

A tipping point in airport-industry economics: securing profits in uncertain times

Arthur D. Little explores how airports must adapt their business models



At a time when the airport industry has never been so attractive, Arthur D. Little explores how airports must deal with fundamental disruptions in their business models. This calls for strong CxO focus and bolder and faster moves to guarantee value creation for all stakeholders in the ecosystem.

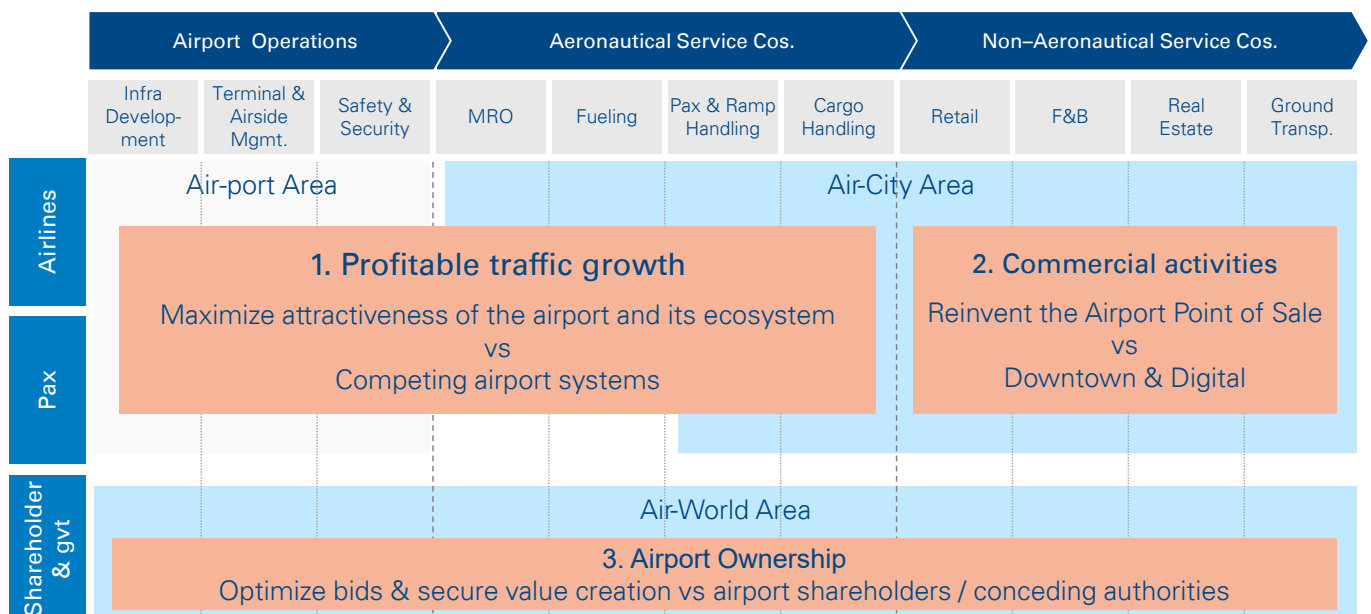
Three strategic battlefields in the airport industry and more competitive intensity than ever

Despite posting healthy profits and return on investment, as well as experiencing high traffic growth, the airport industry is at a key milestone in its history. Indeed, future development means committing to significant CAPEX, while many fundamental aspects of airports' business models are being questioned. Airport managers and investors have to fight three battles at the same time.

- Competition and airline pressure on the core business are increasing, and this is crushing aeronautical revenues
- Digital is disrupting non-aeronautical revenues
- Fierce competition among bidders and more sophisticated PPP schemes are eroding profitability of international expansion

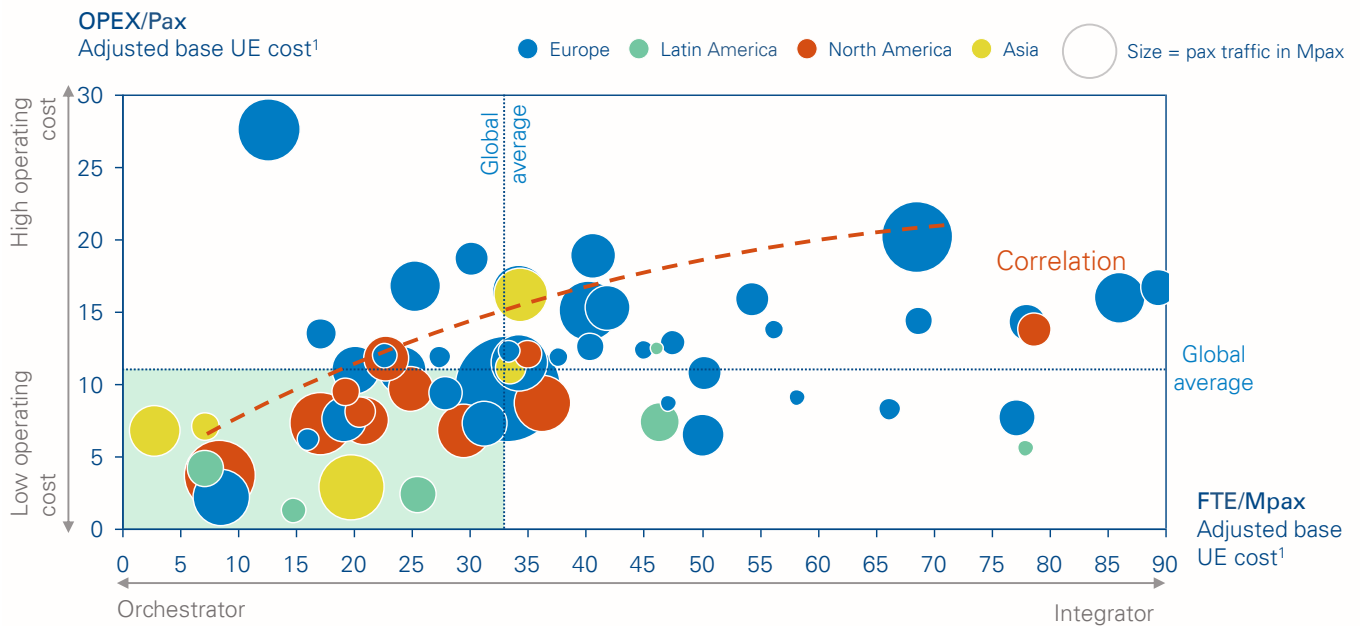
Airports' future profits are thus under strong pressure. Airport business models must evolve and adapt to this new, lasting reality.

3 strategic battlefields for airports



Source: Arthur D. Little

Benchmark of Airport OPEX



1) Adjustments with UE working and labor conditions
Source: Arthur D. Little

1. Winning the battle for traffic: cost competitiveness and ecosystem collaboration are essential

The intensity of the competition among airports to attract traffic has gone one level up over the last five years. This limits the ability of airports to increase unit aeronautical revenues and profits. Many factors contribute to this phenomenon, but three are key: i) Airlines have become more agile in network planning and fleet deployment. ii) New airline business models and aircrafts (A350, B787, A321Neo-LR, etc.) are fostering thinner long-haul routes and enabling the by-pass of mega-hubs, triggering competition among continental and regional airports. iii) Airports are investing much more in traffic development through either or both increased marketing budgets or reduced airport charges. Examples in Europe are Schiphol, AENA and Nice airports.

To stay in the race to attract traffic and preserve their profits, airports have no choice but to drive operation and CAPEX spending down. Empirical evidence suggests that airports posting better performance are the ones that:

- Adopted lean principles and practices to evolve their operations and organizations
- Pioneered the Operation 4.0 concept, with digitally enabled operations and asset management
- Reviewed their make-or-buy policies, making bold choices both ways with regards to out- and insourcing, while implementing smart supplier supervision and gain-sharing schemes

- Developed compact/"one-roof" infrastructures to avoid duplication of operating costs
- Leverage group purchasing for major costs such as utilities, IT and insurance
- Optimized their asset management strategies and capabilities

We can thus observe airports that are able to operate with 25–30 employees per Mpax and to post OPEX down to €2/pax. Also, digitally enhanced operations and asset management generate higher asset utilization – thus enabling 10–15 percent CAPEX savings – and can drastically increase passenger propensity to spend at airports, thanks to optimized dwell-time and enhanced travel experience.

Moreover, airports are not alone in this battle, and can mobilize their local ecosystems to leverage benefits from system-level collaborative performance improvement programs. Great operational and financial gains can be generated by aligning towards a common objective – the home airline, police and border authorities, ground-support service companies (handlers, fuelers, caterers, etc.) and the airport itself. In a large European hub, air-side capacity and punctuality have thus been improved drastically, and more than €80 M of annual economic gain was generated for all the stakeholders.

2. Anticipating digital disruption in commercial activities: more speed, expertise and agility needed

Over the last decade airports have engaged with speed and great ambition in non-aeronautical businesses, through which

they entered into a frontal battle with down-town players (for retail and real-estate) and third-party specialists. All those players are now facing a new competitor: the digital channel.

Business plans that include steady and healthy growth of non-aero-unit revenues over decades would be optimistic if they did not consider mitigation actions and investments. Incidentally, this battle for non-aero businesses is also key to preserving competitiveness in aeronautical business when considering the existing cross-subsidies in single and hybrid-till economic regulation models.

So far digital has brought benefits to airports' non-aero revenues. Digital display has thus enabled doubling of advertising revenues at some regional and large airports. However, it is clear now that digital is a major disruptor for parking and shopping activities, which jointly represent 70 percent of airports' non-aeronautical revenues at the industry level, and usually generate 75–80 percent EBITDA margin.

In the retail activity, the danger is that duty-free will lose attractiveness because of i) price transparency enabled by digital and ii) the potential ability of airlines to capture share of wallet from travelers in the air. Options airports can activate to counter-attack are:

- Recreating exclusivity and uniqueness of the airport “retail story” based on renewed and fast-moving concepts & merchandising; presence in digital channels before, during and after flight; partnerships with brands to foster unique product offerings; and close monitoring of competition
- Investing in more accurate understanding and knowledge of individual customers’ spending profiles, habits and footfall through data collection
- Regaining price competitiveness through more versatile and flexible product offerings and merchandising

A key enabler to implementing these actions is to establish new forms of win-win contractual partnerships with both retail tenants and airlines. This will incentivize them to grow sales at the airport, and smartly share and leverage data.

With regard to car parks, digital distribution and dynamic pricing are being deployed in most of the largest airports now. However, while yield management, up-sell and cross-sell can increase unit revenues by 10–15 percent at a marginal cost, their full potential is not fully being tapped. Medium to long term, car sharing and/or autonomous vehicles could lure cars away from airports. If cars do not stay, a smart tolling system could be an alternative to making drivers pay for accessing the airport. Additional car-servicing offerings could be an incentive for customers to leave their cars at the airport.

3. International airport ownership: the challenge of creating value for buyers in a “seller’s market”

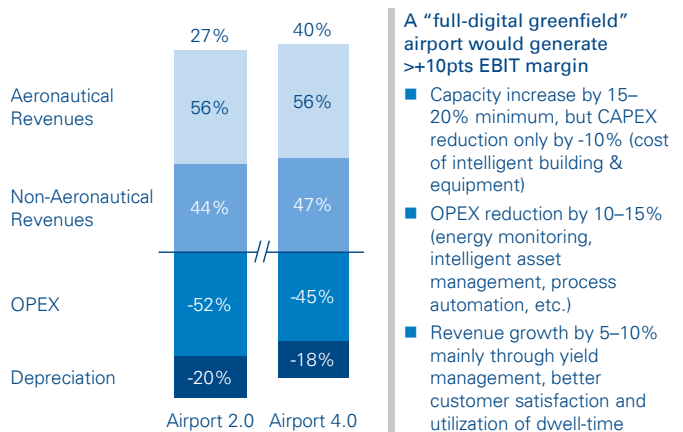
Airport concessions, PPPs and secondary M&A opportunities are popping up around the globe, despite the usual uncertainty about the timings of their actually materializing. All regions are concerned in this trend towards airport privatization.

In this last battlefield, competition among potential bidders in this area has greatly increased, and profit that can be anticipated from such investments is thus being squeezed:

- On one side, prices are soaring – with EBITDA, many are above the x15 mark, while x10–x12 used to be considered an industry standard. This is due to the “dry powder” of private institutional investors, combined with the increased international ambitions of large airport groups (such as Fraport, ADP, Ferrovial, Changi, Vinci Airports, Incheon, Zurich, GMR, and the last kid in the block, HNA Airport division).
- On the other side, the public sector is getting more sophisticated and can impose a stricter regulatory environment on private airport profits. This comes from either i) more challenging initial privatization and risk-sharing schemes such as the revenue-share used in India, Saudi Arabia and Chile, which occasionally includes a preference for O&M contracts rather than BOT; or ii) a tougher regulator approach over the lifetime of the asset, such as with Heathrow Airport and – in a close industry – the French rail network.
- Finally, there are several upcoming multi-billion-euro mega-airport projects (in Vietnam, the Philippines, Kuwait, Costa Rica, Mexico, the US, etc.) that embed a magnified risk level, given the construction risks and large initial capital requirements.

Unleashing the potential value of Airport 4.0 economics

Total EBIT margin (% of revenues)



Source: ACI average world airport P&L 2014, Arthur D. Little analysis

This tough situation is here to stay: potential investors and to-be-deployed capital are numerous, deal opportunities will always be scarce, and public regulators could build on accumulated experience to engage with private investors in a more challenging way.

Solutions to capture and secure value from international operations rely on:

- Establishing long-lasting and anticipated relationships with public authorities and local investors, hence the recent moves of players such as Vinci and ADP to create regional branches
- Pre-empting secondary M&A deals
- Engaging with public authorities early on to optimize concession contracts and risk-sharing schemes with a balanced approach
- Behaving as very “hands-on” shareholders: most sophisticated investors are thus launching joint strategic and business-plan reviews with local management right after airport acquisition, enabling i) validation of accuracy and feasibility of the acquisition business plan, and ii) focus of management on top value creation drivers for shareholders
- Fostering synergies across their airport portfolio, whether through i) best-practice sharing in key areas such as operations, duty-free/retail and real estate; or ii) joint purchasing and resource sharing

Conclusion

At a tipping point for airport economics, industry managers and investors must make proactive and forward-looking moves in adapting their operating and profit generation models. The time to do so is now, before both internal and external competition (e.g., from digital service providers) has hit airport-industry profit generation engines too hard, and massive investments are coming up to accommodate future traffic growth.

Airport operations and “retail story” must be reinvented (with retail and parking as priorities). This means adopting digitally enabled lean and agile models and leveraging the airport’s aero and non-aero ecosystems to facilitate this transformation. From that perspective, data and client ownership will be a key area of concern for airports and ecosystem members, notably between airports and airlines. But finding a common ground, delivering joint initiatives and designing a fair profit-sharing scheme is a must to activate strategic synergies and prepare for the new industry paradigm.

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Arthur D. Little

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