



Airline ‘No Man’s Land’

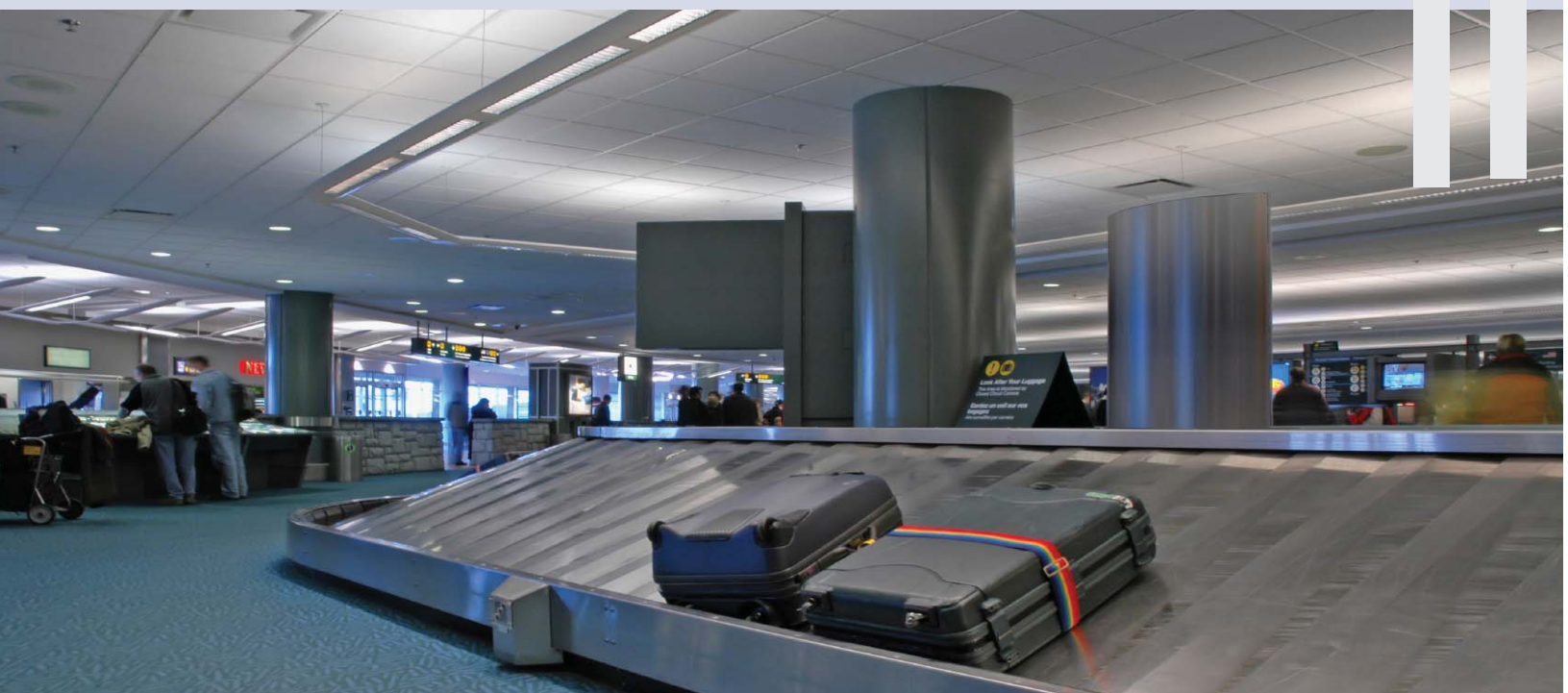
The crisis faced by traditional hub carriers and how to escape it

If you're being chased by a lion, you'd better be quick and agile like a gazelle, or powerful and impressive like a rhino.

If you're in the retail business, it pays to be either super-efficient like Walmart, or plush like Neiman Marcus.

In the airline industry, if you don't have low costs or a great product and service, then you're in 'No Man's Land' and business is either tough or about to get very bad indeed.

Fortunately you **can** escape. But don't forget: your nearest exit may be behind you.



The big squeeze

Why is this happening?

The simple answer is that full service carriers are caught up in the impossible task of trying to be all things to all people. They are relying on a single product to serve both premium business passengers and budget travellers. On board, the same seats, meals and flight attendants and on the ground, the same reservations call centre staff, check-in processes and the same loyalty programs are all expected to do double duty for those seeking a top-level experience as well as those on a \$10-a-day vacation.

The expense of maintaining the illusion of limitless service for full-price ticket holders makes it near impossible for traditional carriers to compete with low-cost carriers' low costs. And because there is a real limit to the service they can afford to offer, they also can't extract the same price premium that premium carriers enjoy. As every business person knows, high costs and low prices are a recipe for disaster.

Worse still, as traditional carriers' profits evaporate, so does their ability to invest in the next generation of aircraft and systems that might go some way to helping them out of their misery by providing lower running costs as well as a better experience for passengers.

Pressure from below: the low-cost carrier model

By contrast, low-cost carriers know exactly what they are offering and to whom. They know their customers are willing to forgo the traditional 'frills' of flying in exchange for a much cheaper ticket. Don't even bother asking for a newspaper or a pillow, and in the dry, thin, stuffy air even a bottle of water will require a cash payment.

The mantra of the low-cost carrier is rigid adherence to the schedule. By turning around their aircraft faster, they can get more flights per day than traditional airlines and drive down their cost per flight. So low-cost carriers get their passengers to departure gates earlier than traditional carriers by allocating seats on a first-come-first-served basis. Anybody who has been forced to go to a gate early to line up to get a seat near the front of a plane will bear witness to that. Making schedule means no overtime pay, no unexpected staff layovers and no airport penalties, all of which can erode profits. If that means herding passengers like cattle into their seats 30 minutes before departure and dumping bags on the tarmac at the other end, then so be it. As Ryanair's Michael O'Leary is fond of saying, 'it's a bus'.

Not everyone wants to travel this way, and it is doubtful that low-cost carriers could survive simply by providing a cheap alternative for existing passengers. The beauty of the low-cost carrier model is that it has created its own market as well. In Europe, a Londoner can travel to Venice for the weekend for less than the cost of dinner and a movie. At those prices, it's easy to keep full planes in the air.

For traditional carriers, the loss of passengers to low-cost carriers cannot be made up with creating new markets for travel. Rather, they rely on filling their aircraft with more connecting passengers, who are less profitable and ensure traditional carriers remain shackled to their costly connecting hubs and all the associated costs of baggage sorting, transfer lounges, etc.

A force from above: premium carriers

At the other end of the spectrum, premium carriers provide continual innovation around the customer experience in terms of comfort, convenience and luxury. New ways to delight, new ways to flatter and new ways to relieve or distract from the myriad of pains of air travel. The goal of the premium carrier is no less than to make the flight itself an experience worth paying for. For those who can afford it, there is no better way to travel. For the airlines that can do it well, there is no better way to make money.

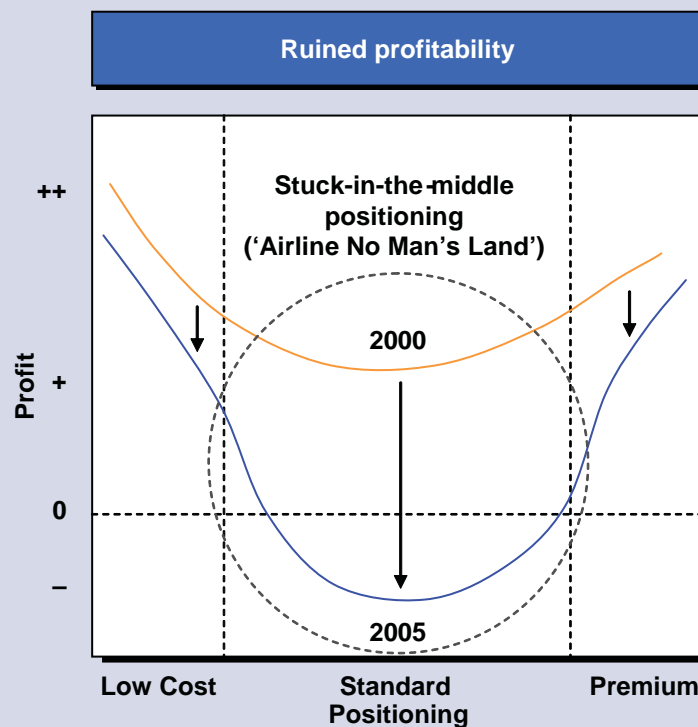
Premium carriers like Emirates and Singapore Airlines have been winning over high-yield customers from traditional carriers with services that traditional carriers simply cannot afford to match. In the all-important business class cabin, for example, yield per square-foot has fallen by around 15% as premium airlines pamper their passengers with fully-flat beds while lesser airlines clamour to stem the exodus from their once top-of-the-line recliners. Business class passengers are now enjoying levels of service that were previously reserved for first class passengers. Even humble economy passengers are learning to expect increased seat pitch and hundreds of video-on-demand choices.

By constructing highly networked hubs, premium airlines can aggregate high-yield traffic from many different markets. Traditional carriers, who carry relatively little high-yield traffic are losing these few passengers to the premium airlines, but more importantly they are losing their largest contributors to their profits.

The results

Between them, these two enemies, low-cost carriers and premium carriers, are squeezing the best sources of value from traditional airlines, leaving little more than barren husks.

Figure 2: Illustration of Airlines' No Man's Land



Question 1: How do I know if I'm in No Man's Land?

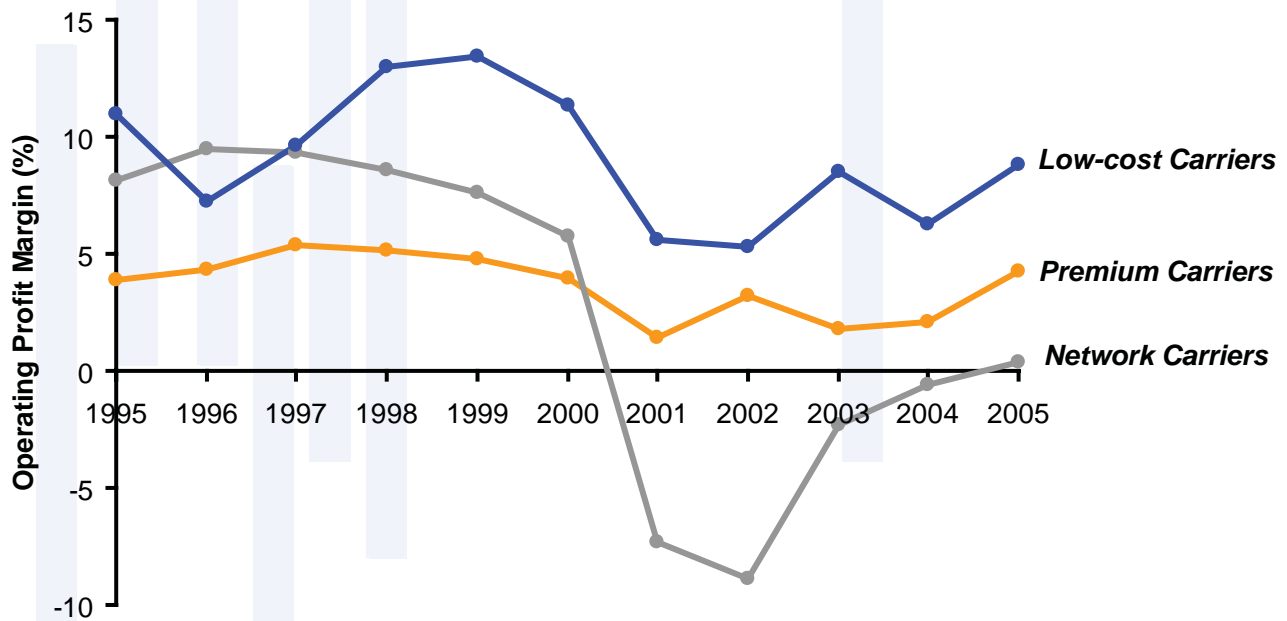
That sinking feeling

- Are low-cost carriers vandalising your yields?
- Are premium carriers spirited away your most valuable customers?
- Are your profits disappearing even as an economic upturn roars into view?
- Do you feel like you're stuck in a never ending cycle of cost-cuts and lay-offs?

It's not just that low-cost carriers and premium airlines are more profitable – they are starting to barge traditional hub carriers right out of the market.

If the answer to any of these questions is 'yes' then you're probably in No Man's Land.

Figure 1: Global Weighted Profit Margin by Airline Category 1995-2005⁽¹⁾



(1) Weighted average operating profit margin

Source: Datastream, Factiva

Question 2: So how can I escape No Man's Land?

It's a hard place to exit

Many airlines have tried to copy their low-cost cousins with little success. Recent airline history is littered with the failed spin-offs of full service carriers.

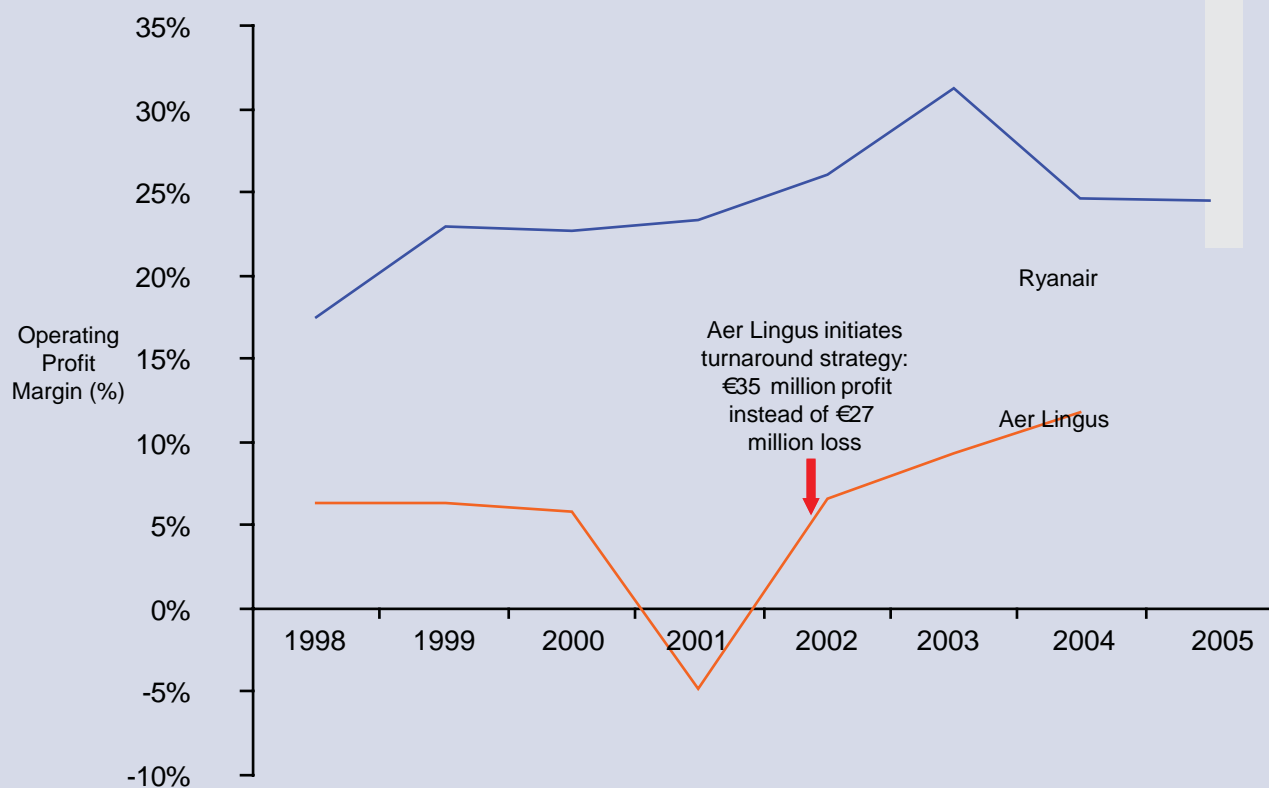
The fortunate few

One of the few airlines to successfully transition to the low-cost model is Aer Lingus. Aer Lingus is the national carrier of Ireland, a small country booming in the wake of European investment. However, it was not an easy transition.

Ryanair first brought the low-cost carrier model to Ireland in 1994 and by 2000 was generating the equivalent of 30% of Aer Lingus' revenues. Together with the losses following 11 September 2001, Aer Lingus was brought to its knees.

Aer Lingus' response was to emulate its nemesis and undertake an extremely painful transformation into a low-cost carrier. A turnaround program was implemented in the first half of 2001 and rapid progress made to achieve its targets: in 2002 they turned around a projected loss of Euro€27 million to a remarkable profit of Euro€35 million.

Figure 3: Aer Lingus and Ryanair Operating Profit Margins



How to become a low-cost carrier:

- Focus on point-to-point passenger traffic and ignore connecting traffic and cargo
- Simplify the fleet to a few (or even one) standard types
- Decrease turnaround times to increase aircraft utilisation
- Strip out cost from every part of the value chain

Gold-plated folly

The opposite challenge, transitioning into a premium carrier, has been even harder to realise in practice.

Ultimately, the risks are very high. The investment required for product development, training and infrastructure can only be repaid with both full planes and price premiums, but this is a combination that proves very hard to realise in practice. It takes time to build loyalty and trust with customers and to persuade them of the value of spending more to fly.

A recent case in point is Australia's OzJet, which launched an all-business class service on the Sydney-Melbourne route, one of the busiest domestic routes in the world and a lucrative business traveller route. Despite a strong economy and good competitor profitability on the route, OzJet lasted just four months before poor ticket sales forced it to suspend operations.

Horses for courses

A different tack has been taken by Australia's largest airline, Qantas. It chose to break up its business into several distinct airline brands. It maintains its international connecting network, but has created separate brands to serve different markets and routes:

- Domestic intercity trunk routes (CityFlyer)
- Low-cost/vacation carrier (Jetstar)
- Small-aircraft regional carrier (QantasLink)

All product and marketing decisions are decentralised within Qantas to the airlines, but operational functions (e.g. maintenance) are largely centralised to exploit economies of scale. While Qantas is still working hard to keep the cost base down, performance to date has been extremely positive. Other carriers around the world have also moved to a segmented model, for example, United Airlines which has created a number of brands (e.g. Ted, p.s., United Express) to compete in different segments.

Figure 4: Shareholder Returns: Qantas Compared to Asian Airlines



How to make a multi-segment model work:

- Create airline brands to serve segments with different needs and to confront the main sources of competition
- Separate major point-to-point flows from the network
- Manage product, distribution and customer flows of the brands separately
- Obtain efficiencies in maintenance, fleet and ground services across all brands

Question 3: What other alternatives do I have?

Air pressure

Most large airlines are simply not in a position to transform themselves into low-cost carriers or premium hub carriers – for example, national flag carriers have a responsibility to act in the best interests of their countries, rather than merely in their own financial best interests. And Qantas' multi-brand model isn't suitable for all markets.

A new operating model

With this in mind, Booz Allen Hamilton has developed a new operating model for airlines that integrates some of the best elements of premium airlines, low-cost carriers, multiple brand airlines and multiple hub airlines. Our resulting toolkit helps traditional hub carriers compete against low-cost carriers and premium airlines.

Step 1. Unmask the real network: Point-to-point flying

Traditional carriers typically carry both connecting and point-to-point traffic, but they configure their business to the connecting passengers, for example, by building their schedule around their connecting windows. But it is point-to-point traffic that generally has the better yields. And it is point-to-point traffic that the low-cost carriers are targeting.

It is no longer possible for traditional hub carriers to continue to treat their best customers as second-class citizens. They must start to separate out the larger point-to-point routes from the rest of their network in order to stay competitive.

Airlines can consider three different routes for separate treatment:

- Intercity trunk routes
- Holiday destinations
- Small regional services

A good example is the London-Munich route. Commuters travelling between these cities find themselves shuffled into the same queues as the mass of connecting travellers, herded onto the same large planes, squashed into the same uncomfortable seats. They even get served meals at odd times of day because some of the passengers' stomachs are still on New York time. What commuter wouldn't prefer the sparse simplicity of a dedicated shuttle?

While point-to-point services are an obvious boon to passengers, the challenge is to maintain efficiency in operations at the same time.

Step 2. Take pressure off the hub: Create 'random' hubs

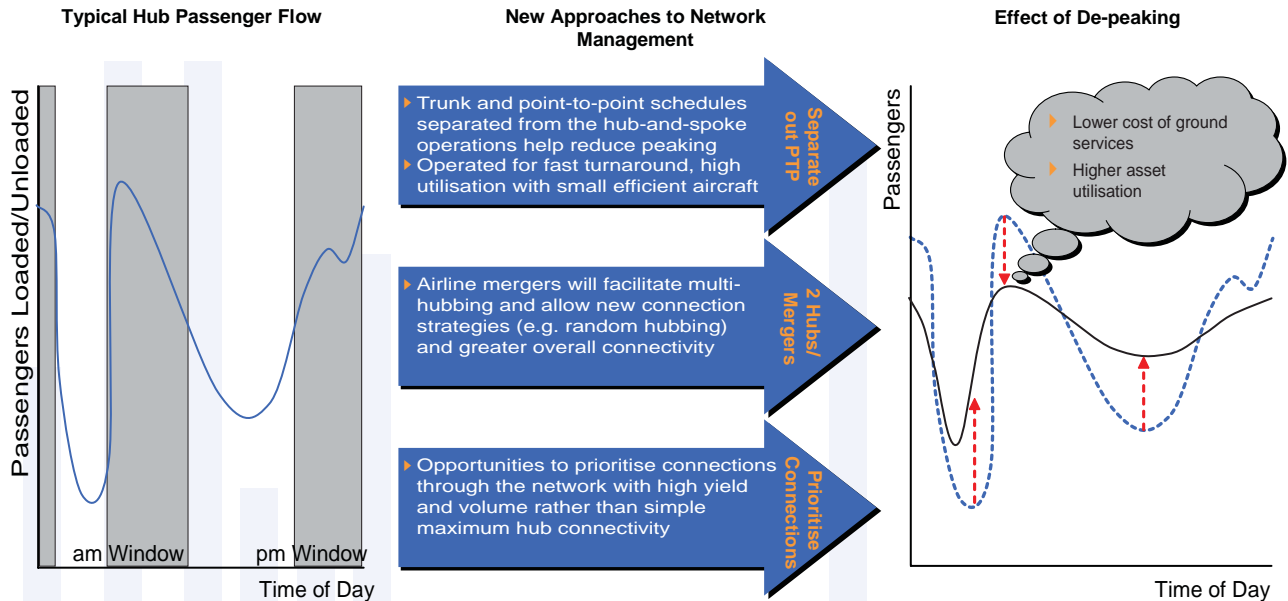
The traditional hub-and-spoke network allows an airline to connect the largest number of cities with the fewest flights. But it suffers from two limitations. First, people generally end up travelling out of their way to go via the hub. Second, arrivals and departures are arranged in 'connection windows' at the hub to maximise the number of connections, but this causes costly peaks in demand for ground services and severe congestion. At its worst, the only way some busy airports can ever make their schedules work is on a perfect weather day with calm air, high visibility and no precipitation.

The solution for many airlines is to use multiple hubs. Often this helps to reduce both problems. Firstly, by putting connections through the most convenient hub, journey distances can be reduced. Secondly, by better allocating the main connections between the two hubs, peaks at each can be reduced and pressures on the hubs can be reduced.

For example, AirFrance-KLM now has two major hubs following its merger – in Paris and Amsterdam. It can exploit this in the way it connects, for example, US to India traffic. Rather than offer connections through one or both hubs, it can serve flights to North India through Amsterdam and to South India through Paris. This spreads the peak demand as well as slightly shortening journey distances.

Further flexibility is also possible. Some connections can be moved to new times, or smaller cities to exploit spare capacity in these cities and get closer to passengers' preferred departure and arrival times. This concept is called 'random hubbing' and while it makes the life of network planners somewhat harder, it can make a big difference to the cost of serving the biggest connecting traffic flows. US carriers have recently been moving down the path of random hubbing.

Figure 5: New Approaches to Network Management: De-peaking and Random Hubbing



Step 3: Give them only what they want: Meeting customer expectations and needs

The logical next step is to look for more opportunities to give groups of customers more of what they want (and less of what they don't). The more closely their individual needs are met, the more loyal passengers are likely to be, and the more willing they are likely to be to pay higher yields.

Premium airlines are masters at understanding what services their customers are willing to pay more for. The key to getting this right is to understand the trade-off between the value of providing additional services and the cost of providing them. Just as important is to understand what costly services can be stripped away for each segment to ensure the overall package is good value for money.

Often national carriers can tailor their services to exploit cultural or behavioural idiosyncrasies in their passenger base that will increase loyalty. For example, differences in passengers' body-shape, aesthetic preferences or taste can be translated into seat selection, décor or meal choices that passengers will prefer. Ground services offer additional opportunities for tailored services: ticketing, ground transport, check-in streaming, lounge facilities and even hotel partnerships can all be a source of service differentiation for particular passenger segments.

Importantly, airlines have an opportunity to move away from the simple three-class segmentation they have traditionally used. A greater focus on customer segmentation may lead to the development of new airline brands for particular routes or passengers. Or to separate passenger streams for ground services.

Segment-focus should see a decentralisation of many of the product and service choices to keep up with changing competitive dynamics within each segment.

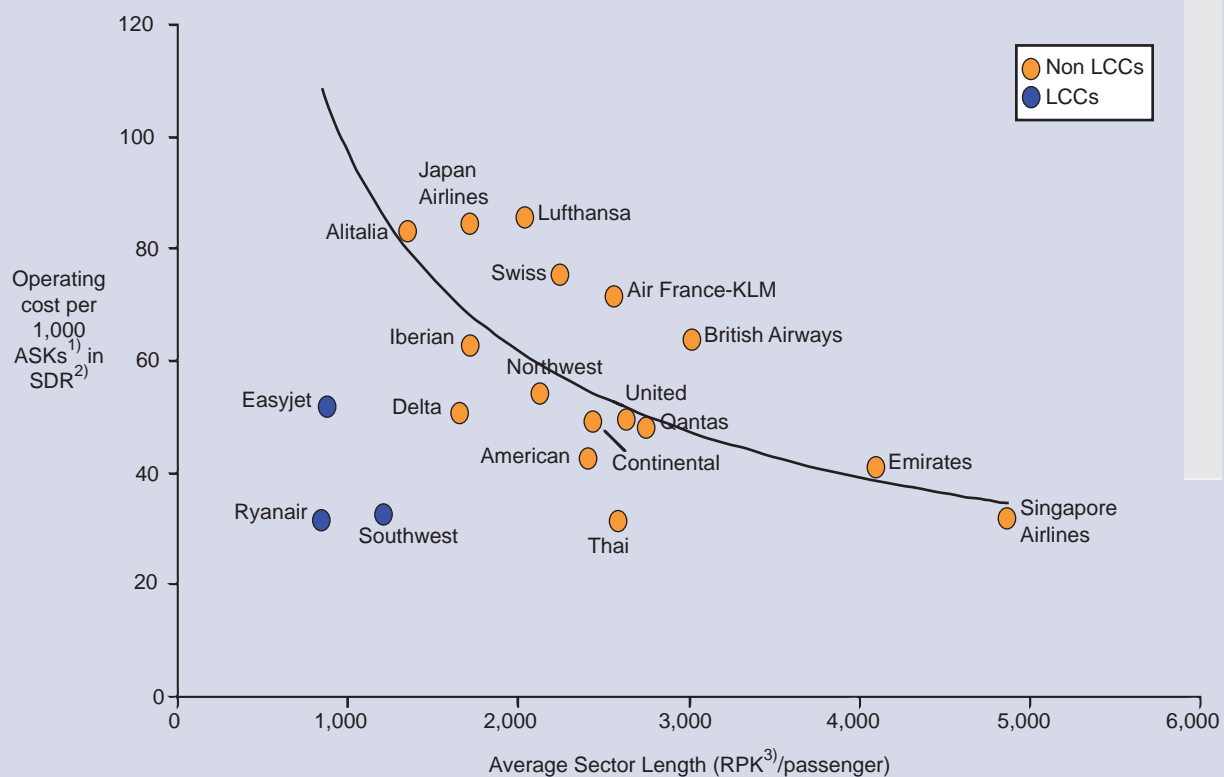
Step 4: Less is more: What everyone can learn from low-cost carriers

The ruthless cost cutting of low-cost carriers has highlighted just how much excess costs most airlines carry. While much of the cost reduction is attributable to using a different business model, there are clear lessons that network carriers can learn:

- The fewer different aircraft types an airline has, the lower the cost
- There is scope to dramatically reduce aircraft turnaround times and increase utilisation
- Ground services offer enormous scope for simplification and automation
- Flexible labour arrangements can help to reduce costs

Perhaps the most important lesson is the ability to continuously improve. The best low-cost carriers are applying techniques more reminiscent of Japanese manufacturing. Traditional carriers can no longer afford to carry their fat – to be competitive they need to get leaner.

Figure 6: Operating Costs - Low-Cost Carriers (LCCs) versus Non LCCs



1) Available Seat Kilometres

2) Special Drawing Rights

3) Revenue Passenger-kilometres

Source: TRL Study: Airline performance Indicators 2005 (2004 data), Annual Reports, Homepages Airlines, Booz Allen Analysis

Booz Allen's approach to cost minimisation

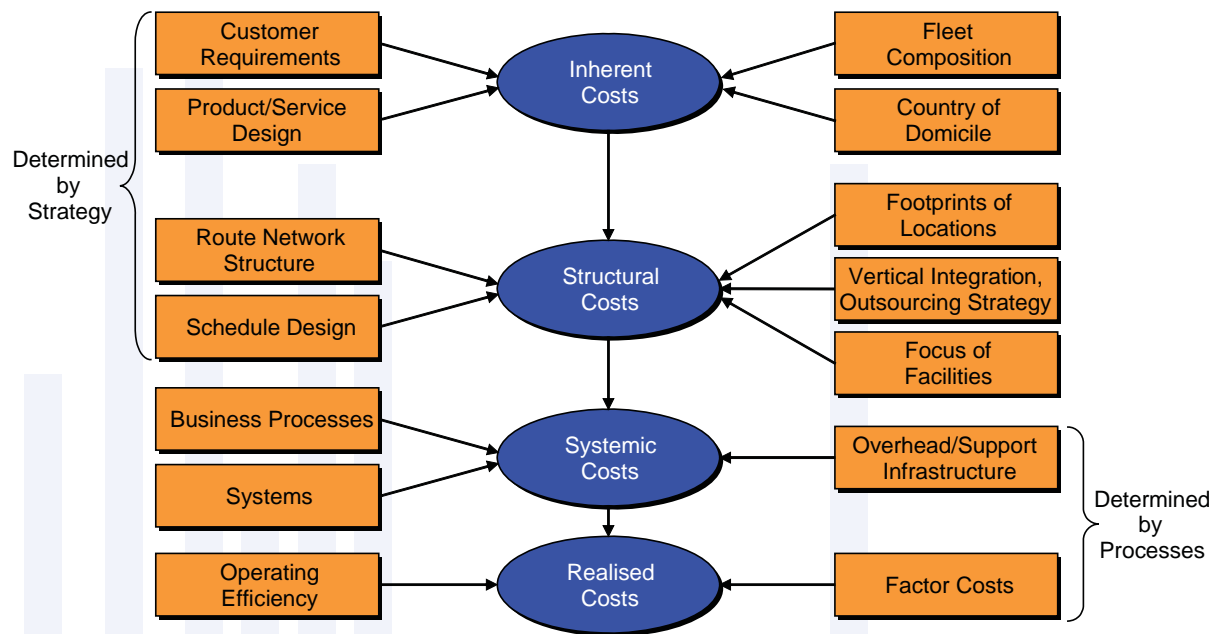
We recognise cost cutting is not a simple task. Too frequently cost reduction efforts are aimed at incremental efficiencies, but fail to recognise that as much as 60% of costs are determined by choices the company makes about the basic business model. Our approach therefore seeks to understand the nature of the drivers of cost; as much effort goes into redefining structural drivers of cost in the business model itself as in identifying low-level cost reduction opportunities.

If traditional carriers want to get their costs close to low-cost carriers, it cannot be solely through cost cutting efforts. They will also have to re-evaluate the way they run their business. To illustrate, it is worth looking a little closer at how low-cost carriers manage to keep their costs so low.

One important business model choice that low-cost carriers typically make is to fly only a single aircraft type. This choice to simplify the business model has a wide ranging impact on cost. For example, maintenance is greatly simplified as spares and equipment are required for only one aircraft type. Training and staffing is simplified both in managing the pilot pool as well as in ground handling. Consistent turnaround times allow for schedules with greater aircraft utilisation.

Overall, Booz Allen's approach is to break an airline's cost structure into four levels of cost driver as illustrated in the diagram below. Each has a different implication for the level of change required to the business model and a different approach to managing the costs.

Figure 7: Drivers of an Airline's Cost Position



We have seen many traditional carriers trapped in No Man's Land that have attempted to reduce their cost base by attacking 'realised' or 'systemic' costs, for example, through improved sourcing, re-negotiating pilot contracts or automating ground operations.

But traditional carriers cannot begin to approach low-cost carrier cost levels until they start to look at the 'inherent' and 'structural' costs in their business models, for example, by restructuring their networks around medium-haul point-to-point traffic, or by focusing on a single customer segment. So far few have been willing to make the change.

Step 5: Share the pain: The benefits of airline mergers

Many smaller or mid-sized airlines cannot generate the scale or cost benefits larger airlines can. So they may need to look for ways to create synthetic scale. Alliances here can help. The problem is that, generally, the global alliances have failed to meet the expectations of their members around cost synergies.

The AirFrance-KLM merger is likely to demonstrate how important scale can be in the airline industry. Some sceptics argued that national interests would get in the way of obtaining any real synergies between the airlines, others, that the new airline would be unmanageable. But so far things are looking good – the airline may prove that big synergies can be obtained through mergers. Booz Allen's research indicates that airlines can save as much as 5%-10% of their total costs by merging with a similar-sized airline.

Most of this saving comes from eliminating duplication:

- Overseas station costs
- IT systems
- Management and planning
- Network rationalisation

Scale benefits are also valuable in many parts of the business:

- Purchasing
- Inventory and fleet management
- Training
- Maintenance facilities

In many cases, airline mergers can also generate significant revenue benefits:

- Improved network connectivity
- Improved marketing and loyalty in key end-markets
- Pricing discipline

The airline industry worldwide is entering an important transition phase in which mergers will become increasingly necessary. Airlines should start to look now to find their most suitable partners.

A workable model

Taken together, these measures add up to a new way of thinking about airlines. It will help traditional carriers on a journey from today's single-hub, single-product monoliths to tomorrow's lean, more decentralised, multi-faceted businesses that can compete effectively against specialist carriers. They will be able to use their size, network and brands to their advantage even while matching the specialists at their own games.



Question 4: Won't the new operating model damage the few strengths I do have?

A justifiable fear of change

Airlines are likely to find the new operating model challenging. Many of its ideas go against long-held industry dogma. And a great deal of change is required in how airlines manage themselves. These fears are fully justified, this is not a change to be undertaken lightly and will involve sacrifice and upheaval. But without it, airlines will remain trapped in No Man's Land.

Managing multiple business streams

The most radical change for most airlines will be the organisational challenge of managing the new operating model. Today, most airlines are highly centralised, with only outstations enjoying limited autonomy. The new operating model's focus on customer segmentation forces airlines to manage differently. There are three elements that must be coordinated:

1. Managing separate process streams, particularly at large airports
2. Managing decentralised business units focused on segment product and services
3. Coordinating different businesses to try to get the greatest possible cost efficiencies

Question 5: Surely such a radical change is very risky?

Yes, changing the way you operate is a tough challenge. But more risky is staying in No Man's Land and allowing low-cost carriers and premium airlines to eat away at your business. The airline industry has historically gone through a series of business model changes - these changes separate the winners and the losers.

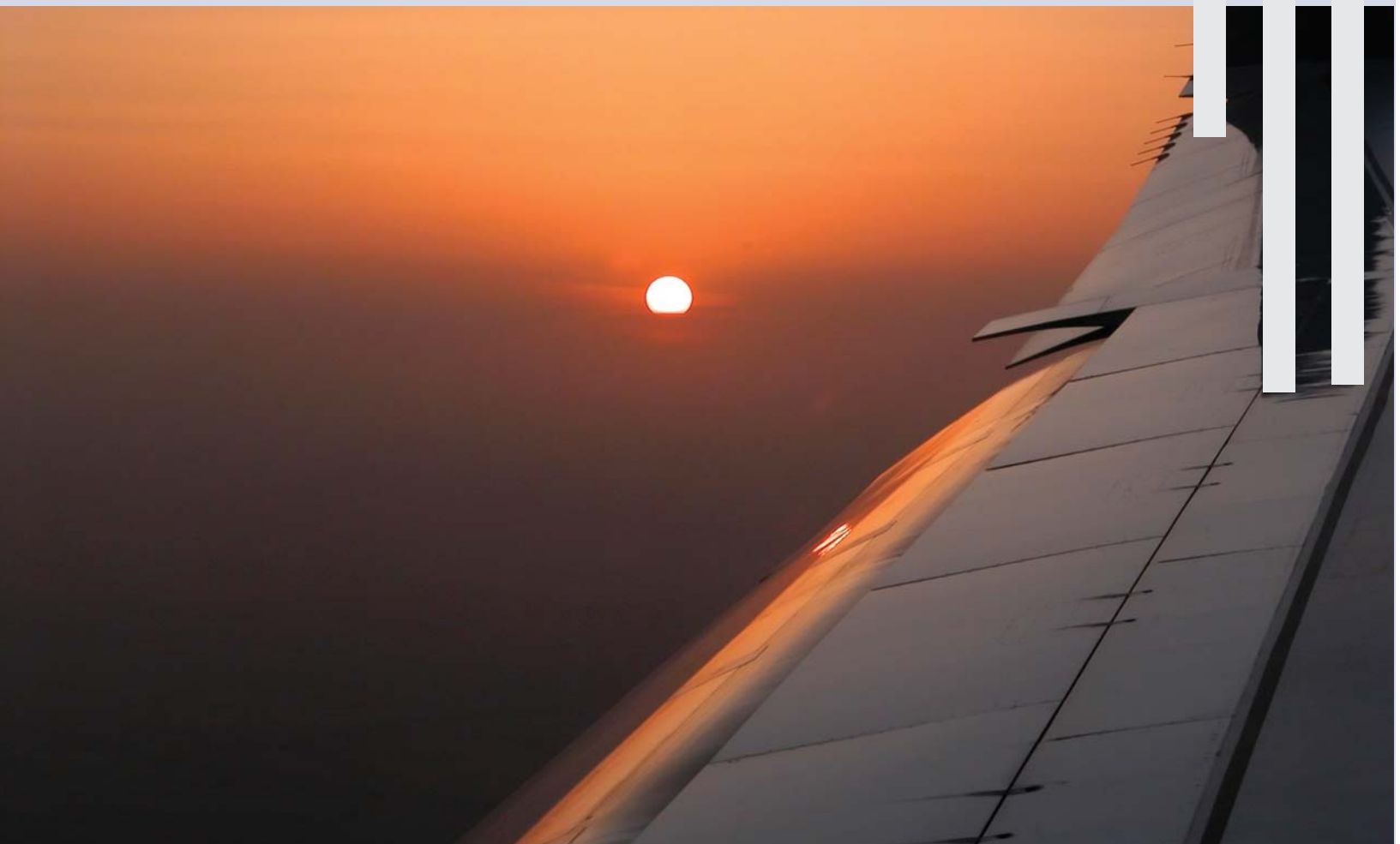
It's time for a re-think - status quo may be the most painful of all outcomes.

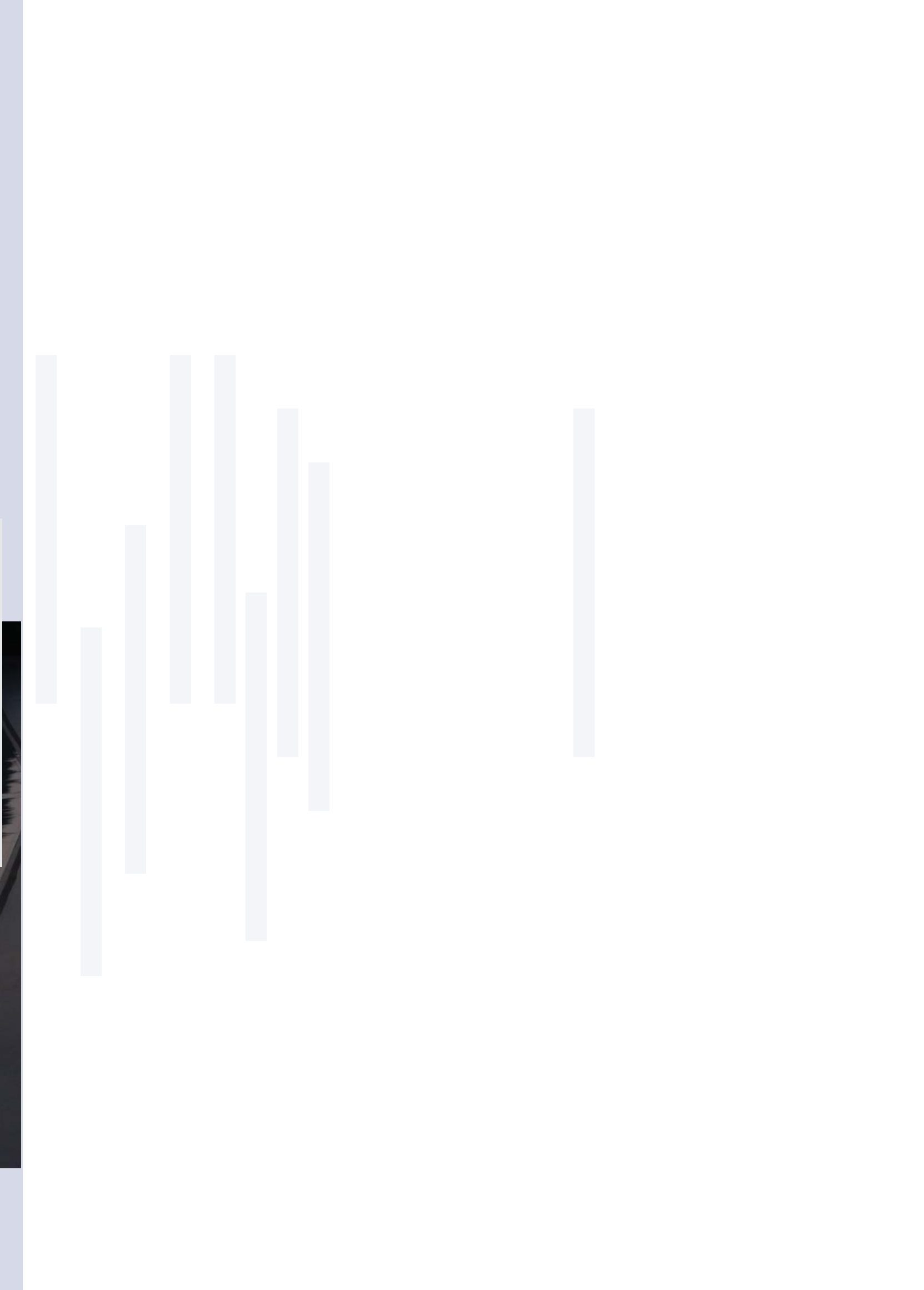
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With 18,000 employees on six continents, the firm generates annual sales that exceed US\$3.7 billion. Booz Allen has been recognized as a consultant and an employer of choice, with Fortune magazine naming Booz Allen as one of 'The Best Companies to Work For'.

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Worldwide Offices

Abu Dhabi Fadi Majdalem 971-2-6-270882	Canberra Chris Manning 61-2-6279-1900	Honolulu Chuck Jones 808-545-6800	Munich Jurgen Ringbeck 49-89-54525-0	Seoul Jong Chang 82-2-6050-2500
Amsterdam Marco Kesteloo 31-20-504-1900	Caracas José Gregorio Baquero 58-212-285-3522	Houston Matt McKenna 713-650-4100	New York David Knott 212-697-1900	Shanghai Edward Tse 8621-6340-6633
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Bangkok Chris Manning 66-2-653-2255	Cleveland Mark Moran 216-696-1900	Lexington Park Cynthia Broyles 301-862-3110	Paris Bertrand Kleinmann 33-1-44-34-3131	Sydney Chris Manning 61-2-9321-1900
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Contacts:

Australia/South Pacific
Chris Manning
61-2-9321-1900

Central Asia/China
Edward Tse
852-3579-8222

Middle East
Fadi Majdalani
961-1-336-433

Scandinavia
Torbjorn Kihlstedt
46-8-506-190-00

Rest of Europe
Jurgen Ringbeck
49-211-38900

United States
Justin Zubrod
1-703-902-5000