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Salvation or misleading temptation – low cost brands of legacy airlines

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We've seen this before: while separate in-house LCC brands seem promising, few have thrived. Success requires a clear rationale, rigorous follow-through…and ensuring the right answer is not to transform the mainline brand

In the past 20 years, many full-service carriers (FSCs), including seven of the ten largest legacy airlines[1], have launched an in-house low-cost carrier (LCC). But of the more than 40 in-house low-cost subsidiaries founded over the past two decades, only half are still in operation (see sidebar, "Three waves of in-house LCCs"). Furthermore, just four of the oldest 20 in-house LCCs are flying today; most were shuttered within a few years of inception, sold to other airlines, or reabsorbed because of lower-than-expected cost savings and cannibalization of their FSC's traffic.

That said, in recent years, there has been renewed interest in having an in-house LCC, especially in Asia and Europe. Airline managers around the world have praised the model as a way to create additional value, by giving airlines an edge in attracting price-conscious travelers. Essentially, they see independent LCCs enjoying a 40 to 60 percent unit cost advantage over FSCs and believe the model might deliver the means to compete.

Given that in-house LCCs have a less-than-impressive track record, however, airline executives should proceed with caution. While we do see three viable strategic rationales for FSCs to pursue an LCC—achieve real product differentiation, capture structural cost advantages, or establish an incubator to facilitate innovation—it is important to realize that the choice between the FSC and LCC models is a false dichotomy. Instead, the fundamental goal should be to gain a deeper understanding of core customers and to offer the appropriate product at the lowest cost possible.

Why FSC versus LCC is the wrong discussion to have

Observers and stakeholders frequently differ on whether FSCs will be able to maintain their position as markets evolve or whether LCCs represent the future of the airline business. As the continued establishment of in-house LCCs attests, many FSCs seem to perceive and perpetuate a stark difference in business models. This debate misses the point: the right model for an airline is one that aligns its product with a nuanced understanding of its customers—how they behave and which amenities they value—and finds a way to deliver it at competitive cost levels.

1 By traffic based on 2015 revenue passenger kilometers.

Historical simple segmentation of customers into premium or value passengers is no longer sufficient; the number of businesspeople in LCC terminals and the proliferation of tour groups on mainline carriers show that this approach is obsolete. Today, much more granular segmentation is needed; starting from a segmentation based on the length of a trip, for example, seems more accurate. On short-haul routes, premium passengers will tolerate limited legroom as a trade-off for a better schedule, especially when combined with add-on fast-track security, immigration, and boarding on each end. A recent McKinsey survey on airline-booking drivers found that seat comfort was the top non-price-related driver for long-haul trips but ranked just seventh on short-haul.

Many LCCs have built their operating models around this focus on main purchase factors, starting with a low-cost base (including factors such as seat density, direct distribution, and low-cost airports) and then offering extras such as custom seat choices, onboard catering, and even service into more mainstream airports. Some have gone even further by matching customer preferences with long-haul service that features more expensive (but still cost effective) business-class configurations.

In response, many carriers have adopted a “hybrid” model, which recognizes that some travelers are more focused on an economical product with the right schedule while other customers are willing to pay for amenities, particularly on short-haul routes. British Airways’s recent move to increase seat density and remove complimentary food in Europe is an industry-standard example. US airlines have taken this approach even further, led by Delta Air Lines’s “Basic Economy” offering (now matched by both United and American[2]), which adds an unbundled base fare that strips away all add-ons and instead lets consumers customize their trip. With 70 percent of US customers no longer searching for airfares via a traditional global distribution system–ranked, schedule-led search[3], these new price-conscious offerings, and the low cost to deliver them, is a competitive requirement.

When the required changes just go too far

Despite the many reasons to differentiate the mainline product rather than launching an in-house LCC, there are cases where the model can work. Our research suggests that three strategic rationales can justify the establishment of a separate LCC venture.

1) Significant product differentiation

Airlines that have established a real premium for their mainline brand and product have on many occasions leveraged a separate LCC brand for product differentiation. Singapore Airlines, for instance, has supported its long-haul brand with a clearly defined product-differentiation strategy; it has also introduced Scoot, SilkAir, and Tigerair to ensure it has the right offering for more price sensitive customer segments. Many other airlines have created similar separation by hub/non-hub flying. Our research suggests such product-driven cost savings can be substantial (exhibit).

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[2] American is expected to launch its basic economy fares in 2017.

[3] Phocuswright’s U.S. Online Travel Overview report estimates that 54 percent of customers book online; McKinsey research shows a further 17 percent of travel-agent bookings are price-based searches.

Structural and product-related cost reductions can be significant.

	Category	Share of total FSC[1] expenses[2] Percent	Savings Potential Percent	Rationale
Structural costs	Fuel	27	0	No additional leverage beyond mainline contracts
	Wages	25	25–45	Lower pay scales, additional flexibility and productivity
	Aircraft ownership (depreciation, amortization, rentals)	13	0	No additional leverage beyond mainline contracts
	General and administrative, overhead, other	8	0–20	Leaner overhead, simpler business
	Maintenance, repair, and overhaul	7	0–15	Simpler cabin product, new line-maintenance contracts
	Subtotal, structural costs	**79**	6–14	Total cost savings based on structural costs
Product-related costs	Airport, navigation, and handling	15	10–30	Simpler handling, low-cost terminal at airport
	Sales and distribution	4	0–50	Shift toward more-direct channels
	Onboard service	2	25–75	More-basic meal and drink service, elimination of blankets and pillows
	Subtotal, product-related costs	**21**	7–23	~2–8% total cost savings based on shown product factors, additional ~5–15% for seat density

1 Full-service carriers
2 Figures may not sum, because of rounding

That said, as discussed previously, many airlines have demonstrated that this significant product variation can be achieved within a brand. Previously discussed examples from British Airways and Delta, or LAN Airlines' domestic offering revamp, demonstrate the extent to which airlines can target specific products against specific segments and price points, without negative consumer reactions. We acknowledge that there are contexts where the gap between market contexts and the required product changes are extreme enough that a separate brand may be warranted – but in our experience, these are few and far between. Put differently, when customers want very different products or price points and airlines cannot deliver the full range of what is desired using their primary brand, product differentiation may be justified. For example, customers that fly from Toronto to Florida and the Caribbean vary significantly compared with those on a shuttle service between Toronto and Montreal. In these instances, carriers can design a different product, with the associated product-driven cost differences helping to reduce unit costs.

2) Structural cost differentiation

Many airlines that have struggled to reduce their legacy operation's structural costs sufficiently have created a separate, lower-cost unit to achieve cost differentiation. By starting over with a new carrier, FSCs can enhance their competitiveness through securing more flexible labor contracts, lower-cost aircraft, leaner overhead, modern and more flexible IT infrastructure, and better supplier contracts. A few years after Qantas started Jetstar, for example, its CFO commented that the hourly rate for narrow-body pilots at its low-cost subsidiary was 30 percent below what Qantas paid. Jetstar was also able to approach rostering, allowances, and pension contributions differently.

To drive down structural costs sustainably, executives must resist the pull of short-term fixes—for instance, reducing labor costs by simply transferring lower-tenure mainline pilots to the new unit without fundamentally altering contract details. Such practices lower costs artificially, since they don't deliver sustained structural advantages, and may actually penalize the mainline.

3) Incubator for innovation

The third strategic rationale for an in-house LCC is to view it as an incubator, test bed, and change agent for new products and business models. Delta Air Lines, for example, used Song to test self-service check-in and large-scale web distribution before rolling these features out across its entire operation. Air Canada's Tango served as a test bed for a new lower-frills fare product that was eventually expanded to the mainline. This rationale could apply to more rigid organizations that have difficulty experimenting within the mainline operation. Often, a faster-moving, more-nimble operation can enable quick adjustments and offer the opportunity to try out innovations while limiting damage to the mainline brand.

Even with clear rationale, an in-house LCC is no sure success

While these rationales can make the case for an LCC, achieving the targeted impact can prove difficult. Of ten reporting in-house LCCs, only four outperformed their parent as measured by operating profit. And only three have achieved a unit cost within 10 percent of their main low-cost competitor, which is required to truly compete on cost.

Why are so few in-house LCCs successful? Most airlines have faced numerous unexpected or poorly predicted costs and complications in launching separate LCC ventures, including from the following sources:

- Operational inefficiencies. The inability to cross-utilize crews and aircraft among the different brands can drive extra cost in the network because of inefficiencies in scheduling.

- Brand overlap. Many times, multiple customer segments want to fly to the same destination, so implementing strict rules can create complicated operational scenarios. For example, SIA Group has three brands (SilkAir, Singapore Airlines, and Tigerair) that fly between Singapore and Denpasar, Bali.

- Customer confusion. While certain journeys are clearly aligned by brand, there are many times when customers need to cross brands. For example, a top-paying business-class customer from London to Toronto on Air Canada may continue on to Las Vegas on Rouge, its low-cost subsidiary.

- Management attention. Setting up a separate venture takes enormous amounts of management's attention and resources that could otherwise be deployed to solve potential problems in the mainline operation.

- Back-office inefficiency. Often, the LCC has a different focus and justifies its own resources (such as sales, finance, and management).

More important, the consideration of a separate venture could be a sign that the legacy operation has more fundamental issues.

An alternative path: Solving the structural issues

Given the spotty record of in-house LCCs, some carriers have opted for a different path, turning their gaze inward to optimize the performance of the mainline. For example, multiple articles and case studies[4] have been written about LAN Airlines in the mid-2000s. LAN had a traditional-network business model but was facing the threat of growing LCC competition. Rather than form its own LCC subsidiary, LAN reimagined its short-haul operation—where it felt the greatest risk of entry by independent LCCs—by essentially taking the best of both the traditional and the low-cost models. The company lowered its structural costs by more than 30 percent by focusing on areas such as increased utilization, reduced onboard service, and more direct sales. Customer research enabled LAN to make informed trade-offs about how to decrease cost per available seat kilometer without losing passengers.

Other airlines have gone down a similar path, including Aer Lingus, American Airlines, and Malaysia Airlines, to name a few. By far, the more a carrier is able to incorporate the LCC rationale into its mainline brand and develop a competitive cost structure, the greater its chance of success.

Of course, this approach still requires much ongoing work. Even LAN (now LATAM) recently announced it was going to double-down by moving short-haul flying even more toward LCCs, continuing to revamp its fare structure, and offering a few-frills fare in order to compete more effectively. The new model, which is much easier to manage, draws on the power of the entire organization to engineer and continually manage it.

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Many FSCs have launched an in-house LCC, often for well-founded reasons. However, before embarking on this journey, airline executives must move beyond conventional wisdom, which pits LCCs against FSCs, to take a closer look at the key factors that affect passengers' choices. In examining each cost lever, the airline should challenge whether a separate carrier is needed to deliver it. In some cases, this exercise might lead to a structural reform of the business rather than a lower-cost subsidiary. If a separate LCC can be supported by one of three strategic rationales—true product differentiation, lower structural costs, or being an incubator for innovation—carriers should seek to achieve those well-defined objectives with laser-like focus. But they should only do so after asking whether they can incorporate the same learnings into their mainline operation.

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[4] See, for example, Ramon Casadesus-Masanell and Jorge Tarziján, "When one business model isn't enough", Harvard Business Review, January–February 2012, hbr.org.

Three waves of in-house LCCs

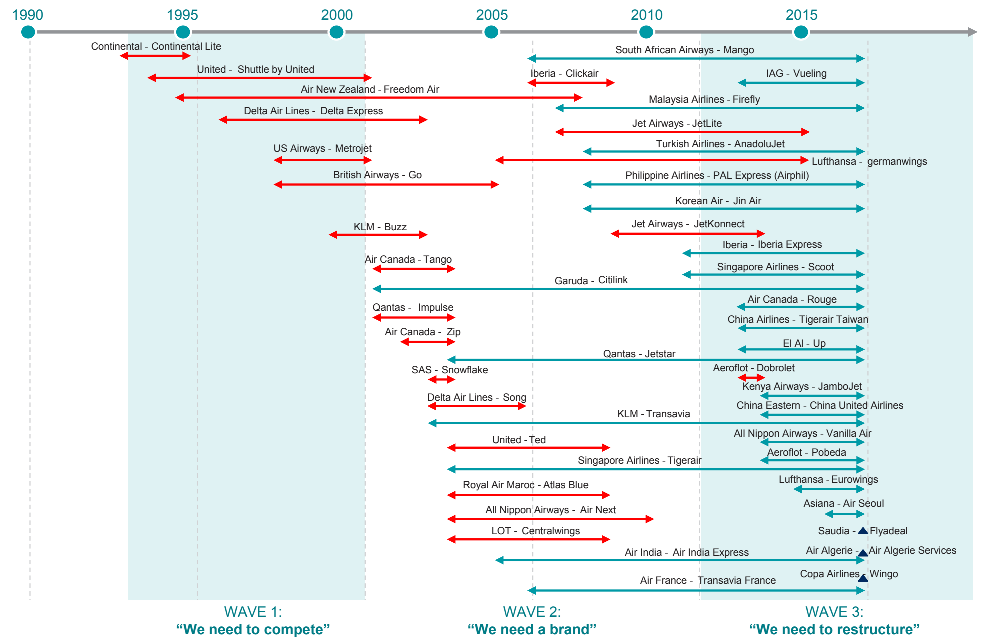
During the past 25 years, in-house low-cost carriers (LCCs) have emerged in three distinct waves. Each wave has a different strategic impetus and reflects efforts by full-service carriers (FSCs) to take advantage of evolving market conditions.

We need to compete. After the airline industry was deregulated in the late 1970s in the United States and in the late 1980s into the 1990s in Europe, independent LCCs began emerging across North America and Europe. Faced with a new type of fast-growing competitor that boasted significantly lower operating costs, mainlines began launching their own LCCs. Examples include Continental Lite and British Airways's Go. Most of these carriers fared poorly because they were unable to close the cost gap to other LCCs or even achieve a sufficient cost advantage over their own mainline operations. Most in-house LCCs were also unable to reach scale, and many cannibalized their FSC's traffic.

We need a brand. Largely a response to charismatic LCCs such as JetBlue, the "we need a brand" phase began around 2000, with airlines launching heavily branded and "hip" in-house LCCs. Many (although not all) of them failed, and some were a mixed bag. In the case of Air Canada's Tango, for instance, the airline closed the separate LCC but has kept the differentiated customer product by offering bargain fares on-board the same aircraft that serve premium passengers.

We need to restructure. In recent years, mainlines have restructured their own short-haul operations in an attempt to better compete with independent budget carriers. Most have found the landscape challenging, leading them to consider starting an in-house LCC once again; Iberia Express is an example. The success of some mature LCCs, such as Jetstar, which is responsible for an increasing share of Qantas's short-haul operations, has proved tantalizing (exhibit).

In-house low-cost carriers have emerged in three waves.



Note: Focus on wholly owned in-house LCCs. Air France—KLM's Transavia included as per 2003, since fully owned by then and low-cost Basiq Air brand active. Germanwings included since 2005 (year when Lufthansa exercised full control over Eurowings) till 2015 (merged into Eurowings). Eurowings included since 2015 as year when redevelopment into low-cost carrier occurred. IAG's Vueling included per 2013 as wholly owned by then

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