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Flag bearers

Carrying the national flag may be an honour but it can also prove a heavy burden. Flag carriers more than others need to reshape strategy as they seek a role in the global airline market.

As the winds of globalisation continue to blow, the airline sector, like others before it, must eventually start to consolidate and segment. The wisdom is that air transport will eventually reorganise around a handful of major global groupings, together with a range of smart niche players and low-cost challengers. But what then of the traditional flag carriers that still dominate the industry's middle order? For those still locked into national markets, this brave new globalised world would seem to offer more challenges than choices, but it also clear that they cannot afford to stand still.

Admittedly not all independent flag carriers are the same. But there are some telling similarities in the burdens that come with carrying the flag. Many still have state shareholders and a legacy of being run less as commercial businesses than as arms of government, often managed by career bureaucrats. They typically have responsibilities for providing local employment and are required to maintain unprofitable routes for reasons of social or political reasons. Given such constraints, the usual strategies of radical cost-cutting and consolidation simply may not apply.

The independent flag carriers are hardly alone in facing a legacy of bureaucracy, cost and national politics. The major carriers, many of which are also bearers of their national flag, are themselves engaged in soul searching over how to mend their badly dented business model. However, what the majors have, by definition, is world scale. Typically they have large and well-developed home markets, or at least access to such markets to feed their hubs. They mostly also have the necessary centre of gravity to exploit liberalisation, through global alliances and the occasional acquisition.

By contrast, the mid-sized flag carriers may have more to lose than win by seeing their national markets opened up to the full force of competition. And relatively few have been able or willing to become junior partners in the global alliances. Even if they did seek membership there is no guarantee that the groupings would be keen to add new members on terms to suit.

The lack of scale is clear from the *Airline Business* annual financial ranking of the Top 150 Airline Groups, a selection that accounts for the bulk of world airline revenues (*see September 2002*). Mid-sized flag carriers can be defined roughly as those which bear their nation's flag but with revenues below a cut-off of somewhere around the $2 billion mark — a figure that represents the average for the ranking and excludes most of the "major" mainline airlines. Under this definition, the flag carriers emerge as the largest single sector of the ranking, accounting for 29% of the groups, but with only 10% of the revenues (*see table*). By contrast, only 35 majors account for over 70% of the industry's sales. The big five European travel groups, not included in the ranking, also cast a long shadow, now having a dominant grip on the big charter markets and close to $30 billion of annual leisure spending.

The ranking also gives evidence of another defining feature of flag carrier life: the fact that many are facing severe and perennial financial stress. In common with most other sectors of the industry, other than the vibrant low-cost players, the flag carriers lost money last year even before the events of 11 September threw air transport into outright crisis. Those listed in the top 150 ranking, or at least those that publish full results, posted a collective operating loss of over $500 million, which translates to a margin of -2.3%. Even that may be understating the true level of losses given the lack of available figures for some of the more financially stressed state-owned carriers.

Positive margins

In fact, even at that level the margin was still slightly ahead of the loss figures posted by the majors – but then 2001 was hardly a typical year. In the wake of 11 September the US majors sank to unprecedented annual operating losses of some $7.6 billion. Take that out of the equation and the remaining majors actually kept operating margins positive at 1.3%. At the same time, the low-cost carriers provided an even starker contrast as they edged profit margins up close to 10%.

Perhaps more telling is that the independent flag carriers have equally struggled to make money in the good years. Despite a few bright individual performances, the group as a whole faced the crisis already in the red. In 2000, as the rest of the industry enjoyed relatively healthy profits, the flag carriers had registered a collective net loss for the year and barely managed breakeven at operating level. The implication is that the sector is structurally unprofitable and in the present climate there is every likelihood that life will get worse before they get any better.

Traditionally, governments have stepped in to bail their carriers out of trouble, but, as demonstrated by the recent loss of some major names such as Swissair and Sabena, that can no longer be a cast-iron guarantee. In the present climate, even the most protective of governments is going to find it increasingly difficult to shield a loss-making national carrier from the tides of liberalisation and consolidation. And without fundamental change, for many ailing carriers, state support may be no more than a temporary postponement of the inevitable.

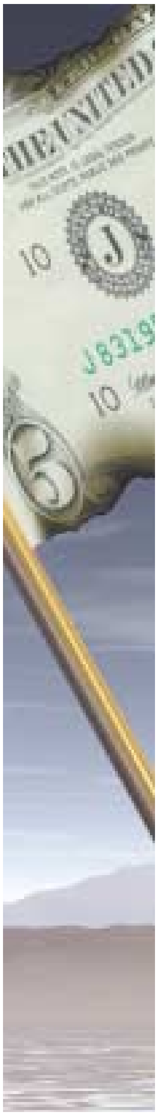
Governments everywhere are coming under increasing political and economic pressure to open up their markets. And the national good of preserving a flag carrier could well be sacrificed to achieve broader development goals. For example, the opportunity of major growth in tourist revenues may be tied to the relaxation of restrictions on foreign carriers and even to an open skies bilateral.

Nevertheless, these current market upheavals may also provide some potential opportunities for independents. Faced with a collapse in high-yielding business traffic and growing pressure on leisure fares, the majors have been forced into a searching re-examination of their own business model.

Long-haul focus

It is likely that the majors will, in future, concentrate more on their long-haul flying on services between and beyond the main alliance hubs. Smaller operators will be relied upon to provide a mix of feed into the main hubs and used to fill in with additional point-to-point services. That role is not restricted to multilateral alliance partners. As they seek to strengthen their networks the majors are likely to look for other bilateral agreements with those independents able to provide consistent feed into the alliance hub or offer direct services to their own secondary hubs and gateways. Indeed the flag carrier could make a virtue of its independence by signing up bilaterals with a range of different majors on its most lucrative markets, rather than committing to a single global alliance.

The drive to reduce unit costs and differentiate service could also lead to a role for more specialist operations in the air market, as it has in other consumer-driven industries such as hospitality and retail. There is already a gathering trend to offer different value propositions to business and leisure segments and it is expected to continue – witness Lufthansa's experiment with corporate jets out of Düsseldorf for its top-end customers. That too could offer potential for the independents, especially in the premium leisure sector, provided that they can meet the necessary benchmarks on reliability and safety. While majors are obliged to deal in standard products, the smart independent has the



Airline Business Top 150 airline groups 2001 – analysis by type

Group type	Group revenues $ million	share	Top 150 groups number	share	Description
Majors	223,555	71.5%	35	23.3%	Mainline carriers above $2 billion
Flag-carriers	31,654	10.1%	44	29.3%	National carriers below $2 billion
Cargo	25,257	8.1%	9	6.0%	Cargo/express operations
Independents	17,347	5.5%	29	19.3%	Non-aligned, non-flag
Leisure	6,911	2.2%	13	8.7%	Charter airline operations
Regional	4,330	1.4%	11	7.3%	Regional airlines
Low-cost	3,717	1.2%	9	6.0%	Budget model independents
TOTAL	**312,770**	**100.0%**	**150**	**100.0%**	

Note: Based on the ranking of the Top 150 airline groups by revenues *Airline Business* September 2002.

Airline Business Top 150 airline groups 2001 – analysis by margins

Type	Operating result 2001	Operating result 2000	Operating margin 2001	Operating margin 2000	Net result 2001	Net result 2000	Net margin 2001	Net margin 2000
Majors	-6,023	13,946	-2.8%	6.0%	-10,912	6,411	-5.0%	2.7%
Flag-carriers	-555	302	-2.3%	1.2%	-847	-218	-3.5%	-0.9%
Independents	-50	846	-0.3%	6.0%	-561	65	-3.9%	0.5%
Low-cost	357	267	9.6%	8.6%	269	170	7.2%	5.5%
TOTAL	**-5,693**	**16,764**	**-2.0%**	**5.5%**	**-11,928**	**6,686**	**-4.1%**	**2.2%**

Note: Based on the ranking of the Top 150 airline groups by revenues *Airline Business* September 2002. All figures in US$ exchanged at average rates. Results include only those carriers with two years of complete data available.

opportunity to be sharper in tailoring its service and price to a precise audience. For example, a flag carrier could make a virtue out of its national character by offering leisure travellers an experience that provides a taste of the country that they are about to visit.

Other opportunities too may be available, but only if the carrier can identify and follow a commercially viable strategy. To do that they need to follow three main steps. The first is to take a hard and objective look at the carrier's realistic potential and its contribution to the global aviation industry. What is it that a flag carrier has to offer which others cannot? What are its natural strengths and assets? What can it not do profitably?

Political decisions

For many flag carriers years of political decision-making have left a tangle of operations and inflated employment levels which are poorly aligned to the markets that they serve. Networks may owe as much to national prestige as commercial logic and fleets too can tend to be stuffed with too many equipment types, often based on the drive to buy the biggest or the latest technology with consequent impact on operating and maintenance costs.

Hence it is essential to separate out the commercially viable parts of the operation from the rest. The key asset of any airline is the passengers that fall within its "natural market", both at home and at the far end of its core routes. Their exact value will depend on disposable income levels, propensity to travel and reason for travel (such as ethnic traffic).

One rough measure is to look at the number of passenger journeys that a carrier makes as a proportion of its local population. That ranges from 3.5 trips per head for a carrier such as Singapore Airlines, with its tiny domestic market and massive hub, down to almost nothing for the largest of the Chinese carriers, in their massive but underdeveloped air market. Those with high ratios, such as Swissair or KLM, are likely to find themselves exposed compared with those such as Lufthansa with a ratio closer to 0.5. In general, it is in developing that core market that will provide the best chance of long-term survival and success. Today, many flag carriers still lack the cachet needed to become the preferred carrier for either their own national travellers, let alone the higher-yielding leisure traffic.

Carriers need to develop a clear understanding of core market needs in terms of destinations, price, product and service. Activities that do not do not contribute should be eliminated. It is a seemingly obvious point but one which is far from easy to put into practice.

One practical strategy is to separate out those parts of the network which are commercially viable from the services which are run as a social or political obligation. If it is not politically acceptable to eliminate the unprofitable elements then the carrier should ring-fence these operations and request that its government stakeholder compensates the airline for any losses suffered either directly or as a consequence of the knock-on inefficiencies they bring to the rest of the operation. Faced with the true cost of these operations it is possible that the stakeholder may re-evaluate the benefits that such services bring.

The next step is to realign the network to serve the best interests of the passengers that are within the commercial market envelope. If there are advantages in operating as a feeder into a secondary hub, then the carrier should seek codeshare agreements and disregard the emotional arguments about the dent to national prestige of being seen to feed a neighbours hub. The key is to make rational choices that are driven by a strictly commercial view of the network.

There are also great lessons to be borrowed from the success of the low-cost carriers in the alignment of network and fleet. Unlike the no-frills carriers, few independents will be able to operate with a single aircraft family, but they must re-assess the trade-offs that are being made between the cost of adding a new type and the advantages that it brings in extending the network. For instance, a carrier could choose to limit the fleet to just two types, knowing that it would have to give up 15% of its market envelope, but may nevertheless offset the loss with significant gains in terms of crews, maintenance and procurement costs.

Similarly the design of the ground and in-flight service will have tradeoffs between levels of service and price expectancies. This should be done with clear understanding of passenger preferences and price sensitivities. Passenger expectations may vary widely across the different destinations, so use of customer surveys will be essential to give an objective, statistical base on which to make decisions.

It may be possible to improve the product by redeploying surplus staff to customer service roles, especially in countries with wage cost advantages and where redundancy programmes are politically difficult. That could help to convert a relative disadvantage to an advantage over majors that have cut back on staffing levels.

Process realignment

The final step is the alignment of the processes to fit the business model. The key here, as for the majors too, is to simplify the model. Airlines everywhere have too many special cases and too little standard practice. The key is to strip out the specials and replace them with clear and transparent processes that can be followed and repeated. That is no more than other industries have been doing for years.

Here too, low-cost carriers provide lessons. An example is the way that carriers such as Southwest Airlines set about slashing aircraft turnaround times to previously unachievable levels. It did so by re-engineering the processes involved in getting the aircraft out, such as refuelling and cleaning, and running them in parallel. A clear case of processes being aligned to the carrier's business need.

Flag carriers, with their traditional bureaucratic and hierarchical structures, have particular cause to revisit their complex and occasionally opaque decision-making processes. Practices can too often end up being established through informal networks and connections rather than on a formal basis. Best practice needs to be institutionalised, with the knowledge locked up in these informal groups captured and spread throughout the business.

The mid-ranking flag carriers are not alone in needing to grasp this kind of change, but perhaps more than any other group their future looks bleak if they do not attempt to adapt. ■

About the authors

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