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The Low Fare Carrier Phenomenon: Implications For Suppliers

The future holds a new mix of airline business models

The aviation environment is in turmoil. The hub and spoke model of the large traditional carriers, successful in the mid-1990s, is under threat, especially in the US.

Point-to-point low fare carriers (LFCs) meanwhile are demonstrating growth, success and robustness despite the current recession. The recent entry of United Airlines and US Airways into Chapter 11 bankruptcy protection is a sad yet almost inevitable outcome – costs, particularly the labor element, must be addressed.

The future holds a new mix of airline business models, with more of the capacity and demand served by the low fare model. As a result, the future fleet mix will no longer be a simple extrapolation of previous buying behavior and the airline supply chain faces inevitable change in its customer base. This in turn will have a fundamental impact on airline

suppliers in terms of their market, service and product strategies.

The LFCs are a critical and growing phenomenon, with the latest aviation recession curiously providing them with a new stimulus. This Commentary focuses on the needs and driving forces behind this business model and the implications for aviation suppliers.

The low fare phenomenon

“Simplicity” has a cascading and consequently huge effect on underlying costs

Much has been written about the LFC business model. The features are commonly understood – no frills, point-to-point and limited/no use of travel agents, etc. Such airlines also tend to take the lead in outsourcing activities that are not core to their business, especially where there is a viable and competitive third party supplier base.

Core activities invariably include network development, pricing, yield management, finance, operations control, and brand management. In contrast, most LFCs outsource catering services, heavy maintenance activity (engine overhaul, component overhaul and heavy airframe checks), ground handling at non-hub airports and flight simulator ownership. In the middle, there are a number of functions that fall into the “some do, some don’t outsource” category including: component management, line maintenance and handling at base airports, and simulator instruction.

The LFC business model has four key strategic imperatives

The outsourcing decision in this middle category will depend on, amongst other factors, the size of the carrier, the previous experience/philosophy of the particular line manager and local supply options.

For suppliers it is important to understand the key strategic imperatives and differentiators

of the low fare business model. AeroStrategy believes there are four: *high asset utilization, simplicity, low cost focus, and scalability.*

High utilization of assets is a critical driver. Low fare airlines typically achieve daily aircraft utilization of 12 hours from a fleet restricted to the shorter flying day of short-haul scheduled carriers. Their scheduled competitors struggle to reach 8-9 hours on short-haul.

Simplicity, the second strategic imperative, has a dramatic impact. The adoption of a few holy grails of “simplicity” has a cascading and consequently huge effect on underlying costs. For example, what is the impact of the simple decision to offer only limited food service in-flight? Benefits include: fewer cabin crew needed on board; less mess, lower cleaning bills; no need for catering replenishment; lower specification costs; quicker turnarounds, and elimination of a high-waste, low-value service – to name but a few. There is another often-missed example, which is the simple decision not to interline with other carriers. Again the benefits are multiple: no need to wait for connecting passengers; more reliable turnarounds, and a massively reduced revenue accounting department.

In the latter case, some major carriers will have literally hundreds of staff

in this complex accounting function – in LFCs this activity is effectively non-existent.

A *low cost focus* as a strategic imperative seems like a blinding glimpse of the obvious and motherhood. However, achieving it is not easy. Without a culture of focusing on costs, the LFCs will be in danger of taking on some of the facets of traditional carriers as they grow e.g., bureaucracy and overhead. Ryanair, with its impressive margins (especially given its fares!) is a great example of an organization where cost focus is virtually a management religion.

The fourth driver is the *scalability* of the business model. As the European LFCs pursue their 25% growth per annum targets, this last strategic imperative is rapidly becoming the most important. If the business model foundations are truly scalable then growth can be achieved with relatively lower growth in costs. An easy example is internet-based sales. If LFCs were dependent on call centers alone, there would be no way that the explosive passenger growth of the last few years could have been maintained or managed. More subtle examples of scalability lie within the organization model. With the right structure and processes, growth can be readily absorbed because adding new planes, routes or airports

The Low Fare Carrier Phenomenon continued

becomes a cookie-cutter, repeatable process that need not add overhead.

easyJet's engineering organization is a good example. Less than 10 engineers manage a rapidly expanding fleet of over 60 aircraft. By virtue of the outsourcing contracts and their structure, the arrival of new planes is a simple plug-in process – the overhead hardly grows at all.

These four key differentiators have enabled the LFCs to flourish at this moment in time. Critically, their resulting cost position enables such airlines to respond to demand pressure at a cost the majors and regionals cannot match. (see figure 1)

AeroStrategy believes that the low fare business model is here to stay. LFC market penetration will continue to increase as demonstrated by the success of Southwest and newer entrants such as JetBlue and AirTran

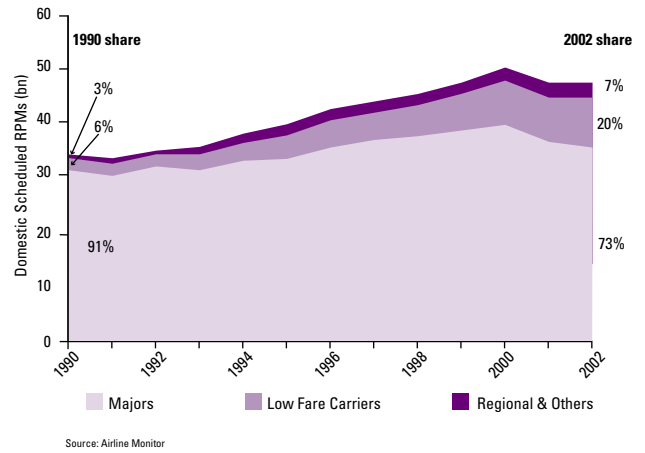
in the US market. Their share of US domestic RPMs has trebled in the last decade to reach 20% today.

(see figure 2)

The European market has seen the extraordinary growth of Ryanair and easyJet, coupled with a very recent proliferation of imitators. It should also be remembered that in Europe, low fare carriers have existed for a long time. The charter operators are extremely cost and price competitive and have an estimated 35% share of intra-European RPKs today.

In Asia, the low fare phenomenon is largely undeveloped. This is driven mostly by the regulatory environment, the distances of travel involved and the continuing dominance of major airports and airlines at the main population centres. However, Virgin Blue is now well established in Australia, Freedom Air is serving the Trans Tasman market and Air Asia in

Fig 2. Carrier Share of US Domestic RPMs

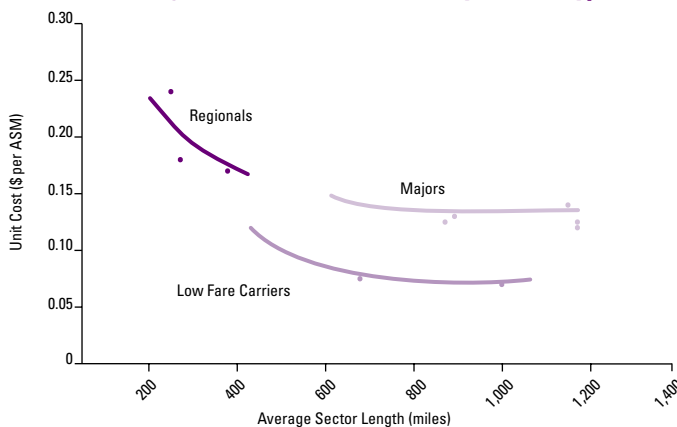


Malaysia represents a new step and experiment in the low fare concept for the more regulated parts of the region.

In Asia, the low fare phenomenon is largely undeveloped

The hub and spoke business model, as used by majors and flag carriers, will remain a dominant part of the airline sector. It was a highly successful model in the 1990s for good reasons. However the low fare phenomenon has two very clear implications. First, the hub and spoke model will have to evolve to compete more effectively. The recent initiatives by American Airlines, including fleet simplification and "de-peaking" of key hubs may be a harbinger of adjustments to come by other majors. The second implication is that LFCs are here to stay and will be grabbing an increasing market share. Thus, they will exert an increasing influence on the aviation supply chain.

Fig 1. US Airline Unit Costs By Carrier Type



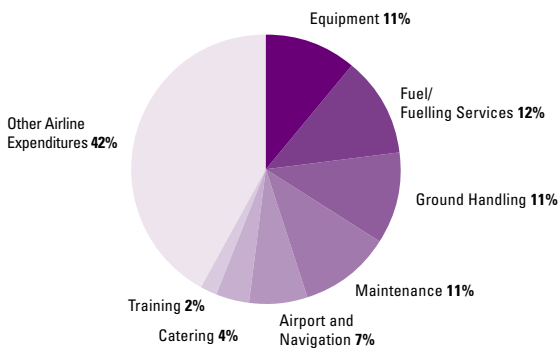
Implications for Suppliers

The LFC market tends to be an “all or nothing” opportunity for OEMs

We now turn to the key question posed for this Commentary: what are the implications for suppliers of the LFCs? Suppliers are here defined as original equipment manufacturers (OEMs) and suppliers of the major aviation service categories that account for just over half of a typical airlines expenditure. (see figure 3)



Fig 3. Airline Expenditure By Supply Category



OEMs

An important implication for OEMs is a changing fleet mix with an increasing requirement for short to mid-haul narrow bodies. AeroStrategy’s fleet forecast model predicts that the 737NG and A320 family aircraft together will grow from 21% of the fleet today to 34% in 2013.

The LFC market tends to be an “all or nothing” opportunity. These carriers stick with one type of equipment, be it an airframe, engine or component system. This focus on a single type, combined with the scalability of their business model, means that the most successful LFCs can become very significant customers in a relatively short period of time. Witness Ryanair’s 250 orders and options for Boeing aircraft since January 2002. This will force OEMs to make significant bets and take a long-term perspective.

The easyJet decision to buy Airbus in addition to Boeing is an exception and most LFCs are unlikely to follow.

Other than low price, what do LFCs seek from OEMs? The imperative of *high asset utilization* means that OEMs must place a strong focus on aircraft availability and reliability of equipment, spare parts supply and technical support. The imperative of *simplicity* and the propensity of LFCs to outsource means that support in training, spares, logistics and maintenance services has to be world-class. Some OEMs, and in particular Airbus and its vendors with their entry into the European LFC market with easyJet, will have to step up to the mark. With the growth of the LFCs, the OEMs product support network and product will become even more important – and will itself have to be *scalable*.



Implications for Suppliers continued

The OEMs must also not forget their core customers – the majors / flag carriers. While the traditional airlines seek to learn “low cost” lessons from LFCs (e.g. higher aircraft utilization), they will continue to need to differentiate and redefine their product. This is particularly important as they strive to attract back the business traveller and develop new value propositions. The cabin product and environment will be a key area of attention for all OEMs.

Ground Handling

LFCs should be good news for ground handling suppliers, as they generate movements, passengers and generally outsource this activity. The winning suppliers will be those who can simplify and adapt their processes to the very tough demands of a high utilization, short turnaround environment.



Furthermore, one of the key value propositions marketed by the new “global” ground handling companies such as Swissport or Penauille is a single source, common standards service proposition. This should be an ideal match with LFCs if this supplier model is indeed correct and can be delivered. The challenge is to demonstrate the value of a network approach and convince carriers not to shop for the best rates by airport. Additionally, the current turmoil may be a one-time catalyst for major airlines to outsource this labor intensive, non-core business activity – particularly in the United States. US majors employ tens of thousands of ground handling employees and should not ignore the cost reduction opportunity represented by this large pool of relatively unskilled labor.

Maintenance

Like ground handling, maintenance suppliers should benefit from the growth of LFCs given their tendency to outsource. They are under no illusion whether or not extensive maintenance capability is core to the airline:



it clearly is not. This means they are more dependent on their maintenance suppliers than typical customers, as they demand services such as component management, technical services and planning support. The reason that easyJet has an engineering organization of less than 10 managers is that it has long-term “full support” contracts in place, including the unique easyTech concept that provides third party yet dedicated line maintenance and maintenance control. This is not to say that LFCs will outsource all maintenance activity: even Southwest Airlines finds it necessary to perform line maintenance and airframe “C” checks to maintain desired levels of dispatch reliability and operational flexibility.

LFCs should be good news for ground handling suppliers

LFCs don't always choose the lowest price maintenance supplier

The issue of airport charges has moved to the front burner for airlines

Implications for Suppliers continued

Does the low cost focus imperative mean that LFCs will invariably choose the lowest price supplier? Not necessarily. Their focus is on high asset availability and productivity, and life-cycle costs are important. Suppliers need to demonstrate how they will deliver the optimal blend of reliability, flexibility, quality, support and performance to win LFC business. In some cases this will benefit independent suppliers, in other cases OEMs and airline maintenance organizations. All suppliers should anticipate aggressive negotiation on service levels for aircraft availability and reliability, and on total price. Finally, a real challenge for maintenance providers is to grow with the carrier. The services required are not new but they have to be delivered to customers with increasing size and the highest demands for low costs, responsiveness, efficient processes and incentivised performance.

Fuel/Fuelling Services

The lions' share of expenditures in this service category is for fuel, the supply of which is virtually totally dominated by the oil companies. This will not change. But what are the implications for into-plane fuelling services?

In Europe and Asia the oil companies also dominate this part of the fuelling supply chain. The cost benefit of

unbundling into-plane services from fuel supply only becomes substantive when an airline has significant scale. So it will be a while until any of the European or Asian LFCs reach this point. Meanwhile, the LFCs will impose high demands on their into-plane suppliers as they continue to focus on short turnarounds. The incumbent oil companies need to satisfy this requirement or face losing business.

In contrast, in the United States the oil companies are generally "off-airport" and into-plane services are provided by independents such as ASIG or by the airlines themselves. The most important observation here is that the US airline recession could be a catalyst for some US major airlines to re-examine the necessity of their in-house into-plane fuelling capability.

Airport and Navigation

Airport business models have become increasingly commercial in recent times and competition between airports has grown. LFCs have important implications for this supplier group. First, LFCs have shown they can generate new traffic and significant growth – hence they provide new opportunities for regional and local airports. Examples abound, from the impact of Southwest Airlines at BWIA, JetBlue at Long Beach,

and Ryanair at multiple secondary and even tertiary airports.

A second implication for airports is that LFCs are in some instances using their negotiating leverage to achieve lower landing fees, traditionally a sacred cow of controlled costs. Ryanair's success in this area with several European airports is well-known. However, with the world's top 50 airport groups showing a comfortable net margin of 11% in 2001, while the top 50 airline groups averaged a 4% net loss, the issue of airport charges has moved to the front burner for airlines.

What about navigation services? This is not an area of expenditure where airlines have a lot of choice or much opportunity to negotiate on charges. However, once again, an LFC is taking a lead and Ryanair is now actively campaigning for greater accountability and charges based on achieving appropriate service standards.

Catering

LFCs are generally bad news for the catering suppliers, as their emphasis on simplicity reduces catering demand. In contrast to major airlines that spend 3-4% of their budget on catering services, LFCs typically spend less than 1%. Clearly, they are not a major growth opportunity for catering

LFCs are generally bad news for catering suppliers

suppliers, which will need to focus on large, long-haul airline customers and help them to redefine and improve their product and value-add to the passenger.

Training

Again, LFCs are natural outsourcers that provide business opportunities for training suppliers. And many of the larger airlines have also recognized that they do not need to own and manage very expensive flight simulators. These trends have already resulted in increased outsourcing and a consolidation of supply, with the simulator OEMs aggressively expanding into this market.

Traditional practice in pilot training is to buy in simulator time but in the interests of quality and operations and safety standards, use in-house instructors. LFCs are again innovators

in this area – easyJet this time, with it’s unique relationship with CTC, where the latter provides instructors not just for the classroom and the simulator, but also for recurrent and line training.

LFCs are natural outsourcers that provide business opportunities for training suppliers

Fig 4. Comparison of Airline Business Models

Activity	Low Fare Carriers	Traditional Carriers
Commercial ¹	●	●
Finance/accounting	●	●
Quality	●	●
Base/hub handling	●	●
Non-hub handling	●	●
Hub line maintenance	●	●
Non-hub line maintenance	●	●
Heavy maintenance ²	●	●
Technical services	●	●
Into-plane fueling	●	●
Catering	●	●
Pilot training	●	●

Primarily in-house
 Mix of in-house / outsource
 Primarily outsourced

¹ Includes e.g., network planning, brand management, purchasing
² Includes engine overhaul, airframe heavy maintenance, component O&R

Conclusion

Today’s turmoil in the aviation market will drive fundamental and long-term change in airline business models and requirements from suppliers. LFCs are here to stay, with an innovative business model that is challenging traditional airlines to re-examine their own business models, reduce costs

and seek new value propositions to maintain competitiveness.

This new world for airline suppliers is a challenging place with customers demanding ever-increasing standards and lower costs. Outsourcing and dependence on a robust, responsive

and competitive supply base will increase – it has to, because the economic imperative exists. Those suppliers that develop processes and approaches that support high asset utilization, simplicity, low costs and scalability to support growth – and deliver on their promises – will succeed.

AeroStrategy is a management consulting firm, specializing in strategy and market analysis for the aviation and aerospace industries. We value your feedback and welcome your letters and comments on any aspect of this AeroStrategy commentary.

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