Yielding to earnings pressure

A triumphant Michael O'Leary, CEO of Ryanair, appeared in the Financial Times last week. Given the bleak state of the European airline industry, you might wonder what was the cause of celebration. Ryanair had announced a pre-tax profit of €15.5 million for the third quarter, against analyst consensus estimates of €16 million net loss. This lifted their full-year profit guidance, and share prices went up accordingly.

So, what was the magic bullet that drove this earnings surprise? Stronger demand? New routes? More efficient operations?

None of the above. According to the FT, the surprising improvement in profitability was due to the Ryanair's decision to ground 80 planes, about 30 percent of its fleet, during the slow winter season, and reduce the number of discounted fares offered during this period. Although passenger traffic was down by 2% relative to the same period last year, the average fare went up by 17%.

Over the last few years, my co-author Yu Zhang (University of California, Irvine) and I have researched the impact of analyst earnings pressures on competitive behaviours. A research paper that we published in 2010 in the Academy of Management Journal showed that U.S. electricity companies facing earnings pressure (pressure to meet or beat analyst earnings consensus) had a tendency to restrict output, particularly in those markets where they had substantial market share, and in more concentrated markets.

We argued that these companies had substantive pricing power in those markets, and faced with the short-term pressure to generate profits, they exploited their power to increase electricity.

An important part of any strategy is investing in creating powerful market positions (like Ryanair's) and then effectively maintaining and exploiting that market position over time. Ryanair has been investing for long. It is now the biggest airline in Europe, and its bargaining position vis-a-vis competitors, airports, and customers is enviable. Because it flies to secondary or tertiary airports, many of its routes are unchallenged by direct rivals. Ryanair's costs and prices are so low than they are likely to remain the cheapest option even after increasing prices. In addition, during winter 2012, the troubles with Thomas Cook and Spanair sent customers looking for alternatives.

It is easy to see why this would be a good opportunity to restrict output and raise prices. However, the risk is that exploiting its pricing power may be perceived as a de-escalation of Ryanair's legendary aggressiveness, a focus on short-term profits over long-term competitiveness, and therefore an opportunity for others to grow. prices and profits. Of course, there is always a catch… Such behavior would encourage rivals to increase their output and capacity, and therefore could undermine the firm's long-term market dominance.

Given the sorry state of the industry, it is not clear whether other airlines would jump at an opportunity to invest in the industry. In fact, in the short-term, a consolidation is more likely. But easyJet's stock price went up by 18% over the last couple of weeks after announcing higher than expected revenues (probably helped by Ryanair's higher prices), and Norwegian Air Shuttle, a barely known low-cost airline in Oslo, announced a colossal plan to buy 222 new aircraft, worth $21 billion (almost as large as Ryanair's fleet size of 277 aircraft, and larger than easyJet's fleet of 204 aircraft). If these threats materialize, Ryanair will be forced to continue fighting to maintain its dominance.