Managing Proactively in Turbulent Times: Insights from the Low-Fare Airline Business

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INTRODUCTION

Airlines have traditionally had severe difficulties coping with a sudden steep decline in revenue, as they are capital-intensive companies and need to maintain a network, with all of the associated fixed costs.[1] For most airlines, the gap between the breakeven and the actual load factor is small, so even a drop of a few percentage points in traffic can result in an operating loss. Moreover, an airline's product – passenger seats – is a perishable item: if it is not used on any given flight it cannot be used again and a company loses the associated revenue. Occasionally, market downturns can be particularly sudden and cataclysmic. The September 2001 terrorist attacks on New York and Washington D.C. had a particularly negative impact on the US and world airline industry. Market confidence, already weakened by a nascent recession in the US and parts of Europe, plummeted in the wake of these attacks and their follow-on. Safety fears meant that air traffic numbers declined sharply. Global airlines such as British Airways (BA) and American Airlines (AA) announced large-scale jobs cuts and sought financial assistance from their respective governments. Already weakened by sustained losses, flag carriers including Swissair and the affiliated Sabena were pushed into or towards the brink of bankruptcy.

This industry turmoil prompted the questions: how were low-fare airlines (LFAs) affected by the fallout from the US attacks and related traffic slump? Were they better able to weather the market storm than their traditional competitors? Evidence in Europe and the US indicates that the leading LFAs fared significantly better than their full-fare rivals in the wake of the terrorist attacks on the US. While established rivals cut staff, grounded aircraft and even collapsed into bankruptcy, the LFAs continue to open new routes and order new aircraft (Campbell and Kingsley-Jones, 2002).

The strategic management principles and operational processes of leading LFAs are examined and compared in this paper and best practice is established for airline management. It is argued that strategically aggressive and operationally efficient LFAs are more resilient than traditional airlines to market downturns. The industry financiers substantiate this fact. For instance, Schoder Salomon Smith Barney tend to value LFAs as growth stocks while traditional airlines are treated as cyclical. US low-fare pioneer, Southwest Airlines, has proven this fact on numerous occasions. In Europe, Ryanair and easyJet have also successfully weathered the market travails post-September 2001 and continue to grow. Consistently successful LFA business models are premised on a willingness to act decisively and aggressively in pursuit of or to retain market share and profit.

Since the atrocities of September 11th, 2001, the persistently high market capitalisations of low-fare leaders such as Southwest and Ryanair – relative to their larger, full-fare peers – are further proof that LFAs have come of age. This is illustrative of the market power and durability of the LFA model and it serves to underline the fact that a variety of useful management lessons can be learned from the low price leaders.

Strategic Management in the Airline Business

The Need to be Proactive

In most companies, recession and market downturn foster an environment of short-term, reactive management, with leadership activity focused on daily operational priorities. Strategic considerations tend to be deferred and offensive market manoeuvring is scaled back. Many firms adopt a siege mentality, with business survival replacing market success as the *modus operandi* for management. Periods of market uncertainty and decline need not be a time of retrenchment for all companies. Instead, opportunities can present themselves for companies that are financially sound and operationally efficient. Among these firms, it is the proactive company that will steal a march over reactive competitors and establish or leverage a market position. This involves aggressive action via strategic options such as price reduction, supplier/distributor contract renegotiation and/or corporate acquisition. The LFA sector provides a vivid example of this proactive approach to corporate strategy, as illustrated by the actions of leading LFAs during the post-September 11th airline industry crisis.

The traditional approach to strategy requires precise predictions and often leads managers to underestimate uncertainty (Courtney, Kirkland and Viguerie, 1997). However, Courtney poses the question:

> Is it better for a company's competitive position to try to influence or even determine the outcome of crucial and currently uncertain elements of an industry's structure and conduct? Or is it the wiser course to scope out defensible positions within an industry's existing structure and then to move with speed and agility to recognise and capture new opportunities when the market changes? (2001: 38)

He concludes that the right strategic bets can return higher payoffs far more quickly. Such strategic risk taking is indicative of what Courtney describes as 'strategy shapers' – firms that generally attempt to get ahead of uncertainty by driving industry change their way. In the 1970s, Southwest Airlines grappled with uncertainty by introducing fundamental product innovations intended to redefine the basis of competition in an industry (the low-price, point-to-point air travel model).

Courtney (2001) argues that whether a company should attempt to shape or adapt[2] depends largely on the level and nature of the uncertainty it faces. He further contends that when a firm faces very high levels of uncertainty about variables it can influence, shaping makes the most sense. This is precisely what the leading LFAs did in the immediate aftermath of September 11th. A high degree of uncertainty existed across the airline industry, pivoted on one key variable: people's willingness to fly. Ryanair, easyJet, Southwest and others shaped airline strategy by tackling this issue immediately and directly, driven by the need to maintain load factor. Unlike many full-fare competitors, they went on the market offensive. The leading LFAs on both sides of the Atlantic launched advertising campaigns expressing their determination not to be beaten by the terrorists and introducing extensive ticket price discounting ('fare sales'). Some, such as Ryanair, also took the opportunity to announce fleet expansion plans. Linked to this, Ryanair availed of the market downturn to negotiate a favourable per unit price with Boeing for their order of 100 Boeing 737-800 aircraft. This is in line with Ryanair's containment of strategic risk through aggressive cash management. Whilst most airlines increase spending during market upturns, airlines with the highest multiples – primarily leading LFAs – 'conserve cash during the boom time and invest in the trough' (Zea, 2002).

Ultimately, the case for a proactive approach to corporate strategy is compelling. It proves more effective than reactive strategies in times of uncertainty, as it challenges the siege mentality. Also, it is the way to win, by stealing a march over reactive competitors and gaining or increasing market advantage at their expense. Finally, proactive strategy implies aggressive action, often resulting in product innovation, the creation of new market space or the renegotiation of outsourcing contracts. It can also imply acquisition, as evidenced by easyJet's decision in 2002 to takeover its low-fare rival Go.

The Cult of Cost Reduction

In choosing a competitive strategy, a key consideration for company strategists is how to configure the value equation to best meet customer needs and demands and offer a unique value proposition. For LFAs this means striving to achieve the lowest possible prices for their products or services. Low prices cannot be sustained unless a company maximises its operational efficiency. This means that the company has to perform similar activities better than rivals (Porter, 1996). One way of doing so is to pursue a rigorous and relentless policy of cost cutting.

Constant and ever-improving methods of operational cost reduction are *de rigueur* for any organisation. Ames and Hlavacek (1990) argue that managing costs is at the heart of every successful company and that four related cost truisms apply universally to every business situation: first, over the long term, it is essential to be a lower cost supplier; second, maintain a competitive position, the inflationadjusted costs of producing and supplying any product or service must continuously decrease; third, the true cost and profit of each product or service and every customer segment must always be transparent; and fourth, a company should focus on cash flow as much as on profit generation. Market deregulation and industry globalisation have increased the competitive pressures on companies, reducing the margin for error and rendering the 'cult of cost reduction' indispensable. Nowhere is this more apparent than in the commercial air transport business. For airline companies, successful and constant cost control is essential and cannot be neglected, even temporarily. SAS learned this lesson during the 1980s when their market-driven philosophy caused their costs to escalate unchecked (Robertson, 1995). The margin of profit for most airline companies is minimal. There is little difference between the average total cost of any given flight and the number of passengers and yield per passenger needed on that flight to turn a profit. For traditional full-fare airlines, the difference is normally only a few percentage points. This means that airlines are highly susceptible to market fluctuations and any related fall in traffic. The obvious way to safeguard a company against this acute market vulnerability is to decrease operational expenses and increase employee and aircraft productivity. By suppressing the breakeven load factor figure, an airline can ensure that any drop in the average passenger load factor figure will still reap a profit – albeit reduced – for the company. The key factors affecting indirect costs for an airline are fleet structure, route network and company policies on remuneration and work rules (Seristö and Vepsäläinen, 1997). Together, these determine the total cost differences between airlines and the primary ways in which an airline can reduce its costs relative to competitors. Uniform fleet structures, flexible work rules, performance-related pay schemes and point-to-point services operating between lower-cost and less congested secondary airports are all examples of ways in which a carrier can reduce its costs and improve its relative competitiveness. All of these cost-reduction techniques are fundamental elements of the LFA business model.

The 1990s witnessed substantial improvements in productivity and costs in the airline industry but the gains were not uniform (Morrell and Lu, 2000). Studies[3] show that during the 1993–98 period, average European available tonne-kilometre (ATK) per employee increased by 31 per cent to 380,000 and unit costs decreased by 15 per cent to 58 US cents per ATK. Improvements also occurred in other areas of productivity and cost reduction. The North American and Asia Pacific regions experienced similar improvements. These were usually not as considerable as in Europe because most European carriers lagged behind their North American and Asian counterparts and were going through a process of 'catch-up'. These gains were not uniform within Europe either, as measures of productivity and cost differ according to the nature and strategic objectives of an airline. For instance, costs are lower for a carrier heavily involved in the charter and cargo markets. Similarly, long-haul carriers have a per unit cost advantage over short-haul carriers (Morrell and Lu, 2000). Likewise, short-haul carriers experience higher aircraft utilisation and greater yields than their long-haul counterparts.

In the airline business, the contest to lower costs, increase productivity and gain market advantage is often accompanied by price-based competition. Demand for air travel is highly elastic: reduce the price and sales rise sharply. However, reducing prices to gain market share is not usually a sound business strategy. Unless a company has a significant cost advantage of at least 30 per cent, reducing prices can trigger a suicidal price war (Garda and Marn, 1993). Price wars are common in the airline industry, where the commodity is largely undifferentiated, customers are highly concentrated and many are very price sensitive, and switching costs for consumers are very low (Garda and Marn, 1993). This scenario is accentuated in markets where many competitors co-exist. In essence, a company that competes on price must ensure that it has the cost base and cash resources to be the low-price leader and not just a low-price competitor. In operational terms, cash resources are vital to ensure a new entrant's survival in the face of predatory pricing by established carriers – a customary reaction by many existing large airlines. Cash also enables the airline to defer any downsizing measures during periods of market stagnation, decline or crisis. Low price market leaders such as Southwest Airlines in the US and Ryanair in Europe have developed business models that place constant cost reduction and cash accumulation at their core. These companies have emerged as the most effective cost and price competitors in the business. They are also the most consistently profitable airlines in the world. In addition, as we will illustrate further on, companies such as Southwest and Ryanair are extremely robust during times of economic crisis and market decline. For these reasons, the structures, strategies and contexts (market and industry) of LFAs hold invaluable lessons both for other airline companies and for all companies struggling to compete in highly competitive international markets.

THE LOW-FARE BUSINESS PARADIGM

The European airline industry experienced its first significant competitive shake-up during the 1990s. As Morrell points out:

> Excluding those airlines based outside the EU, there was a net increase of six in the number of airlines serving intra-EU cross-border scheduled routes between 1992 and 1995 compared to a net loss of four carriers between 1989 and 1992. (1998: 50)

In many cases these new entrants served low-density regional routes. As Bhide (1992) argues, most start-ups begin by pursuing niche markets that are too small to interest large competitors. In other cases, charter airlines such as Air Liberté in France (now Air Lib) commenced scheduled flights in direct competition with established carriers. During the latter part of the 1990s, more than 100 new airlines commenced operations in Europe. During the same period, in excess of 70 went out of business or were absorbed by another airline. Of these airline start-ups, five can be classified as LFAs – easyJet, Go, Buzz, Virgin Express and Debonair.

Cost structures constitute a clear distinction between an LFA and a full service airline. One revealing measure of the running costs of an airline is cost per available seat kilometre (ASK). When cost per ASK is compared between airlines, carriers such as Ryanair and easyJet in Europe and Southwest in the US are, on average, operating at almost half the cost of full service carriers (Campbell and Kingsley-Jones, 2002). Haughey (2001) provides a clear comparative distinction between LFAs and traditional scheduled carriers (Table 11.1).[4]

Table 11.1 Generic Low-fare Versus Full-fare Airlines

Low-fare Airline	**Full-fare Airline**
Simple brand – low fare	Complex brand – price + service
Online and direct booking	Mainly travel agents
Simple ticket price structure and ticketless check-in	Complex fare structures
Use of secondary, low-charging airports (*some exceptions*)	Focus on primary airports
High aircraft utilisation – quick gate turnaround time	Lower utilisation on short haul
Do not interline; point-to-point service	Interlining important part of service
Simple product – all additional services and facilities charged for, e.g. credit card bookings, late check-in, meals	Complex integrated service product(s), e.g. ticket flexibility, business lounges, frequent flyer programme
Focus on ancillary revenue generation – advertising ('the plane as a billboard'), on board retailing (*more common in Europe*)	Focus on primary product
Mainly short-haul focus	Short and long haul
Common fleet type acquired at very good rates	Mixed fleet

Williams (2001) adds two further distinguishing features of the low-fare model, namely extensive outsourcing and high-density seating. For companies like easyJet and Ryanair, outsourcing is evident in virtually all areas of business activity. It is particularly prevalent in capital-intensive activities such as passenger and aircraft handling. High-density seating is a standard element of a no-frills strategy, with customers willing to endure less legroom so as to avail of lower prices.

LFAs also seek to minimise personnel costs and do so though increased staff-passenger ratio and employee compensation linked to productivity-based pay incentives.

Campbell and Kingsley-Jones (2002) argue that the chief cost differences between low-fare and full-fare airlines fall into three groups: first, service savings (e.g. no-frills cabin service and extensive use of outsourcing); second, operational savings (e.g. point-to-point services and uniform fleet); and third, overhead savings (e.g. Internet sales and a streamlined bureaucracy).

Whilst it is relatively easy to identify the core generic features of the LFA business model, many variations do exist. Nonetheless, it is widely accepted that the approach pioneered by Southwest Airlines in the US is the archetype LFA model. easyJet management concur with most of these principles and emphasise an essential feature of its particular model – the direct sell, excluding the travel agent and selling directly to the customer – preferably via the Internet.[5]

Ryanair were the original European adapters of the Southwest model. Whilst continuing to adhere closely to the LFA norms, they also ensure that minimal debt servicing costs, non-participation in alliances and cautions route network expansion are embedded in their business model.

Four LFAs can be identified in Europe: Ryanair, easyJet, Virgin Express[6] and Buzz. A fifth – Basiq Air – does appear to meet most of the criteria. However, operationally and strategically, it is virtually indistinguishable from charter and cargo airline Transavia – itself closely identifiable with KLM.[7] Of the four more obvious LFAs, three are or were associated with larger airlines. Two – easyJet and Buzz – are based at a London airport and Ryanair also has a major base at London Stansted. In addition to easyJet's 2002 acquisition of low-fare rival Go, the London market has also seen a prominent LFA go into receivership, with the 1999 collapse of Debonair. The LFA phenomenon has only recently emerged in mainland European countries. Several new LFAs emerged in 2002, all with the exception of bmibaby – based in continental Europe. These include Goodjet of Sweden, Ciao Fly of Italy and Jetway of France.

A 2000 Salomon Smith Barney report[8] illustrated that only 3.4 per cent of intra-EU passengers used LFAs. Figures supplied by AeroStrategy indicated that by the end of 2002, LFAs accounted for almost 10 per cent of domestic European passengers. Airline Monitor figures for 2002 suggested that LFAs accounted for just under 20 per cent of US domestic airline passengers, indicating that there remained considerable potential for LFA growth in Europe. Based on route analysis, the Salomon Smith Barney (2000) report argued that on almost every route the LFAs have taken at least 5 percentage points in market share from the incumbents. This is in addition to the new market space that they have created – most of which they control.

How do LFAs ensure considerable cost advantage over traditional airlines? Doganis (2001) argues that the LFAs begin with two initial cost advantages arising from the very nature of their operation: higher seating density and higher daily aircraft utilisation. By removing business class and reconfiguring their aircraft, LFAs can significantly increase the number of seats on their aircraft. The seat pitch of an LFA is usually 28 inches, compared to a conventional economy class pitch of 32 inches. This allows LFAs to fit more seats onto their aircraft, thus increasing the maximum capacity of each flight. For instance, easyJet has 148 seats on its Boeing 737-300 aircraft, compared with Bmi British Midland's 124 seats. Assuming similar operating costs and the same aircraft, easyJet's 24 extra seats per aircraft would result in its costs being 16 per cent lower than Bmi British Midland's (Doganis, 2001).

A defining organisational difference exists between LFAs and traditional carriers. LFAs operate on a point-to-point basis whereas traditional carriers tend to utilise a hub-and-spoke system. With the point-to-point system, airlines calculate that using each aircraft for a maximum number of flights per day will generate more revenue and lower unit costs per flight. Freiberg and Freiberg (2001) note that the hub-and-spoke system is an efficient way to fill an airplane. However, it does not usually offer efficient aircraft utilisation. LFAs spurn the hub-and-spoke system on the basis that it increases costs. Baggage handlers, gate staff and other ground crew can be idle if an airplane spends more time on the ground waiting for passengers and their baggage to connect from feeder cities. In addition, the aircraft will accrue higher airport charges for spending longer at the gate (particularly at busier airports). The average LFA takes about 25 minutes to disembark passengers, unload and load baggage, refuel and clean the aircraft, and embark new passengers. This can be as much as half the time it takes a traditional airline to carry out the same activities. In addition to operating a point-to-point model, this rapid turnaround time derived from the use of uncongested secondary airports (whenever possible), the no-frills service (requiring little catering and cleaning support), the non-assigned seating approach and the absence of freight (Doganis, 2001). As a result, aircraft utilisation averages out at eleven hours per day for the LFA, compared with around seven hours per day for a more conventional carrier (CAA, 1998). In addition to the operational efficiencies gained, LFAs believe that the point-to-point model is more convenient for customers, most of whom would prefer to avoid the time and inconvenience of making flight connections.

Overall, Doganis (2001) calculates that LFAs should be able to operate at seat costs that are only 40–50 per cent those of a mainline rival. If this is combined with a significant load factor, differential and lower distribution costs, an LFA's cost per passenger can drop to about one-third those of a conventional airline's.

Research indicates that the absolute cost disadvantage of conventional airlines lies in their provision of a business class (CAA, 1998). However, this element should be offset by higher yields. The real cost advantages of the LFAs are therefore smaller than the bare figures indicate. These cost advantages are sustainable and stem from the nature of the low-fare product. Premised on a more basic no-frills service, the LFA product cannot or will not be emulated by traditional full-service carriers. Such an approach would damage a traditional airline's quality reputation, alienate passengers (particularly many business customers) and undermine its market position.

LFA Performance in Time of Crisis

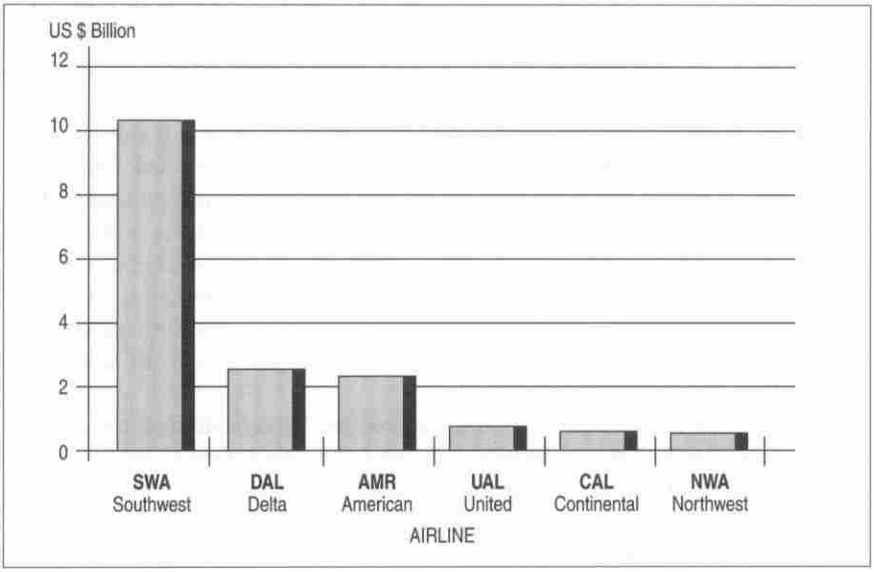
Zorn (2001) argues that LFAs are more resilient than traditional airlines to market downturns. Southwest Airlines has proven this fact on numerous occasions in the US. Zorn cites several reasons for the resilience of LFAs in times of recession: first, a lower overall and more variable cost structure; second, lower breakeven load factor; and third, business and leisure traveller migration from expensive airlines to LFAs. All of the evidence in the US and Europe indicates that the leading LFAs fared significantly better than their full-fare rivals in the wake of the September 2001 terrorist attacks on the US. Nonetheless, a significant variance did emerge between US and European low-price carriers. In the US, LFAs were not as fortunate as their European counterparts. Location (all operations being within the US) combined with the post-attack industry shutdown imposed by the Federal Aviation Administration, meant that all American airlines were adversely affected by the airline industry crisis that developed after September 11th 2001. In early October 2001, the low-fare leader and fourth largest airline in the US, Southwest Airlines, announced that the company flew 2.6 billion revenue passenger miles (RPMs) in September 2001, a 21.6 per cent decrease from the 3.3 billion RPMs flown in September 2000. Available seat miles (ASMs) decreased 3.6 per cent to 4.8 billion from the September 2000 level of 5 billion. Also, the load factor for the month was 53.4 per cent, compared to 65.7 per cent for the same period in 2000. Expressed in an even more obvious manner, Southwest's load factor averaged 66.8 per cent for the period from 1–10 September and 45.4 per cent for the period from 14–30 September. Bookings for the week ended 23 September were approximately 60 per cent below normal targets. However, bookings for the week ended 30 September improved and were only 10–15 per cent below normal targets. The airline acknowledged explicitly that its September 2001 traffic results were severely affected by the September 11th terrorist attacks on the US.[9] Unlike the other major US airlines, Southwest avoided schedule reduction and staff redundancies in the wake of the terrorist attacks. However, it was forced to defer the delivery of eleven new Boeing 737-700, citing as the reason the slowdown in air traffic after the September attacks.[10]

The second most successful US LFA, JetBlue Airways, delayed the start of two new services in light of declining demand after the terrorist attacks (Sobie, 2001). However, unlike its full-fare competitors, JetBlue said that it had no plans to furlough any employees or delay deliveries of new Airbus A320 aircraft.

Several other US low-fares carriers, including AirTran Airways and Frontier Airlines, avoided laying-off some groups (such as pilots) through wage concessions. In addition to AirTran and Frontier, other US LFAs that slashed jobs and schedules in the wake of the September 2001 attacks included American Trans Air, National Airlines, Spirit Airlines and Vanguard Airlines.

Despite these low-fare sector travails, leading budget airlines emerged from the crisis in a stronger market position relative to their full-fare rivals. A prominent and inclusive measure of this disparity is the comparative market capitalisations[11] of leading LFAs and major full service carriers. Morrell (1997) points out that for airlines with stock market quotations, the market capitalisation shows investors' valuation of the airline as a whole on a daily basis, including an assessment of intangible assets (such as slot allocation), management strength and business prospects. The durability of LFA market capitalisations post-US attacks was significant. Broadly speaking, there were three main reasons for this divergence. First, leading LFAs on both sides of the Atlantic had strong balance sheets and very little – if any – debt. Second, consumers are more price sensitive in times of recession and more likely to fly with an LFA than a full-service carrier. Third, airlines that outsource much of their activities (as LFAs do) stand to gain during industry downturns, as they can usually avail of better prices from their subcontractors. Moreover, they are not forced to lay off a large number of employees within their own organisations. Two weeks after the World Trade Centre explosions, despite its problems, Southwest Airlines had the strongest market capitalisation of all the US airlines (Figure 11.1). The Texas-based low-price leader was in fact worth more than the five largest US carriers combined ($10.8 billion versus $8.56 billion).

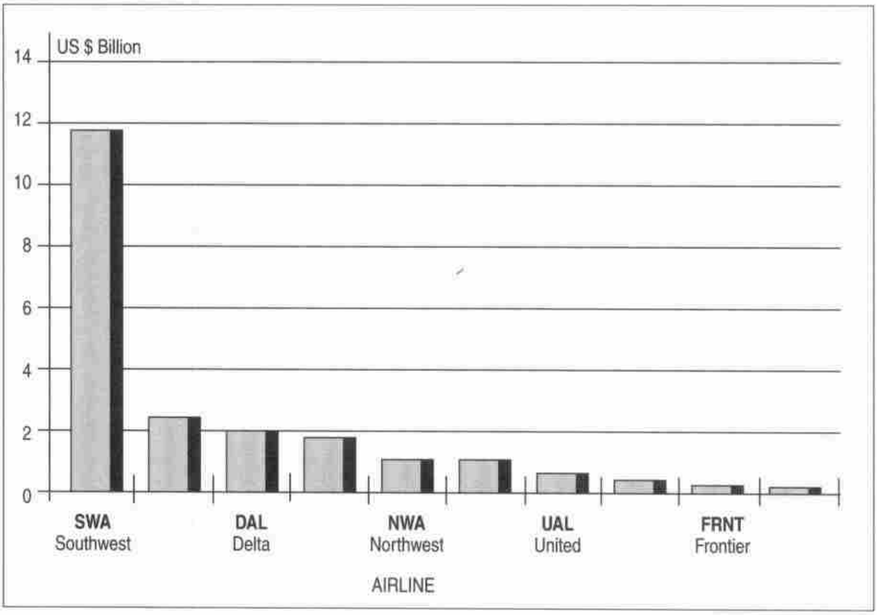
Figure 11.1 Market Capitalisations of the Major US Airlines Post-September 11, 2001



Source: *Data derived from New York Stock Exchange statistics, 26 September 2001.*

These figures can obviously change rapidly and the data point offered here is random. However, it does provide an indication of how the market can value a leading LFA relative to major carriers during a time of industry crisis and economic uncertainty. Furthermore, with virtually no debt, the highest net worth in the industry[12] and operating margins of 16–17 per cent (compared with an industry average of 3–5 per cent), Southwest Airlines was in a considerably stronger market position than all other large US airlines. Shares in Southwest outperformed all of its rivals after the calamities of September 11th 2001, beating the American Stock Exchange's Airline Index by about 50 per cent. In the weeks after the attacks, Southwest stock was up 76 cents – 5.4 per cent – to $14.74 on the New York Stock Exchange.[13] By comparison, other majors fared badly on the stock exchange after September 11th. Within two weeks of the bombings, Continental Airlines shares fell 67 per cent, making it among the cheapest stocks in the sector.[14] Before the attacks, Continental was the only major hub-based airline to post a profit year to date. Similarly, American Airlines stock value fell by 37 per cent during the same period. Moreover, as Figure 11.2 illustrates, nine months after the US attacks, Southwest remained the most highly valued US airline. In fact, its value relative to the other large airlines had increased during the intervening period.

Figure 11.2 Largest US Airline Market Capitalisations as of 21 June 2002



Notes

- SWA (Southwest), AMR (American), DAL (Delta), JBLU (JetBlue), NWAC (Northwest), CAL (Continental), UAL (United), AAI (AirTran), FRNT (Frontier), U (US Airways).
- Market capitalisation figures were sourced from the New York Stock Exchange, via Bloomberg.com, 21 June 2002.
- Total values are rounded up to the nearest 10 million dollars.

In September 2001, airline analysts and the air transport industry as a whole were in agreement that the US hijackings would reduce domestic and international passenger demand in Europe (Wagland, 2001). In a warning to investors, Schroder Salomon Smith Barney stated that, 'the terrorist attacks in New York and Washington on September 11th 2001 are likely to have a catastrophic effect on European airline profitability'. Schroders estimated that air travel would fall by as much as 20 per cent initially, using the Gulf War of 1990/91 as a reference point. In the first quarter after the war, traffic dropped 23 per cent, followed by a drop in traffic of 6 per cent year-on-year for the subsequent three quarters.

This was certainly the case for traditional, full-fare carriers. However, a different story emerged in the low-fare sector. This was acknowledged by market analysts such as Schroders, who saw Europe's low-fare carriers as the only ones to remain in profit:

> We expected all major European airlines to report net losses for the current fiscal year and most likely extending into next year as well. Only short-haul, low-fares airlines are likely to remain profitable through the current situation.[15]

The overall situation for Europe's LFAs was considerably more upbeat than in the US. All three leading LFAs – Ryanair, easyJet and Go – adopted proactive strategies, launching ticket price promotions to maintain sales, eschewing all forms of state aid and remaining on target to increase their passenger numbers and profit margins.[16] A statement in late September 2001 from Barbara Cassani, Go's CEO, stated that Go was well positioned to weather the storm and had no plans to make job cuts.[17] She went on to argue that LFAs would be much less affected than traditional airlines and that with no exposure to the North Atlantic and much lower fixed costs, LFAs could manage their businesses more flexibly to remain profitable. Although Go's sales did drop by 20 per cent in the immediate aftermath of the US attacks, they recovered within two weeks. As with other LFAs on both sides of the Atlantic, Go embarked on a massive low price 'seat sale' in late September to encourage people back on to airplanes. In early October 2001, easyJet announced that it flew 680,383 passengers in September 2001, an increase from 534,913 in September 2000. The month's load factor also increased slightly, rising from 83.03 per cent in September 2000 to 83.16 per cent one year later.

Ryanair gained from the crisis by adding capacity rather than retrenching. In part as a result of its ticket sale, the airline realised a growth of 30 per cent in passenger volume during the third quarter of 2001 and load factor up by 2 per cent to 79 per cent. However, also because of its post-September 11th promotional fares, yields declined by 10 per cent during the period.[18] In the wake of the attacks on the US, Ryanair emerged with the second highest market valuation of all Europe's airlines, preceded only by the German aviation giant, Lufthansa. For instance, just over two weeks after the attacks, Ryanair had a NASDAQ market capitalisation of $2.68 billion. By comparison, Europe's largest airline, British Airways, was listed with a market capitalisation of only $2.65 billion.[19] Other large, full service European carriers fared even worse. For example, the Dutch flag carrier, KLM, had a market capitalisation of just over $400 million in late September 2001.[20] Ryanair management declared that the company had no real decline in business as a consequence of the terrorist attacks on the US.[21] Out of a total schedule of 1,800 flights during the week after the September 11th attacks, the company was obliged to cancel 16 and only half of those cancellations were due to the cumulative impact of additional airport security measures at airports in the early part of the week. Overall, during the week after the atrocities, bookings were down 10 per cent on normal. These subsequently returned to normal levels and the carrier quickly recovered the week of slippage with a number of seat promotions. Advance bookings and loads remained strong, and therefore the immediate consequences of the US events on Ryanair were not significant.[22] The carrier expressed confidence that it could weather the market storm following the US attacks much better than the national flag carriers due to a lower cost base and greater operational efficiencies, together with a lack of aircraft debt and substantial cash resources (all of Ryanair's airplanes are owned by the company and the airline had cash resources of IE£700 million in late 2001). As with Southwest, Ryanair's cash resources ensured that it did not have to lay-off any of its workers and allowed the company to embark on its largest ever seat sale in direct response to the post September 11th drop in demand.

Europe's LFAs took maximum advantage of the problems afflicting their full-fare rivals in the wake of the September 2001 US attacks. For example, following the 2 October 2001 announcement that the entire Swissair fleet was grounded, easyJet offered to fly stranded passengers on services between London Luton and London Gatwick to Geneva, London Luton to Zurich, and Geneva to Barcelona and Nice for just £20 one way.[23] These special fares were made available upon production of a valid Swissair ticket at the airport sales desks and were valid until 5 October. Ryanair also refused to be pessimistic, moving ahead with plans to expand its fleet through the acquisition of up to 50 more aircraft. The belief within the company was that not only could they survive an economic downturn but they could in fact benefit from it. As mentioned earlier, this is because recession means that people become more price conscious for both business and leisure travel - albeit that this growth may be generated at lower fares and yields. Also, taking advantage of an aircraft surplus and downturn in aircraft prices, Ryanair can increase its fleet at a relatively low cost during times of crisis for its traditional competitors.

Challenges Ahead: The Sustainability of Divergent Low-fare Business Models

Since the inception of the low-fare business model, differences have often emerged in its application. The principle divergence arises over the cost-service trade-off (Lawton, 2002). Southwest and Ryanair have long adhered to the principle that cost reduction must be at the heart of everything they do. Being the low-fare leader is essential to their sustainable advantage. Rival LFAs – JetBlue in the US and easyJet in Europe – advance a different proposition (see Appendix 1 for a brief comparative profile of the leading European and US LFAs). They are willing to forego certain cost-reduction opportunities so as to augment customer service. For example, both operate to and from more expensive airports. As a result they rarely match Southwest or Ryanair for the lowest fares. These contrasting approaches have been particularly vivid in Europe, where easyJet's acquisition of the third largest LFA, Go, put it on a par with Ryanair in scale and scope. Which business mode is strategically best positioned to succeed in the turbulent airline industry of the future?

Martin (2002) notes that the easyJet/Go merger is a gamble that will pit two models of low-fare airline against each other. He further argues that only one of the two concepts for Europe's budget airlines can win. Martin's assessment corresponds with Porter's (1996) thesis that market straddling can result in competitive disadvantage. Applied to the LFA sector, the logic is that carriers should compete on cost/price if they are to succeed. Differentiating on service may be precarious, as it takes LFAs into direct competition with full service airlines. This may result in a company like easyJet competing on two fronts: with Ryanair on cost and price and with British Airways on customer service. To successfully straddle both competitive arenas is not impossible, particularly if a firm is not seeking to be the lowest price competitor or the highest quality service provider. However, the history of the airline industry is strewn with examples of firms that have tired and failed to strike the balance. In Europe, the collapse of Debonair in September 1999 symbolised the most potent such example in recent history. Debonair commenced operations with the philosophy 'lower fares with minimal restrictions and no compromise on comfort' (Sull, 1999). As Debonair CEO Franco Mancassola stated, 'Debonair was designed to offer high-quality service at extremely competitive fares'. Sull (1999) points out that inexpensive fares, more legroom and quiet jets were three of Debonair's key selling points to business travellers, who made up 58 per cent of the airline's passengers. The problem with this approach is that it was not sustainable from a cost perspective. As the Ryanair model illustrates, low fares and operating profits can only be sustained in tandem if operational costs are minimised and flight capacity is maximised. Contrary to Sull's (1999) argument, operational efficiency and a reconciliation of the price/service equation cannot be achieved simply through concentrating on point-to-point markets, operating a uniform fleet, concentrating service costs in the UK and subcontracting functions such as maintenance and check-in. On the first point, Debonair's route network was point-to-point but the airline also encouraged passengers to fly from point-to-point and then on to another point. This could result in delays and customer dissatisfaction as it builds an interlining expectation in the minds of passengers. Furthermore, Debonair's 'bus stop principle' simply did not make economic sense. The strategy of operating a single service from London to Munich, Munich to Perugia and Perugia to Rome does not work because the related costs are too high. Much of the fuel cost associated with a flight is expended on the takeoff and landing of the aircraft, thus rendering the Debonair approach extremely fuel intensive. Fuel costs are a large part of an airline's total cost base and passenger numbers on each leg of the flight did not offset the extra costs caused by higher fuel consumption.

On the second point, uniformity of aircraft is important in order to minimise maintenance and crew training costs. However, it must be a uniform *and* cost-efficient/revenue-maximising fleet. The Bae 146 is a much more costly airplane to operate than the Boeing 737. It also has a significantly lower seat capacity (96 seats on a Debonair Bae 146-200 aircraft, compared with 148 on an easyJet Boeing 737-300). Sull's other points are valid but inadequate. LFA success is premised on a much more extensive and rigorous adherence to cost reduction than was evident at Debonair. Finally, Debonair's brand positioning was confused, particularly towards the end of the company's existence. It could not decide whether it was an LFA or a business airline and the resultant confusion and service contradictions severely damaged its cost base. Moreover, Debonair never succeeded in building adequate market awareness or customer recognition.

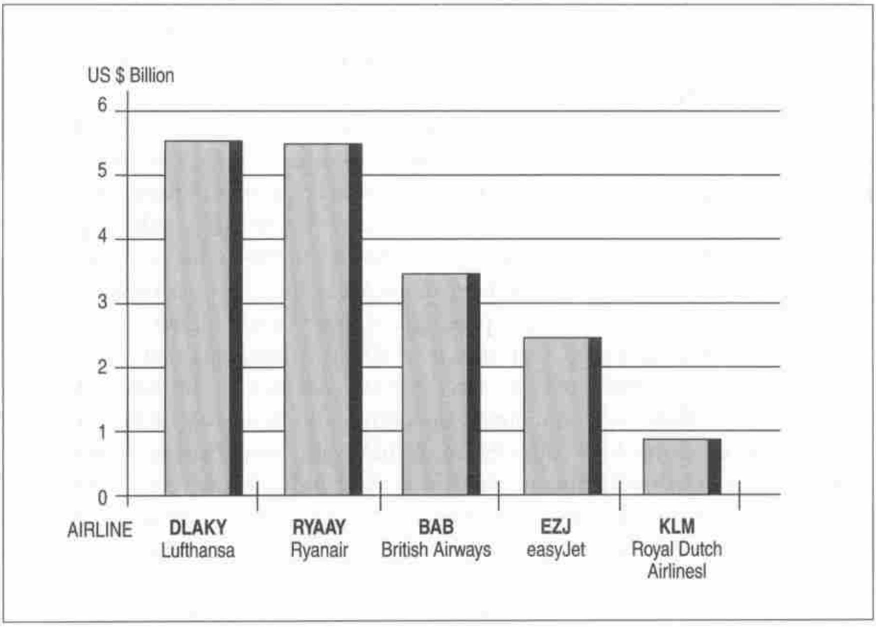
The easyJet business model differs from the Debonair approach in a variety of ways. Most importantly, easyJet has a uniform Boeing 737 fleet, orthodox point-to-point route network, extensive service subcontracting and strong brand recognition and customer loyalty. However, questions do surround easyJet's emergent brand positioning and the associated cost structures. In positioning itself as the airline for price conscious business people, easyJet has developed significant operating bases at airports favoured by business travellers. These include expensive and congested airports such as London Gatwick and Paris Orly. The problem with this strategy is that it risks unravelling the basis of a low-cost model, with the destruction of what Porter (1996) terms the 'strategic fit'. By operating to and from primary airports, an airline adds both direct and indirect costs. The direct costs include higher landing charges. The indirect costs accrue from airport congestion as this increases average aircraft turnaround time, thus reducing the average daily utilisation per aircraft. By reducing overall operational efficiency and neglecting to squeeze out cost wherever possible, an airline faces two choices: increase fares or accept reduced profits. easyJet respond by arguing that their revenue per passenger is significantly higher than low-fare competitors (Ryanair) and that this is a direct consequence of focusing on business travellers who want low fares but not necessarily the lowest fares. As such, they can afford to accrue higher operating costs than rival LFAs, if the extra costs incurred contribute directly to gaining and maintaining higher yield passengers. easyJet's performance figures to date indicate that their approach is effective: interim results for 2002[24] showed a 36 per cent increase in revenue and a pre-tax profit for the first half of the year – the first such profit in its history, given the seasonal nature of the company's business. It should be further noted that these figures represent the immediate post-September 11th period.

Market performance indicators to date support the easyJet strategy. But a number of variables raise a note of caution for the future. First, easyJet's acquisition of Go makes easyJet the largest LFA in Europe, measured by total revenue and passenger numbers. However, it remains too early to assess the market and organisational implications of this merger. Second, in establishing a hub at Paris Orly, easyJet is ratcheting up its cost base in a market where new competitors are emerging (French low-fare start-up Jetway) and established competitors are responding (e.g. the relaunch of Air Lib).

Davy Stockbrokers (2002) argue that lower costs are the only source of competitive advantage in the low-fare sector since air travel is effectively a commodity product. If this is the case, easyJet appears to be at a disadvantage relative to Ryanair. The most recent available data[25] show that easyJet's cost structures are significantly higher than those of Ryanair. Although easyJet enjoys a unit revenue advantage, with average fares 34 per cent above Ryanair's, some analysts argue that this is negated by its higher cost base. Consequently, the per unit profit at Ryanair is 57 per cent higher. Analysis of quarterly costs over a number of years indicates that Ryanair enjoys the lowest operating costs of all scheduled European carriers (Davy Stockbrokers, 2002: 4).

Furthermore, in terms of current market worth, Ryanair's market capitalisation far outstrips its low-fare rivals, notably easyJet (Figure 11.3). Ryanair remains the second most highly valued airline in Europe, not far behind the global carrier Lufthansa and well ahead of BA.

Figure 11.3 European LFA Market Capitalisations in Context (21 June 2002)



Notes

- Market capitalisation figures were sourced from the New York Stock Exchange, via Bloomberg.com, 21 June 2002.
- easyJet is not quoted on the NYSE, therefore the figure cited here is taken from the London Stock Exchange and converted to US dollars at a rate of £1 to $1.527 (exchange rate as of 26 June 2002).
- Total values are rounded up to the nearest 10 million dollars.

There is room for both business models to survive and prosper in Europe. However, this scenario is in no small part premised on the plans and actions of the national flag carriers. As Martin (2002) astutely observes, the easyJet model will thrive more at the expense of the full service airlines. If the large carriers fail to respond to easyJet's cost/price challenge and regulators ensure that a level playing field is maintained, easyJet could realise huge revenue growth. In contrast, Ryanair's business model is based more on creating 'new market space' (Kim and Maubourge, 1997). The larger part of its revenue is accrued through enticing people to fly more often or to fly rather than to travel via another mode of transport.

CONCLUSIONS

Airline Business magazine's profitability analysis of the world's top 150 airline groups added further evidence to our argument that efficient LFAs are the undisputed success story of the world airline business and the role models for future profitability and growth in the industry. Ryanair emerged as the airline with the highest operating margin in the world in 2000 (23.4 per cent), followed by Southwest Airlines with 18.1 per cent. Of the top 25, six were LFAs and less than half were large, full-fare carriers. The remainder were efficient niche players like EVA Air of Taiwan and successful regional airlines such as Mesa Air Group in the US. In the same study, easyJet had the fastest traffic growth of the top 150 ranked airlines in the world.

A key feature of successful LFA business models is a willingness to make hard choices and strategic trade-offs (Porter, 1996) in order to maintain or develop a successful market position. This requires a focus on profitability and cash generation, rather than on gaining immediate market share. Put another way, it involves avoiding lucrative markets if entry entails a significant rise in operating costs. Companies such as Southwest and Ryanair have been willing to forego dense, often high-yield routes that might distort their cost-reduction models.

Low price can increase a firm's customer base but, unless the firm maintains *the* lowest prices in the industry, it will not guarantee customer loyalty. Even with the lowest prices, a firm can lose market share if it fails to respond to changing customer needs and demands. To compete on price *and* turn a profit requires an airline to be extremely strict on cost. The consistent and enduring success of firms like Ryanair and Southwest indicate that this is feasible. Low operating costs and cheap ticket prices are essential to LFA success. However, the success of any airline also depends on providing a safe and reliable product. Safety standards for European airlines are applied universally and carefully regulated. Reliability is not so readily assured. The essential feature of a reliable airline product are on-time departures and arrivals, low cancellation rates, minimal lost or damaged baggage and helpful and informed customer service staff who are readily available when problems occur. Achieving operational cost reductions through diminished service standards can weaken an airline's brand image and loyalty and undermine its long-term market competitiveness. Cost reduction is therefore a necessary *modus operandi* for LFAs but should not be achieved at the expense of an unreliable service product.

During the airline industry crisis of late 2001, the high market capitalisations of low-fare leaders Southwest and Ryanair – relative to their larger, full-fare peers – was further proof that LFAs had come of age. The market capitalisations of low-fare leaders held steady in the wake of the US terrorist attacks, while the major carriers on both sides of the Atlantic were decimated. Moreover, by mid-2002, the market capitalisation of Southwest, Ryanair, easyJet and JetBlue continued to outperform most full-fare rivals by substantial margins. This situation may not endure but it is illustrative of the market power and resilience of the LFA business model. This paper has illustrated how such power and resilience derive from a proactive approach to strategic management, premised on an aggressive pursuit of the customer coupled with a clear and relentless emphasis on operational efficiency. Firms from within and beyond the airline business can derive valuable management insights from these principles and practices of LFA market leaders.

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1. *The Economist* 'uncharted airspace', 22 September 2001, p. 73.
2. 'Strategy adapters' are described as firms who take the existing and future industry structure and conduct as given.
3. These include Cranfield University's Air Transport Group's 2000 study of productivity, costs and yields in 24 of the world's airlines, titled 'Measures of strategic success: the evidence over ten years'.
4. A version of this table was included in a presentation titled 'A new age for Europe: the impact of low-cost airlines on European airport operations', given by Mr Tom Haughey, Director of Strategy and Market Development at Aer Rianta, to a conference in Amsterdam on 27 February 2001.
5. Quoted in "Super models", *Airfinance Journal*, February 2000.
6. Interestingly, in an interview with this author, a former senior Virgin Express manager argued that Virgin Express is not and never was intended as an LFA. Rather, it was conceived more along the lines of British Midland, serving primarily business travellers at a good price and with good service. This position appears somewhat at odds with the original Virgin Express marketing, which emphasised the airline's no-frills, low-cost image.
7. Moreover, it appeared likely in 2002 that parent company KLM would integrate the operations of Buzz, Basiq Air and Transavia, allowing only the Buzz brand to survive.
8. *Airfinance Journal*, op cit.
9. This was confirmed in a Southwest press release of 3 October 2001, www.iflyswa.com
10. Taken from Yahoo! Finance, 'Southwest Airlines says defers 11 Boeing deliveries', 26 September 2001.
11. Morrell defines market capitalisation as the 'market share price per share multiplied by the number of shares outstanding' (1997: 61).
12. In mid-September 2001, Southwest had \$3.8 billion worth of hard assets to borrow against. This compared to \$3 billion for American, \$2.8 billion for Delta, \$2.3 billion for United and \$200 million for Continental. Northwest and US Airways had negative net worths of -\$606 million and -\$1.8 billion respectively.
13. This data are derived from a Reuters report dated 28 September 2001.
14. Stacey L. Bradford writing in Yahoo! Finance, 25 September 2001.
15. Schroders report cited in Maria Wagland, 2001.
16. Joanna Walters 'More job losses a certainty as passengers desert skies', the *Observer*, 7 October 2001, p. 8.
17. Go press release, 24 September 2001, www.gofly.com
18. Figures derived from a Flight International article titled 'Rebel Skies: Case Study of

Ryanair', 9 April 2002.
19. British Airways is approximately ten times larger than Ryanair, measured in fleet size and cities served.
20. Data derived from New York Stock Exchange statistics listed on the Yahoo! Finance website as of 26 September 2001.
21. This was stated by Sean Coyle, Commercial Director at Ryanair, in a communication to this author on 20 September 2001.
22. Information derived from a Ryanair press statement made by CEO Michael O'Leary, 18 September 2001. This can be found at www.ryanair.com
23. This was stated in a press release on easyJet's website, 2 October 2001.
24. easyJet plc, Interim Report, 31 March 2002.
25. This data are sourced from Davy Stockbrokers equity note on Ryanair, February 2002. It should be noted that Davy's are stockbrokers to Ryanair.

Appendix 1 Company Profiles of the Leading European and US Low-Fare Airlines

Ryanair

Turnover (million):	560.0 USD (2001)
Net profit (million):	134.8 USD (2001)
Passengers (million):	11.1 (2001)
Employees:	1,531 (2001)
Fleet:	50 aircraft in service
Destinations:	58

EasyJet

Turnover (million):	815.0 USD (2002)
Net profit (million):	72.4 USD (2002)
Passengers (million):	7.1 (2001)
Employees:	1,632 (2001)
Fleet:	60 aircraft in service
Destinations:	21

Southwest Airlines

Turnover (million):	5,522.0 USD (2002)
Net profit (million):	241.0 USD (2002)
Passengers (million):	63.0 (2002)
Employees:	31,580 (2001)
Fleet:	374 aircraft in service
Destinations:	58

JetBlue Airways

Turnover (million):	320.0 USD (2001)
Net profit (million):	38.5 USD (2001)
Passengers (million):	5.8 (2002)
Employees:	2,116 (2001)
Fleet:	37 aircraft in service
Destinations:	20

Source: *Air Transport Intelligence, January 2003.*

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