White Paper

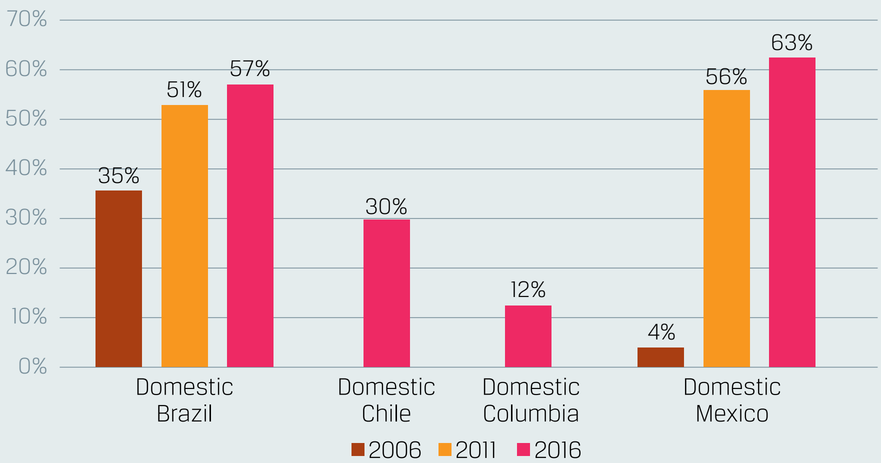
Low Cost Carrier Opportunity in Latin America

By Carlos Ozores, ICF

Nearly two decades have passed since the emergence of Low Cost Carriers (LCCs), but their presence across Latin America lags behind most other world regions. This is in part due to market characteristics that present an obstacle to LCC growth, although there are many untapped opportunities that will eventually be exploited. Existing carriers that fail to adapt quickly will fall prey to LCCs.

The LCC boom began in the late 1990s in developed markets in North America, Europe, and Australia, and spread quickly to emerging markets, including to Latin America. Today, LCCs operate the majority of seats in the Brazilian and Mexican domestic markets and have a growing presence in Chile and Colombia.

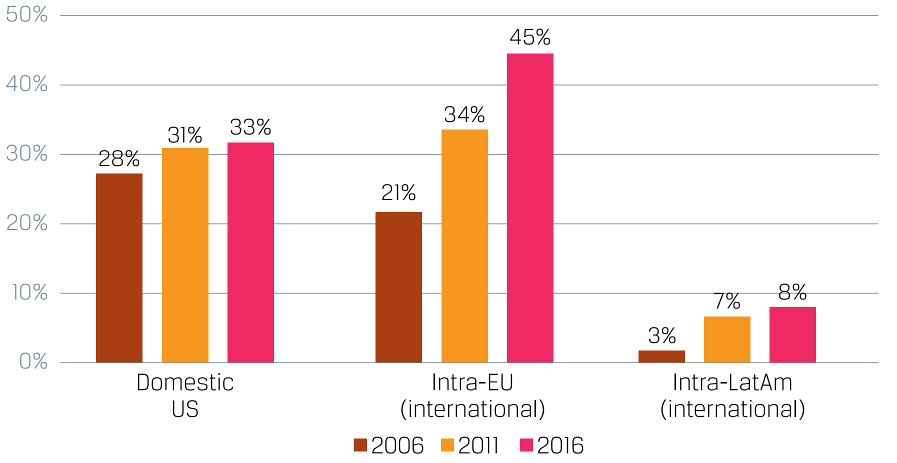
LLC SHARE OF DEPARTING SEATS



Source: Innovata schedules

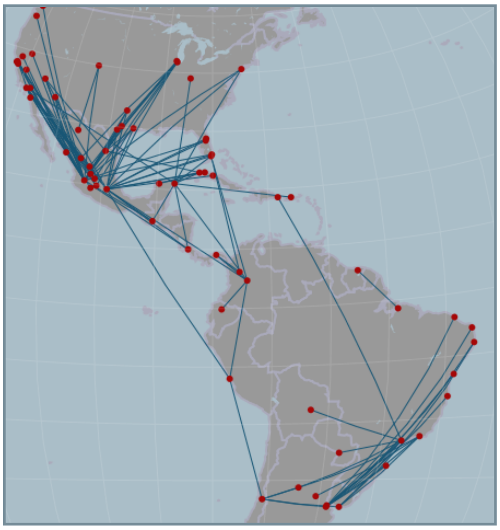
However, on international routes within Latin America, LCC penetration remains very low, representing only 8% of scheduled international seats—significantly less than in the domestic U.S. or intra-European markets. More surprising is the fact that this share has only risen about 1 percentage point in the last five years.

LCC SHARE OF DEPARTING SEATS



Source: Innovata schedules

INTERNATIONAL ROUTES OPERATED BY LATIN AMERICAN LCCS, AS OF OCTOBER 2016



Source: Innovata schedules

LCC penetration on international routes within Latin America is concentrated on routes between Argentina, Brazil, Chile, and Uruguay. Elsewhere, LCC coverage is limited. The one international market where Latin American LCCs have made significant inroads is between Mexico and the U.S.

The Latin American aviation market has strong fundamentals. So, given this, what is constraining LCC growth across the region?

There's a lot of media noise about new LCC start-up plans, many involving Irelandia Aviation, which owns VivaAerobus and VivaColombia. There has been talk of Viva airlines in Costa Rica, Peru, and Argentina. Volaris has also been mentioned in connection with a start-up in Costa Rica. Yet there has been little progress in new LCC start-ups in the region.

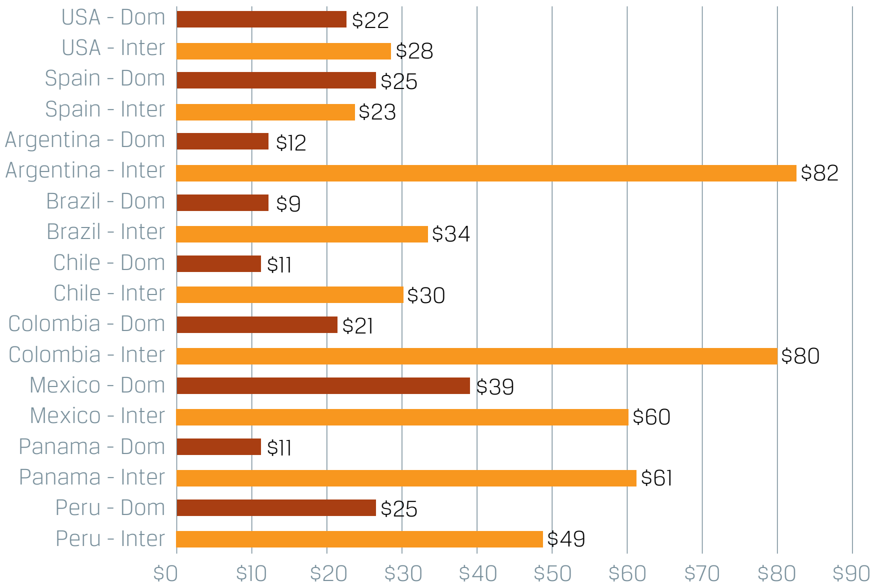
Despite all the noise, there are several obstacles to increased LCC penetration on international routes, such as:

- **Long distances in most large markets:** The weighted average distance on the largest O&D markets (those with over 100 daily passengers each way) is 2,200km or about a 3½-hour flight—equivalent to London-Kiev, New York-Dallas, or Miami-Caracas. However, the LCC model is best suited to short-haul flights, which is why successful LCCs like easyJet, Ryanair, and Southwest have average stage lengths of about 1,200km, or 2 hours. Why is this? Because while operating costs are directly linked to distance traveled (i.e., a 2-hour flight will cost about 50-60% more than a 1-hour flight), airlines cannot pass on a proportional increase to airfares. An ICF aviation analysis of domestic fares across the top 1,000 domestic U.S. markets proves this: whereas the average one-way fare on a 1,000km trip is about $160, the fare on a 2,000km trip is only about $200—only 25% more. As a result, it is more productive for an LCC to

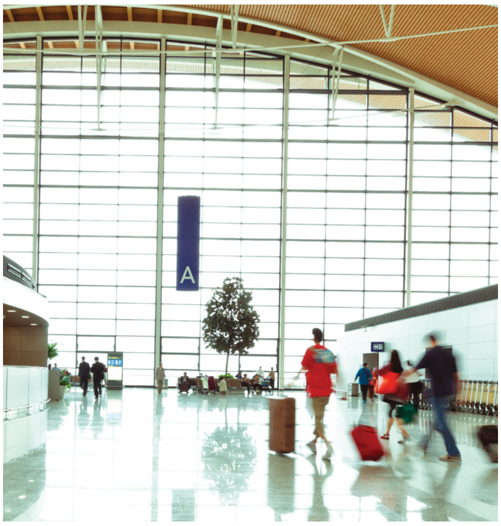
operate six 1.5-hour sectors per day than three 3-hour sectors per day, all else being equal.

- **High ticket taxes on international travel:** Airport and government surcharges applied to international travel in Latin America can easily exceed $100 per round-trip ticket when origin and destination country charges are summed, significantly more than add-ons to domestic tickets. Consequently, LCC efforts to reduce airfares are limited by governments that penalize international travel, although there are noteworthy exceptions such as Brazil and Chile, which have the region's lowest ticket taxes. Note that the blame lies entirely on governments, which impose taxes and regulate the amount that airports—public or private—can charge. With few exceptions, government policy regarding international ticket taxes is incompatible with their trade and tourism development goals.
- **Other factors such as infrastructure and regulation:** While their impact is not limited to LCCs, the lack of infrastructure at large hubs and at secondary airports, and regulations limiting foreign ownership, bilateral route rights, etc., add additional obstacles to LCC growth.

AIRPORT AND GOVERNMENT TICKET TAXES FOR DOMESTIC AND INTERNATIONAL ITINERARIES ONE-WAY TICKETS, IN USD



Source: airfare searches on ITA Matrix (as of October 2, 2016)



Despite these challenges, several markets present opportunities for increased LCC penetration to reach the levels observed in developed markets:

- **Large domestic markets:**
  - Peru and Argentina have large populations and territories, significant long-distance ground travel, and high domestic fares—key ingredients for an LCC.
  - In Chile, Sky Airline has smartly decided to transition to an LCC model to pre-empt a new LCC start-up, although it remains to be seen whether it can achieve true low cost operations. Otherwise, the country's high income per capita and low travel propensity will attract new entrants.
  - Brazil's high LCC share is misleading, as there are no ultra-LCCs along the lines of Ryanair, Spirit, or VivaColombia. Significant portions of the population still do not travel by air, so there is plenty of up-side, although there are many structural barriers to entry.
- **Southern South America:** There are natural economic and tourism links between the region's countries, but international travel remains a luxury good. Lower fares can stimulate demand by making air travel accessible to the emerging middle class. Helping matters is the fact that most South Americans do not require passports to travel internationally within the region.
- **Central America:** Economic and migrant ties within Central America and between Central America and the U.S. are very strong, but air connectivity is often poor and expensive. The fundamentals are there to support a regional LCC; however, the small scale of any one country means that to grow, an LCC needs "flag" status from various countries to set up multiple bases.

It is unlikely that Latin America as a whole will see the levels of LCC penetration observed in other large markets like the U.S., Europe, and beyond. However, given the region's low travel propensity and high airfares, there are distinct pockets of opportunity for increased LCC penetration in the region that have yet to be exploited.

What happens once LCCs do establish themselves? Perhaps Mexico provides a good indicator. Prior to the surge of LCCs in the mid-2000s, Mexico had two loss-making full service carriers (FSC) and a handful of poorly-run regional airlines. Fifteen years later, domestic traffic is up over 50%, the market has a single profitable FSC in Aeroméxico, and three well managed LCCs exist (Interjet, Volaris, and VivaAerobus). Mexicana and the poorly run regional carriers all went bankrupt.

Similarly, we can expect LCCs elsewhere in Latin America to stimulate demand while driving further market consolidation, squeezing out those carriers that cannot create differentiation by offering a superior product or achieving true low cost operations.

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About the Author

Carlos Ozores is an air transport specialist with more than 15 years in aviation strategy and business planning. He advises senior management of airlines and airport operators with strategic planning, and supports investors with investment due diligence. He brings a broad exposure to aviation, and his expertise includes network planning and alliances, fleet planning, air traffic forecasting, revenue management/pricing, and airline and airport operations. In addition, he offers clients a global perspective to solving local issues thanks to extensive work experience across all world regions. Carlos is highly respected for his knowledge and insights about the aviation industry, is regularly cited in the press, and is a frequent panelist in industry conferences. Prior to ICF, Carlos worked in Revenue Management/Pricing at American Airlines and Air France.

Carlos has an Executive MBA from IE Business School and a BA in Economics from Northwestern University. He is fluent in English, Spanish, French, and Portuguese.

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