Vueling: Beyond Low Cost

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Low-cost airlines remain a serious threat to the major operators. Vueling, for example, is already the third largest airline company in Spain in terms of passenger numbers.

On January 27, 2012, the Spanish airline Spanair announced that it was ceasing operations. A few days later, Ryanair CEO Michael O'Leary opportunistically unveiled the Irish company's new routes to Spain during a press conference at Bilbao airport.

Spanair workers, who organized protests following the airline closure, accused Ryanair of trying to force the country's airlines out of the market by making it impossible to compete with their cut-rate prices.

And their argument may hold some truth. Low-cost operators are taking over medium- and short-haul routes, while also becoming increasingly attractive to business travelers.

But now, even the low-cost model is under threat from a range of pressures, including the global economic downturn, intensifying competition within the sector and rising oil prices.

In light of the sector's volatile performance in recent years, Silvia Rodríguez and José Luis Nueno's business case questions the direction in which a company like Vueling should be heading, and asks whether this is "the end of low-cost fundamentalism."

Launch of low-cost airlines

The advent of deregulation in the European airline industry in the 1980s paved the way for the emergence of low-cost carriers. The first was Ryanair, founded in 1985, followed by

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Norwegian Air Shuttle in 1993 and Easyjet in 1995.

While the low-cost model thrived in the 1990s, the recent economic crisis has brought about a decline in passenger numbers and revealed the problems experienced by the previously state-owned flag carriers, such as low productivity, overcapacity, high costs and even undercapitalization.

Some of these flag carriers have even had to create their own low-cost subsidiaries, including Lufthansa, which founded Germanwings.

The key feature of low-cost companies is that they operate according to a model based on cost control, with low prices and "no frills." This is achieved by, for example, eliminating the option to reserve seats, using secondary airports, charging for in-flight catering services and selling tickets online.

In addition, these companies operate short-haul flights of less than two hours, which are more profitable because they save on hotel accommodation for crew members and require less technical support.

The "no problem" airline

Founded by Carlos Muñoz and Lázaro Ros, Vueling began to take shape in a small office in Barcelona in late 2002. It made its first commercial flight from Barcelona to Ibiza in July 2004, and soon after offered routes to Paris, Brussels and Palma.

It was described by its founders as a "no problem" airline because it offered new aircraft, major airports, online check-in and pre-allocation of seats, starting at 20 euros one way.

In late 2006, Vueling went public. Although the IPO resulted in a 100 million euro increase in capital to continue funding the company's expansion, the immediate response was disappointing, with the company announcing more than 22 million euros in losses in the first quarter of 2007.

By then, competitive pressures within the sector were sharply on the rise. Vueling's seat capacity had increased by 75 percent, but passenger numbers had risen by only 32 percent.

Meanwhile, Iberia's low-cost carrier, Clickair, had broken into the market, and both Ryanair and Easyjet had set up base in Madrid.

To make matters worse, in June 2007 Apax Partners, Vueling's largest shareholder, sold its

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stake in the company, causing the company's share price to plummet over the following months.

The company's increasingly unsustainable financial situation forced Vueling executives to rethink their business plan. They began by distinguishing two types of product: a flexible one for business traffic and a basic one for the leisure traveler.

They also developed a hybrid model that combined direct online distribution with travel agency ticket sales. This culminated in 2009 with the Vueling/Clickair merger, which led to Iberia gaining control of a 46 percent stake in the new company.

Expanding horizons

After a decade of rapid development, low-cost airlines are looking to expand their geographic and demographic horizons in a bid to sustain their current growth rate. This will almost certainly mean attracting more business travelers.

They are also trying to increase revenue by offering a broader range of ancillary products and services — in-flight sales of food, beverages and other products, and car rental services — and charging for excess baggage. Ryanair is the leader in this area: such extras accounted for 22 percent of the company's total revenue in 2010.

Vueling CEO Alex Cruz sees this as vital to making the model last. He believes that flag carriers will operate only business-class and long-haul flights in the future, leaving the remaining routes to low-cost carriers.

"For airports, this will translate into growth, higher discretionary income and greater ability to attract investors," he said.

"Low-cost operators will gain in terms of increased sophistication, product development and access to higher fares."

However, with the Spanair collapse highlighting the precariousness of the market, the most important question remains: Will the market for low-cost and good service be big enough to sustain the model?

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