Strategies for the twenty-first century a period of uncertainty

A major question mark hanging over airlines at the start of the new millenium has been whether the early years will be marked by a cyclical downturn of the industry’s fortunes as happened in each of the three preceding decades. The signs were not good. In 1998 the financial results of the world’s international scheduled airlines began to worsen following the very good years of the mid-1990s. In 1999 profits for these airlines dropped to US$1.

9 billion from $3. 1 billion a year earlier. Significantly higher fuel prices, growing overcapacity in key markets and falling yields appeared to be the root causes of the deteriorating financial performance. Unless at least one of these three trends can be reversed a further deterioration in the early years of the new decade is inevitable. It remains to be seen whether the downturn, if it worsens, will be as severe and painful as that of 1990 to 1993.

But whatever the economic outcome, the international airline business will face numerous problems and uncertainty in the coming years. The regulatory environment, as it moves from ‘ open skies’ to ‘ clear skies’, will be one cause of uncertainty. Deregulation will spread to regions of the world hitherto untouched, while Europe and North America will try to move in gradual steps towards the creation of a Transatlantic Common Aviation Area. The ownership rule requiring airlines to be substantially owned and effectively controlled by nationals of their country of registration will be under pressure and is likely to be progressively abandoned.

In Europe, the expansion of the European Common Aviation Area to encompass an additional ten or eleven states will create new opportunities but also threats for many of Europe’s airlines. The airlines, of the new member states, largely government-owned, will be facing the full force of open and free competition domestically and internationally for the first time. During 2000 and 2001 they will be looking to partial or full privatisation and strategic alliances to help them meet the challenges of the single European market. While the regulatory environment is changing, the structure of the airline industry will also be going through a period of flux.

There will be further industry concentration both through the continued enlargement of some alliances and the strengthening of others, as they move from being largely commercial in character to being more truly strategic. This will be done through the creation of joint operating companies and other joint ventures. When the ownership rules begin to be relaxed, a new period of instability and change will occur as cross-border acquisitions and even mergers begin to replace the more traditional alliance agreements. Old partners may be abandoned and new partnerships created.

Moreover, the gradual and further privatisation of the seventy or so international airlines which in 2000 were still majority-owned by their governments will also bring these airlines into play. The better ones will also become acquisition targets. A few will not survive for long. The industry will from an era of concentration to a period of consolidation.

On medium- and long-haul routes, competition will increasingly be between alliances and their hubs rather than between individual airlines. On short-haul routes of up to three or four hours, the low-cost carriers of North America and Europe will capture an increasing share of the market by growing more rapidly than the conventional scheduled and charter airlines. New low-cost carriers will also emerge in other regions such as East Asia and South America. Not all the new entrant low-cost carriers will survive. Some of the European and other low-cost carriers operating at the beginning of 2000 will no longer be flying two or three years later. This too is an unstable sector.

Nevertheless its impact on the conventional airlines will continue to be substantial. Airlines such as Southwest in the US or Ryanair and easyJet in Europe will force the conventional operators to reduce fares where they compete head on, but also to constantly re-examine their cost structures. There is little doubt that the latter airlines still have much to learn from the former. Not only is the structure of the airline industry entering a period of change and uncertainty but markets too will become more unstable. This is an inevitable result of the further liberalisation as the US negotiates more ' open skies' bilaterals, as the European single market spreads eastwards to encompass the central European states, and as different parts of the world move to set up regional open aviation areas. Freer market access will result in more new entrant carriers coming in to compete against the established airlines.

The latter will themselves be competing more aggressively as regulations are relaxed by adding more frequencies and building up their own and their alliance partners' hubs. Periodic overcapacity in most markets will be endemic. Downward pressure on fares and yields is almost certain to continue. On shorter sectors such pressures will be made worse from the incursion of low-cost carriers. The accelerating switch to e-commerce and online ticket sales will also create market instability.

The Internet will give customers instantaneous and easy access to airline price and service data thereby enhancing consumers' market power. This will aggravate the downward pressure on tariffs and fares. There is a risk that the airline product will be commoditised. If this happens, price will emerge as the crucial, perhaps the only, competitive variable.

Branding and product differentiation will become increasingly necessarily for airlines but at the same time progressively more difficult and costly. The switch to online selling will particularly favour the low-cost carriers because search engines will enable consumers to identify and select their low fares even when online travel intermediaries may not list them. Clarifying the corporate mission In a climate of continuous change and uncertainty airlines in the coming years will face critical problems and serious challenges. As a first step in the difficult years ahead, airlines will need to identify and clarify their own corporate mission. What kind of airline do they wish to be? The key issue which needs to be resolved is whether the airline is to be a global network carrier or a niche player. A global carrier would aim to provide a world-wide network of routes and destinations.

It can do this by linking its own wide route network with that of a handful of alliance partners through their respective hubs to create a truly global system. British Airways, Lufthansa, Singapore Airlines, American, Delta and several others clearly aim to be global airlines. The alternative is to be a niche carrier. The niche to focus on may be either geographical or a particular type of service. A geographical niche may take various forms.

Some airlines see their corporate objective as providing only domestic services within a particular country. In a large country, a domestic niche carrier may have a very extensive network or may focus on a particular region within that country. Alaskan Airlines in the United States or Regional Airlines in France are niche carriers of this kind. Another niche strategy is to focus on being the scheduled international airline serving a particular country or a particular region. Many national airlines are of this kind. They have no pretensions to be global carriers.

Their corporate mission is to provide high-quality services to and from their own country or the particular region they are serving. Cyprus Airways and Tunis Air are examples of the former while Gulf Air and Emirates have a more regional niche. To be successful and profitable geographical niche airlines must ensure that they are so strong in the markets they serve that it is difficult and costly for other airlines or new entrants to challenge them effectively. Many niche carriers will reinforce their market position by entering into route-specific alliances or even becoming regional partners of larger network carriers.

Smaller domestic or international carriers may also decide to become franchises of larger airlines operating part or all of their services in the colours and livery of the franchiser. Several small UK domestic airlines have done this as a result of franchisee agreements with British Airways. Very large or relatively small airlines should have little difficulty in clarifying their corporate mission. The greatest difficulty is faced by medium-sized international airlines, such as Finnair, LOT Polish Airlines, Olympic, Pakistan International or Mexicana. They may be too small to be global players but too big to reconcile themselves to the role of a niche airline.

But unless they can identify the long-term role that is most realistic and feasible for them, they will have difficulty in taking the right strategic decisions to achieve their corporate mission since the mission itself will be unclear. Lack of a cohesive, long-term strategy will endanger their survival in the more competitive world of the future. There are in addition several market niches which are not geographical in nature but are linked to the type of air services being offered. One niche is that of the specialist charter or non-scheduled carrier. On the passenger side, this sector of the industry is most developed in Europe with several large airlines such as Britannia Airways and Condor. There are of course separate niche airlines, such as Cargolux, focusing exclusively on scheduled and/or non-scheduled freight traffic.

Another niche is that of the low-cost carrier. Finally, we have the integrated or express carriers such as Federal Express, DHL or UPS, who offer door-to-door high-speed services for parcels and ‘ small’ freight. Clarifying the corporate mission is crucial for two reasons. It facilitates the identification of the correct strategies for long-term success and survival.

But, in the short term, it helps to ensure that current management decisions are consistent with achieving the corporate mission and objectives. Unclear, confused or incompatible corporate objectives lead to poor and often contradictory commercial and operating decisions. The sudden collapse in 1999 of Debonair, one of the first European low-cost carriers, was due in no small measure to confused corporate objectives. It was trying to operate as a low-cost low-fare carrier but offering frills, such as a business class or more leg room, which inevitably pushed up the costs. At the start of 2000, Virgin Express, the Brussels-based low-cost carrier, also appeared to suffer from confused corporate objectives.

Was this a danger signal? New paradigms for the airline business? Airlines need to have a clear, unambiguous corporate mission. One key aspect of that mission must be to decide whether the airline is in the airline or the aviation business. Because of the way the airline business has grown, the traditional airline itself provided in-house most of the services and functions it required. Its departmental structure reflected this.

There were and still are, in most airlines, separate departments dealing with engineering and overhaul, in-flight catering, ground handling, cargo, reservations and ticketing, sales, management information systems and informatics, and so on. All these functions were considered so important and critical for the efficient running of the business that airline managements have felt that they had to control them directly. As a result, most medium-sized and large airlines are self-sufficient in these areas. Some work is contracted is contracted out to other carriers or suppliers but usually in locations away from an airline’s home base. For instance, ground handling or catering is often provided by others at distant airports.

Several airlines contract out some of the more difficult engine or airframe overhauls to specialist maintenance organisations or other carriers with more advanced facilities. The overall aim has been self-sufficiency in most areas with only limited contracting out. As a result, most airlines look very similar in their method of operation and their management structures. This was, and for most airlines still is, what the airline business is about. During the 1990s two alternative and different business models have emerged.

British Airways epitomises the one and Lufthansa and Swissair the other. In the mid-1990s as a reaction to the crisis years of 1990 to 1993 and the need to reduce costs, senior managers at British Airways, among others, launched the notion of the ‘ virtual airline’. The concept was simple. An airline should focus on its core competences, which is operating a network of air services and outsource to others as many non-core activities and functions as possible. By doing this, it could significantly reduce its own costs, especially in areas where traditionally it was over-staffed, and at the same time achieve low future costs by putting out the functions concerned to competitive bidding from alternative suppliers.

In the years that followed, British Airways, as mentioned earlier, outsourced its ground transport services at Heathrow and Gatwick to a US company Ryder, it sold off its in-flight catering at Heathrow to Swissair’s Gate Gourmet and also sold off its heavy engine maintenance facility in South Wales. The airline abandoned the provision of third-party terminal and ramp handling to other carriers at Heathrow’s terminals 1 and 2. In other words it more or less withdrew from the provision of ground handling services to third parties. BA would have gone further in its outsourcing strategy but for union opposition.

While outsourcing worsened industrial relations, British Airways failed to make significant inroads in its staff numbers. It was still employing 56, 000 staff at the beginning of 1999, about 8, 000 more than five years earlier. The virtual airline strategy appears much more effective for new start-up airlines that are not encumbered with existing facilities and staff. By outsourcing most functions they can get the best and lowest cost deals and they can start flying very quickly. Some of the low-cost airlines, such as easyJet and Go, BA’s subsidiary, are close to being virtual airlines. In fact when easyJet started in 1995 it even outsourced the aircraft provision and the flying.

The alternative model is one that suggests that airlines are not just in the core airline business, but that they are in a wider aviation business. The latter consists of much more than flying. In-flight catering, aircraft maintenance, ground handling, air-transport-related informatics and other activities or functions are all parts of the aviation business. Many airlines are too small to provide all of these services economically in-house and are now looking for outside suppliers. Even larger airlines may wish to outsource some of these functions, for instance, ground handling, when and where it can be done more cheaply. Some of these services can also be supplied to non-airline customers.

Thus, there is a whole host of services and activities that are separate business activities in their own right. Traditionally, as mentioned earlier, most scheduled and charter airlines had these activities provided in-house by their own relevant departments and considered them as part of their core business. Increasingly, however, a few airlines have seen the potential value of these activities as profit generators and businesses in their own right.

They have set about transforming what were previously internal departments into separate specialist companies.

In Europe, Swissair and Lufthansa have led the way in this. In Asia, it has been Singapore Airlines. Lufthansa has identified seven separate business segments. These are (i) the ‘ Passenger Business’, which covers the core passenger airlines of which there are two, Lufthansa and Lufthansa Cityline, but also subsidiaries Lauda Air (20 per cent shareholding) and Luxair (13 per cent Lufthansa stake); (ii) a ‘ Maintenance, Repair and Overhaul’ organisation; (iii) ‘ Catering’, both in-flight and on the ground; (iv) ‘ Ground Services’ both in Germany and world-wide; (v) ‘ Leisure Travel’ which encompasses Lufthansa’s charter airline Condor; (vi) ‘ IT Services’; and (vii) ‘ Logistics’, a separate business which includes Lufthansa Cargo and effectively all Lufthansa’s cargo carrying activities (Lufthansa, 1998). By setting these up as separate businesses with their own accountable managements it became easier to achieve more effective cost control and to make each of them much more customer-focused.

As a result marked increases in turnover were achieved in most areas in 1998 and 1999. The Lufthansa Group board was able to set a tough corporate objective for each business segment, namely, for each to become one of the top three providers in the world in its own particular business area. By the end of 2000 most of the businesses had achieved this! The Swissair approach has been very similar, though there are only five separate business areas. It is clear that today Luftthansa and Swissair see their corporate mission as being in the aviation business.

British Airways remains primarily an airline. Which is the correct strategy to follow? While there is a logic in the BA approach of moving towards a virtual airline in terms of reducing costs through outsourcing, it does carry a major risk. The airline business is very cyclical. Concentrating purely on the core activities and abandoning the provision of peripheral services makes an airline more susceptible to any sustained economic downturn.

If passenger growth falls off or if yields decline and revenues go down there are no countervailing sources of revenue, from, say, catering or ground handling services, to offset the revenue fall. Revenues from these areas may also be adversely affected by a cyclical downturn, but much less so than the core airline revenues. After all, other airlines’ aircraft, as well as one’s own, still have to be handled or maintained, and passengers continue to require in-flight meals and catering. In 1999 it was the absence of any countervailing revenues from other sources that led to the dramatic drop in BA’s profits. This poor performance and the collapsing share price ultimately lead to the resignation of the chief executive, Robert Ayling, in March 2000, one of the chief proponents of the virtual airline strategy.

Airlines such as Lufthansa or Swissair also saw profits from their airline business decline that year. Like BA they too were affected by higher fuel prices, overcapacity in key markets and falling yields. But revenue in their ancillary businesses held up better and helped cushion the shortfall in airline revenues. Their chief executives did not have to resign! The Lufthansa-Swissair paradigm also involves some risks.

If, as seems most likely, the core airline business is required to buy all the services it needs, such as catering or maintenance, from its own non-core business units, can one be certain that it is always obtaining the best and cheapest deal possible? On the other hand it could be argued that because these specialist business units are likely to be large they will enjoy economies of scale, and since they are constantly in competitive bidding for external third-party work they are likely to be more efficient than an airline's internal supplier who does not face real competition. There is an added risk that, in the longer term, the non-core businesses may prove consistently profitable while the airline business itself is marginal. Does one then abandon or sell off the latter and keep the former? In the coming years airlines will have three business models to choose from. There is the traditional model of the self-sufficient airline which provides in-house most of the necessary ancillary support services.

This may be more expensive than contracting out but the management feels it is in control of its destiny. Some contracting out is undertaken but usually in specialist areas or for services away from its home base(s). Work may also be contracted in from other airlines. Such work is always welcome but not seen as a major revenue source in its own right, rather as a way of optimising the utilisation of existing staff and facilities.

Second, there is the virtual airline model partially adopted by British Airways. But perhaps the best examples are some of the European low-cost carriers such as easyJet. Cost minimisation is the priority. If any service or function can be provided more cheaply by an external supplier then it should be outsourced. This is of course much easier to do for new start-up airlines than for airlines trying to move from the traditional self-sufficiency model to a more virtual model, since they are encumbered with existing staff and facilities. They inevitably face considerable employee and union opposition.

Finally, there is the aviation business model. This sees each of the ancillary activities related to the core provision of air services as separate and potentially profitable businesses in their own right. Moreover, such businesses aim to capture a customer base which is much larger and wider than their own host airline. To date, the most successful proponents of this model are Lufthansa and Swissair and to some extent Singapore Airlines. Surprisingly, no North American airlines have yet gone down this road. Airline executives and their boards will have to choose which of three business models to adopt and develop as part of their long-term corporate strategy.

A priori, the third option, the aviation business model, appears to be the most attractive. However, not all airlines are large enough or have sufficient resources to adopt this model.