

IBM Institute for Business Value

Airlines 2020: Substitution and commoditization

Two developments the global airline industry can no longer afford to ignore



IBM Institute for Business Value

IBM Global Business Services, through the IBM Institute for Business Value, develops fact-based strategic insights for senior executives around critical public and private sector issues. This executive report is based on an in-depth study by the Institute's research team. It is part of an ongoing commitment by IBM Global Business Services to provide analysis and viewpoints that help companies realize business value. You may contact the authors or send an e-mail to iibv@us.ibm.com for more information. Additional studies from the IBM Institute for Business Value can be found at ibm.com/iibv

By Steve Peterson

The 2000s were a rough decade for airlines. Battered by unprecedented global turmoil, airlines that survived learned powerful lessons about cost containment, efficiency and the importance of financial strength. Airlines that thrive in the next decade, however, will have to do more to stay ahead of the competition. In particular, they will need to think strategically about two issues that have received little attention of late: substitution and commoditization. The IBM Institute for Business Value Airline 2020 Study focuses on these two key challenges and provides a roadmap for how they will likely play out in the next ten years, as well as recommendations for action.

Many airlines, buffeted by uncertain economic conditions and a turbulent market, struggled to remain viable through the first decade of the millennium. Volatile demand, larger and an ever-increasing number of competitors, unstable fuel cost, more diverse traveler needs and a constantly changing distribution model taught airlines to expect the unexpected.

And as if the challenges of demand variance, competition and economic fluctuations were not enough, airlines were confronted with a series of calamities that made the first ten years of the twenty-first century among the industry's most challenging. The September 11, 2001, terrorist attacks on the United States severely impacted global air travel demand and further degraded the customer travel experience by complicating airport security procedures. The outbreak of SARS and avian flu decreased travel and increased restrictions at a time when carriers were struggling to regain traveler confidence. As the decade progressed, oil prices began to increase dramatically, and jet fuel, typically among the industry's top three outlays, increased in price more than 200 percent from 2000 to 2008.¹ The global economic meltdown during the latter part of the decade hit many carriers especially hard – at a time with they were least able to withstand another contraction.

As the industry looks forward to the next ten years, many of these same challenges – increasing competition, economic volatility, heightened customer expectations – will remain. But two other issues, which currently fly beneath the radar of many carriers, threaten to have an adverse and potentially long-lasting impact on the future state of the industry: substitution and commoditization.

With the prevalence of alternative modes of transportation, particularly high-speed rail, customers often have the choice of substituting air travel with less costly modes of travel that require less of a personal time sacrifice. And with commoditization, consumers often find few differences among the product offerings of different airlines – or are unwilling to pay for the differences they do perceive.

Substitution has been around since the advent of mechanized transportation. From covered wagons to steam-driven locomotives, from horse and buggies to automobiles, from steamships to airliners, passenger transportation has been shaped by the immutable desire to travel farther and faster. Travelers have accepted new modes of transportation when reliability, cost and convenience combine to make the competing alternatives viable.

For most of the past 75 years, air travel has enjoyed a substantial advantage over alternative modes in speed and convenience. But in today's world of heightened security and congested skies, the hassles and complications of booking, boarding and departure have stolen much of the time advantage conferred by higher point-to-point speeds. Customer dissatisfaction with the increasing difficulties of flying has made many travelers eager to try new or different alternatives.

The increasing complexity and time involved in air travel comes at a time when government-subsidized high-speed rail in many nations has negated some of air travel's speed advantage, at least over short-to-moderate distances. Combined with ease of booking and boarding, the usually lower cost of high-speed rail, where available, has made it an attractive option for travelers. Further, many companies now substitute telepresence in place of meetings that would previously have required in-person attendance. Travel management companies often work to integrate telepresence into their corporate travel solutions.

Substitution would be a problem in and of itself. But the financial picture for airlines is further darkened by commoditization. Airlines, more focused on immediate operational challenges, have failed to sufficiently differentiate their products and services to appeal to the specific needs of their diverse customer base, making it a struggle to increase revenue per passenger kilometer. While this was poor strategy in the past, it will become completely untenable if either the threat of substitution continues to grow or a competitor begins to offer truly differentiated, compelling and well-targeted service-based products.

How can airlines combat these multiple challenges and position themselves for prosperity in the coming years? A cornerstone of any preservation strategy to guide the industry

through economic turmoil must be a dedicated commitment to maintaining cost discipline. This is an essential step to be undertaken before embarking on any program of change.

To break the cycle of commoditization and to compete more effectively against substitute travel providers, most airlines need to increase the degree of segment specificity that defines their marketing program. Product development must be undertaken with only specific target customers in mind. All subsequent efforts to reach and serve these customers must also be unique to the specific needs of the chosen travel segment. By targeting narrower customer segments, airlines will find that, over time, their products and services will stand out from their competitors, and the customers they attract will be more willing to pay a premium for the differentiated experience delivered.

Another viable response to the threats of substitution and commoditization is to increase the level of journey integration between airlines and other travel service providers. An airline that elects to pursue this strategy will coordinate more closely with other modes, such as hotels, airports, and public transportation providers, to provide consumers with a more integrated travel experience. This is a service no travel provider currently delivers. It should provide an enhanced customer experience that will enable airlines to compete more effectively against substitutes.

Finally, for the truly transformational play, an airline can elect to move forward aggressively with both higher degrees of segment specificity and increased levels of journey integration. These carriers will find themselves delivering specific-segments products that satisfy the unmet desires of travelers for a seamless travel experience.

Properly implemented, we believe each of these strategic options can provide transformational results over the long term.

Forces shaping the industry

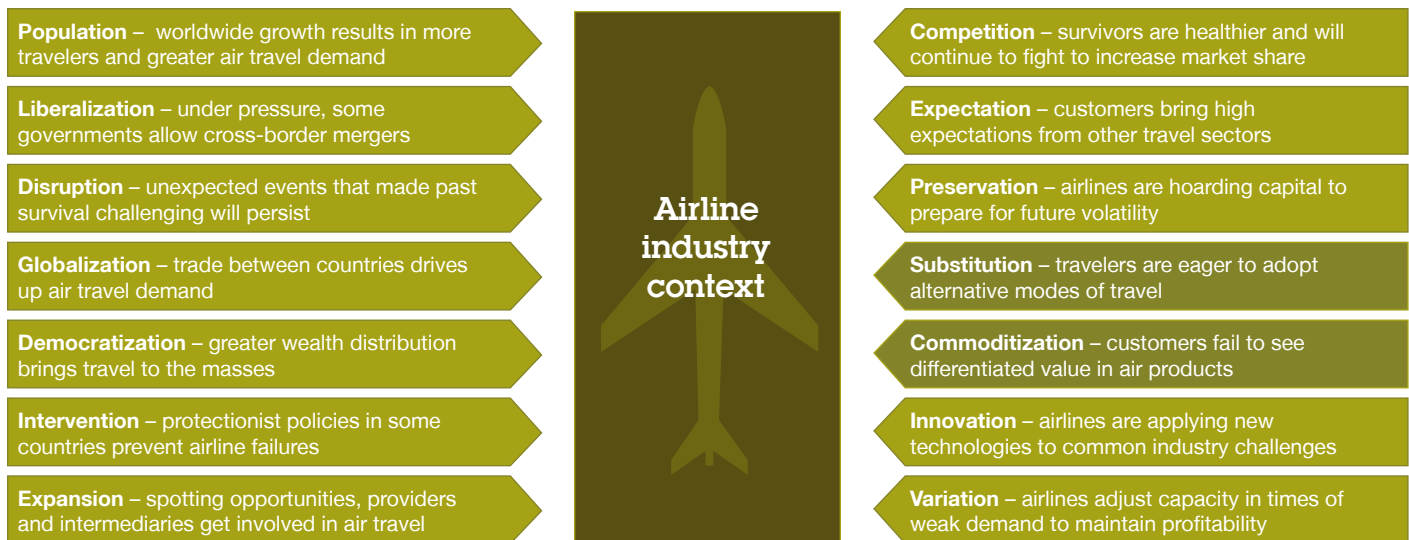
To understand the issues and consumer dynamics likely to shape the airline industry over the next ten years, the IBM Institute for Business Value surveyed more than 2,000 business and leisure travelers, conducted in-depth interviews with travel subject-matter experts and leveraged other external market research and data (for study methodology, see page 18). What we found is that a number of transformative forces – and how airlines respond – will determine how prosperous the industry in general, and individual carriers in particular, are likely to be over the next decade (see Figure 1).

Travel population and competition soar

Once confined to an elite few, air travel is now a medium for the masses. As both population and discretionary income

increase, particularly in emerging markets, more people from a wider range of social, geographic and economic origins will be travelling. As the travel population expands and becomes more heterogeneous, the preferences of travelers will come to mirror those of the population at large. As a result, the traditional “one-size fits all” business model common to many airlines will make it increasingly difficult to meet customer expectations.

This increase in traveler diversity will spur competition for every passenger kilometer from more and larger players. Recent mergers and radical changes to airline cost structures have blurred the lines between low-cost and traditional network carriers, with low-cost carriers accounting for an increasing percentage of global passenger traffic. Also, some governments have begun allowing cross-border mergers,



Source: IBM Institute for Business Value analysis.

Figure 1: Forces shaping the future of the airline industry.

paving the way for larger, multinational carriers. Further fueling the competitive fires is the fact that certain marginal-to-poor performers, which might have folded under unrestricted market conditions, will continue to survive and compete via the protectionist policies of some governments.

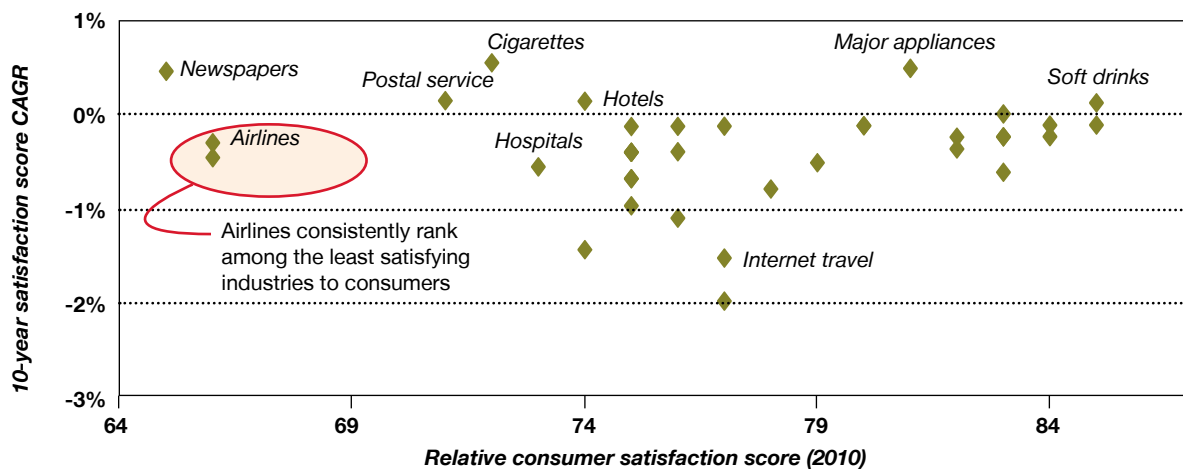
Intermediaries multiply

With the projected increase in air travelers, we can expect more third parties to become involved in air travel. The explosion of intermediaries is likely to dilute the control of exclusive proprietary booking systems and web sites, resulting in the ratio of propriety to intermediary web sites decreasing. The traditional provider-controlled “push” model of travel distribution, in which airlines control bookings through proprietary distribution networks and brick-and-mortar travel agencies, is giving way to a customer-driven “pull” model.

Through a host of intermediaries and tools, travelers now control the complex travel purchase process themselves and are less likely to use traditional travel agents than they once were. In the United States, the number of traditional travel agents fell from 37,000 in 1995 to fewer than 18,000 in 2009, and the share of airline revenue sold through this channel dipped below 25 percent.²

Customer satisfaction continues to plummet

Airlines have seen customer satisfaction decline for many years, but despite investment to improve customer experiences, consumer dissatisfaction continues to grow. In fact, the airline industry consistently generates some of the lowest scores in U.S. customer satisfaction surveys (see Figure 2).



Source: IBM Institute for Business Valueanalysis, “The American Customer Satisfaction Index,” University of Michigan, 2010.

Figure 2: Airlines consistently rank low in customer satisfaction.

Airlines were among the pioneers of industry loyalty programs, but the difficulty in redeeming frequent flyer points among many airlines has actually become a source of increased customer dissatisfaction. The difficulty in redeeming loyalty points was the second most common customer complaint about airlines in 2010, and the value of the rewards was another frequent complaint.³ Obviously, there is a significant disconnect with frequent customers when programs designed to build brand loyalty instead serve as an additional source of alienation.

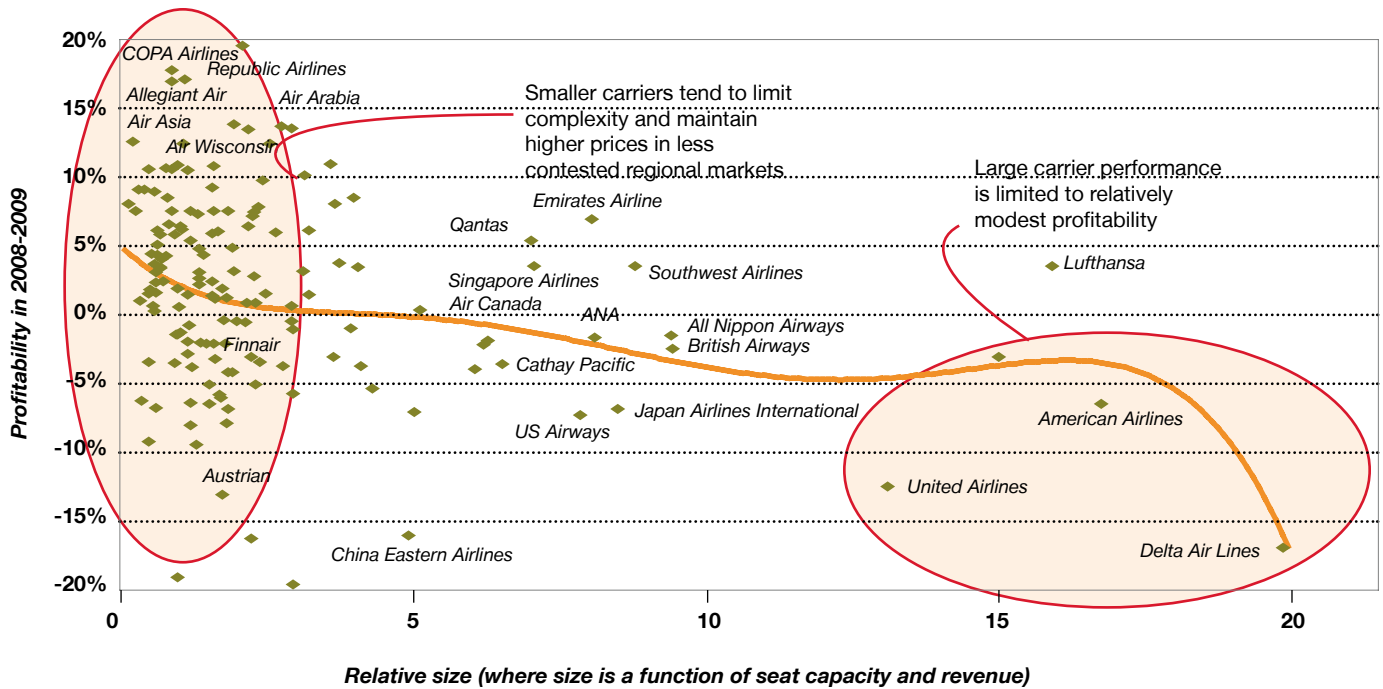
Disruptions will continue

In addition to the other forces exerting pressure on airlines, the disruptive events that plagued the industry throughout the past ten years, some of which are virtually impossible to anticipate, will undoubtedly persist. Fuel price volatility and economic uncertainty will likely be issues for some time to come. For the immediate future, the International Air Transport Association (IATA) predicts a short-term return to profitability for the industry beginning in 2010.⁴ But these forecasts are based on assumptions for increased travel demand spurred by an improving economy. These forecasts will also be impacted by the overall capacity in the market and the prevailing prices. Historically, airlines have enjoyed less pricing power than companies from other industries, so changes in seat capacity or prices could derail an industry-wide recovery.⁵ Any economic slowdown will negatively impact air travel demand and airline profitability. The key question is whether airlines, bolstered by government stimulus plans and an industry-wide reduction in capacity, can maintain the discipline and prices needed to sustain positive results going forward.

Airlines have responded to many of these challenges . . .

With varying degrees of success, airlines have directed attention and investment to account for many of these forces of change. The common response to economic fluctuation and demand variability, for example, has been to reduce costs and increase scale. Carriers have continued to satisfy their urge to merge despite the obvious inverse relationship between size and profitability (see Figure 3). Many airlines have added capacity and routes in markets where they see the most opportunity, and many more have reduced or eliminated service to less profitable destinations. Competitive forces have compelled airlines to adjust to a new normal whereby the marginal profit or loss on any one flight is determined by only a few seats. Indeed, many airlines have gotten very good at filling the planes they have in service. Load factors in the 60-70 percent range were common in the first part of this decade, but today 75-85 percent is more the norm.⁶ Smaller carriers tend to limit complexity and maintain higher profitability in less contested regional markets. Large airlines are less able to quickly adapt and respond to changes in the markets they serve than the smaller and more nimble airlines.

Airlines typically respond to demand shocks by increasing scale to lower costs and reducing capacity to stabilize prices.



Sources: Institute for Business Value analysis, Revenue data collected from airline annual reports 2010, Industry fleet data from IATA. Seat capacity calculated by multiplying the number of seats on each aircraft by the specific fleets of each carrier.

Figure 3: Relative size and profit performance of selected airlines.

... but two significant threats have gone largely unaddressed

As travelers enjoy a wider range of positive experiences with alternative modes of travel, their expectations of the services airlines provide and how they are delivered will only grow. Failing to deliver on these expectations will serve to push disenfranchised customers further away and increase their willingness to explore alternative modes of travel. Travel substitution, as previously referenced, is not a new phenomenon but has been around since the dawn of the industrial age.

Yet airlines have largely ignored the threat, both because they were more focused on more pressing business needs and because they enjoyed an inherent advantage in convenience and point-to-point speed. But with the growing acceptance of high-speed rail and the nearly universal availability of cost-effective telepresence, substitution is an issue that airlines will need to address with a great sense of urgency.

Moreover, the inability of airlines to differentiate their offerings and attract a highly targeted and loyal following will further encourage customers to seek modes of travel where they feel their needs and desires are more likely to be met.

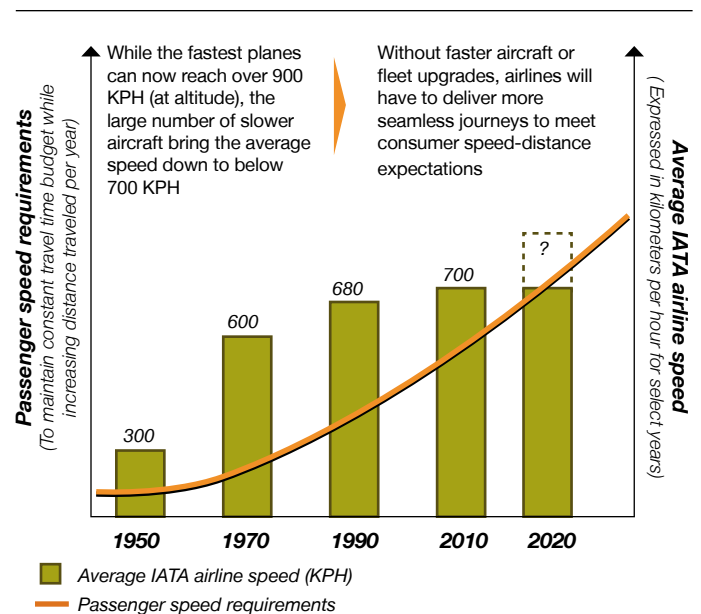
No doubt, the ability to maintain financial discipline, rapidly adjust scale and preserve capital for distressed times will allow some carriers to maintain some semblance of profitability. But for the industry at large, a radical change in business models is in order, and the issues of substitution and commoditization must be addressed. For most airlines, the *status quo* is no longer sustainable.

Substitution

Airlines have historically enjoyed a market with few substitutes, but as travelers and technologies evolve, the magnitude of the substitution threat continues to grow.

For hundreds of years, substitution between travel modes has followed the same general and predictable patterns. As new technologies emerged, they quickly displaced other modes once customers became convinced that these alternatives were accessible, fast and affordable. The lesson from history is that once a new mode or technology is able to satisfy all of these basic travel criteria, it usually displaces the older technology within a few decades. Although the automobile was faster than the horse and buggy in 1885, cars did not become the dominant technology until 1910, when they were also available and affordable. This historical pattern is repeated with other transportation technologies and should guide our thinking about substitutes for modern jet travel.

Speed has enabled passengers to satisfy their desire to travel further without increasing the amount of time they must allocate to travel. Across incomes, time periods and geographies, individuals dedicate between 45-100 minutes per day to travel.⁷ Historically, airlines have satisfied the demand for a speedier travel experience with faster aircraft, but they are on the cusp of losing this advantage, as more laborious search processes, constant security delays and more frequent baggage hassles combine to increase point-to-point journey times (see Figure 4).



Source: IBM Institute for Business Value analysis, IATA Annual Reports 1950 to 2005, 2010 estimate based on fleet changes 2005 to 2010 – IBM, Passenger speed requirements documented by Schäfer in "Long-Term Trends in Global Passenger Mobility," 2005.

Figure 4: Airlines have historically delivered on the customer desire for faster travel, but are losing their advantage.

Evidence suggests that many customers have indeed come to see substitutes as a more viable alternative to air travel and are willing to change if given a choice. Many travelers have high expectations about both substitute technologies and express a clear willingness to explore these alternatives when and if they are available.

Travelers choose air for a variety of reasons; chief among them are costs and time. As high-speed rail improves, however, more travelers will re-evaluate this alternative, and many will defect because the reasons they dislike air travel, such as booking/check-in/security hassles, lost productive time, lower-than-expected reliability and negative environmental impact (see Figure 5). Not surprisingly, in regions where rail travel is common and high-speed rail is an option, substitution has already taken a significant toll on the demand for air travel. And airlines are subject to additional vulnerability in future: research reveals that price reductions for high-speed rail would result in dramatic increases in passenger volumes across several European markets. For example, if rail prices were to fall by 5.5 percent on the Barcelona-Seville route, passenger volume would be expected to increase more than 28 percent.⁸

Air travel providers in those regions where high-speed rail is common, such as Asia and parts of Europe, consistently perceive such substitutes as a material threat to their core business. Rail is not a complete substitute for air travel in all

markets because longer distances magnify the effects of slower travel speeds. But for travel distances of less than 1,200 kilometers, high-speed rail is often a viable choice.

Nowhere has the growth of high-speed rail, or the commitment of government to infrastructure development, been more dramatic than in China. High-speed routes in that nation are expected to grow from approximately 12,000 kilometers in 2009 to about 16,000 kilometers by 2020.⁹

In those nations where high-speed rail has yet to take hold, such as the United States, other substitute technologies are taking a toll on airlines:

- In 2009, 60 percent of surveyed travelers worldwide had cut travel through remote conferencing use.¹⁰
- In 2009, 79 percent of global travelers reported greater use of conference calls, WebEx, and telepresence.¹¹
- In 2010, Asia-Pacific video conferencing market will grow 9.5 percent year-to-year.¹²

	Traditional air		High-speed rail	
	Assumptions		Assumptions	
Cost	Economy class domestic or near-region journey on full-service carrier	Total \$450 RT	Business class domestic or near region journey on high-speed rail	Total \$360 RT
Time	1 hour shopping/booking, 1 hour transit, 2 hour flight, 1 hour transit	Total 5 hours	1/2 hour shopping/booking, 1/2 hour transit, 3 1/2 hour high-speed rail, 1/2 hour transit	Total 5 hours
Hassle	Complex shopping, cross-mode coordination, security, delays, etc.	Very high	Fewer choices, less complexity, shorter transit, limited security, few delays	Fairly mild
Reliability	85% on-time airline arrival plus cross-mode connection points	<70% on-time	Fewer weather/network delays and higher on-time performance	>80% on-time
Productivity	<50% chance of work in flight plus possible time in transit etc.	Maximum 1 hour	Higher class of service results in higher chance of productive time	Minimum 3 hours
Environment	Enormous carbon footprint relative to other modes of travel	High impact	Relatively moderate environmental impact	Low impact

Source: IBM Institute for Business Value analysis, IBM-Oxford Economics Global Travel provider Interviews September 2010.

Figure 5: When high-speed rail delivers the full complement of expected improvements, some portion of current air travelers will migrate to rail.

- Telepresence is expected to replace 2.1 million airline seats worldwide per year by 2012.¹³
- Travel agencies are integrating telepresence into corporate travel solutions to make it easier for companies to leverage a growing network of public and private telepresence centers
- The economic downturn in 2009 dampened global telepresence spending, but corporate spending on telepresence hardware, software and services grew much faster than air travel.¹⁴

Taken as a whole, the developments occurring in the area of substitution are certain to negatively impact many carriers and have the potential to affect even more.

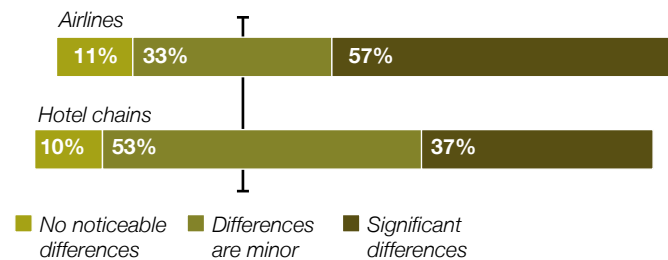
Commoditization

Despite efforts to innovate, many airlines deliver undifferentiated products to price-sensitive consumers overrun by an abundance of too-similar choices. It is no surprise that air travelers are often focused on price and do not see many meaningful differences in air travel products. But our research shows that even when they do perceive differences, travelers are rarely willing to pay a premium for the differences they notice most. We believe this is in large part because airlines have focused product development efforts on quickly and efficiently introducing the next new airline seat or the latest in-flight entertainment capability, while overlooking that customers care more about the intangible, service-oriented aspects of their journeys.

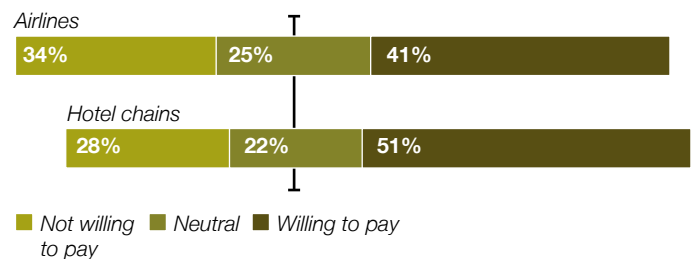
Airlines and industry analysts have asked travelers to rank airline selection criteria for decades, and while their secondary and tertiary concerns vary from survey to survey, price consistently ranks as the most important decision factor. In 2010, for example, 36 percent of travelers in our survey ranked price as their top consideration, with schedules and routes, at 32 percent, the second most valued factor. Airline brand was the only other consideration in double digits. On-time performance, customer loyalty programs and star rating all garnered 7 percent or less.

And while customers do detect a difference among airlines, they are less willing to pay a premium for a favorite carrier than a less differentiated but favorite hotel (see Figure 6.) Among traveler segments, business travelers are more willing than leisure travelers to pay for their preferred air carrier. And in those nations where high-speed rail is relatively well developed, such as France and Germany, customers are even less inclined to pay premiums for their favorite airlines.

Level of perceived differentiation



Willingness to pay 10% more for favorite provider



Source: IBM Institute for Business Value analysis, IBM-Oxford Economics Global Traveler Survey September 2010.

Figure 6: Customers are not as willing to pay a premium for their favorite carrier as they are for a less unique, but favorite hotel.

To overcome commoditization, airlines must understand the actions and inactions that have exacerbated this problem in the past:

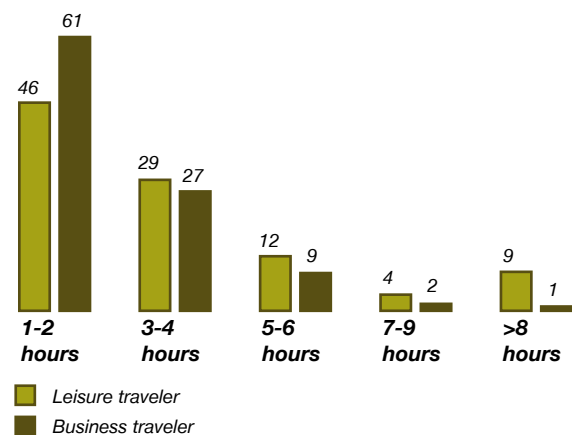
- **Brand fatigue** – Travelers spend many frustrated hours choosing between products they see as similar because brands are not useful to distinguish and select among available choices.
- **Products are similar** – By leveraging the same suppliers and adopting the fast-follower approach in product development, airlines have created undifferentiated customer experiences.
- **Messages are similar** – Marketing messages match products, and are not distinct enough to resonate with target customers.
- **Search is not simple** - Search takes too long, leading to dissatisfaction.
- **Lack of personalization** – The complexity of population served does not match segmentation complexity.

The increased number of choices available to travelers, and the profusion of options for shopping, planning and booking their trip, requires them to spend significant time in pre-booking searches (see Figure 7) According to our survey, almost 20 percent of travelers spent five or more hours shopping and/or booking flights on their most recent trip. Twenty-five percent of leisure travelers spent more than four hours shopping and/or booking. Business travelers were generally more efficient, yet almost 40 percent of them spent at least two hours shopping and booking.

The common perception is that the more choices presented to the consumer, the happier he or she will be with the provider. Surprisingly, academic research suggests that the converse is often more accurate. Consumers who face too much choice are more likely to be dissatisfied. Psychologist often group consumers into two broad categories: “maximizers” and

On their most recent trip...

Business travelers are more efficient, but more than 40 percent of them spent more than 2 hours shopping/booking.



Source: IBM Institute for Business Value analysis, IBM-Oxford Economics Global Traveller Survey September 2010.

Figure 7: The increased number of choices available to travelers requires significant time investment in pre-booking searches.

“satisficers.” While the “maximizers” prefer a larger number of choices than do the “satisficers,” both groups of consumers experience lower levels of satisfaction when the assortment size they have to choose from becomes too large. In the academic context, an assortment size of 24 was considered large for most consumers, but travelers typically face far more choices than that when they book even the simplest trip.¹⁵ Extreme complexity is a reality that confronts travelers for each journey they plan, which may well diminish airline satisfaction.

Technology as a differentiator

Technology can differentiate the travel experience for a short time, but when all travel providers implement the same solutions, differences become hard to discern. Lessons in this area can be learned from the hotel industry. Advances that were

considered cutting edge in 2000, such as in-room high-speed internet, were approaching ubiquity by the end of the decade. The benefits of such advances are fleeting – innovations are quickly replicated by competitors. Novelties become mandatory; as penetration increases, customers come to expect these innovations. Accordingly, active engagement and continuous improvement is required; after customers have come to see an innovation as essential, they will eventually expect additional enhancements to that feature.

Unfortunately for airlines, not only are their core products similar, but the messages carriers take to the marketplace are often indistinguishable to travelers. It is not unusual for two or more airlines to simultaneously introduce identical solutions.

Keeping up with market segmentation

Travel is no longer the exclusive privilege of an elite few, but a product for the masses. Airline segmentation, however, has not kept pace with this development. Over time, the travel population has grown from a very small number of the wealthiest elite to travelers with a wider range of ages, incomes and travel objectives. But current airline delivery platforms limit specialization because diverse customer needs must be fulfilled with a single collection of assets, such as planes, processes and employees.

What are airlines doing to combat substitution and commoditization?

Unfortunately, many providers are not doing enough to prepare for the threats that substitution and commoditization pose. From the carrier perspective, customer preferences will continue to evolve slowly and in mostly predictable ways. Airline executives often think their particular company has the right model for the future and that radical change is not needed. They believe their planned improvement in execution

will make possible substantial passenger and revenue gains. And they are prone to believe that profitability is “just right around the corner.”

With their continuing efforts to forestall changes in their sector, some airline executives may strive to strengthen balance sheets to protect against downturns and to opportunistically expand, consolidate and partner, hoping to maintain the *status quo*. For the industry at large, however, this is not an option. They must accept the threats that substitution and commoditization pose and develop strategies to combat emerging competition, including both high-speed travel alternatives and telepresence, and to provide real degrees of customer-focused differentiation.

The roadmap to accomplishing this is divided into two steps. The first is to maintain cost discipline. Airlines must continue aggressive cost-reduction campaigns; create or extend fuel-hedging programs; redouble efforts to achieve operational efficiency; resist the temptation to initiate spending in times of growth; and introduce cost-justified optimization solutions.

New challenges do not change old realities – airlines must remain committed to controlling both fixed and variable costs in the next decade. Airlines must prepare for future volatility and crises by continuing to strengthen balance sheets. Efforts to improve profitability have become a part of the corporate DNA for most carriers, and any airline that forgets this lesson of industry history is destined to repeat it. Tools and solutions that help airlines optimize resource utilization and lower direct costs should be pursued.

To address substitution and commoditization, airlines must maintain cost discipline and introduce some element of segment specificity or travel integration.

After these essential measures are undertaken, airlines must make a strategic choice in how to proceed. Their options include:

- **Target narrower traveler segments** – Airlines adopting this strategy will tailor programs targeted to only specific segments of the flying population. They will delist segments that do not fit their strength profile and will deploy sub-brands to avoid brand dilution. Airlines that focus on this strategy will increase differentiation by satisfying unmet needs. They will abandon the “fast-follower” strategy of product development and, instead, will set aggressive new product targets to capitalize on service-based innovations.
- **Coordinate across other travel modes** – These carriers will harmonize operations with rail operators, hotels, public transportation organization and other travel services providers. Travel planning, product pricing, trip booking, ticket processing and, of course, journey fulfillment will be coordinated across travel modes. They will look to increase margins on cross-mode, value-added services and will delight their customers by taking responsibility for their entire travel journey – not just the relatively limited time the traveler spends in an aircraft seat.

Target narrower customer segments

Increasing segment specificity will result in the development of products, services, and supporting messages that meet more unique (and valuable) customer needs. Carriers will change from making one product work for the entire market to developing multiple products for the right segments. For many carriers, this shift in focus will require a reinvention of the business. Executives, managers and employees have designed the enterprise around the notions that all customers are targets, all customer needs can be satisfied with a uniform fleet

of aircraft, and that innovation equates to new seats, planes, and systems. These notions need to change, but change of this magnitude will not be easy to digest or execute. That said, it is just the type of change that is essential if airlines are to meet the challenges of the next decade.

Carriers will need to start with a fresh look at the market through the lens of a more complex segmentation model that reflects the full complexity of the travel population. Next, carriers will need to make sure they have selected target segments that are aligned to their current and future capabilities. These capabilities will evolve over time to more closely align to the needs of the target segment, but at a minimum, targets should be chosen that mostly closely hue to the carrier’s natural advantages and strengths.

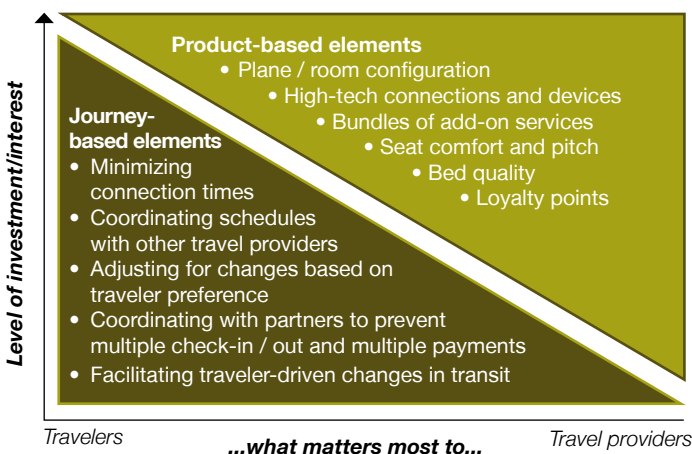
Another byproduct of narrower segmentation is a more effective product development program. Without losing sight of the basic needs that customers have come to expect, carriers should focus on identifying and satisfying unmet customer needs in their target segment (see Figure 8). Unmet needs are difficult to identify and even more difficult to satisfy.

The desire to mitigate current customer frustrations provides ample fuel to feed product reinvention, including the unmet needs for smoother transitions to, through and from airports. In some cases, carriers should rethink the basic value equations that have governed the industry and commit to adding new value for their target customers as a regular part of the product development process.

Carriers will need to make sure they have targeted travel segments that align with their capabilities.

Of course, airlines should resist the temptation to adopt new product improvements that are easily replicable. The fast-follower model of product development has contributed to airline product commoditization in the past, and will put carriers who continue this strategy in a vulnerable position as substitutes become more viable and extend their geographic reach in the years ahead.

Product innovations that are derived from commonly available inputs, such as new aircraft, lie-flat seats and special meals, will be quickly copied by competitors and are not likely to be a source of lasting advantage. Likewise, automatic upgrades given to top-tier customers may become necessary for most carriers, but the relative ease with which such innovations are copied make them an unlikely source of competitive advantage.



Source: IBM Institute for Business Value analysis, IBM-Oxford Economics Global Travel Provider Interviews September 2010.

Figure 8: Providers invest time and money into physical product improvements while most customers place a higher value on the experience-based elements of their journey. Future product development efforts should reverse this disconnect.

But hard-to-deliver service-based innovations linked to segmentation and loyalty programs, such as automatic rebooking across multiple travel modes for select segments, are more likely to create sustainable advantage as other carriers struggle to deliver this more complex service.

Narrower customer segmentation will help travelers manage complexity by simplifying the search process and bringing meaning to airline brands. Via their own web sites and other controlled channels, airlines could offer itinerary recommendations based on a vast array of customer and segment specific data to reduce choice complexity for their target customers. These recommendations would have to meet rigorous criteria for relevance to the traveler's specific situation and preferences, but properly executed, such a service could help differentiate airline brands and deliver unique value to travelers. Given the profusion of airlines in the most competitive markets, carriers who do not deliver to the needs of more narrowly defined segments fail to stand out and will not represent brands that hold meaning or value for travelers.

Finally, to deliver the full benefit of targeting narrower traveler segments, carriers must support this new marketing model by leveraging segment-specific messages at each and every customer touch point. From a shopping experience that is geared to the unique needs of the defined segment, to on- and-off airport customer management tools that guide customers through the travel process, every aspect of airline marketing must be aligned to the target segment. Marketing communication and promotions should speak directly to the needs of the chosen target segments.

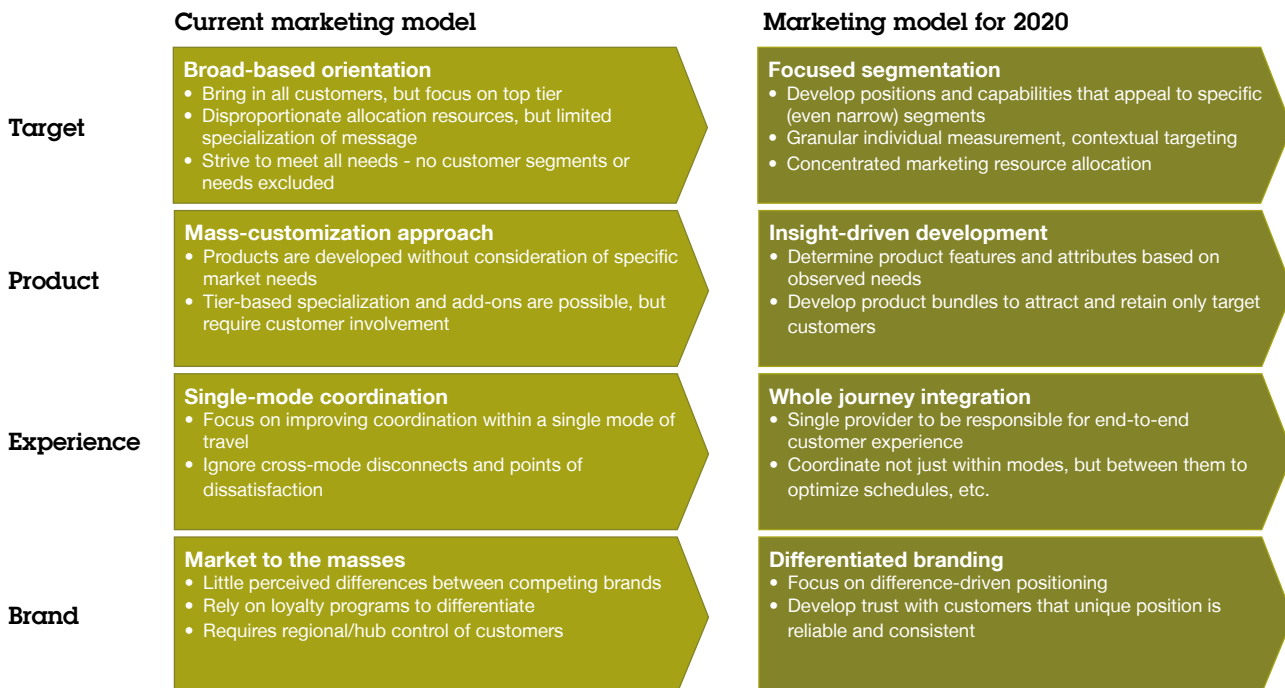
Naturally, not all of these suggestions will fit neatly into the existing strategic development programs and investment plans in place at most carriers. Large carriers may need to deploy sub-brands to address segment-specific needs, and many will struggle to remove segments from their current list of targets. The choices about which customers to target and which to delist will be difficult, but the alternative is a model in which commoditization continues unabated in the industry and emerging substitutes steal share from the most highly commoditized carriers.

In short, the airline marketing model should be defined by focused segmentation, insight-driven product development and differentiated branding. This model will help carriers combat

the impacts of substitution and commoditization over the next decade (see Figure 9.)

Coordinate across other travel modes

Consumers view the travel experience holistically. Many customers place a higher value on the experience-based elements of their journey than they do on the physical attributes of their seat or meal. They are often frustrated by the processes that precede air travel and are equally vexed by their post-flight travel experiences. This impacts their views on travel in general and on air travel in particular. As substitutes continue to evolve, travelers will be more apt to consider the alternatives to air travel if, in choosing those alternatives, they can avoid the most frustrating aspects of a journey. For better



Source: IBM Institute for Business Value analysis.

Figure 9: The travel marketing model should be defined by focused segmentation, insight-driven product development, whole journey integration, and differentiated branding.

Case study

An example of narrow targeting – Allegiant Air¹⁶

By most standards, Allegiant Air is a small carrier. With fewer than 50 aircraft and less than US\$560 million in revenue in 2009, Allegiant Air is the antithesis of the largest global airlines. But Allegiant Air also stands out in terms of profitability. While other carriers have struggled to eke out a profit in the past decade, Allegiant Air has posted a profit every year since its re-birth from bankruptcy in 2000. What lessons can Allegiant Air teach other carriers about focusing on narrow customer segments?

While the concept of focusing on some customers to the exclusion of others is an anathema to most airlines, Allegiant Air has executed on this approach consistently for the past ten years. By targeting sun-hungry residents of mostly northern states in the central United States, Allegiant Air set up a network of point to point routes that shuttles vacationers to popular warm weather destinations such as Miami, Las Vegas and Phoenix.

Allegiant Air is a low-cost carrier not only because of its ability to manage common industry cost swings in jet fuel, labor and landing fees, but also because it has a simple operational structure and a segment appropriate marketing model. For most of its history, Allegiant Air has maintained a single-type aircraft fleet, MD-80s. Cabin configurations are simple and relatively luxury free. Customers respond well to the product on offer, however, because this simplicity enables Allegiant Air to keep fares low and because the company has targeted customers not willing to pay for the common luxuries found on other carriers.

Not surprisingly, Allegiant Air spends less in marketing and distribution than other competitors because its brand resonates with consumers. Plus, its promotion efforts do not cast a wide net over potential customers with un-targeted messages.

On many of the traditional performance metrics that guide the industry, Allegiant Air is not a top performer. Flight schedules are limited, on-time performance is average and revenue per available seat mile (RASM) are all lower than many of its competitors. Instead of working to improve on these variables, Allegiant Air focuses on continually improving on the factors that matter most to their target customers. At 8 cents, Allegiant Air's cost per available seat mile (CASM) is among the lowest in its region, and revenue generated from non-ticket sales are substantially higher than most carriers, accounting for over 20 percent of passenger revenue in 2009. While Allegiant Air's target customers are not willing to pay for luxuries as part of their base fare, their spending patterns suggest that they are willing to do so after completing their purchase.

Allegiant Air has demonstrated that by targeting a narrower segment of the air travel market it has changed the basis of competition. Its products are unique in a market that is highly commoditized. As a result, the threat of substitution is lower for Allegiant Air than many of its competitors. Allegiant Air offers a strong example of what a carrier can do to successfully counteract the forces of substitution and commoditization.

or for worse, airlines must recognize that by failing to address the most pressing customer concerns – even when these concerns are directed at non-air aspects of the travel journey – they are making it easier for customers to select alternate providers.

Seamless travel is not a new concept in the travel industry. For years, providers have discussed the possibility of improving the travel experience for customers by more closely aligning interconnecting pieces of the traveler’s journey. Unfortunately, most of these discussions resulted in few tangible improvements because, in addition to the challenges of coordinating across travel modes on behalf of the consumer, the technologies needed to fulfill this vision were not available.

Today, however, these technologies are in place across almost every dimension of the travel value chain. In the next ten years, as advancements continue, we expect at least a few providers to deliver seamless travel. Further, we expect that the company that succeeds in this endeavor will lock-in loyal customers and further commoditize providers who are not participating in a seamless travel solution.

Many travelers have a clear desire for seamless travel, and would be willing to pay a premium to a provider that delivers on this promise. Travelers are equally willing to accept such a service from an airline, as they are from a hotel, airport authority or travel intermediary. In essence, any other member of the travel value chain could offer this service and would likely be rewarded with loyalty and lasting price premiums.

Airlines that can coordinate across travel modes have the potential to offer value to customers and generate lasting loyalty in the process. All aspects of passenger travel should be managed seamlessly, including travel planning, product pricing, trip booking, ticket processing and journey fulfillment. This is the promise of seamless travel. It serves as a powerful antidote

to the forces of substitution and commoditization and resolves some of the key pain points that travelers face today. If executed well, an airline that delivers seamless travel will simultaneously differentiate its product offering to reduce the impacts of commoditization, while saving travelers time in their travel journeys. The end result is a travel population less eager to try substitutes.

The challenges of substitution and commoditization, together with our recommendations for change, will require change in the business models prevalent in the airline industry. Airlines that execute these recommendations will create the potential for more stable profitability and the increased loyalty of customers who value consistently delivered and unique travel experiences.

Conclusion

Despite the storm of change sweeping through the airline industry, carriers must maintain their commitment to controlling both fixed and variable costs. Any lessening of resolve in this matter is an invitation to disaster.

But beyond that, to create the opportunity to flourish in the realities of an increasingly competitive travel environment, airlines must accept the threat that both substitution and commoditization pose. Those that continue to embrace the *status quo* are likely to struggle. But airlines that offer a truly differentiated customer experience, utilizing both segmentation and/or integration, are those we believe will be industry outperformers in the coming decade.

Seamless travel is a powerful response to the threats of substitution and commoditization.

Perspectives on seamless travel

Although elements of the seamless travel concept have been discussed in the travel community for years, IBM wanted to gain more insight about how travelers and travel providers perceive seamless travel. To support this objective, a concept test was conducted whereby IBM shared a video depiction of a more seamless travel concept to of travel professionals and frequent travelers and collected their feedback in a focus group setting.¹⁷

In this simple test, participants were asked to react to a travel enhancement scenario in which the traveler used a not-yet-developed, hand-held travel support application to make real-time adjustments to a trip that took them across a city, through an airport and across an ocean to their destination. The solution that was depicted was based on data and decision support technologies that are in use today, but the innovative enhancement that was depicted in this scenario brought all these disparate solutions together via a simple, easy-to-use travel management solution.

In general, travel providers and frequent travelers had a very positive reaction to the concept, with over 75 percent of them indicating that they thought the concept was both “viable and desirable.” Travelers expressed interest in such a solution and said that under the right circumstances they would be willing to pay a premium to any service provider that could deliver this solution in a consistent and reliable manner.

Travelers were intrigued by the idea of simplifying their travel purchases through more coordinated schedules, products and offers, but they were even more enthused by the idea of getting better service in times of crisis. Travelers said that travel is least “seamless” today when unexpected events disrupt large numbers of travel providers at the same time. Any travel provider who can offer integrated service recovery

alternatives when such disruptions occur would win the loyalty of many travelers.

Travel providers, including airlines, airports, hotels, ground transit companies and public transportation providers, also supported the concept. Several expected that such a solution for seamless travel support was likely to emerge in the next 3-5 years. Providers had differing views on which travel provider was in the best position to the seamless travel service that was depicted, but almost all of them believed that by 2020 seamless travel would be enabled for many portions of the travel population.

Travelers and travel providers both agreed that such a solution would be most likely to have value for frequent travelers, but many also expected that occasional travelers would value such a solution if it were offered up as a travel supplement, like trip insurance.

Providers indicated that systems should be designed around customer needs and that the broader marketplace would eventually find ways to deliver such a solution. They believed that standards would be essential to develop a truly global solution, and many expected that governments and industry bodies would have a significant and positive role to play in establishing consistent standards of data sharing and update frequencies. At the same time, several industry participants cautioned that the industry was not likely to wait for such standards to be defined if they believed the market opportunity for seamless travel was large enough.

Of course, no matter how valuable and desirable the concept of seamless travel is to consumers, the challenge to develop it will fall to the travel provider community. Will airlines step up to this challenge or will they let other travel providers and intermediaries capitalize on this compelling opportunity?

Key strategic questions for airlines

- What is your airline doing to create sustainable competitive advantage in its chosen target markets?
- Will the programs you have in place lead to improved financial performance in the face of substitution and commoditization?
- What is being done to ensure that your products stand out in the marketplace and are truly differentiated?
- Do you manage a distinct brand that means something unique to travelers?
- Do your products stand out in the market and lead to more customer loyalty from those who value a unique travel experience?
- What is your airline doing to evolve with the changes in the populations it serves?

To learn more about this IBM Institute for Business Value study, please contact us at iibv@us.ibm.com. For a full catalog of our research, visit:

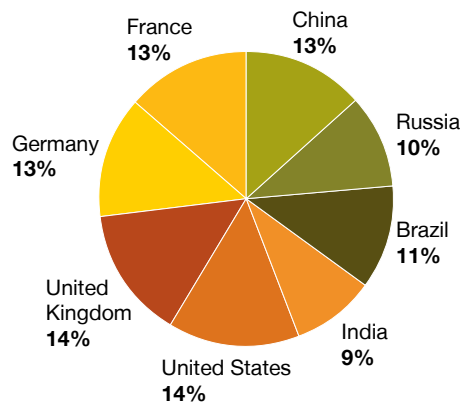
ibm.com/iibv

Be among the first to receive the latest insights from the IBM Institute for Business Value. Subscribe to IdeaWatch, our monthly e-newsletter featuring executive reports that offer strategic insights and recommendations based on IBV research:

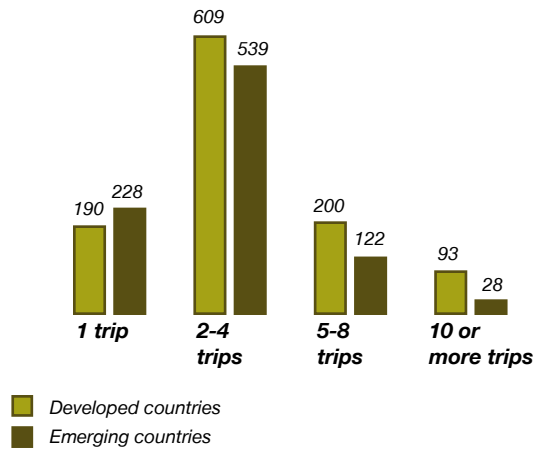
ibm.com/gbs/ideawatch/subscribe

Study methodology

Distribution of survey respondents



Travel experiences in the past 12 months



Source: IBM Institute for Business Value analysis.

Figure 10: Study methodology.

Author

Steve Peterson is the global Travel & Transportation leader for IBM's Institute for Business Value. He has worked as a strategy consultant to airlines and travel companies since 1998 where he focused on operations, marketing, distribution, and cost reduction initiatives across the travel and transport sector. Steve can be reached at steve.peterson@us.ibm.com.

Contributors

Eric Conrad is a Vice President and Partner leading IBM's Travel and Transportation practice globally. He can be reached at eric.conrad@sg.ibm.com.

Brian O' Rourke is a Partner and Airline Segment lead for IBM. He can be reached at beorourke@us.ibm.com.

Tom Liebtag is IBM's Industry Marketing Manager for Travel and Transportation. Tom can be reached at twliebt@us.ibm.com.

Charles Vincent is a Vice President and Partner in IBM's Travel and Transportation practice. He can be reached at charlesv@cn.ibm.com.

The right partner for a changing world

At IBM, we collaborate with our clients, bringing together business insight, advanced research and technology to give them a distinct advantage in today's rapidly changing environment. Through our integrated approach to business design and execution, we help turn strategies into action. And with expertise in 17 industries and global capabilities that span 170 countries, we can help clients anticipate change and profit from new opportunities.

References

- 1 IBM Institute for Business Value analysis. Jet fuel was US\$.087 per gallon in 2000 and \$2.80 per gallon in mid-2010, based on information from Platts. <http://www.platts.com>
- 2 “Are travel agents making a comeback?” CNN Travel, August 12, 2009. http://articles.cnn.com/2009-08-12/travel/travel.agent.comeback_1_travel-agents-travel-booking-online-booking/2?s=PM:TRAVEL and “ASTA Agency Profile membership demographic report” ASTA, March, 2010.
- 3 “Ancillary fees and frequent flyer reward seats head complaints against airlines.” Centre for Pacific Aviation. August 10, 2010. <http://www.centreforaviation.com/news/2010/08/10/ancillary-fees-and-reward-seats-top-complaints-against-airlines/page1>
- 4 IBM Institute for Business Value analysis, based on data from the International Air Transport Association (IATA). August 2010.
- 5 IBM Institute for Business Value analysis based on data from Economy.com. <http://freelunch.com/home/products/samples/industry-workstation.pdf>. 2010
- 6 IBM Institute for Business Value analysis based on data from US DOT Form 41 schedule T2, 2010.
- 7 Schäfer, Andreas. “Long-Term Trends in Global Passenger Mobility.” University of Cambridge. [http://www.members.nae.edu/nae/naefoe.nsf/0754c87f163f599e85256cca00588f49/862570b60074eda88625721a004f370e/\\$FILE/Andreas_Schafer.pdf](http://www.members.nae.edu/nae/naefoe.nsf/0754c87f163f599e85256cca00588f49/862570b60074eda88625721a004f370e/$FILE/Andreas_Schafer.pdf). 2006.
- 8 Sanchez-Borras, M., Nash, C., Abrantes, P. and Lopez-Pita, A. (2010), ‘Rail access charges and the competitiveness of high speed trains’, *Transport Policy* 17, 102-109., 2010
- 9 Bradsher, Keith. “China’s Route Forward.” *The New York Times*. January 22, 2009. http://www.nytimes.com/2009/01/23/business/worldbusiness/23yuan.html?_r=1&pagewanted=all
- 10 Baker, Michael B. “BTN Research: Rise In Remote Conferencing Prompts Marriott, Starwood.” *Business Travel News*. July 27, 2009.
- 11 “What’s Next for Travel Management?” Association of Corporate Travel Executives. June 23, 2009. www.acte.org/docs/Chicago%20Forum%20Final.ppt
- 12 “Frost & Sullivan: Asia-Pacific Video Conferencing Market to Grow Strongly as Enterprise Spending Recovers.” CIO. August 11, 2010. <http://www.cio.com.au/mediareleases/11166/frost-sullivan-asia-pacific-video-conferencing/>

- 13 “Gartner Predicts Video Telepresence Will Replace 2.1 Million Airline Seats Per Year by 2012, Losing the Travel Industry \$3.5 billion annually.” Gartner Newsroom. February 6, 2009. <http://www.gartner.com/it/page.jsp?id=876512>
- 14 IBM Institute for Business Value analysis.
- 15 Mooyman, Casper and Jeroen Visser. ‘More or Less: The impact of assortment size and variety on consumer satisfaction.’ Erasmus University, Rotterdam. August, 2007.
- 16 IBM Institute for Business Value analysis based on data collected on Allegiant Air’s 2009 10K.
- 17 IBM Institute for Business Value analysis based on Frost & Sullivan “Seamless Travel” focus group. 2010.



© Copyright IBM Corporation 2010

IBM Global Services
Route 100
Somers, NY 10589
U.S.A.

Produced in the United States of America
December 2010
All Rights Reserved

IBM, the IBM logo and ibm.com are trademarks or registered trademarks of International Business Machines Corporation in the United States, other countries, or both. If these and other IBM trademarked terms are marked on their first occurrence in this information with a trademark symbol (® or ™), these symbols indicate U.S. registered or common law trademarks owned by IBM at the time this information was published. Such trademarks may also be registered or common law trademarks in other countries. A current list of IBM trademarks is available on the Web at “Copyright and trademark information” at ibm.com/legal/copytrade.shtml

Other company, product and service names may be trademarks or service marks of others.

References in this publication to IBM products and services do not imply that IBM intends to make them available in all countries in which IBM operates.



Please Recycle