A NEW ‘SELLER’ LANDSCAPE?

Miranda Cole

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Airline Retailing under the NDC

Legal Framework Study

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Overview

- Study of the regulatory framework governing retailing of air and non-air content by airlines and third parties using NDC-based solutions
  - What types of non-air or third-party ancillaries could airlines sell using NDC-based solutions?
  - Under which conditions could airlines sell such services? What are the relevant regulatory requirements in terms of, e.g., airline liability?
  - What are the requirements for new players (e.g., chatbots, Facebook, Airbnb) to start selling air content using NDC standard and querying an aggregator or an airline API?

- Identifying obligations that apply to different types of entities and activities using NDC-based solutions in the European Union and the United States

- Scope: airlines, aggregators, (online) travel agents, MSEs, other online service providers (including social media), small office/home office operators
European Union (I): Airlines

Implementation of NDC-based solutions is unlikely to alter existing obligations, but may add obligations where players widen the scope of their activities in selling air- and non-air content

- Regulation of offers by airlines or air and non-air content using NDC-based solutions unchanged
  - provide pre-contractual information concerning the main characteristics and price of the service
  - provide information regarding the content, transfer and termination of package travel contracts
  - enable alterations to contractual terms
  - clearly identify commercial communications and advertisements

- Airlines continue to be responsible for (i) the performance of package travel contracts they offer, and (ii) errors due to technical defects in booking systems attributable to them

- New activities, enabled by NDC-based solutions may trigger additional obligations
  - Airlines using NDC-based solutions may be intermediaries for third parties, without selling their own content
  - From 12 July 2020, intermediaries must ensure appropriate transparency, fairness and effective redress for third party “business users”
European Union (II): MSE/ Aggregators

Implementation of NDC-based solutions is unlikely to alter existing obligations for MSEs

- Customers may (i) select an offer listed by the MSE, and book with an airline or OTA to which they are referred by the MSE, or (ii) select an offer list by, and book with, the MSE itself.
- Both approaches lead to bookings being made by an airline booking engine accessed through an API.
  - MSEs will be neither organisers nor retailers of the air and non-air content, and would generally not be subject to rules regarding package travel.
- MSEs will be subject to obligations regarding intermediation services from July 2020.
New players implementing NDC-based solutions are subject to obligations ...

- **Online service providers** who sell air- and non-air content facilitate bookings on airline booking engines are subject to rules regarding (i) intermediation services; (ii) commercial communications; and (iii) the rights of natural persons to the protection of their personal data (GDPR)

... existing players and activities continue under the same obligations

- **Travel agents** continue to be subject to obligations
  - Provide pre-contractual information concerning the main characteristics and price of the service
  - Re the content, transfer and termination of package travel contracts
  - Receive and pass on messages re performance of package travel contracts
  - Liable for errors from technical defects in their booking systems

- **SOHO operators** could be subject to package travel, consumer rights and/or e-commerce obligations
  - Grey area: May not apply if they are mere intermediaries in contracts between passengers and providers of the travel service; contractual obligations still apply
United States (I): Framework

The US regulatory landscape differs significantly from the EU

- U.S. regulatory landscape encompasses (i) federal & state law, and (ii) general commercial law and laws specific to airline/ travel retailing
- Regulated entities are airlines and “agents”, including third party intermediaries, such as agents and MSEs
  - The scope of the “agent” concept catches chatbots and other players in the distribution ecosystem, such as online social functionality and Airbnb
- With certain exceptions, U.S. federal rules apply to airlines and agents alike
Implementation of NDC-based solutions is unlikely to cause a significant shift in how the U.S. legal framework applies to airlines and agents

- Airlines and agents will continue to be prohibited from engaging in unfair or deceptive practices in supplying or selling air transport.

- The full-fare rule requires that advertising of, solicitation for, or packages including air transport must state the entire price.
  - Airlines and agents cannot raise the price of an airfare, ancillary or surcharge after the full amount of the originally-quoted price has been paid.

- Additional data collection must comply with privacy laws.
  - State privacy laws can impose further obligations on agents.
Credit Suisse Equity Research

Views from a financial analyst
Airlines and intermediaries opportunities and risks

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October 2019
What we do at Credit Suisse
International Airlines Group (ICAG.L) – New insight into BA margin gain prospects

- Introducing our Heathrow Efficiency Model (HEM) – raising expectations! In this view, we argue that the GEMAR convergence to drive a profitable model to map the evolution of efficiency for as long as we can forecast and secure it. We are at a key annual fee increase at around 3% per annum for the next three years, and BA and its allies not only to negotiate a new, lower rate but to secure a long-term contract that secures future profits in this challenging environment.

- BA long-haul efficiency gains to outpace competitors and drive margin expansion. Our HEM suggests BA will improve on long-haul efficiency gains of 12% via new aircraft on a five-year view, outperforming competitors to achieve a 5% margin on the main European feeder services, and ensure margin growth at the majority of the market based on achievable pricing growth. We model BA EBIT margins rising from a record 14.2% in 2017/18 to 15.6% by 2022. Summer 2018 introduces the key competitive risk of the next five years, after which growth should moderate. Nonetheless, the premium cabin seats are expected to improve slightly in the near term due to lower fuel costs.

- BA’s profit margins improve most significantly in the medium term, and the medium-term perspective for BA is expected to improve slightly. The model suggests BA’s EBIT margins rising from a record 14.2% in 2017/18 to 15.6% by 2022. Summer 2018 introduces the key competitive risk of the next five years, after which growth should moderate. Nonetheless, the premium cabin seats are expected to improve slightly in the near term due to lower fuel costs.

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Pursuit of higher revenue quality increasingly important at this point in the airline industry’s development
Cost cutting becoming more difficult

Sector regressing towards cost of capital

- Unit cost inflation persistent
- IATA forecasts suggest the airline industry is regressing towards simply covering capital costs again – new stimulus required

Source: IATA
Huge amount of activity as airlines strive to improve revenue and earnings quality

- IAG’s approach to digital and its NDC-specific strategy show efforts across many areas involving multiple partners – suggests multiple new opportunities
But crucial for stakeholders to focus on what may meaningfully change financial performance

- Equity and credit finance providers need confidence in future returns
- Cash flow return on investment (CFROI®) framework per Credit Suisse HOLT® emphasises the need to generate returns in excess of capital costs
The equity and credit markets reward returns in a capital intensive industry

- Strong correlations between returns / margins and valuations for easyJet, IAG, Ryanair

**easyJet**

\[ R^2 = 0.7894 \]

**Ryanair**

\[ R^2 = 0.851 \]

**IAG**

\[ R^2 = 0.7165 \]

Source: Thomson Reuters data, Credit Suisse research
Thus far..... LHA pricing has underperformed peers despite earliest distribution strategy change in 2015

- LHA has underperformed AF-KL yoy RASK at constant currency 3 out of 4 years on Americas routes since 2015.....
- ..... 2 out of 4 years versus IAG

![Graph showing LHA Americas, AF-KL Americas, and IAG Americas performance from 2014A to 1H19A.](Source: Company data, Credit Suisse research)
Considering relevant costs versus revenue also poses a question that has yet to be answered positively.

Expenses from computerised systems and agency sales commissions have risen slightly as % of revenue – albeit early to judge.

<table>
<thead>
<tr>
<th>Year</th>
<th>Combined systems/commissions costs as a % traffic revenue</th>
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<tbody>
<tr>
<td>2014A</td>
<td>2.7%</td>
</tr>
<tr>
<td>2015A</td>
<td>2.9%</td>
</tr>
<tr>
<td>2016A</td>
<td>3.1%</td>
</tr>
<tr>
<td>2017A</td>
<td>3.0%</td>
</tr>
<tr>
<td>2018A</td>
<td>3.0%</td>
</tr>
</tbody>
</table>

Source: Company data, Credit Suisse research
Opportunities for Airlines
Small benefits would have big impacts on profitability

Structurally improved pricing control could bring emphatic rewards: Improved and more sophisticated usage of data could structurally improve seat pricing. Earnings sensitivities to small movements in revenue are high across the industry.

Industry leaders seeing momentum in revenue self-help stories as illustrated by Delta’s branded fares

Each 1% improvement in passenger unit revenue (RASK) means 8-26% to 2020E operating profit for IATA NDC Leaderboard airlines

Source: Delta Air Lines 2017 Investor Day, Credit Suisse estimates
Ancillary revenue self-help strategies can structurally improve margins

- Selling a wider range of products (i.e. ancillary products) should raise share of passenger wallets, with incremental revenues falling largely to the bottom line.
- The most profitable airlines are usually stronger on ancillaries.
Now is the time for the airline sector to invest

- Leverage levels, as represented by net debt/EBITDA for 2019E, are healthy for most major carriers.
- Consolidating regional markets should increase the resilience of pricing levels in a downturn (in theory).

Source: Credit Suisse estimates
Risks to Airlines
Long-dated investments risk exaggerating effects of a downturn – protecting core pricing critical

- Acceptance of higher costs (IT/distribution) as management sold on future opportunities?
- Capex intensity rising in many parts of the industry
- 2019 estimate reductions YTD illustrate that minor disappointments in core revenue streams can produce major disappointments in earnings and cash flows, postponing the net benefits of retailing/distribution strategies.

Source: Credit Suisse estimates (18 October 2019 versus 1 January 2019)
Global partner alignment may be necessary to maximise effectiveness of new retailing strategies

- Consolidation (M&A or JVs) has driven structural margin gains – alignment of partner revenue generation/distribution strategies could help increase changes of success.
- We frame this by considering Delta’s increasingly expansive portfolio of global investments/partners.

**Delta’s Joint Ventures and Equity Investments are Unique**

60% of international revenue benefiting from joint ventures, up from 35% in 2008

(source: Delta 2018 Investor Day, Credit Suisse research)
Opportunities for Intermediaries
In a gold rush, better to be the shovel seller?

- We highlight recent expansive deals announced by the GDSs, illustrating considerable momentum in upgrading their reach into the changing revenue generation arena:

  - **October 2019:** Partnership announced
  - **October 2019:** Relationship extension agreed
  - **October 2019:** Expanded partnership announced
  - **September 2019:** Partnership announced
  - **September 2019:** Partnership announced
  - **September 2019:** Partnership announced
  - **September 2019:** Partnership announced
  - **August 2019:** Expanded partnership announced
  - **August 2019:** Expanded partnership announced
  - **August 2019:** Expanded partnership announced
  - **July 2019:** Partnership announced

- Amadeus has c.470 airlines on its distribution platform – upselling opportunity compelling
Hybridisation of low cost carriers

- We highlight the following strategic shifts away from pure low cost carrier models towards a more hybrid offering.
- Intermediaries can play a role as carriers seek deeper revenue quality, and increasing connectivity.

- **RYANAIR** ---- Broader product portfolio and customer segmentation targeting
  - Holidays, business travelers and loyalty
  - Pursuing airline partnership strategy for over 10 years, (Norwegian latest addition)

- **easyJet** ----

- **jetBlue** ----

- **AirAsia** ---- packages

Source: Company data, Credit Suisse research
Risks to Intermediaries
Capacity and traffic growth slowing in most major markets – a small taste of the future in an increasingly carbon-conscious world?

Euro short haul and Transatlantic seat growth moderating to 0-2% this winter

Seat growth on Europe-APAC slowing to 0-2%...

..... while Europe-LatAm slowing from double-digit levels to mid-single digits

Source: Diio Mi seat data, Credit Suisse research
LCCs continue to take market share at the expense of travel agents

- LCC growth strategies have driven LCCs to a 24% share of global airline seats versus 15% in 2009. We expect this to move to 30-35% within 5 years.

- As a result, travel agent booking growth has distinctly underperformed global airline capacity growth. We expect limited growth in the future; weighing on GDS volume growth prospects.

Source: Diio Mi seat data, Amadeus data, Credit Suisse research
Global aircraft orderbooks clearly show where future growth is coming from.

Continued LCC share gains may limit travel agent volume growth, making continued global market share losses for agents and GDSs appear very likely.

<table>
<thead>
<tr>
<th>Current LCC orderbook larger than the current installed fleet</th>
<th>Current FSC orderbook just over half the current operated fleet</th>
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<table>
<thead>
<tr>
<th>Orders 113% of current fleet</th>
<th>FSC orders only 56% of current fleet</th>
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<tr>
<td>In Service</td>
<td>Orders</td>
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<td>5,185</td>
<td>4,539</td>
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<td>741</td>
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<th>LOI to Option</th>
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<th>On order</th>
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<td>4,539</td>
<td>888</td>
<td>1,690</td>
<td>5,819</td>
</tr>
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</table>

Source: Cirium data, Credit Suisse research
Large list of tech “enablers” seeking to facilitate strategic change for the airlines – risk to the GDSs

Greater competition, and an increasing number of moving parts, suggests more difficulty to maintaining share and equivalent relevance in the future than in the past

IAG provide a wide choice to agencies seeking NDC content

Source: Company data
Offensive and defensive investment required

- Cash flow consequences; for example as Amadeus invests in the future
- Battle for relevance for new entrants

Source: Company data, Credit Suisse estimates
Disclosure Appendix

Analyst Certification

L. Neil Olyphant, CPA, certify that the views expressed in this report accurately reflect my personal views about all of the subject companies and securities and (2) none of my compensation is, or will be directly or indirectly related to the specific recommendations or views expressed in this report.

As of December 10, 2012 Analysts’ stock ratings are defined as follows:

Outperform (O): “The stock’s total return is expected to outperform the relevant benchmark” over the next 12 months.

Neutral (N): “[T]he stock’s total return is expected to be in line with the relevant benchmark(s)” over the next 12 months.

Underperform (U): “This stock’s total return is expected to underperform the relevant benchmark(s)” over the next 12 months.

Investment Graham’s-method based. [T]he stock’s total return is expected to outperform the relevant benchmark(s)” over the next 12 months.

Graduate (G): “Graduate is a new rating which is assigned to stocks that are not covered by the analyst or are in the early stages of being covered by the analyst. The rating is typically used for companies with limited financial history or for companies that are not yet covered in the analyst’s research coverage universe.”

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WHERE IS THE VALUE IN AIRLINE RETAILING?

Nina Wittcamp
Associate Partner, McKinsey & Company
Where is the Value in Airline Retailing

Nina Wittkamp
Bangkok, October 31st, 2019
Retailing addresses many aspects of airline operations – also beyond distribution

Retailing =

NDC + ONE ORDER + DYNAMIC OFFERS

IT REFERENCE ARCHITECTURE
Retailing addresses many aspects of airline operations – also beyond distribution

Retailing =

- NDC
- ONE ORDER
- DYNAMIC OFFERS

→ Vehicle to deliver a commercial strategy
→ Variety of distribution strategies
→ Business case different for every airline
→ Speed of implementation
→ Interdependences with value chain partners
For customers, retailing could create value through enhanced transparency, more relevant offers and enriched options.

- **Enhanced transparency**
  - Richer product and service description, with enhanced clarity on total cost

- **Relevant offers**
  - Micro-segmented offers pushed based on search details and customer profile

- **Enriched options**
  - Multiple channels: Similar product depth and bundling options across channels

**Customer experience**
Value creation in airline retailing

up to

$\sim$40 bn

annual additional value
by 2030

Corresponding to ~4% of industry revenue in 2030 or ~7 USD/Pax in 2030

~70% of value creation for airlines is driven by additional revenues and ~30% by reduced costs

~50% of sustainable value creation over time

One off investment ~USD 3-15 Bn at an industry level until 2030 (depending on the scenario)
Value creation in airline retailing is driven by 7 major sources:

- Enhance revenue management
- Attract additional passengers
- Mix of distribution channels
- Simplify organization and processes
- Redesign commercial IT architecture
- Optimize payment and fulfillment
- Develop new offer

Mix of distribution channels
Methodology: we quantified the 7 sources of value creation for 4 major industry scenarios and different airline clusters

1. "Incremental NDC development"
2. "Large airlines emerge into travel platforms"
3. "(Online) Intermediaries emerge as platforms"
4. "Greenfield platforms for travel"
Methodology: we quantified the 7 sources of value creation for 4 major industry scenarios and different airline clusters

1. "Incremental NDC development"
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4. "Greenfield platforms for travel"

- ~USD 40 Bn of value creation represents a favorable scenario for airlines
- Value creation for airlines “only” amounts to USD 15 - 20 Bn
- One-off investment requirements ~15 Bn
- ~50% of value creation sustainable
Retailing provides opportunities for airlines, but the path to success requires an individual strategy

**Opportunities**
- Airline-generated offer for each request and channel
- Closer customer relationship and insights, higher customer satisfaction
- Ability to differentiate and create product transparency
- Corporate sales/distribution contracts

**Risks**
- Required investment and shift to retailing capabilities (technology, skills, fulfillment)
- Increased competition/product transparency
- Risk of doing nothing

**Value capture actions**
- Build NDC, offer and order management capabilities
- Develop channel, product, pricing and distribution strategy
- Drive rich content and UX adjustments
- Strengthen customer insights, analytics and retailing capabilities in all aspects of the business
Questions airlines need to answer

→ Strategic objective of distribution?

→ Approach to channel, content and product development?

→ Business case for short and long-term value and required investment?

→ Actionable roadmap including trade, sales and channel partners?

→ Implications for organization, talent, culture and ways of working?
We see significant implications for the aviation value chain (1/2)

Scenarios

1. “Incremental NDC development”
2. “Large airlines emerge into travel platforms”
3. “(Online) Intermediaries emerge as platforms”
4. “Greenfield platforms for travel”

Risk of value being “competed away”, less pronounced for contextualization and (micro-) segmentation

Build capabilities, skills and culture: develop organizational structure and have the right mix of skills, talent and culture

Cater to different customers via presentation and service as well as developing differentiated value propositions across portfolio

More dynamic offers: shifts in traffic and sales across channels; More relevant offers stimulate new demand
We see significant implications for the aviation value chain (2/2)

Scenarios

1. “Incremental NDC development”

2. “Large airlines emerge into travel platforms”

3. “(Online) Intermediaries emerge as platforms”

4. “Greenfield platforms for travel”

More channels and distribution strategies require the right infrastructure and capacity to cope with more complex environment

Need to invest into data, analytics and IT capabilities and talent to handle higher number of requests on own offer creation systems

Opportunity from more standardized order creation for generalist system integrators developing individual modules

More and more complex offer data flows: Need for the airline industry to develop frameworks for data governance and order ownership
CLOSING REMARKS & AIRS
2020 ANNOUNCEMENT

Aleksander Popovich
SVP Financial and Distribution Services, IATA
IATA Strategy: Working Together

Industry license to grow
- Safety and security
- Environmental sustainability
- Rebalancing the value chain

Industry platform for the future
- Infrastructure for growth
- Government, tax and regulation
- Skilled Staff
- Customer Experience

Airlines’ capabilities
- Efficient airline processes
- Digital transformation
- Product differentiation

IATA Capabilities
- Skills Processes Organization
- IATA Governance
- Board & ChairCom
- Advisory Councils

Safe, secure and sustainable air transport industry

ADVOCACY
STANDARDS
SERVICES
### Capabilities: Working Together
Focus of Distribution Advisory Council

<table>
<thead>
<tr>
<th>Product Differentiation</th>
<th>Efficient Processes</th>
<th>Digital Transformation</th>
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<tbody>
<tr>
<td>➢ Environment for innovation and competition</td>
<td>➢ Transparent and innovative payment</td>
<td>➢ Industry transformation strategy</td>
</tr>
<tr>
<td>➢ Freedom of distribution</td>
<td></td>
<td>➢ Data strategy</td>
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<tr>
<td>➢ Agility to retail dynamic offers</td>
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Executive Summit: Working Together

Tackling Blockers to NDC adoption in Business Travel