demand for their services remained resilient.

Boeing in Trouble

The story has been quite different for Boeing. Towards the end of 2019 and early 2020 a series of setbacks associated with Boeing's efforts to manage through the Max-8 crisis materialised. In December 2019, the Chinese authorities raised "important concerns" with Boeing regarding design changes proposed to end the grounding of the Boeing 737 MAX airliner.

Boeing facing a series of crises: from Max 8 to Covid-19

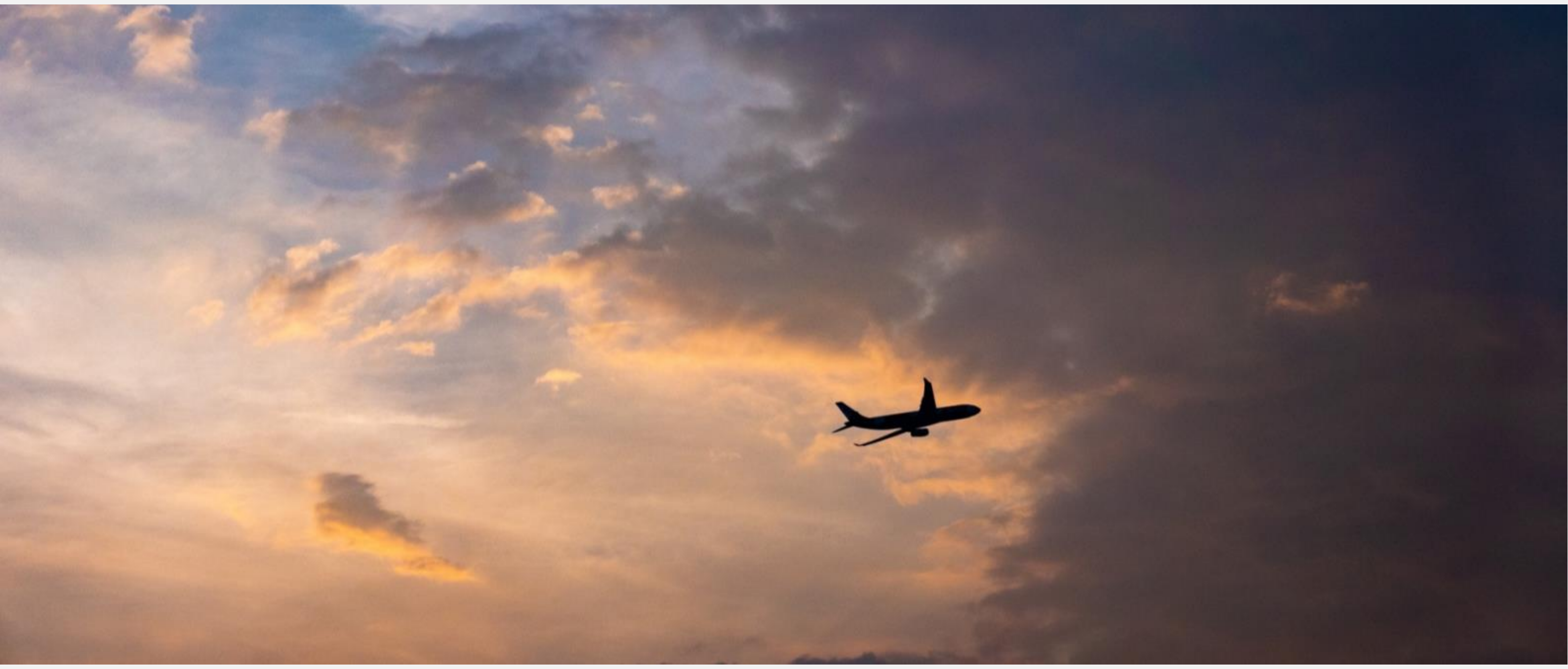
A few days later, Boeing said it would temporarily stop producing its grounded B737-Max aircraft as it struggled to get approval from regulators to put the plane back in the air. The move amounted to an acknowledgement that it would take much longer than Boeing originally expected to win approval from the United States Federal Aviation Administration (FAA) and other global regulators to fly the planes again. Soon after this announcement, the Board fired CEO Dennis Muilenburg in an effort to regain the trust of customers and aviation authorities.

In January 2020 Boeing announced a financial loss for the first time in 20 years and announced the total cost of the Max 8 crisis had accumulated to US$18bn, primarily as it had to ground aircraft and it was impossible to deliver any new aircraft to its customers.

A month later, yet another setback unfolded in the Max-8 crises when debris was found in the fuel tanks of several planes that were ready for delivery to new customers. Due to the grounding of the aircraft around 400 newly build aircraft were ready for delivery to customers and all had to be inspected to avoid any further blow-ups.

New orders for the 737 Max 8 suggest an imminent recovery in demand for air travel

Early in 2021, Boeing's fate finally seemed to have taken a turn with US regulators lifting the 20-month grounding of the 737 Max, and Covid-19 vaccine approvals raising hopes for back-to-normal demand for air travel and aircraft purchases. More recently, several large US carriers have started placing large orders for the jet, likely attracted but attractive discounts by Boeing to rekindle market trust, but also in anticipation of a recovery in demand for air travel.



But Boeing is not out of the woods. In February 2021, 69 of its 777-model jets were grounded following an engine failure on a United Airlines flight out of Denver. Also, the FAA ordered inspections of more than 200 of the 787s due to torn decompression panels in cargo holds that poses a risk to the aircraft if a fire were to break out in the holds.

All the issues above can eventually be fixed by Boeing, they are technical issues for which technical solutions exist. The bigger question that should be asked is how Boeing's corporate culture and governance model has allowed a series of technical glitches to have crept into the organisation where safety and product should always be a the absolute forefront of everyone in the organisation.

Also, Covid-19 is potentially reducing demand for long-haul international travel, and this may not be something Boeing can do much about. Boeing has already announced plans to shutter a 787 factory in Washington. The company expects to build only five 787 Dreamliners and two 777s or 777Xs each month, less than half of the pre-pandemic production rate. With the much slower production rate, Boeing will be much closer to breaking even than making money on widebodies and it will probably depend on sales of 777 freighters rather than passenger planes if they are going to turn a profit on those models.

Consolidation and Restructuring in Asia

As these events were unfolding at Boeing, life for most Asian airlines went on relatively smoothly prior to the pandemic. Many carriers in the region were busy with consolidation and restructuring efforts to position for future growth. In a sign that all was well, Lion Air, the airline that suffered the first 737-Max crash, announced in January 2020 that it would launch a pre-deal investor education roadshow for its Initial Public Offer (IPO) which was estimated at up to $1bn in valuation according to a term sheet from one of the banks involved.

And Lion Air's legacy competitor in Indonesia, Garuda, was busy rebuilding its international footprint in a move to bring higher value traffic onto its planes. At the time, I provided some perspectives on this move in an article for Nikkei Asian (click here for article). I considered that building a viable long-haul business was critical for Garuda given the fierce competition from LCC's in its home market, most notably Lion Air.

I argued that Garuda should expand its international business as this would be more lucrative than the domestic market given the higher share of more profitable business travellers compared to economy class passengers who are more price sensitive. On short haul domestic routes, Garuda is facing fierce competition from low cost airlines who have a more competitive cost structure than Garuda.

Question marks over lang-haul premium service model

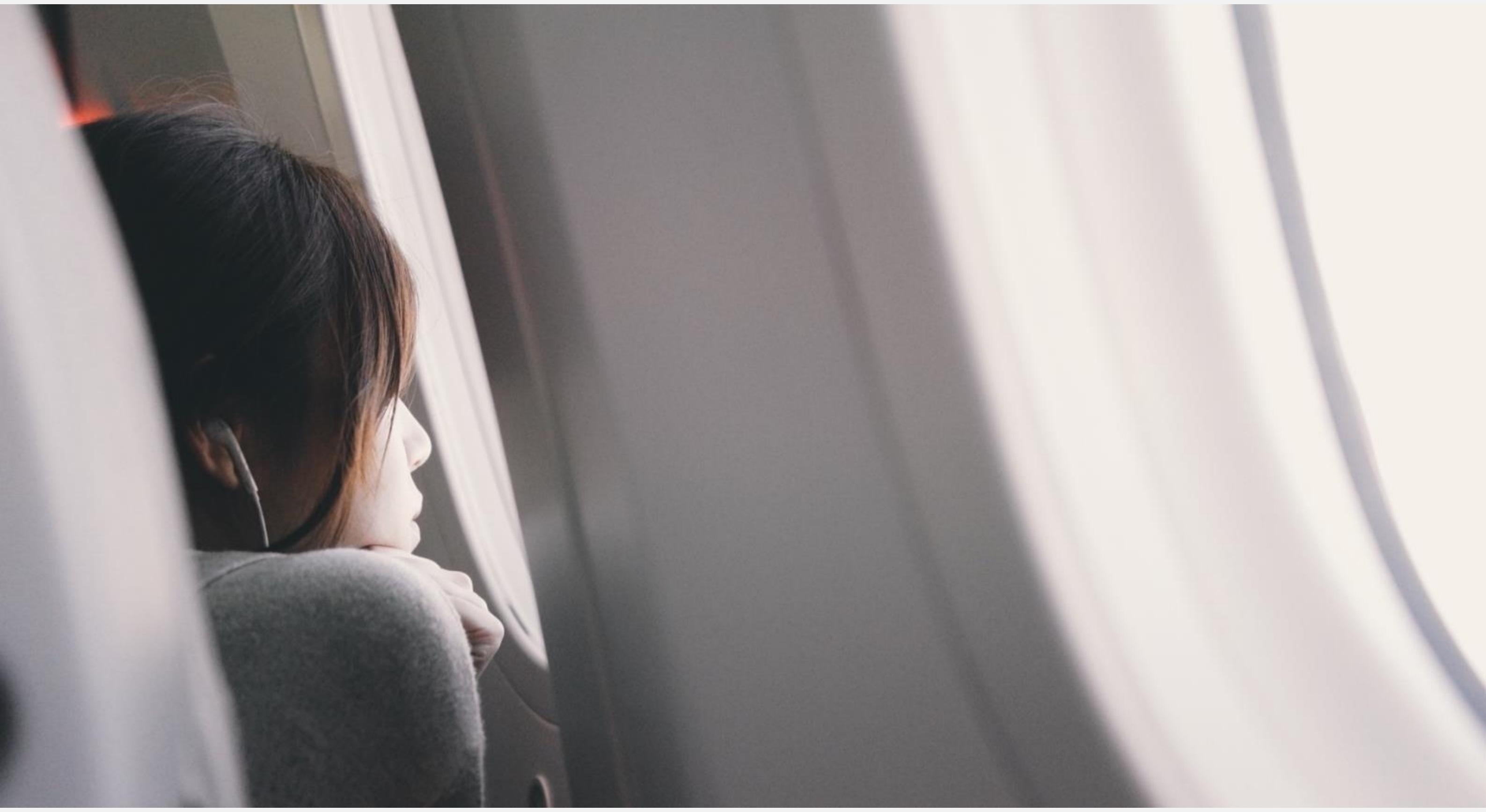
But Covid-19 has put a major question-mark on the validity of this strategy. Demand recovery initially will be realised in domestic markets and then followed by regional markets. Long-haul international business travel is probably one of the last segments to recover putting pressure on the full-service business model pursued by flag carriers in the region.

Asia's premium airline brands, notably Singapore Airlines and Cathay Pacific, are particularly exposed. Without domestic demand to kick-start recovery and a high share of business travel these carriers are fully dependent on international travel restrictions to be lifted and need to shift focus to more regional travel focussed on leisure and VFR segments rather than business travel.

Luckily, both carriers had already started down this path with Singapore rationalising its brand portfolio under the full service Singapore Airlines brand and budget services under Scoot.

And a notable deal was announced in March 2019 when Cathay Pacific confirmed it was in talks to acquire Hong Kong Express from Chinese conglomerate HNA. I provided some perspectives on this deal in an article from Nikkei Asian (click here for article). Following decades of sitting on the LCC side line, Cathay Pacific finally jumped on the budget bandwagon.

Seeing most Asian carriers adopt a dual branding strategy, the opportunity to acquire HK Express and taking out a competitor in the process was too good to pass. With additional capacity coming up at HKIA and recovery likely led by leisure and regional traffic, the deal can provide Cathay a better shot at survival and long-term growth given the intense pressure on its long-haul business.



HNA: COVID's first Casualty

But not all examples of aviation M&A by Asian players have been happy stories. Covid's first corporate casualty, even on a global basis, was China's HNA Group. In an op-ed in Nikkei Asia I shared perspectives on the outlook for HNA, just before the global pandemic hit (click here for article). The group went on an aggressive overseas M&A spree, completing over 25 investments between 2015 and 2018, spending more than $50 billion and quadrupling the company's assets.

HNA's founding chairman Chen Feng was quoted in a Reuters interview in 2015 comparing global M&A opportunities to shopping in a wet market: "You see so many fresh vegetables, you eat here, pick this and that."

COVID-19 hampered HNA's asset sales program due to deteriorated valuations for its aviation assets

The heavy debt load to fund the M&A spree and capital expenses associated with its subsidiaries' aggressive expansion plans had resulted in cash flow problems, despite the acceptable operating performance of most of HNA's subsidiaries.

At the time of the article I already suggested that best for the company would be a radical process to bring debt to a manageable level and put the company on a sustainable path.

A few months later, with Covid-19 creating havoc across airlines globally, HNA appeared on the brink of collapse. I provided additional perspectives to Nikkei Asian regarding the challenging outlook for HNA Group as a result of its heavy debt load and the global turmoil facing the global travel and hospitality industry (click here for article). With operating cash flows collapsing and valuations related to its asset disposal program taking a nose-dive the options for survival appeared limited. A dramatic restructuring appeared to be the only play left.

As it turns out, in January 2021, HNA Group revealed years of unusual cash movements and efforts to restructure the business appeared to spiral out of management's control with several creditors filing bankruptcy petitions. I shared perspectives on these latest developments in an article in Nikkei Asia (click here for article).

HNA's performance deteriorated severely as a result of the pandemic. Furthermore the asset sale program hit a snag as most of their assets are travel and transport related, often in markets outside China, and they will have seen valuations hampered. The pending recovery in the global aviation situation will probably come too late to salvage their business except through a bankruptcy and restructuring process.

Industry outlook 2030

With the green sprouts of industry recovery gradually appearing, it's time to think about the long terms implications of the turbulence witnessed over the past several years and look at how Asia's airline industry will develop in the coming 10 years. We list our top predictions below:

1. Dispersed **recovery starting in the West with Asia, except for China, somewhat behind the curve**. Asia's governments tend to be more conservative in reopening borders and domestic markets, except for China and India, tend to be smaller compared to the US and EU. But despite the slower path to recovery the long term prospects for Asia are actually quite good with high economic growth, large and growing middle classes with increasing disposable income levels and willingness to travel. This potential will eventually translate in growth of the Asia aviation sector well beyond the peak from just before the pandemic.

2. Domestic markets lead the recovery followed by regional markets. **Long-haul intercontinental travel will take most time to recover.** Within Asia, China will be a winner and traffic has already recovered above pre-pandemic levels. Singapore, Thailand and Indonesia are also set to benefit from a recovery in traffic. These countries witnessed strong growth in tourist arrivals prior to the pandemic and are set to benefit once regional travel opens up. Indonesia and, to a lesser extent, Thailand are also benefitting from increased domestic travel which are less susceptible to travel restrictions.

3. **Recovery is led by VFR segment and closely followed by leisure.** Business travel will see a more pro-longed impact as the work-from-home trend will have a lasting impact on frequency of travel for business purposes. A substantial share of business travel will permanently be substituted by, now widely accepted, Zoom or Team meetings.

Furthermore intercontinental business travel will be impacted by a shift in economic paradigm from limitless globalisation to stronger focus back to the home regions. For instance we see European businesses increasingly prioritising growth plans back in Europe whereas 5-10 years ago Asia used to be much higher on the priority list. Likewise, Chinese businesses used to be firmly focused on expansion in Europe and the US but have reprioritised growth towards Belt & Road markets, typically closer to home in Asia. This trend started already prior to the pandemic outbreak but has been accelerated with executives becoming more reluctant to support new endeavours far from home due to travel restrictions and a less welcoming trade climate.

4. Despite the pending recovery **substantial restructuring and consolidation is yet to come**. Many airlines have been propped up by government support and have enjoyed payment holidays from suppliers, most notably aircraft lessors. But when passenger numbers recover this support will likely stop and suppliers will expect payment. Burdened by heavy debt loads, many airlines will not be able to generate sufficient cash flows and a shake-out of weaker players may yet happen. Given that even before the pandemic Asia's airlines industry was characterised by fragmentation and overcapacity, the fallout of the pandemic in the form of consolidation may actually be a positive side-effect.

5. **Chinese and Japanese airline groups may be the key players in regional consolidation.** The Chinese carriers will be cautious given the ongoing HNA saga but likely they will not pass on the opportunity of a strategic M&A in key Asian markets where they have an opportunity to channel increasing Chinese tourist flows. Their route to expansion in Western market is closed off due to the more hostile trade climate but expansion in Asia is still high on the agenda.

For Japanese carriers, growth in their home markets is limited and Japanese players have been very active investors in Southeast Asia and other parts of Asia for many decades. They have the scale and financial cloud to potentially pull of a major strategic move with one of the carriers in the region. Local governments, historically very protective on their flag carriers, will be much more welcoming to foreign investors given the dire situation and financial strain that many governments are under as a result of the Covid-19 crisis.

6. **Airlines will double down on revenue diversification.** Already prior to the pandemic, airlines were pursuing ancillary revenue strategies but the dramatic collapse in their core ticket business has forced airlines to push strategies to diversify revenue streams much more forcefully.

Malaysia's Air Asia is one of the leading players in Asia to pursue this strategy. From 2018, the company saw the potential to drive new revenue streams by building an ecosystem of businesses, all anchored on travel and all leveraging off each other. The arrival of Covid-19 and the subsequent downtime of flights provided the company with the opportunity to fast-track this digital transformation strategy. To facilitate the company's digital transformation, the AirAsia Group split its operations into two main divisions - the airline itself and the digital businesses under AirAsia Digital. Under the digital banner, the company now has four key offerings:

- **airasia.com**. In October, AirAsia re-launched the airasia.com brand around the central concept of enabling its customers to fly, to stay, to shop and to eat, all from the convenience of one platform. There are now 17 lines of business available on the app including airasia food (meal deliveries), airasia fresh (groceries) and airasia shop (retail), powered by AirAsia's logistics arm Teleport. In addition, there is airasia Health, which promotes medical tourism, Islam-compliant service IKHLAS, SNAP (flight and hotel bundles) and more.

- **Teleport.** AirAsia's cargo and logistics division has transformed into a major Southeast Asian e-commerce transportation provider. The entity first focused on a cross-border e-commerce delivery service, leveraging AirAsia's flight networks to enable businesses to conduct cross-border trade anywhere in Southeast Asia within 24-hours. Adapting to post-COVID reality and recognising customers' preference for home delivery orders, Teleport pivoted once more to concentrate on last-mile deliveries, transporting parcels, restaurant orders and fresh produce from airasia shop, airasia food and airasia fresh. Teleport now has over 5,000 delivery partners, with deliveries available across 70 cities.

- **BigPay.** AirAsia's digital payment service started out life as a simple debit product but now offers money transfers, with remittances available in 10 countries including Malaysia and Singapore.

- **BIG Rewards**. One of Southeast Asia's largest travel and lifestyle rewards platforms with over 35 million members, BIG Rewards has evolved from an airline loyalty program to a broader lifestyle rewards service, offering points redemption on a range of dining, shopping and entertainment deals. The platform includes BIG Xchange, the first airlines points exchange platform, which allows BIG Members to convert credit card loyalty points from participating banks into BIG Points.

7. **Airline fleets will be geared more towards narrow-body planes.** With growth concentrated in domestic and regional travel and less long-haul business travel, fleets will be rebalanced towards cost effective single-aisle planes. Boeing and Airbus will invest in more environmentally friendly technology but battery- or hydrogen-powered planes will likely not enter service in the next 10 years. Recent talk of new supersonic technology will also not likely result in viable technology options in the coming decade but airline executives will have to continue to monitor the R&D pipeline, especially with regards to developments in green technologies, to make sure they can adopt technologies when they are commercially viable and meet increasing expectations from travellers and regulators for low carbon solutions.

8. Technology innovation will be more pronounced outside the plane, in bookings and at the airport. The trend towards contactless travel will be spurned by an increased focus on hygiene and safety. Airports will invest heavily in robotics and digital technologies to facilitate this. Bookings will largely go to mobile platforms and airlines will deploy AI technologies to personalise their offer to specific needs of their customers, offering a much broader suite of products and services than merely a ticket to travel from A to B.

9. More so than in the past, Private Equity investors will play a role in supporting the airlines through the turnaround and recovery, but most likely as part of a consortium including guarantees form the local government. Most PE investor look at the high fixed cost, low margins and demand volatility of the airline business model as fundamentally incompatible with their investment philosophy. But as Bain Capital's AUD3.5bn deal for Virgin Australia shows, Covid-19 may provide an opportunity to snap up distressed assets in the region and create value by riding the wave of recovery in regional air travel.

The airline industry has gone through the deepest crisis in its turbulent history. Green shoots are emerging and slowly we are seeing the light at the end of the tunnel. A healthy airline industry will eventually reappear in Asia but the road ahead will be bumpy and the industry landscape and business models of the leading players will look very different from what it was 18 months ago.

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