Flying Low - The evolution of low cost carrier in Middle East

Executive Summary

The purpose of this report is to analyze the business model and strategy of the Low Cost Carrier (LCC) across the globe and especially the Middle Eastern region. The LCC industry is an under-penetrated source of transport given that only 13.5% of total passengers flying from Middle East used an LCC, as compared to Europe and other parts of the world, where penetration level of LCCs are much higher. We believe this is the right time to analyze the sector to give a preview on the challenges and the opportunities of this promising industry.

Report Synopsis

- Analyzing the workings of the LCC industry.
- Evaluating the strengths and weaknesses of LCC industry.
- The opportunities that the sector presents.
- The growth potential of the sector

We have used the following model to analyze the sector

Boston Consulting Group (BCG) Matrix: The purpose of the model is to help a company to decide about the priority for resource allocation. Although the usage of the model is on the Micro (company) level, however, we have utilized it to understand the position of the company within the sector.

Porter’s Generic Strategies: The primary determinant of a firm’s profitability is the attractiveness of the industry in which the company operates. The ability of a firm to add more value to its business model to attain a position of advantage, gives it a competitive advantage over its rivals. Porters Generic Strategies model is used to identify and define such strategies by the company.

Porter’s Five Forces Model: The porters five forces model identifies and analyzes five competitive forces that define and shape the industry. According to porter the main five factor the company needs to look at before entering an industry is i) Threat of new Entrants, ii) Threat of Substitutes, iii) Bargaining power of suppliers, iv) Bargaining power of Buyers, v) Internal Rivalry. The model is frequently used to identify an industry’s structure in order to determine corporate strategy.

Overall Conclusion:

Based on our analysis through the above mentioned models, we believe the sector is “Attractive”.

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History

The introduction of Southwest Airline in 1970’s, right after the airline business became profitable, in many ways was the game changer for the Airline industry. LCC’s with its no frill-cheap flight brought air travel to budget conscious masses.

Most of the subsequent LCC’s based their business model on South West Airline, which till date operates within the territories of USA. However, a couple of these LCCs has taken a step further by going for short haul international destinations, keeping the basics of the business model intact.

Business Model of Low Cost Carriers

This is the basic model of a low cost carrier. However not all LCCs apply the same model. The carriers tweak the business model in accordance with the need and in line with its differentiation strategy.

The differentiation strategy of the carrier is shaped by the local laws, and the level of competition in the local market. For example some LCC’s will charge for the on board meal, whereas some will provide it without a charge depending on the level of competition and the business practices of the local players.
Middle East LCC’s sector

Middle East has seen significant growth in the low cost carriers after the introduction of Airarabia. Currently a total of 6 LCC’s are operating from the region, out of which 3 (airarabia, flydubai, rakairways) are based out of UAE, one (Nasair) form Saudi Arabia, one (Airarabia Egypt) from Egypt and one (Jazeera airways) from Kuwait.

Middle East Low Cost Carriers

LCC penetration in Middle East is slightly higher than Africa, and considerably lower than other region like Europe and the American continent. With low penetration level we believe LCC’s have a long way to go, before it reaches maturity level.

The market share of LCC’s in Asia, also gives Middle eastern LCC’s with an opportunity to improve their footprint in the region. Given the huge concentration of Asian population in Middle East.
Middle East LCCs according to Boston Consulting Group “Growth Share Matrix”

Although The “Growth Share Matrix” is commonly used to assess the performance and standing of Business unit of a large corporation, in order to assess the cash allocation requirement of the company. However we used the model here to understand the Middle East’s Low cost carrier positioning in the wider market.

Based on our understanding of the sector, we have placed LCC’s as a “Question mark”.

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<tr>
<th>Market Potential Growth Rate</th>
<th>Relative Market Share</th>
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<tbody>
<tr>
<td>HIGH</td>
<td>HIGH</td>
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<td>?</td>
<td>We believe, with huge demand for tourism, and an affinity for low cost carriers, due to their flexible rates, will drive a lot of passengers towards LCC’s. Secondly with current low penetration of low cost carriers, this can easily change and place the sector as a Star performer.</td>
</tr>
<tr>
<td>LOW</td>
<td>LOW</td>
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<td>We have placed the Middle East LCC operators as question marks based on its market share of 13.5%, which is comparatively low as considered to other regions. However the sector has shown strong growth, primarily due to strong growth of passengers influx.</td>
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Overview of the Growth Matrix

- **Stars**- Stars represent business units having large market share in a fast growing industry. They may generate cash but because of fast growing market, stars require huge investments to maintain their lead. Net cash flow is usually modest. SBU’s located in this cell are attractive as they are located in a robust industry and these business units are highly competitive in the industry. If successful, a star will become a cash cow when the industry matures.

- **Cash Cows**- Cash Cows represents business units having a large market share in a mature, slow growing industry. Cash cows require little investment and generate cash that can be utilized for investment in other business units. These SBU’s are the corporation’s key source of cash, and are the core business line. They are the base of an organization. These businesses usually follow stability strategies. When cash cows lose their appeal and move towards deterioration, then a retrenchment policy may be pursued.

- **Question Marks** Question marks represent business units having low relative market share and located in a high growth industry. They require huge amount of cash to maintain or gain market share. They require attention to determine if the venture can be viable. Question marks are generally new goods and services which have a good commercial prospective. There is no specific strategy which can be adopted. If the firm thinks it has dominant market share, then it can adopt expansion strategy, else retrenchment strategy can be adopted. Most businesses start as question marks as the company tries to enter a high growth market in which there is already a market-share. If ignored, then question marks may become dogs, while if huge investment is made, then they have potential of becoming stars.

- **Dogs**- Dogs represent businesses having weak market shares in low-growth markets. They neither generate cash nor require huge amount of cash. Due to low market share, these business units face cost disadvantages. Generally retrenchment strategies are adopted because these firms can gain market share only at the expense of competitor’s/rival firms. These business firms have weak market share because of high costs, poor quality, ineffective marketing, etc. Unless a dog has some other strategic aim, it should be liquidated if there is fewer prospects for it to gain market share. Number of dogs should be avoided and minimized in an organization.

Source: www.managementstudyguide.com
Porter’s Generic Strategies

The purpose of this model is to identify the strategic direction of a firm or an overall sector. The ability of a firm to add more value to its business model to attain a position of advantage, gives it a competitive advantage over its rivals. According to Porter the key drivers of competitive advantage are cost leadership and differentiation of products.

Porter’s Generic Competitive Strategies Explained

A firm’s relative position within its industry determines whether a firm’s profitability is above or below the industry average. The fundamental basis of above average profitability in the long run is sustainable competitive advantage. There are two basic types of competitive advantage a firm can possess: low cost or differentiation. The two basic types of competitive advantage combined with the scope of activities for which a firm seeks to achieve them, lead to three generic strategies for achieving above average performance in an industry: cost leadership, differentiation, and focus.

The focus strategy has two variants, cost focus and differentiation focus.

1) Cost Leadership: In cost leadership, a firm sets out to become the low cost producer in its industry. The sources of cost advantage are varied and depend on the structure of the industry. They may include the pursuit of economies of scale, proprietary technology, preferential access to raw materials and other factors. A low cost producer must find and exploit all sources of cost advantage. If a firm can achieve and sustain overall cost leadership, then it will be an above average performer in its industry, provided it can command prices at or near the industry average.

2) Differentiation: In a differentiation strategy a firm seeks to be unique in its industry along some dimensions that are widely valued by buyers. It selects one or more attributes that many buyers in an industry perceive as important, and uniquely positions itself to meet those needs. It is rewarded for its uniqueness with a premium price.

3) Focus: The generic strategy of focus rests on the choice of a narrow competitive scope within an industry. The focuser selects a segment or group of segments in the industry and tailors its strategy to serving them to the exclusion of others.

The focus strategy has two variants.

(a) In cost focus a firm seeks a cost advantage in its target segment, while in (b) differentiation focus a firm seeks differentiation in its target segment. Both variants of the focus strategy rest on differences between a focuser’s target segment and other segments in the industry. The target segments must either have buyers with unusual needs or else the production and delivery system that best serves the target segment must differ from that of other industry segments. Cost focus exploits differences in cost behavior in some segments, while differentiation focus exploits the special needs of buyers in certain segments.

Source: University of Cambridge, IFM Management Technology Policy

Competitive Advantage

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<tr>
<th>Competitive Scope</th>
<th>Lower Cost</th>
<th>Differentiation</th>
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<td>Broad Target</td>
<td>Cost Leadership: Low cost carriers, as the name suggest are highly dependent on keeping the price of tickets low, in order to attract more passengers. LCC’s usually achieve this by keeping their costs low through a multiple of steps like, fuel hedging, point to point service, rapid turnaround etc.</td>
<td>Differentiation: Within the industry, LCC carrier differentiate from each other, by providing services that separates its from its competition, like some LCC’s might provide free food on board, whereas some might charge for it.</td>
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<td>Narrow Target</td>
<td>Cost Focus: we believe, for LCCs keeping an entirely cost focus strategy will hurt its customer growth. At times focus on cost alone can hurt the perception of customer. Case in point when Raynair’s strategy to charge for on-board lavatory backfired and the airline had to take a lot of negative publicity due to it.</td>
<td>Differentiation Focus: LCC carriers market are usually limited to a certain radius, given their business model of short-haul flights.</td>
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Porter’s Five Forces Analysis

Porter’s five forces model provides a simple perspective for analyzing and assessing the competitive strength and position of a corporation. The model can be used to analyze the industry context in which the firm operates. The Porter Five Forces model is a simple yet an effective tool for understanding where the strength of the business lies.

**Threat of New Entrants**
- Barriers to Entry
- Brand Equity
- Economies of Product differences
- Switching Cost
- Capital requirement
- Absolute cost
- Industry Profitability

**Threat of Substitutes**
- Buyer propensity to substitute
- Relative Price Performance of substitute
- Buyer switching cost
- Production differentiation
- Ease of substitution
- Substandard Products
- Quality Depreciation

**Bargaining Power of Suppliers**
- Supplier switching cost relative to firm switching cost
- Impact of inputs on cost or differentiation
- Substitute inputs
- Strength of distribution channel
- Supplier concentration

**Bargaining Power of Buyers**
- Buyers concentration
- Dependency on distribution channels
- Buyer switching cost
- Information availability
- Force down prices
- Substitute products
- Price Sensitivity of Buyer
- Differential advantage

**Competitive Rivalry**
- Sustainable competitive advantage through innovation
- Competition between online and offline companies
- Level of advertising expense
- Powerful competitive strategy
- Firm concentration ratio
LCC's on The Porters Five Forces Model

**Threat of New Entrants:** Medium

- The airline industry is traditionally considered a capital intensive industry, especially upfront. A sufficient fleet size is needed along with maintenance facilities. However, with the advent of leasing schemes for aircrafts, MRO (maintenance, repair, overhaul) facilities and even aircraft parts, it has become more viable for new entrant with limited capital to enter the market.
- In order to remain competitive, an airline has to achieve high level of efficiency, which cannot be achieved without a reasonable fleet size.
- The Middle East market is currently under-served by LCC as discussed earlier, where only 13.5% of total flight were through low-cost carriers. This current under penetration of LCC's along with an attractive growth prospects can attract more potential players.
- Along with new LCC's coming in the fore, we can also see existing traditional carriers competing with their very own low-costs brands.

**Threats of Substitutes:** Low

- Any mode of transport, over a short distance, is a possible substitute for LCC's and conventional airlines (i.e. reasonably priced trains, cars)
- A well connected train network is the biggest threat to LCC's as it eliminates over-head times (e.g. check-in, security check and reservations). However in Middle East, train network is in its infancy state unlike Europe where rail network is direct competition for LCC's.
- However, for a long distance trip, the advantage of higher travel speed out-weights the limitations of land travel.

**Bargaining Power of Customers:** High

- The USP (Unique selling proposition) of LCCs is no frills attached point to point transport in acceptable time in the cheapest possible way.
- The reason that a customer will opt for an LCC is its cheap price.
- With no other services to attract the customer, cheap price are the biggest selling proposition for the customer.
- Deviation in prices will see customers shift very easily and quickly to other airlines.
- In Middle East, due to a lower number of LCC operators the customers have a limited choice to shift from one LCC carrier to another. However price competition from conventional airlines can lure customers.

**Bargaining Power of Suppliers:** Medium

- The aircraft supply side is monopolized by two major manufacturers Airbus and Boeing. However the competition between the two competitors is fierce. This allows airlines to get competitive pricing and good servicing with purchasing an aircraft.
- LCC's based on its single model homogenous fleet size are able to attract quality services from the aircraft supplier, given that their commitment to a single model will result in a long term relation with the supplier has resulted in strong after sales services for LCCs.
- However, it should be noted that switching costs from one model to another model even with the same supplier are very high and even higher when switching to a different supplier. Since the pilots and the support staff will be needed to be retained and the whole supply chain for spare parts and maintenance has to be reorganized.
- LCC's to keep their cost low, have usually avoided large airports with high fees, limited space and extensive infrastructure. Instead they opt for regional under-utilized airports, where they have bargaining power. Whereas, some airlines that operates out of major airports try to reduce cost by flying at off-peak hours.

**Rivalry among Competitors:** Medium

- The major selling point of LCCs are its low prices, which has resulted in high competition in the airline industry, as conventional airline are also coming up with steps to protect itself from the cannibalization of its market share.
- Since the number of LCCs in the Middle East is quite low, as compared to 32 in Europe, market share cannibalization is quite low. However in UAE there are 3 LCCs and 2 major airline. This is where we believe the competition is becoming quite tight.
Conclusion

In light of our analysis based on the information and the models, we believe the LCC sector in the Middle East has found little penetration, and the growth potential in the sector is strong. We believe given the growth expected by IATA in the Middle Eastern sector, LCCs are strategically placed to cater for the growing demand for air travel at cheap prices.

We believe the LCC’s business model makes them a highly attractive industry, with huge growth potential.

On the BCG matrix we placed the sector under the question mark, given its low market share, however we believe the sector has all the makings of becoming a star on the back of strong demand for air travel from the locals and the expatriates.

On the Porter’s Generic model we believe LCC’s main focus is the Cost leadership where they try to manage their cost through a multiple of steps i.e. no frills flights, paid on board meal, operating from secondary airports etc. The purpose of cost management is to provide cheapest form of air travel for the passenger. The differentiation strategy pursued by LCC’s make them differentiate from one another apart from the basic cost leadership strategy.

On the Porter’s five forces model, we believe the industry looks attractive, given the low bargaining power of suppliers due to the fierce rivalry between Boeing and Airbus, which has resulted in attractive agreements for the carrier, with high barriers to entry due to heavy financing cost, however that is changing with the new leasing schemes. For Middle East we believe due to a low existence of railway network, LCC carrier have little risk of being substituted by trains. However customers have the biggest leverage as the cost of changing carrier is negligible, therefore on this front the LCC lack the leverage.

On the basis of our analysis we believe the industry is “Attractive”.
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1. **Overweight:** This rating implies that the stock is currently trading at a discount to its 12 months price target. Stocks rated “Overweight” will typically provide an upside potential of over 10% from the current price levels over next twelve months.

2. **Underweight:** This rating implies that the stock is currently trading at a premium to its 12 months price target. Stocks rated “Underweight” would typically decline by over 10% from the current price levels over next twelve months.

3. **Neutral:** The rating implies that the stock is trading in the proximate range of its 12 months price target. Stocks rated “Neutral” is expected to stagnate within +/- 10% range from the current price levels over next twelve months.

4. **Suspension of rating or rating on hold (SR/RH):** This basically implies suspension of a rating pending further analysis of a material change in the fundamentals of the company.

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