Ryanair: The Growth Airline of Europe

Erica Roseingrave – Senior Sophister

Ryanair has emerged in recent years as the strongest low fares carrier in Europe. In light of such a strong performance, Erica Roseingrave takes us through the factors behind Ryanair's success from the introduction of a more de-regulated European airline market in the early 1990s to Ryanair's ability to keep its costs so low. After briefly contrasting this with the performance of Aer Lingus and its very different set of circumstances, she concludes that Ryanair should be able to maintain its strong position for the foreseeable future.

Introduction

The history of Ryanair is as long and as turbulent as the very country in which it originated. Ten years ago an unlikely contender for the most profitable airline in the world, Ryanair managed to reinvent itself in the early 1990s and has become the largest low fares carrier in Europe. In many ways, the airline's spectacular growth mirrors the transformation of the Irish economy over the same period.

In this paper, I will illustrate how the deregulation of the European aviation sector heralded the arrival of the low cost carrier with its many benefits for the Irish economy as a whole. The current performance of Ryanair will be documented. I will also examine the factors behind the success of Ryanair and any possible threats to the Ryanair strategy. Finally, the growth prospects of Ryanair in an era of increasing competition and polarisation between point-to-point no frills carriers and full-service value-focussed network carriers will be analysed.

Current Performance

Ryanair is Europe's best growth airline investment and one of the most profitable and fastest growing low fare airlines in the world. It is Southwest Airlines' US low fare concept replayed in Europe, where fares are even higher than in the US and where low fare airlines have only 1% of the air travel market. Like Southwest in the US, Ryanair is the lowest cost airline in Europe, which enables it to offer the industry's lowest fares and at the same time realize pre-tax profit margins of 24%.

Given its market share of only 0.3% and industry-leading low costs, Ryanair's growth potential is quite large. Ryanair's Dublin to UK market is its cash cow for development of new European markets. Presently Ryanair serves only 17 cities outside of Ireland and the UK, which implies a major opportunity to add new markets to Continental Europe. The greater London market alone has some 17 million people and is the financial and entertainment centre of Europe. Ryanair's growth for the next several years will come primarily from adding new routes from London and Dublin and the addition of one or two focus cities[1], which could include Glasgow, as a build up of an existing market.

The rate of new market additions is likely to be around six per year. Currently some 60 European airports are pursuing Ryanair to bring its low fare service to their communities. Whilst not all of these markets would be viable new markets for Ryanair, out of this number there should be a sufficient number of new markets for at least five years of growth.

In spite of its abundance of growth opportunities, Ryanair has said that it will adhere to a deliberate, evenly paced capacity expansion strategy. Five new Boeing 737-800 aircraft were added to the fleet in the calendar year 1999 and an average of five more of these same aircraft are scheduled to come on stream in each of the next four years. Management does not want overly fast growth to jeopardise Ryanair's superior profitability and, more importantly, its fifteen years of safe operations. The Valujet accident in May 1996 led to a backlash against low fare carriers in the US. Although air safety standards in Europe are more stringent than in the US, the ensuing negative publicity could lead to a severe decline in passenger volumes.

On the competitive front, Ryanair's competition appears to be getting weaker rather than stronger. Three small low fare airlines serving the London market recently shut down. After losing some $32 million in its first 17 months of existence, GO, British Airways' low fare subsidiary, has abandoned its unrestricted low fare format by approximately doubling the price of walk-up fares. Furthermore BA is pulling out of some 20 European markets and downsizing aircraft on its European routes in order to reduce its economy class capacity and focus on premium priced business traffic.

If an airline offers the lowest fares, it must have the lowest unit costs. Ryanair truly excels in this crucial area. Its cost/ASM[2] is about 32% below the average for the European major airlines, which is an even wider gap than Southwest's 24% cost

[1] A focus city is where many of an airline's flights interline.
[2] Cost / Available Seat Miles: Total operating cost divided by available seat miles, ASM being capacity.

advantage relative to the other US major airlines. With cash of $246 million and debt of $125 million, there is huge confidence that Ryanair has the balance sheet and cash flow generation to fund its growth and withstand any foreseeable competitive threats.

Deregulation

The air transport directive pushed through by Ireland's former EU commissioner, Mr. Peter Sutherland, which has brought US-style deregulation to the European airline market, enabled Ryanair to enter the Irish and later the European transport market. Ryanair strategised that liberalisation, which started in 1993, would create the same growth that had allowed Southwest Airlines' to flourish in America in the 1980s.

Before the arrival of Ryanair in 1985, passengers traveling to Britain were typically paying more than £200 for return flights and at that price many people were more inclined to take the ferry. The same flight today could cost anything between £59 and £99, with passenger numbers constantly growing.

> "*The spectacular performance of Irish aviation since its deregulation in 1986 has become a model for other markets. The effects on fares and numbers have been spectacular and unprecedented in any other market*."[3]

Ryanair with its low costs, no frills philosophy has brought radically lower airfares, particularly on the Dublin-London route. The choice of airports and destinations has also widened appreciably. The advent of the low cost airline has also benefited the overall economy, reducing Ireland's peripherality in terms of Continental Europe and boosting tourism.

All this has been achieved, despite little help from the government, and a view in some official circles that the no frills, low-cost airline was little more than an *enfant terrible* which could make trouble for Aer Lingus and which should be discouraged.

---

[3] Barrett (1999)

The Valuation of Ryanair

Ryanair's has been dubbed the jewel in the crown of the aviation sector and is a star performer on the Stock Exchange. Its share price on the Nasdaq, where it was first floated recently, has gone from strength to strength. Ryanair has a sky-high valuation[4], which stands in stark contrast to the poor valuation market analysts put on Aer Lingus, due to be privatised later this year. Preliminary reports range from as low as £300m[5] to the more optimistic figure of £750 million.

Ryanair arrived as the market was deregulated and as such never experienced the regulatory capture enjoyed by Aer Lingus. It has a very low cost base without the corporate culture and inefficiencies often associated with state airlines. I will now move on to examine some of the reasons for Ryanair's robust value.

The Factors Underlying Ryanair's Strong Rating

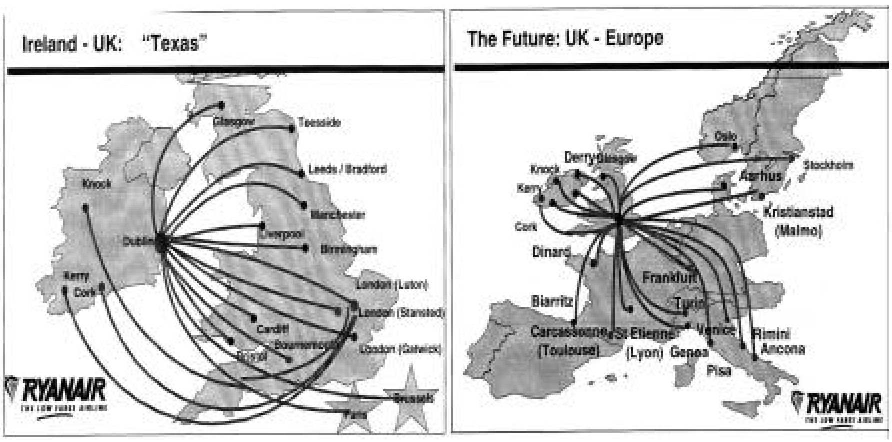
1. An abundance of new market opportunities.
2. Only nominal share of the very large European air travel market.
3. Industry-leading low unit costs, which are set to go even lower over the next few years.
4. A rock-solid balance sheet and unusually strong cash generation ability.
5. The primary reason that Ryanair shares are rated so highly is that investors see the opportunity to realize longer-term returns in Ryanair similar to the case of Southwest. Ryanair is in its tenth year of the development of its low fare concept in Europe, which is approximately where Southwest was in the US market in 1981. Investors perceive a similar growth path ahead and that its share price could show gains approximating those of Southwest.

Ryanair has been branded the Southwest airlines of Europe. It is not surprising that when CEO Michael O' Leary took up the position in 1991, he set out to imitate his American counterpart. The Ireland-UK route, which is the base of Ryanair's business, is analogous to Texas as the cash cow that funded much of Southwest's expansion in the 1980s. This market generated 3.3 million of Ryanair's 4.9 million passengers in fiscal year 1999 and is the platform that provides the cash for the European expansion. Critically, Ryanair follows a very consistent, disciplined and manageable growth strategy. It is not trying to conquer too much in too short a time

[4] Ryanair has a market capitalisation of £1.8 billion.
[5] This is the value put on Aer Lingus by Hibernian.

like other airlines, such as People Express and Valujet, both of which failed in the American market as a result of over ambitious expansion. Ryanair's route network is shown below.

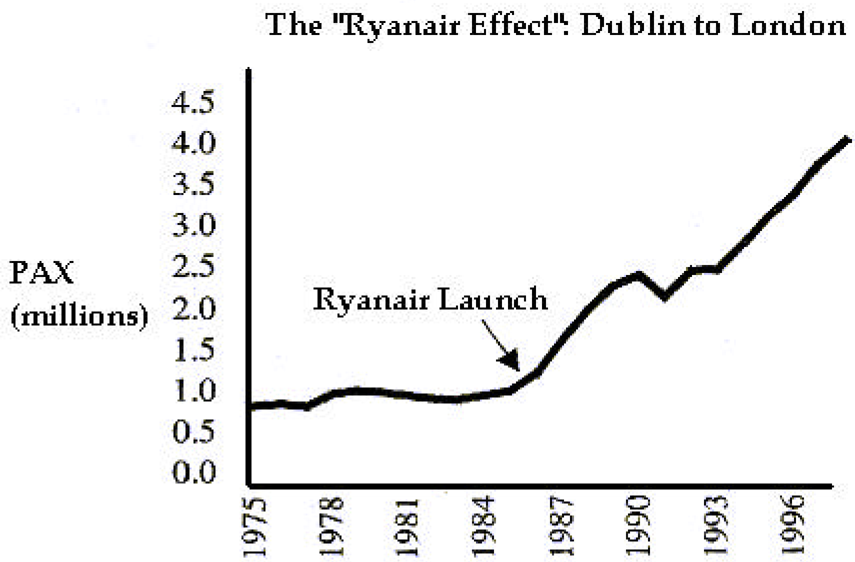
Graph 1 shows Ryanair's Route Network and the 'Texas' Analogy



The Ryanair Effect

Ryanair's strategy is to continually drive down fares, which stimulates traffic growth and deters competition. This gives rise to the so-called *Ryanair Effect*: strong growth in passenger volumes when Ryanair's low fares are introduced into a new market. Total passenger volume between Dublin and London increased from about 1.7 million passengers in 1991 to more than 4.1 million in 1998. Moreover, on every international route that Ryanair has entered since 1991, there has been sharp traffic growth in the period following Ryanair's start-up of service, and Ryanair has captured the largest portion of such growth on each new route. The Ryanair Effect on Continental European markets shows that low fares are not just an American or Irish phenomenon.

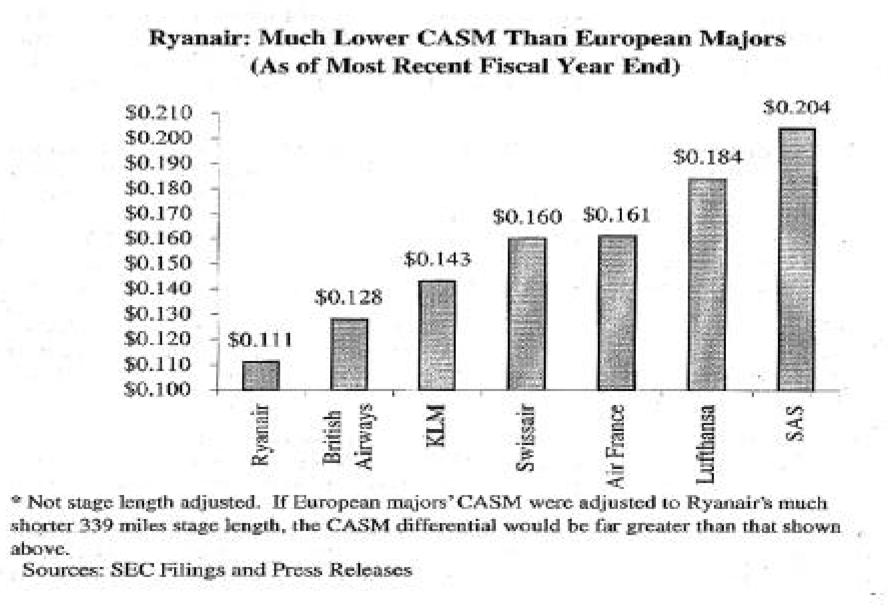
The Ryanair Effect is depicted on Graph 2 below.



(Note: Includes traffic to/from Heathrow, Gatwick, Stansted, Luton and City.)

In order to offer low fares and ultimately be a winner in the airline industry, an airline must have low costs. Ryanair is the lowest cost producer in the European market. Its breakeven load factor is only 51%-52% versus the mid 50% range for Southwest, and should continue to decline as new aircraft enter its fleet and its older 737-200s go ex-depreciation.

Graph 3 below shows that Ryanair has significantly lower CASM than the major European carriers.



Why are Ryanair's costs so low?

1. *A highly productive and incentivised work force.*
   Ryanair's ratio of passengers per employee was 4,035 in fiscal year 1999, which compares with Southwest's passengers per employee of 2,035 in 1998. A primary factor contributing to Ryanair's higher number of passengers per employee is the subcontracting of ground handling activities to independent contractors at all airports other than Dublin. In addition, Ryanair is virtually a non-union airline.
   Ryanair's employees earn productivity-based pay incentives, which in Financial Year 1999 accounted for about one-third of the average flight attendants compensation and nearly half of the average pilot's compensation. Also Ryanair is in the third year of its stock option programme, where it offers its employees stock options and other rights to purchase ordinary shares.

2. *An all Boeing 737 aircraft fleet.*
   This policy minimizes pilots training costs, maintenance expenses, particularly spare parts and aircraft acquisition costs. The training time for flight crews on the new Boeing 737-800 is only two weeks versus an average of seven weeks to be trained on a different type of aircraft.

3. *Low aircraft acquisition costs*
   Ryanair's twenty-one 737-200s were all purchased second hand. Their price tags ranged between $5 and $9 million. This compares with a purchase price of around $30 million for new 737-800s. However, the lower cost of aircraft acquisition is offset by higher maintenance and fuel costs, which tend to rise with the age of an aircraft. The average age of the Ryanair fleet at 17.8 years is well above that of the other major European carriers. Nevertheless, the view has been put forward that Ryanair will continue to obtain unusually attractive financing for the new aircraft, as Boeing believes that Ryanair will in time display the same phenomenal growth patterns as Southwest Airlines' of the US.

4. *Relatively low distribution costs*
   About 48% of Ryanair's bookings are made directly with Ryanair, eliminating travel agents commissions of about 7.5%. Moreover, about 8% of bookings are done via the Internet, which cost between $0.30-$0.50 per customer. Ryanair's percentage bookings though Ryanair Direct and the Internet is expected to grow to a level of 65% by 2002. Ryanair is encouraging customers to make bookings on the Internet, offering a discount of £5. There is also scope for travel agents commissions to be further reduced in line with the trend in parts of Europe.[6]

5. *The use of low-cost secondary airports*
   Flying in and out of low-cost uncongested secondary airports has become the trademark of Ryanair. Selected airports are generally close to large

[6] Travel agents commission is likely to decline based on the trend in other European countries. Lufthansa and SAS are already on a 5% rate on domestic routes in their respective countries.

population centres. Secondary airports work well for Ryanair because they are less expensive, generally because they are the only airline flying there. In some cases these airports actually pay Ryanair to provide services. As Ryanair has a strong negotiating hand, if airports raise costs Ryanair can move capacity to lower-cost airports. Since secondary airports are uncongested, Ryanair is able to do 25-minute turnarounds, which enhance aircraft utilization and on-time performance.

6. *Basic Service on Board*
   A basic service allows Ryanair to operate its 130-seater aircraft with only three flight attendants, whereas big carriers employ five. Passengers must pay for any food or beverages consumed on board.

The Competitive Outlook

- Ryanair may face more competition on the discount end from the national carriers in the future. There is a perception within Ryanair that the low-fare offspring of carriers which are firmly in the high-end of the market (KLM's 'Buzz' for example) will not be able to compete on cost as ruthlessly as Ryanair is prepared to do.

- A more serious worry is airport charges, which are rising at nearly twice the rate of revenues and other operating expenses.

- Poor public image: Ryanair will fly only into airports that offer substantial discounts on landing charges, so that it can maintain its low cost base. This has resulted in the company having vocal arguments with many airport operators, most recently at Knock. If the company continues to follow this strategy throughout continental Europe, it will do little to encourage brand loyalty from customers. For example, customers who previously availed of the low-cost service from Dublin to Manchester have now found that flight availability on the route has been reduced by 60%. Furthermore its industrial relations dispute has generated much negative criticism in the media.

- The company has replaced duty free with other merchandise, but it has seen a drop in in-flight sales, reducing the commission earned by the airline's flight attendants and as a result Ryanair has pledged to increase pay levels to offset this fall, which will increase overall costs.

Conclusion

Ryanair's market capitalization of £1.8 billion is a solid indicator of the confidence the market has placed in the '*jewel in the crown*' of the European low-fares airline industry. Without doubt there is a great opportunity for Ryanair to continue growing its revenues and earnings, as the low-cost airline is a relatively new phenomenon in Europe. Despite the fact that Ryanair does face competition in the low fare sector, market analysts believe that Ryanair will continue to be the winner in the arena. It is much further down the learning curve than its competition, has the lowest costs, which means that it can provide the lowest fares. Cost is the most important factor in the intensely competitive low fares business and it appears that Ryanair is more than well placed to compete.

Ryanair has constantly positioned itself at the vanguard of those who want to deliver the lowest possible fare to the public and this in turn has brought substantial social benefits.

Bibliography

Aer Lingus Group PLC (1998) *Consolidated Accounts for the Year Ended 31 December 1998.*

Barret, S. (1991) *Transport Policy in Ireland in the 1990s.* Gill and Macmillan: Dublin.

Barret, S. (1996) *The Outlook for European Aviation.* Department of Economics, Trinity College Dublin: Dublin.

Barrett, S. (8/1/99) in *The Irish Times*.

Davy Equity Research (1998) *Ryanair Report.* Davy's Stockbrokers.

The Economist (November 1999)

Joint Committee on State Sponsored Bodies Oireachtas: Dublin.
"Ryanair: In for the Big Haul" in *Business and Finance Magazine*, 1998.