March 27, 2008

Skybus: The Un-Boutique

The Budget end of the airline business has seen compelling new models recently. In the United States, we like our Budget airlines friendly and comfortable. But in Europe Ryanair has demonstrated that low fares create and sustain market share even against the most customer-friendly competition. So why is Skybus, the American Ryanair, having such trouble gaining a foothold?

Skybus Airlines, backed by some very big financial names, has taken the ultra-low-cost model to the American heartland with a fleet of 156-seat new Airbus aircraft. The airline's backers include Morgan Stanley, Fidelity, Nationwide, Huntington, and Tiger Partners, among others. Skybus raised $160 million in financing and ordered 65 new aircraft, although all of their aircraft so far have been leased. They launched operations in May 2007.

What's interesting about Skybus is how different it is from others here in the US. No phone number for taking reservations; you can only interact with them over the Web. Really cramped seating (156 seats means 28" or 29" of pitch, or half a foot less legroom than the most uncomfortable seats on JetBlue). Fees for everything, including checked luggage and water on board. And most challenging from a revenue perspective, the airline has an obsessive focus with secondary airports and markets.

While the Skybus route map lists big cities, Skybus actually serves small regional airports that aren't necessarily even close to the cities they're labeled for. Skybus serves Portsmouth (NH, a proxy for Boston/Portland), Chicopee (MA, Hartford/Springfield/Albany area), Stewart (NY, half way between New York City and Albany), Wilmington (DE), Richmond, Greensboro, St. Augustine (FL), and Punta Gorda (FL) among others. Skybus will argue that Ryanair has proven the viability of secondary market routes, but there are some very important differences.

Ryanair was smart enough to build its business on the backs of major cities. As a point to point airline, the strength and composition of traffic in your focus city is critical. As a leisure-focused point to point airline, it's all about vacation and price-sensitive traffic. Here are some of Ryanair's key focus cities - Dusseldorf, Dublin, Milan, Rome, Madrid, London. Notice anything? They're all major markets with established demand. They're hubs for major carriers with plenty of business traffic. It's straightforward to see how Ryanair's product, focused on leisure, is very different from the other airline options available in those cities. And as Ryanair has grown, they've figured out how to connect each of those focus cities to the points across Europe, taking advantage of massive employment-related migration within the European Union to build a base of traffic.

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MARKS AVIATION

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So how about Columbus? Skybus argues that America West thought enough of the city to make it a hub in the mid 1990s. The Columbus base complemented their larger hub operations in Phoenix and Las Vegas. After 9/11 the hub was a regional jet base, with 50 flights a day to key business markets. After taking a stabilization loan from the government, America West consolidated their operations and reduced Columbus to a spoke city.

What America West saw in Columbus was very different from what Skybus has hoped to do with the same base of traffic. Columbus isn't a bad business market. There are a handful of major corporations based there (AEP, Huntington, Nationwide, Cardinal, Sterling, etc.) and good academic traffic. But Columbus is definitely a mid-size city. Today's MSA population is about 1.6 million. That's a reasonable fit for a regional jet model - lots of high-yielding business traffic but not enough price-sensitive leisure traffic to justify flying big airplanes around. But Columbus just isn't big enough on its own for the kind of traffic Skybus wants to draw.

Lower fares do stimulate traffic - as the very competent management at Allegiant likes to say, think about income distributions in a given city as a bell curve. Traditional discretionary air travel (i.e. leisure) correlates to higher income brackets - it targets the right (higher) end of the bell curve. An airline that offers a lower average fare dramatically stimulates consumption, since the potential volume at the middle of the bell curve is much, much bigger. And the lower the median income in a given market (i.e., the more the bell curve is shifted left) the more a low-fare airline can stimulate traffic. But that stimulation also depends on the correlation between its network and where people want to fly, and how tall and steep that bell curve is in the first place.

So what works for Allegiant is a challenge for Skybus. Allegiant combines a rock-solid cost structure, one that only flies when passengers want to fly, with a route network that only takes them where people want to go. By making hotel packages an integral part of its service, it pulls traffic to its focus cities from spoke markets across the United States. Allegiant isn't trying to convince Las Vegans to visit Billings or Bismarck. Allegiant recognizes that a lot of people in Billings and Bismarck want to visit Las Vegas, if the price is affordable.

Skybus, in contrast, wants to persuade Columbians to visit Chicopee, Richmond and Kansas City. Where Allegiant's point of sale is diversified across dozens of secondary markets, in aggregate large enough to support the airline, Skybus' point of sale is about Columbus. And Columbus isn't Las Vegas. Even at $10 per seat, there are only so many Columbians who need to visit Richmond.

It's also interesting how Allegiant and Skybus utilize secondary airport facilities. For Allegiant, secondary cities offer untapped pools of potential Vegas visitors. Allegiant customers drive their own cars to their local airports, park for peanuts and fly to Vegas, where hotel transfers await. In contrast, Skybus asks passengers to travel from a primary airport (Columbus) to secondary facilities where they're miles from their ultimate destinations.

The key is that Americans are used to traveling into primary airports at their destinations. Origins are easier to fudge because you have your own car or can hitch a ride. At the destination you have to fend for yourself. And that's inherently difficult, because with minor exceptions, our transportation system uses airports to transfer passengers between airlines, urban mass transit and cars. Few airports have service from intercity trains or coaches. Intermodal transport to an American means flying to a city and then renting a car or taking a subway. Most of Skybus' airports have only one car rental facility and no urban mass transit options. Need a minivan in Chicopee? Hope Avis has it at the airport, otherwise it's a taxi to Enterprise, All Star Car & Truck Rental, Rusty's Auto or Tony & Sons. What Skybus does offer is a nonstop flight on a route where other airlines force a connection. But whether that nonstop flight and a low fare (if you plan ahead) is worth the inconvenience is another issue.

Say you're heading from Columbus to Northern Virginia. Southwest will offer you a nonstop into Baltimore (on Monday April 7th they want $52 for their 8:55pm departure) and the rest of their departures are between $80 and $100. Skybus will take you to Richmond at 5:27pm for $60. Checking two bags? That's $24 each way for Skybus, free for Southwest. Snack on board? Peanuts and free soft drinks on Southwest, $4 on Skybus. It goes on. While both airports are 90 minute transfers to Northern Virginia, BWI offers mass transit connections as well as car rentals.

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We're seeing similar pricing metrics across the Skybus system. Is Skybus the cheapest option? Sometimes, especially if you don't buy the frills. Is it cheap enough to merit an extra hour of driving on the other end? Not yet.

Skybus seems to think the secondary market approach is the right one, as their second focus city is Greensboro, North Carolina. It looks a lot like Columbus, with similar accessible population (MSA population of 1.5 million across Greensboro, High Point and Winston Salem) and historical hub service by Continental. But like Columbus, Greensboro is bracketed by Southwest service on one side (Raleigh) and a major airline hub on the other (US Airways at Charlotte) that dilute the base of accessible leisure and business traffic.

The problem for Skybus is that they're running out of time. New aircraft require significant pre-delivery deposits, up to 20% of the aircraft list price before delivery. Healthy airlines can seek financing to mitigate that cash outflow. But unhealthy airlines face double peril, with cash losing operations and significant deposits required for 65 new-production aircraft.

Skybus has a lot of advantages, at least for the moment, on the cost side. Their network is designed so that crews can return home each night, saving per diem and hotel costs. The network also allows maintenance to consolidate at bases, either Columbus or Greensboro. And their new fleet of Airbus A319s require little maintenance work and are covered by warranties. By using secondary airports, Skybus also gets deals on landing fees (usually waived), terminal usage (minimal if any) and real estate (for ticket counters, hold rooms and maintenance storage).

So how does this cost advantage translate to passenger revenue? Fuel at $3.50 per gallon dramatically reduces the margin for error. Consider a one-hour flight from Columbus to Richmond that burns about 800 gallons of fuel. That's $2,800 of fuel cost to spread over 156 passengers. Say Skybus managed to sell every seat - that's $18 per passenger in fuel cost alone. (At an 85% load factor - equivalent to Allegiant - it's $22 per passenger.) Now add the rest of operating costs - every departure costs about $400 in maintenance, $2,500 in aircraft rent and insurance, and $750 in crew salaries per flight. Not counting a dime of overhead, airport fees or sales expense, Skybus needs at least $6,400 in revenue, or $51 per passenger.

So what does that mean in practice? Add $21 in taxes and fees and $4 in credit card fees and that means $127 round-trip to the consumer. What are the odds Skybus can find 250 people a day willing to pay $127 round-trip to fly between Columbus and Richmond? Skybus must attract business traffic to survive. Price sensitive demand isn't enough. The big secret of Ryanair is that they do carry business traffic. Their bases in London, Milan and Madrid are close to business centers. And their routes serve consumer markets that are difficult to reach via major European hubs. That parallel doesn't exist today for Skybus.

So what can Skybus do?

Skybus has a revenue problem. Sure, Skybus also has costs under pressure from fuel and labor. The pilots at Skybus are threatening to unionize. I have no idea whether Skybus' employment policies have left pilots with no other option, but unionization will cut off future sources of capital the airline desperately needs to weather fuel costs and pre-delivery deposits. Even if pilots back off, the damage has been done. Skybus pays more than regional airlines, but significantly less than major carriers, and it has been able to attract great pilots who value the no-nights-away lifestyle, modern aircraft, and quick promotion to Captain through growth. It's true that Skybus, like Ryanair, nickels-and-dimes its employees by cutting amenities that are customary at other airlines, but employees knew that when they joined. But unlike Ryanair, Skybus' pay scales don't parallel comparable carriers.

So assuming that pilot unionization doesn't kill Skybus outright in the next 90 days, can anything be saved?

I think the secondary airport play can work, but Skybus has to shift its point of sale to its spoke cities. It can't depend on Columbus or Greensboro to sustain future growth. And to make that happen, they need a fundamental change in how they treat connecting traffic and distribution.

Today, Skybus doesn't permit connecting traffic. Take the example of a New Yorker heading to a second home in Fort Myers. Could Skybus capture that passenger? Maybe, but it's not easy for the passenger to buy the ticket. He has to buy two separate tickets (one on Flight 102, departing Newburgh at 10:54 and arriving Columbus at 12:27pm, and another on Flight 216, departing Columbus at 2:06pm and arriving Punta Gorda at 4:27pm). Since the passenger bought two tickets, if the inbound flight is late, tough luck. And don't expect Skybus to connect the bags for you - pick them up and re-check them (oh, and pay an extra $12 for the privilege).

Why does Skybus do this? Well, the rationale is that Ryanair doesn't permit connections because it adds cost. And in Europe, where airports charge per enplaned passenger, it does. There is no question that full-blown connections (with multiple boarding passes, baggage check-through and liability for missed connections) does add cost. But what Southwest figured out a long time ago is the beauty of the one-stop direct flight.

Take a look at Southwest's model and it can seem like a bus network. A flight can originate in Fort Lauderdale, stop in Tampa, New Orleans, Phoenix and Los Angeles before terminating in Oakland. Because Southwest has quick turns, and because passengers never leave their seats, it's minimally inconvenient for passengers traveling through.

This is a major opportunity for Skybus, but they have to stop wearing Ryanair blinders to make it happen. Columbus and Greensboro may be second-tier originating markets, but they're geographically ideal as stopovers for direct flights. A direct flight from New York to Kansas City over Columbus taps not only the Columbus local market to each city but also the much larger New York to Kansas City market. It's minimally inconvenient for the passenger, and assuming that Skybus doesn't deplane through passengers and isolates their bags in the forward hold, it doesn't add cost. There just aren't many places in Europe where this would work for Ryanair, which is why they haven't done it. Nobody would travel from London to Madrid via Katowice. But a lot of people would and do travel from Boston, New York, and Chicago to Florida, New Orleans and Los Angeles.

Allowing direct, multi-segment bookings gets even more interesting when you think about Skybus' buy on board menus. If I'm on a plane for two hours, I might pass on the $2 soft drink and $6 sandwich (remember that Skybus doesn't permit customers to bring food on board). If I have to sit through 2 hours to Columbus, a 30 minute stop and then four more hours to Los Angeles - and if Skybus doesn't let me off the plane in Columbus to buy food - I'm definitely going to buy something to tide me over. Skybus could probably even get away charging a $5 "connection fee" for through passengers to cover the "cost" of *not* offloading bags in Columbus.

Skybus needs bigger markets, and through flying can be a simple change that explosively grows addressable markets. It also can drive new destinations that might be marginal from Columbus and Greensboro, since local traffic could be supplemented with through traffic.

Apart from training ramp teams at Columbus and Greensboro to leave through-passenger baggage in the hold (maybe they just stick a big red tag on through bags - it's not rocket science) there is another factor to consider. Scheduling for direct flights does complicate how aircraft and crews are operated. To tap local traffic in Columbus, flights can't leave between midnight and 5am. But that means a through flight from New York to Kansas City couldn't leave until 9am - the aircraft and crew must originate in Columbus. To make the model work, some aircraft need to overnight away from base so they could start back to Columbus in the morning.

To do this without increasing cost, Skybus would have to change its policy about crew overnights. It costs money to send a crew from Columbus to New York the evening before and put them up in a hotel. But regional airlines like Comair have solved this problem by using "stand-up" overnights, where crews report for duty in the evening, fly out late at night, stay awake at the airport and fly an early morning departure back to base. It's legal, and to the employees it's like working the night shift.

So it is possible for Skybus to originate flights early in the morning from spoke cities, drawing those larger pools of business and price-sensitive leisure passengers without increasing cost. Since maintenance would still be done at Greensboro and Columbus, the whole fleet couldn't be away at night. But it certainly makes sense for a set of market pairs where Skybus already has a presence.

Tapping larger potential markets pays dividends not only in loads but also in yields. Very few people in Columbus, for example, are actually flying to St. Augustine. Except for those few, St. Augustine is an inconvenience that must be factored into the overall cost. But with major markets like Chicago and New York to draw from, enough people might actually be going to the St. Augustine area so that Skybus could generate *more* revenue from those passengers for the convenience versus Orlando or Jacksonville. It's a feature, not a fault. As importantly, from a revenue management perspective, being able to spread excess inventory across two pools of customers for a given flight is better than having to cut price on a single segment. For example, suppose Skybus scheduled through flights from New York to New Orleans via Columbus. If demand from Columbus to New Orleans and New York looked weak, Skybus could blow out seats from New York to New Orleans without diluting business passengers it would still pick up from Columbus before departure.

Broader markets also require different thinking about distribution. Skybus is a web-only seller today. Here's a basic rule for a new airline: if the customer wants to give you money, take it. If they want to buy over the phone, take the call. If they want to pay you in pennies at the ticket counter, take the cash. Nobody said you can't impose a "service charge" like other airlines do to offset the cost. Skybus' product is not a commodity. A reservations center could be a revenue generator for the airline - explaining buy on board options, showcasing hotel and car rental deals, and playing advertising from partners while callers hold can all boost revenues. A Ryanair call center would have to deal with dozens of languages and currencies. Not Skybus. I'm not suggesting Skybus needs to join global distribution platforms and sell through travel agents, but it does need to get smart about interacting with customers who are scared or unwilling to buy over the web.

I do think there are a host of geographically compelling focus points where they can extend their model. Places like Kansas City, St. Louis, Colorado Springs and Reno come to mind. All have good local markets and are geographically positioned for connecting traffic. Each has served as a hub in the past and would excel with a very low cost airline that could keep local fares low. Deploying ten aircraft in each city can drive hundreds of millions in revenue. But each market would be marginal without through traffic.

It's a question whether Skybus has the will and the resources to make the changes. As for the will, their new CEO has a tough road ahead. Mike Hodge is certainly a capable executive. At Tiger he was known for expertise in oil and aviation. He participated in the financing of Pogo, the Burr/Crandall air taxi service, and managed Tiger's investment in Ryanair. But there's a difference between analyzing a business model from the outside and having to perform trauma surgery from the inside. The pilots couldn't have chosen a worse time to take an antagonistic tone. I can't judge whether their objectives are right or wrong, but poisoning the well at this time puts management in a very difficult position. When one considers the buy-in required to do stand-up overnights, for example, I'm concerned. Pilots went on record with the media complaining that they were given leaky water cups at the airport and not the bottled water they were accustomed to. Asking those same pilots to spend six hours in a dark, empty terminal waiting for a 6am departure is going to be ugly. The good news is that operational changes can drive growth, promotions and pay increases down the road.

But that raises the question of whether Skybus has the cash to survive. Aircraft can be deferred, but Airbus may not cut Skybus the slack it has cut other carriers in the past. Changes to the route network aren't difficult - I think the revenue increases can be obtained through different utilization of assets - but culturally Skybus may not be able to make the turn.

There are differences between the American airline market and that of Europe. Ryanair achieved a defensible position quickly and therefore remains the only real cost-focused option in many markets. The US market is rife with low-fare carriers, and therefore Skybus' relative advantages will only become pronounced with scale (when allocated overhead drops significantly). Asking us to accept a web-only booking, baggage fees, a cramped seat, no free sodas and a barn for an arrivals terminal is a tough proposition. Bending over backwards to take customer money, addressing as wide a base of markets as you can and making secondary airports a feature, not a fault, differentiates in a world of choice. We will soon see whether Skybus follows the Ryanair model into the ground or adapts into a novel innovator that redefines low-cost travel.

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