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The Big Squeeze

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Can traditional legacy airlines find a way out of the "no-man's-land" between the established low-cost carriers and the premium players?

by Chris Manning and Stephan Gross

Ever since September 11, 2001, it's been a bumpy ride for the traditional hub airlines — legacy carriers such as Delta, American, and United in the U.S.; Sabena, Alitalia, and Iberia in Europe; and Japan Airlines and Malaysia Airlines in Asia. Many have fallen into bankruptcy, most have embarked on large-scale restructuring efforts, and profits for all of them have been sporadic. Worse yet, they continue to be squeezed from above and below, as the premium players spirit away the most profitable customers and the low-cost carriers (LCCs) attract more and more price-conscious travelers. It's a situation that promises only to get worse.

The premium carriers are wooing highly lucrative first- and business-class passengers away from legacy carriers with luxury, comfort, and convenience thanks to highly networked hubs. On selected routes and aircraft, for example, Emirates Airline now offers private cabins in first class — with doors. "When you want a meal, you call room service and order whatever you want on the menu," says Chairman Sheikh Ahmed bin Saeed Al-Maktoum.

Meanwhile, low-cost airlines have been nibbling at the legacy carriers' profits for more than 35 years, ever since Southwest Airlines took to the skies, cutting costs and ticket prices — and gaining loyal passengers. Other airlines followed Southwest's lead in the U.S. and in Europe, with the rise of such discount airlines as Ryanair and easyJet, and more recently in Asia and the South Pacific with AirAsia, Jetstar, and Virgin Blue. Wherever they're based, the discounters chant the same mantra: fast turnaround of aircraft at the gate; no frills (no free meals, one-class seats allocated on a first-come-first-served basis, extra charges for checked bags); and limited aircraft types. The ride in crammed seats is anything but grand, but the tickets are cheap. As Ryanair's CEO Michael O'Leary is fond of saying, "It's a bus." And plenty of customers are willing to queue up: Seat capacity on low-cost carriers worldwide has more than doubled in just the past four years, and LCCs now account for about 16 percent of all global passenger-flight seat capacity.

Legacy carriers are thus caught in a kind of no-man's-land. They have two choices: Adapt their business models to reflect the best of all worlds, or fail.

The obvious option — simply copying their low-cost competitors — is not, on its own, a particularly attractive alternative. Indeed, the landscape is littered with failed discount spin-offs of full-service carriers. The network carriers either closed their low-cost operations — as SAS did with Snowflake, US Airways did with MetroJet, and Air Canada did with Zip, or sold them off — as KLM did with Buzz and British Airways did with Go. The legacy players were generally not able to lower

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their operational costs, such as labor, enough to be competitive, and the difference was too great to be made up by economies of scale. Additionally, the traditional carriers faced potential brand dilution and competition among business units for the parent airline's existing passengers, especially on feeder routes into the main hubs, as the distinction between low-cost leisure and business travelers became increasingly blurred.

However, despite this relatively poor track record, a few legacy carriers have shown that it is possible to launch and sustain low-cost operations, such as Qantas's Jetstar and Lufthansa's Germanwings. The key to success seems to be giving the low-cost airline operational independence in managing the network, the overhead, and its fleet. Although both Germanwings and Jetstar's Australian division draw on organization-wide economies of scale for activities such as aircraft purchasing and maintenance, both discounters control the flight operations themselves, giving them wide latitude to set up new routes outside of the legacy carrier's traditional hub-and-spoke network. Such decentralization of operations allows the low-cost airline to adapt its business model to changing competitive dynamics in passenger segments that might be fundamentally different from the legacy carriers' customer portfolio.

Taking this approach a step further, Aer Lingus, the national carrier of Ireland, transformed itself from legacy carrier into low-cost airline in the mode of its rival, Ryanair, with a wrenching reorganization that began in the first half of 2001. After lowering salaries and firing staff, Aer Lingus focused on point-to-point passenger traffic, simplified its fleet, decreased turnaround times, and stripped costs from every aspect of its operations. By 2002, a projected loss of €27 million (US$24 million) had been long forgotten, in the wake of €35 million ($32 million) in earnings. Since then, Aer Lingus has remained profitable and has become such a thorn in the side of Ryanair that the start-up attempted to acquire it in 2006.

Becoming a premium carrier can be even riskier for a legacy airline, in large part because of the need for expensive investments in training, infrastructure, and product development. It is hard to identify a carrier that has successfully made this transformation. Even creating such a premium service from scratch is difficult: Witness Australia's OzJet, which launched an all-business-class shuttle serving the busy Sydney–Melbourne route. It couldn't build a customer base quickly enough and folded after only four months.

How can legacy airlines steer out of this no-man's-land? Booz Allen Hamilton has developed a five-point strategy that integrates the best elements of low-cost and premium airlines, as well as those of multiple-brand airlines (for instance, those serving short-haul routes on a low-cost basis while offering premium services on long-haul international flights). The strategy plays off the strengths of the legacy carriers — their far-flung networks, strong brands, and sheer size — to match, and perhaps beat, the specialists at their own games.

1. Consider point-to-point flying. Traditional hub carriers can no longer treat their best customers as second-class citizens. To compete with low-cost carriers, they must separate out the most heavily traveled point-to-point routes from the rest of their networks and differentiate their service offerings by the needs of the travelers on these flights. Three types of routes should be considered: holiday destinations, small regional services, and intercity trunk routes. A good example of the latter is the London–Munich route: Obviously, commuters would prefer to fly on a dedicated shuttle rather than being squeezed onto large planes along with connecting travelers just in from the long flight from New York, as they now are. The challenge for traditional carriers in setting up point-to-point routes is to maintain efficiency in operations that may lack the scale of large hubs. But by focusing on heavily trafficked direct routes and attracting new passengers with high-quality point-to-point connections, aircraft utilization and seat load factors can be profitable.

2. Create secondary hubs. The traditional hub-and-spoke network relies on just a few major hubs, through which most passengers are routed. Shifting to multiple hubs, which provide flexible routing alternatives, can relieve some of the pressure on individual hubs. Travelers needn't fly so far out of their way when connections are made through the most convenient hub. Peaks in arrivals and departures that cause congestion and costly demands on ground services can be reduced by strategically dividing connections among hubs. Following its merger, Air France–KLM now maintains major hubs in Paris and Amsterdam. The advantage: greater routing flexibility, with some connections that can be moved to new times or smaller cities with spare capacity. U.S. carriers such as Southwest that use random hubs have found that they can make a big difference in overall cost per flight, thanks to faster turnaround times and higher aircraft utilization.

3. Meet customer expectations and needs. The more closely airlines can meet the individual needs of passengers, the more loyal those passengers are likely to be. Premium airlines are masters at understanding which services their customers are willing to pay more for — and which ones they're not. The key is to recognize the trade-off between the *value* of providing additional services and the *costs*. National carriers can tailor their services to suit their passenger base, from meal choices to seat design. Airlines can also move away from the traditional three classes to develop new airline brands for particular routes or passengers. Unbundling product and service choices will enable more competitive and dynamic segment offerings, allowing the air traveler to choose which services he or she considers the most valuable and pay accordingly — whether it's for pickup services, priority check-in and boarding, in-flight entertainment, or onboard food and drinks, for example.

4. Apply "less is more" ideas by taking a lesson from low-cost carriers. Using techniques reminiscent of Japanese manufacturing, successful discount carriers have continuously improved and found new ways of reducing costs. Decrease the number of aircraft types, thus saving on maintenance, training, and staffing. Reduce aircraft turnaround times, thus increasing aircraft utilization. Simplify and automate ground services. Streamline labor arrangements. In these ways, low-cost carriers get in more flights per day than traditional carriers and keep to their schedules, resulting in less overtime and fewer airport penalties. Overall, LCCs have a 40 percent operational cost advantage over traditional network carriers. But what can the traditional carriers do to reduce cost?

Typically, traditional carriers have only gone part of the way, by focusing on the costs that are directly determined by their existing business model and processes (such as reducing overhead expenses, improving systems and infrastructure, renegotiating labor contracts, and automating ground operations). But often, carriers neglect to look at cost items that are driven by their overall strategy. Costs driven by aircraft complexity, passenger services, and the operational footprint across the existing network are key levers that legacies need to pull to achieve the low costs of their competitors.

5. Take advantage of merger opportunities. Our research suggests that airlines can save 5 to 10 percent of their total costs by merging with a similar-sized airline. For example, the Air France–KLM merger demonstrates, with €525 million ($722 million) in realized synergies to date, that substantial cost savings can be achieved through strategic mergers. By 2011, Air France–KLM expects to enjoy cost savings of up to €1 billion ($1.4 billion), driven mostly by consolidated network management, capacity swapping and schedule coordination, and lower cost in aircraft purchasing and maintenance. A carefully thought-out acquisition strategy can also help fill gaps in service and branding, creating a stronger airline that's better aligned with the strategies we've suggested.

Airlines in a New Era

What might a new airline look like once it has escaped no-man's-land? It will be a much more flexible, agile enterprise, with multiple brands that can meet customer and routing needs quickly, effectively, and cheaply. Qantas is perhaps the best example. Originally established as a competitive response to the entry of low-cost carrier Virgin Blue into the Australian domestic market, Qantas's discount carrier Jetstar offers both domestic and international low-cost travel, targeting the leisure customer segment with a lower-cost operating model. Leaving these segments to Jetstar, parent company Qantas has focused on the higher-end business and premium customers. With such pronounced segmentation, Qantas's operating profits have risen to nearly AU$700 million ($546 million) in 2005 from AU$344 million ($193 million) two years earlier.

The new operating model that we recommend involves significant changes that go against the long-held industry dogma that a single airline operating model can be all things to all customers. It will require airlines that are now highly centralized to meet tough organizational challenges: managing separate process streams for differentiated customer service levels, managing decentralized business units focused on segment products and services, and coordinating different businesses to get the greatest cost efficiencies — for example, by maintaining economies of scale in aircraft purchasing and maintenance.

The challenges are tough. As Rod Eddington, former chief executive of British Airways, famously quipped: "Changing airline culture is like trying to perform an engine change in mid flight." But as profits are stripped away by competitors, not changing that culture can be even more risky and can end in a crash landing. +

Resources

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