L.E.K.

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Creating Ancillary Revenue Opportunities: Rethinking the Airline Selling Proposition

For years, investors and other industry observers have impugned the airline industry's long-run commercial viability. They point to such "structural flaws" as low barriers to entry, high fixed costs, undifferentiated service, intractable factor costs (fuel and labor) and consumers' ever-increasing ability to find the lowest price.

However, regarding the airlines as purely a commodity business with unattractive economics is ignoring a subtle but powerful trend that is making major inroads in the industry. A small but growing number of savvy carriers are competing on another dimension: viewing airplanes as a channel for selling a broad range of products and services, rather than simply a means of transportation. The term the industry uses to describe this phenomenon is "ancillary revenue."

In this issue of *Executive Insights*, we draw on our experience in identifying ancillary revenue for several major carriers, providing a way for airlines to think more expansively and create new revenue opportunities.

An Untapped Revenue Source

Ancillary revenue at most airlines is a very small percentage of the total top line. However, carriers such as Ryanair, easyJet and Allegiant are showing that giving consumers a much broader range of choices for how they spend their money before, during and after their flight can generate significantly higher returns. L.E.K. Consulting's research suggests that even these airlines are just scratching the surface and that there is a significant chance of greatly expanding the industry's overall revenue potential.

Numerous industries with high fixed costs have successfully layered additional offerings onto their core products and services. Consumer electronics retailers derive much of their margin from warranty and, increasingly, services revenue; hotels generate significant earnings from food, beverage and in-room services; and shipping firms capture additional sales from optional services related to the timing, handling and security of package delivery. In each case, these ancillary revenue streams have become core drivers of profit. Such examples demonstrate that it is possible to unbundle a product offering and make the base service more affordable to some consumer segments while creating more options for others. The result is higher revenue and profit than a one-size-fits-all plan confers. Airlines, too, can create ancillary revenue opportunities. Airlines' customer demographics are something most retailers yearn for: a captive audience with substantial spending power– namely, business people with minimal time to shop and vacationers who are already relaxing their wallet.

Creating Ancillary Revenue Opportunities: Rethinking the Airline Selling Proposition was written by **John Thomas,** Vice President and **Dan McKone,** Vice President in L.E.K.'s Boston office. Please contact L.E.K. at aviation@lek.com for additional information.

Realizing this, airlines for years have tried to upsell their passengers, encouraging them to upgrade to first class, buy products through Skymall and other in-flight magazines, make satellite phone calls, and pay extra for alcoholic drinks and movies. Airlines also increasingly entice passengers to book other travel purchases through their websites, such as hotels, rental cars and entertainment, from which they take a fee.

Despite having access to attractive consumer segments, only a few airlines today generate significant ancillary revenue. The airlines that do – Ryanair, easyJet and Allegiant among them – tend to have non-traditional business models. However, from our discussions with numerous established carriers, the rest of the industry has begun taking notice of these airlines' success and the opportunities they reflect.

While it has become increasingly difficult for airlines to show incremental gains on top of the significant cost-cutting strategies they have pursued in recent years, our analysis suggests a legacy airline can generate at least 10% more highly profitable revenue from a successful ancillary revenue strategy. For a major U.S. airline, this could translate into hundreds of millions of dollars in additional annual earnings.

Why So Few Successful Ancillary Revenue Strategies?

There are several reasons why few airlines have effective ancillary revenue strategies. One key obstacle has been that onboard sales efforts have simply been ineffective. Most flight attendants view their jobs as being about safety and service, not selling, and they have not been given appropriate incentives to alter their perceptions and behavior. Also, airlines' limited success in selling such products as in-flight phone services and products from onboard catalogs has dampened their enthusiasm for new creative initiatives. Furthermore, operational problems have diminished their interest – such as the historical difficulties of in-flight credit card authorizations, weight and space restrictions, and the challenges of delivery in airports.

Perhaps the most significant reason airlines have been unsuccessful in generating meaningful ancillary revenues is that they do not have a deep understanding of consumer retail behavior. Indeed, L.E.K.'s surveys of thousands of passengers show they have not been enthusiastic about many airlines' early attempts at ancillary products and services.

Specifically:

- They do not associate airline-supplied products with high quality
- They do not view ancillary offers to be a good value for the money
- They have an ingrained reluctance to spend money in-flight through a long-held belief that all onboard amenities should be included in the ticket price

Many airline executives have other, non-operational concerns about launching ancillary revenue strategies. One is that selling more frills to economy passengers would dangerously blur the distinction between first-class and economy service. The experiences of several airlines, and L.E.K.'s consulting work with a number of major carriers, suggests otherwise. Airlines could offer a range of products and services to first-class and economy passengers while keeping their flight experiences very distinct. This requires unbundling the "hard" product (passengers' seat experience) from the "soft" product (food, drinks, etc.). Our research has found that first-class passengers choose this level of service primarily because of seat comfort, not for the better meals, drinks and other amenities that come with it.

A number of airline executives also believe that the pursuit of ancillary revenue will antagonize passengers who feel they are being charged for items that were previously included as part of the ticket price. This does not necessarily need to be the case, as some airlines have been able to decouple standard services from the price of a seat without losing customers. Furthermore, a number of the products with which there have been early successes, such as trip insurance, are incremental benefits to the customer. They have not been stripped out and provided for a separate fee and are in fact new offerings. By clearly communicating to customers that it can lower fares by separating out the incremental perks and providing new and appealing options, a carrier can assuage passenger concerns.

Ample evidence suggests that ancillary revenue can be highly profitable in the airline industry. Ryanair's ancillary revenue in fiscal 2006 jumped 36% to E259 million, accounting for 17% of total revenue. The airline charges extra for checking bags and other items, and has stated that it plans to launch an online gambling service for passengers. Allegiant, a Las Vegas-based carrier with annual revenue of about $240 million, generated 17.5% of its revenue from ancillary products and services in 2006. At this stage, Allegiant's products are mainly disaggregated parts of the standard offer; it charges for beverages, snacks, pillows, souvenirs from its travel destinations and dining coupon books. It also unbundles and charges for booking fees, checked bags and seat assignments.[1]

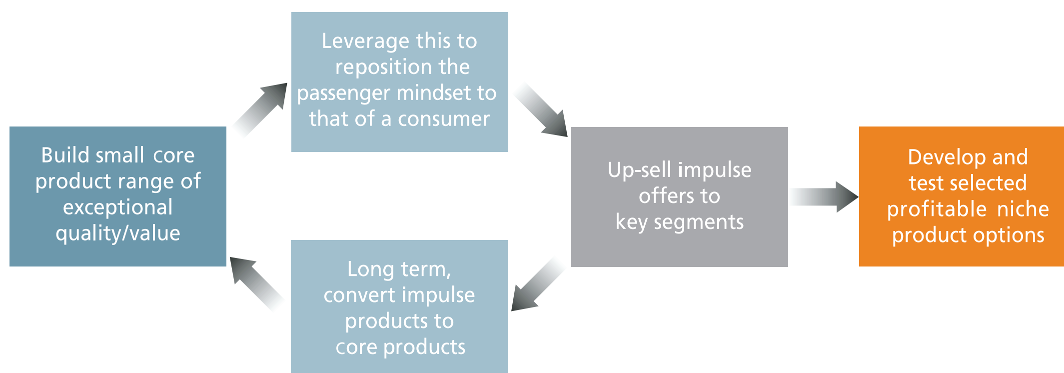
Developing an Ancillary Revenue Strategy

Since the current passenger mindset has been a powerful barrier to introducing new and exciting revenue opportunities, airlines must first address this issue. To this end, L.E.K. has developed a strategic approach, the Passenger Value Framework, for changing consumers' onboard mindsets and buying behavior (*see Figure 1*).

1 Allegiant Travel Company SEC Form S-1, Preliminary Prospectus dated August 23, 2006, and company website (AllegiantAir.com).

Figure 1

Passenger Value Framework



The first step in this process is introducing products and services with strong appeal to the broadest number of passengers. Such "core" products should be familiar to most consumers, have low inherent purchase risk, and provide immediate and relevant benefits. Core offerings can be derivations of products and services with which airlines are already familiar. These include enhanced meal and wine offerings, premium baggage services, temporary lounge access, elite parking and car services, and express airport access.

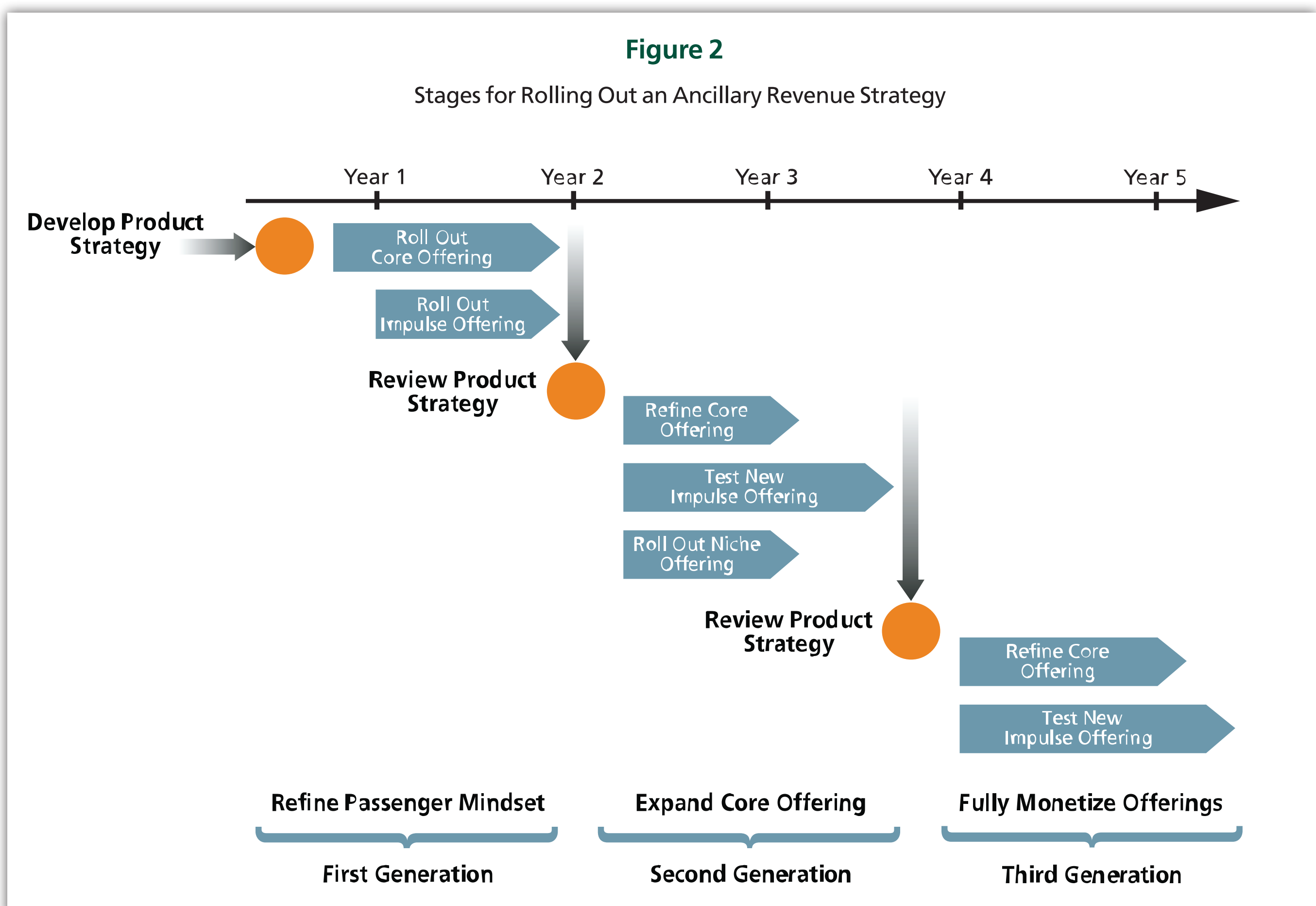
When an airline has established this first generation of core offerings, it will have created a new and higher standard for in-flight products and services. In the process, it will have made customers much more receptive to additional offerings that will improve the travel experience. At that point, it can introduce a second wave of "impulse" and "niche" products and services. These should appeal to a small but loyal base of passengers with greater disposable income and a willingness to spend it during air travel. Figure 2 illustrates the major stages for rolling out an ancillary revenue strategy.

Key Risks and How to Address Them

One risk of aggressively pursuing ancillary revenue is introducing a bevy of new products and services that overwhelm customers and airline and airport operations. Airlines must survey customers and conduct rigorous analysis of potential core, impulse and niche product offerings to ensure they have the right mix and can deliver them flawlessly. They must understand how much customers value each offer and at what price points. For example, L.E.K.'s research has shown that a surprising number of passengers would expend significant money for a better meal on even a short-haul flight.

Figure 2

Stages for Rolling Out an Ancillary Revenue Strategy



As discussed above, while success has been shown in adding new services, airlines must be careful not to offend customers with ancillary revenue programs that add fees for already existing services. Carriers whose loyalty programs currently provide free priority check-in and boarding, for example, would be wise not to begin charging for these services. Taking away incremental benefits from key customers could sour them on the airline.

Two other major obstacles are increased operational complexities and payment risks. Guarding against the first requires an airline to offer products that it can deliver through its current infrastructure. To address the payment risk obstacle, airlines must drive customers to purchase products and services at the time they book their tickets rather than en route, while working to make onboard purchases as seamless as possible. Ultimately, airlines will need to exploit evolving technological advances so that they can know at the moment a passenger makes a reservation what products and services to offer him or her before, during and after the flight.

Payment is an exceptionally large and complicated challenge. However, major airlines have launched initiatives to facilitate multi-point purchase and to-the-seat credit extension. As in-flight broadband Internet service moves from satellite-based technologies to terrestrial-based and hybrid solutions, its wider availability will significantly enhance the ability of airlines to provide onboard offerings. Airlines that effectively lay the groundwork by making passengers more receptive to onboard offerings now will be better poised for significant growth – well beyond what they generate from ancillary offerings today.

Don’t Be Left at the Gate

In their efforts to capture incremental gains, most airlines have fully exploited the traditional levers available to them, such as cost-cutting, loyalty programs and yield management systems. To create new opportunities to improve both their top and bottom lines, carriers should move aggressively to improve and better sell their existing ancillary offerings as well as identify, test and plan the rollout of new ancillary products and services.

While some recent investments in in-flight entertainment technology have certainly been substantial, airlines can generate the first wave of significant revenues without the help of advanced consumer technology. Furthermore, carriers that wait until competitors prove the market for new products and services may lose passengers. On the other hand, airlines that move quickly and invest strategically in this area will be able to increase profits without competing in the zero-sum game that has become the industry norm.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to www.lek.com.

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