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Viva Las Vegas and the King of Ancillary Revenues

Allegiant Air's recent stock prospectus reveals it is changing the business model for US low cost carriers.

Ryanair is generally accorded "rock star" status for its prowess for generating non-ticket revenue from its customers. But another star is standing in the curtains and may take a portion of the stage from this European phenomenon. Las Vegas-based Allegiant Air has perfected its craft in the most unlikely of markets – the United States – where airlines don't typically charge extra for all the extras they provide.

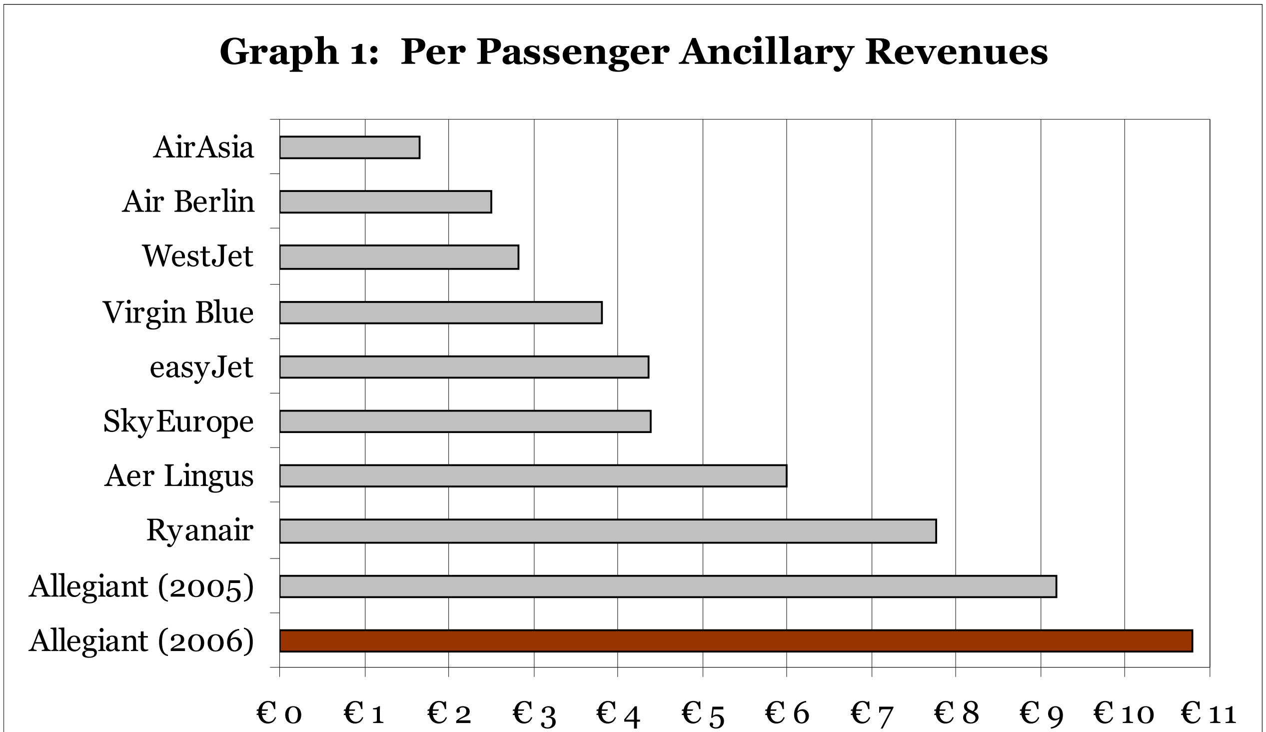
Allegiant Air reports it generated ancillary revenues of €10.79 (US$13.58) per passenger during the first 6 months of 2006,[1] which substantially bests the €7.84 (US$9.87) posted by Ryanair [2] for the same period. This activity translated into overall revenues in excess of €10 million (US$12.6 million), which admittedly were dwarfed by the €147 million (US$185 million) reported by the LCC giant Ryanair for the same period. But Allegiant's results are remarkable contrasted against the prevailing bundled-services airline business model that exists in the United States.

Revenues from non-ticket sources, which are called ancillary revenues, have become an important financial component for low cost carriers (LCCs) in Europe and throughout the world. Ancillary revenues derive from the a la carte services and features that passengers may purchase before or during their travel experience. Legacy airlines bundle these services into the price of an airline ticket. LCCs, especially those outside the United States, tend to unbundle the travel experience. Under this business model, consumers purchase basic airline transportation and pay extra for services such as advance seat assignments, checked baggage and onboard snacks and drinks.

Allegiant Air has veered from the model currently favored in the United States, which bundles amenities in the price of a ticket. Many LCCs in the United States don't charge extra for advance seat assignments, checked baggage, onboard beverages, and payments made by credit card. But it's difficult to argue with the success enjoyed by Allegiant Air. For fiscal year 2005 it enjoyed 46.6% revenue growth above its 2004 results. [3] And its cost structure is an astounding 18.3% lower than the average costs of its LCC peer airlines. [4]

Allegiant Compared with Other LCCs

Results from 2005 place Allegiant Air above other LCCs reporting ancillary revenue for the same period. Graph 1 provides a sample of results from airlines in Europe, Asia, North America and the South Pacific:



Allegiant results in "brown" are from the first 6 months of 2006, all other results are generally from fiscal year 2005. See Table 1 for details.

Caution is advised when comparing the results across regions of the world, such as Asia, where average fares and costs overall are lower than in Europe and the United States. Results are also affected by fluctuations in exchange rates. Please refer to the footnotes in Table 1 for details about the information presented in the graph.

The airlines listed in the graph represent LCCs that have earned a reputation for generating ancillary revenues. The sources of these revenues vary but generally include the commissions earned by airlines on the sale of hotel accommodations, car rentals and travel insurance. Product inclusions and distribution methods further influence the source of revenues.

Airlines selling an unbundled product use a fee-for-service strategy that is designed to maximize the revenue potential of each passenger by charging for services that other airlines normally include in the price of a ticket. They often charge fees for the following services: 1) onboard sales of food and beverages, 2) checking of baggage or excess baggage, 3) assigned seats or better seats such as aisle or bulkhead, and 4) ticket purchases made with credit cards. Table 1 lists specific per passenger results for each airline listed in the earlier graph. Unless otherwise noted, the amounts are from fiscal 2005.

Table 1: Ancillary Revenues for Select Reporting Carriers		
AirAsia [5]	€ 1.66	$2.09
Air Berlin	€ 2.51	$3.16
WestJet	€ 2.82	$3.59
Virgin Blue [6]	€ 3.80	$4.82
easyJet	€ 4.37	$5.50
SkyEurope [7]	€ 4.38	$5.51
Aer Lingus	€ 5.99	$7.60
Ryanair	€ 7.76	$9.77
Allegiant	€ 9.17	$11.55
Allegiant - 2006	**€ 10.79**	**$13.58**

Ryanair likely leads all LCCs worldwide in total annual ancillary revenues. During its fiscal year 2005, Ryanair reported ancillary revenues in excess of €259 million (US$326 million). easyJet is likely in second place with €129 million (US$162 million) for the same period. On a total ancillary revenue basis, Allegiant Air generated a modest €14 million (US$11 million) for fiscal year 2005 and its results are roughly comparable to those posted by AirAsia and SkyEurope.

Lowest Cost and the European Model

Allegiant Air's profitable record, emphasis on low costs, and drive for ancillary revenues places it closer to Ryanair and the European model of low fares and unbundled amenities. But the prevailing model in the United States is to include amenities in the price of the ticket. JetBlue promotes its amenities as a distinction of its product by advertising the following on its home page:

> **"Low fares and great destinations . . . what more could you ask for? (Besides free TV, snacks and drinks).**

JetBlue fulfills the desire of American consumers to "get something for nothing" and pampers its customers with live television and radio, first-run movies, wireless access at hub airports, amenity kits on overnight flights, and a frequent flier program. Amenities are nice, but many travelers place primary value on low fares. Michael O'Leary, Chief Executive of Ryanair, offers a simple philosophy on the power of low costs to deliver a competitive advantage: [8]

> **"It is becoming increasingly clear that being the lowest cost operator is the key competitive advantage in our industry. There is no better business model in the short haul market. Lowest cost wins."**

JetBlue, and other US-based LCCs, may argue they provide low fares "and" amenities. The European experience suggests consumers readily flock to Ryanair and its ultra low priced - - and sometimes almost free - - airline tickets. Ryanair seems to have perfected the art of the impossible by offering thousands of seats at penny fares. Even when it carries passengers for free, Ryanair's ancillary revenue products mean each passenger generates meaningful revenues.

Allegiant has adapted the essential elements of the Ryanair model to the U.S. market. The company clearly embraces the low cost mantra by including it as a key competitive strength in its recent prospectus filing, "We believe low costs are essential to competitive success in the airline industry today." [9] The words are very similar to Mr. O'Leary's. The airline strays from the typical model used by US-based LCCs by listing "growing ancillary revenues" as another key competitive strength.

Allegiant's Ancillary Revenue Manifesto

Allegiant Air relies upon a concise strategy, which is described in its prospectus, to ensure continued growth of ancillary revenues. The following provides a brief overview of the three key areas of the ancillary revenue manifesto described in its prospectus:

- **Unbundle the traditional airline product.** Allegiant Air strives to offer a simple base product at an attractive low fare that drives demand and generates more revenue as customers pay additional amounts for extra services.
- **Expand and add partnerships with leisure companies.** Allegiant Air enjoys a unique benefit by focusing its operations on the huge leisure-oriented destinations of Las Vegas and Orlando. The airline has ample opportunity to earn profits on relationships with a large array of vacation partners.
- **Leverage direct relationships with customers.** Allegiant Air generates more than 80% of its bookings via its web site. The company plans to maximize the e-commerce opportunities associated with this large online community of customers by providing a one-stop shopping solution.

According to its prospectus, the largest component of Allegiant's ancillary revenues is from the sale of hotel rooms packaged with air travel. In Las Vegas alone, the airline has agreements with 37 hotels, including major players such as Harrah's Entertainment, MGM Mirage, and Wynn Resorts. The prospectus specifically references the month of June 2006 in which the airline was responsible for the sale of more than 30,000 room nights in the Las Vegas market. Table 2 describes the airline's vacation package components along with its extensive list of fee-for-service products:

Table 2: Ancillary Revenue Activities for Allegiant Air	
Vacations	•Hotel accommodations •Car rentals •Shuttle bus transfers •Las Vegas show tickets •Vegas Passport (VIP nightclub access)
Onboard Sales	•Non-alcoholic beverages such as soft drinks •Beer, wine and cocktails •Snacks such as nuts, cookies, chips, sandwiches, candy and combination packs •Inflatable travel pillow •Las Vegas or Orlando souvenirs •Las Vegas dining coupon books
Reservations & Airport	•**Booking fee:** $7.50 (€6.00) per segment, per passenger for reservations made via the call center or online at AllegiantAir.com (waived for airport bookings) •**Convenience fee:** $5.00 (€4.00) per segment, per passenger for reservations made via the call center (in addition to the booking fee). •**Online checked baggage fee:** $2.00 (€1.60) per piece, per one-way segment, up to 2 pieces per passenger. Must be designated at time of booking. •**Airport checked baggage fee:** $4.00 (€3.20) per piece, per one-way segment, up to 2 total pieces per passenger. Charged for pieces not listed at time of booking (not in addition to the online fee). •**Seat assignment:** $11.00 (€8.75) per passenger, per segment. Includes priority boarding.

The above information was gathered from the airline's web site (AllegiantAir.com) during December 2006.

IdeaWorks believes Allegiant Air focuses on the unbundled aspect of travel products to a greater degree than any other US-based airline. Charging fees for checked baggage, online reservations, and soft drinks may be common practice in Europe, but assessing fees for all three services makes the airline unique among U.S. carriers.

Observations and Conclusions

Allegiant's prospectus indicates it plans to increase its e-commerce activities at its web site. This provides another example where the company is following in the footsteps of Ryanair. A visit to Ryanair's home page reveals a virtual shopping mall experience with offers for car insurance, personal loans, pre-arranged airport parking, airport motor coach transfers, airport lounge access, co-branded credit cards, holiday packages, bed & breakfast stays, and golfing in Ireland. Allegiant Air will create a retail niche to appeal to the smaller city demographics of its primary consumer market.

Allegiant's core strength should not be ignored. The airline specializes in linking small cities to world-class leisure destinations. Las Vegas and Orlando are unique among U.S. destinations for generating huge amounts of vacation traffic. In addition, Las Vegas and Orlando represent airports that are not major hubs dominated by a single airline. It's astounding that on 44 of its 49 routes, Allegiant is the only carrier providing nonstop service to Las Vegas or Orlando. [10]

Allegiant's route structure focuses on small cities and neglects major urban airports such as Chicago-O'Hare, Los Angeles, and New York. Airports such as Bellingham, Bismarck and Belleville are unlikely to be familiar to readers of this report, but they typify the markets in which Allegiant Air has found success. This style, too, is not unlike Ryanair, which has made a specialty of developing Europe's secondary airports. But are there enough small airports in the United States to fulfill Allegiant's future need for growth and passenger traffic?

The choice of secondary markets has kept Allegiant Air largely off the radar of major airlines and even LCCs. The airline recently added Tampa's secondary airport of St. Petersburg/Clearwater as a hub. As the airline grows it will likely become a competitive force that will affect other carriers. This increased competitive presence may force other airlines to reluctantly borrow elements of the fee-for-service strategy.

All of these distinctions make Allegiant Air a rare bird in American skies. Its record of consistent profits since 2003 suggest the airline has found an attractive niche among U.S. consumers. Allegiant's ability to achieve continued growth and success may eventually force a redefinition of the model used by LCCs in the United States. As Southwest Airlines once influenced a revolution in Europe, Ryanair may return the favor by providing the model fueling success at Allegiant Air.

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Sources used in this Industry Analysis: Unless otherwise noted, frequent flier program information presented in this report is based upon an online review conducted during December 2006 of airline financial filings, web sites, and communication with airline management. Currency exchange rate assumptions: 1US$ = €0.794 Euro, and 1€ = US$1.259

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[1] Allegiant Travel Company SEC Form S-1, Preliminary Prospectus dated August 23, 2006.
[2] Financial reports filed by Ryanair for quarters ended June 30, 2006 and March 31, 2006.
[3] Allegiant Travel Company SEC Form S-1, Preliminary Prospectus dated August 23, 2006.
[4] Cost per Available Seat Mile (CASM) comparison from Allegiant Travel Company SEC Form S-1, Preliminary Prospectus dated August 23, 2006.
[5] AirAsia estimates are for the AirAsia Group (Malaysia, Thailand, Indonesia) for the fiscal year ended June 2006 and reflect 8.4% of group revenues, as referenced in financial documents.
[6] Virgin Blue results are for the fiscal year ended September 2005 and reflect 4.9% of total revenues, as referenced in financial documents.
[7] SkyEurope results are for the 9-month period ended June 2006.
[8] Ryanair May 31, 2005 Press Release, "Ryanair Celebrates 20 Years of Operations," www.Ryanair.com
[9] Allegiant Travel Company SEC Form S-1, Preliminary Prospectus dated August 23, 2006.
[10] Allegiant Travel Company SEC Form S-1, Preliminary Prospectus dated August 23, 2006.