**Address to the Aviation Club at luncheon on Thursday 24 September from Peter Davies, CEO of the Airline Management Group.**

Good afternoon and thank you for the introduction and opportunity of speaking to you today, I consider it an honour.

After having delivered four successful airline turnarounds in different markets around the world one point remains resoundingly clear to me – “**that a single, intense period of change is not sufficient. After restructuring, simple maintenance does not produce adequate results to ensure survival and future success”.** I am often asked how do you manage a turnaround in our industry and I suppose the truth is that you don’t manage a turnaround as such, moreover you manage the expectation of a turnaround, you create hope enveloped in a pragmatic business plan that intellectually understands and takes advantage of the market. But turnarounds are equally, if not more importantly, about the essential yet often forgotten and misunderstood softer issues; leadership, values, integrity, respect, honour - creating vision supported by the right strategy and one’s ability to nurture the underlying talent that exists in our industry. It also relies upon understanding the difference between happiness and unhappiness as according to Mr Micawber – a principle I adopted in my early management days. All the other “hard” business disciplines, objectives and processes are critical but are concomitant to these basic pillars. First, you have to create the right environment in which others are allowed to succeed.

**Good Airlines but Bad Businesses…**

In the four airlines that I led the picture was always the same; they were good airlines but bad businesses and where there was a rapid need to move from losses to profits. There was always undeniable layers of talent, innovation, experience, tenacity and passion amongst the staff. Their understanding of the procedures and processes of their airline were part of their DNA, their knowledge of where it could be improved, often at their colleagues expense was immense and expansive – but they were never truly engaged.

If I were to summarise in my experience why airlines fail, it would be the lack of the following key success factors: commercial independence; strategic and economic cohesion; innovation; critical mass; management talent and culture. If I have learnt anything in the aviation business; it is the ability for people to bury their head in the sand -. I cite two simple examples amid many; a non-airline Chairman asked me why a certain competitor had started to operate on our most profitable route, a route that had been a monopoly for years and produced 100% of the airlines small profits – they clearly lost money on all the others; I answered by quoting James Bond in Goldfinger; about to be cut in halve by a laser Bond asks “do you expect me to talk” – “No Mr Bond, I expect you to die”!! He was visibly shocked by my retort!! The second relates to the complaint from my management that the LCC’s were taking all our business and it wasn’t fair; there was no level playing field – I replied by saying that our biggest competitor was in fact ourselves and forget about a level playing field in our industry – it’s not there and never will be – let’s get on with it. That didn’t go down too well either – nor has it in other areas given the current successful progress of the Gulf carriers.

The tangible issues; SOP’s, airframes and engines, technology, finance, maintenance, ground handling, customer interface etc, are about BPR and making yourself financially competitive and robust by lowering the unit cost of those components; striving to create the lowest possible CASK commensurate with your product and market. The absolute necessity in changing processes and procedures, understanding intellectually the impact on your business is the cornerstone of a successful safe operation **BUT** I have to say the structural changes were not too difficult to attain.

It was with the collective skills and deployment of the team that manifested a successful implementation and change agenda, widely supported where necessary by specific industry expertise that could be imported. The key here was to ensure that the external resources could facilitate the change, be part of the team, be immersed in the detail, transferring their skills and taking accountability for the implementation and being paid on results.

I do not underestimate the relevance and impact of the tangible issues but if BPR was not so difficult what was?

I will answer this question focussing on smaller airlines – whose issues are generally different to the larger / network carriers.

**The principle issues for me were fourfold**;

**First** was changing middle management perceptions and behaviours and that is where a considerable proportion of my effort was spent. Here I am reminded of Bertrand Russell’s quote about change and I have used this profound quotation many times

**“conventional people are roused to fury by departure from convention, largely as they see such a departure as a criticism of themselves”.**

Middle Management can ultimately, and often does, control the communications conduit, up and down and it is there that information, genuine and sometimes malicious; can be held up, terminated, twisted, reversed or accelerated – it’s called Chinese whispers but it is no game.

In my experience it was always one of two most serious threats to the success of the business plan. What I had to do was to head off the communication channel at the pass. Taking positive control of the internal media was paramount and in all my positions around the world that has been a strategic unequivocal must; as important, if not more than your external communications. No point in having a great strap line if you cannot live up to it – that was the other most serious threat.

The **second** principle issue was ensuring that the alignment between production and unit cost was actually understood by – both internally and external partnerships and suppliers; and the role they had to play - the classic I buy –you sell conundrum

Although many in the industry talk about the need for partnership and collaboration; the reality is that in terms of benefit, many of these have been unbalanced with respect of returns and given the nature of the supply side the reality is that this is an increasingly unsustainable position.

To underpin this point, independent research has shown that all suppliers in the transport value chain make an average return on invested capital well above that of the airlines at 4%.

Admittedly the industry has the current benefit of a very low oil price - fool’s gold if not managed correctly - so the airlines have an advantage at present but this benefit has been given by market factors not by internal influences or supplier negotiation; thus equally it can be taken away; but I still strongly believe there is an urgent need for not only a change in the nature of the relationships between airlines and those who provide services, but against a background where airline managers have, perhaps, a necessity to fundamentally change the way in which they strategically address the production system.

Our industry has moved further than most with outsourcing being wide spread – even in “customer facing” areas - but to what extent do the companies in these areas act as “True Partners” for their airline client – or are they just passenger processors?

We all know the market is naturally highly competitive and all airlines need to manufacture their unit cost to the lowest possible base commensurate with the product they are offering. Whilst there is sufficient elasticity in the market for such different service values to flourish; the gap between the extremities is increasing as legacy carriers fail to bring their personnel and operational costs down and suffer from the monopoly and duopoly of service providers.

As I have said on many past occasions, I disagree that the demise of small directional national carriers was due to the LCC’s. To understand the impact that the LCCs are having on the market we need to look at the bigger picture and the structure of the market. Many small national flag carriers are being marginalised in a commoditising industry.

The European legacy airline industry market is struggling to shed expensive, out-dated practices and collective agreements whilst the low cost operators have, ironically, not only increased the size of the market, but also have exploited these inadequacies in improving their market share. This particularly exposes the peripheral destination airlines that find it increasingly difficult to compete profitably. Furthermore, and appropriately, regulatory frameworks are preventing easy access to capital from State shareholders that have historically funded and perpetuated the continuance of these uncompetitive operations.

Also, some believe the established global alliances will help address the CASK challenge; however they are mainly functions of market cooperation and do not create a level of integrated operations and cost savings, and to repeat; traditional outsource service providers are focussed on transactional activity and perhaps are not sufficiently engaged in commercial risk-reward relationships.

The convergence of these factors is requiring the true exploration of the underpinning issues leading to the uncompetitive and non-sustainable operations of these airlines.

The **third** principle issue is Brand and culture. It could be argued that for many countries and specifically destination countries, recognising your brand as a ‘national flag carrier’ is a vital component to the country’s sovereignty, national identity and a strategic asset for economic prosperity and cannot be simply be cast aside as jingoism. I passionately believe that the values of a national carrier should equate to the values of their country; but, that comes at a cost, all too often a cost that is prohibitive simply because those airlines lack the economies of scale and suffer some of the ignoble practices I mentioned earlier. So to argue that the national flag carrier should be allowed to exist simply on these terms is unacceptable. But to ignore brand is clearly commercially suicidal and is vitally far more important than simply a logo and paint job; for me it represents the very essence, the heart, the passion, the embodiment of the values of the company and its people and customers; externally and internally and acts as the vanguard for everything the airline is striving to achieve.

The brand and the internal culture that can be driven from such emotions can never be underestimated but they need to be managed and if I have had any success as a manager, it is the ability to surround myself with people better than myself, create the right environment for them to succeed and to act as their honest and genuine cheer leader.

This brings me to my **final** issue; sustainability, longevity, and shareholder return.

Equally what has been very clear are the immense difficulties small airlines suffer, other than those that can hide in a niche market or a very specific type of operation.

Willie Walsh recently commented, “**The weak [airlines] do not have the right to stay.”** A number of airline managers, politicians, shareholders and Boards of Directors may disagree.

However, and whilst generalizations are usually dangerous, he is right but we must make sure we understand what makes a “weak” airline. In my experience it is weak decisions that will determine the fate of the airline. To this end, some state owned airlines struggle to make rational, sometimes tough, commercial decisions, which are often in conflict with their short-term social and political mandates. Rather I would interpret Willie’s comment that if airlines are not prepared to change their modus operandi then “market economy principles” should prevail – In this respect Willie is right in that they should be left to fail and more efficient providers should move into the gap that is left; sustaining the unsustainable is an increasingly less attractive as an option.

The issue, and particularly in Europe at the moment with its economic challenges and competition frameworks, is whether the weak and inefficient airlines can change, and sufficiently quickly, or if not whether failure is indeed the only option; we should also perhaps recall Charles Darwin’s famous quote “It is not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change.”

The European Commission, and in particular the restrictive state aid regulations, has introduced frameworks to enforce sustainability on inefficient carriers. We are all aware of the many carriers that are going through Approved restructuring processes and which will come to an end – with little prospect of approved extensions.

Essentially, if airlines won’t change voluntarily, the legal mechanisms exist for State airlines to be forced to change – or close; ala Malev, Spanair, Cyprus.

With this, airline shareholders and managers should embrace Willie’s comment and use it as a catalyst for change to highlight some of the issues associated with running a smaller airline and bring them into sharp relief. Indeed for smaller airlines there are inevitable diseconomies of scale given the disproportionate size of some support and back office functions relative to “front line” activities with sub-optimal volumes and as a result they incur a cost burden. Additionally, attracting and retaining management talent is becoming increasingly difficult – not only in aviation – and again smaller airlines find themselves at a further disadvantage.

Of course one way out of this is to grow to spread and reduce these costs on a unit basis - indeed we are very cognisant of the need for growth - however the way to effect a structural change is clearly through involving external partners – indeed if we keep in mind the factors for success that I have identified and remember that these are the in-house resources then almost everything else could be outsourced; however as I have also suggested I believe that the traditional “I buy” – “you sell” relationship will not be enough to deliver what I as an airline manager needs or wants; furthermore I do not want to replace what is in effect an internal monopoly with an external monopoly supplier. The partnerships of the future must deliver real and increasing benefit for both parties. What is required will be a true strategic partnership where there is not only a demonstrable alignment of what might be best described as economic objectives; but also true revenue and risk sharing.

I also believe that it is possible for further collaboration where airlines can provide a new range of services to other airlines across a whole range of areas. Indeed this is clearly demonstrated by James Hogan where Etihad provides a range of support services functions for Air Seychelles and others– his strategy is very clear and should be applauded, the associate airline creates volumes over ABU for Etihad and his partners benefit by reducing their lower unit cost - but it is not a one stop shop for all!! But the concept is fascinating and imaginative.

Our industry is not inept at change, the very embodiment of our business, our DNA has been driven by imagination and technology but we should be in no doubt however that we need to pursue a new global approach for weak airlines and I believe we can pick up the gauntlet that Willie has thrown down and at least some of us will be able to prove that he was not completely correct in his assertion.

With no long term economic cycle to ride to recovery for most airlines, structural change is the key to future financial well-being and in this case we now need to look “beyond the horizon” – given that business as usual is now not an option, even with the current fuel reductions we need to find and apply new approaches. In this respect we should adopt the lessons from hotel management companies, where the brand values of the hotel are absolute to the customer but the service provision is virtual and managed such that fixed costs and many DOC’s are spread over a much wider production, and if applied to our industry airlines operations become virtual and move closer to the self-sustaining virtuous circle. By way of an example – it is conceivable that an airline – or service provider – provides to various airlines derivative management services (fuel & fx hedging), procurement services or further overarching management contracts remunerated purely on revenue, net financial benefit to the airline or better still EBIT performance.

Politically astute governments, shareholders and Boards of Directors can maintain the brand and strategic relevance without the incumbent cost penalty, which is and irrevocably dictated by size, geography and imagination.

Whilst the oil price and market growth is at the vanguard of our current global euphoria there is a very real and lurking danger – short termism, next quarter’s results, competitive pressure and opportunities naturally and inevitably drive management actions, the fact that has to be balanced with long term capital commitments, capacity, production costs, generating free cashflow and regulations is often an anathema for sensible decisions; the crucial fact in today’s market is that it could create a tendency to defer those structural issues.

Whilst all clouds have a silver lining one has to look at the climate [ecosystem] rather than just todays weather. For the brighter, more astute managers and for airlines that are prepared to think and act differently - the future is bright, but for the majority, the outlook is less sure.

At the Airline Management Group we believe there is a solution that will allow some of our struggling airlines to move to a sustainable operating model - **The 4th Alliance perhaps?**

Thank you