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European Legacy Airlines May Experience Ancillary Pains

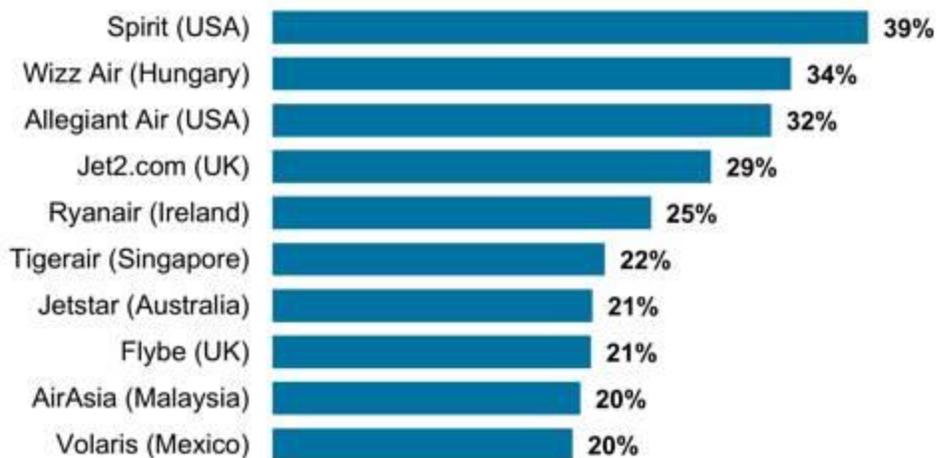
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This article is based upon a report issued by IdeaWorksCompany.

Ancillary revenues are just another area where budget carriers have a leg up on their legacy rivals.

Extra Support

Airlines' ancillary revenue as a portion of 2014 sales



Source: IdeaWorksCompany and CarTrawler | WSJ.com

Extra fees could give European budget airlines more legroom over their legacy rivals.

As discount carriers increase capacity and cut prices to win market share, ancillary revenues are helping to protect their profitability. National legacy carriers like Deutsche Lufthansa are fighting back by aping their cheaper rivals' operating models. But it may be too little too late.

Lufthansa will become the first European legacy airline to unbundle services by introducing a three-tier fare system starting from October. This allows the company to compete more directly on the actual fare but also to charge more for non-ticket items like checked bags and seat booking.

Such services incur minimal costs and therefore can add a very profitable revenue stream for airlines. So-called ancillary revenues jumped 21% in 2014 globally from a year earlier, according to industry consultant IdeaWorksCompany and online booking engine CarTrawler. In comparison, overall airline revenue rose about 6%, estimates the International Air Transport Association.



Low-cost carriers WizzAir and easyJet airplanes prepare for takeoff at Ferihegy International Airport in Budapest, Hungary. Profitability at WizzAir is improving despite lower underlying base fares. PHOTO: BLOOMBERG NEWS

Maximizing non-ticket sales has helped budget carriers maintain profitability as ticket prices plummet. At Hungary's Wizz Air, for example, profitability is improving despite lower underlying base fares, which on average fell 3% annually between 2007 and 2014, Barclays notes. Ancillary revenues rose 24% annually in the same period. The airline now has a higher profit margin at 27% based on earnings before interest, taxes, depreciation, amortization and rent, than Ryanair. It obtains about 34% of its total revenue from non-ticket items compared with legacy airlines at less than 10%.

Legacy competitors may struggle to catch up for several reasons. Budget carriers have some advantages in charging for add-on services. Since Ryanair often flies to out-of-the-way airports, its customers may be more likely to book transfer services.

Budget carriers also design ancillary revenues to grow more consistently with volume compared with the traditionally more punitive measures at legacy airlines. Wizz Air, for example, charges for every check-in bag whereas British Airways typically imposes a fee after customers reach their allowances. The former approach has higher sales potential. Ramping up fees for basic services also risks alienating customers for legacy airlines, who tend to differentiate themselves on their higher level of service.

Lower oil prices are bound to intensify short-haul competition in Europe. Ancillary revenues are just another area where budget carriers have a leg up on their legacy rivals.