Southwest Airlines: A Game Changer in the Domestic Airline Industry

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In a market where consumers are cost-conscious, and consistently on the lookout for added value in their purchases, the lines between low-cost and legacy airlines have begun to blur. The category of low-cost airlines refers to airlines that cater to price-sensitive consumers by focusing on cutting costs and providing no-frills service, whereas legacy airlines strive to provide full-service to its customers by offering luxury options (Azadian & Vasigh, 2019). Southwest Airlines, a leader in the low-cost airline category, stands out from others in this category, such as Frontier and Spirit, by providing exceptional customer service and operating beyond the traditional hub-and-spoke model (Azadian & Vasigh, 2019). This places Southwest Airlines in direct competition with the traditional legacy airlines, in addition to those in the low-cost category.

Company Overview

Southwest Airlines was founded in 1967 by Rollin King and Herb Kelleher (Muduli & Kaura, 2011). The initial focus of the airline was to provide affordable service routes throughout Texas. The focus quickly expanded to offering direct flights throughout destinations across the southwest region through a non-traditional airline model (MarketLine, 2019). This non-traditional model utilizes a series of direct flights rather than a hub (Bozogan & Hurna, 2018). The model used proved to be successful, and by 1977, it became a publicly-traded company on the New York Stock Exchange (MarketLine, 2019).

Southwest Airlines operates primarily in the domestic market, where it services 101 destinations within the United States (Southwest Media, 2019). However, since acquiring AirTran Airlines in 2011, Southwest has expanded to offer limited international service (MarketLine, 2019). As of 2019, Southwest Airlines provides international service to 14 destinations in 10 countries, all within the Caribbean region (Southwest Media, 2019). Despite expanding into the global market, the operating income derived from international service still amounts to less than 10% of Southwest Airlines' total annual revenue (Sanders, 2019).

One of Southwest's essential cost-saving actions is its use of Boeing 737 aircraft (Austin, 2019). By maintaining uniformity across the fleet, Southwest Airlines can ensure that all pilots can fly any plane in the fleet and allows the airline to cut costs when it comes to maintenance because it reduces the number of parts necessary to keep on-hand (Austin, 2019). The simplicity in utilizing the uniform fleet of 754 Boeing 737s also allows Southwest Airlines the flexibility in scheduling and training that its competition lacks, giving it a competitive advantage (Sanders, 2019).

Another cost-saving action that Southwest Airlines uses is direct, short-haul domestic flights (Bozogan & Hurna, 2018). While most other airlines utilize a hub-and-spoke model, meaning the airlines have a central hub that services the surrounding airlines, Southwest Airlines provides consumers with high-frequency short-haul flights (Sanders, 2019). As of 2018, the average length of a flight was 757 miles or approximately two hours (Southwest Media, 2019). By utilizing this strategy, as well as using smaller airports in each market, Southwest Airlines is also able to cut operating costs and runway congestion and increase the frequency of flights, resulting in fewer delays for consumers (Sanders, 2019).

By setting itself apart and offering superb customer service, Southwest has positioned itself as the top low-cost airline in the United States. Southwest Airlines currently holds a 15.2% market share in the scheduled air passenger industry (Sanders, 2019). In recent years, Southwest Airline's revenue has increased by an average of 3.94% per year (Sanders, 2019). In 2018, the total revenue was $21.4 billion, a 3.5 percent increase from 2017's revenue of $20.7 billion

(Sanders, 2019). While these numbers are impressive, it is essential to also look at financial ratios to get a better picture of how an organization is performing. Based on the 2018 annual report, the quick ratio for Southwest Airlines was 0.306, which is lower compared to the previous year when the quick ratio was 0.314 (Southwest Airlines, 2019). Another vital ratio to consider would be the return on equity ratio. The financial reports for Southwest Airlines provide a return-on-equity of 25% for 2018, which is a decrease from the 2017 return-on-equity of 34.82% (Southwest Airlines, 2019). While these ratios might seem unappealing when looking at industry trends, Southwest Airlines is right on target.

Customer/Consumer Overview

Consumers of Southwest Airlines vary significantly in terms of age and ethnic background. However, they share a common feature of being cost-conscious consumers. These individuals are looking for fast, economical ways to travel from one place to another. As a way to meet these consumers' needs, Southwest offers high-frequency point-to-point routes (Bozgan & Hurna, 2018). Southwest also meets cost-conscious consumers by offering two free checked bags per individual, whereas many legacy airlines impose a charge (Asahi & Murakami, 2017).

A great way that Southwest reaches its consumers is through its ticketing categories. By offering consumers different features based on the pricing, the consumers get more control over their experience with the airline (Southwest Airlines, 2019). The three price categories that Southwest uses are: “Wanna Get Away,” “Anytime,” and “Business Select” (Southwest Airlines, 2019). The “Wanna Get Away” price level is the lowest fare option that Southwest offers and must be purchased in advance, but allow consumers to apply the cost to future travel if they cannot make their flight (Southwest Airlines, 2019). The “Anytime” price level earns consumers 10 Rapid Rewards per dollar and is refundable if canceled (Southwest Airlines, 2019). Finally, the “Business Select” price level allows consumers to earn 12 Rapid Rewards per dollar spent and gives the purchaser additional perks such as priority boarding and a complimentary beverage for the day of travel (Southwest Airlines, 2019).

Industry Analysis

The scheduled passenger air transportation industry consists of network carriers using a hub-and-spoke model to fulfill consumer needs (Bozgan & Hurna, 2018). What this means is that network carriers utilize a hub for connecting flights across a given region rather than offer direct flights, allowing airlines to service a larger number of destinations (Azadian & Vasigh, 2019).

This industry has seen rapid growth since the federal deregulation in 1978 (Azadian & Vasigh, 2019). This deregulation allowed for the increase in competition, the emergence of the hub-and-spoke model, and the entrance of low-cost carriers (Bozgan & Hurna, 2018). In addition to this, airlines no longer had to seek federal approval before increasing capacity or cutting offered services, leading to the rise of low-cost airlines (Azadian & Vasigh, 2019). Initially, low-cost airlines catered to a different market segment than legacy airlines; however, the segments have begun to overlap, resulting in a convergence between legacy and low-cost airlines (Bozgan & Hurna, 2018).

The domestic passenger airline industry had an annual revenue of $146.9 billion from 297 organizations around the United States in 2018 (Sanders, 2019). This is an increase of 3.5% from 2017, when the industry saw a revenue of $141.7 billion (Sanders, 2019). The growth is a result of various external industry drivers. The domestic airline industry relies heavily on several vital drivers. The largest of these drivers is the demand for domestic trips by US residents (Sanders, 2019). Demand for domestic flights has been steadily increasing over the past five years (Sanders 2019). Another driver in the industry's success per capita disposable income (Sanders, 2019). As the per capita disposable income rises, consumer spending on leisure travel also increases as individuals feel the need to take more vacations (Sanders, 2019). Finally, the world price of crude oil also is a driver of the airline industry as it affects the overall cost of airline tickets, resulting in a direct influence on the profits of each firm (Sanders, 2019).

This industry has reached the mature stage of its life cycle, meaning the firms within the industry need to differentiate their product to add value to different market segments while also lowering the overall prices for consumers (Nickels, McHugh & McHugh, 2018). Within this industry, much consolidation among organizations has been taking place through mergers across airlines (Azadian & Vasigh, 2019). Despite the consolidations, the industry value added for the domestic airline industry is expected to continue growing at an annualized rate of 3.3% (Sanders, 2019).

Competitive Analysis

Southwest Airlines has taken a unique position within the scheduled air passenger transportation industry. While most airlines within this industry are classified as either a legacy airline or a low-cost airline, through unique marketing strategies, Southwest Airlines has been pushing the boundaries between these classifications (Azadian & Vasigh, 2019).

Legacy Airlines

Legacy airlines are pioneers of the domestic passenger airline industry. Legacy airlines were the traditional airline model before the federal deregulation act of 1978 (Azadian & Vasigh, 2019). These airlines offer full-service options to consumers, including checked luggage, seat selection, refreshments, and more (Bozogan & Hurna, 2018).

Delta Airlines Holding the largest market share in this industry, with 22.7%, Delta Airlines was formed in 1924 in Macon, GA (Sanders, 2019). This airline offers service to 325 destinations in 60 countries, utilizing hubs within each major region (Sanders, 2019).

In recent years, Delta Airlines' revenue has increased by an average of 4.4% per year (Sanders, 2019). In 2017, Delta saw a total revenue of $29.7 billion, and in 2018 this increased 6.5% to $31.6 billion (Sanders, 2019). Several factors have driven the increase in revenue; however, the most important would be the declining fuel prices and the ability to adapt to the changing needs of consumers (Sanders, 2019). Another driver in Delta's success has been the addition of basic fares. These fares allow consumers to purchase low-cost tickets with reduced service options (Sanders, 2019).

American Airlines The second largest airline in this industry, American Airlines, holds a 21.1% market share (Sanders, 2019). American Airlines was founded in 1934 as AMR Corporation in Fort Worth, TX (Sanders, 2019). American Airlines currently services 350 destinations in over 50 countries, with an average of 6,700 flights each day (Sanders, 2019).

In recent years, American Airlines' revenue has increased by an average of 2.44% per year. The annual revenue for 2017 was $29.6 billion, seeing an increase of 2.8% in 2018 for an annual revenue of $30.4 billion (Sanders, 2019). This increase has been driven primarily by the rise in consumer demand; however, due to competition, they experienced a lower average annual increase compared to the industry average (Sanders, 2019).

United Airlines The third-largest airline in this industry, United Airlines, holds an 18.5% market share (Sanders, 2019). United Airlines was formed in 1926 in Boise, ID, and has grown to service 342 destinations around the world, with over 4,500 flights each day (Sanders, 2019).

In recent years, United Airlines' revenue has increased by an average of 4.26% per year (Sanders, 2019). Revenue for 2017 was $23.1 billion and then increased 10.5% in 2018 to $25.5 billion (Sanders, 2019). The increase in revenue for United was driven by consumer demand and the addition of the basic economy seating on their flights (Sanders, 2019).

Low-Cost Airlines

After the federal deregulation act of 1978, low-cost carriers began to appear to offer consumers no-frills services in an attempt to lower the overall price per ticket (Azadian & Vasigh, 2019). Low-cost airlines opened up a new market segment, allowing individuals with lower incomes to partake in air travel (Azadian & Vasigh, 2019). In addition to Southwest Airlines, two key players in the low-cost carrier field are Jet Blue Airlines and Spirit Airlines.

JetBlue Airlines As a critical player in the low-cost airline segment, JetBlue Airlines offers routes to 105 destinations throughout the United States, the Caribbean, and Latin America (JetBlue Airlines, 2019). This results in over 1,000 daily flights allowing JetBlue to serve over 42 million consumers each year (JetBlue Airlines, 2019).

In 2018, JetBlue Airlines had an operating revenue of $7.6 billion (JetBlue Airlines, 2019). This was an increase of 8.4% from the 2017 operating revenue of $7.0 billion (JetBlue Airlines, 2019). The driving force behind this increase would be consumer demand and accessibility of the airline to consumers (Sanders, 2019).

Spirit Airlines Another critical player in the low-cost airline segment is Spirit Airlines. This airline currently services 72 destinations in 16 countries, resulting in more than 500 daily flights (Spirit Airlines, 2019). The airline focuses on offering consumers base-level pricing with the option to add on extras such as carry-on or checked luggage, seat selection, or even priority boarding (Spirit Airlines, 2019).

In 2018, Spirit Airlines had an operating revenue of $3.3 billion (Spirit Airlines, 2019). This was an increase of 21% from the 2017 operating revenue of $2.6 billion (Spirit Airlines, 2019). The primary drivers behind the increase in revenue would be the increase in consumer demand and the per capita disposable income (Sanders, 2019). By offering over 500 flights per day, Spirit Airline has made itself accessible to low-income consumers looking for cost-effective ways to travel (Azadian & Vasigh, 2019).

Conclusion

Southwest Airlines has found success by differentiating itself from the traditional low-cost airline model. The airline offers exceptional customer service and operates outside the traditional hub-and-spoke model. The strategy used by Southwest Airlines is helping to close the gap between low-cost and legacy airlines. This strategy will likely have future implications as the industry shifts towards a hybrid model.

Resources

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