Little Models Take Big Steps

Unique to the traditional merger or airline consolidation seen in recent years are several low-fare carriers that have either acquired their nation's flag carriers or made attempts to do so. Ever-changing processes that are persuading various business models may be at the root of these unusual acquisitions.

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It might, at first blush, seem pretty audacious for low-cost or value-focused airlines to be in the business of acquiring some of the larger, more traditional incumbent flag carriers.

But such acquisitive actions now appear to constitute a developing global trend. Or, at least, if the trend has not been fully established, some low-cost, value-focused or hybrid carriers are attempting to turn it into a trend.

For example, Brazil's low-cost GOL Airlines — known for original, innovative thinking and a savvy business approach — has acquired longtime Brazilian flag carrier Varig.

And Air Berlin, a respected member of the low-cost, value-focused fraternity of airlines, has acquired the larger operations of both LTU and DBA — surprising many business analysts and shaking up the current European lineup of airlines.

On the other side of the ledger, low-cost carrier Ryanair was recently blocked by the European Commission from acquiring Irish flag carrier Aer Lingus (the European Commission cited competitive considerations).

And low-cost carrier Air One — like several other would-be suitors — has been unsuccessful in its ambitious attempt to acquire Italian flag carrier Alitalia.

What's going on here? Does the flurry of merger-and-acquisition activity signal something more than what appears on the surface? Or are airlines of all stripes simply adjusting to competitive and marketing realities across the board?

The answers to these intriguing questions may be found in closer examination of current evolutionary processes that are heavily influencing the respective business models of low-cost/value-focused/hybrid carriers and their larger, mostly "incumbent" brethren among the flag carriers.

In recent years, low-cost, value-focused and/or hybrid carriers have grown at a tremendous pace. And some of those carriers have exhibited outstanding financial performance, considering the fact that their industry has historically achieved, even during very good times, only a few percentage points in net profits.

The low-cost-carrier success around the world can be largely chalked up to the exploitation of latent demand for inexpensive travel as an alternative option to, say, theater tickets or an automobile day trip. At some point, such sources of demand for low-cost air travel are likely to be saturated. In fact, one could argue that some of these sources may already have exceeded the saturation point.

HIGHlight

Basically, there are two ways a low-cost, value-focused carrier can sustain continuous growth: through organic or inorganic means.

In any event, the success of low-cost, value-focused carriers has been based on continuous growth. Theoretically, continuous growth should ensure similarly continuous growth in these carriers' publicly traded share values. But if at any time the growth momentum is interrupted by even a small decrease in load factor, the financial community can be counted on to almost automatically and immediately issue a profit warning.

At that juncture, the low-cost carrier is obligated to do something different, and its business plan may have to morph to accommodate pure physical growth.

Best estimates are that about 75 percent of low-cost-carrier customers originally came to those carriers as the direct, tangible results of new-traffic stimulation — such as passengers who did not previously consider air travel a leisure option.

Logic, though, says that such stimulation cannot continue indefinitely and that low-cost, value-focused carriers, to keep growing and fill the aircraft they have as well as those they've ordered, must deviate from the original, pure low-cost-carrier business model. For instance, Ryanair stands to double the size of its fleet by 2012.

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Organic Growth

Organic growth can be achieved by growing the geographic footprint covered by the airline or by growing its customer base. Either option deviates from the pure low-cost business model.

In fact, to grow its geographic footprint, a low-cost carrier must increase the average stage length of its network, which means flying longer routes that the low-cost carrier would probably not otherwise intentionally choose.

Longer flight times mean significantly lower aircraft utilization and market saturation — straying from the normally high number of daily frequencies low-cost carriers are set up to serve. Ryanair is an example of a low-cost carrier that is pursuing this avenue to sustain growth. It has recently initiated flights between Dublin, Ireland, and Malta, a four-hour time block that would not align with its original business model.

Other low-cost carriers are expanding their customer bases by winning passengers over from incumbent airlines — those large or small carriers that are already flying a specific route in a particular market.

This, by definition, is a deviation from the original low-cost business model and from the actions of other low-cost carriers. And it represents a brand-new challenge for the typical low-cost carrier. Until very recently, direct competition between low-cost carriers represented less than 10 percent of total worldwide airline capacity.

But now that further growth opportunities in potential low-cost-carrier "virgin" markets are drying up, some of the low-cost, value-focused airlines are beginning to saturate each others' markets. In the United States, for example, the yield of Southwest Airlines is more than 10 percent lower on routes on which the carrier faces competition from another low-cost carrier than on routes where it does not.

On the other hand, winning passengers away from traditional airlines is neither easy nor inexpensive — especially when network airlines fight back by attacking their cost bases and trying to emulate features of the low-cost model.

In moving to meet this challenge, many low-cost, value-focused carriers have found themselves obligated to offer "frills" on their flights. This strategy is based on the concept of succeeding at the expense of the larger incumbents, which, believe it or not, was not a foundational element of low-cost-carrier strategy and success.

And it means increasing the cost base of operations — an immediate result of offering frills to attract passengers who are not merely price sensitive, but schedule sensitive.

Low-cost carriers that are following this strategy include jetBlue, Southwest Airlines, Air Berlin and SkyEurope. They offer more services, more convenient schedules and more distribution channels, including global distribution systems.

These low-cost, value-focused carriers are squeezing the gap between themselves and incumbents in terms of four key factors: schedule, service, yield and cost.

Of course, there are different approaches for different value-focused carriers. Southwest Airlines, for example, is counting on its global distribution system for effective distribution as opposed to jetBlue, which is instead offering some interregional connecting flights. There's also easyJet, which is targeting business travelers by flying to main airports instead of secondary airports like those served by Ryanair.

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GOL, Brazil's low-cost, no-frills airline, took a bold step last year when it acquired Varig, the country's flag carrier. The two carriers continue to serve their independent markets and operate under separate brands.

The need to offer more to justify an increase in low-cost-carrier fares and yield is also the result of the need to cope with increasing costs such as various aircraft and jet-fuel expenses that impact every airline, regardless of its business model.

And the larger incumbents are fighting back by incorporating some of the low-cost-carrier business design in their model such as pushing online sales, cutting travel-agent commissions, improving the productivity of resources, focusing their networks around their natural key assets and simplifying their fare structures.

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While some low-cost carriers have been successful at acquiring larger counterparts, the European Commission stopped Dublin, Ireland-based Ryanair from purchasing Irish flag carrier Aer Lingus. And Italy's Air One was unsuccessful in its attempt to acquire the country's flag carrier, Alitalia.

Inorganic Growth

The other way to grow, which is labeled, logically, "inorganic growth," is through mergers and acquisitions.

Actually, all the ingredients seem to be in place for low-cost-carrier consolidation — and merger-and-acquisition activity is already occurring. According to a recent International Civil Aviation Organization study performed through a series of interviews with airline chief executive officers, the vast majority believe the industry will move toward further consolidation.

The primary driver of industry consolidation relates to increasing the share value of consolidating companies in concert, it is certainly assumed, with economies of scale in combining airline fleets and other assets.

But one important factor that always goes hand-in-hand with mergers and acquisitions in the airline industry is stringent regulatory oversight. Antitrust issues and cross-border-ownership restrictions are often roadblocks to merger-and-acquisition success, as in the case of the would-be Ryanair/Aer Lingus merger that was vetoed by the European Commission.

Other examples are to be found in global alliances, which figure to play substantial roles in enabling consolidation through direct equity investment among alliance partners. To a great extent, the global alliances exist to allow a partial "commercial consolidation" of the industry that is blocked by current foreign-ownership restrictions.

Most of the airline CEOs who took part in the ICAO interviews say stronger alliance relations are being formed basically in lieu of a formal merger-and-acquisition process — when the latter is not achievable due to either regulatory or business issues.

Outlook For The Future

The convergence of formerly distinct business models and the increase in low-fare competition present different challenges for the larger incumbent airlines and the low-cost/value-focused/hybrid carriers.

Low-cost carriers will have to engage more and more in actions and imperatives that are intimately familiar to the larger flag carriers: finding new sources and diversification of revenue, streamlining and making the network and operations more effective, redesigning and creating innovative business processes around pricing and revenue management and, of course, keeping tight control on costs.

Given the stereotypical frugality of low-cost carriers, their way forward may especially concentrate on the redesign of some commercial and operational processes, such as new techniques in revenue management, to be better able to face the competition at the same time and in the same markets of

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Germany's budget carrier, Air Berlin, has expanded it's operations with the acquisition of Duesseldorf-based LTU in 2006 and Munich-based DBA last year. The airline is one of several European low-cost carriers that have taken an interest in larger operations.

both large incumbents and other low-cost carriers.

Or the low-cost carrier may look at items such as demand-driven, short-term fleet-assignment processes to better match its capacity to ever-changing demand factors.

Meanwhile, the larger incumbents must exploit differentiating factors such as network size, schedule quality, better customer service, more favorable airport locations, alliances and frequent flyer programs.

A larger incumbent airline can also gain advantages by segmenting its offerings more effectively and simplifying its fare structure — making fare elements more transparent and adding a la carte features: enabling customers to individually select and pay for the specific onboard and in-flight items they really value.

Another priority of the larger incumbent airlines should be refocusing their networks around market needs and their key natural strengths. Larger airlines would be well-advised to shift toward "follow-the-market" instead of "force-the-market-to-follow-you" philosophies. Certain larger carriers, for example, tend to build unnecessarily complex connecting schedules in trying to serve non-natural connecting markets.

Larger incumbent business-transformation priorities might also be shifted to make operations more efficient through fleet rationalization, process automation, outsourcing of non-core business and increasing labor-force productivity.

As the future unfolds, it's likely that — in adjusting to various market factors — the larger flag carriers and low-cost/value-focused/hybrid carriers will primarily continue to coexist. Obviously, price pressure will always represent a huge challenge for every airline, large and small (and could enter into merger-and-acquisition thought processes in a very big way).

And only those airlines that are able to quickly and nimbly adapt to new and continually changing conditions will be rewarded with consistently profitable operations — whether they're actively engaging in mergers and acquisitions or simply trying to forge a conventional path to business-sustaining growth.

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