DISRUPT

AVIATION

Part 2: Changing dynamics and new opportunities for US airlines

Deloitte. *on...*

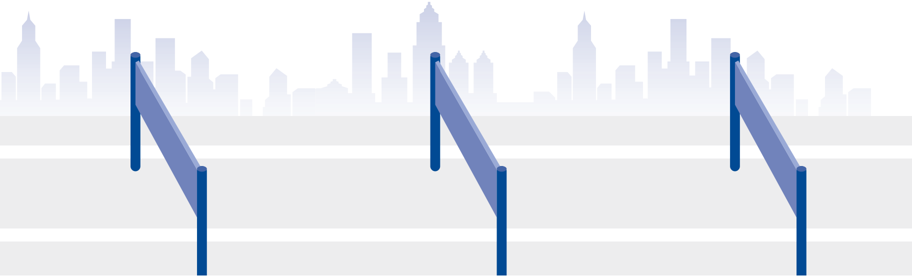
DISRUPTION

MANAGING STRATEGIC RISK IN AVIATION

Part 2: Changing dynamics and new opportunities for US airlines

About Deloitte on Disruption

As US airlines navigate through the disruptive effects of demographic shifts, geopolitical conflicts, evolving business models, and other ever-changing industry dynamics, Deloitte offers many services to help our clients prepare for uncertainty and take advantage of opportunities. Spotting and preparing for strategic risk is one essential component of addressing the challenge business leaders face today. Read on to learn why. And what companies can do to respond.



Disruptive forces are a fact of life in aviation. But can you distinguish between the threats and the opportunities?

A call to action

A good pilot knows you can't fly by just the seat of your pants. Without actively monitoring the instrument panel, scanning the visual horizon, and listening for updates from air traffic control, you can miss a vital adjustment—or fail to make the course correction.

So it is with strategic risk in the aviation industry.

Some strategic risks are known, and maybe even predictable. But others are unknown, unpredictable, or defy conventional wisdom.

An array of forces is changing the face of commercial aviation. From rapid technological development and competing service models to shifting demographic and consumer demands. And from evolving regulatory landscapes and lower energy costs to geopolitical tension and energy policies. Few could have foreseen this pace of change five years ago, let alone ten or twenty. And this pace of change is ever-increasing.

In this dynamic and highly competitive environment, how can airlines adapt and prosper? Step one: Spot turbulent forces and potential game changers while they're still en route. Step two: Recognize that some risks and challenges can net positive results for an organization that chooses to get in front of them. Step Three: Prioritize the risks that you can address to make an impact. Accept those risks where you can't.

But merely recognizing incoming strategic risks isn't enough. Organizations must identify, recognize, and interpret indicators and warnings in a way that lets them engage with, manage, and even shape emerging risks, drivers, and opportunities.

History is already littered with iconic names of airlines that are no longer listed on arrivals and departures boards. But what this paper offers isn't a history lesson. It's a call to action. Because complacency in the face of strategic risks can lead to dire outcomes.

Turbulent forces are changing the game

Energy costs and structural shifts

For years, airlines have competed on a relatively level playing field with respect to fuel prices and market volatility. Shifts were traditionally driven by low-cost carriers that introduced new pricing structures and benefited from cost advantages produced by their younger fleets. But that's no longer the case.

Today, sustained lower energy, innovations across digital technologies, an agile workforce, and changing customer expectations are just a few of the forces sparking a transformation in competition and innovation. Nowhere is this more pronounced than in the Middle East, where fast-growing entrants pose a major competitive threat to US carriers and their associated alliance structures.

> Modern airports and hubs aren't the only advantages some Gulf carriers enjoy—they're also within eight hours of two-thirds of the world's population

But other forces are also at play, including demographic shifts, new technologies, and rising consumer expectations. And then there are the unknown and unlikely events stemming from geopolitics (Brexit, anyone?), terrorism and radicalization, and acts of nature that can wreak havoc. Whether competing on new terms, discovering new demand, or dealing with surprises, changes are coming at carriers from all directions.

Business model threats and impacts

As large, new foreign competitors vie for global market expansion in both passenger and cargo segments, US carriers will need to seek strength in the combined capacity and greater passenger share of an alliance network (OneWorld, SkyTeam, StarAlliance, etc.). They must also overcome a disconnect—the US foreign-ownership policy, energy, and trade stances of the US government don't always align with private sector profit strategies. Against that backdrop, US carriers should anticipate and develop strategies around such systemic changes as new entrants, no-frills models, and the new geography of competition.

Open-skies agreements, for example, have encouraged competition and consolidation within North America and the Middle East. They have led to the proliferation of low-cost carriers (LCCs) and ultra-low-cost carriers (ULCCs) in North America, Africa, Europe, and Asia. Airlines should expect to see further potential disruptions from no-frills LCCs that begin to offer premium segmentation and door-to-door service.

In addition, modern, fuel-efficient Gulf carrier fleets can fly nonstop from their hubs to nearly any major airport in the world. This has resulted in a shift in the industry's center of gravity. In fact, Dubai displaced Heathrow as the world's busiest international passenger hub in 2014—a development that a former British Airways chief executive predicted in 2008 would "link the world's biggest aviation market, North America, with its fastest growing, Asia—and this link would bypass Europe altogether." [1]

The changing who, where, and why of consumer travel

Consider the changing landscape in the Middle East, Asia, and Africa. Populations are exploding, new connectivity patterns are emerging, and income and education levels are rising.

When combined with technological advances in the workplace, these dynamics may create more leisure time and greater mobility in leading markets. They may also place very different demands on consumer airlines.

Airlines will need to invest in analytics, modeling, and simulation tools to develop focused strategies that capture the mind and wallet share of varied and growing demographic groups.

Asia's middle class is growing, and Africa's is soon to follow. The carriers that accommodate changing travel preferences on these continents stand to enjoy greater revenue growth than in established, price-competitive European route systems.

Meanwhile, the aging populations of North America, Europe, and Japan may send legions of older, culturally diverse retirees to far-flung regions of the globe. This demographic group may also make new demands on carriers for fares, access, and services that are oriented toward more mature leisure travelers.

Millennials, too, are making an impact. As the first "digital generation," Millennials seek instant access and customized engagement from the companies they interact with. They're also influencing the buying preferences of other demographic segments. Increasingly, tech- and social media-savvy consumers will drive the ways aviation products and services are packaged, sold, and delivered.

Companies that recognize these shifting forces and adapt accordingly will reap the benefits. Airlines that stick to traditional operating models may fall short.

Because travelers expect to be connected at all times, whether on the ground or in the air, savvy and agile carriers will adapt by enhancing current services and travel environments

The case for change

Commercial aviation boards and management teams that dismiss the likelihood of disruptive innovation in air travel may find themselves at an existential crossroads sooner than expected. Emerging technologies, changing demographics, new business models, and other transformations that threaten "business as usual" could create new opportunities for competing carriers.

Potential outcomes of strategic risk

"Airport-to-airport" is so yesterday. Today's travel boundaries are increasingly defined as "booking-to-bellhop." Many airlines even offer chauffeur service for First Class and Business Class travelers in certain cities. In this area of expanded opportunity, airport amenities begin to take on more importance.

Greater focus will also be placed on infrastructure design. Travelers will prefer airports that whisk them from terminal to terminal on high-speed rail links or let them bypass security checkpoints.

Airlines that can deliver increased and tailored mixed-mode travel and convenience will leap ahead of competitors.

Car pickup, in-flight bar service, conference rooms, restaurants, salons, exercise/therapy, and entertainment are all complementary opportunities worthy of consideration. As airlines pursue more lucrative opportunities and customer well-being, the need for better space utilization and "service in the seat" capacity will also command greater attention, especially for domestic and international carriers that are linked through alliances.

Other potential outcomes of airlines' response to strategic risk could include:

- **Passenger service** may evolve from standard business-day models to true 24-hour delivery conveyance and responsiveness, with more opportunities to differentiate the product. Technology brings many innovation opportunities to drive loyalty, for example, by using real-time sensors and mobility advances to deliver real-time customer service.

- **Modular floor plans** could allow for different uses of space, such as in-flight conference rooms, enhanced pitch seats, and call "pods" for business travelers who will no longer tolerate downtime while up in the air. This modularity could advance futuristic intelligent air traveler workspace design, with sensors and activators that can give travelers control over their micro-environment.

- **Fully e-enabled aircraft** may allow airlines to develop and commercialize in-transit applications that add to the revenue stream by delivering personalized, inflight, on-demand entertainment based on existing user subscription accounts, in addition to managing travelers' day-to-day "to do" lists. In-air video teleconferencing and full concierge service for lodging and transportation needs could also meet the wants and needs of travelers and add revenue for carriers.

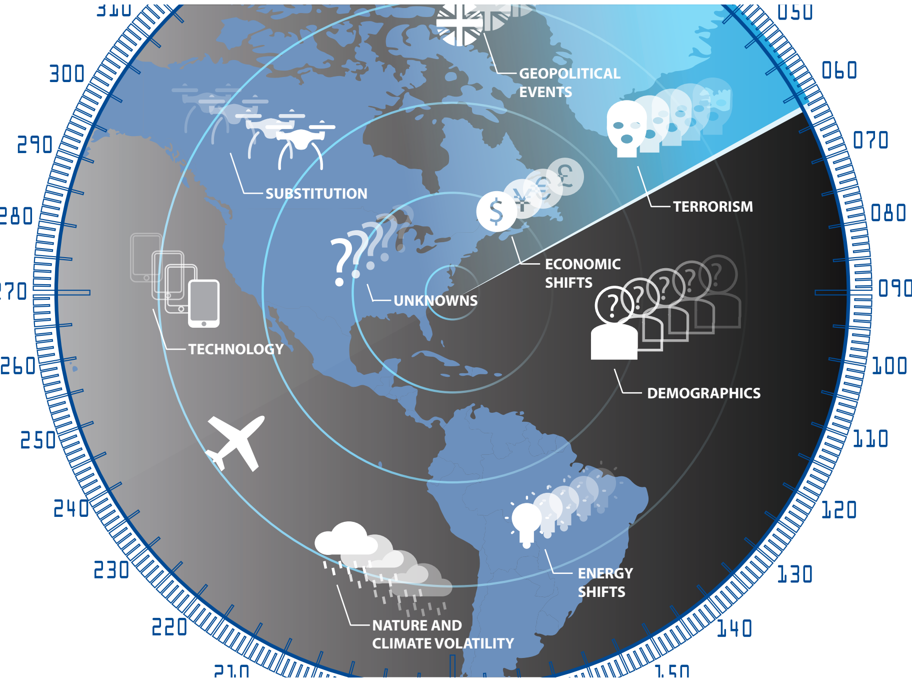
Disruption through substitution

One of the most potentially disruptive risks to aviation is the encroachment of other modes of transportation. Ground route alternatives are the primary threat.

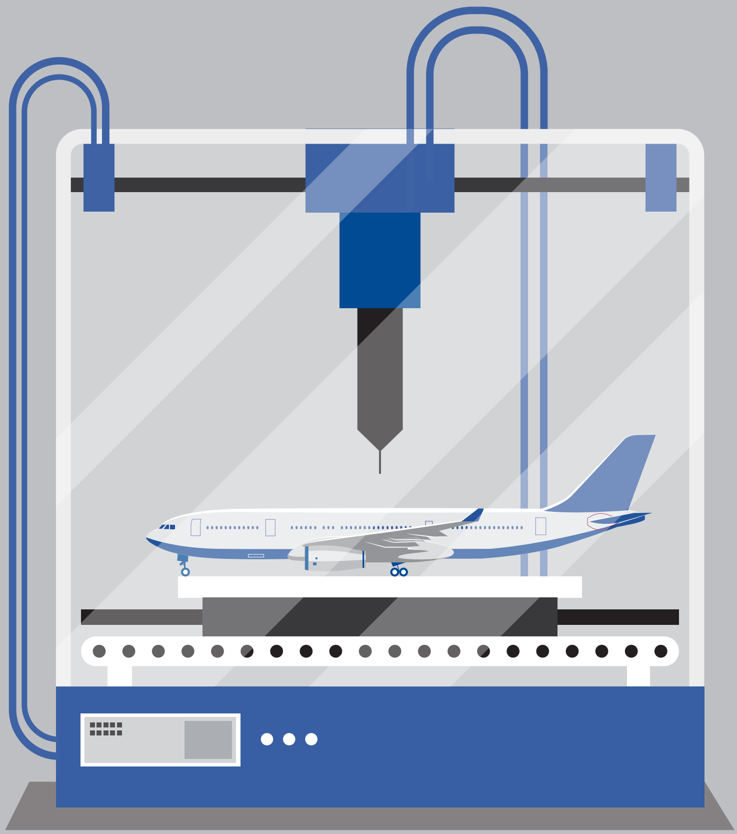
For example, a 200+ mph train from San Francisco to Los Angeles could make regional air service hubs in San Diego and San Jose less relevant. Autonomous cars could eat into airplanes' relative monopoly on letting people sleep or work en route to their destinations.

Newer plane designs with artificial intelligence and robotics are also beginning to displace the second pilot. What lies further down this line of thinking? Today, unmanned aerial systems (UASs, or drones) deliver pictures, munitions, and—perhaps soon—packages. What about people? Could a fleet of personalized, pre-flight-plan-programmed UASs be available for rent with travelers lifting off for solo trips to regional destinations without a pilot? As Amazon continues to pave the way with approval from the FAA to test and evaluate its fleet of UASs, this concept looms larger on the horizon.

An array of forces—signals of change—is changing the face of commercial aviation



Idle musings? Or 20/20 foresight? Only time will tell. But remaining in a holding pattern isn't an option.



Building the modern risk savvy airline

The drone economy. Robotics and new technologies. Geopolitical complexities. Those are just a few of the forces that signal coming changes in the aviation industry. And that point the way toward tomorrow's mainstream landscape.

- Technology is enabling airlines to think about the future of the industry differently
- Consumer preferences are leading companies to repackage products and services and altering modes of delivery
- Growing number of unpredictable events (e.g., climate, terrorism, geopolitics, pandemics) are necessitating new frameworks for rapid decision making and strategic choices

These forces, alone or in combination, could result in surprising disruption. Carriers, therefore, should view and prepare for them through the lens of strategic risk management.

More emphasis on sensing, monitoring, and scenario planning techniques can give organizations a better feel for potential threats and help them develop defensive positions. By challenging assumptions and implementing better analytics, modeling, and simulation tools while looking for patterns of disruption, companies can hone in on sources of risks and signals for change. With a clearer view of vulnerabilities, businesses can think through strategic choices that mitigate disruptive forces or open up opportunities for competitive advantage.

Integrating risk and strategy

As the business environment around us evolves, risk management must evolve as well. According to recent research, traditional risk management spends more than half its time on legal, compliance, and financial-reporting risks. Far less time and attention are paid to strategic risks, even though attention to strategic risk potentially conveys far greater impact to shareholders.

Where should risk management spend its time?

THE PROPORTION OF SIGNIFICANT LOSSES IN MARKET VALUE CAUSED BY EACH TYPE OF RISK OVER THE PAST DECADE

Source: CEB, as reported in "How to Live with Risks," *Harvard Business Review*, July-August 2015, HBR.org.

Strategic risk management can help organizations navigate a VUCA (volatile, uncertain, complex, and ambiguous) world. The most successful airlines will recognize that change isn't just continuous—it's also accelerating. And it's going to reshape their businesses. Prospering amid that change calls for clarity on growth plans and risk appetites. Gaining that kind of self-awareness necessitates a close alignment of business strategy with business tools.

From today's comfort zone to tomorrow's learning zone

Historically, the aviation industry has done a phenomenal job of managing operational risk by keeping a sharp focus on safety and security. But given the modern landscape, airlines should also:

1. Add an increased focus on strategic risk to other risk management programs already in operation. Carriers must account for the strategic implications of fuel price volatility, foreign exchange, regulatory changes, demand forecasting, market and consumer behavior shifts, financial reporting, and more. The rolling combination of these forces presents both opportunities and existential challenges. Teams should identify these and overlay them with a strategic risk management framework that can limit downside risk.

2. View risk as a potential positive, not only as a negative. A holistic view of risk acknowledges its multiple dimensions and the inherent opportunities it brings. But airlines can gain advantage only when they proactively identify, anticipate, assess, prioritize, accept, mitigate, and exploit those risks.

3. Support strategic risk management through organizational change. Building a risk-intelligent airline means attracting and promoting risk takers, challenging the status quo, and embracing innovation and experimentation. For organizations that don't embrace risk, this may require some formalized level of change management.

Some of these steps lie outside the "sweet spot" of an airline's core competencies. But that doesn't make it any less critical to plan them, carry them out, and test their effectiveness. It may also be advisable to bring in third-party help from people who know how to leverage strategic risk techniques for grappling with uncertainty.

Some of today's, and more of tomorrow's, travelers are shrewd, discerning, premium-minded, hyper-connected, must-go personalities. Industry leaders need to focus on them. At the same time, organizations must develop business plans that capitalize on disruptions from lower energy costs, technology game changers, and structural shifts.

Disruption is part of life. Organizations that are willing to challenge assumptions and biases can thrive on it. But to do so, they must implement a thoughtful, multi-dimensional plan to manage change. They must commit to spotting and preparing for strategic risks via scenario planning, assumption testing, and other tools. And they must bring strategy, innovation, and risk together for integrated and dynamic conversations about threats and opportunities.

To capitalize on disruptive forces, management and their boards must:

- Challenge embedded biases and align to a coherent, proactive strategic risk management program
- Promote intelligent risk taking as a result of identifying and prioritizing threats and opportunities
- Encourage and reward innovation and experimentation that protects brand and delivers sustainable financial results
- Understand risk from an integrated perspective and be capable of identifying those risks that have strategic impact or significance

Interested? Join the conversation.

In person

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[1] "The incredible rise of Dubai as the world's airline hub," The Telegraph, January 6, 2015. http://www.telegraph.co.uk/travel/destinations/middleeast/dubai/11327645/The-incredible-rise-of-Dubai-as-the-worlds-air-travel-hub.html