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## EXTREME AIRLINE MANAGEMENT

*A conversation with …*

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INSIDE

- Traditional carriers launch low-fare subsidiaries
- How airlines weathered "the perfect storm"
- Cathay Pacific Airways' crisis management process



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# Turnaround First, Then Privatize

*There are plenty of pitfalls for a state-owned airline preparing for privatization. But a comprehensive turnaround program can minimize the risk and prepare the carrier for the private sector.*

By Shane Batt | *Ascend* Contributor

Many countries that still own their national airlines are examining privatization. Most of these countries are considering such an extreme step because they are struggling economically, and a bloated national carrier makes a politically charged privatization target. Because national carriers are usually among a country's most prominent companies and often the only ones with an international presence, they are perceived to have a substantial value that can be leveraged by the governments to generate capital.

While airlines generate significant cash, they operate on very small margins and therefore frequently require capital injections from their owners to update assets and cover losses, which only serves to make them more attractive for privatization. Many countries must make the difficult decision to re-capitalize an ailing national carrier or to build hospitals, schools and roads. Therefore, many countries, particularly developing ones, are actively moving to privatize their national carriers.

Governments in Latin America and the Far East have led the way in privatizing their national carriers. For the remainder of the developing world, the government continues to own all or most of the national carriers and are actively examining privatization.

## The Strategic Investor

Many of these countries, however, rush into privatization without considering the best option. The quickest model for privatization is through a "strategic investor" where a country sells a majority portion of its national carrier to a "white knight" private carrier with a good reputation. The idea is that the government will receive a large payoff,

"Many countries must make the difficult decision to re-capitalize an ailing national carrier or to build hospitals, schools and roads."

and the private carrier's culture will rub off on the national carrier, improving the country's transportation infrastructure. The country loses a national carrier but gains much needed capital and obtains a better airline for its citizens.

Both Belgium and Portugal used this model when they sold their national carriers to a strategic partner, Swissair. Similarly, Air Afrique sold a portion of its airline to Air France to raise capital. The strategic investor theory sounds good on paper, but the reality often is much different. The list of failures using this approach is much greater than the list of successes. Some carriers have received the expected benefits from this model: Air Lanka under the partial ownership of Emirates Airlines and the "Lan" carriers, including LanEcuador, LanPeru and LanDominicana, under LanChile.

Unfortunately, few airlines as successful as Emirates and LanChile are actively acquiring interests in national carriers. Most strategic investors today are interested only in acquiring a national carrier's assets at very low rates and without substantial conditions.

The strategic investor model offers some unanticipated pitfalls. The white knights can be corporate raiders – airlines wishing to expand in a cost-effective manner by acquiring less stable competitors to strip them of their primary assets and routes, relegating them to colonial feeder status. When a strategic investor talks about "schedule and product alignment," it often plans to relegate the national carrier to second-tier status.

One of the primary benefits of owning an airline is that it generates a substantial amount of cash – often foreign currency. Countries should consider the effect on their own economies when the bulk of the foreign currency generated by their national carrier is channeled through the country of the strategic investor. The loss of foreign exchange can result from schedule and product alignment because, almost invariably,

**A carrier with US$500 Million in annual revenues can reap more than US$164 Million in revenue benefits within two-and-a-half years by employing the turnaround model.**

the "hub" point for the two carriers will be in the strategic investor's home country. At the very least, the strategic investor will insist that the national carrier use competitive business practices, eliminating the various "socio-economic routes" and "foreign policy routes" the national carrier operates.

Another pitfall comes from the decimation of the former national carrier's large employee base to reduce costs, thus reducing tax revenues and increasing the need for social services. Finally, protective fares and scheduling practices will be eliminated. The strategic investor will insist that fares obey market forces, which means that routes protected from fare increases may become much more expensive for passengers.

A likely result of strategic investor privatization is making air travel more elite and reducing the transportation infrastructure, which can cause severe political problems in developing countries.

## Widely Held Ownership

In a second privatization method – the "widely held ownership" model – the government offers shares of the national airline on the open market while restricting individual ownership to ensure government control is maintained. This model, on the surface, appears to resolve many of the issues associated with a strategic investor. Through widely held ownership, the government maintains the controlling stake in the carrier and can ensure that it maintains control over finances, flight scheduling, employment and fares. Many governments have passed legislation to limit foreign ownership. But the widely held ownership model also has pitfalls.

The main problem with widely held ownership is that governments sell their stake in their national carriers for well under their true market value. Governments often give away the

national carrier to a wide base of investors without gaining substantial returns for the remainder of their citizens who are not shareholders. Governments don't privatize their national carriers because they are well-run, highly profitable entities. Except in regions such as the European Union, where legislation requires privatizing national carriers, most countries privatize because their national carriers are bloated and inefficient. Since these carriers are generally unprofitable, the share price of stock will be lower than its potential market value. The minority investor buys shares for income or for growth, neither of which are high with national carriers. So, demand for shares stays low, the price stays low and majority ownership shifts from the government to investors at very low prices. Of course, using widely held ownership reduces the government's responsibilities for future equity injections, but the former national carrier still has the same problems it did prior to privatization. In a few years (or even a few months) following privatization, the new owners start looking to raise much-needed capital and soon turn to a strategic investor or ask for a government investment.

By using the widely held ownership model, the government can inadvertently promote the excesses of a strategic investor without reaping the significant capital advantages.

It may appear that privatization is doomed; however, it's an important step needed for most of today's national carriers to survive in the highly competitive international marketplace. Privatization must protect the national interests of the country as well as develop strong competitors. The best way to privatize is through the "turnaround" model.

### Turnaround

The turnaround model prepares the national carrier for privatization by making it profitable and competitive. Carriers that have sustainable profitability can fund their own capital requirements, enabling them to use widely held ownership or a strategic investor without governments giving away ownership at bargain prices. The turnaround model improves the national carrier at all levels to ensure it is competitive and profitable before privatization occurs. By demonstrating sustainable profitability, the carrier ensures that there is no urgency associated with privatization, and therefore it can take place in a controlled manner.

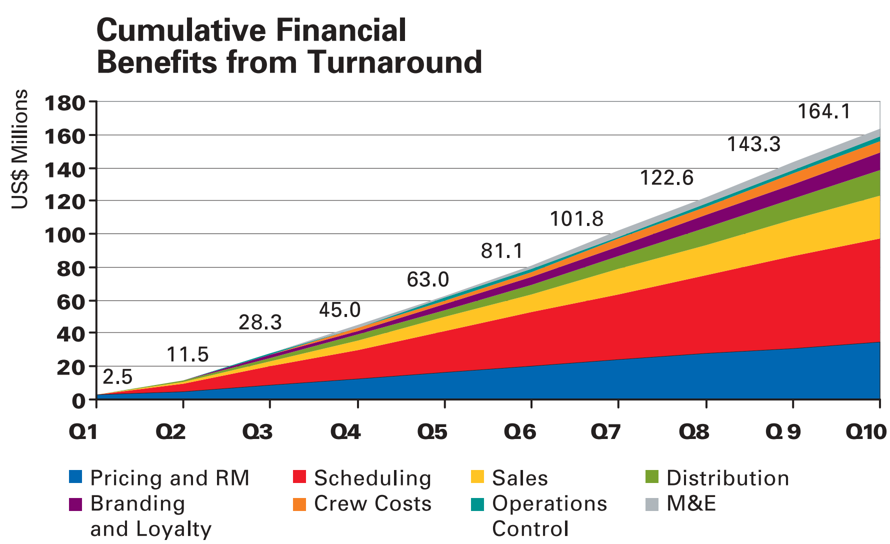
A strategic investor is kept in line because the rising share price of the profitable national carrier discourages its dismantling. Similarly, widely held ownership is strengthened because minority investors are attracted to the growth of the national carrier's share price, which will continue to grow: a form of self-fulfilling prophecy. Most importantly, as a result of the turnaround, the national carrier is strong enough to operate without governmental assistance, the transportation infrastructure of the country is maintained and assured, and the benefits of nationalized ownership, such as socio-economic routes, lower fares and currency benefits, remain intact.

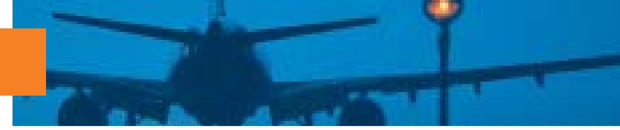
### Implementing the Turnaround Model

In principle, it is not difficult to use the turnaround model. The national carrier, with the help of its government, proceeds through a steady process of rapid improvement to position itself for a strong privatization push. The turnaround begins by improving the national carrier's financial position. Once the financial position of the national carrier has improved, its surplus funds are invested in three primary areas: operating assets, provision of service and personnel.

Once the financial position has improved, governmental support is required. In most cases, when the finan-

**By making improvements throughout its operations, a US$1 billion airline with 70 aircraft serving domestic and international routes can achieve cumulative financial benefits in excess of US$164 million by the end of the two-and-a-half year turnaround process.**



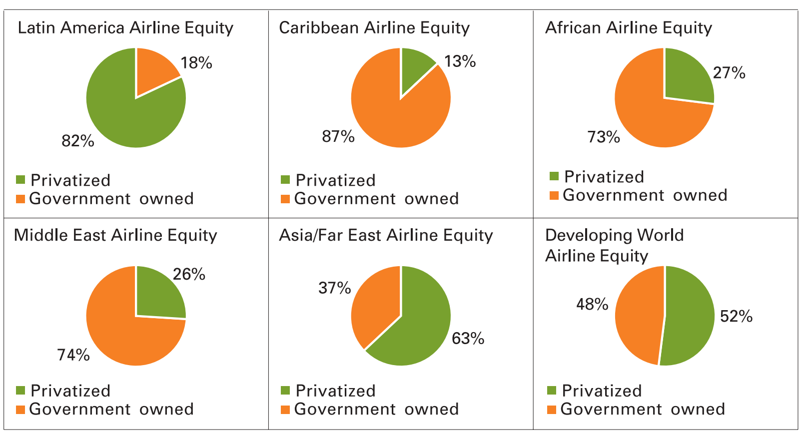


cial position of the national carrier improves, two pressures arise. First, government sources pressure the national carrier to take actions that are counter-productive to its future success. The national carrier, for example, will be instructed to increase employment, increase services on socio-economic routes or give employees raises, which will make the government popular but will seriously impact the long-term viability of the national carrier. Second, factions will argue whether the government should immediately liquidate the national carrier or end privatization discussions. When the financial position of the carrier has improved, the government must demonstrate its support for continuing the turnaround process by providing the national carrier with sufficient breathing room to ensure its own long-term survival.

The "hands-off" approach, however, often proves impossible for the national government to implement. If the carrier's turnaround is cut short before the assets, services and personnel have been upgraded, the carrier's long-term viability will still be in question. For the turnaround model to succeed, the national government must show enough patience to allow the carrier to proceed through financial improvement; asset upgrade, service improvement and personnel upgrade. Once the turnaround has been accomplished, the government will have a strong and valuable asset to privatize.

**Throughout the developing world, nearly half of the airline equity is government owned, and in some regions, such as Africa, the Caribbean and the Middle East, there's tremendous opportunity for privatization.**

### Equity Split in the Developing World




US$50.1 Billion in Airline Equity

## Improving Financial Position

On the surface, improving a carrier's finances appears to be the hardest task. In practice, however, the true challenge is staying on course after the carrier's financial position has improved. Improving the financial position of the national carrier first requires concentration on revenue production. Any financial problem can be solved by increasing revenues, as long as revenue production outpaces cost increases. Therefore, the turnaround process should concentrate first on revenue production.

Revenue is much easier to increase than costs are to decrease. Because an airline's five highest costs are labor, fuel, maintenance, aircraft ownership/lease and customer service, these areas would have to be targeted to achieve substantial and quick cost savings. National carriers, however, cannot easily reduce any of these areas.

Reducing labor costs adversely impacts employees. Because they are typically government employees, national governments are hesitant to reduce their pay. Reducing fuel by more than a few percent usually requires decreased flying, which results in lower revenues. Maintenance costs generally cannot be reduced by double-digit levels without fleet renewal, and national carriers generally do not have sufficient funds or capital to renew their fleets quickly. Aircraft ownership/leases can only be reduced by paying off loans or renegotiating leases. Most national airlines lack resources to pay off loans, and leasers are becoming less receptive to negotiating reduced lease rates. And customer service reductions tend to reduce revenues, which should be protected if the airline is to turnaround properly.

Airlines, therefore, should focus on containing the growth of costs while increasing revenues. Most carriers can contain costs if they concentrate on their indirect fixed costs and lower the growth of their direct operating costs.

Revenue production can be increased for most national carriers by focusing on all factors that influence revenues. Frequently, carriers assign revenue-influencing factors to a variety of different middle managers who do not cooperate extensively. The lack of cooperation impacts the carrier's competitiveness in hidden but significant ways. The



primary factors influencing revenue include pricing, inventory control, flight scheduling, sales, distribution, branding and loyalty, advertising and promotion, and public relations. By using the latest marketing techniques to tie these revenue-influencing factors together, the national carrier will undoubtedly increase revenue, more than offsetting the slightly increased costs.

Without impacting the operational integrity of the carrier, cost containment should begin in key areas such as crew planning and scheduling, fuel purchasing and consumption, flight planning, budget control, capital expenditure control, and maintenance. Cost containment should be geared toward reducing expenditures where possible as long as dependability and service standards are not lowered. Throughout this period, it will be important to watch cash management. Carriers with limited financial resources must ensure that their cash reserves are sufficient to cover the increased operating costs that result from growing revenues. By containing costs and increasing revenues, however, the financial position of the carrier should improve noticeably within a period of less than six months.

## Typical Approach to Financial Improvement

Implementing a turnaround involves six main steps:

1. Initial assessment — A commercial, financial and operational evaluation of the airline identifies major issues and assesses and evaluates the corresponding impact and potential for improvement,

2. Quick hits — Identification of issues that are relatively easy and quick to resolve and have a substantial impact on an airline's performance,

3. Process improvement — Aligning business processes, performance measurements and decision-support tools with the corporate strategy,

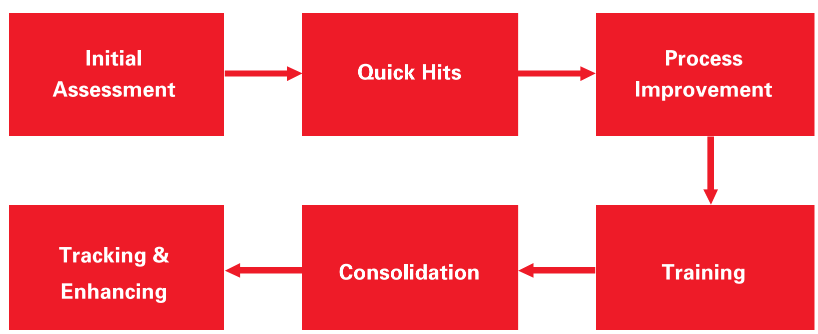
4. Training — Instructing staff on new, improved business processes and practices,

5. Consolidation — Implementation and consolidation of new business processes within the airline environment and culture,

6. Tracking and enhancing — Monitoring airline and process performance and enhancing as necessary.

The largest value derives from the process improvement phase, but the financial benefits begin during the quick hits phase. Revenue increases drive the most benefits during the quick hits period, but cost containment is important because it allows profits to increase at a faster rate.

**The turnaround process involves six main steps that flow seamlessly from one to another. The largest value derives from the process improvement phase, but the financial benefits begin during the quick hits phase.**

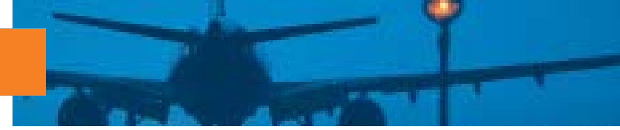



## Applying Improvements

Using the turnaround model, the national carrier can generate substantial improvements in its financial position within one financial year. Taking short-term gains, however, should be resisted until the turnaround process is complete. During the first 30 months of a turnaround implementation, the airline should increase annual revenues by at least 8 percent, producing a substantial war chest of capital for the airline's long-term improvement. The complete turnaround process, however, involves improvement of assets, service and personnel.

Improving the assets of the carrier involves renewing some or all of its primary operating resources including aircraft, facilities and technology. By operating newer aircraft, the national carrier can reduce its operating costs, improve its image and marketability, and provide a higher level of service to its passengers. Renewal doesn't require purchasing aircraft. Operating and financial leasing are viable options for the national carrier turning around its operations. Facilities – particularly customer service areas, but also offices, maintenance and outstation facilities – must also be kept up-to-date so that no substantial capital resources are needed for at least five years following privatization.

Finally, technology must be kept current because airlines today require the assistance of computerized systems. Core systems such as reservations, departure control, flight operations, and maintenance and engineering systems must be modernized and deployed properly to allow for significant expansion as the carrier prospers. Business systems are



just as important as the core foundation systems, and the national carrier should ensure that it has a reasonable strength in decision-support systems including revenue management, flight scheduling and crew planning. Asset renewal is expensive, but it will ensure that the carrier has a sound infrastructure for privatization.

Along with asset renewal, the national carrier must improve its customer service to meet international standards. Many national carriers offer excellent service, but frequently, these carriers fall behind more aggressive competitors in areas such as in-flight entertainment, interior appointments, lounge facilities and catering quality. Passengers have come to expect a high level of service at a very low price. The move toward upgraded first and business classes on world-class carriers such as Singapore Airlines, Cathay Pacific Airways and British Airways show that international carriers must concentrate on passenger service and comfort. For those national carriers that offer less than competitive service today, money will also have to be spent on service training and staff renewal. Service upgrades, however, often result in higher customer satisfaction and ultimately higher revenues. But realizing returns on investment in service takes significant time. A lack of investment in service upgrades, though, will be detrimental to the long-term viability of a national carrier contemplating privatization.

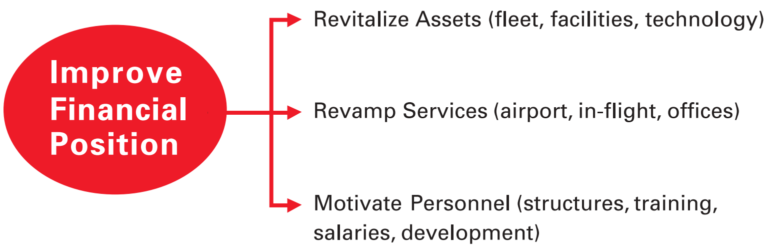
While upgrading other infrastructure, the carrier should ensure that its staff – which often expects the worst from privatization because of its perceived impact on job security and pay – is properly prepared for future privatization. Properly preparing staff members for the changes that will impact their jobs is necessary so that labor actions don't become the inevitable byproduct of privatization. Investment in training is the first major step. Professional training provides staff with viable skills that translate to job security. Operational and service-related staff require frequent training to ensure that their skills are maintained to appropriate international levels. In addition, professional training for business staff in analysis, sales, marketing, revenue management, flight scheduling and similar industry skills is a good investment in the carrier's future and its employees. Most importantly, management training should be provided at all levels to ensure a smooth management migration from a government-owned to a free-market carrier. In addition to training, merit-based promotion and placement should be implemented even if the carrier's government ownership rules must be changed. Merit-based promotion and placement ensures that the most qualified staff rise quickly thus invigorating the management of the carrier. Finally, along with the other personnel initiatives should be a complete examination and restructuring of staff compensation. The new pay scale should be consistent with market conditions in the country and with international standards. As the staff becomes more effectively skilled, its value in the international marketplace increases, and the national carrier will need to adjust compensation to ensure the staff will remain throughout the privatization process.

The complete turnaround process requires less than two-and-a-half years – one for financial improvements and 12 to 18 months for infrastructure improvements. During the final six months of the turnaround, the government can proceed with steps necessary to privatize the carrier.

While the turnaround model requires more time to implement than the strategic investor or widely held ownership models, the outcome of privatization should be much more stable. The consulting group at Sabre Airline Solutions specializes in helping airlines turn around their operations to prepare for privatization, helping produce viable carriers that become sources of national pride – even if they are not owned by their national governments.

**Improving an airline's financial status involves a three-pronged attack, which will help prepare the airline to set the stage for successful privatization.**

## Turnaround Model Implementation

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