M-1382-E
March 2021

The End of Low-Cost Fundamentalism – The COVID Interruption

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Introduction

The post-deregulation era of aviation was exhilarating for all the players involved, particularly in the US and Europe. New players appeared (and some disappeared) and consolidation began to influence market forces significantly, albeit in different forms globally. The successive Chapter 11 filings and subsequent mergers by the three leading airlines (American, United, Delta) concentrated the market, encompassing nearly 70% of available US seats, together with Southwest[1]. In Europe, three main airline groups (Lufthansa, AF/KLM, IAG) joined two growing low-cost platforms, Ryanair and EasyJet. Michael O'Leary, the CEO of Ryanair, even predicted that a reduced number of airline groups would remain – originally he said four,[2] later settling on five[3] groups. Economic growth rates[4] in Asia and the Middle East and assorted political platforms continued to back some very underperforming national carriers (e.g. Air India, Philippines, Garuda, El Al ...), support some of the existing powerhouses (e.g. JAL, Singapore Airlines, Turkish...), and power-charge national projects (e.g. Chinese carriers, Emirates, Qatar...), while a few low-cost carriers grew regionally (e.g. Air Asia, Air Arabia...).

Yet, the lion's share of airplanes, flights, revenues and costs associated with air travel came from short-haul flights, typically those under three hours'[5] duration. Furthermore, the overall market dynamics in this larger segment had been evolving significantly for the main two types of airlines: full-service airlines and low-cost airlines.

[1] "US Airline Market Share, Market Size and Industry Growth Drivers, 2010 – 2020", January 2021.

[2] "Michael O'Leary: Europe will consolidate around four major airlines within a decade," *Irish Examiner,* October 2019.

[3] "Ryanair boss O'Leary predicts Europe will only have five airlines in five years' time future." *Irish Post*, August 2017.

[4] As Billions More Fly, Here's How Aviation Could Evolve." *National Geographic*, June 2017.

[5] CAPA Fleet Database.

This case was prepared by Professors Alex Cruz and José Luis Nueno. March 2021.
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Last edited: 4/10/21

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One Size Didn't Fit All

Traditionally, full-service airlines have never made any profits on their short-haul operations[6] . Legacy airline boards have rushed to put together consultants to address this underperformance on many occasions. Many attempts have been made to address the structural costs and even sometimes to attempt to create alternative, lower-cost operating platforms. Most have failed. While these airlines have had access to higher-fare passengers because of their long-haul product proposition and their main airport operations, their cost base has been insufficient to deliver a profitable platform. These airlines typically have multiple types of aircraft, operate multiple classes of service, support complex ticket distribution arrangements, have more unionized workforces, and continue management practices inherited (or still active) from state-run companies. Yet, they have continued to operate these flights at a loss while carrying valuable connecting passengers to their long-haul network. A few airlines in this category have taken measures to reduce their cost base, such as creating labor arbitrage tools (e.g., Iberia Express, SAS Ireland, etc.), simplified fleets,[7] changed management teams, etc. Yet, the single most widely used set of measures has involved careful reductions of the customer product and service portfolio. These measures are typically easier to implement, as they primarily entail removing certain benefits from many of the existing fares through a now well-accepted process called unbundling[8]. By creating new basic fares that provide only a "right of transport" on a particular flight, adding a myriad of fee-based options such as seating or bag fees, and creating new tiers of fares, traditional airlines began to offer very competitive prices. However, consumers have never accepted this perceived degradation of service, regardless of the fare paid.[9] They have always expected more for less, particularly from traditional airlines.

The challenge of low-cost carriers was completely different. Their proposition from the outset had always been a Spartan, but very price-attractive customer proposition, which had driven record profit margins for most of the operators in the segment. Their initial model included unassigned seats, and additional fees for baggage, food, priority lanes at the airport and even for calling their call center or using airport check-in desks. However, when their growth began to exhaust addressable passenger demand throughout regional airports (as a travel executive said, "who hasn't learned European geography by looking at the Ryanair and Wizzair network?"), they turned their attention to main airports. There, capacity constraints offered a mixed set of opportunities, from "closed" (Heathrow, Amsterdam, New York Kennedy, Tokyo Haneda, etc.) to "partially-open" (Frankfurt, Charles de Gaulle, Tokyo Narita, New York La Guardia, etc.). One European LCC CEO remarked at a conference that his loyalty platform was unique and simple: the price of its tickets. Higher-fare-paying passengers at main airports offered an opportunity to access higher revenues. Thus, The End of Low-Cost Fundamentalism began to take shape.

Low-cost carriers began to slowly introduce new services and to re-bundle them into higher fares that would emulate those offered by traditional carriers. For the first time, we began to see assigned seats, flexible fares and priority services offered by the most "fundamentalist"

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[6] Why Europe's Short-Haul Aviation Market Is in Flux," August 2019, "Ineffective but Reasonable – Why do European Airlines Operate Short-haul Flights?", June 2013, "This Airline Route Makes $1 Billion Annually", July 2018.

[7] "TUI Group to simplify fleet, mulls more B737 MAX 10s", July 2018, "American Accelerates Fleet Simplification – What Does This Mean?", October 2020, "Delta Expands Fleet Simplification Plans," September 2020, "Qantas approaches future fleet with eye for competitive edge, simplification," February 2020.

[8] "Unbundling: How airlines make a profit," December 2020, "Airline outlook: unbundling, fare families, ancillaries," November 2018.

[9] "Unbundling in the airline industry: An empirical study of airline fees and their consequences on customer behaviour," June 2011.

airlines like Southwest, Ryanair and Air Asia. Some advanced even faster (JetBlue, Southwest) by connecting to global distribution systems (GDSs) to expand their sales channels.[10]

With legacy carriers "unbundling" and low-cost carriers "re-bundling," a new short-haul model began to emerge, between the two long-standing types of operators. As 2020 approached, only a few brave carriers in each segment stayed true to their product faith: on one side, the term "Ultra" low-cost airline emerged, led mostly by Phoenix-based airline investment firm Indigo Partner's airlines[11] Wizzair, Volaris, Jetsmart, and Frontier. Even Ryanair was finding itself with cost disadvantages and productivity challenges vs. its new nemesis, Wizzair.[12] On the other side, Middle East airlines were still resisting the unbundling challenge – though a few cracks had begun to appear.[13]

Then, unexpectedly, the single biggest crisis ever to hit the airline industry arrived with force in the first quarter of 2020. With a sudden drop in passenger demand, all the commercial models and trends were put aside as all airline operators and their suppliers entered a new "survival" mode. Passenger initiatives and investments immediately went under scrutiny. Aircraft deliveries were delayed and renegotiated, tens of thousands of employees exited, airport expansion was put on hold and government intervention increased – all against a background of deep uncertainty about how and when the recovery curve would evolve.

In this case, we review pre-COVID-19 trends, discuss the pandemic's main impact on existing models, and provide the likely new post-COVID-19 trends in the airline sector. However, we make it clear that the fundamentals of the democratization of air travel, particularly in the short-haul segments, are left untouched. After a "short" interruption, it will remain a cost-based game in which high return, agile, low-cost carriers compete with typically less-profitable network airlines that leverage their long-haul network and loyalty platforms.

The Airline Industry Pre-Pandemic

Leading into 2020, the airline industry was not in bad shape. IATA was predicting industry profits rising to $29.3 billion in 2020 after a reasonably performing 2019 in aggregate numbers.[14] Most airlines were in the process of ordering or renewing their fleets, investing in new products and technology platforms, and the investment community had begun to regain some of its lost faith. Even Warren Buffet had reinvested in the largest US carriers[15] after having criticized the airline industry for years.[16]

From a Consumer Perspective, a Number of Trends Emerged

For one, ultra-low-cost airlines, particularly those led by Indigo Partners airlines (Volaris in Mexico, Frontier in the US and Wizz in Europe) were beginning to grow, and most importantly, were beginning to have a noticeable cost advantage over the well-established low-cost carriers

[10] "ANALYSIS: Why low-cost carriers are looking towards GDSs", May 2013.

[11] "What keeps driving Bill Franke to invest in low-cost carriers", August 2019.

[12] "The battle of the low cost carriers", October 2020.

[13] "How Basic "Unbundled" Business Class May Backfire On Airlines", November 2020.

[14] "IATA expects airline profits to rise next year after cutting outlook again for 2019", December 2019.

[15] "Warren Buffett: I like airlines because they just 'got a bad century out of the way", February 2017.

[16] "7 ways Warren Buffett blasted the airline industry before investing billions in it", March 2017.

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