

Wall Street Journal

January 7, 2022

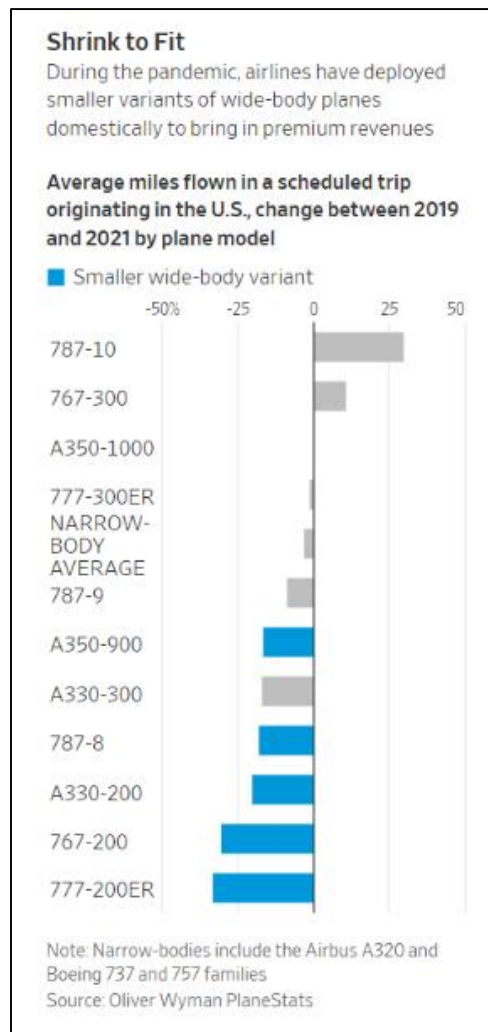
Premium Economy Might Be a Downgrade for Investors

By John Sindreu

IdeaWorksCompany contributed information to this article - - see italics.

Airlines win big by selling slightly roomier seats at four times the price of an economy ticket, but fliers will probably become too price-sensitive to offset lower business-class demand.

Life has given airlines lemons: Where there were corporate travelers flying business class, now they have Covid-conscious tourists paying for premium seats. But this lemonade may be a less profitable thing to sell.



Leisure fliers are upgrading to roomier seats with better food. This “premium economy” class has long been seen by U.S. airlines as a source of growth, and amid the pandemic it is finally living up to hopes. American Airlines said in its latest earnings report that premium sales in the domestic market were higher than in 2019, even though revenues from business passengers were down 36%.

The big question for airlines is whether this trend can make up for the loss of business fliers when it comes to profits.

Many Wall Street analysts forecast a permanent reduction in corporate travel of at least 15% due to videoconferencing. Million-dollar deals will always require face-to-face meetings, but these may increasingly lean on private-jet hailing services. Also, a third of pre-Covid corporate travel involved intracompany visits, and 20% of respondents to a recent Global Business Travel Association poll suggested these could be reduced.

Unlike budget airlines, which stimulate demand by slashing fares, full-service carriers are only sustainable if some passengers are willing to pay a markup. Pre-Covid, corporate fliers made up 15% of passengers but 40% of revenues and, on some flights, as much as three-quarters of profits.

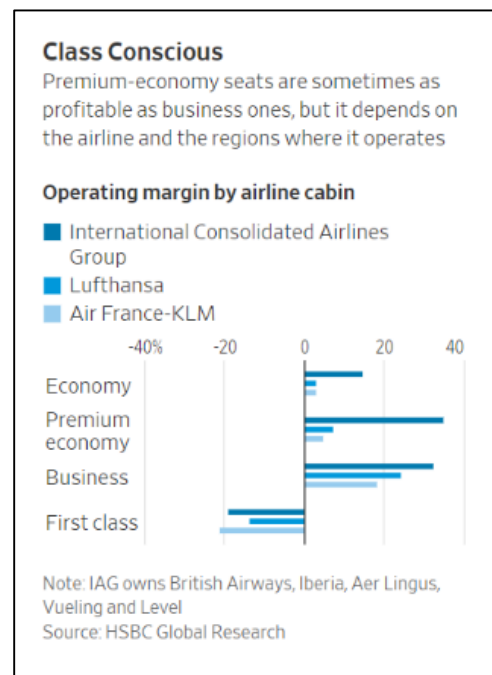
The good news is that, so far, the success of Covid-19 vaccines hasn't deflated premium-economy demand. American's chief revenue officer, Vasu Raja, recently hinted at one reason the bump could be permanent. Previously, tourism was largely restricted to weekends. With the rise of remote work, though, people are building vacations into corporate trips, and using the savings to pay for comfort.

"Even though their company has them flying in an economy seat, they're willing to pay their own money to go in and upgrade into a premium seat," he said.

British Airways is now aiming to include 40 premium-economy seats in cabin layouts, up from 28 to 30 previously, Chief Executive Sean Doyle recently told analysts. Suppliers confirm that airlines are investing heavily in reconfiguring cabins to expand premium economy at the expense of luxury seats. To some extent this was already happening on international routes, as smaller models like the Airbus A350 replaced older jumbos.

On domestic flights, especially in the U.S., jets have actually gotten larger during the pandemic as carriers have repurposed fleets previously used for international flights, according to data from Oliver Wyman. That helps explain why airlines have collected more premium revenue. The trend could outlast travel bans: United recently said it would retire 200 regional planes in favor of larger jets like the Boeing 737 MAX, which will raise the average number of premium seats on short-haul flight to 53 by 2026, from 31 in 2019. Almost all of the growth is expected to come from premium economy.

These "middle class" seats should theoretically be the best deal for the airline: They cost many times the price of an economy seat while offering less than 1½ times the room, whereas a business-cabin seat can take up the space of five.



According to a recent analysis by HSBC analyst Andrew Lobbenberg, British Airways owner International Consolidated Airlines Group gets a 35% profit margin from premium economy, roughly the same as from business class. This may be a feature of the profitable trans-Atlantic travel market that IAG dominates, since Lufthansa's and Air



France-KLM's premium-economy margins are close to basic-economy ones. Overall, in a scenario without first-class seats and business-class capacity down 30%, the analysis suggests that IAG's long-haul net profit margin would remain unchanged, and even its competitors' would fall by less than 1 percentage point.

But there is a problem with these optimistic projections: They are based on 2019 margins, whereas the current boom in demand for premium economy has been stimulated by lower fares, according to a recent report by online travel agent Expedia. Pre-pandemic, the ticket class cost five times as much as economy, on average; now it is less than four times. And this is with economy seats also declining in price.

One consistent finding from consumer surveys is that the foremost priority of leisure passengers is price. Business-class tickets used to be far more profitable because companies are price-insensitive buyers.

Businesses periodically try to rein in travel expenses. But as Jay Sorensen, president of consulting firm IdeaWorksCompany, points out, this often gets resolved with loopholes. Over the past decade, many carriers phased out first-class seats, which businesses were increasingly reluctant to pay for, and instead made business class more expensive and lavish, including lie-flat seats and in some cases enclosed personal cabins. Premium economy then took the place of the old business class and bridged the price gap.

These seats may be in high demand for some years, as cash-rich leisure travelers seek more space due to health concerns and companies return to flying while trying to keep some of their pandemic cost savings. Without a broad pickup in corporate travel, though, airlines may find that all the newly installed medium-class seats won't sell at the type of markup that replaces permanent losses from business class.

Investors who downgrade to premium economy when they fly may need to brace for a lower class of financial returns, too.