Arthur D Little

Viewpoint

Multi-brand airline groups: A winning approach in the hyper-competition era?

Arthur D. Little analyzes the winning strategies of airline groups for owning and operating multiple carriers

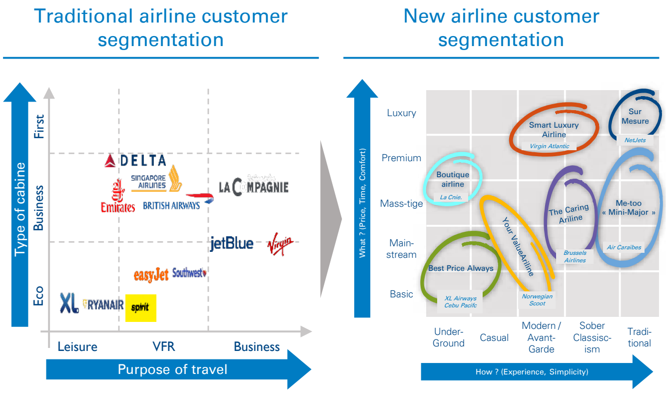
Legacy airlines have long struggled with choosing the best strategy to adopt in the era of hyper-competition, having been faced with i) the rise of low-cost carriers, first in the short-to-medium-haul segment, and now also in the long-haul segment; as well as ii) the natural trend of travelers in a maturing industry increasing in sophistication. Legacy airlines (mostly in Europe and Asia) therefore have decided to create "multi-brand airline holdings" to seize the opportunity of new segments and protect their key markets, but this comes with the risk of cannibalization. In this viewpoint, Arthur D. Little explores winning strategies for operating a multi-brand airline portfolio: What is the right trade-off between integration and independence? Which airline product has the best fit with legacy carriers?

Multi-brand airline holdings are key to competing in the hyper-competition era and propose "mass-customization"

It is critical for legacy carriers to offer a large spectrum of services and experiences to face both the ever-more-competitive environment and customers' expectations heading towards more customization. Like in the similar hospitality industry, key market segmentation criteria in the aviation industry are evolving from a "socio-demographic" approach to a "behavioral" approach, in which what the travel experience is made of and how it is delivered to customers are key.

The challenge for airlines that achieve profit with efficient utilization of assets, including the aircraft cabin and brand, is that this "mass-customization" dilemma is difficult to overcome using this branding and operating model. Many legacy carriers have thus chosen to go way beyond traditional airline alliances (such as Star Alliance) and consolidate into multi-brand holdings, gathering not just other legacy carriers, but also hybrid and low-cost carriers to address new geographies and customer segments.

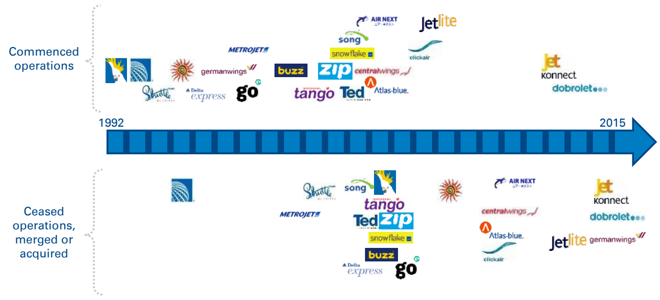
The first moves from legacy carriers to address and compete were triggered by the emergence of low-cost carriers in the late 1990s. Legacy carriers adopted various types of strategies to contain the growth of those new entrants and protect their market shares.



Besides decreases in costs and quality of overall products, as well as large increases in capacity, in order to stop new entrants, a direction many airlines have chosen has been to create (acquire) and operate "LCCs". Since their emergence, more than 30 LCCs have been created by legacy carriers in Europe, the US and Australia. However, many carriers have learned the hard way that the key success factors for running a low-cost operation are radically different from those for running a parent company. Indeed, more than 20 of the newly created airlines disappeared, sometimes after just a few months of operation.

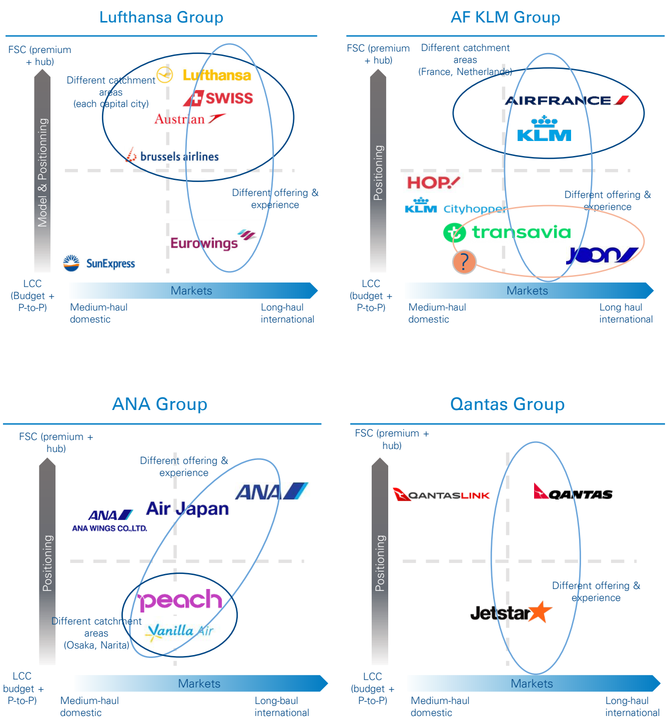
The strategic moves of legacy carriers seem to have stabilized for the short- and medium-haul segment, but are still active in the long-haul segment. These include the launch of Scoot (SIA), Joon (Air France-KLM group), Level (IAG) and the fleet and network extension of Eurowings (Lufthansa Group).

LCCs created by legacy carriers but no longer in operation



Source: Arthur D. Little analysis

Nowadays, airline groups are using "multi-airline brand holdings" with different profiles, rather than trying to create "carriers within carriers". The most common profile is to segregate brands according to i) operating model and ability to rotate assets (i.e., medium versus long haul) and ii) level of service to be provided (basic versus premium). Another option is to invest in comparable airline business models that will address different geographies.

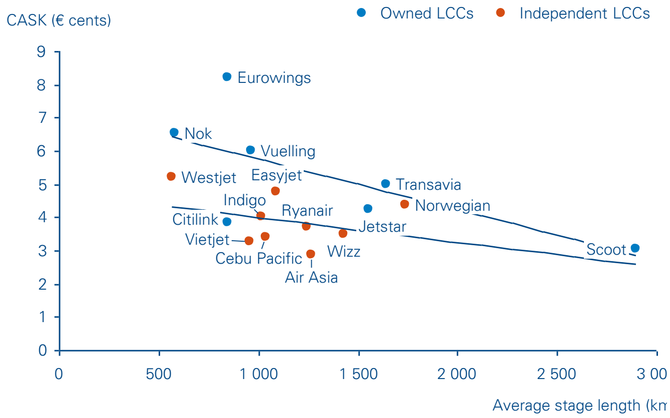


Owning "low-cost" carriers is still a major challenge for legacy carriers

Despite the lessons learned from the bankruptcies of LCCs created by legacy carriers in the early 2000s, independent LCCs seem to still have an edge over their owned counterparts in terms of costs. Indeed, we estimate that the CASK difference can be as high as 45 percent for a similar stage length.

Without assessing the local market differences underlying the variations in CASK, a few drivers seem to be meaningful:

CASK – stage-length comparison: independent and owner LCCs (2016 levels)

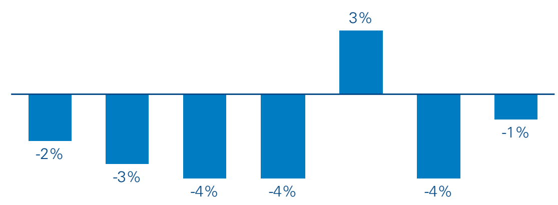


Source: SRS analyser, annual reports, Bloomberg, Arthur D. Little analysis

- Size: Independent LCCs competing with owned LCCs are usually larger in seat production and benefit from economies of scale.
- Agility: Owned LCCs can be constrained by the network choices of the legacy player, which limit their ability to rotate their assets to their full extent.
- Airtightness: Insufficient or inefficient differentiation measures with regards to staff employment conditions and OPEX control.

In addition, the results for legacy carriers have not been fully positive on the yield side. Indeed, the LCCs branch has allowed the carriers to capture new passengers and protect market shares, but unfortunately not protect their own yields. Of all the airlines owning LCCs, almost all experienced unit revenue decreases in 2016 on their LCCs' focus markets.

Yield – Legacy carriers' unit revenue evolution on main markets addressed by LCCs – 2016 versus 2015



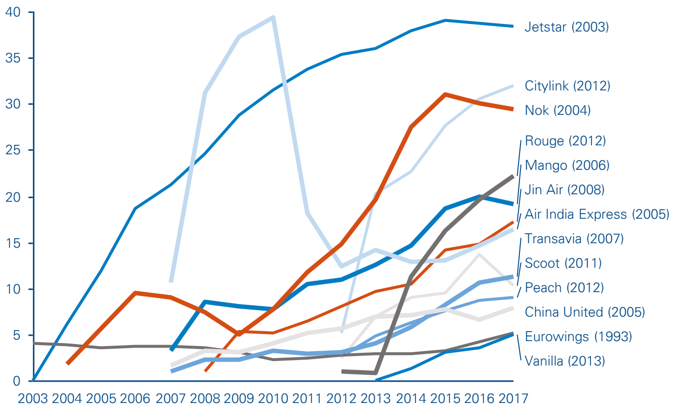
	ANA	Garuda	KLM-Air France	Korean Air	Quantas	Singapore Airlines	Thai Airways
LCC	Peach	Citilink	Transavia	Jinair	Jetstar	Scoot	Nok
LCC focus	Domestic	Domestic	Medium haul	Intl	Domestic	Intl	Domestic
Unit revenue	Yield	Yield	RASK	Yield	Yield	Yield	Yield

Source: Annual reports, Arthur D. Little analysis

Multi-brand airline portfolios should be used for four key network objectives

LCCs and other airlines gathered into holdings are key components of the network structure of airline groups, and there are key differences in the way they are deployed. For instance, the LCC share of seats in the parent group can vary from 5 (Eurowings with Lufthansa) to 38 percent (Jetstar with Qantas), and 40 percent seems to represent the threshold for historical data.

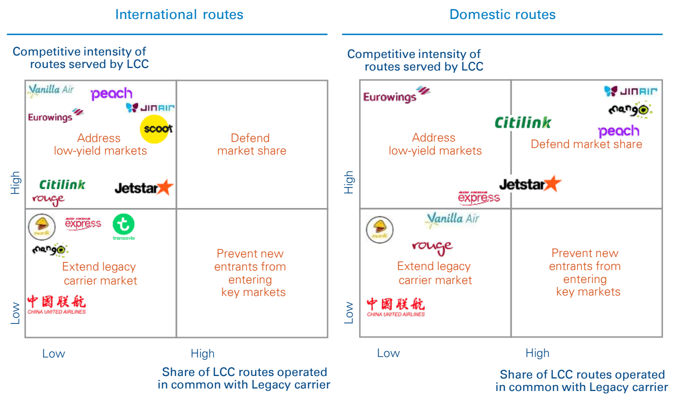
LCC share of seats in percentage (LCC+Legacy carrier)



Source: SRS analyser, Arthur D. Little analysis
(-): operation start under current airline code

- Defend the market share: Most routes with high competitive intensity are jointly flown with the legacy carrier.
- Prevent new competitors from entering key markets: The low-cost carrier has a high share of routes flown in common with the legacy carrier, but the routes have a low competitive intensity.
- Extend the legacy carrier market (fly off base): The routes operated by the additional airlines are done on a stand-alone basis, and mostly on routes with limited competitive intensity.
- Address low-yield markets: The routes operated by additional airlines are also operated without the legacy carrier, but on high competition routes with pressure on yield.

Network strategies for airlines owned by legacy carriers



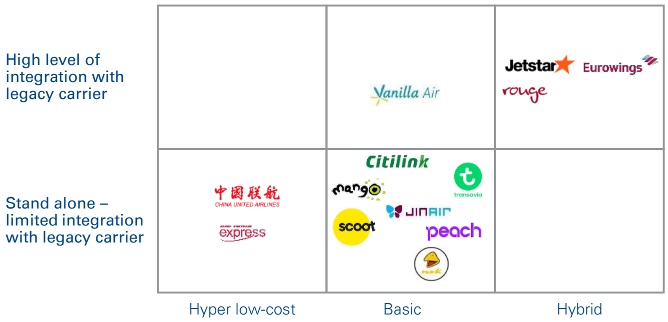
Source: SRS analyser, Arthur D. Little analysis

On international routes, the majority of legacy-owned LCCs are used to address low-yield markets, while defense of market share seems to be a higher priority for LCCs on domestic routes.

Multi-airlines "platform" is key to achieving smart differentiation and synergies

Multi-brand airline holdings can adopt six strategic models according to i) the level of integration between airlines and ii) the positioning and products developed by "non-legacy" airlines:

Possible models for "new" airlines in a legacy's portfolio



Source: IATA, Seabury consulting, Arthur D. Little analysis

Level of integration: Key elements are related to either top-line or operations and asset management.

- In terms of revenue synergies, the key focus is on distribution platforms, frequent flyer programs, hub feeding (while not lowering aircraft utilization), code-share possibilities and the definition of a dual brand/network strategy. From that perspective, Jetstar from Qantas Group is the most integrated airline, with a full dual-brand strategy while, on the other end of the spectrum, airlines such as Nok and Peach are operated as separated entities. For cost items such as fuel or aircraft and MRO supply, integration at group level is necessary to exploit synergy opportunities.
- In other revenue and operational aspects, strict segregation is needed to ensure a low cost base and avoid false efficiencies of shared operations in terms of fleet planning, crew management and employment conditions, product and revenue management, marketing and communication, etc.

Positioning and product: LCCs owned by legacy airlines operate with three main models: ultra-low cost, basic and hybrid. Aside from a limited number of ultra low-cost carriers (Air India Express and China United Airlines), most owned airlines have basic to hybrid operating and product models. All have used significant brand differentiation between the parent and the low-cost subsidiary to prevent dilution of the parent's brand premium, as well as brand confusion between the two airlines.

A solution to achieve both "integration" and "differentiation" is to leverage a "multi-level and multi-airline" platform with, for example:

- Level A: a group corporate platform to leverage some key dimensions, such as fleet management, MRO and fuel contracts.
- Level B: a business unit platform associated with each brand to manage network, product, revenue and distribution management, as well as marketing and communication and supply chain on the ground.
- Level C: a "flight production" platform, with several AOCs enabling the airline to achieve lowest cost base.

To be successful and maximize value, multi-brand airline holdings should master these factors

Looking at actual results, there is no strategic model that seems to emerge as the key winner in terms of financial performance. Although high integration (leveraging economies of scale) and hybrid positioning seem attractive, they do not automatically lead to profitability. The relevance of each option is clearly related to the maturity of airlines in the portfolio and the competitive environment they evolve into. Airlines like Eurowings, Transavia, Jetstar or Citilink thus posted mixed results.

The frontier between success and failure lies, then, in two factors: making clear choices for the positioning and management of multi-airline brands, as well as swift and rigorous implementation of "dos and don'ts" derived from successes and failures in aviation and other industries.

Dos	Don'ts
Create **clear rules of the game** for each airline positioning to avoid cannibalization: define clear geographical focus, service-level focus	Let the airlines position strategically in a fully independent way as the **risk of cannibalization** and internal competition will be high, plus key synergy opportunities will be lost
Ultimately **define a clear "Why?"** vision for each brand/airline in the portfolio (because "What?" and "How?" dimensions of the offering/positioning can be easily copied)	**Hesitate to foster different/decentralized corporate culture,** employee management and innovation practices
Invest in each airline to **reach a critical size** on their respective market segments on both production and marketing dimensions	Let airlines try to **operate in a fully integrated** way, which would limit the agility of owned airlines to compete with their stand-alone competitors
Leverage **group synergies in selected functions** that have no strategic impact on the business & operating model of each airline (e.g.: joint purchasing of MRO services, aircrafts, etc.)	Assign a **limited fleet to the airlines** – economies of scale are key for owned airlines to compete in their segments

Source: IATA, Seabury consulting, Arthur D. Little analysis

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