L.E.K.

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Aviation Insights Review (AIR) – Low Cost Carriers

The global airline industry continues to face significant turbulence created by a soft economy, high capital costs, dramatic fluctuations in fuel prices and other market pressures. That said, some airlines are able to transcend these issues and earn a long-term profit. L.E.K. Consulting's Aviation Insights Review (AIR) series recognizes those aviation industry businesses that have generated attractive returns to shareholders – be they full service carriers, low cost carriers, regional carriers, U.S. carriers, airports, emerging market carriers or manufacturers.

As a leading strategy advisor to the aviation industry and expert on shareholder value analysis, L.E.K. uses economic profit as the relevant measure to gauge a company's ability to meet the financial requirements of its stakeholders over time – whether it's debt holders or shareholders. (L.E.K. broadly defines economic profit as the surplus the company generates after charging for the capital that it employs at its relevant cost of capital rate.) While total shareholder returns are insightful, they are too dependent on the random start and end dates that can be adversely affected by any number of market conditions at the time.

This second AIR report focuses on low cost carriers (LCCs) – often regarded as the "darling" of the market for re-inventing the industry. LCCs have opened up air travel to vast portions of the global public for whom air travel was historically out of their financial reach.

But just as we see with full service carriers, financial success varies dramatically across this industry segment – and merely being classified as an LCC does not guarantee financial success.

Figure 1

Top-Five Highest Performing Low Cost Carriers (2001-2010)

Carrier/Rank	Cumulative 10-year Economic Profit	Total Shareholder Return
1. Ryanair Ltd (Ireland)	U.S. $2,464 million	43.1%
2. WestJet Airlines Ltd. (Canada)	U.S. $420 million	36.6%
3. AirAsia Berhad (Malaysia)	U.S. $348 million	56.2%
4. GOL (Brazil)	U.S. $250 million	7.3%
5. Allegiant Travel Company (U.S.)	U.S. $178 million	78.1%

Source: S&P Capital IQ, L.E.K. Analysis
Note: Not all of the LCCs have 10 years of stock performance to track. AirAsia started trading in 11/04, GOL in 6/04 and Allegiant in 12/06.

As Figure 1 illustrates, for those LCCs that have been financially successful the returns have been significant.

The glaring omission from this list is the U.S. industry's traditional sweetheart, Southwest Airlines, which after a good financial start to the decade, deteriorated in recent years – resulting in a cumulative negative economic profit of (U.S. -$175 million) for the 10-year period.

Aviation Insights Review (AIR) – Low Cost Carriers was written by **John Thomas**, a Vice President and Head of L.E.K. Consulting's global Aviation & Travel Practice. John is also a member of IATA's Travelling Passenger Vision 2020 working group, which is a part of the Simplifying the Business initiative. Please contact L.E.K. at aviation@lek.com for additional information.

So what has set these LCCs apart from their peers and resulted in their strong performance?

Apart from superior management, L.E.K. would contend that a key element of their financial success has been their adoption and successful implementation of ancillary services. L.E.K. firmly believes that the adoption of ancillary revenue is pivotal to financial success of any airline – irrespective of its market position.

At a macro level, consider the chronically unprofitable U.S. airline industry that in 2010 delivered a healthy profit of U.S. $2.6 billion – a hugely successful year against the backdrop of high fuel prices and relatively weak demand given the uncertain economic environment. In the context of this profit, ancillary revenues delivered U.S. $8.1 billion in bottom-line performance to the U.S. airline industry in 2010 – i.e., without ancillary revenue the U.S. industry would have lost approximately U.S. $5.5 billion. And most recently, look at how Delta and United's operating margins have surpassed that of Southwest, and how these two legacy carriers have been able to generate significant economic profit during the past two years – a clear testimony to the value of ancillary revenue.

And in the case of the five LCCs that delivered solid financial performance during the past decade, ancillary revenues were an important driver to their success (see Figure 2).

Figure 2

Ancillary Services Drive Revenues for High-Performing LCCs

Airline	2001-2010 Economic Profit	Ancillary Revenue as a % of 2010 Total Revenue
1. Ryanair Ltd	U.S. $2,464 million	22%
2. WestJet Airlines Ltd.	U.S. $420 million	4%
3. AirAsia Berhad	U.S. $348 million	19%
4. GOL	U.S. $250 million	9%
5. Allegiant Travel Company	U.S. $178 million	29%

Source: L.E.K. Analysis

And in the context of L.E.K.'s framework of which strategies drive success in the airline industry, these carriers should also be complimented for successful execution of the following strategies:

- Being the ultra low cost producer: Ryanair
- Tapping into emerging markets and being ahead of the demand curve: AirAsia and GOL
- Establishing a strong market position in a well-defined market (including geography or customer segment): Allegiant

We also acknowledge GOL for its innovation to stay ahead of the commoditization trend – both from an operational perspective and more recently on the product side by being the first airline in the world to have fully functional wireless in-flight entertainment (IFE) capabilities. This foundational system delivers more timely content to its passengers than any other airline and paves the way for it to further monetize the ancillary revenue opportunities with its growing passenger base.

These carriers have once again proven that even under tough economic conditions in an industry that is overall unprofitable, good management and the right strategies can keep all stakeholders well rewarded.

For further information contact:

Boston
75 State Street
19th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9392

Chicago
One North Wacker Drive
39th Floor
Chicago, IL 60606
Telephone: 312.913.6400
Facsimile: 312.782.4583

Los Angeles
1100 Glendon Avenue
21st Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

New York
1133 Sixth Avenue
29th Floor
New York, NY 10036
Telephone: 646.652.1900
Facsimile: 212.582.8505

San Francisco
100 Pine Street
Suite 2000
San Francisco, CA 94111
Telephone: 415.676.5500
Facsimile: 415.627.9071

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