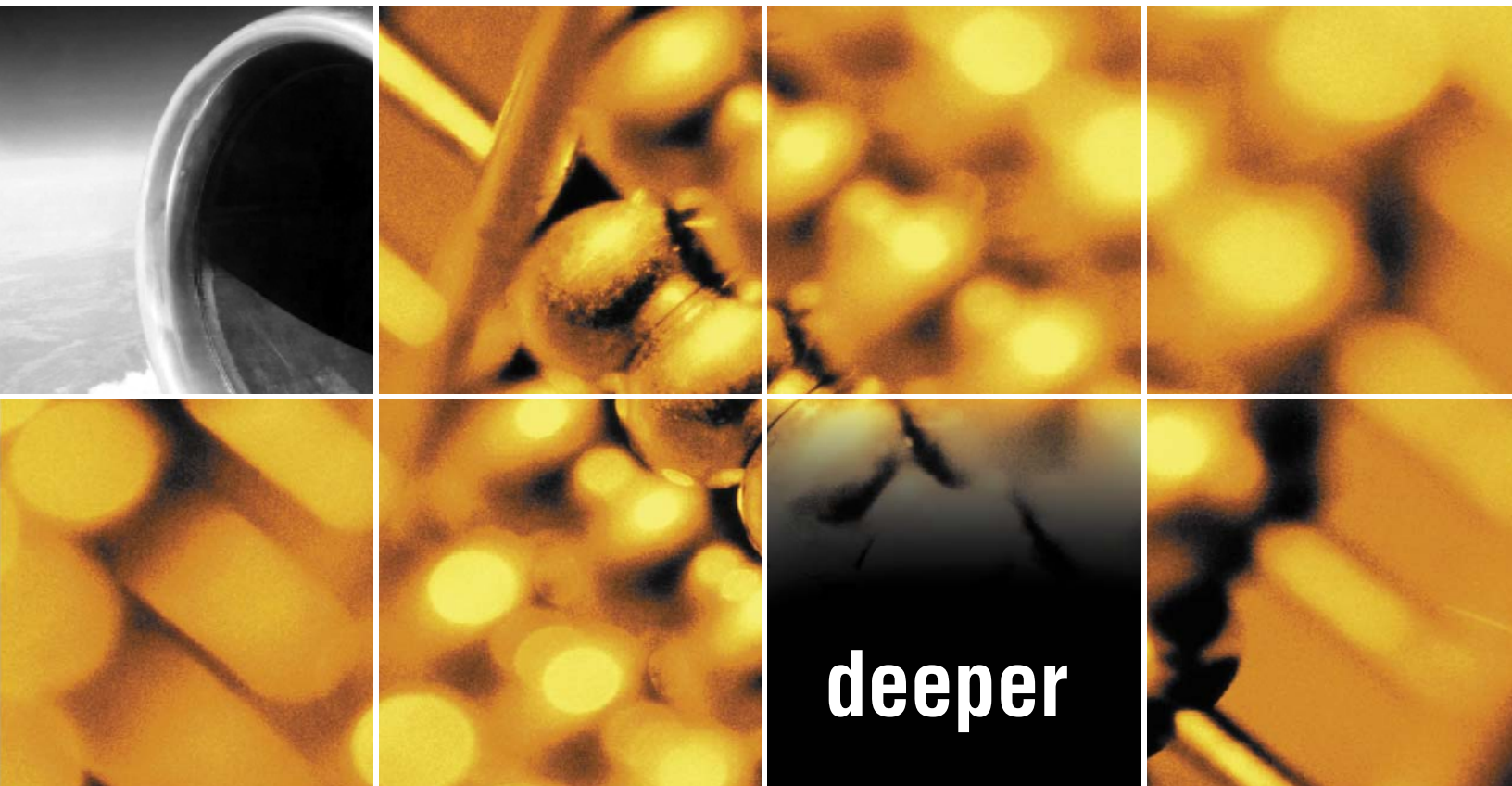


## Winning at the margin

*The impact of low-cost carriers in Asia*



*An IBM Institute for Business Value executive brief*

The IBM Institute for Business Value develops fact-based strategic insights for senior business executives around critical industry-specific and cross-industry issues. This executive brief is based on an in-depth study created by the IBM Institute for Business Value. This research is a part of an ongoing commitment by IBM Business Consulting Services to provide analysis and viewpoints that help companies realize business value. You may contact the authors or send an e-mail to [iibv@us.ibm.com](mailto:iibv@us.ibm.com) for more information.

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## Executive summary

The influx of low-cost airlines across the globe has roiled the industry, and incumbents are scrambling to respond. In Asia,<sup>1</sup> the most recent region to confront this disruption, new entrants and traditional carriers alike can profit from assessing the successes and failures of their North American and European counterparts. Clear success factors include an innovative customer experience, balanced growth, simplicity and efficiency from route structure to fare structure and effective corporate governance. In a far more volatile environment than ever before, three new imperatives emerge for winning the airline margin game: 1) refine the core value proposition, 2) achieve a greater variable cost component and 3) improve infrastructure responsiveness.

“The airline business is won and lost at the margins.”<sup>2</sup> “We were a vibrant, profitable company from 1981 to 1985, and then we tipped right over into losing [U.S.]\$50 million a month.”<sup>3</sup>

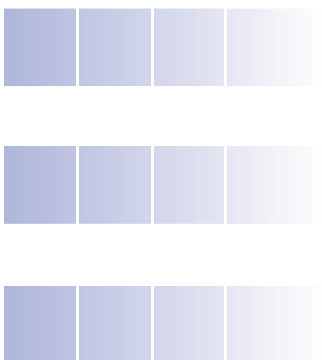
– Donald C. Burr, founder and former Chairman, PeopleExpress

### *Low-cost carriers: Changing the rules of the game*

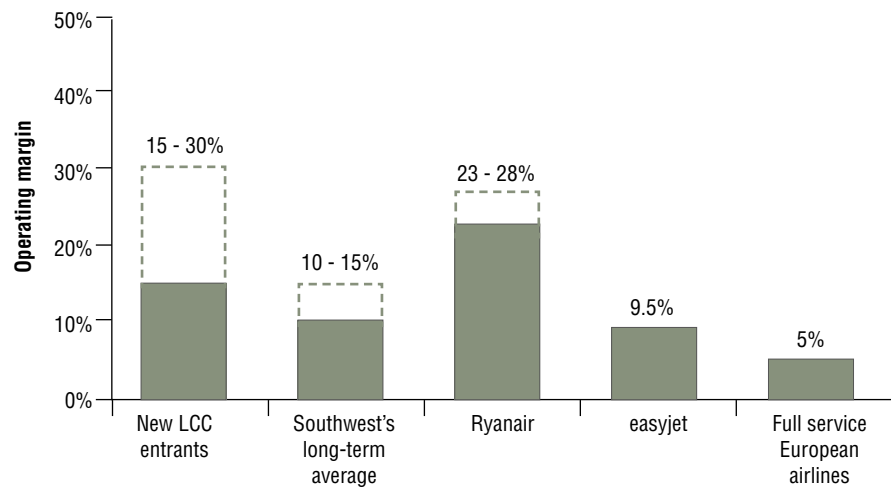
Much to the detriment of traditional network airlines in North America, Europe and Asia, well-capitalized startups have entered the low-cost carrier (LCC) market, and existing no-frills carriers have grown rapidly. These carriers are exploiting a powerful, previously-untapped market opportunity to:

- Leverage low unit costs to stimulate demand among more price-sensitive travelers with lower fares
- Seize market share from less agile competitors saddled with legacy labor and infrastructure costs.

The LCC model has demonstrated its ability to consistently deliver operating margins exceeding those of full-service airlines (see Figure 1). In contrast to the major network carriers, operating margins for many of the new entrants in this environment range from 15 to 30 percent.<sup>4</sup> Even if they continue their downward trend toward Southwest's long-term average of 10 to 15 percent, this remains unreachable territory for the majors in all but the best years.<sup>5</sup> Low-cost carriers have been able to demonstrate consistent profitability – 31 years of consecutive annual profits for Southwest, 13 for Ryanair, 6 for easyJet, and 3 for both JetBlue and Virgin Blue.<sup>6</sup>



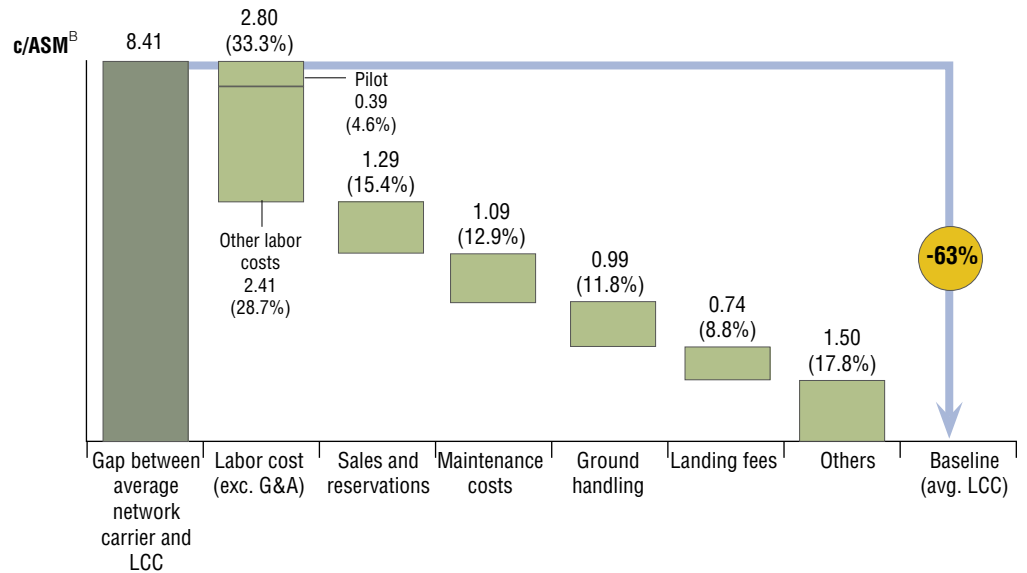
**Figure 1. Greater operating margins for low-cost carriers.**



Source: IBM Business Consulting Services analysis, 2004.<sup>7</sup>

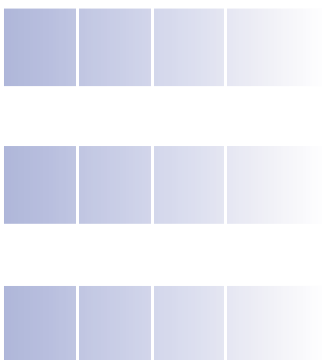
Low-cost carriers deliver these superior margins primarily through cost advantages (see Figure 2). More flexible work models, better aircraft utilization, reengineered processes, fewer amenities, direct distribution and simplified fleets all contribute to a significant gap between the unit costs of the traditional full-service airline and that of low-cost carriers (see Figure 3).

**Figure 2. Significant unit cost differences between European network carriers and low-cost carriers.<sup>A</sup>**

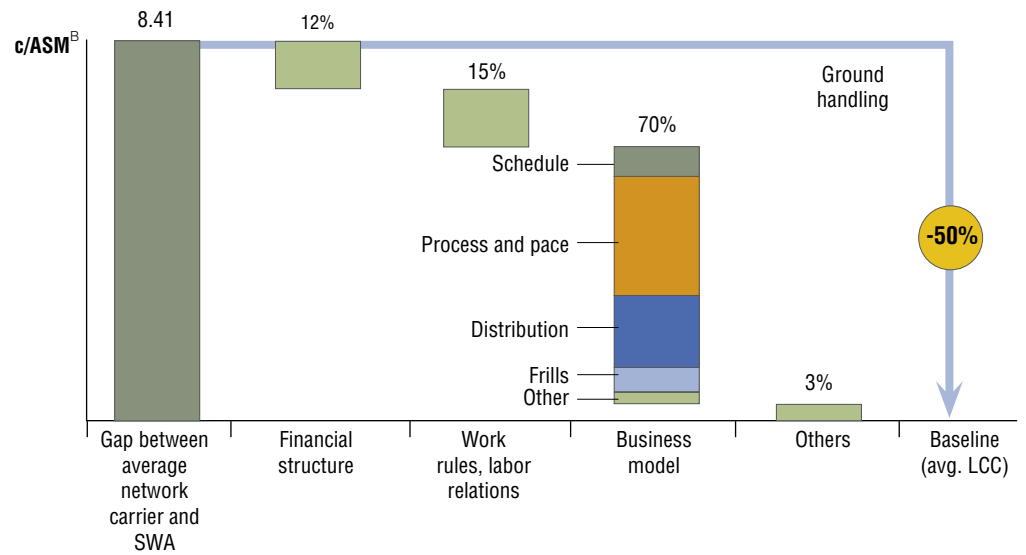


Notes: (A) After adjustment for stage length. (B) c/ASM = cents per available seat mile.

Source: Booz Allen & Hamilton (Hansson, Tom, Dr. Jurgen Ringbeck and Dr. Markus Franke, Airlines: A New Operating Model, April 10, 2002).



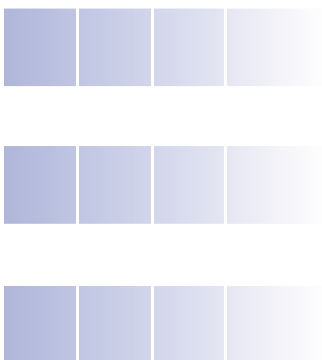
**Figure 3. Drivers of unit cost differences between U.S. network carriers and Southwest Airlines.<sup>A</sup>**



Notes: (A) 737-700: Stage length, seat density and factor cost adjusted. (B) c/ASM = cents per available seat mile. Source: Booz Allen & Hamilton (Hansson, Tom, Dr. Jurgen Ringbeck and Dr. Markus Franke, *Airlines: A New Operating Model*, April 10, 2002).

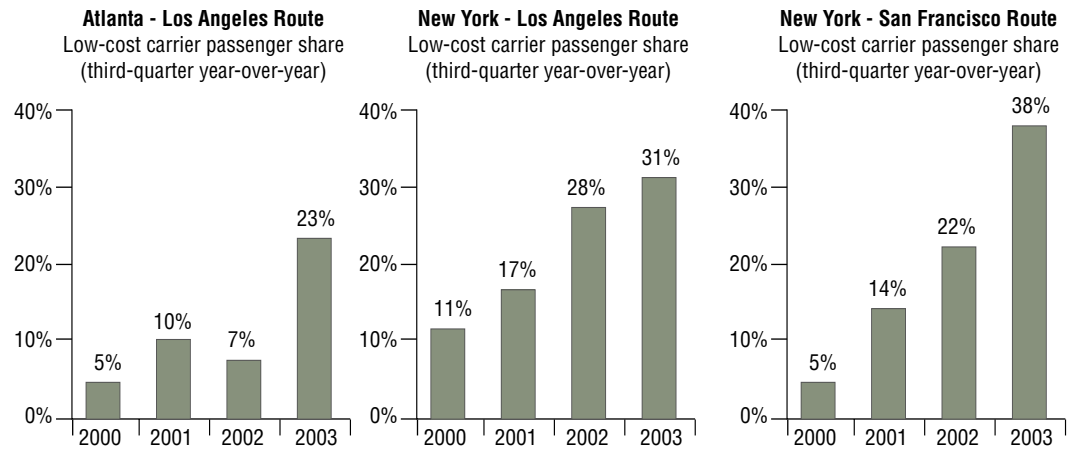
The LCC model has demonstrated its ability to change the market – permanently lowering fares, increasing share and stimulating volume. These competitors are capitalizing on what appears to be a global trend – ever-increasing numbers of travelers willing to forgo amenities for lower costs:

- A long-term and systematic study conducted by the University of Denver concluded that “the 23 airports Southwest entered between 1990 and 1998 saw passenger volumes grow an average of 36.8 percent and fares fall an average of 18.2 percent in the first year after Southwest arrived.”<sup>8</sup>
- Since Ryanair entered the Dublin-London market, “total passenger volume increased from about 1.7 million passengers in 1991 to more than 4.1 million in 1998.”<sup>9</sup>
- “Passenger traffic increased 36 percent when Virgin Blue began flying on the Brisbane to Sydney route and 33 percent on the Melbourne to Brisbane route.”<sup>10</sup>



Market penetration provides additional evidence. Low-cost carriers' market share in North America has steadily increased (see Figure 4) and now exceeds 25 percent overall, as measured by passenger traffic.<sup>11</sup> The low-cost segment in Europe has reached 25 percent in the United Kingdom-Continental Europe market and 11 percent overall, as measured by number of flights, with annual growth of 4 percentage points in both cases.<sup>12</sup> In Australia, Virgin Blue commands 28 percent of the market, based on passenger volume.<sup>13</sup>

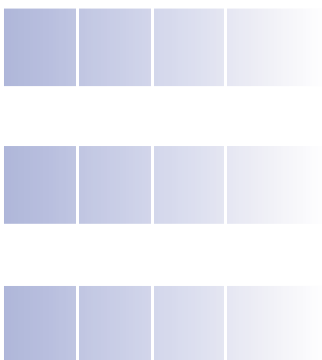
**Figure 4. Low-cost carrier market share growth.**



*Note: New York includes JFK, LaGuardia and Newark airports; Los Angeles includes Los Angeles International, Burbank, Long Beach, Ontario and Santa Ana (John Wayne) airports; San Francisco includes San Francisco International, Oakland and San Jose airports; based on non-stop and one-stop/same-plane service only. Excludes travel by frequent fliers on earned free tickets.  
Source: USA TODAY analysis of the Department of Transportation data provided by Back Aviation Solutions, March 16, 2004.*

The LCC model has challenged the traditional notion that frills and amenities are required to satisfy the consumer. Southwest consistently receives the highest customer satisfaction score among U.S. majors, according to the American Customer Satisfaction Index.<sup>14</sup> Meanwhile, others have demonstrated that a low-cost carrier can offer a differentiated product. Certain new entrants have imitated the retail trend toward low-cost style (for example, H&M, Ikea and Vodafone), combining innovative branding with old and new productivity improvement practices. JetBlue cites the chic U.S. version of the Target brand as one source of inspiration.<sup>15</sup>

If the rapidly changing landscapes in North America, Europe and Australia are any indication, this trend will have an extensive impact on the Asian airline industry. Asian low-cost carriers can follow many of the successful strategies of low-cost carriers elsewhere, but they must adapt these models to the Asian market.



### Definition of the traditional LCC model

- Operates point-to-point, short-haul, high-frequency route network
- Performs fast aircraft turns, high aircraft utilization
- Achieves high load factors through high seat densities
- Uses limited aircraft types to reduce costs associated with crews, maintenance and inventory
- Provides “no-frills” service
- Emphasizes online distribution, either no or low participation in Global Distribution Systems (GDS)
- Pays no travel agency commissions
- Has favorable, innovative labor agreements
- Has no interline, code-share relationships
- Operates a simple fare structure; bypasses Airline Tariff Publishing Company (ATPCo) and global aviation IT provider SITA
- Flies to secondary/alternate city airports
- Fosters a focused, “underdog” corporate culture that is proudly different from traditional carriers

### *The growing surge: Low-cost airlines in Asia*

Today the low-cost phenomenon seems ready to spread across Asia. Looking to emulate the successes of Virgin Blue and Air Asia, an explosion of new entrants have recently announced or initiated operations across many Asian countries (see Figure 5). Similar to their peers in North America, Europe and Australia, these carriers seek to exploit the cost differential between traditional and low-cost carriers (see Figure 6).

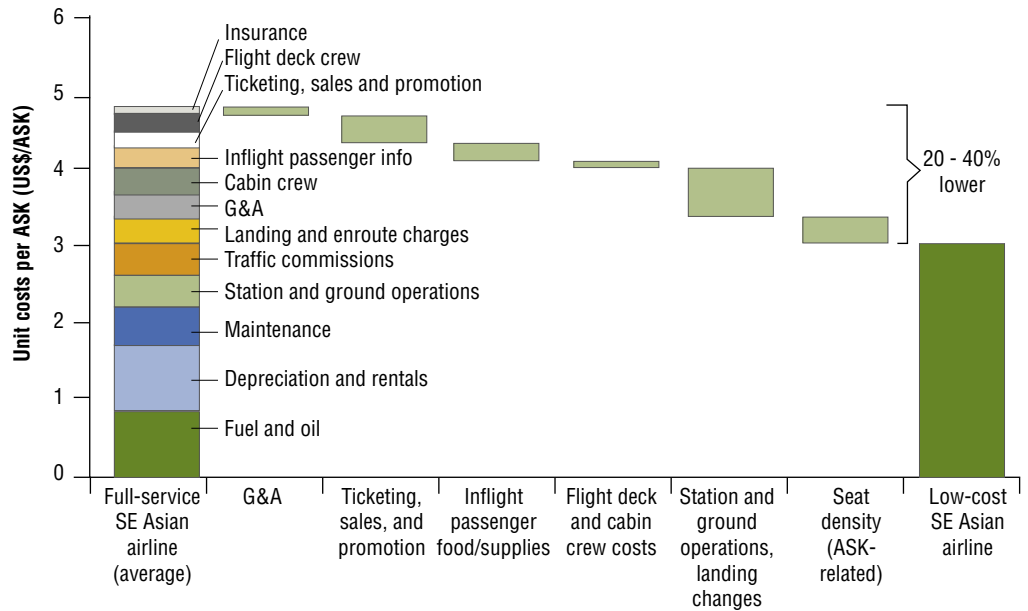
**Figure 5. Major low-cost airlines in Asia-Pacific (as of 1 April 2004).**

Country	Standalone Entrants	Mainline spin-offs
Australia	Virgin Blue	Australian Airlines (Qantas - international) JetStar (Qantas - domestic)
China	Yinglian's Eagle United	
India	Air Deccan Air One	
Indonesia	Lion Air Air Paradise Athena Air Services	Citilink (Garuda Indonesia)
Japan	Skymark Airlines Fair, Inc. Skynet Asia Airways The Fair Inc.	JALways (JAL - international) JAL Express (JAL - domestic) Air Do (ANA partnership) To be announced subsidiary (ANA)
Malaysia	AirAsia	
New Zealand	Pacific Blue Freedom Air	Freedom Air (Air New Zealand) Domestic Express (Air New Zealand)
Philippines	Cebu Pacific Air	
Singapore	ValuAir New Venture (Tony Fernandes)	Tiger Airways (Singapore Airlines) Jetstar Asia (Qantas)
Thailand	Thai AirAsia Diet Jet (PB Air)	Nok Air (Thai Airways) One-Two-Go (Orient Thai) SkyAsia (Thai Airways, other investors)

Source: IBM Business Consulting Services analysis, 2004.

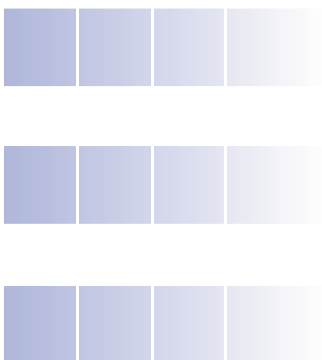
In Asia, as elsewhere, the flag carriers are seeking the best way to respond. As one senior executive at Cathay Pacific makes clear, "It's something we debate every day now. Doing nothing in the next 12 months is not an option."<sup>16</sup> Many traditional airlines have announced their own version of an LCC, thinking that, as does Qantas CEO Geoff Dixon, "If we are going to be cannibalized, we might as well cannibalize ourselves."<sup>17</sup> That said, others airlines, such as Cathay, appear to be taking a more defensive path – focusing on their mainline operations or at least deferring decisions about spin-offs.

**Figure 6. Low-cost carrier cost advantage in Asia.**

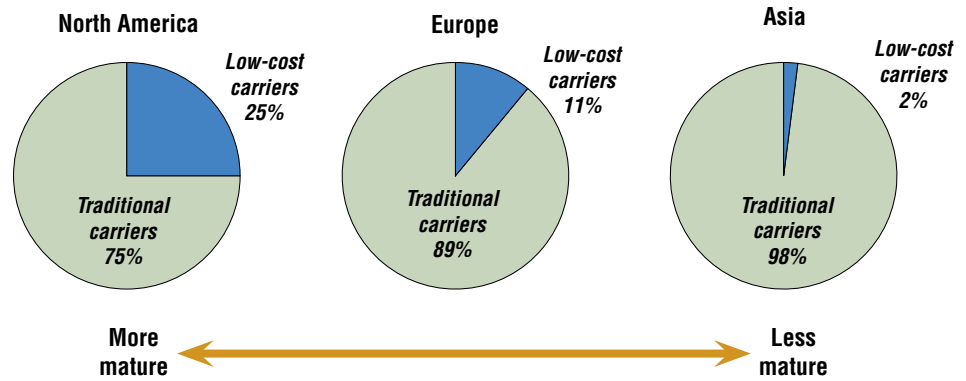


Note: ASK = Available seat kilometer.  
 Source: IBM Business Consulting Services analysis, 2004.<sup>18</sup>

Regardless, both low-cost entrants and subsidiaries (see Figure 7) are looking to capture a market that remains in its infancy – low-cost airlines have captured less than two percent of the Asian market.<sup>19</sup>



**Figure 7. Low-cost carrier market penetration (based on passenger volumes).**

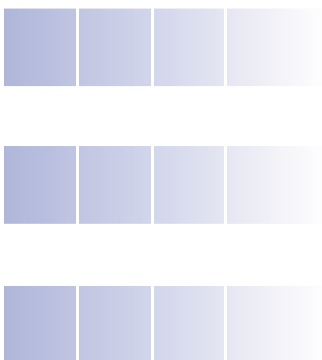


*Note: Data for Asia excludes Australia.*

*Source: IBM Business Consulting Services analysis, 2004.<sup>20</sup>*

Growth expectations vary significantly. Investment bank analysts estimate 10 to 15 percent penetration of the entire Asia-Pacific market by the end of the decade,<sup>21</sup> while others are far more bullish. Indo-Swiss Aviation, an aviation consulting firm, sees a future “where up to one-third of travel will be by low-cost carriers.”<sup>22</sup> Growth rates may exceed those of European and North American low-cost carriers. Increasing liberalization and development of many Asian economies, rapid urbanization, rising discretionary income and increasing interest in intra-Asia tourism will all fuel the region’s business and leisure travel market. As Thai Airways Chairman Thanong Bidaya acknowledges, “If we didn’t do anything, we would only lose about 20 percent to 30 percent of our customers. However, we do have to think of new customers... Many provincial businessmen are using trains and buses, and we can’t let go of that potential customer base.”<sup>23</sup> Sim Kok Chwee, a Director of the Pacific Asia Travel Association, agrees: “Air travel will grow at the expense of surface transportation. What is certain is that many [customers] will be swift to travel more frequently, more impulsively to certain destinations served by low-cost carriers.”<sup>24</sup>

Qantas’ Geoff Dixon expects that low-cost carriers will be “a powerful force in this part of the world, [since] the population, geographic and income characteristics of the region are ideally suited...China, the Philippines, Thailand and Indonesia are examples of countries that have only recently reached [the average income] thresholds [for international travel], and we can expect to see well above average aviation growth from these markets in the next few years.”<sup>25</sup>



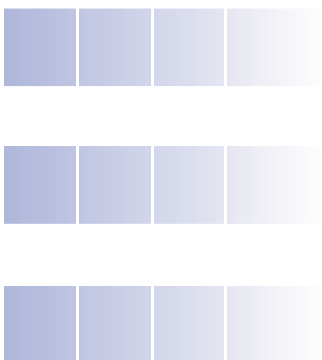
However, regardless of what penetration the low-cost segment ultimately achieves, capacity growth on many routes in the short and medium term may outstrip demand. This could result in short- to medium-term pressure on yields throughout the industry, a competitive battle scenario whose weapons include fare cuts, unit costs and cash reserves. If the opening exchange between JetStar and Virgin Blue is any indication, price wars could persist for a period of time.

### ***Local challenges and obstacles***

Low-cost carriers will face unprecedented challenges, and many may fail. The industry is scattered with the remains of now-defunct low-cost carriers ranging from pioneers such as PeopleExpress to spin-offs such as British Airways' Go. Air Do in Japan survives in part because ANA seized an opportunity to control, rather than launch, a low-cost subsidiary. ING's Philip Wickham predicts: "I would expect most of the newly emerging airlines in Asia now to be gone – either acquired or shut down – by 2005."<sup>26</sup> Tony Fernandes, CEO AirAsia, agrees: "The low-cost airline [industry] in Thailand has become somewhat similar to the dot-com phenomenon a few years ago, and only a few will survive this phase."<sup>27</sup>

Several Asia-specific complexities are certain to curb growth, demand changes to the traditional low-cost carrier model or delay full penetration of the market. First, the longer travel distances in Asia may limit the number of customers willing to embrace no-frills service, which may tempt entrants to add certain frills (and thereby cost and complexity) or accept more limited destination options. This conflict can be partially mitigated through selling amenities, such as food in-flight, as several North American carriers now do.

Second, the secondary airports in Asia are limited by both their numbers and other constraints (for example, domestic access only or lack of connecting bus service), while the cost of primary hubs represents a different challenge. However, more traditional gateway hubs like Singapore and Hong Kong are focusing on becoming more cost-effective as they face rivals like Kuala Lumpur and Bangkok. In fact, it was recently announced that a new low-cost terminal will be built at Singapore's Changi Airport.<sup>28</sup>



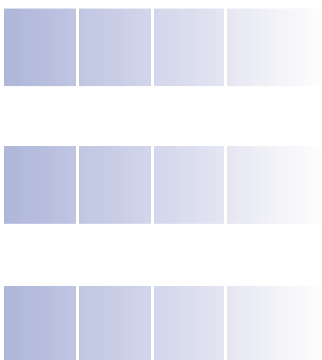
Third, regulatory issues pose important uncertainties. Lacking an integrated market the size of the United States or the European Union, Asia's low-cost carriers are hindered by bilateral international agreements which restrict their ability to offer traditional low-cost, point-to-point service. Furthermore, it remains unclear how quickly these constraints can be removed. Potential solutions range from multinational joint ventures and cooperatives, such as AirAsia, to regulatory reform. Today, airports, local authorities and national governments are torn between viewing low-cost carriers as growth engines, on the one hand, and as unacceptable threats to their national carriers on the other.

In addition, Asian low-cost carriers are also likely to be challenged by the relative strength of traditional network carriers, especially in comparison to their bankrupt and poorly performing peers in North America and Europe. These incumbents may narrow the opportunity and force the low-cost segment to focus on growing the market, not just stealing market share.

Other complexities related to distribution and customer dynamics – such as traditional carriers' reluctance to break travel agents' distribution power and low adoption of their self-service purchase and check-in vehicles to date – increase the uncertainty regarding the overall market opportunity. Yet, ever increasing technology adoption may help diminish the value currently going to distribution intermediaries.

Furthermore, unlike low-cost carriers elsewhere that have focused on large domestic markets (United States, Canada and Australia) and common markets (European Union), Asia's low-cost carriers may focus much more on international routes. AirAsia and Pacific Blue are some of the first to expand internationally, along with North American carriers such as ATA and JetBlue that now offer some international service.

Defining the right business model for Asia's complex market may be challenging, but variations on the core model have always existed, which indicates the potential for flexibility. For example, while most low-cost carriers have embraced one-class service, AirTran, ATA and AmericaWest have built a market for a "low-cost premium" product.<sup>29</sup> And while most low-cost carriers have embraced a common narrow-body fleet, airlines such as JetBlue are adding a small bit of complexity with the somewhat different Embraer 190, and perhaps someday a low-cost carrier will embrace a common, wide-body aircraft for its fleet.



### ***What differentiates a successful low-cost airline***

The large number of failed low-cost carriers in the industry's history underscores the importance of understanding what determines success. No single low-cost business model exists, so carriers must choose carefully to achieve effective differentiation. High asset utilization, Internet distribution and limited fleet diversity are requirements of the LCC model. Customer experience, routes and fares, expansion approach and organizational structure afford more scope for variation.

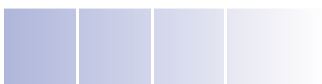
Startups and spin-offs both must ask and answer critical questions to define their strategies:

- What destinations will most appeal to our target customers?
- Are these passengers willing to travel to secondary markets, or should we attempt to operate profitably from major airports?
- Do these customers prefer the no-frills atmosphere of Ryanair, or should we adopt JetBlue's innovative branding and amenities?
- What branding will promote our service most effectively?
- How should we pace our growth?
- For existing carriers, how should we position our new airline versus the mainline carrier?
- How much autonomy will the subsidiaries be given? Will they have the ability to compete directly with the mainline carrier or will their growth be constrained?

Four critical elements separate the winners from the losers: innovative customer experience, balanced growth, simplicity and efficiency from route structure to fare structure and effective governance. These elements are discussed in more detail below. Keep in mind that an essential prerequisite to success is a unique, well-crafted value proposition that appeals to target customer segments.

#### **Innovative customer experience**

Certain new market entrants have exploited the retail trend toward low-cost style with innovative branding. JetBlue has focused significant effort on their brand, image and product – including leather seats, satellite television and 34-inch pitch. They have focused on creating an efficient, yet customer-oriented process from pre- to post-flight, investing in a customer-facing culture that rewards outstanding service and creating inventive but sustainable branding and processes rooted in core values.



These cannot be solitary initiatives but need to be ongoing, integrated programs. The key objective is to deliver a consistently excellent experience across all primary customer touch-points at the right cost. Similar to the retail industry, many aspects of basic operations impact the customer, including the flight attendants' in-flight service and attitude, the pilots' interactions and assurances, agents' alacrity and responsiveness and airport crews' focus on turnaround time. This requires tightly integrated product planning among marketing, HR, crew, operations, maintenance and others, including highly focused investments in training and communication.

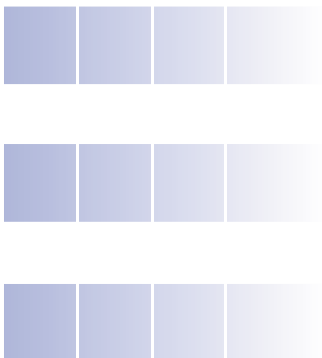
#### **JetBlue: Integrated customer experience design and management**

JetBlue engaged IBM to help them design and implement their passenger check-in kiosks through a well-coordinated, multifunctional effort. The joint team seized the opportunity to use the re-introduction of self-service as a strategy to optimize and transform the check-in experience. IBM conducted customer focus groups and user interface tests, analyzed passenger traffic flow and developed environmental impact reviews. Christian Richel, JetBlue's Director for Interactive Marketing, commented, "The customer is always front and center at JetBlue. We've never been known for thinking 'inside the box' and when we decided to pursue this program, our goal was to develop a system based on what our customers want."<sup>30</sup>

Asian low-cost carriers will need to make very careful decisions about capital investments in the customer experience (television, video and radio programming). Should they be designed into the product, provided as add-ons (such as hand-held devices) or retrofitted after demand can be proven? Should the airline price them into the cost of a ticket or charge extra? These decisions do not just affect the trade-off between unit costs and the customer experience, but also the risk of capital outlays in the face of unclear customer demand. New low-cost airlines must carefully set customer expectations about how they intend to balance these imperatives and then deliver accordingly.

#### **Balanced growth**

Many low-cost carriers today are adding capacity at a rapid pace. While that may be a successful tactic to gain market share quickly, history has shown that a balanced approach to growth distinguishes the winners. Southwest has a long-term average of increasing capacity of only 16 percent per year and decided to acquire a total of only six aircraft in its first five years.<sup>31</sup>



Carriers that choose to embark on more rapid expansion must contend with greater risks and challenges. JetBlue, for example, plans to add 14 to 16 new aircraft in 2004, increasing capacity by 25 to 30 percent.<sup>32</sup> To support the capacity growth, about 100 new employees per aircraft are needed, which translates into 1,400-1,600 people that need to be screened, hired, trained and supported, increasing the employee base by about one-quarter in one year.<sup>33</sup>

To enable rapid growth, close attention to supporting processes and infrastructure is essential, as JetBlue's CEO, David Neeleman acknowledges: "Hiring will step up to a new level next year. The infrastructure's going to have to take it up a notch."<sup>34</sup> JetBlue's Rishel gives an example: "There's a risk of ossification for certain small-culture processes as we grow. For example, we used to have focused, cross-functional 'Tiger Teams' to address tough issues led by managers and directors that included participation by senior executives. Now we've had to separate the development and execution phase from executive validation and approval."<sup>35</sup>

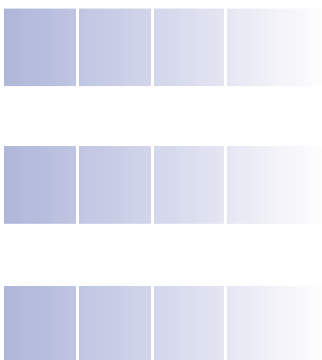
### **Simplicity and efficiency from route structure to fare structure**

Successful low-cost carriers pursue efficiency in every part of their business. They streamline everything from processes to fleet types to route structures and fare structures. Low-cost carriers limit their complexity by adopting point-to-point networks, limiting their fleet to one or perhaps two aircraft types and relying on simple fare class structures (typically 3 to 6 classes in total versus more than 25 in many traditional carriers). Their customers appreciate travel without complex rules, restrictions and highly variable fares for the same flight.

As carriers grow, the temptation increases to gain incremental revenue by adding fare classes and other types of complexity. Management must balance that appeal with the need for sustained customer trust, efficiency and organizational focus – expanding only when a long-term need or significant opportunity arises and doing so in a controlled manner.

### **Effective governance**

Most new entrants enjoy the freedom of being independent carriers, but for low-cost spin-offs, a spectrum of integration issues must be addressed. There is usually value in leveraging some aspect of the parent's processes, systems and brand. But at what point do the costs and risks of complexity outweigh the benefits? What functional control and responsibility should the new airline's management have?



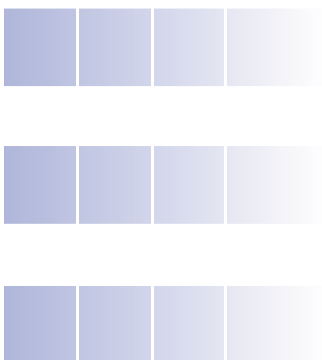
The simple answer is that it depends on the specific carrier. But, more fully, there must be upfront clarity and agreement among senior management about targets, objectives and assumptions for the new entrant. Key areas to consider include:

- Allocation of costs if the entities are to share certain functions (the mainline carrier subsidizing a spin-off's unit costs is not a viable long-term strategy).
- Expectations on cannibalization of the mainline business.
- Mainline carrier contribution to feeder traffic and the effect on the spin-off's operating model (for example, interlining and baggage transfer).
- Feeder traffic impact on route planning, scheduling and pricing.
- Degree of decision-making autonomy for the new airline in terms of corporate strategy and in specific functional areas.

These are all important decision points for senior management to work through together before embarking on this path to avoid unmet expectations, unclear authority or muddled strategic positioning.<sup>36</sup>

Decisions must take into account how the new airline will compete and operate. For example, a new LCC targeting a different segment than its mainline parent, with a new brand, will likely need more authority over marketing. An airline designed to combat a rapidly growing new entrant may trade some cost and complexity for speed to market by leveraging more of its parent's infrastructure. When making this specific trade-off, management must help ensure that existing technology systems, which could be more complex than the subsidiary requires, do not drive complexity into the new airline's business processes.

Culture and organizational behavior can be an important element of successful governance. A spin-off's culture should take the form of the target brand attributes given the significant contributions that service makes toward the customer experience and overall branding. For example, an assessment of Southwest's success conducted over eight years found one crucial, common, ostensibly simple yet supremely effective organizational competency: "Southwest's relationship focus, its commitment and passion for shared goals, shared knowledge, and mutual respect, joins with frequent, timely, problem-solving communication to form a powerful force called relational coordination (coordination and cooperation between employees known to result in efficiency and quality)."<sup>37</sup> As a second example, an executive at



a major North American carrier highlighted the practice of keeping pilots, crew and operations with the same aircraft throughout the day, to the extent possible. This approach reduces the risk of missed connections, minimizes maintenance hand-offs and also fosters a team orientation among the group.<sup>38</sup>

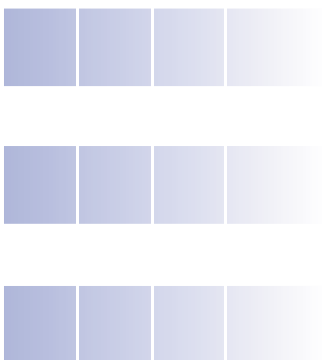
One key decision addresses the degree to which the spin-off is free to cannibalize its parent's prized routes. While most independent low-cost carriers will target high-revenue city-pairs, many subsidiary low-cost carriers have been forced to focus on low-revenue city pairs. However, without sufficient autonomy to compete head-to-head with its parent, how can the subsidiary gain market share and compete successfully with independent low-cost carriers? Each carrier must analyze this question carefully, factoring in the long-term vision for the spin-off to determine the appropriate level of autonomy.

When spin-offs decide to leverage more, rather than less, from the mainline parent, capitalizing on related opportunities can be valuable. As one executive at a major North American carrier points out, "New business practices and processes can be tested, piloted and evaluated for use at the mainline airline. Even for those not adopted, the lessons can help shape the mainline direction."<sup>39</sup>

### ***Implications for incumbents' mainline operations: Universal success factors***

Regardless of whether they choose to launch a low-cost subsidiary, incumbents are left with two potential strategic responses for traditional mainline operations: ignore the low-cost phenomenon or reassess their mainline position. Ignoring the low-cost challenge may only be feasible in very isolated markets and, even so, is likely to be just a temporary option. In the long term, fundamental shifts in the core business model are required. Three key factors should guide this course:

- Refine the core value proposition
- Achieve a greater cost variable component
- Improve infrastructure responsiveness.



### **Refine the core value proposition**

Airline executives must refine their value proposition by continuously assessing what service elements underpin their revenue premium and what additional services might enhance their overall revenue per available seat kilometer (RASK). To do so, they need to understand target customer needs more precisely and define their strategic focus more explicitly.

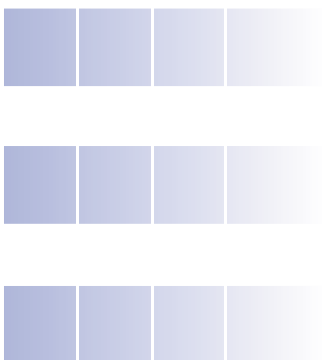
Rich, robust customer data and rigorous analytics are essential tools in this endeavor. For example, Finnair teamed with IBM to transform its approach to customer analytics. Together, IBM and Finnair developed a new model to evaluate customer dynamics and determine optimal marketing strategies. Based on a set of segmentation, dissection, and clustering processes, the model optimizes customer lifetime value, resulting in a 20 percent reduction in marketing costs and a 10 percent increase in customer response rates.<sup>40</sup> With a more sophisticated view of the customer, airlines can more easily decide which service elements are essential to the value proposition and which can be streamlined or eliminated.

### **Achieve a greater variable cost component**

For established carriers, maintaining premium service as a method of differentiation requires a lower and fundamentally more variable cost base. As demand fluctuates, costs must follow closely to ensure adequate service delivery when demand rises and to preserve profitability (or limit losses) when demand falls.

Increasing the variability of core operating costs is not a new idea; aircraft leasing, distribution costs, engine maintenance and catering outsourcing are prime examples. The new emphasis is to transform less traditional cost elements.

To achieve greater cost variability, airlines must enhance their operational flexibility by reassessing their business components enterprisewide, then realigning – and in some cases, redeploying – them to drive the most value. To do this, executives must think critically about which capabilities are truly differentiating – going beyond traditional ideas about what’s “core” versus “non-core” to focus on those capabilities that, when performed at best-in-class levels, provide a substantial competitive edge.



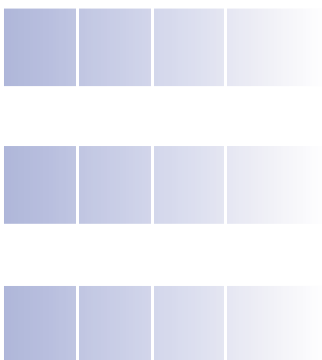
Increasingly, airlines and other companies are reaching the conclusion that functions such as IT, procurement, HR, finance and other areas are less costly and deliver higher service levels if provided by strategic partners. British Airways, for example, outsourced its Heathrow airport facilities management, including 24-hour help desk support, after determining that the service need not be BA-specific.<sup>41</sup> Some partnership opportunities may touch customers more directly. Many airlines, for example, have chosen to outsource elements of their frequent flyer member servicing to third-party marketing specialists.

The objective for incumbents is not necessarily to cut costs to the level of the new entrants, although that remains a possibility depending on the competitive environment and strategic intent. Rather, the aim is to deliver the desired value proposition with an optimal cost structure – as measured by CASK/RASK (Cost per Available Seat Kilometer/Revenue per Available Seat Kilometer) alignment relative peers – based on the carrier’s current position and strategic direction.

Organizational and cultural flexibility can also contribute to greater cost variability. Southwest’s culture and relationship focus has a number of direct benefits, as documented in the previously referenced study: “Well-coordinated organizations have a competitive advantage through their ability to achieve higher quality at lower cost by achieving faster cycle times and by providing a more coherent interface to customers...Efficiency/quality trade-offs are the rule in most business operations, but improvements in relational coordination, like other fundamental process improvements, allow an organization to shift the efficiency/quality curve outward to a more favorable position.”<sup>42</sup> Factoring out product and business model differences, this analysis found that a doubling in “relational coordination” resulted in a 21 percent reduction in turnaround time, a 42 percent increase in employee productivity, a 64 percent decrease in customer complaints, a 31 percent decrease in lost baggage and a 50 percent decrease in flight delays.<sup>43</sup> The magnitude of these benefits makes a compelling case for the organizational changes required to achieve them.

### **Improve infrastructure responsiveness**

Increasing the variable component of costs obviously cannot be achieved by discrete analysis, re-engineering or outsourcing alone. Supporting enterprisewide change in a highly dynamic environment requires companies to transform the underlying process and system infrastructure, which is rarely achieved easily or quickly, especially for incumbents.



Over 80 percent of the more than 450 CEOs surveyed as part of the recent IBM Global CEO Survey cited the need to improve responsiveness to changing market forces as a high priority in the next few years, while only 13 percent identified their organizations' ability to respond as "very capable".<sup>44</sup>

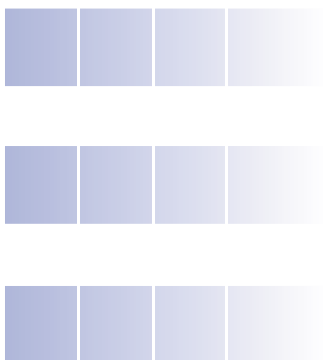
Companies should focus on priority infrastructure elements and ensure "openness" and interconnectivity for new technology investments. For many airlines, reservations and departure control systems are increasingly delivered in a more cost-effective, variable and resilient manner as part of a shared service provided by a third party. Other airlines are beginning to look to airport operations, workforce scheduling and other standard industry systems with significant peaks and troughs in usage as candidates for this treatment.

One major North American carrier, for example, zeroed in on its procurement function and engaged with IBM to transform how it is managed. The IBM solution enables employees to place Web orders for a wide variety of purchases, while providing the requisite business controls to ensure optimal pricing and transactional efficiency. More significantly, a low upfront investment expense addressed the airline's capital constraints but still achieved cost savings of 19 percent in key areas.

Outsourcing represents another approach to increasing infrastructure responsiveness. In a transformational move, consumer products manufacturer Procter & Gamble decided to outsource much of its HR administration and servicing functions, including people and processes, to IBM. Fundamental to the deal was variable pricing. As noted in the partnership announcement, this agreement will "allow P&G to pay only for the services it uses, when and where it uses them, letting it respond more effectively to changing business conditions. It will be able to vary its service capabilities along with its business needs."<sup>45</sup>

Adopting a strategic approach to enhancing responsiveness can yield dividends in later business cycles as future course changes become necessary. Massive investments may not be required. Rather, airlines need to have selective focus on priority infrastructure elements paired with an overarching philosophy to embrace interconnectivity as processes are retooled and technology is replaced. Open standards, Web services and seamless integration with business partners and customers are overriding aims, but they are not always immediately achievable objectives.

Shared investment across the airline industry could also be an important part of the solution. Leveraging infrastructure across multiple carriers to reduce overall costs and drive much greater variability can help realize cost savings of 10 to 15 percent. Potential target opportunities – as highlighted by the cost gap between traditional and low-cost carriers – include all G&A functions, Sales & Reservations, Irregular Operations and Maintenance. Embracing this approach would free up capital for investments in planes rather than having to purchase systems.



## ***Conclusion***

In Asia, as elsewhere, the entry of low-cost airlines is eroding market share for traditional carriers and forcing them to reassess their business models. New entrants and spin-offs alike need to compete based on known success factors such as:

- Innovative customer experience
- Balanced growth
- Simplicity and efficiency from route structure to fare structure
- Effective governance.

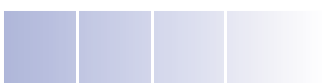
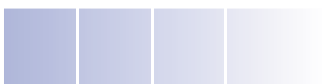
Meanwhile, macroeconomic and geopolitical dynamics have increased revenue variability and overall uncertainty. In this environment, three new imperatives for incumbent competitors emerge:

- Refine the core value proposition
- Achieve a greater variable cost component
- Improve infrastructure responsiveness.

Carriers who accomplish these imperatives can stay competitive and win at the airline margin game.

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- “Travel distribution 2007: The profitability constellation: Effective new patterns of travel distribution.” IBM Institute for Business Value, September 2003. [http://www.ibm.com/services/strategy/e\\_strategy/travel\\_patterns.html](http://www.ibm.com/services/strategy/e_strategy/travel_patterns.html).
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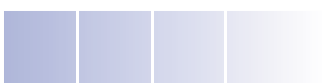
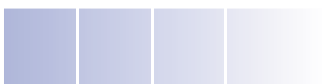
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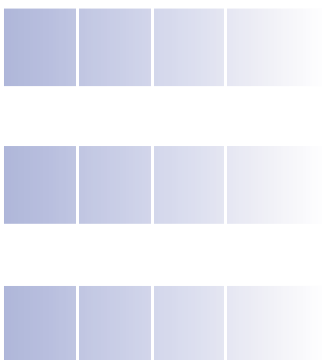
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