

Taking on airlines' toughest challenges

Aviation is still an enormously demanding industry. This speech from a procurement summit touches on airline profitability, new approaches to cost cutting, and treating procurement as a valued partner.

Steve Saxon



The airline industry has destroyed value over each of the last 11 economic cycles. The industry is cyclical, pricing is cutthroat, and airlines go head-to-head for customers online. What's an airline to do? In these short videos, Steve Saxon, a partner in McKinsey's Shanghai office, explains how to boost customer satisfaction and cut costs by finding out what matters to the customer, reinvesting in capital expenditure, getting creative on the purchasing side, and bringing procurement to the table early. An edited transcript follows.

Understanding the industry's challenges

Aviation generates enormous value for the world, at 3.4 percent of global GDP. That's more than \$2 trillion of GDP that's supported either directly or indirectly by aviation. Aviation makes business links happen, it fosters tourism, and it lets cultures mix. We all know that aviation is a force for good,

and that's why we're in the industry. But at least historically, it hasn't been a terribly good industry at making returns for the airlines themselves.

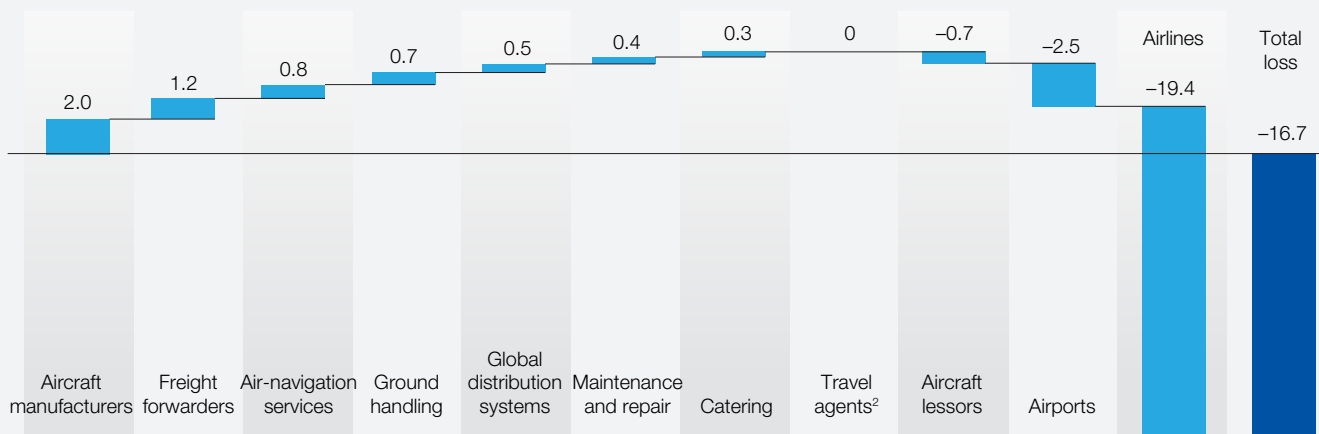
Now, this chart looks historically over the last economic cycle at who made the money (Exhibit 1). And we see that our suppliers, the people we negotiate against on a day-to-day basis, make some money in terms of economic profit—that's profit minus the cost of capital. So if it's positive, you're returning cost of capital, you're creating value for shareholders. The aircraft manufacturers do reasonably well. On the cargo side, forwarders, air navigation, handlers, and global distribution systems all make pretty good money. Travel agents these days just about break even.

However, airports actually destroy value. That's mostly driven by the US, where there are a lot of publicly held airports without an economic

Exhibit 1

Historically, it's not the airlines that have made the money.

Average yearly economic profit 2007–14,¹ \$ billion



Based on invested capital excluding goodwill.

²Rough estimate; insufficient data to provide reliable estimate.

McKinsey&Company | Source: International Air Transport Association; McKinsey analysis

incentive. If you break down the airport numbers to look at the privately held airports and the European airports, they are positive. But across the economic cycle, as I think we know, the airlines have destroyed significant amounts of value.

Warren Buffett himself said, “If a farsighted capitalist had been at Kitty Hawk, he would have done his successors a huge favor by shooting Orville down.” This is an industry which, over the last 11 economic cycles, has destroyed value in every single one of them.

But that’s history. And yes, it’s a long history. Yes, there’ve been some years better than others, but never has the industry sustainably returned cost of capital—with the exception of recently. The last three years, I think, have been much better for all of us. Of course, within that, there are still some airlines that are doing better than others. The US is obviously a particular source of high profits and high returns at the moment. The Asian region, where I come from, has a number of carriers who are still struggling quite a bit more in terms of returning cost of capital. But overall, things are looking significantly more positive.

After being out of the business for 15 years, Warren Buffett finally reentered, investing in airlines. And he didn’t just invest in one, he invested in all four of the largest US carriers, taking a very bullish position that this is an industry which has managed to fix itself.

That said, this is still a hugely challenging industry. If you add together all the profits of all the airlines in the world last year, it’s still lower than Apple. And we need to remember, this is still an industry which has perishable inventory, cutthroat pricing, and perfect competition, with customers going to online portals where they see airlines pitted one against another. Typically, you see aircraft ordering exceeding expected demand. There are long lead times for new aircraft, so that leads to high cyclicity.

And then what do we care about? Factor costs continue to go up. Our customers are, and continue to be, fickle and very price driven. And of course there are threats. I think we all worry about disintermediation, not just from existing travel agencies but also from potential new intermediaries using digital channels.

So there is profitability, on average, at the moment. Some struggle more than others. For all of us, though, it’s critically important to continue to control costs.

This is my favorite chart whenever I present because it really hits home: What is the problem that airlines face? And this is a long time series. Look at the number on the left: 1956 is when this chart starts. This looks at real RASK [revenue per available seat-kilometer], so unit revenue and real unit cost over time. These only go in one direction, and that’s down (Exhibit 2).

Getting creative with solutions

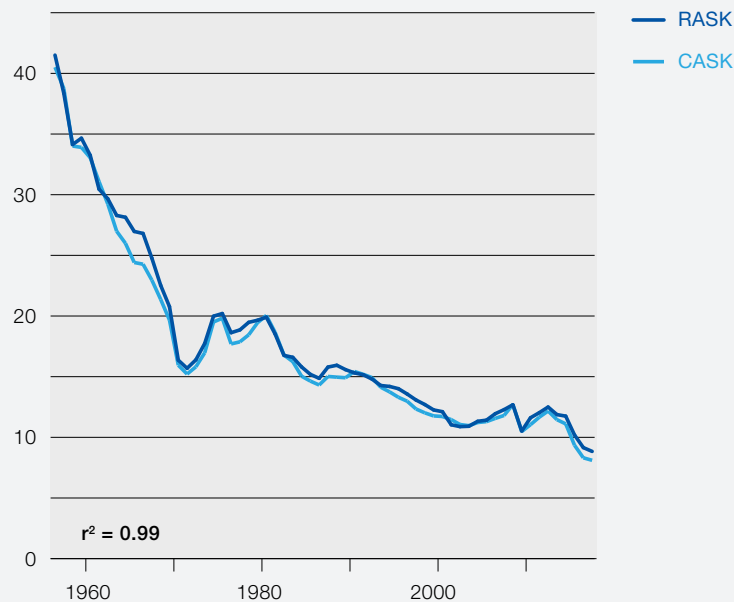
If we want to keep costs going down, we can’t have absolutely the best of everything across the entire airline. Some procurement teams I’ve worked with have started to get very involved, together with the customer-experience team, in shaping what actually makes a difference.

Of course, the customer team wants the best, the best, the best. And they all want to go and try to win awards. Where procurement can really help, though, is getting involved early about what makes a difference to the customer. And that gets into willingness to pay, helping the business figure out what the customer values, and therefore how the airline should be trading off these different areas.

The other way of reducing costs is continually looking for the lowest NPV [net present value]. This industry has tended to favor avoiding capital commitments in favor of operating expenditure. And history has played a big part here; the fact that

Exhibit 2 Unit revenues only go in one direction—down.

Airline industry real RASK¹ and CASK² development,³ ¢ 2017



Note: r^2 is the proportion or % of variance explained by a regression.

¹Revenue per available seat-kilometer.

²Cost of available seat-kilometer.

³Nominal figures deflated using US Consumer Price Index for transportation.

Source: International Air Transport Association; International Civil Aviation Organization; US Bureau of Labor Statistics

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we've all been losing money for 20 years and cash has always been tight has been a key driver of this.

What has that led us to do? It's led us to lease planes rather than purchase. Leasing has increased year by year by year. It's led us to sign power-by-the-hour contracts. We've outsourced things like fuel infrastructure. We've moved IT contracts to transaction based.

And all of this is probably not the right choice in terms of NPV. It's the right choice in terms of short-term cash savings, but it's not the right choice in terms of longer-term value. In our view, now is a

great time to reinvest in some capital expenditures to try to reset costs over time.

This is the time to push creativity. And this is where procurement can play a strong role, thinking about who else we can buy from for different categories. And then we should be starting to use some of the supply-chain and procurement tools to understand suppliers' costs, using tools such as clean sheets, auctions, and so on, to push down the costs.

Looking closely at procurement

McKinsey has a survey we call Global Purchasing Excellence that we use to work with airlines and

score them across a series of different categories. How well does procurement link with strategy? What are the capabilities? How good is category-management execution in the structure and systems? And we can look at the scores in this chart (Exhibit 3). The outer, dark-blue line is the average top-quartile score across all industries, and the light-blue line is where the airlines in our survey are. In all parts of this survey, airlines don't perform as well as top-performing companies across industries.

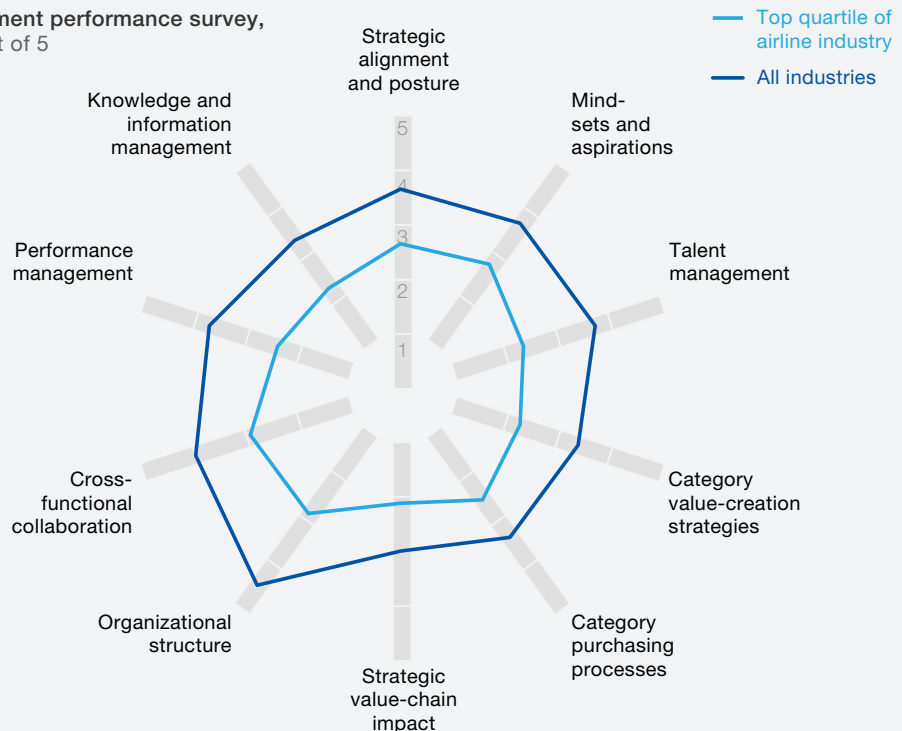
So what do leading airline procurement teams do? In our view, procurement, first of all, shapes demand. The last thing the procurement team wants is to be brought in only at the last minute. Too

many procurement teams I know complain, "The business has already perfectly specified what it wants, and it even knows who it wants to come buy from, and it just hands over to us and says, 'Now go and get the best price.'" And we all know that, at that point, you've got almost no negotiating leverage. So good procurement teams need to be involved early, working as a partner with the business in shaping what we buy.

How do you get there? Well, procurement needs to earn the right to be involved early. Partially, you can have this dictated from the top down—"Oh, you must involve procurement"—but at many airlines, I've seen a kind of lip service paid to this. The business

Exhibit 3 Suppliers are winning partly due to airlines' poor procurement performance.

Procurement performance survey, score out of 5



McKinsey&Company | Source: McKinsey Global Purchasing Excellence Survey results

puts too many specifications on the purchase and still brings in procurement only late.

Procurement needs to be seen by the business as adding value all the way through, and the business will therefore want to bring in procurement early, as a partner to help it shape demand. In our view, a lot of that is down to the people. We think one of the key things to do is to split the roles within procurement, taking some of the more strategic parts out of contract administration and then, within that, having a series of category managers who, in most cases, sit with the business. They might report centrally up to procurement, but they're actually physically sitting with each of the teams, and they're seen as an integral partner to those teams in helping shape the product to be offered, who we buy it from, and then ultimately, how much we pay for it.

The single biggest driver of procurement success is the people—the capabilities and the culture. So as much as we might talk about great category management or great strategic posture, it's the people who are the single biggest determining factor between higher-performing procurement organizations and lower.

If we were to look at this in terms of shifts, in some carriers, procurement can be seen as a backwater, whereas it needs to be seen as, “Hey, this is a great training ground for future airline leaders.” We actually think you don't want a team

full of procurement specialists. You want airline generalists who get rotated through procurement, so they move on to leadership positions in the airline understanding procurement.

Procurement is not a necessary evil which the business is forced to engage, and so it does it as late as possible. It's a valued partner, to be engaged early.

The single most important thing, as we talked about earlier, is people, but the model for success is people supported by the right tools. To pick on one of them, obviously getting your hands around total procurement spend is essential. In our view, 80 to 90 percent of the total spend of the airline should be within procurement. Some departments will push back on that and say, “Oh, no, no, no, wait, engineering is, too, or maintenance is too special to give to procurement.” But that's not our view. Our view is that, “Great, we'll have somebody from procurement in engineering with you, working with you day-to-day, but still we want procurement to be across 80 to 90 percent of the spend.” And having the analytics we need on spending—really understanding how much we spend with suppliers—is step number one. ■

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