# European low-cost carrier –
# Status quo and current trends

Discussion paper

Munich, August 1, 2006

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# A. Introduction to the low-cost carrier market and business model

# The original low-cost carrier business models are based on three key success factors

Key success factors for low-cost carrier

**Low-cost carrier (LCC) business model**

### 1 Market position

- Avoidance of direct competition
- Aggressive marketing
- "Success generates success"

### 2 Cost management

- No-frills, e.g. no free catering and no seat reservations
- High seating density
- Secondary airports
- Point-to-point flights
- Standardized fleet and high a/c utilization
- High crew productivity
- Direct sales

### 3 "Cash Generation"

- Efficient yield management
- Aggressive and flexible pricing
- Ancillary revenues

Source: Roland Berger

# The LCC development was triggered by Southwest Airlines which is one of the most successful US airlines nowadays

The Southwest Airlines success story in the US

### 1971

- Southwest is the world's first real LCC
- Operations started in summer 1971 with three B737 connecting Houston, Dallas and San Antonio
- Business model
  - No-frills service: no meals, no access to airport lounges, etc.
  - High-frequency short trip service
  - Low fares

### 1972-2004

- Continuous network expansion
- Avoidance of competition by choosing secondary airports
- Average annual pax growth rate 5.3% (1996-2005, inspite of 9/11 terrorist attacks)

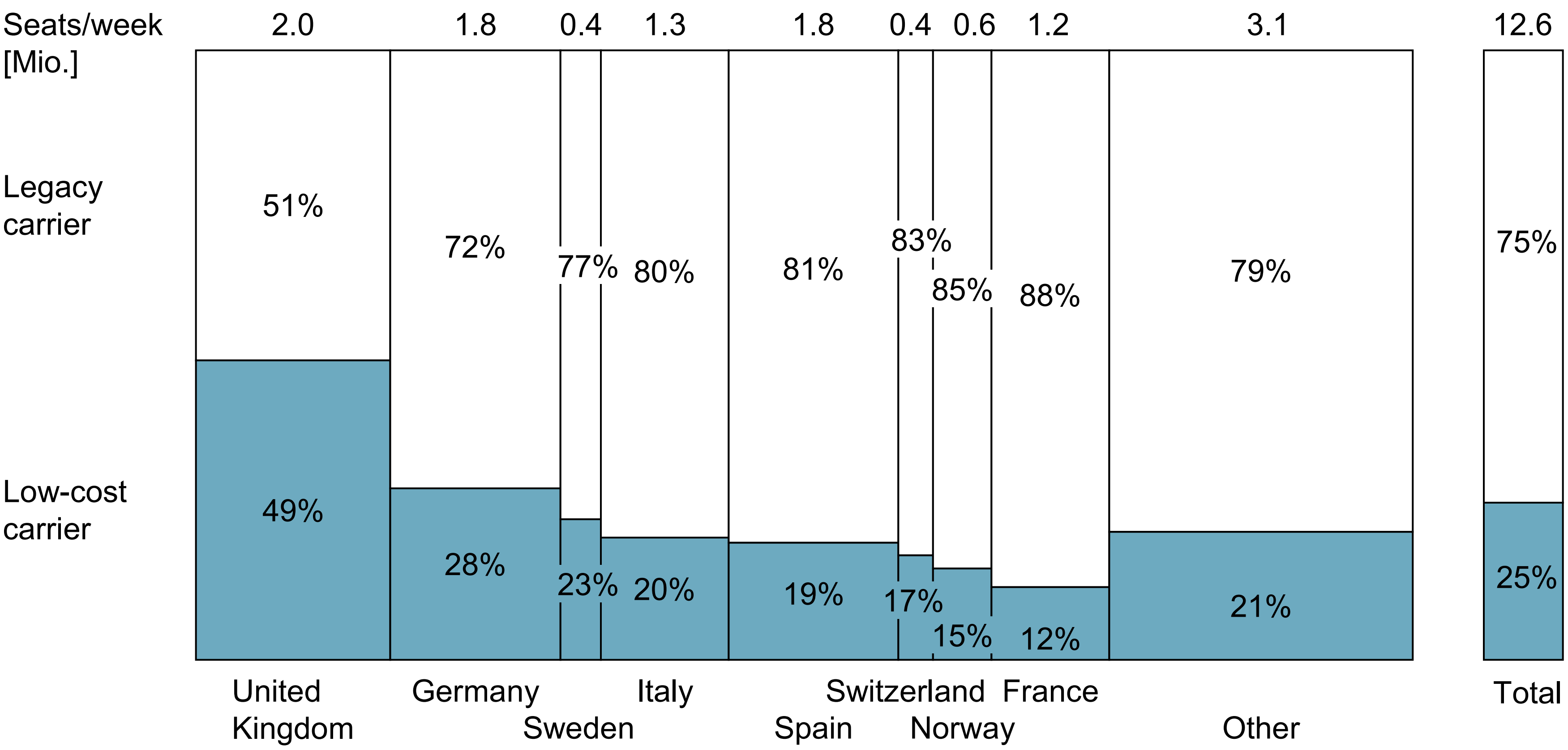
### 2005

- Today, Southwest is one of few highly profitable airlines
- Key facts:
  - 88.4 m pax carried
  - 445 B737 aircraft
  - 31,000+ employees
  - Revenue: USD 7,584 m
  - Revenue/pax: USD 86
  - Net profit: USD 548 m
  - Net profit margin: 7.2%

Source: Company reports, Roland Berger

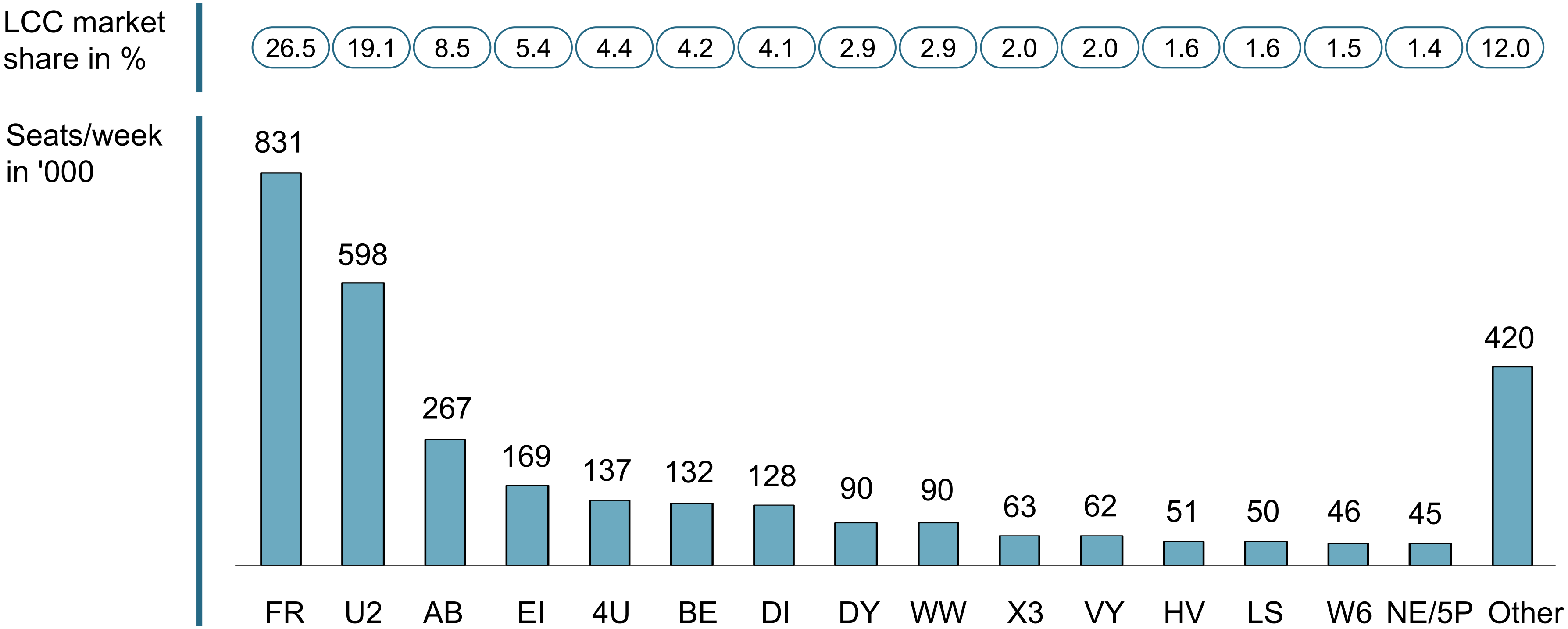
# Today LCC offer a substantial capacity in all large European markets – the UK dominates the LCC segment in Europe

LCC share of total capacity ex European airports winter 2005/06



# Having a combined market share of almost 50%, Ryanair and easyJet dominate the European LCC market

Capacity and share of capacity in the low cost segment winter 2005/06

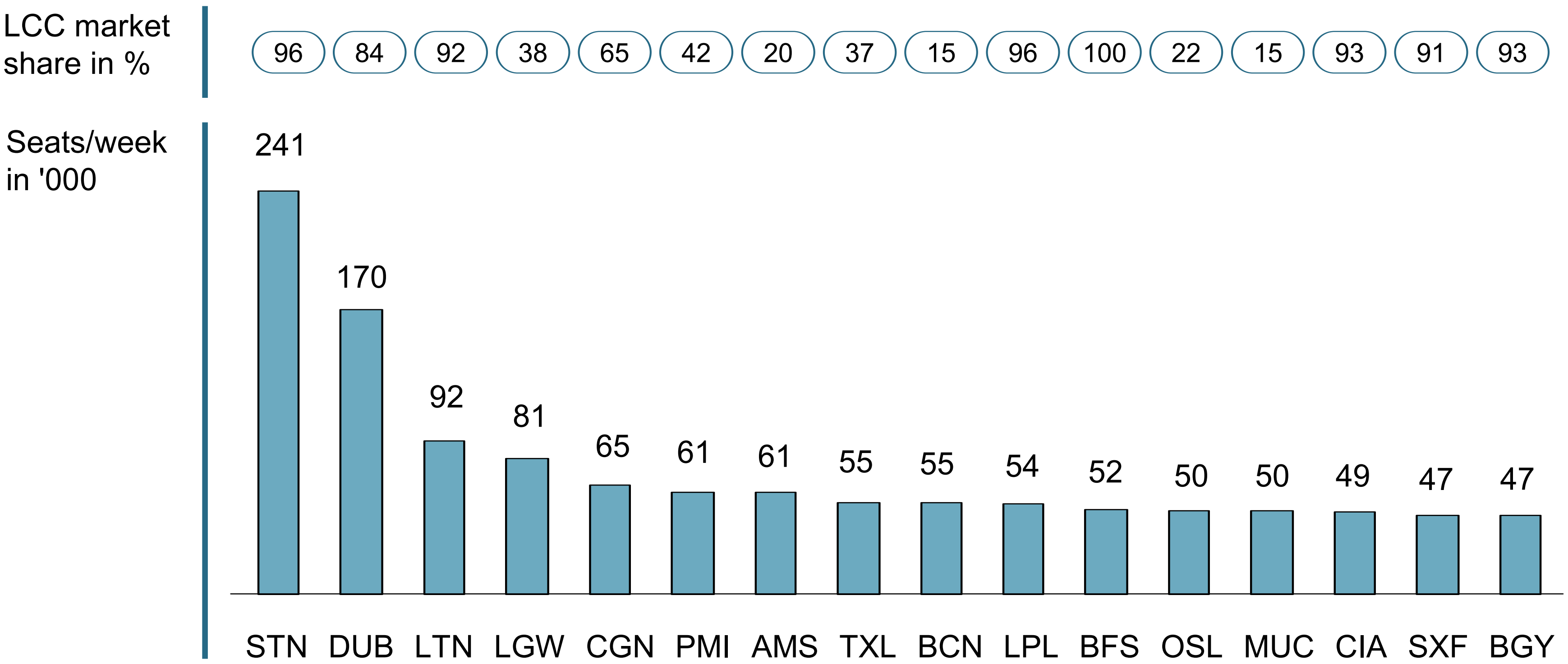



FR: Ryanair U2: easyJet AB: Air Berlin EI: Air Lingus 4U: Germanwings BE: FlyBe DI: dba DY: Norwegian WW: BMI Baby
X3: HLX VY: Vueling Air HV: Transavia LS: Jet2 W6:Wizz Air NE/5P: Skyeurope/Skyeurope Hungary
Other: LF, TV, IV, RE, NE, BT, NB, SH, VG, VA, HG, 8I, WOW, C0, 2L, 6G, F7, OF, JN

Source: OAG, Reference week: Feb. 13-19, 2006, Roland Berger

# Some LCC use primary airports - London comprises three of the five largest airports for LCC in Europe

LCC capacity ex European airports, winter 2005/06



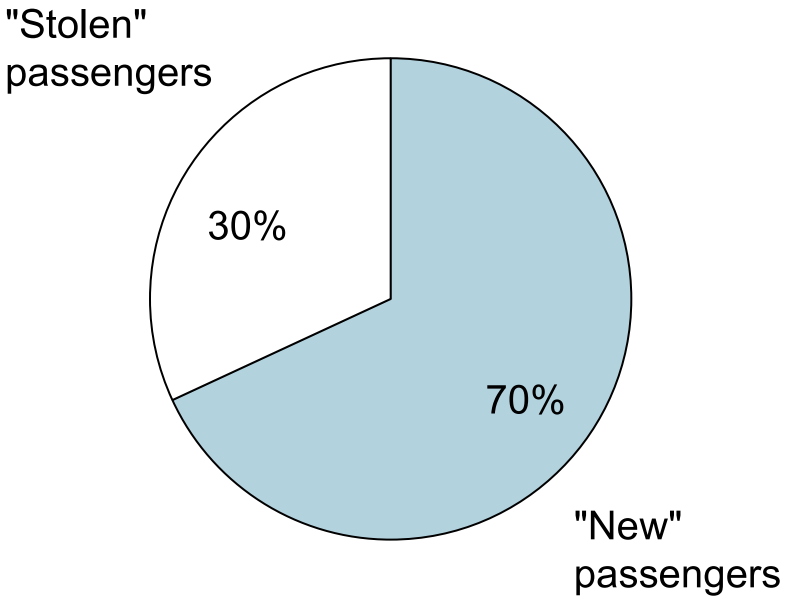

STN: London (Stansted) DUB: Dublin LTN: London (Luton) LGW: London (Gatwick) CGN: Cologne PMI: Palma de Mallorca AMS: Amsterdam TXL: Berlin (Tegel) BCN: Barcelona LPL: Liverpool BFS: Belfast OSL: Oslo MUC: Munich CIA: Rome (Ciampino) SXF: Berlin (Schoenefeld) BGY: Milan Bergamo

Source: OAG, Reference week: Feb. 13-19, 2006, Roland Berger

# Past experiences suggest that LCC usually cannibalize around one third of legacy carriers' traffic when entering a market

Cannibalization of legacy carriers' traffic by LCC

**Low cost carriers growth sources**

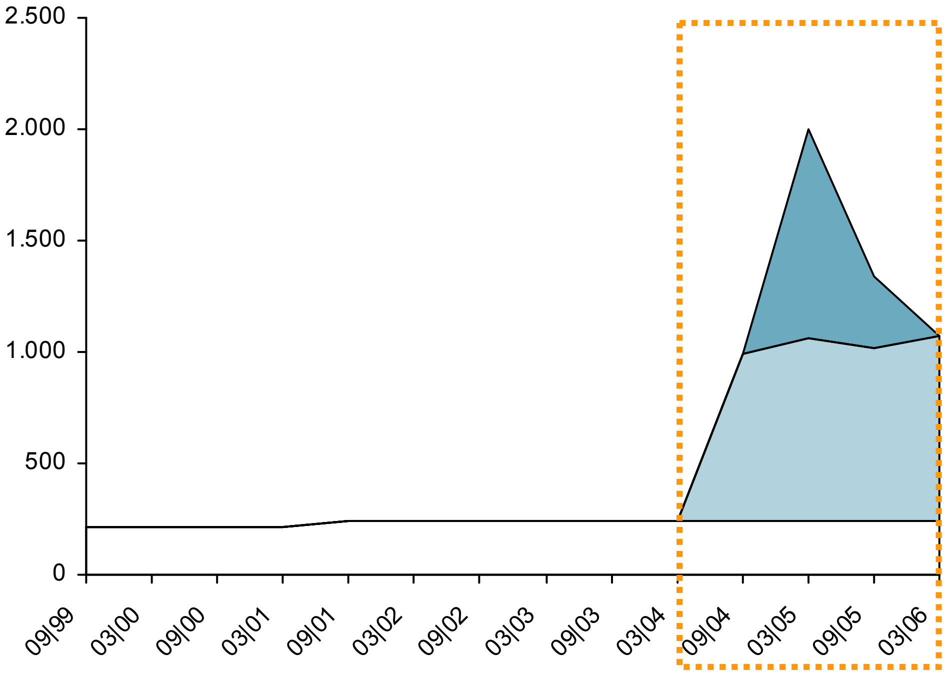



- Studies by industry experts suggest that between 20% and 45% of low cost carriers' growth comes from cannibalization of other carriers‘ traffic
- The by far larger portion of growth stems from newly generated air traffic
  - Cannibalization of other means of transport
  - "New" supply-stimulated demand
- Degree of cannibalization highly depends on the relation considered – differences are significant and cannibalization therefore is difficult to predict

Source: Roland Berger

# However, on some routes a LCC entry did not harm the established carrier at all

Pax per week[1] Berlin (TXL, SXF[2]) – Manchester / Liverpool (MAN, LPL)




- British Airways is sole player and shows a stable, but low market performance

## Experienced cannibalization

### Market development

- easyJet's market entry induces significant new traffic without impacting British Airways
- Air Berlin enters the route for one year and leaves thereafter – without impacting easyJet or British Airways
- easyJet and bmibaby have "stolen" **none** of its passengers as of winter 2005/2006

### Assumptions

- Market showing a steady performance at the point of easyJet's market entry

British Airways | easyJet | Air Berlin

1) Seats per week at load factor 70% (Legacy) and 80% (Low Cost) 2) No flights from THF

Source: OAG (scheduled flights), Roland Berger

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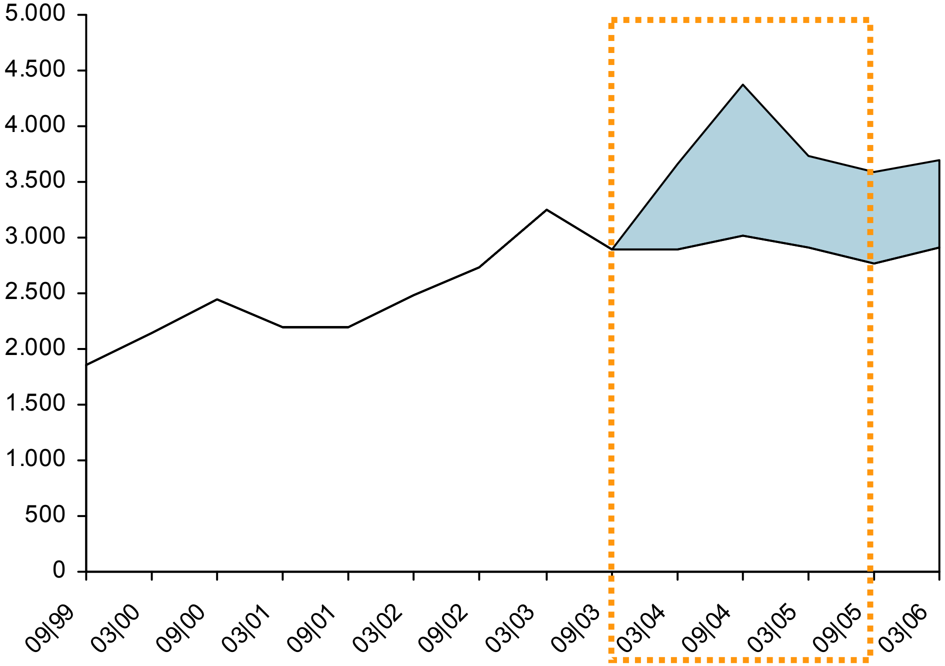
# On other routes an average cannibalization of roughly one third of passengers took place

Pax per week[1] Amsterdam (AMS) – Bristol (BRS, CWL)




- KLM is sole player and shows steady growth with some seasonal peaks

KLM easyJet

**Experienced cannibalization**

**Market development**

- With market entry of easyJet, KLM levels off
- easyJet captures the market's growth potential
- easyJet has "stolen" **28%** of its passengers as of winter 2004/2005

**Assumptions**

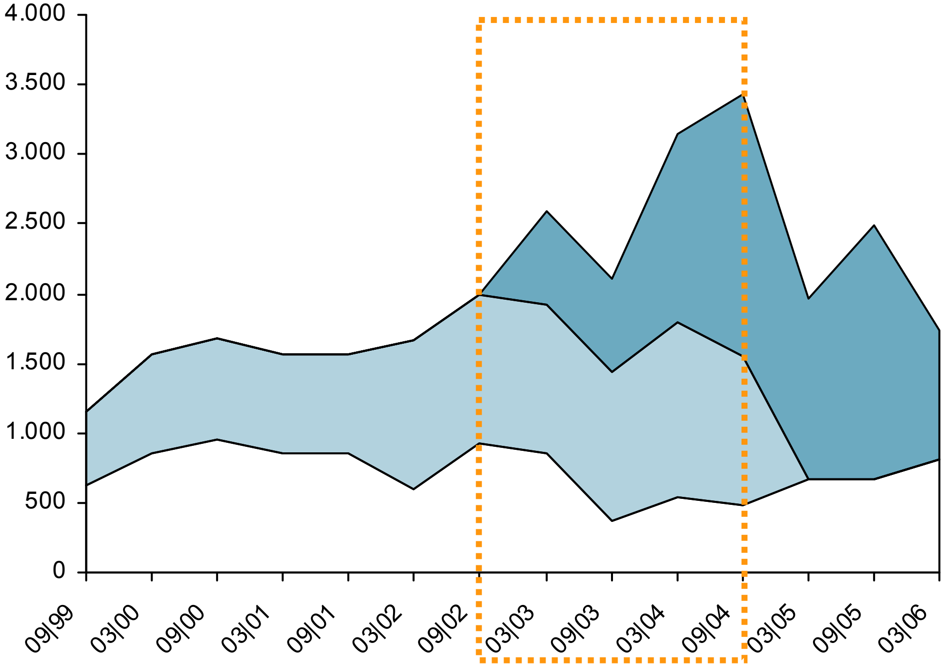
- Market growing visibly in the years 2000-2003
- 40% KLM transfer passengers taken into account

1) Seats per week at load factor 70% (Legacy) and 80% (Low Cost)

Source: OAG (scheduled flights), Roland Berger

# And sometimes LCC heavily cannibalized established traffic and finally drove legacy carriers out of the market

Pax per week[1] Düsseldorf (DUS) – Barcelona (BCN, GRO, REU)




- Lufthansa  showing a rather stable performance after a period of growth from 1999-2000
- Iberia growing visibly

Lufthansa | Iberia | Air Berlin

1) Seats per week at load factor 70% (Legacy) and 80% (Low Cost), w/o charter

**Experienced cannibalization**

**Market Development**

- The arrival of Air Berlin to the market stops Iberia's growth
- Two years after Iberia stops operating this route
- Air Berlin has "stolen" **41%** of its passengers as of summer 2004

**Assumptions**

- Visible market growth up to Air Berlin's market entry
- 10% Iberia transfer passengers taken into account

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# B. LCC have similar characteristics, however the original marketing mix becomes diluted

# The original product characteristics of LCC are diluted and some LCC offer services similar to those of legacy carrier

## Grading of airlines according to fulfillment of typical LCC product characteristics

*Typical legacy carrier* → *Pure LCC*

| **LCC characteristics** | **BA** | **AB** | **DI** | **4U** | **X3** | **U2** | **FR** |
|---|---|---|---|---|---|---|---|
| Mainly secondary airports | ○ | ○ | ○ | ○ | ○ | ○ | ● |
| No free catering | ○ | ○ | ○ | ● | ● | ● | ● |
| No reserved/assigned seats | ○ | ○ | ○ | ● | ● | ● | ● |
| Non flexible tickets | ○ | ○ | ○ | ● | ● | ● | ● |
| No transfer flight | ○ | ○ | ● | ● | ● | ● | ● |
| No frequent flyer program | ○ | ○ | ● | ○ | ● | ● | ● |
| Single class | ○ | ● | ● | ● | ● | ● | ● |

BA: British Airways AB: Air Berlin DI: dba 4U: Germanwings X3: HLX U2: easyJet FR: Ryanair

● Fulfilled ○ Not fulfilled

Source: Company websites, Roland Berger

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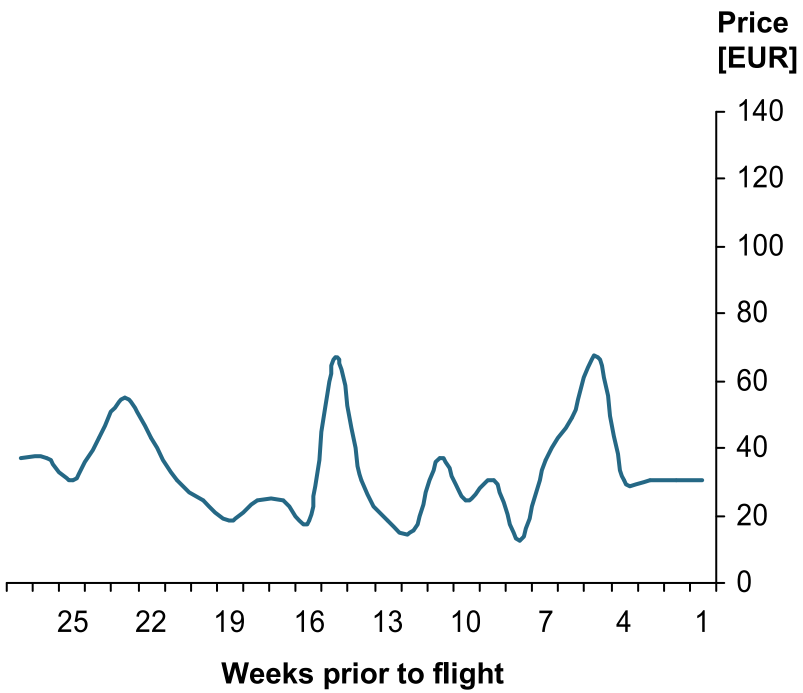
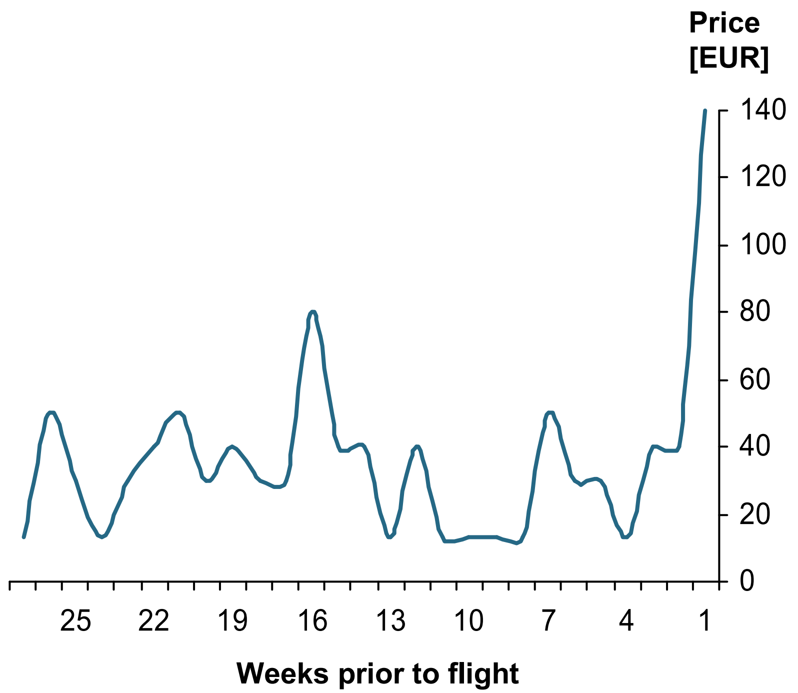
# LCC's yield management systems produces highly volatile fares over time ...

Examples of volatility of one-way fares excluding tax and other charges [EUR]

**easyJet flight LTN-MAD [EUR]**



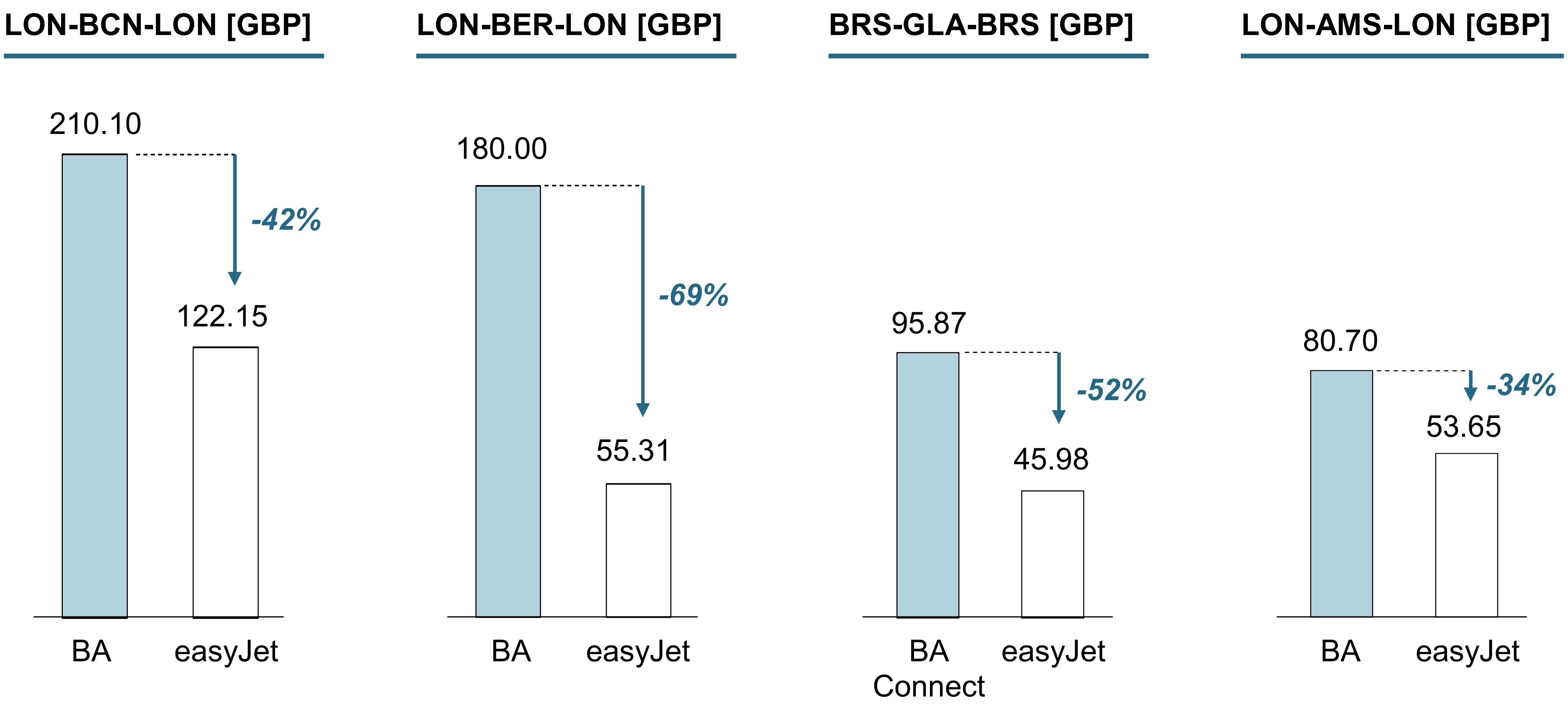

**Ryanair flight SZG-STN [EUR]**




Source: Ryanair, easyJet website, Roland Berger analysis

# ... but usually LCC ticket prices are still far below those of legacy carriers

Average total fares of three return flights[1)] for selected city pairs




1) Flights: 16-18 June 2006, 28 June 2006, 7-11 August 2006, booked on 5 June 2006

Source: Company websites, Roland Berger

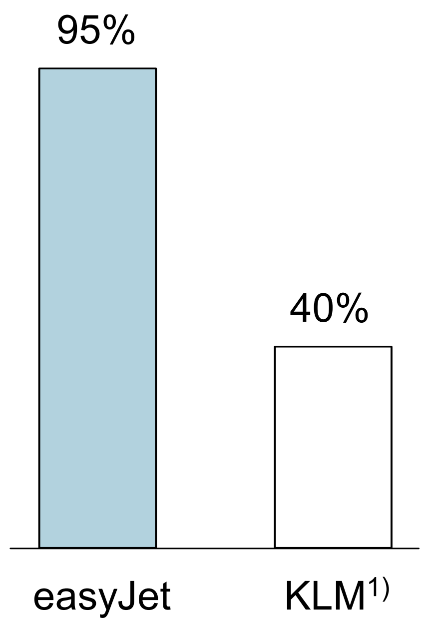
# Pure LCC push online sales whereas other LCC use traditional channel like travel agents as well

The establishment of the internet as the industry's market place

## LCC's use of an online distribution system

- The online distribution of flight tickets has been a distinctive characteristic of LCC right from the beginning
- In 1998 easyJet sold its first seat online at easyJet.com
- Since then, the internet has been established as the industry's preferred distribution channel and is widely accepted among its customers
- easyJet and Ryanair just offer online and telephone sales
- Less rigorous LCC like Air Berlin and Germanwings also distribute their tickets via travel agents, but all LCC push online sales – usually through price discrimination and promotion

## Share of online ticket sales




1) Target 2007

Source: easyJet, KLM, Roland Berger

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# LCC's promotion concepts aggressively aim at raising attention – at any price

Distinctive characteristics of LCC promotion campaigns

### 1 Colorful

- Compared to legacy carriers, company's colors are flamboyant and shiny -HLX and easyJet perfectly embody this
- Websites are usually colorful, rather than discreet and respectable

### 2 Nonchalant

- Advertising slogans are usually nonchalant, and often range from humorous to indiscreet, e.g.
  - "Fancy a cold beer? Cologne from £20.99"
  - "Go to bed with HLX" (Book a hotel)

### 3 Boiled down to price

- Through promotion, the flight characteristics are reduced to the product's price
  - "HLX – kost fast nix"
  - "Fly for the price of a taxi"
- For promotion means, tickets are sold at a symbolic price of a few cents during frequent specials

Source: Company information, Roland Berger

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# C. LCC maintain a substantial cost advantage over legacy carrier – Example easyJet vs. British Airways

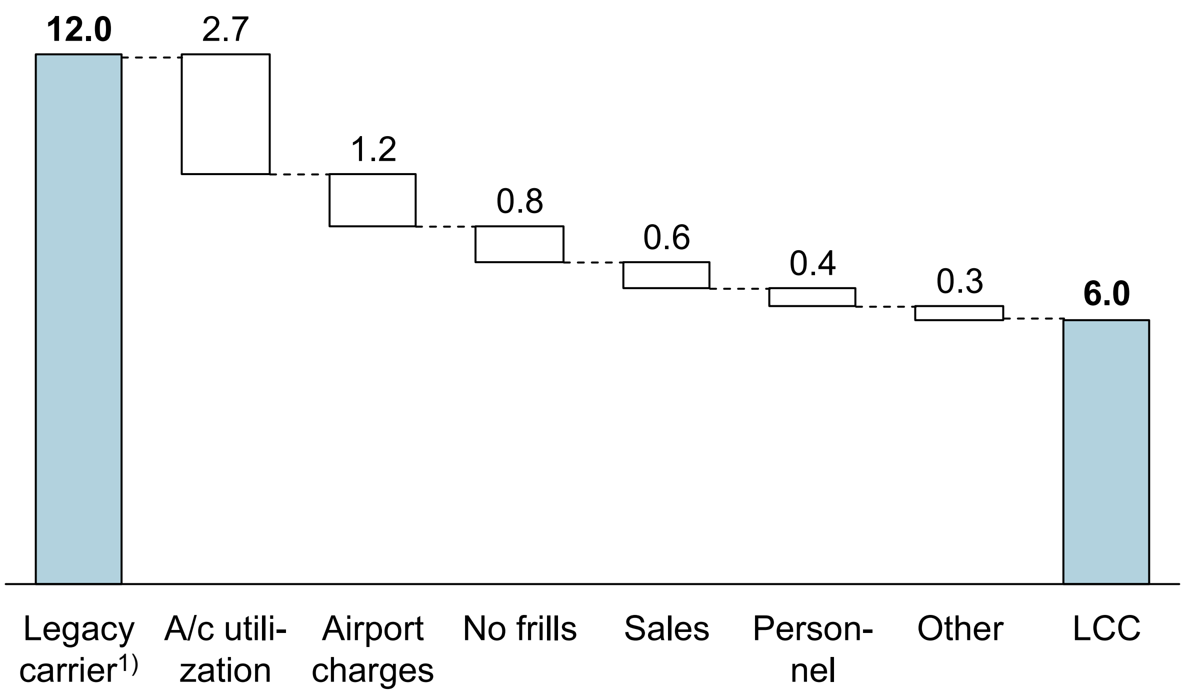
# According to a recent study, legacy carriers' operating costs per ASK are twice as high as those of LCC

Costs savings according to a recent study by the Association of European Airlines

**AEA study findings**

- According to an AEA study presented in 2004 LCC save six cents per ASK compared to legacy carrier – this corresponds to half of legacy carriers' costs
- The main cost savings arise from
  - An efficient aircraft utilization
  - Use of secondary airports
  - Reducing the product to the core service

**LCC cost savings compared to legacy carrier [c/ASK]**




1) Adjusted to LCC stage length

Source: AEA

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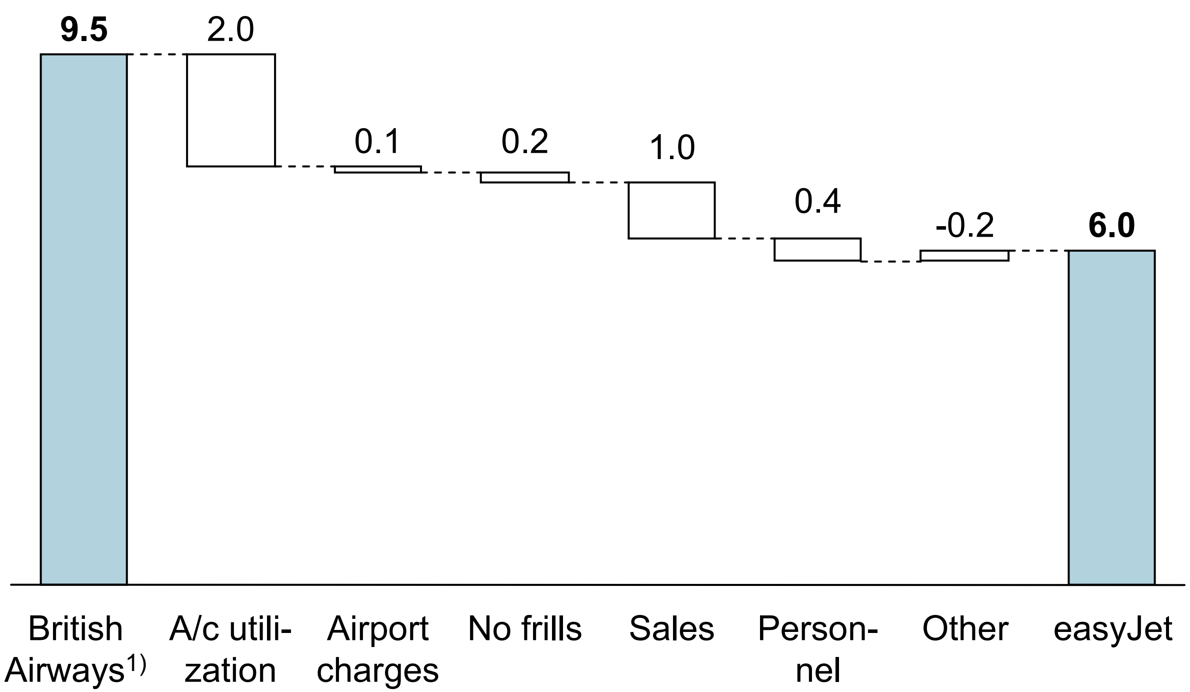
# The current cost gap between British Airways and easyJet is less than that presented in the AEA study

Comparison of British Airways and easyJet operating costs per ASK 2005

**Airline costs development**

- During the past few years legacy carriers have eroded some of the LCC's competitive advantage by reducing their own costs
- LCC like easyJet deliberately do not make use of all potential savings – easyJet does not avoid major airports in order to save airport charges and frequent congestions

**U2 cost savings compared to BA [EUR c/ASK]**




1) Adjusted to easyJet average stage length

Source: CAA, Airbus, Roland Berger

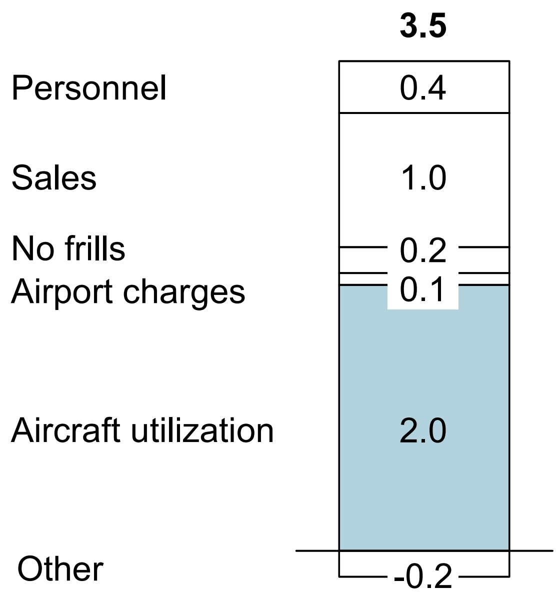
# easyJet uses the high potential to save costs by avoiding business class seating and applying low seat pitch

easyJet cost advantage over British Airways through higher aircraft utilization 2005

## Factors influencing aircraft utilization

- The savings potential from a higher aircraft utilization on a ASK basis mainly stems from the number of seats installed
- When considered on an ASK basis, the number of seats per aircraft influences all cost positions directly (doubling the number of seats reduces operating costs/ASK by half)
- Saving potential due to faster turnarounds is comparably low because it only influences the aircraft depreciation costs/ASK and parts of the personnel costs

## U2 cost advantage in EUR c/ASK




Source: CAA, Roland Berger

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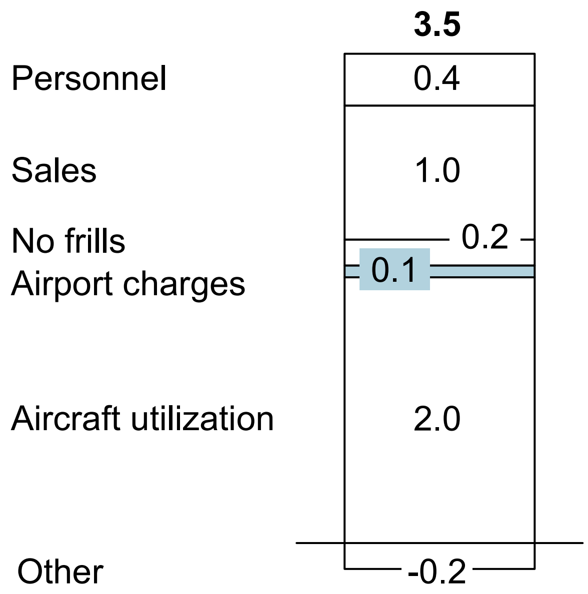
# Use of secondary airports does offer significant savings potential easyJet does not capitalize on

easyJet cost advantage over British Airways in airport charges 2005

### Savings potential by servicing secondary airports

- LCC often connect secondary airports, which usually have airport charges far below those of major airports and cheaper office space
- On some major airports LCC successfully negotiate special LCC contracts
- LCC usually do not offer its passengers access to airport lounges
- easyJet does not avoid main airports and does thereby not have a significant respective cost advantage

### U2 cost advantage in EUR c/ASK




Source: CAA, Roland Berger

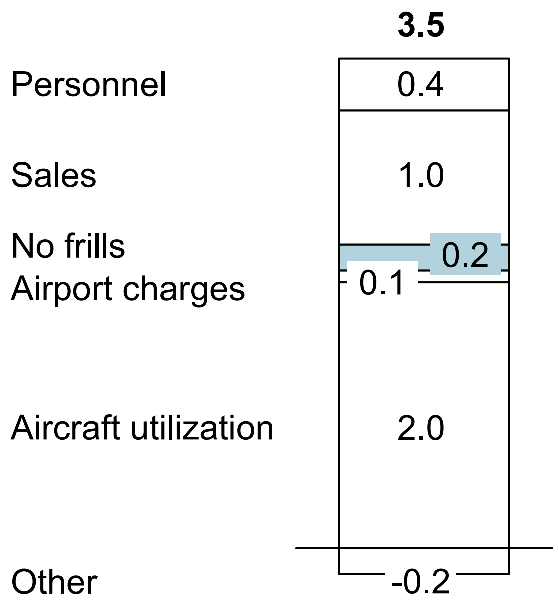
# easyJet's cost advantage in passenger services mainly results from not offering connected flights and free catering

easyJet cost advantage over British Airways by reducing passenger services 2005

## Savings potential in passenger services

- Point-to-point route network and total avoidance of connected transfer flights reduces delays and related passenger expenses
- LCC do usually not offer free on-board catering nor access to catered airport lounges

## U2 cost advantage in EUR c/ASK



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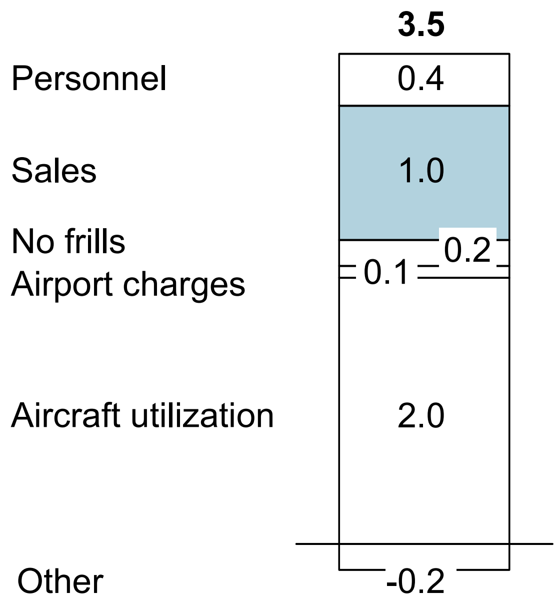
# By pushing the internet as the major channel easyJet achieves a significant cost advantage in sales expenses

easyJet cost advantage over British Airways through online sales 2005

### Savings potential in sales

- LCC force the commission-free and low-cost online sales channel and do not distribute through travel agents - for details see page 20
- Most LCC only issue electronic tickets
- Most LCC do not allow seat reservation

### U2 cost advantage in EUR c/ASK




Source: CAA, Roland Berger

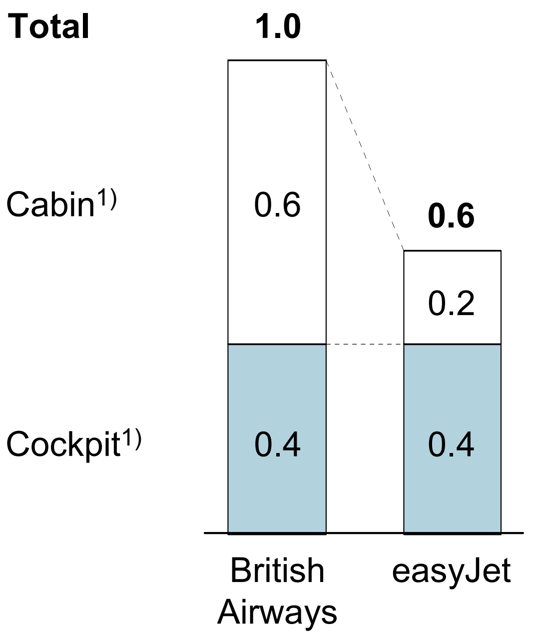
# easyJet's potential for aircrew cost reduction is limited for cockpit but significant for cabin personnel

easyJet cost advantage over British Airways through high aircrew productivity 2005

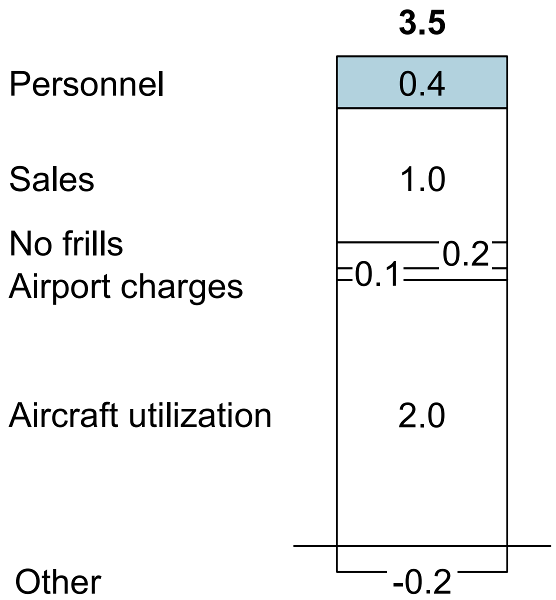
### Airborne personnel savings

- LCC achieve high crew productivity by reducing its cabin crew to one third of a legacy carrier's size
- Legal and technical requirement to deploy a cockpit crew of two limit LCC's respective potential for cost reduction
- LCC's aircrew costs are positively affected by reduced taxi-time at less congested secondary airports

### Aircrew costs in EUR c/ASK




### U2 cost advantage in EUR c/ASK




1) British Airways' inter-continental traffic leads to differences in crew costs

Source: CAA, Roland Berger

# D. Players and business models change frequently to grab market share but consolidation is inevitable

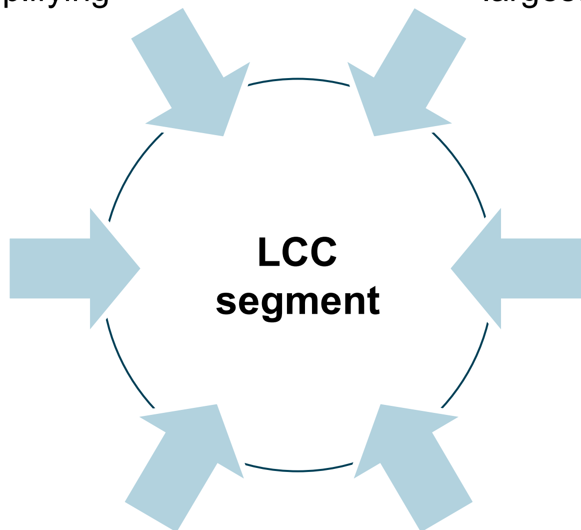
# Many legacy carrier and tour operators have learned to participate in the LCC boom

Examples of legacy carriers and a tour operator taking stake in the LCC segment

British Airways uses BA CitiExpress as its own regional LCC and keeps on simplifying its operations

In 2002 BMI started Bmibaby which today is the second largest LCC in UK

Iberia is to set up a LCC with local partners in October 2006




Lufthansa has a 49% stake in Eurowings which fully owns the LCC Germanwings

Polish flag carrier LOT takes stake in the LCC segment via Centralwings

Leading European tour operator TUI entered the LCC segment with its own fully owned airline HLX in 2002

Source: Company information, finanznachrichten.de, Interfax Poland Weekly Business Report, Roland Berger

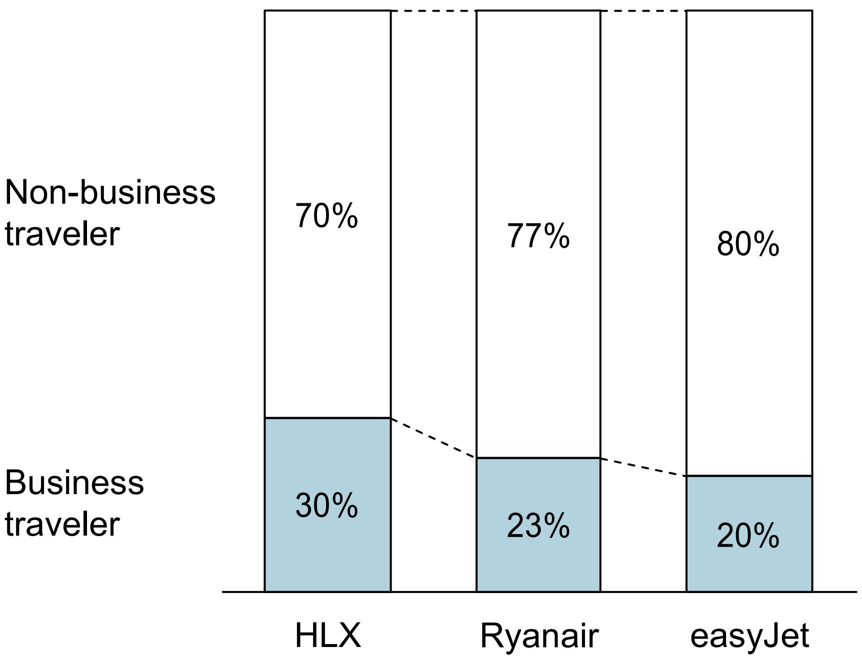
# LCC are making their way in the business traveler segment, reducing the difference to legacy carriers even more

Recent developments and business traveler share of on-board pax

### Recent developments

- Ray Webster, easyJet's former head of the board, considered all extras as "Disturbances of our business model"
- After Andrew Harrison became new head of the board, several changes have been introduced
  - Access to airport lounges
  - Business traveler may embark first
  - Internet Check-in
- And easyJet's moves are not unique; HLX boss Roland Keppler: "We are seeing an about-turn here"

### Share of business traveler 2006

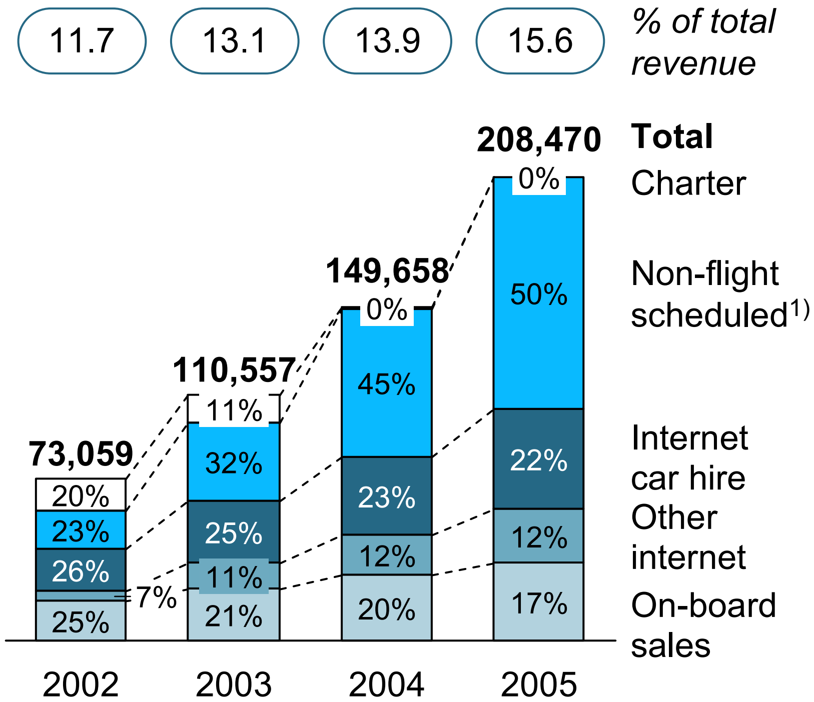



Source: Wirtschaftswoche, Davy (Bank of Ireland Group), Roland Berger

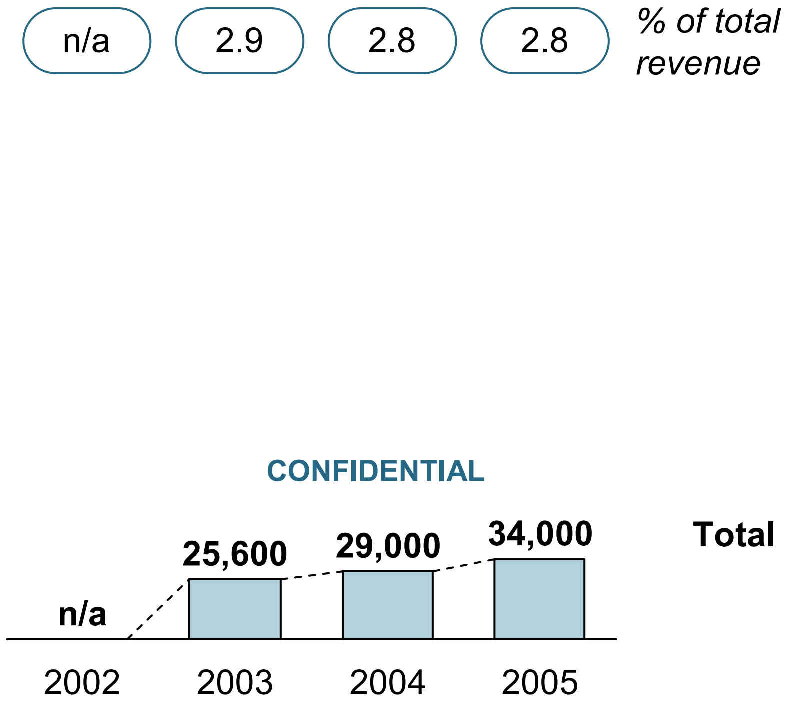
# Ryanair increasingly uses additional ways to generate revenue

## Ryanair and Air Berlin non-ticket revenue development

**Ryanair ancillary revenues** [EUR '000]




**Air Berlin ancillary revenues** [EUR '000]




1) Sale of rail and bus tickets, hotel reservations, excess baggage charges, etc.

Source: Annual reports, Commerzbank

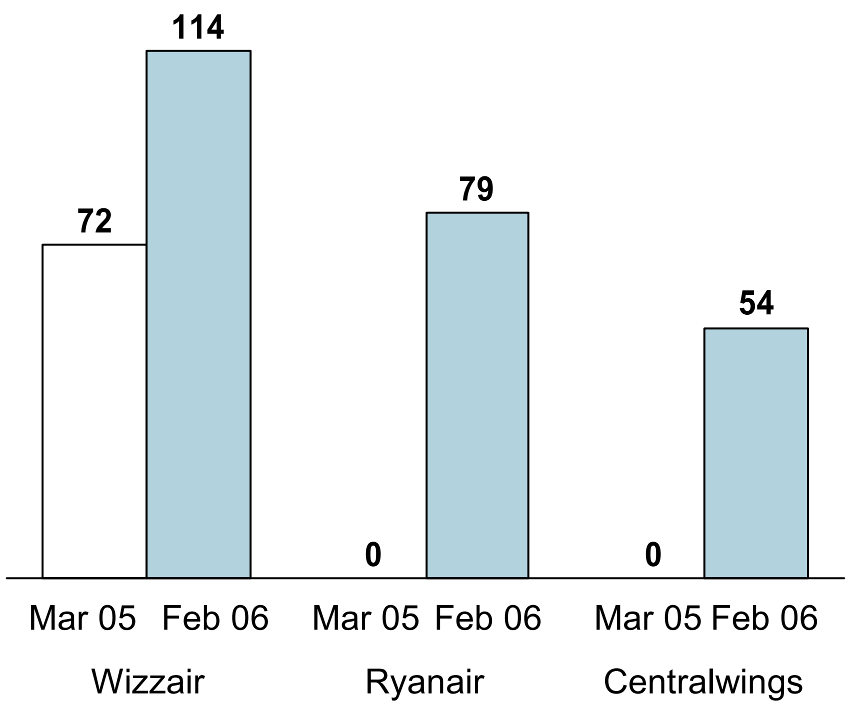
# Eastern European LCC markets growth rapidly – Especially Poland is currently highly dynamic

The LCC market in Eastern Europe

**Recent market developments**

- Eastern Europe
  - Eastern European low-cost markets keep on growing at high growth rates
  - Both Western and Eastern European LCC participate in this development
- Poland in detail
  - Polish airline market is currently the most dynamic in Europe – the low-cost market growths by 30% annually
  - Having a LCC market share of 42%, Wizzair is the dominant player
  - Ryanair entered the Polish market in 2005, but plans to reach a dominating position in 2006 by carrying five times as many passengers as in 2005

**Departures/week ex Poland 2005 and 2006**




Source: OAG, Poland Weekly Business Report, Roland Berger

# The emergence of Jet4you could signal the beginning of a new competitive trend in the European airline industry

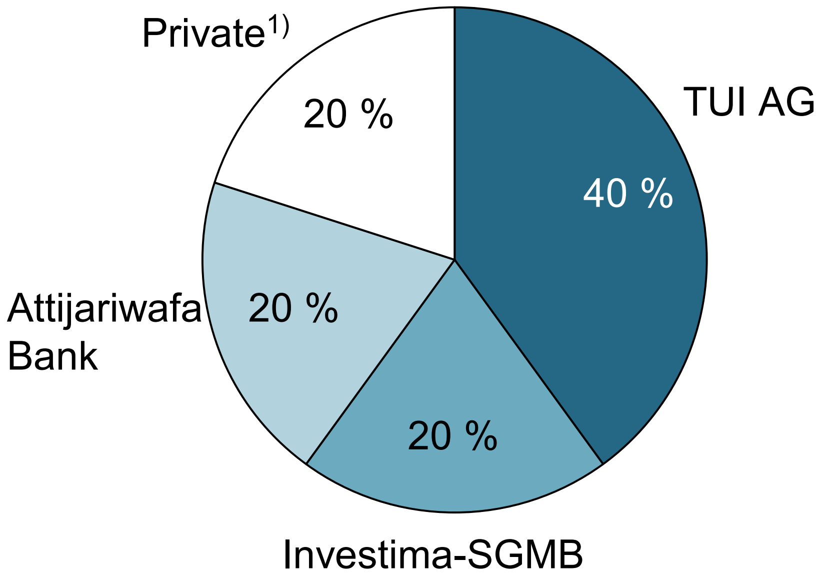
Jet4you facts and shareholder structure

## Company facts

- Airline based in Morocco
- Start-up made possible after recent open-skies agreement between the EU and Morocco
- Operations were launched in March 2006
- Currently three routes are served from Paris Orly, future routes are expected to focus on Europe
- Fleet of two B737, painted in TUI style -plans to increase fleet by two aircrafts per year
- Main competitor is the Morocco's second LCC Atlas Blue

**The development could threaten the European LCC by beating them at their own game**

## Shareholder structure




1) MM. Marrache and Benabbes Taarji

Source: Aviation Week & Space Technology, ATI, Roland Berger

# The past few years showed that consolidation in the low-cost segment is on its way

Examples of past consolidation in the LCC segment

| Jan 2003 | Oct 2003 | Oct 2004 | Feb 2006 |
|---|---|---|---|
| **Buzz takeover** | **Go Fly takeover** | **V Bird Insolvency** | **LTU/dba cooperation** |
| The unprofitable KLM unit Buzz is taken over by Ryanair for a (bargain) net price of EUR 4.9 m | The LCC Go Fly, operating 27 aircrafts on 38 routes, is taken over by easyJet for EUR 535 m. The airline was established by British Airways and returned profits after only two years of operations | After less than one year of operations, Netherlands based LCC V Bird suspended its service and had to file for bankruptcy | Hans Rudolf Woehrl's INTRO Verwaltungs GmbH buys a 60% stake in LTU[1)]. The company already held a 59.9% stake in dba and now plans to link both carriers in order to create the world's first globally operating LCC |

1) Later reduced to 36%

Source: Roland Berger

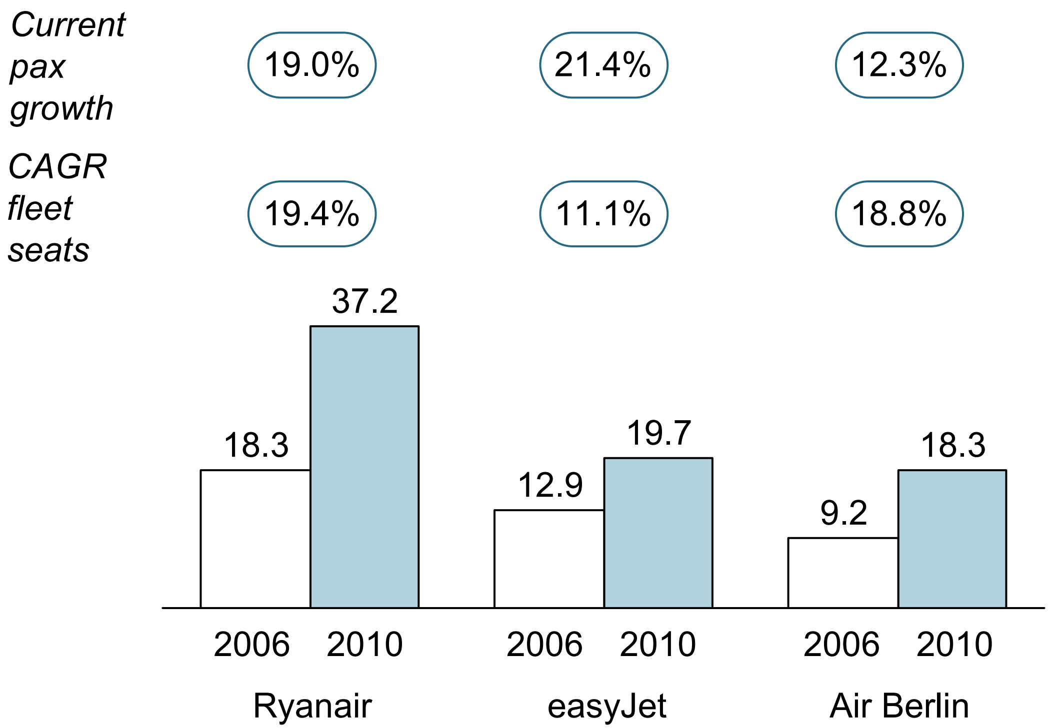
# If the aggressive fleet expansion plans of major LCC cannot be met by sustaining current growth rates ...

Recent huge aircraft orders and expected growth in total seats of fleet per airline

### Recent aircraft orders

- In October 2003, easyJet signed a deal with Airbus to deliver 120 aircraft to the airline over five years, with price protection on a further 120 Airbus A319 aircraft until 2012
- Ryanair currently holds 143 firm orders of B737-800 and an option on 193 aircrafts
- Air Berlin ordered 60 A320 to be delivered until 2011 and purchased an option on 40 additional aircrafts

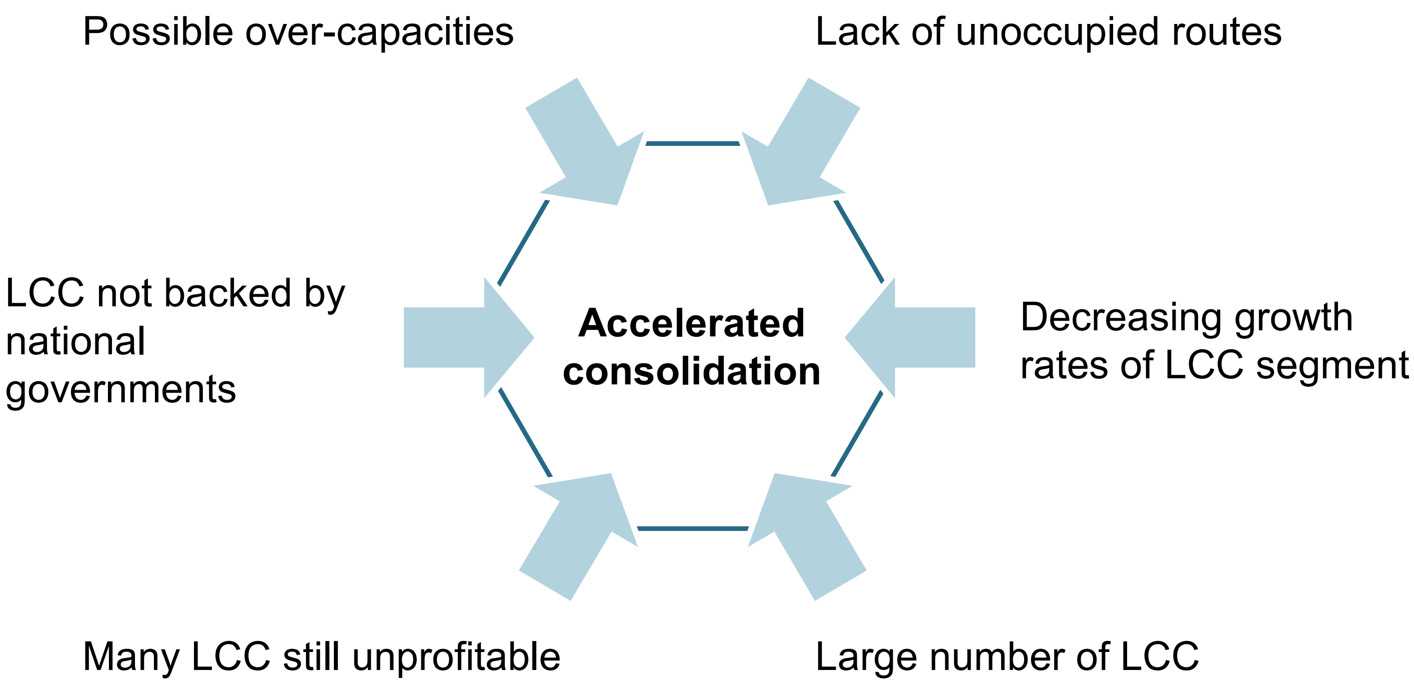
### Expected growth in seats of total fleet in '000




Source: ATI, company information, Roland Berger estimates

# ... the over-capacities will, supported by several other factors, result in an accelerated consolidation among the LCC

Factors leading to accelerated consolidation




Source: Roland Berger