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STRATEGY PRACTICE

Sizing the advantages of incumbency

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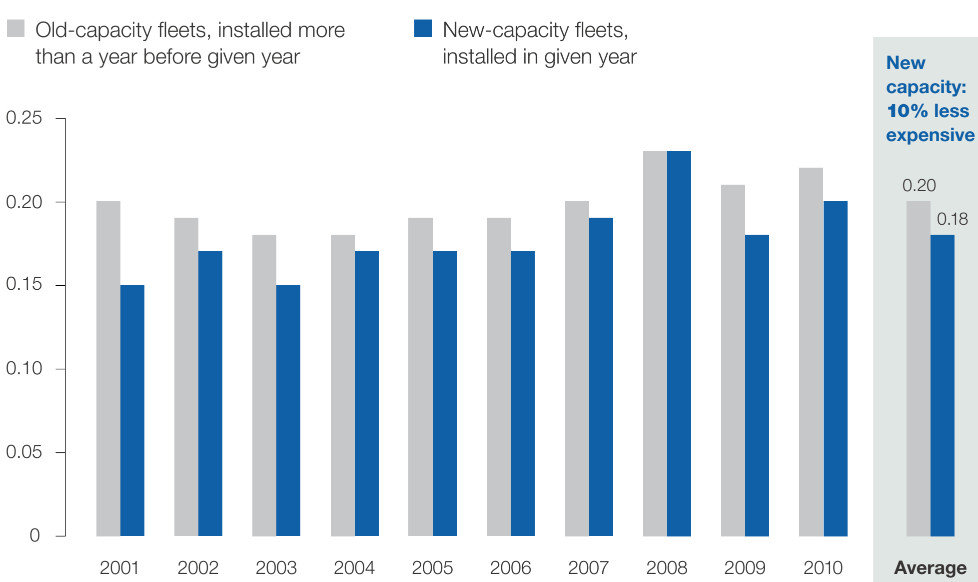
Incumbents in network-based industries, such as telecommunications, usually benefit from economies of scale that set high barriers to entry for new players. Airlines are an exception to this rule. Our analysis of the performance of the top nine US airlines over the last ten years indicates that the industry's new capacity is about 10 percent less expensive to operate than existing capacity,[1] since newer planes are typically more efficient and require less maintenance than older models. Carriers with newer fleets thus enjoy operating benefits that help them to offset the capital costs of new planes and to charge less for flights than do established airlines that have older planes or may be locked into long-term leases.

Lower operating costs give airline entrants an edge.

US airline industry's operating cost per available seat kilometer,[1] $



[1]Based on 9 top US airlines: Alaska Airlines, American Airlines, America West (now US Airways), Continental (now United Airlines), Delta Air Lines, Northwest Airlines (now Delta Air Lines), United Airlines, US Airways, Southwest Airlines.

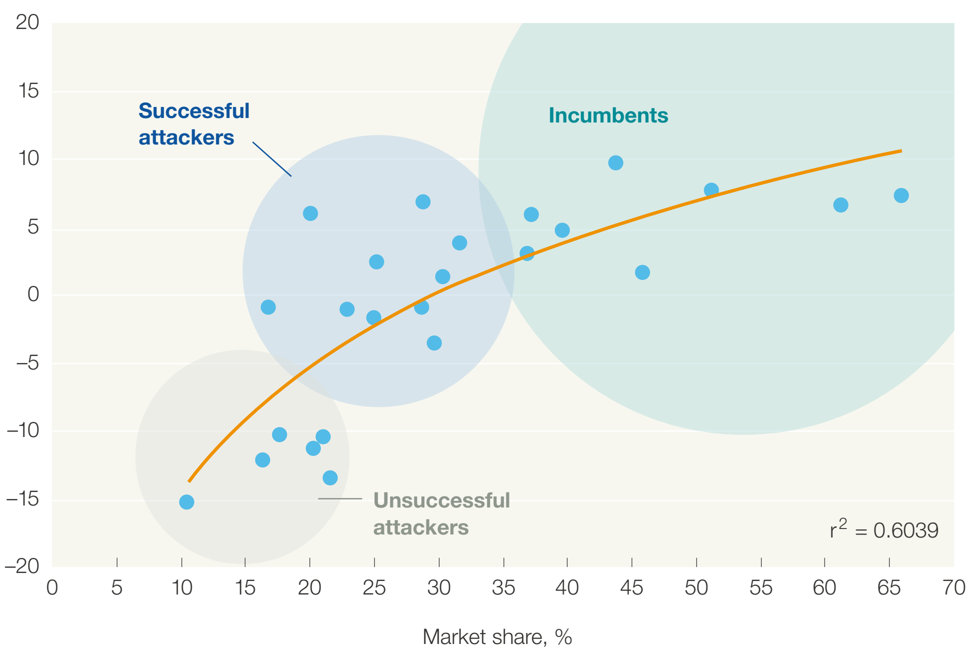
Source: Air carriers' financial data (Form 41) and Lundkvist fleet database, UBM Aviation

This cost edge among entrants helps create the perpetual oversupply and depressed margins that characterize the airline sector. It also contrasts sharply with the situation in telecommunications, where depreciated fixed assets provide a cost edge that upstarts find hard to match. Companies in capital-intensive industries where network effects predominate should always be scanning their environment for signs that new technologies might deliver operating savings that swamp the economic advantage incumbents expect to enjoy by not incurring new capital costs.

[1] The industry's new capacity costs about 10 percent less (per available seat kilometer) to operate than existing capacity.

Telecom incumbents benefit from depreciated assets.

Telecom industry's relative EBITDA margin,[1] %



r^2 is the proportion of variance explained by a regression.

[1] Relative EBITDA (earnings before interest, taxes, depreciation, and amortization) margin calculated by subtracting market average EBITDA from that of individual players.

Source: Merrill Lynch; World Cellular Information Service; McKinsey analysis

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