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Breaking the Yield Barrier

How airlines can create new revenue streams by merchandising ancillary goods and services

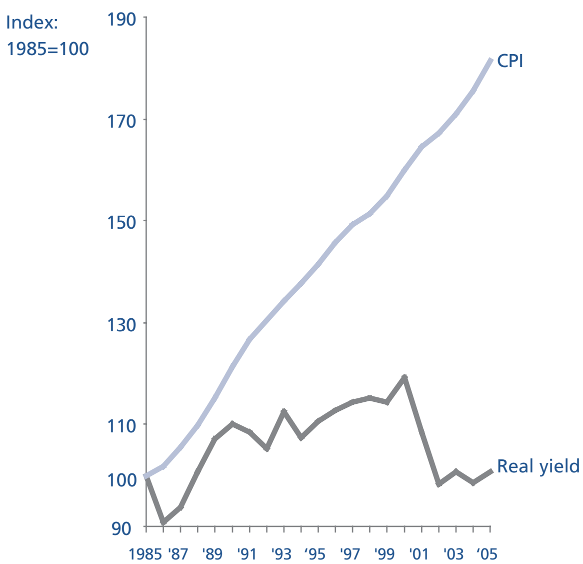
By Andrew Watterson and Raj Lalsare

Airline passengers represent a huge potential market for food, insurance, package tours, and other products that are adjacent to the core product of a seat in an aircraft. Carriers in search of high-margin growth can cultivate this market by building awareness, generating traffic, closing transactions, and filling the "shopping basket"—in short, by learning how to think like a retailer.

Despite recent successes in raising fares, the airline industry continues to experience long-term price deflation on its primary product: a seat on an airplane. It has proved difficult for airlines to break through this "yield barrier" to increase revenues (Exhibit 1).

The problem is that for most customers air travel has become a commodity based primarily on ticket price and a convenient flight. Some airlines, such as Virgin Atlantic, have tried to offer a different travel experience, and some customers seem willing to pay a bit more for that. For most other airlines, however, yield and the profitability of a ticket will continue to decline.

Exhibit 1 **The long-term decline of airline yields**



Source: Air Transport Association
Note: Yield is defined as the average revenue from sold seat-miles; real yield adjusted to 1985 dollars.

Over the past five years, airlines have aggressively reduced costs only to see soaring fuel prices eat away much of their savings. Even Southwest Airlines, which has one of the lowest cost structures in the business, realizes that revenues have to grow and raised its top fares in March and July of 2006. This is a sure sign that cost reduction, while imperative, is not sufficient to achieve financial stability.

All industries face the threat of commoditization of their core products at one point or another. Demand curves shift and drive innovation for better products and services. Pharmaceutical firms, for example, confront the challenge by developing derivatives of existing drugs or drugs for adjacent disease areas. The good news is that, as in other industries, airlines can achieve new levels of growth by addressing customer demand that is adjacent to the core product of an airplane seat.

When purchasing their tickets, Internet-enabled passengers are notoriously adept at finding the lowest price. But once travel has begun, passengers may be far more willing to trade price for convenience, just as people who buy a 2-liter bottle of soda at a discount retailer for 99 cents will pay the same price

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for a .35-liter can at a vending machine.

Several industries have been particularly adept at capitalizing on customers' different demand elasticities for different purchase occasions. Gas stations are a well-known example. In a perpetual price war for their basic product of fuel, they looked for new sources of revenue and profits and began offering food, beverages, tobacco, and other items that didn't warrant a trip to the supermarket and could easily be combined with a fill-up. Hence the term "convenience store." A decade ago, non-fuel sales contributed less than one-fifth of the gross margin at gas stations, whereas today almost half of the gross margin comes from non-fuel sales, according to the National Association of Convenience Stores. British Petroleum, after merging with Amoco in 1998, embarked on a major marketing campaign to re-brand itself and remodel its gas stations into a welcoming place under the slogan "beyond petroleum."

In the movie theater business, over 90% of profits now come from concession stands and advertising. The average movie ticket in the U.S. costs about $6.50, while in most theaters, a medium-size drink and bag of popcorn cost $7.50. Two major theater chains, AMC and Regal Cinemas, report that they barely break even on movies; it is the ancillary products that contribute to the movie experience and keep them in business.

Many hotels, casinos, and theme parks have also dealt with the commoditization of their core product by cultivating adjacent demand. Host Hotels and Resorts, for instance, reported that 38% of its revenue for the first quarter of 2006 came from non-room sources. In Las Vegas, casinos have added 3 million square feet of new retail space over the past five years, with many of these shops, restaurants, and spas becoming some of the most profitable retail real estate in the country.

The European Experience

Among airlines, it is the innovative carriers in Europe that are leading the way in capturing high-margin revenue from adjacent demand. For instance, easyJet's 2006 earnings forecast projects that passenger revenues per seat will grow between 3% and 4%, driven largely by ancillary revenues, which are projected to grow 30%.

European low-cost carriers have developed three types of non-transport revenue models:

- *Partnership deals*, in which co-branded partners market their services and products across the carriers' travel chain as if it were a real estate property or a marketing channel. These carriers have cultivated strong brands in order to draw customers directly to their websites, and partners have been willing to pay for the brand association and channel leverage. Ryanair markets packages for events such as the Grand Prix and wine-tasting tours. EasyJet markets car rentals for Europcar, ski packages for several resorts, lodging for many hotel chains, and has even co-branded air sickness bags on board with photo developer Klick Photopoint.

- *Retail sales*, where the carriers sell add-ons such as trip insurance and in-flight food, beverages, and merchandise. Here again, easyJet has been aggressive, co-marketing lounges on a per-use basis with Servisair operators at select airports. Via easyJet's website, customers can purchase entry to use in conjunction with their trips.

- *Service fees and penalties* related to luggage, seat assignment, and other aspects of travel. Flybe, which has a rapidly expanding network of European and domestic flights from regional U.K. airports, has been charging customers £4 a bag per one-way flight for checked-in luggage since February, 2006. The fee drops to £2 if customers pay via the website up to two hours before the flight departs. Other U.K. airlines are charging extra for an exit row seating assignment. To be sure, there is an implicit risk in charging customers for something they may perceive as part of their travel purchase; nonetheless, service fees are a new source of revenue.

North American airlines, particularly the legacy hub-and-spoke carriers, have been slower to harvest adjacent demand. Most of U.S. carriers' non-ticket revenue comes from loyalty-program-related partnerships, and is stagnating, while most of the European low-cost carriers' non-ticket revenue is generated via retail sales and brand partnerships, and is growing rapidly (Exhibit 2).

The U.S. carriers' experience in this area has emerged primarily through frequent flyer programs, which they have monetized through partnership deals and consumer product selections. In 2005, Air Canada raised $200 million by selling 12.5% of its loyalty program, Aeroplan, into an income trust; this implied a total valuation of $1.6 billion for Aeroplan.

The top three North American airlines derived 8% to 10% of their 2005 revenue from non-transport sources, mostly business partnerships. They have also turned to penalty-based sources of revenue, charging for ticket changes, excessive baggage weight, or talking with a reservation agent. However, such service fees may undermine customer loyalty, no matter how clear the fine print.

At the same time, these carriers have been slow to cultivate other non-ticket revenues. They have not made customers aware of the few products that do exist, such as buy-on-board food, and they lack robust transaction systems at the point of sale. As a result, customers still perceive the travel experience as one, all-inclusive product, which remains a hurdle to selling add-ons.

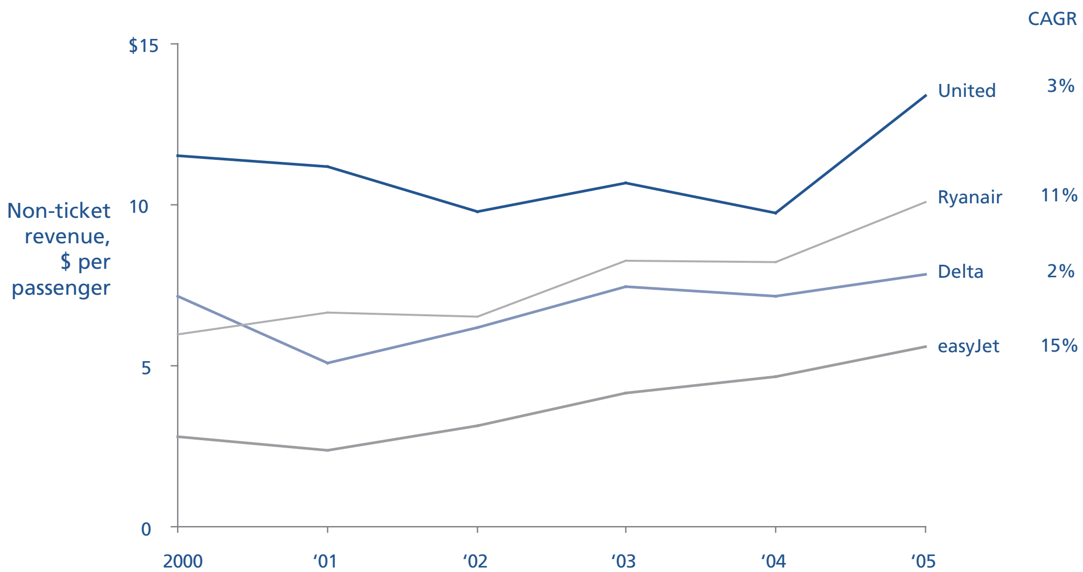
As managers at legacy carriers and other airlines start to experiment with developing ancillary revenues, they can benefit by studying some powerful principles from the retail sector. As we have seen, well-run retailers are adept at developing products and services around their core offerings.

Think Like a Retailer

A retailer's management of the shopper's experience and the firm's method of capturing value can be simplified into five steps (Exhibit 3):

Build awareness. Retailers spend enormous resources to build a brand and secure consumers' attention. Wal-Mart's entry into groceries and fresh produce is a great example. Just a few years ago, Wal-Mart was a discount store. Wal-Mart ran a steady campaign to create awareness of its Supercenter grocery concept. Awareness grew in just a few years as Wal-Mart effectively expanded its "always

Exhibit 2 **European low-cost carriers are aggressively growing non-ticket revenues**



Source: Company annual reports, The Airline Monitor low prices" guarantee to groceries. In many regions, it has become the preferred destination for grocery and fresh produce shopping.

In selling a seat on an aircraft, airlines promote their brands, prices, and sometimes their products, so that customer awareness of travel choices is generally high. Awareness of new purchase opportunities could be created for far less money, as the target segment has been reduced to those already planning and buying travel.

Generate traffic. Based on a perceived need and brand awareness, consumers come to the retailer's store or website to assess the products' attributes and value. While the Internet may have reinforced the commoditization of many products, including the aircraft seat, it has also generated a lot of traffic to the virtual store window. At Amazon.com, throughout the book browsing and buying process, customers are informed of related titles and authors, which increases Amazon's chance of making an add-on sale.

For airlines, sales of the aircraft seat generate traffic for the ancillary store. Not all passengers will buy, of course, but as each passenger goes through the travel experience, he or she is progressively more willing to pay a premium for certain products. Some airlines have realized that this dynamic exists, and their agents ask at the end of the reservation process whether a rental car or hotel booking is needed. The propensity and capability to sell ancillary products and services needs to be embedded in airlines' entire value chain.

Create a transaction. Many retailers try to get consumers to make a purchase through "loss leader" products or everyday low prices. In selling seats, airlines and travel resellers have put a lot of effort into improving the "look to book" ratio, and like retailers, their tactics often center on price. For ancillary products and services, there are several points in the customer experience where transactions can be created:

- *At the time of booking*, suitable for travel "add-on" and partner sales, which do not drive up costs by adding a complex delivery chain
- *At the airport,* when price sensitivities generally decline, suitable for product enhancements such as club entry, exit row seating, and cabin upselling

Exhibit 3 **Thinking like a retailer**

	Build awareness	Generate traffic	Create a transaction	Increase the value of transaction	Build loyalty
What it means	• Make customers aware of value-added products and services across their travel experience.	• Invite and channel customers to try the products and services.	• Develop the organizational and technical capability to convert traffic into transactions.	• Develop product and service extensions, to capture incremental share of wallet.	• Make the retail experience into a proposition that customers would consider again.
Examples	• EasyJet's website offers an airport parking space reservation service to address the growing shortage of parking spaces; customers get a discount for reserving early—an attractive proposition for time- and cost-conscious customers.	• At Lufthansa boarding gates, marketing reps typically offer an hour of free onboard Internet access on international flights; beyond the hour, customers pay for continued access.	• Carriers such as Air Europa and easyJet have been successfully selling food on board, but U.S. airlines have struggled because they lacked point-of-sale transaction capabilities.	• In its buy-on-board offering, Hapag-Lloyd Express has "virtual" combo deals, which are assembled from the à la carte choices. This increases the value of the transaction, without the need for pre-assembled boxes.	• Ryanair's average fare is $53 and it has a cult-like following of customers who repeatedly spend an average of $10 per trip on Ryanair's car rental, hotel, and apartment finder, on-board food, car insurance, and even an online lender.

- *On board the aircraft*, where products are often consumables such as food, a purchase point akin to a convenience store

Increase the value of the transaction. Once the consumer has put an item in the basket, there is enormous leverage to be gained from filling the basket with other products. Retailers are becoming increasingly sophisticated at using in-store advertising and displays to expand their share of wallet at each touchpoint. Supermarkets place impulse-buy products with high margins at the checkout.

Here, airlines must walk a fine line of promoting additional products and services without bombarding the customer with too many offers. At each transaction point, the messaging and mechanisms should match the type of sale—"meal deal" pricing on board the aircraft and product images at the airport.

Build loyalty. Just as there is leverage in filling the basket, it is also valuable to know the profitability of each existing customer and, for them, skip the awareness and traffic steps. Instead, reinforce their loyalty via targeted promotions, an activity that airlines know well. Once customers grow accustomed to buying additional products and services around the seat purchase, airlines can use loyalty programs' offer and reward systems to deepen the relationship and increase marketing ROI.

Learning How to Merchandise

To effectively execute on this approach, airlines need to develop capabilities in two areas of retailing, among both headquarters executives and the front-line staff.

The first area, merchandising, is the analytical approach that retailers use to help them gain insights into customer behavior and decide which products to stock and how to array them. Given the expensive real estate on a website, at an airport, or on an aircraft, it is critical to maximize cash margin per unit of space.

The second area for development, operations, addresses the fact that even the best products with the best placement don't sell themselves. Airlines need to deploy the right point-of-sale devices and give front-line staff the right type of training for high-volume and non-routine transactions.

Just as airlines have been evaluating which aviation activities should be outsourced and which kept in-house, airlines may not want to develop all the skills needed to create ancillary revenues. Even retailers do not perform all these activities in-house, as evidenced by the famous collaboration between P&G and Wal-Mart, where the supplier manages levels, stocking, and product selection within certain categories. A similar partnership can be arranged with airline suppliers.

* * *

Airlines cannot count on the current temporary firmness in ticket prices to lead them to sustainable profitability and revenue growth; the commoditization of travel will continue. Capturing adjacent demand through ancillary products and services is the most feasible alternative. North American network carriers started the process with their loyalty programs, but European low-cost carriers have taken the lead in this area.

Non-ticket revenues can create new revenue streams at attractive margins, while addressing customers' needs and improving their flying experience. To do so, airlines must adopt a merchandising mindset. This doesn't necessarily mean investing large sums in new capabilities or departments. Rather, it involves incorporating a retail element into the strategy, selectively building capabilities, and above all understanding what passengers want and are willing to pay for. ❖