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EXECUTIVE

## Insights

## Here for the Long Haul: Low Cost and Legacy Carriers Really Can Coexist

Media reports of the inevitable demise of legacy airlines are somewhat exaggerated. While legacy carriers have clearly lost market share to low cost carriers (LCCs), the two types of business models continue to serve distinct market needs. Although LCCs have driven down fares, legacy carriers offer much greater network coverage and broader product offerings.

Over the past year, legacy carriers have made major strides in addressing their cost issues to become more competitive with LCCs. As costs continue to rise, LCCs will be forced to raise fares to preserve their margins and justify their relatively high current market capitalization levels. We believe that these fare increases will set the stage for ongoing coexistence between the two business models.

### Should the Prevailing Wisdom Prevail?

The prevailing wisdom among some market analysts implies that today's legacy airline carriers will not be around for the long haul. Over the past several years, we have seen many large providers such as United, American, Delta, Northwest and U.S. Airways experience one bad turn of events after another. Higher fuel costs, strained labor relations, the economic recession, and the fallout in passenger traffic since the September 11th attacks have devastated this segment of the airline industry. As a result, many carriers have been forced to cut back routes or file for Chapter 11 bankruptcy reorganization in an effort to stay afloat. The popular wisdom is that a few of the current carriers are unlikely to survive.

One segment that has garnered a significant share of media attention has been LCCs, an umbrella term that encompasses such airlines as Southwest, JetBlue, Frontier, AirTran, ATA, and Spirit. The US LCC segment has grown at over a 15% Compound Annual Growth Rate (CAGR) since 2001, and Wall Street analysts forecast

that they will continue to grow at a steady 16% a year through 2008. Excluding any new routes from this forecast, this suggests that the market expects LCCs to achieve a 12.6% CAGR during this same period based solely on revenues from their existing routes.

LCCs have been able to carve out a lucrative niche within the air travel industry by taking away market share from the large legacy carriers. In fact, most legacy carriers have seen a significant portion of their markets penetrated by the LCCs, with United and American suffering the highest penetration from this group. By 2003, approximately 80% of their domestic passenger revenues were on routes where they had already seen significant penetration by LCCs—more than any other legacy carrier.<sup>1</sup>

<sup>1</sup> U.S. DOT DB1A Database 2003

*Here for the Long Haul* was written by John Thomas, Vice President and Air Transport Practice Leader in L.E.K.'s Boston Office.

LCCs have been able to realize rapid market share growth due in large measure to their ability to translate a lower cost structure into driving down ticket prices as they enter new markets. According to the U.S. Department of Transportation, approximately 36% of the LCC cost advantage comes from labor cost savings alone.<sup>2</sup> In stark contrast, legacy carriers have been struggling with the repercussions from higher senior pilot wages, union contract commitments and pension payouts for retirees. When combined with the impact of the recession and the turmoil associated with highly public layoffs and re-structuring, these trends explain why many in the media have predicted the demise of the legacy carriers.

Just when industry pundits are predicting a sunset for the large legacy carrier segment, though, there are indications that there may be a brighter dawn just over their horizon. Given the growing operating costs for all carriers, such as the recent steep rise in fuel costs (which reduces the traditional cost advantage of the LCCs), there are indications that the ability of LCCs to maintain their current growth levels over the long term may be somewhat unfounded. Recent research conducted by L.E.K. Consulting has revealed that the low ticket price advantage that has been responsible for contributing to LCCs' initial market share gains will be less of a factor and more difficult to maintain in the future. In order to

maintain their present growth rates, LCCs will need to seek additional revenue-generating strategies—a much more difficult approach to take than lowering fares.

A close examination of just how LCCs have gained market share at the expense of legacy carriers reveals a picture of how these two segments will evolve over time. This analysis can be valuable for both LCC and legacy carriers alike because it can help them more effectively develop their future market strategies. Southwest Airlines serves as a good illustration. As the most successful of the LCC group, once Southwest becomes more established in specific markets through a strategy of lower fares, the carrier is able to establish a strong share position. As it becomes more established, Southwest begins to increase fares in these same markets to increase operating margins.

It is revealing, however, to explore whether or not this model is sustainable.

## Can Southwest Maintain Its Current Strategy?

To gain a deeper understanding of the impact that LCCs have had on the legacy carrier market, L.E.K. Consulting focused on the competitive relationship between Southwest Airlines and several of the legacy carriers. L.E.K. analyzed the Southwest Airlines business model over a three year period to observe and quantify exactly how the LCC consistently captured market share from the incumbent carriers. Southwest was chosen for the study because of its proven track record of growth and profitability. While other LCCs may have demonstrated initially strong market share growth and/or brand recognition, most have shown inconsistent financial results, eliminating them from consideration.

**Table 1—Factors for LCC Route Entry into Legacy Markets**

Criterion	Description
<b>Leisure Route</b>	Leisure travelers are more price sensitive than business travelers.
<b>Large Market Size</b>	Higher revenue routes provide more upside potential.
<b>Distance</b>	LCCs are increasingly targeting medium and long hauls.
<b>High Yield</b>	LCCs have more of a competitive advantage relative to mainline carriers in high yield routes.
<b>Low Market Competition</b>	Routes dominated by fewer carriers are likely to provide more opportunity for LCCs.
<b>Existence of Alternative Airport</b>	LCCs seek less congested airports of small cities and smaller, less congested airports of large cities.

<sup>2</sup> Source: U.S. DOT—Form 41

For this study, L.E.K. examined the activity on 285 Southwest routes, which were identified as instances where Southwest was either established in a market or entered an incumbent's market,<sup>3</sup> between 1997 and 2000 (i.e., before the destabilizing effect of 9/11). The data was collected from public filings to represent airline revenues accurately. L.E.K. used this information along with a proprietary data analysis model for the top 2,800 Origin and Destination (O&D) routes, representing approximately 82% of total U.S. airline revenues.

To determine the likelihood of future route expansion by an LCC into an existing legacy route segment, L.E.K. also established six criteria to assess the vulnerability of legacy market entry by an LCC. (See Table 1).

### What Does the Data Suggest?

The results were divided into two categories, which are shown in Tables 2 and 3. The first, entitled Impact of New LCC Competition on Yield, shows the effect that Southwest had on the incumbent's yield when Southwest entered the route during the three year period. The second table, entitled Impact of Established LCC Competition on Yield, shows the effect that Southwest had on the incumbent's yield once Southwest was already established and had a sizeable presence on the route.

**Table 2—The Impact of New LCC Competition on Yield**

WN Share (1997–2000)	Avg. of WN Share (1997–2000)	Avg. % Change in Legacy Yield (1997–2000)	Number of Routes
<b>10–20%</b>	<b>14.2%</b>	<b>(11.9%)</b>	<b>18</b>
<b>20–40%</b>	<b>26.6%</b>	<b>(15.0%)</b>	<b>12</b>
<b>40–100%</b>	<b>72.8%</b>	<b>(24.1%)</b>	<b>15</b>

Simply put, yields tend to fall for legacy carriers following the entry of LCCs into their markets. For example, when Southwest enters a market and establishes a 26.6% market share within 3 years, legacy carriers undergo an average 15% drop in yields. This drop increases with the share captured by the LCC in that market.

Interestingly, this trend appears to change—up to a point—once LCCs are established. Once the LCC has captured reasonable market share, the

legacy carrier can benefit from a rise in yields. Table 3 reflects this shift: when Southwest had established an average 12% market share, legacy carriers also enjoyed an increase in their yields of around 12%. This trend did not hold, however, if an LCC was able to capture more than 20% of the market. Once this happens, the LCC's presence tends to produce a slight decrease in yields for the mainline carriers in the same market over time, but nowhere near the level of the initial decrease in yields.

**Table 3—The Impact of Established LCC Competition on Yield**

WN Share (1997–2000)	Avg. of WN Share (1997–2000)	Avg. % Change in Legacy Yield (1997–2000)	Number of Routes
<b>10–20%</b>	<b>11.5%</b>	<b>12.3%</b>	<b>58</b>
<b>20–40%</b>	<b>27.1%</b>	<b>(4.7%)</b>	<b>29</b>

<sup>3</sup> LCC routes greater than 5% O&D market share

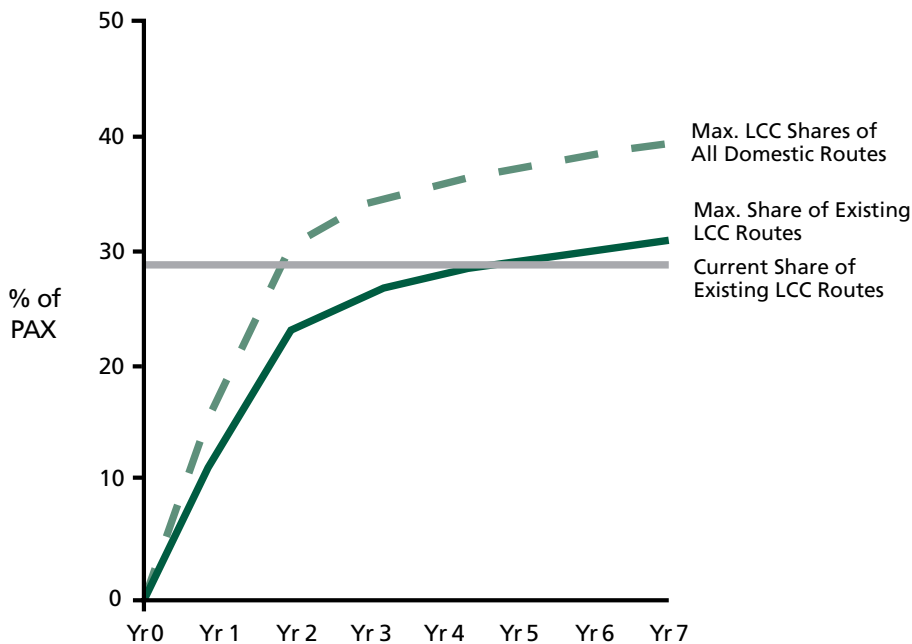
L.E.K.'s analysis also concluded that LCCs appear to be approaching market share saturation within their existing routes. In fact, after the third year, Southwest's penetration rate begins to flatten and stabilize. To better understand the implications of this trend, L.E.K. used this data to extrapolate LCCs' likely route penetration across the entire US domestic market over a seven-year period (See Figure 1):

over 35% market share. While LCCs can still achieve a higher overall penetration rate by expanding into new routes (which they inevitably will do), there is a rapidly decreasing number of attractive routes for them to enter. As LCCs enter and penetrate these additional markets and routes, they are likely to stabilize at an overall eventual market share of approximately 45% across the US network.

In order to meet Wall Street's 16% growth expectations (implicit in their current market capitalization), approximately 1,150 new routes would have to be added over the next five years—a difficult bar for LCCs to reach. A more realistic estimate would be 250 new routes (50 per year), yielding an incremental revenue growth rate of around 3% per annum. L.E.K. estimates that the LCCs will more likely achieve an overall 12% total revenue growth rate generated from a combination of existing and new route penetration.

**Figure 1—LCC Projected Share Penetration of Existing LCC Routes and All Domestic Routes**

(Approximately 80% of all O&D Routes\*)



Note: \*Represents 2,773 city pairs comprising 82% of O&D Routes by Revenue  
 Source: O&D Plus, Morgan Stanley, RBC Dain, Raymond James, Smith Barney, Value Line, L.E.K. Analysis

LCCs still have room to grow within their existing routes, but the data suggests that LCCs are nearing a stabilized penetration level on these routes. For example, while current results show LCCs at approximately 29% overall market share today, L.E.K. Consulting predicts that on these existing routes, LCCs' will not attain much

These results indicate that LCC growth within their existing markets is more likely to grow at a much lower rate going forward. Future growth can still be achieved, but it will have to be obtained through new route expansion (and not from continuously taking share from legacy carriers on routes where they have already penetrated).

If the LCCs can only achieve this lower growth rate (i.e. 12% vs the market's expectations of 16%) then, in order to maintain their current market capitalization, they will have to resort to margin enhancement—achieved through either cost reductions or yield increases. Cost reduction will be difficult given the current fuel environment and recent labor rate increases at the LCCs. Therefore, the only tool left for LCCs will be yield increases that will erode their competitiveness with the legacy carriers.

**Renewed Competition and Coexistence**

LCCs have made a significant impact on the global airline travel industry. But their initial strategy—growing market share based on lower costs and lower yields—is beginning to generate smaller returns within the U.S. market. As this trend continues, it will become increasingly obvious that there is room in the market for both LCCs and legacy carriers to coexist.

To maintain future growth that is in line with Wall Street expectations, LCCs will need to focus more on margin management. LCCs will have to implement strategies that generate higher gross margins in order to maintain their current level of market capitalization: higher ticket prices, new routes, new sources of revenue, new products, etc.

On the other hand, legacy carriers that have made significant strides to lower operating costs will be in a much better position to compete with the LCCs and regain some of the market share losses they incurred over the past eight years. Of course, this does not eliminate the need for legacy carriers to be savvier about their market strategies. They must identify and re-assess their most lucrative network segments and determine how to defend them from further LCC penetration in order to maintain the profit levels necessary to have a more secure future within the industry.

L.E.K. has the following suggestions for LCCs and legacy carriers based on the results of this study:

- **LCCs Should Consider Additional Growth Strategies**—Current projections show slower market share growth for LCCs. To maintain growth and meet Wall Street and investor expectations, LCCs need to develop additional strategies designed to grow margins and improve shareholder value. Implementing additional strategies that will yield the same degree of success as the low cost/low yield model will be challenging. LCCs may be forced to consider strategies

that include enhancing their products, increasing yields by going into thinner regional routes (requiring a change in the business model) and finding other sources of revenue in order to minimize any negative impact on shareholder value.

- **Legacy Carriers Should Carefully Evaluate their Existing Markets**—Over the next five years, legacy carriers need to assess their current and future market strategies to gain a realistic appraisal of their potential revenue contributions. Market segments that show consistent growth and will generate higher gross margins should be heavily fortified and defended with more effective marketing programs and competitive ticket prices where appropriate. Legacy carriers also have the opportunity to eliminate additional costs by further simplifying their operations and by re-thinking how they can offer the same levels of enhanced in-flight services but delivered through different mechanisms. Additionally, the US legacy carriers have international franchises that they can and should more effectively leverage.

As L.E.K. research has shown, the legacy airline carrier segment has the potential for future success despite a great deal of media attention and opinion to the contrary. With the results from this research, L.E.K. has concluded that there are a number of additional factors that indicate legacy carriers may very well be competitive for the long haul.

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As a leading strategic advisor to the air transport industry, L.E.K. has worked on many of the key issues driving future success for clients in all major geographies, including: how to maximize cashflow from existing programs; how to prepare for the next stage of consolidation as customer demands broaden across geographies and the costs of capability continue to rise; and how to develop the critical technical and management capabilities for success.



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