KATHMANDU UNIVERSITY SCHOOL OF MANAGEMENT

Balkumari, Lalitpur, Nepal

Managerial Economics EMBA 2021

Case Review #2

Low Cost Carriers

A Sustainable Business Model in the Global Aviation Industry?

Submitted By:
(Group E)
Bibek Maharjan
Binaya Dhakal
Nirsha Shrestha
Omshree Narasingha KC
Riza KC
Yashoda Tamang

Submitted To:
Ms. Anupama Shrestha Pant

Table of Contents

Synopsis	**2**
Core Issues	**2**
Facts	**2**
Analysis	**5**
Solutions	**12**
Managerial Implications	**13**
References	**14**

Synopsis

The case is based on the emergence of Low-Cost Carriers (CC) in the aviation industry with aggressive strategy on cost reduction that made airline travel more effective, affordable, time saving and also opened up air transportation to new segments of people with low income. It also highlights the direct and indirect impacts on the Traditional Carriers with the introduction of LCCs in the industry. As Traditional and Low Cost Carriers both have their pros and cons they look for new ways to keep maintaining their market status and growth in the industry.

Core Issues

1. Does the commencement of Low Cost Carriers (LCC), in the already seasoned industry of Traditional Airlines (TA), create ambiguity in the aviation industry and therefore challenge the overall sustainability of the industry in the long run?
2. Does revising business models and offering competitive pricing help LCC and TA to retain their loyal customer base?
3. Can Traditional Airlines and LCCs implement independent sustainable strategies and prosper simultaneously?

Facts

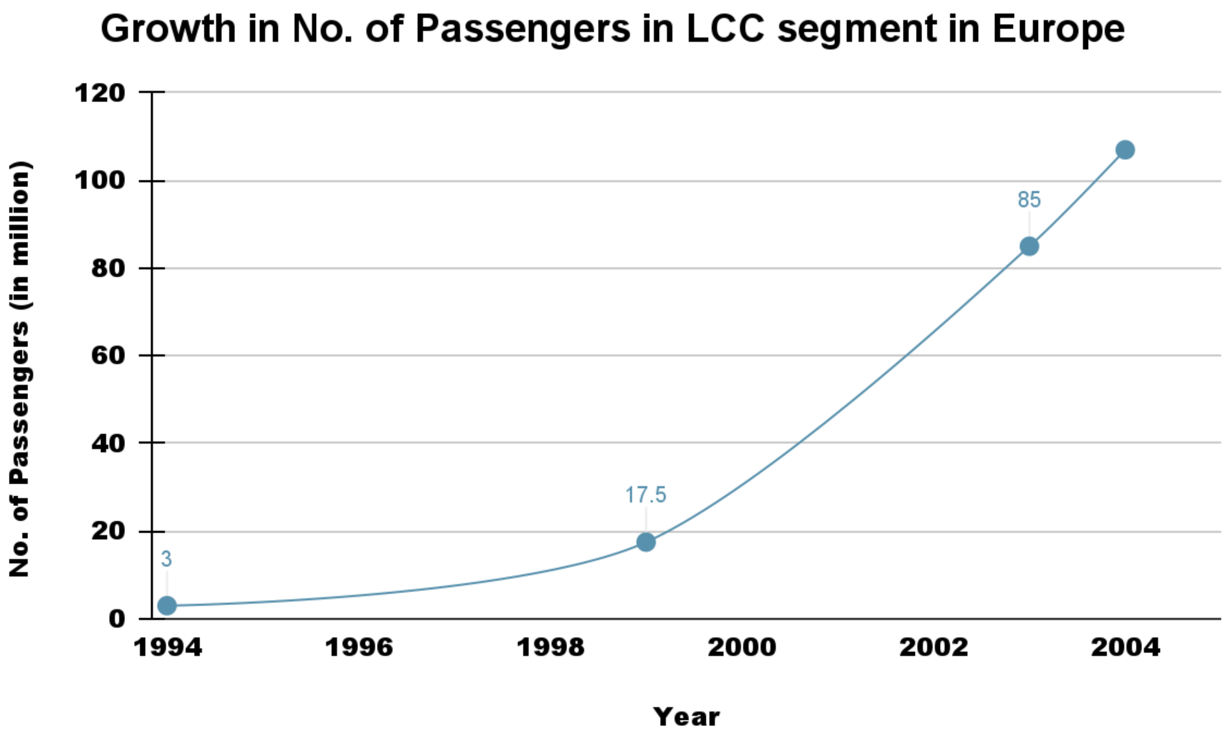
Year	Significant Events	Facts/Implications
1970s	Commencement of LCCs	Southwest airlines began operations in the US in the LCCs sector.
1978	The Deregulation Act passed	• Encouraged new entrants to enter aviation industry • Waved out all restrictions preciously levied by TAs on the LCCs
1978-1990	Growth of LCCs	• 7% of US domestic passengers were using LCCs • Southwest Airlines claimed 1% of US market share • Number of TAs was reduced from six to three in the US.

1991-2001	LCCs on the rise Challenges cropped up in Aviation Industry, especially for TAs	● LCCs gained popularity in Europe and arrived in Asia. ● LCCs reported to be major contributors of environment pollution ● Safety and ethical concerns were raised against LCCs ● Airline industry was reported to contribute 3.5% to global warming ● TAs were in the midst of major restructuring exercises.
2001	9/11 Attacks	● Tourism and Aviation Industry were hit hard ● Increase in Fuel Prices ● The Traditional airlines in the US reported huge losses whereas LCCs remained remained profitable even though their profit percentage decreased
2001-2006	Dominance of LCCs over TAs	● 85% of domestic passengers in the US were travelling by Low-cost airlines. ● LCC captured 31.7% revenues of Traditional Airlines ● Emergence of many LCCs in Europe ● LCCs reported to carry 107 million passengers in Europe (which was only 3 million in 1994) ● No. of flights and seat capacity of budget carriers increased rapidly. ● LCCs captured 16% of the total aviation industry.

Low Cost Carriers started out as the second movers to the Traditional Carriers in the airline industry, so they were able to study the market and come up with competitive strategies which helped them to prosper in the industry. The major characteristics of Low cost carriers that made them popular among customers are:

- ❏ No-Frill service at cheapest rates
- ❏ Point to point travelling
- ❏ Single Passenger class
- ❏ Encouraged use and issuance of the electronic ticket or ticketless travel
- ❏ High Frequency of Flights
- ❏ Proper Time management
- ❏ Attractive flight schedules

The Low cost carriers were experiencing a boom in the global aviation industry and growing rapidly in the US, Europe and Asia as well. The substantial growth of LCCs in Europe can be seen in the following graph which was recorded between 1994 to 2004.



Along with continuous growth and popularity in the market, the Low-cost carriers were also starting to face challenges in the form of various controversies and competition from the Traditional airlines. The traditional airlines launched their own low cost airlines to remain competitive. LCCs were often accused of violation of ethical standards, safety norms and poor customer service. There were many incidents of overbooking, poor baggage handling, obligation to provide assistance, Pilots being inefficient and disobeying instructions from air traffic controllers from all over the globe. There were also concerns about environmental pollution caused by Low-cost carriers releasing huge amounts of carbon dioxide, nitrogen oxides and sulphur oxides. Amidst all the concerns about the credibility and serviceability, LCCs were looking to improve and counter the problems and keep sustaining in the market.

Analysis

In order to analyse the entire aviation industry and what internal strengths and external opportunities companies could use to face the internal weaknesses and external threats, we have used SWOT Analysis and further used Market STP (Segmentation, Targeting and Positioning) analysis.

SWOT Analysis of Aviation Industry

<table>
<tr><td rowspan="2">Internal</td><td>Strengths</td><td>Weaknesses</td></tr>
<tr><td>● Fastest/Safest mode of Transportation
● Profitable Industry
● Growing Occupancy/Usage</td><td>● Huge Capital Investment
● Large Skilled Workforce
● Competitive Market
● Technological Infrastructure
● Spoilage Rate</td></tr>
<tr><td rowspan="2">External</td><td>Opportunities</td><td>Threats</td></tr>
<tr><td>● Industry Expansion
● Investment Opportunities
● Seamless Service through Technology
● Supply Chain Management
● Time Management
● Secondary Service-Mails/Cargo</td><td>● Global Economic Crisis
● Pandemic
● Environmental and Seasonal Threats
● Government Intervention</td></tr>
</table>

I. **Strengths**

- Fastest/Safest mode of Transportation - It is evident that airline is the fastest mode of transportation and safest too. Further, advancement of science and technology as well as aviation engineers are investing in Research and Development to make the airline the most safest mode of transportation.
- Profitable Industry - Over the years, the aviation industry has grown in multi-folds in terms of revenue, reach and numbers of airlines companies as it has proven itself to be one of the most profitable industries. Airlines leverage on major festivals, seasons, popular destinations and tend to raise the tariff.
- Growing Occupancy/Usage - Further, year-on-year, over the last 20 years and so, we have seen the surge in the usage of airplanes as mode of transportation and arrival of such low cost carriers (LCC) or budget airlines has made it easy in terms of reach and affordability.

II. **Weaknesses**

- Huge Capital Investment - airline industry is one of those industries that require huge initial investment, and cannot operate in isolation and require optimum support from its management, shareholders and other stakeholders. The initial year of operation might be difficult to sustain and might not be a profitable business as well and key performance metrics like Return on Investment (ROI), Return on Equity (ROE) and Return on Assets (ROA) will have negative yield.

- Large Skilled Workforce - Airline companies require a huge workforce with certain skills and expertise to smoothly run the operations, from ticketing to ground security, entrance, transportation, baggage management, to control tower, and many others.
- Competitive Market - Airline industry is one of the most competitive industries, where price war is a day to day struggle, especially to keep a tab on rival companies during major festivals and holiday seasons is a challenge. During the off-season, the competition on lowering prices is very harsh.
- Technological Infrastructure - Science and technology is forever changing and to keep abreast with latest technology involves energy, time and cost.
- Spoilage Rate - the rate of cancelling the flights and not showing up on flight date/time is high in aviation industries is comparatively high and refunds on such cases lead to loss in income for the companies.

III. Opportunities

- Industry Expansion/Investment Opportunities - aviation industry has proven itself to be one of the profitable industries over time and the size of the industry has grown into multi-folds. This has attracted many top notch investors in this field. Further, the construction of airports in far and unexplored corner of the world, evolution of wide variety of airplanes/carriers too has spiked the
- Seamless Service through Technology - Although the aviation industry is decently seasoned, however, we experience one or another technical glitches and the room for improvement still lies in the seamless execution of day-to-day operation. There is a huge opportunity for digitisation and technological advancements.
- Supply Chain Management - Since aviation industry is heavily dependent on oil and other supplies (Food and beverages, sanitary/toiletries items), periodic overhauling, interiors etc, the airline companies can optimise cost with robust supply chain management system.
- Secondary Service- Mails/Cargo - Airlines companies can also leverage its reach and work on delivering mails and small cargos for incremental revenue.

IV. Threats

- Global Economic Crisis - Following the major global recession and job cuts/ layoffs, more people are working on minimum wages. Travel has been restricted to indispensable business meetings only, else many corporate houses are relying on conference calls.
- Pandemic - Major pandemics like (Covid-19), and epidemics have affected industries like tourism, hotels and aviation. Many airlines companies are on loss and on the verge of closure.
- Environmental and Seasonal Threats - Environmental threats like storms, heavy rainfall, high turbulence are always going to impact the aviation industry. Further, seasonal spikes during holiday seasons and low occupancy for the rest of the year can lead to loss for airlines companies.
- Government Intervention - Government intervention on tariffs and schedule and destination location may have detrimental impact on the profitability of airline companies.

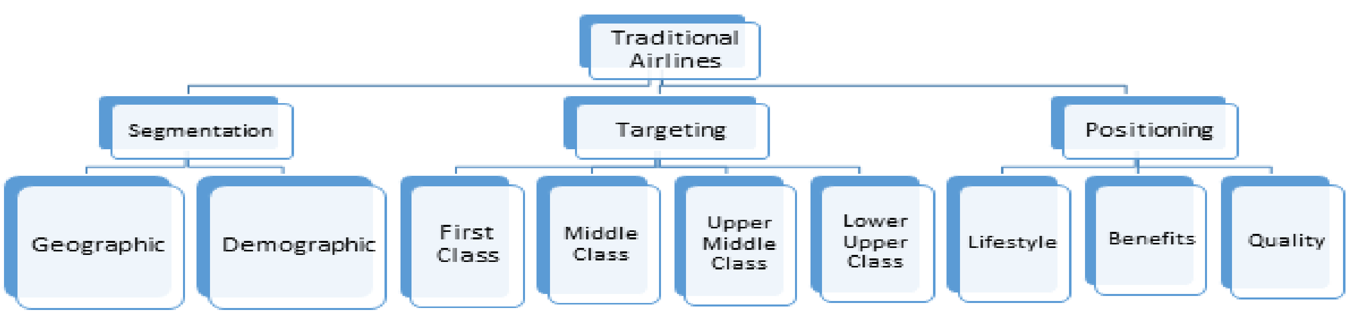
Market STP (Segmentation, Targeting and Positioning) Analysis

The airline sector can be segmented in a variety of ways. The first type of segmentation is the geographic area served by airlines. The "major" airlines serve the entire country and even transport people worldwide, while the "national" airlines serve the country and give services to the majority of its areas, and the "regional" airlines serve particular areas or a small number of towns.

The selling marketing concept was used by traditional airlines. National airline routes to or from its home country, which has to be sold. Consumers would not buy enough airline products unless the airline ran a large-scale marketing and promotion effort. The goal of a selling marketing strategy is to make as many sales as possible. When sales began to decline, airlines began to promote without first analyzing why sales were declining. They did not make any attempt to change their goods to the changing market. They worked harder to sell their items to customers, relying on more promotion to do so.

The key point is that low-cost airlines examined through market research what the customers really need. If, and only if, the research shows that there are potential customers for a service (e.g. flight route between two cities) or product, it is planned and produced. Moreover, all marketing activities will be focused on these customers.The low-cost airlines are therefore balancing customer orientation with operating efficiency: It was the change from **“selling and production oriented marketing”** to the **"modern and customer oriented marketing concept".**

Traditional Airlines



Segmentation:

- Geographic Segmentation: National Destinations/ International Destinations
- Demographic Segmentation: Gender- both Male and Female, Social Classes - Any Age Group, Income Level:-Higher and Higher Middle Income group (both are Modern, Trendy and Upwardly mobile looking for a great flying experience)

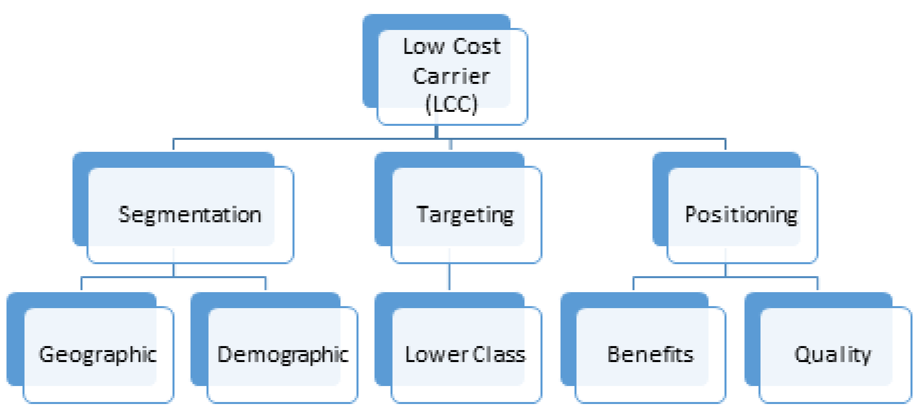
Targeting:

- First Class
- Middle Class
- Upper Middle Class
- Lower-Upper Class

Positioning:

- Lifestyle - Funliners Experience, Designer Interiors
- Benefits - Last time booking facilities, refund in case of Cancellation, In flight entertainments and many more
- Quality:- World Class Service provider, Comfortable seats, Safety majors, following ethical standards etc.
- Traditional airlines is not merely into the business of Transporting people from point A to point B, but making service and Hospitality their main focus.

Low-Cost Carriers (LCC) Airlines



Segmentation:

- Geographic Segmentation: Point to Point short distance Services
- Demographic Segmentation: Gender- both Male and Female, Social Classes- Any Age Group, Income Level - Appealing to price sensitive passengers.

Targeting:

- Lower Class (Only One Class Seats, targeting to price sensitive passenger)

Positioning:

- Benefits:- No special services
- Quality:- Unreserved seating, uncomfortable Seats, no refund in case of Cancellation, No meals, luggage handling charges, no safety majors.
- LCC is only focusing on volumes to increase revenue, and doesn't care about hospitality and services.

Analysis of the events:

Commencement of LCCs in Airlines industry

LCCs emerged in the 1970s with Southwest Airlines and became a phenomenon by 1990 by attracting new customer segments (low income group people) and capturing the market share of Traditional Airlines. With its core competency: cost effectiveness and the key mantra to provide lowest possible fares to the customers, LCCs began grabbing markets by providing proper time management, e-Ticketing and affordable travel to its customers. Besides, LCCs would provide point-to-point travel and faster turnaround time as well. Use of secondary airports helped LCCs avoid congestion and reduce grounding charges which in turn decreased their operational cost thus enabling them to provide tickets at lowest possible prices.
LCCs used lesser cabin crews, thus minimizing administrative and operational costs. With minimized grounding time more flights could be scheduled which generated more revenue for the firms. They also eliminated the concept of premium, executive and economy class and provided only one class for travel. Gradually, LCCs were implementing the strategies and policies that they gained through second mover advantage i.e. the weaknesses of traditional airlines were being eradicated in LCCs that would in turn become the strengths of LCCs.

Business Model

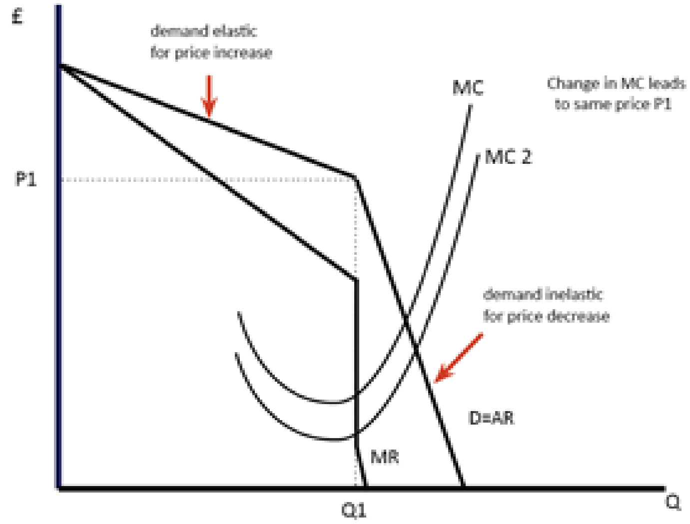
Business Model/Concepts	Traditional Airlines	Low Cost Carriers
	Modern and Customer Oriented	Selling and Production Oriented
Product/Service Concept	Different Transport class for customers Primary airports Seat Assignments	Single Passenger Class Operating from secondary airports No Special services

Communication Concept	Loyalty Program	Selective advertising Emphasizing communication on prices
Revenue Concept	Ticket sales biggest source of return Complicated/ High Fares	Price differentiation w.r.t Time/Demand Increasing revenues by focusing on volumes
Growth Concept	Conventional Product quality as a national carrier	Growth as long as it is efficient
Cooperation Concept	Cooperation in order to cover regional flight offerings	Vertical cooperation to generate marketing provisions

Law of Demand and Oligopoly market structure

According to the law of demand, when the price of airplane tickets decreased, buyers raised their desire for more tickets. Airlines were able to fill more seats by offering cheaper tickets, which enhanced the industry's efficiency by better utilizing existing aircraft. However, one unforeseen result of decreased prices and increased consumer demand was a drop in flight quality. Airlines began offering business class seats at a premium to satisfy passengers who desired a flying experience similar to that of the pre-deregulation years. These seats are a few hundred dollars more expensive than ordinary airfares, but they come with greater space and in-flight services. While airlines have the freedom to improve service quality and charge more fees to consumers, despite the lesser-quality flying experience, choose lower airfares. This preference incentivizes airlines to adjust their flights to the average flyer, making business class the exception rather than the norm.

The growth of low-cost flights has pushed the airline industry, which was arguably an **oligopoly**, trying toward monopolistic competition. The airline industry is characterized by an oligopoly market structure, a form of imperfect competition in which a limited number of firms dominate the industry.Oligopoly firms have market power in setting or altering prices for their products by establishing various output levels. Since oligopoly firms produce similar outputs and compete with their industry rivals, any action an oligopoly firm takes is noticed by its competitors. Consequently, rivals may react with price-cutting or other attempts to enhance market share. Thus, the firms in an oligopoly are interdependent, and each recognizes that its market power is vulnerable to erosion by competitors or new market entrants.



At P1, if firms increased their price, consumers would buy from the other firms. Therefore, they would lose a large share of the market and demand will be elastic. Therefore, firms will lose revenue by increasing the price.

If firms cut prices then they would gain a big increase in market share. However, it is unlikely that firms will allow this. Therefore, other firms follow suit and cut-price as well. Therefore demand will only increase by a small amount: Demand is inelastic for a price cut and revenue would fall.

Challenges faced by LCC and TA

Though LCCs were beginning to dominate the market of the aviation industry, they too were facing various challenges. Changing preferences of customers (value market segment) and violation of ethical standards and safety norms and rights of passengers by the LCCS were their major concerns. Although LCCs were gaining attraction they lacked even the primary facilities like refund of fares, assurance of proper baggage handling, monitoring of safety gadgets, booking and occupancy check, and so on. LCCs were accused of having substandard customer service, from being accused of intentionally delaying flights to meet their occupancy, to reporting their occupancy incorrectly which led to the stranding of passengers in the airport, LCCs' compliance was under scrutiny and subject to inspection from aviation regulations.

As customers began to realize hidden charges incurred: cost involved in baggage handling, food and check-ins, extra payment for priority seats, cost of travelling to and from the main cities to the secondary airports of budget airlines and charging higher on return flights, LCCs were no longer praised for their reasonable prices.

Besides, LCCs were said to be the contributors of pollution and global warming as well.

As LCCs, with the whole aviation industry, were facing the challenges, LCCs started applying strategies to tackle these challenges.
They started buying new planes that were known to be more eco friendly. They also reduced the number of check-ins and gate staff. Customer satisfaction was being met by employing efficient processing staff. Most importantly they started addressing the needs of the new value market segment as customers were looking not only for reduced prices but also some quality services.

Not only LCCs but Traditional Airlines were also facing even more significant challenges. Besides challenges brought about by LCCs, increasing debts, hike in fuel prices and union aggravated problems were to name a few. Just for instance, American Airlines was reported to be spending $33 million for every cent rise in the price of each gallon of jet fuel.
Increase in price of one factor (oil price) obliged traditional airlines to reduce their cost through other means such as laying off of employees, reduction in pensions. This somehow reflects the <u>input substitution where, with an increase in the cost of one factor of production, isocost line becomes steeper and the producer is obliged to choose a different combination of factors of production.</u>

After LCCs started gaining popularity and market share, Traditional Airlines underwent various strategic changes. They implemented the Hub and Spoke model with aims to reduce cost. However, it didn’t prove to be an effective means to meet their objective. They even launched their own LCC airlines subsidiaries to remain competitive. However LCCs launched by established airlines were affected by the same problems as experienced by the major carriers. They cut the jobs and reduced the pensions only to realize their negative consequences. And as last resorts, they opted for alliances, mergers, and partnerships with other airlines, which didn’t bear fruits either. Critics argued, they should restructure their business and pricing strategies; which led them to implement “sweating the assets” and “the yield management system” that basically meant maximum utilization of fixed assets and fluctuation of fare rates depending upon the demand of seats respectively. They were also suggested to enhance their key strengths: clean interiors, excellent facilities, cozy seating, proficient cabin crews, good food and entertainment and overall quality rather than emulating the LCCs to stay ahead in the race.

Solutions

In oligopoly market structure, since companies are interdependent to each other, and each recognizes that its market power is vulnerable to erosion by competitors or new market entrants, the airline industry in global arena has undergone a major shift and Low Cost Carriers (LCC) came as a new entrant in the already seasoned industry of Traditional Airlines (TA) and created ambiguity in the aviation industry. But LCC and TA have realised over time that both carrier models need to co-exist, revise their product strategy, practice ethical standards, thrive and prosper together in order to achieve the overall sustainability of the industry in the long run.

Since, total revenue is the product of price and quantity, airliners need to realize that increasing customer number or base is not the only way to maximize revenue. Rather, one can opt for higher prices by addressing the higher income and value market segment and still generate the same or even higher revenue by catering to the same or even less number of customers.

Traditional Airlines can focus on their customer base of superior/leisure flyers whereas LLCs can continue doing what they are doing while improving their shortcomings mentioned above. Moreover, LCCs can also introduce new service lines to address the needs of the value segment market, which is said to hold 60% of the market, and thrive to achieve economies of scope along with the economies of scale. Meanwhile, the traditional carriers could also endeavor service mix where they do not change their original customer base and strategy but also provide LLCs to the existing demand in the market.

Managerial Implications

Thus, to sustain in the competitive market of the aviation industry, as a firm one should always comply with legal and regulatory standards and then only apply strategies for profit maximization. Addressing the proper market segment and choosing the right combination of inputs is the mantra to reduce cost and maximize revenue and thus maximize profit. Hence, as of now, both LCCs and TAs need to revise their segmentation and pricing strategies first and then work out on ways to reduce cost without violating the aviation standards.

Consumer based models can be implemented with some sort of customer rights provided to the Aviation customers by government regulation, such as rights to refund if flight is overbooked,insurance coverage and safety standards.

Competition in the Aviation industry rocks the boat but that encourages competitive prices, and promotes customer value.

References

https://en.wikipedia.org/wiki/Low-cost_carrier
https://www.investopedia.com/articles/investing/022916/economic-analysis-lowcost-airline-industry-luvdal.asp
http://www1.skyeurope.com/EN/Default.aspx?CatID=36