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The Social Responsibility Challenge during the Covid-19 Crisis – as illustrated by the Airline Industry

The Covid-19 crisis has a far-reaching impact on economies and societies around the globe. The existence of many companies is under acute threat, and executives have to weigh the interests of different stakeholders when deciding how to best mitigate losses and secure going concern. The approaches taken vary from company to company and tend to show how serious they are about social responsibility. Our analysis of the airline industry indicates that certain capital distribution and executive compensation practices are not aligned with corporate social responsibility values. It also shows that we, as shareholders and investment advisors, must continue to proactively encourage sustainable business models.

Undoubtedly one of the hardest and most directly hit sectors is the airline industry. The spread of Covid-19 has provoked a near-standstill in air travel with airlines facing zero revenues for the foreseeable future. Executives and directors have to take steps that will allow their companies to survive the coming weeks, perhaps even months. In the following sections, we take a closer look at 15 airline companies, examining how the measures they are implementing align with social values. All 15 companies analysed have grounded most, if not all, of their aircrafts. As a result, their revenue streams have dried up while, at the same time, their cost basis has only decreased marginally. All companies have thus had to take measures to a) increase liquidity and b) bring their cost base down.

The Liquidity Conundrum

All 15 airline companies have indicated that they are undertaking actions to increase liquidity. However, the urgency and scale of liquidity needs vary greatly across companies, as shown in the chart below[1].

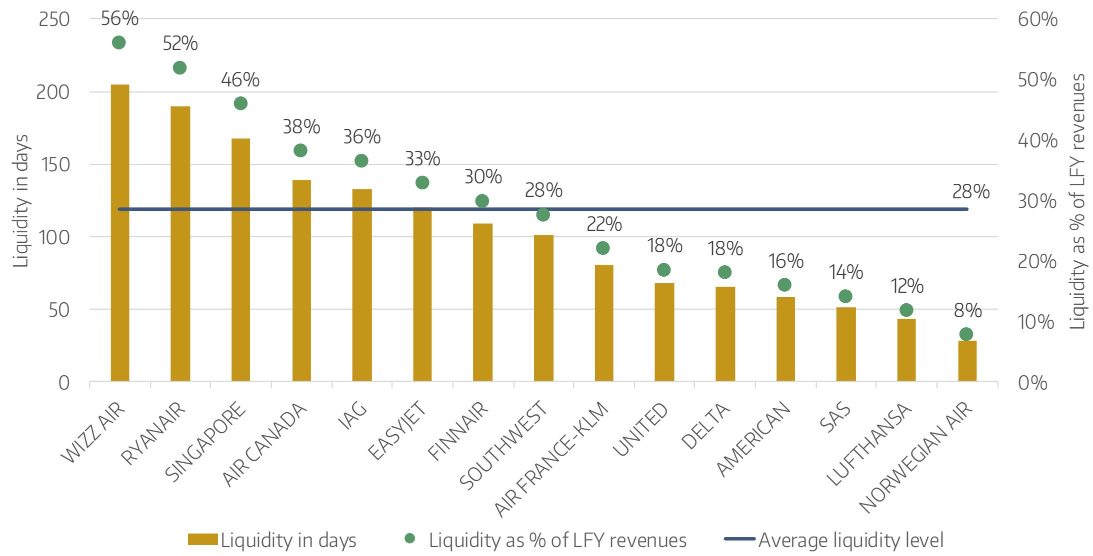

Chart 1: Liquidity Levels of Airline Companies

Companies that have solid balance sheets, with large cash positions and undrawn credit facilities, are obviously in a significantly stronger position to face an economic crisis. The two best positioned companies on this count are low-cost airlines Wizz Air and Ryanair, whereas Lufthansa, SAS and Norwegian Air lie at the other end of the spectrum. In simplified terms, liquidity can be obtained either by generating substantial profits every year and retaining them, or by taking on leverage. As such, earnings generation and retention, as well as the leverage ratio, are of interest. The chart below shows the amount of cash that was returned to shareholders during the past five years[2] (left), and the debt-to-capitalisation ratio[3] (right).

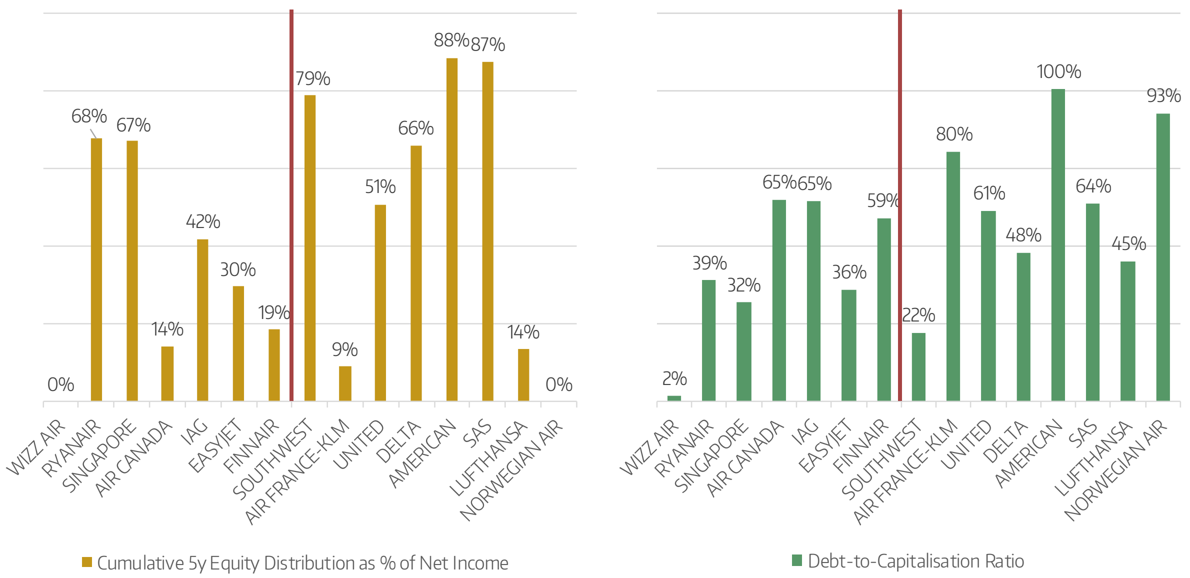

Chart 2: Distribution to Shareholders and Debt-to-Capitalisation Ratio

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1 Most recent reported liquidity, includes cash & equivalents as well as undrawn credit facilities. Sources: Bloomberg and company reports as of 31 March 2020
2 Distributions made in the form of dividends and share buybacks. Sources: Bloomberg and company reports as of 31 March 2020
3 Long-term debt as a percentage of long-term debt plus total equity, including preferred equity and minority share. Source: Bloomberg as of 31 March 2020

Chart 2 shows that five of the eight companies with below average liquidity (i.e. those shown on the right-hand side of the red line) have made significant cash distributions to their shareholders, four of which are US airlines. These US companies returned some USD 45bn to their shareholders over the last five years. It is worthwhile to note that these same companies recently requested a USD 50bn bailout from their government, stating that they would otherwise be unable to pay their workforce's wages. When looking at debt-to-capitalisation, it appears that over half the companies have ratios close to or above 60%. The higher the current debt level, the more difficult it is to raise additional debt, especially during an economic crisis, which in turn means greater need for government support. Norwegian Air, for instance, received a NOK 3bn (USD 0.3bn) credit guarantee from the Norwegian government without which it would not have been able to raise additional debt.

The companies mentioned here are of course not the only ones to have asked governments to step in and help them out during this unprecedented crisis. The majority of airlines have received some form of aid. Furthermore, most support measures come with some restrictions regarding the use and distribution of capital. It is not reasonable to expect that airlines executives could have anticipated – and prepared for – such a pronounced revenue shortfall. Still, this demonstrates that shareholders and bondholders, who should in theory be the principal risk bearers, are in fact mainly beneficiaries of government help. Similar to large banks during the financial crisis, large airlines are deemed systemically critical and hence possess an implicit government guarantee. A strategy of high capital returns at the expense of prudent cash and risk management is certainly not discouraged by this fact. To date, IAG and Singapore Airlines have for example not mentioned plans to discontinue their dividend payments, although both have distributed significant amounts in the past and will likely face liquidity constraints in the future. Southwest and American Airlines would also have continued their dividend payments but are now restricted from doing so by the provisions of the government support program.

Decreasing the Cost Base at Whose Expense?

Reducing the cost base is paramount for airline companies to offset their lost revenues. However, because of their business model, airlines have a high cost basis, which usually proves difficult to cut quickly. A major expense category for airlines is the wages of their large workforce. Hence, all 15 companies in our study are making some adjustments to their workforce spending. The scope of such adjustments is heavily dependent on the country of employment, the strength of the respective unions and the government support programs. In the US, for instance, airline companies are prohibited from laying-off or furloughing staff until September 2020 if they accept government aid money. American Airlines and Delta Airlines nonetheless asked their employees to take voluntary temporary leave. A request that was accepted by 13,000 Delta employees (ca. 15% of the total). In Europe, SAS and Norwegian Air temporarily laid-off 90% of their staff, knowing that Scandinavian countries have generous unemployment programs. EasyJet furloughed all of its staff, but 80% of the salaries are covered by the UK government job retention scheme. Lufthansa and Air France-KLM are in negotiations over short-time work with the unions. Ryanair, on the other hand, is cutting all salaries in half, from the CEO all the way to cabin crew members. Reductions in executive and supervisory board compensation are also being made by some other airlines, as shown in the table below[4].

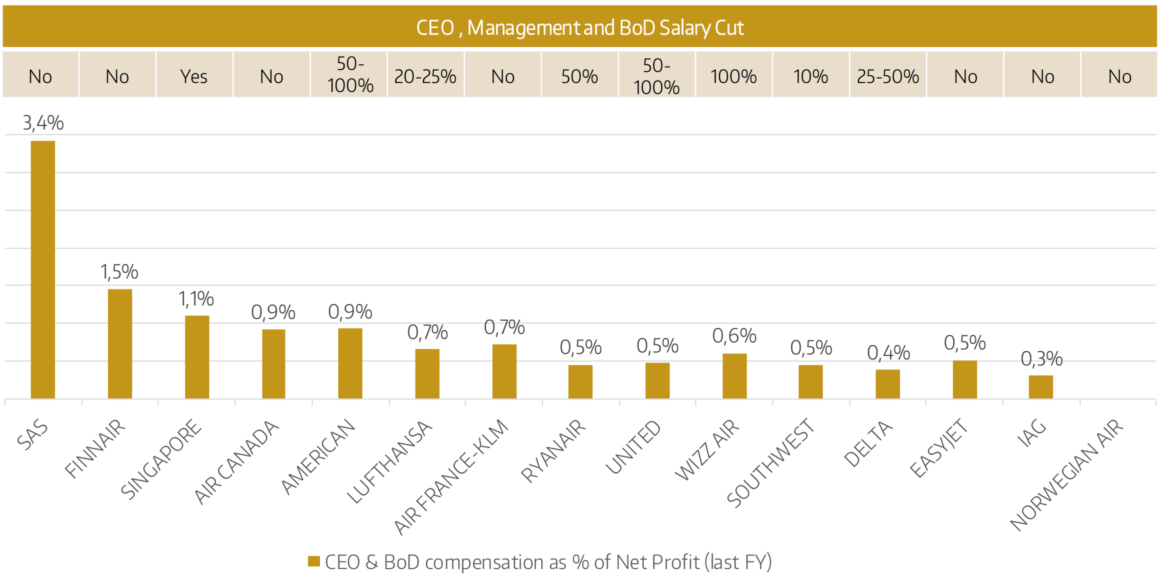

Chart 3: CEO & BoD Compensation

[4] Sources: Bloomberg and company statements as of 31 March 2020

Interestingly, SAS and Finnair, which have the highest CEO and Board of Directors (BoD) compensation packages relative to earnings, have not announced any modification plans. An argument can be made that the CEO and BoD salaries make up an insignificant sum compared to the vast levels of cash these airlines are currently burning every day. Still, a significant reduction in management and supervisory board compensation (by the way, we do not think that 10-20% is significant) would show that they too are willing to bear a share of the overall costs.

Socially Responsible Actions Required from All Stakeholders

All told, we believe that most companies mentioned in this study are trying to find a way to reduce costs and enhance liquidity in a socially acceptable way. However, especially when it comes to executive compensation and capital distribution to shareholders, there are some laggards. First, companies that pay out dividends in times when cash is scarce and employees are being furloughed or put on short-time work are, in our view, acting in anything but a socially responsible way. Second, we think that executives who ask their employees to take significant pay cuts without making any adjustments to their own salaries show bad leadership and a lack of empathy. And, third, we opine that shareholders who care more about short-term capital distributions than sound balance sheets and solid liquidity reserves act irresponsibly and are short-sighted.

There is certainly no doubt that many companies (and not just in the airline industry) are experiencing extremely challenging times, which they could not possibly have foreseen. They face enormous losses, and it would not be economically and socially appropriate for governments to leave them in the lurch. However, particularly in the current crisis which is essentially “no one’s fault”, it is easy for corporates to put the blame entirely on external circumstances. Going back to business as usual once the crisis is over and not learning any of its lessons would be grossly inappropriate and dangerous. Hence, we are convinced that it is our responsibility as shareholders and investment advisors to try to prevent companies from repeating their past mistakes and to continue promoting and encouraging long-term sustainable business models.

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