

PRESENTATION AT SIB-CONFERENCE IN BREMEN

Building Blocks of future Business Models

Refocusing Airline Strategy

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Agenda

- ▶ Anatomy of the Aviation Crisis
- ▶ Current Airline Strategy Paradigm
- ▶ Building Blocks of Advanced Business Models
- ▶ Potential Conclusions

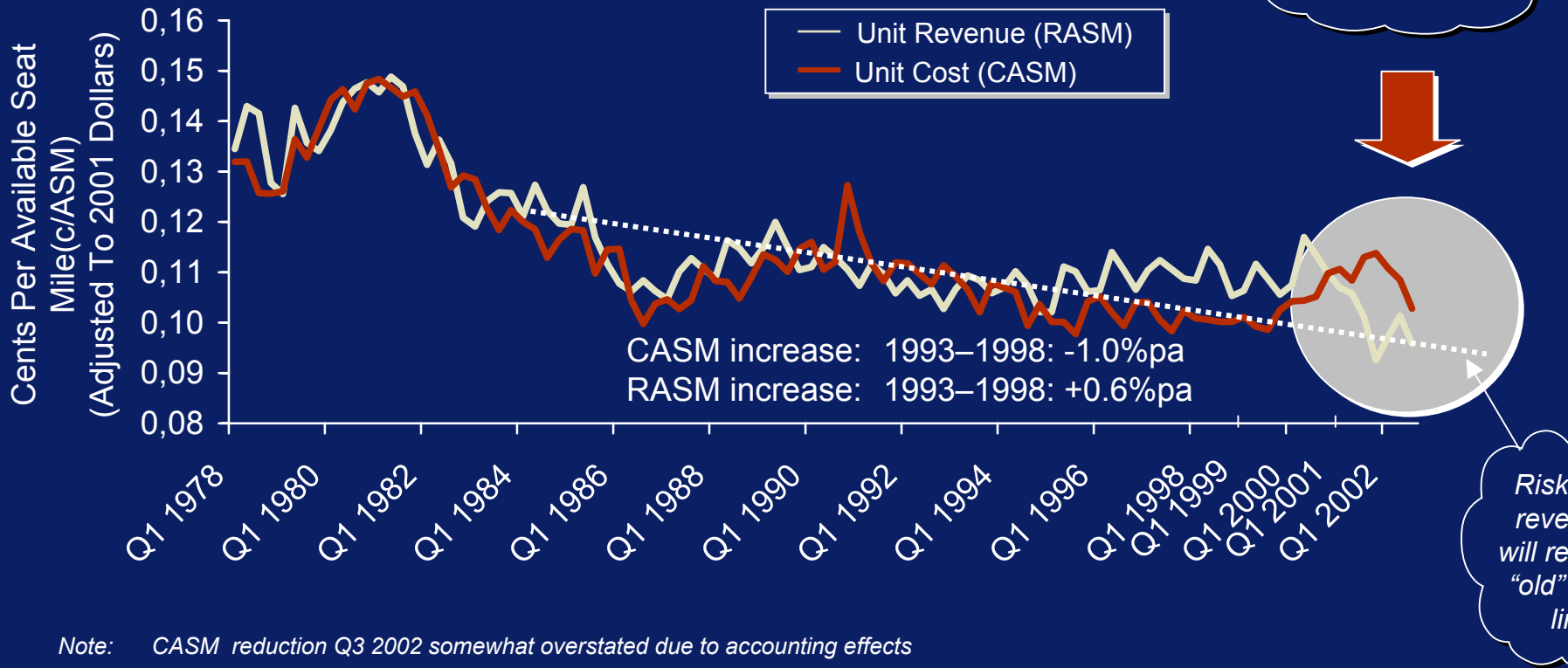
Anatomy of the Aviation Crisis

Initial situation: massive threat to the position of established network carriers

- ▶ **Current crisis** in the worldwide airline industry massively **threatens position** of many airlines
- ▶ Crisis has **not** been **caused**, but **deepened** by **terrorist attacks** on September 11, 2001. Originally, the root cause was the **decline** of the historically unequalled **high yield level** in the late 90s and, in parallel, considerable **cost increase**
- ▶ For the “classic” network carriers, the critical situation has also **deteriorated** due to the current **boom** of **low cost carriers** (LCCs), the only players in the market to gain money despite the crisis
- ▶ LCCs capitalize on their **simple** and **efficient business model** and their extremely **lean cost structure** (up to 60% lower unit costs in comparison with network carriers)
- ▶ Wherever LCCs have entered the markets successfully, they gain considerable **market share**, stir **additional demand** and cause a **declining yield level**. In theory, LCCs can attack **70% of all domestic/ continental traffic markets**

This crisis is unprecedented – current price levels appear consistent with long term trends

Unit Revenue and Cost Trend (U.S. Industry)



Note: CASM reduction Q3 2002 somewhat overstated due to accounting effects

Source: Company Financial Statements, Back Associates, BAH Analysis

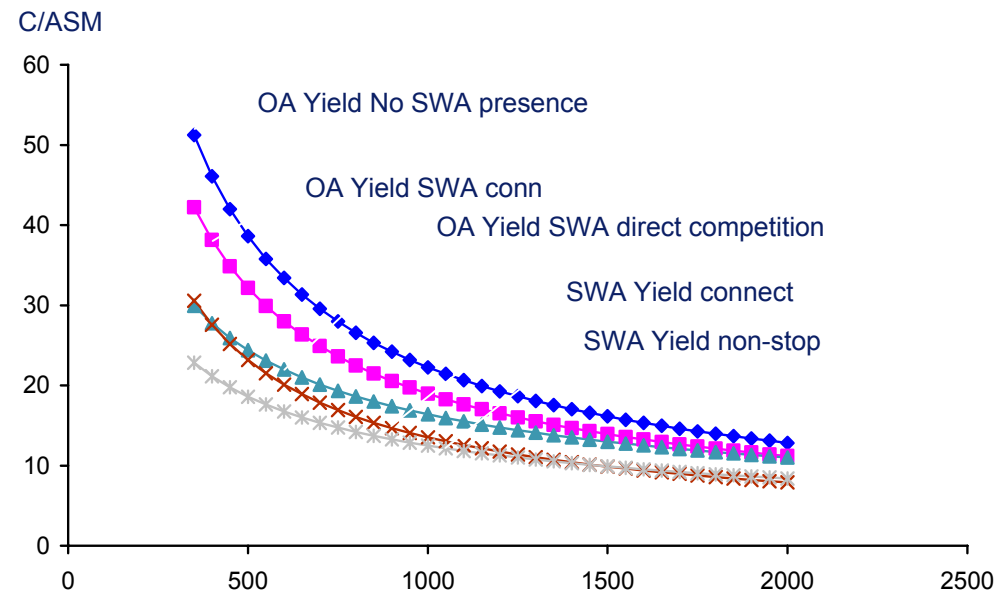
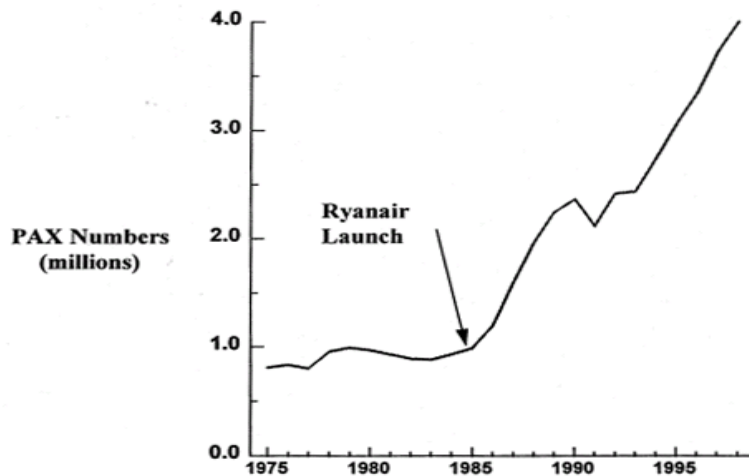
Demand stimulation through Low Cost Carriers is eaten up by yield decrease

Massive stimulation effect on demand through market entry of LCCs ...

... but accompanied by severe yield drop

Example: Demand growth LON-DUB 1975-2000

Durchschnittlicher Yield in U.S.-Hub-Märkten (Effect of „co-existence“ with Southwest Airlines)

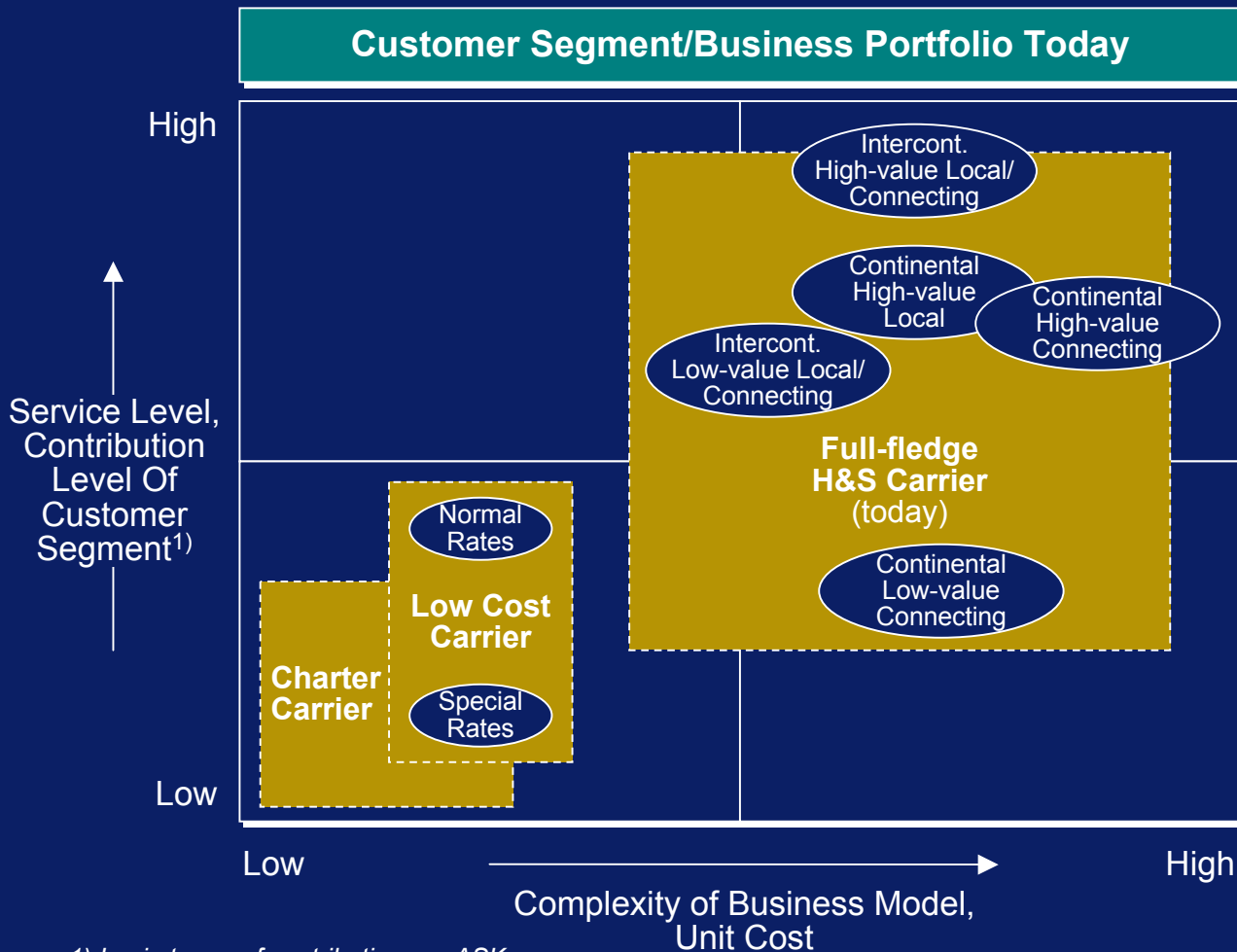


→ Passenger number quadrupled since market entry of Ryanair (but: yield has dropped to a fourth in the same period!)

→ Empirically observed yield decrease of 40% on average in the U.S.

Current Airline Strategy Paradigm

The hub & spoke business model is widespread and entails complexity without adequate differentiation

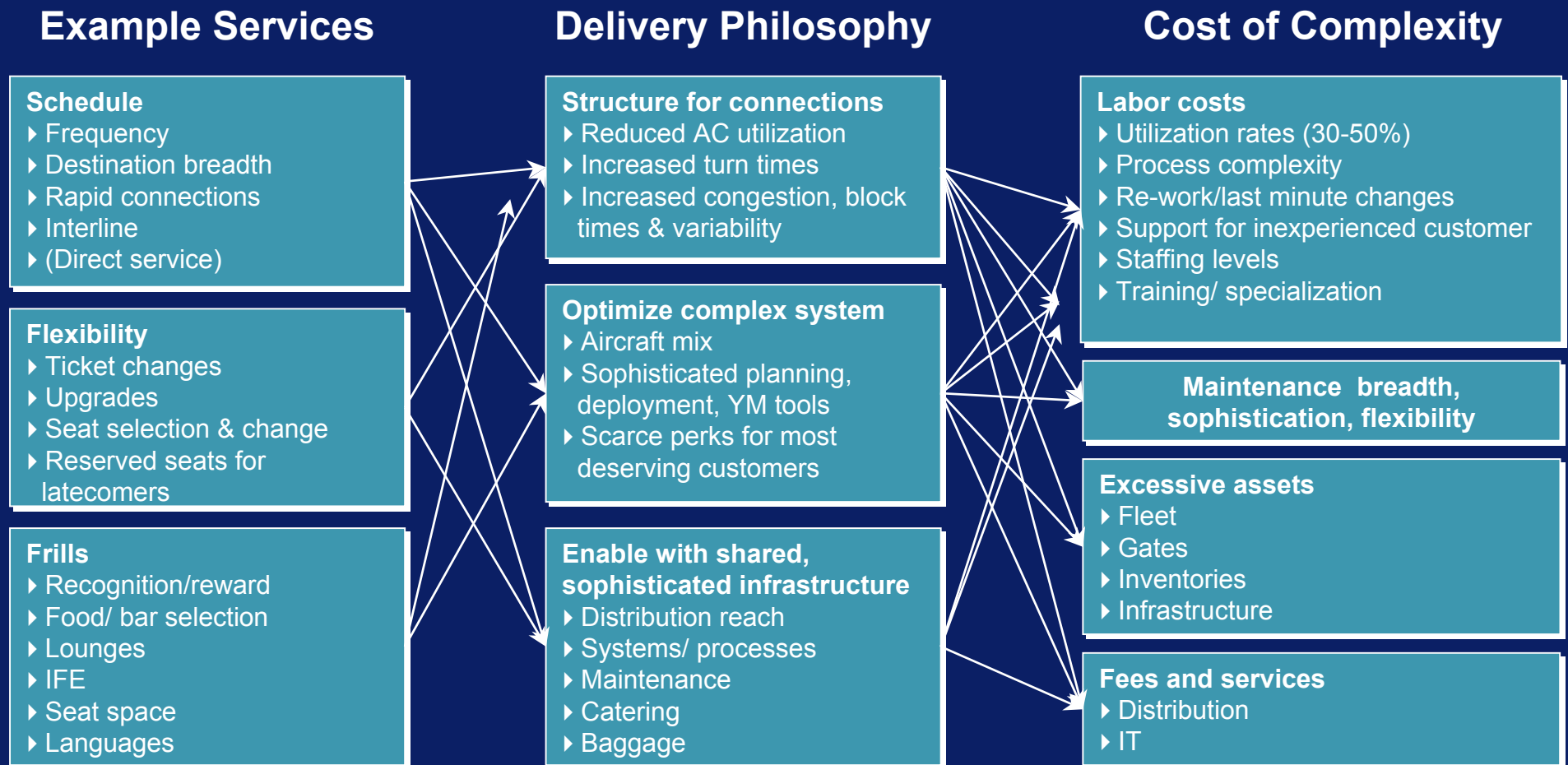


Implications

- ▶ Hub & Spoke carriers typically cover a widespread range of customer segments, service levels, and operational patterns
- ▶ Formerly, this approach ensured maximum revenue potential
- ▶ Complexity is not necessarily linked to yield level (not all extra processes are valued by the client)
- ▶ H&S carriers designed their complex hub structure around their least profitable clients (connecting passengers)
- ▶ Low Cost Carriers challenge this model by offering an alternative service at low complexity and low price

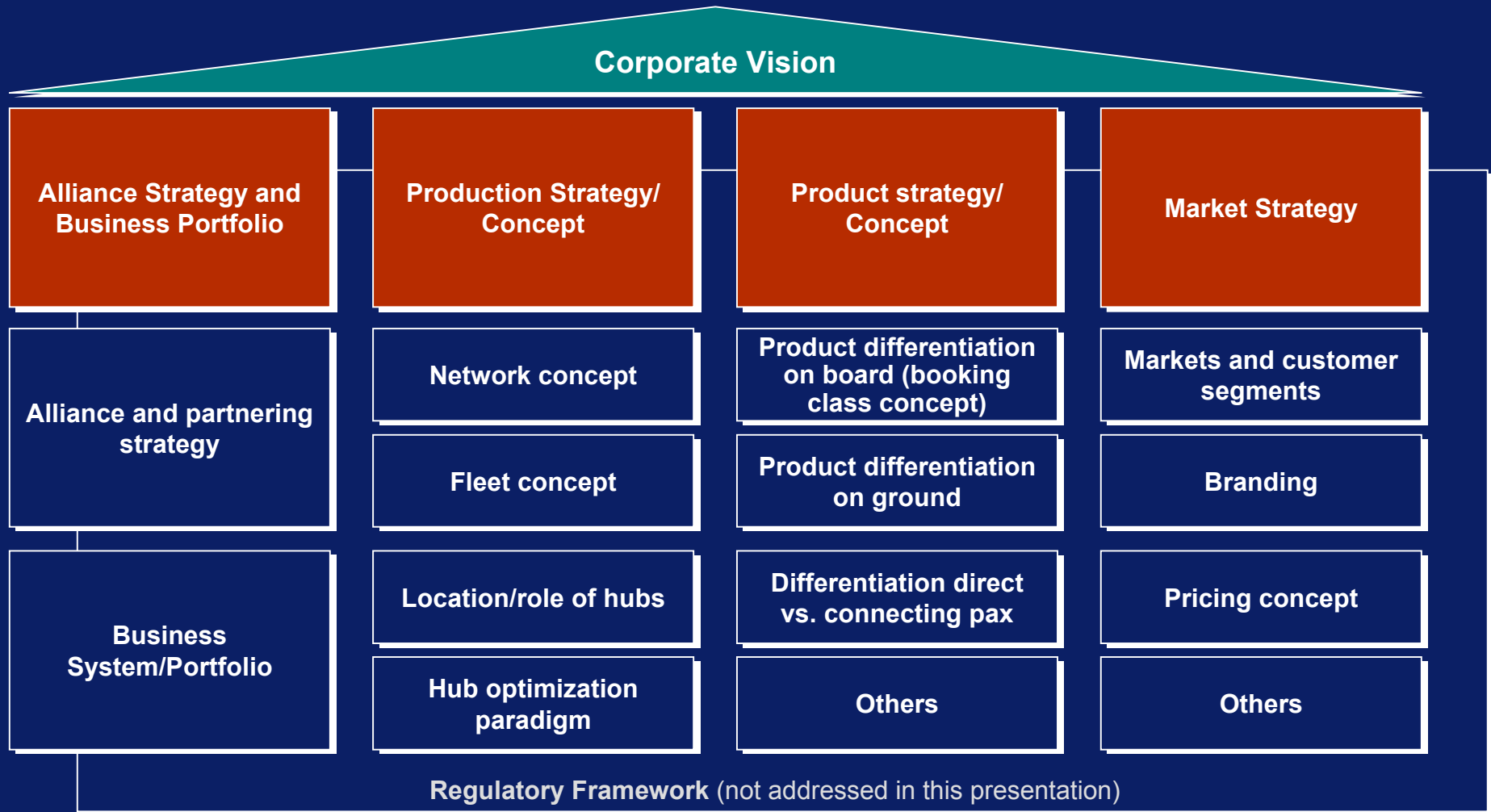
1) I.e. in terms of contribution per ASK

The current hub model creates a complex system, optimizing connectivity on the expense of productivity



Building Blocks of Advanced Business Models (Bottom-up; Focus on Europe)

Building blocks of airline strategy and business models

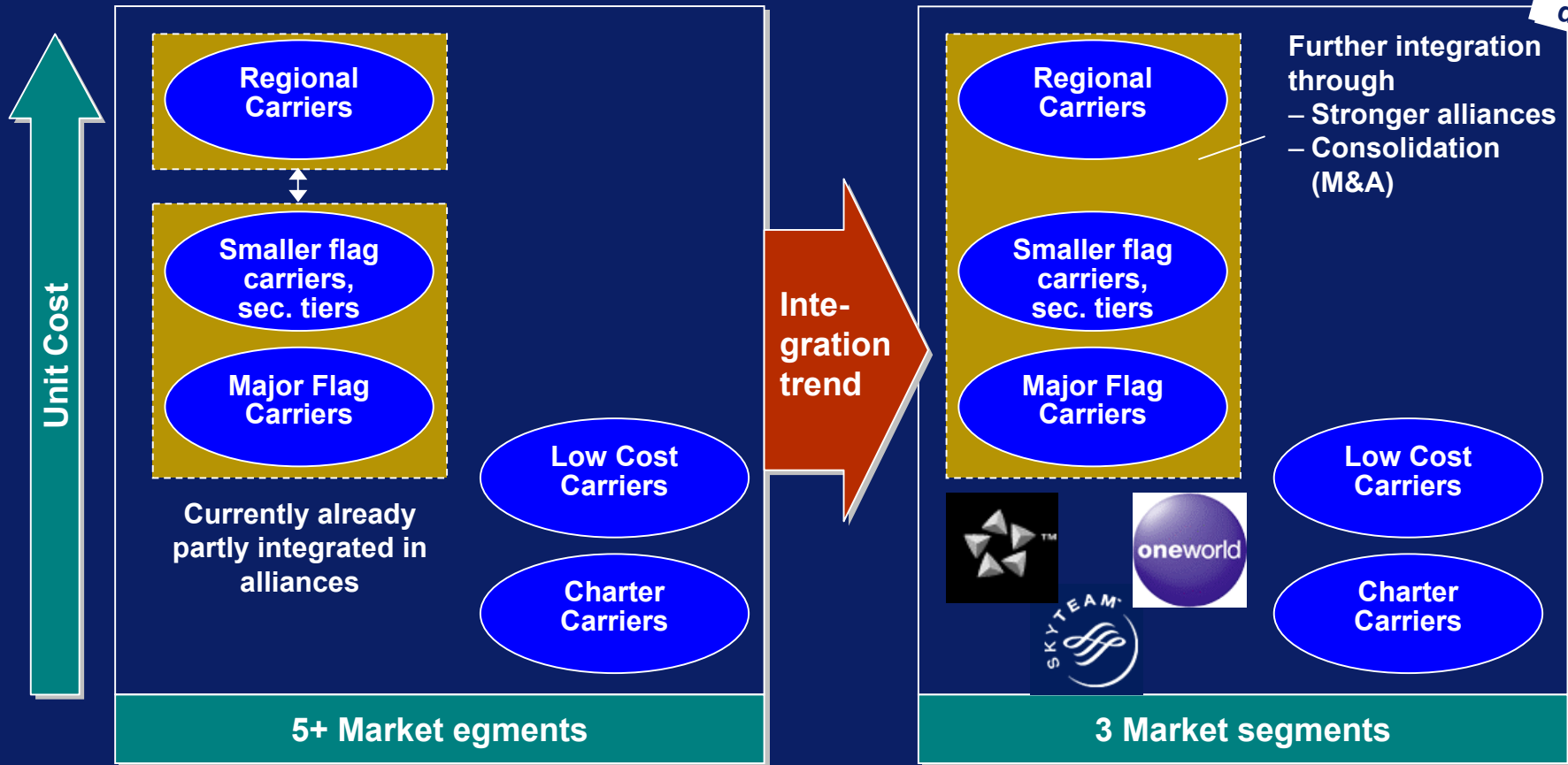




Market and cost pressure could result in further alliance integration and/or airline consolidation

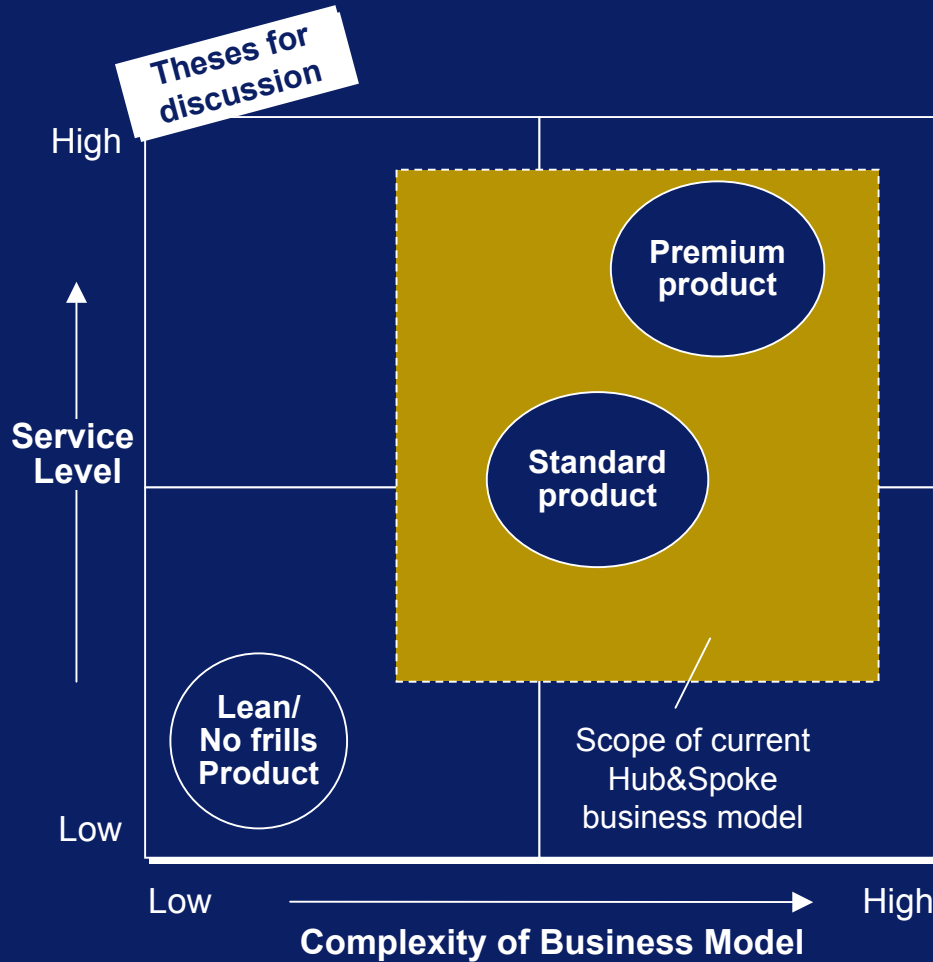
Current Market Segments (Europe)

Potential Future Market Segments





Coverage of attractive businesses achievable through portfolio approach or integrated system



Option1: Portfolio approach (separate production platforms/entities)

Premium Production Model



- ▶ Diversification through coverage of different business models

Standard Production Model



- ▶ Specialization through separation of platforms

Low Cost Production Model



Option2: Integrator approach (joint operations if suitable)

Standard | Premium



- ▶ Flexible response to varying demand through integrated platform

Lean | Standard | Premium



- ▶ Tailored Business Streams (TBS) must be applied to master increased complexity

Lean | Standard

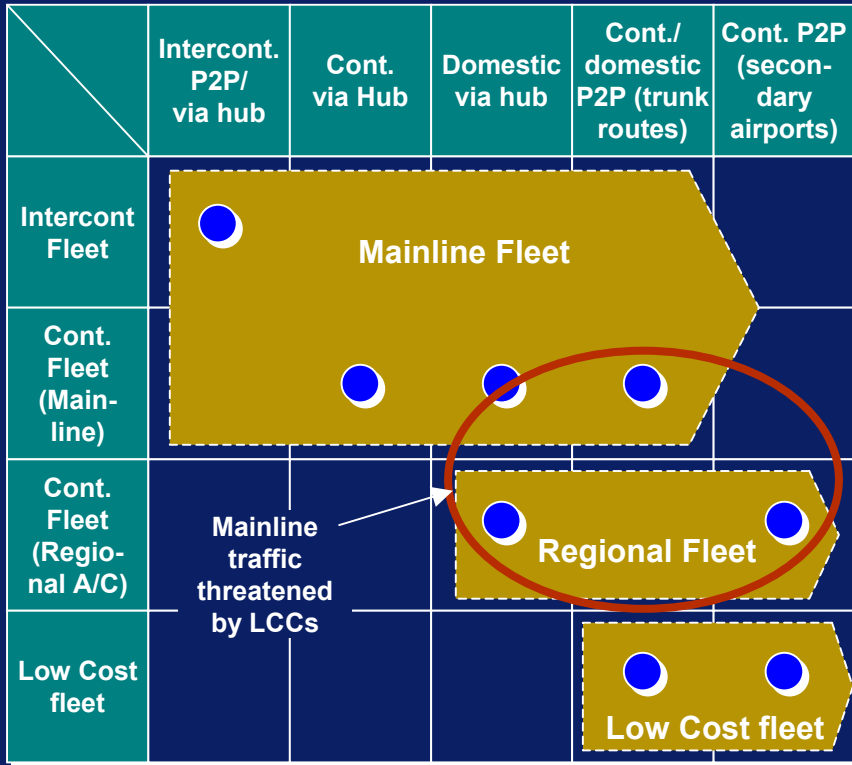


- ▶ Integration benefits must compensate for additional complexity costs



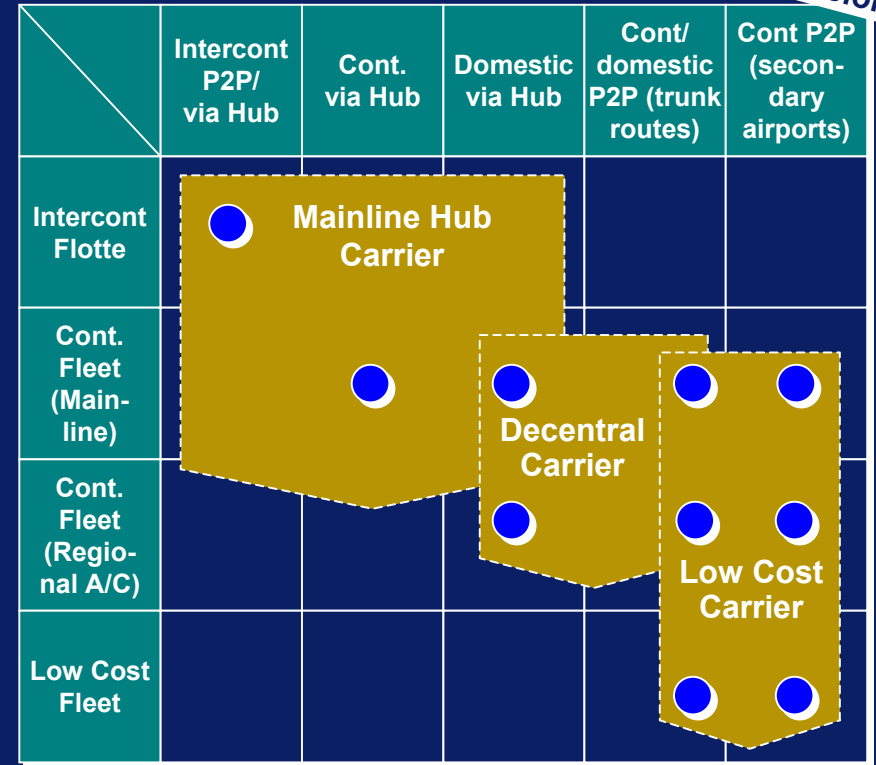
Fleet and Network Concept: Segmentation of traffic according to business model instead of fleet

Current Logic (example: portfolio approach)



Potential Future Logic

Theses for discussion



▶ Segmentation according to aircraft type and production platform

▶ Segmentation according to traffic profile and business model

P2P = Point to Point (direct service)



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Changes in traffic structure and carrier roles within alliances will reshuffle the hub landscape in Europe



Theses for discussion

Current Hub Landscape in Europe



- Variety of large, medium-sized, and small hubs with intercontinental traffic

Potential future Hub Landscape



- Consolidation/specialization of hubs due to crisis, increased direct service offerings, and adjusted hub roles within major alliances
- Mega hubs
- Regional/cont. hubs
- “Specialist” hubs with certain share of intercontinental traffic



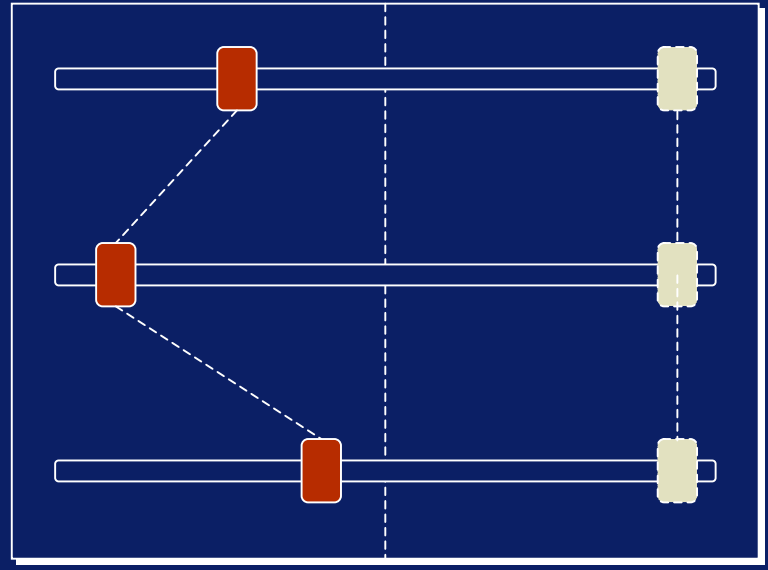
Hubbing paradigm: Network carriers have to re-evaluate trade-off between connectivity and productivity

Focus on Revenue Optimization
(→ Hub)

Focus on Cost minimization
(→ Hub)

Trade-Offs

- Hub Connectivity (→ ACT, MCT)
- Hub Connectivity (→ scheduled, ground time)
- Hub Connectivity (→ actual ground time)



- Airside Productivity (Aircraft, crew)
- Landside Productivity (ground handling)
- Stability (punctuality, few irregularities)

Network carriers maximize connectivity, but accept high cost penalty for scheduling constraints

Low cost carriers avoid dilemma by not offering (planned) connections

Note: ACT = Average Connecting Time; MCT = Minimum Connecting Time



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First experiences from AA's de-peaking exercise: productivity gains through block time reduction

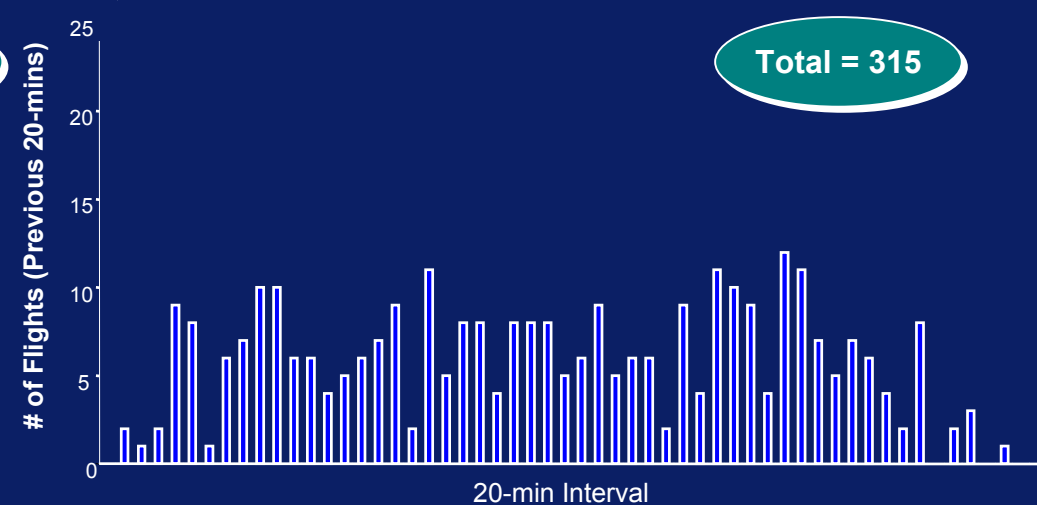
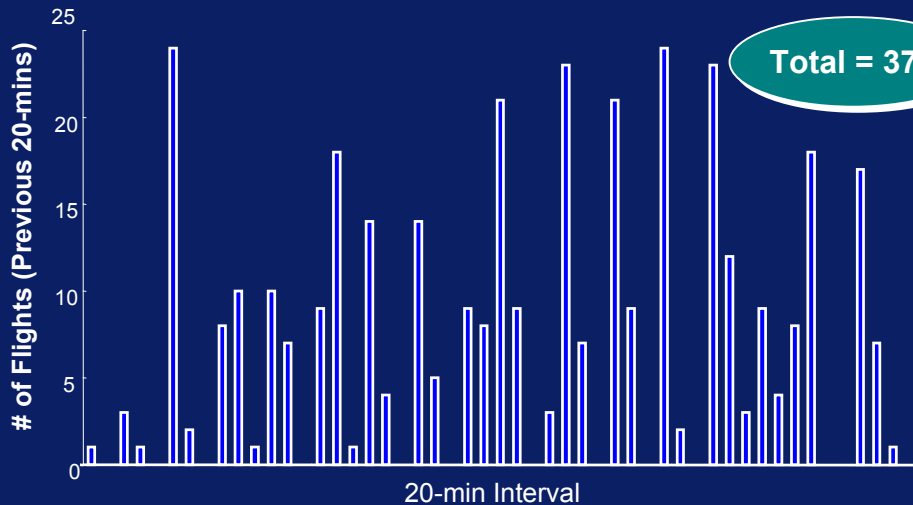


Example

Traditional hub pattern:
United Airlines departures
in ORD (per 20 min.)



Continuous hub pattern:
American Airlines departures
in ORD



First learnings from AA's de-hubbing strategy in ORD and DFW

- ▶ Start of new pattern as of April 2002 in ORD; as of November 2002 in DFW
- ▶ **First analyses indicate operational savings in ORD:**
 - 4 Gates less needed
 - Same schedule volume covered with 5 a/c less

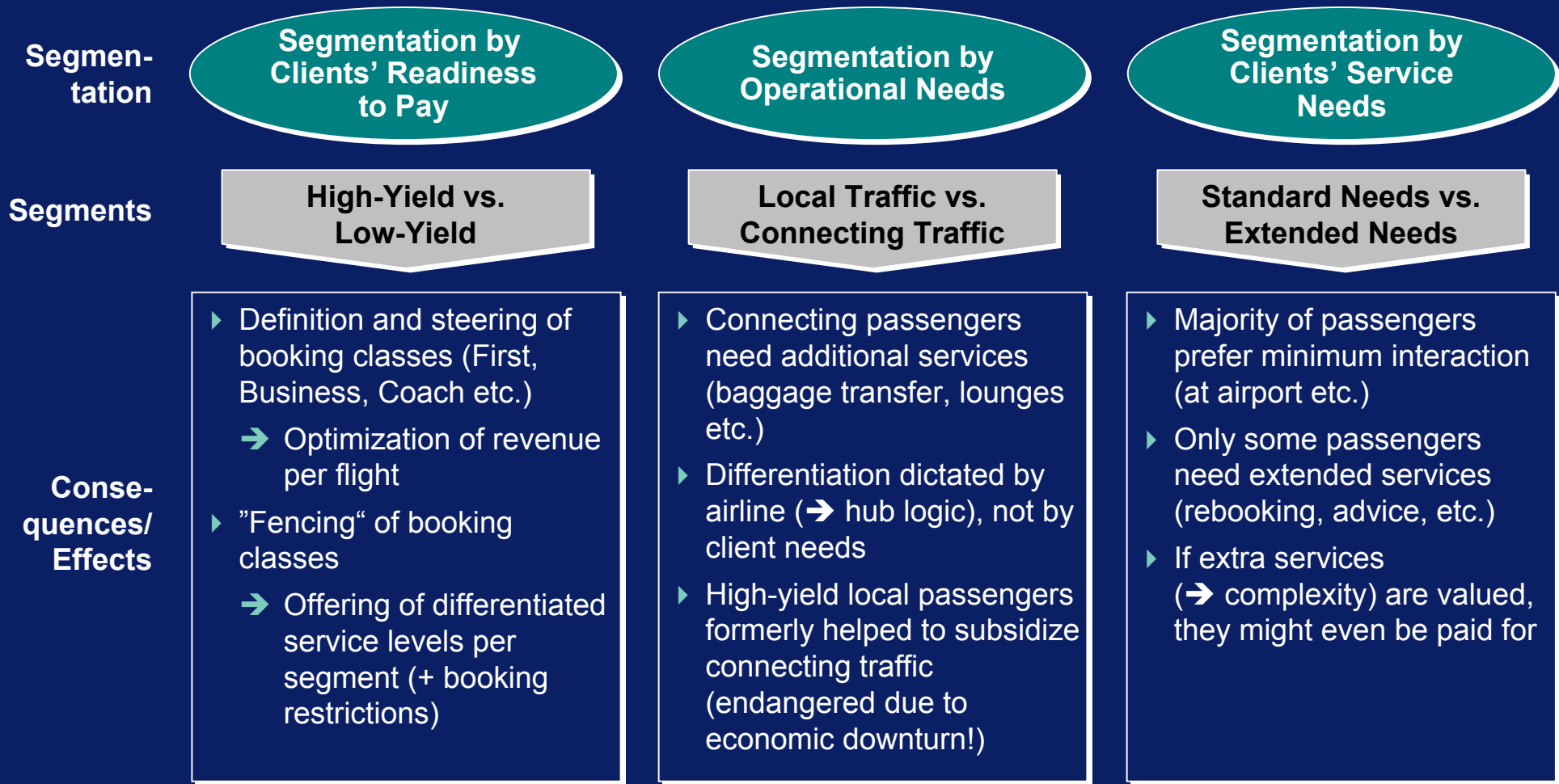


Improved utilization of assets!

(AA realized 10% increase of departures per A/C p.d. after de-peaking in ORD and DFW!)

Source: Published schedules, Booz Allen Analysis

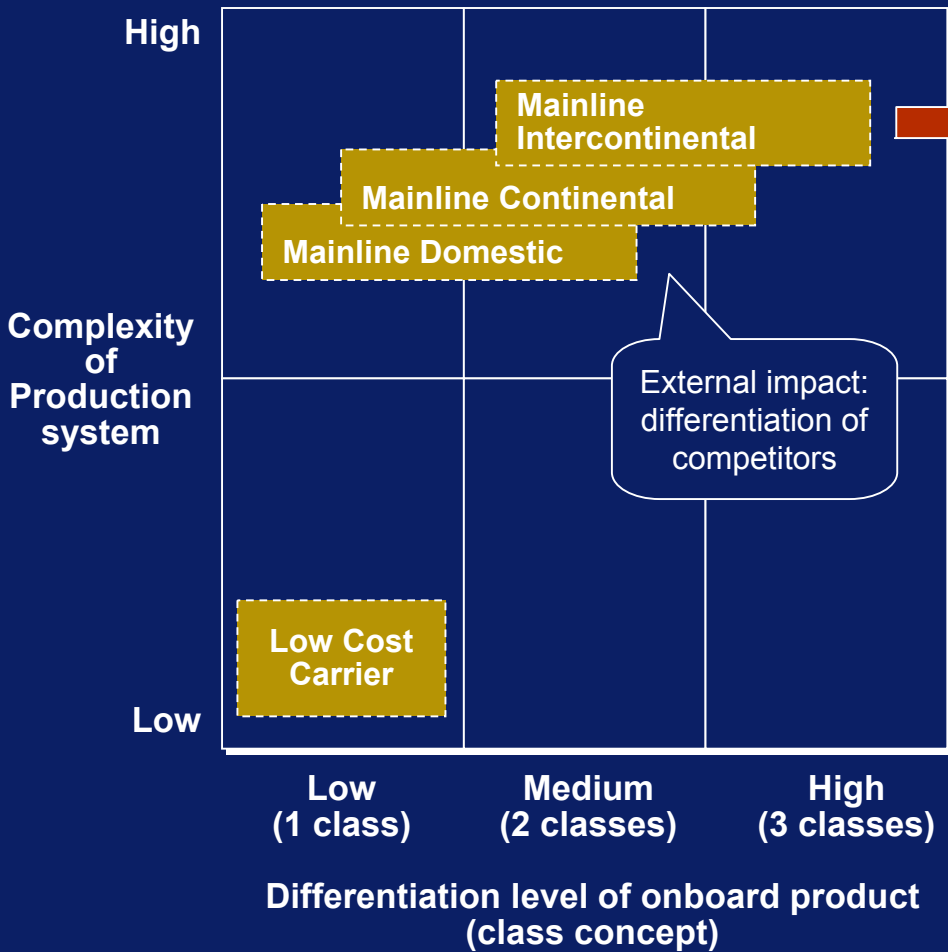
Customer and product segmentation: decide whom to serve and how to do it



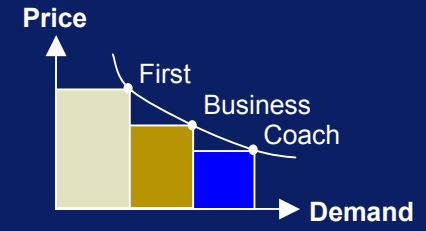
More intense on-board product differentiation is suitable in more complex production systems



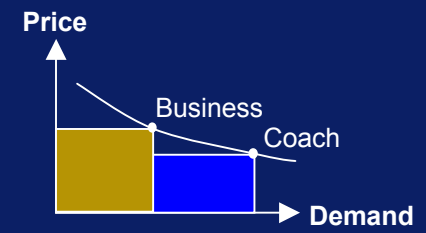
Theses for discussion



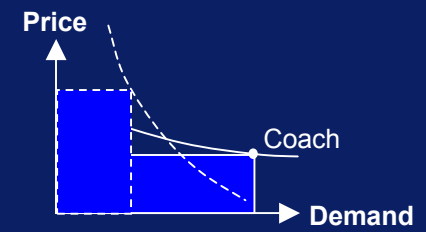
- 3-Class concept**
- ▶ Steep inclination of demand curve
 - ▶ Achievable product differentiation is high
 - ▶ Differentiation effort is covered by additional revenue



- 2-Class concept**
- ▶ Medium inclination of demand curve
 - ▶ Differentiation more difficult



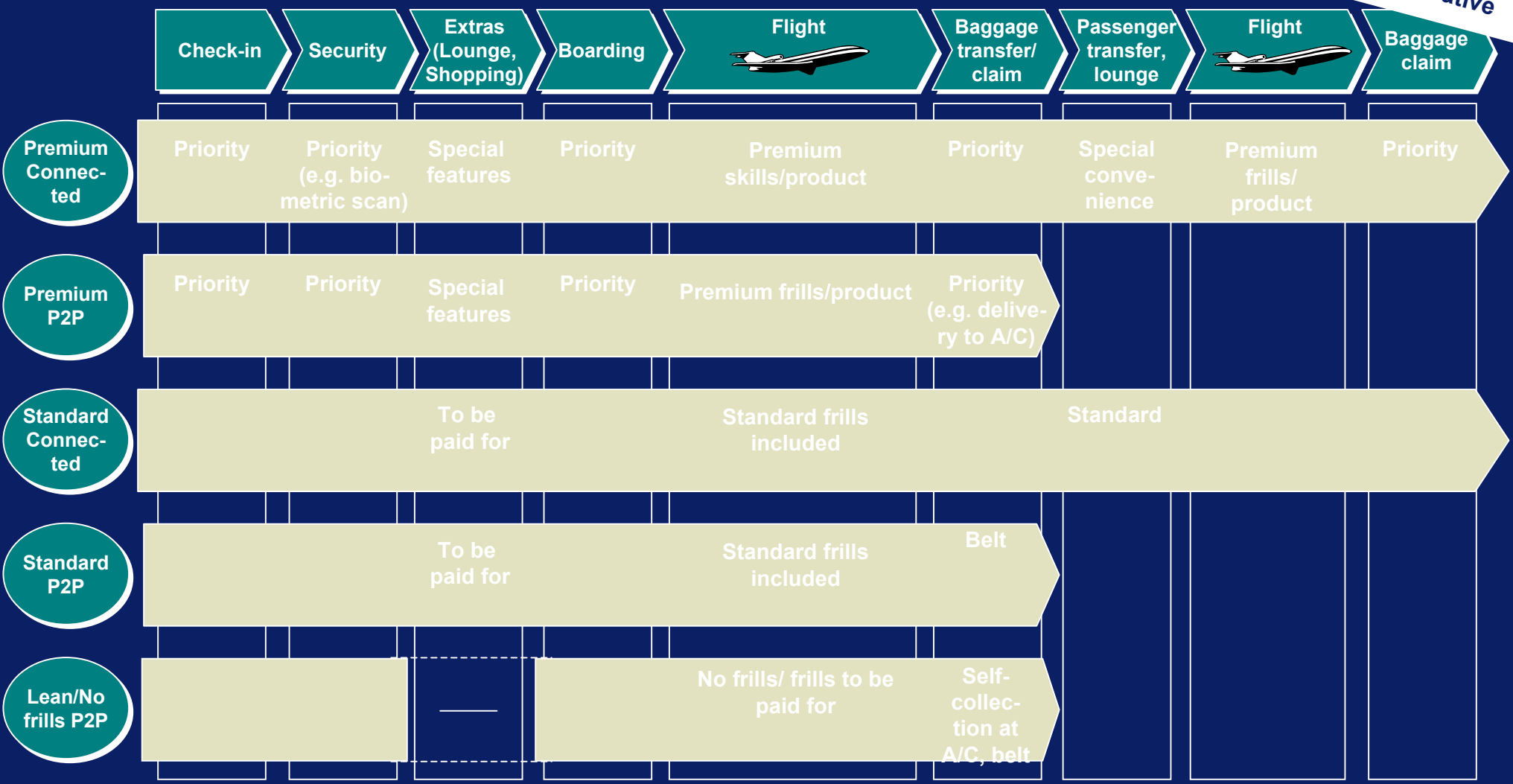
- Single-Class concept**
- ▶ Inclination of demand curve either very steep or rather flat (or combination of both)
 - ▶ Differentiation difficult, effort not covered by additional revenue



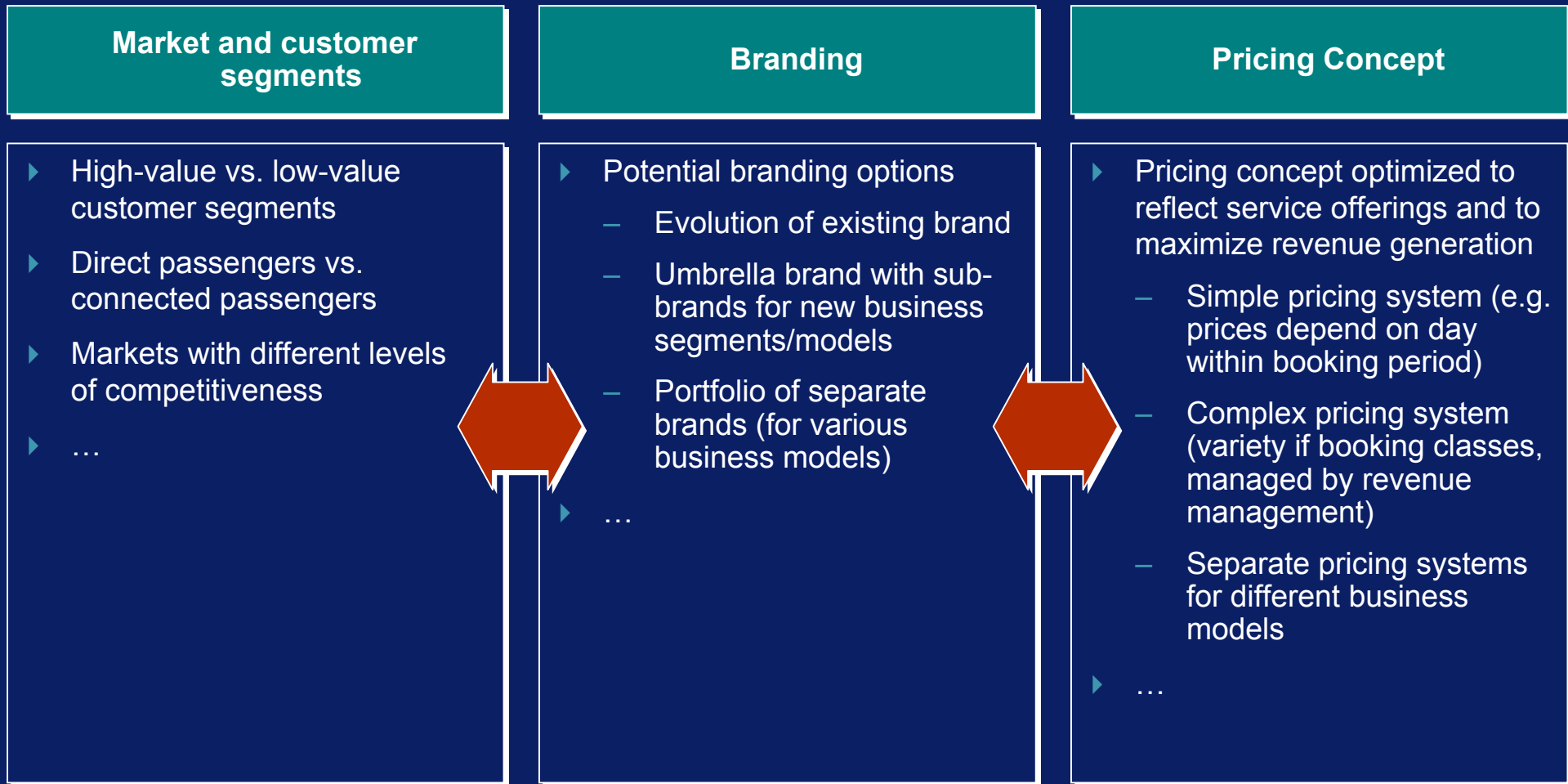
Product differentiation according to customer value, production model, and type of traffic



Illustrative



Customer segmentation, branding, and pricing are interlinked via business model and product concept



Potential Conclusions

A New Business Model for Network carriers should cover three major improvement levers

A

Restructure network/hub operations to remove scheduling constraints

- ▶ Apply random hubbing, improve asset productivity
- ▶ Reduce turnaround times and handling complexity
- ▶ Alter trade-off between efficient operation and optimum connectivity

B

Simplify customer interface at the airport and in distribution

- ▶ Separate simple from complicated tasks, industrialize simple tasks
- ▶ Reduce low-value interaction with airline staff
- ▶ Simplify reservation, ticketing, and check-in

Reduction of complexity, increase of pace

- ▶ Lower Cost
- ▶ Differentiated Services
- ▶ Viability



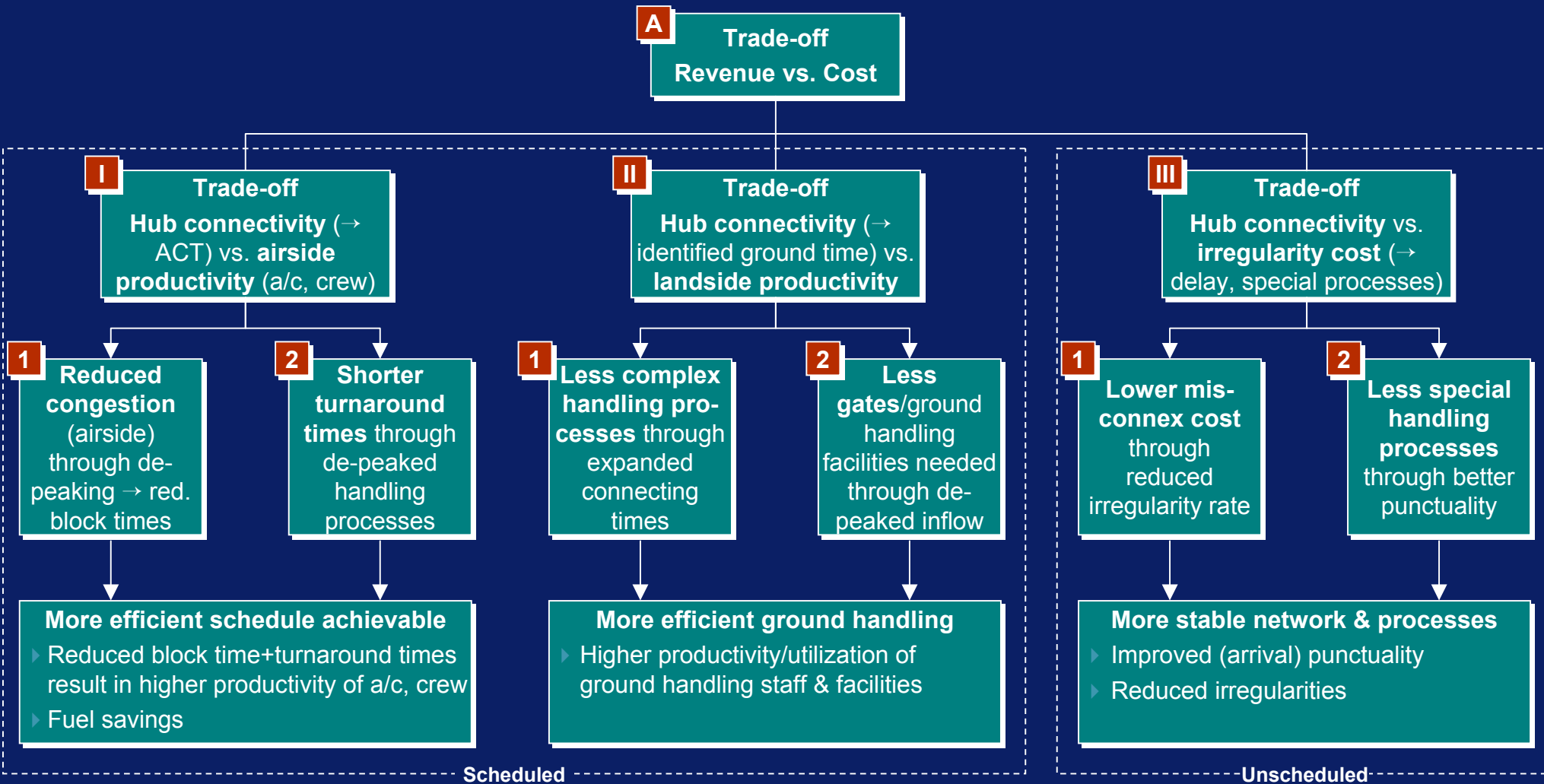
C

Create separate business systems for distinct customer segments

- ▶ High service level where needed, low cost level where possible
 - Local vs. connecting passengers
 - High-value vs. low-value passengers



Network carriers need to review three basic trade-offs in their hub and network logic



The final business model can be determined by choosing the relevant building blocks

ILLUSTRATIVE

