Strategy

Low Cost vs Legacy – definitions get cloudy

Strategy: Low Cost vs Legacy – definitions get cloudy

EasyJet – the British-born low cost airline that launched in the mid-90's with the slogan 'flights as cheap as a pair of jeans' – announced record profits of 686 million pounds in 2015. That was 18% above its previous year's results and its 5th record profit in a row. Southwest Airlines, the U.S. low cost airline that started it all in the 1970's with hostesses in orange hot pants and white go-go boots, also finished 2015 with record profits of 620 million U.S. dollars. It was Southwest's 43rd consecutive year of posting a profit.

While these low cost carriers (LCCs) are making profits, legacy airlines are struggling to cut costs and increase margins. Low fuel costs have helped the legacy airlines' bottom line in recent years, but profitability has been far more variable than for LCCs.

Disrupting the market

Low cost airlines disrupted the traditional air travel market, changing the concept of a domestic flight from a luxury to a commodity. They focused on short-haul flights, leaving the costly long-haul flights to the legacy carriers. As the low cost carrier market has matured, however, the gap between low cost and legacy airlines services has narrowed significantly. In recent years legacy airlines have watched their markets erode, they cut costs and services in an attempt to match the competition. Meanwhile, the no-frills airlines have become successful, and begun to introduce a few fancy ruffles, if not fully fledged frills – like assigned seats and perks for business passengers.

The LCC sector took off in new markets as well. According to the Center for Asia Pacific Aviation, the region's LCC fleet increased 50% from 2013 to 2015 in Southeast Asia, from 400 to 600 aircraft. AirAsia, the leading Asian LCC based in Malaysia, was voted World's Best Low-cost Airline at the Oscars of the aviation industry, the Skytrax Awards, for the 8th year in a row in July 2016.

While these low cost carriers (LCCs) are making profits, legacy airlines are struggling to cut costs and increase margins.

New profit model

Low cost carriers developed a new profit model for air travel. They cut costs in a myriad of ways. Specifically, they cut fleet costs by using one type of aircraft with minimal additions (seats on Ireland's Ryanair planes, for example, did not recline or have seat back pockets to reduce weight and maintenance costs). They hedged gas price contracts to smooth their fuel

costs. They cut labor costs by hiring less experienced staff at lower pay grades. According to The Economist, one Indian low-cost carrier hires only female flight attendants because they are on average 10–15kg lighter than men. Such parsimony pays off. Fuel accounts for a third of an airline's costs and every kilogram thus shed removes $100 from an aircraft's annual fuel bill.

Many ways to cut

LCCs cut passenger amenities to the bone, offering no inflight entertainment and charging for each service including food, beverage, luggage, pillows, blankets – even debating the merits of charging for bathroom use. They cut airport fees by ensuring planes spent less time on the ground, using secondary airports instead of major hubs and avoiding jetways that attract high usage fees. The result was an ability to cut prices – sometimes to as low as zero (excluding taxes and charges) – with simple fare structures such as one-way fares priced at half return fares and seat prices that increase as flights fill up. For some time, all that cutting allowed the LCCs to offer what European guide book publisher and media personality Rick Steves called "remarkable, it-must-be-a-typo deals".

Major shake-ups, and more to come

The shake-up has led to several dramatic shifts. Delta and Northwest Airlines have merged. Legacy airlines like Lufthansa have acquired their own LCCs (Eurowings). United failed in building a low-cost brand (Ted). Over time, the price gap has even slightly closed between low cost and legacy airlines. Analysis by The Economist in May 2013 showed it cost a typical legacy carrier 2.5 cents more to move one seat through the air for one kilometer (0.6 miles) than it cost a low cost carrier – but that was down from a 3.6-cent premium in 2006: "The cost gap between traditional and budget airlines has fallen by an average of 30% in six years, partly because legacy airlines have abandoned old differentiators like free baggage and in-flight catering on short-haul flights."

For customers, the price of a flight has dropped more than 20% since 1995. Customers are winning; for airline shareholders the story is less clear. Airline stocks are down an average of more than -15% to mid 2016, "and if you include all of 2015 the average is worse than -20," according to Forbes.com.

With cost cutting being the only game in town for airlines, further innovation in the industry is likely. Suggestions like containerizing passengers and crew in portable cabin pods that are loaded into the plane in minutes is one suggestion. Whatever technologies are employed, however, the overall impact of the LCCs means the search for lower costs will continue until the next big disruption in the industry.

... the gap between low cost and legacy airlines services has narrowed significantly.