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TAP

Facing the low-cost competition

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ABSTRACT

Title: TAP – Facing the low-cost competition

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TAP, the Portuguese national airline was founded in 1945, and since then it has been the predominant airline operating in the Portuguese market. It offers short, medium and long-haul routes mainly focusing on the European, South American and African territories. However, in recent years it has been losing market share in the short-haul segment to low-cost carriers, who continue to penetrate and grow in the Portuguese market.

Due to the liberalization of the European airline market in 1997, TAP, and the other established airlines at that time, saw major changes in the industry. Within a few years, several low-cost carriers (LCCs) were able to enter the market and reach leadership positions. Given the current threat that low-cost carriers pose to TAP, the company has to make a strategic decision on how to adapt to this kind of competition and how to best react to LCCs. Should it focus its strategy on differentiating, thus offering a value proposition that is worth paying a premium for? Or should the company restructure the business and compete with the low-cost airlines on price terms?

This case study analyses the competition between LCCs and full-service carriers (FSCs) in Europe, by explaining the differences between the two business models, and the strategies full-service carriers have followed. The objective of the case is to allow the reader to make an informed decision regarding the general strategy TAP should choose when competing against LCCs.

Keywords:

Low-cost carrier (LCC), full-service carrier (FSC), airline industry, differentiation, competition, business model, strategy

RESUMO

Título: TAP – Competição com companhias aéreas de baixo custo

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A TAP, companhia aérea nacional Portuguesa, foi fundada em 1945 e, desde então, tem sido a companhia predominante a operar no mercado Português. Oferece voos de pequeno, médio e longo-curso, focando-se no mercado Europeu, Sul-Americano e Africano. Contudo, tem vindo a perder quota de mercado, no segmento de pequeno-curso, para companhias aéreas de baixo custo.

A TAP, juntamente com todas as outras companhias Europeias existentes na altura, atravessaram um período de enorme mudança com a liberalização do mercado aeronáutico Europeu em 1997. Após a liberalização, um elevado número de transportadoras de baixo custo entrou no mercado e atingiu posições de liderança poucos anos depois. Tendo em conta a ameaça que as mesmas representam para a TAP, é necessário tomar uma decisão estratégica relativamente à concorrência com este tipo de transportadoras. Deverá a TAP focar-se numa estratégia de diferenciação, oferecendo uma proposta de valor elevada? Ou deverá concorrer com estas companhias em preços?

Este caso analisa a concorrência entre as companhias tradicionais e de baixo custo no mercado Europeu. Aborda também as diferenças entre os dois modelos de negócio e as estratégias que as companhias tradicionais têm adotado. O objetivo primordial do caso é permitir ao leitor efetuar uma decisão informada sobre qual a estratégia que a TAP deverá seguir, para concorrer com as transportadoras aéreas de baixo custo.

Palavras-chave:

Companhia aérea de baixo custo, companhia aérea tradicional, mercado aeronáutico, diferenciação, concorrência, modelo de negócio, estratégia

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Contents

ABSTRACT	ii
RESUMO	iii
ACKNOWLEDGMENTS.....	iv
LIST OF EXHIBITS.....	vii
LIST OF FIGURES	viii
LIST OF TABLES	viii
CASE STUDY.....	1
Introduction	1
Company overview - TAP	1
History	1
Industry	2
Worldwide.....	2
Europe	2
Competitive environment	4
Ryanair.....	4
easyJet.....	5
Vueling and Transavia	5
Differences between low-cost carriers and full-service carriers	6
Business model.....	6
Fleet.....	7
Routes and bases	7
Costs	9
Strategies followed by FSCs to fight the low-cost competition	11
Reducing costs.....	11
Mergers and acquisitions	12
Entering the low-cost market.....	13
Ancillary revenue.....	13
Differentiation	14
TAP	15
What has TAP done so far?	15
TAP's 2015-2020 strategic plan.....	16
Conclusion	17
Exhibits	18
TEACHING NOTES.....	25
Introduction	25

Synopsis.....	25
Recommended assignment questions	25
Teaching objectives.....	26
Analysis.....	26
Core question	26
Additional questions for discussion	29
LITERATURE REVIEW	34
Porter’s Five Forces	34
Low-cost Business Model.....	34
A framework for responding to low-cost rivals.....	35
Strategies to compete with low-cost rivals.....	36
REFERENCES	39

LIST OF EXHIBITS

Exhibit 1 – TAP's income statement

Exhibit 2 – New entrants and exits on the airline market between 1970 and 2009

Exhibit 3 – Comparison between FSCs and LCCs business models

Exhibit 4 – Percentage of “other revenue” in total revenues

Exhibit 5 – Fleet differences

Exhibit 6 – TAP routes and load factor per route

Exhibit 7 – Factors that influence operating margin

Exhibit 8 – Passengers increase, load factor and revenue growth

Exhibit 9 – Percentage of TAP's sales and passengers per route in 2013

LIST OF FIGURES

Figure 1 – Air passenger transport in the EU28

Figure 2 – Comparison of TAP's and LCCs market share in Lisbon's and Porto's airports

Figure 3 – Comparison of bases and routes

Figure 4 – Comparison of the cost per available seat mile and operating margin in 2014

Figure 5 – Comparison of employees per available seat mile

Figure 6 – Comparison of load factors

Figure 7 – TAP's average revenue per passenger per route in 2013

LIST OF TABLES

Table 1 – Biggest airlines in Europe in 2014

CASE STUDY

Introduction

It was a typical Thursday morning when Fernando Pinto, the Chief Executive Officer of TAP, was eating breakfast, getting ready to go to work and heard on the news that easyJet after opening a route to Ponta Delgada, intended to continue the investment in the Portuguese market by opening a base in Porto^[24]. Ryanair has gone even further since its CEO, Michael O’Leary, has stated “we think we will surpass TAP and be the biggest airline company in Portugal”^[31] (the company recently launched its base in Lisbon). After hearing this he started wondering what the future of TAP would be with the biggest low-cost carriers (LCCs) betting heavily in the Portuguese market. Therefore, he asked his advisors to provide an analysis of the competition between full-service carriers (FSCs) and LCCs in Europe and assess possible strategic solutions TAP can incorporate.

Company overview - TAP

TAP Portugal is the main Portuguese airline, flying to 87 destinations in 38 countries with a fleet of 77 airplanes and operating on average 296 flights per day. In 2014 it achieved around 2,7 billion euros (exhibit 1) in revenue and had 13 268 employees^[33].

History

Transportes Aéreos Portugueses was founded on the 14th of March 1945, by then director of the civil aviation secretariat, Humberto Delgado. In that time it acquired the first two DC-3 Dakota airplanes, with a 21 passenger capacity. The first commercial route, Lisbon – Madrid, was opened on the 19th of September 1946. Later that year the “imperial route” is created which connected Lisbon – Luanda - Lourenço Marques (Maputo) and had a duration of 15 days.

The company continued to open new routes and in 1953 changed from a public service company to a public limited company (plc). However, with the Portuguese revolution in April, 1974 the company follows the trend of extensive nationalizations and is again transformed into a public service company in 1975. In 1979 the company changes its name to TAP Air Portugal and in 1980 goes through a rebranding process. It continues to open new routes and has some profitability problems until the start of the new millennium when for the first time in several years the company has a profit. It undergoes another rebranding, changing its name to TAP Portugal with the intent of reflecting modernization and the start of a new era.

In 2006 TAP assumes the control of Varig Manutenção & Engenharia (VEM), the largest maintenance center in South America, and in the subsequent years TAP is distinguished with several awards including, World Travel Awards' (WTA) Leading Airline to Africa in 2011 and 2012, Leading Airline to South America in 2009, 2010, 2011 and 2012. It was recognized by Global Traveler magazine as the best airline in Europe in 2011, 2012 and 2013 and in 2014 it receives, once again, recognition by the WTA as Europe's leading airline to Africa and Europe's leading airline to South America^[34].

Industry

The aviation industry has suffered significant changes in the past years. In the last 40 years over 1300^[24] (exhibit 2) airlines were formed and a major cause for this exponential increase was the liberalization of the markets. Twenty years after the North American deregulation, established in 1978, Europe followed the same road and in 1997, the market was liberalized allowing any European airline to provide services inside any EU country^[35]. This of course, favoured the exponential growth of the low-cost carriers in the 1990s and in the beginning of the third millennium.

For this analysis, it is important to realize the main trends in the global aviation industry, however, the main focus will be on the European and Portuguese markets since these are the markets where TAP is threatened the most by the competition of LCCs.

Worldwide

With the increase in efficiency, scale economies and economic development, travelling by plane is no longer seen as luxurious but as a common transportation method and the most practical to cover long distances. This is represented by the exponential growth in airline passengers registered over the years. According to the International Air Transport Association (IATA), the total number of passengers will continue to increase significantly in the coming years^[16].

Europe

Having established that the general market is set for a continued growth it is important to further analyse the European Market. Despite being the market which will have the smallest growth rate according to IATA, it is still forecasted to grow by 2,7% per year until 2034^[16].

Another important fact is that most of the flights involving EU28 countries, measured by the departures or arrivals involving at least one of these countries, are routes within the European Union. Which means, the highest percentage of flights originate and land in EU28 countries^[12]. This fact, helps us realize why Europe is seen as such a valuable market for low-cost carriers. Typically these airlines operate short and medium-haul flights and Europe is ideal to operate such a strategy.

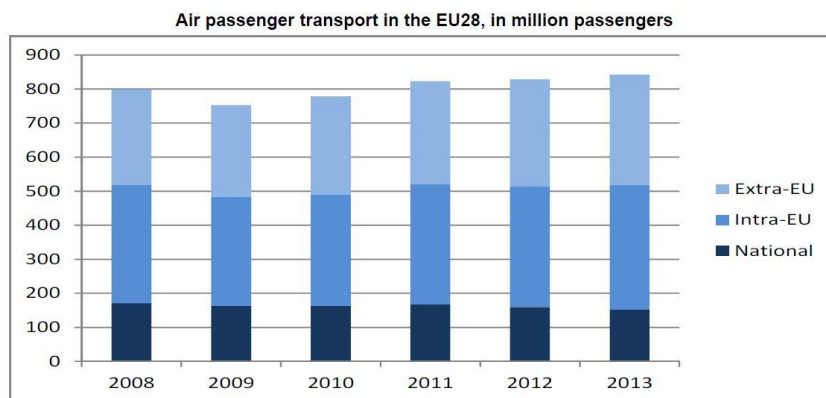


Figure 1: Air passenger transport in the EU28

Source: Eurostat news release. December 4th 2014. *Air passenger transport in the EU28*

This translates into the increasing influence, in the past few years of low-cost carriers in Europe, which can be verified by the presence of several low-cost companies in the list of the biggest airlines in Europe measured by the number of passengers carried.

	Passengers Carried (in Millions)	Type	Centre of operations
Lufthansa Group	105,9	FSC	Frankfurt and Munich
Ryanair	81,7	LCC	Dublin and London
Air France - KLM	77,5	FSC	Amsterdam and Paris
International Airlines Group	77,3	FSC	Madrid, Barcelona and London
easyJet	64,8	LCC	London
Turkish Airlines	54,7	FSC	Istanbul
Aeroflot Group	34,7	FSC	Moscow
Air Berlin Group	31,7	FSC	Berlin and Dusseldorf
SAS Group	28,4	FSC	Copenhagen, Stockholm and Oslo
Norwegian Air Shuttle	24	LCC	Oslo
Alitalia	23,9	FSC	Rome
Pegasus Airlines	17,3	LCC	Istanbul
Wizz Air	15,8	LCC	Budapest
Transaero	13,2	FSC	Saint Petersburg
TAP Portugal	11,4	FSC	Lisbon

Table 1: Biggest airlines in Europe.
Source: Annual Reports and company websites

The European market is also being affected by the growth of airlines such as, Emirates, Turkish Airlines, Etihad and Qatar. Taking advantage of their privileged locations¹ these companies are growing fast and intend to provide a global network, establishing themselves as the main carriers to connect European passengers to long-haul destinations. This means, in addition to the competition with LCCs in the short-haul routes, European FSCs will have to face severe competition in the long-haul segment as well from the emerging airlines that are penetrating the European market^[36].

Competitive environment

As it was stated, in the current environment TAP faces competition not only from low-cost carriers but also from full-service carriers. However, the analysis will be focused on the LCC competition.

The main LCC players in the Portuguese market have been gaining market share² in the two most important airports in Portugal, Lisbon and Porto. This increase in the number of passengers carried is negatively correlated with the percentage of passengers carried by TAP^[17] which leads us to assume that TAP is negatively affected from the penetration of LCCs.

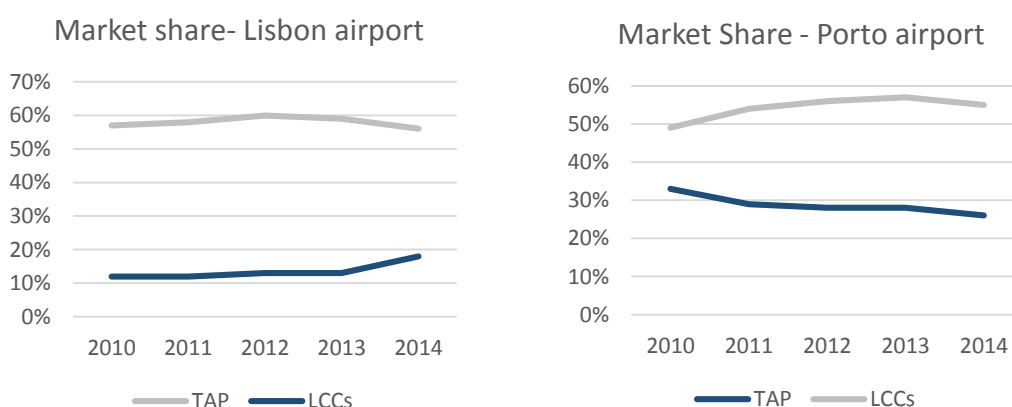


Figure 2: Comparison of TAP's and LCCs market share in Lisbon's and Porto's airports.
Source: INAC's statistics

Ryanair

Ryanair was created in 1985 by Tony Ryan, Christopher Ryan and Liam Lonergan and began by operating a small route between Waterford and London. In 1990 the company was having major losses which led to a restructuring procedure that applied Southwest's airlines low-fares model and made Ryanair the first low-cost airline in Europe^[29]. Currently, Ryanair is the biggest low-

¹ "The Gulf is handily placed between Europe, Asia, Africa and America: all are in range of modern long-haul jets. Istanbul, on the edge of Europe, is a short-haul flight from 55 capital cities"^[36]

² Measured by the percentage of passengers carried

cost airline in Europe and second biggest airline in terms of passengers carried, after the Lufthansa group.

In terms of its competition with TAP, Ryanair is the biggest low-cost competitor. In 2014, it had three bases in Portugal, Lisbon, Faro and Porto, being the leader in the last two and acquiring almost a 10% market share in Lisbon, after only 9 months of the base's launch in 2014. Nowadays Ryanair offers 17 routes out of the Lisbon airport, 29 routes out of Faro and 42 routes from Porto airport^[29]. Furthermore, Ryanair has stated that it has the intention of keeping the growth in the Portuguese market^[31].

easyJet

EasyJet was founded in 1995 by Sir Stelios Haji-loannou and started by operating two routes from London to Glasgow and Edinburgh^[10]. Currently it is the 5th biggest airline in Europe according to the number of passengers carried.

In Portugal, EasyJet poses a relevant threat to TAP as the second biggest LCC in the country. It operates in the five biggest airports and has two bases, Lisbon, since 2012 and Porto, since March 2015. It currently offer, 16 destinations out of Lisbon, 11 out of Porto and 10 out of Faro^[10] and intends to keep growing in the Portuguese market^[24].

Vueling and Transavia

The other LCCs worth mentioning in the Portuguese market are Vueling and Transavia. Both are subsidiaries of full-service carriers' conglomerates. Vueling is owned by IAG group while Transavia is a subsidiary for the Air France – KLM group. These represent a small percentage of passengers carried however, they still figure among the top 10 airlines flying out of the two major Portuguese airports^[17].

According to the Portuguese Civil Aviation Institute (INAC), Vueling is a constant presence in the top 10 airlines operating in Lisbon, with a market share in terms of passengers carried of approximately 2%^[17].

Transavia is also a relevant player, being one of the top 10 companies operating in Porto with approximately 4%^[17] of the total number of passengers carried, and currently offers 4 routes out of Lisbon and 5 routes out of Porto^[41]. The Air-France KLM's subsidiary was also mentioned in the Portuguese press regarding the possibility of opening two bases in Portugal, Lisbon and Porto until 2020^[40].

Differences between low-cost carriers and full-service carriers

Business model

Low-cost airlines and full-service carriers display many differences which result in two distinct business models(exhibit 3).

The LCCs business model achieves results through low fares. They operate point-to-point³ short-haul flights and have more operational bases spread between several countries. The low-cost business model is profitable despite the low fares since it also depends on the combination of many other factors. LCCs are cost efficient, which is derived from many aspects, some of them are the various economies of scale, the optimal use of staff, using the internet as the exclusive channel for ticket sales and the regular use of secondary lower cost airports. Another important aspect of the LCC business model are the ancillary revenues⁴ (exhibit 4). In LCCs everything besides the ticket has a cost, which represents a substantial source of revenue for LCCs. Almost everything one would expect from a FSC, such as, choosing seats, having a meal, or being able to carry hold luggage⁵ has a price on most low-cost carriers.

FSCs operate all types of flights, short, medium and long-haul and have much fewer bases, usually located in important cities of their countries of origin. Typically, they use a hub and spoke system which means they gather passengers from secondary airports at a major hub and then transport them to another major hub, thus having connecting flights^[14]. FSCs can also be flag carriers⁶ (TAP's case), which means they can have social obligations (and benefits) thus having restrictions in the destinations they offer^[15]. LCCs have no social obligations towards any specific state. Another important aspect is that after the deregulation, governments lost part of the political power necessary to provide benefits to their respective flag carriers^[15].

Full-service carriers also have more amenities and a more personalized service. The FSC business model depends largely on the long-haul flights and some of its medium and short-haul routes are just connections serving the more profitable long-haul segment^[2]. In spite of the recent efforts to increase its cost efficiency, FSCs are still not as efficient as LCC.

³ Point-to-point means passengers are flown directly to their destination without going through any central hub.

⁴ Revenues from non-ticket sources, such as the sale of food and beverages, baggage, among others...

⁵ Luggage placed in the hold of the plane

⁶ Airlines owned by a government or that are locally registered in a given state and enjoy preferential rights agreed with the government for international operations.

Fleet

In aviation, having a fleet that follows a certain pattern, (model, manufacturer, generation, among others...) is called fleet commonality and while most airline companies do this in some way, LCCs follow this principle to the extreme by operating a fleet composed by only one or two models. Consequently, LCCs achieve lower costs in training everybody involved in dealing with the aircraft (pilots, crew, etc...), and also benefit from scale economies in the maintenance operations since every plane needs the same components. This not only ensures greater flexibility in moving parts between aircrafts but it also enables LCCs to possibly achieve better deals with manufacturers in ordering parts and planes^[4].

For instance, Ryanair operates more than 300 airplanes of the same model, Boeing 737-800, with an average fleet age of 5,5 years^[28] meaning that planes are equipped with the latest technology and the company can benefit from the advantages explained above. EasyJet operates only two types of planes (Airbus 319 and Airbus 320)^[9] while the FSCs counterparts operate a larger number of models. For instance, TAP's fleet is composed by 8 types^[33] of planes (including the ones operated by Portugalia Airlines⁷) which implies higher costs (exhibit 5).

Routes and bases

Passengers often think about why they have to take a bus or train that takes one hour to reach the city. Wouldn't it be easier if easyJet, Ryanair and all the other LCCs travelled to the main airports? It would but this does not happen by chance.

It is a fact that the vast majority of LCCs travel to secondary airports. This happens because in a large number of secondary airports state aid is given to the low-cost carriers in order to develop the region. This aid usually comes from the airports (majority of airports are state owned) and it may come under the form of a fee for every passenger that the LCCs bring, it can be as a subsidy to start flying to that airport, and in most cases it can be in the form of discounts in landing and baggage handling charges^[38]. This type of aid is regulated by the EU aviation guidelines and it plays a significant role in the low-cost business model. However, this type of "revenue" translates into controversy, since it is hard to prove that the subsidies provided to LCCs are indeed used to develop that region and not to finance its operations elsewhere. Also, in light of fairer competition, full-service carriers complain about these easier conditions provided to low-cost carriers and there are cases in which legal action is pursued. Air France, for

⁷ Portugalia Airlines or PGA is a Portuguese subsidiary of TAP

example, took matters into their own hands as they sued 20 airports in its home market for giving these type of subsidies^[38].

Nonetheless, the time for special benefits for LCCs in Europe is coming to an end since the EU heard the concerns of the FSCs and in 2014 adopted new aviation guidelines. This new set of rules is an update to the last aviation guidelines issued in 2005 and intends to provide better means for fair competition in the airline industry^[11].

Regarding the absolute differences in the number of routes and bases, LCCs have a significantly higher number of both. Most LCCs are a short-haul point to point airline which means they operate short-haul flights and perform limited connection flights. Furthermore, LCCs are not flagship airlines⁸ (as is the case of many FSCs) which means they can have operational bases in multiple countries and serve several destinations departing from each of these bases. Figure 3, shows the differences in bases and routes between TAP’s most direct LCCs competitors and the top two FSCs in Europe.

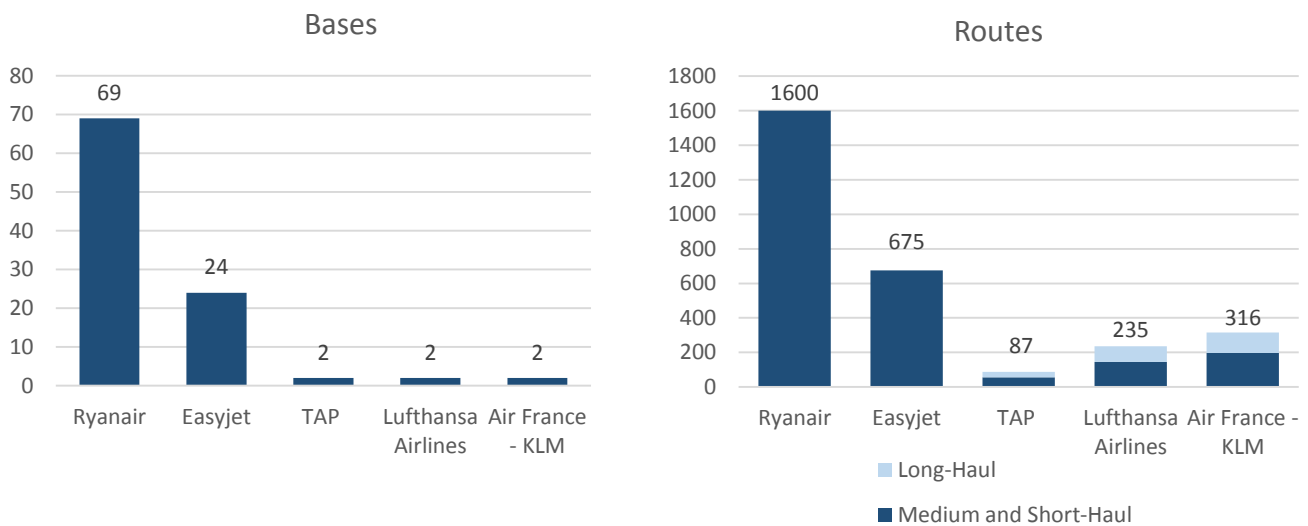


Figure 3: Comparison of bases and routes
Source: Company’s annual reports

In the case of TAP’s most direct low-cost competitors, easyJet and Ryanair, they have much higher number of bases⁹ compared with TAP and other European FSCs. As stated before, it is also observable that LCCs only have short-haul and medium-haul flights while FSCs operate long-haul as well. Of the 87 destinations TAP currently flies to, 31 are long-haul flights.

Despite the absolute difference in the number of routes offered, FSCs counterbalance this fact due to the existence of alliances between airlines. These alliances allow codeshare agreements,

⁸ Flag carriers

⁹ Airports where the companies have established operations.

which are contracts between airlines that enable them to share flights. This means, airlines can sell flights in their own reservation systems operated by other airlines in the alliance^[1]. Hence, airlines have access to the destinations offered by partner companies and can get additional revenue from routes they do not operate^[33]. TAP is part of the Star alliance, which is considered the biggest airline alliance^[32], and this allows TAP to increase the number of destinations it “flies” to (exhibit 6).

Costs

Regarding costs, it is a well-known fact that LCCs are much more cost efficient than full-service carriers, being this one of the main competitive advantages, low-cost carriers have. Two of the major aspects of airlines’ costs are fuel and staff. When we look at the operational expenses of LCCs we see that fuel has a higher percentage in the total of operating costs. However, this higher share is deceiving given that the price of fuel is one of the few operational costs airlines don’t control. Some airlines even exclude fuel from the operational expenses possibly because the price of fuel is something that can’t be easily influenced.

Before comparing the costs of full-service carriers and low-cost carriers it is important to explain one of the most relevant measures available to compare airlines costs - The cost per available seat mile (CASM). The CASM is achieved by calculating the available seat miles (ASM), which is the total number of miles that the seats available for sale¹⁰ flew. After dividing the operating expenses by the ASM, the CASM is obtained^[3]. When comparing the CASM of the two biggest LCCs in Europe with TAP and the two biggest FSCs¹¹ we can observe that the low-cost companies have much lower CASM. This, once again is due to a higher cost efficiency. This cost efficiency is translated into a higher operating margin which also reflects superior performance by the low-cost companies.

¹⁰ The seats for sale, are all the seats in an aircraft with the purpose of carrying passengers, which means the seats of crew and pilots are excluded. Therefore, ASM are calculated by multiplying the number of available seats by the number of miles flown.

¹¹ Lufthansa Passenger Airlines includes SWISS and Austrian Airlines

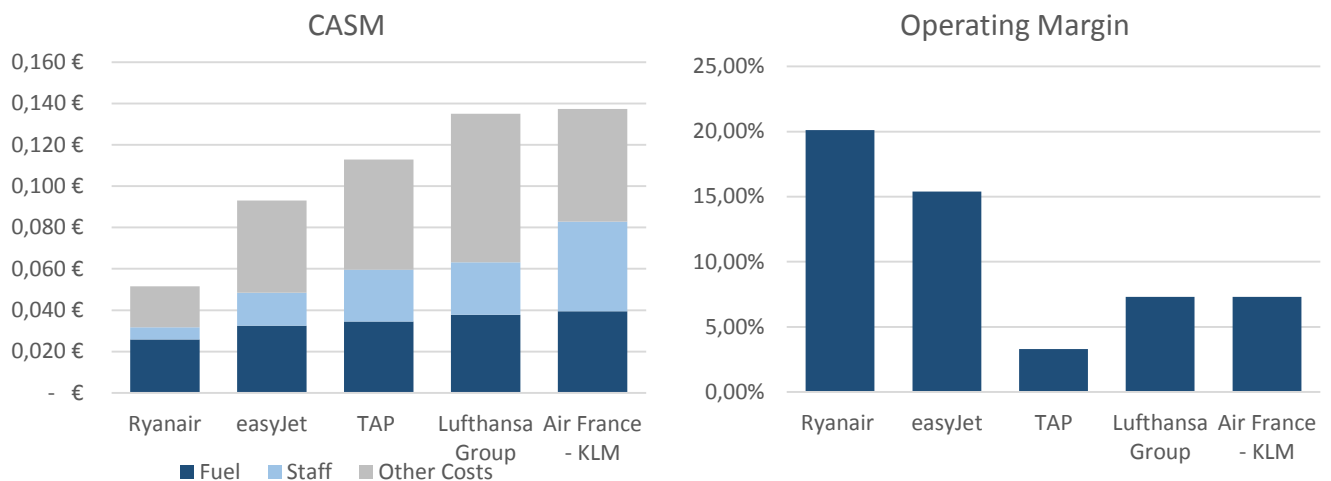


Figure 4: Comparison of cost per available seat mile and operating margin in 2014
 Source: Company's annual reports

TAP does not perform badly on the CASM measure since it achieves a cost lower than both of the other FSCs identified in 2014. Nonetheless, after analysing the operating margin of 2014, it is clear that TAP still needs to improve its operational efficiency, and this can be done by changing the factors that influence it (exhibit 7).

Another takeaway from the analysis above is that staff costs represent a much lower share in LCCs operational expenses than in FSCs. Staff is an aspect directly controlled by the companies, thus indicating this is a differentiating aspect for low-cost airlines. This is mainly due to the different company policies. Usually, FSCs have to deal with powerful work unions¹² that don't allow mass restructuring and salary cuts while LCCs are formed with a cost saving policy which enables them to be "stricter" with their work force¹⁵ and pay less than typical market values⁶. Also, LCCs ensure their workers know that there is a need for flexibility and to perform different tasks. This means that pilots, for instance, can also help in cleaning the plane to achieve a quicker turnaround time¹³. To better understand these higher staff costs we can look at the number of employees per available seat mile and the difference between LCCs and FSCs is clear.

¹² While this case study was being written, there was a strike called by the pilot's work union of TAP, which lasted 10 days and cost the company approximately 35 million Euros¹³.

¹³ The time an airplane needs to be parked at the gate before commencing operations again.

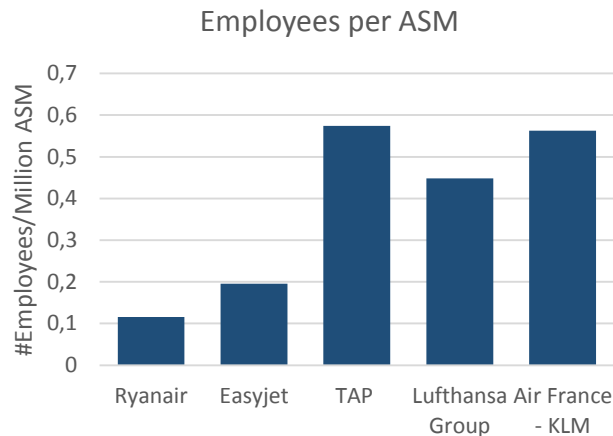


Figure 5: Comparison of employees per available seat mile
Source: Company's annual reports

Strategies followed by FSCs to fight the low-cost competition

Ever since low-cost carriers appeared FSCs have been trying to develop strategies that would allow them to accommodate this change in the aviation industry and reach profits despite the higher costs. Several strategic decisions have been made by most of FSCs, however, in Europe, LCCs are dominating the intra-European market^[7], reaching higher profit margins and continuing to grow. Nonetheless, some strategies are more effective than others, and some are even a necessity for survival in this fierce competitive market. In the following section some of the more frequent strategies followed by FSCs will be identified.

Reducing costs

One of these necessities is to reduce costs. This is the most common measure and one that the vast majority of the full-service carriers followed^[2]. To adapt to a competitive environment in which low-cost carriers are thriving in Europe, FSCs knew that in order to stay competitive they would also need to become more efficient. Many FSCs have even accommodated practices developed by LCCs^[42]. Improving this aspect can be done in several ways some of which we already mentioned earlier.

It is possible to cut costs by modernizing and standardizing the fleet. Modernizing can decrease fuel consumption and a uniform fleet enables economies of scale derived from commonality¹⁴. Another option regarding aircrafts, is to “adapt travel class configurations to specific markets”^[21]. For instance, Lufthansa modified its fleet of Airbus A340 for a two-class

¹⁴ In aviation Commonality is the principle called to a fleet that follows a certain pattern (model, manufacturer, generation, among others...)

configuration for routes where premium demand is lower, hence lowering unit costs. Air France is also restructuring its medium and short-haul fleets by decreasing the number of aircrafts intended for this type of routes^[2].

Another way to reducing unit costs is to increase productivity which in turn can be achieved in many ways. For instance, decreasing the turnaround time. Many FSCs have been trying to understand how Ryanair is able to disembark all the passengers of an aircraft, clean the passenger area, refill foods and beverages, fuel and board the new passengers in just 25 minutes^[39]. A quicker turnaround would allow an increase in productivity measured in flight hours per aircraft. Air France, for example, intends to increase its productivity in the medium-haul flights by 9% until the end of 2015^[2].

Some of the full-service carriers had to undergo more drastic measures and needed to go through restructuring processes in order to lower their costs. International Airlines Group, had to cut 3000^[42] jobs at its Spanish subsidiary, Iberia.

So far, FSCs were able to reduce the cost gap to their low-cost rivals by more than one third. In 2013 a full-service carrier spent, on average, 3,12 cents more than LCCs to move a seat through the air for one mile. This is a significant improvement compared to the 4,52 cent premium on 2006^[19]. There are risks, however, of focusing too much efforts on trimming costs. As FSCs emulate LCCs they force themselves into competing solely on price and this is done sometimes by cutting into FSCs already thin margins^[37].

Mergers and acquisitions

As airlines cut costs, they were forced to face the LCCs on unfavorable terms, therefore, some airlines have already failed such as, Alitalia, MALEV, Mexican and Air Jamaica while the “survivors tend to seek efficiency through consolidation”^[37].

The past two decades have seen the creation of massive airline groups such as, International Airlines Group, with the merger of Iberia and British Airways in 2011, Air France – KLM, which resulted from the merger of Air France and KLM in 2004, the Lufthansa group, since Lufthansa acquired both SWISS and Austrian Airlines in 2005 and 2008 (respectively), United Airlines merged with Continental Airlines in 2012, Northwest Airlines merged in Delta Airlines in 2010, US Airways merged with American Airlines in 2013, and more examples can be named.

This type of deals has been very common in the past few years in the effort by FSCs to increase efficiency through mergers and acquisitions.

TAP itself is currently waiting to be privatized and if everything goes according to plan it will be acquired. The state will receive the final offers for the company on the 5th of June 2015^[23].

Entering the low-cost market

In spite of the consolidation processes some full-service carriers had with other airlines on the same segment, there is also a clear pattern that has been arising from FSCs - to acquire or create their own low-cost carrier.

In Europe this was a path followed by the top 3 FSCs airline groups. . The Air France – KLM group was the first of the major FSCs in Europe to own a low-cost company due to Transavia, which was already owned by KLM when the companies merged. Lufthansa acquired Germanwings from its already subsidiary Eurowings in 2008¹⁵. In 2013, the IAG group also reinforced its presence on the low-cost market when it took over Vueling Airlines, which was already partly owned by Iberia.

Strategies designed for these LCCs by the parent company may vary but it makes sense for FSCs to pass on their less-profitable short-haul segments to their low-cost subsidiaries, allowing these companies to take over some control of the domestic market and achieve higher margins on the latter, while focusing themselves on the more profitable long-haul routes. There are, although, some risks for a FSC to acquire or launch its own LCC mostly due to the possibility of cannibalization¹⁶, therefore such a strategic move needs careful deliberation.

Ancillary revenue

Ancillary revenue, has been part of the LCC business model since the beginning. However, the trend in the current business environment is for full-service carriers to start charging for additional services^[37].

It is only natural that FSCs try to incorporate some of the LCCs success factors, however in this case, this measure bears a risk since it makes the difference in value proposition offered by LCCs and FSCs thinner, while LCCs continue to dominate on tariff prices. An example of this is British Airways that started charging more for additional checked baggage^[37], or Delta Air Lines charging passengers to see a movie on board, or as many FSCs do by charging passengers for Wi-Fi access.

¹⁵ Germanwings operations will be incorporated into the Eurowings brand once again in October 2015, allowing the Lufthansa group to comply with its objective to unify its low-cost segment and create a short and long-haul option for customers with the Eurowings brand.

¹⁶ The negative impact that a company's new product has on the sales performance of its already existing products.

There is a big set of examples that can be found but this type of revenue is starting to be a necessity for airlines all around the world. According to CNN Money, in some cases ancillary fees make up for 20%^[25] of the company's total revenue.

Differentiation

It is also possible to tackle the competition by offering differentiation services and focusing on a more high-quality service. LCCs are dominating the short-haul market but FSCs still have a significant share in the business segment and dominate the long-haul routes. However, this may change in the near future since LCCs, such as easyJet and Ryanair have begun to tackle the business traveler market^[37] and intend to enter the long-haul segment^[8]. EasyJet, for instance, is doing this by shifting its focus to primary airports and by starting to offer additional services such as complimentary seat reservations and flexible ticketing^{17[37]}.

Nevertheless, on the other end of the spectrum, some FSCs started improving even more its services in order to become high-quality carriers and attract more customers that are less sensitive to price. Part of the growth in the airline industry comes from business customers at the lower end of the hierarchy^[15], therefore it is possible for FSCs to try to capture this segment by offering services than create higher switching costs such as loyalty programs. For business customers, frequency¹⁸ is also a main differentiator between similar airlines on a certain route^[15], implying that airlines can also explore this aspect. But even for business customers it is important to be aware of the competition and have competitive prices. Travel agents are usually in charge of corporate demand and these agents have to comply with company's strict travel policies and budgets^[15].

Lufthansa is one of the full-service airlines that wants to excel at offering a high quality service and aims at achieving quality leadership in all classes. Being an airline in which 42,2%^[21] of the long-haul revenue is already derived from business and first class customers, a strategy focused on quality where existing services are personalized and additional benefits are established, may be the right approach to follow.

¹⁷ Ticket that allow some date flexibility

¹⁸ The number of flights to a destination in a specific time frame. Typically it is measured in weeks.

TAP

What has TAP done so far?

TAP, as all the other full-service carriers had to adapt to a changing industry and perform some structural changes. TAP has been trying to decrease unit costs while growing and has done so by renewing capacity. In 2014 it introduced 11 new routes and 6 new airplanes, 4 of which, intended for the medium-haul segment. From the 11 routes it introduced, 7 are in Europe, 2 in Brazil and 2 in Latin America. In spite of the efforts TAP was only able to reduce its CASM by 0,3% in 2014 compared to the previous year^[33]. TAP has managed to grow in revenue, passengers carried and in load factor¹⁹, however it is still behind some of its industry peers(exhibit 8).

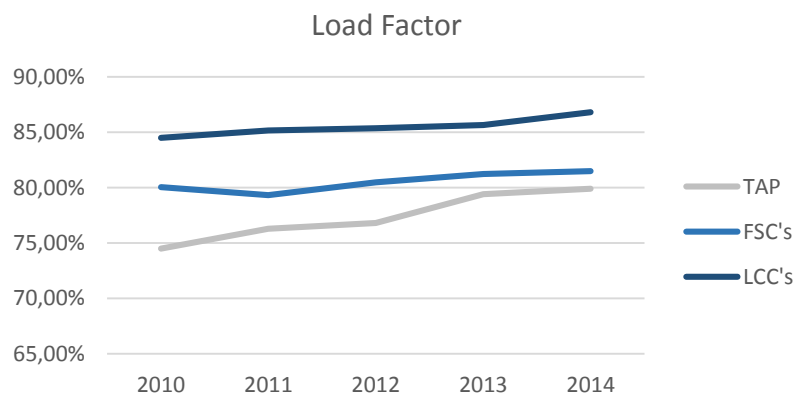


Figure 6: Comparison of load factors
Source: Company's annual reports

It has also been trying to increase the Revenue per unit and has done so by introducing a new system that optimizes the utilization of the network²⁰ and ensures a real time tuning of demand and supply, ensuring a better match in prices which will in turn provide a higher revenue per ASM. Furthermore, it has been expanding its offer of destinations on the most profitable long-haul segment in markets, such as, South America, Latin America and Africa (exhibit 6). Markets which compose more than 50% of the company's total revenue (exhibit 9).

¹⁹ Load Factor is the production compared to capacity. It is obtained from dividing Revenue passenger miles(RPMs) by the ASMs. RPM is the multiplication of the number of passengers flying with the length of the flight. For instance, 100 passengers flying 500 miles generate 50000 RPMs^[3]. In figure 5 FSCs are composed by Lufthansa, Air France – KLM and IAG, and LCCs by easyJet and Ryanair

²⁰ The total number of destinations offered by an airline

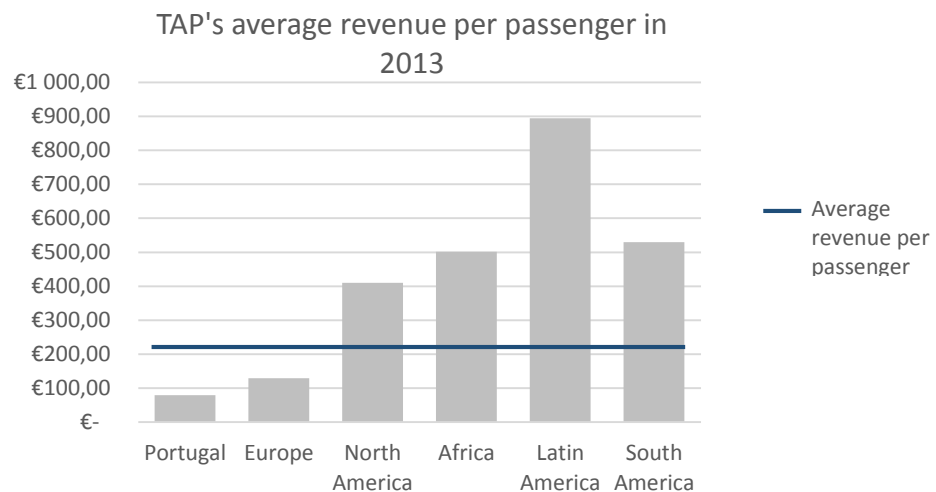


Figure 7: TAP's average revenue per passenger per route in 2013
Source: Company's annual reports

TAP's 2015-2020 strategic plan

In sequence of what is already being done, TAP has a long-term strategic vision it wants to achieve before the end of 2020. The company has six main long-term goals^[33]:

- **Renewal and expansion of the fleet:** TAP intends to have a young fleet in comparison with the industry's average, which will hopefully allow TAP to maintain competitive advantage in unit costs.
- **Evolution of the company's business model:** TAP intends to develop its product in order to compete with the highest industry standards while providing the greater comfort to passengers. It also has the goal to increase the weight of ancillary revenues on total revenues.
- **Empowerment and improvements on the customer experience:** The current long-term strategy aims at further differentiate the services offered by TAP from the LCCs, ensuring the continuous increase in competitive advantages from the passengers' point of view.
- **Growth consolidation and increased focus on the hubs:** TAP intends to keep growing its network and increase focus on the Lisbon base operations allowing its continuous improvement. It is the company's goal to reinforce its position in the markets it is currently present in and to grow in markets with high potential in which the company has a lower presence.
- **Improve operational efficiency:** TAP intends to develop an additional effort in optimizing its cost structure with the objective of ensuring a base that allows a sustainable growth as efficient as possible.
- **Reposition the maintenance units in Portugal and Brazil:** The Portuguese unit will continue to serve primarily TAP's fleet but increase its efforts in capturing an external market. The Brazilian unit will consolidate the results in its restructuring program.

TAP's goals approach the main challenges of the company but are still somewhat vague and don't cover everything the company will have to do in order to stay competitive. Furthermore, the company states it wants to increase competitive advantages in the eyes of the customer but it also says it wants to increase the weight of ancillary revenues, which can in turn decrease the

value proposition. It also lacks consideration regarding what customer segments to pursue, which can indicate the company is still not sure about its future strategy.

Conclusion

The gap between the low-cost's and the full-service's business model is getting thinner^[19]. With FSCs adopting some features that were for many years characteristic to LCCs, such as the need for ancillary revenues and cost efficiency, and as LCCs attempt to capture a higher share of the less price sensitive customers, by offering complementary services and beginning to explore the long-haul possibility, the aviation industry is yet to see major changes in the years to come. Given this, FSCs have two major strategic options to follow when choosing how to tackle the low-cost competition. One path is to differentiate themselves enough so that their value proposition is significantly higher and worth paying a premium for, or, they can choose to undergo major restructuring, and transform their business model in a way that enables price competition with LCCs.

As low-cost carriers are effectively penetrating the Portuguese market and with TAP's privatization process to be completed this year, Fernando Pinto, should take the threat of LCCs seriously and make the necessary changes to the company's current outlined strategic plan, so it can endure the competition and the changes in the industry still to come.

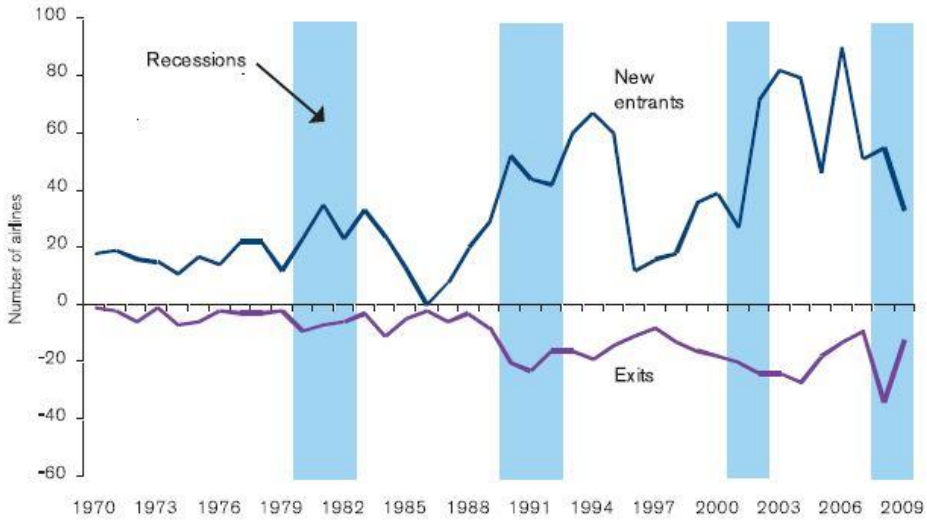
Exhibits

Exhibit 1 – TAP's income statement

(values in thousands of euros)	2010	2011	2012	2013	2014
Sales and Services	2 315 521	2 438 880	2 618 049	2 669 027	2 698 321
Operating Grants	4 565	3 253	4 312	3 852	1 151
Gains and losses in associates	-44 066	-11 124	4 110	706	1 611
Variation in production	-838	10 512	-7 887	-5 072	8 894
Own work capitalised	2 406	950	1 144	1 593	791
Cost of goods sold and materials consumed	-175 829	-188 272	-205 028	-214 811	-276 583
External supplies and services	-1 444 939	-1 647 060	-1 768 063	-1 705 328	-1 816 262
Personnel costs	-559 721	-523 970	-506 883	-571 855	-578 880
Inventory adjustments (losses/reversals)	3 966	-2 448	-1 964	-5 908	-105
Impairment of debts receivable (losses/reversals)	4 307	588	3 323	-366	-14 044
Provisions (increases/decreases)	3 701	12 603	3 687	3 623	-5 706
Fair value increase/reductions	0	255	2 210	-410	104
Other income and gains	75 108	47 638	55 972	49 359	103 958
Other costs and losses	-45 540	-35 332	-42 443	-64 598	-33 257
Earnings before interest, taxes, depreciation and amortisation	138 641	106 473	160 539	159 812	89 993
Depreciation and amortisation cost/reversals	-138 622	-122 190	-119 776	-115 751	-85 437
Impairment of assets subject to depreciation/amortisation	-440	-2 350	0	0	-1 984
Net operating Income (earnings before interests and taxes)	-421	-18 067	40 763	44 061	2 572
Interest and similar revenue received	6 896	8 596	5 696	6 155	3 091
Interest and similar costs paid	-50 893	-55 032	-57 371	-50 656	-84 509
Pre-tax earnings	-44 418	-64 503	-10 912	-440	-78 846
Corporate income tax for the year	-8 497	-7 700	-9 196	-475	-2 103
Net Income for the year	-52 915	-72 203	-20 108	-915	-80 949
Net Income of shareholders of the parent company	-57 103	-76 807	-25 487	-5 868	-85 096
Net income of non-controlling interests	4 188	4 604	5 378	4 953	4 147
Basic and diluted earnings per share (euros)	-38	-51	-17	-4	-57

Source: TAP's annual reports

Exhibit 2 – New entrants and exits on the airline market between 1970 and 2009



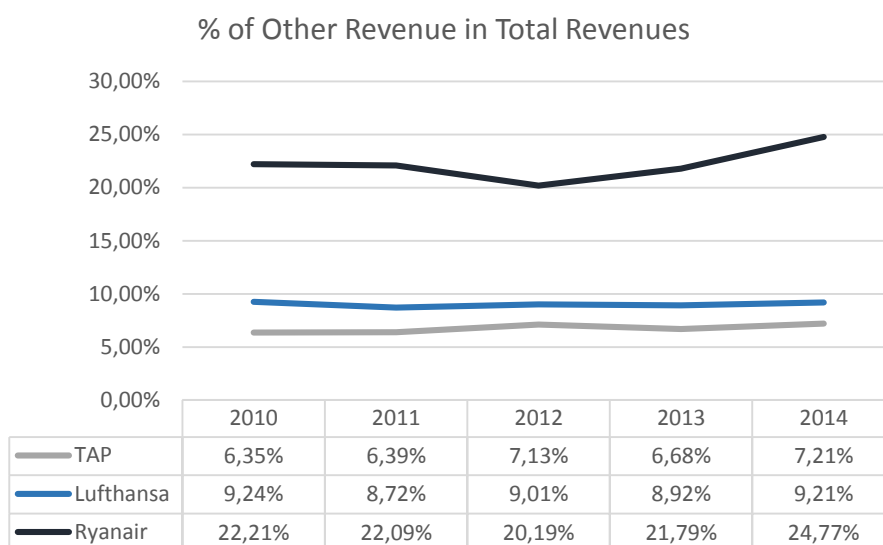
Source: IATA's Vision 2050 report

Exhibit 3 – Comparison between FSCs and LCCs business models

Characteristic feature	FSC	LCC
Generic Strategy	Differentiation	Cost minimisation/cost leadership, entrepreneurial in character
Scale	Typically large	Generally smaller, but some major players (e.g. Ryanair, EasyJet)
Operational Model	Hub and spoke/Multiple hub and spoke, linking with feeder routes Mix of short/medium/ and long-haul routes Moderate Capacity utilisation Multiple aircraft models	Point to point, no interlining, short-sector length (400 – 600 nautical miles) Mainly short haul Uniform aircraft type High capacity utilization, rapid turnaround between sectors
Market	In competition with other FSCs and LCCs, leading to differentiation by class (quality) of service, with high service image, including: Frequent scheduling & flight flexibility Extensive in-flight services Comprehensive ground services Use of main airports Moderate focus on ancillary revenues	Cheap travel sector of the market, segmentation by time of booking and choice of flight Quality of service basic, e.g.: Little flexibility of flight changes (use or lose!) No catering (or meals charged for) Ground services typically outsourced Typically use secondary airports High focus on ancillary revenues
Inventory management	Pre-arranged tickets and seats: reservation system complex, due to feeder routes: use of travel agents	Inventory management simplified: direct or online bookings, ticketless, no use of travel agents
Labour	Specialized workforce Higher Wages Lower Flexibility Moderate use of outsourcing More Unionized	Flexible workforce Lower Wages High Flexibility High use of outsourcing Less Unionized

Table partially drawn from Hunter, L., 2006

Exhibit 4 – Percentage of “other revenue” in total revenues



Source: Company's Annual Reports

Exhibit 5 – Fleet differences

Fleet	2010	2011	2012	2013	2014	Nº of Aircraft Models in 2014
TAP	71	71	71	71	77	8
Lufthansa Airlines	342	355	360	431	423	10
Air France - KLM Group	625	609	573	611	571	20
IAG	-	348	377	431	459	> 9
Ryanair	231	272	294	305	297	1
easyJet	196	204	214	217	226	2

Source: Company's Annual Reports

Exhibit 6 – TAP routes and load factor per route

# of Routes	2010	2011	2012	2013	2014
Portugal	8	7	7	7	7
Europe	35	41	44	42	49
North America	1	2	2	2	2
Africa	11	13	13	15	15
Latin America	1	1	1	1	3
South America	9	9	9	9	11
Total	65	73	76	76	87

Source: TAP's Annual Reports

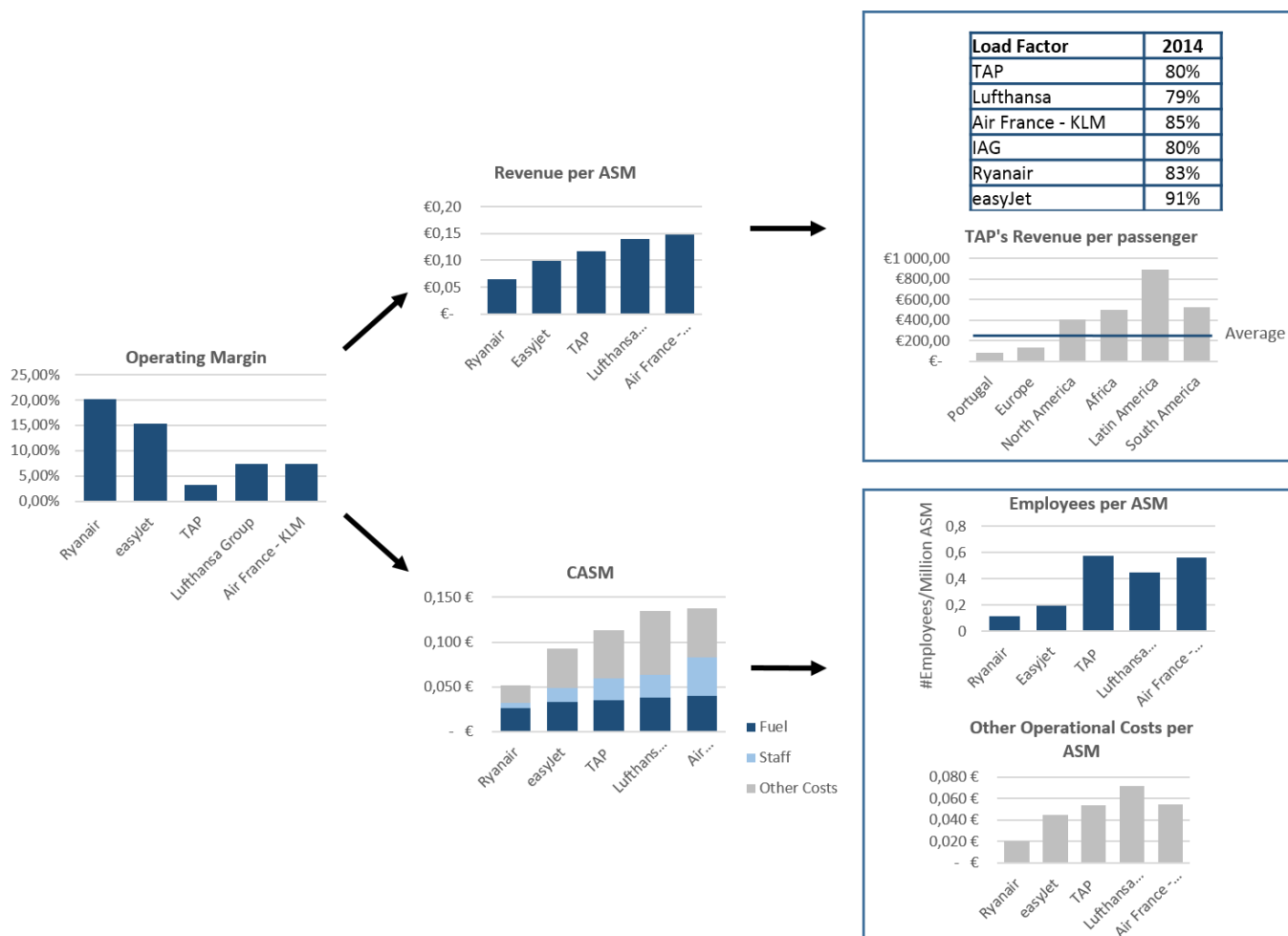
Routes operated by(2013):	Portugal	Europe	North America	Africa	Latin America	South America	Rest of the world	Total
TAP	7	42	2	15	1	9	0	76
Partner Companies	1	59	23	6	1	24	8	122

Source: TAP Annual Report 2013

Load factor per route	2010	2011	2012	2013	2014
Portugal*	60,9%	65,7%	65,9%	69,0%	-
Europe	68,1%	71,2%	72,7%	75,9%	-
North America	80,2%	76,4%	80,1%	82,8%	-
Africa	71,9%	72,8%	73,5%	76,6%	-
Latin America	68,8%	78,6%	78,0%	85,9%	-
South America	83,4%	83,1%	82,5%	84,2%	-
Total	74,5%	76,3%	76,8%	79,4%	79,9%

Source: TAP's Annual Reports

Exhibit 7 – Factors that influence operating margin



Source: Company's Annual Reports

Exhibit 8 –Passengers increase, load factor and revenue growth

Passengers (millions)	2010	2011	2012	2013	2014	GAGR ²¹
TAP	9,1	9,7	10,2	10,7	11,4	4,6%
Lufthansa Airlines	58,84	65,42	74,74 ²²	76,26	77,5	5,7%
Air France - KLM	71,39	71,32	77,4	77,3	77,5	1,7%
IAG	-	51,7	54,6	67 ²³	77	10,5%
Ryanair	66,5	72,1	75,8	79,3	81,7	4,2%
easyJet	48,8	54,5	58,4	60,8	64,8	5,8%

Source: Company's Annual Reports

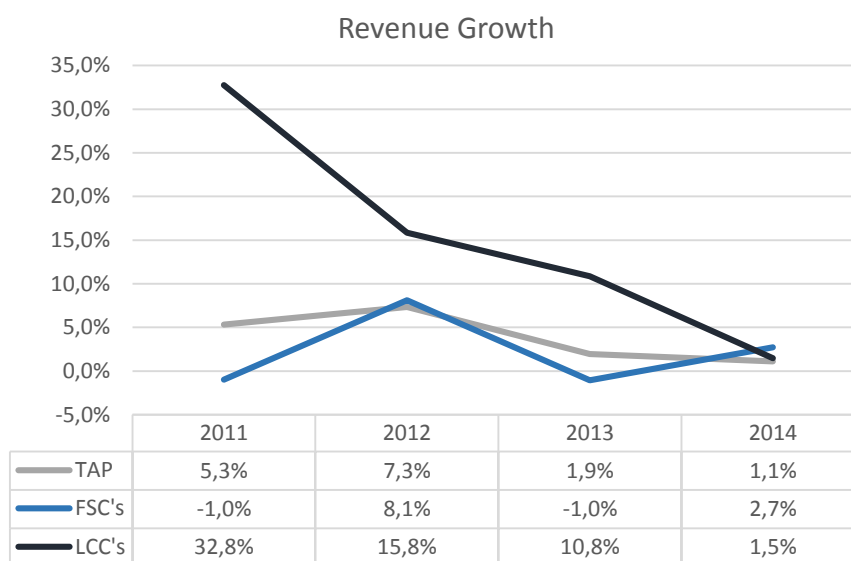
²¹ Compound Annual Growth Rate

²² Incorporation of Germanwings into Lufthansa Airlines

²³ Acquisition of Vueling

Load factor	2010	2011	2012	2013	2014	CAGR
TAP	75%	76%	77%	79%	80%	1%
Lufthansa	79%	77%	78%	79%	79%	0%
Air France - KLM	81%	82%	83%	84%	85%	1%
IAG	-	79%	80%	81%	80%	0%
Ryanair	82%	83%	82%	82%	83%	0%
easyJet	87%	87%	89%	89%	91%	1%

Source: Company's Annual Reports



Source: Company's Annual Reports

Exhibit 9 – Percentage of TAP's sales and passengers per route in 2013

%	Sales	Passengers
Portugal	5,2%	14,3%
Europe	36,3%	61,2%
North America	4,5%	2,4%
Africa	15,5%	6,8%
Latin America	3,7%	0,9%
South America	34,8%	14,4%
Total	100,0%	100,0%

Source: TAP annual report 2013

TEACHING NOTES

Introduction

This section is intended to provide guidelines for the instructor. It contains a summary of the case, suggested assignment questions as well as possible answers that relate the case with relevant theory and industry specific approaches.

Synopsis

TAP, the Portuguese national airline carrier was founded in 1945, and since then it has been the predominant airline operating in the Portuguese market. It offers short, medium and long-haul routes, focusing mainly on the European, South American and African territories. However, in recent years it has been losing market share in the short-haul segment to low-cost carriers, who continue to penetrate and grow in the Portuguese market.

Given the current threat low-cost carriers pose to TAP, the company has to make a strategic decision on how to adapt to this kind of competition and how to best react to LCCs. Should it focus its strategy on differentiating, thus offering a value proposition that is worth paying a premium for? Or should the company restructure the business and compete with the low-cost airlines on price terms?

Recommended assignment questions

The following questions are divided into two parts. The core question which addresses the main issue of the case and additional questions that intend to analyse a few important aspects also mentioned in the case.

Core question:

1. Imagine you are an advisor to Fernando Pinto. What would you recommend regarding the competition with low-cost carriers?

Additional questions for discussion:

1. In your opinion what are the reasons behind the success of low-cost carriers in Europe?
2. How would you define the aviation industry in terms of competition?
3. What do you think are the trends in the industry?

Teaching objectives

The case study was developed according to the following teaching objectives:

- For students to understand the challenges and key aspects of dealing with low-cost competition.
- To interpret the difficulties of operating in a highly competitive industry.
- To comprehend the differences between the low-cost's and the full-service carriers' business models.
- For students to analyse the environment of the aviation industry at a macro level, making use of strategic frameworks, such as, the Porter's five forces framework.
- To present a strategic solution to TAP's problem having into consideration the consequences of both alternatives.

Analysis

Core question

- 1. Imagine you are an advisor to Fernando Pinto. What would you recommend regarding the competition with low-cost carriers?**

As it is stated in the case airlines have two main strategies to fight against low-cost competitors. They can choose to keep their prices high or they can opt to lower their prices and try to fight LCCs on price terms.

In order to keep their prices higher and retain market share, full-service carriers need to find ways to differentiate themselves. There is the need to offer a high enough value proposition so that customers are willing to pay a premium for the extra features offered^[20]. This ensures incumbent firms²⁴ are able to achieve success while not competing directly with its low-cost counterparts. Instead, they can create a premium segment in the market and satisfy the needs of less price sensitive consumers.

This strategy is more efficient when companies have strong brands and operate in industries with highly differentiated products. It is also easier to implement such a strategy when a large share of consumers is not price sensitive and when the overall market doesn't grow substantially with the introduction of low price levels[6].

²⁴ Powerful, established companies that have a large market share.

Keeping the prices higher is also, in some cases, the only possible outcome, since large established firms find it hard to compete on prices due to the difficulty of reducing costs and increasing operational efficiency. Even after spending considerable time and resources in lowering costs there is a great chance that incumbent firms will not be able to equal the cost structure of its low-cost rivals^[6].

Nevertheless, this strategy has some risks and downsides. For a firm to offer a significantly higher value proposition it has to monitor its value proposition from the perspective of its consumers, and it needs to be able to communicate these differentiating aspects in a way that drives consumers into paying the premium. It is also important to be aware of the customers' level of brand-loyalty and switching costs in order to avoid underestimating the low-cost's penetration potential^[30].

The other possible path for airlines to follow is to try to compete with LCCs on prices and this can be done in two ways, severe restructuring that transform the company into a low-cost carrier, or create its own low-cost subsidiary which can be achieved from using, for instance, extra capacity and current means, building a brand new company, or by acquiring an existing LCC and take advantage of already existing operations.

Price matching is appropriate for markets where there is a large share of price sensitive customers, significant economies of scale, firms that offer undifferentiated goods, and if it is an industry where the overall market grows if price levels decrease^[6].

The first approach to price matching, has often been used by companies that want to stop the low-cost's growth, or even lead these companies to failure, and are available to cut into its own margins and endure losses until the low-cost rival has exited the market. However, this path is not advisable as a defensive strategy since, low-cost companies may still exist after these sacrifices and incumbents are worst off in the end. Instead, companies should compete on prices if their aim is to increase profitability^[27]. Complete restructuring is usually hard to implement due to the difficulty in lowering costs to a level that equals the low-cost rivals. Companies also need to be aware of competitive convergence^[6], which means if a company focuses too much on cutting services they think are not worth a premium to the consumer, products will end up competing solely on prices as all the differentiating factors will fade. This may be hurtful to incumbent companies if in the end they are not able to fully match the lower prices and their product is not differentiated anymore.

The second approach, which involves the creation or acquisition of a low cost brand, in this case a low-cost carrier, is more effective since it allows large corporations to fight the low-cost competition directly while differentiating its older brand to a more premium service. It also helps the main brand to keep its current loyal customers that are willing to pay more, while having a say in the lower end of the market, slowing down the competitors' growth and having direct access to the developing low-cost segment. This approach also has some risks, mainly due to the possibility of cannibalization, therefore it is important for companies to distinguish and communicate assertively the benefits and services provided by each brand so that the entire company is able to capture both segments of the market in an effective way^[27]. Another downside of this approach is the investment required to start or acquire a new company. This approach is only possible if the company has the ability to invest or if it has extra capacity.

Focusing on what is stated above, the strategy that appears to be more efficient for the airline industry, is to find a way to compete on prices since a large share of customers are price sensitive, the main product does not offer significant differentiation and the overall market has indeed grown with the introduction of low price levels. Nonetheless, TAP cannot restructure itself in a way that enables competition with low-cost carriers on prices, using its own brand, due the difficulty in cost cutting, which derives, for instance, from the unionized workforce. And, at first sight, (exhibit 1) it does not have the necessary investment capacity to start or buy a low-cost carrier.

Thus, the best possible alternative is to maintain its strategic course and **follow the path of differentiation**. With TAP's privatization, most probably, the company will have less public service requirements and can increase its focus on the more profitable long-haul routes (exhibit 9). It should also differentiate itself in a way that attracts low price-sensitive passengers that are willing to pay a premium. One of these segments is the business travelers. TAP can follow the footsteps of Lufthansa and try to provide a leadership service that retains the high-end class. As the company is a renowned airline between Europe-South America and Europe-Africa, it can utilize its premium brand image to provide the best service for business travelers within these routes. Possibly even, maximizing and increasing the first and business class capacity.

There is also the remote possibility that TAP can utilize its extra capacity, mainly with the PGA fleet and transform its Portuguese subsidiary into its Low-cost operator, nonetheless, significant investment would still have to be made in order to increase PGA's capacity.

Additional questions for discussion

1. In your opinion what are the reasons behind the success of low-cost carriers in Europe?

Low-cost carriers operate short-haul point to point flights and Europe is the perfect market to operate such a strategy. As it is referred in the case most flights in the European Union originate and land in the European Union. Furthermore, Europe is relatively small which means, amenities are not missed by the majority of customers in short flights. It is possible to assume that passengers often tend to choose the airline completely based on price since the service is not a relevant necessity in short-haul flights.

Despite the territorial advantages that Europe provides there are other factors that led to the rapid growth of the low-cost carriers. Many airports provide special benefits to LCCs so they can fly to that area and help develop the region. Usually this happens in secondary airports.

The technological advancements and the increase in airplane's efficiency also helped LCCs thrive since it enabled these companies to lower their unit costs and to offer low prices.

Another important factor is that when LCCs started to appear, FSCs undermined their ability to succeed, by believing customers would prefer quality over price when it came to choosing an airline. This enhanced the growth of LCCs since full-service carriers didn't react to the new competition when they should have. Furthermore, to react and lower their costs, FSCs went through severe restructuring processes that are usually demanding on time. Once again, this enabled LCCs to grow without much opposition from the FSCs.

2. How would you define the aviation industry in terms of competitiveness?

To answer this question it is important to understand the industry competitiveness by first analyzing each of the aspects that compose the competitive environment. One way to do this is to look at the industry using Michael Porter's 5-forces framework. This model takes into consideration the threat of new entrants, the threat of substitute products and the bargaining power of suppliers and buyers. After analyzing all of these aspects it is possible to reach a conclusion regarding the rivalry among existing competitors.

Despite what many may think, **the threat of new entrants in the airline industry is high**. As it is stated in the case, several new airlines were formed in the past years. This is mainly due to the fact that the barriers to entry are low.

Deregulation, affected the way in which airport slots are granted and made it easier for airlines to get access to certain airports. Also, after the deregulation, government policies to defend the position of incumbent flag carriers became less effective.

Access to the distribution channels is becoming easier, with the introduction of the internet, new airlines can offer their services to a big number of online travel agencies quickly. Customer switching costs are low. Although alliances make it harder to switch between two airlines of different alliances, it makes no difference in switching between two airlines of the same alliance. Another important aspect is the cost of acquiring aircraft, which is high, but the appearance of several leasing companies and private investors, makes the search for funding more accessible.

The threat of substitute products is medium but it is increasing. Airplanes are still different from every other transport in terms of speed of travel, however with technological advancements this difference may begin to fade specifically in the short-haul point-to-point routes, with the emergence of high-speed trains. Air travel is also more inconvenient than its alternatives due to the high security measures and protocols that are needed before the flight. Nevertheless, the increase in efficiency and cost reduction of the airline travel industry is so far winning and counterbalancing the appearance of other means of transportation.

Nonetheless, the threat of substitute products doesn't come merely from other means of transportation but also from services that can substitute the need to travel. In the case of leisure travelers, they can choose to spend their money on other activities, and in the case of business travelers, it is possible to satisfy some business needs through new technologies, such as, video conferences.

The bargaining power of suppliers is high. For airlines we can divide the suppliers into five types. The manufacturers, labour, airports, ground handling services/catering and sources of financing.

There are few manufacturers capable of producing passenger aircrafts. These are spread among a handful of companies (the most know are Boeing and Airbus) which in turn can subcontract companies to build the engines and other parts. This means that the aircraft market is highly concentrated and as stated in the case, fleet commonality has several benefits which means the cost of switching between suppliers can be substantial.

Labour is another important supplier of airlines, since these are dependent on their skilled workforce, (pilots, crew and maintenance) to perform their business activity. This dependency, associated with powerful work unions, typically in FSCs, makes it hard for airlines to manage their work force efficiently. TAP's pilot syndicate, for instance, went into strike for 10 days in May 2015, costing to the company approximately 35 million euros^[13]. These aspects make the labour force one of the most powerful suppliers in the airline industry.

Sources of financing also have relative bargaining power since airlines are dependent on these to run their business. Although competition in this sector is also high and airlines have many options to choose from.

Airports are often local monopolies since the competition from secondary airports is low. Which means switching costs between airports are high especially for FSCs depending on the connecting flights.

Ground Handling services, are typically the factor that poses the least threat to airlines since there are many companies capable of providing these services, and airlines can also operate this services in-house which means their dependency on the suppliers is not significant.

The bargaining power of airline customers is high. The industry of traveling has changed and airlines are betting on the online channels to sell tickets. However, as this trend spreads, big traveling websites are concentrating the consumers buying power which means airlines can become dependent on these websites to sell tickets. Furthermore it is a well-known fact that these websites (skyscanner, edreams among others...) compare prices of several airlines increasing the options for the end consumers. A big share of end consumers is highly price sensitive, which can be confirmed by the rapid growth of LCCs, which means their loyalty towards a specific airline is low as well as their switching costs.

For business consumers, as it is stated in the case, travel agents often hold most of the corporate demand and these agents can switch between airlines easily since they have to operate with a specific budget.

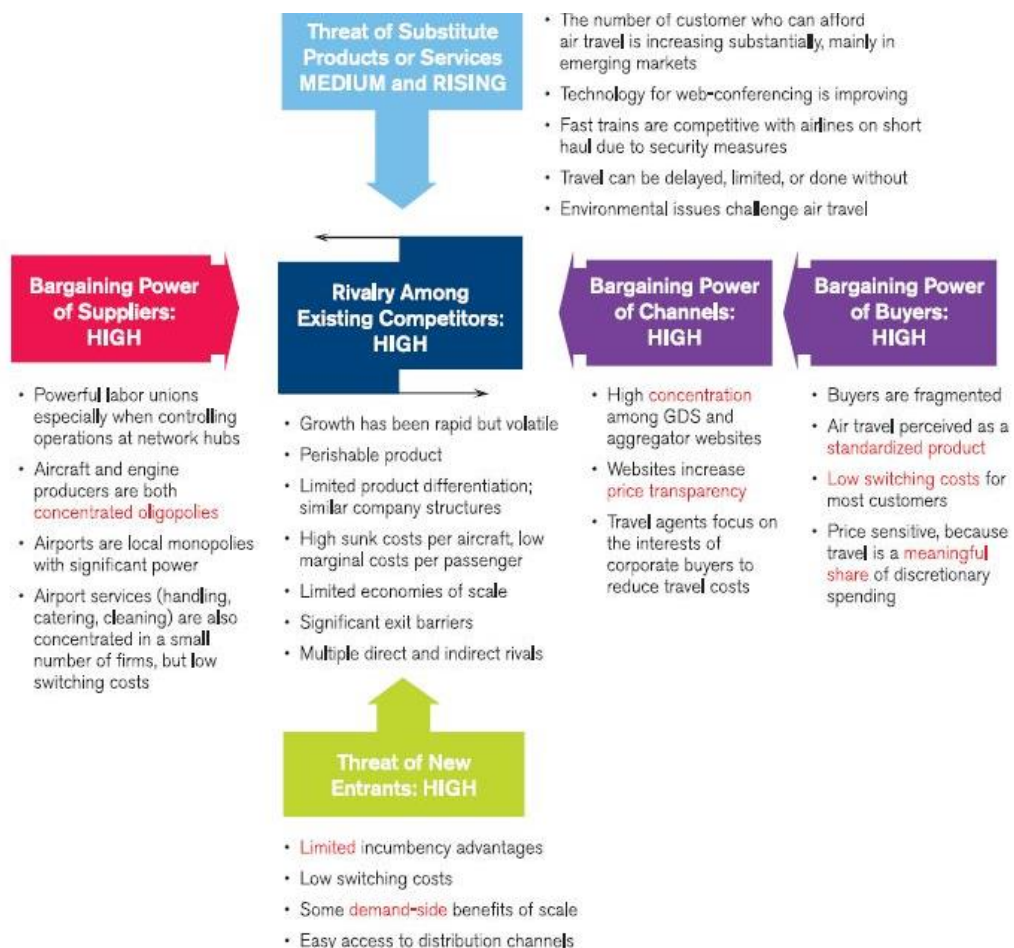
Given all of the factors mentioned above it is clear that the airline industry is **highly competitive**. Airlines compete on quantity and price. These factors are based on several strategic decisions that a company has to make. On the long term the company has to decide about its capacity and its capacity is driven by the number of airplanes and type of planes it has in operation. This choice is not easy since bigger aircrafts can lower the marginal cost per passenger but they can also compromise a company's financial health. Bigger airplanes are more expensive and the cost

per flight is fairly the same in spite of the occupation of the plane. Capacity is also related to the number of flights and the destinations the company chooses to offer.

Pricing, is done daily through complex yield management systems (TAP introduced its new system recently) in order to maximize profits. However, these tools take into account the competitors prices which means they also limit the possible payoff and are even a tool for a more intense price competition^[15].

Deregulation was also a major cause for an increase in competition for all the reasons mentioned above. Furthermore, airlines offer in essence a similar product. Even if it is a LCC or a FSC the need satisfied is the same, which is to go from one point to another. This makes it harder for airlines to differentiate themselves and increases the tendency to a price competition. It is also relatively easy for airlines within a segment to copy other's products, for instance, loyalty programs, amenities offered on board, among others. Furthermore, as costs decrease and operational efficiency increases, there is the temptation of lowering prices again, which reduces margins and increases price competition.

Overall there are several factors which make the airline industry very competitive. We talked about the most important aspects, and the ones reflected on the case. Nonetheless, Michael Porter, in its own analysis of the industry has used is model to help us understand its competitiveness.



3. What do you think are the trends in the industry?

The aviation industry is yet to see major changes in the coming years. The increase in efficiency, lower prices, globalization, the development of emerging economies, all lead to forecasts predicting significant growth for all markets in the years to come.

The market is converging and the differences between low-cost carriers and full-service carriers are slowly fading. This is due to the effort FSCs are making in cutting costs and finding alternative revenue methods, such as ancillary revenues. This means the product offered by LCCs and FSCs tends to become similar. As stated in the previous questions, this phenomena has some risks, however, it also represents an opportunity for companies who truly want to differentiate and pursue a high-end market.

Competition is going to increase, since some full-service carriers, such as Lufthansa, have been entering the low-cost segment through its own subsidiaries and offering point-to-point routes in an effort to transfer the less profitable short-haul segment to these companies. Also, some low-cost carriers are moving upwards in their customer segments and are now trying to capture a share of the business market which, until recently, was granted territory for FSCs. EasyJet, for example, is transforming its business model shifting from a pure LCC into a hybrid carrier since it now offers flexible ticketing, and some other amenities. Competition is also going to increase in the long-haul with the growth of emerging airlines, such as, Emirates, Qatar, Etihad and Turkish Airlines, and with the LCCs intending to enter this segment.

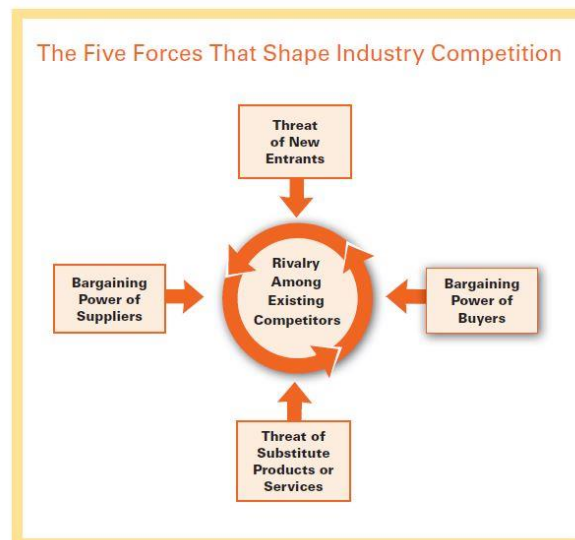
Overall, in spite of its maturity, the aviation industry is flexible and prone to change in the coming years. In the long-run with technological developments, who knows if there will be even lower cost companies entering the market and penetrating a segment now dominated by current LCCs.

LITERATURE REVIEW

There are useful frameworks and concepts in the literature that help to understand the industry and strategic decisions regarding the competition with low-cost rivals. For the present analysis, 2 frameworks and other relevant concepts were considered.

Porter's Five Forces

The Porter's five forces framework was developed by Michael Porter and helps understand the industry's profitability and competition^[26]. "Understanding the competitive forces and their underlying causes, reveals the roots of an industry's current profitability while providing a framework for anticipating and influencing competition (and profitability) over time." (Porter, M., 2011). The framework is comprised by the following factors: threat of new entrants, bargaining power of buyers, threat of substitute products, bargaining power of suppliers and rivalry among existing competitors. "The extended rivalry that results from all five forces defines an industry's structure and shapes the nature of competitive interaction within an industry." (Porter, M., 2011).

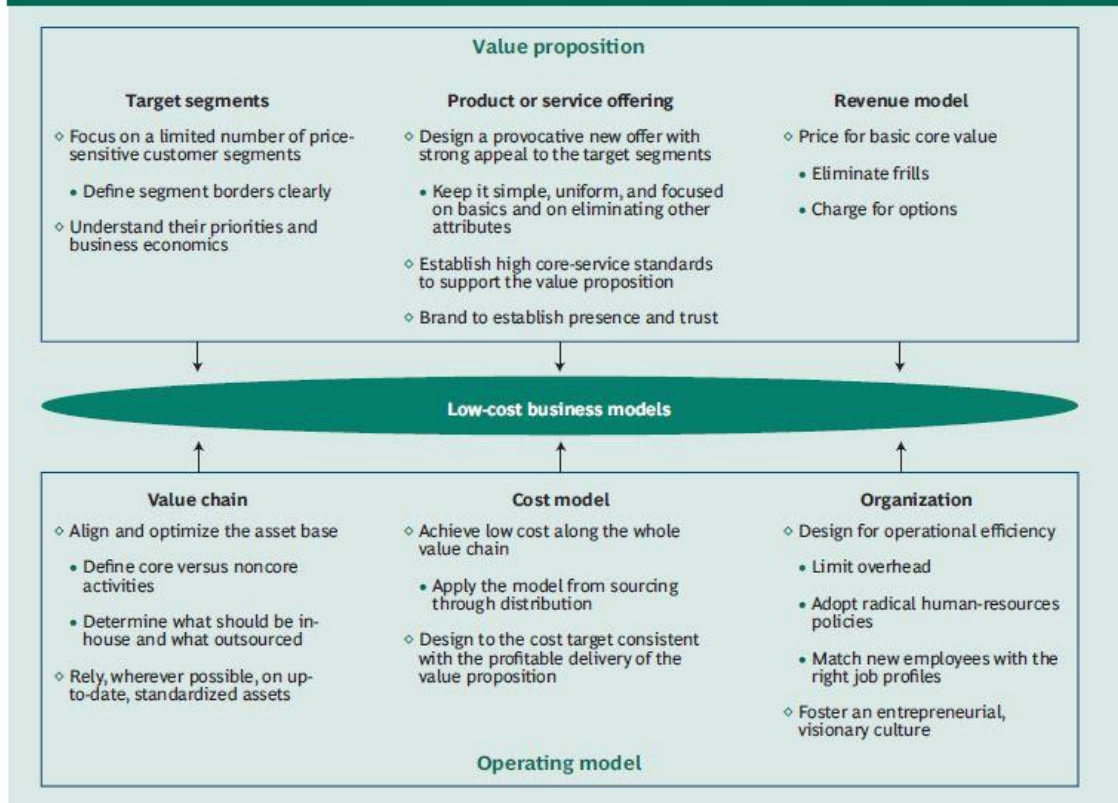


Source: Michael E. Porter, Harvard Business Review, 2011

Low-cost Business Model

The low-cost business model has been vastly described and studied in the literature, and there are many similarities that can be found in distinct low-cost business across varied industries. These similarities allowed BCG to comply an analysis identifying the main factors of the low-cost business models.

Low-Cost Business Models Are Based on an Integrated Model with Radical Choices



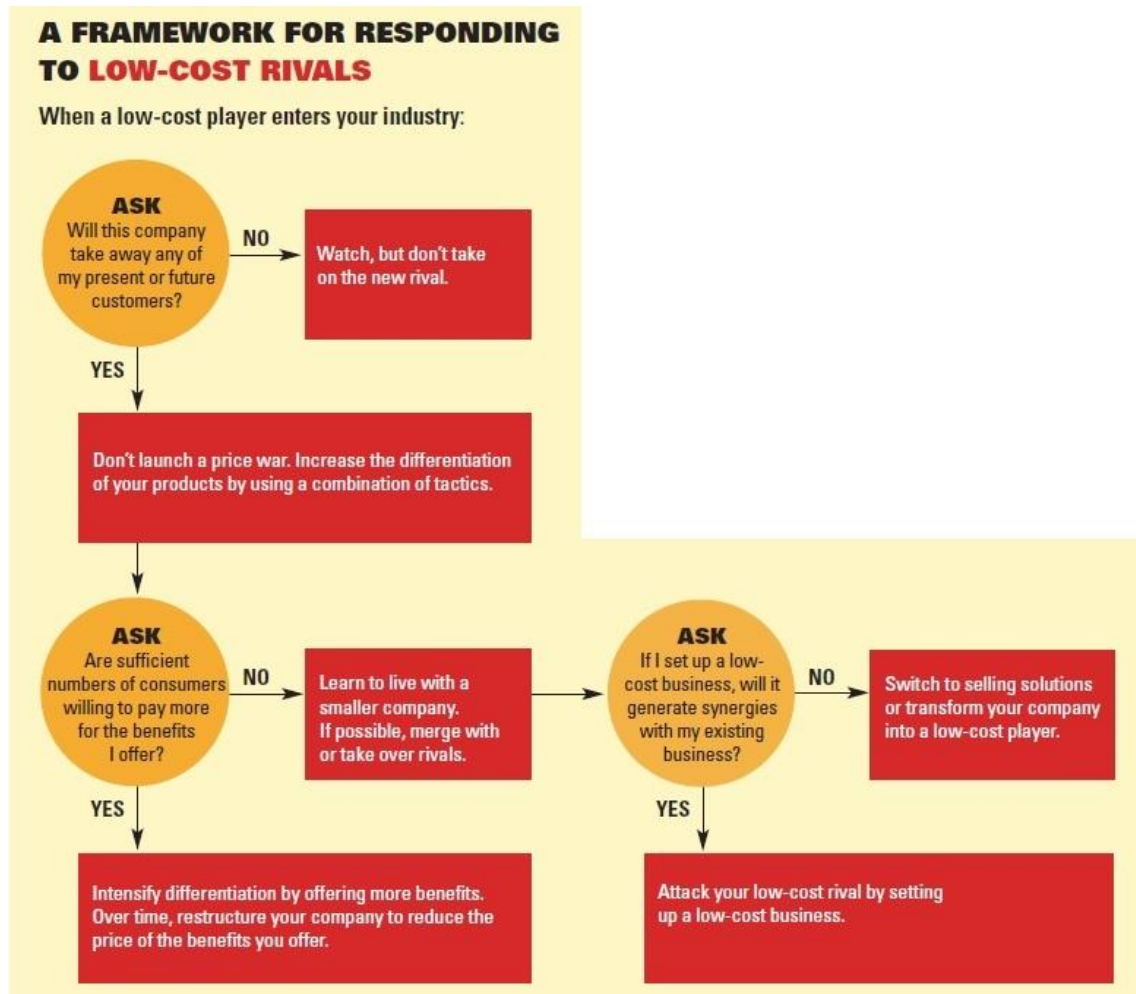
Source: Kachaner, N., Lindgardt, Z. & Michael, D., 2010

The article states that there are four golden rules of low-cost business models. Low-cost doesn't mean low-margin, instead low-cost business can have some of the best margins in their respective industries (as it happens with LCCs). Low-cost is not a synonym for lower quality, instead it is usually a synonym for a narrower range^[18]. Low-cost is innovation rather than, imitation and "low-cost is not unbranded. It is frequently supported by potent brands" (Kachaner, N., Lindgardt, Z. & Michael, D., 2010).

A framework for responding to low-cost rivals

The competition with low-cost companies has attracted the attention of several researchers and academics in an effort of finding an effective approach to fight low-cost challengers. One of the articles considered in the analysis also includes a framework. It defends that the competition

with low-cost companies should be done in a sequential way after a careful analysis of three main questions displayed in the framework:



Source: Kumar Nirmalya, Harvard Business Review, 2006

According to the author, market leaders tend to ignore and underestimate the threat low-cost rivals, thus, postponing their response “When market leaders do respond, they often set off price wars, hurting themselves more than the challengers” (Kumar, N., 2006) therefore companies should assess its customers for the willingness to pay a premium for differentiated benefits, and, only if the number of customers willing to pay more is insufficient, the company should attack the low-cost business directly.

Strategies to compete with low-cost rivals

Barry Berman, states that established firms can respond to low-cost competition via one of four strategies. These strategies are, waiting and watching, keeping the current pricing strategy, coming close or matching the low-cost competitor’s price levels, or develop a fighting brand to be inserted into the low-cost segment.

According to the author “established firms with strong brands, highly differentiated goods and services, and/or complex products are the most likely to find success with the strategy of keeping current pricing and not directly competing against low-cost competitors” while “matching or coming close to low-cost competitor’s price levels is appropriate for markets with the following characteristics: a large and growing segment of price-conscious consumers, significant economies of scale, firms that offer undifferentiated goods and services, and decreasing price levels that can drastically expand the overall market for a good or service” (Berman, B., 2015).

Companies that rely only on its products’ quality and reliability can see their customers switch if a lower price offering is presented and shows similar quality. “By contrast, customers attracted to a premium brand because it offers a total solution – for instance, financing, very high levels of technical support or service, and strong personal relationships – may be less likely to switch” (Ryans, A., 2010), therefore companies, when differentiating, could sell complete solutions rather than increasing the benefits of an existing product. Differentiation is also defended by Joan Magretta^[22] who states companies should compete to be unique, not to be the best. The competition to be the best will lead companies into benchmarking each other, increase the competition and not on increasing its value proposition. “Customer, lacking meaningful choice, buy on price alone, Profitability deteriorates.” (Magretta, J., 2011).

Starting a fighter brand is also one of the possibilities accessed in the analysis. Many airlines entered the low-cost segment by acquiring or starting a low-cost business. These new companies are intended to fight directly the low-cost rivals and ideally eliminate them. Nonetheless, there some risks in pursuing such a strategy as outlined by, Mark Ritson in his article regarding the launch of fighter brands. The first risk is cannibalization meaning that the fighter brand may penetrate into some of the premium brand’s existing consumers. The second hazard is the failure to bury the competition, which occurs when companies are too afraid of cannibalization and restrain its fighter brands potential. There is also the possibility of financial losses for the company if the fighter brand does not perform as well as expected. Furthermore, established companies start low-cost brands in an effort to fight the competition, not to satisfy a new customer need, meaning customer focus is sometimes lost and this can severely hurt the company. Lastly, incumbents that start lower-end brands can be distracted since “Launching a fighter brand while selling a premium brand is like fighting a war on two fronts” (Ritson, M., 2009)

Yield Management Pricing, is the pricing method used by most airlines. This type of pricing system is ideal for companies that have, relatively fixed capacity, are booked via reservation and have low marginal costs compared to fixed costs^[5]. “The fundamental objective of yield management pricing is to adjust prices to fill all available capacity” (Berman, B., 2005) often done by adjusting prices according to time and occupancy rates. For instance, lower prices may be charged in early stages and the remaining capacity may be saved for last minute, less price-conscious consumers.

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