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Turning the Corner

For many airlines, a complete turnaround is required to return to profitability and reclaim long-term status.

By Shane Batt I *Ascend* Contributor

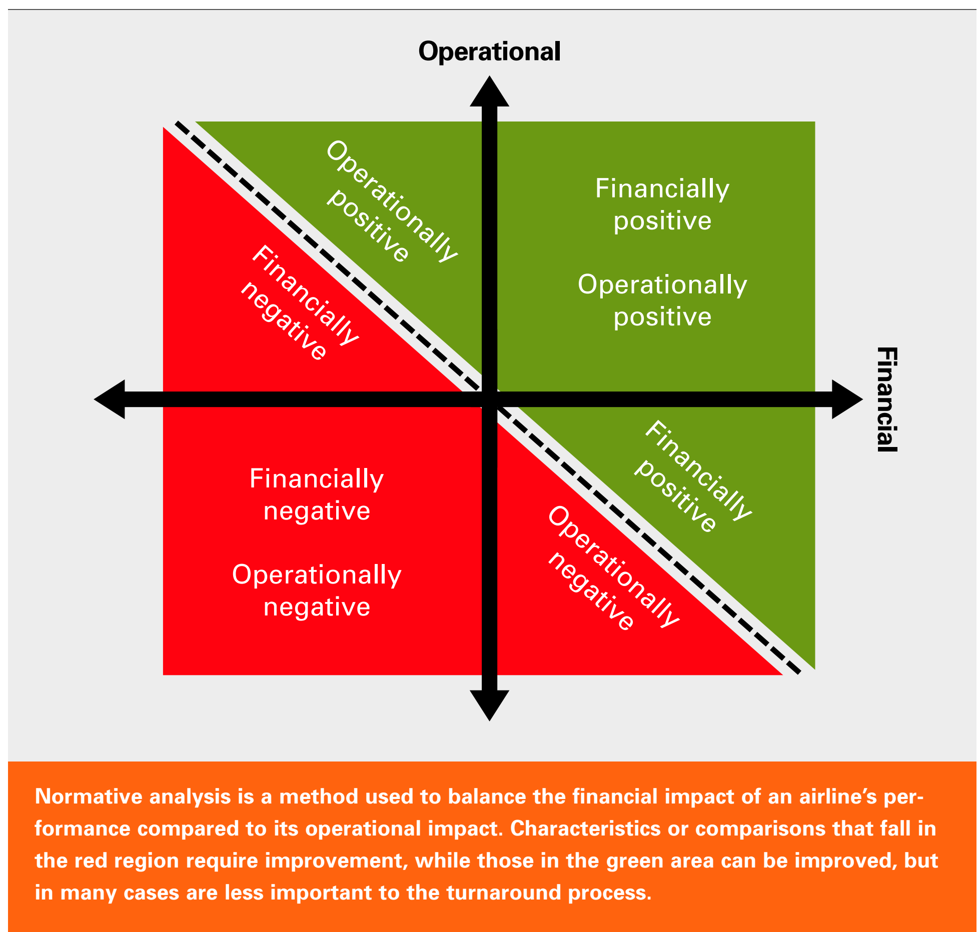
Many airlines appear to be focused on cost containment at the exclusion of many other management activities. The escalating costs of jet fuel, employee salaries and benefits, and rising interest rates are only three examples of why airlines continue to focus on expenditures. While unit costs are declining across the industry, revenues also continue to diminish, which continues to put profit pressure on all airlines. Inevitably, many airlines under these circumstances will find themselves short on cash and nearing financial collapse, leaving them in a position to seriously contemplate the implementation of an airline turnaround.

The object of a turnaround is to reverse the losses that an airline experiences and lead it back into profitability. When the carrier is able to maintain a consistently profitable position, then the turnaround is complete. While this process is often misunderstood, there are basic characteristics of an airline turnaround and key steps that should be followed for a successful outcome.

The Basic Rules

A few simple rules can be identified that are common for almost all successful turnarounds. The most basic issue is the turnaround must bring about both tactical improvements and strategic change in business practices. Successful airlines with industry-leading management practices don't require turnarounds. Therefore, airlines requiring turnarounds need to have at least some business process changes to be successfully improved. While few would complain about revenue increases, there will be many arguments about any new cost-containment exercises. These truths lead to five simple rules regarding airline turnarounds:

Normative Analysis Decision Model



Normative analysis is a method used to balance the financial impact of an airline's performance compared to its operational impact. Characteristics or comparisons that fall in the red region require improvement, while those in the green area can be improved, but in many cases are less important to the turnaround process.

1. Start an airline turnaround with revenue-improvement exercises rather than cost-containment exercises.
2. Of an airline's employees, 5 percent make money and 95 percent spend money. Find the 5 percent who make money and improve their performance. Then, work on the cost-containment capabilities of the remaining 95 percent.
3. Survival is a tactic not a strategy. Fix the airline's financial condition first and then implement a strategy for long-term health and success.
4. Follow the money; perform turnaround actions in the order that will produce the largest financial improvements in the shortest length of time.

5. Communicate with all stakeholders. Information should be free-flowing and disbursed to alleviate concerns and drive business culture changes.

These simple rules almost always produce positive results. What is surprising with these rules is not their simplicity, but the fact that many airlines attempt to force financial improvements without considering these rules or something similar.

Controlling Costs

Controlling costs of an airline is not an easy task. The reasons are fairly simple but also say a great deal about the airline business. A basic expenditure tree demonstrates how costs of an airline are split and allocated — total operating costs at an airline are split into two types of costs, indirect and direct:

- Indirect operating costs are commonly referred to as overhead. For an airline, they include most management functions such as finance and human resources. In addition, costs include "general and administrative" items, non-operating facility costs and similar infrastructure costs. For the average airline, about 16 percent of its total costs are indirect operating costs, but this number is closer to 8 percent for low-cost carriers.
- Direct operating costs are precisely related to the provision of air services to customers, and they are split into two types — fixed and variable. For the average airline, direct operating costs account for about 84 percent of total costs and about 92 percent for low-cost carriers.
- Fixed direct operating costs are directly related to the provision of air service that does not change from month to month. These costs generally include aircraft leases or ownership, fixed salaries of crew and other operating personnel, and the costs of operating facilities. For average airlines, about 42 percent of direct operating costs are fixed, which equates to about 35 percent of the total operating costs. For low-cost carriers, about 46 percent of direct operating costs are fixed, equating to about 42 percent of total operating costs.
- Variable direct operating costs are related to the provision of air service that changes from month to month. These costs are split into two types — flight costs and passenger costs. For average airlines, variable operating costs are about 58 percent of direct operating costs, which means they are about 49 percent of total operating costs. Low-cost carriers are not very different; their variable operating costs are about 54 percent of direct operating costs, which means they are approximately 50 percent of total operating costs.
- Flight costs are variable and directly relate to the operation of the flight. They include the majority of fuel costs, crew variable costs, landing and navigation fees, most maintenance costs, and similar expenditures for airlines. These costs exist even if a flight departs without passengers. For the average airline, flight costs are approximately 82 percent of variable operating costs, which equates to roughly 37 percent of total operating costs. For low-cost carriers, flight costs are about 80 percent of variable operating costs, which equates to about 38 percent of total operating costs.
- Passenger costs are variable and directly relate to passengers in areas such as catering, passenger weight-related fuel costs, baggage-handling costs, reservations costs and passenger handling (where these costs are paid for each passenger to a passenger handling service provider). For average airlines, passenger costs are about 18 percent of variable operating costs, which means they are roughly 9 percent of total operating costs. Similarly, low-cost carriers have shown that about 20 percent of variable operating costs are passenger costs, approximately 10 percent of total operating costs.

Of course, the percentages vary from airline to airline, but not by much. The implications of this expenditure tree are very important. First, 90 percent to 91 percent of total airline costs are unrelated to passengers. Despite the fact that most airlines are dedicated to passenger carriage, nine-tenths of their expenditures are not related to passengers. If passenger demand decreases or passenger yields decrease, the costs of operating an airline generally remain about the same. This is a fundamental problem with the financial performance of the airline industry. This also presents a potential strength of the industry because the revenues that are attributable to incremental passengers are essentially all profit, meaning incremental passengers equal incremental profit. Low-cost carriers obviously understand this simple approach, which is why they offer low fares to stimulate very high load factors. This is also the reason for the first rule of airline turnarounds — start with revenue-improvement exercises rather than cost-containment exercises. Incremental revenues increase profits rapidly, so this is the first place to start when implementing an airline turnaround.

Increasing Airline Revenues

Just about any struggling airline's revenues can be increased by introducing changes that affect its revenue drivers, including:

- Flight scheduling — Network configuration, flight times, capacity applied to the flights and connectivity to codeshare partners and other airlines,
- Pricing — The fares and rules that an airline applies,
- Revenue management — How the airline overbooks its flights and applies discount-allocation levels to each of its fare classes,
- Sales — How the airline sells its products and provides incentives to representatives to sell its products,
- Distribution — The storefront where the airline makes its products available for sale, including traditional bricks-and-mortar distribution storefronts as well as online distribution outlets,
- Branding — How the airline projects the image of its products and services,
- Loyalty — How the airline rewards its most frequent flyers to ensure continued loyalty,
- Advertising — Where and how an airline advertises its products, services and branding,
- Promotion — How the airline promotes its products to its customers and third-party service providers.

Airline turnarounds begin with an examination and improvement of these basic revenue drivers. Work is performed on all drivers concurrently to ensure revenue improvements occur rapidly and enhance the performance of each other.

Revenue performance still requires human interaction, which is the reason for the second rule of airline turnarounds — 5 percent of an airline's employees make money and 95 percent spend it. Find the 5 percent who make money and improve their performance. Then, work on the cost-containment capabilities of the remaining 95 percent.

The 5 percent of the employees who are in areas such as flight scheduling, pricing, revenue management, and sales or distribution roles have the most positive impact on an airline's revenues. The performance of these employees should be the first concentration of the airline turnaround; however, they are often the most difficult to change. While these revenue-impacting employees are happy to see the revenues of their airlines increase, they often do not wish to change their procedures or practices to allow these same increases in revenues. This is the reason the performance of these 5 percent must be an immediate

point of concentration. It is also important that all employees feel a sense of urgency about the need for an airline turnaround.

The Tactics of Survival

In the worst cases of airlines requiring a turnaround, there is breakdown in trust between the various stakeholders involved in the airline:

- The board of directors, as representatives of the shareholders, do not trust airline management or employees,
- Airline management does not cooperate well with the board of directors or trust in the performance and abilities of employees,
- The employees mistrust management and the board of directors,
- The passengers have little faith in the airline and generally "vote with their feet" by using the services of the airline's competitors.

The board of directors and management are responsible for setting the strategy of the airline. It is important, therefore, that the strategy not be simply to survive. Airlines should have a strategy that forces financial success and meets social obligations to their stakeholders. While airlines should not have a strategy merely to survive, they should implement tactics to ensure survival. The difference between strategies and tactics is a difference of perspective. Strategies have a long-term perspective, while tactics have a short-term perspective. Airlines that require a turnaround need to implement the tactics of survival first, but in such a way that the strategy of the airline is supported. The tactics of survival — increase revenues, decrease unit costs, implement cost-containment exercises on controllable costs and conserve cash as much as possible — are fairly easy to understand, even if they are not so easy to implement.

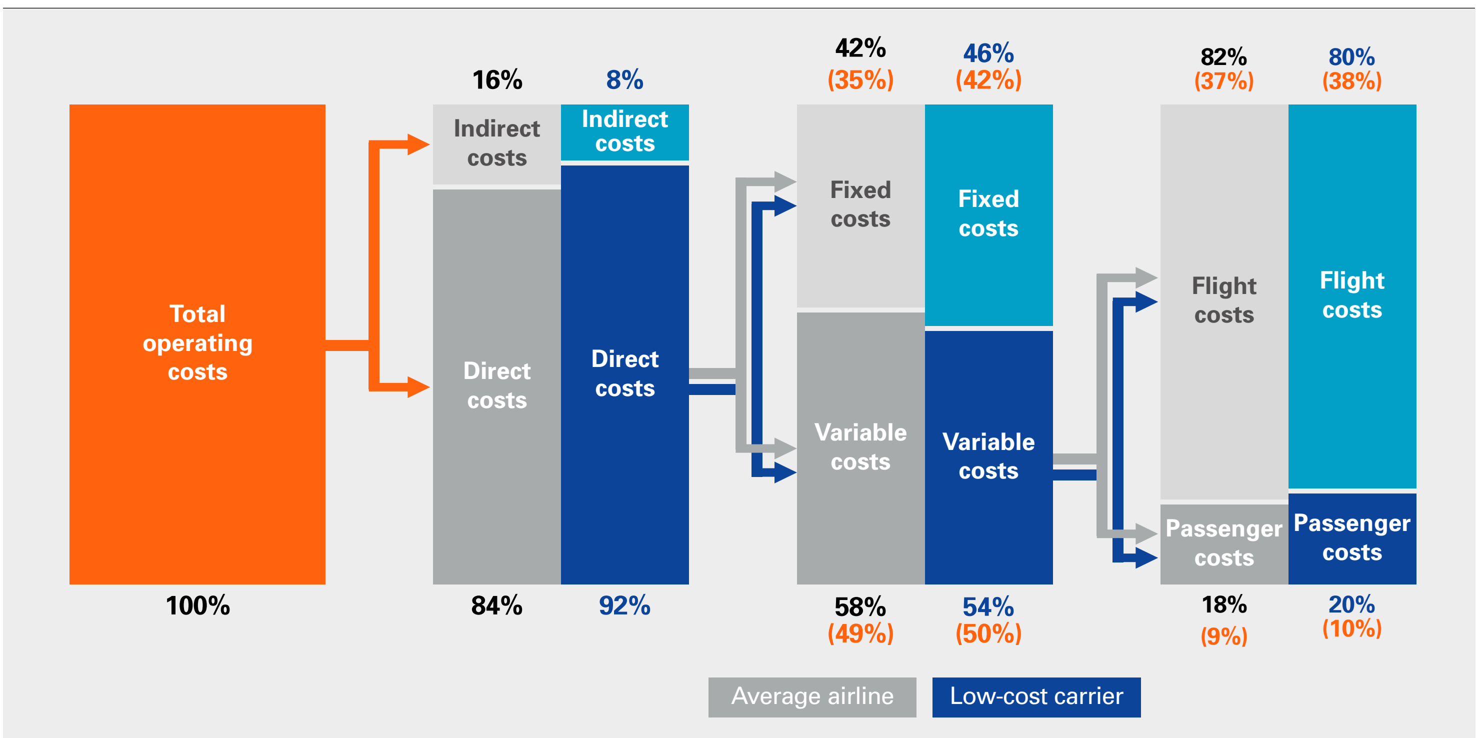
Airlines generally fail because of a lack of cash, not because of a lack of profitability. Airlines can operate for years with losses without ceasing operation. It is only when cash reserves become insufficient that airlines are forced to cut back operations. When this occurs, the airline will shrink rapidly and become very difficult to save. It is very difficult to "shrink" an airline to profitability. While airlines should be "right sized," the most effective turnarounds tend to grow the airlines instead of shrink them. While there will be tactical "retrenchments" on selected routes and in specific markets, successful turnarounds generally find other markets to profitably assign the carrier's assets. Airline managers have to implement the tactics of survival first and then ensure that the strategy of the airline promotes the long-term health and success of the airline. The tactics of survival have to be implemented quickly, indicating that the airline's management should implement the right practices that will enable it to survive.

Following the Money

Determining the best tactical approach to survival is addressed by "following the money." During the initial stages of the turnaround, the airline should take a careful assessment of its current procedures and practices. A standard four-part methodology helps perform this assessment:

1. Characteristic analysis — Specific characteristics of the airline and its performance, which is accomplished through the collection of financial and performance data as well as via direct interviews with its management and staff, need to be gathered.

Expenditure Breakdowns for Average Airline and Low-cost Carrier



Because nine-tenths of an airline's expenditures are not driven by passengers, operating costs would generally remain the same if passenger demand or yields dropped. While only averages, these values represent the general level to be expected at most airlines.

2. Comparison analysis — Results of the characteristic analysis are compared to industry data, previous performance, budgets, goals, standards and other items to identify the differences between the characteristics of the airline and realistic performance benchmarks.
3. Normative analysis — The characteristics and comparisons identified in the previous analyses are analyzed against a context of expected financial and operational impact on the airline. Those characteristics and comparisons that are uniquely identified and are not performing successfully are marked for examination.
4. Prescriptive analysis — All characteristics and comparisons that are identified as requiring change during the normative analysis are examined during this analysis. Specific "prescriptions" are identified for the changes that must occur to improve the performance of the airline.

The prescriptions are specific measures that need to be implemented to successfully produce the turnaround, and they provide a variety of information, including:

- The specific recommendation to be implemented,
- The length of time necessary to implement the recommendation,
- The expected financial impact associated with implementing the change, which should include expected capital costs, operating costs, revenue impact and profit shift associated with implementing the prescription.

"Following the money" is the process of implementing the prescriptions in the manner that will produce the largest financial benefits in the shortest possible time. The "timed benefits equals financial impact divided by length of time" formula is used to determine the order of implementing the prescriptions.

Timed benefits are calculated for all prescriptions and the prescriptions are sorted in the descending order to timed benefits. That is, the items with the largest financial impact in the shortest possible time will be implemented first, meaning that a prescription that may take a long time to implement but will have a very large financial benefit will be implemented with high priority.

During the implementation, there will be several important tasks identified that do not necessarily impact the performance of the airline quickly. For example, organization changes and realignment requirements are frequently identified during the turnaround assessment. The airline's management must resist implementing these with priority unless it is clear that implementation will have a positive financial impact in a short period of time. This requires discipline and a single-minded approach to the turnaround and tactical survival. This discipline must be implemented throughout all levels of stakeholders in the airline.

Communication Among Stakeholders

Rule No. 5 (Communicating with all stakeholders. Information should be free-flowing and disbursed to alleviate concerns and drive business culture changes.) is probably the most important rule.

All stakeholders of the airline will show anxiety related to the turnaround. First, the fact that the airline requires a turnaround leads to anxiety. Shareholders, management, employees and even passengers will know that an airline's financial performance is sufficiently degraded to require a turnaround. In publicly traded companies, shareholders nervously watch their holdings and look for opportunities to lower their risks wherever possible. Management should understand the position of the carrier and that key managers will leave for other positions, thus causing a "brain drain." Employees will lose morale and this will affect their ability to provide high-quality services, which will be clearly noted by passengers and other customers.

By starting a communications program early in the turnaround process, the airline will be able to eliminate some of the worst anxiety issues. The communication should detail as much of the turnaround plan as possible without detailing items that might impact competitiveness. For example, the airline can share that it will examine its revenue drivers, but not the exact way prices will be altered. Communication of competitive details of the turnaround plan in advance of implementation may provide a competitor with the ability to counteract the positive effects of implementing the plan. Nevertheless, many characteristics of the plan can be shared with stakeholders.

Communicating details of the airline turnaround to stakeholders has several important benefits, including:

- Reduces anxiety among shareholders, which tends to keep share values higher,
- Reduces anxiety among management, which should reduce "brain drain,"
- Improves employee morale, encouraging higher service levels,
- Maintains customer loyalty because of passenger confidence in the airline.

The benefits of communication tend to far outweigh the possibility of inadvertent dissemination of competitive information and, therefore, should be free flowing.

Profitability is not easy to produce at most airlines. If it came in a bottle, all airlines would be profitable. Therefore, airline turnarounds are the unfortunate result of a difficult industry where margins are tight and competition is aggressive. An airline turnaround can produce short-term profit shift and long-term stability. Sabre Airline Solutions has been successful at using the key rules of a successful turnaround to help airlines in many regions around the world. These simple rules can be used by diverse airlines to improve their success and profitability. a

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+count it up

25 — Age of the youngest female jet captain in the world. Capt. Linda Pauwels flew Boeing 707 aircraft for Southern Air Transport.

1986 — Year of the first husband/wife cockpit crew. Capt. Jim Price and First Officer Penny Price operated Boeing 727 aircraft for FedEx.