L.E.K.

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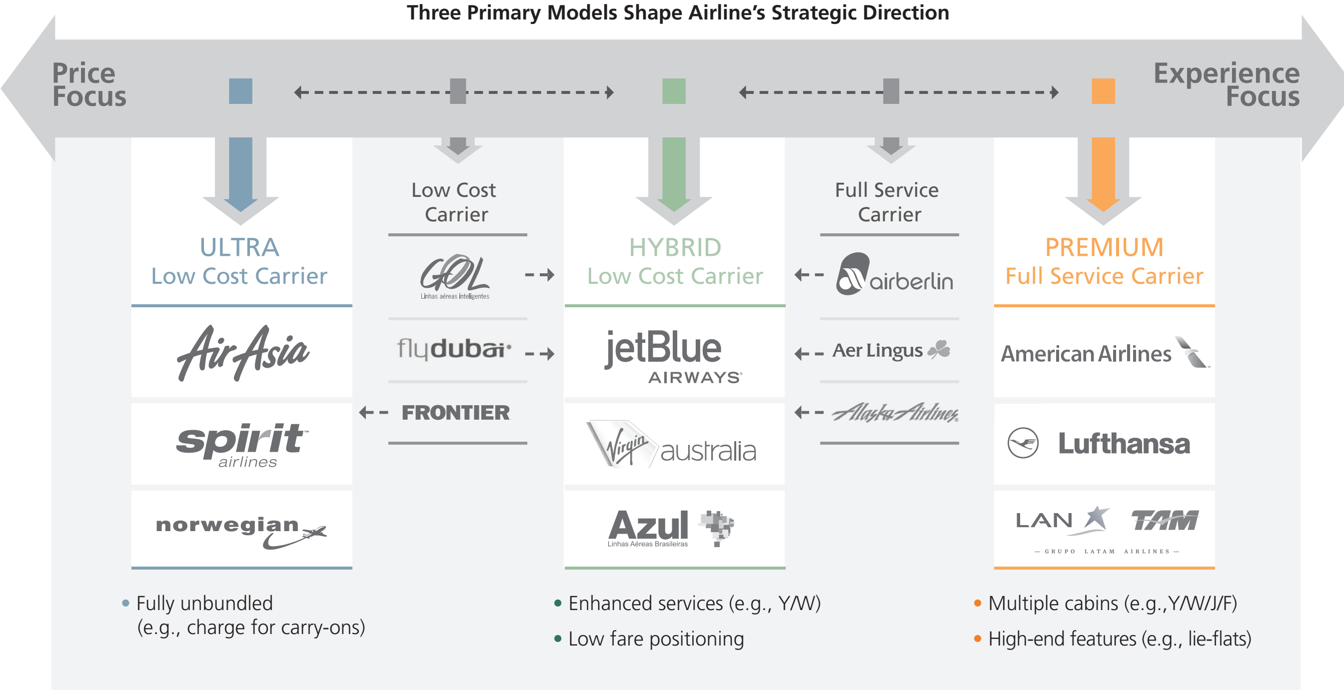
Aviation Insights Review (AIR): The Future of Airline Business Models – Which Will Win?

It's been more than three decades since U.S. deregulation spurred the first crop of airline business model innovations. As markets liberalized across the globe, industry reformers searched for sustainable competitive advantage across dozens of different models covering the spectrum of service level, aircraft gauge, geography, frequency and, of course, price.

Through the 2000s, the net result of this business model experimentation was a clear competitive dichotomy between traditional full-service carriers (FSCs) and upstart low-cost carriers (LCCs). This dynamic is quickly changing as LCCs come of age, FSCs restructure and the broader market landscape forces new thinking on how to deliver differentiated value.

Figure 1
Three Primary Models Shape Airline's Strategic Direction



Aviation Insights Review (AIR): The Future of Airline Business Models – Which Will Win? was written by **John Thomas**, a managing director in L.E.K. Consulting's Boston office, and **Brett Catlin**, an engagement manager in L.E.K. Consulting's Boston office. For more information contact aviation@lek.com.

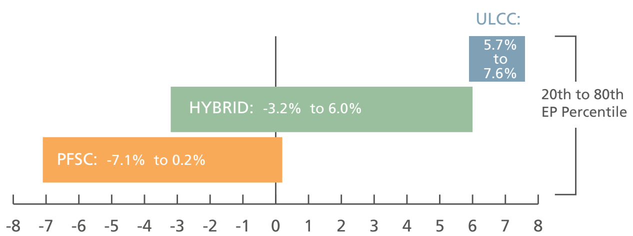
Realignment of Airline Business Models

Against this backdrop, L.E.K. observes a market that has steadily given way to coalescence around three primary business models (see Figure 1).

For carriers that have pioneered or actively transitioned to one of the three observed models, there is almost always a clear customer value proposition and supporting brand ethos. For ultra-low-cost carriers (ULCCs), it's a relentless focus on stimulating new demand with low fares ("Now Everyone Can Fly"). In the case of hybrids, it's a value-centric appeal with a service orientation ("You Above All"). The premium full-service carrier (PFSC) proposition increasingly emphasizes and differentiates around the holistic passenger experience ("A Great Way to Fly").

To remain competitive over the long term, carriers employing either a traditional LCC model or legacy FSC operation are at a strategic crossroads. In many cases, the choice is to reinvent themselves as hybrid carriers or to implement large-scale changes aimed at dramatically reducing base fares or to double down on experiential enhancements.

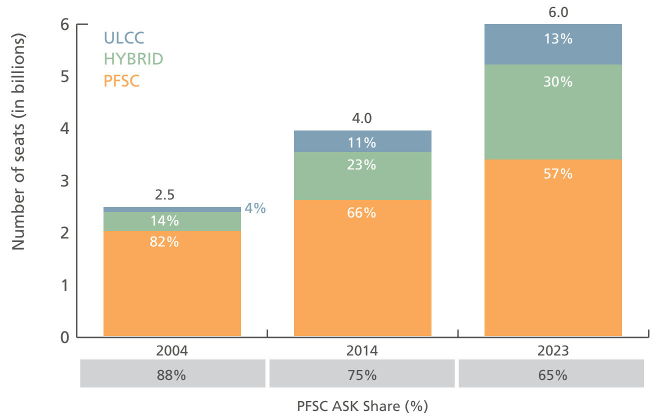
Figure 2
Economic Profit by Carrier Business Model (2008-2013)



Note: 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 champions have emerged for each business model, the superior aggregate financial performance of ULCC and hybrid carriers has enabled these operators to flourish in a market where legacy FSCs have historically dominated (see Figure 2). As a result, ULCCs and hybrids have grown from 18% of global traffic in 2003 to over 34% today. Looking out a decade, L.E.K. projects this share will increase to 43%, with ULCCs and hybrids registering nearly double the annual growth rate of premium carriers (see Figure 3).

Figure 3
Top 150 Carrier Capacity by Carrier Type (2004 – 2023)



Growing Presence of Hybrids Across Regions

On a regional basis, the steady ascent of hybrid carriers is evident across virtually all geographies with the model already commanding roughly 20–40% market share (less Africa). With the exception of North America, the expanding hybrid carrier model is expected to endure as a strong value proposition continues to resonate with consumers in both developed and emerging markets. The ULCC growth story is more mixed as regulatory hurdles, infrastructure constraints and entrenched labor interests challenge the ultra-low-cost premise in underpenetrated markets including Africa, the Middle East and Latin America. Across the liberalizing/liberalized markets of Asia and North America, L.E.K. expects ULCCs to post sustained growth for the foreseeable future as penetration ultimately approaches the now-saturated levels seen in Europe (see Figure 4).

This global dynamic and the associated regional variations present both critical long-term strategic questions and short-term tactical opportunities (and potential challenges) for carriers across the continuum.

Next Steps: What to Consider

As executives work to optimize their operating models, it is incumbent on all carriers to sharpen their strategic focus on delivering a clear customer value proposition in order to maintain relevance in an increasingly competitive global environment. For each of the observed business models, L.E.K. offers key considerations for moving forward.

Ultra-Low-Cost Carriers: Delivering on the Lowest Fare Promise

The rise of the ULCC model has rapidly moved from Europe to Australia to North America and Asia. As existing carriers look to sustain rapid expansion and new carriers aim to enter highly competitive markets, there are a number of potential strategies to continue delivering on the lowest fare promise:

Tactical opportunities:

- Embrace mobile technology and self-service options to streamline the end-to-end experience
- Introduce a for-fee "club" in lieu of a traditional loyalty program
- Solve the ULCC network paradox (e.g., charge a fee to interline)
- Reinvent ancillaries with variable pricing and value-added bundles
- Improve monetization of the captive customer base

Strategic questions:

- How do you maintain a best-in-class cost position in an industry that is notorious for cost escalation?
- How do you attract and meet the needs of price-conscious small and medium enterprises without radically changing the business model?
- What is the truly addressable market for ULCCs in terms of length of haul?
- How do you create win-win partnerships with hybrids and premium carriers?

Hybrid Carriers: Generating Differentiated Value

Delivering a strong customer value proposition has enabled hybrid carriers to thrive across a number of global markets. From Brazil to the United States, Australia and Singapore, there has consistently been demand for carriers that offer low fares and a quality service proposition. As hybrids move into the mainstream in many markets, there are a number of step-out opportunities to continue delivering a compelling value proposition:

Figure 4
Regional Business Model Outlook

REGION	ULCC	HYBRID	PFSC
AFRICA	3%	12%	85%
ASIA	7%	17%	75%
AUSTRALASIA	18%	23%	58%
EUROPE	25%	20%	56%
LATIN AMERICA	0%	42%	58%
MIDDLE EAST	1%	19%	80%
NORTH AMERICA	4%	31%	65%

Decreased business model share (2023) (10%) (5%) 0% 5% 10% Increased business model share (2023)

Tactical opportunities:

- Build a virtual network of strategically aligned partners in lieu of traditional alliance membership
- Develop pioneering product solutions (e.g., seating, entertainment, ground services, etc.)
- Introduce a rewarding (and differentiated) loyalty scheme for both individuals and small/medium enterprises
- Investigate unique distribution strategies and revenue management policies

Strategic questions:

- How do you continue to deliver superior value in a market with airlines flanked on both sides of your business model (lower cost; "better" experience)?
- What is the strategy to expand the relevance of the platform without straying from the value proposition that makes the model successful?
- How do you use customer segmentation to solidify your value proposition?

Premium Carriers: Providing a Superior Travel Experience

While often lamented as "legacy" players, a number of global premium carriers are on the rebound with intriguing propositions that effectively deliver value in even the most competitive markets. As premium carriers look to extend their position (or survive under siege) there is a broad range of opportunities to leverage their global platforms, including:

Tactical opportunities:

- Pursue innovative partnerships to add scale in key markets with non-traditional partners
- Take customer segmentation to a new level with personalization that solidifies the value proposition
- Enhance the passenger experience through innovative ancillary options
- Utilize the loyalty program as the "front door to the airline"
- Recognize and delight high-value flyers through technology-enabled experience tailoring

Strategic questions:

- What is the most effective method of competition against the hybrid value proposition (e.g., fare brands, airline-within-an-airline, etc.)? Is the solution the same for short-, medium- and long-haul?
- What are the unexploited opportunities to truly differentiate the premium carrier model? How do you move beyond a largely commoditized economy product (and prevent the commoditization of the business product)?
- Is there a way to fundamentally change the labor model?
- To increase differentiation with the hybrid model, do you need to go further upmarket and if so, what are the most effective means to do so?
- How do you truly "own" your customer's overall travel experience (and participate in a much bigger value pool) while maintaining your core brand proposition?

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